

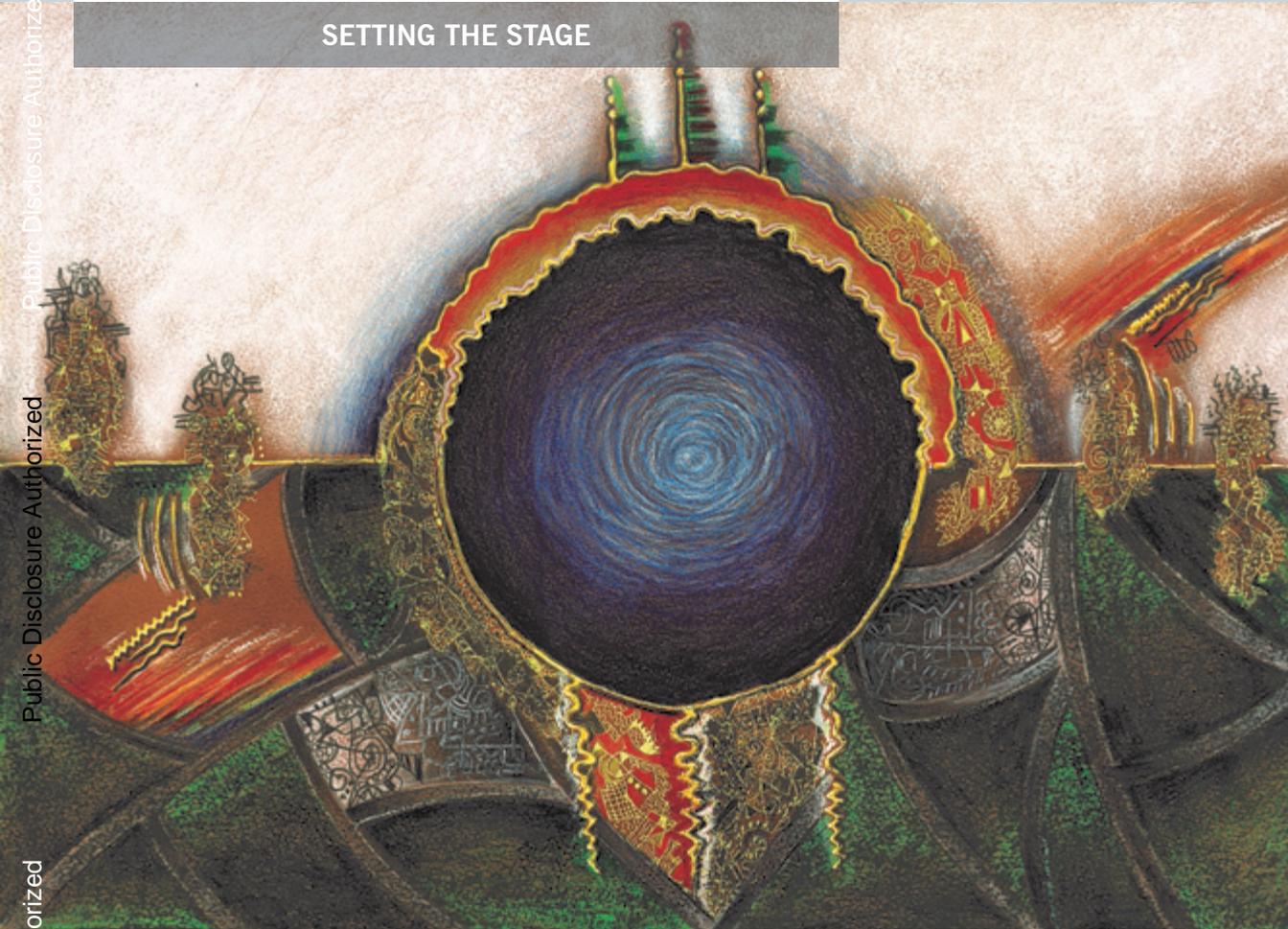


WORLD BANK GROUP

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

SETTING THE STAGE



"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.

Setting the stage: Reviewing the state and vulnerabilities of the Western Balkan Economies as they face COVID-19¹

An Unprecedented Shock

In Spring 2020, Western Balkan countries—like most others in the world—have been forced to impose tight restrictions on economic life to contain the COVID-19 pandemic. In the first half of 2020, the world has seen explosive growth of infections with the deadly novel virus. As country after country has been forced to shut down large areas of social and economic life to slow contagion, the Western Balkans have not been spared. The first cases were recognized as early as the first week of March. As of April 27, 2020, the Johns Hopkins corona virus data center now reports that over 11,000 cases have been confirmed in the six countries in the region. In response, all six have enforced lockdowns and strict social distancing measures. International airports in all countries were closed for passenger traffic. The initial lockdowns have been extended. The capitals of Kosovo and Albania are under quarantine, as are other cities in the region. Key economic sectors, such as restaurants and non-essential retail, have been shut down. Travel and social gatherings have been restricted or banned, and schools and universities have been closed.

