



Implications of Changing Geopolitical Landscape for Western Balkan Economies

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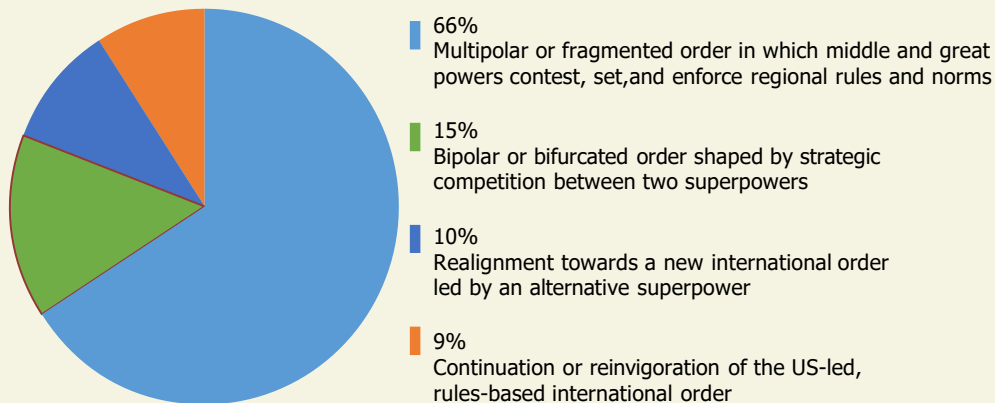
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From global integration towards geo-economic fragmentation?

- A **Black Rock study** on 68-risk events since 1962 indicates that geopolitical events typically have had short-lived impact on markets and economies (this time different)
- **World Economic Forum Report** - geo-economic fragmentation is rated as one of the top global risks, both on medium and long-term horizon
- It does not come as a surprise, as recent shocks **present one of the greatest stress test to the globalization** - a long-standing globally beneficial process
- While there were individual winners and losers, overall **it enabled decline in global inflation, financial system development, rising global incomes**, in particular of less developed economies - engine for income convergence, including in the WB region

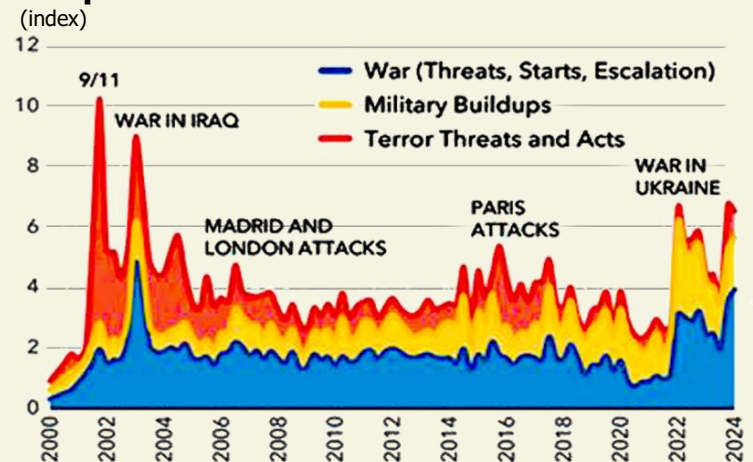
Global political outlook

Which of the following best characterizes the global political environment for cooperation on global risks in 10 years?



Source: The Global Risks Report 2024, World Economic Forum.

