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The Coordination of Fiscal and Monetary Policy in Context of Economic Stability - The Case of Macedonia

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Abstract

The paper goal is to point out the relevance of efficient coordination of fiscal and monetary policy in order to achieve economic stability and prosperity. It will analyze several critical economic situations like low industrial production, escalation of hyperinflation tension, high unemployment, an unfavorable balance of payments situation, and low foreign exchange reserves during the 90s in R. Macedonia. In this period the country tried through joint fiscal and monetary policy to battle off all the economic challenges that had risen from the dissolution of the Former country Yugoslavia.

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Especially the focus will be aimed on the stability programs through which the country successfully survived those critical times.

Keywords: economic stability; fiscal policy; monetary policy; coordination; unemployment; hyperinflation.

1. Introduction

Disintegration processes in the former Yugoslavia in the early 1990s led to the dissolution of the Yugoslav federation and the creation of several independent states of its republics. These processes were the result of efforts to find a way out and a solution to the economic crisis that began in the 1980s and was caused primarily by the following factors: ineffective and irrational political and economic systems, outdated and inadequate economic structure, high import dependency, structural imbalances high degree of bureaucratization of the economy, non-profit businesses and government bodies, falling behind in the technical - technological progress and scientific development. Consequently, there was economic inefficiency and low productivity of labor, social capital was increasingly melting in non- production consumption, accumulative and reproductive ability of the economy rapidly weakened, losses and insolvency in the economy grew at a high level of external economic indebtedness.

Hence, the main challenge was the creation of a new political and economic system of the country. After the referendum on separation from the former Yugoslavia on 8 September 1991 Macedonia became a sovereign and independent state, and the adoption of the Constitution as the highest legal act of the state on November 17 the same year, were set basic values of the new constitutional order. After gaining independence, the Republic of Macedonia faced the problem of dramatically narrowing the market as a result of the loss of a large part of the single Yugoslav market, but also with the loss of key transport communication, net transfers from the federal government and about 10 % of the foreign currency savings deposited with the National Bank of Yugoslavia (which was more than 1.2 billion dollars). Further deterioration of the situation caused the introduction of economic sanctions of the United Nations to the Federal Republic of Yugoslavia, which led to the abolition of the previous economic ties with the former republics. The whole crisis situation imposed immediately after the independence of Macedonia urgently to occupy at finding out solutions and mobilize all academic, economic and political staff to achieve them. The main priority tasks were:

- Monetary independence, i.e. the introduction of the national currency - as a symbol of sovereignty and independence;
- Development and implementation of stabilization (anti-inflation) program as a prerequisite for achieving macroeconomic stability necessary for long-term and sustainable economic growth;
- Restoration of the banking system as an integral part and a prerequisite for the development of the financial system in the country;
- Privatization of social capital as an important prerequisite for the transition to a market economy.

Macedonia has brought monetary independence in the spring of 1992, amid the "classic hyperinflationary chaos". During that period, the monthly inflation rate had exceeded the level that indicates hyperinflation and dangerously threatened to cause the breakup of the monetary system. In fact, just before the monetary independence, the monthly inflation rate stood at 86%, while the unofficial or "street" exchange rate was increased by 300%.

This situation had an immediate introduction of a stable currency that the country will be carried out by hyperinflation. In addition, all studies indicate a potential risk of balance-of-payment difficulties and inability to provide enough foreign currency for the purchase of basic vital products such as food, pharmaceuticals, oil and others. The historic date when the monetary independence was established is 26 April 1992 with the adoption of several laws by Parliament and the Law on currency of the Republic of Macedonia, the use of the currency of the Republic of Macedonia, the Law on the National Bank of Republic of Macedonia and the Law on taking over savings deposited by citizens of the Republic of Macedonia, with whom it was found that the denar will be legal currency in the country and it will be exchanged with the dinar in the ratio 1: 1 in order to facilitate and simplify the exchange of citizens.

