OPENING SPEECH OF THE GOVERNOR OF THE NATIONAL BANK OF THE REPUBLIC OF MACEDONIA PETAR GOSHEV, MSC. OHRID, SEPTEMBER 26, 2009, GRANIT HOTEL

XIV ANNUAL MEETING OF ACI MACEDONIA - THE FINANCIAL MARKETS ASSOCIATION

Ladies and Gentlemen,

Honorable members of ACI - the Financial Markets Association

It is an honor to open the fourteenth annual meeting of ACI - the Financial Markets Association held in a year of exceptional challenges for both the global financial markets and the financial markets in the Republic of Macedonia. I would like to address three issues, not for a moment forgetting the key word for a successful functioning of the financial markets - the trust.

1) ***What are the reasons behind the current financial and economic crisis?***
2) ***How and to what extent has the financial crisis spilled over the Republic of Macedonia? and***
3) ***What are the challenges in the future period?***

At the beginning, let me address briefly the reasons behind the current financial and economic crisis.

The financial crisis could also be compared with an illness of a human organism. In both cases, the finding of a cure first requires identification, and then remedy of the reasons that caused the illness, i.e. the crisis. Observing the events over the several recent years, the reasons behind the current crisis could be divided into two broad categories: *macroeconomic and microeconomic.* **The macroeconomic reasons** for the occurrence of the current crisis could further be divided into two groups: a) problems related to unbalances in the international **claims** and b) problems caused by the maintenance of low real interest rates over a longer period. The first group of macroeconomic reasons includes unbalances in the current accounts of balance of payments among economies, which, in turn, brought about unbalances between the capital accounts. In that process of creating unbalances, especially in the decade before the crisis, the capital spilled over from the developing countries to the developed economies, particularly to the US. The second group of macroeconomic reasons resulted from the excessively long maintenance of low real interest rates. The historically low real short-term interest rates actually reflected adjustable anti-deflation monetary policy. The low long-term interest rates, on the other hand, largely reflected the high savings rate in the capital-exporting countries, particularly in the Asian developing countries and several oil-exporting countries. These countries, seeking for sound financial instruments to place their savings, increased the demand for long-term government securities issued by the governments of the developed countries, thus contributing towards reduction of the long-term interest rates. The low interest rates had multiple effects, including the acceleration of the credit growth in a number of industrial countries, swift growth in the prices of properties and share; and generally, taking high risks during the contest for generating higher earnings.

The financial crisis, however, demonstrated that there are serious problems in the area of microeconomics, as well. It turned out that the investors are insufficiently informed on the nature and the risks of the complex financial instruments; wrong incentive of the financial assets managers arising from the reward system based on generated earnings; the problem of objectivity of the rating agencies which provide credit rating for the financial instruments on issuer's request. Furthermore, it turned out that also there have been non-ignorable problems at a micro level in the area of risk measurement and monitoring, arising from the application of statistical models which do not take account of the infrequent events, and after a longer period of high instability, a priory produce perceptions for globally lower risk level. Within the microeconomic reason behind the financial crisis, we came to the highly frequent issue of "shadow banking system", as an expression of the liberalistic approach for as higher deregulation as possible. **All these macroeconomic and microeconomic reasons, in environment of higher financial system complexity, created systemic risks which occurred in the last quarter of 2008.**

Distinguished!

It is an axiomatic truth that the financial system functioning relies upon trust. Practically, it is a must, illustrated by this crisis, as well. It turned out that it is easier to undermine the trust rather than to restore it. On September 15, 2008, Lehman Brothers bankrupted. The avalanche of losing the trust accelerated in the complex and closely connected modern financial system. The consequences, quite naturally, were first evident in the US financial market which plays an exceptionally important role in the funding of the banks and the private sector. It also became clear that the banks' off-balance sheet activities, in environment of illiquidity of entire segments in the global financial market, will cause enormous losses which will have to be funded with the banks' capital. This, understandably, further increased the mistrust with respect to banks' capital adequacy rate. In a short period, the markets went dry. The ghosts typical for the crisis of the thirtieth (1929 - 1933) flied over, although I agree with those asserting that any comparison between that and this crisis is virtually unsuitable.

In mid-October 2008, the governments of the developed countries started taking measures to get the trust in the financial system back. On October 8, the Government of Great Britain disclosed a complex plan for recapitalization of the banking system. This measure followed the first coordinated measure for cutting the interest rates, undertaken by the six most influential central banks. Moreover, the governments of the Euro-area states adopted a joint decision to issue guarantees and inject capital for stabilization of the banking system. In mid-October, the US Treasury Department also announced that it will invest US Dollar 250 billion to recapitalize the major banks.

