Private and Financial Sector Development in Transition Economies:

The Case of Macedonia

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Abstract

Large gaps have opened up between the transition countries in terms of the real income rises they have achieved since 1989. Since phases of hyperinflation are a thing of the past in nearly all of the reforming countries, and the private sector has established itself as the largest contributor to every country's gross domestic product, stabilization and privatization can largely be discounted as likely causes of the differences in economic performance. Macedonia, for instance, has rigorously implemented a set of conventional stabilization policies, but its growth performance is rather disappointing. An analysis of the development of its private sector and financial system shows that this can be traced to inadequate corporate governance. Accordingly, Macedonia can be regarded as an example which demonstrates that corporate governance arrangements play a key role in explaining the overall performance of the transition economies.

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"Financial discipline, as I see it, means the enforcement of four simple rules:

1. Buyers: Pay for the goods you buy.

2. Debtors: Abide by your loan contract; pay back your debt.

3. Taxpayers: Pay your taxes.

4. Enterprises: Cover your costs out of your revenues."

János Kornai (1993, p. 315)

1. Introduction

As the new century begins, Central and Eastern Europe is embarking on its second decade of transition. This would seem an appropriate time to take stock of the transition process to date. However, assessments like the one provided by EBRD (1999) are motivated not solely by the calendar, but also by the desire to analyze the patterns of economic development in Central and Eastern Europe that are now emerging. In particular, they address the question of why large gaps have opened up between the transition countries in terms of

- the extent to which they have succeeded in raising real income since 1989, when they could all still be regarded as centrally planned economies,
- the strength, in the sense of a J-curve effect (Portes 1992), of the growth process following initial output losses

(see Table 1, columns 2 and 3). Whereas Poland can be regarded as *the* success story of the reform era, having not only increased income levels but also – since 1993 – achieved sustained, dynamic growth, Slovenia, Hungary, Slovakia and the Czech Republic have only just regained the level of per capita income they recorded in 1989, and all of the other transition economies are still striving to make good their initial output loss. Some, like Albania and Georgia, have made considerable progress (see column 3 of Table 1) – albeit after a massive initial decline – but most of the other countries are finding that recovery is a slow and very arduous process. Indeed, the large CIS countries, Russia, Ukraine and Kazakstan, are only now, in the year 2000, starting to report significantly positive growth rates.

Table 1: Income levels in 1998 (compared to 1989), cumulative growth rate (since lowest point on real income curve), inflation rate (average for the years 1995 – 1998) and private sector's share of GDP in selected transition countries

Country	Incomes in 1998 (1989 = 100)	Cumulative growth rate* (Ranking)	Inflation rate in per cent (Ranking)	Share of the private sector in GDP, mid-1999, in per cent (Ranking)
Poland	117	42.5 (2)	15.47 (9)	65 (8)
Slovenia	104	25.7 (5)	8.32 (4)	55 (14)
Slovak Republic	100	32.9 (3)	6.15 (3)	75 (3)
Hungary	95	16.2 (9)	19.20 (11)	80 (1)
Czech Republic	95	12.7 (11)	8.32 (4)	80 (1)
Albania	86	43.1 (1)	18.55 (10)	75 (3)
Croatia	78	20.6 (7)	4.10 (2)	60 (10)
Estonia	76	25.7 (6)	15.22 (8)	75 (3)
Romania	76	1.8 (14)	69.17 (16)	60 (10)
Macedonia	*72*	*5.2 (12)*	*1.97 (1)*	*55 (14)*
Bulgaria	66	3.5 (13)	232.17 (17)	60 (10)
Lithuania	65	19.8 (8)	14.87 (7)	70 (6)
Kazakstan	61	0.0 (15)	25.55 (12)	55 (14)
Latvia	59	14.0 (10)	11.5 (6)	65 (8)
Russia	55	0.0 (16)	61.45 (14)	70 (6)
Ukraine	37	0.0 (17)	62.70 (15)	55 (14)
Georgia	33	29.2 (4)	53.27 (13)	60 (10)

* = Cumulative output growth between lowest level year since 1989 and 1998
Source: EBRD (1999, pp. 24, 63, 73, 76), own calculations

Although regional factors undoubtedly play a part here, they cannot in themselves fully account for the differences between the countries' performance (EBRD 1999, p. 27); economic analysis is needed to establish the causes. For this purpose, the obvious starting point is to examine the theories and ideas which underpinned economic policy-making in the early days of the reform programs. This is comparatively easy in the sense that macroeconomic stabilization and privatization/liberalization can be clearly

identified as the two main concerns of the early reform period (Gelb/Gray 1991). Furthermore, there is widespread agreement that the reforms have been more or less successful in both of these areas (cf. Stern 1998): In nearly all of the reforming countries, phases of hyperinflation are a thing of the past and the private sector has established itself as the largest contributor to every country's gross domestic product (see Table 1, columns 4 and 5).

However, this means that stabilization and privatization can largely be discounted as likely causes of the differences in economic performance. For, while it is true of the transition economies in general that there is a positive correlation between monetary stabilization and economic growth (Fischer/Sahay/Vegh 1998; Bruno/Easterly 1996), the countries at the top of the growth table are by no means the ones with the best record on macroeconomic stability. What also emerges clearly is that there is no unambiguous correlation between the size of a country's private sector and its GDP growth rate. For example, despite the fact that Russia's private sector accounts for 70 per cent of its GDP, it has not achieved any growth at all, whereas in Poland, where the private sector contributes only 65 per cent of GDP, incomes have risen by more than 42 per cent since 1992. In other words, countries whose policies have been particularly zealous in regard to stabilization and privatization have not necessarily been rewarded with outstanding growth performance.

From a macroeconomic point of view, Macedonia is a particularly striking case in point. Whereas Macedonia leads the rankings among transition economies in terms of price stabilization, when it comes to economic growth the country is languishing at the bottom of the table alongside its (in monetary terms) unstable neighbors Bulgaria and Romania and the CIS countries Russia, Ukraine and Kazakstan (see Table 1).[1]

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[1] Of course, this peculiarity of Macedonia's economic transition, i.e. the unusual combination of monetary stability and stagnation in the real economy, can be attributed to two sets of external factors:

- wars and political crises in the region (the disintegration of former Yugoslavia, unrest and instability in Albania),
- financial crises and recession in Macedonia's eastern neighbors Romania and Bulgaria.

However, whereas these adverse external factors have undeniably hindered Macedonia's economic transition, they do not in themselves fully account for the lack of growth. For example, the externalities have been similarly unfavorable in neighboring Albania. Yet despite its significantly higher inflation rates, crisis-ridden Albania achieved much faster GDP growth. Indeed, measured against the lowest point on the real income curve since the start of the transition process, its growth

So why has Macedonia's successful monetary stabilization not had a positive impact on the real economy? In the following it will be argued that one of the main reasons is a failure to resolve the structural problems which caused the period of monetary instability in the first place. The macroeconomic parameters have changed (section 2), but the structural problems persist. Analysis of the enterprise and financial sectors (sections 3 and 4) shows that Macedonia has not succeeded in inculcating financial discipline as defined by Kornai (1993) in the four principles that preface this paper. Among the transition economies, Macedonia is therefore a particularly telling example of the accuracy of the statements that in transition economies "stabilization is at best not the whole story behind growth" (Johnson/Kaufmann/Shleifer 1997, p. 163) and that "finding adequate corporate governance solutions is likely to have an impact on the overall performance of those countries." (Roland 2000, p.2)

2. Macroeconomic Stabilization without Growth

At the start of its reform program, Macedonia, like other transition countries, experienced a sharp decline in output and employment levels, coupled with extreme monetary instability (see Table 2).