The COVID-19 crisis has severe ramifications for the economies of the Western Balkans as both aggregate supply and aggregate demand contract simultaneously. Not only government restrictions but also the responses

of households and businesses to the crisis are putting unprecedented strain on the economies in the region. Declining economic activity is also complicating public finances and expanding the financing needs of governments.

Aggregate demand is collapsing. Consumers avoid activities that could expose them to infection. The summer tourism season is expected to be dismal. Nonessential consumption and investment are delayed until the uncertainty linked to the crisis is resolved. Similar problems in key trading partners, such as the EU, will weigh on exports.

Aggregate supply is also contracting. Government restrictions force nonessential businesses and companies that cannot meet social distancing requirements to close or scale back operations to mitigate the outbreak. While some businesses can continue to operate through online sales or telework, for most, productivity will suffer. Some workers must stay home to look after children whose schools have closed or are social distancing to avoid infection. Disruptions in global and domestic supply chains hurt manufacturing. Declining commodity prices eat into the margins of extractive industries. Liquidity constraints might cause further disruptions in production.

Services, especially those that require physical interaction, are likely to suffer most. Government restrictions have forced much of the hospitality, retail, and in-person service sector to close. Restrictions on travel intended to avoid travelers sharing close quarters with others, as in buses, trains, and

¹ This note has been prepared by Christoph Ungerer and Asli Senkal. The note benefited from comments from Marc Tobias Schiffbauer, Edith Kikoni, Enrique Blanco Armas, Jasmin Chakeri, Gallina Vincelette and Michael Lokshin.

planes, have severely disrupted transportation. Tourism has for all practical purposes collapsed; it will take time to revive even when the crisis is brought under control. Manufacturing suffers from social distancing safeguards that disrupt production, a collapse in orders, and supply chain problems. Relatively more robust are essential sectors like medicine, the food supply chain, the public sector, and sectors that can more easily shift to telework, such as professional services related to the digital economy.

This crisis is different:

1. It is a large-scale health shock that has required a conscious—and necessary—temporary activity freeze to slow the spread of infection. The length and depth of the crisis will depend on how effective the containment measures are, how well the health system can deal with the outbreak, and the successful development of effective treatment and vaccines for the illness.
2. Economic policy alone cannot end this crisis, but it does have a crucial role: to protect livelihoods by preserving jobs and reinforcing the social safety net.
3. A brisk economic recovery is possible—but not a given. Relaxation of lockdown measures may free pent-up consumption and investment, which would encourage economic activity to rebound quickly. But to the extent that the economic freeze and liquidity shortages force fundamentally viable businesses to shut down, rupture productive supply-chain relationships, or let go of employees who have built up significant on-the-job knowhow, the

shock may have undermined medium-term productivity. To the extent that the crisis eats into public and private financial buffers, efforts to consolidate and to restore balance sheets may weigh on recovery. To the extent that the threat of the virus lingers, the recovery may be overshadowed by concerns about a recurrence of the epidemic, and of containment measures.

To mitigate the impact of the crisis, Western Balkan countries have announced sizable fiscal packages ranging from 1 to 7 percent of GDP (excluding guarantees) to support their citizens and businesses.²

How well prepared for a major crisis were Western Balkan countries?

The Fall 2019 Regular Economic Report had already noted growing uncertainty about the outlook for the region, because even before the COVID-19 crisis, both global and Euro Area growth rates were expected to slow. The Euro Area, which houses the main trading partners for the Western Balkans, was expected to decelerate to 1 percent.³ And prices for base metals, an important share of regional goods exports, were projected to decline. Domestic risks were already heightened by political circumstances: Elections are planned in several countries. Kosovo held parliamentary elections on October 6th and formed a government in February 2020—which suffered a no-confidence vote on March 25 and currently operates as a care-taker government. Elections are planned for Montenegro, Serbia, and North Macedonia and municipal elections are planned

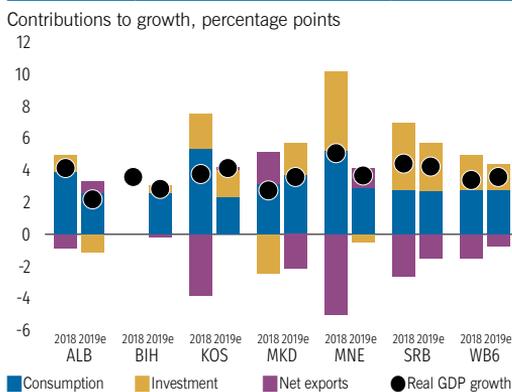
² See the companion RER note “Western Balkans Outlook: Hard Times Require Good Economics”.