Geopolitical risk

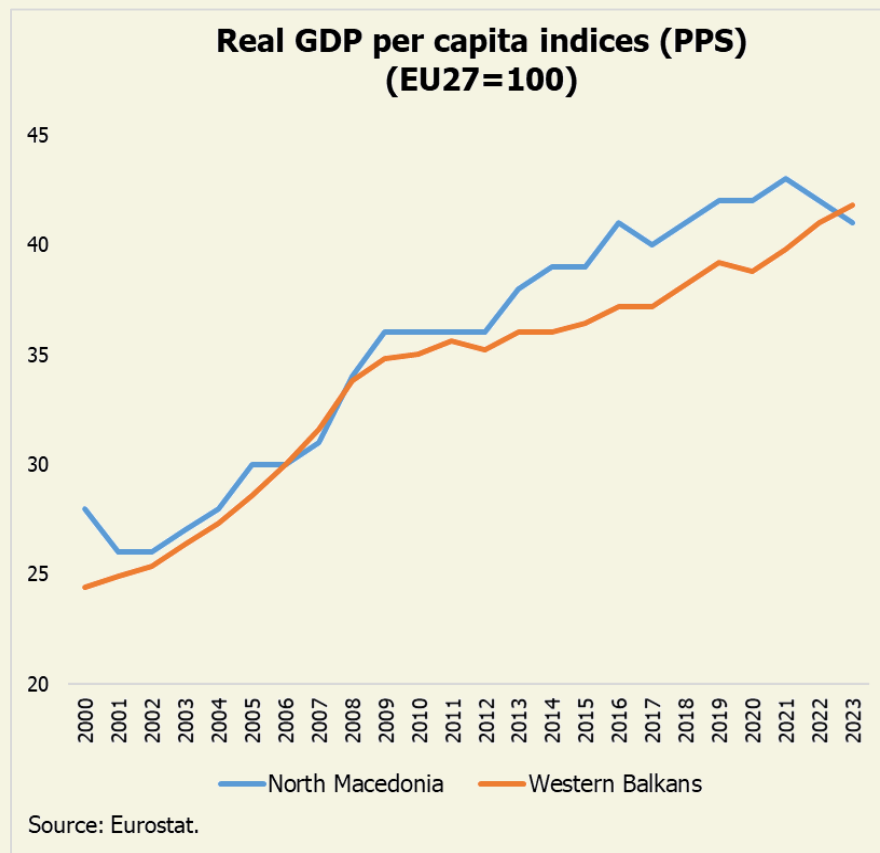
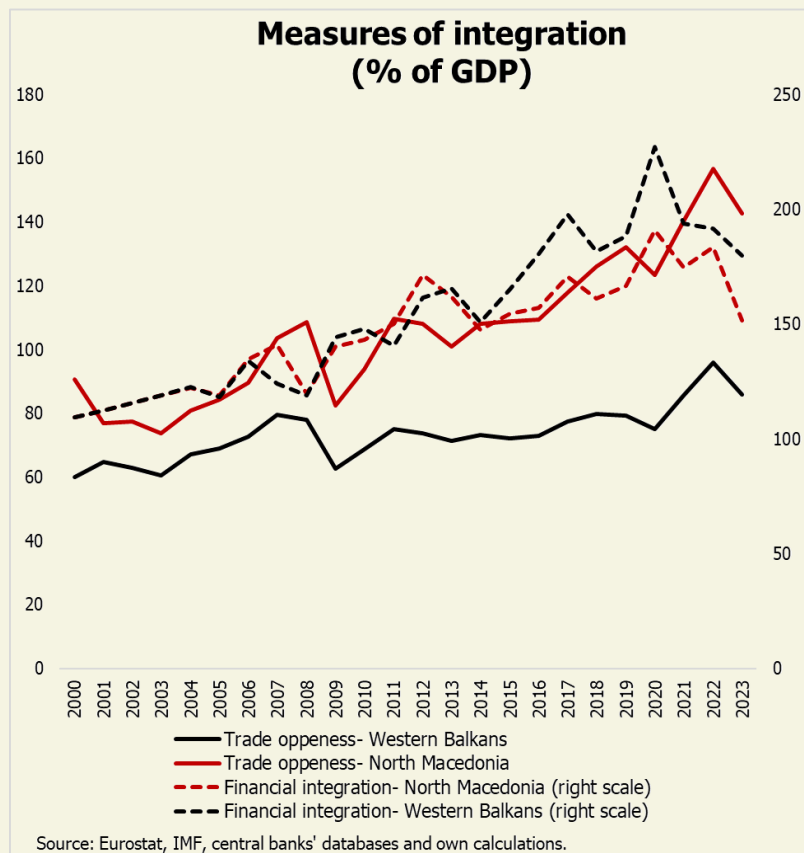


Source Caldera, Dario, and Matteo Iacoviello. "Measuring geopolitical risk." American Economy Review 112.4(2022): 1194-1225



Integration of the WB into the global economy- engine for income convergence

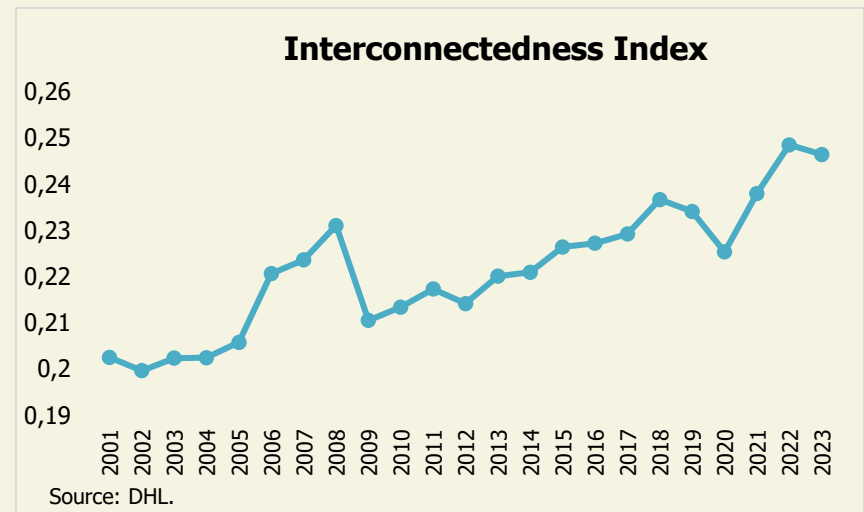
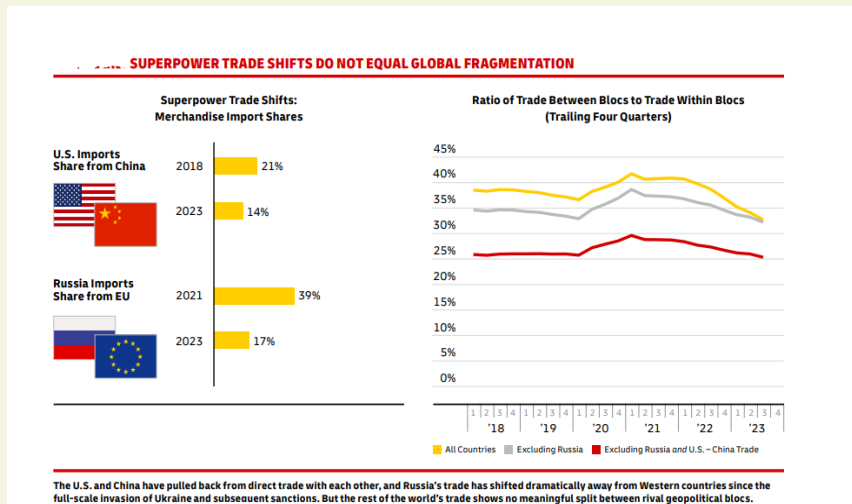
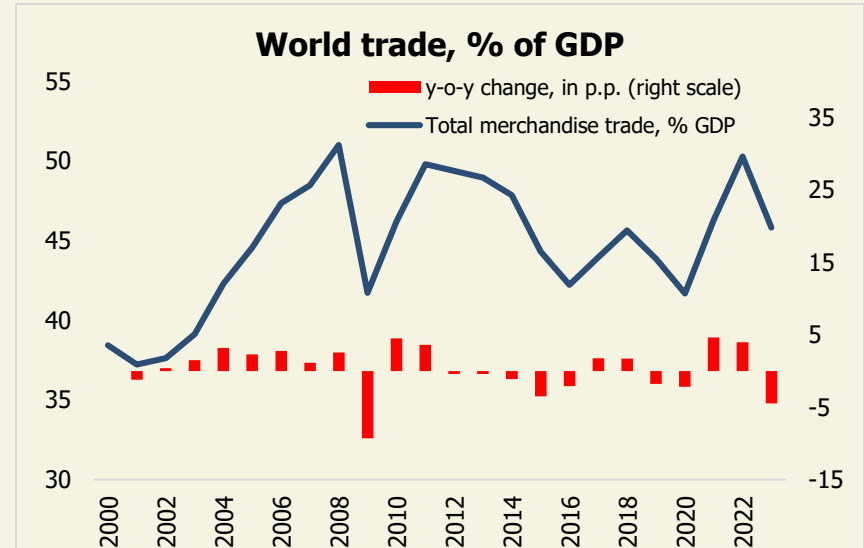
- **Trade integration** increased by 25 p.p. of GDP (supply chains)
- **Financial integration** by 70 p.p. (FDIs)
- Both acted as engine of growth and **income convergence** – almost doubled, while **inflation** remained low and stable



