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Former Yugoslav Republic of Macedonia: Second Review Under the Stand-By Arrangement and Ex Post Assessment of Performance Under Fund-Supported Programs—Staff Report; Staff Supplement; Ex Post Assessment of Longer-Term Program Engagement—Staff Report; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Former Yugoslav Republic of Macedonia

In the context of the second review under the Stand-By Arrangement and ex post assessment of performance under Fund-supported programs with the Former Yugoslav Republic of Macedonia, the following documents have been released and are included in this package:

- the staff report for the second review under the Stand-By Arrangement and ex post assessment of performance under Fund-supported programs, prepared by a staff team of the IMF, following discussions that ended on **February 19, 2004,** with the officials of the Former Yugoslav Republic of Macedonia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on July 20, 2004.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff supplement of **July 27, 2004** updating information on recent economic developments.

- a staff report on ex post assessment of longer-term program engagement, which was completed to **July 22, 2004**.

- a Public Information Notice (PIN) and Press Release summarizing the **views of the Executive Board as expressed during its August 2, 2004 discussion** of the staff report that concluded the review of performance under Fund-supported programs and the review under the IMF arrangement, respectively.

- a statement by the Executive Director for the Former Yugoslav Republic of Macedonia.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Second Review Under the Stand-By Arrangement and Ex Post Assessment of Performance Under Fund-Supported Programs

Prepared by the European Department
(In consultation with other departments)

Approved by Susan Schadler and Donal Donovan

July 20, 2004

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ABBREVIATIONS AND ACRONYMS

AML	Anti-Money Laundering
EPA	Ex Post Assessment
ERM II	Exchange Rate Mechanism II
EU	European Union
FDI	Foreign Direct Investment
HIF	Health Insurance Fund
NATO	North Atlantic Treaty Organization
NDA	Net Domestic Assets
NIR	Net International Reserves
NBRM	National Bank of the Republic of Macedonia
PC	Performance Criterion
PFA	Peace Framework Agreement
PRO	Public Revenue Office
ROSC	Report on Observance of Standards and Codes
SBA	Stand-By Arrangement
STA	Statistics Department
USAID	U.S. Agency for International Development
VAT	Value-Added Tax

Executive Summary

Political stability and sound macroeconomic policies have provided the basis for an economic recovery, but growth remains fragile and a persistently wide external current account deficit is a cause for concern. Growth is still narrowly based and dependent on a few key exports. The prospect for broad-based, sustained, growth is clouded by structural disincentives to investment. Inflation remains in the low single digits, kept in check by FYR Macedonia's de facto peg to the euro.

Against this background, the authorities have achieved the main objectives of the program—to regain a sustainable fiscal position—and have met most of the end-March program targets. The exceptions were breaches that did not undermine the objectives of the program, were small in size, or have now been corrected. The staff recommends that the review be completed.

Weak fiscal management in 2003 led to a stop-go expenditure pattern: significant underspending early in the year and a burst of spending at the end. The NBRM reacted by allowing the interest to come down substantially when the budget was tight but was slow to raise rates when the fiscal position loosened. The resulting speculation against the denar led to a significant outflow of reserves at year-end.

For 2004, the authorities have maintained the overall macroeconomic targets that were set during the first program review. This entailed easing the fiscal stance and raising the interest rate compared with the 2003 outcomes. The new policy mix appears to strike an appropriate balance between supporting growth and protecting balance of payments objectives. As in 2003, spending has been low in the first half of 2004, which will make careful expenditure management necessary in the second half. The NBRM may need to raise the interest rate further as spending rises; the Ministry of Finance needs to avoid allowing an other end-year burst of spending.

As indicated in the ex post assessment that accompanies this staff report, attention must now turn to addressing structural issues. The option of changing the exchange rate regime needs to be considered**.** In the banking sector, supervision has to be strengthened further to address risks arising from the high level of euroization. Fiscal risks arising from the poor planning of major reforms in public sector employment need to be addressed early. Finally, in order to improve the business climate, which is stifling investment, the authorities need to press ahead with implementing the Peace Framework Agreement (PFA), with reforming the judiciary and the labor market, and with measures to improve governance. A long-delayed reform of the health sector will be an important test of the authorities' commitment to fight corruption and improve basic social services.

I. Introduction

1. **Staff teams visited Skopje during October 29-November 19, 2003, February 4-19, 2004, and May 19-20, 2004 to discuss, respectively the 2004 budget, the second program review, and the ex post assessment.**[1] On April 30, 2003, the Executive Board approved a 14-month SBA for SDR 20 million, or 29 percent of quota (25 percent on an annual basis). The arrangement was extended to August 15, 2004, after the accidental death of President Trajkovski slowed program implementation and delayed the discussion of the ex post assessment. To date, three tranches of SDR 4 million each have been purchased; the two remaining tranches will become available upon completion of this review. The authorities have indicated an interest in a successor arrangement.

2. **The key objective of the program—to regain a sustainable fiscal position after the 2001 security crisis—has been achieved and most end-March program targets were met, although two structural benchmarks and two indicative targets were breached (Table 1 and Appendix I).**[2] In the staff's view, the breaches need not stand in the way of review completion (Box 1).

3. **The accidental death of President Trajkovski in February was handled calmly, and the subsequent presidential election was conducted without major incident.** The election resulted in a consolidation of the ruling coalition's power: the Prime Minister, Branko Crvenkovski, won the presidency and a new government was formed by the Minister of the Interior, Hari Kostov. Most ministers from the previous government kept their portfolios. In an unrelated development, the term of the NBRM Governor ended on May 22; Petar Gošev, a former Minister of Finance, was appointed to the post.

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[1] The staff teams comprised Mr. Rozwadowski (head), Ms. Dieterich, Ms. Ribakova, and Ms. Tuladhar (all EUR), and Mr. Loko (PDR) (for the February mission). Mr. Lane (PDR) and Mr. Rozwadowski discussed the ex post assessment. The missions were assisted by the Resident Representative, Mr. Ross, and met the Prime Minister, key economic ministers, and the Governor of the NBRM. The mission also met labor leaders, the leaders of some political parties and representatives of the international community.

[2] Several end-December 2003 targets, including performance criteria, were also breached but waivers are not needed because end-March 2004 data now govern this review.

Box 1. Program Targets

Most end-March targets were met. The exceptions were breaches that did not undermine the objectives of the program, were small in size, or have now been corrected:

- **Health sector retrenchment (structural benchmark).** While the benchmark was a cut of 1,240 positions by end-March 2004, (900 positions as a prior action for the first review and another 340 by March), only 1,160 positions have been eliminated.

- **General government deficit in the 2004 budget (structural benchmark).** The 2004 budget presents a general government deficit equivalent to 1.4 percent of GDP, not 1¼ percent as agreed in the program. The staff supported this change, which allowed the Road Fund to bring a donor-financed project, delayed in 2003, back on schedule. The increase is more than offset by cuts in borrowing for other capital spending. (The benchmark was set on a definition of general government which includes the Road Fund but excludes some donor-financed projects that are difficult to monitor.)

- **Clearance of VAT refund arrears by end-March 2004 (indicative target)**. The stock of arrears, which was denar 933 million at end-June 2003, still stood at denar 133 million at end-March 2004. By end-May, the stock had been reduced to denar 40 million. The arrears still outstanding, which are very old, are being verified and cleared. Verification is taking time because the Public Revenue Office's (PRO's) database is weak. Nonetheless, the PRO expects to complete the process by end-September 2004.

- **Net Domestic Assets (NDA) of the banking sector (indicative target).** The target was breached in March by 0.2 percent of GDP. The breach was smaller by two-thirds than in December 2003: this improvement was in part the result of a tightening of monetary policy in February.

4. **Progress toward political stabilization continued in 2004 but the implementation of the Peace Framework Agreement (PFA) suffered further delays.** Preparations for decentralization (a key component of the PFA), already well behind schedule, were delayed further by a parliamentary recess after the President's death. The international community is pressing the authorities to enact the necessary—but highly controversial—legislation in the summer so that local governments can start work in 2005. Another key element of the PFA, hiring "nonmajority" individuals in order to redress ethnic imbalances, is being implemented sporadically but is broadly on track as regards overall numbers.

5. **The authorities' intention to join the EU and NATO—a key government priority—has begun to influence policy decisions.** FYR Macedonia submitted a formal application for EU candidacy in March 2004. Admission to candidacy is likely to take some time and accession is years away, but the *aquis communautaire*, Maastricht criteria, and ERM II rules have already begun to influence the pace and direction of economic reforms. The government has also begun to restructure the army in order to meet standards for NATO accession.

II. Background and Near-Term Prospects

6. **Growth has picked up in spite of a significant fiscal retrenchment in 2003, but the recovery was narrowly-based and constrained by the inhospitable business climate.** Macroeconomic developments to date have been broadly in line with program targets (Text Table 1, Table 2):

- The **growth** pickup in 2003 was fueled by strong household consumption and boosted by the reopening of a major steel exporter. Growth is projected to accelerate slightly in 2004 but remains dependent on the performance of a few key exports, notably steel and textiles. Recent floods in agricultural regions and a first quarter decline in industrial production have introduced downside risks to the projection. For the medium term, the outlook for broad-based and sustained growth is clouded by structural disincentives to investment: a weak judiciary, inflexible labor market institutions and weak governance.

Text Table 1. Macroeconomic Indicators (2002-04)

	2002	2003		2004	
	Act.	1st. Rev.	Actual	1st. Rev.	Rev. Proj
Real GDP growth	0.9	2.8	3.1	3.0-4.0	4.0
Unemployment rate	31.9	...	36.7	...	...
CPI inflation rate	2.4	1.8	1.2	2.5	2.8
Current account / GDP excluding grants	-11.2	-8.5	-8.2	-8.2	-8.9

Source: Authorities; and IMF staff estimates.

- Preliminary data for the first quarter of 2004 show a **sharp decline in GDP** (3.6 percent year-on-year). However, most indicators (such as tax collection and electricity consumption) suggest that the slowdown was much less pronounced than implied by the GDP data. The government has therefore set up a working group to reassess the data. The staff intends to issue a supplement prior to the Executive Board meeting, updating the assessment of macroeconomic developments.

- Measured **unemployment**, which was already high owing to labor market rigidity and a wide tax wedge on labor, rose further in 2003.[3] High labor force entry, a loss of jobs in agriculture and mining, and the concentration of growth in non labor-intensive sectors all contributed to the rise.

- **Inflation** remains in the low single digits, anchored by the de facto peg of the denar to the euro. The inflation rate dipped to an exceptionally low 1 percent in 2003 and early 2004 owing to a decline in food prices and the strength of the euro (Figure 3). To date

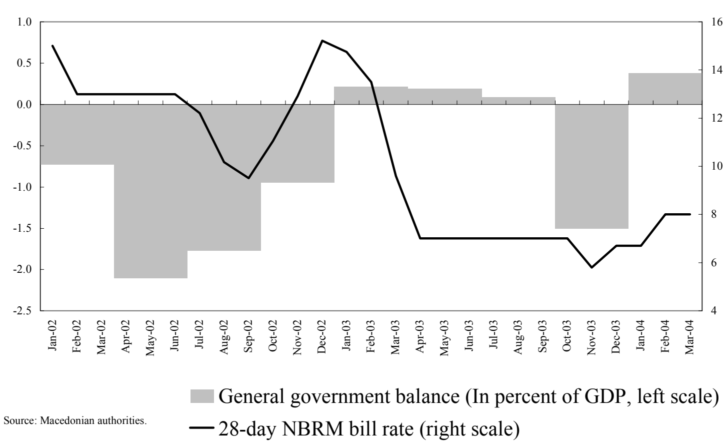
[3] Measured unemployment is inflated by workers in the "grey economy" who register as unemployed to receive health care benefits.

inflation in 2004 has been below the annual projection (2.8 percent). While food prices are expected to pick up owing to recent floods, inflation could turn out lower than projected.

- The external **current account deficit,** while still wide, narrowed significantly in 2003 thanks to the tightening of fiscal policy. FDI, which is low by regional standards, financed only about one-fourth of the deficit (Figures 1 and 5). Donor support and private debt-creating flows more than covered the rest, raising gross international reserves to a comfortable four months of imports by year-end. In 2004, the current account deficit is expected to widen, mostly because of government investments with a high import content. A slight decline in the import coverage of international reserves is projected for the year.

7. **In the fiscal area, program targets were met by large margins in 2003 but poor expenditure management and budget planning led to a see-sawing of demand.** Spending was very low in the first three quarters, then ballooned in the final quarter when the rebalanced budget let ministries shift surplus funds to expenditure categories where funding was short. The sharp swings in expenditure, and an abrupt relaxation of the tax effort in the fourth quarter produced destabilizing swings in the deficit (Text Figure 1). This stop-go cycle threatens to recur in 2004, since low spending and a renewed tax effort have produced a first-quarter fiscal surplus and set the stage for a second-quarter surplus as well.

Text Figure 1. Interest Rate and Fiscal Balance
2002-04



Source: Macedonian authorities.

8. **The NBRM cut the interest rate drastically when the fiscal stance tightened in early 2003 but did not react in a timely way to the spending hike in the fourth-quarter (Text Figure 1)**. The budget's injection of liquidity was thus not sterilized. The result was a large drain in foreign exchange reserves, which led to breaches of several program targets, eliminated a large NIR cushion, and sparked rumors of devaluation (Table 5). The NBRM's slow reaction resulted in part from a preference for lower interest rates and in part from insufficient advance warning of the government borrowing.

9. **The easier monetary stance in 2003, together with increased competition among lenders, contributed to strong private sector credit growth, which continues in 2004 (Table 6, Figure 4).** Improvements in the quality of loan portfolios and the strong growth of the deposit base allowed banks to lend aggressively when GDP picked up in 2003. In this

more competitive climate, banks promoted new loan products and allowed a greater-than-usual pass-through of the cut in the central bank interest rate. Another factor was an increase in mortgage lending in advance of the January 2004 hike in the VAT on real estate transactions.

III. Policy Discussions

10. **Discussions focused on policies for the program period and beyond.** The November mission reached understandings on the budget and the macroeconomic framework for 2004. The February mission focused on the implementation of the budget, an interest rate hike needed to reach end-March program targets, and the implementation of structural policies.

A. Fiscal and Monetary Policy for 2004

11. **A key policy decision in November 2003 was to maintain the overall macroeconomic framework and—with minor modifications—the 2004 fiscal targets that had been set during the first program review (Text Table 2 and Box 2).** This was not a self-evident choice. In light of the tighter-than-planned fiscal outcome in 2003, the original fiscal targets for 2004 deliver a stronger positive impulse than had been envisaged. Was this appropriate in view of an incipient economic recovery and a still-wide external current account deficit (Table 7)? The mission and the authorities agreed that it was. Although growth was picking up, there was no evidence of overheating: unemployment was rising; the external current account deficit had narrowed compared to 2002; and inflation was in check. Bank credit was increasing rapidly, but from a very low base. Debt dynamics were also benign: the projected general government deficit for 2004 was comfortably below the debt-stabilizing level.

Text Table 2. Fiscal Deficit, 2002-04 (In percent of GDP)

	2002	2003		2004	
		Prog.	Act.	Prog.	Proj.
General government balance	-5.6	-2.5	-1.6	-2.5	-2.2
General government balance (excl. foreign financed projects)	-5.6	-1.8	-1.0	-1.2	-1.4
Central government balance	-5.3	-1.4	-0.9	-0.9	-0.9

Source: Ministry of Finance; and IMF staff estimates.

Box 2. The 2004 Budget and Revised Budget

The 2004 budget reflects the government's key priorities—restructuring the army to prepare for NATO accession, hiring minorities in line with the PFA, and increasing spending on roads (to make up for delays in 2003). With tax rates unchanged, budgetary savings to make room for these expenditures include a public sector salary freeze, a 4 percent across-the-board cut in public sector employment, limits on the escalation of pensions, and the elimination of the budgetary subsidy to the Health Insurance Fund (HIF).

It was clear early on that a supplementary budget would be needed to cover policies that were decided upon too late for the budget: civil service salary decompression and additional ethnic hiring. Two items were added later on: the cost of the delay in implementing the 4 percent scale-back in public sector employment and the cost of severance packages for a World Bank-supported railway reform. The latter will widen the deficit by 0.1 percent of GDP but all other expenditure increases will be offset by cuts in recurrent spending. The authorities intend to pass the supplementary budget in September.

12. **With fiscal easing in prospect, the mission in February urged the NBRM to tighten interest rates in order to rebalance the policy mix and stem the persistent outflow of international reserves.** The outflow signaled an overly loose monetary posture and put at risk the end-March program targets for NIR and NDA as well as the end-year target for international reserves. The NBRM shared the mission's view and raised the interest rate on 28-day central bank bills by 125 basis points. The Ministry of Finance objected vigorously on the grounds that this hike might raise the cost of borrowing on the new treasury bill market and slow the economic recovery by driving up commercial banks' lending rates.

13. **In the event, the interest rate hike, combined with a tighter-than-anticipated fiscal stance in the first half of the year, had the desired effect.** International reserves flowed in for the first time in five months and the end-March program targets for NIR and NDA were met. Commercial banks did not raise lending rates (Figure 4). The staff has emphasized to the authorities that when the fiscal position turns more expansionary later in the year the NBRM will need to consider further increases in the interest rate.

14. **The mission also discussed the strong growth in M3 and private sector credit (Figure 4).** This reintermediation reflects a return of confidence in banks. While denar deposits increased faster than GDP, much of the increase in M3 was in foreign currency deposits (Table 10). Households deposited "mattress money," and enterprises deposited export proceeds, taking advantage of the more liberal foreign exchange law. As regards bank credit, the strong growth in lending has not caused, to date, a deterioration of loan portfolios, but makes it necessary for supervisors to monitor asset quality carefully and to increase their capacity to analyze new loan products.

B. Budget Implementation and Medium-Term Risks

15. **Fiscal discussions in February focused on budget implementation and the future impact of reform initiatives underway.**

16. **On revenues, a sharp drop in VAT collection at end-2003 put tax administration in the spotlight in February, but collection has subsequently picked up and is now on track.** The authorities attributed the decline in collection to an abrupt relaxation of the tax effort, which have been corrected by replacing the management of the Public Revenue Office's (PRO). As of May, VAT was well ahead of program projections while other taxes were broadly on track, except for the corporate income tax, which is running slightly behind projections. Looking ahead, the PRO is taking steps to strengthen collection further.

17. **On expenditures, budget implementation was set back in January when most ministries stonewalled a government-approved plan to prune public sector employment by 4 percent across the board.** The episode reflects weak ownership as well as poor government discipline. The government introduced a revised plan, under which the retrenchment would be effected by a combination of layoffs—to be completed prior to the current program review—and natural attrition, through the year. The revised plan is a second best: it provides little scope to rationalize employment by selecting non-essential positions for elimination. However, the revision does not reduce the long-term fiscal impact of the retrenchment; for 2004 the fiscal impact of the modification is small and will be reflected in the supplementary budget. The agreed layoffs have now been completed, if at times in a non-transparent way.[4]

18. **The successful launch of a Treasury bill market early in 2004 was an important first step to reducing the government's dependence on external finance and privatization receipts.** The volume of placements was initially smaller than hoped, owing to inadequate promotion and the absence of a secondary market, but more recent auctions have been oversubscribed. The introduction of a secondary market is underway, after a slow start. Once secondary trading picks up, the Ministry of Finance should move into longer maturities.

19. **Turning to medium-term issues, the mission urged the authorities to limit the impact on the public sector wage bill of three multiyear reforms now underway (Box 3)**. The mission supports the reforms—civil service salary decompression, the hiring of ethnic minorities, and administrative decentralization—but noted that too little attention has been paid to phasing, to the interactions between the reforms, and to limiting their cost. Each of the reforms could lock in significant costs that would prove difficult to claw back in future. For the moment, the mission urged the authorities to refrain from further initiatives until

[4] For example, one Ministry (acting without informing the Ministry of Finance) signed an agreement to purchase services from laid off workers and allow them to use government premises and equipment without remuneration. When staff questioned this practice, the Ministry clarified that it did not intend to carry out the agreement which, indeed, was not consistent with the Law on Public Procurement.

overall public sector employment and wage policies had been assessed in a comprehensive multiyear framework.

Box 3. Budget Risks Associated with Public Sector Reforms

Three major public sector reforms under way present risks for the budget:

- In April 2004 the authorities began to implement a World Bank-supported program to **decompress civil service salaries**. Decompression will be achieved mainly by increasing the salaries of senior personnel, raising the average salary by about 20 percent. The fiscal impact in 2004 is small because the decompression will be phased in over three years and applies only to civil servants (12,000 of the 70,000 public sector employees). But Fund staff (and the authorities) are concerned that the wage increases could spill over to political appointees (numbering about 1,000) and to the wider public sector.

- To date the PFA-mandated **hiring of ethnic minorities** has been episodic. The cost has been modest, but most of the hiring still lies ahead: the authorities intend to increase the share of ethnic Albanians in the public sector—now 13 percent—by about 10 percentage points. The authorities need to prepare a multiyear plan that uses natural attrition and further rationalization to achieve equitable representation while controlling the wage bill.

- PFA-mandated **government decentralization** will start with the creation of new municipal governments in 2005. An effort will be needed to limit the duplication of positions and to exploit synergies with minority hiring. FAD has provided technical assistance on fiscal decentralization; while some FAD advice has been taken on board, key recommendations on municipal borrowing and on an equalization fund have not. At this stage, it is critical that public expenditure management capacity be created in the new municipalities before further spending responsibilities are devolved.

C. Financial Sector Issues

20. **In view of the euroization of the banking system and the upsurge in foreign currency lending, tough supervision of exchange rate risks is a priority.** A good start has been made. The NBRM has introduced on-site supervision procedures that incorporate borrowers' exchange rate exposure in commercial banks' credit risk assessment (structural PC) and has asked the Fund to help train supervisors in assessing exchange rate risks. In addition, the NBRM has put in place more detailed reporting requirements for banks in order to monitor the composition and time structure of foreign currency assets and liabilities.

21. **In other areas progress has been mixed.** The banking system is still anchored by large banks that appear stable, but little progress has been made in addressing the weaknesses of a few (small) banks under enhanced supervision.[5] On governance, a bank partly owned by a political party (in violation of the law) has been sold, but the strategic investor is not a first-

[5] One small bank was closed, in an orderly manner, but after significant delay and at a high cost to the NBRM which had pledged assets to guarantee certain liabilities of that bank.

tier bank. On the positive side, the NBRM has started to supervise money transfer houses (structural benchmark) and amendments strengthening the Anti-Money Laundering (AML) law have been sent to parliament. However, the implementation of AML measures remains poor because of limited administrative resources.

D. Structural Policies

22. **While progress has been made in improving some aspects of the business climate, the most critical reform—that of the judiciary—is only now starting.** The new government has made judicial reform a high priority, but plans for a comprehensive reform supported by the World Bank and drawing on expertise financed by USAID are at an early stage. In other areas, steps taken so far to improve the business climate include the establishment of an internal audit unit in the PRO (structural benchmark), the liberalization of the tobacco sector (structural benchmark), and the enactment of the company law.[6] In addition, the World Bank and USAID are working with the government on measures to enforce the application of international accounting and audit standards.[7]

23. **In the health sector, only limited progress has been made in cutting costs, increasing transparency, and improving governance.** World Bank-supported reforms, particularly the introduction of open, competitive tender procedures, have been subject to delays. Implementation of Fund-supported measures has also been mixed:

- The HIF has lived within the **financial envelope** agreed in the program: the budget transfer was cut to zero in 2004 (from 0.2 percent of GDP in 2002-03) and liabilities of the HIF (loans plus arrears) remain at the end-2002 level in line with the spirit of the program benchmark.[8]

- In view of the **inadequate reporting of the HIF,** it is not possible at this stage to assess definitively whether the financial adjustment so far is sustainable. However, pending measures—notably the use of international tenders—should generate further savings.

- On **employment policy,** the layoffs fell slightly short of the agreed number (structural benchmark).

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[6] The law strengthens minority shareholders' rights, tightens the regulation of conflict of interest, and facilitates company registration by introducing a "one-window" system.

[7] The World Bank also intends to address administrative and regulatory barriers to business and to assess the need for labor market reforms.

[8] The benchmark was set on arrears, but staff focused on total liabilities after learning that the HIF had borrowed from banks in violation of its statute.

- To **improve tracking of financial flows**, the Ministry of Finance has taken steps to transfer the HIF's account balances into the Treasury Single Account.[9] HIF resistance could delay implementation beyond the September target date.

- **HIF audit.** As agreed, the findings of the State Audit Office's financial audit, which includes critical remarks on inefficiency and fraud, have been published.

The weakness of the reform effort in the health sector mainly reflects weak oversight and conflict of interest on the HIF's board.

IV. Program Monitoring

24. **Severe problems with data quality made it necessary to correct the reported outcomes of several performance criteria and indicative targets.** The most important correction was to repair an omission: borrowing by the HIF had been reported neither by the HIF itself nor by the lending banks.[10] Owing to wide overperformance margins, the PCs for June and September were still met after the corrections, which did not give rise to noncomplying purchases.

25. **The authorities agreed on measures to improve the data submitted to the Fund.** The coverage of HIF borrowing has been corrected in banks' reports to the NBRM; the coverage of HIF arrears has been strengthened; responsibilities for data compilation have been consolidated at the NBRM; and the PRO is revamping its data management system. More broadly, a fiscal transparency ROSC is planned for early 2005, and the authorities requested technical assistance from the STA based on the findings of a recent statistics ROSC.

26. **The elimination of VAT refund arrears, which was to have been a performance criterion, is treated in this report as an indicative target because it was inadvertently omitted from the relevant Board decision.** The target was in fact missed, so a waiver would have been needed. Staff would have supported a waiver request because the authorities have now cleared nearly all arrears and provided an explanation of the delay (see Box 1).

27. **All the core recommendations arising from FYR Macedonia's safeguards assessment have been implemented.**

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[9] The transfer is also part World Bank PSMAL conditionality.

[10] Other, smaller, corrections affected privatization revenues, non-bank domestic amortization, domestic credit to the government, and foreign financing.

V. Ex Post Assessment

28. **In its ex post assessment (EPA), the staff found that FYR Macedonia's IMF-supported macroeconomic stabilization had been successful while the implementation of structural reforms had been weak. In view of this experience, the EPA identified two possible circumstances in which further program engagement could be beneficial.** First, a major push to implement ambitious medium-term structural reforms, showing a greater commitment to reform than before, could merit Fund support. Given the time needed, support for such reforms could best be provided through an extended arrangement. Second, in the absence of major structural reforms, an SBA could support a change in the exchange rate regime should that be viewed as necessary given increased capital mobility.

29. **The authorities broadly agreed with the assessment but felt that Fund-supported programs had produced greater benefits than were recognized in the report.** They stressed that the programs, and the associated conditionality, had buttressed political forces favoring reform. Thus, while progress on the structural side may have been slow it would have been slower still without the presence of a Fund-supported program. They also emphasized that some donor financing was still explicitly contingent on the existence of a Fund arrangement.[11] Consequently, the authorities did not wish to restrict the circumstances in which a successor arrangement would be desirable.

30. **The authorities shared staff's view that a new program should give prominence to structural reform and possibly to the exchange rate regime.** They emphasized that the new government had a mandate, and the intention, to move ahead with difficult and politically costly structural reforms. On the robustness of the peg, the NBRM's view was that in the near term pressures arising from volatile, short-term capital flows would be modest and easily contained by existing administrative impediments or by domestic interest rate movements. In any event, the NBRM felt that further analysis was needed to determine the timing of any regime change and saw the need for further capacity building with Fund support. In considering the alternatives, the authorities did not wish to pursue the possibility of a currency board arrangement, which they felt would send an adverse and misleading signal.

VI. Staff Appraisal

31. **The recent slowdown in FYR Macedonia's growth and the wide external current account deficit are both cause for significant concern.** FYR Macedonia's lackluster productivity growth, its continued dependence on a short list of export products, and its rising imports—largely of consumption goods—underscore the risk of a future with slow growth and persistently large current account deficits. What is needed now is steady macroeconomic

[11] The staff noted that assessment letters could be an alternative signaling device.

management and structural reforms bold enough to transform the business and investment climate.

32. **By restoring fiscal sustainability, the authorities have achieved the core goal of the program; the challenge now is to ensure that upcoming fiscal reforms do not reverse this achievement.** If well implemented, these reforms—fiscal decentralization, equitable representation of ethnic groups in public employment, and salary decompression—can contribute to political stability and more effective government. Otherwise, they could weaken administrative capacity and increase costs. Success will require more forward planning, and more attention to medium-term costs than has been evident to date.

33. **The fiscal position in 2004 strikes an appropriate balance between growth and balance of payments objectives.** The stimulus delivered by the 2004 budget is not inappropriate in view of the high unemployment and evidence of a growth slowdown. And public investment programs need to be put back on track. But a still more relaxed fiscal position would not be advisable, given the wide external current account deficit. The staff therefore welcomes the authorities' commitment to keep the fiscal framework in place when preparing a supplementary 2004 budget.

34. **The authorities should avoid repeating in 2004 the stop-go outcome that marred the 2003 budget execution.** The end-year burst of spending in 2003 weakened the budget process and provoked speculative outflows of foreign exchange. In light of the underspending in the first half of 2004, there is a risk that the stop-go pattern will be repeated. To prevent this, the authorities should take immediate steps to strengthen budget planning and expenditure management. In any event they should refrain from another end-year spending spree, even if this restraint means lower-than-budgeted spending.

35. **In managing monetary conditions, the NBRM should not again react too slowly when financial market conditions call for higher interest rates.** In view of the robust growth in private sector credit and a likely increase in government borrowing in the months ahead, the central bank may need to increase the interest rate further in order to keep foreign exchange reserve cover at a comfortable level. Its readiness to do so will be a test of the NBRM's independence.