The undertaken measures for stabilization of the banking system helped curbing the global trust crisis in the international financial system, but gaining it back goes slowly. Therefore, the financial problems spilled over the real sector, bringing about global recession primarily caused by the substantial decrease in the private consumption (in the USA) and in the exports (of the Euro-area and Japan).

In the last quarter of 2008, the financial and economic crisis in the developed economies spilled over the developing countries. Their export demand went down as a result of the depreciated private and investment consumption in the developed economies. Simultaneously, for overcoming the significant lack of liquidity in the domestic markets, some international banks reduced their lending to these countries. The higher need for liquidity, and the higher risk aversion resulted in a withdrawal of portfolio investments by foreign investors. Under such conditions, the countries with high current account deficit faced with a higher need of external funding, which, given the high instability on the international financial markets, was very hard. Reasonably, this led to pressures on the exchange rates of the economies with higher external unbalances.

How and to what extent has the financial crisis spilled over the Republic of Macedonia?

The Republic of Macedonia has not been hedged from the problems shaking the world, particularly at the end of 2008 and 2009. The implications of the crisis internationally-wide entered primarily through the external sector, and particularly through the transmission channels given below:

- the export-based production registered swift and rapid fall, due to the depreciated global demand, whereas the downward revision of the domestic demand took place in a slower pace, leading to some import reduction (particularly in the last quarter of the last year and the first quarter of this year),
- This uneven pace of the fall in the exports and the imports brought about widening the trade gap, whereas the increase in the uncertainty and establishment of bearish expectations caused decrease in the net inflows from private transfers, Reasonably, it led to higher current account deficit in this period,
- Although the syndrome of sudden cessation was not present, the capital inflows went down significantly, making the current account funding fall considerably on the foreign reserves,

- The perceptions for increasing the macroeconomic risks made the banks accumulating foreign assets, the households converting large amounts of Denars into foreign currencies, thus creating additional pressure on the foreign reserves of the Republic of Macedonia.

Accordingly, the consequences of the crisis could not be avoided, which is understandable if the size and the openness of the Macedonian economy are taken into consideration. The global crisis actually emphasized the **main weaknesses of the Macedonian economy,** such as the high concentration of the export in non-propulsive activities, completely dependant on the movements on the international market and, of course, the trade deficit financing through vulnerable and hardly predictable private transfers. The blow these two components suffered from the decrease in the world economy meant significant widening of the deficit on the current account, which reached 13.1% of the GDP in 2008. These trends continued also in the first part of 2009 and together with the decrease in the capital inflows created serious pressures on the foreign reserves. It reflected directly on the **confidence in the stability of the national currency.** Thus in the first quarter of 2009, the demand for foreign exchange went up by 77% compared to the supply of foreign exchange. The increased misbalance on the foreign exchange market was equilibrated with the National Bank interventions on the foreign exchange market, in the amount of Euro 230 million, only during the first quarter.

Moreover, we were forced to undertake measures to adjust the monetary instruments in function of foreign exchange rate stability maintenance. At the end of March, we adopted a decision on increasing the **interest rate** on the core monetary instrument - the CB bills from 7% to 9%. Such a monetary reaction was motivated by the need for increasing the attractiveness of the CB bills, in order to redirect the Denar liquidity from the foreign exchange market and to ease the pressures on the foreign exchange rate. Although after the increase in the core interest rate of the National Bank, from the beginning of the second quarter, moderate stabilization of the movements on the foreign exchange market was registered and the demand for foreign exchange began to decrease, however, also during April and May, the interventions of the National Bank on the foreign exchange market continue to reduce to net sale of foreign exchange. Simultaneously, the trend of currency conversion of the households' savings from national into foreign currency continued, indicating that although after the culmination in March (during the presidential and local elections) the psychological pressures began to ease, they are not completely depleted. Such accomplishments were the reason for additional intervention with new measures. In May, we **increased the reserve requirement allocation rate** for the banks' liabilities with currency component, as follows: for liabilities in foreign currency, from 10% to 13%, and for the liabilities in domestic currency with FX clause, from 10% to 20%. The undertaken measures should stimulate the Denar saving and we expect to cause change in the trend of accumulation of foreign assets by the banks, which would contribute to decrease in the demand for foreign exchange and to stabilization on the foreign exchange market. And definitely, part of the expectations is already happening.

The depreciated global demand, reflected through several channels, with a decrease in the national economy and real decrease in the GDP in the first half of the year of 1.2%. Also the pressures on the inflation caused by the import prices decreased, which together with the entering into the zone of a negative production gap, resulted in **price stabilization.** The average annual inflation rate in the first eight months of 2009 is negative and it equals -0.3%, which is a significant downward movement, compared to the preceding year.

