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PREGLEDNI RAD

THE FUTURE DEVELOPMENT OF THE SERVICE SECTOR AND IT'S IMPACT ON THE BANKING INDUSTRY. THE CASE OF MACEDONIA

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Abstract: *The aim of this paper is to elaborate the importance of service sector and how its future development will affect the banking industry in the Republic of Macedonia. We live in a service society, where services sector represents more than two-thirds of economic activity and four-fifths of growth in recent years in OECD countries. This trend is evident in Macedonia also, where the service sector represents around 60% from the economic activity. Stil, because of the positive correlation with the economic development, further development will result with growth of the service sector. Further liberalization, removing product market barriers still limiting competition in various sub-sectors, allowing more FDI are factors that are indicated by experts that can contribute for further development of the service sector.Regarding banking industry in Macedonia, service sector has the biggest share in the credit portfolio. Especialy this is due of the high exposure towards trade.Comparative analysis with developed countries shows that the share of exposure towards service sector is greather in Macedonia. This is mainly due of the lower risk of this credit portfolio, whose average riskiness is below the industry sector and agriculture.Also, in deficiency of strong industrial sector who can export its goods, Macedonian banks are turned towards wholesale and retail trade sectors. So it is expected with growth of GDP per capita in future banks to increase the loan portfolio of industry and in the same time to decrease the share of trade sector portfolio in total service portfolio.*

Keywords: *service sector, banking industry,*

JEL Classification: *G20, G21*

INTRODUCTION

The development towards the „Service Society" has long viewed to be just an academic vision but has already become a reality to a large extent. The expansion of output and trade in manufactured goods constituted the engine of growth of the past century. Although developed countries pride themselves on their global technological lead in many industries, still simple analysis shows that manufacturing has long taken the back seat to services industries, in terms of both output and employment. In OECD countries, the services sector represents more than two-thirds of economic activity. Almost 70% of employed persons in the EU27 worked within the service sector in 2011, compared with 62% in 2000. Reflecting the long-term trends in employment structure, net job creation is occurring almost exclusively in the service sector. The growth of existing service industries, the development of new services – not least in light of technological, demographic and other trends – and increased internationalization suggest that the service sector will continue to increase in scope and intensity.

In Eastern European countries, the importance of the services sector for GDP and employment has substantially increased since the beginning of transition and accounts presently for more than half of the economic activity in those countries [World Bank, 2006]. Future development of these countries, in which belongs Macedonia, depends on further development of the service sector and its efficiency. An efficient services sector has indirect consequences for economic growth through the efficiency of other sectors in the economy.

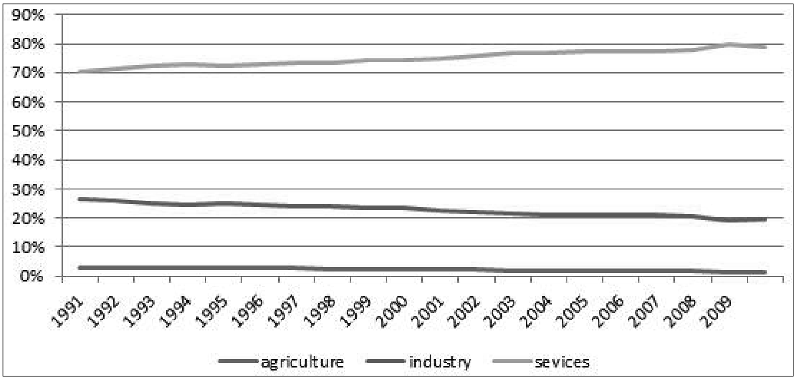
The development of the service sector also will have positive influence on the development of the financial sector. Further development in this sector will mean increase lending on the companies and employees in this sector and growth of other financial activities which will strengthen the banking industry,too.

THE IMPORTANCE OF SERVICE SECTORIN EU AND EASTERN EUROPEAN COUNTRIES

The analyzes of the importance of the service sector will be done by historic analyzes of the structural changes of the economies in Europe. One way to look at the structure of an economy is to compare the shares of its three main sectors—agriculture, industry, and services—in the country's total output and employment.

