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Understanding Reforms in Macedonia

The wiiw Balkan Observatory

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About

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This study has been developed in the framework of research networks initiated and monitored by wiiw under the premises of the GDN–SEE partnership.

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The GDN–SEE programme is financed by the Global Development Network, the Austrian Ministry of Finance and the Jubiläumsfonds der Oesterreichischen Nationalbank.

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Understanding Reforms in Macedonia

Macedonia was the least developed of the republics of the former SFR Yugoslavia, accounting for roughly 5.5 percent of output and 7 percent of total population. The Macedonian economy was strongly integrated with those of the other republics and depended heavily on the overall performance. Yugoslav economy had fallen into deep recession in the mid- 1980s, including high international indebtedness, high inflation that in 1989 was transformed into hyperinflation, and high unemployment. Having in mind that more than 75 percent of goods were sold on the inter-republican markets, the production of non-tradable goods was high. The stagflation was persisting for a decade before the break-up of the former Yugoslavia. At independence, the Macedonian economy had been contracting for more than six years, inflation was at hyperinflation level and unemployment stood at about 24 percent. Furthermore, the country was not internationally recognized, almost without foreign exchange reserves and isolated from international financial markets.

1 Stabilization policies and output development

1.1 Monetary independence, stabilization and early transition

The monetary independence followed after the referendum of September 8, 1991, when the citizens of the country voted for an independent state with modern market economy. The monetary order in the Republic of Macedonia was set up on April 26, 1992.

The Macedonian currency was issued in the form of coupons. The rate of exchange of Yugoslav Dinar for Macedonian Denar was 1:1. It was born in a hyperinflationary environment (monthly rate of inflation above 50 percent) emanating from the money overhang and monetization of federal government deficit of former Yugoslavia. Furthermore, the Denar was born as a pure paper currency that was not backed either by gold or foreign exchange reserves. Namely, with the break-up of former Yugoslavia, international reserves remained at the Central Bank of former Yugoslavia.

1.2 First stabilization effort

Simultaneously with the introduction of the Macedonian currency, stabilization programme of orthodox-heterodox nature was launched. The establishment of the monetary order and introduction of the stabilization policies were carried out in very unfavourable environment. The Republic of Macedonia was still struggling for its' international recognition and United Nations membership, due to which the assistance from the international financial institutions (IMF, World Bank) was impossible. Military conflicts among some ex-Yugoslavian Republics were underway, which severely affected access of the Macedonian companies to international markets. United Nations embargo was imposed against

Yugoslavia, north neighbouring country of Macedonia[1]. Thus, high political risk hindered the inflow of private capital and borrowing from commercial banks. Furthermore, the top political leadership was mainly preoccupied with activities related to recognition and isolating of the country from the inter-republican conflicts that were getting momentum.

The macroeconomic stabilization started without explicit social partnership agreement. However, the implicit consensus was the referendum that took place in September 1991. The programme was designed by a distinguished team of economists under the leadership of the President Gligorov, who enjoyed very high reputation and confidence from both the citizens and leaders of political parties. However, the President and other top political leaders were not free to focus primarily on economic reforms, which meant that they could not supervise the bureaucracy closely and make sure that the bureaucrats assisted rather than hindered the stabilization efforts.

The main goal of the stabilization policies was the two digit monthly rate of inflation to be reduced to one digit rate of inflation.

Although the country did not have international reserves, fixed exchange rate regime was assessed as the most appropriate, due to the low credibility of fiscal, financial and monetary institutions (Calvo, Mishkin, 2003, p. 16)[2]. The fixed exchange rate was selected in order to discipline the demand management policies but also as an instrument for gaining credibility. The prices, except for the goods and services of basic necessities, energy, transport, communications and public utilities, were fully liberalized. The controlled prices accounted for 25 percent of total prices.

The rate of inflation had started falling with time lag of a month. In June the monthly rate of inflation was reduced to 17 percent from 72.4 percent in May. The deceleration of inflation

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[1] During the whole decade of transition, Macedonian economy was exposed to severe political shocks out of which four external and one internal. The first external shock was the hostile break-up of former SFR Yugoslavia in October 1991. The international reserves were seized on the federal level at the National Bank of former Yugoslavia and Central Banks of the new states were established without any stock of foreign exchange reserves. In the Macedonian case the domestic market had shrunk from 20 million citizens to 2 million citizens. The second external shock were international sanctions against the north neighboring country – the Federal republic of Yugoslavia (now Serbia and Montenegro) imposed in 1992 (and ban on transshipment of products through the country 1993) were partly lifted in 1995. Third external shock was the trade blockade from the south neighboring country Greece in the period April 1994 – November 1995. Kosovo crisis in 1999 represents the fourth external shock that hit the Republic of Macedonia. The conflict in Kosovo pushed about 350,000 refugees across the border into Macedonia, the equivalent of 17 percent of the country's population. Simultaneously new sanctions from international community were imposed against Yugoslavia (now Serbia and Montenegro). The sanctions were lifted after the fall of Milosevic regime – October 2001. Finally, the internal conflict in 2001, which ended with signing of the peace agreement known as the Ohrid agreement.

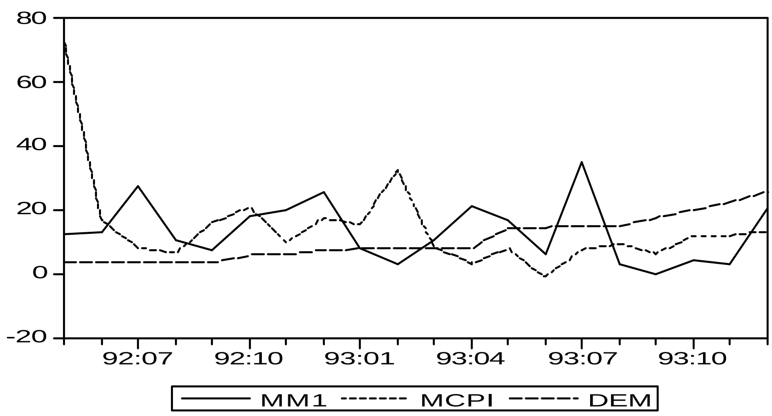
[2] "If an emerging market country is able to develop fiscal, financial and monetary institutions that provide credibility for society's pursuit of price stability, then monetary policy can be used to stabilize the economy. Still, not all-emerging market countries are up to this task, and so they may decide to choose a hard exchange rate peg instead. (However, the absence of strong institutions may make it difficult for them to sustain hard peg.)" – Guillemo A. Calvo, Frederic S. Mishkin, The Mirage of exchange rate regimes for emerging market countries, National Bureau of Economic Research, Working Paper 9808, June 2003, p. 16.

continued in July (8.3 percent) and August (6.6 percent). This was mainly outcome of the deceleration of money supply growth from 73.3 percent in April to 13.9 percent in May and 9.7 percent in June 1992, and impact of heterodox elements.

However, unskilled and unprofessional bureaucracy that was not effectively supervised by top political leaders together with strong groups from agricultural and industrial sector at the end of August 1992 succeeded to change the main elements of the stabilization programme. The Central Bank was pressed to relax the monetary policy by securing funds for financing the crop of wheat and tobacco through activation of the so-called selective function of the monetary policy[3]. Simultaneously, the main heterodox element, wage freeze was abolished, allowing wage increase in the economic sector by 65 percent, and in the non-economic sector by 141 percent. The two digit monthly rate of inflation was back on the horizon. The exchange rate was devalued on October 10, 1992 by 66.7 percent and pegged against basket of currencies.

Graph 1

Monthly growth rates of money supply (M1), consumer prices and level of the exchange rate of the denar against the German mark



New higher goal for the rate of inflation was set up. Monetary policy target was accommodated to this goal. In December 1992 the exchange rate was devalued again by 26.7 percent. Thus, the year ended with the inflation rate of 1,925 percent (450 percent in the period May – December 1992), money supply grew at 704.5 percent, fiscal deficit was 9.8 percent and gross domestic product decreased by 6.6 percent.

[3] Despite to control monetary and credit growth the central bank had selective function as well. This meant that the central bank had to direct credit to support certain agricultural and export activities. Such activities were undermining the control over money supply growth.

Table 1

Selected economic indicators, 1992 to 1993

Year	Inflation goal	Achieved inflation	Monetary target	Monetary growth	Fiscal balance %	GDP growth	Rate of unempl.
1992	2,408.4	1,925.2	755.1	704.5	- 9.8	- 6.6	23.6
1993	434.2	229.6	268.3	239.7	-13.4	- 7.5	24.9

The main contributions of the stabilization programme were the acceptance of the Macedonian Denar as a legal tender and the establishment of the new monetary order in the Republic of Macedonia.

As a consequence of the pressures from different interest groups, in 1993, the goal for inflation was set up very high (434.2 percent), and the target for money supply 268.3 percent. Wages were fully liberalized. However, the inflation was lower than the projected. Fiscal deficit was increased by 3.6 percentage points in comparison to the previous year and reached 13.4 percent. The contraction of the economy continued which was reflected into increased unemployment (24.9 percent).

From May 10th to November 30th, 1993 the substitution of coupons with definite paper currency took place. The exchange of coupons to paper currency was in a ratio of 100 : 1. This facilitated the monetary authorities to gain control over money supply growth. Simultaneously, reforms of monetary policy instruments were initiated. The so-called selective function of the Central Bank (direct allocation of credits to some economic activities) was reduced significantly. This function was fully phased out until the end of March 1994. In order to satisfy the rent seeking groups from agriculture the stock of the existing selective credits was transformed into interest free long-term loans (maturity of 15 years).

On April 8, 1993 Macedonia become a member of the United Nations. Accordingly, it became member of the World Bank in March 1993, and member of International Monetary Fund in April 1993. These enabled Macedonia to become eligible for cooperation and assistance from the international multilateral financial institutions. However, high political risks and unfavourable environment de facto blocked the inflow of private capital into the country.

1.3 Second stabilization effort

Comprehensive stabilization policies with deep structural reforms were initiated in 1994. The stabilization policies and reforms were for the first time supported by the IMF – Systemic Transformation Facility, by International Bank for Reconstruction and Development (IBRD) - Extended Recovery Loan and by International Development

Association (IDA) – Extended Recovery Credit. The total amount of the approved support for reforms was Special Drawing Rights (SDR) 80.7 million.

The IMF has had leading role in designing and monitoring the implementation of stabilization and structural adjustment policies. The role of IMF was threefold. First, IMF substituted the lack of strong political base, "visionary and authoritarian leadership", and non-existence of coherent economic team. Second, IMF contributed to creation of consensus among different interest groups and political parties. Third, the IMF was free to focus on economic goals and had undertaken the role of top political leaders to supervise the bureaucracy. Furthermore, IMF through a lot of training courses contributed to creation of a team of skilled bureaucracy that is able to design and implement macroeconomic policies.

