

NATIONAL BANK OF THE REPUBLIC OF MACEDONIA



**Annual Report
1997**

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National Bank of the Republic of Macedonia

In 1997 the Republic of Macedonia continued the economic growth, started in 1996. The rate of gross domestic product real growth of 1.5%, although twice higher than in the previous year, was below expectations. However, it is very important that positive economic growth trend is retained, especially having in mind the difficulties which Macedonian economy faced in the first half of 1997.

Namely, in the first half of 1997 the unfavorable developments in foreign trade balance which started in 1996 were deepened, therefore the deficit in exchange of goods to abroad in the amount of USD 214.3 million surpassed the long term capital inflow in the country. In a situation when further short-term borrowing from abroad was impossible, the deficit was determined to be financed by decrease of the foreign exchange reserves of the monetary system on permanent basis.

In these conditions, exchange rate stability, as main objective of the monetary policy, was maintained in two ways: a/ by sale of foreign exchange on the foreign exchange market and decrease of foreign exchange reserves of the National Bank of the Republic of Macedonia. Thus, foreign exchange reserves in the first six months of 1997 decreased by USD 11.7 million, which was the amount of the net sale of foreign exchange by the Central Bank for maintaining the denar exchange rate and; b/ by automatic increase of the tightness of the monetary policy. Namely, according to adopted monetary strategy, the National Bank of the Republic of Macedonia did not neutralize the monetary effects of unissued reserve money on the basis of foreign exchange transactions, because of the possibility to endanger in that way the maintenance of the denar exchange rate stability. Such a policy, also characteristic for 1996, made it possible to maintain the exchange rate stability in the first six months of 1997, but at the same time necessitated too restrictive monetary policy.

The responsibility of maintaining a stable, but overvalued exchange rate in that way fell entirely upon the back of the monetary policy, causing loss of foreign exchange reserves, high and long term unsustainable monetary contraction and high real interest rates. Thus, the negative rates of money supply growth, which were for the first time registered at the end of 1996, were also retained in the first six months of 1997. At the end of June 1997 money supply M1 realized a negative annual rate of growth of 3.3%, while money supply M2 - denar in the same period realized a negative growth rate of 0.2%. In addition, the real lending rates of the banks were retained at a high level of over 20% on annual basis.

This situation definitively confirmed that the initially determined level of the denar exchange rate against Deutsche mark (27 denars for a Deutsche mark) is not the equilibrium one, i.e. maintaining overvalued exchange rate caused high and unsustainable economic cost. For these reasons at the beginning of July 1997 (09.07.1997) a onetime devaluation was undertaken, by which denar exchange rate was set up on the level of 31 denars for a Deutsche mark. Stability of the denar exchange rate at the newly established level was maintained without serious problems in the second half of the year, in conditions of excess foreign exchange on the foreign exchange market, improvements in the balance of payments and acceleration of monetary growth rates.

The effects of the devaluation regarding the restoration of monetary growth, revival of export and rebuilding foreign exchange reserves became evident in the first months after the correction of the domestic currency value. However, the effects of the devaluation, especially upon export, are not entirely drained, so that the improvement of price competitiveness of the Macedonian economy is expected to be performed with certain time lag, i.e. in the first half of 1998. Expectations in this direction are based on the fact that the nominal devaluation degree (16.1%), meant a degree of real denar devaluation, having in mind that correction of domestic currency value was accompanied by adequate measures in income policy, by which wages of employees in all not completely privatized enterprises were practically "frozen". Nevertheless, it should be taken into consideration that the slow character of regaining confidence in saving and in the banking system on one hand, and the need for investment intensification on the other, will determine continuation of structural imbalance between saving and investments in the following years. Thus, the high level of the deficit in current account of the balance of payments of the Republic of Macedonia will be retained.

It is of vital importance that in spite of the corrected external value of the domestic currency, its internal value in 1997 remained stable, which is its main characteristics over the past three years. With an inflation rate time series of 9.2%, 0.2% and 4.5% in the last three years, the Republic of Macedonia, according to the price stability criterion, is among the most successful countries in transition and very close to the developed industrial countries. Permanent maintenance of low and stable inflation rate as long-term policy makers' orientation, is certainly the most favorable macroeconomic environment for reviving the investment activity and accomplishing dynamic economic growth.

In 1997, the fiscal policy continued its adjustments towards compliance of the size and structure of revenues and expenditures with the needs of the country at the attained level of development. Because of the drop in revenues in the first half of 1997 due to the deteriorated liquidity and profitability of the economic subjects, in the middle of 1997 some measures for further budget expenditure reduction and revenue collection improvement were undertaken. Realization of these measures enabled the maintenance of the 1997 public sector deficit at low level of 1.8% of GDP, which is very important according to the Maastricht criterion. Sound fiscal policy, besides being indispensable factor for reducing the balance of payments deficit, also takes part in the process of projected tightening of the public sector role and expanding the scope of the private sector operations, as a long-term strategy.

By all means, the transition process brings numerous temptations and social expenditures, among which the most apparent in the Republic of Macedonia are the high unemployment problem and the low living standard of the population. Solving these problems, as well as their generating, is a long-term process whose dynamics can be hastened by hastening the structural reforms in the companies, higher wage flexibility, labor market reforms, saving reaffirmation as a factor for domestic investment reviving, more aggressive and more organized presentation for attracting foreign investors, etc. In alleviating these problems, the inflow of foreign funds for structural adjustment and private sector development has had positive influence, for which purpose in 1997, USD 18.4 million were withdrawn from the International Bank for Reconstruction and Development and USD 8.4 million were withdrawn from the European Bank for Reconstruction and Development for small and medium size enterprises' development. There are credit funds, left to be withdrawn in the next year, for private sector development, based on the current, as well as on new credit arrangements.

During 1997, the enterprises restructuring process, which is the key element for the success of the post privatization reforms, evolved slowly. Due to the insufficient level of domestic accumulation and indigent foreign capital inflow in form of direct investment, in 1997, the defensive way of enterprises restructuring continued, and it consisted mostly of firing the outnumbered workers. This has resulted in increasing unemployment, with simultaneous increase

of the bankrupted enterprises and inter-enterprise arrears. That implies the need in this domain, in which in 1997 was done less than expected, for more intensive engagement in order to compensate for what was omitted and to catch the pace with more developed countries in transition.

Problems which started or continued to be solved in 1997, and still remain open for the next period, can be connected with the problem of capital increasing and banking system modernization. It is expected that these problems will be solved with the forthcoming entering of several foreign financial institutions in the Republic of Macedonia, which at the same time will provide increased competition in the banking system. In order to regain depositors' confidence and create more solid and more liquid banking institutions, Deposit Insurance Fund (March 1997) and Inter-bank Money and Securities Market (November 1997) were established. In that way the Republic of Macedonia almost entirely completed its own financial system, whose solid base and functioning are main prerequisites for achieving permanent economic development.

Skopje, April, 1998

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Governor and President of the National Bank
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I. World economic developments

For the world economy, 1997 was a year of a relatively high growth, as according to the projections, the annual growth rate is expected to be 4.1%. That was identical with the previous year's increment which means consecutive exceeding of the average world output for the period 1970-96. The continuity of the global economic expansion is a result of the widely accepted approach for inflation reduction and achieving price stability, growing efforts for fiscal consolidation, and maintaining the exchange rates of the leading world currencies within the frameworks of the levels determined by the economic principles. These are the factors that can make the global economic growth sustainable, even on a long-term basis. All groups of countries made their own contribution in the 1997 world output growth, although it was not identical.

Table 1
International economic indicators

	GDP real increase in %			Inflation (retail price increase in %)			Unemployment in %			Current account of balance of payments in billion USD		
	1995	96	97	1995	96	97	1995	96	97	1995	96	97
Developed countries	2.5	2.7	3.0	2.5	2.4	2.2	7.3	7.3	7.1	37.0	16.1	19.2
European Union	2.5	1.7	2.6	2.9	2.5	1.9	11.2	11.4	11.1	52.6	86.4	88.8
USA	2.0	2.8	3.8	2.8	2.9	2.4	5.6	5.4	5.1	-129.1	-148.2	-176.1
Germany	1.9	1.4	2.3	1.8	1.5	1.9	9.4	10.3	11.3	-	-	-
Japan	1.4	3.5	1.0	-0.1	0.1	1.6	3.1	3.3	3.4	111.4	65.8	98.9
Countries in transition	-0.8	0.1	1.8	119.0	40.0	32.0	-	-	-	-3.3	-18.4	-24.1
Central and Eastern Europe	1.6	1.5	2.1	70.0	32.0	41.0	-	-	-	-6.1	-17.2	-22.3
Developing countries	6.0	6.5	6.2	22.7	13.2	10.0	-	-	-	-94.5	-80.7	-87.1

Source: IMF, World Economic Outlook (October 1997, December 1997), previous data

In 1997, the group of *developed countries* was characterized by economic performances similar to those from the previous year. It is expected the stable increase of the real GDP to continue and reach 3.0%, which is a 0.3 percentage points increase when compared to 1996. Savings reached the level of 21.3 percent of GDP and continued their increasing trends. Investments increased as well (21.0 percent of GDP), while private investments increased their share for the account of public investments. The output increment of the developed countries was supported by further inflation reduction, and the inflation is estimated to average 2.2%. This means that maintaining price stability remains high priority task. Modest decrease of the unemployment rate was expected in 1997, which would lead to a 7.1% average unemployment rate. In terms of fiscal consolidation, in the group of developed countries a consensus for the need of "balanced budget" is made, motivated by the idea to create fiscal scope that will allow to cover future expenditures associated with the population aging process. In 1997, developed countries had a surplus in the current account of their balance of payments, which is expected to be up to USD 19.2 billion. Compared to the previous year, surplus increased by USD 3.1 billion (or 19.3%), but still represents almost half of the level achieved in 1995.

In 1997, economic performances within the group of developed countries varied considerably from country to country. The United States are reaching the mature phase of

their economic expansion, with an unprecedented low unemployment rate. But, the possibility of "overheating" the economy still exists, as well as the need for determining the moment of possible monetary "tightening". Japanese economy was unpleasantly hurt by the developments in their financial sector and in the economies in the region. The largest continental countries, members of the European Union commenced a process of economic recovery, which is still not big enough to evaluate their economic performances in 1997 as satisfactory. One of the major problems is the very high unemployment rate, which is close to the highest postwar level (over 11%). Like in the previous year, most of the unemployment in 1997 (8%-9%) is structural by its nature, which initiates the need for complex reforms for its reduction. The unfavorable situation on the labor market was accompanied by continuing efforts for budget consolidation of the European economies in order to meet the Maastricht criteria for fiscal convergence of the member countries. The fiscal consolidation and the lack of decisive measures for overcoming the structural unemployment in 1997, created uncertainties about the future developments in the European Union, which adversely affected corporate sector's investment activities.

In 1997, *developing countries* continued their vigorous economic expansion from the previous years. The economic growth rate is expected to reach 6.2%, which is a slight slowdown when compared to the previous year (6.5%). This was achieved under established macroeconomic stability, through improvement of macroeconomic discipline, continuing efforts for carrying out the structural reforms and conducting prudent fiscal policy. Savings and investments rates were 27.1% of GDP and 29.1% of GDP, respectively, which means that they maintained their high level in spite of the slight fall compared to the previous year. It is estimated that in 1997, compared to the previous year, developing countries additionally reduced the inflation rate for 3.2 percentage points and brought it down almost to a single digit inflation (10.0%). Deficit in the current account of the balance of payments in the developing countries is estimated to amount USD 87.1 billion, which is USD 6.4 billion increase when compared to 1996. From a regional point of view, a developing country with intensive and remarkable economic expansion in 1997 is China, which at the same time has low inflation rate. Improved economic performances in 1997 are expected especially in the developing countries in Latin America, and slightly less impressive in Middle East countries, European and African countries.

In 1997, *countries in transition* were characterized by a revival of their economies. It is estimated that this is the first year of their positive growth, with real GDP growing at 1.8%. Savings continued their downward trend and were brought to 18.6% of GDP. At the same time, investments fall was stopped, and for the first time in this decade, they increased, while their share in GDP was 22.1%. Central and Eastern European countries in transition, excluding Russia, and Central Asian countries continued their inflation reduction trend. The average inflation rate for 1997 is expected to be 41.0%. Simultaneously, the deficit in the current account of the balance of payments was increased and reached the level of USD 24.1 billion. This is a 31.0% increase compared to the deficit in 1996. It is important that economic reforms in Russia in 1997, finally resulted in diverting the declining economic trend into a positive direction.

In 1997, countries in transition from Central and Eastern Europe, excluding Russia, accomplished higher increase of the real GDP (2.1%) than the average for the group of countries in transition as a whole (1.8%). This is a result of the efforts for successful completion of the already started structural reforms, and within the integration process with the European Union, an effort to set closer economically to the member countries of the Union. The inflation rate in 1997 in Central and Eastern European countries in transition, excluding Russia, was maintained at a moderate level (41.0%), which needs additional reduction. At the same time, the deficit in the current account of the balance of payments is increased and is expected to reach USD 22.3 billion. The

trend of maintaining a relatively high level of direct investments is continued. In general, 1997 economic performances of the countries in transition from Central and Eastern Europe indicate that a satisfactory level of macroeconomic stability is achieved. In addition, some countries achieved better results (Poland, Hungary, Slovenia, Czech Republic), while others (Albania, Bulgaria, Romania) have considerably slowed down the transition process, due to the incomplete institutional framework of the economic system and the problems with the financial sector inefficiency.

II. Real sector developments in the Republic of Macedonia

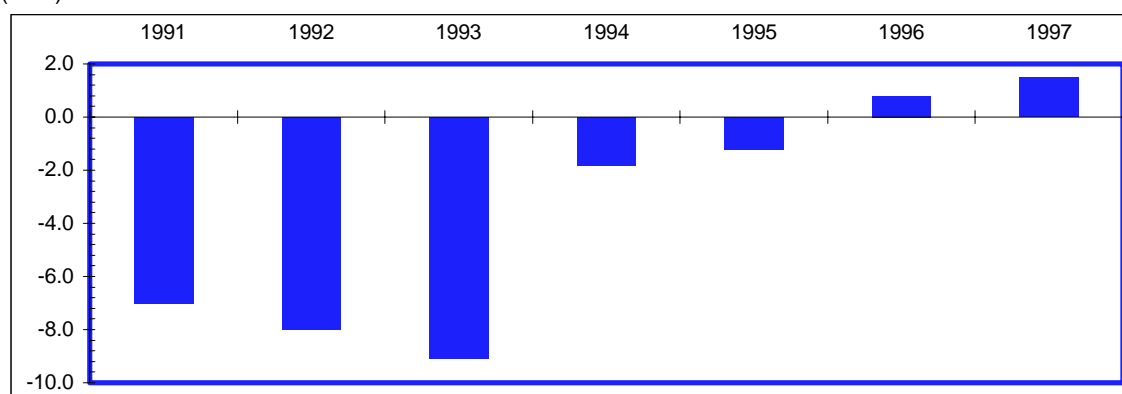
2.1. Gross Domestic Product

In 1997, real gross domestic product of the Republic of Macedonia increased by 1.5%, which is two times higher growth rate than the one in 1996. Still, this achievement is considerably below the projected real gross domestic product growth rate of 5.0%.

Chart 1

Real gross domestic product

(in %)



Achieving lower economic growth in 1997 than expected comes as a result of the poor economic performances in the first half of the year. The exchange rate of the denar against the Deutsche mark being overvalued (since 1994 - 1995), led to a diminished international competitiveness in the second half of 1996 and in the first six months of 1997, and to lower export increase than expected, which supposed to be main generator of the economic development. Unfavorable results in foreign trade had negative impact on the foreign exchange market, where the supply was considerably lower than demand. With the exchange rate targeting strategy being implemented, there was a need for Central Bank interventions for defending the exchange rate, which automatically resulted in a restrictive monetary policy. Such situation caused a decline in the global liquidity, which accompanied with the relatively slow restructuring of the enterprises resulted in a lower output than expected. High interest rates of the banking sector also made big impact in that direction, and they did not stimulate healthy and profitable enterprises to take new credits, which resulted in keeping the investment at a low level.

After the devaluation of the denar against the Deutsche mark, in the second half of 1997 monetary growth was normalized, global liquidity was improved and money demand from the enterprises was revived. That created good conditions for normal evolving of the reproduction process, which enabled a moderate real gross domestic product growth rate of 1.5%.

From the structural point of view, the achieved real gross domestic product growth in 1997 was a result of the trade increase (by 8.9%) and agriculture and fishing increase (by 7.3%), whose share in the gross domestic product is 11.5% each. Increase in the output was also achieved in industry (1.3%), which share in the gross domestic product is 19.2%. On the other hand, the largest decline was realized in construction (by 6.1%).

2.2. Domestic output

In 1997 the industrial output in the Republic of Macedonia was lower than projected. In the period January - December 1997, industrial output increased by 1.6%, compared to the same period last year, which is a deceleration of the last year's average annual growth rate of 3.2%.

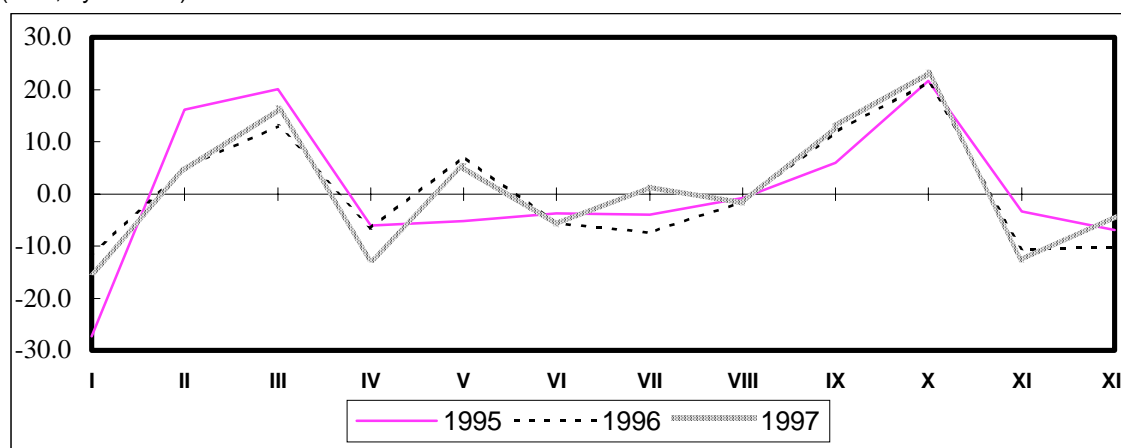
In respect of dynamics, the first half of 1997 was characterized by cumulative decrease of the industrial output by 10.6%. Nevertheless, in the second six months of the year, with the monetary policy conditions being relaxed, the industrial output increased by 15.7%.

From a structural point of view, total industrial output growth in 1997 compared to 1996, was a result of the increased production of consumer goods by 5.8%, whose share in the industrial output structure is 43.1%. On the other hand, production of means of production and production of reproduction materials in the same period, declined by 1.0%, and by 0.7%, respectively.

