



## ПРАШАЊА И ДИЛЕМИ ВО ВРСКА СО КАПИТАЛНАТА ЛИБЕРАЛИЗАЦИЈА-ПОСЕБЕН ОСВРТ НА РЕПУБЛИКА МАКЕДОНИЈА

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### Апстракт

Во последниве децении, капиталната либерализација е предмет на интензивни академски расправи, дебати и истражувања во бројни студии. Дискусиите се сосредочени на прашањата во врска со предностите и недостатоците на капиталната либерализација, но и на предусловите што треба да бидат исполнети пред да се пристапи кон полна либерализација на капиталните текови.

Заклучоците од истражувањата на ефектите од капиталната либерализација се различни и често спротивставени. До појавата на азиската криза, во литературата доминираше гледиштето, официјално поддржувано и од страна на ММФ, дека користа од капиталната либерализација е поголема од трошоците, кои таа ги предизвикува. Денес, врз основа на анализа на искуствата од бројните валутни и финансиски кризи, особено по големата финансиска и економска криза од 2007 до 2009 година, во економската литература се чини постои определено конвергирање на ставовите, во смисла на повнимателно третирање на оваа проблематика и укажување дека капиталната либерализација, особено во земјите во развој, треба да се одвива градуално, да се контролира и да биде проследена со добра регулација. Главната предност на контролите на капиталните движења е дека тие го решаваат проблемот на т.н. „трилема“ или невозможно тројство во монетарната политика, според кое земјата во исто време не може да дозволи слободно движење на капиталот, фиксен девизен курс и независна монетарна политика. Според тоа, капиталните контроли овозможуваат водење на автономна монетарна политика, т.е. можност да се создаде разлика помеѓу домашните и странските каматни

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стапки. Заклучокот се покажува како релевантен и за македонската економија.

Основна цел на овој труд е да дискутира некои дилеми врзани за либерализацијата на капиталните текови во Р.Македонија - динамиката, неопходните чекори и реформи, предностите и опасностите, што со себе ги носи процесот. Во трудот најпрвин укажуваме на искуствата на некои земји во развој во имплементирањето на процесот на капитална либерализација, а потоа поопстојно ќе се задржиме на Р.Македонија, т.е. на прашањата за степенот на глобализација на македонската економија, динамиката на капитална либерализација и импликациите врз девизниот курс.

**Клучни зборови:** *капитални текови, земји во развој, капитал, финансиски систем.*

## **CAPITAL LIBERALIZATION MATTERS AND DILLEMAS – SPECIAL REFERENCE TO THE REPUBLIC OF MACEDONIA**

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### **Abstract**

During the period of the recent decades, the capital liberalization has become an issue of intensive academic proceedings, debates and research for numerous studies. Discussions have been focused on matters related to the advantages and disadvantages of capital liberalization, as well as on the pre-conditions which need to be fulfilled, prior the accession to the full liberalization of capital flows.

The conclusions of the research on the effects of capital liberalization are various and very often contrary. Until the occurrence of the Asian crisis, the literature was dominated by the point of view, which was also officialy supported by the IMF, that the capital liberalization benefit is higher than its expenses. Nowadays, based on the analysis of the experience of numerous currency and financial crises and especially after the great financial and economic crisis dated from 2007 to 2009, in the economic literature there seems to have happened certain convergence of the view-points in terms of treating these issues more carefully and indicating that capital liberalization, especially the one in the developing countries, should take place gradually, also it should be controlled and followed by good regulation. The major advantage



of the capital control is that it solves the problem of the so called trilemma or the impossible trinity in the monetary policy, according to which the country cannot simultaneously permit free capital flow, fixed rate of exchange and independent monetary policy. Therefore, controls of capital enable conducting autonomous monetary policy, that is to say, they create an opportunity to make a difference between domestic and foreign interest rates. This conclusion seems to be relevant for the Macedonian economy as well.

The main goal of this paper is to discuss several dilemmas related to the capital flow liberalization in the Republic of Macedonia – dynamics, necessary steps and reforms, advantages and disadvantages which go along with the process. Within this context, first of all the experience that certain developing countries have had throughout the process of implementation of the capital liberalization will be indicated, and after it will thoroughly focus on the Republic of Macedonia, that is to say, on the issues related to the level of Macedonian economy globalization, the dynamics of the capital liberalization and the implications on the exchange rate.