If we analyze gross value added in EU 15 (Figure 1), more than clear is that services are dominant sector with more than 70% of the total gross value added. Also the trend is evident. The share in gross value added on service sector continues to increase.

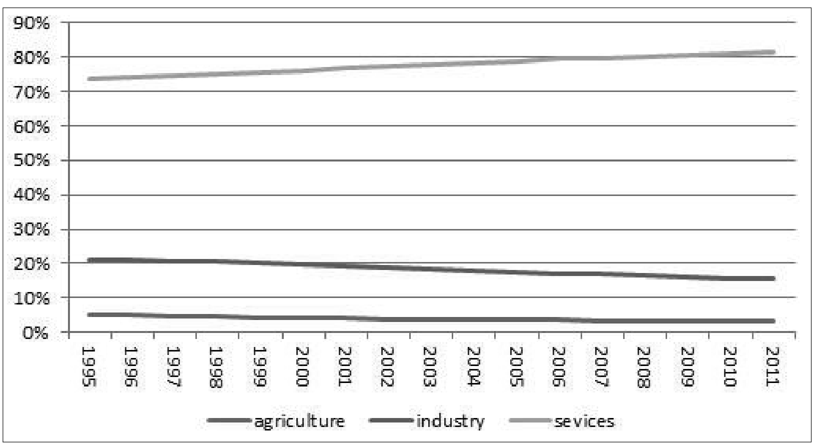
Figure 1: Gross value added at current prices in EU 15



***Source**: [European Commission, Economic and Financial Affairs, AMECO*]

The same conclusion can be drawn if we analyze the importance of services for labor market (Figure 2). Above 70% of the total number of employed in EU 15 is due to the service sector. Employment trends are rather closely related to output trends, so that a similar picture emerges for the increase in the share of services in total employment. In recent decades EU Member States have experienced a significant change in their employment structure in favor of service-sector employment, with a concomitant reduction in the share of jobs in industry and agriculture.

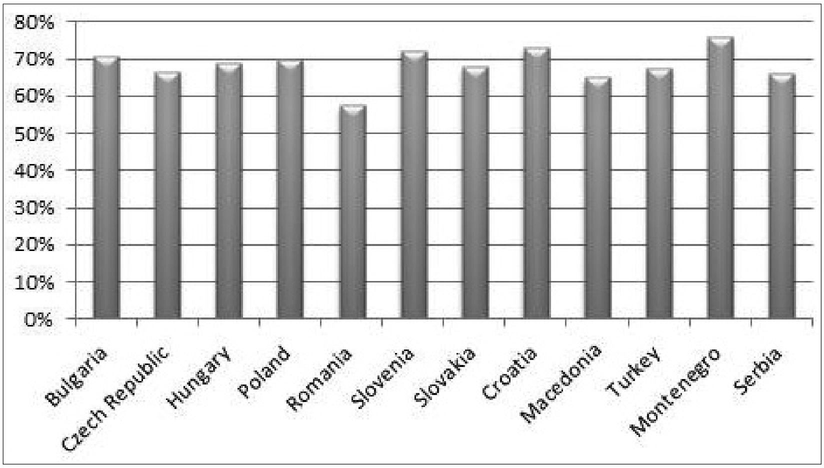
Figure 2: Employment share of services, industry and agriculture, EU15



***Source:**[European Commission, Economic and Financial Affairs, AMECO*]

A little different picture of the importance of services will be received if we analyze EU 27 countries. There are significant differences of share in gross added value and employment in the service sector in new and old EU countries. In Eastern Europe countries in which are included some of new EU Countries, the share of service sector in GDP is smaller than in developed EU countries (Figure 3).

