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De-Euroization in Macedonia: Is Euroization Irreversible?

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Abstract: Macedonia is high euroized country. Considering the exchange rate experience of Macedonia, it's likely to remain significantly euroized country for an extended period. IMF considers that the appropriate strategy is the one which provides support for the gradual de-euroization for maintaining macro-prudential policy, development of the domestic market and maintain prudent policies that mitigate the risks of foreign currency. These factors should create an effect of de-euroization and provide buffers in the financial sector. Through the analysis of IMF could be seen that the de-euroization will provide security and other reasons which are more constrained by the fixed exchange rate.

In this paper we analyze the main reasons for the process of euroisation in Macedonia and will be presented any aspect of the potential benefits of de-euroization.

Key wordrs: euroization, de-euroization, currency, benefits, Macedonia.

1. Introduction

As mentioned above, Macedonia is high euroized country. The high level of euroization is common in emerging countries in Europe as in countries with fixed exchange rate regime. European countries have a higher degree of euroization of around 60% on average, compared to 25-30% - Latin America and 5-10% in East Asia (IMF, 2012).

In recent years, foreign exchange (FX) and FX-indexed deposits amounted more than 50% of total deposits in the private sector in Macedonia. Credit euroization increased by 40% since the beginning of this decade and rose about 55% in recent years. Countries with fixed exchange rate are increasingly euroized compared to countries with flexible exchange rate regime. Macedonia has the lowest pillar, with over 55% in recent years that is below the average in the region. In terms of deposit euroisation, Macedonia is one of the most euroized country among others.

The high level of credit euroization is usually considered as a challenge for politics. Euroization is a balance sheet risks for the economy, as well as debtors in FX, revenues and assets denominated in local currency which are subject to sudden changes in exchange rate (Baliño, 1999). As a result, currency risk could turn into indirect credit risk. In addition, high euroization reduces the effectiveness of monetary policy transmission as the central bank may affect local currency rates through its policy rate, but has little effect on foreign currency rates.

2. Reasons for credit euroization identified in the literature

The most reasons for credit euroization identified in the literature can be classified as reasons of supply and reasons of demand. Explanations of demand can be grouped in three categories (Zettlemeyer et al., 2010):

-Interest rates on foreign currency loans are lower than loans in local currency due to devaluation/depreciation of the risk.

-Borrowing in FX may be optimal individual and social decisions surrounding the lack of credible macroeconomic policies or institutions. For example, borrowing in FX can be a risky strategy in the environment where inflation is difficult to predict.

-Residents may choose to borrow in FX, because they do not expect to have full costs related with amortization and insolvency. This could be case of explicit or implicit government guarantees of debtors.

-From the supply side, the banks can make FX loans more attractive from credits in the national currency matching the currency structure of their assets and liabilities. This may be a result of regulatory requirements or bank reluctance for directly assumption of currency risk (Rosenberg and Tripak, 2008).

3. Credit euroization of Macedonia

Some analysts say that high FX depreciation and volatility of devaluation discourage foreign loans (De Haas, 2015), and others - lending is more evident in countries with higher inflation volatility (Brown M. and De Haas, 2015) (Figure 1).

