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The role of foreign banks in the development of the Macedonian Banking System

Lindita Muaremi, Rigersa Konomi

Abstract— This paper aims at reviewing the work done towards developing quantitative measures of financial stability in Macedonia when Banks have a very strong impact on the other participants in the economy. That is why there are very strict rules that determine when a bank can get a business license and when to allow some form of concentration of banks. All these changes have a direct impact on changes in the market shares of each bank. One the one hand, banks aim to achieve the greatest possible profit, and on the other hand are the bank's clients that besides the more favorable conditions of purchase of financial products, they also want the security of their funds. Banks can compete on the market with the price, type of service provided, quality or a combination of factors but only when there is market confidence in banks and when there is investment security

Index Terms— Financial stability, Currency, Deposit Insurance.

1 The factors for the entry of foreign banks into the Macedonian market

The entry of foreign banks into the Macedonian banking market causes great public interest as well as an interest of the whole economic sector. The entry of foreign banks increases the number of participants in the domestic market, which intensifies competition. However, the level of increase of the competitiveness of the Macedonian market depends on the extent of foreign investment and the objectives of foreign participants. By analyzing the state of the Macedonian market, we can conclude that the foreign banks mostly use the method of purchasing shares in existing banks while entering the market, while they rarely founded entirely new banks.

Greek-owned banks hold a significant share of FYR Macedonia's banking sector assets but appear sound. About 22 percent of assets and 24 percent of deposits in the banking sector are Greek-owned, mainly through the Stopanska Bank (a subsidiary of National Bank of Greece holding one fifth of assets/deposits), and marginally through a small subsidiary of the Alpha Bank. Both subsidiaries are adequately capitalized, liquid, mostly deposit-funded, operate on a stand-alone basis, and do not hold Greek sovereign bonds. Exposures to parent banks are limited at less than 3 percent of assets.

The reason that banks see interest in expanding operations in other countries is the competitive pressure that is created by their domestic market. If the profit on the domestic market is low due to high competition, macroeconomic disturbances or strict regulations, banks often turn to other foreign markets where they see their opportunity to increase profits and profitability.

In order to better explain the Macedonian financial market, which is the subject of this article, the focus here is on the review of the examples of foreign direct investment in less developed countries. Manpower is one of the most important factors of production. Banks that enter in less developed countries usually have better know-how and better technology than domestic banks and by entering into a market with a lower cost of the workforce they see their comparative advantages in order to achieve the greatest possible profits.

Bigger profits can be achieved internally, by using better management techniques adopted and implemented in parent banks, by the introduction of better information technology, by using already acquired know-how through the placement of new products and services with lower operating costs but also in various other ways, such as imitation, brokerage of consultants etc. An increase in efficiency is achieved by using the advantages that are achieved through the use of the economy of scale, which explains that the cost of production per unit of product decreases with the increase in the number of units produced.

On the other hand, there may be other factors that make foreign markets especially attractive. One of these factors is the availability of new clients i.e. the increase of the overall customer base that would be offered their own, already developed products. This is particularly important in countries with rapid GDP growth, which is expected to grow in the future, a characteristic of transition countries, including Macedonia.

The next factor that greatly affects the decision of foreign banks to enter a market is the low competition in foreign markets, especially in countries where the opening of the markets to foreign capital is in its initial stages. While deciding to enter a foreign market, banks take into account the more lenient regulations governing the banking area, as well as the departure of customers from their home country to foreign markets (the motive of monitoring clients). Another reason for the entry into foreign markets is also the financing of international trade as well as the diversification of risk.

The advantage that banks have in entering foreign markets is the use of economy of scale and it also includes the use of information on relevant economic variables that are not equally accessible to all financial markets. Given that foreign banks are usually large banks, which play a leading role in the market, their business may be of a greater scale than that of domestic banks.

In addition to these positive effects, the entry of foreign banks may have some negative effects. Domestic banks cannot always cope with foreign competition and are forced to leave the market, either by merging with another bank or declaring bankruptcy.