The causes of macroeconomic instability were not at all specific to Macedonia, although their effect was amplified by the disintegration of Yugoslavia and the attendant collapse of the Yugoslavian economic system. A number of large-scale manufacturing plants that were designed to provide inputs to factories in other parts of former Yugoslavia suddenly found themselves cut off from demand for the goods they produced.[2] As a consequence, there was a massive drop in production, and the enterprises concerned sustained huge losses. To avert the liquidation of these enterprises and the attendant adverse effects on incomes and employment, the newly established central bank, the National Bank of Macedonia, became a lender-of-*first*-

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has been stronger than that of any other transition country. Even Georgia, another economy facing adverse external conditions, achieved real GDP growth rates of over 5 per cent in the second half of the 1990s.

2 Until 1945 Macedonia was an agrarian country with three-quarters of the population engaged in agriculture. It was not industrialized until it became part of Tito's Yugoslavia, when state money poured into the region and industrial production grew at over 8% annually (Macedonian Business Resource Center 1999, p. 17).

resort (Perotti 1994). Large volumes of central bank money were issued, either by supplying funds to the commercial banks, or by directly financing the steadily growing budget deficit. This led to a rapid expansion of the money supply, negative real interest rates, (hyper-) inflation and a significant depreciation of the country's new currency, the Macedonian denar.

Table 2: Macroeconomic Indicators, 1992 – 1994

Indicator	1992	1993	1994
Monetary indicators			
Inflation rate* (consumer prices)	1,664.4	3,338.4	126.5
Exchange rate* (MKD per DEM)	3.4	14.0	26.6
Interest rates on regular liquidity credit (by NBM)	719.0	848.0	66.0
Denar M1 (in millions of denar, end of period)	1,661	5,591	10,508
General government balance (in per cent of GDP)	-9.6	-13.6	-3.2
Current account (in per cent of GDP)	n.a.	-3.5	-6.8
Real indicators			
GDP (percentage change in real terms)	-8.0	-9.1	-1.8
Unemployment* (in per cent of the labor force)	27.8	28.3	31.4

* Annual average

Source: IMF (1998), EBRD (1999)

In 1994/1995 the central bank abandoned its attempt to use monetary policy as a means of avoiding the necessary reforms in the real economy, or at least mitigating their effects. A limit was placed on the expansion of the money supply – partly through the imposition of credit ceilings on the commercial banking sector; the main central bank lending rate was raised above the rate of inflation; and the denar was pegged to the D-

mark (see Table 3).[3] At the same time, fiscal policymakers changed course, and since then their efforts at consolidation have made considerable inroads into the budget deficit. As a result, the inflation rate has stayed below 3 per cent since 1996, and in 1999 there was even a slightly deflationary trend. Of all the monetary indicators, only the current account deficit continued to get worse, increasing to 8.1 per cent of GDP by 1998. The war in Kosovo and its aftermath were responsible for a reduction in the deficit in 1999, but forecasters predict that this trend will not last. On the contrary, it is expected to be back up to 8 per cent this year (VWD 2000).

Table 3: Macroeconomic Indicators, 1995 – 1999

Indicator	1995	1996	1997	1998	1999
Monetary indicators					
Inflation rate* (consumer prices)	16.4	2.5	1.5	0.8	-1.1
Exchange rate* (MKD per DEM)	26.54	26.58	28.70	30.95	30.99*
Interest rates on regular liquidity credit (by NBM)	30.0	18.4	14.2	18.3	11.9
Denar M1 (in millions of denar, end of period)	12.533	12,143	13,985	15,178	19.694
General government balance (in per cent of GDP)	-1.2	-0.5	-0.2	-1.7	-1.5
Current account (in per cent of GDP)	-5.2	-6.5	-7.4	-8.1	-4.1
Real indicators					
GDP (percentage change in real terms)	-1.2	0.8	1.5	2.9	2.7
Unemployment* (in per cent of the labor force)	37.7	31.9	36.0	34.5	32.0

* Annual average

Source: IMF (1998), EBRD (1999), VWD (2000), National Bank of Macedonia

3 The shift to a policy of monetary stabilization was supported by the IMF with a Systemic Transition Facility of USD 35 million (1994/95), a Stand-By Agreement worth USD 40 million (1995) and an Enhanced Structural Facility amounting to USD 80 million.

However, for the most part, the upturn in the real economy that was supposed to follow on the heels of monetary stabilization did not materialize. Although growth rates have been positive again since 1996, they are nowhere near large enough to compensate for the drop in output during the first half of the decade of transition (see Table 1). A particularly dramatic statistic is the unemployment rate of over 30 per cent. If this figure is an accurate reflection of reality, it would mean that among transition economies Macedonia has by far the highest level of unemployment, nearly twice as high as in Azerbaijan, Albania, Croatia or Georgia, which are reported to have unemployment rates of between 14.5 and 19.3 per cent (EBRD 1999, pp. 182 – 385).

3. The Enterprise Sector in Macedonia

a) Enterprises in Macedonia – a Statistical Overview

The disappointing development of Macedonia's real economy could be attributable to insufficient development of the private sector. However, at first sight the official statistics show that Macedonia has come very close to achieving the objective of establishing an enterprise sector based largely on private ownership. The number of registered businesses increased substantially during the first decade of reform. Since 1992 the number has nearly tripled; roughly 90 per cent of them are privately owned (see Table 4).

Table 4: Enterprises registered in the FRY of Macedonia, 1992–1999

	1992	1993	1994	1995	1997	1999
Total number of enterprises registered	37,232	58,268	73,158	86,309	91,214	117,762
- State owned	2	15	24	26	29	280
- Public owned	1,224	1,296	1,288	1,254	1,108	9,636
- Private owned	34,138	54,760	69,561	82,658	87,322	104,448
- Cooperative	795	932	973	1005	1257	1,714
- Mixed	1,073	1,265	1,312	1,366	1,498	1,684

Source: World Bank (www.worldbank.org/ecspf/PSD-Yearbook/macedonia.html), Statistical Office of Macedonia

By far the largest number of enterprises are engaged in trade, followed by transportation, food and catering, tourism, financial and other services, industry/mining, crafts and construction (see Table 5).

Table 5: Enterprises by sector

	1998	1999
Trade	59,085	62,728
Transportation/food and catering/tourism/financial and other services	16,453	19,317
Industry/mining	9,866	10,671
Crafts	4,958	5,359
Construction	4,334	4,687
Agriculture, forestry and fisheries	3,093	3,205
Other*	10,949	11,795

* = real estate, education/science/arts/health/social services/administration authorities/organizations/ associations)
Source: Statistical Office of Macedonia

By no means all registered enterprises are economically active. Estimates, including those based on information supplied by the Payment Operation Service (ZPP), indicate that no more than one third to one half of registered enterprises are actually operating (EBRD 1998, p. 169; Gruber 1997, p. 105). At the same time, many enterprises that are active are not registered. While the number of enterprises operating in the informal sector is the subject of intense speculation, the informal sector is said to contribute 20–30 per cent of GDP. In particular, “the share of services in GDP is probably underestimated as informal activity is likely to be disproportionally higher in the service sector.” (IMF 1998, p. 10)

The total number of registered private enterprises also includes the privatized former state enterprises. From the start of the transition process up to June 30, 1999, 1,467 Macedonian enterprises were privatized; 179 are still in the process of privatization (see Table 6).

Table 6: Privatized enterprises (and enterprises undergoing privatization) as of June 30, 1999

Sector	Enterprises *number*	Employees *number*	Equity *DEM*
Total	1,467 (179)	217,111 (24,914)	4,217,394,069 (441,674,850)
Manufacturing	452 (54)	132,511 (11,088)	2,788,599,198 (175,526,104)
Agriculture	336 (59)	15,324 (9,071)	265,429,676 (133,633,384)
Construction	110 (10)	31,777 (363)	238,790,620 (1,326,413)
Trade	322 (24)	17929 (1,700)	478,338,614 (45,841,570)
Transport/Traffic	49 (5)	7,147 (724)	65,677,974 (9,920,492)
Finance/Services	99 (14)	6,663 (370)	216,109,818 (14,460,588)
Craft	51 (1)	2,299 (75)	30,648,494 (360,000)
Catering/Tourism	48 (12)	3,483 (1,523)	133,799,676 (60,606,299)

Source: Macedonian Privatization Agency

The 20–25 largest state enterprises were initially excluded from privatization; instead, they were subjected to a "Special Restructuring Program".[4] The objective was to rehabilitate these "politically sensitive enterprises" (World Bank 1995), which accounted for roughly 80 per cent of all losses in the Macedonian enterprise sector (Gruber 1997, p. 105), or to break them up into smaller units. At the end of the program, the government was then to decide "which enterprises would continue as viable, but probably smaller enterprises and which would be closed down." (World Bank 1995) However, progress has been very slow, and the program has yet to be completed (EBRD 1999 p. 166, 1998 p. 169).

