SS CYRIL AND METHODIUS UNIVERSITY IN SKOPJE
FACULTY OF ECONOMICS – SKOPJE

ECONOMIC RECOVERY IN THE POST-CRISIS PERIOD

Proceedings from International Conference

Edited by Vladimir Filipovski

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SUSTAINABILITY OF EU CONVERGENCE BASED ON EXCHANGE RATE ANCHOR DURING CRISIS AND POST CRISIS PERIOD

Tatjana Boshkov
University "Goce Delcev" – Shtip

ABSTRACT

To cope with competitive pressures and market forces within the EU in the medium-term, the SEE6 needs to address important challenges through determined implementation of structural reforms. Progress with structural reforms can help for macroeconomic stability, for example, by reducing the structural external deficits. Also it helps nominal convergence, as the productivity realizes the improvement of competitiveness and helps disinflation by maintaining low unit cost. So in terms of macroeconomic convergence for SEE6 countries and the case of Macedonia, EU membership requires convergence of the Macedonian economy with that of the EU in realistic conditions, indicating income per capita and economic structure, and in nominal terms, meaning convergence of prices, inflation and interest rates.

Because of the fact that Southeastern European countries rely mainly on exchange rate anchors to reduce inflation, the appreciation of the real exchange rate among countries in the region is significant, although it is slightly lower when compared to countries in the EU member states. As a result, these countries suffer from loss of competitiveness. This can be clearly seen from the movements of the deficit on their current account, which are important in all these countries. Using the exchange rate as anchor for inflationary expectations, on long run have been effective so far, producing a low and stable inflation rates. However, in periods of low inflation and deflationary pressures, exchange rate anchors do not allow sufficient space for fiscal and monetary stimulus. In this respect, policy makers are under following dilemma: to deviate from exchange rate anchor and increase the space for fiscal and monetary stimulus; to accelerate structural reforms and competitiveness and on short run deepen the recessionary pressures; and to increase foreign debt and thus increase scope for fiscal and monetary stimulus while preserving the exchange rate anchor. All three scenarios are analyzed in this paper.

Economic policies can be instrumental for growth in the near- and the medium-term in SEE6. On the fiscal side, sustained reform effort is needed to address structural rigidities in the budgets of SEE6. Priorities include: changes in the composition of public expenditure toward investment and away from wages, public expenditure targeting and prioritization as well as improvements in revenue collection and the broadening of the tax base, among others. On the monetary policy side, with regional inflation at a very low 1.2 percent and big output gaps remaining, some scope for short-term easing of monetary conditions exist, especially in those countries where deficits have begun to decline. Above facts and real situations are our challenges for making analysis and contribution in this area.

Keywords: EU, convergence, SEE6, structure reforms, Macedonia
JEL classification codes: F150.

INTRODUCTION

According to literature, the macroeconomic policy of the new EU member states, is facing with two main challenges. The first is to manage the continued and rapid process of future real economic convergence, which will come with high real GDP and productivity growth rates and large capital inflows. The second challenge is to achieve the degree of nominal convergence required to enter into

European Monetary Union (EMU). These two challenges are not unrelated, such as rapid growth and large capital inflows can make it difficult to realize nominal convergence, i.e., there are good reasons to think that the real convergence would be easier to manage for some countries, if they were allowed to adopt the euro immediately. Both challenges are mainly associated with fiscal policy: managing capital inflows, because fiscal policy can absorb some of their demand effects, nominal convergence, because the sustainability of public finances is part of the requirements for entering EMU.

MACROECONOMIC CHALLENGES FOR COUNTRIES OF SOUTH-EASTERN EUROPE

Like many countries in the early stages of transition, South-eastern European countries rely mainly on exchange rates to reduce the inflation. In many countries, exchange rate helps to reduce the inflation to lower single digits since 2004. Albania's managed float and informal inflation targeting were also successful in keeping inflation low, while in Romania, inflation, although declining under the managed float, remains close to double digits. Since 2000 Serbia has shifted between nominal and close to real exchange rate targeting (with important regime shifts in early 2003 and 2005).

Inflation first declined with the exchange rate anchor, but an increasing external deficit prompted a shift to a managed float in 2003. However, inflation resurged, as suppressed administrative prices were readjusted and growing euroization contributed to an increased pass-through from the exchange rate to prices. The regime shifts may also have adversely affected monetary policy credibility, as indicated by the growing euroization. The exchange rate anchors and sluggish structural reform put pressure on competitiveness. Fixed or nearly fixed exchange rates can lead to unsustainable real appreciation and loss of competitiveness, unless fiscal and incomes policies remain tight and structural reforms boost productivity. For example, in Serbia, the exchange rate anchor in 2002 became unsustainable as large real wage increases and slow structural reforms eroded competitiveness and increased the external deficit. Pressures for real appreciation in the region also arise from the large inflows of foreign currency. The evolution of EU export market shares also suggests that Macedonia may have lost competitiveness, while most others have increased their share in the EU market. The real effective exchange rates data (REER) show a large appreciation in Bulgaria, Romania, and Albania in recent years, which at least in the former two is likely to reflect changes in market fundamentals in terms of increased productivity. In the remainder of the SEE, there is no clear trend with real appreciation and the REERs have remained relatively flat in the past few years.

Southeastern Europe can draw experience from recent new EU member states with monetary framework during accession. Exchange rate regimes during accession had shown different variations, which indicate the importance of fundamentals and associated policies in the implementation and achievement of macroeconomic stability[65]. Some of the larger recent EU members gradually moved from exchange-rate-based stabilizations to more flexible monetary policy as transition progressed. South-eastern Europe has very lower speed of reforms and lower growth rates. Related to this, capital inflows to the region are very smaller and have shown greater dispersion between countries.

