INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/354

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

November 2017

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with the Former Yugoslav Republic of Macedonia, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 13, 2017 consideration of the staff report that concluded the Article IV consultation with the Former Yugoslav Republic of Macedonia.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 13, 2017, following discussions that ended on September 18, 2017, with the officials of the Former Yugoslav Republic of Macedonia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 17, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Former Yugoslav Republic of Macedonia.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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International Monetary Fund
Washington, D.C.

Press Release No. 17/454
FOR IMMEDIATE RELEASE
November 22, 2017

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

IMF Executive Board Concludes Article IV Consultation with Former Yugoslav Republic of Macedonia

On November 13, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the 2017 Article IV Consultation with the Former Yugoslav Republic of Macedonia.[1]

Following a solid economic recovery since the Global Financial Crisis, growth has slowed to 2.4 percent in 2016 and contracted by 0.9 percent in 2017H1. Economic activity has been supported by private consumption and exports, while negative effects from the prolonged political instability have restrained investment and slowed down corporate credit growth. Inflation has gradually picked up, after staying negative during the past few years, driven by rising increasing services prices and, to a smaller extent, food prices. The current account deficit has widened in recent years, albeit a narrowing trade deficit, reflecting higher profit repatriation by foreign firms, weaker remittances and higher foreign currency cash holdings by households.

On the fiscal front, the overall deficit narrowed to 2.6 percent in 2016. The improvement was largely due to under-execution of capital investment, spending constraints imposed during the pre-election period, and accumulation of payment arrears. The under-execution of goods and services and capital spending continued in 2017H1, which is expected to keep overall fiscal deficit around 3 percent of GDP in 2017. Public debt is projected to rise to 47 percent of GDP in 2017. Currently, the government is in the process of preparing the draft economic program.

The financial sector is well-capitalized, liquid, and profitable. The authorities adopted Basel III standards on capital adequacy earlier this year. The banking system's liquidity is high, in

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

part due to a significant slowdown in credit growth to the non-financial corporate sector and banks' limited preference for increasing sovereign assets holdings. Monetary conditions are accommodative, with the main policy rate reduced back to 3.25 percent in February 2017.

Executive Board Assessment[2]

Executive Directors noted the negative impact of the prolonged political crisis on economic growth and the limited progress on structural reforms. They noted that the formation of the new government is a turning point for the Macedonian economy, and underscored this as an opportunity to rebuild policy space and revive reforms.

Directors emphasized the need for fiscal consolidation, in light of the rapid rise in public debt and high gross financing needs. They welcomed the authorities' intention to reduce the overall deficit gradually to 2 percent of GDP in the medium term, but stressed that this should rely on durable measures. They recommended strengthening tax administration, and increasing property and energy taxation to boost revenues. At the same time, they noted the importance of improving spending efficiency through subsidy rationalization and better targeting of social spending, and ensuring pension sustainability. Directors also supported the authorities' plan to strengthen public finance management and increase fiscal transparency.

Directors agreed that an accommodative monetary policy remains appropriate given the still-negative output gap, low inflation, and external stability. However, they emphasized that the monetary stance should be appropriately tightened as inflation developments warrant or in case of a loss of market confidence, and urged close monitoring.

Directors noted that the banking system remains well capitalized, liquid, and profitable. They commended the authorities for strong policy actions that restored stability after a period of financial turbulence, and the recent adoption of Basel III capital standards. They stressed that continued vigilance is important in light of a high degree of financial euroization and moderate deleveraging risks. Directors recommended that the authorities continue to complement monetary policy with macro-and micro-prudential measures to counter financial stability risks.

Directors urged the authorities to intensify the pace of structural reforms to increase employment and boost productivity. They welcomed the authorities' plan to support employment and social inclusion, which need to be carefully targeted. To preserve competitiveness and fiscal sustainability, they stressed the need to keep wage growth in line with productivity developments. In light of an aging population, they noted the importance of increasing labor force participation, particularly that of women, through a mix of tax, social assistance, and family leave policies, as well as active labor market policies. Directors advised further improvements in governance and public administration, trade-enabling logistics, and skills to boost FDI inflows.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

FYR Macedonia: Selected Economic Indicators

	2012	2013	2014	2015	2016	2017
	Year-on-year change, unless otherwise specified					
Real GDP	-0.5	2.9	3.6	3.8	2.4	1.9
Real domestic demand	3.5	1.3	4.4	3.4	1.5	1.0
Consumption	1.4	1.6	2.4	3.4	3.7	2.6
Gross investment	10.2	0.5	10.7	3.6	-4.3	-3.6
Net exports	-26.3	7.0	-8.0	-1.0	3.9	1.8
CPI inflation (annual average)	3.3	2.8	-0.3	-0.3	-0.2	1.2
Unemployment rate (annual average)	31.0	29.0	28.0	26.1	23.6	23.0
Private Sector Credit 1/	5.2	6.3	9.8	9.5	1.0	5.8
	In percent of GDP					
Current account balance	-3.2	-1.6	-0.5	-2.0	-2.7	-1.9
Goods and services balance	-22.4	-18.3	-17.2	-16.3	-14.8	-14.7
Exports of goods and services	44.5	43.3	47.7	48.8	49.3	51.3
Imports of goods and services	66.9	61.6	64.9	65.1	64.2	66.0
Private transfers	20.6	18.1	17.3	16.9	15.1	15.4
External debt	68.2	64.0	70.0	69.4	73.5	71.8
Gross investment	28.9	28.8	30.3	31.1	33.6	33.2
Domestic saving	25.8	27.2	29.8	29.1	30.9	31.3
Public	0.2	-0.5	-0.9	-0.1	0.2	0.0
Private	25.5	27.7	30.6	29.3	30.7	31.3
Foreign saving	3.2	1.6	0.5	2.0	2.7	1.9
General government gross debt	33.7	34.0	38.0	38.2	39.0	38.8
Public sector gross debt 1/	36.2	37.9	43.3	44.1	45.7	47.1
Central government balance	-3.8	-3.8	-4.2	-3.5	-2.6	-3.0
Memorandum items:						
Nominal GDP (billions of denars)	466.7	501.9	527.6	558.2	607.5	631.6
Nominal GDP (billions of euros)	7.6	8.1	8.6	9.1	9.9	10.3
GDP per capita (euros)	3680	3930	4126	4374	4755	...

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

1/ Includes general government and public sector non-financial enterprises.

INTERNATIONAL MONETARY FUND

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

October 17, 2017

KEY ISSUES

Context: The prolonged political uncertainty has taken a toll on economic growth, with investment suffering because of weak sentiment. With the formation of the new government, policies should now focus on rebuilding fiscal buffers and implementing critical reforms to rekindle growth and give EU accession prospects a new push.

Key policy recommendations

Fiscal Policy. Fiscal expansion in recent years has been accompanied by higher pensions and subsidies. Consolidation should start without delay to create policy space through more efficient collection of VAT, rationalization of subsidies, pension reforms and higher fuel and property taxation. These measures will ensure fiscal sustainability and help meet large investment needs in infrastructure and human capital. The new government's focus on improving the quality and transparency of public institutions is encouraging and should be nurtured through a well-prioritized action plan.

Monetary and Financial Policy. An accommodative monetary policy remains appropriate for now, but a tightening may be needed if inflation picks up rapidly, or there is a loss of market confidence. The financial sector remains well-capitalized, liquid, and profitable; however, the high degree of financial euroization and possible deleveraging by parent banks pose risks. The authorities should use micro and macroprudential tools as needed to manage these risks.

Structural Policy. While FYR Macedonia's external position is in line with economic fundamentals, high unemployment, under-utilization of labor and rising debt ratios highlight the need for corrective structural and fiscal measures to preserve competitiveness. Addressing persistent labor market weaknesses will require a mix of taxation, wage, social assistance, and family leave policies that incentivize participation and employment, particularly for the low-skilled and women. To durably lift investor confidence, policies should focus on improving governance, trade-enabling logistics and labor skills. Any direct support to enterprises in the form of subsidies or tax incentives should be carefully assessed to not jeopardize fiscal sustainability.

Approved By
Mahmood Pradhan (EUR) and Zeine Zeidane (SPR)

Discussions were held in Skopje, September 6–18, 2017. The mission met with Prime Minister Zaev, Deputy Prime Minister Angjushev, Finance Minister Tevdovski, NBRM Governor Bogov, other senior officials, private sector representatives, parliamentarians and envoys representing the international community.

The staff team comprised Ms. Rahman (head), Ms. Jirasavetakul, Messrs. Ioannou and Halikias, and Mr. Nacevski (local economist). Mr. Omoev contributed to the background analysis of this report. Mr. Clicq (OED) and Mr. Shimbov (World Bank) attended some meetings. Ms. Mahadewa and Ms. Meng assisted in the preparation of the staff report.

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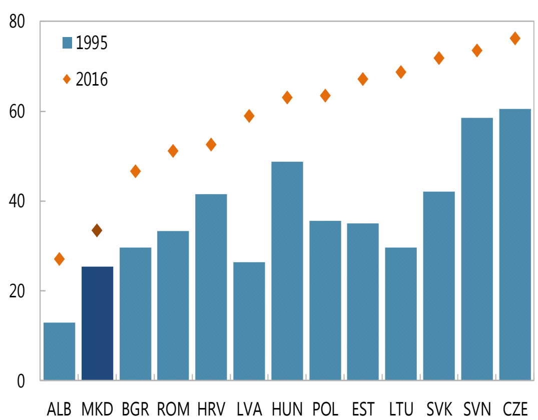
CONTEXT

1. **After a prolonged political crisis, stabilization is underway with the formation of the new government.** The crisis, which originated in the aftermath of the April 2014 parliamentary elections, deepened subsequently with allegations by the opposition of voter fraud and abuse of power. Under an EU-US led political agreement, the incumbent Prime Minister agreed to step down, hold early parliamentary elections and allow the appointment of an independent prosecutor. The early elections held in December 2016 failed to produce a clear winner. After five months of intense negotiations and political violence, Parliament approved a new government in June 2017 led by the Social Democratic Union of Macedonia (SDSM) with coalition partners from two ethnic Albanian parties. The formation of the new government has been an important turning point for the country.

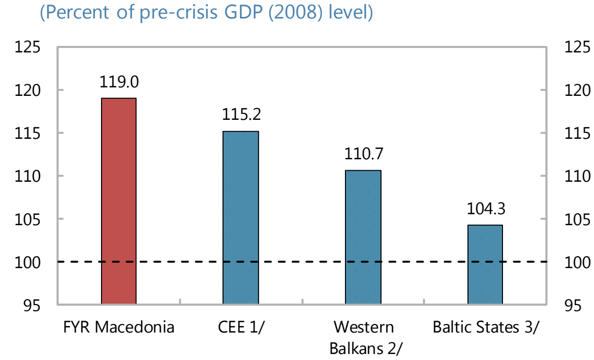
2. **The priority now should shift to reviving reforms and giving convergence a new push.** In the last two decades, FYR Macedonia has experienced one of the slowest income convergence with advanced Europe compared to peers despite a solid recovery since the Global Financial Crisis (GFC). To achieve higher and more sustainable growth, the country needs to start implementing deeper institutional reforms that will ensure an optimal use of the labor force and a more predictable operating environment for the private sector. The new government's intention to improve the quality and transparency of public institutions, stimulate employment, increase social inclusion, and provide a level-playing field for all investors is encouraging. These goals, however, should be pursued without jeopardizing fiscal sustainability and recent gains in competitiveness.

Real GDP per Capita, Purchasing Power Parity (USD)
(Percent of EU-15)



Sources: World Economic Outlook (WEO); and IMF staff calculations.

Real GDP, 2016
(Percent of pre-crisis GDP (2008) level)



Sources: IMF, WEO; and IMF staff calculations.
1/ Weighted average of Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovak Republic, and Slovenia.
2/ Weighted average of Albania, Bosnia and Herzegovina, Kosovo, FYR Macedonia, Montenegro, and Serbia.
3/ Weighted average of Estonia, Latvia, and Lithuania.

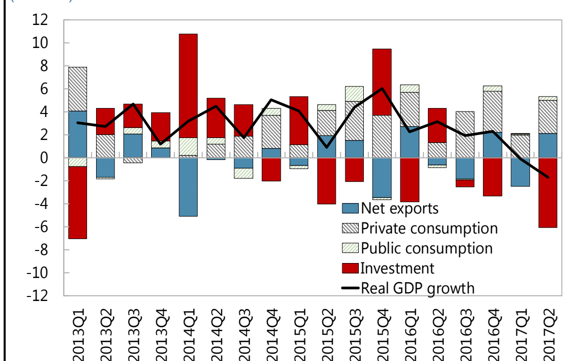
3. **Macroeconomic policies should focus on rebuilding policy buffers.** Against the backdrop of a rapid rise in public debt since 2008, fiscal consolidation, based on durable measures, should start without delay to create policy space and safeguard sustainability, particularly as monetary policy remains accommodative in light of low inflation, weak credit growth, and a negative output gap.

RECENT ECONOMIC AND FINANCIAL DEVELOPMENTS

4. **Economic activity has weakened since late 2015 with the political crisis adversely affecting investor confidence.** Following a slowdown to 2.4 percent in 2016, real GDP contracted by 0.9 percent in 2017H1, mainly reflecting a large drop in investment amidst intensifying political instability. Private consumption held up on the back of rising employment and wages, and robust household credit growth, while exports registered further market gains (Table 1). After remaining negative during the past three years, inflation recently picked up in part reflecting rising wages and services sector prices (Figure 1). The overall unemployment rate declined to below 23 percent by 2017Q2, an impressive nearly 9 percentage points reduction since 2011Q4. Broad-based employment growth during this period was led by construction, public, and services sectors.

FYR Macedonia: Contribution to Real GDP Growth, SA

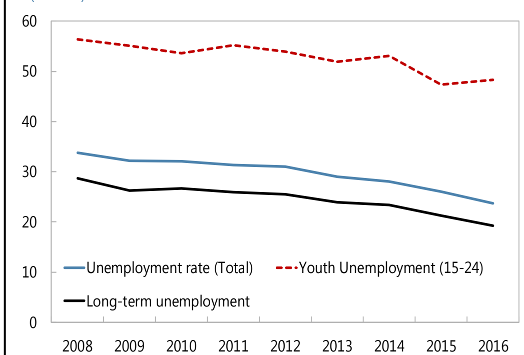
(Percent)



Sources: FYR Macedonia State Statistical Office; and IMF staff calculations.

Unemployment Rates

(Percent)



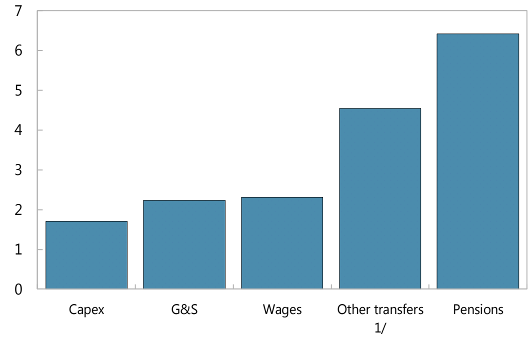
Sources: State Statistical Office; and Haver Analytics.

5. **The overall fiscal deficit improved two years in a row on the back of temporary measures.** Despite weaker-than-projected revenues, the cumulative consolidation in the overall deficit of 1½ percent of GDP during 2015–16 largely reflects under-execution of capital and goods and services spending due to constraints posed by the multi-party political agreement. The new administration has also reported possible accumulation of payment arrears and blocked VAT refunds, which could imply a much lower fiscal consolidation. The under-execution of expenditures continued in 2017H1 amidst protracted political stalemate. In recent years, large increases in pensions and subsidies spending have contributed to fiscal deterioration (text chart).

FYR Macedonia: Recent Fiscal Developments

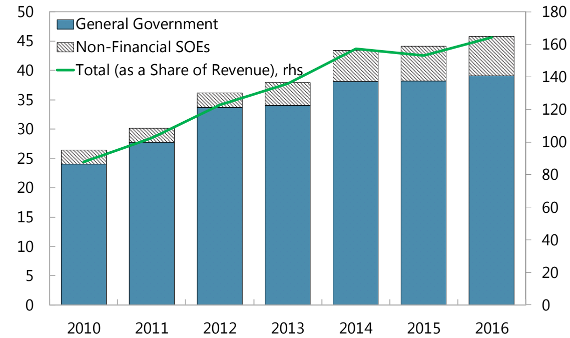
Spending on pensions and transfers increased sharply in recent years...

Expenditure Growth
(Percent, Average Annual Growth during 2010-2016)



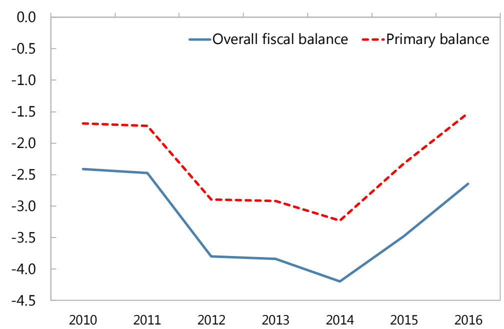
...contributing to the fast build-up of public debt.

Non-Financial Public Debt
(Percent of GDP, Othewise Indicated)



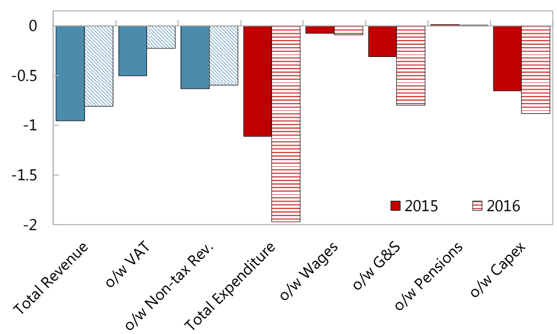
More recently, headline deficit has improved...

Overall Fiscal Balance and Public Debt
(Percent of GDP)



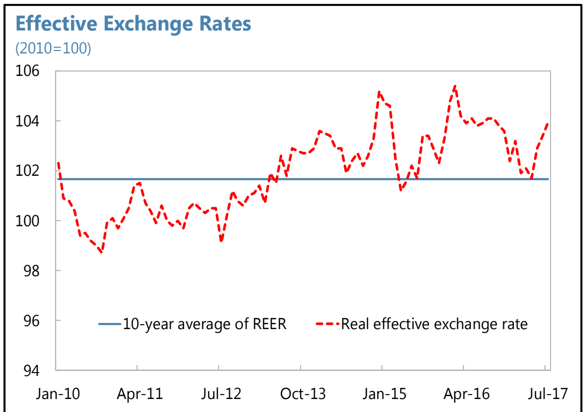
...due to large under-execution of goods and services and capital spending.

Under-execution of Revenue and Expenditure Items
(Percent of GDP, compared to the supplementary budget)

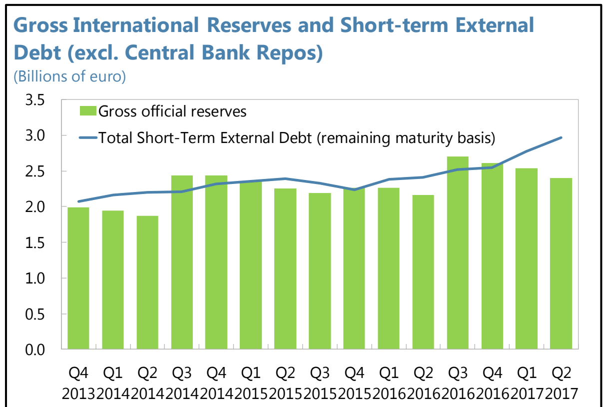


Sources: FYR Macedonian Authorities; and IMF staff calculations.
1/ Other transfers include all other social protection programs, subsidies, and transfers to local governments.

6. **Staff's analysis shows the external position to be broadly in line with economic fundamentals** (Annex 1)**.** All three EBA-lite methodologies indicate a slight undervaluation of the real effective exchange rate, while broader competitiveness indicators show strength. Favorable energy prices and rising exports from the technological and investment zones (TIDZ) continue to improve trade balances (Figure 3). The current account deficit widened in 2016 reflecting higher profit repatriation by foreign firms, weaker remittances and higher foreign currency cash holdings by households. The level of gross international reserves was adequate at the end of 2016, including by the IMF's ARA metric. More recently, reserves have declined, with coverage of short-term debt falling below 100 percent due to lower FDI inflows and postponement of sovereign bond issuance. FYR Macedonia's external funding base has become progressively less diversified—with weaker private capital inflows, reserves accumulation in recent years has largely relied on sovereign external borrowing.

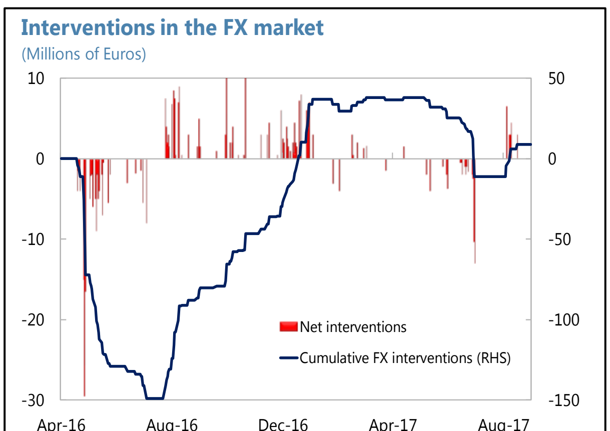


Sources: Haver Analytics; and IMF staff calculations.

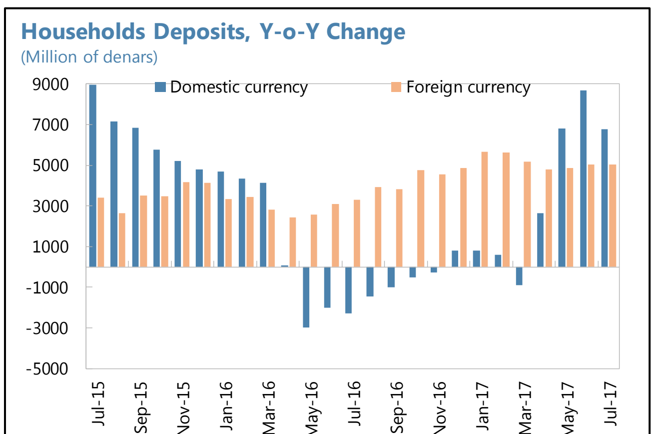


Sources: National Bank of the Republic of Macedonia; and IMF staff calculations.

7. **Strong policy actions restored stability in the financial sector after a period of turbulence.** In April-May 2016, an intensification of the political crisis and rumors of exchange rate devaluation led to large deposit outflows and currency conversion that resulted in a significant loss of reserves. The speculative pressures receded following NBRM's strong policy measures and external borrowing which boosted reserves coverage. Deposit growth in domestic currency resumed in 2016H2, which partly prompted NBRM to lower the policy rate back to the pre-turbulence level of 3.25 percent by February 2017. Foreign currency deposits, including local currency deposits indexed to FX, have increased slightly since end-2016, reflecting lingering effects of political uncertainty (Figure 4).



Sources: National Bank of the Republic of Macedonia; and IMF staff calculations.

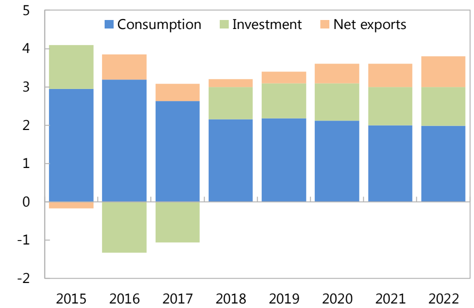


Source: National Bank of Republic of Macedonia.

OUTLOOK AND RISKS

8. **Real GDP growth is projected to moderate this year but pick up in the medium-term.** High frequency indicators point to a bottoming out of subdued corporate credit growth and some strengthening in exports and private consumption. These developments, together with a resumption of public investment in infrastructure projects, are likely to yield a positive real GDP growth of 1.9 percent for 2017. Growth is expected to pick up to 3.2 percent in 2018 and further accelerate in the medium term supported by stronger investment and credit growth, expansion of export capacity, and continued improvement in labor markets (Table 1). Headline inflation is projected to gradually reach 2 percent by end-2019. Despite narrowing trade deficits, the current account deficit is projected to widen in the medium term reflecting weaker remittances receipts. External debt would remain around 70 percent of GDP, due to both public and private sector borrowing.

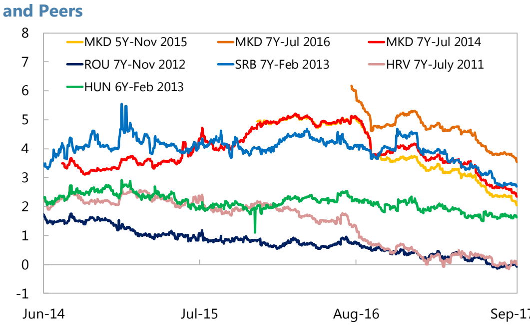
Real GDP Growth, Contributions
(Percent, year-on-year growth)



Sources: Haver Analytics; and IMF staff calculations.

9. **Risks to the outlook have improved but are still mostly on the downside** (Box 1)**.** The return of political stability has reduced sovereign risk perceptions. Capitalizing on this stability, a decisive push for structural reforms in labor markets, management of public finances and judiciary could enhance EU accession prospects and growth potential. On the downside, a slim-majority governing coalition, in the context of upcoming local elections, could reintroduce political uncertainties, undermine the fragile confidence and investment, and slow down growth. There are also external downside risks from weaker growth in partner countries, and global policy uncertainty which could reduce exports and FDI directly or through the global supply chains. In addition, banking sector links expose FYR Macedonia to a possible return of financial volatility in Greece.

Sovereign Eurobond Yield Spread over German Bond: Macedonia and Peers



Sources: Bloomberg Financial Market, L.P.; and IMF staff calculations.

Authorities' Views

10. **The authorities broadly agreed with staff's economic outlook and risks.** They mentioned the near-term potential downside risks to confidence in the context of the October local elections. However, they viewed downside external risks to be contained due to a favorable economic outlook in major Euro area trading partners and limited spillovers from any renewed financial volatility in Greece. The authorities also highlighted upside risks to the economic outlook from planned support to the private sector, improved transparency, reforms in the judiciary, as well as their intention to foster deeper integration with North Atlantic Treaty Organization and the EU.

