

**NATIONAL BANK OF THE REPUBLIC OF MACEDONIA**

**Annual report**  
**1996**

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## I. World economic movements in 1996

In 1996, global worldwide economic and financial activity had positive trends. According to the estimations based on first nine months performance, the 1996 output is expected to increase by 3.8%, which is 0.3 percentage points higher than in the previous year. Main sources of worldwide economic developments in 1996 were: low and stable inflation rates, increased savings and investments, and higher productivity. Although economic performance of different countries groups is divergent, main characteristic besides exceptional dynamic economic growth of developing countries, and better economic results of Central and Eastern transition countries, is that the output of developed countries from continental Europe has still downward trends. The intensity of the economic activity is especially impressive in Asian developing countries, where the advantage of structural reforms results and reestablishment of financial markets have their full utterance. However, in some countries in this group, the economic growth in 1996 was partly slowed down due to the possibility of "overheating" the economy.

Table 1

### International economic indicators

	GDP real increase in %			Inflation (retail price increase in %)			Unemployment in %			Current account of balance of payments in billion USD		
	1994	1995	1996	1994	1995	1996	1994	1995	1996	1994	1995	1996
Industrial countries	2.8	2.1	2.3	2.3	2.4	2.3	8.1	7.7	7.8	-7.8	13.9	2.5
European Union	2.8	2.5	1.6	2.9	2.9	2.6	11.6	11.2	11.4	23.0	54.0	73.5
USA	3.5	2.0	2.4	2.6	2.8	2.8	6.1	5.6	5.6	-148.4	-148.2	-149.5
Germany	2.9	1.9	1.3	2.7	1.8	1.6	9.6	9.4	10.3	-19.7	-21.0	-18.8
Japan	0.5	0.9	3.5	0.7	-0.1	0.2	2.9	3.1	3.5	130.6	111.4	66.7
Countries in transition	-8.8	-1.3	0.4	264.8	128	41.3	-	-	-	-2.4	-1.9	-14.4
Central and Eastern Europe	-2.9	1.2	1.6	46.2	25.8	20.6	-	-	-	-4.0	-5.3	-9.1
Developing countries	6.6	5.9	6.3	46.8	19.8	13.3	-	-	-	-76.8	-90.2	-112.2

Source: IMF, World Economic Outlook (October 1995), previous data

In 1996, developed industrial countries maintained their traditionally low inflation rates, although the output and employment performance results in most countries were poor. According to the previous data, average inflation rate in developed countries in 1996 will be 2.3%, which is exactly at 1995 level, while output will achieve growth of 2.3% (2.1% in 1995). However, the aggregate picture becomes different if economic indicators are observed by different countries and groups. Namely, opposite of USA and Japan dynamic output growth determined by the relaxed monetary conditions, in European Union countries due to built in structural and macroeconomic weaknesses, significant slowing down of the economic activity and rise of unemployment is expected. Declining long term interest rates in 1996 may result in certain dynamics of the economic growth in next years, nevertheless high unemployment problem in these countries (the unemployment rate in European Union counties on average amounted over 11%). Having in mind that 8 - 9 percentage points of the

unemployment rate is structural unemployment (it can not be absorbed by cyclical growth revival in these countries, without triggering inflationary risks), the solution demands deeper structural reforms on labor market focused on its greater flexibility and dynamics. Simultaneously, in European Union countries which economic policies are oriented towards greater convergence to Maastricht Treaty criteria, have need for reducing relatively high fiscal imbalances. In wider terms, fiscal deficit financing in these countries creates a pressure on international interest rates, determining lower investment and growth level in terms of long term potential growth level.

Developing countries, which in whole worldwide output participate with 41.2%, in 1996 maintained high economic growth dynamics from previous years of 6.0%. Main sources of these countries fast economic growth are efficient realization of the economic reforms, high foreign capital inflow in form of direct investments, export sector expansion, fiscal deficit decrease, curbing down the inflation rate on one digit level, notably high domestic savings rate, etc. Observed by regions, in 1996 unlike 1995, the dynamics of the economic activity growth in Asian countries is a thing moderate (although still high), as result of demand constraint due to fear of "overheating" the economy. Namely, high economic growth rates of these economies, as well as increasing current account deficit in the balance of payments, creates pressure as higher demand, which consequences could be macroeconomic imbalances, rise of inflation and losing the domestic and foreign investors credibility. Therefore, fast growing Asian countries undertake measures for restraining the demand on level which is approximately at level of sustainable long term productive potential. On the other hand, in 1996 there was a significant intensification of the output in African countries, which jointly with reducing the inflation rate is basic precondition for increasing low living standard level in these countries. In Latin American countries, Chile is still traditionally the most successful economy. In addition, it is important that in 1996 revitalization of economic activity in Mexico (after financial crises from 1994 and 1995) and Argentina (inflation is brought down to lowest level in last fifty years) occurred.

Positive effects from successfully undertaken stabilization and reform processes in transition countries during 1996 have its full effects. In 1996, output in this group (which is 4.9% from whole worldwide output) achieved average growth rate of 0.4%, which is important having in mind negative growth rates in the previous years (-8.85 in 1994 and -1.3% in 1995). Economic growth of Central and Eastern European transition countries is yet more dynamic. In 1996, real social product growth rate achieved 1.6%, i.e. 4.2% (excluding Belorussia and Ukraine). Strengthened domestic demand, and export increase are two main streams of development in the most successful countries in transition. At the same time, domestic sources of investment are significantly supported with foreign capital inflow, whereby it should be emphasized that foreign investors are oriented only towards several most progressive transition countries. Trend of reducing inflation rate in transition countries have continued in 1996. Average retail price increase in these countries amounted to 41.3%, which is 6.4 times less compared to average inflation rate in the period 1991 - 1996. In addition, inflation in European countries in transition (excluding Belorussia and Ukraine) was reduced to average rate of 20.6%, which is 2.6 times lower inflation rate than average for the period 1991 - 1996. During 1996, positive developments are also noticed in countries which reform processes in past years were realized with slower pace, for example in Russia, where in first eight months of 1996 inflation rate on annual basis is reduced to 22%.

Nevertheless, opposite tendencies are present, too. For example, the case of Bulgaria where as result of high fiscal deficit and banking system crises, fall in remarkably difficult economic situation.

Experience from the undertaken reform processes in transition countries in past five years put on lay out certain fundamental conclusions: 1/ reducing the inflation rate is necessary condition for stopping the output growth to decrease. Thereby, price stability was crucial to be achieved in the first phase of the transition process; 2/ permanent economic growth can not be achieved if essential structural reforms in all segments of the economic life are not undertaken and 3/ enterprises restructuring and efforts for increasing the productivity could result in unemployment enlargement. The only way out of such situation is endurance of "hard budget constraints" policy for enterprise and flexible wage policy through organized system for labor re - qualification and qualitative social safety net.

The worldwide trade in 1996 performed some what lower growth dynamics compared to previous years. Thus, total goods and services trade has increased by 6.7%, which is for 2.2 percentage points less in terms of previous two years average. At the same time, goods and services export in industrial countries realized an increase of 4.6% which is 1.7 times lower growth rate compared to 1995, while import growth rate amounted 4.2%, or 2 times less in terms of previous year. Likewise industrial countries performance, developing countries developments had similar characteristics - export has increased by 10.0% (12.2% in 1995), while import growth in 1996 amounted 10.7% (11.2% in 1995).

In 1996, compared with the previous year, performance of the balance of payments current account indicate a deterioration of the position. Developed industrial countries in 1996 performed total surplus of USD 2.5 billion in trade with goods and services with abroad, which is by 5.6 times lower compared with 1995. In the same period, developing countries balance of payments positions, as well as ones in transition countries have significantly deteriorated. Thus, balance of payments current account deficit in developing countries in 1996 achieved USD 112.2 billion, which is USD 22 billion more in terms of 1995. In the same period, countries in transition performed total deficit in goods and services trade with abroad of USD 14.4 billion, which was 7.5 higher in terms of 1995.

## **II. Economic movements in the Republic of Macedonia in 1996**

In 1996, macedonian economy finally came out from the several year recession. Achieved real social product growth rate of 1.6% is in line with the average growth rate in Central and Eastern Europe transition countries, and it is an indicator of significant turnover in the economic cycle of the macedonian economy. Revival of the production means that finally the biggest "disinflation costi is paid out, i.e. that structural reforms are on the right track and their first positive signs are already shown.

It is significant that positive output results in the Republic of Macedonia are achieved in terms of low inflation rate, i.e. when it is brought down to the developed industrial countries level and significantly under the inflation level in the most progressive transition countries. Stable price level, on permanent basis, is determined by high stability of Denar exchange rate in terms of Deutsche Mark, as main nominal anchor in the economy. Besides that, other demand side factors such as wages and budget consumption, which could be potential generators of inflation were under control. On supply side, several factors had positive influence on the stability of the price level: a/ removal of the blockade on transfer of people, goods and services over the southern and northern border; b/ drop of the prices of the agriculture products, as result of unrealized export on the foreign markets; c/ labor productivity increase as result of more intensive realization of the enterprises restructuring process and lowering the costs of working.

Achieved price stability, on permanent basis, is an excellent foundation for faster economic growth in the following period, which in terms of not sufficient domestic savings of the private and social sector should be "supported" with increased government savings and more intensive inflow of foreign capital in form of direct investment.

As in 1995, fiscal sector in 1996 had one of key roles in maintaining high price and Denar exchange rate stability. Stabilization efforts of the fiscal sector are more significant if it is considered that realization of bank rehabilitation and enterprises restructuring (i.e. high costs of social protection of the households) needed engagement of significant amount of Budget resources. In such circumstances, control over Budget expenditures resulted in continuation of the stabilization trend from the previous years. Simultaneously, in 1996 continued the preparation for tax system modernization, focused at enlarging the tax base, improvement of tax collection rate and replacement of sales tax with value added tax.

Structural reforms in the real sector in 1996 were more intensive. Bank rehabilitation, especially rehabilitation of the largest bank in the Republic of Macedonia was in its final phase, which is expected to be accomplished with capitalization of the bank with foreign investors entrance. Due to the financial system stability realization, as well as avoidance of systemic risk within bank and saving houses, international supervision standards are entirely

implemented. In terms of strengthening the financial system stability and increasing the credibility of the financial institutions, in 1996 all groundwork activities for introducing the Deposit Insurance Fund were accomplished, and it should start with work in the first quarter of 1997. In the same time, in order to build more modern and efficient payment system, in 1996 the multiphase reform process of the Payment System has started.

The privatization process of socially owned enterprises in 1996 was accomplished in accordance with its projected dynamics. At the end of 1996, 918 from projected 1,217 enterprises were entirely privatized, where remaining enterprises will be privatized until the end of 1997. In order to accelerate and promote the enterprises restructuring process, future measures for its enlargement on the agriculture enterprises will be undertaken, as well as measures for strengthening the corporate governance. The largest 23 loss making enterprises, which were subject of special restructuring program are already divided on 123 business entities, and further measures in 1997 forecast to continue with their definite privatization, or liquidation.

Low level of domestic savings in terms of increased investment activity determined creation of significant current account deficit in the balance of payment, which had to be financed with foreign capital inflow. So, overall current account deficit in the balance of payment in 1996 amounted to USD 284 million<sup>1</sup>, which is 6.4% of country's GDP. Having in mind the potential of the export sector, such deficit in the balance of payments current account in long term is unsustainable, meaning that necessary measures should be undertaken for its gradual reduction.

During 1996, Republic of Macedonia continued with its efforts for normalization and strengthening its relations with international financial institutions. In that direction, agreement for reprogramming the obligations towards EUROFIMA has been reached, as well as agreement for debt reprogramming to the "London Club of creditors", under very favorable terms for the Republic of Macedonia.<sup>2</sup> Simultaneously, in 1996 bilateral negotiations on basis of concluded agreements for the reprogramming of the obligations towards "Paris Club of creditors", whereas agreements with eight countries are signed.

In the last quarter of 1996 terms and program for approving 3 year ESAF arrangement with International Monetary Fund was negotiated, for supporting country's efforts for realization of the structural reforms and completion of final phase of transition to the modern market economy. Besides signed bilateral arrangements for free trade agreements with SR Yugoslavia and Slovenia in 1996, efforts are made for negotiating same arrangements in the following period with other countries from nearer and wider region (Bulgaria, Albania, Croatia, Turkey, Greece, etc.). Concerning the foreign trade regime, efforts are

<sup>1</sup> According to the National Bank of the Republic of Macedonia data, which are different from the Republican Bureau of Statistics

<sup>2</sup> During the negotiations with the "London Club of Creditors" it is agreed Republic of Macedonia to undertake 5.4% for principal of the total debt, and 3.65% for due unpaid interest and for capitalized interest (Official Gazete of RM No. 14/97).

undertaken for realization of necessary measures for accepting the obligations from Article VIII from International Monetary Fund agreement.

Beside constant improvement of economic performance, macedonian economy still faces a number of challenges and difficulties. Opposite to the achieved price stability and output growth, the enterprises liquidity is not improved and financial results have been worsen. Thus, enterprises current losses in 1996 amounted to 17,163 million Denars, which is 50% increase in terms of 1995. The privatization process was not accompanied with adequate changes in the method and organization of the management, meaning that enterprises reorganization (ownership structure changes, change of the organization of the work, more modern and aggressive marketing penetration to the foreign markets, etc.) have not reached the desired dynamics. On the other hand, the extreme low domestic savings level is not sufficient for more intensive reanimation of the business cycle, i.e. for modernization and technological changes in the enterprises, without which export promotion and penetration to the foreign markets is not possible. Capital market is still in first phase of its development, which does not include the necessary dynamics and scope of work to ensure bigger transfer of savings which will drag the economy in developing phase.

Among open problems needed to be solved in the following period, which also determine the success of the transition process to market economy are following: a/ conclusion of the financial markets by introducing money market, which will provide more optimal distribution of free liquid assets; b/ completion of banking system rehabilitation, with purpose to be efficiently and up to date organized system where wide range of financial instruments and services will be provided in order to stimulate saving and to strengthen the financial institutions credibility; c/ reducing the public consumption level, which besides significant consolidation efforts in the fiscal sector is still on higher level than acceptable, having in mind the financial potential of the macedonian economy; and d/ privatization and modernization of the agriculture sector, as well as the development of small and medium manufacturing enterprises which could increase total output and absorb part of unemployed labor force.

## **2.1. Gross Domestic Product**

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1996 was first year when economic activity in Republic of Macedonia was measured by the gross domestic product concept.<sup>3</sup> Namely, till 1995, economic performance in the country was measured through gross social product, which was based on material production, i.e. does not take into consideration non productive activities. The calculation and following of the gross domestic product gives more realistic picture for macroeconomic movements in the

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<sup>3</sup> Simultaneously, calculation of the gross domestic product of the Republic of Macedonia is accomplished and for the previous years, in order to have more adequate time series.

country as well as more international comparability of the level and dynamic of the country's economic activity.

Gross domestic product of the Republic of Macedonia in 1996 amounted to 178,289 million Denars.<sup>4</sup> This means that in 1996 for the first time after several years of recession, real gross domestic product increased by 1.6%. After all, due to the tremendous decrease of the real gross domestic product in the period 1990 - 1995, and besides positive growth rate in 1996, growth rate in 1996 in terms of 1990 level was lower by 22.0%.

Table 2

## Gross domestic Product

(in million Denars)

	1990	1991	1992	1993	1994	1995*	1996**
Current prices	490	935	12,005	58,145	149,637	170,917	178,289
Constant 1990 prices	490	454	418	392	382	376	382
Indices:							
Current prices	-	190.8	1.284	484.3	257.4	114.2	104.3
Constant 1990 prices	-	92.7	92.1	93.8	97.4	98.4	101.6

Source: Republic of Macedonia Bureau of Statistics

\*/ Previous data

\*\*/ Estimates

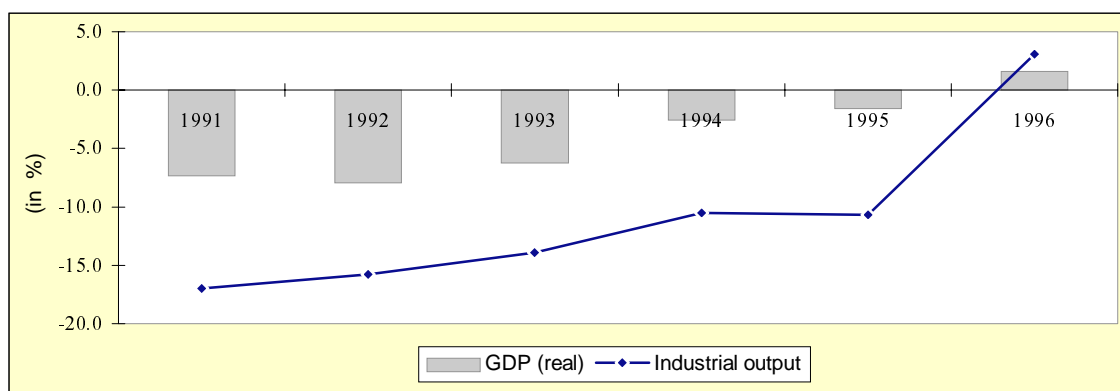
Revitalization of the economic activity in 1996 was due to the favorable supply side factors, expressed in elimination of strong external shocks which act as constrain for the output growth in the previous year, i.e. normalization of goods and services transfer after the removal of blockade on the northern and southern border. Besides that, positive influence on the economic structure have following factors: a/ labor productivity increase by 6.4% as result of more intensive realization of the privatization process as well as restructuring of the enterprises; b/ real increase of investment of 8.9%, which is significant not only for the current economic performance, but for the long term economic growth as well.