Regardless the exchange rate regime, the appreciation of the real exchange rate among countries in the region is significant, although it is slightly lower when compared to countries in the EU member states. As a result, these countries suffer from loss of competitiveness. This can be clearly seen from the movements of the deficit on their current account, which are important in all these countries. For example, the current account deficit in 2007 ranged from 3.1% of GDP in Macedonia to

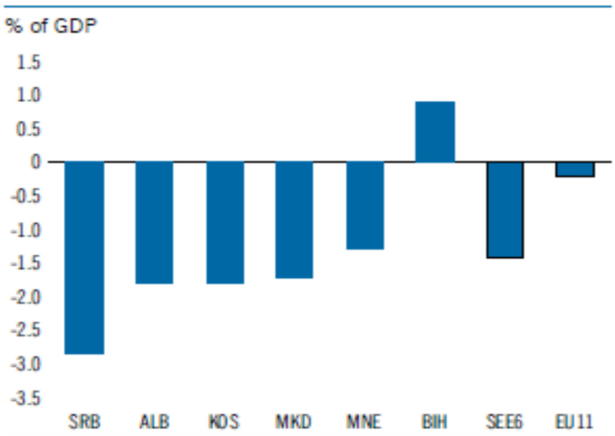
[65] Schadler, S., P. Drummond, L. Kuijs, Z. Murgasova and R: van Elkan (2005), "Euro Adoption in the Accession Countries: Vulnerabilities and Strategies", in S. Schadler ed. *Euro Adoption in Central and Eastern Europe: Opportunities and Challenges", IMF.*

36.2% of GDP in Montenegro[66]. Using the exchange rate as hope for inflationary expectations have been effective so far, producing a low and stable inflation rates. In terms of high import dependence and the relatively slow implementation of structural reforms realized in increased export potential, contributed to the importance of high trade deficit, which was largely financed by high private transfers.

CONVERGENCE OF MACEDONIA AND SEE6 - ECONOMIC CONDITION AND RECOVERY

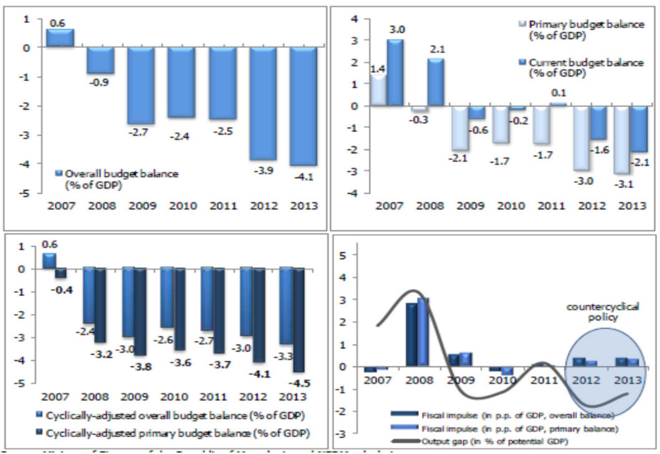
Most countries have seen declines in revenue as a share of GDP (Figure 1) and international trade taxes have performed especially badly. Receipts from international trade taxes declined by an average of 0.5 percent of GDP between 2009 and 2013, associated with shrinking imports. Albania and Montenegro were hit especially hard by falling VAT receipts, suffering declines by 0.5 percent of GDP and over 1 percent of GDP respectively relative to 2009 levels as a result of slow or negative economic growth. Only in Bosnia and Herzegovina did revenues increased slightly largely due to the success of the Indirect Tax Authority.

Figure 1. Change in Revenues, 2009–13



Source: World Bank staff calculations.

Figure 2. Fiscal indicators for Macedonia



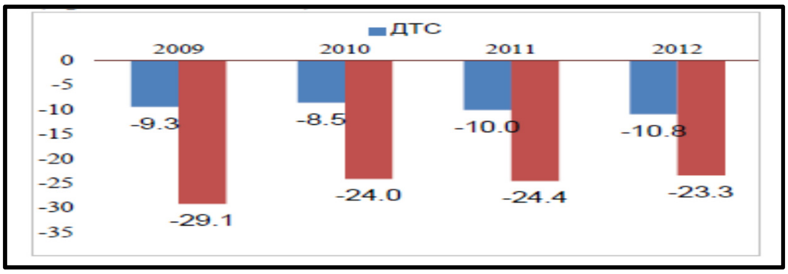
Source: Ministry of Finance of the Republic of the Macedonia and NBRM calculations.

[66] European Commission (2007), *The EU Economy 2007 Review, Moving Europe's Productivity Frontier.*

The analysis of the discretionary changes in the fiscal policy suggested further countercyclical policy. The total structural deficit increased to 4.5% from 4.1% in 2012, amid simultaneous increase also in the structural primary deficit from 3% in 2012 to 3.3% in 2013 (Figure 2)[67]. Consequently, as in 2012, a positive fiscal impetus was given, which, according to the structural primary balance was slightly higher than in 2012. If the analysis includes the output gap, than the fiscal policy was countercyclical also in 2013. Financing of the budget deficit on a net basis in 2013, was done through auctions of government securities, and the rest of the required net inflows was provided from external sources. Reports also showed that also in 2013 there was a trend of increased borrowing through government bonds versus the moderate reduction of the borrowing through Treasury bills.

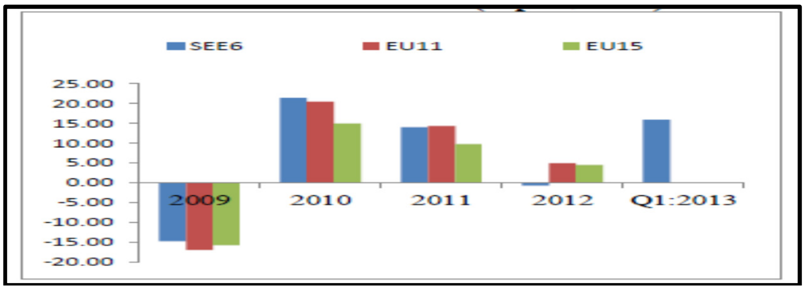
Due to the close economic ties, external factor in SEE6 highly correlated with development of events in the EU. In 2012 SEE6 experienced a drop in trade, current account deficits, FDI and transfers. In the first quarter of 2013 exports is driven by FDI and the improved economic performance of the EU. While current account deficits and trade balances deteriorated in 2012, in the first quarter of 2013 they registered reverse. Reducing the demand for EU goods SEE6 led to a decline in the region which began in 2011 and continued in 2012 (Fig. 3 and 4).