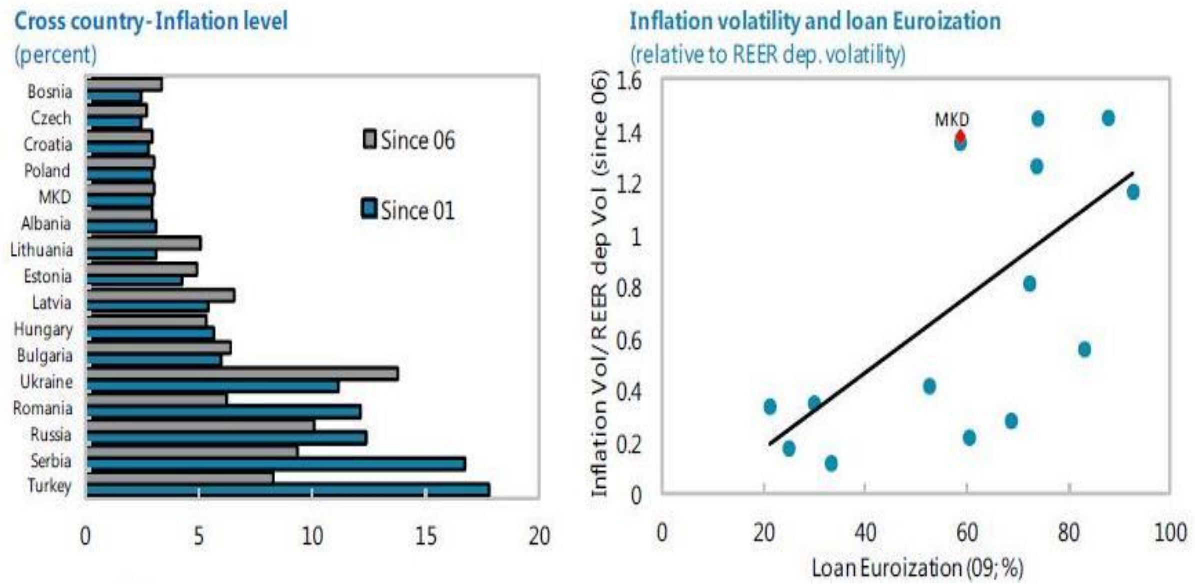

Figure 1. Inflation level and volatility.

a) Cross country- Inflation level

b) Inflation volatility and loan Euroization
Source: IFS.

The stability of the financial system and stable exchange rate regime - fixed exchange rates, are of particular importance for the national economy. This means that debtors can count on implicit government guarantee. The regulation in Macedonia requires net open FX position which not exceed 30% of their own funds. Therefore, there is no significant currency mismatch on banks' balance sheets. However, there is considerable indirect credit risk, as many borrowers of FX loans do not pay attention. Naturally, loans protect the company's accounts for 9.9% of total FX and FX-indexed loans. In case of risk of significant devaluation, the consequences can be dramatic for financial system (Chaillouk et al.,2010).

According to the hypothesis stated that borrowers are not strong reason for credit euroization, debtors will prefer to borrow cheaper foreign currency loans. Explaining that debtors can not understand – this is underestimated or exaggerated tolerance of the risks are associated with borrowing in foreign currency and are in conflict with the high degree of deposits euroizations in Macedonia.

Despite higher feedback supply by deposits in local currency, residents choose to retain a portion of their deposits in foreign currency, which shows understanding for currency risk.

On the supply side, the deposit euroization is widespread, which contributes for high credit euroization. In the case of Macedonia, the funding of foreign currency from abroad is limited. Still, the deposit euroization ranks among the highest in the region (Figure 2).

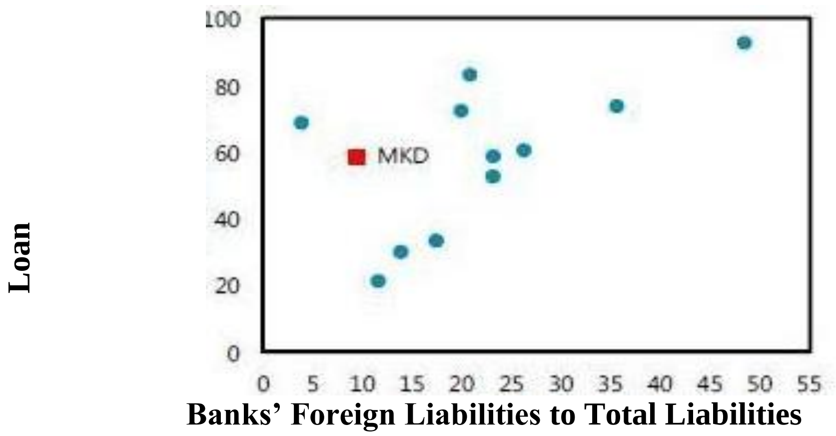

Figure 2. Funding sources currency denomination

Foreign Funding,2015 (Percent)
Sources: IFS.

