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## **1. FINANCIAL SYSTEM (FISCAL AND MONETARY POLICY)**

### **1.1. Planned and implemented activities of the Government of the Republic of Macedonia in the reporting period**

#### **1.1.1. Fiscal policy**

The main activities of the Government of the Republic of Macedonia in the reporting period in the field of fiscal policy were mainly aimed at the following directions:

1) Further liberalization of the fiscal policy towards increasing its development purpose, which was manifested through the realization of the following program activities:

a) Continuation of the process of reducing the social contribution rates. In 2009, the rate for the pension insurance contribution was reduced from 21.2% to 19%, the rate for the health insurance contribution was reduced from 8.5% to 7.5%, and the rate for the employment contribution was also reduced from 1.4% to 1.2%. The aim of such measures is to decrease the financial burden of the companies and creating opportunities for release of funds to be used in stimulating production, and thus increasing the number of employed persons (reducing the number of the unemployed);

b) At the start of 2009, the system of gross salary was introduced. This means that the calculation of the whole salary of the employees includes also food allowance and allowance for commuting to and from the place of work (travel allowance). This measure should lead to protection of interests of the employees (thus they are able now to get exact calculation of the amount of their salary and of the contributions paid on various grounds to the state) and of the employers (gradual elimination of the unfair competition by those who tried to evade the payment of contributions or salaries of the employees in gross amount);

c) Directly connected to the previous is also the realization of the program determination of the Government of the Republic of Macedonia to introduce integrated collection of contributions and taxes conducted by the Public Revenue Office (PRO). The realization of such measure, as aforementioned, is to the benefit of the employees and employers, as well as to the benefit of the state budget because this provides uninterrupted and regular inflow of funds in the budget;

d) In order to stimulate foreign investors to reinvest their realized and undistributed profit back in the Republic of Macedonia (i.e., not to repatriate such profit back to their domicile countries), which in turn would enhance the protection of the domestic economy from the incoming recession and would further boost its growth, such foreign investors are exempted from payment of taxes on undistributed profit. However, this measure did not produce major effects, because many foreign investors, faced with financial problems of their mother companies in the domicile countries, decided to repatriate the undistributed profit back to their domicile countries and pay domestic taxes on this. This represented additional pressure (in addition to the other ones to be mentioned later) on spending state foreign exchange reserves, and even on reduction (methodologically) of the volume of FDI (foreign direct investment) in the country;

e) In order to simplify the taxation procedure for the SMEs (small and medium sized enterprises), the Government of the Republic of Macedonia introduced electronic portals for electronic payment of taxes by expanding the capacity of the existing electronic portal for payment of taxes and by formation of a contact center that would reduce the need for enterprises to make direct contacts with the PRO employees and make in person visit to the PRO offices.

## **2) Other activities in the field of fiscal policy**

During the analyzed period, the fiscal policy was conducted in two, diametrically opposite environments.

In spite of the initial manifestations of the global economic crisis, the Macedonian economy was marked by continued growth in 2008. Its real GDP increased for 4.9% in that year. The intensive economic activity in 2008 caused the central budget revenues to be collected according to the planned volume and pace, and even more than that. This provided some room to the fiscal policy to conduct not only the planned activities, but also to commence some other, unplanned ones. However, the last 2008 quarter introduced the effects of the global economic crisis into the Macedonia economy as well. The Macedonian economy already started to enter the recession phase. Companies and businesses suddenly were faced with serious liquidity-related problems. In order to reduce such problems, the Government of the Republic of Macedonia made decision, at the end of 2008, that companies which are faced with liquidity-related problems and have not paid yet their due taxes, contributions and other public levies would be allowed to have reprogramming of such debts, with possibility to write off the accrued interest on such debts if interested companies pay the principal of their debts on regular basis and within agreed deadlines. After the end of the deadline in which interested companies were obliged to apply in order to acquire such right, 2,807 companies applied whose overall debts amounted to more than 165 million € as the principal and about 60 million euro as accrued interest (this interest could be written off if affected companies were willing to pay the principal).

