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WESTERN BALKANS & EASTERN EUROPE:

REGIONAL INSTABILITY AND RESILIENCE TO EXTERNAL SHOCKS

REGIONAL ECONOMIC GROWTH PROJECT

APRIL 2017

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Regional Economic Growth Project

WESTERN BALKANS & EASTERN EUROPE: REGIONAL INSTABILITY AND RESILIENCE TO EXTERNAL SHOCKS

Provisional Impacts of the Situations in the EU, Euro-zone (including Greek Crisis), EAU, Russia & FSU, Turkey and the Middle East

DISCLAIMER

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ABBREVIATIONS

B&H – Bosnia and Herzegovina

CEE – Central Eastern Europe

CEFTA – Central European Free Trade Agreement (includes Western Balkan and Moldova)

CESEE – Central Europe and South East Europe

ECB - European Central Bank

EFW – Economic Freedom of the World index (published by the Fraser Institute and Economic Freedom Network)

FSU – former Soviet Union

FTA - Free Trade Agreement

GCI – Global Competitiveness Index

GCR - The Global Competitiveness Report

GFCF – Gross fixed capital formation

GNS – Gross national savings

IEF – Index of Economic Freedom (of Heritage Foundation and Wall Street Journal)

NE - New Europe (ex-Communist countries, members of the EU since 2004, 2007 and Croatia (after 2013)

NPL – non-performing loans

RULI – Rule of Law Index

SAA - Stabilization and Association Agreement

SEE – South Eastern Europe

WB – Western Balkans

WEF - World Economic Forum

WEO - World Economic Outlook (IMF)

WGI – Worldwide Governance Indicators (World Bank)

WIIW – Wiener Institute fuer international Wirtschaftvergleiche

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I. EXECUTIVE SUMMARY

The report assesses threats to the economic and political stability of the WB countries, other countries from New Europe (NE – Bulgaria, Czech Republic and Romania) and the Former Soviet Union (FSU – Armenia, Georgia, Moldova and Ukraine) are used for comparison.

The report's focus is on political risk and it's affect on economic development, defined as a destruction or expropriation of resources and capital, or a threat of such destruction affecting the likelihood of future prosperity. The period analyzed is 2007-2016, concentrating on the effects of the recession period monetary policies (the Euro and the ECB), investment, fiscal affairs, redistribution, FDIs, specific policies on energy dependence, effects of the Greek default and the current banking crisis in Italy, "pure" political matters (like refugees), exposure to terrorism, the political fate of the EU and the WB post-Brexit, geopolitical standoffs, Russia's and Turkey's role in the region and the capacity of governments to deal with these threats.

A. MACROECONOMIC BACKGROUNDS

The WB economies are as resilient to external shocks as other transition countries, in the near future they are likely to see higher rates of GDP growth then new EU member states, but probably a notch less rigorous than FSU.

The proximity of Greece and its government debt crisis did not affect the Western Balkans in any significant way. WB Countries even benefited from the Greek banks and flight of capital. Similarly, the political challenges (the Coup d'état in the summer of 2016, the ensuing crack-down on opposition and the free press, and the constitutional referendum on Presidential Powers) and the resulting economic difficulties of Turkey in 2016-2017 are not likely to directly hamper the growth prospects of WB economies and/or their political landscape. Turkey, similar to Russia, emerges as a one-party-state in the the Balkans' near orbit. This new paradigm should be taken into account in the context of political threats.

The WB average GDP per capita (at PPP) has doubled in the last 15 years. The Eurasian Economic Union (EAEU) average GDP growth for the same period (in 2010 USD) was about 45% of GDP. However, the WB GDP per capita is roughly 50% that of Bulgaria and Romania, 33% of that of Hungary and Poland, and 25% of Western Europe.

- It is possible to assume that **trade within the EAEU is less advantageous for members than the FTAs between the WB and the EU.** For the period between 2005 and 2015, WB exports to the EU grew by 356.6%; the highest growth rates were registered in 2006 (61%) and 2010 (30.7%); the sharpest decline of -22% – in 2009. In 2014, the EU was the region's largest trading partner for both imports (73.9%) and exports (81.2%). Unilateral measures originally granted by the EU, and perhaps the prospect of a membership in the EU has helped the WB attract FDIs and increase prosperity at home.
- **The global recession of 2008-2009 had a similar impact and lasted as long in the WB as in the countries of the FSU. However, EAEU members were affected by the challenges of the Russian economy after Crimea and the decline of oil and gas prices.**
- The inefficiency of the Russian economic policies **after 2013 lead to a very different economic growth pattern in comparison to India and China, the latter is likely to be the major beneficiary of the EAEU.** This is likely to create tensions between the members of the Union.

Trade relations between the EU and Russia are likely to remain at their current level for the foreseeable future. **The EU will grow less dependent on Russia for energy supplies, while Russia will become less reliant on European finance, industry, and infrastructure.**

B. MONETARY IMPACTS ON BANKS

The WB fastened monetary regimes to the Euro, and "imported" ECB impacts; the process was beneficial helping increase trade and investment and serving as a factor of stability and predictability. Except for Serbia (until 2011), inflation in WB economies has shown the same dynamics as in the Euro-zone. The WB did not manage to use ECB interest rate policy to refinance their government debts. However, this may be an incentive for European banks to resolve issues with non-performing loans (NPL) in the WB.

The EAEU is a semi-currency zone of the Russian ruble, whose fate is strongly associated with speculation of the commodity markets. The currencies of the region have been depreciating in the last two years, following the exchange of the Ruble to the USD.

Like elsewhere, **the risks for the WB are not directly associated with the Euro but rather, with licensing and supervisory-transparency policies of national central banks, and with WB governments fiscal and welfare policies. In the EAEU, the risk lies in the underlying lack of reforms that could integrate themselves to member jurisdictions within the global market.**

The foreign ownership of banks is a good indicator of the level of international integration of a given economy. Resource based economies of FSU tend to rely on local owners in the banking sectors. Excluding Georgia and Armenia, the foreign share in FSU and EAEU banks is 2 to 4 times lower than in New Europe: in the largest economies of Russia and Kazakhstan it is 17 and 20%.

It's not that "Italy" or "Greece" owes money to the "WB", on the contrary: WB companies and individuals must repay their credits to Italian, Austrian and Greek lenders. **There is at least temporary incentive for banks to attract additional clientele and restructure the outstanding NPLs, utilizing arbitrage opportunities.** The Italian political instability is not likely to negatively impact the banking sector of the Balkan countries.

Russian banks play no major role in the banking industry: the largest Russian bank is in Serbia, with a 3.62% share of total assets. The next largest is in Croatia – with 2.5%. These banks serve as a payment conduit for Russian enterprise and trade **Turkey:** Turkish banks are present in the region due to increased trade, especially after 2001. Turkey has unilaterally liberalized tariffs with the WB, which opened some prospect for Turkish FDI. The total amount of FDI inflow from Turkey has reached 3% of all inflows. Greek banks served as the easiest scheme to export capital from Greece to the WB, the small share of Turkish banks in Albania and B&H are not likely to have any such impact.

C. RISKS ASSOCIATED WITH PUBLIC FINANCES

Beside relatively better economic performance, WB unemployment is two-three times higher when compared to Bulgaria, Czech Republic, Romania, and FSU economies, and in the post-recession period it remains high. There is a disconnect between economic performance and employment, which puts pressure on governments to increase social welfare transfers, unemployment benefits, unproductive public sector jobs, programs for subsidized private sector employment etc., thus presenting the risk of loose fiscal discipline.

In Bosnia & Herzegovina, Montenegro and Serbia the ratio of government expenditures to GDP is at the level of the world's richest countries in old Europe, like that of Ukraine, one of the most inefficient transition economies and higher than government expenditures of

most countries in new Europe. The result is budget deficits and mounting costs of servicing government debts, despite historically low interest rates and QE.

In fiscal policy, the WB (except for Albania and Kosovo where the governments in 2015 spent 30% and 27% of GDP respectively) allows itself expenditures and EU debt levels (80% of GDP) with real GDP per capita and below 40% of EU average.

From the EAEU countries only the Kyrgyz Republic resembles the fiscal problems of the Western Balkans. In the recent years, Armenia and Belarus showed a marked tendency of growing government borrowing. For the time being it is not yet clear for now long this trend will be sustained. **FSU countries tend (with exceptions) to have relatively low levels of government expenditures and debt relative to GDP, flexible labor markets and relatively low unemployment.**

D. ECONOMIC INTEGRATION AND FDI

In 2006-2010 (the end of recession in the EU and neighboring countries), annual FDI inflow almost quadrupled in Albania; in B&H it increased 2.5 times from 2006 to 2007, then dropped down 9 times; in Macedonia – 2.5 times, and in Serbia – 3 times.

Average FDI stock per capita in the WB in 2014 was around EUR 2,600, while in the EU it was around EUR 14,300 - more than five times higher. Even compared with NE average, the region's average FDI stock per capita was less than half.

Policy for FDI (and domestic) incentives popular across the region (especially in Macedonia) leaves little room to maneuver. **The Balkan countries have failed to favorably improve their institutions (compared to NE), regarding protection of property rights and fight against corruption, and thus worsened the overall investment climate.** The stock of inward FDIs with Bulgaria (which is not a best example of working institutions), the WB FDI as percent of GDP is half that of Bulgaria.

In terms of cumulative FDIs per capita the Baltic countries since independence have received more than USD 7,000; and the EAEU – less than USD 2,000, in spite of abundant natural resources of Russia and Kazakhstan that are typically attractive to foreign investors. These countries retain strong and oftentimes arbitrary control over the oil and gas sectors and impose restriction of foreign ownership in other sectors.

Dependencies in the Energy Sector

The macro developments of the energy sector resemble those of other transition countries: in last five years the energy consumption was basically flat while GDP grew. This reduces the risk of depending on import of energy resources.

The power sector investment by Russian companies is significant not as whole but as a control of an important economic sector of individual countries like Serbia and Republika Srpska. This is a tool for political influence in those countries, typically exercised not through those companies but via private corporations, banks and civic groups (and the Church).

The following are threats to economic development.

> **The overall dependence on energy resources from Russia is not a problem by itself – the domestic consumption is relatively small, on the other hand, the diversification is technically feasible, with committed finance, and economically beneficial.**

However, **the process of harmonizing the legal frameworks has just started, can be delayed for political reasons, and might be influenced by Russia.**
Given reliance on coal, if strictly implemented, EU policies on climate change and renewables put the power sector and the employment situation at risk.

E. PURE POLITICAL RISKS

Tracing the Impact of Refugees and Migration

Citizens of the WB were refugees and IDPs themselves, at times as many as 600-700 thousand people (especially in 1995-1996). But they were very different from the influx of refugees in 2014 and 2015 – they spoke the language, had local knowledge, friends and social capital in the countries they fled to, where people and government were hospitable.

Macedonia and Serbia are now particularly stressed. Refugees tried to make their way via the Hungary and Croatia, and then to Western Europe, preferably Germany. This led to unprecedented numbers of migrants seeking to re-enter the EU through Hungary's borders with Serbia. **In 2015, the region recorded a 16-fold rise from 2014. The effect had an insignificant burden on the state budget, but the situation created opportunities for populist politicians to increase their popularity. In this respect the threat is similar to that of Bulgaria, Hungary or Poland.** The lack of sophistication of WB welfare states has an advantage: there are little to no stimuli to rent-seek on them.

The Russian Federation and the FSU do not experience a refugee threat, but they do constitute a specific region of international migration.

Regardless of the attractiveness of Russia as a migrant destination from the FSU, the percentage of migrants in the last 15 year remained constant (8.1%); in Germany, it increased from 11 in 2000 to 14.9% in 2015, in USA – from 12.3 to 14.5%.

For Russia, FSU migration does not create a direct economic and political threat to the recipient countries. In Russia, xenophobic movements are somewhat wide-spread but seem well-controlled by the political party in power through different subordinated organizations, government rhetoric towards the West, US and EU, policies towards Ukraine and the neighbors and Syria provide a lightning rod for the xenophobic mood of the public.

The threat is economic except in countries with negative net migration: they lose from both the declining amount of remittance due to recession in Russia, and they lose from emigration itself.

Exposure to Terrorism

Muslim countries and communities have been the main victims of Islamic terrorism and ISIL. B&H, Albania and Macedonia (and then Bulgaria) are the countries of Europe with the most sizable shares of Muslim residents. In Russia, it is 10%, but the 14 million Muslims constitute the largest group of Muslim population in Europe. More importantly, Russia isolated itself from the international community as a result of the annexation of Crimea, and, with its military and political support to the Assad regime in Syria, fashioned and opened a new Pandora's box of threats.

The Global Terrorism Database reports on average 7-8 potential terrorist incidents per year. In the last ten years there six fatalities, perpetrated by (unidentified) individual against individuals. It looks as if WB exposure to terrorism is very low.

In terms of victims of terrorism in non-Muslim countries, Russia had 2,606 victims from 2001 – 2014, second only after the USA (the victims of 9/11 and other smaller attacks). **The**

difference is not only in the number but also in the fact that Russian terrorist acts are most often perpetrated not by foreigners by its own citizens. The database of attacks since 1991 shows that severe incidents with more than ten or even hundreds of victims have been rather common Russia for the 25 year period and that incidents are frequently linked to the war in Chechnya. Russia's role in the Syrian civil war puts the country on the terror map of the Islamic state and other similar groups.

Russia after Crimea

In the past, Russia took sides in post-Yugoslav conflicts, at times disrupting and interrupting the efforts of the international community to appease the region, especially in tense situations in Bosnia, Macedonia, Kosovo/Serbia and Montenegro, including recent vociferous opposition to its membership in NATO. The Western Balkans are symbolically important for Russia, Kosovo's independence and generally western reorientation is viewed as precedent that shall be avoided in Russia's periphery. Such attitudes motivated the 2008 war in Georgia.

It also supports political groups that make no common sense – nationalist parties with 19th century understanding of politics and Balkan constellations, glorify the Communist past and hate towards "the Americans" and the EU. All NATO members in NE agree that the RF, particularly the group of individuals and state-owned companies around its incumbent leadership, is restoring its old KGB-networks, friendships and ways of handling international affairs. Their common assessment is that the RF is an unreliable partner, violating international law by annexing Crimea and supporting insurgents in Eastern Ukraine.

Unfortunately, West Balkan country constitutional arrangements of their own political processes (especially the government machinery) often serves as a home-made source of instability.

In addition, Russian state-owned companies and private companies, working on joint projects with domestic companies or pretending to just minding their own business, support aggressive pro-Russian propaganda "information campaigns". The countries in the region that risk heavy political influence on behalf of current Russian leadership are Serbia and, perhaps, Republika Srpska, Bulgaria, and to some extent Greece.

At the same time, Russia's own economic challenges (necessitated by its oil-dependency) result in dysfunction of the Eurasian Economic Union and political tensions between its members. They are not likely to result in significant changes in the Balkan political landscape, as the April 2017 presidential elections in Serbia have proven[1].

Turkey after the Coup

Turkey too, used to take sides in the past Balkan affairs of the 1990's, and by and large behaved like a NATO member and reliable partner of international community efforts to appease Bosnia & Herzegovina and Kosovo, and Macedonia.

This story seems over. In the short term, Turkey will focus on power consolidation, Northern Syria and anti-Kurdish operations. In the WBs, Turkey will maintain the image of a *komsu* – good neighbor. However, after the April 2017 Referendum of the constitutional powers of the president, Turkey has emerged as a one-party-state with a populist, (and rather unpredictable) president who uses nationalist rhetoric and blames European *dusmans* (enemies).

[1] On April 2, the new president Alexander Vucic, considered pro-Western, was elected at the first round, with a considerable majority of 56% of the popular vote (the presidential mandate in Serbia is five years).

Cooperation will required by Balkan countries in their internal relations' consolidation, especially with the EU. Related to Turkey's circles of influence in the Western Balkans - Muslim schools, education centers, NGOs and newspapers - if linked or suspected to be associated to the so-called opposition to President Erdogan - would suffer shortages of support and political pressure.

The economic impact on the WB will be negligible. There is a possibility of the flight of capital from Turkey that could benefit Balkan economies, as it happened as a result of the Greek foreign debt crisis. Turkey will focus on big issues – internal political tensions, Syria, and large international friends and foes (Russia, EU and USA), changing its preferences ad-hoc.

F. QUALITY OF GOVERNMENT: RISKS

As with banks, public governance is often a more direct threat than pure economic constellations. According to the World Bank, rule of law indicators in Macedonia and B&H look better than in Bulgaria, an EU member, but far from the levels of best countries in Europe.

Rule of law: WB and Selected Countries

	2014
Denmark	.88
Germany	.80
United Kingdom	.78
Romania	.59
Macedonia	.58
B&H	.55
Bulgaria	.53
Serbia	.51
Albania	.49

Source: WGI (World Bank)

In the WB, Rule of Law has been gradually improving in the last five-six years. The situation is very different in FSU and EAEU countries. Georgia made considerable progress, and after some deterioration since 2012, its rank is the same as Romania. The trend for EAEU members is unclear and their position in the index is worse than the WB and all ex-Communist countries. Similar to the situation in Moldova and Ukraine.

The international comparisons allow for identification of some commonalities:

- There is significant correlation between rule of law indexes and FDIs inflows and stock, and gross fixed capital formation;
- The WB performed worse than most of the new Europe countries until 2008; on some rule of law indicators, however, after 2009-2010 some of them do better than Bulgaria, and they are better than all FSU, except Georgia;
- Business environment and property indicators are stagnant; Rule of Law, FDI (inflows and stocks of FDI), FCF, Judicial Independence and Regulatory Uncertainty indicators show there is little progress or change; on some of these indicators the Western Balkans perform somewhat better than Bulgaria, and much better than the FSU.

G. BREXIT: THREATS FOR TODAY AND TOMORROW

For obvious reasons, Brexit causes instability in the EU, and for the moment appears to be developing towards a weaker international position for the EU.

The British vote to leave the EU has only indirect impacts on the WB: there is no UK investment or banks operating directly or indirectly in these countries. But the Brexit would inevitably reform the EU. One should take into account, however, that even if there is no procrastination or delay, Great Britain will leave the Union no earlier than 2020.

The first immediate impact on the WB had already happened: the Brexit has affected the sovereign debt market, probably temporarily.

The "leave" vote was a surprise, it changed conditions for bond markets, triggering flight to safety. Government bonds of Germany, Austria and Netherlands became more attractive to investors at the expense of riskier ones. The decreasing yields of the former implies higher risk of premiums for the latter. Albania, Macedonia, Montenegro, and Serbia have issues with government bonds in international markets which seemed slightly effected, increasing their costs of borrowing.

In general, Brexit is not likely to cause any other significant effects on WB in the mid-term. Exports of these countries to the UK represent a very small share overall. In the view of negligible UK investment, even a greater shock on the UK's economy (which is itself debatable) may not be a threat to the economic and financial relations of the Balkans with the UK.

Brexit is not likely to affect the ear-marked EU budget for Balkan EU accession (EUR 5.7 billion). Even if the UK leaves, in order to trade with EU on EFTA principles, it will continue contributing to the EU budget (roughly the amount of Norway – 0.8% of GDP, currently – due to rebates in place, where it contributed 0.54% of GDP).

What would affect the WB in the long run is the fate of the European Union itself: currently there are two competing visions: a Closer Union or a Liberalized Union. The WB should prepare for both. The general elections in Holland, the presidential elections in France and the prospects for the general elections in Germany seem to sustain the political status quo in Europe, which make the task for the WB somewhat easier to accomplish.

Overall, the impact of Brexit on Western Balkan economies will be negligible.

II. INTRODUCTION

A. RATIONALE

In comparison to the mid 1990's (the aftermath of ex-Yugoslav wars) or ten years ago (the Kosovo, Macedonian crisis and emergence of sovereign Kosovo), the Western Balkans have lost their relatively select place in the international policy agenda.

The reasons are twofold, and they explain the rational for this Report.

On one hand, **the countries were gradually reintegrated in the European and global markets:**

- FTAs linked former foes with one another, Central European FTA (CEFTA) has become a Balkan agreement,

- All countries (most recently Kosovo[2]) have embarked on the path of EU integration.
- This path, especially after Bulgaria and Romania (in 2007) and Croatia (in 2013) have become members of the EU, is being generally perceived as a technical affair.
- Simultaneously, WB had been as successful as New Europe in overcoming the impacts of the 2009-2010 recession.

On the other hand, many other **regional and global developments necessitated prioritized attention by the EU, USA and NATO.**

Since 2007, the Russian Federation (RF) grew (or reasserted itself) as a regional power with a global economic, political and military mission.

The RF signed FTAs and invested heavily in some Balkan countries, acquiring an important stake in their power sectors. However, the admission led to the 2014 annexation of Crimea and support for break-away paramilitary insurgents in Eastern Ukraine. It triggered a sense of instability throughout the region and especially in ex-Communist European member states. In reaction to these events, EU and US sanctions, combined with speculation on global markets, weakened RF economic strength and affects its expansion to the Balkans.

Even before 2014, the **RF sponsored the creation of a partnership with Belarus and Kazakhstan which failed to bring about trade gains for participating nations, and is seemingly the same fate of the next stage of post-Soviet integration via the Eurasian Economic Union.** Countries outside the EAU – Azerbaijan, Georgia, Moldova and Ukraine (with a massif of specific challenges) have different, ostensibly brighter prospects.

At the same time, **since 2009-2010 the EU has been preoccupied with its own challenges** – from fiscal and government debt issues of the Eurozone countries (mostly in the so called old Europe), to the Greek debt and "the Euro", to lack of clarity on how to handle the Brexit and the refugee inflows, to its decision making and constitutional customs.

As recently, as **this summer Turkey experienced an extraordinary political instability**, which was resolved by a state of emergency and an onslaught on perceived dissidents in the state apparatus, the army and its own NATO representatives, courts, schools and universities and the media, while the country's leadership sends out mixed signals to its EU, neighbors and trans-Atlantic partners.

All these factors constitute an external threat to the Balkan and FSU nations, although there are region-specific peculiarities, including various macroeconomic and fiscal challenges.

With regards to the WB, it is important to take into account that:

Their currencies are pegged to the Euro; the RF and Turkey are the largest, although not most important, trade partners and investors in the Region;

Their banking sectors are typical with significant market (and ownership) shares of Greek and Italian banks (which entered a non-performing loans crisis this summer);

The countries are part of the route of Syrian, Afghani, Iraqi and (sometimes) African refugees and migrants;

[2] As recently as May 2016, the EU association process for Kosovo was officially declared. An overview of this developments might be found in our previous Regional Trade Report on Free Trade Agreements and the Actual Regional Trade Facilitation Throughout the Balkans) of June 2016, especially in the sections on the political background of the FTAs and individual countries.

They themselves have high shares of Muslim populations, some are with predominantly Islamic traditions;

Domestic political stability, peaceful government transition, government efficiency often leaves vast room to improve on some of the average standards of even New Europe.

The threats are somewhat different in the FSU:

- Half of the countries have independent trade policies and have signed FTAs with largest center of economic influence – the EU; but five countries that choose to join Russia dominated the Eurasian Economic Union (EAEU), and for them the power center is the Russian economy;
- Foreign banking ownership is a less important factor in the EAEU, they have had little risk of impacts similar to those associated with Greek government debt and Italian banks of recent years;
- However, they are effected by Russia's economic challenges – be they associated with oil and gas market speculation or resulting from Russia's policies in Ukraine and "near abroad";
- These countries do not have a refugee problem, although internal migration within the FSU is a specific political and economic challenge.

The idea of this report is to assess threats to economic and political stability of both regions, using the available statistics and reviews of the above factors, comparing them with the processes in other transition economies of new Europe (NE) and analyzing in-country political stability and risk factors.

B. METHODOLOGY

The main focus of this report is to access political risk that effects economic development and prosperity of the Western Balkans with a comparative perspective.

The working definition of "**political risk**" affecting economic development is: a destruction or expropriation of a resource and capital, or a threat of such destruction affecting the likelihood of future prosperity.

The report understands "economic development" as "an extension of the range of choice.., an increase in the range of effective alternatives open to people". This is both the core objective and the criterion of economic development".[3]

Political risk in the above sense is a threat faced (and dealt with) by individuals, investors and their voluntary associations (from households, to sole proprietors, to corporations, to consumers, etc.), imposed on them by factors beyond their control. The threat itself is a perceived likelihood or probability of an expected value of a given economic action to be destroyed.

The report limits itself to the analysis of risk factors associated with monetary policies, investment, banking and credit activities, different economic policies (like fiscal, welfare and energy polities), banking sector in current international context. Since there are social and global factors affecting economic life, we decided to pay attention to the refugee crisis and exposure to terrorist attacks, geopolitical challenges and their impact on governments and policies to cope with these challenges.

These factors are grouped in the following categories: EURO, ECB monetary policy related impacts, Domestic policies (related to fiscal challenges and welfare states), economic reforms, economic integration and FDIs, energy dependence and power sector policies, banking sectors and their international exposure, and a large group of "pure political factors", of which the focus is mainly on

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[3] Peter T. Bauer, Economic Analysis and Policy in Underdeveloped Countries, Durham, N.C.: Duke University Press, 1957, p. 113.

Europe as the refugee crisis, geopolitical challenges and the key indicators of government's capacity to cope with them.

The structure of the report is organized around this logic. The period of analysis is most often 2007 – 2016.

For each of these areas we analyze the data and sources available in the public domain, some specific data sets and statistics are accessed separately, and on bank ownership specific information, when unavailable or unclear, we consulted central banks via e-mail. This information is from non-audited reports. We used assessments on the foreign bank ownership from the literature and made KC2 reassessments from the information on owners from bank websites themselves.

Often different data portals, even when established by the same group, like for instance the World Bank Group, differ in methodology and hence final data may be different. The report circumvents such discrepancies, using same source for the core information on a subject, e.g. GDP data is derived most often from IMF, while public governance indicators – from the World Bank.

Where needed, we provide additional explanations of the methodology applied to specific categories of threats. In the section on banking sectors, the main sources are statistical and analytical publications, data-analytical portals that allow access to data and grouping of data according to the analytical needs. Most often this the portal Knoema.com and the background data on economic indicators is collected by the IMF and the World Bank.

III. REVIEW OF THE RECENT DEVELOPMENTS AND THREATS

A. MACROECONOMIC DEVELOPMENTS

Positives in the Western Balkans and Negatives in the FSU

In the aftermath of the 2009-2010 recession, the macroeconomic performance of the WB seems somewhat better than that of the countries of New Europe.

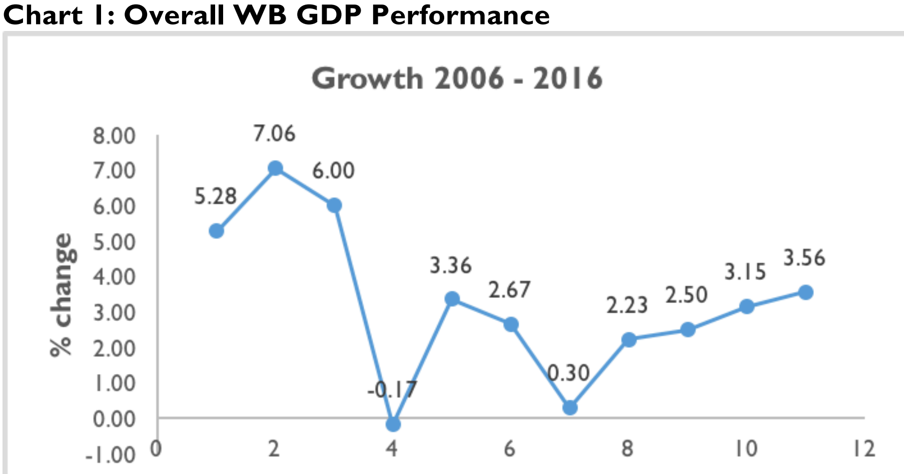
Table 1: WB real GDP dynamics before and after 2009 crisis (2006-2015, % change)

	Albania	B&H	Macedonia	Kosovo	Montenegro	Serbia	Average
2006	5.43	5.69	5.03	3.41	8.60	3.56	5.28
2007	5.90	5.98	6.15	8.30	10.70	5.38	7.06
2008	7.54	5.59	4.95	7.23	6.90	3.82	6.00
2009	3.32	-2.72	-0.92	3.47	-5.70	-3.51	-0.17
2010	3.80	0.84	2.90	3.21	2.46	1.01	3.36
2011	3.08	0.96	2.77	4.41	3.22	1.57	2.67
2012	1.30	-1.21	-0.39	2.54	-2.55	-1.52	0.30
2013	0.70	1.20	3.10	2.54	3.35	2.46	2.23
2014	2.10	2.00	3.16	3.94	2.82	0.98	2.50
2015	3.30	3.20	3.44	4.55	2.92	1.50	3.15

Source: IMF World Economic Outlook, 2016

In the three years before the recession, the average WB economic growth was 6.15% of GDP. Thanks to Albania and Kosovo's growth and Macedonia's modest GDP decline in 2009, the regional average recession (calculated for the sake of comparison) is insignificant – 0.16%. Montenegro's GDP decline in that year is sharp but still less dramatic in comparison to Croatia (-7.5%) or Romania (-7.7%), according to the IMF.

Chart 1: Overall WB GDP Performance

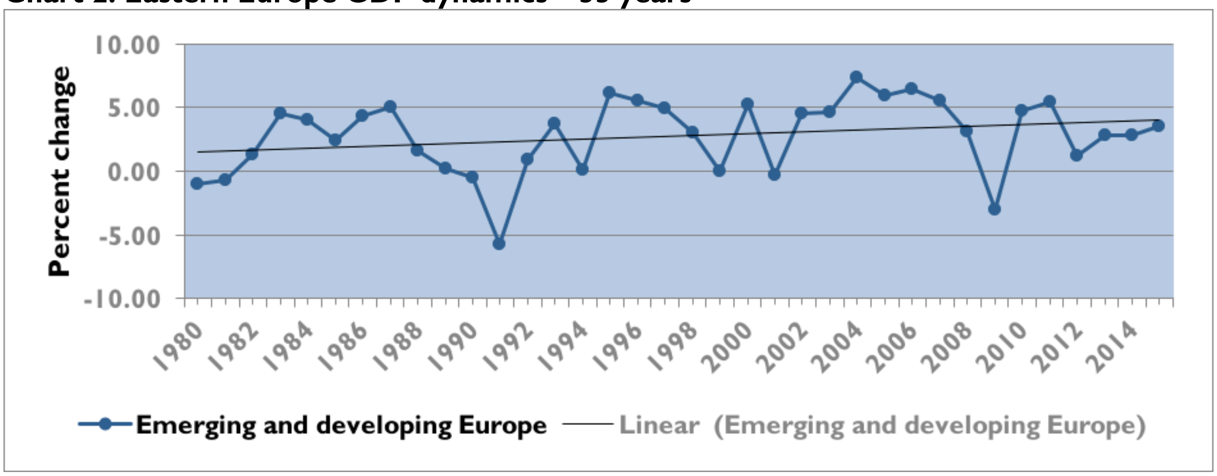


Source: IMF WEO

A comparison with New Europe is positive for the WB. The recession hit Latvia worst of all NE countries, (-14.19% of GDP), but in other countries the GDP decline was similar to Montenegro and more severe than in the WB: Hungary -- -6.6%, Czech Republic -- - 4.84%, and Bulgaria -- -5.1% of GDP. In other words, even the worst recession in WB (Montenegro)[4] seems relatively less affected than other transition economies.

The combined average growth rate expected by the IMF forms by the economy of the Western Balkans in 2016 is 3.56%. The consensus forecast for 2017 is that the growth will be sustained at this level. It is roughly 1.5 times higher growth rate than the EU and the Eurozone. In the long run, as shown on the chart below, the GDP growth rates of WB and NE growth basically coincide.

Chart 2: Eastern Europe GDP dynamics – 35 years



Source: Eurostat

However, WB growth after 2009 is roughly two times lower than in the period before crisis and despite this relatively strong economic growth, WB real GDP per capita levels covert slowly to NE and EU levels.

Table 2: WB candidate real GDP per capita as percent EU average

Country	2012	2013
Albania	28%	28%
Macedonia	34%	36%
Montenegro	39%	40%
Serbia	37%	37%

Source: EUROSTAT

Table 3: WB GDP per capita at PPP (2000-2015 in constant 2011 USD)

	2000	2003	2005	2008	2010	2012	2013	2014	2015
Albania	4,225	5,353	6,426	8,544	9,525	10,517	10,947	11,390	11,872
B&H	5,148	5,468	6,900	8,825	8,861	9,218	9,614	9,892	10214

[4] The factor that triggered sharper decline on Montenegro was the instantaneous inflow of foreign investment just before the crisis, for the sale of the aluminum "giant" KAP to CAEC, a Cyprus-based company owned by the Russian alleged tycoon Oleg Deripaska: KAP was his by the global speculation of 2008-2010, and its downsizing of operations hit the economy of the country.

Macedonia	7,144	7,547	8,729	11,055	11,562	12,215	12,724	13,379	13,938
Montenegro	7,705	8,581	9,894	13,687	13,434	13,995	14,670	15,105	15,716
Serbia	6,165	7,705	9,455	12,086	12,110	12,796	13,404	13,378	13,576

Source: IMF WEO

In the last 15 years trade and economic integration with the EU resulted in remarkable growth of overall prosperity for the WB: individual country GDP per head at PPP grew as follows – approximately 4 times in Albania; in B&H – almost 2 times, and in Montenegro and Serbia – more than 2 times. At the same time, as the next table demonstrates, the WB are poorer than neighboring members of the EU – Croatia, Bulgaria and Romania.

Table 4: WB neighboring Countries GDP per capita at PPP (in constant 20111 USD for 2000-2015)

	2000	2003	2005	2008	2010	2012	2013	2014	2015
Bulgaria	7,631	9,648	11,676	15,388	15,208	16,697	17,253	17,925	18,501
Romania	8,010	10,314	12,490	17,487	16,719	17,849	18,826	19,743	20,697
Croatia	12,444	15,410	17,694	21,476	20,034	20,416	20,586	20,947	21,324

Source: IMF WEO

WB and Greece and Italy

In 2011-2012 the economic growth decelerated in most WB countries. This was an effect of their integration with EU, especially with Greece and Italy.

Greece is important for them as a factor in the banking sectors, trade and investments. In terms of FDIs in WB Greece is on the third place, with 7-8% of the total accumulated investment. Up until the advent of the crisis, Greek bank subsidiaries have strongly increased their presence in the WB, trade relations with Greece are strong and particularly important for Montenegro or Macedonia, and Greek FDI are important for all the countries, but particularly for Albania, Macedonia and Serbia. The Greek government debt crisis and recession resulted in a contraction of trade volume and remittances for the WB. The flight of capital from Greece had no significant impact, while it was beneficial for EU neighbors of Greece – Cyprus, Bulgaria and, to some extent, Romania.

Italy is the WB leading trade partner and economic investor (especially of Albania and Montenegro) and banking sectors across the entire region (as we shall see below). It is likely that the recession in Italy was a factor in the increased presence of Italian (and Austrian – due to the mixed ownership) banks in the region, while WB exports to Italy deteriorated in 2011-2012.[5]

If one takes a longer period of comparison, e.g. from 2000 to 2014, the growth rate of WB economies is roughly and same as that of NE. Like in NE, the WB annual average real GDP growth rates of about 6% were highest in between 2003 and 2007. This pattern is demonstrated in Turkey as well, as one of the regional centers of economic influence for the WB.[6]

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[5] See: Sandra M. Leitner, Financing constraints and firm growth in the NMS-10 and the Western Balkan countries – a comparative analysis, WIIW, Balkan Observatory, Working Paper 115, October, 2015, p. 6-7.

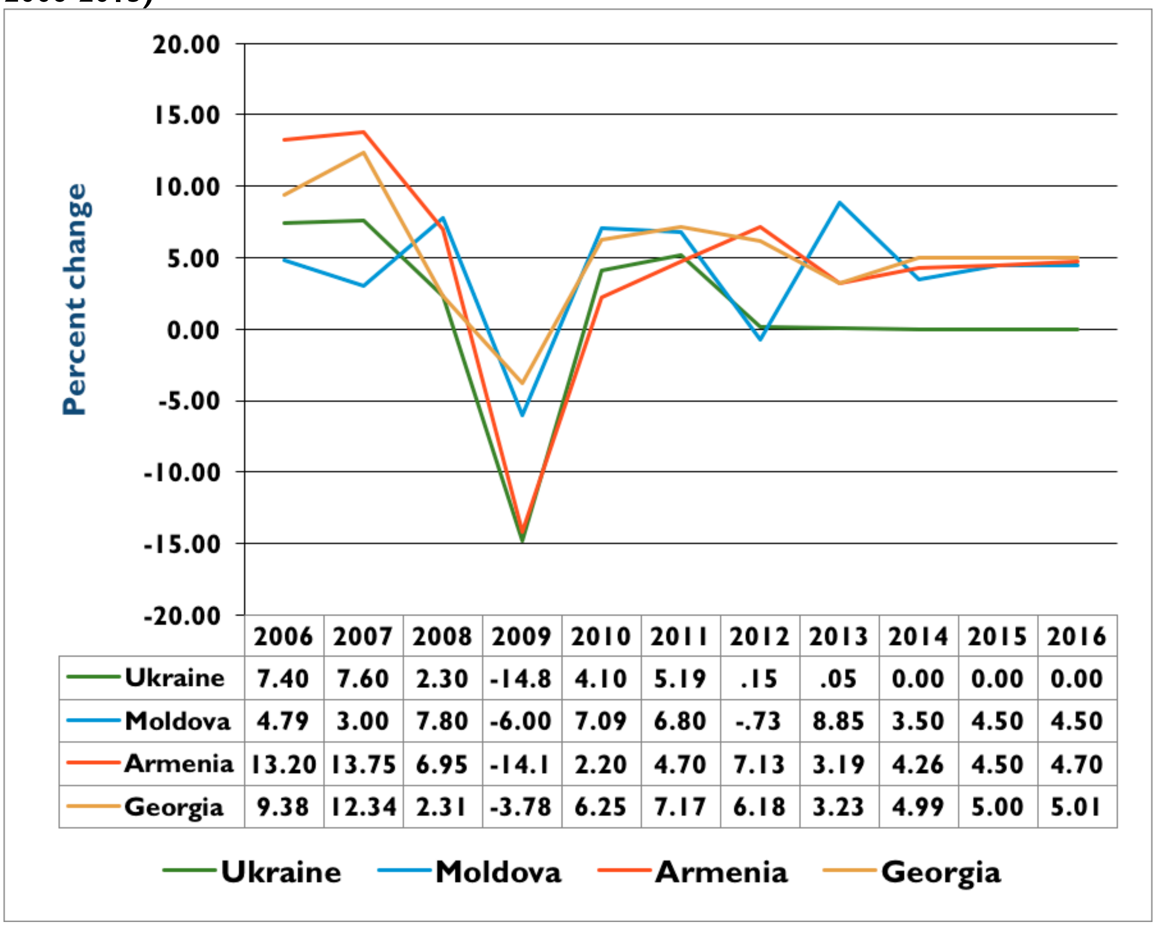
[6] Sandra M. Leitner, p. 8.

Another fact is that recession in today's WB took less time (between four and five quarters), similar to Bulgaria and the Czech Republic (and most of the EU), than in Romania (more than two years) or neighboring Croatia and Latvia (where it lasted six and three years respectively).

GDP in Selected FSU Countries

The comparison with selected former USSR countries that are not members of Eurasian Economic Union (EAEU – Armenia joined in January 2015, the only country to enter the Union was Kyrgyzstan, in August 2015) shows that the recession was much more severe in those countries then in the WB, and that the post-crisis recovery there was more resilient (perhaps, due to the lower starting point).

Chart 3: Real GDP Dynamics in Ukraine, Moldova, Armenia and Georgia (% change for 2006-2015)



	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Ukraine	7.40	7.60	2.30	-14.8	4.10	5.19	.15	.05	0.00	0.00	0.00
Moldova	4.79	3.00	7.80	-6.00	7.09	6.80	-.73	8.85	3.50	4.50	4.50
Armenia	13.20	13.75	6.95	-14.1	2.20	4.70	7.13	3.19	4.26	4.50	4.70
Georgia	9.38	12.34	2.31	-3.78	6.25	7.17	6.18	3.23	4.99	5.00	5.01

Source: IMF WEO

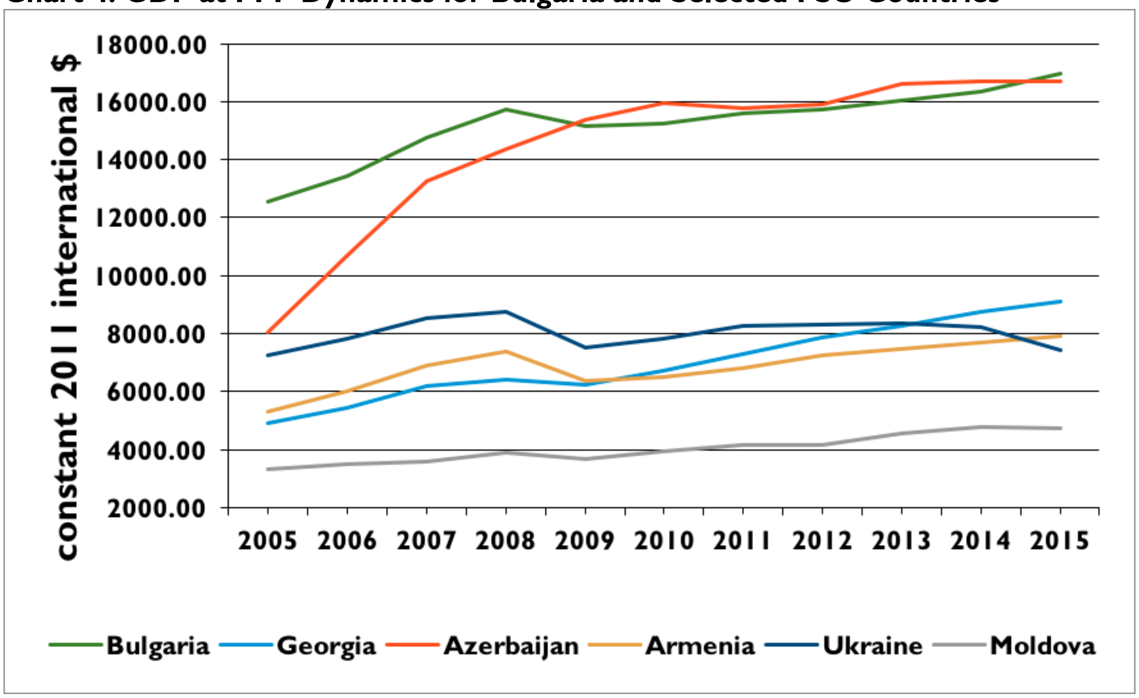
Two ex-USSR countries' GDP (Armenia and Ukraine) plunged down as deep as Latvia, but the recession lasted for the same period of time as that of the Western Balkans. At the same time, in Georgia and Armenia, the recovery seems more robust than in the WB. Ukraine's macroeconomic performance deteriorated on the eve of and especially after the annexation of Crimea and the separatist war in the Eastern provinces, and the Moldavian economic recovery is uneven (with ups and down of 7-8% of GDP on annual basis).