Box 1. Risk Assessment Matrix[1]
(Scale—high, medium, or low)

Source of Risks	Relative Likelihood	Impact If Realized	Recommended Policy Response
Country-specific			
Return of political instability	**Medium**	**Medium** • Deterioration of investor confidence, delayed FDI inflows, possible deposit outflows and financial instability; • Further fiscal widening and higher sovereign borrowing costs.	• Tighten monetary policy and adopt targeted macro-prudential measures to counter financial sector stress; • Durable fiscal consolidation within a credible medium-term budget framework.
Decisive push for structural reforms	**Medium**	**Medium** Improved investor confidence, higher FDI inflows, and stronger growth.	• Adopt a medium-term strategy with concrete steps garnering support from domestic stakeholders and international partners.
Global			
Retreat from cross-border integration	**Medium**	**Medium / Low** Potential damage to global supply chains, and global trade could adversely impact FYR Macedonia's economy through lower exports.	• Advance structural reforms to enhance productivity and diversification. • Invest in skills and human capital.
Policy uncertainty and divergence	**High**	**Medium / Low** Negative impacts of uncertainty on market sentiment and FDI outlook.	• Pursue a growth- and employment-friendly fiscal consolidation.
Structurally weak growth in key advanced and emerging economies	**High / Medium**	**Medium** Weaker exports and FDI, given significant direct trade and FDI linkages with the Euro area.	• Adopt a slower pace of fiscal consolidation, depending on the size of the shock. • Accelerate structural reforms to attract FDI; [Tighten monetary policy to support the exchange rate;]
European bank distress	**Medium**	**Medium / Low** Any renewed financial volatility in Greece could trigger deposit outflows as in Summer 2015 and pose risks to financial stability.	• Apply existing micro- and macro-prudential measures in place and tighten monetary policy as needed to restore confidence.

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks at the time of discussions with the authorities.

POLICY DISCUSSIONS

A. Fiscal Policy: Supporting Sustainability and Creating Policy Space

Background

11. **The authorities' draft economic program includes various fiscal stimulus measures to support investment and job creation and raise living standards** (text table). Based on preliminary estimates and details, these measures will widen the deficit in the near-to-medium term. Direct pressures for higher spending could stem from subsidized wage increases, financial assistance to domestic companies, expansion of tax incentives and pension increases. While the economic program intends to include budgetary safeguards, such as revenue and employment generation criteria, as well as annual spending limits, there are significant risks to fiscal sustainability due to its wide scope and complicated implementation structure. The authorities are contemplating some revisions in personal income tax policies to generate additional revenues, but these have not yet been formulated.

Selected Fiscal Components in the Draft Economic Reform Program and Staff Positions

Proposed Policy	Staff's Position
Wage and Employment Policy	
1. Create 64,000 jobs, by 2020, in the private sector through active measures.	~
2. Raise net minimum wage to 12,000 denars/month in 2017 and towards 16,000 denars/month by 2020; and provide minimum wage subsidy of 100 percent for the first six month and 50 percent for the next six months for new jobs created.	X
3. Provide subsidies of 10 percent to firms for a newly created job which pays employees 50 percent higher than the minimum wage level, and of 20 percent for a newly created high-paid/skilled job which pays higher than twice of the average wage of the economy.	X
4. Provide financial and non-financial supports to both domestic and foreign companies, based on criteria related to revenue expansion, new job creation, and linkages with other domestic companies.	~
5. Provide additional financial supports to exporters that attain a specific rate of export growth over the past 3 years.	~
Social Spending	
1. Apply more frequent pension adjustments (from once to twice a year).	X
2. Allow for early retirement up to a maximum of 5 years before the regular pension status, with reduced pension allowance.	X
3. Tentative implementation of welfare pensions for elderly aged above 65 who do not fulfill the conditions for regular-age retirement.	X
4. Introduce a guaranteed minimum income scheme in the medium term.	~
5. Consolidate social assistance programs and improve targeting.	✓
Tax Policy	
1. Introduction of progressive tax rates on personal income.	~
2. Cancellation of the maximum income base for social security contributions.	✓
3. Raise property tax for high-valued property (with market value above €400,000) by 0.1 percentage point in the medium term.	✓

Note: Specific details of these policies are still to be formulated and released.
✓ = Support; X = Not recommended; ~ = More details required.

12. **The new government has significantly stepped up dissemination of fiscal data and reported sizable unpaid claims from previous years.** Their preliminary estimates suggest payment arrears of around 0.7-1 percent of GDP for the general budget and another 2½ percent of GDP for other public institutions and enterprises. However, these are unaudited claims based on information submitted by general budget users and other public institutions, which include intra-government payments, possible fraudulent claims, and planned spending as opposed to only unpaid obligations. Furthermore, the absence of a legal and standardized definition of payment arrears has complicated the efforts to accurately measure the total outstanding amount.

13. **Without consolidation measures and pending tax policy revisions, staff's baseline projections show a deficit of 3 percent of GDP for 2017 with a further widening in the medium term.** For 2017, the slightly higher deficit relative to 2016 is driven by lower-than-budgeted revenue collection reflecting growth slowdown although overall expenditure is also projected to be below the budgeted amount. Over the medium-term, the fiscal deficit is projected to stay above 3½ percent of GDP with public debt rising to 53½ percent of GDP by end-2022 and gross fiscal financing needs peaking above 15 percent of GDP in 2020–21 (text table and Figure 2). The medium-term deterioration of the fiscal deficit is primarily due to the measures included the economic program: subsidies for proposed wage increases, the roll-out of additional employment and business incentives, and an increase in public sector wage bill from the pass-through of economy-wide minimum wage increase, as well as clearance of some unpaid claims.

Fiscal Balance and Public Debt

(Percent of GDP)

	2016	2017	2018	2019	2020	2021	2022
Baseline 1/							
Public debt	45.7	47.1	50.7	51.7	53.1	53.9	53.5
Fiscal balance	-2.6	-3.0	-3.7	-3.7	-3.7	-3.8	-3.8
o/w: Clearance of unpaid claims	-1.0	0.0	0.4	0.3	0.0	0.0	0.0
Recommendation 2/							
Public debt	45.7	47.0	49.8	49.9	49.9	49.0	47.1
Fiscal balance	-2.6	-3.0	-3.1	-2.8	-2.3	-2.1	-2.0
o/w: Clearance of unpaid claims	-1.0	0.0	0.4	0.3	0.0	0.0	0.0
Memorandum items:							
Primary fiscal balance, excluding one-off items 3/							
Baseline	-2.0	-1.7	-2.0	-2.1	-2.3	-2.3	-2.3
Recommendation	-2.0	-1.7	-1.7	-1.5	-1.2	-0.9	-0.7

Source: IMF staff calculations.

1/ The baseline fiscal scenario includes measures that have been discussed in the parliament (minimum wage increases) or are at an advanced stage (wage subsidies and financial incentives to investors). The budgetary impacts of these measures are assumed as follows: (1) higher spending arising from wage subsidies (0.1-0.15 percent of GDP in 2018-20); (2) additional financial incentives to investors (0.1-0.15 percent of GDP in 2018-20); and (3) public sector wage increases due to pass-through effects of minimum wage increases (0.1-0.2 percent of GDP in 2018-20). It also (conservatively) assumes an arrears clearance of 0.7 percent of GDP in 2018-19. The scenario does not take into account any pension measures and planned tax reforms as policy parameters remain unknown.

2/ The recommended scenario assumes non-implementation of the authorities' expansionary measures included in the baseline scenario (a savings of 0.5 percent of GDP). In addition, revenue gains are assumed from one-off collection of VAT arrears (¼ percent of GDP per year during 2018-21), higher property taxes (0.05 percent of GDP by end-2022), and tax administration reforms (0.5 percent of GDP by end-2022). On the expenditure side, it assumes a reduction of subsidies (0.4-0.6 percent of GDP by end-2022). Similar to the baseline scenario, this scenario also assumes clearance of arrears of 0.7 percent of GDP and does not take into account any pension measures or tax reforms.

3/ One-off items include accumulation and clearance of unpaid arrears, and collection of VAT arrears.

14. **Staff recommends a gradual fiscal consolidation to ensure sustainability and create policy space.** The government's intention to support employment and improve social inclusion are

appropriate. However, staff advises against a strategy that relies primarily on subsidized higher wages and expansion of tax incentives. To ensure durable results, these objectives should instead be pursued through policies that enhance incentives for labor market participation and reduce inefficiencies in social spending (text chart, details below). The combined effect of these policies, along with higher property taxes and lower subsidies, would reduce the overall fiscal deficit to 2 percent of GDP in the medium term (a reduction in the primary deficit, excluding one-off measures, of 1.3 percent of GDP during 2018–22) and keep public debt comfortably below 50 percent of GDP (text table).

- ***Raise additional revenues through more efficient collection of VAT and higher property taxation.*** The VAT revenues have been deteriorating and remain significantly lower than in Western Balkan peers. As identified in the findings of the recent Tax Administration Diagnostic Assessment Tool (TADAT), increasing the coverage and targeting of compliance risks, improving the operation of the large tax payer office, and establishing a fully-functioning risk management unit can yield notable revenue gains. Further gains can be achieved from the collection of VAT arrears and higher taxes on property.

- ***Reduce the labor tax wedge at low-income levels.*** A regressive labor tax system discourages low-skilled workers from entering the labor force and taking up formal employment, particularly if non-wage family income in the form of social assistance and remittances is available. To stimulate participation, staff recommends decreasing the minimum income base for the social security contribution to the minimum wage level. To ensure revenue neutrality, this should be accompanied by strong audit processes and some progressivity in line with the authorities' current thinking.

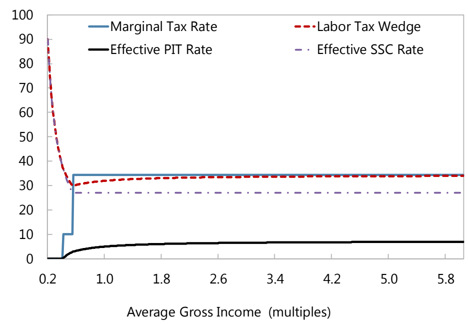
- ***Reduce untargeted subsidies and increase efficiency of social spending.*** Sizable savings can be made from rationalization of untargeted budgetary subsidies, particularly to the agricultural sector. For social assistance, better targeting and reallocation within the current envelope would improve social inclusion. While some programs— such as the Social Financial Assistance (SFA)— are well-targeted, only a quarter of total non-pension social benefits go to the poorest quintile. In addition, with concentration of poverty risks among the unemployed and the inactive, these programs should include labor activation components to ensure sustainable exit from poverty.

A more ambitious fiscal consolidation could be achieved through higher collection of VAT arrears, higher fuel taxation, and moving towards CPI-only indexation of pensions. These measures could yield a one-off gain of around 1–1½ percent of GDP and additional savings of around 1½ percent of GDP over the medium term, both of which could be used to support vital investment needs in infrastrucure and human capital.

FYR Macedonia: Fiscal Policy Recommendations

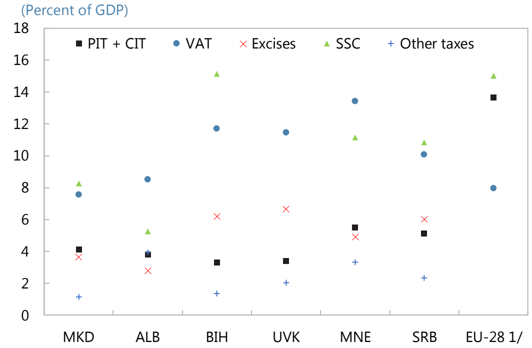
To increase work incentives, reduce labor tax wedge at the lower end in a revenue neutral way.

FYR Macedonia: Labor Income Taxation, 2016
(For a single person, no children)



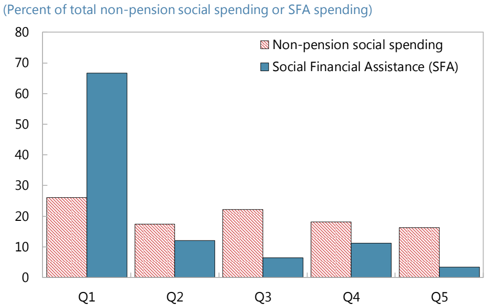
Raise additional revenues by improving VAT collection along with higher property taxation.

Tax Revenues in the Western Balkans
(Percent of GDP)



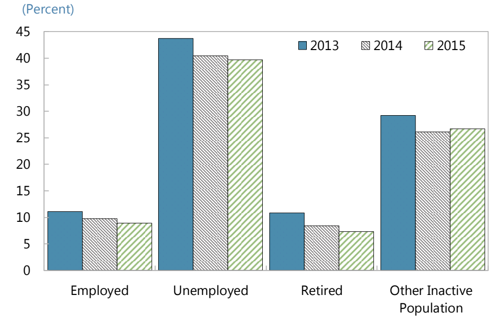
Improve efficiency of non-pension social spending where a redistribution in favor of the lower income group could yield higher inclusion

Benefit Incidence of Non-Pension Social Spending 2/
(Percent of total non-pension social spending or SFA spending)



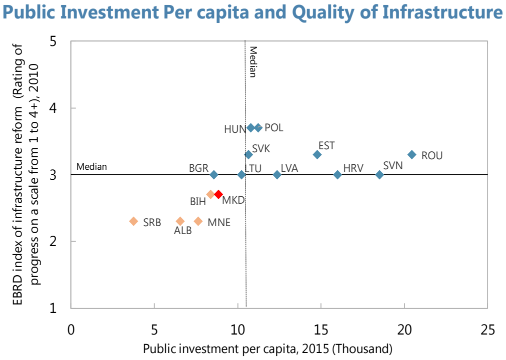
With at-risk-of-poverty population mostly concentrated among the unemployed and inactive, labor market reforms are important to improve inclusion …

At-Risk-of-Poverty Rates by Employment Status
(Percent)



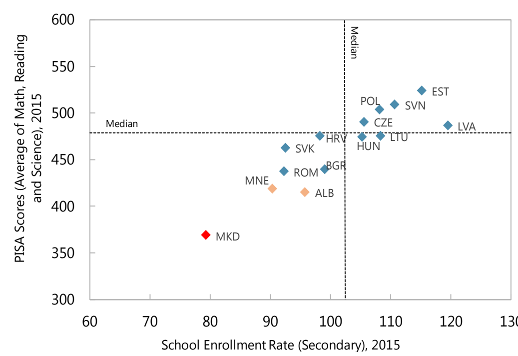
..along with stronger growth which will require public investment in infrastructure…

Public Investment Per capita and Quality of Infrastructure



… and human capital.

School Enrollment Rate and PISA Scores, 2015

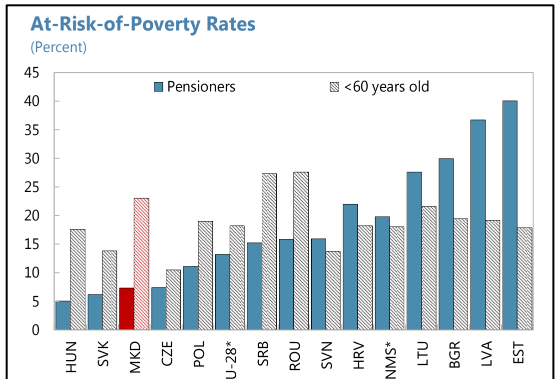


Sources: FYR Macedonia State Statistical Office; EBRD; Eurostat for EU-28; IMF FAD Investment and Capital Stock Dataset; OECD; World Bank ASPIRE data; World Economic Outlook; IMF Working Paper, WP/17/194, Western Balkans: Increasing Women's Role in the Economy; and IMF staff calculations.

1/ GDP weighted average. No breakdowns between tax and non-tax revenue available.

2/ Households are ranked by their per-adult equivalence disposable income. Benefit incidence is defined as shares to total benefits going to each quintile.

15. **Staff reiterated the need to rein in the pension deficit**. FYR Macedonia's generous pension system has reduced risks of poverty among pensioners, compared to both the domestic working-age population and pensioners in other countries. This has, however, come at a cost of unsustainable pension dynamics with the deficit at 4.4 percent of GDP in 2016. To ensure sustainability, staff recommends increasing the statutory retirement age to the average for EU countries, tightening options for early retirement, indexing pensions to CPI inflation only and refraining from ad-hoc increases.



Source: Eurostat.
*Unweighted average.

16. **Staff strongly supports the authorities' plan to strengthen public financial management (PFM) and enhance fiscal transparency**. Priorities include strengthening the capacity to prepare realistic macroeconomic forecasts and analyze fiscal risks, separating estimated budget impacts of on-going policies from new initiatives, and including policy plans and sectoral guidance in the medium-term fiscal strategy (MTFS) preparation. To prevent accumulation of new payment arrears, it is important to put in place a system to better control expenditure commitments. The improvement in public debt management, particularly efforts to lengthen the average maturity of domestic debt and authorities' plan to smooth out the external debt service profiles, is welcome and should be continued.

Authorities' views

17. **The authorities agreed on the need to rebuild fiscal policy space but also highlighted the importance of supporting employment and social inclusion.** While still in the process of preparing the 2018 budget and the Medium-term Fiscal Strategy, the authorities acknowledged the importance of keeping the headline fiscal deficit under 3 percent of GDP in 2018 through expenditure restraints and better revenue collection. However, they intend to implement the government's economic program to support investment and employment as planned and contain fiscal costs through annual limits on budgetary subsidies and cost-benefit analysis. In the medium term, the authorities agreed with staff's recommendation to reduce the overall deficit gradually to 2 percent of GDP to be achieved by further reduction of non-productive discretionary spending, improvement in revenue administration, and better targeting of social assistance, while they are also considering subsidies to enterprises as part of the plan to reignite economic growth. On revenue administration, the authorities appreciated the ongoing IMF technical assistance and expressed their commitment for continued engagement.

18. **The authorities stressed their intention to improve the management of public finances and further enhance fiscal transparency.** They acknowledged the ambitious scope of the draft PFM reform program and the need for prioritization. On arrears, they are working with the European Union and the World Bank to build a consolidated information platform, which will enable them to

regularly and properly take stock, verify, and report outstanding amounts, as well as develop a framework for clearance and a mechanism to prevent this problem from reappearing in the future.

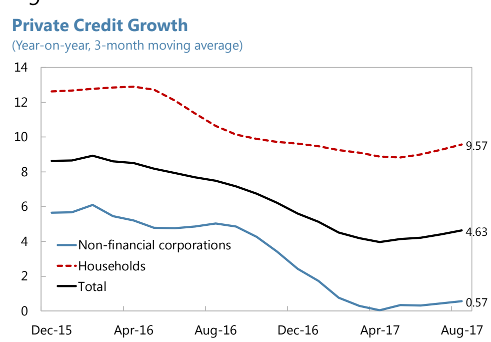
B. Monetary and Financial Sector Policies: Safeguarding Stability

Background

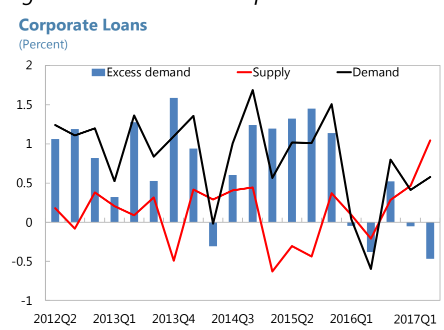
19. **After a period of robust growth, credit to the private sector slowed in 2016** (text chart). Despite continued monetary accommodation manifested by a low real policy rate, strong bank liquidity, and declining lending rates, credit growth to non-financial corporate (NFC) sector slowed significantly in 2016. A supply-demand decomposition points to demand factors becoming binding for both corporate and household credit growth in 2016Q2 largely reflecting confidence effects from the deepening political crisis.[1] With moderate household and corporate indebtedness to the banking sector (around 23 and 25 percent of GDP, respectively) and the return of political stability, staff projects a pick-up in credit growth in the medium term.

FYR Macedonia: Credit Growth and Fundamentals

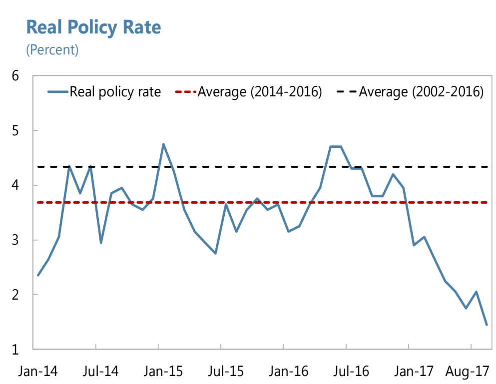
Credit growth slowed in 2016



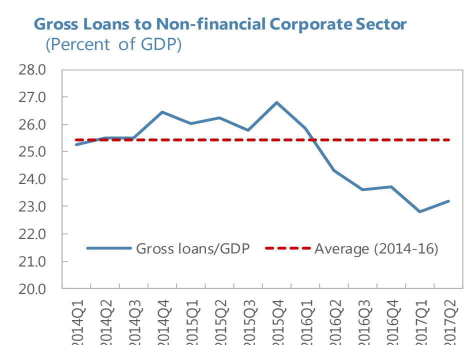
Reflecting lower demand due to political uncertainties



With accommodative conditions…



…and low corporate indebtedness, stronger credit growth is projected to resume.



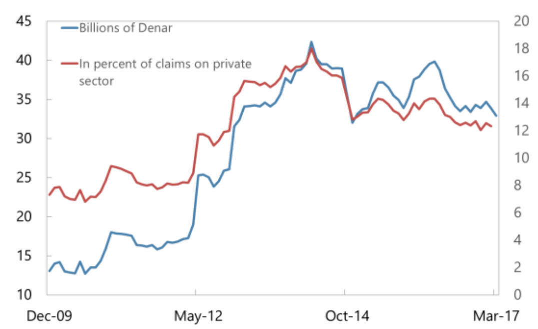
Sources: National Bank of the Republic of Macedonia; and IMF staff calculations.

[1] The analysis is based on the methodology in October 2012 GFSR.

20. **The banking sector remains healthy.** The banking system is currently well capitalized, liquid, and profitable. The capital adequacy ratio in 2017Q2 was almost twice the regulatory requirement of 8 percent. In late 2016 and 2017Q1, the authorities adopted several amendments to the Banking Law that brought capital standards in compliance with the Basel III accord.[2] Banking sector liquidity remains strong, with liquid assets at 2017Q2 making up more than a quarter of total assets and covering almost half of short term liabilities. Bank profitability has been improving since 2016Q2 benefiting from higher net interest income, mainly as a result of lower interest expenses, and improved cost efficiency (Figure 5). The non-performing loan (NPL) ratio stood at 6.5 percent in 2017Q2 reflecting the write off of loans that were fully provisioned for more than two years in 2016H1.

21. **High degree of euroization and possible deleveraging by parent banks constitute main risks to the financial sector.** Banks' FX lending to households appears well-hedged, but net exposure to the non-financial corporate sector remains sizable at around 5¾ percent of GDP (12 percent of total bank loans) which poses some credit risks. In addition, the banking system is exposed to risks of deleveraging by parent banks if credit growth fails to pick up and the appetite for government securities stays limited. Under the EU directive, EU parent banks with subsidiaries in FYR Macedonia are required to apply 100 percent risk weight to their subsidiaries' exposure to central bank and government securities. Commercial banks' holdings of sovereign assets have stabilized since 2014Q1.

Domestic Banks' Claims on Central Govenment



Sources: National Bank of Republic of Macedonia; and IMF staff calcualtions.

Macedonian banks' liabilities to EU -headquartered parents total (in 000 of EUR)

Source: NBRM, on the basis of data submitted by banks

22. **An accommodative monetary policy remains appropriate.** FYR Macedonia's still-limited integration with global financial markets and a sound financial sector provides some leeway for activist monetary policies despite the pegged exchange rate regime (classified as de-facto *stabilized arrangement*). With low inflation, still-negative output gap and stability on the external front, the current accommodative monetary conditions are appropriate. Staff recommends a tightening in case

[2] All banks currently meet the capital conservation buffer, while the capital buffer for seven systemically important banks will be phased in two steps, with full implementation by March 2018. In addition, the NBRM levies additional system-wide capital requirements (pillar 2) for bank-specific risks, which vary from 1.6 to 9.5 percentage points.

of sustained or rapid pick-up in inflation or precipitous pressures on foreign exchange reserves and loss of market confidence.

23. **As in the past, the NBRM may need to complement monetary policy with macro-and micro-prudential policies to counter risks**. For example, differentiated reserve requirements may need to be continued to facilitate financial de-euroization, and micro-prudential policies, including higher liquidity coverage ratio for individual banks, may be needed to counter possible deleveraging risks. The banking law limits the exposure to qualified shareholders including connected parties (parent banks and member of the banking group) to 10 percent of own funds. In addition, in case of risks to stability and safety of a particular bank or the banking system, the law empowers the NBRM to impose stricter limits on exposure to parent banks, higher liquidity requirements and stricter net FX position limits.

24. **Staff discussed possible policy responses in the event of stress.** In the hypothetical scenario of weaker confidence, similar to what was experienced in the recent past, the authorities may need to apply a combination of instruments to instill confidence, ranging from increased issuance of CB bills to absorb liquidity, a higher policy rate, and foreign exchange intervention to defend the exchange rate peg.

25. **Cooperation between the NBRM and the European Single Supervisory Mechanism (SSM) is satisfactory.** In October 2015, FYR Macedonia, together with four other southeastern European non-EU countries, signed a memorandum of understanding with the European Banking Authority (EBA) to establish a framework for cooperation and information exchange. The authorities are yet to be informed about the timing of the EBA's assessment of the equivalence of FYR Macedonia's supervisory and regulatory framework relative to that in EU countries.

Authorities' views

26. **The authorities broadly agreed with staff's views on the monetary policy stance**. They saw no ground at this stage for a change. A policy adjustment will depend on a number of factors: inflation developments, international reserves level, ECB policy, political stability and fiscal policy. They noted that the foreign exchange market is currently balanced, and that the small projected decline in reserves in 2017 is temporary and mostly related to the delay in external borrowing.

27. **The authorities see risks to banking system stability as contained**. They consider the adoption of the Basel III standards on capital adequacy as a strong tool to buttress banks' ability to withstand shocks. They noted that the strong liquidity position puts banks in a comfortable position to expand credit once the lingering effects of political uncertainty are removed. The NBRM did not consider high euroization as a significant risk, but underscored the importance of confidence to preserve the exchange rate peg and banking system stability. They intend to continue their de-euroization policy based on differentiated reserve requirements, but acknowledged the limits to what this policy can achieve. Low interest rates in EU parents have contained deleveraging risks, but the normalization of monetary policy in Europe may reignite risks. The authorities encourage the EBA to perform an assessment of the equivalence of FYR Macedonia's supervisory and regulatory

framework relative to that in EU countries to ease constraints on parent bank subsidiaries' purchases of government securities and CB bills.

