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**MONETARY-FISCAL MIX POLICIES IN THE REPUBLIC OF  
MACEDONIA: ECONOMIC GROWTH AND STABILITY**

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***Abstract:** The paper gives an overview over issues concerning of financial and monetary policy mix objectives. Historically, financial stability has figured highly among central banks' objectives, with policy measures ranging from interest rate stabilization to serving as a lender of the last resort. With the ascent of macroeconomics, these traditional tasks of central banks have been displaced by macroeconomic objectives, price stability, full employment, growth. The financial crisis has shifted the focus back to financial stability concerns.*

*The paper first surveys the issues of financial-stability concerns in central banking and monetary-fiscal policy mix. Then it discusses two major challenges in the Republic of Macedonia: (i) monetary and fiscal policies through growth and stability issue(ii) monetary and fiscal policy coordination; assessment of the synchronization and consistency of the policy mix to the macroeconomic;coordination between the institutions in charge of monetary and fiscal policies.*

***Keywords:** Financial stability,fiscal policy, monetary policy, systemic risk, central banking.*

## **1. Introduction**

The main purpose of the paper is to explore the coordination of the monetary and fiscal policies in the Republic of Macedonia in other to achieve dynamic economic development (hereinafter: RM). The aim is to investigate the interactions of the policies with a view of determining whether the policies were coordinated and consistent and thus contributing to the achievement of macroeconomic objectives. Also, the institutional and

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operational arrangements that define the level of independence of the central bank, and the public finance system are investigated, as they are considered important preconditions for prudent fiscal policy.

The monetary and fiscal policies are conducted by different institutions, have different objectives and different instruments. While in most cases price stability is considered a primary objective of the central bank, fiscal policy is tasked with providing public goods that cannot be provided by the private sector, redistribution of the income in the society and a short-term macroeconomic stabilization. Monetary policy relies on a set of monetary policy instruments for achieving the price stability. Policy rate has been traditionally considered as the main monetary instrument, although the recent crisis underlined the need for adoption of new non-conventional instruments. Fiscal policy relies on the tax and expenditure policies as main instruments to achieve its objectives. Still, there are close interactions between the policies, so that activities in one area affect the activities in the other through a number of channels. In this vein, uncoordinated and inconsistent policies may result in a failure to achieve macroeconomic objectives and lead to sub-optimal economic outcomes.

The coordination between the monetary and fiscal policies has been subject to a wide theoretical and empirical research. Although there are different views on this issue in the literature, the view advocating for close coordination dominates. The close link between the policies has been the main argument of the proponents of a close coordination. On the other hand, the economists who do not support this view claim that links between the policies are weak and thereby there is no need for coordination. As inflation is considered a purely monetary phenomenon independent of the fiscal variables, it is deemed that fiscal policy does not affect monetary policy. The weak effect from the monetary policy to fiscal variables is explained on the ground of small share of seigniorage revenues in the government financing and the “Ricardian equivalence”, which implies that under rational expectations fiscal policy cannot affect aggregate demand and inflation.

Coordination of the monetary and fiscal policies in the RM has not been widely investigated, although in the recent period, the interest in this field has increased. What was the prevailing regime, monetary-dominant or fiscally-dominant and what were the related implications for the macroeconomic objectives, are aspects that have attracted particular interest. Given the monetary strategy of a stable exchange rate and the need of having a disciplined fiscal policy, cyclicity of the fiscal policy has also been subject to empirical research, including estimates of the effects of the discretionary fiscal policy through fiscal multipliers. Also, there are some studies on the level of the independence of the central bank of the RM, which mostly do not cover the latest legal framework, and a couple of multi-country studies on the quality of the public finance management system that include assessment of the quality of budgetary procedures in the RM. There is no study specifically focused on the RM.

The article investigates the level of coordination of monetary and fiscal policies in the RM. The aim is to explore the relationship between the policies, the forms of cooperation, and to determine which policy adjusted with an objective of preserving macroeconomic stability. The coordination is assessed on the basis of the consistency of the policy mix with the macroeconomic objectives. Given that primary objective of the central bank is the price stability and that the stable exchange rate is an intermediate objective, the

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consistency of the policy mix is primarily assessed against the price and exchange rate stability.

