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The Impact of Banking Sector Credits on Economic Growth in Western Balkan Countries

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Abstract

While it is widely acknowledged that bank credit can contribute to a country's economic growth by providing essential financing to the public and private sectors, the relationship between economic growth and bank credit is complex. This study aims to explore the impact of bank credit, along with four other variables, domestic credit to private sector, deposit interest rate, inflation rate, and non-performing loans on economic growth in six Western Balkan countries from 2008-2021. The research, based on secondary data from international organizations, the World Bank, and National Statistical Agencies, utilized Panel data with 69 observations. Various econometric models including OLS, fixed effects and random effects were used due to unbalanced panels. Findings suggest a mixed impact of bank credit on growth, with inflation rate positively affecting it, while domestic credit to private sector, deposit interest rate, and non-performing loans have negative effects.

Keywords: *Banking Sector, Economic Growth, Interest Rate, Inflation, Non-performing Loans*

INTRODUCTION

The banking sector is an important part of an economy's structure and affects economic growth. This is especially important in Western Balkan countries, where major economic and political transformations have taken place in recent decades. In this respect, analysis of the relationship between the banking sector and economic growth is indispensable for understanding the dynamics of economic development and determining how the banking sector can contribute to the economic growth of a country. An in-depth analysis of the impact of banking sector loans on economic growth in the countries of the Western Balkans is necessary to better define the challenges and opportunities for the development of the financial sector and economic growth in the region. It is important that governments and financial market institutions work together to develop an appropriate and favorable environment for businesses and foreign investors, facilitating access to private sector credit. This would help increase production, create new jobs and increase national income, contributing to the economic growth of the Western Balkans. While many businesses need credit to enable their growth and development, the banking sector in the region often does not meet their requirements. This may be due to the lack of capital in the banking sector, the lack of information about businesses and enterprises, and the limitations of government policies affecting the financial sector. These challenges can affect the country's economic growth, making it more difficult for businesses to invest and increase production and create new jobs.

The Western Balkan region has undergone significant economic and political changes since the early 1990s, following the breakup of the former Yugoslavia. The development of the banking sector has been an essential aspect of economic transition and integration into the global financial system. Therefore, this part aims to provide an overview of the main moments and challenges in the evolution of the banking sector in the Western Balkans region, focusing on Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Montenegro and Serbia.

The emergence of the banking sector in the Western Balkans can be traced back to the late 19th and early 20th centuries, when the region was part of the Austro-Hungarian and Ottoman Empires. During this period, banks were created to facilitate trade and finance industrial projects, with a strong influence from the banking systems

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of empires. With the collapse of Yugoslavia in the early 1990s, the Western Balkans region faced substantial political and economic challenges, including the need to overhaul the banking sector. The transition to a market-oriented economy prompted important reforms to facilitate foreign investment, privatization and financial liberalization. According to Čihák & Podpiera (2006), during this period, governments in the region sought help from international financial institutions, such as the International Monetary Fund and the World Bank, to implement structural reforms and stabilize their economies.

One of the most visible characteristics of the development of the Western Balkans banking sector has been the significant presence of foreign-owned banks. Foreign banks, mainly from European Union countries, entered the region seeking new growth opportunities and access to an expanding market. They brought with them advanced banking technologies, risk management practices and corporate governance standards. The wave of foreign investment led to consolidation within the banking sector. Smaller domestic banks were acquired or merged with larger foreign-owned institutions, resulting in more stable and well-capitalized financial institutions. However, this also raised concerns about financial stability, as some argued that excessive foreign ownership could create vulnerability to external shocks IMF (2011).

The global financial crisis of 2008-2009 had a significant impact on the banking sector of the Western Balkans World Bank (2017). While the region was not at the epicenter of the crisis, the interconnection with European markets exposed it to several risks. However, the region's banking sector displayed remarkable resilience, largely due to the conservative lending practices that had been implemented and the early responses of governments and regulators. Following the global financial crisis, the Western Balkans region initiated further reforms to strengthen the regulatory and supervisory framework of the banking sector. Governments aimed to harmonize their banking regulations with EU directives, as most countries in the region expressed aspirations for EU membership. According to Balkans (2019), the EU accession process has prompted governments to improve their regulatory framework, increase transparency and address issues such as non-performing loans (NPLs) and money laundering.

So, the development of the banking sector in the Western Balkan region has been a dynamic process, influenced by historical, political and economic factors. From its socialist roots to post-socialist transitions, the sector has undergone significant transformations, attracting foreign investment and strengthening its regulatory landscape.

