GLOBAL FINANCIAL CRISES IMPACT ON MACEDONIAN ECONOMY[1]

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"Bureaucrats managing companies does not work, politicians dominating the economy does not work,"
Newt Gingrich Former US House of Representatives Speaker told about 2,000 Republicans who attended the event at the Washington Convention Center in 2009.

Abstract

The Macedonian economy is on the edge of recession with real growth rate of GDP expected to be around zero and inflation to remain below 1% in 2009. Given the importance of the exchange rate peg for country's macro-financial stability, the authorities will have to provide external financing until the end of Q2. Otherwise, the peg could be challenged, thereby jeopardizing the future of the highly euroized economy. Our expectations are that the authorities are aware of the threat and will timely support the peg with appropriate external financing.

Main challenges ahead are the government dilemma whether to request external financing from international financial institutions (that has to be IMF endorsed and might require additional budget cuts) or access the global (private) capital markets at substantially higher price. The "Name issue" with Greece remains to be the main obstacle for NATO membership.

Background

Macedonia gained its independence from the ex-Yugoslavia in 1991. The transition to efficient market economy has been slow as illustrated by the EBRD's Transitional Indicators-TI[2].

[1] In preparing this brief for the conference on: Impact in the global economic and financial crisis on Armenia: Short and long run perspectives in Armenia (organized by the AIPRG), different CEA products prepared by CEA team were used.
[2] TI can score from 1 to 4. 4 being efficient market economy.

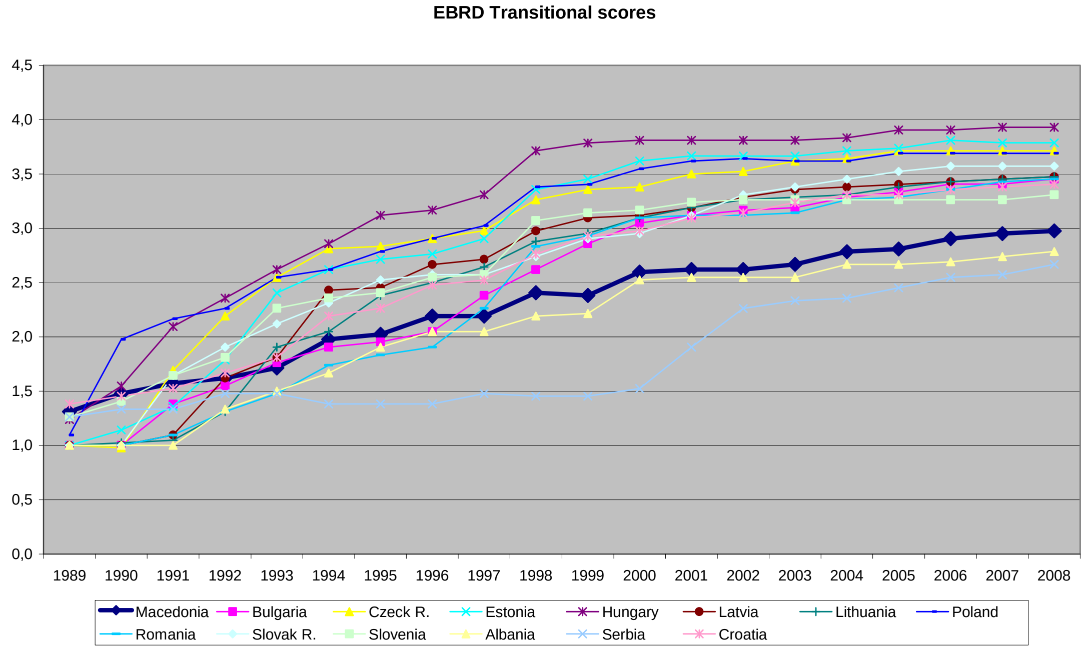


Figure. Transitional Indicators for selected countries.

From the figure we can see that Macedonia is lagging behind its peers and shows better performance only to Serbia and Albania.

Between 2005 and 2008 Macedonia's GDP growth averaged almost 5 percent however Macedonia's growth remains at the lower bound of growth in the central and eastern European countries.

Table. Macedonia at a glance (population of 2 million).

	2005	2006	2007	2008
Real GDP growth in %; central and eastern European countries	6.0	6.6	5.4	2.9
Real GDP growth in %; Macedonia	4.1	4.0	5.9	5.0
Per capita GDP (as % of EU 27 average)	24.6	29.4	31.2	32.5
GDP in billion EUR	4.7	5.1	5.8	6.5
FDI in % of GDP	1.6	6.8	8.8	6.3
Trade balance as % of GDP	-18.4	-20.1	-20.3	-26.6
General budget balance in % of GDP	0.2	-0.5	0.6	-1.0
Current account balance in % of GDP	-2.6	0.9	-7.2	-13.1

Source: Ministry of finance bulletin: www.finance.gov.mk and EUROSTAT.