From structural point of view, gross domestic product growth in 1996 was result of industrial output increase by 3.2%. In addition, positive movements were also realized in all other economic sectors excluding agriculture output, which due to the unfavorable weather conditions and cattle disease in 1996 was lower by 3.2%.

<sup>4</sup> Estimations of the Republic of Macedonia Bureau of Statistics

Chart 1

## Gross domestic product and industrial production



## 2.2. Domestic output

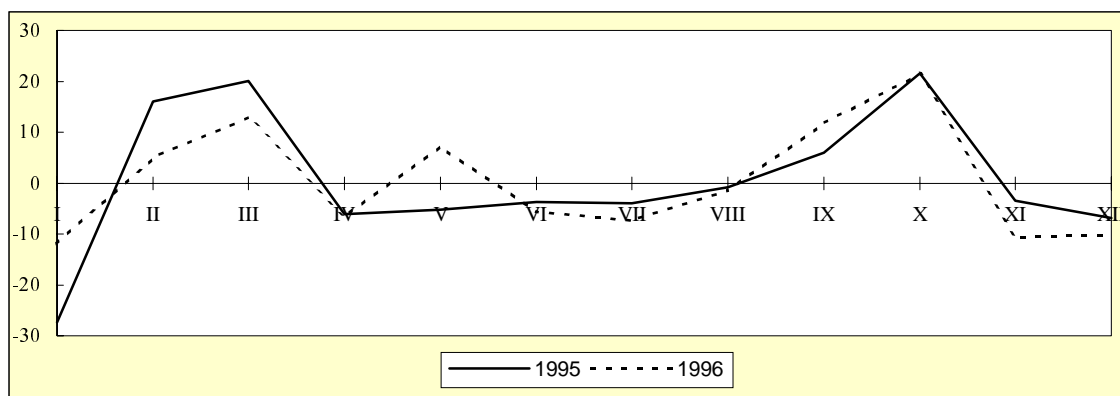
Industrial output in the period January - December 1996 in terms of the same period 1995, realized growth of 3.2%. By structure, it is positive that the biggest increase by 6.1% occurred in the production of means of production, and in the production of reproduction material of 4.6%. On the other hand, production of consumer goods has decreased by 1.5%.

By industrial branches, in eleven of total thirty two branches, which share in overall industrial output is 33.4%, in period January - December 1996 production increase was mostly realized in: production of oil derivatives (due to restarting of the oil refinery for processing, which performance in the previous year was restricted because of the blockades), black metallurgy (40.3%), beverage industry (32.1%) and production of electricity (8.1%). Simultaneously, the biggest decline of the industrial output in 1996 was noticed in the production of tobacco of 19.8%, production of finished textile products for 12.6%, chemical products processing of 9.9% and machine production of 6.3%.

Chart 2

## Industrial output

(in %, by months)



Agriculture output in 1996 decreased by 3.2%, opposite from the previous two years when agriculture output has increasing tendency. The epidemic illness of the cattle, as well as occasional wet periods in the Republic of Macedonia during 1996 were main reasons for agriculture output decrease. In addition, negative effects to the volume of the agriculture output were also caused by not suitably organized output purchase, as well as insufficient openness of the European market, especially the European Union market.

### 2.3. Labor market

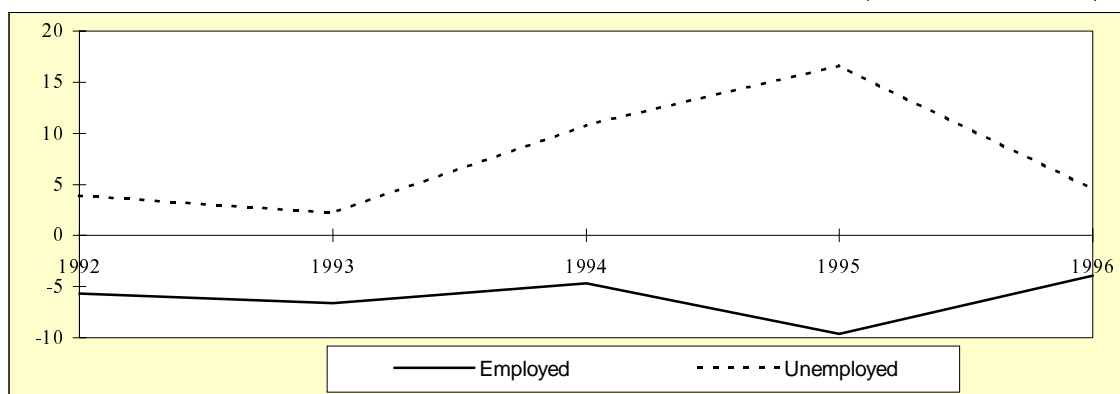
Privatization and enterprises restructuring realization, among other things, means more efficient labor engagement. Having in mind the accumulated over employment from the previous period, this process in the Republic of Macedonia in past years resulted in permanent decline of employed persons. The revival of the economic activity in 1996 did not result with increase of the employment in the Republic of Macedonia, meaning that output increase is realized through labor productivity increase, and not by opening new working places. However, the decline rate of employed persons in 1996 is three times lower than the same indicator in 1995.

At the end of 1996, the employed persons in Republic of Macedonia amounted to 336,176, which is 4.5% less than in December 1995. From structural point of view, the number of employed persons has declined more in the economic activity sector and it amounted to 6.1%, while in non - economic activity sector it increased for 0.6%.

Chart 3

#### Employed/unemployed in the Republic of Macedonia

(annual rates, in %)



At the end of December 1996, number of persons seeking job amounted to 245,095, which is 16, 143 persons, or 7.1% more than in December previous year. This contributed Republic of Macedonia to be at the top among transition countries in terms of the unemployment rate, which calculated as ratio between unemployed and economic active households amounted to 26.8%.

Employment decline of 4.5%, in terms of increased economic activity by 1.6% means labor productivity increase of 6.4%. Having in mind real wage growth of 0.4%, it means that real unit labor cost in 1996 declined by 6.0%. The growing trend of gross domestic product and industrial output, as well as labor productivity increase in 1996, is a signal that process of economic activity intensification has been started and it will determine decline of the unemployment rate in the country.

## **2.4. Domestic Consumption**

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### **2.4.1. Public consumption**

In 1996, total collected revenues for financing of the public needs amounted to 65,205 million Denars, which, compared to the revenues collected in the same period in 1995 is increase of 1,928 million Denars, or of 3.0%. In real terms, revenues for financing of the public needs in 1996 remain at the last year level.

In addition, among total public revenues, higher increasing intensity was notable in revenues of the social funds (taxes on wages, taxes on profit) which nominal increase was 5.0%, or 1.8%. Budget revenues (taxes, customs duties, and other revenues) were nominally higher for 2.0%, meaning their real decline of 1.0%.

Among budget revenues, which share in total public revenues in 1996 was 62.4%, the most notable were excise revenues (29%), personal income tax revenues (22%), sales tax revenues (22%) and customs duties (16%), where the structural share maintained same as in 1995. The largest share among social funds revenues have taxes on wages (71.0%). Not regular wage payment to the employees during 1996 determined decline of social funds revenues on this basis. Thus, from taxes on wages in total were collected 17,400 million Denars, which is by 1,622 million Denars, or by 8.5% less than the previous year. At the same time, notable increase was achieved in revenues from other taxes, which in 1996 amounted to 6,682 million Denars, which is by 71.2% more higher in terms of 1995.

### **2.4.2. Investment**

Trend of investment activity increase started in 1995 continued during 1996, although with lower intensity than in the previous year. Thus, in the period January - December 1996, investments amounted to 27,503 million Denars, which is by 11.3% more in terms of the previous year. In real terms, investment is higher for 8.9%. Enhanced investment activity in the Republic of Macedonia resulted in increased investment participation in gross domestic product from 14.5% in 1995 to 15.4% in 1996. Nevertheless, the investment rate in the

Republic of Macedonia is still low which is not sufficient for generating more dynamic economic growth rate. The reason for such situation is notably low level of domestic savings, which determined negative difference between investment and saving, i.e. in 1996 has created high trade and current account balance deficit in the country.

Table 3

## Investments in the Republic of Macedonia

	In million Denars			Indices		
	1994	1995	1996	1994/93	1995/94	1996/95
Total:	19,636	24,704	27,503	180.5	125.8	111.3
Social sector	10,683	13,08	14,126	235.0	122.4	108.0
Private sector	8,954	11,624	13,377	141.4	129.8	115.1
Economic activities	12,476	16,361	18,637	224.3	131.1	113.9
Non-economic activities	7,161	8,343	8,866	134.7	116.5	106.3

Source: Republic of Macedonia Bureau of Statistics

By sectors, more dynamic investment growth was realized in the private sector, which indicates the more evolving role of this sector in country's economic activity. Thus, private sector investment in 1996 increased by 12.6%, in real terms, while social sector investment realized real increase of 5.7%. From structural aspect, during 1996 surpassing investments were achieved in the economy, and this variable performed real increase of 11.4%. That determined participation of the economic activity sector investment in gross domestic product to reach 10.4%, which is 0.8 percentage points more than in 1995. The non - economic activities investments increased by 4.0% and their share in gross domestic product remain at the same level from the previous year.

## 2.5. Wage policy

In 1996 as in the previous years, control over personal consumption as aggregate consumption component was realized through the operation of the Law for Wage and Pension Control introduced at the end of 1993. Change in the ownership structure of the economy in favor of the private sector resulted in decline of the economic agents who were obliged to comply to this Law, i.e. the scope of its effective application was reduced.

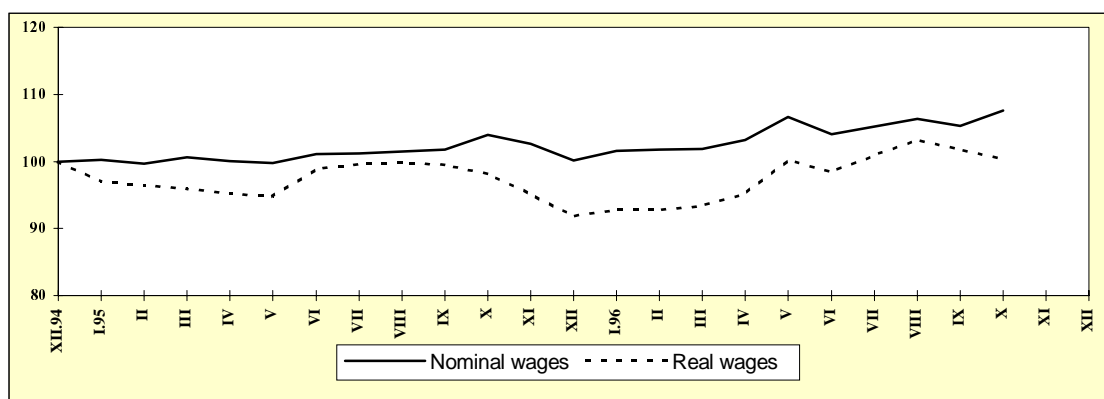
In the period January - December 1996, the average net paid wage per worker amounted to 8,817 Denars, which in terms of same period last year is nominal increase of 2.8%. In real terms, average wage in 1996 compared with 1995 increased by 0.4%.

By sectors, tendency for lowering the differences between economic activity and non - economic activity sector wages has continued. Thus, average

net paid wage per worker in economic activity sector in 1996 compared with 1995 was in real terms higher by 0.9%. On contrary, paid average wage in non - economic activity sector in 1996 in terms of the previous year average is lower by 1.5%, in real terms.

Chart 4

## Average paid net wage per worker



If average wage in December 1996 is compared with average paid wage in December previous year, net wage paid in December 1996 was higher by 5.9%, or in real terms 6.6%. At the same time, the average net wage in the economic activity sector in December 1996 compared with December 1995 was in real terms higher for 8.3%, while in the non - economic activity sector the increase was more moderate and amounted to 1.5%.

## 2.6. Prices

During 1996, in the Republic of Macedonia high price stability level was achieved. Price stability, on permanent basis, mutually with strengthened structural reforms efforts should create a sound basis for investment and saving increase, which will enable sustainable long term growth of the economy.

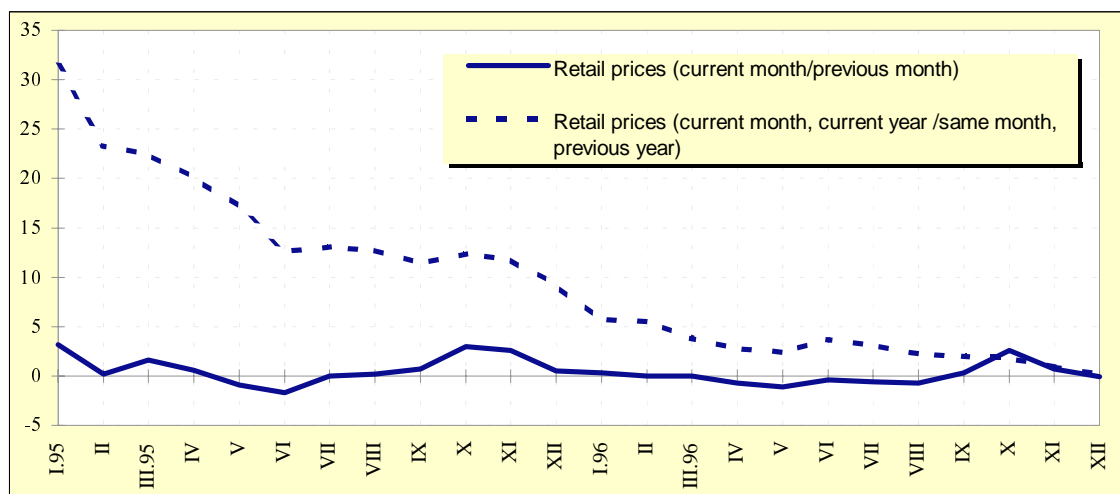
The inflation rate measured by the retail price increase on December basis (December 1996/December 1995) amounted to 0.2%. On average, retail prices in 1996 were higher than in 1995 for 3.0%. The inflation rate, on permanent basis, excluding the seasonal factors effect, in 1996 was brought down to 1.1%.

Observed by months, during six months of 1996 deflation occurred, while in other months excluding October when the inflation rate reached 2.6%, low and stable inflation rates were realized. Deflation trends in the price movements were characteristic especially for the first half of 1996, when cumulative deflation rate amounted to 1.9%. On contrary, in the second half realized inflation rate amounted to 2.1%. This increase was due to seasonal factor effects - price increase of the agriculture products and correction of the electric energy price due to winter tariff implementation.

Chart 5

## Retail price movements

(in %, by months)



From structural point of view, in the period January - December 1996, in terms of the same period previous year, the biggest increase has realized prices of the services of 6.8%. Simultaneously, moderate increase of 1.9% was achieved by industrial products prices, where prices of producers of industrial products in the same period declined by 0.3%. Besides that, although during 1996 due to wet periods and cattle disease, the agriculture products supply was lower than in the previous year, prices of the agriculture products in 1996 decreased by 8.2%. This is due to, first of all, not properly organized purchase and slow penetration of the agriculture products on new markets.

Cost of living in December 1996 compared with December previous year were lower for 0.7%. The cost of living dynamics has entirely followed the retail prices movements. Compared with the average costs of living in 1995, the consumption basket in 1996 is dearer by 2.3%.

### III. Monetary policy

#### 3.1. Aims and objectives of the monetary policy

Strengthening the achieved price stability in 1995, which will be in function of long term economic growth realization was the basic objective of the monetary policy in 1996. In realization of this objective, monetary policy acted jointly with fiscal and wage policy efforts.

On contrary from the period April 1992 - September 1995, when strategy for monetary targeting was implemented, starting from the last quarter of 1995 and beginning of 1996 strategy of Denar exchange rate targeting was implemented. Choosing the Denar exchange rate as main intermediate target of the monetary policy meant change of the combination between money supply and exchange rate in terms of the previous years. Namely, diversely from the strategy of monetary targeting where the control over money supply was directly focused towards achieving price stability, while the exchange rate was an indicator of monetary policy optimality, in the strategy of exchange rate targeting the money supply increase is transformed in instrument through which the exchange rate stability is directly achieved, and consequently price stability. In such circumstances, money supply becomes an endogenous variable whose movement is determined by the necessity of maintaining stable Denar exchange rate. Thus, the projected increase of the monetary aggregates is the highest possible monetary supply increase with aim to restrain Denar exchange rate stability as primary objective. As long as the relation between foreign exchange supply and demand on the foreign exchange market creates pressure on the external Denar value stability, adjustment of the monetary aggregates increase was outlined with purpose to maintain exchange rate stability.

Monetary strategy change and introduction of the exchange rate as main nominal anchor in the economy come out from several reasons: a/ the importance of the exchange rate in small and open economy, which exchange with abroad over 75% of its GDP. In such circumstances, the exchange rate is main economic variable which pose hard budget constraints for formation of other prices in the economy (wages, interest rates and domestic products prices); b/ insufficient money demand stability in terms of undertaken crucial economic reforms and high degree of currency substitution. Namely, currency substitution coefficient measured as share of foreign currency deposits in money supply M1 in 1996 reached 0.30, which is on level of the average in other transition countries. High degree of currency substitution is also visible by second, indirect indicator - coefficient of economy monetization, which at the end of 1996 was brought down to 0.07 (M1/GDP). That is by 3.5 times lower coefficient of monetization than in the developed countries and in the most progressive transition countries; and c/ the advantage of exchange rate being an indicator due to the biggest transparency and ability for its monitoring on daily basis by the economic agents.

