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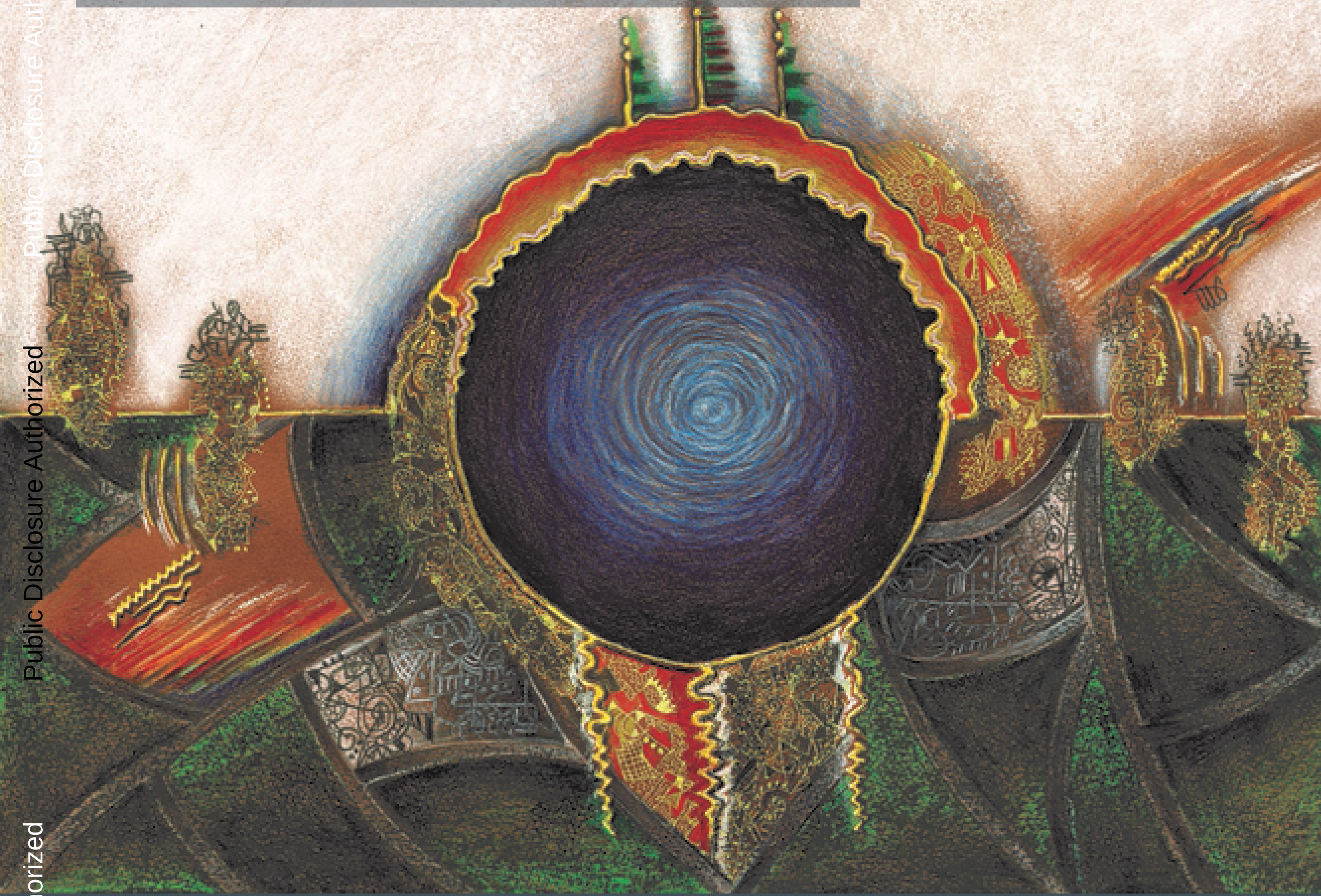
The Economic and Social Impact of COVID-19

THE COUNTRY NOTES



"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 will be published in two parts. This first part includes three Notes: "Setting the stage: Reviewing the state and vulnerabilities of the Western Balkan Economies as they face COVID-19"; "Outlook: Hard Times Require Good Economics"; and the Western Balkan Country Notes. The second part discusses the impact of COVID-19 on specific economic areas, social sectors, and on poverty and income distribution in the region and will be published in a follow-up e-launch in May.

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This Regular Economic Report (RER) covers economic developments, prospects, and economic policies in the Western Balkans' region: Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia.

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This Western Balkans RER and previous issues may be found at: www.worldbank.org/eca/wbrer/.

Albania

- Albania has been hit by two devastating shocks in quick succession: The November 2019 earthquake and the COVID-19 pandemic in Spring 2020 that has frozen large parts of the economy.
- Reliance on tourism, close ties to the heavily affected Italian economy, and limited fiscal space make Albania particularly vulnerable to the COVID-19 crisis.
- Even in a baseline scenario in which most economic life can resume by the start of the summer, annual GDP growth is expected to contract by 5 percent in 2020.
- The recession and economic support measures are projected to increase the fiscal deficit to 5.4 of GDP in 2020, pushing government debt up to 75.8 percent of GDP.
- Once the crisis is overcome, normalization of economic activity and earthquake reconstruction are expected to drive a brisk growth spurt, but in the medium-term structural reforms are necessary.
- Because the COVID-19 crisis is unprecedented, uncertainty about the forecast is unusually high.

Recent Economic Developments

Albania has had two devastating shocks in quick succession: a highly destructive earthquake late in 2019 and the global COVID-19 pandemic early in 2020. These shocks dominate recent economic developments and the near-term outlook for the economy.

The earthquake that hit Albania on November 26 was severe. It measured 6.3 on the Richter scale, caused 51 fatalities, and displaced the 17,000 people who lost their homes. Damages to physical assets and losses were equivalent to an estimated 7.5 percent of GDP. The damages amounted to 26.4 percent of 2018 gross fixed capital formation. Tourism and housing[1] were hit hardest, although also damaged were buildings related to education, health and other public infrastructure, manufacturing, and trade. Action by the Albanian government and international partners helped mitigate the adverse human and economic impact.

Growth decelerated from 4.1 percent in 2018 to an estimated 2.2 percent in 2019. In the first half of 2019, drought had already slashed energy production. Because large FDI-financed energy projects were winding down, investment decelerated, and consumption became the main driver of the economy. When the November earthquake disrupted Q4 GDP, both consumption and investment contracted dramatically.

A February 2020 donor conference had just raised €1.15 billion for reconstruction when in March the COVID-19 pandemic plunged the country into an unprecedented—and continuing—public health crisis. To contain the spread of the virus, Albania ordered the temporary lockdown of such key economic sectors as restaurants, theaters, and nonessential trade; limited the movement of people; and issued wide-ranging limitations on domestic and international travel. Many industries still

1 The 11,490 housing units categorized as fully destroyed or demolished need to be rebuilt. Another 83,745 housing units were somewhat damaged, needing repair and refitting. In the Durres municipality, Albania's largest tourism destination, not many hotels were destroyed, but many residential buildings are rented out to tourists.

permitted to operate, among them textiles, mining, call centers, and construction, have had to restrict business to comply with the restrictions. Given the current disruptions and uncertainty about what is to come, both households and businesses are also delaying nonessential spending. And severe economic dislocations in major trading partners, such as Italy, have caused export orders to collapse.

Albania entered the crisis with little space for fiscal and monetary policy to operate. Despite a gradual decline of public debt and an S&P rating confirmed at B+ in February, public debt, which ended 2019 at 68 percent of GDP, is high. There are also significant contingent liabilities and fiscal risks from public-private partnerships and energy SOEs. Moreover, after the monetary policy rate was cut to 0.5 percent in March, there is little room for any more conventional monetary policy.

Banks are well-capitalized, highly liquid, and mainly funded by deposits. Nonperforming loans (NPLs) have been reduced through mandatory write-offs, sales, and out-of-court resolution. After the central bank moved to address the dominance of the euro in domestic transactions, the share of foreign-exchange loans in total loans fell from 60 percent in 2015 to 50.1 percent in 2019. Foreign-exchange deposits, which to some extent reflect relatively high remittances, rose to 54.6 percent of total deposits.

When the crisis began, the current account deficit (CAD) was already large but was cushioned by reserves. The CAD widened from 6.7 percent of GDP in 2018 to 7.6 percent in 2019. Despite the record high tourism receipts in 2019, low commodity and energy exports plus high energy imports caused the CAD to widen. Foreign direct investment (FDI) in Albania declined to 7.6 percent of GDP as the investment phase of large energy and gas transmission projects ended. Foreign-exchange reserves, which have been going up consistently for several years, reached €3.3 billion as 2019 ended; their coverage of over 6 months of imports of goods and services are an adequate safeguard against adverse shocks.

Outlook and Risks

Together, last year's earthquake and this year's COVID-19 pandemic are likely to drive Albania into recession and expose its external and fiscal vulnerabilities. The government's earthquake reconstruction package of €160 million, mainly for housing, and private sector spending were expected to support a domestic demand-driven short-term increase in GDP, as has generally followed similar disasters.

However, the current health crisis has substantially diminished Albania's growth prospects. The effects of its supply and demand shocks to the economy could spiral down through several rounds. The economy would face supply shocks due to both disruption in global supply chains and a decrease in the labor supply due to quarantines and social distancing. Given the acute uncertainty about the duration and progression of the pandemic, there may be additional demand effects as workers lose their incomes, particularly in the most affected sectors, such as tourism and hospitality, manufacturing, and nonessential trade. In the likely event of a drop in disposable income, households would consume less, especially durables, which would prevent reconstruction from achieving its full effect. Trade disruptions and foreign investor risk-aversion are also likely to add pressure. Albania's exposure to Italy, the most affected country in the EU, is substantial: Italy receives 47 percent of exports (mainly manufactures) and is the source of 9.7 percent of FDI. As recession spreads throughout the entire EU, the external shocks are expected to be higher: the EU receives 94.9 percent of exports and provides 44 percent of FDI.

Because the evolution of the COVID-19 pandemic is so uncertain, we present two scenarios for the 2020 outlook. The baseline assumes that the pandemic in Europe begins to slow soon enough that containment measures can be fully lifted by end of June and normal economic activity starts in H2 2020. In the downside scenario, the outbreaks continue, and containment measures cannot be lifted until the end of August.

Tourism receipts alone equate to about 15 percent of GDP, but with the related indirect effects on construction, employment, and other industries, tourism is responsible for about 26 percent to GDP.[2] Tourism, which is highly seasonal and provides most of its contribution in Q3, would thus rely on the ability of the owners of facilities to carry out post-earthquake reconstruction, but that is expected to be delayed by the lockdown. If COVID-19 containment measures are lifted by the end of June, in combination with the effects of the earthquake, the forecast for tourism is still expected to be lower by one-third.

Albania's extractive industry will also be hit hard by a drop in global demand, as seen in lower commodity prices generally and a continuous decline in oil prices, causing major fiscal and economic repercussions.

2 World Tourism and Trade Council 2018.

In the baseline scenario, 2020 will drive Albania into recession. The country's growth was expected to rebound to 3.4 percent because of reconstruction and a return to normal energy production, but the cost of COVID-19 and the related restrictions are projected to cause GDP to contract by 5 percent (Table 1). Total real exports are projected to fall by 25 percent, based on less activity in tourism, extractives, and manufacturing; imports would decline by 9.5 percent. Less economic activity and higher uncertainty would also reduce private investments and consumption. The government is expected to make a major contribution to domestic demand because of reconstruction and the COVID-19 packages. In 2021, growth is expected to rebound to an estimated 8.8 percent, driven by base effects on exports, consumption, and investments.

Table 1. Albania: 2020 Outlook

	Pre COVID-19	Baseline scenario	Downside scenario
Real GDP growth	3.3	-5.0	-6.9
Consumption	3.1	-1.6	-2.2
Investment	7.7	1.0	0.8
Exports	2.7	-25.0	-30.0
Imports	4.6	-9.5	-10.6

Source: World Bank staff estimates.
Note: The Pre-COVID-19 scenario includes the effects of the earthquake and reconstruction.

The estimated revenue shortfall will lead to high fiscal imbalances in 2020. Heightened crisis-related spending for reconstruction and health, unemployment, and social protection benefits would raise spending from 29.7 percent of GDP in 2019 to 32.4 percent. Combined with a steep drop in tax revenues, from 25.7 percent of to 24.2 percent of GDP, the fiscal deficit will widen to 5.4 percent of GDP. Much lower revenues and tighter financing conditions may force spending cuts.

The debt-to-GDP ratio is projected to rise to 75.8 percent.

The CAD is expected to expand to 12 percent in 2020. External imbalances are still elevated, as net FDIs are projected to fall from 7.6 to 6.7 percent of GDP in 2020 and the need for external financing to amortize foreign government debt is high. As a mitigation factor, Albania has sufficient international reserves.

In the downside scenario, Albania must deal with a more severe recession as GDP contracts by almost 7 percent. Major domestic demand shocks are expected to results from a longer interruption and downsizing of activities and a sharper contraction of manufacturing and extractive exports. In this scenario, consumption contracts more severely, by about 2.2 percent in 2020 as employment and wages fall further and as containment measures prevent nonessential retail trade. Liquidity concerns would further deter private investment. Compared to the baseline scenario, medium-term growth prospects would dim, with unemployment rising and the financial health of businesses deteriorating.

In the downside scenario internal and external imbalances would worsen further. The decline in net exports in 2020 would result in an estimated CAD of 13.2 percent of GDP, which Albania may find it hard to finance. Significant revenue shortages would exacerbate the fiscal deficit, which, reaching 6.0 percent of GDP, and push public and publicly guaranteed debt up to 77.5 percent of GDP. Given the uncertainty about the evolution of the pandemic and the possibility of a second wave the outlook is subject to significant risk.

