

Coordination of macroeconomic policies in Macedonia

Summary

Initial conditions in the Macedonian economy prior to stabilization policy were large internal imbalances and a vulnerable external balance. The stabilization policy that started in 1994 was aimed at *restoring internal balance, to achieve sustainable external balance and to facilitate structural reforms* on the macro (transformation of government administration and social security system) and micro level (privatization and restructuring of socially-owned enterprises). An important feature that followed the stabilization in 1994 and 1995, and strongly influenced policy coordination, was the appearance of a “Dutch Disease” effect as a consequence of a short-term favorable external shock (UN sanctions against Serbia and Montenegro). The “Dutch Disease” effect created an illusion that the economy is in external balance. Therefore, the National Bank and Ministry of Finance used all policy tools (including exchange rate policy) to restore internal balance. In the meantime, the government was supposed to conduct privatization and enable restructuring of the economy. The stabilization policy resulted in rapid and sustained reduction of inflation. Stability of the nominal exchange rate in 1994 helped to build credibility and to eliminate inflation expectations. After a decline in the 1990-1995 period, real growth started to recover. Since the exchange rate was actively used in the stabilization policy, at first as a key indicator of the monetary policy and, later, as main anchor of stabilization policy, the external sector was left without a main policy tool. This policy caused a strong real appreciation i. e. negative switching, thus reducing profitability of export and of import-competing industries. While the central bank was executing consistent and highly professional work, the government was occupied with distributing the privatization cake and benefits from the short-term favorable external shock between different lobby groups. Thus, it missed the exceptional opportunity of having three years time-out, using the external benefits to prepare the Macedonian economy for competing in a market environment. With vanishing of a favorable external shock the external current account balance slumped from 0 in 1995, to a deficit of almost 8% of GDP in 1996. In the middle of 1997, after three and a half years of stabilization, internal balances have reemerged, and another large external deficit is threatening. GDP growth is far from forecasted level of 5%, inflation is less than 1% annually, savings are extremely low (only 11% of GDP), the budget deficit is going to be less than 2.5% in 1996, and the current account deficit is going to remain at the level of 1996 (8% of GDP). It is time for a redesign of economic policy.

1. Background of the reform

After announcing political independence in September 1991, the Macedonian government started preparations for taking control over the Macedonian economic territory. In the meantime, it had to bear all consequences of an expansionary monetary policy run by the federal government of Yugoslavia. Eventually, in May 1992 after monetary independence, the Macedonian government took control over the domestic economy. Since then, all efforts of Macedonian economic policy were focused on rapid adjustments of macroeconomic imbalances while, at the same time, carrying out limited structural reforms.

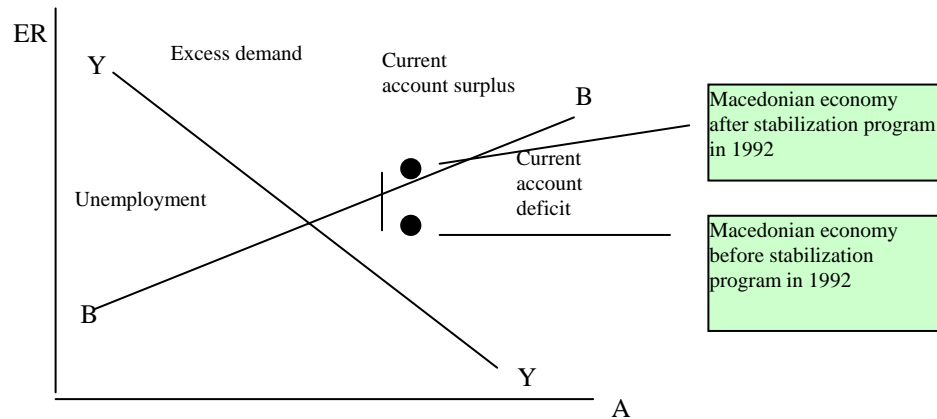
In the early 1990's Macedonian economy was characterized by falling GDP in three consecutive years, a current account deficit of almost 6% of GDP in 1991, large budget deficits, galloping inflation, a heavy debt service burden and almost no international reserves. This unfavorable economic environment was aggravated by adverse supply shocks that hit the economy, the disintegration of the former Yugoslav market and the disintegration of the CMEA trade zone (before 1990 around 70% of Macedonian exports and 60% of imports were realized in these two markets). Faced with this unfavorable economic situation Macedonia embarked on its first stabilization program following monetary independence in May 1992. The program was based on heterodox approach with tight monetary policy, fiscal restrictions, strict wage controls, and an exchange rate policy and trade administrative regulations aimed at discouragement of imports and promotion of exports of goods and services. Given high disinflationary costs, the lack of external financial and professional support and the obscure of majority in the parliament it was a question of time when the program would fail. After only three months, the lobby of socially-owned enterprise managers in the parliament, succeeded in withdrawing the law on wage controls.

