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Report from the UNDP mission to the Former Yugoslav Republic of Macedonia, April 26 – May 1, 1999.

1. Introduction

The purpose of the mission was to help the Government of Macedonia (GoM) in assessing the economic consequences of the Kosovo crisis for this country in the context of the forthcoming Consultative Group (CG) meeting in Paris.

2. Progress in Macedonia's economic transition before the Kosovo crisis.

Macedonia represented the lowest level of economic development among the former Yugoslav republics (apart from Kosovo province in Serbia). The first five years of its independence (1991-1995) brought a further decline in real GDP due to negative effects of disruption of the Yugoslav federation and Yugoslav market, terminating fiscal transfers from the federal to republican budget, UN economic sanctions against Yugoslavia, Bosnia war, diplomatic conflict with Greece and resulting Greek economic sanctions against Macedonia, hyperinflation and delaying necessary economic reforms. Thus, numerous weaknesses of domestic economic policy overlapped with the extremely unfavorable geopolitical environment: Macedonia is in fact surrounded by countries that either experience serious political and economic crises (Yugoslavia, Albania, and Bulgaria), or are not open enough in relation to Macedonia (Greece).

Only since 1996 and during two subsequent years a very moderate economic recovery revealed the very mixed balance of the Macedonian economic transition.

After tough lesson of hyperinflation in 1992-1993, the Macedonian authorities adopted very prudent monetary and fiscal policies that allowed to accomplish one of the lowest inflation figures among countries in transition, stable exchange rate (apart from one devaluation in 1997) and almost balanced budget. Unfortunately, these achievements were not sufficiently supported by microeconomic, structural, and institutional reforms. Among the most important weaknesses one can mention a delayed privatization dominated by managers and employees, fragile financial sector subordinated to the interests of big loss-making non-financial enterprises, slow progress in reforming big state farms, lack of the effective bankruptcy mechanism, labor market and other regulatory rigidities.

In fact, Macedonia did not draw an adequate lesson from the period of 1993-1995. Macedonian economy was not reoriented enough towards economic partners other than Yugoslavia. After stopping Bosnian war and terminating UN economic sanctions against Yugoslavia only partly reformed Macedonian enterprises rebuilt their "traditional" links with the Yugoslav unreformed enterprises, very often continuing production of substandard goods, which cannot be sold to other markets. Part of these relations were based on barter contracts what makes trade reorientation even more complicated now. Microeconomic flexibility did not increase substantially during the period of 1996-1998. Most of the above mentioned rigidities have not been removed what makes Macedonian economy very vulnerable vis a vis any new shock.

The planning and administrative capacities of the GoM in dealing with the possible crisis situations (such as inflow of refugees) were also not enhanced enough.

Economic policy of Macedonia did not take account of the "Yugoslav" risk forgetting the obvious fact that Yugoslavia never fully normalized its political and economic relations with the rest of Europe, and never stopped to be the source of regional destabilization. Additionally, Yugoslav economy remained in fact unreformed and its fundamentals were always extremely fragile. Even in the beginning of 1999, when conflict in Kosovo was already significantly advanced, Macedonian economic relations with Serbia worsened, and signs of economic slowdown in all of Europe, including the Balkan region were obvious, budget projection for 1999 assumed completely unrealistic real GDP growth target of 6.5% (!). This does not help dealing with macroeconomic and fiscal consequences of the new situation at the end of March of 1999 when Kosovo crisis entered the new dramatic phase.

3. Immediate economic consequences of the Kosovo crisis for Macedonia

After starting the NATO military action against Yugoslavia and intensifying ethnic cleansing in Kosovo by the Serbian authorities Macedonia's economic and social situation dramatically deteriorated. It is still too early to precisely assess all possible consequences of the new phase of Kosovo crisis. First, it would need a much more disaggregated and fully updated statistical information, and good macroeconomic forecasting model of the Macedonian economy. Both are unavailable to GoM and to the author of this report. Second, in this stage of political developments around Yugoslavia and Kosovo any assumptions related to future condition of trade, situation with refugees, etc. seem to be very risky. Therefore, I can only outline the main direction of analysis which should be done by the GoM together with experts. Such updated macroeconomic projection would create basis for the revised version of the 1999 budget, and monetary policy program, as well as for the specification of a foreign financial and economic aid.

In the coming few months the macroeconomic situation of Macedonia will likely develop in the following way:

Trade and output losses

Most of trade relations with Yugoslavia is stopped (but probably not completely). This means demand shock for many of Macedonian exporters (particularly for enterprises, which produce specific goods saleable only on the Yugoslav market), and supply shock for those Macedonian producers who have become heavily dependent on inputs imported from Yugoslavia. Export reorientation usually is more difficult and takes more time than import reorientation. However, the latter is sometimes difficult due to technological reasons or involves much higher costs of alternative supplies.