36. **The rapid growth of bank deposits and bank credit signals a return of confidence in banks, but also highlights the need to strengthen bank supervision.** Since financial euroization is already deep and much of the new lending is in or indexed to foreign currency, recent steps to strengthen supervision of the exchange rate exposures of banks and their clients were welcome, but these initiatives need to be carried forward by providing further training for supervisors and developing the capacity to analyze the more detailed information on foreign currency exposures that banks now provide.

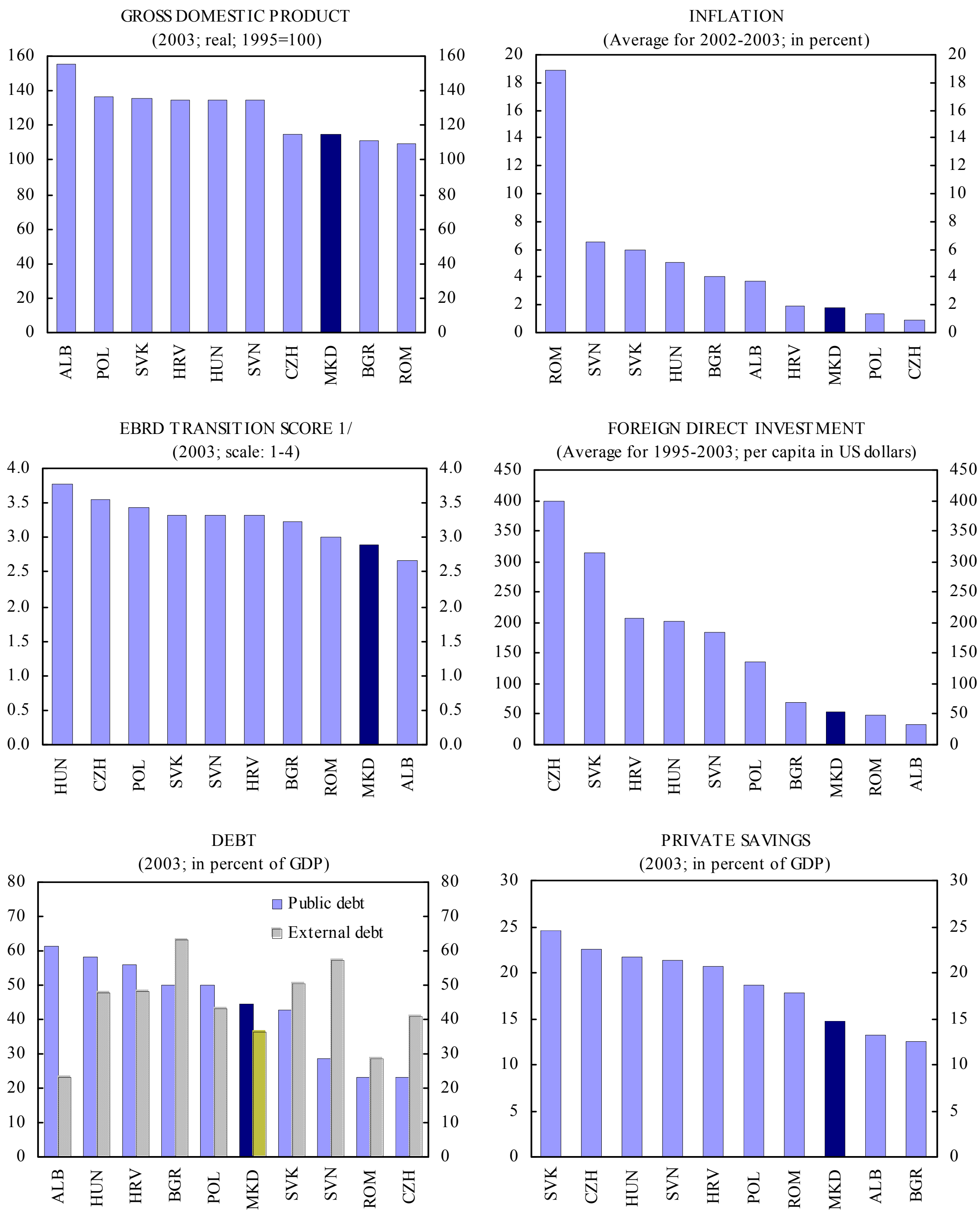
37. **Although the de facto peg to the euro continues to serve FYR Macedonia well, the exchange rate regime needs to be kept under review.** The peg has anchored both monetary and fiscal policy, and its robustness during several crises has lent it credibility. While exposure to volatile shifts in sentiment by foreign investors–which would weigh on the side of modifying the exchange rate regime–is not expected to become an issue in the near future, recent movements in foreign currency-denominated bank assets and liabilities underscore that shifts by domestic investors may be important. As proposed in the EPA, the staff encourages the authorities to make their decision on the exchange rate regime from a position of strength and stands ready to provide such technical support as the authorities may need.

38. **With the successful implementation of this program, FYR Macedonia's post-crisis financial stabilization is complete, but the inhospitable business climate is still stifling growth.** Improving the business climate poses two major challenges. First, to press ahead and implement the PFA. This must be done quickly, to regain momentum after lengthy delays. It must also be done well or else the reform will be costly and counterproductive. Second, to move ahead with structural reforms. As indicated in the EPA, key reforms include strengthening the judiciary, reducing tax and institutional disincentives for employment, and improving governance and public sector management. The delays and non-transparency that have marred the ongoing public sector retrenchment suggest that the authorities are still hesitant to take politically difficult measures.

39. **A reform of the HIF will be an important test of the authorities' commitment to fight corruption and improve basic social services.** While there is some evidence of progress in fighting corruption in the public sector, governance at the HIF remains weak and has contributed to non-transparency, high costs and mismanagement.

40. **Since all performance criteria have been met, and since the objectives of the program have been reached, the staff recommends that the second review under the SBA be completed.**

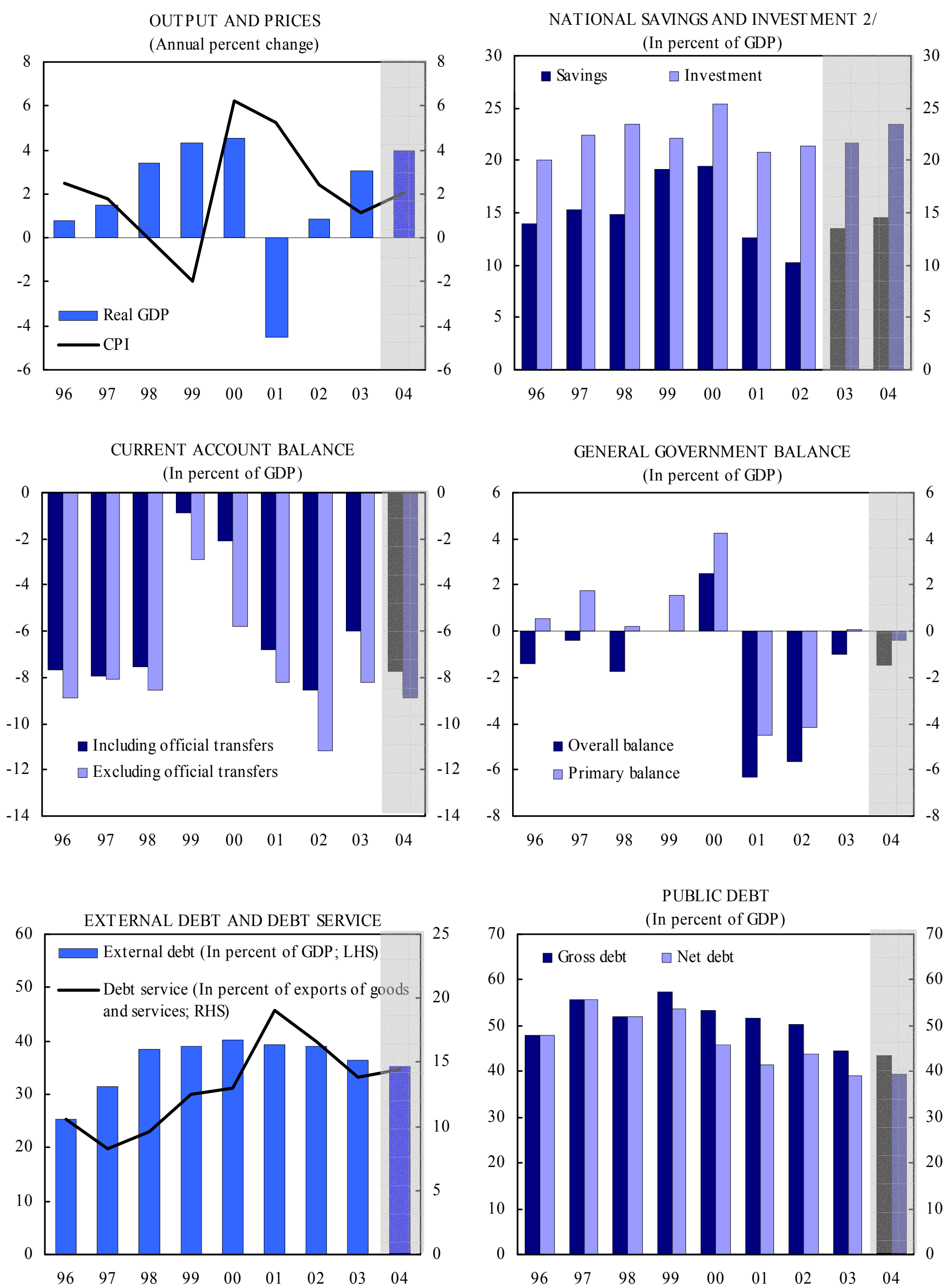
Figure 1. Cross-Country Comparison of Selected Economic Indicators



Sources: EBRD Transition Report 2003; and World Economic Outlook.

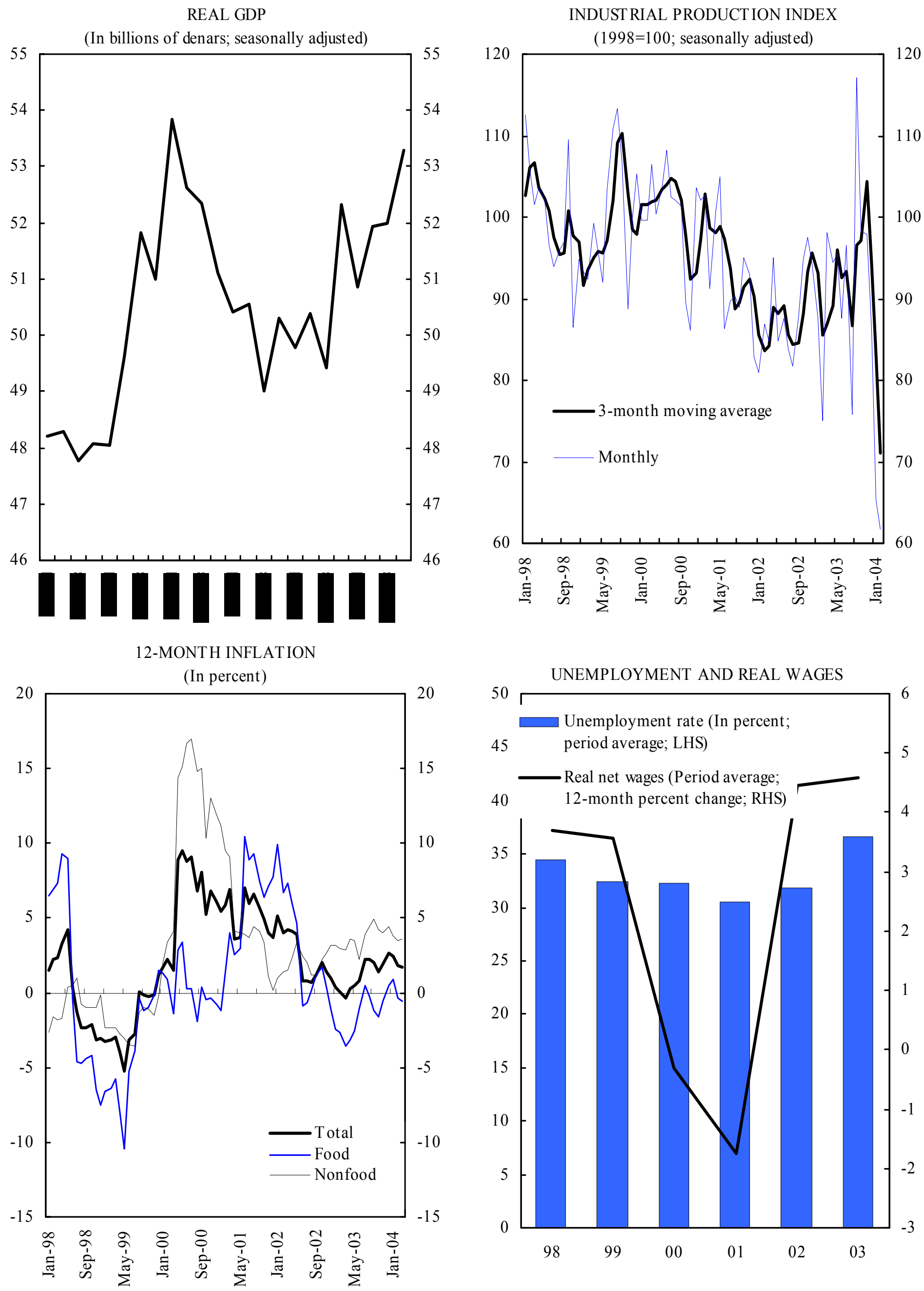
1/ Average of EBRD index scores across various measures of transition including liberalization, privatization, enterprise reform, infrastructure, financial institutions, and legal environment.

Figure 2. FYRM: Selected Economic Indicators, 1996-2004 1/



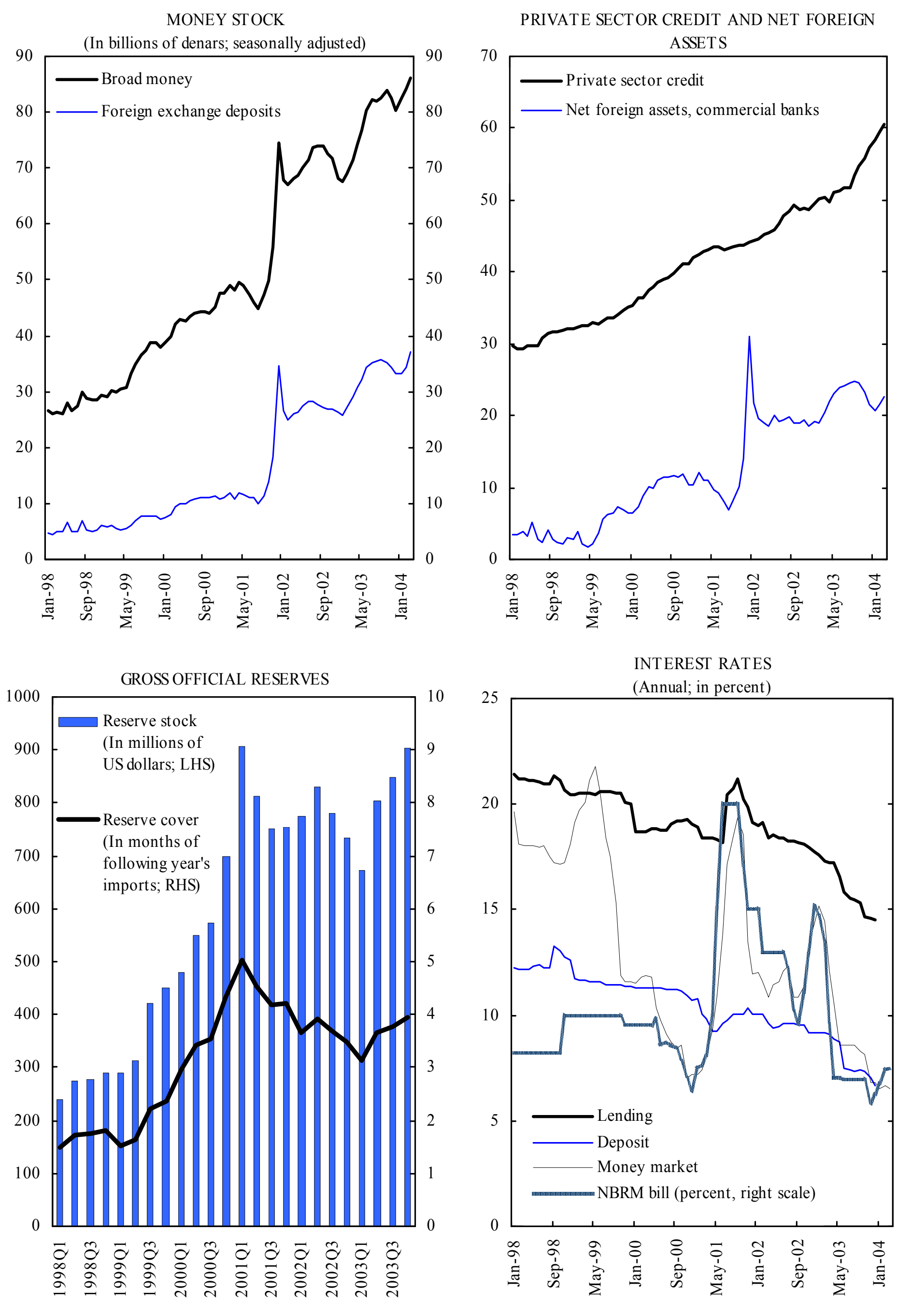
Sources: Macedonian authorities; and Fund staff estimates.
1/ 2004: Fund staff projections.
2/ 2003: Fund staff estimates.

Figure 3. FYRM: Real Sector Developments, 1998-2004



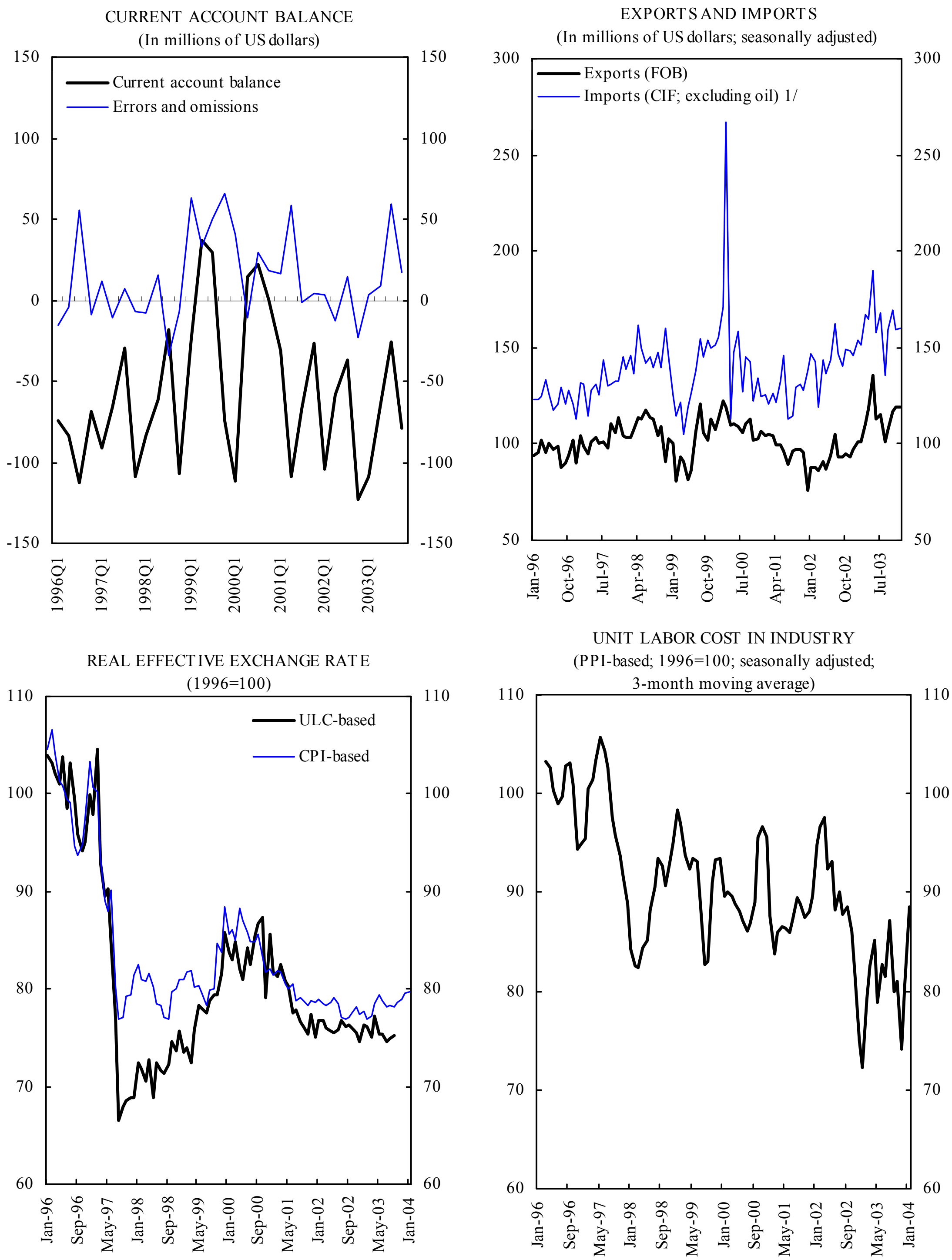
Sources: Macedonian authorities; and Fund staff estimates.

Figure 4. FYRM: Monetary and Financial Indicators, 1998-2004



Sources: Macedonian authorities; and Fund staff estimates.

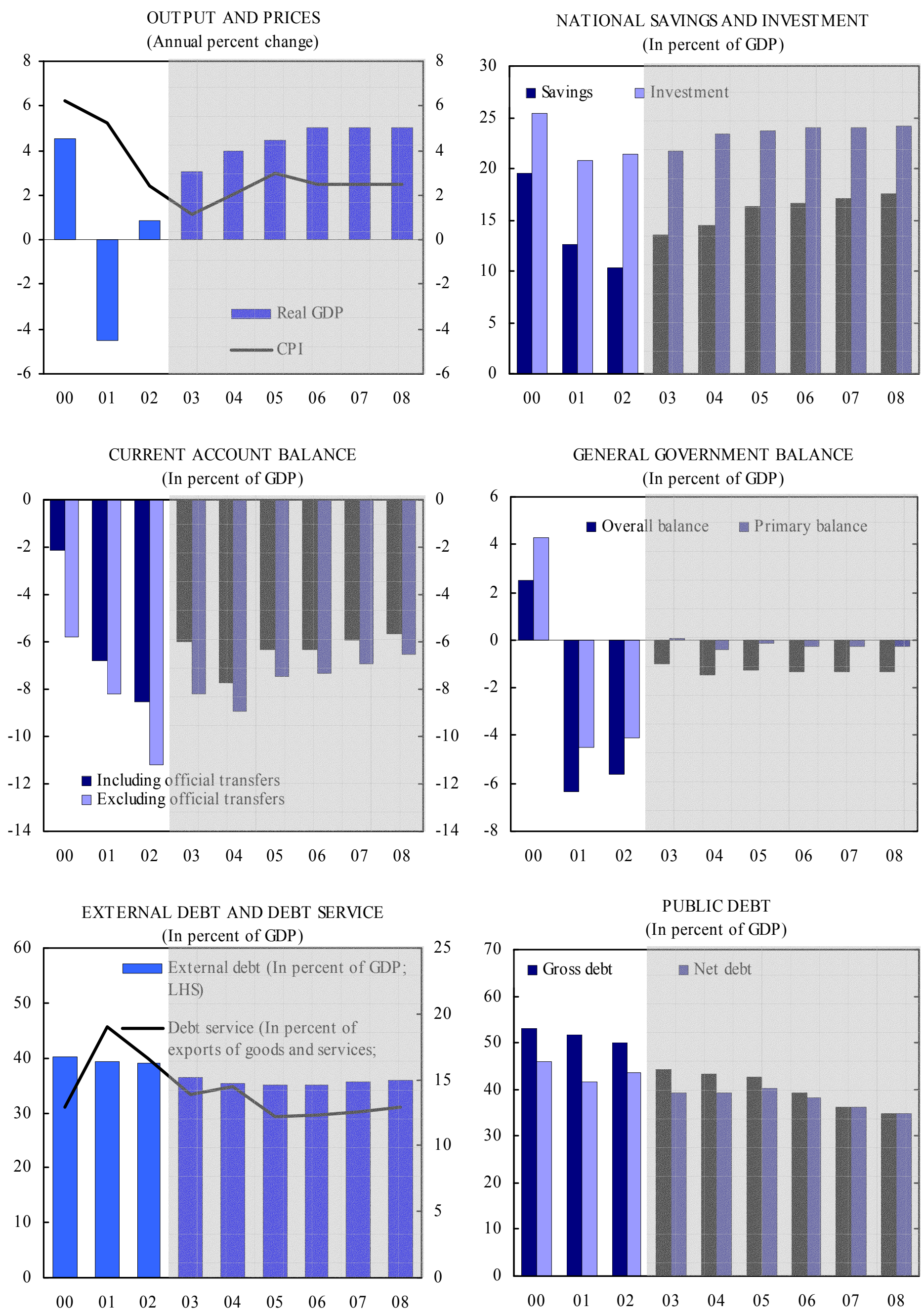
Figure 5. FYRM: External Sector Developments and Competitiveness, 1996-2004



Sources: Macedonian authorities; and Fund staff estimates.

1/ A sharp increase in imports took place prior to the introduction of the VAT in March 2000.

Figure 6. FYRM: Recent Developments and Medium-Term Projections, 2000-2008 1/



Sources: Macedonian authorities; and Fund staff estimates.
1/ 2003 onward: Projections.

Table 1. FYRM: Quantitative Performance Criteria and Indicative Targets for 2003 and Q1 2004 1/

	2002	2003																			2004			
	Actual	End-Mar.				End-Jun.					End-Sep.					End-Dec.					End-Mar.			
		Indic. Target	Indicat Adj. T.	Actual	Perf. margin	Prog. PC	Adjuste PC	Unadju actual	Actual	Perf. margin	SBA orig. PC	1st Rev revised PC	Adjuste PC	Actual	Perf. margin	SBA orig. PC	1st Rev revised PC	Adjuste PC	Actual	Perf. margin	1st Rev PC	Adjuste PC	Actual	Perf. margin
		(Cumulative changes since end-December 2002)																						
		(In millions of U.S. dollars)																						
	End-year stocks																							
Floor for net international reserves of the NBRM	654	-80	-73	-63	10	-16	-26	25	-16	10	-52	-30	-44	34	78	1	2	8	28	20	8	35	44	9
Ceiling on new nonconcessional medium- and long-term external debt contracted or guaranteed by the general government or the NBRM with original maturities of more than 1 year	...	0	0	0	0	25	25	0	0	25	210	210	210	41	169	250	250	250	198	52	250	250	198	52
Of which : with maturities of 1–5 years	...	0	0	0	0	0	0	0	0	0	30	30	30	0	0	30	30	30	0	30	30	30	0	30
Ceiling on short-term external debt of the general government or the NBRM with maturities of up to 1 year (stock); including guarantees for such debt	... 0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Accumulation of external payments arrears on a continuous basis	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
		(In millions of denars)																						
Ceiling on net domestic assets of the NBRM	-25,002	3,154	2,129	459	1,670	-67	594	...	-796	1,390	2,174	98	200	-2,641	2,841	752	129	-719	-560	-159	-674	-1,542	-2743	1201
Ceiling on net domestic assets of the banking system (indicative)	9,585	4,382	3,344	858	2,486	3,562	4,198	...	2,404	1,794	7,400	4,661	4,763	2,701	2,062	6,629	6,601	5,752	6,903	-1,149	7,349	6,480	6924	-444
Ceiling on net domestic credit to the general government from the banking system 2/	-4,670	4,516	3,491	1,245	2,246	2,575	3,236	...	-420	3,656	4,989	1,250	1,352	-1,716	3,068	3,907	3,383	2,534	2,379	161	4,017	3,148	-599	3747
Ceilings on central government domestic arrears (indicative)																								
Excluding those to suppliers	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
To suppliers	597	0	0	-10	10	0	0	-153	-153	153	0	0	0	-177	177	0	0	0	-304	304	0	0	-171	171
Ceilings on health fund arrears (indicative) 3/	1,209	0	0	363	-363	0	0	308	587	-587	0	0	0	763	-763	0	0	0	298	-298	0	0	-146	146
	Annual	(In millions of denars)																						
Ceiling on the central government wage bill (indicative)	18,339	5,143	5,143	4953	190	10,429	10,429	10,011	10,011	418	15,527	15,109	15,109	14,920	189	20,953	20,785	20,785	20,234	551	25,981	25,981	25,368	613
Ceiling on personnel expenditures financed from special revenue account (indicative)	640	188	188	142	46	375	375	306	306	69	563	528	528	451	77	750	750	750	604	146	938	938	751	187
Floor for central government fiscal balance 4/	-13,019	-1,685	-1,685	754	2,439	-3,132	-3,132	633	787	3,919	-4,021	-1,104	-1,104	905	2,008	-4,075	-3,203	-3,203	-2,738	465	-3,636	-3,636	-752	2884
Floor for general government fiscal balance	-13,554	-1,630	-1,630	378	2,008	-3,513	-3,024	277	373	3,397	-4,627	-1,664	-1,265	704	1,969	-5,117	-4,616	-3,570	-3,590	-20	-5,077	-3,933	-1252	2681
Ceiling on VAT refund arrears/outstanding VAT refund claims 5/	...	...	...	...	...	...	...		933	...	...	866	866	790	76	...	366	366	654	-288	0	0	509	-509

Sources: Data provided by the authorities; and IMF staff estimates.