The results of this short lived stabilization program were mixed. With the loss of wage controls and a large fiscal deficit owed to excessive expenditures necessary in the initial stage of the independence, inflation surged and galloped to a rate of 1500% in 1992 - the highest in Macedonian history. In this hyperinflationary environment, GDP continued to decline at an accelerated rate. Despite the fact that during the implementation of the stabilization program the economy was hit by additional two external shocks (UN sanctions against Serbia and Montenegro and the first Greek oil embargo on Macedonia), the external sector showed good results. Export stayed on the same level while import decreased by 15% in real terms, which contributed to a balanced current account and enabled an increase of international reserves. This was a result mainly of a large nominal and real depreciation of the Macedonian denar and a multitude of administrative import restrictions.

The unfavorable economic trends continued in 1993 with a slight, further deterioration. The positive effects of the 1992 real exchange rate depreciation on exports were exhausted by increased inefficiency of enterprises, which in turn led to a deterioration in the trade balance. The current account stayed almost the same due to a large increase in transfer receipts. The loss of wage controls led the final consumption to accelerated growth, crowding out investment. The government deficit reached 13.6% of GDP. The only positive policy measure was the achievement of a positive real discount

rate by the National bank that increased the costs of refinancing for deposit money banks and forced the latter to raise interest rates to positive levels in real terms (real lending rate was 80%). As a consequence, the CPI decelerated to “only” 362%.

Swan diagram 1



ER-Real exchange rate (a movement upward – a real depreciation)

A – Real absorption

YY – Equilibrium on market for goods and services

BB – Current account equilibrium

In 1991, $S-I=CAB$ in relative terms was $12.1-17.7 = -5.5\%$ of GDP.

Internal imbalance was generated by excess consumption and was reflected in a high budget deficit. The unemployment rate was very high, but bearing in mind the structure of the Macedonian economy and the limited ability to produce in a market environment, there was overemployment in some sectors and excess demand. It was confirmed in the following years by shedding of labor.

The real exchange rate depreciation restored the external balance, but aggregate demand still exceeded supply.

2. Stabilization policy and structural reform

At the beginning of 1994 the government adopted a comprehensive and consistent stabilization program which was supported by IMF under the Systemic Transformation Facility (STF) arrangement. The policy was aimed at *restoring internal balance, achieving a sustainable external balance and at facilitating structural reforms* on the macro (transformation of government administration and social security system) and micro levels (privatization and restructuring of socially owned enterprises). The basic features of the economic policy were supposed to be: *managing the level of aggregate demand through monetary policy, fiscal policy, exchange rate policy and wage control; implementation of structural reform in order to enhance the supply response and promotion of efficient allocation of resources*. Having in mind this broad framework, this paper centers on three main themes: *how the timeliness of policy responses to emerging imbalances influenced the impact of stabilization policy on output and investment;*

consistency and sustainability of policy with respect to short-term and long-term goals; and the willingness and ability of government and economic agents to cope with structural rigidities.

It should be mentioned that stabilization policy had to cope with two external shocks. The first one was the second Greek embargo on the flow of goods and capital, and the movement of people that lasted two years (1994-1995). It can be considered as adverse supply shock. The second one was the already mentioned UN sanctions on Serbia and Montenegro (our main trading partners). Despite conventional perception and treatment in Macedonian public as adverse supply shock, in this paper it will be considered as favorable external shock in the short-run and adverse in the medium-term (arguments for such treatment will be given below).