Part of the hitherto export to Yugoslavia can be probably sold to other countries or domestic market. Stopping import from Yugoslavia can create additional market for some domestic producers of the same products or close substitutes. Finally, increased domestic demand coming from an increasing number of foreign visitors (journalists, employees of international aid agencies, etc.), foreign military personnel, and refugees can also increase demand for some Macedonian goods and services. Probably 25-50% of export losses can be compensated by the above mentioned factors.

Transport/ transit losses.

Transit routes through Yugoslavia has been blocked by air strikes and some of them were physically damaged. This complicated conditions of Macedonian export and import to many European countries other than Yugoslavia. Alternative transportation routes will involve higher transportation costs. In addition, transportation sector in Macedonia will lose from decreasing transit car and railway traffic through the Macedonian territory and other transport services (for example, decreasing number of passenger flights to and from Macedonian airports). It will be only partly compensated by an increasing volume of transport services connected with deployment of international military forces and humanitarian aid.

Increased country risk perception

Close geographical neighborhood to the territory affected by military conflict certainly increases perception of the country risk. This will negatively influence foreign investments, some current trade and service transactions (there are signals about canceling many export subcontracts to Macedonian textile industry), insurance and credit costs, balance of payment flows (for example, limiting private transfers to Macedonian banks, requesting prepayment for import, private capital outflow) and demand for domestic money balances. Economic agents may prefer to keep their financial assets in D-Marks and US dollars rather than in Macedonian denars.

Increased social burden

Output losses of many enterprises will lead to employment reduction, and consequently to the increased social spending (unemployment benefits and other social benefits, maybe also an increased number of earlier retirees). However, if we take into consideration existing labor market and corporate governance rigidities, employment reduction will be less than proportional in relation to GDP decline and will follow negative output trend with certain time lag only.

The biggest social expenditure increase is connected, however, with the inflow of Kosovo refugees. Part of the additional expenditures in this sphere can be refinanced by the international donors depending on the presence an adequate expenditure control mechanism.

Fiscal consequences

Trade shock and output losses will lead to decreasing tax revenues. This relates, in the first instance, to profit tax collection as inertial reaction of many enterprises (in searching new markets or in firing redundant employees) will be reflected in disappearing profits. Expected less than proportional reduction in employment means only limited decrease in personal income tax collection and in payroll taxes (contribution to social funds). Stronger investment than consumption reduction will also help to keep relatively strong sales tax, excise tax and import duties collection. Taking into consideration an increased perception of the country risk and recession/stagnation in many sectors it is difficult to expect revenues from privatization.

As it was mentioned earlier, Kosovo crisis will increase pressure for all types of social related expenditures, related mainly to refugees, unemployment and poverty alleviation. In addition, some increased spending for national defense, and public security will also be needed.

Balance of payments projection

This part of macroeconomic projection is the most uncertain. What concerns balance of trade of goods the scale of export reduction depends mainly on an enterprise ability to find alternative export markets which would substitute the lost Yugoslav market. Import will also decrease but the scale of its reduction will depend on the size of GDP decline, structure of its decline (consumption versus investments) and its marginal import absorption.

Worsening in balance of services will be determined, to significant extent, by the losses in transit services, increased transport costs, and perception of the country risk. On the other hand, lower GDP may lead to a decreased demand for some of the imported services. Presence of the large number of foreigners (military personnel and civilians) and massive humanitarian action will increase demand for certain exported service items.

Estimates of other BoP items, i.e. private and official transfers and capital account items are connected with a great uncertainty. Certainly, Macedonia cannot expect inflow of private FDI or portfolio investments as well as private credits in the current situation. Private transfers from abroad can decrease but not necessarily. On the contrary, presence of a large number of refugees may be connected with some additional transfers from their families abroad. Probably some of refugees when coming to Macedonia bring foreign currency.

Financial aid from international organizations and some Western governments can help to close at least partly the financial gap in the BoP.

Challenges for monetary policy

Monetary policy of the NBRM will have to respond to the following challenges:

1/ Possible balance of payments gap will lead to decrease in net foreign assets (NFA) position what means increased pressure on the exchange rate and, other things being equal, smaller monetary base and money supply. The NBRM should avoid sterilizing decrease in NFA by increasing net domestic assets (NDA) in order to avoid devaluation pressure.

2/ Avoiding such a sterilization will be difficult because of the expected increase in fiscal deficit. If other sources of deficit financing are not in place (for example, foreign official aid), central bank will remain the creditor to government, despite the existing legal barriers (it will happen through running down government deposits in the NBRM).

