

I. COUNTRY CONTEXT AND DEVELOPMENT ACHIEVEMENTS

A. Transition and EU Accession

1. **FYR Macedonia is a landlocked country of two million people.** It is ethnically diverse, with some 65 percent of the population made up of ethnic Macedonians, 25 percent ethnic Albanians, 4 percent ethnic Turks, and nearly three percent Roma. The country remained largely peaceful during the wars following the dissolution of Yugoslavia in the 1990s. Conflict between extreme ethnic Albanian armed groups and FYR Macedonian security forces broke out in March 2001, but proactive international intervention helped end the fighting five months later with both sides agreeing to terms under what has come to be known as the Ohrid Framework Agreement. The main elements of this Agreement provided for greater devolution of political authority to local communities, equitable representation of minorities in the public administration as well as mechanisms to protect minorities' interests in the legislative process. Nearly 10 years later the Ohrid Framework continues to provide the basis for peace, political expression and social stability.

2. **The center-right Internal Macedonian Revolutionary Organization – Democratic Party for Macedonian National Unity (VMRO-DPMNE) party strengthened its mandate in early parliamentary elections in 2008 and in presidential and local elections in 2009.** The Prime Minister and the President are members of the ruling party, and VMRO-DPMNE hold strong majorities in the national parliament and in local municipalities. The country is on the threshold of EU accession; it achieved “candidate” status in 2005, and in October 2009 the European Commission recommended the commencement of accession negotiations. Movement toward EU membership has, however, been slowed pending resolution of the “name issue” with Greece.

3. **EU accession continues to be highly popular and remains the anchor of reform in nearly every area of government and public services.** The authorities are harmonizing national legislation with the EU *acquis communautaire*, with specific achievements in procurement, transport policy, customs union, taxation and statistics. The European Commission's (EC) assessment from October 2009¹ notes that FYR Macedonia “has made significant progress in meeting key priorities of the accession partnership,” particularly related to governance and the soundness and stability of its political institutions. Indeed, in a major improvement upon its 2008 report, the 2009 report notes that FYR Macedonia “has consolidated the functioning of its democracy and ensured the stability of institutions guaranteeing the rule of law and respect of fundamental rights.” Overall, legislation is aligning FYR Macedonian policy closer with the EU. However, further work is essential to enhance administrative capacity for legislation implementation and enforcement.

¹ Communication from the Commission to the European Parliament and the Council: Enlargement Strategy and Main Challenges 2009-2010 {COM (2009) 533}, October 14, 2009, page 13.

B. Macro-Economic Performance and Outlook

Pre-Crisis

4. **Economic performance improved considerably prior to the global crisis.** Considered a laggard in terms of economic growth for most of its transition period, output expanded vigorously in 2007 and 2008 when growth averaged 5.5 percent and approached the regional average.

5. **Macroeconomic policies supported stability and accelerated growth and were complemented by structural reforms.** A historically balanced and relatively modest budget (at around 34 percent of Gross Domestic Product (GDP)) helped keep aggregate demand manageable and avoided crowding out financing for the private sector. Monetary policy also responded adequately to price and foreign exchange market developments. As a result, inflation was low and stable,² government debt fell to below 21 percent of GDP while at around 48 percent of GDP external debt remained moderate. Structural reforms were also advanced. Fees and charges were reduced, procedures eliminated, and labor relations overhauled, while reforms in the judiciary and cadastre improved creditor and property rights. Tax policy and administration reforms reduced the fiscal burden while strengthening public finances. Sound banking regulation and supervision contributed to keeping risks manageable while stronger competition reduced the cost of finance.

Impact of the crisis

6. **Prudent macroeconomic policies and complementary reforms helped FYR Macedonia weather the global crisis better than most countries in the region.** In response to a collapse in demand for exports and reduced private capital flows, fiscal policy turned countercyclical while monetary policy was tightened to alleviate reserve pressures. As a result, in 2009 output contracted by only 0.5 percent, the fiscal deficit was 2.6 percent of GDP (among the lowest in ECA) and the current account deficit narrowed from 2008 by 4.2 percentage points to 8 percent of GDP. The impact of the crisis on living standards also appears to be moderate.

