EXCHANGE RATE AND EXPORT-LED GROWTH IN SEE6: ECONOMIC CONVERGENCE MACHINE – WHAT HAPPENED? WHAT NEXT?

DEVIZNI KURS I IZVOZNI RAST U JUGOISTOČNOJ EVROPI: EKONOMSKA KONVERGENCIJSKA MAŠINA – ŠTA SE DESILO? ŠTA JE SLEDEĆE?

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Abstract: *During the past decade, the ten new EU member states reached a high degree of market integration and macroeconomic stabilization as part of their accession process. The main challenge for these countries is to deal with large and potential volatile capital inflows and to achieve nominal convergence needed for adopting the euro. These challenges must be addressed within the scope of the limited fiscal policy. In the context of macroeconomic adjustment, macrofiscal policies will be in the focus of macroeconomic policies in the years that follow. They need to focus on meeting the requirements for sustainability of EMU, and to assist in absorbing the effects of aggregate demand of large capital inflows. So in terms of macroeconomic convergence for SEE6 countries and the case of Macedonia, EU membership requires convergence of the Macedonian economy with that of the EU in realistic conditions, signifying income per capita and economic structure, and in nominal terms, means convergence of prices, inflation and interest rates.*

Keywords: *EU convergence, South-Eastern Europe, Macedonia, exchange rate, growth*

Sadržaj: *U toku prošle decenije 10 novih članica EU ostvarile su visak stepen tržišne integracije i makroekonomske stabilnosti, kao deo pristupnog procesa. Glavni izazov za ove zemlje je suočavanje sa velikim i potencijalnim kapitalnim prilivom i realizacija nominalne konvergencije koja je neophodna za usvajanje evra. Ovi izazovi moraju biti ostvareni u delu limitirane fiskalne politike. U kontekstu makro ekonomskog prilagođavanja, makro fiskalne politike će biti u fokusu makro ekonomske politike u godinama koje slede. One treba da se fokusiraju na ispunjavanje održivosti EMU i pomognu u apsorbiranju agregatnih efekata velikih priliva kapitala. Dakle, u uslovima makroekonomske konvergencije u šest zemalja jugoistočne Evrope i u slučaju Makedonije, članstvo u EU zahteva približavanje makedonske ekonomije onoj u EU u realnim uslovima, ističući dohodak po glavi stanovnika i ekonomsku strukturu u nominalnom smislu, te podrazumeva približavanje cena, inflacije i kamatnih stopa.*

Ključne reči: *EU konvergencija, Jugoistočna Evropa, Makedonija, devizni kurs, rast*

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1. INTRODUCTION

According to literature, the macroeconomic policy of the new EU member states is facing with two main challenges. The first is to manage the continued and rapid process of future real economic convergence, which will come with high real GDP and productivity growth rates and large capital inflows. The second challenge is to achieve the degree of nominal convergence required to enter into European Monetary Union (EMU). These two challenges are not unrelated, such as rapid growth and large capital inflows can make it difficult to realize nominal convergence, i.e., there are good reasons to think that the real convergence would be easier to manage for some countries, if they were allowed to adopt the euro immediately. Both challenges are mainly associated with fiscal policy: managing capital inflows, because fiscal policy can absorb some of their demand effects, nominal convergence, because the sustainability of public finances is part of the requirements for entering EMU.

Dr. Gligor Bishev, was born on 5 of April, 1958 in Strumica, R. Macedonia. With his 29 years of experience he was appointed as the President of the Board of Sparkasse Bank, Makedonia since 2013. His career began in 1984 at the National Bank of Republic of Macedonia, first as a junior economist, and later in 1993 as General Manager. In 1994 he was appointed to be Vice-governor and in the period from 1997 to 2000 he was also Vice Governor of the National Bank of Macedonia. Since 2000, he was serving as General manager in Stopanska banka AD Skopje.

Besides the professional engagement, Dr. Bishev is active in the field of economic sciences:
- Professor at the Faculty of Economics - Prilep, State University “St.Kliment Ohridski” – Bitola, Macedonia
- Professor on Faculty of Economics “ St.Cyril and Methodius” – State University in Skopje and
-Professor on Institute of Economics “St. Cyril and Methodius” - Skopje.
After completing his doctoral studies in 1991, Dr. Bishev continued with his specialization in the London School of Economics and Political Science in 1995 and as a guest researcher at the Vienna Institute for Comparative Economic Studies in 1997.
During his experience, Dr. Bishev was active in several institutions like:
-Member of the Management Board of the Agency for Restructuring of Banks (1995-1999),
-Member of the technical committee of the MANU research project "Strategy for Economic Development of Macedonia" (1996-1998),
-Member of the Managing Board of the Money Market (1997-2000)

-Co-chairman of the Second desk for economic reconstruction and development of the Stability Pact (January-June 2000),
-Member of the Securities and Exchange Commission of the Republic of Macedonia Securities (March 1999 - October 2003) and
-President of the Association of Banks (2006-2010).