C. Structural Policy: Strengthening Growth Potential

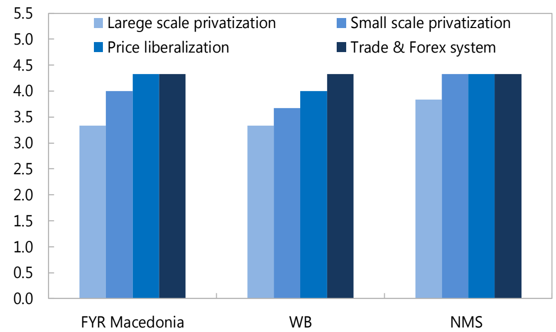
28. **Structural reforms have largely stalled in recent years.** FYR Macedonia made a strong push at the beginning of the transition process to gain grounds on broad reforms, particularly with regards to price liberalization, and trade and foreign exchange system. However, progress in more challenging areas of governance, regulatory quality and competition policy has largely stalled (text chart). Third-party indicators show that while FYR Macedonia fares well in macroeconomic stability, goods market efficiency and financial market development relative to emerging European peers, there is significant room for improvement in skills, labor market efficiency, infrastructure and institutions. Not surprisingly, the stock of per capita FDI has been relatively modest despite generous tax incentives, strong investor protection, and ease to set up business.

FYR Macedonia: Structural Reforms

FYR Macedonia fares well in broad reforms...

Transition Indicators, Latest

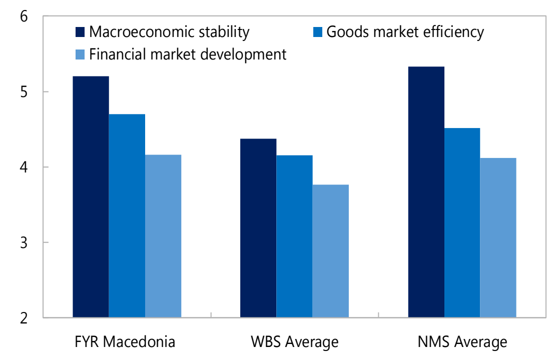
(Rating of progress on a scale from 1 to 4+)



..as well as in macroeconomic stability, goods market efficiency and financial sector development.

Global Competitiveness Report

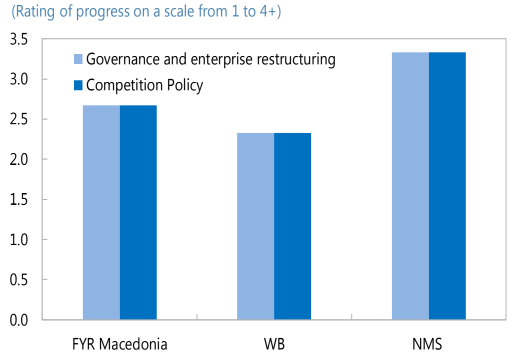
(Rating scores on a scale from 1 to 7)



However, in comparison to EU new member states, reforms are lagging in governance and competition ...

Transition Indicators, Latest

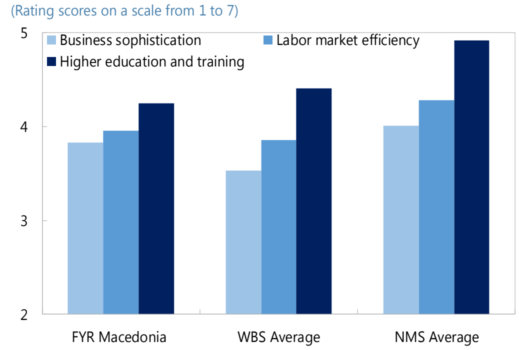
(Rating of progress on a scale from 1 to 4+)



.. business sophistication, workers' skills and labor market efficiency.

Global Competitiveness Report

(Rating scores on a scale from 1 to 7)



Source: EBRD and Global Competitiveness Report, 2016–17.

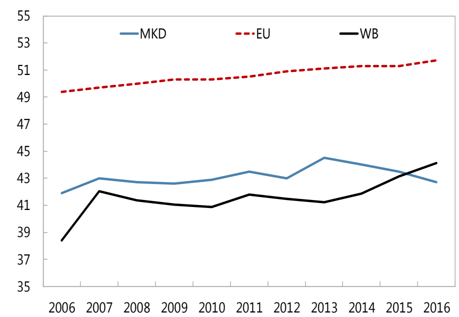
Note: Country group aggregates reflect median. NMS stands for new member states of the European Union.

29. **A significant share of working age population remains untapped.** Female labor force participation rates are among the lowest in Europe with inactivity rates for women significantly higher than men across all age groups, including for prime age (25–54) women (text chart). About a quarter of young working age women (15–24) are neither in school nor in employment. Staff's

FYR Macedonia: Labor Force Participation

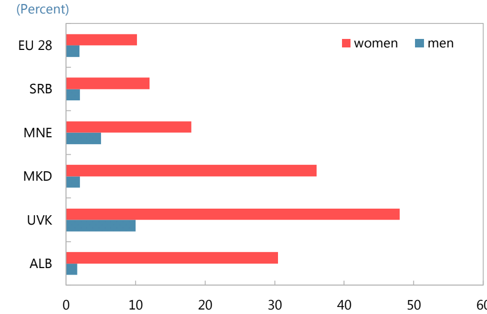
Less than half of working age women are active…

Female labor force participation rate
(percent)



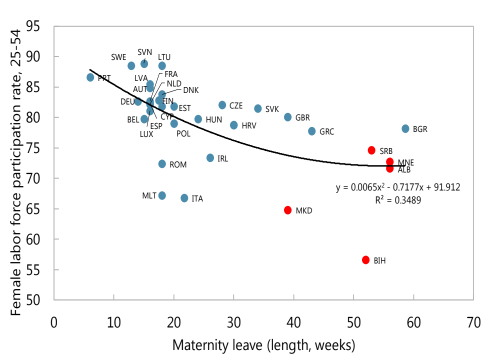
Family responsibilities provide an important explanation…

Share of Women and Men Indicating Family and Personal Reasons for Inactivity
(Percent)



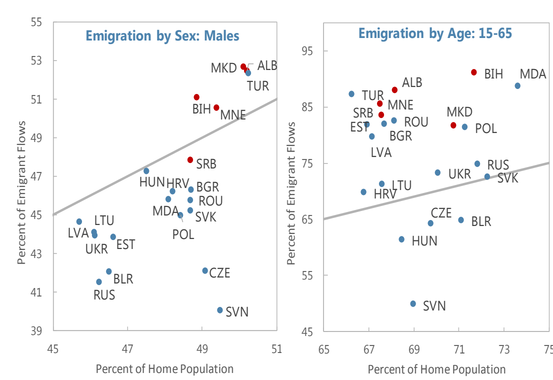
…Partly driven by family leave policies, and…

Paid Maternity Leave and Female Labor Force Particiaption



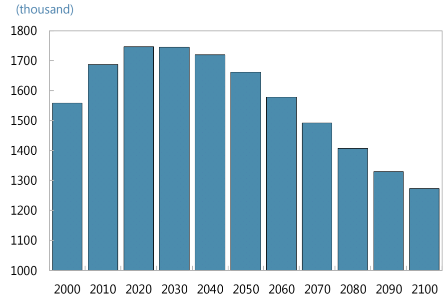
..and emigration of male population.

Demographics of Emigration Flows to OECD Countries



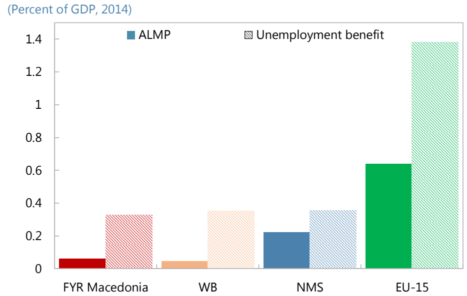
With aging population, it is important to make optimal use of available labor…

Working age population in FYR Macedonia
(thousand)



…which will need more active labor market policies given high structural unemployment.

Active Labor Market Policy and Unemployment Benefit 1/
(Percent of GDP, 2014)



Sources: Eurostat, Labor force surveys; FYR Macedonia State Statistical Office; ILO; OECD; UN statistics; World Bank World Development Indicators (WDI); and IMF staff calculations.

1/ ALMP (Active Labor Market Policy) includes training, employment incentives, job creation and start-up incentives. Country group aggregates reflect simple average.

analyses show that disproportionate family responsibilities due partly to a family leave policy heavily tilted toward mothers and emigration of young males, and a lack of quality and affordable childcare contribute to high inactivity rates among women in FYR Macedonia and other Western Balkan countries, particularly for women with lower-than-tertiary education.[3]

30. **With a projected decline in the working age population, multipronged policies are needed to ensure optimal use of available labor.** Labor market, welfare, and fiscal policies need to ensure that labor taxation, pension benefits and social assistance do not create inactivity traps or push people into the informal sector. Family leave policies should try to increase a balance between maternity and paternity leave to ensure women's continued participation in the labor force after child birth. Greater availability of childcare is also important. Further reduction of unemployment, mostly structural and concentrated among the low-skilled and youth, will require scaling up of active labor market policies with a clear focus on skills and on-the-job training, and reforms in the education system to ensure a better job market transition. In view of large regional diversion in unemployment rates, geographically targeted policies and better infrastructure are also needed to increase employment in under-developed regions.

31. **To ensure greater integration with the EU and attract higher FDI, policies will need to strengthen institutions and trade logistics.** Experience of central European economies shows that FDI inflows, facilitated by financial incentives, skilled low-cost labor and predictable business environment, can act as a strong anchor for export-driven growth and convergence. For FYR Macedonia, given the already attractive tax rates and generous financial incentives, higher level of FDI will require a decisive improvement in skills, infrastructure, governance and trade logistics. Governance reforms are critical not just for foreign investors, but also domestic entrepreneurs who identified policy uncertainties as the number one constraint for doing business (see *Global Competitiveness Report*, 2017-18). Staff's analysis shows that raising FYR Macedonia's policy and institutional quality to that of the median or best-performing EU new member state could result in additional FDI inflows of 2-4 percent of GDP in the medium term (Annex 2).

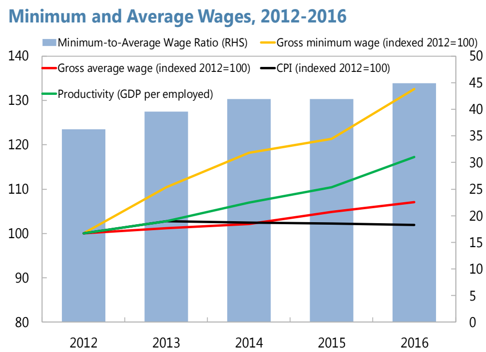
32. **Further increases in minimum wages, as planned, pose competitiveness concerns and may exacerbate regional unemployment**. Like other countries in emerging Europe, FYR Macedonia has seen sizable increases in minimum wages in recent years (a cumulative 32 percent increase during 2012–16 in gross nominal terms) both relative to productivity and inflation. At 45 percent of the average wage and 58 percent of GDP per capita, the current minimum wage level is one the highest among peers (text chart). Staff's analysis shows that, while the economy-wide average wage level is currently broadly in line with productivity, further increases in minimum wages, as planned, could reduce employment among the low-skilled, particularly in sectors where a large share of workers is compensated at the minimum wage level. Through close correlation with the average

[3] See Atoyan and Rahman, *Western Balkans: Increasing Women's Role in the Economy*, IMF Working Paper No. 17/194.

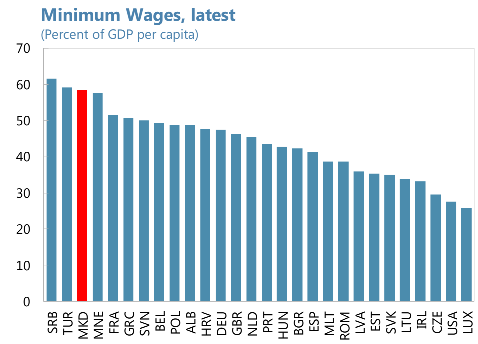
wage, higher minimum wages could also jeopardize labor-intensive export industries and competitiveness.

FYR Macedonia: An Assessment of Minimum Wage Level

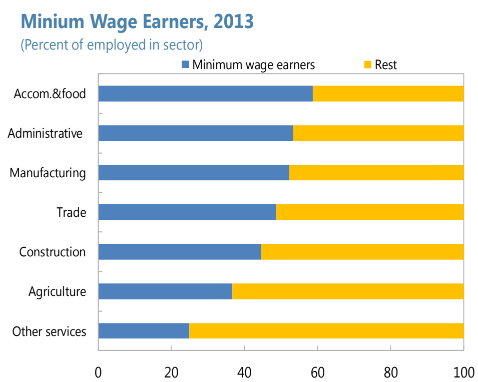
Minimum wages have increased rapidly relative to productivity and inflation…



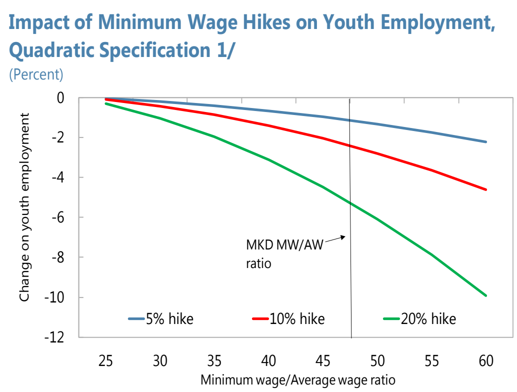
Compared to other emerging European countries, minimum wage relative to per capita income is one of the highest.



Further increases could negatively affect employment in sectors that rely on low-skilled workers…



…as well as youth workers.



Sources: Eurostat; World Economic Outlook; FYR Macedonia State Statistical Office; and IMF staff calculations.
1/ The sample includes 17 central and eastern European countries during 2000-15.

Authorities' views

33. **The authorities agreed with the urgency to reduce unemployment and improve labor force participation**. Reducing youth unemployment is a priority, including through the youth guarantee program which focuses on increasing links with potential employers, internships and training. They shared concerns over low labor force participation rates, especially among women, and considered a lack of adequate and affordable childcare a main contributor. The authorities plan to increase availability of publicly-funded childcare facilities, with better geographical coverage and greater income progressivity in tuition payments to contain fiscal impact. They agreed that addressing skill mismatches is key to promoting employment growth and reducing emigration. While acknowledging the role of the high labor tax wedge in affecting employment growth, they had no

plans to reduce social contributions, even at the low end, noting that they were essential for redistribution and that past attempts to reduce them had widened the pension fund deficit.

34. **The authorities noted that improving the quality and transparency, checks and balances and democratic processes of public institutions are at the core of their agenda.** The government has proposed a wide-ranging reform program—"Plan 3–6–9"—to address key institutional weaknesses in the judiciary, public administration and functioning of security apparatus (Box 2). The plan addresses the urgent reform priorities identified by the European Commission (EC) to further the country's prospective accession to the EU. The authorities hope that material progress in these areas will usher a stronger cooperation with the EU paving the path to opening accession negotiations.

Box 2. The Authorities' 3–6–9 Plan to Improve Governance and Rule of Law 1/

Judiciary. The reform plan aims to free the judicial system from political interference and create an environment for adopting the necessary legal amendments to ensure the independent functioning of courts while providing recourse for disciplinary responsibility of judges. The reform measures among other include:

- Revising the Draft Strategy for reform of the justice sector in line with the recommendations of the EC, the Venice Commission, and Group of States Against Corruption (GRECO);
- Organizing open discussions on the elements of the justice system reform in working groups and public;
- Providing institutional support and resources to the Office of Special Prosecutor.

Public administration. The reform targets creation of a fully depoliticized, professional, and service-oriented public administration that would have clear accountability lines based on effective public financial management. The Government measures focus on:

- Revising the Draft Strategy and the Draft Action Plan for the implementation of the public administration reform and launching an inclusive dialogue on the Draft Program for Public Finance Management 2018-2021 with the representatives of civil society, experts and academia, international organizations and other interested parties;
- Declassifying all documents of public interest and obliging institutions to publish public documents on their websites;
- Revising the Register of public information holders and persons authorized for free access to public information and publishing the accurate total count of public employees by sectors.

Fight against corruption and organized crime. Despite the existing legislative and institutional framework developed over a decade, corruption remains prevalent in many areas including judiciary, law enforcement capacity, and public procurement. Political interference in the work of anti-corruption government bodies hampers their ability to act proactively and non-selectively, especially in high-level cases. The government measures aim to focus on:

- Launching the reforms of the Ministry of Interior's anti-corruption unit, Customs Administration, and Financial Police, and establishing an inter-ministerial working group to improve the capacity and expertise for conducting investigations and confiscation of assets on a more systematic basis;
- Preparing a detailed report on all initiated procedures and investigations for corruption in the last five years.

1/ Prepared by Gjorgji Nacevski.

35. **The authorities acknowledged the benefits of FDI, but noted the importance of establishing a level-playing field.** They considered the existing subsidy system for foreign investors as too expensive and lacking transparency, with a limited "greenfield" component and links to the domestic private sector. While respecting existing FDI contracts, the authorities emphasized the need

to establish a level playing field going forward, applying same subsidy rules to foreign and domestic investors alike. They consider a results-based and transparent set of investment incentives would limit the scope for corruption and increase employment and growth in the long run.

STAFF APPRAISAL

36. **Real GDP growth is projected to moderate in 2017 but pick up in the medium term.** Supported by expanded export capacities, higher investor confidence and continued improvement in labor market, growth is projected to rebound from 1.9 percent in 2017 to 3.2 percent in 2018 and towards 3.8 percent in the medium term. Downside risks to the outlook are both domestic and external, arising from risks of renewed political instability in the context of the upcoming local elections and lower exports and FDI inflows due to possible weaker economic conditions in trading partners and global policy uncertainties. On the upside, more stable political conditions may lead to a decisive push for structural reforms enhancing EU accession prospects and growth potential.

37. **Fiscal consolidation should start without delay.** The overall fiscal deficit is projected to be around 3 percent of GDP in 2017 and stay above 3½ percent of GDP in the medium term reflecting the government's planned expansionary measures and clearance of unpaid claims. As a result, public debt is expected to exceed 53 percent of GDP by 2022, with gross fiscal financing needs increasing to around 15½ percent of GDP increasing fiscal risks. Meanwhile, FYR Macedonia faces significant investment needs to upgrade its infrastructure and human capital. To support these needs and ensure public debt sustainability, staff recommends a reduction in the overall fiscal deficit to 2 percent of GDP in the medium term to stabilize public debt below 50 percent of GDP by 2022.

38. **Fiscal consolidation should rely on both revenue- and expenditure-based measures.** In the past two years, improvements in the overall fiscal deficit were largely due to one-off measures reflecting spending constraints imposed during the pre-election period, under-execution of capital spending and accumulation of arrears. To create durable policy space, staff recommends not to implement increases in current spending as planned in the draft economic program and, instead, adopt the following measures: (i) achieve higher VAT efficiency based on enhanced coverage and targeting of compliance risks, improved operation of the large tax-payer officer, and establishment of a fully-functioning risks management unit; (ii) increase property taxes at the upper end, and increase fuel taxation; (iii) reduce untargeted subsidies, particularly in the agricultural sector; (iv) improve efficiency of existing social assistance programs; and (v) rein in pension deficits through both parametric reforms and avoidance of ad-hoc increases.

39. **Tax, social assistance, and wage policies should target higher participation and employment in the formal labor market, while supporting competitiveness.** Reducing the high labor tax wedge at low-income levels, by adjusting the minimum income base for the social security contribution towards the minimum wage level, would help stimulate participation and formal employment. In addition, any increases in the minimum wage should be closely aligned with productivity gains to avoid erosion of competitiveness or increase informality. Staff strongly supports

the authorities' intention to improve social inclusion which needs to be achieved by better targeting as well as addition of labor activation components in existing social assistance programs.

40. **With external stability, low inflation, and a still-negative output gap, the current accommodative monetary policy remains appropriate.** In recent years, improving trade balance due to low energy prices and strong exports has supported external stability with adequate official reserves. Staff assesses the external position to be broadly in line with economic fundamentals, with wages in line with economic fundamentals and steady export market gains. Monetary tightening will be needed if, among other things, inflation increases rapidly or there is a loss of market confidence.

41. **The financial sector remains well-capitalized, liquid, and profitable**. Strong policy actions by the NBRM last year after a period of turbulence, were instrumental in preserving banking system stability. The adoption of Basel III standards on capital adequacy earlier this year further reinforces the capacity of the banking system to withstand shocks. However, there are balance sheet risks from a high degree of financial euroization and possible deleveraging risks from large presence of parent banks headquartered in EU countries. The authorities should monitor developments closely and use micro and macroprudential tools as needed to manage these risks.

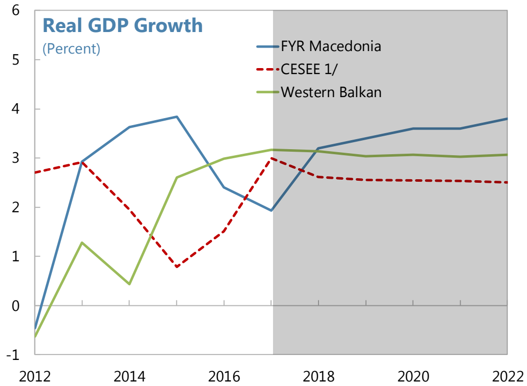
42. **With population set to age rapidly, policies need to ensure full participation of available workforce.** Scaling up active labor market policies with a focus on training and skills improvements, lowering the labor tax wedge for earners at the lower end, and education policies to ensure a better job market transition would help further reduce structural unemployment. To increase female labor force participation, which is among the lowest in Europe, reforms should focus on revising family leave policies to provide greater flexibility between parents and increase availability of affordable childcare.

43. **Given the already attractive tax regime and financial incentives to foreign firms, strengthening institutions would be key to raising FDI inflows.** With stability on the political front, significant gains in FDI can materialize if FYR Macedonia raises its institutional quality to that of the average EU member country. Improved governance, better trade logistics and infrastructure, and availability of skilled and professional workers would cement confidence of both foreign and domestic investors, enabling a higher level of steady FDI inflows.

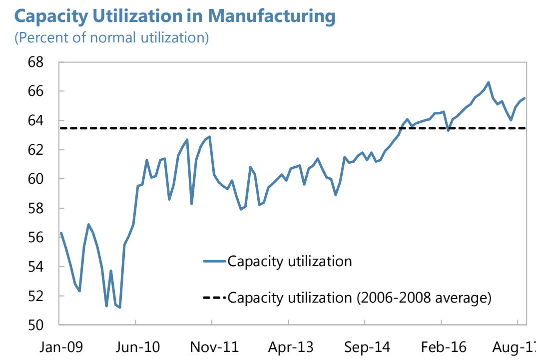
44. **It is recommended that the next Article IV consultation with FYR Macedonia be held on the standard 12-month cycle.**

Figure 1. FYR Macedonia: Real Sector Developments, 2008–2022

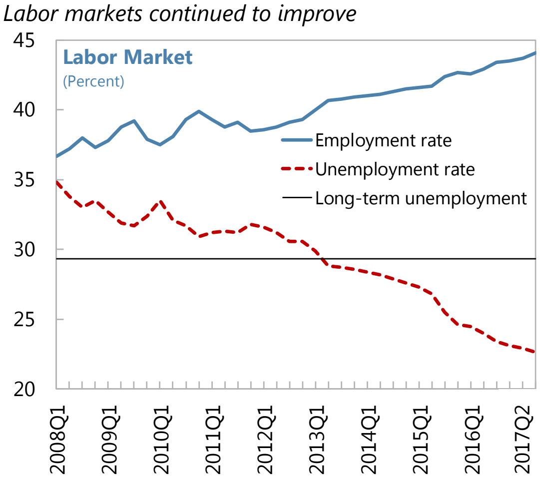
Growth saw a significant slowdown recently, but is expected to pick up in the medium-term



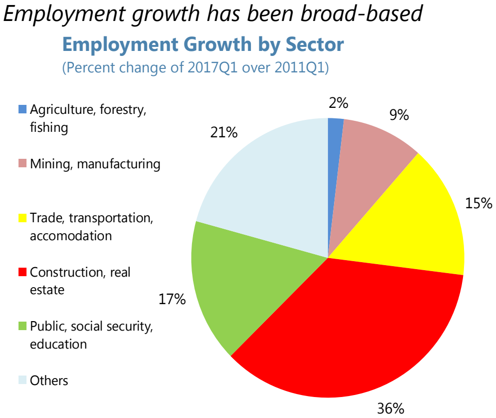
Capacity utilization in the manufacturing sector remained above the pre-crisis level.



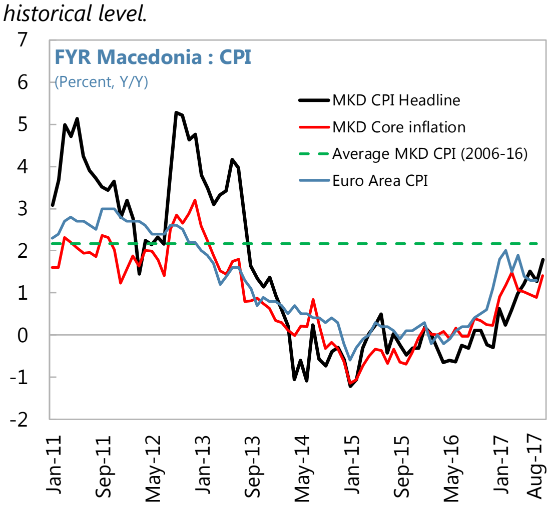
Labor markets continued to improve



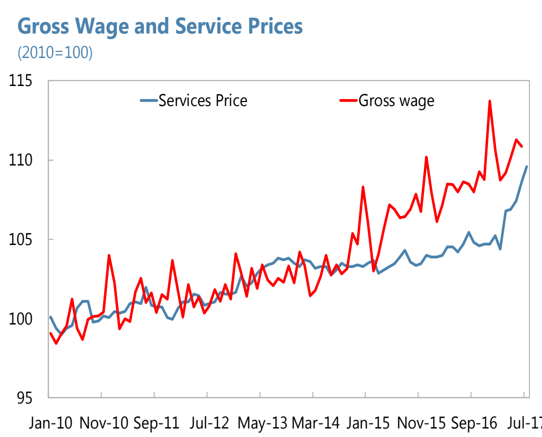
Employment growth has been broad-based



Inflation is picking up recently, but remains below the historical level.



Wages are also on the rise.