Macedonian authorities have put in place several and initiative measures for protection and incentives for reducing the risk of euroization and building buffers. There is a supervisory framework created by the Central Bank of Macedonia (NBRM) to regulate FX-induced credit risk.

4. Supervisory framework of NBRM for regulation of FX-induced credit risk?

Macedonian authorities have put in place several safeguards and initiative to reduce the risk of euroization and build buffers. Thus there is a supervisory framework created by the Central Bank of Macedonia (NBRM) to regulate FX credit induced risks.

The prudential regulation is implemented by the monetary authorities, which include several categories:

-diferential mandatory reserves

-net open currency position

-capital adequacy

-identification of unhedged foreign currency borrowers

-documentation for FX exposure.

Reserve requirement is 10% of Denar deposits, 13% of foreign currency deposits and 20% of FX indexed deposits. Aggregate net open foreign currency position at the end of each day should not exceed 30% of banks' own funds. Foreign currency position includes the clause and foreign currency assets and indexed liabilities.

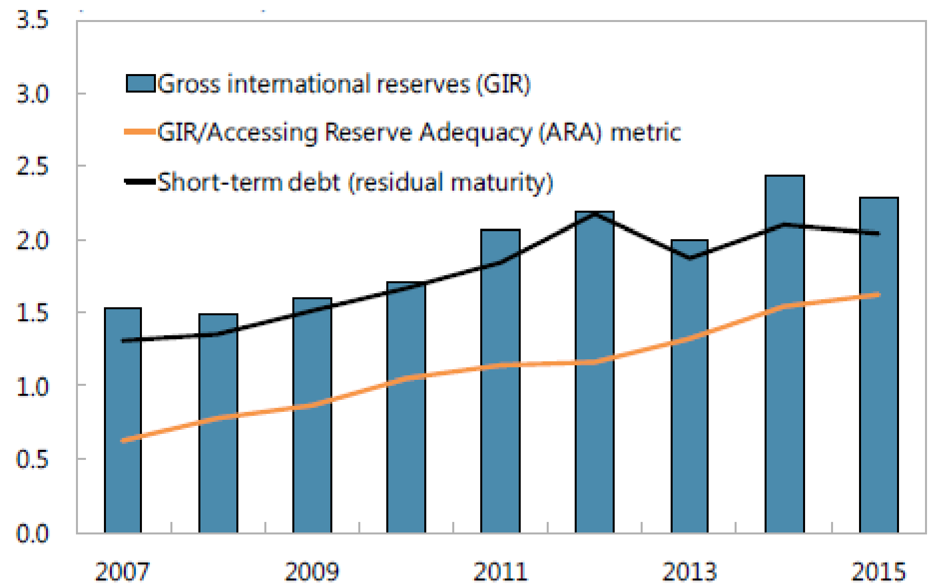

Figure 3. FYR Macedonia: Reserve Adequacy Ratios (Billions of Euros)
Sources: National Bank of the Republic of Macedonia (NBRM); and IMF staff calculations.

The calculation of capital adequacy ratio is regulated in detail by:

- The Law on Banks
- Decision on Capital Adequacy
- Reporting Guidelines for Banks in relation to Capital Adequacy Ratio, Capital Requiremenets and Trading Book.
- Also, the Bank should have a system to assess and monitor compliance FX position of the client.