The monetary aggregates projection for 1996 was based on the projected increase of the social product by 2.0% and inflation rate by 6%. As result of strengthened price stability and increased economic and monetary policy credibility, in 1996 real money demand was expected to increase by 4.5%. According to that, nominal money supply in 1996 was projected to grow utmost by 12.5%. On basis of balance of payment projection, the excess foreign exchange supply over demand at the foreign exchange market was expected to be USD 63 million. This excess was projected to be purchased through sterilized Central bank interventions at the foreign exchange market.

As in the previous year, with 1996 monetary policy projection, monetary limits for foreign exchange market intervention were projected to increase through budget fund deposited in the special fund within National bank of the Republic of Macedonia. Simultaneously, implementation of direct instrument - limitation of Denar credits increase to banks and saving houses continue in order to avoid the possibility of losing control over money supply during the process of transition from direct to indirect monetary regulation instruments. The National bank of the Republic of Macedonia discount rate was oriented towards following the inflation trend rate, inflationary expectations and interest rates formed at the interbank money market. In the limits of accepted monetary strategy, interest rates were instrument for regulating the money supply and demand in the economy.

Table 4

Projection of basic real and monetary variables for 1996

(in %)

	First projection	revised projection in February	revised projection in June
1. Inflation	6.0	5.0	2.0
2. Gross Domestic Product	2.0	3.0	3.0
3. Reserve Money	12.8	15.8	13.5
4. Denar Credits	7.6	11.8	13.4
5. Money Supply M1	12.5	13.3	8.3
6. Net foreign assets of the monetary system (changes in million USD)	63.0	40.0	20.0

Achieved higher than expected price stability in the first half of 1996 was determined, first of all, by reasons of non monetary character: a/ low prices of import products; and b/ high seasonal drop of prices of the agriculture products due to unsuccessful placement at the foreign markets (cattle disease, problems with transit through certain countries and etc.). At the same time, planned excess of foreign exchange supply over demand at the foreign exchange market was not realized, which with strategy focused towards Denar exchange rate stability determined slowing down of the monetary growth in terms of projected one. From that reasons, in mid 1996, projection of main monetary variables was revised, and money supply growth was projected to utmost 8.3% in 1996. Accordingly were corrected projections of money supply creation and withdrawal, as well as other main real and monetary variables.

### 3.2. Financial movements in 1996

Basic monetary policy targets - bringing down and control over inflation on permanent basis and maintaining stable nominal Denar exchange rate in terms of the Deutsche mark, in 1996 were accomplished over expectations. In 1996, inflation rate in the Republic of Macedonia on December basis is brought down to 0.2%, which is by 1.8 percentage points lower than projected price increase in revised projection. On that way, according to the achieved price stability in 1996, Republic of Macedonia is equalized with the most developed low - inflation countries, and it is at the top among countries in transition from Central and Eastern Europe.

Denar exchange rate in 1996 maintained its high stability from the previous two years. In the period December 1995 - December 1996, local currency - Denar lose from its nominal value in terms of Deutsche mark only 0.5%. Having in mind that inflation in 1996 in Republic of Macedonia has converge with the retail price growth rate in Germany, and that labor productivity in this period has increased, nominal stability of the Denar exchange rate in 1996 did not cause drop of competitive ability of the macedonian economy towards abroad. However, if the horizon of observation is wider, nominal stability of Denar exchange in last three years determined its real appreciation, which could be stated through following the real effective Denar exchange rate dynamics.

Chart 6

Nominal Denar exchange rate in terms of DEM and USD

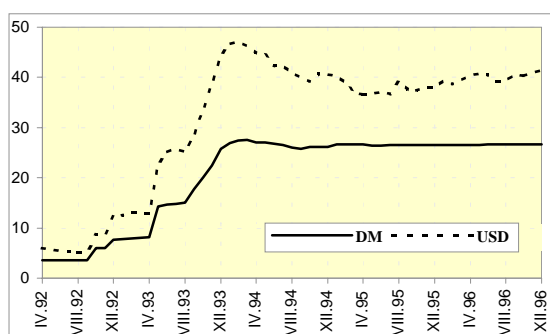
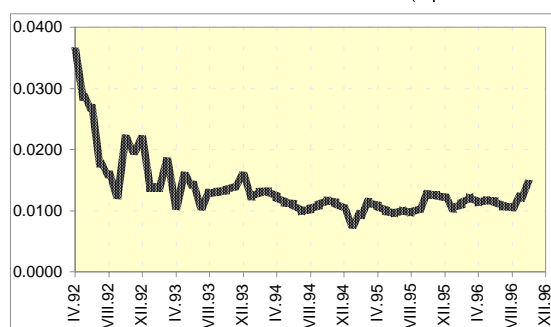


Chart 7

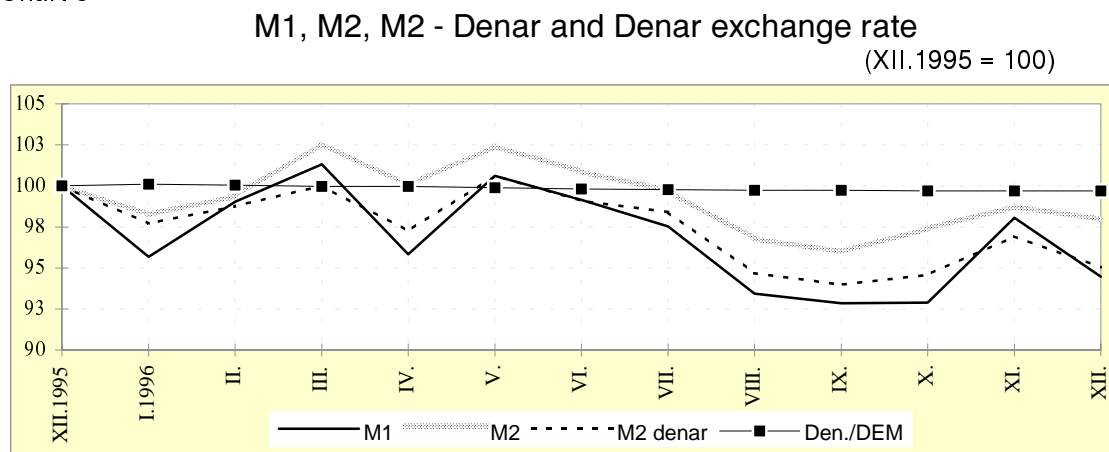
Real effective Denar exchange rate movements  
-DEM/unit labor costs - (April 1992=100)



According to the adopted strategy for exchange rate targeting, nominal Denar exchange rate in terms of Deutsche mark was main nominal anchor in the economy through out price stability was maintained. Monetary policy measures were focused towards maintaining exchange rate, i.e. inflation rate was indirectly controlled. In accordance with that, stable exchange rate was primary monetary policy target, which determine money supply growth dynamics and interest rate level. Competitiveness towards abroad in such circumstances mainly was sustained through enterprises restructuring and labor productivity increase. Such monetary strategy enable stable nominal Denar exchange rate in terms of Deutsche mark, but in the same time it determine high monetary contraction expressed through low, i.e. negative monetary aggregates growth.

Thus, money supply M1 in December 1996 was lower in terms of December level 1995 by 2.8%. Negative monetary supply growth rate is slightly moderate if data is corrected for the change in the methodology, i.e. if beginning and end of period data are presented by the old methodology.<sup>5</sup> In that case, money supply M1 in 1996 realized negative growth rate of 1.7%. Besides chosen monetary policy stance, money supply contraction in 1996 was also determined by the autonomous real money demand drop by 3.4%.

Chart 8



Broader monetary aggregate, money supply M2 on annual level has realized minimal growth rate of 0.4% (according to old methodology), i.e. decrease of 0.3% (if data at the end of December 1996 are presented according to the new methodology). At the end of 1996 broader money supply M2 was lower than the projected one by 748 million Denars, or by 3.8%. Alike narrower money supply definition, lower growth rate of this monetary aggregate is due to foreign exchange market developments, as well as decrease of real money demand M2 by 7.8%.

Similar developments occurred at the monetary aggregate - Denar M2, which in period January - December 1996 realized increase of 70 million Denars, or by 0.4%. If the end of year 1996 position is presented according to the old methodology, the Denar M2 money supply increase amounted to 97 million Denars, or 0.6%. Independently of the implemented methodology, realized movements significantly vary from the monetary projection, according to which in 1996 Denar M2 money supply was projected to increase by 9.1%. Real money demand for Denar M2 in 1996 performed minimal increase of 0.2%.

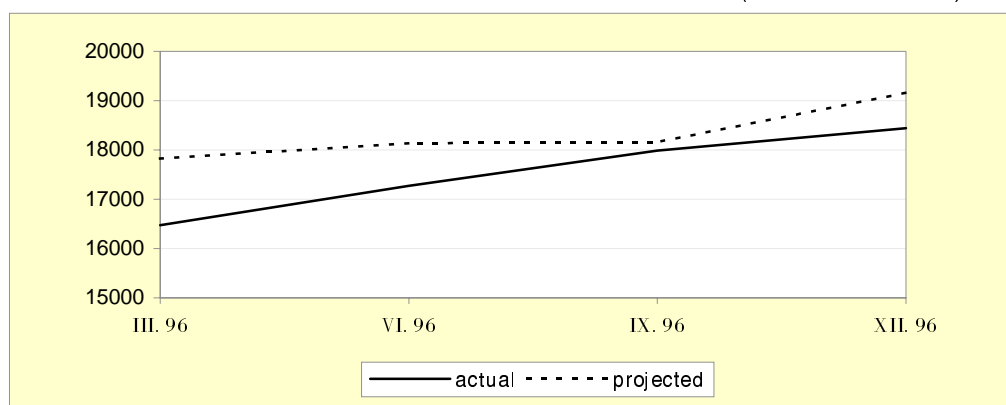
Similar to the other monetary aggregates, bank Denar credits in 1996 realized lower increase than projected one. Increase of bank Denar credits extended to the private and social sector in period January - December 1996 amounted to 1,250 million Denars, or 7.4%. If the end of period 1996 positions are presented according to the old methodology (i.e. Fund credits are also

<sup>5</sup> According to the new methodology which is applied starting from December 1996, deposits and credits of the Funds, Agencies and Institutions of the Central Government are not included in the monetary aggregates definition, i.e. are comprised in the Central Government sector. Before that, deposits and credits of these institutions are included in the monetary aggregates definition, i.e. in the non Government sector.

included), increase of bank Denar credits in 1996 amounted to 1,650 million Denars, or 9.8%. That is for 596 million Denars, or 3.2% lower growth than the allowed limits with the monetary policy projection. In that way, at the end of 1996, bank Denar credits were lower from the projected position for 719 million Denars, or by 3.3%. In spite of this, together with reserve money, bank Denar credits were the only aggregate which in 1996 has realized increase close to the projected one.

Chart 9

Projected and actual level of domestic bank Denar credits  
(in million Denars)

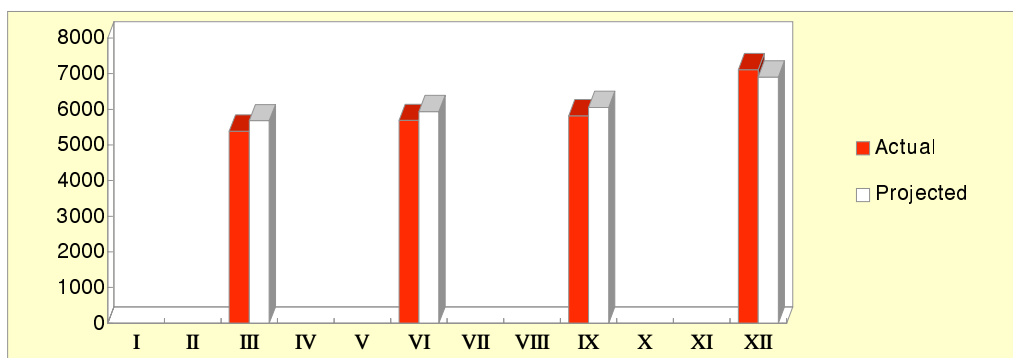


Main reasons for not utilizing the allowed limits for bank Denar credits increase in 1996 are: a/ maintaining high nominal and real interest rates, due to the high risk premium and high operative costs of the banks. So, interest rates were several times higher than the marginal profitability rate of the investment projects, and therefore were not stimulate for the potential investors; b/ high criteria and cautious bank behavior when decisions for credit lending are made, which is in accordance with supervision standards for their working; c/ not sufficient number of qualitative investment projects; d/ not appropriate dispersion of liquid assets, where bank with which dispose with free assets have not room for credit increase, and opposite, bank with shortage of liquid assets have not utilized credit increase. In that way, negative secondary effects and rigidity of the monetary regulation instrument bank Denar credits limitation were proved, when it is applied longer term.

Reserve money are the solely monetary aggregate which in 1996 achieved growth rate in accordance with the projected increase, although in the first half of the year this monetary aggregate was in the range of negative values. In period January - December 1996, reserve money realized increase of 844 million Denars, or by 13.5%, which is within projected growth limits with the revised monetary projection policy.

Chart 10

Projected and actual level of reserve money in 1996  
(in million Denars)



Compared with the projected level at the end of 1996, reserve money on 31.12.1996 were higher by 3.0% due to enhanced seasonal demand for currency outside banks in terms of expected ones as result of joining the Christmas and New Year holidays. However, potential effects of injecting reserve money in the banking system have not resulted through credit multiplication in higher money and credit supply, which is due several factors: a/ unstable foreign exchange market developments, which determine money supply withdrawal; b/ high interest rates of bank credits; c/ significant decrease of money multiplier (from 2.19 in 1995 to 2.04 in 1996), as result of currency outside banks increase, on one hand, and demand deposits decrease, on the other hand.

## **IV. Monetary movements**

### **4.1. Money supply creation and withdrawal**

The narrowest definition of money supply M1, in the period of January-December 1996, has decreased by 355 million Denars, that is, it had a negative growth rate of 2.8%. If the end of the year positions are presented according to the old methodology, where the Government Funds, Agencies and Institutions are included in the money supply, the decline is 214 million Denars, or 1.7%. On the contrary, with the monetary policy projections it was foreseen that the growth of the narrowest definition of money supply will be 1,037 million Denars, or 8.3%. At the end of 1996, compared to the projected position, money supply M1 was lower by 1,244 million Denars, or by 9.3% (according to the new methodology), that is, by 1,068 million Denars, or by 8.0% (according to the old methodology).

Dynamics of movements in the money supply narrowest definition M1, considering individual quarters of 1996, were occurring according to the standard form determined by the influence of the seasonal factors, except in the last quarter. Thus, in the first quarter of the year there was a decline in the narrowest definition of money supply, which is common seasonal occurrence and it is due to stabilization of the demand for transaction deposits following the excessive growth during the New Year and Christmas Holidays. In the second and third quarters, money supply had a tendency of moderate growth, whereas in the last quarter of the year (when traditional seasonal factor induces significant growth of money supply and demand for transaction purposes), there was an unexpected decline in the money supply. Namely, because of the worsened liquidity of economic entities and negative financial results, in the last quarter of 1996 there was a withdrawal of high amount of funds from their giro-accounts, which resulted in strong contraction of money supply M1.

Table 5

## Money supply (M1) creation and withdrawal

	Position 31.12.95	Quarterly changes (in million Denar)					Position 31.12.96	Factors of growth in %			
		I	II	III	IV	Total		03.96 12.95	06.96 12.95	09.96 12.95	12.96 12.95
<b>M1 (excluding Government sector)</b>	12,533	-1,212	247	787	-177	-355	12,178	-9.6	-7.7	-1.4	-2.8
Net foreign assets /2	15,039	-2,340	-373	-1,291	271	-3,733	11,306	-18.7	-21.6	-31.9	-29.8
Net domestic assets	8,319	998	650	2,276	-503	3,421	11,740	8.0	13.1	31.3	27.3
Domestic credits	45,044	864	3,342	2,387	89	6,682	51,726	6.9	33.6	52.6	53.3
of which: Credits to private and social sector	19,117	-178	3,621	1,128	973	5,544	24,661	-1.4	27.5	36.5	44.2
- in Denar	16,792	-317	3,601	716	456	4,456	21,248	-2.5	26.2	31.9	35.6
- in foreign exchange /2	2,325	139	20	412	517	1,088	3,413	1.1	1.3	4.6	8.7
NBRM credits to Government, net	-563	42	70	343	-1,520	-1,065	-1,628	0.3	0.9	3.6	-8.5
Other items, net	-36,725	134	-2,692	-111	-592	-3,261	-39,986	1.1	-20.4	-21.3	-26.0
Non-monetary deposits, net	10,825	-131	31	198	-54	44	10,869	-1.0	-0.8	0.8	0.4
of which: Government	704	0	0	0	0	0	704	0	0	0	0

1/ (+) reserve money creation

(-) reserve money withdrawal

2/ Positions valued at constant exchange rate (end-December 1995 1 USD = 37.9796); flows valued at current exchange rate.

3/ Positive change means reserve money withdrawal,

Negative change means reserve money creation.

## 4.1.1. Domestic credits

The basic flow of money supply M1 creation in 1996 were banks' domestic credits to the private and social sector as a component of the net domestic assets. Banks' balance sheet data on this flow of reserve money creation contains effective changes that come from accounting records. Namely, according to the program for reconstructing of enterprises - the biggest lost-making enterprises, during 1996, the banks' claims for principle and interest from these enterprises were transformed into permanent share. Having in mind that the amount of interest (2,806 million Denars) methodologically was not part of the beginning balance of Denar credits nor of the projected amount, it is necessary to eliminate it from the realized movements in order to get a real picture of Denar credits movements and their effects related to the creation of money supply.

