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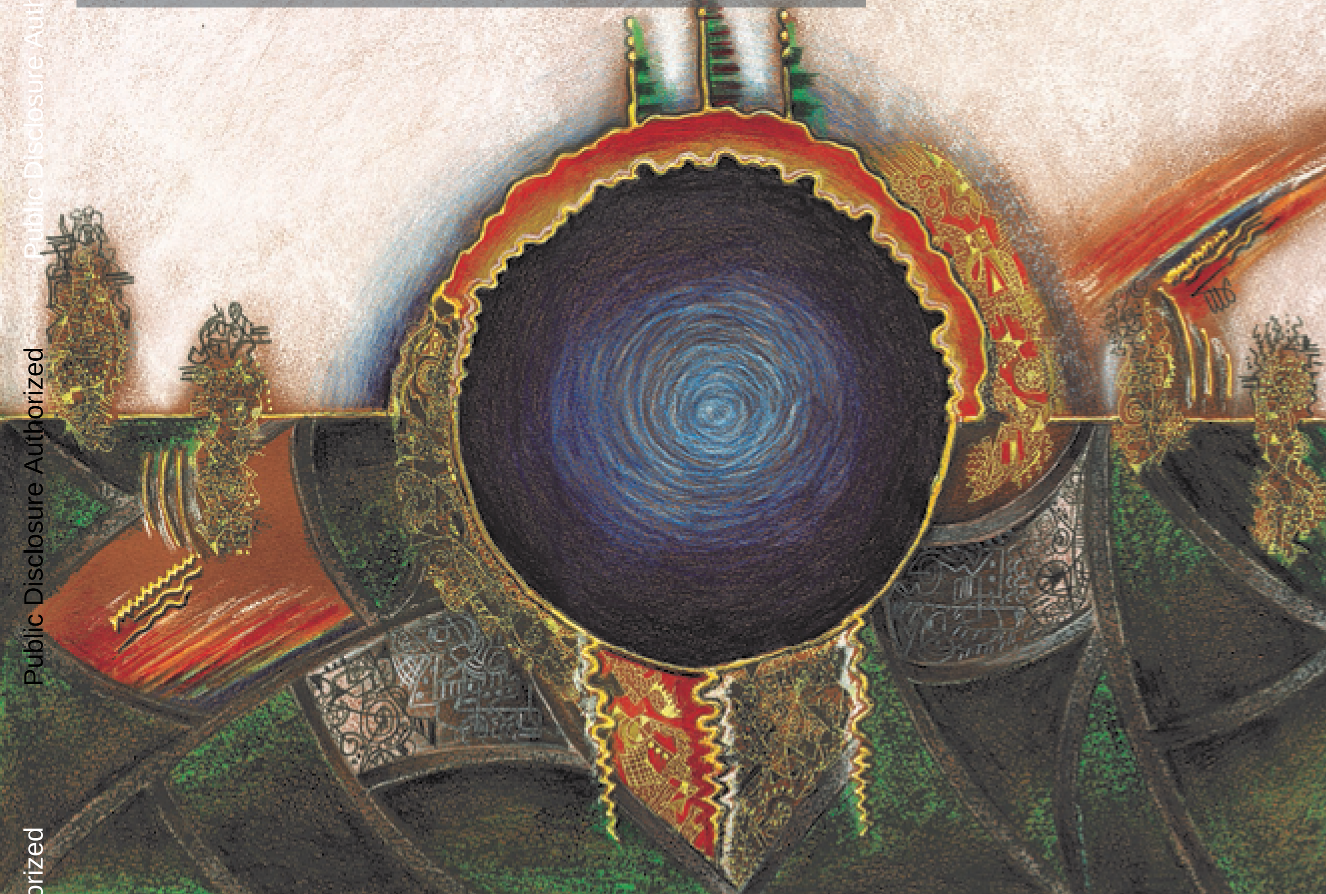
The Economic and Social Impact of COVID-19

