

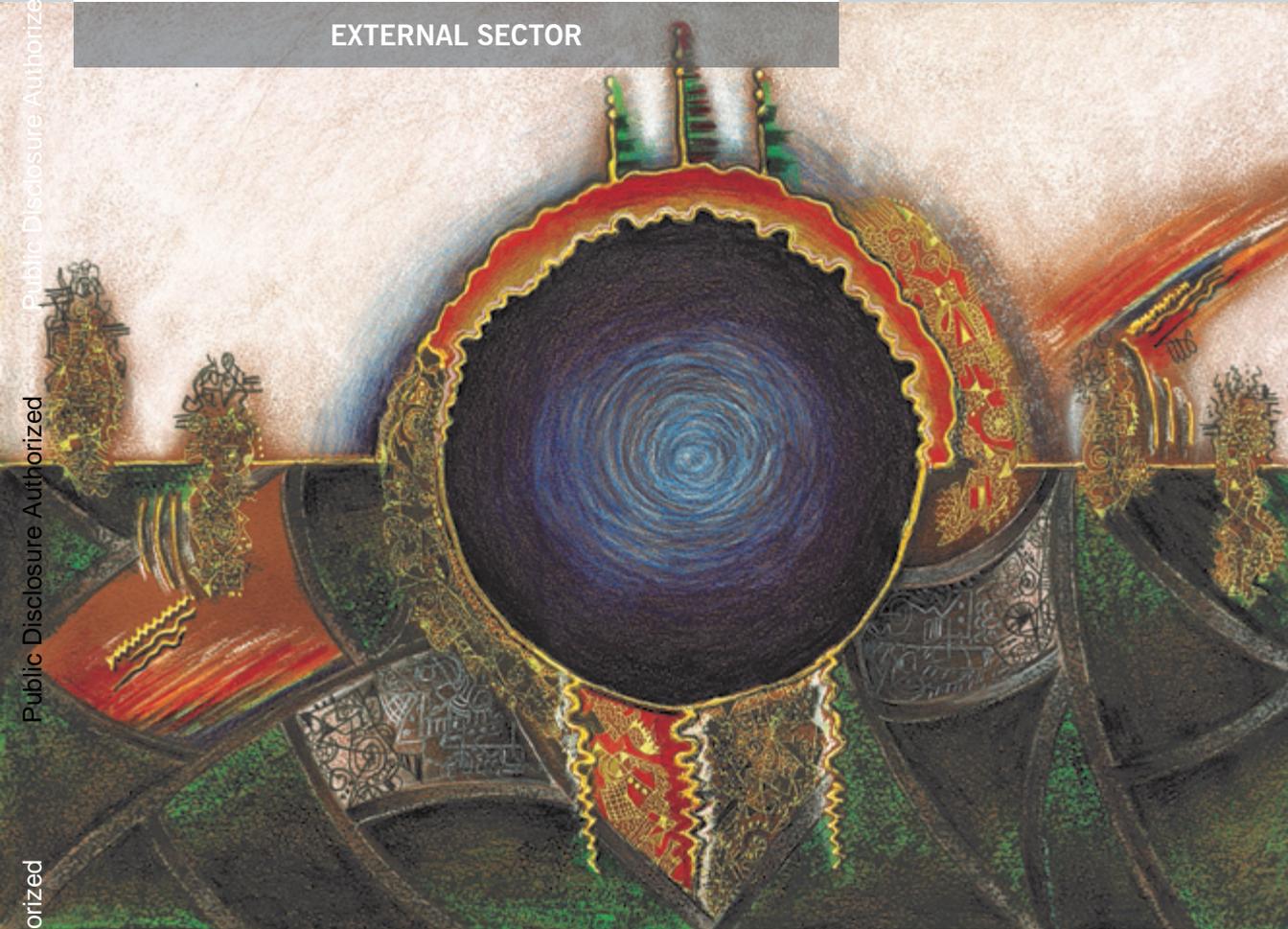


WORLD BANK GROUP

WESTERN BALKANS REGULAR ECONOMIC REPORT
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The Economic and Social Impact of COVID-19

EXTERNAL SECTOR



"You and me" by Tanja Burzanovic (Montenegro)

The RER No. 17 is a collection of notes on the Economic and Social Impact of COVID-19 that has been published in three parts. The first part was launched on April 29 and focused on the macroeconomic impact of COVID-19. This second part, launched on May 29, shows how the macroeconomic impact affects the people in the region. This third part focuses on specific economic policy response areas—fiscal, external, and financial sector—and the crisis impact on the private sector as reported by firms.