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4 In the main, this measure concerns public utilities, agrocombinats, mines, textile companies, chemical and mechanical/electrical machinery producers (EBRD 1998, p. 169). At the start of the program, these firms employed 60,000 people, or about 15 per cent of the total Macedonian workforce in 1992.

Despite their small number, the privatized enterprises – alongside the remaining state enterprises – dominate the formal enterprise sector in terms of output and employment. If the official statistics are accurate, the figures in Table 6 imply that roughly two-thirds of the Macedonian workforce are employed by privatized companies. This means that the new private sector consists mainly of micro and small enterprises, many of which employ no more than 1 or 2 people.

b) The Crucial Distinction Between Private and Privatized Enterprises, and Between the Formal and Informal Sectors

Recently, there has been growing support for the hypothesis that private ownership in and of itself does not lead to (major) efficiency gains if it is not accompanied by improved corporate governance (EBRD 1999, p. 92; Roland 2000). The extent to which effective corporate governance has been established in the private sector of the transition economies is a function of two factors:

1. The method used to privatize formerly state- or socially owned enterprises. Of the three possible methods, direct sales to private investors, management/employee buyouts (MEBOs) and voucher privatization, the last two are generally considered to be less likely than the first to lead to a situation in which the new private owners run their newly acquired enterprises, or ensure that they are run, with the aim of improving efficiency or maximizing profits. In the case of MEBOs, the reason generally given for this assumption is that the new owners – managers and/or employees – have other interests, e.g. saving their jobs, that far outweigh the goal of profit maximization, and may even make it seem totally marginal. Consequently, they do not implement the measures that are almost always necessary, i.e. they fail to restructure the company to meet the new demands of a market economy. The problem with voucher privatization is that each of the new owners holds such a small share of the privatized enterprises that, even though they may well have a genuine interest in profit maximization, it is not economic for them to bear the transaction costs involved in exercising corporate governance. Moreover, the holders of the vouchers generally have neither the know-how, nor the capital, to initiate a restructuring process in "their" enterprise.[5] As a result, management is

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[5] Conversely, the advantage of the direct sales privatization method is that "the needs for outside financing and control are not decoupled from the transfer of ownership since investors who purchase the firms also have the means to restructure them." (Roland 2000, p. 24).

mostly able to operate without checks and balances, and can therefore get away with delaying the necessary restructuring measures, or indeed not implementing them at all.

2. The share of the new private sector in GDP, i.e. the share contributed by companies that were not previously (part of) a state-owned enterprise. This is so because these firms, which are usually run by a single owner/manager, or a small group of owner/managers, are by definition much less prone to the corporate governance problems that are endemic to those enterprises that were privatized through MEBOs or the voucher method.[6] Thus it is above all the new entrants that are responsible for growth and employment in the transition economies (EBRD 1999, pp. 92, 134).[7] However, the dynamism and the efficiency of this section of the enterprise sector is determined to a fundamental degree by whether the new entrants can evolve mainly within the formal economy or are instead forced – by excessively high taxes and social charges, for example – to operate in the informal economy (Johnson/Kaufmann/Shleifer 1997). This does not mean that informal-sector activities as such are to be condemned. On the contrary, the informal sector more often than not cushions the output decline and provides an outlet for entrepreneurial talent. However, in comparison to an ideally functioning formal sector it is usually a rather inefficient shock absorber because firms waste time and money in their efforts to get around controls and taxes. Furthermore, informality usually also implies instability and uncertainty, which together create an incentive to pursue mainly short-term objectives (World Bank 1996, p. 27).[8] Thus, a company's scope for productivity-enhancing investments and growth is more limited in an informal sector than in a well functioning formal sector.

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6 Benácek/Zemplinerová (1995, p. 437) speak in this context of a "private sector which shows features of effective ownership."

7 In addition, there is another indirect effect which is stressed by the literature on soft budget constraints, according to which "entry and competition reduce the softness of budget constraints because they reduce the opportunity cost to government of not bailing out firms in terms of job losses and the other costs of hard budget constraints." (Roland 2000, p. 7).

8 A new private sector that operates largely informally is also severely limited in the extent to which it can accumulate sufficient capital to acquire shares in privatized companies and thereby improve their corporate governance (Roland 2000, p. 30).

Table 7: **Privatization methods, newly established private sector's share of GDP and shares of the unofficial/informal economy in GDP in selected transition economies**

Land	Incomes in 1998 (1989 = 100)	Cumulative growth rate* (Ranking)	Primary/ secondary privatization method	Estimated share of the new private sector in GDP, 1995, in per cent (Ranking)	Estimated share of the unofficial/ informal economy in GDP, 1995 (in per cent)
Poland	117	42.5 (2)	Direct sales	50 (1)	12.6 (4)
Slovenia	104	25.7 (5)	MEBOs	45 (5)	Na
Slovak Republic	100	32.9 (3)	Direct sales	45 (5)	5.8 (1)
Hungary	95	16.2 (9)	Direct sales	45 (5)	29.0 (7)
Czech Republic	95	12.7 (11)	Vouchers	30 (13)	11.3 (2)
Albania	86	43.1 (1)	MEBOs	50 (1)	Na
Croatia	78	20.6 (7)	MEBOs	45 (5)	Na
Estonia	76	25.7 (6)	Direct sales	50 (1)	11.8 (3)
Rumania	76	1.8 (14)	MEBOs	35 (12)	19.1 (5)
Macedonia	*72*	*5.2 (12)*	*MEBOs*	*40 (9)*	*30*(8)*
Bulgaria	66	3.5 (13)	Direct sales	40 (9)	36.2 (11)
Lithuania	65	19.8 (8)	Vouchers	40 (9)	21.6 (6)
Kazakstan	61	0.0 (15)	Direct sales	20 (16)	34.3 (9)
Latvia	59	14.0 (10)	Direct sales	50 (1)	35.3 (10)
Russia	55	0.0 (16)	Vouchers	20 (16)	41.6 (12)
Ukraine	37	0.0 (17)	Vouchers	30 (13)	48.9 (13)
Georgia	33	29.2 (4)	Vouchers	25 (15)	62.6 (14)

* = IMF (1998, p. 30)
Sources: EBRD (1999, pp. 181 - 288), Raiser (1999, p. 11), EBRD (1997, p. 74),

As can be deduced from Table 7, these two factors help to explain the large differences between the transition economies in terms of their growth rates. Countries that have succeeded in privatizing their former state enterprises primarily by the direct sale method, and in which a large sector of new private enterprises has evolved that choose to operate largely in the formal economy, report higher growth rates than those countries which opted for the MEBO or voucher method and in which the new private

sector is small and/or is forced to operate largely informally. Macedonia falls into this second category.

c) The Privatized Sector

Table 8 offers a detailed breakdown of privatization in Macedonia by method used. It confirms the result presented in Table 7, namely that the management/employee buyout has been the predominant method of privatization in Macedonia.

