FOR AGENDA

EBS/14/2
Correction 1

January 29, 2014

To: Members of the Executive Board

From: The Secretary

Subject: **Former Yugoslav Republic of Macedonia—Second Post-Program Monitoring Discussion**

The attached corrections to EBS/14/2 (1/14/14) have been provided by the staff:

Evident Ambiguity

Page 1, Context, line 5: for "at 36 percent" read "at a projected 36 percent"

Page 5, para. 3, bullet 3, line 4: for "since end-2012." read "as of early December, since end-2012."

Page 42, para. 5, line 1: for "at about 36 percent" read "at a projected 36 percent"

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 4, para. 1, line 1: for "3.1 percent" read "3.2 percent"

Page 5, para. 5, line 4: for "50 basis points" read "25 basis points"
line 5: for "loans in domestic currency" read "liabilities in domestic currency"
line 7: for "credit growth" read "deposit growth"

Page 6, para. 8, line 8: for "a 40 percent share" read "an almost 40 percent share"

Page 8, para. 11, line 14: for "44 to 52" read "44 to 49"

Page 9, para. 13, line 8: for "0.5 percent" read "0.3 percent"

Page 16, para. 28, line 2: for "3.1 percent" read "3.2 percent"

Page 27, Figure 2, **Private Sector Deposit Growth:** data series corrected

Page 41, para. 2, line 2: for "3.1 percent" read "3.2 percent"

Page 42, para. 3, line 5: for "50 basis points" read "25 basis points"
para. 5, line 5: for "44 to 52" read "44 to 49"

Typographical Errors

Page 12, para. 23, line 1: for "dynamics appears" read "dynamics appear"

Page 14, para. 25, line 7: for "of the peg is" read "of the peg if"

Page 27, Figure 2, **Credit Developments by Customer:** for "Loans to HH" read "Loans to Non-Fin Corps"
Figure 2, **Credit Developments by Customer:** for "Loans to Non-Fin Corps, LC" read "Loans to HH, LC (incl. FX-indexed)"
Figure 2, **Credit Developments by Customer:** for "Loans to HH, LC" read "Loans to Non-Fin Corps, LC (incl. FX-indexed)"
Figure 2, **Credit Developments by Customer:** for "Loans to Non-Fin Corps, FX" read "Loans to HH, FX"

Page 27, Figure 2, **Deposits Developments by Customer:** for "Deposits to HH, FX" read "Deposits to Non-Fin Corps, FX"
Figure 2, **Deposit Developments by Customer:** for "Deposit of Non-Fin Corps, LC" read "Deposit of Non-Fin Corps, LC (incl. FX-indexed)"
Figure 2, **Deposit Developments by Customer:** for "Deposits to HH, LC" read "Deposits to HH, LC (incl. FX-indexed)"

Page 29, Figure 4, Bank Profitability: inserted correct data series

Questions may be referred to Ms. Vladkova Hollar (ext. 39695) and Mr. Gerard (ext. 39576) in EUR.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (13)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

CORRECTED: 1/28/14

SECOND POST-PROGRAM MONITORING DISCUSSIONS

January 13, 2014

KEY ISSUES

Context. Growth continues to strengthen, although the recovery is not yet broad-based. External and fiscal vulnerabilities have risen: private non-debt creating capital flows have slowed, and could leave the reserve path increasingly driven by an accumulation of external public debt; central government debt—although still moderate at a projected 36 percent of GDP—has increased by about 15 percentage points since the beginning of the global financial crisis, in the context of growing broader public sector operations.

Fiscal Policy. The newly re-established medium-term strategy is welcome, as it highlights the government's policy priorities and helps shape stakeholder expectations. The targets are consistent with a gradual withdrawal of stimulus, and would produce stable baseline debt dynamics. However, should private demand recover faster than expected, frontloading the consolidation would stave off the emergence of imbalances and would boost policy credibility. Ensuring adequate fiscal space for priority infrastructure remains key.

Monetary and Financial Policies. Looser monetary policy in the second half of 2013 has not resulted in the hoped for pickup in private credit growth. Nonetheless, the strong recovery in H1 2013, high bank liquidity, and the decline in reserves (albeit not indicative of pressures on the peg) suggest an end to the easing cycle would be in order.

External Position. Capacity to service outstanding external debt obligations, including to the IMF, remains adequate. Despite still weak net FDI flows, increased activity in large foreign-owned companies is contributing to stronger exports. However, backward linkages will likely develop only slowly. In the absence of domestic spillovers, the structural improvement in the trade deficit will be gradual and growth could be uneven.

Approved By
Philip Gerson and Dhaneshwar Ghura

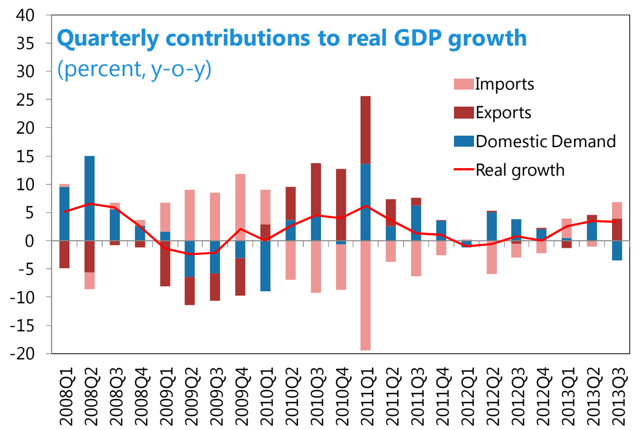
Discussions were held in Skopje, October 29–November 8, 2013. A team comprised of Ms. Vladkova-Hollar (head), Mssrs. Gerard and Impavido, Ms. Taheri Sanjani (all EUR), and Mssrs. Gitton and Nacevski (Res Rep office) met with Finance Minister and Deputy Prime Minister Stavreski, NBRM Governor Bogov, other officials, and private sector representatives. Mr. Hadzi-Vaskov (OED) joined some of the discussions. A joint press conference was held at the conclusion of the mission. Ms. Mahadewa and Mr. Peterson assisted in the preparation of the staff report.

CONTENTS

APPENDICES

RECENT ECONOMIC DEVELOPMENTS

1. **Growth is returning, and less tentatively than expected earlier**. Following 3.2 percent yoy growth in the first three quarters of the year[1], a stronger than expected recovery of about 2½ percent for 2013 is achievable. Private consumption growth turned positive in 2013, supporting an acceleration of domestic demand. However, a sustained improvement in investment, amid signs of a pickup in private credit, would be needed to balance the risks to the outlook, and help maintain growth momentum into next year. While European prospects remain uncertain, the contribution of external trade to growth has turned increasingly positive this year, with sizeable import compression accompanied by a pickup in exports in the second and third quarters.



Source: SSO; and IMF staff calculations.

2. **Headline inflation has decelerated with lower food and energy prices, but core inflation remains elevated**. After peaking at 4.2 percent (yoy) in June 2013, headline inflation decelerated to 1.3 percent in October. In contrast, the deceleration in core inflation during the first half of the year has given way to acceleration to 3.2 percent in October[2]. However, with the output gap not expected to fully close until 2017, price developments are likely to be moderate, and inflation is expected to return to around 2¼ percent at the end of 2013.

3. **Despite positive net balance of payment inflows, negative valuation effects have resulted in a decline of official reserve assets throughout 2013**.

- ***The trade deficit is expected to improve to 22 percent of GDP by the end of the year from 23.6 percent in 2012***, mainly due to weaker-than-anticipated imports, particularly fuel imports, while exports have been increasing since July, with a notable contribution from free-trade zones. Against the backdrop of declining private transfers to about 19 percent of

[1] Unusually large revisions to data for previous quarters in the context of the Q3 GDP data release have complicated the analysis of the driving factors of growth during 2013.