### **2. Monetary and Fiscal Policies: Growth and Stability**

Monetary policy objectives have traditionally included price stability, economic growth, full employment, stabilizing business cycle, preventing financial crises, stabilizing long-term interest rates and the real exchange rate (Khan, 2003, p.3). Some of these objectives are not fully consistent and monetary authorities have placed different weights. Since the 1990s there has been a shift in favor of price stability as a primary objective. Double digit inflation in the 1970s was conducive to bigger separation of monetary and fiscal policies and assigning monetary policy to an independent institution with primary objective of price stability. This move was also influenced by the theoretical work of Kydland and Prescott (1977) and Barro and Gordon (1981) regarding the “inflation bias” of discretionary government. A low and stable inflation is the main goal of most of the central banks, as stable macroeconomic environment is considered a crucial precondition for sustainable long-term growth. High inflation and inflationary expectations cloud the horizon, rise uncertainty, adversely affect the expectations of the economic agents and their investment and spending decisions thereby negatively affecting the overall economic activity.

Major monetary policy transmission channels are the following: bank lending (narrow credit) channel, interest rate channel, broad credit channel, wealth channel and exchange rate channel. The empirical evidence for the effectiveness of the transmission channels is stronger for developed countries compared to developing countries. This is commonly explained by the specifics of the transition economies that are undergoing structural reforms and are characterized by underdeveloped financial market, lower level of financial intermediation and high dollarization (Creel & Levasseur, 2004; Mayes, 2003). Central banks use their policy instruments to influence primarily the intermediate target and consequently their final objective. Monetary instruments are classified as either being direct instruments, where the central bank sets limits on the balance sheets of the banks or the price of loans and deposits, or indirect instruments, where central banks operate by influencing supply or demand conditions in the money market (Alexander, Balino, & Enoch, 1995).

The fiscal policy effects are materialized by using tax policy, expenditure policy or budget balance. Tanzi and Zee (1997) explain the channels through which public finance instruments influence the long-run growth performance of countries. Tax policy affects the labor-leisure choice, i.e., labor market, consumption-saving-behavior, relative profit abilities of different industries. Size and composition of expenditures affect the capital accumulation (physical and human capital) and total factor productivity. Spending on education, research and innovation tends to have positive impact on growth. Sustainable budget balance, from stability point of view, is considered to have positive effect on the growth. While pointing out that empirical evidence on the relation between public finance instruments and growth is not very conclusive, they conclude that fiscal policy can play a fundamental role in shaping the long-term prospects. One of the difficulties is the problem of direction of the causation. For example, even if there is a strong relation, it is difficult to

determine whether the low expenditures affect high growth, or high growth entails low expenditures. According to Sala-i-Martin (2002, p. 11) the government is the single most powerful economic agent, so its actions are quite important. He states that government can affect economy in many ways, including by: setting up of legal system, preserving macroeconomic environment, imposing taxes and purchasing part of the country's output.

There is a high interdependence between these three policies. High debt and interest payments can heavily constrain fiscal policy by reducing its discretionary space and increase the uncertainty about its future course. Lax fiscal policy can undermine price and exchange rate stability, and erode the credibility of the macroeconomic policies. Large debts can be reduced through high economic growth, prudent fiscal policy, defaulting or rescheduling, or inflation. As inflation is one of the channels for debt stabilization, large debts are risk for implementing prudent monetary policy. Dornbusch (1996 p.16) claims that monetary policy can affect the debt in four separate ways. Tighter monetary policy increases real interest rate, entailing higher debt service and pressures for rapid growth of debt. Tightening of the monetary policy stance slows down the economic growth rate, raising the share of debt to GDP, reduces the primary surplus (because of the cyclical component) and reduces seigniorage, thus increasing the need for debt financing.

### **3. Monetary and Fiscal Policies coordination in the Republic of Macedonia: Approach and Effects**

For small open economies, it doesn't matter whether the monetary framework is inflation targeting or an exchange rate peg. In the end, you have to have the same prudent policies. Otherwise, although the transmission channels may be different, the outcome will always be the same. If you have upward pressures on the foreign exchange market, eventually you will end up with higher interest rates – regardless of whether you achieve this through exchange rate depreciation or through interest rate increases to defend the exchange rate. Maybe the large economies have a choice, but small economies do not have much freedom in choosing the right monetary policy.