To support the economy through this crisis, Albania has announced a series of policy measures. Besides allocating US$20 million more to health care and defense to fight the virus, the measures include:

- A credit guarantee fund for soft loans to businesses that are finding it difficult to pay wages and insurance contributions (US$100 million).
- Additional social transfers for the poor, small businesses, and unemployment benefits (US$65 million).
- Humanitarian emergencies: US$20 million for operational humanitarian emergencies.
- Amnesty on penalties for late payment of energy bills, which will affect about 211,000 people (US$150 million).
- Rescheduling of the corporate income tax payment for businesses with turnover of US$17−120 million.
- Extension of loan repayment deadlines for businesses and individuals in distress due to COVID-19: they can contact financial institutions to reschedule loan repayments or delay interest payments. If an agreement is reached, banks do not need to increase provisioning for these loans and borrower credit status is not affected.
- Suspension of rent payments for affected households and small businesses.
- A budget contingency that is higher by US$10 million.

The package of policy measures will cushion some private sector losses,[3] but some design and execution challenges need to be addressed

3 As of April 7, the government was considering expanding the package with measures to improve business liquidity and support affected households.

to maximize their effectiveness. The authorities also need to think of an ultimate exit strategy:

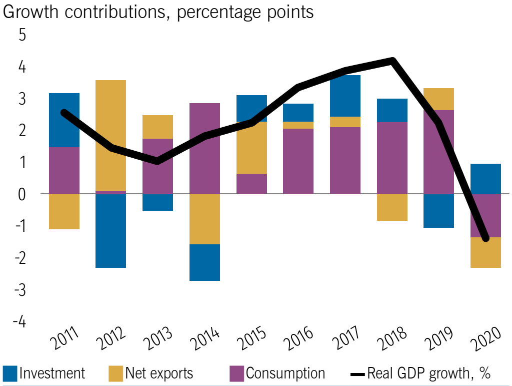
- In a first phase, credit restructuring and the guarantee fund may have limited uptake, since businesses may not have the financial health and the right incentives to avoid lay-offs.

- Measures may also be necessary for businesses in sectors not affected directly but suffering from supply disruptions. The magnitude of the informal sector also suggests that many individuals affected would not be reached by measures directed to the formal sector.

- While responding to the epidemic is urgent, earthquake reconstruction should not fall by the wayside. While the pandemic has halted many reconstruction projects temporarily, it is crucial to proceed where it is safe to do so. These projects can also stimulate Albania's economy in 2020 and 2021.

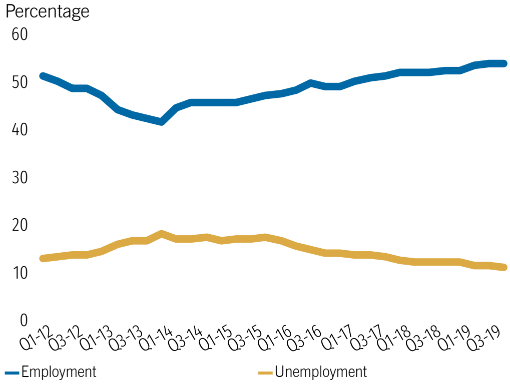
To accelerate the economic recovery and sustain higher medium-term growth, Albania must address both its fiscal imbalances and its productivity problem. Though extreme, the combined epidemic and earthquake shocks underscore the importance to improving resilience, of reinforcing macroeconomic balances and building up the private sector. Additional challenges are linked to sustainable use of the environment and managing rural to urban shifts. Structural reforms to improve the business environment and address other areas that are barriers to sustained and higher economic growth will also help to make the economy more resilient.

Consumption drove growth in 2019 but investment plunged.



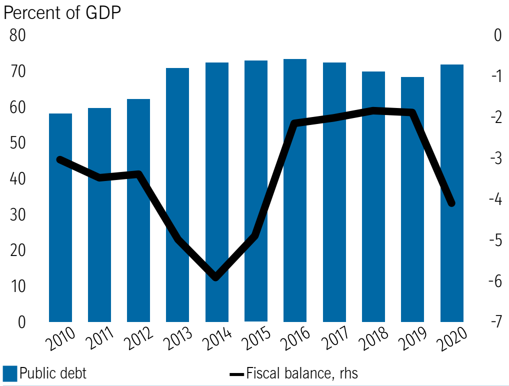
Source: Instat and World Bank.

Growth supported recovery of the labor market.



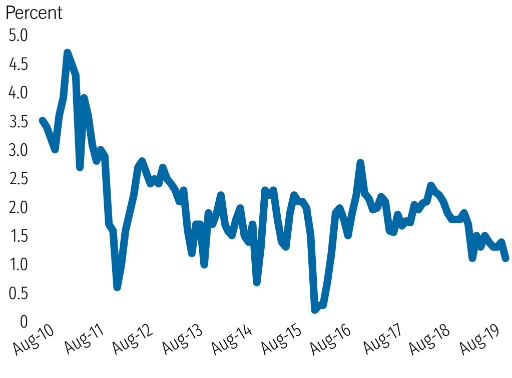
Source: Instat.

Debt is declining as spending is contained.



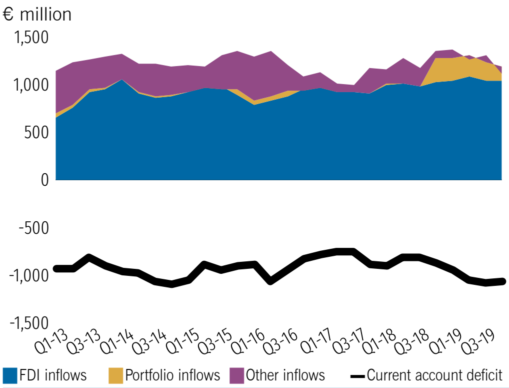
Source: Ministry of Finance and World Bank.

Inflation remained below the 3 percent target hence monetary policy was again accommodative.



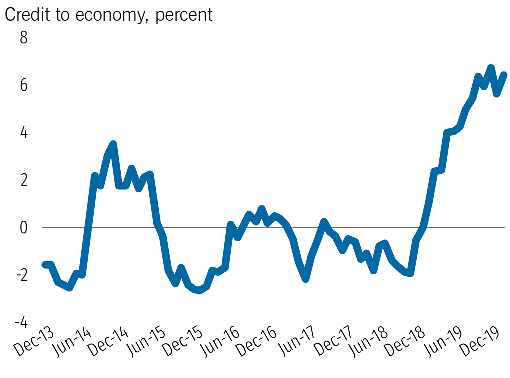
Source: Bank of Albania and World Bank.

Sustained non-debt-creating flows (FDI) entirely covered the CAD.



Source: Bank of Albania and World Bank.

Credit growth resumed.



Source: Bank of Albania and World Bank.

ALBANIA	2014	2015	2016	2017	2018	2019	2020f	2021f
Real GDP growth (percent)	1.8	2.2	3.3	3.8	4.1	2.2	-5.0	8.8
Composition (percentage points):								
Consumption	5.9	0.0	4.8	3.7	3.9	2.6	-1.3	3.1
Investment	-2.5	0.6	-1.7	-0.2	1.0	-1.1	0.2	1.2
Net exports	-1.6	1.6	0.2	0.3	-0.8	0.7	-4.0	4.5
Exports	0.3	0.3	3.3	4.0	1.0	2.0	-8.5	9.8
Imports (-)	1.9	-1.3	3.1	3.7	1.8	1.3	-4.5	5.3
Consumer price inflation (percent, period average)	1.6	1.9	1.3	2.0	2.1	1.4	2.1	2.4
Public revenues (percent of GDP)	26.3	26.4	27.6	27.7	27.6	27.8	27.0	27.9
Public expenditures (percent of GDP)	32.3	30.9	29.6	29.8	29.4	29.7	32.4	30.5
Of which:								
Wage bill	5.1	5.1	4.6	4.7	4.5	4.6	4.8	4.8
Social benefits	11.8	11.3	12.0	12.0	11.6	11.9	13.3	12.7
Capital expenditures	4.3	4.4	4.0	4.4	4.8	4.5	5.9	5.1
Fiscal balance (percent of GDP)	-6.0	-4.5	-2.0	-2.0	-1.8	-1.9	-5.4	-2.6
Primary fiscal balance (percent of GDP)	-3.1	-2.2	0.5	0.0	0.4	0.2	-3.0	-0.1
Public debt (percent of GDP)	66.1	69.1	68.7	67.8	64.6	63.5	71.2	65.9
Public and publicly guaranteed debt (percent of GDP)	72.0	72.7	72.3	71.9	69.7	68.0	75.8	70.4
Of which: External	29.6	34.2	32.6	32.6	32.9	31.5	34.9	30.4
Goods exports (percent of GDP)	9.3	7.5	6.7	6.9	7.7	6.8	6.3	5.9
Goods imports (percent of GDP)	31.6	29.9	30.9	31.3	30.2	32.0	30.4	28.7
Net services exports (percent of GDP)	3.2	5.1	7.4	9.4	8.6	11.4	4.7	8.5
Trade balance (percent of GDP)	-19.0	-17.3	-16.8	-15.1	-13.8	-13.8	-19.4	-14.3
Remittance inflows (percent of GDP)	5.9	5.8	5.7	5.5	5.2	5.2	5.0	5.0
Current account balance (percent of GDP)	-10.8	-8.6	-7.6	-7.5	-6.7	-7.6	-12.0	-7.5
Net foreign direct investment inflows (percent of GDP)	8.1	8.0	8.7	8.6	8.0	7.6	6.7	7.5
External debt (percent of GDP)	69.5	74.4	73.5	68.7	62.9	0.0	0.0	0.0
Real private credit growth (percent, period average)	-1.3	-1.8	-2.1	-2.3	-3.0	n.a.	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	22.8	18.2	18.3	13.2	11.1	n.a.	n.a.	n.a.
Unemployment rate (percent, period average)	17.5	17.1	15.2	13.7	12.3	11.5	n.a.	n.a.
Youth unemployment rate (percent, period average)	32.5	33.2	28.9	25.9	23.1	n.a.	n.a.	n.a.
Labor force participation rate (percent, period average)	53.7	55.7	57.5	58.3	59.4	n.a.	n.a.	n.a.

Sources: Country authorities, World Bank estimates and projections.

Note: Youth unemployment rate is for labor force aged 15–29. Statistical discrepancy contribution is divided at the ratio of 80 percent and 20 percent investment. Change in inventories is included in Investments.

Bosnia and Herzegovina

- The coronavirus pandemic poses the most serious threat to the BiH economy since the global financial crisis.
- Despite important reductions in internal and external imbalances, the growth outlook for 2020 is much less optimistic than it was earlier, mainly because of COVID-19 but also because of political gridlock, low capital spending, and slow progress in reforms.
- The immediate challenge for the government is to prevent further COVID-19 infections, reinforce medical care, and counteract the negative economic effects of the containment measures.
- Several policy measures to limit the human and economic cost of the pandemic have been announced. However, the complexity of the country's institutional setup and its limited resources constrain the provision of support.

Recent Economic Developments

BiH economy, which was already in the grip of a slowdown, is now confronted by the possibility of a deep recession as the coronavirus outbreak crimps economic activity. In 2019 real GDP growth slowed from 3.6 percent in 2018 to an estimated 2.8 percent because of a less supportive external environment and domestic political uncertainty. Slower growth in the Euro zone, the largest BiH export market, and regional trade disputes contributed to a fall in exports, as did a slump in industrial production, resulting in part from temporary output disruptions at large exporting firms. Delayed formation of the government also delayed policy-making and impaired confidence in the economy. Consumption growth moderated adding 2.6 percentage points (pp) to economic growth in 2019, investment added 0.4 pp, but net exports subtracted 0.2 pp. More recent data for Q1 2020 indicate a sharp broad-based slowdown of economic activity as a result of the current pandemic.

Unemployment, already high, is expected to increase as a result of COVID-19. The unemployment rate fell from 18.4 percent in 2018 to 15.7 percent as employment[4] rose from 34.3 to 35.5 percent, though the activity rate was unchanged. However, the labor market still suffers from high structural unemployment, and the falling unemployment rate partly reflects the country's aging and shrinking workforce. Job creation has been minimal, and COVID-19 now threatens loss of a significant share of existing jobs, especially in the service industry. BiH labor market presents a formidable challenge in the unfolding crisis, with over 20,960 jobs lost in FBiH since the start of the pandemic through April 14, according to FBiH tax authority data. In the RS, authorities estimate that about 800 jobs have been lost.

Low inflation of 2019 is expected to carry over into 2020. Consumer prices rose by an average of 0.6 percent in 2019. Food and transport are the two largest components of the consumer price index—global food, feedstuffs, and beverage prices declined on average by 4.3 percent in 2019 and global oil prices dropped by 9.9 percent. The lower food and

4 2019 Labour Force Survey.

oil prices were combined with weak demand-pull pressure on prices. In early April 2020, due to the effect of decreasing oil prices on global markets the FBiH government decided to impose maximum margins on trade in oil derivatives. As a result, local prices of gasoline fell.

The financial sector is expected to remain stable even with COVID-19. Credit growth has been positive and accelerating in 2019, with lending growing faster to households than to businesses. Most banks are sufficiently capitalized, liquid, and profitable but the performance of foreign-owned and domestic banks differs. The latter suffer from lower capitalization, high nonperforming loans (NPLs), and falling intermediation margins. NPLs are high at 7.4 percent (Q4 2019) but seem to be sufficiently provisioned by most banks.

The fiscal deficit is expected to persist in 2020 due to COVID-19. In 2019, the deficit was estimated at 0.5 percent[5] of GDP, down from a surplus of 2.5 percent[6] in 2018 as growth in public spending outpaced a solid expansion in revenue. The main upward spending pressure has been on the public wage bill: after several years of freezes both entities increased wages for public employees, and FBiH raised the minimum pension by 3.2 percent. Capital spending rose by 3.6 pp in 2019 mainly due to investments in roads, and at yearend total public debt was a moderate 33.1 percent of GDP. Fiscal discipline has been largely maintained, clearing some space to address the economic and human costs of the pandemic. Still, with the additional financing needs the authorities have announced, public debt is estimated to rise to about 37.4 percent in 2020.