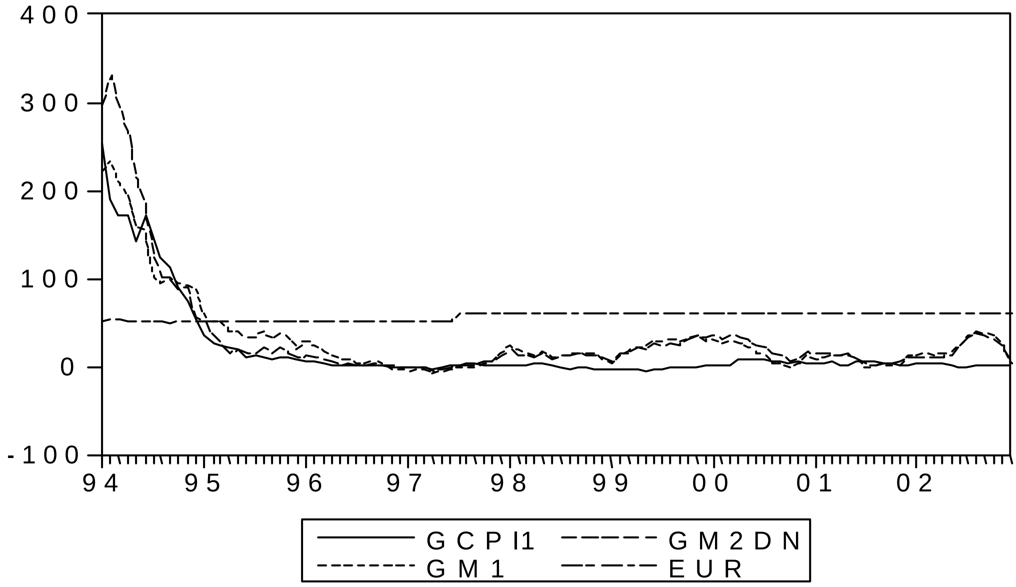
The main features of the stabilization programme from 1994 were: monetary and fiscal restrain, regime of pre-announced crawling peg against the DEM and partial indexation of wages to the rate of inflation.

The inflation rate was reduced to 55.4 percent in 1994, to 9.2 percent in 1995 and since the beginning of 1996 the rate of inflation was brought to the EU countries level.

The reforms of the instruments of monetary policy and increased legal and functional independence, enabled the Central Bank to gain full control over money and credit. In the period January 1994 – September 1995 the Central Bank was implementing monetary targeting strategy as a tool for reducing and controlling inflation. Since the fourth quarter of 1995 the Central Bank started de facto with the implementation of exchange rate targeting strategy. The fixed exchange rate of Denar against German Deutsche Mark was selected as main monetary target. However, this was not reflected in the official announcements of the monetary targets. The Central Bank continued officially to announce monetary aggregates as main targets. Official announcement of the exchange rate as monetary target started since 1997. Simultaneously the Central Bank has continued with disclosure of targets for the growth of monetary aggregates (see table 2 in Appendix). This, to some extent has been creating confusion among economic agents in respect to which is the leading monetary target. Simultaneously, this was giving an incentive to some interest groups to put considerable pressure against the Central Bank to deliver the disclosed monetary growth in cases when there was conflict between the target of stability of the exchange rate and disclosed monetary growth. However, the exchange rate targeting strategy harmonized the growth rates of monetary aggregates to the ones in the anchor currency country - Germany. Since 2002 the anchor currency has become Euro, and the EU as anchor currency area.

Graph 2

Money supply growth rates: M1, M2,
rate of inflation, and exchange rate of the denar against the euro



1.4 Structural aspects of public finance

1.4.1 Fiscal consolidation

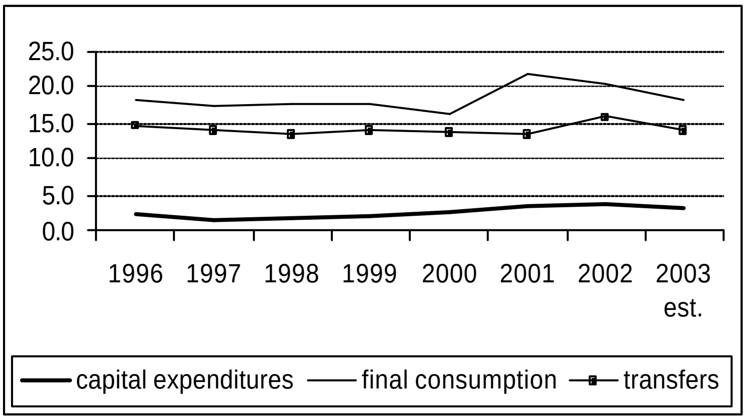
The fixed exchange rate regime disciplined the fiscal policy as well. The fiscal adjustment was considerable. The fiscal deficit was reduced from 13.4 percent in 1993 to 2.7 percent in 1994. The fiscal prudence has become permanent feature during the whole period of transition. The fiscal deficit in the period 1995 - 1998 was moderate, not higher than 2 percent. In addition, moderate surplus was recorded in 2000. Exceptions were the years of internal conflict 2001 and the election year of 2002, when due to high expenditures connected with the internal conflict the fiscal deficit increased to 7.2 percent and 5.7 percent, respectively. Severe fiscal adjustment has been in place in 2003, which was reflected in reducing the deficit to 1.7 percent (see tables 3, and 4 in the Appendix).

Most of the fiscal adjustment was accomplished through expenditure cutting policies. Reductions in subsidies, capital expenditures and pension payments accounted for over half of the total expenditure cuts. Lower interest payments after the restructuring of external debt in 1995 and 1996 also contributed significantly. Although during the Kosovo crisis the fiscal expenditures were increased by 8 percent in order to cover the costs for hosting 340.000 refugees from Kosovo (17 percent of Macedonian population), thanks to better economic performance than expected and inflows of foreign assistance the fiscal budget in 1999 remain balanced. The fiscal balance was threatened in 2001 and 2002, again. The expenditures surged primarily due to the internal conflict. In 2002, election cycle apart from post conflict costs affected fiscal expenditures, as well. The contraction of expenditures in 2003 overshoot the projections, which led to fiscal deficit of 1.7%.

Graph 3

Structure of fiscal expenditure, 1996 to 2003

(as % of GDP)



1.4.2 Public expenditures

Final consumption expenditures and transfers account for 90 percent of fiscal expenditures. Capital expenditures account for 7.9 percent of fiscal expenditures, only. They are lagging behind in comparison to the levels in other transitional economies. The quality of expenditures is not contributing to acceleration of the economic growth. The budget's economic composition remained ill suited for promoting economic growth. High transfers, although lower than in other transition economies, in the matured stage of transition is an evidence for high poverty, unemployment and large number of losers that need compensation in order to preserve social peace. In the coming years, in order to promote economic growth, through better fiscal management, qualitative changes in the structure of the budget are becoming an imperative. The share of capital expenditures should increase significantly on behalf of final consumption. The level of transfers should resemble to the values compatible for low-income country.

Government expenditures are lower in Macedonia compared with other economies in transition as a result of a significant fiscal adjustment. Public spending declined from 45.8 percent of GDP in 1994 to 34.2 percent in 2000, although it temporarily ballooned during the security crisis.

Table 2

Fiscal structure of economies in transition, average for 1997 to 2001

	Macedonia	Bulgaria	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Romania	Slovak Republic	Slovenia	Average
~~Total Revenue and Grants~~	34.9	38.3	39.5	38.2	44.7	37.9	32.0	41.5	31.4	38.4	43.0	38.2
Total Revenue and Grants	34.4	37.5	39.4	37.9	44.6	38.3	31.9	41.7	32.4	38.4	43.0	38.1
Tax Revenue	32.0	29.2	36.4	33.7	37.5	32.5	30.0	35.0	28.3	33.3	40.1	33.5
-taxes on income and profits	5.5	8.1	8.8	9.7	9.1	8.2	8.8	8.8	6.9	8.0	7.7	8.1
-social security taxes	11.2	7.6	14.8	10.6	11.8	10.2	7.7	11.8	9.7	12.7	13.8	11.1
-domestic taxes on g&s	11.3	11.2	11.6	12.9	14.1	12.6	12.4	12.0	9.2	10.8	15.0	12.1
-taxes on international trade	3.3	1.3	0.7	0.0	1.3	0.5	0.5	1.0	1.3	1.3	1.3	1.1
-other taxes	0.8	1.0	0.6	0.5	1.3	1.1	0.6	1.5	1.2	0.6	2.3	1.0
Nontax revenue	2.2	7.8	2.6	3.4	6.0	5.1	1.8	6.0	3.5	4.4	2.6	4.1
Capital revenue	0.1	0.5	0.5	0.9	1.1	0.7	0.1	0.6	0.6	0.7	0.2	0.5
Grants	0.6	0.8	0.0	0.3	0.1	-0.5	0.1	-0.2	-1.0	0.0	0.1	0.0
Total Expenditures	36.1	36.6	41.3	37.3	48.5	39.7	34.3	43.3	34.5	42.1	44.0	39.8
Current expenditures	33.5	34.3	37.3	34.8	43.3	35.3	31.4	41.5	31.3	36.8	39.5	36.3
Wages and salaries	8.0	6.1	3.8	6.8	9.1	8.2	8.9	8.3	5.5	6.4	9.8	7.4
Goods and services	4.3	9.8	4.8	12.6	7.4	8.4	10.0	9.0	7.2	5.0	8.4	7.9
Interest payments	1.8	4.8	1.1	0.4	7.2	1.0	1.4	3.1	3.9	2.8	1.4	2.6
Subsidies and current transfers	14.6	13.5	27.6	14.9	19.6	17.7	11.1	21.1	13.7	22.6	20.0	17.9
Capital expenditures	2.3	3.9	5.5	4.0	6.7	3.9	3.5	3.3	4.1	5.4	4.6	4.3
Overall Deficit/Surplus	-1.2	1.7	-1.8	0.9	-3.8	-1.8	-2.3	-1.8	-3.1	-3.7	-1.0	-1.6

As to the structure of expenditures, non-discretionary outlays excluding interest payments (consisting of wages and social transfers) are slightly over 60 percent of total expenditures. A largest single component is “wages and salaries”, at 8.0 percent in the period 1997-2001,which reflects that employment in central government administration accounts for almost 2 percent of population, almost twice the level in other low- and middle income countries and higher than in many transition economies. It is often the case that immediately before elections there is a rapid increase in the number of employees in the government administration (but also in some public enterprises), which means that ruling parties use public employment as a way to influence the elections results. On the contrary, social transfers are considerably lower than in other transition economies, which certainly reduces public support for economic reforms. According to the literature on policy reform (Williamson, 1994;Rodrik, 1996) reforms become easier if losers are compensated.

However, the fiscal system was not structured to promote growth, to deliver fear compensation of unemployed losers, to tax economic agents achieving considerable gains, and to de-stimulate tax evasion and gray activity (For more details see L. Kaplow, NBER WP, April 2003).