Therefore, the main purpose of this research is to evaluate the impact of the loans provided by the banking sector on economic growth in the countries of the Western Balkans through analysis of the main variables—economic growth, domestic credit to private sector, deposit interest rate, inflation rate, and loans of non-performing loans.

LITERATURE REVIEW

Previous studies on the impact of banking sector loans on economic growth have largely used private credit/GDP. In recent years, the nexus of private credit/GDP and economic growth has been a major issue in economic discourse around the world, and the empirical literature has been inconclusive on the issue. An important study in this field is that of Van Cuong (2020), which used the fixed effects, random effects, and generalized least squares estimation methods for panel data to examine the impact of credit on the private sector and the flow of foreign direct investment on the economic development of Asian countries from 1995 to 2017. The results indicate that credit in the private sector has a negative influence on the economic growth of these countries. Also, Tahir et al. (2015) examined the relationship between bank credit to the private sector and economic growth in Pakistan, for the period 1973-2013. Economic growth was treated as the dependent variable, while bank credit to the private sector, interest rates, inflation, investment to GDP, and government consumption were considered as independent variables. In the regression analysis, it was revealed that there was a negative impact of bank credit on economic growth in Pakistan. Also, results of Petkovski and Kjosevski (2014), show that credit to the private sector is negatively related to economic growth. On the other hand, the authors Gaffar and Osman (2014), aim to determine if the increase in private sector loans has a positive and statistically significant impact on the economic growth of Saudi Arabia, in a period of time 1974-2012. Their study, found different results on the results of other researchers, the study found that there is a long-term relationship between loans to the private sector and economic growth. Moreover, loans to the private sector

were found to have positive long-term and short-term relationships. Also, other researchers (Bijlsma et al., 2018; Akin et al., 2019;Kunanti and Adry, 2020), empirically examined the impact of credit to the private sector on economic growth, reaching the same conclusion.

The deposit interest rate is another important factor in economic growth and therefore many researchers have examined the relationship between it and economic growth. Since the countries included in our study have different monetary policy instruments, then as a variable we used the deposit interest rate. On one hand, an increase in the deposit interest rate implies a more restrictive monetary policy, exerting a negative impact on credit. Conversely, on the other hand, a higher interest rate encourages depositors to allocate their capital, consequently bolstering banking capacities for loan provision. Therefore, the direction of the impact is unclear. The authors (Duramany-Lakkoh et al., 2022; Ismail, 2021; Udoh and Ogbuagu, 2012; Hamada et al., 2018), examined the relationship between the deposit interest rate and economic growth and reached the same conclusion that the deposit interest rate has a positive impact on economic growth.

In the examination of the relationship between inflation and economic growth, there has been a continuous effort of discussion and disagreement, both in theoretical analyses and empirical studies. In the majority of studies, there is a strong tendency to support the idea of a negative relationship between them. However, some studies also propose the possibility of a positive correlation between them. (Adaramola and Dada, 2020; W. Madurapperuma, 2016;Huseynli, 2022), found that an increase in inflation has a negative impact on economic growth. On the other hand, (Gebeyehu Yismaw, 2019; Uddin, 2021) empirically examined the relationship between inflation and economic growth, concluding that there exists a strong and significant positive relationship between economic growth and inflation.

Non-performing loans pose a significant challenge to the banking sector, and therefore, the literature on the relationship between non-performing loans and economic growth is extensive. Referring to Zhang et al. (2022), who studied the connection between financial inclusion, non-performing loans, and economic growth in 21 OECD countries, their empirical results indicate that non-performing loans have a negative impact on economic growth. Similarly, Ahmad et al. (2016), investigated the relationship between non-performing loans and economic growth. They utilized economic indicators data (economic growth, interest rates, and inflation) and non-performing loans for the time span of 1998-2010 on an annual basis. Through regression analysis, the authors concluded that there is a negative relationship between economic growth and non-performing loans. Additionally, other researchers (Morakinyo and Sibanda, 2016; Osunnaiye and Alymkulova, 2022) studied this relationship, reaching the same conclusion.

DATA AND ECONOMETRIC METHODOLOGY

The methodology used in the research belongs to the type of quantitative methodology as it is based on secondary data. The countries studied are the six countries of the Western Balkans in a period of time from 2008 to 2021, in order to include the period of the global financial crisis. The type of data used in the research belongs to the Panel type, the collection of which will be done mainly from the database of the World Bank, which publishes statistics on an annual basis for all countries of the world and NBS (National Bank of Serbia). Statistical data processing will be done using the STATA program. In addition to descriptive statistics and correlation analysis, several types of econometric models will be implemented in this research, since the use of Panel data allows us to explore a larger number of models. The analysis begins with OLS model, but due to the work with unbalanced panels, the fixed effects model (FE) and the random effects model (RE) will also be used.

