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Center for Economic Analyses

"Making Difference"

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Global financial crises impact on Macedonian economy

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What is behind the financial crisis:

- Large macroeconomic imbalances
- Excessive household and government indebtedness in the „rich" world
- Securitisation and distribution of risky debt („toxic" assets) at a global scale
- Distortion of asset prices and lack of transparency via „structured" products

Result:

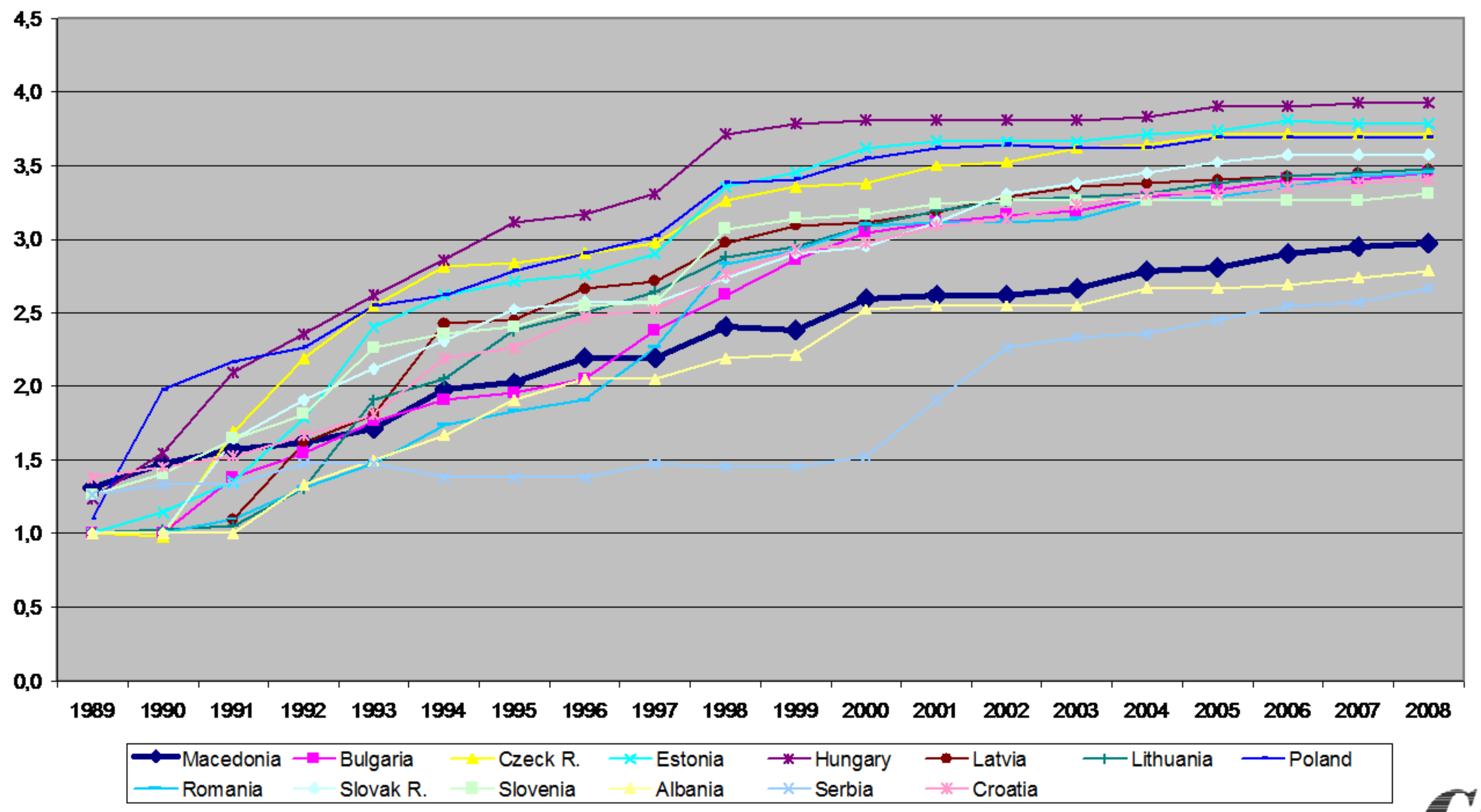
- The rich world is already in recession
  - Unemployment, foreclosures, corporate bankruptcies, falling prices, liquidity trap risk
- Other economies are dragged in through:
  - reduced FDI, liquidation of local assets, weaker net exports, lower remittances, exchange rates
- Macedonia can escape economic and social consequences?