Table 8: Privatization methods used – Figures as of June 30, 1999

Sector	Enterprises	Employees	Equity
	Number	*Number*	*DEM*
Total	1,467	217,111	4,217,394,069
Markovic Law[9]	66	11,522	114,471,007
Employee Buy-out	370	18,007	155,099,082
Managmt. Buy-out	249	74,480	1,431,615,434
Liquidations	164	984	-
Foreign Equity	156	1,933	52,269,791
Outsider Buy-out	149	49,585	1,005,413,094
Private Equity	124	5,136	57,762,915
Debt/Equity Swap	73	18,220	52,629,791
Others	116	37,244	1,348,132,955

Source: Macedonian Privatization Agency

This is due not least of all to the design of the legislation on which privatization was, and still is, carried out. For example, if only a very small number of companies were sold to foreign investors, it was (partly) due to the fact that managers were in a position

9 The Markovic Law was the former Yugoslavia's privatization law, based on a decree issued by Prime Minister Markovic in 1990. Under this law "enterprises could be corporatized and employees could purchase shares – usually at a substantial discount to their market value." (IMF 1998, p. 21) It also obliged the managers of the enterprises to take due account of the interests of the employees. Macedonia repealed this law in August 1991. The new Macedonian privatization law, which forms the legal basis for all of the other privatizations, was passed in 1993.

to choose the method of privatization (IMF 1998, p. 23) and insiders were given the right of first refusal to own an enterprise (World Bank 1995). Thus, for the period 1989–1998, Macedonia had the lowest level of cumulative FDI-inflows per capita in Central and Eastern Europe and the Baltic States (EBRD 1999, p. 79). Even Albania, with USD 132 per capita, attracted a slightly larger volume of foreign capital than Macedonia (USD 121). It was not until 1999 that there was a significant increase in foreign investment in the Macedonian enterprise sector.[10]

The situation was made even less conducive to sound corporate governance by the government's decision in the fall of 1995 to allow employees to pay for their shares five years after acquiring them, rather than having to pay immediately. Moreover, this de-facto loan by the enterprises to their owners was interest-free, and did not have to be serviced in the first two years (Gruber 1997, p. 105).

The widespread use of the MEBO method meant that the situation at most of the privatized enterprises hardly changed at all. They received neither new capital, nor new management,[11] and hence lacked precisely those factors which would have been necessary in order to reorient the enterprises toward the new market-based environment and to restructure them accordingly. This explains why the number of illiquid companies has steadily increased since the start of the transition, or at least since Macedonia's independence, and not fallen, as one would have expected after a successful restructuring process, i.e. after a process whereby unprofitable enterprises are either closed down or restructured to a point where they become profitable and liquid (IMF 1998, p. 16).

The fact that these enterprises still exist at all is therefore mainly attributable to the following two factors (IMF 1998, p. 16):

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[10] The Macedonian Business Resource Center (1999, p. 17) estimates that the inflow of foreign capital from January through October 1999 was USD 160 million.

[11] Attempts to compensate for this by wooing outsiders – be they Macedonians or foreigners – as owners proved unsuccessful because, so rumor had it, managers threatened to dismiss workers who sold their shares to outsiders. The lack of publicly available information on the financial status of companies is also attributable to efforts by insiders, and management in particular, to deter outsiders from purchasing shares (IMF 1998, p. 28). As enterprises listed on the stock exchange are required to publish audited accounts, it is hardly surprising that only a few companies are listed. Accordingly, capital markets play virtually no part in the Macedonian financial system.

1. Despite the absence of profitability, their owners, managers and employees and the banks to which they owe money[12] have no interest in closing them down.

2. Despite insufficient profitability, the managers repeatedly succeeded in persuading the banks to lend them enough to finance the enterprise's activities, i.e. to tide them over liquidity bottlenecks.[13]

The problems associated with the privatized enterprises are overshadowed by those of the 20–25 largest state enterprises that were initially excluded from privatization and instead subjected to a "Special Restructuring Program". For the most part, efforts to restructure and then privatize these "largest loss-making enterprises" have failed. Today, four years into the program, these enterprises still account for more than half of the total losses of the enterprise sector (EBRD 1998, p. 169). The international financial institutions have therefore increased the pressure on the government either to close these enterprises immediately or to privatize them by direct sale.

In other words, privatization may appear to have been successful in formal terms, or judged on the basis of the statistical overview, but on closer inspection it turns out to have been a failure and a significant obstacle to growth and employment creation, because the corporate governance structures in the privatized and state-owned enterprise sector have remained virtually unchanged since the start of the reform program. Neither the providers of equity nor the providers of loan capital have put pressure on management to restructure their enterprises to the point where debts can be serviced and profits earned. Consequently, these enterprises have done nothing to promote growth and employment (World Bank 1999).

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[12] Through debt-for-equity swaps, banks became owners of enterprises that had been unable to service their bank debt. As the enterprises in turn often own the banks, however, this privatization method also failed to produce an improvement in corporate governance. On the contrary, it merely increased the extent to which the banks "found themselves pressurized to extend more credit and to finance the companies' losses out of bank profits." (IMF 1998, p. 26) This behavior, referred to in the literature as "creditor passivity" can be (or could be) observed in many transition economies in which close credit and cross-shareholding relationships exist (or existed) between the enterprises and the banks.

[13] Anecdotal evidence indicates that "loans" from employees in the form of wage arrears made it easier for the enterprises to continue their operations. It appears to be quite common for Macedonian employees to receive a smaller salary than agreed, or even no salary at all, at the end of the month. Brixi/Ghanem/Islam (1999, p. 20) estimate that wage arrears amount to 15 billion denars or 9 per cent of GDP.

d) *The New Private Sector*

As could be inferred from Tables 4 and 5, the new private sector in Macedonia is dominated by small trading businesses, i.e. shops and kiosks, as well as small restaurants and cafés. The streets of Macedonia's cities are lined with many small shops. Trading activity is also concentrated in small shopping centers and bazaars. Skopje, for example, has numerous small, privately owned shopping centers and malls in its various districts, which rent out stalls and small stores to microentrepreneurs. Enterprises engage in trading activities of one kind or another, primarily selling food products, general merchandise, textiles, electrical goods, car spare parts, etc. Some traders sell luxury goods, though these businesses are less numerous. In the service sector, by far the largest group consists of cafés, restaurants and snack bars. There are also a large number of repair shops and manual self-employed. The chamber of craftsmen claims to have more than 4,000 members in Skopje alone, who are registered as natural persons and operate in many different lines of business, including food production and catering, arts and handicrafts, repair and maintenance services, small-scale manufacturing and of course retailing.

Some of the firms that make up the micro and small enterprise sector are family owned businesses with many years' entrepreneurial experience, sometimes dating back to the days when Macedonia was part of former Yugoslavia. This is especially true of the manual and craft businesses. However, a very much larger proportion were either former wage- and salary earners who were forced to set up a business by imminent or actual redundancy, or are still in paid jobs that do not earn them enough to meet their basic needs. There are many cases of two friends or relatives who, in the absence of financing opportunities, enter into a business partnership in order to pool their funds to buy merchandise and lease selling space.

Many enterprises are driven to informal activity by the high level of taxes and social charges, by relatively rigid labor laws that still clearly bear the mark of former Yugoslavia (IMF 1998, p. 14, 15), and by corruption and incompetence on the part of administration officials. Anecdotal evidence suggests that many of the registered companies significantly understate the number of people they employ and their volume of value-added in order to avoid bearing the full burden of taxes and social insurance contributions. Thus, the new private sector in Macedonia exemplifies the features that were described in general terms above. On the one hand, the income earned by this sector has probably had a decisive impact on stabilizing the incomes of private

households, which had no alternative but to go into business on their own initiative, indicating that "statistics on employment in FYRM are highly unreliable." (IMF 1998, pp. 15/16). On the other hand, the informal status that many of these enterprises choose in order to avoid excessively heavy tax and other legal burdens explains why they are able to grow only slowly, if at all, even if they are successful in the goods markets and thus earn profits which could be invested in the firm's expansion.[14]

Another reason for Macedonia's lack of a burgeoning sector of new private enterprises that could foster growth and provide employment is the inadequate supply of financing. Even internal financing is a problem, and one that is made significantly more difficult by a lack of financial discipline within the sector.[15] All of the anecdotal evidence provided by different sources indicates that enterprises appear to be in a kind of credit chain. Lenders often grant supplier credit even though they know that the customer may not be able to service the loan. When asked why suppliers are willing to give credit under these circumstances, informants consistently replied that suppliers may use their claims against customers as a "means of payment" with which to settle the claims of their own suppliers. The experience of other transition economies has demonstrated the fragility of such credit chains, or interenterprise arrears, although in those countries the phenomenon has been mainly confined to the sector of state-owned or recently privatized enterprises. In Macedonia, evidently, the lack of financial discipline typical of the privatized enterprise sector has spread to the business transacted among the micro and small enterprises of the new private sector.

