Maja Kadievska-Vojnovik: Prospects of the Macedonian economy in 2015

Address by Ms Maja Kadievska-Vojnovik, Vice-Governor of the National Bank of the Republic of Macedonia, at the panel discussion on the "Prospects of the Macedonian economy in 2015", organized by "Finance Think", Skopje, 22 December 2014.

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Macedonian economy is small and open, as evident from the high and growing share of exports and imports in GDP (in the last four years the openness increased by almost 20 percentage points, reaching high 105% of GDP in 2013). Given this feature, it is undoubtedly exposed to global developments, especially developments in Europe, which is our key trading partner to which we export over 70% of the Macedonian products. Economies of this kind, by definition, are economies that absorb the shocks from external environment, with relatively limited opportunities for influence. In fact, the decrease of economic activity in 2009 and in 2012 (about 0.5% in both years) showed that the real sector of the economy cannot remain immune to the adverse demand shocks arising from Europe. Also, an important structural feature of our economy is its high import dependence of the export sector and its high energy dependence.

However, the adverse second-round effects felt in the Macedonian economy were far weaker than those registered in the other countries in the region, although the Macedonian economy is more open than the other economies in South East Europe (with the exception of Bulgaria). The average decrease in GDP in SEE countries was nearly 2%. At the same time, the pace of economic recovery in the post-crisis period is faster than the average for the region. Thus, in the period 2010 – 2013, the cumulative increase in the economic activity is close to 8 percentage points, which is nearly 3 percentage points more compared to the average cumulative growth for the region. In fact, Macedonia is one of the few countries in the SEE region, which has already exceeded the pre-crisis maximum economic activity.

Therefore, quite logical is the question: what are the factors that provided a relatively good response to the crisis and a relatively solid economic recovery of the domestic economy, amid an anemic global setting? And more importantly, whether these factors will continue to be the engine of growth in the medium term, determining the future prospects of the economy? Domestic factors are also very important. Sound ***macroeconomic policies*** in the pre-crisis period prevented major imbalances in the economy and left room for conducting countercyclical policies in the wake of the crisis relieving its effects (which was not the case with the other countries in the region). More intensive implementation of ***structural reforms***, in particular, improving the business climate, also played a very important role, whose positive effects have become especially prominent in recent years.

Thus, despite the weak growth in foreign demand, our economy has grown by solid rates. The external environment is still not sufficiently stimulating. Foreign effective demand has not yet offset the sharp decline of nearly 5%, registered in 2009, although it shows signs of recovery, which gradually reduces its importance as a limiting factor for the growth of the domestic economy. It is estimated that it will continue to gradually recover, moving around 2% in 2016. However, the key factors that ensure solid economic performance, with economic growth of 2.7% in 2013 and 3.9% in the first three quarters of 2014, are factors that are specific to Macedonia, i.e. they are of inner character.

One of the key factors that cause "decoupling" of the speed and intensity of the recovery of the Macedonian economy and foreign effective demand, and increase the resilience of the economy to external shocks is the presence of new companies – foreign investments (mainly in the tradables sector), which gradually and steadily increase the capacity utilization and diversify the production and export structure of the economy. ***Since 2010, their activity has grown steadily, with the current exports of these facilities accounting for around 35% of total exports. However, more importantly, their net value added is constantly increasing*** and thus relieves the trade deficit of the economy. Since 2010, the cumulative positive effect of these companies on the trade balance is about Euro 200 million, or 2.6% of GDP. This reduces the external vulnerability and improves the risk profile of the country and its foundations. The raised technological level, the increase in manpower, the improved access to capital, the spillover effects on domestic companies (which is already visible in our country), the absorption of the workforce, are also significant favorable effects. In the medium term more positive effects should be expected.

The second key factor that significantly contributes to achieving solid rates of economic growth is the fiscal stimulus, through the increased number of investments in infrastructure projects. Large investments in road, rail and energy infrastructure are, on the one hand, an important impetus for growth in the short run, while on the other, they improve the competitiveness of the economy and contribute to the increase in the potential growth. The public sector share in the investments during the crisis has increased (from 20% in 2007 to 34% in 2010), offsetting the smaller investments from the private sector and providing positive stimulus for the economy. It is expected that Government's announcements of infrastructure projects will continue to provide significant support for the growth in the medium term.