However, a broader comparison helps in understanding of economic challenges of these countries. The chart below summarizes the dynamics of GDP per capita at PPP of these countries plus Bulgaria and Azerbaijan.

Bulgaria is included because it is the country with the lowest GDP per capita in the EU: it has no natural resources and its growth in the last ten years was based on FDIs and improvement of the business environment. Bulgaria looks worse than most new Europe countries (which by 1995-1996 have recovered from post-Communist GDP decline) because it restarted its reforms after a deep, "homemade" crisis in 1996-1997. [7] Bulgaria returned to the economic growth path after 1998 and this allows for a comparison with the entire FSU where the countries were, on one hand, late reformers (see IMF 25 Years of Transition), but, on the other hand, were hit by the Russian crisis of 1998.

Azerbaijan, unlike Bulgaria and the non-EAEU ex-Soviet countries, is an economy based on minerals rights and its FDIs in oil and gas supported strong real economic growth of 2004-2011 of 18% of GDP per annum, and of 7.9% for the period of 2011-2014.

Chart 4: GDP at PPP Dynamics for Bulgaria and Selected FSU Countries



Source: IMF WEO

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[7] This experience is summarized by IMF in a report on the 25th anniversary of post-1989 reforms: "The rapid reforms undertaken in Poland set an example for other countries in the region. They were followed most closely by Czechoslovakia in 1990 and, two years later, by the Baltic countries. Hungary, Croatia and Slovenia trod more cautiously, in part because they had more liberalized economies at the start of the transition and less of a need for rapid change. Albania, Bulgaria and Macedonia tried to implement quick reforms and made some initial progress. But the transition pace in these countries subsequently slowed…" (James Roaf , Ruben Atoyan, Bikas Joshi , Krzysztof Krogulski and an IMF Staf f Team, 25 Years of Transition and IMF, Regional Economic Issue, Special Report, IMF, OCT 14, 2014, p. 12.
In Bulgaria, the Council of Ministers that led the country from November 1992 to September 1994 was blocked in its privatization and liberalization efforts by ad hoc majorities in the parliament, and was forced to resign immediately after signing a debt-restructuring deal. The new cabinet took office in January 1995 and proceeded to change privatization rules and protect still state-owned economy and loss making (servicing less than 40% of its credits) from bankruptcy, thus triggering bank bankruptcy – the most expensive bank crisis in new Europe. The fiscal costs of the 1996-1997 bank crisis cost Bulgaria 41.5% of GDP, next worst were Macedonia – with 30.3%, Czech Republic – 25.4%, Kazakhstan – 18% and Hungary – 12.9% of GDP (See: Helena Tang, Edda Zoli, Irina Klychnikova, Banking Crisis in Transition Countries: Fiscal Costs and related Issues, World Bank, 2000, World Bank Working Paper No 2884.)

The chart proves that a country with no natural resources like Bulgaria (lowest EU GDP per capita at PPP) can reach prosperity similar to oil rich Azerbaijan, through a proper reform mix and integration with richer and sophisticated economy of the EU. The pattern of GDP per capita at PPP dynamics for Georgia and Armenia is like that of Bulgaria, while their economies are much poorer.

Recent Macro-Performance of the EAEU Countries

In terms of PPP performance, among the above countries, Georgia marked a more than threefold increase in GDP per capita. Georgia – from (constant 2011) USD 2,770.5 in 2001 to 9,591.0 in 2015 or 346.2% (2/3 of the development happened after 2005). The worst was Ukraine - 178.3% growth for the period.

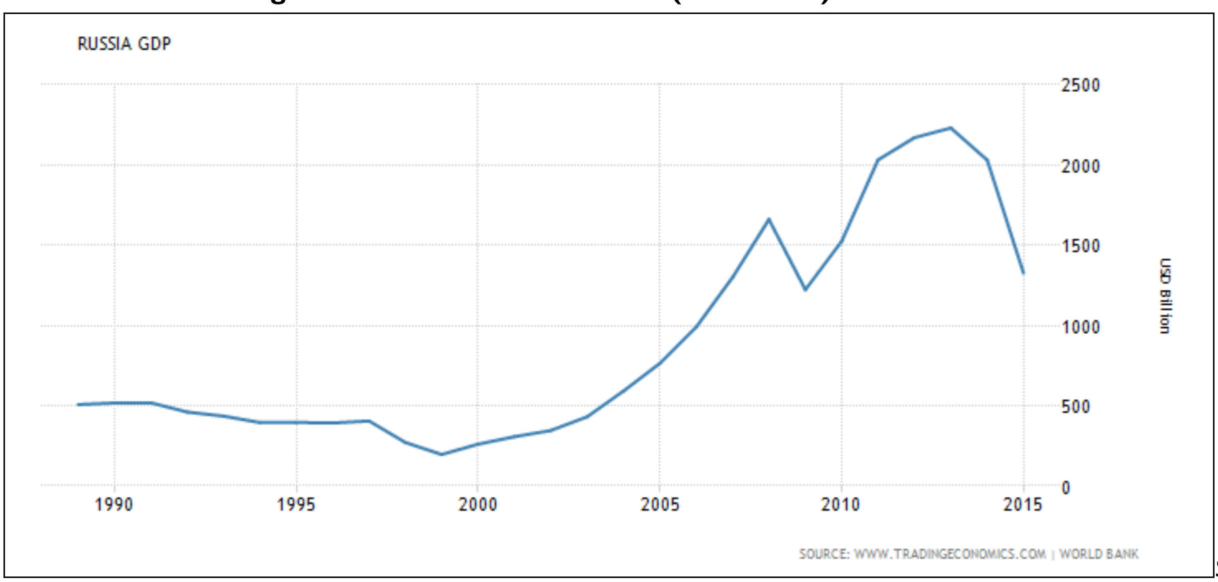
Table 5: EAEU countries GDP per capita dynamics after 2001 (in 2011 constant USD)

	2001	2005	2010	2015	Growth since 2001
Armenia	2,561.9	4,721.8	6,383.8	8,492.0	**331.5%**
Belarus	6,225.9	9,619.2	15,369.3	17,714.8	**284.5%**
Kazakhstan	9,537.3	14,748.7	20,324.2	25,911.7	**271.7%**
Kyrgyz Republic	1,760.1	2,115.6	2,718.9	3,394.8	**192.9%**
Moldova	1,998.2	2,939.7	3,829.4	5,047.5	**252.6%**
Russia	12,053.9	17,231.0	22,638.6	25,965.1	**215.4%**

Source: IMF WEO

From Eurasian Union member countries a pattern similar to Georgia's development emerged. Russia, the dominant economy of the Union with abundant natural resources developed in a manner very much like Kyrgyzstan. Contributing factors include oil and gas market speculation, which challenged GDP performance (in current prices), as it is obvious from the following chart.

Chart 5: Russia Long-term Performance of GDP (1989-2015)



Source: World Bank WDI

GDP in Russia averaged 876.86 USD billion from 1989 until 2015 (basically the same as Indonesia in 2015 and a bit higher than Turkey, if we take a country from the region). The registered all-time high of 2,231 billion USD was in 2013 (the same as Brazil) and a record low of 196 billion USD in 1999 (same as Portugal and Greece in 2015).

Economic Developments Under Putin

Between 1999 (when president Putin was first nominated as acting president and then elected as in March 2000)[8] Russia's GDP in current prices grew almost 6 times; this economic development substantially improved the living standards across the country but especially in European regions. The rapid growth explains the overall popularity of the president and his policies (a popularity that seems unshaken by the negative economic troubles after Crimea). On the other hand, the Russian voters are accustomed to economic hardships much more severe than those the economy experience after 2009 (deceleration of the rate of growth) and after 2013 (recession). This difference between the two periods of recent Russia economic history is more than obvious from the World Bank statistics: from 1990 to 1994 the GDP growth was stubbornly negative, averaging – 8.8% per year, between 1995 and 1999-- -1%; then it started to grow with remarkable 6.9% for 2000–2004 period, decelerated t- 4.1% in 2005–2009, and further slowed down before Crimea to 2.8% in 2010–2014.[9]

The period of Russia's decelerated growth and relatively aggressive foreign policy coincided with policies of consolidation of state ownership and control on the economy. "By mid-2015, about 55% of the Russian economy was in state hands, with 20 million workers directly employed by the government, equal to 28 percent of the workforce."[10]

Since mid-2014, Russian GDP shrank by 4.5-5% depending on the estimate. The IMF, Goldman Sachs and Danske Bank foresee that the recession will be over by the end of 2017 or early 2018. The recovery would coincide with Russia's presidential elections.[11] But even optimistic forecasts do not see Russia's GDP returning to its peak (2011-2013) levels in the medium to long run. The IMF expects that it will reach 1,531 USD in 2020 (31% lower than in 2013).[12] The following table gives a different dimension of Russia's relative economic strength demonstrating the real GDP dynamics of the BRIC's group during the last seven years.

Table 6: GDP growth of BRIC countries – 2010-2016 (in current USD bln)

	Brazil	Russia	India	China
2010	2,208.7	1,626.6	1,708.5	6,005.3
2011	2,612.4	2,031.8	1,823.0	7,442.0
2012	2,459.5	2,171.7	1,829.0	8,471.4
2013	2,464.7	2,231.8	1,863.2	9,518.6

[8] For more detail on Russia economic reforms before 1999 see: Anders Aslund, Why Has Russia's Economic Transformation Been So Arduous?, Testimony, Carnegie Endowment for International Peace, 28 April, 1999.
[9] This calculation is borrowed from: Simeon Djankov, Russia's Economy under Putin: From Crony Capitalism to State Capitalism, Peterson Institute for International Economics (PIIE), Policy Brief 18/2015, September 20915 statistical appendix: at: https://piie.com/publications/policy-briefs/russias-economy-under-putin-crony-capitalism-state-capitalism). Simeon Djankov remarked that first years of Putin presidency he pursued some liberal reforms… enacted a flat income tax of 13 percent, a reduced profits tax, and [introduced] new land and legal codes. During Putin's first premiership and two presidential terms (1999–2008), fueled by these and previous reforms, real incomes in Russia rose by 250 percent, while real wages more than tripled and unemployment and poverty more than halved" (p.2).
[10] Djankov, p.3; here Djankov quotes Petr Aven, 1990s: Back to the USSR? The World Today 71, London: Chatham House, No. 3, June 2015. On overall difficulties (besides oil and gas prices) see also: Philip Hanson, An Enfeebled Economy, The Russian Challenge, Chatham House, 2015, p. 17.
[11] This fact puts under stress the government in Moscow, see: Alexander Baunov, The Storm Clouds of 2017: Russia's New Protests, Carnegie Moscow Center, 31 March 2017, at: http://carnegie.ru/commentary/?fa=68471.
[12] See: Gross domestic product (GDP) of the BRIC countries from 2010 to 2020 (in billion U.S. dollars), at: https://www.statista.com/statistics/254281/gdp-of-the-bric-countries/

2014	2,417.2	2,029.6	2,042.6	10,430.7
2015	1,772.7	1,324.7	2,090.7	10,982.8
2016*	1,534.8	1,132.7	2,288.7	11,383.0

*Source IMF WEO; *Forecast.*

Brazil followed, like Russia's mixed policy (retained and increased the role of the state-owned enterprises – SOEs, central control on private sector, etc.); expectedly, the economy shrunk although not that sharp as Russia.[13] The opposite picture of India and China's economic growth. The IMF expects India's GDP in 2020 to grow by 194% relative to 2010, and China – almost 270% compared to 2010.

Russia and the Eurasian Union

The landscape of the Russian economy is incomplete without taking into account the role of the energy sector and attempts to establish a special economic center of influence, the Eurasian Economic Union (EAEU).

In 2014 the energy sector accounts for 25% of Russia's GDP, 70% of its exports and 50% of federal revenues.[14] In the same year, Russian oil and gas companies earned 98% (up from 77% in 2013) of all profits made by the 500 largest Russian companies (which have a combined revenue 77% of the country's economic output), ranked by the Russian Business Chamber.[15] This is proof of Russia's failure to diversify its economy, irrespective of broadly advertised efforts to so since 2009.[16]

Another major economic policy adventure was the EAEU. In 2016-2017, the centrifugal processes reached a level of official-political discontent in the context of disagreements between the Russian and Belarussian presidents, and surfaced in symbolic gestures, like the March 2017 decision of President Nazarbaev of Kazakhstan to replace the Cyrillic alphabet with a Latin one (a reform associated with Atatürk's reorientation of Turkey towards the West in 1920's).

In its framework, Russia's populations and the size of its economy dominate the EAU landscape.

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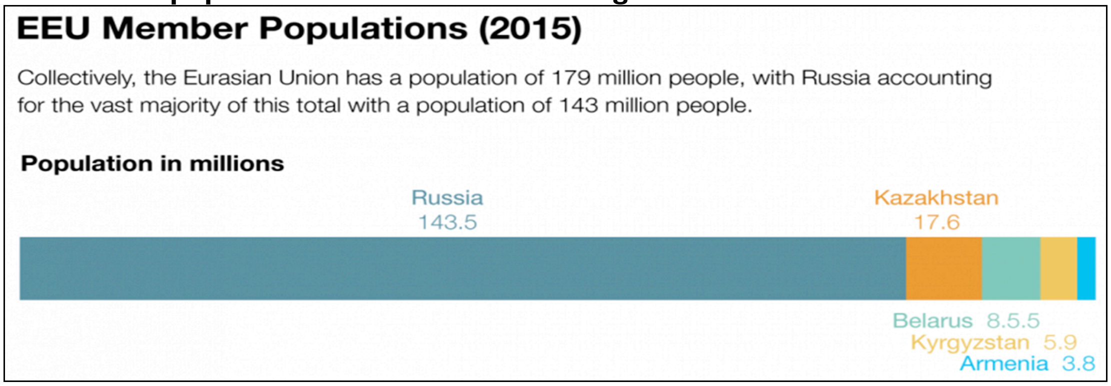
[13] Russia's business environment challenges are also important, but difficult to measure: Russia Penal Code, its Section VIII on Crimes in the Sphere of Economics was amended in 2011-2012 and should have made application trickier than ever before 1996, when the code was adopted). It defines 47 categories of such crimes and it is anybody's guess what prosecutors and the court scan accomplish on these grounds. One of the outcomes is the comparative discouragement of entrepreneurship: the number of adult active population (aged 15-63) owning established or new business, measured by the Global Entrepreneurship Monitor (GEM), in Russia is times less than in China, Chile, India or South Korea (see: http://www.gemconsortium.org/). In 2012, Russian entrepreneurial intentions (to start a business by adult members of society) were the worst globally (see: Глобальный мониторинг предпринимательства. Национальный отчет: Россия 2013, стр. 17), after 2013 Russia was not covered by GEM, and after 2014 there is no country profile available.

[14] Ellen Simon, How Long Can Russia Survive With Low Oil Prices?, Investopedia, April 24, 2015; statistics retrieved from IMF: https://blog-imfdirect.imf.org/2014/12/22/seven-questions-about-the-recent-oil-price-slump/ With regard to resulting political challenges, see: Андрей Мовчан. Ресурсное проклятие: Экономические проблемы России в свете опыта других нефтезависимых государств. Московский Центр Карнеги, 19 апреля 2017, на: http://carnegie.ru/2017/04/19/ru-pub-68719 [Andrey Movchan, Resource Curse: Russia" Economic Challenges in the Light of Other Oil-depending Countries, Carnegie Moscow Center, 19 April 2017]

[15] Peter Hobson, Energy Sector Accounts for 98% of Russian Corporate Profits, Moscow Times, 24 September, 2015, at: https://themoscowtimes.com/articles/energy-sector-accounts-for-98-of-russian-corporate-profits-49823 .

[16] See also: Andrey Movchan, Decline, Not Collapse: The Bleak Prospects for Russia's Economy, Carnegie Moscow Center, 2 February 2017, at: http://carnegie.ru/2017/02/02/decline-not-collapse-bleak-prospects-for-russia-s-economy-pub-67865 .

Chart 6: RF population almost four times larger than rest of EAEU members

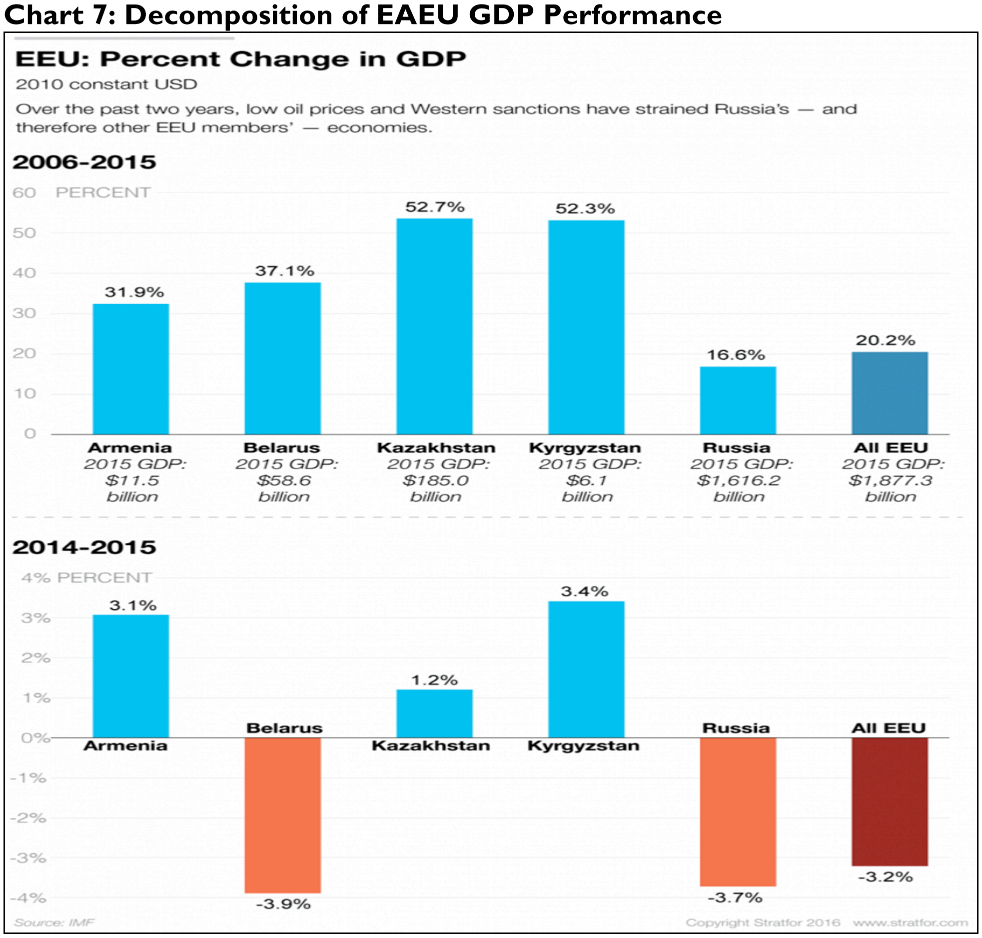


Source: Stratfor, UN data.

According to the World Bank WDI, in 2015 the economy of the Russian Federation fell to the 13th largest in the world, with 1.3 trln USD of GDP (it is down from 8th place in 2013). The next in terms of size EAEU economy is that of Kazakhstan: though it is too resource based it is the 50th globally, next to the economy of the Czech Republic (with a negligible share of natural resources in GDP). In 76th place is Belarus – a 24 times smaller economy followed by the economy of Armenia - 135th place (108 times smaller than Russia) and the Kyrgyz Republic on 146th place (176 time smaller than Russia).

The general economic rationale of the EAEU is not very clear.

Chart 7: Decomposition of EAEU GDP Performance



Source: Stratfor, data from IMF.

It is natural that neighboring economies would gravitate towards the economy of Russia and the policies of the Central Bank of Russia: this prospect has little to do with politics and is necessitated by the sheer size of the central economy, the purchasing power of its currency, the natural barriers to access richer Western, EU markets (all countries but Russia are landlocked) and all of them but Kazakhstan depend on energy imports from Russia.[17]

As it is obvious from the table above (Table 5) the overall economic development of the EAEU has been less pronounced than that of the WB or the new members of the EU. After the establishment of the EAEU, the situation is no better, although the hardships are not a result of the Union itself. Recently Stratfor published a report titled "Why EAEU will Never be EU" which helps in presenting an overall picture.

The oil price speculation decelerated economic growth in Kazakhstan and in combination with the Crimea associated sanctions (including Russia reverse ban on EU agriculture) has had a negative impact the Russian GDP and affected the economies of the other members, especially Belarus.

For the richer economies, trading with poorer economies contains a risk of losses which might be offset either through full liberalization or via unchallenged control and domination, but the tougher the protectionism the lesser the costs (or the greater the benefit) of overcoming the trade barriers with an Internet platform similar to Ali-Baba.

The liberalization option is obviously in the interest of China: since Kyrgyzstan joined the EAEU in August the EAEU border with China was already 6 thousand kilometers while the route from China to the West has become shorter. For 2016, compared to the previous year, the Kyrgyz import from China grew 52 times, as a physical volume. With 23 mln of population the Central Asian republics import as much clothing and shoes (worth USD 2.5 bln) from China as the Russian Federation itself.[18]

Trade within the EAEU and its impacts

With the decline of oil prices, values of EAEU trade turnovers plummeted after few years of modest growth in previous years (of the Eurasian Custom Union). The quoted Stratfor report compiles the following picture.

The trade with the world did not suffer from the Custom Union, which was established in 2000; the trade within the Union and with the outside world follows the overall pattern of the GDP dynamics.

At the time the EAEU was not benefitting the countries with high trade to GDP ratios - Belarus (115.1% trade to GDP in 2014) and especially Kyrgyzstan (134.4% trade to GDP in 2013). The latter was obliged to stop re-exports from its Eastern neighbor China but this did not happen (and, as explained by Zuenko, creates fiscal problems even for the budget of the Russian Federation).

In 2015, the total trade turnover between Kyrgyzstan and Kazakhstan contracted by 50%. The impact on the Kyrgyz state budget is negative since cheaper fuels and energy resources in Kazakhstan motivated Kyrgyz public and businesses purchasing those across the border.

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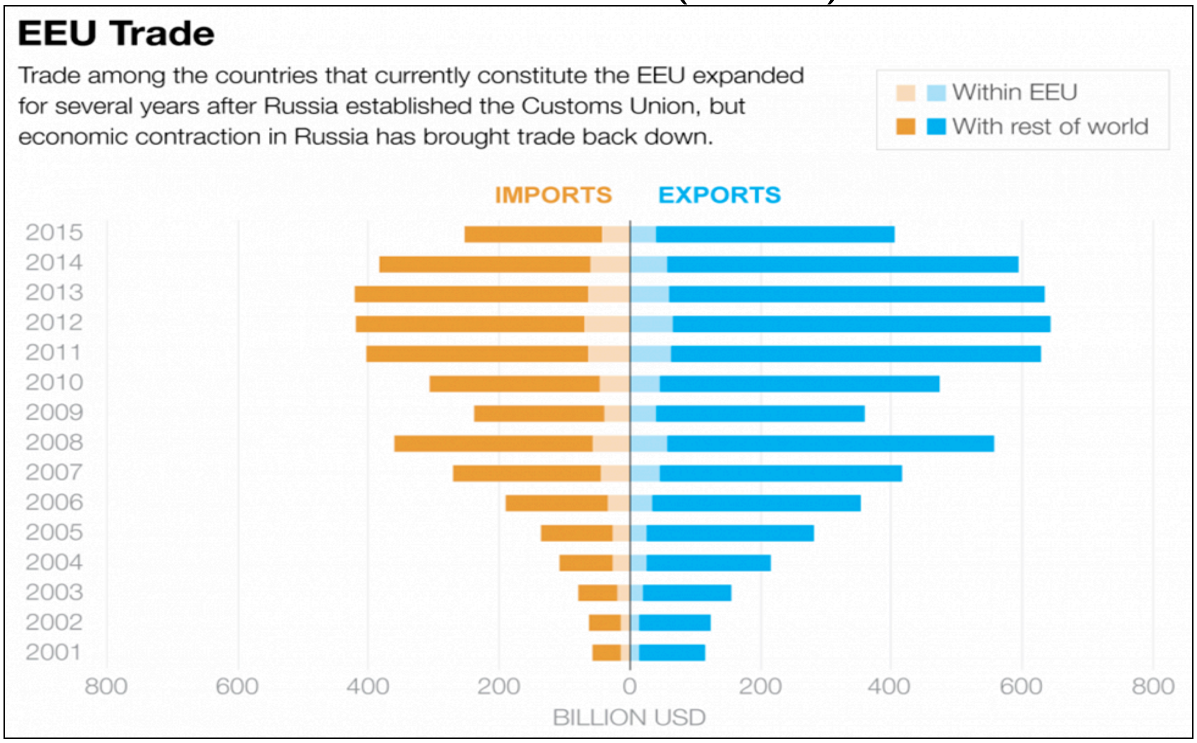
[17] The geographic disadvantages of Belarus are relatively negligible – it borders EU. The landlocked Armenia has in addition a blocked trade with Azerbaijan and Turkey, and until recently had just a limited trade with Iran. Kyrgyz international trade has suffered from asymmetric higher tariffs from neighbors ever since she was the first to join WTO in 1998.

[18] See: Иван Зуенко. Евразийская брешь: кто выиграл от вступления Киргизии в ЕАЭС. Московский центр Карнеги, 1 ноября 2016; see English version: Ivan Zuenko, The Eurasian Gap: Winners and Losers of the Economic Union, Carnegie Moscow Center, 11 November 2016, at: http://carnegie.ru/commentary/?fa=65114.

Chart 8: EAEU Trade and Trade with the World (2001-2015)



Source: Stratfor, data from TradeMaps (UN)

The recession in Russia and Kazakhstan has had a negative impact on other countries. These two countries have devalued their currencies to cope with a downturn in oil prices. And the overall trade with Ukraine is likely to suffer because of Russian conflict with these countries.

According to Trading Economics (which uses) data from statistics offices of the WTO member states), the export dynamics since the monthly peaks of 2014 to monthly averages in 2016 was the following: [19]

- In Armenia exports increased from USD 120 million a month to USD 135 million a month in 2016 (the trend is positive);
- In Belarus it went down from USD 3.2 billion a month to 1.8 billion a month in 2015 (the trend is negative);
- In Kazakhstan it went down from USD 8.2 billion a month to USD 2.5 billion a month in 2016 (the trend is negative);
- In Kyrgyzstan it went down from USD 250 million a month to USD 75 million a month in 2016 (the trend is negative);
- And in Russia it contracted: from USD 45 billion to USD 25 billion (the trend is negative).

From 2014 to 2015, Armenian trade with Russia declined: exports by 36%, imports from the world – by 38%; very similar is the data on Armenian trade with Kazakhstan, with Belarus the decline of export is 40%; with Kyrgyzstan the export increased by 11%.

For the same period, the trade of Belarus behaved as follows: exports to Russia decreased by almost 50%, while imports from the world – by 38%; the exports to Armenia remained unchanged, with Kazakhstan export declined by 40%, and the exports to the Kyrgyz Republic shrank by 36%.

[19] The complete data for 2016 is yet to be published, but we do not expect any significant changes in the trend.

Interim Conclusions

However incomplete, this brief overview allows for several observations that will be further analyzed in the sections that follow.

- At first glimpse, **the macroeconomic developments of the WB countries before and after the crisis do not differ significantly from those of NE and/or FSU**;
- They do not differ considerably from other countries in terms of dealing with the recession, which suggests that **their economies are at least as resilient as most transition countries**;
- **The proximity of Greece and its government debt crisis, and Italy's recession did not affect the Western Balkan in any significant way**, at least, as macroeconomic data suggests, the impact was limited only to slowing GDP growth but did not trigger recession;
- **WB GDP growth rates indicate that, like other regions, the countries are catching up and it is probable that in the years to come they will grow at a faster pace than economies in the EU and NE, on average**. However, it is impossible, to build a causality link between different factors of economic development; specific country situations suggest that, sometimes even firm-level events can affect the overall dynamics.
- **Russia and the EAEU countries have had less robust economic development** in comparison to other Eastern Countries – Azerbaijan, Georgia, and Moldova but not Ukraine (which is a special case before the annexation of Crimea). All these countries made less progress towards prosperity than even less advanced NE reformers like Bulgaria and Romania.
- **Trade within the EAEU is less advantageous for members than the FTAs between the WB and the EU**. For the period between 2005 and 2015, the WB exports to the EU grew by 356.6%; the highest growth rates were registered in 2006 (61%) and in 2010 (30.7%); the sharpest decline of -22% – in 2009. In 2014, the EU was the region's largest trading partner for both imports (73.9%) and exports (81.2%). Unilateral measures originally granted by the EU, and perhaps the prospect of a membership in the EU has helped the WB attract FDIs and increase prosperity at home.
- **The global recession of 2008-2009 had a similar impact and lasted as long in the WB as in the countries of the FSU. However, the EAEU members were affected by the challenges of the Russian economy after Crimea and the decline of oil and gas prices.**
- The inefficiency of the Russian economic policies did lead to a recession **after 2013 with a very different economic growth pattern in comparison to India and China, the latter is likely to be the major beneficiary of the EAEU**. This is likely to create tensions between the members of the Union.
- As one prominent Russian economic policy commentator observed: "trade relations between the EU and Russia will likely remain stable for many years, even as the overall volume of bilateral trade gradually contracts. **The EU will grow less dependent on Russia for energy security, while Russia will become less reliant on European finance, industry, and infrastructure**."[20]

[20] Andrey Movchan, Worst Friends, Best Enemies: Trade between the EU and Russia, Carnegie Moscow Center, 20 June, 2016.

IV. "IMPORTED" MONETARY POLICIES OF THE WB AND THEIR EFFECTS

A. ECB POLICY IMPACTS

Background: WB Currencies

WB monetary regimes mirror the Euro and are potential importers of ECB policies. This import may happen through inflation and interest rates (quantitative easing policies) of ECB.

Four countries do this directly: Montenegro and Kosovo opted for full euro-ization and use the Euro as their "national" currency, while B&H Konvertibilna Marka (originally fixed 1:1 to the Deutsche Mark - DM) is the foundation of the country's euro-based currency board system and Macedonia pegs its Denar to the Euro.

Regardless, nominally independent Albania, Croatia (before 2013) and Serbian central banks policies of managed and/or free-floating exchange rate regimes, "they also face in practice substantial monetary policy constraints, given the high asset and liability euro-ization in their banking systems".[21]

Such constraints lead to a synchronization of business cycles and reflected in the macroeconomic statistics. The countries of ex-Yugoslavia had achieved a considerable degree of currency substitution as early as 1980's due to persistently high levels of monetary expansion (combined with relative freedom of movement – and work abroad – of ex-Yugoslavs) and become wide-spread with the years of wars and hyperinflation. This explains the ease of "de-markization" of B&H and the euro-ization of Montenegro, the latter being additionally motivated by the vision to divorce the Montenegrin economy from the Serbian Dinar.[22]

Synchronization with the EU and direct and indirect euro-ization, seemingly happened by itself, after Yugoslav discretionary monetary policies, periods of high and even hyperinflation in Serbia, Bosnia and Herzegovina and Republika Srpska (currently part of B&H).

Yugoslav hyperinflation in 1994 was the world's third worst hyperinflation on record, the fourth was the hyperinflation of RS, with their respective daily inflation rate of 64.6% and 64.3%.[23] Since 1994, independent and discretionary monetary policies did not make sense for either the West Balkan countries, without much of a policy debate. It makes little theoretical sense: the constraints on independent monetary policy in all WB countries are "serious because of high levels of openness and euro-ization", such countries cannot form independent optimal currency in terms of Robert Mundell,

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[21] See: Antje Hildebrandt and Isabella Moder, Business cycle synchronization between the Western Balkans and the European Union, Ostereichische Nationalbank, Focus on European Economic Integration No. 3, 2015, p. 8.

[22] Similarly, in early – mid 1990s, Slovenia move from Yugoslav Dinar to Slovenian Tolar, originally targeting inflation and then fixed to the DM and the Euro, to eventually join the Eurozone. (See the background perspective on Slovenian monetary policy by: Joze Menzinger, From Tolar to Euro and., in Aleksandra Jovanovic, Ljubomir Madzar (editors), Law, Rules and Economic Performance, Belgrade, University of Belgrade Law Faculty, 2013, 289-305; for overall ex-Yugoslav perspective see in the same volume: Miroljub Labus, Institutional Arrangements in the Full Euroization Economy, pp. 231-346. (Messrs. Menzinger and Labus were respectively minister of finance and deputy-PM of Slovenia and minister of economy and deputy-PM of Serbia.)

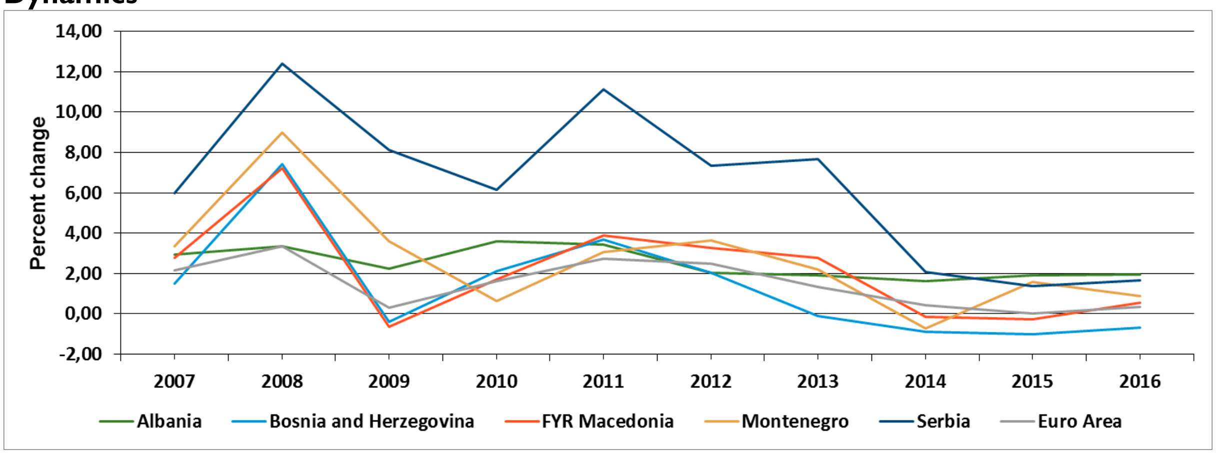
[23] See: Steve H. Hanke and Nicholas Krus, World Hyperinflations, CATO WP, August 15, 2012, pp. 5-7 and 12.

who was awarded Nobel Prize in Economics in 1999 for his research of such areas. [24] It is relatively easy to lose any anticipated benefits from increased money supply since any unit of currency can be "exported" via purchases or foreign goods or services, or though inflation, because of the size of the economy. The quote is from Antje Hildebrandt and Isabella Moder, applying Mundell modeling and correlations of optimal currency areas found "that foreign trade is the most important positive contributor to business cycle convergence" between EU and the WB.

As KC2 highlighted in the report on the WB FTAs, between 2005 and 2015, the WB exports to the EU grew by 356.6%. The highest growth rates were registered in 2006 (61%) and in 2010 (30.7%), while the sharpest decline of -22% – in 2009, following the pattern of the EU and Eurozone recession. In 2014, the EU was the region's largest trading partner for both imports (73.9%) and exports (81.2%).

The following Chart grasps this synchronization of monetary policies in terms of inflation.

Chart 9: Eurozone and WB Inflation Dynamics



Source: Knoema, via IMF WEO 2016

Except for Serbia[25] with its managed exchange rate regime (and the dynamics Croatian inflation is basically the same), the inflation pattern of the WB repeats that of the Eurozone (ECB). The difference, in both inflation and deflation, is due to the greater volatility and risks of the Balkan domestic markets. Montenegro is close to other WB countries in terms of levels of inflation (CPI), but thanks to its real economic integration with Serbia the patterns coincide.

It is worth noting that the pick-up of inflation in 2009 is due to the Greek-debt crisis related policies of the ECB (a typical regularity would be that inflation goes down in recessions).

Current Situation: Quantitative Easing, Italian Banks and WB

Another interesting observation is that ECB's 2015 policies of quantitative easing (QE) did not result, for the time being, in higher inflation. QE potential impact are indirect, and would be perhaps translated through the countries' banking sectors. Because of their exposure to Greek and Italian banking industries, they are analyzed separately.

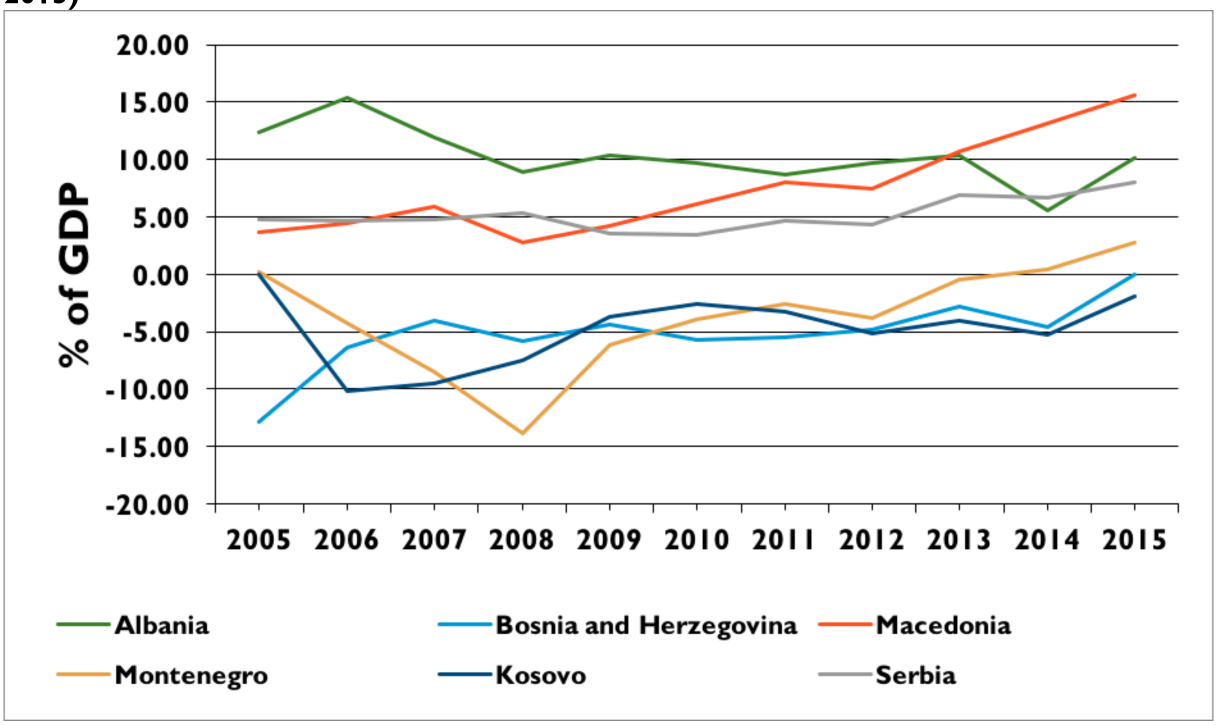
[24] See: Igor Velickovski, Assessing independent monetary policy in small, open and euroized countries: evidence from Western Balkan, Empirical Economics, August 2013, Volume 45, Issue 1, pp. 137–156.
[25] In post-Milosevic Serbia of 2001-2002, the central bank of Serbia was acting as ad hoc commercial bank, with two credit lines – for residential mortgages and automotive purchases (leasing).

The economic growth in Euro Area was 2% in real terms in 2015 and ECB's expectations are the growth rate to decelerate to 1.7% in 2016 and 1.6% in 2017[26]. Combined with inflation rates well below the target of 2% (in 2015 rate of inflation was 0%, while it is expected to be 0.2% and 1.2% in 2016 and 2017 respectively), this suggests continuing loose monetary policy of close to zero interest rates and continuing programs for purchasing securities. Overall, this implies no significant change of ECB's policy in the short to medium term.

Both inflation and QE should, in theory, result in a shrinking savings rate. However, unlike NE it is characteristic with growth of gross domestic savings (explained with raising real income and cautious borrowing after 2009), the picture in the WB is mixed.

Longer term QE impacts on assets prices (inflated currently) and the uptick in real estate prices are not directly observed in the WB.

Chart 10: West Balkan Economies Saving Rates (% of GDP in 2005-2015)



Source: IMF WEO, 2015

In Albania, Macedonia and Serbia the rate of saving remains positive, but in 2014 Albania was three times lower than in 2005 (going up afterwards). In the other three countries, the rate is negative but the post-recession trend is certainly upwards.

Regardless, the apocalyptic press coverage that rejection of constitutional amendments by the recent referendum in Italy may end up in government's bailing out of banks, which in turn may create a mess in the Eurozone, [27] the referendum was a vote of confidence for the PM Renzi. A sober reality check suggests that non-performing loans (NPL) problems of Italy (reported at 16.9% of the overall credit at

[26]According to the latest ECB economic forecast, available at:
https://www.ecb.europa.eu/pub/pdf/other/ecbstaffprojections201609.en.pdf?f9ff11c812f7b63170b535e291a0368f
[27] See review in: Bernardo Ferrero, Why the Hysteria Over the Italian Referendum?, Mises Wire, 6 December 2016.

the end of 2015, now estimated at above 20%)[28] are not likely to derail the overall stability of the Eurozone banks (with NPLs at 4.45% at the end of 2015) or the EU banks in general (4.23%).[29]

As we shall see below, the WB banking sector is very much exposed to Italian banks penetration. However, the profitability of the banks is beneficial, institutional and foreclosure procedures are reliable and the NPL situation in the WB set advantages for foreign banks, and foreign banks are not likely to siphon cash out of the region. The threats remain still on the political side: financial instability in the EU may be put at risk by hastening policies to bailout Italian banks that violate EU banking rules, thus questioning the whole legitimacy or the EU.

Monetary and Banking Features of the EAEU

There have been talks since 2010 and plans since 2014 to set a single currency of the Eurasian Union, tentatively creating a Eurasian Central Bank by 2025.[30] The idea is faint so far but it is clear that it mirrors the concept of the Euro and is based on an end-of-19th century understanding of money as predominantly a government affair. There were plans to kick-off the process from September 1, 2016. It looks as if the plan has been put on hold for now, and for good reason.