The equation used for the empirical analysis is as follows:

$$\textbf{Economic Growth} = \alpha + \beta_1 (\text{DCP}) + \beta_2 (\text{DIR}) + \beta_3 (\text{INF}) + \beta_4 (\text{NPL}) + u_i$$

α – constant coefficient (intercept)

β1 – is the parameter estimated by the explanatory variable " Domestic credit to private sector"

β2 – is the parameter estimated by the explanatory variable " Deposit interest rate"

β3 – is the parameter estimated by the explanatory variable "Inflation rate"

β4 – is the parameter estimated from the explanatory variable "Non-performing loans"

$\mathbf{u_i}$ – error term

Table No 1. Description of research variables

Variable	Abbreviations	Unit	Source	Expected impact
Economic growth	EG	%	World Bank	
Domestic credit to private sector	DCP	% of GDP	World Bank	+
Deposit interest rate	DIR	%	World Bank	-
Inflation	INF	%	World Bank	-
Non-performing loans	NPL	% of total gross loans	World Bank & National Bank of Serbia	-

RESEARCH RESULTS

This part contains the empirical results of the research, the analysis of which was done by statistical calculation program STATA. First, we will present the descriptive statistics of the variables, then the correlation coefficient table to understand what relationship exists between the variables and the results of the econometric models.

Table No 2. Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
EG	83	2.547	3.823	-15.31	12.43
DCP	84	45.771	9.521	30.54	86.45
DIR	70	3.234	3.068	.37	16.13
INF	84	2.422	2.851	-2.41	12.41
NPL	84	10.401	5.797	1.93	22.24

The table above presents the descriptive analysis of the research variables, according to which the model contains a total of 84 observations, including the six countries of the Western Balkans in a 14-year time period. The data show that out of a total of 84 observations the model has, due to the lack of data in the entities publishing statistics, we have a lack of data on two variables; economic growth and deposit interest rate.

The average value of economic growth for the six countries of the Western Balkans during the period 2008-2021 is 2.547%. If we are based on the average data of domestic credit to private sector, they show that the countries of the Western Balkans during the aforementioned period, have a demand for credit of 45.771% of GDP. Then, the interest rate of deposits throughout the studied years resulted in an average of 3.234%. As for the following variables, the countries under study are characterized by an average inflation rate of 2.422% and non-performing loans with 10.401% of total loans.

The highest value of domestic credit to private sector during the research period was in Montenegro in 2008, where during this year this country is characterized by the demand for credit of 86.45% of GDP.

Table No 3. Correlation coefficient

Variables	(1)	(2)	(3)	(4)	(5)
(1) EG	1.000				
(2) DCP	-0.259	1.000			
(3) DIR	-0.050	-0.112	1.000		
(4) INF	0.169	0.011	0.607	1.000	
(5) NPL	-0.131	0.026	0.307	0.055	1.000

After presenting the descriptive statistics of the study variables, in ***Table 3*** we have presented the results from the correlation coefficient, a statistical indicator that shows how strong the relationship is between two

variables. This coefficient is used to see if there is a problem of multicollinearity, which appears in cases where the independent variables have a strong positive or negative relationship with each other (with a correlation coefficient higher than 0.8).

Based on the results of our study, it can be seen that the problem of multicollinearity has not been presented because the independent variables have a correlation of less than 0.8 among themselves.

In addition, the above table also shows the relationship between the dependent variable and the independent variables. Based on the results, it can be seen that between the variable of economic growth and domestic credit to private sector, the coefficient is r = -0.259, which shows us that there is a weak negative relationship, therefore, the increase in the demand for credit from the private sector results in economic decline and vice versa. Also, between economic growth and the deposit interest rate, we have a weak negative relationship, which is reflected by the correlation coefficient of -0.050, which means that the increase in the deposit interest rate results in economic decline and vice versa. On the other hand, between the economic growth and the inflation rate we have a weak positive relationship which is reflected by the correlation coefficient of r = 0.169, a value which shows that with the increase in the inflation rate we will have economic growth and vice versa. Finally, we have the relationship between non-performing loans and economic growth, where it can be seen that we have a weak negative relationship which is reflected by the correlation coefficient of -0.131, which means that the increase in non-performing loans results in economic decline and vice versa.

