THE IMPACT OF THE CRISIS ON THE BALANCE OF PAYMENTS - THE CASE OF MACEDONIA (WHEN VULNERABILITIES COME TO THE FORE)[1]

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I. Introduction

After a period of relative improvement of its external position, the outbreak of the economic crisis brought new worries for the Macedonian economy and acted as a harsh reminder of the vulnerabilities existing in this sector. The booming phase of the business cycle meant increased financial inflows into the economy, but the trade balance remained in the negative area despite the increase in the country's exports. The main reason for this imbalance is found in the increased import demand, induced by the additional exports, the increased foreign direct investments, as well as the rising domestic demand pressures.

The current crisis deteriorated this balance additionally, as the data from the first quarter of 2009 show. Namely, the exports fell faster than the imports and both the foreign investments and private transfers slowed down dramatically. Albeit the second quarter data indicate certain shift in the trends, still the overall outlook remains weak. This paper portrays the situation in the external sector of the Macedonian economy prior to and during the crisis and tries to identify the main vulnerabilities that caused the deterioration in the external accounts of the country. At the end, the current expectations about the future developments are given, and an attempt is made to derive conclusions about the possible further steps that could help avoid the sensitivity of the economy to similar shocks in the future.

II. The External Profile of the Economy Over the Years

After the collapse of former Yugoslavia, the Macedonian economy entered a difficult period of adjustment to the new reality. The economy, developed as a complementary part of a larger economy, was now left to struggle to survive in an entirely different environment. The wars that occurred in the region in the 1990s complicated the situation further. The traditional markets were now not only separated with borders, but completely lost, as the traffic connections were cut and the businesses in these countries were closed or operating under conditions of war. To make things even worse, the embargos imposed by the United Nations on Serbia and by Republic of Greece on Macedonia devastated the international position of the Macedonian businesses, as the capacity of the traffic connections with

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Bulgaria and Albania, the remaining neighbors of the country, is insufficient and offers very limited opportunities.

In such a situation the GDP of the country was dropping year-by-year, reaching its bottom in 1995, when the GDP per head was only 76% of its 1990 level. The foreign trade was marked by large and increasing current account deficits, a trend that was slightly changed at the end of the decade as a result of the increased export of services (mostly construction). These deficits were somewhat alleviated by the increasing private transfers, mostly from remittances, which started to increase concurrently with the rise of the confidence in the national currency and the banking system.

Current account of the balance of payments (1993-2000) in millions USD

	1993	1994	1995	1996	1997	1998	1999	2000
CURRENT ACCOUNT	**-82,5**	**-262,9**	**-298,9**	**-339,8**	**-286,6**	**-278,8**	**-65,3**	**-97,6**
Goods, net	42,8	-184,9	-222,8	-314,7	-386,3	-515,6	-495,9	-690,8
Services, net	-154,5	-155,1	-200,5	-156,2	-137,8	-59,8	38,9	48,7
Income, net	-56,7	-46,6	-39,6	-51,3	-54,5	-52,3	-71,8	-64,5
Current transfers, net	85,8	123,7	163,9	182,3	292,0	348,9	463,6	609,0

Source: National Bank of the Republic of Macedonia

In the same period, the economy was undergoing a process of privatization. Despite the expected inflow of foreign capital in the form of FDI during this period, most of the companies were bought by domestic citizens and company insiders. This is a result of the lack of interest by foreign investors, mostly due to the uncertain environment, the small domestic market and the low purchasing power of the population. The chosen method of privatization could also have contributed to this outcome.

In such a situation, the only available means of financing of the current account deficit were the loans from the World Bank and the IMF. The country underwent several restructuring programs in collaboration with the IMF and all the time it was under the pressure of fulfilling the stringent requirements of these loans. This process had its positive, as well as negative impacts. On one hand, it brought about a fiscal and monetary discipline, helped in overcoming inflation and stabilized the currency. On the other hand, it enforced a process of rapid privatization, often accompanied by misdemeanors and limited the potential for growth. In terms of the balance of payments, these borrowings were the most significant item in the capital and financial accounts. The only exception are the years 1998 and 2000, when a more significant inflow from FDI was received and both these higher one-off figures are the result of the several large privatizations (e.g. the National Telecom).