Chart 2

Industrial output

(in %, by months)



In addition, in 1997, industrial output increased in eighteen¹ of the total number of thirty two branches. In 1996, there were only eleven branches achieving positive industrial output growth. In 1997, the most significant growth was achieved in the production of basic chemical products (22.0%), processing of chemical products (17.4%), black metallurgy (15.6%) and production and processing of tobacco (14.3%). At the same time, the biggest industrial output decline was registered in oil derivatives production (40.1%), leather and fur production (29.7%), machinery (22.7%) and production of wooden products (20.1%).

After the decline registered in the previous year, agriculture output in 1997 realized positive growth rate. Thus, in 1997 agriculture output increased by 3.8%, which encouraged the economic growth in the national economy. The highest increase was achieved in wine-growing (30.8%). This increase of the agriculture output in 1997 was due to better organized product purchase, as well as higher export in the countries with free trade agreement with the Republic of Macedonia.

¹ Their share in the structure of the total industrial production is 75.5%.

2.3. Labor market

The trend of permanent decline of the employed persons continued in 1997. Such a movement was due to the defensive way of enterprises restructuring which resulted in firing the outnumbered workers. Accordingly, expectations that economic revival in 1996 and 1997 will cause a decline in the unemployment, fell short. This confirms the structural character of the unemployment, which accompanied with the cyclic factor determines high unemployment level during the transition period.

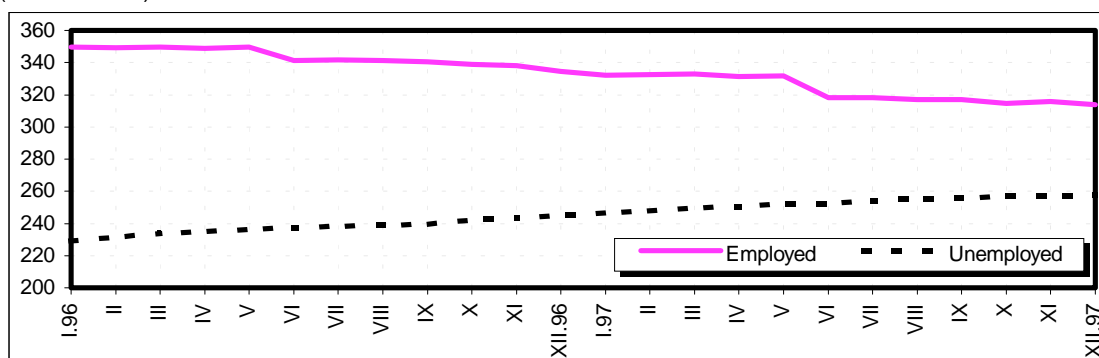
At the end of December 1997, the number of employed persons amounted to 313,808, or 6.7% less than in December 1996. This indicates a more intensive decline of employment compared to 1996, when the decline was 4.5%. Structurally observed, the decline of employment in the economic sector was more intensive than in the non - economic sector. At the end of December 1997, the economic sector employed 229,241 persons or 8.8% less than in December 1996. At the end of 1997, in the non - economic sector 84,567 persons were employed, which is 0.3% less than of the end of the previous year.

The unemployment increasing trend continued in 1997 as well. At the end of December 1997, 257,666 unemployed persons were registered, which is an increment of 12,571 persons or 4.9%, on annual basis. According to the results of the Labor Force Survey² for 1997, conducted by the Statistical Office of the Republic of Macedonia, the number of active population amounts to 800,513 persons, and the unemployment rate³ is 36.0%. In order to solve this problem, a Law for Employment Increment has been passed. According to this new law, employers are exempted from paying any contributions and personal income tax and these expenditures will be taken over by the Government for two years for any new employee hired in addition to the current number of employed persons. This law came into force at the beginning of 1998.

Chart 3

Employed and unemployed in the Republic of Macedonia

(in thousands)



With the employment being reduced, real economic growth of 1.5% is a result of the increased labor productivity by 8.8% in 1997, compared to the previous year. Labor productivity growth, and the moderate real wages increase of 0.2% contributed for the unit labor cost to decline by 8.6% in 1997. That certainly will affect the future competitiveness of Macedonian enterprises.

² The Survey was carried out in the period from April 21, 1997 to April 27, 1997, in 7,200 households in the whole country, excluding Debar.

³ The unemployment rate is calculated as number of unemployed persons share in the total labor force.

2.4. Domestic Consumption

2.4.1. Public revenues

In 1997, total amount of denar 65.3 billion was collected for financing the public consumption in the Republic of Macedonia. Projected budgets and social funds public revenues for 1997, after the supplementary budget in October 1997, amounted to denar 62.7 billion. Projected public revenues were exceeded by 4.1%. These results are due to the strengthened financial discipline after the changes in the Law on Financial Operations (which came into force in July 1997), which led to improved collection of the personal income tax and social security contributions.

Structural analysis confirms this, clearly showing that more regular collection of the total public revenues in 1997 is a result of the increased collection of the social funds revenues, while the budget revenues decreased. Thus, in 1997 budget revenues amounted to denar 38.6 billion⁴, which is 5.2% lower than in the same period of the previous year. In addition, the budget revenues diminished their share in total public revenues structure from 62.4% in 1996, to 59.1% in 1997. Among main budget revenues, slight increase was registered in the sales tax revenues collection, while collection of all other revenues decreased. Thus, in 1997, from the *sales tax* a total amount of denar 8.8 billion was collected, which is 0.2% more than in 1996. Collection of projected sales tax revenues is a result of the diminished tax evasion in the second half of 1997, because of the strengthened control over the tax payers. On the other hand, the most significant decrease in 1997 is registered in the *income tax* revenues. Collected revenues from this tax in 1997 amounted to denar 1.3 billion which is 36.1% less than the previous year. That is a result of the income tax rate reduction from 30% to 15% in the beginning of 1997, and the deteriorated profitability of the domestic enterprises. Substantial decline is registered in the *custom duties* revenues, the collection of which in 1997 amounted to denar 5.6 billion, or 15.9% less than the previous year. Such a custom duties revenue collection is due to the free trade agreements with FR Yugoslavia, Slovenia and Croatia. *Excise* revenues in 1997 amounted to denar 11.7 billion, which is 2.2% lower collection compared to 1996. Within the main budget revenues, *personal income tax* revenues in 1997 amounted to denar 9.1 billion, which is 0.4% less than in 1996.

Table 2
Budget revenues
(in million denar)

	January - December		Indices 97/96	Structure in %	
	1996	1997		1996	1997
Total Budget revenues	40,682	38,565	94.8	62.4	59.1
- income tax	2,025	1,294	63.9	5.0	3.4
- personal income tax	9,175	9,134	99.6	22.5	23.7
- sales tax	8,818	8,831	100.2	21.7	22.9
- excise	11,936	11,679	97.8	29.3	30.3
- tax to non-residents	4	4	100.0	0.0	0.0
- property tax	530	564	106.4	1.3	1.5
- dues	1,169	1,228	105.0	2.9	3.2
- custom duties	6,658	5,597	84.1	16.4	14.5
- other revenues	370	233	62.9	0.9	0.6

Compared to 1996, the main budget revenues share in the total budget revenues changed in 1997. Thus, personal income tax revenues and sales tax revenues share increased identically by 1.2 percentage points, while the excise revenues increased their

⁴ Data source: Payment Operations Bureau of the Republic of Macedonia.

share by 1.0 percentage point. At the same time, custom duties revenues and income tax revenues decreased their share in the total budget revenues by 1.9 and 1.6 percentage points, respectively.

In 1997, social funds revenues amounted to denar 34.9 billion.⁵ In respect of dynamics, revenue collection was accelerated in the second half of the year, due to the changes in the Law on Financial Operations. Revenue collection in the second half of 1997 amounted to denar 19.4 billion or 25.3% more than the collection in the first half of the year. From a structural point of view, the largest part of the revenues was collected through the Pension Fund, which share in the structure of the total revenues is 59.2%. In 1997, in this fund denar 20.7 billion were collected, of which the largest part (68.9%) comes from the wage taxes. In this fund, in the second half of the year, denar 11.2 billion were collected, or 17.7% more than in the first six months. Revenue collection in the Health Insurance Fund in 1997 amounted to denar 10.3 billion. The largest part of the collected revenues came from the health insurance taxes (65.6%). The collection in the Employment Fund in 1997 amounted to denar 4.0 billion. Structurally, most of these funds came from the Central Government budget transfers (74.8%) and from the contributions in this fund (24.9%).

2.4.2. Public expenditures⁶

In 1997 total budget expenditures (Central Government Budget and Local Government Budgets) amounted to denar 41.4 billion. Compared to 1996, 1997 budget expenditures were lower by denar 1.3 billion, or by 3.1%, which indicates a higher restriction on the expenditure side of the Budget. In 1997, 93.2% of the budget expenditures were covered by budget revenues.

The largest part of the budget expenditures refers to current expenditures, for which denar 36.9 billion were spent, i.e. denar 1.3 billion (3.7%) more than in the previous year. From a structural point of view, current expenditures increase was determined by the increased expenditures on interests and by the increased transfers. The budget transfers in 1997 amounted to denar 15.3 billion, or 4.9% more, compared to 1996. Interests expenditures came from the interests on foreign debts and in 1997 this item amounted to denar 1.7 billion, which is 1.6 times more than in the previous year. Expenditures for goods and services were the only category having a decline. In 1997, from the budget, denar 20.0 billion were spent for this category, which is 0.1% less, compared to the previous year. Although this is a category with the highest share in the structure of the total expenditures (54.1%), it does not neutralize the total current expenditures increase. Within this category, the largest portion of the 1997 expenditures was made for wages and salaries. For this purpose denar 15,148 million were spent, which is 0.6% less than the spending in 1996.

In spite of the higher current expenditures, capital expenditures and net lending in 1997 were lower than the respective ones in the previous year. In the analyzed period, this category reached the amount of denar 2.5 billion, i.e. 1.7 times less than in 1996. Sectors with the highest share in this expenditures category were the fixed assets investments (51.6%) and railroad investments (44.8%).

In 1997, total social funds expenditures in the Republic of Macedonia amounted to denar 34.5 billion. They were by denar 0.4 billion or 1.1% lower than the social funds

⁵ Data source: Ministry of Finance.

⁶ Data source: Ministry of Finance.

revenues, which emphasizes their complete coverage by the revenues. The Pension Fund has the most significant role among the social funds with a share of 58.4% in the structure of the total social funds expenditures. In 1997, this fund's expenditures amounted to denar 20.1 billion, which is denar 0.5 billion or by 2.6% lower than this fund's revenues. The largest share of the expenditures (denar 17.3 billion or 86.1%) was used for pensions payments. In 1997, Health Insurance Fund expenditures amounted to denar 10.4 billion, and they were by 0.9% higher than this fund's revenues. Structurally analyzed, the largest share of the expenditures was aimed for the purpose of ambulance expenditures (36.6%) and hospital treatment (35.8%). In 1997, Employment Fund spent denar 4.0 billion, which is by 0.2% more compared to the collected revenues in this fund. Ninety-six percent of the expenditures were used for unemployment benefits health insurance contributions and pension contributions for unemployed persons.

2.4.3. Investments

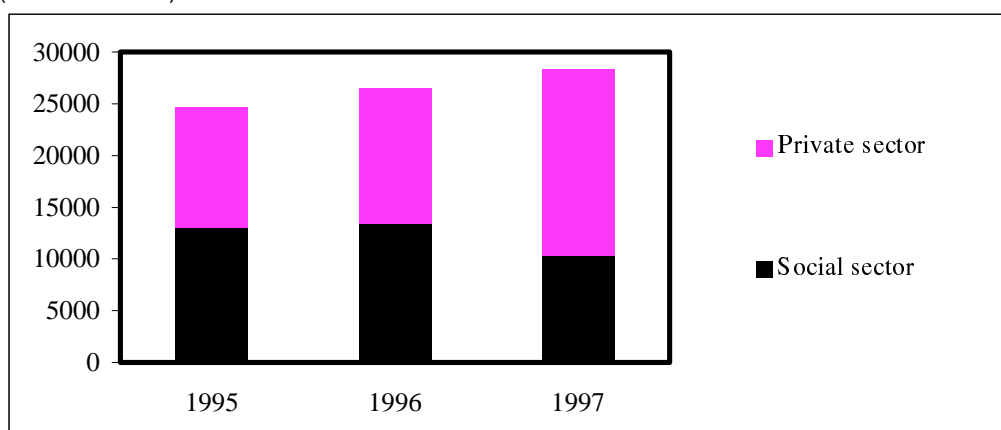
In 1997 fixed assets investments rising trend continued with almost identical dynamics as in 1996. In the period January - December 1997 denar 28,333 million⁷ were invested in fixed assets, which is by 7.0% more, compared to the previous year. In real terms, fixed assets investments were increased by 4.3%. Investments share in gross domestic product in 1997 was 17.1%, against 15.4% in 1996. Still, such investment level is low and insufficient for considerable acceleration of the economic growth.

The low investment level is a result of: a/ insufficient accumulation determined by the poor financial results of the enterprises; b/ discouraging influence of banks' high interest rates, which emerge from the extremely low domestic saving in the banking sector, inefficient operation of the judicial system, lack of financial discipline, high operational costs of the banks; and c/ insufficient foreign capital inflow in the form of direct investments.

Chart 4

Investments in the Republic of Macedonia

(in million denar)



Observed by sectors, in 1997, social sector investments in real terms decreased by 25.0%, while private sector investments in real terms increased considerably by 34.0%. This indicates the evolving role of the private sector in the total economic activity in the country.

⁷ Estimation of the Statistical Office of the Republic of Macedonia.

From structural aspect, the most significant investment increase in real terms is realized in industry and mining (12.1%), transport and communications (3.3%) and housing and public utilities (2.3%), which aggregate share in the structure of the total investments is 69.9%. At the same time, the highest decline is noticed in forestry (2.5%) and construction (1.6%).

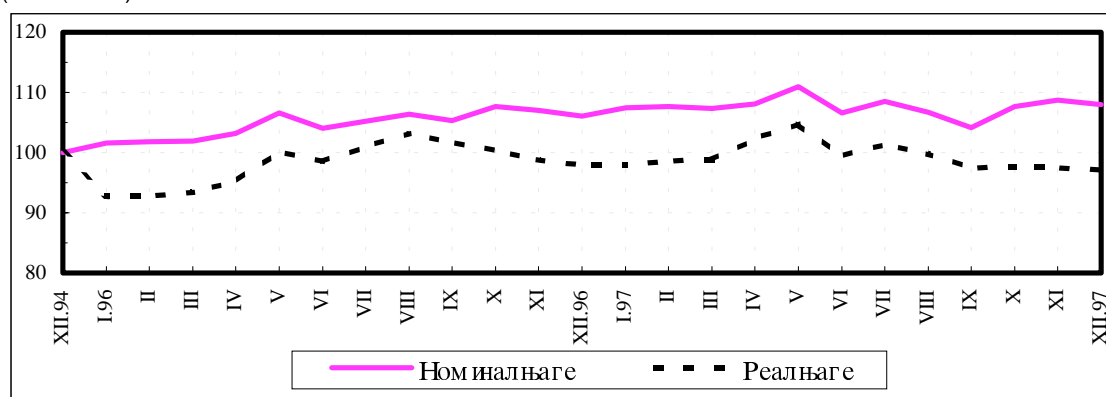
2.5. Wage policy

Main purpose of the income policy in 1997 was further control over wages, which is significant item in the enterprises total cost structure. In that respect the Law on Modifications and Amendments to the Law on Wage Payments was passed as an additional measure to the devaluation of the exchange rate of denar against the Deutsche mark in July 1997. With this law, wages were "frozen" on the level before the devaluation for all legal subjects except for the entirely privatized ones. Thus, stronger control over wages and private consumption, as a component of the aggregate consumption was established and cost inflation was prevented. Simultaneously, wide appearance of the positive effects of the devaluation was enabled.

In the period January - December 1997, the average net paid wage per worker amounted to denar 9,063, and it is by 2.8% higher in terms of the same period last year. The increase of the average nominal wage of the economic sector (3.7%) was higher than the one in the non-economic sector (0.3%).

Chart 5

Average paid net wage per worker (XII.94=100)



In real terms, average net wage in the period January - December 1997 amounted to denar 8,833, which is 0.2% increase in comparison to 1996. That is a result of a wage increase in the economic sector by 1.1%, while the wages in the non-economic sector decreased by 2.2%.

The comparison of the average net wage on December level indicates the nominal growth by 1.8% in December 1997 compared to December 1996. Wages in the economic sector increased by 2.5%, while wages in the non-economic sector remained on the December 1996 level. Average net paid wage in real terms in December 1997 was by 0.9% lower compared to the same month last year, primarily as a result of the wage decrease in the non-economic sector (by 2.6%), compared to the slight decrease registered in the economic sector (by 0.2%).

2.6. Prices

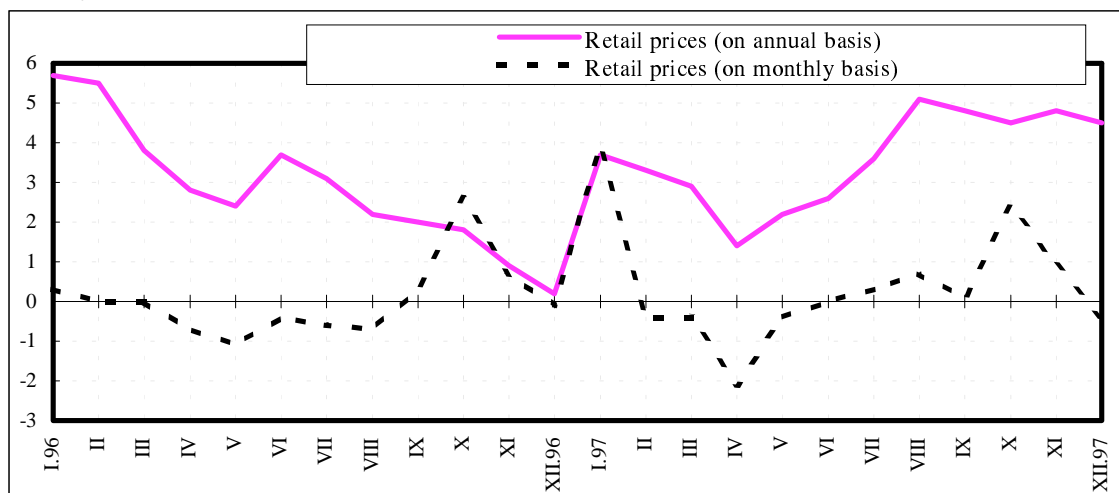
In spite of the devaluation of the denar in 1997, the established permanent price stability was maintained, which provided favorable long-term macroeconomic environment for dynamic economic growth. Price stability is a result of the coordinated efforts of monetary, fiscal and income policy. In 1997, the inflation rate on December basis amounted to 4.5%, which is 0.5% percentage points lower than the projected retail price increase. The average retail price increase in 1997 was also in the expected frames and amounted to 4.4%. Herewith, the Republic of Macedonia (together with Croatia) realized the lowest inflation rate in 1997 among the countries in transition. The seasonally adjusted inflation rate in 1997 amounted to 3.2%.