Another risk of the entry of foreign banks is the possibility that the changes in the economic conditions in the home country of foreign banks negatively affect bank activity in the local market (when the local economy is successful, whereas the bank's operations are affected by the negative trends and problems in the home country).

The risks of a particular country arising from this hazard are lower as long as the structure of the countries that entered on a specific market is broader. However, if the majority of foreign banks come from one country or a group of countries that have a synchronized business cycle, then the country that is the recipient of foreign direct investment can greatly feel the impact of the recession in the country or countries of origin of the respective foreign direct investment. An example of this trend are the economic situations of some Eurozone countries, such as Greece and Italy, which are in a large scale affected by the financial crisis in recent years.

Foreign banks may also affect the reduced lending to small businesses. Larger banks think that is more profitable to concentrate on major clients and customers with standardized needs, and this, in combination with the abovementioned threat of the disappearance of the smaller domestic banks from the market that cannot cope with the new competition, greatly reduces the opportunities for small businesses to obtain the necessary financial funds for financing and the ability to continue operating.

On the other hand, with a slightly increased competition and the fact that foreign banks usually introduce several new products and services, it has been proven that foreign banks have cheaper funding sources, possess approximately equal knowledge of the local market and employ a more qualified staff than domestic banks, which negatively affects the survival of domestic and smaller banks.

On the one hand, the presence of the same foreign banks in the banking systems of the region can be explained by the desire of the bank to be strongly present in multiple markets and then by using the effect of synergy to reduce the costs of managing banks in some countries, on the other hand to support customers in their home countries that decide in the real sector of the economy to invest in new markets. [1]

Based on the examples of the cases of entry of foreign banks into the Macedonian market, motives can be summed up in the attractiveness and interest in investing in a relatively underdeveloped banking systems, in which foreign banks could earn revenues at higher rates than in their domestic economies, but have also contributed not only to the development of the banking system but also to the entire economy which resulted in benefits for the bank that entered the Macedonian market and the Macedonian economy.

Foreign banks also entered new markets so that by using riskier but more profitable investing they are able to strengthen the slightly lower earnings that they made in the Western European markets.

Taking into account the cost-benefit analysis and considering the motives which foreign banks had when entering new markets, as a consequence we may indicate significant progress in the development of banking systems which in many economies, due to the presence of foreign capital, were able to develop at a faster rate than other economic activities.

The entry of foreign capital is particularly important for strengthening market competition and greater efficiency.

Due to the specificity of the banking sector in relation to the factors that determine the success of banks, the operations of all banks are strongly influenced by exogenous factors of development. The liabilities of the bank (taken deposits) are under the influence of the degree of sustainable economic stability and future expectations related to the economy and the political environment of the country and the region. Foreign assets are also influenced by macroeconomic developments of the country and the region, as well as the influence of developments in the monetary and fiscal policy.

2. The gaining of confidence in the Macedonian currency and the savings system

The Macedonian national currency is the Macedonian denar (MKD), which is fully convertible on the domestic market, however, it is not convertible on the international markets.

While gaining trust in the Macedonian currency and the savings system the most important thing is to ensure confidence in the central bank as the main pillar of the system which economic entities and the population observe during the gaining of the impression of the stability of a given currency.

The elements that influence on the creation of confidence in the local currency must be continuously monitored by the central bank. The activities of the banks must be well designed, transparent and appropriately communicated to the general public. These activities among others include: obtaining and publishing of favorable financial results of the central bank, the determination of the amount of required reserves that must be a combination of a sufficient amount that will create security in customers during the investment and the amount that will not be a limiting factor in the performance of the activities of the banks. The acquisition of trust is affected by the state of the foreign exchange reserves, the inflation rate and other important information that must be continuously available to the general public.

Public trust in the central bank, and thus in the Macedonian currency will strengthen if the central bank achieves all the planned activities and objectives and does not betray the expectations of the public, since trust is difficult to obtain, and very easy to lose.

Since the central bank appears as the issuing bank (responsible for the production, distribution and for the quality of the currency) it is extremely important that the general public believes in the value and reliability of the currency. The possibility of replacing the currency in unlimited quantities in both directions strengthens the confidence of the general public.