In 2019 the current account deficit (CAD) narrowed to 3.7 percent. The improvements are the result of increased worker transfers and services offsetting the widening trade deficit. Exports fell by 2.3 percent and imports rose by 1.3 percent. Exports were weighed down by the slowdown in economic growth in the EU and the loss of markets for some commodities due to regional trade disputes. Rises in other components of the CAD, such as the services surplus arising from construction, transport, travel, and remittances, have been sufficient, supported by FDI and other investment, to finance a significant part of the CAD. FDI rose by 12.1 percent in 2019 and, together with other investment, was sufficient to finance the CAD. Reserve coverage seems to be adequate thanks to official inflows, remittances, and FDI. Because monetary policy is managed through a currency board, it is important that the Central Bank of BiH (CBBiH) remain independent in crises. In particular it is vital not to use its reserves to finance the CAD. Due to COVID-19, the CAD is expected to widen as trade conditions worsen and receipts from other trade services slow.

Outlook and Risks

The outlook is affected by the measures taken to combat the pandemic. What started as a shock to the health sector has quickly become an economic crisis that has engendered both a supply and a demand shock. BiH production and supply chains are being disrupted as measures to contain the pandemic are imposed.

5 BiH Global Fiscal Framework for 2020–22.
6 See Consolidated CBBiH data, available at the CBBiH Panorama web portal; consolidated 2019 data will be available in June 2020.

The outlook is subject to significant uncertainty. A baseline scenario assumes that the region manages to stem the coronavirus tide so that containment measures can be fully lifted by midyear. The World Bank is estimating that BiH will enter recession in 2020 with annual growth contracting by 3.2 percent. Q1 is expected to be slightly positive, followed by a steep decline in Q2 and a slightly negative Q3 as economic activity starts to recover. This scenario depends on the length of the pandemic and the magnitude of the state programs necessary to stabilize the economy (Table 1).

Table 1. BiH: 2020 Outlook

	Pre COVID-19	Baseline scenario	Downside scenario
Real GDP growth	3.4	-3.2	-4.2
Consumption	3.3	-2.7	-3.8
Investment	1.0	-6.2	-7.1
Exports	3.0	-8.8	-10.0
Imports	5.0	-6.5	-7.5

Source: World Bank staff estimates.
Note: Growth rates in percent.

The effects on BiH's small and open economy (foreign trade is 81.3 percent of GDP) will affect almost every sector of the economy. In addition to the containment measures that have been introduced, an acute contraction in tourism and connected sectors, such as accommodation and food; real estate (5.0 percent); transport; and wholesale and retail sales will cut deeply into private consumption, which is still the main driver of the economy (74 percent of GDP) but is expected to decline by −1.9 percent in 2020.

Disruption in supply chains and lower demand from the EU will cause declines in both manufacturing and exports of goods and services. Compared to 2018 exports are projected to decline by 8.8 percent and imports by 6.5 percent as demand drops in both the EU and Western Balkan countries.

Investment is also expected to decline sharply in 2020 (−6.2 percent). In 2019 BiH had already seen a severe decline in industry and export-oriented manufacturing (the second largest individual sector, accounting for 14.2 percent in GDP), and a further decline of −6.5 percent is expected in 2020, though with a less pronounced impact on production of food, beverages, and hygienic products. Sectors oriented to the domestic market or connected to online services are less likely to be directly affected by COVID-19 due to higher demand or fewer disruptions; they include agriculture, information and communication (ICT), and health and social services. Looking at the expenditure side of GDP, the only stabilizing factor is public consumption, which is expected to grow by 0.8 percent.

Increased financing needs will reverse the recent downward debt trajectory, but debt is expected to remain sustainable. The fiscal deficit should widen to 3.7 percent of GDP this year compared to last year. Compared to the agreed global fiscal framework the expected fall is from a 1.2 percent surplus to a 3.7 percent deficit because of higher spending on health and social and economic support, and lower revenues. The authorities plan to expand the country's social safety net to provide help to individuals by, e.g., extending unemployment benefits; they are also considering measures to support the businesses most affected by the crisis. Because part of the increased financing needs will be met through borrowing, the general government debt-to-GDP ratio is projected to rise from 33 percent in 2019 to about 37.4 percent this year. Inflation will again be subdued: along with weak demand and lower private consumption, downward pressure on consumer prices will be exerted on transport and housing costs, which depend heavily on oil prices and make up 27.3 percent of the CPI.

The downside scenario assumes a longer pandemic and a need for containment extending into Q3 2020, which would cause GDP to contract by 4.2 percent (Table 1). On both the production and expenditure sides, all components of GDP would be more severely reduced. The impact on services and industry would intensify; on the expenditure side, exports and consumption in particular would be most affected. The fiscal deficit would reach 5.7 percent of GDP, because of a larger revenue shortfall, mainly in both direct and indirect tax receipts. Current spending, especially for transfers and social benefits, would need to go up, pushing public debt up to about 40 percent of GDP. Similarly, the BOP position would deteriorate further, and the CAD would widen to 5.6 percent of GDP.

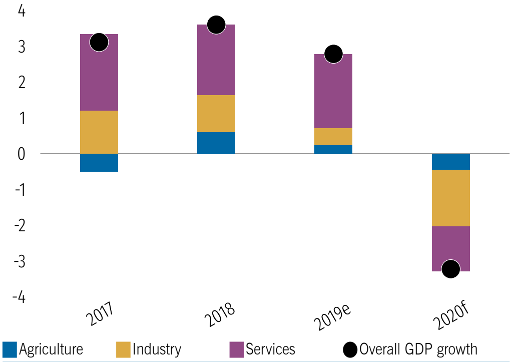
There are notable risks to the economic outlook, both domestic and external. In the short term, COVID-19 is the largest risk. Difficulty containing the outbreak promptly could result in the downside scenario. The unfolding economic crisis, together with the challenging political environment. will make it difficult to carry out the new socioeconomic program, especially in such areas as infrastructure, energy, and transport, which could further affect growth. During and after the unfolding crisis, a major challenge will be to address unemployment and minimize layoffs in the private sector. The main external risk for BiH will continue to be slow growth in the EU and political tensions within the region.

The announced solidarity and guaranty funds and other elements of the government's response can help mitigate the economic and social impact of the unprecedented crisis. Authorities in BiH have responded with measures to protect affected economic sectors and households and strengthening health sector resilience to COVID-19. The entity governments have so far allocated about KM 100 million (0.28 percent of GDP) for pandemic- related health spending. RS has postponed the deadline for payments of business tax from March 31st to June 30th and is speeding up tax and SSC refunds. It also plans to introduce one-off support of 1,000KM per health worker. In rebalancing its budget, the FBiH government announced that a total of about KM 1 billion (3 percent of GDP) will be secured to support the economy, through setting up special funds (1) to stabilize the economy, mainly by supporting exporting companies; and (2) to maintain and improve the liquidity of companies and prevent loss of jobs. The banking agencies have announced a six-month moratorium on loan repayments for businesses and individuals that may be finding it difficult to repay loans. As these measures are developed, in particular those related to establishing the new funds, it is important to ensure that the support is transparently allocated, carefully targeted, fiscally sustainable, and easily scaled back.

Beyond the current crisis, it is important that BiH keep to its structural reform path to address medium-term challenges. Reforms are necessary to address long-standing structural and institutional weakness and to enhance competitiveness. BiH needs to unleash the potential of the private sector as it reduces the footprint of the very large public sector. It also needs to shift its economy from a focus on local consumption and imports to one that recognizes the potential of international integration through investments and exports. To achieve this, the country needs a business environment that allows companies to grow and expand output, employment, and exports. Currently, incentives for reform are misaligned, and unfavorable demographics exacerbate the problems.

GDP growth slowdown in 2019 is expected to continue in 2020 due to crises.

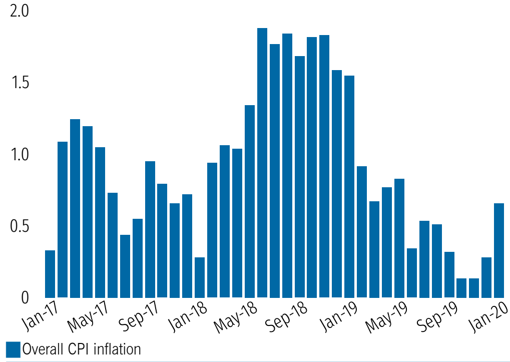
Contributions to growth, percentage points of GDP



Source: BiH Agency for Statistics, World Bank.

Inflation remains low but price pressures are present in the first months of 2020.

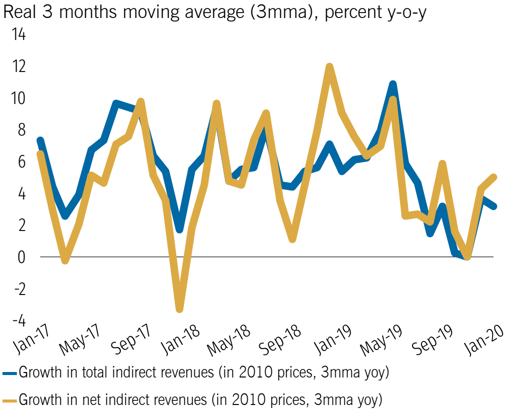
Percent y-o-y



Source: BiH Agency for Statistics, World Bank.

Strong indirect tax revenues strong early in the year are expected to weaken...

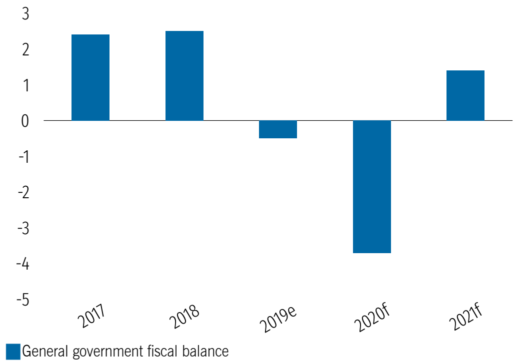
Real 3 months moving average (3mma), percent y-o-y



Source: BiH Indirect Tax Office, World Bank.

...and higher public spending will keep the fiscal balance in a deficit position.

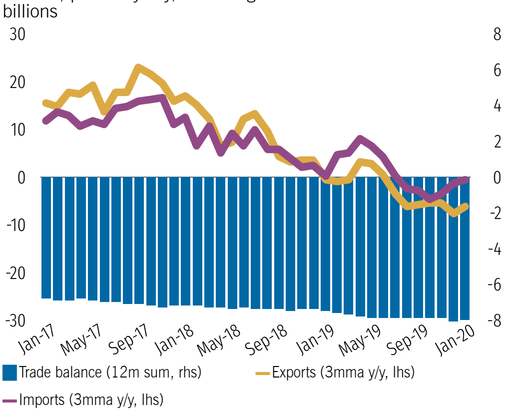
Percent of GDP



Source: Fiscal authorities, World Bank estimates.

The deficit in goods trade continues to widen.

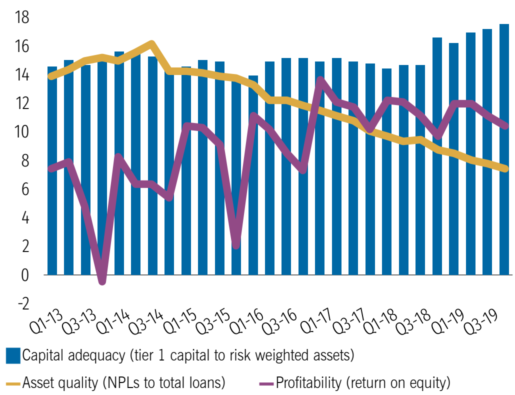
3 mma, percent y-o-y, and the goods trade balance in KM billions



Source: BiH Agency for Statistics, World Bank.

Nonperforming loans in commercial bank portfolios are declining but still high.

Percent



Source: Central Bank of BiH, World Bank calculations.

BOSNIA AND HERZEGOVINA	**2017**	**2018**	**2019e**	**2020f**	**2021f**
Real GDP growth (percent)	3.1	3.6	2.8	-3.2	3.4
Composition (percentage points):					
Consumption	n.a.	n.a.	2.6	-2.6	3.5
Investment	n.a.	n.a.	0.4	-1.1	0.0
Net exports	n.a.	n.a.	-0.2	0.5	-0.1
Exports	n.a.	n.a.	-0.1	-3.1	0.3
Imports (-)	n.a.	n.a.	0.1	-3.6	0.3
Consumer price inflation (percent, period average)	0.8	1.4	0.6	0.7	0.5
Public revenues (percent of GDP)	43.8	42.7	42.6	42.4	43.9
Public expenditures (percent of GDP)	41.4	40.2	43.2	46.1	42.5
Of which:					
Wage bill (percent of GDP)	11.0	10.2	11.0	11.6	11.3
Social benefits (percent of GDP)	17.8	17.8	18.1	19.9	19.1
Capital expenditures (percent of GDP)	2.3	2.8	3.6	2.7	2.4
Fiscal balance (percent of GDP)	2.4	2.5	-0.5	-3.7	1.4
Primary fiscal balance (percent of GDP)	3.2	3.2	0.3	-2.9	2.3
Public debt (percent of GDP)	36.1	34.2	33.1	37.1	36.6
Public and publicly guaranteed debt (percent of GDP)	37.7	35.6	34.6	37.4	37.2
Of which: External (percent of GDP)	30.7	29.9	28.9	31.3	31.0
Goods exports (percent of GDP)	29.8	31.2	29.0	27.2	27.0
Goods imports (percent of GDP)	53.4	53.6	51.8	49.3	49.1
Net services exports (percent of GDP)	7.4	7.4	7.5	6.8	7.2
Trade balance (percent of GDP)	-16.2	-15.0	-15.2	-15.3	-14.9
Remittance inflows (percent of GDP)	8.4	8.1	8.4	7.4	7.8
Current account balance (percent of GDP)	-4.4	-3.9	-3.7	-4.8	-4.2
Foreign direct investment inflows (percent of GDP)	2.1	2.5	2.7	2.6	2.8
External debt (percent of GDP)	68.5	66.8	66.5	70.5	68.3
Real private credit growth (percent, period average)	5.3	5.1	5.2	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	10.0	8.8	7.4	n.a.	n.a.
Unemployment rate (percent, period average)	20.5	18.4	15.7	n.a.	n.a.
Youth unemployment rate (percent, period average)	45.8	38.8	33.8	n.a.	n.a.
Labor force participation rate (percent, period average)	42.6	42.1	42.1	n.a.	n.a.
GDP per capita, PPP (current international $)	12,875	13,200	13,775	14,258	14,550

Sources: Country authorities, World Bank estimates and projections.
Note: Nonperforming loans show year-to-date actuals.