What is the experience of Macedonia regarding the coordination of monetary and fiscal policies? An exchange rate peg means having a constraint on monetary policy. In the case of Macedonia, it is not a full constraint because the “impossible trinity” is not present, since we do not have capital mobility for various reasons. One reason is that the capital account still has some restrictions; but more importantly, in my opinion, it is the general political instability of the country which is not very favourable to capital inflows. Constraints to capital inflows enable some degree of independence to monetary policy in a fixed exchange rate regime. Anyway, it is fiscal policy that should take on the burden of adjustment when one has an exchange rate peg. This means that fiscal policy must be disciplined. When we analyse the 19 years from 1994 to 2012, we find that in half of these years fiscal policy was countercyclical, while in the other half it was procyclical. When we look at dominance, whether fiscal or monetary, we find that in and around the years Macedonia suffered shocks – 2001, when we had an internal security crisis; and 2008, when the global financial crisis started – we had fiscal dominance. Otherwise, fiscal policy was quite disciplined, especially in the period before 2001. Maybe it helped that Macedonia always had some arrangements with the IMF, and that the exchange rate peg pushed fiscal

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policy to be very disciplined. Before 2001, fiscal policy was subordinated to monetary policy, supporting the stability of the peg. In 2001, this was disturbed as other priorities emerged. After fiscal stabilisation in 2003, however, coordination of monetary and fiscal policy was restored and fiscal policy supported the exchange rate peg and monetary policy. It should be noted that before 2008, fiscal deficits in Macedonia were very small – the country's budgets were always either balanced or had a deficit of no more than 1% of GDP.

Before 2008, when the economy was booming, the government made two decisions – one favourable and one not so. The first decision was to reduce the tax burden, with corporate tax and income tax rates reduced substantially to 10%. Social contributions (the tax wedge) were also reduced. This appeared to be very beneficial after the crisis. The unfavourable development was that the windfall in the budget at that time tempted the government into spending more on higher public sector salaries, more generous pensions, increased social welfare and higher subsidies for farmers. At that time, this did not place a burden on the budget because it was in surplus. However, after 2008–2009 when there was a sharp deceleration in capital flows and foreign trade and GDP also declined, a shortfall in the budget emerged. Fortunately, fiscal policy did not reverse the action on taxes, and this proved to be supportive for businesses and the economy after 2009. There also was room for fiscal stimulus in 2009. Because budget deficits had historically been low, public debt was extremely low (at around 23% of GDP), creating the space for fiscal stimulus. Hence, fiscal policy supported economic growth in Macedonia after the onset of the global financial crisis in 2008. However, fiscal stimulus worsened the public finances, and public debt rose very quickly to the current level of 45% of GDP – public debt has thus doubled in seven years.

Monetary policy had to take the opposite stance: it had to tighten. First, because in 2009 Macedonia had to defend its exchange rate through very high interest rates. Once the situation stabilised and as economic growth picked up and the external balance was restored, monetary policy was loosened. It remained in this loosening cycle until early May 2016. Why was this possible? Because there were structural changes in the economy and the balance-of-payment position improved substantially thanks to policies aimed at attracting foreign direct investment. The policy rate of the central bank was reduced to an historically low level of 3.25%. At that time, many asked why the rate could not be lowered to 0%, as the ECB had done. We could go close to zero if fiscal policy were more balanced, but in a context in which fiscal deficits since 2008 had been between 3% and 4%, monetary policy had to keep the balances in the economy. So 3.25% is Macedonia's "zero lower bound". We have to have this spread vis-à-vis the ECB's policy rate in order to preserve the exchange rate peg.

The lesson from this is that when you have disciplined fiscal policy and there is fiscal space, fiscal policy can support the economy when it is faced with a shock without endangering monetary policy. Monetary policy could tighten if necessary, but not by much. If the fiscal space were exhausted, however, then support from fiscal policy would be very difficult. Now we are wondering what will happen if Macedonia is hit by another shock. Fiscal policy has no room for expansion – our debt level is over 45%, and our limit is obviously much lower than that of the euro area countries.