2.1. Interaction of monetary, fiscal and wage control policy

The stabilization policy resulted in rapid and sustained reduction of the inflation. From near hyperinflation at the end of 1993, the annual rate of inflation was reduced to 128% in 1994, 15.7% in 1995 and to industrial country levels (2.3%) in 1996. During the whole period monetary policy was acting in close accordance with exchange rate policy, fiscal policy and incomes policy.

The stabilization policy started in 1994 as a money-based stabilization, using the exchange rate as a key indicator of the monetary policy. In the last quarter of 1995 it was transformed into an exchange rate-based policy, as a consequence of unstable money demand and a presumed strong link between the price and the exchange rate stability. The change in monetary strategy and establishment of the exchange rate as a nominal anchor was argued on the following grounds:

- The importance of the exchange rate in a small open economy;
- Unstable money demand in a period of structural reforms;
- High dollarization as the share of foreign currency deposits in narrow money M1, which reached 30% in 1996;
- Low level of monetization (M1/GDP) of only 7%;
- Exchange rate is a transparent indicator of the government commitment to appropriate stabilization policies.

The coordinated implementation of *exchange rate and monetary policy* contributed to a sharp deceleration of money supply growth, followed by high nominal and real interest rates. While the nominal exchange rate has stabilized from January 1994, the real exchange rate appreciated considerably (by 36% by the end of 1996) that led to a deterioration in international competitiveness. The growth rate of money supply M1 decelerated from 222% at the beginning of 1994 to 9% in 1995, and it became negative (-3%) in 1996 as a result of a tight monetary stance.

The *interest rates* in the first months of the implementation of stabilization policy, rose to very high levels (in March 1994 the short term lending rate was 331% in nominal terms and 63% in real terms). As the credibility of stabilization policy increased, the interest rates started to fall, but they still remained high in response to high credit demand, low domestic saving, and the need to maintain stability of the nominal exchange rate (in December 1996 the short-term lending rate was 21%, both in nominal and in real terms).

Restrictive monetary policy was supported by extraordinary *fiscal consolidation*

efforts indicated by a reduction of the budget deficit from 13.6% of GDP in 1993, to 3.2% in 1994 and further to 2.5% of GDP in 1996. Financing of the budget deficit was concentrated on foreign borrowing to avoid the destabilizing effects of an inflation tax. Non-bank financing (issue of bonds) as alternative was not possible due to low savings and lack of capital market. These adjustments were based on the consolidation of the budget expenditures through reduction of expenditures, including public sector wages, and by broadening the tax base through withdrawal of most tax exemptions. However, the level of general government expenditures (45.4% of GDP in 1996) is still very high and requires decisive action for further reduction. Simultaneously, technical preparations for introduction of a VAT system in 1999, instead of the sales tax system, has been under way since 1995.

The third tool used for managing the level of aggregate demand was *wage restraint*. In the first stage of the stabilization program, the key purpose of wage control was deindexation of wages, while in the second stage the main purpose was to prevent possible wage-push inflation, to reduce unit labor costs, and therewith to increase international competitiveness. Wage controls were introduced as a law at the end of 1993. According to this law, wages in the public administration and pensions can be increased up to the CPI in the last month minus 2 percentage points (e. g. if monthly CPI in the April was 3%, wages for April that are to be paid in May are allowed to increase only 1%), while in socially-owned enterprises by CPI in the last month minus 1 percentage point. Since, private enterprises are excluded from this law, privatization of the socially-owned enterprises resulted in a declining coverage of employees by this law. As a consequence, contrary to declining real wages in 1994 and 1995, in 1996 real wages rose slightly (Table 1 of the Appendix). This tendency continued in 1997.

2.2. External sector policy

Since exchange rate was actively used in stabilization policy, at first as a key indicator of the monetary policy and later as a main anchor of stabilization policy, the external sector was left without a main policy tool. The nominal exchange rate in the period December 1994 to December 1996 rose only 5% while domestic inflation was 70% (55 in 1994, 9 in 1995 and 0.2 in 1996). The ensuing real appreciation involving negative switching, reduced the profitability of export industries and of import-competing industries in the absence of noteworthy productivity growth in the real sector. However, the Macedonian economy was enjoying the benefits of a favorable external shock (already mentioned UN sanctions imposed to Serbia and Montenegro) that was yielding large amounts of foreign currency earnings that were sufficient to cover the current account deficit and even increase international reserves, a typical “Dutch Disease” effect.