Capital and financial account of the balance of payments (1993-2000) in millions USD

	1993	1994	1995	1996	1997	1998	1999	2000
CAPITAL AND FINANCIAL ACCOUNT	**-12,9**	**162,3**	**280,6**	**318,2**	**349,6**	**296,3**	**-91,4**	**40,2**
Capital Account, net	**0,0**	**30,0**	**1,7**	**0,0**	**0,0**	**-1,8**	**0,0**	**0,3**
Financial Account, net	**-12,9**	**132,3**	**278,9**	**318,2**	**349,6**	**298,1**	**-91,4**	**39,9**
Direct investment, net	0,0	24,0	9,5	11,2	58,0	150,5	88,1	215,7
Portfolio investment, net	0,0	0,0	2,7	0,3	1,3	0,0	0,0	-0,1
Other investment, net	44,0	150,2	367,4	300,8	294,1	200,9	-36,2	88,8
Gross official reserves (- = increase)	-56,8	-41,9	-100,6	5,9	-3,8	-53,3	-143,3	-264,5

Source: National Bank of the Republic of Macedonia

The basic features of the external profile of the economy of Macedonia in this period can be summarized as follows:

- Persistently wide trade deficits;
- Export of low value added products with raw materials accounting for 51,5% of the total exports;
- Low private transfers in the beginning of 1990s, but increasing steadily later;
- Small impact of FDIs;
- Deficits financed mostly by borrowing (IMF, World Bank).

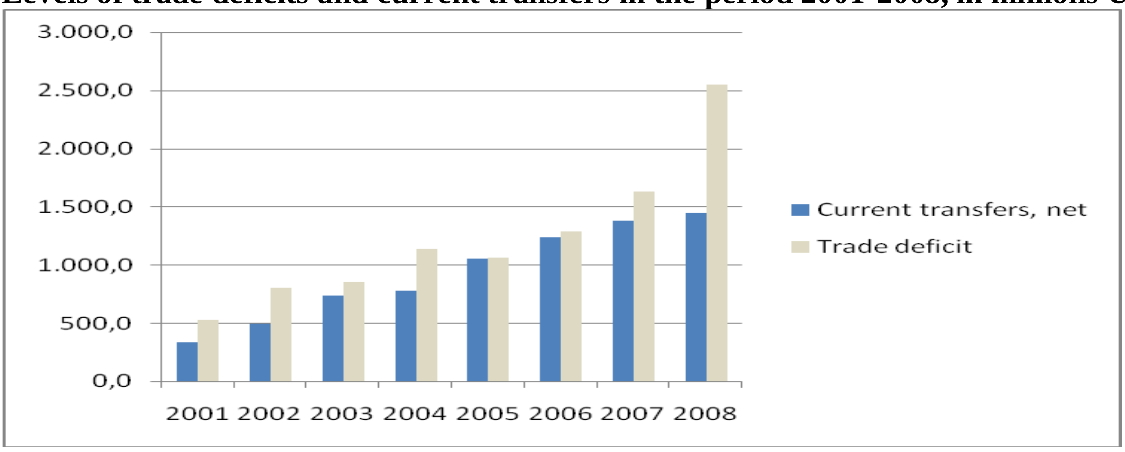
III. The External Profile of the Economy, Prior to the Crisis

The BoP situation changed somewhat during the last decade. Namely, in the beginning of the new millennium, a number of industrial plants which were hibernating in the 1990s, were restarted. Also, with the increase in the international demand for metals, especially iron, steel and copper, several mines have been bought out by foreign investors and restarted in 2003 and 2004. This brought about higher and steadier positive rates of GDP growth, but also created problems with the energy supply, an issue which was almost forgotten during the 1990s. The electricity production capacities of the country were sufficient when the economy was operating far below full capacity utilization, but the energy shortages re-emerged in the early stages of the economic recovery. In terms of the BoP, this caused huge financial outflows to pay for the energy imported.

On the other hand, the restarting of the mines and the accompanying metallurgy had a positive impact on the export side of the current account. This impact has been strengthened by the increase in the world metal prices, so that the value of the Macedonian exports in 2008 was twice its value in 2004. However, this could not help in diminishing the current account deficit, which more than doubled in the same period, because of the fact that the Macedonian exports are import dependent to a very large extent.