Furthermore, the package of anti-crisis measures also included the conversion of the debt of four state-owned companies into a permanent stake by the state for raising the level of competitiveness and interest in these four companies for future sale. The increase in the economic crisis, with its reinforced reflections on the Macedonian economy as well, compelled the Government of the Republic of Macedonia to adopt the second set of anti-crisis measures. The most important measures in that package, as already mentioned, included exempting companies to pay profit tax in the amount of the profit redistributed back into investment and reduction of customs tariffs for many raw materials used in the textile industry, as well as customs tariffs for the import of machines and equipment for the metal industry; the intention was to protect these two major export-orientated industrial sectors from the oncoming recession mostly evident in these two sectors of the national economy. Further increase in the recession tendencies in the economy and the ever growing lack of liquidity of companies made the Government of the Republic of Macedonia to adopt, in April 2009, a third package of anti-crisis measures (about 70). The major thrust in these measures was the decision by the Government of the Republic of Macedonia to take loans from the European Central Bank in amount of 100 million

euro; this amount would be allocated to the companies through the Macedonian Bank for Development Promotion and supported by adoption of many measures intended to simplify the customs clearance and faster transit of goods through the borders (see next chapter for a detailed description of such customs measures).

In summer of 2009, after seeing that one of possible stronger ways to deal with the crisis is providing support and incentive to the construction industry, the Government of the Republic of Macedonia decided to lower the VAT for new houses and apartments from 18% to 5%. It has been expected that such measure would stimulate the construction sector, and that this sector, being a locomotive of the economic growth of the country, would push the growth of other economic sectors as well. The effects of such measure are expected to be realized in the further period of its application.

Faced with diminishing revenues in the central budget because of poor performances of the economic operators, the Government of the Republic of Macedonia was compelled on two occasions to make revisions of the central budget (June and September 2009). The basic content elements of such revision have been reduction of the projected level of the budget from 2.6 to 2.4 billion euro, while keeping the planned budget deficit of 2.8% of the GDP. At the same time, reduction was made of all unproductive expenditures and capital projects with predominantly import component, at the expense of projects which imply engagements of the construction and other domestic companies.

Finally, the Government of the Republic of Macedonia started to deal with the permanently growing deficit, i.e., lack of funds in the budget for the realization of the planned activities by replacing this deficit through intensive and more frequent issuance and sale of government bonds. These bonds were bought mainly by the commercial banks. In a given moment, the selling rate for these bonds grew more than 9% per year; this in turn became very attractive interest rate for the banks and other economic operators interested in buying them. Such approach by the Government of the Republic of Macedonia to fill the budget deficit prompted also the National Bank of the Republic of Macedonia (NBRM) to sell its treasury bills at an annual interest rate of 9%. The issuance and sale of these two types of securities jointly caused a great problem in the economy: the economic operators being put aside from the loans that the banks could have granted them. This further aggravated their liquidity.

### **1.1.2. Monetary policy**

The monetary policy is completely in the hands of the already mentioned NBRM (i.e. the central bank of the country). This means that in this field it would be inappropriate to make analysis of activities that are the competence of the Government of the Republic of Macedonia. Indeed, its 2008-2012 action plan does not include measures and activities that directly relate to the implementation of the monetary policy. The only thing mentioned in this context is that the Government of the Republic of Macedonia will pursue in the given period a policy of macroeconomic stability which, usually, implies maintaining the stability of the prices and the exchange rate of the denar. These are the two domains where, generally speaking, one could analyze the realization of the monetary policy in the reporting period:

a) The tendency in context of consumer prices (internationally accepted standard for measuring the inflation rate) in the analyzed period can be observed in two parts. In the first part of 2008 the inflation rate was marked by upward swing as outcome of the price

increase of energy-generating sources (mostly of oil) and of food products on the global markets. It marked the period when the Republic of Macedonia was faced with imported inflation of expenditure character. The consequence of such tendencies was continuing increase of the inflation rate which rose to 10.1% per year by the end of June 2008.

In order to check the further growth of prices and to start the process of disinflation the country, NBRM, at the end of the second and in the third quarter of 2008, undertook several measures that influenced the reduction of the inflation rate. This, together with the tendency of reduction of oil and food prices on the global markets and the start of recession in the greater part of the global economy, caused gradual decrease in the inflation rate. By the end of 2008, it was reduced to acceptable (close to the projected level) 4.1% per year.