Structure of the presentation

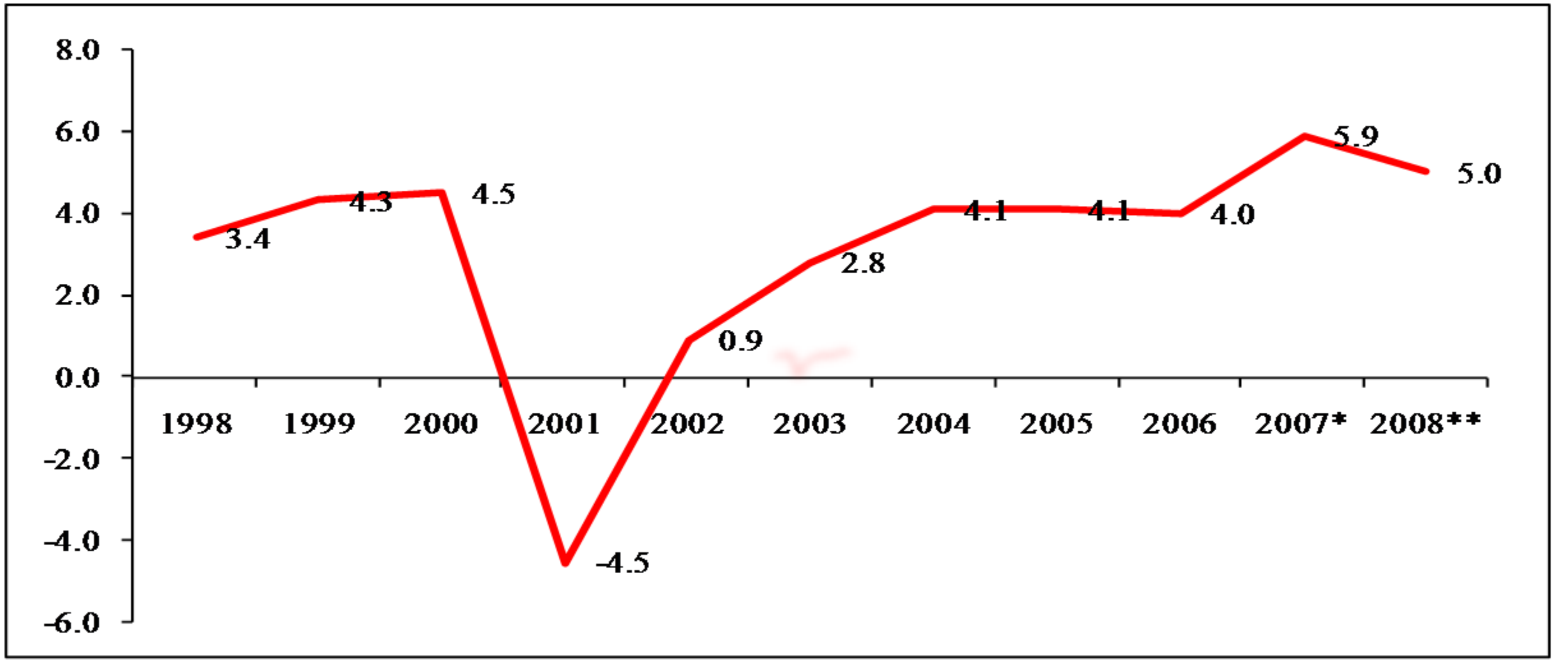
- Current situation in Macedonian economy
  - Background
  - Financial sector
  - Real sector
  - External sector
- Expectations for Macedonian economy
- Specific points
- Final thoughts

Transition

EBRD Transitional scores



Economic activity



Financial sector

- Financial sector in Macedonia is composed of banks, insurance companies and stock exchange. The share of bank assets is 90% of the total assets,
- Macedonian banks are well capitalized
  - Capital adequacy ratio 15% as of end 2008 (Basel II standards minimum 8%),
  - Only 2.8% of total liabilities account for liabilities on the basis of borrowings from foreign banks,
  - Only 9.1% of granted credits are risky in a sense that can be considered as non-performing loans (but were 5.5% in Q2: 2008).