7. **The Government's response was generally sound.** The authorities carried out a sizable fiscal stimulus in late 2008 and increased the 2009 target deficit, in line with sustainable liquidity and longer-term solvency indicators. As in neighboring countries, budget revenues fell from 33.1 percent of GDP in 2008 to 31 percent in 2009. The authorities responded by trimming expenditures to meet the deficit target. Additional measures were taken to mitigate the impacts of the crisis, including extending profit tax exemptions, implementing a major payroll reform, and supporting access to finance for small and medium-size enterprises (SMEs) by securing a credit line from the European Investment Bank (EIB) in the amount of 100 million Euro. The National Bank tightened policies to stop the outflow of foreign exchange reserves and protect the currency peg.

8. **Though growth turned positive in the last quarter of 2009, data for 2010 suggest recovery will be gradual and tentative.** GDP contracted by 0.9 percent year-on-year (y-o-y) in the first quarter of 2010. Despite some rebound in external demand, domestic spending remained slack as households faced weak labor markets and investors remained cautious. Still, indicators of economic activity (e.g., industrial production, tax collection, private sector credit, volume of transactions, electricity consumption, etc.) improved significantly by mid-2010.

² Inflation did pick-up somewhat in late 2007 and early 2008 as a result of the surge in world prices of food and energy, but declined once the shock receded.

Outlook over the CPS period

9. **The economy is projected to grow by 2 percent in 2010—but risks remain significant.** The 2010 budget deficit target has been reduced slightly to 2.5 percent of GDP. In fact, cuts to wages and services have made room for higher subsidies, transfers, and investments. With revenues underperforming at the start of 2010, the authorities adopted a supplemental budget in June cutting expenditures by around 1.2 percent of GDP to meet this revised target. Since end-2009, the Central Bank has gradually reduced the intervention rate from 9 to 4.5 percent, and credit to the private sector has picked up somewhat. Exports and Foreign Direct Investment (FDI) recovered modestly as major trading partners returned to growth (with the exception of Greece), though the recent gains may prove short-lived if risks materialize.

Table 1: Recent Economic Developments and Outlook

	2007	2008	2009	2010	2011	2012	2013
	Actual		Est.		Projected		
Real Sector							
Real GDP growth (percent)	6.1	5.0	-0.5	2.0	4.0	4.5	5.0
Investment (percent of GDP)	24.6	26.8	25.4	22.8	25.2	25.5	25.5
Unemployment rate (percent), LFS	35.2	34.0	32.3				
Fiscal Accounts (percent of GDP)							
Revenues, including grants	32.7	33.1	31.0	31.1	31.6	31.7	31.8
Expenditures	32.1	34.0	33.7	33.6	34.1	33.7	33.6
Balance, including grants	0.6	-0.9	-2.5	-2.5	-2.5	-2.0	-1.8
General Government debt	24.0	20.6	23.6	26.9	27.8	28.1	28.0
External Accounts (percent of GDP)							
Current Account balance	-4.3	-12.2	-8.0	-5.8	-6.7	-6.5	-6.2
Exports of Goods and Services	52.4	50.9	38.8	41.5	41.4	42.1	42.7
Imports of Goods and Services	70.8	76.2	60.2	62.6	63.2	63.7	63.5
Foreign Direct Investment (FDI)	5.5	5.9	3.6	3.6	4.0	4.1	4.1
External Debt	51.0	47.6	58.7	60.4	59.8	58.8	57.2
Reserves (months of imports of G&S)	4.7	3.4	4.9	4.9	4.8	4.7	4.6
Inflation							
Consumer Prices (period average)	2.3	8.3	-0.8	1.7	2.0	2.0	2.0

Source: National authorities and Staff calculations

10. **Macroeconomic policies need to remain prudent.** Gradually reducing the fiscal deficit to a level that stabilizes debt will ensure that fiscal policy remains accommodative to the slower growth environment without endangering the sustainability of public finances. A fiscal deficit of around 1.5

percent of GDP by the end of the CPS period should stabilize public debt and put it on a declining trajectory. Improving the structure of public spending is also a key area for improvement and will require strong commitment, given rigid spending patterns and declining revenues linked to the ongoing payroll reform. Under the baseline scenario of gradual recovery, a carefully managed budget and strong reforms, a coordinated further loosening of monetary policy might also be possible, though with the NBRM's intervention rate already reduced to 4.5 percent the scope for further reduction is limited.