FINANCIAL SECTOR



"You and me" by Tanja Burzanovic (Montenegro)

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

Financial Sector Policy Interventions – Liquidity Support and Risk Mitigation[1]

- The financial sector can do much to help mitigate the impacts of COVID-19 on the real economy by providing bridge financing and restructuring of loans for viable firms to help them alleviate the impacts of the crisis, adopt to the new operating environment, and, eventually, contribute to the recovery stage.
- Arising financial sector vulnerabilities have more impact on emerging markets like the Western Balkans whose financial systems are less prepared to weather shocks.
- While national financial sectors in the region are generally stable, it is necessary to monitor credit and liquidity trends closely as COVID-19 poses the most serious threat, globally and locally since 2008.
- Prolonged financial stress will require measures to prevent the build-up of financial stability risks.

The escalating COVID-19 outbreak constitutes both a supply and a demand shock whose full magnitude, duration and financial, fiscal, and social ramifications are still not clear. The rapid global spread of the virus has reached pandemic proportions and prompted a flurry of emergency measures—rate cuts, liquidity support, tax deferrals, travel bans, mandatory closure of businesses, limitations on gatherings—to contain the spread, mitigate disruption to economic activity, and avert a dislocation in financial markets. While incremental easing of lockdown measures has been initiated in the region, households, and firms, especially MSMEs, are confronted by plunging incomes, disruptions in supply chains, tighter credit conditions, and a liquidity crunch; together, these are delaying deliveries and payments and causing job losses and ultimately firm closures and bankruptcies. Less profitability, lower asset quality, and a drop in growth of credit can have second-round effects on the real economy and jeopardize financial stability. Disruptions from lack of staff in financial institutions and regulatory agencies may affect provision of financial services. Heightened uncertainty and risk aversion among investors may raise the cost of funding in both external and local capital markets.

A. *Snapshot of Western Balkans Financial Sectors Today*

While national financial sectors in the region are generally stable, it is necessary to monitor credit and liquidity trends closely because COVID-19 poses the most serious threat, globally and locally since 2008. As countries in the region deal with the full impact of the pandemic, they have the advantage that their financial systems indicators are generally sound. On the whole, banks are sufficiently capitalized, liquid, and profitable, and the indicators have improved over time. As of 2019, bank capital adequacy averaged 18.3 percent, far above the regulatory minimum. Compared to 1.7 percent a year earlier, profitability as measured by

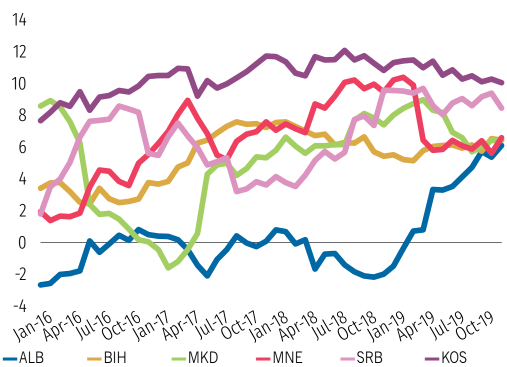
1 This note was prepared by Ruvejda Aliefendic, Gunhild Berg, Keler Gjika, Johanna Jaeger, Alena Kantarovich, Alper Ahmet Oguz, Blerta Qerimi, and Nan Zhou. It benefited from the comments of Mario Guadamillas, Miquel Dijkman, Marc Tobias Schiffbauer, Edith Kikoni, and Enrique Blanco Armas.

return on assets has slipped slightly, to 1.6 percent, but the ratio of liquid to total assets averaged 29 percent and loan-to-deposit ratios are below 100 across the board (see Table 1 for indicators and trends). De-euroization has been progressing slowly but steadily, though the stock of outstanding forex loans ranges from about 41 percent of total loans in North Macedonia to almost 70 percent in Serbia. There is also considerable indirect credit risk from exposure to unhedged borrowers in case of currency depreciation. Banks—dominating the financial systems in the region—generally follow more traditional business models mainly funded by local deposits—compared to their EU peers and financial intermediation remains low. At the same time, the Western Balkans are small open economies with foreign dominated banking sectors, making them vulnerable to external shocks.