What is also important is that the growth in recent years has created preconditions for improving the conditions in the labor market. The number of employees has grown steadily since the beginning of 2012, with the growth being especially pronounced during 2013 (over 4%) on an annual basis, as a combination of the labor demand by new companies (the number of companies with a large number of employees began to grow faster exactly in 2013), the active measures on the labor market, and the gradual intensification of the activity of the rest of the economy. The unemployment rate, though still high, is constantly declining and according to the latest data it is 27.9%. What is important is that its reduction is a combination of the decline in the number of unemployed persons, and the larger number of active population. The participation rate reached 57.3%, which is an upward adjustment of about 1 percentage point compared to 2008 and is a sign of the positive perceptions of the conditions on the labor market. As expected, the indicators of productivity and unit labor costs also register positive movements starting from this year (increase in productivity and decline in costs by about 2% on average in 2014). Although these indicators are still less favorable compared with the pre-crisis performances, given the growth of the economy, this gap is gradually decreasing. In the medium term we expect further narrowing of the gap.

The banking system provides additional credit flows in the economy, whereby it actively supports the economic growth. Unlike other countries, where credits extended to the private sector reduced in certain periods after the crisis, in Macedonia credit flows were constantly growing and currently credits are 1.5 times higher than before the crisis. The average credit growth from 2008 to 2014 was almost ***6%*** which is well above the average for the region of about ***1.8%,*** and certainly above the average for the Euro-zone, where lending decreases. Credit growth accelerated particularly in 2014, and in November this year it was close to 10% on an annual basis. The fact that the banking system is in excellent condition, with a capitalization rate of over 16%, with high liquidity and low reliance on external funding sources, explains the current room for lending. We expect the solid credit support to continue in the medium term, supporting growth.

What are our expectations for the economic growth in the period ahead? Although foreign demand suffers downward adjustments, our estimates for the growth of the domestic economy in the next period point to solid performances. Considering the solid economic growth that is already certain to take place in 2014, and the assessments for further support of the growth through foreign and public investment, our estimates point to an economic growth of ***4.1% in 2015 and its acceleration to 4.5% in 2016***. As before, these solid growth rates are a consequence of the growth of the activity of the foreign facilities, the announced new foreign investments, with some of them expected to employ a larger number of people, but also the expected additional ***fiscal impetus in infrastructure***. Their positive second-round effects are expected to continue to be felt in the ***labor market*** by increasing the demand and price of labor. Current projections show room for growth in the number of employees and the nominal wages of around 3%. Partial effect on the wage growth is expected from both the realized and the announced increase in the wages of the public administration. Under such assumptions, our projections show that ***domestic demand*** will be a source of economic growth, while net exports would have a negative contribution. By the end of the time horizon of the projections, there are assessments for gradual balancing of the growth structure, with a gradual reduction of the negative contribution of ***net exports***.

Consumption and investment decisions of the entities are still expected to be financially supported by domestic banks. The performances of the credit market in 2014 are better than our initial expectations, and lending surveys show that these performances are a combined effect of the growth of both the supply and the demand for loans. These performances and the assumptions about the movement of the sources of funding for banks indicate credit growth in 2014, which is assessed at 8.7%, and its acceleration to 9% in 2015 and 10% in 2016. These projections continue to be contingent on meeting the assumptions for the recovery of the economy as the main prerequisite for the growth of the deposit potential, for forming positive expectations of banks and for greater propensity of the private sector to borrow. In this context, the dynamics of ***"bad loans"*** is of particular importance. Comparatively speaking, although their share in the total portfolio is moderate, there is room for improvement in this area, especially in the corporate sector segment. Given the fact that until recently, the granting of loans was concentrated with households, the new credit flows need to be more balanced between the sectors, which implies gradual resolution of the problems with non-performing loans to the corporate sector. The application of the ***new regulations – the new Basel standards***, may also be a medium-term challenge for the banking system.