Alike the pressures on the foreign exchange market caused by the indirect effect of the global crisis, transmitted through the movements in the balance of payments, no movements typical for the global money markets characteristic for the past two years on the Money Market in the Republic of Macedonia were registered. Namely, on the Money Market, in the segment of the non-collateralized borrowing, increase in the turnover and stable movements of the interest rate in the last two years were registered, proving that the mutual confidence in the banking system of the Republic of Macedonia was not impaired. Thus in 2007 exactly, when the global financial crisis began in August, the turnover registered on the Money Market in the Republic of Macedonia started to increase, with the average monthly turnover reaching the level of Denar 1,712 million and it was higher by twice relative to the average monthly turnover registered in the preceding year. The turnover on the Money Market continued to increase also in 2008 and 2009, with the average monthly turnover reaching the level of Denar 3,813 million, i.e. Denar 4,187 million, respectively. The deepening on the Money Market is largely a result of the activities the National Bank and ACI - Financial Markets Association undertook in the that period: introduction of electronic trading platform; introduction of the interbank interest rate for selling Denar deposits calculated from the quotations of the reference banks (SKIBOR); and initiation of the calculation and disclosure of the interbank interest rate for concluded overnight transactions by the reference banks as sellers of Denar deposits (MKDONIA) etc. All of these activities resulted in improved market transparency, easier matching of the supply and the demand and creation of interest rates on the basis of information on the market condition in real time.

Such stable movements on the Money Market, exactly in the segment of non-collaterized borrowing, were indicator that in the period when the rest of the world economy faces with a serious banking crisis, **the banking system of the Republic of Macedonia remained relatively safe and sound.** This is contributed by several factors: orientation of the Macedonian banks towards traditional banking activities, direction towards domestic market and absence of utilization of structural products and execution of complex financial activities, as well as low dependence on the external sources of financing. The banks solvency (shown through the capital adequacy ratio, which equaled 16.4% on June 30,2009) is evidently beyond the prescribed minimal level of 8%, which provides enough capacity to absorb the possible negative shocks from further increase in the risks in their operating.

However, the banks in the Republic of Macedonia face with several challenges. **The consequences of the global economic crisis, which was felt in the Republic of Macedonia through the real sector, had negative influence also on the banking system.**

First, the reduced economic activity and the enhanced psychological pressures arising from the uncertainty regarding the duration and the consequences of the international economic crisis, reflected on the **banks' balance sheets.** In the first half of 2009, the banks' total assets reduced by 0.9%, with the annual growth rate reducing to only 3%. The decrease in the assets was reflection of the deposit core contraction, which went down by 2.4% in the same period, because of which the annual rate of change obtained negative value and on June 30, 2009 it equaled 0.1%. Only the banks' credit activity continued to expand, although with very slower dynamics relative to the preceding years. In the first quarter of 2009, the credit growth equaled only 1.7%, while the annual growth rate on June 30, 2009 reduced to 14.4%. Parallel to the lower volume of activities, also the currency propensity of the banks' depositors was changed. They were apparent through their enhanced interest for saving in currency component. It resulted in additional strengthening of the currency component in the banks' balance sheets. On June 30, 2009, the share of the liabilities with currency component in the total liabilities of the banking system equaled 54.7% and in comparison with December 31, 2008, registered an increase of 5.7 percentage points, while the assets with currency component participated with 56.5% in the banks' total assets, which is an increase of 4.2 percentage points compared to the end of 2008.

Second, the reduced volume of banks' activities, followed by higher significance of the credit risk in the risks spectrum the banks face with, reflected also on their profitability. The profit the banks realized during the six months of the year, in the amount of Denar 646 million, is lower almost by four times compared to that registered in the same period of the preceding year.

Third, despite the intensified carefulness of the banks in the banking activities conduct, in the first half of 2009 **the trend of deterioration of the indicators for their credit portfolio quality continued.** On June 30,2009, the credit exposure with higher risk degree (classified in the risk categories "C", "D" and "E") participated with 7.6% in the total credit exposure of the banks. These movements in the banks' credit portfolio primarily reflect the hampered working conditions of the domestic credit users as a result of the economic crisis. However, thus the procyclical nature of the banking operations and the banks' tendency for larger relaxation of the credit activity standards in periods of growth are proven, which in time of economic activity deceleration, through risks reassessment, results in higher loss volume due to impairment and restraint from crediting non-financial entities.

And the last, however key question: What are the challenges for the forthcoming period? It is definitely clear that there is a need of a comprehensive response to the world financial (banking) crisis. In his new book "The Return of Depression Economics and Crisis of 2008"), Paul Krugman says: "How did this second colossal muddle arise? In the aftermath of the Great Depression we redesigned the machine so that we did understand it, well enough at any rate to avoid big disasters. Banks, the piece of the system that malfunctioned so badly in the 1930s, were placed under tight regulation and supported by a strong safety net.