Another structural weakness is very low level of capital expenditures, which are only half the level of other transition economies. This implies that fiscal policy has been focused mainly at the stabilization and hence the issues of growth and capital formation have been somewhat overlooked.

1.4.3 Public revenues

Since independence, revenue collection has been buoyant and revenue to GDP ratios have remained high, relative to comparable emerging economies. However, general government revenues declined significantly between 1992 and 1998 from 40.5 to 33.3 percent of GDP, which represents a moderate fiscal burden. The introduction of VAT in 2000, boost revenues again to 36.7 percent of GDP and created room for a reduction in personal income taxes, introduced in 2001.

As regards the structure of revenues, it is broadly in line with other transition economies. Two main and almost equally important sources of revenues are sales taxes(VAT and excises) and labour-based taxes(social contributions and personal income tax).Interestingly, while the IMF often argues that Macedonia relies too much on labour income taxation, the World Bank finds that: "At below 17 percent of GDP, taxes and contributions on employment as a share of GDP are below levels elsewhere, and they have been declining, although this is mostly because of shrinking formal sector employment rather than lower labour costs" (World Bank, 2003a, p. 20).

Contrary to other transition economies, presented in Table 2, tariffs are important source of revenue in Macedonia. Despite that, either because of tariff exemptions or because of tariff evasion due to corruption and weak customs administration, actual tariff collections are far below potential to what the average tariff rates suggest they should be.

1.5 International financial assistance

The stabilization and reforms in Macedonia have been supported considerably by the international multilateral financial institutions. However, the inflow of private capital was moderate. The cooperation with IMF and World Bank during the transition was permanent. In the period 1994 – 2002, Macedonia used funds from IMF, in amount of USD 129.3 million, having six arrangements. USD 341.6 million were contributed from World Bank Group for structural reforms, USD 67 million were used funds from International Bank for Reconstruction and Development, and USD 274.6 million were used funds under IDA terms. The country ceased to be eligible for IDA in July 2001.

The funds from international financial institutions were not followed by the private capital inflows. Especially the foreign direct investments were modest. Experience in other transition economies and in the developing world points to the importance of foreign direct investment in energizing economic growth. Macedonia was not attractive location for foreign investors. The main reasons were unfavourable regional environment until 2000 and the internal conflict in 2001. Low return on equity and return on assets had made Macedonia unattractive for foreign investors. The cumulative inflow of foreign direct investments in Macedonia at the end of 2002 was USD 905 million or 24.3 percent of GDP or USD 442 per head (see table 6 in the Appendix). This level is close to the regional average for South Eastern Europe, but only a fraction of the levels achieved by the more successful transition economies (see table 7 in the Appendix). As a result, the share of foreign-controlled companies is limited, accounting for only 10 to 15 percent of total value-added in the economy in 2001 and employing less than 5 percent of workers.

1.6 Transition costs and renewal of economic growth

In the beginning of the transition it was generally expected that output would fall at the start of the reform process, as a result of both macroeconomic stabilization and the reallocation of resources from unproductive sectors to sectors that would be profitable at world prices[4]. Table No. 3 shows that this happened in all transition economies. In Macedonia output declined for five consecutive years with a cumulative decline of 21.2 percent. The duration of transition recession was longer than the average duration in the countries of Central and South Eastern Europe and the Baltics. Primarily this was result of long disinflationary process (four and half years) and unfavourable external environment. However, the cumulative contraction of the output was equal to the average decline.

Table 3

The transition recession

Countries	Consecutive years of output decline	Cumulative output decline (percent)	Real GDP,2000 (1990=100)
Macedonia	5	21.2	91.2
Central and South Eastern Europe and the Baltics	3.8	22.6	106.5
of which:			
Albania	3	33.0	110.0
Bulgaria	4	16.0	81.0
Croatia	4	36.0	87.0
Romania	3	21.0	144.0
Slovenia	3	14.0	105.0
CIS countries	6.5	50.5	62.7

Source: World Bank (2002e) and Bank staff calculation

The growth was renewed in 1996, but it remained weak. The economic growth depended on the speed and comprehensiveness of structural reforms and internal and external political environment. The structural reforms of enterprise and financial sector were slow.

4 See for more details in Stanley Fisher, Ratna Sahay, The Transition Economies After Ten Years, International Conference Paper, Warsaw, October 15-16, 1999, pp. 1–4.

The performance of institutions and rule of law were weak. These obstacles did not allowed swift reallocation of resources from unproductive sectors to sectors that would be profitable at world prices. Growth was not sufficient to reduce significantly the high unemployment (average rate of 33 percent in the period 1996 - 2003), which required high fiscal transfers in order to preserve social peace, during whole transition period. The 2001 civil conflict disrupted the momentum of economic development. However swift resolution of conflict in August 2001 through signing the General Framework Agreement for Peace (the Ohrid Agreement)[5] limited the direct damage of the conflict. In 2001 output contracted by 4.5 percent. Contraction was stopped in 2002. Sustainable economic recovery started in 2003, in which GDP increased by 3.1 percent.

1.7 The role of savings and investment in promoting growth

The structure of the consumption was not favourable for promoting high long-term economic growth. The demand management policies were mainly oriented to maintain price stability, and not to change the structure of consumption in order to promote high economic growth and employment. Total investments and especially investments in fixed assets, which are motor of the high sustainable growth, were low. Furthermore, the investments in fixed assets as share of GDP have been moderately falling since 1997. The fall was significant in the internal conflict year – 2001. In 2002 they were equal to their 1997 level (17.3 percent). Although, gross national savings was permanently increasing since 1997 it was not enough to support sustainable high economic growth. Record was achieved in 2000 (23.2 percent of GDP). The gross national savings significantly fell as a result of severe contraction in 2001. In 2003 the gross national savings slightly increased to 15.6 percent of GDP.

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5 The General Framework Agreement for Peace (the Ohrid Agreement) was signed on August 13, 2001 by the leaders of the four main political parties in Macedonia at that time, representing ethnic Macedonians and ethnic Albanians. It set out specific reforms and protections aimed at strengthening the rights of minority communities, especially ethnic Albanians. The Ohrid Agreement institutes a minority veto over certain categories of legislation, including laws that directly affect culture, use of language, education, local government and personal documentation, and provides for affirmative action in public employment. The agreement also mandates the increased use of the Albanian language in public affairs and decentralization of the responsibility for many government functions to the municipalities.

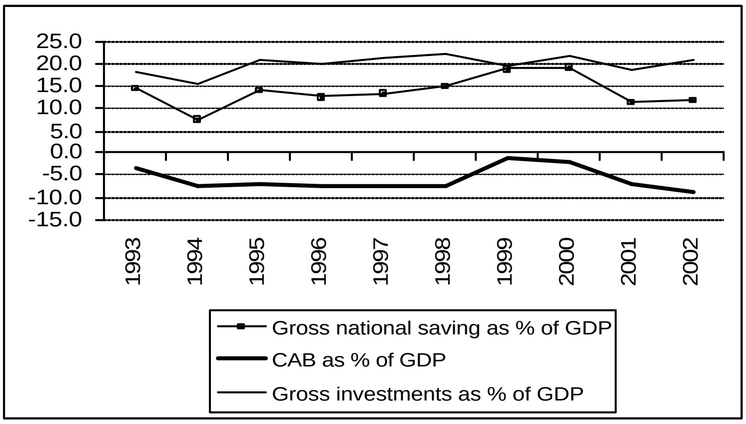
The amendments to the Constitution required by the Ohrid Agreement were adopted by the Parliament on November 16, 2001. After considerable debate the new Law on Local Self – Government was adopted by the Assembly on January 24, 2002. The Law assigns local governments responsibility for establishing and financing primary schools, providing social care for the disabled and other social categories, and providing primary health care and health protection for persons without health insurance. The transitional provisions of the law anticipate an implementation period of two years, specifying that existing sector-specific laws should be harmonized by the end of 2003.

An important aspect of the Ohrid Agreement from an economic perspective is that it includes a commitment to create "equitable" representation of minorities in the public administration, addressing present imbalances. This will require the employment of under represented minorities, which will be difficult to fulfill while containing wage spending. This challenge will be amplified by the need to decompress wage structures in public employment. Improving the representation of minorities will also compound difficulties in implementing regulations intended to create a professional, merit-based civil service. The achievement of civil service reform objectives will be further complicated by the reduction in central government employment and increase in local government employment implied by decentralization.

Graph 4

Savings, investment and current account balance

(as percent of GDP)



Although low, domestic investments were higher than the domestic savings, during the whole transition period. In the period 1997 – 2002 the average gap was 5.3 percentage points. The gap has been covered by import of foreign savings and current account deficits. Thus, the domestic economic growth was dependent on the import of long term private capital, which was modest and the capacity of the banks efficiently to allocate the scarce domestic and foreign savings.

Changing the structure of consumption, especially of the fiscal expenditures, would become high priority for policy-makers in order to promote growth. The recommendations for policy makers are twofold. First, on medium term, without import of foreign savings (capital), the Macedonia cannot become fast growing economy. On long run the propensity to save has to grow at higher pace than in the matured market economies. In order Macedonia to render into a group of fast growing economies, the domestic savings has to reach the threshold of 24 – 26 percent of GDP. Second, the need of import of foreign savings, on medium term will determine the country to be faced with considerable current account deficits. These deficits would be not possible to be cured by corrections of the foreign exchange rate, although policy of competitive exchange rate is inevitable ingredient for promoting high economic growth (Bishev, 2002). The alternative for policy makers would be to accept lower rates of economic growth and higher level of unemployment. Thus, for the coming years the main challenges for policy makers will be qualitative changes in the structure of fiscal expenditures and appropriate mix among domestic savings, current account deficit and the rate of economic growth. Competitive exchange rate policies are part of these challenges. Efficient allocation of domestic and foreign savings will play crucial role. The main test for the banking industry, as the spinum column of the financial sector, would be whether it would be sound and would have capacity to perform its historic role.

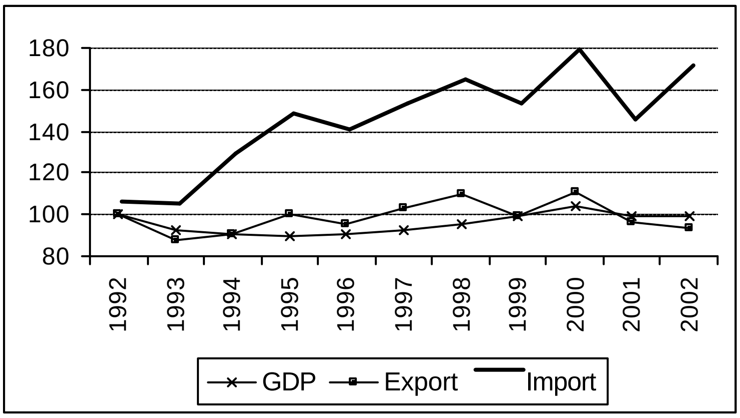
1.8 Export-oriented growth a necessity

Apart from domestic investment, the contribution of export to the economic development was not significant. As a small and open economy Macedonia is heavily dependent on international trade. The years of economic growth 1996 – 2000, are overlapping with the years of export growth. However, the export growth was very weak. Due to the unfavourable internal environment in 2001 and 2002 the export of goods and services was reduced to its pre-transitional level (1992). Contrary the more successful transition economies that are facing high economic growth and low unemployment (Slovenia, Hungary, Estonia, Czech Republic, Slovakia) succeeded to triple their export during the transition decade (EBRD, Transition Report 2002, pp. 110 – 217). The Macedonia has to follow the same pattern of behaviour. This would require bold, swift and comprehensive structural reforms that would result in better allocation of resources from sectors producing non-tradable goods into export oriented sectors producing tradable goods and services.

