Policy brief No. 39

Coping with the economic effects of Covid-19 - measures that balance the liquidity needs of companies and the state

FINANCETHINK OUT OF THE BOX

HR EXCELLENCE IN RESEARCH

The rapid spread of Coronavirus Covid-19 disrupted the global economic flows. In general, the economic shock caused by the coronavirus exerts an impact through two channels:

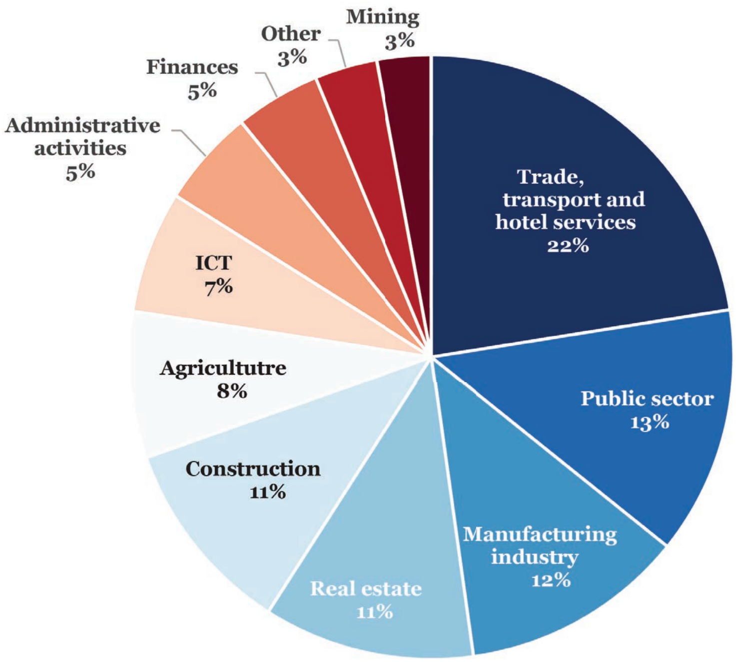
• **Decline in the supply of goods and services due to disrupted supply chains.** This has led to closed factories or reduced production - mainly of factories located in the most affected economies: China and Italy. The Chinese economy accounts for nearly 20% of the world GDP, and the forecasts show that the Chinese production accounts for up to 30% of the world's supply chains.

• **Decline in the demand for goods and services** due to increased uncertainty, investment restraint and prudent consumer behaviour. Under the immediate shock, the demand has sharply fallen for services in the tourism and air transport sectors, though with the restrictions of and constraints on movement and gathering in larger groups, a number of other service activities are already suffering.

Decreased economic activity will have a negative impact on budget revenues, which, given the growing need for crisis management funds, may require additional sources of funding.

Wholesale and retail, transport and warehousing, accommodation and food services have the largest share of North Macedonia's gross domestic product (22%). Currently, it is the most exposed sector that has been hit by the coronavirus on the demand side. With the exception of the public sector, the second most important sector in the economy is the manufacturing industry (16%), which is most exposed to the coronavirus impact on the supply side.