For external financing, the new private enterprises rely largely on loans from family and friends, whereas the formal financial sector, i.e. banks, play virtually no role at all. Loans from family and friends are mostly provided interest-free, but the biggest drawback with this source of credit is that it is unreliable in terms of volume, duration and availability.

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[14] On this point, see also Johnson/McMillan/Woodruff (1999, 2000).

[15] On the dominance of internal financing in the new private sectors of transition economies, see Johnson/McMillan/Woodruff (1999/2000). The significance of internal financing opportunities as the first and most important step toward private sector and financial sector development – not only in transition economies but also in western economies in the 19th century – is stressed by Winkler (2000).

The extent of lending by the informal financial sector, and the terms available, are difficult to ascertain because according to Macedonian law any kind of lending outside the banking sector is illegal. Moneylenders appear to be a source of credit, charging between 3 and 5 per cent interest per month. Apparently, some bureau de change operators also lend money to entrepreneurs they know well at similar interest rates. Comparable terms are also available from savings houses. In addition to mortgages, these lenders are reportedly willing to accept checks guaranteed by the central bank as collateral. Again, these sources of finance are rather unreliable in terms of volume, maturity and availability. Moreover, they are very expensive, which impedes the respective enterprises' internal accumulation of funds and accordingly hinders their growth.

4. Financial Development and Financial Sector Policy

a) Containing Agent Banks

Prior to independence, the Macedonian banks were part of the Yugoslav banking system, whose institutions were founded, in the course of the 1971 banking reform program, by the "socially owned enterprises". The purpose of these new banks was to provide their parent enterprise inexpensive financial services, and especially credit.[16] The Macedonian banks were therefore classic examples of what are known as "pocket banks" or "agent banks", i.e. banks that served as the financial arms of their owners, rather than as financial intermediaries between private households and enterprises.[17] By far the largest of these banks was Stopanska Bank, which at the time Macedonia gained independence had a 65 per cent share of the market.

When Yugoslavia began to fall apart and the transition process got under way, enterprises faced increasingly severe financial difficulties, and asked their banks for loans to pay their outstanding bills. The banks could not, or did not want to, turn these requests down – regardless of whether or not there was any prospect of the loans being serviced and repaid. However, the demand for credit soon exceeded the banks' supply

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[16] In 1969 President Tito defined the objective of the banking reform as follows: "The banking system must be developed in such a way that the banks can actually be integrated into the self-management system, that they can become an integral part of the economy, that the producers can gain genuine influence over not only the banks' decision-making but their entire business activities... In particular, they should support modernization and for this purpose issue long-term loans at low interest rates." Cited in: Djekovic-Sachs, L. (1994, pp. 132f (our translation)).

[17] On the use of this terminology, see World Bank (1989, 1993).

of funds. As has been already mentioned, the central bank intervened by rediscounting loans from the banking system to the enterprises or monetizing bank loans to the state to an almost unlimited extent. This inflationary pressure, triggered by the banks' excessive lending, was reinforced by the rapid increase in the number of institutions operating in the banking sector as a consequence of the central bank's low minimum equity capital requirements. The opportunity to meet their financing needs by borrowing at (exceedingly) negative real rates of interest – in effect, by printing money – encouraged many enterprises to found their own bank. Thus, between May 1992 and May 1993 the number of banks rose from five to eighteen.

In 1994/95 macro policy switched to stabilization: the central bank effectively stopped rediscounting the banks' loans and established a positive real rate of interest on the funds it supplied. Since a large share of the outstanding loans at Stopanska Banka, Kommerciljana Banka and Macedonska Banka, the large banks that still dominated the financial system, were non-performing, these banks would have been insolvent had the government not responded with "one of the largest recapitalization operations of all transition economies" (IMF 1998, p. 34), transferring the non-performing loans of the 25 largest enterprises to the state "Bank Rehabilitation Agency" and replacing them in the banks' balance sheets with government bonds.[18] The cost of this bail-out amounts to over 2 per cent of GDP per year and is borne by the government budget (Brixi/Ghanem/Islam 1999, p. 20).

Since then the central bank and the government have put the financial sector into a kind of quarantine. All financial sector and monetary policy measures – to put a positive interpretation on it – serve the objective of imposing a quantitative limit on the activities of the banking sector, and especially lending activities, so as to achieve monetary stability, i.e. to avoid a repetition of having to choose between inflation/monetization and financial crisis/recapitalization.[19]

The most important step towards the stabilization of the banking system was to significantly raise the entry barriers in the hope of preventing any further expansion of

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[18] The World Bank (1995), in its introduction to the Financial and Enterprise Sector Adjustment Loan and Credit, states that at that time 80 per cent of the banking system was illiquid.

[19] Capital markets play no part in the Macedonian financial sector. The highest value reported in the EBRD Transition Report for Macedonia's stock market capitalization has been 0.3 per cent of GDP. In other words, for all practical purposes, the financial sector can be regarded as synonymous with the banking sector.

lending due to an increase in the number of banks. The most important instrument used for this purpose was a sharp increase in the minimum equity capital requirement. The Banks and Savings Houses Act, which came into force in 1993, had already set a DEM 3 million minimum entry requirement for a bank with domestic operations only. Licenses for a full fledged bank, permitted to execute international payment transactions, as well as to borrow and invest funds abroad, were made subject to a minimum of DEM 9 million. A reform of the Banks and Savings Houses Act in April 1996 put these requirements up to no less than DEM 7 million and DEM 21 million respectively. For banks that were licensed prior to 1996, transitional rules have been in force since then. These banks have until April 30, 2001, to increase their equity to DEM 21 million in stages; the deadline for the last intermediate step is April 30, 2000, by which date they are required to have DEM 18 million of equity.

Table 9: Minimum equity capital (in per cent of nominal GDP) in selected transition economies

Country	Minimum Equity Capital
FYR Macedonia	0.32
Bulgaria	0.0041
Czech Republic	0.027
Estonia	0.033
Hungary	0.0087
Lithuania	0.023
Romania	0.0025
Slovak Republic	0.061

Source: Koch (1998), EBRD (1999), own calculations

High minimum equity capital requirements have come to be used by central banks in nearly all transition economies as an instrument for limiting or reducing the number of banks (Schmidt 1999). As Table 9 shows, however, as a percentage of GDP Macedonia's minimum equity requirement of DEM 21 million is far higher than the limits set by any of the other countries in this group of selected transition economies. Consequently, the number of banks has remained practically unchanged since 1996.[20] Disregarding the five new banks that have been created by spinning off the biggest

[20] In addition to the 24 banks, including two branches of foreign banks, the financial sector at the end of 1998 also included 18 savings houses, yet together they account for a mere 1.7 per cent of total assets in the Macedonian financial system. The most significant activity of the savings houses is their lending (!) to private households, where their market share is no less than 9.6 per cent (NBM 1999a, p. 60); see also section 3.2.

regional branches of Stopanska Bank, very few new banking licenses have been issued. Hence, there has been little change within the sector in terms of market shares. Stopanska, Kommerciljana and Makedonska Banka still dominate: roughly 60 per cent of all assets are held by these three, and indeed Stopanska and Kommerciljana alone account for 55 per cent. The largest newly founded bank is Tutunska Banka, which in 1998 succeeded in overtaking Almako Banka; yet with total assets of approx. MKD 2,800 million (≈ DEM 90 million), it held no more than about 5 per cent of all assets in the Macedonian banking sector.