Table No 4. Multiple linear regression (OLS)

EG	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
DCP	-.109	.043	-2.50	.012	-.194	-.024	**
DIR	-.335	.193	-1.73	.083	-.713	.044	*
INF	.49	.213	2.30	.021	.073	.907	**
NPL	-.043	.091	-0.48	.632	-.221	.134	
Constant	8.1	2.243	3.61	0	3.704	12.497	***

Mean dependent var	2.549	SD dependent var	3.817
Overall r-squared	0.154	Number of obs	69.000
Chi-square	11.686	Prob > chi2	0.020
R-squared within	0.117	R-squared between	0.594

**** p<.01, ** p<.05, * p<.1*

In order to answer the research objectives, multiple linear regression analysis using OLS, FE and RE was used in our study. Through regressions and tests we will see the explanatory power of the independent variables, the power or reliability of our model through the R-statistic and the level of significance of the variables taken into consideration.

Table 4 presents the multiple linear regression analysis with the method of least squares (OLS). According to the results, the coefficient of determination is 0.154, a value which shows that the model selected for this analysis has a not very good explainability of 15.4%. Based on the data presented above, domestic credit to private sector and the inflation rate have a statistically significant impact at the 5% significance level, while the deposit interest rate at the 10% level.

In addition to the OLS estimator, the model has been tested with two other Random Effect and Fixed Effect estimators, then to select the final model for the study we will use the Hausman test.

Fixed Effects

The data obtained using fixed effects are presented in **Table 5.** Based on the data, the model selected for this analysis has a weak explanation since 14.6% of the changes that occur in economic growth are explained through the independent variables that are included. In our model (ie, domestic credit to private sector, deposit interest rate, inflation rate and non-performing loans). Based on the results, we can conclude that only private sector lending and the inflation rate have a statistically significant impact on economic growth at the 5% significance level.

Table No 5. Multiple linear regression (Fixed effects)

EG	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
DCP	-.18	.083	-2.16	.034	-.347	-.014	**
DIR	-.169	.3	-0.56	.576	-.769	.432	
INF	.607	.238	2.55	.013	.13	1.084	**
NPL	.021	.13	0.16	.871	-.239	.281	
Constant	9.987	3.888	2.57	.013	2.208	17.766	**

Mean dependent var	2.549	SD dependent var	3.817
R-squared	0.146	Number of obs	69.000
F-test	2.528	Prob > F	0.016
Akaike crit. (AIC)	374.079	Bayesian crit. (BIC)	385.250

**** p<.01, ** p<.05, * p<.1*

Random Effects

Based on the results of the random effects model, it is found that private sector lending, the deposit interest rate and the inflation rate have a statistically significant impact on economic growth. Also, from Table 6, we can conclude that only the inflation rate variable has a positive impact on economic growth, while all other variables included in the model have a negative impact on economic growth.

Table No 6. Multiple linear regression (Fixed effects)

EG	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
DCP	-.109	.043	-2.50	.012	-.194	-.024	**
DIR	-.335	.193	-1.73	.083	-.713	.044	*
INF	.49	.213	2.30	.021	.073	.907	**
NPL	-.043	.091	-0.48	.632	-.221	.134	
Constant	8.1	2.243	3.61	0	3.704	12.497	***

Mean dependent var	2.549	SD dependent var	3.817
Overall r-squared	0.154	Number of obs	69.000
Chi-square	11.686	Prob > chi2	0.020
R-squared within	0.117	R-squared between	0.594

**** p<.01, ** p<.05, * p<.1*

The fixed and random effects models are compared to select the final study model using the Hausman test, which is presented in the table below.

Table No 7. Hausman specification test

	Coef.
Chi-square test value	3.263
P-value	.515

To select the final model for the study we will use the Hausman test, so based on the results presented above through the Hausman test, we have concluded that the preferred model for the data is the random effects model, because the P value from the test has resulted to be 0.515, i.e. less than 0.05, thus the random effects model is more stable and efficient for our data.