However, since GFC globalization has slowed down with recent crisis further elevating risk of fragmentation

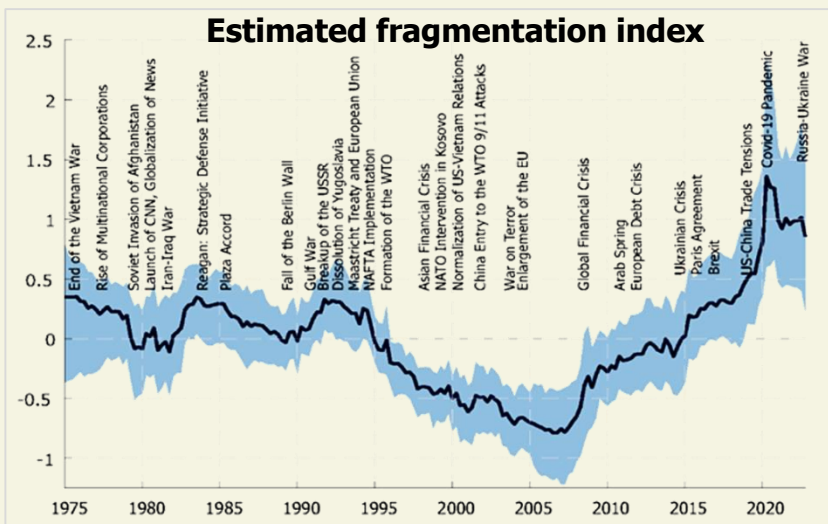
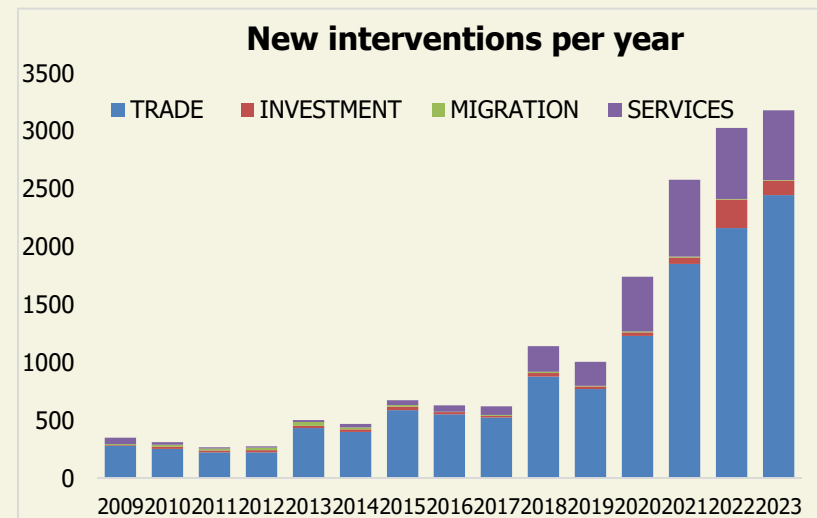
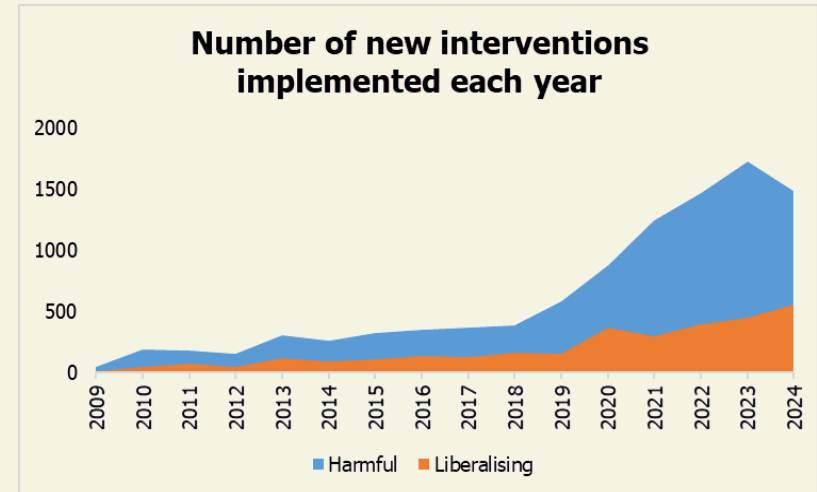
Is fragmentation already taking place?