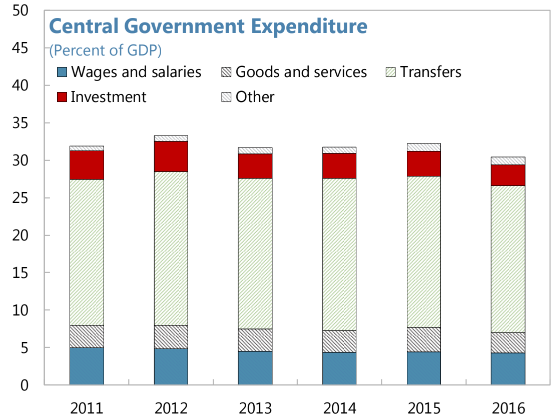


Sources: National authorities; and IMF staff calculations.

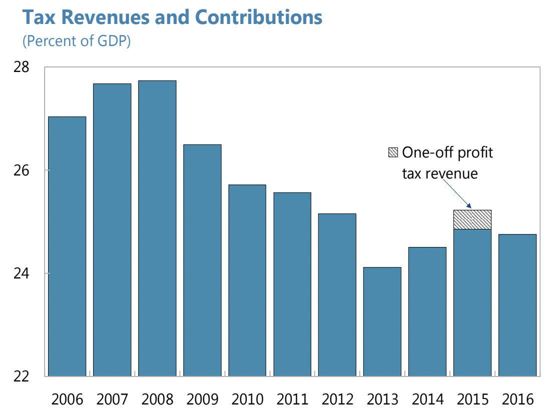
1/ CESEE: Albania, Belarus, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Ukraine, and Turkey. Western Balkan includes Albania, Bosnia, Bulgaria, Croatia, Kosovo, Macedonia, Montenegro and Serbia.

Figure 2. FYR Macedonia: Fiscal Sector Developments, 2006–2022

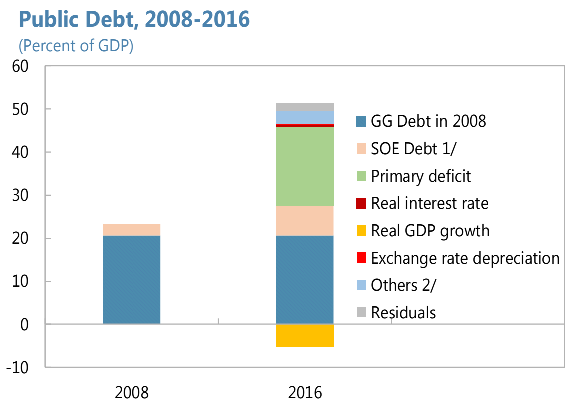
Expenditures have remained relatively stable as a share of GDP



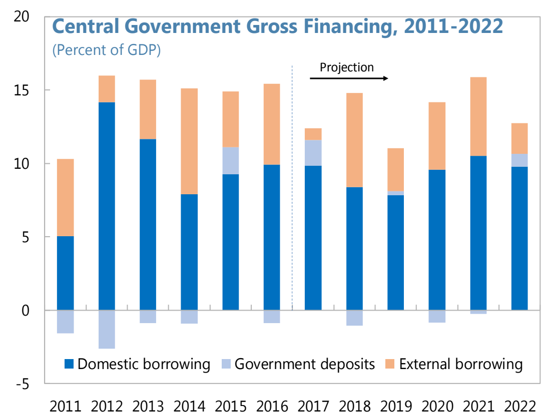
Tax revenues and social contributions have declined.



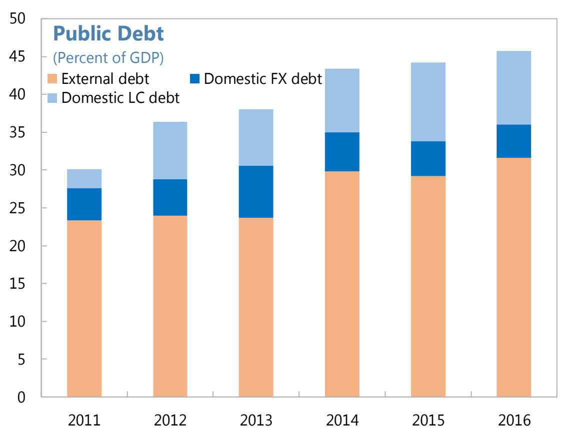
Rising primary deficits have increased public debt.



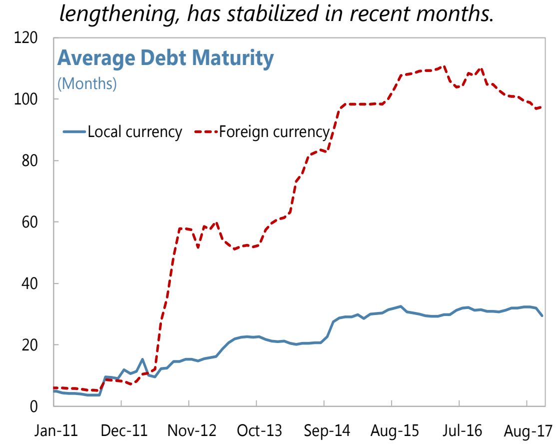
The share of external financing has increased over time.



Consequently, external public debt has increased.



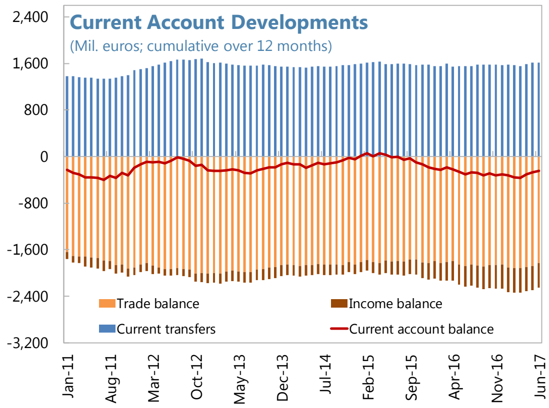
Average debt maturity, after significant gains in lengthening, has stabilized in recent months.



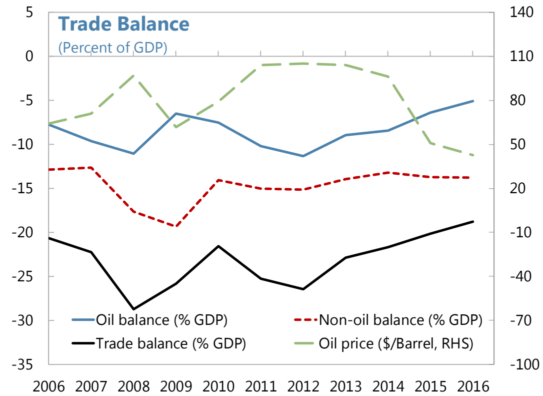
Sources: National authorities; and IMF staff calculations.
1/ SOE debt presented here includes only non-financial public enterprises.
2/ Other debt creating flows include, for instance, privatization receipts, changes in cash deposits or securities held for liquidity purposes, etc.

Figure 3. FYR Macedonia: External Sector Developments, 2006–2017

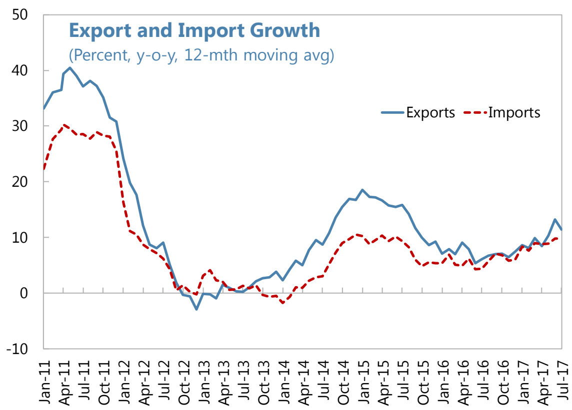
The current account deficit widened a little



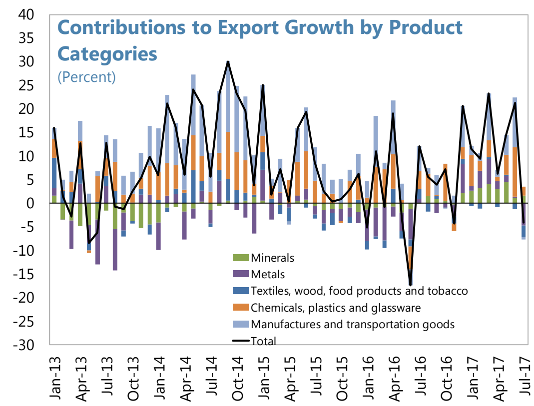
Trade balance continued to improve supported by favorable energy price



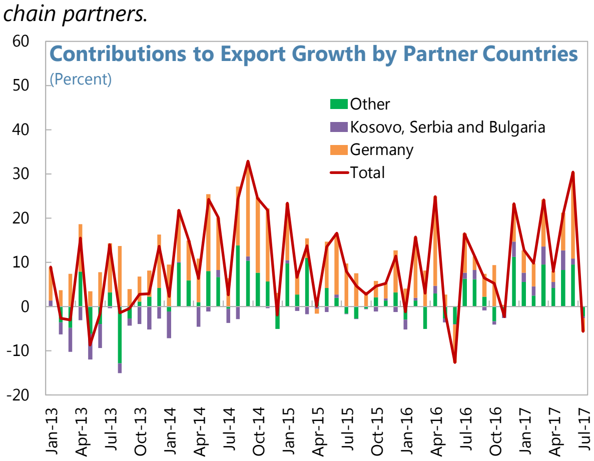
Export growth has been robust



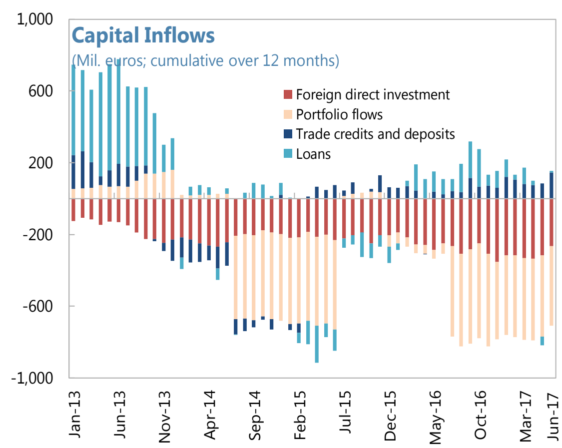
led by machinery and chemical exports.



Exports have benefited from links to European supply chain partners.



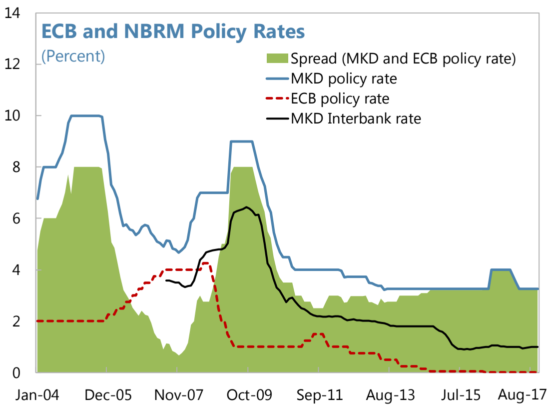
FDI inflows held up despite the political crisis



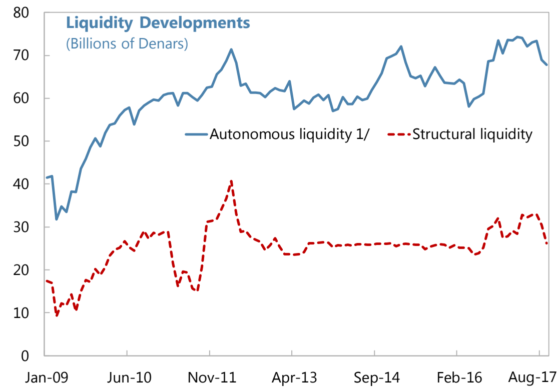
Sources: National authorities; and IMF staff calculations.

Figure 4. FYR Macedonia: Monetary Sector Developments, 2004–2017

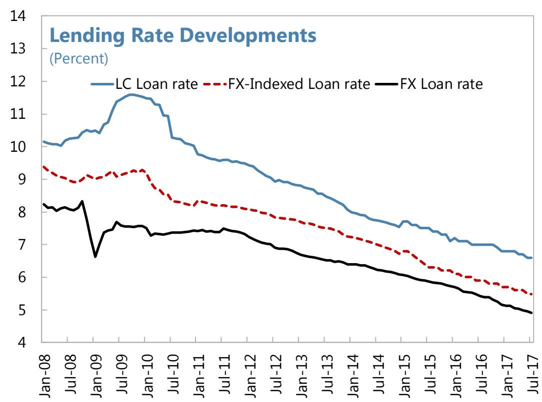
The NBRM reduced the policy rate recently



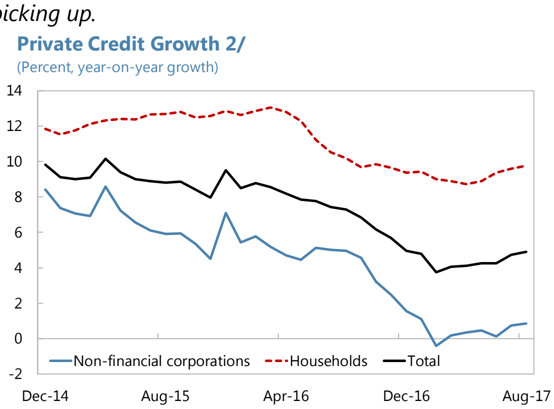
Liquidity is strong.



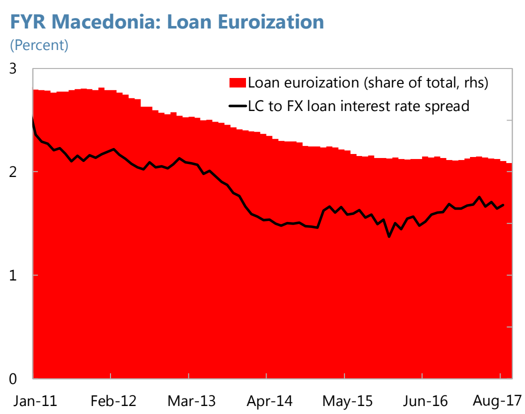
Lending rates continued to decline.



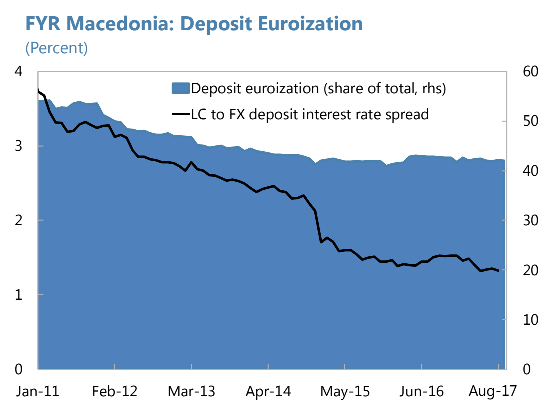
Credit growth, after a slowdown in 2016, seems to be picking up.



De-euroization seemed to have stalled on both asset...



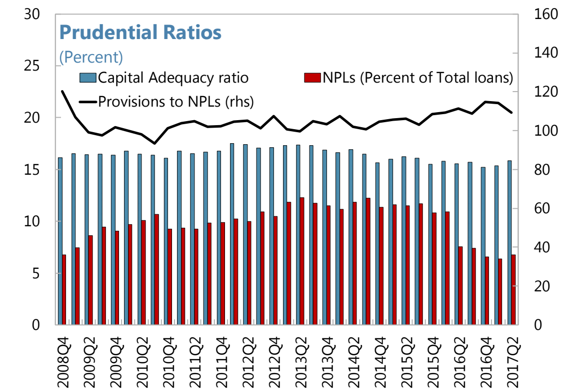
.. and the liability sides.



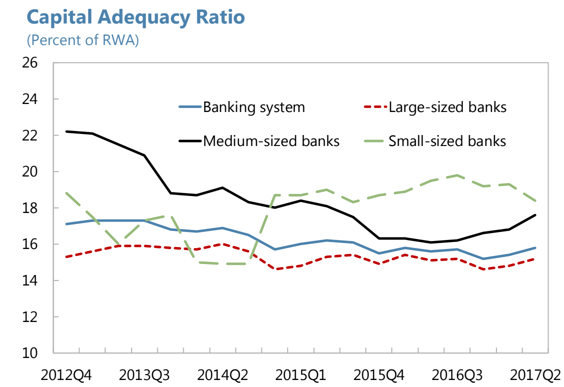
Sources: NBRM; and IMF staff calculations.
1/ Autonomous liquidity is computed as the sum of net foreign assets, net public sector assets, net bank assets, other items net, minus currency in circulation. Structural liquidity is calculated as autonomous liquidity minus reserves held by banks at the central bank. 2/ Credit growth series for March-June 2016 reflect adjustments for the NPL write--offs.

Figure 5. FYR Macedonia: Banking Sector Developments, 2008–2017

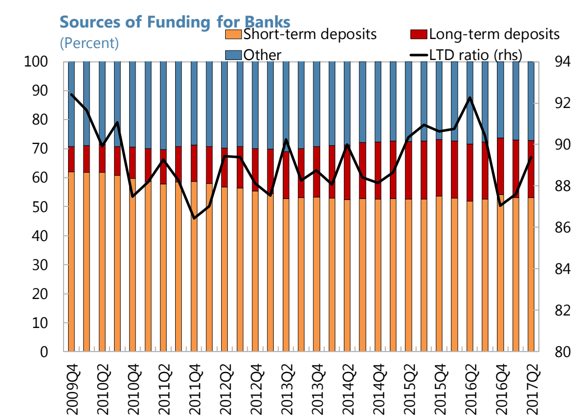
Banking sector remains resilient…



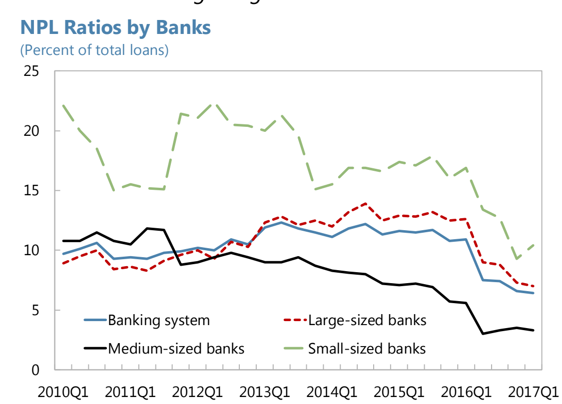
…with adequate capitalization



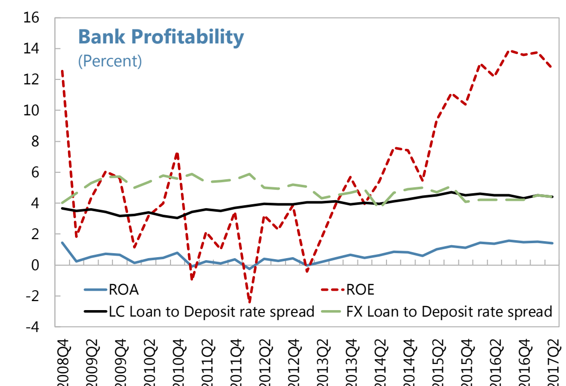
..and a funding structure reliant on domestic deposits.



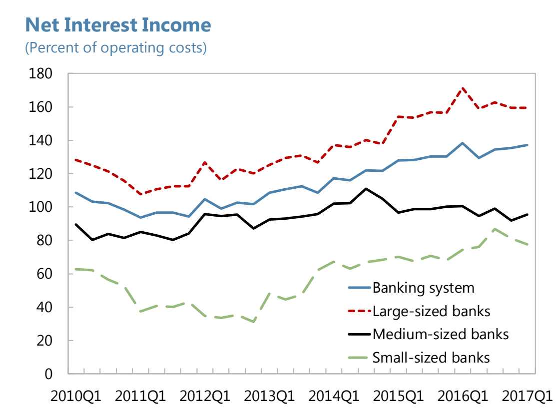
NPLs are in the single-digits.



Rising profitability is supported by…



…, net interest income.



Sources: NBRM; and IMF staff calculations.

Table 1. FYR Macedonia: Macroeconomic Framework, 2012–2022
(Year-on-year percentage change, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
								Projections			
Real GDP	-0.5	2.9	3.6	3.8	2.4	1.9	3.2	3.4	3.6	3.6	3.8
Real domestic demand	3.5	1.3	4.4	3.4	1.5	1.0	2.6	2.7	2.7	2.7	2.7
Consumption	1.4	1.6	2.4	3.4	3.7	2.6	2.5	2.5	2.5	2.4	2.4
Private consumption	1.2	1.9	2.2	3.7	4.2	3.0	2.6	2.7	2.8	2.8	2.8
Gross investment	10.2	0.5	10.7	3.6	-4.3	-3.6	3.0	3.3	3.5	3.6	3.7
Exports (volume)	2.0	6.1	16.5	6.7	11.5	11.8	11.0	11.0	11.1	11.1	11.0
Imports (volume)	8.2	2.2	14.1	5.2	7.6	8.8	8.6	8.6	8.7	8.8	8.7
Contributions to growth 1/											
Domestic demand	4.0	1.6	5.2	4.1	1.8	1.7	3.0	3.1	3.1	3.0	3.0
Net exports	-3.9	1.3	-1.3	-0.2	0.7	0.3	0.2	0.3	0.5	0.6	0.8
Output gap (percent of potential GDP)	-1.9	-1.3	-0.5	-0.4	-0.5	-0.5	-0.3	-0.2	-0.1	0.0	0.0
Central government operations (percent of GDP)											
Revenues	29.5	27.8	27.5	28.8	27.8	28.3	28.4	28.5	28.5	28.5	28.5
Expenditures	33.3	31.7	31.7	32.3	30.5	31.3	32.2	32.3	32.3	32.3	32.3
Of which: capital	4.0	3.3	3.3	3.3	2.8	3.0	3.2	3.2	3.2	3.2	3.2
Balance	-3.8	-3.8	-4.2	-3.5	-2.6	-3.0	-3.7	-3.7	-3.7	-3.8	-3.8
Savings and investment (percent of GDP)											
Domestic saving	25.8	27.2	29.8	29.1	30.9	31.3	31.5	31.1	30.9	30.9	31.1
Public	0.2	-0.5	-0.9	-0.1	0.2	0.0	-0.5	-0.5	-0.5	-0.6	-0.6
Private	25.5	27.7	30.6	29.3	30.7	31.3	32.0	31.7	31.5	31.5	31.7
Foreign saving	3.2	1.6	0.5	2.0	2.7	1.9	2.2	2.5	2.8	2.9	2.9
Gross investment	28.9	28.8	30.3	31.1	33.6	33.2	33.6	33.7	33.8	33.9	33.9
Consumer prices											
Period average	3.3	2.8	-0.3	-0.3	-0.2	1.2	1.7	1.9	2.0	2.0	2.0
End-period	4.7	1.3	-0.5	-0.3	-0.2	1.7	1.7	2.0	2.0	2.0	2.0
Private sector credit growth	5.2	6.3	9.8	9.5	1.0	5.8	6.0	6.2	6.4	6.6	6.8
Memorandum items:											
Current account balance (percent of GDP)	-3.2	-1.6	-0.5	-2.0	-2.7	-1.9	-2.2	-2.5	-2.8	-2.9	-2.9
Gross official reserves (millions of euros)	2,193	1,993	2,437	2,262	2,613	2,493	2,964	3,269	3,378	3,431	3,591
in percent of ST debt	92.1	96.1	105.2	101.2	102.5	95.5	118.2	111.1	111.0	132.7	130.4
in months of prospective imports	5.2	4.3	5.0	4.3	4.6	4.1	4.5	4.6	4.4	4.1	n.a.
Gross general government debt (percent of GDP)	33.7	34.0	38.0	38.2	39.0	38.8	41.6	42.9	45.1	46.6	46.9
Public and publicly guaranteed debt (percent of GDP) 2/	36.2	37.9	43.3	44.1	45.7	47.1	50.7	51.7	53.1	53.9	53.5
Foreign direct investment (percent of GDP)	1.7	2.8	2.3	2.2	3.2	2.8	2.6	2.8	3.0	2.9	3.0
External debt (percent of GDP)	68.2	64.0	70.0	69.4	73.5	71.8	75.4	72.9	70.1	70.5	69.5
Nominal GDP (billions of denars)	467	502	528	558	607	632	665	701	742	786	834
Nominal GDP (millions of euros)	7,585	8,150	8,562	9,061	9,862	10,254	10,793	11,383	12,053	12,761	13,538

Sources: NBRM; SSO; MOF; World Bank; and IMF staff estimates and projections. National Accounts are revised by SSO, using ESA 2010 Methodology.

1/ Including general government and public sector non-financial enterprises.

