

# **NATIONAL BANK OF THE REPUBLIC OF MACEDONIA**

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## **INTERSET RATE POLICY IN THE REPUBLIC OF MACEDONIA**

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# ***C*ONTENTS:**

## ***ABSTRACT***

## ***INTRODUCTION***

### ***1. DETERMINANTS AND FUNCTIONS OF THE INTEREST RATE***

### ***2. FINANCIAL POTENTIAL OF THE BANKS***

### ***3. FACTORS AFFECTING INTEREST RATE POLICY***

### ***4. INTEREST RATES MOVEMENTS IN 1996 AND 1997***

## ABSTRACT

The interest rate policy is one of the most significant economic policy instruments. Current evidence from developed countries, as well as from countries in transition, shows that the optimal interest rate policy is an essential precondition for achieving dynamic economic growth.

Extremely low level of domestic saving in the banking system versus high and rigid demand for funds, high risk premiums due to the lack of financial discipline and inefficient juridical system, and high operational costs, determined interest rates in the Republic of Macedonia in the last two years to be formed on high nominal and real level.

The long - run solution of the unfavorable situation in the field of interest rate policy necessarily means improvement of fundamental economic performances which determinate interest rate policy, and it is, first of all, the relation between supply and demand of resources, i.e. in the national identities the relation between saving and investment.

However, in the short run, some measures can be undertaken which would have a positive influence on interest rate policy, and in the same time they would not disturb the main market principles, meaning banks independence in designing and implementing the interest rate policy. These measures are: **1.** To revise the existing tax policy which has a negative influence on saving; **2.** To increase the interest rate which the National Bank of the Republic of Macedonia pays to the banks on the compulsory reserves; **3.** Designing and implementation of internal policies, procedures and standards by banks for credit approval, sound credit portfolio management and more efficient claims collection; **4.** Strengthening of the supervision regulation concerning provisions for bad placements of the banks; **5.** To improve the efficiency of the juridical system and instruments for protection and insurance of the claims (collateral); **6.** To revise the existing law regulation concerning the Deposit Insurance Fund; **7.** Acceleration of the activities for foundation of the credit register; **8.** Adoption of the practice of "prime rate" formation; **9.** Change of the operative procedures under the Law for foreign exchange operation; and **10.** Stimulation of foreign capital inflow in the form of direct investments, by which the total supply of funds in the Republic of Macedonia will be increased.

## **INTRODUCTION**

The interest rate policy is one of the most significant instruments of the economic policy. The experiences from the developed economies, as well from the transition economies, show that the optimal interest policy is the essential precondition for dynamization of the economic development. The efficiency of the interest rate mechanism in realization of this goal needs fulfillment of certain preconditions: price stabilization and elimination of the price disparities, coordination of the exchange rate, inflation and interest rate movements, etc.

The realization of these preconditions in the countries with diversified financial structure, as well as the formation of the interest rates on equilibrium levels, is realized through the market mechanism. The experiences of the interest rate liberalization in the countries with undeveloped financial market, unfavorable real economic performances, structural imbalance between the supply and demand for money and disturbances in the transmission mechanism, point out that special attention and subtlety should be given to the conduct of the interest rate policy.

Having in mind that the above mentioned problems exist in the Republic of Macedonia, there should be critical estimation of the effect of the interest policy on the economic trends in the past period. That is why, this information analyses the interest policy in the period December 1996-December 1997.

The information is divided into five parts: the first part is related to the basic functions of the interest and of the factors that determine the interest rate level; the second part is analysis of the movements of the banks' financial potential from the structural and dynamic standpoint; the third part deals with the factors that determine the supply and demand of credit assets by the economic agents; the fourth-central part deals with the (un)optimality of the interest policy in the analyzed period; and the fifth part gives certain directions for the creation of the future interest policy in the Republic of Macedonia in order to achieve bigger efficiency and rationality.

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# 1. DETERMINANTS AND FUNCTIONS OF THE INTEREST RATE

Interest rate is the price for using the credit (financial) assets in certain period and it is formed on the financial market. Generally speaking, the benefits from the financial resources are higher in the present moment in relation to the future, and there is a need a certain price to be paid for their usage in the appropriate period. Namely, the agents with surplus (the depositors) give their own financial resources to the agents with deficit (the debtors), with agreement for certain compensation (interest) in the period of utilization of the resources (repayment deadline). Accordingly, the role of the interest can be viewed from two aspects: a) for the depositor, it is award for postponing the present consumption in favor of the future consumption. Hence, the savings are defined as part of the current income that is sacrificed for a certain price (interest) in order to realize increase of the property in the future period, and b) for the investor the interest is the part of the expected profit that he must pay to the depositor as a compensation for using his accumulation.

The interest rate acts as a specific price of a specific good on the financial market and as such it is included in the total system of valuation in the national economy. Because of the fact that all the variables in a market economy are expressed in nominal and real terms, there should be a distinction between a nominal and real interest rate. *Nominal interest rate* is agreed between the creditor and the debtor and it is identical to the real interest rate only in case if there aren't changes in the general level of the prices. *Real interest rate* is the nominal interest rate corrected by the changes in the inflation rate. In practice, the real interest rate is the one with real influence on the investment demand, while the nominal interest rate mainly affects the structure of the financial investments. In accordance with this, the nominal interest rate has two functions: a) to provide protection of the financial property real value; and b) to provide certain revenue in terms of real interest rate. The first component is the premium of the anticipated loss of the property value as a result of the expected price increment, and hence it is not the income component. The second component is the real award for the depositor for postponing his current consumption in favor to the future consumption, and that is income component. The incorporation of these two components in formation of the nominal interest rate can be expressed as follows:

$$\text{Nominal interest rate} = (1+r)(1+i) \quad (1)$$

where,

$r$  = real interest rate

$i$  = expected inflation rate

According to this, the factors influencing the formation of the interest rate can be divided in two groups: a) factors influencing the real interest rate (saving, investment), and b) factors influencing the expected inflation rate (monetary policy, expected currency devaluation, psychological factors, and so on). In the market economies, the key determinants in formation of the real long-term interest rates are the fundamental economic categories, and first of all the ratio of the saving and investment expressed through the supply and demand of assets on the financial market, as well as the general rate of return of

the real investments (marginal capital productivity). The calculation of the nominal interest rate, in accordance to the equation (1), does not include the risk parameter, i.e. it includes “zero” risk. Of course, the actual formation of the interest rates also includes the influence from the Central bank discount rate policy, as well as the type and the intensity of the interest risk. The risk premium is not under the monetary policy control, but it is determined by other factors: credit risk (which depends on the degree of financial discipline, inefficiency of the court system in solving the disputes in the financial area, and so on), political risk in the country, the foreign exchange risk (protection from devaluation), and so on. Accordingly, the complete formula for calculation of the nominal interest rate, including the risk component, would be:

$$\text{Nominal interest rate} = (1+r) (1+i) (1+cr) (1+dr) (1+pr) (1+ir) \quad (2)$$

where:

$r$  = real interest rate

$i$  = expected inflation rate

$cr$  = credit risk

$dr$  = foreign exchange risk

$pr$  = political risk

$ir$  = interest risk, and so on..

