

National Bank of the Republic of Macedonia

Honorable,

It is my pleasure and special privilege to submit the Annual Report of the National Bank of the Republic of Macedonia (hereinafter NBRM) for 1998, in accordance with the Article 8 of the NBRM Act which requires from the NBRM to submit a Report on the realization of the monetary policy to the Parliament of the Republic of Macedonia. The Council of the NBRM adopted this Report on April 8, 1999.

Briefly, 1998 is the third year of continuous macroeconomic stability, revealed through low and stable rate of inflation and modest, but continuous economic growth. On the other hand, the problems of high unemployment, high foreign trade deficit, slow restructuring of the economy and banking system, lack of financial discipline etc. not only remained, but also deepened. This shows that the transition towards a market economy is a long-lasting and difficult process that requires a great amount of knowledge, hard work and persistence to succeed.

According to the preliminary data, the real gross domestic product (hereinafter GDP) growth equaled 2.9%, which is twice faster than the growth realized in 1997, but also by 2.1 percentage points below the projected growth. Having in mind the very low basis due to the high decrease in the output in the period 1990 – 1995, the realized increase in the economic activity is modest and insufficient for a more substantial improvement of the economic conditions. However, it is important that the Macedonian economy remained in the expansion phase of the business cycle.

The dynamics of the economic growth in 1998 was under the favorable influence of the re-starting of several large production companies and the increase in the exports. On the other hand, the GDP growth was influenced adversely by unfavorable external factors, the crisis in FR Yugoslavia above all, decline in the commodity prices, and several important economic partners of the Republic of Macedonia entering recession. Regarding the internal factors, slow implementation of the structural reforms and lack of financial discipline are the main problems affecting adversely the development of the sound segment of the economy.

Although in 1998 investment activity somewhat intensified, it is still insufficient for achieving more dynamic economic growth. With the domestic saving being low, investment activity was financed by foreign capital inflow, where foreign direct investment played important role, amounting to USD 118 million. It is important that the trend of increasing investments in the private sector continued in 1998, reflecting its role as a generator of the economic growth.

Slow GDP growth did not produce reduction in the high unemployment rate, which is the basic macroeconomic problem in the Republic of Macedonia. Unemployment rate of 34.5% registered in 1998 is the highest in Europe and among the highest in the world.

In 1998 relative to the previous years there were no major changes in the design and realization of the monetary policy. According to the law and authorizations of NBRM, in 1998 monetary policy was aimed towards keeping the inflation rate low and stable, which is its main goal. In the realization of this goal, the implementation of the monetary strategy of targeting the Denar exchange rate against the Deutsche Mark, as an instrument for realization of the ultimate objective, continued. Implementation of the strategy of exchange rate targeting disciplined efficiently the macroeconomic policies, which was particularly important in an election year. This resulted in achieving an average annual inflation rate of 0.8% in 1998, which is the lowest rate since the independence of the Republic of Macedonia. On end-year basis (December 1998 / December 1997) a deflation of 1.0% is registered, where the projected increase of the retail prices was 3.0%.

Realization of a lower inflation rate than the projected one for 1998, i.e. entering into the deflation zone by the end of the year is due to the following reasons: a/ realization of an unexpected excessive decline in the prices of the agricultural products by more than 25%, caused by the inability to sell them on the markets of FR Yugoslavia and Europe; b/ low prices of raw materials and oil on the world markets, and c/ continued control over the wage increase, lasting for several years.

In 1998, global supply exceeded demand on the foreign exchange market. However, that was a result of the inflow of foreign currency from the selling of several large enterprises to foreign investors, not a surplus of foreign currency from current transactions (imports and exports). Although in the first half of 1998 positive movements were realized in the foreign trade, in the second half of the year an excessively high increase of the imports and decrease of the exports was registered, mainly due to the speculations about devaluation of the Denar, unfavorable prices of the raw materials on the world markets and deteriorated situation in the region. In 1998, this resulted in deceleration of the exports growth rate to 6.9%, which is below the imports growth rate of 7.6%. In 1998, a high deficit in the current account of the balance of payments was registered in the amount of Denar 289 million, which is 8.1% of GDP.

Despite the unfavorable conditions in the foreign trade, the inflow of foreign currency from the selling of several enterprises to foreign investors in 1998 enabled NBRM to realize a net purchase of foreign currency in the total amount of USD 35.4 million, which exceeded the projected amount by USD 8.4 million. Excessive purchase of foreign currency in 1998 and increase in the foreign reserves based on that, were supported by the fiscal policy, through a transfer of funds from the Budget to the Central Bank in the amount of Denar 1,200 million. Movements on the foreign exchange market resulted in an increase of the Central Bank's foreign reserves to the historically highest level (USD 333.5 million), which is equivalent to the value of 2.1 months of imports, while at the same time enabled realization of satisfactory growth rates of the monetary aggregates.