Figure 3. Current account deficit and trade balance SEE6 (percentage of GDP)



Source: IMF, World Bank

Figure 4. Export growth (%)



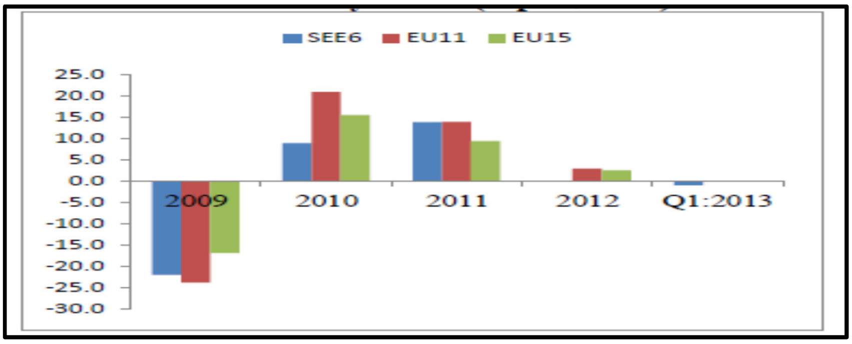
Source: IMF, World Bank

From the first quarter of 2013, exports are likely to improve in future for the entire region. Imports remained unchanged in 2012 and fell again in the first quarter of 2013. Movements in terms of trading, also play a major role in explaining the growth trends of imports through SEE6. Prices for energy imports fell sharply in 2009 and increased significantly in 2010, while in 2011 remained at the same level in 2012 and declined in 2013. In Macedonia, the imports in the second half of 2012 was falling faster, because domestic demand and industrial production continued to decline which is

[67] NBRM (2013), *Annual Report.*

an example for the first quarter of 2013 too(Fig. 5), mainly due to weak domestic demand and economic activity.

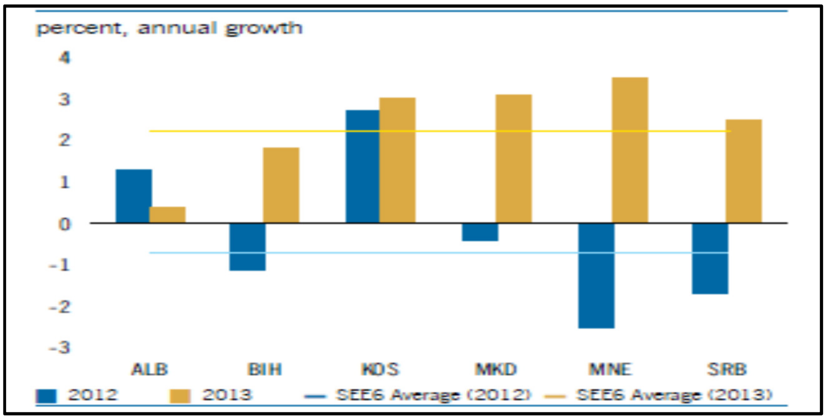
Figure 5. Import growth (%)



Source: IMF, World Bank

The SEE6 countries exited from recession in 2013 with economic growth supported by the recovery in high-income countries, particularly those in the European Union (EU). After a 0.7 percent decline in 2012, the average real GDP of SEE6 grew 2.2 percent in 2013 (Figure 6). All six SEE countries marked positive growth, with growth at or exceeding 3 percent in Kosovo, FYR Macedonia and Montenegro. Only in Albania did economic growth slow in 2013 compared to 2012, though it remained positive. External demand for SEE6 exports was the key driver of this growth recovery, reflecting an improving European and global economy.

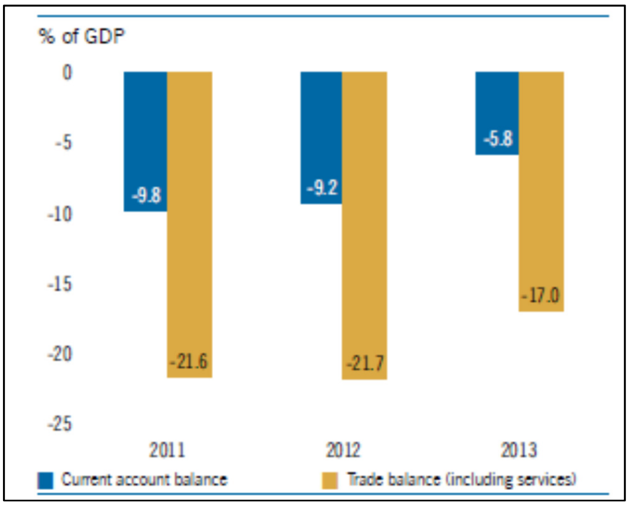
Figure 6: Growth in SEE6, 2012–13



Source: National statistics offices, and World Bank.

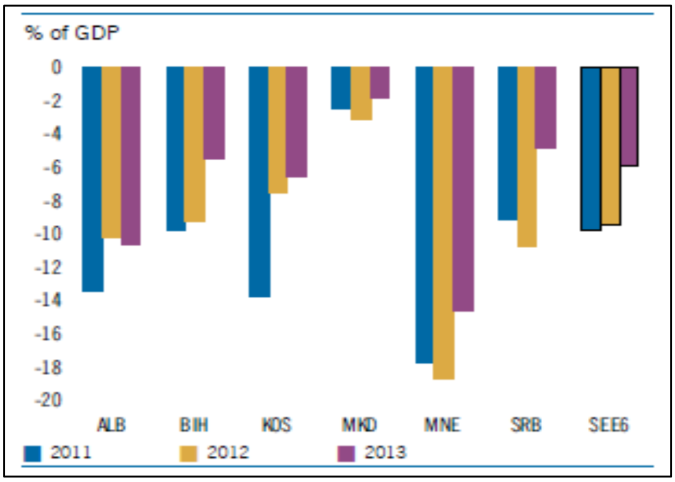
An export-led recovery combined with depressed domestic demand resulted in a significant narrowing of current account imbalances in all SEE6 countries. The increases in exports and the declines in imports lowered the trade deficit of SEE countries by 4.7 percent of GDP and the current account deficits by 3.4 percent of GDP in 2013 (Figure 7, Figure 8). Exports to the EU grew strongly, especially in Bosnia and Herzegovina, FYR Macedonia, and Serbia. Montenegro's and Kosovo's share of exports to the SEE region increased. Manufactured goods were the largest share of exports from SEE6 followed by machinery and transport equipment. Jointly they comprised over 60 percent of exports in 2013 in the region. The major increase in 2013 came from export of machinery and transport equipment from Serbia. Exports in FYR Macedonia grew also on the back of machinery and transport equipment as well as chemical materials. Mineral fuels exports were quite significant in Albania and Montenegro, while base metals were around a quarter of exports from Kosovo in 2013.