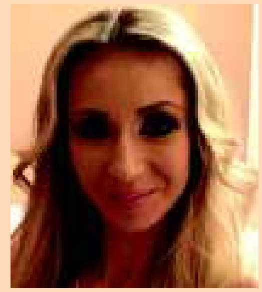
Today is active as a Vice president at the Economic Chamber of Macedonia and he is a member of the Council of the Faculty of Economics in Ljubljana.
As one of the creators of the new currency and the reforms in Republic of Macedonia, Dr. Bishev also examined reforms in almost all transition economies, and he is participating in many research projects in the areas of banking and monetary theory and policy, applied economics, economic development policies of course, the balance of payments, international financial institutions, capital flows, corporate finance, investment and financial markets.
Dr. Bishev has published two books, more than 300 articles and he has taken part in many discussions and research studies in professional and scientific journals in the country and the region.

2. IS THE REAL EXCHANGE RATE A POLICY VARIABLE?

Like many countries in the early stages of transition, South-Eastern European countries rely mainly on exchange rates to reduce the inflation. In many countries, exchange rate helps to reduce the inflation to lower single digits since 2004. Albania's managed float and informal inflation targeting were also successful in keeping inflation low, while in Romania, inflation, although declining under the managed float, remains close to double digits. Since 2000 Serbia has shifted between nominal and was close to real exchange rate targeting (with important regime shifts in early 2003 and 2005). Inflation first declined with the exchange rate anchor, but an increasing external deficit prompted a shift to a managed float in 2003. However, inflation resurged, as suppressed administrative prices were readjusted and growing euroization contributed to an increased pass-through from the exchange rate to prices. The regime shifts may also have adversely affected monetary policy credibility, as indicated by the growing euroization. The exchange rate anchors and sluggish structural reform put pressure on competitiveness. Fixed or nearly fixed exchange rates can lead to unsustainable real appreciation and loss of competitiveness, unless fiscal and incomes policies remain tight and structural reforms boost productivity. For example, in Serbia, the exchange rate anchor in 2002 became unsustainable as large real wage increases and slow structural reforms eroded competitiveness and increased the external deficit. Pressures for real appreciation in the region also arise from the large inflows of foreign currency. The evolution of EU export market shares also suggests that Macedonia may have lost competitiveness, while most others have increased their share in the EU market. The real effective exchange rates data (REER) show a large appreciation in Bulgaria, Romania, and Albania in recent years, which at least in the former two is likely to reflect changes in market fundamentals in terms of increased productivity. In the remainder of the SEE, there is no clear trend with real appreciation and the REERs have remained relatively flat in the past few years.

South-eastern Europe can draw experience from recent new EU member states with monetary framework during accession. Exchange rate regimes during accession had shown different variations, which indicate the importance of fundamentals and associated policies in the implementation and achievement of macroeconomic stability[52]. Some of the larger recent EU members gradually moved from exchange-rate-based stabilizations to more flexible monetary policy as transition progressed. South-eastern Europe has very lower speed of reforms and lower growth rates. Related to this, capital inflows to the region are very smaller and have shown greater dispersion between countries.

Regardless the exchange rate regime, the appreciation of the real exchange rate among countries in the region is significant, although it is slightly lower when compared to countries in the EU member states. As a result, these countries suffer from loss of competitiveness. This can be clearly seen from the movements of the deficit on their current account, which are important in all these countries. For example, the current account deficit in 2007 ranged from 3.1% of GDP in Macedonia to 36.2% of GDP in Montenegro[53]. Using the exchange rate as hope for inflationary expectations has been effective so far, producing a low and stable inflation rates. In terms of high import dependence and the relatively slow implementation of structural reforms realized in increased export potential, contributed to the importance of high trade deficit, which was largely financed by high private transfers.



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3. ECONOMIC CONVERGENCE OF MACEDONIA AND SEE6

In order to accede to EMU, Macedonia should complete a real and nominal convergence. In this way, statistic show that the food prices are still the main driver of inflation in the SEE6, but the pressures on energy prices are decreasing . In the first quarter of 2013 the inflation in food prices rose by 9.3% annually, which is higher than the peak of 9.2% in the fourth quarter of 2012. With slowing consumption, global demand for oil remains passive, and the pressures of energy prices decreased practically in all SEE6. Inflation declined notably across the SEE6 region in the course of 2013. As the effects of increases in food and administered prices as well as taxes dissipated, the region experienced a dramatic

[52] Schadler, S., P. Drummond, L. Kuijs, Z. Murgasova and R: van Elkan (2005), "Euro Adoption in the Accession Countries: Vulnerabilities and Strategies", in S. Schadler ed. *Euro Adoption in Central and Eastern Europe: Opportunities and Challenges", IMF.*
[53] European Commission (2007), *The EU Economy 2007 Review, Moving Europe's Productivity Frontier.*

drop in inflation rates, which turned into deflation in some countries. Falling world food prices, in particular, drove much of the drop in the CPI inflation in SEE6 in 2013 (Figure 1)[54].

