

Honorable,

*As Governor of the National Bank of the Republic of Macedonia (hereinafter NBRM), I am honored to submit to you the 1999 Annual Report of the National Bank. This is a fulfillment of the legal obligation, stipulated in article 8 of the National Bank of the Republic of Macedonia Act, for submission of the Annual Report on monetary policy implementation to the Parliament of the Republic of Macedonia. This report was adopted by the NBRM Council on March 23<sup>rd</sup>, 2000.*

*Behind us is a year which economically speaking was very specific. In order to come up with an objective evaluation of the economic developments in the Republic of Macedonia one must take into account the circumstances prevailing in the Macedonian economy. Namely, the external shock, caused by the war in the neighboring FR Yugoslavia, had a major impact on the Macedonian economy, creating negative effects on the demand side as well as the supply side. This imposed the need of revision of the initial economic estimates, replacing them with new, quite pessimistic ones. However, under these circumstances, the Macedonian economy showed surprisingly high level of vitality, i.e. capability of facing the extremely unfavorable external influences. What was achieved on the macroeconomic field in 1999, partly departs from the initial estimates, but on the other hand it is far better than the pessimistic projections formulated at the height of the crisis in FR Yugoslavia.*

*Briefly, the upward trend in the economy registered in the last couple of years continued in 1999. Despite the fact that it is relatively slower, it is exceptionally important that it was achieved at times of extremely unfavorable external influences. At the same time, despite all the turbulent movements, the previously established stability of the domestic currency was preserved on both internal and external plan. Namely, the rate of inflation remained low and stable, while the exchange rate of the Denar against the Deutsche Mark was preserved at the targeted level. However, this was not followed-up by more significant improvement on the issues that have been causing problems in the previous years. The rate of unemployment, the foreign trade deficit and the lack of financial discipline remained high. Also, the need of further improvement in the corporate management remained, as a way to bring the corporate sector closer to the logic of free market. The unsolved problems in 1999 call for prompt continuation and acceleration of the structural reforms in the Macedonian economy, in order to bridge the gap to the most developed countries in transition.*

*Contrary to the estimates for contraction of the economic activity in the Republic of Macedonia in 1999 inspired by the influence of the external shock, according to the preliminary estimates, the real gross domestic product (GDP) increased by 2.7%. Despite the fact that the rate of growth is by 0.2 percentage points lower compared to 1998, it is far better than the pessimistic estimates of reduction in real GDP by 4.0% to 15.0%. It is important to note that this is the fourth year in a row in which positive rate of economic growth is being registered. However, in the future, this rate of growth should increase more rapidly in order to have visible positive effects.*

*What is typical for 1999 is that the growth in GDP is not a result of the implementation of structural reforms, but of the responsiveness of the supply side factors to the changes in demand following the war in FR Yugoslavia. The increase in GDP was generated by the increase in the value added to services, baring in mind that for the first time,*

following a three-year continuous trend of positive growth rates, the industrial production remained in the zone of negative growth rates. However, a favorable development is that the decline in the industrial production was significantly reduced from the two-digit negative growth rates in the period of the height of the crisis in FR Yugoslavia, when the access to the Yugoslav market, a major trading partner of the Republic of Macedonia, and the transport corridor through this country was blocked. Hence, the removal of the influences that were restricting the enhancement of the economic activity in the Republic of Macedonia caused by the external shock, resulted in positive economic developments in the second half of 1999, which serve as a basis for the projections of the continuation of this tendency in the year 2000.

One of the necessary pre-conditions for more significant economic growth is the acceleration of the investment activity. The level of investments in fixed assets in the Republic of Macedonia in 1999 remained very low, thus their share in GDP also remained at unsatisfactory low level. This is due, on one hand, to the high interest rates on bank loans and their unfavorable maturity structure, and on the other hand to the increased risk level in the region. This had a negative effect on the foreign investors which is why, despite the preserved macroeconomic stability in the country, the level of foreign direct investment in 1999 was significantly lower compared to 1998. However, it is encouraging that in 1999, few contracts for foreign direct investments in the Republic of Macedonia were concluded, which are expected to be finalized in the year 2000.

The modest reduction in the rate of unemployment during 1999, does not alter the conclusion that the unemployment is the single macroeconomic variable that corrupts the positive developments in the Macedonian economy to the largest extent.

