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The Center for Economic Analyses (CEA) is a think tank of economists who share a common vision for the Republic of Macedonia as an emerging new European economy integrated in the regional and worldwide market.

The Mission of CEA is to continuously research economic development and economic policy in the Republic of Macedonia and to offer recommendations, suggestions and measures where it is deemed appropriate.

PRESS RELEASE

CEA Analysis on “The Openness of the Capital Market in Macedonia”

The full text of the analyses is available at:

http://www.cea.org.mk/Nikolov/MEASURING_OPENNESS_CAPITAL_MARKET_MACEDONIA.pdf

Main findings from the analysis:

- The complexity of the topic requires more time resources to investigate it in a satisfactory manner. So far I have started to set a ground for more extensive work I will conduct in near future, I hope. There are many issues with no consensus and it must be further investigated on what is relevant for Macedonia.
- The topic of monitoring the capital market openness is of crucial importance for Macedonia given the confirmed dedication to the fixed exchange rate and the agreed with the new IMF arrangement as well.
- Just for now it seems that Macedonia can keep the current exchange rate regime as long as capital markets remain relatively closed (if the expectations are adaptive). In that case the observed differences in the interest rates between Macedonia and the rest of Europe are most likely due to domestic factors. The more open becomes the capital market, the more problematic becomes the pegging monetary policy. The higher degree of the capital openness will require a choice of the corner solutions-either a more purely pegged exchange rate system – euroization or currency board or towards a purely floating system with either monetary aggregate nominal anchor or inflation as the nominal anchor (in accordance with the impossible trinity theorem).
- NBRM will be less able to affect interest rates as capital markets open, if it continues to pursue a pegged exchange rate. If it continues to fix the exchange rate it will have only one policy tool to pursue the one goal, in accordance with the Tinbergen (1952) rule. It cannot target interest rates and fix the exchange rate regime at the same time. If it wants to target the interest rate it must allow for the exchange rate regime to float. The risk is that if it wants to hold down the interest rates to world level, in a floating environment, it would either print money or cause a loss of the reserves. This is why the institutional strength of the system is of importance.
- The NBRM should conduct a thorough cost benefit analyses of removing/imposing capital controls in Macedonia. The cost of possible crises should be compared with the cost of having

distortion in the capital market. This is of special interest for Macedonia which suffers from sectoral deficiencies. The speculative reversals, a decline in external competitiveness, exchange rate appreciation, loss of control over the monetary base and inflation are some of the detrimental effects that can be provoked by surges in capital flows if the economy suffers from fundamental sectoral deficiencies (see Oplotnik 2002).

- In Macedonia the concentration of export in the production sector is high thus, in terms of flexible regime every shock on the exporting sectors might result in radical disturbances in the price level.
- Even though there is not much capital inflow in Macedonia it is of importance to analyze the results from stress test of the banking system response to external crises as the sudden stops and reversals in depth. Sebastian (2004) has shown that there are no significant relations among them. However, Kaminsky and Reinhart (1999) analyze the importance of joint occurrence of external crises and banking crises.
- A separate technical issue is to conduct a thorough study on finding evidence on rational expectations versus the adaptive expectations in the case of Macedonia with a time varying parameters.
- The IMF gave signals to Macedonia back in 2002 that the authorities could start to think about possible exit strategy but they were expecting thorough analyses from the Macedonian authorities. Whether there exist or not such analyses is important to know because if they do not exist the arguments that are in the country report from the IMF are showing nothing more but existence of fear of floating in Macedonia.
- With the taken responsibility of the Macedonian government and the joint effort of the new IMF's SBA and the WB's PDPL including the BERIS project, we are expecting more efficient administration services and lower levels of corruption that should increase the effect of further financial opening and fostering the development of equity markets as well. The IMF program supports increasing the flexibility of the labor market, raising the efficiency of the judicial system, and improving public sector governance and efficiency. These measures will be supported by continued prudent fiscal and monetary policies. This is more important for the potential investors to be active in a more developed Macedonian equity market.
- In theory, capital account liberalization should allow for more efficient global allocation of capital, from capital-rich industrial countries to capital-poor developing¹ economies. For Macedonia, the EU membership provides a strong incentive for policymakers to adopt and maintain sound policies, with obvious benefits in terms of long-term growth. On contrary, the expected membership will be unlikely to boost capital market integration to a significant degree and to trigger huge capital inflows in Macedonia. The membership in the EU will require that Macedonia abolish remaining entry barriers into their financial sectors and hereby import institutional stability. Seen from this angle, the benefits of further capital account liberalization may outweigh the risks of such a strategy. At the moment this is still a distant future to trigger such analyses taking into account the recent failure to NATO membership expectations and the fragile expectation of EU candidature.
- Capital account liberalization could pose major risks if implemented in unfavorable circumstances. In the case of Macedonia with the fixed exchange rate regime, and especially when domestic macroeconomic policies might not be consistent with the requirements of the regime, it can be a reason for crises. For instance, capital account liberalization can aggravate risks associated with imprudent fiscal policies by providing access to excessive external borrowing. The foreign borrowing and overall fiscal sustainability is very important issue in the

¹ I am using the term developing country, since the literature in this area is making the classification of developing and industrialized countries. However, the distinction between a country in transition and developing countries is very significant. In this paper I will not investigate further this important topic and its role on financial liberalization.

light of the fixed exchange regime in Macedonia and higher degree of capital mobility. Macedonia might maintain or only gradually ease capital controls while moving toward a more flexible exchange rate regime. Premature opening of the capital account can also pose serious risks when financial regulation and supervision are inadequate.

- The only transmission mechanism in Macedonia is through the exchange rate, as per Bank's sources. This could be due to inadequate NBRM framework and lack of instruments and/or lack of competition and the possible oligopoly of the banking sector.
- Thus, it is important that the range of instruments for implementing monetary policy will be widened in Macedonia (see IMF 2005). The NBRM will consider introducing a low-interest deposit facility, which will complete the interest rate corridor, thus providing a guide for market expectations of interest rates. This instrument might take effect on the behavior responses on the credit supply. Namely, the risk averse banking sector in Macedonia, and its most likely oligopoly position so far, was investing in the high interest instrument of the NBRM and were not increasing the lending to the private sector. NBRM also, plans to improve the guidelines on the currency composition of reserves, the management of the benchmark portfolio and its intended maturities.
- Related to the relevant institutions. Their importance is crucial since the view of free capital markets delivering efficient allocation of resources is only a theoretical fragment with no ground in reality. In reality this market is distorted with incomplete information on different levels: adverse selection, moral hazard (up to the extreme case of *gambling for redemption* as the case with the Export-Import Bank) and herding. Thus, the story of efficient allocation is true only if the regulator have developed policies (prudential supervision and well developed lender of last resort system) to limit the incomplete information and contain the potentially damaging consequences.