Kosovo

- Kosovo was projected to grow at about 4 percent in 2020; however, because of the COVID-19 outbreak, the economy is expected to contract by 4.5 percent as service exports, public and private investment plunge.
- If the outbreak is prolonged and containment measures are maintained through the third quarter of 2020, the recession may be longer and the revenue shortfall larger, limiting further policy response.
- The government has announced a stimulus package of 2.8 percent of GDP to support affected citizens, businesses, and professions. Adequate targeting of this package remains crucial in softening the economic, poverty, and social impact of the crisis.

Recent Economic Developments

The economy continued to grow at 4.2 percent in 2019, but the COVID-19 outbreak will interrupt the growth momentum.[7] The main drivers of growth will continue to be consumption and service exports, predominantly travel services to the Kosovar diaspora. Private consumption added 1.8 percentage points (pp) to growth, supported by a double-digit expansion of credit, higher remittances, and higher employment. Government consumption added another 0.5 pp. Exports overall added 3.9 pp to growth thanks to reactivation of the Ferronickeli plant and solid growth in services exports growth due to diaspora tourism. Investment in general contributed 1.3 pp to growth, fueled by higher lending and private investment in construction; public investment held constant in nominal terms. On the production side, services—primarily trade and financial services—were the main engine of growth, followed by industry. For the second consecutive year agriculture subtracted from growth.

Labor market indicators improved in 2019 but are weak compared to other countries in the Western Balkans. The employment rate increased by an average of 1.3 pp in 2019, compared to the same period in 2018, but is still the lowest in the region. Unemployment dropped by 3.9 pp as more citizens found jobs, but labor force participation dropped by 0.4 pp, and participation averages a low 40.5 percent. Thus, as Kosovo enters the COVID-19 crisis, 70 percent of the working-age population are not employed.

Because Kosovo ended 2019 with higher government deposits and relatively low debt, it has some fiscal room to mitigate the effects of the pandemic, albeit limited by the concurrent growth of current expenditure. At yearend 2019 Kosovo had a deficit of 2.8 percent of GDP, and a fiscal rule deficit of 0.3 percent of GDP.[8] Revenues grew by 7.5 percent driven by strong growth and higher tax debt collections; spending went up by 7.4 percent as current spending went up. Capital spending rose by just 0.2 percent, with notable underspending on projects financed

7 The growth statistic is based on the quarterly GDP figures; the Kosovo Agency of Statistics will announce annual GDP estimates in September.

8 The fiscal rule definition excludes capital spending financed by privatization proceeds and project loans financed since 2015 by international financial institutions.

by external debt. As a result, government cash deposits increased by 0.5 pp, to 5.2 percent of GDP (€367 M). Public and publicly guaranteed debt remains low at 17.6 percent of GDP.

The performance of the financial sector supported growth in 2019, but the COVID-19 outbreak will put pressures on the sector. Continuing the 2018 momentum, bank loans to corporations grew by 9.8 percent, and household loans grew by 10.4 percent. In December 2019 nonperforming loans made up 2 percent of total loans. Average effective interest rates on new loans decreased slightly, from 6.6 to 6.5 percent, and household loan rates had a more pronounced drop, from 7.2 to 6.8 percent. In the banking sector deposit growth of 16 percent, surpassed loan growth of 10 percent. Capital adequacy at 15.9 percent at yearend was above the regulatory minimum, and stress tests show that the sector is resilient to significant shocks.

Consumer price inflation stabilized in the second half of 2019, resulting in a y-o-y average of 2.7 percent for the year. Inflation averaged 2.7 percent in 2019, driven by rises in prices for food, tobacco, and fuel, largely as a carryover effect from price increases in the first quarter.

The current account deficit (CAD) improved in 2019 as import growth slowed and exports increased, but the external balance is highly susceptible to diaspora-driven service exports, remittances, and foreign direct investment (FDI). The CAD dropped from 7.6 percent of GDP in 2018 to 5.5 percent. At yearend reserve coverage was up from 3.5 months of imports in 2018 to 3.6 months. Merchandise import growth decelerated from 9.6 percent in 2018 to 3.8 percent as large public infrastructure projects were completed in early 2019. Merchandise exports grew by 4.4 percent y-o-y and service exports by 7.3 percent. The share of service exports, mainly diaspora visits, increased to 23.4 percent of GDP. Net FDI stayed low at 2.8 percent of GDP, concentrated mainly in real-estate purchases by nonresident Kosovars. Remittances continued to be the main source of financing for the external deficit, which went up by 7.9 percent to an estimated 11.5 percent of GDP.

Outlook and Risks

In 2020 the COVID-19 outbreak will weigh on Kosovo's growth. The impact of the COVID-19 outbreak will be transmitted through both external channels and lower domestic demand. The baseline outlook scenario discussed below assumes that the pandemic affects only the second quarter and economic activity picks up in the second half; the downside scenario assumes that containment measures are not fully lifted until August and recovery starts in the fourth quarter.

In the baseline scenario, the economy is projected to contract by 4.5 percent in 2020, followed by a rebound in 2021, as in the rest of the region and the World. Before the pandemic, Kosovo was expected to grow at a strong 4 percent. However, the pandemic and the associated containment measures are expected to cause a contraction of 4.5 percent (Table 1). Service exports constitute about 23.7 percent of GDP, of which 80 percent relate to travel by Kosovo diaspora. Assuming a 60 percent decline in service exports y-o-y in Q2, this translates into an 11 percent decline from last year. Exports as a whole are expected to subtract 3.4 pp from growth, not only because of lower services exports, but also because of a projected decline in nickel prices. Private investment is also expected to fall because of the uncertainty and cash constraints that containment measures are causing firms and also a decline in real estate FDI. Private consumption is projected to slip only slightly, by just 0.2 percent, but government consumption is expected to grow considerably based on the budget but also due to the necessary COVID-19 response. Budget-financed public investment is likely to decline due to limited fiscal space to respond to the outbreak. Several large public investment projects that were expected to advance, notably railway and road projects financed by international financial institutions (IFIs), may also be delayed. A rebound in growth is expected in 2021, following the contraction in 2020.

Table 1. Kosovo: 2020 Outlook

	Pre COVID-19	Baseline scenario	Downside scenario
Real GDP	4.1	-4.5	-11.3
Consumption	3.2	1.1	-0.6
Investment	3.8	-21.5	-28.5
Exports	4.0	-12.2	-25.5
Imports	2.2	-6.8	-8.0

Source: World Bank staff estimates.

The likely large revenue shortfall combined with the fiscal stimulus is expected to widen the budget deficit in 2020. Revenues are projected to plunge by 11 percent due to the slowdown in economic activity and the tax deferral announced by the government. The fiscal deficit is estimated to reach 6.3 percent of GDP despite the expected 43.5 percent drop in capital spending, driven by both the decline in revenues and the government stimulus package, which is estimated will cost 2.8 percent of GDP.

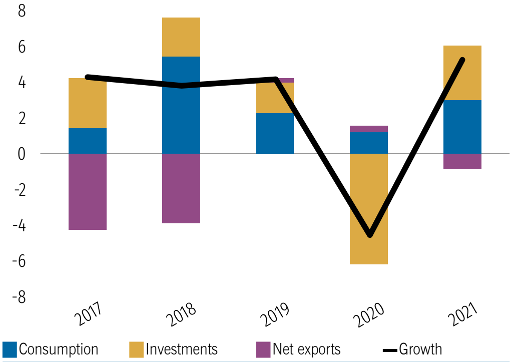
If containment measures continue into the third quarter, Kosovo may fall into a deep recession. In the downside scenario, exports are expected to decline in real terms by 25.5 percent, mainly because of steep nominal declines in exports of services (25.9 percent) and goods (18.6 percent). Net FDI is expected to decline by −8.3 percent due to both lower inflows for real estate and less reinvestment of earnings because of lower profits. Investment, both public and private, is expected to suffer from the uncertainty, financing constraints, and limited fiscal space. Private consumption is also expected to subtract more from growth as employment and disposable incomes fall. Remittances received from informal channels and FDI are expected to go down, making it more difficult to finance the CAD. Given the limited financing options, it is assumed any further revenue shortfalls will be partially compensated by reducing capital spending and spending on goods and services, pushing up the fiscal deficit to 6.6 percent.

The caretaker government has announced a stimulus package to mitigate the economic and poverty impact of the epidemic. It includes temporary increases in social assistance benefits and pensions that are less than €100 a month, and a severance payment for employees who lost their jobs because of the outbreak. The package also includes short- and medium-term measures to support private firms that are affected by the epidemic, among them wage subsidies. The cost of the package is estimated at €190 million, about 2.8 percent of GDP. However, a longer outbreak would push up the cost of the package. To address fiscal space limitations, the government is negotiating additional concessional financing with IFIs and bilateral and multilateral donors. In April the government received €51.6 million from the IMF Rapid Financing Instrument (RFI). European Union has opened the possibility of a new window for macro-financial assistance to non-EU partner countries, including Kosovo. Kosovo is also finalizing a health and social protection emergency operation and discussing budget support operation with the World Bank to ease financing needs. In addition, the Central Bank has instructed that loan repayments are postponed for firms and households affected. Given the limited fiscal envelope, the cost, financing, and targeting of the measures should be carefully assessed to increase the effectiveness of the stimulus package. For Kosovo, fiscal policy is particularly relevant for supporting the economic recovery because it lacks monetary policy options. Rationalizing non-essential public spending may be necessary it is to afford the package announced and the additional cost of the social assistance program in the future.

Advancing structural reforms in the medium term will be necessary to reverse the negative economic impact of the outbreak and help citizens to become more resilient to future negative shocks. The epidemic has proved the importance of well-functioning social protection mechanisms that can identify and support groups vulnerable to adverse economic shocks while preserving fiscal buffers. Better targeting of social protection spending to the poorest is crucial for faster poverty reduction and as an automatic stabilizer to prevent a steep decline in consumption. To sustain high and inclusive growth it is also necessary for Kosovo to boost productivity by reducing the administrative burden on firms, e.g., by better coordinating business inspections, investing in human capital, and improving rule of law so that all firms and citizens are treated fairly.

The Covid-19 outbreak will cause a contraction in 2020.

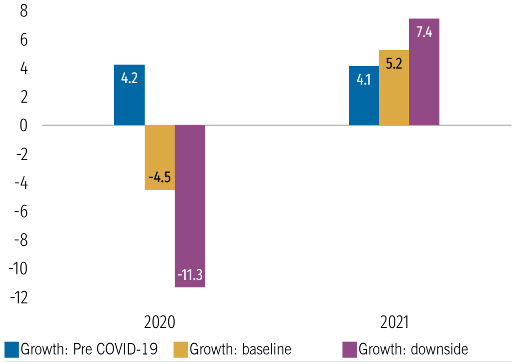
Contributions to growth, percent



Source: Statistics Agency of Kosovo and World Bank.

A prolonged outbreak may deepen the contraction, though significant recovery is expected in 2021.

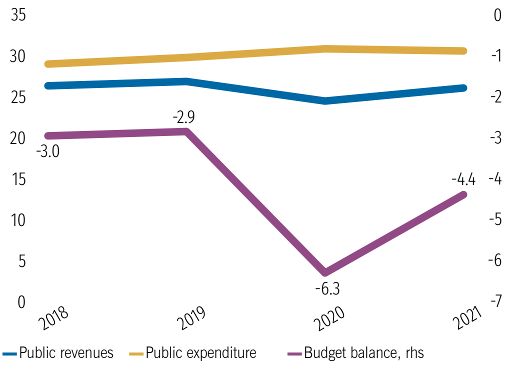
Growth contributions, percent



Source: World Bank staff calculations and projections.

Fiscal deficits will widen due to steep revenue decline.

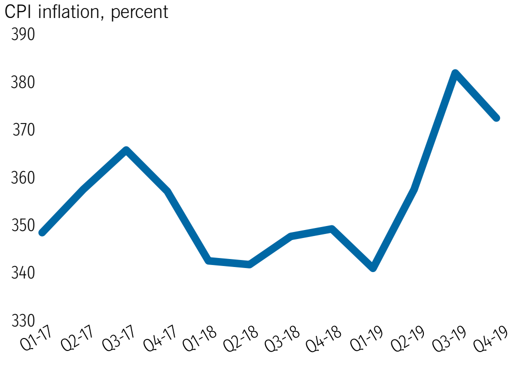
Percent of GDP



Source: Ministry of Finance and World Bank.

Consumer price inflation started to ease in the second half 2019.

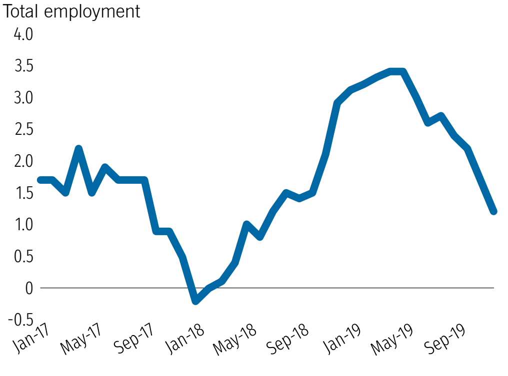
CPI inflation, percent



Source: Kosovo Statistics Agency.

Employment went up in 2019, but may be severely impacted by the Covid-19 outbreak.

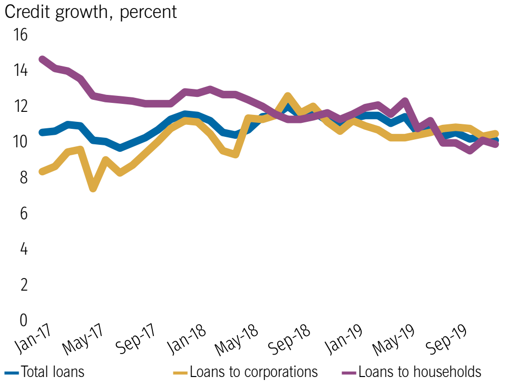
Total employment



Source: Statistics Agency of Kosovo, Labor Force Survey.

Double-digit expansion of credit supported growth in 2019.

Credit growth, percent



Source: Central Bank of Kosovo.

