D. Summary

17. FYR Macedonia has made considerable progress in macro-economic management and improving the transparency and operations of the public sector. Although continuing governance and macro-economic challenges remain, there is broad consensus that a stronger focus on structural reform will be required to overcome key impediments to growth and employment. This is reflected in both the IMF and Bank programs. The strong similarities between aspects of the IMF SBA and the Bank's proposed adjustment and investment lending program have considerable potential to generate synergies and complementarities. This will, however, require continuing strong collaboration between the Macedonian Government, the Bank and the IMF.

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IMF Concludes 2006 Article IV Consultation with the former Yugoslav Republic of Macedonia

On July 28, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the former Yugoslav Republic of Macedonia.[1]

Background

Economic performance has started to improve. After a decade of sluggish growth, in part the result of external shocks, growth has reached 4 percent for two years in a row. In 2005, growth was driven by strong exports. A broadly balanced fiscal position and the fixed exchange rate have kept inflation under control. The external position has strengthened, with gross reserves rising from €700 million at end-2004 to around €1,200 (more than 4 months of imports or 25 percent of GDP) by May 2006. The recorded current account deficit fell sharply to 1.3 percent of GDP in 2005 driven by increased private transfers, though these may also capture capital account transactions.

The increase in reserves has allowed the central bank to cut interest rates. Bank credit has expanded, especially to households and in foreign currency, though from a low base and less rapidly than in the region's other countries.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

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The overall fiscal position showed a small surplus in 2005. Last year's 0.3 percent of GDP central government budget surplus was better than projected by 1 percent of GDP, reflecting continuing underperformance of ministries' Special Revenue Accounts, restraint in public employment, and procurement delays. One-off revenue developments, including the unusually high telecom monopoly dividend and advancing VAT payments by importers, also contributed.

In 2006, growth is projected to remain at 4 percent, with higher domestic demand offsetting some decline in net exports. Inflation is expected to increase to 3 percent, driven by supply factors, including higher tobacco taxes and oil prices. The official current account deficit is projected to widen to 3 percent of GDP due to higher oil prices, lower interest rates stimulating imports, and some slowing in last year's increase in private transfers.

Despite recent progress, structural weaknesses constrain the economy's ability to increase employment and achieve more rapid output growth. Recorded unemployment in 2005 reached 35 percent, one of the highest in the region, as employment has barely increased since 1995. Levels of financial intermediation and the stock of foreign direct investment remain low. Macedonia ranked poorly in international comparisons of the business environment due to high costs of opening and closing a business, hiring and laying off workers, and enforcing contracts. Property rights are poorly defined with the land cadastre incomplete, the tax wedge on labor remains high, and telecommunications services are expensive. The government has amended the constitution and passed new laws to introduce comprehensive judicial reform, yet implementation has just started.

Executive Board Assessment

Executive Directors commended the Macedonian authorities for their sound macroeconomic policies which, after a decade of sluggish growth, have now started to deliver economic recovery. Inflation has remained under control, the current account deficit has narrowed, international reserves have increased, and the fiscal position is sound.

Directors noted that, despite these successes, considerable challenges lie ahead. These include raising living standards closer to European levels, reducing unemployment, and keeping the current account deficit under control. Directors stressed that the best way to meet these challenges would be by maintaining the country's hard-won macroeconomic stability, and accelerating structural reforms.

Directors viewed the 0.6 percent of GDP fiscal deficit target as one of the anchors of macroeconomic stability. They cautioned that loosening the fiscal stance would be premature in view of uncertainties about the current account's true size, medium-term fiscal challenges, and the limited institutional capacity in line ministries to spend additional funds efficiently. Rationalization of the public sector should be undertaken before spending increases are envisaged. Going forward, Directors also encouraged efforts to strengthen the fiscal revenue base and reduce nondiscretionary spending.

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Directors considered that the exchange rate peg is appropriate given the Macedonian economy's size and openness, and its limited international financial market integration. The peg has kept inflation low, and, although there are structural weaknesses in the economy, price competitiveness and the level of the exchange rate seem broadly satisfactory. Directors considered it important to continue to strengthen the central bank's policy instruments. They welcomed the central bank's recent interest rate cuts, but with euro-area rates higher and the need to see the effects of the cuts on credit and the real economy, a pause now seems appropriate.

Directors stressed the importance of structural reforms for accelerating growth. Institutional reforms, ranging from judicial reform and improving public governance to market liberalization and privatization, will be essential to developing a functioning market economy. Reducing the very high unemployment rate should be a priority, and can be achieved through active labor market policies, reducing the tax wedge, and eliminating barriers to part-time employment. Financial market development is also needed, notably to lower intermediation costs, improve the credit culture, and enhance banking supervision. Such reforms would boost investment and employment, strengthen total factor productivity, and increase Macedonia's attractiveness for foreign direct investment. Directors noted that although these tasks are immense, so too are the potential rewards, and they encouraged the authorities to implement these reforms expeditiously.

Macedonia's provision of data to the Fund is broadly adequate for surveillance purposes. Directors nevertheless underscored the need for continued efforts to improve the quality and coverage of statistics, including in the area of fiscal transparency.

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