MACEDONIA: IMPLICATIONS OF THE INTERNATIONAL FINANCIAL TURMOIL

By Bert van Selm, IMF Resident Representative

Last week, the IMF published revised growth projections for the global economy. The numbers were exceptionally gloomy. For the eurozone—which accounts for more than half of Macedonia's exports—the IMF now projects a 2 percent decline in output this year. Projections for Central and Eastern Europe were also sharply reduced, to a 0.5 percent output decline in 2009. This crisis is truly global, and no country will escape its effects.

Unlike in other countries in both developed and emerging Europe, the direct impact of the crisis on Macedonia's *financial* sector has been limited so far. Macedonia's banks remain adequately capitalized, with an average capital to asset ratio of 15 percent—almost twice the regulatory minimum. They rely largely on domestic deposits rather than international credit lines to fund lending—the banking system's loan-to-deposit ratio is well below 100 percent. And the two most important parent banks that operate in Macedonia—National Bank of Greece, the owner of Stopanska Banka, and Nova Ljubljanska Banka, which owns Tutunska—appear to be strong.

But the crisis has hurt Macedonia's real economy. First, industrial output fell by 10 percent year-on-year in December, with metals falling almost 60 percent. As this sector is a major exporter, this also increases pressure on the external position. Related sectors, such as transport, are now also suffering. Second, private transfers—or, more precisely, foreign currency sold to the foreign exchange buros, on a net basis—also fell sharply in 2008, by more than 10 percent relative to 2007. This reflects a number of factors: declining economic activity in the eurozone, as well as uncertainties in Macedonia. Third, the international credit crunch led to a sharp contraction in foreign direct investment in the second half of 2008 (€140 million through October), following strong FDI in the first half of the year (more than €300 million). As a result of these developments, the current account deficit increased to 16 percent of GDP in 2008, and international reserves declined from €1.7 billion at end-September 2008 to €1.5 billion at the end of the year.

The authorities have taken opposite approaches to meeting the challenge of the increasing external deficit. In December, the NBRM took measures to tighten monetary policy, while the government engaged in more expansionary fiscal policy. The prudential measures announced by the NBRM on December 25—which include bank-by-bank limits for credits to households, as well as minimum liquidity ratios—should help reduce credit growth and reduce imports. But the government ran a fiscal deficit of 11 billion denar (3 percent of annual GDP) in December 2008 alone. Unfortunately, this will worsen the external deficit. The accelerated government spending took the cumulative budget balance for the year from a 2 percent surplus at end-November to a 1 percent deficit at end-December. Part of the December spending increase reflects transfers from government accounts to those of state-owned enterprises—the macroeconomic impact of these will continue to play out in the first half of 2009. Moreover, on December 29, parliament approved a 2009 budget with a deficit of 2.8 percent of GDP—a further fiscal expansion. Revenue projections are based on the very optimistic assumption that economic growth this year will reach 5½ percent—a desirable objective for Macedonia, but incredibly difficult to achieve given the current world recession. Even the 3 percent growth in used in the 2008 Article IV consultation now seems too high. If a more realistic projection is used, full execution of the expenditure side of the budget would result in an even higher deficit. This deficit would need to be financed—but, in the current difficult international environment, it is not clear where these funds will come from.

The authorities now need to take a determined response to the challenge of the increasing external deficit, by tightening both fiscal and monetary policy. The current policy mix means that the public sector crowds out the private sector. This runs counter to the government's announced policy of creating a more favorable business climate in Macedonia. There is an urgent need to take a fresh look at 2009 government revenue and financing projections, and adjust spending plans accordingly. The International Monetary Fund stands ready to assist the Macedonian authorities in this effort.