- **World trade data** - decline of 4.5 p.p, but close to pre-pandemic average - trend of stagnant trade flows
- **The DHL interconnectedness index** (flows in trade, capital, people, and information) – despite decline in trade (between blocs), overall index reached record high level
- **Investment trends** indicate that companies have not lost their appetite for international expansion-sharp rise in announced greenfield FDI in 2022, followed by a smaller increase in 2023



Is fragmentation already taking place?

- Still, number of discriminatory interventions increasingly exceeds liberalizing
- **Discriminatory interventions** tripled, in particular on goods
- Recently published comprehensive **Index on fragmentation** (14 indicators) suggests that it is taking place



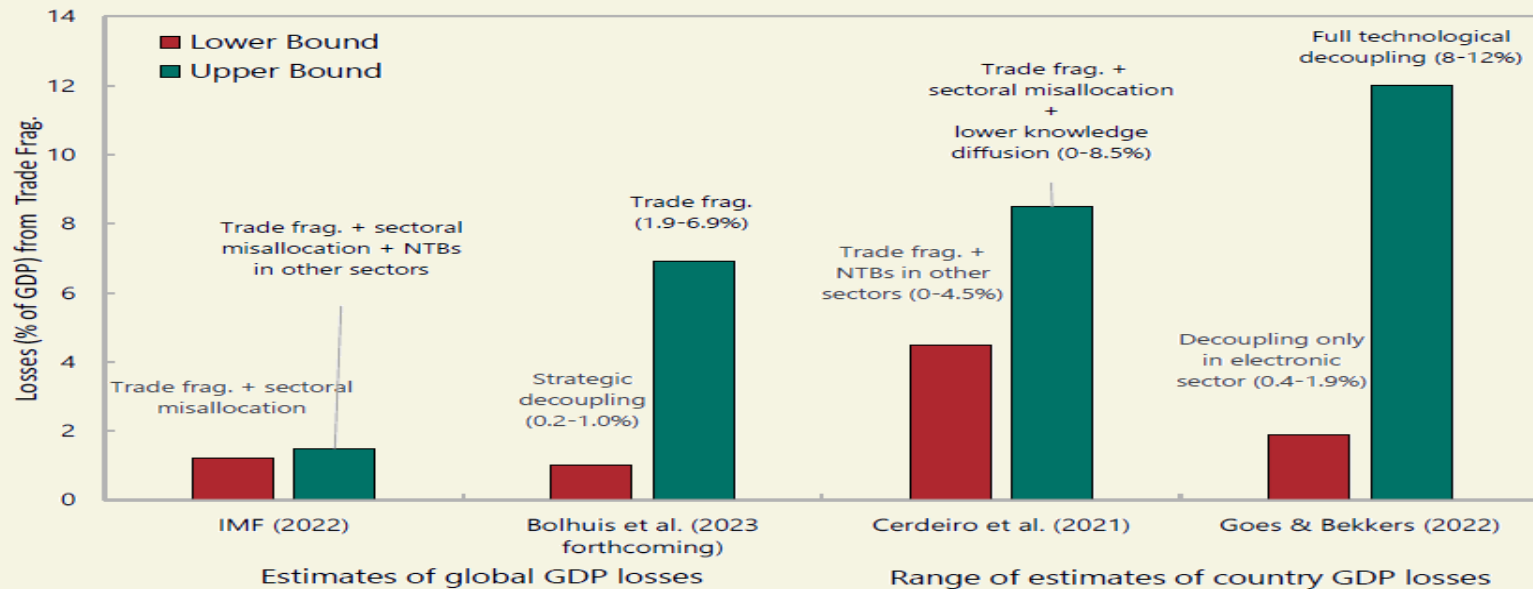
Source: Fernández-Villaverde, J, Mineyama, T and Song, D, Are We Fragmented Yet? Measuring Geopolitical Fragmentation and its Causal Effect (June 2024). NBER Working Paper No. w32638

Source: Global Trade Alert.

Reversal of globalization can be very costly and work through a number of channels

- **Available studies point to costs of trade fragmentation** ranging from 0.2% to 7% of GDP, which can be higher in case technological fragmentation (12% of GDP). Other channels such as capital flows, migration and uncertainty can further amplify the adverse effects
- The effects stronger for **EMs and LIC** as they tend to have higher finance, knowledge and technology gaps