In line with these developments, GDP growth rate in the last quarter of 2008 was still positive at 2.1% (yoy), but the CEA consensus forecast[3] for the first two quarters of 2009 is 0.4% and -0.2%, respectively. ***The latest SSO data for the Q1 shows negative GDP growth rate of -0,9%.***

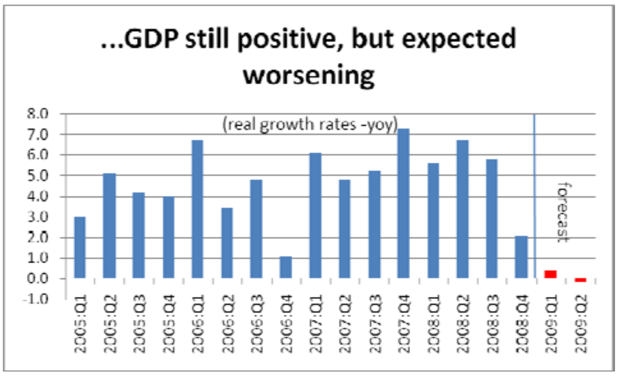


Figure. Macedonian GDP quarterly growth. Source: SSO and CEA consensus forecast

Change in fiscal paradigm

With the change of the government in the parliamentary elections in 2006 the fiscal paradigm changed from the strong record of macroeconomic stability toward boosting aggregate demand. The flat tax rate was introduced (10% PIT and profit tax), it was introduced a 10% three year in a row growth of salaries[4] for the administration, increase of pensions. The regulatory guillotine was introduced and measures were taken to improve the scores at the WB's Doing business[5] and WEF's global competitiveness index[6] in order to improve the business environment. ***However, the fiscal risks from coverage of government operations being too narrow also, understating future liabilities are not being properly addressed[7] leading to external vulnerabilities.***

The current account deficit had improved in recent years but deteriorated in 2008. Much higher FDI inflows and decline of foreign exchange reserves have financed the rising current account deficit. Reserves

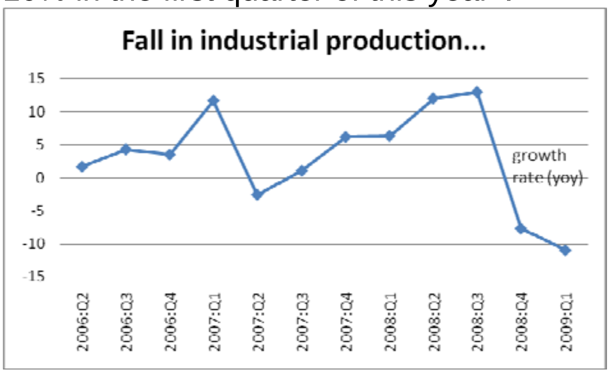
[3] CEA consensus forecast is based on expert judgment survey conducted with 15 macroeconomists from the state universities, National Bank, Ministry of Finance, as well as financial experts from bank and non-bank institutions in the country.
[4] This year's salary increase was cancelled as one of the measures to fight the crisis.
5 Improvements in businesses entry/exit and Central registry administrative procedures have contributed to Macedonia's ranking as fourth-best reformatory state among 178 countries in the World Bank Report "Doing Business 2008".
[6] In 2005 Macedonia ranked 81st out of 114 countries, in 2006 84th out of 122 countries, in 2007 94th out of 131 countries, in 2008 75 out of 178 (in 2008 Macedonia was one of the top 10 performers as per the Doing Business). More detailed country reports about Macedonia in the Competitiveness reports at: www.cea.org.mk.
[7] See IMF country report from February 2009, No. 09/61. Also: Nikolov 2009: Budget process in Macedonia; Recent developments and challenges (forthcoming at OECD Journal on Budgeting).

have declined considerably since last quarter in 2008. Over the longer term, there has been a significant and growing trade gap, financed to a large extent by rising private transfers. The NBRM (Macedonian Central Bank) responded to the recent inflation, balance of payments developments and the rapid growth in household credit with measures to tighten monetary policy (raising interest rates in Central Bank bill auctions and introducing stricter liquidity risk regulations). The government ran a fiscal surplus in the first ten months of 2008 of 2.6 percent of GDP, but intensive spending in the last two months of the year led to a deficit of 0.9 percent of GDP for the year as a whole, which might have put further pressure on the reserves.

The ongoing international financial crisis highlights the risks represented by a deteriorating balance on trade in goods and services and the current account. The ongoing financial crisis and the decline in projected world demand (including the decline in metal prices) will result in a decline in FDI, foreign financing, domestic credit flows, and exports for FYR Macedonia. These developments highlight the risks posed by the deterioration in the current account in 2008, including the drop in private transfers (official remittances as well as transfers and transactions through the exchange offices) in 2008 and the overall large deficit in goods and services.

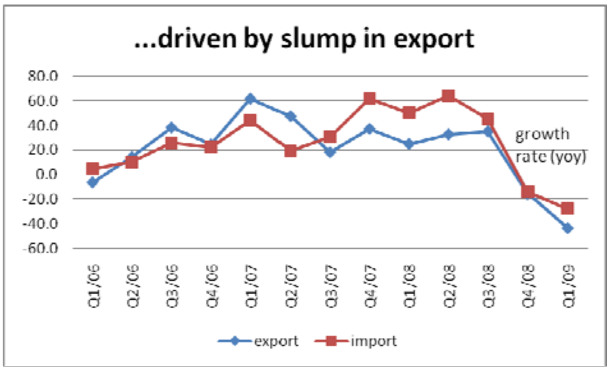
On the edge of recession

The Macedonian economy has not remained immune to the spillover effects from the deepest post-war world economic recession. Due to the limited capital account openness[8], the Macedonian economy was shielded from the first wave of the global economic turmoil. The deepening global downturn was transmitted through the trade channel, i.e. the external sector of the export-oriented economy. Initially driven by drop of world demand for metals, export fell by 20% (yoy) in November 2008 after five years of almost uninterrupted growth. Then, fall in external demand for textiles, shoes and ores led to the slump of export by 43% in the first quarter of 2009. As a result, the industrial production declined by 8% in the last quarter of 2008 and by 10% in the first quarter of this year[9].

