

# **CAPITAL MARKET ANALYSIS**

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**Skopje**  
**MARCH, 2007**

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## Acknowledgments

This report has been prepared by Karolina Karovska, Economist in CEA. Critical review and useful comments and inputs were provided by Marjan Nikolov, Dimitar Bogov and Borko Handziski.

## Introduction

The creation of a viable and sound financial system in Republic of Macedonia has been a fundamental aspect of the transition to a market economy. Building such a system has proven to be very difficult and challenging. Various studies and assessment reports have confirmed the view that in the beginning of the transition process the financial sector was weak, underdeveloped and shallow. The economy in Macedonia used to operate on a cash basis with a small and highly centralized banking sector and no functioning capital markets.

During the last few years, public authorities in Republic of Macedonia have introduced and implemented numerous initiatives affecting all aspects of banking and financial market development. The legal, institutional, regulatory and supervisory framework of financial institutions has been consistently improved and strengthened. Through the implementation of economic adjustment, surveillance and stability programs, these authorized institutions have provided the broader context for improvement economic conditions which is a prerequisite for effective reform in capital market in Republic of Macedonia. In a more specific context, through monetary policy management programs, legislative in these areas, application of positive experience, practice in developed countries, have greatly helped the promotion and the implementation of specific policies leading to the reform of the financial system.

The financial institutions in the Republic of Macedonia are banks (20), insurance companies (10), leasing companies (8) and the brokerage houses (11)-(as of November 2006). Macedonian Stock Exchange, on the other side, has been fundamental aspect of the transition to a market economy. All these entities function in separately regulated and supervised segments. The Macedonian financial system has the same characteristics as the continental one (Europe) where most dominant sector is the banking sector (see table 1), where around 90% of the total assets of the financial institutions are located together with a 50% share of GDP.

The remaining segments in the financial markets of the Republic of Macedonia are in a process of development. In the last couple of years the capital market and the insurance segment have seen rapid development, though much remains to be done.

Table 1. Financial institutions in the Republic of Macedonia (as of end of 2005)

	Banks	Insurance companies	Brokerage houses	Leasing companies

Assets ( in mill denars)	140,345.0	13,618.0	447.0	2,275.0
Share in the total assets of the financial institutions	89.6	8.7	0.3	1.5
Share in GDP (%)	50.6	4.9	0.2	0.8
Concentration in % ( largest two/three ) from the total asses of the industry	66.0	81.4	58.8	61.0
Capital (in mill denars)	21,670.0	2,894.0	348.0	121.0
Foreign capital in %	52.5	63.0	100.0	100.0

Source: The future of local government finance, CEA 2006.

One of the manners of assessment the relative size of financial market is by comparing figures that are collected at the international level. For example, the volume of listed securities in exchanges or transactions in the exchanges to the overall GDP of the country is a rough indicator of the relative role of the financial markets in the economy (in Macedonia this ratio is 11% at the end of 2005).

### **Banking sector**

The financial sector in Macedonia is still dominated by the banks as the core of financial activity and commercially based funding. The absorptive capacity of domestic capital market is:

- Outstanding stocks of financial assets:
  - Government debt outstanding: EUR 669 m. (August 2006)
  - Total bank deposits: EUR 1.79 b. (June 2006)

The banking system in Macedonia consists of 20 private banks, 15 savings houses and the state-owned Macedonian Bank for Development Promotion. According to the Banking Law, banks observe the principles of profit maximization, liquidity, safety and profitability. A foreign bank can establish a branch either as a legal entity or as a representative office. Savings houses are limited in their banking activities to savings-related services for individuals. They may neither undertake other banking operations nor directly offer services to companies. The three largest banks – Komercijalna Banka AD Skopje, Stopanska Banka AD Skopje and Tutunska Banka AD Skopje dominate the banking system.

In general, Macedonia is experiencing a trend of permanent increase in banking activities. Although growth of bank credit to the enterprise sector has been recorded, banks rarely manage to meet enterprise needs in terms of maturity and collateral requirements. Shortage of funds (access to cheap financing), lack of credit skills and unavailability of

good lending opportunities are among the many possible factors responsible for low level of bank credit to the private sector.