3/ Possible worsening of the commercial banks assets portfolio caused by deterioration of financial results of many enterprises (see above) will lead to increasing pressure for activating the lender of last resort functions of the NBRM. As in the case of increased public sector borrowing requirements, this means higher NDA, higher monetary base, and higher money stock.

4/ Additional pressure for the denar exchange rate can come from the decreased demand for denar caused both by lower real GDP and increased domestic money velocity. The latter may result from expected higher economic and political risk.

5/ If the NBRM cannot defend the current denar/DM (EUR) exchange rate, negative consequences of such situation for a macroeconomic, social and political stability of the country can be very serious.

Possible future scenarios

Projecting macroeconomic policy for the rest of 1999 and year 2000, and trying to estimate the size of needed foreign financial assistance, it is necessary to take into consideration that political situation in the region can develop according to various scenarios. Military phase of the Kosovo conflict may finish during next few weeks but may last many months and further escalate. It can be ended with the global peace arrangement involving also Serbia into political and economic normalization process and post-war reconstruction. However, one can imagine only a partial solution (some form of cease-fire) not addressing fundamentals of the conflict, leaving Serbia isolated from the international community and keeping situation in the region still fragile.

Under any scenario, Serbia and Kosovo will go out of the conflict heavily devastated economically. Thus, pre-conflict scale of Macedonian -Yugoslav relations cannot be rebuilt very quickly. The same relates to transit corridor through Serbia where a lot of transport infrastructure was damaged by NATO air strikes.

Return of refugees to Kosovo will also need time, depending on the speed of reconstruction of this province.

4. Estimates of war damages

A very rough and simplified calculation made by the author of this report gives an approximate GDP decline between 4 and 8% of GDP depending on the length of Kosovo crisis and its final outcome. This estimation is coming from the current share of export in GDP (ca. 45%), and share of export to Serbia in the total export (ca. 20%), plus some additional losses (transport and transit, consequences of increasing perception of country risk), minus possible compensation effect (reorientation to other market, increased demand for domestic production). In the optimistic variant I assume that war will last 3 months and later trade with Serbia will be rebuilt up to 50% of its pre-crisis size. In the pessimistic variant I assume that military conflict or economic isolation of Serbia will last until the end of 1999 and trade relations with Serbia can be maintained only on the level of 10% of the pre-crisis turnover.

5. Recommended direction of an international financial aid to Moldova

CG meeting in Paris will naturally concentrate on the short term emergency needs of Macedonia: financing assistance to refugees and short term balance of payments support. However, the GoM should address, at least in general terms, three other important issues to the international donor community:

1/ Apart from a short term emergency assistance, Macedonia needs a longer oriented development aid focused, for example, on restructuring the Macedonian economy towards other than Yugoslav markets, increasing microeconomic and social flexibility in order to deal effectively with the current shock, and any other possible future shocks (which cannot be a priori ruled out in this highly risky region), building alternative transportation routes, etc.

2/ Macedonia needs a more liberal trade regime both with the European countries and with the United States. Particularly, an opportunity to start negotiations between the EU and Macedonia on free trade and association agreement should be taken under a serious consideration.

3/ GoM should suggest NATO and administrators of humanitarian programs to realize part of their supplies directed to Macedonia through procurement addressed to Macedonian enterprises.

6. Recommended direction of the international technical assistance

Macedonia needs various types of technical assistance in order to effectively deal with the current crisis, and accelerate market-oriented economic reforms. In the context of the conducted mission author of this report wants to stress some specific technical assistance needs which should be addressed relatively quickly:

1/ GoM would benefit from assistance in building modern macroeconomic forecast and analytical capacity (according to the information from GoM officials, such a capacity in fact does not exist at present). This assistance should be in first instance addressed to the Ministry of Finance and to the NBRM in order to improve the quality of the monetary and fiscal policy programming and their better mutual coordination.

2/ Even more urgent is the technical assistance related to budget projection and budget management of the assistance to refugees. In fact, Ministry of Finance does not have enough capacity to plan and control expenditures for this purpose and verify proposals submitted by the spending ministries.

3/ GoM also seems to lack proper mechanism for the coordination of economic policy. Hence, there are problems with designing the complex and consequent economic reform program, with preparing consistent and well justified estimation of crisis damages (see section 4), and with well coordinated actions of individual ministries and agencies, addressing both current crisis, and accelerating economic reforms. Thus, some kind of technical assistance/training in this sphere could help the new government to work together and work out more aggressive anti-crisis and pro-reform strategy.

Skopje, April 30, 1999.