

### III. Monetary Policy

#### 3.1. Monetary Policy goals and objectives

According to the macroeconomic program, in 1999, intensification of the economic development and achievement of a real GDP growth of 6.5% at the end of the year was expected. The projected economic growth in the Republic of Macedonia was supposed to be reached by intensifying the structural reforms in the real and financial sectors, which at the same time was expected to be supported by foreign capital inflow and increased productivity of the Macedonian economy. In such a global framework, by maintaining the stability of the nominal Denar exchange rate against the Deutsche mark, the monetary policy was supposed to provide price stability by keeping the inflation rate below 3% on December basis. In this manner, a macroeconomic environment which is the most favorable for achieving economic growth sustainable on a long run would be created and the monetary policy would give adequate contribution for realization of the projected macroeconomic objectives in the Republic of Macedonia for 1999.

Hence, with the monetary policy projection for 1999, the money supply M2 - Denar was projected to increase by 11.4% on annual basis, taking into account the expected net purchase of foreign exchange on the foreign exchange market of US Dollar 53 million. In order to sterilize the monetary effects of the foreign exchange transactions of the Central Bank, an amount of Denar 1,850 million was projected to be deposited from the Budget with the NBRM aimed at monetary policy support.

Nevertheless, the escalation of the crisis in FR Yugoslavia led to a military intervention of the NATO forces in this neighboring country and a military conflict in the March - June 1999 period. This caused a strong external shock with large negative consequences for the Macedonian economy. Namely, a significant market for Macedonian products was lost, taking into account that FR Yugoslavia is the second most important trading partner of the Republic of Macedonia. At the same time, this meant a closure of the transport corridor through this neighboring country, as a most favorable one for transporting Macedonian products into West European markets. In addition, the increased political risk of the country also had a negative impact, by discouraging the foreign capital inflow needed for implementation of the structural reforms in the financial and real sectors. The external shock had a reflection on the supply side by decreasing domestic production and imports, as well as on the demand side by exports decline. Considering the uncertainty about the duration of the war in FR Yugoslavia, the negative effects were not expected to be neutralized in the short-run, which resulted in pessimistic scenarios for the macroeconomic performances of the Macedonian economy in 1999.

However, the macroeconomic developments in the period after the end of the Kosovo crises were significantly better than the expected ones. Namely, the unfavorable developments in the primary activities, resulting from the deteriorated working conditions during the war in FR Yugoslavia, were compensated by an increase in tertiary activities, which enabled an increased new value-added. At the same time, contrary to the expected small acceleration in inflation, in the period after the end of the conflict a deflation trend was registered, mainly due to the decline in the prices of agricultural products on the domestic market, as well as the fall in the prices of raw materials on the world market. In such conditions, it was estimated that the Republic of Macedonia in 1999 will achieve a positive rate of GDP growth and lower inflation rate than the projected one. Instead of the projected shortage, there was an excess of foreign exchange on the foreign exchange market and the stability of the Denar exchange rate was maintained. The favorable developments on the foreign exchange market, together with the increase of the deposits in the banks (especially of

the demand deposits), modified the assumptions on which the developments in the monetary aggregates were based. According to these developments, the annual growth rate of the money supply M2 - Denar at the end of 1999 was estimated to reach 34.2%.

In 1999, a further development and upgrading of the monetary policy instruments as well as moving into indirect market instruments of monetary regulation was supposed to take place. The reforms in the payment system, together with a full affirmation of the Money market in 1999 was expected to result in a more optimal dispersion of the liquidity within the banking system. The strengthening of the banks supervision and functioning of the deposit insurance system was supposed to enable strengthening of the credibility of the banking system, as a pre-condition for growth of domestic saving and credit financing to the economy. At the same time, the efforts for improving the financial discipline and collection of claims from the debtors, as well as the increased competition between the banks; considering the expected entrance of foreign prominent banks, was supposed to lead to a decline in the lending interest rates and interest rate margins of the banks.

### **3.2. Report on monetary developments in 1999**

The main factor influencing the monetary developments in the Republic of Macedonia in 1999 was the strong external shock caused by the war in FR Yugoslavia. Despite the direct and indirect consequences resulting from the escalation of the crisis in the neighborhood, the macroeconomic and monetary movements realized in 1999 exceeded the expectations. Thus, contrary to the pessimistic scenario of the inflation rate reaching 4%, the achieved rate of inflation on December basis equaled 2.3%. It shows that the monetary authority succeeded in maintaining the price stability and fulfilling the main objective of the monetary policy.