11. **Recovery of investments will be critical.** The prospects for private investment, especially FDI, will be boosted by closer EU integration and associated reforms. Gains from reforms affecting the investment climate and the quality of the labor force can be particularly substantial, especially given the pegged exchange rate environment. Public investments are projected to remain relatively high during the CPS period and help improve the competitiveness of the economy. Well designed policies on public-private partnerships can also crowd-in private investments. Due to its reliance on domestic deposits and limited exposure to wholesale financing (90 percent loan/deposit ratio in mid-2010), the banking sector remains sound with strong liquidity and capital adequacy indicators and can support growth by providing improved access to credit for the private sector.

Debt Sustainability

12. **The external balance is expected to improve.** The current account deficit is projected to fall to below 6 percent of GDP in 2010, widen slightly in 2011 as domestic demand recovers and gradually decline afterwards. Exports should grow as major trading partners recover, while imports are expected to rebound more slowly, partly due to fiscal consolidation over the medium term. Private transfers will remain significant as EU-integration increases labor mobility³. Financing requirements are projected to be around 10 percent of GDP on average during the CPS period with the current account deficit averaging around 6 percent of GDP. Amortization is expected to add around 3 percent of GDP to financing requirements while an increase in reserves of around 1 percent of GDP is expected to be needed to ensure that reserves continue to provide a comfortable coverage of 4-5 months of imports of goods and services.

13. **The external financing requirements are not excessive, but macroeconomic policies may need to be adjusted in case capital inflows underperform.** The 10 percent of GDP needed to meet the financing requirements is projected to come primarily from FDI (accounting for 4 percent of GDP on average) as delayed investments are undertaken and new investors enter the market and from disbursements on debt instruments, which are expected to provide around 6 percent of GDP—of which around half will be from issuance of public debt (Table 2). While a considerable part of public borrowing will be from official sources (EBRD, EIB, IBRD, etc.), the authorities plan to finance a significant part of the fiscal deficit by issuing debt on private international capital markets. If reemerging financing risks keep borrowing terms unfavorable (see Box 1) a tightening of macroeconomic policies may be required in order to limit the financing requirements.

14. **Public and external debt should remain sustainable.** General government debt is projected to peak at 29 percent of GDP by 2012. Still, the move from concessional to commercial creditors will increase interest expenditures and shorten maturity. Gross external debt is projected to reach

³ Still, a larger increase is unlikely given that labor markets are expected to remain stagnant over the next few years in the most frequent migrant destinations.

60.5 percent of GDP in 2010 and then gradually decline. Most debt is in favorable longer-term loans to the public sector or FDI-related transactions and small exposure to wholesale financing. No major deterioration in debt servicing indicators is expected, though large repayments in 2012 and 2015 indicate increased roll-over risks.

Table 2: External Financing Requirements

	2010	2011	2012	2013
	in USD million			
Financing requirements	808	982	1,213	1,124
Current Account Deficit	532	655	670	690
Amortizations	226	216	416	314
Reserve Changes	50	111	127	120
Financing sources	808	982	1,213	1,124
FDI	330	388	420	456
Portfolio Investments	245	220	370	250
Disbursements	213	354	403	398
Other Capital	20	20	20	20

Note: Debt issued on private capital markets (i.e. Eurobond) is presented as Portfolio Investment. Source: Bank Staff calculations

15. **The risks to this scenario remain considerable.** Stronger growth will depend on continued recovery in FYR Macedonia's main trading partners and investors responding to an improved business environment. So far, the European fiscal and debt crisis appears to have had only limited impact on financial conditions and economic activity in the country. FYR Macedonia has important economic links with Greece (see Box 1), and to a lesser extent with more exposed countries such as Italy, Ireland, Spain and Portugal. A loss of confidence resulting from a significant deterioration in the five most-exposed EU countries, though unlikely, risks driving FYR Macedonia's richer trading partners into recession and dampening growth prospects. Drastic domestic adjustments were unnecessary in FYR Macedonia as macroeconomic fundamentals were largely appropriate prior to the crisis. Nonetheless, heightened uncertainty, tighter economic policies, or reduced remittances and capital inflows could slow or reverse growth. Further, the analyses suggest that public debt will not stabilize under an extended output shock or failure to adjust the fiscal balance, and external debt will not stabilize if growth, exports and FDI underperform. Public and external debt levels are significantly affected by the exchange rate.