In the countries with developed financial system, there exists transparent mechanism in which the great number of individual decisions to save and invest are under direct influence of the formed and expected interest rates, but simultaneously there is a reversible influence by the economic agents on the formation and movement of the interest rates on the market. The equilibrium market interest rate is formed on a level on which there is a equilibrium in the supply and demand of capital on the financial market. The equilibrium “natural” interest rate equals the rate of real return of the capital (marginal profit) realized in the national economy. On a long term, there is equilibrium between the natural and market interest rate. On a short term, certain disparities are possible between these two rates as a result of the changes in the price level, which in developed economies is eliminated by automatical movement of the market forces.

The interest rate is an instrument for achieving equilibrium of the supply and demand for savings in the national economy. Simultaneously, the interest rate has a central part in the process of mobilizing the financial resources, the absorption of the formed savings by the real investors, as well the optimal allocation of the resources. The supply of financial resources is determined by the size of the national savings and by the imported savings. The demand for financial resources is determined by the size of capital investments and the real interest rate, as well as by the general level of economic activity in the country. Hence, the interest elasticity (sensitivity to the changes in the interest rate) of these two categories is different. Thus, the size of the savings, is first of all determined by the level of the income in the national economy and the propensity to save, and to a lesser degree by the level of the real interest rates. The ratio between the savings and the level of the interest rates is in direct proportion (increasing curve of savings supply). On the other hand, investments are the element of the total demand with highest interest elasticity, where inverse correlation exists between the level of the real interest rate and the size of investments (decreasing curve of savings demand).

The interest rate is at the same time revenue and expenditure component in the balance of each banking institution. On one hand, the banks mobilize the free assets from the economic agents with surplus of assets with existence of certain structure of the interest rates, and for the banks this is a expenditure for formation of the financial potential. On the other hand, banks allow credits from the available collected assets with different structure of interest rates, usually higher on average than the interest rates used for formation of their deposit potential. The realized difference between the lending and borrowing interest rates (interest margin) is revenue for the bank that should provide coverage of the financial transaction expenses, proper quality and standard of services, and so on. The basic principles for formulation of the commercial banks' interest policy are as follows: a) to make the term and the currency structure of the assets and liabilities compatible; b) maintaining a moderate and stable level of the interest margins; and c) building in of appropriate instruments for limiting the interest risk.

The basic economic criteria for allocation of the banks' resources is to finance those investment projects which marginal profitability is higher than the real interest rate. In case of low real interest rates there is low economic agents' propensity to save, and high propensity to invest. In this case, because of the low threshold of the capital marginal efficiency, a great number of investment projects can obtain real profit higher than the level of the credits' real interest rate. This will result in a large number of economic agents who will decide to invest, instead of to save. Preference for the current consumption (investing) rather than to future consumption (savings) leads to disturbances in the equilibrium relations of these two economic categories. In the countries with developed financial market, the disproportion between the savings and the investments determines automatical activation of the market mechanisms for coordination, where the interest rate has the key role in the process of obtaining equilibrium between the supply and demand for savings. Otherwise, in case of high real interest rates, the level of the marginal profitability that should be realized by some project is increasing, that leads to greater selectivity in choosing the investment project to be financed. This will result in decrease of the investments, i.e. reduction of the investment demand and increase of the savings.

The interest rate influence on the economic movements is realized through three channels:

a/ through the "substitution effect" - low interest rates lead to higher propensity to invest, and lower propensity to save. While in case of high interest rates the economic agents prefer the future consumption rather than the current consumption;

b/ through the so called "wealth effect" - low interest rates lead to increase in the price of the economic agents' financial wealth on the market. That's why, they feel richer and decide to spend more. Otherwise, high interest rates lead to decrease in the property value, that result in postponing the consumption by the economic agents;

c/ through the payment and collection of the interest - low interest rates result in lower interest for the economic agents that save, meaning lower possibility to spend. In the opposite case, higher interest rates result in higher revenues, and hence higher possibility to spend. Debtors pay high interests that result in reduction of their spending.

## 2. FINANCIAL POTENTIAL OF THE BANKS

The size of domestic savings is the key factor that influence the dynamism of the economic activity in the national economy. There is no official data in the Republic of Macedonia for the amount of savings according to the System of National Accounts. Anyway, according to certain indicators, it is estimated that the size of domestic savings in the Republic of Macedonia is on an exceptionally low level and does not exceed 7.0%-8.0% of the GDP. According to the international standards, that is an exceptionally low level of savings, compared to the levels in the transition countries (ex.: in China, Hungary, Russia, Uzbekistan, Lithuania and Estonia the level of savings is 42.9% (!), 22.4%, 22.3%, 16.1%, 15.2% and 14.9% of the GDP), and even more compared to the situation in the developed countries (Japan has a level of savings of 31.3% of the GDP, Austria-24.9%, Belgium-21.0%, France-18.8%, Germany-20.4%, Brazil-16.9%, USA-15.2% of the GDP, and so on).

The supply of the financial resources, i.e. the financial potential of the commercial banks in the Republic of Macedonia consists of the following categories: denar and foreign exchange deposits, credits from non-financial institutions, resources collected through issuing securities, banks' capital, and borrowing from abroad.

According to the data from the 31.12.1997, the total financial potential of the banks in the Republic of Macedonia is denar 37,502 million. Of that amount, denar 12,953 million (or 34.6%) are denar deposits, denar 6,060 (or 16.2%) are foreign exchange deposits, denar 8,529 million are borrowings from abroad and denar 9,960 million (or 26.6%) is the banks' capital.