1/ Adjustments to quantitative targets under the program are described in the Technical Memorandum of Understanding (342 milion denars VAT Arrears and 802 milion denars RF Disbursements for End-March data).

2/ The actual is adjusted to exclude the programmed transfer of unclaimed FFCBs that was scheduled for Q1 2003 but has been effected in Q3 2003.

3/ Earlier reported data IMF Country Report/03/354 on Health Insurance Fund arrears and net credit to the general government was adjusted to accurately reflect credits by domestic banks to the Fund that were previously recorded as arrears.

4/ Earlier reported data on central and general government deficits IMF Country Report/03/354 was corrected for lower privatization revenues, higher non-bank domestic amortization, adjustments to NBRM data on net domestic credit to the government, and adjustments to foreign financing.

5/ Earlier reported actual stock IMF Country Report/03/354 is now adjusted to reflect more accurate data.

Table 2. FYRM: Selected Economic Indicators, 1999–2004

	1999	2000	2001	2002	2003			2004	
					Prog. 1st Rev	Prel.		Prog. 1st Rev	Proj.
Real economy				(Percent change)					
Real GDP	4.3	4.5	-4.5	0.9	2.8	3.1		3.0-4.0	4.0
Consumer prices									
period average	-0.7	5.8	5.3	2.4	1.8	1.2		2.5	2.8
end of period	2.6	6.1	3.7	1.0	2.2	2.6		2.5	3.3
Real wages, period average	3.6	-0.3	-1.7	4.5	...	4.9		...	...
Unemployment rate (average)	32.4	32.2	30.5	31.9	...	36.7		...	...
Government finances				(In percent of annual nominal GDP)					
General government balance									
w/o foreign financed projects	0.0	1.8	-7.2	-5.6	-2.5	-1.6		-2.5	-2.2
Revenues	35.4	36.2	34.0	34.9	34.0	33.1		33.1	33.0
Total expenditures	35.4	34.4	41.1	40.5	36.5	34.7		35.6	35.3
Central government balance	0.8	2.7	-5.8	-5.3	-1.4	-0.9		-0.9	-0.9
Government debt 1/									
Gross	57.4	53.2	51.6	47.7	44.8	46.6		41.8	44.8
Net	53.8	46.0	41.6	41.3	40.1	41.3		37.9	40.5
Money and credit 2/				(Percent change, end of period)					
Broad money (M3) 3/	29.7	25.6	56.7	-8.6	14.7	17.2		9.4	17.9
Total credit to private sector 4/	9.4	17.2	7.3	9.9	9.5	19.3		7.2	17.3
Short-term lending rate (percent)	20.0	19.0	19.2	17.7	...	14.5		...	...
Interbank money market rate (percent)	11.6	7.2	11.9	14.4	...	5.8		...	...
Balance of payments				(In millions of U.S. dollars)					
Exports	1,190	1,321	1,155	1,113	1,354	1,359		1,443	1,499
Imports	1,686	2,011	1,677	1,878	2,123	2,211		2,202	2,360
Trade balance	-496	-690	-521	-765	-769	-851		-759	-860
Current account balance									
excluding grants	-105	-208	-282	-422	-395	-382		-409	-440
(in percent of GDP)	-2.9	-5.8	-8.2	-11.2	-8.5	-8.2		-8.2	-8.9
including grants	-32	-75	-234	-322	-292	-278		-347	-382
(in percent of GDP)	-0.9	-2.1	-6.8	-8.5	-6.3	-6.0		-7.0	-7.7
Overall balance	166	226	118	-120	16	53		-23	5
Official gross reserves 5/	450	700	756	735	816	903		839	946
(in months of following year's imports									
of goods and services)	2.4	4.3	4.2	3.5	3.9	4.0		3.9	4.0
External debt service ratio 6/	12.4	13.0	19.0	16.6	13.5	13.9		13.3	14.4
External debt to GDP ratio (percent)	39.2	40.1	38.0	38.4	32.9	34.4		33.1	35.3
Exchange rates 7/				(Percent change, period average)					
Nominal effective exchange rate	12.4	12.4	3.3	0.7	...	2.7	*a*	...	...
Real effective exchange rate (CPI-based)	2.9	4.0	-6.1	-2.4	...	0.4	*a*	...	...
Real effective exchange rate (ULC-based)	7.6	7.6	-6.2	-2.4	...	-0.8	*b*	...	...

Sources: Data provided by the FYRM authorities; and IMF staff projections.

a As of end-December 2003

b As of end-September 2003

1/ Total debt of the general government; includes liabilities assumed by the government upon the sale or closure of loss-making enterprises and associated with the cleaning up of Stopanska Banka's balance sheet prior to its sale.

2/ The projections for 2003 and 2004 are prepared based on current exchange rate data, while historic data is based on the stock-flow methodology.

3/ Includes foreign currency deposits; strong growth of foreign currency component explains the high growth in Broad Money in 2003.

4/ Adjusted for provisioning until 2002.

5/ Includes receipts from privatization of telecommunications company of US$323 million in January 2001.

6/ Debt service due, including IMF, as a percentage of exports of goods and services.

7/ An increase means appreciation of the denar. Partner countries include among others Serbia and Montenegro, and Bulgaria.

Table 3. FYRM: Central Government Operations, 2000–04

	2000	2001	2002	2003		2004			2000	2001	2002	2003		2004		
				Prog.	Act.	Prog.	Proj. 1/	Q1 Act.				Prog.	Act.	Prog.	Proj. 1/	Q1 Act.
	(In millions of denars)								(In percent of GDP)							
Total revenues and grants	57,805	51,812	57,358	55,785	53,881	56,856	57,255	14,102	24.5	22.2	23.5	22.1	21.2	21.3	21.1	5.2
Tax revenues	51,115	47,564	54,387	50,932	49,163	52,536	52,785	12,556	21.6	20.3	22.3	20.2	19.3	19.7	19.4	4.6
Taxes on income and profits	13,586	10,253	10,140	10,897	10,773	10,982	11,642	2,696	5.7	4.4	4.2	4.3	4.2	4.1	4.3	1.0
Individual income tax	10,793	7,247	7,514	7,713	7,502	8,083	8,139	1,738	4.6	3.1	3.1	3.1	2.9	3.0	3.0	0.6
Enterprise profits tax	2,793	3,006	2,625	3,184	3,271	2,899	3,503	958	1.2	1.3	1.1	1.3	1.3	1.1	1.3	0.4
Domestic taxes on goods and services	29,733	27,813	31,236	33,089	31,739	35,681	34,712	8,452	12.6	11.9	12.8	13.1	12.5	13.4	12.8	3.1
VAT & Sales tax	17,452	17,133	20,521	22,792	21,175	24,820	23,990	6,103	7.4	7.3	8.4	9.0	8.3	9.3	8.8	2.2
Excises	12,281	10,681	10,715	10,297	10,564	10,861	10,722	2,349	5.2	4.6	4.4	4.1	4.2	4.1	3.9	0.9
Import duties	7,733	6,111	6,335	6,596	6,140	5,551	5,997	1,228	3.3	2.6	2.6	2.6	2.4	2.1	2.2	0.5
Other taxes	63	3,387	6,677	350	511	321	434	180	0.0	1.4	2.7	0.1	0.2	0.1	0.2	0.1
o.w. Financial transaction tax	0	3,111	6,335	0	31	0	0	0	0.0	1.3	2.6	0.0	0.0	0.0	0.0	0.0
Nonntax revenues	3,028	3,370	2,395	4,253	4,163	3,721	3,920	1,371	1.3	1.4	1.0	1.7	1.6	1.4	1.4	0.5
Capital revenues	424	462	576	600	555	600	550	175	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1
Grants	3,239	415	0	0	0	0	0	0	1.4	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditure	51,520	65,363	70,378	59,198	56,258	59,269	59,702	11,872	21.8	28.0	28.8	23.5	22.1	22.2	22.0	4.4
Total expenditure w/o errors and omissions	51,337	65,413	69,550	59,198	56,431	59,270	59,702	13,100	21.7	28.0	28.5	23.5	22.2	22.2	22.0	4.8
Current expenditure	45,585	58,032	61,329	53,117	51,394	52,610	53,511	12,415	19.3	24.8	25.1	21.1	20.2	19.7	19.7	4.6
Goods and services	22,576	36,398	32,329	28,551	27,559	28,904	28,587	6,932	9.6	15.6	13.3	11.3	10.8	10.9	10.5	2.6
Wages and salaries	16,285	16,407	18,339	20,785	20,234	21,169	21,128	5,135	6.9	7.0	7.5	8.2	8.0	7.9	7.8	1.9
Goods and nonlabor services	6,137	19,825	13,803	7,576	7,119	7,540	7,232	1,785	2.6	8.5	5.7	3.0	2.8	2.8	2.7	0.7
Reserves	154	166	187	190	206	195	227	12	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Transfers	19,060	17,434	25,672	21,802	21,392	20,879	22,481	4,952	8.1	7.5	10.5	8.6	8.4	7.8	8.3	1.8
Interest	3,949	4,200	3,328	2,764	2,443	2,827	2,443	531	1.7	1.8	1.4	1.1	1.0	1.1	0.9	0.2
Domestic	1,183	1,066	1,177	971	950	1,210	1,025	81	0.5	0.5	0.5	0.4	0.4	0.5	0.4	0.0
Foreign	2,767	3,134	2,151	1,793	1,493	1,617	1,418	450	1.2	1.3	0.9	0.7	0.6	0.6	0.5	0.2
Capital expenditure 3/	5,751	7,380	8,221	6,081	5,037	6,660	6,191	685	2.4	3.2	3.4	2.4	2.0	2.5	2.3	0.3
Statistical discrepancy/Measures	184	-49	827	0	-172	0	0	-1,228	0.1	0.0	0.3	0.0	-0.1	0.0	0.0	-0.5
Balance	6,285	-13,551	-13,019	-3,413	-2,377	-2,413	-2,447	2,230	2.7	-5.8	-5.3	-1.4	-0.9	-0.9	-0.9	0.8
Financing	-6,285	13,551	13,019	3,413	2,377	2,413	2,447	-2,230	-2.7	5.8	5.3	1.4	0.9	0.9	0.9	-0.8
Domestic	-9,157	18,722	12,158	-804	-1,422	298	-207	-2,528	-3.9	8.0	5.0	-0.3	-0.6	0.1	-0.1	-0.9
Banking system	-10,233	-5,821	8,875	2,240	1,243	3,318	3,120	-2,548	-4.3	-2.5	3.6	0.9	0.5	1.2	1.1	-0.9
Central bank	-9,328	-5,527	7,989	3,183	1,839	1,388	1,644	-2,712	-3.9	-2.4	3.3	1.3	0.7	0.5	0.6	-1.0
Commercial banking system	-905	-294	886	-943	-596	1,930	1,477	164	-0.4	-0.1	0.4	-0.4	-0.2	0.7	0.5	0.1
o/w T-bills issue (starting 2004)	0	0	0	0	0	3,020	2,000	524	0.0	0.0	0.0	0.0	0.0	1.1	0.7	0.2
Other domestic financing	-1,547	0	1,872	-3,111	-3,492	-3,020	-3,347	0	-0.7	0.0	0.8	-1.2	-1.4	-1.1	-1.2	0.0
Privatization receipts	2,622	24,543	1,411	68	827	0	20	20	1.1	10.5	0.6	0.0	0.3	0.0	0.0	0.0
Foreign	2,872	-5,171	862	4,217	3,799	-476	2,654	298	1.2	-2.2	0.4	1.7	1.5	-0.2	1.0	0.1
Unidentified financing	0	0	0	0	0	2,591	0	0	0.0	0.0	0.0	0.0	0.0	1.0	0.0	0.0
Memorandum item:																
Nominal GDP	236,389	233,841	243,971	252,242	254,372	266,393	271,761	271,761								

Sources: Data provided by the authorities; and IMF staff projections.

1/ The budget is revised to incorporate external financing closing the financing gap: EU of about US$9 million budgeted in 2003 and received in 2004, EBRD financing of US$13.5 million, and succesion proceeds preliminary estimated at US$8 million.

2/ The lower than programmed social spending in 2003 and 2004 is due to the faster than expected return of refugees and the tightening of criteria for social assistance, child allowances, and other social benefits.

3/ Excludes foreign-financed capital expenditure projects. These projects are included in the general government operations.

Table 4. FYRM: General Government Operations, 2000–04 1/

	2000	2001	2002	2003		2004			2000	2001	2002	2003		2004		
				Prog.	Act.	Prog.	Proj. 2/	Q1 Act.				Prog.	Act.	Prog.	Proj. 2/	Q1 Act.
	(In millions of denars)								(In percent of GDP)							
Total revenue and grants	85,533	79,453	85,204	85,868	84,088	88,083	89,779	21,208	36.2	34.0	34.9	34.0	33.1	33.1	33.0	7.8
Tax revenue	77,009	73,644	80,569	78,795	77,056	81,722	82,702	19,131	32.6	31.5	33.0	31.2	30.3	30.7	30.4	7.0
Taxes on income and profits	13,586	10,253	10,140	10,897	10,773	10,982	11,642	2,696	5.7	4.4	4.2	4.3	4.2	4.1	4.3	1.0
Social insurance contributions	25,091	25,363	25,494	27,224	27,217	28,514	29,200	6,423	10.6	10.8	10.4	10.8	10.7	10.7	10.7	2.4
Domestic taxes on goods & services	30,537	28,529	31,923	33,728	32,415	36,352	35,428	8,604	12.9	12.2	13.1	13.4	12.7	13.6	13.0	3.2
VAT	17,452	17,133	20,521	22,792	21,175	24,820	23,990	6,103	7.4	7.3	8.4	9.0	8.3	9.3	8.8	2.2
Excises	13,085	11,397	11,402	10,936	11,240	11,531	11,438	2,501	5.5	4.9	4.7	4.3	4.4	4.3	4.2	0.9
Import duties	7,733	6,111	6,335	6,596	6,140	5,551	5,997	1,228	3.3	2.6	2.6	2.6	2.4	2.1	2.2	0.5
Other taxes	63	3,387	6,677	350	511	321	434	180	0.0	1.4	2.7	0.1	0.2	0.1	0.2	0.1
Non-tax and capital revenue	5,284	5,307	4,600	7,072	7,031	6,363	7,062	2,077	2.2	2.3	1.9	2.8	2.8	2.4	2.6	0.8
Grants	3,239	502	35	1	1	0	15	0	1.4	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Total expenditures	81,377	96,186	98,912	92,188	88,173	94,796	95,859	19,071	34.4	41.1	40.5	36.5	34.7	35.6	35.3	7.0
Total expenditures, w/o errors & omissions	81,161	95,875	98,505	92,188	88,239	94,796	95,859	20,544	34.3	41.0	40.4	36.5	34.7	35.6	35.3	7.6
Current expenditure	73,085	85,863	89,513	83,026	81,320	83,639	84,930	19,749	30.9	36.7	36.7	32.9	32.0	31.4	31.3	7.3
Goods and services	24,207	37,907	34,557	30,760	29,780	30,869	30,364	7,403	10.2	16.2	14.2	12.2	11.7	11.6	11.2	2.7
Wages and salaries	16,863	16,946	19,012	21,454	20,881	21,844	21,680	5,229	7.1	7.2	7.8	8.5	8.2	8.2	8.0	1.9
Goods and nonlabor services	7,191	20,795	15,358	9,116	8,693	8,830	8,457	2,163	3.0	8.9	6.3	3.6	3.4	3.3	3.1	0.8
Reserves	154	166	187	190	206	195	227	12	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Transfers	44,717	43,597	51,377	49,182	48,811	49,605	51,789	11,808	18.9	18.6	21.1	19.5	19.2	18.6	19.1	4.3
Interest	4,161	4,359	3,579	3,084	2,730	3,165	2,777	538	1.8	1.9	1.5	1.2	1.1	1.2	1.0	0.2
Domestic	1,183	1,066	1,177	971	995	1,210	1,029	81	0.5	0.5	0.5	0.4	0.4	0.5	0.4	0.0
Foreign	2,978	3,293	2,402	2,113	1,735	1,954	1,748	457	1.3	1.4	1.0	0.8	0.7	0.7	0.6	0.2
Capital expenditure	8,076	10,012	8,992	9,161	6,919	11,158	10,929	795	3.4	4.3	3.7	3.6	2.7	4.2	4.0	0.3
o/w foreign-financed Road Fund spending	578	902	866	1,412	11	1,287	1,562	…	0.2	0.4	0.4	0.6	0.0	0.5	0.6	…
foreign financed projects (FFPs)	1,749	1,887	154	1,849	1,489	3,383	2,171	…	0.7	0.8	0.1	0.7	0.6	1.3	0.8	…
Statistical discrepancy/Measures	215	311	408	0	-66	0	0	-1,473	0.1	0.1	0.2	0.0	0.0	0.0	0.0	-0.5
Balance	4,156	-16,733	-13,708	-6,320	-4,085	-6,713	-6,080	2,137	1.8	-7.2	-5.6	-2.5	-1.6	-2.5	-2.2	0.8
Financing	-4,156	16,733	13,708	6,320	4,085	6,713	6,080	-2,137	-1.8	7.2	5.6	2.5	1.6	2.5	2.2	-0.8
Domestic	-9,355	19,163	11,827	-1,157	-1,214	-72	-306	-2,877	-4.0	8.2	4.8	-0.5	-0.5	0.0	-0.1	-1.1
Bank financing	-10,446	-5,546	8,373	2,241	1,626	3,252	3,121	-2,897	-4.4	-2.4	3.4	0.9	0.6	1.2	1.1	-1.1
Central bank	-9,367	-5,320	7,780	3,183	2,080	1,388	1,644	-3,082	-4.0	-2.3	3.2	1.3	0.8	0.5	0.6	-1.1
Commercial banking system	-1,079	-226	593	-942	-454	1,864	1,477	185	-0.5	-0.1	0.2	-0.4	-0.2	0.7	0.5	0.1
o/w T-bills issue (starting 2004)	...	...	...	...	...	3,020	2,000	524	...	...	...	...	...	1.1	0.7	0.2
Other domestic financing	-1,547	0	1,872	-3,531	-3,688	-3,390	-3,497	0	-0.7	0.0	0.8	-1.4	-1.4	-1.3	-1.3	0.0
Privatization receipts	2,637	24,709	1,582	134	848	66	70	20	1.1	10.6	0.6	0.1	0.3	0.0	0.0	0.0
Foreign	5,199	-2,430	1,881	7,477	5,299	4,194	6,387	740	2.2	-1.0	0.8	3.0	2.1	1.6	2.4	0.3
o/w foreign financed projects (FFPs)	1,749	1,887	154	1,849	1,489	3,383	2,171	…	0.7	0.8	0.1	0.7	0.6	1.3	0.8	…
Unidentified financing	0	0	0	0	0	2,591	0	0	0.0	0.0	0.0	0.0	0.0	1.0	0.0	0.0
Memorandum item:																
Nominal GDP	236,389	233,841	243,971	252,242	254,372	266,393	271,761	271,761								
Fiscal balance excluding foreign financed projects	5,905	-14,846	-13,554	-4,470	-2,596	-3,330	-3,924	2,137	2.5	-6.3	-5.6	-1.8	-1.0	-1.2	-1.4	0.8

Sources: Data provided by the authorities; and IMF staff projections.

1/ Excludes most of the costs of implementing the Peace Framework Agreement. These costs are financed off-budget during 2002-04.

2/ The budget is revised to incorporate external financing closing the financing gap: EU of about US$9 million budgeted in 2003 and received in 2004, EBRD financing of US$13.5 million, and sucession proceeds preliminary estimated at US$8 million.

Table 5. FYRM: Central Bank Accounts, 2002-04
(Current exchange rate)

	2002	2003				2004		2003		2004
	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Dec.	Sep.	Dec.	Mar.
	Actual	Actual	Actual	Actual	Actual	Actual	Proj	1 st Rev.	1 st Rev.	1 st Rev.
Net foreign assets	41,852	37,886	41,626	43,976	42,501	42,503	43,889	40,488	42,237	42,532
Net domestic assets	-23,677	-22,855	-23,447	-24,873	-21,479	-24,171	-21,558	-22,378	-22,347	-23,150
Banks (net)	-2,784	-3,633	-3,980	-5,260	-4,297	-5,673	-7,007	...	...	...
Credits	214	96	99	98	82	78	78	...	...	...
Instruments (NBRM bills)	-2,998	-3,729	-4,079	-5,358	-4,379	-5,751	-7,085	...	...	...
Government (net) 1/	-9,857	-9,728	-11,210	-9,945	-7,050	-10,132	-5,407	...	...	...
Credit	3,754	3,665	3,351	3,271	3,267	3,188	3,188	...	...	...
Deposits	-17,416	-19,140	-14,561	-13,216	-10,317	-13,320	-8,595	...	...	...
External account 2/	3,805	5,747	0	0	0	0	0	...	...	...
Other items (net)	-11,036	-9,494	-8,257	-9,668	-10,132	-8,366	-9,144	...	...	...
Reserve money	18,175	15,031	18,179	19,103	21,022	18,332	22,331	18,110	19,890	19,382
Currency	14,136	11,861	12,726	13,046	14,177	12,953	14,838	...	...	...
Other	4,039	3,170	5,453	6,057	6,845	5,379	7,493	...	...	...
Cash in vaults	679	669	720	667	833	730	730	...	...	...
Total reserves	3,360	2,501	4,733	5,390	6,012	4,649	6,763	...	...	...
o.w. On foreign exchange deposits 3/	0	0	2,474	2,669	2,770	2,898	3,160	...	...	...
Memorandum items										
NBRM balance sheet aggregates in constant exchange rates										
NFA	42,074	38,360	43,053	45,652	45,485	44,978	...	41,915	43,664	43,959
NDA	-23,899	-23,329	-24,870	-26,540	-24,459	-26,642	...	-23,801	-23,770	-24,573
o/w Credit to the government	-9,877	-9,589	-11,386	-10,133	-7,261	-10,412	...	-7,583	-5,552	-5,287
Reserve money	18,175	15,031	18,183	19,112	21,026	18,336	...	18,114	19,894	19,386

Sources: The National Bank of Macedonia; and IMF staff projections.

1/ Excludes the unclaimed amount from the Frozen Foreign Currency Accounts (see definition in the Technical Memorandum of Understanding).
2/ The External Account was closed in June 2003 (see Technical Memorandum of Understanding).
3/ Reserve requirements on foreign exchange deposits were introduced in the second quarter of 2003.

Table 6. FYRM: Monetary Survey, 2002-04
(Current exchange rate)

	2002	2003				2004		2003		2004
	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Dec.	Sep.	Dec.	Mar.
	Actual	Actual	Actual	Actual	Actual	Actual	Proj.			
								1st Rev.	1st Rev.	1st Rev.
Net foreign assets	62,902	59,627	62,742	66,453	65,792	65,766	70,288	62,278	65,550	64,745
National Bank of Macedonia (NBRM)	41,852	37,886	41,626	43,976	42,501	42,503	43,889	...	...	...
Domestic money banks (DMB)	21,050	21,741	21,116	22,477	23,291	23,263	26,399	...	...	...
Net domestic assets	7,472	8,765	11,129	11,382	16,676	16,205	26,875	13,168	15,108	15,856
Credit to the government 1/	-1,880	-2,064	-4,114	-3,129	288	-2,500	3,517	...	...	...
Banks	7,977	7,664	7,096	6,816	7,338	7,632	8,924	...	...	...
NBRM (net)	-9,857	-9,728	-11,210	-9,945	-7,050	-10,132	-5,407	...	...	...
Credit to the private sector	38,396	39,346	40,883	43,076	45,677	48,144	53,575	...	...	...
In denars 2/	32,661	33,047	34,205	36,208	38,430	40,268	43,465	...	...	...
In foreign currency	5,735	6,299	6,678	6,868	7,247	7,876	10,110	...	...	...
Other items (net)	-29,044	-28,517	-25,640	-28,565	-29,289	-29,439	-30,217	...	...	...
Broad money (M3)	70,374	68,392	73,871	77,835	82,468	81,971	97,163	75,446	80,659	80,600
Currency in circulation	14,136	11,861	12,726	13,046	14,177	12,953	14,838	...	...	...
Deposits of public entities 3/	1,938	1,805	2,029	2,303	1,655	1,764	1,764	...	...	...
Private denar deposits	26,426	25,872	28,278	29,183	32,161	31,040	38,429	...	...	...
Private foreign currency deposits	27,874	28,854	30,838	33,303	34,475	36,214	42,132	...	...	...
Memorandum items:										
Monetary aggregates in constant exchange rates										
NFA	63,230	60,268	64,492	68,478	69,339	68,770	...	64,028	67,300	66,495
NDA	7,283	8,345	9,905	9,984	14,186	14,207	...	11,944	13,884	14,632
o/w Credit to the government	-1,867	-1,874	-4,192	-3,218	229	-2,640	...	-526	1,607	2,241
Broad Money	70,513	68,613	74,397	78,462	83,525	82,977	...	75,972	81,185	81,126
o/w Credit to the government	1,938	1,805	2,029	2,303	1,655	1,764	...	2,029	2,029	2,029
M3 private denar	40,562	37,733	41,004	42,229	46,338	43,993	53,267	...	...	...
(Percent change from end of previous year)	2.9	-7.0	1.1	4.1	14.2	-5.1	15.0	...	...	...
M3	70,374	68,392	73,871	77,835	82,468	81,971	97,163	...	...	...
(Percent change from end of previous year)	-9.7	-2.8	5.0	10.6	17.2	-0.6	17.8	...	...	...
Velocity of M3	3.6	3.7	3.4	3.3	3.1	3.2	2.8	...	...	...
Net credit to government	-3,818	-3,869	-6,143	-5,432	-1,367	-4,264	1,753	...	...	...
Total private sector credit	38,396	39,346	40,883	43,076	45,677	48,144	53,575	...	...	...
(Percent change from end of previous year)	-0.9	2.5	6.5	12.2	19.0	5.4	17.3	...	...	...
NFA of DMBs in percent of private FX deposits 4/	75.5	75.3	76.5	75.5	75.6	72.2	69.0	...	...	...
Ratio of private FX deposits to private denar deposits	1.05	1.12	1.09	1.14	1.07	1.17	1.10	...	...	...
Share of forex deposits in BM	0.40	0.42	0.42	0.43	0.42	0.44	0.43	...	...	...
Foreign currency indexed lending	...	8,211	8,297	9,757	10,032	...	...	...	...	...

Sources: The National Bank of Macedonia; and IMF staff projections.

1/ Differs from domestic credit shown in the fiscal tables until 2003 because part of the payments for frozen foreign currency bonds were not withdrawn from the government accounts by the bondholders.

2/ Includes denar loans with foreign exchange indexing clause, amounting to about 25 percent of total private sector denar lending at end-2002.

3/ Includes deposits of extra-budgetary funds and public entities outside the central government.

4/ Includes required reserves (RR) on FX deposits.

Table 7. FYRM: Balance of Payments, 1999–2004
(In millions of U.S. dollars)

	1999	2000	2001	2002	2003 Est.	2004 Proj.
Current account	-32	-75	-234	-322	-278	-382
Excluding official transfers	-105	-208	-282	-422	-382	-440
Trade balance (fob)	-496	-690	-521	-765	-851	-860
Exports	1,190	1,321	1,155	1,113	1,359	1,499
Imports	1,686	2,011	1,677	1,878	2,211	2,360
Services (net)	42	47	-16	-25	-3	-16
Income (net; including net interest)	-42	-45	-39	-30	-32	-67
Transfers (net)	464	614	343	498	608	561
Official	73	132	49	100	103	58
Private	391	481	294	398	504	503
Capital and financial account	-14	223	273	220	241	288
Capital account (net)	0	0	1	8	-7	7
of which : Capital transfers (net)	0	…	4	10	-7	7
Financial account	-14	223	272	212	248	281
Disbursements	167	142	108	162	217	246
Multilateral	91	90	62	75	108	139
IBRD/IDA	56	52	23	34	59	67
EBRD	5	20	9	4	9	43
Other, including hypothetical	30	19	30	37	39	29
Bilateral	26	16	8	10	20	12
Commercial banks	3	7	9	0	30	95
Other	47	28	29	78	59	0
Amortization	106	120	182	164	160	193
Multilateral	28	31	57	74	32	33
Bilateral	27	26	43	34	38	48
Commercial banks	0	0	44	6	8	8
Other	51	63	37	50	82	104
Direct and portfolio investment (net)	32	176	443	78	98	120
of which : Direct investment	32	176	442	77	94	115
Portfolio investment	0	0	0	1	3	5
Currency and deposits (net)	-114	-122	27	69	24	3
Individuals (incl. euro-conversion effect)	-63	-29	377	-136	40	51
Commercial banks	-51	-93	-349	206	-16	-49
Short-term loans (net)	0	0	0	0	-16	17
Trade credits (net)	7	147	-125	66	85	88
Errors and omissions	213	79	79	-17	90	96
Overall balance	166	226	118	-120	53	2
Financing	-166	-226	-118	120	-53	-28
Net foreign assets (flows)	-184	-259	-133	120	-60	-28
Valuation effects on the stock of NFA (increase: -)	18	18	45	-108	-92	0
Change in the stock of NFA (increase:-)	-166	-241	-87	11	-152	-28
Change in gross foreign reserves (increase:-)	-160	-250	-56	21	-169	-43
IMF (net)	2	-16	-8	-9	-5	-8
of which: Current SBA	…	…	…	…	17	11
BIS (net)	0	14	-14	0	0	0
Other (net)	-8	10	-10	-1	22	22
Change in arrears 1/	-7	14	15	0	7	0
Rescheduling 2/	25	18	0	0	0	0
Financing gap	0	0	0	0	0	27
Memorandum items:						
Current account (in percent of GDP)	-0.9	-2.1	-6.8	-8.5	-6.0	-7.7
Excluding official transfers	-2.9	-5.8	-8.2	-11.2	-8.2	-8.9
Including errors and omissions	4.9	0.1	-4.5	-9.0	-4.1	-5.8
Export growth rate (percent)	-7.9	11.0	-12.5	-3.7	22.1	10.3
Import growth rate (percent)	-6.7	19.3	-16.6	12.0	17.7	6.8
Gross reserves	450	700	756	735	903	946
(in months of following period's imports of goods and services)	2.4	4.3	4.2	3.5	4.0	4.0
External debt service ratio (in percent) 3/	12.4	13.0	19.0	16.6	13.9	14.4
Medium-term and long-term external debt to GDP ratio (in percent) 4/	40.6	41.5	41.3	40.7	37.5	38.4
Nominal annual GDP (in millions of U.S. dollars)	3,675	3,582	3,437	3,769	4,636	4,944

Sources: Data provided by the FYRM authorities; and IMF staff estimates and projections.