Widening external imbalances but with different magnitudes among Western Balkan countries¹

- Western Balkan countries trade structures will be affected by the combination of a supply side shock, largely through global value chains (GVCs), and a demand side shock due to recessions in major trading partners.
- The differences in the trade structure will influence the effect of the trade slowdown.
- Albania, Kosovo, and Montenegro are likely to see their current account deficits (CADs) worsen most because they depend so heavily on tourism-related services exports.
- Bosnia and Herzegovina (BiH), North Macedonia, and Serbia are more integrated into GVCs and will mainly be affected through lower goods exports.
- Trade policies, such as tariff reductions and other measures to facilitate border crossings, will be key to alleviate the immediate disruptions caused by the pandemic and to facilitate recovery.

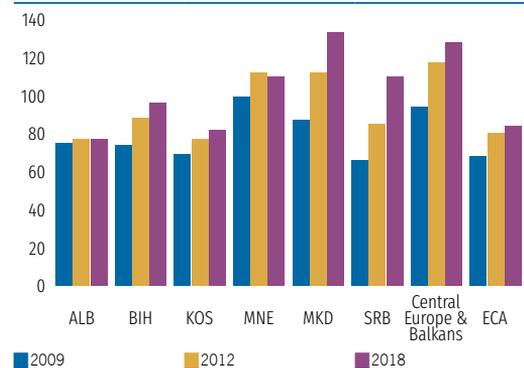
Differences in trade structure will influence the effect of the trade slowdown

The outbreak of COVID-19 initially disrupted trade through global supply chains (GVCs), but the combined demand and supply shocks are now weighing more heavily on global trade of overall goods and services. International border closures disrupted global trade flows and confinement measures weakened demand—both reasons have caused painful problems for tourism. The extent of economic distress and the consequent trade slowdown will depend on how well health impacts and measures flatten the curve of infections, and how effective other policy responses are. From current information and estimated 2020 external sector data for Western Balkan countries, it appears that the more dependent countries are on tourism sector and related services as transport, particularly airlines

and hospitality services, the harder they will be hit—but those more reliant on trade in goods like automotive, industrial and basic metals will not be far behind.

Thus, the COVID-19 crisis is playing havoc with the gains from trade integration Western Balkan countries have made in recent years. Trade has lately been contributing more to all Western Balkan economies as they have become more open to trade. Because all countries in the region have been expanding their trade relations consistently, their trade openness is

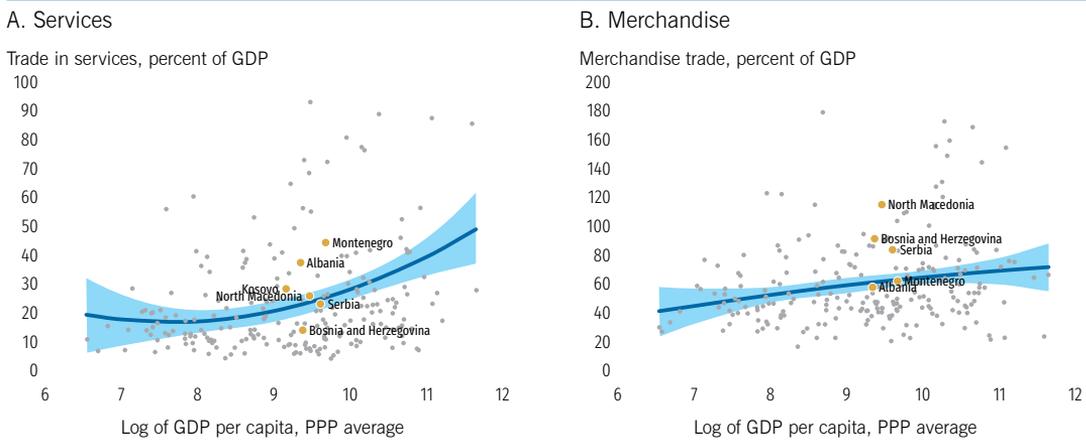
Figure 1. Trade Openness Index



Source: World Development Indicators (WDI).