Meanwhile, international movements of capital, which played a disruptive role in the 1930s were also limited [due to the regulations]. The financial system became a little boring but much safer. Then things got interesting and dangerous again. Growing international capital flows set the stage for devastating currency crises in the 1990 of the 20th century, and for a globalized financial crisis in 2008. The growth of the shadow banking system, without any corresponding extension of regulation, set the stage for latter-day bank runs on a massive scale... What we're going to have to do, clearly, is relearn the lessons our grandfathers were taught by the Great Depression. I won't try to lay out the details of a new regulatory regime, but the basic principle should be clear: anything that has to be rescued during a financial crisis, because it plays an essential role in the financial mechanism, should be regulated when there isn't a crisis so that it doesn't take excessive risks. Since the 1930s commercial banks have been required to have adequate capital, hold reserves of liquid assets, that can be quickly converted into cash, and limit the types of investments they make, all in return for federal guarantees when things go wrong. Now that we've seen a wide range of non-bank institutions create what amounts to a banking crisis, comparable regulation has to be extended to a much larger part of the system. We're also going to have to think hard about how to deal with financial globalization." At this moment, the activities and the approach of the international financial institutions, governments and central banks are similar to such understanding of the response to the crisis. Financial regulations are being changed intensively. They are directed toward broadening of the perimeter of the regulations (toward everything that could produce significant risks for the financial system), but also toward declining of its procyclical character. In that respect, activities have already been undertaken towards actual solutions for:

- Increasing the quality, consistence and transparency of the core capital. Largest portion of the core capital must be consisted of common shares and retained earnings. Appropriate principles will be prepared for the legal entities who are not organized as shareholding companies for ensuring high-quality core capital comparable with the quality of the core capital of the shareholding companies. Also, deductive items and prudential filters will be harmonized on an international level and will be applied at the level of a shareholding capital or its equivalent in the case of the legal entities which are not organized as shareholding companies. Moreover, all components of the capital will be fully published.
- Introduction of a leverage ratio as an additional measure of the risk-based Basel 2 framework, in order to include it in the treatment envisaged in the First Pillar in the future, on the basis of an appropriate analysis. So as to provide comparability, the details about the leverage ratio will be harmonized on an international level, with full adjustment of the accounting differences.
- Introduction of a minimum global standard for providing liquidity for the financing needs which cover the compulsory rate of coverage of the liquidity in stress-scenarios, backed by a long-term rate of structural liquidity.
- Establishing of counter-cyclical capital buffers above the minimum compulsory level. This framework will include measures for maintaining the capital, such as restrictions on the possibility for allocation of the capital elements. The Basel Committee will take into account an appropriate group of indicators, such as the indicators of profit and credits, as a way of ensuring the creation and utilization of the capital buffers. The Committee will endorse a manner of determining the provisions which will be based on the future expected losses.
- Development of recommendations for reduction of the systemic risk related to rehabilitation of the internationally active banks.
- The group of Governors and responsible persons for the supervision, supported the below mentioned principles for directing the supervisors in the shift toward a higher level of capital in the banking system:
- On the basis of the framework for counter-cyclical capital buffers, supervisors should require from the banks to strengthen their capital through a combination of the measures for maintaining the capital including activities for restricting the excessive payments of dividends, of purchase of own shares and compensations for the senior executives.
- Compensations for the senior executives should correspond with the reasonable undertaking of risks and long-term sustainable operations, based on the principles of granting compensations to the senior executives issued by the Financial Stability Board.
- The banks will be obliged to react promptly towards increasing the level and the quality of the capital in accordance with the new standards, in a way that will support the stability of the national banking systems and broader economy.

These changes are expected to strengthen significantly the stability of the financial system. This will increase the confidence in the financial system as a "conditio sine qua non" for the functioning of the financial markets.

In the case of Macedonia, which follows and will appropriately adjust to the changes in the world financial system, the crisis emphasized the existing weaknesses of the macroeconomic reality: the high import dependence of the economy, high export concentration, vulnerability of the sources of financing of the balance of payments deficit and currency risk, which can be easily transformed into a credit risk as a threat to the financial stability. Therefore, in a short run, we have to maintain the appropriate level of foreign reserves, as a precondition for maintaining the confidence in the stability of the domestic currency. In a medium run, more serious structural adjustments are needed, which will lead to narrowing of the trade deficit, primarily through increased export, which will enable higher growth rates of the economy and containing of the significance of the vulnerable sources of financing of the current account deficit. As a conclusion, Macedonia has succeeded in maintaining the confidence in the financial system, i.e. in the banking system. That was possible due to the prudential macroeconomic policies and sound supervision of banks. However, the struggle for maintaining the confidence is a constant effort. Risk management is never a completed process. We should always have in mind that the costs for regaining the lost confidence are always and everywhere incomparably higher than the investment in its maintaining.

Thank you for your attention and I wish you a successful work in the forthcoming period.