Box 1: Impact of the Greek and Eurozone Sovereign Debt Crisis

Greece is an important economic partner of FYR Macedonia, and a prolonged recession in Greece will negatively impact growth prospects. To date, however, indicators suggest a relatively modest impact on FYR Macedonia's economic activity.

Greece is the second most important trading partner of FYR Macedonia. A decline in trade so far in 2010 has so far been compensated for by increased trade with other countries. Greece is also a major transport corridor, with foreign trade in critical FYR Macedonian products (oil, iron and steel etc.) largely going through the Greek port of Thessaloniki. Prolonged closures of the port due to strikes will add to the costs of doing business in FYR Macedonia. Greece's importance as a foreign investor has receded in recent years though remains high. However, risks are somewhat mitigated by the fact that most of the investments are from retained earnings.

In the financial sector, two banks, including the largest bank in the country, are subsidiaries of Greek banking groups. So far, risks to these two banks appear manageable. Both banks are well-capitalized, have sound liquidity and solvency indicators and limited exposure to mother banks and, according to stress-test results, should be able to withstand significant withdrawal of deposits. However, increased vigilance and improved coordination between key stakeholders will be needed in case the situation deteriorates further or is extended over a longer period.

The increased risk perceptions due to the Greek crisis may also undermine growth prospects by keeping risk premiums elevated for a considerable part of the CPS period. This may lower the availability and increase the costs of foreign capital and require an adjustment in macroeconomic policies. Already, the authorities have delayed the issuance of a Eurobond amid rising risk premium as a result of the Greek debt crisis.

Beyond Greece to the Eurozone more broadly, continued uncertainty related to Europe's debt and fiscal crisis is expected to dampen economic growth. According to the June 2010 *Global Economic Prospects*, the higher probability of faster tightening of policies in developed economies will somewhat lower global growth. This tightening may have a disproportionate impact on FYR Macedonia owing to its strong links with EU countries. A major crisis of confidence, though unlikely, could have far-reaching consequences on growth and the global financial system. If such a crisis occurred, FYR Macedonia might not be able to avoid a larger loss of output and deterioration in economic fundamentals.