2. Overview of the fiscal and monetary policy

Along with the monetary independence was adopted anti-inflation program, which had a heterodox character. It was supposed to last six months and included radical measures of monetary and fiscal policy coupled with control of salaries and wages. This program was with ambitious nature and aimed, in the period from May to December, to bring down inflation, as measured by the retail prices, to 8.5% per month or 92% on an annual basis. The outcome of this first stabilization program largely depended on the persistence and the credibility of fiscal and monetary policy, i.e. the corresponding restriction of monetary and fiscal policy. This determination was due to empirical findings confirmed that price stability creates the most favorable macroeconomic environment for rapid, long-term sustainable economic growth.

The macroeconomic situation in introducing inflation program in Macedonia was very unfavorable and was characterized by a prolonged decline in industrial production, escalation of hyperinflation tension, high unemployment, an unfavorable balance of payments situation, low foreign exchange reserves, obsolescence of technology systems, higher deficits in the trade balance budget, drastically declining of GDP as a result of the rapid disintegration of the Yugoslav market, the country's international isolation and economic blockade imposed by Greece. Key stabilization measures which included inflation program were:

- Restrictive monetary policy aimed at reducing the supply of money, namely the growth rate of money supply M1 and maintenance of positive real interest rates;
- Restrictive fiscal policy aimed at reducing public spending from 38% to 35% of GDP as a result of the commitment of the government to combat inflation, a balanced budget;
- Freeze all salaries to the level of March 31 with a possibility of an increase of 25-35% in the future
- Limited price freezing, which covered about 18% of all commodities, particularly strategic industrial products and some food products (bread, flour, cooking oil and sugar). The prices of these products were corrected upwards before been frozen in order to reduce distortion in the existing structure of relative prices.

- Establish a fixed exchange rate with parity against the German mark (GM) 1 GM = 360 denars.

At the core of the stabilization policy was the strategy of monetary targeting that envisaged disinflation to be achieved by gradual reduction in monetary growth. In the initial period, most transition countries joined the disinflation using a strategy of monetary targeting by some of them, such as Albania, Latvia, Lithuania, Slovenia, it has proved amazingly successful in controlling inflation [1]. The use of monetary targeting in transition countries is usually justified by the difficulties in determining the equilibrium exchange rate in the starting period of market liberalization as well as insufficient foreign reserves necessary for exchange rate targeting [2]. At the beginning of the program, the monetary policy showed a restrictive direction because the monthly growth rate of the narrow money supply - M1 decreased from 73.3% in April to 13.9% in May and 6.7% in June. However, this decisive move was durable only for a period of two months, and already in July, the central bank to take a loose course and register double-digit rates of monetary growth. Thus, during 1992 there was an average monetary growth of M1 of 18.9%. However, compared with the planned monetary growth of 755.1% money rose by 704.7%, which meant that monetary policy was more restrictive than what was planned. Hence, the central bank cannot be blame that didn't led restrictive policy, but the fact remains that the monetary growth of 704.5% per year was too high to reduce inflation.

Namely, the central bank could not effectively control the money in this period due to several important reasons: the insolvency of banks, monetarization of the quasi-fiscal deficits and the mechanism of primary issue [3]. Inflation continued the declining trend in the following months, reducing to 8.3% in July and 6.6% in August 1992. Monetary policy in the initial two or three years, when it was not supported by other macroeconomic policies, had the lead in the conduct of stabilization policy. Moreover, during this period the fiscal policy was led irresponsibly, resulting in higher budgetary and quasi-budgetary deficits and at the same time, the policy of wages and salaries were conducted in a passive manner. Indeed, one can freely say that in the initial period after the monetary independence, the overall burden of macroeconomic stabilization policy fell to monetary policy. Overall, the foundation of any successful stabilization policy represents strong fiscal position, hence the restriction of public spending is an indispensable element of the policy of disinflation. Namely, during the creation of the program it was planned for budget expenditures to actually shrink for 22%, bringing the budget spending to a level of 35% from the domestic product. Thus, to ensure fiscal discipline, a legal limit was set on the possibility of financing the budget deficit by borrowing from the central bank in the amount of 5% of the current budget.

