FORMER YUGOSLAV REPUBLIC OF MACEDONIA
COUNTRY ASSISTANCE STRATEGY
PROGRESS REPORT

1. This report provides an update on progress in implementing the Country Assistance Strategy (CAS) for former Yugoslav Republic of (fYR) Macedonia, as described in the July 14, 1998 CAS document. A new CAS will be prepared and presented to the Executive Directors towards the end of FY01. This Progress Report provides an update on CAS implementation during a turbulent period of political shifts and of economic and social fallout from the Kosovo crisis. Economic reforms came to a halt after parliamentary elections, which were just four months after the CAS was discussed. In addition, during this CAS period the country struggled in dealing with hundreds of thousands of Kosovar refugees and the cessation of crucial economic ties with neighboring Federal Republic of (FR) Yugoslavia. As a result, implementation of the agreed strategy has been slower than expected.

Following the Presidential elections of November 1999 and an extensive reshuffling of the Cabinet among coalition partners in December 1999, the authorities now have an opportunity to move forward on stalled reforms and to improve prospects for integration with Europe through participation in the Stability Pact for South Eastern Europe.

Background

2. The 1998 CAS was prepared jointly with the International Finance Corporation (IFC) and was also a pilot self-evaluation CAS under which performance against a proposed set of outcomes detailed in the CAS matrix would be measured at the end of the CAS implementation period. The CAS anticipated continued government commitment towards reforms as outlined in the National Development Strategy for Macedonia and identified a program of support for the three priority areas outlined in the national strategy: (i) promoting private sector growth and job creation; (ii) enhancing the efficiency of the state; and (iii) alleviating poverty and developing human capital. The Government and the Bank Group agree that these themes are still fundamental, and the overall objectives and strategy of the 1998 CAS remain valid. Moreover, developments in fYR Macedonia since January 2000 now allow stronger efforts to accelerate reforms and reduce poverty. This Progress Report reviews implementation of the CAS, recent developments in the region and the project portfolio and presents our plans to increase our impact on poverty alleviation.

I. POLITICAL SITUATION AND ECONOMIC DEVELOPMENTS

A. The Political Environment

3. After parliamentary elections in November 1998 followed by the Kosovo crisis, the political environment made it difficult for the coalition to deliver on its promises to advance structural reforms. In November 1999, a governing crisis linked to the controversy surrounding the presidential elections further distracted the Government’s ability to focus on the reform agenda. The December 1999 cabinet reshuffle brought in a new team with some key ministers who are now working hard to push for reforms. However, anti-reform movements within the Government may

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2 At the height of the crisis last Spring, fYR Macedonia was host to more than 350,000 refugees from Kosovo.
3 Negotiations on a Stabilization Association Agreement with the European Union were officially launched on April 5, 2000 in Brussels.
4 See Annex B1.
5 FYR Macedonians voted in a three-party coalition -- the nationalist Democratic Party for Macedonian Unity (VMRO/DPMNE), Democratic Alternative Party (DA) and the Albanian Democratic Party (DPA).
strain its ability to muster the necessary support to move forward on the reform agenda thus making it difficult to deliver an adequate flow of resources from the Bank -- resources that are needed to leverage significant flows from other major partners, for example, the European Union (EU). Occasionally, the Government has managed to make progress in spite of this difficult political environment. A recent example is the passage of important laws and amendments to reform the public pension system, unemployment benefits, health insurance, and labor regulations under the Social Sector Adjustment Credit (SSAC). More recently, the Government has advanced a substantial program of financial and enterprise policy reforms making it possible for the Bank to move forward with preparation of the second Financial and Enterprise Sector Adjustment Loan /Credit (FESAL/C II).

4. **The Stability Pact.** FYR Macedonia strongly supports the regional policy initiatives under the Stability Pact, established after the Kosovo crisis to promote peace, stability, and prosperity in South Eastern Europe. The Stability Pact calls for South East European countries to initiate domestic structural reforms, collaborate economically and politically, develop open democratic societies, foster social inclusiveness, improve governance, strengthen domestic security and combat corruption. South East European countries will receive support for these efforts through regional programs.

**FYR Macedonia** hosted the first meeting of the Stability Pact Working Group on Trade Liberalization and Facilitation in Skopje in February 2000 and signed a Memorandum of Understanding on trade and transport facilitation, committing itself to regional cooperation. FYR Macedonia has already received substantial pledges for “quick-start” projects with regional impact at the Regional Donor Conference in Brussels in March 2000. The European Union (EU) has established Stabilization and Association Agreements (SAAs) to align South East European countries to European institutions. Negotiations on an SAA with FYR Macedonia were officially launched in April 2000 in Brussels.

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**Box 1: The Impact of the Kosovo Crisis**

**The Crisis.** FYR Macedonia had more than 350,000 Kosovar refugees (equivalent to 17 percent of the population) at the height of the Kosovo crisis (March-June 1999). Camps were set up to receive the refugees but many were also taken in by Albanian families. When the crisis ended, refugees quickly began to return home and by September 1999, most had returned to Kosovo.

**The Impact.** The crisis placed an enormous strain on the Government’s budget and on its administrative capacity. The large number of refugees exacerbated inter-ethnic tensions although these abated somewhat with the early ending of the hostilities, defusing a potentially explosive situation. The financial impact of the crisis turned out to be much less than anticipated, owing to a quick recovery in exports and a significant increase in turnover in the service sector. As a result, the economic impact of the crisis was moderate, reducing GDP growth by an estimated 1.3 percent. Despite extra refugee demands, inflation did not emerge (in fact prices declined) due to tight monetary policy and to humanitarian aid, some of which entered local markets and depressed food prices. Although expenditure control weakened, by year-end, general government expenditures (including extra budgetary funds) totaled about 2 percent of GDP above budget; and as a result of an extraordinary effort at revenue collection, the overall general government budget balanced for the year. The current-account deficit for 1999 (with grants included as official current transfers) is now estimated to have been about 4 percent of GDP, rather than the near 15 percent of GDP feared at the outbreak of the crisis.