Thus, based on balance sheet data, total banks' credits to the private and social sector (in Denars and in foreign currency) in 1996 have increased by 5,544 million Denars. Denar credits to the private and social sector grow by 4,456 million Denars, or by 26.5%, whereas credits to the private and social sector in foreign currency have increased by 1,088 million Denars, that is, by 46.8%. In this way total credits have caused creation of money supply of 44.2%, of which 35.6% Denar credits, and 8.7% foreign credits.

However, the effective growth of banks' Denar credits that actually influenced the creation of money supply was lower then accounting one for the amount of transformed interest claims, from the lost-making enterprises, into permanent share, in amount of 2,806 million Denars. That means banks' Denar credits in the period January-December 1996 have increased by 1,650 million

Denars, or by 9.8%. In this way, the Denar credits' growth have effectively induced money supply creation by 13.2%, and the difference up to the accounting record of 35.6% is neutralized with correspondent withdrawal of money supply through other assets.

Table 6

## Net domestic credits of deposit money banks

(in million Denar)

	Positions					Quarterly changes				
	31.12.95	31.03.96	30.06.96	30.09.96	31.12.96	I	II	III	IV	Total
<b>Domestic credits, net</b>	44,903	45,725	48,997	51,040	52,650	822	3,272	2,043	1,610	7,747
1. In Denar	42,578	43,261	46,513	48,145	49,237	683	3,252	1,632	1,092	6,659
a) Credits to Government, net	4,254	4,266	5,833	5,840	5,202	12	1,567	7	-638	948
- credits	4,924	4,938	6,502	6,515	5,891	14	1,564	13	-624	967
- interest	34	32	35	29	15	-2	3	-6	-14	-19
- Government deposits	-704	-704	-704	-704	-704	0	0	0	0	0
b) Private and social sector credits	38,324	38,995	40,680	42,305	44,035	671	1,685	1,625	1,730	5,711
-credits	16,792	16,475	20,076	20,792	21,248	-317	3,601	716	456	4,456
-interest	21,532	22,520	20,604	21,513	22,787	988	-1,916	909	1,274	1,255
2. In foreign currency /*	2,325	2,464	2,484	2,896	3,413	139	20	412	517	1,088
- Government	0	0	0	0	0	0	0	0	0	0
- Private and social sector	2,325	2,464	2,484	2,896	3,413	139	20	412	517	1,088

\*/ Stocks valued at constant exchange rate (end-December 1995 1 USD = 37.9796); flows valued at current exchange rate.

Regarding dynamics, more intensive credit activity of banks was effectuated in the second half of 1996, when the monetary policy was somewhat relaxed. Still, the credit framework for 1996 was not used completely, which, in conditions when Macedonian economy is far from optimal capacity of utilization of natural resources, meant lower rates of investment and development compared to the potential one.

#### 4.1.2. Net foreign assets

Opposite to the realized movements in the previous two years, when the net foreign assets of the monetary system have acted toward creation of money supply, in 1996 this flow acted toward withdrawal of money supply M1. That is also opposite to the monetary policy projection, that was anticipating creation of money supply in 1996 to be accomplished through growth of net foreign assets. Thus, in the period of January-December 1996 the net foreign assets of the monetary system were diminished by 3,733 million Denars, which induced money supply withdrawal by 29.8%. Thereby, net foreign assets of deposit money banks was decreased by 3,038 million Denars, that determined withdrawal of the money supply by 24.2%, whereas the net foreign assets of the National Bank of the Republic of Macedonia were decreased by 694 million Denars, which induced the money supply withdrawal of 5.5%.

Observed dynamically, net foreign assets of the monetary system during 1996 had a tendency of permanent decline, that was especially intensive in the first and third quarter of the year. Decrement of the net foreign assets of the monetary system in 1996 represents a reflection of unfavorable movements in the trade balance and in the current account of the Balance of Payment of Republic of Macedonia. Namely, high deficit in the trade balance and current

account caused befitting erosion of foreign assets in the monetary system, as well as necessity of additional borrowing from abroad for its financing.

#### 4.1.3. Non-monetary deposits

Total non-Government non-monetary deposits (comprising foreign exchange and Denar sight deposits, time deposits up to and more than a year, and restricted deposits) in 1996 have performed minimal increase of 44 million Denars, or 0.4%. In this way, total non-monetary deposits' impact was toward insignificant withdrawal of money supply by 0.4%. In real terms, total non-monetary deposits in 1996 have decreased by 74 million Denars, or by 0.7%.

Observed dynamically, the movement of the total non-monetary deposits in 1996 is characterized by big oscillations, that most of all refers to the movement of short-term Denar and foreign currency deposits. Thus, in the first and last quarter of 1996, total non-monetary deposits have decreased (causing therefore creation of money supply), whereas in the second and third quarter their movement was opposite, causing withdrawal of money supply.

Table 7

#### Non-monetary deposits

(in million Denar)

	Positions					Quarterly changes				
	31.12.95	31.03.96	30.06.96	30.09.96	31.12.96	I	II	III	IV	Total
<b>Total non-monetary deposits</b>	<b>10,121</b>	<b>9,990</b>	<b>10,021</b>	<b>10,219</b>	<b>10,165</b>	<b>-131</b>	<b>31</b>	<b>198</b>	<b>-54</b>	<b>44</b>
in Denar	5,888	6,305	6,181	6,351	6,458	417	-124	170	107	570
in foreign exchange	4,233	3,685	3,840	3,868	3,707	-548	155	28	-161	-526
<b>I. Quasi deposits</b>	<b>6,252</b>	<b>6,295</b>	<b>6,297</b>	<b>6,290</b>	<b>6,159</b>	<b>43</b>	<b>2</b>	<b>-7</b>	<b>-131</b>	<b>-93</b>
in Denar	3,187	3,682	3,575	3,610	3,639	495	-107	35	29	452
in foreign exchange	3,065	2,613	2,722	2,680	2,520	-452	109	-42	-160	-545
<b>II. Other non-monetary deposits</b>	<b>3,869</b>	<b>3,695</b>	<b>3,724</b>	<b>3,929</b>	<b>4,006</b>	<b>-174</b>	<b>29</b>	<b>205</b>	<b>77</b>	<b>137</b>
in Denar	2,701	2,623	2,606	2,741	2,819	-78	-17	135	78	118
in foreign exchange	1,168	1,072	1,118	1,188	1,187	-96	46	70	-1	19

With respect to the non-monetary deposits currency denomination, Denar and foreign currency non-monetary deposits movement in 1996 had a divergent tendency. Namely, Denar deposit categories in 1996 have increased by 570 million Denars, or by 9.6%, whereby, there was increase of short-term Denar deposits (by 452 million Denars, or by 14.1%) as well as of time deposits over a year (by 118 million Denars, or by 4.4%). The increase of Denar non-monetary deposits in 1996, opposite to the decrease of foreign currency non-monetary deposits is due to the following: a) existence of high real return on Denar deposit categories, that is more than 3-4 times higher compared to the real interest on foreign currency deposits with same maturity; and b) increase in confidence of economic entities in domestic currency stability.

Contrary to this, foreign currency deposits in 1996 have decreased by 546 million Denars (12.3%), that corrected by Denar foreign exchange rate movements and intervalutary relations, means decline of 651 million Denars, that is by 15.3%. That is due to the big decrease in short-term foreign currency

deposits by 545 million Denars, or by 17.8%. Presented as real value, quasi foreign currency deposits in 1996 have decreased by 625 million Denars, or by 20.4%. The big decline in foreign currency deposits is a result of the high deficit in the Trade balance of the Republic of Macedonia. Namely, decreased foreign exchange inflow in times of high import dependability, that is in times of more moderate fall of import demand, have forced the enterprises to use their deposited foreign assets to pay their obligations abroad.

## V. Reserve money creation and withdrawal

### 5.1. Reserve money

Reserve money, according to the narrowest definition (currency in circulation plus giro-accounts and cash in vaults of the banks), in the period January-December 1996 increased by 844 million Denars, or by 13.5%. Monthly average growth rate of the reserve money in 1996 was 1.1%, which is identical growth dynamic as in 1995. However, because of the decrease of money multiplier, the primary issue did not result in appropriate growth of money supply in 1996.

Table 8

#### Reserve money, the narrowest definition

(in million Denar)

	Position 31.12.95	Quarterly changes					Position 31.12.96	Factors of growth in %			
		I	II	III	IV	Total		03.96 12.95	06.96 12.95	09.96 12.95	12.96 12.95
Reserve money (narrowest definition)	6,271	-885	302	131	1,296	844	7,115	-14.1	-9.3	-7.2	13.5
-currency in circulation	5,965	-783	263	55	1,198	733	6,698	-12.4	-8.3	-7.4	11.7
-giro-accounts and cash in vaults	306	-102	39	76	98	111	417	-1.6	-1.0	0.2	1.8

1/ (+) reserve money creation  
(-) reserve money withdrawal

Dynamics of the reserve money movements during 1996 was following the characteristic seasonal trend, that means significant decrease in the amount of reserve money in the first quarter and applicable effect in opposite direction (that is, increase of reserve money) in the last quarter of the year. These movements are determined by decrease/increase of the seasonal demand for currency in circulation before and after the New Year and Christmas Holidays. Specific for 1996 is that the intensity of the seasonal factors' impact in these time intervals was much more emphasized compared to 1995, which is due to continuation of the New Year and Christmas Holidays.

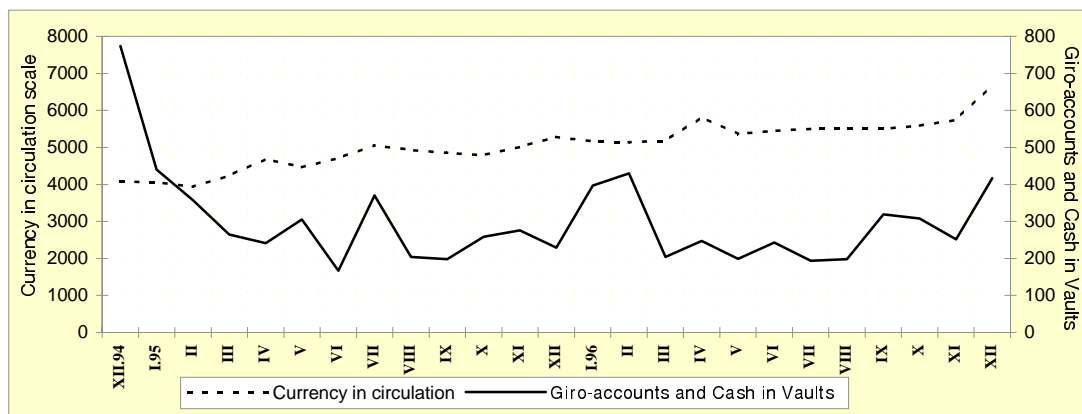
In the first six months of 1996 reserve money have decreased by 583 million Denars, or by 9.3% which is due to seasonal decline of demand for currency in circulation, as well as to the deficiency in the projected issue of reserve money based on foreign exchange transactions. In the second half of 1996, the conditions on the foreign exchange market have relatively stabilized, and the monetary policy was slightly relaxed. Together with the seasonal factor influence, that at the end of the year acts toward enlargement of demand for currency in circulation, it resulted in growth of reserve money in period January-December 1996 by 1,427 million Denars, or by 25.1%.

Components of the reserve money in 1996 had growth tendency. Currency in circulation in period January-December 1996 have increased by

733 million Denars, or by 12.3%. In the same time, banks' liquid assets increased by 111 million Denars, that is, by 36.3%. This big increase of currency in circulation in 1996 is a result of the strengthening of real demand for currency in circulation at the end of the year. Usually, in certain periods of time the dynamics of the currency in circulation was under strong, short-term influence of the seasonal factor with reverse effect.

Chart 11

**Dynamics of currency in circulation and bank liquid assets**  
(in million Denar)



### 5.1.1. Bank liquidity

Movements of the bank liquid assets in Republic of Macedonia in 1996 was a result of interactive activity of system changes and monetary policy measures. Within the framework of system solutions, the liquidity of the banking system in 1996 was determined by the following factors: a) changes in the system and organization of payment system; b) introduction of average system of reserve requirements; and c) changes in the organization and operational procedures of the interbank money market. These system changes, aimed to more qualitative planing of the liquidity flows, as well as allowing bigger flexibility in disposal and trading with the free short-term liquidity funds, act toward decline of demand for liquid assets. In the same time, through the instruments of monetary policy (most of all through auctions of deposits and bills) the efforts were made to maintain the general level of liquidity in the banking system within optimal framework. Proper effect on global liquidity of the banking system in 1996 also had the achieved progress in the process of rehabilitation of the biggest bank in the Republic of Macedonia.

At the end of 1996, the amount of bank liquid assets was 417 million Denars, which is by 111 million Denars, or by 36.3% more then December 1995 level. On average, in period January-December 1996 banks in their giro-accounts and cash in vaults had 277 million Denars, that is on the 1995 level of average liquidity. As a result of the system changes, especially because of unstable movements on foreign exchange market, dynamics of the bank liquid assets in 1996 was characterized by big fluctuations. Thus, after the relatively high starting liquidity level at the beginning of 1996, in the period of March-

August 1996 there was too big "exhaustion" of bank liquidity, and than in the last quarter the satisfactory level of primary liquidity was accomplished again.

Money market in 1996 did not succeed to allocate efficiently the liquid assets among distinct banks, therefore, as in the previous years, the problem of unoptimal dispersion of liquidity among banks continued. In conditions of long implementation of credit ceilings as an monetary policy instrument, inappropriate distribution of liquidity was causing twofold problem: existence of space for credit activity with insufficient level of free assets at one group of banks, that is, too high liquidity but completely used credit limits at other.

### 5.1.2. Net foreign assets of the National Bank of Republic of Macedonia

Opposite to the developments in the previous two years, when net foreign assets of the National Bank of the Republic of Macedonia acted toward creation of reserve money, in 1996 they represented a flow of reserve money withdrawal. That is also opposite to the monetary policy projection, that was anticipating an increase in net foreign assets in 1996, based on purchase of foreign exchange surplus at the foreign exchange market. Therefore, it was also anticipated a broadening of the monetary framework for central bank intervention on foreign exchange market (that is, for purchase of foreign exchange surplus), through transfer of Government deposits aimed for monetary support in amount of 1,200 million Denars.

In the period of January-December 1996 net foreign assets of the National Bank of Republic of Macedonia were decreased by 694 million Denars, which is a result of decrease in foreign exchange assets by 226 million Denars, and increase of foreign exchange liabilities of central bank by 468 million Denars. In this way, net foreign assets of the National Bank in 1996 acted toward reserve money withdrawal of 11.1%.

Table 9

#### Reserve money creation and withdrawal<sup>1/</sup>

(in million Denar)

(in million Denar)

	Position 31.12.95	Quarterly changes					Position 31.12.96	Factors of growth in %			
		I	II	III	IV	Total		III.96 XII.95	VI.96 XII.95	IX.96 XII.95	XII.96 XII.95
Reserve money	6,271	-885	302	131	1296	844	7,115	-14.1	-9.3	-7.2	13.5
Net foreign assets <sup>1/2</sup>	8,583	-822	-349	-428	905	-694	7,889	-13.1	-18.7	-25.5	-11.1
-Foreign assets	10,732	-869	194	-434	883	-226	10,506	-13.9	-10.8	-17.7	-3.6
-Foreign liabilities	2,149	-47	543	-7	-21	468	2,617	0.7	-7.9	-7.8	-7.5
Domestic credit, net	49	75	298	549	-378	544	593	1.2	5.9	14.7	8.7
Domestic credits	3,482	232	149	534	-522	393	3,875	3.7	6.1	14.6	6.3
Other items, net	-3,433	-157	149	15	144	151	-3,282	-2.5	-0.1	0.1	2.4
Instruments <sup>1/3</sup>	1,355	252	-315	-288	-443	-794	561	4.0	-1.0	-5.6	-12.7
Public sector deposits <sup>1/3</sup>	1,006	-114	-38	278	-326	-200	806	-1.8	-2.4	2.0	-3.2

1/ (+) reserve money creation

(-) reserve money withdrawal

2/ Stocks valued at constant exchange rate (end-December 1995 1 USD = 37.9796); flows valued at current exchange rate.

3/ Positive change means reserve money withdrawal, Negative change means reserve money creation.

Regarding dynamics, in the first three quarters of 1996 net foreign assets were continuously decreasing, and the intensity of the decline was the most evident in the first quarter of the year (because of the realized sale of foreign assets on the foreign exchange market in amount of USD 6.5 million and payment of foreign liabilities in amount of USD 24.7 million). The growth of the net foreign assets of the National Bank of the Republic of Macedonia was realized only in the last quarter of 1996, mainly due to the increased foreign exchange purchase on the foreign exchange market in the last days of 1996, as well as due to the net inflow of foreign exchange based on reception of the second trench of FESAK credit to the Government from the World Bank, when the Government transferred the assets into foreign exchange reserves with the National Bank of the Republic of Macedonia.

### 5.1.3. National Bank of the Republic of Macedonia credits

In circumstances when the net foreign assets have lost the role of reserve money creator, the primary source for reserve money creation were domestic credits to deposit money banks, that is, installment of funds through auctions of deposits. However, for 1996 is specific that significant impact on reserve money creation had net other assets, as well as other instruments usually employed for reserve money withdrawal.

