

Petar Goshev: Monetary policy challenges under a current account deficit

Introductory speech by Mr Petar Goshev, Governor of the National Bank of the Republic of Macedonia, at the international conference "Monetary policy challenges under current account deficit", during the 60th anniversary of central banking in the Republic of Macedonia, Skopje, 21 October 2006.

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Honorable President of the Government of the Republic of Macedonia, Mr. Nikola Gruevski,
Honorable Minister of Finance, Mr. Trajko Slaveski,
Honorable Ministers,
Distinguished colleagues,
Dear Malcolm,
Your Excellencies,
Distinguished participants in the Conference,
Dear friends,

I am deeply honored that I can welcome you to the first international conference organized by the National Bank of the Republic of Macedonia. To be emphasized even more is that the reason for having this conference organized, i.e. six decades of central banking on the territory of the Republic of Macedonia, is extraordinarily important for the Macedonian state.

The topic of the conference, **Monetary policy challenges under current account deficit**, is not selected by chance. It is contemporary both for the Macedonian economy and for a number of transition economies whose transition path is also followed by our economy. If we consider addressed the issue of price stability, as a primary objective of the monetary policy, then the issue of how to achieve this objective in conditions of globalization of the financial markets, balance of payments' deficits and an intensified trend of liberalization of the capital flows, becomes the basic puzzle. Therefore, today we would like to discuss these issues.

Empirical research shows that compared with other developing countries the transition countries are characterized by a relatively higher current account deficit. Certain research of the IMF¹ shows that for the period 1995-2004 the average current account deficit for the countries from Central and Eastern Europe amounted to 5.5 percent of GDP², compared to the deficit of 2.2 percent of GDP in the countries from Latin America and to the current account surplus of 3 percent of GDP in the Asian countries. Simultaneously with the larger current account deficit, the first two groups of countries also registered a significant increase in their external indebtedness, i.e. a fast growth of their net foreign liabilities.

Ladies and Gentlemen,

It is a fact that the current account deficit is a variable of great importance for the monetary policy conduct. Nevertheless, it is also a fact that the control over the current account balance could not, neither it is done only through the monetary policy measures, which without any doubt puts the central bank in a delicate position when the external position is deteriorated, since the current account is a function of the interactions between the private sector entities' decisions and the decisions of the economic policy decision-makers. Therefore, the identification of the factors that cause these movements and the implications for the monetary policy conduct are essential.

The analyses of the main features of the balance of payments in transition countries indicate that the key and dominant factor for the external disequilibrium is **high trade deficit**. The experiences of the transition countries in dealing with this problem vary. One can notice, though, that in most of them the process of structural reforms implementation and conduct of sound and consistent macroeconomic policies, with the EU integration being a clearly defined objective, produced positive achievements in the external sector. Nevertheless, registered improvements in the exports are still insufficient for a more significant reduction of the trade deficit, having in mind the **initially high imbalance in the foreign trade**, which is a logical consequence of the inherited economic structures, whose main

¹ P. Lane, G.M. Milesi-Ferreti, "Capital Flows to Central and Eastern Europe, Working Paper 188, 2006, IMF.

² It refers to 11 countries from Central and Eastern Europe-CEE.

feature is lack of flexibility and import dependence. The problem regarding the balance of payments current account deficit is even bigger if one has in mind the fact that the negative trade balance is to a large extent compensated with the positive achievements in services and private transfers, as current account components, which in 2003 (according to BIS³ calculations) compensated over 45 percent of the negative trade balance. Vulnerability of the transition economies with respect to the sustainability of the current account balance is additionally increased, if it is considered that in the process of creating a "market economy", these economies faced also with a process of trade liberalization, which, especially in a short run, may additionally contribute to the trade imbalance.