Another benefit from the booming world economy before the crisis is represented by the increase in the amount of current transfers, and especially their major component, the private transfers. Yet, it mostly refers to increased inflows through cash exchange, which mirrors the "money under the mattresses" attracted to the system by the rising confidence and yields, some "shadow economy" receipts, such as the amounts for exported goods received in cash, as well as "pure" remittances in cash. In 2005 and 2006 the amount of these transfers almost covered the trade gap.

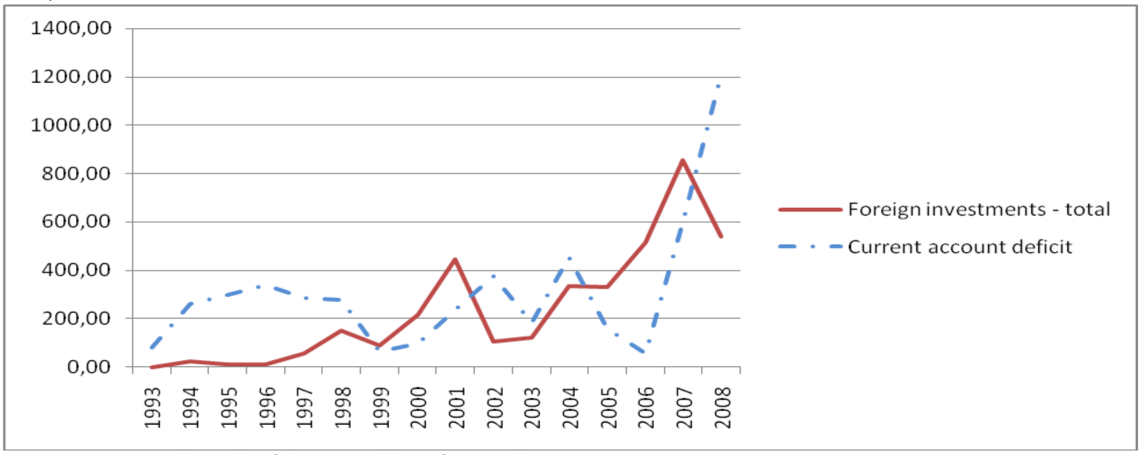
Levels of trade deficits and current transfers in the period 2001-2008, in millions US$



Source: National Bank of the Republic of Macedonia

In the capital and financial account, a major change in this period is represented by the increased share of FDI and portfolio investments. The inflows from these two categories in the period between 2004 and 2007 notably outweigh the corresponding amounts from the previous years. This has alleviated the pressure on the government for borrowing to cover the current account deficits. In some periods, the amounts of FDI and portfolio investments together were sufficient to serve this purpose. The change in the relationship between these two categories can easily be observed from the following chart.

Levels of current account deficits and foreign investments over the years, in millions US$



Source: National Bank of the Republic of Macedonia

These favorable conditions in the country's foreign trade and financial relationships led to a significant improvement in the BoP position. The current account deficit's share in the GDP dropped from 8,4% in 2004 to 2,6% in 2005 and almost leveled out at 0,9% of GDP in 2006. Another positive consequence of this economic environment is the significant increase in the level of gross foreign exchange reserves. They have increased from 723 millions EUR in 2003 to 1.524 millions EUR at the end of 2007, accounting for a 4,4 month coverage of the country's imports.

IV. The Global Crisis – Strong Impact in a Small and Open Economy

Although trade linkages with the rest of the world are quite strong, the financial ones are still being pale, which is why initially it was thought that the global financial crisis will not be translated strongly to the domestic economy. Yet, as the global financial crisis evolved into a "great recession", it was obvious that the consequences can not be circumvented . The crisis pass-trough to the domestic external sector went through the trade, financial, and the expectations channel, as well.

The impact of the recession on the real sector of the domestic economy was felt with a certain time lag after the larger economies - the country's most important trade partners - declared recession. After the sharp slowdown in growth in the last quarter of 2008, in the first quarter of 2009, the rate of GDP growth was negative for the first time (-0,9%), while in the following quarter it deepened to -1,4%. It became evident through the drop in orders for consumer and intermediary goods, the sharp fall in the prices of metals, etc. The first layoffs began in the last months of 2008 and they were felt in the mining sector, metallurgy and the textile industry.