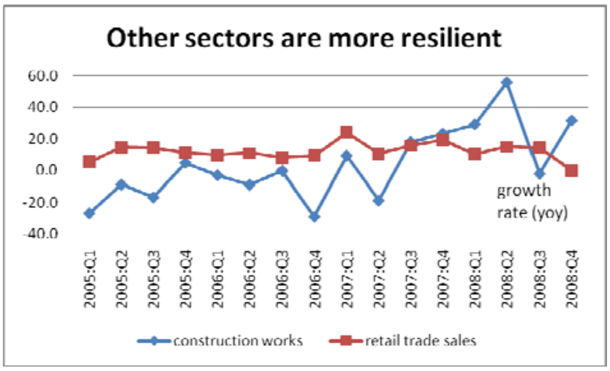


Source: State statistical office (SSO)

[8] On measuring capital account openness in Macedonia see the proper paper at: www.cea.org.mk.
[9] The decline of IPI in May 2009 compared to May 2008 was 15.3%.



Source: SSO



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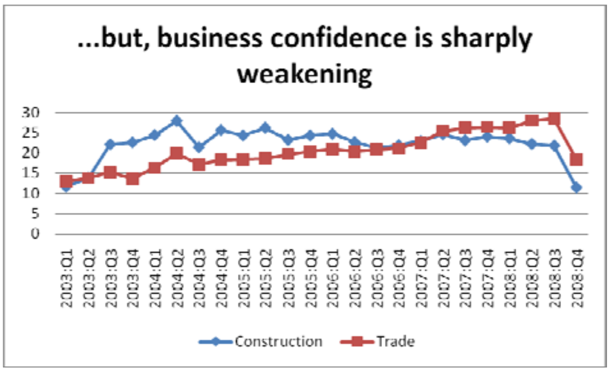
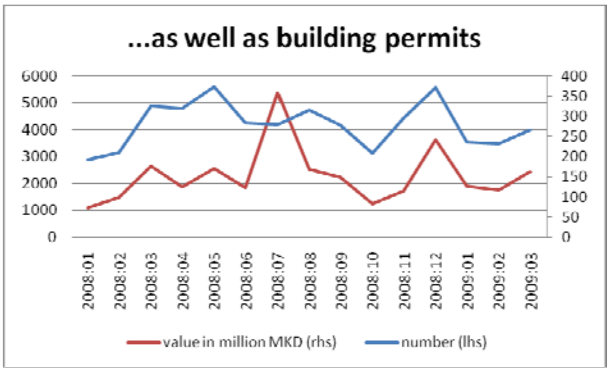


Source: SSO

Other sectors relying on domestic demand demonstrate greater resilience due to still strong private and public consumption. Retail trade sales growth rates after two years of continuous two-digit figures, suddenly slumped to zero in the last quarter of 2008. The unfavourable outlook increased the level of uncertainty among top managers of leading retail companies, who made downward revision of their expectations for the sales volume in the next six months. Construction works picked up in the last quarter of 2008 supported by strong public investments and ongoing private projects. Downward adjustment could be expected too, but with certain time lag due to the specific nature of the construction sector. The expectation is in line with the sharp reduction of business sentiment in construction[10] in the last

[10] Business confidence in construction reflects the top managers' expectations for the new orders in the next 3-4 months.

quarter of 2008 as well as by the fall in both the number and value of issued building permits in March 2009 by 18% and 8% respectively.



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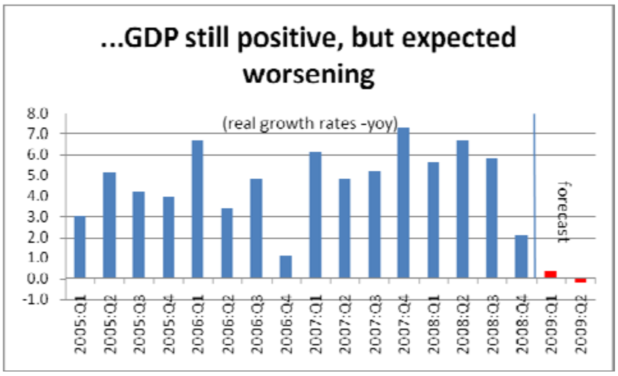


Source: SSO and CEA consensus forecast

Source: SSO

In line with these developments, GDP growth rate in the last quarter of 2008 was still positive at 2.1% (yoy), but the CEA consensus forecast[11] for the first two quarters of 2009 is 0.4% and -0.2%, respectively. Recently, GDP estimates for the 2009 were revised downwards by several domestic and international institutions. The Ministry of Finance forecasts 1% growth rate, NBRM -0.4%, European Commission -0.6%, EBRD -1.3% and the IMF -2.0%. CEA April consensus forecast for 2009 is 0.25%. On the demand side, investments, public consumption and net export are expected to

[11] CEA consensus forecast is based on expert judgment survey conducted with 15 macroeconomists from the state universities, National Bank, Ministry of Finance, as well as financial experts from bank and non-bank institutions in the country.

exhibit negative contribution to the GDP growth rate, while only private consumption to remain with slight positive contribution. On the production side, manufacturing and most of the market services will decline, while agriculture and trade are expected to be slightly positive.