The effects of the policies over macroeconomic variables were explored by Fetaj (2008). Investigating the effects of the monetary and fiscal policy mix in the RM on real

GDP, he finds that the changes in the primary fiscal deficit and government expenditures do not show any significant conventional Keynesian effects on real GDP due to counteracting effect of monetary policy reactions. In case of fiscal expansion, monetary policy reacts immediately, and it continues its counteracting policy until the effects of fiscal policy disappear. For positive macroeconomic outcomes, he suggests fiscal strategy based on fiscal rules. As for the monetary policy effectiveness, he finds that changes in money supply affect the price level, but do not have significant effect on economic activity. Interlinkages between policies and macroeconomic variables were also investigated by Kurtishi (2013). Estimated expenditure multiplier points to a positive short-term and negative medium-term effect over economic activity explained by a medium-term "crowding out" effect of the expansionary fiscal policy. Namely, he finds that higher aggregate demand stimulated through higher government spending does not lead to higher aggregate supply, as monetary policy tightens resulting in crowding out of the private sector. A shock in primary expenditures (increase) results in rising central bank interest rate. Estimated revenue multiplier points to a neutral short-term and positive medium-term effect on the economic activity. Similar are the conclusions of Damčevski (2013), who investigates the effects of the money aggregates on real growth by applying impulse response function. He finds that economic activity responds very slowly to changes in M1. Gaber (2013) also finds that a fiscal shock in terms of increased primary budget deficit does not significantly affect real GDP due to tightening monetary policy that offsets the effect stemming from the fiscal stimulus.

### ***3.1. Assessment of the Synchronization and Consistency of the Policy Mix to the Macroeconomic Objectives in the Republic of Macedonia***

The aim is to explore the relationship between the policies, the forms of cooperation, and to determine which policy adjusted with an objective of preserving macroeconomic stability. The coordination is assessed based on the consistency of the policy mix with the macroeconomic objectives. Given that primary objective of the central bank is the price stability and that the stable exchange rate is an intermediate objective, the consistency of the policy mix is primarily assessed against the price and exchange rate stability. Assessment of the level of coordination from the point of view of the economic growth i.e., whether the policy mix was adequate and contributing to economic growth consistent with its potential level, goes beyond the scope of the dissertation. Yet, the interactions between the policies are investigated from a cyclical point of view to determine whether the policies played a stabilizing or amplifying role for the cycles.

Interactions between the monetary and fiscal policies are examined and assessed through the analysis of the balance sheet of the central bank whereas net domestic assets of the NBRM is equal on net claims of NBRM on banks and net claims of NBRM on government plus other items net and RM denotes reserve money. For the purposes of this analysis, balance sheet items net claims of bank and net claims of government of the NBRM are used as a proxy for the monetary and fiscal policy stance, respectively. Have the actions of both policies been in the same direction, or in the opposite direction i.e., one policy tightening and the other loosening; to what extent have fiscal and monetary policies contributed to the reserve money creation; and what have been the macroeconomic implications of this mix of policies, are the key investigated aspects. Given that automatic

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stabilizers are triggered automatically through endogenous changes in certain revenues and expenditures with the business cycle, structural fiscal position represents a better proxy for the fiscal policy stance. Therefore, fiscal efforts are usually measured by stripping out cyclical component of the budget revenues and expenditures, i.e., by calculating a cyclically adjusted budget balance. There are a number of approaches for calculating this fiscal indicator, but very common approach is the one that relies on estimate of the output gap and revenue and expenditure elasticity to output gap. In this way an indicator of underlying fiscal position is derived, as it estimates fiscal position when economy operates at potential output. Still, calculation of cyclically adjusted balance is not a straight-forward exercise. For example, there are other automatic effects that go beyond the changes in the output gap and cannot be evaluated taking into account only the output gap. Budget may be automatically affected by changes in housing prices, commodity prices or financial sector profits and to the extent these changes are not fully correlated with the cycle, these effects will not be fully captured while cyclically adjusting.

### ***3.2. Coordination between the Institutions in charge of Monetary and Fiscal policies in the Republic of Macedonia***

The degree of independence of the central bank and practical mechanisms put in place for cooperation can affect the level of coordination between the decision-makers and consequently the macroeconomic outcomes. Thus, the institutional aspect of the coordination seems inevitable part of the analysis of the degree of coordination of the policies. This part elaborates on the institutional settings that outline the framework under which the NBRM operates with a view of assessing the level of its independence from the executive branch in pursuing its objectives. It focuses on the legal framework defining the objectives of the NBRM, the authority to determine and implement monetary and foreign exchange policies, appointment and dismissal of the top personnel, relations with the government and the parliament, and other legal dimensions that determine the strength of the mandate and the independence of the NBRM. Furthermore, it analyzes the practical mechanisms for cooperation on strategic and operational issues relevant for pursuing a synchronized mix of policies.