On the other hand, the banking sector showed a respectable resistance to the pressures. Fortunately, most of the assets of the Macedonian banks are in the form of loans to domestic clients and most of their funding comes from savings deposits of our residents. Therefore, the foreign exposure of the domestic banks is quite low, so that the impact of the crisis on them came mostly through the real sector, i.e. the withdrawal of deposits, conversion of domestic to foreign currency deposits, worsened quality of their credit portfolio, etc.

The balance of payments brought the first statistical evidence of the impact of the recession. The quarterly data for 2008 show a sharp deterioration in most of the BoP items as the year was approaching its end. This tendency continued in the first quarter of 2009. The exports decreased both in value and volume terms, because most of the previous orders for the textile industry were canceled by the buyers, predominantly from Western Europe, the demand for metals dropped sharply, while the prices of the metals also fell significantly. As the exports of metals and textile account for more than a half of the Macedonian exports, it is not surprising that this led to an increase in the trade deficit by 60% compared to its level one year before. The private transfers (remittances) also fell, mirroring deteriorated expectations.

In the financial and capital account, the changes are also obvious. The FDI began to fall and many announced projects were delayed or canceled. The portfolio investments turned negative in 2008, i.e. there was a net-outflow as the foreign portfolio investors withdrew from the Macedonian Stock Exchange.[4]

All of this deteriorated the BoP position as a large current account deficit was recorded for 2008 and the beginning of 2009 was even more dramatic. The worsened external position had its impact in the domestic economy as the level of confidence in the domestic currency and the domestic banks increased and a pressure on the banks and the domestic currency was felt. The National Bank responded decisively and did not let the panic to spread around. In order to prevent the additional leakage of the FX reserves, it undertook measures, such as:

- increased reference interest rate from 7% to 9%;
- increased level of compulsory reserve requirements.

Both these measures were aimed at the reduction of the domestic demand, additionally spurred by the increased budget deficit. Although these measures presumed a possible sacrifice of growth to a certain extent, the costs of destabilizing the exchange rate were estimated to highly outweigh the benefits of such a measure.[5]

[4] This period is also marked with an intensified outflow of portfolio investments by the newly created pension and investment funds investing abroad.

[5] The research has shown that the elasticity of the Macedonian exports with respect to price is negligible, so that any devaluation would not improve the competitiveness of the Macedonian export sector. See: Kadievska-Vojnovic, Unevska (2007).

Balance of Payments of Republic of Macedonia for the period 2003 - second quarter of 2009, in EUR millions