The financial potential of the commercial banks in the Republic of Macedonia is increased by denar 8,200 million in the period 31.12.1996-31.12.1997 (or by 28.0%), which is quite satisfactory rate of annual increase. If from the total increase of the financial potential we subtract the increase of the demand deposits as a category which has a pure transaction nature, then the increase of the financial potential of the commercial banks in the analyzed period is denar 6,774 million (or 27.7%). If from the total increase of the financial potential we subtract the increase of the banks' capital, together with the subtraction of the demand deposits, then the financial potential in the last year increased by denar 5,509 million (or 35.0%)

Despite the satisfactory dynamism of increase in the financial potential of the banks in the Republic of Macedonia in 1997, because of the low starting position the share of the financial resources in the banking system of the GDP reached only 5.2% in 1997 (including the increase of the demand deposits and the capital), i.e. 4.3% of GDP (without the increase of the demand deposits), and only 3.5% (if the increase of the demand deposits and of the capital is subtracted).



### Financial potential of the commercial banks

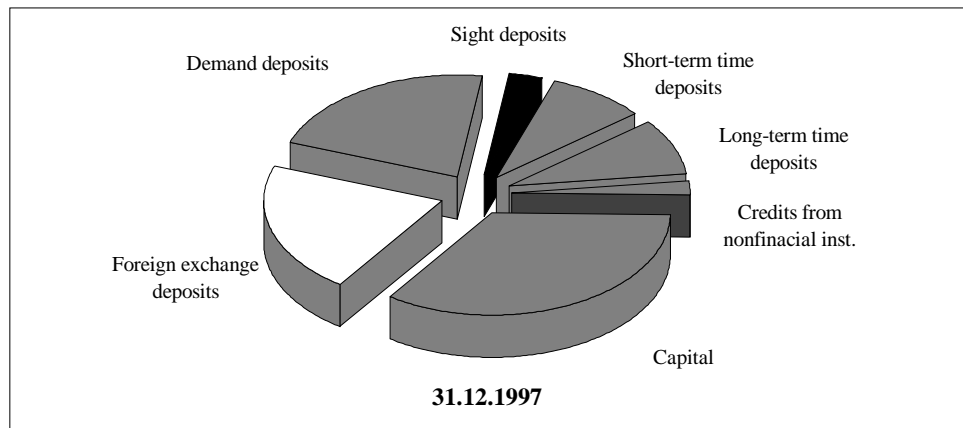
(in million denars)

	31.12.96	31.12.97	absolute change	change in %	structure 1996	structure 1997
I. Denar potential	19797	22913	3116	15.7	67.6	61.1
1. Deposits	10235	12295	2060	20.1	34.9	32.8
1.1. Demand Deposits	4854	6280	1426	29.4	16.6	16.7
1.2. Sight Deposits	782	857	75	9.6	2.7	2.3
1.3. Time Deposits up to 3 months	1588	1731	143	9.0	5.4	4.6
1.4. Time Deposits over three months	730	908	178	24.4	2.5	2.4
1.5. Time deposits over one year	2158	2346	188	8.7	7.4	6.3
1.6. Restricted deposits	123	173	50	40.7	0.4	0.5
					0.0	
2. Credits from non-financial institut.	867	658	-209	-24.1	3.0	1.8
2.1. Short-term	467	284	-183	-39.2	1.6	0.8
2.2. Long-term	400	374	-26	-6.5	1.4	1.0
3. Capital	8695	9960	1265	14.5	29.7	26.6
II. Foreign Exchange potential	9505	14589	5084	53.5	32.4	38.9
2.1. Deposits	3846	6060	2214	57.6	13.1	16.2
2.1.1 Sight Deposits	2574	4749	2175	84.5	8.8	12.7
2.1.2 Time Deposits up to one year	142	225	83	58.5	0.5	0.6
2.1.3 Time Deposits over one year	135	226	91	67.4	0.5	0.6
2.1.4 Restricted Deposits	995	860	-135	-13.6	3.4	2.3
2.2. Borrowings from abroad	5659	8529	2870	50.7	19.3	22.7
2.2.1 Short-term	4527	6823	2296	50.7	15.4	18.2
2.2.2. Long-term	1132	1706	574	50.7	3.9	4.5
III. TOTAL (I+II)	29302	37502	8200	28.0	100.0	100.0

The situation is even worse if only the long-term financial potential of the banks is analyzed, which actually is the only one that has the attribute of financial saving. Namely, the growth of the long-term financial potential (denar and foreign exchange deposits over one year, long-term credits of non-financial institutions and long-term foreign borrowings) in 1997 was denar 827 million, or only 0.5% of the realized GDP. This means that the savings rate with the banking system in the Republic of Macedonia is at an extremely low level, which prevents the opening of a new investment cycle and accomplishing a more dynamic economic growth on that basis.

From a structural point of view, during 1997, movements of the financial potential of the commercial banks were unfavorable. Namely, there was a decreased participation of the most important saving categories (denar and foreign exchange deposits over one year, long-term credits of non-financial institutions and long-term foreign borrowings) by 0.7 percentage points (from 13.1% at the end of 1996, to 12.4% at the end of 1997). Simultaneously, there was a decreased participation of capital, which is also a long-term resource of funds, by 2.4 percentage points (from 29.7 in 1996, to 26.6% in 1997). On the other hand, participation of short-term denar and foreign exchange deposits increased, which at the end of 1997 participated in the total financial potential of the banks with 61.0%, which is 3.7 percentage points more compared with the end of 1996.

### Structure of the financial potential of commercial banks



Denar potential of banks consists of: demand deposits, sight deposits, short-term and long-term denar time deposits, credits from non-banking entities and banks capital. In total denar deposits at the end of 1997, the short-term deposit categories participated with 79.0%, which is 2 percentage points more compared with the situation from the end of 1996. Adequately, the participation of long-term denar categories in the total foreign exchange potential of the banks in the Republic of Macedonia decreased from 23.0% to 21.0%. This suggests that during 1997, short-term denar deposits had a larger growth in comparison with the long-term deposits, which deteriorated the already unfavorable condition of saving with the banking system in the Republic of Macedonia.

The most important deposit category from the aspect of domestic saving are time deposits over one year. The amount of these financial assets clearly reflects the confidence of the economic entities in the national currency, as well as the total credibility of the economic and monetary policy. In the period 31.12.1996 - 31.12.1997 long-term denar time deposits grew by denar 162 million<sup>1</sup>, or 6.3% (on nominal basis), i.e. by denar 45 million, or 1.8 (on real basis), which is slower growth in comparison with other denar deposits.