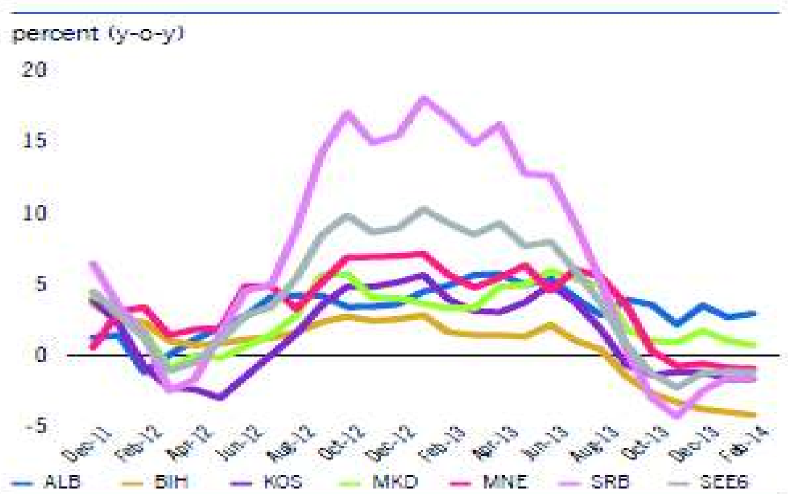

Figure 1: Food Price Inflation
Source: National statistical offices and World Bank staff calculations.

The average fiscal deficit for SEE6 declined in 2013 (Fig. 2). The deficit in Macedonia remains stable as a percentage of GDP. The increase in revenues is expected to lead to fiscal recovery in the region, remaining stable with an average 35.2 % of GDP.

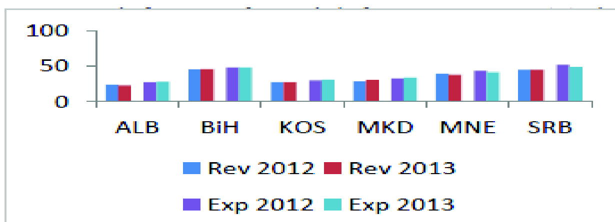

Figure 2: Changes in revenues and expenditures, 2012 and 2013 (% of GDP)
Source: Eurostat.

While fiscal deficits fell in 2013, the fiscal situation in SEE6 is not sustainable unless countries tackle structural rigidities in their expenditures[55]. On average, SEE6 countries reduced their fiscal deficits in 2013 thanks to tighter control of expenditures. The average unweighted fiscal deficit declined to 3.8 percent of GDP in 2013 from 4.3 percent of GDP in 2012.With sluggish growth, deflationary pressures and the shift toward external demand driven growth, revenues came under pressure, falling by an average of 0.5 percent of GDP. But tighter spending, falling by 1 percent of GDP on average, more than compensated the revenue drop.

[54] World Bank (2013d), *World Development Report: Jobs*, World Bank, Washington, DC.
[55] World Bank (2013d), *World Development Report: Jobs*, World Bank, Washington, DC.

