

Ljube Trpeski: Goals and objectives of the monetary policy for the year 2001

Address by Ljube Trpeski, Governor of the National Bank of the Republic of Macedonia to the Parliament of the Republic of Macedonia on 6 February 2001.

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Honorable,

According to Article 3 of the National Bank of the Republic of Macedonia Act, the Central Bank is responsible for the stability of the domestic currency, the monetary policy and the overall domestic and international payments liquidity in the Republic of Macedonia. Furthermore, the National Bank, within its rights and duties, is responsible for providing and preserving sound banking system of the Republic of Macedonia. Given such defined legal duties and taking into account achievements in this area, it may be concluded that in 2000 the National Bank of the Republic of Macedonia, acting in compliance with the given rights, accomplished its legal duties.

Stability of the domestic currency

The stability of the domestic currency may be observed from two aspects:

- Stability of the internal value of the Denar. It is expressed through its purchasing power, i.e. the price stability in the Republic of Macedonia; and
- Stability of the external value of the Denar. It is expressed through the stability of the exchange rate of the Denar, i.e. its preservation at adequate level against other currencies.

The preservation of the *price stability* is the primary objective of the monetary policy of the National Bank of the Republic of Macedonia. In 2000, relative price stability was achieved and the inflation rate on annual basis (December 2000 / December 1999), measured through the retail prices index equals 10.8%. Measured through the costs of living index, as agreed with the IMF arrangement, the inflation in 2000 equaled 6.1%. In 2000, compared to the previous several years, the inflation is higher, however it should be underlined that the reason for that is not the monetary policy, but the impact of the non-monetary factors.

These factors are the following:

- one-time effect of the introduction of the value-added tax on prices;
- increase in the price of oil on the world markets, accompanied with the appreciation of the US Dollar;
- increase in the price of electricity and maintaining higher tariff for calculation of the price of the electricity;
- increase in the prices of particular services which are under direct control of the government

However, it is crucial that the potential fundamental generators of inflation such as the monetary policy, the fiscal policy, the exchange rate and the wages remained under control and coordination. Therefore, the Central Bank considers that the impact of the non-monetary factors that gave rise to the inflation in 2000 are of temporary character and that in 2001 the inflation will get back to the level from the previous several years. Thus, measured according to the costs of living index, the annual rate of inflation in 2001 on December basis (December 2001 / December 2000) is projected to equal 1.2%. In that sense, the National Bank of the Republic of Macedonia will continue with its intention to preserve that inflation rate to low, stable and predictable level, which is in compliance with the empirically confirmed knowledge that the price stability creates the most favorable macroeconomic environment for accelerated, long-term sustainable economic growth.

The second aspect of the domestic currency stability is preserving the *stability of the Denar exchange rate*. The National Bank of the Republic of Macedonia managed to preserve the nominal exchange rate of the Denar against the Deutsche Mark at the targeted level of Denar 31 per 1 Deutsche Mark. The exchange rate stability was preserved, despite the developments on the foreign exchange market, where the supply significantly exceeded the demand for foreign currency. As a result, the National Bank of the Republic of Macedonia intervened on the foreign exchange market in order to prevent the appreciation of the domestic currency – Denar. From the beginning of the year to December 31, 2000,

net-amount of USD 190.1 million was purchased on the foreign exchange market. Relating other currencies, the Denar fluctuated according to the changes of the exchange rate of the Deutsche Mark against these currencies on the world markets.

Monetary Policy

In 2000, in order to achieve the price stability as its primary objective, the National Bank of the Republic of Macedonia successfully implemented the monetary strategy of targeting the nominal exchange rate of the Denar against the Deutsche Mark. Hence, the Central Bank aimed the money supply at preserving the exchange rate stability as a nominal anchor in the economy. Thus, the stock of money supply was sized according to the needs for regular execution of financial transactions in the economy. It should be underlined that in the first half of 2000, the money supply registered considerably high annual growth rates, while in the second half of the year they slowed down, due to the high comparison base from the previous year. Thus, in June 2000, the money supply M2 - Denar component compared to the same month of the previous year, was by 24.4% higher, while in December 2000, compared to December 1999 was higher by 17.5%. At the end of December 2000, the broadest money supply aggregate M4 registered annual growth rate of 21.7%.