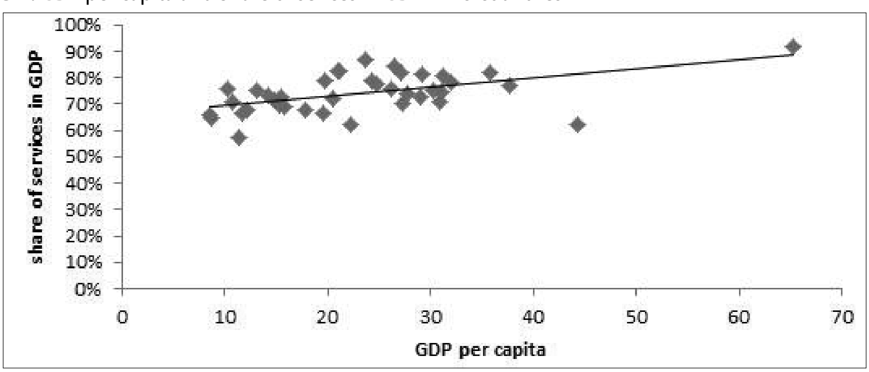
Figure 3: Share of services in gross value added in Eastern Europe countries



Source:*[European Commission, Economic and Financial Affairs, AMECO]*

This can be explained by the level of economic development. Countries with bigger GDP per capita have more developed service sector and vice verse (Figure 4). So in new EU countries there is still place for development of the service sector which can be confirmed by faster growth in service sector then in the old EU countries.

Figure 4: GDP per capita and Share of serices in GDP in EU countries



Source*: [European Commission, Economic and Financial Affairs, AMECO]*

DETERMINANTS OF DEVELOPMENT OF THE SERVICE SECTOR

Dominant and still growing importance of service sector and the differences between countries put in place the question what are the main drivers for service sector developments. A lot of scholar hypothesis and empirical analyzes to answer this question are present which can be aggregated in two basic views. According to Clark [Clark, 1957] the increasing demand for services is the driving force of services growth. So Clark explains the growth of the service sector with shifts in income elasticity of demand.

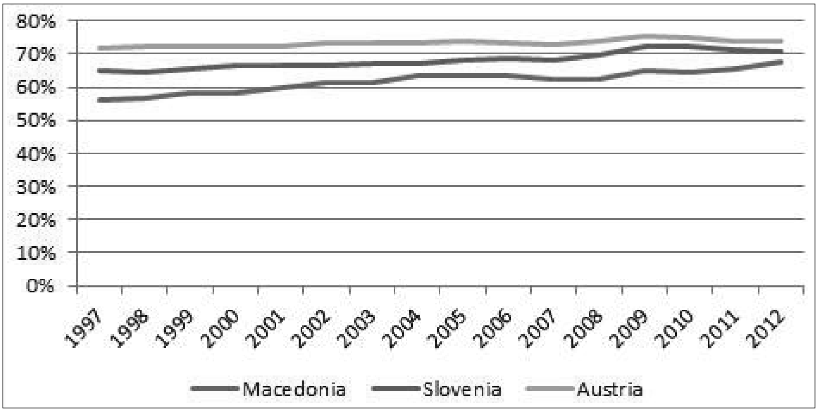
More common explanation for service sector growth is linking this growth with the level of economic development of a country. This connection is straight forward, more developed economy has stronger service sector and vice verse [Francois and Reinert, 1996]. Of course stronger service sector accordingly will impact with appropriate level of development in it. Other view of the growing importance of service sector links the growth with supply side [Baumol, 2001]. According to Baumol the productivity growth is faster in manufacturing than in services but wages are raising equal. The rising productivity in manufacturing will result in increased demand for services. But because the wages are rising equal this will result with reallocation of employment to lower productivity sector. In long term, according to this author, the productivity will slow down and reverse process will follow.

One of the most recent and extensive study on this field is done by Maroto [Maroto, 2009]. According to him the growth of the service sector can be explained by changes in production factors, changes in productive systems, changes in markets and changes in the institutional system. These changes are related to factors such as information and communication society, globalization and demographical and territorial changes. Among these factors, some stand out: integration between goods and services, which has increased the intermediate demand for business services; the interrelation between new technologies, innovation and services; the importance of human capital and qualifications (particularly in advanced services) and specialization; the role of international trade and investment; and finally, through its regulations and institutional changes, the role of the State in the economy.