¹ This note has been prepared by Sandra Hlivnjak, Bojan Shimbov, and Aleksandar Stojanov. The note benefitted from comments from Marc Schiffbauer, Edith Kikoni, Jasmin Chakeri, Enrique Blanco Armas, and Gallina Vincelette.

Figure 2. Trade Openness: Service and Merchandise, 2014–18



Source: WDI and World Bank staff calculations.

above the average for the Europe and Central Asia (ECA) region, though still lower than the average for Central European and Baltic countries, although here North Macedonia and Serbia meet that standard (Figure 1).

The different sources of growth in trade in goods and services will determine the size of the impact among countries, with two groups emerging. In Albania, Montenegro, and Kosovo trade in services plays a much bigger role (Figure 2A), largely because of significance of tourism and related services in their economies. Their trade integration is larger than the size of their economies would suggest, because in these countries, trade in services is either larger than goods trade (Albania) or has contributed far more to overall trade openness (Montenegro and Kosovo), but for all three the pandemic is likely to be a severely negative factor as eroding tourism undermines services exports. Moreover, activity in other services, particularly food, entertainment, and retail, will also pull back. All these negative effects will be compounded by the timing of the crisis—just as preparations for the tourism season started—so a considerable amount of tourism-related investment will also be lost.

In the other group are the economies of BiH, North Macedonia and Serbia (Figure 2B), where goods trade integration is more pronounced. Their trade became far more open through expanding goods trade as their economies became ever more integrated into GVCs. The disruption of the supply chains by the slowdown in manufacturing in China, Europe, and the USA and the global drop in aggregate demand caused by the economic downturn will be the main channels of transmission to these countries.

The negative effects from trade will be compounded by the expected major slowdown in the EU as real GDP growth projections for 2020 are -7.1 percent (IMF WEO April 2020). The EU is by far the main trade partner of the Western Balkans. Because all Western Balkan countries are closely integrated with the EU economies through a dense network of trade in both intermediate and final goods and services, some through GVCs, they are vulnerable to any disruption there. Almost 70 percent of Western Balkans exports go to the EU, which is also the source of almost 60 percent of their imports. Trade agreements between the EU and countries in

the region have also fostered regional trade integration through GVCs.

North Macedonia, Serbia, and to a lesser extent BiH are more thoroughly integrated into GVCs

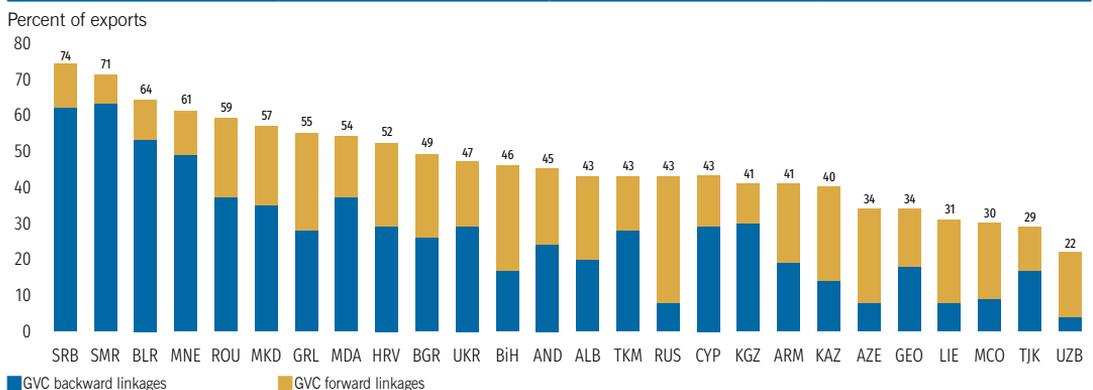
One way the pandemic is disrupting economic activity is through its impact on GVCs, which can amplify the effects on countries of shocks to trade, production, and financial markets. Because trade flowing through GVCs is heavily dependent on just-in-time delivery of critical imported components makes them particularly vulnerable when supplies are interrupted by regional quarantines, production shutdowns, and border controls. Thus, the negative effects of the trade slowdown in trade are compounded for intermediate goods producers flowing through GVCs because they may cross borders several times until they get to a final product.