1/ Private sector arrears. Clearance of technical arrears to Paris Club is included in debt service due.
2/ Refers to deferral of debt service to Paris Club creditors from April 1999 through March 2000.
3/ Debt service due including IMF as percent of exports of goods and services.
4/ Including IMF and short-term debt.

Table 8. FYRM: Balance of Payments, 1999–2004
(In millions of euros)

	1999	2000	2001	2002	2003	2004
					Est.	Proj.
Current account	-35	-70	-209	-341	-249	-342
Excluding official transfers	-112	-192	-253	-447	-341	-394
Trade balance (fob)	-529	-638	-467	-810	-761	-770
Exports	1270	1220	1035	1178	1215	1342
Imports	1798	1858	1502	1989	1976	2113
Services (net)	45	43	-14	-26	-2	-14
Income (net; including net interest)	-45	-42	-35	-32	-29	-60
Transfers (net)	495	567	307	528	543	502
Official	78	122	44	106	92	52
Private	417	445	264	421	451	450
Capital and financial account	-15	206	244	233	216	258
Capital account (net)	0	0	1	9	-6	6
of which : Capital transfers (net)	0	0	3	10	-6	6
Financial account	-15	206	243	224	222	252
Disbursements	178	131	97	172	194	221
Multilateral	97	83	56	79	96	125
IBRD/IDA	60	48	21	36	53	60
EBRD	5	18	8	4	8	39
Other, including hypothetical	32	17	27	40	35	26
Bilateral	28	15	7	11	18	11
Commercial banks	3	7	8	0	27	85
Other	50	26	26	82	53	0
Amortization	113	111	163	173	143	173
Direct and portfolio investment (net)	34	163	396	82	87	107
of which : Direct investment	34	163	396	82	84	103
Portfolio investment	0	0	0	1	3	4
Currency and deposits (net)	-121	-113	24	74	21	3
Individuals (incl. euro-conversion effect)	-67	-27	337	-144	35	46
Commercial banks	-55	-86	-313	218	-14	-43
Short-term loans (net)	0	0	0	0	-14	16
Trade credits (net)	8	135	-112	70	76	79
Errors and omissions	227	73	70	-18	80	86
Overall balance	177	209	106	-127	47	1
Financing	-177	-209	-106	127	-47	-25
Net foreign assets (flows)	-196	-239	-119	127	-54	-25
Valuation effects on the stock of NFA (increase: -)	19	17	41	-115	-82	0
Change in the stock of NFA (increase:-)	-177	-222	-78	12	-136	-25
Change in gross foreign reserves (increase:-)	-170	-231	-50	22	-151	-38
IMF (net)	2	-14	-7	-9	-4	-7
BIS (net)	0	13	-13	0	0	0
Other (net)	-9	10	-9	-1	19	20
Change in arrears 1/	-7	13	13	0	6	0
Rescheduling 2/	26	17	0	0	0	0
Financing gap	0	0	0	0	0	24
Memorandum items:						
Export growth rate (percent)	-12.3	-3.9	-15.2	13.9	3.1	10.5
Import growth rate (percent)	-11.2	3.3	-19.2	32.4	-0.6	6.9
Gross reserves	480	646	677	778	808	847
Nominal annual GDP (in millions of Euros)	3921	3308	3079	3991	4144	4426

Sources: Data provided by the FYRM authorities; and IMF staff estimates and projections.

1/ Private sector arrears. Clearance of technical arrears to Paris Club is included in debt service due.

2/ Refers to deferral of debt service to Paris Club creditors from April 1999 through March 2000.

Table 9. FYRM: Medium-Term Balance of Payments, 1999–2007

(In millions of U.S. dollars)

	1999	2000	2001	2002	2003	2004	2005	2006	2007
						Projection			
Current account	-32	-75	-234	-322	-278	-382	-332	-356	-358
Excluding official transfers	-105	-208	-282	-422	-382	-440	-392	-416	-419
Trade balance (fob)	-496	-690	-521	-765	-851	-860	-883	-908	-931
Exports	1190	1321	1155	1,113	1,359	1,499	1,609	1,735	1,871
Imports	1686	2011	1677	1,878	2,211	2,360	2,492	2,642	2,803
Services (net)	42	47	-16	-25	-3	-16	37	37	47
Income (net; including net interest)	-42	-45	-39	-30	-32	-67	-65	-79	-85
Transfers (net)	464	614	343	498	608	561	579	595	611
Official	73	132	49	100	103	58	60	60	60
Private	391	481	294	398	504	503	519	535	551
Capital and financial account	-14	223	273	220	241	288	282	302	318
Capital account (net)	0	0	1	8	-7	7	0	0	0
of which : Capital transfers (net)	0	0	4	10	-7	7	0	0	0
Financial account	-14	223	272	212	248	281	282	302	318
Disbursements	167	142	108	162	217	246	212	217	221
Multilateral	91	90	62	75	108	139	124	133	144
IBRD/IDA	56	52	23	34	59	67	34	55	29
EBRD	5	20	9	4	9	43	53	28	15
Other, including hypothetical	30	19	30	37	39	29	36	51	100
Bilateral	26	16	8	10	20	12	23	25	27
Commercial banks	3	7	9	0	30	95	65	59	50
Other	47	28	29	78	59	0	0	0	0
Amortization	106	120	182	164	160	193	164	161	162
Multilateral	28	31	57	74	32	33	33	40	44
Bilateral	27	26	43	34	38	48	39	35	30
Commercial banks	0	0	44	6	8	8	8	11	11
Other	51	63	37	50	82	104	85	74	76
Direct and portfolio investment (net)	32	176	443	78	98	120	129	139	150
of which : Direct investment	32	176	442	77	94	115	124	133	144
Portfolio investment	0	0	0	1	3	5	5	6	6
Currency and deposits (net)	-114	-122	27	69	24	3	17	17	17
Individuals (incl. euro-conversion effect)	-63	-29	377	-136	40	51	40	40	40
Commercial banks	-51	-93	-349	206	-16	-49	-23	-23	-23
Trade credits (net)	7	147	-125	66	85	88	88	91	93
Errors and omissions, and short-term capital	213	79	79	-17	90	96	103	111	120
Overall balance	166	226	118	-119	53	2	53	57	79
Financing	-166	-226	-118	119	-53	-2	-53	-57	-79
Net foreign assets (flows)	-184	-259	-133	120	-60	-28	-68	-68	-79
Valuation effects on the stock of NFA (increase: -)	18	18	45	-108	-92	0	0	0	0
Change in the stock of NFA (increase:-)	-166	-241	-87	11	-152	-28	-68	-68	-79
Change in gross foreign reserves (increase:-)	-160	-250	-56	21	-169	-43	-59	-57	-61
IMF (net)	2	-16	-8	-9	-5	-8	-9	-10	-19
BIS (net)	0	14	-14	0	0	0	0	0	0
Other (net)	-8	10	-10	-1	22	22	0	0	0
Change in arrears 1/	-7	14	15	0	7	0	0	0	0
Rescheduling 2/	25	18	0	0	0	0	0	0	0
Financing gap	0	0	0	0	0	27	16	10	0
Memorandum items:									
Current account (in percent of GDP)	-0.9	-2.1	-6.8	-8.5	-6.0	-7.7	-6.3	-6.2	-5.8
Excluding official transfers	-2.9	-5.8	-8.2	-11.2	-8.2	-8.9	-7.4	-7.3	-6.8
Export growth rate (percent)	-7.9	11.0	-12.5	-3.7	22.1	10.3	7.3	7.8	7.9
Import growth rate (percent)	-6.7	19.3	-16.6	12.0	17.7	6.8	5.6	6.0	6.1
Gross reserves	450	700	756	735	903	946	1005	1062	1123
(in months of following year's imports of goods and services)	2.4	4.3	4.2	3.5	4.0	4.0	4.0	4.0	4.0
External debt service ratio (in percent) 3/	12.4	13.0	19.0	16.6	13.9	14.4	12.1	11.7	11.5
External debt to GDP ratio (in percent) 4/	40.6	41.5	41.3	40.7	37.5	38.4	38.9	39.4	39.8
Nominal GDP (in millions of U.S. dollars)	3,675	3,582	3,437	3,769	4,636	4,944	5,304	5,720	6,170

Sources: Data provided by the FYRM authorities; and IMF staff estimates and projections.

1/ Private sector arrears. Clearance of technical arrears to Paris Club is included in debt service due.

2/ Refers to deferral of debt service to Paris Club creditors from April 1999 through March 2000.

3/ Debt service due including IMF as percent of exports of goods and services.

4/ Including IMF and short-term external debt.

Table 10. FYRM: Macroeconomic Framework, 1998–2004

	1998	1999	2000	2001	2002	2003	2004
		Official				Staff Estimate	Proj.
	(In percent of nominal GDP)						
Foreign saving (including official grants) 1/	8.6	2.9	5.8	8.2	11.2	8.2	8.9
excluding official grants	7.5	0.9	2.1	6.8	8.5	6.0	7.7
National saving 2/	14.9	19.2	19.5	12.6	10.2	13.5	14.5
Government	0.1	1.1	3.8	-3.1	-1.9	1.0	1.6
Non-government	14.8	18.1	15.7	15.7	12.2	12.5	12.9
Gross domestic investment	23.4	22.1	25.3	20.8	21.4	21.7	23.4
Government	1.8	2.3	3.4	4.3	3.7	2.6	3.9
Non-government	21.7	19.8	21.9	16.5	17.8	19.1	19.5
Fixed investment	17.4	16.6	16.2	14.8	16.6	17.0	16.8
Change in stocks	6.0	5.5	9.1	5.9	4.9	4.7	6.6
Non-government national saving minus investment	-6.9	-1.7	-6.2	-0.8	-5.6	-6.6	-6.7
Fiscal indicators							
General government balance (excluding grants)	-1.7	-1.2	0.4	-7.4	-5.6	-1.6	-2.2
Revenues	33.3	34.2	34.8	33.8	34.9	33.1	33.0
Total expenditures	35.0	35.4	34.4	41.1	40.5	34.7	35.3
of which:							
Non-interest current expenditure 3/	31.4	31.7	29.2	35.0	35.4	31.0	30.4
Interest expenditure	1.9	1.5	1.8	1.9	1.5	1.1	1.0
Central government balance	-0.8	0.8	2.7	-5.8	-5.3	-0.9	-0.9
Government debt 4/							
Gross	52.0	57.4	53.2	51.6	47.7	46.6	44.8
Net 5/	52.0	53.8	46.0	41.6	41.3	41.3	40.5
Memorandum items:	(Percent change in real terms)						
GDP	3.4	4.4	4.5	-4.5	0.9	3.1	4.0
Foreign saving including errors and omissions (in percent of nominal GDP)	8.5	-4.9	-0.1	4.5	9.0	4.9	6.3
Nominal GDP (billions of denars)	195.0	209.0	236.4	233.8	244.0	254.4	271.8

Sources: Data provided by the FYRM authorities; and IMF staff projections.

1/ External current account deficit, excluding official grants (+).
2/ Equal to gross domestic investment minus foreign saving.
3/ In 2001-02, includes security related expenditures and compensation to the depositors from failed pyramid schemes.
4/ Includes domestic debt of central government and external debt of the public sector. Figures include bonds issued in 2001 for the frozen foreign currency deposits, as well as abilities assumed by the government as of end-March 2000 on account of bank and enterprise restructuring, but exclude obligations for retroactive payments to pensioners.
5/ Gross debt net of general government deposits in the banking system.

Table 11. FYRM: Indicators of External and Financial Vulnerability, 1999-2003

	1999	2000	2001	2002	2003 Prel.
Financial indicators					
Broad money (end of period; percent change from end of previous year)	29.7	25.6	55.4	-7.7	17.2
Private sector credit (end of period; percent change from end of previous year)	9.4	17.2	8.3	-0.9	19.0
Share of non-performing loans in total bank exposures (end of period, in percent)	41.3	34.8	33.7	15.9	15.1
Foreign currency deposits (end of period, in percent of total broad money)	19.2	22.8	37.4	39.6	41.8
Indexed loans to private sector					
(end of period, in percent of denar credit to private sector)	...	...	26.9	25.9	26.1
Foreign currency credit to private sector					
(end of period, in percent of total credit to private sector)	21.3	14.0	13.8	14.4	18.9
Indexed loans and foreign currency credit to private sector					
(end of period, in percent of total credit to private sector)	...	...	37.0	40.3	45.0
Central Bank short-term foreign liabilities (in millions of US dollars)	102	14	0	0	0
Short-term foreign assets of commercial banks (in millions of US dollars) 1/	393	426	638	558	670
Short-term foreign liabilities of commercial banks (in millions of US dollars) 1/	191	174	145	90	88
Money market rate (end of period; in percent)	11.6	7.2	12	14.4	8.6
External Indicators					
Exports (percent change, in terms of US$)	-7.9	11.0	-12.5	-3.7	22.1
Imports (percent change, in terms of US$)	-6.7	19.3	-16.6	12.0	17.7
Current account balance (in percent of GDP)					
(Including official grants)	-0.9	-2.1	-6.8	-8.5	-6.0
(Excluding official grants)	-2.9	-5.8	-8.2	-11.2	-8.2
Foreign direct investment (in percent of GDP)	0.9	4.9	12.9	2.1	1.9
Gross official reserves (in millions of US dollars; end of period)	450	700	756	735	903
(In months of next year's imports of goods and services)	2.4	4.3	4.2	3.5	4.0
(In percent of private denar broad money)	67.1	89.9	65.6	59.1	62.6
Total external debt (in percent of GDP)	39.2	40.1	38.0	38.4	34.4
of which: public sector (in percent of GDP)	34.1	35.7	33.7	33.4	30.4
Short-term debt (by remaining maturity)					
(In percent of GDP)	4.8	5.3	7.3	6.2	5.3
(In percent of official reserves)	39.2	27.2	33.3	31.8	27.1
External debt service payments (in percent of exports of goods and services)	12.4	13.0	19.0	16.6	13.9
Exchange rate (denar per U.S. dollar, period average)	56.9	66.0	68.0	64.7	54.9
REER (average percent change; (-) depreciation)					
CPI-based	2.9	4.0	-6.1	-2.4	0.4
ULC-based	7.6	7.6	-6.2	-2.4	...

Sources: The FYRM authorities; and IMF staff estimates and projections.

1/ The previously used time series, which was taken from the BOP, was replaced by data taken from commercial banks' balance sheets.

Structural Performance Criteria and Structural Benchmarks Under the Stand-By Arrangement

I.	**Original Program**		
A.	**Structural Performance Criterion**		
1.	Raise electricity prices per kilowatt-hour by 7 percent in each category of household electricity consumption (MEFP ¶9).	July 1, 2003	Completed in June
B.	**Structural Benchmarks**		
1.	Amend the Law on Budgets and the Law on Public Procurement to expand budget authorization and payment functions of the treasury system in the Ministry of Finance to ensure proper monitoring and control over line ministries' expenditure commitments and payments arrears effective September 2003 (MEFP ¶13).	By end-May, 2003	Completed in April
2.	Improve labor market flexibility (MEFP ¶21) by:	By end-May, 2003	Completed in April
	(i) amending the Law on Employment and Unemployment Insurance to limit the duration of unemployment benefits to a scale rising to a maximum of 14 months for the unemployed with more than 15 years of service, and		
	(ii) amending the Law on Labor Relations to reduce the legally required severance pay to one month for every three years of service, from one month for every two years.		
3.	Initiate an external audit of the financial position and procurement procedures of the Health Fund, with terms of reference approved by the World Bank (MEFP ¶14).	By end-June, 2003	Financial audit initiated; audit of procurement procedures delayed
4.	Publish the external audit of the NBRM's 2002 statements (MEFP ¶29).	By end-July, 2003	Completed in June
5.	Enact a 2004 budget consistent with the general government deficit (fiscal balance excluding foreign-financed projects) of 1 1/4 percent of GDP (MEFP ¶7).	By end-December, 2003	Completed in December, 2003; budget deficit increased to 1.4 percent of GDP

II. Revised Program			
A. Prior Actions for the First Review			
1.	Send out notification letters of redundancy to 900 employees of the health sector.		Completed
2.	Set up a working group with members from the MOF and the NBRM in charge of reconciling monetary and fiscal accounts. The working group will prepare a detailed report on the reason for the discrepancies and list recommendations for preventing such discrepancies in the future.		Completed
3.	Send a supplementary budget to parliament in line with the agreement in the LOI.		Completed
B. Structural Performance Criterion			
1.	Revise the on-site banking supervision manual of the NBRM to include the indirect exchange rate risk exposure of borrowers in the credit risk assessment.	By end-December, 2003	Completed
C. Structural Benchmark			
1.	Send out notification letters of redundancy to additional 340 health sector employees selected in line with a health sector reorganization plan to ensure that the layoffs are permanent and do not impair the quality of health care.	By end-March, 2004	Only 260 positions were cut
3.	Strengthen the internal control department of the Public Revenue Office by the addition of qualified staff and define and implement a program of system audits.	By end-December, 2003	Completed
4.	Submit a new Tobacco Law to parliament that, among other things, allows any company, domestic or foreign to purchase and market tobacco in Macedonia.	By end-November 2003	Completed
5.	Introduce legislation under which the NBRM will have the authority to license and supervise money transfer houses.	By end-December 2003	The law became effective in December 2003, by-laws were passed in January 2004.

FYR Macedonia—Fund Relations
(as of May 31, 2004)

I.	**Membership Status**:	Joined 12/14/92; Article VIII	
II.	**General Resources Account**:	SDR Million	Percent of Quota
	Quota	68.90	100.00
	Fund holdings of currency	85.84	124.59
III.	**SDR Department**:	SDR Million	Percent of Allocation
	Net cumulative allocation	8.38	100.00
	Holdings	0.58	6.97
IV.	**Outstanding Purchases and Loans**:	SDR Million	Percent of Quota
	Contingency and Compensatory	1.72	2.50
	Extended Arrangements	1.15	1.67
	ESAF/PRGF Arrangements	21.73	31.54
	Stand-By	12.00	17.42
	Systemic Transformation Facility	2.07	3.00

V. **Latest Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	04/30/2003	06/15/2004	20.00	12.00
EFF	11/29/2000	11/22/2001	24.12	1.15
PRGF	12/18/2000	11/22/2001	10.34	1.72

VI. **Projected Payments to the Fund (Expectations Basis)**[1]
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	6.39	7.87	12.18	10.27	1.25
Charges/Interest	0.40	0.58	0.45	0.25	0.14
Total	6.79	8.46	12.64	10.53	1.40

[1] This schedule presents all currently scheduled payments to the IMF, including repayment expectations and repayment obligations. The IMF Executive Board can extend repayment expectations (within predetermined limits) upon request by the debtor country if its external payments position is not strong enough to meet the expectations without undue hardship or risk, repayment schedules and IMF lending for details).

Projected Payments to the Fund (Obligations Basis)[2]
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2004	2005	2006	2007	2008
Principal	6.39	6.68	6.99	11.08	6.45
Charges/Interest	0.40	0.59	0.54	0.42	0.24
Total	6.79	7.27	7.53	11.51	6.69

VII. **Safeguards Assessments:**

Under the Fund's safeguards assessment policy, the National Bank of the Republic of Macedonia (NBRM) is subject to a full safeguards assessment with respect to the Stand-By Arrangement, approved on April 30, 2003. The assessment was completed on April 24, 2003 and proposed specific measures to address a few weaknesses, as reported in IMF Country Report/03/151. These measures are being monitored by staff under the present Stand-By Arrangement.

VIII. **Exchange Arrangement**:

The currency of the FYRM is the denar. The FYRM maintains a managed floating exchange rate system with a de facto peg to the Euro. Households can transact only through commercial banks or through foreign exchange bureaus that act as agents of banks; enterprises can transact through the banking system. The reserve requirement on all foreign currency deposits is set at 7.5 percent.

At end-October 2003, the official exchange rate was denar 55.8 per U.S. dollar. The FYRM has accepted the obligations of Article VIII, Sections 2, 3, and 4 with effect from June 19, 1998. The FYRM maintains an exchange restriction subject to the Fund's approval under Article VIII, Section 2(a) arising from restrictions imposed on the transferability of proceeds from current international transactions contained in former frozen foreign currency saving deposits.

[2] This schedule is not the currently applicable schedule of payments to the IMF. Rather, the schedule presents all payments to the IMF under the illustrative assumption that repayment expectations-except for SRF repayment expectations-would be extended to their respective obligation dates by the IMF Executive Board upon request of the debtor country (see repayment schedules and IMF lending for details). SRF repayments are shon on their current expectation dates, unless already converted to an obligation date by the IMF Executive Board.

IX. **Article IV Consultations**:

The first consultation with the FYRM was concluded in August 1993. The last consultation was concluded on April 30, 2003 IMF Country Report/03/131. The FYRM is on the standard consultation cycle.

X. **Technical Assistance (since 1999)**:

Purpose	**Department**	**Date**
National Accounts	STA	May 2004
Debt Management	FAD	March 2004
Data ROSC	STA	February 2004
Fiscal Decentralization	FAD	September 2003 March 2002
FSAP	MFD/WB	May 2003 and June 2003
Public Expenditure Management	FAD	May 2003
Monetary Operations and Payment System	MFD	November-December 2002 April 2004
Balance of Payments Statistics	STA	June-August, 2000 October 2002
Tax Policy	FAD	December 2001
Development of a Treasury System	FAD	October 2000 November 2001
Value-Added Tax	FAD	February 1999 October 1999 October 2000
Article VIII	MFD/LEG	September 2000
Monetary Policy and Banking Supervision	MFD/ WB MFD	October 1999 December 1999, May 2000
Resident Experts		
Value-Added Tax	FAD	October 1999-April 2001
Development of a Treasury System	FAD	January 2000-July 2001

XI. Resident Representative

The Fund has had a resident representative in Skopje since 1995. Mr. Kevin Ross has held this position since May 2003.

FYR Macedonia—Statistical Issues

The authorities, with technical assistance from the Fund, and other bilateral and multilateral agencies, have made significant progress in upgrading the country's statistical system in recent years. Continued efforts are made to further improve the quality and data availability of the country's statistical system. Data reporting to the Fund remains timely and an IFS page is available. The authorities began participating in the General Data Dissemination System (GDDS) from February 2004. A data ROSC mission was conducted in mid-February 2004. A fiscal ROSC mission and technical assistance for BOP have been proposed for 2004.

Real sector data have improved, but remaining deficiencies need to be addressed. Quarterly GDP volume estimates, based on a set of production indicators, are being produced on a regular basis. These estimates are revised to be consistent with the final annual GDP figures. Quarterly GDP data using the expenditure approach are not available but are expected to be developed within a year and a half under a Fund technical assistance program in national accounts agreed with the authorities in May 2004. Calculations of deflators should be reviewed, as historical deflators appear to be out of line with price developments elsewhere in the economy. Deficiencies in inventory valuation have been identified. Consumer, retail, and producer price statistics are compiled on a timely basis. However, methodological improvements are needed in the calculation of the producer price index. Employment statistics continue to be unreliable. The annual labor force survey has been conducted every April since 1996, except 2001 when it was postponed until October 2001 following the outbreak of the security crisis.

The compilation and coverage of balance of payments data, in particular on external debt, have improved in recent years. However, a large portion of private transfers and short-term capital flows is unrecorded, which manifests itself in significant and fluctuating errors and omissions. Kosovo-related non-resident purchases are recorded as a separate item under exports of goods and services in the national income accounts but are not fully captured in the exports of goods and services under the balance of payments statistics. The technical assistance mission from the Fund in June-August 2000 identified the following areas where improvement was needed: (i) recording of external assets and liabilities of the monetary authorities in accordance with the BPM5 methodology, and (ii) correcting the overstatement of private transfers due to transactions involving foreign currency accounts. Furthermore, the October 2002 STA technical assistance mission recommended further improvements to the estimation of short-term trade credits, reviewed the work that had been carried out to adjust for the "Euro-conversion effect" and to improve the valuation of transactions in goods. Further recommendations were made relating to the valuation of imports of goods and to the estimation of transportation services. A mission is planned for late 2004 to provide assistance with the implementation of new data sources—new surveys for short term trade credits and transactions of residents through their accounts abroad—and improvements to the data collection for direct investment and external debt.

No government finance statistics (GFS) have been reported to STA since the annual data for 1996 were provided by the Ministry of Finance and published in IFS. However, satisfactory sources exist for central government fiscal data from which GFS can be compiled. The financing data for the central government from the BOP and the monetary survey is now being reconciled on a monthly basis in line with the recommendations by the recent (June 2003) FAD technical assistance mission and discrepancy has been significantly reduced. The data for extra-budgetary funds are less reliable than the central government data; however, the authorities have started ad hoc monetary and fiscal data reconciliations for individual funds. Off-budget operations and special revenue and expenditures of line ministries have been compiled with a lag since February 2001 and are presented in the budget document. General government table, consolidating central government and funds' operations, was presented to the Parliament for the first time with the 2004 budget. Data on central government domestic arrears has improved following introduction of commitment accounting in autumn 2003. Data on funds arrears, especially of the Health Insurance Fund, remain unreliable.

Money and banking data are reported to the Fund on a regular basis. However, there is a need for the National Bank of Macedonia (NBRM) to review the effectiveness of processes in place for reviewing and assessing the accuracy and reliability of source data for compiling monetary statistics. On several recent occasions, data inconsistency and misclassification have been identified. The institutional coverage of monetary statistics could be improved by including all other depository corporations, such as savings houses. Improvement of the analytical usefulness of interest rates could be made by compiling weighted average lending and deposit rates for different maturities. Other improvements need to be made in the data reported by the commercial banks to the NBRM for specific analytical and supervisory purposes, such as reporting of data on credit by economic activity, currency (including indexed lending) and maturity, and monthly data on full financial statements of the banks. The authorities have started reporting monetary data on both current and constant exchange rate basis although reconciling the data continues to be difficult due to weaknesses in institutional capacity. A monetary and financial statistics mission has been scheduled for early 2005 to follow up on the data ROSC mission in 2004.

FYR Macedonia—Core Statistical Indicators
(as of July 1, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt/ Debt Service
Date of Latest Observation	June 4	June 4	June 25	May 31	May 30	May 30	June	April	March	March 31	March	Dec 31, 2003
Date Received	June 15	June 15	July 1	June 10	June 28	June 28	July	June 1	June 15	April 25	July	March 2004
Frequency of Data	Daily	Daily	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly
Frequency of Reporting	Weekly	Weekly	Monthly	Weekly	Monthly	Monthly	Monthly	Variable	Variable	Monthly	Quarterly	Variable
Source of Update	NBM	NBM	NBM	NBM	NBM	NBM	SOM	NBM	NBM	MOF	SOM	MOF/NBM
Mode of Reporting	Fax	Fax	Fax/E-mail	Fax	Fax/E-mail	Fax/Email	Fax/E-mail	E-mail	E-mail	E-mail	Mission/ Fax	Mission/ E-mail
Confidentiality	UR	UR[1]	UR[1]	UR[1]	UR	UR	UR	UR	UR[1]	UR[1]	UR	SB
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly

List of abbreviations:

NBM: National Bank of Macedonia
MOF: Ministry of Finance
UR: Unrestricted use
SB: For use by staff and the Executive Board
SOM: Statistics Office

[1/] Preliminary data received by Fund staff before it has been published by the authorities should be treated as confidential.

FYR Macedonia: IMF—World Bank Relations

Partnership in FYR Macedonia's Development Strategy

The former Yugoslav Republic of Macedonia (FYR Macedonia) has been a member of the World Bank since 1993. Since FYR Macedonia joined the Bank, 29 loans have been approved with a total value of over $655 million. Of this, over $290 million has been extended under IBRD and over $365 million under IDA. Approximately $90 million remains undisbursed as at May 2004. FYR Macedonia graduated from IDA in 2003, and all new lending to FYR Macedonia is now on IBRD terms.