Domestic credits in the period of January-December, 1996 have increased by 393 million Denars, or by 11.3%, that caused creation of reserve money of 6.3%. Fundamental components of the domestic credit category are Denar credits granted to the banks and the net position of the Government. Denar credits to the banks in 1996 had a tendency of continuous growth, that at the end of 1996 resulted in higher Denar credits by 1,315 million Denars, or by 32.5%, compared to December 1995. In the same time, net Government liabilities have increased by 922 million Denars, that caused reserve money withdrawal of 14.7%.

Table 10

#### Domestic credits of the National Bank of the Republic of Macedonia

(in million Denars)

	Position 31.12.95	Quarterly changes				Total	Position 31.12.96	Factors of growth in %			
		I	II	III	IV			III.96	VI.96	IX.96	XII.96
								XII.95	XII.95	XII.95	XII.95
Domestic credits	3,482	232	149	534	-522	393	3,875	3.7	6.1	14.6	6.3
I./ Credits to banks	4,045	190	79	191	855	1,315	5,360	3	4.3	7.3	21
- Selective credits	23	-20	0	0	0	-20	3	-0.3	-0.3	-0.3	-0.3
- Repo arrangements	0	0	500	0	0	500	500	0	8	8	8
- Deposits sold on auctions	3,527	258	-466	183	847	822	4,349	4.1	-3.3	-0.4	13.1
- Liquidity credits	288	21	11	5	-11	26	314	0.3	0.5	0.6	0.4
- Other credits	207	-69	34	3	19	-13	194	-1.1	-0.6	-0.5	-0.2
II./ Credit to Government, net	-563	42	70	343	-1,377	-922	-1,485	0.7	1.8	7.3	-14.7
- Credits to Government	1,860	0	-3	-7	-2	-12	1,848	0	0	-0.2	-0.2
- Government deposits	-2,083	-355	-304	-187	-621	-1,467	-3,550	-5.7	-10.5	-13.5	-23.4
a) for monetary support	-1,411	-300	-300	-300	-300	-1,200	-2,611	-4.8	-9.6	-14.4	-19.1
b) giro-account	-662	-23	-10	138	-278	-173	-835	-0.4	-0.5	1.7	-2.8
c) other restricted deposits	-10	-32	6	-25	-43	-94	-104	-0.5	-0.4	-0.8	-1.5
III./ External financing	-340	397	377	537	-754	557	217	6.3	12.3	20.9	8.9

The primary flow of reserve money creation within the framework of Denar credits to the banks in 1996 were the auctions for selling deposits to the banks. The average daily balance of sold National Bank deposits at auctions to the banks was 3,510 million Denars, that is by 1,583 million Denars more than in December 1995. In this way, this flow in 1996 induced reserve money creation of 13.1%.

Sold deposits to the banks had maturity of 1 up to 14 days, but mostly they were sold on 1, 3 and 7 days. In general, interest rates of the sold deposits on auctions have slightly decreased during 1996, following the trend of discount rate. However, because of the increased competition between banks for purchase of auction funds, in the second half of 1996 there was a moderate increase in the interest rates traded on the auction for selling deposits.

Table 11

## Maturity and interest rates of deposits sold at auctions

Maturity (in days) and weighted interest rates (annual) of sold deposits on auctions												
	1	2	3	4	5	6	7	8	9	10	11	14
January	15.97		16.78	17.13			18.06					
February	15.97		16.78				18.06					
March	12.78		13.42				14.45					
April	12.78		13.42	13.70		14.17	14.45					
May	12.78	13.06	13.42									
June	11.00		11.55									13.15
July	11.00		11.55				13.44					14.82
August	11.00		11.55	11.80	12.04		13.00					14.04
September	11.00		11.55	11.80			12.44					13.41
October	11.00		11.55	11.80			12.44		12.64	12.74	12.95	13.21
November	11.00		11.55	11.80	12.04		12.44			12.86	12.95	
December	11.00		11.89	12.16	12.66	12.24	12.68	12.54	13.15	12.78	12.84	13.15

Beside sale of deposit to the banks at auctions, reserve money creation in 1996 was also influenced by the National Bank purchase of Government bonds, in amount of 500 million Denars. Because of the lack of Government securities supply, development of this segment of financial market was slow, and at the end of 1996 there were no other transactions of this type. The realized purchase of Government securities in April 1996 resulted in reserve money creation of 8.0%.

Net credits to the Government in 1996 caused reserve money withdrawal. At the end of 1996 the Government had net claims from the National Bank of the Republic of Macedonia in amount of 1,485 million Denars, that is by 922 million Denars more compared to the beginning of the year. Increase of the Government claims from the central bank (that is, the National Bank liabilities to the Government) in 1996 means that this flow caused reserve money withdrawal of 14.7%. Increase of the central bank liabilities to the Government is due to the following factors: a) increase of the Government deposits aimed for monetary support, in amount of 1,200 million Denars, as it was predicted with the monetary projection; b) increase of the assets on the Government giro-account and of other central government deposits in amount of 267 million Denars; and

c) insignificant decrease of gross credits to the Government in amount of 12 million Denars. In the same time, the following factors were acting in opposite direction (that is, in direction of decrease of the National Bank liabilities to the Government): a) bigger outflow of funds from the external account of the Government for payment of foreign liabilities compared to the total assets inflow to this account in Government benefit, by 557 million Denars. In this way, external account net claims of the Government from the National Bank in amount of 340 million Denars (at the end of 1995), on December 31, 1996 were transformed into net liabilities of the Government toward central bank in amount of 217 million Denars.

#### 5.1.4. Instruments for reserve money withdrawal

Monetary policy execution in 1996 continued through application of indirect instruments for monetary regulation in form of auctions of deposits and bills. Monetary effects from the application of these instruments in 1996 were opposite to the usual one, that is, instead of function for reserve money withdrawal, for stabilizing the effects of reserve money creation through foreign exchange transactions, they were in function of reserve money creation. That actually means that the reserve money creation through other forms in 1996 was complemented by effects toward reserve money creation from the auctions for purchase of deposits and sale of National Bank bills. The only instrument that in 1996 served for reserve money withdrawal was compulsory reserves, as a traditional instrument for creation of reserve money demand.

Through the instruments for reserve money withdrawal at the end of 1996 the total of 561 million Denars were withdrawn, that is by 794 million Denars less than in December, 1995. This resulted in reserve money creation of 12.7%.

Table 12

#### Instruments for reserve money withdrawal<sup>1</sup>

(in million Denars)

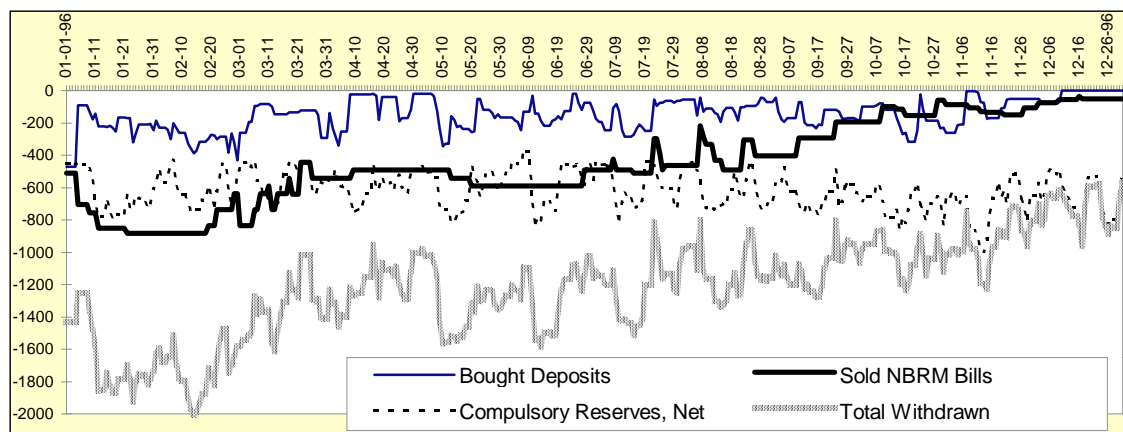
Instruments	Position 31.12.95	Quarterly changes					Position 31.12.96	Factors of growth in %			
		I	II	III	IV	Total		III.96 XII.95	VI.96 XII.95	IX.96 XII.95	XII.96 XII.95
Compulsory reserves	365	208	-111	165	-104	158	523	-3.3	-1.5	-4.2	-2.5
Deposits bought on auction	480	12	-154	-157	-180	-479	1	-0.2	2.3	4.8	7.6
Auction of Central bank bills	510	32	-50	-296	-159	-473	37	-0.5	0.3	5.0	7.5
Total withdrawn	1,355	252	-315	-288	-443	-794	561	-4.0	1.0	5.6	12.7

1/ (+) reserve money withdrawal  
(-) reserve money creation

The amount of withdrawn reserve money through auctions for purchase of deposits and sale of the National Bank of the Republic of Macedonia bills, at the end of 1996 was deduced to 38 million Denars, that is by 952 million Denars less compared to December, 1995 position. Regarding dynamics, except in the first quarter, when because of the excess liquidity that banking system entered with into 1996, through these instruments was realized reserve money withdrawal, in the other three quarters they acted toward reserve money creation.

Chart 12

## Effects of the instruments for reserve money withdrawal



The amount of sold bills on auctions at the end of 1996 was deduced to 37 million Denars, that is by 473 million Denars less than in the previous year. On average, during 1996, there were 448 million Denars withdrawn from circulation through this instrument, which is 7.7% of the average amount of reserve money. That is by 300 million Denars, or by 60.0% less compared to the average amount of withdrawn reserve money in 1995. Particularly intensive decline in the amount of sold bills was realized in the second half of 1996, when the average monthly amount of withdrawn reserve money through this instrument was deduced to 250 million Denars, or by 2.6 times less than the average in the first six months of 1996.

At the beginning of 1996 banks have shown the biggest interest in bills with maturity of 60 days. Toward the midyear the maturity of the bills mostly traded with was increased up to 90 days, whereas in the last quarter it was diminished to only 30 days. Decline in the maturity that banks were purchasing bills the most, together with decreased amount of bought bills in the third and fourth quarter of 1996, are a result of more intensive credit activity of the banks that have been previously selling deposits, that is, buying bills on the auctions at the National Bank of the Republic of Macedonia.

The interest rate movement of the issued bills was following the trend of decline in the discount rate of the National Bank of the Republic of Macedonia, decreasing from 12.0% annually in January to 8.0% annually in December, 1996.

Table 13

**Maturity and interest rates of the National Bank of the Republic of Macedonia  
bills sold at auctions**

Period 1996	Maturity (in days) and interest rates (annual) of Central bank bills			
	30 days	40 days	60 days	90 days
January			12.04	
February				
March			9.62	
April			9.63	
May			9.62	
June				
July			8.82	9.43
August			8.82	9.44
September				
October	8.24	8.57		
November	8.24			
December	8.24			

The amount of withdrawn reserve money through auctions for purchase of deposits at the end of 1996 was deduced to only one million Denars. In this way, this instrument in the period of January-December 1996 was determining reserve money creation of 7.6%. On average, monthly, through auctions for deposit purchase were withdrawn from circulation reserve money in amount of 150 million Denars, and the dynamics were very similar to the one at the auctions of bills. Namely, the average amount of withdrawn reserve money in the first half of 1996 (180 million Denars) was by 1.5 times bigger than the one in the last six months (120 million Denars).

Table 14

**Maturity and interest rates of deposits bought at auctions**

Period 1996	Maturity (in days) and weighted interest rates (annual) of bought deposits on auctions								
	1	2	3	4	5	6	7	8	9
January	3.09	3.19	3.3	3.5	3.7		8.84		
February	3.09	3.19	3.3	3.5		3.87	8.84		
March	2.47		2.64	2.8			7.07		
April	2.47		2.64	2.8	2.96	3.1	7.07		
May	2.47	2.55	2.64	2.8	2.96		7.07		
June	2.47		2.64	2.8	2.96	3.1	6.48		
July	2.47	2.55	2.64	2.8	2.96		6.48		
August	2.47	2.55	2.64	2.8	2.96		6.48		
September				2.8			6.48		
October				2.8	2.96	3.1	6.48	6.56	6.64
November				2.8	2.96		6.48		
December							6.48		

At the beginning of 1996 deposits bought by banks were mostly with maturity of 1 to 9 days, with interest rate spread from 3.1% to 8.8% at annual level (corresponding to the maturity), whereas at the end of the year they decreased, ranging from 2.5% to 6.5% annually, depending on the maturity.

The only instrument that in 1996 was acting toward reserve money withdrawal was compulsory reserve. At the end of 1996 through this instrument were withdrawn in total 523 million Denars, that is by 158 million Denars more than in December 1995. In this way, the compulsory reserves movement in 1996 was determining reserve money withdrawal of 2.5%.

A significant news in 1996 was the change from fixed to average system of compulsory reserves at the deposit money banks. According to the new system the banks are obliged to provide the amount of compulsory reserves in average for the entire allocation period, whereas on daily basis are allowed oscillations above (unlimited) and below ( up to 20% ) of established amount. Used funds from the compulsory reserves the bank has to replace during the same accounting period, that is, on average to perform their obligation 100% for the accounting period. In this way bigger flexibility in the application of the compulsory reserves instrument was allowed, in the sense of bank opportunity to use the allocated funds for overcoming short-term liquidity problems.

In the same time a change was made in the way of compulsory reserves calculation, and the obligation for compulsory reserves allocation is determined on the basis of average balances of deposit accounts for every working day from the previous accounting period, on contrary to the past, when for the basis estimation were taken the ten-days balances. The estimated average balance is multiplied by the rates for compulsory reserves allocation, 8.0% (for sight deposits and time deposits up to 3 months) and 3.5% (for time deposits over 3 months), and that amount is the obligation for compulsory reserves allocation for the period from the 11<sup>th</sup> in the current month till the 10<sup>th</sup> in the following month.

Introduction of the system of average compulsory reserves contributed to better liquidity management of the banks and to overcoming of the situations of short-term shortages of liquidity assets. Based on the right to use 20% of the allocated compulsory reserves, banks in distinct critical periods during 1996 have used on average 31 million Denars for complementing daily shortages of liquid assets, or 5.0% of the average allocated compulsory reserves. This temporary usage of compulsory reserves funds was replaced by banks on time with latter allocation of higher amount of compulsory reserves than the obligation, within the same accounting period, by which the obligation for compulsory reserves allocation was fulfilled completely.

For the savinghouses, the fixed system of compulsory reserves remained unchanged with allocation rates of 4.0% (for sight deposits and time deposits up to 3 months) and 1.5% (for time deposits over 3 months).

## VI. Interest rate policy

In the case when the monetary policy is aimed to sustaining exchange rate stability as a key nominal anchor, the central bank is unable to achieve targets for low inflation rate and positive economic growth through interest rates targeting. On contrary, the interest rate policy of the central bank is directly directed to sustaining stability of the Denar exchange rate.

Table 15

### Nominal and real interest rates

(annually, in %)

Month	Inflation rate*	Discount rate		Weighted bank interest rates					
				Active		Passive over 3 months		Interbank	
		Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
January	3.66	15.00	11.34	25.60	21.94	16.60	12.94	35.67	32.01
February	0.00	15.00	15.00	25.20	25.20	16.60	16.60	35.82	35.82
March	0.00	12.00	12.00	25.30	25.30	16.40	16.40	33.33	33.33
April	-8.08	12.00	20.08	23.60	31.68	14.90	22.98	33.74	41.82
May	-12.43	12.00	24.43	23.10	35.53	14.50	26.93	31.88	44.31
June	-4.70	10.00	14.70	20.90	25.60	12.60	17.30	29.04	33.74
July	-6.97	10.00	16.97	20.50	27.47	12.80	19.77	26.67	33.64
August	-8.08	10.00	18.08	20.90	28.98	12.60	20.68	26.96	35.04
September	3.66	9.20	5.54	20.90	17.24	12.70	9.04	25.47	21.81
October	36.07	9.20	-26.87	20.80	-15.27	12.70	-23.37	24.43	-11.64
November	8.73	9.20	0.47	20.90	12.17	12.60	3.87	24.54	15.81
December	-1.19	9.20	10.39	21.50	22.69	12.40	13.59	22.48	23.67

\*/ Monthly rate of inflation, at annual level

*Interest rates of the National Bank of the Republic of Macedonia.* National Bank of the Republic of Macedonia in 1996 continued the employment of consistent interest rate policy as well, and hence the discount rate was continuously following the declining trend of inflation rate. During 1996 discount rate of the National Bank of the Republic of Macedonia was diminished three times: in March from 15.0% to 12.0% on annual level, in June to 10.0% and in September to 9.2% annually, remaining at that level till the end of the year. The low inflation rate, that in distinct months was even negative, caused the real discount rate to remain at relatively high level, that on average was 10.2% annually. The same direction was also followed by active and passive interest rates of the National Bank of the Republic of Macedonia, that as their estimation basis have the discount rate.

*Interest rates of deposit money banks.* Even though the active and passive interest rates of the deposit money banks in 1996 were following the trend of inflation movements, the intensity of their decrease was not sufficient for obtaining economically acceptable nominal and real level of interest rates, that is, for deduction of the real interest rates to the level of marginal profitability of enterprises.



29.3% higher than the healthy bank credits to entities in private and social sector.

However, a positive tendency in interest rates movements in 1996 represents the significant decline of interest rates margins compared to 1995. Thus, in 1995 interest margin between active and passive bank interest rate was on average 22.1 percentage points, whereas the same one in 1996 was deduced to 8.5 percentage points, or by 2.6 times less than previous year.

