Anita Angelovska-Bezoska: Macedonia's current macroeconomic landscape and main challenges ahead

Speech by Ms Anita Angelovska-Bezoska, Vice-Governor of the National Bank of the Republic of Macedonia, at the economic and financial dialogue on the Economic Reforms Programs on Western Balkan and Turkey, Brussels, 12 May 2015.

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Dear Ministers,

Dear representatives of the European Commission, European Central Bank and Eurostat,

At the beginning, let me express our gratitude to the European Central Bank, European Commission and Eurostat for their assessment of our Economic Reforms Program for the period 2015–2017. Let me mention that we appreciate very much this dialogue with the EU institutions and the overall feedback on our policies that we have received during the process and we believe that it is highly beneficial regarding our preparedness for joining the EU. At this point, I would like to address several important issues related to the current macroeconomic landscape of the Macedonian economy, as well as the main challenges ahead.

The growth momentum was kept in 2014, with the real GDP growth accelerating to 3.8% p.a. As the external environment is not sufficiently "growth-conducive", the strong performance of the domestic economy is explained by country-specific factors. Firstly, it is a reflection of the positive fundamental shifts, with growing foreign investments, mainly in the tradable sector. They are helping the economy to gradually increase its resilience, by significantly increasing the diversification of the production and the export structure of the economy, but also by yielding positive second-round effects, improving the labor market conditions, increasing the know-how, integrating domestic suppliers in the production process. Secondly, the economy has been impacted favorably by the fiscal stimulus in the infrastructure, an area continuously being pinpointed as a weak spot, when it comes to the structural competitiveness. Hence, albeit the fiscal impulse does have positive short run effects on growth – bridging over the current "anemic external environment", it also affects the long-term potential of the economy. The solid economic recovery is significantly improving the labor market conditions, increasing the labor demand, reducing the unemployment, positively impacting the participation rate, but also boosting the productivity growth of the economy. As being largely export and investment-led, the solid growth does not create pressures on the external position of the economy, nor on the inflation. On the contrary, the external sector is in a relatively good shape, with the current account deficit being brought down to 1.3% of GDP, hitting the low end of the average of around 2% in the last five years. The incessant improvement in the current account, to a large extent reflects the rising net-impact on trade of the new foreign production facilities, this particularly being the case in 2014. Yet, as the foreign demand has started to recover, some positive shifts in the more traditional export segments are also visible. Of course, last year the fall in the oil prices was also beneficial for the trade balance. On the financing side, the financial flows were large enough to cover the current account deficit and to provide additional reserve accumulation. It is important to note that FDI inflows continued to flow in the economy, with their ratio to GDP being kept stable at 3.3% of GDP. Yet, the largest part of the financing flows came through the government borrowing at the international market, at rather favorable terms, pinpointing the perception of the investors for sound fundamentals and rather prudent policies in the Macedonian economy. Observing the inflation path, it more or less resembled the inflation pattern elsewhere, with the falling food and energy prices pushing prices down. The average headline rate for 2014 was mildly negative (–0.3%), while the core inflation albeit slowing down, on average remained positive. The inflation adjustment is perceived as temporary, driven by supply-side factors, and without any risks to become entrenched in the inflation expectations and to jeopardize the economic recovery. The fact that the negative output gap has been narrowing and the fall of the prices has been significantly slowing down in the first months of this year, just support the former notion.

Domestic financing through the banking sector significantly increased in 2014, with credit market recovering much faster compared to the previous years. Given that the banking system entered the crisis with sufficient capital and liquidity buffers, the credit flows to the economy in fact never seized. Yet, during the last year, on the backdrop of the economic recovery and the improvement in the overall risks perceptions, the credit accelerated to 10% on an annual basis, reflecting both the supply and demand for credits. A notable rise of the allocation of credits to corporate sector compared to the previous years was observed. Hence, both the size and the structure of credits were growth supportive. The financing of the credit growth was underpinned by solid rise in deposits (10.4% p.a.), confirming yet again the reliance of the banks on domestic sources of financing, rather than on cross-border flows, which might be quite volatile at the current juncture. An important point here is the trend of rising preferences to save in domestic currency, which continued in 2014, reflecting stable expectations and reducing the monetary policy burden. The banking sector remained stable and sound, with solid liquidity and capital adequacy ratio of 15.7% at the end of 2014. Non-performing loans of the banks remained at a moderate level during the crisis period, compared with the region. In 2014, they were relatively stable, slightly decreasing to 11.3% at the end of the year and remained highly provisioned. The actual and the envisaged economic recovery is expected to further improve the quality and the financial soundness of the borrowers, and to further support the downward path of the NPLs. Yet, vigilance in this area is important to prevent buildup and materialization of systemic risk. Last year was no exception in terms of close monitoring of the soundness of the banking system, and changes in the prudential regulation, which were an appropriate balance between the need to support private sector financing, while maintaining the health of the banking system at the same time.