A modest increase in the inflation rate was also seen in the first five months of 2009. This was not the outcome of the aforementioned; however, in context of the growing pressure on the stability of the exchange rate of the denar when there was less and less inflow of foreign money into the country and thus spending of great amount of the foreign exchange reserves, NBRM, in the first half of 2009, increased the restrictiveness of the monetary policy. This is best seen through the increase in the rates under which the banks set aside compulsory reserves of their denar and foreign currency deposits and through the basic interest rate of such reserves (i.e., the interest rate of the treasury bills issued by NBRM) of 9% per year. This was sign also for the commercial banks to increase their interest rates; consequently, all this resulted in more expensive bank loans, and thus reducing the liquidity of the economic operators (of legal and natural persons) in the Republic of Macedonia. The outcome of such policy was reduction of their consumption, and, also reduction of the price level, i.e., growing signs of deflation.

Such deflation was present in June (1.7%), July (1.3%), August (1.4%), and September 2009 (1.47%), with tendency of further increase. According to theory and practice, conditions of continuing deflation represent far greater risk to the economy than inflation rate, let us say, of 8-10% per year. Hence, by the end of the reporting period, company executives and experts in the Republic of Macedonia started to ask that NBRM ease up its restrictiveness and so help the national economy get out of recession and deflation.

b) The exchange rate of the denar in the analyzed period was exposed to strong pressure for devaluation. The reasons for this was the smaller inflow of foreign currency (mostly, on grounds of export of goods and services and exchange of foreign currency) and the permanent outflow of foreign currency abroad (mostly, on grounds of import of goods and services). The outcome of the aforementioned was that the last quarter of 2008 and the first half of 2009 were marked by significantly higher demand of foreign currency than of its supply at the domestic forex. Such state of affairs made even stronger pressure on the exchange rate of the denar towards its devaluation. In order to prevent this, NBRM spent more than 500 million euro from the foreign currency reserves for intervention at the forex; as previously said, this in turn increased the level of restrictiveness of the monetary policy.

In the third quarter of 2009, the situation on the forex improved considerably. Because of the seasonal inflow of foreign currency due to money orders from abroad and increased exchange operations, the supply of foreign currency was (although modest) again greater than the demand of such foreign currency. At the same time, the national foreign currency reserves increased on grounds of money inflow from the issued government

euro bonds and withdrawing of part (57 million euro) of the NBRM quota with the IMF. By this, the situation with the foreign currency reserves was improved considerably, thus reaching by September 2009 the amount of 1.5 billion euro. This in turn caused the pressure for the denar devaluation to be reduced instantly and created conditions for NBRM to consider gradual easing of the restiveness of the monetary policy in the period until the end of the year, towards increasing the liquidity of the economy, and thus decreasing the bank interest rates.

c) Although as previously said the Government of the Republic of Macedonia is not directly charged with the credit and monetary policy, in the analyzed period the Government managed to undertake certain credit activities caused by the need for assistance to the economy to get out of the recession phase. The Government took loans from the EIB (European Investment Bank) for 100 million euro, that should be granted as loans to companies meeting appropriate criteria. These loans should be granted via the Macedonian Bank for Development Promotion, and with the mediation of seven business banks which additionally agreed to join this credit line with their own 80 million euro. The average interest rate is planned to be 6% per year.

Still, the realization of these loans is taking place in rather slow manner. By the end of the reporting period, no loan was approved from these funds. The main reason for this is lack of proper projects that meet the criteria for granting loans. This means that granting such loans should take place in the forthcoming period.

### **1.2. What remains to be implemented (not yet implemented or not yet finished) in the analyzed period**

A greater part of the program activities of the Government of the Republic of Macedonia were implemented in the analyzed period. One could notice their diversification with new measures and activities stemming from the newly created conditions for activity, being the outcome of the global economic crisis. However, dedicating higher attention to current economic problems indeed impedes the Government of the Republic of Macedonia to address the realization of the other reform activities that have been planned to be carried out or finished in the monitored period. Here, we mean mostly the continuation and finishing the processes of property denationalization and decentralization of power. The denationalization process has been done in rather slower pace than previously; this in turn has become a serious problem in the implementation of the planned increase of investment (domestic and especially foreign) in the country.

At the same time, the decentralization process has almost completely been halted. There are still 17 units of local self-government (ULS) that have not able to enter the second phase of the fiscal decentralization (this second phase involves another 68 ULS). Not finishing this process also blocks the implementation of the further reforms activities in this context, as seen in the realization of the regional economic development of ULS, their fiscal equalization, the gradual replacement of the block-donations from the central budget with new ways of financing the corresponding competencies of ULS, etc.