The intensification of the process of financial integration and liberalization of the capital transactions as global processes, have set new challenges for the countries in transition, which reflected not only in the balance of payments capital account, but in return in the balance of payments current account, as well as the exchange rate regime. Positive macroeconomic performances of the countries, as well as the fast global growth, low rate of inflation and historically low level of the interest rates in the developed countries are factors that caused high capital inflow in the transition countries and produced significant implications for the conduct of monetary policy in the transition countries. Having in mind that the majority of them are characterized by fixed exchange rate regimes, high capital inflows resulted in appreciation of the real exchange rate and further deepening of the trade deficit, and consequently of the deficit in the balance of payments current account. The process was intensified additionally by the higher productivity growth in the tradable goods through the so-called Balassa Samuelson effect, which according to certain estimates increased the appreciation of the currency on average by 1.5 to 2.5 percentage points⁴.

Experiences of more developed transition countries are of special importance for the future challenges of the Republic of Macedonia, as a part of the increasingly intensifying process of EU integration. Having in mind that the Macedonian economy is characterized by initially high trade deficit and current account deficit (substantially mitigated by the private transfers) it is essential for the macroeconomic policy decision-makers to consider the experiences of the advanced transition economies with respect to all significant aspects related to the process of real convergence to the EU, including the enlargement of markets and facing with increased competition, possible effects from the liberalization of the goods and capital flows, as well as the possible measures and reactions of the macroeconomic policies with respect to these issues.

High trade deficit, and consequently the current account deficit, had certain repercussions on the monetary policy conduct. Lack of foreign exchange in the Macedonian economy caused constant pressures for depreciation of the Macedonian Denar, which under a strategy of exchange rate targeting ultimately produced relatively higher interest rates.

Such conditions changed significantly in the last two years. The political stabilization of the country and of the region, given the maintained macroeconomic stability and clear European orientation confirmed in 2005 with the acquiring of the status of candidate country for European Union membership, created environment for significant positive achievements in almost all sectors of the economy. In the external sector, higher growth rates of exports are recorded, which in 2005 were twice higher than the growth rate of imports of goods. The stabilization generated high foreign exchange inflows from private transfers that enabled significant decrease of the current account deficit. In 2006, sizeable external inflows were registered from the continuous privatization process. Consistent macroeconomic policies, confidence in the Denar and increased competition in the banking system had to cause easing of the monetary policy and lower interest rates in the economy.

The expectations for maintaining the current direction of the Macedonian economy, the firm stance of the Government of the Republic of Macedonia for continuation and intensification of the structural reforms, the realistic expectations for achieving faster growth and the expectations for setting a date for the Republic of Macedonia to start negotiations for getting the status of a member of the European Union, then, intensification of the process of liberalization of the capital flows in 2008, as well as the larger financial integration of the European capital markets through issuance of Eurobonds, definitely build a foundation of realistic expectations for much higher capital inflows in the forthcoming period.

³ BIS Working Party on Monetary Policy in Central and Eastern Europe, 21-22 February 2005, Sinaia, Romania.

⁴ Buitier W.H. and Grafe C., "Anchor, Float, or Abandon Ship: Exchange rate regimes for the Accession Countries", European Investment Bank Papers, 7 (2), 2001.

These expectations are supported also by the positive interest differential and attractiveness of the securities that are listed on the domestic securities market.

Under such circumstances, key challenges of the monetary policy, in the context of the capital account liberalization and potential risks for deepening of the current account deficit in the Republic of Macedonia, are the following:

1. Capital inflows, depending on the degree of variability, may cause **speculative pressures on the Denar exchange rate**, which would increase the vulnerability of the economy. The experience of the more advanced transition economies shows that these effects may be partially mitigated by attracting foreign direct investments and securing their dominance in the composition of inflows, where the generally higher rates of return on investments provide certain protection from quick and sudden changes in the capital flows. Another issue is the **size of the capital inflows** that given the implementation of the strategy of exchange rate targeting potentially puts at test the capacity of the NBRM for their sterilization and causes certain implications upon the monetary policy conduct, and the exchange rate regime. Through the presentations that follow we will likely see a number of such experiences.
2. Foreign capital inflows, especially the facilitated access of the banks to foreign capital, may cause **credit boom and expansion of the domestic consumption**. That may generate additional increase in the current account deficit. From the point of view of the current situation, the upward trend of credit growth that started in the Republic of Macedonia in 2003, largely emerges from the low starting point and at the same time indicates the natural process of increase in the degree of financial intermediation. Nevertheless, having in mind the potential implications from the credit growth, it is necessary to strengthen the capacity of the banks to assess adequately the credit risk, as well as to monitor the quality of the credit portfolio through the NBRM's banking supervision.
3. **Danger of real appreciation of the currency**, encouraged by: potential capital inflows, expected productivity increase in the sector of tradables in the process of approaching the developed economies (appearance of the Balassa Samuelson effect also in the Macedonian economy) as well as completion of the process of price deregulation. Real depreciation of the exchange rate registered so far distinguishes the Republic of Macedonia as a specific example in comparison to almost all the countries in transition. To a high extent such performances are due to the improved competitiveness of the Macedonian economy as a result of the relatively lower rate of inflation compared to the trading partners, given the higher productivity achieved in the non-tradables sector, and the higher new value added that was significantly influenced by the relatively lower number of employed persons. In 2005, this trend experienced a change (which was expected) shown by achieving higher growth rate of productivity in the sector of tradables compared to the sector of non-tradable products. Such changes indicated the beginning of the process of exchange rate appreciation that is actually recorded in the course of 2006 (primarily caused by the higher domestic prices, mainly because of the higher additional duties on tobacco. Generally speaking, real appreciation leads to deepening of the current account deficit, but negative effects would be partially mitigated, having in mind that it does not come from erosion in the external competitiveness of the economy, but is to some extent caused by the sound macroeconomic factors, such as the higher productivity.
4. **Uncertainty related to the future inflows of private transfers**. Private transfers, as a component of the balance of payments that registers surpluses, traditionally compensate a significant portion of the negative trade balance of the Macedonian economy, on average around 60-70 percent. The upward trend was significantly intensified in 2005 when the transfers increased substantially and reached approximately 18 percent of GDP. That's how they compensated about 90 percent of the negative trade balance and brought the current account deficit to the relatively low level of 1.3 percent. Fast growth of the transfers, given the inability to actually identify the sources from which they origin and consequently the difficulty to anticipate their future size and future sustainability, is another factor that produces sensitivity of the Macedonian economy. In this context, one may even more emphasize the need of implementing the adequate structural reforms aimed at strengthening of the export sector and its competitiveness at the foreign markets.

Dear Ladies and Gentlemen,

Integrating of the economy at the global capital market implies larger exposure towards larger and potentially more unstable capital flows. In spite of this, such flows may not be considered as one-time effects, but as flows that are characteristic for the process of transition and which have to be incorporated in the monetary policy conduct. The implications of the capital inflow and appreciation of the domestic currency, as well as the reactions of the macroeconomic policy decision-makers will vary from case to case and will depend on the features of the economy itself.

Balance of payments deficits, potential factors that may cause their deepening and the liberalization of the capital flows, obviously pose numerous challenges for the monetary policy, both regarding the monetary strategy and the exchange rate regime and regarding its operational setup. The central banks, as key institutional macroeconomic policy makers, and at the same time institutions that permanently work on strengthening and maintaining of their own credibility, unavoidably should focus on the contemporary challenges of the monetary policy, making attempts for timely comprehension of the possible solutions and repercussions. Having in mind this objective, I am glad that on the today's conference are present distinguished experts, governors and representatives of central banks from a number of countries across the world, as well as high rank officials from important international institutions, whose expertise and experience may contribute to good quality discussions regarding the specified contemporary challenges for the monetary policy.

Distinguished speakers, dear friends, collaborators and guests, let me once more, as a host, to thank you for the precious time you dedicated, joining us in the celebration of the 60-th anniversary of central banking in the Republic of Macedonia, as well as for your participation in the today's conference. I wish you pleasant work and fruitful discussion, beneficial for all of us.

Thank you.