Government ambitious public infrastructure plan could have strong positive impact on construction activity, thus compensating for the downsized private construction projects and lower construction works abroad.

But the Fiscal space available to undertake a fiscal stimulus program for countering the impact of the financial crisis (based on World Bank staff assessments in early 2009) for Macedonia is low.

	Fiscal space
Azerbaijan	Adequate
Belarus	Low
Bulgaria	No space
Croatia	No space
Kazakhstan	Adequate
FYR Macedonia	Low
Montenegro	Low
Poland	Low
Romania	No space
Russia	Adequate
Serbia	No space
Turkey	No space

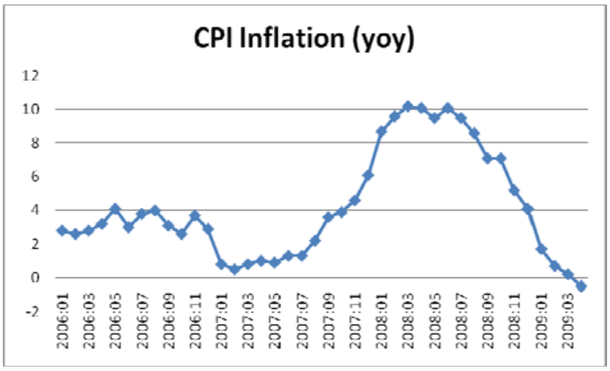
Figure. Fiscal space. Source: World Bank's Office of the Chief Economist.

While part of this plan especially upgrading of roads has secured funding from already approved loans from the World bank and EBRD, the implementation of the projects dependent on budget financing could be uncertain due to the constraints on the budget revenue side.

Sharp deceleration of inflation

With the exchange rate peg to the euro, Macedonian economy imports the price stability from the Euro zone. Therefore, as long as the peg remains stable the inflation will follow similar pattern as in the Euro zone. Continuous decline of food and oil prices in the second half of 2008 contributed to sharp deceleration of inflation from its peak of 10.1% in June

2008, to a deflation of 0.5% in April 2009. It is expected that deflation will prevail in the second quarter, before currently rising oil prices reverse the trend in the third and fourth quarter. We forecast average inflation for 2009 in the range between 0% and 0.5% and end of year inflation of 1%.



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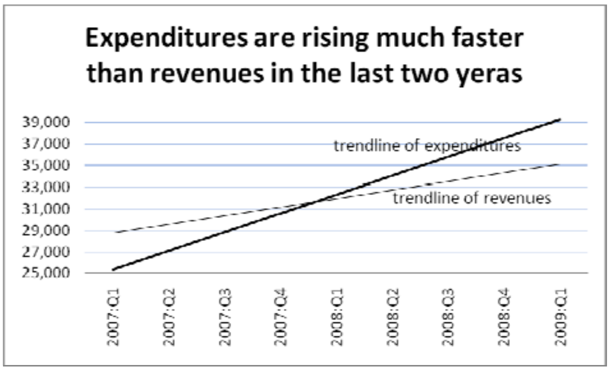
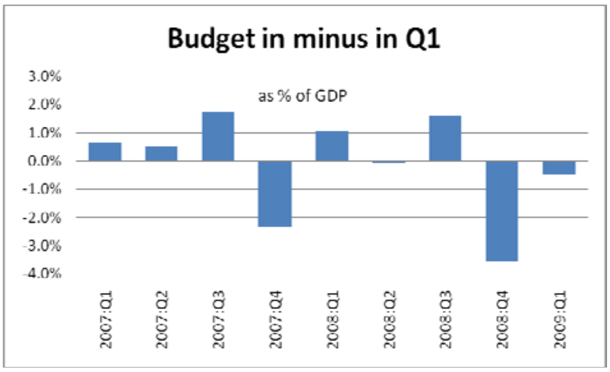