Credit growth has been positive as of end 2019, with lending to households growing faster than to businesses, which calls for close monitoring. In particular household lending has been expanding steadily in all countries in the region, supported by record-low interest rates, stable bank credit conditions, and strong consumer confidence. By the end of 2019 loans outstanding to households in the region were growing at an average of 9 percent (6 percent for corporates). With high credit growth to households continuing and long maturities for non-purpose loans in some countries, risks and vulnerabilities deserve careful attention. Kosovo again saw the strongest growth of credit to the private sector, to slightly over 10 percent in December 2019 (y-o-y) as, backed by strong demand, credit standards eased; it was followed by Serbia with private credit growth above 8 percent because of healthy growth in demand on the back of broadly neutral credit standards. Lending in Bosnia and Herzegovina (BiH) and Montenegro was 6–7 percent. In Albania, as demand gradually improved, credit growth has been picking up, reaching 6 percent in 2019.[2] Credit growth in North Macedonia slowed in the second half of 2019 as corporate lending

Figure 1. Credit outstanding continued positive throughout the region.

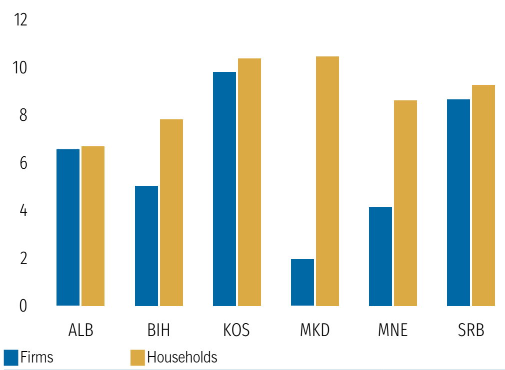
Change in nonfinancial private sector credit outstanding, percent, y-o-y



Source: IMF IFS, central banks.

Figure 2. Credit to households grew consistently, but not credit to firms.

Change in credit outstanding, December 2019, percent, y-o-y



Source: Central banks.

Note: Consistent data on private sector credit growth in Albania, BiH, Republic of North Macedonia, and Serbia are from IMF *International Financial Statistics* (IFS). Data on household and corporate credit are from national central banks. Other depository corporations surveyed are expressed in local currency (euros for Kosovo). Data for Montenegro are based on central bank statistics for credit to residents but not to governments and financial institutions.

2 CESEE Bank Lending Survey for H2 2019.

Table 1. Banks are sufficiently capitalized, liquid, and profitable with trends having improved over time.

Percent

Economy	Capital adequacy ratio	Liquid assets to total assets	Loan-to-deposit ratio	Return on assets	Return on equity	NPL ratio
Albania	↑ 18.3	35.7	54.0	1.5	13.4	↑ 8.4
Bosnia and Herzegovina	↑ 18.1	29.6	88.7	1.4	11.1	7.4
Kosovo	15.9	28.9	77.6	2.1	18.4	2.0
Montenegro	↑ 17.7	↓ 20.8	88.1	↑ 1.3	↑ 10.0	5.1
North Macedonia	↑ 16.3	24.0	↑ 83.8	1.3	13.5	4.6
Serbia	23.4	36	91.6	1.8	10.5	4.1

Note: The statistics, in percentages, are based on information available on April 15, 2020. They reflect conditions of the financial systems as of December 2019. Liquid assets to total assets for Albania refer to the broad measure as published by Bank of Albania. Arrows left of values indicate changes beyond one historical standard deviation away from the most recent three-year averages. The icons on the right illustrate indicator evolutions over a decade.

fell, impacted by NPL write-offs; it decelerated from about 8 percent early in 2019 to slightly over 6 percent by yearend (Figure 1). Despite general progress in deepening credit markets across the Western Balkans, domestic credit to the private sector continues to significantly lag behind EU levels.