Figure 7: SEE6 Current Account and trade & Service Balances



Source: Central banks, IMF WEO, and World Bank.

Figure 8: SEE6 Countries' Current Account Balance



Source: SEE6 Central Banks

The reports by NBRM showed improved performance in the current account in 2013 due to the improved balance of goods and services, amid reduced net inflows in current transfers and higher net outflows in income[68]. The reduction in the trade deficit by 3 percentage points of GDP was mainly

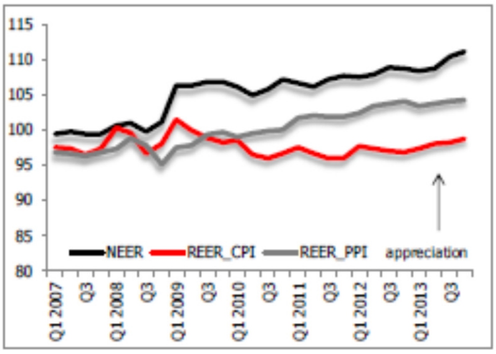
[68] NBRM (2014) *Recent Macroeconomic Indicators* ,Review of the Current Situation.

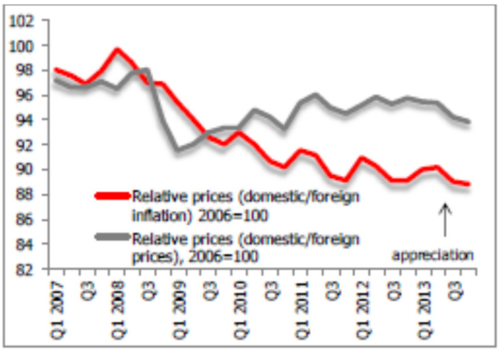
caused by a narrowing of the energy deficit, although the non-energy had the same, however significantly milder effect. The individual components of trade registered divergent movements. Exports, driven by the enhanced activity of the new capacities in the economy with foreign ownership, registered an annual growth of 3.2%, while the reduced demand for energy products and the annual decline in energy prices reduced the import component, causing an annual decline of 1.5%. Divergent movements in exports and imports caused stagnation of total foreign trade on annual basis.

The exports of the companies from the industrial development zones were the most important driver of Macedonian exports in 2013, increasing their resilience, amid still unfavorable global conditions that caused a decrease in the exports of the metal industry. Also, increased exports of new companies were sufficient for offsetting the significant decline in the exported petroleum products, caused by the simultaneous reduction of the exported quantities and lower export prices. Price competitiveness indicators of the Macedonian economy showed a negligible appreciation of the Denar in 2013. The CPI-deflated real effective exchange rate rose by 0.9%, while the PPI-deflated REER recorded an annual appreciation of 0.4%. The change was entirely caused by the movement of the nominal effective Denar exchange rate, as a result of the appreciation of the domestic currency against the Russian Ruble and Turkish Lira, with favorable slower movements of domestic relative to foreign prices.

Figure 9. NEER and REER (CPI and PPI, 2006=100)

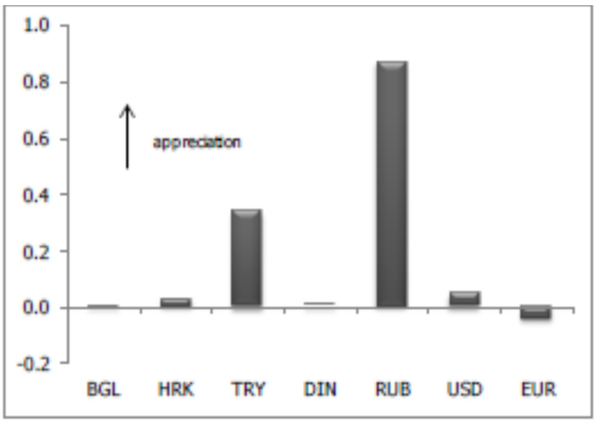
Relative prices (2006=100)





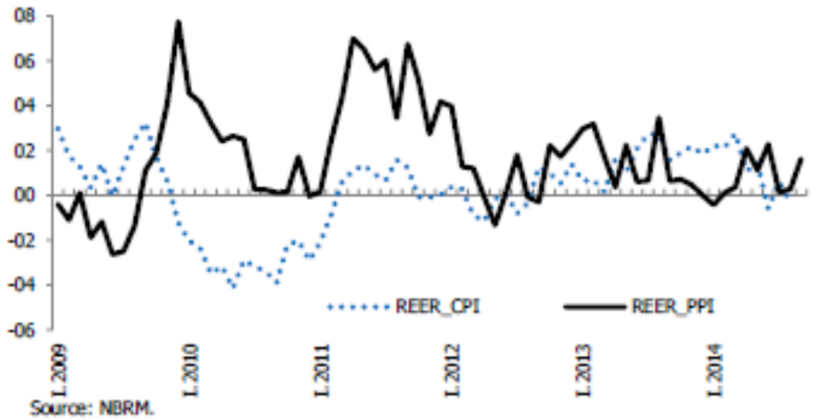
Source: NBRM

Figure 10. Contribution to the annual change of NEER of the Denar (in percentage points)



Source: NBRM

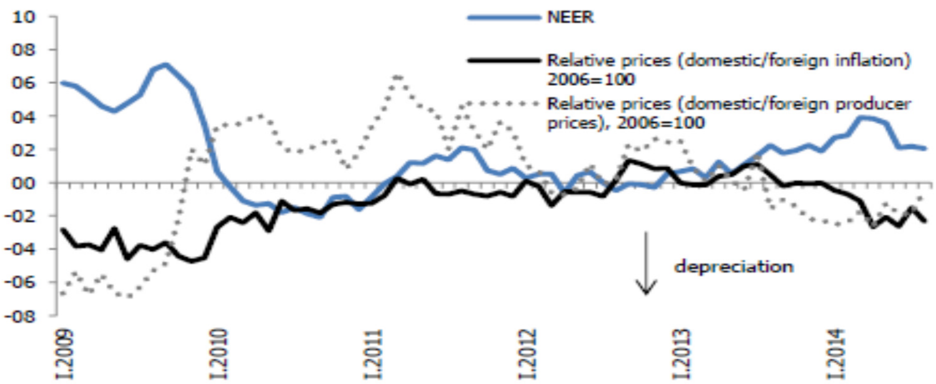
Figure 11.REER annual changes, in %



Source: NBRM

In August 2014, price competitiveness indicators of the domestic economy registered divergent movements on an annual level. Ehen this is compared with the same month of the 2013, the REER deflated by consumer prices depreciated by 0.3%, while the REER deflated by producer prices appreciated by 1.6% on an annual basis.