Source: CEA

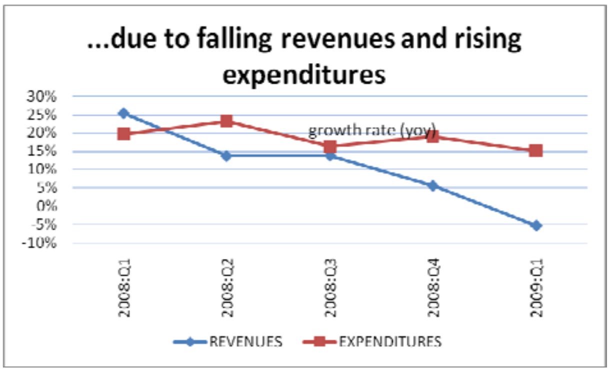


Budget deficit and its financing

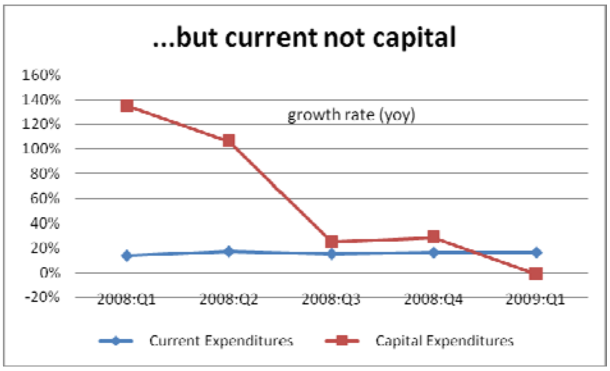
As a response to the recessionary outlook, the government embarked on countercyclical fiscal policy. After the extraordinary high fiscal spending in the last quarter of 2008 that created a budget deficit of 3.6% (Q4), the government continued with high spending in the Q1 of 2009, thus creating a fiscal deficit of 0.5%. For comparison purposes only, Q1 is usually characterized with low spending and fiscal surplus (0.6% in 2007, 1.1% in 2008). However, declining economic activity led to fall of revenues by 5%

(yoy) in Q1, while expenditures continued with the steady growth of 15% (yoy).

Despite the expectations that the government will boost capital expenditure that are supposed to gave strong positive impact on the economic growth, they declined by 1% while current expenditures increased by 17% in Q1 (yoy). Capital expenditure were planned to grow by 46% in 2009 to compensate for the expected fall in private investments and lower external demand. However, the weak implementation once again turned out as the main obstacle for timely execution of publicly funded projects. On the other side current expenditures are dominated by non-discretionary spending (wages, pensions, social assistance, agricultural subsidies) which were substantially increased in the last two years.



Source: Ministry of finance



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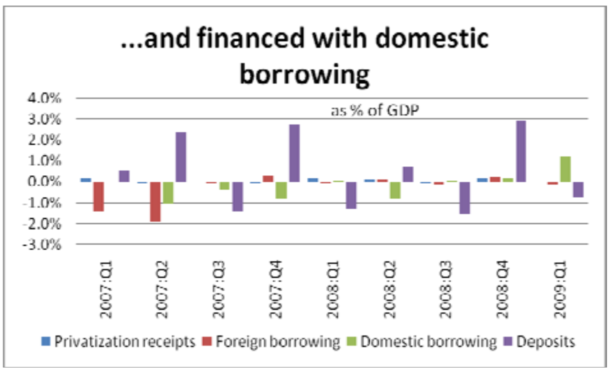


Source: Ministry of finance and CEA

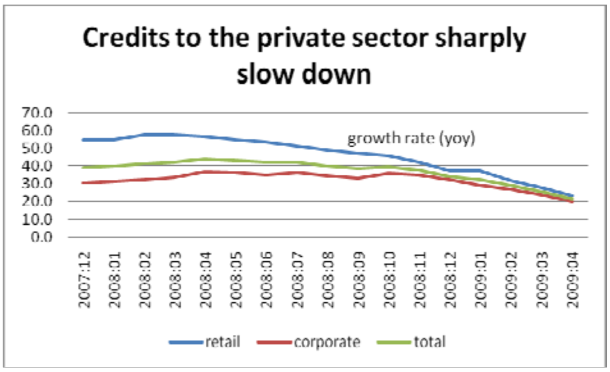
Extensive domestic borrowing equal to 1.3% of GDP was used to finance the budget deficit in Q1 and to build up deposits for repayment of an instalment of domestic bond (0.5% of GDP) maturing on April 1 (frozen foreign currency bond). Due to the lack of foreign financing, government had to rely on the shallow domestic market, thereby crowding out the private sector. At one moment in March, in order to improve its access to the scarce resources it raised the T-bills interest rate almost 200 b.p. above the Central bank policy rate.

In economies with fixed exchange rate regime, the fiscal policy is more powerful in defending the stability than monetary policy

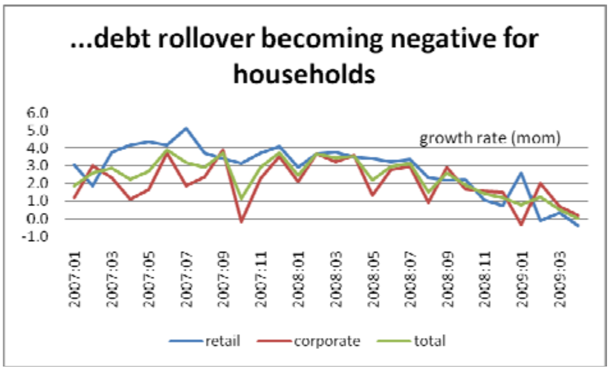
Obviously, continuation of fiscal policy from Q1 is unsustainable and will inevitably trigger strong monetary policy tightening. Therefore, it could be expected two adjustments of fiscal policy in the rest of 2009: (1) downsizing expenditures to match the intensity of fall in revenues; (2) shift in financing from domestic to foreign sources to ease the pressure on the domestic financial and foreign exchange market.