However, despite the planned fiscal restriction, the year ended with a large budget deficit 12.6% from GDP, which indicates that there was no budgetary discipline in the fiscal and quasi-fiscal deficits were fully financed through monetary system. In addition, due to insufficient own revenues, budget users were forced to borrow loans from commercial banks and thus indirectly to finance public expenditure through the monetary system and contribute to the high monetary growth.

At the beginning of the stabilization program, with a special law the wages, salaries and pensions were frozen to the level from March 31, 1992 and it was planned to last six months. Moreover, in order to prevent a significant reduction in living standards, it was allowed the March salaries and wages to increase by 30-35% in the economy. However, both this element of the program was not respected and it proved to be crucial in the collapse of stabilization efforts. In fact, in August 1992 the parliament with amendments amend the Law on salaries that enabled the rise of wages by 50% in the economy and by 141% for employees in the public service for which the government has had to borrow from the central bank.

The reason why this measure is used in stabilization programs is due to two main factors: (1) the reduction in real wages leads to reduced costs of enterprises and thus reduces the cost of disinflation and (2) the reduction in real wages leads to a reduction in private consumption and thus mitigates the inflationary pressures. However, given the fact that the increase in salaries and wages are largely funded, whether directly or indirectly, through the monetary sector, it becomes immediately clear that this element instead stabilizing had inflationary effect.

In one of the stabilization measures was also a freeze on the prices of certain important products, such as basic food, oil and oil derivatives, electricity and utilities, which also was supposed to last six months. Namely, the control included products accounting for 24% of the index of retail prices and the basic desired effect was: (1) to reduce costs inflation and (2) to protect living standards. Unfortunately, with the fall of the expert government in early July, instantly rose some controlled products leading to a chain reaction in a further increase in prices of all other products.

Finally, it should be noted the last element of stabilization policy, and it was fixing the exchange rate against the German mark at the level of 1 GM for 360 denars, which aimed to directly attack the inflationary expectations, which are considered for the main source for inflation in the short run. In addition, policy makers hoped with this to attract foreign funds that companies have held on their accounts abroad; For example, in the first quarter of 1992, with exports of 208 million dollars, the foreign currency inflow amounted to 37.5 million, i.e. that is only 18%. The reason why this measure has been introduced has psychological nature, because the German mark was significantly represented as calculative unit in domestic transactions and the fact that the stability of the exchange rate equated with price stability. Due to the modest foreign exchange reserves of only $ 18 million at the beginning of June, economic policy makers decided to fix the exchange rate for a period of 3 months. One way to fill the foreign exchange reserves was through binding the companies to sell 30% of their foreign exchange earnings to the central bank under the official exchange rate. In order to defend the exchange rate, financial assistance from abroad, in the amount of $ 200 million, was planned [4].

What was interesting in this stabilization policy is a combination of monetary targeting with a fixed exchange rate targeting, because the strategy of monetary targeting is usually performed in the presence of a flexible exchange rate. Officially, the strategy of monetary targeting was used within one year, until May 1993. However, due to the high monetary growth, exchange rate suffered few adjustments i.e. denar devaluations, as follows: (1) on October 10, 1992, the Macedonian denar devalued on the level of 600 denars for one German mark; and (2) on December 7, 1992, rate again devalued by 30% and this level of 914 denars for one German mark. At the same time, the exchange rate regime was supplemented with the introduction of oscillation margins at ± 10% compared to the average exchange rate. However, after the October devaluation, which was only official recognition of the actual situation, the exchange rate at a street market again rapidly departed from the official exchange rate, which meant a general collapse of this element of stabilization policy.

In summary, given that all elements of the stabilization policy were undermined from the start, it is not surprising that this program endured a complete collapse. Namely, at the end of 1992, the annual rate of inflation reached frightening 1 965.3%, data that alone speaks for the infamous end of the program. However, the assessment of the stabilization program from 1992 includes also the unfavorable conditions under which it was conducted. In such circumstances, it seems proper note that in transitional economies, macroeconomic stabilization is a more difficult task, since it is realized in parallel with the resolution of a number of other problems, which because of the inherited economic structure there is a risk of failure of conventional macroeconomic policies. In addition, it is necessary to note that stabilization policy was launched by the expert government which had no firm political support in parliament, but also the government had no help from the permanent team of economic advisers. In fact, at that time, Macedonia had neither enough political will nor the basic social consensus for the successful implementation of the program. The doom of the stabilization program in 1992 was caused by the complete absence of discipline in all areas of macroeconomic policy.