Tabel 1. Reserve adequacy ratios for Macedonia (2012-2020)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Reserve/STD(percent)1/	101.0	106.5	115.9	111.5	121.3	118.5	120.6	134.4	133.2
Reserve/Months of prospective import goods2/	6.2	5.2	6.0	5.2	5.2	5.2	5.0	4.6	4.8
Reserve/Broad money (percent)3/	50.7	43.7	48.3	44.1	45.4	45.3	42.0	39.0	37.0
Expanded “Greenspan-Guidotti” metric:Reserves/(STD+ CA deficit)	91.6	98.8	110.0	97.7	100.9	100.0	103.1	113.6	112.9
Reserves/Fund combination metric (percent)4/	135.1	125.3	133.3	123.2	123.4	196.4	191.0	187.6	187.4

Notes: 1/ Suggested threshold for adequacy: 100 percent; 2/ Suggested range for adequacy: 3-6 months; 3/ Suggested threshold for adequacy: 20 percent; 4/Suggested range for adequacy: 100-150 percent

IMF recommended a tightening of monetary policies should demand pressures pick up, a low probability in the current environment, or risks to financial stability emerge. Consumer and mortgage lending growth rates have been in the double-digits, which require vigilance. The authorities agreed and expressed their intention to use targeted macro-prudential policies to address risks concentrated in specific borrower group, while an increase in the policy rate would be considered in case of external or price stability risks. Staff supports this approach. Reserves are adequate according to various metrics and are projected to remain so in the medium term dampening external instability concerns (text table). Nonetheless, some policy tightening may be needed to preserve the ongoing de-euroization, which has a bearing on financial stability, should external uncertainties negatively impact the pace of private transfer inflows and conversion of deposits from foreign to local currency (EBRD, 2010).

Credit history of the bank must contain all relevant details for the bank to establish the identity, creditworthiness, orderliness to perform its obligations and quality of collateral, including the approval and monitoring of exposures that are part of the retail portfolio and analyzes of exposure to the debtor of the exchange rate risk.

5. De-euroization trends in Macedonia

Similar to other Balkan countries that operate a fixed exchange rate regime, euroization has traditionally been high in FYR Macedonia. This has been driven by factors typically identified in the literature:

-low initial credibility of institutions,

-volatility of inflation and income,

-lower interest rates offered on foreign currency-denominated loans by foreign bank subsidiaries.

In addition, large private transfers, notably from Germany, have contributed to significant deposit euroization –prompting banks to extend foreign currency-denominated loans in order to match the asset and liability structure of their own balance sheets. While price and exchange rate stability remains the primary objective of monetary policy in FYR Macedonia, fostering a continuous process of de-euroization has been an important policy goal. With a view to contain balance sheet risks of unhedged non-financial private sector agents, the monetary authorities have progressively put in place regulatory safeguards and buffers against excessive euroization since 2009. These have included:

- differentiated reserve requirements for LC and FX liabilities;
- a cap on the daily net open FX position of banks to 30 percent of their own funds;
- requirements from banks to identify and document the situation of large unhedged FX borrowers.

More recently, the central bank continued to balance the needs for monetary stimulus with the objective of maintaining a significant spread between the central bank bill and ECB main policy rates, in order to incentivize the banks to offer a substantial currency deposit/loan spread. These policies have borne fruit, bringing down loan and deposit euroization levels, particularly for the non-financial private sector. In the context of declining LC and FX lending rates but of a slower decline in the currency spreads, the proportion of foreign currency-denominated loans has fallen below 45 percent of total loans at end-2014 compared to 53.5 percent in January 2009. The proportion of foreign currency-denominated deposits has fallen to below 42 percent of total deposits from the peak of about 59 percent observed during the 2009 financial crisis, driven by both corporates and households.