- **Resource-based economies of the union are inevitably influenced by the price volatility of commodity markets, and the recent floats of the Russia and Kazakh currencies create unexpected risks for non-resource economies of the Union.**
- Due to the size of the member economies and irrespective of policy that countries and the Union may plan and implement, **the EAEU is a ruble zone while the ruble itself is deeply influenced by the oil and commodity market speculation.**
- **Russia accounts for more than 80% of the Union's GDP, while Belarus for only 3%,** the new currency cannot be anything else but an instrument of Russia domination, which would certainly motivate dispersion of parallel legal monetary units.
- **Given the recent devaluation of currencies triggered by the weakening of the ruble, the population and even countries' politicians doubt whether a provisional single currency would create greater economic benefits**, facilitating trade (which is seemingly not happening at the moment) and capital market integration (which is obviously happening due to the influence of ruble) and infrastructure dependencies on Russia of the Central Asian land-locked countries.
- There is no reliable data on the foreign bank ownership and market shares in Russia and the Eurasian Union in recent years. The latest (2011) EBRD and IMF data estimates the share of **foreign bank ownership in Russia at only 17%.** The situation was very different in NE countries: it was 91% in Croatia, 86% in the Czech Republic, 85% in Romania, 79% in Bulgaria and 68% in Poland.[31]
- If we exclude the most open and internationally integrated economy of Georgia (87% foreign ownership, similar to NE), **Armenia has the largest share of foreign banks – 67.2%** (from Russia, Switzerland, Iran, Lebanon, France, UK, USA and Kazakhstan): we estimate foreign

[28] See: NPLs in the Banking Union: stocktaking and challenges, European Parliament Briefing, January 2016, p. 1, 2 and 10.
[29] See also: Nicolas Vernon, European banks: bumpy transition to a new regime, in Olivier Blanchard and Adam S. Posen (editors), Reality Check for the Global Economy, PIIE Briefing, March 2016, pp. 23-26.
[30] Mike Bird, Russia's new Eurasian Economic Union could get its own single currency, UK Business Insider, 20 March 2016, at: http://uk.businessinsider.com/russia-eurasian-economic-union-could-get-its-own-single-currency-2015-3
[31] Simeon Djankov, Is Foreign Ownership of Banks Problematic for Eastern Europe?, PIIE Real Time Economic Issues Watch, January 26, 2015.

shares between 40 and 50%. The largest foreign share in a single bank is with HSBC – 70%, but the second largest bank in the country is the Russia state-owned VTB, with 12% market share.

- In early December 2016, the NYSE quoted the governor of Kazakhstan Central bank: "in our opinion the optimal share of foreign banks is 30% to 40%, but when it exceeds 50% then there are significant risks of shrinking lending by banks to the real sector of the economy", no further explanation was given except that "foreign bank ownership is low at the moment". "Kazakhstan has the largest exposure to foreign banks in financing capital assets at 20%, but the federal budget share remains high at 17%".[32] Foreign banks present in the country are HSBC, UniCredit, Royal Bank of Scotland, Kookmin and the Russian Sberbank; these are local legal entities since foreign bank and insurance company branches are forbidden to operate in Kazakhstan.[33]
- **The foreign ownership of banks is a good indicator of the level of international integration of a given economy. Resource based economies of the FSU tend to rely on local owners in the banking sectors.** Except for Georgia and Armenia, the foreign share in FSU banks is overall 2 to 4 times lower than in New Europe. This is particularly limited in EAEU and land-locked countries (some of which failed to reform at all in a political and economic sense). The following table summarizes the picture.

Table 7: Foreign Bank Ownership in USSR Successor States (2015)

Country	Foreign banks ownership (%)
Armenia	67.5
Azerbaijan	9.5
Belarus	20.6
Georgia	87.2
Kazakhstan	19.2
Kyrgyz Rep.	47.9
Moldova	40.9
Russia	16.9
Tajikistan	6.7
Turkmenistan	1.2
Ukraine	38
Uzbekistan	4.4

Source: EBRD.[34]

- **In all EAEU countries Russian banks take a lead role among foreign banks**. The issue at stake is that they are perceived as state-owned even if they are private: the government share in the Russian banking sector is 49% and, according to analysts, private banks are "strongly dependent on relations with individual oligarchs and the government" (quoted by Kirkham). **In Russia itself, the foreign banks finance less than 2% of the capital investment and about the same share percent in portfolio investments.**

[32] Ksenia Kirkham, The formation of the Eurasian Economic Union: How successful is the Russian regional hegemony?, Journal of Eurasian Studies, Volume 7, Issue 2, July 2016, p. 120.

[33] The country imposes restrictions on foreign ownership, e.g. 20% in media; 49% in domestic and international air transportation services, and a 49% in telecommunications but mobile operators are excluded.

[34] EBRD, Forecasts, macro data, transition indicators, at: http://www.ebrd.com/what-we-do/economic-research-and-data/data/forecasts-macro-data-transition-indicators.html

- **The low share of foreign banks in EAEU markets and Russia is evidence of relative insulation from global capital flows**.

Some Conclusions

- **For these and many other reasons, the EAEU jurisdictions do not meet the conventional criteria for an optimal currency area.** Labor mobility across EAEU is not legally restricted but one-sided towards Russia and money flow is mostly in remittances. Except for the restrictions mentioned, capital mobility and price and wage flexibility is well established. However, there is no formal and transparent risk in sharing systems between the countries (e.g. no an automatic fiscal transfer mechanism to redistribute funds to areas and sectors affected by market speculation). And member countries have a similar business cycle but are totally driven by that of Russia.
- In general, **all WB countries have little choice by tethering their monetary regimes to those of the ECB**, this approach is based both on tradition and economic realities. It seems that **this policy pays off with increased trade and investment, and, presumably serves as a factor of stability and predictability**. Available alternatives, e.g. the past policies of central banks of Serbia and Croatia are less likely to play such a role.
- **The fact that local currencies are pegged to the Euro is not immediately translated into inflated assets (shares) and real estate prices due to the underdeveloped and unintegrated capital markets**.
- The differences in monetary policy indicators are insignificant and reflect specific domestic factors and risks. **The risks may occur in the licensing and supervisory-transparency policies of the central banks, and, given the overall lack of monetary policies – in the area of WB fiscal and welfare policies**.
- In general, **low interest rates decrease the rate of savings and increase consumption and investment in the short-term**. The savings picture in the WB is mixed, and the investment is almost flat. **The policy of (artificially) low interest in the Western Balkans could create an unsustainable increase of demand while distorting investment decisions towards different and less productive use. As a result, the long-term growth potential of the economy could be decreased.** Of course, this effect is not limited to WB countries and could be partly offset by other domestic policies.

V. DOMESTIC FACTORS: GOVERNMENT DEBT AND FISCAL FRAMEWORKS

Unlike the monetary policy area, WB countries are exposed to risks associated with public finance. This is by no means their distinctive feature. But in some respects they differ from the countries of the Former Soviet Union, being exposed to different political risks.

This includes the need to catch up in economic development, faster economic growth due to low income per capita levels created in the Western Balkans, and pressures on governments to implement unsustainable policies to promote short-term economic activity at the expense of negative longer-term impacts.

A. UNEMPLOYMENT AND FISCAL PRESSURES ON THE WELFARE SYSTEMS

Table 8: WB Key Labor Statistics

	Labor Force Participation Rate		Employment to Population Ratio		Unemployment Rate	
Country	**2014**	**2015**	**2014**	**2015**	**2014**	**2015**
Albania	61.5%	64.2%	50.5%	52.9%	17.9%	17.5%
B&H	43.7%	44.1%	31.7%	31.9%	27.5%	27.7%
Macedonia	n. a.	64.9%	n. a.	47.8%	n. a.	26.3%
Kosovo	41.6%	37.6%	26.9%	25.2%	35.3%	32.9%
Montenegro	61.6%	62.6%	50.4%	51.4%	18.2%	17.8%
Serbia	51.6%	51.6%	42.0%	42.5%	17.0%	17.7%

Source: Websites of national statistical offices. Indicators for Serbia refer to population aged 15 and over.

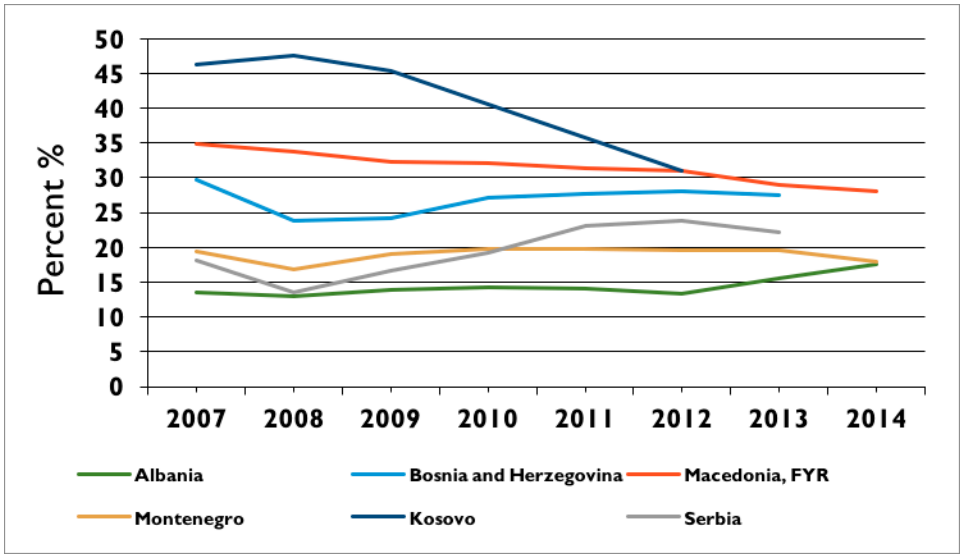
There is no clear pattern of key labor market indicators in Western Balkan countries.

B&H and Kosovo are characterized by low labor force participation rates and employment rates combined with high unemployment rates.

In 2015, the unemployment rate was above 17% in all of these countries, while in Macedonia it reached 26.3%. There are at least three factors determining these numbers. The first one is the large share of informal economy in Western Balkan countries. Many jobs are not registered in order to avoid paying taxes, and on the other hand especially in B&H and Kosovo there is not enough institutional capacity of the tax administration.

Equally important is the fact that long term unemployment dynamics is positive but rates persist at high levels.

Chart 11: WB Unemployment Rates (% of labor force, 2007-2014)

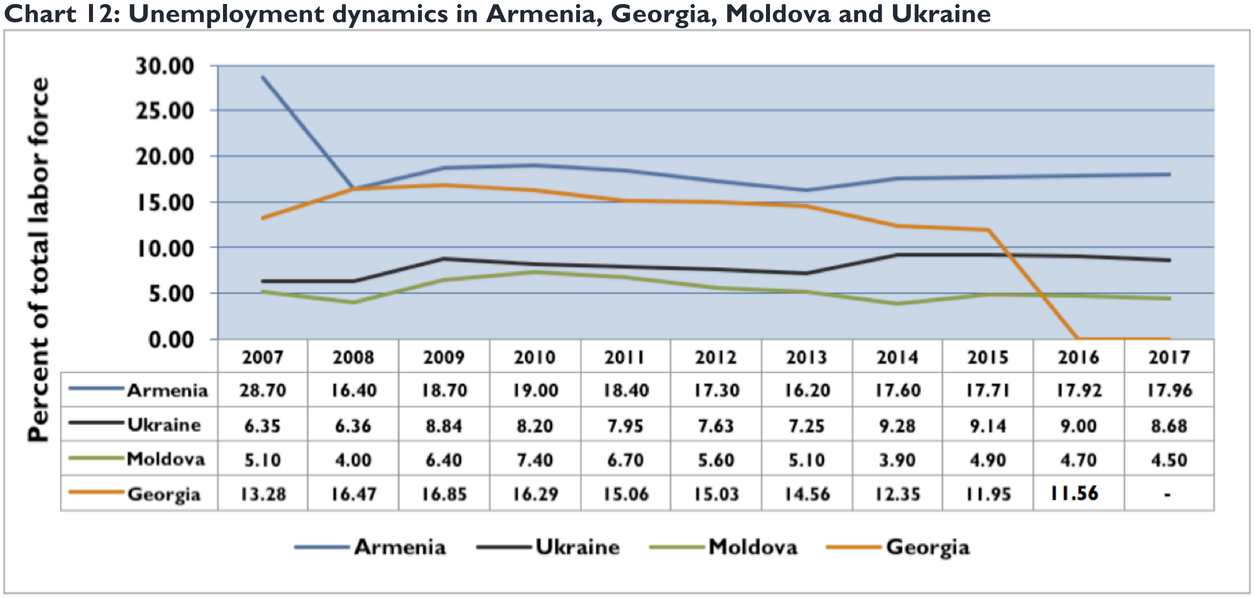


Source: WDI

This is very different from the dynamics of unemployment in other transition economies. In the Czech Republic it jumps from 4.4% in 2008 to 7.3% in 2010, and then, with economic recovery, it went down to 6%. In 2008 Romania it was 5.8%, in Bulgaria - 6%, but then worsened to 12.9%, to decrease to 7.8% in 2015. In Romania unemployment fluctuated around 7% for the entire 2000-2015 period. The international comparison with ex-USSR is also disadvantageous for the WB.

According to national statistics, WB unemployment in 2015 was at 21.6% (in 2014 - 22.9%), youth unemployment - 45% (mostly thanks Serbia's 63%). The comparison with FSU highlights the problem for the WB.

Chart 12: Unemployment dynamics in Armenia, Georgia, Moldova and Ukraine



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Armenia	28.70	16.40	18.70	19.00	18.40	17.30	16.20	17.60	17.71	17.92	17.96
Ukraine	6.35	6.36	8.84	8.20	7.95	7.63	7.25	9.28	9.14	9.00	8.68
Moldova	5.10	4.00	6.40	7.40	6.70	5.60	5.10	3.90	4.90	4.70	4.50
Georgia	13.28	16.47	16.85	16.29	15.06	15.03	14.56	12.35	11.95	**11.56**	-

Source: WDI

Historically, only Armenia used to have a high unemployment rate, in Georgia the dynamics are positive, although at a level that was typical for Bulgaria in 2011-2014.

Another factor that affects WB welfare states is emigration. Its main WB destinations are Italy, Greece and Germany, as well as Switzerland for Kosovo.

In fact, great number of persons which are out of the labor force work abroad. The third factor is structural unemployment – mismatch between the offered skills of workers and demanded skills by the employers. Another option, as Balkan Opinion Barometer (BOB) poll found out in 2015, is to seek government employment: 79% of the respondents would prefer working in the public sector, while only 16% would choose to work in the private sector.

As a result of the low employment rates and high unemployment rates which are typical for the region there is a pressure on the state budgets to increase social welfare transfers, unemployment benefits, unproductive public sector jobs and programs for subsidized private sector employment.

On the other hand, smaller number of official jobs also leads to a narrower tax base and lower revenue in the state budget. This means that the low employment is one of the most significant risks to these economies. Another problem is the big share of economically inactive young people.

For example, in Kosovo 31.4% of young persons (between 15 and 24) are not included in working, schooling or training. This means that they can take only the jobs that not require any particular skills or qualification. In the longer-term this will maintain the high rate of structural unemployment.

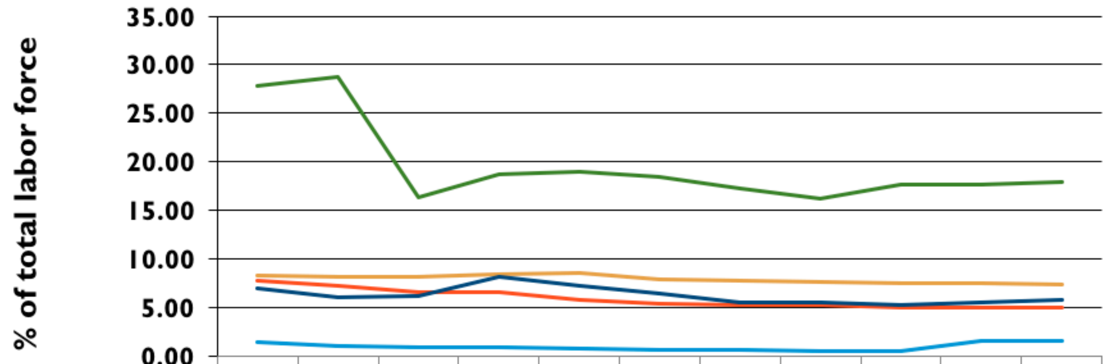
Different Unemployment Rates in EAEU

The picture of unemployment is very different in the FSU but especially in the EAEU countries.

There is only one country that has followed the WB pattern of unemployment – Armenia. This should be explained by the following peculiarities of its economy: the country is land-locked, which is particularly exacerbated by frozen diplomatic and trade relations with Azerbaijan and Turkey. Neighboring Georgia in the last ten years provides better business conditions for Armenian enterprises than the situation at home.

For the rest of the EAEU countries the unemployment rate is very low: labor market conditions are very much liberalized; the central planning helps Belarus, and oil and natural resources also helps Russia and Kazakhstan.

Chart 13: EAEU Unemployment rate (% of total labor force, 2006 – 2016*)



	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Armenia	27.80	28.70	16.40	18.70	19.00	18.40	17.30	16.20	17.60	17.71	17.92
Belarus	1.42	1.06	.94	.90	.83	.67	.62	.52	.52	1.52	1.52
Kazakhstan	7.80	7.26	6.62	6.58	5.78	5.40	5.29	5.22	5.04	5.04	5.04
Kyrgyz Republic	8.30	8.20	8.20	8.40	8.60	7.92	7.74	7.65	7.56	7.47	7.38
Russia	7.00	6.00	6.20	8.20	7.30	6.50	5.50	5.50	5.20	5.58	5.84

Armenia Belarus Kazakhstan Kyrgyz Republic Russia

*Source: IMF WEO, *2016 is a forecast.*

None of the EAEU countries' unemployment rate was impacted by the global recession of 2009. As we shall see, it was due to the relatively isolated nature of these economies. Irrespective of the reasons, it seems obvious that unemployment is a much less important political challenge in EAEU than in WB or NE countries.

B. GOVERNMENT EXPENDITURES: WB, NEW EUROPE AND THE FSU

Standards of Pro-growth Fiscal Philosophy

There are different patterns of managing economic affairs and public finance. We take as standard of assessment two empirically (historically) tested practicalities.

- The first is the share of general government expenditures to GDP, where the lower shares are associated with higher growth potential: the optimal level of government spending to allow for a steady growth is 25% according to one of the macroeconomic models, the Scully model; however the "true" optimum government level is even smaller and depends also on the quality of a government (including efficiency of government procurement and the rule of law), and not only on its size and level of economic freedom.[35]
- In recent years, two contemporary economic growth patterns have been compared – that of East Asia (excluding China as a special case) which for 1996 – 2005 marked economic growth of above 4% of GDP, and that of old Europe (the so called EU 15) with growth for the same period of 20 years of 3 and less than 3% of GDP. The former is characterized by conservative monetary

[35] Adriana Mladenova, Dimitar Chobanov, What is the Optimal Size of Government, IME, August 2009, at: http://ime.bg/uploads/335309_OptimalSizeOfGovernment.pdf. See also, James A. Kahn, Can we determine the optimal size of government?, Cato Institute, Development Policy Briefing Papers, No 7, September 14, 2011.

and macroeconomic policy, balanced (or with moderate deficits, much lower than growth rate) budgets, low levels of general government expenditures to GDP and relatively high levels of economic freedom. The lower rates of GDP growth in EU-15 are associated with higher levels of government expenditures to GDP, and, respectively – higher levels of taxes, social transfers and stagnating, over-regulated labor markets. At the same time, the level of social equality is not hampered but improved by the "Asian" model, and is registered by lower rate of youth unemployment, while the political system might be defined as "mild authoritarianism".[36]

As we shall see, the countries of the Western Balkan and the Former Soviet Union match features of both models, often the disadvantageous ones.

Western Balkans

Western Balkan countries differ significantly in terms of share of budget expenditures in GDP. Albania, Macedonia and Kosovo have a low redistribution of income through the state budget (around 30%), while B&H, Montenegro and Serbia have much higher rate of redistribution (around 45%), which is closer to the EU average.

Table 9: WB General Government total expenditure as % of GDP

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Albania	29.2%	31.7%	32.7%	29.4%	28.9%	28.2%	29.2%	31.6%	30.0%
B&H	46.6%	49.4%	49.0%	49.5%	47.8%	48.0%	46.3%	47.8%	46.8%
Macedonia	31.4%	33.8%	33.6%	32.5%	31.9%	33.3%	31.7%	31.8%	33.1%
Kosovo		24.7%	28.0%	27.7%	28.3%	28.6%	28.0%	27.2%	27.9%
Montenegro	44.0%	51.4%	51.6%	46.6%	45.3%	45.7%	47.6%	46.1%	48.0%
Serbia	43.4%	43.4%	43.4%	43.6%	42.4%	46.1%	43.2%	45.9%	44.7%

Source: https://knoema.com/products

One of the major WB and NE recession factors was the decline of external demand.

The global financial crisis hit the EU economies and triggered the Greek debt crisis and also the problems in Italy, Spain, Portugal, and Ireland, and in 2016 – the liquidity and non-performing loans (NPL) crisis of Italian banks.

The slow-down of economic activity in the EU reduced the capacity of WB countries to export to its most important trading partner.

The worsened credit market conditions and risk aversion of investors heavily reduced the capital flows from EU to WB countries. In terms of budget revenues, they affected Serbia and Montenegro, as for Albania it looks as if that decline of budget revenue resulted from domestic factors.

Table 10: WB: general government total revenue as percent of GDP

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Albania	26.1%	26.8%	26.1%	25.9%	25.4%	24.8%	24.0%	26.2%	26.0%
B&H	46.7%	45.5%	43.7%	45.4%	45.0%	45.3%	44.6%	44.9%	45.4%
Macedonia	32.0%	32.8%	30.9%	30.1%	29.4%	29.5%	27.8%	27.6%	29.4%
Kosovo		24.7%	28.1%	25.9%	27.2%	27.3%	25.5%	24.2%	29.6%
Montenegro	52.5%	49.1%	44.8%	41.8%	38.5%	39.9%	41.3%	43.5%	40.6%

[36] See discussion of the two models in: Anders Alslund, How Can the EU Emulate the Positive Features of the East Asian Model?, CASE Studies & Analyses No. 338, Warsaw, February 2007, pp. 7-18.

Serbia	42.5%	41.5%	39.8%	39.9%	38.2%	39.4%	37.9%	39.7%	41.1%

Source: IMF WEO 2016

New Europe: Government Expenditures

From NE countries, only Hungary and ex-Yugoslav Slovenia and Croatia have persistently high (above 45% of GDP) levels of expenditure.

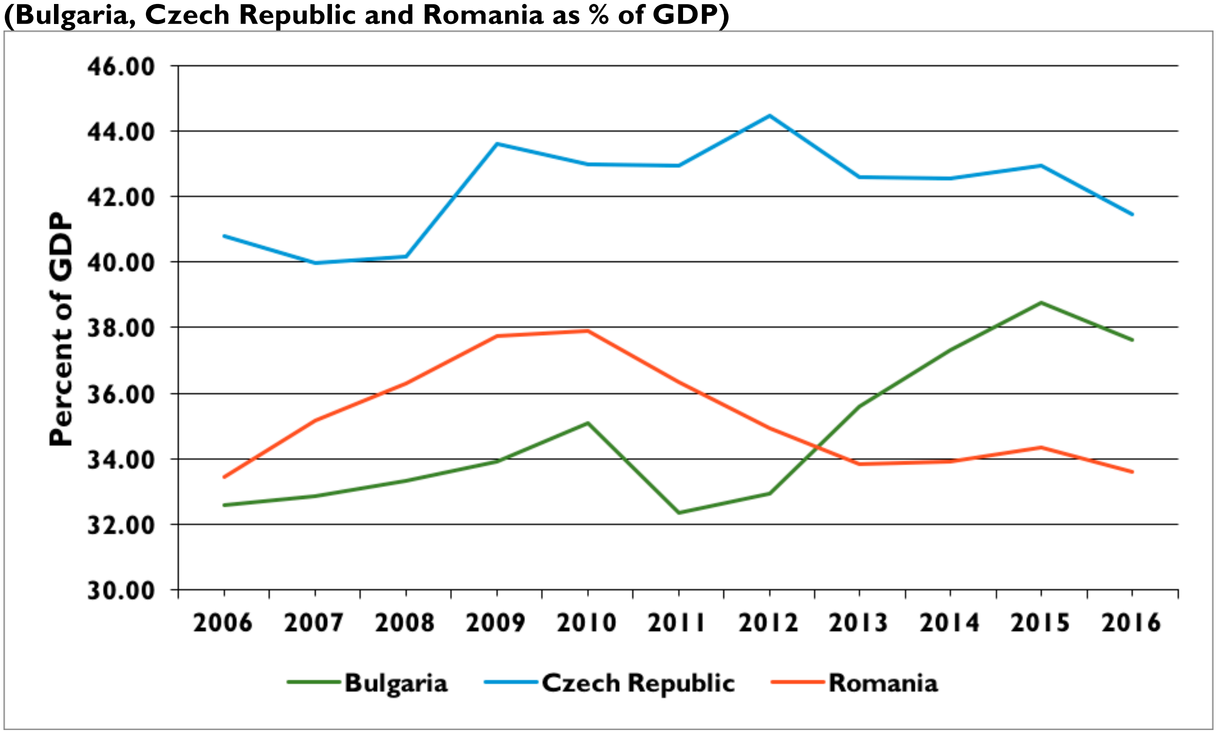
Slovenia holds the record for high general government expenditures in 2013 - 54.9% of GDP, to deal with bank and SOE debts.

Only in 2009 – 2014 the average NE government expenditures were above 40%, reaching the highest point of 43.5% in 2009 and then were gradually reduced to below 40% of GDP (37.7% in 2015).

Five countries (Bulgaria, Estonia, Latvia, Lithuania and Romania) almost never passed this level (40% of GDP), and most often kept their expenditures between 37 and 38%. This philosophy of public finances is very simple: countries should first become rich before governments embark on the path of redistribution.

These two patterns of public finance are well demonstrated by the countries selected for the following chart: Bulgaria and Romania (and the Baltics) maintain relatively low levels government expenditures to GDP.

Chart 14: General government expenditures in NE (Bulgaria, Czech Republic and Romania as % of GDP)

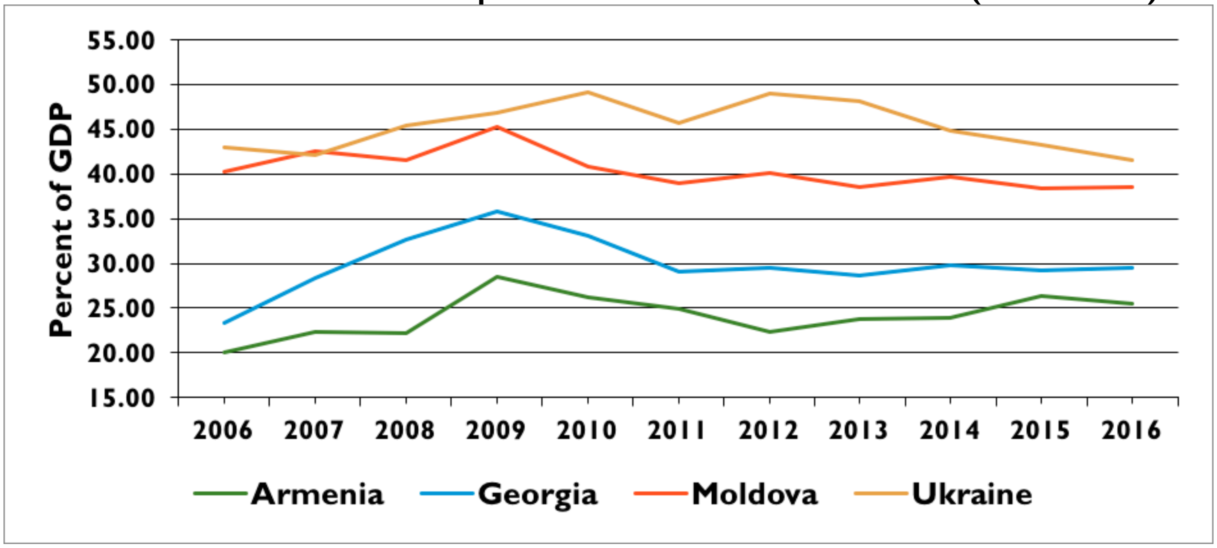


Source: IMF WEO

FSU and EAEU Government Expenditure

The same two philosophies are being followed by some FSU and EAEU countries, although it is rather obvious that these countries have relatively sound healthy fiscal situations in comparison to the WB. In the tables and charts below we take Azerbaijan separately.

Chart 15: General Government Expenditures in Select FSU Countries (as % of GDP)



Source: IMF WEO

Armenia, Georgia and Moldova after recession have consolidated their government expenditures. Armenia and Georgia seem to follow the fiscal philosophy of low government expenditures, thus supporting private sector led economic growth, a philosophy similar to fast growing Asian emerging economies. Moldova is more in line with the old EU and Central European fiscal philosophy.

It should be noted, however, that in Armenia this fiscal philosophy is supported by the fact that defense expenditures are outsourced to Russia, thus saving costs of the taxpayers. In 2010 Armenia expanded its military pact with Russia (originally signed in 1995).

The pact allows Russian ground and air forces access to a base in the west of the country to protect not only the interests of the RF, but to also to secure the territorial integrity of Armenia. Thus, some traditional lines in the budget are covered by foreign taxpayers.[37] Additionally, there is a tradition that some public works are paid for by wealthy members of the Armenia Diaspora.[38]

Azerbaijan as a Special Case

It has already been mentioned that oil and gas FDIs have caused exclusive high rates of economic growth. There was a strong real economic growth of 18% of GDP for 2004-2010, and of 7.9% for the period of 2011-2014. This background also helps the public finances of the country.

Chart 16: Azerbaijan Government Expenditures, Revenue and Debt (2001-2016)

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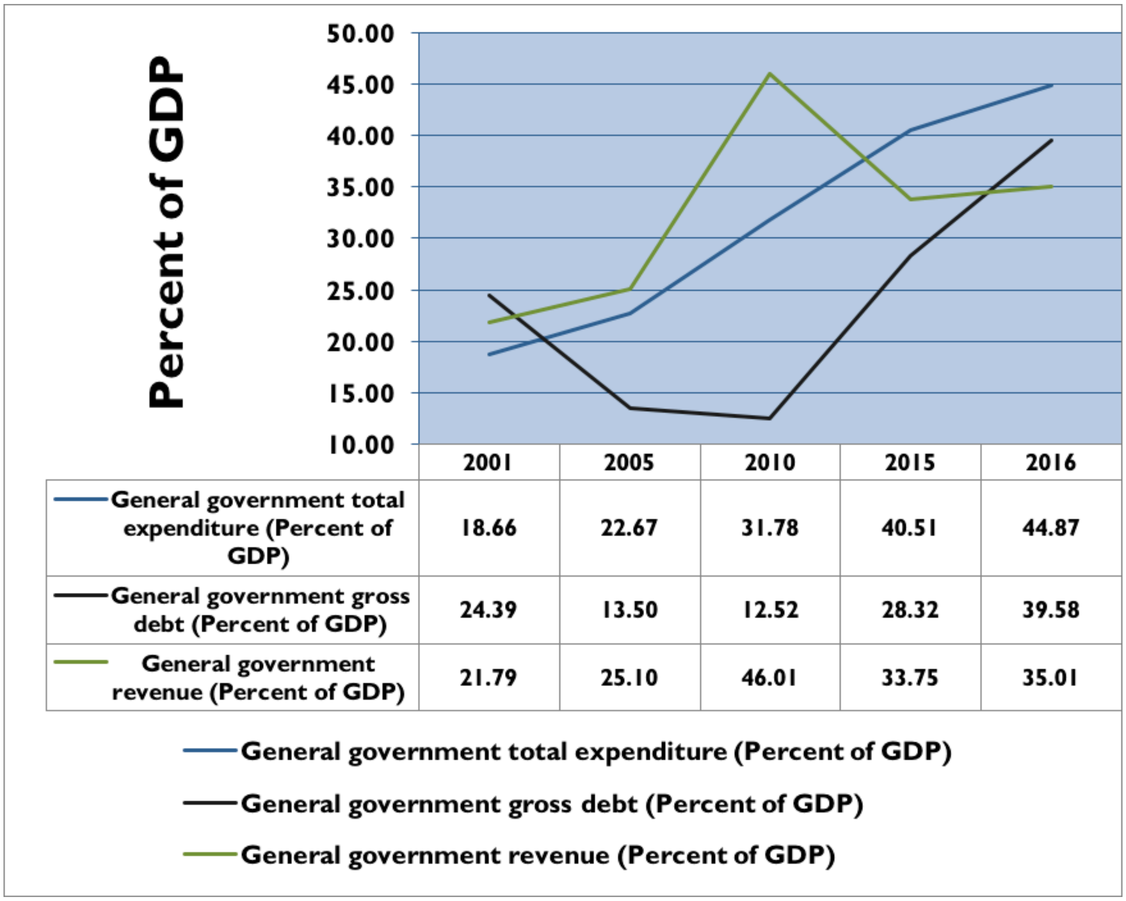
[37] Breffni O'Rourke, Russia, Armenia Sign Extended Defense Pact, RadioLiberty, August 20, 2010.

[38] It is not clear what the volume of such grants is and where exactly they come and what they exactly finance, except for Hayastan All-Armenian Fund (see: https://en.wikipedia.org/wiki/Armenia_Fund). It is known also that in 2005-2010 80% of FDI were done by the diaspora, 50% originated in Russia (see: Baseline Study: Current Situation of the Diaspora Connected FDIs in Armenia, Yerevan, GTZ, November 2011, p.19).



	2001	2005	2010	2015	2016
General government total expenditure (Percent of GDP)	18.66	22.67	31.78	40.51	44.87
General government gross debt (Percent of GDP)	24.39	13.50	12.52	28.32	39.58
General government revenue (Percent of GDP)	21.79	25.10	46.01	33.75	35.01

Source: IMF WEO

It is obvious that the general government debt increased three times in the last 10 years as a percentage of GDP. The government revenues are only 10% short of the total outstanding government debt, meaning that there are no problems servicing the debt. Additional stability is provided by the Azeri Oil Fund, SOFAZ, which in 2014 was approximately equal to 100% of the country's GDP. (SOFAZ is conservatively managed, 90% of its investment is in low risk sovereign bonds and only 10% in assets. The latter is channeled typically to long term public projects, like, e.g. the railways to Georgia renovation and industrial parks.)[39]

The low risk investment is most often earmarked to support the state pension fund, with long term projections. In general, since 2001 the oil and gas revenues have helped investment in infrastructure (which increased 12 times between 2000 and 2008, and, after a 10% drop in 2009, it increased two times by 2014 (to decrease again by 25% in 2015). Between 2000 and 2015, the increase of investment in education and healthcare has marked a steady trend, without ups and downs, and it was in education – 8 times, in health – about 7 times.[40]

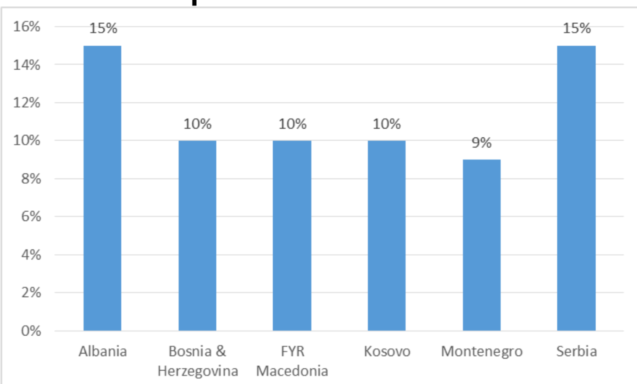
Fiscal Policies in the EAEU Compared to those in the WB

It makes sense to compare the fiscal behavior of the WB and EAEU countries.

[39] See: Alexander Winning, Azerbaijan's anti-crisis defenses larger than dwindling reserves imply, Reuters, January 2016.
[40] Azerbaican Republicasi Presidentinin Iqtisadi islahaplar ueze Koemekcisi Hidmedi. Baku, 2016, p. 149.

The decelerated economic growth in the Western Balkans necessitated a response by the governments. The crisis impact led to lower budget revenues in almost every country of the region, and lower budget revenues required cutting the expenditures, but governments chose to borrow money. According to the World Bank, public debt of these countries has been rising continuously, averaging at 6% annually since 2011. Another policy they pursued was to lower company and personal income taxes, hoping for the Laffer curve effect. Corporate income tax rates in the region are among the lowest in the world excluding tax heavens.

Chart 17: Corporate Income Tax Rates



Source: http://www.stern.nyu.edu/~adamodar/pc/datasets/ctrypremJuly16.xls and Kosovo Agency of Statistics

In other countries this worked, but in WB the governments' responses were not timely and effective. Countries with the highest budget deficits are Albania, B&H, Montenegro, and Serbia. Except for Montenegro all other countries succeeded in reducing their budget deficits in 2015 compared to 2014. This development could be partly attributed to the existing arrangements between these countries and the IMF; Albania, Bosnia and Herzegovina, Kosovo, and Serbia have arrangements with the IMF. Macedonia made an early repayment of its entire outstanding obligations to the IMF in February 2015 (They were due in March, 2016).

The table below shows that after 2009 only Kosovo and B&H managed to consolidate their budgets to modest deficits. The spending pattern of WB governments is typical for much richer EU member states.

Table 11: General government budget balance as percent of GDP

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Albania	-3.1%	-4.9%	-6.6%	-3.5%	-3.5%	-3.4%	-5.2%	-5.4%	-4.0%
B&H	0.1%	-3.9%	-5.3%	-4.1%	-2.8%	-2.7%	-1.7%	-2.9%	-1.4%
Macedonia	0.6%	-1.0%	-2.7%	-2.4%	-2.5%	-3.8%	-3.9%	-4.2%	-3.7%
Kosovo	n. a.	0.1%	0.1%	-1.8%	-1.1%	-1.2%	-2.5%	-2.9%	1.6%
Montenegro	8.5%	-2.3%	-6.8%	-4.8%	-6.8%	-5.8%	-6.3%	-2.6%	-7.4%
Serbia	-0.9%	-1.9%	-3.6%	-3.7%	-4.2%	-6.7%	-5.3%	-6.2%	-3.6%

Source: KC2 calculations based on data of https://knoema.com/products and Kosovo Agency of Statistics.

The table below gives the long-term picture of fiscal policies in EAEU.

The spending pattern is different. General government expenditures are "naturally" high for the centralized economy of Belarus, although here they are at below of EU average level of 48.2% of GDP in 2014 and the recent trend is to further cut them down.

In all other countries, the level of government expenditure in the last 15 years has been more in line with the poorer EU new members.

Table 12: EAEU General Government total expenditure as % of GDP (16 years picture)

	2001	2005	2010	2015	2016*
Armenia		19.87	26.20	26.39	25.61
Belarus	45.81	45.09	42.05	44.21	42.83
Kazakhstan		22.13	22.47	23.46	21.62
Kyrgyz Republic	28.09	29.61	37.10	39.24	42.97
Russia	31.38	29.38	35.41	36.27	34.97

Source: IMF WEO

Except for Kazakhstan,[41] there is the tendency toward larger shares of government expenditures to GDP, in Kyrgyzstan they are already close to those of Central Europe and Croatia, while in Russia they are at the level of smaller governments of the EU, fluctuating around 35% of GDP.

The table and the chart below confirm the same picture, but with greater attention paid to years immediately before and after the recession.

C. GOVERNMENT DEBT AND FISCAL FRAMEWORKS: WB VS EAEU

Table 13: General Government Gross Debt (% of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Albania	53.4%	55.1%	59.7%	57.7%	59.4%	62.1%	70.3%	71.7%	71.9%
B&H	18.7%	30.9%	35.1%	42.8%	42.6%	44.3%	43.5%	44.0%	45.5%
Macedonia	23.5%	20.6%	23.8%	24.1%	27.7%	33.7%	34.0%	38.3%	38.6%
Kosovo	n. a.	n. a.	n. a.	n. a.	n. a.	n. a.	n. a.	n. a.	5.8%
Montenegro	27.5%	29.0%	38.3%	40.7%	45.6%	53.4%	55.2%	59.9%	66.4%
Serbia	33.4%	32.4%	36.0%	43.7%	46.6%	58.3%	61.4%	72.0%	77.4%

Source: https://knoema.com/products and Kosovo Agency of Statistics.

Government debts sharply increased during the period after 2007 because of the high budget deficits. The level of government debt to GDP is not just important by itself – a country may slide down to default even with modest level of government debt to GDP ratio. What make sense are the dynamics, the costs of services, and the ability to bring in tax revenue.

Between 2007 and 2015 Albania's gross government debt relative to GDP increased by 18.5 p.p., the B&H's increased by 26.8 p.p., Macedonia's increased by 15.1 p.p., Montenegro's increased by 38.9 p.p., and Serbia's increased by 44 p.p. relative to GDP.

As a result, government debts of Albania exceed 70% of GDP in 2015, and in Serbia close to 80% of GDP (a level similar to EU average government debt to GDP ratios). At the same time in Montenegro the pattern is close to that level and the trend is worsening.

The situation in Montenegro and Serbia is more concerning as the need to reverse the trend of fast growing public debt is more pronounced.

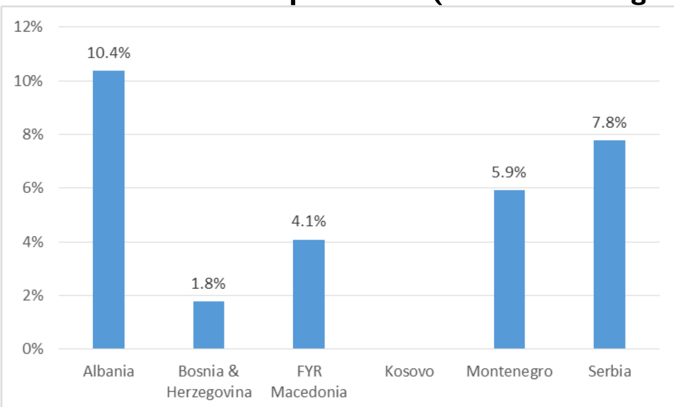
Another consequence of growing public debt is the increasing cost of servicing.

These costs are relatively manageable in Kosovo and B&H. Despite historically low interest rates on international financial markets, the cost of servicing public debts in Western Balkans tends to be high. In

[41] The relatively high government expenditures for 2007 and 2008 here (28.6 and 28.2% of GDP) should be explained by the fact that the economy was hit by a home-made real estate crisis in 2007.

2015, the general government interest expenditures were 10.4% of total revenues in Albania, 7.8% in Serbia and 5.9% in Montenegro. Such ratio of interest payments to total revenues is a serious concern.

Chart 18: Interest Expenditure (% of total budget revenue in 2015)

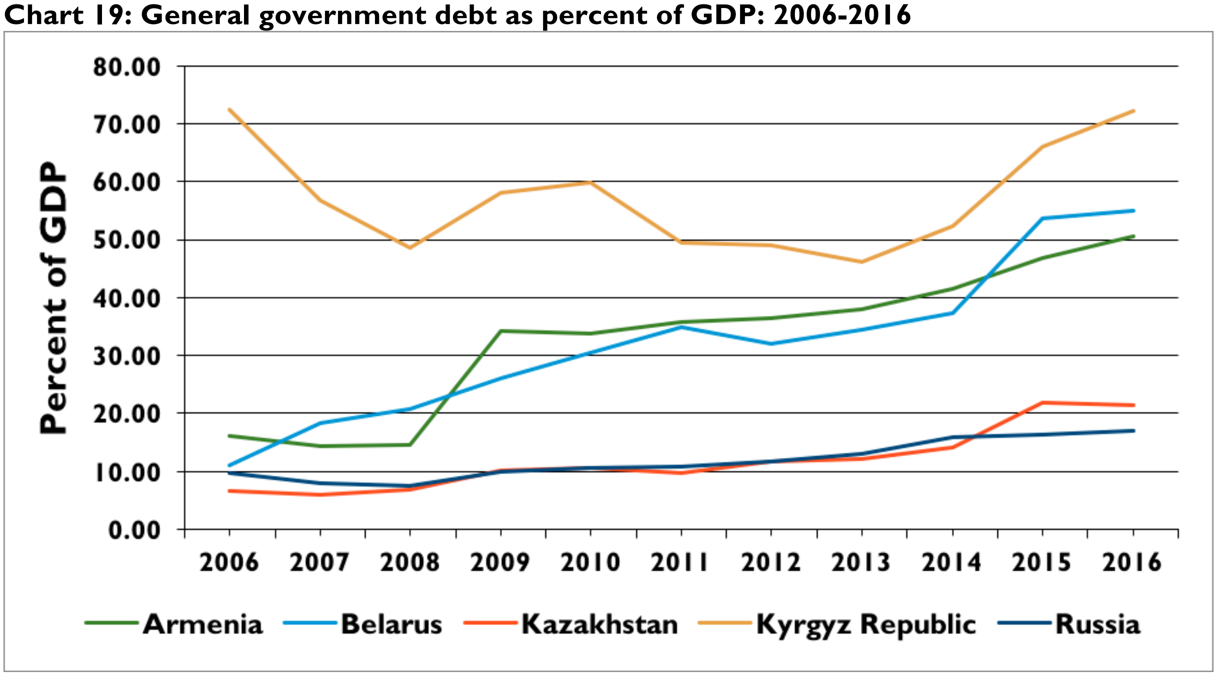


Source: KC2 Ltd. calculations based on data of https://knoema.com/products. Data on necessary indicators on Kosovo are not available in the database.