THE IMPORTANCE OF THE SERVICE SECTOR FOR THE BANKING INDUSTRY IN MACEDONIA

From the empirical evidence of developed countries is more than clear that share of services in gross value added and employment will increase parallel with GDP growth. This will have proper impact on the banking activities. In order to predict the influence of growth of service sector, we will use the current data for exposure to service sector and default figures. Comparation will be made with Slovenia as one of the "new" EU countries and Austria as developed EU country, about the share of exposure towards service sector and its trend and about default figures. First we analyze the importance of service sector for the economy and the trend of growth for our country, Slovenia and Austria.

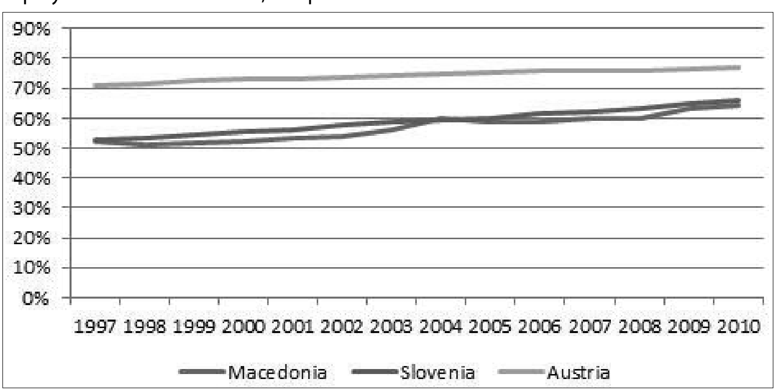
Figure 5: Gross added value in sample countries



Source: *[European Commission, Economic and Financial Affairs, AMECO]*

As we can see from Figure 5 the trend of services in gross added value is upward in Slovenia, Macedonia and Austria. Still, the share of services in Slovenia in gross added value is bigger for 4 % than in Macedonia which can be explained with the higher GDP per capita. The gross added value from service sector in Austria is higher from Slovenia and Macedonia but the trend of growth is slower. This means that to some level the share of service sector in gross added value grows faster and after that the growth is slower.

Figure 6: Employment share of services, sample countries

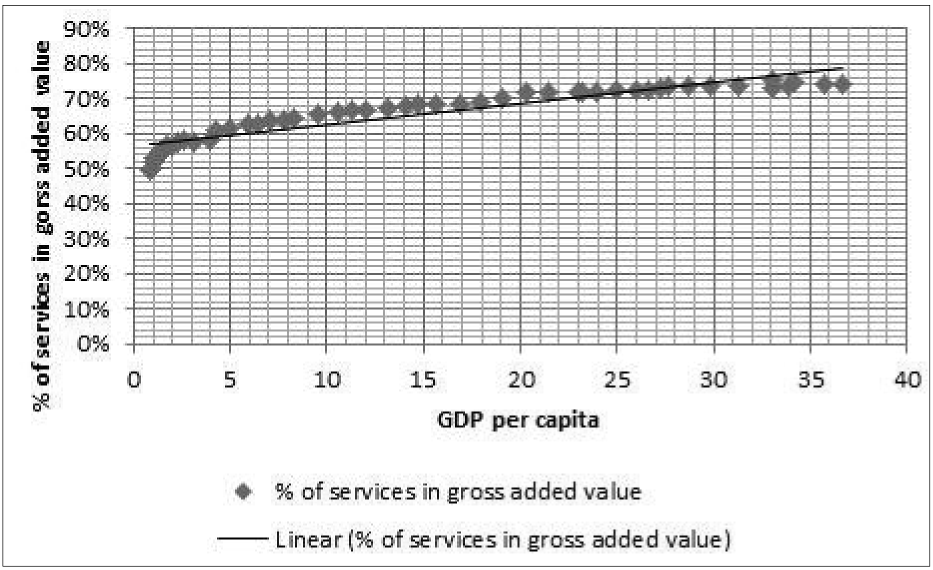


Source: *[European Commission, Economic and Financial Affairs, AMECO]*

Regarding the number of employees, the trend in Macedonia and Slovenia is very similar and the share of number of employees in the service sector is almost the same (Figure 6). The main difference between the sample countries is the unemployment rate. In Macedonia the unemployment rate according to State statistical office is above 31% and in Slovenia the level of unemployment is around 13%. What is unknown is the share of employees in service sector if the level of unemployment in Macedonia is similar to Slovenia.