	2003	2004	2005	2006	2007	*Q1-2008*	*Q2-2008*	*Q3-2008*	*Q4-2008*	2008	*Q1-2009*	*Q2-2009*	Q1-2/2009
I. CURRENT ACCOUNT	**-168**	**-363**	**-121**	**-45**	**-415**	**-173**	**-210**	**-67**	**-401**	**-851**	**-329**	**-106**	**-435**
Goods, net	**-753**	**-914**	**-858**	**-1.020**	**-1.175**	**-371**	**-460**	**-416**	**-489**	**-1.737**	**-444**	**-333**	**-777**
Exports, f.o.b.	1.203	1.345	1.643	1.903	2.441	612	736	745	592	2.684	400	491	891
Imports, f.o.b.	-1.956	-2.259	-2.501	-2.923	-3.616	-983	-1.196	-1.161	-1.081	-4.421	-844	-824	-1.668
Services, net	**-6**	**-43**	**-25**	**22**	**26**	**-1**	**-9**	**28**	**-19**	**0**	**-2**	**-2**	**-5**
Income, net	**-55**	**-33**	**-92**	**-28**	**-278**	**23**	**0**	**-14**	**-102**	**-93**	**-12**	**-31**	**-44**
Current transfers, net	**646**	**628**	**853**	**982**	**1.012**	**176**	**259**	**335**	**209**	**979**	**129**	**261**	**390**
Official	89	55	53	59	24	8	22	11	8	48	10	13	23
Private	557	573	800	923	988	168	238	324	201	931	119	248	367
II. CAPITAL AND FINANCIAL ACCOUNT	**194**	**347**	**128**	**38**	**448**	**185**	**220**	**58**	**391**	**853**	**312**	**124**	**436**
Capital Account, net	**-6**	**-4**	**-2**	**-1**	**4**	**-1**	**-3**	**-1**	**-9**	**-13**	**1**	**2**	**3**
Financial Account, net	**200**	**351**	**129**	**39**	**444**	**186**	**222**	**58**	**399**	**865**	**311**	**123**	**434**
Direct investment, net	100	260	75	345	507	130	128	90	74	422	40	69	109
Portfolio investment, net	5	9	200	73	114	-8	-11	-8	-23	-51	-19	-12	-32
Other investment, net	133	98	202	-81	-76	56	129	104	154	442	38	13	51
Trade credits, net	67	71	106	3	-29	-15	63	-12	-12	25	55	0	55
Loans, net	50	6	100	-22	-129	-2	48	60	66	172	-5	-3	-8
Currency and deposits, net	6	-2	-20	-84	6	61	8	52	87	207	-22	6	-16
Monetary authorities, net	15	23	0	-6	0	11	6	0	-1	16	-4	1	-3
Commercial banks, net	-45	-84	22	-10	68	47	9	41	137	235	-56	1	-55
Individuals, net	35	59	-43	-68	-62	3	-7	11	-50	-43	38	4	41
Other, net	10	23	16	22	76	11	10	5	12	38	10	11	21
Gross official reserves (- = increase)	-39	-16	-348	-298	-102	8	-24	-128	195	52	253	52	305

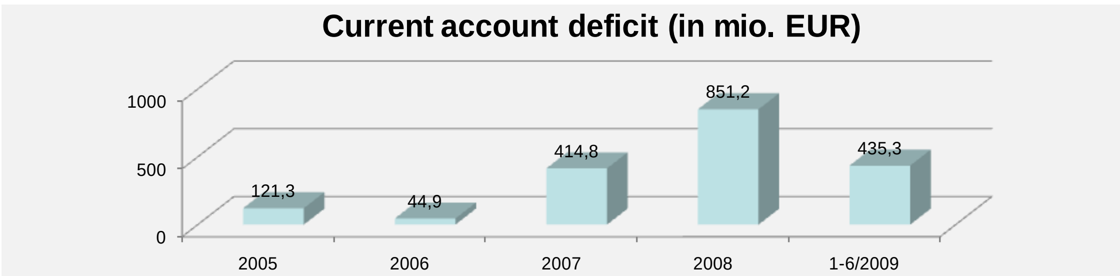
Source: National Bank of the Republic of Macedonia

The current account deficit doubled in 2008 compared to 2007, a level that remained in the first half of 2009 on a semiannual basis. The reduction in the foreign investments and the withdrawal of the portfolio investors caused a pressure on the foreign currency reserves. In 2008 the banks had to withdraw some of their foreign assets in order to defend their liquidity. In the first quarter of 2009, the same burden fell on the foreign reserves. The National Bank had to intervene with about 250 million EUR, which led to a sharp decline of the country's foreign currency reserves from about 1,5 to 1,25 billion EUR in a period of 3 months. This action was defended on the grounds that the exchange rate should remain stable.

Therefore, the five main channels of transmission of the recession from abroad can be identified as:

- The sharp fall of metal prices, prior to the peak of the crisis, imposed deterioration of the terms of trade;
- As foreign demand is shrinking the volume of the domestic export started to fall;
- The confidence factor has further suppressed the flows through private transfers;
- Though no "sudden stop" syndrome was observed, capital flows slowed down significantly;
- The risk perceptions of the banks yielded in accumulation of foreign assets, which created further pressures on the gross foreign reserves of the central bank.