Despite the real appreciation of 34% in 1994, export grew 27%, and additional 5% in 1995 as a result of re-export activities. The lifting of UN sanctions resulted promptly in a sharp downturn of export in 1996, bringing it back to the level of 1993.

Large inflows of foreign currency from re-export activities, and the real appreciation of denar created favorable conditions for importers. A large influx of cheap imported goods at lower costs flooded the market, thereby crowding out domestic producers. After three years of conducting of stabilization policy import grown 30% in real terms contrary to the 4% growth of export, resulting in sharp jump of the current

account deficit from 0 to 7.7% of GDP in 1996.

2.3. Real sector failure

After declining during 1990-1993, real growth recovered to a small positive rate in 1996. Actually, the growth rates were -1.8 in 1994, -1.2 in 1995 and 0.8 in 1996, but a closer look reveals that numbers are weak and the sign can easily be the opposite of the existing one. Because of the Greek embargo, oil production registered a big decline in 1994 and 1995, and recovered in 1996. For instance, in 1996 production increased more than five times. Contribution to the growth of industry was around 14%, and to the total GDP around 3%. That means that excluding oil production, the Macedonian industry in 1996 had growth of -10%, and GDP of -2%. A similar exercise can be done for 1995 and 1994 with opposite results. So, any thought that broad-based growth started in 1996 is questionable.

Due to the contractionary demand policy, real consumption decreased, while gross fixed investment, after reaching the lowest level in 1994, started to grow sharply in 1995 and 1996.

Speaking about sectors in the economy, we can say that after most loss-making enterprises went out of business, industry probably regained strength in 1996. Services experienced the same in 1994 and especially in 1995 helped by the “Dutch Disease” effect. It is worth noting that the financial sector has a share of about 20% of GDP which cannot be taken as a sign of strength of this sector. Namely, value added of financial intermediaries is measured as the difference between interest receivable and interest payable. Having in mind high real interest rates prevailing in the period 1993-1995 and the level of non-performing loans it is only an accounting illusion. So, high real interest rates had adverse effects on both, industry and banks.

Even though the declining trend in the real sector stopped, it does not mean that sustainable growth has been achieved. Restructuring is still far from being completed. Without determined government action in this direction the agony of a weak real sector may continue.

2.4. Privatization: What has been achieved and what is left for the future?

Privatization in Macedonia started in 1990 with the introduction of workers' shareholders. After two years' break during the dissolution of the former federation, it was revigorated at the end of 1994 by a new privatization law. Till the end of 1996, privatization was carried through in 918 out of planned 1217 socially-owned enterprises. Privatization of the rest is planned to be completed by the end of 1997. The most popular method of privatization was management buy-out, followed by employees buy-out. Foreign investors' participation was recorded only in 12 enterprises, with a symbolic share in the industry.

The privatization process was followed by many tensions and real battles among different managerial levels, or between managers and workers about gaining control over the shares that were issued according the 1990 law and were recognized by the 1994 law. The group that would take control over the old shares had the biggest chances to privatize the enterprise. Part of the decline in output can be attributed to the controversial

implementation of the privatization laws.

Since the manager teams were allowed to buy at least 51% of the enterprises within five years from the realized profit attributed to the shares that they controlled (it was not important to own them), receipts from privatization were about 3% from the value of concluded contracts. Bearing in mind that the Agency for Privatization has the right to cancel the contract if buyers do not fulfill obligations and that many enterprises at the beginning will not be sufficiently profitable, it is most probable that in many enterprises privatization will be repeated in the next five years.

Privatization was not followed with appropriate enterprise restructuring. It can be said that in many cases insiders wanted just to take ownership over the enterprises, without having an idea what to do with them. Apart of it, because there is not clear distinction between the principal and the agent (both are concentrated in the same group) the effect of shareholders' pressure over the managerial team is lost. The situation will be even worse in the new law for trade companies according to which the executive board is given the right not to allow trading of the existing shares on the secondary market.