Considerable challenge for the NBRM in 2000, was the high amount of foreign currency purchased by the Central Bank on the foreign exchange market, which exceeded the projections. Nevertheless, the close coordination between the monetary and fiscal policy and the high growth of the government deposits with the NBRM adequately sterilized the monetary effects of the Central Bank foreign exchange transactions. The higher purchase of foreign currency on the foreign exchange market acted towards increase in the NBRM gross foreign exchange reserves. On December 30, 2000 they reached USD 713.6 million, thus increasing by USD 235.5 million compared to the end of 1999¹.

In 2000, the upward trend of the deposits with the banks continued due to the gradual strengthening of the confidence of the economic agents in the banking sector. Thus, on annual basis (December 2000 / December 1999), the total non-government deposits with the money deposit banks increased by Denar 6,906 million, or by 23.1%. In addition, the foreign exchange deposits registered more intensive growth of 49.1%, while the Denar deposits increased by 13.9%. Analyzed by maturity, both short-term and long-term deposits increased by 27.0% and 4.4%, respectively.

It should be underlined that in 2000, the banks' credit activity registered considerable expansion. Thus, in December 2000 relative to the same month of the previous year the total banks' credits in favor of the non-government sector (according to the actual balance) increased by Denar 6,042 million, or by 17.2%. A good and close coordination between the monetary and fiscal policy created a room for such an increase in the credits, significant increment in the liquidity of the banks, removal of the credit ceilings by the NBRM and increased banks' deposit potential.

With respect to the currency of denomination, the increment in the total banks' credits is solely due to the increased Denar credits, whereas the foreign currency placements registered a fall. The banks' Denar credits increased by Denar 7,463 million, or by 27.8%. The increase was primarily due to the abolishment of the credit limits of the banks' Denar placements at the end of March 2000, which was a period of significant credit expansion. It should be underlined that according to the supervisory examinations of the NBRM, the newly extended credits are granted to good clients. In December 2000, compared to the same month of 1999, the banks' foreign currency placements to the non-government sector decreased by Denar 1,421 million, or by 17.2%. The fall was primarily due to the higher attractiveness of the banks' Denar credits due to the higher interest rates.

At the end of March 2000, the NBRM continued with further reforms of the monetary policy instruments, where the abolishment of the credit ceilings being the most significant one. Hence, the transition to indirect market-oriented instruments for monetary regulation has entirely been completed. Moreover, the existing monetary instruments have been improved in order to be modern and closer to those used in developed market economies. Within the framework of continuous and intensive efforts to lower the banks' interest rates, the NBRM, in April 2000, decreased the discount rate and the Lombard credit interest rate by one percentage points, thus reducing them to 7.9% and 17.5% p.a. respectively.

¹ On December 30, 2000, according to the new methodology, the NBRM gross foreign exchange reserves equaled USD 478.1 million.

Domestic and International payments liquidity in the Republic of Macedonia

In 2000, the *liquidity of the banking system* considerably improved. In January – December 2000, compared to the same period of 1999, the average daily liquidity of the banking system was by 42.1% higher. This resulted in decrement of the demand for liquid funds by the banks, which was reflected upon the movement of the interest rate on the Money Market. In December 2000, the average weighted interest rate on the Money Market amounted to 7.1% and was by 4.5 percentage points lower compared to the same month of 1999.