The Macedonian banking system in 2005 experienced a positive trend regarding the profitability (although still lagging behind when compared with some other countries from SEE) reaching on average 1.3% and 8.1% for ROAA (return on average assets) and ROAE (return on average equity) respectively. This was mainly due to the considerable improvement in the profitability of the group of small banks. The main driving force behind this development was the increase in net income together with a better cost efficiency in their operating activities, which is certainly an important aspect for maintaining the stability and security of the entire banking system.

During the transition period and especially during the last six years, authorized institutions have taken measures to improve banking system asset quality, such as the write-off of non-performing loans, the enforcement of the regulatory framework according to the BIS standards and the application of risk management systems.

Also the level of financial intermediation increased significantly. The deposit base was increased while the adequate legal protection of the lenders, the introduction of modern credit risk management techniques and the good performance of the enterprise sector, led to high credit expansion. One of the most important factors for further development is competition. As competition has increased slightly, very few new products and services have been introduced on the market.

The privatization of the banking system was characterized by the entry of foreign banks in the market. Foreign banks usually enter the market either by acquiring local banks (state-owned or private) or by establishing subsidiaries and branches. The entry of foreign banks was very important, since they introduced modern risk management techniques and financial management know-how. Foreign ownership is a necessary condition for the efficient transition of the banking sector.

With the acquisition of Ohridska Banka by Société Générale we believe that a certain era of mediocre banking practices applied by the Macedonian banks (as well as foreign banks with 'Macedonian corporate culture') is coming to an end.

### **Insurance companies**

The insurance market in the Republic of Macedonia consists of 10 insurance companies. QBE Macedonia is the largest investor in the insurance market in the Republic of Macedonia. The Company provides extensive coverage in the following fields:

- Industrial Property Insurance
- Civil property Insurance
- Transport Insurance
- Motor Vehicle Insurance
- Life / Personal Accident Insurance

## Leasing companies

In 2002 a Leasing Law has been adopted and amended the following year. The Law on Leasing has been drafted in an emergency to address the need for a legal frame when a leasing company wanted to start its operations.

Leasing is provided through 2 leasing companies (LBIS and EUROLEASING) and other 3 traders are licensed to lease the equipment they trade (2003). 99% of the leasing market is covered by LBIS, which is leasing mostly cars. EUROLEASING was created in 2003 and is also successful in leasing cars. In June 2004 the company called ARKADA started operations. They have foreign (Ukrainian) founding capital and aim at leasing real-estate for private individuals. In 2006 Hipo Alpe Adria Bank opened a branch in Macedonia. The banking law provides basis for banks to engage in leasing. Three major banks announced that they would engage in leasing and finance the acquisition of apartments by private individuals. No attempts to lease equipment exclude the leasing of katterpillar vehicles were made so far.

The Ministry of Finance is open for cooperation and, if needed, to change the law, but currently is more focused on the promotion of the leasing activity and is not very willing to introduce the cross-border leasing, nor operational leasing, which is considered risky.

## Pension system

Reforming the pension system is a complex process that has been prepared step by step in order to avoid sudden changes to individual persons. The pension system structure is based on three pillars.

### **1. Mandatory pension and disability insurance based on generation solidarity (first pillar).**

The first pillar implies the mandatory government pension fund – (The Pension and Disability Insurance Fund of Macedonia – PDIF), which will continue to function in the same manner as now on the principle of generation solidarity. That means that contributions of insured workers will be used for pension benefit payments for current and future pensioners.

### **2. Mandatory fully funded pension insurance (second pillar).**

The second pillar includes the two private pension funds (NLB Nov penziski fond and KB Prvo penzisko drustvo) each insured worker will choose one. Assets will be invested according to the strict legal regulations that will ensure high protection of insured workers' interests and their funds. In the private pension funds each member will have his/her own personal (individual) account to which contributions will be paid. Funds paid from your salaries and the profit obtained from their investments is only yours, and will represent in total the amount of

your pension after retirement. Insured workers will be regularly informed about the balance of funds on their accounts that are planned for their retirement days.

### **3. Voluntary fully funded pension insurance (third pillar).**

This pillar will be an innovation that will enable pension insurance for citizens who will not be included in the pension system. Also, this pillar will offer an opportunity for higher pensions for insured workers that voluntarily decide to save more from their salaries.