Long-Term Losses, Percent of GDP, from Global Trade Fragmentation



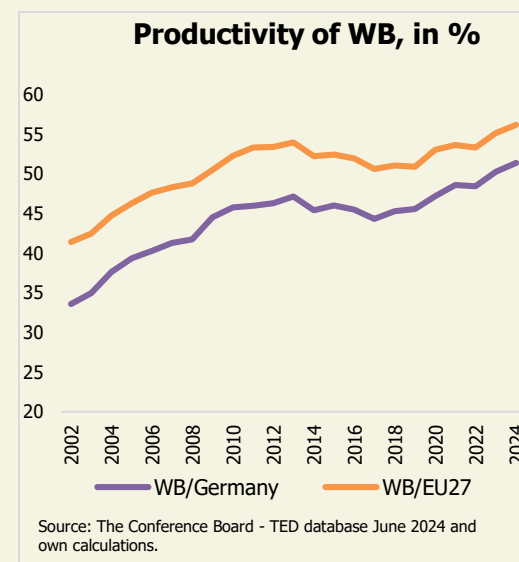
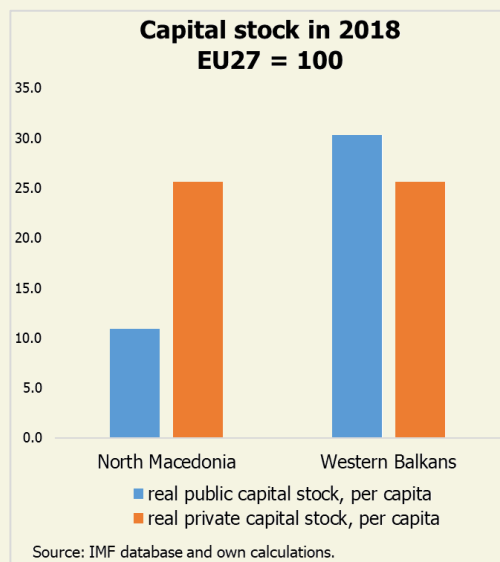
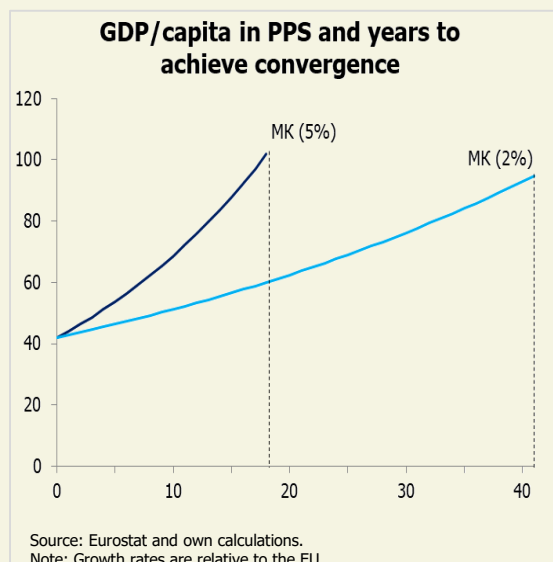
Source: Geoeconomic Fragmentation and the Future of Multilateralism (2023). Staff Discussion Note SDN/2023/001. International Monetary Fund.

Note: Estimates of long-term losses (percent of GDP) from Global Trade Fragmentation from various studies. Numbers refer to GDP losses that are not directly comparable across papers as some refer to global GDP while others refer to specific regions or countries. Numbers in brackets represent ranges of losses based on assumptions about the severity of fragmentation and trade elasticities, and /or geographical ranges. The height of each bar corresponds to the upper limit of the range. NTBs = non-tariff barriers to trade.



What is at stake for WB?

- Despite the progress, **convergence has significantly slowed down** after GFC and income gap remains wide - 40% of EU
- At the historical relative growth speed, it will take us about **40 years to converge** to the average EU income level
- **Not just actual, but potential growth** as well, reflecting wide gaps in all three long-term growth determinants - human capital, physical capital and TFP
- To narrow the gaps **priority is more, not less integration**
- **Fragmentation can be costly** and work through a number of channels

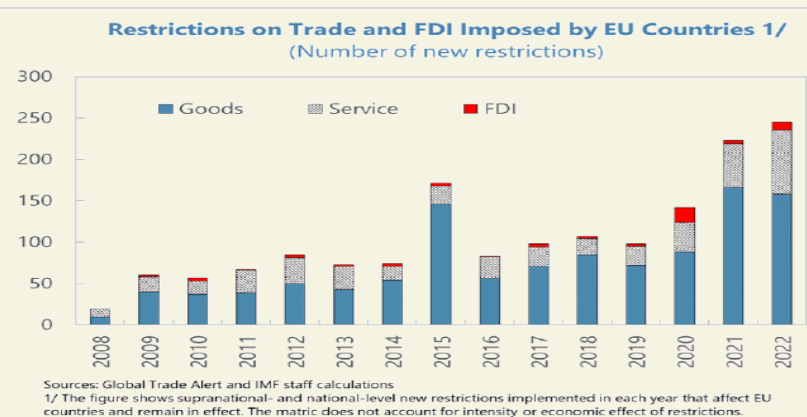
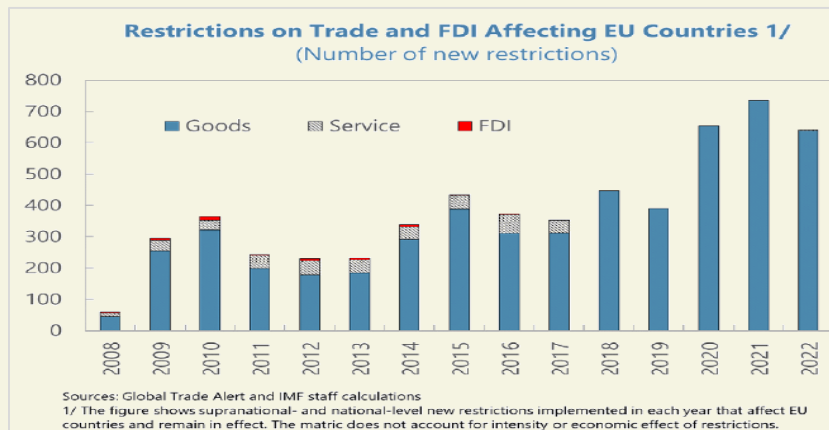
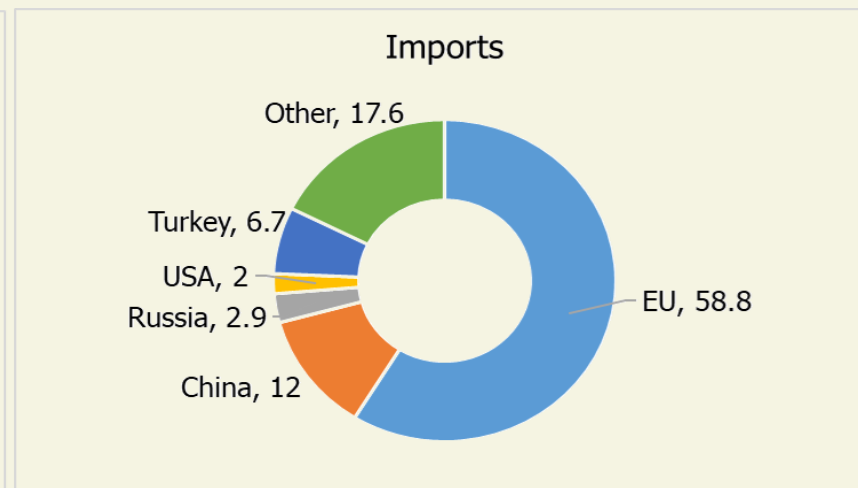
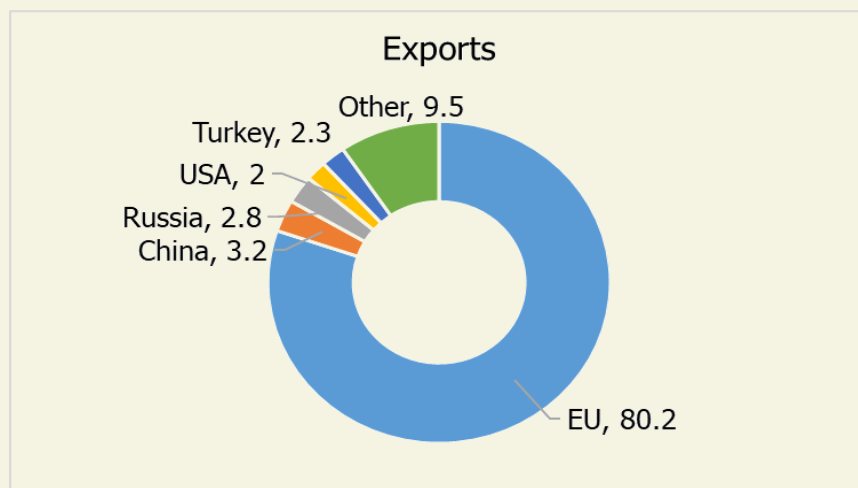