Real sector

- Decline in aggregate demand (foreign and domestic),
  - Biggest share from the exporting iron&metal industry (50% decline Q4:2008)
- Q1:2009, 9.9% decline in industrial production compared to Q1:2008,
- Unemployment higher only for about 700 person in May 2009 but
  - Macedonia has 32.7% unemployment rate
  - On the other side, the employment rate increased by 2.9% in Q1:2009 (For Man. Women decreased-textile?)

External sector

- Current account deficit almost double,
  - Q1:2009, Export decline 33.8% compared to the same Q1:2008 but
  - Q1:2009, Import decline only 17.1% compared to the same Q1:2008
  - Private transfers lower by 29.1%
  - Capital inflow lower by 60%
  - Thus, foreign reserves lower by 230 million euros (from 1.5 billion euros in December 2008)

Monetary policy

- External risks thus, the Central Bank:
  - Protect the exchange rate peg to euro
  - Increase the referent interest rate from 7% to 9%
  - Mandatory reserves increased

Expectations

- Scenario
  - No information how deep the global financial crisis is,
  - Global Economic nationalism and inefficient global coordination,
  - Post crisis growth likely to be lower globally
  - Possible need for "second wave" IMF arrangements

Expectations

- Scenario
  - Macedonia has low fiscal space for fiscal stimulus

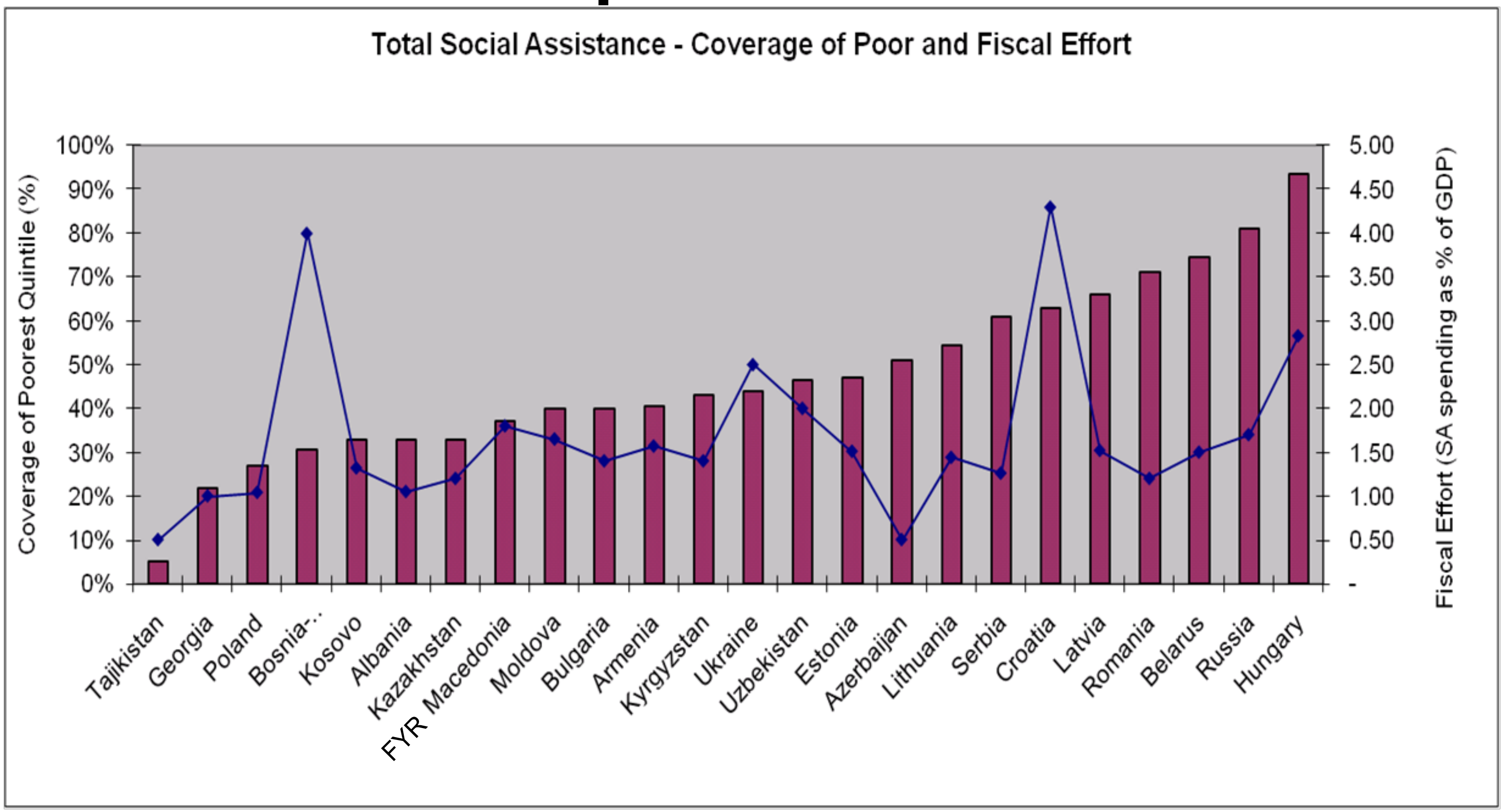
Source: World Bank's Office of the Chief Economist