Table 1. Summary of World Bank Operations
(As of May 2004)
(In US$ Millions)

FY	Name of Operation	IDA Amount	IBRD Amount	Status	Undis-bursed
1994	Economic Recovery Credit	40	40	Closed	
1995	Transit Facilitation Project		24	Closed	
1995	Social Reform and Technical Assistance	14		Closed	
1995	Financial and Enterprise Sector Adjustment	85		Closed	
1996	Private Sector Development		12	Closed	
1996	Private Farmer Support	7.9		Closed	
1996	Health Sector Transition	16.9		Closed	
1997	Structural Adjustment Credit	30	30	Closed	
1998	Education Rehabilitation	5		Closed	
1998	Private Sector Development II		25	Closed	
1998	Irrigation Rehabilitation	5	7.5	Active	7.1
1998	Power System Improvement		35	Active	4.7
1999	Pension Reform TA	1		Closed	
1999	Social Sector Adjustment	29		Closed	
1999	Transport Sector Project		32	Active	8.1
1999	Emergency Recovery Credit	50		Closed	
1999	Social Support Credit	10		Closed	
2001	Trade & Transport Facilitation (SE Europe)	9.3		Active	4.8
2001	Financial & Enterprise Sector Adjustment II	20	30.3	Closed	
2001	Community Development and Culture	5		Active	4.5
2001	Children and Youth Development	2.5		Active	1.8
2002	Emergency Economic Recovery Credit	15		Closed	
2002	Public Sector Management Adjustment	15		Closed	
2002	Community Development Project	5		Active	4.8
2004	Education Modernization		5.0	Active	4.9
2004	Public Sector Management Adjustment II		30.0	Active	30.0
2004	Social Protection		9.8	Active	9.8
2004	Health Sector Management		10.0	Active	10.0
	TOTAL	**365.6**	**290.6**		**90.5**

2. The World Bank's Board endorsed a Country Assistance Strategy (CAS) for FYR Macedonia on September 9, 2003. The CAS presents an IBRD program of support which seeks to build on the improved macro-economic management and progress in structural reform that has occurred since the formation of the current Government following elections in September-2002. While considerable risks remain, the CAS reflects the window of opportunity for improved growth presented by the relatively calm internal and external environment, following regional conflict during much of the 1990s and the internal conflict in FYR Macedonia that was concluded with the Ohrid Peace Agreement of August-2001. The Stabilization and Association Agreement (SAA) signed between the Macedonian Government and the European Union in 2001 also provides a longer-term framework for the development agenda in FYR Macedonia, supported by FYR Macedonia's application in early-2004 to join the EU.

BANK GROUP STRATEGY

3. Reflecting Government priorities, the CAS outlines three broad themes for World Bank assistance to FYR Macedonia: (i) promoting the efficient management of public resources and tackling corruption; (ii) promoting the creation of jobs through sustainable private sector led growth; and (iii) promoting social cohesion, building human capital and protecting the most vulnerable. Following ethnic tensions in 2001, the reform agenda was largely derailed and much of the program, under a TSS, focused on reconstruction and reconciliation, as well as a range of community focused programs intended to provide a peace dividend. Activities started in the late 1990s to support key road and energy infrastructure also continued. With a more conducive environment for reform, recent adjustment operations and associated investments have focused especially on strengthening public sector management. While maintaining a focus on key areas of public sector reform, the future program is anticipated to increasingly support Government efforts to improve the business environment and support broad-based growth and employment.

4. The CAS envisages a high-case program of up to $165 million over three years. In approving a Public Sector Management Adjustment loan and interlinked health and social protection investment operations in May-2004, the World Bank Board agreed that it was appropriate to move to a high case lending scenario subject to continuing policy performance. Disbursement of the bulk of the adjustment operation is, however, dependent on continuing reform of health sector management, which has proved a particularly problematic area in the past. Lending will be supported by a substantial body of diagnostic and fiduciary work and substantial TA. An indicative program is outlined in Table 2.

5. Promoting the efficient management of public resources and tackling corruption. The Macedonian Government has been successful in stabilizing the economy. Macro-economic indicators have improved, and fiscal policy is relatively prudent. Nevertheless, public resource management has been, and remains, a major issue. Despite progress, much remains to be done, especially in strengthening fiduciary controls over public finances. A critical weakness which remains, and which has been a major source of corruption and misuse of public resources in the past, is the operation of four extra-budgetary funds, which have been outside the control of the central government budget and are subject to weak oversight. These together comprise approximately 40 percent of general government spending. The Bank is providing advice and

assistance to support the Government to meet its commitments to the IMF to consolidate the extra-budgetary funds within the Treasury Single Account. The civil service and broader public sector employment structures require considerable reform, which is being supported by the Bank and the IMF. Significant function decentralization, as envisaged in the Law on Local-Self Government will also pose significant challenges.

Table 2. The Planned IBRD Assistance Program FY04-06

	Base Case	*US$m*	***High Case***	*US$m*
FY04	Education Access:		Education Access	
Lending	Improvement Project	5	Improvement Project	5
	Health Sector Management	10	Health Sector Management	10
	Social Protection	9.8	Social Protection	9.8
			PSMAL II	30
ESW/AAA	*FSAP*		*FSAP*	
	Energy Sector Strategy		*Energy Sector Strategy*	
	Poverty Assessment		*Poverty Assessment*	
	Urban Slums Analysis		*Urban Slums Analysis*	
FY05	Land Registration	15	Land Registration	15
Lending	Business Environment	15	Business Environment	15
	Water Resources (GEF)		Water Resources (GEF)	
			Railways Restructuring	15
			PSAL 1	15
ESW/AAA	*Poverty Assessment*		*Poverty Assessment*	
	Legal/Judicial Diagnostic		*Legal/Judicial Diagnostic*	
	Social Services Delivery		*Social Services Delivery*	
FY06	Reg/ Judicial Reform	10.2	Reg/Judicial Reform	10.2
Lending	Electric Power Dev	25	Electric Power Dev	25
			PSAL 2	15
ESW/AAA	*Poverty Assessment*		*Poverty Assessment*	
	Public Expenditure Update		*Public Expenditure Update*	
	Country Procurement Update		*Country Procurement Update*	
	Social Development Update		*Social Development Update*	
Total		***90***		***165***

6. Financial support and associated policy dialogue linked to the recently approved Public Sector Management Adjustment Loan (PSMAL 2) will assist as further measures to consolidate improvements in budgetary planning and execution such as the implementation of controls over commitments by budget entities, which was put in place in September-2003. A key element of this loan, and the associated Health Sector Management Improvement Project will be the reform of the Health Insurance Fund and the strengthening of pharmaceutical procurement through international competitive bidding. The ongoing wage decompression for the civil service will make a start at creating a structure that would help attract and retain qualified staff in the civil service and reduce some of the incentives for corruption. Reform of the existing instruments of social protection to improve targeting, eliminate adverse incentives affecting the labor market, and reduce the fiscal drain on government finances will also be supported. As progressively

deeper reform of public administration is currently anticipated through the CAS period, the Bank will also look, as part of a high case lending program, to commence a three-year series of linked Programmatic Structural Adjustment Loans. The PSAL operations are planned to support both the improvement of public sector management and reforms to improve the investment climate.

7. Lending has been supported by a range of analytic work focused on improving public expenditure management. This includes a Public Expenditure and Institutional Review (PEIR) conducted in 2000, a Country Procurement Assessment Report (CPAR) in 2002, a Country Financial Accountability Assessment (CFAA) in 2003 and a Country Economic Memorandum in 2003. A PEIR update and a further CPAR are anticipated in FY06 to review progress.

8. Promoting the creation of jobs through sustainable private sector driven growth. A rebound in private sector activity and growth will be critical to reduce poverty in FYR Macedonia, especially given persistently high unemployment. Extensive work will be undertaken to define a multi-year program of reforms aimed to stimulate the private sector. This will include measures to improve the business environment, further strengthen the broader financial sector, improve the functioning of the judiciary and the application of commercial legislation, strengthen the land titling system and the scope for borrowers to use secure title to access credit, and complete the process of resolution of state owned enterprises.

9. Despite a relatively sound macro-economic environment, comparatively slow progress with structural reform has resulted in disappointing growth and employment creation. A key element of reform, the resolution of the largest loss making enterprises through privatization, financial restructuring, or closure, has been largely completed, with the Financial and Enterprise Sector Adjustment Loan (FESAL) supporting the sale or closure of approximately forty loss–making enterprises by December-2003. Nevertheless, the enterprise sector remains inefficient and uncompetitive. Weak enforcement of contracts and protection of property and creditor rights remain significant impediments to robust private sector growth. Given the importance of contract enforcement, creditor and property rights for private sector activity, the Bank intends to retain a degree of flexibility in designing future activities to support short-term actions that might be needed to implement recommendations of the judicial and legal diagnostic study (currently under preparation), and which could also contribute to the preparation of the groundwork for the planned free-standing project. Analytical work by the Bank and the IMF, including a ROSC (Report on Observance of Standards and Codes) on Accounting and Auditing, indicates that the observance of auditing and accounting standards in FYR Macedonia is poor, and contributes to the overall climate of poor fiduciary control. Changes currently being processed to the Audit Law should, however, help to ensure that a framework is in place to address these issues.

10. As with the public sector reform program, the Bank's support to this objective will be anchored in programmatic lending, specifically through the linked PSAL operations. Adjustment lending will be supported by a series of complementary and linked investment operations. Reflecting the constraints to growth posed by a lack of secure land titles, a Land Registration project is planned for FY05 to support the completion of a real estate cadastre and the building of capacity to support land title transfer and land use monitoring. A Business Environment investment operation scheduled for late FY05 or early FY06 will focus on (i) improving business

entry, operations, and exit; and (ii) enhancing the competitiveness of the enterprise sector. This will draw in part on the joint IMF and World Bank Financial Sector Assessment Program completed in September-2003 which identified priorities for strengthening of financial sector supervision and regulation. In addition, a Legal and Judicial Diagnostic study will expand on other studies which have identified significant weaknesses in the judicial system that adversely affect creditor and property rights, as well as generally undermining the rule of law. On the basis of this analysis, a Regulatory and Judicial Reform project is also planned for FY06, with a particular focus on improving the application and enforcement of commercial law. This will need to be coordinated closely with the European Commission, which has the lead among donors in the legal and judicial sector, as well as to ensure that proposed reform is consistent with the EU *acquis communautaire*.

11. In order to provide an enabling environment for private sector led growth, interventions in the transport and energy sectors are intended to increase private participation, improve services, and explore opportunities for greater sub-regional cooperation. Given FYR Macedonia's land-locked position, improvements in the transport sector are essential for regional integration and to promote growth. A primary objective of a Railways Restructuring project planned for FY05 is to restructure Macedonian Railways to facilitate the opening of the transport sector to private sector investment and to reduce the burden on public finances from mounting losses. The Bank will also continue efforts to assist the harmonization of customs and improve trade links through the regional Trade and Transport in South East Europe (TTFSE) initiative. An Energy Sector Strategy will seek to analyze options for alternative fuel sources for FYR Macedonia giving dwindling lignite supplies as well as exploring possibilities to diversify electricity supply and integrate more closely into regional energy markets. This work will inform the design of an Electric Power Development project. Through this project the Bank will seek to catalyze partnerships with other institutions and the private sector, as well as reducing electricity losses in distribution. This operation will take advantage of the Bank's position to overcome obstacles to private sector involvement in infrastructure provision.

12. Promoting social cohesion, building human capital and protecting the most vulnerable. The Kosovo crisis and the civil conflict of 2001 eroded social cohesion. There are substantial social and economic differences between FYR Macedonia's ethnic communities, rural and urban populations and, more generally, between sub-regions of the country. While the implementation of some provisions of the Ohrid agreement has begun to promote reconciliation and reintegration of communities, there remains a substantial unfinished agenda.

13. The Government's primary vehicle for improving social cohesion is the Ohrid Agreement. Given significant donor assistance pledged to support the implementation of the agreement, and especially to support technical capacity building at the municipal level, the Bank will not focus its resources in this area. The Bank will, however, be looking to support specific elements of the decentralization process and seeking to mitigate against critical risks, such as a breakdown in the delivery of key services. Support will focus especially on education. The Education Access Improvement project is focusing on improving the quality of primary and secondary education in FYR Macedonia while piloting new financing arrangements. The project will seek to improve the access of minority groups to education, including support especially for

Roma children who remain particularly disadvantaged. Through the adjustment lending program and the Health Systems Improvement and Social Protection projects the Bank will also assist the government with a redesign of the existing social protection system to improve targeting of the safety net and provide better coverage of the poorest. The improvements in the transparency and accountability of health service delivery expected under the project will also be important to improving access to and quality of health care for the most vulnerable. The Bank will be working closely with the government to implement pension reform to improve the long term financial sustainability of the pension system, while mitigating the significant risks that exist. The Bank will also continue to support the broader reconciliation agenda through its existing portfolio, in particular through the Children and Youth Development and the Community Development projects under implementation.

14. Lending operations will be supported by a range of technical assistance and analytic activities. A Programmatic Poverty Assessment is intended to provide a comprehensive analysis of poverty data, as well as building the capacity of national institutions to collect and analyze data. Results of the November-2002 census will allow for the formulation of a new sampling frame and renewed analysis of poverty data from previous years. Although data deficiencies mean this is unlikely to be sufficient to deliver a robust poverty assessment, it will provide a much more accurate poverty profile than currently available and form the basis for more regular poverty monitoring reports. The proposed poverty assessment activities related to the evaluation and assessment of government programs will assist the authorities in better targeting of policies and improve public resource management.

Bank—Fund Collaboration in Specific Areas

15. World Bank assistance for structural reform in FYR Macedonia has supported the IMF's lead role on support for macro-economic policies aimed at facilitating sustainable growth. Continuing collaboration is likely to become even more critical given that most of the outstanding areas for reform remain on the structural side. In areas of direct interest to the IMF, the Bank is engaging in policy dialogue and providing financial and technical assistance to support (i) improved public expenditure management; (ii) public sector reform; (iii) pension, health and social assistance reform; (iv) financial sector reform and development; (v) an improved policy environment for business, including legal and judicial reform, with a focus on the application of commercial law. This is set out in Table 3.

16. **Public expenditure management.** The Bank has complemented IMF policy conditionality and technical assistance to improve budget management with a multi-pronged assistance program including lending operations and fiduciary and diagnostic work. A range of weaknesses in public resource management identified in a Public Expenditure and Institutional Review (PIER) conducted in 2000 have since been addressed in a revised Law on Budget and Financial Management and other enabling legislation. The implementation of an effective treasury system, and a further systems upgrade being undertaken in September-2003, have been important steps forward in improving budget execution and strengthening expenditure control systems, although further improvements are needed especially in budget preparation and the establishment of a medium-term budgetary framework. The Law on Budget and Financial

Management and the Law on State Audits have also provided a solid legislative basis for the operations of the State Audit Office and the establishment of internal audit functions, although this function will require further strengthening. The Country Procurement Assessment Report (CPAR) and the Country Financial Accountability Assessment (CFAA) undertaken in 2002 has helped to define further public expenditure management components and conditionality included in PSMAL II.

17. **Public sector reform**. The civil service and broader public sector employment structures require significant reform. Hiring has often proved to be politically motivated, although progress has been made to improve systems and to focus on merit, including the passage of and subsequent revision of a Law on Civil Servants and recent enforcement efforts. Recent wage decompression supported through PSMAL II should help to start improving the civil service salary structure, which is highly compressed and remains an obstacle to attracting and retaining skilled staff. The Bank and IMF will need to work closely to ensure that an appropriate framework is in place to allow the Government to move ahead with efforts to increase minority participation in the civil service in a manner that is fiscally responsible. Bank efforts to strengthen structural improvements in civil service salary scales, have been supported by IMF conditionality that has supported Government efforts to streamline overall civil service staffing. As progressively deeper reform of public administration is currently anticipated through the CAS period, the Bank will also look, as part of a high case lending program, to use the programmatic PSALs to continue to engage on civil service reform.

Table 3. IMF—World Bank Collaboration in FYR Macedonia

Area	Specialized Advice from the IMF	Specialized Advice from the Bank	Key Instruments
Public Expenditure Management	Appropriate fiscal policy envelope; management of decentralization; Treasury development.	Reform in central budget formulation and execution, procurement practices and auditing functions; sectoral aspects of decentralization	*IMF*: SBA performance criteria; technical assistance *Bank*: *Analysis*: PEIR (2000); CPAR (2002); CFAA (2002); Decentralization status (2003). *Lending*: PSMAL II (FY04),
Public Sector Reform	Appropriate fiscal envelope; implementing health sector redundancy program.	Civil service reform; decompression of salaries.	*Bank*: *Analysis*: CEM, PEIR *Lending*: PSMAC (2000); PSMAL II (FY04)
Pension, Health and Social Assistance Reform	Reform of unemployment benefit entitlements; incorporating Extra-budget funds into Single Treasury Account; Remove subsidies to Health Insurance Fund; Implement health sector redundancy program.	Management reform of Health Insurance Fund (HIF), based on audit; Reform of pharmaceutical procurement; strengthening sustainability of pension system and Pension Fund.	*IMF*: SBA performance criteria *Bank*: *Analysis*: *Lending*: Health Sector Improvement (FY04); Social Protection (FY04); PSMAL II (FY04)
Financial Sector	Strengthening NBRM;	Improving regulatory and	*IMF*: SBA performance criteria

Reform and Development	Amending AML/CTF Law	supervisory framework for the financial sector, strengthen AML/CTF policies and compliance; assist development of financial markets.	*Bank*: FESAL II (FY01); Business Environment project (FY05) *Joint*: FSAP
Improved Business Environment	Monetary Policy, exchange rate, balance of payments, economic statistics.; electricity pricing reform; Tobacco Law reform.	Economic growth; investment environment for private sector activities, especially in regulatory framework and land markets; judicial and regulatory reform; infrastructure development for growth.	<u>IMF</u>: SBA performance criteria <u>Bank</u>: *Analysis*: CEM (2003); Energy sector strategy (2003); Legal/ Judicial diagnostic (2004). *Lending*: PSAL I (FY05); PSAL II (FY06); Judicial and Regulatory Reform (FY06); Land Registration (FY05); Trade and Transport Facilitation for Southeastern Europe (2001);

18. **Pension, health and social assistance reform**. The Bank and the IMF are cooperating closely to assist the Government to improve management of the Health Insurance Fund and the Pension Fund, which are the largest of the extra-budgetary funds, that the Government is consolidating within the Treasury Single Account. Continuing reform will be critical to reduce liabilities on the central government budget from these sources and to reduce opportunities for corruption and mismanagement, for which such funds have in the past proved a source.

19. Inefficiency and corruption in the state Health Insurance Fund (HIF) and state-owned healthcare institutions is a major source of poor performance in the health system. Efforts at reform have been tentative, though progress has occurred in some areas. For example, the HIF now contracts with private as well as public primary care providers. The Bank is also supporting the Government in its commitment to audit the Health Insurance Fund and to implement cost saving measures to ensure that further transfers to the HIF are not required from 2004. This will include new tenders for pharmaceuticals and other efficiency gains. Completing the audit of the HIF, implementing an action program to improve control and procurement systems, and undertaking international competitive bidding for pharmaceutical are key performance triggers for the disbursement of PSMAL II. Bank support for structural reform in the health sector has been supported by IMF conditionality to implement a redundancy program aimed at reversing the large number of appointments made immediately prior to the 2002 election.

20. Further reform of the pension system is also urgent. In 2002, the Pension and Disability Insurance Fund (PDIF) required considerable transfers from general revenue to meet expenditures. The structural deficit in the PDIF is expected to grow into the future. Reform will need to include parametric changes, along with efforts to improve administration through strengthened accounting and improved internal controls. The Bank has been active in supporting pension reform efforts in the past through a series of operations and technical assistance. The recently approved Social Protection Project, will focus especially on strengthening the financial sustainability of the current defined benefit "first pillar" pension scheme, as well as ensuring that essential pre-conditions for the move to a "second pillar" (including sufficient depth and breadth of financial instruments to allow a sensible investment strategy) are put in place.

21. **Financial sector reform and development**. The health of the banking system has been improved through the strengthening of regulatory and supervisory framework and the resolution of a number of problem banks, but the sector remains under-developed and significant weaknesses persist. More effective banking and financial market supervision will especially be important to improve financial stability and integrity and to ensure that capital is allocated efficiently to promote private sector led growth. The Government has already taken steps to implement the recommendations of the joint IMF and World Bank FSAP completed in September-2003, including moves to improve central bank accountability and strengthen banking and financial market supervision. A planned Business Environment project will assist further improvements in the regulatory and supervisory framework for the financial sector, including the insurance and pension systems, strengthening the legal framework for Anti-Money Laundering. Counter-Terrorist Financing (AML/CTF) polices and provide legal authority to monitor compliance. The operation will also support efforts to promote financial market development, including increasing market breadth, by the introduction of new instruments and increase transparency and accountability.

22. **Improving the business environment**. Improving the business environment will be crucial to overcome very high levels of unemployment and to attract investment flows, which, to date, have been disappointing. Complementing IMF dialogue with the Government o maintain a stable macro-economic environment conducive to increased private investment, the Bank will be engaging in policy dialogue through proposed adjustment operations, as well as providing technical and financial support to assist the Macedonian Government engage in structural reform. Extensive work will be completed through FY04 and FY05 to define a multi-year program of reforms aimed to stimulate the private sector. A proposed business environment investment operation could potentially help to: (i) reduce the heavy regulatory burden on business, including through streamlined licensing systems and increased accountability of Government processes; (ii) strengthen the institutional and regulatory framework to enhance competitiveness and encourage healthy competition, including through strengthening the anti-trust regime and improved standardization, testing and quality systems; and (iii) improve access to finance and commercial information, including upgrading credit information systems. This reform agenda will be coordinated closely with European Commission institutions, especially in those elements of the reform agenda, such as competition policy, that are linked with the *acquis communautaire*.

23. Legal and judicial reform will also be a crucial element in strengthening the business environment in FYR Macedonia. A legal an judicial diagnostic study is currently underway in order to provide a basis for policy dialogue through the linked PSAL adjustment operations and for a proposed investment project. Systemic problems in the Macedonian judicial sector include weak enforcement of creditor and property rights, high levels of politicization at all levels in the courts, lack of accountability of judges and the absence of a systematic program of assessment, review and training of judges. This will focus on the impediments in the legal framework and key institutions necessary for the effective enforcement of creditor, contractual and property rights, in particular the linkages to the judicial system.

FYR Macedonia: Selected Social and Demographic Indicators

	FYR of Macedonia	Albania	Bulgaria	Romania	Greece
Area characteristics					
Total land area (sq km)	25,430	27,400	110,550	230,340	128,900
of which : arable land (2000, in percent)	21.8	21.1	40.0	40.7	21.3
Population density (2001, people per sq km)	80.4	115.5	72.6	97.3	82.2
Population					
Total population (2001, in thousands)	2,035	3,164	7,913	22,408	10,590
Average annual population growth (2001, in percent)	0.6	1.0	-0.7	-0.2	0.4
Life expectancy at birth (2001, in years)	73.1	74.0	71.7	69.9	78.0
Male	70.9	71.7	68.3	66.1	75.3
Female	75.5	76.4	75.2	73.8	80.7
Under 5-years mortality rate (2001, per 1,000 live births)	26.0	25.0	16.0	21.0	5.0
Crude birth rate (2001, per 1,000 persons)	13.3	17.2	8.9	10.4	10.5
Crude death rate (2000, per 1,000 persons)	8.3	5.7	14.3	12.2	10.6
Income and poverty					
GDP per capita (2003, in U.S. dollars)	2,254	1,943	2,103	2,429	15,867
Poverty rate (2000, in percent) 1/	22.3	29.6	11.7	21.5	...
Urban	18.8	17.2	...	20.4	...
Rural	27.2	36.8	...	27.9	...
Health					
Physicians (1998, per 1,000 persons) 2/	2.3	1.3	3.5	1.8	4.3
Hospital beds (1997, per 1,000 persons) 3/	5.2	3.2	8.6	7.6	5.0
Education					
Net enrollment ratios (2000, in percent)					
Primary	92.4	97.6	94.3	92.8	97.3
Secondary 4/	81.0	73.9	87.6	79.6	87.4

Sources: World Development Indicators, 2002, World Bank; FYR of Macedonia: Statistics Office; Bulgaria: Poverty Assessment Update, 2001, World Bank; World Development Report 2002, World Bank; and Albania: National Strategy for Socio-Economic Development, Medium-term Program of the Albanian Government "Growth and Poverty Reduction Strategy", November 2001.

1/ Percentage of population below the national poverty line. For FYR of Macedonia, the poverty rate or the incidence of poverty is the proportion of individuals with an income (consumption) below 70 percent of median monthly 2000 consumption. Data for Romania refer to 1994. For Bulgaria, data refers to 2001 and the poverty rate is the proportion of indifiduals with consumption below two-thirds of median consumption in 1997. Data for urban Albania refers to 1998.
2/ Data for Macedonia is for 1997.
3/ Data for Albania is for 1995, and for Romania is for 1996.
4/ Data for Macedonia is for 1999.

FYR Macedonia: Millennium Development Goals

	1990	1995	2001	2002
Goal 1. Eradicate extreme poverty and hunger				
Target 1: Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day.				
1. Population below US$1 a day (percent)	...	...	...	...
2. Poverty gap ration at US$1 a day (percent)	...	...	...	...
3. Share of income or consumption held by poorest 20 percent (percent)	...	...	...	...
Target 2: Halve, between 1990 and 2015, the proportion of people suffering hunger				
4. Prevalence of child malnutrition (percent of children under 5)	...	...	5.9	...
5. Population below minimum level of dietary energy consumption (percent)	...	15.0	10.0	...
Goal 2. Achieve universal primary education				
Target 3: Ensure that, by 2015, children will be able to complete a full course of primary schooling.				
6. Net primary enrollment ratio (percent of relevant age group)	94.4	95.4	92.8	...
7. Percentage of cohort reaching grade 5	95.3	95.4	...	...
8. Youth literacy rate (percentage ages 15-24)	...	...	...	...
Goal 3. Promote gender equality				
Target 4: Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education by 2015.				
9. Ratio of girls to boys in primary and secondary education (percent)	98.6	97.8	98.1	...
10. Ratio of young literate females to males (percent ages 15-24)	...	...	...	...
11. Share of women employed in the nonagricultural sector (percent)	38.3	38.5	41.9	...
12. Proportion of seats held by women in the national parliament (percent)	...	...	...	...
Goal 4. Reduce child mortality				
Target 5: Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.				
13. Under-five mortality rate (per 1,000)	41.0	28.0	26.0	26.0
14. Infant mortality rate (per 1,000 lie births)	34.0	24.0	22.0	22.0
15. Immunization against measles (percent of children under 12-months)	...	97.0	92.0	98.0
Goal 5. Improve maternal health				
Target 6: Reduce by three-quarter, between 1990 and 2015, the maternal mortality ration.				
16. Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	23.0	...
17. Proportion of births attended by skilled health personnel	...	...	97.0	...
Goal 6. Combat HIV/AIDS, malaria and other diseases				
Target 7: Halt by 2015, and begin to reverse, the spread of HIV/AIDS				
18. HIV prevalence among females (percent ages 15-24)	...	...	0.0	...
19. Contraceptive prevalence rate (percent of women ages 15-49)	...	...	...	...
20. Number of children orphaned by HIV/AIDS	...	...	...	...

FYR Macedonia: Millennium Development Goals

	1990	1995	2001	2002
21. Incidence of tuberculosis (per 100,000 people)	...	...	35.0	41.5
22. Tuberculosis cases detected under DOTS (percent)	...	...	51.0	37.4
Goal 7. Ensure environmental sustainability				
Target 8: Integrate the principles of sustainable development into policies and program. Reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least100 million slum dwellers.				
23. Forest area (percent of total land area)	35.6	...	35.6	...
24. Nationally protected areas (percent of total land area)	...	7.1	7.1	7.1
25. GDP per unit of energy use (PPP $ per Kg oil equivalent)	...	...	...	...
26. CO2 emissions (metric tons per capita)	5.5	5.4	5.5	...
27. Access to an improved water source (percent of population)	...	...	...	...
28. Access to improved sanitation (percent of population)	...	...	...	...
29. Access to secure tenure (percent of population)	...	...	...	...
Goal 8. Develop a global partnership for development				
Target 9: Develop and implement strategies for productive work for youth				
30. Youth unemployment rate (percent of total labor force ages 15-24)	...	...	...	...
31. Fixed line and mobile telephones (per 1,000 people)	147.5	178.5	372.7	448.3
32. Personal computers (per 1,000 people)	...	...	...	...
General Indicators				
Population	1.9 million	2.0 million	2.0 million	2.0 million
Gross national income ($)	3.4 billion	3.4 billion	3.4 billion	3.5 billion
GNI per capita	1,750.0	1,710.0	1,690.0	1710.0
Adult literacy rate (percent of people ages 15 and above)	...	...	...	...
Total fertility rate (births per woman)	2.1	2.0	1.8	1.8
Life expectancy at birth (years)	71.6	71.9	72.8	73.4
Aid (percent of GNI)	...	1.8	7.3	7.4

Sources: World Development Indicators database, April 2004.

INTERNATIONAL MONETARY FUND

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Second Review Under the Stand-By Arrangement and Ex Post Assessment of Performance Under Fund-Supported Programs

Supplementary Information

Prepared by the European Department
(In consultation with other departments)

Approved by Susan Schadler and Donal Donovan

July 27, 2004

1. This supplement provides updated information on FYR Macedonia's growth in the first quarter of 2004 and its implications for the outlook for the rest of the year.

2. Official data for the first quarter of 2004 show a 3.6 percent decline in GDP (year on year), compared with the 3.1 percent increase projected at the beginning of the year. The reported decline is almost entirely attributable to a 25 percent drop in the industrial production index (IPI), which the authorities use as a proxy for industrial value added in quarterly GDP estimates. In the rest of the economy, first quarter growth was close to 2 percent.

3. The reported sharp reversals in GDP and industrial value added are not consistent with the behavior of other indicators of economic activity. Tax collections, exports, and electricity sales to industry all suggest that growth was positive in the first quarter. The authorities have therefore set up a Working Group to assess the methodology used to calculate the IPI. They do not intend to revise their GDP projection for 2004 until the Working Group's report has been delivered and reviewed.

4. The staff's view is that growth did slow in early 2004 but that the extent of the slowdown is exaggerated by the official data owing to shortcomings in the method and possibly the data used to calculate GDP and the IPI. Most of the reported first quarter reversal in growth can be traced to the closure of one large steel producer (which has since reopened), with an implausibly large weight in the GDP estimate. Staff calculations using a more plausible weight for that producer, and making some other adjustments, suggest that GDP may in fact have increased moderately in the first quarter, rather than declining as reported. More broadly, in the context of a recent technical assistance mission, STA has urged the authorities to review the weights in the IPI and to replace the IPI with a more reliable survey

when estimating industrial value added. Follow-up technical assistance is planned for later this year.