The share of employees in service sector in Austria is quite above than Slovenia and Macedonia. This is another confirmation that the level of economic development is excellent predictor of the share of service sector in gross added value and employment. As can be seen the correlation is almost linear, and as the growth of GDP per capita slows the % of service sector in gross added value maintain the same level (Figure 7).

Figure 7: GDP per capita and Share of serices in gross added value in sample countries



Source: European Commission, Economic and Financial Affairs, AMECO

Another aspect that must be analyzed, in order to asses the impact on service sector development is the level of financial intermediation and characteristics of banking sector.

Table 1: Level of finanancial intermediation

Country	Assets/GDP	Loans/GDP
Romania	75%	43%
Poland	88%	57%
Lithuania	98%	72%
Slovakia	86%	49%
Hungary	136%	79%
Bulgaria	112%	78%
Czech rep.	117%	58%
Slovenia	153%	102%
Estonia	155%	114%
Latvia	161%	70%
Cyprus	822%	341%
Malta	721%	373%
EU	334%	141%
R.Macedonia	72%	44%

The level of financial intermediation in Republic of Macedonia is still on the lowest level relative to some countries from the European Union, the EU average and the Euro zone average including Slovenia (Table 1). Of course the level of financial intermediation is determined by the level of development as the share of service sector. This leaves space for further deepening of the financial intermediation with parallel enhancement of the service sector.

Source: [NBRM, 2013:11]

Another important characteristic of Macedonian banking system is the high level of concentration. CR5 and CR3 show high concentration in all market segments.Two-thirds of total assets of the banking system is concentrated in three banks, while seven of total sixteen banks occupy the less than 3% of total assets of banking system. So the credit capacity of the three systemic banks is one of the factors for service sector development.

Table 2: CR5 and CR3 in banking system of Macedonia

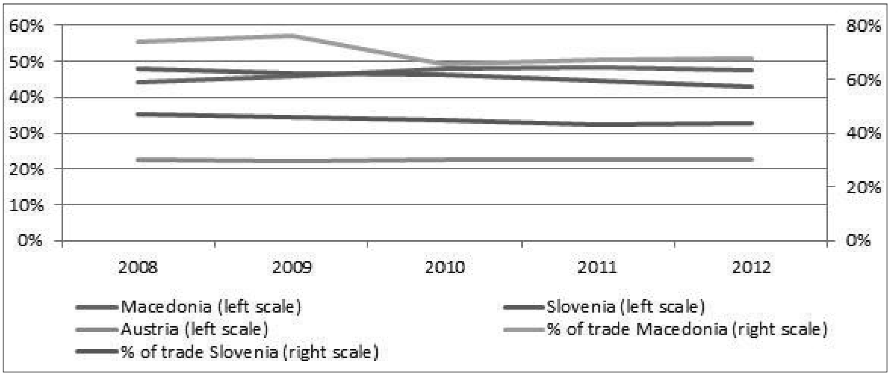
Year		Total assets	Loans do individuals	Corporate loans	Deposits on individuals	Corporate deposits
CR5	31.12.2010	77.2%	79.3%	81.1%	84.9%	83.3%
	31.12.2011	76.6%	78.8%	81.7%	82.9%	83.5%
	31.12.2012	74.5%	79.2%	79.9%	81.0%	82.1%
CR3	31.12.2010	66.0%	68.6%	69.2%	76.7%	62.5%
	31.12.2011	64.0%	67.7%	67.4%	75.0%	57.5%
	31.12.2012	61.7%	67.1%	65.6%	72.9%	59.9%

***Source**:* [NBRM, 2013:17]

The analyze of the importance of the service sector for the banking industry will be conduct based on the share of loan portfolio in this sector. The share of loan portfolio on service sector will be compared with Slovenia and Austria in order to conclude further developments in the future. Another important aspect is the default rate of the service sector which of course will influence on the determince of banking industry to support it.