Transmission channels -trade channel-

- **Trade channel can have strong impact** - all countries are small and dependent on external trade (trade accounts 86% of GDP), in particular, if the EU is hit strongly (70% is trade with EU)

Western Balkan countries' trade with main partners, 2023 (%)



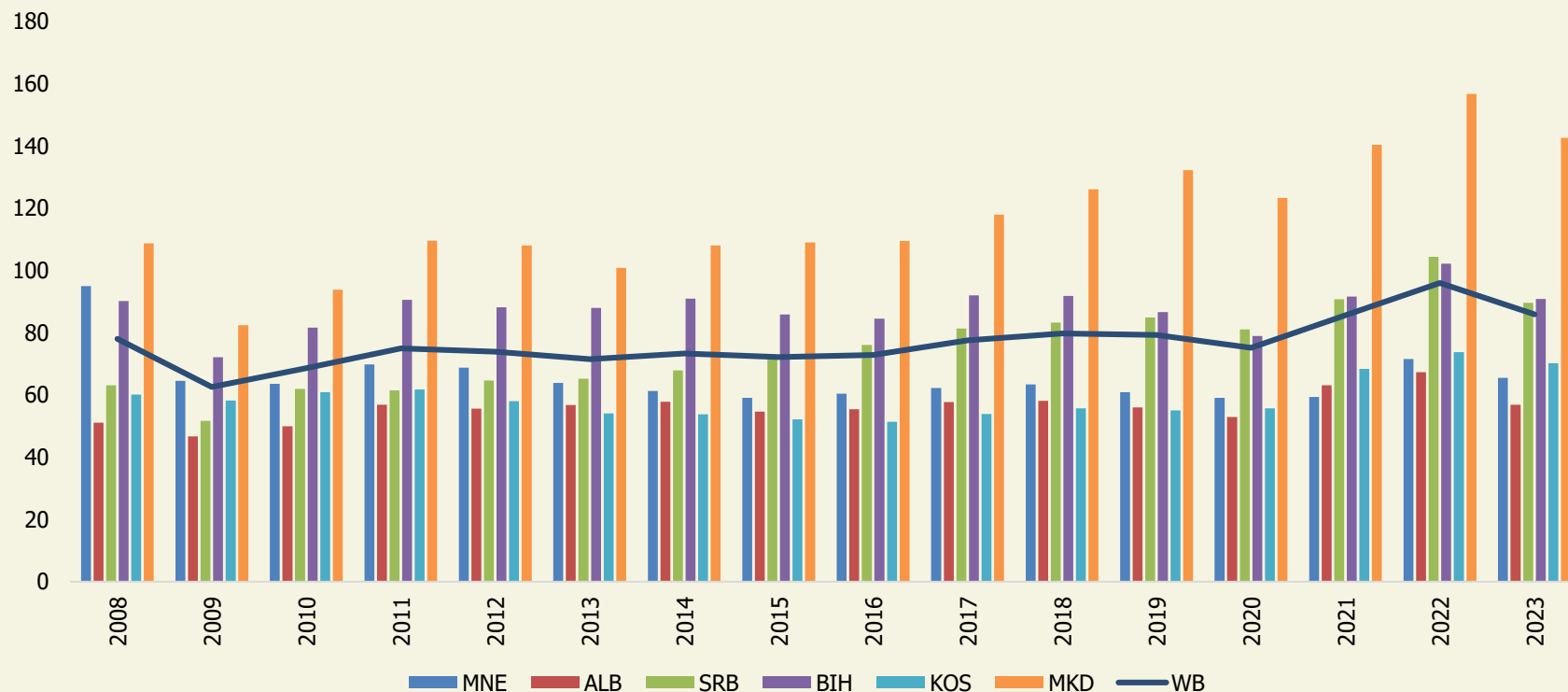


Transmission channels

-trade channel-

- Signs of declining trade?** After reaching historically highest level in 2022, last year declined, but remains above pre-pandemic level, without significant changes in the structure/country destinations