Most Western Balkan countries are integrated into GVCs through backward linkages (Figure 3). The World Development Report 2020 found that countries specializing in manufacturing like Serbia, BiH, and North Macedonia mainly integrate into GVCs through

backward linkages to the global economy: their exports, such as autos or electronics, require considerable amounts of parts imported from abroad. These countries are more susceptible to supply-side shocks. Demand shocks, by contrast, are felt more acutely by countries dependent on forward linkages, such as commodity exporters, which see a fall in demand from manufacturing centers when they are reacting to the drop in how much they can export of the finished goods they produce. As so far trade and industrial production have fallen off most in countries with strong forward linkages, suggesting that the demand factor in the COVID-19 economic shock has been more severe than the supply factor, to some extent shielding Western Balkan countries.

Of the six Western Balkans, given the structure of their economies, BiH, North Macedonia and Serbia, are more integrated into GVCs than the rest. For example, trade in intermediate industrial goods linked to GVCs (Figure 3) in North Macedonia is about 50 percent of its total goods trade (over 25 percent of GDP) and in Serbia it is 40 percent (about 14 percent of GDP). In both cases, about 2/3 of this trade is with EU countries, in particular Germany, Italy and the

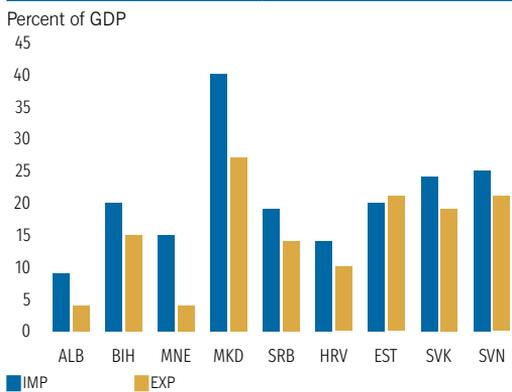
Figure 3. Backward and Forward GVC Linkages, Western Balkans and Elsewhere in ECA



Source: Eora and World Bank staff calculations.

United Kingdom, as part of regional European value chains (Figure 4). The EU is the region that is the most affected by the pandemic and production facilities in these countries are being shut down, this will have a contagion effect on both import of industrial parts and components and the consequent exports of goods from the Western Balkan countries.

Figure 4. Trade in Intermediate Industrial Inputs

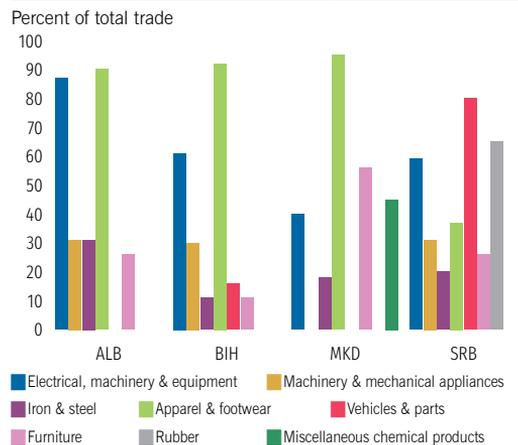


Source: UN Comtrade and World Bank staff calculations.