	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

Expectations

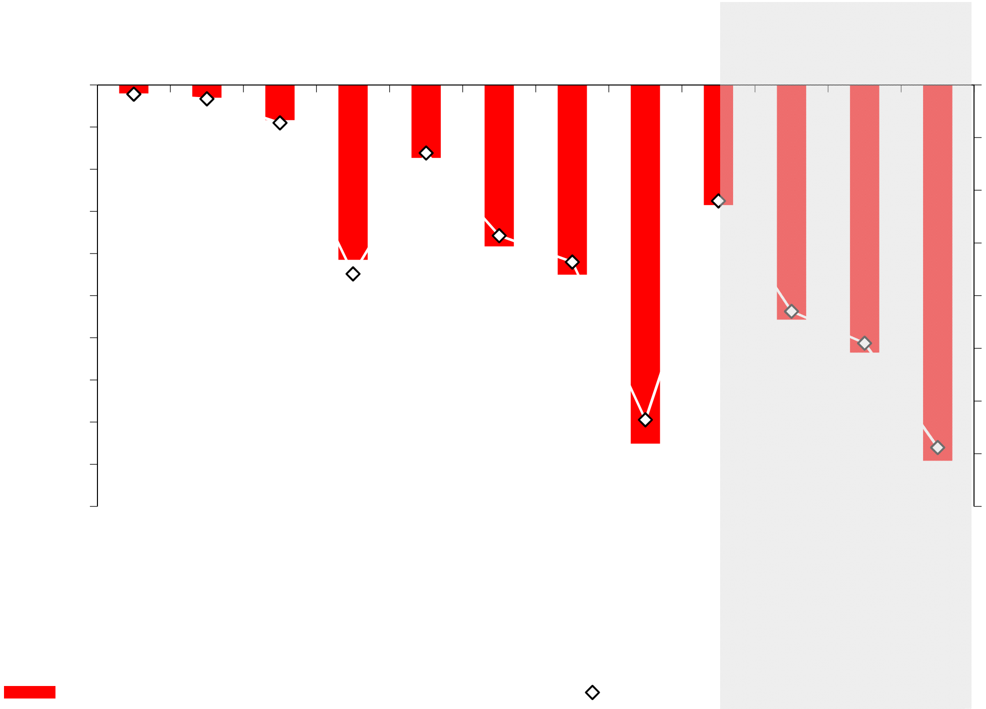
- Scenario
  - However, the financial sector is sound
  - BUT: High inequalities and poverty in Macedonia
    - S80/S20=8, Gini coeff.038,
    - 35% of households living under the 60% of the median income
  - Trade gap still a problem

Expectations



Source: World Bank

Expectations



Source: Macedonian Central Bank.

Expectations (model results)

- Expected GDP growth in 2009 of -0.9%
  - Industry production decline of 8% (mainly in the elastic sectors)
  - Agriculture – small growth of 1-2% - thanks to subsidies and maybe IPA funds
  - Service sector – will have small positive growth 1-2% (due to still high consumption and higher wages)
  - IT and high tech sector might benefit as companies are moving to low cost countries – Johnson Controls

FIRST PACKAGE OF GoM MEASURES TO FIGHT THE CRISIS

Measure 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

- The expected value of this measure is 50 million EUR
- Pros:
  - "cleaning" of the Balance Sheets
  - Insurance that the budget will receive the benefits inflows in the next four years
- Cons:
  - the liabilities will be written-off in 2012
  - not a direct injection of cash
  - double standard (moral hazard) punishing the regular benefit payers

Measure 2: Writing-off all accumulated interest payables on the liabilities for social care insurance benefits if the company pays the principal dept and Measure 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)