KOSOVO	**2014**	**2015**	**2016**	**2017**	**2018**	**2019e**	**2020f**	**2021f**
Real GDP growth (percent)	1.2	4.1	4.1	4.2	3.8	4.2	-4.5	5.2
Composition (percentage points):								
Consumption	3.8	2.5	4.7	1.5	5.4	2.3	1.2	3.0
Investment	-1.4	2.9	2.1	1.5	2.1	1.7	-6.1	3.1
Net exports	-1.2	-1.3	-2.7	1.2	-3.8	0.2	0.4	-0.8
Exports	2.9	0.5	0.5	4.0	1.0	2.8	-3.4	1.8
Imports (-)	4.1	1.8	3.2	2.8	4.8	2.5	-3.8	2.6
Consumer price inflation (percent, period average)	0.4	-0.5	0.3	1.5	1.1	2.7	1.6	1.8
Public revenues (percent of GDP)	24.0	25.1	26.3	26.4	26.1	26.7	24.4	26.1
Public expenditures (percent of GDP)	26.6	27.1	27.7	27.6	29.0	29.5	30.7	30.5
Of which:								
Wage bill (percent of GDP)	8.7	9.0	9.0	8.6	8.8	8.7	9.4	8.9
Social benefits (percent of GDP)	5.0	5.4	6.1	6.1	6.1	6.3	7.1	6.3
Capital expenditures (percent of GDP)	7.4	7.0	7.2	7.3	7.9	7.5	4.4	7.8
Fiscal balance (percent of GDP)	-2.6	-2.0	-1.4	-1.2	-3.0	-2.9	-6.3	-4.4
Primary fiscal balance (percent of GDP)	-2.4	-1.7	-1.1	-0.9	-2.7	-2.5	-5.8	-3.9
Public debt (percent of GDP)	10.4	12.7	14.1	15.6	16.3	17.0	22.5	23.3
Public and publicly guaranteed debt (percent of GDP)	10.6	12.8	14.4	16.3	16.9	17.6	23.1	23.9
Of which: External (percent of GDP)	5.8	6.2	6.2	6.6	6.2	5.8	8.7	8.2
Goods exports (percent of GDP)	5.8	5.5	5.1	5.9	5.6	5.6	5.0	5.0
Goods imports (percent of GDP)	42.7	41.9	42.8	44.3	46.3	45.7	45.8	43.5
Net services exports (percent of GDP)	8.3	7.9	10.5	12.9	12.7	13.2	13.3	11.5
Trade balance (percent of GDP)	-28.7	-28.4	-27.2	-25.5	-28.0	-26.9	-27.5	-27.0
Remittance inflows (percent of GDP)	9.9	10.5	10.5	11.1	11.3	12.0	11.6	12.3
Current account balance (percent of GDP)	-6.9	-8.6	-7.9	-5.4	-7.6	-5.5	-7.2	-6.7
Net foreign direct investment inflows (percent of GDP)	2.2	4.7	2.9	3.3	3.4	2.8	2.9	3.4
External debt (percent of GDP)	31.2	33.3	33.2	32.6	30.3	30.4	34.0	32.8
Real private credit growth (percent, period average)	3.3	7.8	8.7	8.8	10.1	7.8	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	8.3	6.2	4.9	3.1	2.5	2.0	n.a.	n.a.
Unemployment rate (percent, period average)	35.3	32.9	27.5	30.5	29.5	25.7	n.a.	n.a.
Youth unemployment rate (percent, period average)	61.0	57.7	52.4	52.7	55.4	49.4	n.a.	n.a.
Labor force participation rate (percent, period average)	41.6	37.6	38.7	42.8	40.9	40.5	n.a.	n.a.
GDP per capita (US$)	4,061	3,577	3,698	3,956	4,423	4,409	4,318	4,615

Sources: Country authorities, World Bank estimates and projections.

Montenegro

- The COVID-19 crisis has exposed Montenegro's vulnerability to external shocks.
- Montenegro's growth was expected to moderate, but the crisis is projected to push the economy into recession primarily due to a plunge in tourism, which has multiplier effects on all sectors.
- If outbreaks linger until August, the recession will be severe resulting in significant revenue shortfalls in 2020.
- The government has adopted measures to help soften the economic and social impacts, but the country's limited fiscal buffers constrain their financing and scale.
- If an economic recovery with high growth is to be sustainable over the medium term, Montenegro must improve the economy's resilience to shocks by addressing its internal and external imbalances and boosting productivity growth.

Recent Economic Developments

The economy started to cool off in 2019; now the COVID-19 pandemic and the associated containment measures have begun to stifle economic activity. Although in 2018 growth expanded briskly at 5.1 percent, in 2019, growth fell to 3.6 percent due to lower domestic demand. Private consumption still was the backbone of 2019 growth, adding 2.6 percentage points (pp); it was supported by booming tourism, solid lending to households, and higher employment. However, under-execution of highway spending caused investment to decelerate, subtracting 0.5 pp from growth. Strong service exports resulted in a positive net exports contribution to growth of 1.2 pp but industrial production contracted by 6.3 percent and construction began to cool. Retail trade, on the other hand, grew by 5.2 percent and tourist arrivals by 10.3 percent. The travel restrictions amid the COVID-19 pandemic started reversing this trend in the first quarter of 2020.

Montenegro entered the COVID-19 crisis with employment at a historical high. In 2019 employment went up 2.6 percent, mostly in construction, tourism, and retail sectors. The participation and employment rates reached their record highs of 57.4 and 48.7 percent. The unemployment rate was 15.1 percent and youth unemployment rate fell to a record low of 25.2 percent. Yet many Montenegrins of working-age entered the COVID-19 crisis without a job.

From 2.6 percent in 2018, inflation fell to just 0.4 percent and the recent plunge in oil prices is further cooling it. The lower inflation in 2019 was driven by falling garment, alcohol, and tobacco prices. After dropping by 2.5 percent in 2018, real wages grew by 0.5 percent in 2019. In March and April 2020 the COVID-19 pandemic pushed down global commodity prices, further reducing inflationary pressure.

Though bank lending has remained robust, the pandemic will severely test the financial sector. In 2019 bank lending, mainly to households, grew by 4.5 percent. After two banks were liquidated early in the year, deposits recovered slightly, growing in 2019 by 0.5 percent. In December, nonperforming loans fell to 5.1 percent of total loans, and the capital adequacy ratio was a healthy 17.7 percent. The uneven distribution of profits discloses vulnerabilities of some smaller banks. Although declining asset quality will reduce profitability, the financial sector can play an important role to mitigating the economic impact of the crisis.

External imbalances lessened as lower tourism receipts are starting to reverse this trend in 2020. As the trade deficit shrank, the current account deficit (CAD) narrowed in 2019 from 17 percent of GDP in 2018 to 15.2 percent. The strong tourism season had boosted exports in 2019, but imports grew much more slowly. The primary account shrank as remittance inflows held at 5 percent of GDP. Net FDI covered almost half of the CAD; the rest was mostly financed by external debt. In December 2019, foreign reserves covered 6.3 months of merchandise imports.

As a result of recent consolidation efforts, Montenegro's fiscal position as it entered the COVID-19 crisis was significantly better than it was two years ago. Continued fiscal consolidation reduced the fiscal deficit from 4.6 percent of GDP in 2018 to 3 percent in 2019. A new law taking over the debt and capital spending of Montenegro Airlines' debt and capital expenditures implies an estimated total net fiscal impact of about 1.5 percent of GDP over the next five years. Supported by favorable global financial conditions, in September 2019 Montenegro issued a €500 million Eurobond at a record-low interest rate of 2.55 percent and a record-long maturity of 10 years. This pushed public and publicly guaranteed (PPG) debt to 81 percent of GDP in 2019 but the proceeds were deposited, and some were used in March 2020 to repay €320 million in Eurobonds; the rest will be used to fill 2020 financing needs. Revenues in the first quarter of 2020 were stronger than a year ago but the crisis impact is expected to become evident in April.

Outlook and Risks

The COVID-19 pandemic exposes how vulnerable Montenegro is to external shocks. This health crisis is different from past crises because it implies shocks to both supply (value chain disruptions) and demand (lower earnings, the effects of social distancing). It affects countries through a variety of channels, among them underutilization of human and physical capital, lower commodity prices, fewer tourists, capital outflows from emerging market, credit rationing, and higher uncertainty. Montenegro is particularly affected by plummeting tourism, which is a critical driver of growth: tourism receipts account for more than 20 percent of GDP. The country's lack of monetary policy, limited fiscal buffers, and high public debt amplify its vulnerability.

The uncertainty about how the COVID-19 pandemic will evolve blurs the outlook. The magnitude of the slowdown depends on how long the pandemic lasts in Europe. In the following, we present two scenarios. The baseline assumes that the COVID-19 outbreak in Europe begins to slow soon enough that containment measures can be fully lifted by end-June and economic activity can start recovering in H2 2020. Here, we assume that the contraction in tourism is acute in the second quarter but more moderate in the third, resulting in a 34 percent decline in tourism receipts for the year. In the downside scenario, we assume that the outbreaks linger such that containment measures can only be fully lifted in August. It is assumed that this more severe shock will cut tourism receipts for the year by half. In both scenarios, economic activity is further undermined through other channels and second-round effects. It is also assumed that given the country's lack of fiscal buffers, such policy responses as higher health and social transfers will be mostly financed by reducing other spending.

In the baseline scenario, economic activity in Montenegro in 2020 will contract considerably. Growth was forecast to moderate to about 3 percent as highway construction was completed, but the COVID-19 outbreak and associated restrictions are expected to drive Montenegro into recession, with growth contracting by an estimated 5.6 percent (Table 1). The 34 percent drop in tourism receipts is reflected in a projected 18.5 percent decline in total exports in 2020, while imports are projected to decline by 12.4 percent. It is also estimated that less economic activity and greater uncertainty will reduce both investments and private consumption. Government consumption will be strong due to the budgeted increase in health and education salaries. In 2021, growth would rebound by an estimated 4.8 percent, driven by consumption and exports.

The estimated revenue shortfall is expected to equate in 2020 to high fiscal imbalances. Given falling demand and the spillover effect from lower international commodity prices, inflation is projected to stay low. External imbalances will remain elevated and net FDI is expected to decline from 7 to 3 percent of GDP as global uncertainty affects flows to emerging markets. As revenues decline, the recession will push up the fiscal deficit to about 7 percent of GDP in 2020. The assumption is that crisis-related spending for unemployment and social protection benefits will be financed by lower spending elsewhere. It is expected that the COVID-19 pandemic will delay debt reduction and push up debt service costs as borrowing costs rise in international markets.

Table 1. Montenegro: 2020 Outlook

	Pre COVID-19	Baseline scenario	Downside scenario
Real GDP growth	3.2	-5.6	-8.9
Consumption	2.9	-3.6	-4.8
Investment	0.0	-8.8	-13.7
Exports	4.1	-18.5	-27.8
Imports	1.9	-12.4	-17.7

Source: World Bank staff estimates.
Note: The baseline assumes that tourism receipts decline by 34 percent, in the downside by 50 percent.

In the downside scenario, Montenegro is confronted by a severe economic recession. The contraction of tourism-related receipts by half will lead to a steep drop in service exports, which will exacerbate the recession. Total exports would shrink by 28 percent in 2020 and imports by 18 percent. In this scenario, in 2020 consumption would contract more severely by about 7 percent because of worse declines in employment and wages. Moreover, given their lower profitability and larger outflows from emerging markets, banks will be forced to ration credit. That in turn implies a more severe drop in investment, which would shrink in 2020 by an estimated 14 percent. In this scenario, growth would be projected to rebound strongly to about 6 percent in 2021. A longer economic recession will worsen internal and external imbalances, exposing how vulnerable Montenegro is to a sudden stop in FDI.

If other risks materialize, domestic or external, they could amplify the negative effects of the crisis on Montenegro's growth, labor market, and household welfare.

The uncertain evolution of the COVID-19 pandemic in Europe drives the external risks to the outlook scenarios. A second wave of the outbreak could deepen the recession. The impact of the COVID-19 crisis on volatility in global financial markets and emerging market capital flows entails other downside risks. Domestic risks are also elevated by the general elections, scheduled to take place in 2020 in a highly polarized political context. And appreciation of the US dollar against the euro could heighten debt service costs in 2021 as Montenegro starts to repay the US$-denominated Chinese loan.

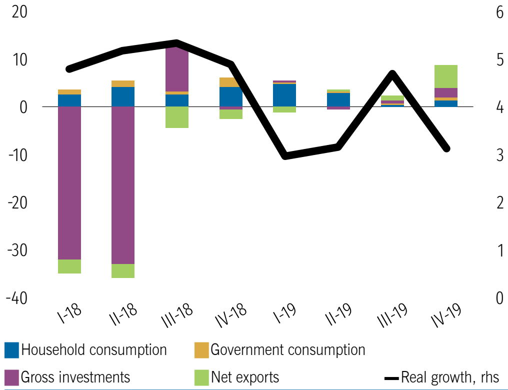
Montenegro has announced short-term policy responses to mitigate the economic and social impact of the COVID-19 crisis. Among them are improving supplies and capacity in the health sector, giving firms access to subsidized credit through the IDF, deferring tax and loan payments for 90 days, two-month wage subsidies of up to 100 percent of the minimum wage for firms in affected sectors, six-month wage subsidies for newly reported employment, exemption of taxes and contributions to the minimum wage for firms in the most affected (lockdown) sectors, support to agriculture, and one-off support for pensioners, those unemployed, and the vulnerable. The government further announced a cut in public officials' wages for two months to free resources for crisis response measures. The total net cost is estimated at about 1 percent of GDP. These measures are in line with policy responses in the EU—the intent is to reduce lay-offs and bankruptcies so as to minimize the economic and social impact and enable a quick recovery.

But Montenegro's labor market is not like that of the EU: a larger share of the vulnerable population depends on the informal economy and may receive little support. Because the limited fiscal space constrains the financing and scale of the measures, restructuring of spending can help reallocate resources from less-productive spending to support for affected firms and individuals, including the self-employed, part-time workers, firms and employees in the informal economy, and the poorest and most vulnerable citizens.