The international liquidity in the payments is visible through the ability of servicing the external debt. On September 30, 2000, the external debt of the Republic of Macedonia, based on disbursed medium-term and long term foreign credits, amounted to USD 1,400.8 million. Compared to the end of 1999, the external debt of the Republic of Macedonia was reduced by USD 37.7 million, as a result of the repayment of the regular liabilities, as well as the exchange rate differentials. According to the payment schedule, liabilities in the total amount of USD 43.3 million are projected to be paid in the last quarter of the year. At the end of September 2000, the short-term debt of the private sector of the Republic of Macedonia amounted to USD 42.9 million, and compared to the end of 1999 was by USD 10.8 million lower. The share of the external debt in GDP accounts for 42.0%, which ranks the Republic of Macedonia in the countries with moderate to medium degree of indebtedness.

Sound and stable banking system in the Republic of Macedonia

In 2000, the banking sector of the Republic of Macedonia continued to recover from the adverse effects caused by the external shock in 1999. The share of high-risk credits in the total credit exposure of the banks in the first nine months of 2000 reduced by 4.1 percentage points, however, still remaining high at the level of 37.3%. Nevertheless, the high average capital adequacy ratio of 33.8% at the end of September 2000, positively affects the banking system stability, by far exceeding the required minimum of 8%. Significant investments of foreign capital in the Macedonian banks was registered in the first six months of 2000, increasing the share of the foreign capital in the total banking capital from 19% to 33.3%.

In 2000, the legal framework regulating the banks' operations was subject to fundamental improvement. In that context, the newly adopted Banking Law in July 2000 is of great importance, in which preparation the National Bank of the Republic of Macedonia had a considerable contribution. This Law represents a step towards the harmonization with the European legislative and the European Union Directives and achieves greater degree of compliance with the so-called Core Basle Principles for Effective Banking Supervision.

In November 2000, certain changes were made in the regulation on banks' foreign exchange operations, as well. With the new amendments of the regulation, the requirement for holding portion of the foreign exchange deposits collected by the banks on their accounts abroad was reduced. This measure is expected to have positive effect on the banks' credit supply in the economy.

Monetary Policy in 2001

Monetary policy projection for 2001 has been defined in the macroeconomic policy package incorporated in the arrangement with the International Monetary Fund. Primarily, the 2001 monetary policy will be directed towards preservation of stable macroeconomic environment, as a precondition for achieving long-term sustainable economic growth. The projected economic growth will be supported through the adequate money and credits supply, simultaneously designing the monetary policy in a manner that will not endanger the price stability.

Monetary Strategy

In 2001, the NBRM will continue implementing the monetary strategy of targeting the exchange rate, thus remaining a nominal anchor in the Macedonian economy. Thus, in 2001, the nominal exchange rate of the Denar against the Deutsche Mark will also be preserved at the targeted level of Denar 31 per one Deutsche Mark. The preservation of the stable Denar exchange rate, as an intermediate goal, will be directed towards achieving the ultimate objective of the monetary policy – the price stability. In addition, the annual inflation rate measured through the costs of living index, is projected to equal 1.2% (December 2001 / December 2000).

Monetary Aggregates

Taking into account the assumptions for the inflation rate, the real growth of the gross domestic product and the increase in the real demand for money in 2001, it is estimated that the nominal growth in the demand for money, expressed through the money supply M1 will equal 12.0%. In 2001, the money supply M2 – Denar component and the broadest money supply M4 should increase by 12.1% and 13.3%, respectively. The projected growth in the money supply will enable regular execution of financial transactions in the economy and adequate liquidity of the banking sector, and simultaneously, will not disturb the stability of the domestic currency.

Reserve money and foreign currency net-purchase

The stability of the monetary multiplier, in other words the existence of stable connection between the reserve money and the money supply has been taken as an initial presumption when projecting the reserve money. Accordingly, in 2001 the reserve money is planned to increase by 12.0% in order to meet the projected growth in the money supply. The reserve money issuance is planned to be carried out through the foreign exchange transactions of the NBRM. In 2001, the supply is planned to exceed the demand for foreign currency on the foreign exchange market. In compliance with the strategy for targeting of the nominal exchange rate of the Denar against the Deutsche Mark, the NBRM plans to purchase foreign currency on the foreign exchange market in the net amount of USD 29.0 million in 2001 in order to preserve the exchange rate of the Denar at the targeted level. The reserve money issuance based on foreign exchange transactions of the Central Bank will be supported through further increment of the government deposits with the NBRM. The support of the monetary policy by the fiscal policy, through the increase in the government deposits with the NBRM, will enable the reserve money increase to be aimed at acceleration of the banks' credit activities.