The comparation between Macedonia and Slovenia shows that the loan portfolio of service sector constitutes around 40% of total portfolio in selected countries (Figure 8). The trend in these two countries is different. In Macedonia the loan portfolio share increase and in Slovenia decrease but still the differences are minor.

Figure 8: Share of service portfolio in sample countries



Source*:* [European Commission, Economic and Financial Affairs, AMECO]

Further analyzes shows big differences in the exposure towards service sector. Almost 70% of the service sector portfolio on Macedonian banks is due to wholesale and retail trade and in Slovenian banking sector this figure is 44% (Figure 8). In Austria the share of service sector portfolio is twice as smaller and is around 23%. The difference in the share of service loan portfolio probably can be explained by the level of economic development. More developed economy has developed industry which needs credit support. Also the industry sector is more financially extensive and bigger credit support is needed. In deficiency of strong industrial sector who can export its goods, Macedonian banks are turned towards wholesale and retail trade sectors. So it is expected with growth of GDP per capita to increase the loan portfolio of industry and in the same time to decrease the share of trade sector portfolio in total service portfolio. The main conclusion is that further development of the economy will result in growth of loan portfolio of industry sector and smaller growth in service sector portfolio. But this growth in service sector portfolio will be accompanied with structural changes and decline of the exposure towards wholesale and retail trade sectors.

Another key factor, except slightly developed industry, for big share of service sector portfolio is its quality. As can be seen from Table 3 wholesale and retail trade has the smallest rate of default from all the other sectors and what is more important the rate is almost unchanged. This is important fact for the difference of share of this sector in Macedonia with the other sample countries.

Table 3: Default rate by sector in Macedonian banking system

Sector	31.12.2008	31.12.2009	31.12.2010	31.12.2011	31.12.2012
Agriculture, forestry, fishing, mining	10.8%	9.1%	9.3%	16.1%	11.8%
Manufacturing	8.5%	10.8%	12.3%	13.5%	14.1%
Electricity, gas, water	0.3%	0.3%	0.2%	0.4%	14.5%
Construction	6.2%	4.1%	4.0%	5.7%	11.0%
Wholesale and retail trade	5.5%	5.2%	5.0%	5.8%	6.3%
Transport, storage	2.5%	5.5%	4.8%	5.8%	7.8%
Accomodation facilities and catering services	0.7%	4.2%	4.6%	24.1%	30.4%
Information and communication	1.0%	1.0%	0.7%	2.0%	6.3%
Real estate services	2.1%	1.5%	2.1%	8.4%	7.4%
Profesional scientific and tehnical activities	4.5%	1.3%	3.7%	0.1%	9.7%
Other sectors	4.3%	6.8%	4.1%	3.5%	3.2%

***Source**:* [NBRM, 2013]

The analyze of loan portfolio in Slovenia shows riskier portfolio than in Macedonia (Table 4). The same conclusion can be made for the service sector too. The biggest part of the portfolio which is in trade in Slovenia also is one of the less risky. Also the economic crises in which is the country had not so much influence as in the other sectors. The same conclusion can be brought for Slovenian banking system that wholesale and retail trade is one of the healthiest sectors for lending and can be used for explanation of the bigger share of this sector versus Austria. The other service sectors in Slovenia are more risky than the average of banking system and are very sensitive of economic conditions but their share in total service sector portfolio is small.