In March 1994 was brought to light a macro-economic policy that included more restrictive fiscal and monetary policy, accompanied by some changes in the exchange rate regime and the mechanism of primary emission, which dramatically improved the effectiveness of stabilization policy; Despite the predicted disciplined fiscal policy, during 1993 was not realized significant restriction of budget spending, which contributed to high budget deficit of 13.4% of GDP. Moreover, wage policy was not aimed at supporting the stabilization policy as it gave rise in real wages of 28.9%. All these points support the fact that the leading engine stabilization policy was precisely monetary policy .In fact, on May 15, 1993, the denar deflated by 62% and at the same time abandoned the peg and moved to a flexible exchange rate, which bridge the inconsistency between strategy of monetary targeting and the fixed exchange rate targeting.

During this month short-term loans from primary issue were converted in long-term loans and left out the agriculture lending through the primary issue. In addition, the process of successively leaving the selective lending started. The results of the taken measures were excellent. The tight monetary policy has resulted in a drastic reduction in monetary growth (below the planned growth rate of 268.3%) and a decrease in the rate of inflation, which was measured on December basis, stood at 241.6% twice lower than planned. Namely, for the first time was planned double-digit rate of monetary growth of 80.7%, thus accommodating nature of monetary policy is replaced by a more aggressive anti-inflation approach. The consistency in the implementation of the measures was not confined to monetary policy only, but for fiscal policy too. Namely, this year began with more restrictive approach to fiscal policy that explicitly envisaged a budget deficit of 5.6% of GDP. As a consequence of the significant restriction of budget expenditures, budget deficit at the end of the year stood at 2.9%, which was far lower than the projected deficit. In addition, adoption of the new tax system was aimed to strengthen public finances and contribute to a more efficient fiscal policy. Restrictive fiscal and monetary measures ultimately contributed to a sharp decline in the rate of inflation which, for the first time in many years, was reduced to a level of 55.4%, significantly less than planned inflation of 70%; In theory, such a large fiscal effort to cut the budget deficit, expressed as a percentage of GDP, by at least 1.5 percentage points over two years, and in any year should not come to increase in the deficit. During the two years (1993-1995), Macedonia reduced the budget deficit by an impressive 12.2 percentage points. Thus, fiscal consolidation in Macedonia can be compared with the significant fiscal contraction in modern times. At the same time, for the first time in a while was achieved exceptional stability of the exchange rate, which oscillated in a narrow frames between 26 and 27 denars against the German mark.

The success achieved in macroeconomic stabilization has prompted policy makers to further restrictive measures, so in 1995, monetary policy has reduced monetary growth of only 19.3%. At the same time, disinflation was firmly supported by fiscal policy managed to reduce the budget deficit to 1.2% of GDP, which was extremely important fiscal effort. Finally, discipline in the movement of wages and salaries has been maintained throughout 1995 and caused a decline in real wages by 8.1%.

Table 1: The basic macroeconomic indicators in the period 1992-1995

Indicators	1992	1993	1994	1995
Production	-6.6	-7.5	-1.8	-1.1
Unemployment	26.2	27.7	30.0	35.6
Current account	-3.9	0.6	-4.7	-4.8

Source: NBRM (in percentage)

Thus, at the end of 1995, the first time since the monetary independence, the annual inflation was reduced to single-digit levels of 9% and the exchange rate was stable around the level of 26 denars for 1 German mark. The main conclusions of stabilization policy brought in this period were: (1) stabilization policy during this period was led under extremely unfavorable internal and external circumstances, ranging from inadequate institutional infrastructure until negative external shocks that constantly hit the economy; (2) The strategy of monetary targeting has resulted in successive disinflation and single-digit inflation rate at the end of 1995; and (3) stabilization policy entail considerable disinflation costs, such as: declining production, rising unemployment and external imbalances.