Table 2a. FYR Macedonia: Central Government Operations, 2012–2022
(Billions of denars)

	2012	2013	2014	2015	2016	2017			2018	2019	2020	2021	2022
						Budget	Supp. Budget	Proj.	Projections				
Total Revenues	137.5	139.7	145.2	160.7	169.0	187.2	184.4	178.6	189.1	200.1	211.9	224.4	238.0
Tax Revenues and Contributions	117.4	121.0	129.3	140.8	150.4	160.7	159.5	157.7	166.4	176.2	186.6	197.5	209.6
PIT	9.6	10.3	12.3	12.9	14.2	15.3	15.2	15.0	15.8	16.6	17.6	18.6	19.8
CIT	3.7	4.4	5.1	12.0	10.8	11.6	11.8	11.2	11.8	12.4	13.2	13.9	14.8
VAT (net)	38.5	39.8	43.9	41.7	45.9	52.1	49.1	48.1	50.6	54.1	57.2	60.6	64.3
Excises	16.6	16.0	17.4	19.8	22.2	22.6	23.3	23.3	24.6	25.9	27.4	29.0	30.8
Custom Duties	4.1	4.3	4.2	4.3	4.8	5.0	5.1	5.0	5.2	5.5	5.8	6.2	6.5
Other Taxes	4.3	3.8	2.3	2.2	2.2	2.3	2.2	2.2	2.7	2.9	3.0	3.2	3.4
Social Contributions	40.8	42.4	44.2	47.9	50.3	51.9	52.7	53.0	55.8	58.8	62.3	65.9	70.0
Pensions	27.5	28.6	29.7	32.2	33.8	35.0	35.5	35.6	37.5	39.5	41.9	44.3	47.0
Unemployment	1.7	1.8	1.9	2.0	2.2	2.2	2.2	2.3	2.4	2.5	2.7	2.8	3.0
Health	11.5	12.0	12.6	13.6	14.3	14.8	15.1	15.1	15.9	16.8	17.7	18.8	19.9
Non-Tax Revenues	12.6	12.1	10.6	12.9	13.0	17.5	16.3	13.7	15.0	15.9	16.8	17.8	18.9
Capital Revenues	4.4	3.1	1.9	2.3	2.0	2.6	1.9	1.9	2.0	2.2	2.3	2.4	2.6
Grants	3.0	3.5	3.4	4.7	3.6	6.3	6.6	5.3	5.6	5.9	6.2	6.6	7.0
Expenditures	155.2	158.9	167.3	180.1	185.0	205.8	203.0	197.6	213.9	226.3	239.5	254.0	269.7
Current Expenditures	137.1	142.9	150.4	162.0	168.4	179.3	179.9	179.1	190.3	202.4	216.3	229.4	243.6
Wages and salaries	22.7	22.6	23.1	24.7	26.0	26.8	26.6	26.6	28.5	30.5	32.3	34.2	36.3
Goods and services	14.7	14.9	15.5	18.1	16.8	19.6	17.7	16.8	18.0	18.9	20.8	22.0	23.3
Transfers	95.5	100.8	106.8	112.7	118.9	124.6	127.4	127.5	135.1	143.4	152.6	161.6	171.5
Pension fund expenditures	40.9	45.0	48.1	50.3	54.6	56.7	57.9	58.0	61.4	65.1	68.9	73.0	77.4
Health	20.9	21.4	22.1	23.6	25.6	26.4	27.1	27.1	28.5	30.1	31.8	33.7	35.7
Other	33.7	34.5	36.6	38.8	38.7	41.6	42.4	42.4	45.2	48.2	51.9	54.9	58.3
Interest	4.2	4.6	5.1	6.5	6.8	8.2	8.2	8.2	8.8	9.6	10.5	11.6	12.5
Capital Expenditures	18.8	16.6	17.6	18.7	17.0	27.0	23.4	18.9	21.2	22.3	23.7	25.1	26.6
Lending minus repayment 1/	-0.6	-0.6	-0.7	-0.5	-0.4	-0.5	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.5
Clearance of unpaid claims 2/								0.0	2.8	1.9	0.0	0.0	0.0
Overall fiscal balance	-17.7	-19.3	-22.1	-19.4	-16.1	-18.6	-18.6	-19.0	-24.8	-26.2	-27.6	-29.7	-31.7
Primary fiscal balance	-13.5	-14.7	-17.0	-13.0	-9.2	-10.4	-10.4	-10.8	-16.1	-16.6	-17.1	-18.1	-19.2
Financing	17.7	19.3	22.1	19.4	16.1	18.6	18.6	19.0	24.8	26.2	27.6	29.7	31.7
Domestic	13.3	13.1	-6.1	21.7	-3.4	10.2	4.1	23.0	-7.2	11.8	25.3	25.2	21.6
Central Bank deposits	-12.3	-0.3	-5.4	10.3	-5.3	1.7	-7.4	11.0	-6.9	1.9	-6.3	-2.0	7.1
Other domestic financing	25.6	13.4	-0.8	11.4	1.9	8.5	11.5	12.0	-0.3	10.0	31.7	27.2	14.5
Privatization receipts	0.1	0.6	0.5	0.0	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	4.3	5.6	27.8	-2.3	19.3	8.4	14.5	-4.0	32.0	14.3	2.3	4.5	10.1
Memo items:													
Overall fiscal balance excl. clearance of unpaid claims	-17.7	-19.3	-22.1	-19.4	-16.1			-19.0	-22.0	-24.3	-27.6	-29.7	-31.7
Gross general government debt (in percent of GDP) 3/	33.7	34.0	38.0	38.2	39.0			38.8	41.6	42.9	45.1	46.6	46.9
Nominal GDP (billions of denars)	467	502	528	558	607			632	665	701	742	786	834
Stock of government deposits at the NBRM (billions of denars eop)	19	19	23	11	16			5	12	10	16	18	11
Public and publicly guaranteed debt (in percent of GDP) 3/ 4/	36.2	37.9	43.3	44.1	45.7			47.1	50.7	51.7	53.1	53.9	53.5

Sources: MoF and IMF staff estimates.

1/ Resulting from excluding: (i) revenues from lending; and (ii) lending guarantees from current expenditures.

2/ The authorities' estimate of the total unpaid claims for the public sector is 22.4 billion denars (as of May 31, 2017). Staff assumes the clearance of unpaid claims of 4.7 billion denars in 2018-19, which reflects the authorities' estimated amount for the basic budget.

3/ 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.

4/ Including general government and non-financial SOEs.

Table 2b. FYR Macedonia: Central Government Operations, 2012–2022

(Percent of GDP)

	2012	2013	2014	2015	2016	2017			2018	2019	2020	2021	2022
						Budget	Supp. Budget	Proj.	Projections				
Total Revenues	29.5	27.8	27.5	28.8	27.8	29.7	29.3	28.3	28.4	28.5	28.5	28.5	28.5
Tax Revenues and Contributions	25.2	24.1	24.5	25.2	24.8	25.5	25.3	25.0	25.0	25.1	25.1	25.1	25.1
PIT	2.0	2.0	2.3	2.3	2.3	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4
CIT	0.8	0.9	1.0	2.2	1.8	1.8	1.9	1.8	1.8	1.8	1.8	1.8	1.8
VAT (net)	8.2	7.9	8.3	7.5	7.6	8.3	7.8	7.6	7.6	7.7	7.7	7.7	7.7
Excises	3.6	3.2	3.3	3.5	3.7	3.6	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Custom Duties	0.9	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Other Taxes	0.9	0.8	0.4	0.4	0.4	0.4	0.4	0.3	0.4	0.4	0.4	0.4	0.4
Social Contributions	8.7	8.5	8.4	8.6	8.3	8.2	8.4	8.4	8.4	8.4	8.4	8.4	8.4
Non-Tax Revenues	2.7	2.4	2.0	2.3	2.1	2.8	2.6	2.2	2.3	2.3	2.3	2.3	2.3
Capital Revenues	0.9	0.6	0.4	0.4	0.3	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Grants	0.7	0.7	0.6	0.8	0.6	1.0	1.1	0.8	0.8	0.8	0.8	0.8	0.8
Expenditures	33.3	31.7	31.7	32.3	30.5	32.7	32.2	31.3	32.2	32.3	32.3	32.3	32.3
Current Expenditures	29.4	28.5	28.5	29.0	27.7	28.5	28.6	28.4	28.6	28.9	29.1	29.2	29.2
Wages and salaries	4.9	4.5	4.4	4.4	4.3	4.3	4.2	4.2	4.3	4.4	4.4	4.4	4.4
Goods and services	3.1	3.0	2.9	3.2	2.8	3.1	2.8	2.7	2.7	2.7	2.8	2.8	2.8
Transfers	20.5	20.1	20.2	20.2	19.6	19.8	20.2	20.2	20.3	20.5	20.6	20.6	20.6
Pension fund expenditures	8.8	9.0	9.1	9.0	9.0	9.0	9.2	9.2	9.2	9.3	9.3	9.3	9.3
Health	4.5	4.3	4.2	4.2	4.2	4.2	4.3	4.3	4.3	4.3	4.3	4.3	4.3
Other	7.2	6.9	6.9	7.0	6.4	6.6	6.7	6.7	6.8	6.9	7.0	7.0	7.0
Interest	0.9	0.9	1.0	1.2	1.1	1.3	1.3	1.3	1.3	1.4	1.4	1.5	1.5
Capital Expenditures	4.0	3.3	3.3	3.3	2.8	4.3	3.7	3.0	3.2	3.2	3.2	3.2	3.2
Lending minus repayment 1/	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Clearance of unpaid claims 2/								0.0	0.4	0.3	0.0	0.0	0.0
Overall fiscal balance	-3.8	-3.8	-4.2	-3.5	-2.6	-3.0	-2.9	-3.0	-3.7	-3.7	-3.7	-3.8	-3.8
Primary fiscal balance	-2.9	-2.9	-3.2	-2.3	-1.5	-1.7	-1.6	-1.7	-2.4	-2.4	-2.3	-2.3	-2.3
Financing	3.8	3.8	4.2	3.5	2.6	3.0	2.9	3.0	3.7	3.7	3.7	3.8	3.8
Domestic	2.8	2.6	-1.2	3.9	-0.6	1.6	0.6	3.6	-1.1	1.7	3.4	3.2	2.6
Central Bank deposits	-2.6	-0.1	-1.0	1.8	-0.9	0.3	-1.2	1.7	-1.0	0.3	-0.9	-0.3	0.8
Other domestic financing	5.5	2.7	-0.1	2.0	0.3	1.4	1.8	1.9	0.0	1.4	4.3	3.5	1.7
Privatization receipts	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	0.9	1.1	5.3	-0.4	3.2	1.3	2.3	-0.6	4.8	2.0	0.3	0.6	1.2
Memo items:													
Overall fiscal balance excl. clearance of unpaid claims	-3.8	-3.8	-4.2	-3.5	-2.6			-3.0	-3.3	-3.5	-3.7	-3.8	-3.8
Gross general government debt (in percent of GDP) 3/	33.7	34.0	38.0	38.2	39.0			38.8	41.6	42.9	45.1	46.6	46.9
Nominal GDP (billions of denars)	467	502	528	558	607			632	665	701	742	786	834
Stock of government deposits at the NBRM (billions of denars eop)	19	19	23	11	16			5	12	10	16	18	11
Public and publicly guaranteed debt (in percent of GDP) 3/ 4/	36.2	37.9	43.3	44.1	45.7			47.1	50.7	51.7	53.1	53.9	53.5

Sources: MoF and IMF staff estimates.

1/ Resulting from excluding: (i) revenues from lending; and (ii) lending guarantees from current expenditures.

2/ The authorities' estimate of the total unpaid claims for the public sector is 22.4 billion denars (as of May 31, 2017). Staff assumes the clearance of unpaid claims of 4.7 billion denars in 2018-19, which reflects the authorities' estimated amount for the basic budget.

3/ 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.

4/ Including general government and non-financial SOEs.

Table 3a. FYR Macedonia: Balance of Payments, 2011–2022
(Millions of euros, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
							Projections					
Current account	-189	-240	-134	-43	-177	-265	-200	-234	-288	-340	-373	-391
Trade balance	-1905	-2008	-1863	-1856	-1823	-1809	-1870	-1969	-2065	-2175	-2290	-2402
Exports	2396	2307	2375	2784	3047	3471	3803	4209	4621	5085	5588	6145
Imports	4301	4315	4238	4640	4870	5279	5674	6177	6686	7260	7878	8547
Services (net)	359	309	375	384	349	347	366	391	418	448	500	524
Primary Income (net)	-131	-164	-193	-161	-286	-384	-353	-372	-403	-427	-452	-480
Secondary Income (transfers, net)	1487	1622	1547	1589	1583	1581	1658	1716	1763	1814	1868	1966
Of which												
Official	77	60	74	110	54	91	83	74	83	80	79	81
Private	1411	1562	1473	1479	1529	1490	1574	1641	1680	1733	1789	1885
Of which: Cash exchange	1054	1189	1107	1094	1095	1062	1122	1170	1198	1236	1276	1344
Capital account (net)	-2	9	15	3	7	11	9	9	7	8	9	8
Net lending (+) / Net borrowing (-)	-192	-231	-119	-40	-170	-254	-191	-226	-281	-331	-365	-383
Financial account	-511	-354	-63	-436	12	-603	-71	-697	-585	-441	-418	-543
Direct investment (net)	-345	-131	-229	-197	-203	-317	-287	-285	-323	-356	-376	-399
Portfolio investment (net)	76	-77	159	-482	-66	-429	94	-444	-220	-210	-100	-200
Of which: Eurobonds amortizations	0	0	175	0	151	0	0	0	0	270	500	0
Of which: Eurobonds disbursements	0	0	0	491	266	450	0	555	200	420	550	150
Other investment	-243	-146	8	244	280	143	122	32	-41	125	59	56
Trade credits (net)	40	-158	88	-32	-61	-30	-21	-22	-24	-25	-26	-28
MLT loans (net)	-528	-43	-341	-63	58	-94	-140	-188	-270	-12	-111	-130
Public sector	-378	-57	-282	36	106	90	-25	-74	-47	98	-38	-29
Disbursements	457	161	379	126	78	95	83	136	136	136	136	136
of which : IMF credit	221	0	0	0	0	0	0	0	0	0	0	0
Amortization	-89	-99	-102	-154	-219	-69	-72	-76	-103	-249	-113	-122
Banks	-53	26	-26	-19	24	12	-76	-40	-70	-65	-51	-55
Other sectors	-97	-13	-33	-80	-72	-196	-39	-74	-152	-45	-22	-46
ST loans (net)	25	-48	16	-4	-4	-12	20	21	22	24	0	27
Currency and deposits (net)	220	104	245	342	287	279	263	221	229	138	196	188
Of which: Commercial banks	87	-124	28	81	-17	-17	16	-6	-3	2	-2	-1
Other (net)	0	0	0	0	0	0	0	0	0	0	0	0
Errors and omissions	12	19	13	13	-2	-12	0	0	0	0	0	0
Overall Balance	331	142	-44	409	-183	337	-120	471	304	109	53	160
Memorandum Items:												
ST debt at residual maturity (year-end)	2059	2382	2073	2315	2236	2550	2611	2508	2941	3042	2585	2754
Gross foreign exchange reserves	2069	2193	1993	2437	2262	2613	2493	2964	3269	3378	3431	3591
Months of prospective imports of G&S	4.9	5.2	4.3	5.0	4.3	4.6	4.1	4.5	4.6	4.4	4.1	n.a.
Percent of short-term debt (residual maturity)	100.5	92.1	96.1	105.2	101.2	102.5	95.5	118.2	111.1	111.0	132.7	130.4
External debt (percent of GDP)	64.2	68.2	64.0	70.0	69.4	73.5	71.8	75.4	72.9	70.1	70.5	69.5
Medium and long-term	45.7	48.5	49.1	54.4	54.6	57.4	56.2	60.5	58.7	56.7	57.5	57.1
Short-term	18.5	19.7	14.9	15.6	14.8	16.2	15.6	14.9	14.2	13.5	13.0	12.3
External debt service	1506	1786	2032	1591	1949	1742	1937	2008	1907	2341	2449	1997
Percent of exports of G&S	43.8	52.9	57.6	38.9	44.1	35.8	36.8	34.9	30.4	34.2	32.7	24.5
Percent of exports of G&S and transfers	31.0	36.2	40.6	28.6	32.7	27.4	28.3	27.1	24.0	27.3	26.4	19.9

Sources: NBRM; and IMF staff estimates.

Table 3b. FYR Macedonia: Balance of Payments, 2012–2022
(Percent of GDP, unless otherwise indicated)

	Avg 2003-11	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
							Projections					
Current account	-5.1	-3.2	-1.6	-0.5	-2.0	-2.7	-1.9	-2.2	-2.5	-2.8	-2.9	-2.9
Trade balance	-23.0	-26.5	-22.9	-21.7	-20.1	-18.3	-18.2	-18.2	-18.1	-18.0	-17.9	-17.7
Exports	24.7	30.4	29.1	32.5	33.6	35.2	37.1	39.0	40.6	42.2	43.8	45.4
Imports	47.7	56.9	52.0	54.2	53.7	53.5	55.3	57.2	58.7	60.2	61.7	63.1
Services (net)	2.9	4.1	4.6	4.5	3.8	3.5	3.6	3.6	3.7	3.7	3.9	3.9
Primary Income (net)	-1.5	-2.2	-2.4	-1.9	-3.2	-3.9	-3.4	-3.4	-3.5	-3.5	-3.5	-3.5
Secondary Income (transfers, net)	16.6	21.4	19.0	18.6	17.5	16.0	16.2	15.9	15.5	15.0	14.6	14.5
Of which												
Official	0.9	0.8	0.9	1.3	0.6	0.9	0.8	0.7	0.7	0.7	0.6	0.6
Private	15.6	20.6	18.1	17.3	16.9	15.1	15.4	15.2	14.8	14.4	14.0	13.9
Of which: Cash exchange	10.9	15.7	13.6	12.8	12.1	10.8	10.9	10.8	10.5	10.3	10.0	9.9
Capital account (net)	0.0	0.1	0.2	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Net lending (+) / Net borrowing (-)	-5.1	-3.0	-1.5	-0.5	-1.9	-2.6	-1.9	-2.1	-2.5	-2.8	-2.9	-2.8
Financial account	-7.5	-4.7	-0.8	-5.1	0.1	-6.1	-0.7	-6.5	-5.1	-3.7	-3.3	-4.0
Direct investment (net)	-4.3	-1.7	-2.8	-2.3	-2.2	-3.2	-2.8	-2.6	-2.8	-3.0	-2.9	-3.0
Portfolio investment (net)	-0.7	-1.0	2.0	-5.6	-0.7	-4.4	0.9	-4.1	-1.9	-1.7	-0.8	-1.5
Of which: Eurobonds amortizations	0.0	0.0	2.1	0.0	1.7	0.0	0.0	0.0	0.0	2.2	3.9	0.0
Of which: Eurobonds disbursements	0.6	0.0	0.0	5.7	2.9	4.6	0.0	5.1	1.8	3.5	4.3	1.1
Other investment	-2.5	-1.9	0.1	2.8	3.1	1.4	1.2	0.3	-0.4	1.0	0.5	0.4
Trade credits (net)	-0.8	-2.1	1.1	-0.4	-0.7	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
MLT loans (net)	-1.7	-0.6	-4.2	-0.7	0.6	-1.0	-1.4	-1.7	-2.4	-0.1	-0.9	-1.0
Public sector	-0.4	-0.7	-3.5	0.4	1.2	0.9	-0.2	-0.7	-0.4	0.8	-0.3	-0.2
Disbursements	1.9	2.1	4.6	1.5	0.9	1.0	0.8	1.3	1.2	1.1	1.1	1.0
of which : IMF credit	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Amortization	-1.5	-1.3	-1.2	-1.8	-2.4	-0.7	-0.7	-0.7	-0.9	-2.1	-0.9	-0.9
of which : Repayment to the IMF	0.0	0.0	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Banks	-0.5	0.3	-0.3	-0.2	0.3	0.1	-0.7	-0.4	-0.6	-0.5	-0.4	-0.4
Other sectors	-0.9	-0.2	-0.4	-0.9	-0.8	-2.0	-0.4	-0.7	-1.3	-0.4	-0.2	-0.3
ST loans (net)	-0.1	-0.6	0.2	0.0	0.0	-0.1	0.2	0.2	0.2	0.2	0.0	0.2
Currency and deposits (net)	0.5	1.4	3.0	4.0	3.2	2.8	2.6	2.1	2.0	1.1	1.5	1.4
Of which: Commercial banks	0.1	-1.6	0.3	0.9	-0.2	-0.2	0.2	-0.1	0.0	0.0	0.0	0.0
Other (net)	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Errors and omissions	-0.1	0.2	0.2	0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	2.4	1.9	-0.5	4.8	-2.0	3.4	-1.2	4.4	2.7	0.9	0.4	1.2
			(Percentage change, year-on-year)									
Exports of G&S (Value)	12.2	-2.0	4.6	15.8	8.2	10.0	8.2	9.4	8.8	9.1	9.4	9.0
Volume	9.2	2.0	6.1	16.5	6.7	11.5	11.8	11.0	11.0	11.1	11.1	11.0
Price	2.2	-3.8	-1.4	-0.6	1.4	-1.3	-3.2	-1.5	-1.9	-1.7	-1.5	-1.8
Imports of G&S (Value)	10.3	1.7	-1.1	10.8	6.1	7.3	7.0	8.4	7.9	8.2	8.3	8.2
Volume	6.7	8.2	2.2	14.1	5.2	7.6	8.8	8.6	8.6	8.7	8.8	8.7
Price	2.9	-6.0	-3.2	-2.9	0.8	-0.4	-1.7	-0.2	-0.7	-0.4	-0.5	-0.5

Sources: NBRM; and IMF staff estimates.

Table 4. FYR Macedonia: Monetary Survey, 2012–2022
(Billions of denars, unless specified otherwise)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
						Projections					
NFA	126.1	114.8	146.4	137.4	158.5	151.2	178.1	194.9	205.6	208.9	222.3
Central Bank	128.9	118.2	145.0	134.2	155.6	148.2	175.2	191.9	202.7	206.0	219.4
Commercial Banks	-2.8	-3.4	1.3	3.2	2.9	2.9	2.9	2.9	2.9	2.9	2.9
NDA	140.2	165.6	163.5	193.6	192.7	219.5	212.0	216.6	230.1	252.4	267.0
Credit to Government (net)	1.9	10.8	-2.6	13.2	2.5	19.1	12.2	15.7	9.4	7.4	14.5
From Banks (net)	29.1	37.0	31.4	36.5	32.6	37.3	37.3	39.0	39.0	39.0	39.0
of which: Credit (Tbills)	31.7	38.8	33.3	38.0	34.0	39.1	39.1	40.8	40.8	40.8	40.8
From Central Bank (net)	-27.2	-26.2	-33.9	-23.3	-30.1	-18.2	-25.1	-23.2	-29.6	-31.5	-24.5
of which: Deposits	-30.4	-29.5	-37.1	-26.3	-32.7	-21.6	-28.6	-26.7	-33.0	-35.0	-27.9
Credit to Private Sector (Gross)	218.9	232.7	255.5	279.8	282.7	299.0	316.8	336.4	357.8	381.5	407.2
From Banks	218.8	232.7	255.4	279.7	282.5	298.8	316.6	336.2	357.6	381.3	407.1
Denars	164.4	178.4	199.2	223.1	232.1	239.9	254.2	270.0	287.1	306.2	326.9
FX	54.4	54.3	56.2	56.6	50.4	58.9	62.4	66.2	70.4	75.1	80.2
From Central Bank	0.1	0.0	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other Items (net)	-80.6	-78.0	-89.4	-99.5	-92.5	-60.1	-63.5	-67.0	-68.6	-72.2	-85.4
Broad Money (M3)	266.3	280.4	309.9	331.0	351.2	370.6	390.2	411.5	435.7	461.3	489.4
Currency in Circulation	20.1	20.7	23.2	26.3	28.2	29.3	30.9	32.5	34.5	36.5	38.7
Total Deposits	246.2	259.7	286.7	304.7	323.0	341.3	359.3	378.9	401.2	424.8	450.7
Denars	135.1	147.9	171.2	182.1	190.6	201.4	212.0	223.6	236.7	250.6	265.9
FX	111.1	111.7	115.5	122.7	132.4	140.0	147.3	155.4	164.5	174.2	184.8
(Percentage change, year-on-year)											
Private Sector Credit	5.2	6.3	9.8	9.5	1.0	5.8	6.0	6.2	6.4	6.6	6.8
Broad Money	4.4	5.3	10.5	6.8	6.1	5.5	5.3	5.5	5.9	5.9	6.1
Private Sector Deposits	4.4	5.5	10.4	6.3	6.0	5.7	5.3	5.5	5.9	5.9	6.1
(Contribution to annual growth in broad money)											
NFA	0.5	-4.2	11.3	-2.9	6.4	-2.1	7.3	4.3	2.6	0.7	2.9
NDA	3.9	9.5	-0.7	9.7	-0.3	7.6	-2.0	1.2	3.3	5.1	3.2
(Percent of GDP)											
Private Sector Credit	46.9	46.4	48.4	50.1	46.5	47.3	47.7	48.0	48.2	48.5	48.8
Broad Money	57.1	55.9	58.7	59.3	57.8	58.7	58.7	58.7	58.7	58.7	58.7
Private Sector Deposits	52.7	51.7	54.3	54.6	53.2	54.0	54.0	54.0	54.0	54.0	54.0
Memorandum Items:											
Money Multiplier	4.8	5.2	5.1	5.4	5.4	5.2	5.2	5.2	5.2	5.1	5.1
Reserve Requirement Ratio (% of deposits)											
Denars	10.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0
FX Indexed	20.0	20.0	20.0	20.0	50.0	50.0	50.0	50.0	50.0	50.0	50.0
FX	13.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Velocity	1.8	1.8	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7	1.7

Sources: NBRM; and IMF staff estimates.

Table 5. FYR Macedonia: Central Bank Survey, 2012–2022

(Billions of denars, unless specified otherwise)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
						Projections					
NFA	128.9	118.2	145.0	134.2	155.6	148.2	175.2	191.9	202.7	206.0	219.4
Assets	143.3	122.7	149.9	139.4	160.7	153.4	182.4	201.1	207.8	211.1	224.5
Liabilities	-14.4	-4.5	-4.8	-5.1	-5.1	-5.1	-7.1	-9.1	-5.1	-5.1	-5.1
NDA	-73.0	-64.7	-84.2	-73.0	-90.1	-77.7	-100.7	-112.8	-118.1	-115.7	-123.8
Banks (net)	-26.1	-28.2	-35.6	-34.0	-41.1	-39.8	-55.9	-69.8	-68.8	-64.4	-79.6
of which:											
NBRM Bills and short-term facilities	-27.1	-28.3	-35.6	-34.0	-36.5	-38.5	-53.5	-68.5	-68.5	-64.3	-69.3
Central Government (net)	-24.9	-24.1	-31.4	-20.2	-26.6	-15.6	-22.5	-20.6	-27.0	-29.0	-21.9
of which:											
Deposits at Central Bank	-30.4	-29.5	-37.1	-26.3	-32.7	-21.6	-28.6	-26.7	-33.0	-35.0	-27.9
Denar	-19.5	-16.3	-8.2	-8.9	-11.0	-6.1	-9.2	-8.3	-11.2	-12.1	-8.9
FX	-10.9	-13.1	-28.9	-17.4	-21.7	-15.6	-19.4	-18.4	-21.9	-22.9	-19.0
State and Local Governments (net)	-2.3	-2.1	-2.6	-3.1	-3.5	-3.5	-3.5	-3.5	-3.5	-3.5	-3.5
Other items (net)	-19.7	-10.2	-14.6	-15.8	-18.8	-18.8	-18.8	-18.8	-18.8	-18.8	-18.8
Reserve Money	55.9	53.5	60.9	61.2	65.5	70.6	74.6	79.2	84.6	90.3	95.6
Currency in Circulation	20.1	20.7	23.2	26.3	28.2	29.3	30.9	32.5	34.5	36.5	38.7
Other	35.8	32.8	37.6	34.9	37.4	41.3	43.7	46.6	50.1	53.8	56.9
Cash in Vaults	3.9	4.3	4.9	5.7	6.2	6.4	6.6	6.8	7.0	7.2	7.4
Total Reserves	32.0	28.4	32.8	29.3	31.1	34.8	37.1	39.8	43.1	46.6	49.4
on Denar Deposits	18.9	16.2	20.2	16.0	17.0	19.7	21.1	22.9	25.2	27.7	29.4
on FX Deposits	13.0	12.2	12.6	13.3	14.1	15.2	16.0	16.8	17.8	18.9	20.0
	(Contribution to annual growth in reserve money)										
NFA	11.9	-19.2	50.3	-17.8	34.9	-11.2	38.2	22.4	13.6	3.9	14.9
NDA	-7.7	14.8	-36.5	18.4	-27.9	18.9	-32.6	-16.3	-6.8	2.9	-9.1
	(Percentage change, year-on-year)										
Reserve Money	4.3	-4.4	13.8	0.6	7.1	7.7	5.7	6.1	6.8	6.8	5.8
Memorandum Items:	(Percent of GDP)										
NBRM Bills	5.6	5.1	4.8	4.5	3.8	4.1	6.3	8.3	7.8	6.8	7.1
Government Deposits at Central Bank	6.5	5.9	7.0	4.7	5.4	3.4	4.3	3.8	4.5	4.5	3.4

Sources: NBRM; and IMF staff estimates.