Movements in the Country's BoP Positions During the Latest Business Cycle



- **Trade deficit ↓** (increased exports and metal prices)
- Private transfers ↑
- FDI ↑
- Portfolio investments ↑

- FDI and PI finance the CA deficit

- **Trade deficit ↑** (induced by FDI and energy demand)
- Income balance ↓
- Private transfers ↑
- FDI ↑
- Portfolio investments ↑

- FDI and PI finance the CA deficit

- **Trade deficit ↑↑** (induced by FDI and personal consumption)
- Income balance ↓
- Private transfers ↓
- FDI ↓
- Portfolio investments ↓ (-)
- FDI and PI insufficient

- Banks withdraw FX assets
- FX reserves suffer

V. What are the current expectations?

In the middle of the crisis, it is very hard to tell how far the BoP troubles are going to reach. The initial projections about the expected current account deficit have been revised twice: first downward and than upwards. The first quarter's results brought a lot of pessimism, but the picture got improved in the second.

The highest perceived risk was related to the maintenance of the stability of the exchange rate. Still, after the rapid drop in the FX reserves, their level was stabilized and brought back to the amount from the beginning of the year. This was done through an issuance of Eurobonds, which provided an inflow of 175 million EUR into the country and by the SDR allocation equal to about 60 million EUR. The private transfers also recovered from the previous lows.

After the first quarter, the expectations were that the annual current account deficit will reach 13% of the GDP. Yet the second quarter data showed for the imports to adjust much more strongly and expectations to be stabilized, yielding in downward revision of the current account gap to around 10%. Yet, this is still much higher than the levels from 2006 (-0,9%) or 2007 (7,2%), but better than the 13,1% from 2008, and the outlook remains quite uncertain. .

However, it must be mentioned that there were certain facilitating factors that prevented the occurrence of bigger problems. First, there were no huge imbalances before the crisis. Compared to other countries in the region, the BoP deficits were at moderate levels. Second, the economy was not in the "overheated" phase, i.e. the rates of growth in the previous years were lower than in other countries and no large output gap was created. Third, the level of indebtedness of the country was moderate, so that the debt repayments do not generate an unbearable burden. Also, the lower level of foreign investments in the years before the crisis made the impact of their reduction more easily manageable.

Before the crisis, a part of the current account deficit was attributed to the import induced by the increased foreign investments in the country. The FDI led model assumed that these deficits will be reduced once the impact of the FDI is felt on the supply (export) side. Now, these views have been changed since the future is clouded with more uncertainty. It is believed that the exports will recover with a significant time lag after the recovery of the major economies. Also, the structure of the recent FDIs is quite unfavorable. Most of these investments were in the fields of banking and telecommunications. These industries will certainly not lead directly to an increase in exports.

Again, we come to the same conclusion that the problem with the external position of the Republic of Macedonia is structural. It will be necessary to change the structure of the economy toward greater participation of export oriented sectors, production of higher value-added products, as well as through a greater diversification of the structure of exports. In this context, the entrance of new FDI 's that will facilitate the abovementioned processes is of a key significance, thus reducing the vulnerability to similar shocks in the future.

VI. Conclusion

The BoP position of the Republic of Macedonia is a textbook example of the reflection of the stages of a business cycle on the external sector of a small and open economy. The upswing and peak stages of the cycle were reflected in the increased amounts of FDIs and private transfers flowing into the country, the import induced by these investments and the higher personal and government consumption, as well as in the peak of the portfolio investments. The early signs of the recession were first felt by the reduction in exports and FDIs and the withdrawal of the foreign portfolio investors. After the initial shock in the current account, the deficit is beginning to take moderate levels as the import demand is slowing down.

The major risk caused by these movements is the one related to the maintenance of the exchange rate at the fixed level. Although one may assume that the exchange rate adjustment is a proper tool to solve part of the large trade gap and alleviate BoP pressures, yet this is not straightforward. The cost-benefit analysis strongly suggests that any change in the exchange rate will pose much of a harm, than a benefit. This is particularly being supported by the previous research, which revealed the price elasticity of the Macedonian exports to be very low. Also, no study has found the exchange rate to be misaligned with the fundamentals, up to now, thus pinpointing the problem of structural, rather than price competiveness as an issue.

The expectations are that the recovery in the BoP positions will not be fast and easy. Having in mind the structure of the Macedonian exports, one could reasonably expect that the impact of the higher world demand for metals will impact their prices and the value of the Macedonian exports of metals with a significant time lag. This creates an obligation for the Government to consider this issue with higher urgency and propose measures for restructuring the trade balance of the country which would help diminish this kind of vulnerabilities for the future.

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