In October 1995, the government moved on to the second phase of stabilization, and that was abandoning the strategy of monetary targeting and accepting the strategy of targeting the exchange rate, where the Macedonian denar was pegged to the German mark in the ratio 1 GM for 27 denars. During this period, a formal anti-inflation program wasn't adopted, but it continued with the implementation of previous restrictive macroeconomic policies which apparently gave the desired results and stabilization effects. The main justification for the targeting of the exchange rate is in the attempts by tying the national currency to a traditionally stable currency to import the credibility of the monetary policy of the country with hard currency. Namely, with the binding rate to the German mark, monetary policy made a decisive step towards ensuring a low inflation rate, which virtually related with the price stability and thus gave a clear signal to the public that is determined to adhere to disciplined, prudent and anti-inflation policy.

This strategy enabled further reduction of inflation and maintenance at low and single-digit level. Namely, at the end of the first year of use of this strategy, the inflation rate was reduced to -0.6%, and in the coming years the rate of inflation continued to be maintained at a low level. Hence, the strategy of targeting the exchange rate gave a positive effect in terms of price stability and the stability of the denar and later in the stability of the euro as a nominal anchor. However, the credibility of monetary policy would not have been possible without a disciplined and prudent fiscal policy, which in this period contributed to a significant reduction of budget expenditures from 24.2% in 1996 to 21.9% in 1998, with the exception of 2001 and 2002, when due to the military conflict, budget expenditures increased to 29.4% in 2002. Overall, fiscal policy was disciplined, budget balance maintained (except in 2001), public expenditure were maintained at a level that ensured efficient control of aggregate demand. Moreover, fiscal policy has shown a direct financial support to monetary policy by constantly transferring large amounts on a special account within the central bank (from 600 million in 1997 to over 1.2 billion denars in 1996 and 1998).

Regarding the policy of wages and salaries, in order to prevent inflation spiral by increasing wages and salaries, control of wages and salaries in state enterprises and the public sector continued in this period together with price controls on certain products. Thus, in 1997, it passed a law providing for the freezing of wages in the public and private sector to the level before the July devaluation rate with basic intention of avoiding a progressive increase in wages that would undermine the effectiveness of this measure of economic policy and would upset stabilization policy.

Hence, we realize that stabilization policy in the second phase, from all aspects and measures, had a really successful impact in ousting effect of inflation and stabilization of the Macedonian economy. However, on the other hand, analyzing its effects on real variables, this strategy failed to yield positive results in terms of unemployment and external imbalances - the long-term problems of the Macedonian economy. A positive trend was observed only in the movement of production which after years of decline in production started showing positive growth rates.

Table 2: The basic macroeconomic indicators in the period from 1996-2002

Indicators	1996	1997	1998	1999	2000	2001	2002
Production	1.2	1.4	3.4	4.3	4.5	-4.5	0.7
Unemployment	31.9	36.0	34.5	32.4	32.2	30.5	31.9
Current account	-6.3	-7.2	-8.7	-3.0	-3.1	-8.6	-8.7

Source: Ministry of Finance; NBRM (in percentage)

3. Conclusion

The coordination of fiscal and monetary policy showed us in many cases and even now that without productive comunication and reaction between the two authorities its imposible to achieve economic stabilisation. From this paper we saw that at the begining in the first phase tha monetary authority were making all of the efforts to achieve the economic goals. However, the fiscal policy was inadequte and unserius in approuching this economic situation at the begining. Despite that, after serious monetary influance starting with restrictive policy and monetary targeting strategy, evaluations which were result from the second phase of stabilization can be summarized as follows: 1) the stabilization policy continued to be implemented in adverse conditions (for example, attacks on Yugoslavia in 1999, the war in Macedonia in 2001); 2) In terms of combining with other policies, stabilization policy in the second phase was far more consistent in comparison to the first, i.e. that monetary policy has enjoyed full support from fiscal policy and policy of wages; 3) The strategy of targeting the exchange rate contributed to further bring down inflation and its maintenance on low level.

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