**The Bank’s Response.** The Bank responded quickly to the Kosovo crisis – taking the lead in organizing donor support and providing rapid assistance to the FYR Macedonian Government. The Bank sponsored an emergency informal donor meeting in April 1999 for the countries most affected by the crisis. A follow-up Emergency Joint G24/Consultative Group Meeting was held in Paris in May 1999, resulting in significant pledges of support from the donor community and a commitment to FYR Macedonia’s long-term development. The Bank made a significant contribution by processing within six weeks an Economic Recovery Credit (US$50 million equivalent, approved in May, 1999), and a Social Support Credit (US$10 million equivalent, approved in June 1999) to help mitigate the economic and social costs of the Kosovo crisis and structural reforms. A Post Conflict Grant of US$1.0 million, implemented by UNICEF, provided aid and services to Kosovar refugees.

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6 The Trade and Transport Facilitation in South Eastern Europe Program (TTFSE) supported by the World Bank/IDA, includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia and Romania.

7 Under the Stability Pact, “quick start” projects are those that can be started over a 12-month period. It is expected that FYR Macedonia’s proposed five projects for US$104 million will be fully funded.
**B. Impact of the Kosovo Crisis**

5. **The past year was shaped by the crisis that erupted in Kosovo.** Government attention shifted to crisis management forcing short-term economic priorities and financial needs to the top of the agenda rather than the medium-term economic and social reforms agreed upon in the context of the CAS. The World Bank and FYR Macedonia’s other major international partners also made the shift to crisis management to concentrate on providing assistance to the country in the face of a staggering number of refugees, the cessation of trade with FR Yugoslavia, and resulting political uncertainty. In addition to the influx of refugees, the Government had to contend with the loss of its trade routes through neighboring FR Yugoslavia, its main trading partner, and the loss of its export markets as foreign customers cancelled contracts with domestic private sector firms because of the uncertainty and instability caused by the crisis. Box 1 provides more information on the impact of the crisis.

**C. Social Context**

6. **Social cohesion is key to sustainable development.** Wide ethnic differences in FYR Macedonia make it particularly vulnerable to inter-ethnic tensions. FYR Macedonia has managed to maintain relatively peaceful interethnic relations and has, up to now, escaped violent confrontations between ethnic and cultural groups which characterized some of her neighbors. However, wide differences exist between cultural practices and economic and social achievements of the different groups in society. Regional imbalances are another threat to social cohesion. FYR Macedonia is a small country but with relatively important regional differences between rural and urban populations, between mountainous regions and other parts of the country and more generally between various sub-regions of the country. Because of these differences, ensuring equal access to services and economic and social opportunities to all FYR Macedonian citizens is also an important challenge that requires careful attention to public spending allocation and investment policies. The problem of access by the poor and minorities to benefits and services was identified in the social assessment that accompanied the Poverty Assessment. There needs to be a focused systematic approach on the capacity of local governments to fund, define appropriate programs and targeting mechanisms, and then properly administer services and benefits that are needed by the poor. Some of these issues will be further reviewed in the context of work to be undertaken in FY01 in support of the planned interim Poverty Reduction Strategy Paper (PRSP) to be prepared by the Government (see para. 7).

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**Box 2: Poverty in FYR Macedonia**

A 1999 World Bank Study, “Former Yugoslav Republic of Macedonia: Focusing on the Poor,” shows that poverty largely affects rural households with many children, limited asset ownership (durables and land), a high share of food in total consumption, and with a poorly educated head of household and female household members.

- About 20 percent of the population is poor (defined as monthly consumption of about US$50 per adult based on the 1996 poverty line);
- Poverty is highest among the “traditional poor” (rural, agricultural households, with more than three children; the “new poor”, (non-agricultural households who are unemployed/transfer recipients) as the largest group of poor; and the “chronic poor”, (the elderly, the disabled and aged farm households without pensions or other fixed incomes).
- Poverty is strongly linked to unemployment; almost two-thirds of the poor are unemployed;
- The increase in poverty among workers is related to a sharp decline in real wages;
- Poverty increases with household size, rising sharply for households with more than three children;
- Poverty is strongly linked to educational attainment. Nearly 80 percent of the poor live in households headed by individuals with primary education or less;
- Poor living conditions are a hallmark of poverty in the country and are worse for the rural poor but are also difficult for peri-urban residents.

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8 FYR Macedonia: Focusing on the Poor (June 11, 1999).
7. Due to the availability of better data (see para. 29), the GNP per capita for fYR Macedonia is estimated to be US$1690 in 1999; based on older time series data, 1998 GNP per capita was reported as US$1290. Despite the seeming improvement in 1999, this is just a statistical correction and for many fYR Macedonians poverty remains debilitating (see Box 2). This change in per capita income will mean that beginning in FY02 fYR Macedonia will become ineligible for IDA, although the Fund currently is considering a blend of Poverty Reduction and Growth Facility (PRGF) and Extended Fund Facility (EFF) support. In this context, the Government will continue to work on its interim PRSP. A joint World Bank/IMF mission in June will review with the Government its preparation of this paper, which is scheduled to be discussed with the Executive Directors in August 2000. In support of the full PRSP which the Government plans for the summer of 2002, analytical work will be undertaken to update the existing poverty profile and better understand impediments to income growth for the poor.

D. Economic Developments and Prospects

8. At the time of the 1998 CAS for fYR Macedonia, macroeconomic developments painted a positive picture for imminent growth. Output had stabilized in 1996 after falling by 40 percent between 1991 and 1995, reflecting the impact of the macro-economic stabilization program launched by the Government in 1994. A modest expansion in 1997 seemed to set the stage for a projected 3.5 percent of real GDP growth for 1998. Stubbornly high recorded rates of unemployment, with over 30 percent of the formal labor force out of work, indicated the need for a deepening of economic reforms, particularly in the financial and enterprise sectors. In mid-1998, such reforms seemed likely. Rising rates of growth seemed the probable result during the ensuing three-year CAS period, supported by reasonably strong export performance and rising domestic savings rates. The Bank projected annual GDP expansion to approach 5 percent in the medium-term.