In respect of dynamics, restrictive monetary policy in the first six months of 1997 drained the economic subjects liquidity that together with seasonal factors, contributed to the deflation, registered in several months of the first half of the year. Deflation was registered in five months of the year, and in four of them (February, March, May and December), identical monthly deflation rate of 0.4% was realized. The highest monthly deflation rate was noticed in April (2.1%), due to seasonally determined implementation of lower tariff on electricity price. After the devaluation, prices moderately increased in the second half of the year, but they did not slip out of control, primarily as a result of the prudential measures in the income policy. Thus, the spiral wages-prices-wages was not activated.

Chart 6

Retail price changes

(in %, by months)



From the structural point of view, in 1997 compared to the previous year, the prices of agricultural products showed the most significant increment (by 19.3%), due to the decreased supply of these products on the Macedonian market, especially after signing free trade agreements with FR Yugoslavia, Slovenia and Croatia. Prices of services considerably increased as well (by 9.4%), while the industrial products prices slightly increased (by 0.6%).

Producer price index increased by 8.6% on December basis. In the period January - December 1997 compared to the same period last year, the prices of producers of industrial products increased by 4.2%. The increase is a result of higher prices in all three components: reproduction materials (5.3%), means of production (4.2%) and consumer goods (2.8%). Relatively high increase of the producer prices is logical consequence of the dearer imported products, after the devaluation of the denar in the middle of 1997.

Costs of living on annual basis (December 1997 / December 1996), increased by 2.7%, i.e. they followed the retail price dynamics. The comparison with the last year average costs of living, indicates on the dearer consumption basket in 1997 by 5.7%. In terms of dynamics, the highest cost of living increase (October, 3.1%) and decrease (April, 2.7%) is a result of the seasonal tariff changes of electricity price. In the other months of the year, costs of living maintained the stable level.

III. Monetary Policy

3.1. Monetary policy objectives

For 1997 an ambitious macroeconomic program was designed, the main objective of which was to foster the economic growth in the Republic of Macedonia, i.e. to achieve a real GDP growth of 5.0%. In order to intensify the structural reforms, without threatening the already accomplished price stability, a coordination of the measures of the monetary, fiscal and wage policy was insured.

The basic objective of the monetary policy within the macroeconomic program was to maintain the inflation rate on a low, stable and predictable level, where the annual inflation rate for 1997 was projected at a 2.0% level. Basic intermediate target of the monetary policy was to maintain de facto fixed denar exchange rate against the Deutsche mark. At the end of 1996, it was estimated that the denar exchange rate against the Deutsche mark was on equilibrium level.

In realizing the monetary policy objective for 1997, the National Bank of the Republic of Macedonia continued with the implementation of the denar exchange rate targeting strategy. Thus, the movement of the money supply in 1997 was endogenous variable, i.e. it was subjected to maintaining the stability of the nominal denar exchange rate against the Deutsche mark. In case of shortage of foreign exchange on the foreign exchange market, the determination was to balance the supply and demand on the foreign exchange market through automatic tightening of the monetary policy.

The increase in the nominal money supply M1 was projected to be 9.1% in 1997, based on the assumptions for the existence of an equilibrium denar exchange rate against the Deutsche mark, projected increase in the real GDP, projections for the inflation rate and for the autonomous increase in the money demand. In accordance with the balance of payment projection, it was expected that the monetary policy of the National Bank of the Republic of Macedonia will be implemented with supply of foreign exchange prevailing on the foreign exchange market, so that the Central Bank will undertake net purchase of foreign exchange on the foreign exchange market in amount of USD 29 million.

Table 3

Projection of basic real and monetary variables for 1997

(in %)

	First projection	Revised projection
1. Inflation	2.0	5.0
2. Gross Domestic Product	5.0	5.0
3. Reserve Money	10.0	8.0
4. Denar Credits	14.9	19.6
5. Money Supply M1	9.1	9.5
6. Excess foreign exchange on the foreign exchange market (changes in million USD)	29.0	8.0

But, the realization of the macroeconomic policy in the first half of 1997 showed that the assumption for the monetary policy being implemented in conditions of excess foreign exchange existing on the foreign exchange market and the assumption for the denar exchange rate against the Deutsche mark being in equilibrium, were not real.

Contrary to the expectations, in the first six months of 1997, a foreign exchange shortage on the foreign exchange market existed, which led to the National Bank interventions by net selling of foreign exchange in amount of USD 11.7 million, in order to defend the targeted denar exchange rate against the Deutsche mark. Consequently, instead of increase in the monetary aggregates, there were monetary contraction and decrease in the global liquidity which resulted in high interest rates. This type of monetary policy led to deflation and was not aimed at supporting the economic growth. Moreover, a need for revision of the monetary policy objectives and targets appeared, as a result of which on the 9th of July 1997 the denar exchange rate against the Deutsche mark was devaluated by 16%, in order to correct its overvalued level. The change of the denar exchange rate was aimed at removing the deflationary influence of the monetary policy, normalizing the monetary growth, enabling increase of the foreign exchange reserves and bringing the liquidity of the economy to the needed level.

The projected inflation rate, as a target of the monetary policy, was revised from 2.0% to 5.0% p.a. That means that even though there was devaluation of the denar exchange rate, the economic policy was consistent with the maintaining of the price stability as a long-term objective, because there was intention to provide for a real devaluation of the denar exchange rate against the Deutsche mark of about 10.0% in order to improve the country competitiveness against the international markets. As a follow up, the devaluation was supported with measures from the fiscal and wage policy. The change in the inflation target determined the revision of the monetary variables projection, where the increase of the money supply M1 was estimated to be 9.5% (December 1997/December 1996).

3.2. Monetary developments in 1997

The monetary policy objective in 1997, to maintain the inflation rate at utmost 5.0% (December 1997/December 1996), was accomplished. The increase in the costs of the imported goods after the devaluation of the denar exchange rate was not completely transferred in the domestic prices, because frozen wages did not allow the creation and development of the spiral prices - wages - prices. Because of that, an inflation "strike" did not occur and the inflation rate at the end of 1997 was 4.5% p.a. (December 1997/December 1996). Thus, the inflation remains low and stable, by which the Republic of Macedonia is one of the leading economies in the Central and Eastern Europe transition countries group.

Basic intermediate target of the monetary policy of the National Bank in 1997 was maintaining the regime of de facto fixed denar exchange rate against the Deutsche mark. The expectations were that the realization of this target, in a small and open economy as it is the case with the Macedonian economy, will indirectly contribute to the maintaining of the price stability on low level. During 1997, there was only one change - the devaluation in July, because before and after it the nominal denar exchange rate against the Deutsche mark was maintained at the, for the time being, targeted level. Having in mind the reasons for changing the denar exchange rate, as well as keeping the new exchange rate unchanged until the end of the year, one may say that this target of the monetary policy was also realized. The degree of the denar exchange rate devaluation was balanced enough to achieve the expected effects until the end of 1997, without causing destabilization of the prices and rise in the inflationary expectations.

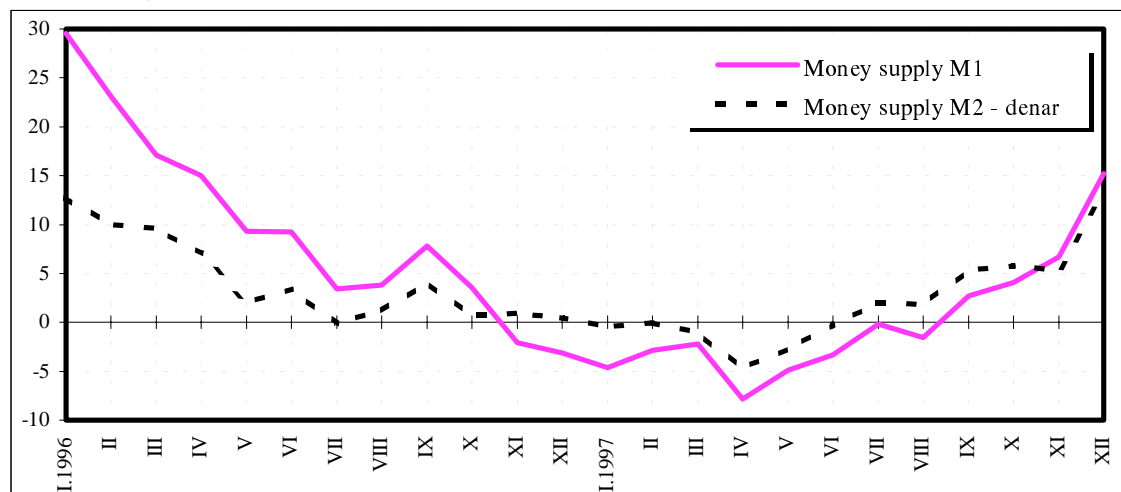
In 1997 the money supply M1 was increased by 15.2% p.a. (December 1997/December 1996), which exceeded the projection by 5.7 percentage points. At the end of November 1997, the level of the money supply M1 was within the projected one, while the exceeding at the end of the year was the result of: a/ an extremely high increase of currency in circulation in the last month of the year; b/ exceptionally low December

1996 level of M1, which makes the comparison inappropriate. Having in mind the trend of negative annual rates of increase of the monetary aggregate M1 realized in the first eighth months of the year, one may conclude that the normalization of the monetary growth was achieved after the devaluation (with time lag of one month).

Chart 7

Money supply M1 and Money supply M2-denar movements

(in %, annually)



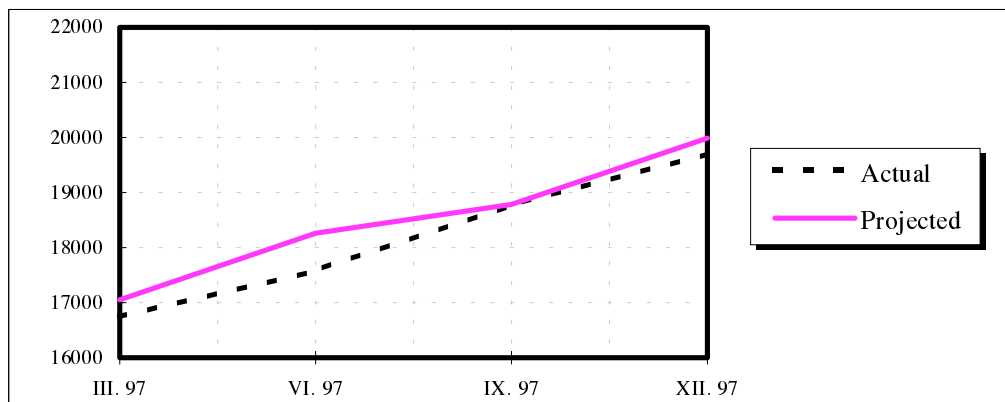
In 1997, money supply M2-denar grew by 13.2%, on annual level. This increase is higher than the projected one by 4.3 percentage points, due to the same reasons as in the money supply M1.

At the end of 1997, the bank denar credits to the non-government economic agents have reached level that was within the projections. Thus, the annual rate of increase of the bank denar credits to the non-government economic agents was 18.0%, which is within the projected increase of 19.6%. Even though in 1997 the National Bank continued to use credit ceilings as a direct instrument for monetary control, credit frames were wide enough and the banks have given substantial credit support to the economy. But, the structure of denar credits to the non-Government sector was unfavorable because of the predominant short-term credits, which determined financing, primarily, the needs of the economy for working capital, but not financing of long-term investment projects.

Chart 8

Projected and actual level of domestic banks denar credits

(in million denars)

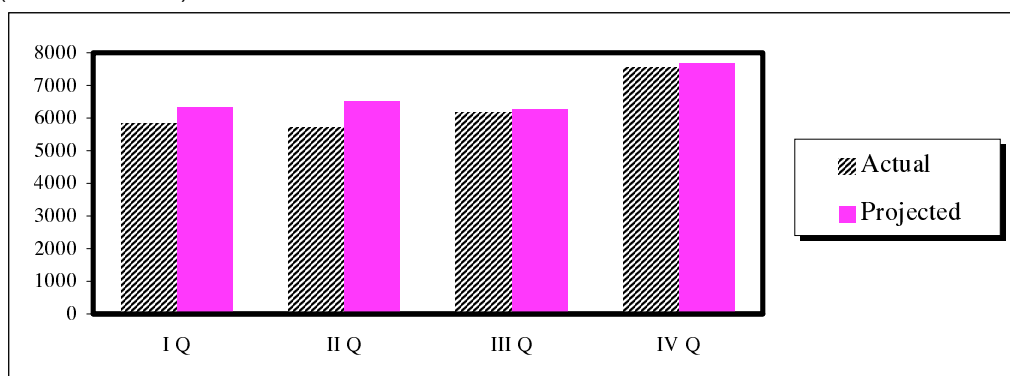


In accordance with the revised projection of the monetary policy, the increase of the reserve money for 1997 was projected to be 8.0% p.a. At the end of the year they realized an increase of 6.2% p.a., which is relatively close to the projected level. But, one must have in mind the increased tightening of the monetary policy in the first half of 1997 and the withdrawal of reserve money through net selling of foreign exchange on the foreign exchange market, in order to defend the targeted denar exchange rate. Thus, at the end of July 1997, the annual reserve money growth rate was 0.2%.

Chart 9

Projected and actual level of reserve money in 1997

(in million denars)



After the denar devaluation against the Deutsche mark, an intensive net purchase of foreign exchange by the National Bank occurred in the second half of 1997, totaling USD 44.6 million. This led to a complete neutralization of the unfavorable consequences from the first half of 1997, with a net purchase of foreign exchange on the foreign exchange market in the amount of USD 32.9 million for the whole year. The reserve money creation by the National Bank of the Republic of Macedonia on the basis of the foreign exchange transactions resulted in normalization of the reserve money growth. Thus, the annual reserve money rate of growth at the end of the third quarter of 1997 was 5.9%, reaching a level of 6.2% by the end of the year. This led to a substantial improvement of the global liquidity and support of the economic growth, where the monetary factors were not a source of inflationary movements.

IV. Monetary Developments in the Republic of Macedonia

4.1. Money Supply Creation and Withdrawal

According to the National Bank's definitions of the monetary aggregates, money supply M1 includes the most liquid assets used as payment instruments, i.e., currency in circulation and demand deposits. At the end of 1997 the level of money supply M1 by its narrowest definition was higher by denar 1,842 million, or 15,2% relative to the end of 1996. Compared to the projected growth of 9.5%, in 1997 monetary aggregate M1 exceeded the projection by 5.7 percentage points. Exceeding the projection was a result of the seasonally caused excessive growth of the currency in circulation in the last month of the year. Compared to its negative growth rate achieved in the previous year, the level of the money supply M1 at the end on 1997 was an indicator for the normalization of the monetary growth and for the avoidance of the excessive monetary policy tightening.

Table 4
Money supply (M1) creation and withdrawal ^{/1}
(in million denar)

	As of 31-12-96	Quarterly changes (in million denars)					As of 31-12-97	Factors of growth in %			
		I	II	III	IV	Total		03.97	06.97	09.97	12.97
M1	12,143	-1,074	115	1,181	1,620	1,842	13,985	-8.8	-7.9	1.8	15.2
Net Foreign Assets /2	12,037	-1,255	1,176	1,327	-41	1,207	13,244	-10.3	-0.7	10.3	9.9
Net Domestic Assets	11,418	257	-278	765	1,746	2,490	13,908	2.1	-0.2	6.1	20.5
Domestic credits	48,108	1,786	863	1,702	1,816	6,167	54,275	14.7	21.8	35.8	50.8
o/w: Credits to social and private sector	20,285	404	1,463	1,321	1,436	4,624	24,909	3.3	15.4	26.3	38.1
- in denar	16,704 ^{/3}	40	836	1,192	931	2,999	19,703	0.3	7.2	17.0	24.7
- in foreign currency /2	3,581	364	627	129	505	1,625	5,206	3.0	8.2	9.2	13.4
NBRM claims on											
Government, net	-1,270	236	2,698 ^{/4}	506	622	4,062 ^{/4}	2,792 ^{/4}	1.9	24.2	28.3	33.5
Other items, net	-36,690	-1,530	-1,140	-937	-70	-3,677	-40,367	-12.6	-22.0	-29.7	-30.3
Non-monetary deposits (non-Government sector) /5	10,265	-63	557	445	588	1,527	11,792	-0.5	4.1	7.7	12.6
Government deposits /5	1,044	142	225	467	-504	330	1,374	1.2	3.0	6.9	2.7
-demand deposits	35	50	-2	383	-194	237	272	0.4	0.4	3.5	2.0
-non-monetary deposits	1,009	92	227	84	-310	93	1,102	0.8	2.6	3.3	0.8

1) (+) Money supply (I1) creation; (-) money supply (I1) withdrawal

2) Stocks are valued at a constant rate (September 1996); flows are valued at a current rate.

3) In the first quarter, claims on loss-making enterprises were reclassified in a total amount of denar 4,144 million. In order to obtain the actual changes in the denar credits in 1997, recorded accounting balance as of 31.12.1996 (20.848) is reduced for denar 4,144 million.

4) In April a conversion of NBRM claims on Stopanska banka, A.D. Skopje (deposits sold on auction) into NBRM claims on Government (Government securities) was executed.

5) Positive change reflects withdrawal of money supply, negative change reflects creation of money supply.

In respect of dynamics, two different trends could be distinguished in the money supply M1 movements in 1997. First, there was a declining trend from the previous year that continued in the first half of 1997. Thus, at the end of the first and the second quarter of 1997 negative annual growth rates of the money supply M1 were realized of 2.2% and 3.3%, respectively. Decline in the money supply M1 was caused by the need to 'defend' the targeted level of the denar exchange rate during the unfavorable developments on the foreign exchange market. Namely, being endogenous variable, the money supply was declining in order to "defend" denar exchange rate, which meant an automatic tightening of the monetary policy.

The change in the money supply M1 trend started in the third quarter of 1997. Loosening the monetary policy that followed the denar devaluation against the Deutsche mark in July, resulted in a significant increase in the monetary aggregate M1 until the end

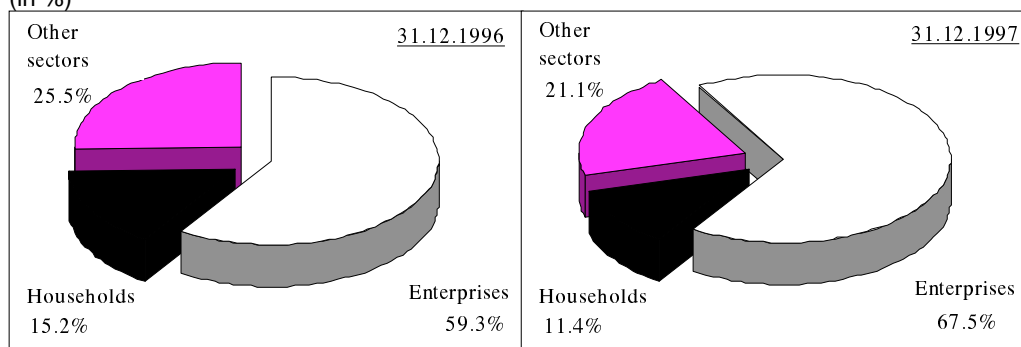
of 1997. Money supply growth was sufficient to fully compensate the decline from the first half of 1997.