In conclusion, it can be said that public opinion in Macedonia was *for privatization*, but its implementation created feelings that the burden of the stabilization policy is not shared equally.

2.5. Restructuring of the banking sector

The bank rehabilitation operation took place in 1995 as part of the stabilization program. Eligible for rehabilitation were only five traditional banks that had inherited the largest part of the bad loans from the previous economic system. The newly established banks had no such burden from the past and they have to take full responsibility for bad loans. The non-performing loans in the banks' balance sheets were replaced with government bonds. The collection of claims for bad loans was transferred to the Agency for Bank Rehabilitation, established at the beginning of 1994. The Agency assumed the management over uncollected claims from 429 enterprises.

Bearing in mind the weakness of the still not restructured real sector, risk exposure of the banking sector is still high. Because of the high risks, excessive operating costs, and high demand for credit in the economy on the one hand, and the fact that the primary goal of monetary policy of the National Bank was to maintain interest rates on an appropriately high level in support of the exchange rate anchor on the other, banks have not been able to exhaust their credit ceilings allotted by the National Bank and enterprises that received credits used them in highly risky projects in order to realize profits that will allow them to repay the high interest.

Such credit policy was not in favor of stimulating productive investment, and growth and contributed to increased vulnerability of the banking system.

3. Did macroeconomic policy fail?

Initial conditions prior to stabilization policy were large internal imbalances and a vulnerable external balance. Before the end of 1997, after four stabilization years the Macedonian economy is in opposite position – renewed weak domestic balance and large, unsustainable external imbalance. How did it happen? Where did the policy makers fail?

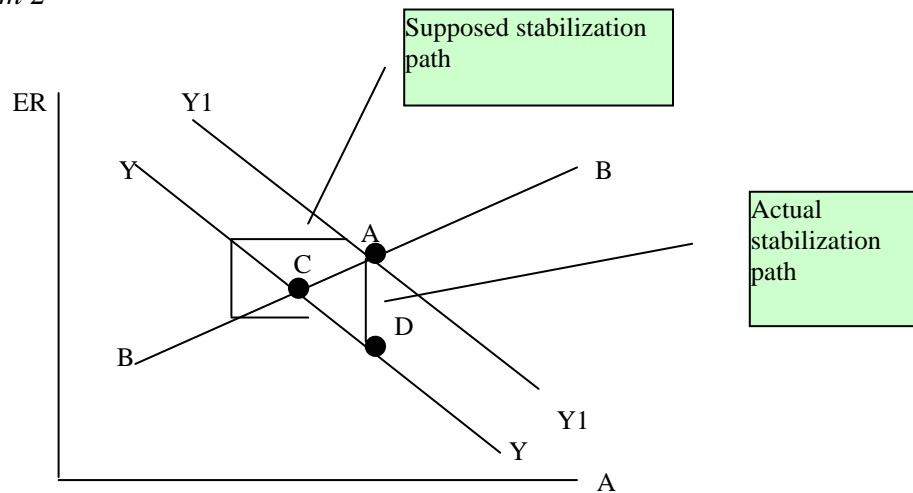
Choice and combination of policy tools were to a great extent determined by the

initial conditions. Since the situation was most critical on the domestic front, and because of the favorable short-term external shock, the thrust of policies was concentrated on restoring internal balance. At the beginning, the role of the exchange rate was one of abeyance. It served only as an indicator of success of monetary policy.

The National Bank and Ministry of Finance were jointly assigned to restore internal balance and create a stable macroeconomic environment for private agents. In the meantime, the government was supposed to conduct privatization and enable restructuring of the economy. The two policies should meet in point C (Swan diagram 2) when the restructured private sector was to push the economy from the supply side in 1996 and more strongly in 1997, bringing the Macedonian economy in new balance in point A (now on higher level of income).