Since the Random Effect model turns out to be the most reliable model for our data, we will continue to use this model by comparing the significance of the years we obtained in our model. Therefore, to see this model over the years, we refer to the following table:

Table No 8. Random effects model over the years

EG	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
DCP	-.09	.027	-3.31	.001	-.143	-.037	***
DIR	-.111	.158	-0.70	.482	-.421	.199	
INF	-.197	.187	-1.05	.292	-.563	.169	
NPL	-.081	.066	-1.22	.221	-.211	.049	
Viti1	.563	1.776	0.32	.751	-2.919	4.045	
Viti2	-7.685	1.742	-4.41	0	-11.1	-4.271	***
Viti3	-4.089	1.62	-2.52	.012	-7.264	-.913	**
Viti4	-3.833	1.549	-2.48	.013	-6.868	-.798	**
Viti5	-7.212	1.588	-4.54	0	-10.325	-4.1	***
Viti6	-4.221	1.637	-2.58	.01	-7.43	-1.012	***
Viti7	-5.454	1.668	-3.27	.001	-8.722	-2.186	***
Viti8	-4.29	1.567	-2.74	.006	-7.362	-1.218	***

Viti9	-4.915	1.59	-3.09	.002	-8.032	-1.799	***
Viti10	-4.731	1.462	-3.24	.001	-7.596	-1.866	***
Viti11	-4.494	1.452	-3.10	.002	-7.34	-1.648	***
Viti12	-5.241	1.551	-3.38	.001	-8.282	-2.201	***
Viti13	-15.182	1.567	-9.69	0	-18.254	-12.111	***
Viti14	0	.	.	.	.	.	
Constant	13.348	1.724	7.74	0	9.968	16.728	***

Mean dependent var	2.549	SD dependent var	3.817
Overall r-squared	0.764	Number of obs	69.000
Chi-square	165.069	Prob > chi2	0.000
R-squared within	0.761	R-squared between	0.864

**** p<.01, ** p<.05, * p<.1*

CONCLUSION

Based on these results, we conclude that in the countries of the Western Balkans, lending to the banking sector has suffered challenges and difficulties in promoting economic growth. The results of this research, show that independent variables such as lending in the private sector, deposit interest rates, inflation rates and non-performing loans have a significant impact on the economic growth of these countries.

During the research, we discovered that lending to the private sector has had a negative impact on economic growth in the countries of the Western Balkans. This unexpected finding suggests that other factors may be more important in determining economic growth. So, bank lending itself is not the main factor promoting economic growth in these countries. It may be other factors such as macroeconomic policies, political stability, poor infrastructure, corruption, lack of productive capacity, or others that have a greater impact on economic performance. With this attitude, even though the research results show a negative impact of credit in the private sector on economic growth, this finding can serve as a guide for the development of further policies and strategies in the countries of the Western Balkans. In addition, the deposit interest rate also had a negative impact on economic growth. While the inflation rate showed a positive impact, suggesting that moderate inflation has stimulated economic growth. If we analyze the impact of non-performing loans, the findings show a negative impact on economic growth. This can be related to the lack of quality of loans, the problems of their return and the growth of risky loans, which have resulted in a burden for the banking system and economic development in general.

Based on the results, some important recommendations to improve the impact of loans on economic growth are highlighted. Financial authorities and banks should work together to develop policies and mechanisms that facilitate access to credit for the private sector. This could include developing loan guarantee programs to reduce risks for banks and encourage lending to new projects and investments.

Financial institutions should strengthen their credit evaluation and monitoring mechanisms to reduce the risk of non-performing loans. This means that you must have high standards in the loan granting process and have regular checks to assess the performance and repayment capacity of loan recipients.

Economic authorities should implement appropriate fiscal policies to encourage investment and domestic consumption. This includes the implementation of tax and tariff reduction policies to increase the availability of income for investment and consumption. In addition, it is important to improve the management of public expenditures and promote effectiveness in the use of public resources.

To increase investor confidence, it is essential that Western Balkan countries promote transparency and strengthen their financial institutions. This step will help create a safe and stable environment for investors, increasing the presence of foreign capital and increasing investments in the country.

Western Balkan countries should invest in the development of financial infrastructure, including advanced electronic payment systems and internet banking services. This would facilitate access to financial services and help increase economic transactions and trade.

An important investment would be to promote financial literacy for citizens and businesses. Further knowledge of personal finance and credit management would help increase financial awareness and reduce the risk of taking out bad credit.

The countries of the Western Balkans should develop a close regional cooperation in the field of finance and banking. This cooperation may include the sharing of experiences and knowledge, the harmonization of legislation and the creation of common financial markets to increase effectiveness and competition in the banking sector.

These recommendations aim to address the challenges and improve the impact of banking sector loans on economic growth in Western Balkan countries. Through the implementation of these measures, this region has the opportunity to improve access to credit, promote productive investments and create an environment suitable for sustainable economic growth.

It is necessary to address other factors that affect economic performance, such as macroeconomic policies, political stability, corruption and poor infrastructure. Also, we need to improve the effectiveness of lending in the private sector and carefully monitor the quality of loans to minimize non-performing loans

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