[2] The price increases are dispersed, and notable in medicine, air transport, and shoes and clothing. The authorities cite a mix of second-round effects and, for the latter category, measurement issues.

GDP, the current account deficit is projected to widen by about 0.4 percentage points, to 3.4 percent of GDP[3].

- ***After remaining muted in the first semester, net foreign direct investment has picked up recently and is expected to reach 3.3 percent of GDP***. These flows are now expected to be some 1.2 percentage points below the forecast at the time of the 2013 Article IV discussions. Nonetheless, they reflect a strengthening of net FDI relative to 2012, particularly as the scale of capital outflows in the form of profit repatriation and intercompany loans observed in 2012 has diminished.

- ***Foreign exchange reserves have declined.*** While robust net borrowing by the public sector has generated a sustained inflow of foreign exchange, sizable negative valuation effects affecting gold and foreign securities have resulted in an erosion of the stock of official reserve assets by about €185 million as of early December, since end-2012.

4. The banking sector remains healthy, although profitability has been declining. As of the third quarter, capital ratios are high, with an average CAR of 17.3 percent (Tier 1 of 14.7 percent). Liquidity is, too, with a liquidity ratio above 32 percent of total assets. NPLs fell to 11.8 percent of total loans from 12.3 percent in June, reversing the previous trend increase. Moreover, recent stress tests conducted by the NBRM, partially based on macroeconomic scenarios, indicate that the banking sector is resilient to significant deposit withdrawals or to a sharp deterioration in the quality of loans. Yet profitability has been declining, with ROE down to about 1.8 percent on average, due to the practice of fully provisioning non-performing loans and impaired assets, in a context of uncertainty surrounding the situation of euro area parent banks.

5. Further monetary easing has been unable to revive credit growth. In the face of a deceleration in credit growth to about 3.1 percent in the first half of the year, in July the authorities reduced the central bank bill rate (the main policy instrument) and the 7-day deposit facility rate by 25 basis points, to 3.25 percent and 1.50 percent, respectively. At the same time, they lowered reserve requirements on liabilities in domestic currency, simultaneously tightening them on short-term FX deposits and FX-indexed loans, with the dual objectives of stimulating deposit growth in local currency and encouraging long-term foreign capital funding of domestic banks. Yet credit growth has remained subdued so far, especially to the corporate sector—partly due to risk aversion, partly to portfolio cleaning.

6. Budget execution through October suggests that the new 2013 deficit target will likely be met. The higher cash deficit target established by the supplementary budget and approved by Parliament in November accomodates a MKD 1 billion increase in pensions as well as MKD 0.4 billion to clear arrears with foreign suppliers. Despite revenue underperformance of

[3] This represents a substantial upward revision of the current account balance projection relative to the 2013 Article IV Consultation, due to sizeable base effects. Statistical revisions related to activities in the free-trade zone have led to revisions of the official historical data on current account deficits to 2.5 percent of GDP in 2011 (from 3 percent) and 3 percent of GDP in 2012 (from 3.9 percent).

about 1.3 percent of GDP on a full year basis, expenditure compression in goods and services and capital expenditures—some of it automatic— suggest that the overall fiscal deficit target of 3.9 percent of GDP for 2013 is attainable.

OUTLOOK AND RISKS

7. Growth is expected to strengthen to 4 percent in medium term. Domestic demand will continue to be the main driver of growth. While unlikely to return to pre-crisis growth rates of about 6 percent, consumption is expected to recover to about 3–3 ½ percent growth. The contribution of net exports would strengthen only gradually, as imports increase in line with the rebound in both private consumption and foreign direct investment. Nevertheless, there are risks to this outlook, particularly from weak credit growth, which could impede the rebound in private consumption and investment (see ¶8), as well as broader risks to institutions and investment from continued uncertainty regarding the start of EU accession talks.[4] With no substantive policy distortions in the labor market (see SM/13/137) and generally good policies, stronger convergence growth seems to have been hampered primarily by slower accumulation of capital (text figure). The authorities' growth agenda is thus appropriately focused on building capital— where both public infrastructure and foreign investment flows play a key role.

8. Credit conditions are expected to improve in 2014, but risks are tilted to the downside. Credit expansion will likely accelerate, as some banks reach out to under-served market segments through refined monitoring and credit scoring methodologies that allow them to lend against cash flows, in contrast with the predominant strategy to only lend against collateral[5]. A supply-side analysis of potential space for expanding credit to the private sector—taking into account government financing needs—suggests scope for credit growth of around 4.5 percent in 2014. Risks to the credit outlook pertain to potential restructuring in Slovenian and Greek parent banks, whose local subsidiaries, with an almost 40 percent share of assets, are systemically important to the Macedonian banking system. The authorities underscored that a lengthy process of divestment of these Macedonian subsidiaries—should it become part of the restructuring process of their parent banks—risks a shift in strategy away from credit intermediation toward portfolio beautification, negatively affecting domestic demand.

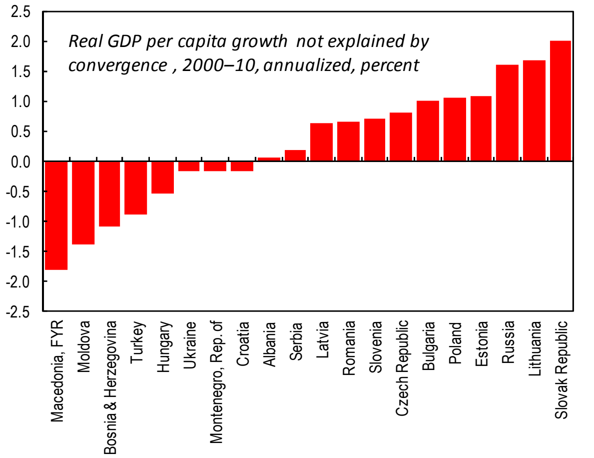
9. The current account is expected to deteriorate in 2014, mainly due to a further decline in private transfers. Import volume growth is projected to accelerate in line with both the setting up of new production capacities and the intensification of trade in the free-trade zones. Yet, export volume growth would outpace import growth, broadly stabilizing the trade

[4] The European Commission's latest communication on enlargement is available here: http://europa.eu/rapid/press-release_SPEECH-13-816_en.htm

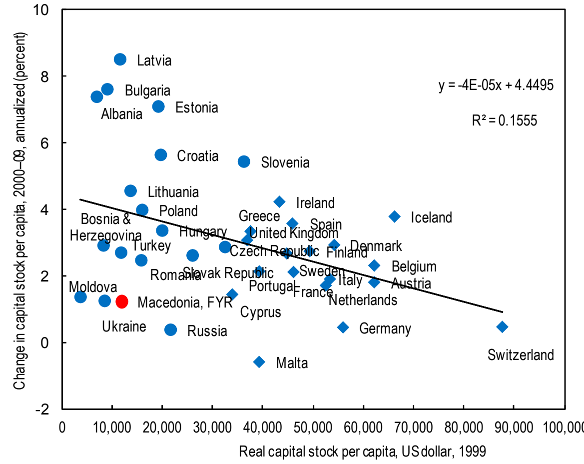
[5] (SM/13/137).