In 1997, the highest growth within denar categories, was realized by demand deposits, denar time deposits over three months (up to one year) and restricted deposits. Thus, in 1997 the demand deposits which participate in the total denar deposits<sup>2</sup> with 48.5% (43.7% at the end of 1996) accomplished a growth rate of denar 1,426 million, or 29.4% (on nominal basis), i.e. denar 1,156 million, or 23.8% (on real basis). The realization of most dynamic growth with this category, which has the role of a transaction rather than saving instrument, is unfavorable from the aspect of the quality of the financial supply in the national economy. Sight deposits have the same quality and significance in respect of saving. In the period December 1996 - December 1997 they nominally increased by denar 75 million, or 9.6%, whereas the real growth of the denar sight deposits in the same period was only denar 38 million, or 4.9%.

The funds that the banks accept in the form of short-term time deposits are of a higher quality from the aspect of saving, although these funds are not categorized as “pure” saving. In the period 31.12.1996 - 31.12.1997, denar time deposits up to three months realized a nominal growth rate of denar 143 million (9.0%), whereas the denar time

<sup>1</sup> Including the so called long-term credits (deposits) of non-financial institutions.

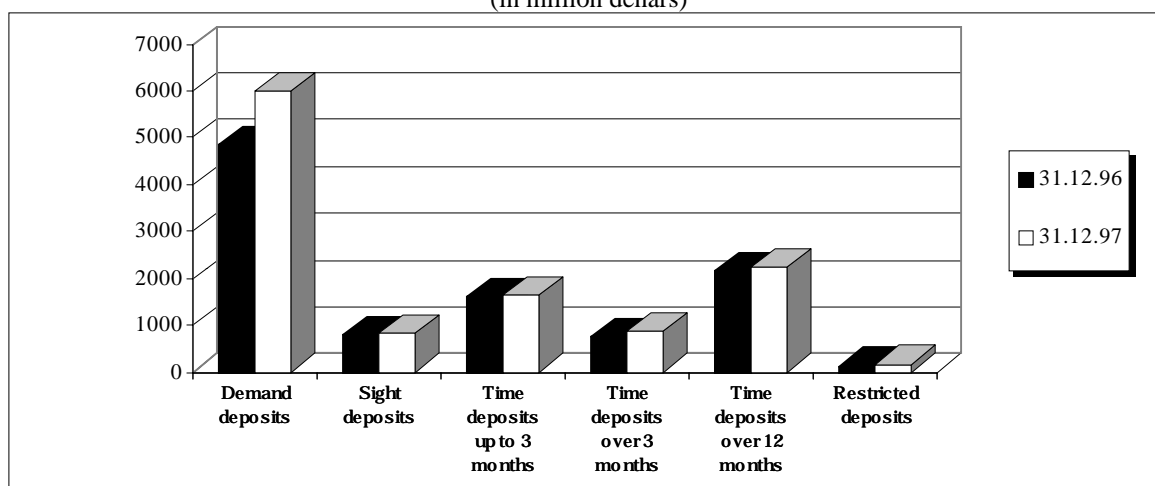
<sup>2</sup> Including the credits of non-financial institutions

deposits over three months up to one year in the same period increased by denar 178 million (24.4%). In the observed period, both deposit categories realized a real growth: denar time deposits up to three months by denar 68 million, or 4.3%, whereas denar time deposits over three months up to one year by denar 139 million, or 19.0%. The intensive growth of this deposit category is, on one hand, a result of the attractive interest rates which ensure a lot higher interest income in relation to the sight deposits and the time deposits up to three months, and on the other, result of the fact that this category still enables the depositors to have a sufficiently high level of liquidity of their funds. At the same time, the high oscillations of the amount of short-term time deposits and frequent changes in the structure (from one into another group of short-term time deposits), point to the domination of speculative motifs of the holders of these financial instruments, over the saving motive.

Capital is a financial category which bears the total risk of the banks' operations. In the period 31.12.1996 - 31.12.1997, the total capital of banks in the Republic of Macedonia nominally increased by denar 1,265 million, or 14.5%. Real growth of the commercial banks' capital in 1997 is denar 836 million, i.e. 9.6%. However, it should be emphasized that in 1997, the capital growth of the banks in the Republic of Macedonia is not a result of their intention to strengthen their own capital basis, but it is due to the legal regulations which "put pressure" on the commercial banks in respect of increasing the capital, in order to achieve the legally prescribed census for operation with abroad. Nevertheless, having in mind the fact that achieving the obligatory capital census is connected with the denar counter value of the German mark according to the current foreign exchange rate, and that in 1997 the denar value in respect to the mark decreased by 16.1%, which goes beyond the nominal and real growth rate of the capital in the same period, it appears that, from the aspect of legal censuses, the capital of the banks in the Republic of Macedonia in 1997 actually decreased.

### Components of the denar deposits

(in million denars)



The foreign exchange financial potential of the banks in the Republic of Macedonia consists of short-term and long-term deposit funds and external borrowings. Out of the total foreign exchange deposit potential as of 31.12.1997, 86.8% are short-term foreign exchange deposits and short-term external borrowings, which is on the same level as of the end of 1996. Long-term sources of foreign exchange funds cover 13.2% of the total foreign exchange potential, with the dominance of the external borrowings (89.3% of the long-term

foreign exchange potential in 1996 and 1997). Long-term foreign exchange time deposits, which together with the long-term denar time deposits represent the categories of highest quality from the aspect of saving, at the end of 1997 amounted only to denar 226 million. That confirms the conclusion that a minimum amount of savings deposits is concentrated in Macedonian banks, i.e. the saving is at a marginal level.

From a structural point of view, in 1997, all categories of foreign exchange deposits (except for the restricted deposits) accomplished a positive growth, with highest dynamics in sight deposits. Preferring the most liquid deposit category is a result of the disturbed confidence of the economic entities in the stability of the national currency after the devaluation of the denar, which reactivated the suppressed inflationary expectations. In such circumstances, the protection of property is largely oriented towards its conversion into foreign convertible currencies, such as German Mark and US Dollar. On the other hand, economic subjects could not decide upon "tying" the foreign exchange funds with the banking system for a longer period of time, i.e. they preferred the highest possible level of foreign exchange deposits liquidity.