Thus, the monetary aggregate by the narrowest definition - M1, which includes currency in circulation and demand deposits, realized an average annual growth rate of

14.9% in 1998. However, due to the relaxation of the fiscal policy in the period prior to the parliamentary elections, which destabilized the foreign exchange market and exchange offices market, in the last quarter of 1998 monetary policy had to become more restrictive in order to preserve the stability of the prices and exchange rate. Consequently, at the end of 1998 money supply M1 growth rate equaled 8.5%, or increased by Denar 1,193 million relative to the end of 1997. Hence, realized increase in the money supply was within the projected by the ESAF arrangement with the IMF.

In 1998, monetary aggregates defined by broader definitions, had more rapid growth than the money supply by the narrowest definition – M1, which is an indicator of a small, but significant increase in saving. Thus, money supply M2 – Denar component realized annual growth by Denar 1,989 million, or by 11.1%, exceeding the projected growth rate by 1.9 percentage points. At the end of 1998 relative to the level at the end of 1997, the most widely defined monetary aggregate M4 was higher by Denar 3,683 million, or by 14.3%.

Monetary growth realized in 1998 created preconditions for increased lending activity of the banks. Thus, total foreign currency and Denar credits extended by the banks to the economic agents (households and enterprises) increased by Denar 2,253 million or by 9.0% in 1998. However, it is unfavorable that in 1998 no qualitative improvements in the term structure of the banks Denar credits took place, because the share of the short term credits remained dominant.

In 1998, the movements on the foreign exchange market caused reserve money issuance. In 1998 reserve money realized an average annual growth rate of 13.4%. However, due to the high basis for comparison from December 1997, withdrawal of the reserve money through the interventions on the foreign exchange market during the parliamentary election, and the increase in the money multiplier, the end-year growth rate of the reserve money is slowed down to 1.4%.

With the fundamental conditions (low saving) and unfavorable systemic conditions (slow collection of the banks' claims covered by collateral) being unchanged, in 1998 deposit money banks' interest rates in the Republic of Macedonia remained at a high and economically unacceptable level. Thus, the interest rates made a negative impact on the investment activity and further on the general growth rate of the Macedonian economy. In nominal terms, banks' average weighted lending interest rates equaled 21.0% in 1998, while in real terms they equaled 21.4%. In 1998, interest rate margins were high, and on average equaled 9.3 percentage points, which is an indicator for the insufficient efficiency of the banking system. Although the minimum interest rate at which the Central Bank offered deposits to the banks through auction sales was 11.0%, in 1998 an average weighted interest rate of 14.9% is realized on the auctions, which confirms the insufficient responsiveness of the banks to the monetary signals and the inefficient liquidity planning on their part.

What are the main problems that remained unsolved in 1998, and require a quick solution in the forthcoming period, in order to compensate for what the economy has missed and to catch up with the most advanced countries in transition?

From the Central Bank's point of view, those are definitely the restructuring of the banking system and improvement of the financial discipline. Banking system in the

Republic of Macedonia has the central position in the process of financial intermediation, because other segments of the financial system (money market, capital market, deposit insurance fund etc.) are still at the starting phase of their development. Due to these reasons, improvement of the soundness and level of competitiveness in the banking system is the key precondition for the success of the reforms and increase of the investment and economic activity in general. This implies further strengthening of the supervision, strengthening of the financial discipline and improvement in the collection of the banks' claims, as necessary preconditions for improvement of the banks' assets quality.

The start in solving the problem of 'old' foreign currency savings, as a precondition for regaining confidence in the banks and increasing the saving, accompanied by the improvement in the regulations related to the collateral collection, and expected inflow of foreign capital, should produce reduction of the high interest rates. It is expected that the improvement of the banks' operations efficiency supported by the reforms in the payment system as well as the strengthening of the competition in this sector, through entrance of well-known foreign banks in the Republic of Macedonia and mergers of domestic banks, will also act in this direction. It will create conditions for revitalization of the investment activity, which accompanied by the further reforms on the labor market, is a necessary precondition for alleviation of the problem of high unemployment in the Republic of Macedonia.

Skopje, April, 1999

*Ljube Trpeski, Ph.D.
Governor and President of the National Bank
of the Republic of Macedonia Council*