5. For 2004 as a whole, staff now projects growth of 1½ -2½ percent, compared with 4 percent projected at the time of the review discussions (and 3 percent projected at the time of the first review). The projection takes into account the official first quarter GDP data, adjusted as suggested above, and an estimate of the impact of floods in late spring.

6. Since the downward revision of the 2004 GDP projection results largely from temporary factors (floods and the temporary closure of the steel producer) and given the wide margin for error at this stage, no change in the Staff Appraisal is being proposed.

INTERNATIONAL MONETARY FUND

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Ex Post Assessment of Longer-Term Program Engagement

Prepared by Staff Team from EUR, FAD, MFD, and PDR, and from the World Bank

Authorized for distribution by the European
and Policy Development and Review Departments

July 22, 2004

I. INTRODUCTION

1. **The Former Yugoslav Republic (FYR) of Macedonia's economic performance during the years since independence has featured both notable achievements and disappointments.** A major success was the early attainment of a relatively high degree of macroeconomic stability which was maintained through a period punctuated by some major shocks. The country dismantled the apparatus of central planning and took many steps to strengthen the institutional framework for a market economy. However, some key structural weaknesses—many of which were identified at a much earlier stage—remain to be addressed effectively and hinder the country in achieving sustained higher growth.

2. **The Fund remained engaged with FYR Macedonia during much of this period, with a series of financial arrangements.** These included access under the Systemic Transformation Facility (STF) in 1994; a Stand-By Arrangement (SBA) in 1995; an ESAF/PRGF arrangement in 1997; an EFF/PRGF blend arrangement in 2000; and a SBA in 2003.

3. **This report presents an ex post assessment of FYR Macedonia's longer-term program engagement with the Fund.**[1] Section II provides an overview of economic developments. Section III discusses achievements and shortcomings in some key areas. Section IV assesses the role of the Fund in this process, including the reasons for and consequences of the longer-term program engagement. Section V discusses the implications for possible future Fund engagement.

II. OVERVIEW OF ECONOMIC DEVELOPMENTS

4. **Since achieving independence from Yugoslavia in 1991, the FYR Macedonia has been buffeted by several shocks**. These include the hyperinflationary breakdown of the monetary system of former Yugoslavia; the "transitional recession' experienced by many countries in the early years after the fall of Communism; the impact of trade embargoes, conflict and UN sanctions in other parts of former Yugoslavia (including the 1999 Kosovo crisis); and the internal security crisis of 2001. Since 2001, however, FYR Macedonia has enjoyed a period of comparative stability.

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[1] The report was prepared by a team consisting of Mr. T. Lane (PDR—head), Ms. Dieterich (EUR), Ms. Kahkonen (World Bank), Mr. Pivovarsky (FAD), and Mr. Quintyn (MFD). The report draws on a review of Fund documents and benefited from informal discussions with current and former mission chiefs.

5. **Geography and history created important challenges for FYR Macedonia in launching its transition to a market economy.** It is a landlocked, mountainous country, dependent on the stability and goodwill of its neighbors for access to international markets. Recent independence, and the Yugoslav legacy, were also important factors. Like many other transition economies, FYR Macedonia had to build up the institutions of a nation-state from those of a republic within a wider federation: while this provided the opportunity to design appropriate institutions, it strained the authorities' administrative capacity to implement other reforms. The country inherited the Yugoslav model of socialism based on worker-controlled enterprises, the starting point for transition was a network of somewhat ambiguous entrenched claims of existing workers and managers. Moreover, as a result of central planning in former Yugoslavia, its economy was heavily concentrated in a small number of activities that are heavily protected in foreign markets—including agriculture (notably tobacco), steel, and textiles. Finally, conflict in other former Yugoslav republics presented the image of a "bad neighborhood" which made it more difficult to attract foreign investment than elsewhere in Central and Eastern Europe.

6. **The country's ethnic divisions are an important condition underlying the political economy of transition.** Ethnic Macedonians comprise 64 percent of the population, ethnic Albanians 25 percent and other minorities 11 percent. The ethnic Macedonians had a greater role in the traditional industrial sector while ethnic Albanians had greater involvement in small business and higher rates of emigration. Reforms had a differential impact on the two largest ethnic groups, as the transition reduced the value of ethnic Macedonians' access to jobs in state-owned enterprises or the civil service, while raising the value of ethnic Albanians' experience with small businesses and their connections abroad (including the steady flow of remittances).[2]

7. **From this starting point, the period since independence can be divided into three phases: the post-transition slump and the restoration of macroeconomic stability (roughly 1991-96); a period of hesitant structural reform (1996-2001); and a period of post-conflict stabilization and renewed reform (2001-04).** A detailed chronology of events is provided in Table 1.

8. **The 1991-94 period was characterized by a massive decline in economic activity—a cumulative decline in GDP of more than 25 percent—reflecting the breakdown of central planning and trading arrangements in former Yugoslavia along with acute financial instability and inflation.** Inflation reached a maximum of 1600 percent per annum, and the denar depreciated by some 650 percent from its value at independence through 1994 (Figure 1). The macroeconomic instability reflected the existing regime of soft

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[2] See, for instance, *Ahmeti's Village—The Political Economy of Interethnic Relations in Macedonia*, European Stability Initiative, Skopje and Berlin, October 2002.

budget constraints: socially-owned enterprises had almost unlimited access to credit because the National Bank of the Republic of Macedonia (NBRM) was required to rediscount loans provided by commercial banks, which were not operated on commercial principles. In the context of this regime, the transitional slump led to widespread insolvency in the financial system.

9. **The authorities were successful in stabilizing the economy by 1996.** The decline in economic activity leveled out in 1994; by 1996, inflation was brought down into single digits and growth turned positive. This stabilization was the result of a strategy introduced in 1993, which included a sharp deceleration of monetary expansion associated with an abrupt tightening of fiscal policy and limitations on credit expansion to state enterprises. The exchange rate—which initially had been nominally pegged to the deutsche mark (DM) but with frequent adjustments—was de facto pegged to the DM in early 1994. The process of stabilization was, however, delayed by a trade embargo imposed by Greece in early 1994, in protest over the country's name and flag, which continued until September 1995.

10. **The 1996-2000 period was one of hesitant but significant reform in the context of a reasonable degree of macroeconomic stability.** Progress was made in a number of areas for reform—albeit considerably slower than envisaged, and in some cases not optimally designed. A majority of state-owned enterprises were privatized, in most cases into the hands of insiders. Important reforms were made in the financial sector, although major gaps in supervision and regulation remained. A major trade reform undertaken in 1996 reduced tariff rates and abolished numerous non-tariff restrictions (such as licensing requirements for imports and exports). The government also abolished various restrictions in the labor market, although as discussed below this reform was piecemeal. During this period, growth picked up to levels averaging 3 percent during 1996-2000. Inflation was kept in a range averaging around 2 percent, with the pegged exchange rate playing a vital role as a nominal anchor. The external current account deficit was a source of concern, however, widening to close to 8 percent of GDP, amid sluggish exports and high interest rates. Market pressures prompted a 15.5 percent devaluation of the denar in mid-1997. While pass-through from the devaluation to inflation was limited, the effect of the resulting increase in competitiveness is unclear: the current account did strengthen to near-balance, but this effect occurred only after about a year and a half, was short-lived, and was also associated with the Kosovo crisis in 1999. The Kosovo crisis changed the complexion of events in other ways: this crisis led to an influx of refugees and of international aid and interrupted the gradual progress of reform.

11. **Civil conflict broke out in early 2001, threatening macroeconomic stability and halting progress with structural reforms.** The conflict—ignited by the war in Kosovo against a background of ethnic tensions—was relatively contained and quickly resolved: a Peace Framework Agreement (PFA), brokered by the EU and US, was concluded in Ohrid in August. But the economy was affected: GDP slumped by about 4 percent while the related surge in defense-related spending pushed the general government fiscal balance to a deficit of some 7 percent of GDP and the external current account deficit to over 8 percent of GDP. Moreover, implementing the PFA would place further demands on the government: the

ethnic-Albanian minority was promised higher representation in the civil service, the use of Albanian as a second official language, and greater autonomy through fiscal decentralization to the local government level.

12. **During the period following the 2001 PFA through the present, the main tasks have been to restore stability, reactivate economic growth, and push forward with reforms—including those associated with the PFA and in preparation for eventual accession to the European Union.** Fiscal policy was adjusted to ensure that the transient expenditures associated with the conflict—and the inefficient temporary revenue measures used to finance them—did not become entrenched. In particular, the financial transactions tax introduced to cover temporary crisis-related spending was abolished on January 1, 2003, followed by offsetting expenditure cuts. The exchange rate anchor was maintained throughout this period, underpinning price stability. Growth recovered to near pre-crisis rates, although the growth rate did not move to a distinctly higher path. The external current account deficit remained wide, although it appears to have been financed in part by errors and omissions, presumably reflecting unrecorded remittances and proceeds from trade in the informal sector. Some structural reforms were undertaken during this period, albeit not path-breaking ones.

III. Achievements and Shortcomings

13. **FYR Macedonia's experience reveals a mix of achievements and shortcomings.** This section provides an overview of progress in key areas. The IMF's role will be examined in the following section.

14. **A noteworthy success was in stabilization.** Inflation was subdued from near-hyperinflationary levels and a comparative degree of price stability maintained, often under difficult circumstances. The de facto pegged exchange rate was maintained from 1994 onward (albeit with one large devaluation), throughout a very turbulent period. The external current account deficit, although worryingly large at times (including during the period from 2001 to the present), resulted in strong adverse market pressures only in 1997. The step devaluation undertaken in response to those pressures in the context of weak demand, a wage freeze, and tight fiscal policy, translated into improved competitiveness with little pass-through to inflation. The current account was financed in most years mainly through a combination of official financing and errors and omissions. The real growth rate fluctuated considerably over this period, but it is not clear that these fluctuations were avoidable, given the various shocks buffeting the economy.

15. **Unlike many other transition economies, FYR Macedonia managed to avoid an unsustainable run-up of debt.** Both the external and public debt dynamics were reasonably stable, due to relatively small ongoing imbalances, although debt did ratchet up with transitory surges in deficits. At end-2003, external debt stood at about 33 percent of GDP, of which public external debt consisted of about 29 percent of GDP. At the same time, given

that debt is primarily foreign currency-denominated, the debt ratios are vulnerable to a possible change in the exchange rate.[3]

16. **FYR Macedonia also made substantial—albeit often delayed and still in many ways incomplete—progress in building the institutional foundations of sound macroeconomic policies: an independent central bank and a modern fiscal system.** A modern legal framework for the central bank was established in 1992, although the independence of the central bank has not been without challenges—for instance, in the handling of problem banks and government pressures over the stance of monetary policy. A number of important improvements were made in central bank accounting and monetary policy operations, as well as in the payments system infrastructure.

17. **Public resource management has been, and remains, a major issue.** Despite repeated efforts, little progress has been made in rationalizing the public service, although there has been significant progress with some elements of civil service reform.[4] While measures to rationalize government functions, reduce staffing, and review salary structure were proposed as far back as 1997, average expenditures have remained virtually unchanged as a percent of GDP since 1995, without substantial improvements in the quality of public services. Related reforms were made with long delays and important weaknesses in the budget planning system and internal audit remain. The establishment in 2000 of a Treasury, although long delayed (it was originally planned in 1995), was a notable accomplishment in this area.

18. **The tax system was gradually reformed to reduce the distortionary effect of taxation on the economy.** One key step in this direction, the implementation of a VAT, was taken in 2000, several years after it had first been put on the agenda. Some measures have been taken to reduce the tax burden on labor (e.g. the lowering of income tax rates in 2001) but the burden remains high—recently a 47-50 percent tax wedge.[5] The effectiveness of

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[3] This is illustrated by the standard stress tests presented in the Staff Report for the 2003 Article IV Consultation, which show debt ratios rising substantially in the event of a major currency depreciation.

[4] The civil service covers only a small fraction of overall public sector employment, though. The reforms in question include the establishment of an independent Agency for Civil Servants responsible for preparing and enforcing civil service management policies and procedures; a competitive process for civil service recruitment; uniform definitions of positions; and unification and decompression (ongoing) of the salary structure.

[5] This wedge combines social contributions (at a rate of 32 percent) and income taxes (at rates of 15 or 18 percent). The comparable wedge in Serbia was recently 32 percent, in Croatia 45 percent, and in Bosnia-Herzegovina 50 percent in one republic and 67 percent in

(continued…)

collection has remained a major issue—particularly for labor taxes, where the high tax rates and weak enforcement has led to widespread evasion (i.e. unreported employment).

19. **The development of the economy's long-run growth potential has been disappointing, however.** Macedonia's growth performance was weaker than that in a number of more successful transition economies (Figure 2)—including other Balkan countries that experienced even greater conflict-related turbulence. Foreign investment has been particularly slow to materialize. While in part this performance reflects the political risk associated with the Balkan region, and with FYR Macedonia in particular, it also in large part reflected other aspects of the investment climate, notably weak institutions and governance more generally—in turn resulting from comparatively slow progress with structural reforms (as summarized by the EBRD's transition score).[6] Another important factor is the low savings rate—with national and domestic savings rates among the lowest in Eastern Europe.

20. **One key element of reform needed to mobilize growth, the privatization of socially- and state-owned enterprises, had been largely[7] completed by late 2003, eliminating a major structural drain on the public finances. But the method of privatization, together with the absence of a market for corporate control, gave insiders the dominant role.** Privatization was undertaken in several phases. A privatization law passed in 1993 gave enterprise managers and employees the right to choose the method of privatization—in particular, permitting management and employee buyouts. In 1995-96, privatization was accelerated and, among other things, a Special Restructuring Plan focusing on the largest loss-makers was launched. In 2000, as privatization was still not complete, another effort was launched to privatize or liquidate the largest loss-makers. Most of the enterprises were sold via preferential share sales to former managers and employees. While the reliance on insiders for privatization may have helped build public support for privatization—as they did not disenfranchise existing stakeholders—it also meant that effective enterprise restructuring was undertaken much more slowly than envisaged, as the insiders often had neither the incentive nor access to the resources needed to modernize these firms. The government was unwilling to push chronically loss-making enterprises into

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the others. (In the latter country, Fund staff have advised the authorities to reduce the tax wedge.)

[6] The EBRD Transition Score shown in Figure 2 consists of an average of EBRD index scores across various measures of transition, including liberalization, privatization, enterprise reform, infrastructure, financial institutions, and legal environment.

[7] By 2003, the privatization of most enterprises had been completed, but the fate of a handful of loss-making enterprises remained to be solved. To date, privatization of public utilities, notably the electricity company, has not yet been undertaken.

liquidation, and in some cases put direct limitations on the restructuring undertaken by privatized firms.[8]

21. **Once privatization had taken place, the resulting boost in efficiency and foreign investment was smaller than hoped,[9] reflecting the absence of mechanisms for strengthening corporate governance.** While in principle employee-owned firms can be efficient, this requires that the employee-owners internalize the benefits of restructuring and respond to market signals and discipline. In FYR Macedonia, this did not happen: the privatization mechanisms chosen led to diffuse ownership structures, and managers and employees were frequently allowed to control the secondary sales of shares. These factors are a strong disincentive for shifting corporate control to those with the resources and know-how to modernize these firms. Another factor is the information needed to value firms: enterprises are legally required to prepare accounts in line with International Accounting Standards, but these rules have not been applied consistently. In fact, only a handful of firms with shareholding structure trade in the FYR Macedonia'a minute stock market owing to weak accounting practices. Passage of a new bankruptcy law was long delayed and enforcement remains weak, with judicial processes proceeding very slowly and frequently with a bias in favor of existing owners and employees. Finally, although the automatic extension of credit to state enterprises was eliminated, various other aspects of softness in budget constraints—arrears in taxes and social contributions and politically-directed lending—remained. These factors tended to dull the incentives for privatized enterprises to restructure and expand—as reflected in virtually zero growth in these enterprises over the past decade.[10]

22. **With regard to the financial sector, major reforms were undertaken but the results were mixed.** In the early years of transition, the authorities faced the urgent task of changing the way the banking system operated to end the automatic expansion of credit to state enterprises, recapitalizing the banks after loan losses associated with the early events of

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[8] Employment concerns has been the dominant source of delays in dealing with large loss-making firms. Those that have been sold to private investors over the past few years often involved commitments by investors to maintain certain levels of employment in exchange for preferential tax treatments and special utility fees, clearly a second best option.

[9] For evidence on the performance of privatized enterprises, see for instance, J. Zalduendo, Enterprise Restructuring and Transition: Evidence from the Former Yugoslav Republic of Macedonia, IMF Working Paper WP/03/136, 2003. See also R. Glennerster, Is Privatization Effective in an Environment of Weak Corporate Governance? The Case of the Former Yugoslav Republic of Macedonia, IMF Working Paper (forthcoming).

[10] Insider privatization also occurred in other former Yugoslav republics, and in many cases similar issues arose. For instance, weak corporate governance has been an important concern in Bosnia-Herzegovina.

transition, and establishing the rudiments of a modern regulatory and supervisory system. While these tasks were accomplished—enabling the system to operate on a commercial footing and hardening the state enterprises' budget constraints—another set of problems proved much more difficult to address. Recapitalization was incomplete and labor practices limited the opportunities for more efficient staffing, so banks continued to rely on stiflingly high interest rate spreads to rebuild their capital. In particular, Stopanska Bank, the dominant banking institution, had significant governance problems as well as being undercapitalized; this institution was privatized and recapitalized in 2000, but similar problems persisted elsewhere in the system. There was insufficient emphasis on liquidating non-viable institutions, perpetuating a situation in which the country is overbanked—with 21 banks, unusually many for a country this size.

23. **The development of the financial regulatory framework was slow. Moreover, excessive political interference together with a lack of expertise prevented it from dealing effectively with the complexities of new types of financial institutions.** A dramatic example of the combination of these factors was the rise and, in 1997, fall of the TAT pyramid scheme. Problems associated with politically-connected lending recurred, resulting in balance sheet problems in some major institutions as recently as the past year. Moreover, with the fixed exchange rate, the financial system has built up substantial foreign currency exposures which have not been adequately measured or regulated.[11] In the late 1990s—to some extent in response to the TAT scandal—significant improvements were made in both the regulatory framework and supervisory capacity. Nonetheless, the 2003 FSAP still identified a number of remaining areas in which the banking and financial market supervision needed to be strengthened: advancing to a more risk-based surveillance and monitoring system; introducing accounting and disclosure standards for banks, identifying and managing exchange rate risks, and strengthening bank supervision in a number of respects. A number of the reforms recommended—notably those related to the identification and management of exchange rate risks and improved procedures for on-site assessments—have now been implemented in the context of the current standby arrangement.

24. **The trade system was overhauled in 1996 but given the other rigidities in the economy this did not result in a major shift in production to new activities.** Tariffs were reduced and import licenses abolished, substantially reducing the degree of trade restrictiveness—from the lowest ("restrictive") to the highest ("open") ranking on the classification system of trade restrictiveness (CSTR). But due to various supply-side rigidities and disruptions, the country was not able to take advantage of a more liberal trade regime by substantially increasing the share of trade in the economy and diversifying away from products that are heavily protected in external markets.

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[11] Typically banks have maintained long positions in foreign currency through foreign currency-denominated and -indexed lending, but this has exposed them to exchange rate-related credit risk to the extent that their borrowers are unhedged.

25. **Improving the overall business climate—particularly by strengthening governance—was, and to a significant extent remains, a missing ingredient for robust growth.** Corruption has been prevalent—constituting a high and uncertain tax on entrepreneurship. Weak governance has, at times, vitiated the effects of other reforms: for example, despite reforms in customs administration, that administration remained notoriously corrupt as late as 2002, constituting an informal trade tax.[12] Efforts have been made at various times to tackle corruption. Notably, a major anti-corruption drive was launched in early 2003, based on sound principles—setting up appropriate administrative structures (such as establishing an internal audit function) and changing regulations to reduce opportunities for corruption. Although there is a perception in the private sector that the level of corruption has diminished, some areas of public administration—notably the health insurance fund and the courts—remain problematic. As a related point, a new procurement law has been enacted and work has started on establishing regulations and institutional arrangements to implement it; although it remains to be seen whether the new law will be adequately enforced, the World Bank is supporting these reforms and following up on implementation. The Bank is also supporting attempts to address corruption through a number of actions to strengthen internal audit, budget formulation and execution, and above all, reform pharmaceutical procurement.[13]

26. **The labor market was, and remains, a key area of weakness.** Official unemployment rates rose during the early years of transition, remaining above 30 percent from 1996 through the present. Measured unemployment reflects, in part, the system whereby individuals are required to register as unemployed to qualify for health and other social benefits—as a result of which many of those active in the informal sector, as well as many undocumented workers in registered enterprises are counted as unemployed. At the same time, there is clearly also a genuine unemployment problem, associated with the high tax wedge on labor, a more general lack of flexibility of the labor markets, and a lack of employment opportunities in the formal sector more generally—the latter being attributable primarily to broader macroeconomic and structural factors rather than the labor market itself. The cosmetic problem associated with underreporting of employment hampers efforts to quantify and address the real problem. Various piecemeal efforts at reforms, which have aimed to increase labor market flexibility, for example by reducing severance pay and unemployment benefits, have been mainly ineffective in tackling the problem.

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[12] See, for instance, *Macedonia's Public Secret—How Corruption Drags the Country Down*, International Crisis Group Balkans Report No. 133, Skopje/Brussels, 14 August 2002.

[13] These measures include widening the coverage of the Treasury Single Account, ex ante controls over major spending items, and procurement regulations requiring ex ante Ministry of Finance approval of contracts.

27. **Poverty is another important focus of economic policies.** As in other transition economies, absolute poverty has been less prevalent in FYRM than in other countries with similar living standards, as income inequality has been less extreme. But due to low per capita income, absolute poverty rates are among the highest in Europe (exceeded only by Turkey and Albania). Moreover, over time, as growth has raised average living standards, the percentage of the population in absolute poverty has changed little, as inequality has tended to increase. Poverty has greater incidence for members of minority groups.[14] More generally, building human capital remains a priority for growth and poverty reduction.[15]

28. **To put growth on a sound footing, it is essential that its benefits be shared by all members of society.** The Ohrid agreement includes measures to provide employment opportunities in the public sector for the communities and enshrines non-discrimination, decentralization, access to education, and official status for languages spoken by more than 20 percent of the population. Full implementation of these measures—and accounting for their costs in the country's fiscal plans—is essential. Beyond this, steps to increase the economy's flexibility and reduce the rents earned by entrenched insiders would also tend to work in the direction of greater equity.

IV. Experience with Fund-Supported Programs

29. **Economic policies were set in the context of Fund-supported programs through much of the period, but performance under the programs was mixed (Table 2). FYR Macedonia's uneven progress during the overall period raises questions about program design, conditionality, and implementation, which will be addressed in this section**.

- The initial programs under the STF in 1993 and the 1995 SBA, focusing on macroeconomic stabilization, were successfully implemented, and all of the agreed financing was drawn. In particular, the STF succeeded in supporting a swift stabilization of the economy; and the 1995 SBA succeeded in its primary objective of "securing a further reduction of inflation."

- The 1997 ESAF had the objectives of "further restructuring of the economy on market lines and the maintenance of a stable financial environment as indispensable ingredients for achieving sustainable growth and reducing unemployment and poverty." This arrangement

[14] See Robert Ackland, Poverty and Social Transfers in Macedonia: Results from the 2000 Household Budget Survey (SSORM and MLSP, Skopje 2002).

[15] Improvements in these areas have been a priority for the World Bank, which has and continues to support major projects in education and social protection. There has been some progress in these areas but significant challenges remain: the health insurance fund is highly wasteful, the educational system poor, and social safety nets poorly-targeted.

went off track during its second year—the 1998 mid-term review of the second annual arrangement was never completed and the arrangement was allowed to expire in 2000, with structural reforms the main stumbling block; the stated objectives were, for the most part, not achieved.

- The EFF/PRGF arrangement approved in late 2000 was designed to "reduce the incidence of poverty by a substantial margin [through] rapid and sustained growth." It started to go off track at an early stage; given the internal conflict of May 2001, and the political climate thereafter, it could not be salvaged and the objectives were not met. A staff-monitored program adopted in 2002 was not successfully implemented.

- The most recent arrangement—the Stand-By approved in April 2003—was intended to "reduce the large current account and fiscal imbalances stemming from the security crisis and its aftermath, addressing vulnerability to domestic and external shocks and generating growth and employment." This arrangement has had more encouraging results, with successful completion of the first review.

30. **FYR Macedonia has had a longer-term program engagement with the Fund for several reasons.** The Fund's financing was used in the STF and the initial SBA to satisfy balance-of-payments needs associated with the process of macroeconomic stabilization; then, from 1996-2000, in the context of longer-term structural reforms, and during 2003-04, to help smooth the macroeconomic adjustments in the wake of the 2001 conflict. The Fund's financial arrangements were intended to provide a framework for macroeconomic policies and related structural reforms during the transition to a market economy—also in the context of financial support from the World Bank, multilateral development banks, and the donor community. As in other countries in the region, establishing a viable market economy was an enormous task—and as in most of those countries, the obstacles were initially underestimated. In FYR Macedonia, the transition process was prolonged by the shocks to which the country was subjected and by delays in implementing key reforms, in large part reflecting weak ownership and limited administrative capacity. As in many other countries,[16] the desire for a Fund-supported program for signaling purposes led to pressure from donors for a Fund-supported program, particularly following the 2001 Peace Framework Agreement; in 2002, however, the Fund resisted these pressures, based on the judgment that little policy reform was likely to take place in advance of elections; the Fund instead provided a Staff-Monitored Program (SMP) that in the event had little ownership by the authorities and was weakly implemented.

[16] The Independent Evaluation Office report on Prolonged Use of Fund Resources stresses the importance of this signaling role as a factor contributing to prolonged use in other countries, sometimes leading to continued program engagement that is not warranted on the basis of a country's policies and financing needs.

31. **As in many Fund-supported programs, the underlying macroeconomic projections were somewhat unrealistic.** On the whole, growth projections showed a significant degree of over-optimism (Figure 3): in all but two years since 1995, growth fell short of projected levels; the largest shortfalls were due to exogenous events (notably the 2001 internal conflict), but the projections proved over-optimistic even in calmer times. (One exception was 2003, when the growth projections were fulfilled.) The inflation projections, on the other hand, were met or bettered. The external current account projections were highly inaccurate—although here the difficulties of forecasting were compounded by exogenous shocks and measurement problems (as reflected by highly variable and often very large Errors and Omissions). These patterns of inaccuracy in program projections are similar to those found for other countries—although it should also be recognized that staff faced exceptional challenges in making macroeconomic projections in the turbulent environment of FYR Macedonia.[17] As in other cases, the unreliability of macroeconomic projections heightened the challenges of designing appropriate macroeconomic policies. Fortunately, however, the failure of projected growth rates to materialize did not result in an unsustainable run-up of debt in FYR Macedonia, as had occurred in some other transition countries: a relatively prudent fiscal policy was followed.[18]

32. **A second set of issues concern the appropriateness of macroeconomic policies. With regard to monetary policy, the exchange rate peg against the euro was central to bringing down inflation rapidly and then maintaining stability during a period of turbulent economic and political events; but it is not clear whether this regime remains appropriate.[19]** The need for a nominal anchor was particularly felt by the monetary authorities for much of the 1990s, given their comparatively recent experience with hyperinflation with the breakdown of the Yugoslav monetary system immediately preceding independence. The continuing appropriateness of the peg was reassessed at various times during the course of FYR Macedonia's program engagement, and discussed by staff with the authorities, most recently prior to discussions on the current SBA: the argument for greater flexibility included reduced vulnerability to market pressures and greater ability of the real exchange rate to adjust to maintain competitiveness in the face of changes in equilibrium real

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[17] See, for instance, A. Musso and S. Phillips, Comparing Projections and Outcomes of IMF-Supported Programs, IMF Staff Papers, 49, no. 1 (2002), 22-48.

[18] This experience is in contrast with the CIS7 countries where unsustainable fiscal policies and borrowing were pursued while the Fund's support was provided on the basis of over-optimistic growth projections. See *Assessing Sustainability*, May 2002, Box 2.

[19] The continuing appropriateness of the exchange rate regime was examined repeatedly in staff's discussions with the authorities—including in the context of the 2003 Article IV consultation.

exchange rates that may arise from changes in the structure of the economy over time.[20] By encouraging the euroization of financial assets and liabilities, the peg may also have contributed to vulnerabilities that will become increasingly important with the liberalization of capital flows. (As a related issue, the liberalization of capital flows undertaken in 2002 was ill-sequenced—at least, to the extent that it was not offset by administrative restrictions: it should have been preceded by steps to strengthen supervision to address the increased risks associated with currency exposures.[21]) On the other hand, the possibility of moving to a more formal peg—e.g. a currency board or full euroization—was also considered. These considerations, which are relevant to the question of future Fund engagement, are discussed further below (paragraphs 53-54).

33. **Another general issue is the appropriateness of the stance of macroeconomic policies: did the programs' success—or even overachievement—on inflation come at the expense of other objectives?** Here, there are two general views, which were aired in staff discussions with the authorities: one is that a more inflationary policy configuration—with easier monetary and fiscal policies in conjunction with currency devaluation—would have been beneficial to the transition, acting as a lubricant for the redistribution and relative price changes that are needed for successful transition. An alternative view is that the discipline provided by tight macroeconomic policies was an important element in the transition, weeding out non-viable enterprises as a precondition for the emergence of new ones—a central part of the "discipline and encourage" strategy that has been key to successful transition.[22] While there are some qualifications to this discipline argument—it is counterproductive if it leads to a general collapse, or if it generates irresistible demands for government bailouts—there are no indications that easier policies would have done much to stimulate growth, given the supply-side limitations.