Thus, in the period December 1996 - December 1997, foreign exchange sight deposits accomplished a nominal growth of denar 2,175, or 84.5%, i.e. real growth of denar 1,363 million, or 53.0%. Simultaneously, foreign exchange time deposits over one year accomplished a nominal growth of denar 83 million, or 58.5%, i.e. real growth of denar 45 million, i.e. 31.4%. Regardless of the intensive relative growth, the increase of the short-term foreign exchange time deposits did not give any contribution to a more significant strengthening of the deposit potential of banks, due to their low absolute amount. It is the same situation with the long-term foreign exchange time deposits, which in 1997 grew by denar 91 million, or 67.4% (on nominal basis) i.e. by denar 52 million, or 38.8% (on real basis). In 1997, external borrowings accomplished a high growth rate. They increased by denar 2,870 million, or 50.7% (on nominal basis), i.e. denar 1,412 million, or 24.9% (on real basis). The only foreign exchange category which decreased in 1997, were the restricted deposits (earmarked deposits for letters of credit, guarantees etc.), which faced a nominal decrease of denar 135 million, or 13.6%, i.e. real decrease of denar 282 million, or 28.3%.

### 3. FACTORS AFFECTING INTEREST RATE POLICY

Domestic saving is a key determining factor for the economic activity. In the Republic of Macedonia there is no official data for the national saving according to the SNA system. Still there are some indicators that the saving rate is very low, assessed not to exceed 7%-8% of GDP. According to the international standards this is very low saving rate, either compared to the transition countries, or to developed countries. Situation is even more serious if one takes into account that out of total saving, only a minor part “passes” through a financial system, i.e. is held in a form of financial instruments in banks. Main part of the total saving is in a form of cash, either in denars or in foreign currency, implying that it is held in least productive form both from an individual and from an economic point of view. Thus, Macedonian banking system practically disposes with negligible amount of long-term funds, that is not enough for supporting credit and investment activity of the economy. In situation where there are no alternative ways of investment financing (mobilizing resources through the capital market, or by foreign direct investments), this determines low rate of growth of Macedonian economy.

The low level of domestic saving, present in all period of transition, is first of all a consequence of the low income level, that inhibits the capacity for saving. Simultaneously, despite all the efforts for banking system rehabilitation, the inherited problem of “frozen foreign currency saving”<sup>3</sup> still has a negative impact on the confidence in the banking system. Besides these two factors, the recovery of inflationary expectations after the July 1997 devaluation of the denar was a third factor that had an adverse influence on the household propensity to save.

Empirical experience shows that the basic condition for increasing saving rate is the increase of net disposable income of economic agents, implying more dynamic growth of the economy. This implies more intensive structural reforms, foreign capital inflow in a form of direct investments, increase of productivity, etc. Obviously, this process has a long-term character, meaning that improvement in household’s standard and creation of necessary preconditions for saving can be expected after the finalization of the transition process, i.e. on medium and long-run. The second factor that has an adverse effect on the saving in the Republic of Macedonia - lack of confidence in the banking system and in the stability of the currency - is inherited from the past (the unresolved problem of the frozen foreign currency deposits) which became more severe with the biggest saving house (TAT) bankruptcy and July 1997 devaluation of Denar. The recovery of the confidence in the banking system is by no means as long process as is the process of generating this problem. Among other factors, it includes efforts for improving the soundness of a banking system, permanent orientation towards price stability, proper functioning of the deposit insurance fund, application of supervisory standards, elimination of all problematic banks and saving houses, etc.

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<sup>3</sup> At the moment of dissolution from Former Yugoslavia, all foreign assets remained in the National bank of SFR Yugoslavia, as a Central bank of former country SFRY. Liabilities of banks to household for foreign exchange deposits remained in Macedonian banks, and were undertaken as a debt by Macedonian Government. Through a comprehensive Government program, in the past six years the amount of public debt for these liabilities has been almost halved, from USD 1.2 billion to less than USD 0.7 billion.

So, the recovery of the domestic saving as one of most important factors for achieving more dynamic growth can be expected only on medium or long term. On short term, the structural imbalance between domestic saving and investment will continue, determining high trade deficit and high real interest rates.

The demand for funds is the second fundamental factor affecting commercial banks interest rate policy. In the whole period after monetary independence, including 1997, credit demand is constantly kept at the high level. It is determined by two factors:

*a/ the demand for funds for new investments.* Total amount of new investments started in 1997 is Denar 1,985 million, meaning that they are 7 times lower than current enterprise losses in the 1997. So, investments in fixed assets represent only 24.2% of new financial potential of commercial banks in 1997, or 36.0% (excluding the rise of demand deposits and capital); and it was not the leading factor determining the high demand for funds, and consequently, high lending rates in the analyzed period.

Situation is even more unfavorable if the structure of investments is analyzed, showing a dominance of investments in traffic and communications, non-economic investments and water supply (around two thirds of total investments). These investments are financed mainly from the budget, or by public enterprises. Thus, according to the sources of investment financing, 49.6% of total investments in 1997 are financed by investors own funds, 18.3% with budgetary funds, 10% is participation of foreign banks, and only 13.5% are funds from Macedonian commercial banks. This is a similar situation as in 1996, when own funds participated with 50.8%, budgetary funds with 18.2%, foreign banks with 11.2% and domestic banks with only 13.8%.

The prevalence of public sector investments has a double negative effect: first, it leads to "crowding out" of the private sector from shallow credit market; and second, in a situation where supply of funds is scarce, it leads to formation of high interest rates. Thus, creating a framework for more intensive development of the private sector (including lowering of lending rates) requires public sector investments in the Republic of Macedonia to be reduced on optimal level, according to the current potential of the Macedonian economy.<sup>4</sup>

*b/ the demand for funds for covering enterprise losses.* Current enterprise losses in the first half of 1997 amounted Denar 9.7 billion, which on annual level will represent around 12% of GDP. So, total increase of banks' potential in 1997 covers only 42.3% of enterprise losses, or 28.4% (if demand deposit and capital are excluded). On the basis of this, it is obvious that new investments are not the key factor determining the high demand for banks funds. On the contrary, extremely high demand for funds for covering enterprise losses completely exhausted banks saving potential, contributing to formation of high interest rates.

Besides the demand and the supply of funds as key fundamental factors, banks interest rate policy is affected by other factors:

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<sup>4</sup> According to the "National Strategy for Development of the Republic of Macedonia", public investments should not exceed 25% of total investments.

1/ *Poor quality of banks placements and lack of financial discipline.* Out of total denar placements at the end of 1997 (Denar 44.5 billion), Denar 5.9 billion are due but unpaid claims on the basis of principal, and Denar 24.8 billion are due but unpaid claims on the basis of interest, resulting in total share of due but unpaid claims in Denar placements of 69%. This is unsustainable level of due but unpaid claims, that it is in direct causal link with the interest rates.