Convergence Growth and Bottlenecks

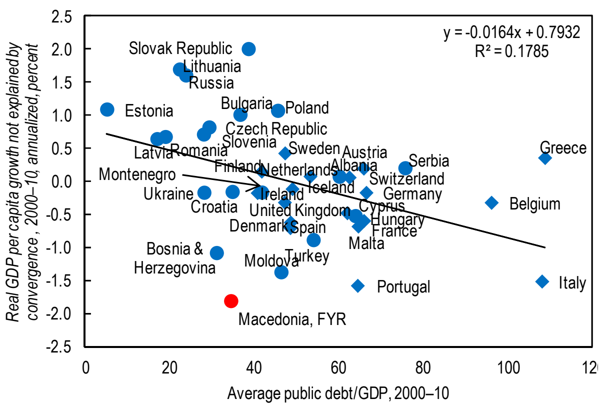
Growth has been weaker than would have been expected given initial income levels…



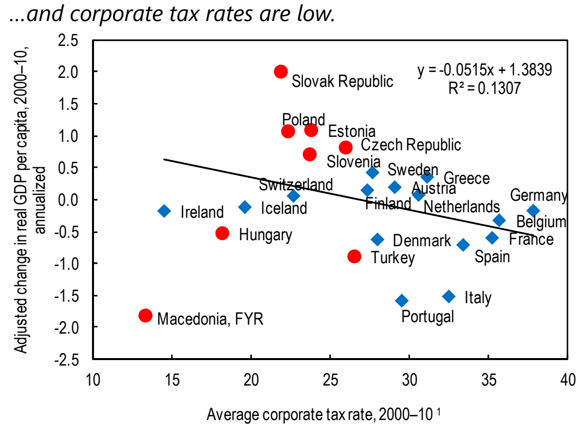
Modest capital flows and weaker investment rates seem to be the key culprits…



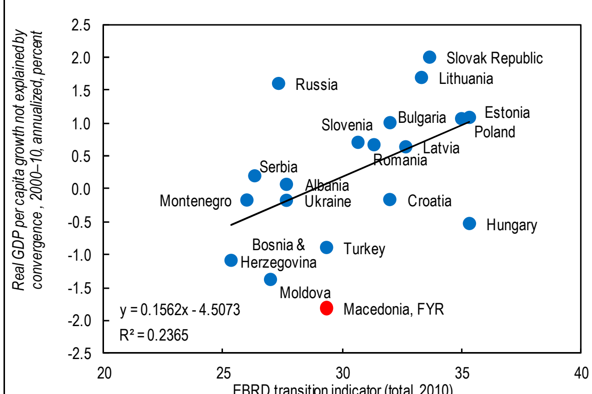
Government debt levels are moderate…



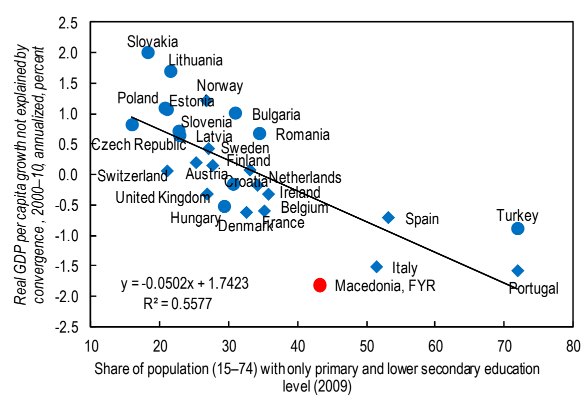
…and corporate tax rates are low.



Economic liberalization proceeded faster than in regional peers…



…although a high share of the population with only basic education may also be a constraint.

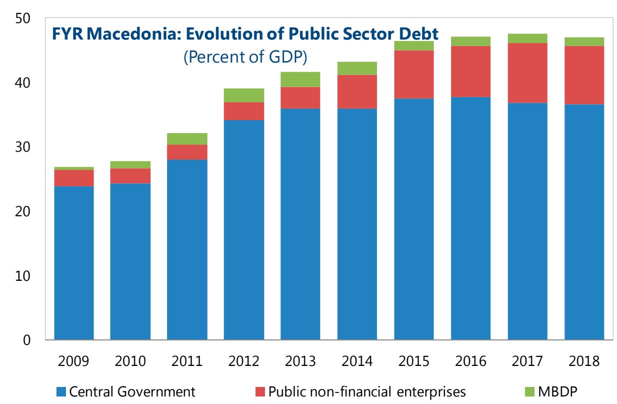


Sources: Adapted from International Monetary Fund, 2011, *Regional Economic Outlook: Europe—Navigating Stormy Waters* (Washington, October).

deficit and lowering the negative contribution of net exports to activity. However, with private transfers assumed to continue to normalize to about 18.5 percent of GDP, the current account deficit would widen to just under 4 ½ percent of GDP. Over the medium term, these dynamics of strong imports, catching-up exports, declining transfers and modest but steady foreign direct investment flows are expected to remain in place, widening the current account deficit through 2015 but gradually improving it thereafter.

10. Reserve accumulation would resume in 2014, largely on account of public sector external borrowing. In view of a strong pipeline of foreign-financed projects in the tradable sector, mainly concentrated in the automotive industry, foreign direct investment is projected to strengthen, albeit to the modest level of 3.8 percent of GDP, covering about 80–85 percent of the projected current account deficit in the next two years. Sizable public sector medium-term external borrowing, largely reflecting the implementation of foreign-financed construction projects, is expected to dominate net inflows on the financial account. In the near term, absent disruptive valuation effects, these developments would allow for the resumption of reserve accumulation.

11. The growth of public sector debt continues to outpace that of central government debt. While general government debt remains close to central government debt, public sector debt has been progressively diverging from central government debt. The Public Enterprise for State Roads (PESR) has signed a EUR 550 million credit line with the Chinese Ex-Im bank to be disbursed over the 2014–18 period. The Macedonian Bank for Development Promotion (MBDP) has contracted an additional credit line of about EUR 100 million from the EIB for SME financing. Overall, staff projects public sector debt to increase from 44 to 49 percent of GDP in the period 2013–18 (text graph).



Sources: Ministry of Finance; and IMF staff calculations.
PESR debt is projected to increase from 1.5 to 6 percent of GDP in the period 2014-18, at a pace of about EUR100 million per year until 2018 for the Miladnovic-Stip and Kicevo-Ohrid motorways; debt of other SOEs is projected to decrease from 3.8 to 3.3 percent of GDP over the 2014-18 period, based on amortization of existing debt and no new investment activity.

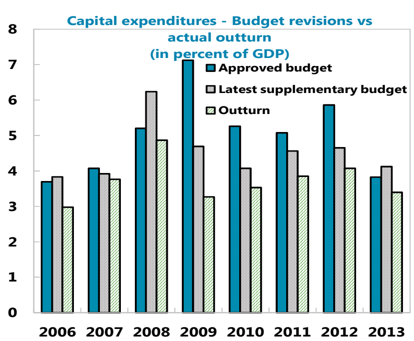
POLICY DISCUSSIONS

The authorities broadly agreed with staff's advice on the policy mix—namely that they should start shifting away from providing stimulus by ending monetary easing and by gradually withdrawing fiscal stimulus, proceeding apace with the economic recovery. Discussions focused on fiscal risks from operations of the broader public sector and the nature of the risks to the external position, particularly in the context of weaker private capital flows.

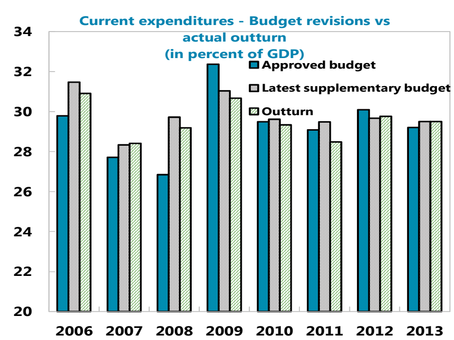
A. Fiscal Policy

12. Despite likely overstated budgetary space, the deficit target for 2014 appears attainable. While different factors have been at play, revenues have, on average, consistently underperformed budget forecasts. Looking forward, and relative to expected end-2013 outturns, revenues projections in the 2014 budget are likely overstated. However, about 1 percent of GDP of the difference relative to staff's projections comes from non-tax revenues and grants, the latter reflecting estimates by individual ministries of project-based grants and donations they can secure during the fiscal year. Expenditure authorization for these specific projects—on ministries' individual accounts and outside the core budget—can only be obtained once the availability of funds is confirmed; thus, underperformance on these revenue targets automatically curtails the execution of linked expenditures, providing the mechanism for adjustment.