9. Economic outcomes in 1998 did not match the Bank's CAS projections, and the Kosovo crisis (the prospect of which was mentioned in the CAS) undercut growth in 1999 (See Box 1). Fiscal and external balance targets (set under an IMF Enhanced Structural Adjustment Facility (ESAF) program) were missed in 1998, although inflation continued to slacken and foreign direct investment (FDI), at 5 percent of GDP, surpassed expectations. FDI quickly declined again in 1999, and over the 1995-99 period has been quite low (see para. 16). Resulting GDP growth was just under 3 percent in 1998; despite robust total demand, the economy's supply response remained weak due to insufficient progress on structural reforms. By early 1999, before the Kosovo crisis, fYR Macedonia's IMF-supported ESAF was off-track despite positive developments on the macroeconomic front. Discussions for the midterm review could not be concluded because of slow progress on enterprise sector reform. However, by year-end 1999, economic outcomes were dominated by the impact of the crisis in neighboring Kosovo. The cutoff of trade with and through FR Yugoslavia and a lapse in expenditure management and control by the government during the crisis created pressures on the balance of payments and on the fiscal accounts. However, the refugee crisis ended sooner than feared, and exports recovered more quickly than projected. As a result, 1999 GDP is estimated to have expanded by around 2.7 percent in real terms, rather than contracting by nearly 4 percent as estimated during the crisis. Further, prices declined in 1999, rather than increasing by as much as 2 percent as had been expected. Buoyant tax collection strengthened the underlying fiscal position, and the general government’s budget balanced by year-end. High exports to Kosovo and compression of imports earlier in the year kept the external current account deficit to 4 percent of GDP, and net foreign
exchange inflows topped US$118 million, raising the foreign exchange reserve cover to 3.1 months of imports.

10. **Medium Term External Environment.** The promise of stability and closer economic relations within the region and Europe contained in the Stability Pact has improved external prospects for FYR Macedonia. The geographical isolation imposed by the repeated closing of the northern or southern borders since independence, and the resulting suffocation of trade and of foreign investment is expected to continue to dissipate. The current account deficit is expected to widen in 2000 to slightly over 8 percent of GDP and then moderate towards a more easily financed 6-7 percent of GDP in the medium term. Export growth (of goods and net factor services) is projected at 8-9 percent in 2000, as recovery from the shortfalls of 1999 continues. The positive impact of improved relations with trading neighbors and association with the EU could push export growth to near 12 percent in the medium term. This robust expansion of exports would help to contain the current account deficit, despite the need for higher investment levels and imported capital goods. The burden of external debt remains moderate despite an increase in 1998 as the private sector gained access to international borrowing for the first time. Total external debt is estimated to have very slightly exceeded the high case trigger of 45 percent of GDP in 1999, but is projected to fall towards 30 percent of GDP in the medium term as borrowing from preferred creditors is replaced by foreign direct and portfolio investment. The one-year deferral of debt service payments granted by the Paris Club in April 1999 is expected to be followed by a discussion of options for further rescheduling later this year. A possible blended PRGF/Eff program from the IMF, the FESAL/C II currently under discussion with the Bank, and EU support could provide needed balance of payments assistance for 2000-02 and help the country through its 2000-01 hump in debt service payments.

11. **Economic Outlook.** Despite the Kosovo crisis in 1999 and generally delayed economic reform, FYR Macedonia is now poised for levels of growth over the next two years slightly higher than projected in mid-1998. A high case scenario, in which the government aggressively embraces economic reforms during 2000 could elicit overall GDP growth of 6 percent per annum in 2000-01. Underpinning this growth will be strong export growth of around 8-9 percent, spurred by maintenance of a stable exchange rate and financial and enterprise sector reforms that facilitate efficient resource reallocation and spur private sector activity, and public sector management improvements. Rising domestic savings, higher rates of financial intermediation of these assets, and inflows of foreign direct investment will allow overall investment levels to rise to over 20 percent of GDP. At the same time, prudent monetary and fiscal policies should enable the country to contain inflation to 2-4 percent and the public deficit to under 2 percent of GDP. In this high growth scenario, the current account deficit will remain relatively high because of the high import levels necessary to support economic growth, but financing will shift steadily towards private flows and especially direct investment so that the country’s debt burden remains moderate.

12. If the Government is unable to implement necessary although difficult reforms, then sustainable growth is less likely. A low case scenario projects growth for 2000-01 of only 2 percent per annum. Even in this scenario, monetary policy will remain tight to contain inflation. The fiscal deficit will be kept under control, but the quality of adjustment will be poor, with further cuts in capital expenditures and accumulation of arrears providing financing of current expenditures, dominated by wages for public employees. Without reforms of the public sector and the financial and enterprise sectors, however, private sector growth will founder; there is no basis for an intermediate, base-case scenario.

13. In summary, the regional environment that has emerged after the Kosovo crisis is much changed from that at the time of the last CAS. FYR Macedonia has lagged in its reform efforts. Part of the delay can be attributed to the economic setback of Kosovo and part to shifting political priorities and increased cautiousness. However, since January 2000, the newly constituted Government has been
trying to generate momentum for further market-oriented reform, supported by new regional initiatives that promise greater donor assistance and improved relations with the EU. The IMF is discussing a new three-year PRGF/EFF program, and the EU stands ready to provide additional resources in support of a reform program. It is now possible that FYR Macedonia can catch up and even exceed the expectations set in 1998, placing the country in a high case scenario. If, alternatively, the current government fails to generate popular support for further reform, then economic hardship, rising ethnic tensions, and gridlock in the political system could dominate the next few years, leaving the country in a low case scenario.