Monetary regulation instruments

In 2001, it is projected NBRM to continue using indirect, market - orientated instruments for monetary regulation. The most utilized instrument will be the CB bills auction, which will serve for dynamic regulation of the liquidity of the banking sector. Regarding the changes in the monetary regulation instruments, it should be pointed out that the fulfillment of some criteria incorporated in the IMF arrangement will be carried out in a qualitatively different environment. Namely, the absence of direct instruments, as credit ceilings for the banks, will make things more difficult for the Central Bank, nevertheless it remains firmly determined to use indirect monetary regulation instruments, exclusively.

Non-Government sector deposits

It is projected that the upward trend in bank deposits will continue in 2001. The total non-government sector deposits (including the demand deposits) are planned to increase by Denar 5,139 million or by 13.6% in 2001. The deposits growth should result from the increased confidence of the economic agents in the banking system, as a result of:

- Stable macroeconomic environment
- Increased income of the economic agents resulting from the projected acceleration of the economic activity
- Initiation of bond repayment process of so-called "old foreign exchange savings"
- Modification in the legal framework regarding the operations of the Insurance Deposit Fund, which has been transformed into a state fund. Moreover, the amount of the insured deposit, and the indemnification percentage in case of risky event have been increased, as well
- Increased presence of foreign investors in the banking system of the Republic of Macedonia.

Analyzed by currency denomination, in 2001, Denar and foreign currency deposits are projected to increase by Denar 3,139 million, or by 12.0%, and by Denar 2,000 million, or 17.5%, respectively. Namely, following its introduction in the first half of 2002, the Euro will replace the currencies of the EMU member countries. This will result in enhanced Euro conversion of the households' foreign currency deposits currently denominated in these currencies and not deposited in the banking system. Hence, part of the converted savings are expected to remain within the banking system, increasing the foreign currency deposits.

Credits

The monetary projection for 2001 envisages continuation of the intensified credit activity of banks registered in 2000. It is consistent with the expected growth in the banks deposit potential and the growth in the government deposits with the Central Bank. In 2001, total banks' credits in favor of the non-government sector should increase by Denar 5,420 million or by 13.1%. Observed by structure, the Denar credits are projected to increase by 10.9%, or by Denar 3,610 million, while the foreign currency credits are projected to increase by 21.5% or by Denar 1,810 million. The monetary policy will be aimed at achieving the projected dynamics of the economic growth in the Republic of Macedonia, creating room for growth of banks' credits to the non-government sector. Simultaneously, the downward trend in lowering the share of the non-performing credits in total banks' credit exposure is expected to continue. This should derive from the initiated improvements in the commercial banks' credit policy, stimulated by the strengthened banks' corporate governance, on one hand, as well as by the continuous strict supervision examination on the banks operations by the Central Bank, on the other hand.

Foreign exchange reserves, balance of payments

In 2001, the Central Bank's net purchase of foreign currency on the foreign exchange market, together with the movements in the government external account with the NBRM and the inflow based on interest received on the foreign exchange funds deposited abroad, is expected to result in increased gross foreign exchange reserves of the NBRM by US Dollar 75 million, (government deposits with NBRM are included in the new definition for foreign exchange reserves). Thus, the foreign exchange reserves should increase from the level of 3,5 to 3,6 months of imports of goods and services in the current year. The projected developments in the balance of payments in 2001 should result in deficit on the current account in the amount of 8,2% of the Gross Domestic Product (if the official transfers are included), i.e. 9,1% of the GDP (if the official transfers are excluded).

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