Namely, as a result of deterioration of the liquidity of many economic agents, and their inability to repay their debt-obligations, a high amount of uncollectable claims was concentrated in banks portfolios. The quality of banks placements also deteriorated due to a lack of good credit procedures, non-transparent control over the process of making credit decisions, inability of banks for "complete coverage" of their clients (as payment system is not performed through the banks), etc.

Having in mind the relatively low level of investment demand, it is obvious that new credits were mainly approved for repayment of old credits and for working assets, i.e. unproductively from the point of view of generation of inflows that will ensure timely payment of the obligations. Simultaneously, having regular obligations to the depositors, banks were trying to "transfer" the interest rate burden on sound clients, creating thus a strong problem of moral hazard. This policy has put many enterprises in liquidity and solvency problems. In general, the unreasonable interest rate policy had a counterproductive impact on the efforts of enterprises for restructuring as a key component in the reforms process.

Term structure of banks placements is also unfavorable, reflecting unfavorable structure of sources of funds. Namely, short term credits dominate, both in Denar credits (representing 79.6%) and in foreign currency credits (65.8%). This is a reflection of deposits structure, where short-term denar deposits participate with 79% in total denar deposits. Thus, banks have no capacity for supporting investment process, and they mainly lend on short term basis (credits for working assets). That hinders the process of enterprise restructuring, resulting in their low profitability, which adversely affects the possibility for repayment of credits, creating thus a vicious circle.

2/ *Inefficient juridical procedure.* The process of realization of collateral in the Republic of Macedonia is very slow, and often takes two - three years. Banks compensate for this by increasing the interest rate, that has double negative effect: first, it contributes to increase of the interest rates, and second, the burden of lack of financial discipline and of inefficient juridical system, is transferred on sound clients. This seriously undermines their profitability and creates a moral hazard problem. For example, realized collateral represent only 1.7% of total due but unpaid claims for principal and interest, as of 31.12.1997.

3/ *High operational costs of Macedonian banks.* This refers first of all to tax liabilities - banks (depositors) are obliged to pay personal income tax on interest income on time deposits (tax rate is 23%), as well as tax on net interest income (13%). In addition, they have to pay high premiums to the Deposit Insurance Fund. A compulsory reserve obligation (paid in average rate of 5.8%) remunerated with low rate of 3.4% on annual basis, also creates a significant cost in a form of lost interest. If we assume these funds to be invested in non-risky instruments (such as Central Bank Bills), they would get an interest of 8.4% on annual level. This means that the opportunity cost for banks in a form

of lost interest on compulsory reserves is relatively high, or around 5% of the deposited funds.

In addition, two other cost factors are important: excess of employees (mainly in old banks), and the opportunity cost of keeping high amount of non-interest bearing assets by some banks.

4/ *Monetary policy.* It affects interest rates through its influence on the formation of expected rate of inflation, rather than influencing real interest rate. In a situation when monetary policy is oriented to maintenance of the exchange rate stability, the central bank is unable to achieve its inflation and growth targets through interest rate targeting. On the contrary, the level of interest rates necessary for maintaining the stability of the exchange rate, generates high interest rates in order to attract foreign capital necessary for deficit financing. As besides high interest rates there is no such inflow of capital shown in banks balance sheets, it seems that adjustment is done through the high amount of errors and omissions in the balance of payments.

Basic monetary policy instruments in the last few years are open market type operations in a form of auctions of deposits (credits) and central bank bills. Interest rate achieved on auction of credits is the most representative among the rates that are under central bank influence. In accordance with the monetary strategy, the supply of funds on the auction was determined by the need for maintaining the stability of the exchange rate, while interest rate was a goal of secondary importance. Due to a high trade deficit, the necessity of maintaining the exchange rate stability in the past two years led to formation of high interest rates on credit auctions, approaching 14%-15% on annual level at the end of 1997. Unfortunately, because of a very thin financial market (M2/GDP ratio in 1997 was 14.1%), only few transactions determine the interest rate achieved on these auctions. Thus, unfavorable balance of payment movements in the last two years, through the monetary mechanism, have adverse influence on the central bank interest rates, and indirectly on commercial banks interest rates.

5/ *Foreign exchange regulation.* Total foreign liabilities of commercial banks increased by Denar 2,870 million in 1997, while foreign assets increased by Denar 3,696 million. So, there was net outflow of domestic accumulation abroad that further squeezed the scarce potential of domestic banking system. This is mainly result of foreign exchange regulation according to which households and enterprises foreign currency deposits have to be 100% covered by liquid foreign currency assets;



## 4. INTEREST RATES MOVEMENTS IN 1996 AND 1997

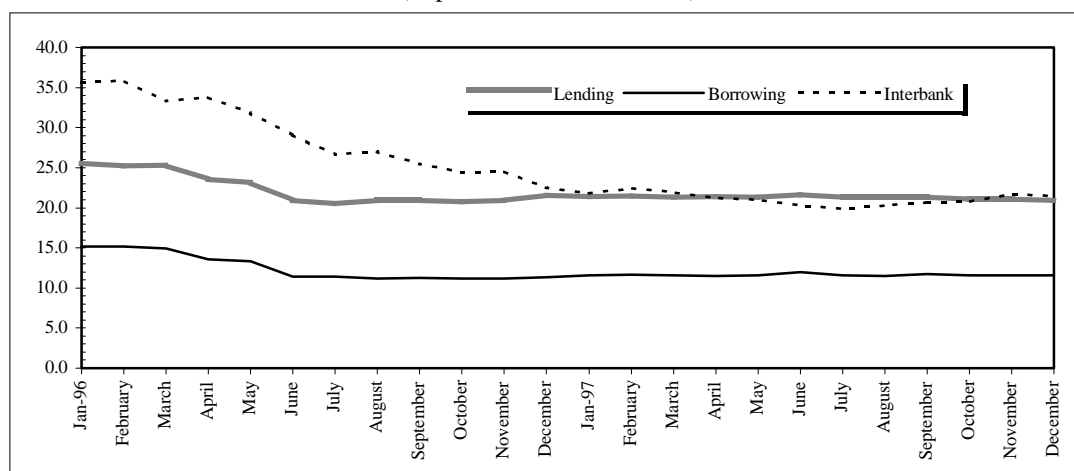
Extremely low level of domestic saving in the banking system versus high and rigid demand for funds, high risk premiums due to the lack of financial discipline and inefficient juridical system, and high operational costs, determined interest rates in the Republic of Macedonia in the last two years to be formed on high nominal and real level.