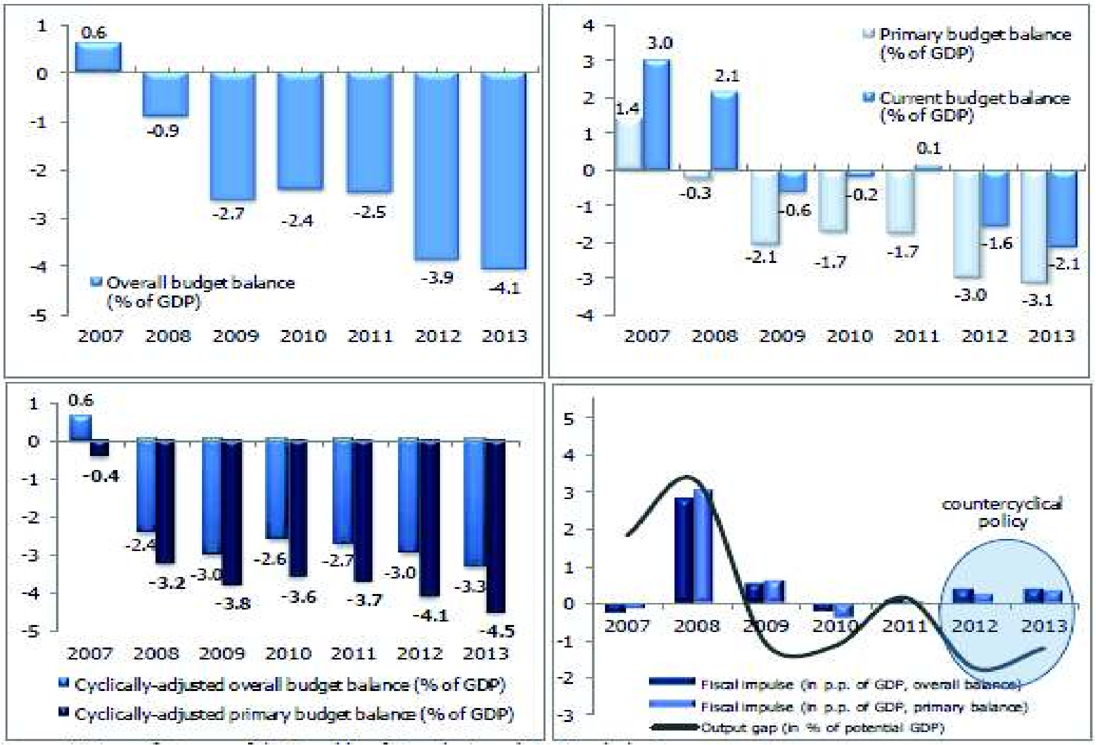

Figure 3. Fiscal indicators for Macedonia
Source: Ministry of Finance of the Republic of the Macedonia and NBRM calculations.

The analysis of the discretionary changes in the fiscal policy suggested further countercyclical policy. The total structural deficit increased to 4.5% from 4.1% in 2012, amid simultaneous increase also in the structural primary deficit from 3% in 2012 to 3.3% in 2013 (Figure 3)[56]. If the analysis includes the output gap, than the fiscal policy was countercyclical also in 2013. Financing of the budget deficit on a net basis in 2013, was done through auctions of government securities, and the rest of the required net inflows was provided from external sources. Reports also showed that also in 2013 there was a trend of increased borrowing through government bonds versus the moderate reduction of the borrowing through Treasury bills.

Due to the close economic ties, external factor in SEE6 highly correlated with development of events in the EU. While current account deficits and trade balances deteriorated in 2012, in the first quarter of 2013 they registered reverse. Reducing the demand for EU goods SEE6 led to a decline in the region which began in 2011 and continued in 2012 (Fig. 4 and 5).

[56] NBRM (2013), *Annual Report.*

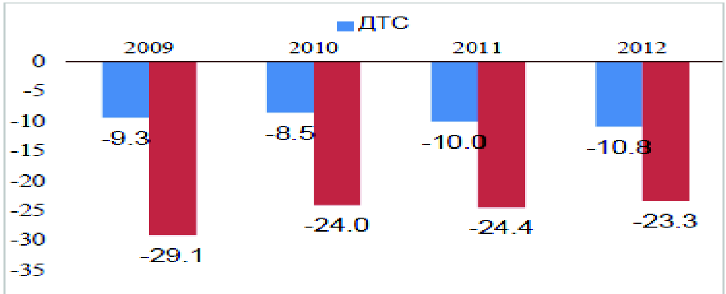

Figure 4. Current account deficit and trade balance SEE6 (percentage of GDP)
Source: IMF, World Bank

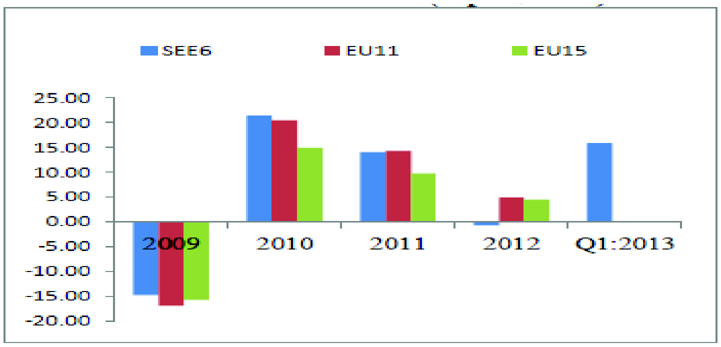

Figure 5. Export growth (%)
Source: IMF, World Bank

An export-led recovery combined with depressed domestic demand resulted in a significant narrowing of current account imbalances in all SEE6 countries. The increases in exports and the declines in imports lowered the trade deficit of SEE countries by 4.7 percent of GDP and the current account deficits by 3.4 percent of GDP in 2013 (Figure 6, Figure 7). Exports to the EU grew strongly, especially in Bosnia and Herzegovina, FYR Macedonia, and Serbia. Montenegro's and Kosovo's share of exports to the SEE region increased. Manufactured goods were the largest share of exports from SEE6 followed by machinery and transport equipment. Jointly they comprised over 60 percent of exports in 2013 in the region. The major increase in 2013 came from export of machinery and transport equipment from Serbia. Exports in FYR Macedonia grew also on the back of machinery and transport equipment as well as chemical materials. Mineral fuels exports were quite significant in Albania and Montenegro, while base metals were around a quarter of exports from Kosovo in 2013.