II. PROGRESS UNDER THE 1998 CAS AND OUTLOOK FOR FY00-FY01

14. Due to political events and the Kosovo crisis, the authorities have lost about 12-18 months against the structural reform objectives laid out in the CAS, although macroeconomic performance remains largely in line with the CAS’s projections. The fiscal deficit stands at about 2 percent of GDP ceiling and the country’s external debt/GDP ratio is 45.7 percent in 1999. Projections for 2000 and 2001 are that external debt will drop to about 43 and 41 percent of GDP, respectively, below original CAS forecasts. There has been some forward movement since January 2000, but during next year the Government will need to advance substantially on the stalled structural reform agenda as it also exerts efforts to keep the fiscal deficit under control. The discussion below outlines the progress that has been achieved against the three major national priorities for reform and development that the Government defined and discusses how the assistance program supported by the Bank over the remainder of this CAS period will help the Government deliver upon its commitments.

15. As indicated earlier, this CAS is a pilot self-evaluation CAS which included specific measurable indicators of country and Bank performance in the Country Program Matrix and proposed three monitoring exercises to provide periodic feed-back: an annual Joint Portfolio Performance Review (the first which has just been concluded and is discussed in paragraph 28); a follow-up of the 1998 Client Survey which will be initiated in the context of preparing the next CAS; and a possible evaluation of the results under the CAS by OED. While it remains too early to come to any firm conclusions about the effectiveness of this CAS, given that there is a final year of implementation to go and this may coincide with a renewed reform effort, Annex B1 provides a snap-shot of progress against agreed benchmarks to date.

A. Promoting Private Sector Growth and Job Creation

16. Some recent, bold steps by the Government have revived the enterprise reform agenda, which has been stalled since 1998. For the last two years, little progress has been made on the resolution of the largest remaining loss making enterprises in the economy through either closure or sale, and where privatization was carried out, it was done in a haphazard manner. Two items on the agenda stand out for their importance to future private sector development and economic growth - - the continued presence of a number of large, majority or partially state-owned loss making enterprises, and the need to improve the business enabling environment, which continues to be plagued by many legacies from the former communist regime. While recent labor market reforms which attempted to reduce termination costs, and introduce flexibility in collective bargaining (under the SSAC) reflect government commitment to stimulate job creation, ensuring that the legislative and judicial environment remains favorable to job creation will be key. The Bank will remain engaged in policy dialogue on labor issues in the context of the Social Sector Support Credit and the Government’s PRSP. Enterprise growth, however, has remained significantly below expectations, and the country has attracted relatively little FDI (amounting to only US$125 million since 1995). The Bank is working actively with IFC in the context of the Balkan Enterprise Facility, with the Foreign
Investment Advisory Service (FIAS) which undertook a study of the FDI regime in 1998, and more recently with MIGA to accelerate reform efforts in this area.

17. The main policy issues that will need to be addressed over the next eighteen months include: (i) developing a credible and non-distorting approach to privatization of the large loss makers that embraces the principles of independent financial and economic cost-benefit analysis, and fiscal sustainability; and (ii) improving the business enabling environment, to significantly simplify the enterprise entry and exit process, and to create a legal and regulatory framework more supportive of private business. The Government has recently taken some bold steps in meeting this agenda making it possible for the Bank to proceed with the appraisal of FESAL/C II in June 2000. For example, the authorities requested the Bank to arrange for a privatization advisor who will work with the Privatization Agency to ensure that privatization is carried out based on sound and transparent principles. The Privatization Advisor has been in post since April 24, 2000. Through the FESAL/C II operation, the Bank will support a range of both enterprise and financial sector reforms.

18. Gains also have recently been achieved in financial sector reform. Since last year, the Bank has been working actively with the Government to improve the overall financial sector legal and regulatory framework and health, including through a joint Basle Core Principles Review that was carried out in September 1999 in cooperation with the IMF. The sale of the largest bank, Stopanska Banka, to a foreign strategic investor, has been completed with IFC’s support and equity financing, and participation from the European Bank for Reconstruction and Development, and very recently, one of the larger private banks has sold a majority ownership stake to a Greek Bank, thus setting the stage for significantly enhanced competition and quality of financial services in the future.

19. Since 1998 and especially since the end of the Kosovo crisis, several donor funded initiatives have been launched in close cooperation with the Bank, that are also likely to contribute to further financial sector strengthening. These activities include technical assistance for the Central Bank, diagnostic studies of the four largest banks other than Stopanska, reform of the former Yugoslav Bureau of Payments Operations, and creation of collateral registries, a central share registry and a securities clearing and settlement system. New bankruptcy, collateral and banking laws have also been drafted. The main reform priorities in the financial sector for the next 18 months are: (i) the passage by Parliament of new banking and collateral legislation; (ii) the upgrading of NB M’s regulatory regime for banks in line with the joint IMF/World Bank Basle Core Principles Review recommendations, including further strengthening of NB M enforcement actions; and (iii) design and enforcement of prompt corrective action programs for the four largest banks (other than Stopanska), taking into account the findings of the diagnostic studies.
B. Enhancing the Efficiency of the State

20. Over the next eighteen months, the Bank intends to strengthen the dialogue on public administration reforms focusing on the role and organization of the State and on reforming public expenditure management. The SSAC, envisaged under the 1996 CAS, was delivered in July 1998 and has initiated efforts to rationalize public expenditures through further reform of the public pension system, and reforms in health insurance, labor and employment laws. The draft Public Expenditure and Institutional Review (PEIR) will be discussed with the Government in the next few weeks with a view to drawing up an action plan to address weaknesses in key state functions that make policy reforms difficult to adopt. The PEIR indicates that sweeping reforms in public sector management are needed. The Government must focus its attention on re-defining the role of the State in a modern, market-oriented economy as opposed to opting to maintain all existing functions albeit with lower resources. Non-core programs need to be shed to be able to better cover the cost of reforms. The reform effort in key sectors needs to continue to ensure the transition of the health and pension systems towards sustainable and efficient systems. The Government will also need to progress in improving the transparency of budget management and developing the basis for a merit-based civil service system. In each of these areas, the need for building capacity will have to be addressed urgently. Actions on these recommendations will serve as the basis for the proposed Public Sector Management Adjustment Loan/Credit (PSMAL/C) now planned for Board presentation in late FY01. While these reforms should ease the budgetary pressures from inefficient social protection programs, measures to further improve the cost effectiveness and targeting of unemployment/social assistance programs, and to develop the institutional capacity for the establishment of the second pension pillar will be further supported by the Bank through its ongoing operations (Pension Reform and Technical Assistance Credit and the Social Support Credit) and possible future support in the next CAS period.