C. Competitiveness

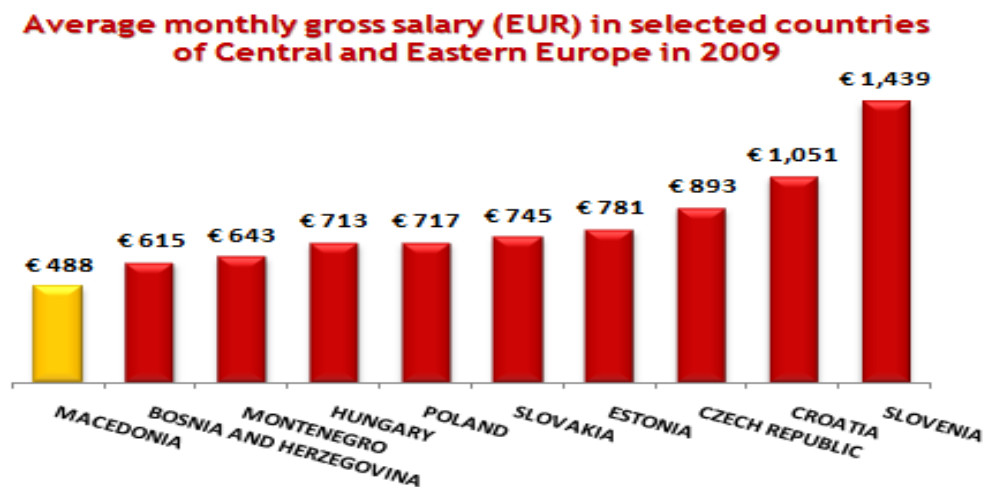
Business Environment

16. **FYR Macedonia has significantly strengthened its business environment.** The ranking of FYR Macedonia in "ease of doing business" in the 2010 World Bank Group *Doing Business* Report jumped to 32 out of 185 countries from 69 in 2009 and 92 in 2006. In 2010, FYR Macedonia was recognized as the third overall "top reformer." As a result of a new Law on Business Registration, the time to register a company was cut from 48 days in 2006 to 4 in 2009; and the cost to less than €50. Business regulation was also reduced by introducing a "Regulatory Guillotine," which reviewed more than 2,000 laws and by-laws, out of which 64 laws and 482 by-laws were amended. In addition, the flexibility of the labor market was increased through a new Labor Law.

17. **The Government has significantly cut tax rates.** Corporate and personal income tax rates have been cut to a flat rate of 10 percent (one of the lowest rates in the ECA region) and additional exemptions have been introduced to reinvested profits. These measures are designed to complement broader efforts underway to improve the business environment and reduce the impediments to investment, including ensuring FYR Macedonian labor remains competitive in Europe.

18. **An ambitious payroll tax reform is also underway to reduce the burden of hiring and retaining workers.** Indeed, the Government has made wage competitiveness and access to the EU market a key element of a global marketing campaign, *Invest Macedonia* (Figure 1).⁴ Part of this strategy was to reduce Social Insurance Contributions, which have been cut from 32.5 percent of gross income in 2008 to 27 percent in 2010. Reaching the target of 22.5 percent during the CPS period will depend on the fiscal outcomes during recovery. Payroll tax reforms have been carried out while managing fiscal implications by expanding the tax base, harmonizing income bases for social security, and moving from a net wage to a gross wage basis for calculating contributions. These reforms are having positive effects on the labor market in general, and for unskilled and younger workers in particular. In fact, labor participation has jumped by five percentage points since 2004.

Figure 1. Wage Competitiveness



19. **The country has strengthened its real estate market and courts.** Reforms in the real estate cadastre have resulted in the coverage of 99 percent of the territory; nearly tripled the number of mortgages; doubled the number of registered transactions; and shortened the period for transaction registration. Seventy percent of all transactions are now registered in one day, and 30 percent between 3 and 8 days, a dramatic improvement from the 60 to 90 days required in 2005. In addition, improvements have been made to the judicial and legal framework. The court system is better organized and new laws, including one on Administrative Procedure, are reducing the back-log of cases and strengthening the enforcement of court judgments. Similarly, a new Bankruptcy Law has helped shorten the average court processing time from 43 to 26 months.

20. **Better infrastructure is strengthening competitiveness.** The Government has made a particular commitment to the transport sector, with significant Bank support. Over the past 15 years, more than 200km of motorway roads have been rehabilitated and the average border entry and exit

⁴ Invest Macedonia <http://www.investinmacedonia.com>; Vienna Institute for International Economic Studies.

time has decreased threefold. Similar progress has been achieved in railways. A new EU-compliant Railway Law, for example, has helped strengthen the entire sector. Macedonian Railways (MR) has been reformed to improve the financial viability, productivity, and effectiveness of railway operations. In addition, the energy sector is more efficient. MEPSO (the public electric power transmission company) has increased the capacity of the transmission network by completing the power transmission line to Greece, and restored 38 transformer stations throughout the country, including the main power transformation station for the capital of Skopje. This work has led to a significant reduction of technical losses and an increase in the stability of the power system.

21. Closer alignment with EU Procurement Standards is enhancing transparency and predictability. Consistent with EU requirements, Parliament has approved a new public procurement law, and the Government has established an independent appeals commission and independent public procurement bureau (PPB) under the Ministry of Finance. Authorities issued a detailed handbook explaining the law, and further developed an e-procurement system, which is now under pilot implementation. These improvements to the procurement system are helping to level the playing field for all domestic and foreign investors. Finally, the Government has asked the Bank for an assessment of its new public procurement system for the potential use of country systems for Bank financed operations. The Bank has responded to this request and cooperated very closely with the PPB, the EU and United States Agency for International Development (USAID) field offices in conducting the assessment at the country level. An action plan is in discussion with the PPB for further streamlining the implementation of the public procurement system with international good practices.