Figure 12. NEER and relative prices annual growth rates, in %

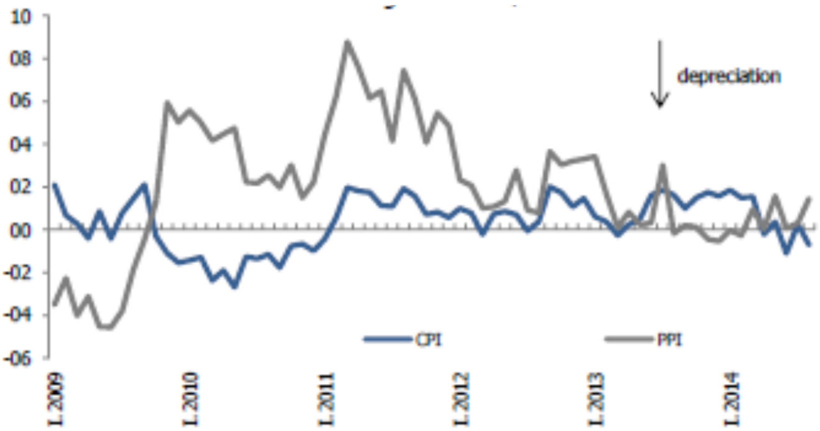


Source: NBRM

Depreciation of the Ukrainian hryvnia, Russian ruble and Turkish lira against the denar had a influence for the further appreciation of the nominal effective exchange rate by 2% on an annual basis,and this caused upward pressures on both REER indices[69]. The growth of foreign consumer prices and as faster growth in foreign versus domestic prices of industrial products, led to a decline in relative prices by 2.3% and 0.4%.

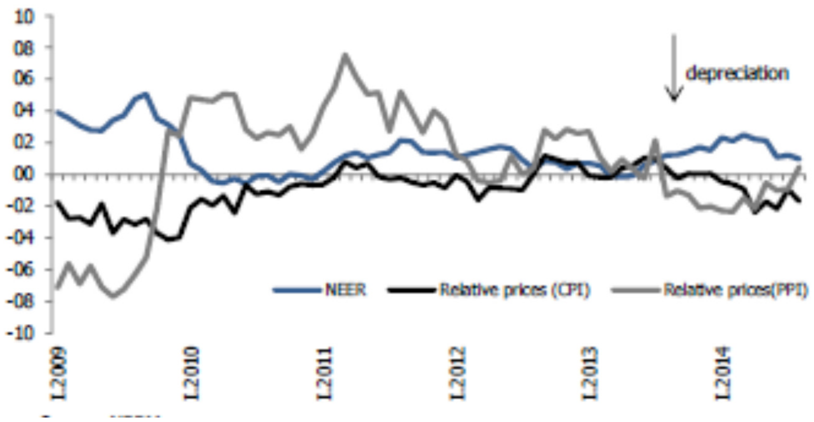
[69] NBRM (2014) *Recent Macroeconomic Indicators* ,Review of the Current Situation.

Figure 13.REER, excluding primary commodities annual growth rates, in %



Source: NBRM

Figure 14. NEER and relative prices, excluding primary commodities annual growth rates, in %



Source: NBRM

The movement of the REER , excluding primary commodities, indicates similar movements in the domestic price competitiveness. The REER deflated by producer prices appreciated by 1.5%, while the REER deflated by consumer prices depreciated by 0.7% on an annual basis. Figure 13 show that due to decline in domestic prices, relative CPI registered an annual decline of 1.7%. Also, relative prices of industrial products recorded a growth of 0.5%, driven by higher domestic prices. NEER appreciation continued in August 2014, annual change driven by the depreciation of the Turkish lira and the Serbian dinar against the denar.

Economic policies can be instrumental for growth in the near- and the medium-term in SEE6.

On the fiscal side, sustained reform effort is needed to address structural rigidities in the budgets of SEE6. Priorities include:

- changes in the composition of public expenditure toward investment and away from wages,
- public expenditure targeting and prioritization as well as
- improvements in revenue collection and the broadening of the tax base, among others.

On the monetary policy side, with regional inflation at a very low 1.2 percent and big output gaps remaining, some scope for short-term easing of monetary conditions exist, especially in those countries where deficits have begun to decline.

However, caution needs to be exercised in the economies with flexible exchange rates to ensure that these do not come under pressure. In terms of financial sector policies, addressing the high NPLs would be critical to ultimately restoring the growth of credit and supporting entrepreneurship and job creation.

The region that provides greater long-term rate of real economic growth, and sustainable GDP growth based on profitable production with sufficient export content has a better chance of attracting foreign capital. Namely, international investors rightly expect to achieve high rates of return on invested capital in that region enjoying long-term sustainable economic growth. Thus, the trend of the movement of the real exchange rate euro / dollar mostly affect the sustainable rate of real economic growth, which is associated with net capital flows.

Financial stability and the efficient allocation of macroeconomic level appear in each economy as an indirect product of successful political coordination. Variables such loans, the cost of funds and the real exchange rate are not aim of any instrument; transparency limits the extent to which they could be involved in decisions. The experiences of this region confirmed that alternative monetary and fiscal regimes, giving adequate political support, can provide very well low inflation. Much more difficult for assessment are the risk characteristics of the regimes.

In Southeast Europe, the conspirators for fixed and floating regime can easily underestimate the dangers which monetary policy are facing with during pre-assessment period.