13. Nonetheless, new current expense commitments may reinforce a less growth-friendly expenditure mix. The need to promote infrastructure development in Macedonia is clear. Yet, capital expenditure is low—including when compared with peers—and *ex post* shares of capital expenditure in total spending differ from the *ex ante* statement of policy priorities in the context of the annual budgets (text figure). In contrast, transfers rank among the highest among peers, and the draft 2014 budget includes a number of new current expenditure commitments, among which is a 5 percent ad hoc increase in pension benefits estimated to cost 0.3 percent of GDP. Thus, while the budget appropriately targets an acceleration of large capital expenditures—railways, gasification, hospitals—space for these outlays could continue to be constrained by increases in entitlement spending. The lack of timely granular information on the implementation of priority infrastructure projects makes it difficult to assess the degree to which such projects are protected from cuts and delays.



Sources: Ministry of Finance; and staff calculations.
2013 outturn is computed using staff projections



Sources: Ministry of Finance; and staff calculations.
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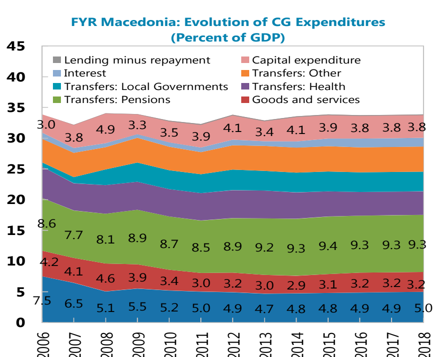
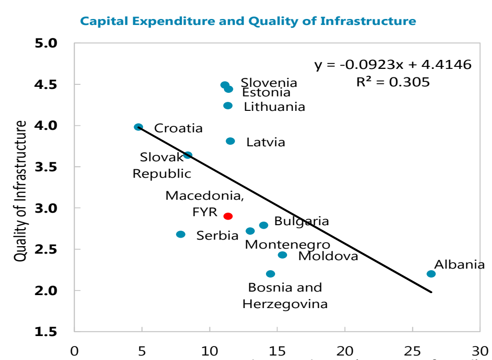


Sources: Ministry of Finance; and IMF staff calculations.



Sources: World Economic Forum; and IMF staff calculations
Average capital expenditure (2006-2013), in percent of total expenditure.

14. The return to publishing a medium-term fiscal strategy, in line with recommendations in the 2013 Article IV consultation, is a welcome step forward in anchoring expectations. The published medium-term fiscal strategy envisages a central government fiscal deficit decreasing from 3.9 percent to 2.6 percent of GDP in the period 2013–16.

- ***The planned fiscal path is consistent with reducing central government debt over the medium term and is broadly appropriate from a cyclical point of view***. Central government debt is projected to increase to 37.5 percent of GDP in 2016–17, before declining to just under 36 percent of GDP by 2018 (Appendix I). The negative fiscal impulse in 2014–16 is unlikely to jeopardize the recovery (text table), as the strong performance of exports from new capacity combined with an improved outlook for the euro area will likely sustain growth. Nonetheless, if private sector-led growth returns earlier than anticipated, some front-loading of the adjustment in 2014–15 would strengthen the credibility of the consolidation plan and build up fiscal buffers that would allow a countercyclical response to any future downturn.

FYR Macedonia: Cyclically-adjusted Fiscal Balances (percent, 2012-2018)

	2012	2013	2014	2015	2016	2017	2018
Primary fiscal balance 1/	-3.0	-3.1	-2.6	-1.8	-1.1	-1.1	-1.1
Cyclically-adjusted primary balance (HP) 2/	-2.6	-2.8	-2.4	-1.8	-1.2	-1.1	-1.1
Fiscal impulse (primary balance, HP) 2/	0.5	0.2	-0.4	-0.7	-0.6	0.0	-0.1
Memo:							
Output gap (HP) 2/	-1.2	-0.9	-0.5	-0.1	0.1	0.0	-0.2

Source: IMF staff estimates.
Note: HP stands for Hodrick-Prescott Filter. The fiscal impulse is the difference in the cyclically-adjusted balance between the previous and the current year (a negative fiscal impulse means a cyclically-adjusted contraction).
1/ Percent of GDP.
2/ Percent of potential GDP.

- ***The envisaged adjustment is attainable***. The primary gap is about 2 percentage points of GDP. While recent fiscal shortfalls may have weakened the credibility of the target—the primary balance forecasting error is higher than the average for other market access countries—the projected maximum cumulative adjustment in the cyclically-adjusted primary balance (CAPB) over any three-year period during the projection horizon is below the top quartile for reference market access countries (Appendix I).

- ***Financing requirements are declining and can be met under reasonable conditions***. Gross central government financing requirements are projected to decrease from almost 15 percent of GDP to 10 percent in 2015–16, mainly driven by a progressive lengthening of debt maturity. These financing requirements are likely to be met by a strong identified pipeline of external financing commitments from multilaterals (some 16 percent of GDP over 2014–18).

15. With a widening scope of public sector operations, a more comprehensive picture of public sector fiscal risks is needed. The scope of government operations in the pre-crisis period was largely limited to operations of the budgetary central government. However, with road infrastructure spending shifting off-budget, a greater role of the Macedonian Bank for Development Promotion (MBDP) in securing financing for SMEs, and investment in the energy sector including through state-owned ELEM, the authorities should analyze the evolution of, and risks to, the broader public sector fiscal position in setting budgetary targets and prioritizing spending. A retrospective look at the lessons from the global crisis suggests that coverage of public debt should be as broad as possible, with particular attention to entities that present significant fiscal risks, be they off-budget public entities or partnerships with the private sector[6]. A comprehensive picture of public sector fiscal risks would also facilitate monitoring by external lenders, particularly in the context of the strong pipeline of committed project financing from the EBRD, EIB, and the World Bank over the next few years.

Authorities' views

16. The authorities reiterated their commitment to priority infrastructure projects and noted that current expenditure has been reduced to minimum sustainable levels during the crisis. The Ministry monitors implementation of priority capital projects closely. In the energy sector, recent delays in implementation have been related to environmental monitoring as well as the need to reopen some tenders.

17. The authorities argued that the relevant debt concept—as per Maastricht criteria—is general government debt. A broader public debt concept, which would include operations of state-owned enterprises, suffers from a lack of specific benchmarks and thresholds against which debt levels can be assessed, as well as from a lack of comparability across countries, as a large number of countries report fiscal aggregates only at the general government level or at the budgetary central government level. Furthermore, the authorities argued that, absent any event of stress, public enterprises' borrowing should not be considered as government debt, but only as contingent liabilities.

18. In that light, the authorities stated that they remain aware and in control of fiscal risks. Their risk management strategy focuses on two key areas:

- *Strict control over indebtedness of public enterprises*. The Public Enterprise for State Roads submits a 5-year investment program that is subject to approval by the government and must pass the same scrutiny as that of any other budget user.

- *A long-dated and comprehensive analysis of capacity to pay*. In assessing the borrowing capacity of public sector enterprises, the Ministry of Finance conducts a long-term debt sustainability analysis (through 2025) which goes beyond the central government debt concept to include contingent liabilities from operations which carry government guarantees.

[6] IMF, 2011, *Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis,* http://www.imf.org/external/np/sec/pn/2011/pn11118.htm

concept to include contingent liabilities from operations which carry government guarantees. The analysis is used to establish maximum borrowing limits, but is not made public, mostly due to the large degree of uncertainty associated with projections over that time frame.