From the EAEU countries only the Kyrgyz Republic resembles the fiscal problems of the Western Balkans. In recent years Armenia and Belarus marked a tendency of growing government borrowing. For the time being it is not yet clear for how long this trend will be sustained. It is important, however, that the government borrowing grows faster than the GDP in recent years.

Russia and Kazakhstan do not seem to have major issues with debt to GDP ratios: the floating exchange rate mechanism of their currencies helps follow market (oil and gas price) fluctuations. And, like in Azerbaijan, their oil reserve funds provide for a security in the short to medium term.

Chart 19: General government debt as percent of GDP: 2006-2016



Source: IMF WEO

In Georgia, the government debt to GDP in 2000 was almost 70% of GDP, by 2008 it was reduced to 31% in 2008, but since then it grew again to 35% in 2012 and 42% in 2016. Moldova's story is very similar: from 2000 to 2008 the government debt was reduced from 77% to 20% of GDP, and from 24.5% in 2012 it went up to 42% - much faster than the GDP Growth. Worst of all is Ukraine, whose government debt grew from 36% to 93% of GDP.

D. CONCLUSIONS REGARDING FISCAL RISKS

There are serious challenges to the fiscal policies of Western Balkan countries. **The fast growing and hardly manageable public debts, fueled by persistent budget deficits could be a significant threat to the sustainable economic development** of the WB economies.

In terms of fiscal policy, government spending in the WB is like that the old EU member states – in both indicators – government expenditures and government debt, being three to five times poorer in terms of real GDP per capita and below 50% of EU average levels persistently high unemployment.

In comparison to the East Asian growth model, **the former USSR countries emulate (with exceptions) relatively low levels of government expenditures and debt relative to GDP, and the flexible labor markets and relatively low unemployment. But the growth rate is low to negative and they seem also to follow the pattern of mild authoritarianism**.

As countries with rapidly growing public debts do not have many options, WB need to decrease expenditures, increase revenues, curb government consumption and investment, which would hamper economic growth in short-term and could lead the economy into recession. On the other hand, **the postponement of structural reforms will make them even more painful in the future as is evident in Greece and many other countries**.

The **QE policies of ECB do not have any impact on WB government interest rates to serve their debts. The global QE is one of the reasons for EAEU government to seek more borrowing (this was one of the causes for tensions between Belarus and Russia).**

VI. REFORMS AND ECONOMIC INTEGRATION WITH EU AND FDIS OF THE WESTERN BALKANS

A. REFORM AND INTEGRATION PECULIARITIES OF RUSSIA AND EAEU

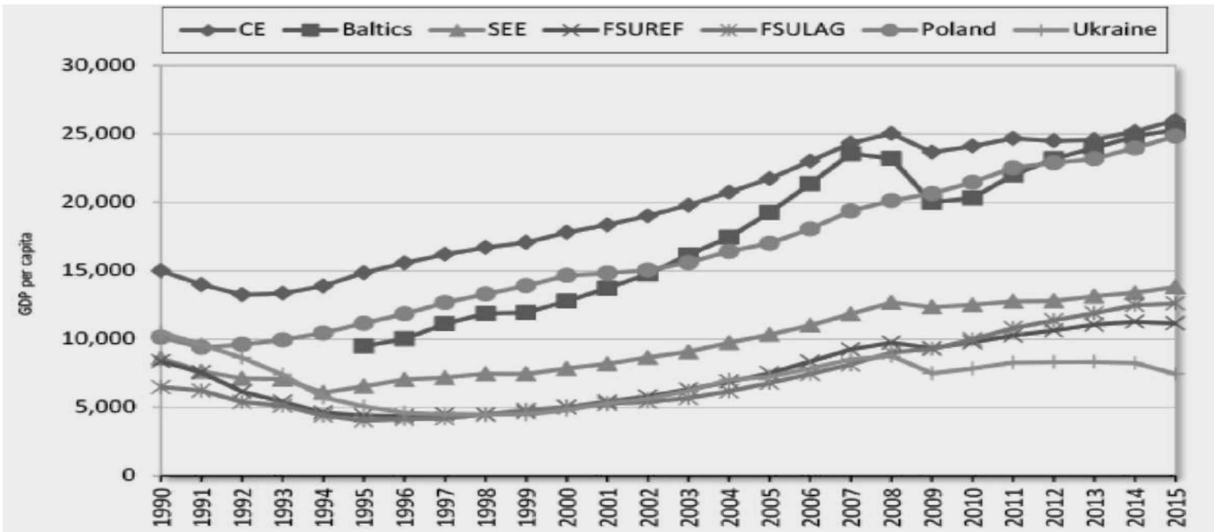
Political and economic reforms in FSU, except the Baltic countries, took place with some time lag in 1991, and they differ from NE in several important aspects.

- The state machinery remained in direct control of ex-Communist leaders of the former Soviet republics; in some countries in the periphery of Russia political pluralism was short-live and/or restricted.
- The political establishment did not develop a friendly attitude towards markets and private property; none of the countries attempted restitution of formerly confiscated and nationalized private property while this happened on a large and comprehensive scale in almost all New Europe countries.
- In countries like Russia, Kazakhstan and Kyrgyzstan, fast and comprehensive market (liberalization) reforms, often referred to as "shock therapy" and "big-bang" reforms were first attempted but then aborted; in other countries (Georgia, Moldova and Ukraine) such reforms

came late and succeeded only in Georgia; except for Georgia after 2004, these countries are typically characterized as slow or gradual reformers.[42]

- Since the early 1990's, these countries have benefitted from market reforms half as much as the countries of New Europe, if prosperity is measured by GDP per capita at PPP. Havrylyshin, Meng and Tupy have created the following chart that proves this observation.

Chart 20: GDP per capita by country group according to reform progress*
(in 2011 USD, 1990-2015)



**Note: CE = Central European; SEE = Southeast European; FSUREF = Former Soviet Union, gradual reforms; FSULAG = Former Soviet Union, lagged reforms.*

- This situation results from the overall unsatisfactory level of reforms, not from different external shocks of individual policy constellations. The reforms' level is measured by EBRD Transition indicators: in 2014, the rank of new EU members was between 3.7 (for Bulgaria and Romania) and 4.2 (Czech Republic) on the 5-grade scale, while in EAEU the best reformer was Russia, with 3.2 points. The unreformed sphere in NE is, typically, "Enterprise restructuring", while in EAEU and other FSU countries (again excluding Georgia) unreformed areas also include "Competition" and "Large scale privatization".[43]
- IMF reviewed the macroeconomic history of all transition countries since 1989: at the start of the reforms the recession was much deeper in the Baltic countries (almost 25% of GDP for the three countries) than in the FSU – approximately 19% of average.44 Irrespective of these initiative disadvantages, the above graph proves that Baltic countries starting from the same point as ex-members of the USSR may, thanks to reforms, succeed remarkably better than adverse FSU reformers.

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[42] See: Oleh Havrylyshin, Xiaqfan Meng, and Marian Tupy, 25 Years of Reforms in Ex-Communist Countries (Fast and Extensive Reforms Led to Higher Growth and More Political Freedom), Cato Institute Policy Analysis No 795, 12 July 2016, p. 7. In fact, Havrylyshin et. al. distinguishes five categories of reforming countries: "sustained big-bang", advanced start/steady", aborted big-bang", "gradual reforms", and "limited reforms" (and include in the latter category Belarus, Turkmenistan and Uzbekistan.

[43] See: EBRD, Forecasts, macro data, transition indicators; the ranks are based on experts' assessment of the following six areas of reforms: Large scale privatization, Small scale privatization, Governance and enterprise restructuring, Price liberalization, Trade & Forex system, Competition Policy.

[44] See: James Roaf , Ruben Atoyan, Bikas Joshi , Krzysztof Krogulski, 25 Years of Transition: Post-Communist Europe and the IMF, IMF Special Report, 14 October 2014, p.14.

- In terms of cumulative FDIs per capita the Baltic counties have received since independence more than USD 7,000; the EAEU – less than USD 2,000.[45] This is in spite of abundant natural resources of Russia and Kazakhstan that typically attract FDI. This is because these countries retain strong and oftentimes arbitrary (especially in Russia) control over the oil and gas sectors.
- According to October 2016 report of the Centre for Integration Studies of the Eurasian Development Bank (EDB) in St. Petersburg, since 2008 the total accumulated amount of mutual CIS FDIs was USD 23.7 bln in 2015. (This is half the amount - USD 48 bln – more developed Western countries and China invested in the all transition countries in 2014.)46 Russian investment is approximately 80% (82.6% in 2012) of the mutual FDI in FSU countries, second is Kazakhstan with 11.6%, and third place is Azerbaijan – with 5%. The Report finds also that "the share of non-Russian direct investment is growing slowly, but steadily". Ukraine is the largest recipient of FSU FDI's (20% of the total, down from 32%) but its share is almost equal to Belarus – 19.8%. For the entire period EAEU investment from Kyrgyzstan is USD 4 mln, from Armenia 14 mln, from Belarus - 239 mln, from Kazakhstan – USD 4.1 bln, and from Russia – 19.3 bln.[47]
- In the meantime, 2015 FDI annual inflows went down by 91% (and in 2014 contracted by 53.4% relative to 2013); FDIs contracted in Belarus in 2015 by 18%, in Kazakhstan – by 19.6%, in Kyrgyzstan – by 60.4%, and in Russia – by 45.4%.[48]
- Irrespective of the recent decline, the FDI stock is also important. It has never reached more than 60% of GDP in any country except for Kazakhstan (65% in 2015). And it increased also in Belarus (current level – 33.7%) and Kyrgyz Republic (current level – 57.2%). In Armenia from 2012 to 2015 the FDI stock went down from 53.2% to 42.2% of GDP. In Russia, the FDI stock in 2013 as 22.7% of GDP, in 2014 -15.5% and in 2015 – 19.9% of GDP.49 As percentage of the grossed fixed capital formation (GFCF), the role of the FDI does not seem significant. In Armenia in the last ten years it is around 20%; in Kazakhstan, it fell down from 41.3% in 2009 to 19.3% by the time the Union was established; in the Kyrgyz Republic, the importance of FDI for the GFCF dropped from 46.6% in 2011 to 10.5% in 2014. In Russia and Belarus, the dynamics is similar: Russia's highest percentage of FDI in GFCF as in 2008 – 20.5, in 2014 – 7.7%; for Belarus, the highest point was in 2011 – 17.6%, in 2014 – 7.5%.[50]

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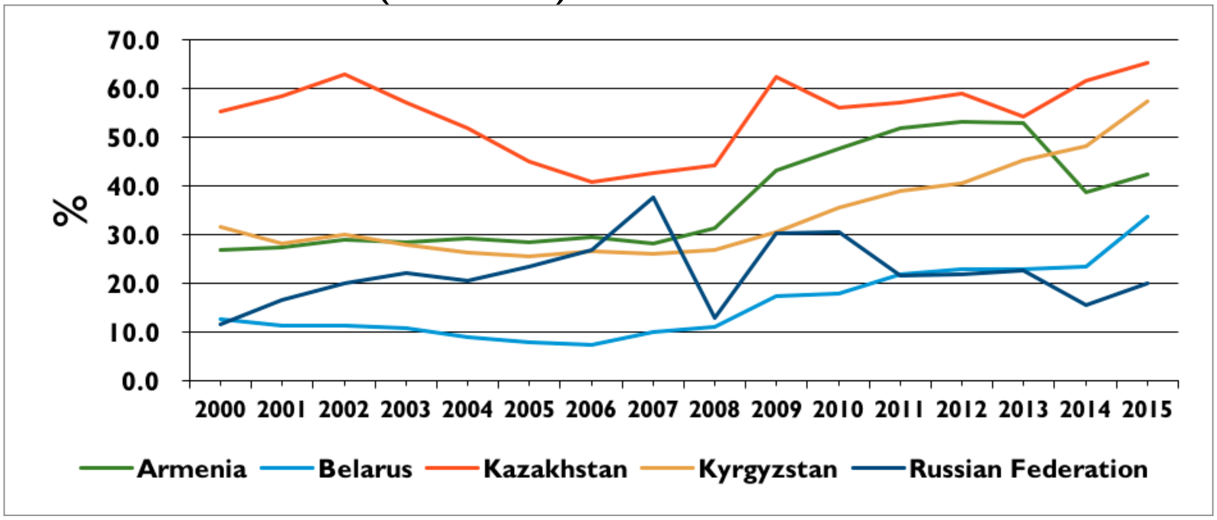
[45] Havrylyshin et. al., p. 14.
[46] See: UNCTAD, 2016 FDI Report, p. 67.
[47] Monitoring of Mutual Investments in CIS Countries 2016, EDB, St. Petersburg, 2016, pp. 7-9.
[48] Source: UCTAD FDI database.
[49] See the next chart.
[50] Source: UNCR+TAD database.

Chart 21: EAEU FDI Stock (as % of GDP)



Source: UNCTAD

B. WESTERN BALKANS

After turmoil in the Balkans in the end of the last century and wars in former Yugoslavia, the six countries of the WB – Albania, Bosnia and Herzegovina, FYR Macedonia, Kosovo, Montenegro and Serbia – faced a formidable array of challenges.

If countries and the region are compared to themselves, they have made a significant progress. The picture changes in comparative perspective.

Economic growth rates after the 2009 recession, although relatively high in comparison to other transition countries, remain below the levels of other late reformers of FSU. They are in the low single digits at best, and negative at times in some countries.

Levels of unemployment and poverty are persistently high. Supplies of foreign credit and capital from private sources – plentiful in the pre-crisis years – have largely dried up.

At the same time, governments did very little to tackle these problems having political and fiscal constraints. WB are still lagging in reforms behind all other regions in Europe, including their neighbors.[51]

Differing Transition Backgrounds: NE and WB

WB average GDP per capita, adjusted for purchasing power parity (PPP), doubled in the last 15 years.[52] However, it is roughly 50% of Bulgaria and Romania, 33% of that of Hungary and Poland, and 25% of the richer Western EU members. Such gaps reflect many years of WB under-performance and turbulence. The following tables illustrate these facts.

Table 14: WB countries' GDP based on PPP (USD per capita in WB countries)

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[51] See: Zuzana Murgasova, Nadeem Ilahi, Jacques Miniane, Alasdair Scott, Ivanna Vladkova-Hollar, and an IMF Staff Team, The western Balkans: 15 years of economic transition. – Washington, D.C., International Monetary Fund, 2015.

[52] Data are derived by dividing GDP in PPP dollars by total population. Country data on population may be found below, in the section of banks.

	2000	2003	2005	2008	2010	2012	2013	2014	2015
Albania	4,225	5,353	6,426	8,544	9,525	10,517	10,947	11,390	11,872
B&H	5,148	5,468	6,900	8,825	8,861	9,218	9,614	9,892	10214
Kosovo	-	-	-	-	-	-	-	-	-
Macedonia	7,144	7,547	8,729	11,055	11,562	12,215	12,724	13,379	13,938
Montenegro	7,705	8,581	9,894	13,687	13,434	13,995	14,670	15,105	15,716
Serbia	6,165	7,705	9,455	12,086	12,110	12,796	13,404	13,378	13,576

Source: IMF WEO, October 2015

Neighboring EU members are the poorest in the EU but comparisons with the WB GDP at PPP in the last 15 years shows that the WB have a long distance to cover.

Table 15: GDP at PPP per capita: Bulgaria, Romania and Croatia

	2000	2003	2005	2008	2010	2012	2013	2014	2015
Bulgaria	7,631	9,648	11,676	15,388	15,208	16,697	17,253	17,925	18,501
Romania	8,010	10,314	12,490	17,487	16,719	17,849	18,826	19,743	20,697
Croatia	12,444	15,410	17,694	21,476	20,034	20,416	20,586	20,947	21,324

Source: IMF WEO, October 2015

And Hungary and Poland seem twice as rich as WB economies.

Table 16: GDP at PPP per capita: Hungary and Poland

	2000	2003	2005	2008	2010	2012	2013	2014	2015
Hungary	14,152	16,995	18,778	22,613	21,790	22,905	23,688	25,019	26,084
Poland	11,559	13,039	15,065	16,497	20,956	23,197	23,983	25,247	26,402

Data: IMF WEO, October 2015

Constrained by the unstable political situation, in the first years of the transition to market economy FDIs were sporadic to non-existent in the WB. Political instability has left deep footprints and some of unresolved political problems remain on the agenda even today. The disintegration of Yugoslavia and new nation building led to deep recession, a break-up of a regional economy of scale (although it was better integrated to Western Europe than COMECON countries), and the disappearance of traditional economic and trade links. This also caused delays of market reforms and reintegration of the WB economies with one another, the EU and the globe.

For the sake of comparison, the countries that avoided wars and political turmoil, and "took bolder and more front-loaded reforms—notably in Central Europe and the Baltics—were rewarded with a faster return to growth and stability, including avoiding the series of crises that hit the region in 1997 and 1998."[53]

The situation was by no means stress-free or trivial. As mentioned above, in the beginning of the 1990s recession in the Baltic countries was as deep as in the Balkans or FSU, without a war. IMF calculated that

[53] James Roaf , Ruben Atoyan, Bikas Joshi , Krzysztof Krogulski, 25 Years of Transition: Post-Communist Europe and the IMF, IMF Special Report, 14 October 2014, p.3.

GDP contraction "in the first three years of transition ranged from about 13% in Poland and Czechoslovakia to about 25% in Bulgaria and Romania, 30–40% in the Baltics, Russia, and Ukraine, and 50 percent in Moldova".[54]

Bulgaria made an attempt to reestablish central planning in 1995, plunged in a second deep (of -10% of GDP in 1996) recession, a short hyperinflation period (in 1997), and effectively made the transition twice. Here is the picture, which shows that even in such conditions it is possible to resume growth, balance the state budget, attract FDIs, pay off debts, and restore after a double-dip recession.

Table 17: Bulgaria's Two-Transition History

Indicators (annual average)	1990-1997	1998-2014
Inflation (%)	210.1	3.1
Inflationary tax rate (%)	57.7	0
GDP growth (%)	-4.7	5
Gross Value Added growth (%)	N/A	6.8
Gross Fixed Capital Formation growth (%)	-8.8	10
Budget deficit/surplus (% of GDP)	-6.3	1.5
Government debt (% of GDP)	168	18%
FDI (accumulated - USD bln)	0.168	45.1
FDI stock (as % of 1998 GDP)	3	120%
Subsidies (% of GDP)	N/A	1%

Source: National statistics, KC2 calculations

Politics of EU Accession

The decisive periods for the WB were in the end of 1990s (intra-Balkan FTAs on the aftermath of Dayton agreement) and after 2007 (CEFTA and EU Stabilization and Association Agreements).

After a marked drop in GDP in the first half of the 1990s, the WB countries continued to have negative growth rates in the second half of the decade. The economic recovery from the wars and Yugoslavia disintegration has generally been slow; by 2011 three countries (Serbia, Montenegro and B&H) had still not reached pre-war GDP levels.

In addition to positive political moves towards more democratic regimes, from the early 2000s the WB countries, as mentioned above, have greatly improved their economic performance. Macroeconomic stabilization, relatively strong GDP growth, increasing foreign trade and gradual catching up with the more developed countries in the transition region characterized the WB countries between 2001 and 2008. Acceleration in economic reforms also took place, even in countries that until 2000 had been lagging behind.

Since 2001 the WB countries have benefitted from trade liberalization with the EU and within the Balkans region, gradually improved the business environment, and privatized many enterprises and

[54] Ibid. p.13.

almost the entire banking sector. The EU launched the Stabilization and Association (SA) Process for the WB countries offering unilateral trade liberalization measures and financial assistance.[55]

Although full membership for any of these countries during the mandate of the present Commission (2014-19), is not on the horizon, in recent years most WB countries made progress in the enlargement process. The most advanced in this regard is Montenegro which, having started membership negotiations in June 2012, had by December 2015 opened more than half of the negotiation chapters, including the most challenging relating to judiciary and fundamental rights; and justice, freedom and security, respectively.

The delays for political reasons and the pace of accession is different. Serbia opened EU accession negotiations in January 2014 but the actual first steps were taken in December 2015. Albania, a candidate country since June 2014, is defined in the European Commission reports as "making steady progress." B&H submitted its application for membership on 15 February 2016. Kosovo and the EU SAA in October 2015. Due to name-disputes with Greece, Macedonia's EU candidate status (since 2005) did not progress.

Table 18: State of Progress on EU Approximation

Indicator/country*	Albania	B&H	Macedonia	Kosovo	Montenegro	Serbia
Public administration	3	1	3	2	3	3
Rule of law						
judiciary	1	2	2	1	3	2
Corruption	2	2	2	1	2	2
Organized crime	2	2	2	1	2	2
Economy						
Market	3	1	4	1	3	3
Competitiveness	2	1	3	1	3	3

*Source: European Commission.[56] *(1) early stage; (2) some level of preparation; (3) moderately prepared; (4) good level of preparation; and (5) well advanced.*

The above table is from the recent EU Enlargement Strategy, the assessment of WB preparedness for EU membership is the following:

The country most advanced as a potential EU member is Montenegro: it is "moderately prepared" in areas of public administration, the judicial system, functioning market economy, and competitiveness within the EU.

At the bottom are Kosovo and B&H; they are poorly prepared for EU membership: "at an early stage".

It is clear that no WB country will be a member of the EU by 2020. But there is an Instrument for Pre-Accession Assistance (IPA) designed to support reforms.

Table 19: EU's Pre-Accession WB Assistance Funds (2014-2020, EUR mln)

	Albania	B&H	Macedonia	Kosovo	Montenegro	Serbia
Reforms in preparation for membership	**321**	**64**	**206**	**237**	**99**	**543**
Democracy and governance	224	31	123	110	47	278

[55] The new EC Enlargement strategy, released at the end of 2015 reaffirmed the EU membership perspective for Western Balkans.
[56] EC Country Reports, 2015: http://ec.europa.eu/enlargement/pdf/key_documents/2015/20151110_strategy_paper_en.pdf

Rule of low	97	34	83	127	52	265
Socio-economic and regional development	**168**	**-**	**299**	**235**	**91**	**565**
Environment and climate action	68	-	113	-	38	160
Transport	56	-	113	-	32	175
Energy	0	-	0	100	-	125
Competitiveness and innovation	44	64	73	135	21	105
Total per country	978	193	1,010	944	380	2,216

Source: European Commission.

The total amount of funds is not trivial – EUR 5.72 bln, that creates incentives for elected and full time public servants of the individual countries to maintain their EU membership efforts, but, as we shall see below, the public opinion is rather skeptical about the prospects of membership.

WB Competitiveness

It was mentioned above that WB did not make any significant progress in the area of competitiveness.

The Global Competitiveness Report (GCR) of the World Economic Forum (WEF) gives the following picture.[57]

The rankings for each country (excluding Kosovo - data are not available) are taken in three benchmark comparators: the EU as a whole, the old EU-15 (member states of before the Eastern enlargement of 2004)[58] and the NE (the new 11 member states, ex-centrally planned economies and Communist regimes).[59]

- The data shows a clear competitiveness gap between the WB and the EU. On average, the region is ranked 86th (ranging from Macedonia in 60th to B&H on 111th place);
- NE's average rank is 50;
- EU as a whole – 36;
- The gap is particularly large between WB and old Europe, which ranks 23rd.

The Global Competitiveness Index (GCI) is made up of three main categories, (Basic Requirements, Efficiency enhancers and Innovation and sophistication factors), which are divided into 12 sub-categories.

The WB scores reasonably well on indicators associated with health and primary education, as well as higher education and technology readiness - electricity and telephone infrastructure and information and communications technology use.

The most problematic areas are Business sophistication, ranking 105, with EU ranking 39, Labor market ranking 101, as confirmed by the brain drain problem; and innovation where WB are ranking 95, while the EU average ranking is 37.

The poor quality of roads, railways, airports and ports is responsible for bad scores for overall infrastructure (ranking 83, average ranking for the EU 33).

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[57] See: World Economic Forum Global Competitiveness Index 2015-2016: http://reports.weforum.org/global-competitiveness-report-2015-2016.

[58] Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom.

[59] Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

Table 20: Rankings in GCI 2015-2016

	Albania	B&H	MK	MNE	SRB	WB	NE	EU	EU15
Institutions	84	127	52	70	120	91	72	47	30
Infrastructure	88	103	78	73	75	83	52	33	18
Macroeconomic environment	118	98	47	79	125	93	46	59	66
Health & education	52	48	76	33	62	54	45	30	20
Higher education	47	97	46	54	71	63	40	30	20
Goods Market efficiency	63	129	33	70	127	84	53	39	29
Labor market efficiency	97	131	84	74	118	101	68	54	45
Financial market	118	113	52	44	120	89	56	53	48
Technological readiness	89	79	63	55	51	67	37	26	16
Market size	104	97	108	131	75	103	66	54	37
Business sophistication	95	125	72	102	132	105	63	39	19
Innovation	118	115	58	69	113	95	58	37	20
GCI	**93**	**111**	**60**	**70**	**94**	**86**	**50**	**36**	**23**

Source: WEF.

The overall ranking shows Macedonia as relatively close to EU 11 and B&H is last, with similar ranks to the late reformers of the FSU.

A Closer Look at FDIs in the WB

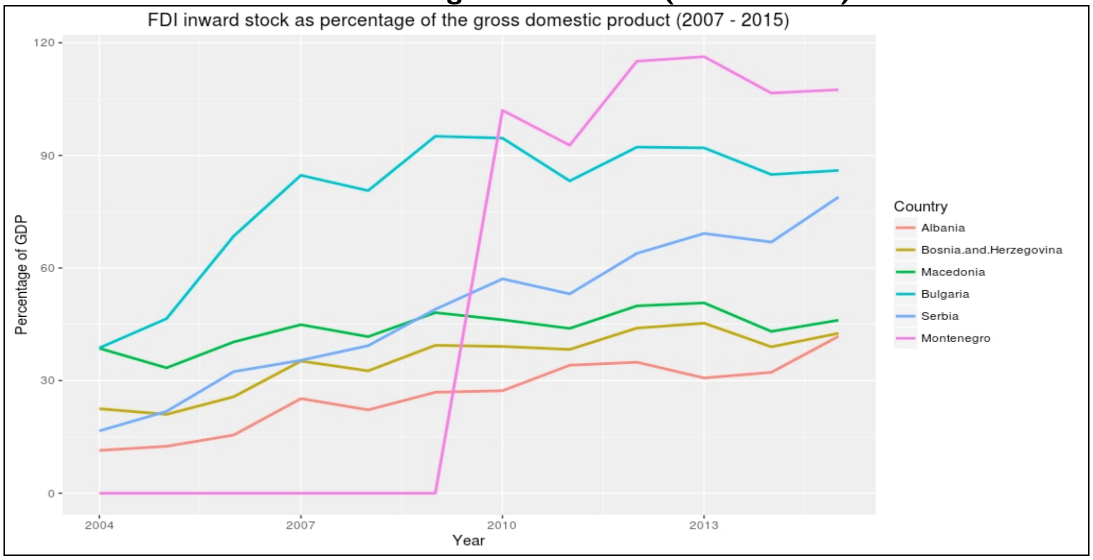
The role of the FDI's for the economic growth of the WB countries is more important than for the countries of the EAEU.

Besides differences between the WB and the EU members, the integration and prospects of EU membership makes them attractive to foreign investors: it promises potential political and macroeconomic stability, opportunities to use strategic location, favorable taxes and low labor costs combined with a relatively well educated labor force.

The ranks of Macedonia in the GCI resulted from special policies designed to bring in foreign savings and boost domestic investment. It is the country with the most elaborate investment incentives: free economic zones, with corporate tax holiday; no customs duties and VAT on imported equipment, raw and construction materials; 0% personal income and property tax for 10 years as well as fee-free connection to utilities; up to EUR 500 thousand subsidies for construction costs, "green" customs channel for export to EU countries; long-term land lease (up to 99 years); and training and job creation grants.

Other countries rely on macroeconomic factors and the EU membership prospect. This simple policy was manifested well by Bulgaria. If one compares Bulgaria with WB, similar trends in FDI stock are evident.

Chart 22: Trends of WB and Bulgaria FDI stock (as % of GDP)



Source: UNCTAD

WB countries accumulated stocks, which almost doubled as share of GDP. (The chart singles out Montenegro is special case: one large privatization and foreigners' investment in the resort areas, while the economy is relatively small.) The trend after the outbreak of the global recession flattens but remains positive. Still, by 2010, the six WB countries had received only around a quarter of the volume of FDI that has gone towards the eight countries of NE and the Baltics.

Most WB countries started attracting FDI rather late, some only after 2003. The share of the eight SEE countries (WB plus Bulgaria and Romania) in total inward FDI stock in the Eastern Europe (excl. FSU) increased from 9.4% in 2000 to 14.7% in 2010, of which 5.8 percent in the Western Balkans and 8.9 percent in Bulgaria and Romania.

By 2010 the FDI inward stock, in comparison to the previous decay (1990-2000), increased in Serbia by as much as 20 times and in Albania by 17 times. The two countries that had a less impressive increase in inward FDI stock during the 2000s were B&H (a six-fold increase) and Macedonia (an eightfold). Serbia has also registered a fall in FDI inflows (not the stock of FDIs) during the 2006-2010 period, but a strong increase in 2011 when FDI inflows almost doubled.

Albania, B&H, Macedonia and Montenegro - have had annual FDI inflows of almost EUR 1.5 bln throughout the 2004-2011 period. Most of these countries have also registered a GDP decline after 2007-2008, Albania being the only exception. The impact of the global economic crisis differs from country to country.

Table 21: Annual WB (excl. Kosovo) FDI inflow in 2006-2010 (USD, mln)

	2006	2007	2008	2009	2010
Albania	325	662	959	964	1,110
B&H	768	2071	982	235	232
Montenegro	N/A	934	960	1,527	760
Macedonia	424	699	587	197	296
Serbia	4,968	3,432	2,996	1,936	1,340
Total	6,485	7798	6,484	4,859	3,738

Source: World Bank

Serbia is the biggest recipient of FDI in aggregate terms, while Montenegro received the biggest share of foreign capital in each of the last ten years in per capita terms. Still, the region lags significantly behind the new EU and its members in terms of FDI stock per capita: the average FDI stock per capita in the WB in 2014 is around EUR 2,600, while in the EU it is around EUR 14,300 (more than five times higher) and is more than two times higher in NE.[60]

Table 22: FDI Stock per capita (in EUR, 2011 and 2014)

	Albania	B&H	Macedonia	Serbia	MNE	WB	NE	EU 15	EU
2011	900	1,120	1,650	2,200	6,900	2,550	5,640	17,800	13,200
2014	1,100	1,240	1,980	2,600	5,900	2,600	6,000	18,200	14,300

Source: IMF WEO.

The next table shows the main sources, by country, of the stock of FDI to the region. Traditionally, the most important investors have been countries like Austria, the Netherlands, Greece and Italy. However, an examination of FDI into individual countries of the region reveals important differences.

Greece holds 26% per cent of FDI stock in Albania, Austria is the top investor in B&H and Serbia (21% and 17% respectively); Turkey is the biggest investor in Kosovo, Netherlands has 22% in FYR Macedonia, while Russia holds 17% of the FDI stock in Montenegro, although its overall share in WB FDI is negligible. However, in order to assess the risk it makes sense to look at the sectoral picture, the role of FDI's in fixed capital formation and country specific situations.

Table 23: Largest FDI stock owners in WB (% 2014)

Foreign investor country	%
Austria	14.6
Netherlands	9.8
Greece	7.5
Italy	7.0
Russia	6.6
Germany	6.4
Slovenia	5.6
Switzerland	5.3
Luxemburg	4.6
Serbia	4.2
Norway	3.7
Croatia	3.4
Turkey	3.0

Source: UNCTAD FDI database and country statistics.

Particularly interesting is 2010, it demonstrates the accumulated stock of FDIs by end of recession.

Table 24. WB inward FDI stock by country 2010: top 5 investors (%)

Country	Top five investors (% of inward stock)				
Albania	Greece - 27.4	Italy -15.2	Austria 13.7	Canada - 10.6	Turkey - 10.6
B&H	Austria - 19.7	Serbia - 18	Croatia - 14.1	Slovenia - 11.2	Russia - 9.6
Macedonia	Netherlands -16.5	Greece - 12.9	Slovenia - 12.4	Austria - 11.1	Hungary - 10.3
Montenegro	Russia – 15.4	Italy – 11.8	Switzerland - 9	Hungary – 8.4	Cyprus – 8.2
Serbia	Austria – 17.1	Netherlands – 10.1	Greece – 9.6	Germany – 9.1	Norway – 8.4

Source: WIIW FDI database, KC2 calculations.

[60] It should be noted that, according to UNCTAD annual FDI reports, the economies of USA and EU are the main directions of FDI inflows in the years after 2013.

Economic Sectors and FDIs in WB

The sectoral distribution of FDIs has been different across the WB countries. This indicator is likely to be important in the longer-term impact of FDI on individual economies. FDI are of main importance for exports or to the generation of new employment.

The table below summarizes the distribution of FDI in sectors of economy for five WB countries (comparable data for Montenegro are not available). The data have been aggregated to present FDI stock grouped into the primary, manufacturing and services sector of the WB countries in 2010 and 2014.

Table 25: FDI stock in WB countries by Economic Activity, 2014 (%)

	Industry	Trade, Transport & communications	Financial & insurance	Real estate	Construction	Agriculture, forestry & fishing	Other
Albania	33	32	17	9	2	0	8
B&H	35	29	21	8	1	0	6
Kosovo	19	16	17	26	11	1	10
Macedonia	48	18	21	4	5	1	3
Serbia	24	28	28	14	3	1	2

Source: WIIW.

The WB have a relatively diversified structure of FDI stock per activity and the sectoral distribution of differs across the region. It is important in assessing the longer-term impact of FDI on individual WB economies. FDI are important for exports or to the generation of new employment. For all the countries except Serbia, there is a strong correlation between FDIs and exports.

By 2010, the services sector accounted for most inward FDI stock in all WB countries, but with substantial variations among them. The services sector represented just over 60% of total FDI stock in the region. Banking, telecommunications, real estate and retail trade have been among the most favored sectors of foreign investors in the region.

Regarding manufacturing, there are even greater differences across countries. Only two countries that have attracted a considerable amount of FDI in manufacturing in 2010 – B&H (35% of the total) and Macedonia (31%). This is in contrast to the lower shares in the other countries – 16% in Albania, 19% in Serbia.

In 2014 the highest shares of FDI in WB region are in transport and communication (Albania and Serbia), manufacturing (Bosnia and Herzegovina and FYR Macedonia), financial services (Serbia, Bosnia and Herzegovina and FYR Macedonia) and real estate, renting and business activities (Kosovo).

Comparison with NE

The share of FDI invested in various services is similar in NE and WB countries: on average 67.7% NE and 69.8% in WB. Although the averages for the two regions are similar, the variations within NE have been much lower than within WB. A share of FDI in services of over 70% was registered in only one NE but ex-Balkan country (Slovenia).

The differences between the two regions are even more pronounced regarding manufacturing.

In the CEE countries manufacturing accounts, on average, for 30% of inward FDI stock, compared to 24% in the WB countries, again with substantial country variations.

Particularly the Czech Republic, Poland and Slovakia have attracted substantial amounts of FDI in manufacturing, well over 30%. This probably helps to explain why FDI has been less an agent of structural changes in WB than in NE.

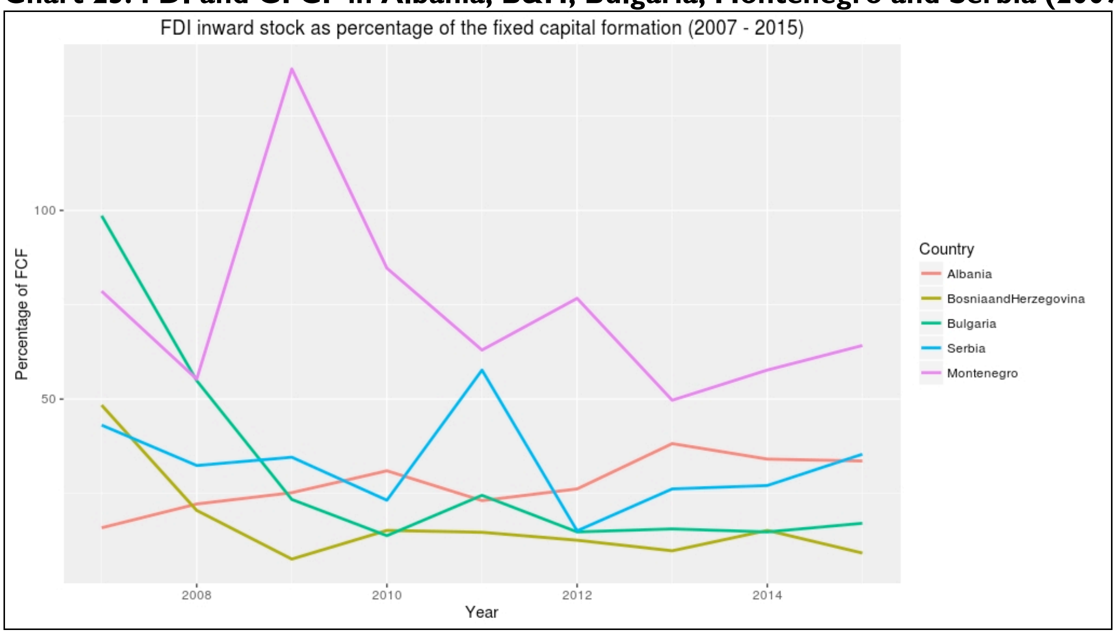
Some countries, notably Albania, have attracted FDI in natural resource exploration. Much of the FDI in all countries has happened in the context of privatizations in sectors intended primarily for domestic consumption, such as financial services and telecommunications. As sources of privatization have largely dried up, countries in the region are focusing on attracting FDI in tradable sectors, which contribute to export capacity rather than domestic consumption.

Throughout the WB, foreign capital has been an important source for financial accumulation, together with domestic savings. In the transition region the ratio of FDIs to gross fixed capital formation has tended to be higher than the world average and has increased over time.

FDI in the WB economies play an important role in the capital formation.

The ratio of FDI to GFCF in the region increased over the 1990s and reached a peak of 16% in 2000, but fell under 10% in 2002-2005, exceeding 10% in 2006 and 2008.[61] Recent data suggest that FDI has contributed substantially to GFCF (gross fixed capital formation). During the 2005-2013 period, the ratio of FDI to GFCF has been, on average, over 30% for the region, but it has been particularly high in Montenegro (over 70%), while in Serbia is over 30%, in Macedonia over 20%, and in Albania and B&H around 18%.

Chart 23: FDI and GFCF in Albania, B&H, Bulgaria, Montenegro and Serbia (2007-2015)



Source: UNCTAD, 2016 FDI Report.

Another important FDI indicator is their share in GDP. The inward FDI stock represented 30% in Albania, 38% in B&H, 50% in FYROM and Serbia and in Montenegro 130%. This is compared to Bulgaria, a benchmark country.

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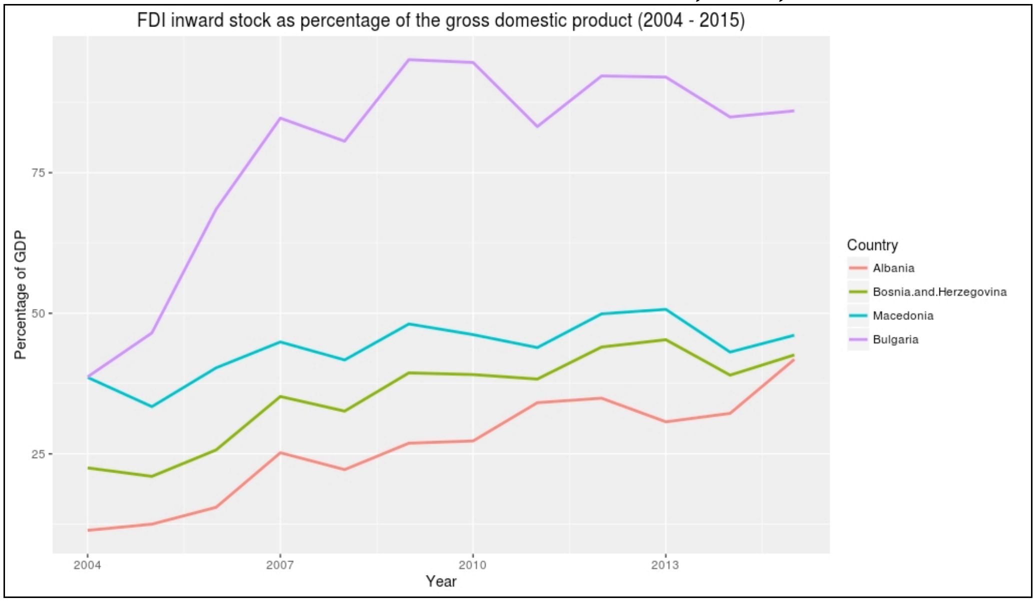
[61] See: Gabor Hunya, A Short-lived recovery: FDI in Central, East and Southeast Europe, Vienna, WIIW, 2012, and Kalman Kalotay, Patterns of inward FDI in economies in transition, Eastern Journal of European Studies, 1/2010.

If we take out somewhat specific cases of Montenegro (one factory and real estate) and Serbia (Russia investment in the oil sector, discussed below) the stock of inward FDIs in the WB as percent of GDP is roughly half of that of Bulgaria.

Chart 24: FDI inward stock as % of GDP in Albania, B&H, Macedonia and Bulgaria



Source: UNCTAD.

Business Environment and Economic Freedom

All WB countries are seeking options to attract higher levels of FDIs. One way is to offer fiscal incentives to investors. A stable and favorable tax climate and incentives for foreign businesses are sometimes deciding, although not always important, factors to invest.