NPLs have been decreasing in all countries but the dimming of economic prospects is expected to adversely impact asset quality and deter banks from lending. Through 2019, the regional NPL average again declined, to 5.3 percent of total loans, closing in on its pre-global financial crisis level of about 4.4 percent. Kosovo's NPLs are the lowest in the region but although on a steady downtrend NPLs are still high in Albania, at 8.4 percent, and BiH at 7.7 percent (Figure 2). Recent reforms have helped reduce NPLs considerably as Albania, Montenegro, and Serbia continue to write off and sell old NPLs. New insolvency laws are in place in Albania, the BiH entity Republika Srpska, and Kosovo. In July 2019 the Bank of Albania adopted a framework for voluntary out-of-court bank restructuring of large NPLs. Montenegro has expanded coverage of the credit registry to enhance the capacity of lenders to assess credit risk and has aligned its credit risk management regulation with European Banking Authority standards. However, there are indications that in many countries, despite the improvements in reported NPLs, the financial position of corporate borrowers is still problematic. It will now be even more important to reinforce corporate and consumer insolvency regimes to deal with loan defaults and NPLs.

B. Financial Sector Vulnerabilities

Financial systems are affected through four main channels: The impact of a crisis on the financial sector depends on the sector's ability to mitigate four risks: (a) *Market risk:* Acute swings in investor sentiment combined with heightened uncertainty may push up funding costs on both international and domestic markets for both governments and the private sector. (b) *Liquidity risk:* Market volatility has already spurred demand for liquidity. Moreover, cash flow disruptions in affected firms and shifts in public demand for cash could tighten funding and liquidity conditions for banks, and ultimately affect lending to the private sector. Increased demand for forex instruments especially could cause a serious liquidity crunch. (c) *Credit risk:* Dimming economic prospects will heighten NPLs and deter both banks and nonbanks from lending to support real activity. Credit risks are compounded when cash-constrained firms and households have debt obligations they must keep current and fail to secure bridge financing to cover loss of income. (d) *Risk to earnings and resilience*. The previous risks will weaken earnings and profitability in the financial sector, particularly if stressed conditions persist.

These risks have more impact on emerging markets like the Western Balkans whose financial systems are less prepared to weather shocks. Governments must deal with volatile funding markets even as their financing needs and funding costs rise, foreign capital outflows, and investor behavior becomes more unpredictable. March saw portfolio outflows from emerging Europe of about US$4.8 bn, of which US$3.3 bn account for equity and US$1.4 bn for debt outflows.[3] The COVID-19 pandemic has also triggered severe stock market losses, with 10 percent of European equity values wiped out and the S&P 500 down by as much as 25 percent since the early February high.[4] Similarly, in the region BELEX15 (Serbia) has lost about 15 percent of its value since its February peak and the MBI10 (North Macedonia) has lost about 20 percent. Financial links, especially with the EU, have gained significance as a result of the integration of Western Balkan financial markets, and the cross-border exposure of financial institutions is making countries vulnerable to spillovers from other parts of the region. The region also relies heavily on remittance flows (almost 10 percent of GDP in 2018), which the crisis is severely disrupting. High unofficial euroization constitutes a tail risk for financial stability in countries where banks are threatened by indirect credit risk because of their exposure to unhedged borrowers and by possible increased demand for forex instruments. Although NPLs have been decreasing throughout the region, they are still high in Albania and BiH. The effect of clouded economic prospects on asset quality and willingness of banks to lend can create a vicious cycle of substandard financial sector performance and falling economic growth.

Further risks stem from monetary and crisis management limitations and private sector debt vulnerabilities. In terms of crisis prevention, BiH, Kosovo, and Montenegro have little control over monetary policy, which makes it harder for them to manage and support liquidity. Although the last decade has seen significant improvements, throughout the region there are still weaknesses in the existing crisis management, supervisory and resolution frameworks. Moreover, private sector vulnerabilities have arisen from a combination of such factors as the level of both corporate and household debt and the currency and maturity structure of debt. In particular the financial health of companies is a concern because of debt from the 2008–09 crisis that is still unresolved.