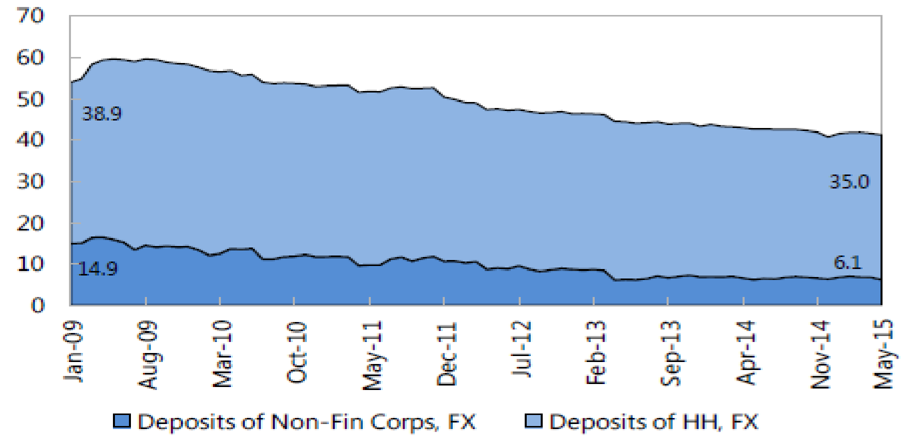

Figure 4.FYR Macedonia: Deposit Developments by Customer

(Percent of private sector deposits)
Sources: NBRM; and IMF staff calculations

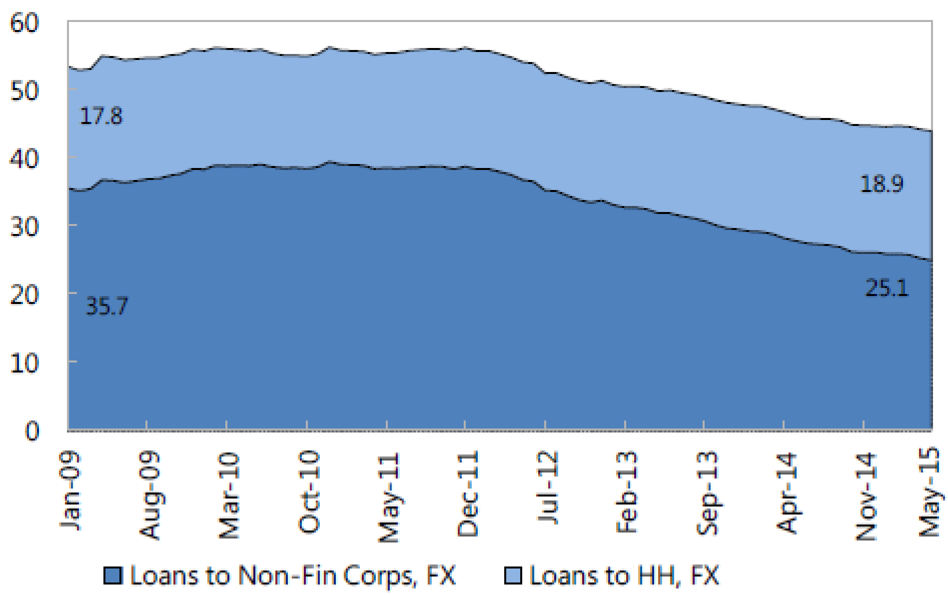

Figure 5. FYR Macedonia: Credit Developments by Customer

(Percent of private sector credit)
Sources: NBRM; and IMF staff calculations.

6. What are the consequences of de-euroisation for Macedonia?

As stated above, de-euroization will bring benefits, but they are limited in fixed exchange rate regime (like Macedonia) as opposed to a more flexible regime:

- The underlined benefit is avoiding the loss of the difference between the value of money and the cost of their production. If there is a high degree of substitution of currency (use of euro banknotes), then the loss of the value of money and the cost of their production can be great. So, de-euroization unlikely to affect the economic price of the currency within a country.

- De-euroization can improve the effectiveness of monetary policy. The high degree of euroization limits the efficiency of the transmission of monetary policy. Considering the fact that Macedonian regime is fixed exchange rate pegged to the euro, it should be noted that it serves to the domestic economy and is an important tool for both monetary policy and fiscal policy in Macedonia.
- Another benefit is the reduction of risks in the balance sheet, which is considered one of the main benefits to de-euroization in Macedonia. Exposure to currency of bank balance sheets makes the banking system vulnerable to large movements in exchange rates. However, at the individual level this is considered as low risk, but at the aggregate level, this must not be overlooked. However, at the aggregate level, when the balance sheet depleting Macedonia should use exchange rate flexibility as a shock absorber in the script.