Table 10: Banks majority-owned by foreign investors in selected transition economies (in per cent of all banks)

Country	1994	1996	1998
Poland	13.41	30.86	37.34
Slovenia	13.63	11.11	12.50
Slovak Republic	21.05	37.50	33.33
Hungary	39.53	60.97	67.50
Czech Republic	21.81	24.52	28.88
Croatia	1.85*	7.01	18.33
Estonia	4.54	20.00	33.53
Romania	15.0	25.80	44.44
Macedonia	-	22.72	20.83
Bulgaria	2.5	7.14	25.00**
Lithuania	0.00	25.00	50.00
Kazakhstan	0.54	8.91	28.16
Latvia	26.19	45.16	55.55
Russia	0.82*	1.13	1.96
Ukraine	0.43	2.26	5.28**
Georgia	0.04	9.09	20.9

Source: EBRD (1999, pp. 194 – 281), own calculations
* = 1995; ** = 1997

The raising of equity capital requirements has not brought about a change in ownership structures either. Most of the institutions are still agent banks; only the macroeconomic and sector-specific parameters have changed. In particular, in contrast to countries where transition has reached a more advanced stage, such as Poland or Hungary,[21]

[21] According to Buch (2000) foreign banks in Poland held more than one third of the capital of the banking system in mid-1999, while by the end of 1998 foreign banks were owners of about 60 – 70 per cent of the registered capital in the Hungarian banking system.

foreign (western) capital in Macedonia accounts for a very small share of total equity in the banking system – a mere 15.5 per cent (NBM 1999a, p. 61). At the end of 1998 foreign capital was in the majority at only five out of 24 banks (see Table 10). Accordingly, there has been very little transfer of reputation, know-how and corporate governance.[22] In this respect, the banking sector is a mirror image of the (privatized) enterprise sector.

b) Main Indicators of Financial Development

The policy of containment is also reflected in the time series of most of the quantitative indicators of financial system development, which at first glance might seem to suggest stability, but on closer analysis, given the low base, could also be interpreted as evidence of stagnation (see Table 11). Particularly remarkable is the fact that, despite the monetary stability described in section 2, Macedonia has not been more successful in raising the ratio of M2 to GDP, the most important indicator of financial depth, nor in reducing the volume of foreign-currency term deposits relative to denar-denominated deposits in spite of the more favorable interest rates on the latter.

A striking statistic is the sharp decline in the volume of credit to the private sector relative to GDP in 1998, from 30.6 to 20.5 per cent.[23] According to the 1998 Annual Report of the National Bank of Macedonia (NBM 1999a, p. 24), this decrease is the result of a reclassification of the commercial banks' accrued interest claims against the "private and social sector", which at MKD 21,550 million as of mid-1998 exceeded the volume of outstanding credit, standing at MKD 18,597 million. Whereas they had previously been recorded under outstanding loans, starting in July 1998 all overdue claims based on principal and interest which were classified in the riskiest category for two quarters in a row are now entered as off-balance records. As the volume of funds involved in this operation was in the order of MKD 17,000 million, even the strong

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[22] Apart from the two branches of foreign banks, the main foreign investments in the Macedonian banking market are the following: EBRD's stake in Komerciljana Bank (just under 9 per cent), the 51 per cent stake in Makedonska Banka held by Ljubljanska Banka from Slovenia, and the majority stake in Balkanska Banka held by a Bulgarian consortium. The planned takeover of Stopanska Banka by Erste of Austria, IFC and EBRD failed to materialize; a new takeover scheme, this time with the National Bank of Greece as strategic investor and management partner, has just been finalized.

[23] The much lower ratio of currency in circulation to M2 in 1999 is mainly attributable to a rise in deposits following the war in Kosovo, for which non-profit organizations, the public sector and the enterprise sector are chiefly responsible. By comparison, deposits held by private households have remained almost unchanged (see NBM 1999, pp. 29ff).

growth of new lending in the last quarter of 1998 did not prevent the thus redefined total volume of outstanding loans in the banking system falling by roughly one third compared to the previous year's figure.

Table 11: The Macedonian financial system – main indicators, 1995 – 1999

	1995	1996	1997	1998	1999 (Sept. 30)
No. of banks (foreign-owned)	n.a.	22(5)	22(5)	24(5)	23*
Broad Money (M3)/GDP	11.7	10.8	12.8	14.08	n.a.
Private Sector Credit/GDP	25.6	29.8	30.6	20.5	n.a.
Currency in Circulation/M2	31.9	36.2	31.4	27.4	23.5
Foreign Currency Term Deposits/Total Term Deposits	54.7	48.7	61.6	61.5	61.9
Bad loans (per cent of total loans)	n.a.	42.2	35.6	32.9	n.a.
Capital accounts / (Total liabilities + equity)	22.49	28.45	24.97	31.31	31.08

* = including foreign bank branches

Source: EBRD (1999, pp. 220f), National Bank of Macedonia, own calculations

The change in the volume of loans outstanding to the "private and social sector" due to the aforementioned accounting operation is in itself an indication that, for all the stability that has been achieved over the last five years in quantitative terms, the core problem of the Macedonian banking sector has not been solved: namely, the poor quality of the banks' lending. Roughly one third of the banks' aggregate loan portfolio is still in arrears. Indeed, observers in Macedonia believe that, given the banks' tendency to underprovision, even this figure presents too favorable a picture, and that therefore the improvement in portfolio quality indicated by the penultimate line of Table 11 is not necessarily an accurate reflection of reality.[24] Against this background,

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[24] The National Bank of Macedonia itself refers to a "further deterioration in the collection of claims" (NBM 2000, p. 27): In October 1999, compared to the same month of the previous year, overdue claims based on principal had apparently risen by 21.1 per cent (MKD 2,214 million), and overdue claims based on interest by 16.7 per cent (MKD 4,432 million).

the Macedonian banking system's high equity ratio, reported in the final line of Table 11, should probably be revised downwards by a significant amount.[25]

Given their heavy loan losses, it is perhaps only to be expected that loans to the non-bank financial sector made up only 32 per cent of the banking system's aggregated balance sheet in September 1999.[26] Consequently, the banks have comparatively high liquidity ratios. However, this cannot be interpreted as a sign of stability, because it too is attributable to their lending problems. Banks are forced to keep large volumes of cash on hand in order to remain liquid, since they cannot rely on an adequately functioning interbank market. The interbank market, in turn, does not function properly because the banks do not have confidence in the stability and solidity of their transaction partners: "liquid banks have perceived such lending as too risky." (IMF 1998, p. 44)

Conversely, interest income from lending activities is nowhere near as dominant as it is in the balance sheets of Western banks. Despite high interest rates and interest margins, fees are a much more important source of income in Macedonia than, say, in the German banking system. For the newly established private-sector banks, fees are even on a par with interest earned on outstanding loans in terms of their contribution to earnings (IMF 1998, p. 34). Most of these fees come from (international) payment transactions, a line of business in which the banks benefit from the rule dating back to the old Yugoslavian system that "all legal entities and public agencies must maintain a BPO giro account for the settlement of payments, as do most self-employed persons and private individuals. Typically entities participating in the BPO system must maintain demand deposits with a commercial bank of their choice." (IMF 1998, p. 42) Thus, whereas most banks have no more than 300 enterprises as credit customers, they administer giro accounts for up to 4,000 enterprises.

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[25] See also Dziobek/Frecaut/Nieto (1995). To appreciate just how little information the (aggregated) equity ratio reveals about the stability of any individual institution, or group of institutions, one need only consider the fact that the equity ratio of all Macedonian savings houses in 1997 was 56.5 per cent. Nonetheless, in that year the central bank revoked eight licenses, and in 1998 another three saving houses lost theirs. 1997 also saw the collapse of the savings house TAT in Bitola, which was being run as a pyramid scheme.

[26] For comparison: in the Federal Republic of Germany, loans to non-banks account for roughly 60 per cent of the banks' total business volume.

c) Characteristics of Banking Activities

The poor quality of loan portfolios in the Macedonian banking system is attributable to various deficiencies in the banks' lending policies and procedures. The main problem is that they still concentrate on lending to "older loss-making enterprises". Reporting on the year 1997, the IMF notes that "one half of new lending ... was to enterprises with a poor track record of loan servicing. In particular, between March and December, exposure to the 20 largest delinquent debtors increased by 21 percent ... . By end-December, these enterprises alone accounted for almost a third of outstanding credit." (IMF 1998, p. 36)[27] Locally based observers report that there has been no change in this tendency. They say that in 1999 too, around 70 percent of all new loans went to some 20 companies, most of which are known to be loss-makers.