Although the main growth projection for the Macedonian economy suggests relatively dynamic growth during 2015 and 2016, there are risks related to this scenario, mainly arising from the external environment. They are mostly in a downward direction, and it was assessed that they further increased this year. It is assessed that the increase in the short-term risks is a consequence of the growth of ***geopolitical tensions in the countries of the Middle East*** and the tensions between Russia on the one hand, and Ukraine and West-European countries on the other. Although the initial effects of the ***Ukrainian crisis*** are perceived as limited to the affected countries and countries in their region, further deterioration of the situation could lead to expansion of the second-round adverse effects globally, particularly in the case of disrupted production/transport of gas and oil and escalation of the sanctioning and counter-sanctioning measures, which would especially violate global trade and financial flows. On the other hand, a more severe turmoil in the Middle East could lead to significant disruptions in oil production and consequently, to a sharp rise in oil prices. The probability of lower growth of the ***Chinese economy*** in the short run, as a result of significant adjustments on the real estate market also poses a risk to global growth. From the perspective of ***emerging economies***, major risk factor is the time and the pace of increase of the Fed's policy rate. Namely, if for some reason (such as a revision of the assessment of capacity utilization in the US economy) the ***Fed's policy rate increases faster than the expectations of market participants***, it would increase the volatility of the financial markets and would trigger capital outflows, especially from the vulnerable emerging economies. Such outflows and pressures on the exchange rates of emerging countries could also be caused in the event of adverse economic and geopolitical developments in global terms, which would lead toward increased global risk aversion and resorting to "safe" assets. From the perspective of ***developed countries***, the main risk arises from the possibility the prolonged very low inflation, or the occurrence of deflation, to produce significant negative effects on the economic activity and public debt sustainability. This risk is particularly pronounced in the euro zone, where the longer underperformance of inflation in comparison with the target would cause a decline in longer-term inflation expectations, which in the absence of room for loosening the monetary policy would lead to higher real interest rates and consequently, to lower economic activity. In the medium run, the risks to the global economy arise from the possibility of lower potential growth of developed economies and developing countries, as well as the possibility of prolonged economic stagnation of the developed countries (the so-called secular stagnation). The risk of secular stagnation is particularly pronounced for the countries of the euro zone, where the constantly low domestic demand due to lower investment and higher private savings would have negative effects on economic growth and productivity in the long run.

Yet, the challenges for growth in the forthcoming period are not related only to the external environment. Namely, this is a period in which it appears that the ***room provided by the macroeconomic policies for supporting further growth is largely exhausted***. Macroeconomic policies have played a key role in the post-crisis economic recovery, but they require gradual consolidation in order to prevent the emergence of imbalances in the economy. Monetary policy has taken a number of standard and non-standard measures which have resulted in historically low interest rates. Hence the assessment for the limited room for further adjustment measures. Given the expected low inflationary pressures, the monetary policy stance, in general, will depend on the developments in the external sector.

Hence, the main point that needs to be highlighted, and which is aimed at supporting long-term growth, are the structural reforms. In the recent period, Macedonia has been making great efforts to improve the business climate, which is being confirmed by the business indicators (Doing Business). In this regard, Macedonia is ranked 30th place for 2015, which is an improvement of six positions relative to 2013. Improved ranking is observed in all categories, with the exception of the segments “obtaining credit” and “procedures for obtaining building permits”. However, there are segments where there is room for further improvement – ***procedure for obtaining building permits, access to electricity, registration of property, implementation of contracts***. The latest Transition Report of the EBRD also refers to the areas where greater efforts are required. In fact, there are few segments where there is complete convergence to the setup in the developed market economies. ***The energy sector, infrastructure and financial sector*** (particularly in the part of providing additional funding through the capital market) are highlighted areas where further reforms are needed. The last aspect, i.e. the deepening of the capital market is a very important element in the growth pattern. Currently, the main source of funding are either companies’ own funds or bank loans. Alternative financing by providing funds through the capital market is limited, as confirmed by the low share of the stock exchange turnover in GDP, which on average in the period 2010 – 2013 totaled 1.5% of GDP. In this context, a significant support could be provided by international financial institutions.

All in all, in our views, solid economic growth higher than 4% is expected also in the next two years. The main growth factors are the present and the announced foreign investments, as well as the fiscal impetus in the infrastructure, which are key determinants of the growth of investments and exports. Credit support and growth in demand and price of labor are considered factors that will support also the private consumption. The risks around the baseline scenario are mainly downward and depend on the external environment. However, what is ***crucial is to increase the development potential and productivity of the economy in the long run***, wherefore it is especially important to continue the plan for structural reforms, particularly in the already established vulnerable areas.