At the end of 1997 the share of demand deposits in the money supply M1 was 49.0%, which is an increase by 4.2 percentage points relative to the end of 1996. The level of demand deposits at the end of 1997 was by 25.9% when compared to the level at the end of 1996. By sectors, demand deposits of the non-financial legal entities sector (enterprises) had the fastest growth in 1997 (43.1)%, simultaneously increasing their share in the total demand deposits by 8.1 percentage points. At the end of 1997 the level of households' demand deposits dropped by 5.0% p.a., reducing their share in the total demand deposits by 3.8 percentage points.

Chart 10

Demand deposits by sectors

(in %)

**4.1.1. Domestic credits**

The main factor causing the growth of the money supply M1 in 1997 were banks' domestic credits extended to the non-government sector. In order to evaluate their impact on the creation of the money supply M1, an accounting change from the first quarter of 1997 were taken into consideration which comes from the reclassification of Komercijalna banka's a.d., Skopje claims on loss-making enterprises, when they were classified off-balance sheet. Consequently, a sharp decline of the banks' domestic credits appeared in the accounting data in the first quarter of 1997. In order to obtain the actual impact of the changes in the banks' credits on the money supply M1, the accounting balance of the banks' credits as of December 31, 1996, was reduced and then used as a starting point for calculation, and this change adequately reflected in the calculations of all the relevant categories.

Table 5
Deposit money banks' domestic credits, net
(in million denars)

	As of					Quarterly changes				
	31.12.96	31.03.97	30.06.97	30.09.97	31.12.97	I	II	III	IV	Total
Domestic credits, net	48,604	50,201	48,366	49,542	50,736	1,597	-1,835	1,176	1,194	2,132
1. In denar	45,023	46,256	43,794	44,841	45,530	1,233	-2,462	1,047	689	507
a) Credits to Government, net	5,532	5,659	2,332	1,399	1,034	127	-3,327	-933	-365	-4,498
- credits	6,291	6,368	3,042	2,133	1,768	77	-3,326	-909	-365	-4,523
- accrued interest	15	18	17	13	13	3	-1	-4	0	-2
- Government deposits	-774	-727	-727	-747	-747	47	0	-20	0	27
b) Credits to private and social sector	39,491	40,597	41,462	43,442	44,496	1,106	865	1,980	1,054	5,005
-credits	16,704 ^{/**}	16,744	17,580	18,772	19,703	40	836	1,192	931	2,999
-accrued interest	22,787	23,853	23,882	24,670	24,793	1,066	29	788	123	2,006
2. In foreign currency /*	3,581	3,945	4,572	4,701	5,206	364	627	129	505	1,625
- Government	0	0	0	0	0	0	0	0	0	0
- Social and private sect.	3,581	3,945	4,572	4,701	5,206	364	627	129	505	1,625

*/ Stocks are valued at a constant rate (September 1996); flows are valued at a current rate.

**Reduced by denar 4,144 million for the reclassification by Komercijalna banka, a.d., Skopje.

According to the actual change, in 1997 total domestic credits of the deposit money banks extended to the non-government sector went up by denar 4,624 million, or by 22.8%. Thus, they induced money supply M1 creation by 38.1%. In 1997 deposit money banks' denar credits increased by denar 2,999 million, or by 18.0% and induced money supply creation by 24.7%. By sectors, in 1997 banks' denar credits extended to enterprises grew by denar 2,219 million, or by 15.0%, while denar credits extended to households increased by denar 721 million, or by 40.3%. Growth of the banks' domestic credits in foreign currency amounted to denar 1,625 million, or by 45.4%, that provided for a money supply M1 creation by 13.4%. By sectors, banks' credits in foreign currency are almost entirely extended to enterprises and increased by 77.9%⁸ in 1997.

Extension of banks' denar credits was determined by the level of liquidity in the banking system. In the first half of 1997 the National Bank was selling foreign currency in order to maintain the targeted exchange rate of the denar against the Deutsche mark which resulted in contraction of the banking system liquidity. Consequently, the banks' credit activity slowed down. After the denar devaluation in July, in the second half of 1997 the global liquidity of the banks was normalized and credit activity accelerated. Despite the high lending interest rates, in 1997 banks' denar credits increased substantially by 18.0%. The National Bank intended to regulate the changes of the banks' denar credits primarily through indirect instruments, while the monetary instrument "credit ceilings" determined the ultimate limits of their growth.

In respect of dynamics, in the first two quarters of 1997 the amounts of banks' denar credits were under the projected values. However, in the third and in the fourth quarter of 1997 they almost reached the projected level.

4.1.2. Net Foreign Assets

In 1997 net foreign assets of the monetary system induced creation of money supply M1. Net foreign assets increased by denar 1,207 million, or by 10.0%, that provided for a rise in the money supply M1 by 9.9%. By components, net foreign assets of

⁸Presented increase of the banks' foreign currency credits to enterprises incorporates the effects of denar devaluation against the Deutsche mark.

the National Bank increased by denar 380 million, or by 4.6% and induced creation of money supply by 3,1%. In 1997 net foreign assets of the deposit money banks grew by denar 827 million, or by 22.1%, and provided for a rise in the money supply by 6,8%.

In respect of dynamics, in the first quarter of 1997 the unfavorable developments in the balance of payments adversely affected net foreign assets of the monetary system, reducing it by denar 1,255 million, where net foreign assets of the National Bank dropped by denar 1,009 million and net foreign assets of the deposit money banks by denar 245 million. In the second quarter net foreign assets of the monetary system increased by denar 1,176 million, reflecting the increase both at the National Bank and the deposit money banks. Overall, in the first half of 1997 net foreign assets of the monetary system provided for a withdrawal of the money supply in a total amount of denar 79 million.

After the July devaluation of the denar against the Deutsche mark, in the third quarter of 1997 net foreign assets increased by denar 1,327 million. It was primarily caused by the overwhelming net purchase of foreign currency by the Central Bank (USD 36.4 million) that exceeded the payment of foreign debts (USD 16,9 million). Consequently, in the third quarter of 1997 net foreign assets of the National Bank increased by denar 1,100 million, and net foreign assets of the banks grew by denar 227 million. In the last quarter of 1997 net foreign assets dropped by denar 41 million, where net foreign assets of the National Bank (decline by denar 169 million) and net foreign assets of the deposit money banks (increase by denar 127 million) had divergent movements.

4.1.3. Non-monetary deposits

Total non-monetary deposits of the non-government sector include sight deposits, short term and long term time deposits and restricted deposits, regardless of the currency of denomination. In 1997 total non-monetary deposits induced withdrawal of money supply M1. Their annual growth by denar 1,527 million, or by 14.9%, provided for a money supply M1 withdrawal by 12,6%. In respect of dynamics, after the decline in the first quarter of 1997 (denar 63 million), in the remaining three quarters of the year total non-monetary deposits of the non-government sector had a stable and balanced growth, in the second quarter by denar 557 million, in the third quarter by denar 445 million and in the last quarter by denar 588 million.

Regarding deposit maturity, quasi non-monetary deposits increased by denar 1,702 million, or by 26.9%, while other non-monetary deposits dropped by denar 175 million, or by 4.4%. Facing a low level of domestic saving economic agents preferred to keep short term non-monetary deposits with a relatively higher liquidity. Regarding the currency of denomination, in 1997 non-monetary deposits in foreign currency had larger growth (denar 1,205 million, or by 31.7%) than denar non-monetary deposits (denar 322 million, or by 5.0%).

Within the total denar non-monetary deposits of the non-government sector, in 1997 denar quasi deposits increased by denar 248 million, or by 6.8%, while other denar non-monetary deposits grew by denar 74 million, or by 2.6%. Regarding the dynamics of the movements, growth of the quasi denar deposits in the first two quarters (denar 138 million, or denar 148 million, respectively) slowed down in the third quarter (increase by denar 57 million), but in the last quarter they dropped by denar 95 million. Other quasi denar deposits had erratic movements in 1997, where the largest decline was recorded in the first quarter of the year (denar 174 million), and the largest increase in the second quarter of 1997 (denar 239 million). In the last quarter of 1997 both types of denar non-

monetary deposits declined, which reflects their conversion into transaction deposits, needed for payments during the New Year's holidays.

Regarding the structure, in 1997 quasi denar deposits of the enterprises increased their share into the total quasi denar deposits by 3.2 percentage points and reached 51.1%, while the share of the households' deposits declined by 4.8 percentage points was reduced to 41.4%.

Table 6

Non-monetary deposits

(in million denars)

	As of					Quarterly changes				
	31.12.96	31.03.97	30.06.97	30.09.97	31.12.97	I	II	III	IV	Total
Total non-monetary deposits of the non-Government sector	10,265	10,202	10,759	11,204	11,792	-63	557	445	588	1,527
in denar	6,458	6,422	6,809	6,916	6,780	-36	387	107	-136	322
in foreign currency /1	3,807	3,780	3,950	4,288	5,012	-27	170	338	724	1,205
I. Quasi deposits	6,323	6,435	7,083	7,494	8,025	112	648	411	531	1,702
in denar	3,639	3,777	3,925	3,982	3,887	138	148	57	-95	248
in foreign currency /1	2,684	2,658	3,158	3,512	4,138	-26	500	354	626	1,454
II. Other non-monetary dep.	3,942	3,767	3,676	3,710	3,767	-175	-91	34	57	-175
in denar	2,819	2,645	2,884	2,934	2,893	-174	239	50	-41	74
in foreign currency /1	1,123	1,122	792	776	874	-1	-330	-16	98	-249

1) Stocks are valued at a constant rate (September 1996); flows are valued at a current rate.

Within the total foreign currency quasi deposits of the non-government sector, foreign currency quasi deposits and other foreign currency non-monetary deposits had divergent movements. Foreign currency deposits increased substantially by denar 1,454 million, or by 54.1%. On the other hand, other foreign currency non-monetary deposits dropped by denar 249 million, or by 22.2%. Growth of the short term foreign currency non-monetary deposits is a consequence of the economic agents' intention to have more flexible portfolio, fearing possible changes in the denar exchange rate. Thus, in the first quarter of 1997, when the expectations for a denar devaluation were not created yet, short term foreign currency deposits (as well as the long term ones) declined. When it became obvious that the denar exchange rate is not in equilibrium, short term non-monetary foreign currency deposits have increased substantially. After the July devaluation, their growth slowed down, in face of the expectations of the future movements on the foreign exchange market. In the last quarter, with the speculations for a new devaluation of the denar against the Deutsche mark and the domestic citizens returning from the countries where they work and live, foreign currency non-monetary deposits had their highest quarterly increase (denar 724 million). Quasi foreign currency deposits increased by denar 626 million, while other foreign currency non-monetary deposits grew by denar 98 million.

By sectors⁹, at the end of 1997 the growth of the enterprises' foreign currency non-monetary quasi deposits exceeded the growth of the households' deposits. Share of the enterprises' deposits went up from 55.8% to 57.1%, while the share of the households' deposits grew from 44.1% to 42.8%. Within the total other foreign currency non-monetary deposits, deposits of enterprises reduced their share from 91.9% to 81.0%, while the share of the households' deposits increased.

⁹ Presented changes of the foreign currency non-monetary deposits by sectors, incorporate the effects of the denar devaluation against the Deutsche mark.

4.2. Reserve money

According to the narrowest definition, reserve money include currency in circulation and liquid assets of the deposit money banks (giro accounts and cash in vault). At the end of 1997 the level of reserve money was higher by denar 441 million, or by 6.2% in comparison with the level from the end of 1996. Increase in the reserve money was within the projected annual growth of 8.0%.

Table 7

Reserve money, narrowest definition¹

	As of 31-12-96	Quarterly changes				Total	As of 31-12-97	Factors of growth in %			
		I	II	III	IV			03.97 12.96	06.97 12.96	09.97 12.96	12.97 12.96
Reserve money (narrowest definition)	7,115	-1,294	-119	458	1,396	441	7,556	-18.2	-19.9	-13.4	6.2
- currency in circulation	6,698	-1,175	-127	428	1,306	432	7,130	-16.5	-18.3	-12.3	6.1
- reserve accounts and cash in vault	417	-119	8	30	90	9	426	-1.7	-1.6	-1.1	0.1

1/ (+) denotes creation of reserve money; (-) denotes reserve money withdrawal

By quarters, in the first quarter of 1997 reserve money dropped significantly by denar 1,294 million, while in the second quarter the decline slowed down and amounted to denar 119 million. Decline of the reserve money in this period of the year was due to two factors: 1/ seasonal decline in the currency in circulation after the New Year's and Christmas Holidays; and 2/ withdrawal of reserve money based on the foreign exchange transactions. In the third and the fourth quarter of 1997 reserve money increased by denar 458 million, and denar 1,396 million, respectively. High growth of the reserve money at the end of the year is caused by the seasonally determined high demand of the economic agents for cash.

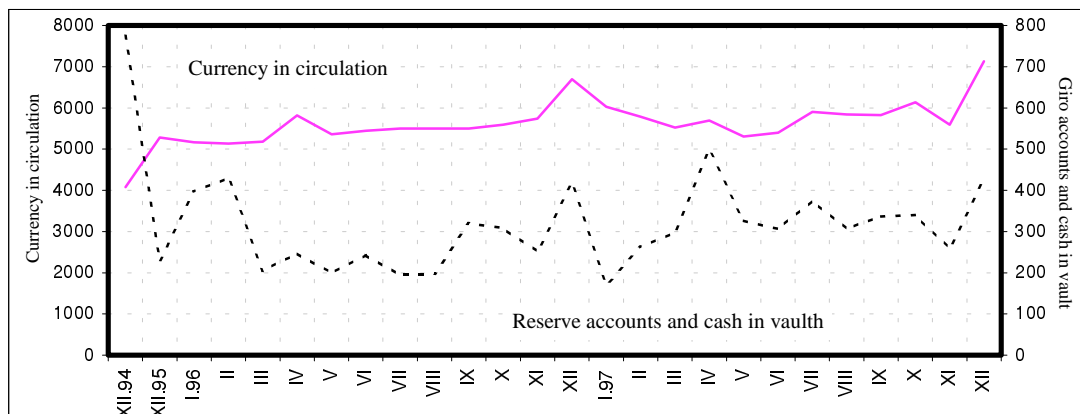
According to the monetary strategy of the National Bank of the Republic of Macedonia monetary variables were subordinated to the need to maintain the stability of the targeted exchange rate of the denar against the Deutsche mark, which caused the movements of the reserve money to depend on the exchange market conditions. Consequently, regarding the movements in the reserve money in 1997 one can distinguish two periods, prior to, and after the July devaluation of the denar against the Deutsche mark. In the first half of the year demand for foreign currency exceeded the supply, which forced the National Bank by selling foreign currency to intervene continuously on the foreign exchange market, in order to defend the targeted exchange rate of the denar. Instead of a net purchase of foreign currency and creation of reserve money in amount of denar 400 million, a net selling of foreign currency took place, and a withdrawal of reserve money in amount of denar 516 million. That is why at the end of the first half of the year reserve money had an annual growth rate of only 0.2%, which caused a serious contraction in the global liquidity of the banking system.

After the devaluation of the denar against the Deutsche mark, in the second half of 1997 the situation on the foreign exchange market improved, and the National Bank realized a substantial net purchase of foreign currency in amount of USD 44.6 million. Consequently, including the seasonal increase of the reserve money at the end of the year, in the period July - December 1997 reserve money significantly increased by denar 1,854 million, or by 32.5%, approaching the annual projected values.

Chart 11

Movements in the currency in circulation and banks' liquid assets

(in million denars)



Currency in circulation is a dominant component of the reserve money. In 1997 they went up by denar 432 million, or by 6.4%, which provided for a rise in the reserve money by 6.1%. In respect of dynamics, changes in the currency in circulation during the year are mainly determined by seasonal factors (holidays etc.). In general, the level of the currency in circulation in 1997 and their high share in the money supply point on the underdeveloped non-cash payment system in the Republic of Macedonia and the existence of unregistered transactions in which payments are done in cash.

4.2.1. Banks' liquidity

In the period January - December 1997 liquid assets of the deposit money banks in the Republic of Macedonia increased by denar 9 million, or by 2.2%. They induced an increase in the reserve money by 0.1%. In respect of dynamics, banks' liquidity in the first half of the year declined (denar 111 million), because the National Bank compensated only partially the loss of liquidity emerging from the foreign exchange transactions. However, the loss of liquidity from the first half was compensated in the second half of 1997, when reserve money grew by denar 120 million.

Banks' liquidity was partially affected by their (in)ability to project successfully their liquidity, due to the following factors: a/ the reform of the payment system has not been completed yet. In order to overcome the adverse implications from this systemic issue, in 1997 the transfer of the payment system to the banks started as the transactions with a value exceeding denar 10 million began to be executed through the banks; b/ underdeveloped financial market, i.e. the lack of efficient inter-bank money market and diversified supply of short term securities. In November 1997 inter-bank money and short term securities market was established in the Republic of Macedonia. However, due to the short time period until the end of the year it could not increase significantly the flexibility of the banks in determining their liquidity position, and cause more optimal liquidity distribution by individual banks.

Banks' inability to project their liquidity in an optimal manner affected the global liquidity. However, the liquidity of the banking system was more directly affected by the movements on the foreign exchange market, which according to the monetary strategy of the National Bank made an impact on the reserve money. Unfavorable movements on the foreign exchange market and the need to defend denar exchange rate denied the creation of reserve money projected amount and caused a substantial contraction in the

banks' liquidity. After the denar devaluation and the excessive net purchase of foreign currency by the Central Bank, the level of reserve money and banks' liquidity normalized.

4.2.2. Net foreign assets of the National Bank of the Republic of Macedonia

In 1997 net foreign assets of the National Bank induced a creation of reserve money. In the period January - December 1997 net foreign assets went up by denar 380 million, or by 4.6%, and provided for a rise in the reserve money by 5.3%. Increase in the net foreign assets of the Central Bank came from the higher growth of the foreign assets relative to the increase in the foreign liabilities. Thus, in 1997 foreign assets increased by denar 1,616 million, or by 14.4%. At the same time foreign liabilities grew by denar 1,236 million, or by 42.6%. Changes in the net foreign assets of the National Bank were caused by: a/ Central Bank's activities on the foreign exchange market (interventions by selling / purchasing foreign currency); b/ withdrawn foreign currency from extended foreign credits, which do increase the foreign reserves of the National Bank (acting as an agent for the Government); c/ repayment of foreign liabilities on behalf of the Government, and d/ net interest income on deposits held abroad.