Graph 5

Export, import and GDP levels

(1992 = 100)



2 Liberalization

Macedonia introduced full current account convertibility in 1998 and government control of prices is limited only to the regulation of the state monopolies. Given the fact that foreign exchange and domestic price liberalization so far have proceeded smoothly and without significant opposition from interested parties, we will focus only to the issue of trade liberalization.

2.1 Trade liberalization

2.1.1 Trade policies

Macedonia opted for a gradual approach in trade liberalization. It inherited a relatively liberal foreign-trade regime from SFRY. In 1996 a further liberalization and rationalization was carried out, by lowering the average tariff rate (which fell to about 15 percent), eliminating all the quantitative restrictions and reducing the number of custom duty rates. In 2001 the Tariff Law was changed and as a result a simple nominal average rate has been slightly decreased to 14.6 percent. Finally, Macedonia became WTO member in 2003, which means a significant step toward further foreign-trade liberalization because it assumes additional cuts in the nominal tariff rates.

Besides that, government has pursued bilateral trade agreements as the principal vehicles fore trade liberalization, mainly with regional partners (Table 4). Multilateral agreements are also signed with the EU and EFTA. Although trade integration involves not only positive effects, but also some well-known costs, it seems that the positive ones are prevailing. The importance of regional trade integration isn't limited only on trade flows. By free trade zones, Macedonia could overcome limitation of small domestic market, which is one of the constraints for more intensive inflow of foreign direct investment in the country.

Table 4

Bilateral and multilateral free trade agreements

Bilateral agreements

	signed	applied	population in million
Slovenia	1996	1996	2.0
FR Yugoslavia	1996	1996	8.4
Croatia	1997	1997	4.5
Turkey	1999	2000	68.0
Bulgaria	1999	2000	8.2
Albania	2002	2002	3.6
Bosnia and Herzegovina	2002	2002	4.0
Ukraine	2000	2001	48.0
Romania	2003	2003	22.5
Total population			**169.2**

Miltilateral agreements

	signed	applied
EFTA	2000	2002
EU	2001	2001

It is interesting to note that Macedonia, with the smallest economy of the five SEE countries presented in the Table, has the highest average protection, which is according to Michalopolus (2003) ”a questionable distinction”. Despite that, the IMF assesses Macedonia’s trade regime as open and liberal, with a rating of 2 on the Fund’s index of trade restrictiveness, which runs from 1 to 10. Macedonia also achieved a ‘4’ rating in EBRD rating on trade liberalization in 2002.

Table 5

Five SEE countries: average tariff rate

	Simple average	Weighted average
Macedonia	14.6% (2001)	14.2% (1999)
Albania	7.2% (2002)	-
Croatia	7.0% (2001)	6.13% (2001)
Yugoslavia	9.2% (2001)	8.0% (2001)
Bosnia and Herzegovina	6.8 % (2001)	-

There is no doubt that slow decline in the degree of tariff protection reflects, at least partly, the pressure of interest groups and business lobbies. But authorities had also some good reasons to avoid a rapid opening of the economy. First, since 1991, Macedonian foreign trade has suffered a number of adverse external shocks, plus the security crisis in 2001.Second, large current and trade deficits have persisted during the whole period of transition. Third, Macedonian labour markets are inflexible, which implies that radical trade liberalization may not reallocate economy’s resources appropriately.

2.1.2 Trade performance and external deficits

Starting in 1994, with some temporary exceptions, a continuous widening of external deficits began, so that by 1998 the current account deficit widened to 8.8% of GDP and to over 10% of GDP in 2002.The growth of external deficits has primarily been caused by worsening of the trade balance. The value of imports of goods and services in the period 1992-2000 grew by an average annual rate of 8.9 percent, while value of exports increased only 3.2 percent annually.

Managers of domestic firms, trade unions, and some academic economists (for example, see Kostovska, 1998) have often blamed trade liberalization for the decline of domestic output and the rise in unemployment and in external deficits. They have argued that Macedonian companies that operated in highly protected environment during a socialist era cannot restructure themselves immediately and hence, they are not in a position to compete with foreign ones. Therefore, the argument proceeds, they need some transitory period of protection in order to implement restructuring measures.

However, there are several strong arguments against the critics of trade liberalization. First, the costs from liberalization appear only in a case of rapid liberalization. Given the four-year delay in the liberalization process (initiated in 1996) and the modest decline in tariff rates, this is certainly not the case in Macedonia. Second, the decline of economic activity in Macedonia took place in the first half of 1990s, while trade liberalization efforts started in the second half. Third, large external shocks appear to be the primary cause of the recession and the abysmal export performance. Fourth, the widening of deficits and the decline of output can be partly explained by the significant real exchange appreciation in the first years of stabilization.

Therefore, major weaknesses in enterprise and banking sectors, which are discussed below, remain the root cause of the low competitiveness at the side of Macedonian producers. To achieve rapid export growth both energetic reforms in the enterprise and banking sectors and sound macroeconomic policies will be needed.

3 Structural reforms

3.1 Privatization

The Macedonian privatization started in 1990, when the last federal government introduced the Law on Social Capital. Under that law, enterprises could be corporatized and employees could purchase shares in their own firms("internal shares")-usually at a substantial discount to their market value. By mid 1991, roughly 67 large and medium-sized enterprises in Macedonia had been fully privatized under the law and hundred more partially privatized (IMF, 1998). It is interesting to note that, compared to all other former Yugoslav republics, the process of distribution of these internal shares went furthest in Macedonia. As Slaveski(1997) points out, a small group of powerful managers of big socialist enterprises acted as a lobby and were capable of discouraging any move towards a suspension of The Law on Social Capital, before 18, 1991, when its legal validity expired.

Not until June 1993 was the federal law replaced by the Law on the Transformation of Social Capital and only in late 1994 did the privatization process get started again. The new law was based upon the selling of enterprises on a case-by-case basis. Enterprises, i.e. the existing management were permitted to choose the method of privatization although their plan had to be approved by the Privatization Agency.

The turning point in Macedonian privatization came when the authorities had realized that privatization of large enterprises might not be feasible, despite the generous concessions offered by the law(10 to 20 percent down payment and five year interest free credit).Since nobody showed interest in putting money on the table, authorities found an "original" solution: management teams from within enterprises were allowed to use their internal shares, obtained in previous privatization, as a down payment. Moreover, more internal shares might be used for securing the right to purchase the rest of the shares for up to at least 51 percent of the appraised value of the company in five annual interest-free instalments. This concession to insiders effectively blocked any outside party interested in offering an alternative development plan for a specific enterprise undergoing privatization (Slaveski,1997). Even when shares were made available to both insiders and outsiders (the buyout model), insiders tended to purchase the majority of stake as they had more information on the company and could benefit from discounts and the chance to purchase shares in instalments.

By March 1998, roughly 87 percent (weighted by the number of employees) of privatized companies were purchased by insiders, including a number of different privatization forms. The low level of outsider, and particularly foreign, involvement in privatizations meant that privatized companies did not benefit from the injection of capital or know-how seen in many other transition economies. At 0.9 percent of GDP in 1997 Macedonia had the lowest level of foreign direct investment of any transition economy. The insider- dominated ownership had serious adverse implications for the corporate governance and restructuring, which are explained, in the next section.

Slaveski (1997) concludes that Macedonian insider dominated privatization has probably emerged as an unintentional product of the strategic mistake of not combining the sell-off method with some of variants of mass privatization. While that is partly true, it is at the same time very likely that politicians in charge tried to use privatization as a way of strengthening their own position. Implementing the insider method, at one hand, they gained support from the powerful business lobby, given the fact that managers became main winners of the privatization. At the other hand, they might have hoped that employees would, at least ex ante, support reforms, in exchange for shares received in the privatization process.

It will be probably fair to say that the same privatization model applied in Macedonia would deliver better final results if the country had stronger institutions. The World Bank comments:"…the impact of privatization has been rather disappointing….most likely because of the dominance of insider buy-outs but also because improper procedures and substantial corruption during the process, discouraging new owners from investing in their new acquisitions because of uncertainty about property rights"(World Bank,2003a, p. 4).But it is also quite interesting that international financial institutions were more or less passive during the creation of the privatization law and in the early phase of its implementation. It seems that almost the only thing they were worried about was the speed of the process, obviously trying to secure the irreversibility of the ownership change. For example, the World Bank required privatization of 790 enterprises in 1995 alone, out of around 1,500 identified for privatization as one of conditions of the FESAK arrangement.

3.2 Enterprise restructuring and governance

Despite a large-scale privatization programme and significant foreign trade liberalization, Macedonia's track record in enterprise reforms has been weak. The persistence of payment and wage arrears and poor profitability in the enterprise sector suggest low corporate restructuring. This reflects first, a privatization process dominated by insider buyouts and second, unfavourable institutional framework for investment and restructuring (tolerance of soft budget constraints, weak legal protection for creditors, relatively inefficient banking system, large informal sector etc.).Yet, cross-country comparisons of profitability indicators show that Macedonia significantly reduced the gap with other transition economies in 2000, although net profits remained the lowest among the group of countries presented in Table 6 (Zalduendo – 2003) (During the recovery period 1997-2000,many other indicators of corporate performance-productivity, turnover of firms, concentration of losses-also witnessed a strong positive reversal). The 2001 civil conflict certainly made aggregate profitability indicators worse, even though data for the years 2001 and 2002 are not available.

Table 6

Profit and losses in transition economies

(in percent of GDP, before taxes)

	Gross profits			Gross losses			Net Profits/Losses		
	1994	1997	2000	1994	1997	2000	1994	1997	2000
Bulgaria	na	11.3	9.1	na	-5.4	-8.0	4.5	6.0	1.0
Czech Republic	13.7	na	na	-5.7	na	na	8.0	2.5	1.6
Macedonia	2.5	3.5	6.5	-14.5	-6.4	-5.9	-12.0	-2.9	0.7
Poland	10.0	8.8	7.4	-3.9	-2.9	-4.4	6.1	6.0	3.0
Slovak Republic	13.9	na	na	-7.2	na	na	6.7	na	8.8
Slovenia	4.5	na	na	-6.4	na	na	-1.9	na	na

3.2.1 Insider privatization

It is now well understood that privatization that results in widely dispersed ownership structures can work well only in countries with effective standards of corporate governance (IMF, 2000). Macedonia obviously lacks such standards and at the same time, as we previously explained, its privatization process resulted in highly fragmented ownership, which creates specific governance problems. These are particularly acute in the case of employee buyouts because share ownership is diffuse and employees have a strong incentive to maintain employment. At the other hand, managers with relatively small ownership stakes wield considerable power without being effectively controlled by shareholders, which provides incentives for asset stripping and self-dealing. Many managers (even of viable enterprises) found that generating profits was not the best way of increasing their income-instead, they did better by selling assets and products at below market rates to related persons.