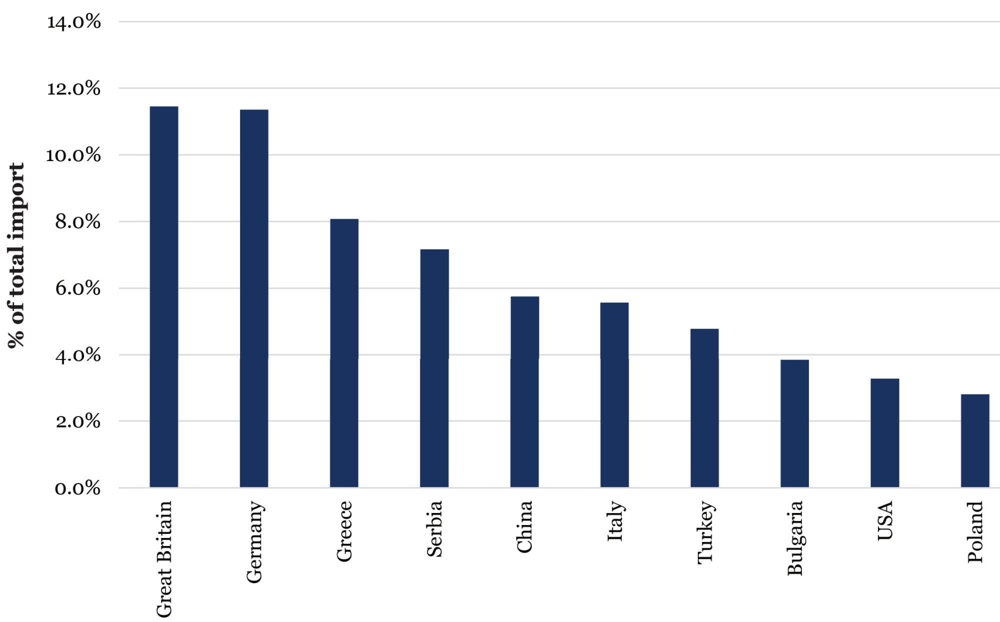
Graph 1: Sectoral structure of GDP



Source: State statistical office of North Macedonia

The Macedonian economy is open and connected with the global supply chains through trade of goods. In general, foreign trade takes place with countries from the EU and the Western Balkans, with the largest trading partners being Germany, UK, Greece, Serbia and Italy (2019). China is our fifth largest trading partner in imports (Graph 2), with a share of 5.8%, while Italy is the sixth with a share of 5.5%. Hence, the disruption of production in these two most affected countries will also affect the supply of inputs and the smooth running of domestic production. In addition, although there are currently no significant supply-chain disruptions from Germany and the UK, the rapid developments will adversely affect the trade dependency on these two countries.

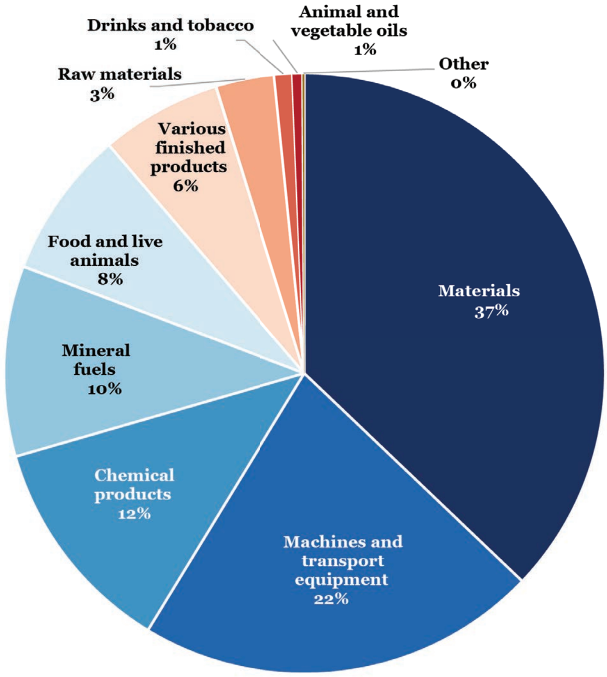
Graph 2: Top 10 import countries in 2019



Source: State statistical office of North Macedonia

37% of total imports in 2019 have been materials (Graph 3), namely metals, textiles, iron and steel, and 22% machinery and transport equipment. These are primarily materials used in the working processes of the foreign companies that operate in the free economic zones and companies in the metal processing industry. Imports of chemical products account for 11.6%, and 45% of imported chemicals are medical and pharmaceutical products and chemicals and chemical products facing higher demand despite growing bans, by many countries, on exports of medical and pharmaceutical products for disinfection and protection against the virus. Food imports are relatively low and account for 8.2%.

Graph 3: Import structure in 2019



Source: State statistical office of North Macedonia

Overall, the expectations of the effects of the spread of coronavirus on our economy may move along several consecutive scenarios:

1. Short-term and sectoral shock, mainly on the directly-affected sectors. Due to the reduced workload (both, due to disrupted supply chains and significantly reduced demand), impaired liquidity is the first serious risk. Then, it increases the risk of firing workers (primarily those with short-term employment contracts), reducing working hours and wages. These workers will have to adjust their spending to lower wages, which will further reduce demand.