**Keywords:** capital flows, developing countries, financial crisis, capital, financial system

### **The experience of several developing countries with the Capital liberalization**

The liberalization of capital flows represents a significant factor for increasing the economic development in developing countries. Nevertheless, while certain countries have gained great benefit from the free capital flows, others have encountered with sudden stoppage and overturns of the capital accounts, which resulted with financial crises in some of these economies. Such a phenomenon initiated discussions among the academic economists and economic policy holders for setting control on capital outflows. The goal of the capital control is to provide time for developing countries to make the necessary reforms related to strengthening the financial markets and turning to more flexible exchange rate regime, as well as to protect themselves from the big waves of capital inflows (Fischer, 2003).

Notwithstanding the strong arguments in the economic theory which refer to capital liberalization benefit for some of the countries (higher growth rates and macroeconomic stability), the empirical records confirm that there are numerous exclusions. Many developing countries which were financially integrated, have encountered with financial instability during the last century 90s. Therefore, full capital liberalization in some of the developing countries increases the macroeconomic fluctuation. The major problem refers to the venture short-term capital, which is very instable and has a cyclic movement.



Taking into consideration the examples for the financial crises which occurred at the end of the last century, it may be concluded that opening of a capital account, prior to conducting appropriate banking and financial supervision and regulation, prior to introducing International Accounting Standards, prior to strengthening the corporative management, as well the shareholders rights, may increase the vulnerability of the country to financial problems and crises.

Untill 1997, the opening of the capital accounts used to be the most significant reform in the agendas of many developing countries. Nevertheless, only a year later, the Asian crisis weakened this point of view and many economists started to support the capital limitations again. Krugman, (Krugman, 1998) highly emphasized the importance of temporary controls over the capital outflows in the developing countries. Stiglitz (2000) following the example of Chile, suggested introduction of controls on the short-term venture capital in the developing countries. According to Chowdhury (2009), the central banks of the developing countries should set some kinds of limitations on the capital flows, which will enable control over the monetary aggregates and a possibility for independent monetary policy-making. Apart from that, even IMF emphasized the significance of gradual capital liberalization in developing countries, and the importance of flexible foreign exchange rate and firm fiscal policy for efficient management with the huge capital inflows.

During the transitional period towards full capital liberalization, the capital controls protect the developing countries from capital flow fluctuation and leave time and space for them to fulfill the necessary pre-conditions, prior to the transition towards fully open capital account (Schneider, 2000).

During the period of the years following the crises in Eastern Asia, Russia and Brasil, the capital liberalization in developing countries and in the growing economies, became a subject of intensive debate in the economic field. Many eminent economists came to a conclusion that the capital liberalization may be risky for the developing countries and that an appropriate intervention is necessary.

Taking into consideration the benefits and risks of the capital flows liberalization in developing countries and considering the fact that the underdeveloped institutional structure increases the possibility of crises, these countries should convey the process of capital liberalization gradually and at the same time should make significant reforms in their economies. Also, primarily, the countries should liberalize the current account and only after should they liberalize the capital account of the payment balance. The required pre-conditions generally refer to providing fiscal balance, appropriate mix of instruments for managing the capital flows, appropriate policy of the



foreign exchange rate, reforms in the financial sector and banking supervision (Schneider, 2000).

Developing countries should take into account that fixed exchange rate and subsequent loss of monetary policy independence decreases the possibility of controlling the domestic economic boom, caused by excessive investing and consumption (Schneider, 2000). Also prior accepting full capital liberalization, the countries should make sure that the inflation rate and foreign exchange reserves are being maintained on acceptable levels. It should be taken into account that healthy financial system is not a guarantee that crises will not be happening, but it can significantly contribute towards increasing the scope and integrity of crises. Nevertheless, each developing country should adjust the level and the speed of capital flow liberalization in regard with its characteristics and the situation of their economy.