Over the medium term, Montenegro must act to make the economy more resilient to shocks by addressing its internal and external imbalances and boosting productivity growth. Both would make an economic recovery with high growth sustainable over the medium-term. Improving the fiscal stance is critical to reduce Montenegro's acute vulnerability to shocks and reduce the large swings in economic activity. The economic recovery and the subsequent higher growth should thus be leveraged by committing to debt reduction and starting to build fiscal buffers. Otherwise, future periods of high growth are again likely to be short-lived. Sustaining high and inclusive growth further requires Montenegro to boost productivity by improving the quality and mobility of its human capital, intensifying its efforts to strengthen the rule of law, leveling the playing field for businesses, and making the public sector more efficient.

Growth softened in 2019…

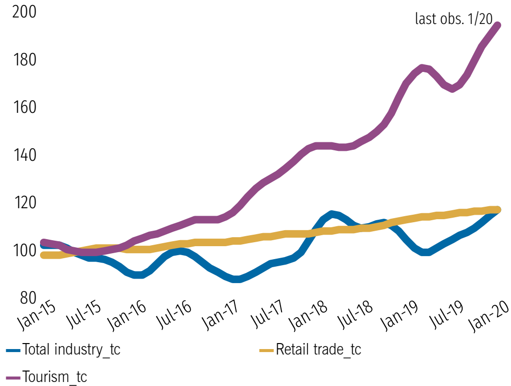
Contribution to growth, percentage points



Source: MONSTAT data, World Bank staff calculations.

…despite the strong tourism season.

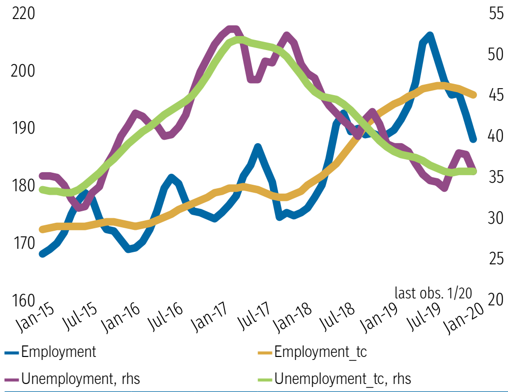
High-frequency data, trend-cycle, Jan 2015–Jan 2020



Source: MONSTAT. Tc = Trend cycle.

Employment strengthened…

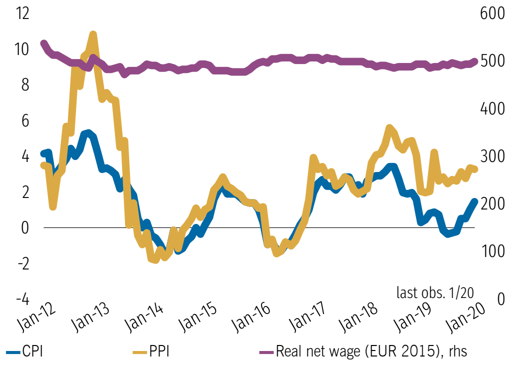
Administrative data, thousands, Jan 2012–Jan 2020



Source: MONSTAT data.

…but real wages were mostly flat.

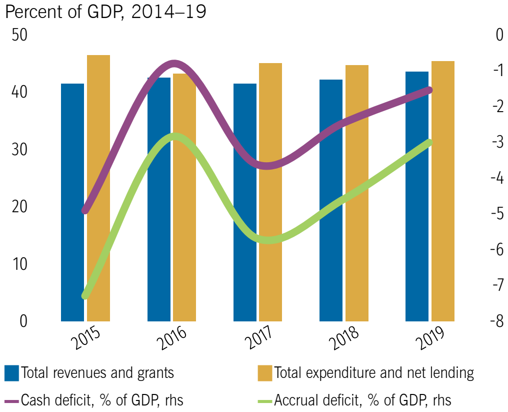
Administrative data, Jan 2014–Feb 2020



Source: MONSTAT data.

In 2019, the fiscal deficit was reduced to 3 percent of GDP…

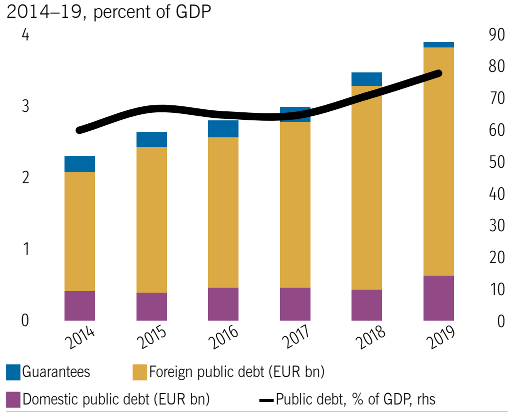
Percent of GDP, 2014–19



Source: MOF and MONSTAT data.

…while public and publicly guaranteed debt reached a peak of 81 percent of GDP.

2014–19, percent of GDP



Source: MoF, CBCG, and MONSTAT data.

MONTENEGRO	2014	2015	2016	2017	2018	2019e	2020f	2021f
Real GDP growth (percent)	1.8	3.4	2.9	4.7	5.1	3.6	-5.6	4.8
Composition (percentage points):								
Consumption	2.7	2.3	4.8	3.2	5.2	2.8	-3.7	4.7
Investment	0.6	1.7	7.2	8.0	4.9	-0.5	-3.9	-2.2
Net exports	-1.6	-0.6	-9.1	-6.5	-5.0	1.2	2.1	2.3
Exports	-0.4	2.8	2.9	0.9	3.4	3.2	-9.5	7.4
Imports (-)	1.2	3.4	12.0	7.4	8.4	2.0	-11.5	5.1
Consumer price inflation (percent, period average)	-0.7	1.5	-0.3	2.4	2.6	0.4	0.2	1.5
Public revenues (percent of GDP)	44.6	41.5	42.5	41.4	42.0	43.6	44.1	44.1
Public expenditures (percent of GDP)	47.7	48.8	45.3	47.0	46.6	46.6	51.3	44.1
Of which:								
Wage bill (percent of GDP)	12.7	12.3	12.2	11.8	11.2	11.1	12.4	12.1
Social benefits (percent of GDP)	14.2	13.3	14.1	12.5	11.7	11.3	13.8	12.3
Capital expenditures (percent of GDP)	5.3	8.1	3.7	7.8	8.5	8.8	7.6	4.6
Fiscal balance (percent of GDP)	-3.1	-7.3	-2.8	-5.7	-4.6	-3.0	-7.1	0.0
Primary fiscal balance (percent of GDP)	-0.8	-4.9	-0.7	-3.3	-2.4	-0.8	-4.9	2.2
Public debt (percent of GDP)	59.6	66.2	64.4	64.2	70.1	77.2	83.1	73.6
Public and publicly guaranteed debt (percent of GDP)	65.8	72.7	70.4	69.1	74.1	80.7	86.9	77.1
Of which: External (percent of GDP)	45.7	53.9	58.4	57.9	64.6	68.7	76.4	67.0
Goods exports (percent of GDP)	10.3	9.0	8.9	8.9	9.4	9.5	9.4	9.5
Goods imports (percent of GDP)	50.1	49.1	50.8	52.2	53.3	51.5	46.9	47.3
Net services exports (percent of GDP)	20.0	21.6	19.4	19.8	20.1	20.7	14.7	19.3
Trade and services balance (percent of GDP)	-19.8	-18.5	-22.5	-23.5	-23.9	-21.4	-22.7	-18.6
Remittance inflows (percent of GDP)	4.7	4.4	4.0	3.9	4.0	4.0	3.4	4.0
Current account balance (percent of GDP)	-12.4	-11.0	-16.2	-16.1	-17.0	-15.2	-17.0	-12.9
Net foreign direct investment inflows (percent of GDP)	10.2	16.9	9.4	11.3	6.9	7.0	3.0	8.0
External debt (percent of GDP)	162.8	171.4	162.5	160.1	163.9	170.7	175.8	167.9
Real private credit growth (percent, period average)	-1.5	0.3	3.5	4.4	5.9	6.7	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	18.8	14.8	11.5	8.4	7.4	5.1	n.a.	n.a.
Unemployment rate (percent, period average)	18.0	17.6	17.7	16.1	15.2	15.1	n.a.	n.a.
Youth unemployment rate (percent, period average)	35.8	37.6	35.9	31.7	29.4	25.2	n.a.	n.a.
Labor force participation rate (percent, period average)	52.7	53.7	54.5	54.7	56.0	57.4	n.a.	n.a.
GDP per capita, PPP (current international $)	15,371	16,337	17,866	19,355	21,994	21,950	20,974	22,230

Sources: Country authorities, World Bank estimates and projections.
Note: Nonperforming loans show year-to-date actuals.

North Macedonia

- After a robust 3.6 percent growth in 2019, the outlook for 2020 is for a recession amid the unprecedented downside risks due to the coronavirus pandemic.
- After a historical low in 2019, unemployment rate will rise as the firms worst affected by the pandemic begin defensive restructuring despite government subsidies.
- The fiscal deficit and debt will widen as the impact of the pandemic on fiscal outcomes is compounded by the 2019 procyclical policies (through wage and transfers' increases).
- While mitigating the crisis impact takes priority, once conditions normalize NATO accession and launch of the EU accession negotiations offer the country an opportunity to accelerate fiscal, competition, judicial, and regulatory reforms for faster recovery.

Recent Economic Developments

The economy continued to expand in 2019 before COVID-19 interrupted the upturn economic cycle. Growth accelerated in 2019 to 3.6 percent, up from 2.7 percent in 2018. The main contributors—wholesale and retail trade, construction, and real estate services—together added 1.7 percentage points (pp) to growth. Agriculture and public services each contributed 0.3 pp, while due to a slowdown in late 2019 the contribution of manufacturing was neutral. The energy sector and mining added to the growth. On the demand side, the main contributor to growth was private consumption (2.6 pp) spurred by rising wages, employment, pensions, and household lending. Investments added another 2.1 pp, but as import growth surpassed exports net exports subtracted from growth.

The labor market continued to improve. Employment went up by 5.1 percent y-o-y, more than doubling growth in 2018, partly thanks to government employment schemes. Manufacturing, trade, transport, accommodation, administrative services, and entertainment created the most jobs. The employment rate further improved to 48.4 percent in 2019—up 3.2 pp, as unemployment rate declined to 17.3 percent, down 3.5 pp. The participation rate improved marginally (to 57.2 percent) but in the most dynamic regions around technological zones labor shortages continued. However, the administrative unemployment data already suggests an increase by 1.4 percent y-o-y by March 2020 as firms cope with the COVID-19 crisis.

Wage pressures intensified in 2019. The average gross wage increased in real terms by 4.1 percent, mainly because a continued increase in the minimum wage, particularly affected such labor-intensive industries as construction, textiles, and agriculture. Public sector wages also went up with the largest impact to be felt in 2020. In January 2020, average real gross wage increased by 12.2 percent y-o-y. The continued trend of wage growth, coupled with a decline in labor productivity in most sectors, is making the economy less competitive. Average inflation remained low in 2019: consumer prices rose by 0.8 y-o-y because of higher prices for food. Moreover, it further slowed down to 0.6 percent y-o-y by March 2020 as oil prices declined.

The external imbalance widened ahead of the crisis. In 2019 current account deficit reached 2.8 percent of GDP, compared to just 0.1 percent in 2018. FDI-related exports like automobile parts, electrical machinery, and buses grew at double-digit rates, and exports of furniture, iron, and steel were solid, but traditional apparel exports declined. However, the trade deficit hit 14.3 percent of GDP because of rising imports, and lower net services exports due to an outflow of intellectual property services in late 2019. Net current transfers declined driven by a fall in remittances and EU grants. Though very low in early 2019, by year-end net foreign direct investment picked up to reach 2.6 percent of GDP. External debt was relatively stable at 74 percent of GDP.

In 2019 the banking sector supported growth. Credit growth of 6 percent was led by household loans (10.5 percent y-o-y), accounting for 80 percent of total growth in credit; for credit to businesses growth was just 1.9 percent. At 4.6 percent nonperforming loans (NPLs) were down from 5.1 percent in 2018, but corporate NPLs stood at 7.4 percent, down from 7.8 percent. Deposit growth was a buoyant 10.1 percent y-o-y, for a loan-to-deposit ratio of 83.1 percent. Banks thus have ample room to lend more.

The fiscal deficit widened as spending increased more than revenues. The general government deficit was 2.1 percent of GDP in 2019; the increase in general government revenues of 0.7 pp of GDP was not enough to compensate for spending that was up by 1.7 pp of GDP. The rise in revenues was underpinned by social contributions, which were up by 10 percent y-o-y because pension and health contribution rates rose in January 2019, personal income tax (though the higher rate introduced in January was suspended in September), VAT, and one-off nontax revenues. On the other hand, higher spending was driven by the government scaled up subsidies for wages and social contributions; higher spending for goods and services; and clearance of local government arrears. From a historic low in 2018, capital spending went up to 3.4 percent of GDP, not counting the operations of the Public Enterprise for State Roads (PESR). With PESR, capital spending would be 4.4 percent of GDP, and the deficit 2.4 percent of GDP. Public and publicly guaranteed debt was up slightly from 2018 at 48.9 percent of GDP.

Outlook and Risks

Unprecedented downside risks related to the coronavirus pandemic now confront the economy, which entered recession in Q2 2020. On March 18, the president declared a state of emergency and the government announced measures to contain the impact of the coronavirus crisis. Due to the crisis, the snap elections scheduled for April have been postponed. The growth projections reflect the uncertainty surrounding the ultimate severity and duration of the pandemic. While the magnitudes are uncertain, the channels of transmission are clear. On the one hand, the pandemic is pushing down commodity prices; while on the other is disrupting global and regional supply chains, reducing travel and tourist arrivals, decreasing demand for exports, and reducing household demand as containment measures and job losses change household incomes and behavior.