- ✓ Hard pegging is linked with the region with credible policy management, and they insulate the economy from shocks to the nominal exchange rate. But they may accelerate the expansion of non-hedging borrowing in foreign currency, and they put a high premium on the flexibility of the real sector in terms of shocks.
- ✓ Meanwhile, the dynamics of inflation can question the early adoption of the euro as an exit strategy from that pegging. Flexible exchange rate facilitates the adjustment, and as part of a coordinated political effort can help in slowing the growth of risk in the balance sheet items. But to the extent that such risks are created over time, these modes offer no more than qualified safety valve in case of exogenous or policy caused shocks.
- ✓ Regarding the stability of the money, i.e. price and exchange rate stability, in Maastricht Treaty is guaranteed that the stability of the price level is the main priority of monetary policy in the Euro area. What will be the actual performances of the monetary policy of the ECB does not only depend on the formulation of monetary policy objectives but also from the real sector movements in the economy.
- ✓ It can be estimated that the real effects of monetary policy will be influenced by two conflicting groups of real factors. The increasment of competitiveness of the society will act to strengthen the internal and external power of the euro, and therefore the attractiveness of the euro as an international currency too. On the other side, there is a potential danger that may arise from low rates of economic growth combined with pressures in the direction of large fiscal deficits, which were associated with lower rates of growth and a greater participation of old population.
- ✓ The challenge of managing rapid financial convergence is something that calls for risk-averse macroeconomic policies. But it also depends to a large extent by strong structural policies. Structural reforms are key to strengthening the tradable sector and other productive activities, but also in providing capacity for sharing resources between sectors and generally adjustment to the economy over time.
- ✓ The process of real convergence should has balanced path of economic growth, with manageable external current account and real exchange rate dynamics during the

convergence, as well as adequate capacity for adjustment in the medium term. Challenges for fostering sustainable growth and preserving financial stability on the road to EU accession, are with full complementarity.

- ✓ What can be concluded from the first aspect of the monetary framework which is best suited for managing the real and nominal convergence on the road to the euro, starts exactly from the view that inflation targets seem to have a better set of available tools than those that peg for managing the process of convergence with balance towards adopting the euro.
- ✓ The main risk for targeters are excessive fluctuations in exchange rates, but if the policies are aimed at macroeconomic stability, the probability to make this reality is reduced. Then, the possibility danger is excessive appreciation of the nominal exchange rate, which is likely to lead the country toward expensive interventions or reduction of domestic interest rate that could fuel a credit boom. Options are limited for those who peg.

Leaving hard pegging before adopting the euro brings danger of losing the confidence and depreciation of the currency, which can create a deep recession in negative effects on the debt of households and firms in the country (where the debt is high euroized), as in the Baltic countries. If the output is well communicated as a transition step towards early adoption of the euro, the recession may not occur or would be mild, in the country would become better positioned to contain inflation. Here the danger is that the appreciation of the nominal exchange rate can shift and leads to loss of competitiveness or worsening already weak competitive position. Therefore, the risks of leaving highly pegged should be carefully measured prior to considering such an action. Well-timed and well prepared step of revaluation on "pegging" may be another option to consider if the competitiveness is not in question. The risks here are the positive effects on wealth of the eurozation debt and would increase demand at a time when current accounts are already high in these countries.

WHAT FACTORS WILL LIKELY DRIVE THE ECONOMIC CONVERGENCE MACHINE IN SEE6 IN 2015? IS THERE CONVERGENCE PROJECTION FOR SEE6 AND MACEDONIA IN 2015?

The main goal of National Bank of Republic of Macedonia is the maintenance of the price stability.In this way, the National Bank is committed to applying strategy of maintaining stable nominal exchange rate against the Euro.

The role of the exchange rate as a nominal anchor derives from the characteristics of the domestic economy, as a small and open economy that is highly dependent on the import of primary commodities. Also, Macedonian exchange rate can be used as an instrument for export performances of the country.

Macedonian policymakers should create policy with several aims focused on exchange rate policy because:

- A competitive real exchange rate provides an incentive for exports
- The impact of exchange rates on trade should be seen in the context of continued integration of supply chains
- Exports generally include high import content and impact of foreign currency-exchange appreciation or depreciation on any finished product because it is complex. If the depreciation of the exchange rate makes its exports of finished products "cheaper", it makes imported components "expensive" for domestic producers.
- Maintaining growth and reducing the unemployment in a small and open economy such as Macedonia depends from improved performance of exports.
- Improving the performance of exports can help to preserve macroeconomic stability by closing the gap in the current account to avoid wasting supplies and to stop the growth of external debt.
- Improving performance requires improving export competitiveness.

- An outward oriented, market-friendly trade regime, which emphasizes the dismantling of import controls and tariffs (permitting access to inputs at world prices), and streamlined bureaucratic procedures, *i.e.* export and import procedures, modern customs administration and efficient value added tax administration will facilitate exports, including from SMEs.

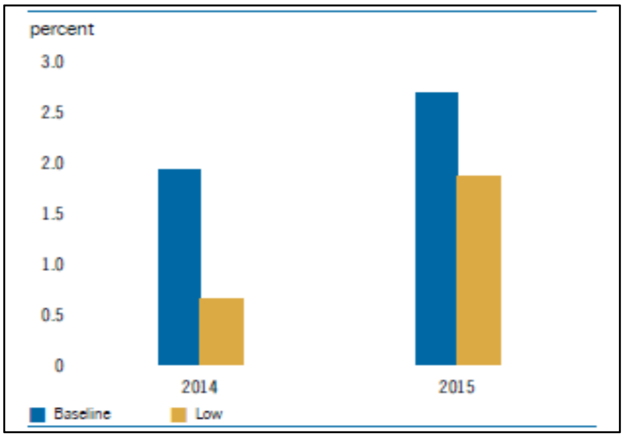
According to the expectations from reports by NBRM, the inflation will slow down also in 2015, when it will approach the historical average and equal 2%. Also, in 2015, it is expected that the current public investments will continue, and as there are expectations for new infrastructure projects[70]. It is estimated that these developments in the export sector and the strengthening of investment activity will create positive transmission effects on both the labor market and the expectations, and thus be a factor for further increase in the household consumption. It is expected that the GDP growth in 2015 it would speed up even more and reach 4.4%. Given the high openness of the economy, the risks to the projected growth continued to result from the global environment and developments in the external environment.