Within the context of the risks which result from capital liberalization, developing countries should take into account that foreign direct investments apart from being more expensive form of capital flows for the recipient countries, are stable, unlike the banking countries, which yield less expenses. Therefore, there is a consensus among the economists that developing countries, apart from their expenses, should encourage foreign direct investments (Schneider, 2000).

### **Liberalization of capital flows in the Republic of Macedonia** **Dynamics of capital account liberalization in the Republic of Macedonia**

The basis on regulating the capital flow and current payments in the Republic of Macedonia is the Stabilization and Association Agreement (SAA) between the Republic of Macedonia and EU, signed in April 2001.

Major consequence arising from signing the Agreement is the obligation of our country to convey gradual liberalization of movement of goods, services, people and capital. According to Article 58 from the Agreement, the parties are obliged to permit any kind of payments and transfers on the current account of the payment balances between the Community and the Republic of Macedonia in free convertible currency. In accordance with Article 58 from the Agreement, both parties are obliged to provide free capital movement in the form of direct investments. The transfer of profit and invested capital from direct investments is free, provided the direct investment is registered in accordance with the Law on Foreign Exchange Operations and under the condition that all legal obligations on the basis of taxes and contributions are fulfilled. After starting the second phase, it is necessary to provide free capital movement in a form of portfolio investments and loans with maturity less than a year (SAA, 2001).



The Law on Foreign Exchange Operations, 2001, provides gradual liberalization of capital transactions, which is to be accomplished in two phases:

In the first phase of the SAA, which began at the end of 2002, full liberalization of foreign direct investments of short-term trade transactions and long-term financial transactions was conducted. Also, liberalization of credit transactions was conveyed, which means that banks can approve loans to non-residents and can do credit supply on residents in foreign exchange. Portfolio investments were only partially liberalized, that is to say, the freedom referred only to portfolio investments of the non-residents.

Since April, 2008, it was accessed towards the second phase of SAA, which anticipates full liberalization of portfolio investments and real estate transactions. After the termination of the second phase, the residents will be able freely to open and hold foreign exchange accounts in foreign banks, which, in the meantime, they will be able to realize it only with preliminary gained permit on the behalf of the National Bank of the Republic of Macedonia.

Nevertheless, besides the legal possibility for free investment in domestic securities on the behalf of non-residents, in order to protect from the risk for destabilization on the foreign exchange market, certain implicit administrative controls have been applied on this type of transactions (Law on Foreign Exchange Operations, Official Gazette of the Republic of Macedonia, 2009).

In 2008 the Law on Property was amended, which enabled the non-residents (that is to say the persons from EU and OECD) to acquire properties under the same conditions as the citizens of the Republic of Macedonia (Law on Foreign Exchange Operations, Official Gazette of the Republic of Macedonia, 2008).

The activities in the foreign exchange operations are regulated by the Law on Foreign Exchange Operations. All transactions among Macedonian citizens are conveyed in MKD. On the other hand, resident and non-resident companies and natural persons are allowed to have foreign exchange accounts in commercial banks. There are no limits in relation to the amount of foreign currency assets which the company can buy in order to make payment of an obligation that they have abroad, if they provide valid document with details for the goal of payment or for making the transfer (Markovska, 2007).

In order to alleviate the conditions for inflow and outflow of effective foreign money and cheques to and from the Republic of Macedonia, a Decision on amending of the Decision on conditions and the amount of effective foreign money and cheques, which can enter or can be taken out from our country, was adopted in 2008. According to the Decision residents and non-residents can either intake or take out effective foreign money and cheques to and from our



country, in the amount of 10 000 EUR (Law on Foreign Exchange Operations, Official Gazzette of the Republic of Macedonia, 2008).

Residents, in accordance with the Law on Foreign Exchange Operations can not invest in real estate abroad. Diplomatic, consular and some other representative offices of the Republic of Macedonia abroad are the only exceptions.

There are no exceptions in Macedonia in regard to foreign investors and their property. Foreign companies, as well as the domestic ones, are allowed to form new or buy already existing companies which still belong to the state and are not yet privatized in the country. According to the Constitution of the Republic of Macedonia foreign investors have the same protection and rights as Macedonian investors. Also, foreign investors have special reliefs in the field of taxes and customs, although slowly they are becoming valid for all the investors with no regard to their origin. Foreign investors can invest in Macedonia through establishing new company or representative office (Markovska, 2007).