If the coronavirus outbreak is largely contained by mid-2020, by year-end the economy will still have to deal with a

recession of 1.4 percent. Under this scenario, the recovery is expected from July as measures to contain the virus are gradually lifted and financial market and supply-chain disruptions ease. In this scenario, the economy would contract by 11.5 percent in Q2, led by manufacturing, construction, tourism, trade and real estate, and exit recession in Q3 at 0.4 percent growth. Personal consumption is expected to slow significantly compared to 2019, and exports and investments will also decline. However, government consumption would ramp up in an attempt to boost the economy and to counter the impact of the coronavirus. Higher government spending will result in higher deficit and debt levels just as both domestic and external financing conditions are likely to tighten. The budget revision under preparation will need to reprioritize spending. Poverty reduction gains will likely be lost as firms defer to labor shedding in tourism and manufacturing, the sectors most affected by the crisis. These are also the sections that have contributed most to reducing poverty in the past.

On the other hand, prolonged disruption of economic activities until August 2020 would cause growth to fall by -3.2 percent, the biggest drop since 2001. The prolonged shock would worsen the contraction in demand and probably cause a longer disruption of supply chains. For aggregate demand, this would imply less consumption as consumer confidence dwindles, unemployment rises despite government support schemes, and both wages and household lending fall. The nascent 2019 recovery of private investment will be severely affected as investors struggle to avoid bankruptcy and financing conditions tighten. Public investment would be postponed to finance crisis-related emergencies. On the supply side the major shock will come from the slowdown in manufacturing as global-supply chains are disrupted and sourcing of both capital and intermediate goods halts, affecting both foreign-funded and local companies. Consequently, this would also affect services with close ties to manufacturing. Companies will also suffer from the deterioration in financing conditions as banks become more risk-averse and there are flight-to-safety flows in international financial markets.

Table 1. North Macedonia: 2020 Outlook

	Pre COVID-19	Baseline scenario	Downside scenario
Real GDP growth	3.6	-1.4	-3.2
Consumption	4.3	0.6	-0.3
Investment	8.0	-0.1	-2.6
Exports	7.4	-0.1	-2.9
Imports	9.4	1.7	0.1

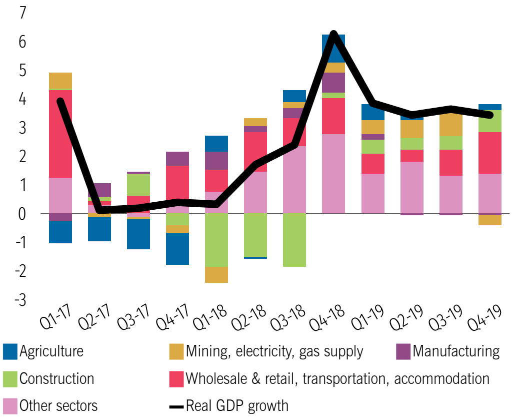
Source: World Bank staff estimates.
Note: Assumptions for the baseline include a largely contained coronavirus outbreak by mid-2020 resulting in a temporary disruption of economic activities. For the downside scenario the disruptions continue until August 2020, with widespread disruption of economic activities, and a major global slowdown.

The slowdown in both supply and demand calls for strong fiscal and monetary responses. To counter the negative effects of the pandemic, by March 2020 the National Bank had lowered the base rate in two steps to a historic low of 1.75 percent, provided additional liquidity to banks by lowering the amount of C-bills auctioned, reactivated the unconventional measure related to the reserved requirements instrument to support most affected sectors and several regulatory measures aimed to maintain the banks' credit cycle. To support people and firms the government announced a package of measures amounting to about 2 percent of GDP. It includes partial social contributions and wage subsidies to all affected firms, unemployment benefits and social assistance to the people affected, delayed revenue collection and subsidized loans to smaller businesses. The emergency response will add to the fiscal strain. The economic slowdown will result in falling revenues, which are already comparatively low, thus adding significant pressure to the already tight fiscal space for boosting growth. Moreover, the country has large Eurobond repayments coming due late this and end-July next year, which will require it to mobilize significant financing, which could be difficult if international capital markets are disrupted and financing conditions are adverse. North Macedonia has already approached both domestic and international financial institutions, and the EU funding has already been underway. In addition to the disbursed IMF Rapid Financing Instrument of EUR176.7 million, the World Bank is approving the package of emergency response of about EUR140 million. The EU has also announced that it will provide financing (EUR 160 million) under its Macro-Financial Assistance program.

Mitigating the near-term impact of the crisis is urgent, but it is also important to keep in focus long-term policy priorities of addressing low and declining human capital, weak competition policy and judiciary, declining productivity, and rising emigration. Until mid-year, the authorities should focus on securing medical supplies and staffing, measures to slow the spread of the virus and reduce the peak load on health systems, securing fiscal stability and access to finance, keeping the financial sector stable while ensuring adequate liquidity, protecting the affected people and helping businesses to survive and retain workers.

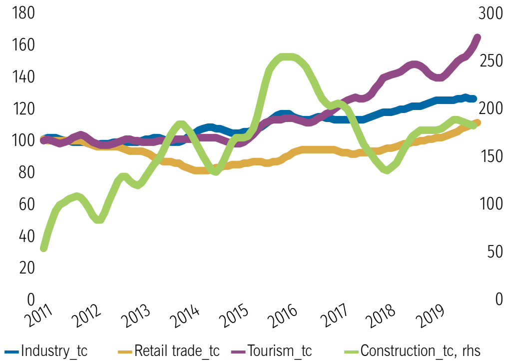
Over the medium term, growth is expected to return as demand strengthens after the outbreak loses force. The launch of the EU accession negotiations announced on March 25, 2020, should boost both reforms and investor confidence so that once the crisis is over, growth rebounds faster. In this scenario of a V-shaped recovery, growth in 2021 is expected to reach 3.7 percent, as restored consumer and investor confidence pushes up personal consumption, private investment, and exports. Given expected real wage growth and the improvement in the labor market, starting in 2021 poverty may once again begin to decline.

Economic growth accelerated in 2019 before the COVID-19 shock…



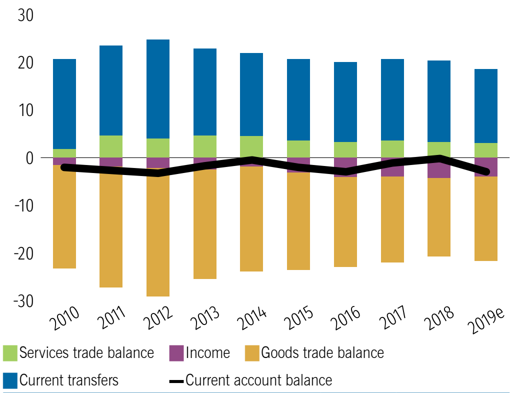
Source: State Statistics Office.

…and was broad-based even in early 2020.



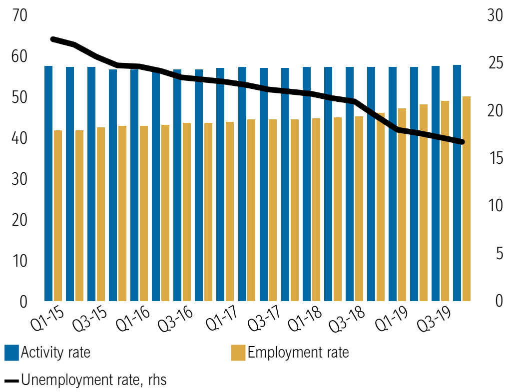
Source: State Statistics Office and World Bank calculations.

The external deficit widened as investment and consumption picked up.



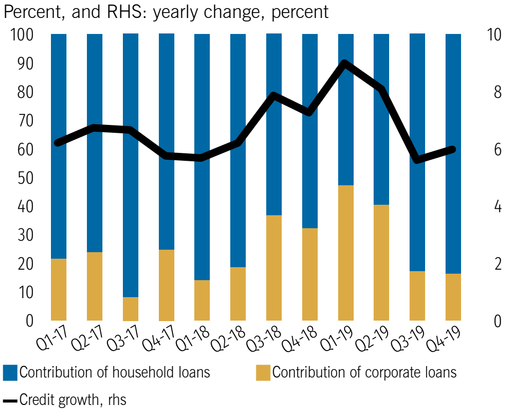
Source: National Bank.

Solid growth reduced unemployment to a historic low, but the crisis threatens to wipe out the gains.



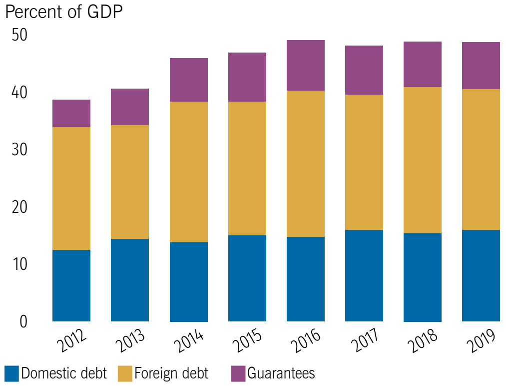
Source: State Statistics Office.

As monetary policy relaxed, lending to corporations rose.



Source: National Bank.

Public debt remained stable despite an increase in guaranteed debt.



Source: Ministry of Finance and World Bank estimates.

NORTH MACEDONIA	**2015**	**2016**	**2017**	**2018**	**2019**	**2020f**	**2021f**
Real GDP growth (percent)	3.9	2.8	1.1	2.7	3.6	-1.4	3.7
Composition (percentage points):							
Consumption	3.7	1.9	1.3	3.3	3.6	0.6	3.8
Investment	2.6	4.1	-0.8	-2.6	2.1	-0.1	1.9
Net exports	-2.5	-3.2	0.6	2.0	-2.1	-1.9	-1.9
Exports	4.2	4.7	4.6	9.2	5.5	-0.1	4.1
Imports (-)	6.7	7.9	4.0	7.3	7.6	1.7	6.0
Consumer price inflation (percent, period average)	-0.3	-0.2	1.4	1.5	0.8	2.1	1.8
Public revenues (percent of GDP)	31.0	30.6	31.0	30.5	31.2	28.2	31.2
Public expenditures (percent of GDP)	34.4	33.2	33.8	31.6	33.3	32.9	33.8
Of which:							
Wage bill (percent of GDP)	7.0	6.8	6.6	6.3	6.3	6.3	6.1
Social benefits (percent of GDP)	14.8	15.0	15.3	15.3	15.5	16.5	15.4
Capital expenditures (percent of GDP)	4.2	3.8	4.2	2.5	3.4	1.9	3.8
Fiscal balance (percent of GDP)	-3.4	-2.7	-2.8	-1.1	-2.1	-4.7	-2.7
Overall Fiscal Balance with the Public Enterprise for State Roads*	-4.1	-3.8	-3.5	-1.7	-2.4	-5.0	-3.2
Primary fiscal balance (percent of GDP)	-2.3	-1.5	-1.5	0.1	-1.0	-3.5	-1.5
Public debt (percent of GDP)	38.1	39.9	39.4	40.6	40.2	46.0	46.7
Public and publicly guaranteed debt (percent of GDP)	46.6	48.8	47.7	48.6	48.8	55.7	56.4
Of which: External (percent of GDP)	31.4	34.0	31.7	33.1	32.7	38.4	38.3
Goods exports (percent of GDP)	33.6	36.5	40.6	45.6	47.0	45.8	46.9
Goods imports (percent of GDP)	53.7	55.3	58.4	61.8	64.3	64.6	64.3
Net services exports (percent of GDP)	3.8	3.5	3.7	3.4	3.0	2.8	2.9
Trade balance (percent of GDP)	-16.2	-15.2	-14.1	-12.8	-14.3	-16.0	-14.6
Remittance inflows (percent of GDP)	2.3	2.0	1.9	1.9	1.7	1.7	1.6
Current account balance (percent of GDP)	-1.8	-2.6	-0.9	-0.1	-2.8	-3.3	-2.1
Net foreign direct investment inflows (percent of GDP)	2.2	3.3	1.8	5.6	2.6	1.4	4.0
External debt (percent of GDP)	69.3	74.7	73.4	73.3	73.9	78.5	78.4
Real private credit growth (percent, period average)	9.9	0.2	4.0	5.7	4.9	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	10.3	6.3	6.1	5.1	4.6	n.a.	n.a.
Unemployment rate (percent, period average)	26.1	23.7	22.4	20.7	17.3	20.0	18.3
Youth unemployment rate (percent, period average)	42.55	40.6	39.2	37.1	32.8	n.a.	n.a.
Labor force participation rate (percent, period average)	57.0	56.5	56.8	56.9	57.2	56.9	57.4
GDP per capita, PPP (current international $)	13,831	14,813	15,299	16,359	17,046	17,096	17,831

Sources: Country authorities, World Bank estimates and projections.
Note: Poverty rates are based on North Macedonia survey on income and living conditions (SILC).

Serbia

- After solid growth of 4.2 percent in 2019, the Serbian economy is now dealing with a COVID-19-related recession.
- Unemployment at a historical low of 10.4 percent in 2019 will help to cushion the negative impact.
- However, both external and fiscal imbalances are widening: the current account deficit reached 6.9 percent of GDP in 2019, and the small fiscal deficit from 2019 is expected to go up significantly in 2020.
- As the COVID-19 pandemic spreads, chances are rising that the economic scenario will worsen.

Recent Economic Developments

The Serbian economy grew by a solid 4.2 percent in 2019 but it is now threatened by a COVID-19-related recession. Though the start of 2019 was disappointing[9], in the second half of the year the government stepped up efforts to complete the gas pipeline to Bulgaria (part of the "Turkish Stream"), which lifted real GDP growth by 0.7 pp. Resilient to global developments, Serbian exports grew by 8.7 percent in 2019, and preliminary estimates indicate that growth surprised on the upside at 4.2 percent y-o-y. The main drivers of growth were services, up 4.2 percent, and construction, up 30.2 percent; while manufacturing sector disappointed.

Before the pandemic the labor market had improved significantly. According to Labor Force Survey data, in 2019 unemployment fell to an estimated 10.4 percent (annual average, population age over 15) and employment reached a record-high 49 percent. Average wages also went up, by 10.6 percent in nominal terms. As of February 2020, the number of unemployed registered with the National Employment Service had declined by 9.8 percent (y-o-y).