### **1.3. Evaluation of potential risks from (non)implementation or from (non)quality implementation of activities**

The highest risk that the Government of the Republic of Macedonia was faced with in the implementation of its program activities in the report period was the growingly intensive 'infection' of the domestic economy from the global economic crisis. This is manifested by entering of the economy in the recession phase with all negative consequences mentioned above. Although the greatest economies in the world have started to come out of the recession phase or at least have started to show some signs of recovery, the Macedonian economy even in the forthcoming period will have to be faced with the prolonged activity of the global economic crisis. This will be most strongly seen in the further presence of the non-liquidity of companies, smaller output of the industrial production, and thus leading to negative rate of overall economic growth by the end of 2009.

As result of the expected slower coming out of the Macedonian economy from the recession phase and the time lag of the positive tendencies in the economies of its major foreign trade partners (Germany, Russia, Serbia, Italy, Greece), the Macedonian economy might be facing another additional problem – increase in the number of unemployed persons (as it is already happening in the industry). If such tendency is not stopped or mitigated, in the forthcoming period this may cause the emergence of certain elements of social crisis, which will greatly engage the national budget in dealing with the appropriate consequences. This would also imply the reduction of the funds and resources to be engaged in the development activities of the economy.

Certain risk for the Macedonian economy in the forthcoming period could become (non)making a decision by EU to set a date for the start of the accession negotiations with the Republic of Macedonia. A possible negative reply from EU could slow down the inflow of FDI in the Republic of Macedonia; in conditions of insufficient financial capacity of the country, this might have a serious limitation for the successful outcome of the future program activities of the Government of the Republic of Macedonia, especially in context of restructuring and simulation of the future growth of the economy.

Finally, a serious risk to the implementation of the program and even more of the newly imposed activities and measures of the Government of the Republic of Macedonia may be the lack of synchronization between the monetary policy and the fiscal policy, whose consequences are manifested in higher level of non-liquidity of domestic companies.

#### **1.4. Overall evaluation by the expert on implemented activities for the reporting period, with possible recommendations**

Greater part of the planned activities of the Government of the Republic of Macedonia and of the other state institutions in the field of financial policy in the reporting period was implemented. In addition to the program measures, the Government of the Republic of Macedonia undertook also other measures that were originally not planned but were imposed by the current economic situation and tendencies in the country, caused by the global economic tendency and entering of the domestic economy in the recession phase. Measures and activities undertaken so have contributed to major change and improvement of the economic environment in the country. This was even recognized by the WB (World Bank) project "Doing Business," according to which the Republic of Macedonia is ranked at third place according to the strength of the reforms needed for 'doing businesses, and at 32<sup>nd</sup> place according to the conditions required for the operation

of the companies in the country. In normal circumstances of economic activity, the improvement of the economic environment most probably would have resulted in major positive changes in the national economy. This would have been reflected mostly in drawing more FDI and through the higher rate of economic growth. However, intensification of the global economic crisis and its spillover in the territory of the Macedonian economy has prevented the realization of such results, at least in 2009. In spite of the positive grades for the reform engagements in the reporting period, there remains an impression that, especially in the first nine months of 2009, there has been no synchronization between the fiscal policy and the monetary policy, when deciding on measures to address the crisis. NBRM, guided by its rather restrictive resolution to maintain the fixed exchange rate of the denar, conducted very restrictive monetary policy. This created illogical situation for the monetary policy to be restrictive in conditions of growing inflation (2008) and even more restrictive in conditions of longer deflation of the economy (2009). The outcome of such policy is reduced company liquidity and increased impossibility for these companies to address the ever-growing problems imposed by the recession and the existence of deflation in the economy. Such lack of any synchronization between the most important elements of the macroeconomic policy caused overall insecurity and uncertainty with most companies on the future directions of the national economic policy and turned out to be a major risk in the implementation of the future program activities of the Government of the Republic of Macedonia. This in turn imposed the need for their future synchronized action in order to achieve a common goal – that the Macedonia economy get out of the recession phase and take the right track on the road of prosperity in its development cycle. Furthermore, the Macedonian economy is faced with other two risks: the speed uncertainty in recovery of the global economy and of the Macedonian economy as well from the present crisis and the uncertainty about setting a date for the start of the EU accession negotiations, as well as joining NATO. These risks may have serious impact on the future directions and pace of the development of the Macedonian economy, whereby one would recommend high attention and rationality of the competent institutions in undertaking future measures for improvement of the conditions in the Macedonian economy.