Manufacturing exports linked to regional value chains will likely be most affected. The deep slowdown projected for the EU will affect countries that have a significant participation in Europe’s regional value chains, in particular Serbia, North Macedonia, and BiH through the goods trade channel. Manufacturing sector in particular will suffer from (1) supply disruptions that hinder production; (2) supply-chain contagion, which will amplify direct supply shocks for countries less affected; and (3) demand disruptions due to drops in aggregate demand (i.e., recessions), consumer wait-and-see purchase delays and firm investment delays. In particular, the sectors producing electrical machinery and equipment, machinery and mechanical appliances, automobiles, iron and steel, furniture and apparel, and clothing and footwear which are the most integrated in

processing trade through GVCs with Europe will be hit the hardest (Figure 5). For example, in mid-March Volkswagen, Audi, Peugeot, Ford, and other major manufacturers halted production in Europe, which reduced demand for car parts and components produced in the Western Balkans. Furthermore, North Macedonia’s exports of electronic boards, which 89 percent go to Germany, BiH exports of metals (largely intended for the automotive industry) and furniture; and Serbia’s exports of machines and machine parts, rubber and plastics, and furniture now see supply chains disrupted, and a drop-in demand for their products. Finally, in all Western Balkan countries will also suffer because exports of finished products depend heavily dependent on the Italian market, which has been the hardest hit in Europe.

Figure 5. Selected Processing Trade Exports



Source: Eurostat ComExt data and World Bank staff calculations.

The large decline in goods exported by BiH, North Macedonia, and Serbia is cushioned by a similar-sized decline in their imports, reflecting the relatively low domestic value-added in exports from the region. While those three economies will be hard hit by the crisis, the negative effect on their external position

may be slightly smaller than in the other three countries in the region, because imports will also decline, as they largely import-to-export and the recovery should be easier once production restarts and GVCs, especially in the EU, are back in operation.

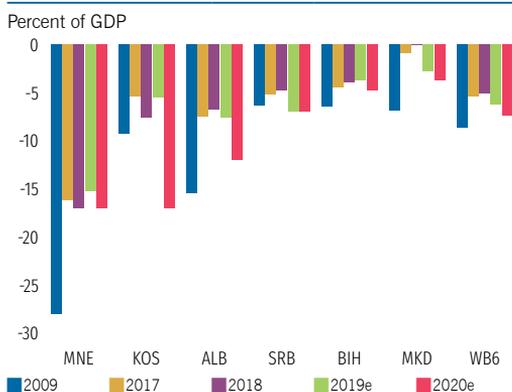
External imbalances will rise more in Albania, Kosovo, and Montenegro which rely more on tourism services exports

Albania, Kosovo, and Montenegro are projected to see the largest increase in their current account deficit due to their strong dependence on tourism related services exports (Figure 6). Most affected will be Albania with CAD estimated to reach 12 percent of GDP in 2020, 4.3 pp more than in 2019. This will be driven not only by lower tourism receipts and consequences of earthquake, but also by fewer exports extractive industries and manufacturing. In the Western Balkans, Albania is the country most exposed to Italy, which receives almost half of its exports. Kosovo's CAD will worsen due to lower diaspora-driven service exports and remittances, and Montenegro is

particularly affected by plummeting tourism, which accounts for more than 20 percent of its GDP. Because of connection to regional GVS, increases in the CADs of Serbia, North Macedonia, and BiH will be smaller because the decline in their exports will be partly offset by a comparable decline in imports, as these countries largely “import-to-export” as part of their GVCs participation. The overall CAD for the region as a whole is estimated to widen from 6.2 percent in 2019 to 7.4 percent in 2020.

The expected drop in remittances as a result of the COVID-19 crisis will add to the pressure on the CAD generated by lower exports. For most Western Balkan countries, remittances are essential source of trade deficit financing. At an average of 6.1 percent of GDP for the past five years, their contribution in most countries in the region was considerable. In 2020 that trend is unlikely to continue: The economies of Austria, Germany, Greece, Italy, and Switzerland, the primary sources of remittances, have all been ravaged by the COVID-19 crisis. Emigrants that have lost their jobs are therefore unable to send money home and those who have kept their jobs earning less because they are working fewer hours. It is estimated that remittances to the region will be lower in 2020 by 0.5 percent of GDP, which will be painful because often the recipients are those most vulnerable and will have less for consumption. And for BiH, Kosovo, and Serbia it is estimated that remittances will go down even more, 0.8 to 1.1 percent of GDP.