What was the monetary policy stance like in 2014 given the already elaborated economic and financial conditions? In general, the accommodative stance was maintained. The main interest rate was maintained at the historically lowest level, the targeted measures to support net-exporting and electricity producing companies were extended until the end of 2015, and certain credit-supportive macro-prudential measures were undertaken. This relatively loose stance was maintained as a consequence of the "benign" external position, which did not jeopardize the foreign reserves, and enabled a rather balanced foreign exchange market during the year. Low inflation was also in favor of maintaining the accommodative stance. Yet, the room for monetary policy accommodation appears to be largely exhausted.

The outlook for the 2015–2016, is more or less expected to resemble the state of the economy in the previous year. Growth of the economy is expected to accelerate to 4.1% and 4.5% in 2015 and 2016. The fundamental factors to underpin the growth dynamics remain the same. The boost to the export and investment is expected by the new and the existing foreign companies, as well as those envisaged to enter the market. Investment cycle is expected to be further strengthened by the continuation of the productive fiscal investments. As the external demand is envisaged to recover further, additional stimuli is expected through this channel. The above mentioned growth factors are expected to strengthen further the labor market and the disposable income of the households, hence boosting the private consumption as well. The growth expectations provide room for additional rise of the deposit potential in the banking system, which accompanied with the rise in the credit demand and the willingness of the banks to lend, should enable credit growth at a rate of 9–10% in the period to come. The inflation is expected to be influenced mainly by the global prices of primary commodities and the consumers prices of our main trading partners. An average inflation of 0.5% is expected for 2015, with the current forecast indicating its reversal to 2% in 2016, reflecting the rise in the demand and in the import prices. The structural improvements in the export sector are expected to continue in 2015, which along with the overall external recovery and the much lower oil prices, are envisaged to bring about a moderate current account deficit of bellow 1.6% of GDP. In the following year, widening to 3% is expected, reflecting the fall in private transfers and import pressures from the new investment. The external financing needs, within the current scenario, are expected to be covered by further inflows of foreign direct investments and by the public borrowing for infrastructure purposes. The current forecast points to a rather stable external debt to GDP ratio. No major pressures are foreseen in the following two years on foreign reserves, and they are to be maintained at the adequate level.

Risks surrounding this baseline macroeconomic scenario should not be neglected. For us, as a small an open economy, they mostly come from the external environment and our main trading and financial partners. Although with the latest monetary easing of the ECB the downside risks to the euro zone growth are less pronounced, and in general the global growth risks are more balanced, they are still present and if being materialized, could impact the economy. Additional source of risks are the sharp and sudden swings in the primary commodities prices, which for country like ours, can change the envisaged economic profile to a large extent. A new, additional source of risks is the current domestic political context, which can harm the economy, if not being tackled swiftly.

Of course, the risks are challenging and are to be closely monitored. This is even more pronounced, given that the policies' space at the current juncture is to a great extent exhausted. Hence, the continuation of the structural reforms remains paramount and a challenge, as it can further increase the resilience of the economy, mitigate the risks and reduce the policy burden. For us as emerging country, with foreign bank presence, the global financial regulatory reforms also pose challenges, as they can possibly stimulate deleveraging, reduce access to financing and financing flows to the private sector.

At the end, let me also avail myself of this opportunity to emphasize yet again our continuous efforts to align with the EU requirements in all areas of operation, especially the banking regulation and statistics, notwithstanding the efforts and the progress done in all other fields.

Thank you for your attention.