The stability of the nominal exchange rate in 1994 helped to build credibility of the stabilization policy and to eliminate inflation expectations. Initial success in restoring internal balance, a slightly positive current account and increased international reserves encouraged policy makers to continue without changes in 1995. Due to the effects of “Dutch Disease” it looked that the stabilization policy followed the drawn path and the economy achieved internal and external balance (point C). But it was only a statistical illusion. What actually happened was a big real exchange rate appreciation that was exacerbated by lower import tariffs and liberalization of import in 1995. Instead of being in point C, it appears that without the “Dutch Disease” effect the Macedonian economy was in point D.

Swan diagram 2



Before the end of 1995 the favorable external shock vanished and the underlying weakness in the external sector resurfaced. The government being under pressure of public expectations that now devaluation is inevitable and threatened by the failure of stabilization policy decided to reinforce the domestic front. It put the exchange rate in the game as a nominal anchor, giving to the public a clear signal that it will defend internal stability and hoped that the partly privatized, but not yet restructured real sector, is able to defend external balance on its one by increased productivity.

When the exchange rate is a nominal anchor, it leads and monetary policy follows. As in 1996, the demand for foreign currency was higher than supply, external reserves decreased, causing a strong contraction in money supply¹ (M1 decreased by 3% and M2 remained broadly unchanged). This monetary strategy resulted in virtual price stability measured December/December of 0.2% (during six months in 1996 monthly inflation was negative). Due to lack of liquidity huge arrears accumulated among private agents and between private agents and government.

The external current account deficit was so high that the required adjustment (e.g. devaluation) threatened to upset the fragile internal balance. The disappearance of “Dutch Disease” effect in 1996 resulted in 8% current account deficit, financed mainly by short-term credit, and the rest by decrease in reserves and exceptional financing. At this time, it was clearly visible that the Macedonian economy was in point D indicating a strongly overvalued exchange rate.

Obviously, the shift in policy from monetary-based to an exchange rate-based policy was not a good choice. The policy of monetary targeting supported with fiscal adjustment and wage control policy was working very well in 1994 and 1995. It should have been continued in 1996, but with a more active use of the exchange rate for expenditure switching policy with a step depreciation of the exchange rate at the outset to correct for overvaluation. However, it have to be recognized that demand adjustment policy followed by the monetary authorities did not bring economy in point C, because restructuring was lagging far behind.

About government policy

Despite real appreciation of 36% in three years export grew by 4%. Knowing the structure of Macedonian economy one can say exporters had no other choice, because they do not have a market in Macedonia. Shedding of labor and decline of real wages contributed to some cut of costs, but it was far below 36%. So, despite losses exporters continued to export. As a compensation some of them were unofficially authorized to trade in re-exports.

Also, at about the same time many large enterprises (some of them even privatized) started not to pay social security contributions. Surprisingly, the tax authorities did not react. The central budget covered part of the deficit of the pension fund (the larger part was borne by pensioners who were receiving pensions with two months lag), many new pensioners still cannot get their pensions because their employer did not pay pension contributions in the last two years, and the health fund recorded large arrears. In 1997, a law was passed that allowed all debtors to social security funds, to pay either 30% of debt in cash or the whole amount over six months. At the same time the government announced a devaluation of 16%.

With such selective government policy some favored enterprises or directors were indirectly subsidized. Lack of transparency that accompanied this practice created uncertainty among private agents about future government behavior.

¹ Domestic sources of money supply were not able to cover the negative effect of decreased external reserves due to high interest rates, small number of attractive investment projects, inappropriate dispersion of liquid assets among the banks (banks which have liquid assets had reached the credit ceiling, while the banks which had room to extend credits have had not liquid assets), and decreased money multiplier.

Instead of coping with restructuring on both the micro and macro levels, the government behavior created a perception among private agents that it is concerned with distributing the privatization cake and benefits from short-term favorable external shock between different lobby groups. Thus, it missed the exceptional opportunity of having three years of time-out, and of using the favorable external shock to prepare the Macedonian economy for competing in a market environment.

The whole restructuring process suffered a setback with cuts of budget expenditures and a reduced pace of privatization of socially owned enterprises. Bearing in mind what restructuring really means we can say that it actually has not yet started. Cuts in government expenditures were not followed by a reform of public administration.

Despite the progress of fiscal consolidation it was not sufficient. The level of expenditures of 45% of GDP is still high and further cuts are impossible without thorough reconstruction of government sector.