Table 6. FYR Macedonia: Financial Soundness Indicators of the Macedonian Banking System, 2012–2017

(Billions of denars, unless specified otherwise)

	2012	2013	2014	2015	2016	2017Q1	2017Q2
Capital adequacy							
Regulatory capital/risk weighted assets	17.1	16.8	15.7	15.5	15.2	15.4	15.8
Tier I capital/risk weighted assets	14.5	14.4	13.7	13.9	13.9	14.1	14.5
Equity and reserves to Assets	11.2	11.3	10.8	10.8	10.6	11.1	11.3
Asset composition							
Structure of loans							
Enterprises (loans to enterprises/total loans)	56.9	55.4	55.2	53.9	51.3	50.1	49.9
Households (loans to households/total loans)	36.4	37.7	38.7	40.0	42.9	44.3	44.8
Lending with foreign currency component to private sector	55.4	52.7	49.4	46.5	44.9	45.3	44.7
Foreign currency lending/total credit to private sector	25.5	23.8	22.4	20.5	18.0	17.9	17.5
Foreign currency indexed lending/total credit to private sector	29.8	28.9	27.0	25.9	27.0	27.4	27.2
NPLs 1/							
NPLs/gross loans	10.1	10.9	10.8	10.3	6.3	6.1	6.5
NPLs net of provision/own funds	-3.7	-1.8	-3.0	-5.3	-5.5	-5.0	-3.3
Provisions to Non-Performing Loans	107.1	103.1	104.6	108.4	114.8	114.2	109.1
Large exposures/own funds	205.1	188.5	233.1	212.4	185.4	190.4	165.0
Connected lending							
Banking system exposure to subsidiaries and shareholders/own funds	3.5	4.2	4.3	3.4	8.4	4.3	4.5
Banking system equity investments/own funds	1.8	1.7	2.6	2.6	2.0	2.0	2.1
Earning and profitability							
ROAA 2/	0.4	0.6	0.8	1.1	1.5	1.5	1.4
ROAE 2/	3.8	5.7	7.4	10.4	13.6	13.8	12.7
Interest margin/gross income 3/	60.7	62.2	63.5	62.8	62.7	63.6	62.6
Noninterest expenses/gross income 4/	65.3	62.8	58.1	54.7	53.2	53.6	54.3
Personnel expenses/noninterest expenses	33.1	35.0	35.5	35.8	35.2	36.2	35.0
Interest Rates							
Local currency spreads	3.5	3.6	4.0	4.2	3.9	4.0	4.0
Foreign currency spreads	4.6	4.8	4.9	4.6	4.2	4.1	4.1
Interbank market interest rate	2.1	2.2	1.5	1.2	1.0	1.1	1.1
Liquidity							
Highly liquid assets/total assets 5/	29.4	27.3	25.5	24.3	25.7	24.2	23.6
Highly liquid assets/total short-term liabilities 6/	48.2	47.6	45.5	42.4	44.5	42.6	40.9
Liquid assets/total assets	32.4	31.2	29.8	28.2	28.9	27.8	27.2
Liquid assets/total short-term liabilities	53.0	54.5	53.2	49.2	50.1	48.9	47.1
Customer deposits/total (noninterbank) loans	113.5	112.7	113.4	110.3	114.9	114.1	111.9
Foreign currency deposits/total deposits	47.3	44.9	42.3	42.1	43.0	43.6	43.3
Including foreign exchange-indexed 7/	48.3	45.5	42.8	42.4	43.1	43.8	43.4
Sensitivity to market risk							
Net open foreign exchange position/own funds	11.4	15.6	17.5	11.1	14.5	9.6	7.8

Source: NBRM's Financial Stability Unit.

1/ Includes loans to financial and nonfinancial sector.

2/ Adjusted for unallocated provisions for potential loan losses.

3/ Interest margin represents interest income less interest expense. Gross income includes net interest income, fees and commissions income.

4/ Noninterest expenses include fees and commissions expenses, operating expenses and other expenses excluding extraordinary expenses.

5/ Highly liquid assets are defined as cash and balance with the NBRM, treasury bills, NBRM bills, and correspondent accounts with foreign banks. Assets in domestic banks are excluded from total assets.

6/ Short-term liabilities are defined as deposits and other liabilities with a maturity of one year or less (without deposits and borrowings from domestic banks).

7/ FX indexed deposits include deposits and other FX indexed liabilities.

Annex I. External Stability Assessment

The external position seems to be broadly in line with fundamentals based on the three EBA-lite methodologies which all indicate a slight undervaluation of the real effective exchange rate, as well as broader competitiveness indictors. However, sustained high unemployment, under-utilization of labor and rising debt ratios highlight the need for corrective structural and fiscal measures.

FYR Macedonia: Estimated Current Account Gap and Real Exchange Rate Misalignment 1/
(Percent of GDP, otherwise indicated)

EBA-lite CA Method	
Cyclically-adjusted CA	-2.9
Cyclically-adjusted CA norm	-4.0
CA gap	1.1
REER gap (Percent)	-2.8
EBA-lite REER Index Model	
REER Gap (Percent)	-0.7
EBA-lite External Sustainability Model	
Underlying CA	-3.0
CA norm	-3.5
CA gap	0.4
REER gap (Percent)	-1.1

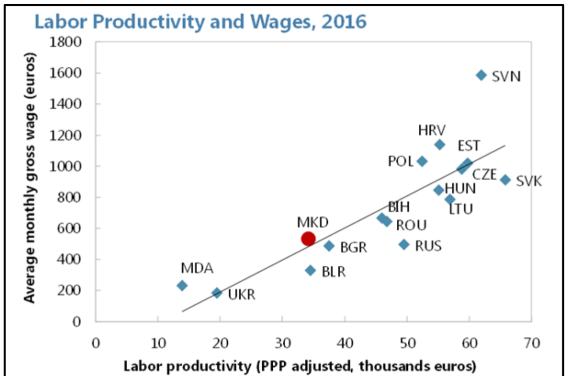
Source: IMF Staff Estimates
1/ Negative value implies undervaluation

1. **The current account (CA) based estimates show a moderately stronger position relative to fundamentals.** The cyclically-adjusted CA norm is -4.0 percent of GDP, in which the norm incorporates a policy gap of 0.45 percent resulting from fiscal policy (0.9 percent), private sector credit (0.7 percent) and reserves (-0.7 percent) vis-à-vis medium-term objectives. This implies a gap of 1.1 percent of GDP, or a slight REER undervaluation of 2.8 percent.

2. **The EBA-lite REER model suggests a small undervaluation of 0.7 percent of the exchange rate relative to fundamentals**. This estimate includes an underlying misalignment of -1.63 percent adjusted for a policy gap of around 0.95 percent resulting from a change in reserves (1.68 percent), real interest rate (0.28 percent), and private credit (-1.0 percent).

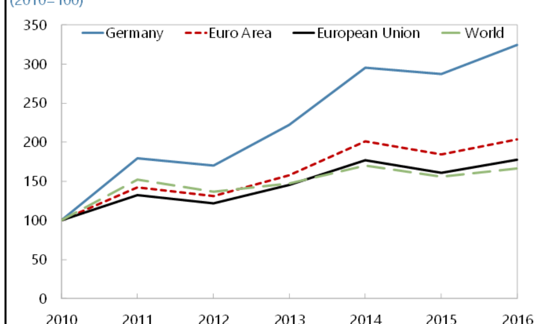
3. **The external sustainability approach also suggests an external position slightly stronger than fundamentals.** Stabilizing the net IIP at its 2016 level of -59.1 percent of GDP suggests a real exchange rate undervaluation of 1.1 percent.

Labor Productivity and Wages, 2016



Sources: National authorities, The Conference Board Total Economy Database™ (Adjusted version), May 2017and IMF staff calculations.

FYR Macedonia: Exports Share Evolution
(2010=100)



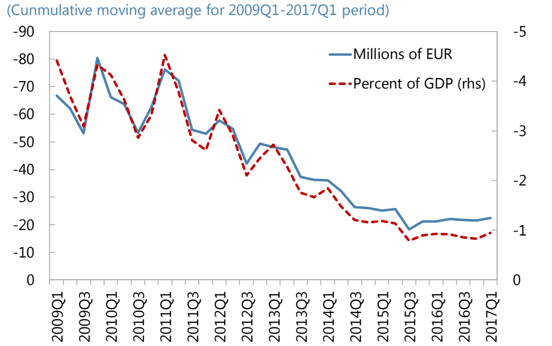
Sources: IMF, DOTS database; and IMF staff calculations.

4. **Broader measures of competitiveness, such as cost and market share, also show no concerns.** FYR Macedonia's wages are closely aligned with productivity. In addition, its export market share has been on an upward trend reflecting, to a large extent, deepening integration within the German supply chain. Staff's estimated narrow output gap implies that the economy is also close to internal equilibrium, with the high registered unemployment relating in large part to

a sizeable informal sector, a reflection of domestic distortions and inefficiencies. In that sense, a gradual reduction the size of the informal economy, in line with the authorities' objectives, would mainly necessitate an adjustment in internal, rather than external, relative prices.

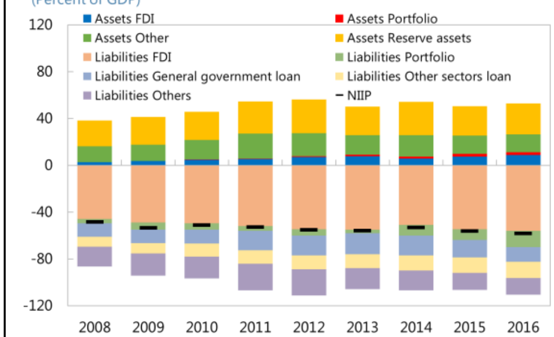
5. **Private capital flows have declined in recent years although FDI inflows have held up throughout the political crisis.** The reduction in private capital inflows was mainly driven by private loans, trade credits and currency and deposits. The latter component reflects deleveraging by parent banks and households' preference to hold FX cash, which is recorded as an outflow in BOP statistics. The structure of the IIP on the liability side has been dominated by FDI (56 percent of GDP), while the asset side is dominated by reserves assets (26 percent of GDP). There is a high correlation between FDI inflows and outflows which may indicate in part hedging of currency and country risks by investors, or opportunistic behavior of foreign investors.

Private Financial Net Flows
(Cunmulative moving average for 2009Q1-2017Q1 period)



Sources: National Bank of the Republic of Macedonia; and IMF staff calculations.

Net International Investment Position
(Percent of GDP)



Sources: National Bank of the Republic of Macedonia; and IMF staff calculations.

6. **Reserves coverage in FYR Macedonia is broadly adequate per various reserve adequacy metrics.** Gross international reserves, at 2.61 billion euros at end-2016, covered 4.7 months of prospective imports of goods and services and nearly 46 percent of broad money. Reserves stood at some 108 percent of the Fund's ARA metric, within (but near the low end of) the suggested range, and a little over short-term debt (at remaining maturity). While postponement of a Eurobond issuance this year would bring reserves below some standard thresholds at end-2017, prospective foreign borrowing in 2018 would restore reserve adequacy over the medium term. On the other hand, accumulation of reserves has increasingly relied on an issuance of sovereign bonds as the expectations of strong private capital inflows have persistently disappointed.

Reserve Adequacy Ratios for Macedonia 2016–2022

	2016	2017	2018	2019	2020	2021	2022
Reserve/STD (percent) 1/	102.5	95.5	118.2	111.1	111.0	132.7	130.4
Reserve/Months of prospective import goods and services 2/	4.6	4.1	4.5	4.6	4.4	4.1	4.0
Reserve/Broad money (percent) 3/	45.7	41.4	46.7	48.8	47.7	45.7	45.1
Expanded 'Greenspan-Guidotti' metric: Reserves/(STD + CA deficit)	92.8	88.7	108.1	101.2	99.9	116.0	114.2
Reserves/ARA metric (percent) 4/	107.5	98.6	109.9	113.4	110.7	109.5	108.5

1/ Suggested threshold for adequacy: 100 percent.
2/ Suggested range for adequacy: 3-6 months;
3/ Suggested threshold for adequacy: 20 percent
4/ Suggested range for adequacy: 100-150 percent.

Annex II. Determinants of FDI and Potential FDI in the Western Balkan Region[1]

1. **Considering FYR Macedonia's strategy to pursue an FDI-led export growth, this annex tries to look at policy priorities to reach the full FDI potential.** Experience in Central European countries has shown that FDI can play a strong role in supporting an export-led growth and convergence strategy through investment and technology transfer. To understand policy factors, the following bilateral FDI gravity model is used to estimate determinants of FDI inflows:

$$FDI_{i,j,t} = \alpha H_{i,j,t} + \beta X_{i,t} + \gamma K_{j,t} + \varepsilon_{j,t}$$

where $FDI_{i,j,t}$ is FDI inflows from country j to country i, at time t; $H_{i,j,t}$ contains variables which are source-host country-specific, such as geographical distance, and trade agreements; $X_{i,t}$ contains host country-specific variables, some of which are policy related; and $K_{j,t}$ contains source country-specific variables, such as their macroeconomic conditions. The host country-specific policy variables ($X_{i,t}$) include corporate income tax rates, per capita public capital stock, unit labor costs, proportions of skilled population (proxied by shares of population with at least an upper secondary education, and vocational enrollment), institutional variables from the EBRD's transition and the World Bank's Governance indicators, and the EU membership status. The sample includes 20 host countries (5 Western Balkan countries; 11 new-EU member states; Belarus, Moldova, Turkey, and Ukraine) and 29 source countries (20 host countries; additional 17 EU countries; the US, and Switzerland), while covering the period of 2001 to 2012.

2. **The overall empirical results show that, while market size and proximity between source and host countries matter the most, policy-related variables also significantly influence FDI inflows.** Key policy variables supporting FDI include competitive tax rates and labor costs, skills adequacy, quality infrastructure, political stability, and good governance (Table 1). In addition, external conditions—particularly those of source countries—can affect FDI inflows.

3. **Given the already attractive tax regime in FYR Macedonia and the relatively more challenging external conditions, reforms in following areas are of high priority.** First, improvements in skills while keeping labor costs competitive would be important. The country will need to invest in human capital and allow wage growth to be in line with its productivity growth. Second, continued investment in infrastructure is needed to increase connectivity. Third, good governance and political stability will strengthen institutional quality and cement foreign investor interest, as well as reduce the volatility of FDI flows.

[1] Prepared by La-Bhus Fah Jirasavetakul based on the forthcoming IMF Working Paper—*Potential FDI in the Western Balkans: Can the Central European Experience Be Repeated?*

Table 1. Main Regression Results of the Bilateral FDI Gravity Model

	(1)	(2)	(3)	(4)	(5)	(6)
	Log of FDI inflows (USD millions)					
Main Model						
Log of population (millions)	0.593***	0.685***	0.684***	0.633***	0.725***	0.726***
	(0.026)	(0.028)	(0.028)	(0.026)	(0.028)	(0.028)
Log of GDP per capita (PPP-USD)	0.033	0.141	0.110	0.144	0.255**	0.246*
	(0.153)	(0.154)	(0.154)	(0.128)	(0.130)	(0.130)
1{Both host and source countries are in EU-28}	0.186**	0.185**	0.181**	0.247***	0.247***	0.252***
	(0.076)	(0.076)	(0.076)	(0.075)	(0.075)	(0.075)
Log of distance in kilometres	-0.906***	-1.086***	-1.084***	-0.905***	-1.081***	-1.074***
	(0.041)	(0.048)	(0.048)	(0.041)	(0.048)	(0.048)
Log of population (millions): Source country	0.347***	0.419***	0.419***	0.346***	0.417***	0.414***
	(0.018)	(0.021)	(0.021)	(0.018)	(0.021)	(0.021)
Log of GDP per capita: Source country (PPP-USD)	2.210***	2.587***	2.591***	2.209***	2.579***	2.571***
	(0.055)	(0.071)	(0.071)	(0.055)	(0.071)	(0.071)
CIT rate (%)	-0.037***	-0.057***	-0.054***	-0.031***	-0.050***	-0.046***
	(0.008)	(0.008)	(0.008)	(0.008)	(0.008)	(0.008)
Unit labor cost (relative to country source)	-0.590***	-0.595***	-0.601***	-0.529***	-0.533***	-0.530***
	(0.081)	(0.083)	(0.084)	(0.078)	(0.081)	(0.081)
Log of public capital stock (per capita; PPP-2011 USD)	0.164**	0.222***	0.173**	0.092	0.149**	0.092
	(0.068)	(0.069)	(0.069)	(0.071)	(0.072)	(0.071)
% of +15pop w/ >=upper secondary	0.004	0.005*	0.005*	-0.003	-0.002	-0.003
	(0.003)	(0.003)	(0.003)	(0.004)	(0.004)	(0.004)
Vocational enrollment (% of secondary enrollment)	0.007**	0.009***	0.009***	0.007**	0.010***	0.010***
	(0.003)	(0.003)	(0.003)	(0.003)	(0.003)	(0.003)
EBRD Transition-i: Governance & enterp restruc.	0.335***	0.345***	0.399***			
	(0.094)	(0.095)	(0.093)			
WB Governance-i: Political stability				0.346***	0.352***	0.396***
				(0.098)	(0.098)	(0.098)
Constant	-16.378***	-20.947***	-20.638***	-15.943***	-20.444***	-20.026***
	(1.214)	(1.334)	(1.338)	(1.258)	(1.384)	(1.376)
Heckman Correction						
WB Governance-i: Rule of law		0.132***			0.127***	
		(0.043)			(0.043)	
WB Governance-i: Voice&accountability			0.411***			0.406***
			(0.034)			(0.034)
Time	Dummies	Dummies	Dummies	Dummies	Dummies	Dummies
Observations	3,991	3,991	3,991	3,991	3,991	3,991
R2	0.412			0.411		

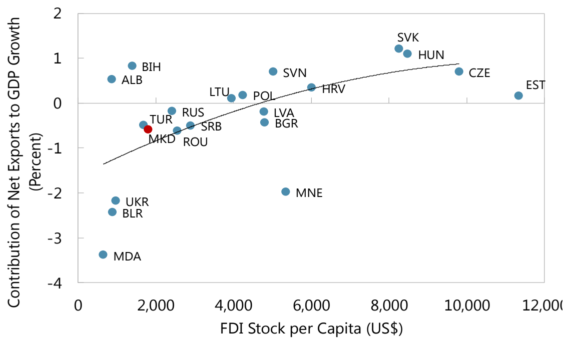
* p<0.1; ** p<0.05; and *** p<0.01.
Robust standard errors in parentheses.

4. **Based on the cross-country regression analysis of FDI inflows in emerging European countries, potential gains in FDI range from 2 to 4 percent of GDP for FYR Macedonia.** Using the coefficient estimates from the cross-country bilateral FDI gravity regressions and the IMF WEO medium-term growth projections of source countries, potential gains in FDI are computed for Western Balkan countries under the two scenarios of improvements in the policy variables ($X_{i,t}$ in the bilateral FDI gravity model, except for the EU membership status) towards (i) the median and (ii) the best new-EU member states. Cumulative gains in FDI inflows for FRY Macedonia are estimated to be around 2 percentage points of GDP in the medium term if the country improves the policy variables towards the levels observed in the median new-EU member states, and these gains could double to 4 percentage points of GDP if the policy variables are improved towards the best performer (text chart). These estimates for FYR Macedonia are around the average gains estimated for Western Balkan countries.

FYR Macedonia: FDI, Exports and Structural Reforms

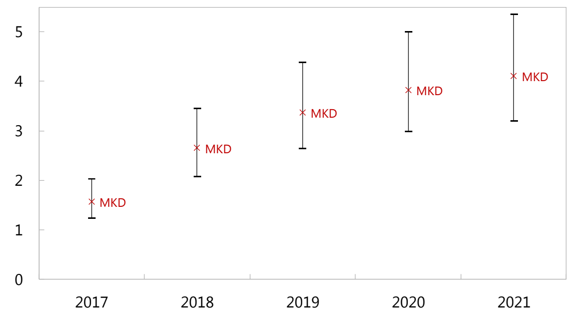
FDI has played a strong role in exports and convergence of central European economies.

FDI and Net Exports in Central and Southeastern Europe
(Average, 2003-2014)



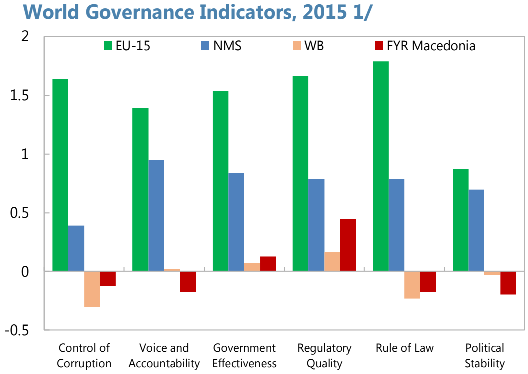
There are significant potential gains for Macedonia

Western Balkans: Potential Gains in FDI Inflows
Improvements in Policy Variables towards the Best NMS Performer
(Percentage Points of GDP, cumulative)



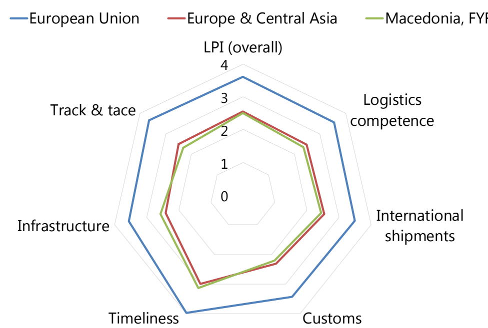
With reforms in governance and institutions...

World Governance Indicators, 2015 1/



...and trade-enabling logistics.

Logistics Performance Index, 2016
(1=low to 5=high)



Source: UNCTAD; IMF World Economic Outlook (WEO); World Bank WDI; and IMF staff calculations.
1/ The indicators range from approximately -2.5 (weak) to 2.5 (strong) governance performance. Country group aggregates represent the median country.

Annex III. Debt Sustainability Analysis

General government and public debt is projected to increase, driven by primary deficits. High gross financing needs and potential shocks to growth constitute major risks. Durable fiscal consolidation is therefore needed to stabilize debt and rebuild fiscal space. Improvement in public debt management is visible and should be continued.

Background

1. **FYR Macedonia's public debt has nearly doubled since 2008, reaching 45¾ percent of GDP in 2016.** Over this period, the general government debt has increased by 18½ percentage points of GDP to about 39 percent of GDP at end-2016. The fiscal deficit has widened mainly due to a shortfall in both tax and non-tax revenues and increases in pensions and subsidies. Publicly guaranteed debt of non-financial enterprises rose from 2½ percent of GDP in 2008 to 6¾ percent of GDP at end-2016 due to implementations of public transport infrastructure projects by the Public Enterprise for State Roads (PESR). Meanwhile, gross financing requirements of the general government and the public sector are high at about 14½ and 16¼ percent of GDP, respectively, reflecting high roll-over needs.

2. **There have been improvements in the public debt structure, particularly in domestic public debt.** The average maturity of outstanding government securities has increased significantly from less than 12 months in 2011 to more than five years by 2016, reflecting increasing reliance on long-term borrowing. In the meantime, the share of FX-linked domestic government securities has declined from 90 percent in 2009 to around 36 percent in 2016. Interest rates on all types of securities have decreased noticeably. However, most of the public debt is external, resulting in around three-quarters of public debt being FX-denominated.

3. **External debt has increased by 25 percent of GDP since 2008, reaching 73.5 percent of GDP by end-2016**. The main drivers of the increases in external debt have been public sector borrowing and FDI-related intercompany borrowing. There was a notable one-time decline in the external debt level on the back of the repayments to the IMF. External gross financing needs have declined from nearly 32 percent of GDP in 2008 to close to 20 percent in 2016 benefiting from persistent improvement in trade balances.

Public DSA Results

Baseline

4. **The baseline scenario assumes fiscal expansions as envisaged in the 2017 supplementary budget and the new government's draft economic plan. It's underpinned by the following assumptions:**

- *Real GDP growth* is projected to be around 1.9 percent of GDP in 2017, owing to a very gradual resumption of investment in 2017H2 with the onset of political stability. Medium-term growth is projected to pick up to almost 4 percent of GDP, supported by investment, expanded export capacities, and continued improvements in the labor markets. This is broadly consistent with the medium-term growth potential.

- *Headline inflation* is projected to gradually reach 2 percent by end-2019 reflecting a narrowing output gap and wage pressures.

- *The general government overall balance* is projected to be around 3 percent of GDP in 2017 and widen further to nearly 4 percent of GDP in the medium term, reflecting a current expenditure-based fiscal expansion as in the proposed economic plan as well as the clearance of unpaid claims. Meanwhile, improvements in revenue are assumed to be modest and not yet incorporate the impact of tax policy reforms as policy parameters remain unknown.

5. **Forecast error analysis suggests no systemic bias in historical estimations of real GDP growth and primary balance, but some negative bias on inflation. Forecasts of the primary balance were optimistic between 2012 and 2014.** However, this bias disappeared in recent years and became more conservative after a continued deterioration of balances. Growth projections have remained within the interquartile range in the past five years.

6. **Under the baseline scenario, the public debt is expected to rise to around 53½ percent in the medium term with gross financing needs reaching 16½ percent of GDP in 2021, both of which are driven by general government components.** Due to the projected fiscal expansion, the general government debt would continue its upward trajectory and reach almost 47 percent at end-2022. Publicly guaranteed debt is expected to grow by around 2½ percentage points of GDP between 2017 and 2018, reflecting continued borrowing to finance public infrastructure investments, before gradually declining in the medium term to around 7 percent of GDP at end-2022. Baseline public gross financing requirements are projected to remain high and peak in 2020–2021, at above the 15-percent benchmark, mainly due to the general government's amortization of Eurobonds and syndicated loans.