The slow pace of enterprise restructuring in Macedonia is visible in statistical data on the work history of registered unemployment. Since early 1980s, the vast bulk of registered unemployed-between 73 and 84 percent-were young people leaving the education system with no work experience. Contrary to several countries in the region, there were no massive lay-offs in Macedonia (World Bank, 2003a). The saying that the Macedonian labour market is a "heaven" for those that have a job and a "hell" for those that do not is not far from truth.

The disappointing performance of privatized enterprises is also evident from deeper analysis of the aggregate profitability indicators shown in the Table. Analyzing financial accounts of a sample of manufacturing firms, Zalduendo (2003) finds a profound difference between privatized old firms and nimbler new ones. In fact, privatized firms had a weak performance and the recent improvements in aggregate profitability were driven by new private firms. The privatized firms recorded a marked decline in operating profits in 1994-1997 and only partial recovery in 1997-2000, which was insufficient to reverse that deterioration. Despite substantial labour shedding, their labour productivity in 2000 remained below 1994 levels. Zalduendo argues that the predominance of insider privatization is one reason for the poor performance of privatized firms.

3.2.2 Institutional framework

There is now growing recognition among economists that market-oriented policies may be inadequate without more serious institutional transformation, in areas ranging from the bureaucracy to labour markets (Rodrik,2003). During transition, Macedonia has not been successful in creating efficient institutions, due to several reasons. Firstly, as a newly independent state, it had to build many basic institutions virtually from "scratch". Secondly, it has traditionally been an underdeveloped region. Therefore, it is logical that its inhabitants do not possess any "institutional memory" on market based institutions (for example, stock exchanges) which existed in more developed parts of Yugoslavia and in advanced transitional economies between the two world wars. Thirdly, to date, Macedonian policy makers have paid relatively little attention to institution building process, which is typical for less successful transition strategies.

Therefore, privatization has failed to boost restructuring and better performance of enterprises partly as a result of privatization method but also partly because of the institutional impediments that affect enterprise development and growth. The Macedonian experience also confirms that process of privatization risks producing perverse results in the absence of hard budget constraints and effective competition.

3.2.3 Hardening budget constraints

While direct budget subsidies to firms were drastically reduced during the 1990s, privatized firms continue to receive implicit support in the form of soft credits and wage, tax and social contributions arrears. As presented below the share of the non- performing loans in the Macedonian banking system has been one of the highest among transition economies. As regards wage, tax and social contributions arrears, analyzing a sample of manufacturing firms, Zalduendo (2003) finds that they remained high between 1994 and 2000 (in the range of 3 to 4 percent of GDP).

This tolerance of arrears mainly reflects slow progress in resolving the loss-making enterprises in Macedonia, especially the large ones. Macedonian reformers have started transition in the context of the already very high unemployment and that have been probably a main reason why they were reluctant to deal fast with the endless number of loss-makers. In 1990, the unemployment rate amounted 23.5 percent of labour force and in 1997 it was at its highest 36 percent.

Protection of creditor rights

Inefficiencies in the bankruptcy process and weak creditor rights have also undermined the imposition of hard budget constraints and slowed the process of restructuring. In October 2000 the government strengthened the bankruptcy, collateral and executive procedures laws. Nevertheless, financial discipline and liquidity of enterprises have not improved significantly.

It seems that main problem remains inefficient court enforcement of creditor rights. According to Business Survey conducted jointly by the EBRD and World Bank (BEEPS-2002) contract enforcement in Macedonian courts is slow, complicated and expensive. Among the eight South East European countries only Albania has higher costs proceedings and a heavier procedure than Macedonia (World Bank,2003b).

Behaviour of the banks

The root cause of financial indiscipline among enterprises is probably the interlocking relationship between many of commercial banks and their shareholders-being mainly net debtor enterprises. Privatization of banks occurred through privatization of dozen of owner shareholders, resulting in fragmented ownership, dominated by net debtors, with a tendency to abuse credit rather than safeguard bank capital.

The case of by far the largest Macedonian bank at the start of transition is a good example. In 1995, the non-performing loans of the Bank, comprising two-thirds of the credit base have been replaced in the Bank's balance sheet by the government bonds. Dealing with the stock problem of a bank's credit portfolio, however, was not enough to prevent a resurgence of the flow problem of bad financing to nonviable enterprises. In 1999,when government sold the bank to foreign investors, it had to recapitalize the bank again, by issuing Euro-denominated bonds in exchange for the four largest borrower's bad debts amounting to EUR 120 million. Such behaviour of the banks was also a result of the government's failure to address the issue of loss-making enterprises.

3.2.4 Improving competition

As we have seen before, Macedonia has liberal foreign trade regime, domestic prices are generally free, and turnover (exit and entrance) of the firms is rather high. In other words, firms are exposed to strong competitive pressures, which is likely to improve their performance.

However, one important aspect of competition policy in Macedonia has been so far largely neglected-protection of small and growing private firms from the possible anti-competitive policies of large state or privatized enterprises (anti-monopolistic policy). For that reason, until recently (end of 1999) Macedonia constantly received the lowest possible grade for its competition policy (score 1 according to the EBRD ranking of transition economies). After that, finally, The Law against limiting of competition was enacted and the Monopoly Office was established.

Despite these legislative changes, significant actions against monopolistic behaviour and abuse of market power have not been observed, although media and anecdotal evidence offer many examples of anti competitive behaviour. The most probable reasons are a combination of complicated legislation and inadequate enforcement mechanism. The Law is considered to be too extensive and complicated and the Monopoly Office is de facto and de jure dependent on the Ministry of Economy.

An important source of unfair competition is a big informal sector, which is estimated to be around 40 percent of official GDP.A large size of the informal sector reflects a weak institutional framework and high costs of doing business in Macedonia. Therefore, bringing the informal sector into the formal economy will require significant improvement of the quality of Macedonian institutions, which is likely to be a long-run process.

3.3 Financial sector reforms

In contrast to other command economies, Macedonia, within the former Yugoslav Federation, has had a two-tier banking system since 1964. Extending credit and collecting deposits were the main bank activities in pre-transition period. The features of the banking industry were in accordance to the main characteristics of the economic system based on associated labour. The main function of a bank was not to make profit by undertaking calculated risks, but to extend as much credit as possible to enterprises at the lowest possible interest rate. Borrowing from the banking industry at significantly negative real interest rates in the period of high inflation, with intention not to repay the loan has a treatment as subsidy. Banks were perceived as institutions for subsidizing enterprises. This was emphasized through the programme of selective credits supported by the Central Bank. In addition to banks, insurance companies were in existence, only.

A universal type banking system was inaugurated after the monetary independence (April 1992). Banks were defined as institutions that collect deposits and extend credits in order to make profit. However, it was stipulated that they had to be solvent and liquid, and other supervisory standards were prescribed for the first time. The Central Bank undertook the role of banking supervision. The low standards for entering banking industry had contributed to rapid increase of the number of banks. From four banks before independence, in 1993 they increased to 19. The record was reached in 1998 – 24. The new established banks had the same defect function of performance as the old banks. They were established primarily from domestic non-financial companies that did not have any expertise in financial operations. In the most of cases, the main goal of the shareholders of newly established banks, were to attract funds for financing their own businesses. Thus, the newly established banks from the beginning had ill-corporate governance and distorted operation function.

The structure of the financial system remained simple even in the matured transition phase. The dominance of the banks within the financial system remained during the whole transition period. In 2002 they accounted for 96.5 percent of total financial transactions. Other bank like financial institutions consist of saving houses. They are small financial intermediaries that can collect deposits and extend loans to households. They account for 1.8 percent of total financial transaction. A compulsory deposit insurance scheme was established in 1996. The scheme is insuring only household deposits up to Euro 20,000. Apart from state own health insurance fund and pension fund, which have been functioning as pay as you go systems, private investment funds have not been established (see table 13 in the Appendix).

3.3.1 Financial restructuring of the banking sector

The restructuring of the banking system started in 1995 with big delay. Mainly, soft loans seeking groups (individuals and enterprises) through borrowing from state owned banks with intention not to repay loans, were prolonging financial sector reforms. Due to this financial reforms started only as financial restructuring[6] of the banking system. The operational restructuring[7] of the industry was put in halt.

The main goal of financial restructuring of the banking system was to clean up the bad loans from the portfolio of the old banks. The costs of the rehabilitation were extremely high. Total costs reached 42.3 percent of GDP, out of which 12.1 percent refers to the cleaning of bad loans from the balance sheet of the banks, and 30.2 percent refer to the costs for payment of foreign currency deposits of households, deposited in the banking industry before 1992. Thus, soft loans from old banks that were playing a role of implicit government subsidy de facto became explicit government subsidies. This was, worldwide, one of the most costly operations of bank restructuring[8].

There was no special programme for privatization of the old banks which were owned by socially owned enterprises. Banks were automatically privatized along with privatization of enterprises. Thus, the root cause of financial indiscipline among enterprises is probably the interlocking relationship between many of commercial banks and their owners – enterprises that were interested to get soft loans from the banks instead to maximize the shareholders value.

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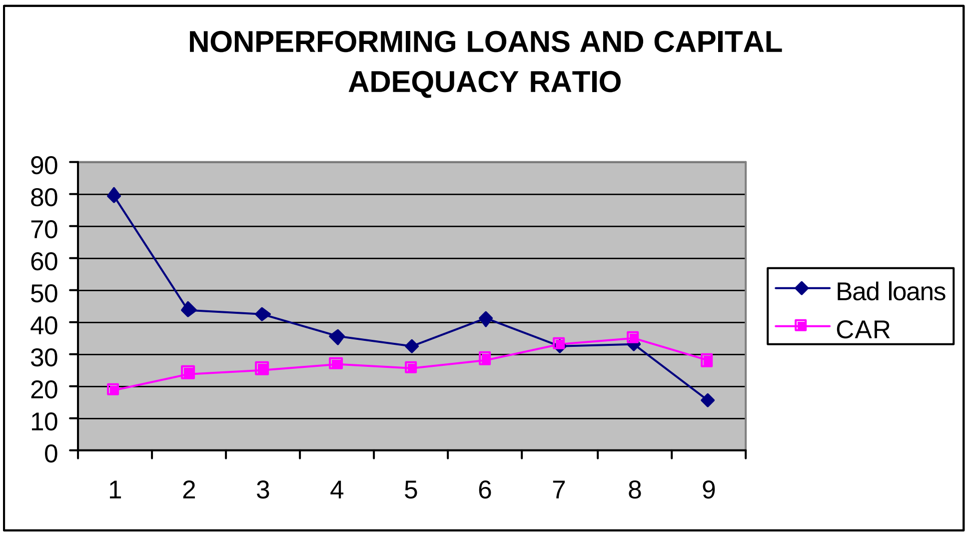
6 The main purpose of financial restructuring is the renewal of the bank's solvency (net worth). The bank could improve its balance sheet by inflow of new capital (from the present and new shareholders), by reducing the liabilities (for instance, some liabilities to be written off), or by increasing the value of the assets (for instance, by improving the collection of bad claims, by accelerating the realization of collateral for bad loans and so on). This phase of the bank's restructuring usually includes government intervention by: replacement of bad claims with government bonds, establishment of a government agency for the collection of bad claims undertaken from banks, liquidity support from the central bank, acceleration of the privatization process in banks and so on.