21. With respect to the objective of developing infrastructure and increasing the quality and efficiency of public utilities, work has advanced on the Water Utility Improvement Project and a regional Trade and Transport Facilitation in South Eastern Europe (TTFSE) Credit, both of which are planned for FY01 Board approval. In addition, a GEF-funded Mini-Hydro Project, was presented to the Board in December 1999. The planned FY99 Road Rehabilitation and Railway Restructuring Loan was replaced by the Transport Loan, approved by the Board in FY99.

22. While no formal assessment on corruption in FYR Macedonia has yet been undertaken, weak governance in both the corporate and public sectors has long been recognized as a key development issue. To date, we have monitored the use of Bank resources carefully through our supervision efforts including compliance with audit covenants. Where we have detected problems in procurement, we have stepped in swiftly to address the problem. As the future lending program will include substantial adjustment lending, particular attention will be devoted during preparation of these operations to putting in place appropriate budgetary and auditing mechanisms that will ensure that funds are used for the purposes intended. The PSMAL/C agenda for improving management of public resources will place strong focus on developing transparency and accountability mechanisms within the Government. In addition, specific analysis will be undertaken to sensitize the public to governance issues, and a governance survey to identify the most vulnerable public institutions is under consideration. The Government’s PRSP also provides an instrument for developing governance since stronger linkages between the public administration/anti-corruption agenda and the poverty agenda are vital prerequisites for poverty alleviation. Ensuring greater transparency and accountability in public finance management (see Box 5) is essential to ensuring that key expenditures are not crowded out. Reduction of smuggling and corruption at border crossings is one of the objectives of the TTFSE Credit. Enhancing transparency and accountability in the management of public resources needs also
to be supported by accountability demands from civil society, although pressure from civil organizations is currently weak.

C. Alleviating Poverty and Developing Human Capital

23. The CAS focused appropriately on policies for poverty alleviation and more is now known about FYR Macedonia’s poverty profile. A first Poverty Assessment was completed last year and some specific findings are presented in Box 2. As in all Central and Eastern European countries, poverty increased in FYR Macedonia in the early years of the transition (so that 22 percent of households were below the poverty line in 1996). However, the poverty gap, or the difference between the average income of the poor and the poverty line, remains small. In particular, the data reveal that there is a strong correlation between poverty and unemployment, so that raising overall economic growth and job creation must be the government’s first weapon in a poverty reduction strategy.

24. FYR Macedonia has achieved long-run improvement of health status but continues to suffer from a burden of disease which is largely preventable or treatable through cost-effective interventions at the primary level. The high rates of infant mortality make more effective health promotion, prenatal care, nutrition education and clinical services for maternal and child health a priority at the primary level. The twin objectives of the Government’s agenda for health system reform are to address high priority health problems contributing to infant, maternal and premature adult mortality, and to increase efficiency and effectiveness in the health system to release resources for improving quality and access to health care. The ongoing Health Sector Transition Project’s (FY96) objectives are to address these issues. Project implementation has suffered due to frequent changes in staff, lack of adequate management skills and the impact of the Kosovo crisis. Recently, the project has been restructured and extended by eighteen months. The recent passage of the Health Insurance Law under the SSAC will promote reforms to enhance cost effectiveness, fiscal sustainability and patient choice and promote public accountability. The Government plans to focus its attention on the reform agenda for pharmaceuticals to lower the cost of drugs through a more competitive market and pricing revision during the extension period.

25. As is the case elsewhere, education has a high rate of return in FYR Macedonia. Investment in human capital is likely to be the most important longer-term investment poverty alleviation and growth strategy for the country. The FY99 Poverty Assessment identifies the need to address quality issues in the education system and the low enrollment rates of the poor. The Government, with substantial support from the Dutch Government, is in the process of developing an education sector strategy to improve the quality, efficiency and equity of the education system. The Government strategy will be an important input to the Bank’s own analytical efforts in this area. School rehabilitation and construction under the ongoing pilot Education Rehabilitation Project (FY98) are helping improve the learning environment in high poverty and predominantly rural areas. Inadequate governance, weak institutions and poor management performance are added constraints to a cost-effective education system. It is expected that the Bank’s planned Education Sector Strategy (FY01) will lay the groundwork for an education sector loan in FY02.

26. The Bank’s lending and non-lending services will continue over the remainder of the CAS period to support poverty alleviation and human capital development in an integrated, cross-sectoral manner. The Government’s interim PRSP will provide the framework for this approach and will have as its underpinning social assessments, the poverty update based on the household survey, consultation with civil society at large (FY00-01), sector work in education (FY01) and agriculture (FY02) to identify constraints to sustainable development and
poverty alleviation in rural areas, and a study on access to services and economic and social opportunities for different socio-economic and cultural groups in FYR Macedonia. Anti-corruption work to establish more transparent, inclusive organizations and institutions will be carried out in FY01 within the framework of poverty reduction strategies under the Government’s PRSP as well as public administration reforms.