Table 8

Reserve money creation and withdrawal¹

(in million denars)

	As of 31-12-96	Quarterly changes				Total	As of 31-12-97	Factors of growth in %			
		I	II	III	IV			03.97 12.96	06.97 12.96	09.97 12.96	12.97 12.96
Reserve money	7,115	-1,294	-119	458	1,396	441	7,556	-18.2	-19.9	-13.4	6.2
Net foreign assets /2	8,303	-1,009	458	1,100	-169	380	8,683	-14.2	-7.7	7.7	5.3
- Foreign assets	11,207	-1,009	1,022	1,100	503	1,616	12,823	-14.2	0.2	15.6	22.7
- Foreign liabilities	2,904	0	564	0	672	1,236	4,140	0.0	7.9	7.9	17.4
Net domestic assets	-1,188	-285	-577	-642	1,565	61	-1,127	-4.0	-12.1	-21.1	0.9
-Domestic credit	3,590	247	-19	-24	1,718	1,922	5,512	3.5	3.2	2.9	27.0
-Other items, net	-4,217	-317	-407	-106	186	-644	-4,861	-4.5	-10.2	-11.7	-9.1
-Instruments	-561	-216	-150	-512	-338	-1,216	-1,777	-3.0	-5.1	-12.3	-17.1

1/ (+) creation of reserve money, (-) withdrawal of reserve money

2/ Stocks are valued at a constant rate (September 1996); flows are valued at a current rate.

In respect of dynamics, in the first quarter of 1997 net foreign assets dropped by denar 1,009 million, as a result of the significant amount of foreign currency sold by the Central Bank on the foreign exchange market (USD 13.2 million), which exceeded the amount of net payments on foreign debts (USD 11.5 million). In the second quarter of 1997, net foreign assets of the National Bank grew by denar 458 million, because there was a net purchase of foreign currency on the foreign exchange market of USD 1.6 million and inflow of USD 5.8 million from new net foreign borrowing. The largest quarterly increase in the net foreign assets in 1997 took place in the third quarter (denar 1,100 million), mainly caused by the substantial net purchase of foreign currency by the Central Bank on the foreign exchange market (USD 36.4 million). In the last quarter of 1997 net foreign assets declined, but not significantly (by denar 169 million).

4.2.3. National Bank of the Republic of Macedonia credits

Domestic credits of the National Bank include denar credits extended to the banks and net claims on the Government (the amount of credits extended reduced by the amount of Government deposits). At the end of 1997 the level of Central Bank's domestic credits was higher by denar 1,922 million, or by 53.5% relative to the level at the end of 1996. National Bank's domestic credits induced an increase in the reserve money by 27.0%.

Table 9

National Bank of the Republic of Macedonia domestic credits

(in million denar)

	As of 31.12.96	Quarterly changes				Total	As of 31.12.97	Factors of growth in %			
		I	II	III	IV			III.97 XII.96	VI.97 XII.96	IX.97 XII.96	XII.97 XII.96
Domestic credits	3,590	247	-19	-24	1,718	1,922	5,512	3.5	3.2	2.9	27.0
I./ Credits to banks	4,860	11	774*	-530	1,096	1,351*	6,211*	0.2	11.0	3.6	19.0
- selective credits	3	0	0	0	0	0	3	0.0	0.0	0.0	0.0
- deposits sold on auction	4,349	49	791	-529	824	1,135	5,484	0.7	11.8	4.4	16.0
- liquidity credits	314	7	4*	2	3	16*	330*	0.1	0.2	0.2	0.2
- other credits	194	-45	-21	-3	269	200	394	-0.6	-0.9	-1.0	2.8
II./ Government, net	-1,270	236	-793**	506	622	571**	-699**	3.3	-7.8	-0.7	8.0
- Credits to Government	2,348	0	0**	0	0	0**	2,348**	0.0	0.0	0.0	0.0
- Government deposits	-3,828	-266	-516	-367	-85	-1,234	-5,062	-3.7	-11.0	-16.1	-17.3
a) for monetary support	-2,611	-600	-442	150	290	-602	-3,213	-8.4	-14.6	-12.5	-8.5
б) reserve account	-835	262	-244	-441	-182	-605	-1,440	3.7	0.3	-5.9	-8.5
b) other restricted dep.	-382	72	170	-76	-193	-27	-409	1.0	3.4	2.3	-0.4
- External financing	210	502	-277	873	706	1,804	2,014	7.1	3.2	15.4	25.4

*/**/ In April 1997 the first repurchase agreement was executed, based on bonds issued by the Agency for Bank Rehabilitation in amount of denar 3,491 million. In order to provide comparability with the balances on December 1996 and to determine the actual changes, the amount of denar 3,491 million is added to the accounting balances marked with *, while the same amount is deducted from the accounting balances marked with **.

The execution of the first repurchase agreement caused a change in the accounting balances of the relevant positions. However, in order to obtain the actual impact of the Central Bank domestic credits' components, adjustments were made described in the table 9 footnote. From that point of view, in 1997 both components of the domestic credits provided for a rise in the reserve money.

In the period January - December 1997 credits extended to the banks went up by denar 1,351 million, or by 27.8%, and induced an increase in the reserve money by 19.0%. Within their structure the main factor causing a reserve money creation were the auctions for selling deposits to the banks. In 1997 these deposits increased by denar 1,135 million, or by 26.1% and provided for a rise in the reserve money by 16.0%. In respect of dynamics, after the increase of denar 49 million in the first quarter of 1997, the amount of deposits sold on auction went up more significantly in the second quarter (denar 791 million). In this period, movements of the net foreign assets were causing a withdrawal of reserve money, so that the auctions for selling deposits to the banks were the main factor for reserve money creation. In the third quarter of 1997, after the intensive net purchase of foreign currency by the Central bank on the foreign exchange market which resulted in a substantial creation of liquidity, reserve money in amount of denar 529 million were withdrawn through the auctions of deposits. In the last quarter of 1997 as a result of the impact of seasonal factors, the amount of deposits sold on auction went up by denar 824 million.

Table 10

Interest rates and maturity of the deposits sold on auction

Weighted interest rates (annual) and maturity (in days) of deposits sold on auction (in %)									
	1 d.	2 d.	3 d.	4 d.	5 d.	6 d.	7 d.	11 d.	14 d.
January	11.00	11.48	11.56	11.91			12.58		13.15
February	11.00	11.48	11.55		12.41		13.39		13.15
March	11.00		11.55				13.97		13.15
April	11.00		11.55				13.48		12.34
May							12.58		11.57
June							12.37	11.75	11.57
July							13.06		11.57
August	11.57	9.95					13.84		11.57
September						13.99	14.08		11.57
October							14.32		11.57
November							14.95		11.57
December	12.40						15.17		11.57

Interest rates on the deposits sold on auction fluctuated throughout the year. In respect of dynamics, in the first quarter of the year the interest rate on deposits with a 7 day maturity (considered by the National bank as representative) increased and reached the level of 14.0% p.a.. That was a consequence of the strong pressure on the denar exchange rate and under these circumstances the automatic increase in the tightening of the monetary policy. In the second quarter, in order to encourage the demand for reserve money, the Central Bank reduced the interest rate on the deposits offered for sale to the banks to 11.0% p.a.. Hence, at the end of the second quarter the average weighted interest rate realized at the auctions declined to 12.4% p.a.. In the third quarter, after the denar devaluation the Central Bank faced the need to sterilize the effects of the excessive net purchase of foreign currency, which led to a dynamic reduction of the amount of deposits sold on auction. Consequently, the interest rates on the auctions went up again. The tendency of the interest rates to increase continued in the last quarter and at the end of the year reached the level of 15.2%.

Government position, net, presents on a net basis: credits of the National Bank extended to the Government, Government deposits with the Central Bank and the account for external relations of the Government. If the same approach is applied as with the credits given to the banks and the effect of the accounting reclassifications is excluded, then it is shown that the net liabilities of the Central Bank against the Government dropped by denar 571 million, or by 45.0% in the period January - December 1997. Hence, they provided for a creation of reserve money by 8.0%.

Taking into account that there was no actual change in the credits of the National Bank extended to the Government in 1997, movement of the Government net position was determined by the changes in the Government deposits and in the external account. In 1997 Government deposits with the National Bank went up by denar 1,234 million. Out of this, Government deposits for support of the banks' credit activity and support of the denar exchange rate stability, increased by denar 602 million. According to the projection of the monetary policy for the first half of 1997 the Government was required to deposit denar 200 million with the Central Bank, which was almost completely done (deposited denar 1,042 million). In the second half of the year these movement reversed as the Government withdrew denar 440 million. In 1997 government reserves on the giro account with the National Bank increased by denar 605 million. In 1997 the National Bank's claims on the Government on the external account increased substantially by denar 1,804 million, of which by denar 1,579 million in the second half. This suggests that the payment the National bank made on behalf of the Government exceeded the inflow of funds from abroad on behalf of the Government.

4.2.4. Instruments for reserve money withdrawal

Besides the auctions for selling deposits, the National Bank also implements the compulsory reserves and the auctions of Central bank bills as main instrument for monetary regulation. Contrary to the previous year when the auctions of bills provided for reserve money creation and the reserve money was withdrawn only through the compulsory reserves, in 1997 both instruments induced reserve money withdrawal.

Table 11

Instruments for reserve money withdrawal

(in million denars)

Instruments	As of 31.12.96	Quarterly changes					As of 31.12.97	factors of growth in %			
		I	II	III	IV	Total		III.97 XII.96	VI.97 XII.96	IX.97 XII.96	XII.97 XII.96
		Compulsory reserves	-523	-109	-195	-64		-148	-516	-1,039	-1.5
Auctions for purchasing deposits	-1	0	0	0	1	1	0	0.0	0.0	0.0	0.0
Auctions for selling CB bills	-37	-107	45	-448	-191	-701	-738	-1.5	-0.9	-7.2	-9.9
Total withdrawn	-561	-216	-150	-512	-338	-1,216	-1,777	-3.0	-5.1	-12.3	-17.1

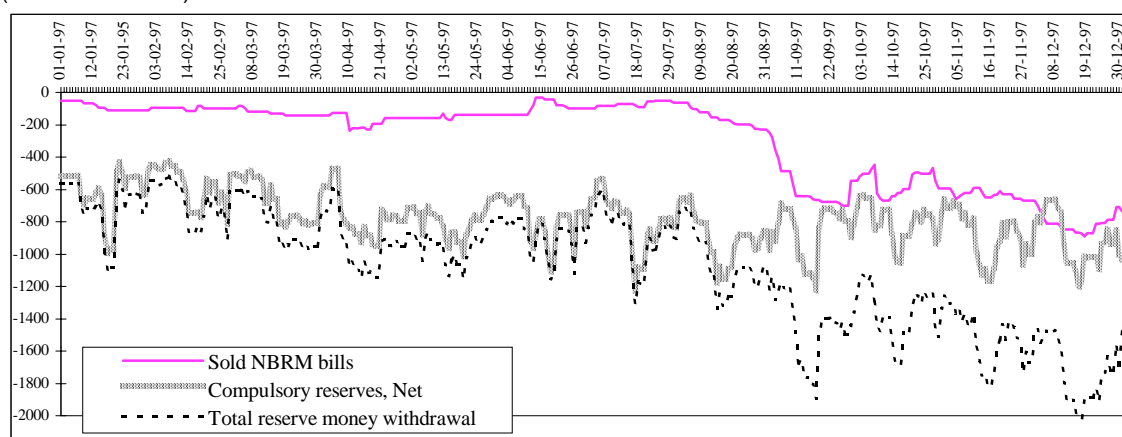
1/ (+) reserve money creation, (-) reserve money withdrawal

At the end of 1997 the total amount of withdrawn reserve money through the instruments: compulsory reserves, auctions for selling bills and auction for purchasing deposits, amounted to denar 1,777 million, which represents an increase by denar 1,216 million relative to the level at the end of the previous year. Hence, these instruments provided for reserve money withdrawal by 17.1%.

Chart 12

Effects from using the instruments for reserve money withdrawal

(in million denars)



The instrument auction of bills provided for a larger reserve money withdrawal, which reached the level of denar 738 million at the end of the year, i.e., in the period January - December 1997 denar 701 million were withdrawn. Hence, the auctions of bills induced a withdrawal of reserve money by 9.9%. In respect of dynamics, in the first two quarters of the year the amount of bills sold on auction increased by denar 62 million. However, the Central Bank did not have an intention to reduce the global liquidity of the banks, but to use this instrument to improve the liquidity distribution among individual banks. The need for such an intervention was caused by the lack of operations of a more

efficient money market. Nevertheless, in the second half of the year the auctions of bills were given their traditional role - to withdraw reserve money, needed for sterilization of the excessive net purchase of foreign currency by the Central bank. In this period, bills in a total amount of denar 639 million were sold on auction, which accounts for 91.2% of the amount sold in the entire year.

Table 12

Interest rates and maturity of the National Bank bills sold on auction

Month 1997	Interest rates (annual) and maturity (in days) of NBRM bills (in %)			
	30 days	40 days	60 days	90 days
January	8.24			
February	8.24			
March	8.24			
April	8.24			
May	8.24			
June	8.24			
July	8.24			
August	8.24			
September	8.24			9.44
October	8.24			
November	8.24			9.44
December	8.24	8.54		9.44

Regarding the maturity, bills that were sold were mostly those with maturity of 30 days, although at the end of the year there were cases when banks bought bills with maturity of 40 or 90 days. With the discount rate being unchanged, the interest rate on the bills sold on auction did not change as well throughout 1997. The interest rate on bills with a 30 day maturity remained at a level of 8.24% p.a..

In 1997 compulsory reserves increased by denar 516 million and at the end of the year reached the level of denar 1,039 million. Hence, compulsory reserves provided for a withdrawal of reserve money by 7.3%. By quarters, the growth of the compulsory reserves was distributed throughout the year. In general, transition from a system of fixed towards a system of average compulsory reserve realized in 1996, caused improved efficiency in the implementation of this instrument in 1997. It is a result of the flexibility that the new system brought to the banks, so that they could overcome unexpected changes in their liquidity. Under these circumstances they could use a portion of the compulsory reserves instead of immediately demanding liquid assets on the money market. Hence, the new system of compulsory reserves indirectly reduced the fluctuations of the interest rates on this market. In addition, as a second factor, improved liquidity of the biggest deposit money bank in the country also had a positive impact, increasing the efficiency in the implementation of the compulsory reserves as an instrument.

Being a 'lender of last resort', the National Bank of the Republic of Macedonia in 1997 occasionally used the collateral loan as an instrument to support the banks experiencing substantial shortage of liquidity, and not being able to provide it from another source. In the period January - December 1997 six deposit money banks used a collateral loan. These loans were used in a total time period of 82 days, with the average daily amount of the loan in the days when the loans were used, amounting to denar 14.4 million.

V. Interest rate policy

In the case when the monetary policy is aimed towards sustaining denar exchange rate stability as a key nominal anchor, the National Bank of the Republic of Macedonia is unable to achieve targets for low inflation rate and positive economic growth through interest rate targeting. On contrary, the interest rates should provide a stable denar exchange rate against the Deutsche mark and generate foreign capital inflow.

Interest rate created on the deposit auctions of the NBRM is the most relevant interest rate from the group of interest rates upon which the Central Bank has adequate influence. Therefore, in accordance with the established monetary strategy, the supply of funds on the auctions in 1997 was determined by the necessity for provision of stable denar exchange rate, meaning that the interest rates level was not the primary objective. Because of the high balance of payments deficit, the need for maintaining stable exchange rate determined formation of high interest rates on the auctions of deposits of the Central Bank, amounting to 14%-15% on annual basis at the end of 1997. Insufficiently deep financial market (M2/GDP was 14.1% at the end of 1997) created a situation where small number of transactions (one or two) determined the interest rates level on the deposit auctions. Consequently, the unfavorable developments in the balance of payments continuously present in the previous years, especially in 1996 and 1997, had considerable impact, through the monetary mechanism, on the Central Bank, as well as on the banks' interest rates level.

The extremely low level of domestic saving in the banking system, opposite to the high and rigid demand for financial funds, building in of a high risk premium due to the lack of financial discipline and problems with legal collection of the claims, as well as the banks' high operational costs, determined the banks' interest rates in the previous years, including 1997, to be continuously maintained at a high nominal and real level.

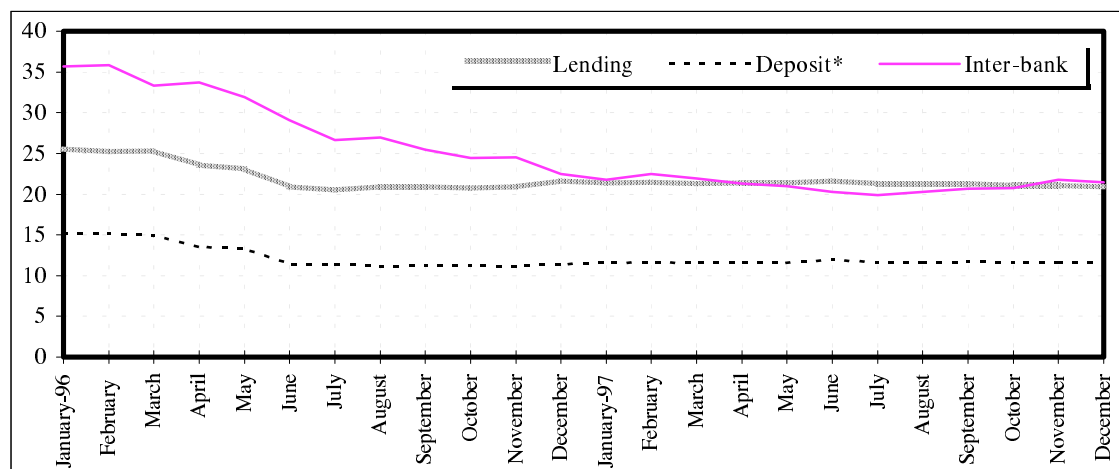
Thus, in 1997, on average, banks' nominal lending interest rate on credits was 21.4% p.a., which is a decrease of one percentage point compared to the average from 1996. The average annual lending interest rate, in real terms was 15.2% in 1997.

Nominal deposit interest rates were also maintained at a high level in 1997, amounting to 11.6% p.a. on average. In real terms, the average deposit interest rate was 5.4% p.a. High deposit interest rates failed to achieve impact on the size of the domestic saving in a situation of permanent decrease of the disposable income, i.e. they did not act towards broadening of the narrow financial base. On the other hand, such deposit interest rate policy contributed the lending interest rates to be established on high nominal and real level.