7 Operational restructuring includes: audit of the business strategy of the bank; improvement of corporate governance; establishment of sound management and accounting systems; adoption of better techniques for risk evaluation and asset and liability management; efficient liquidity management; and implementation of an efficient internal control and audit system as a prevention against different kinds of risks. Operational costs in banks could be reduced by the implementation of new technologies, closing some branches, opening agencies, and reducing the number of employees. Usually this phase begins with a change of management of banks under the rehabilitation programme.

8 The financial restructuring of the banking system has considerable fiscal implications, with the costs being borne by taxpayers. There is empirical evidence that these costs range from 4 percent of GDP in the case of bank restructuring in Philippines to 45 percent of GDP in the case of restructuring of the banking system in Kuwait. The average costs for restructuring of the banking systems in transition economies were about 8 percent of GDP (the Czech Republic in 1993: 7.8 percent of GDP; Hungary in 1993: 12.2 percent of GDP; Poland in 1993: 5.7 percent of GDP).

Graph 6

Non-performing loans and capital adequacy ratio



The misallocation of funds continued, although the share of bad loans in total loan portfolio was decreasing. Non-performing loans level remained high until 2000. Kosovo crisis has its contribution in worsening the loan portfolio of banks also. Thus, competition in the financial sector remained weak, resulting in low efficiency.

3.3.2 Operational restructuring

Inflow of foreign capital and presence of the reputable foreign banks started after almost a decade of transition. This was big disadvantage for the financial sector. The entrance of the first foreign reputable bank was in 2000. This initiated process of operational restructuring of the banking industry. The largest bank – Stopanska Banka Skopje, was sold to three foreign reputable institutional investors: National Bank of Greece S.A. Athens, European Bank for Restructuring and Development and International Finance Corporation. Actually, Stopanska Banka Skopje, became subsidiary of National Bank of Greece, having in mind that it has had share stake of 74 percent. The precondition for this development was a second financial restructuring of the bank, which occurred at the end of 1999 with the replacement of EUR 125 million of bad loans by government bonds. This created additional costs of 3.5 percent of GDP for rehabilitation of banking industry. Another small bank was undertaken by Alfa Bank from Greece, and the third largest bank by Nova Ljubljanska Banka Ljubljana. Simultaneously, at the end of 2002, Bank of Austria opened representative office in Macedonia. Thus, at the end of 2002 more than half of the banking industry was in the hands of reputable financial institutions that has had expertise and experience to manage a bank.

The link between enterprises - shareholders searching for soft loans and banks was broken. Corporate governance of banks was normalized. Competition and efficiency has been increased through the comprehensive reorganization and restructuring, that was dictated by Stopanska Banka Skopje. All these measures had increased the soundness, efficiency and credibility of the banks, which was reflected into reduction of the bad loan portfolio, lower interest rate margins and high capital adequacy ratio, resulting with grade 3 in classification of banking reform in the EBRD Transition Report for 2002 (EBRD, Transition Report, p. 20). However, the inter-mediation and depth of the financial market remained low, and from this respect Macedonia was lagging behind to other transition economies (see table 14 in the Appendix).

Increasing profitability and efficiency, together with introducing higher transparency and larger market discipline are remaining main short-term goals of the banking industry and supervisory authorities. Securitization of the economy remains as medium term goal. The role of the banks is remaining crucial for promoting high economic growth. Efficient allocation of domestic and foreign savings is precondition for sustainable economic development and increasing of employment. The challenge for supervisory authorities would be small weak banks (about ten almost half of the total number) that do not account more than 20 percent of total banks assets. These banks were created as banks with ill-corporate governance, to attract funds for financing activities of their shareholders. The shareholders of these banks do not have expertise and experience to transform them from weak to sound banks. Their phasing out from the market seems inevitable.

4 Conclusions

The Macedonian economic transition has been implemented under unpleasant external and internal environment. However, due to the small size of economy and unstable regional situation, the country was exposed to the variety of external shocks. Due to this, the country reformers did not enjoy any " honeymoon period". The main internal shock was the security crisis in 2001, which undercut business prospects and investment activity. The size and frequency of external and internal disturbances did not allow the policy makers to fully concentrate on the comprehensive long-term economic reforms. The short-term attempts for overcoming unexpected unfavourable shocks dominated their decisions.

Despite this, the first generation reforms: stabilization, foreign trade liberalization and small-scale privatization were successfully implemented until 1995. The effectiveness of initial economic reforms was especially increased with arrangements concluded with the IMF and the World Bank. In addition, domestic team of economic advisors contributed to the efficiency of the reform process, as well.

The second generation reforms, which are focused on large scale privatization, microeconomic restructuring and institution building obviously have tended to advance more slowly than initial phase reforms. The reasons for weak results lie in the facts that they are considerably more complex, require significant implementation capabilities from the state and broader social consensus in order to overcome the resistance coming from different interest groups in this advanced stage of transition.

During the transition period, the permanent IMF arrangements along with its dominant leadership enabled authoritarian approach to policy making. The IMF and World Bank arrangements partially substituted for the lack of broad based consensus for the transition reforms. Due to the falling output and increasing unemployment and poverty, the authorities were not able to create compensating mechanisms for the transition losers.

All these factors together with unfavourable structure of fiscal expenditures tied the hands of policy makers to promote more energetically the capital accumulation and economic growth. A major weakness remains the weak institutional framework and especially the lack of the firm rule of law. Despite considerable support of the reforms by the international financial institutions, the inflows of private capital and foreign direct investment were low, while export growth was anemic and stagnant. Due to the delayed transition and high social costs there is widespread public feeling of “reform fatigue”.

Continuous institution building, energetic reforms in the financial and real sectors and the continuation of sound macroeconomic policies are the only ways for bringing more dynamism into the economy. In this regard, the entrance of the reputable foreign banks has increased the industry’s efficiency and represents a solid background for promotion of other sectors’ restructuring and for acceleration of the economic growth. The process of EU accession would give additional impetus for accelerating and finalizing the transformation into the modern market economy.

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Appendix

Table 1

BASIC MACROECONOMIC INDICATORS

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Output					Percentage change in real terms						
Gross Domestic Product	-7.5	-1.8	-1.1	1.2	1.4	3.4	4.3	4.5	-4.5	0.9	3.1
Industrial gross output	-7.1	6.0	2.3	-1.7	-0.1	4.5	-2.6	3.5	-3.1	-5.3	4.7
Agricultural gross output	2.6	7.8	4.1	-2.0	1.0	4.0	1.0	3.5	-9.8	2.5	na
Economic development					Denominations as indicated						
Population (mid-year millions)	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
GDP at current prices (in million denars)	59165	146409	169521	176444	186019	194979	209010	236390	233841	241243	254372
GDP at current prices (in million US $)	2510	3389	4456	4412	3733	3581	3674	3588	3437	3727	4684
GDP per capita in US $ at current exchange rate	1299	1742	2267	2225	1869	1784	1821	1771	1688	1821	2289
GDP deflator	542.1	251.9	117.1	102.9	103.4	101.4	102.7	108.2	103.6	102.2	102.3
Gross national saving (% od GDP)	0.3	7.5	14.1	12.4	13.3	15.9	21.2	23.2	14.0	12.9	15.6
External sector					in millions US $						
External debt stock		n.a.	1062	1123	1141	1380	1438	1436	1378	1518	1771
Foreign reserves	119	172	283	277	287	367	478	714	775	735	903
Foreign reserves (in months of import of goods and services)		1.3	1.9	1.9	1.8	1.8	2.4	4.3	4.2	3.5	4.0
					Denominations as indicated						
Current account balance (% of GDP)	-3.3	-7.8	-6.7	-7.7	-7.7	-7.5	-0.9	-2.1	-6.8	-8.5	-6.2
External debt (as % od GDP)	n.a.	n.a.	23.8	25.5	30.6	38.5	39.1	40.0	40.1	40.7	37.8
External debt/exports of goods and services (in per cent)	n.a.	n.a.	76.4	86.3	83.0	95.8	98.3	87.8	98.8	118.3	130.3
Openess of the economy	90%	76%	66%	63%	81%	87%	78%	93%	83%	81%	76%
Employment					In per cent of labor force						
Unemployment	24.9	25.6	28.9	31.9	36.0	34.5	32.4	32.1	30.5	31.9	36.7
Monetary sector					*(Percentage change)*						
Broad money (M2-denar, end-year)	560.8	31.9	5.2	-1.1	13.3	11.1	33.5	17.5	11.3	7.9	15.4
					(In percent of GDP)						
Broad money (M2-denar, end-year)	9.5	8.0	8.8	8.9	9.0	9.7	11.1	12.2	14.1	14.9	15.8
Interest and exchange rate					*(In percent per annum, end-year)*						
Discount rate of the National Bank		66.0	16.0	11.0	15.2	10.3	11.8	8.9	10.7	10.7	6.5
Inter-bank interest rate		n.a.	35.7	22.5	21.1	18.1	11.6	7.2	11.9	11.9	5.8
Deposit rate		117.6	24.1	12.8	11.6	11.7	11.4	10.7	10.0	9.2	6.7
Lending rate		159.8	46.0	21.5	21.4	21.0	20.0	19.0	19.2	17.7	14.5
Exchange rate den/US $ (end-year)		40.6	38.0	41.4	55.4	51.8	60.3	65.3	69.2	58.6	49.1
Exchange rate den/US $ (annual average)		43.2	38.0	40.0	49.8	54.5	56.9	65.9	68.1	64.7	54.3
Prices and wages					Percentage change						
PPI (annual average)	358.3	88.9	4.7	-0.3	4.2	4.0	-0.1	8.9	2.0	-0.9	-0.3
CPI (annual average)	462.0	128.0	15.7	2.3	2.6	-0.1	-0.7	5.8	5.5	1.8	1.2
CPI (end year)		55.0	8.8	-0.7	2.7	-2.4	2.4	6.1	3.7	1.1	2.6
Indexes of real net earnings (1990=100)	75.3	67.6	64.7	65.0	65.1	67.6	70.0	69.8	68.5	70.9	73.4
Revenues and expenditures of consolidated general gov.					*% of GDP*						
Revenues	40.2	43.1	37.9	35.7	34.8	33.3	35.4	36.6	34.4	35.8	
Expenditures	53.6	45.8	39.0	36.3	35.5	35.0	35.4	34.9	41.6	41.5	
Balance	-13.4	-2.7	-1.0	-0.6	-0.8	-1.7	0.0	1.8	-7.2	-5.7	-1.7