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[20] These changes may include the Balassa-Samuelson related real appreciation that is to be expected in the course of the transition; they may also include other changes, in either direction, resulting from changes in the terms of trade and other factors.

[21] This step was taken by the authorities outside the program context, more quickly than Fund staff advised at the time (and more quickly than required under the association agreement with the EU). Related issues are discussed in R. B. Johnston, Sequencing Capital Account Liberalizations and Financial Sector Reforms, *International Economic Policy Review* Volume 1 (1999). The 2003 FSAP report suggests some specific steps to measure and control foreign currency exposures, including systematic credit risk associated with foreign currency-indexed lending; a number of these steps have been implemented in connection with the 2003-04 SBA.

[22] See for instance *Transition—The First Ten Years* (World Bank, 2001).

34. **A number of questions can also be asked about the structural content of the Fund-supported programs. A key issue that stands out is the weakness of implementation of structural reforms—with extensive delays in a number of areas.** Here, the experience points to a lack of desire for reform on the part of the authorities. This may in part have reflected other aspects of FYR Macedonia's situation and in particular the relative attractiveness of rent-seeking versus entrepreneurship. The power of vested economic interests appears to have been a stronger brake on reforms than the ethnic differences. In addition, the country's lack of administrative capacity was an important constraint; it was partly but less than fully compensated by extensive technical assistance in many areas, as discussed below.

35. **There are also a number of issues about structural program design and conditionality. One key question is whether the Fund could have helped bring about a better outcome for the privatization program.** Here, the basic problem was that insiders' stakes in the enterprises to be privatized were firmly planted; a process requiring sales to outsiders would probably have brought about a much slower privatization process, both due to political resistance and to the fact that, given political risks and the investment climate, few qualified outside buyers existed. Another alternative would have been to restructure the enterprises while keeping them under state control—but it is not clear how successful this would have been in boosting efficiency, given the lack of administrative capacity. Moreover, there is some evidence suggesting that, even with the weaknesses in governance, privatization did lead to some efficiency gains, compared with maintaining the enterprises in state ownership.[23] But, while it is not clear that the IFIs could have brought about a different method of privatization—and whereas it would probably not have been better to eschew privatization altogether—they could have pressed harder for liquidation rather than bailouts of some of the loss-makers. They could also have attached greater priority to reforms to strengthen corporate governance, through greater transparency, investor protection, and reformed bankruptcy procedures—both the passage of laws and strengthening their implementation through reform of the judiciary. The latter reform agenda remains to be completed.

36. **A second question is with regard to the sequencing of reforms affecting the financial system and markets.** The financial sector was rightly an area of focus, given the depth of problems there and its centrality to the transition process—particularly in light of the need to boost FYR Macedonia's savings rate.[24] The highest priority in this area should have

[23] See R. Glennerster, Is Privatization Effective in an Environment of Weak Corporate Governance? The Case of the Former Yugoslav Republic of Macedonia, IMF Working Paper (forthcoming). This paper also documents some of the factors that weakened corporate governance.

[24] From the onset of the transition the banking system, and therefore financial intermediation had to overcome another handicap: the freezing of the foreign exchange deposits held in the

(continued…)

been given to establishing the soundness of the financial system and strengthening its supervision and regulation. This, in turn, would have required addressing the deep structural problems in the nexus between the enterprises and the financial sector—notably the fact that many large enterprises remained insolvent. Delays in addressing these fundamental problems reduced the effectiveness of some other reforms advanced by the Fund, such as the development of money markets and the use of market-based instruments of monetary policy: since insolvent banks are not very responsive to market forces, the indirect instruments did not become sufficiently effective to replace direct credit ceilings for a considerable period of time although subsequently they were used successfully.

37. **A third question is whether more could have been done early on to address distortions in the labor market.** Labor market reforms were included in a number of the programs, but they were piecemeal in nature and were not given high priority. The results were disappointing: the unemployment rate remains in the mid-30s. One interpretation is that this outcome was largely unavoidable: actually solving the unemployment problem it will require sufficiently robust growth in the formal sector to draw substantial amounts of labor back out of the informal sector—solving at once the cosmetic problem of underreporting of employment and the genuine lack of employment opportunity.[25] At the same time, granted the stubbornness of the problem, there are nonetheless some reforms that could have made a difference. In particular, a priority would have been to find a way to reduce the tax wedge on employment that distorts the labor market. Moreover, better targeting of social benefits, including by de-linking health care from employment status and cracking down on evasion, may both have helped to measure unemployment more accurately and to reduce distortions in the labor market.[26]

38. **A fourth question is whether more could have been done in the programs to strengthen governance.** The programs did indeed include elements of liberalization and institution-building that went in the direction of narrowing the opportunities for rent-seeking. But effectively tackling the problem of corruption would have required a wide-ranging strengthening of institutions, including the judiciary, with strong support at the highest

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National Bank of Yugoslavia abruptly and deeply undermined the confidence of the public at large in the banks. As a result, FYR Macedonia still has one of the shallowest banking systems among the transition economies.

[25] Even then, recorded unemployment may remain high: data on long-term unemployment suggest that there may be a large group whose skills are obsolescent and have not been employed for more than a decade and thus may not be employable at any reasonable wage.

[26] For example, weak enforcement results in a narrow base for taxes on employment, thus hindering efforts to lower tax rates; it also implies a distortionary differential tax on labor in sectors in which there is greater scope for evasion.

political level. Given the pervasiveness of corruption, there were large and powerful entrenched groups with a strong interest in opposing such reforms. It is unlikely that the threat of withdrawing the Fund's support would have been effective in bringing about such a sweeping change in the absence of a strong and broad-based commitment from the authorities; and the design of the detailed reforms required is largely outside the Fund's area of expertise.

39. **Implementation of the structural incentives covered by conditionality was mixed.** The major program interruptions make it difficult to assess the overall effectiveness of conditionality, since implementation of the conditions is, strictly speaking, not relevant in the periods of program interruption.[27] Even while the programs remained on track, however, implementation was mixed: the structural performance criteria (PCs) and prior actions (PAs) were generally implemented, while the record in achieving structural benchmarks (SBs) was weaker.[28] The implementation record was much better in the 2003 SBA—all conditions for the first review were met—although that program's structural content was perhaps less ambitious than that of the earlier ones.

40. **A final question relates to the effectiveness of the Fund's technical assistance (TA) in remedying, or compensating for, weaknesses in administrative capacity.** In the fiscal area, advice was geared mainly toward conceptualizing reforms that were then implemented by the authorities, often with the assistance of other providers. Such assistance was thus not mainly intended to remedy deficiencies in administrative capacity, although in some cases in which Fund staff have had a longer-term involvement there have been indications of skill transfer. For instance, with the establishment of the treasury function, further progress is now being driven mainly by treasury officials themselves. The picture is very similar regarding assistance given in the monetary and financial sector. Technical assistance missions offered conceptual advice on reforms, while a transfer of skills took mainly place through the work of long-term resident advisors. Regarding financial sector regulation and supervision, the actual putting into use of these skills, once absorbed, was slow, on the one hand because of the highly complex and technical nature of the work, and on

[27] Moreover, in the case of program interruptions, data on implementation of specific conditions are incomplete, since their delayed observance or non-observance is not systematically recorded in staff reports or in the MONA database.

[28] Specifically, only 6 out of 10 SBs established under the 1995 SBA were met (the remainder being either delayed/ongoing or not met); in the 1997 ESAF, only 6 out of 11 SBs were met. The pattern of better implementation of "harder" conditionality (PCs and PAs) than of SBs is typical, though: given the nature of prior actions—i.e. the fact that they must be implemented before program approval—implementation rates are generally close to 100 percent, while failure to achieve structural PCs is more likely to result in a program interruption.

the other hand because of other obstacles (political and other) mainly outside the control of supervisors.

41. **The quality of Bank-Fund collaboration was mixed during the 1990s, but more recently appears to have been improving.** There was a need for close coordination, in particular, given the priority Fund-supported programs (especially the 1997 and 2000 arrangements) attached to financial sector and enterprise restructuring—areas in which the World Bank normally shares or takes the lead. While there was considerable collaboration in these areas, some frictions emerged, apparently reflecting different priorities and inadequate communication. The Fund-supported programs sometimes included "home-made" conditionality in these areas, which, to the extent that it was not linked to a more comprehensive policy dialogue, was limited in its effectiveness and also led to tensions with the World Bank. In the area of public expenditure management and civil service reform, disagreements surfaced over the pace of reforms. There were also disagreements over macroeconomic policies, with some World Bank staff viewing the Fund-supported program as overly restrictive. To some extent these frictions were unavoidable, given the two institutions' different roles and time frames; but to some extent they might have been alleviated through better upstream collaboration to establish a common view on priorities and lead agency (as prescribed in the 2002 Guidelines on Bank-Fund Collaboration). In the more recent period, there has been more upstream dialogue to clarify priorities and better consultation on the form of conditionality. Some elements of duplication of conditionality remain, but these appear largely to reflect reform measures that are critical to both Bank- and Fund-supported programs.

Summary of Lessons

42. **There were several reasons for the longer-term nature of FYR Macedonia's program engagement with the Fund.** To begin with, it reflects the magnitude and complexity of the reforms required to make a successful transition to a market economy and the need to maintain macroeconomic stability and external viability while that process was going on. But it also partly reflects slow progress with those reforms. The Fund's decision to remain engaged despite that slow progress may reflect, in part, the prevalent view in the 1990s that the Fund should be involved in the transition countries if there was a reasonable chance of having a beneficial effect—in contrast to the greater emphasis on selectivity and ownership in more recent years.[29] Moreover, given that FYR Macedonia was also receiving financial support from the World Bank, multilateral development banks, and the donor community, there was implied pressure for Fund-supported programs to provide a signal for donors; it is worth noting, however, that in 2002 the Fund resisted donor pressures for an

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[29] The latter approach is associated, in particular, with the 2002 Conditionality Guidelines and the Fund's response to the 2002 Independent Evaluation Office study of Prolonged Use of Fund Resources.

arrangement at a time when implementation prospects were weak, instead agreeing to a staff-monitored program.[30]

43. **The Fund's program engagement appears to have been instrumental in establishing and maintaining macroeconomic stability in the face of adverse shocks—no small achievement.** This role is evident in the initial successful stabilization in the context of the 1995 SBA and more recently, with post-conflict adjustment in the context of the 2003 SBA. The success of stabilization may reflect in part the authorities' strong commitment—stemming from their desire to avoid a recurrence of the macroeconomic and financial chaos around independence—to a well-defined strategy for achieving stability, and the Fund's expertise in this area.

44. **The lackluster progress in structural reform and program interruptions in the 1997 ESAF and 2000 PRGF/EFF arrangements, however, bring into question whether the Fund's program engagement continued to play a constructive role once the economy had successfully been stabilized.** In some instances, weak implementation reflected unforeseeable developments—notably the 2001 security crisis. But implementation was weak even in relatively calm times prevailing during 1997-98, suggesting that the authorities' commitment to reforms was lacking. In hindsight, the Fund should have been more cautious in entering a program relationship once stabilization was completed, particularly in light of delays in implementing reforms (under the 1995 SBA and the 1997 ESAF). Conditionality might also have played a larger role in ensuring that the Fund's financing was provided only if critical measures were taken, as discussed in the next paragraph. Had the Fund moved to a surveillance-only relationship at that time, it would have been important to find a way of providing a convincing signal to donors of whether macroeconomic policies were on track; the Fund's policy on assessment letters now provides a vehicle for institutional endorsement.[31]

45. **The Fund's conditionality was not very effective in fomenting needed reforms, although it was reasonably effective in shutting off Fund financing when reforms stalled.** Greater reliance on "harder" forms of conditionality—i.e., prior actions and structural PCs rather than structural benchmarks—could have strengthened implementation. However, this would not necessarily have increased ownership and would still have left critical gaps in structural reform in areas outside the Fund core mandate.

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[30] The Fund did not agree to a financial arrangement on the grounds that implementation was unlikely in a pre-election setting. Weak implementation of the SMP confirms this judgment.

[31] Staff-monitored programs were previously available for signaling purposes, with the drawback that they do not carry the endorsement of the Board; the Fund's policy on SMPs has been changed to eliminate their use for signaling.

46. **The sequencing of structural reforms could have been improved.** In particular, steps to strengthen corporate governance should have been taken alongside enterprise privatization; while much has been done to strengthen financial system soundness, this should have been given greater priority than other aspects of financial sector development; greater priority should have been given to strengthening the processes for enforcement of regulations and improving governance more generally; and problems in the labor market should have been addressed more vigorously (including by reducing the tax wedge on labor and increasing the flexibility of the labor code). Deficiencies in sequencing did not primarily reflect conceptual problems, however: in each of the instances noted above, the steps that in principle should have been taken earlier were those that were more likely to encounter political resistance from vested interests, and in many cases were in areas in which the Fund is not the lead institution.

47. **Given that reforms in areas in which the World Bank took the lead had important implications for the objectives of the ESAF and PRGF/EFF programs, effective Bank-Fund collaboration was vital. But there were significant frictions—which appear to have eased in recent years.** This experience underscores the importance of effective upstream collaboration, with a clear designation of lead agency, as prescribed in the 2002 guidelines on Bank-Fund collaboration.

V. Considerations for Future Program Engagement

48. **Should the Fund continue its program engagement with FYR Macedonia, and if so, what form should this engagement take?** This section draws on the ex post assessment to provide some general considerations on these questions.

49. **The goal should be a successful exit from a program relationship with the Fund.** Exit should be seen as a sign of a sustainable external position that does not require the Fund's financial support. It should also be viewed as a sign of maturation in domestic decision-making processes—indicating that the Fund is no longer needed to provide a policy framework. Ideally, exit should take place in a setting in which significant further progress has been made with structural reforms. But the completion of reforms should not be viewed as a necessary condition for exit: if the authorities have established a *modus vivendi*, based on their domestic political equilibrium, it may be that the Fund's program engagement is no longer productive. This is a question that should be examined, on the basis of the authorities' current policy plans and a candid assessment of their commitment to those plans, in considering any possible successor arrangement, including the next one as well as any in the future.

50. **In determining whether there should be a financial arrangement, and if so what form such an arrangement should take, an important consideration should be the existence and duration of a balance-of-payments need.** Such an assessment should not be based mainly on the ex post assessment but on the forward-looking balance-of-payments

analysis by the mission team. It is, however, useful to delineate the broad circumstances under which such a need may arise.

51. **Now that stabilization has been largely achieved, an important** outstanding macroeconomic issue is the exchange rate regime. While Macedonia's experience under the existing de facto peg has generally been favorable, this regime is likely to become increasingly difficult to maintain as capital mobility increases.[32] It may thus be prudent to review the options at a time when there are not immediate market pressures on the exchange rate. The setting for a change would be made more favorable by successful implementation of the current SBA, against the background of a longer period of reasonable success in maintaining stability.

52. **In deciding whether a change in the exchange rate regime should be in the direction of greater flexibility or more formal peg with appropriate supporting policies, the authorities would face some important tradeoffs.** Greater flexibility would permit shifts in equilibrium real exchange rates to be accommodated without variations in inflation rates, and would provide greater resilience in the event of market pressures. It is likely, however, that a more flexible exchange rate would need to be a tightly managed float, particularly at the outset, given the configuration of direct and indirect foreign-currency exposures in the banking system. A key question is whether the authorities have sufficient administrative capacity to manage a flexible exchange rate and to implement monetary policy to meet a domestic objective such as an inflation target or a money supply target.[33] On the other side, a more formal peg—which could take various specific forms—would require that the authorities be prepared to live within the associated constraints, including a particularly prudent fiscal policy and greater emphasis on structural reforms to promote flexibility. Moreover, a more formal peg, by providing an implicit guarantee of the exchange rate, encourages currency mismatches throughout the economy; if there did come a time at which there was no alternative to adjusting the exchange rate in response to market pressures—for instance, associated with political uncertainties—these mismatches would make such an adjustment much more costly.

53. **In the event that the authorities chose to change the exchange rate regime, a Fund arrangement could provide useful support.** In whichever direction the exchange rate

[32] See, for instance, A. Burbula and I. Otker-Robe, Are Pegged and Intermediate Exchange-Rate Regimes More Crisis-Prone?, IMF Working Paper WP/03/223, 2003.

[33] The authorities' goal of eventual EU accession and participation in monetary union could cut both ways: to the extent that it may require an intervening period of participation in ERM2, it would put a premium on exchange rate stability; but an exchange rate peg could potentially undermine the country's ability to satisfy a convergence criterion for inflation, to the extent that there is a need for adjustment in real exchange rates.

regime were changed, the Fund's financing could help boost reserves and strengthen confidence. Moreover, a program relationship could be a suitable framework for intensive advice and consultation, both on the operation of the new regime and on the other policies needed to support it. A SBA—which could perhaps be treated as precautionary—could be a suitable vehicle for this purpose.

54. **Another form of program engagement that could be considered would be an extended arrangement to support a comprehensive program of reform.** In general, support under the Extended Fund Facility (EFF) is intended for countries with "serious payments imbalances relating to structural maladjustments in production and trade and where price and cost distortions have been widespread", or those characterized by "slow growth and an inherently weak balance of payments position which prevents pursuit of an active development policy".[34] Arguably, FYR Macedonia has a mix of these two characterizations: its structural problems are associated with slow growth and a weak balance-of-payments position. An extended arrangement would require a comprehensive program to correct the structural imbalances identified. Such a program would need to command strong support from the authorities and in the country more generally, to provide a credible prospect for its implementation. This would require, in particular, clear evidence of significantly greater commitment to reforms than has been evident in the past.

55. **If an EFF is to be considered, it should move forward with the unfinished elements of the structural agenda identified above.** These include: (a) following through reforms of public administration, notably in the health sector; (b) devising and implementing reforms to reduce distortions in the labor market—some element of which should include reducing the tax wedge on labor and eliminating the distortionary effect of the health insurance system; (c) strengthening governance in general, including through reform of the judiciary; (d) strengthening corporate governance in particular, including by increasing transparency and enforcing protections for the rights of minority shareholders; and (e) continuing to strengthen financial supervision and regulation, with a view to strengthening incentives for domestic savings and channeling them into productive uses. At the same time, the authorities will need to allow room in their fiscal plans for pressures that will emerge, including the fiscal decentralization and hiring of minorities mandated in the PFA as well as the public sector salary reform needed to strengthen the efficiency of the public service.

56. **Since many of the reforms indicated are in areas covered by the World Bank rather than the Fund, effective Bank-Fund collaboration would be of the essence. The Bank is planning to support many of the reforms identified in its ongoing operations.** Upstream coordination will be essential to reach agreement on structural priorities and ensure

[34] See International Monetary Fund, *Selected Decisions* (27th Issue, December 31, 2002), page 253.

that these are adequately covered. Collaboration with the European Union will also become increasingly important as FYR Macedonia sets its sights on possible accession.

57. **Successful implementation of another program would depend, in large part, on the authorities' commitment to reform.** The shortcomings of implementation have been discussed above. The experience with implementation of the current program has been more favorable than with previous ones, perhaps signaling greater ownership by the authorities—although it should also be kept in mind that the current program is not particularly ambitious on the structural side. Implementation of many of the structural reforms that are now needed is likely to be politically challenging, in the face of strong vested interests and inter-ethnic differences. There is the potential to strengthen ownership—by promoting the view that structural reforms are needed to deliver the economic growth that will help reconcile competing demands as well as to pave the way to EU accession. But building a durable consensus in favor of reform is a task that still lies ahead.

58. **Should neither of the premises discussed for a successor arrangement turn out to be viable, the Fund's involvement with Macedonia would shift to surveillance and technical assistance.**

Table 1. FYRM: Chronology of Economic and Political Developments (1990-2004)

Year	Economic and Political Developments
1990	First democratic, multi-party elections in the Yugoslav Republic of Macedonia.
1991	War in Slovenia. Declaration of independence from Yugoslavia. War in Croatia.
1992	Inflation accelerated due to high military spending in Yugoslavia. Introduction of an own currency pegged to the DM, but frequently adjusted. Start of the war in Bosnia. The National Bank of the Republic of Macedonia (NBRM) was established as central bank. Due to growing wages, socially owned enterprises increased credit demand which was accommodated by the banking system. December 14, 1992: FRY Macedonia joins the IMF.1/
1993	Month to month inflation accelerated to 30 percent with depreciation of the currency in the informal market. UN tightens sanctions against Yugoslavia, making transit trade through Yugoslavia almost impossible. Floating of the exchange rate. The adoption of the Privatization Law gives enterprise managers and employees the right to choose the method of privatization. Privatization Agency and Bank Rehabilitation Agency were established to support privatization and bank rehabilitation, respectively. Effective February 25, 1993 Macedonia became a member of IBRD, IDA, and IFC.
1994	January 28, 1994: Board approved a purchase under the Systemic Transformation Facility (STF). The first IMF supported program had the following main features: (1) Stop of cheap bank loans to state-owned enterprises; (2) Reduction of the fiscal deficit from 11 percent of GDP in 1993 to 2.6 percent in 1994; (3) Introduction of a wage control law. Greece imposed a trade blockade. Introduction of a de-facto peg of the denar to the DM. Inflation declined to single digits and the denar appreciated. Massive increase in wage arrears and non-performing loans in the banking sector.
1995	Paris Club rescheduling. Launch of the Special Restructuring Program (SRP) aiming to restructure and privatize the 25 largest loss-making enterprises, supported by the World Bank (Financial and Enterprise Sector Credit). May 5, 1995: Board approved a Stand-By Arrangement and a purchase under the STF: 1995 Article IV Consultation concluded. Greece lifted the trade blockade. UN lifted sanctions on Yugoslavia.
1996	Reform of the tariff law and abolition of most important and export quotas. Macedonia Stock Exchange commenced trading. Second privatization law covering agricultural enterprises and cooperatives passed.

Table 1. FYRM: Chronology of Economic and Political Developments (1990-2004)

Year	Economic and Political Developments
	June 4, 1996: Stand-By Arrangement expired.
1997	Only 914 of 1,216 of the companies specified under the SRP were privatized. World Bank support for the privatization and liquidation of agricultural enterprises; completion of the SRP with World Bank support (Structural Adjustment Loan and Credit). April 14, 1997: Board approved an ESAF/PRGF arrangement and concluded the 1997 Article IV Consultation. Collapse of the savings pyramid scheme "TAT Savings House". Depreciation of the denar to the DM by 14 percent. Amendments to the employments and labor law, but severe restrictions remain to labor mobility. October 31, 1997: Board approved the completion of the first review under the ESAF/PRGF.
1998	June 19, 1998: Board approved the ESAF/PRGF arrangement and concluded the 1998 Article IV Consultation; in late 1998, the ESAF/PRGF arrangement went off track.
1999	Outbreak of the armed conflict in Kosovo, causing a refugee flow (estimated 370,000 refugees) and the disruption of trade through Kosovo and Yugoslavia. Sharp increase in non-performing loans as a consequence of the crisis. End of the armed conflict in Kosovo; economic activity picked up after the end of the war, benefiting from setting up a UN administration in Kosovo. August 5, 1999: Board approved a purchase under the Compensatory and Contingency Financing Facility to compensate for a projected export shortfall arising from the Kosovo Crisis. As of December 31, 1,488 out of a total of 1,726 enterprises (including agricultural enterprises and cooperatives) with social and state capital were privatized (about 42 percent privatized through employee or management buyouts).
2000	Issuance of bonds to holders of foreign currency accounts which were frozen by Yugoslavia. Introduction of the VAT. April 2000: ESAF/PRGF arrangement expires. Recapitalization and sale of Stopanska Bank, the largest commercial bank. The World Bank Board approved the Second Financial and Enterprise Sector Adjustment Loan that, in tandem with EFF/PRGF, supports: (i) final resolution (privatization/financial restructuring or closure) of the largest loss-making enterprises, and (ii) banking sector reform. November 29, 2000: Board approved a new program (70 percent EFF and 30 percent PRGF resources); the program went off track in late December and got cancelled in early 2001. Sale of the majority share in the telecom company to a strategic investor.
2001	Albanians, organized in the National Liberation Army (NLA) attached security forces. Introduction of a financial transaction tax to finance military spending. Stabilization and association agreement with the EU was signed. A new coalition government was formed which includes the major ethnic-Macedonian and Albanian parties.

Table 1. FYRM: Chronology of Economic and Political Developments (1990-2004)

Year	Economic and Political Developments
	Agreement reached on regional trade integration with Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania and Yugoslavia. The Peace Framework Agreement (PFA), brokered by the EU and the US, was signed by the major ethnic-Macedonian and Albanian parties. Deployment of a NATO mission. Start of a comprehensive reform of the treasury system.
2002	January 1, 2002: Six month staff monitored program commences. Replacement of the Yugoslav style payment system by a modern payment operation bureau. March 4, 2002: 2001 Art. IV Consultation concluded. Reform of the Law on Foreign Exchange, liberalizing trade credits, direct investment and non-resident portfolio investment.
2003	Abolition of the financial transaction tax. Start of a employment program that subsidizes specific forms of hiring by the private sector. Reduction of the import tariffs; WTO accession. April 30, 2003: Board approved a Stand-By Arrangement and concluded the 2003 Art. IV Consultation. Over the summer months, numerous violent clashes between organized criminal groups and security forces. Privatization or liquidation of the remaining large loss-making companies. October 17, 2003: Board approved the completion of the first review under the Stand-By Arrangement. Draft laws on local government financing and municipal borders submitted to parliament. NATO troops were replaced by a police force from EU member countries.
2004	

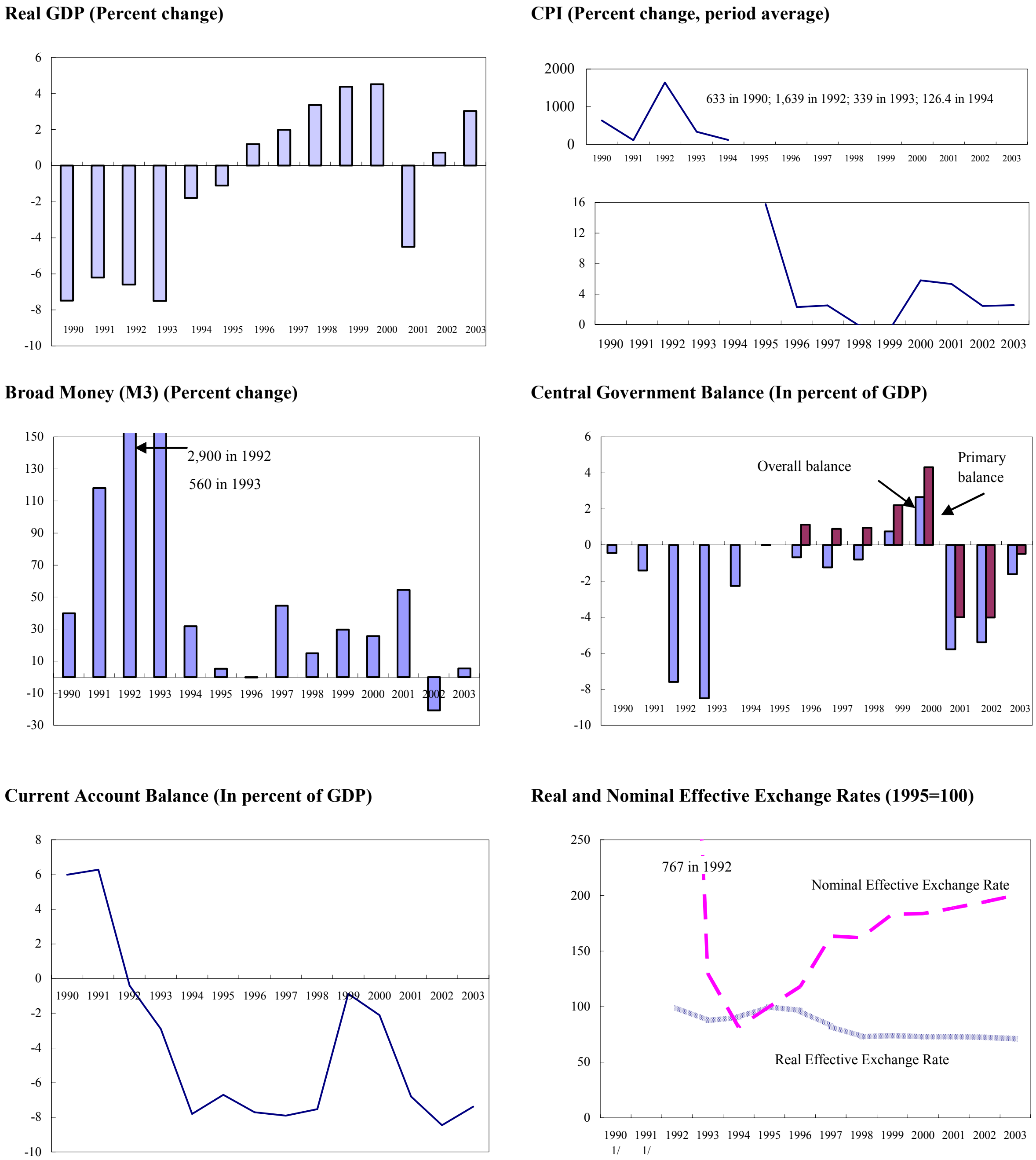
Sources: IMF staff.
1/ Shaded lines refer to IMF involvements.