By the end of 2015, the credit growth is projected to accelerate and it would reach 8.5%. Projections for 2015 show that the external position can provide further increase in the foreign reserves and their maintenance at appropriate level. In addition, in 2015, widening of the current account deficit by 5.7% of GDP is expected, mainly due to the fall in private transfers. Despite the moderate deterioration on the current account, it is estimated that its negative balance will be fully financed by capital inflows, mainly coming from foreign direct investment and external borrowings for infrastructure projects. It is expected that the foreign direct investments will gradually increase in 2015 at 4.5% of GDP, respectively. In 2015, prudent fiscal policy is expected, with gradual consolidation of the budget deficit and relatively stable level of public debt. The fiscal policy is important factor that influence the monetary policy setup, while the adequate coordination of these policies is crucial for creation and maintenance of the macroeconomic stability. After the risen level in 2013, the budget deficit is expected to fall gradually and it would range about 3% of GDP on a medium run. Hence, in 2015, it would equal 3.2% of the GDP. The primary budget deficit should be equal 2.2% of the GDP in 2015, respectively.

SEE6 growth in 2015 is expected to accelerate to 2.6 percent on average. All six SEE economies are expected to contribute to the increase in growth rates as external demand firms up and domestic demand begins to recover. Albania, Bosnia and Herzegovina, Kosovo and Serbia are all projected to have higher or the same growth in 2015 than in 2014. In 2015, SEE6 economies are projected to grow slightly slower than the average for the EU11 countries (2.6 percent compared to 2.7 percent growth for EU11). These external and domestic risks, if they materialize, will affect negatively the prospects for growth in the SEE6 countries and slow the nascent economic (Figure 15)[71]. In an extreme case of major deterioration of economic conditions driven by the materialization of above risks, SEE6 output growth in 2014 would less than halve (to 0.6 percent) of the baseline projection (of 1.9 percent). In 2015, growth would drop by a third (to 1.7 percent) from the baseline (2.6 percent).

[70] NBRM (2014) *Recent Macroeconomic Indicators* ,Review of the Current Situation.
[71] IMF (International Monetary Fund). 2012b. *International Financial Statistics*. Washington.

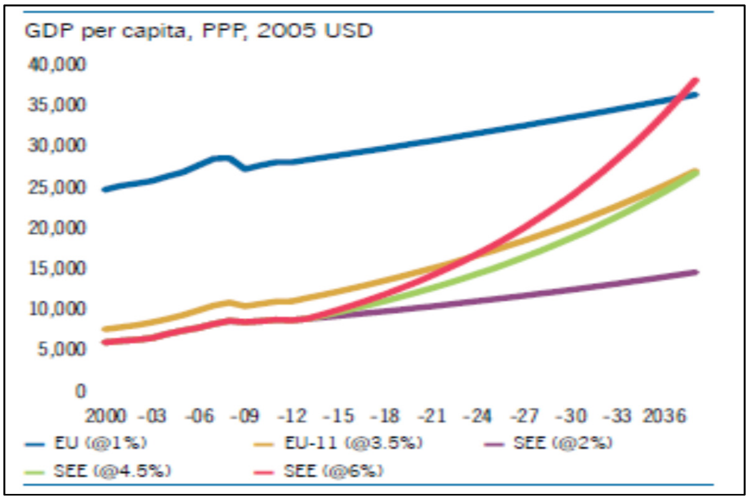
Figure 15: SEE6 Real GDP Growth Rate under Baseline and Low Case Scenarios



Source: World Bank staff

A recent analysis focuses on EU member countries and shows that expanding the growth potential through structural reforms in a stable macroeconomic environment drives strong income convergence.Translated to the SEE6, it means that removing structural rigidities in the macroeconomic policy mix, increasing global integration, improving the economy's productive potential and competitiveness, enhancing skills and labor productivity, and strengthening institutions would ultimately contribute positively to income growth and convergence.

Figure 16: Income Convergence



Source: World Bank staff.

Boosting incomes in the medium to longterm with the aim of converging with EU standards will mean not only maintaining the pace of reforms—but also converting reforms benefits into robust and equitable economic growth. Both of these are proving challenging. The reform pace appears to have slowed during the financial crises. Countries will need to take advantage of the economic rebound to relaunch the reform and convergence processes. There is evidence suggesting that improvements in the business climate should be broad rather than targeted toward specific sectors, as growth and employment creating firms tend to be young and dynamic, but not concentrated in any particular sector. Improving trade links in terms of logistics, institutions and regulations will be important to take advantage of the EU market. In addition, governments need to provide reliable and streamlined processes that guarantee EU safety standards are met for exporting firms, particularly for agricultural exporters. Improvements in governance standards—including the rule of law—will be closely linked to the EU integration process. But reforms required by the EU will also help to boost economic growth in SEE6 countries.

Such reforms are essential to boost labor demand, reduce unemployment, address the challenges driven by demographic changes and improve prosperity for all in SEE6. Increasing employment is essential to reduce poverty and to bring about shared prosperity in SEE6. Since the major source of income for most households is through selling labor, increasing employment opportunities and ensuring that workers have the skills necessary to take advantage of these opportunities are essential to increase the income generation capacity of the entire population.

ACCEPTANCE OF THE EURO: PRESSURE FOR EARLY DATE OR ACHIEVEMENT HIGHER LEVEL OF REAL CONVERGENCE?

Leaving hard pegging before adopting the euro brings danger of losing the confidence and depreciation of the currency, which can create a deep recession in negative effects on the debt of households and firms in the country (where the debt is high euroized), as in the Baltic countries. If the output is well communicated as a transition step towards early adoption of the euro, the recession may not occur or would be mild, in the country would become better positioned to contain inflation.

Here the danger is that the appreciation of the nominal exchange rate can shift and leads to loss of competitiveness or worsening already weak competitive position. Therefore, the risks of leaving highly pegged should be carefully measured prior to considering such an action. Well-timed and well prepared step of revaluation on "pegging" may be another option to consider if the competitiveness is not in question. The risks here are the positive effects on wealth of the eurozation debt and would increase demand at a time when current accounts are already high in these countries.

So, when we focus on the question about the time of the adoption of the euro, there is two options: making pressure for early date or obtaining a greater real convergence?

The question for optimal time of adopting the euro must be resolved. Potentially, the most difficult criterion of nominal convergence criteria is inflation. This is because approximation means convergence of price level that can be achieved either through higher inflation or exchange rate appreciation.