*Interbank interest rates.* Restrictive monetary policy, incident liquidity problems of some of the banks, nonexistence of developed financial markets and bigger cautious in interbank lending, have caused the demand for free funds in banking system to be significantly higher than current supply. This condition had direct impact on interest rates in interbank market, that even with a declining tendency, in 1996 remained on high nominal and real level. Thus, at the end of 1996, the nominal interbank interest rates were 22.5% annually (35.7% at the beginning of the year), whereas real interest rates in the same time were deduced on 22.3% annually (32.0% at the beginning of the year).

In the same time, interest rates of bank credits to the savinghouses were much higher: 45.6% nominal annual average, that is, 44.7% annually in real terms. This high price of credits to the savinghouses is due to the higher degree of anticipated risk of bank credits to these financial institutions.

## **VII. External Sector**

### **7.1. Balance of Payments**

The National Bank of the Republic of Macedonia presents the Balance of Payments (BOP) figures according to a methodology in the fifth edition of IMF Balance of Payments Manual. According to this methodology, value of goods in foreign trade is presented on gross basis, including the value of imported end exported goods for finishing, processing and reprocessing (so called "Ion" works). As a source of data for this item, data from Republic Bureau of Statistics are used, where on the basis of customs reports, foreign trade data are processed and announced on the gross basis.

Analyzing the problem of high trade deficit based on customs reports, the National Bank of the Republic of Macedonia has realized that in presenting data for so called "Ion" works, the Republic Bureau of Statistics has included on the side of import a value of goods imported for finishing, processing and reprocessing, while on export side only a value added component of the services is included (but not the total value of goods), which means the gross principle is not applied. This way of presentation does not provide an adequate picture for the trade balance position of the Republic of Macedonia, as well as for the current account balance and a ways of deficit financing. For these reasons, in the presentation of Balance of payments for 1995 and 1996 in this report, the value of goods imported for finishing, processing and reprocessing is added on export side. As a source, data from the Republic Bureau of Statistics for value of goods imported for finishing, processing and reprocessing on the F.O.B. parity, is used.

Due to above mentioned facts, and a lack of correct data from the Republic Bureau of Statistics, analysis of the realized movements in this report refers to global movements. Detailed analysis from point of view of distribution of imported goods by branches, degree of finalization, etc., is not available.

Table 16

## Balance of Payments of the Republic of Macedonia

(in million USD)

	1995	1995				1996				1996
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
<b>I. Current account balance</b>	<b>8</b>	<b>30</b>	<b>39</b>	<b>11</b>	<b>-71</b>	<b>-40</b>	<b>-59</b>	<b>-77</b>	<b>-107</b>	<b>-284</b>
<b>Goods, net</b>	<b>10</b>	<b>49</b>	<b>27</b>	<b>3</b>	<b>-69</b>	<b>-34</b>	<b>-60</b>	<b>-109</b>	<b>-113</b>	<b>-317</b>
Export, FOB	1.434	356	375	347	356	270	298	252	284	1.104
Registered export	1.205	313	327	273	292	220	228	200	238	886
Other export/1	230	43	49	75	63	51	70	51	46	218
Import, FOB	-1.425	-307	-349	-344	-425	-305	-358	-361	-397	-1.421
Registered import, FOB	-1.373	-297	-328	-336	-413	-289	-348	-336	-382	-1.356
Aid and grants	-25	-4	-14	-3	-4	-10	-2	-15	-5	-33
Individuals	-27	-6	-7	-6	-8	-6	-8	-9	-9	-32
<b>Services, net</b>	<b>-200</b>	<b>-51</b>	<b>-43</b>	<b>-48</b>	<b>-58</b>	<b>-40</b>	<b>-41</b>	<b>-27</b>	<b>-43</b>	<b>-151</b>
<b>Income, net</b>	<b>-29</b>	<b>-8</b>	<b>-8</b>	<b>-6</b>	<b>-6</b>	<b>-12</b>	<b>-6</b>	<b>-5</b>	<b>-6</b>	<b>-30</b>
of w/interest, net	-40	-11	-11	-10	-8	-17	-12	-16	-12	-56
<b>Current transfers, net</b>	<b>228</b>	<b>39</b>	<b>63</b>	<b>62</b>	<b>63</b>	<b>47</b>	<b>48</b>	<b>65</b>	<b>54</b>	<b>213</b>
Official/2	27	5	15	3	5	18	11	16	7	52
Other	201	35	48	59	58	28	37	49	47	161
<b>II. Capital and financial transactions</b>	<b>-72</b>	<b>-75</b>	<b>-58</b>	<b>-6</b>	<b>67</b>	<b>25</b>	<b>9</b>	<b>26</b>	<b>114</b>	<b>174</b>
<b>Capital transactions, net</b>	<b>2</b>	<b>2</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>
Capital transfers, net	2	2	0	0	0	0	0	0	0	0
Official	2	2	0	0	0	0	0	0	0	0
Other	0	0	0	0	0	0	0	0	0	0
<b>Financial transactions, net</b>	<b>-74</b>	<b>-77</b>	<b>-58</b>	<b>-6</b>	<b>67</b>	<b>25</b>	<b>9</b>	<b>26</b>	<b>114</b>	<b>174</b>
Direct investments, net	9	1	5	1	2	2	3	2	4	11
Portfolio investment, net	3	1	2	0	0	0	0	0	0	0
Other investment, net	-86	-78	-64	-8	64	23	7	24	110	163
Trade credits, net	-88	-81	-52	-10	55	-10	17	8	63	79
Loans, net/3	-21	-16	-33	22	6	-10	-9	1	40	23
Foreign currency and f.c. deposits	23	18	20	-19	4	42	-1	15	6	61
Other, net	0	0	0	0	0	0	0	0	0	0
<b>III. Errors and omissions</b>	<b>7</b>	<b>28</b>	<b>-20</b>	<b>5</b>	<b>-5</b>	<b>-23</b>	<b>16</b>	<b>27</b>	<b>-5</b>	<b>14</b>
<b>IV. Total balance</b>	<b>-56</b>	<b>-17</b>	<b>-39</b>	<b>10</b>	<b>-10</b>	<b>-38</b>	<b>-35</b>	<b>-24</b>	<b>1</b>	<b>-95</b>
<b>V. Financing</b>	<b>56</b>	<b>17</b>	<b>39</b>	<b>-10</b>	<b>10</b>	<b>38</b>	<b>35</b>	<b>24</b>	<b>-1</b>	<b>95</b>
Net change in official reserves/4	-64	-6	-7	-32	-20	24	7	8	-18	21
Gross foreign assets/5	-101	-5	-30	-32	-34	24	-7	8	-18	8
IMF	37	0	23	0	14	0	14	0	0	13
Changes in total arrears	-152	9	46	-225	18	14	-10	16	17	37
New arrears	107	23	46	20	18	17	18	16	18	69
Regulated due but unpaid liabilities	-259	-13	0	-245	0	-3	-28	0	-1	-32
Reprogram	272	13	0	247	12	0	37	0	0	37
Paris club	259	0	0	247	12	0	10	0	0	10
EUROFIMA	0	0	0	0	0	0	22	0	0	22
EFR	0	0	0	0	0	0	6	0	0	6
IFC	13	13	0	0	0	0	0	0	0	0

1) The value of imported goods for finishing, processing and reprocessing is not included in the amount for import received from the Republic Bureau of Statistics, although according to their methodology value of these goods should be presented on gross basis both on import and on export side. According to NBM calculations based directly on customs declarations, it is found that on export side RBS has included only value added services, but not total value of exported goods. This way of presentation of export for finished and reprocessed foreign goods gives unrealistic picture for the trade deficit and current account deficit. Due to this reasons, a correction for export data has been made in 1995 and 1996

2) Data for PHARE support in official transfers are provided by the Ministry for Development

3) Excluding IMF

4) End of period; increase of assets denoted by a minus; includes IMF

5) Excluding cross exchange rates effects

Starting from a fact that for 1995 and 1996 export by the Republic Bureau of Statistics is presented without value of imported goods for finishing, processing and reprocessing, data for foreign trade distribution by countries are analyzed only from the aspect of export and import movements, without

comments on the trade balance, in order to get impression about the regional distribution (table 17).<sup>6</sup>

### 7.1.1. Realized movements in 1996

A negative balance of USD 284 million has been realized in 1996 in the current transactions of balance of payments. Financing of the deficit has contributed to the rise of Republic of Macedonia liabilities to abroad for financial transactions, by USD 174 million. Total BOP deficit was USD 95 million, while unidentified inflows as a result of statistical errors and omissions amounted to USD 14 million.

For the purpose of financing the balance of payments deficit, international reserves of the National Bank of the Republic of Macedonia were used in amount of USD 8 million. The deficit has been also financed through following transactions: disbursements of funds on the basis of new arrangements with IMF for BOP support (Stand By arrangement) in net amount of USD 13 million, net change in due but unpaid liabilities to foreign creditors in amount of USD 37 million, and new agreements for debt rescheduling in amount of USD 37 million (Graph 14).

In current and financial account of the balance of payments for 1996, an amount of USD 34 million has been shown for due but unpaid liabilities on the basis of interest, and USD 35 million for due but unpaid liabilities on the basis of principal. These liabilities have been shown on financing side as new accumulated nonpaid liabilities, that finance the total deficit on short run. These liabilities refer mainly to credits used from foreign commercial banks (so called "London club of creditors"), in a period when Republic of Macedonia was a constituent part of the former Yugoslavia.

During 1996, due but unpaid liabilities from previous years in amount of USD 32 million have been regulated, to following institutions: EUROFIMA (European association of railways) - USD 24 million, CEF (European Council Fund for social development - former European fund for reintegration) - USD 6 million, and Paris club of creditors - USD 2 million.

Due but unpaid liabilities to EUROFIMA and CEF have been regulated through a new reprogramming agreements. The reprogramming of current liabilities to Paris club of creditors was also accomplished in 1996, in amount of

<sup>6</sup> The foreign trade balance of the Republic of Macedonia for 1996, according to the data from Republic Bureau of Statistics, amounts to USD 691 million. The methodology adopted for foreign trade statistics calculates the export of goods on FOB basis, and import on CIF basis, i.e. in addition to the value of imported goods, all transport and insurance costs to Macedonian border, are included. According to BOP methodology of IMF, trade balance is the balance of the exchange of goods. So, the Republic Bureau of Statistics data for imported goods are transferred from CIF on FOB basis, and transport and insurance costs are included in the value of goods. Thus, the import value according to CIF basis is USD 1,577 million, while on FOB basis, it amounts to USD 1,364 million. The trade balance deficit on CIF basis is USD 534 million.

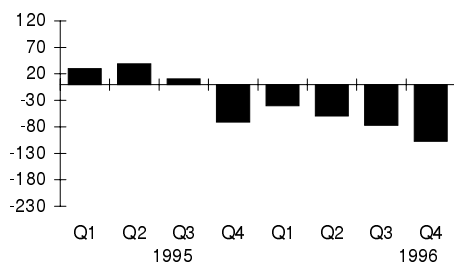
USD 10 million, in accordance with the agreement with these creditors from May 1995.

Graph 14

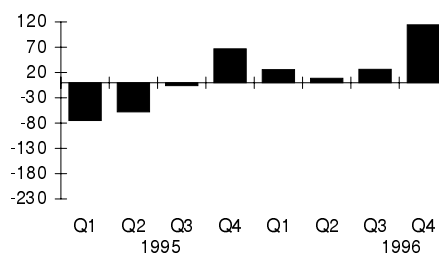
### Balance of payments influence on the official foreign exchange reserves

(in million USD)

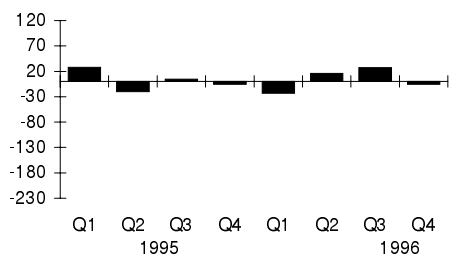
Current account - balance



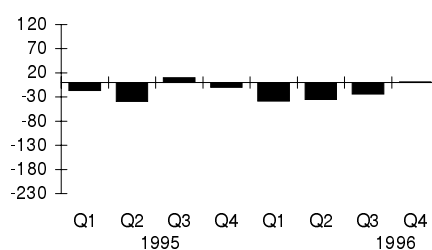
Capital & financial account - balance



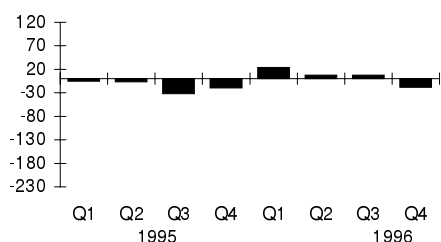
Errors and omissions



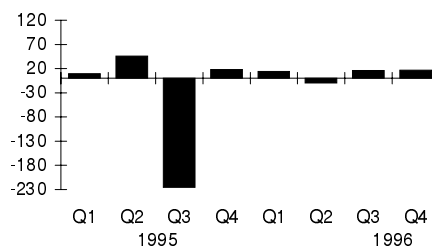
Overall balance



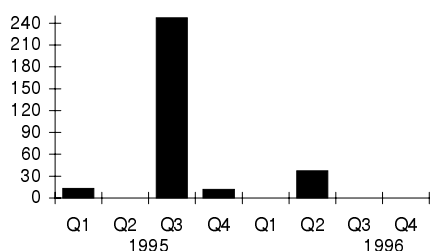
Changes in official foreign exchange reserves



Changes in total arrears



Rescheduling - Paris Club



#### 7.1.1.1. Current transactions

Current account deficit in 1996 reached USD 284 million, due to high foreign trade deficit of USD 317 million. Negative current account balance is also a result of realized negative net balance in services and net income position. The only positive item in current account is net current transfers (private and official - Graph 15). Contrary to 1995, when current account surplus

of USD 8 million was realized, in 1996 current account deficit as percent of GDP reached 6.4%.

Realized trade deficit of USD 317 million in situation when import was reduced by 1.3%, is mainly due to the decrease of export by 23.0%. Main factor that influenced foreign trade movements in 1996 was changed regional situation. On export side, better results would be achieved if there was no cattle disease (traditionally, Macedonia is lamb meat exporter), and if expected export of vegetables was realized. Improvement in export results was achieved in: tobacco industry, as a result of good last year production; wine industry, where due to the proved quality, a successful penetration was made on the western markets and; lead and zinc export, due to good world prices.

Table 17

## Foreign trade of the Republic of Macedonia by trade partners

(in million USD)

	EXPORT					IMPORT					BALANCE				
	1992	1993	1994	1995	1996	1992	1993	1994	1995	1996	1992	1993	1994	1995	1996
1. Developed countries	655	529	478	524	385	561	520	718	862	800	94	9	-240	-338	-415
EU	477	354	343	408	302	438	381	512	690	625	39	-27	-169	-282	-323
Germany	239	148	146	153	114	171	160	254	283	234	68	-12	-108	-130	-120
Greece	39	50	13	14	63	50	52	23	29	83	-11	-2	-10	-15	-20
Italy	89	94	126	118	42	123	78	110	179	111	-34	16	16	-61	-69
Netherlands	40	14	15	30	25	36	15	40	43	37	4	-1	-25	-13	-12
G. Britain	22	13	9	21	22	15	12	18	20	22	7	1	-9	1	0
EFTA	61	49	55	37	22	42	52	80	20	25	19	-3	-25	17	-3
Other developed countries	117	126	80	78	61	81	87	126	151	150	36	39	-46	-73	-89
USA	73	62	39	36	38	28	26	50	58	67	45	36	-11	-22	-29
Turkey	17	44	35	38	18	32	34	48	55	44	-15	10	-13	-17	-26
Japan	18	11	1	1	2	7	10	13	15	15	11	1	-12	-14	-13
2. East and central European countries	224	287	401	446	126	409	330	383	435	345	-185	-43	18	11	-219
Bulgaria	63	83	240	256	33	173	131	242	256	107	-110	-48	-2	0	-74
Russia	98	115	87	87	37	163	138	46	60	122	-65	-23	41	27	-85
3. Developing countries	58	43	65	44	12	79	60	59	86	94	-21	-17	6	-42	-82
4. Former Yugoslav republics	262	196	142	190	363	156	289	324	335	338	106	-93	-182	-145	25
SR Yugoslavia	70	51	40	85	241	9	63	101	161	163	61	-12	-61	-76	78
Slovenia	83	89	71	72	72	97	174	162	116	123	-14	-85	-91	-44	-51
Total	1,199	1,055	1,086	1,204	886	1,205	1,199	1,484	1,718	1,577	-6	-144	-398	-514	-691

From point of view of regional direction, in 1996 there is a tendency of export redistribution from East European countries (former CMEA) to developed countries markets, and return to former Yugoslav Republics markets. Thus, 43% of total export is directed to developed countries, 41% to former Yugoslav Republics, and 14% to countries from east and central Europe. For comparison, in 1995 respective participation in total export was 43%, 16% and 37%. By countries, export is directed mainly to European Union countries and USA.

Export of Macedonian goods to countries from former Yugoslavia is increased from USD 190 million to USD 363 million, which mainly refers to rise in export to SR Yugoslavia (Serbia and Montenegro) from USD 85 million to USD 241 million. Thus, SR Yugoslavia become the largest single trade partner of the Republic of Macedonia. The return on Yugoslav market is of great importance for Macedonian export, having in mind the complementary structure of former Yugoslav economy. SR Yugoslavia is also one of the few countries with which Macedonia has recorded positive balance in mutual trade. In the group of former Yugoslav Republics, considerable trade partner of the Republic of Macedonia is Slovenia (third on the scale of importance), but with bigger role on import than on export side.