19. The authorities emphasized that data on government guaranteed debt are available to all stakeholders. Data on the size of debt liabilities which carry government guarantees are compiled on a monthly basis by the Ministry of Finance, and are complemented by data made available by the relevant public enterprises. Furthermore, all external loans that have been approved by Parliament are published in the official gazette.

B. Monetary Policy and External Sustainability

20. Amidst high bank liquidity, a less tentative economic recovery, and small declines in the reserve stock, a pause in monetary easing would be appropriate. Continued relaxation of the monetary policy stance has been unsuccessful in spurring private sector credit growth, particularly as high risk aversion in big banks binds. At the same time negative valuation effects have weakened the reserve position, in a context of high banking system liquidity, a stronger economic recovery, and elevated core inflation. While there is no evidence of pressures on the peg (the NBRM has been a net buyer on the foreign exchange market through November), preserving Macedonia's strong reserve position in the context of the peg to the euro would call for a pause in monetary easing.

21. Structurally large trade deficits continue to represent an important vulnerability. The trade deficit is forecast to gradually decline to about 21 percent of GDP, under the assumption that the import dependence of exports would improve alongside strengthening production capacity in the tradable goods sector. In the meantime, however, the current account could widen further, with private transfers (mostly remittances, but also unregistered exports of services) conservatively forecast to return to pre-crisis levels of about 16½ percent of GDP from the record level of 21 percent reached in 2012.

22. In that respect, while FDI has been a key driver of stronger export performance in 2013, it has played only a limited role in affecting structural change so far. The authorities' strategy of setting up technological industrial development zones (TIDZ)—building adequate infrastructure, granting tax breaks, streamlining red tape and ensuring direct access to high-level decision-makers to help address potential problems—is bearing fruit, with about one third of total foreign direct investment now being attracted in the zones. Exports from enterprises located in the zones represent about 25 percent of total exports in 2013, and have substantially strengthened the country's position in sub-segments of the automotive car industry. At the same time, the import dependence of these exports remains high, and domestic spillovers still nascent, limiting the pace of improvement of the trade balance (Box 1).

23. External debt dynamics appear resilient to shocks, but are more sluggish than in the past. Under the baseline, external debt is expected to stabilize at just under 64 percent of GDP before trending downward in 2016 under the combined effect of an improving trade current account and interest rate hikes would not jeopardize this trend (Figure 6). Nonetheless, risks remain—notably, the baseline dynamics are significantly weaker than under a scenario with

Box 1. Foreign Direct Investment, Growth, and Structural Change

The authorities' well-executed proactive strategy of attracting large foreign companies to the free-trade zones has resulted in clear positive outcomes on the labor market— through employment growth, notably at a regional level— and on diversification of the export basket. The latter in particular will have positive effects on external sustainability, but should be considered a necessary and not sufficient condition for the development of a resilient domestic tradable sector in the long run. Spillovers to the domestic productive sector would be key.

Well-executed strategy. What are winning components of the authorities' strategy, beyond fiscal incentives and the provision of physical infrastructure in the zones? Foreign investors place high value on the ease of the dialogue with high-level counterparties within the government—in addition to the Directorate of the TIDZ, the authorities have designated 3 ministers with an FDI portfolio, and open access to the Minister of the Economy as well as the Prime Minister's office.

Results and challenges. Foreign direct investment is having a non-negligible effect on balance of payments developments, particularly with respect to export performance, accounting for a large part of the acceleration in exports, and a notable diversification—in terms of both products and markets—in the export basket. Nonetheless, the development of backward linkages to the domestic economy will be challenging, for at least two reasons:

- From a human capital viewpoint, spillover effects are still somewhat limited, as labor-intensive firms are attracted by the low cost and plentiful supply of labor—a clear comparative advantage of the Macedonian economy—and provide the required on-the-job training for generally low-skilled tasks, including within the automotive industry supply chain. Nonetheless, anecdotal evidence suggests a gradual build-up of critical local managerial skills.

- From a technological transfer viewpoint, the small domestic component of production activities in the zones—estimated at less than 10 percent on average—originates largely from the very strict quality and security standards to be met by the intermediate goods used in the production process, which most local suppliers are not in a position to deliver yet. Currently, the main spillover effects accrue to local transporters and construction companies. Anecdotal evidence also suggests some transfer of customer service activities to Macedonia, based on strong foreign language skills of the local workforce.

key parameters at historical averages, a result largely driven by lower non-debt creating flows (Table 8). And with weaker private non-debt creating flows, the path of reserve accumulation would increasingly depend on the external public debt trajectory—requiring a careful calibration of the public debt management strategy so as to ensure adequate foreign exchange reserves as well as to reduce public debt vulnerabilities (see also Appendix I).

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Authorities' views

24. The NBRM saw a slightly more balanced set of risks to the external position. The NBRM noted that a shortfall in either private transfers or FDI inflows would mechanically entail some import compression, as private transfers from migrants mainly finance private consumption, while the import content of foreign-financed investment projects remains substantial. This would reduce both financing requirements as well as the need for policy tightening in response to such a shock.

25. The authorities reiterated their readiness to tighten monetary policy if needed to support the peg. They noted that, for a number of idiosyncratic reasons, core inflation has recently not been a meaningful indicator, and that other measures—such as imports of consumption goods and foreign exchange market pressure—confirm that there is room to delay any tightening action. Nonetheless, they emphasized that they remain vigilant to pressures on the balance of payments, including from the near-term policy mix and the government's 2014 financing strategy, and would tighten monetary policy to preserve the sustainability of the peg if needed.

26. The authorities noted that while linkages between domestic suppliers and foreign investors would inevitably take time to establish, they continue to improve the operating environment for all firms. They highlighted ongoing efforts to boost the entrepreneurial spirit of local producers and to promote exports, notably at a regional level. Besides holding regular meetings with small exporters, the authorities noted the following steps taken to improve the business climate for all investors:

- ***Business-friendly tax regime***. Business taxes have remained low through the crisis; SMEs benefit from profit tax exemptions;
- ***Flow of credit to SMEs***. EIB credit lines secured by the Macedonian Bank for Development Promotion and intermediated by commercial banks have helped the flow of affordable financing to SMEs;
- ***Reducing costs***. Procedures to buy land and to open businesses have been streamlined; labor laws have become more flexible;
- ***Improving corporate liquidity.*** The authorities showcased the draft law on financial discipline (now approved by Parliament) which, through substantial financial sanctions, enforces a strict limitation on payment delays pertaining to transactions both between public and private entities, and among private entities themselves.

long-term public sector borrowing should help Macedonia meet the heavy amortization schedule, particularly in 2015, while preserving reserve adequacy ratios. Risks around that baseline are balanced:

FYR Macedonia: External Financing Requirements
(Millions of euros, unless specified otherwise)

	2012	2013	2014	2015	2016
		Projections			
Gross financing requirements	2157	2307	2415	2718	2494
Current account deficit	226	267	369	508	490
ST debt amortization (original maturity)	1588	1725	1720	1760	1807
MLT debt amortization 1/	344	141	326	300	198
of which: Syndicated loan amortization	0	0	0	0	0
Sovereign Eurobond amortization	0	175	0	150	0
Financing sources	2157	2307	2415	2718	2494
FDI (net)	78	264	321	338	362
ST debt disbursements	1725	1720	1760	1807	1861
MLT debt disbursements	410	507	549	651	553
of which: Syndicated loan disbursment	75	0	0	0	0
Sovereign Eurobond disbursment	0	0	0	150	0
Other 2/	67	-373	-36	-44	-61
Net change in reserves (-: increase)	-123	189	-179	-184	-221
Gross international reserves (GIR)	2193	2004	2183	2367	2588
Short-term debt (residual maturity)	2041	2046	2210	2004	2202
GIR as % of ST debt	107.5	98.0	98.8	118.1	117.5
GIR as % of Fund New Metric	130.3	182.1	169.3	167.4	159.6

Sources: NBRM; and IMF staff estimates.