Exceptionally important macroeconomic achievement in the Republic of Macedonia in 1999 is the preservation of the established macroeconomic stability. Hence, on December basis (December 1999 / December 1998), the rate of inflation, measured through the increase in retail prices, equaled 2.3%, which is within the framework of the projected maximum increase of 3.0%. This was not an easy task to achieve in conditions of explicit danger that the negative external influences caused by the war in FR Yugoslavia could generate deterioration of the price stability. However, with a successful coordination between the monetary policy, fiscal policy and wages policy, the major potential factors that could lead to intensified inflationary movements were kept under control. Together with the low annual rate of inflation on December basis in 1999 in the Republic of Macedonia, this represents a five-year trend of one-digit rates of inflation.

In order to keep the rate of inflation within the projected framework, during 1999, NBRM continued with the implementation of the monetary strategy of targeting the nominal exchange rate of the Denar against the Deutsche Mark. In accordance with this strategy, preserving the exchange rate of the Denar at the targeted level was the intermediate target, through which the price stability, being the main goal, was preserved. In addition, baring in mind the strong external shock to the Macedonian economy, the usage of such a strategy made the Money market the main absorber of the unfavorable influences, which resulted in significant increase in the interest rate on this market during the height of the crisis. However, utilizing all available monetary regulation instruments, under very difficult circumstances, the Central Bank managed to normalize the situation on the Money market, while, at the same time, keeping the exchange rate of the Denar against the Deutsche Mark at the targeted level. In the period following the end of the Kosovo crisis, the average weighted interest rate on the Money market registered a continuous decline, thus falling from 25.2% in May 1999, the highest level registered, to 11.6%p.a. in December 1999.

The favorable movements on the foreign exchange market, especially in the period following the end of the military action in FR Yugoslavia contributed significantly to the

successful realization of the projected monetary policy for 1999. Namely, the greater supply than demand on the foreign exchange market resulted in net-purchase of foreign exchange in the amount of US Dollar 118 million by NBRM, which is by US Dollar 82 million more compared to 1998. In addition, the Ministry of Finance had a significant contribution to the successful sterilization of the monetary effect from the substantial purchase of foreign exchange by NBRM, which simultaneously created room for more intensified credit activity in the banking sector. During 1999, the State Budget funds deposited with the NBRM were transferred to the Monetary Policy Support Fund of the NBRM, thus continuing the successful coordination of the monetary and fiscal policies. The significant net-purchase of foreign currency from the foreign exchange market was the main factor, acting towards an increase in the foreign exchange reserves of NBRM by US Dollar 125 million. Thus, at the end of 1999, they reached US Dollar 458 million, which represents the highest level since the monetary independence of the Republic of Macedonia and covers 3.1 months of imports.

However, the favorable movements on the foreign exchange market in 1999 are primarily due to the influence of external factors (foreign donations and increased presence of non-residents), and not to the qualitative improvement in the foreign trade and inflow of foreign exchange on these grounds. Namely, in 1999, the foreign trade deteriorated, which can be seen through the unfavorable changes in its structure, reduction in the import-export coverage ratio, and foreign trade deficit which still remained high. The external shock caused a contraction in the foreign trade by 7.4%, resulting from a reduction in exports and imports by 9.1% and 6.2%, respectively. The lower pace of decline of imports relative to exports resulted in a continuation of the trend of registering high foreign trade deficits, which equaled US Dollar 604 million in 1999. It is especially important to note that the deficit in the current account of the balance of payments in 1999 was brought to half of the level in 1998 and equals 3.9% of GDP.

Regardless of the generators of the significant net-purchase of foreign currency from the foreign exchange market by NBRM in 1999, it resulted in an increase in the reserve money and a high level of liquidity of the banking sector. Namely, the average annual rate of increase of the reserve money equaled 9.4%, while on December basis, the increase is even more significant and equals 11.2%. The increase in the reserve money, together with the increased level of the monetary multipliers resulted in a substantial increase in the money supply. In 1999, on December basis, the money supply M1, which includes the currency in circulation and the demand deposits, increased by Denar 4,516 million, or by 29.8%. The average growth rate of the money supply M1 in 1999 reached 24.3%. At the same time, there were favorable changes in the structure of the money supply M1 and an increase in the share of the demand deposits at the expense of the currency in circulation by 5.7 percentage points.