The main contributors to these aggregate figures are the three former state banks, Stopanska Banka and its regional spin-offs, Komerciljana Banka and Makedonska Banka. The credit policies of these banks are still determined by the kind of economic policy goals that prevailed under the old Yugoslavian system, according to which the bulk of loans should go to large, export-oriented industrial enterprises with large payrolls. Despite the adverse experience of the past ten years, these enterprises are still regarded as comparatively safe borrowers because, unlike the new private enterprises, they can provide formal collateral in the form of real estate and also because they can present the banks with what the latter generally regard as a *conditio sine qua non*: a business plan outlining a "good project", which basically means a fixed asset investment plan. As a rule, lending to the new private sector is viewed as being too risky, too expensive and/or incompatible with the respective bank's lending guidelines.

At the newly established banks, the main reason for the high degree of loan concentration on just a few enterprises is the banks' focus on serving their owners. This concentration affects the entire way in which the credit business is organized. For example, most banks' credit departments are very small: they rarely employ more than

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[27] Chapter 7 of the National Bank's 1997 Annual Report also conveys an impression of the degree of concentration exhibited by the Macedonian banking sector's lending business: "Other problems concerning the quality of assets are the high credit concentrations to single clients, which exceed the prescribed legal limits of 30.0 per cent, and 10.0 per cent in relation to the guarantee capital. But one must bear in mind the fact that these violations have had a decreasing trend in the last several years. Significant violations are still present in the bigger banks which finance large export activities, as well as in some of the smaller banks which are directed to support their dominant founders with credits. As on 31.12.1997, 10 banks exceeded the legal limit of 30.0 per cent and 7 saving houses exceeded the legal limit of 10.0 per cent."

five or six staff. This is enough to serve the core clientele of 200 to 300 firms. To deal with a larger number of business customers, which is a precondition for portfolio diversification, they would have to considerably expand their capacity. This would still be necessary even if the banks decided to reduce the large number of individual steps involved in the lending procedure and the high degree of concentration of decision making authority. Conversely, it is precisely these conditions of the lending process which make a significant expansion of the lending business to include customers not yet known to the bank appear to be (too) expensive.

An important formal obstacle to an expansion of lending is the legal situation regarding collateral. The Macedonian legal system favors the debtor in cases of default, which seriously impedes the expansion of credit relationships, or reinforces the tendency to lend to large and/or known enterprises. The reform of the law on collateral in 1998 has gone some way toward overcoming this problem; however, banks still issue loans only if they can be secured by mortgages. The other forms of loan security which the new law seeks to make possible are still not accepted because they have not yet been tried out in practice.[28]

Funding loans appears to be an expensive undertaking for the banks. For example, the NBM refinancing rate for central bank balances sold at auctions has been around 15 per cent p.a. for years (see Table 12). During the war in Kosovo, the banks were even having to pay upward of 25 per cent p.a. for central bank money. The interest rates for sight and term deposits published by the central bank also indicate that the banks face heavy funding costs. At the same time, the NBM reports interest rates on loans to small enterprises no higher than 26.7 per cent p.a. since 1998 (NBM 1999, p. 78). The high cost of funds is another argument put forward by the banks to justify their practice of issuing comparatively large loans with comparatively low transaction costs relative to the size of the loans.

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[28] "Check security" is another method of loan security that has established itself in Macedonia. It is particularly common in connection with lending to private households and hence it is frequently used by savings houses and in the informal sector (Boven/Stremme/Winkler 1998, Annex E, pp. 4/5). What makes bank checks a suitable form of a loan security is the fact that they are guaranteed by the central bank up to the amount printed on them. Thus they offer the lender security even if they are not covered by an account balance when the loan is issued.

Table 12: Key interest rates on funds in the Macedonian banking system

	12/97	6/98	12/98	3/99	6/99	9/99	12/99
Interest rate on deposits sold at auctions (NBM refinancing rate)	15.2	13.9	18.3	21.2	19.1	13.5	11.9
Sight deposits households (Enterprises)	3.0–6.1 (2.5–8.0)	3.0–6.1 (2.5–8.0)	3.0–6.3 (2.5–8.0)	3.0–6.3 (2.5–8.0)	3.0–7.0 (2.5–8.0)	3.0–7.0 (2.5–8.0)	3.0-7.0 (2.5-7.0)
Time deposits							
> 1 month Households (Enterprises)	3.6–17.5 (3.6–17.5)	3.6–17.5 (3.6–17.5)	3.6–17.5 (3.7–17.5)	3.6–16.0 (3.7–12.0)	3.6–15.5 (3.6–15.5)	3.6–15.5 (3.6–15.5)	3.7-15.5 (3.7-15.5)
> 3 months Households (Enterprises)	9.0–20.5 (5.0–20.5)	9.0–20.5 (5.0–19.2)	9.0–20.5 (5.0–19.2)	9.0–20.0 (5.0–15.0)	9.0–19.2 (5.0–16.2)	9.0–19.2 (5.0–16.2)	9.0-19.2 (5.0-16.0)
> 6 > 12 months Households (Enterprises)	9.5–23.5 (6.2–23.5)	9.5–23.5 (6.3–23.5)	9.5–23.5 (6.3–23.5)	9.5–21.0 (6.3–18.0)	9.5–16.5 (6.3–18.0)	9.5–16.5 (6.3–18.0)	9.5-16.5 (6.3-18.0)

Source: National Bank of Macedonia (www.nbrm.gov.mk)

Analysis of the funding costs actually incurred by the banks indicates, however, that they are very much lower than the above figures suggest. For example, based on interest expenses relative to total liabilities reported by selected commercial banks in 1998, the cost of funds works out to be 5 percent p.a. or less. Although this merely captures the average, as opposed to the marginal cost of funds, which would be the relevant factor when deciding whether or not to issue additional loans, there is nonetheless cause to question the validity of the argument that prohibitive funding costs are preventing an expansion of lending operations.

The low actual funding costs reflect the large percentage of sight deposits maintained by enterprises as a share of total deposits held in the banking system (see Table 13). The banks are thus right to point out that the funds available to them are largely short-term, obliging them to maintain a large share of their assets in the form of liquid funds and to issue predominantly short-term loans.[29]

[29] Just under 75 per cent of loans financed with the banks' own denar-denominated funds have a maturity of less than one year (NBM 2000, p. 26).

<u>Table 13</u>: Structure of deposits held in the Macedonian banking system (in per cent)

	1995	1996	1997	1998	9/1999
Demand Deposits/Total Deposits (= M4)	39.5	34.9	35.0	34.8	31.4
(Share of sight deposits held by enterprises)	56.4	59.3	65.9	62.9	64.5
Time Deposits over 1 year + restricted deposits/Total deposits	21.4	23.3	19.0	17.3	17.1

Source: NBM (1999), own calculations

However, the lack of long-term funds is also a symptom rather than a cause of the problem. Banks are enterprises whose purpose is to issue loans (Stiglitz 1992, p. 40). If, in respect of this objective, they perform as poorly as the Macedonian banks as a whole have done, it is only to be expected that they will receive only short-term deposits which (apparently) can easily be withdrawn again[30] if necessary and/or are maintained (solely) in order to enable the account holders to make cashless payments. Accordingly, the root of the problem is that the Macedonian population in general, including both enterprises and private households, do not have confidence in the banking system. And certain events over the past few years have only reinforced this general distrust: First of all, there was the effective loss of all the deposits that were frozen in the former state banks of Yugoslavia; then there was the erosion of financial and monetary assets during the (hyper-)inflation of 1992–1994. The collapse of the TAT savings house in Bitola, which was being run as a pyramid scheme, served as a warning that a more favorable macroeconomic environment does not go hand in hand with a more stable financial system. On the contrary, it showed that a persistently unstable financial system can create serious problems for macroeconomic policymakers. For, while the failure of TAT did not precipitate runs on banks or other savings houses, it was accompanied by excess demand for hard currencies on the forex market, which eventually led to the last devaluation of the denar against the D-mark in July 1997 (IMF 1998, pp. 7, 31, 38). Finally, the recent collapse of Almako Banka, which only two years ago was still the largest of Macedonia's newly founded banks, shows that the Macedonian financial system is far from stable.