Source: Ministry of Finance, State Statistical Office, National Bank

Table 2

MONETARY POLICY GOALS AND TARGETS

	Projections			Indicative target		Achievement		
	Goal: Rate of inflation* (eop)	Target	Growth rate	Monetary agregate	Rate of growth	Rate of inflation* (eop)	Exchange rate MKD/EUR (eop)	Monetary growth (eop)
1992	2408.4	M1	755.1	-	-	1925.2	14.97	704.5
1993	434.2	M1	268.3	-	-	229.6	50.37	236.6
1994	70.0	M3-denar	81.0	-	-	55.4	51.26	56
1995	17.8	M1	23.0	-	-	9.2	51.81	10.4
1996	6.0	M1	12.5	-	-	0.2	52.08	0.4
1997	2.0	MKD/DEM	stable	M1	9.1	4.5	60.48	13.4
1998	5.0	MKD/DEM	stable	M1	11.0	-1	60.59	11.5
1999	3.0	MKD/DEM	stable	M2-denar	11.4	2.3	60.62	33.5
2000	4.0	MKD/DEM	stable	M2-denar	13.5	6.1	60.79	17.5
2001	1.2	MKD/DEM	stable	M2-denar	12.1	3.7	60.96	11.3
2002	2.5**	MKD/EUR	stable	M2-denar	7.4	1.8**	61.07	7.9
2003	3.0**	MKD/EUR	stable	M2-denar	9.6	1.2**	61.29	15.4
2004	2.8**	MKD/EUR	stable	M2-denar	11.7			

* till 1999 Retail Price Inflation, since 2000 CPI inflation
** average inflation

Table 3

CENTRAL GOVERNMENT

in million denars

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
total expenditures	13,384	37,678	37,200	41,396	40,792	41,391	45,613	51,520	65,363	70,378	56,708
capital expenditures	1,185	5,853	5,190	4,338	2,505	2,616	2,957	5,751	7,380	8,221	5,037
final consumption	7,663	18,883	19,819	20,134	20,048	21,476	22,510	22,759	36,349	33,156	27,836
transfers	4,536	10,937	12,191	13,712	14,283	13,862	17,127	19,060	17,434	25,672	21,393
interest	0	2,005	0	3,212	3,956	3,436	3,019	3,949	4,200	3,328	2,443
primary balance	6,745	-1,948	-1,695	2,005	1,665	1,864	4,610	10,234	-9,352	-9,691	-384
balance	6,745	-3,953	-1,695	-1,207	-2,291	-1,572	1,591	6,285	-13,551	-13,019	-2,827
GDP	59,165	146,409	169,521	176,444	186,019	194,979	209,010	236,389	233,841	241,243	254,372

in % of GDP

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
total expenditures	22.6	25.7	21.9	23.5	21.9	21.2	21.8	21.8	28.0	29.2	22.3
capital expenditures	2.0	4.0	3.1	2.5	1.3	1.3	1.4	2.4	3.2	3.4	2.0
final consumption	13.0	12.9	11.7	11.4	10.8	11.0	10.8	9.6	15.5	13.7	10.9
transfers	7.7	7.5	7.2	7.8	7.7	7.1	8.2	8.1	7.5	10.6	8.4
interest	0.0	1.4	0.0	1.8	2.1	1.8	1.4	1.7	1.8	1.4	1.0
primary balance	-13.4	-1.3	-1.0	1.1	0.9	1.0	2.2	4.3	-4.0	-4.0	-0.2
balance	-13.4	-2.7	-1.0	-0.7	-1.2	-0.8	0.8	2.7	-5.8	-5.4	-1.1
GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Table 4

GENERAL GOVERNMENT

in milion denars

	1996	1997	1998	1999	2000	2001	2002	2003 est.
total expenditures	65,515	65,352	68,280	73,946	80,678	95,349	99,808	91,633
capital expenditures	4,112	2,577	3,472	4,746	6,327	8,125	8,838	7,319
final consumption	32,168	32,532	34,745	36,956	37,909	51,479	49,127	45,868
transfers	25,715	26,223	26,363	29,077	32,281	31,386	38,265	35,257
interest	3,520	4,020	3,700	3,167	4,161	4,359	3,579	3,189
primary balance	1,019	3,317	364	3,228	10,066	-10,487	-9,975	-1,928
balance	-2,501	-703	-3,336	61	5,905	-14,846	-13,554	-5,117
GDP	176,444	186,019	194,979	209,010	236,389	233,841	241,243	254,372

in % of GDP

	1996	1997	1998	1999	2000	2001	2002	2003 est.
total expenditures	37.1	35.1	35.0	35.4	34.1	40.8	41.4	36.3
capital expenditures	2.3	1.4	1.8	2.3	2.7	3.5	3.7	2.9
final consumption	18.2	17.5	17.8	17.7	16.0	22.0	20.4	18.2
transfers	14.6	14.1	13.5	13.9	13.7	13.4	15.9	14.0
interest	2.0	2.2	1.9	1.5	1.8	1.9	1.5	1.3
primary balance	0.6	1.8	0.2	1.5	4.3	-4.5	-4.1	-0.8
balance	-1.4	-0.4	-1.7	0.0	2.5	-7.2	-5.7	-1.7
GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Table 5

RELATIONS WITH THE IMF 1992-2003

	period	aproved arrangements in SDR	Used funds in SDR	Used funds in US $
Systemic Transformation Facility	1994-1995	24,800,000	24,800,000	36,798,279
Stand By	1995-1996	22,300,000	22,300,000	32,843,572
Enhanced Structural Adjustment Facility	1997-1998	54,562,000	27,281,000	37,043,673
Compensatory and Contingency Financial Facility	1999	13,780,000	13,780,000	18,777,218
Extended Fund Facility	2000	24,115,000	1,148,333	1,472,123
Poverty Reduction and Growth Facility	2000	10,335,000	1,722,500	2,247,337
Stand By	2003-2004	20,000,000	8,000,000	11,279,191
Total		**169,892,000**	**99,031,833**	**140,461,394**

Relations with the World Bank

	period	approved arrangements in SDR	Used funds in SDR	Used funds in US $
Extended Recovery Loan/Extended Recovery Credit	1994	55,957,776	55,957,776	83,030,253
Financial and Enterprise Sector Adjustment Credit	1995	54,700,000	54,700,000	79,944,680
Structural Adjustment Loan/Structural Adjustment Credit	1997	39,240,979	39,240,979	54,462,191
Social Sector Adjustment Credit	1998	21,600,000	21,600,000	29,065,815
Emergency Recovery Credit	1999	36,900,000	36,900,000	49,854,511
Financial and Enterprise Structural Adjustments Loan/Financial and Enterprise Sector Adjustment Credit II	2000	37,361,863	22,487,783	30,755,751
Emergency Economic Recovery Credit	2001	11,600,000	11,600,000	14,487,077
Public Sector Management Adjustment Credit	2003	12,100,000	12,100,000	17,181,428
Total		**269,460,618**	**254,586,538**	**358,781,705**

Loans extended by IBRD

Extended Recovery Loan	1994	26,957,777	26,957,777	40,000,000
Structural Adjustment Loan	1997	18,640,979	18,640,979	25,871,642
Financial and Enterprise Sector Adjustment Credit II	2000	22,161,861	13,387,782	18,310,000
Total IBRD loans		**67,760,617**	**58,986,538**	**84,181,642**

Loans extended by IDA

Extended Recovery Credit	1994	29,000,000	29,000,000	43,030,253
Financial and Enterprise Sector Adjustment Credit	1995	54,700,000	54,700,000	79,944,680
Structural Adjustment Credit	1997	20,600,000	20,600,000	28,590,549
Social Sector Adjustment Credit	1998	21,600,000	21,600,000	29,065,815
Emergency Recovery Credit	1999	36,900,000	36,900,000	49,854,511
Financial and Enterprise Sector Adjustment Credit II	2000	15,200,000	9,100,000	12,445,751
Emergency Economic Recovery Credit	2001	11,600,000	11,600,000	14,487,077
Public Sector Management Adjustment Credit	2003	12,100,000	12,100,000	17,181,428
Total IDA loans		**201,700,000**	**195,600,000**	**274,600,063**

Table 6

NET FOREIGN DIRECT INVESTMENTS IN MACEDONIA

	in million US $		in % of GDP		per head in US $	
	flow	stock	flow	stock	flow	stock
1992	0	0	0	0	0	0
1993	0	0	0.0	0.0	0	0
1994	24	24	0.7	0.7	12	12
1995	10	34	0.2	0.8	5	17
1996	11	45	0.3	1.0	6	23
1997	16	60	0.4	1.6	8	30
1998	118	178	3.3	5.0	59	89
1999	32	210	0.9	5.7	16	104
2000	176	386	4.9	10.8	87	191
2001	442	828	12.8	24.1	217	406
2002	77	905	2.1	24.3	38	442
2003	95	999	2.0	21.3	46	485

Source: National Bank of Republic of Macedonia

Table 7

FDI FOR SELECTIVE COUNTRIES-CUMULATIVE 2000

	stocks in million US $	per head in US $
Czech Republic	21095	2052
Hungary	19863	1978
Slovenia	2809	1415
Croatia	4764	1046
Slovakia	4504	835
Poland	32000	828
Bulgaria	3309	403
Romania	6519	290
Macedonia	386	191
Yugoslavia	990	118

Source: WIIW

Table 8

SAVINGS AND INVESTMENTS

	Gross national saving as % of GDP	CAB as % of GDP	Gross investments as % of GDP	Gross fixed investments as % of	Changes in stocks as % of GDP
1993	14.6	-3.3	17.9	18.6	-0.7
1994	7.5	-7.8	15.5	15.3	0.1
1995	14.1	-6.7	20.8	16.5	4.2
1996	12.4	-7.7	20.1	17.4	2.7
1997	13.3	-7.7	21.0	17.3	3.6
1998	15.9	-7.5	23.4	14.4	6.0
1999	21.2	-0.9	22.1	16.6	5.5
2000	23.2	-2.1	25.3	16.2	9.1
2001	14.0	-6.8	20.8	14.8	5.9
2002	12.9	-8.5	21.4	16.6	4.9
2003	15.6	-6.2	21.8	15.6	6.3