High growth rates were registered in the broader monetary aggregates as well. Hence, the money supply M2 - Denar component increased by Denar 6,648 million, or by 33.5% on December basis in 1999, while the broadest definition of money supply increased by Denar 8,642 million, or by 29.3%. Despite the considerable increase in the money supply, NBRM did not endanger the established price stability, and at the same time supplied amount of money sufficient for the normal execution of economic transactions in the economy. Simultaneously, the banking sector of the Republic of Macedonia passed a major test, showing great responsiveness while facing a danger of "a run on the banks". Namely, the banks successfully responded to the sudden and intensive withdrawal of deposits by the economic agents in the moments prior to the beginning of the war in FR Yugoslavia, when the risk and uncertainty were greatest. This led to a relaxation in the overall environment, which acted towards further increase in the confidence in the banking system and continuation of the tendency of growth in the savings of both households and enterprises.

The increase in deposits resulted in an increase in the deposit potential of banks, i.e. their capacity for a more intensive credit support to the economy. The banks' total placements

increased by Denar 3,027 million, or by 9.4%, in 1999. As well as in the previous years, the maturity structure of the banks' total placements remained unfavorable, with the short-term credits accounting for the largest part. The absence of a substantial long-term support for the economic agents is still a factor that restricts the process of a more dynamic economic activity in the Republic of Macedonia. With respect to the currency of denomination, the foreign currency credits registered a more significant increase, which corresponds with the more attractive interest rates charged on these credits.

The banks' interest rates in 1999 remained high, thus continuing their adverse effect on potential investors. Characteristics of the interest rates is that they remained unchanged even during more intensive economic fluctuations, generated by the influences of external factors, which reflects the rigidity of the banks designing of their interest rate policy. In 1999, the banks' nominal average weighted lending interest rates equaled 20.5%, which represents only 0.5 percentage points decline compared to 1998. In conditions of established price stability, this resulted in substantially high real interest rates of banks, which equaled 21.6%.

Generally speaking, the positive trend of development of the financial sector in the Republic of Macedonia and the steps towards its consolidation and strengthening continued in 1999. Macedonian banks managed to overcome the challenges they faced during the escalation of the crisis in FR Yugoslavia relatively successfully. At the same time, there was a further affirmation of the role of the Money and short-term securities market and the Macedonian Stock Exchange. In 1999, the activities related towards the reform of the payments system continued, as well as the successful functioning of the Deposit Insurance Fund. With this, environment is being set for an increased financial intermediation in the Republic of Macedonia, as a precondition for a more efficient allocation of financial resources and promotion of economic growth.

Looking ahead to the future, to assure a more dynamic economic activity and to reduce the effect of the problem of unemployment in the Republic of Macedonia, two major issues should be addressed and resolved. Firstly, a prompt continuation and expansion of the structural reforms. This is the only way for a long-term restructuring of the Macedonian economy and accomplishment of a greater degree of compatibility with the international economic processes. For this purpose, it is necessary to successfully negotiate the needed arrangements with the international financial institutions, due to their financial effects for the support of the balance of payments, but perhaps even more important for their signaling effects for the potential foreign investors. It is worth noting that in 1999, despite the cancellation of the ESAF arrangement of the Republic of Macedonia with the International Monetary Fund, the Central Bank did not change the course of its behavior and asserted once again its firm commitment to the preservation of the hardly achieved price stability.

Secondly, a reduction in the price of capital borrowed from banks is of utmost importance for the future development of the Macedonian economy. In this context, few steps should be undertaken. Continuation in the upward trend in domestic saving is very important, thus creating a basis for the credit activity of banks. For that purpose, it is necessary to preserve the macroeconomic stability, to further strengthen the banking supervision and to successfully operate the Deposit Insurance Fund, as well as to resolve the problem of the old foreign exchange deposits (frozen deposits), which will in turn lead to greater confidence of the economic agents in the banking system. Further more, the reduction in the banks' interest rates could be achieved through the qualitative increase in the competition in the banking sector, through further capitalization of domestic banks and entry of foreign banks, which will also simultaneously act in direction of increasing the level of saving. Also, the legal framework regarding the collection of claims of banks should be completed, thus eliminating part of the risk currently incorporated in the high interest rates. The development of the Macedonian Stock Exchange and the further institutional diversification in the financial sector, motivated among other things also by the reforms of the pension system in the

*Republic of Macedonia, will allow the economic agents access to cheaper sources of financial assets, which will in turn act toward reduction in the traditional orientation of the economic agents to finance their needs exclusively by banks' funds. Rapid economic growth in conditions of sustainable macroeconomic stability in the national economy is the best invitation for a more intensive entrance of foreign investors in the Republic of Macedonia.*

*Skopje, April, 2000*

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National Bank of the Republic of Macedonia*