1/ Excluding the amortization of MLT intercompany loans, which is included in FDI (net).
2/ Including the capital account balance, net errors and omissions, currency and deposits, portfolio investments, and discrepancies between ST debt flows and stock data. In 2013, valuation effects are projected to decrease reserves by EUR 200 M. These are assumed to recover by 2014.

- Despite a strong identified pipeline of foreign direct investment, the baseline forecast is conservative. At 3¾ percent of GDP per year in the medium term, projected FDI flows are about one percentage point of GDP below their historical average;

- Public sector external borrowing is mainly linked to the implementation of investment projects, for which there are substantial identified lending commitments, mostly from official sources (¶14 and ¶15);

- The rollover rates of trade credit and intercompany loans, which account for the bulk of short-term external liabilities, have remained above 95 percent over the last four years, despite the global crisis. Rollover risks from the stock of medium- and long-term private external debt, which represented about 23 percent of GDP in 2012, also appear contained, as they mainly reflect debt financing of direct investment projects, thus involving naturally hedged borrowers with a real stake in the domestic economy.

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28. Macroeconomic prospects are improving, even as the external environment remains weak. A pickup in activity to 3.2 percent yoy growth in the first three quarters of 2013 suggests a less fragile recovery than previously expected. Export growth has accelerated on the they mainly reflect debt financing of direct investment projects, thus involving naturally hedged borrowers with a real stake in the domestic economy.

STAFF APPRAISAL

28. Macroeconomic prospects are improving, even as the external environment remains weak. A pickup in activity to 3.2 percent yoy growth in the first three quarters of 2013 suggests a less fragile recovery than previously expected. Export growth has accelerated on the back of expanding FDI-related capacity; a better euro area outlook in 2014 should sustain that trend. Private consumption growth has turned positive, supporting a strengthening of domestic demand. A sustained improvement in domestic demand, and particularly investment, amid signs of a stronger pickup in private credit growth, would be needed to balance the risks to the outlook.

29. To preserve solid fundamentals, the focus of policies should start shifting away from providing stimulus.

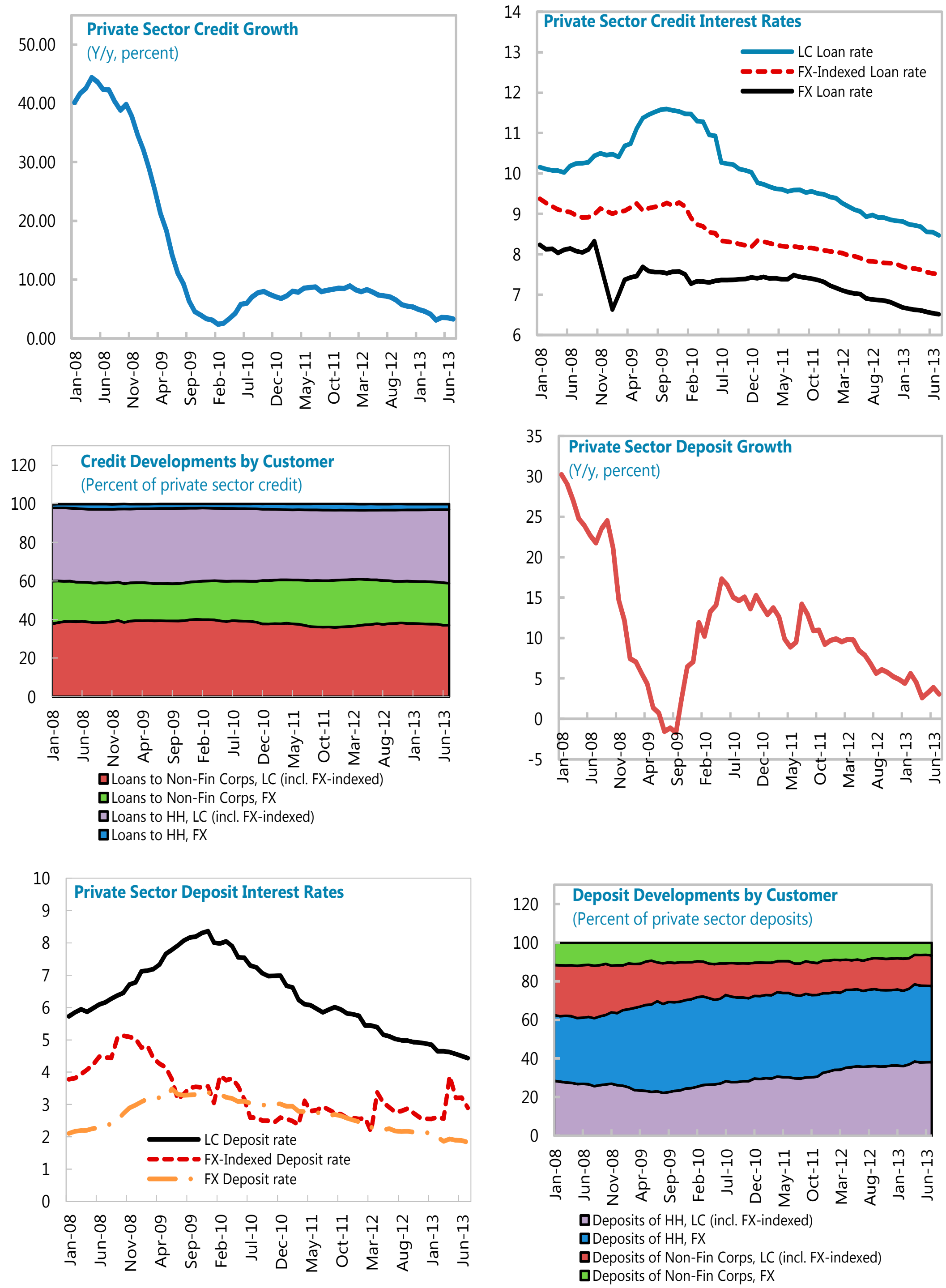
- In that respect, the authorities' planned fiscal path is consistent with reducing central government debt over the medium term and is broadly appropriate from a cyclical point of view. Nonetheless, if private sector-led growth returns earlier than anticipated, some front-loading in 2014–15 would strengthen the credibility of the consolidation plan and build up fiscal buffers that would allow a countercyclical response to any future downturn.

- Amidst high banking system liquidity, a stronger economic recovery, and small declines in the reserve stock, a pause in monetary easing would be appropriate.

30. Large infrastructure needs require a carefully calibrated fiscal space. Fiscal adjustment needs to protect the execution of priority capital spending. The return to multiyear budget frameworks should help ensure a growth-friendly expenditure mix that helps address infrastructure gaps, particularly in roads, railways, and energy. Given the widening perimeter of public sector operations—namely SOEs—which are executing such investment, the authorities should continue to analyze the evolution of, and risks to, the broader public sector debt in setting budgetary targets and prioritizing spending. Prompt collection and dissemination of information on the implementation of strategic investment projects will also help in this respect.