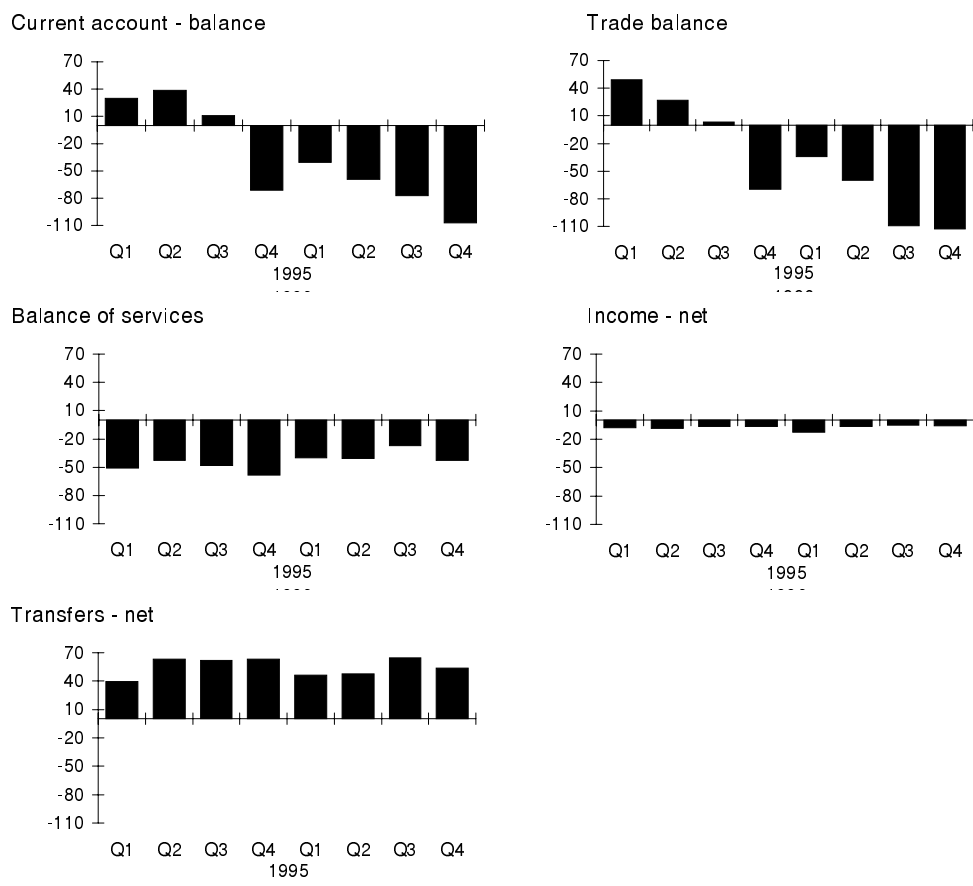
Among the European Union countries, the most significant trade partner is Germany, as the greatest trade partner of the Republic of Macedonia from 1992 to 1995. During 1996, Macedonian export to this country was reduced by 25%, and import from Germany was reduced by 17%. Reduction in total trade in 1996, especially on export side, was also recorded with Italy, one of the important foreign trade partners of the Republic of Macedonia. One of the characteristics for 1996 is the re-establishment (and even improvement) of trade relations with Greece, as a result of a normalization of relations after the abolition of two and a half year Greek embargo on Macedonia. So, Greece become the sixth most important trade partner for the Republic of Macedonia, with import from Greece increased by two times, and export of Macedonian goods in Greece increased by four times in 1996.

Despite a tendency of decline of trade with former CMEA countries, Russia is still one of important trade partners of Macedonia, particularly on import side. Total trade with neighboring Bulgaria, which was a country through which most of the trade in a period of UN sanctions against SR Yugoslavia was done, decreased by 87% (on export side), and 58% (on import side). Besides the improved regional situation, reduction in trade with Bulgaria is a result of adverse political and financial situation in this country in 1996.

Graph 15

The impact of current transactions on the current account balance

(in million USD)



Negative balance in services, that in 1996 reached USD 151 million, is 24.5% lower than in 1995. This is a result of reduced transport expenses, after north and south transport corridors have been re-established. Deficit in income transactions in 1996 was USD 30 million. Negative balance on net interest paid to abroad increased from USD 40 million in 1995 to USD 56 million in 1996, as a result of higher interest payments on rescheduled arrangements with Paris club of creditors and disbursed funds upon new credit arrangements with multilateral financial institutions. Interest expenditures include due but unpaid interest liabilities in 1996 in amount of USD 26 million, that mainly refer to London club of creditors.

Current account transfers are the only positive item in BOP current account in a period after the monetary and economic independence. A surplus of USD 213 million realized in 1996 is 6.4% lower than in 1995, due to lower private transfers as a result of reduced amount of foreign exchange on citizens foreign accounts, and increased foreign currency purchase. As a result of used PHARE 95 support in 1996, an increase of 91% has been recorded in official transfers, i.e. they have increased from USD 27 million in 1995 to USD 52 million in 1996.

#### 7.1.1.2. Capital - financial transactions

Net increase of USD 174 million was realized in capital - financial transactions<sup>7</sup> with abroad in 1996, while in 1995 net liabilities to abroad were reduced by USD 72 million.

Foreign direct investments in Republic of Macedonia are still on very low level, contrary to direct investments in many other transition countries. Low level of direct investments, in a situation when positive macroeconomic movements are realized in Macedonia, is a consequence of unstable economic and political situation in the region. However, successful negotiations with foreign creditors with respect to unpaid liabilities of the Republic of Macedonia, stable and transparent macroeconomic policy supported by IMF, and completed legal regulation, are positive signals for foreign investors in the following period.

Higher amount of liabilities in the capital - financial account in 1996 is mainly a result of increased BOP support, through net trade credits received in amount of USD 79 million. Trade credits used in 1996 stood at USD 235 million, and they refer to imported, but unpaid goods. Trade credits granted to foreign partners for exported Macedonian goods for which payment was not received, were USD 156 million. In 1995, due to reexported goods, trade credits granted to foreign partners were higher than used trade credits, by USD 88 million.

For the first time in 1996 an inflow on the basis of used foreign credits was realized in amount of USD 23 million. Finalization of the process of

<sup>7</sup> Capital - financial transactions are transactions on the basis of transfer of capital, such as medium and long-term credits and loans, as well as portfolio and direct investments

settlement of Macedonian liabilities upon "old" credits in 1996, has resulted in higher usage of new funds from EBRD and IBRD for specific projects in the country.

Total amount of funds withdrawn on the basis of new credit arrangements in 1996 is USD 109 million (without IMF), distributed as follows: USD 54 million from EBRD for approved projects; USD 44 million from IDA and FESAC credit - for social reform project; USD 2 million IBRD credits; USD 1 million from EUROFIMA; and USD 8 million bilateral credits from the German and the Czech Government.

Simultaneously, current liabilities for principal were paid to foreign creditors in amount of USD 46 million. Due but unpaid liabilities in 1996 stood at USD 34 million, mainly referring to the London club of creditors. In addition, current liabilities to Paris club of creditors were rescheduled in 1996, in amount of USD 7 million.

Deposit money banks foreign assets were reduced by USD 25 million, which in situation when liabilities for short-term credit lines and deposits were increased by USD 36 million, represents total net increase of liabilities to abroad of USD 61 million.<sup>8</sup> Net foreign liabilities of DMB's in 1995 increased by USD 23 million.

## 7.2. International reserves

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According to legal regulation, international reserves comprise international reserves managed by the National Bank of the Republic of Macedonia (official international reserves) and international reserves of full - licensed commercial banks. At the end of 1996, international reserves amounted USD 317.3 million, which means a reduction in comparison with 1995 for USD 36.7 million (10.4%).

International reserves managed by the National Bank of the Republic of Macedonia at the end of 1996 were USD 267.5 million, or USD 7.4 million (2.7%) lower than end of 1995 position. Excluding intervalutary changes, with negative effect on international reserves of USD 9.85 million (USD value in comparison with DEM has increased by 9.03% in 1996), international reserves increased by around 1.0%. However, contrary to the previous two years, when large foreign exchange inflow was realized, for the first time in 1996 transactions on the foreign exchange market have resulted in net loss of international reserves of USD 2.8 million. One of the most important factors for such movements on the foreign exchange market is changed regional situation, especially after UN

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<sup>8</sup>Total foreign assets include foreign assets in cash and short-term and long-term claims of DMB's on foreign accounts abroad. Foreign liabilities include only liabilities for short-term credits, while liabilities upon medium and long-term credits are presented in financial transactions position "loans and credits".

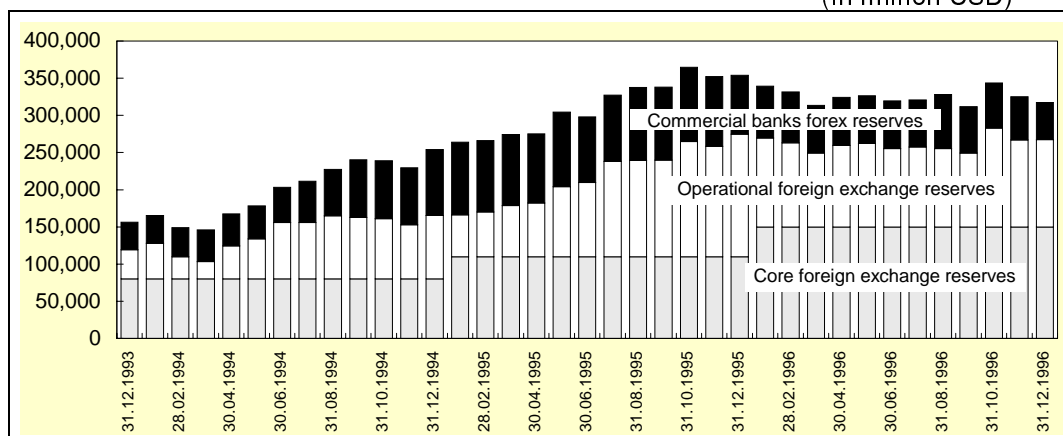
sanctions against SR Yugoslavia have been lifted and exceptional revenues have been reduced.

At the end of 1996, net international reserves of the National Bank of the Republic of Macedonia were USD 199.3 million. Net international reserves represent the difference between foreign assets of the National Bank and foreign liabilities to IMF. For the first time in 1996 net international reserves have decreased by USD 21 million (excluding intervalutary relations and monetary gold). This is opposite situation in comparison with projected increase of international reserves by USD 63 million, which is a consequence of a shortfall in foreign exchange inflows.

The dynamics of changes in international reserves are shown in the following graph. Permanent foreign exchange reserves, that serve for maintaining liquidity in payments abroad, in 1996 were planned on one month level payments, or USD 150 million. Current or operating reserves managed by the National Bank of the Republic of Macedonia at the end of 1996 were USD 117.5 million.

Graph 16

Foreign exchange reserves of the Republic of Macedonia  
(in million USD)



As a result of the imbalance between supply and demand on the foreign exchange market, a tendency of commercial banks foreign exchange reserves decline from 1995 has continued at accelerated pace in 1996. Current foreign exchange reserves, managed by full - licensed banks, at the end of 1996 stood at USD 49.8 million, or USD 29.3 million less than the position on December 31, 1995, and USD 4.2 million lower than the foreign exchange minimum prescribed by the Decision of the National Bank Council for minimum and maximum amount of foreign exchange assets for each bank.

In order to maintain current liquidity of payments to abroad, the Council of the National Bank prescribes, on quarterly basis, the level of commercial banks foreign exchange reserves, i.e. the minimum foreign exchange reserves they have to hold on their foreign exchange accounts, and the maximum that they can have on their foreign exchange accounts. For the first quarter of 1996, the minimum was prescribed at USD 52.5 million, while maximum amount of commercial banks foreign exchange reserves was USD 105 million. For second

and third quarter, foreign exchange reserves minimum was not changed, and foreign exchange reserves maximum was lowered to USD 84 million, in order foreign exchange excess over maximum amount to be used for increasing the supply of foreign exchange on the market. For last quarter of 1996 foreign exchange reserves minimum was increased to USD 54 million, and maximum to USD 86.4 million, as one bank got full operating license in this period.

The amount of foreign currency deposits on exporters accounts at the end of 1996 was USD 31.7 million, new foreign currency deposits of citizens stood at USD 30.9 million, foreign currency deposits of foreigners were USD 48.5 million, and other foreign currency deposits stood at USD 34.7 million. Total foreign currency deposits in amount of USD 145.7 million, decreased by USD 10.9 million in comparison with December 1995. Total foreign exchange potential of the Republic of Macedonia, including these deposits, at the end of 1996 was USD 463.0 million.

### **7.3. Exchange rate movements**

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The Denar exchange rate is formed on the foreign exchange market, where purchase and sale of foreign exchange between enterprises and banks is performed. As a result of lack of foreign exchange supply on the market, exchange rate of the Denar was under strong pressure during 1996. On the exchange offices market, which is part of the foreign exchange market where individuals can buy or sell foreign currency, despite increasing sale of foreign exchange, net purchase of foreign exchange has been realized. This excess was used for maintaining the stability of the Denar in 1996. Namely, total supply of foreign exchange on the foreign exchange market, broadly speaking, was still higher than total demand, which in combination with National Bank interventions in periods when seasonal imbalance of foreign exchange inflows and outflows occur on the market, enabled the maintenance of the average Denar exchange rate on level of 26.58 Denar for one Deutsche mark.

At the end of 1996, nominal exchange rate of the Denar against the Deutsche mark was higher by 0.53% (Denar depreciation) in comparison to the end of 1995. As a result of USD rise on the international markets, Denar depreciated against the USD in 1996 by 9.0%. After continued weak position of USD in 1994 and in the first quarter of 1995 (at March 31, 1995 USD reached its bottom line, with exchange rate of 1 USD = 1.3725 DEM), in the remaining part of 1995 and in 1996 (with minor oscillations), there was a clear tendency of rising value of the USD, ending 1996 with exchange rate of 1 USD = 1.5410 DEM.

The price competitiveness of Macedonian export represented by a real effective exchange rate of the Denar (expressed in industrial producers prices), increased in 1996 by 4.1% (Table 18). The improvement in price competitiveness in a situation when nominal exchange rate of the Denar increased by 4.4%, is a result of high USD appreciation, and low annual

increase of industrial producers prices on domestic market (1.2%). The rise of industrial producers prices in 1996 was also low on international markets - only 0.9%.

Table 18

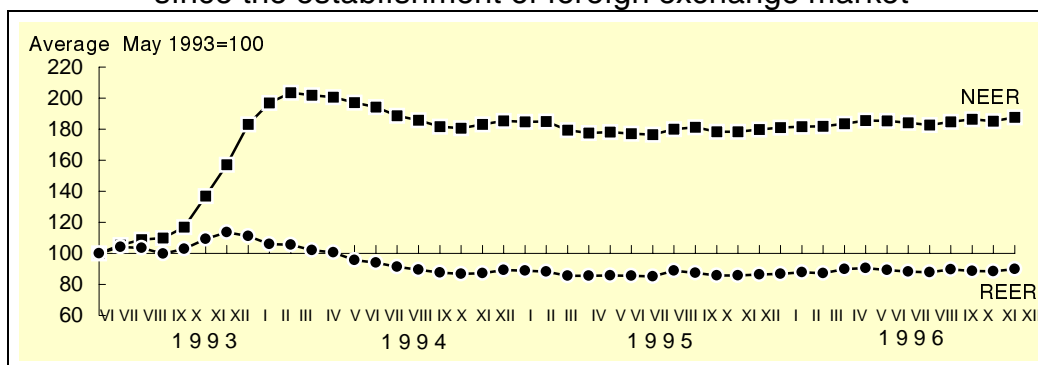
**Price competitiveness of Macedonian export  
based on real effective exchange rate index**

Indices	31.12.1993	31.12.1994	31.12.1995	31.12.1996	31.12.1996
	31.05.1993	31.12.1993	31.12.1994	31.12.1995	31.05.1993
1. Nominal effective exchange rate of Denar <sup>1)</sup>	183.01	101.34	96.97	104.36	187.68
2. Industrial producer prices in Macedonia	165.44	128.60	102.16	101.16	219.87
3. Foreign industrial producer prices	100.30	103.04	101.89	100.91	106.26
4. Relative prices (2/3*100)	164.95	124.80	100.27	100.25	206.92
5. Real effective exchange rate of Denar (1/4*100) <sup>2)</sup>	110.95	81.20	96.71	104.11	90.71

- 1) Nominal effective exchange rate of Denar calculated as a weighted average of monthly average exchange rate against US\$ and DEM
- 2) The real effective exchange rate index, as internationally accepted and used indicator for the reality of the exchange rate, is calculated as an averaged index of domestic currency movements against the currencies of the biggest trading partner countries, adjusted for the relative prices movements. For calculating the average rate, equal weights for USD and Deutsche mark are used. Real effective exchange rate index above 100 presents increase of price competitiveness, while index below 100 means a decline in price competitiveness.

Graph 17

**Nominal and real effective exchange rate movements  
since the establishment of foreign exchange market**



Despite the improvement in 1996, due to adverse movements in previous two years, price competitiveness of Macedonian export is still lower by 9.3% in comparison to the beginning of foreign exchange market functioning. Namely, 1994 and 1995 were years in which there was high foreign exchange supply on the foreign exchange market, from one side, and high rate of inflation as well as of industrial prices rise, from other side. In these circumstances, it was unreasonable to keep pace with the increase of domestic industrial producers prices, that only in January 1994 increased by 13.1%. Although in the remaining period of 1994 these prices remained relatively stable, real exchange rate in that year appreciated by 18.8%. The National Bank of the Republic of Macedonia often intervened by absorbing the excess of foreign exchange supply, and thus preventing the pressure towards higher price competitiveness loss (Graph 17). As a result of higher supply than demand for foreign exchange

on foreign exchange market (both for enterprises and individuals), during 1994 and 1995 international reserves were accumulated in amount of USD 44.4 million, and USD 54.3 million, respectively, while in 1996 total net inflow was USD 7.6 million.