Table 4: Default rate by sector in Slovenian banking system

Sector	31.12.2008	31.12.2009	31.12.2010	31.12.2011	31.12.2012
Agriculture, forestry, fishing, mining	6.2%	5.5%	5.8%	9.4%	15.4%
Manufacturing	3.8%	6.3%	9.2%	11.4%	15.7%
Electricity, gas, water	1.3%	0.8%	1.5%	2.2%	3.8%
Construction	3.0%	7.7%	19.5%	49.9%	62.2%
Wholesale and retail trade	5.1%	5.1%	13.6%	11.8%	14.2%
Transport, storage	2.6%	1.9%	6.5%	11.3%	13.7%
Accomodation facilities and catering services	3.6%	7.9%	6.6%	14.5%	23.2%
Information and communication	1.4%	1.8%	23.2%	25.5%	29.5%
Real estate services	2.1%	4.8%	10.3%	17.3%	24.0%
Profesional scientific and tehnical activities	5.1%	7.6%	17.7%	20.3%	19.9%
Other sectors	3.5%	2.2%	2.7%	5.0%	8.3%

***Source**:* [Banka Slovenije, 2012]

In short and medium term is certain that the lending activity towards service sector in Macedonia will be directed towards trade. In medium term and long term if there is economic development and GDP growth, the share of trade portfolio will decrease and the portfolios of other service sectors will grow. The small default rate of service sector gives good ground for further lending activities in other segments of the service sector.

CONCLUSION

The development towards the „Service Society" has long viewed to be just an academic vision but has already become a reality to a large extent. The service sector is dominant one, with more than 70% of the total gross value added in EU 15. Also the trend is evident. The share in gross value added on service sector continues to increase. Also above 70% of the total number of employed in EU 15 is due to the service sector. Employment trends are rather closely related to output trends, so that a similar picture emerges for the increase in the share of services in total employment. The share of service sector in th eeconomy is highly positive correlated with the level of economic development. Countries with bigger GDP per capita have more developed service sector and vice verse.

The trend of services in gross added value is upward in Slovenia, Macedonia and Austria. Still, the share of services in Slovenia in gross added value is bigger for 4 % than in Macedonia which can be explained with the higher GDP per capita. The gross added value from service sector in Austria is higher from Slovenia and Macedonia but the trend of growth is slower. This means that to some level the share of service sector in gross added value grows faster and after that the growth is slower.

The service sector with 67% share in gross added value is dominant in Macedonia too. Regarding the number of employees, the trend in Macedonia and the other sample country Slovenia is very similar and the share of number of employees in the service sector is almost the same. The main difference between the sample countries is the unemployment rate. In Macedonia the unemployment rate according to State statistical office is above 31% and in Slovenia the level of unemployment is around 13%. What is unknown is the share of employees in service sector if the level of unemployment in Macedonia is similar to Slovenia.

Regarding the loan portfolio, the comparation between Macedonia and Slovenia shows that the loan portfolio of service sector constitutes around 40% of total portfolio in selected countries. The trend in these two countries is different. In Macedonia the loan portfolio share increase and in Slovenia decrease but still the differences are minor.

Further analyzes shows big differences in the exposure towards service sector. Almost 70% of the service sector portfolio on Macedonian banks is due to wholesale and retail trade and in Slovenian banking sector this figure is 44%. In Austria, as developed EU country, the share of service sector portfolio is twice as smaller and is around 23%. The difference in the share of service loan portfolio probably can be explained by the level of economic development. More developed economy has developed industry which needs credit support. Also the industry sector is more financially extensive and bigger credit support is needed. In deficiency of strong industrial sector who can export its goods, Macedonian banks are turned towards wholesale and retail trade sectors. So it is expected with growth of GDP per capita to increase the loan portfolio of industry and in the same time to decrease the share of trade sector portfolio in total service portfolio. The main conclusion is that further development of the economy will result in growth of loan portfolio of industry sector and smaller growth in service sector portfolio. But this growth in service sector portfolio will be accompanied with structural changes and decline of the exposure towards wholesale and retail trade sectors.

Another key factor, except slightly developed industry, for big share of service sector portfolio is its quality. Wholesale and retail trade portfolio in Macedonia has the smallest rate of default from all the other sectors and what is more important the rate is almost unchanged in time. This is important fact for the difference of share of this sector in Macedonia with the other sample countries.

In short and medium term is certain that the lending activity towards service sector in Macedonia will be directed towards trade. In medium term and long term, if there is economic development and GDP growth, the share of trade portfolio will decrease and the portfolios of other service sectors will grow. The small default rate of service sector gives good ground for further lending activities in other segments of the service sector.

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