Chart 13

Lending, deposit and inter-bank interest rates

(annual, in %)



* time-deposits, over 3 months

The continuous maintaining of high bank nominal and real lending interest rates has twofold negative effect: first, it leads to a lower credit activity, opposite to the efforts to foster the investment activity and economic growth; and second, enterprises that use credits from the banking system are forced to invest the credit funds in projects with high risk, for gaining profits high enough to cover the interest expenses. In return, that increases the credit risks, i.e. it points out to the low possibility of the banks to collect the claims when they are due. In case of extreme lack of financial discipline, it resulted in increase of the companies' indebtedness towards the banks, i.e. cumulating high amounts of uncollected claims on interest in the banking portfolio. Banks tried to transfer those non-performing claims to the clients that are current on their obligations, creating in that way one vicious indebtedness circle: high interest rates - high risk, non-performing loans - high interest rates, and so on. At the same time, because of the lack of financial discipline, the indebtedness was constantly appearing in the mutual relations of the enterprises, especially in the first half of 1997, and it resulted in global illiquidity. Hence, one may conclude that the banks' interest rate policy in 1997 was inefficient and irrational, acting unfavorably on the general level of economic activity in the country.

Besides maintaining high nominal and real interest rates, the banks' interest rate policy in 1997 was also characterized by existence of high interest rate margins. The average interest rate margin in the analyzed period was 9.8 percentage points. That means that the interest rate margins were 5-7 times higher than the average interest rate margins in the developed countries, i.e. about 5.0 percentage points higher than the margins in the transition countries with similar inflation rate. The existence of high interest rate margins is basically due to the high operational costs of the banks, the concentration of high amount of overdue claims in the banks' balance sheets and inefficient competition in the financial sector.

A more detailed analysis of the banks' balance sheets data showed that the average rate of collected interest by the banks was 14.7% p.a. in 1997, which is 7.2 percentage points lower than the average nominal lending interest rate on banks' credits. That confirms the existence of low financial discipline and low degree of collection of claims by the banks. At the same time, the average deposit interest rate obtained through banks' interest expenditures was 7.7% p.a. in 1997. This means that the effective interest rate margin in the banking system of the Republic of Macedonia was 7.0 percentage points. The effective net interest rate margin, obtained after deduction of tax premiums

and the allocation of reserve for potential loan losses, is lower by 50.0%, i.e. it was 3.4 percentage points.

The restrictive character of the monetary policy, incident liquidity problems of some of the banks, nonexistence of developed financial market and insufficient cooperation of the banks, were reasons for the permanently higher demand than supply of funds on the inter-bank money market in the last two years. As for the deposit auctions of the Central Bank, special problem on this market was also the insufficiently deep financial market, determining a small number of transactions to have strong impact on the inter-bank interest rates. This, as well, contributed to the high nominal and real interest rates on the inter-bank market, even though a trend of their moderate decrease could be recognized. Thus, at the end of 1997, the average annual interest rate of the bank credits to other banks was 21.1%, one percentage point lower compared to the end of 1996.

VI. External sector

In 1997 balance of payments and exchange rate policies were directed towards reduction of the deficit in the current account of the balance of payments and further increase of the foreign exchange reserves. Decrease of deficit in the current account was expected to come out from the decrease of the trade deficit through export increase, as well as from transportation cost decrease due to normalizing of the situation in the region. On these basis, foreign exchange reserves managed by the National Bank of the Republic of Macedonia were expected to grow at the level of 2.5 months of import of goods, by which the limit of three months of import as internationally accepted minimum level would be gradually reached. This orientation of the external trade policy in 1997 was supported with a new (ESAF) arrangement of the International Monetary Fund.

6.1. Foreign trade¹⁰

Movements realized in the foreign trade, especially in the first half of 1997, were opposite of the expectations. Namely, the export of goods in the first half of 1997 compared to the first half of the previous year increased by 2.8%, generally as a result of the increased export of the so called tolling manufacturing or goods for reprocessing by 14.8%, while the regular export fell down by 2.8%. At the same time, import of goods realized an increase of 2.6%, when imported goods for reprocessing increased by 8.4%, but also 1.1% increase of the regular import. Such movements resulted in continued disproportion between export and import from 1996, so trade deficit realized in the first six months in 1997 in amount of USD 214.3 million was larger than in the first half of 1996 for USD 4.3 million. In the same period, the exchange of goods excluding goods for reprocessing registered a deficit of USD 246.7 million, or USD 17.3 million more than in the first six months in 1996.

Table 13
Foreign trade of the Republic of Macedonia
(in USD million)

	EXPORT			IMPORT			BALANCE		
	total	goods for reprocessing	excluding goods for reprocessing	total	goods for reprocessing	excluding goods for reprocessing	total	goods for reprocessing	excluding goods for reprocessing
	1	2	3	4	5	6	7=1-4	8=2-5	9=3-6
1996	1,147.44	371.52	775.92	1,626.92	301.91	1,325.01	-479.48	69.61	-549.09
Q1	271.55	93.15	178.40	355.63	73.20	282.43	-84.08	19.95	-104.03
Q2	288.51	86.02	202.49	414.48	86.65	327.83	-125.97	-0.63	-125.34
Q3	276.13	94.53	181.60	399.89	69.26	330.63	-123.76	25.27	-149.03
Q4	311.25	97.82	213.43	456.92	72.80	384.12	-145.67	25.02	-170.69
1997	1,201.43	436.54	764.89	1,740.07	435.09	1,304.98	-538.64	1.45	-540.09
Q1	272.93	103.23	169.70	374.10	72.36	301.74	-101.17	30.87	-132.04
Q2	303.02	102.42	200.60	416.16	100.90	315.26	-113.14	1.52	-114.66
Q3	308.57	114.82	193.75	429.53	112.65	316.88	-120.96	2.17	-123.13
Q4	316.91	116.07	200.84	520.28	149.18	371.10	-203.37	-33.11	-170.26

The improved price competitiveness after the devaluation of the denar exchange rate against Deutsche mark resulted with export increase in the third quarter of the year of 11.7% compared to the same period in 1996, and the increase of regular export only, was 6.7%. In the same comparing period, import increased by 7.4%, generally due to the

¹⁰ The data are given in accordance with international methodology for foreign trade statistics in which the export value is represented on f.o.b. basis and the import value on c.i.f. basis.

augmentation of the import of goods for reprocessing of 62.6%, while regular import realized a downfall of 4.2%. These movements in the import of goods for reprocessing continued in the following months with enforced dynamics, which brought to further more intensive import increase compared to the export increase. Thus, the negative balance in the foreign trade in the fourth quarter of 1997 was bigger for 39.6% compared to the same period from the previous year, which is due to the realized deficit in goods for reprocessing in the amount of USD 33.1 million (while in the same period of 1996 there was a surplus of USD 25,0 million). The deficit in the remaining foreign trade at the end of fourth quarter of 1997 is smaller for 0.3% compared to the same period of the previous year. Positive export effects from the interim import of goods for reprocessing in the country should be expected in the first months of 1998, depending on processing duration.

In general, the total export value in 1997 was USD 1,201.4 million, which is 4.7% more compared with the previous year. The total import in 1997 was USD 1,740.1 million and it is 6.9% higher compared to the previous year. Thus, the foreign trade deficit in 1997 amounted to USD 538.6 million, which is 12.3% higher than in the previous year. However, taking into consideration that goods for reprocessing on import side during 1997 increased by 44.1%, and on the export side by 17.5% (and the export effects should be expected in the next year), the 1997 foreign trade deficit excluding goods for reprocessing recorded a decline of 1.6% compared to 1996.

In the exchange of goods in 1997, from the point of view of economic groups of the countries, the Republic of Macedonia realized the biggest cooperation with European Union countries and with former Yugoslav republics. In 1997 in the export structure European Union countries participated with 37,6%, which is 5.1 percentage points less than in the previous year. The export value in European Union countries in 1997 decreased by 7.8% compared to the previous year. In 1997 former Yugoslav republics participated in total export structure of the Republic of Macedonia with 32.2% which compared to the participation in 1996 reflects a decrease of 0.9 percentage points. The export value in the former Yugoslav republics realized during 1997 increased by 1.9%. In addition, the export in FR Yugoslavia, Croatia and Bosnia and Herzegovina registered almost identical rate of growth of about 11.0%, while the export in Slovenia has recorded a significant downfall of 32.4%.

In the total export value, the other developed countries participated with 11.9%, EFTA countries with 6.7% and compared to the previous year both groups registered an increase of the participation of 3.8 percentage points. The export of the Republic of Macedonia to other developed countries in 1997 realized 52.9% augmentation, generally as a result of the increase of exported goods to USA by 62.0% and to Turkey by 24.9%. There are also positive movements in the export to EFTA countries (an increase of 142.4%) and the Republic of Macedonia, within this group, realized the most significant cooperation with Switzerland.

From the point of view of separate countries, the most important trade partners of the Republic of Macedonia on the export side are still the northern neighbor FR Yugoslavia with 22.8% and Germany with participation of 16.2% in the total export. As a result of high increase of export to the USA (62.0%), this country in the Macedonian export in 1997 realized a participation of 9.5%, which is 3.3 percentage points more compared to 1996. Greece participated with 8.1% in the total export value in 1997, which is almost identical with its participation in the previous year, when it was the third most important trade partner of the Republic of Macedonia on the export side. Switzerland is the fifth biggest importer of Macedonian products with participation of 5.4% in the total Macedonian export.

Table 14

Foreign trade of the Republic of Macedonia by economic groups and trade partner countries
(in USD million)

Economic groups of countries	1996			1997		
	Export	Import	Balance	Export	Import	Balance
1. Developed countries	616	806	-190	675	842	-167
1.1. European Union	490	630	-140	452	644	-192
France	6	49	-43	6	35	-29
Italy	51	110	-59	43	95	-52
Netherlands	48	40	8	41	40	1
Germany	215	240	-25	195	233	-38
Great Britain	31	23	8	30	22	8
Greece	102	77	25	97	127	-30
Austria	20	38	-18	18	44	-26
Others	17	53	-36	22	48	-26
1.2. EFTA	33	25	8	81	28	53
Switzerland	33	23	10	65	23	42
Others	0	2	-2	16	5	11
1.3. Other developed countries	93	151	-58	142	170	-28
Japan	2	15	-13	1	12	-11
USA	71	68	3	114	80	34
Turkey	18	44	-26	23	49	-26
Others	2	24	-22	4	29	-25
2. Central and Eastern European countries	135	344	-209	116	357	-241
Bulgaria	38	107	-69	32	98	-66
Russia	39	122	-83	25	68	-43
Albania	32	5	27	30	4	26
Ukraine	5	32	-27	2	92	-90
Others	21	78	-57	27	95	-68
3. Developing countries	14	98	-87	21	111	-89
4. Former YU republics	380	342	38	387	413	-26
FR Yugoslavia	246	166	80	274	202	72
Croatia	34	49	-15	37	68	-31
Slovenia	82	124	-42	56	136	-80
Bosnia and Herzegovina	18	3	15	20	7	13
5. Other countries	2	37	-32	2	17	-16
TOTAL:	1,147	1,627	-480	1,201	1,740	-539

The largest participation in the total import of the Republic of Macedonia in 1997 was on the part of the European Union countries with 37.0%, which compared to the level of the previous year is 1.7 percentage points lower. The import value of the European Union member countries in 1997 realized an increase of 2.2%. The former Yugoslav republics participate with 23.8% in the total import value in 1997, or 2.8 percentage points more than in 1996. Moreover, the import from these countries in 1997 increased by 20.8%. Central and East European countries participate with 20.5% in total import in 1997 which represents almost identical participation as of the previous year. The other developed countries participate with 9.8% in the total import structure (approximately at the level of the previous year) and in 1997, 12.4% increase of the import of the Republic of Macedonia from these countries is registered.

From the point of view of separate countries, the three most important trade partners of the Republic of Macedonia on the import side are: Germany with 13.4%, FR Yugoslavia with 11.6% and Slovenia with participation of 7.8% in the total import. Furthermore follows the neighboring Greece with participation of 7.3%, which is due to the significant growth of import from this country in 1997 of 64.1%. The weaker goods supply and deteriorated economic and political situation in neighboring Bulgaria were the reason for decline of the import from this country of 8.6%, because of which its participation in the total Macedonian import in 1997 compared to 1996 is 1.0 percentage points lower and amounts to 5.6%.

In the exchange of goods with separate countries, in 1997 the Republic of Macedonia realized a positive trade balance in the exchange with FR Yugoslavia (USD 72 million), Switzerland (USD 42 million), USA (USD 34 million), Albania (USD 29 million) and Bosnia and Herzegovina (USD 13 million). The highest negative trade balance is realized in the exchange with Ukraine (USD 90 million), and significant deficit is also realized in the exchange with Slovenia (USD 80 million), Bulgaria (USD 66 million), Italy (USD 52 million), Russia (USD 43 million) and Germany (USD 38 million).

Analyzed from the standpoint of economic use of the goods, in the export structure in 1997 the goods for reproduction participate with 52.3%, consumption goods with 44.7%, and means of production with 2.9%. This structure of export is partly more unfavorable than in the previous year, when participation of the goods for reproduction was 2.8 percentage points lower and consumption goods' participation was 2.4 percentage points higher. In 1997 the export of goods for reproduction realized an increase of 11.0%, the export of means of production decreased by 9.0%, while export of consumption goods realized a slight decline of 1.0%.

Table 15
Foreign trade by economic use of the products
(in USD 000)

Products	1996	1997	index 1997/1996	1996	1997	index 1997/1996
Republic of Macedonia (total)	1,147,434	1,201,248	105	1,626,917	1,740,096	107
1. Reproduction goods	567,616	628,575	111	904,614	1,068,134	118
raw materials and semi-manufactures	418,500	476,644	114	422,423	500,295	118
fuel	8,701	3,701	43	131,202	178,237	136
other reproduction goods	140,415	148,230	106	350,989	389,602	111
2. Means of production	38,490	35,122	91	218,058	182,659	84
plant mashines	15	246	1,640	7,071	6,892	97
agricultural mashines	110	124	113	4,004	5,399	135
metal processing mashines	3,048	756	25	2,046	1,756	86
other mashines	5,332	4,763	89	72,025	80,473	112
electric mashines	10,953	8,797	80	66,147	33,482	51
transportation means	5,296	5,315	100	20,394	11,127	55
other investment goods	13,736	15,121	110	46,371	43,530	94
3. Consumption goods	540,276	536,126	99	492,673	478,721	97
food	80,865	67,113	83	175,016	153,776	88
drinks and tobacco	94,617	111,383	118	6,224	6,375	102
clothes and shoes	303,126	291,056	96	105,999	141,960	134
furniture	2,985	2,569	86	8,956	10,068	112
textile (without clothes)	21,490	19,624	91	8,092	9,273	115
medicine, pharmacy and cosmetics	23,036	27,669	120	44,670	41,015	92
other consumption goods	14,157	16,712	118	143,716	116,254	81
4. Residual	1,052	1,425	135	11,572	10,582	91

The import increase in 1997 was exclusively due to the increased import of goods for reproduction by 18.0%. At the same time, the import of means of production declined by 16.0%, while import of consumption goods realized a decline of 3.0%. It contributed to a notable improvement in the import structure in 1997, referring to the increased participation of goods for reproduction by 5.8 percentage points and decreased participation of consumption goods by 2.8 percentage points. Therefore, the participation of goods for reproduction in total import in 1997 reached 61.4%, consumption goods participate with 27.5% and means of production with 10.5%.

6.2. Balance of payments

Table 16
Balance of payments of the Republic of Macedonia
(in USD million)

I. Total balance of payments	1996	1996				1997				1997
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
I. Current transactions	-288	-45	-74	-65	-104	-88	-55	-15	-118	-276
Goods, net	-317	-38	-74	-96	-108	-70	-78	-83	-157	-388
Export, f.o.b.	1,147	272	289	276	311	273	303	309	317	1,201
Registered export	1,147	272	289	276	311	273	303	309	317	1,201
Other export	0	0	0	0	0	0	0	0	0	0
Import, f.o.b.	-1,464	-310	-362	-372	-419	-343	-380	-391	-474	-1,589
Registered import, f.o.b.	-1,399	-293	-352	-348	-405	-337	-375	-387	-468	-1,566
Other import	0	0	0	0	0	0	0	0	0	0
Aid and grants	-33	-10	-2	-15	-5	-1	0	0	0	-1
Individuals	-32	-6	-8	-9	-9	-6	-6	-5	-6	-22
Unregistered import	0	0	0	0	0	0	0	0	0	0
Services, net	-155	-41	-41	-29	-44	-29	-36	-32	-48	-145
Income, net	-30	-12	-6	-5	-6	-8	-2	-15	-8	-34
of which: interest, net	-56	-17	-12	-16	-12	-13	-7	-20	-15	-55
Current transfers, net	213	47	48	65	54	19	61	115	95	290
Official/1	52	18	11	16	7	1	1	1	5	7
Other	161	28	37	49	47	18	60	114	90	283
II. Capital and financial transactions	174	29	22	13	109	-93	70	97	113	187
Capital transactions, net	0	0	0	0	0	0	0	0	0	0
Capital transfers, net	0	0	0	0	0	0	0	0	0	0
Official	0	0	0	0	0	0	0	0	0	0
Other	0	0	0	0	0	0	0	0	0	0
Financial transactions, net	174	29	22	13	109	-93	70	97	113	187
Direct investments, net	11	2	3	2	4	3	2	2	10	16
Portfolio investments, net	0	0	0	0	0	0	0	0	2	2
Other investments, net	163	26	20	11	105	-95	69	94	101	169
Trade credits, net	79	-6	31	-5	59	40	67	52	110	268
Loans, net/2	23	-10	-9	1	40	-139	21	50	-2	-70
Foreign currency and f.c. deposits, net	61	42	-1	15	6	4	-19	-7	-7	-29
of which: Commercial banks, net	61	42	-1	15	6	4	-19	0	0	-16
Other, net	0	0	0	0	0	0	0	0	0	0
Official reserves	0	0	0	0	0	0	0	0	0	0
III. Errors and omissions	19	-23	17	28	-4	6	-5	-30	-1	-30
IV. Total balance	-95	-38	-35	-24	1	-175	10	52	-6	-119
V. Financing	95	38	35	24	-1	175	-10	-52	6	119
Net change in official reserves/3	21	24	7	8	-18	21	-11	-20	0	-11
Gross foreign assets/4	8	24	-7	8	-18	21	-24	-20	-13	-35
IMF	13	0	14	0	0	0	12	0	12	24
Changes in total arrears	37	14	-10	16	17	-75	1	-32	0	-106
New arrears	69	17	18	16	18	6	1	1	1	8
Regulated due but unpaid liabilities	-32	-3	-28	0	-1	-80	0	-33	-1	-114
Bilateral creditors	-2	-1	0	0	-1	0	0	-2	-1	-3
Commercial banks - London club	0	0	0	0	0	-80	0	0	0	-80
EUROFIMA	-24	-2	-22	0	0	0	0	0	0	0
EFR	-6	0	-6	0	0	0	0	0	0	0
EIB	0	0	0	0	0	0	0	-30	0	-30
Rescheduling	37	0	37	0	0	229	0	0	6	235
Paris club	10	0	9	0	0	0	0	0	0	0
EUROFIMA	22	0	22	0	0	0	0	0	0	0
EFR	6	0	6	0	0	0	0	0	0	0
MFK	0	0	0	0	0	0	0	0	0	0
Commercial banks - London club	0	0	0	0	0	229	0	0	6	235

1) The data for official transfers are provided by the Ministry for development.