## **7.4. Foreign exchange market and exchange offices market operation**

### **7.4.1. Foreign exchange market**

Total turnover on the foreign exchange market has had constantly increasing path, since the beginning of its functioning in May 1993, until the end of 1995. This trend was broken in 1996, when for the first time weak decline of the turnover was realized.

Total turnover on the foreign exchange market in 1996, in amount of USD 960.1 million, was lower than in 1995 by 2.4%. The first quarter turnover was USD 231.3 million, or by 6.8% higher than the turnover in first quarter of 1995. The tendency of turnover decrease was noticed in the following quarters of 1996: in the second quarter, total turnover was USD 230.4 million (8.5% lower than corresponding period in 1995); in the third quarter, total turnover was USD 227.8 million (5.6% lower), and in last quarter of 1996, total turnover of USD 270.7 million was realized (1.1% lower than in 1995).

Average monthly turnover on the foreign exchange market in 1996, was USD 80.0 million, with daily average of USD 3.8 million, whereas in 1995, the average monthly turnover was USD 82 million, with a daily average of USD 3.9 million.<sup>9</sup>

The trading among participants on the foreign exchange market was mainly between enterprises and banks - USD 621.5 million, or 64.7% of total trade. Direct trade between enterprises amounts to USD 307.5 million, or 32% of total trade, and only USD 31.1, or 3.2% of total, was trade between banks.

The National Bank of the Republic of Macedonia intervened on the foreign exchange market during the whole 1996, in order to maintain the stability of the exchange rate of Denar. Total interventions in 1996 amounted to USD 154.7 million, or 59.8% more than in 1995. Within this, USD 59.5 million were bought, and USD 95.2 million were sold, i.e. net sell of USD 35.7 million was achieved in 1996 (USD 24.4 million in 1995). Increased National Bank interventions by selling foreign exchange are a consequence of lower supply on the foreign exchange market, due to changed regional situation and decreased reexport revenues.

<sup>9</sup> Foreign reserves position and turnover is expressed in USD. Intervalutary changes between USD and Deutsche mark have contributed to realized movements. For example, average daily turnover expressed in DEM has increased from DEM 6.1 million in 1995 to DEM 6.9 in 1996.

### **7.4.2. Exchange offices market**

While banks and enterprises are main trading partners on the foreign exchange market, individuals can buy or sell foreign currencies on the exchange offices market. Main characteristic of this market is constantly higher supply than demand of foreign currencies, that made it the most important source of international reserves.

Total turnover realized on the exchange offices market in 1996 was USD 332.1 million, or 6.9% higher than in 1995. In 1996, USD 212.1 million were bought, and USD 120.0 million were sold, giving net amount of USD 92.1 bought on the exchange offices market. Comparing to 1995, demand for foreign currencies was higher. Namely, amount of foreign currencies purchased from citizens was reduced by 1.9%, while foreign currencies sell to citizens increased by 27.3%, resulting in lower net purchase for USD 29.8 million, or for 24.5%.

The biggest part of exchange offices turnover (89.3%) was realized through exchange offices that work in their name and for their own account. The rest of 10.7% was realized through exchange offices that work in their name, and for account of the Central bank. In 1995, distribution between these two groups was 72.5% and 27.5%, respectively. However, net purchase of foreign exchange from exchange offices working for account of the Central bank has declined from USD 72 million, in 1995, to USD 21.0 million in 1996. Main reason for this decline is fallen interest of the exchange offices to work for account of the Central bank, due to following reasons: extended costs for setting up protection systems, and an obligation for providing insurance guarantee for advances used from the Central bank for purchasing foreign exchange. In addition, exchange rates set up by independent exchange offices were constantly higher (although not for significant percent) than the National Bank exchange rates, which redirected exchange offices work towards independent operation.

Out of total net inflow from exchange offices of USD 92.1 million, USD 43.3 million (or 47%) was transferred to the international reserves of the National Bank, while the rest of USD 48.8 million (or 53%) increased foreign exchange assets of the commercial banks. Comparing to 1995, inflow of net National Bank of the Republic of Macedonia international reserves is reduced by USD 36.2 million (or by 45%), while net inflow to commercial banks foreign assets is increased by USD 6.4 million, or by 15.1%.

## **7.5 External medium and long-term debt of the Republic of Macedonia**

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The external debt position of the Republic of Macedonia, as shown in this report, includes data for principal and due but unpaid interest according to the evidence of the National Bank. Also, an estimation is made for capitalized

interest on due, but unpaid liabilities to creditors with which mutual relations are not settled yet (mainly some countries from Paris club of creditors, with which bilateral agreement for debt rescheduling is not signed yet). In addition, an assessment is made for this category of creditors for the part of an unallocated debt of former SFR Yugoslavia that belongs to the Republic of Macedonia, in accordance with IMF criteria for Macedonian participation in total debt of 5.4% .

The external debt to London club of creditors was assessed and shown in accordance to the agreement reached in October 1996, while definite data were known at the end of March 1997, when old credits were exchanged for bonds issued by the Republic of Macedonia.

The stock of external medium and long-term debt of the Republic of Macedonia at the end of 1996 was USD 1,172.4 million, of which USD 1,138.2 refers to liabilities on the basis of principal (in which USD 23.6 million is due unpaid principal), USD 21.3 is due but unpaid regular interest, and USD 12.9 million is assessed capitalized interest.<sup>10</sup>

Total due but unpaid liabilities to abroad at the end of 1996 were USD 57.8 million, of which USD 32.3 million, or 55.7% refer to unpaid liabilities to European Investment Bank. Another USD 11.2 million, or 19.4%, are unpaid liabilities to member countries of Paris club of creditors, with which Republic of Macedonia has not signed a bilateral agreement, or there is an agreement but certain credits are not included because they are used through banks from former Yugoslav republics. Additional USD 14.3 million, or 24.7%, are due but unpaid liabilities to other private creditors, for credits signed before March 30, 1992.

In accordance with the agreed Minute on consolidation of the debt of Republic of Macedonia with official bilateral creditors - members of Paris club, from June 17, 1995, bilateral agreements have been reached with five countries in 1996: Great Britain, Sweden, Denmark, France and Spain. At the end of 1995, agreements have been signed with Germany, Swiss, and Austria. Thus, bilateral agreements for debt rescheduling are already signed with eight countries, out of thirteen that signed the Minute from June 1995. Data adjustment operations have also been done in 1996 with USA, Holland, Italy and Japan, while an agreement with Kuwait was signed in January 1997.

In addition, due but unpaid debt to EUROFIMA was settled, as well as a debt to European fund for reintegration, or Council of Europe Fund for Social Development (CEF). In general, it was agreed due but unpaid liabilities to EUROFIMA on the basis of principal in amount of USD 16.9 million to be rescheduled on 7.5 years, with 5 years grace period and market interest rates. The repayment should start in 2001 year, and end in September, 2003. Due regular interest and penalty interest, in total amount of USD 4.9 million, should be repaid in three annual installments, beginning 1997.

<sup>10</sup> According to international standards, the net present value of the debt comprises total liabilities on the basis of principal, and due unpaid liabilities on the basis of interest and penalty interest that is capitalized.

A general agreement was signed with CEF, prescribing due but unpaid liabilities (principal and interest) to be paid in period of 6 years. Due but unpaid interest in amount of USD 1.6 million will be paid in 3 years, beginning December 1996, and ending August 1999. Due principal in amount of USD 4.1 million will be paid in period of 6 years, with 3.5 years grace period, i.e. beginning February 2000 and ending August 2002. The reprogrammed credits will be repaid without interest.

### **7.5.1. Realized movements in 1996**

External debt stock at the end of 1996 was reduced by USD 265 million in comparison with end of 1995 position. This is mainly result of a reduction of London club credits from USD 603 million to USD 281 million, i.e. by USD 322 million. Former position of London club of creditors debt comprises total amount of credits used by final users from the Republic of Macedonia, including due but unpaid regular and penalty interest, and part of an unallocated debt to these creditors. New (latter) position of the debt to these creditors<sup>11</sup> is presented in accordance with the agreement from October 1996, when it was stated that Republic of Macedonia is going to undertake 5.4% of an unallocated debt of former SFRY on the basis of principal, and 3.65% on the basis of due but unpaid interest.

The external debt stock on December 31, 1996 also includes credits used in 1996, in total amount of USD 127.2 million (comprising IMF credits and USD 3.3 million other credits). On the basis of approved Stand By Arrangement from IMF in 1995, in amount of USD 33 million (SDR 22.3 million), last two tranches were disbursed in 1996, in amount of USD 14.3 million.

From the World Bank, USD 46.1 million were disbursed in 1996, of which USD 2.0 million on the basis of Road Network Construction Project approved in 1995 in amount of USD 24 million. Additional USD 2.0 million remain to be disbursed from this credit. On the basis of credit for Social Reform approved in 1995 from IDA in amount of USD 14 million (SDR 9.0 million), USD 3.4 million were disbursed in 1996, and USD 8.8 million have to be withdrawn in next period. In addition, remaining part of the first tranche of FESAK credit was disbursed in January 1996, in amount of USD 1.3 million. Second tranche in amount of USD 39.4 million (SDR 27.4 million) was disbursed in October 1996.

Total funds of USD 54.0 million were disbursed in 1996 from credits granted by the European Bank for Reconstruction and Development (EBRD), for following projects:

- energy sector project, in amount of USD 11.9 million (SDR 17.6 million). This credit was approved in 1994 in amount of USD 31.0 million. So far, USD 17.6 million have been used, and USD 13.4 remain to be used under this credit line;

<sup>11</sup> The definite amount was agreed on the day of exchange at the end of May 1997, in amount of USD 228.7 million.

- for improving the system of flying control, USD 2.2 were disbursed. This credit was also approved in 1994 in amount of USD 14.05 million, of which until the end of 1996 USD 2.6 were used;

- for postal and telecommunications system, USD 23.4 million were used in 1996, from a credit line approved in 1995 in amount of USD 42.55 million;

- for Skopje Airport, USD 5.5 were disbursed in 1996 from a credit line approved in 1995 in amount of USD 11.9 million. Until the end of 1996, USD 5.6 million have been used from this credit;

-for a project for development of small and medium enterprises, USD 11.1 million were disbursed in 1996. This credit was approved in 1995, in two tranches of USD 20 million and USD 6.7 million, and the disbursement of funds started in May 1996, through four commercial banks authorized for using funds under this credit line.

In 1996, bilateral credits were used in amount of USD 8.0 million for import of equipment for Electroindustry of Macedonia, USD 1.5 million credit from EUROFIMA for Macedonian railways, and USD 3.3 million from other private creditors.

Macedonian external debt was reduced in 1996 on the basis of repayments of principal, in total amount of USD 48.3 million, while interest paid was USD 32.8 million. The level of indebtedness of the Republic of Macedonia (as ratio between total repayments of principal and interest on foreign credits, and export of goods and services) in 1996 is 12.3%. According to international standards, Republic of Macedonia belongs to a group of mid-indebted countries. However, the level of international reserves of the country is not enough for servicing the external debt without necessary financial support from abroad.

In that sense, it is very important the usage of foreign funds to be redirected from infrastructure to productive projects, in order to renew and improve the technological modernization, and to rise production and export. Low level of direct investments imposed the need all foreign debt burden to be undertaken by enterprises that have foreign exchange inflows.

#### **7.5.2. External debt structure by creditors**

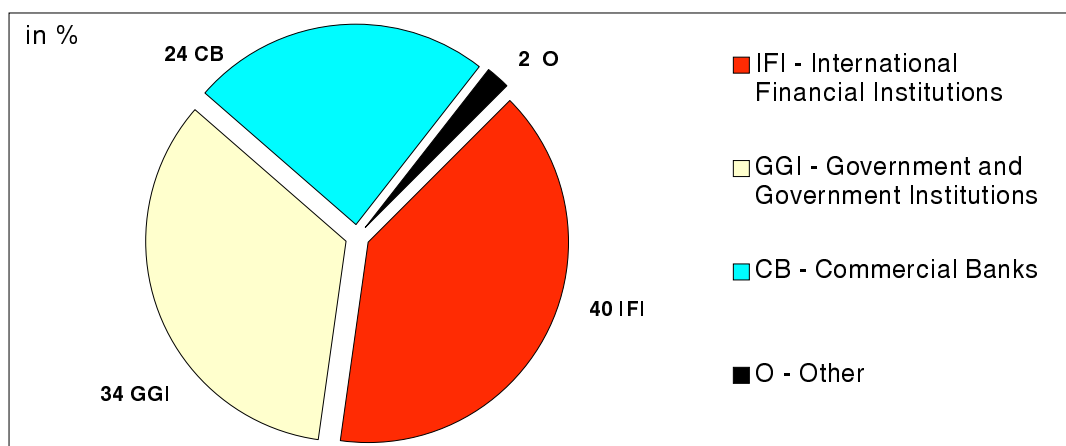
External debt structure by creditors is presented in accordance to the institutional foundation, where global division is made between official and private creditors. Official creditors participate with 74% in total external debt, and remaining 26% is debt to private creditors. Official creditors comprise multilateral creditors (or international financial organizations), and bilateral creditors (or foreign countries governments and government agencies). The biggest part of bilateral creditors is so called Paris club, whose task is to negotiate the mutual terms of debt rescheduling and refinancing. Private

creditors comprise private commercial banks, or so called Zurich club, later named as London club, with which former SFRY has reached a refinancing agreement in 1988. Private creditors also include other private commercial banks and foreign firms.

Total debt of the Republic of Macedonia to multilateral creditors was USD 464.7 million, to bilateral creditors USD 402.3 million and to private creditors USD 305.3 million (of which USD 281 million to London club).

Graph 18

Structure of the medium and long-term debt  
of the Republic of Macedonia on December 31, 1996



In total debt to bilateral creditors in amount of USD 402.3 million, debt to Paris club for which Republic of Macedonia has signed an Agreement (June 17, 1995) for debt consolidation, amounts to USD 324.7 million. Another USD 62.9 million debt to Paris club creditors, which refers to previously reprogrammed liabilities by former SFRY that mature in July 1996, and regular liabilities that are not going to be reprogrammed, is not consolidated. Bilateral debt includes new credits in amount of USD 14.8 million.

The biggest part of external debt to Paris club of creditors refers to debt to Germany (29.6%), USA (29.2%), France (9.9%), Kuwait (8.4%), Italy (6.4%), Switzerland (5.0%). About 88,5% of total debt to Paris club creditors belongs to these countries.

Due but unpaid liabilities to this group of creditors at the end of 1996 stood at USD 7.5 million, and due but unpaid interest was USD 2.1 million. These liabilities refer to credits where main debtor are banks from former Yugoslav countries, and regular liabilities that mature after cut-off date, to countries with which there is still no agreement for debt rescheduling. A penalty interest has been calculated on these liabilities in amount of USD 1.6 million.

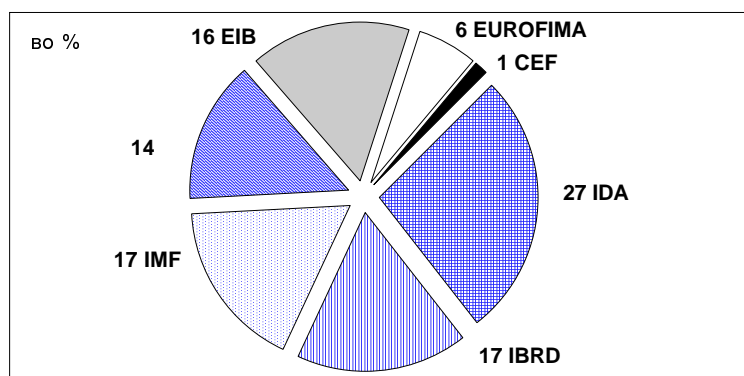
According to the global agreement from October 1996, total debt to commercial banks (London club) was assessed at USD 281 million. The definite

amount of USD 228.7 million was agreed on March 1997, when old credit records were exchanged for bonds issued by the Republic of Macedonia. These bonds mature in 15 years with 4 years grace period and LIBOR interest rate plus 0.8125 percentage points. The installments will be semiannual and progressive, that is from 1.5% in the first year, to 9% in the last years. A part of interest is going to be capitalized in first four years, and a part (3.5% and 3.75%) is going to be paid starting from January 1, 1998.

In the group of multilateral creditors, the biggest participation has a debt to International Development Association (IDA) with USD 124.8 million; International Bank for Reconstruction and Development (IBRD) with USD 81.0 million; International Monetary Fund (IMF) with USD 80.2 million, European Investment Bank (EIB) with USD 76.3 million, European Bank for Reconstruction and Development (EBRD) with USD 65.9 million, EUROFIMA with USD 28.7 million; European Council Fund (CEF) with USD 6.1 million and International Financial Corporation (IFC) with USD 1.6 million.

Graph 19

Structure of the medium and long-term debt to international financial institutions



Credit liabilities to multilateral creditors are repaid regularly, but there is still unregulated due, but unpaid debt to European Investment Bank in amount of USD 32.3 million. In the process of negotiations with European Union, an appropriate solution is expected to be found for Macedonian debt to EIB.