Only in the first half of 1996 interest rates followed the inflation pattern, although with slower pace of reduction. Thus, although in the first half of 1996 lending interest rates were reduced from 25.6% to 20.9% on annual level, they were still high and did not correspond to the achieved level of price and exchange rate stability. The falling trend of interest rates was completely stopped in the second half of 1996, and in 1997 there was only a negligible reduction of banks interest rates. With inflation rate maintained on low and stable level (including the period after the devaluation of Denar), this created very high real interest rates, that were much higher than the marginal capital productivity.

Thus, average nominal lending interest rate in the period 1996 - 1997 reached 21.9% on annual level (22.4% in 1996, and 21.4% in 1997). Adjusted for the increase of prices in the same period, it gives an average real lending rate of 18.3% (21.6% in 1996, and 15.2% in 1997).

### Interest rates in the Republic of Macedonia

(in percent, on annual level)



The long-lasting maintenance of high lending rates has a negative impact in two aspects: 1/ it leads to less than optimal utilization of credit limits, that is opposite to the efforts for intensification of investment activity and economic recovery, and 2/ enterprises that were willing to take credits in these circumstances, were forced to invest in more risky projects in order to earn high profits necessary for covering the cost of credits. This reversibly deteriorates the quality of banks placements. Banks were trying to compensate for bad loans by "removing" the cost of these loans to sound clients, creating thus a vicious circle: high interest rates - risk (bad) loans - high interest rates, etc. Simultaneously, due to the lack of financial discipline, the debt chain was expanded in relations among enterprises, resulting in general lack of liquidity and creation of "bottle necks" for the production process. Thus, it can be concluded that interest rate policy of commercial banks in the

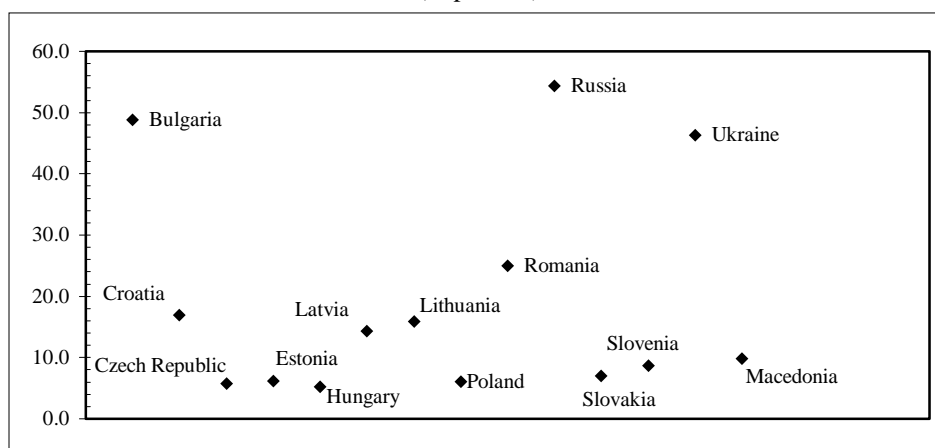
period 1996-1997 was very inefficient and counterproductive, with adverse impact on general level of economic activity.

Nominal borrowing rates in the period 1996 - 1997 were also high, averaging 12.1% on annual basis. In 1996, average borrowing rate reached 12.6%, while in 1997 it was reduced to 11.6%. In real terms, average borrowing rate of 8.6% was realized in the analyzed period. Due to the lost confidence in the banking system, these high borrowing rates did not significantly improved domestic saving, confirming once again the empirically based conclusion that saving is primarily determined by the general level of development (income), and not by the level of interest rates. From other side, such an interest rate policy on the liability side determined lending rates to be formed on high nominal level.

The restrictive monetary policy, temporary liquidity problems of some banks, undeveloped financial market and poor cooperation among banks, were the main reasons for constantly higher demand than supply of funds on the interbank money market. As with the Central Bank's auctions, the insufficient depth of the financial market is a problem for this market as well, that contributed for the nominal and real interest rates on the interbank market to be formed at a high level, although with a declining tendency. At the end of 1997, the banks were lending to other banks at an average nominal interest rate of 21.1%, which is by one percentage point lower than the level at the end of 1996. However, the general observation is that the interest rates on the interbank market of the Republic of Macedonia are also kept at a level which is too high.

Besides keeping the nominal and real interest rates at a high level, in 1996 and 1997 the interest rate policy of the commercial banks in the Republic of Macedonia was also characterized by the existing high interest margins. The average interest margin between the interest rates for short term loans and time deposits over three months is 9.8 percentage points. If the lending interest rates are compared with the weighted deposit interest rate that incorporates all the denar deposits, the interest margin reaches 14 percentage points. In any case, the interest margins are 5-7 times higher than the average margins in the developed countries, and 5-8 times higher than those in the most advanced countries in transition. The existence of high interest margins emerges from the high operation costs of the banks, the concentration of high amount of overdue claims, insufficient competition in the financial sector, etc.

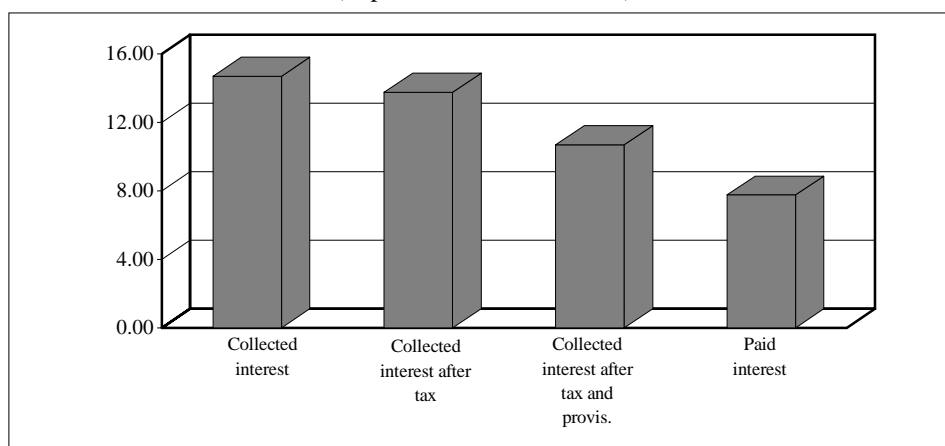
### Interest rate margins in countries in transition (in percent)



More detailed analysis of the data provides a conclusion that the average rate of collected interest by the banks was 14.7% p.a. in 1997, that is for 7.2 percentage points lower than the nominal lending interest rate charged by the banks for credits. This confirms the conclusion that there is a low level of financial discipline and low level of claim collection by the banks. At the same time, the average deposit rate derived from the banks' interest expenses in 1997 is 7.7% p.a. Consequently, the effective interest margin in the banking system of the Republic of Macedonia is 7.0 percentage points, which is lower by 2.8 percentage points than the margin derived from the comparison of the nominal lending and deposit interest rates.