2) Excluding IMF.

3) End of period; increase of assets is denoted by minus; including IMF.

4) Excluding cross exchange rates effects.

As a result of high trade balance deficit, a deficit of USD 276 million was realized in the current account of the balance of payments in 1997, which, however, is 4.3% lower compared to the previous year. The decline is generally due to the high net inflow of private transfers in the amount of USD 283 million, which is 75.1% more than in the previous year. In the same direction was also the diminishing of the services deficit by

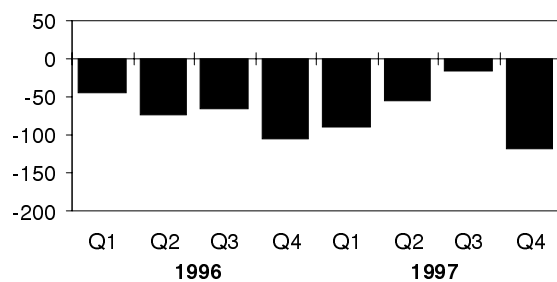
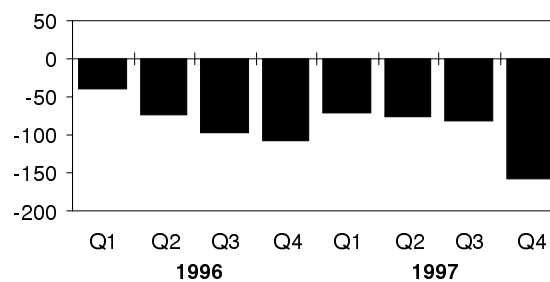
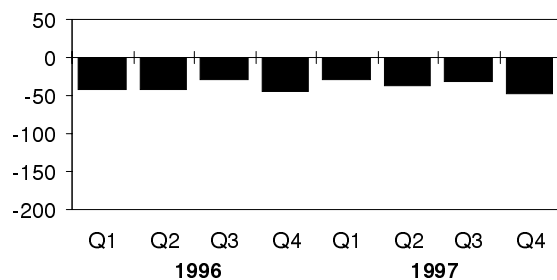
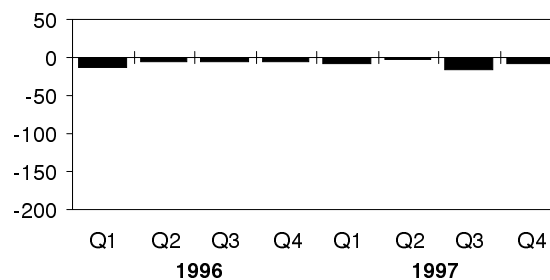
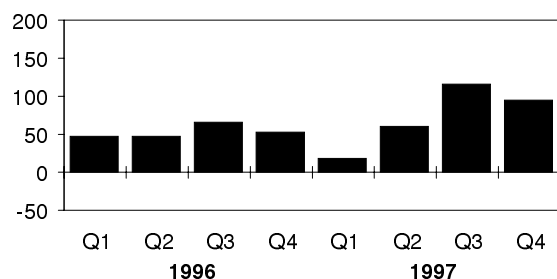
6.7%, which is mainly a result of decreased transportation costs. The trade balance deficit in 1997 amounted to USD 388 million, which is USD 71 million more than in 1996.¹¹

Such situation in the trade balance and in the balance of payments current account is also specific for some of the other transition countries which face disproportion between aggregate supply and demand of goods and services. Namely, the period needed for approaching the productivity of labor and capital to the world standards, as well as adjustment of the domestic products to the requirements of the international markets, inevitably imply slower dynamics of the export increase compared to the import one. On the other hand, the orientation towards faster economic growth implies investments growth, which in shortfall of domestic accumulation, is covered by foreign saving. On this basis, the external position of the Republic of Macedonia can be assessed as logical for a country which strives to catch up with fast-growing developing countries and more enhanced transition countries, which of course does not reject the need for dynamic reduction of the deficits in the trade balance and in the current transactions balance and their adjustment in long term sustainable frames.

Graph 14

Components impact on the balance of payments current account

(in USD million)

Current transactions - balance**Trade balance****Balance of services****Income - net****Transfers - net**

¹¹ Foreign trade deficit in the balance of payments differs from foreign trade deficit by official statistics. The reason for this is presentation of the import on f.o.b. basis in the balance of payments, while its presentation by official statistics is on c.i.f. basis.

The deficit in the current account of the balance of payments of the Republic of Macedonia in 1997 was financed on two basis. From one side, on the basis of capital-financial transactions there is an inflow in the amount of USD 187 million. In this respect, foreign direct investments reached the level of USD 16 million, which of course is not enough for more significant compensation of the poor domestic accumulation and for dynamization of the investment cycle in the Republic of Macedonia. The other investments on the basis of financial transactions with abroad amounted to USD 169 million, of which the short term trade credits on the basis of exchange of goods of domestic enterprises with foreign partners achieved the biggest increase. Namely, net trade credits in 1997 reached the amount of USD 268 million, while in the previous year they amounted to USD 79 million. More precisely, they are short term liabilities of the domestic enterprises for imported, but still unpaid goods. The increase of these liabilities in 1997 is partially due to the increased import of goods for reprocessing purposes whose export effects should follow in the next period.

On the other hand, the remaining part of the deficit in current account of the balance of payments in the amount of USD 119 million (the item errors and omissions of USD 30 million is included), is financed by changes in the official foreign exchange reserves, changes in total arrears and rescheduling the liabilities to foreign creditors.

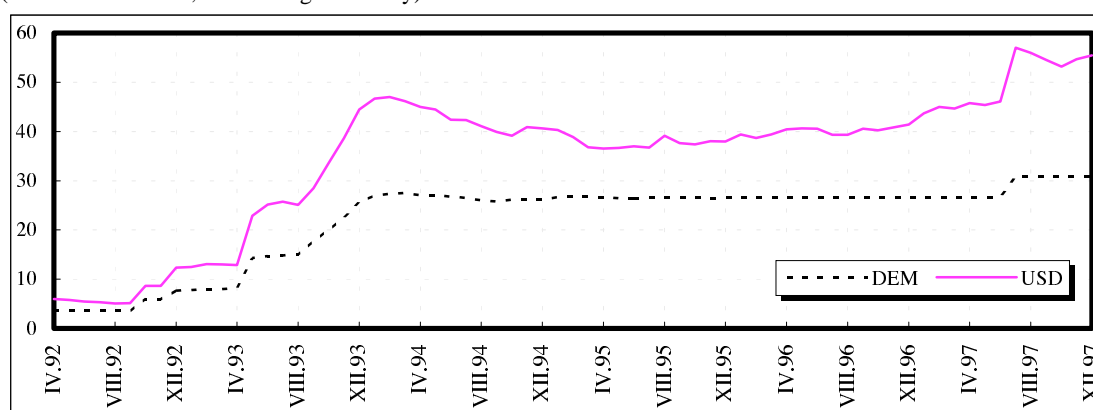
6.3. Denar exchange rate and price competitiveness to abroad

The fundamental equilibrium exchange rate of the national currency enables: level of competitiveness to abroad which equilibrates the balance of payments and achieving economic growth which is close to the potential level and does not produce any inflationary pressure. In the Republic of Macedonia denar exchange rate is formed on the foreign exchange market in accordance with foreign exchange supply and demand. In this context, according to the adopted monetary strategy, the National Bank of the Republic of Macedonia maintains the denar exchange rate against Deutsche mark at the targeted level, while the denar exchange rates against the other currencies are formed on the basis of cross exchange rates on the Frankfurt foreign exchange market.

Graph 15

Nominal denar exchange rate against DEM and USD

(in absolute amount, for 1 foreign currency)



In 1997, the nominal effective denar exchange rate, defined as denar exchange rate against Deutsche mark and US dollar with their equalized participation (as a respective reflection of the currency structure of the Macedonian export), realized an increase of 24.9%. At the end of 1997 the nominal denar exchange rate against Deutsche mark was 30.92 denars for a Deutsche mark, which represents an annual increase of 16.1%. This is a consequence of onetime July devaluation of the denar exchange rate

against the Deutsche mark. At the end of 1997 the nominal denar exchange rate against US dollar reached the level of 55.42 denars for a US dollar, which is an increase of 33.8% on annual level. Beside the July correction of the denar exchange rate, in 1997 the decline of the denar value against US dollar was also affected by the change of the relation between exchange rates of the Deutsche mark and US dollar on the Frankfurt foreign exchange market (1.55 DEM for 1USD on December 31, 1996 and 1.79 DEM for 1USD on December 31, 1997).

Table 17

Price competitiveness based on real effective exchange rate index

Indices	31.12.1993/ 31.05.1993	31.12.1994/ 31.12.1993	31.12.1995/ 31.12.1994	31.12.1996/ 31.12.1995	31.12.1997/ 31.12.1996	31.12.1997/ 31.05.1993
	1. Nominal effective Denar exchange rate	186.57	96.36	97.31	104.78	124.90
2. Domestic industrial producer prices	165.40	128.56	102.16	99.36	108.60	234.40
3. Foreign industrial producer prices	100.46	103.04	102.27	100.93	100.20	107.06
4. Relative prices (2:3*100)	164.65	124.77	99.89	98.44	108.38	218.94
5. Real effective Denar exchange rate (1:4*100)	113.32	77.23	97.41	106.44	115.24	104.57

1) Nominal effective denar exchange rate calculated as a weighted average of exchange rates against DEM and USD at the end of the period.

2) The real effective exchange rate index, as an internationally accepted and used indicator, is calculated as an average index of domestic currency changes against the currencies of the biggest trade partner countries, adjusted for the relative prices changes. For calculating the average exchange rate, equal weights for USD and DEM are used. Real effective exchange rate index above 100 means increase of price competitiveness, while index below 100 means a decline in the price competitiveness.

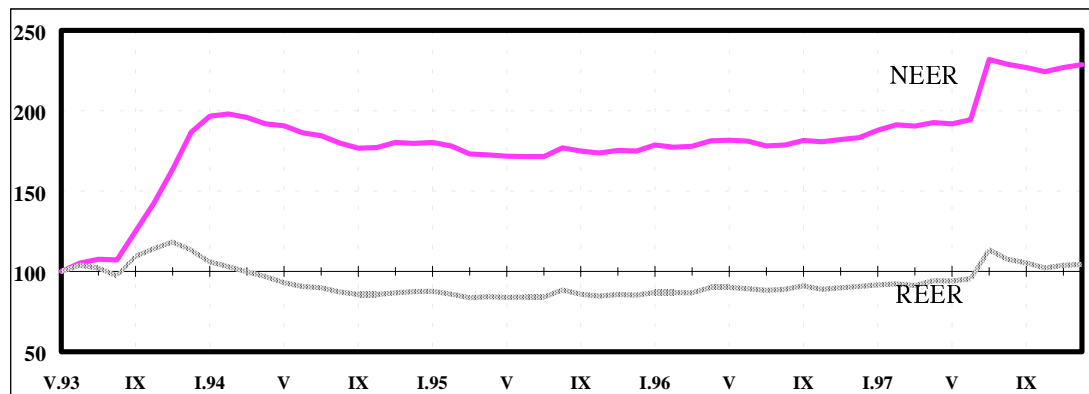
In 1997 the real effective denar exchange rate, which represents the nominal effective exchange rate adjusted for the changes of the relative prices on the domestic and the foreign markets, realized a growth of 15.24% compared to 1996, which shows an improvement of price competitiveness of the Macedonian export. In favor of improving the price competitiveness was the decline of the denar value against the Deutsche mark and US dollar. On the other hand, changes of the relative domestic prices in relation to foreign prices as a result of increase of the domestic industrial producers prices by 8.6% and minimal foreign prices increase of 0.2% deteriorated price competitiveness.

In the first half of 1997 the real effective denar exchange rate diverged from the fundamental equilibrium level, it did not support the economic growth and determined the deficit in the current account of balance of payments and losing foreign exchange reserves of the Central Bank. However, the July devaluation of the denar exchange rate against the Deutsche mark enabled its approach to the fundamental equilibrium level and led to improvement of the price competitiveness of the Macedonian export. It was expressed by acceleration of the economic growth in the second half of 1997, increase of the foreign exchange reserves of the Central Bank and absence of inflationary pressures.

Graph 16

Nominal and real effective denar exchange rate

(indices, V.1993=100)



Compared to the period when the foreign exchange market started functioning, the price competitiveness of the export in 1997 for the first time surpassed the level of May 1993, by which the trend of decreasing competitiveness of the Macedonian export in the preceding years was ceased. Namely, at the end of 1997 the price competitiveness of the export was 4.57% higher compared to May 1993.

6.4. Foreign exchange reserves of the Republic of Macedonia

According to legal regulation, foreign exchange reserves of the Republic of Macedonia consist of the foreign exchange reserves managed by the Central Bank and the foreign exchange reserves managed by the banks licensed for payments and credit relations to abroad. At the end of 1997 foreign exchange reserves of the Republic of Macedonia amounted to USD 349.9 million. In comparison with the level of the end of 1996 they are USD 32.6 million, or 10.3% higher.

On December 31, 1997, gross foreign exchange reserves of the National Bank of the Republic of Macedonia (the official foreign exchange reserves of the Republic of Macedonia) amounted to USD 280.1 million, which compared to the end of the previous year represented an increase of USD 12.6 million, i.e. 4.7%. Gross foreign exchange reserves changes in 1997 were generally determined by the situation in the balance of payments and the developments on the foreign exchange and exchange offices markets, by inflow and outflow of the foreign exchange on the basis of borrowing from abroad and foreign debt servicing, as well as from the character of the monetary strategy implemented by the Central Bank (using the denar exchange rate as a main nominal anchor).

Two periods can be distinguished in the movements of the gross foreign exchange reserves of NBRM - before and after the July devaluation of the denar exchange rate. Thus, in the first half of 1997 the accomplishments in the foreign trade of the Republic of Macedonia were below expectations (the export failed), which created a continuous pressure upon denar exchange rate on the foreign exchange and exchange offices markets. In accordance with the adopted monetary concept, NBRM defended the targeted level of the nominal denar exchange rate against Deutsche mark, by using the foreign exchange reserves for interventions on the market. Consequently, in the period January - June 1997 a net sale of foreign exchange in amount of USD 11.7 million was realized. It had a negative influence upon movements of the gross foreign exchange reserves of NBRM, although it was compensated by withdrawal of the SAL arrangement first tranche.

In the second half of 1997, after denar exchange rate devaluation, the foreign trade situation improved and supply exceeded the foreign exchange demand on the foreign exchange market and exchange offices market. It resulted in net purchase of foreign exchange by NBRM in the amount of USD 44.6 million. In spite of the significant outflow of funds in the same period because of the foreign debt repayment, in the second six months of 1997 gross foreign exchange reserves of NBRM on net basis increased by USD 24.3 million.

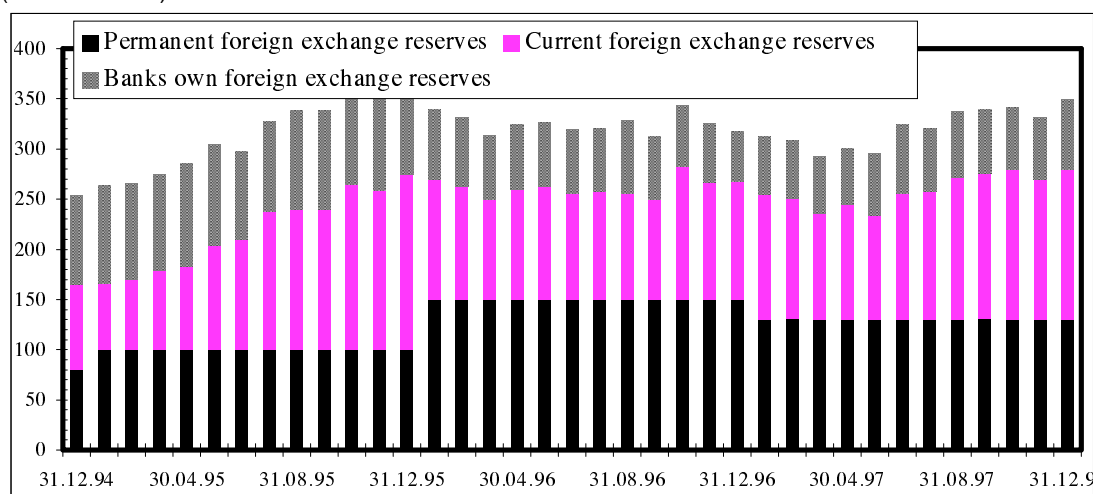
The total foreign exchange inflow in the gross foreign exchange reserves of NBRM realized in 1997 amounted to USD 233.1 million. Largest participation in the total inflow structure had the foreign credits and donations, which together participate with 40.1% and the inflow from the purchased excess foreign exchange on the exchange offices market with 36.9%. In 1997 the total foreign exchange outflow from the gross foreign exchange reserves of NBRM amounted to USD 220.5 million. The largest part of the outflow refers to repayment of foreign credits (48.6%), oil purchase (22.5%) and interventions on the foreign exchange market (12.1%).

The net foreign exchange reserves of the National Bank of the Republic of Macedonia, as difference between gross foreign exchange reserves and liabilities to IMF, at the end of 1997 amounted to USD 192.0 million and in comparison with the level of the end of the previous year were USD 7.0 million lower. This decrease is mostly due to the realized net outflow of the foreign exchange for servicing the foreign debt of the Republic of Macedonia (USD 36.0 million). At the same time, liabilities to IMF in 1997 realized an increase as a result of a withdrawal of the first tranche of the ESAF arrangement (USD 25.0 million).

Permanent foreign exchange reserves of the Republic of Macedonia for 1997, by which minimum level of liquidity in payments to abroad is secured, were fixed at one month level payments to abroad, i.e. at the level of USD 130.0 million. The current or operative foreign exchange reserves managed by NBRM at the end of 1997 amounted to USD 150.1 million.

Graph 17

Foreign exchange reserves of the Republic of Macedonia (in USD million)



On December 31, 1997, the total foreign exchange assets of fully fledged banks amounted to USD 256.9 million and compared with the level at the end of the previous year were higher for USD 61.4 million, or 31.4%. The own foreign assets of the banks at

the end of 1997 reached the level of USD 69.8 million, which is USD 20.0 million higher than the level at the end of 1996 and also USD 14.7 million above the prescribed foreign exchange minimum which banks have to have at their disposal. The increase of the own foreign assets of the banks is realized in the period after devaluation of the denar exchange rate against Deutsche mark.