Most WB countries have made significant progress in reforming their tax systems in line with best international practice. During the past decade, tax rates in the region have been relatively stable, there has been a fall in the administrative burden of submitting taxes and efforts have been made towards widening the tax base.[62]

The total tax burden as a percentage of firms' profits in WB countries is lower in comparison with EU countries. The average composition of total tax - profit tax, labor tax and contributions, and other taxes, in the Western Balkans is under 20%. The two exceptions are Albania – 35% and Serbia – 40%. In Kosovo and Macedonia the percentage of taxes in companies profit is under 15 and in B&H and Montenegro is about 20%[63]

Although there are differences among WB countries, their total tax burden is lower than both NE and Old Europe (due to lower profit and labor tax burden).

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[62] See: Zuzana Murgasova, Nadeem Ilahi, Jacques Miniane, Alasdair Scott, Ivanna Vladkova-Hollar, The Western Balkans: 15 Years of Economic Transition, IMF, March 2015, at: https://www.imf.org/external/pubs/ft/reo/2015/eur/eng/pdf/erei_sr_030915.pdf

[63] See: The World Bank's Doing Business database.

Macedonia has one of the lowest total tax burdens in the world – largely because there are no labor taxes (that is, social insurance contributions borne by companies), but also because it levies taxes on corporate profits only once they are distributed as dividends and has low levels of other taxes.

B&H, Kosovo and Montenegro also have a relatively low tax burden. Albania and Serbia are the only countries where the total tax share of profits is almost at NE level of 40%. Regional FDI policy mix is similar to that of Macedonia, described above: it may have a role, but the administrative capacity to implement them credibly and consistently is often weak.

WB have legally created a level playground for all companies: no country has official limits for foreign ownership or such policy (like in EAEU); only production of weaponry requires government approval. Impediments to FDIs are mostly informal or related to the rule of law.

The Heritage Foundation/WSJ Index of Economic Freedom (IEF) summarizes areas that are important for FDIs (100 points would mark a perfectly free country). WB's average score is 63.4 on average in 2016, while the EU is 81.9. The highest ranking country is Macedonia – 67.5 and last among WB countries is B&H – 58.6.[64]

Table 26: 2016 IEF: WB Rankings

	Points total	Ranking	Property rights	Freedom from corruption
Macedonia	67.5	47	35	45
Albania	65.9	59	35	33
Montenegro	64.9	65	40	42
Serbia	62.1	77	50	41
Kosovo	61.4	84	30	33
B&H	58.6	108	20	39

Source: Heritage Foundation.

According to the ranking all WB countries are classified as "moderately free" with the exception of B&H, classified as "mostly unfree." The score in Rule of Law, ranks the region among the "less free" and is defined as "repressed."

Conclusions on the FDI Factors and Reforms

Western Balkans

Generally the FDI in the WB has been influenced primarily by exogenous factors such as size, level of development and geographical position, or by endogenous, policy-induced measures. Given the present unfavorable regional climate for FDI, exhausted privatization opportunities and policy mixes in most Balkan countries and still unsettled political issues, **the return of large amounts of FDI is unlikely in the short and medium term.**

For the Western Balkans both factors, endogenous and exogenous are important.

- Generally, the location of WB countries is more distant from the major foreign investors than the transition economies of Central Europe. WB is relatively remote from investing economies of Western Europe and the USA, and their remoteness is a negative factor.
- FDI and investment incentive schemes invented by economists are implemented in most countries. They have improved the ranking in competitiveness and doing business indexes, especially for Macedonia, but it seems there is little room to maneuver with further incentives.

[64] See: Heritage/WSJ IEF: http://www.heritage.org/index/ranking .

- A more important obstacle is the institutional environment. The Balkan countries have failed to favorably (compared to NE) improve their institutions, regarding the protection of property rights and fight against corruption, thus worsening the overall investment climate. FDIs to the Balkan countries could therefore be further increased by government policies, but this would require a comprehensive institutional reform.
- The WB economies are relatively small in size and the positive effect of local GDP to FDI is negligible. KC2 analysis of FTAs and trade integration has proved that FDIs have a positive correlation to exports (except for Serbia, which stands alone with sizable Russian investment oil sector with a focus on the local market). At the same time, the conventional wisdom suggests that it is more likely that more FDI would be directed to countries with higher levels of rule of law and market friendly institutions.

Taken together all these factors predetermine relatively low investments in the region. On the other hand, institutional quality is closely related to EU membership – EU member countries have more highly developed institutional quality. Thus, the process of joining the EU leads countries to improve their institutional quality. In the same time, the EU tends to admit as members countries with more advanced and developed institutions.

The very announcement of EU membership leads to higher levels of FDI, but this effect is definitely connected with the institutional quality effect. EU membership leads countries to improve their institutions and the EU membership is easily achieved with better institutions.

Taking the above into account: **it is obvious that WB still experience disadvantages associated with recent political history of conflicts and fragmentation**.

The political risk, coming from various unsettled political issues in the region, still seems to exercise a negative effect on FDI, and these effects are amplified by weak institutions and rule of law related deficiencies.

A Comparison with EAEU

Unlike WB, EAEU countries:

- **Impose restriction on foreign ownership in different sectors** (Kazakhstan) **or pursue a policy mix of government control, which creates disincentives for FDIs** (Russia); such restrictions are more typical for the resource economies, economies of Armenia, Belarus and Kyrgyzstan are more open to foreign investors;
- **The banking sector is dominated by locally owned banks, with significant market share of Russian banks; mutual investment is predominantly originating in Russia while foreign non-EAEU capital inflow plays relatively limited role;**
- **EAEU does not provide political incentives to continue market oriented reforms**, **and does not seem to have contributed to more integrated economic space**, outside Russia's dominance: member countries trade more with the world than between themselves, China is like benefitting more from the Union that the members, and the slowdown of the Russian economy has a negative impact on the Group's overall economic performance;
- **Plans for establishing a common currency are apparently put on hold: the EAEU does not satisfy the criteria for an optimal currency area.**

VII. WB ENERGY DEPENDENCY

After the Dayton Accords, Western Balkan cooperation in the power sector was singled out as a priority policy area to reduce risk and attract FDI. The Athens Process on Energy Cooperation and the Southeastern Europe Energy Community Treaty have been in place for more than 10 years (the last country to join was Kosovo, in July 2006). The Treaty's most important role was to set a regulatory framework for energy cross-border trading and gradually integrate the Western Balkans into the EU energy market, thus securing property rights, predictability of intra-regional energy contracts and the possibility to finance power sector related projects.

However, the Energy Community did not reach the necessary administrative and economic level required by EU, for objective and policy reasons.

A. OVERVIEW WITH A FOCUS ON RUSSIA

Russia is the fifth foreign investor in the WB, with 6.6% of the total FDI stock in the region in 2014; German FDI is almost equal to that of Russia – 6.4%. The difference is that, with exception of real estate, Russian investment is limited to the energy sector. After 2014, Russia's share of FDI is declining and it is likely that in 2016 it will become the seventh largest investor.

In general, the primary energy supply structure in the WB is less advanced than in the EU. Coal has a 2.3 times higher share than in EU, while the consumption of natural gas is 50% lower. The EU member states make up for the lower share of coal with higher shares of crude oil, natural gas, renewable and nuclear energy. The higher share of coal (a domestic energy source) reduces energy dependency of the WB.

The reason for the low participation of natural gas in the energy balance of the WB countries is lack of natural gas networks and interconnectors in most countries in the region. Domestic production is low while dependence on imports (mainly from Russia) is increasing.

In the wake of the Ukraine crisis since 2014 Russian policy with respect to the Western Balkans changed. The new Russian foreign policy, adopted in 2013, looks to the region of WB as a high degree of strategic importance.

Russia's dominant position in the energy sector is crucial for maintaining its influence. Serbia, Bosnia, and Macedonia depend significantly on Russian natural gas. Serbia covers more than 75% of its needs with Russian gas. Moreover, Russian state firms control oil and gas production and operate refineries as well as the distribution network.

However, in other energy resources Russia is a less significant player: the markets are competitive and alternative suppliers are easy to attract, except, perhaps, for Serbia.

Russia and Serbia's Oil Production and Retail Market

In 2008-2009, Gazprom acquired 56% of the shares of NIS, which is effectively a total control thereby gaining full control over the oil processing sector (the Panchevo and Novi Sad refineries) and a large market share of the fuel market (82%) and retail (38%). Gazprom also privatized natural gas storing facilities of Banatski Dvor and has a virtual monopoly on oil and gas extraction.

At the same time Serbia has been dependent on fuel imports from Russia at 98.8%.

Apart from the energy sector and oil and gas imports, Russia's role in the Serbian economy has been insignificant. From 2005–2013, Russia invested EUR 598.4 million in Serbia, which is 4.5% of the FDI for the period. This includes also the acquisition of Beopetrol (a retailer) by Lukoil. In other sectors Russian investment is insignificant. But ultimately, such investments translate into a political influence. It is obvious in Serbian defense of the Gazprom's South Stream Project (stopped for violating the EU law) and by the public opinion polls.[65]

47% of Serbs in 2014 believed Russia to be the largest supplier of development aid to Serbia. In fact, 89.49% of funding comes from the US and the EU, and the Russian contribution has not even been included in statistical reports.[66] Due to subsidization policy Serbia accumulates debts to Gazprom (currently estimated at EUR 250 million), not being able to pay for the supplies.

In the Republika Srpska (of B&H), the only Bosnian oil refineries are under Russian control, while a joint venture with Russian majority shareholders holds the exclusive rights in gas and oil extraction. This explains the Russian share in B&H FDI inward stock.

The strategic value of the region comes down to the importance of the Balkans as a transit route. Russia's announcement at the end of 2014 that it was terminating the South Stream pipeline was widely regarded as a setback for its relations with the Western Balkans.

South Stream had been intended to convey Russian gas via Bulgaria and the Western Balkans to Central Europe. Now Russia envisages the construction of a pipeline only to Turkey, but it is still not clear whether there will be continuations to Europe or where they will go. The projects are ill-prepared from a business perspective: the existing capacity of natural gas pipelines are underutilized – by 40 or even 50%, depending on the assessment. Additionally, by-passing Ukrainian infrastructure is costly and alternative supplies of natural gas are gradually being developed.

There is a danger that gas pricing and gas deliveries could be used for political leverage in the Balkans, as was the case in the past with Ukraine. The EU as well as the Western Balkans states are therefore seeking alternative supply sources.

The Balkans are situated in an area which serves as a bridge between energy producing countries and European countries that are major consumers of energy products. The advancement on the path of European integration and the planned construction of gas pipelines, which will reduce Russian influence in the region, will have direct implications for the Balkan countries and for the EU.

Russia is aware of its limited options in the Western Balkans. It is all the more interested in generating political capital by acting as a serious threat to EU integration of the countries in the region. Russia is more amenable to the Western Balkans elites and their self-interest in retaining power than the EU. Therefore, there is backing for the vision of an economy integrated into the EU, combined with a society oriented towards Eastern values and authoritarian democracy.

However, the gas in the energy consumption plays a minor role in the WB region, so energy dependence on Russia should not be over–estimated, but it is still a political risk for the region.

B. DIVERSIFICATION PROSPECTS

In order to diversify gas supplies to WB several projects aim to transport natural gas from the Caspian region into the European markets. Most of the pipelines are designed to pass through several Balkan states' territories.

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[65] See summary of these developments in: Marta Szpala, Russia in Serbia – soft power and hard interests, OSW Commentary, No 150, 150, 27.10.2014, at: www.osw.waw.pl .

[66] European Orientation of the Citizen of the Republic of Serbia, Trends: http://www.seio.gov.rs/upload/documents/nacionalna_dokumenta/istrazivanja_javnog_mnjenja/opinion_poll_14.pdf .

One of the main pipelines, which will transport gas from Azerbaijan into the European market, is the Trans Adriatic Pipeline. According to the official site of the project, TAP will serve the transportation of natural gas from the Caspian region to the European market. Connected to the Trans Anatolian Pipeline (TANAP) in the Greek-Turkish border, TAP will pass through northern Greece, Albania and the Adriatic Sea up to southern Italy where it will be connected to the Italian network of natural gas. TAP is a part of the Southern gas corridor and will provide a direct and cost-effective passage to transport gas from the Caspian Sea to Europe. TAP is a project that includes a number of important companies, such as SOCAR, Statoil, BP, Fluxys, Enagas and Axpo.

The project's initial capacity will be 10 bcm per year, which is thought to double over time. Beside TAP's importance to the European market, this project will have a direct impact on transit countries. Greece, Albania and Italy will have strategic benefits from TAP by insuring an important position in the European energy map.

For Albania TAP will be the largest Foreign Direct Investment up to date and will also affect EU integration through increased regional and geo-strategic importance. TAP also might improve the Albanian infrastructure as well as internal energy market.

Chart 25: Map of Balkan Pipelines

Such projects will directly affect the diversification of EU energy sources and will reduce Russian gas dependency, a necessary element for increasing the level of energy security for the region. This does not mean that the WB will be independent of Russian gas in the future, but it can serve as a tool to lighten Russia's monopoly and influence, and at the same time increase the Balkans' geopolitical importance.

Since there has been a reduction of gas reserves in the North Sea, one of the main sources of energy for Europe, the diversification of energy sources for Europe has become a necessity and the Caspian region can play a key role in this aspect. The planned energy projects, whereby gas will be transported from this region to Europe, will pass through the Balkans territory. This would increase the Balkans role and importance in the European energy map.

The WB is increasingly being viewed as a potential transit region of gas supplies to the European Union, with implications for developing gas infrastructure in the region. The key project, as already mentioned, is the Trans-Adriatic Pipeline, but in addition, the construction of the proposed 5 bcm Ionian Adriatic Pipeline (IAP) from Albania through Montenegro and B&H to Croatia is planned and would have the capacity to add further supply to markets throughout central and south-eastern Europe. The plan is to link the pipeline to a liquefied natural gas (LNG) terminal (with a possible capacity of 15 bcm) on the island of Krk in the Northern Adriatic, a project that has been seen by the European Union as a priority with respect to energy security.

Lastly, the region has significant potential in offshore resources, which could come into play in the longer term. Montenegro opened its first offshore bidding round in 2013 with three international oil and gas consortia replying to a tender.

Private companies, including Petromanas Energy and Royal Dutch Shell, are also currently exploring oil and gas production onshore in Albania, while three other companies (San Leon Energy, Emanuelle Adriatic Energy Ltd and Orion Energy) are exploring offshore.

These projects will have geopolitical and economic implications. Geopolitical implications are associated with the increased importance of the Balkans to the EU, which will serve as a motive for better integration.

On the other hand, regarding the economic aspects, it should be highlighted that since the Balkan countries are transit countries, they will have direct revenue as a result of taxes, an access to a power source with a more favorable price, and medium and long term employment. Geopolitical and economic implications will be associated with a direct impact on other aspects related to the stability, development and prosperity of these countries.

C. ELECTRICITY SECTOR IN WB COUNTRIES

WB power sector has been characterized for many years by poor management, under-investment and low efficiency.

Some projects are underway or in preparation that have the capacity to transform the region's energy supply and change the overall picture in the sector. Private sector involvement is increasing, especially in the field of renewable energy and the building of new energy facilities. At the same time a process of modernization of the existing energy infrastructure gives hope that will overcome the lag in industry and will make the region more attractive to investors.

Table 27: Net capacity of electric power plants in 2014, MW

	Total installed capacity (MW)	Hydro power (MW)	Coal-fired power plants (MW)
Albania	1,800	1,730	-
B&H	4,000	2,100	1,900
Kosovo	1,215	45	1,170
Macedonia	2,018	663	800
Montenegro	880	660	220
Serbia	7,000	2,900	3,850

Source: South-Eastern Europe Energy Community.[67]

[67] See: https://www.energy-community.org/portal/page/portal/ENC_HOME/MEMBERS

In the production of electricity, coal and hydro power are the dominant energy source, accounting for more than 96%.

Though those countries with a predominant share of coal have large reserves of this energy resource, an increase in the use of natural gas and renewables can be expected in the future, due to ecological requirements and the need to reduce CO^2 emissions.

At present, the region has a net maximum electrical capacity of about 17,000 MW, almost evenly divided between hydropower and thermo-power plants (coal-fired and less gas/oil-fired). Power production from renewables, other than certain types of hydropower plants, is negligible.

Table 28: Production and Consumption of Electricity in WB Countries

	Total electricity production GWh	Total electricity consumption GWh	Import GWh	Export GWh
Albania	4.726	7.815	3.356	
B&H	15.030	12.210	3.000	6.000
Kosovo	4.900	5.400	.960	.490
Macedonia	4.982	8.026	3.073	
Montenegro	3.000	3.300	.800	.500
Serbia	32.150	34.100	3.100	1.080

Source: South-Eastern Europe Energy Community.

Albania, Macedonia and Kosovo are electricity importers, Montenegro and Serbia have a relatively even electricity balance, while B&H is the only power exporter in the region.

Serbia has the largest install production capacity (about 7,000 MW), with almost two-thirds of it being based on coal-fired power plants. Bosnia & Herzegovina is the region's second largest electricity producer, with an installed capacity of about 4,000 MW, equally divided between hydro and coal-run power plants. Bosnia & Herzegovina is at the same time the largest electricity exporter in the region, with substantial electricity resources still unexploited. Albania and Macedonia each have a production capacity of about 2,000 MW. However, while Albania gets its power almost entirely from hydro, the production mix in Macedonia is more diverse, including hydropower plants as well as coal-run and gas/oil-run thermo-power plants. Kosovo (with an installed capacity of around 1,200 MW) gets almost 100% of its production from coal power plants, while Montenegro (which has around 900 MW) relies on coal for almost one-third of power supplies, with the rest coming from hydro resources.

The potential for increasing power production capacity and energy efficiency lies in several directions. First, significant energy projects are under construction or in progress. The construction of a high-voltage underwater electrical cable connecting Italy and Montenegro will open up the region's markets for exporting electricity, and further investments in the sector. This EUR 775 million project, led by the Italian transmission system operator Terna and the Montenegrin electricity company, and supported by the EBRD, is expected to be operational by 2017.

Major improvements can be expected in the field of energy efficiency. Losses in distribution account for at least 10% of gross electricity consumption in all Western Balkans countries, but the problem is especially dramatic in Albania and Kosovo, where the losses in distribution (mostly due to theft and mismanagement) account for more than 30% cent of gross electricity consumption.[68]

Losses in transmission are also significant, though they are lower than losses in distribution. Electricity supply is regarded as a key obstacle by businesses in Albania and Kosovo as the outages are frequent and the region ranks poorly on this indicator in the World Bank's *Doing Business* global rankings.

Regional cooperation in the energy market is still limited. The market is fragmented and there is no constant coordination among countries in the region. Fortunately legislative harmonization has begun in recent years, with the Energy Community having the central role in promoting sectoral reform and integration into the EU internal energy market. In addition, the efficiency of the regional electricity market has recently been enhanced with the creation of the regional Coordinated Auction Office in Montenegro. The development of a full regional market will be supported by strengthening inter-country linkages, establishing power exchanges and a regional balancing market. WB countries have agreed to a list of several investment projects, including power interconnectors and reinforcement to the region's power transmission system.

Renewable Energy and Energy Efficiency

Despite improvements in policy and regulatory frameworks in recent years, the region is still facing some constraints in attracting investments in the energy sector. The main interest is in the field of renewable energy and energy efficiency.

Attracting investors in order to fund renewable energy projects is still challenging: there are no clear regulations and transparency is lacking. Policy reforms need to be integrated into long-term energy strategies. Achieving policy credibility, transparency and stability is a priority in almost all Balkan countries. Weak governance, inefficient government bureaucracy, corruption and frequently changing policies are just one side of the picture. At the same time complexity of government structures is an obstacle to foreign capital. Lack of information between different levels of administration, including agencies and institutions, is a serious problem in all countries.

For instance, in B&H, there is no legislative framework for renewable energy at the national level. The regulatory mechanisms are in power of two institutions – the Federation of B&H and Republika Srpska, both with their own targets and different laws regulating renewable energy.

Another problem which hampers investors is obtaining permits and licenses. In Albania, there are issues related to defining land ownership combined with multi-layered control authority of state water companies, local and national agencies, requiring numerous permits, authorizations and licenses. Starting an energy project is a long and bureaucratic process, especially for a foreign investor.

The next problem comes from a lack of skilled and experienced personnel in the power sector. This is particularly evident at administrative, as well as at project planning levels. The potential of renewable energy is not politically recognized in WB, despite its significant importance in the region, where more than half of electricity is produced with low quality coal.

All six Western Balkan countries have made some progress in aligning their regulations and operations with the EU standards, but energy systems in the region are fragmented, and cooperation between them is practically lacking. Most markets suffer from power shortages and electricity imbalances, which means that they can largely gain from a regional integration and cooperation of markets.

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[68] See: South-Eastern Europe Energy Community: https://www.energycommunity.org/portal/page/portal/ENC_HOME/MEMBERS).

The coordination and integration of energy markets could allow to diversify energy mix and to optimize production capacities. The small size of all markets in the region coupled with their low energy density allows for little and almost no opportunities for economies of scale in production.

Besides these regulatory risks and small size of the markets, political instability in some of the countries in the region create a perceived risk of possible spill-over effects in all Western Balkans countries.

For the countries of the Western Balkans, the clear perspective of EU membership is a key stabilizing factor. At the same time, continuous efforts are needed to tackle bilateral issues in energy sector among WB countries and EU.

D. CONCLUSIONS REGARDING THE POWER SECTOR

- FDI in the sector, originated from state-owned or private companies from the Russian Federation and their subsidiaries companies are significant; not as whole, but as control of an important economic sector for individual countries like Serbia and Republika Srpska. This translates easily into political influence in those countries and, as bargaining strength on an international level – for countries which depend on imports of electricity from these two countries.
- **The overall dependency on energy resource from Russia is relatively insignificant problem by itself** – the **domestic consumption is relatively small**, and, except for natural gas, both domestic and alternative imported supplies are available at a relatively lower price than in previous years; on the hand, the **diversification is technically feasible, with committed finance, and economically beneficial**.
- The investment needed to improve the energy distribution networks of the WB (both oil and natural pipelines and electricity distribution grids) is large, given the size of the economies. It can compensate for somewhat missing FDI, especially Greenfield FDI. **However, the process of harmonizing the legal frameworks has just started and can be delayed for political reasons.**

E. FOCUS ON BANKING SECTORS: WESTERN, ITALIAN AND GREEK BANKS

Introduction: Typical Benefits from Banking in NE and the WB

Since mid-1990, first in Central Europe and the Baltics, and then (after 1998 in Bulgaria and Romania) western European banks have gradually penetrated and reformed the banking industry in the reforming post-Communist Europe.

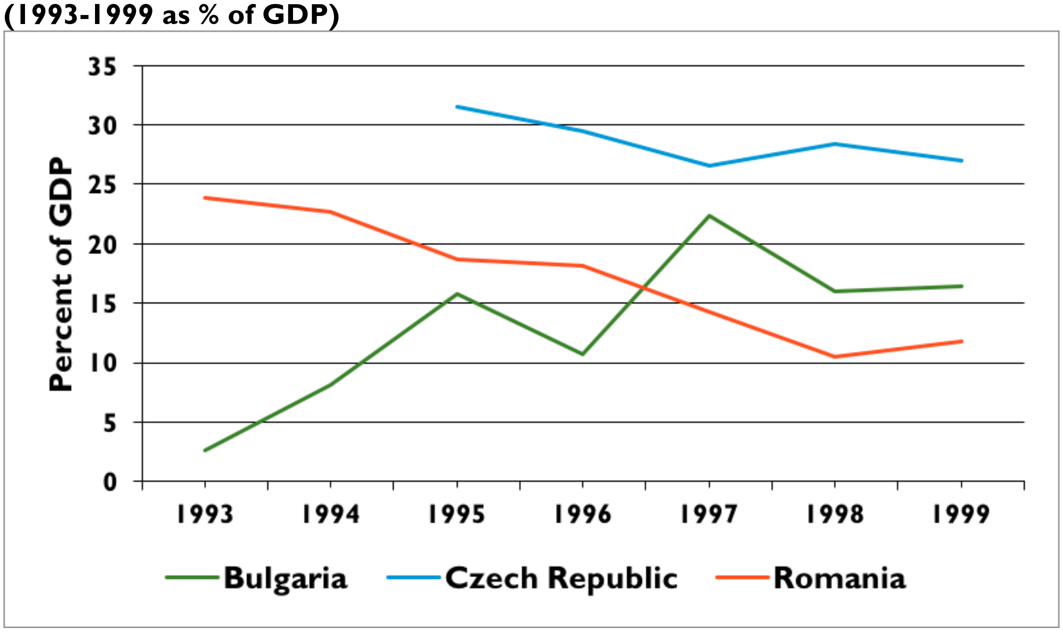
Benefits

This development was instrumental in providing the following benefits to their shareholders and the economies they serve, arranged here in historical order.

Firms and citizens in the transition countries gained security and confidence for deposits in the aftermath of high inflation (or even hyperinflation) periods, in which, at least in some countries they lost their savings.

A typical picture of 1990s gross national savings rate (GNSR - national gross disposable income minus final consumption) is presented by the benchmark countries of this analysis.

Chart 26: National GNSR in Bulgaria, Czech Republic and Romania (1993-1999 as % of GDP)

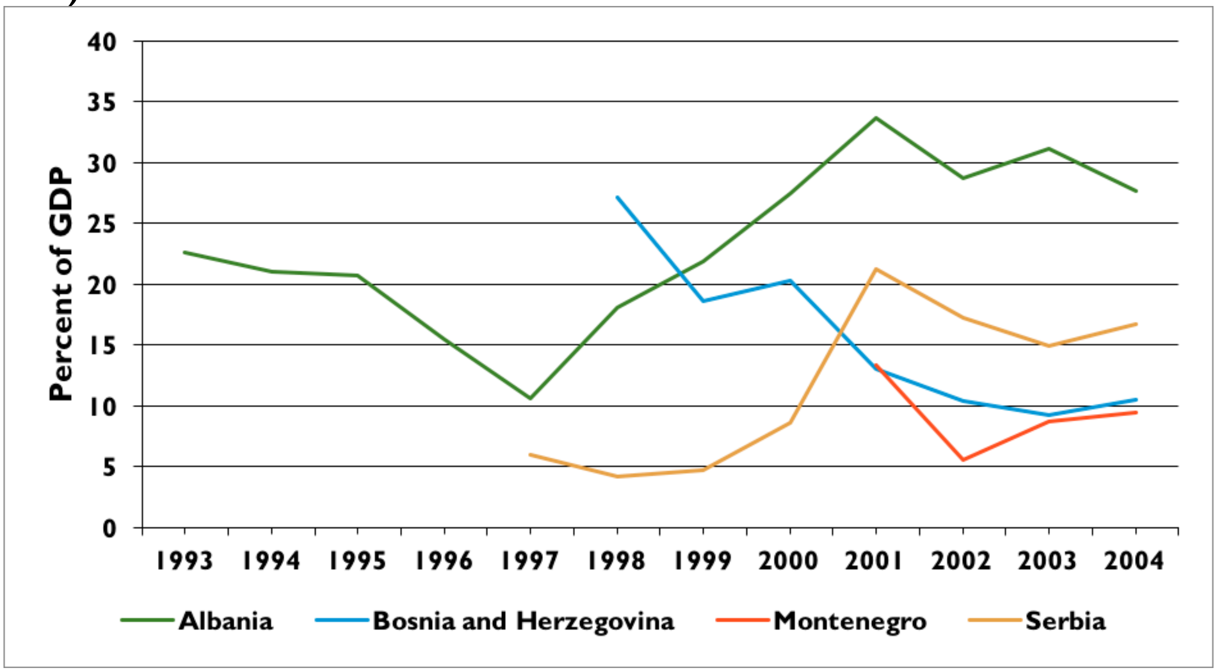


Source: IME WEO

Part of the picture is the loss in household savings, which is a benchmark to measure political risk. In fact, household savings rate (typically in a national currency) was affected more severely in 1990s than national saving, which include firms and government accounts. There is no comparable data, but it is estimated that hyperinflation in 1996 – 1997 Bulgaria (combined with a bank bankruptcy) reduced the household savings from 18 to 6% of GDP. Similar was the effect of prolonged inflation period in Romania. In the Czech Republic households were affected by the bank crisis of 1997 (where state-owned banks were custodians of the privatization funds, while enterprises in their portfolios were making losses before being restructured, resold or bankrupt) resulted in about 40% loss of household savings.

The process of economic restructuring in WB was longer and more challenging, here is the situation for WB countries for which there is a comparable data.

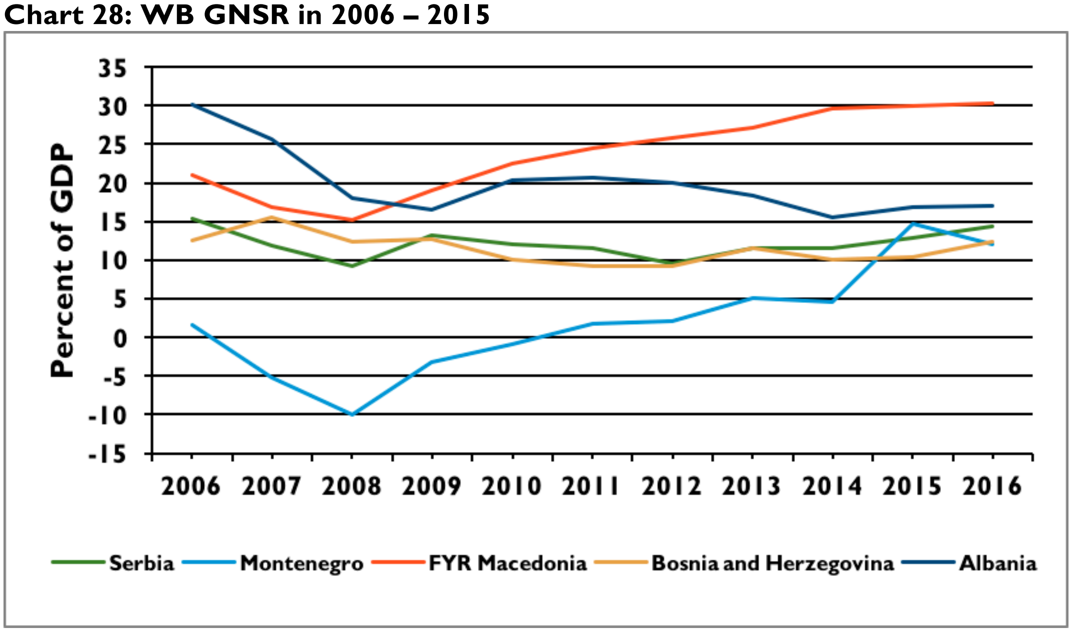
Chart 27: National GNSR of Albania, B&H, Montenegro and Serbia (1993-2004)



Source: IMF WEO

In the period from 1993 to 2004, WB GNS were at the lowest levels except for Albania (where in 1997 it was affected by the collapse of the pyramid schemes). Then, before and after the recession of 2009, the countries' GNS were not affected. The rate for Montenegro is negative for pure accounting reasons caused by the re-registration of banks and separation of national accounts from Serbia.

Chart 28: WB GNSR in 2006 – 2015



Source: IMF WEO

In addition to security of saving, the foreign banks in post-Communist Europe provided numerous services with better quality than domestic, often still state-owned banks in the period before EU integration:

- They served cheaper, faster and better international payments needed for the reorientation of trade and economic integration;
- They provided cheaper and easier access to credit, and by competing for local customers, they reduced the interest rates in the reforming economies, while the interest arbitrage secured prospects for reasonable profitability or the lenders themselves;
- They engineered virtually all innovations, diversified services and improved the standard of customer relations; improved the standards of information and credit risk analysis;
- The very presence of foreign banks improved banking supervision, for the simple reason that a) supervisors cannot "go fishing" with bank owners and b) shareholders and mother-bank supervisory bodies expected higher risks and had an interest to prevent it.

The likelihood of arbitrage and profitability attracted Western European and sometimes global players into the banking sectors of all emerging post-Communist markets. By all available estimates their share in total banking sector assets in these countries is higher than 50%, for some countries, it was about 80% until 2007, while in B&H and Lithuania it is estimated to be even above 90%.

Threats

The process had costs as well. In some countries, like Estonia and Hungary in early 2000s the foreign bank access to cheap resources was one of, although not the most important, the factors in the mortgage lending boom and house price bubbles. An element of this is to be observed in many other economies. In the aftermath of the 2008 crisis, there were concerns that foreign banks would withdraw funds from their international subsidiaries in order to cover losses in developed economies.

None of these materialized in any significant measure because the banks were foreign, although often balance sheets of subsidiaries branches (not so much of banks registered as local legal entities) shrank in 2009-2011 and eventually, in the post crisis years some withdrawals had taken place from all subsidiaries.[69] Bank bankruptcies and, notably, bailouts at the expense of the taxpayers are rare events in New Europe. In fact, the indirect bailout happened via IMF and EU support for the balance of payments of countries that experience withdrawal.

In Hungary a sum equivalent to 37% of GDP was withdrawn by foreign banks, followed by Latvia with an equivalent of 36%, Slovenia - 32%, Lithuania - 22%, and Croatia - 14%. This happened for a period of five years (between 2009 and 2014).[70] The fact that most of NE countries recovered from recession hints that a combination of national and international factors led to the events. For Hungary, one of the explanations is the deliberate policies to increase fiscal deficit in 2003, on the eve of EU entry. While for Slovenia the government' majority stake in the system and the lack of structural reforms in the enterprises played a role.

The global recession and domestic factors certainly had a significant negative impact on banking and credit. As a special IMF report of credit institutions in these countries points out: "Before the 2008–

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[69] Vukan Vujić, Internal capital markets and crisis transmission: evidence from foreign bank subsidiaries in CESEE, Osterreichische Nationalbank, Focus of European Economic Integration, No 3/2015, p. 10.
[70] See: CEE Banking Sector: 2015 as a transition year, Raiffeisen Bank, 10.06.2015, at: https://www.rbb.bg/en/news-and-media-center/news/2015/cee-banking-sector-2015-transition-year/ , Banking in Central and Eastern Europe and Turkey: Challenges and Opportunities, ECB, January 2013, and IMF, Mind the Credit Gap.

2009 global financial crisis, private debt stocks across CESEE increased much faster than GDP, opening credit gaps, whereby the debt-to-GDP ratios are lifted well above their long-term trends. In the aftermath of the crisis, many countries came under pressure to realign their debt levels with economic fundamentals, resulting in simultaneous deleveraging, which exacerbated the overall decline in economic activity."

In the following section the analysis separates domestic factors and indicators from risk associated with regional exposure of western banks.

Western Balkan Peculiarities

In the NE, there is diversity in the structure and dynamics of foreign ownership of banking sectors.[71] In Slovakia and Estonia it was 99% in 2008 but somewhat declined in the following years. In ex-Yugoslav Slovenia, the foreign ownership of banks is lowest in NE – approximately 30%. In NE, the foreign ownership of banks is high as a share of assets but diverse by country of origin. In the WB, the ownership structure of foreign banks is relatively concentrated: Italian and Austrian banks are very present in Croatia; Greek, Italian, and Austrian banks - in Serbia; Dutch and Greek - in Macedonia.

The banking sector in the WB sustained certain specifics. Some of the common developments are probably rooted in tradition: Yugoslavia as early as in 1960s decentralized the banking system, creating sectoral banks; by mid-1970 central bank credits virtually disappeared, the economic activities become autonomous and were intermediated by these banks, and the banks of Serbia and Croatia (as republics of Yugoslavia) dominated the market.[72] Then still Communist, Croatia was decentralized only in the second half of 1980s and banks became autonomous only after 1991, with the start of the reforms.

What the WB have in common with NE is the expansion of the large European banking groups, which, after entering the region, were there to stay. The effect to the systems is also comparable to NE: transfers of know-how, methodology and best practices were implemented, providing the subsidiary banks with a shortcut to the state of-the-art business of the advanced markets.

Although the entire system is "pulled" ahead by the pioneers and the standards generally improved, the level of transparency for example is still uneven and subject to other, probably local factors, related both to the background and/or the current events in the country. The other side of that coin is also related to the national aspect – the local competitors, which in most cases were and are much smaller (both in terms of market share in assets and coverage) are challenged or will be challenged by a discrepancy with the significantly more demanding EU market.

Apart from the EU banking groups, there is a presence of Turkish and Russian banks, which is far from dominating or even determining (even in Kosovo where 3 out of 10 banks are Turkish, their combined assets are around 11% of the total assets in the system). Strategic or not, their investments in banks from the WB could be connected to the structure of trade relations compared to European banking groups whose expansion in the beginning and throughout the first years of the new century was "group policy" rather than a segment driven one (even though exports of each of WB country are primarily with the EU, its significance to the overall trade of EU is negligible).

There are also stand-alone foreign investments in banks which together with the locally-owned banks could be driven by interests in select economic sectors. With locally-owned banks it is not uncommon that the bank was or still is owned by a joint-venture of companies with a common background or

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[71] See overview: Sandra M. Leitner, Financing constraints and firm growth in the NMS-10 and the Western Balkan countries – a comparative analysis, p. 11.

[72] See: Predrag Cetkovic, The Role of Banks in Economic Development in the Former SFR Yugoslavia, WIIW, 2015, p.4.

business interests, which in some of cases is a post-Yugoslav phenomenon, in other instances it has roots in the segment-servicing model of the planned economy after WW2, and in other cases, dates or times, when financial institutions emerged as bottom-up, "self-made" co-operative associations and/or mutual funds.

Conclusions on Risks Associated with Banks

The average foreign ownership of banks in the region is above 80%. Often Italian and Austrian banks control around 50% of the total assets in most of the countries of the region, except for Montenegro. The details per country are provided in the Annex 1 to this Report.

At the same time, except for Croatia in 2009-2013 **there is little sign of an intention to withdraw funds from the WB**. It is easy to explain why, and **the explanation is in the relatively high levels of NPLs to GDP and the interest arbitrage opportunities**. Excluding Kosovo, the best WB country performance using this indicator is still less than half that of the EU average.

It turns out that there is a temporary benefit of the situation:

a. This is **not "Italy" that owes money to "WB: WB companies and individuals must repay their credits to Italian and Austrian institutions**;
b. Due to risk assessment reflected in the interest rate, **the profitability of the banks in WB remains high while costs of refinancing (because of the ECB policies discussed above) go down**;
c. **There is at least a temporary incentive for banks to attract additional clientele and restructure the outstanding NPLs**, utilizing the arbitrage opportunities.

There are no bank bankruptcies in the WB and in the wider region. One bank in Croatia recently had its license revoked of its license without an explanation. Another bank, in Bulgaria, the fourth largest, was effectively robbed and bankrupted by its shareholders and political supporters. **The bank was locally owned, managed as a sole proprietorship and capitalized through channeling accounts of still state-owned enterprises (mostly power sector monopolies). None of this is likely to happen with a foreign owned bank managers: their institutions are better supervised and their owners would not conspire with local politicians** – it is too costly. Reporting standards of foreign banks in the WB are much higher than those of the locally owned banks.

There are two cases of consolidating ownership of Greek banks – one in Bulgaria, and one in process – in Serbia. These issues are addressed by the players in respective sectors, and have no impact on the taxpayers or the economy: the scope of the assets involved allows for such solutions.

As discussed in the section of imported monetary risks, **the adherence to the classic banking system still makes sense, as it is obvious from the example of B&H**.

More importantly, the **B&H example demonstrates that independent monetary policies make little sense in small open economies**. **The counter-example is Serbia**: the attempts to manage investment (FDIs) and quasi-independent central bank policy resulted in high levels of NPLs and under-potential economic performance.

Previous experience with inflationary policies substantiate the belief that pegging domestic currencies to the Euro is just the best of all available options.

Plus, the recent history of trade relations and economic development proves that this strategy pays off. However, **in the medium-term QE policies of ECB may, in the Balkans, lead to misallocation of resources and create incentives for government borrowing.**

Understanding the Background of Italian Bank Crisis

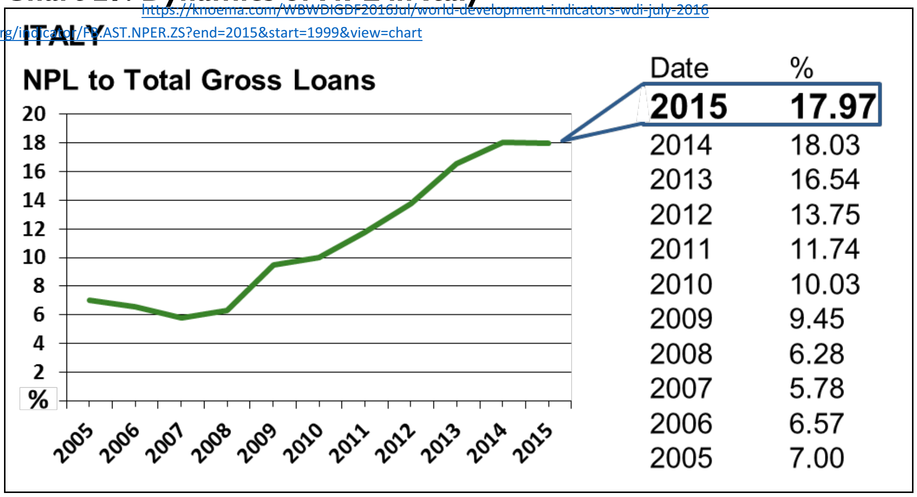
To outline the odds of possible Italian banks in WB and elsewhere, one needs to understand the issues these banks face "at home".

Italy's non-performing loans' share to GDP, in number and value has been rising steadily in the past 9-10 years, for the fundamental reasons and that the banks' strategy has been to operate abroad, for compensation.

Chart 29: Dynamics of NPL in Italy

https://knoema.com/WBWDIGDF2016Jul/world-development-indicators-wdi-july-2016

http://data.worldbank.org/indicator/FB.AST.NPER.ZS?end=2015&start=1999&view=chart

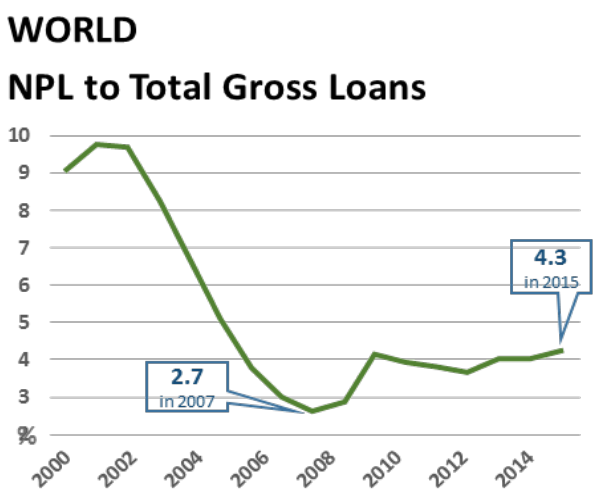


Source: World Bank WDI

While the world's average (after a significant decline in the previous 5-6 years) value of the nonperforming loans of the total gross loans started slowly increasing from 2.7 %, in Italy a steep upward trend started at the much higher level of 5.78%, again in 2007.

Currently Italy's NPL (17.97%) is a little more than 4 times higher than the global average in the (4.3%).