The reform was being implemented to ensure the financial and social security of today's pensioners and of generations of future ones. In Macedonia, as in other European countries, there is a trend towards the aging of the population. This will cause increased number of older people in the total population, i.e. the changing of the ratio of pensioners to employees. In the future, the number of pensioners is expected to equal the number of insured employees, ultimately making it difficult to pay out pensions, as in the systems financed on the basis of generation solidarity as it is in our system, the current insured workers pay for the pensions of current pensioners. This would cause the system to become insolvent in the long run.

The main objective of the reformed pension system is to safeguard the interests of each member, since retirees deserve to spend their days feeling secure.

## **Macedonian Stock Exchange**

The Macedonian Stock Exchange was founded on September 13, 1995 and commenced trading on March 28, 1996, as a central marketplace for trading in securities and the first organized stock exchange in the history of the Republic of Macedonia.

The MSE was founded as a non-for-profit joint stock company with a founding capital of 500,000 EUR. According to the legislation that was in force in 1996 only eligible found of the MSE were banks and other financial institutions (saving houses and insurance companies) MSE had initially 19 members: 13 banks, 3 saving houses and 3 insurance companies. Since 1997, according to the new Law on Issuance and Trading in Securities MSE members could only have been legal entities which sole activity is trading in security (9 brokerage houses). Due to these changes the number of MSE members decreased to 7.

The new Securities Law from 2000 introduced again the possibility of banks being MSE members (starting from 2002). All MSE members must be licensed for trading in security by the Macedonian Security and Exchange Commission. Only brokers, authorized by the members may trade in securities at MSE.

MSE has currently 17 members – 11 brokerage houses and 6 banks. According to the Securities Law from 2000 the initial share capital of each MSE must be at least 75,000 Euro (license for acting as an agent) and the liquid capital must be 15,000 Euro. In order

to get full license as broker-dealer, Brokerage Company must have at 500,000 Euros share capital.

Starting from June 20, 2001 (with the new amendments of the Securities Law), MSE start to operate on a for-profit basis, with a founding capital of 500,000 Euros. MSE shareholders may be any legal and private domestic and foreign entity. Shareholdings entity is limited up to 10% of the MSE outstanding shares.

Currently MSE has 20 share holders (8 brokerage houses, 8 banks, 1 insurance company and 3 private investors).

Analyzing transactions realized on MSE in 2006, trading on the Macedonian Securities Stock Exchange via traditional trading amounted to Denars 10.794 mil, which in relation to 2005, grew by 61.08%. Trading realized via block transaction amounted to Denars 13.970 mil, government securities were traded in amount of Denars 6.237 mil. Total trading on the Macedonian Securities Stock Exchange amounted to Denars 31.071 mil., which in relation with the previous year increased by 248.92 %.

In order to identify the underlying trend in the development of the stock market, we analyze the turnover structure. Block transaction participate with 45.04%, official market with 29.58%, government auction with 20.11%, unofficial market took 5.22% and other securities 0.05% from all turnover realized in 2006. The new issues of securities of some banks listed on the Stock Exchange reflect a positive perception of the investors for the economic environment and the business potential of the banking sector of the Republic of Macedonia.

The ownership structure of capital of the shareholding companies showed that foreign investors were most present in the total capital of the companies, being among the 10 most liquid companies on the Macedonian Stock Exchange.

On June 30, 2006, the Stock Exchange started calculating and publishing the Bond Index of the Macedonian Stock Exchange AD Skopje (OMB). The OMB index is composed of bonds for old foreign exchange and denationalization bonds of the 1<sup>st</sup>, 2<sup>nd</sup>, 3<sup>th</sup>, 4<sup>th</sup> and 5<sup>th</sup> issue, and the initial value of the OMB is 100. OMB is a price index weighted by the turnover, with a restriction according to which the share of none of the bonds within the index structure is not allowed to exceed 30%. In order to provide index continuity, every time, before the index is calculated with a new composition, a corrective factor is determined, which is to provide time comparability of the index, notwithstanding the possible changes in the index composition. The OMB index for 2006 is 99.06%.

Komercijalna banka, Stopanska banka AD Bitola and Ohridska banka – these are the most profitable banks in the country according to non revised financial reports the listed companies submitted to the Macedonian Securities Stock Exchange. Banking remains to be the most lucrative business in the country. This year even three, out of the first five companies, according to their successful financial performance, are banks.