27. The Bank’s proposed lending will include the planned Community-Based Regional Development Project (FY01) which aims at identifying new sources of growth for some isolated communities through development of local tourism and artisan activities and encouraging stronger initiatives from communities, based on the sense of pride for their past and their culture. The proposed adjustment operations will also focus on opening space for private sector development, growth and employment (FESAL/C II) and improving the effectiveness and efficiency of public expenditures, ensuring that a larger share has direct and measurable impacts on the poor (PSMAL/C). A second Post Conflict Grant to help strengthen social capital is planned in FY01 and institutional reforms to improve delivery of services through the Water Utility Improvement Project (FY01) will also benefit the poor. The Human Development Adjustment Loan (HDAL) originally planned for FY01 will need to be reconsidered given that significant progress is being achieved against the proposed objectives of this project under the pension framework and health insurance laws as well as labor and employment laws supported by the SSAC; in addition, the recently restructured Health Sector Transition Project also now supports some of the objectives which were to be furthered by the HDAL.
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<th>Actual/Revised Lending Program</th>
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<td>Public Sector Adjustment Loan (renamed Public Sector Management Adjustment Loan/Credit, now FY01)</td>
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<td></td>
<td></td>
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<tr>
<td><strong>Subtotal for FY00</strong></td>
<td>60.0</td>
<td><strong>Subtotal for FY00</strong></td>
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</tr>
<tr>
<td><strong>FY01</strong></td>
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<td></td>
</tr>
<tr>
<td>Human Development Adjustment Loan (now FY02)</td>
<td>25.0</td>
<td>Water Utility Improvement Loan/Credit</td>
<td>32.0</td>
</tr>
<tr>
<td>Agricultural APL (now FY02)</td>
<td>20.0</td>
<td>Community Based Regional Development Credit</td>
<td>5.0</td>
</tr>
<tr>
<td>Education, Training, and Employment APL (now FY02)</td>
<td>25.0</td>
<td>Second Financial and Enterprise Sector Adjustment Loan/Credit</td>
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</tr>
<tr>
<td></td>
<td></td>
<td>Public Sector Management Adjustment Loan/Credit</td>
<td>40.0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Trade and Transport Facilitation in South Eastern Europe Credit</td>
<td>9.3</td>
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<tr>
<td></td>
<td></td>
<td><strong>Subtotal</strong></td>
<td>136.3</td>
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<td>Post Conflict Grant II</td>
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<tr>
<td><strong>Subtotal for FY01</strong></td>
<td>70.0</td>
<td><strong>Subtotal for FY01</strong></td>
<td>137.3</td>
</tr>
<tr>
<td><strong>Total Support (including all grants)</strong></td>
<td>204.0</td>
<td><strong>Total Support (including all grants)</strong></td>
<td>231.0</td>
</tr>
</tbody>
</table>

*a/ Lending triggered under the emergency scenario of the 1998 CAS because of the Kosovo crisis.

*b/ Excluding SSAC (US$29 million equivalent) and PERTAC (US$1 million equivalent) approved in FY99 but included under the 1996 CAS and funded from an earlier IDA allocation.
III. THE BANK GROUP’S ASSISTANCE PROGRAM

A. Portfolio Management and IDA Lending Levels

28. Implementation of investment projects has been afflicted by a number of systemic and project-specific constraints. Total commitments (IBRD/IDA) amount to US$455 million of which US$113 million remain undisbursed. The objectives of the first Joint Portfolio Performance Review (JPPR) of March 2000 were to: (i) to assess the status of the portfolio of World Bank assisted projects in terms of their performance and use of funds; (ii) to identify bottlenecks which afflict project implementation across the portfolio and within particular projects, (iii) to agree on an action plan to remove the identified bottlenecks, and (iv) to review the scope and objectives of ongoing projects, particularly in the aftermath of the Kosovo crisis, to ensure that they still meet the development priorities of the Government of fYR Macedonia and to determine whether any projects should be restructured or cancelled. The JPPR has identified a number of systemic and project-specific issues that affect overall portfolio performance. Although at the time of the JPPR review only one project was rated as unsatisfactory (8 percent of the portfolio), six projects were identified as presenting some risks of being downgraded and have been put on a special monitoring program. Given that one of the high case triggers of the CAS requires that the share of problem projects be less than 10 percent of the portfolio, this development poses a significant risk to moving to a high case scenario during the remainder of the CAS period. The authorities and the Bank will need to carefully monitor portfolio implementation on a continuous basis to ensure that appropriate actions are taken with respect to the at-risk projects.

Lending Scenarios

29. Creditworthiness and IDA. The CAS had anticipated fYR Macedonia’s graduation from IDA at the end of the CAS cycle in FY01. Given the recent very significant change in GNP/capita⁹, which is currently estimated at US$1,690 for 1999, we recommend that the graduation strategy in the 1998 CAS be implemented and that fYR Macedonia graduate from IDA at the end of FY01. This graduation strategy has been discussed with the authorities, who fully understand the implications of graduation, i.e. that the country will stop being a blend country and will not have access to IDA starting July 1, 2001, at which time it will become an IBRD-only country.

30. As would be expected, delays in implementing needed structural reforms have thus far made it impossible to move to the high case lending program envisaged under the 1998 CAS. At the time this CAS was prepared, it was estimated that in a high case scenario, fYR Macedonia would receive up to