Table 2. Macedonia, FRY; History of IMF Lending Arrangements
(In millions of SDRs, unless otherwise indicated)

Facility	Date of Arrangement	Date of Expiration or Cancellation	Amount Agreed	Amount Drawn	Percent Drawn	Notes
STF	1994		12.4	12.4	100.0	The Fund's financial engagement with FYR Macedonia begins.
SBA & STF	5/5/1995	6/5/1996	22.3	22.3	100.0	All reviews under the SBA were completed and all purchases were made. The SBA had attached to it a request under STF equivalent to SDR 12.4 billion.
ESAF & CCFF	4/14/1997	4/10/2000	54.6 13.8	27.3 13.8	50.0 100.0	Two purchases were made under the first year program and a mid-year review successfully completed in October 1997. One purchase was made under a second year program, agreed upon with some delay in June 1998. As the November 1998 parliamentary elections shifted the authorities' focus, the program went off track and the mid-term review could not be completed. While by spring 1999 an acceptable macro-fiscal framework was agreed upon with the new government, lack of progress on the structural measures (in particular, privatization of an agreed list of large enterprises) remained a stumbling block for the program. Following an outbreak of the Kosovo conflict the structural reform agenda was abandoned. In August 1999, the Board approved a purchase under the CCFF in the amount of SDR 13.8 million, which was drawn on August 9, 1999. The program was allowed to expire in April 2000 without completion of a mid-term review under the second annual arrangement.
PRGF & EFF	11/29/2000	11/22/2001	34.4	2.9	8.3	One purchase was made upon approval of this combination arrangement. The signs of slippage appeared early in the arrangement. Due to an escalation of the security crisis in the spring of 2001 the government's ability to achieve the objectives of the arrangement was compromised and the arrangement was cancelled in November 2001. It was followed by a staff monitored program, which was in place in the first half of 2002 and had mixed results. While on track in the first quarter of 2002, the program veered off track due to introduction of populist pre-election fiscal measures. Negotiations on an SBA were resumed after the September 15, 2002, elections.
SBA	4/30/2003	6/15/2004	20.0	12.0	60.0	Ongoing. The first review has been completed as scheduled and three purchases were made.

Source: Fund MONA database and program documents.

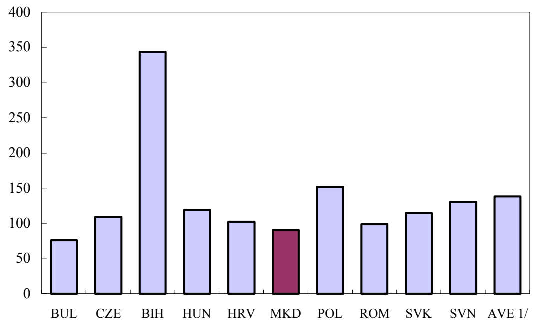
Figure 1. Macedonia, FYR: Selected Economic Indicators, 1990-2003



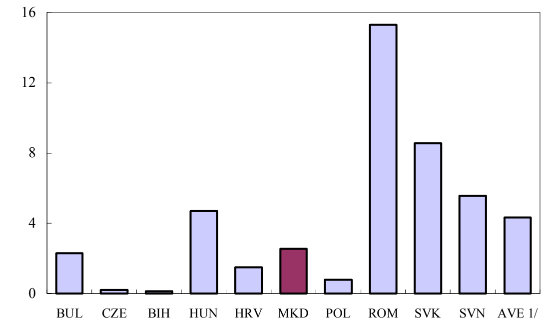
Sources: Fund WEO, and staff estimates.
1/ Data not available.

Figure 2. Selected Transition Countries: Comparison of Economic Indicators, 2003

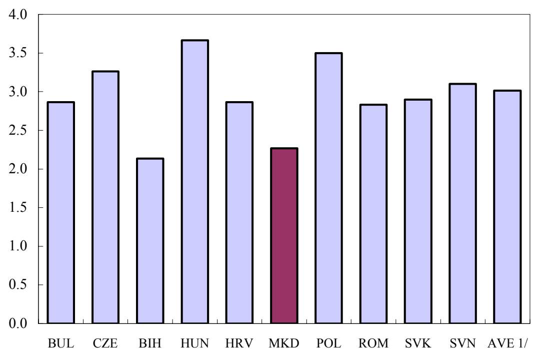
Gross Domestic Product; 1990 = 100



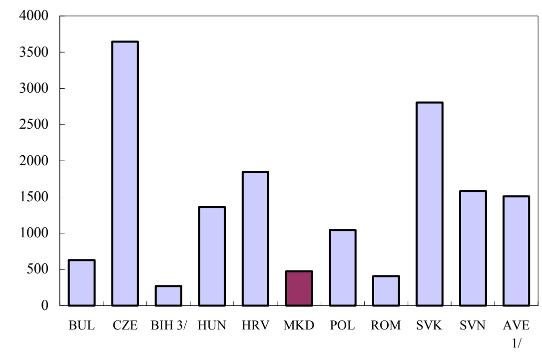
Inflation, in percent; period average



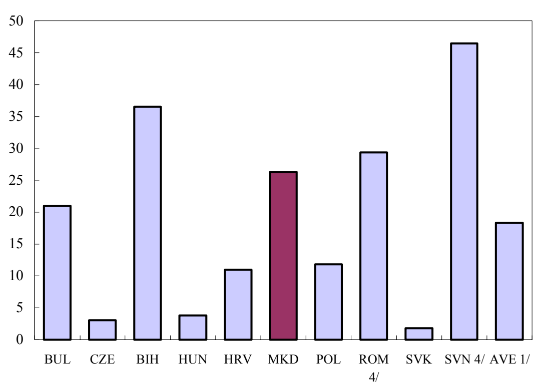
Transition Score in 2002 2/



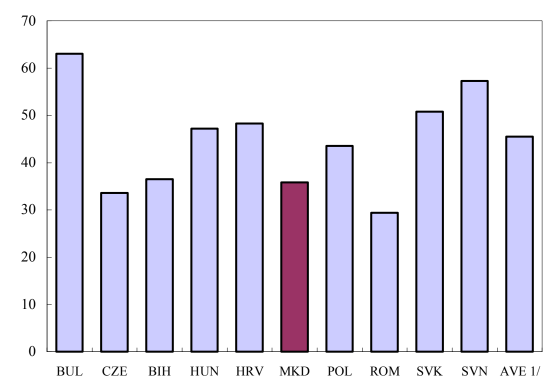
Cumulative FDI Per Capita, 1996-03; in US dollars



Official Debt Outstanding; in percent of GDP



Total debt outstanding; in percent of GDP



Sources: Fund WEO, and staff estimates.

1/ Averages exclude Macedonia, FYR.

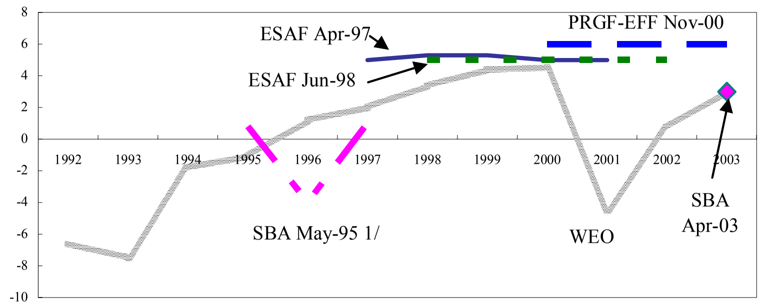
2/ EBRD transition score, averaged across enterprise, markets, infrastructure and financial institutions.

3/ 1998 - 2003 only, as data for 1996-97 are not available.

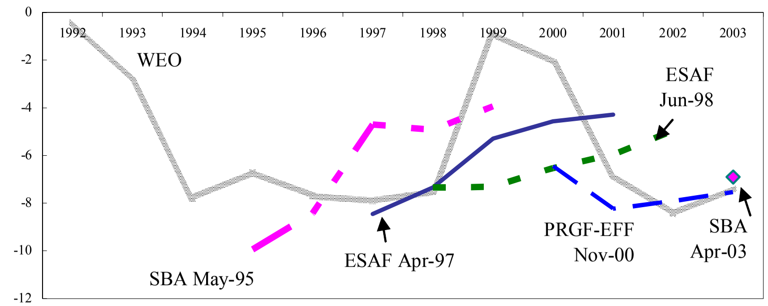
4/ Medium- and long-term debt outstanding at year-end.

Figure 3. Macedonia, FYR, Projections and Outcomes; 1992 - 2003

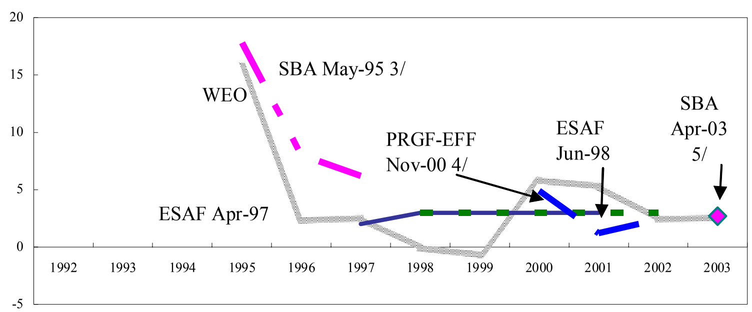
GDP growth, in percent



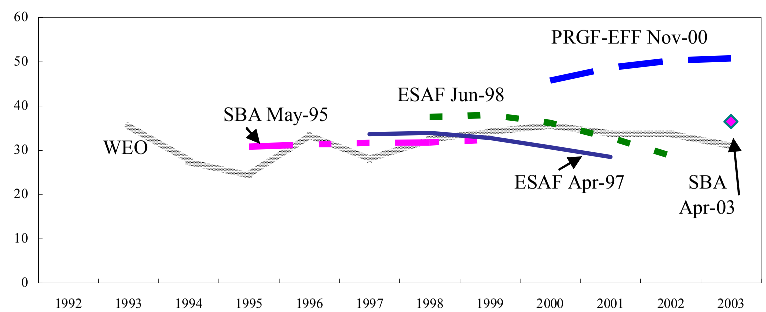
Current account balance, in percent of GDP 2/



Consumer price index



External debt, in percent of GDP 2/ 6/



Source: WEO database and staff calculations.
1/ Data for 1996-97 not in program document. Taken from Oct-95 Draft Letter of Intent, Table 1: Main Economic Indicators;
2/ The WEO data shown reflect subsequent data revisions.
3/ Data for 1996-97 not in program document. Taken from Oct-95 Draft Letter of Intent, Table 1: Main Economic Indicators;
4/ Data for 2002 not in program document. Taken from 5/23/01 Memo:Briefing Paper for 1st Pogram Review under PRGF/EFF Arrangements; Tab 4: Performance under the Program (comparing program with actuals).
5/ Data for 2005-07 for the inflation rate represent GDP deflator, in percent, and are from the document's table 9: Public sector debt sustainability framework.
6/ At year-end, debtor based data.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 04/97
FOR IMMEDIATE RELEASE
August 25, 2004

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Reviews the Former Yugoslav Republic of Macedonia's Performance Under Past Fund-Supported Programs

This PIN summarizes the views of the IMF's Executive Board as expressed during the August 2, 2004 discussion based of the Ex Post Assessment of fYR Macedonia's Longer-Term Program Engagement. Ex Post Assessments are prepared for countries with a longer-term program engagement in order to evaluate the success of past programs and implications for possible future Fund involvement.[1]

Background

The former Yugoslav Republic (fYR) of Macedonia's economic performance since independence has been marked by notable achievements in macroeconomic management, as well as some disappointments in the area of structural reforms. Overall, macroeconomic management has been good. Inflation was brought down from hyperinflationary levels to the low single digits by the de facto exchange rate peg, which was sustained in spite of sometimes challenging circumstances. At the same time, sound fiscal policy helped to gradually lower the level of government debt to about 40 percent of GDP and recently even lower. But the implementation of structural reforms was mixed. Important progress was made in financial sector reforms and trade liberalization; further progress is needed in reforming labor market institutions and the judiciary and in strengthening governance. Privatization has been largely completed but the method of privatization gave insiders a dominant role, resulting in a smaller boost in efficiency than had been expected. Partly as a result of the unfinished structural agenda, economic growth has been lackluster. The average annual growth rate since the mid-1990s was around 1½ percent, well below other transition economies. Unemployment figures have remained high. In the external sector, the current account deficit has widened in recent years while foreign direct investment has been generally low.

[1] This PIN summarizes the views of the Executive Board as expressed during the discussion based on the staff report.

Executive Board Assessment

Executive Director welcomed the opportunity to review fYR Macedonia's longer term engagement with the Fund, which has involved a series of successive Fun-supported programs starting at an early stage of the country's transition to a market economy beginning in the early 1990s. Directors agree that over this period Fund involvement has been quite effective in promoting macroeconomic stability in fYR Macedonia, especially when viewed against the back ground of the series of internal and external shocks that have buffeted the economy. The experience with Fund support for structural reforms has been more mixed, although many Directors agreed with the authorities' own assessment that Fund support has served to underpin an acceleration of structural reforms.

Directors acknowledged that fYR Macedonia's longer term engagement reflected in part the scope and complexity of the set of reforms required to ensure a successful transition, while ensuring that macroeconomic policies remained geared to maintaining stability and external viability. At the same time, the Fund's long term involvement reflected the slow pace of reforms. The Fund's involvement also served the donor community by performing a signaling function with respect to the quality of measures being taken by the authorities to promote stability and growth.

Directors considered several aspects of the Fund's experience that could have influenced, and possibly speeded up, the pace of fYR Macedonia's successful exit from a program relationship with the Fund. Most Directors agreed with the view that the disappointing progress in the area of structural reforms and the repeated program interruptions suggested that the Fund should have been more cautious in entering into new program relationships, once macroeconomic stabilization was achieved in the context of Fund-supported programs. They also felt that the sequencing of structural reforms and the Fund's collaboration with other international institutions—especially the World Bank—could have been improved, with greater emphasis placed on strengthening governance, financial sector development, and labor market reforms.

This review of experience provides valuable lessons for possible future Fund engagement. Strong national ownership will remain essential. Most Directors felt that any financial engagement should be strongly directed at supporting essential remaining reforms that address fundamental problems—particularly in the structural area—and to lay the basis for successful exit for fYR Macedonia from the program relationship with the Fund. It was also suggested that the alternative of an arrangement not involving the further use of Fund resources should not be ruled out.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with the Former Yugoslav Republic of Macedonia is also available.

FYR Macedonia: Selected Economic Indicators, 1999-2004

	1999	2000	2001	2002	2003 Prog. 1st Rev.	2003 Prel.	2004 Prog. 1st Rev.	2004 Proj.
Real economy			(Percent change)					
Real GDP	4.3	4.5	-4.5	0.9	2.8	3.1	3.0-4.0	4.0
Consumer prices								
period average	-0.7	5.8	5.3	2.4	1.8	1.2	2.5	2.8
end of period	2.6	6.1	3.7	1.0	2.2	2.6	2.5	3.3
Real wages, period average	3.6	-0.3	-1.7	4.5	...	4.9	...	...
Unemployment rate (average)	32.4	32.2	30.5	31.9	...	36.7	...	...
Government finances			(In percent of nominal GDP)					
General government balance								
w/o foreign financed projects	0.0	1.8	-7.2	-5.6	-2.5	-1.6	-2.5	-2.2
Revenues	35.4	36.2	34.0	34.9	34.0	33.1	33.1	33.0
Total expenditure	35.4	34.4	41.1	40.5	36.5	34.7	35.6	35.3
Central government balance	0.8	2.7	-5.8	-5.3	-1.4	-0.9	-0.9	-0.9
Government debt 1/								
Gross	57.4	53.2	51.6	47.7	44.8	46.6	41.8	44.8
Net	53.8	46.0	41.6	41.3	40.1	41.3	37.9	40.5
Money and credit 2/			(Percent change, end of period)					
Broad money (M3) 3/	29.7	25.6	56.7	-8.6	14.7	17.2	9.4	17.9
Total credit to private sector 4/	9.4	17.2	7.3	9.9	9.5	19.3	7.2	17.3
Short-term lending rate (percent)	20.0	19.0	19.2	17.7	...	14.5	...	...
Interbank money market rate (percent)	11.6	7.2	11.9	14.4	...	5.8	...	...
Balance of payments			(In millions of U.S. dollars)					
Exports	1,190	1,321	1,155	1,113	1,354	1,359	1,443	1,499
Imports	1,686	2,011	1,677	1,878	2,123	2,211	2,202	2,360
Trade balance	-496	-690	-521	-765	-769	-851	-759	-860
Current account balance	-32	-75	-234	-322	-292	-278	-347	-382
(in percent of GDP)	-0.9	-2.1	-6.8	-8.5	-6.3	-6.0	-7.0	-7.7
Official gross reserves 5/	450	700	756	735	816	903	839	946
(in months of following year's imports of goods and services)	2.4	4.3	4.2	3.5	3.9	4.0	3.9	4.0
External debt to GDP ratio (percent)	39.2	40.1	38.0	38.4	32.9	34.4	33.1	35.3
Exchange rates 6/			(Percent change, period average)					
Nominal effective exchange rate	12.4	12.4	3.3	0.7	...	2.7 *a*	...	...
Real effective exchange rate (CPI-based)	2.9	4.0	-6.1	-2.4	...	0.4 *a*	...	...
Real effective exchange rate (ULC-based)	7.6	7.6	-6.2	-2.4	...	-0.8 *b*	...	...

Sources: Data provided by the FYRM authorities; and IMF staff projections.

a As of end-December 2003
b As of end-September 2003

1/ Total debt of the general government; includes liabilities assumed by the government upon the sale or closure of loss-making enterprises and associated with the cleaning up of Stopanska Banka's balance sheet prior to its sale.
2/ The projection for 2003 and 2004 are prepared based on current exchange rate data, while historic data is based on the stock-flow methodology.
3/ Includes foreign currency deposits; strong growth of foreign currency component explains the high growth in Broad Money in 2003.
4/ Adjusted for provisioning until 2002.
5/ Includes receipts from privatization of telecommunications company of US$323 million in January 2001.
6/ An increase means appreciation of the denar. Partner countries include among others Serbia and Montenegro, and Bulgaria.

Press Release No. 04/167
FOR IMMEDIATE RELEASE
August 3, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Final Review Under Stand-By Arrangement with the Former Yugoslav Republic of Macedonia and Approves US$11.7 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) has completed the second and final review of the former Yugoslav Republic of Macedonia's economic performance under the Stand-By Arrangement. The decision will enable FYR Macedonia to draw an amount equivalent to SDR 8 million (about US$11.7 million), which will bring total drawings to the equivalent of SDR 20 million (about US$29.4 million).

The 14-month Stand-By Arrangement amounting to SDR 20 million was approved on April 30, 2003 (see Press Release No. 03/63). The arrangement was extended to August 15, 2004 after the accidental death of President Boris Trajkovski earlier this year.

The Executive Board has also reviewed Macedonia's experience with Fund-supported programs since the early 1990s, under the new guidelines on assessments of countries with a longer-term program engagement.

Following the Executive Board discussion of Macedonia on August 2, 2004, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, said:

"The FYR Macedonia authorities have achieved the core goal of the economic program they adopted in early 2003—namely, to promote fiscal sustainability following the 2001 security crisis. They have achieved this by putting in place a sound macroeconomic policy framework, which has brought the fiscal deficit back to a sustainable level while maintaining the de facto exchange rate peg to the euro. Significant and welcome progress was also made in strengthening the NBRM's capacity to supervise foreign exchange related risks in commercial banks. Despite mixed performance in some other areas, the program remains broadly on track.

"Economic growth resumed in 2003, with low inflation, as a result of the macroeconomic stabilization and the return of political stability. However, growth, which slowed in early 2004, remains fragile. This, together with the widening external current account deficit, persistent high unemployment, and narrow export base underscores the need for further reforms.

"Going forward, it will now be crucial to complement sound macroeconomic policies with structural reforms aimed at reforming the health sector, bolstering the supervision of the banking and financial sectors, strengthening governance, and improving the business environment, in order to strengthen and diversify the sources of growth. Economic and financial policies could be improved by implementing the remaining elements of the peace framework agreement in a fiscally-sound manner.

"Macroeconomic policies will need to be carefully managed during the remainder of 2004. In the fiscal sphere, a key challenge will be to avoid the stop-go outcome that characterized budget execution in 2003. Fiscal underspending in the first half of the year should not lead to a sharp acceleration of spending in the second half of the year—and especially a burst at year-end—which could be destabilizing. The NBRM's interest rate policy will need to respond quickly to current fiscal and balance of payments developments and to monetary conditions more broadly.

"The Fund looks forward to continued close collaboration with FYR Macedonia in helping to prepare it to meet the considerable challenges ahead, as it completes its transition to a market economy and adapts and strengthens institutions and policies to gear up for greater integration with Europe," Mr. Kato said.

Statement by Jeroen Kremers, Executive Director for the Former Yugoslav Republic of Macedonia August 2, 2004

I thank staff for the comprehensive set of reports. The authorities are pleased that all quantitative and structural performance criteria under their Stand-By Arrangement have been met. Two indicative targets and two structural benchmarks were missed narrowly or have been corrected in the meantime, thus without implications for material compliance with the program. Successful program implementation offers the perspective of completing this second and final review of the Stand-By Arrangement. As always, the authorities agree to publication of the staff report and the Ex Post Assessment.

The end of the security crisis and consolidation of the fiscal stance contributed to the improved economic situation in 2003, supported by price stability and a stable exchange rate. After modest improvement in 2002 (GDP growth of 0.9 percent), the year 2003 registered a real increase in GDP of over 3 percent. For 2004, economic growth will show some slowdown, mainly due to the temporary closure of a major steel factory and restructuring of loss-making enterprises. For 2004, staff estimates imply a revised growth rate of 1½ -2½ percent GDP, compared with 3 percent projected at the time of the first review.[1]

Fiscal policy

On the fiscal front, the authorities realized an impressive consolidation in 2003 by implementing, among others, a politically difficult VAT increase, raising utility prices and cutting expenditure. In 2003, the central budget deficit was very significantly reduced to a level of 0.9 percent of GDP (from 5.3 percent of GDP in 2002), which contributed to the achievement of the key objective of the program - a sustainable fiscal position- as staff concludes. This trend is continuing. In the first quarter of 2004, an increase of more than 10 percent in budget revenues was registered compared to the same period last year, not in the least owing to the new management of the Public Revenue Office. Although expenditures showed a slight slowdown, the authorities note staff's concern about a stop-go cycle. By strengthening their budget planning and expenditure management they are committed to avoid a repetition of this phenomenon. Furthermore, as staff mentions, the authorities are committed to keep the fiscal framework in place when preparing their supplementary 2004 budget later this year.

[1] The preliminary official data for the first quarter of 2004 showed a 3.6 percent decline in GDP, compared to the 3.1 percent increase projected at the beginning of the year. As this sharp reversal in official GDP and manufacturing data was not consistent with the behavior of other economic indicators, it appeared the discrepancy reflected shortcomings in the method used to calculate GDP and the industrial production index. The government has established a working group, to analyze the applied methodology and production trends of companies having a significant weight in the calculations of GDP.

Conversely to the considerable reduction of the fiscal deficit, the current account deficit remained high in 2003, albeit at a substantially lower level compared to 2002. The current account is still projected to widen slightly by the end of this year. In this respect, the composition of the capital and the financial account indicates the need for relying more on foreign direct investment, as a high-quality and productive source of financing.

The indicators for the level of indebtedness in 2003 remained favorable and FYR of Macedonia belongs to the group of less indebted transition countries. As staff notes, the general government deficit will be comfortably below debt stabilizing level in 2004. Moreover, the introduction of short-term government securities in the domestic market expanded the sources for budget deficit financing, thereby inducing the further development of financial markets as well as diversifying the securities portfolio. In the first quarter of 2004, five treasury bill auctions were successfully conducted.

Monetary policy

In 2003, the National Bank of the Republic of Macedonia (NBRM) continued with the successful implementation of the strategy of targeting the exchange rate of the Denar against the Euro. The maintenance of exchange rate stability as a nominal anchor essentially contributed towards preserving low and stable inflation rates, as the ultimate goal of monetary policy. The year ended with an average inflation rate of 1.2 percent, below the projected inflation of 1.8 percent.

The tight fiscal stance in the first half of 2003 enabled the NBRM to reduce the interest rates on Central Bank bills. At the very end of the year, as staff rightly notes, there had been an increase in budget spending, which caused fluctuations in domestic liquidity and a dip in foreign exchange reserves. While monitoring these developments closely, the NBRM maintained the level for net international reserves above program targets without changing interest rates. Nevertheless, in light of a more expansionary fiscal policy in the second quarter of 2004 and the need for stabilizing the movements on the foreign exchange market, the NBRM, in line with Fund advice, raised the interest rate on CB bills early this year. Staff points out that the NBRM could have reacted more actively to the increased fiscal spending, but on the matter of timing the NBRM emphasized that, based on a thorough assessment of the situation and the expectations related to liquidity and reserves, they decided it was the right moment to increase interest rates early 2004. The effects of these changes were particularly evident in March, when a considerable amount of liquid funds was withdrawn through CB bills auctions. For the remainder of the year, the NBRM will, while learning from past experience, monitor these developments closely, remain vigilant on budgetary developments through an enhanced cooperation with the Ministry of Finance and be ready to react whenever there is a need for further measures.

Financial sector

Confidence in the banking system was evidenced by the continuous growth in deposits. In addition, banks actively supported economic activity through accelerated lending to the private sector. Deposit base extension (higher credit potential), expansion of credit supply (introduction of new types of credits and diversified terms and conditions for using the credits), as well as the further liberalization of foreign exchange operations (possibility for foreign exchange lending to all interested entities) resulted in a higher growth rate of lending to the private sector.

The process of harmonization of regulation with the European Union has continued. Amendments to the Law on the NBRM were made aimed at further enhancing NBRM independence and transparency. Furthermore, the introduction of on-site supervision procedures as well as amendments to the Banking Law should allow larger security, stability and efficiency in the operations of the banking system and are part of the ongoing process to strengthen overall financial supervision, also on smaller branches. The number of banks under enhanced supervision has successfully been reduced.

Labor market policy and business environment

Unemployment remains the crucial weakness of the Macedonian economy. In 2003, the registered rate of unemployment amounted to 37 percent, which is an annual increase of 5 percentage points. High structural unemployment still reflects the lingering effects of the transition process. Overcoming this problem is the key priority of government policy, which will be focused on establishing mechanisms for restoration of the distorted labor market functions. To that end, in accordance with the government employment strategy, a National Employment Action Plan for 2004-2005 is being prepared.

Special emphasis will be put on entrepreneurship, by considerably reducing the overhead costs and administrative barriers for business. The recently launched Agency for Support of Entrepreneurship will contribute to this government policy. Furthermore, in collaboration with the World Bank, a Business Environment Investment Operation is scheduled for late FY05 or early FY06, which will draw in part on the FSAP completed in September 2003. A Regulatory and Judicial Reform project is also planned for FY 2006.

Public sector reform

As staff highlights, another major challenge for the authorities will be to implement the provision of the Framework Agreement, in a democratic and well-sequenced manner. Adopting the decentralization agreement and implementing it in a fiscally sound manner will be a milestone. The ongoing wage decompression for the civil service (with the help of the World Bank) will make a start at creating a structure that would help attract and retain qualified staff and help fight corruption. In this light, the government will by the end of this year complete the reduction of public sector employment by 4 percent, a highly sensitive but necessary measure. Progress has also been achieved in some areas of the health sector, particularly in reducing inefficient employment. Nevertheless, more significant savings need to be realized, especially regarding the Health Insurance Fund.

The authorities, with technical assistance from the Fund and other bilateral and multilateral agencies, have made significant progress in upgrading their statistical system in recent years. They began participating in the General Data Dissemination System in February 2004 and a data ROSC mission was conducted in mid-February 2004. Further methodological improvements are needed. In the area of debt management, the authorities have requested a follow up FAD mission to provide assistance with the implementation of new data sources.

Ex Post Assessment

The authorities appreciate the Ex Post Assessment (EPA), which contains a balanced evaluation of successes and failures on the side of both the authorities and staff. As mentioned in the staff report, the authorities consider the Fund dialogue and programs as highly valuable. Although some reforms proceeded slower than envisaged, they always felt a strong sense of ownership of the programs and were well aware of the importance of reaching the program targets.

Regarding the appropriateness of the exchange rate regime, as highlighted in the EPA, the authorities would like to emphasize that the current peg has helped Macedonia achieve and maintain macroeconomic stability, even throughout the 2001 security crisis and subsequent elections, and has continued to deliver low inflation. For the future, they agree that the adequacy of the regime has to be kept under close review. Given the proven capability of the current regime to contain inflation and preserve macro stability, the authorities would not see a currency board as credible progress. Going forward, the Fund will have to treat the exchange rate mechanism as part of Macedonia’s overall policy-mix and economic environment. In doing so, the Fund is right to open discussion of the exchange rate regime and should also be prepared to close it. The authorities welcome an open assessment of underlying factors that influence the choice of exchange rate regime, with the objective of maintaining a well-founded policy in this area. Clear Fund advice will be important as part of exploring a follow-up arrangement.

Going forward

As the EPA mentions, the authorities agree that important structural challenges need to be addressed and they are firm in their determination to cope with them in an expeditious and constructive manner. Some of these reforms have been burdening the authorities for years, such as reducing unemployment through reducing the tax wedge on labor, and strengthening fiscal management and the financial sector. Other challenges are new, such as the proposed fiscal decentralization, reforms of the public administration and the road towards EU accession.

To tackle these challenges, Macedonia counts on continued support from the international community. Over the past few years, Macedonia has received important support from bilateral donors and the multilateral organizations. After the current arrangement expires, the authorities would like to continue their cooperation with the IMF through the most appropriate medium-term arrangement that will strengthen the reform component of existing economic and financial policies, while tackling the projected financing gap and external vulnerabilities. In this way, the authorities are confident that the international community will continue to support the country in the final stages of transition to a modern market economy.

In closing, I would, on behalf on the authorities, like to once again thank staff, the IMF Resident Representative and management for their dedicated work and sound policy advice to Macedonia.