## Government securities

Apart from the banking sector, the capital market shows rapid deepening as well as an increment of awareness in the broader population about the advantages of investing in securities. However, the corporate governance issues have to be reflected in the practice as well in order to increase confidence in the capital market issuers and institutions.

The public debt of the Republic of Macedonia comprises the government debt and all financial liabilities in the form of loan and securities created via borrowing by the municipalities and the city of Skopje, as well as borrowing by the public enterprises and the companies being fully or predominantly owned by the state.

Public debt portfolio of the Republic of Macedonia comprises inherited from former Yugoslavia, borrowing with international financial institutions and on international financial markets, as well as borrowing on domestic markets. Thus, in the second quarter of 2006 the total public debt, according to the Law on Public Debt is EUR 1.770 million i.e. 37 % of GDP. General government debt is EUR 1.678 million i.e. 35 % of GDP.

Table 2. Total public debt

	<b>in million EUR</b>			
	Month			
	31.12.2005	30.04.2005	31.05.2006	30.06.2006
External public debt	1,441.16	1,215.00	1,207.36	1,219.60
General government debt	1,245.35	1,030.00	1,025.89	1,037.70
Central bank debt	52.66	50.00	48.39	47.82
Public enterprises debt	143.15	135.00	133.08	134.08
Domestic public debt	750.39	800.90	784.32	753.29
General government debt	603.66	656.59	660.46	642.71
Central bank debt	0.00	49.05	49.03	43.64
Central bank debt	146.74	144.31	123.86	110.59
Public enterprises debt	N/A	1.16	1.10	1.52
Total public debt according the GFS methodology	2,191.55	2,015.90	1,991.69	1,972.89
Total public debt as % of average GDP	48.55	42.19	41.68	41.29
Total public debt according Public Debt Law	1,992.16	1,772.53	1,770.40	1,770.84
Total public debt as % of average GDP	44.10	37.90	37.05	37.06

Source: Ministry of finance and NBRM Adopted by the author

In December 2005 the Republic of Macedonia appeared on the international market for the first time with an issue of the Eurobond, the offers for which were EUR 593 million i.e. four times its issued amount (EUR 150 million).

At the same time, rating agencies Standard and Poor's and Fitch assigned the following ratings to the newly issued Eurobond: BB+ (with stable outlook) and BB (with positive outlook), respectively. The issued Eurobond in the amount of EUR 150 million is with 10- year maturity period, as well as 4,625% coupon interest rate. So as to improve the structure of the debt portfolio full buyback of the debt towards London Club of Creditors was carried out in January 2006, which is the first major active measure of the Ministry of finance to actively manage the public debt.

The policy of continuous issue of government securities continued in the first half of 2006. The focus was placed on the following:

- Increasing the issue of government securities (in the first six month of 2006 was Denars 6,3 billion).
- Increasing the maturity period of government securities (according to the 2006 Calendar of issues of government securities, until the end of the year, issue of the first 3 – year government boned is planned).
- Greater attractiveness of government securities and expansion of the base of foreign investors.

These actions take there place on the Primary government securities market. In parallel of developing of the primary market, secondary trading of government securities also developed. Most significant institutions where secondary trading was made were Macedonian Stock Exchange and the OTC market. Trading on the OTC market does not bear transaction costs and the settlement is made in real time. Until June 2006, 16 transactions in treasury bills were carried out on the OTC market.

## **Conclusion**

At this moment, the failure of the Macedonian financial system to respond to the demand for finance by the local private sector appears to be a significant problem for economic growth. With the capital market being underdeveloped, the burden of intermediation of savings for financing private enterprise sector development is fully on the “shoulders of the banking system”, which still largely is in the need of significant reforms. Furthermore, the resulting degree of financial intermediation is much lower when compared with that in Western economies.

It is a very important step forward concerning the liberalization of this market segment (by removing all administrative barriers and simplifying the entry procedures for prominent financial institutions on Macedonian market), the improvement in the legal and regulatory environment. Also one of the most important factors for further

development is competition and attendance of strong brand in banking sector. The EU accession and the possibility for adopting the euro in the future, the implementation of the new Basel II treaty, the strengthening of the regulatory framework and the financial performance are some of the challenges for the Macedonian financial sector.

The growing economic strength in the area, will allow the financial institutions to improve their performance and expand their activities. However, so far, the convergence towards the EU financial sector is low, but is expected to increase in the near future.

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