Foreign investors in the Republic of Macedonia are allowed and are stimulated to invest in all the sectors of Macedonian economy (there are some exceptions in the area of military industry, flow and trade of weapons and narcotics and protection of historic monuments and cultural heritage). It is typical that foreign companies are allowed to locate their companies in the Macedonian free economic zones and thus benefit from tax exemptions. The Law on Free Economic Zones was adopted in 1999. In 2007 a new Law on Technological Industrial Development Zones was adopted, in order to support the investments in production, information technology, research and development, new technologies and similar ones (Markovska, 2007).

The gradual and controlled liberalization of the short-term capital, from less to more risk capital flows, is in accordance with the current policy of foreign exchange rate fixed regime, taking into account that short-term financial assets represent a potential danger for maintaining that regime. Nevertheless, the process of capital liberalization and perspective of the larger financial integration, with having relatively high domestic interest rates, influences on the long-term maintenance of the exchange rate fixed regime.

### **Capital infows and implications on the exchange rate**

The role of the exchange rate is crucial for understanding the fact that international capital flows and the sudden change of direction of capital movement have an important role in many financial crises, especially under conditions when countries maintain fixed exchange rate.





Developing countries usually have at disposal lower level of domestic savings and offer potentially higher contributions to the investments. Therefore, developing countries struck by currency crisis, usually have net capital inflow and deficit in the current account before the crisis. The currency crisis results with huge capital outflow, that is to say, a runaway of capital. Provided the country has a large amount of loans denominated in foreign currency, under conditions of devaluation of local currency, domestic enterprises are about to face with increase of the real value of their debts.

The current exchange rate regime in the Republic of Macedonia is different from the experiences of the transitional economies which have entered the EU or have adopted the euro as a national currency.

A potential risk for Macedonian economy is the eventual entry of short-term venture capital. Along with it there are the high interest rates and fixed exchange rate (Mitreska and Terzijan, 2003).

It should be taken into account that the fixed exchange rate has accomplished the goal of high stability of price and now it limits the capital market. NBRM must intervene daily, to extract money from sales and to watch on the foreign exchange reserves. As a matter of fact, the inflation is no longer a problem in our country, but the low economic growth. Therefore we should turn to more flexible exchange rate. An inappropriate level of exchange rate feeds the current deficit.

Under conditions of free capital movement, maintaining the exchange rates is becoming difficult and for the need of maintaining high interest rates, which bring about huge expenses to the banking system and the economy as a whole. Thus, during the period of the latest crisis, the countries which applied the strategy of inflation targeting, taking into consideration that the exchange rate was not the only intermediate goal, they managed to transfer part of the crisis burden on the exchange rate. They conveyed weak devaluation of national currencies thus increasing the export competition.

During the global crisis, in the Republic of Macedonia the reference interest rate increased, which caused growth of interest rates in the banking system. Actually, the Central Bank had to react with significant growth of reference interest rate in order to oppose the foreign exchange reserves for maintaining stable value of the exchange rate.

Therefore, the countries which applied the strategy of inflation targeting were able to easily manage their own economy, which involves more flexible reaction to shocks and to a certain degree taking care of real production, except for the inflation.

Also, the general insecurity in the country is almost present during the whole period of application of the fixed exchange rate of the denar, which is





the reason why the domestic and foreign investments have noticed the lowest level in Europe for a longer period of time. After a meeting with Macedonian authorities in 2005, the mission of the International Monetary Fund estimated that the results of the monetary policy in the Republic of Macedonia are not satisfactory if the achievements in real economy are taken into account. Therefore, the mission of IMF suggested to Macedonian authorities to change the monetary strategy. Instead of maintaining fixed exchange rate of denar, the Fund suggested for the inflation rate targeting to be an intermediate goal of the monetary policy of the Republic of Macedonia (Nenovski, 2007).

Therefore, lately, the question about the monetary policy in the following years for the Republic of Macedonia is becoming more and more actual. Should we continue with the already existing strategy, which turned out to be efficient in the years lately, or should it be changed? Many authors are of the opinion that after the achievements of goals for which this strategy of exchange rate targeting was introduced, and the goal was the high price stability for a longer period, it should be replaced with some other strategy that will enable achievement of the same goal.