[1] Šubić R., Proklin M., Zima J.,: The changes of quantitative indicators of concentration in the countries of the region in the period of the transformation of the banking systems, Economic News XXIII Osijek 2010. Page 230.

Through many years of activity of the monetary policy, Macedonia has managed to build a significant degree of confidence of the general public in the local currency through a stable monetary environment with a low inflation rate and a stable currency.

The Macedonian banking sector is stable and the population and the corporate sector have a significant degree of confidence in the security of savings deposits. The Denar is a stable currency that achieves the highest yields for the population, which encourages savings in the local currency as opposed to the trend in other European countries that face a loss of confidence in their own currency and banking sector caused by the financial crisis in recent years.

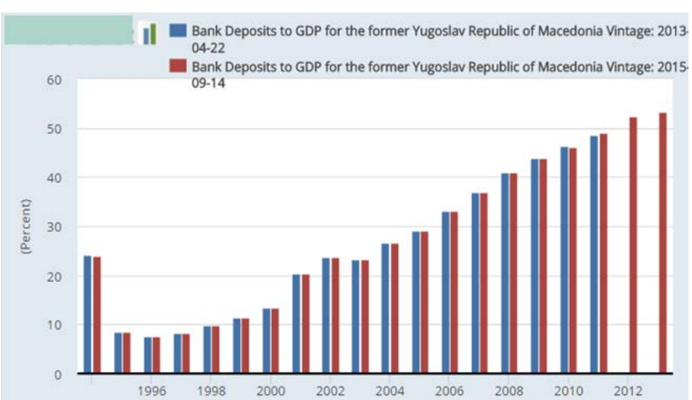
According to various experts who drafted the analysis of trends in the Macedonian market, the stability of Macedonia's currency in comparison to other European countries, which are faced with serious problems, was influenced by the fact that the Macedonian financial system had a high degree of fiscal and monetary discipline and management, which achieved and managed to keep the trust of the population.

With this combination, despite the crisis, the income of the population did not decrease significantly. In 2009 and 2010 the spending by the citizens was reduced while the savings increased. At the same time the budget deficit was very low, the lowest in Europe, which showed that the government was focused on fiscal discipline and austerity.

There are several options on how to design the deposit insurance system of a country. There is still a debate about which is the most optimal way to design a system of deposit insurance, i.e. which is the best model of the system of deposit insurance (depending on the conditions in a country).

The deposit insurance has a significant impact on the creation of confidence in the savings system. The banks also have benefits deriving from the deposit insurance because it facilitates the collection of deposits.

The best indicator of the confidence in the banks is the amount of savings in the banks. Banks grant loans from the funds that are collected, or by depositing cash surpluses of economic sectors in the form of savings deposits in the bank accounts. This



fact may undermine the confidence in the banking system if savers want to simultaneously raise their savings.

Source: Macedonia Bank

There are many reasons why was the deposit insurance system established. One of the reasons is the effect of the spillover of the crisis from one bank to another, from one country to another, leading to the decline of public confidence in the stability of the financial system and consequently to the "storming of the banks". In this case the deposit insurance system becomes an instrument in the prevention of the "storming of the banks". Depositors will not withdraw their savings so quickly due to rumors of problems at the bank or the banking system when they realize that the government, or the competent institution, has ensured their savings.

Regardless of the reasons for establishing the system it is important to note that such a system does not function at a time of crisis, but when the banking system is stable and strong enough to build such a system. So, at the time of the establishment there must be public confidence in the system.

There are several arguments in favor of the insurance system. One of the arguments is the protection of consumers due to the fact that the most savers do not possess adequate knowledge or information by which to assess the riskiness of banks. In general, banks are complex and not very transparent organizations so people who are most often the clients and customers of the products of the banking sector simply cannot fully understand or appreciate the risks. Thus, deposit insurance increases the sense of reduced risk and safety in the savings system. The deposit insurance system aims to increase the savings in banks, in particular the savings from the population sector. Through an increase in savings, which are located in the banks, the deposit insurance system should also have an impact on stimulating economic growth. Through all of these objectives, the system allows the establishment of a general financial stability of the country. It is important that the deposit insurance system is effective, otherwise it loses the meaning of existence and represents only a cost. For the system to be effective, it must have clearly defined objectives and a manner how to achieve them.