7. **The alternative scenarios indicate that a fiscal consolidation could help avoid a continuous increase in the general government debt and a high level of the general government's gross financing needs.** Under the historical and constant primary balance scenarios, the general government debt outlook and the general government gross financing needs are more favorable than the baseline. When the real GDP growth, the primary balance, and the real interest rate are set at their ten-year historical average, the general government's primary deficit will be around 1.7 percent of GDP, compared to 2½ percent of GDP under the baseline. Under this historical scenario, the general government debt would be around 44¼ percent of GDP at end-2021 and start to decline in 2022. Meanwhile, the peak of gross financing needs would be around 14¼ percent of GDP in 2021, below the 15-percent benchmark. Alternatively, assuming that the general government's primary deficit remains constant at the

2017 level would provide similar results to the historical scenario, as the primary deficit in 2017 was also close to the ten-year historical average of 1.7 percent of GDP.[1]

Macro-Fiscal and Additional Stress Tests

8. **Macroeconomic and fiscal shocks can significantly increase public debt and public gross financing needs relative to the baseline.** Among all stress test scenarios, FYR Macedonia has the highest vulnerability to a combined macro-fiscal shock and the real GDP growth shock of one standard deviation in 2018–19.[2] Under these stress test scenarios, public debt would rise to 59–62 percent of GDP in the medium term with gross financing needs being around 15 percent of GDP and above throughout the projection period. Closing the real exchange rate gap implies a small exchange rate appreciation which will result in a very slight decline in external public debt and external gross financing needs.[3] Nonetheless, the substantial share of FX-denominated public debt poses general vulnerability to exchange rate risks.

9. **In addition, fan charts illustrate the possible evolution of public debt over the medium term.** They present a spectrum of possible outcomes for the public debt level based on a probabilistic view of uncertainty around the baseline. Under a symmetric distribution, an 80 percent confidence interval for the public debt stock at end-2022 ranges between 45 and 62¼percent of GDP. However, under a restricted distribution, which precludes positive shocks to the primary balance, public debt could be above 60 percent with a probability of more than 20 percent, relative to the baseline scenario of 53½ percent.

External Debt Sustainability

10. **Over the medium term, the external debt is expected to stay at a moderately higher but stable level.** The debt level is expected to reach a maximum of 75.4 percent of GDP in 2018 before gradually declining to around 70 percent, as growth improves, and public infrastructure borrowings moderate. The persistent reduction in trade deficits on the back of the continued expansion in the FDI-financed export capacities is projected to continue with trade deficits falling from 18.3 percent of GDP in 2016 to 17.7 percent by 2022. FDI-related debt liabilities will continue to accumulate on the back of expanding TIDZs operations while counting for a larger share of overall FDI liabilities. The projected expansion in private sector borrowing in medium and long-term loans will slightly more than offset the gradual repayment of infrastructure related borrowing by the public sector. At the time, external debt service and repatriated FDI profits are

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[1] The alternative scenarios for the public debt present opposite results as they assumed higher primary balance due to the inclusion of public enterprises whose debt is guaranteed by the government. Their deficits and borrowings have been high in the past five years due to infrastructure investment, but they are projected to decline starting from 2019 as some road projects will be finished.

[2] Stress tests include individual shocks to macro variables (real interest rate, real GDP growth, real exchange rate) and primary balance. The combined macro-fiscal shock incorporates the largest effect of individual shocks on all variables.

[3] The real exchange rate gap is estimated to be around -0.7 to -1 percent (Annex I).

expected to rise gradually through the medium-term, with peak amortization on government bonds and public sector loans coming due in 2020–2021.

11. **The external debt path is particularly sensitive to real exchange rate depreciation and non-interest current account shocks.** Under a 30 percent exchange rate depreciation shock, foreign debt level would rise to 110 percent of GDP by 2018 before stabilizing at 102 percent by 2022. The shock to the current account of half a standard deviation (around 2½ percent of GDP), on the other hand, would lead to a steady deterioration in external debt position to almost 80 percent of GDP. A reversion in fiscal adjustment measures assumed under the baseline could also have a significant impact on external debt dynamics by leading to higher trade deficits and a rising external premium on the issuance of government debt.

Conclusion

12. **Stronger fiscal consolidation through higher tax and expenditure efficiencies is needed to stabilize debt and rebuild fiscal space.** While the level of public debt is not alarmingly high, the speed of debt accumulation since the financial crisis calls for caution. Baseline gross financing needs are already above the benchmark, and adverse shocks, particularly in GDP growth could send general government and public debt well above 40 and 50 percent of GDP respectively by 2022. Space for fiscal policy, the main countercyclical stabilization policy tool in FYR Macedonia, is limited. The general government's primary deficit is expected to be around 2.3 percent of GDP by 2022, 0.3 percentage points higher than the debt-stabilizing primary balance, revealing a pressing need for stronger fiscal consolidation. In addition, public debt sustainability depends on sound macroeconomic management and continuing progress on institutional and structural issues which would help unlock the economy's growth potential and reduce its vulnerability to shocks.

13. **The improvement in public debt management is welcome and should be continued.** Efforts to further lengthen the average maturity of domestic debt and deepen the secondary market would help reduce the domestic debt roll-over and interest rate risks. With a large share of public debt being external, the medium-term fiscal strategy should be accompanied by a debt management strategy that strikes a balance between achieving an efficient mix of external and domestic financing to maintain overall macroeconomic stability.

Figure 1. FYR Macedonia: General Government Debt Sustainability Analysis (DSA) – Baseline Scenario

(In percent of GDP, unless otherwise indicated)

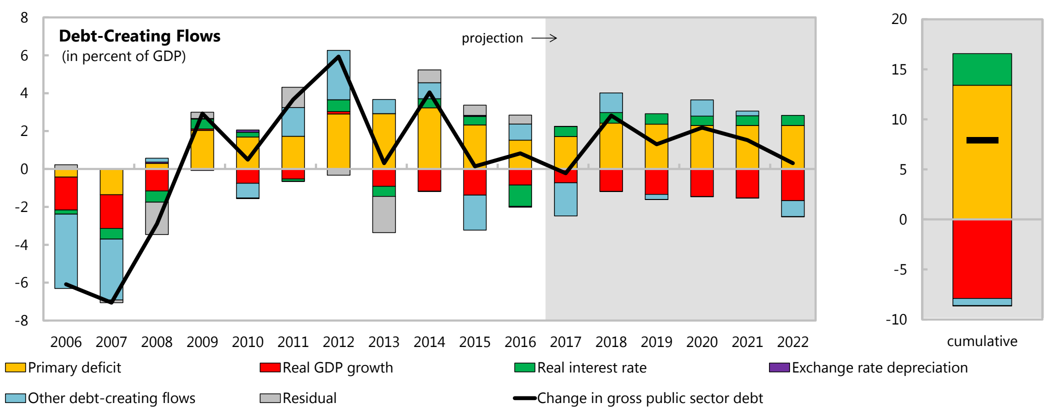
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2006-2014 [2]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	28.4	38.2	39.0	38.8	41.6	42.9	45.1	46.6	46.9
Public gross financing needs	12.9	14.9	14.5	12.4	13.7	11.0	13.3	15.6	12.8
Real GDP growth (in percent)	3.2	3.8	2.4	1.9	3.2	3.4	3.6	3.6	3.8
Inflation (GDP deflator, in percent)	2.9	1.9	6.3	2.0	2.0	2.0	2.2	2.2	2.2
Nominal GDP growth (in percent)	6.2	5.8	8.8	4.0	5.3	5.5	5.9	5.9	6.1
Effective interest rate (in percent) [4]	3.0	3.2	3.2	3.5	3.6	3.5	3.5	3.5	3.5

As of September 13, 2017		
Sovereign Spreads		
EMBIG (bp) 3/		348
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	n.a.	n.a.
S&Ps	BB-	BB-
Fitch	BB	BB

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	0.1	0.1	0.8	-0.2	2.8	1.3	2.2	1.5	0.3	7.9	
Identified debt-creating flows	0.4	-0.4	0.4	-0.2	2.8	1.3	2.2	1.5	0.3	8.0	
Primary deficit	1.4	2.3	1.5	1.7	2.4	2.4	2.3	2.3	2.3	13.4	-2.0
Primary (noninterest) revenue and grants	30.1	28.8	27.8	28.3	28.4	28.5	28.5	28.5	28.5	170.9	
Primary (noninterest) expenditure	31.6	31.1	29.3	30.0	30.9	30.9	30.8	30.8	30.8	184.3	
Automatic debt dynamics [5]	-0.9	-0.9	-2.0	-0.2	-0.6	-0.8	-1.0	-1.0	-1.1	-4.7	
Interest rate/growth differential [6]	-0.9	-0.9	-2.0	-0.2	-0.6	-0.8	-1.0	-1.0	-1.1	-4.7	
Of which: real interest rate	0.0	0.5	-1.1	0.5	0.6	0.5	0.5	0.5	0.5	3.2	
Of which: real GDP growth	-0.9	-1.4	-0.8	-0.7	-1.2	-1.3	-1.5	-1.5	-1.7	-7.9	
Exchange rate depreciation [7]	0.0	0.1	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.2	-1.9	0.9	-1.7	1.0	-0.3	0.9	0.3	-0.8	-0.7	
Privatization receipts (negative)	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Changes in cash, deposits, and securities	0.6	-1.8	0.9	-1.7	1.0	-0.3	0.9	0.3	-0.8	-0.7	
Residual, including asset changes [8]	-0.2	0.5	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

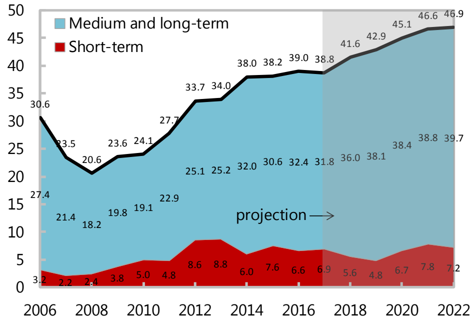
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 2. FYR Macedonia: General Government DSA – Composition of General Government Debt and Alternative Scenarios

Composition of Public Debt

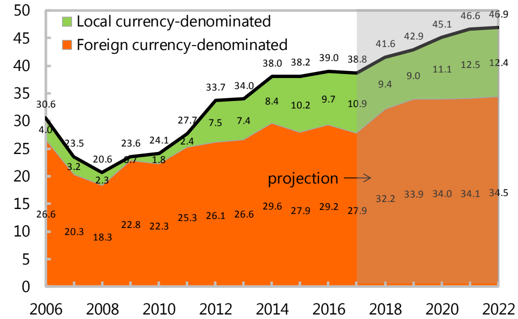
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

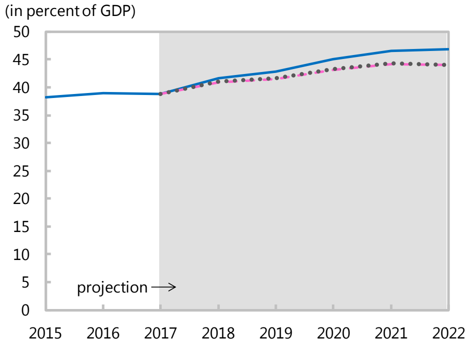


Alternative Scenarios

Baseline Historical Constant Primary Balance

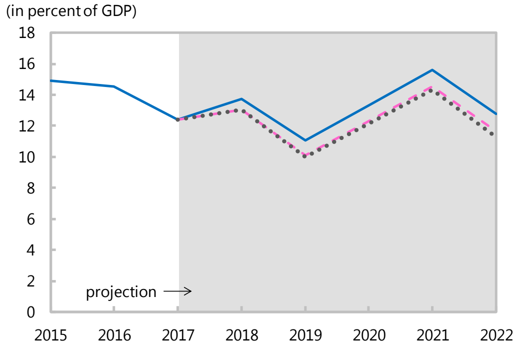
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	1.9	3.2	3.4	3.6	3.6	3.8
Inflation	2.0	2.0	2.0	2.2	2.2	2.2
Primary Balance	-1.7	-2.4	-2.4	-2.3	-2.3	-2.3
Effective interest rate	3.5	3.6	3.5	3.5	3.5	3.5
Constant Primary Balance Scenario						
Real GDP growth	1.9	3.2	3.4	3.6	3.6	3.8
Inflation	2.0	2.0	2.0	2.2	2.2	2.2
Primary Balance	-1.7	-1.7	-1.7	-1.7	-1.7	-1.7
Effective interest rate	3.5	3.6	3.5	3.5	3.5	3.6

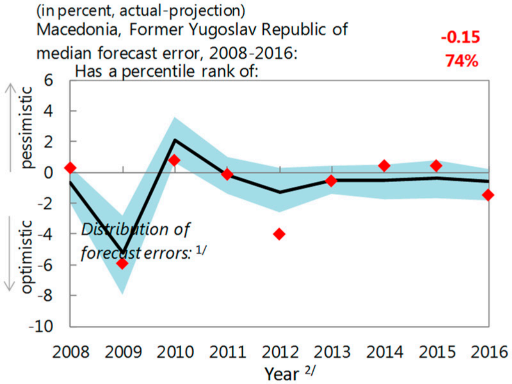
Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	1.9	3.0	3.0	3.0	3.0	3.0
Inflation	2.0	2.0	2.0	2.2	2.2	2.2
Primary Balance	-1.7	-1.7	-1.7	-1.7	-1.7	-1.7
Effective interest rate	3.5	3.6	3.0	2.9	2.7	2.6

Source: IMF staff.

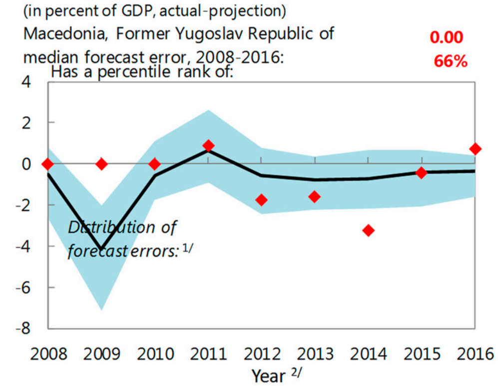
Figure 3. FYR Macedonia: General Government DSA – Realism of Baseline Assumptions

Forecast Track Record, versus all countries

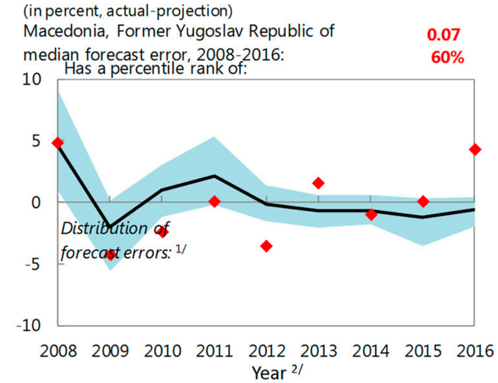
Real GDP Growth
(in percent, actual-projection)



Primary Balance
(in percent of GDP, actual-projection)

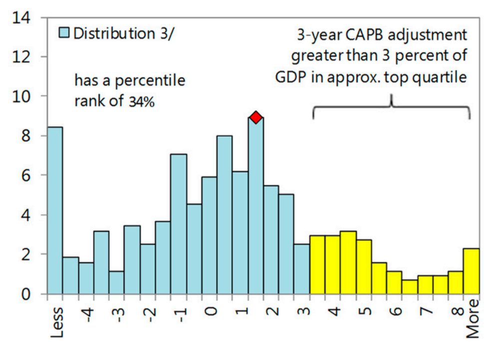


Inflation (Deflator)
(in percent, actual-projection)

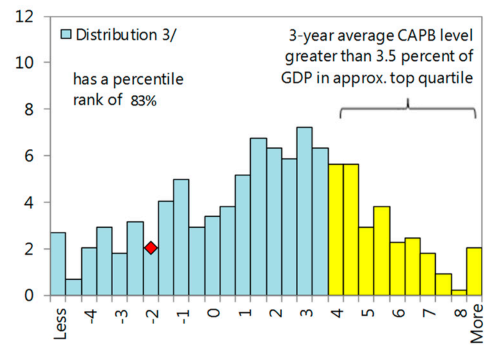


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



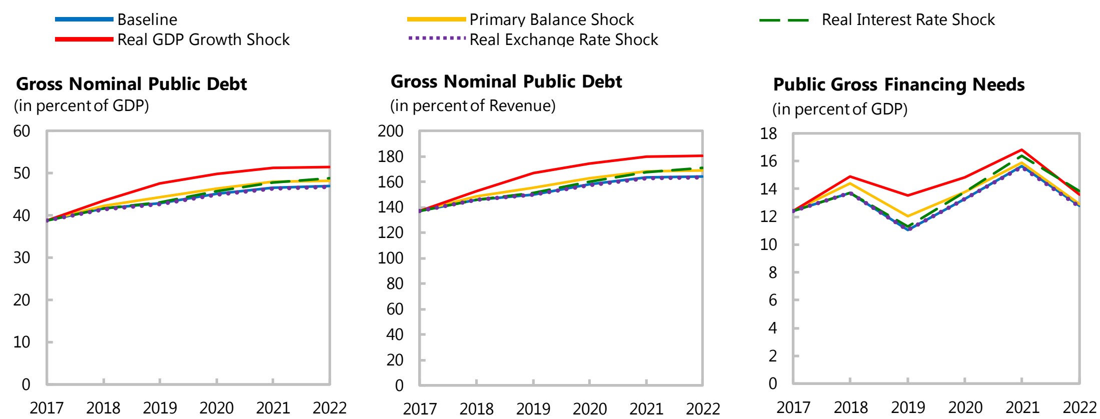
3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



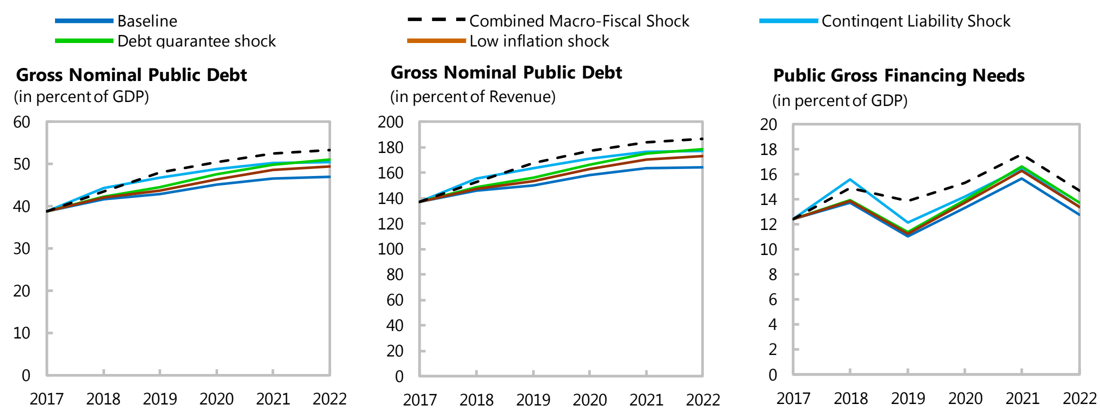
Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 4. FYR Macedonia: General Government DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	1.9	3.2	3.4	3.6	3.6	3.8
Inflation	2.0	2.0	2.0	2.2	2.2	2.2
Primary balance	-1.7	-3.1	-3.1	-2.3	-2.3	-2.3
Effective interest rate	3.5	3.6	3.5	3.5	3.5	3.5
Real Interest Rate Shock						
Real GDP growth	1.9	3.2	3.4	3.6	3.6	3.8
Inflation	2.0	2.0	2.0	2.2	2.2	2.2
Primary balance	-1.7	-2.4	-2.4	-2.3	-2.3	-2.3
Effective interest rate	3.5	3.6	4.2	4.4	4.7	5.0
Combined Shock						
Real GDP growth	1.9	1.0	1.2	3.6	3.6	3.8
Inflation	2.0	1.5	1.5	2.2	2.2	2.2
Primary balance	-1.7	-3.3	-4.1	-2.3	-2.3	-2.3
Effective interest rate	3.5	3.6	4.2	4.4	4.7	4.9
Debt guarantee shock						
Real GDP growth	1.9	1.2	1.4	1.6	1.6	1.8
Inflation	2.0	2.0	2.0	2.2	2.2	2.2
Primary balance	-1.7	-2.4	-2.4	-2.3	-2.3	-2.3
Effective interest rate	3.5	3.6	3.5	3.5	3.5	3.5

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	1.9	1.0	1.2	3.6	3.6	3.8
Inflation	2.0	1.5	1.5	2.2	2.2	2.2
Primary balance	-1.7	-3.3	-4.1	-2.3	-2.3	-2.3
Effective interest rate	3.5	3.6	3.5	3.6	3.5	3.5
Real Exchange Rate Shock						
Real GDP growth	1.9	3.2	3.4	3.6	3.6	3.8
Inflation	2.0	1.8	2.0	2.2	2.2	2.2
Primary balance	-1.7	-2.4	-2.4	-2.3	-2.3	-2.3
Effective interest rate	3.5	3.6	3.5	3.5	3.5	3.5
Contingent Liability Shock						
Real GDP growth	1.9	1.0	1.2	3.6	3.6	3.8
Inflation	2.0	1.5	1.5	2.2	2.2	2.2
Primary balance	-1.7	-3.9	-2.4	-2.3	-2.3	-2.3
Effective interest rate	3.5	3.7	3.5	3.5	3.5	3.5
Low inflation shock						
Real GDP growth	1.9	2.2	2.4	2.6	2.6	2.8
Inflation	2.0	2.0	2.0	2.0	2.0	2.0
Primary balance	-1.7	-2.4	-2.4	-2.3	-2.3	-2.3
Effective interest rate	3.5	3.6	3.6	3.6	3.6	3.7

Source: IMF staff.

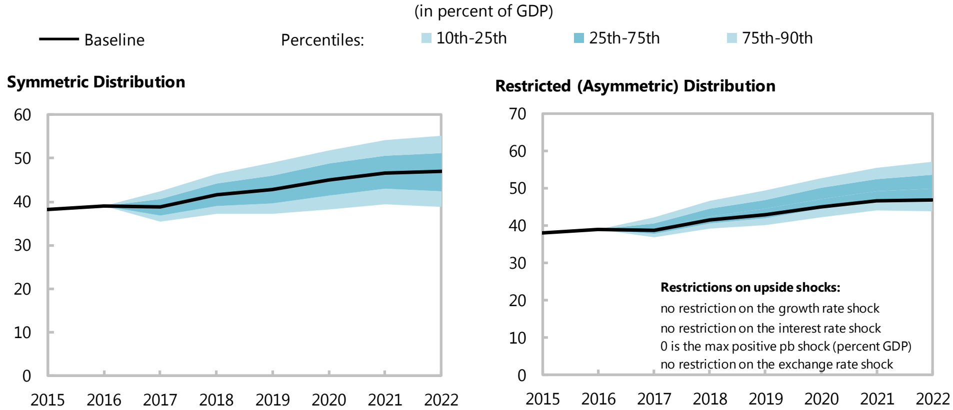
Figure 5. FYR Macedonia: General Government DSA Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

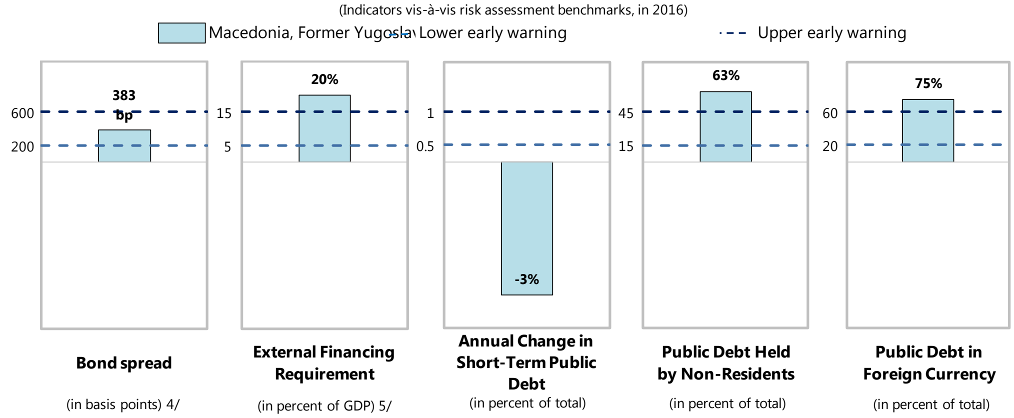
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 15-Jun-17 through 13-Sep-17.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 6. FYR Macedonia: Non-Financial Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

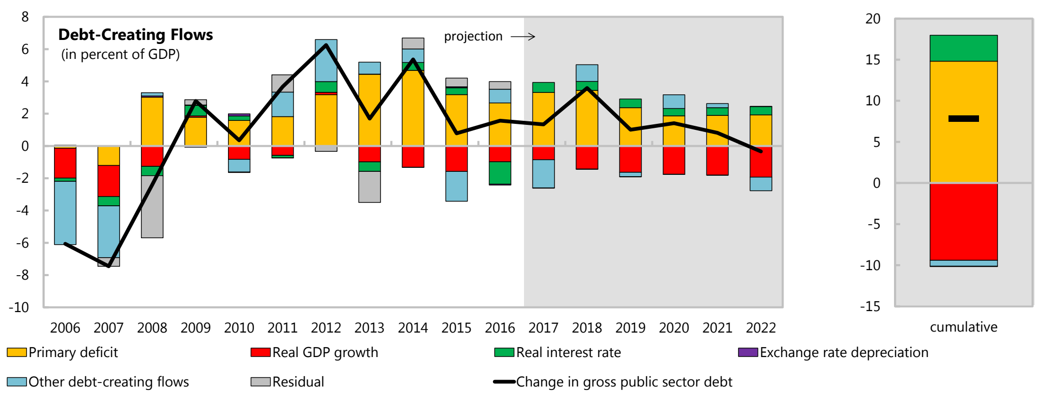
(In percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of September 13, 2017		
	2006-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022	Sovereign Spreads		
Nominal gross public debt	31.4	44.2	45.7	47.1	50.7	51.7	53.1	53.9	53.6	EMBIG (bp) 3/		348
Public gross financing needs	14.5	16.2	16.2	14.8	15.6	12.3	14.3	16.5	13.6	5Y CDS (bp)		n.a.
Real GDP growth (in percent)	3.2	3.8	2.4	1.9	3.2	3.4	3.6	3.6	3.8	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	2.9	1.9	6.3	2.0	2.0	2.0	2.2	2.2	2.2	Moody's	n.a.	n.a.
Nominal GDP growth (in percent)	6.2	5.8	8.8	4.0	5.3	5.5	5.9	5.9	6.1	S&Ps	BB-	BB-
Effective interest rate (in percent) [4/]	3.1	3.0	3.0	3.5	3.3	3.2	3.2	3.2	3.3	Fitch	BB	BB

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.5	0.8	1.6	1.3	3.6	1.0	1.4	0.8	-0.3	7.8	
Identified debt-creating flows	1.0	0.2	1.1	1.3	3.6	1.0	1.4	0.8	-0.3	7.9	
Primary deficit	2.1	3.2	2.7	3.3	3.4	2.4	1.9	1.9	1.9	14.8	-2.3
Primary (noninterest) revenue and grants	30.1	28.8	27.8	28.3	28.4	28.5	28.5	28.5	28.5	170.9	
Primary (noninterest) expenditure	32.2	32.0	30.5	31.6	31.9	30.9	30.4	30.4	30.5	185.7	
Automatic debt dynamics [5/]	-0.9	-1.1	-2.4	-0.2	-0.9	-1.1	-1.3	-1.3	-1.4	-6.2	
Interest rate/growth differential [6/]	-1.0	-1.1	-2.4	-0.2	-0.9	-1.1	-1.3	-1.3	-1.4	-6.2	
Of which: real interest rate	0.0	0.4	-1.4	0.6	0.6	0.5	0.5	0.5	0.5	3.2	
Of which: real GDP growth	-0.9	-1.6	-1.0	-0.9	-1.4	-1.6	-1.8	-1.8	-1.9	-9.4	
Exchange rate depreciation [7/]	0.0	0.1	-0.1	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.2	-1.9	0.9	-1.7	1.0	-0.3	0.9	0.3	-0.8	-0.7	
Privatization receipts (negative)	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Changes in cash, deposits, and securities	0.6	-1.8	0.9	-1.7	1.0	-0.3	0.9	0.3	-0.8	-0.7	
Residual, including asset changes [8/]	-0.5	0.5	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as non-financial public sector.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as -g.