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30 The absence of a functioning interbank market is again relevant in this context, as the refusal of the banks to lend to each other only serves to confirm the general public's view that the banks are not trustworthy.

5. Summary and Conclusion

At the beginning of the study we cited Janos Kornai's four principles of financial discipline as guidelines for a program of reforms. Generally speaking these principles have not guided Macedonia's transition process. Eight years after the start of reforms there are still many buyers who do not pay for the goods they buy; many debtors, who do not abide by their loan contract and pay back their debt; many taxpayers who refuse to pay taxes, and many enterprises who do not do not cover costs out of their revenues. Thus, if the Macedonian enterprise sector has made the transition from a planned economy based on state or social ownership of the means of production to a market-oriented economy based on private ownership of the means of production, it has done so in formal and quantitative terms only. In qualitative terms, the transition has made much less progress. This is due in part to the privatization method used, insofar as management/employee buyouts created serious corporate governance problems. As a result, the necessary restructuring of the privatized enterprises broadly failed to take place, so that at the micro level an essential precondition for economic growth was left unfulfilled.

The new private sector, to which most private enterprises belong, has also not been able to grow dynamically because too many enterprises have been forced by high taxes and social charges to operate (largely) informally. Furthermore, financial discipline appears to be underdeveloped, even in the new private sector, which is suffering from the adverse effects of interenterprise arrears that are more typically encountered in privatized and public sectors. As a consequence of these factors, many of the newly created private enterprises are very small and are not really growing at all.

The problems in the privatized and the newly emerging private enterprise sector are exacerbated by the behavior of the banks that dominate the Macedonian financial system. For, instead of acting as "agents of change" (Van Wijnbergen 1993, p. 27) by exercising corporate governance, the banks have been "agents of preservation of the old system". It is true that, thanks to the policy of containment pursued by the Macedonian central bank, the number of banks and their level of activity have remained virtually unchanged over the past few years, so that the banking system has indeed stabilized in quantitative terms. However, neither at the level of the sector, nor at the level of individual institutions, has there been a significant qualitative change of business policy orientation compared with the years prior to 1993/94. This is so because the financial sector policies, which have been implemented mainly on the basis of quantitative criteria (e.g. higher equity capital requirements), have not led to an orderly retreat by

the institutions that were founded as agent banks, nor have they – with a few (possible) exceptions – led to a qualitative improvement in the institutions operating in the banking sector.[31] The fundamental problems – lending to bad debtors and connected lending – have remained because their causes also remain unchanged. Most bank owners still regard their institutions as instruments for meeting their own liquidity requirements, so that they still deserve to be regarded as "market-distorting" rather than "market-supporting institutions" (Johnson/Kaufmann/Shleifer 1997, p. 161).

The central bank's stabilization policies have limited the effectiveness of this instrument by halting the rediscounting and monetizing of these loans. However, the strategy of using higher equity capital requirements either to squeeze the agent banks out of the financial market or to persuade them to adopt market-oriented business policies, has not achieved its objective. Instead, the sizeable incomes that banks can earn from payment services make it economic for their owners to raise the additional capital that the central bank now requires. At the same time, these high equity requirements coupled with the fact that Macedonia is a vulnerable country in a generally unstable region and has a shallow market for financial services, deters foreign investors from getting involved in the Macedonian banking market: Why should foreign banks raise DEM 21 million to establish a presence in the Macedonian market when for only DEM 6 million more they could go into business in the Czech Republic instead? Consequently, the existing institutions have been able to exploit these income-generating opportunities undisturbed by competition from foreign-owned banks. This means that there has been no incentive to abandon old patterns of behavior, as the high percentage of bad loans on the banks' books illustrates. Conversely, the banks' lack of involvement in financing enterprises in the new private sector is a further reason for the absence of growth in this sector.

Under these circumstances, it is not surprising that monetary stability has not been accompanied by financial deepening. For that to occur, the banks would have to prove themselves to be qualified delegated monitors (Diamond 1984), i.e. they would have to demonstrate that they are better than the general public at organizing credit relationships. Yet this is precisely not the case. Consequently, enterprises and households prefer to hold onto their cash rather than deposit it in the banking system. This is the root of what is known in Macedonia as "mattress money", the hoarding of

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[31] The failure of Almako Banka, which at the end of 1997 was still the largest Macedonian bank apart from the three former state banks in terms of total assets, may serve as a warning not to attach too much significance to the currently positive assessment of some of the new private banks.

monetary assets in the form of cash. That this is not conducive to the development of the real economy is hardly a new insight (see McKinnon 1973, King/Levine 1993). Thus, the financial sector is one of the keys to understanding the peculiarity of Macedonia's economic development over the past five years, namely monetary stability coupled with stagnation in the real economy (see also Bishev 1999).

To summarize: Although macroeconomic policy changed dramatically in the mid-1990s, the market infrastructure in Macedonia has stayed more or less the same. Accordingly macroeconomic stabilization policy has only put a lid on a still boiling pot. The general public is not fooled, however. And sometimes the lid is blown off by the forces underneath: TAT and Almako are two examples. To prevent a full-scale explosion, it is high time to address the cause of the problem, in other words to turn the heat down, by introducing sound corporate governance in and by the banking sector. Otherwise it will only be a matter of time before the central bank and/or the state are forced to make a fundamental decision: Either they can stand back and watch banks fail on a grand scale; or the central bank can monetize the banks' liabilities and thereby indirectly monetize, ex post, the liabilities of the enterprises, and/or they can be declared as liabilities of the state (Brixi/Ghanem/Islam 1999, p. 19). Either way, Macedonia's exceptionally good record on monetary stabilization over the past five years would prove to be unsustainable.

What is needed now is not the imposition of further quantitative limits, but rather a fundamental reorientation. The switch that can turn down the heat lies in the change of the ownership structure of the institutions that make up the Macedonian financial sector. As things stand in Macedonia – and indeed in other transition economies facing similar problems, such as the Czech Republic – help can only come from abroad in the shape of foreign owners' taking over existing institutions or founding new ones.[32]

These outsider-owners would have an interest in the profitability of their bank(s), not the survival or profitability of the enterprises to which they lend. They would therefore make a key contribution to breaking down "the vested interests created by the initial distribution of economic power following [the] specific privatization policies" (Roland 2000, p. 4) that Macedonia implemented in the early 1990s. While it cannot be assumed that banks with foreign capital will immediately turn their attention on a large scale to

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[32] On this point, see also Buch (2000).

the new private sector in Macedonia,[33] at least the policy of preserving old structures would have been abandoned. The experience of other transition economies, e.g. Poland (Gomulka, 1998), has shown that this in itself can be a decisive stimulus, triggering the dynamic development of the new private sector that has not yet taken place in Macedonia.

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[33] The foreign banks usually follow non-financial enterprises from their native countries (Buch 1996) that have begun to operate in the countries undergoing transition or that are cooperating with local enterprises. They then concentrate on areas of business which bring in fees and commissions, e.g. international payments, short-term credit in support of trade, or issuing securities, while by and large avoiding services for the general public. However, an analysis of the role of foreign banks in the Czech Republic, Hungary and Poland shows that foreign-owned banks were able to acquire rather large market shares in corporate loans. This indicates “that foreign banks have not confined themselves to small market segments only, or that they have shied away from financing domestic investment. Quite to the contrary, a comparison of the balance sheet structure of domestic and foreign banks shows that the share of lending to firms has been consistently higher for the latter.” Buch (2000).

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