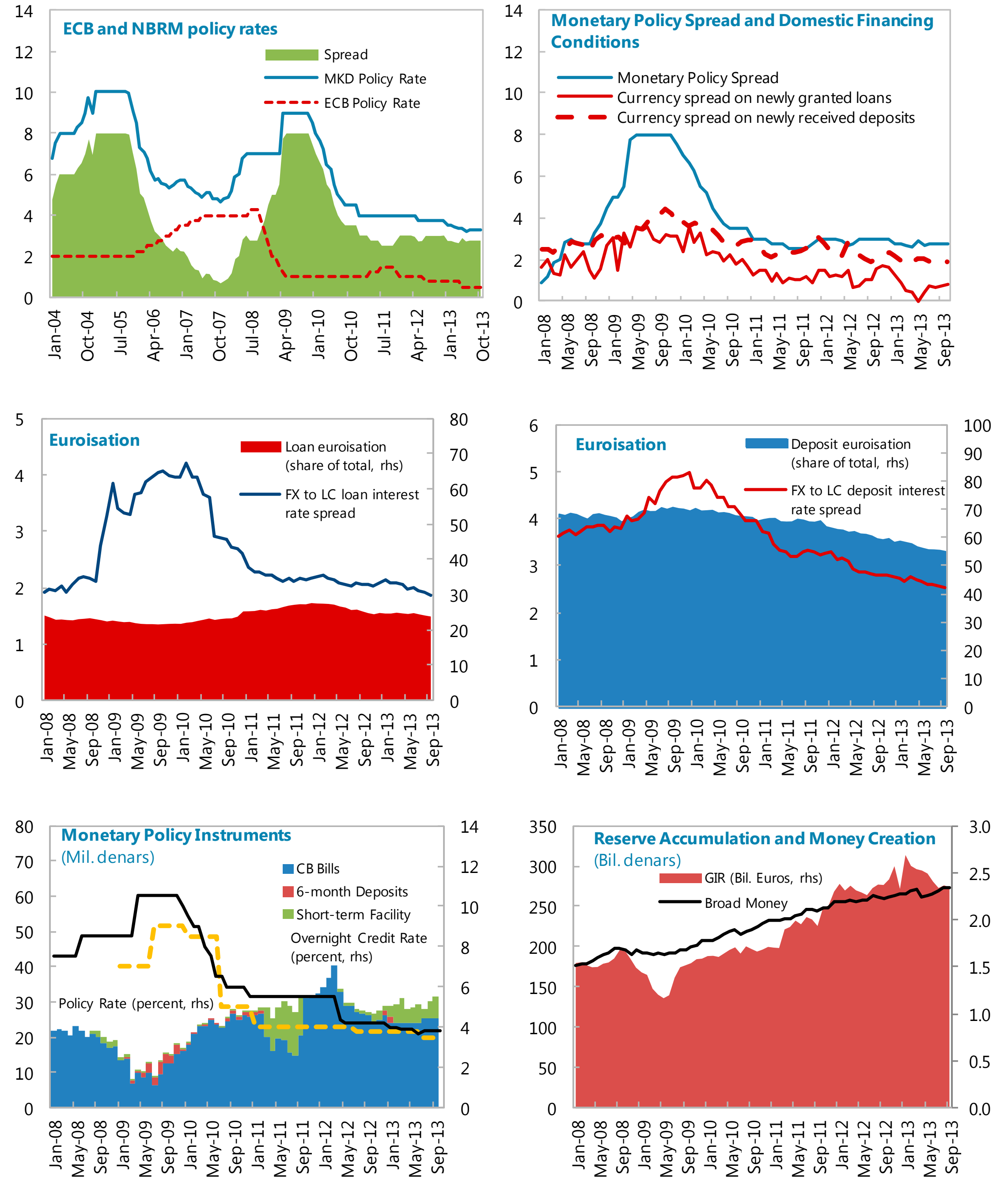
31. Further good progress on public debt management would strengthen both the fiscal and external positions. The authorities have made important progress toward the recommendations of the 2011 Article IV consultation—increasing the size of domestic issuance, lengthening domestic maturities, and setting operational targets for variability as well as currency composition of central government debt. To further strengthen debt management, a broader perspective of public debt is appropriate (¶30). In addition, with weaker private non-debt creating flows, the path of reserve accumulation would increasingly depend on the external public debt trajectory—requiring a careful calibration of the public debt management strategy so as to ensure adequate foreign exchange reserves as well as to reduce public debt vulnerabilities.

Figure 2. FYR Macedonia: Credit Developments, 2008–2013
(Percent, unless otherwise indicated)



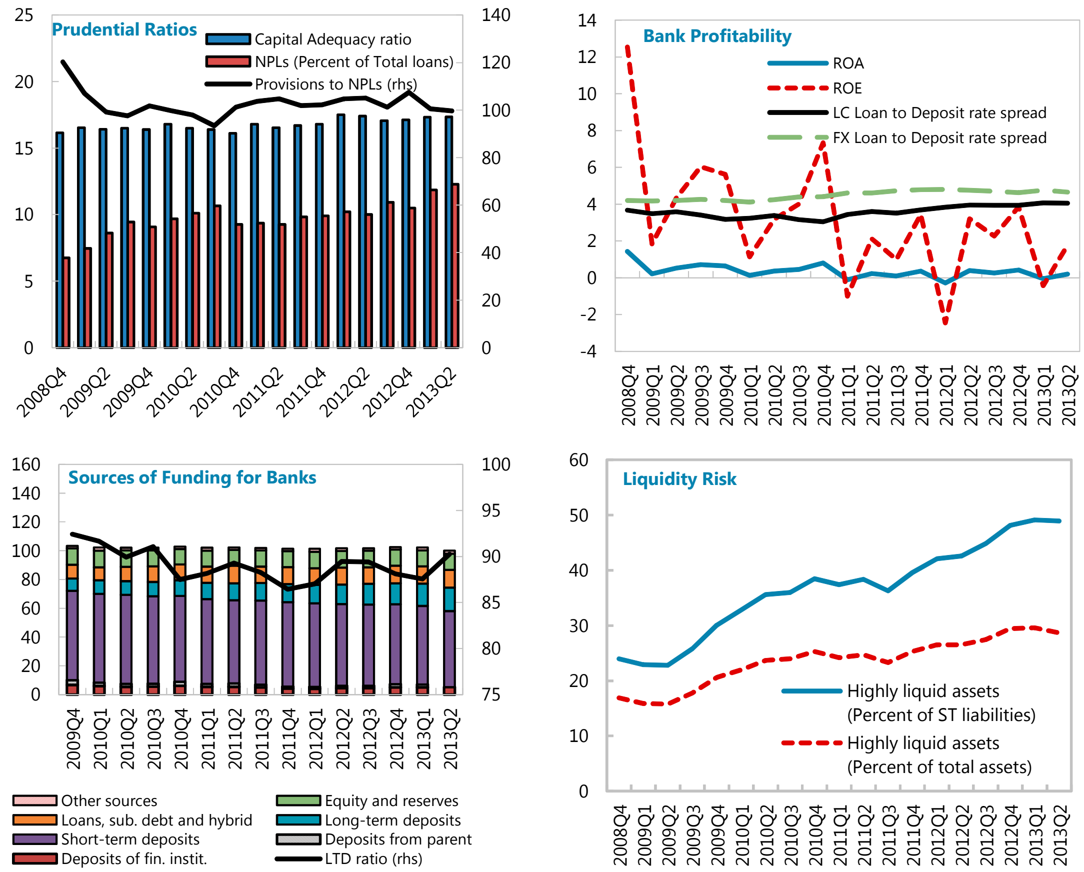
Sources: NBRM; and IMF staff calculations.