Credit tightening and rising NPLs

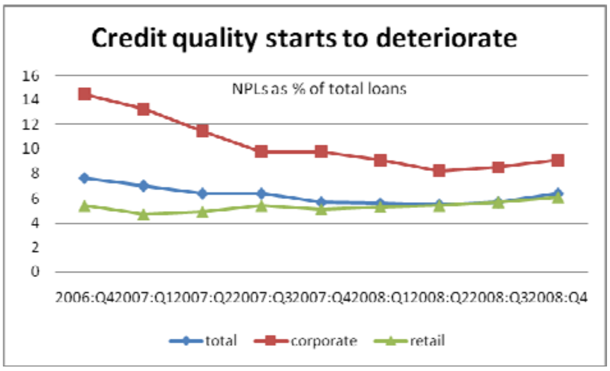
Credit boom characteristic for the previous three years came to a sudden stop in November 2008 as a direct consequence of the escalation of the financial crisis in the world. Nevertheless, it was more a precautionary reaction of domestic banks rather than a serious liquidity drain. The credit expansion in the Macedonian banking sector started in 2006 lagging behind the other Central and Eastern European economies. As a result, the loan portfolio was predominantly financed by domestic deposits, as indicated by the loans-to-deposits ratio of 93% at the end of 2008.



Source: NBRM



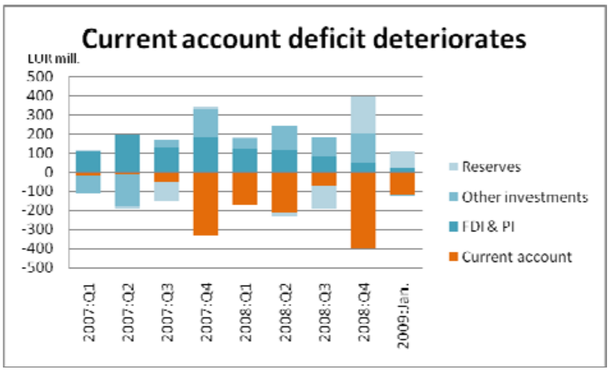
Source: NBRM



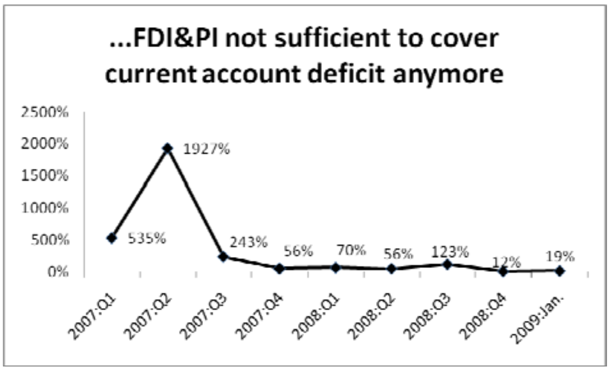
Source: NBRM

Initial autonomous credit tightening by the banks was then strengthened by the reaction of the monetary policy and later by crowding out effects of the loose fiscal policy. At the end of December 2008, the Central bank adopted a new prudential regulation requiring banks to have coverage of their short term liabilities of up to 90 and 180 days with short term assets with the same duration in ratio of 1 to 1. Bearing in mind that banks are probably short of the required ratio they will have to adjust their balance sheets gradually in the next 2 years. In addition, Central bank has limited the retail credits growth to 11% for the whole 2009 (Dec. 2009 / Dec. 2008) requiring a penalty deposits bearing only 1% interest for those exceeding the allowed growth rate. Fiscal policy in the first four months of the year run a deficit of 0.8% of GDP that was financed from borrowing on domestic market, thus competing with the private sector for already scarcer funds. Eventually at the beginning of April, the National Bank of the Republic of Macedonia increased its policy rate from 7% to 9% indicating further tightening. As a consequence, the private sector credit growth rate (yoy) was almost halved from 40% in October 2008 to 21% in April 2009. Monthly rate of credits to the private sector were reduced to zero in April with retail loans rate declining by 0.4% and corporate slightly increasing by 0.2%. In this situation, a further steep declining of the credit growth rate to one digit figure till the end of the year is expected.

The deceleration of credit growth was followed by rising level of non-performing loans (NPLs) from the lowest of 5.5% in Q2 2008 to 6.4% at the end of 2008. Retail portfolio has been continuously deteriorating since the beginning of the year jumping from 5.1% to 6.1%. The declining trend of the NPLs of corporate portfolio was reversed in the second half of 2008 when it rose from 8.2% to 9.1%. Slowing economy and sharp reduction of credit growth are expected to further lift the NPLs ratios in the course of 2009 shifting the banks' focus from targeting credit growth to collection efforts.