Chart 30: NPL in the World: 2000-2014



The root causes are hard to summarize as the Asset Quality Review (AQR) that has carried out regularly in the past few years might reveal flaws in the portfolios. They could never become transparent enough to track the root causes behind the risk management of each bank (for confidentiality reasons) and track the prescribed corrective measures de-skewing each snapshot of the AQR-testing (while the results interpretation could be influenced by bank, central bank and economy-level considerations).

It is certain that the Italian banking sector reflects the situation in the economy, which is a core factor motivating banks to expand internationally.

Chart 31: Italy's Dynamics of per capita GDP (at PPP, EUR thousand)

http://www.tradingeconomics.com/italy/gdp-per-capita-ppp

It's easy to see that while the NPLs were climbing, the trend of GDP-based indices was inversely proportional – declining. Italy's GDP per capita, adjusted by PPP, is equivalent to 189% of the world's average (in USD): since a peak in 2007, it regressed by approximately 9% to 2016, back to 1997 levels.

The SME business which takes significant part of the contribution to the Italian economy is often "blamed" for contributing to Italy's debt pile, being vulnerable and susceptible to crisis like the one of 2008-2009. Another factor is the slow and costly bankruptcy resolution in Italy. It is not helping banks, so the banks help themselves and resort to off-court procedures and seek profitable compensation internationally.[73]

What is different from the NPL crisis in UK, Ireland and Spain is that these where largely mortgage loans i.e. property (even marked as toxic) is involved. It not only has actual worth but a market for distressed-debt would be more flexible.

Other measures are applicable – transferring the bad debt into a "bad-debt" banks, releasing the rest of the assets off the toxic ones so that they can continue to operate (of course upon magnified risk management control) and with no rush or panic, diligent selling could be carried out. In Italy's case the loans are under-collateralized or uncollateralized loans to small businesses.

So far the market of distressed debt is not as active as is necessary to be a solution and the IMF's idea of how to "build" a full-bodied market in NPLs is unclear, as is whether implementation is feasible, and if so how. Additionally, another thing that has changed since the previous bank crisis is the newly tightened European (January 2016) rules on guaranteed deposits (up EUR 100 thousand) and particularly the requirement that the holders of subordinate shares and sometimes the senior creditors should take loss before public funds can be used (either national funds or European Stability Mechanism (ESM) funds), i.e. a bail-in is a prerequisite for bail-out. So far the European commission's signals were very firm that no

[73] On bankruptcy procedures, see: http://www.cnbc.com/2016/09/03/demand-to-buy-italys-nonperforming-loans-is-growing-bpms-rossi-says.html

exceptions to those rules should be allowed, although ECB itself would rather support a bail-out scenario on which the Italian government still insists.

On the horizon, there is also a peculiarity involved with the nature of the central bank of Italy (Banka di Italia): at the end of 2016 the transition period expires by which the ceiling of no more than 3% shares in the Central Bank per shareholder shall be reached - a requirement stipulated by law in the beginning of 2014.[74]

In January, this year, the government named the price at which individual Central Bank shares should be sold. This is a veiled bail-out as the biggest shareholders were the two biggest lenders in Italy (and now with largest NPL expositions) – Intessa Sanpaolo with 42% and UniCredit with 22% shares in Banka di Italia.[75]

In the current stagnant situation, two factors could be outlined as possible influencing forces – the upcoming referendum, which has no compulsory effect but may have other effects as the Italian Prime Minister Mateo Renzi "pledged to resign if the public does not agree to his proposed reforms". And the other is that if the Italian government keeps on insisting to be allowed to bail-out banks (if it survives the vote in October), the European peers and particularly the to-be German government which will find itself in a complicated situation regarding the matter too (vis-a-vis Deutsche Bank) more responsive to working around the bail-in rule request.

"Risky" Bank Owners: Greece, Italy, Turkey, etc.

Greece

The Greek banks in WB have relatively sizable stakes in Albania and Serbia (13-14%) of the total bank assets. In Albania, this is the 180 thousand people strong Diaspora in Greece which uses the Greek banks as a custodian of income earned in Greece and for remittances. In Serbia, as far it is possible to judge, the Greeks banks remain part of the system.

The above reasoning on **temporary factors that prevent funds' withdrawal finds a confirmation in the recent (and to some extent ongoing) Greek crisis**: Greek institutions, most of them with new owners are very cautious of cashing-out and run away strategies. **They wish their debtors to perform well and act as system stabilizers**, especially when their daughter-institutions are locally registered entities. **Also, address the flight of Greek capital, in the last two years Greece is a world champion with a level of outgoing FDIs of about 30% of GDP**.[76]

The case in point here is Bulgaria: in 2008 Greek banks held about 22% of the saving and 25% of the credit, no funds withdrawal ever took place, bank-health indicators of these institutions were above the Bulgarian average (and Bulgaria itself had bank indicators sometime twice better than EU average – especially in terms to saving to loans ratios, level reserves, and capital adequacy). Only in 2015 one Greek bank was sold by its new owners to a Canadian buyer.

Italy

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[74] See: Banka di Italia, Rules of shareholding capital: (https://www.bancaditalia.it/chi-siamo/funzioni-governance/partecipanti-capitale/index.html?com.dotmarketing.htmlpage.language=1

[75] See: Intesa & Unicredit stake in the Central Bank, Reuters: http://www.reuters.com/article/intesa-unicredit-centralbank-stake-idUSL5N0L53LR20140131 . For them the measure was at least Safeway through the AQR stress tests (practically holding a direct deposit by the Central Bank), as the only other bank with a stake in the central bank exceeding 3% is Monte dei Paschi di Siena and Banca Carige (which as a result of the latest stress tests turned out would have the greatest" difficulty to overcome adverse economic conditions").

[76] See; UNCTAD Country FDI Profiles.

In the WB, Italian banks combined with Austrian (which is also Italian UniCredit Group) have more than 50% share in the total bank assets. If there is risk, it would materialize in Croatia.

There are two options: the one is the above reasoning of the "window of opportunity", the other one is to become preoccupied with the "home dilemmas" of bail-in or bail-out initiatives of the Italian government and Central bank.

The first option is "business as usual": NPLs (16.8% of the gross credit) in Croatia are above the levels of Kosovo, B&H and Macedonia, the trend seems to be worsening but still seem manageable. A closer look at Croatian challenged banks shows that smaller banks could be forcibly closed or consolidate. For the above listed benefits (supervision and innovation), foreign banks, particularly Austrian and Italian groups in the country seem less risky and more trusted by the public.

It is very likely that clients of Banka Splitsko-Dalnatinska (BSD) whose license was revoked would "flee" to those groups. BSD is a very small bank (way below 1% of the total assets.

The resolution of the "home dilemma". If Italy goes into the bail-in resolution it would need the opportunity to arbitrate, which, in case of Croatia and the WB, not only has an interest rate but an additional institutional dimension – the collateral is typically property, and contract enforcement procedures are faster and with greater recovery rates, particularly in Croatia.

The bail-out option, resolutely advocated by the PM of Italy, leads to wait-and-see strategy for UniCredit, it likely to keep its Croatia and WB exposure for the reasons already explained, and seek options to improve the quality of its assets and business at home.

Russia

The largest Russian bank is in Serbia, with a share in total assets of 3.62% the next "big" Russian presence in the WB is in Croatia – with 2.5%.

It is likely that these banks serve as a payment conduit for Russian enterprise and trade (as well as capital income) in these countries flight and, perhaps, in the region – Republika Srpska and B&H Federation.

In general, however, the free-trade agreement did not produce any positive development, in fact traded volumes, and exports from Montenegro and Serbia with/to Russia went down in the years after the agreements were enforced.

Before the annexation of Crimea, Russian bank access to cheap resources was facilitated by foreign loans and bonds. This source of financing virtually disappeared by the end of 2014.[77] It is not likely that the Russian investment will resume at the pace of Serbia in 2008-2012.

Turkey

Turkish banks are present in the region due to increased trade, especially after 2001. Turkey has unilaterally liberalized its tariffs with the Western Balkans which opened some prospects for Turkish FDI. The total FDI inflow from Turkey is represents 3% of all the Balkans near abroad, not only Western Balkans.

Greek banks served as the easiest way to export income, saving and capital. At this stage, it is not clear whether, after attempted coup and the changes in the international forex markets (the USD appreciation and depreciation of the Turkish Lira, there will capital flight from Turkey. There are signs

[77] See: IMF, Mind the Credit Gap, p.12.

that the economy is weakening, the country debt is USD-denominated and this currently causes capital outflow (mostly portfolio FDIs), while there is a massive government investment program (incl. the new Istanbul airport and the channel parallel to Bosphorus.

VIII. "PURE" POLITICAL FACTORS

A. POLITICAL SITUATION: THE BIG PICTURE

The process of EU accession of the Balkan countries, preceded by trade, monetary and economic integration has helped WB political normalization. This is comparatively a self-evident observation.

If we take the WB countries compared to their own past, it is obvious that they have made a great progress after the Dayton Accords. The threat, however, comes from the simple fact that citizens compare themselves with the deeds and situations they would like to achieve.

In this respect, the EU had offered a perspective but accession seems remote. In early 2016, the citizens of Albania, B&H and Kosovo remain extraordinarily positive towards the EU as a prospect to work and/or study, and economic prosperity, while in Macedonia, Montenegro and Serbia the opinion is less enthusiastic but still positive. Despite the overall expected benefits of EU accession, there is a common pessimism regarding anticipated household income and the economy in general.[78] In other words, the positive view of the future is commonly attributed to EU.

When asked in 2016 "when do you expect the accession of your economy to EU to happen?", the most optimistic group of WB (believers that this will happen by 2020) was equal to the group that thought that this would never happen. In B&H, Macedonia and Serbia the latter group was larger than the former.

Table 29: WB Optimists and Pessimists re: EU Accession

Economy	2020	2025	2030	Never	Don't know
SEE	27	21	14	27	11
Albania	51	31	13	5	0
B&H	19	19	16	38	8
Kosovo	37	20	23	13	8
Macedonia	24	24	17	25	9
Montenegro	33	22	12	23	10
Serbia	21	17	12	33	17

Source: BOB[79]

However skeptical the public opinion towards the EU and membership prospect, the idea of prosperity and work in EU, freedom of movement and, and as we shall see below, applications for work and asylum from WB citizens raise the question on how EU skepticism fits political behavior and systems in the Balkan countries.

The first point to make is that trade and economic integration have served as motivator of both individual and political parties' vision of the EU as desirable prospect of development. Individuals do not

[78] See respective answers at BOB: http://www.rcc.int/seeds/results/2/balkan-opinion-barometer
[79] See: http://www.rcc.int/seeds/results/2/balkan-opinion-barometer

dispute the EU or its members as valid destinations of work and travel, this public mood motivates political leaders to step up the rhetoric and the pace of membership in the Union. As recently as on September 20, 2016, the Council of the EU had accepted B&H's application for membership, which was the last to be submitted (in February this year).[80] This gives the EU a tool to keep WB conflicts from escalating into violence[81] as well preventing nationalistic aspirations from taking an upper hand in countries' political agenda. The only unclear membership status is that of Kosovo, but it has SAA with EU in force since April 2016 to smooth the tensions.[82]

Second, whatever the fate of the EU, Europe remains the prospect of choice. There is no doubt that "The prospect of EU membership used to be the spur for reforms and the democratization of these states' societies."[83]

Third, the 2014 – 2016 international refugee crisis, the conflict in Ukraine, the coup in Turkey and the Brexit emerged as a challenge to domestic political delicateness of political balance. This, on one hand explains the rising pessimism vis-a-vis the EU. But on the other hand, it calls for an international comparison of political systems and conflicts.

WB political systems are often criticized as failed democracies but this criticism fails when comparing WB with other post-Communist countries.[84] Besides the recent Republika Srpska referendum on such a "minor" constitutional matter as the national holiday[85] and the rampant violation of the rule of law during anti-government demonstrations in Macedonia,[86] the WB are very different from the periphery of the Russian Federation:

- There is no international "power" to dominate the region and/or intentionally violate the international order; just the opposite: sometimes clumsily and ineffectively but persistently EU, US and NATO are assisting the region and the countries in their path to democracy, rule of law and prosperity;
- Free trade agreements and European economic integration deliver prosperity;
- At worst, occasionally, provocative political leaders and top government official allow themselves proxy symbolic wars; they are dangerous and important and thanks to them countries progress towards liberal-democratic and economic normalcy stagnate;
- However, 21 years after the Dayton Accords and 15 years after the outburst of ethnic clashes in Western Macedonia, there is source of open violent conflict or foreign intervention; the periphery of Russia is "embalmed" with such conflict zones intentionally maintained by Russia;
- Unlike Russia's periphery there is no Balkan "club of dictators" (Russian opposition political commentators prefer to speak of "Dictators' Cooperative", referring to leaders and political

[80] See: Council of the EU, Council conclusions on the application of Bosnia & Herzegovina for membership of the EU: http://www.consilium.europa.eu/en/press/press-releases/2016/09/20-conclusions-bosnia/
[81] Kosovo's Long Road to EU Membership, Stratfor, October 27, 2015.
[82] Adea Kondirolli, Kosovo's Agreement with EU comes into force on April 1, Pristina Insight, 31 March 2016.
[83] Juddy Dempsey, The Balkans' Rocky Path to Democracy, Carnegie Europe, 20 April 2015, at: http://carnegieeurope.eu/strategiceurope/?fa=59830 .
[84] See: The Twilight of Balkan Democracy, European Western Balkans, 10 September 2016, at: https://europeanwesternbalkans.com/2016/09/10/the-twilight-of-balkan-democracy/ .
[85] Bosnian Serbs defy Sarajevo with referendum for a national holiday, Deutsche Welle, 25 September 2016, at: http://www.dw.com/en/bosnian-serbs-defy-sarajevo-with-referendum-for-a-national-holiday/a-35885579 .
[86] See: The former Yugoslav Republic of Macedonia: Recommendations of the Senior Experts' Group on systemic Rule of Law issues relating to the communications interception revealed in Spring 2015 (ACA Priebe Report), European Commission, 8 June 2015, at: http://ec.europa.eu/enlargement/news_corner/news/news-files/20150619_recommendations_of_the_senior_experts_group.pdf

systems from Kazakhstan to Azerbaijan); the change of government takes place by constitutional means, irrespectively how imperfect the process;

- It has been many years since political prisoners in WB have been silenced, while the situation is deteriorating in the FSU;
- There are populist political leaders and parties everywhere, not to mention Western Balkans; but none of those is yet holding an office or has such a major role in influencing the political agenda like similar parties in Spain, Holland, Finland, Bulgaria or Ukraine – to mention just a few countries, where populists are either in the government or are major competitors of the incumbent "traditional" political parties.

This is not to conclude that the situation cannot change under the challenges of taking in refugees or conflicts near the region. The point is that the WB look more like a typical democracy and they have moved towards a more advantageous political system than in the past or when compared to the FSU.

B. IMPACTS OF REFUGEES AND MIGRANTS ON THE ECONOMIES AND POLITICAL STABILITY

Western Balkans

WB themselves experienced huge masses of refugees and internally displaced persons (IDP) during and in the aftermath of the ex-Yugoslav wars, the Kosovo crisis of 1999, and South Serbia – North-West Macedonian crisis of 2001.

Those refugees and IDPs, at times reaching 600-700 thousand people (especially in 1995-1996), were very different from the influx of refugees in 2014 and especially 2015. They spoke the language, had relatives and friends, they were not transitory (most those who fled to Europe did so directly and at the beginning of the war), political leaders and government of the countries had no choice but to cooperate and find resources to subsidize the accommodation of the refugees, which also facilitated international government and private support.

Macedonia and Serbia are particularly stressed. **The record number of migrants arriving in Greece had a direct effect on the Western Balkan route, as the people who entered the EU in Greece tried to make their way via Macedonia and Serbia into Hungary and Croatia, and then towards Western Europe. This led to unprecedented numbers of migrants seeking to re-enter the EU through Hungary's borders with Serbia. After Hungary completed the construction of a fence on its border with Serbia in September 2015, the flow of migrants shifted to Croatia. In all of 2015, the region recorded more than 764 000 detections of illegal border crossings by migrants, a 16-fold rise from 2014.**

The top-ranking nationality was Syrian, followed by Iraqis and Afghans.

The route became a popular passageway into the EU in 2012 when Schengen visa restrictions were relaxed for five Balkan countries – Albania, Bosnia & Herzegovina, Montenegro, Serbia and Macedonia.

WB as Potential Migrants

Part of the problem, however, is that WB citizen are potential migrants themselves. In the WB, the diaspora accounts for between 10% and 30% of the population. The average share of remittances to GDP in 2015 was 9% - twice as large as the inflow of FDI.

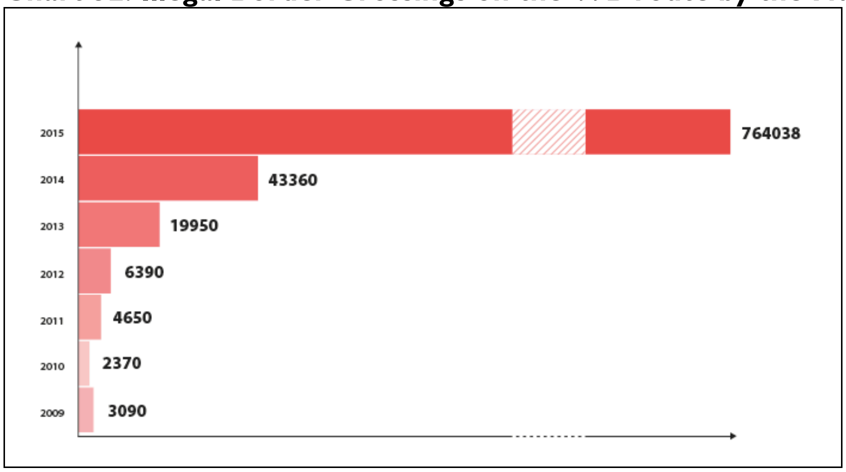
The opening of the Balkan route for refugees has had an unexpected side effect: for in 2015 Eurostat reported that 177,925 asylum applications were submitted to EU and EFTA countries by citizens of Albania, B&H, Macedonia, Montenegro, Kosovo and Serbia, in the first three quarters of 2015 alone. "Albanians and Kosovars were the second and third most frequent arrivals to Germany in 2015 (after

Syrians), while Serbs and Macedonians were in sixth and seventh place, respectively (after Afghans and Iraqis) – even though Serbia was listed as a safe country of origin the year before, and all Balkan states were on the list by the end of October."[87]

Illegal Border Crossings

In 2013, some 20,000 people crossed the Hungarian border illegally. Nearly all of them applied for asylum after crossing. They were encouraged by a change to Hungarian law that allowed asylum seekers to be transferred to open holding centers, which they absconded soon after. In July 2013, the Hungarian authorities further amended asylum legislation and strengthened their border controls. Migrant flows from Greece tailed off, but overall numbers rose again in 2014.

Chart 32: Illegal Border Crossings on the WB route by the Numbers



Source: EU Frontex.[88]

Part of the reason for the rise was irregular migration by nationals of the region, especially from Kosovo (in 2014 unprecedented numbers of Kosovo nationals crossed the Serbian-Hungarian border illegally), who joined the northward march by Syrians and Somalis. Upon arrival in Hungary, they too requested asylum, and were accommodated in open refugee centers. Soon after they left the centers and headed to other EU countries, particularly Austria and Germany, where many again applied for asylum.

Since the autumn of 2015 to spring 2016, over 600 000 people migrated to Europe via the Western Balkans, most having sought asylum in countries across the European Union (EU). The vast majority of migrants travelled to Europe via Turkey, Greece and the Western Balkans. The once fluid migration route changed significantly in February 2016, following the introduction of successive new policies and border closures, culminating in implementation of the EU-Turkey Plan, which effectively closed all borders along the Western Balkans route.

The WB "migration corridor" has been officially closed since 20 March 2016, following the implementation of the EU-Turkey Plan, leaving over **50,000 migrants reported along the migration route in Greece, Macedonia, Slovenia, Bulgaria and Hungary**, unable to continue their march towards western Europe and unaware of legal ways to do so.

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[87] Sabina Lange, The Western Balkans: back in the EU spotlight, European Union Institute for Security Studies, March 2016, p. 1-2.
[88] Frontex Analytical Reports: http://frontex.europa.eu/publications/

Building on a rapid assessment at the peak of migration in September 2015, REACH[89] conducted a six-month study of migration trends via WB. It confirmed that migrants come from conflict-affected countries – predominantly Syria, Afghanistan and Iraq, that some are educated and in the past, have had stable source of income. But the category of those of disadvantaged backgrounds grew o**ver time,** with considerable number of those who already lived in another country as refugees with temporary employment to support their further exodus to Europe.

Most crucially, the report highlights the **consequences of changing border policies and the EU-Turkey plan on the vulnerability of migrants.** While these policy changes have led to a decrease in the number of new arrivals in Europe; those continuing to travel have been exposed to far greater risks: **either left stranded along the WB route, or continuing the journey by other illegal routes, where they are more vulnerable to physical violence, trafficking and exploitation.**

Continued assistance is required at several levels to address the humanitarian needs of crisis-affected populations: in transit, upon arrival, and in migrants' areas of origin, where some of the most vulnerable community members were forced to remain behind. Migration to Europe has remained very dynamic, highlighting the need to continue monitoring migration in the future, both to inform humanitarian responders of changing needs, and policy makers of the implications of their actions.

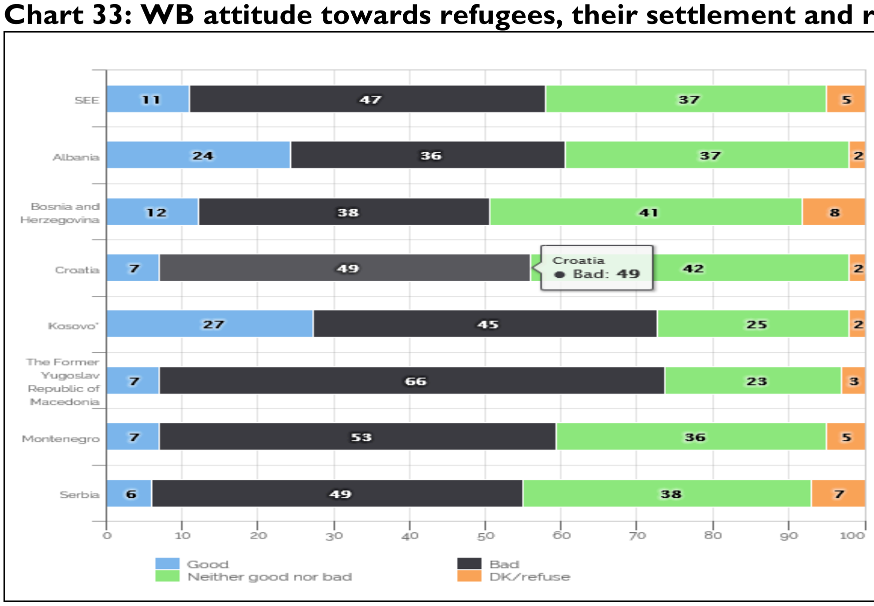
The migration crisis in the region of WB is perceived as a weakness of the EU.

Such perceived EU failure is opening up spaces for other powers to assert their interests - above all Russia, but also Turkey, and to some extent China and the Gulf states.

If the EU continues to show weakness in the WB towards refugees, instability may return.[90]

An early 2016 poll by the Balkan Opinion Barometer (BOB) demonstrated how intense the situation is.

Chart 33: WB attitude towards refugees, their settlement and role in the economy



Source: BOB[91]

[89] REACH is a joint initiative of IMPACT, its sister-organization ACTED, and the United Nations Operational Satellite Applications Program (UNOSAT)

[90] Francisco de Borja Lasheras, Vessela Tcherneva and Fredrik Wesslau, Return to Instability: How Migration and Great Power Threaten the Western Balkan, European Council for Foreign Relations (ECFR), March, 2016.

Although the question asked mixes two different perspectives and is not perfect from a methodological standpoint, it seems that even a better polling methodology would not change the overall picture: the negative attitude prevails more than four times, in Macedonia – nine times.

Like in Europe, the refugees in the Western Balkans are perceived as a threat not just because of their numbers. In the WB, the illegal crossing would constitute between 3.8% and 4.5% of the population, depending of the estimate. Those who remain for a temporary settlement are between 50 and 60 thousand for the entire Balkans, including Bulgaria.

The problem is that they disturb, by the nature of things, the urban life and, also, that they are visible – it is easy to spot them, find a TV crew to record real but often artificial and made up tensions, for the sake of a political propaganda. The low public trust in elected legislators, governments and public servants in not helping the situation. The overall level of such trust is in the middle of the BOB 5-degree scale, around 2.5, but in 2015 is slightly improving relative to 2014 in almost all WB countries.[92]

People are ready to accept all sorts of irrational and simplistic explanations to a complex problem. Populist parties are ready to offer conspiracy theories: a new "great power's game" is "taking place", etc. "In the face of other foreign policy challenges, the EU has collectively "dropped the strategic ball" in the Western Balkans and largely adopted a managerial firefighting approach – reports a group of professional political scientists. "Unsolved conflicts, latent tensions and weak institutions remain stumbling blocks against an EU's transformative power." [93]

Russia and FSU: Migration

The Russian Federation and the FSU do not experience a refugee threat, but they constitute a specific region of international migration.

The establishment of the Commonwealth of Independent State (CIS) in December 1991 have retained and protected the free movement of citizens of the member states. The more developed regions of the former USSR, with its large cities west of the Urals have remained in the Russian Federation. Irrespectively the hardship associated with the collapse of centrally planned economy and however unsatisfactory the reforms in Russia, FSU economies were weaker, reforms rarely took place outside the countries of today's EAEU, the individual countries were with lesser potential and the societies were harder hit by economic decline, political instability and oftentimes by violence.

All these factors, plus the knowledge of the language, family and social connections and already existing Diasporas, have retained Russia as one of the most attractive countries to emigrate or seek temporary employment and business opportunities.

In 2000, migrant in Russia were 11.9 million, in 2015 – 11.6 million, or 8.1% of the population; almost 80 of them were of working age. The 2015 host of the largest immigrant population is the USA (46.6 million, for a comparison - the number of immigrants in EU is roughly 42 million), next is Germany with 12 million, and Russia comes in third place.[94]

The specific migration situation in the FSU countries is the following:

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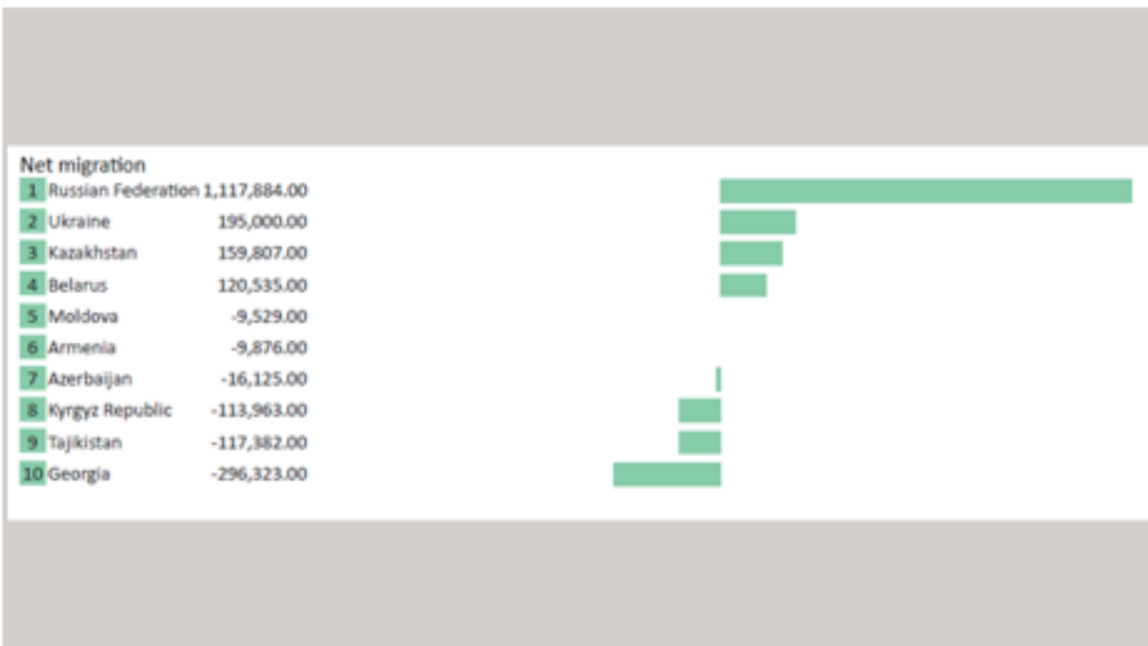
[91] See the entire survey: http://www.rcc.int/seeds/results/2/balkan-opinion-barometer
[92] Balkan Barometer 2016, p. 105 a.f.
[93] See: Francisco de Borja Lasheras, Vessela Tcherneva and Fredrik Wesslau.
[94] UN, International Migration Wallchart, at:
http://www.un.org/en/development/desa/population/migration/publications/wallchart/docs/MigrationWallChart2015.pdf

– Irrespectively the attractiveness of Russia as migrant destination, the percentage of migrants in the last 15 year remained constant; in Germany it increased from 11 in 2000 to 14.9% in 2015 (in USA – from 12.3 to 14.5%);
– Russia has the largest Muslim population on the European continent (excluding Turkey) – 14 million estimated and with migrants and seasonal workers up to 20-21 million; the policy of taking the side of the President Assad in the Syrian conflict motivates extremism on Russian soil, as it was demonstrated by the St. Petersburg Metro bombing in early April 2017. This causes divisions in the Russian society;[95]
– FSU includes Tajikistan, Kyrgyzstan, and Uzbekistan – these are remittance-dependent countries; the economic crisis of Russia resulted in sharp decline of the amount sent to relatives at home: according to the Central Bank of Russia, in 2015 remittance transfers shrank by 43. 38, and 51% to these countries respectively;[96] the total amount of remittances from Russia to migrant home countries from 2000 to 2015 grew 4 times, from USD 1.28 billion to 7.1 billion;[97]
– There is a follow up emigration from Russia and Ukraine to the West, but in 2015 Russia, Ukraine, Kazakhstan and Belarus were net "recipients" of immigrants from FSU; the following chart summarizes the situation.

Chart 34: Net migration in FSU (2015)



Source: UN population statistics

Interim Conclusions on the Refugee Crisis and Migration

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[95] See: Alexey Malashenko, Preserving the Calm in Russia's Muslim Community, Carnegie Moscow Center, 9 September 2016, at: http://carnegie.ru/commentary/?fa=64520 .
[96] See: Nate Schenkkan, A Perfect Storm in Central Asia, Foreign Policy, January 22, 2016, at: http://foreignpolicy.com/2016/01/22/a-perfect-storm-in-central-asia/
[97] International Migration Wallchart. (It is interesting to note that the change in Ukraine was absolutely dramatic – from USD 33 million in 2000 to USD 7.6 billion in 2015.)

For Russia and FSU, migration does not create a direct economic and political threat to the receiving countries. In Russia xenophobic movements are somewhat wide-spread but seem well-controlled by the political party in power through different subordinated organizations, and government rhetoric towards the West, US and EU, and its policies towards Ukraine and the neighbors, and in Syria provide a lightning rod for xenophobic mood of the public.

The threat is economic but for the countries with negative net migration: they lose from both declining amount of the remittance due to recession in Russia and they lose from emigration itself.

On the political level, this dependence on remittances from Russia amplifies hesitant attitudes to Russia dominance in general.

The **refugee and migration crisis threatens years of fragile development gains from trade, reforms, FDIs and building institutions in WB**.

The threat is not so much through the burden on the economies or the state budgets – the review of the fiscal reports of Macedonia and Serbia – do not indicate such problems, the fiscal consolidation is progressing, 2015 and 2016 have been good years in terms of revenues thanks to economic recovery. **The risks are rather associated with the rise of xenophobic rhetoric and action, more on the political side and not on every day social life.** Political controversies have a potential to spark old domestic conflicts.

ECFR has a point when finding that WB "have less-advanced welfare systems, limited institutional capacity and struggling economies that are further strained by having to provide for large numbers of transiting migrants". However, **the lack of sophistication of WB welfare states has an advantage: there is little incentive to rent-seek on them**, this is the situation for locals and foreigners alike, and the lack of such systems, at least, does not add unneeded incentives to rely only on publicly sponsored programs.

As the Syrian and Middle East crises are likely to last years, this means that the **WB refugee route to EU will be a risk factor for at least two or three more years.**

In this situation, with Brexit, Ukraine and the Middle East on the agenda, the EU does not seem ready to simplify and speed up the EU accession process for the WB countries.

The vacuum is filled with Russian influence, but it is yet limited to only a few countries' political establishments and has little potential to go beyond the borders of Serbia, Republika Srpska and to some extent Bulgaria and Greece.

C. EXPOSURE TO TERRORISM

Muslim countries and communities have been the main victims of Islamic and ISIL. B&H, Albania and Macedonia (and then Bulgaria) are the countries of Europe with the most sizable shares of Muslim residents.

"In Europe overall, however, Russia's population of 14 million Muslims (10%) is the largest on the continent", finds one of the recent estimates based on UN population statistics.[98] It is exposed to terrorism because of internal tensions in Chechnya, Tatarstan, Dagestan and some smaller republics of the Northern Caucasus, but also because of its involvement in the Syrian war and its past domestics terrorist tensions (e.g. Beslan and the Nord Wind Theater hostage crises).

[98] Conrad Hackett, 5 facts about the Muslim population in Europe, Fact Tank, Pew Research Center, July 19, 2016.

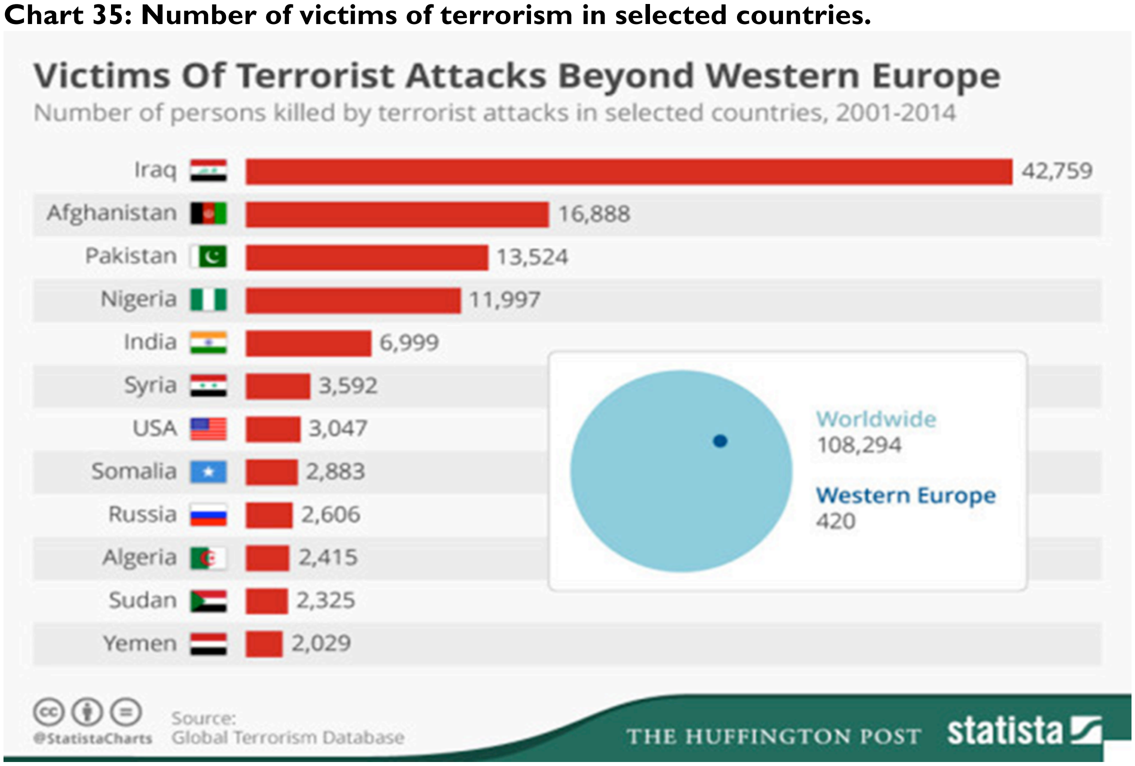
For the WB countries, the Global Terrorism Database reports for 2006-2015 on average 7-8 potential (i.e. the link still must be established) terrorist incidents per year. For the last ten years, there were six fatalities, perpetrated by (unidentified) individuals against individuals. It looks as if the WB exposure to terrorism is very low.

For the FSU (including Georgia and Ukraine but excluding the Baltic States) the number of incidents is much higher: between 2005 and 2013 the number of potential terrorist acts is 200 per year (then the number grows).[99]

In terms of victims of terrorism in non-Muslim countries, Russia has 2,606 victims from the period 2001 – 2014, second number after terrorism in USA (the victims of September 11 and other attacks). The difference is not only in the number but also in the fact that in Russia terrorist acts are most often perpetrated not by foreigners but by citizens. The database of attacks since 1991 show that severe incidents with more than ten and even hundreds of victims have been rather common in Russia for the entire 25-year period and is frequently linked to the war in Chechnya.[100]

Russia's terrorism threat is significant, that for the WB is insignificant.

Chart 35: Number of victims of terrorism in selected countries.



Source: Statista, GTD

By international comparison the homicide index for WB is also relatively low.

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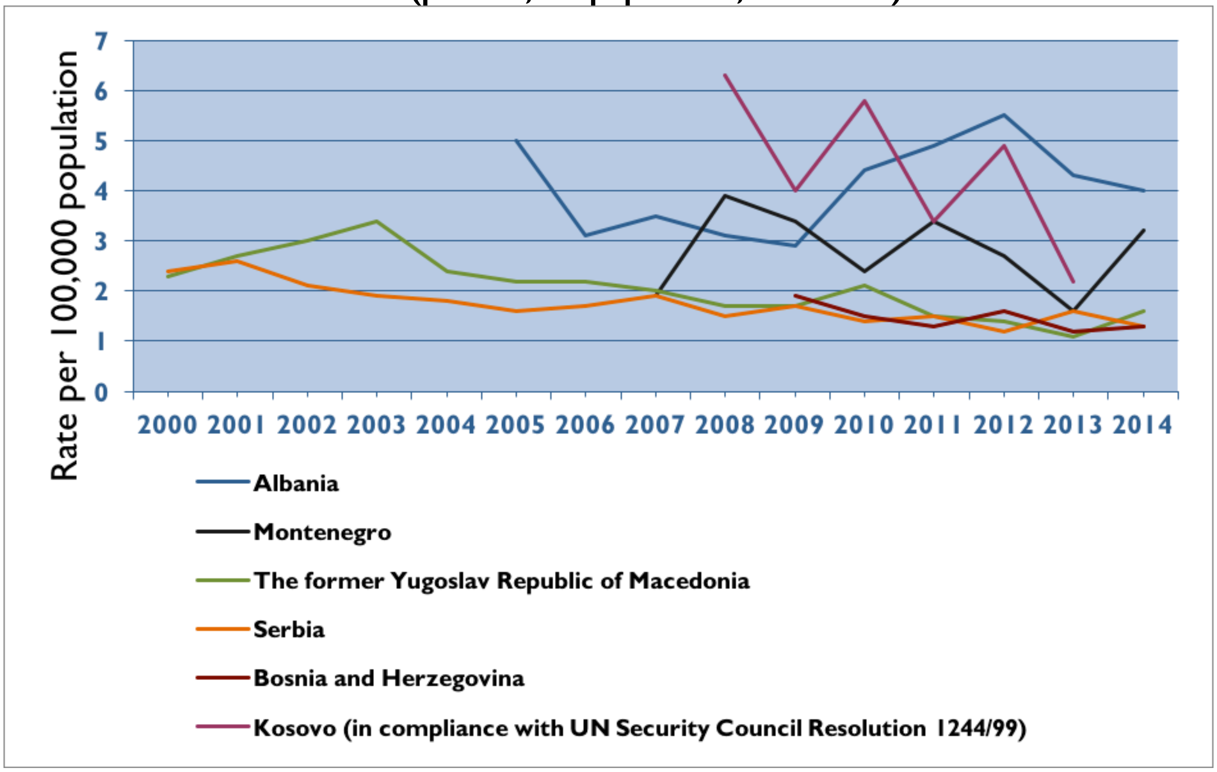
99 See all countries number of casualties from terrorism in the Global Terrorism Database: https://www.start.umd.edu/gtd/search/

100 See: Robert Johnson, Terrorist attacks in Russia (with statistical summary), 22 May 2015, at: http://www.johnstonsarchive.net/terrorism/terr-russia.html

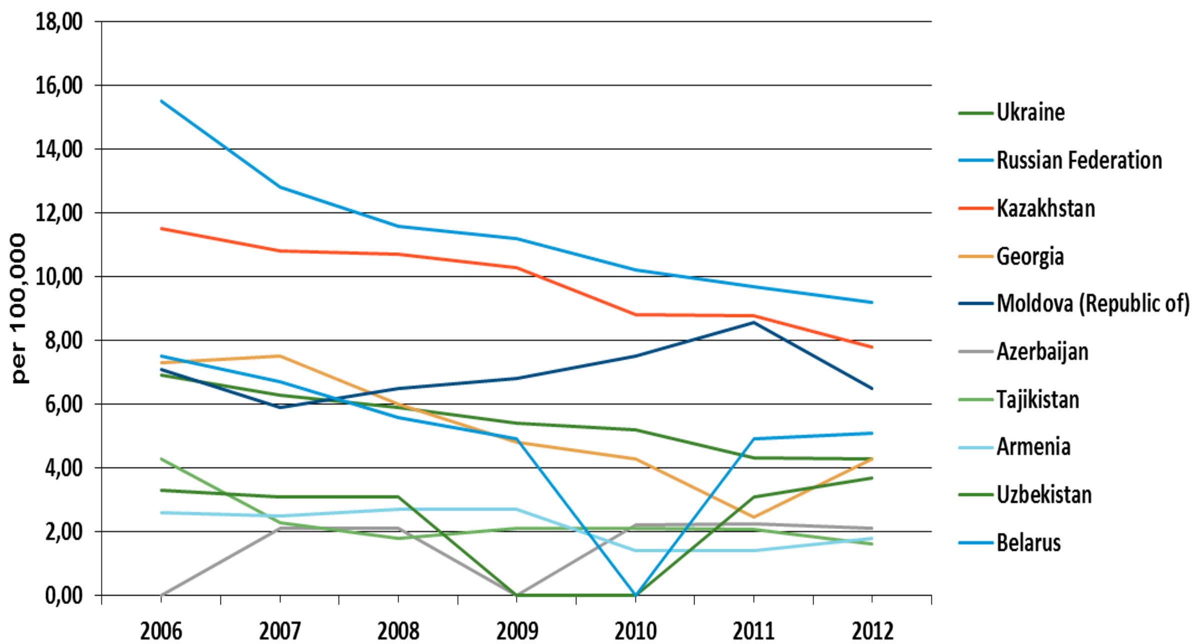
Chart 36: WB Homicide rate (per 100,000 population, 2000-2014)



Source: World Bank (WGI)

The situation in the FSU is much less satisfactory. Homicide rates used to be roughly twice as high than in WB ten years ago, but went down, remaining in Russia the highest in the region.