There are two basic models of deposit insurance - ex ante and ex post systems.[2]

The ex-ante model of deposit insurance exists when the law prescribes the establishment of a financial fund for the payment of insured deposits that may be established by initial capital when the fund is established and the compensation of the members of the system, from regular and additional premiums paid by the members and from additional sources such as borrowing from the market or the budget.

The ex post model of deposit insurance does not create a fund in advance, it rather collects revenues at a time when it is necessary to pay the insured deposits. The first model of insurance is more efficient but more expensive since the revenues are collected continuously while in the second model, revenues are collected as needed.

The deposit insurance system in Macedonia was initiated in January 1997, when according to the Law on banks and savings banks the Fund for the Insurance of Savings Deposits was founded. The Fund for the Insurance of the Savings Deposits

[2] Đ. Ognjenović: Osnovna načela financijskog planiranja ex-ante sustavima osiguranje depozita. Financijska teorija i praksa 30(4) st.369-382 (2006.)

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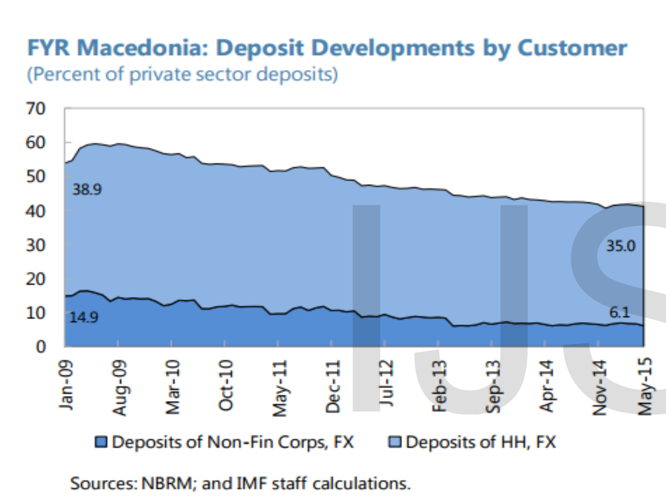
in its legal form was a joint stock company until February 2001 when the fund turned into a state institution and renamed in the "Deposit Insurance Fund". Members of the fund are domestic banks, branches of foreign banks and savings banks established in the Republic of Macedonia. During its function it met with many difficulties that were directly a result of numerous problems within the Macedonian banking system, which it overcame thanks to state aid that stabilized the system in the years of crisis.

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.



The actual savings deposit insurance system is based on the Law on Deposit Insurance.[3]
The Deposit Insurance Fund through the Deposit Insurance Act of banks and housing savings banks provides protection for citizens' savings in the event of bankruptcy of banks and housing savings banks. At present, the Fund provides insurance only for deposits owned by individuals while the insurance of deposits owned by legal entities will begin on the date when the Republic of Macedonia joins the European Union. The Deposit Insurance Fund is a member of the European Forum of Deposit Insurers (EFDI). The last amendment of the Deposit Insurance Act from December 2010, says that the currency funds of citizens deposited in denars and foreign currency shall be insured up to a limit of 30,000 euros.
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, and 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.

3 Conclusion

This paper develops a analyse of factors that measure the financial stability in Macedonia. We must use all the internal resources taking into account the structure of banks of Macedonia before the 90s and after 90s. The country should define, calculate and measure all factors that influenced our economy in order to have the opportunity to avoid in the future the repetition of global recessions.
It is necessary to strengthen the rules on banking supervision and transparency in higher level, more frequent and in all sectors.
Coordination of implementation of monetary and fiscal policies from the Central Bank and the Macedonia Government, and their harmonization ensure sustainable development.
Determination of the comparative advantages of the Macedonia economy explain branches and priority sectors of the economy.

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