If a decision is adopted on the exchange rate in the Republic of Macedonia for taking away its role of nominal anchor it will be necessary to define a new anchor. Under conditions of global orientation towards stable prices, that role might be taken over by the inflation. It implies clear orientation of the Central Bank towards maintaining price stability (Mitreska and Terzijan, 2003). It should be taken into account that inflation targeting represents a compromise between the discretionary monetary policy and the monetary policy based on rules. Two advantages arise from this: first of all, the inflation expectancies are eliminated (the Central Bank announces target in a kind of range and the inflation will move within the frames of it – for instance from 2% to 4% annually, second, if the economy faces with recession disruptions the inflation can reach the upper limit in order to stimulate the economy and vice versa. But the strategy itself has some disadvantages, significant for an economy such as ours. If the announced target and range in which the inflation is to move does not realize, the Central Bank and the Government lose their credibility and the inflation expectations can happen (Fiti, 2009).

Taking into consideration the size and the degree of transparency of Macedonian economy, as well as the rapid and direct effect of the exchange rate changes over the price movement and the simultaneous orientation of NBRM towards maintaining price stability, the strategy of quasi inflation targeting can be considered as future alternative monetary strategy. It anticipates fulfillment of the presumptions for gradual increase of the exchange rate flexibility and providing the necessary institutional, personnel and technical pre-conditions for laying a new concrete inflation target (Mitreska and Terzijan, 2003).



Nevertheless, the eventual switch from fixed towards flexible rate should happen gradually, in order for the economic agents not to get an opinion that firm policy is being abandoned, that is, to avoid strengthening of inflation expectancies. Additionally, the flexibility should not be levelled with free movement of exchange rate for the danger of big rate oscillations, which can further generate huge instability of the inflation rate, as well as in the real sector.

The key question in this context is whether the abandonment of the fixed exchange rate and the introduction of inflation targeting is possible for the Macedonian economy in this moment and in this constellation of relations. It should be taken into account that in order for a certain country to be able to apply the strategy of inflation targeting, it is necessary to fulfill certain macro-economic, institutional and operative pre-conditions.

Regarding the economic structure, certain features of Macedonian economy do not contribute towards the acceptance of the monetary rule of inflation targeting. Namely, as a small and open economy, the Republic of Macedonia is highly sensitive to changes in the world prices of the primary products and changes of the exchange rate. Perhaps the main obstacle for abandoning the fixed exchange rate regime is that the process of eurosation is still a widely spread phenomenon in Macedonian economy. Under conditions of high degree of currency substitution and emphasized transmission effect of the exchange rate on the prices, a flexible exchange rate is not recommended. The eventual transfer towards more flexible exchange rate must be very precautious and narrowed with regard to the implications that might happen over the economy and the financial system.

In view of the pre-condition for healthy financial system, it might be concluded that the financial system of the Republic of Macedonia has not achieved yet the level of development, necessary for successful functioning of this monetary concept. Macedonia, as an economy in transition, is characterized by shallow financial and foreign exchange market, for only very few transactions can cause huge and unwanted fluctuations of the interest rates and the exchange rate. Therefore, the Republic of Macedonia can not be counted as one of the countries with sufficiently sophisticated financial system, which allows acceptance of the inflation targeting, as an official monetary frame.

On the basis of the afore mentioned, it can be concluded that, even though for long term the inflation targeting can be observed as an appropriate option for the Republic of Macedonia, at this moment and under these economic conditions, the Republic of Macedonia does not fulfill the key pre-conditions for accepting this strategy.



Nevertheless, the combination of flexible exchange rate regime and monetary frame in form inflation targeting, could gain the role of valid and leading long-term monetary strategy with potential for promoting the macro-economic performances and strengthening the credibility of the monetary policy.

However, under conditions of high level of currency substitution and emphasized transmission effect of the exchange rate on prices, a free fluctuation exchange rate is not recommended. The eventual transfer towards more flexible exchange rate must be very precautous and narrowed (for instance  $\pm 5\%$  in the period of the first two years) with regard to the implications in regard to the economy and the financial system.