Chart 36: WB Homicide Rate (per 100,000 population, 200-2014)



Source: World Bank (WGI)

The above statistics allows for the conclusions that the threat of terrorism is negligible in WB and remain significant in Russia.

Quality of Government as a Risk: WB and FSU

As with banks, public governance is often more a direct threat than pure economic entanglements.

According to the World Bank rule of law indicators in Macedonia and B&H look better than in Bulgaria, a member of EU, but far from the levels of the best countries in Europe.

Table 30: Rule of law: WB and Selected Countries

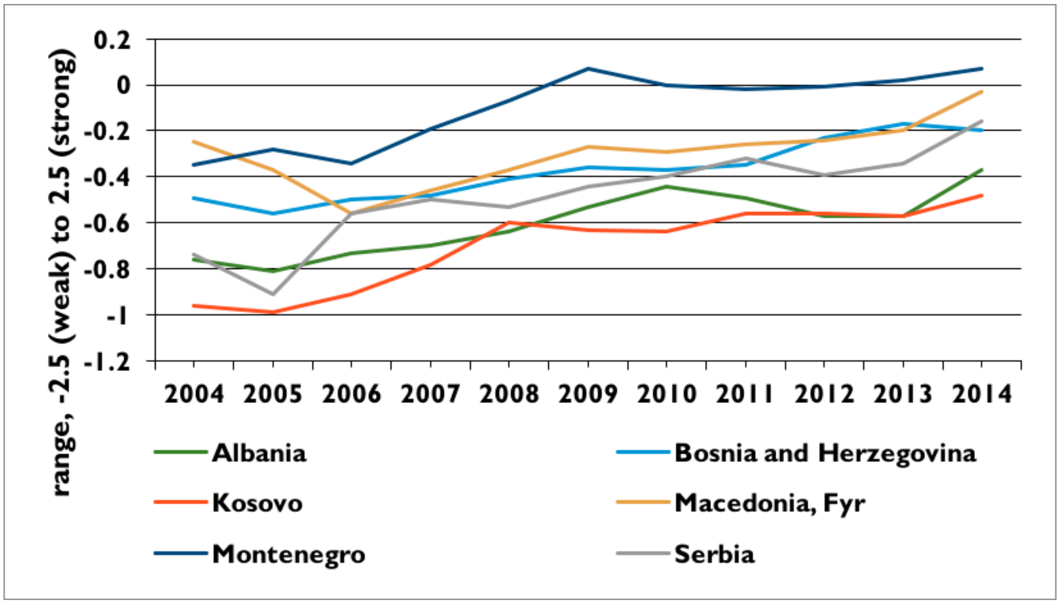
	2014
Denmark	.88
Germany	.80
United Kingdom	.78
Romania	.59
Macedonia	.58
B&H	.55
Bulgaria	.53
Serbia	.51
Albania	.49

Source: WGI (World Bank)

The estimated situation with the rule of law in WB, used by the WEF's Global Competitiveness Report and other international comparisons, is not improving significantly in 2004-2014, except for Kosovo. The prevailing perception is that "Western Balkan countries share problems related to widespread corruption, the presence of organized crime, the lack of an independent and/or functioning judiciary, and the deep politicization of public administration".[101] Such statements should be taken with a pinch of salt. As the WGI of the World Bank indicate, the quality of the rule of law is far from the best global standards but it is around the levels of Bulgaria (which since 2013 is at the bottom of the EU ranks) or above it, as Macedonia (although the score is indicative for the period before the above quoted Priebe Report).

Chart 37: Rule of law in WB countries: estimated dynamics for 2004-2014

[101] See: Sabina Lange, p. 4.

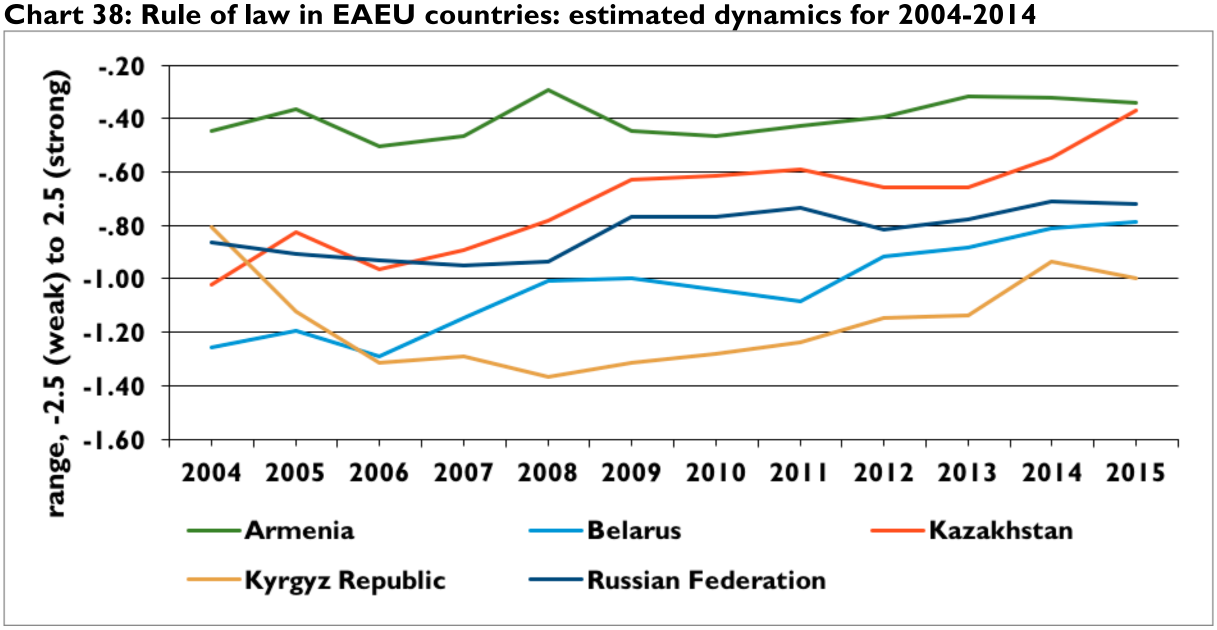


Source: WGI (World Bank)

As the following graph shows, in 2004, when Central European countries become members of the EU, the overall Rule of Law situation in the WB started to improve and there is a strong trend upwards in the last five years.

The situation is very different in EAEU: the Rule of Law scores are considerably worse and the trend is unclear.

Chart 38: Rule of law in EAEU countries: estimated dynamics for 2004-2014



Source: WGI (World Bank)

What presumably matters to the overall quality of life and ease of transaction in the economy, is the level of integrity of the judicial official, such as whether "government officials in the judicial branch do not use public office for private gain".

Table 31: Integrity of judicial officials, selected countries (2012-2014)

	2012	2013	2014
Denmark	,96	,96	,95
Germany	,92	,92	,93
UK	,87	,87	,85
Czech Republic	,79	,79	,71
Georgia	,64	,64	,59
B&H	,51	,51	,52
Croatia	,62	,62	,56
Estonia	,86	,86	,90
Macedonia	,40	,40	,43
Moldova	,17	,17	,24
Romania	,62	,62	,59
Russia	,42	,42	,41
Serbia	,45	,45	,41
Bulgaria	,47	,47	,46
Ukraine	,38	,38	,41
Turkey	,61	,61	,62

Source: World Bank (WGI)

The history of this indicator shows that until recently the situation was worse than in Turkey or another (successful) transition country like Georgia, and twice or almost twice worse than such countries like Estonia or the Czech Republic. The picture is similar for the quality of government with regard to the situation where the government official are sanctioned for misconducts. The only difference is that WB perform much better than Bulgaria. FSU countries are very different from one another in terms of the integrity of the courts.

Table 32: Responsibility of Government Official for Misconduct (selected countries, 2012-2014)

	2012	2013	2014
Denmark	,89	,89	,94
Germany	,76	,76	,78
UK	,74	,74	,78
Czech Republic	,53	,53	,59
Georgia	,59	,59	,58
B&H	,39	,39	,42
Croatia	,48	,48	,56
Estonia	,78	,78	,81
Macedonia	,43	,43	,46
Moldova	,29	,29	,30
Romania	,47	,47	,48
Russia	,29	,29	,35
Serbia	,31	,31	,34
Bulgaria	,34	,34	,34
Ukraine	,25	,25	,32
Turkey	,45	,45	,47

Source: World Bank (WGI)

Some Conclusions Regarding the Quality of Public Governance

The international comparisons allow for identifying some regularities:

- There is a significant correlation between rule of law indexes and FDIs inflows and stock, and gross fixed capital formation;
- WB performed worse than most of the new Europe countries until 2008; on some rule of law indicators, however, after 2009-2010 they do better than Bulgaria;
- Business environment and property indicators remain stagnate; Rule of Law, FDI (inflows and stocks of FDI), GFCF, Judicial Independence and Regulatory Uncertainty indicate there is little change; on some of these indicators the Western Balkan perform better than Bulgaria;
- In all the areas mentioned above indicators and their correlations to FDI the Western Balkans are moving closer to the former USSR than to NE;
- There are factors that counteract these trends: monetary policies, tax simplicity and transparency, provisional positive impacts of the EU, and, most importantly the accumulated stocks of FDIs.

D. RUSSIA AND TURKEY: GEOPOLITICAL GAMES

Russia after Crimea

In the past, Russia took sides in post-Yugoslav conflicts, at times disrupting the efforts of the international community to appease the region, especially in tense situations in Bosnia, Macedonia, Kosovo/Serbia and Montenegro, including recent vociferous opposition to membership in NATO.

Only in the last year[102] has Russia attempted to prevent the NATO accession of Montenegro (and allegedly used KGB-style operations), to influence Serbian presidential elections (the majority of the eleven candidates were campaigning against the EU and, especially, NATO), to stir conflicts between Kosovo and Serbia, and to successfully support the election of Socialist and pro-Russia, although not visibly anti-NATO, president of Bulgaria.[103]

It also supports political groups that make no common sense – nationalist parties with 19th century understanding of politics and Balkan constellations, glorify the Communist past and hate towards "the Americans" and the EU. All NATO members in NE agree that the RF, particularly the group of individuals and state-owned companies around its incumbent leadership, is restoring its old KGB-networks, friendships and ways of handling international affairs. Their common assessment is that RF is an unreliable partner that violated the international law by annexing Crimea and supporting the insurgents in Eastern Ukraine.

The Western Balkans courtiers themselves are far from perfect in arranging their political systems. The government machineries often malfunction, the political tradition is not the same as in EU, and it takes time to adjust it, like everywhere in the history of democracy. Time wise, the countries are doing this relatively well in comparative perspective, but, as exemplified by Macedonia (including recent, April 2017 disorder in the parliament), Republika Srpska, Bosnia and Herzegovina and Kosovo constitutional arrangements of own political process (especially the government machinery) often serves as home-

[102] For greater detail on the earlier similar attempts, see: Jan Mus, Russia in the Balkans. Threat or Opportunity? 2015 Yearbook of the Institute of East-Central Europe, Lublin, 2015, http://www.iesw.lublin.pl/rocznik/pliki/Rocznik_2015-226.pdf

[103] See: Stratfor, Russia Stirs the Hornet's Nest, Stratfor Assessment, 28 March, 2017.

made source of instability.[104] The big picture, however, is that the constitutional and practical process of fixing democracy is faster, less violent and relatively more encouraging (in comparative perspective) than what we know from the history of the majority of today's liberal democracies.

In its "near neighborhood" and the Baltic, Balkan and Caucasus countries Russia is waging a disinformation war. Studying the developments in the Baltic countries, Poland, Ukraine, Czech Republic and Slovakia, Edward Lucas and Vladimir Pomeranzev concluded:

"Russia aims to erode public support for Euro-Atlantic values in order to increase its own relative power. It exploits ethnic, linguistic, regional, social and historical tensions, and promotes anti-systemic causes, extending their reach and giving them a spurious appearance of legitimacy. Consequently, information warfare intensifies geopolitical, economic and ideological competition in areas that are crucial to U.S. interests, such as the Baltic north and Black Sea south."[105]

In addition, Russian state-owned companies and private companies, working on joint projects with domestic companies or pretending to just be minding their own business, support aggressive pro-Russian propaganda "information campaigns". The interference in economic affairs sometimes results in in dysfunctional subsystems, like energy-resource dependency or penalties on unfinished contracts (like December 2016 Bulgaria's payment of EUR 650 million – 1.25% of the country's GDP - to Gasprom as a result of an unfinished Belene Nuclear Power Station project that was unrealistically designed and unnecessary) that could garnish a challenge to public finance.[106] The dominant economic stance of Russian companies in some sectors can hardly be underestimated.[107]

Part of this campaign is the already quoted result of 2012 public opinion poll that: "47% of Serbs believe Russia to be the largest supplier of development aid to Serbia. In fact, 89.49% of funds comes from the USA and the EU, and the Russian contribution has not even been included in statistical reports."

The peculiarities of the WB power sector limits the capacity of such companies in terms of market influence except for the natural gas sector, while in this sector their power is limited:

- Other resource markets are competitive;
- Balkans are relatively undiversified, respective electricity sectors rely on coal power plants;
- Projects are often ill prepared, irrespective of the planning process involved;
- And companies themselves lack financial strength.[108]

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[104] See: Krassen Stanchev, Petya Platikanova, Balkan Constitution Making: Is there a Peculiarity and What's to Expect, Krassen Stanchev and Ivan Krastev (editors), The Inflexibility Trap: Frustrated Societies, Waek States and Democracy (The State of Democracy in Southeast Europe), Sofia, CLS and IME, 2003, pp. 61-93, especially the section on the so called government machinery, p. 83-89. A similar view is expressed by James Lyon, Is War About to Break Out in the Balkans?, Foreign Policy, Argument, 26 October 2015.

[105] See: Edward Lucas and Peter Pomeranzev, Winning the Information War Techniques and Counter-strategies to Russian Propaganda in Central and Eastern Europe, Washington D.C., Center for European Policy Analysis, Legatum Institute, August 2016, p. 6.

[106] Due to sizable fiscal surplus of 2016 Bulgaria state budget, this did not happen. On the background of the impacts of such projects see: Krassen Stanchev, Russia's State-Owned Companies and Contemporary Bulgarian Political and Economic Landscape, Russia in the Balkans. Threat or Opportunity? (edited by Jan Mus), 2015 Yearbook of the Institute of East-Central Europe, Lublin, 2015, pp. 9-34, at: http://www.iesw.lublin.pl/rocznik/pliki/Rocznik_2015-226.pdf

[107] See: Heather A. Corney, James Mina, Ruslan Stefanov, Martin Vladimirov, The Kremlin Playbook: Understanding Russian Influence in Central and Eastern Europe, Sydney, CIS, 13 October 2016, at: https://www.csis.org/analysis/kremlin-playbook .

[108] See on the subject the reports of RusEnergy Consulting Group: http://www.rusenergy.com/en/reports/

For larger countries Russian state-owned resource companies use the tactics of the so called "Schroederization": hiring top ranking government official as a reward for alleged services provided or planned by the companies.

In the long run such policies do not seem beneficial for Russia either. In mid-March 2017, the EU Commission threatened Russia's Gasprom with EUR 6 bln penalty for its dominant position the natural gas markets in eight EU member states, the countries are invited to justify further with more detailed claims and Gasprom is currently seeking a settlement of up to EUR 2 bln. Such protection is, presumably, open to WB candidate countries as well. In the short term, in 2017 and 2018 Russia is likely to curb recession and resume growth of GD, from a lower level, with exhausted reserves from the oil fund, and limited access to capital from the international market.[109]

EAEU cannot become EU neither in terms of income per capita, nor in terms of public governance and rule of law. The trade between members is already declining, when it resumes it will be a trade with poorer neighbors, dominated by Russia, but poorer than EU and other global alternatives. Additionally, EAEU countries may not return on the growth path simultaneously with Russia.[110] Russia is currently the global champion of capital flight, often sponsored by the government. In 2014 it was USD 153 billion, in 2015 – 56.9 billion.[111] After 2017 it may stabilize on its typical levels of approximately USD 30 billion a year.

For smaller countries this tactic does not pay off, as is obvious from the experiences of Bulgaria and Serbia. They would rather finance PR projects to secure friendly relations with Kremlin. Often they, or the RF government may rely on the competition between local politicians and lobbying for the Russian cause: this type of competition reduces the costs of the demanded services.

Irrespective of all these factors, the Russian Federation influence in the region is not likely to succeed in counter-acting forces of EU economic and longer-term political integration. Other analysts are of the same opinion.

"Although there are pro-Russian sympathies in the area and despite the EU's splintering façade in recent years, the economic pull of Western Europe cannot be seriously compared to the cliental based Russian model. Therefore, the EU candidate countries in the Balkans will continue their pro-European trajectory. The situation, however, is delicately poised and is vulnerable to external events and crises, which currently are not in short supply."[112]

On both the domestic and international political arena, Russia faces new challenges:

- Due to its sizable Muslim populations and involvement in the Syrian war, it is confronted by internal security threats and is likely to become an exporter of terrorists to EU;
- The annexation of Crimea and support for breakaway movements in Eastern Ukraine seems to be a fiscal burden for the RF state budget; the conflicts have tendency to freeze at their current status quo;

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[109] This is a consensus forecast of most market commentators. See, e.g.: Alisa Lockwood, Charles Movit, Andrew Neff, Renee Friedman and Adrian Rogstad, Where is Russia Heading, Institute for Humane Studies, Policy Paper 2015, at: : https://www.ihs.com/articles/features/russia-heading.html#.VMjelzgbVy8.facebook .

[110] See: Why the Eurasian Union Will Never Be the EU, Stratfor, 17 September 2016.

[111] Central Bank of Russia estimate.

[112] Robert Ledger, Is Russia winning a battle of hearts and minds in the Western Balkans?, New Eastern Europe, 15 March 2016, at: http://www.neweasterneurope.eu/articles-and-commentary/1923-is-russia-winning-a-battle-of-hearts-and-minds-in-the-western-balkans .

- The next year's presidential elections force the Kremlin administration to focus on economic reforms, and most likely in the direction of lowering budget dependency on oil-exports and liberalizing quasi-government sectors (namely pensions, healthcare and education);
- Until 2016, the president of the Russian Federation enjoyed the luxury position of the only unpredictable leader of a large country, now this position is challenged and formerly friendly leaders of EAEU countries demonstrate emblematic discontent (like, e.g. the change of the Kazakh alphabet to Latin); it is likely that Russia will reassess and probably propose reforms of this Union.

Conclusions re: Russia's Role in WB and FSU

Russia took and takes sides in post-Yugoslav conflicts, disrupting efforts to appease the region, especially in tense situations in Bosnia, Macedonia, Kosovo/Serbia and Montenegro (including vociferous opposition to membership in NATO). Russia supports political groupings that make little common sense – nationalist parties, a 19th century understanding of politics and Balkan constellations, glorify Communist past and hate "the Americans" and the EU.

In the short to medium term Russia is likely to pursue the following political objectives in the Balkans:

- To erode public support for Euro-Atlantic values in order to increase its own relative power;
- To exploit ethnic, linguistic, regional, social and historical tensions, promote anti-systemic causes, extending their reach and giving them a spurious appearance of legitimacy
- To intensify geopolitical, economic and ideological competition in areas that are crucial to U.S. and EU interests

In the FSU and EAEU context the strength of Russia is much more visible, but, if unreformed, it is likely to fade away.

There is a "natural" economic and historic influence that has led to economic and political dependence of the EAEU countries and leaders from Russia. The economic and political deficiencies of its sponsored Union are becoming an urgent matter to address.

- The EAEU is the de-facto Ruble zone: from November 2013 to January of this past year the Ruble lost 128% against the US dollar. "To avoid losing competitiveness, the Central Asian countries have been forced to let their currencies weaken along with the ruble. Kazakhstan's Tenge is down 137% against the dollar since November 2013 after the government finally abandoned a currency peg that had already cost it tens of billions of dollars to defend. The Kyrgyz Som is down 55%, the Tajik Somoni is down 42%, and even the Uzbek Som — which is mostly traded on the black market — is officially down 25 percent. Turkmenistan performed an overnight devaluation of 19% last January, and there is a strong expectation that a new one, or some kind of currency float, is inevitable if it wishes to catch up to the rest of the region."[113]
- EAEU is an international project that cannot escape the dominance of the largest Russian economy, in its years as a custom union EAEU did not substituted the trade with the rest of the world in any significant measure, and after 2013 the trade between the members declined. The Union is not delivering promised prosperity and sets little incentive to continue with market reforms and economic integration with the rest of the world.

113 Nate Schenkkan, A Perfect Storm in Central Asia, Foreign Policy, January 22, 2016.

- Russia dominates the international security arrangements in the region but violates international order and maintains territorial disputes and armed conflicts on its borders. These are zones of "managed conflicts".
- It often exercises direct political influence, supporting a Club of Dictators of sorts on the periphery. Since the fall of the Soviet Union the FSU countries (except for Georgia, Moldova and Ukraine) have had basically identical constitutional arrangements of presidential power that allow for non-democratic transitions of power.

The UN Human Rights Committee expressed concern about the lack of independence of the judiciary in Armenia (2012), Azerbaijan (2009), Belarus (2011 and 2014)1, Kazakhstan (2011), Kyrgyzstan (2014), Moldova (2009), the RF (2009), Tajikistan (2013), Turkmenistan (2012), Ukraine (2013) and Uzbekistan (2010).[114]

- Human rights defenders, dissidents, opposing politicians, lawyers, independent journalists and bloggers, and religious activists – for expressing opinions critical of the authorities. Were imprisoned solely to punish them for freedoms of expression, assembly, association or their freedom of religion, conscience or belief - convicted via unfair trial.
- The Memorial, one of most prominent human rights organization in Russia, lists of political prisoners: 87, and it is rising.

With regard to WB, Russia's economic influence and political influence is relatively limited.

- It cannot directly initiate conflict similar to those on its borders, the political influence of the EU, however imperfect, is in line with the international aspirations of the majority of the population.
- The attempt to undermine Montenegro NATO membership and influence Serbian elections was completely unsuccessful. The impacts were limited to rhetoric against NATO, EU and the West; Serbia elected a pro-EU president in April 2017 with a decisive 56% majority of the popular vote, while eight of the eleven candidates led a pro-Russian campaign. The threat remains but seems manageable, due to economic realities of the Western Balkan countries.
- Russia's role in the energy supplies is difficult to translate in political influence: WB power sectors rely on sources different from natural gas, the energy supplies are relatively easy to diversify, and the Russian companies have a vested interest in the prosperity of the countries they have invested in. Export trends to Russia are negative even for Serbia and Montenegro, with FTAs with Russia. Approximately 80% of exports and more than 75% of B trade is with EU, and the bulk of the FDIs originated in Europe; Russia (at best) qualifies as 7–8th trading partner. Russian banks have some significance in Serbia and Republika Srpska, they serve Russian business and capital flight.

Turkey after the Coup

Turkey too, used to take sides in the past Balkan affairs of the 1990's, and by and large behaved like a NATO member and reliable partner of international community efforts to appease Bosnia & Herzegovina and Kosovo, and Macedonia.

It seems that if the Coup was successful, the impacts on WB could have been negative: the prospect for civil unrest and even a war would have been an additional risk factor for the region.

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[114] See: 2014 OSCE Human Dimension Implementation Meeting, OSCE, 24 September 2014, at: http://www.osce.org/odihr/124153?download=true

This story of partnership in the WB seems over for Turkey. In short term, it will focus on power consolidation, northern Syria and anti-Kurdish operations; in the WB it will keep the image of a *komsu* – good neighbor.

But Turkey will require Balkan countries to cooperate in her internal power consolidation. Circles, Muslim schools, education centers, NGOs and newspapers if linked to the so called opposition would suffer shortages of support and political pressure.

The economic impact on the WB will be negligible. Turkey will focus on big issues, friends and foes.

After the Referendum of April 16th 2017, Turkey seems to have already embarked on the path of a one-leader, one party semi-dictatorship. The slim majority (51.8%) in favor of Erdogan's extraordinary constitutional powers is warning signal for the president. He must address his domestic political agenda first, and his rather unpleasant international rhetoric should be read as one for domestic consumption.

Muslim and ethnic schools, mosques and minorities in the Balkans often happened to be affiliates of Zaman newspaper, now closed, and charities believed to have been sponsored by Fethullah Gulen – the US based Turkish religious teacher. Their links to Turkey (via schools, universities and civic initiatives) are now closed and the financial support has dried out after the Coup. Some WB schools and charities may attempt to get involved in alternative sources of finance from other Muslim sponsors.

Russian and Turkish influence, combined with socio-economic discontent and the refugee crisis may create an option for a jointly sponsored backlash against pro-EU reforms, but Russia and Turkey in the near future need to address more urgent priorities: Syria, domestic political and economic challenges.

The refugee crisis offers an opportunity for EU to reinforce association of the WB with the Union. Such effort would, however, depend in the near future on other challenges the EU is facing – the Brexit effects, the Italian banks, etc.

These countries need to be part of the mechanism for dealing with the refugee crisis, including decision-making. At the same time, the EU must also use the accession process to pressure WB on issues of governance and rule of law. The impediment here is the traditional enlargement approach of the European Commission: it never demonstrated flexibility towards aspiring countries, mostly constrained by the prospect of difficult decision on political level.

E. BREXIT: THREATS FOR TODAY AND TOMORROW

The British vote to leave EU has only indirect impacts on the WB: there is almost no UK investment or banks operating directly or indirectly in these countries. Investors from other countries raise capital on the London based stock exchange; they will find other source if and when the City is hit. But the Brexit would inevitably reform the EU. One should take into account, however, that if there is no delay, Great Britain will leave the Union not earlier than 2020.

Delays are possible due to the decision to hold general elections before formally leaving the EU, and seem to be motivated by the possibility of such delays – to allow companies and banks prepare for it.

The factors that will prevent prompt activation of the Article 50 of the Lisbon Treaty (a single country leave option) are both internal and European. On the domestic front, there is a Supreme Court case on the constitutionality of the procedure, as who should submit the application for exiting the EU. Internationally, besides the rhetoric, the EU leaders have no unified vision how to proceed, for some of them face general elections in the near future, and there is a weak appetite for additional political challenges.

The Brexit process is not a technical problem in term of renegotiating treaties, fixing the conditionalities with the EU, and reinforcing agreements with other global framework like WTO, EFTA, North America, etc.[115]

The first immediate impact on WB had already happened: the Brexit has affected the sovereign debt market, probably temporary.

UK citizens traditionally interpreted the EU as a cost, not so much benefit. This is well documented by the Eurobarometer surveys.

The "leave" vote, however, was a surprise, it changed conditions on bond markets, triggering flight to safety. Government bonds of Germany, Austria and Netherlands became more attractive to investors at the expense of riskier ones. Decreasing yields of the former implies higher risk premiums for the latter. Albania, Macedonia, Montenegro, and Serbia have issues of government bonds on international markets which seemed slightly affected, increasing their costs of borrowing.

In general, Brexit is not likely to cause in the mid-term any other significant effects on WB. Exports of these countries to the UK represent a very small share of total. In the view of negligible UK investment, even a greater shock on the UK's economy (itself under question) could not be a threat to the economic and financial relations of the Balkans with the UK. Traditionally, the trade and investment of UK were more intensive with other parts of Europe, France and Germany, Ireland, and with the British Commonwealth.

UK investment is very important in Czech Republic, Poland and Hungary. There is already preparation for re-registering formerly British companies as legal entities of those countries.[116] Such companies may reduce their tax contributions to UK national budget but it is not likely that their investment will be withdrawn from NE.

The Brexit is not likely to affect the ear-marked EU budget for Balkan EU accession (EUR 5.7 billion). Even if the UK leaves, in order to trade with EU on EFTA principles, it will continue contributing to the EU budget (roughly the amount of Norway – 0.8% of GDP, currently – due to rebates in place, it contributing 0.54% of GDP).

What would affect WB in the long run is the fate of the Union itself: currently there are two competing visions: A Closer Union or a Liberalized Union. The WB should get ready for both.

The so Jean-Cloud Junker's White Paper on the future of Europe,[117] released on March 1, 2017, lists five scenarios – three of them are versions of these two possibilities. They allow for greater flexibility in relation to WB candidate countries, although the accession process is likely to be put on hold until Brexit is completed. The political challenge for the Western Balkan political leaders shall be associated by the possible changes in EU political establishment.

For the time being, the general elections in the Netherlands, the presidential elections in France and the projections for the general elections in Germany (scheduled for 24 September, 2017) have little prospect to significantly influence the political composition of the EU decision making bodies.

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[115] See: Iain Murray, Rory Broomfield, Cutting the Gordian Knot (A Roadmap for British Exit from the European Union), Competitive Enterprise Institute, Issue Analysis, No 34, August 2016, pp. 10-11, at: https://cei.org/sites/default/files/Iain%20Murray%20and%20Rory%20Broomfield%20-%20Cutting%20the%20Gordian%20Knot.pdf .
[116] Kryštof Kruliš, Will Brexit Cut the Investment in CEE Countries? 4Liberty.Eu, Policy Paper, July 2016, pp. 7-9.
[117] See: Commission presents White Paper on the future of Europe: Avenues for unity for the EU at 27, Brussels, 1 March 2017.

Overall, the direct impact of Brexit on Western Balkan economies will be negligible.

IX. CONCLUSIONS

A. WB RISK ASSESSMENT MATRIX

The following Matrix provides a summary of the above analysis of threats and political risks. The likelihood and potential impacts (if realized) is assessed by KC2 in three categories: "low", "medium" and "high". In the "Source of risk" column (which follows the rubrics of the above analysis) the term of the threat is indicated as "short" (typically 1-2 years), "medium" (up to 3 years) and "long term" (more than 3 years).

Threat	Relative Likelihood	Impact if realized
	Risks related to monetary and economic policies	
1. Failure to use ECB QE policies to reduce costs of government debt services. (short term)	**High** There is discord between governments and political leaders on fiscal consolidation issues. Such policies are advocated by IMF, but conditionalities do not seem firm. Plus, refinancing debt may not be successful for image, political risk perceptions.	**High** Debt service costs would rise above level of 10% of GDP for all the countries but Kosovo. In two years there will be a fiscal pressure to cut government expenditure and/or raise taxes. Governments would rather opt for IMF program, which is likely to do the both.
2. Relative depreciation of the Euro may further restrict the access to foreign savings (FDIs) in medium to long term.	**Low** The FDIs depend on other factors: market integration and size, property rights and rule of law situations, and availability of human capital.	**Medium** If FDIs are further reduced, irrespectively the factor, growth rate would be diminished and there will be more incentives for WB national to seek career and wealth opportunities abroad.
3. Failure to integrate regional markets in the power sectors as frameworks, including negotiation of derogation with the EU (on climate issues), in short term.	**Medium** It seems that currently the major reason for delay is the lack of admin capacity and expectations that if markets liberalize some of installed capacity would become obsolete.	**Medium** Often EU accession government limit themselves to "ticking boxes" to comply; WB may learn from NE experience. If not, it is likely that a) large infrastructure project will be put on hold, b) consumers and investors won't benefit from liberalized markets (lower prices in the long run), and c) Russian imports of energy resources and investment in electricity sector may be stepped up.
4. Failure to reduce unemployment through the above mentioned reforms in short to medium term.	**High** There is little consensus on the policy mix, and the tradition to lay	**High** The high unemployment is already a factor for worsening public

	off reforms for electoral considerations. External pressures (advice, opinion) have rarely worked well if there is no crisis.	finance. Reduction of productivity potential and lost FDIs. Political discontent and sustained desire to emigrate among the young generation are also likely.
5. Lower external demand in the event of new recession in the Euro zone in short run.	**Medium** WB has little to no room to maneuver, the factors are: investment crowding-out effects of the QE and Italian bank problems. Like in previous years, WB governments are not likely to address the reforms heads-on.	**Medium** Like in 2011-2012, the reduction or growth rates and even limited recession is likely.
	Banking sector risks	
6. Bank failure to reduce the levels of NPLs, in short to medium term.	**Medium** Except for Albania and Serbia, the levels of NPL seem manageable. Banks have access to cheap resources and can utilize it in short period of time, restructuring debts, but retaining profitability. Failing might be motivated by ECB and home country policies	**Medium** Lower levels of credit and bank intermediations, higher provision and higher interest rates. FDIs will not be affected by this factor, but inter- and intra-firm credit may rise.
7. Capital flight – Italian banks in short to mid-term	**Low** The international interest rates arbitrage and fact that WB own the money, will keep them in a country.	**High** In general the stability is good to depositors in banks; if these bank change owners, the new ones will have the same incentive to operate in a country.
8. Capital flight – Greek banks, short to mid-term	**Low** For the same reason, plus Greek are less important as owners than Austrian and Italian banks	**High** Same as above.
9. Capital flight – Russian and Turkish banks, short to mid-term	**Low** Russian banks service Russian investment and residents; Turkish banks – the trade with WB; neither of those is likely to be significantly reduced or disappear	**Low** These banks will continue their business as usual; the Russian banks will continue their involvement side political activity.
10. Failure to streamline prudential regulations in banking and financial industry and apply them at arm-length, in medium term.	**High** Island of locally owned banks etc. are perceived as small and insignificant players (as they in reality are), often issues are being resolve by leaving them on	**Low** But low in economic term. Such institutions play a role of political temptation – to channel friend's accounts and savings. In these terms, limited the share of these

	themselves.	institutions in the system, political risk increases over time
"Pure" political risks		
	Low	**High**
11. Political system (representative democracy) failure, in short term.	The system improved in the last 10-15 years and is likely to do so, necessitated by EU accession integration with Europe prospects.	Elements of political discontent will increase to, perhaps, uncontrollable levels; the rise of populist parties is to be expected and reforms would set back.
	Medium	**Medium**
12. EU enlargement fatigue, in medium to long term.	This is one of the side-effects of Brexit, which might be counter-acted by plans for show-case enlargements.	EU pessimism may evolve into Omni-pessimism, about the fate of the countries, fueling populism, migration and dislike of political and economic openness.
	Low	**Medium**
13. Failure to prevent Russia imperialistic drive, in short term	The Russian investment, trade and penetration in banking sectors, except for Serbia and Republika Srpska, plus the above factors make this prospect unlikely.	Countries that fail to do so would put in a disadvantageous position not so much themselves but would challenge the status quoin the regions as a whole.
	High	**Low**
14. Failure to benefit from the Future-of-Europe debate initiated by Brexit, in short to medium term	WB are likely to benefit from a more relax political Union, from greater tax, regulatory and labor market competition. There is a lack of leadership to insist on and take responsibility for such development, both on the side of EU and WB.	The EU enlargement will continue as business as usual; the impacts of the Brexit will be indirect, depending on choices other countries make.
	Medium	**Medium**
15. Failure to improve public governance and rule of low, in short and medium term	Other countries, e.g. Georgia, NE, have demonstrated how beneficial may be such approach to reforms. WB may learn from negative examples as well.	The countries will lose opportunities to improve investment climate for domestic and foreign investors alike.

B. CONCLUSIONS: EAEU RISK ASSESSMENT MATRIX

Threat	Relative Likelihood	Impact if realized
	Risks related to monetary and economic policies	
1. Failure to create a non-Ruble currency area (short term)	**High** The economic influence of Russia is insurmountable; its economy is heavily geared towards natural resources and their markets determine the value of the Ruble with direct side effects on other currencies.	**Low** There are substitutes to the Ruble as an accounting unit and means of exchange; in fact most member states use USD. The project to create a Eurasian currency is put on hold.
2. Relative depreciation of the Ruble - medium to long term impacts	**High** In the short run the Ruble is likely to stabilize it exchange rate. The depreciation of EAEU currencies is not to produce greater export opportunities...	**High** The exports and FDIs would remain dependent on natural resources and Russia's economic performance and infrastructure.
3. Failure to integrate regional markets in the power sectors as frameworks	**Medium** The challenge is not relevant to energy system of the EAEU but rather for the links with China. Kazakhstan already started such integration, Russian project are not well designed and may not realize in the terms planned	**Medium** The impacts of the Russia – China energy cooperation, if realized in planned terms, are likely to benefit China but not Russia and the EAEU.
4. Failure to reduce unemployment through the above mentioned reforms in short to medium term.	**Medium** What is relevant are remittances from Russia to Armenia and Kyrgyzstan.	**High** The unsatisfactory economic performance of Russia and EAEU may cause pressures on the welfare systems of poorer members and other FSU countries.
5. Lower external demand in the event of new recession in the Euro zone in short run.	**Medium** WB has little to no room to maneuver, the factors are: investment crowding-out effects of the QE and Italian bank problems. Like in previous years, WB governments are not likely to address the reforms heads-on.	**Medium** Like in 2011-2012, the reduction or growth rates and even limited recession is likely.
	Banking sector risks	
6. Bank ownership and NPLs, in short to medium term.	**High** NPL situation seem manageable,	**Medium** Inter- and intra-firm credit may

	the problem is the heavy impact of domestic political networks on banks. The risk is to retain insulation of the EAEU payment system.	rise, government project finance – too, putting a stress on the fiscal systems.
7. Capital flight –short to mid-term	**High** Russia leads the capital flight "completion" globally.	**High** The EAEU members depend on Russian FDI up to 80% of mutual FDI.
8. Capital flight – Russian and Turkish banks, short to mid-term	**Low** Russian banks service Russian investment and residents (remittances); Turkish banks – serve Turkish FDIs in Central	**Low** These banks will continue their business as usual.
9. Failure to streamline prudential regulations in banking and financial industry and apply them at arm-length, in medium term.	**High** See above the comment on bank ownership.	**High** Banks would support government projects, perhaps more carefully than in the past due to threat to the entire economic and political system of the Union.
"Pure" political risks		
10. Political system (representative democracy) failure, in short term.	**Low** The system is not likely to improve in the next 3 to 5 years.	**Medium** Elements of political discontent will increase to, perhaps, uncontrollable levels; however political parties supporting the current regime will remain in control.
11. Failure of EAEU integration - in medium term.	**High** There are divergence factors that are impossible to neutralize – dependence on the Ruble and Russia economic performance.	**Medium** EAEU will attempt prolonging its current designs and plan with no greater success. In the long run this may motivate reforms, which again will depend on Russia's leading role.
12. Failure to improve public governance and rule of law, in short and medium term	**High** There is a lack of political will to do so.	**Medium** The countries will lose opportunities to improve investment climate for domestic and foreign investors alike.

X. ANNEXXES

A. ANNEX 1: PROFILING THE WB BANKING SECTORS: FOREIGN OWNERSHIP AND NPLS[118]

For each of the countries, the capital origination country and the respective assets of each of the banks with active licenses are listed further below (the data is available in editable format in the Annex 2). Below we give the country specifics in an ownership perspective.

For instances when the originating jurisdiction of the owners is associated with risks – like, e.g. Italy, for the reasons of a banking liquidity and NPL crisis, or Greece – for risks associated with its government default, there is separate section to assess their overall role in the WB. On June 29, the European Banking Authority announced that Italian, Austrian, Irish banks fare worst in EU stress tests.[119] In WB one of the mentioned bank are present: the Austrian bank Raiffeisen.

With regards to that it should be noted that ownership cannot be clarified in all cases even if formally stipulated. In many, apart from the official sources or where the information was missing from the official ones, additional information was used to study the background (available in the same attachment, along with selected shareholders, whether public or private company and/or other details and references, captured for separate banks during the research).

Italian Banks

- Group Intesa Sanpaolo
  - Serbia - Banca Intesa a.d. Beograd,
  - Albania - Intesa Sanpaolo Bank Albania,
  - Bosnia & Herzegovina
    - Intesa Sanpaolo Banka d.d Bosnia i Herzegovina,
    - Privredna banka Sarajevo d.d. Sarajevo
  - Croatia
    - Privredna Banka Zagreb d.d.
    - PBZ Stambena Štedionica d.d. – housing savings bank
- UniCredit Group
  - Serbia - Unicredit Bank Srbija a.d. Beograd
  - B&H
    - UniCredit Bank d.d Mostar
    - UniCredit Bank a.d Banja Luka
  - Croatia
    - Zagrebačka Banka d.d.
    - Prva Stambena Štedionica d.d. – housing saving bank
- Veneto Bank
  - Albania - Veneto Banka
  - Croatia - Veneto Banka d.d.
- Other

[118] The sources for this section are respective national banks and the sites of the individual banks or bank groups.
[119] See EBA website: http://www.eba.europa.eu/ .

    - Serbia - Findomestic banka a.d. Beograd (merger with OTP banka Srbija announced, but not a fact yet, BNP leaving the Serbian market (Findomestic Italy operates as subsidiary of BNP)
    - Kosovo - Banka për Biznes (Banca Di Cividale)
    - Montenegro - Hipotekarna banka AD Podgorica (various shareholders)

French Banks

- Société Générale Group
    - Serbia - Société Générale banka Srbija a.d. Beograd
    - Albania - Societe Generale Albania
    - Montenegro - Societe Generale banka Montenegro AD
    - Croatia
        - Splitska Banka (Societe Generale)
        - Shareholder in housing saving bank (along with other commercial banks) - Wüstenrot Stambena Štedionica d.d.
    - Macedonia - Ohridska Banka a.d. Skopje
- BNP Paribas
    - Serbia – Findomestic banka a.d. Beograd via Findomestic Banca Spa
    - Kosovo - TEB Bank
- Credit Agricole
    - Serbia - Crédit Agricole banka Srbija a.d. Novi Sad
    - Recently sold the Credit Agricole Bank Albania to a new shareholder Tranzit sh.p.k and the bank is now called American Bank of Investments (Tranzit is wholly-owned by investment funds managed by NCH Capital Inc. Established in 1993, NCH is one of the largest and earliest private investors in Russia and Central and Eastern Europe, with over USD three billion of capital under management.
- The French banking groups do not have presence in B&H.

Observed Risks

Some of the Italian banks are under stress at home, where the resolution for the banking problems proceeds as we speak.

So far, however, the withdrawal of Italian or French capital is not observed. The possible withdrawal of the Italian Findomestic could rather be evaluated as withdrawal of French capital as its owner is BNP Paribas. In general, the cross ownership allows for individual solutions that are not necessarily linked or caused with/by processes in the "home" jurisdiction.

An alarming trend with regards to the Italian Banks could be sought in the parallel with the Greek default and banking crisis. It triggered, for example, the sale of a "French"-controlled Credit Agricole's assets and particularly of the Greek Emporiki which resulted in the selling of some of the "grand-daughter" banks. Similarly, with the Luxembourg EFG and the Greek Eurobank.

Since there is no such indication neither for BNP's direct subsidiaries in the Western Balkans or in the CEE (where it has broad presence), nor for the other big French group Societe General whose coverage on those markets is also wide, there is no such parallel.

Moreover, Credit Agricole kept its Serbian subsidiary - Crédit Agricole Banka Srbija a.d. Novi Sad and stayed in Romania, but it withdrew from Albania, selling Credit Agricole Bank Albania, and withdrew from Bulgaria.

