MACEDONIA AND THE IMF IN TURBULENT TIMES

Remarks prepared for European Business Association/Konrad Adenauer Foundation

Roundtable Discussion

Skopje, April 8, 2009

By Bert van Selm, IMF Resident Representative

Ladies and Gentlemen,

1. **The international financial crisis has been with us for 20 months now—it started in August 2007 and hit the world economy in full force after the collapse of Lehman Brothers in September of last year**. In my talk today, I will discuss the impact of the crisis on Macedonia, on the IMF, and on the relation between the two.

2. **At first, the effects of the crisis on emerging market economies, and thus on IMF lending, were limited.** The crisis started in the financial sector of advanced market economies, and initially there was much talk of "decoupling" of emerging markets. The first major systemic crisis appeared in Iceland, which concluded a Stand-By Arrangement with the IMF in November 2008.

3. **The initial effect on Macedonia's economy appeared limited, too**. Macedonia's economy continued to grow at a brisk pace until the summer of 2008, and its 2005-8 Stand-

By Arrangement with the IMF, which had been treated as precautionary after an initial disbursement in 2005, expired in August 2008.

4. **The global crisis dramatically worsened in the second half of 2008, in particular after the Lehman Brothers bankruptcy on September 14, 2008**. Increased investor risk aversion and severe deleveraging by western banks in response to impaired balance sheets and liquidity constraints made it more difficult for emerging markets to continue to finance external deficits. Many emerging markets, especially in Asia and Latin America, had run current account surpluses and accumulated large foreign reserves, which reduced their vulnerabilities. However, many Central and East European countries, which had developed large current account deficits that were financed by foreign banks and foreign direct investment, quickly found themselves in trouble. Many turned to the IMF for financial support: to date, Ukraine, Hungary, Serbia, Latvia, Belarus, and Armenia have agreed with the Fund on sizeable packages to support their economies, and discussions on Fund programs are underway with others, including Romania, Montenegro, Turkey, and Bosnia and Herzegovina. Several countries outside the European region have also come to the Fund for support. A common feature of these programs is that they combine financing and adjustment: macroeconomic policies aimed at reducing external deficits to sustainable levels are underpinned by IMF financial support, usually with additional contributions from multilateral and bilateral donors. Financial support from the Fund helps to finance shortfalls in the balance of payments, thereby cushioning the adjustment, and in many cases Fund support has also helped support the banking system.

5. **Macedonia entered into the period of global crisis with a large current account deficit—13 percent of GDP in 2008 and heavy dependence on foreign financing. Like many of its neighbors, Macedonia is now vulnerable to the global financial and economic crisis.** Several channels are at work. First, the global downturn has led to a severe contraction in global trade—which translates into lower exports for Macedonia. This is compounded by falling prices for metals, which are a big part of its exports. 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, and is likely to remain under pressure until the global economy recovers. The decline in remittances is a global phenomenon caused by slowing economies and rising unemployment, although it may have been exacerbated by political and macroeconomic uncertainties in Macedonia. Third, after strong **FDI inflows** in the first half of 2008 (4 percent of GDP), the international credit crunch led to a sharp contraction in the second half of the year (2½ percent of GDP) and to diminished prospects in the period ahead. These developments have contributed to pressures on Macedonia's balance of payments, which can be seen in the decline in international reserves, from €1.7 billion at end-September 2008 to €1.5 billion by the end of the year. The decline in reserves continued in the first quarter of 2009, to around €1.3 billion by end-March, with exports contracting faster than imports in early 2009.

6. **To reduce external imbalances, the National Bank of the Republic of Macedonia (NBRM) has tightened monetary 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. On

March 26, the NBRM further tightened monetary policy by increasing its key interest rate from 7 to 9 percent.

7. **At the same time, the government further expanded fiscal policies, thereby contributing to the external deficit.** In December 2008 alone, the central government ran a deficit of 3 percent of (annual) GDP. This took the cumulative 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 spree 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 this year. Moreover, on December 29, parliament approved a 2009 budget with a deficit of 2.8 percent of GDP—a further fiscal expansion.

8. **In the face of the deepening international crisis, the Macedonian authorities should now adopt a comprehensive and consistent plan to maintain macroeconomic stability.** This will need to include a significant tightening of fiscal policy to bring spending in line with revenues and staunch the outflow of international reserves. While many advanced countries are trying to support flagging demand though more expansionary monetary and fiscal policies, in Macedonia the room for doing this is severely constrained by (1) an already large overhang of public and private spending over incomes, reflected in Macedonia's substantial current account deficit; by (2) the challenge of finding financing to cover budget deficits; as well as by (3) the need to support the exchange rate peg. The loss of international reserves in recent months is a clear demonstration of the limited room for expansionary policies.

9. **Turning to the exchange rate, the pegged regime has served Macedonia well.** It has been well-suited to Macedonia's status as a small open economy, in particular in light of trade concentration towards the euro area the and partial euroization of the financial sector. But such a regime needs the strong support of **both monetary and fiscal policies**, especially in difficult times such as the present. A fixed regime means that the exchange rate is not available to help redirect demand and spending from foreign goods to domestically produced goods as the economy adjusts to the loss of foreign financing. Hence it puts a heavier burden on strong policy efforts to contain the economy's overall spending.

10. **In light of these considerations, there is an urgent need to revise and tighten the 2009 budget**. In the first quarter of 2009, revenue was 5 percent less than in 2008, whereas the 2009 budget projects a 13 percent increase. Given limited financing options, expenditures will have to be brought in line with revenues.

11. **Let me conclude by saying that the IMF continues to stand ready to assist Macedonia in whatever way the authorities judge to be most appropriate.** A new IMF mission chief for Macedonia has been appointed: Mr. Wes McGrew. He will meet with Macedonian officials in Washington in late April, at the Spring Meetings. A key goal of the talks will be to review with the authorities economic prospects and to try to develop a common perspective on the challenges that Macedonia faces and the most appropriate policy responses.

Thank you.