Source: NBRM

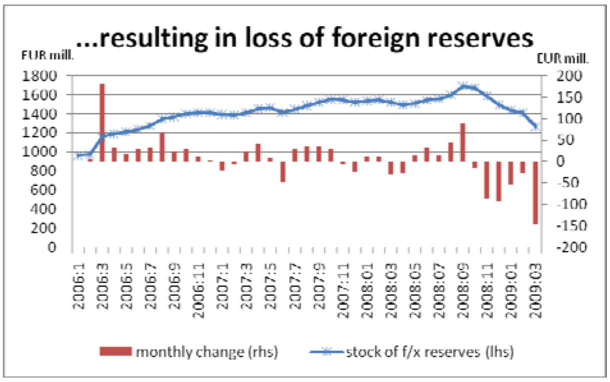


Source: NBRM and CEA calculations

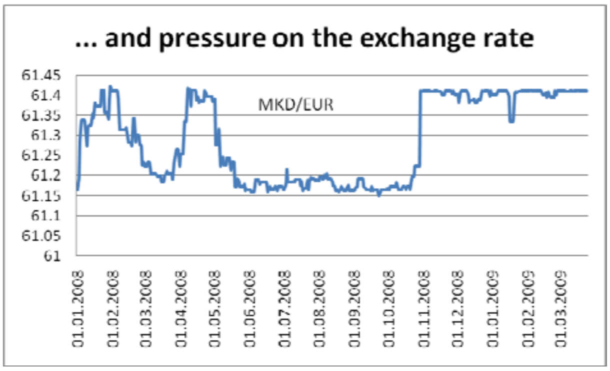
Pressures on the foreign exchange market

Large external current account imbalance built in the last two years left the Macedonian economy highly vulnerable to the shift in market sentiment after the collapse of Lehman Brothers in mid-September 2008. Before Q4 in 2008, rising current account deficit (0.7% in 2006, 7.2% in 2007, 13.1% in 2008) was easily financed by large FDI inflows (around 80%). However, FDI and other capital inflows were abruptly reduced in Q4 of 2008 and Q1 of 2009 leaving a substantial gap in current account financing to be met by depletion of foreign exchange reserves. In Q4 of 2008, foreign reserves declined by EUR 195 million and in Q1 2009 by EUR 226 million or a total of EUR 421 million which is a reduction of 25% compared to the highest end of September 2008 level of EUR 1689 million.

The loss of foreign exchange reserves put the exchange rate peg under serious pressure in the last six months. Data comparison between changes in foreign exchange reserves and the average daily exchange rate movements reveals the interventionist pattern of the Central bank. The average exchange rate fluctuates in the narrow band between approximately 61.17 and 61.41 Denars for one Euro. When the average nominal exchange rate is at the lower margin, the foreign exchange reserves are rising and *vice* *versa*. This implies that the Central bank buys Euros on the foreign exchange market when the exchange rate reaches the level of 61.17 and sells Euros when the exchange rate reaches 61.41. These margins could be considered as benchmarks for delineation of the appreciation and depreciation pressures on the foreign exchange market. The chart demonstrates that the exchange rate is under constant pressure of depreciation since the end of October 2008.



Source: NBRM and CEA calculations



Source: NBRM and CEA calculations

Mounting pressure on the foreign exchange market raised speculative attacks and created expectations that after the second round of presidential and local elections in the first week of April the authorities will have to make a one-off devaluation of the Denar. This has further exacerbated the pressure on the foreign exchange market. Household denar deposits have declined by 14% (100 million euros) in the period October 2008 to April 2009, while Euro deposits increased by 14% (140 million euros). The share between household denar and euro deposits has changed from 42%/58% in September 2008, to 36%/64% in March 2009. Simultaneously, the companies started to link their denar deposits to the euro. As a result, the foreign exchange reserves have declined by record 146 million euros in March. The situation calmed in April after the end of the presidential and local elections.

The authorities will have to support the peg with urgent large capital inflows no later than the end of Q2. The current level of foreign reserves is equal to approximately 3.5 months of the projected imports this year, the current account deficit is expected to remain above 10% of GDP whereas the prospects for capital inflows in the private sector remain weak. Hence, the government external borrowing is the only solution to preserve the fixed exchange rate regime and the macro-financial stability. The authorities can choose between a package from international financial institutions (IFI) that would be available upon the IMF endorsement of the macroeconomic policies or borrowing on the global (private) capital markets at much higher price. For illustration only, the current yield to maturity of Macedonian Eurobond is around 9% p.a. However, the IMF-supported adjustment program most probably would require further budget cuts.

Neglected dimensions in the debate about the crisis impact in Macedonia

Statistics and credible data

Back in 2004 CEA was invited to review the calculation of the IPI (Industrial production index prepared by the State statistical office-SSO) by the Minister of Economy. Mainly CEA findings were that the SSO's IPI is not representative and its weights should be recalculated each 3 years (Eurostat recommends each 5 years) given the volatility and transition of our economy.

Risks:

- Lack of credible data cannot be a good base for forecasting.
- Because of the volatility of the Macedonian industry, the trend component of the time series doesn't dominate but rather the cycles and the irregular components. In such a set up the weights of the sample within the stratums should be evaluated rather each at least 3 years than the 5 years recommended by the Eurostat.

Structure of public finances – Local self government-LSG

As per the law on financing LSG in Macedonia as own source revenues are also considered the following:

<u>Shared revenues</u>:

1. Personal Income Tax (PIT) revenues
    a. 3% of PIT collections from salaries are allocated to the local government where the employee resides.
    b. 100 % PIT collected from artisan activities.

<u>Unconditional grant:</u>

2. Value added tax (VAT) revenues (total fund equal to 3 % of the VAT collections in the previous fiscal year).

But there are also strong contingent liabilities as illustrated in the next table.

Accounts payable of LSG to creditors.