³ Global Economic Prospects, January 2020.

for Bosnia and Herzegovina. Furthermore, Albania was hit by a severe earthquake in November 2019, which created a need for major new financing for reconstruction.

The Western Balkan growth model was vulnerable before the crisis. In the region, consumption accounted for more than 60 percent of growth in recent years (Figure 1). Consumption growth in some countries has been fueled by higher public spending and by one off wage policies and near double-digit growth in household lending, raising questions on the sustainability of the consumption-driven growth in the region. The contribution of investment was about 47 percent in 2019 while net exports subtracted from growth. In Albania, Bosnia and Herzegovina, and Kosovo, growth of investment in 2019 has been limited while consumption grew strongly driven by remittance inflows and higher consumer lending. Across the region, net exports in 2019 were a drag on growth: on average, in 2012–18 they subtracted from growth because of the high level of imports, there are few competitive exporters, and the region’s main trading partners, in particular EU members, were

Figure 1. Pre-crisis Western Balkan growth was limited by modest investment rates and net exports.



Source: National statistical authorities; World Bank staff calculations.

weakening. Productivity, including growth of advanced manufacturing and services, has lagged behind what is necessary for the region to catch up with incomes in the advanced EU.

Going into the COVID-19 crisis, Western Balkan countries had different economic strengths and weaknesses. A heatmap (Figure A.1) is a useful way to summarize this, particularly if complemented by granular country-by-country qualitative analysis. Also useful is a multidimensional assessment that reviews characteristics of regional labor markets, the sectoral composition of each economy, fiscal policy space, monetary policy space, financial buffers, and external vulnerabilities.⁴

First, labor markets where informal, temporary, and self-employment is disproportionate, are likely to be confronted by job destruction, which will cause considerable hardship, especially if the social safety net is not adequate. By end-2019, the employment rate in the Western Balkans reached 44.3 percent, up from 42.7 percent for 2018 and 36.9 percent for 2012. However, many of the jobs created were in low-paying labor-intensive manufacturing and services. Low employment rates and high unemployment rates have had considerable influence in limiting inclusive growth in the Western Balkans. Many jobs are temporary or informal. As the COVID-19 crisis unfolds, those jobs are likely to be highly vulnerable to destruction, reversing the job creation gains of recent years. Worse, many of these workers may not be able to access social safety nets. As highlighted by the heatmap (Figure A.1),

⁴ In the following, we briefly discuss the Western Balkan economies’ state and vulnerabilities in each of these areas. A detailed discussion of the impact of COVID-19 on these areas and social sectors will be provided in separate RER notes that will be published in a follow-up e-launch.

these problems are particularly acute in Kosovo (low employment, much of it temporary), Bosnia and Herzegovina (low employment and high informality), and Albania (high self-employment and informal employment).

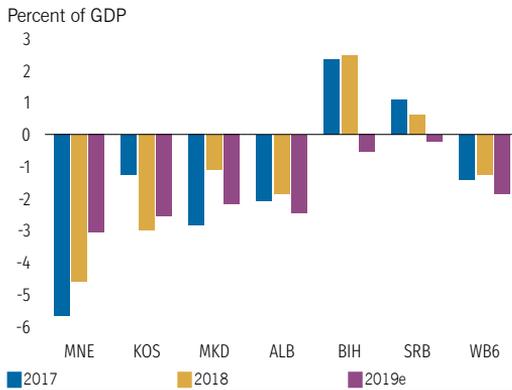
Second, the importance of tourism to their economies makes Albania, Montenegro, and Kosovo more vulnerable to the economic impact of the crisis than the rest of the countries in the region. The structure of Western Balkan economies contributes to their vulnerabilities. Externally, the economies of Albania, Montenegro, and Kosovo are highly dependent on services exports, mainly tourism; the goods exports base is very narrow (see Figure A.1). Hence, the COVID-19 outbreak may affect Albania, Montenegro, and Kosovo not only directly through travel restrictions but also perhaps through a change in consumer behavior after the outbreak. Kosovo's tourism might prove more resilient: it depends mainly on diaspora tourists. For the economies of Bosnia and Herzegovina, North Macedonia, and Serbia, goods exports are a higher percentage of GDP; they are thus better connected to global value chains because of healthy automotive and automotive parts industries. These economies are affected by the disruption in global value chains and by lower demand for durable goods.⁵ In all Western Balkan economies, the retail, hospitality, and entertainment sector accounts for more than 10 percent of employment, and much that business has had to close because of the epidemic.