D. Social and Human Development

22. Non-income dimensions of poverty as measured by human development indicators have improved in several areas but remain low by EU standards. Life expectancy at birth is about 74 years, while the EU average is 78. Infant mortality rates have dropped significantly to 13 deaths per 1,000 live births. But this is still well above the EU average of five.⁵ The pattern is similar for education outcomes with gains over the last decade in primary and secondary enrollments, but lags in educational attainments and other outcomes. There have also been important advances in gender equality and empowerment of women over the past decade, with more women represented in Parliament, employed in the non-agricultural sector and, perhaps most importantly, enrolled in every level of education, with especially significant gains in tertiary education.

23. FYR Macedonia is building an innovative and well-targeted social safety net. The Government has improved its definition and calculation of benefits—including indexing benefits to inflation rather than wages—and revised the terms of eligibility. It has taken advantage of a relatively well-targeted means tested last-resort program—Social Financial Assistance—to introduce a conditional cash transfer (CCT) program, supported by the Bank. The CCT will help to reduce the inter-generational transmission of poverty by linking benefits to the fulfillment of standards for secondary school enrollment and attendance. Authorities are considering extending CCT benefits to improve outcomes in kindergarten and primary-school, job training and adult education, and the health sector, particularly through programs designed for mothers and children.

⁵ Using the latest comparable data.

24. **Improvements are also underway in pensions.** The Government has introduced parametric reforms to the existing defined benefit (PAYGO) system, including an increase in the retirement age and contribution rates and a reduced replacement rate. Further, a voluntary defined contribution component was added in 2009 to complement the mandatory defined contribution system. Improvements were also made to consolidate collection of all social contributions, strengthen the regulatory and supervisory capacity for the payout phase in the fully funded pension scheme, and work with market participants on a range of investable instruments available for the pension funds. These are important measures, but the fiscal strains of the global crisis and the slow recovery are placing these achievements at risk.

25. **Particular attention has been directed to improving education outcomes.** Poor performance on the International Large Scale Assessment Studies (TIMSS, PIRLS and PISA) in 2000 and 2001 has triggered wide reforms in education system. Key challenges included improving teacher performance and strengthening enrollment. Between 2004 and 2008, secondary enrollment increased from 85 to 95 percent, and dropout rates for primary school decreased to below 2 percent. A market for teacher training was established, along with criteria for accreditation and monitoring of teacher training. The State Matura examination, the national assessment of student achievement, was given for the first time in 2008 in all four-year general and vocational schools. From 2004 to 2007, 49 percent of school managers and teachers reported improvements in students' achievements; more than 60 percent saw improvement in planning and assessment processes, and 28.5 percent confirmed improved attendance and participation. The Ministry of Education is administering a second round of School Improvement Grants, with support from the Bank, focusing on elementary and rural schools, as well as introducing electronic "school profiles" for all elementary and secondary schools, to house administrative records.

26. **Progress is also underway toward ensuring the sustainability of the health system.** The Health Insurance law was amended to streamline the operations, decision-making and transparency of the Health Insurance Fund (HIF), the public entity charged with coordinating health financing. These reforms permit a more efficient payment system for hospitals and other health care providers. The managerial capacity of the HIF has also improved, both through training and improved information systems. In addition, efficiencies were realized through the competitive procurement of pharmaceuticals and changes in the payment mechanism to providers. Most recently, the HIF board instituted reference pricing and stronger controls over spending. Financial results improved markedly. Arrears of the HIF to suppliers were cleared in 2007, while financial obligations of the entire public health sector fell from 1.7 percent of GDP in 2004 to 0.4 percent in 2008.

II. DEVELOPMENT CHALLENGES

A. Faster Growth

27. **FYR Macedonia's development achievements have been substantial, but continued effort across a range of areas will be required to generate economic growth that puts people to work and improves living standards for all.** The Government and the World Bank Group agree that such growth will have to be faster, more inclusive and, increasingly, "greener."

28. **Continued growth and employment creation will depend on sustained macroeconomic stability.** A continued prudent policy framework would narrow the fiscal and external imbalances