Figure 3. FYR Macedonia: Monetary Policy Developments, 2004–2013
(Percent, unless otherwise indicated)



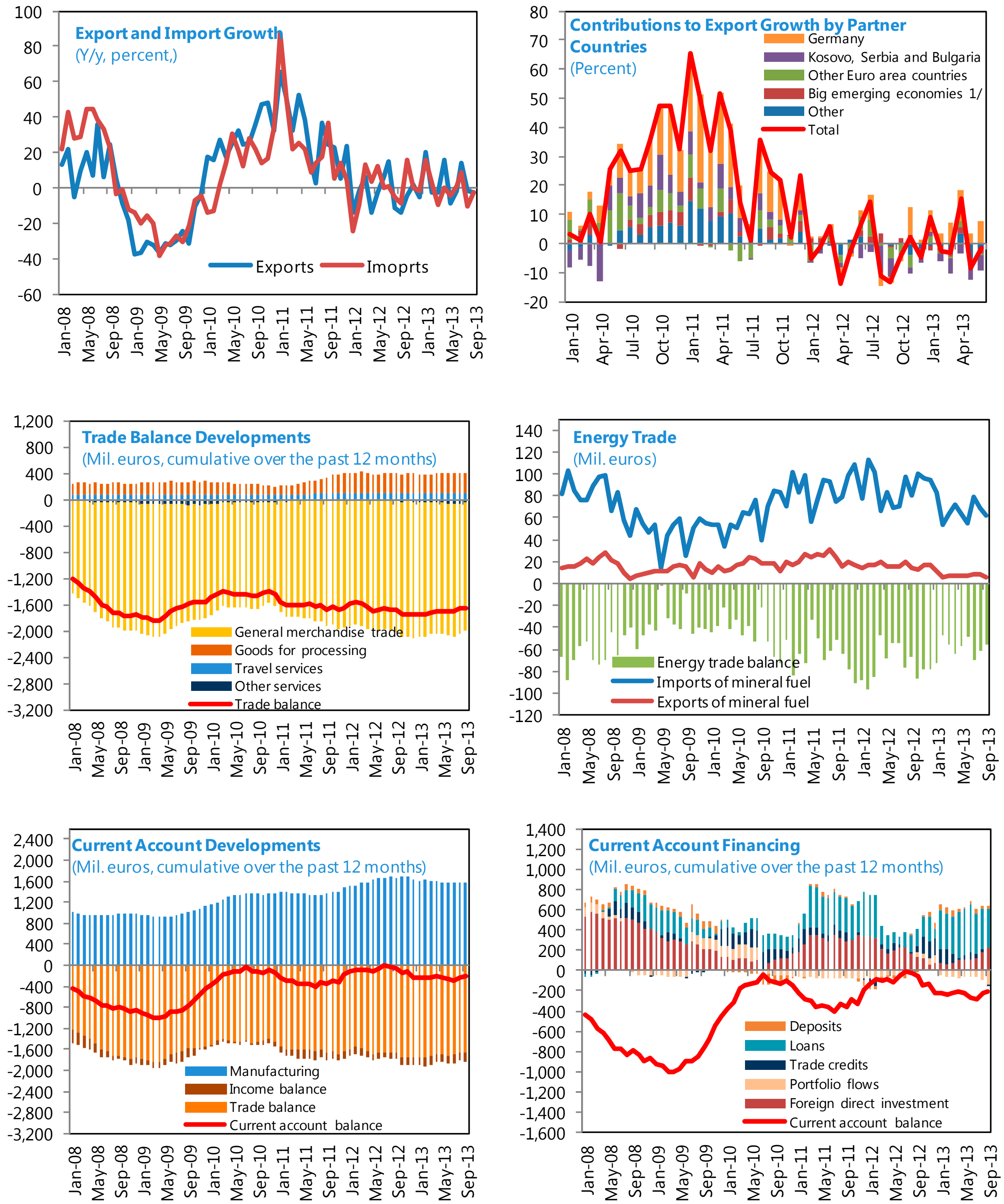
Sources: NBRM; Haver Analytics; and IMF staff calculations.

Figure 4. FYR Macedonia: Banking Sector Developments, 2008–2013
(Percent, unless otherwise indicated)



Sources: NBRM; and IMF staff calculations.

Figure 5. FYR Macedonia: External Sector Developments, 2008–201



Sources: NBRM; and IMF staff calculations.
1/ Brazil, China, India, Russia and Turkey.

INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Appendix II. Draft Press Release

Press Release No. 14/xx
FOR IMMEDIATE RELEASE
January xx, 2014

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

IMF Executive Board Concludes Second Post-Program Monitoring Discussions and Ex-Post Assessment of Exceptional Access with the former Yugoslav Republic of Macedonia

On January 29, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Second-Post Program Monitoring Discussions (PPM)[1] with the former Yugoslav Republic of Macedonia. The Executive Board also discussed the Ex-Post Evaluation (EPE) of Exceptional Access Under the 2011 Precautionary and Liquidity Line Arrangement.[2]

Following a contraction of 0.4 percent in 2012, growth is restarting, and less tentatively than expected earlier, with activity expanding 3.2 percent in the first three quarters of 2013. However, a sustained improvement in investment amid signs of a pickup in private credit would be needed to balance the risks to the outlook, and to help maintain growth momentum into next year.

The trade deficit has improved, and is projected at 22 percent of GDP at end-2013, from 23.6 percent in 2012, mainly due to weaker-than-anticipated imports, while exports have been increasing, with a notable contribution from free trade zones. With private transfers weakening from historic highs to 19 percent of GDP, the current account deficit is projected to widen slightly, to 3.4 percent of GDP. Net foreign direct investment has picked up recently and is expected to reach 3.3 percent of GDP— a strengthening relative to 2012—particularly as capital outflows in

[1] Post-Program Monitoring provides for more frequent consultations between the Fund and members whose arrangement has expired but that continue to have Fund credit outstanding, with a particular focus on policies that have a bearing on external viability. There is a presumption that members whose credit outstanding exceeds 200 percent of quota would engage in Post-Program Monitoring.

[2] The requirement for ex post evaluations (EPEs) was agreed by the IMF Executive Board in September 2002 for members using exceptional access in capital account crises, and extended to any use of exceptional access in February 2003. The aim of an EPE, which must be completed within a year of the arrangement ending, is to determine whether justifications presented at the outset of the individual program were consistent with IMF policies and to review performance under the program.

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the form of profit repatriation and intercompany loans that were observed in 2012 have diminished.

Despite marginally net positive balance of payment flows, sizable negative price effects affecting gold and foreign securities have resulted in an erosion of the stock of official reserve assets by about €200 million since end-2012. Nonetheless, at over 25 percent of GDP, the stock of foreign exchange reserves provides a significant buffer, and capacity to repay remains adequate.

The banking sector remains healthy, with high capital and liquidity ratios, although profitability has been declining. Non-performing loans have fallen to 11.8 percent of total loans, reversing the previous trend increase. In the face of a deceleration in credit growth to about 3 percent in the first half of 2013, in July the National Bank of the Republic of Macedonia reduced the central bank bill rate (the main policy instrument) and the 7-day deposit facility rate by 25 basis points, to 3.25 percent and 1.50 percent, respectively. Yet credit growth has remained subdued, especially to the corporate sector—partly due to bank risk aversion, partly to continued portfolio cleaning.

The return to publishing a medium-term fiscal strategy, in line with recommendations in the 2013 Article IV consultation, is a good step forward in anchoring expectations. The 2014 budget is appropriately contractionary, and the deficit target appears attainable. While the authorities aptly target an acceleration of large capital expenditures—railways, gasification, hospitals—space for these outlays could be constrained by increases in entitlement spending.

Central government debt remains moderate, at a projected 36 percent of GDP, but public sector debt has been progressively diverging from central government debt, as infrastructure needs are met by investment and borrowing by public enterprises, and as financing for SMEs is provided through external lines of credit extended to the Macedonian Bank for Development Promotion. Overall, staff projects public sector debt to increase from 44 to 49 percent of GDP in the period 2013–18.

The ex-post evaluation of exceptional access reviewed the former Yugoslav Republic of Macedonia's engagement with the IMF under the 2011 two-year Precautionary and Liquidity Line (PLL) arrangement. Macedonia made a purchase under the PLL of SDR 197 million (286 percent of quota) in March 2011.

The EPE finds that the PLL effectively insured Macedonia against external shocks and helped the government adhere to their planned policies without the need for a large adjustment. This reduced the costs to the country when economic growth turned out much lower than expected. However, the purchase highlighted weaknesses in debt management practices, and arrears were accumulated after the First Review under the PLL, when the arrangement was no longer active. The authorities have since taken steps to address these issues.