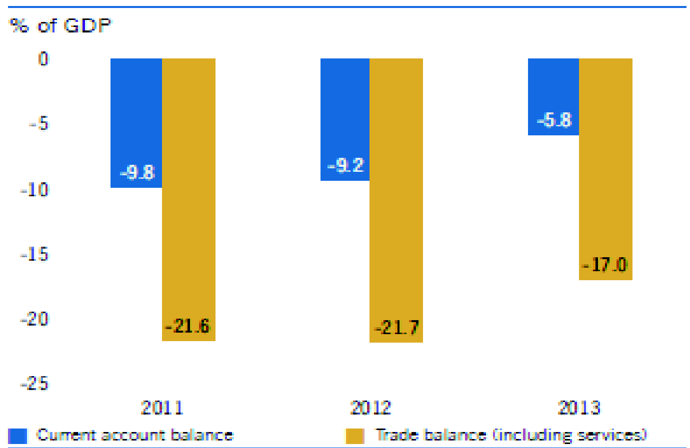

Figure 6: SEE6 Current Account and Trade & Service Balances
Source: Central banks, IMF WEO, and World Bank staff calculations.

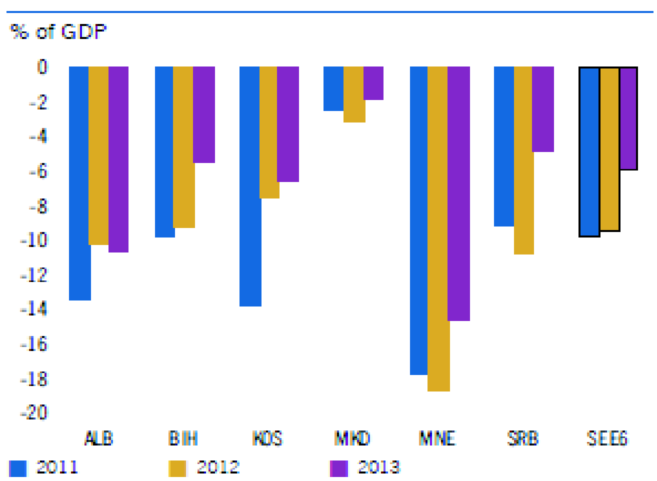

Figure 7: SEE6 Countries' Current Account Balance
Source: SEE6 Central Banks

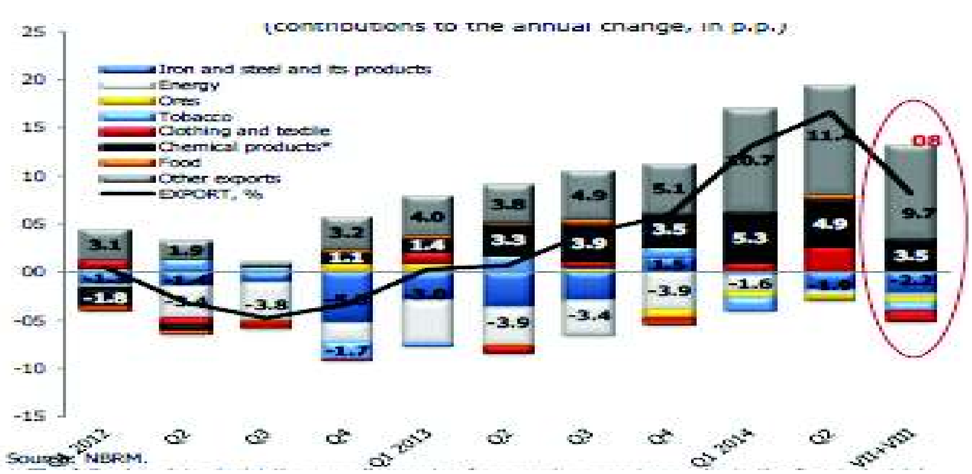

Figure 8. Macedonian export by components
Source:NBRM

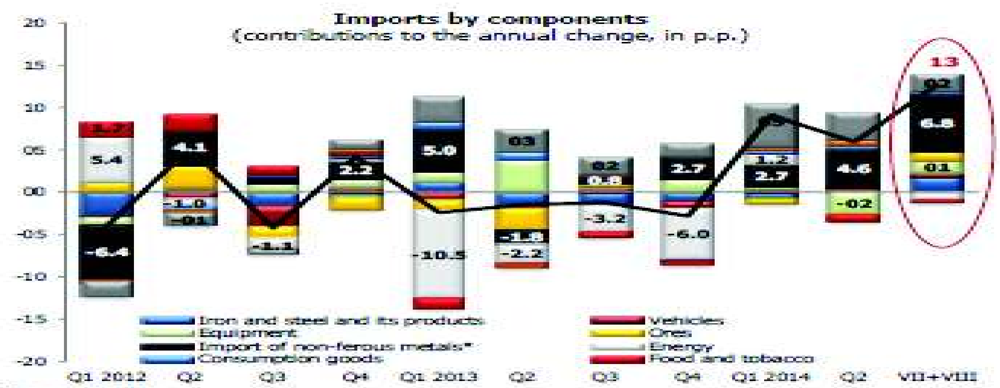

Figure 9. Macedonian imports by components
Source: NBRM

In the period from July to August 2014, the foreign trade deficit expanded by 22.4% on an annual basis, conditional on the faster annual growth of import relative to the growth of export activity. Macedonian exports during the second quarter in 2014 recorded an annual growth of 8.2%, and the increased use of new facilities remains a major factor of the positive changes in exports while all other categories acted in the opposite direction, with the largest decline being registered in the export of iron and steel (Fig.8)[57]. On the other side, Macedonian imports in the second quarter of 2014 reached an annual growth rate of 12.7% which was driven by the rising import of raw materials for the new export oriented facilities and metal industry versus the moderate annual decline observed in the energy imports (Fig.9). Larger downward deviations occurred in part of the traditional export products, i.e. exports of iron and steel, ores and tobacco, which is offset with the export activity of the new facilities.