Source: State Statistical Office, NBRM

Table 9

THE IMF CLASSIFICATION OF OFFICIAL EXCHANGE RATE REGIMES

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Albania	3	3	8	8	8	8	8	8	8	8	8	8
Armenia	na	na	(3)	(8)	8	8	8	8	8	8	8	8
Azerbaijan	na	na	(3)	(3)	8	8	8	8	7	7	7	7
Belarus	na	na	(3)	(3)	(7)	7	4	7	7	7	5	6
Bulgaria	3	8	8	8	8	8	8	2	2	2	2	2
Croatia	na	na	3	8	4	4	4	4	4	7	7	7
Czech Rep.	3	3	3	3	3	3	4	7	7	7	8	8
Estonia	na	na	2	2	2	2	2	2	2	2	2	2
Georgia	na	na	(3)	(8)	7	7	7	3	8	8	8	8
Hungary	3	3	3	3	3	6	6	6	6	6	6	4
Kazakhstan	na	na	(3)	(8)	8	8	8	7	7	8	7	7
Kyrgyz Rep.	na	na	(3)	(8)	8	7	7	7	7	7	7	7
Latvia	na	na	(8)	(8)	3	3	3	3	3	3	3	3
Lithuania	na	na	(8)	(8)	2	2	2	2	2	2	2	2
Macedonia	na	na	8	8	8*	3	3	3	3	3	3	3
Moldova	na	na	(3)	(8)	8	8	8	8	8	8	8	8
Poland	3	5	5	5	5	6	6	6	6	6	8	8
Romania	3	7	8	8	8	8	8	8	7	7	7	7
Russia	na	na	(3)	(8)	8	4	6	6	7	8	8	8
Slovak Rep.	na	na	na	3	3	3	4	4	7	7	7	7
Slovenia	na	-7	7	7	7	7	7	7	7	7	7	7
Tajikistan	na	na	na	(3)	(3)	8	8	8	7	7	8	8
Turkmenistan	na	na	(3)	(3)	3	7	7	3	3	3	3	3
Ukraine	na	na	(3)	(8)	8	7	7	4	4	7	7	7
Uzbekistan	na	na	(3)	(3)	(8)	7	7	7	7	7	7	7

Note: End-year observations. Codes in parentheses refer to the periods when the newly introduced national currencies have not yet assumed the status as the sole legal tender. The meanings of the codes are: na=not available, 1=currency union (no separate legal tender), 2=currency board arrangements, 3=conventionally fixed pegs (adjustable pegs, de facto pegs), 4=horizontal bands, 5=crawling pegs, 6=crawling bands, 7=managed floating without pre-announced path for the exchange rate, 8=independent floating.

Source: Jürgen von Hagen and Jizhong Zhou, "De Facto and Official Exchange Rate Regimes in Transition Economies," Bonn: Center for European Integration Studies working paper B13, 2002; 2000 and 2001 from Andrea Bubula and Inci Ötker-Robe, "The Evolution of Exchange Rate Regimes since 1990: Evidence from de Facto Policies," Washington: IMF Working Paper 02/155, September 2002.

* -- We note that von Hagen and Zhou classify Macedonia as a conventionally fixed peg for 1994, but in fact Macedonia did not fix exchange rates until October 1995.

Table 10

IINDICATORS OF PUBLIC INDEBTEDNESS OF TRANSITION ECONOMIES, 1997 - 2001

	Macedonia	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Slovak Republic	Slovenia	Average
~~Average for 1997 - 2001~~				*(in % of GDP)*						
Total debt	54.0	15.7	5.9	60.2	13.1	20.5	43.5	32.4	25.1	30.0
Domestic debt	20.6	12.1	2.4	49.9	5.1	7.9	21.7	20.7	14.1	17.2
Foreign debt	33.4	1.8	3.6	10.3	8.0	12.6	21.8	11.7	11.0	12.7
For 2001										
Total debt	51.6	19.1	4.8	53.7	15.0	24.0	42.0	43.5	27.5	31.2
Domestic debt	17.9	17.7	2.1	38.6	5.4	8.4	25.8	30.4	14.5	17.9
Foreign debt	33.7	1.4	2.7	15.1	9.6	15.6	16.2	13.0	13.0	13.4

Source: World bank

Table 11

DECOMPOSITION OF EMPLOYMENT GROWTH, 1997-2002

In %	1997	1998	1999	2000	2001	2002	Average 1997-2000
Employment growth	-4.7	5.4	1.0	0.8	9.0	-6.3	0.6
of which:							
Exports	10.7	3.2	2.6	8.6	-5.9	-1.5	6.3
Imports	-12.6	-3.7	-0.2	-13.6	7.9	-5.8	-7.5
Consumption	1.9	2.6	4.1	6.3	-2.5	7.0	3.7
Investment	1.7	1.3	-2.2	3.2	-2.9	1.6	1.0
Productivity	-6.4	1.9	-3.3	-3.7	12.4	-7.5	-2.9

Source: World Bank staff calculations

Table 12

NON-WEIGHTED AVERAGE CUSTOMS RATE

1992	16.0%
1993	16.0%
1994	16.0%
1995	16.0%
1996	15.1%
1997	15.1%
1998	15.1%
1999	15.1%
2000	15.1%
2001	14.6%
2002	14.2%
2003	11.5%

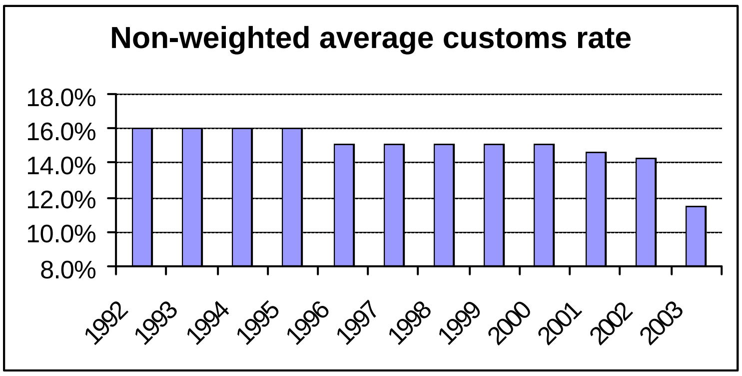

Table 13

FINANCIAL INSTITUTIONS IN THE REPUBLIC OF MACEDONIA

Type of FI	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Banks	7	19	19	21	22	22	24	22	22	21	21
Foreign bank branches	0	0	1	1	1	1	2	1	0	0	0
Savings houses	n/a	n/a	23	22	27	20	18	16	19	17	17
Exchange Offices	0	351	540	729	757	395	341	370	397	396	403
Explicit deposit insurance funds	0	0	0	0	1	1	1	1	1	1	1
Insurance companies	4	4	4	6	8	8	9	9	9	9	10
Stock exchange	0	0	0	0	1	1	1	1	1	1	1
Total no. of FI	11	374	587	779	817	448	396	420	449	445	453

Table 14

DEPTH OF FINANCIAL MARKET, PROFITABILITY AND RISKS

	Total Assets/GDP	Total Deposits/ GDP	Total Loans/GDP	ROA	ROE	Interest rate spread	Non-performing loans/total loans	Capital Adequacy Ratio
Albania	53.9	49.2	4.9	1.5	21.6	5.7	7.0	35.3
Bulgaria	45.0	31.0	18.0	2.7	19.2	11.7	3.3	26.8
Croatia	87.3	57.5	44.8	2.2	21.4	7.7	6.8	17.1
Srbia and Crna Gora	40.3	22.7	16.0	-	-26.0	16.1	12.7	21.9
Romania	29.2	18.9	11.0	3.1	21.8	14.8	2.1	25.8
Greece	155.0	109.0	59.6	1.0	12.0	4.6	5.2	11.9
Euro Area	260.0	96.5	107.8	0.9	7.5	3.8	2.9	11.5
Macedonia (according NBRM-2002)	39.0	24.2	13.4	0.4	2.1	8.8	15.9	28.1

Data refers to 2001-2002

Source: NBG Bulletin for South Eastern Europe and Mediterranean Emerging Market Economies

Table 15

DEPTH OF FINANCIAL MARKET AND CURRENCY SUBSTITUTION

	Monetary agregates as % of GDP						
	M2	M2 denar	M4	M4 denar	Total assets	Foreign currency deposits/Total denar deposits	Foreign currency deposits of M2/Total denar deposits of M2
1993	13.2	9.5	14.7	11.0	88.0		
1994	10.7	8.0	12.5	9.8	65.5	25.4	25.0
1995	10.8	8.8	13.0	10.7	26.0	27.1	19.6
1996	10.5	8.9	12.8	10.5	23.5	24.4	17.2
1997	11.1	9.0	13.2	10.6	27.5	33.2	27.2
1998	12.5	9.7	14.6	11.2	31.0	37.4	30.9
1999	14.3	11.1	16.6	12.7	34.6	33.6	27.2
2000	16.0	12.2	18.4	13.8	34.7	41.7	34.7
2001	23.9	14.1	26.7	15.7	45.2	111.6	101.2
2002	27.8	14.9	30.5	16.6	39.0	75.6	71.6
2003	27.6	15.8	29.6	17.3	40.0	79.6	76.6

Source: NBRM

Table 16
FOREIGN CURRENCY COVERAGE OF MONEY STOCKS

	foreign reserves coverage of M1	foreign reserves coverage of M2 denar
1993	77.4	50.1
1994	92.5	63.6
1995	93.3	71.7
1996	90.0	70.4
1997	109.3	84.8
1998	137.2	106.1
1999	156.0	117.3
2000	223.5	163.1
2001	221.3	160.3
2002	183.7	131.8
2003	163.1	102.5

Source: NBRM

Table 17
DOMESTIC CREDIT TO THE PRIVATE SECTOR, 1997-2001

In % of GDP	1997	1998	1999	2000	2001
Macedonia	*27*	*18*	*21*	*18*	*18*
Croatia	37	41	37	36	42
Czech Republic	76	67	61	54	44
Estonia	27	25	26	26	27
Latvia	11	16	16	19	23
Lithuania	11	11	13	12	12
Slovenia	29	33	36	38	40
Albania	4	3	4	5	6
Armenia	6	9	9	11	8
Bulgaria	6	8	10	12	14
Georgia	5	6	7	9	8
Kyrgyz Republic	4	5	5	4	4
Moldova	7	14	12	13	15
Romania	8	12	8	7	8

Source: World Development Credit to the Private Sector, 1997-2001

Table 18

RETURN ON AVERAGE ASSETS AND RETURN ON AVERAGE EQUITY

As at	ROAA	ROAE
12/31/1997	2.2%	9.3%
6/30/1998	2.4%	9.6%
12/31/1998	2.0%	8.2%
6/30/1999	0.7%	2.9%
12/31/1999	0.8%	3.5%
6/30/2000	1.3%	6.1%
12/31/2000	0.8%	3.8%
6/30/2001	-0.2%	-0.6%
12/31/2001	-0.7%	-3.2%
6/30/2002	-1.8%	-9.1%
12/31/2002	0.4%	2.1%

Source: NBRM