Third, fiscal policy support is crucial to help the private sector through the COVID-19

crisis, but countries in the region have little fiscal space for new measures (Figure A.1). In 2019 all Western Balkans countries had fiscal deficits, though all were relatively small (Figure 2). However, despite relatively strong revenue performance in recent years, the fact that revenues in the region trail those in the Euro Zone also limits fiscal space for crisis response compared to advanced economies. This is especially true of Kosovo and Albania. Except for Kosovo and Bosnia and Herzegovina, as a legacy of the global financial crisis and the Euro Zone crisis, public debt levels in the region are still elevated (Figure 3); but both those countries find it difficult to access international capital markets, so that their only financing sources are the international financial institutions (IFIs). There is some space for accepting higher deficits during the COVID-19 crisis that should be used as economic policy support measures are activated, but fiscal policy is expected to be inhibited by concerns to keep debt under control and secure financing from markets and official creditors. Furthermore, automatic stabilizers are expected to be limited as social safety nets, such as unemployment benefits and social protection spending, are limited in the region.

Fourth, countries across the region have few monetary policy options, especially Kosovo and Montenegro, which undertook unilateral euroization. Tools for active monetary policy are also limited in Bosnia and Herzegovina by its currency board arrangement. In the other countries, low pre-crisis interest rates narrow the space for conventional monetary easing. Meanwhile, high unofficial euroization is a tail risk for financial stability in countries where banks are exposed to indirect credit risk through their exposure to unhedged borrowers and by possible increased demand for foreign exchange

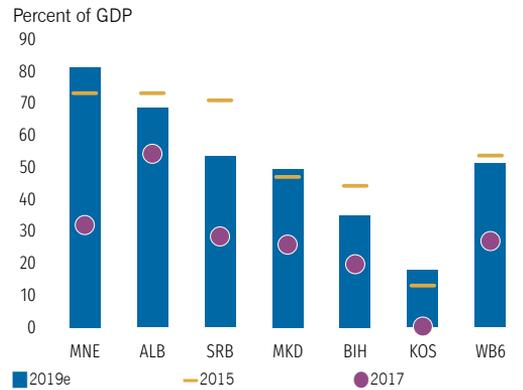
⁵ The pattern of demand for durable goods is similar to that of investment; both tend to be highly cyclical, falling during economic downturns (Bils and Klenow 1998, Caramp, Colino and Restrepo 2017).

Figure 2. Fiscal deficits have been moderate.

Source: National statistical authorities; World Bank staff calculations.

(FX) instruments. As international capital pulls back from emerging markets during the crisis, countries with flexible exchange rates are seeing their currencies depreciate. But price competitiveness gains do not offer much support, given the general freeze of the global economy, and central banks are intervening to stabilize their exchange rates. For example, the National Bank of Serbia is providing liquidity to the system by cutting its policy rate and by FX swap and repo operations.

Fifth, financial sectors have generally solid capital and liquidity buffers—though they will be tested in this downturn. Financial systems are more resilient than before, partly because of financial sector reforms undertaken after the global financial crisis of 2008/09. Western Balkan banking systems enter this crisis with strong aggregate capital and liquidity buffers. In Albania, mergers and license removals have strengthened the system through consolidation. In Montenegro, two under-capitalized banks have been liquidated. In Kosovo, introduction of private enforcement agents and write-off have helped lower NPLs, which by the end of 2019 had reached an all-time low of 2 percent of total loans. However,

Figure 3. Several Western Balkan economies already have considerable debt.

Source: National statistical authorities; World Bank staff calculations.

although NPLs have been decreasing in all countries, in Albania and BiH they are still elevated, and concerns about vulnerabilities in individual private and state-owned banks remain. While pre-crisis credit outstanding grew in most of the region, the economic freeze is likely to test the system. Many current borrowers will face liquidity constraints and may have to stop paying down their loans, and in these difficult economic times banks are likely to become extremely careful about issuing new loans. It will thus be important to leverage such mechanisms as partial credit guarantee funds, export subsidies, and subsidized loans from development banks to reduce the liquidity challenges of otherwise solvent firms. The crisis calls for close monitoring and surveillance of the financial sector to minimize potential risks that might arise from the crisis—policy makers need to be ready to intervene swiftly as needed. Although notable improvements have been made over the last decade, there are still weaknesses in bank supervision in terms of crisis management, resolution, and insolvency that should be tackled.