Further analysis of the influence of individual factors on the interest rates and interest margins shows that within the total effective lending interest rate (14.7%p.a.) the premium for reserves for loan risks contributes with 3.1 percentage points, while taxation of the interest income contributes with 0.5 percentage points. Hence, the effective lending interest rate collected by the banks in 1997 (14.7%) is derived from the effective deposit interest rate (7.7% p.a.) increased by 0.5 percentage points for taxes, by 3.1 percentage points for reserves for loan risks, and by 3.4 percentage points as a real income for the bank. This calculation revises the view for the high level of the interest margins, because after the deduction of the premiums for taxation and reserves for risks, the effective net interest margin reduces by 50%, i.e. from 7.0 percentage points to 3.4 percentage points.

**Effective interest rates and effective interest rate margins**  
(in percent, on annual level)



In any case, in the last few years the interest rate policy in the Republic of Macedonia is inefficient and counterproductive, especially for the "healthy" part of the economy that pays high interest on time. Such an interest policy is also irrational from the banks' point of view, as in the existing conditions they have a relatively little room for a "maneuver" with the interest rates. Namely, the banks in the Republic of Macedonia manage to collect high nominal interest rates from a very small number of enterprises that pay their debts on time. Hence, the existing interest rate policy is adequate only for undisciplined borrowers, that are borrowing with "in advance" intention not to service regularly their liabilities.

The main reasons for formation and maintaining of extremely high nominal and real interest rates of commercial banks and for existing of high interest margin in the period 1996-1997 are the following: a/ low level of domestic saving; b/ high demand for financial resources which mostly arises from the big losses in the economy; c/ the existence of high lack of financial discipline by economic subjects; d/ inefficient work of the courts in resolving the financial disputes and payment of the mortgages; e/ high operative costs of the banking institutions, due to over-employment, insufficient technical equipment of the banks, poor variety of services, tax burden, low level of compulsory reserves remuneration, payment of high premiums to the insurance fund etc.

The long - run solution of the unfavorable situation in the field of interest rate policy necessarily means improvement of fundamental economic performances which determinate interest rate policy, and it is, first of all, the relation between supply and demand of resources, i.e. in the national identities the relation between saving and investments. The increase of saving in the Republic of Macedonia means returning the confidence of the population in the banking system (which includes also resolving of the problem of old foreign exchange saving) and achieving much more dynamic economic growth, for which a longer period of time is necessary.

However, in the short run, some measures can be undertaken which would have a positive influence on interest rate policy, and in the same time they would not disturb the main market principles, meaning banks independence in designing and implementing the interest rate policy. These measures are:

**1.** To revise the existing tax policy which has a negative influence on saving, and regarding this it is especially necessary:

a/ to reconsider the taxes on interest revenues - from the point of view of budget revenues, from the tax equality principle point of view, from the point of view of incentives for saving, etc.;

b/ to reexamine and avoid double taxation in the banking, such as the payment of turnover tax on the banks net revenues from interest (the difference between active and passive interest), which in the same time is the basis for making a profit which is also a subject of tax;

**2.** The increase of the interest rate which the National Bank of the Republic of Macedonia pays to the banks on the compulsory reserves, in order to decline the opportunity cost. The actual level of this interest rate of 3.4% at annual level, should be increased to around 6.3%;

**3.** Designing internal policies, procedures and standards by banks for credit approval, sound management of credit portfolio and more efficient claims collection;

**4.** Strengthening of the supervision regulation concerning provisions for bad placements of the banks, in order to stimulate their long-term orientation toward financing the profitable projects, which by their flows of funds will insure a regular servicing of the

liabilities. That means through the measures of prudential regulation to de-stimulate the approval of credits to loss-making enterprises, used for coverage (socialization) of the losses. In order not to disturb the market relation between banks and their clients, this should be done not by prohibition of credit extending to some firms, but through entirely removing of this kind of placements costs on the bank itself, by 100% allocation of reservations for this kind of placements. It would decrease unsound credit demand, which will make a room for market mechanism to press automatically toward declining of interest rate level.

**5.** To improve the efficiency of the juridical system and instruments for protection and insurance of the claims (collateral), so that the inclusion of high risk premium in the active interest rates would be avoided. For this objective, the possibility for foundation of a special court for financial disputes should be considered, that would record a detail evidence for debit and credit relations in the banking system, and would be specialized (regarding technique equipment and staff experience) for resolving the disputes from this area.

**6.** To revise the existing law regulation concerning the total amount of funds which the Fund for Insurance of deposits should attain in the term of four years from the foundation (15% of the saving deposits level), in direction of decreasing the amount on level of 5%-7% of total saving deposits. In the same time, the premiums paid in the Fund should also be revised, in direction of reducing the maximal premium to 2.0%-2.5% (at the moment the premiums are in the range of 1% to 5%);

**7.** Accelerating the activities for foundation of the credit register, by which a qualitative informational basis of data will be created which will enable banks for complete overview and monitoring of the financial situation of the borrowers. With this, the possibility of having unsound economic agents credit demands in the same time in more banks, would be eliminated. In addition, the "building up" of interest rates by these enterprises, which in the efforts to provide financial funds offer (and accept) unreal high interest rates, would be precluded;

**8.** The practice of "prime rate" formation to be entirely promoted, i.e. the subjects classified as first class debtors to be distinguished from the other debtors. For placements to more risky categories (subjects), commercial banks would increase their active interest rate for 2.0-3.0 percentage points on annual level;

**9.** Change of the operative procedures under the Law for foreign exchange operations, in the part concerning the coverage of the foreign exchange saving with liquid foreign assets (held in foreign banks), which is the basic reason for existence of the net outflow of accumulation from the Republic of Macedonia;

**10.** Stimulation of foreign capital inflow in the form of direct investments, by which the total supply of funds in the Republic of Macedonia will be increased. That means bringing of a new Law for foreign direct investments and elimination of administrative and regulative barriers in the accompanying laws relevant for this area ( first of all, in the Law for issuing and trading with securities).