Within this context, it is of great significance to emphasize the risk from the change of the exchange rate, which especially arises as a problem in developing countries. The risk from the change of the exchange rate refers to the long indexed or denominated debt in foreign currency. Thus, a larger amount of debt in foreign currency in relation to the total public debt implies on a bigger risk from the change of the exchange rate. This is a key risk for developing countries which have their foreign public debt almost fully indexed in foreign currency, while the bigger part of the interior public debt is denominated in foreign currency. The portfolio on debts of the Republic of Macedonia is also significantly exposed to the exchange rate risk, where the changes of the exchange rate can increase the anticipated expenses for payment of the public debt, denominated in foreign currency. Taking into account the fact that the Republic of Macedonia de facto applies fixed exchange rate of denar in relation to the euro, the exposure to the foreign exchange risk should also be measured as participation of the euro in the total portfolio of the public debt (Ministry of Finance of the Republic of Macedonia, 2010).

### **Conclusion**

This paper analysed the effects of capital flow liberalization on the economic and financial stability in countries where it is implemented.

The capital liberalization is a significant factor for increasing the economic development in developing countries. Free capital flows enable optimum international capital allocation, that is to say, direction of resources towards their most productive usage. Capital flow liberalizations enables better risk diversification, accelerated development of financial systems, increased flexibility and responsiveness of financial systems and economies to various shocks and it results in accelerated economic development.

Nevertheless, while certain countries have great benefit from free capital flows, others have encountered with sudden stoppage and turnovers of capital accounts, which even resulted with financial crises in some of these economies.



Namely, free capital flows can oppose domestic policy measures and can cause numerous distortions and generate numerous risks.

Taking into consideration the experience of numerous currency and financial crises, especially after the great financial and economic crisis dated 2007/2009, it seems that in the economic literature there is a certain convergence of opinions in a sense of more precasious treatment of these problems and there is an indication that capital liberalization, especially in developing countries, should be implemented gradually, should be controlled and followed by good regulation.

Taking into account the instance of the financial crises from the end of last century, it can be concluded that opening a capital account before conveying appropriate banking and financial supervision and regulation, before introducing international accounting standards, before strengthening the corporative management as well as the shareholders rights, can increase the vulnerability of financial problems and crises in the country.

Within the context of financial crises, this paper especially emphasizes the importance of the exchange rate regime which is applied in the country. Thus, it is concluded that developing countries should take into account that fixed exchange rate and subsequent loss of monetary policy independence, reduces the possibility of controlling the domestic economic boom, which resulted from exceeding investment and consumption.

The paper also discusses the degree of economic globalization of the Republic of Macedonia. On the basis of the indicators: the weak relation between GDP and foreign trade, the small scope of FDI and low level of integrity in the world market, it can be concluded that the Republic of Macedonia does not represent fully globalized economy.

In relation to capital flow liberalization, the Law on Foreign Exchange Operations, 2001, provided gradual liberalization of capital transactions.

It should be taken into account that gradual and controlled liberalization of short-term capital, from less to more risk capital flows, is in accordance with the current policy of fixed exchange rate regime, taking into consideration that short-term financial assets represent a potential danger for maintenance of the regime.

Nevertheless, the process of capital liberalization and perspectively larger financial integration, with the existence of relatively high domestic interest rates, involves the maintenance of fixed exchange rate regime for a long term.

The current exchange rate regime in the Republic of Macedonia is not typical for the experiences of transitional economies, which joined EU or adopted the euro as their national currency.



If a decision is made to take away the role of nominal anchor to the exchange rate in the Republic of Macedonia it will be necessary to define a new anchor. Under conditions of global orientation towards stable prices, the role might be taken over by the inflation. That suggests clear orientation of the Central Bank towards maintaining price stability. Nevertheless, the strong and weak points of this rule should also be taken into account. The strong points reflect in the inflation targeting, if it is successfully implemented it contributes to elimination of inflatory expectancies and to relieve economic implications from the change phases in the economic cycle. But the biggest weakness of this strategy is the loss of credibility of the Central Bank and the government, if the announced target is to be overcome.

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