The maintenance of the price stability is a result of the fulfillment of the intermediary objective of the monetary policy - maintenance of the nominal Denar exchange rate against the Deutsche mark at the targeted level. The stability of the Denar exchange rate against the Deutsche mark was maintained by adjusting the monetary policy to the foreign exchange market movements and through the direct interventions of the Central Bank on this market. Namely, in the April - May 1999 period, a foreign exchange shortage on the foreign exchange market was registered, mainly due to the influence of psychological factors and uncertainty related to the war in the neighborhood. In order to preserve the targeted level of the exchange rate, the Central Bank in this period intervened on the foreign exchange market directly, with a net-sale of foreign exchange of US Dollar 8 million. The tightening of the monetary policy resulted in an increase of the interest rates on the deposit auctions and on the money market, which reached 25.2% and 21.8%, respectively in May 1999. In the period after the end of the Kosovo crisis, opposite movements on the foreign exchange market were registered. Namely, the exceptionally high supply of foreign exchange resulted in foreign exchange surplus on the foreign exchange market and net-purchase of foreign exchange in the June - December 1999 period of US Dollar 113 million realized by the Central Bank. It enabled a relaxation of the monetary policy, high rates of monetary growth and fall of the interest rates on the deposit auctions and money market, which in December 1999 were brought down to 11.9% and 11.6%, respectively.

Contrary to the projected foreign exchange net-sale in 1999, exceptionally favorable movements were registered on the foreign exchange market. Namely, in 1999, NBRM realized a net-purchase of foreign exchange in total amount of US Dollar 118 million. The large foreign exchange inflow resulted mainly from grants and from non-residents (in the March - June 1999 period), and from the revival of the export to FR Yugoslavia, mainly Kosovo (in the period after the end of the war). These movements on the foreign exchange

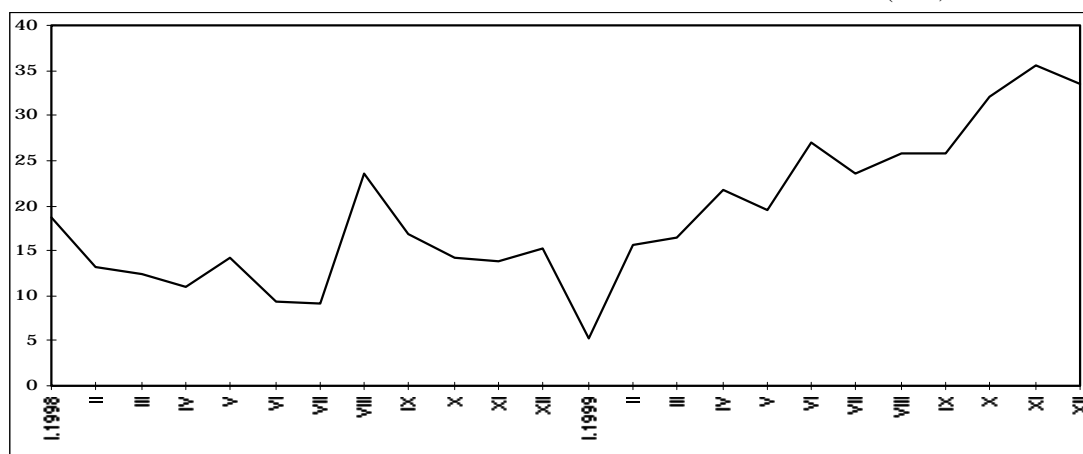
market during the year had a positive impact on the foreign exchange reserves and dynamics of the money supply growth.

Hence, the money supply M2 - Denar component exceeded the projected level and at the end of 1999 realized an annual growth rate of 33.5%. In addition, this monetary aggregate realized a high average rate of annual growth of 23.5% in 1999, mainly due to the developments registered in the second half of the year. Namely, in the period following the end of the war in the neighborhood, the deposits within the banking system registered high growth rates.

Chart 11

## Money supply M2 - Denar component

(in %, on annual basis)



Money supply increase in 1999 was a result of reserve money growth and strengthened process of monetary multiplication. In addition, the movement of reserve money in 1999 was caused by the foreign exchange market developments. The average annual growth rate of reserve money in 1999 equaled 9.4%. On December basis, the reserve money in 1999 was higher by 11.2%.

At the end of 1999, the money multiplier of the money supply M2 - Denar component reached 3.11 and was significantly higher compared to the level from the end of the previous year (2.59). Such a growth of the money multiplier was due to the increase of the deposits in the banks, as a basis for monetary multiplication.

The high liquidity level in the economy in the period after the end of the war in the neighborhood enabled an increased credit expansion of the banks. Thus, the total banks' credits to the non-government sector increased by Denar 3,027 million, or by 9.4% on annual level in 1999. In addition, the foreign currency credits, which are mainly based on credit lines from abroad registered a more intensive increase in amount of Denar 1,430 million, or by 21.0%. In 1999, the Denar credits increased by Denar 1,597 million, i.e. by 6.3%. The biggest portion of the Denar credits refers to short-term financing, which means that the qualitative improvements in the maturity structure of the banks' Denar credits were not registered in 1999.