The control of the authorities in these two areas is limited because of the unrestricted flow of capital and related restrictions on domestic monetary policy. Quitting tools of exchange rate policy could be a problem. If the approximation related to the factors that feed inflation, as convergence of structural price level and low level of financial deepening that moves demand for credit, is still strongly present in the economy, the loss of foreign exchange policy could lead to increased destructive cycles and derail the smooth process of convergence, such as difficulties related to Latvia to cool the overheating economy. This is because it seems easier to keep the appreciation of the real exchange rate inherent in the process of approaching a greater or lesser balance by allowing the nominal exchange rate to appreciate than keeping inflation in balanced direction after leaving all flexibility, however limited it is, independant from monetary policy. If overheating of the economy leads to a loss of competitiveness and slow growth, it is difficult to recover through wage and price disinflation after denying the independence of monetary policy in the euro area, as it is known experience of Portugal.

It does not mean that it is easy to keep the nominal exchange rate at direction of equilibrium appreciation in current conditions of free movement of capital and globalized financial markets. These questions further develop their own assessment of the advantages and disadvantages of:

1) the efforts of early adoption of the euro and address the risks of higher inflation and the need to regain competitiveness without available tool – exchange rate or

2) delay of membership in the euro zone and its advantages as addressing the risks that arise from the volatility of the exchange rate.

This dilemma could be analyzed from the perspective - where is the country in the process of convergence? If the gaps are closed to GDP per capita and the price level is still pretty high and the speed of convergence is on satisfactory level, the country will have difficulties in controlling inflation in the monetary union. Consequently, it could be proposed to postpone the adoption of the euro until reducing the gaps or differences. From the reports and studies can be concluded that all new members in terms of traditional optimal currency area, their stance should not be an obstacle in adopting the euro. Empirical studies show that membership in the monetary union promotes synchronization of business cycles and financial integration.[72] New researches show that the strength of the endogenous variables in the euro zone is strengthened by the fiscal discipline embodied in the supervisory structure of the EU by reducing the possibility of specific fiscal shocks[73].

CONCLUSION

Wich are the results of conducting reforms for speeding up the economic convergence?

The analysis show that large potential gains could be reaped from structure reforms. Reports identificate that Euro-area GDP could be around 6% higher after ten years if Member States adopt measures to halve the gap vis-a-vis the average of the three best-performing Member States in each of the reform areas considered. When the structural reform will be successful implemented, it promises growth of the economy. Growth effects are significant and higher growth potential can also stimulate investment demand and help to restore investment to pre-crisis level. Analyzing reforms it could be noticed that reforms that labour force participation yield the largest output effects in the short to medium run. Reforms relating to product markets can lead to large output gains. Structural fiscal reforms that shift the tax burden away from labour towards less distortionary taxes could be implemented relatively rapidly and boost employment and growth already in the short to medium run. Differences across countries mainly reflect where a country stands relative to "best performance" for different structural indicators. Performance gaps are particularly large in participation rates and tax structures, and reforms in these areas can deliver the largest effects. There are positive cross country spillovers of structural reforms, adding up to 10% to the gains in output in the long run. The demand effect boosts imports and supports trading partners' growth, though this is partly offset by the competitiveness effect. Trade balance effects are relatively small and can turn negative where the demand effect dominates the competitiveness effect. Reforms lead to significant improvements in fiscal positions and can yield sizeable reductions in debt-to-GDP ratios in the medium/long term, alleviating the need for further consolidation measures and contributing to long-term debt sustainability.

How Macedonia could reach and sustain higher rates of economic growth thus speeding up the process of economic convergence too?

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[73] Ferrando A., Baele L., Hördahl P., Krylova E. and Monnet C., „Measuring Financial Integration in the Euro Area", ECB Occasional Paper, No. 14, 2004.

The researches offer options that include increasment of the labor contribution to economic growth by raising labor participation and reducing unemployment. The second options means improvement of allocative efficiency. This understands promotion enterprise restructuring and reforming product market regulation as including regulation in the infrastructure sector. Next options is focused on deepening trade integration by promoting export-oriented FDI and developing the supply of exportable goods, meaning that Macedonia would need to integrate its logistics infrastructure. Accelerating the process of economic convergence will be supported by fostering technological progress. The recommendations are focused on policy-makers, inviting them to identify what policies are politically feasible and to be checked for their consistency with the overall objective of raising and sustaining economic growth.

Next, these strategies need to generate institutional requirements that are commensurate with the existing institutional endowment of Macedonia. This will lead to a near-term focus on deepening trade integration and fostering innovation, while measures related to expanding labor participation and employment could be adopted more gradually with a long-term perspective.

These measures would better position the country to fully benefit from EU Accession and to better manage the effects of the global financial crisis, by strengthening Macedonia's international competitiveness

- In addition to the policy measures directly recommended for deepening trade and fostering innovation, the following complementary policy initiatives would be required:
  - Advancing *enterprise restructuring* (privatization) and the promotion of stronger *market competition* (improving product market regulation and de-regulation).
  - Adjusting the *life long learning system* to market needs, encouraging *labor training* by firms, and improving the supply of (selected) skills by possibly reviewing *migration rules* for labor market segments where the skills-gap is binding.
- Political resistance to the trade and innovation measures associated to the proposed strategy is likely to be comparatively low, with the exception of enterprise restructuring efforts. C*ompensatory policies* for workers negatively affected by enterprise restructuring should be considered.
- Preliminary evidence on the positive association between access to non-banking finance and total factor productivity suggests further examination of the role of non-banking financial institutions in the selection of investment opportunities and thus in fostering growth in Macedonia.

Summarizing, there are starting point to introducing high integration for structural adjustments and growth:

- 1.faster productivity and quality catching – up
- 2.faster wage catch-up
- 3.faster upgrading of commodity structure leading to a faster disappearance of asymmetries in income and price-elasticities
- 4.impact on invisible and income accounts:more trade and transport services (balance impact neutral); more tourism in both directions; more deficits in other services (here lies one of EU's comparative advantages; more personal transfers
- 5.impact on capital movements: more FDI and portfolio investment; easier access to credits and better conditions for debt servicing
- 6.greater pressure towards reducing the "undervaluation" of the national currencies:speed up of institutional changes and market functioning will increase convergence of price structures;more pressure to achieve a higher level of international purchasing power because of greater tourist flows and more imports;more pressure to achieve monetary stability and use of the nominal exchange rate as an anchor with the view of coming closer to the Maastricht criteria
- 7.greater openness of EU market.

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