Figure 6. Current Account Balances, 2009–20e

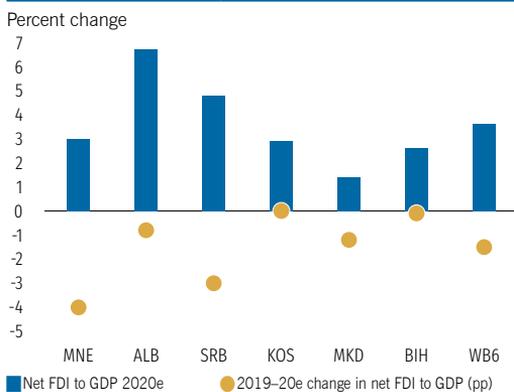


Source: National authorities and World Bank staff calculations.

FDI to the region is expected to be lower in 2020 than in 2019 by 1.5 pp, which will affect the ability of countries to finance the CAD (Figure 7). While the supply side shock to trade and GVCs might be overcome as containment measures in Europe are lifted,

the effect of demand side disruptions will be more lasting. Most FDI to the region has gone into automotive, basic materials industries, electrical equipment, and tourism—the sectors hardest hit globally. Companies operating in these sectors are therefore likely to delay investment decisions as their corporate earnings contract because of the lower demand. According to UNCTAD, global FDI flows in 2020 are expected to fall 5 to 15 percent, to the lowest level since 2008–09. The Western Balkans are no exception: Average FDI to the region is expected to fall from 5.1 percent of GDP in 2019 to 3.6 percent in 2020—the lowest level since 2005. The biggest declines compared to 2019 are expected in Montenegro (4 pp), Serbia (3 pp), and North Macedonia (1.2 pp). Declines are expected to be much smaller in Albania and BiH, and no decline at all is expected in Kosovo. Nevertheless, as capital markets are already tightening, further deterioration in investor confidence cannot be excluded. A worsening of the pandemic could further amplify capital outflows from emerging markets like those in the Western Balkans countries and put the brakes on investment, a serious threat to Montenegro, Albania, and Serbia, which rely on FDI to finance their large CADs.

Figure 7. Net FDI-to-GDP Ratio



Source: National authorities and World Bank staff calculations.

The balance of payments will require serious attention to “balance” rising trade deficits with lower FDI. In previous years rising FDI financed CADs in the region, in the current environment of declining FDI, financing of the CADs will have to be supplemented by other sources. As countries turn to increased financing from international sources largely from IFIs (especially EC, IMF, or World Bank) would on one side ease the pressure on the CADs, but on the other it would have implications for both overall external debt and governments public debt in particular. In 2020 all Western Balkans countries public debt has already gone up: on average their external public debt is expected to go up by 4.7 pp of GDP. The largest increases expected in Serbia, by 5.8 pp, and North Macedonia, by about 5.1 pp; the range for the others is 3.6 to 4.9 pp of GDP.

Access to free trade in goods and services will be necessary to contain the immediate impact of the pandemic and facilitate recovery

Western Balkan countries have already moved to lessen the disruptions in transport and trade of goods as the CEFTA² Secretariat adopted the green lane concept. The Concept began on April 13, 2020, at designated crossing points that fulfil specific requirements: As announced by the Secretariat the green lanes will be open to all goods, and traffic will flow through 24/7. The crossing points chosen are those where custom and other required proceedings are handled most efficiently. Priority is given to the most essential food, feed products, and medical supplies as defined in the World Customs Organization. The list of

2 CEFTA is the Central European Free Trade Agreement; it consists of the six Western Balkan countries and Moldova.

Table 1. Export Bans on Medical and Food Products

Country	Food Products	Medical Consumables	Medical Equipment	Medicines or Drugs	Effective Date	Removal Date	Measure Type
Albania	No	Yes	Yes	Yes	3/11/2020		Restrictive
Macedonia	Yes	No	No	No	3/20/2020	4/30/2020	Restrictive
Serbia	Yes	Yes	Yes	No	3/14/2020	4/14/2020	Restrictive
Serbia	No	No	No	Yes	3/16/2020	4/16/2020	Restrictive
Serbia	Yes	Yes	No	No	3/17/2020	4/14/2020	Restrictive
Serbia	No	Yes	No	No	3/17/2020		Liberalizing
Serbia	Yes	Yes	No	No	3/21/2020		Liberalizing
Serbia	Yes	No	No	No	3/24/2020	4/14/2020	Restrictive
Serbia	Yes	Yes	No	No	3/27/2020		Liberalizing