Total trade, % of GDP





Transmission channels -financial channel-

- **Slowing down of global financial flows, including FDIs is not new**, but the rising interest in reshoring/friend-shoring (strategic sectors)
- **Given the high dependence on external finance** (high savings-investment gap), lower/fragmented financial inflows can have significant effect on further deepening and sophistication of the FS, growth dynamics and macro stability-higher domestic buffers

Financial Development Index for WB, scores

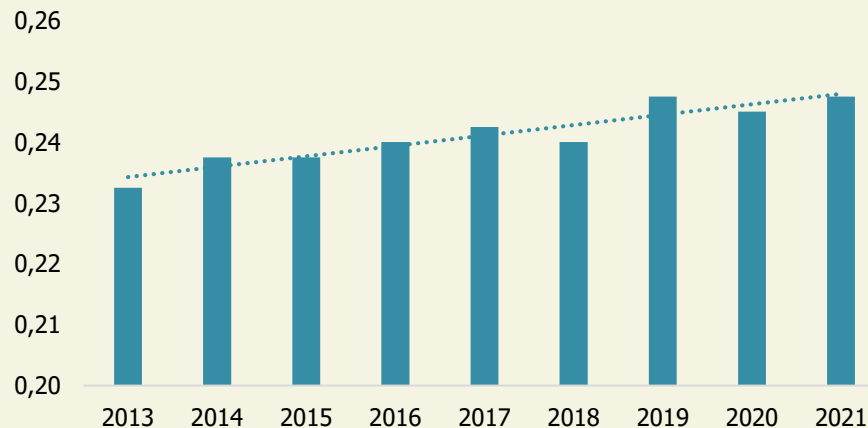


Figure 4.1. “Slowbalization”
(Percent of GDP)

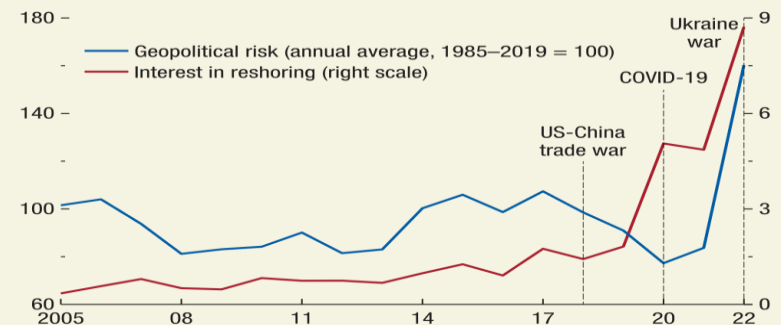
Foreign direct investment sharply declined after the global financial crisis.



Source: IMF staff calculations.

Figure 4.2. Rising Geopolitical Tensions and Foreign Direct Investment Fragmentation
(Index; frequency of mentions of reshoring on right scale)

Recent years have seen increasing geopolitical risk and companies' interest in reshoring and friend-shoring.



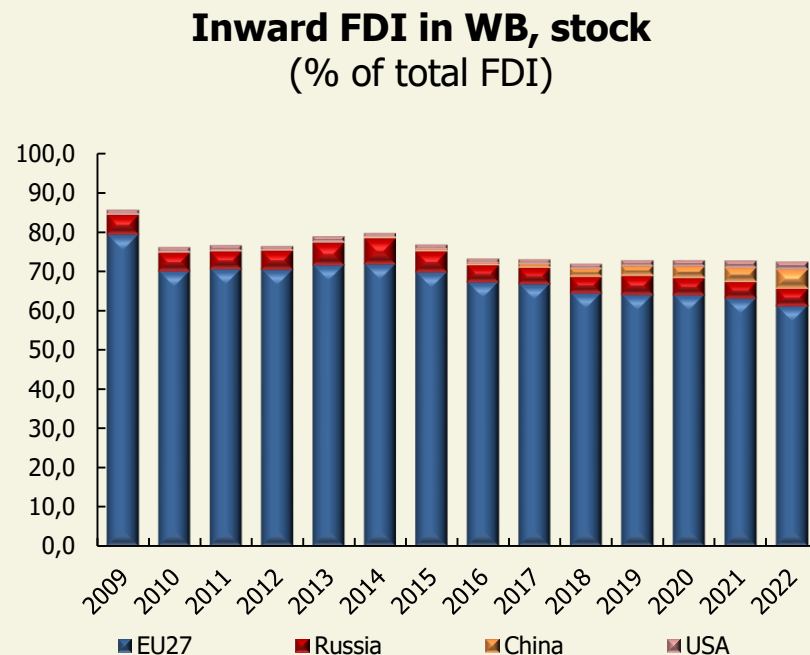
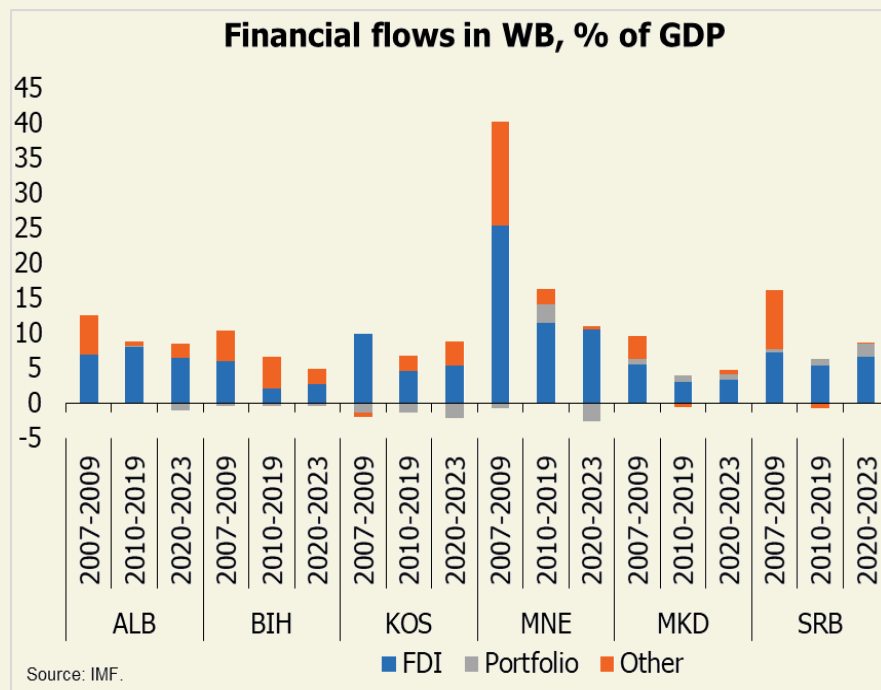
Sources: Bailey, Strezhnev, and Voeten (2017); Hassan and others (2019); NL Analytics; and IMF staff calculations.
Note: The interest in reshoring measures the frequency of mentions of reshoring, friend-shoring, or near-shoring in firms' earnings calls.