Price competitiveness indicators of the Macedonian economy showed a negligible appreciation of the Denar in 2013. The CPI-deflated real effective exchange rate rose by 0.9%, while the PPI-deflated REER recorded an annual appreciation of 0.4%. The change was entirely caused by the movement of the nominal effective Denar exchange rate, as a result of the appreciation of the domestic currency against the Russian Ruble and Turkish Lira, with favorable slower movements of domestic relative to foreign prices.

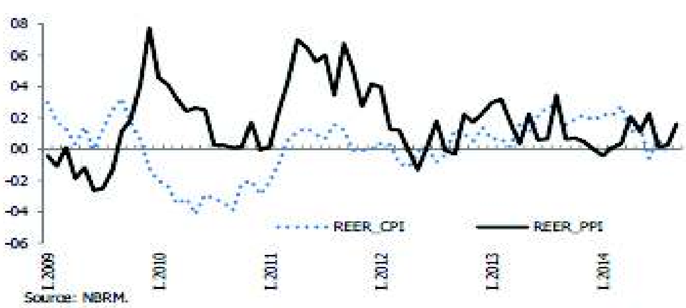

Figure 10. REER annual changes, in %
Source: NBRM

In August 2014, price competitiveness indicators of the domestic economy registered divergent movements on an annual level. Ehen this is compared with the same month of the

[57] NBRM (2014) *Recent Macroeconomic Indicators* ,Review of the Current Situation.

2013, the REER deflated by consumer prices depreciated by 0.3%, while the REER deflated by producer prices appreciated by 1.6% on an annual basis.

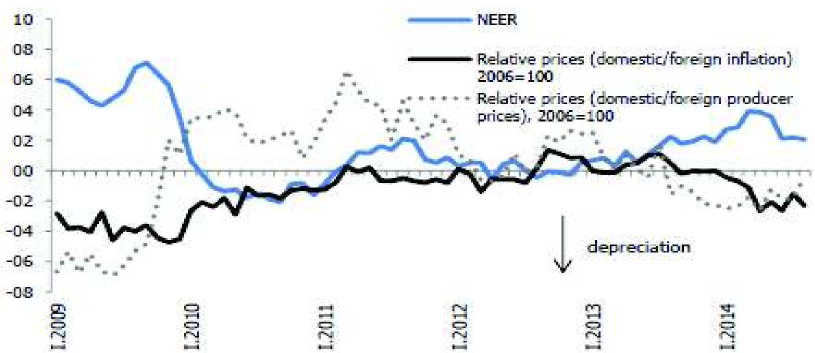

Figure 11. NEER and relative prices annual growth rates, in %
Source: NBRM.

Depreciation of the Ukrainian hryvnia, Russian ruble and Turkish lira against the denar had a influence for the further appreciation of the nominal effective exchange rate by 2% on an annual basis,and this caused upward pressures on both REER indices[58]. The growth of foreign consumer prices and as faster growth in foreign versus domestic prices of industrial products, led to a decline in relative prices by 2.3% and 0.4%.

Figure 12. REER, excluding primary commodities annual growth rates, in %
Source: NBRM.