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⁹ In 1998, fYR Macedonia’s GNP/capita, calculated using the Bank’s Atlas method with a conversion factor based on 1993 price survey data, was US$1,290. The GNP/capita calculation for 1999 was able to make use of newly available 1996 price survey data which resulted in the revision of GNP/capita to US$1,690. The new conversion factor is very close to the official exchange rate.
US$80 million for IDA lending channeled toward poverty alleviation, employment generation and human capital development. This lending would be supplemented by an additional US$120 million on IBRD terms, mainly through adjustment operations. Two years into the CAS period, adjustment lending has been curtailed; lending has been limited to an Emergency Recovery Credit in the wake of Kosovo, the Social Sector Support Credit, and a Transport Loan, for total annual lending of US$93 million equivalent (see Box 3). With no IDA or IBRD lending planned in FY00 (a small GEF operation was approved in December 1999), it is only by embarking on an ambitious reform program that permits movement to the high case scenario that FYR Macedonia will begin to approach the level of assistance envisaged in the CAS. Assuming that the high case is achieved in FY01, an ambitious adjustment program together with important infrastructure investments with strong institution-building objectives would be supported by lending totaling about US$136 million, of which IDA resources would amount to about $77 million equivalent. In summary, as actions on the reform front stalled during the first two years of the CAS period, lending has been much below that envisaged under the CAS high case scenario. If the Government takes the actions required to move to a high case lending scenario, up to about US$77 million equivalent in IDA funding could be utilized in FY01. Thus, total Bank assistance over the CAS period could be as much as US$231 million (of which IDA lending represents US$137 million equivalent, including the $50 million equivalent Emergency Recovery Credit in response to the Kosovo crisis) compared to the US$204 million originally envisaged (of which IDA lending was $80 million equivalent).

Box 4: Joint Portfolio Performance Review

The joint portfolio performance review is one of the self-evaluation tools identified in the 1998 CAS to assess the impact of Bank assistance to FYR Macedonia. Since 1993, 12 IDA credits amounting to US$ 293.8 million equivalent and 8 IBRD loans totaling US$ 205.5 million equivalent have been approved by the World Bank group for FYR Macedonia. Total commitments since FYR Macedonia joined the World Bank thus amount to US$ 499.3 million equivalent. These funds have been allocated to finance 17 operations, including 4 economic recovery and adjustment operations (US$ 254 million equivalent), one emergency operation (USD$ 50 million equivalent) and 12 investment projects (US$ 195 million equivalent). As of January 1, 2000, a total amount of US$ 347.2 million had been disbursed. Almost 80% of disbursed funds went to finance adjustment and emergency operations.

Of the key issues identified during this review, the following merit closer attention in order to prevent deterioration in portfolio performance over the next eighteen months.

- weak project management;
- over ambitious project design;
- need for increased internal supervision and guidance;
- procurement delays;
- difficulties with obtaining waivers for import duties;
- effects of the introduction of the VAT on World Bank-supported projects;
- disbursement delays due to unfamiliarity with World Bank procedures; and
- delays in submission of audit reports.

Both the Government and World Bank representatives agreed that the JPPR report properly identified the key factors behind the above named issues and that remedial steps outlined in the JPPR actions matrix were appropriate measures to be taken to help overcome these problems. In addition, it was agreed that, the Private Farmer Support Project would need to be restructured and simplified if the project closing date were to be extended. Similarly, the Irrigation Rehabilitation and Restructuring Project will need to be reviewed and possibly restructured following adoption of the Government’s irrigation sector strategy.

Both parties agreed that JPPR’s will henceforth be carried out on a regular basis, as they provide an excellent opportunity to jointly take stock of the status and performance of ongoing projects and to agree on what actions need to be taken to further facilitate project implementation. It was also proposed that a meeting with participants of the Government, the World Bank and key donors be held to discuss projects in the pipeline and to assure effective coordination.

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10 See Annex B2.
31. Overall lending program triggers for the high case remain the same as those identified in the 1998 CAS (Box 5), although with the recent work in support of FESAL/CII and PSMAL/C, more specific interpretations of the high case triggers can be formulated. While there is already compliance with some of the triggers (the fiscal deficit is at less than 2 percent; external debt to GDP ratio currently stands at about 45 percent of GDP, the share of problem projects is now at 8 percent and the privatization/restructuring of agrokombinats has been completed), others remain outstanding. The high case scenario will also require satisfactory progress by the Government towards completion of a full PRSP and maintenance of the quality of the portfolio.

32. If the high case triggers are not met, we envision a low case scenario where lending could be as low as US$46 million equivalent. The low case scenario comprises infrastructure investment projects that contribute to long-term institution building, although the program would continue to emphasize an intensive policy dialogue to encourage a return to the high-case policy framework. Even in the low case scenario, we would consider delivering the Community-Based Regional Development Project in FY01, provided that circumstances permit. Actual lending, however, could fall somewhere between the low and high cases as we expect the Government to be able to take the actions necessary to deliver the FESAL/C II operation in FY01; it remains to be seen whether the other triggers for the high case could be met which would also allow the PSMAL/C to move forward in FY01.

<table>
<thead>
<tr>
<th>Box 5: Proposed Program and Triggers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lending:</strong> Water Utility Improvement, TTFSE, Community-Based Regional Development</td>
</tr>
<tr>
<td><strong>NLS:</strong> PRSP, Anti-Corruption Survey, Education Sector Strategy; Agricultural Sector Note, analytical services and policy dialogue in support of financial enterprise and public sector reform objectives</td>
</tr>
</tbody>
</table>

**Maintain Macroeconomic Stability**

| Lack of compliance with relevant triggers | Macroeconomy: Satisfactory performance as evidenced by satisfactory implementation of the IMF supported program. Maintain fiscal deficit at 2 percent of GDP or less through 1998-2001. Maintain external debt to GDP ratio at 45 percent or less through 1998-2001. Poverty: Preparation of an interim PRSP (FY01) and full PRSP (FY02) and successful implementation of agreed poverty strategies. |

**Strengthen and Deepen Structural Reforms**

| Lack of progress in implementing key structural reforms | • Complete enterprise and agro kombinat privatization and undertake strong post-privatization restructuring or liquidation of loss-making enterprises in 1999 and 2000. (FESAL/C II)  
• Sell residual state-owned shares and shares from delinquent installment payments to strategic investors: 50 percent by end-1999 and 80 percent by end 2000. (FESAL/C II)  
• Raise capital requirements to encourage mergers of small banks, enforce and strengthen Banking Act regulations and penalties on lending to single debtors, shareholders and defaulters by end-1999. (FESAL/C II)  
• Begin coherent and comprehensive reform of the state with intent to: reduce number of ministries, restructure and eliminate duplicative functions; downsize civil service and revise recruitment, evaluation and remuneration policies by end-2000. (PSMAL/C) |