The role that the newly established private enterprises can play in restructuring of the economy was neglected and abandoned. The lack of transparency in policies, and the excessive use of discretion in favor of vested interest groups created many obstacles for regular market competition. Consequently, it distorted markets and send the message that only lobbying for favors can succeed. In this way, privatized enterprises were protected against the market pressure that would have forced them to restructure.

4. Proposed adjustments in macroeconomic policy

What can be done to move the Macedonian economy out of point D i.e. to restore external balance without upsetting the internal one? GDP growth is slowly recovering, and inflation is stabilized; however, saving is extremely low (only 11% of GDP), and the external current account is in deficit to the tune of almost 8% of GDP.

Devaluation without supporting demand restriction will have only temporary effects or maybe even no effects at all. If we choose only additional demand contraction without devaluation, it may thwart the nascent recovery of output growth. So, there should be a consistent and well-coordinated *package of exchange rate policy supported by fiscal adjustment, and monetary and wage restraint*. Only in this case will devaluation result in real depreciation needed for the restoration of external balance.

Fiscal contraction of around 2% as result of a reduction of current expenditures would increase national saving to 13% of GDP. Real depreciation will certainly cause a reduction of imports, especially of consumer goods (having in mind the wage control policy), thus creating a better environment for the domestic import-competing industry. Looking at the trend of exports from 1992 to 1996 and adjusting 1994 and 1995 for re-export income, one can note a very stable pattern. That means the price elasticity of Macedonian export is very close to 0. The reasons can be found in very rigid structure of Macedonian economy without new entrants and new products. Taking this into account, real depreciation without supporting supply-side policies will not cause sustainable export growth.

Obviously, these measures will eliminate the budget deficit and slightly cut CAB, but output and investment growth will be negligible. If we want to restore equilibrium at the higher level, at point A, *this package of measures has to be accompanied by strong supply-side policy. Immediately, new incentive should be given to the expansion of new*

small private enterprises. Inefficient administration can only be an obstacle for them. The only support that small enterprises should be given but probably from the chamber of commerce is to create an information center that will provide all available information about export procedures, regulations, economic situation and possible customers in our main trading partners. *The second step* should be to remove legal obstacles for trading the shares of all privatized enterprises on the secondary market. This two measures will create necessary pressures on privatized enterprises to start a restructuring process and introduce corporate governance, and in turn, will attract foreign direct investment.

As a *third step*, the government should start a *comprehensive program for establishing a professional public administration* that will better serve the public. Having in mind the long-term practice of employing and promoting government employees according to criteria other than merits and competence, transformation ought to be radical. New Zealand's model of paying for the produced output (government services) of government departments and agencies would be an example to follow. Why should the government continue to pay for the inputs regardless of the output? Why should employees in government sector not bear the consequences of their poor performance, like employees in the private sector? Reforms directed to solve these questions would create an environment necessary for credible, efficient and low cost government administration.

Finally, *the low saving level* is a problem that cannot be solved in the short-run. To find a solution it is necessary to know reasons for it. Although a deep analysis is not possible due to the lack of detailed national accounts data, some conclusions based on available data can be drawn. Total savings decreased from around 17% of GDP in the period of 1993-1995 to 11% in 1996. In the former period, probably due to the "Dutch Disease" effect, the gross operating surplus of the corporate sector (after deduction of direct taxes and transfers can be obtained savings) was around 10% of GDP, unlike in all other years in the period 1990-1996 when it was close to zero. Thus, the main reason for the low saving level is the low profitability of enterprises and high unemployment. Supply-side policy mentioned above will improve saving level of both, corporate and household sector but only in the long-run. Something that can be done in the medium-term is to attract more household saving into the financial sector. Namely, at the beginning of 1997 the largest saving institution with liabilities of around 120 million of DM went into bankruptcy revealing the role of many government officials in this fraud. Thus, immediate action should be taken to restore the credibility of the government and financial sector in order to strengthen financial intermediation and channel more household saving into the real economy.

Only a combination of supply side measures, with expenditure-reducing and expenditure-switching policies will enable both, sustainable internal and external macroeconomic balances, as well as a quick recovery to durable economic growth.

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