Source: WTO and national governments.

essential goods may be reassessed and modified, and other crossing points may be designated once they fulfill the requirements. The System of Electronic Exchange of Data (SEED) is in use to accelerate clearance of the most essential goods. Some countries still have restrictions imposed earlier on some COVID-19 related products (Table 1) but is expected they will decide to lift these bans in the spirit of green lane concept and their commitment to open trade.

Measures to streamline trade procedures and facilitate trade at borders are necessary to reduce the impact of the crisis and support recovery. Maintaining transport and logistics services along the main corridors will be essential for continued access to essential goods and services. Enhancing transit agreements, expediting movement along corridors of pandemic-related medical goods and food and energy products and maintaining adequate health controls will be required to complement trade policy reforms and trade facilitation measures through the medium term. Trade policies, such as tariff reductions and other border-crossing facilitation measures, can

minimize the immediate disruptions caused by the pandemic.

Immediate policies to facilitate trade, manage risk, and ease the flow of essential medical goods:

- **Suspend tariffs on key medical/sanitary supplies.** Simplify the process of obtaining licenses for medical products and consider opening trade in health-related services to help countries address the crisis and release some of the pressure on domestic health services;
- **Consider reducing import and export taxes,** especially tariffs on food and other necessities, as part of a program to support household incomes and business activity.
- **Reduce tariffs for medical materials and food products** to support consumption of essential items and limit the negative impact on the poorest.
- **Adopt measures to facilitate safe cross-border trade, in particular to ensure the flow of essential medical and food products, and more generally facilitate business continuity** by (1) protecting front-line officers at the borders;

(2) prioritizing risk-based handling of emergency relief consignments; (3) support intensified use of risk management to facilitate movement of low-risk cargo and minimizing pile-up of cargo and stoppage of trade flows

Immediate policies to ease pressure on export and import operators:

- Reduce tax and administrative burdens on importers and exporters
- Prioritize risk-based handling of emergency relief consignments.
- Support enhanced use of risk management to facilitate low-risk cargo and minimize cargo pileups and bottlenecked trade flows.

Once the immediate response to crisis turns into the recovery phase, medium-term policies should be considered, such as:

- Encourage internal and external border agency collaboration designed to facilitate trade based on principles of equivalency, mutual recognition, and equivalent systems
- Ensure that measures and border activities are transparent so that logistics providers and traders can better anticipate problems and manage trade flows.
- Quickly analyze and remove any duplicative or unnecessary processes (documentary requirements, licensing, etc.) that are not required that may hamper the movement of critical and perishable items.

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You and me

by Tanja Burzanovic (Montenegro)

Dr. Tatjana Burzanovic has a wide experience in the fields of graphic design, graphics in architecture, interior design. She has worked as an art editor, interior designer and graphic designer at various levels. Many of her art exhibitions have taken place at different places. She has received many awards for her arts and literary works. She has published a book with a title *The Interrelation between Art Worlds*, with the support from the Embassy of India for Austria and Montenegro in Vienna. Her artistic philosophy includes displaying of interrelationship between art worlds (spatial and temporal arts). The artist thus meditates between nature and the sprits and yet stems from the absolute idea and serves the goal of realization of absolute sprit. 'Grasping the meaning through the form' is a task of the art set by a contemporary thinker to demonstrate that building forms and creating sense are two simultaneous, intertwined, and absolutely inseparable processes in Arts. Without that recognition it is not possible to take any further step in investigating the nature of art and literature. She believes that art is a way to search the truth. Art is inseparable from searching the truth.

People forge ideas, people mold dreams, and people create art. To connect local artists to a broader audience, the cover of this report and following editions will feature art from the Western Balkan countries.