For achieving greater progress towards Euroization is necessary more time. But the history of countries that had successfully de-euroization show that its mainly countries with flexible exchange rate regime. Examples are Chile, Israel, Mexico and Poland (Reinhart et. al.,2003).

Since Macedonia has strong commitment for fixed exchange rate which is peg, this can be credible reason to be harder for rapid de-euroisation. Macedonia's long-term commitment to join the EU and eventually the euro area adds credibility to the exchange rate regime and make a move towards more exchange rate flexibility. De-euroization should be supported by macroeconomic stability, public debt management and development of the domestic financial market. For example, Israel, Chile and Poland started their process of de-euroization by reduced inflation and gradually stabilization of the economy as liberalization of the financial sector and capital account.

Macedonia is able to achieve macroeconomic stability under a fixed exchange rate and prudent fiscal policy in recent years, and has managed the global crisis relatively well. Active management of public debt and the development of the domestic financial market are important policies in supporting the de-euroization. The issuance of local currency-denominated public debt may be de-euroized balance sheet of the government as extend the yield curve of domestic currencies. The development of deep and liquid domestic financial market will increase the range of local currency – denominated securities and may contribute to the reduction of foreign exchange denominated assets (foreign currency deposits). Encouraging the development of the domestic investor base such as pension funds, are likely to be supportive of demand for local currency instruments and markets in the long term.

De-euroization can be a lengthy process and can take in achieving macroeconomic stability. The public tends to have long memories of past crisis episodes, and watch the local currency as risky (Basso et al., 2007).

Also when the public becomes accustomed to using foreign currency in financial transactions and not internalize the negative externality of using foreign exchange to the economy, de-euroization does not happen automatically, even in the case where the successful macro stabilization increase the attractiveness of the local currency.

Prudential regulation should be aimed to resolve the euroization. This will help to provide management with foreign exchange risks to provide buffers and to create soft initiative for de-euroization.

Conclusion

The focus in this paper was the causes of euroization in Macedonia. Beyond the incentives for de-euroization, Macedonia will remain euroized for a long time.

The evidences suggest that is difficult to reverse euroization. This is hard also when macro stability has been well established. There is some regional pattern of euroization and researchers think that its related with the region economic integration into EU and aspiration for joining to the euro area.

De-euroization is good in providing a safety valve for future risks, as the fact that opportunities are limited regarding the fixed exchange rate peg to the euro. The main characteristic of de-euroization in Macedonia is to reduce balance sheet risks that could make the banking system vulnerable to large movement in exchange rate.

Also, the process of de-euroization will allow safety valve to work when circumstances warrant (Luca and Petrova, 2007). Other benefits of de-euroization are limited in Macedonia. Those are avoiding loss of seigniorage and improving the effectiveness of monetary policy. Under the peg, there is limited amount of monetary policy autonomy, and de-euroization would not help much on that front. Macedonia can certainly serve to measures implemented by other countries such as higher liquidity requirements for foreign currency deposits (Angola and Uruguay) or foreign currency loans (Croatia) higher equity collateral requirements for foreign currency loan, especially non-hedged debtors (Angola Honduras and Vietnam) and lower ratio of the loan amount to improve a damper on foreign currency-denominated loans (Hungary).

The best strategy is to provide incentives and a supportive macro-financial context for gradual reduction of euroization, through prudential policies and by maintaining macro stability and developing domestic debt markets. Macedonia has been implementing prudent macro policies and has achieved macro stability in the last decade, including during the global financial crisis. Maintaining such a policies is a pre-requisite of de-euroization. Given that the exchange rate peg has limited the scope of monetary policy to respond to inflation, fiscal policy could play a larger role, including by improving public debt management and relying more on longer term denar loans. This would be an important step to de-euroize the balance sheet of the public sector and to lengthen the yield curve, fostering the development of domestic debt market. A deep and liquid domestic capital market could provide more investment opportunities in denar as a substitute for FX-denominated assets, thus helping the de-euroization.

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