Transmission channels

-financial channel-

- Signs of declining financial flows?** Broadly stable, in some economies even accelerated possibly indicating relocation strategies towards the region with inflows mostly from the EU (exposure to “anti-Western” bloc remains low)

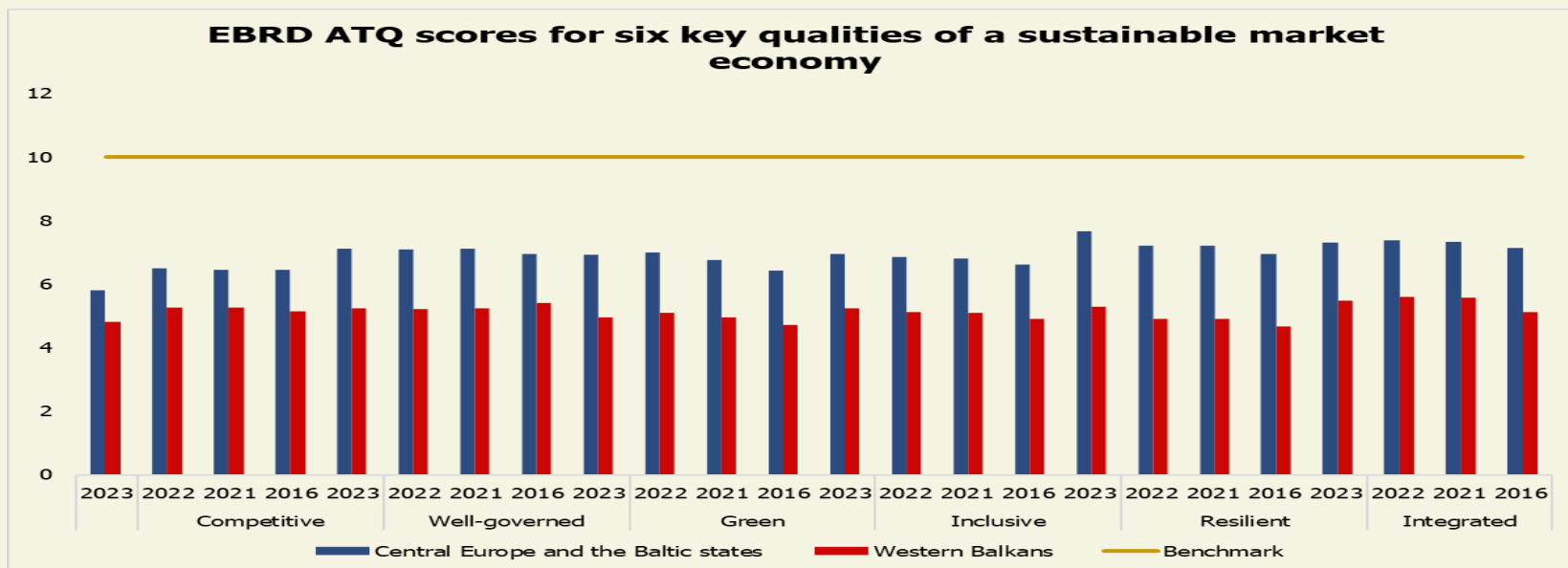


Извор: IMF Coordinated Direct Investment Survey.



To conclude

- Although there is still not clear evidence on reversal of globalization and adverse effects on the WB region, no doubt geopolitical **risks have reached historically high level**
- **How to turn the risks into opportunities?** Nearshoring seems one avenue. It will imply continues access to external finance (FDI), but also higher trade, diffusion of knowledge and technology
- Given the small sizes of the WB economies even small-scale nearshoring could have a **significant economic impact**-GDP level by 3 to 10% (IMF, 2019)
- The WB has some advantages such as proximity to EU, skilled labor force, low ULC, EU candidates, but to fully use the opportunities, priority is addressing remaining **structural hurdles** (which according to EBRD are present in all 6 structural qualities) to make them more attractive destinations for foreign investors





THANK YOU FOR YOUR ATTENTION