Yet, this form of cooperation and exchange of information was rather limited to short-term liquidity management, without encompassing a systematic coordination on broader issues relevant for the conduct of the monetary and fiscal policies. The coordination on the strategic questions was more on an ad hoc basis. Undeveloped primary market for government securities can partially explain the relatively weak cooperation. Financing through the primary market of government securities reinforces the need for cooperation, as the two institutions are present at the same market and weak coordination can result in competition and can undermine the achievement of the objectives of the both institutions. At that period external borrowing from international financial institutions was the main source of financing of the budget needs. The weak coordination became apparent especially in 2000. Significant spending and injection of liquidity by the budget remained largely unsterilized by the central bank, creating significant pressures on the foreign exchange market and official reserves.

Two formal mechanisms of coordination within the MOF were established: coordination committee at a strategic level and coordination committee at the operational

level. The committee at the strategic level was composed of the top officials of the MOF and the Central bank with a task of increasing the cooperation as regards strategic issues relevant for the conduct of the monetary and fiscal policies. In line with the Protocol on the establishment of the committee, signed by the minister of finance and the governor, a wide range of questions were discussed at the monthly meetings, including the projections of the monetary aggregates, inflation, balance of payments and official reserves, as well as projections and execution of the budget aggregates and budget financing structure. Still, this committee functioned effectively for a short period of time.

#### **4. Conclusion**

Monetary policy objectives have traditionally included price stability, economic growth, full employment, stabilizing business cycle, preventing financial crises, stabilizing long-term interest rates and the real exchange rate. Some of these objectives are not fully consistent and monetary authorities have placed different weights. Major monetary policy transmission channels are the following: bank lending (narrow credit) channel, interest rate channel, broad credit channel, wealth channel and exchange rate channel. The empirical evidence for the effectiveness of the transmission channels is stronger for developed countries compared to developing countries. The fiscal policy effects are materialized by using tax policy, expenditure policy or budget balance. explain the channels through which public finance instruments influence the long-run growth performance of countries. There is a high interdependence between these three policies. High debt and interest payments can heavily constrain fiscal policy by reducing its discretionary space and increase the uncertainty about its future course. Lax fiscal policy can undermine price and exchange rate stability, and erode the credibility of the macroeconomic policies. Large debts can be reduced through high economic growth, prudent fiscal policy, defaulting or rescheduling, or inflation.

The lesson from this is that when you have disciplined fiscal policy and there is fiscal space, fiscal policy can support the economy when it is faced with a shock without endangering monetary policy. Monetary policy could tighten if necessary, but not by much. If the fiscal space were exhausted, however, then support from fiscal policy would be very difficult. Interactions between the monetary and fiscal policies are examined and assessed through the analysis of the balance sheet of the central bank whereas net domestic assets of the NBRM is equal on net claims of NBRM on banks and net claims of NBRM on government plus other items net and RM denotes reserve money. Two formal mechanisms of coordination within the MOF were established: coordination committee at a strategic level and coordination committee at the operational level. The committee at the strategic level was composed of the top officials of the MOF and the Central bank with a task of increasing the cooperation as regards strategic issues relevant for the conduct of the monetary and fiscal policies.

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## MONETARNI I FISKALNI MIKS POLITIKA U REPUBLICI MAKEDONIJI: EKONOMSKI RAST I STABILNOST

*Apstrakt: U radu se daje pregled pitanja vezanih za ciljeve interakcije finansijske i monetarne politike. Istorijski gledano, finansijska stabilnost je visoko uticala na ciljeve centralnih banaka, uz mere politike koje se kreću od stabilizacije kamatnih stopa do služenja kao posljednjeg utočišta. Uz podizanje makroekonomije, ovi tradicionalni zadaci centralnih banaka su zamenjeni makroekonomskim ciljevima, stabilnošću cena, punim zaposlenjem, rastom. Finansijska kriza je usmerila pažnju na pitanja finansijske stabilnosti.*

*U radu se prvo istražuje pitanje finansijske stabilnosti u centralnom bankarstvu i monetarnoj i fiskalnoj politici. Zatim se u Republici Makedoniji razmatraju dva glavna izazova: (i) monetarna i fiskalna politika kroz pitanje rasta i stabilnosti (ii) koordinacija monetarne i fiskalne politike; procena sinhronizacije i doslednosti miksa politike na makroekonomsku koordinaciju između institucija zaduženih za monetarnu i fiskalnu politiku.*

*Ključne reči: finansijska stabilnost, fiskalna politika, monetarna politika, sistemski rizik, centralno bankarstvo.*