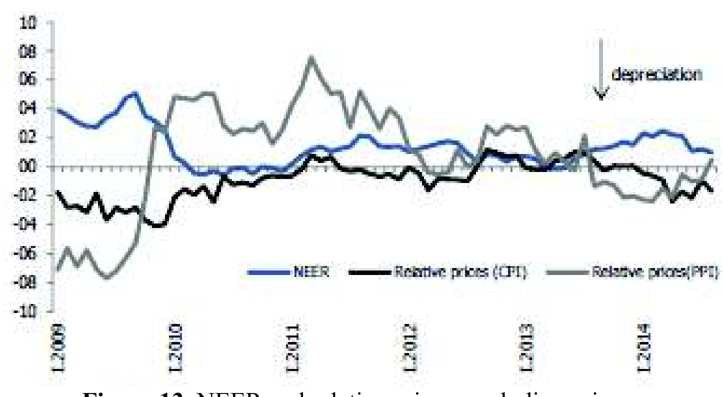

Figure 13. NEER and relative prices, excluding primary commodities annual growth rates, in %
Source: NBRM.

58 NBRM (2014) *Recent Macroeconomic Indicators* ,Review of the Current Situation.

The movement of the REER , excluding primary commodities, indicates similar movements in the domestic price competitiveness. The REER deflated by producer prices appreciated by 1.5%, while the REER deflated by consumer prices depreciated by 0.7% on an annual basis. Figure 26 show that due to decline in domestic prices, relative CPI registered an annual decline of 1.7%. Also, relative prices of industrial products recorded a growth of 0.5%, driven by higher domestic prices. NEER appreciation continued in August 2014, annual change driven by the depreciation of the Turkish lira and the Serbian dinar against the denar.
Economic policies can be instrumental for growth in the near- and the medium-term in SEE6. On the fiscal side, sustained reform effort is needed to address structural rigidities in the budgets of SEE6. Priorities include: changes in the composition of public expenditure toward investment and away from wages, public expenditure targeting and prioritization as well as improvements in revenue collection and the broadening of the tax base, among others. On the monetary policy side, with regional inflation at a very low 1.2 percent and big output gaps remaining, some scope for short-term easing of monetary conditions exist, especially in those countries where deficits have begun to decline. However, caution needs to be exercised in the economies with flexible exchange rates to ensure that these do not come under pressure. In terms of financial sector policies, addressing the high NPLs would be critical to ultimately restoring the growth of credit and supporting entrepreneurship and job creation.

4. WHAT FACTORS WILL LIKELY DRIVE THE ECONOMIC CONVERGENCE MACHINE IN MACEDONIA IN 2015?

The main goal of National Bank of Republic of Macedonia is the maintenance of the price stability. In this way, the National Bank is committed to applying strategy of maintaining stable nominal exchange rate against the Euro.

The role of the exchange rate as a nominal anchor derives from the characteristics of the domestic economy, as a small and open economy that is highly dependent on the import of primary commodities. Also, Macedonian exchange rate can be used as an instrument for export performances of the country.
Macedonian policymakers should create policy with several aims focused on exchange rate policy because:

- A competitive real exchange rate provides an incentive for exports
- The impact of exchange rates on trade should be seen in the context of continued integration of supply chains
- Exports generally include high import content and impact of foreign currency-exchange appreciation or depreciation on any finished product because it is complex. If the depreciation of the exchange rate makes its exports of finished products "cheaper", it makes imported components "expensive" for domestic producers.
- Maintaining growth and reducing the unemployment in a small and open economy such as Macedonia depends from improved performance of exports.
- Improving the performance of exports can help to preserve macroeconomic stability by closing the gap in the current account to avoid wasting supplies and to stop the growth of external debt.
- Improving performance requires improving export competitiveness.
- An outward oriented, market-friendly trade regime, which emphasizes the dismantling of import controls and tariffs (permitting access to inputs at world prices), and streamlined bureaucratic procedures, *i.e.* export and import procedures, modern

customs administration and efficient value added tax administration will facilitate exports, including from SMEs.

According to the expectations from reports by NBRM, the inflation will slow down also in 2015, when it will approach the historical average and equal 2%. Also, in 2015, it is expected that the current public investments will continue, and as there are expectations for new infrastructure projects[59]. It is estimated that these developments in the export sector and the strengthening of investment activity will create positive transmission effects on both the labor market and the expectations, and thus be a factor for further increase in the household consumption. It is expected that the GDP growth in 2015 it would speed up even more and reach 4.4%. Given the high openness of the economy, the risks to the projected growth continued to result from the global environment and developments in the external environment.