German and Austrian Banks

Germany

- Procredit
    - Serbia - ProCredit Bank a.d. Beograd
    - Kosovo - Procredit Bank
    - Albania - ProCredit Bank
    - B&H - ProCredit BankProCredit Bank d.d. Sarajevo
    - Macedonia - Procredit Banka a.d. Skopje
- German Investment and Development Fund – DEG is co-owner in Lovcen banka AD Podgorica

The Austrian Banking Groups

- Erste Group
    - Serbia - Erste Bank a.d. Novi Sad
    - Croatia - Erste & Steiermärkische Bank
    - Montenegro - ERSTE Bank AD Podgorica
    - B&H – co-owner of Sparkasse Bank d.d. BiH via Steiermärkische Sparkasse
    - Macedonia – co-owner of Sparkasse Bank Makedonija AD Skopje via Steiermärkische Sparkasse
- Raiffeisen
    - Serbia - Raiffeisen banka a.d. Beograd
    - Kosovo - Raiffeisen Bank
    - Albania - Raiffeisen Bank Albania
    - Bosnia & Herzegovina - Raiffeisen Bank d.d. BiH
    - Croatia
        - Raiffeisenbank Austria d.d.
        - Raiffeisen Stambena Štedionica d.d. – housing savings bank
- Hypo Alpe-Adria Bank – after the bankruptcy of the group its assets in Western Balkans (and in Slovenia) were acquired by EBRD and Advent International via Addiko Bank
    - Serbia – On 8 July, 2016, Hypo Alpe-Adria Bank a.d. Beograd changed its business name into Addiko Bank a.d. Beograd
    - Montenegro - Addiko Bank AD Podgorica
    - Croatia - Addiko Bank former Hypo Alpe-Adria-Bank d.d.
    - B&H (not rebranded yet):
        - Hypo Alpe-Adria-Bank d.d. Mostar
        - Hypo Alpe-Adria-Bank a.d. Banja Luka
- Former Volksbank International AG, now Sberbank Europe AG, a banking group 100%- acquired by Sberbank Russia in 2012. Volksbank International AG oversaw ventures outside Austria (Hungary, Serbia, Malta, Bosnia-Herzegovina, Slovenia, Romania, Croatia, Slovakia, and Czech Republic). The Bank in Ukraine - Volksbank Ukraine is now owned directly by Sberbank although acquired via the acquisition of Volksbank International AG and in 2013 was rebranded to PJSC "VS Bank", L'viv
    - Serbia - Sberbank Srbija a.d. Beograd former Volksbank a.d. Beograd,

Russian Banks

- Sberbank
    - Serbia - Sberbank Srbija a.d. Beograd (former Volksbank a.d. Beograd)
    - Croatia:
        - Sberbank d.d.

        - Shareholder in Wüstenrot Stambena Štedionica d.d. – housing saving bank
    - B&H:
        - Sberbank BH d.d. Sarajevo
        - SberbankSberbank a.d. Banja Luka
- VTB Group
    - Serbia - VTB banka a.d. Beograd, which was formed in 2008 as Moskovska banka a.d. Beograd. In May, 2013, the bank became member of VTB Group

Observed Risks Associated with German, Austrian and Russian Banks

No funds withdrawal from any of these banks is observed.

It seems that German investment, companies and trade are intermediated in WB by Austrian banks. The only German bank present throughout WB is ProCredit, but it operations are totally local and focused on small business, financed by arbitrage opportunities.

No other Russian officially stipulated ownership was identified in the rest of the western Balkan countries, except for Serbia and B&H. However, as there are many privately owned banks, where the background of the shareholders is not publicly announced as well as public companies where the float shares are not listed, there might be other Russian participations (which is applicable to any other origin of capital of such types of companies/banks).

It seems that German and Austrian banks adhere to better reporting standards.

Greek Banks

Being EU banking groups, these banks are easily attributed to the same category as their western European peers.

Greek banking groups are found in Serbia, Macedonia and Albania.

- Alpha Bank
    - Serbia - Alpha Bank Srbija a.d. Beograd
    - Albania - Alpha Bank Albania
    - Macedonia – As of May 2016 Alpha Bank Skopje, the Bank operates under the name Silk Road Bank AD Skopje. It was acquired by a Swiss-based company Silk Road Capital AG, Switzerland, whose registration is quite recent
- EFG Eurobank – After the Greek financial crisis and bailouts of Greek banks in 2012 Swiss-Luxembourg based EFG Group, the then owner of Eurobank, was told to separate the Greek bank from the rest of its business. In July that year Eurobank was deconsolidated from the group and the shares sold to the Greek Latsis family and was renamed Eurobank Ergasias
    - Serbia - Eurobank a.d. Beograd former Eurobank EFG a.d. Beograd
- Piraeus Bank SA Athens
    - Serbia - Piraeus Bank a.d. Beograd
    - Albania - Tirana Bank
- National Bank of Greece
    - Serbia - Vojvodanska banka a.d. Novi Sad
    - Albania - NBG Bank Albania
    - Macedonia - Stopanska banka a.d. Skopje
- In Montenegro, there is a bank which is also created by Greek capital - Universal Capital Bank AD Podgorica, whose ownership was transferred to the Sigma Group Holding which belongs to Petros Stathis and it has its base at Podgorica. Mr. Stathis is a Greek businessman and a Greek

citizen, but he also has Montenegrin citizenship. UCB considered a member of the Montenegrin bank system

- A Cyprus based Group - Cyprus Popular Bank, is to looking to sell off its Serbian subsidiary - Marfin Bank a.d. Beograd via tender and in April 2016 announced that the binding offers for the acquisition of CPB's participation in Marfin Bank AD Belgrade were submitted by the preselected investors and are under examination. Cyprus Popular Bank was the second largest banking group in Cyprus behind the Bank of Cyprus until it was shuttered in March 2013 and was split into two parts

Observed Developments with the Greek Banks

Although in some markets they were direct competitors, the Greek banks' expansion into the Balkans as well as some Central and Eastern European countries was activated upon acquisition by western European groups (Credit Agricole, EFG Luxembourg).

In the Westerns Balkans, their presence is limited to Serbia, Macedonia and Kosovo (but also found in Bulgaria, Romania, and Turkey). The impact of the Greek financial crisis did not threaten the system as whole. Although the aftermath is not complete (there some recent acquisitions or currently ongoing tenders - see below), the recovery measures for owning parent were undertaken with not as much panic and hurry as was expected, looking for market driven pricing and deals.

Similar to the said mergers and acquisition happened recently in Bulgaria, the pattern is common: Greek (in fact international) banks that invested sovereign Greek debt swapped their assets to their creditors, and now the creditors restructure the exposure to neighboring markets as part of an intra-group consolidation. This happens in isolated and insignificant for the local banking system or taxpayer dimensions, with no bailouts.

Turkish Banks

- Türkiye Halk Bankası A.Ş was founded by the leader of Turkey Mustafa Kemal Atatürk in on 26/08/1924; The bank is publicly owned since its establishment (Isbank Pension Fund (40.15%), Free Float (31.76%) - About 60% of the free float is held by foreign investors and Ataturk's Shares (28.09%) - The Republican People's Party (CHP) is the testamentary heir to the shares initially held by Ataturk)
    - Serbia - Halkbank a.d. Beograd. In 2015, the Turkish Halkbank became the owner of 76.74% of the share capital of Čačanska banka. Halkbank purchased shares of the four major shareholders - the Republic of Serbia, European Bank for Reconstruction and Development (EBRD), International Finance Corporation (IFC) and Beogradska banka
    - Albania - Türkiye Is Bankasi (branch)
    - Macedonia - Halk Banka a.d. Skopje
- Ziraat Bank
    - Kosovo – Ziraat Bank, the bank is new on the Kosovo market (since 2015) and although listed in the Central Bank of the Republic of Kosovo the Financial Stability report (data as of June 2015) was not covering its balance sheet assets/liabilities yet
    - Montenegro - ZIRAAT Bank Montenegro AD Podgorica
    - B&H - ZiraatBank BH d.d.
- Banka Kombëtare Tregtare is fully owned by Çalık Holding A.Ş based in Istanbul (focus on major business lines such as construction, energy, textiles, finance, telecom and media).
    - Albania - Banka Kombëtare Tregtare
    - Kosovo - Banka Kombëtare Tregtare (Branch)
- Kentbank d.d. – Croatia - Eksen Holding (Süzer Group) took over Banka Brod d.d. In July 2012, the Bank changed its name to KentBank d.d. The mother bank in Turkey no longer exists as was

taken from the owners by the Agency and transferred to FADE (a savings insurance foundation) in 2001, although Turkish State Council judged that the transfer was illegal; Süzer Group had appealed to the ECHR in 2005, demanding $4.13 billion in compensation from the Turkish government for its loss. In Feb 2013, Turkish bank and state agency settled the case with the owner of Kentbank, Mustafa Süzer, who agreed not to apply for the return of the company's banking license, or to apply for a new one.

Observed Risk

While the Greek Banks coverage in Western Balkans was related to the geographical reach of their Greek clients' businesses, the interface with the real economy of the Turkish banks is more strongly connected to its origin.

It could also be observed that their orientation is not as much geographically driven as by other factors – possibly the cultural background of the population and may be even its religious structure.

Small but not Insignificant NE and WB Banks

Apart from the above it should be noted that there is another small but not insignificant number of banks or even banking groups with local or internal-to-the NE-Balkans countries background. Not covering the stand-alone locally owned banks, the following can be summarized (details for which, where found are available case by case in Annex 2.2).

- **NLB Group – Slovenia** - 23.3% market share by total assets in Slovenia
    - Serbia - NLB banka a.d. Beograd
    - Kosovo - NLB Prishtina
    - Bosnia & Herzegovina
        - NLB bankaNLB Banka a.d. Banja Luka
        - NLB BankaNLB Banka d.d. Sarajevo
    - Montenegro - NLB Banka AD Podgorica
    - Macedonia - NLB Banka a.d. Skopje
    - The group provides financial services (leasing and factoring) in Bosnia Herzegovina, Croatia, Bulgaria, Czech republic, it has presence in Italy via NLB, Trieste Branch office)
- **OTP Group – Hungary**
    - Serbia - OTP banka Srbija a.d. Novi Sad; possible merger or acquisition of Findomestic banka a.d. Beograd (owned by BN Paribas via Findomesic Italy)
    - Montenegro - Crnogorska komercijalna banka AD Podgorica
    - Croatia - OTP Banka Hrvatska d.d.
    - The group also owns banks in Romania, Bulgaria, Slovenia, Ukraine and Russia; it also provides other financial services
- **Komercijalna banka a.d. Beograd** – Serbia. Shareholders: Serbia state owned shares - 41.74%, EBRD 24.43%, IFC Capitalization (Equity) Fund, L.P. 10.15%
    - Serbia - Komercijalna banka a.d. Beograd
    - Kosovo - Komercijalna Banka ad Beograd - Mitrovica Branch (branch)
    - Bosnia & Herzegovina - Komercijalna banka a.d. Banja Luka
    - N.B! Macedonian Komercijalna Banka a.d. Skopje and Crnogorska komercijalna banka AD Podgorica are not related with the above
- **Bulgarian banks:**
    - First Investment Bank AD, Sofia (4th in assets in Bulgaria)
        - Macedonia - Univerzalna Investiciona Banka a.d. Skopje
        - Albania - FIBANK Albania
    - CKB Group owner of Central Cooperative Bank, Sofia

        - Macedonia - Centralna Kooperativna Banka a.d. Skopje
    - Alfa Finance Holding SA Sofia (investment company)
        - Capital Banka a.d. Skopje

Selected Cases[120]

Last, but not least it should be noted that there are separate cases, which cannot be attributed in either of the categories but when going through list of banks in each country, stand out. Some of them are.

- In Serbia:
    - Apart from the EBRD-Advent International owned Addiko Bank a.d Beograd, there is one more bank with capital originating from USA – Opportunity banka a.d. Novi Sad (member of "Opportunity International" – a network of banks and microfinance organizations which was founded in Chicago in 1971).121
    - KBC Group, Belgium withdrew from the Serbian market transferring the KBC Banka a.d. Beograd assets to Telenor Danmark Holding A/S (multinational mobile services provider), renamed to Telenor banka a.d. Beograd in May 2014.
    - MIRABANK a.d. Beograd received license in December 2014 and is registered in February 2015, its capital is attributed to Netherlands, and however no further details were captured for the shareholder Duingraaf Financial Investments B.V. Retterdam.
- In Albania
    - United Bank of Albania operating since 1999 is now owned by Islamic Development Bank, Saudi Arabia 86.70%, the rest of the shared are owned by 2 other companies, based in Saudi Arabia, 2 in Bahrain and 1 in Malaysia.
    - Credit Bank of Albania – according to Albania Supervision Annual Report from 2015, issued by the Central Bank of Albania, the bank is owned by 8 individuals with country of capital origin Kuwait (the source is used for all the banks in Albania, one of the instances where official information was available, for some however additional research was done and the links are captured in Annex 2.3).
    - Credins Bank - 21 individuals ~ 75% Albania, B.F.S.E Holding B.V ~18% Netherlands, SIFEM AG ~3% Switzerland, EDRO sh.p.k ~ 1% Albania
    - International Commercial Bank Albania – 100% owned by Financial Group ICB Holding, Switzerland, which also owns banks in Bangladesh, Djibouti, The Gambia, Ghana, Guinea, Indonesia, Lao Pdr, Senegal, Sierra Leone
- In Montenegro
    - AZMONT BANKA AD Podgorica is owned by Azmont Investments, the corporate parent of which is Azerbaijan Global Investments (AGI), a consortium of three leading Azerbaijani Investment Holding companies
- In Croatia
    - PRIMORSKA BANKA d.d. was established in 2001 and currently is subsidiary of a privately owned Swiss bank - CIM Bank, focused on private banking or may be even boutique banking

[120] The explicitly stipulated details on some entities should not put the emphasis on them – it is result of the uneven accessibility of the information (for example the profiles, coverage, background etc. of the so called big western European groups are with better known and transparent track records and are easily accessible). Where other standalone shareholders are identified and information was gathered, they could be found in the Annex 2.5.
[121] Also it should be mentioned that apart its bigger projects (such as Hypo Alde Adria Group), EBRD is shareholder in other separate ventures such as Komercijalna Banka a.d. Skopje, TTK Banka a.d. Skopje, Union bank, Albania and other.

    - In Croatia's number of local banks is highest among the western Balkan countries. Many of them are privately (i.e. not by public traded corporations) owned, sometime individually owned, or even if listed on the stock exchange shareholder structure remained nontransparent, which involved using unstructured information as reference in many cases (particularly captured Annex 2.4)
- In Macedonia
    - The already mentioned Silk Road Banka a.d. Skopje was initially established in April 1993 under the name Kreditna Banka a.d. Skopje and was one of the first private banks in Macedonia. In January 2000, Alpha Bank A.E., Athens, acquired the majority stake in it. The new shareholder Silk Road Capital AG which was registered recently (in Oct 2015) in Switzerland could be associated (although no indication of direct relationship was found) with Silk Road Group also based in Switzerland with offices in Georgia. If relevant to the acquisition of the bank in Macedonia it should be noted that the Group is operating in transportation and telecommunications in: Azerbaijan, Georgia, Iran, Kazakhstan, the Russian Federation, and Turkmenistan; transportation and trading of crude oil and petroleum products from Azerbaijan and the Central Asian states of Turkmenistan, Uzbekistan, and Kazakhstan to the Georgian Black Sea ports of Batumi and Poti, as well as Iran and Afghanistan; forwarding of container cargoes from the Persian Gulf and the Black Sea ports of Georgia to the Caspian and Central Asian regions. The group also owns a bank in Georgia – Silk Road Bank, Tbilisi and is active in financial sector with different subsidiaries. it should be noted that the group possesses the group also owns a Georgian Bank which is a group
- In B&H
    - Bosnia Bank International d.d. Sarajevo is owned by United Arab Emirates and Dubai 54.5% and Saudi Arabia 45.5%.

Assets and NPLs: Country Snapshots

In this section WB banks are listed with their respective assets and the country of capital origin. We include also the bank system of Croatia. The rationale is that a) as ex-Yugoslav and former WB country its banks are interlinked with the other countries and b) it demonstrates some patterns that are important in the context of political risk analysis.

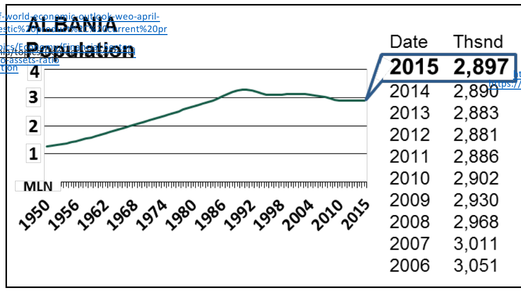
To provide orientation for the context in which each banking system is functioning and as basis for zoomed-out comparison the following statistical data is also provided: Population, GDP in billions of USD, Credit provided by the banks to private sector as share of GDP, bank capital to assets ratio (aggregated), Non-performing Loans (NPL) to total gross loans (the source of the latter is knoema.com Atlas and World Development Indicators, also extracted using, knoema.com).

The assets of the Banks in B&H are not available for each bank as the official source provides only data aggregated on system level. Detailed information on different countries banking systems is provided in Excel-format in Annex 2: WB Banking Systems (ownership, size of banks and data sources).

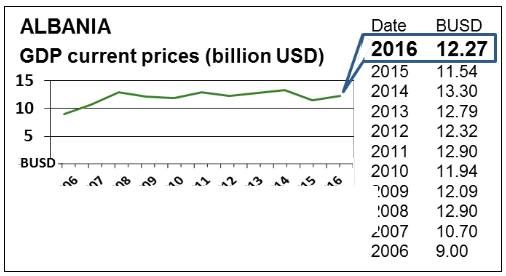
Albania

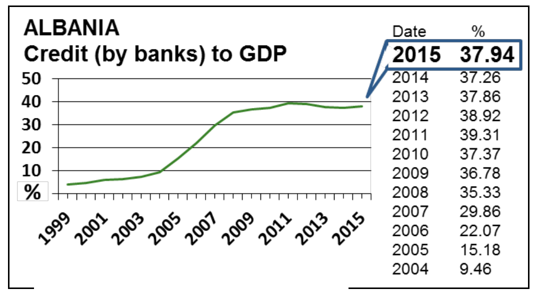
The foreign ownership in the country's banking system is above 90%; the largest bank is Turkish, with 25.4% of the total assets in 2015 (or equals 20.3% of GDP).

The Greek ownership is 14%, the Italian – 13%. Holland's share is bigger than Albania at 10.7%. If we take into account the mixed ownership, the Albanian capital is probably 7% or less.

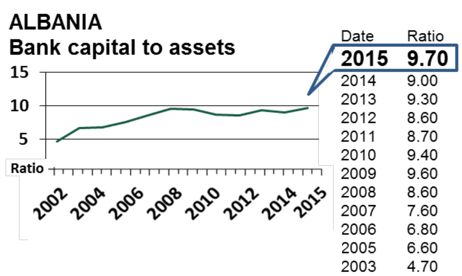


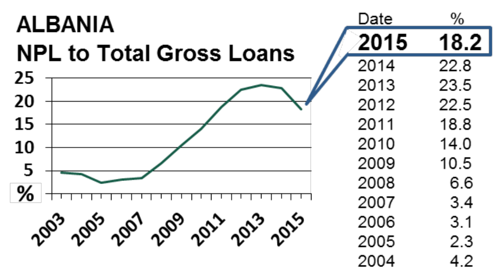
The dynamics of credit activity does follow strictly the GDP and economic performance; credit doubled before the recession, and then remains below 40% of GDP.





Capital to assets ratio is on the level of what is required by the Central Bank, and, and after several years of worsening, the NPLs' up-trend seems to have been reversed downwards.



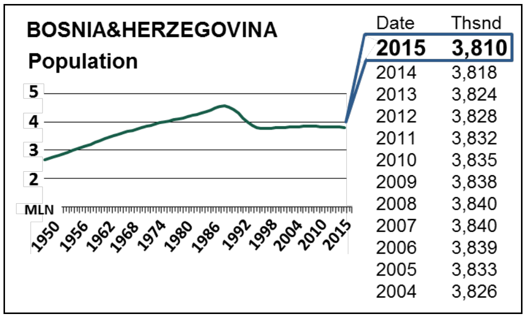


B&H

There is no reliable data on bank ownership in B&H.

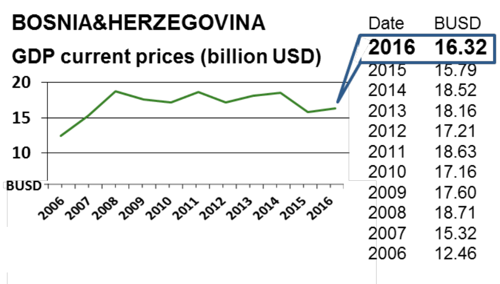
The central bank of Bosnia & Herzegovina operates like a currency board, with emission monopoly right for a national legal tender, Kovertibilna Marka (KM). The central bank and currency reform took place, as political and technical preparation, in 1997 and the KM was circulated from 22 June 1998 (on July 7, the previous legal tender, the Bosnia & Herzegovina Dinnar, ceased to exist). The system: fixed the exchange rate first to the DM, and then to the Euro (at 1.95583), prohibits central bank credit to public and private entities, and requires 100% coverage of the money in circulation with hard currency reserves.

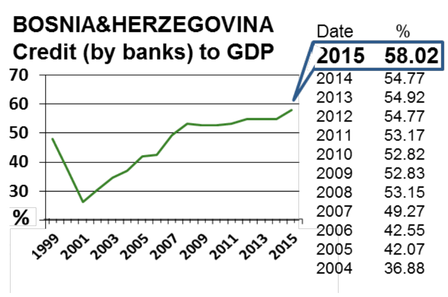
The B&H system is, arguably, one of the most successful reforms in the post-Communist world, for the fact that it was upheld in a war-torn country, and for its multiple positive effects on the economy and politics of the country.[122] It is not widely known that KM reform proceeded almost in parallel with a similar reform in Bulgaria, with practically the same team of experts involved. The currency board system in Bulgaria was introduced on July 1, 1997, had the same features,[123] and the Bulgaria Lev (BGN) was fixed at the exactly same rate as KM.



B&H with a population of less than 4 million, has basically as many banks as Croatia and Bulgaria. The explanation is that different parts of the countries prefer supervising own registered bank entities.

13 out of 25 banks are foreign. We estimate first and second tier banks are foreign, i.e. the total foreign ownership at about 91% of the system's assets. (There are other estimates., e.g. IMF most recent review estimates is 82% of the banking sector assets - see footnote below.) Also, it is the only WB country with visible, though not dominant presence of non-EU (Turkish, Arab and Russian) banks. Their total ownership is about 25-30% of the assets, at 15% lesser exposure than EU bank groups.[124]





IMF and B&H Central Bank estimate is that five largest banks control about 50% of the assets.

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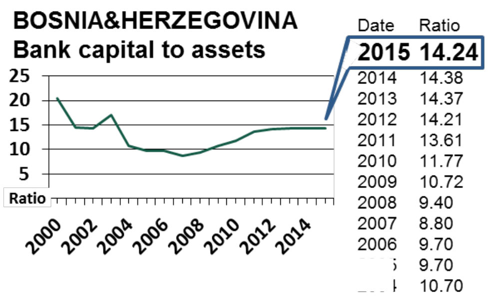
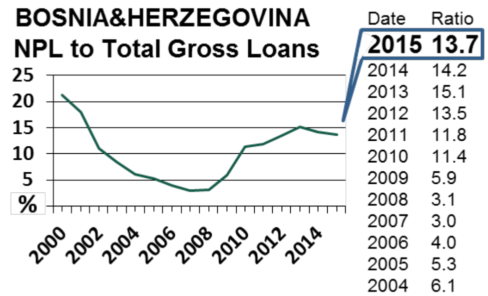
[122] For greater details on the process and challenges of the reform see: Warren Coates, One Currency for Bosnia: creating the central bank of Bosnia & Herzegovina, New York, Jameson Book, 2007.
[123] The only difference is that Bulgarian National Bank was set to include a Bank Department, capitalized with USD 150 million, to intervene in an event of bank runs. The motivation was the 1996-1997 bank crisis, estimated as the most severe in the transition from plan to market in Europe: half of the banking system collapsed, and the costs were calculated at 41.5% of 1996 GDP (see: Helena Tang, Edda Zoli and Irina Klytchnikova, Banking Crises in Transition Countries: Fiscal Costs and Related Issues, 2000, World Bank Working Paper 2484). No such run had ever happened, until 2014 when a locally owned, politically protected bank was robbed, allegedly by its main shareholder and political supporters. (See, on this particular case and associated bank run of June 25-25, 2014: Krassen Stanchev, Reputation Matters: A Not-So-Typical June 2014 Bank Run in Bulgaria (A Public Choice Perspective), 4Liberty.Eu, July 9, 2014, at: http://4liberty.eu/newtheme/reputation-matters-a-not-so-typical-june-2014-bank-run-in-bulgaria-a-public-choice-perspective/ .)
[124] Compare other estimates: Claessens, S. and N. Horen. 2014. Foreign banks: Trends and impact. Journal of Money, Credit and Banking. Supplement to 46(1), pp. 295–326; Sònia Muñoz, Peter LõhmusFinancial System Stability Assessment (FSSA) for Bosnia & Herzegovina, IMF Country Report, 15/177, May 20, 2015, pp. 6, 11.

The credit expansion of B&H was one of the most modest in the region, the banks control 87% of the financial system, resort to classic lending traditions and avoid investing in risky assets. This explains the relatively low level of NPLs in the system. https://knoema.com/atlas/Bosnia-and-Herzegovina/topics/Economy/Financial-Sector-Assets/Bank-nonperforming-loans-to-total-gross-loans

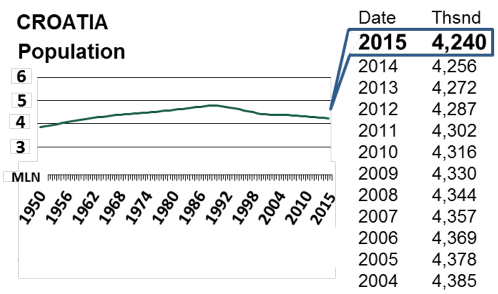




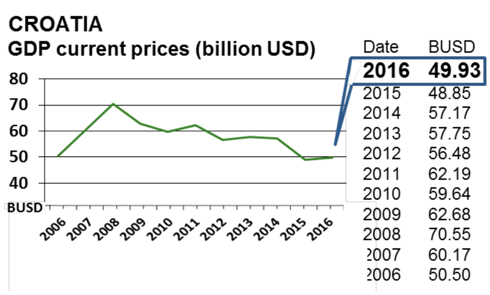
Croatia

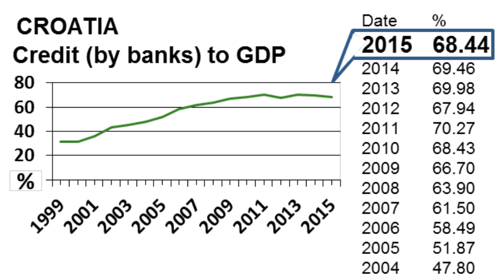
In 2000, Croatia was the first Balkan country to benefit from froreign bank penetration, during and on the aftermath of a deep bank crisis of 1998-1999, securing the "mid-term survival" of the system - all above listed benefits of such strategy were to be observed in Croatia.[125]

Since then, the performance has been uneven. In the period between 2009 and 2014 the foreign banks withdrew, according to IMF, EUR 6 billion from the system, a sum euqal to 14% of 2013 GDP.



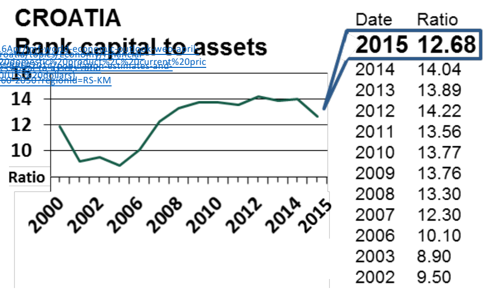
Irrespectively to the recession, the bank credits continued to rise as percent of GDP after 2008-2009, and in 2015 this share was one of the highest in the region.

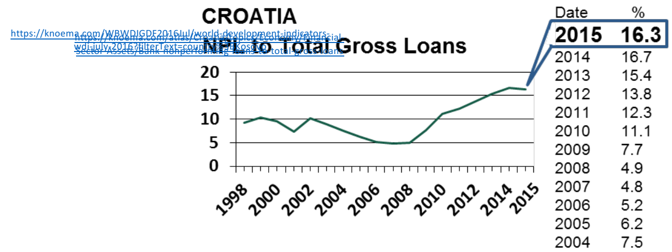




The bank capital to assets requirement is 12%, and the average compliance is at this level, although CNB indicates some deviations and the supervision assigned specific measures to enhance compliance.

[125] Tomislav Galac, Evan Kraft, What Has Been the Impact of Foreign Banks in Croatia?, CNB, December 2000, at: http://old.hnb.hr/publikac/pregledi/s-004.pdf; see especially on the mid-tem survival: pp. 10-12.





At the same time, the NPL's share in total gross loans is less of a problem than in Serbia.

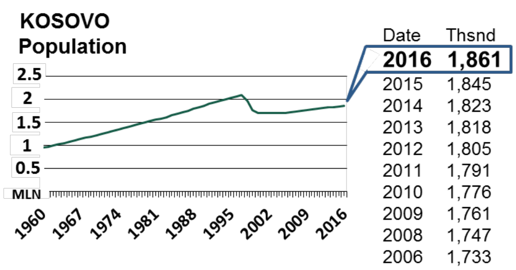
Based on the CNB latest data and banking sector balance sheet, the estimated share of foreign banks, not calculated the cross shareholding in the system is 77.6%. The lead banks may be considered Austrian, with 22.8%, followed by Italy – 18.8%. However, one bank that is listed as mixed Italian Austria ownership, UniCreditGroup has 26.2% of the total assets.

The Russian share is 2.5, US – 6.05%, Czech Republic and Turkey (and San Marino) – less than 0.5%.

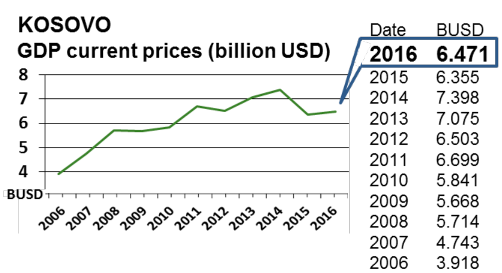
***Kosovo*[126]**

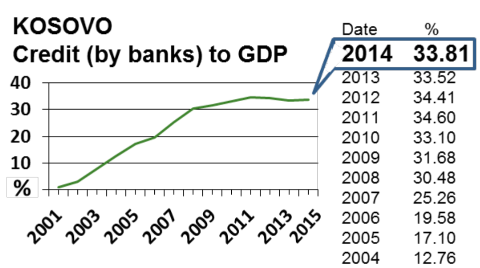
Kosovo's central bank data on foreign ownership suggest that it may be as high as 94%, the only bank listed as domestically owned Banka Ekonomike has 5.9% of the total assets, and one with supposed Italian ownership has 3.7%. Austria and Germany each have approximately 25% of the total assets.

The rest of the banking sector can be viewed in the enclosed 2015 balance sheet.



All available data on Kosovo banks suggest that the system is healthy and there is a room for the credit to grow: it is the smallest banking sector in WB, in terms of credit to GDP and in terms of number of bank to the population.





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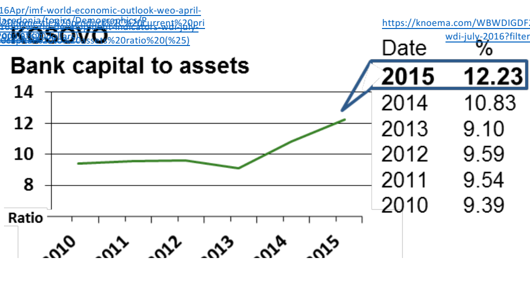
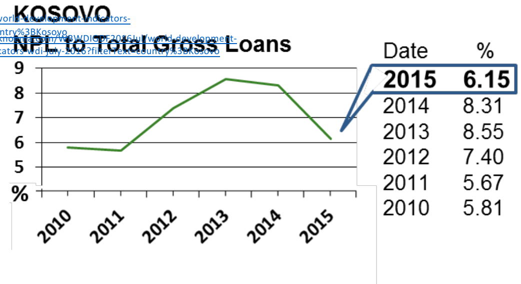
[126] Source: Central bank of the republic of Kosovo, Financial Stability Report: http://bqk-kos.org/repository/docs/2015/Central%20Bank%20of%20the%20Republic%20of%20Kosovo-FSR.%20No.%208..pdf



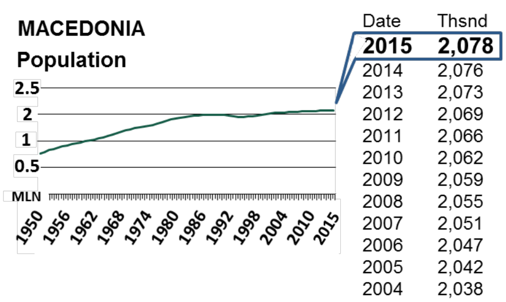


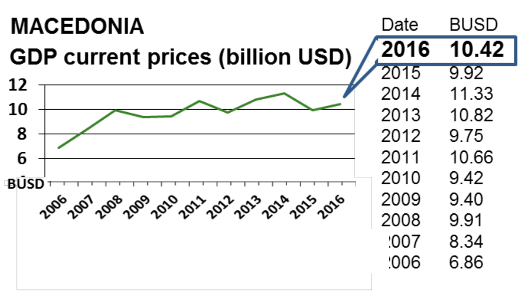
The NPL indicator is much closer to best EU standards.

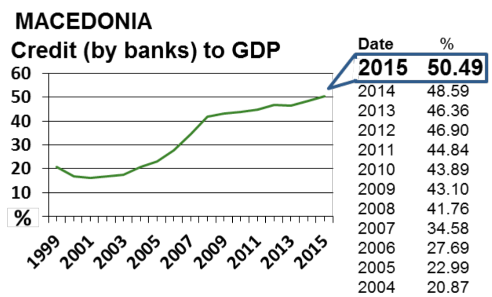
Macedonia[127]

The foreign ownership of the sector is 84.2% but unlike other WB countries, the lead share of the total banking assets is Swedish. Next is Greece with 20.3% and Slovenia with almost 16% of the assets. From IMF reports on Kosovo it is possible to speculate that Swedish and Swiss (3.2%) banks serve the Kosovo Diaspora.

Turkey is the fourth owner, with 7.6%, followed by Bulgaria (with three banks and almost 6% of the total assets). Germany is less than 5%. Some shareholders of locally owned banks are not clear; the foreign ownership may be 2-3% higher.

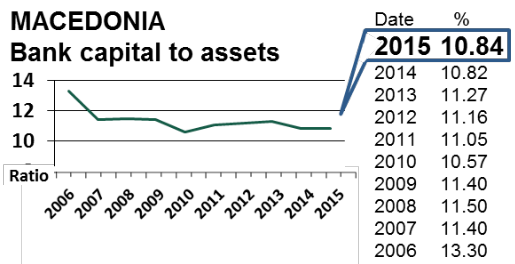


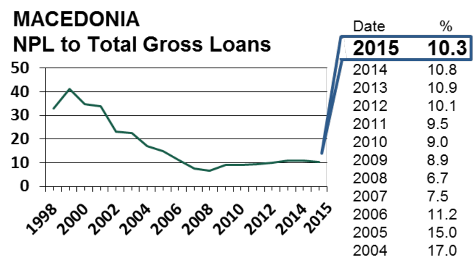




[127] Source: National Bank of the Republic of Macedonia, Banking Supervision and Regulation, Banking System Indicators and Reports, Banking System Indicators: http://www.nbrm.mk/default.asp?ItemID=BF9EB19BE82C6F4288BBE28DE2C18163

The bank credit is on a steady upward trend; its share of GDP has more than doubled since the Kosovo and Macedonian crisis of 1999 and 2001. NPLs are at a relatively tolerable level. The capital to assets ratio suggests that the Central Bank still needs to implement Basel II and Basel III standards.

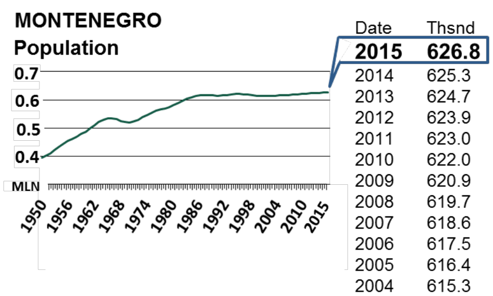


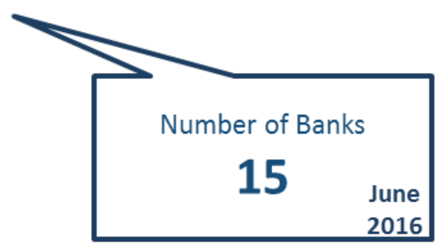


Montenegro[128]

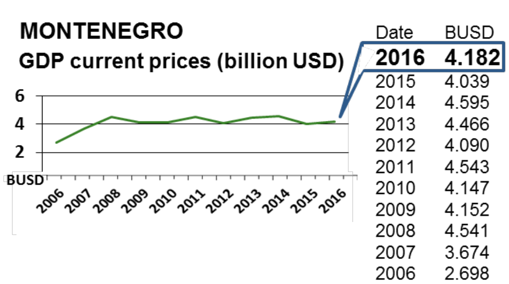
The local ownership in banks is 9.4%. There is no foreign owner as dominant as in other WB banking sectors; it is the only country where there are Ukrainian and Azeri banks, although with insignificant share in the total assets, of 1.5 and 0.4% respectively. It is also the country with the most sizable declared American presence in the system – 6.8%, twice higher than the Serbian share.

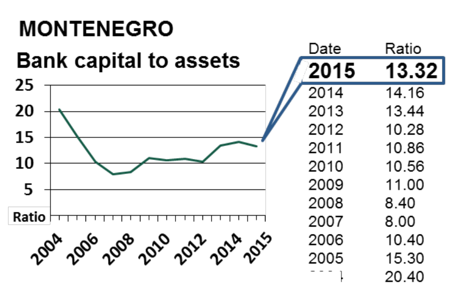
The largest foreign bank owner is a Hungarian institution – with almost 16% of the assets, followed by Slovenia, France and Austria (with shares 13.3, 12, 11.6%).





Montenegro looks like a "champion" in the WB and probably outside the region in terms of bank per capita: there is one bank per 41-42 thousand residents.





Data on bank credit to GDP is not available; it is impossible to speculate on banking sector development. It is obvious that in recent years banks have met the capital to assets requirements.

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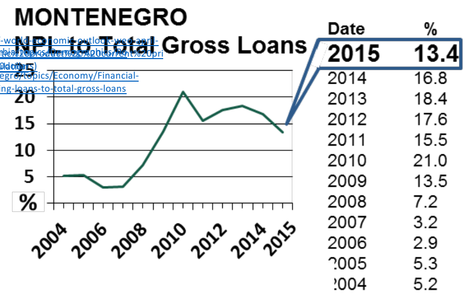
[128] Source: Central Bank of Montenegro, Bank Supervision, Balance sheets and P/L statements of banks: http://www.cb-cg.org/eng/index.php?mn1=bank_supervision&mn2=balance_sheet_and_profit_and_loss_statements_of_banks

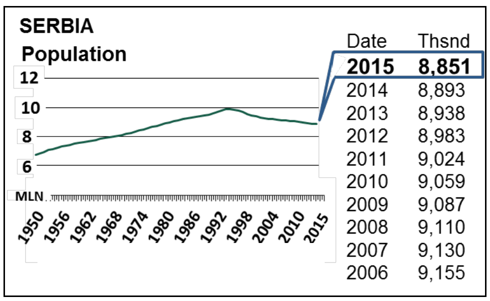


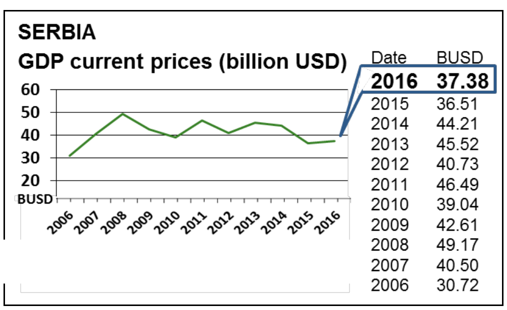
https://knoema.com/WBWDIGDF2016Jul/world-development-indicators-wdi-july-2016?filterText=country%3BKosovo

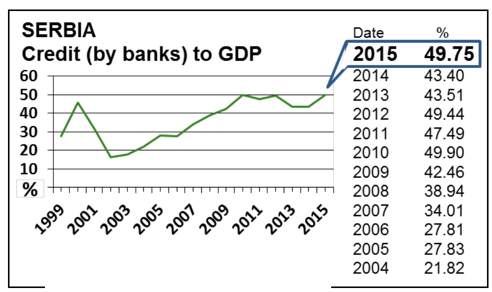
NPLs are at a tolerable level, although far worse than EU best performers (of 5.6%).

Serbia[129]

Serbia is the largest WB economy. The total foreign ownership in Serbia banking industry, measured as share of the total net assets of the system, is 71.83%. This share does not include banks that were just licensed, declared their capital but do not operate as well as banks (or rather credit cooperatives established by charity programs).



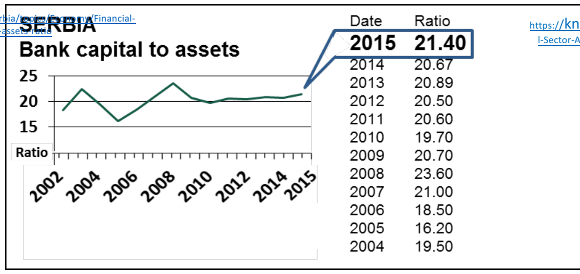


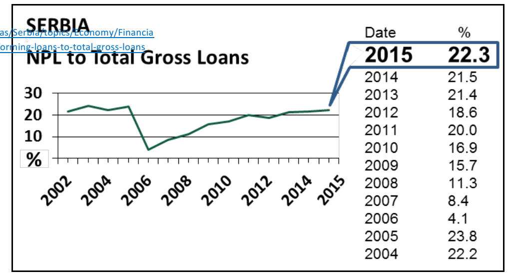


Serbia GDP dynamics is the only one in WB in which there are short periods of growth followed by equally short periods of recession.

The credit in Serbia more than doubled in the last twelve years. It grew even in the recession years, but dropped by 2 and 6% respectively in 2011 and 2012.

[129] Sources on banking system data for this section are: National Bank of Serbia, List of banks: http://www.nbs.rs/internet/english/50/50_2.html and National Bank of Serbia, Financial reports Balance Sheet Assets, net: http://www.nbs.rs/internet/english/50/50_5.html





The capital to assets ratio in Serbia, like in all WB countries, is required by central bank regulation to be 12%.

After 2006, the NPLs (share to gross extended credit) grew five times.

The largest foreign owner in the system is Italy with 26.7% of the total net assets (or EUR 6.86 billion, in two banks – roughly 18.3% of Serbia's GDP). Next comes Austria – two banks, EUR 3.4 billion (9.1% of GDP), 13.25% of the total assets, followed by Greece, with EUR 3.26 billion in four banks and 12.7% of the total assets. France has 7.5% of the assets. (The share of Russia is 3.6% of Germany – 2.7 and of Hungary – 1.9%.

The NPLs are roughly equally distributed between the leading banks.

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C. ANNEX 3: STATISTICAL AND BANK ATTACHMENTS (SUBMITTED SEPARATELY)

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