Foreign assets of banks on the basis of foreign currency deposits at the end of 1997 amounted to USD 187.1 million and compared to the situation at the end of the previous year were USD 41.4 million higher. Foreign currency deposits of residents (individuals and enterprises) amounted to USD 89.0 million and compared to the previous year increased by USD 19.0 million, i.e. 27.1%. Foreign currency deposits deposited by non-residents at the end of 1997 amounted to USD 71.0 million and compared to the end of 1996 were higher by USD 23.0 million, or 47.9%.

The total foreign exchange potential of the Republic of Macedonia, which consists of foreign exchange reserves managed by NBRM adding the total foreign exchange funds of the banks with full operating license, at the end of 1997 amounted to USD 536.9 million. It represents its highest level in the period after the monetary independence and it is higher by USD 73.9 million, or 16.0% than the level at the end of 1996.

6.5. Foreign exchange market

The foreign exchange market of the Republic of Macedonia operates on two levels:

- a) foreign exchange market where supply and demand for foreign currency of enterprises and banks meet; and
- b) foreign exchange market on which individuals trade with foreign currency (exchange offices market).

Starting from 1994, on the foreign exchange market where enterprises and banks trade, net outflow of funds has constantly been present, which means demand is permanently higher than supply. Therefore, net outflow from the foreign exchange reserves on this market in 1997 reached the level of USD 37.0 million, which is USD 1.3 million higher than the respective one from the previous year. In respect of dynamics, excluding August and December, in all other months in 1997 on the basis of NBRM interventions on the foreign exchange market net outflow of foreign exchange from the foreign exchange reserves was realized, especially outstanding in March and November.

On the exchange offices market, during 1997, as well as in the whole preceding period after the monetary independence, foreign exchange supply exceeded the demand. This enabled foreign exchange inflow on the basis of purchased excess effective foreign currency on the exchange offices market to represent the most significant source of the foreign exchange reserves. From the total net purchase of foreign exchange on the exchange offices market in 1997, USD 86.0 million were spilled into foreign exchange reserves of NBRM, which is the highest amount in the preceding period. Compared to the previous year, the inflow into foreign exchange reserves from the exchange offices market is higher by USD 42.7 million, or 98.6%. The largest inflows from the exchange offices market into foreign exchange reserves were realized in the second half of 1997, when foreign exchange sale became more attractive for the citizens. Namely, in the first half of 1997 NBRM purchased USD 18.8 million from the exchange offices, which is 22.1% more than in the first half of the previous year, while in the second half of 1997, after devaluation total USD 65.8 million were purchased from these subjects, which represents an increase of 158.0% compared to the second half of 1996. The practice of giving advances to the licensed exchange offices ceased in February 1997 and NBRM started to purchase the excess effective foreign currency on the exchange offices market

indirectly, through the licensed banks, paying the denar countervalue at the moment of foreign exchange transfer.

6.6. Foreign debt of the Republic of Macedonia

At the end of 1997, the total medium and long - term foreign debt of the Republic of Macedonia amounted to USD 1,126.8 million. The level of the foreign debt at the end of 1997 compared to the end of 1996 was lower for USD 45.6 million, or 3.9%. This was due to the repayment of foreign liabilities in the amount of USD 125.2 million, of which USD 72.0 million interest and USD 53.2 principal.

The largest part of realized payments to abroad during 1997, i.e. USD 70.0 million referred to the multilateral creditors. In favor of European Investment Bank payments in the amount of USD 36.1 million were made, which was a condition for signing an agreement and withdrawing a credit from European Union in the amount of ECU 40,0 million, in the frames of macroeconomic support of the balance of payments agreed at the donor conference in Brussels. In spite of this, in 1997 liabilities to European Bank for Reconstruction and Development (in amount of USD 12.5 million), International Bank for Reconstruction and Development (USD 11.2 million) and International Monetary Fund (USD 3.7 million) were paid.

Regulating the debt to the countries members of the Paris club continued in 1997, and the Republic of Macedonia signed bilateral agreements with Kuwait, Netherlands, USA and Japan. With this, bilateral agreements were concluded with all countries which signed the Agreement for consolidation of the Republic of Macedonia debt with Paris club on July 17, 1995.¹²

The payments to bilateral creditors in 1997 amounted to USD 45.7 million, of which USD 27.8 million paid interest and USD 17.9 million paid principal. Largest part of realized payments to bilateral creditors, i.e. USD 24.4 million is paid interest on rescheduled debt from 1995/96, while from the total paid principal, USD 17.0 million refers to payments for regularly matured principal.

Within the activities for regulating the debt to the London club of creditors, in March 1997 a swap of old credit records for bonds issued by the Republic of Macedonia was made. The bonds issued on the basis of old credit records mature in 15 years, with 4 years grace period and Libor interest rate plus 0.8125 percentage points. Moreover, with the agreement signed with the London club, the debt of the Republic of Macedonia towards this group of creditors is fixed at the level of USD 228.7 million. Compared to the situation at the end of 1996, it is lower for USD 52.3 million due to exclusion of "the linked persons"¹³ from the debt swap.

On December 31, 1997, the total amount of due but unpaid liabilities to abroad amounted to USD 11.7 million, of which USD 9.3 million were due but unpaid liabilities to the member countries of the Paris club of creditors. The remaining USD 2.4 million of the total due but unpaid liabilities referred to liabilities to commercial banks - London club of creditors members.

¹² Bilateral agreement with Italy is concluded at the beginning of 1998.

¹³ FR Yugoslavia, which did not participate in the negotiations with the London club, is excluded and the total amount of the debt is reduced for its debt participation. On that reduced basis the part of the debt which belongs to the Republic of Macedonia (5.4% of the debt on the basis of principal, and 3.65% of the debt on the basis of due unpaid interests) is calculated.

During 1997 new credits in the amount of USD 149.4 million were withdrawn, of which USD 105.1 million from multilateral creditors. The largest part, i.e. 30.4% of the total disbursed amount referred to the credit from European Bank for Reconstruction and Development, then the credit from the International Development Association with participation of 27.7%, the credit from International Monetary Fund with 23.7% and the credit from International Bank for Reconstruction and Development with 18.2% of the total borrowing from multilateral creditors.

During 1997, on the basis of the approved ESAF arrangement, from the International Monetary Fund funds in the amount of USD 24.9 million were disbursed in two tranches.

During 1997 from the International Bank for Reconstruction and Development total USD 19.1 million were disbursed, of which the biggest part referred to: a/ the first tranche of the approved structural adjustment loan (SAL) in the amount of USD 12.7 million and b/ private sector development loan in the amount of USD 5.7 million.

From the International Development Association during 1997 credits in total amount of USD 29.1 million were disbursed, which primarily refer to the first tranche of the structural adjustment loan (SAL) in the amount of USD 23.0 million and the disbursement of USD 3.7 million from the social reforms credit approved in 1995 in total amount of about USD 14.0 million.

From the European Bank for Reconstruction and Development during 1997 funds in total amount of USD 31.9 million were withdrawn for the following projects: 1/ for development of small and medium enterprises USD 8.4 million; 2/ for improving the telecommunications USD 8.1 million; 3/ for energy sector development USD 4.3 million; 4/ the approved financial credit to one commercial bank amounted to USD 5.2 million; 5/ for reconstruction of the Skopje Airport USD 4.2 million were used; 6/ for a project for improving the system of flying control USD 1.7 million were withdrawn.

During 1997 from the bilateral creditors credits in the amount of 34.7 million were granted. The largest part of disbursed funds (80.1%) refers to the first tranche of the credit from European Union in the amount of USD 27.8 million. The remainder of the used funds generally refers to the credits from Germany and Czech Republic for import of equipment for electric power industry. In 1997 the Republic of Macedonia withdrawn in total USD 9.5 million from the private creditors.

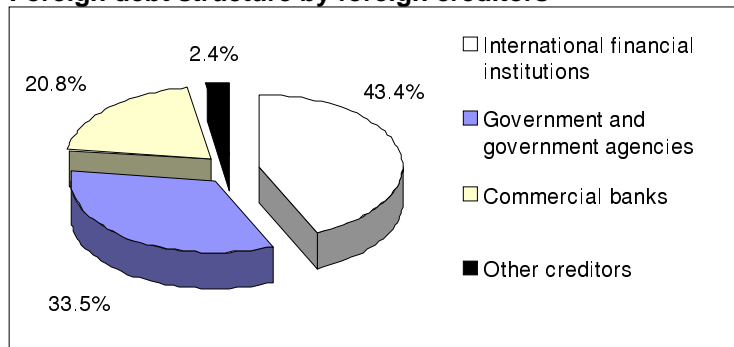
The new credits approved during 1997, funds of which have not been disbursed yet, at the end of the year reached the amount of USD 48.4 million. Those are credits approved by the following creditors: 1/ the International Bank for Reconstruction and Development (IBRD) for the project of irrigation system reconstruction granted USD 7.5 million; 2/ from the International Development Association (IDA) a credit in the amount of USD 5.0 million was approved; 3/ from the International Finance Corporation an amount of USD 6.1 million aimed at raw materials and semi-manufactures for the textile industry needs, as well as equipment for the manufacturing enterprises was approved; 4/ from International Fund for Agriculture Development (IFAD) for the project of rural development of southern and eastern regions USD 7.6 million were approved; 5/ from the bilateral creditors a framed credit for import of capital goods from Switzerland in the amount of USD 17.2 million and credit of USD 5.0 million for import of equipment from Czech Republic were approved.

6.6.1. Foreign debt structure

The analysis of the structure of the foreign debt of the Republic of Macedonia by types of foreign creditors indicates that 76.8% of the total debt is the debt to the official creditors (multilateral and bilateral creditors) and 23.2% to the private creditors.

Graph 18

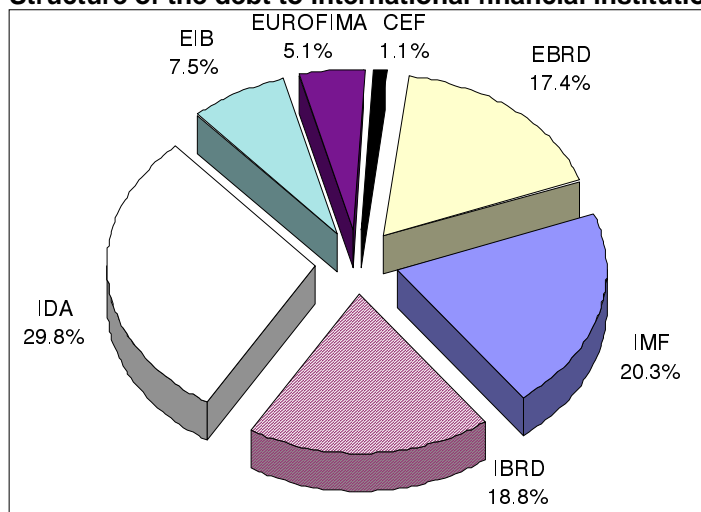
Foreign debt structure by foreign creditors



Within the official creditors group, the debt to the multilateral creditors at the end of 1997 amounted to USD 488.8 million, which is 43.4% of the total foreign debt of the Republic of Macedonia. The participation of this debt in the total foreign debt at the end of 1997 increased by 3.7 percentage points in comparison with the end of the previous year. The largest participation in the total debt from the multilateral creditors was on the part of the International Development Association (12.9%), after that International Monetary Fund (8.8%), International Bank for Reconstruction and Development (8.2%), European Bank for Reconstruction and Development (7.5%) etc.

Graph 19

Structure of the debt to international financial institutions



At the end of 1997 the debt towards bilateral creditors amounted to USD 376.9 million, i.e. 33.4% of the total foreign debt of the Republic of Macedonia. Its participation in the total foreign debt at the end of 1997 was lower by 0.9 percentage points compared to the end of 1996. This was a result of the newly signed bilateral agreements during 1997 in which the agreed level of the debt is lower compared to the assessed level at the end of 1996, as well as of the regular payments of interest and principal on rescheduled and nonrescheduled debt.

In the bilateral debt structure the rescheduled debt had dominant participation of 76.8%, after which followed the new credits from bilateral creditors with 12.5% and nonrescheduled debt with participation of 10.7%. In the structure of the debt to the bilateral creditors, the debt to the USA and Germany had the largest participation (28.7% and 27.2%, respectively).

At the end of 1997 the debt towards private creditors amounted to USD 261.0 million. Its participation in the total foreign debt of the Republic of Macedonia was 23.2%. In comparison with the end of the previous year, the participation of the debt to the private creditors in the total foreign debt at the end of 1997 was lower by 2.9 percentage points, which was due to the favorable contract with the London club signed in March 1997. In addition, the debt to the London club participates with 89.7% in the amount of the debt towards private creditors, i.e. with 20.8% in the total foreign debt of the Republic of Macedonia.

VII. Supervision of banks and savings houses

7.1. Structure of the banking system

The regulative framework for functioning of the banking system in the Republic of Macedonia promotes the universal character of banking, which means performing the traditional banking activities, such as: deposit collection from legal entities and individuals, lending and borrowing credits, as well as the possibility for participation on the capital market through issuing own securities or acting as an intermediary in the trade with other securities of other entities.

Banking system of the Republic of Macedonia consists of banks and savings houses. Commercial banks are the core of the banking system of the Republic of Macedonia, considering the functions that they are performing and their share of 98.7% in the total financial potential. The marginal role of the sector of savings houses can be presented through several indicators:

- insignificant role of the savings houses in the total financial potential of the banking system - about 1.3%, according to the data from balance sheets on 31.12.1997;
- participation of the savings houses credits to the citizens of only 12.0% of the total credit portfolio of the population on the banking system level.
- participation of the household deposits in the savings houses in total household deposits with the banking system is only 4.0%, i.e. 7.0% if only denar deposits are taken into consideration.
- the capital strength of the savings houses - on 31.12.1997, the savings houses participated with only 2.2% in the total banking system own capital.

At the end of 1997, there were 21 banks, 1 branch office of a foreign bank and 20 savings houses in the Republic of Macedonia. During 1997, working licenses were withdrawn from 8 savings houses due to the violation with the legal regulation. In the same period, one license for foundation and operation of the savings house was granted.

The structural analysis of the banking system, from the standpoint of the size of the financial potential and the banks' own capital, shows extreme imbalance in terms of capital strength and the distribution of the financial potential among the banks. According to the disposable financial potential, the two biggest banks participate with more than half of the banking system total financial potential. The third biggest bank participates with only 5.5% in the total financial potential, which is a big lag behind the two biggest banks.

If the amount of own sources of capital in the liabilities is taken as a criteria, then again the two biggest banks have the dominant share - their participation in the total banking system own potential is 37.0%, according to the data on 31.12.1997.

With regard to the degree of privatization of the Macedonian banking system, there are high variations by banks, starting from slightly above 50.0% for the biggest bank, and up to 100.0% for some of the smaller banks.

According to the ownership structure of Macedonian banks, they could be divided in several groups, such as:

-Banks with dispersed equity structure, where the highest influence in managing of the bank comes from a large number of shareholders. This group of banks consists of 12 banks, which is the core of the banking system of the Republic of Macedonia.

-Banks with oligo-ownership structure, where there are several founders who have the managing control, and in the most cases one dominant shareholder or several persons connected by their capital and managing relations. This group includes 5 banks.

-The third group consists of 4 banks, founded by foreign banks.

From the total number of banks, half of them are with mixed capital, and the rest of 10 banks are with domestic capital only. The lowest participation of foreign capital in one bank is 7.0%, and the highest share, belonging to one founder, is 95.0%.

The regional structure of the banking system of the Republic of Macedonia shows very inadequate territorial distribution. Namely, only 6 banks and 4 savings houses are located outside of Skopje. Financial potential of the banks outside of the capital city is only 15.0% of the total banking system potential. This shows high concentration of the financial potential in the capital of the country, resulting in overconcentrated and asymmetric supply of financial services.

7.2. Analysis of the banking system performances

7.2.1. Asset Quality

The banking system of the Republic of Macedonia disposes with a relatively poor quality of assets. On 31.12.1997, all the claims classified in the risk groups C, D and E participated with 35.6%, which points out to the conclusion that there are serious problems in the collection of more than one third of the credit portfolio. But, one should take into consideration the fact that this indicator significantly improved compared to the previous year (on 31.12.1996 it was 42,8%). The high percentage of non-performing claims points out to two possible problems: creation of non-performing loans as a result of inadequate credit procedures in the banks, or maintaining of non-performing loans from the previous years in the banks' portfolios, with almost no chance for their collection. Thus, most of the positions classified in the risk category E have almost no chance to be collected, they originate from the previous years and fulfill conditions to be written off. Having in mind this, if we exclude the positions classified in the risk category E from the total credit exposure, then the share of the negatively classified positions will be reduced to 27.6%.

Other problem concerning the quality of assets are the high credit concentrations to single clients, which exceeds the prescribed legal limits of 30.0%, and 10.0% in relation to the guarantee capital. But one must bear in mind the fact that these violations have had a decreasing trend in the last several years. Significant violations are still present in the bigger banks which finance large export activities, as well as in some of the smaller banks which are directed to support their dominant founders with credits. As on 31.12.1997, 10 banks exceeded the legal limit of 30.0% and 7 saving houses exceeded the legal limit of 10.0%.

7.2.2. Capital adequacy

On 31.12.1997, the average guarantee capital of the banking system was denar 516.3 million, which equals to DEM 16.7 million, while the guarantee capital of the savings houses was denar 13.5 million, which equals to DEM 435.5 thousand. The capital

adequacy indicator is the ratio of the guarantee capital and the risk weighted assets, and it is the basic indicator for the estimation of the real, i.e. the adequate level of capitalization. On 31.12.1997, this indicator was 28.3% and was much higher than the minimum prescribed limit of 8.0%.

The capital adequacy indicator can be partially reduced on the basis of the additionally determined loan loss provisions through on-site controls in several banks, but in any case it will be higher than the prescribed limit. This is due to the fact that there are banks whose capital adequacy ratios are even above 100%, which is result of the significantly higher amount of the capital than the risk assets. At the end of 1997, all the banks operating in Macedonia fulfilled the prescribed capital adequacy limit. The aggregate indicator of the capital adequacy of the savings houses was 56.5%, due to the restriction of the size of their operations, through setting limit by which the amount of the deposits should be completely covered by the founding capital. All the savings houses, except one, fulfilled the prescribed minimum.

7.2.3. Profitability

The annual financial statement for 1997 showed that the banking sector of the Republic of Macedonia has realized net profit in the amount of denar 1.1 billion, which is increase of 142.0% compared to the financial results in 1996. This was mainly due to the effects from the devaluation in July, i.e. to the high amount of positive foreign exchange gains realized on that basis.

The profitability indicators of the Macedonian banks in 1997 were within the internationally accepted standards. The return on assets (ROA) was 2.2%, and was one percentage point increased compared to 1996. This indicator shows that 100 units of assets of the Macedonian banks produce 2.2 units net profit. The indicator ROE - return on equity, was 9.3% in 1997, compared to 4.3% in 1996. That means that 100 units of banks' capital in the Republic of Macedonia produce 9.3 units net profit.