By the end of 2015, the credit growth is projected to accelerate and it would reach 8.5%. Projections for 2015 show that the external position can provide further increase in the foreign reserves and their maintenance at appropriate level. In addition, in 2015, widening of the current account deficit by 5.7% of GDP is expected, mainly due to the fall in private transfers. Despite the moderate deterioration on the current account, it is estimated that its negative balance will be fully financed by capital inflows, mainly coming from foreign direct investment and external borrowings for infrastructure projects. It is expected that the foreign direct investments will gradually increase in 2015 at 4.5% of GDP, respectively.

In 2015, prudent fiscal policy is expected, with gradual consolidation of the budget deficit and relatively stable level of public debt. The fiscal policy is important factor that influence the monetary policy setup, while the adequate coordination of these policies is crucial for creation and maintenance of the macroeconomic stability. After the risen level in 2013, the budget deficit is expected to fall gradually and it would range about 3% of GDP on a medium run. Hence, in 2015, it would equal 3.2% of the GDP. The primary budget deficit should be equal 2.2% of the GDP in 2015, respectively.

5. IS THERE CONVERGENCE PROJECTION FOR SEE6 IN 2015?

SEE6 growth in 2015 is expected to accelerate to 2.6 percent on average. All six SEE economies are expected to contribute to the increase in growth rates as external demand firms up and domestic demand begins to recover. Albania, Bosnia and Herzegovina, Kosovo and Serbia are all projected to have higher or the same growth in 2015 than in 2014. In 2015, SEE6 economies are projected to grow slightly slower than the average for the EU11 countries (2.6 percent compared to 2.7 percent growth for EU11).

There are significant downside risks to the macroeconomic outlook for the SEE6 region. These risks, both external and internal, are related to[60]:

- Deflationary risks in the Euro Area leading to weak Euro Area economic recovery:
- The pace of the Euro Area recovery could be weaker owing to disinflation or even deflation. This would reduce the export growth that has been so important to the nascent economic recovery of SEE6 countries.

[59] NBRM (2014) *Recent Macroeconomic Indicators* ,Review of the Current Situation.
[60] World Bank (2013e): Western Balkans Activation and Smart Safety Nets AAA Synthesis Note, Mimeo, World Bank, Washington, DC.

- The pace of rising global interest rates: In light of the gradual tapering by the United States Federal Reserve, developing and emerging market economies, including the SEE6, are entering a period of expected global financial tightening in the medium term. This could have implications for funding inflows to the region.
- The potential geo-political ramifications of the ongoing Russia-Ukraine conflict:
- The escalation of the political crisis will introduce new risks for Europe. While the SEE6 linkages with Russia and Ukraine are limited, further intensification of these geo-political tensions would have inevitable direct (through trade and financial channels) and indirect (though second-round effects via Europe) implications for economic growth in the SEE6 region. Broader risks related to contagion and negative investor confidence may also appear as a result of the Russia-Ukraine conflict.
- Insufficient effort in tackling remaining structural weaknesses: "Reform fatigue" may delay implementation of policies designed to improve, for example, the business climate or address weaknesses in labor markets or reduce the large structural fiscal deficit or restructure the state-owned enterprise sector. In addition, the fiscal challenges to stabilize and reduce public debt in several countries may appear daunting. Also, lack of progress on the resolution of NPLs, and public sector arrears to suppliers could adversely impact credit recovery and growth prospects.
- Socio-political tensions: Albeit to a different degree across the SEE6, high levels of unemployment, ongoing SOE restructuring efforts and elections in Bosnia and Herzegovina and Kosovo are among the factors which may trigger heightened social tensions, as seen most recently in Bosnia and Herzegovina.
- Weather related risks: The impact of the recent floods on economic activity in Bosnia and Herzegovina and Serbia is not known yet, but it will likely put further downward pressure on the recovery in these two countries in 2014. Agriculture is especially likely to be hit and mining as well as infrastructure may also be harmed. On the other hand, reconstruction efforts may partly counteract the negative effect of the floods. In addition, the increased rainfall will ensure full reservoirs, benefitting hydro-power generation (which suffered during droughts in 2012).

There is evidence suggesting that improvements in the business climate should be broad rather than targeted toward specific sectors, as growth and employment creating firms tend to be young and dynamic, but not concentrated in any particular sector. Improving trade links in terms of logistics, institutions and regulations will be important to take advantage of the EU market. In addition, governments need to provide reliable and streamlined processes that guarantee EU safety standards are met for exporting firms, particularly for agricultural exporters. Improvements in governance standards—including the rule of law—will be closely linked to the EU integration process. But reforms required by the EU will also help to boost economic growth in SEE countries.

Such reforms are essential to boost labor demand, reduce unemployment, address the challenges driven by demographic changes and improve prosperity for all in SEE6. Increasing employment is essential to reduce poverty and to bring about shared prosperity in SEE6. Since the major source of income for most households is through selling labor, increasing employment opportunities and ensuring that workers have the skills necessary to take advantage of these opportunities are essential to increase the income generation capacity of the entire population.

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