Serbia entered the COVID-19 crisis from a strong fiscal position thanks to its fiscal consolidation efforts in recent years: the deficit, 0.2 percent of GDP in 2019, was small. Compared to 2018, revenues rose by 8.2 percent in nominal terms, supported by higher social contributions, up 9.2 percent, and VAT, up 10.2 percent. Spending went up by 10.4 percent, mainly because more was spent on investment, up by 33.6 percent, y/y in 2019) and public sector wages (up by 10.1 percent in 2019 as the cost of decision to increase wages in the public sector was 0.9 percent of GDP in that year alone). Public and publicly guaranteed debt at the end of December reached 52.9 percent of GDP. In early 2020, the general government budget was in deficit already. Revenues performed well (up 3.1 percent compared to January-February 2019) however this was not enough to compensate for a high increase in spending (in particular on wages and subsidies) which was increased by 12 percent over the first two months, compared to the same period 2019.

Low inflation and a sound banking sector are a solid foundation for pandemic

9 To a large extent because of the repair and maintenance in some of the largest companies in the oil and chemicals sectors.

responses. Inflation in 2019 was low and stable, as it was through February 2020, with prices up 1.9 percent. In March inflation eased to 1.3 percent. To stimulate the economy, the National Bank of Serbia (NBS) continued to lower the key policy rate—in March by 50 bps to 1.75 percent, and in April further down to 1.5 percent. After a small appreciation in 2019, the dinar held steady in Q1 2020. The NBS intervened regularly in the foreign exchange market. Consequently, official foreign currency reserves declined by €264 million and stood at €13.1 billion. The banking system is performing well with a continued increase in lending (up by 10.3 percent, y/y, as of February), while NPLs continued to decline. Gross nonperforming loans (NPLs) declined to 4.1 percent in December 2019 and remained unchanged through end-February.

The widening current account deficit (CAD) has become a concern as the COVID-19 pandemic has caused international financial markets to tighten, thus making its financing more difficult. In 2019 the CAD went up by 52 percent from 2018 and hit 6.9 percent of GDP. Most of the rise is explained by the fact that the trade deficit widened by 10.4 percent. Exports of goods rose by 8.8 percent, despite a slowdown in Europe and a halt of exports to Kosovo. However, imports were up by 9.2 percent, from a much higher base. Still, foreign direct investment continued to be strong at €3.6 billion, more than sufficient to finance the CAD in 2019. Over the first two months of 2020, the CAD increased by 38.4 percent compared to the same period 2019. In early 2020, remittances declined significantly (down 9.4 percent) and FDI were lower than in corresponding period of 2019. By the end of 2019 total external debt had begun to go up in nominal terms, reaching €28.4 billion, 61.9 percent of GDP. Risk premiums for Serbia as measured by the Emerging Market Bond Index went up by 269 bps over the previous two months, in line with the increase in global EMBI.

Outlook and Risks

Because of the COVID-19 pandemic, in 2020 the Serbian economy will enter recession. In the first half of March, 168 companies were temporarily closed and nearly 5 percent of all employees had to stay at home. The disruption to economic activities is most pronounced in transport and tourism. Based on government estimates, the transport sector has had losses of about €110 million since the crisis began, and tourism arrivals and bookings declined dramatically.

In the baseline scenario Serbian GDP will drop by 2.5 percent in 2020. The baseline assumes that the coronavirus outbreak in Europe will slow enough that containment measures can be fully lifted by the end of June. It is also assumed that recovery will start in the second half of the year, but will not be enough to annul the losses in the first half. The impact on the economy will vary by sector. Most affected will be manufacturing, with a projected decline of about 9 percent. Services will also be severely affected, but to varying degrees: transport and tourism will be hit hardest because they will not be able to compensate for first-half losses by overperforming in the second half. Services are thus projected to decline by about 1 percent in 2020. Agriculture could see a small increase in 2020.

Developments in the real sector will affect both external and fiscal accounts. Trade in goods is expected to drop considerably in euro terms: merchandise exports by 12 percent and imports by 17.8 percent. Transport and tourism exports would be lower by about 30 percent, and remittances are expected to fall by about 20 percent. As a result, in 2020 the CAD could increase to about 7 percent of GDP. The fiscal deficit could reach 7.3 percent of GDP because revenues are expected to fall by about 3.3 percent as part of the announced fiscal package, and spending will increase by about 3.5 percent. Public debt may reach 63.9 percent of GDP by yearend.

Table 1. Serbia: 2020 Outlook

	Original Projections	New Base Case	Low Case
Real GDP Growth	3.9	-2.5	-5.3
Consumption	5.7	-2.3	-3.5
Investment	5.3	-5.2	-7.7
Exports	4.9	-10.2	-18.5
Imports	7.6	-9.7	-15.1

Source: World Bank staff estimates.

The downside scenario assumes that a longer-lasting pandemic would have a more severe impact on the economy. In this scenario, containment measures can only be fully lifted in August, deepening the recession because GDP would also shrink in the third quarter. Value chains would not be re-established immediately, and services would recover more slowly. In that case GDP could fall by 5.3 percent in 2020. On the spending side, all components of GDP would have a steeper fall, especially exports and consumption. The fiscal deficit would reach 8.6 percent of GDP as revenues decline further and spending for social transfers rises, with public debt rising to 69.1 percent of GDP. Similarly, the balance of payments would deteriorate, and the CAD would reach 9.3 percent of GDP.

Should the pandemic be prolonged beyond Q3, the impact on the economy would be even more dramatic. The result would be a deeper recession and more pronounced financial pressures, both fiscal and external. Finally, a major concern is that investors would become more risk-averse, which would push up the cost of borrowing and put additional pressure on both fiscal and external accounts.

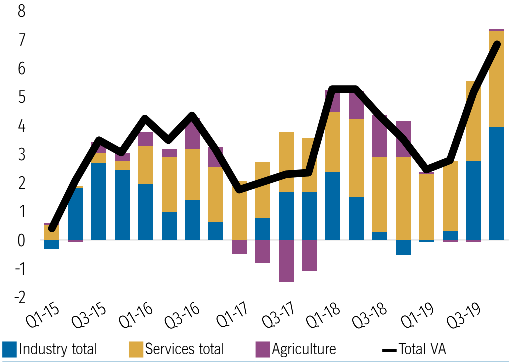
The government and the NBS have early on introduced several measures to mitigate the economic impact of the pandemic. In April the government provided a one-off payment to pensioners (about €34 per person) and increased salaries for health sector employees by 10 percent (from April onward). The NBS is providing additional liquidity: it cut the policy rate from 2.25 to 1.75 percent and then to 1.5 percent and has provided additional dinar liquidity equaling to about €340 million through foreign exchange swap and repo operations. It has also introduced a moratorium on debt repayments for all firms and individuals, and the tax administration waved forced collection of taxes from financially stressed entities that previously signed a payment rescheduling program with the Tax Administration. By yearend the government plans to increase capital spending by RSD 24 billion (about €200 million). Meanwhile it has banned exports of some basic food items, agricultural products, medicine, and medical products.

On March 31st the authorities announced a package of assistance valued at about €5 billion (11 percent of GDP). The new package supports smaller businesses and entrepreneurs through tax deferrals and compensation for wages paid to employees; support to larger enterprises includes subsidized lending through the Development Fund and issuance of guarantees. Finally, it plans a one-off payment of €100 to all adults.

To accelerate economic recovery from COVID-19 and sustain higher medium-term growth, Serbia needs to address long-standing structural problems. Management of state-owned enterprises (SOEs), especially utility companies, and the level and performance of public investment are major bottlenecks for the government. Most SOEs still do not have permanent, professional managers. Among the results are underinvestment, underperformance, and general poor management. Moreover, public investment is not always well prioritized and carried out in line with good management practices. Social safety nets need to be strengthened and better-financed. Adopting already identified measures could further improve the business environment, among them measures to ensure more competition in the market; better manage state aid; and administer tax payments and trade facilitation more effectively. Finally, comprehensive reform of the education system is needed to respond to growing skills shortages.

Solid growth in 2019 driven by services and construction.

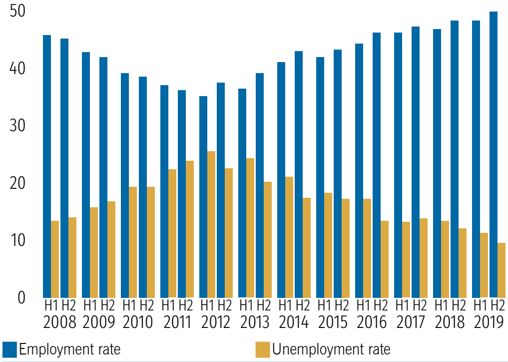
Percent contribution to growth



Source: Statistics Office of Republic of Serbia.

As a result, the labor market has improved.

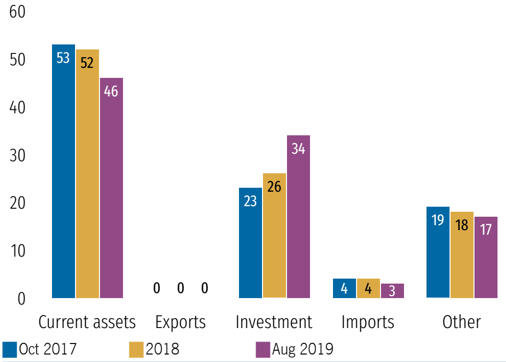
Employment and unemployment rates



Source: Statistics Office of Republic of Serbia.

Credit recovered and the structure of new loans improved further.

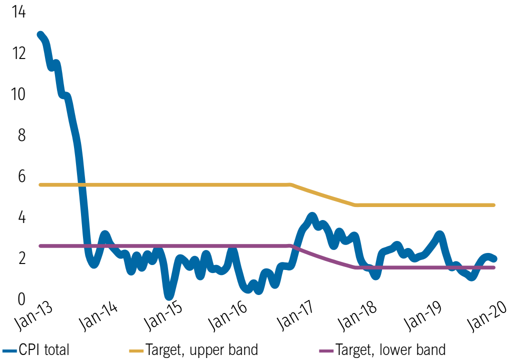
Share in total



Source: National Bank of Serbia.

Inflation remains low.

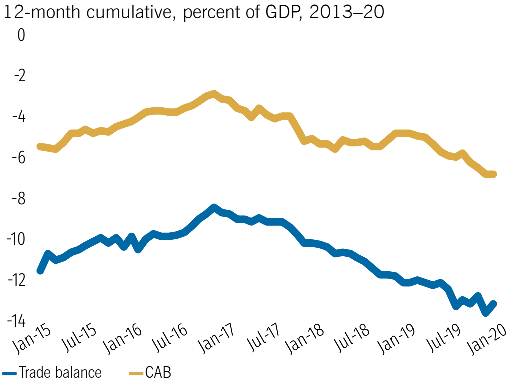
Percent, 2013–20



Source: National Bank of Serbia.

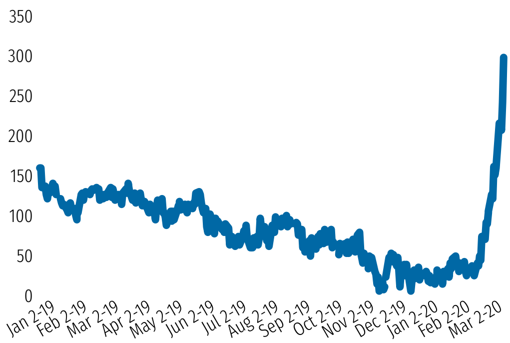
The CAD is widening rapidly.

12-month cumulative, percent of GDP, 2013–20



Source: National Bank of Serbia.

Concerns about external financing mount as risk premium rises.



Source: JP Morgan EMBI.

SERBIA	**2017**	**2018**	**2019e**	**2020f**	**2021f**
Real GDP growth (percent)	2.0	4.4	4.2	-2.5	4.0
Composition (percentage points):					
Consumption	1.9	2.8	2.7	-1.9	2.8
Investment	2.2	4.2	3.0	-1.3	1.4
Net exports	-2.1	-2.6	-1.5	0.8	-0.2
Exports	4.0	4.3	4.6	-5.7	4.3
Imports (-)	6.1	6.9	6.0	-6.5	4.5
Consumer price inflation (percent, period average)	3.2	2.0	1.9	2.0	2.2
Public revenues (percent of GDP)	41.5	41.5	42.1	37.7	41.1
Public expenditures (percent of GDP)	40.4	40.9	42.3	45.0	42.9
Of which:					
Wage bill (percent of GDP)	9.0	9.2	9.5	9.8	9.8
Social benefits (percent of GDP)	15.1	14.7	14.5	15.9	14.8
Capital expenditures (percent of GDP)	2.8	3.9	4.9	3.7	4.5
Fiscal balance (percent of GDP)	1.1	0.6	-0.2	-7.3	-1.8
Primary fiscal balance (percent of GDP)	3.6	2.8	1.8	-5.5	0.2
Public debt (percent of GDP)	55.6	50.8	49.7	56.9	52.3
Public and publicly guaranteed debt (percent of GDP)	58.7	54.4	52.9	63.9	57.3
Of which: External (percent of GDP)	35.5	31.4	30.3	36.5	37.0
Goods exports (percent of GDP)	35.9	35.2	35.8	34.4	35.1
Goods imports (percent of GDP)	46.1	47.1	48.0	44.0	47.5
Net services exports (percent of GDP)	2.4	2.3	2.3	1.2	2.6
Trade balance (percent of GDP)	-7.8	-9.5	-9.9	-8.4	-9.8
Remittance inflows (percent of GDP)	5.2	6.4	5.8	4.8	5.2
Current account balance (percent of GDP)	-5.2	-4.8	-6.9	-7.0	-7.5
Net foreign direct investment inflows (percent of GDP)	6.2	7.4	7.8	4.8	5.2
External debt (percent of GDP)	68.9	61.3	61.9	67.7	68.8
Real private credit growth (percent, period average)	1.9	3.7	7.1	n.a.	n.a.
Nonperforming loans (percent of gross loans, end of period)	9.8	5.7	4.1	n.a.	n.a.
Unemployment rate (percent, period average)	13.5	12.7	10.4	13.9	13.6
Youth unemployment rate (percent, period average)	31.9	29.8	27.6	n.a.	n.a.
Labor force participation rate (percent, period average)	54.0	54.5	54.6	n.a.	n.a.
GDP per capita, PPP (current international $)	16,363	17,552	18,564	19,767	21,067

Sources: Country authorities, World Bank estimates and projections.
Note: Nonperforming loans show year-to-date actuals.

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The Country Notes

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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.