Sixth, throughout the crisis significant current account deficits will need to be

financed, especially in Montenegro and to a lesser extent in Albania, Kosovo, and Serbia (Figure A.1). In 2019, Western Balkan trade deficits reached 13.8 percent of GDP. Key exports were international tourism, manufactures, and extractives—all of which were vulnerable to the coronavirus crisis. In the past, trade deficits were mainly financed by remittances and foreign direct investment (FDI), which have both been slashed in this crisis. While remittances tend to be resilient during downturns, that may not be true this time, partly because a large share of remittances arrive through informal channels, but also because the virus containment measures may have cost many in the diaspora their jobs. Current as well as new FDI flows are likely to be delayed as the crisis freezes much of economic life in the Western Balkans and economic uncertainty is not resolved. Throughout the crisis foreign currency reserve buffers are likely to be crucial for financing external imbalances.

The resilience of Western Balkan economies will be tested as the COVID-19 crisis unfolds. The economic freeze will put pressure on both government budgets and private sector balance sheets. Households will lose jobs, and some once-viable businesses will close. Throughout the economy liquidity will need to be carefully managed to avoid escalating the crisis. In these difficult times public policy needs to do whatever it can to limit hardship, targeting measures to quickly support those most in need. The longer the economic freeze lasts, the deeper the economic ramifications of this public health crisis are likely to be as capital and liquidity buffers are drawn down across the economy. These times will test the resilience of Western Balkan economies—and test the determination of their people to aggressively tackle and win the fight against COVID-19.

Countries need to take advantage of all available options to navigate the crisis, using assistance when it is available, such as accessing funding through IFIs. Wherever there is fiscal and monetary policy space, now is the time to use it to maintain the productive capacity of economies and the functioning of markets and to support, and save, lives and livelihoods. Given limited resources, policy support needs to be timely, time-bound, targeted, and transparent. As countries in the region come out of the crisis, their policies need to shift from crisis-fighting to restarting the economy—and eventually to normalizing balance sheets and bringing down the debt accumulated during the crisis.

Figure A.1. Heatmap of Relative COVID-19 Vulnerability in the Western Balkans

		Albania	BIH	Kosovo	Montenegro	North Macedonia	Serbia
1. Labor Market	Self-employed (% total emp)	34.7	17.6	21.3	19.4	14.3	22.4
	Temporary employment (% total emp)	9.7	17.5	79.5	34.6	16.1	22.6
	Informal employment (% total employment)	61	29.5		19.9		19.8
	Employment rate (% population aged 15+)	52	34.3	25.4	48.1	44.9	48.6
2. Fiscal policy	Fiscal balance (% GDP)	-2.5	-0.5	-2.5	-3.0	-2.1	-0.2
	Revenue (% of GDP)	27.8	42.6	26.7	43.6	31.2	42.1
	PPG Debt (% GDP)	68.0	34.6	17.6	80.7	48.9	52.9
3. Monetary policy	Exchange rate (1-flexible, 0-fixed)	1	0	0	0	1	1
4. Financial sector policy	Capital adequacy ratio	18.3	18.1	15.9	17.7	16.3	23.4
	Liquidity ratio (liquid assets as % of total assets)	35.7	29.6	28.9	20.8	24.0	36.0
	Non-performing loans (% of total loans)	8.4	7.4	2.0	5.1	4.6	4.1
5. External vulnerability	Current account (% GDP)	-7.6	-3.7	-5.5	-15.2	-2.8	-6.9
	Goods exports (% of GDP)	6.8	29.0	5.6	9.5	47.0	35.8
	Service exports (% of GDP)	23.9	10.8	23.2	34.6	14.7	14.0
	International tourism (% of exports)	48.2	12.7		50.8	5.1	7.7
	Travel/transport exports (% of services exports)	60.7	44.8	82.5	85.5	20.9	33.5
	Remittance inflows (% of GDP)	5.2	8.4	12.0	4.0	1.7	5.8
	Reserves (in months of imports)	6.4	7.8	2.3	6.3	3.8	5.7

Sources: ILO, UNCTAD, WDI, national authorities (latest data available as of April 22, 2020).

Note: The selected indicators on the real sector, financial sector, external sector, fiscal policy, and monetary policy only present a limited view of a broad range of factors that are associated with macroeconomic risks and vulnerabilities. Color coding is based on indicator values relative to each other and should be viewed strictly within the context of the discussion in this note.

Note: Worker's remittances coming to North Macedonia through official channels amounted to 1.6 percent of GDP in 2019. Nevertheless, overall private transfers in 2019 were 13.6 percent of GDP.

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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.