

**FOR
INFORMATION**

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From: The Acting Secretary

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Republic of North Macedonia—Assessment Letter for the World Bank

August 7, 2019

Recent Developments and Outlook

1. Macroeconomic conditions are stable. Real GDP growth rebounded to 2.7 percent in 2018 after stalling in 2017, driven by strong net exports and private consumption. In the first quarter of 2019, GDP grew at its fastest pace in three years, reflecting a pick-up in corporate credit growth, a recovery in both public and private investment, and a continued reduction in unemployment. Against a background of low inflation, solid deposit growth, and favorable FX market developments, the National Bank of the Republic of North Macedonia further cut its policy rate by 25 bps to 2.25 percent in March 2019.

2. Growth is expected to firm up to 3.2 percent in 2019, supported by a rebound in investment. Rising wages—including from minimum wage and planned public sector wage increases—are expected to provide a further, albeit temporary, boost to consumption. Rising trade tensions and a protracted increase in global risk aversion are key downside risks to the outlook. On the upside, a decisive push for structural reforms and opening of EU accession negotiations could boost capital inflows and confidence.

3. The 2019 budget target of 2.5 percent of GDP is achievable. Based on budget execution through June, some shortfalls in revenue and projected overruns in transfers and subsidies are expected to be offset predominantly by under-execution of capital spending. However, there are potential downside risks to the fiscal outlook from new measures that could be adopted as part of the 2019 supplementary budget in September.

Economic Policies

4. Staff expects the fiscal stance to ease somewhat in 2020. Beside the recently implemented VAT reimbursement scheme, several other initiatives are now being discussed. In particular, ad-hoc increases in the minimum wage and pension benefits are under discussion, which would represent a deviation from the rules-based frameworks adopted in 2018. To mitigate any potential negative effects on employment of the minimum wage increases, the government is considering subsidizing social security contributions. Moreover, agricultural subsidies may be further increased. Assuming these policy initiatives move ahead, public debt is projected to increase and stabilize just above 50 percent of GDP over the medium term. The government also plans to use Public-Private Partnerships for various investment projects, but limited information is available at this time. An assessment of the framework for public investment management (PIMA) is planned for 2020.

5. A gradual but steady consolidation would be needed to preserve the fiscal policy space. Public debt is sustainable under the baseline projection, but high gross financing needs and potential shocks to growth constitute downside risks. Rebuilding room for fiscal policy maneuver and placing public debt firmly on a downward path would require a cumulative consolidation of 1½ percent of GDP over 2020–24, compared to staff's baseline projections, to reach a primary

budget balance. The consolidation should be achieved through steadfast implementation of recent reforms to pensions and social assistance, as well as enhanced revenue administration and rationalization of agricultural subsidies. Staff recommends protecting capital and social spending in light of North Macedonia's large infrastructure and human capital investment needs, underpinned by measures to strengthen the public investment management framework.

6. The banking system is healthy, but risks need to be closely monitored. The 2018 Financial Sector Assessment Program (FSAP) found that banks are well capitalized, liquid, and profitable. Further efforts to gradually increase deposit denarization, coupled with carefully calibrated macroprudential measures to reduce foreign currency lending to households, would help strengthen financial system resilience.

7. Achieving faster income convergence with the EU will require structural reforms to address key labor market and institutional weaknesses. Enhancing the quality of secondary and vocational education remains central to tackling skills shortages that constrain growth and investment, together with strategic planning to realign tertiary education toward delivering the skills demanded by the economy. Active labor market policies should focus more on skill building and facilitating education-to-work transition. Efforts to strengthen governance and the judiciary system, reduce corruption, and ensure more effective rule of law should continue. Better public administration, including through tackling tax evasion, strengthening labor inspection, and ensuring predictable implementation of business regulations, is critical to combatting informality.

8. IMF Relations. The 2018 Article IV consultation took place during November 8–16, 2018 and was concluded by the IMF's Executive Board meeting on January 23, 2019. IMF capacity development in the next year will focus on strengthening revenue administration, public investment management, and government finance statistics.

North Macedonia: Selected Economic Indicators

	2015	2016	2017	2018	2019 (p)	2020 (p)
	Year-on-year change, unless otherwise specified					
Real GDP	3.9	2.8	0.2	2.7	3.2	3.5
Real domestic demand	5.4	5.0	0.3	0.3	3.6	3.2
Consumption	4.3	2.1	0.1	3.5	2.4	3.0
Gross investment	8.3	12.5	0.8	-7.2	6.5	3.5
Net exports	-14.1	-16.7	-2.1	7.8	-2.9	-1.5
CPI inflation (annual average)	-0.3	-0.2	1.4	1.5	1.6	2.2
Unemployment rate (annual average)	26.1	23.8	22.4	20.7	20.4	19.7
Private Sector Credit 1/	9.5	0.0	5.3	7.3	8.8	7.2
	In percent of GDP					
Current account balance	-2.1	-3.1	-1.3	-0.3	-0.9	-1.3
Goods and services balance	-16.4	-15.1	-14.0	-12.9	-12.6	-12.2
Exports of goods and services	48.6	50.1	55.2	60.1	62.6	64.8
Imports of goods and services	65.0	65.2	69.2	73.0	75.2	77.0
Private transfers	16.9	15.4	15.9	15.8	15.2	14.7
External debt	69.3	74.7	73.6	75.2	76.7	76.5
Gross investment	30.4	32.5	33.0	33.0	33.5	33.4
Domestic saving	28.3	29.4	31.6	32.7	32.6	32.1
Public	-0.1	0.2	0.5	0.1	0.4	0.3
Private	28.5	29.2	31.2	32.6	32.3	31.8
Foreign saving	2.1	3.1	1.3	0.3	0.9	1.3
General government gross debt 1/	38.1	39.8	39.5	40.4	41.9	42.2
Public sector gross debt 1/ 2/	44.0	46.7	46.1	47.3	49.9	50.8
Central government balance	-3.5	-2.7	-2.7	-1.8	-2.5	-2.7
Memorandum items:						
Nominal GDP (billions of denars)	559.0	594.8	616.6	660.3	694.7	733.7
Nominal GDP (billions of euros)	9.1	9.7	10.0	10.7	11.3	11.9
GDP per capita (euros)	4,380	4,657	4,825	5,163

Sources: NBRM; SSO; MOF; IMF staff estimates.

1/ The historical debt ratios differ slightly from the numbers reported by MoF due to using end-year debt in local currency divided by local currency GDP.

2/ Includes general government and public sector enterprises.