2. Shock spillover onto other sectors, due to further spread of the effect of disrupted supply chains, the generally reduced demand and liquidity, following the closing borders, as well prohibitions to and suggestions of reduced mobility.

3. Further production disruptions, especially those that cannot be restarted quickly and easily, as a result of the inability to easily obtain inputs and raw materials, or because they have significantly higher price.

Finance Think estimates that at the moment, although the effects of scenario 1 have not taken full swing yet, the economy of North Macedonia is already penetrating into scenario 2.

As a consequence of this gradual effect, the Budget of the Republic of North Macedonia will face a decrease in revenues - an effect that will be further deteriorating along the intensification of the above effects on production and consumption.

Finance Think calls for a plan of measures to cope with the economic consequences of the coronavirus that will provide reasonable balancing between the liquidity support of companies and citizens, on one hand, and the capacity of the state budget, on the other. Therefore, the measures should be dimensioned in sets:

GROUP 1

Tax delays

- Deferment of VAT payment during a period of reduced economic activity and impaired liquidity. Such a measure has already been introduced in Denmark, Greece, Italy, Spain.

- Suspension of profit tax advance for at least 3 months.

- Deferred payment of social contributions, up to 3 months, for the directly-affected sectors, primarily trade, transport and hotel services, and with a particular focus on small and medium-sized enterprises. France, Greece and the UK are among the countries that have introduced such measures.

Financial support for companies

- Undertaking the compensation for forced absence from work;

- Providing interest-free loans or loans with very low interest rates to maintain current liquidity due to disrupted production or due to the current difficulty in covering input price differentials.

Measures from this group have

been introduced by Germany, UK, France, Japan, South Korea, Denmark.

- Reducing the parafiscal charges in the trade, transport and hotel service sectors by at least 50% over a 12-month period.

Protection of the living standard of the population

- Ceiling the price of the primary food products, in case the increased demand accelerates their growth.

- Extending the deadlines for repayment of loans to citizens facing (or who will face) (temporary) loss of jobs for up to six months.

- Suspension of the penalty interest rate for the settlement of liabilities by the citizens on any grounds (repayment of loans, settlement of liabilities for utilities) up to nine months after they mature.

GROUP 2

Tax deductions

- VAT reduction for import of specific products (medical devices and equipment, disinfectants, etc.)

- Temporary reduced direct taxes for small and medium-sized companies, companies located in "red" zones, and companies that faced severely-impaired liquidity and risk of foreclosure.

Protection of the living standard of the population

- Relaxing the conditions for unemployment benefit by redesigning the current solution where these funds are scarce.

GROUP 2 should be applied **only after exhausting the effects of GROUP 1 and in the event of further serious disruptions of the liquidity in the economy, in order not to disrupt the revenue side of the budget.**

In parallel with the contingency plan of measures, and in order to balance the liquidity needs of the economy and the capacity of the state budget, the **Ministry of Finance** should prepare a plan for availability of funds, as follows:

- Calculation of current liquidity, including of the liquidity reserves of public companies;

- Freezing of all unproductive spending (purchases of furniture, cars, travel and other goods);

- Purposeful use of the cash held in the National Bank;

- A plan for re-allocation of funds within a ministry and between ministries, program re-allocation (e.g. re-allocation of funds for innovation into liquidity packages for companies and citizens); and

- A borrowing plan.

The National Bank of North Macedonia should immediately reduce the basic interest rate to 0%, given that inflationary pressures do not exist (with the exception of selected products) and the foreign exchange market is stable. A fully relaxed monetary policy will create room for the Ministry of Finance to borrow from domestic banks with short-term interest rates close to zero. By doing so, the central bank will send a signal that it will not allow the liquidity position of the financial system to be disrupted.

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Finance Think is an independent Institute for economic research and policy in Skopje.

Our Vision
To steer economic thinking for increased wellbeing tomorrow.

Our Mission
To enhance the impact of economic and social trends and policies on citizens in North Macedonia and the Western Balkans, through economic research, evidence-based and data-driven advocacy, and steering critical debate on economic processes.
The research of Finance Think helps policymakers, policy advocates, opinion makers, journalists, and the public understand the issues affecting ordinary citizens.

St. Frederik Shopen 1/2
1000 Skopje
North Macedonia
www.financethink.mk
info@financethink.mk