C. Mitigating Financial Sector Vulnerabilities and Supporting Corporate Liquidity

The financial sector can do much to help mitigate the impact of COVID-19 on the real economy. Bank bridge financing and restructuring of loans for sound borrowers who have become cash-strapped can help them

3 IIF Capital Flows Tracker, April 2020.
4 World Bank. 2020. "'Fighting COVID-19 Europe and Central Asia Economic Update (Spring)." Washington DC: World Bank.

alleviate the impacts of the crisis, adopt to the new operating environment, and, eventually, contribute to the recovery stage. Here, lines of credit and partial credit guarantees[5] can provide additional financing to keep viable enterprises in operation and restore credit flows to boost investment. In the recovery phase, exporters and firms integrated in supply chains would also benefit from tailored export financing, factoring, and credit insurance mechanisms. Financial sector measures to support the economy should be broad, transparent, and rapid while balancing financial stability concerns. Emergency measures should be time-bound and have clear exit strategies.

Prudential measures can responsibly create capital space for banks to resume lending. This can be done through the release of countercyclical capital buffers, release of the conservation buffer, and temporary bans on executive bonuses, dividend payouts, and share-buybacks. Countries might also introduce regulatory forbearance measures such as temporary, well-targeted moratoriums on loan repayments. Other measures, particularly freezing classification and provisioning, could rapidly create serious risks for banks and customers alike, let alone making supervisory responses even more challenging unless they are temporary and closely monitored. They need to therefore be carefully assessed on a case by case basis.[6]

5 See for further information Principles for Public Credit Guarantee Schemes for SMEs: http://documents.worldbank.org/curated/en/576961468197998372/pdf/101769-REVISED-ENGLISH-Principles-CGS-for-SMEs.pdf

6 See for further information World Bank Policy Note on Borrower Relief Measures in ECA, April 2020; http://pubdocs.worldbank.org/en/993701588092073659/Borrower-Relief-Measures-Note-for-ECA.pdf

At the same time, prolonged financial stress will require measures to prevent the build-up of financial stability risks. Central banks and supervisory authorities will need to monitor financial soundness more intensively, especially credit and liquidity trends. To prevent second-round effects on the economy and support financial stability, building up macroprudential, insolvency, and financial safety net frameworks will be crucial. Crisis management that can deal effectively with weak financial institutions plus an insolvency framework that can resolve the problems of ailing firms quickly will help mitigate value-destroying defaults throughout the supply chains, relieve financial stress, and sustain the flow of credit to support the economy.

Financial sector authorities across the region have already moved to limit the economic fallout and maintain financial stability. They are closely monitoring liquidity and credit trends in light of rising financial stability concerns. Regulatory and supervisory authorities in Albania, BiH, Kosovo, Montenegro, and Serbia introduced regulatory forbearance measures such as moratoriums on loan repayments and changes to credit risk classifications (BiH). The National Bank of North Macedonia has extended the number of past-due days after which a credit is considered nonperforming and in Albania, BiH, and Montenegro supervisory agencies have suspended bank dividend and bonus payments.

As for monetary policy, the central banks of Albania, North Macedonia, and Serbia have all cut their policy rates. Serbia's has also launched a liquidity support program for banks through repo and swap transactions, and North Macedonia's has changed denar reserve requirements for new and restructured loans and postponed application of liquidity requirements to allow banks to focus on lending to businesses and households. The Bank of Albania has lifted the ceiling on the loans that commercial banks receive from the central bank and has announced that should there be further liquidity constraints, it may resort to quantitative easing through, e.g., purchase of government securities and ultimately use of reserves within the statutory limits. Lastly, governments in Albania, BiH, Montenegro, North Macedonia, and Serbia have announced direct financial support to businesses through loans and credit guarantees, to be distributed via development finance institutions, new guarantee funds, and the banking system.

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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.