Maintain Portfolio Performance

| Share of problem projects exceeds 10 percent of the portfolio | Maintain share of problem projects at less than 10 percent of the portfolio |

B. Collaboration within the World Bank Group

33. IFC’s strategy fully supports the CAS’s priority of promoting private sector growth and growth creation and has approved investments in FYR Macedonia as of March 2000 totaling US$54.7 million. With IFC’s support and equity financing, privatization of Stopanska Banka has now been finalized. IFC has also extended support to equity funds and exploring the possibilities for IFC’s involvement in the micro-financing and insurance sectors in FYR Macedonia and plans to update a study on the framework needed for the development of a leasing sector in FYR Macedonia. IFC has also provided financing to the telecommunications company for modernization and expansion in preparation for privatization. Other approved investments include financing in the textile and pharmaceutical sectors. IFC is considering a line of credit for on-lending to small-and-medium scale enterprises and is actively seeking other investment prospects, particularly post-privatization opportunities. The Corporation has also provided substantial technical assistance to private FYR Macedonian enterprises in developing business plans and feasibility studies, management support, financial audit and legal reviews, as well as environmental studies. Early this year, IFC approved an investment in the Balkan Enterprise Facility. The Facility will operate in FYR Macedonia, Bosnia and Herzegovina, and Albania with the objective of assisting in the development of the private sector throughout the region, by (i) improving the capacity of small and medium enterprises to access finance; (ii) supporting improvements in the business enabling environment; (iii) supporting training and education projects; and (iv) launching specific initiatives in knowledge transfer and dissemination.

34. FYR Macedonia joined MIGA in 1994 and is one of the three countries for which MIGA has funding under a Swiss Trust Fund to undertake a capacity building program. To initiate this, MIGA compiled a needs assessment of the country’s investment promotion structures in February 2000. An advisory report is currently being prepared for the Government proposing the activities that the country needs to put in place to spur domestic and foreign private sector investment: (i) establishing one effective FDI promotion structure; (ii) implement the recommendations from FIAS and others regarding improvements in the investment climate; and (iii) undertake a “sources of growth” study to assess the country’s growth prospects in a changed economic environment.

C. Collaboration with International Partners

35. The Bank’s strategy clearly continues to pursue its comparative advantage by taking the lead in supporting systemic and structural reforms – an area where other donors expect us to play this role and provide the intellectual leadership. The Bank’s approach is to be selective in its interventions and only provide assistance in areas where other donors are not active. The Bank works in partnership with FYR Macedonia’s major partners which include the IMF, EU, the US Government-in particular with USAID, the Government of the Netherlands, and the EBRD and actively seeks opportunities for cooperation. For example, the Bank joined the Government of the Netherlands in developing a sector strategy note in education and plans to initiate work in cooperation with the Netherlands on an agricultural sector note in FY01. The US Government supports regional cooperation initiatives under the Southeast European Cooperative Initiative. The Bank is also actively working with the EU and the British Know-How Fund on public administration reforms. Other donors support adjustment lending and capacity building through technical assistance, especially EU-PHARE and United States Agency for International Development (USAID). Reforms under the future PSMAL/C will benefit from work being carried out under the USAID-funded Central Government
project and EU/OECD programs as well as technical assistance from the British Know-How-Fund. The Bank will continue to play a lead role in donor coordination and is working increasingly to involve non-governmental organizations in the design, implementation and evaluation of IDA-supported projects. Public awareness campaigns (such as the anti-corruption initiative), increased focus on strengthening civil society through consultations arranged by the Government during the PRSP process are part of our strategy to deepen the impact of our assistance.

IV. RISKS

36. The Bank Group remains prepared to fully assist FYR Macedonia in meeting the development objectives laid out in the CAS. Recent political events have provided another opportunity for the Government to advance the structural reform agenda that will allow the high case triggers to be met. There is a risk, however, that the present political environment may not be sufficiently strong to implement the required program of structural reforms. The political environment remains characterized by political fragmentation and a coalition government that must continuously seek common ground among parties with varied interests. Also, labor unions remain quite strong and often lobby effectively against some reforms. The social fabric is under pressure since Kosovo resulting in an increasing trend in criminal activity, smuggling and corruption that may present obstacles to stabilizing domestic politics and allow politicians to shy away from making difficult economic decisions. In addition, unless the Government is successful with respect to project implementation, movement to the high case will not be possible. The strong advisory programs that will be offered in the context of work related to the PEIR, and the preparation of the FESAL/C II and PSMAL/C operations will provide a context for on-going dialogue with key policy makers in support of the reform process. Also technical assistance delivered through project monitoring and the annual JPPR process should help to bolster the Government’s portfolio monitoring efforts.

37. The possibility of renewed conflict in neighboring countries adds a further element of risk. The presence of North Atlantic Treaty Organization troops in Kosovo mitigates these risks but also adds to the insecure environment in which reforms have to be carried out. Recent skirmishes on the border with FR Yugoslavia is also a reminder of the fragility of FYR Macedonia’s ability to depend on its major trade routes for resumption of normal economic trade with Europe. Another major factor in mitigating the risks in the region is the recent move to integrate the countries of South Eastern Europe within the framework of the Stability Pact. Internal instability provoked by widespread outbreak of disturbances and weak institutions require that we focus our attention on building social cohesion and strengthening institutional capacity by reforming the public administration and public expenditure process.

38. In summary, our assessment is that the Government has started to demonstrate a renewed commitment to reform that had been lacking particularly since the Kosovo crisis. The adoption of pension, health and labor reforms supported by the SSAC, the recent completion of the sale of Stopanska Banka, and agreement on the reform agenda under FESAL/C II all are clear signals that the Government is now ready to accelerate action on long-delayed reforms. The Government’s commitment will likely be reinforced by the Stability Pact framework and continued donor support.