- There is no available information about the expected value of this measure
- Pros:
  - reduction of bad debt liabilities of the companies
- Cons:
  - reduce the liquidity of the companies with significant cash outflows
  - double standard (moral hazard) punishing the regular benefit payers
  - writing off revenues of the state budget

Measure 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

- There is no available information about the expected value of this measure
- Pros:
  - increase the liquidity of the companies by postponing the cash payment for the liabilities
  - substitution for bank loans for liquidity and working capital
- Cons:
  - can be used only by companies with satisfactory creditworthiness

Measure 5: Relieving of the companies from the obligation of income tax payment if the total annual profit is retained within the companies

- The expected value of this measure is 100 million EUR
- Pros:
  - incentive for increased investments within the companies
  - potentially new employments or reduced layoffs
  - reduced national cash outflow outside the country
- Cons:
  - investors will be de-motivated to invest in securities
  - increased fragility of the Macedonian capital market

Measure 6: Reduction of the custom taxes (for 498 items)

- The expected value of this measure is 3 million EUR
- Pros:
  - lower input costs
  - increased price competitiveness
  - increased competitiveness if the inputs are exported as finished products
- Cons:
  - potential threat for the domestic production

Measure 7: Lower personal incomes taxation rates for the individual farmers

- There is no available information about the expected value of this measure
- Pros:
  - improved control of group so far evading tax
  - reduced tax rate for the existing registered payers
- Cons:
  - increased costs for producers not paying tax until now
  - potentially more expensive exports and reduced international competitiveness

Measure 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

- There is no available information about the expected value of this measure
- Pros:
  - the liabilities turned into capital may increase the value for future company sales
- Cons:
  - concerns 4 specific companies with already questionable future
  - the state will generate double loss (will not collect the receivables and will become owner of questionable companies)
  - the state becomes owner in low quality companies

Specific points

- Budget 2009 at risk? Revenues:
  - Tax revenues decline 14% than planned in Q1:2009 (in June VAT collection lower 40% than planned)
  - VAT is around 50% of the total tax revenues of the budget thus, in June tax revenues lower 30% than planned,
  - Lower consumption can cause further revenue collection decline

Specific points

- Budget 2009 at risk? Expenditures:
  – Expected lower revenues will put pressure for another supplementary budget
  – Expected low performance of capital expenditures (two shortcomings: one from the weak historical performance and second from the lower liquidity)
  – Risk for crowding out because government capital expenditure is substitute for private capital expenditure in an environment of weak institutions

Specific points

- Budget 2009 at risk?
  - 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 Q1:2009

Specific points

- Local governments can be affected:
  - Macroeconomic channel (lower VAT transfer)
  - Will to take LSG as partner
  - Pressure for increased expenditures
  - Previous underinvestment in infrastructure
  - Previously deferred and inadequate maintenance
  - Geographical and other distinctions among various LSG jurisdictions

Specific points

- LSG can:
  - Find internal sources of funding from improved efficiency in providing services to citizens
  - Intensify the dialogue with the central government to secure an orderly budgeting process
  - Less ethically, also, postpone payments of invoices for goods and services and additionally worsen the already popular "LSG debt" position
  - Reduce the quality of services.

Specific points

- Macedonia has a bit more than 120 months experience with IMF
- External financing is needed but the GoM wants to build domestic credibility and not imported for the policies
- The IMF's offer is 1.4% for Macedonia but the debate is still going on in the country

Final thoughts

- Fiscal transparency is needed
- Budget process and transparency weaknesses
- Strong correlation between the political and economic cycle (supplementing of the not sustainable budget plan done after elections)
- Lack of performance based culture
- Lack of long-term strategy creates problems in:
  - Defending government policies
  - Making priorities in difficult times and
  - Creating inflation of sector strategies that are not integrated (recent energy strategy)

Final thoughts

- Given the nature of the crisis and the specific Macedonian economic performance:
  - Short term policies targeting real sector
  - Policies should be focused on securing financing and know-how for the small and medium enterprises
  - GoM announced arrangement with EIB for 50 mln euros with lower interest rates to SMEs in Macedonia

Final thoughts

- Given the nature of the crisis and the specific Macedonian economic performance:
  - External financing is needed
  - Eurobonds in amount of 175 million euros were issued with 9,875% coupon interest rate with 3.5 years maturity and the IMF's offer was not accepted
  - Strong political influence is shadowing the sound economic decision making

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