	2005	2006	2007
As % of total LSG revenues	15,95%	24,24%	12,83%
In mln denars	5431	7626	8618

Risks:

- Lower than planned revenues for the LSG (for which they have discretion) in amount of 2% of their total revenues or in amount of 4% from their own revenues given their fiscal dependency from the central government of almost 50% in 2008.
- Bad planning from central level downloads to the local governments (central government used to score LSG by the supplementing budget incident).
- Lower unconditional transfers together with already existing accounts payable can further diminish credibility of local government, increase of contingent liabilities and endanger the macroeconomic stability in long run.

Fiscal transparency and Budgeting

Related to the fiscal transparency and budgeting:

- The GoM is aware of the fact of the low capacity of the administration and thus instead of further enhancing the budget process it tries to bypass it,
- The decision making is highly centralized and not following the organizational governance structure of the state bodies and public enterprises,
- That situation leads to non-efficient use of scarce resources, bad human capital management, discretion in decision making and thus, potentials for corruptive activities,
- One example is the newly established Committee for strategic projects and it is not clear how this is connected with the regular PIP development, how this Committee is connected with the strategic priorities of the GoM and of the other functions of the government and how it is actually connected with the budget process,
- Lack of long term strategy creates loss of resources for preparing strategies that actually contributes nothing. Example, Energy strategy preparation at the moment is not efficient as one cannot develop energy strategy without having long term strategy on Macedonia (one thing is to satisfy base load demand future needs and it is another thing to satisfy peak load demand future needs).

Risks:

- Highly concentrated and discretionary decision making,
- Creating bottlenecks and delays in many projects and /or tenders cancellations.
- Long term projects on hold and impediments to PFI/PPP.
- Low quality of institutions lead to the poor quality in public investments (cancellations, delays, low quality) like: health equipment tender, Cebren and Galishte and other and are substituting the private investments.

New political economy issues

Highly politicized society leads to high correlation between political and economic cycles. The supplementing budget was late just because of the elections.

Risks:

- Long term projects can never be implemented efficiently because are longer than the political cycle and because there is no guarantee that the next political option will continue the same restructuring agenda.
- The 4 years political cycle cannot answer the long run socio-economic needs of Macedonians.
- Further deterioration of Macedonian society.

Conclusion

- The crisis in Macedonia effects the real sector by lowering domestic household and foreign demand, declining exports, lower FDI, widening current account deficit,
- The fiscal paradigm of the GoM was to treat the foreign reserves together with domestic borrowing as ones to satisfy the volume of the budget in an environment of crisis,
- The public finance approach of this GoM was to follow the functional finance which is typical Keynes approach. With high unemployment in the country, running a deficit is a sensible way to stimulate demand. The problem is that this approach requires external financing especially with exchange rate peg,
- The story was that the public sector volume within Macedonian economy is significant and if there is a sudden stop in government expenditures it will additionally slow the economy,
- This paradigm is not sustainable in long run and it requires immediate change of policy because of the low fiscal space and that is why it resulted so far in high interest rates, widening current account deficit, depletion of foreign reserves and pressure on the exchange rate peg,
- Domestic government borrowing can be sustainable in short run but it should be meet with further lowering in budget expenditures,

- If the GoM wants to sustain the existing exchange rate regime it should go for foreign borrowing,
- Signals of crisis:
    - De facto closing capital account (latest deal between the GoM and Telecom about the dividend)
    - Higher interest rates

Risks:

- Following the balance sheet approach:
    - Solvency risk
    - Maturity risk
- Exchange rate regime endangered
- Possible political pressure to go for monetizing government debt

Annex.

Measures undertaken by the Macedonian Government[12]

Due to some of the above events, at the end of December 2008, the Macedonian Government, decided to undertake measures that will protect the real economy from the economic and financial crisis already spread all over the world. As all institutions agreed that the crisis will have higher implications on the real sector, it was decided to implement several measures that will have impact to the real economy through aiding the economic entities to get over the widely spread economic crisis.

Our goal in this analysis will be to review and describe what might be the impact on the real economy by these measures and to make a comparison with other measures undertaken by other governments.

The ten governmental measures for protection of the real sector against the implications from the global crisis are:

1. Writing-off the outstanding current liabilities for health insurance, if in the next four years the companies regularly and on time pay the employee's health insurance benefits.
2. Writing-off all accumulated interest payables on the liabilities for social care insurance benefits if the company pays the principal dept;
3. Writing-off all the accumulated interest payables on the unpaid tax liabilities if the company pays the principal debt (VAT, Income tax, Property tax, PIT).
4. Opportunity for the company for postponed payment to the main tax liability if the company secures the debt with banking guarantee of 100% or if the company offers mortgage with a value of 250% of the main liability.
5. Discharging of the companies from the obligation of income tax payment if the total annual profit is retained within the companies (if no dividends are paid).
6. Reduction of the custom taxes (for 498 items)
7. Lower personal incomes taxation rates for the individual farmers.
8. Postponing of the payment operations law for a period of one year, for the companies which have blocked accounts.
9. Transformation of the tax receivables of the government into a permanent share in some companies where the government is already the major shareholder/owner.
10. Reduction the Governmental New Year's spending (2008).

The total package of the measures is estimated to have a value of around 330 million Euros, however it should be stressed that there are no specific information regarding each single measure's value and the effects of the 2009

[12] For a detailed review of these measures by CEA see: www.cea.org.mk.

national budget. Nonetheless, the review will try to consider and explain the possible positive and/or negative effects on the business sector for every measure separately.