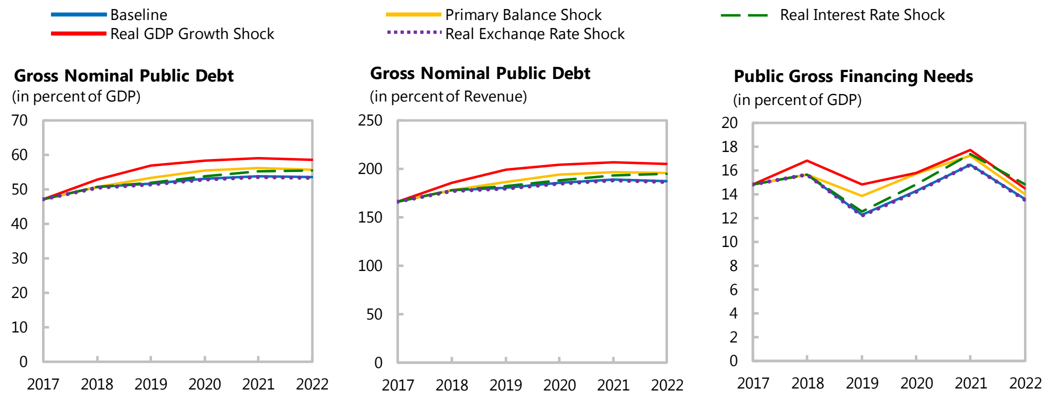
7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

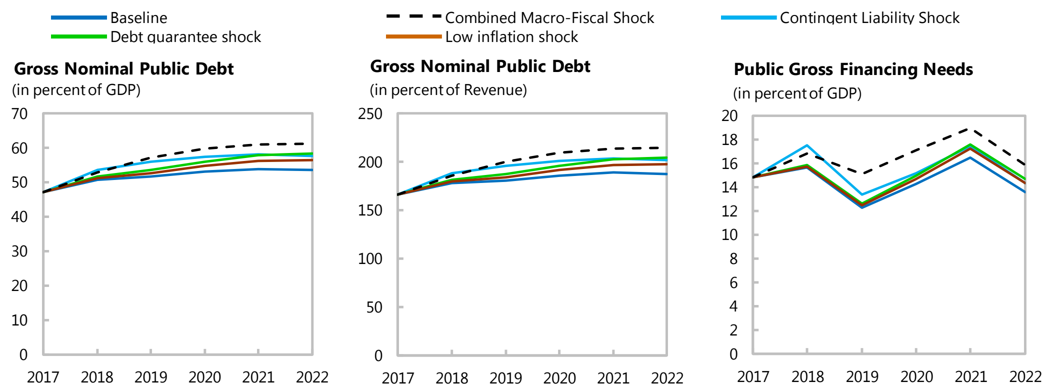
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 7. FYR Macedonia: Non-Financial Public Sector DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	1.9	3.2	3.4	3.6	3.6	3.8
Inflation	2.0	2.0	2.0	2.2	2.2	2.2
Primary balance	-3.3	-3.4	-4.0	-2.6	-1.9	-1.9
Effective interest rate	3.5	3.3	3.2	3.3	3.3	3.3
Real Interest Rate Shock						
Real GDP growth	1.9	3.2	3.4	3.6	3.6	3.8
Inflation	2.0	2.0	2.0	2.2	2.2	2.2
Primary balance	-3.3	-3.4	-2.4	-1.9	-1.9	-1.9
Effective interest rate	3.5	3.3	3.9	4.1	4.4	4.8
Combined Shock						
Real GDP growth	1.9	1.0	1.2	3.6	3.6	3.8
Inflation	2.0	1.5	1.5	2.2	2.2	2.2
Primary balance	-3.3	-4.3	-4.1	-2.6	-1.9	-1.9
Effective interest rate	3.5	3.3	3.8	4.1	4.4	4.7
Debt guarantee shock						
Real GDP growth	1.9	1.2	1.4	1.6	1.6	1.8
Inflation	2.0	2.0	2.0	2.2	2.2	2.2
Primary balance	-3.3	-3.4	-2.4	-1.9	-1.9	-1.9
Effective interest rate	3.5	3.3	3.2	3.2	3.2	3.3

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	1.9	1.0	1.2	3.6	3.6	3.8
Inflation	2.0	1.5	1.5	2.2	2.2	2.2
Primary balance	-3.3	-4.3	-4.1	-1.9	-1.9	-1.9
Effective interest rate	3.5	3.3	3.2	3.3	3.3	3.3
Real Exchange Rate Shock						
Real GDP growth	1.9	3.2	3.4	3.6	3.6	3.8
Inflation	2.0	1.8	2.0	2.2	2.2	2.2
Primary balance	-3.3	-3.4	-2.4	-1.9	-1.9	-1.9
Effective interest rate	3.5	3.3	3.2	3.2	3.2	3.3
Contingent Liability Shock						
Real GDP growth	1.9	1.0	1.2	3.6	3.6	3.8
Inflation	2.0	1.5	1.5	2.2	2.2	2.2
Primary balance	-3.3	-5.0	-2.4	-1.9	-1.9	-1.9
Effective interest rate	3.5	3.4	3.3	3.3	3.3	3.3
Low inflation shock						
Real GDP growth	1.9	2.2	2.4	2.6	2.6	2.8
Inflation	2.0	2.0	2.0	2.0	2.0	2.0
Primary balance	-3.3	-3.4	-2.4	-1.9	-1.9	-1.9
Effective interest rate	3.5	3.3	3.3	3.3	3.4	3.5

Source: IMF staff.

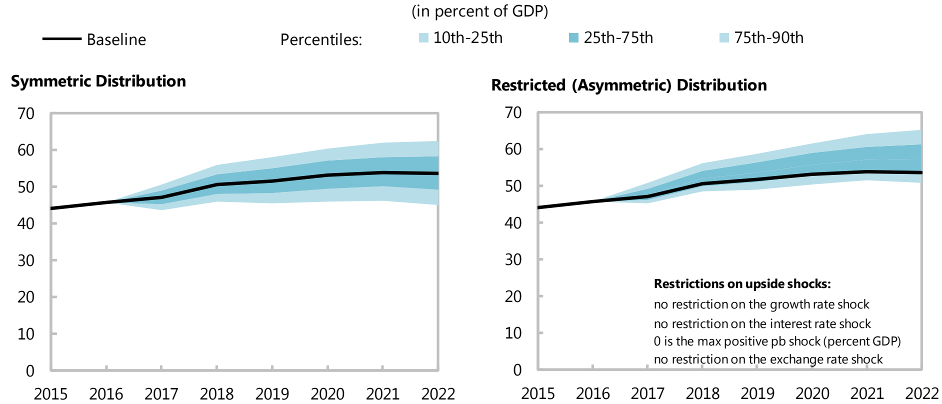
Figure 8. FYR Macedonia: Non-Financial Public Sector DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

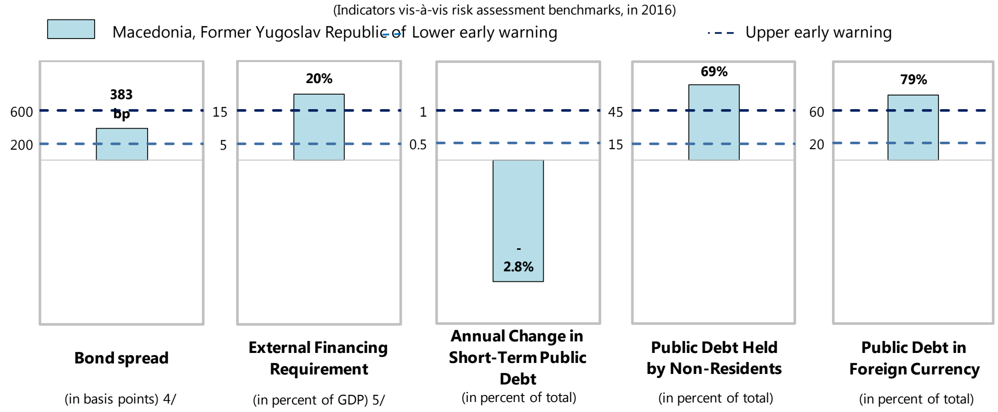
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 15-Jun-17 through 13-Sep-17.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Table 1. FYR Macedonia: Non-Financial Public Sector Debt Stress Scenarios

Name	Description	Impact on debt 1/
Primary Balance Shock	Minimum shock equivalent to 50% of planned adjustment (50% implemented), or baseline minus half of the 10-year historical standard deviation, whichever is larger. There is an increase in interest rates of 25bp for every 1% of GDP worsening in the primary balance.	2.3
Real GDP Growth Shock	Real GDP growth is reduced by 1 standard deviation for 2 consecutive years; revenue-to-GDP ratio remains the same as in the baseline; level of non-interest expenditures is the same as in the baseline; deterioration in primary balance lead to higher interest rate (see above); decline in growth leads to lower inflation (0.25 percentage points per 1 percentage point decrease in GDP growth).	5.0
Interest Rate Shock	Interest rate increases by difference between average real interest rate level over projection and maximum real historical level, or by 200bp, whichever is larger.	2.0
Real Exchange Rate Shock	Estimate of overvaluation or maximum historical movement of the exchange rate, whichever is higher; pass-through to inflation with default elasticity of 0.25 for EMs and 0.03 for AEs.	-0.2
Combined Macro-Fiscal Shock	Shock size and duration based on the underlying shocks.	7.8

1/ Percentage points in excess of the baseline at the end of the projection period.

Table 2. FYR Macedonia: External Debt Sustainability Framework, 2011-2022

(In percent of GDP, unless otherwise indicated)

	Actual								Projections							
	2011	2012	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022		**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	64.2	68.2	64.0	70.0	69.4	73.5			**71.8**	**75.4**	**72.9**	**70.1**	**70.5**	**69.5**		**-6.2**
Change in external debt	6.5	3.9	-4.1	5.9	-0.6	4.1			-1.8	3.6	-2.4	-2.8	0.3	-1.0	0.0	
Identified external debt-creating flows (4+8+9)	-5.3	1.2	-5.9	-4.9	-4.0	-6.1			-2.2	-2.6	-2.7	-2.6	-2.4	-2.5	0.0	
Current account deficit, excluding interest payments	1.8	2.6	1.1	0.1	1.3	2.0			1.2	1.4	1.8	2.1	2.2	2.2	6.2	
Deficit in balance of goods and services	20.5	22.4	18.3	17.2	16.3	14.8			14.7	14.6	14.5	14.3	14.0	13.9		
Exports	45.6	44.5	43.3	47.7	48.8	49.3			51.3	53.3	55.0	56.7	58.6	60.2		
Imports	66.1	66.9	61.6	64.9	65.1	64.2			66.0	68.0	69.5	71.1	72.7	74.1		
Net non-debt creating capital inflows (negative)	-4.5	-1.7	-2.8	-2.3	-2.1	-3.1			-2.8	-2.6	-2.8	-2.9	-2.9	-2.9	-2.9	
Automatic debt dynamics 1/	-2.6	0.3	-4.2	-2.6	-3.2	-4.9			-0.7	-1.4	-1.7	-1.8	-1.7	-1.8	-3.3	
Contribution from nominal interest rate	0.7	0.6	0.5	0.5	0.6	0.7			0.7	0.8	0.7	0.7	0.7	0.7	0.7	
Contribution from real GDP growth	-1.3	0.3	-1.9	-2.2	-2.5	-1.5			-1.4	-2.2	-2.4	-2.5	-2.4	-2.5	-2.5	
Contribution from price and exchange rate changes 2/	-2.1	-0.6	-2.9	-0.9	-1.3	-4.1			...	...	...	...	...	...	-1.5	
Residual, incl. change in gross foreign assets (2-3) 3/	11.8	2.8	1.8	10.8	3.5	10.2			0.4	6.2	0.3	-0.2	2.7	-1.5	0.0	
External debt-to-exports ratio (in percent)	140.8	153.3	147.9	146.6	142.2	149.1			139.8	141.3	132.5	123.6	120.2	115.3		
Gross external financing need (billions of Euros) 4/	1643.6	1979.6	2124.6	1595.1	2069.4	1935.5			2063.6	2159.6	2110.5	2594.7	2729.6	2290.7		
in percent of GDP	21.8	26.1	26.1	18.6	22.8	19.6	10-Year	10-Year	20.1	20.0	18.5	21.5	21.4	16.9		
Scenario with key variables at their historical averages 5/									**71.6**	**75.4**	**73.3**	**70.9**	**71.4**	**70.7**		**-7.2**
Key Macroeconomic Assumptions Underlying Baseline							Historical Average	Standard Deviation							For debt stabilization	
Real GDP growth (in percent)	2.3	-0.5	2.9	3.6	3.8	2.4	3.0	2.2	1.9	3.2	3.4	3.6	3.6	3.8	3.8	
GDP deflator in US dollars (change in percent)	3.7	1.0	4.4	1.4	1.9	6.3	3.1	2.1	2.0	2.0	2.0	2.2	2.2	2.2	2.2	
Nominal external interest rate (in percent)	1.3	1.0	0.8	0.7	1.0	1.1	0.8	0.4	1.0	1.1	1.0	1.0	1.1	1.1	1.1	
Growth of exports (Euro terms, in percent)	26.1	-2.0	4.6	15.8	8.2	10.0	10.4	16.5	8.2	9.4	8.8	9.1	9.4	9.0		
Growth of imports (Euro terms, in percent)	20.8	1.7	-1.1	10.8	6.1	7.3	8.6	13.6	7.0	8.4	7.9	8.2	8.3	8.2		
Current account balance, excluding interest payments	-1.8	-2.6	-1.1	-0.1	-1.3	-2.0	-3.6	3.9	-1.2	-1.4	-1.8	-2.1	-2.2	-2.2		
Net non-debt creating capital inflows	4.5	1.7	2.8	2.3	2.1	3.1	3.6	2.7	2.8	2.6	2.8	2.9	2.9	2.9		

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

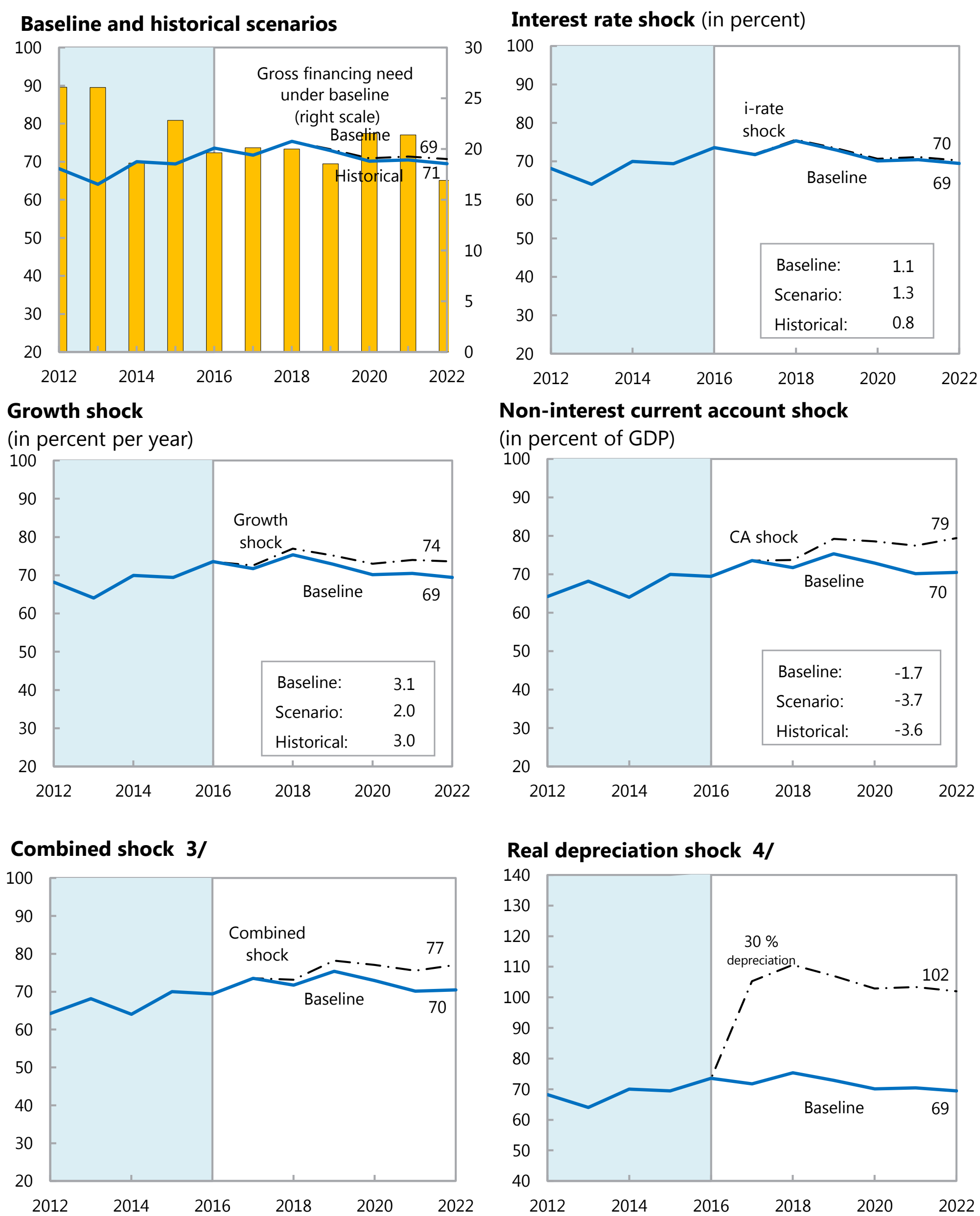
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 9. FYR Macedonia: External Debt Sustainability: Bound Test 1/2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2017.

INTERNATIONAL MONETARY FUND

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

October 17, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | European Department

CONTENTS

FUND RELATIONS

(As of October 17, 2017)

Missions. Article IV, Skopje, September 6-18, 2017. Concluding statement is available at: http://www.imf.org/en/News/Articles/2017/09/18/ms091817-macedonia-staff-concluding-statement-of-the-2017-article-iv-mission

Staff team. Jesmin Rahman (head), La-Bhus Fah Jirasavetakul, Ioannis Halikias and Iacovos Ioannou (all EUR), and Gjorgji Nacevski (local economist).

Discussions. The staff team met Prime Minister Zaev, Deputy Prime Minister Angjushev, Minister of Finance Tevdovski, National Bank Governor Bogov, other senior officials, and representatives of the banking, business, political and international communities.

Publication. The Macedonian authorities have indicated that they agree with publication of this staff report.

Membership Status:	Joined 12/14/92; Article VIII	
General Resources Account:	SDR Million	Percent of Quota
Quota	140.30	100.00
Fund holdings of currency	140.30	100.00
Reserve position	0.00	0.00
SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	65.62	100.00
Holdings	3.55	5.41
Outstanding Purchases and Loans:	None	

Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PLL [1/]	01/19/2011	01/18/2013	413.40	197.00
Stand-By	08/31/2005	08/30/2008	51.68	10.50
Stand-By	04/30/2003	08/15/2004	20.00	20.00

[1/] Formerly PCL.

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

	Forthcoming				
	2017	2018	2019	2020	2021
Principal					
Charges/Interest	0.09	0.34	0.34	0.34	0.34
Total	0.09	0.34	0.34	0.34	0.34

Exchange Arrangement:
FYR Macedonia has accepted the obligations of Article VIII, Sections 2, 3 and 4 and currently maintains an exchange system free of restrictions on payments and transfers for current international transactions.

Article IV Consultations:
The first consultation with the FYR of Macedonia was concluded in August 1993. The last consultation was concluded on November 21, 2016 (IMF Country Report 16/513). The FYR Macedonia is on the standard 12-month Article IV consultation cycle.

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Table 1. Technical Assistance Since 2006

Purpose	**Department**		**Date**
Banking Law	LEG/MCM		June 2006
Central Bank Law	LEG/MCM		July 2007
FX Reserves Modeling	RES/MCM		February 2012 February 2013
Macroeconomic Modeling at NBRM	MCM		May 2007 November 2009 September 2010 November 2010 May 2011 November 2011 February 2012 November 2012 March 2013 November 2013 March 2014
Liquidity, Cash and Debt Management	MCM		April 2007
Contingency Planning and Crisis Preparedness	MCM		February 2009
Stress Testing	MCM		February 2011
Domestic Debt Market Development	MCM		October 2011
Provisioning Regulation	MCM		November 2012
Public Debt Management	MCM/WB		January 2017
Expenditure Rationalization	FAD		November 2007
Public Financial Management	FAD		September 2009 November 2012 October 2017
Medium-Term Budgeting	FAD		May 2011
Budgeting Framework/Payment Arrears	FAD		March 2012
Tax Policy	FAD		September 2006 July 2007 January 2017 September 2017
Tax Administration	FAD		April 2007 July 2009 April 2010 June 2011 September 2013 December 2014 April 2016 May 2016 July 2016 May 2017 September 2017
Tax IT System Improvement	FAD		May 2017 September 2017

Table 1. Technical Assistance Since 2006 (continued)			
Tax Audit Function	FAD		February 2016 November 2016 March 2017
Tax Arrears Management	FAD		March 2013 October 2014
Large Taxpayers Office	FAD		March 2016
Tax Compliance Management	FAD		November 2013 March 2014 October 2014 February 2015 October 2015 October 2016 November 2016
National Accounts Statistics	STA		April 2007 June 2007 January 2008 May 2008 September 2008 December 2008 June 2009 August 2011 September 2012 March 2013 October 2013
Export and Import Deflators	STA		December 2007
Government Finance Statistics	STA		June 2006 December 2007 October 2008 January 2015 June 2016 November 2016 February 2017 July 2017
Balance of Payments Statistics	STA		October 2006 October 2008
External Sector Statistics	STA		April 2017
SDDS Subscription	STA		December 2010
STA TA Evaluation	STA		September 2012
Monetary and Financial Statistics (MFS)	STA		January 2015
Safeguards Assessment	FIN		February 2011
Regional Advisors			
Revenue Administration	FAD		2015-
Public Financial Management	FAD		2015-
National Accounts	STA		2012-2014
Resident Experts			
Tax Administration	FAD		October 2006–August 2011
Banking Supervision	MCM		May 2006–May 2008

Table 1. Technical Assistance Since 2006 (concluded)			
FSAP Participation and ROSCs (since 2003)			
FSAP	MCM/WB		May-June 2003
FSAP update	MCM/WB		March 2008
Data ROSC	STA		February 2004
Fiscal ROSC	FAD		February 2005

IMF–WORLD BANK COLLABORATION

Background

The Bank and the Fund country teams on the Former Yugoslav Republic of Macedonia maintained close collaboration, seeking synergies and harmonizing policy recommendations. Close coordination has resulted in largely shared views of the economic situation in the country.

Upon the request of the authorities a joint IMF-World Bank team was assembled which is providing technical assistance in the foiled of strengthening public debt management. The first mission of the team was held in January 2017 and a report was presented to the authorities. A second mission is scheduled for September 2017 and the project is supposed to continue in the coming period.

Key Areas of World Bank Involvement

- The World Bank program in FYR Macedonia focuses on two interrelated themes: i) Growth and Competitiveness; and ii) Skills and Inclusion. For Growth and Competitiveness, successful poverty reduction would need sustained private sector led growth, making FYR Macedonia more attractive as a destination for investments and as a country whose private companies can compete at the regional and global level. For Skills and Inclusion, the fruits of growth can be shared broadly if more Macedonians have access to better jobs and if public services are of good quality and delivered efficiently. Since FYR Macedonia's future is clearly linked to the European integration, the Bank's Country Partnership Strategy (CPS) actively promotes the EU accession agenda and this represents a cross-cutting theme of the strategy. The Bank is currently in the preparation process of a Performance and Learning Review of the current CPS, which will be an opportunity to evaluate progress with the strategy and consider possible adjustments for the remaining period.

- The Bank continues to be engaged in the transport sector through two projects. The National and Regional Roads Rehabilitation Project (US$ 71 million) is helping enhance the connectivity of selected national and regional roads, primarily to Corridors X and VIII, and to improve the Public Enterprise for State Roads' capacity for road safety and climate resilience. The new Road Upgrading and Development Project's objective (US$90.95 million) is to improve transport connectivity for road users along Corridor VIII between Skopje and Deve Bair, and to improve the asset management and planning functions of the Public Enterprise for State Roads. Its objective was to improve the transmission grid, including an interconnection with Serbia. There are two investments in the area of local government development. The first is the Municipal Services Improvement Project (MSIP) (US$75 million), which is helping to improve transparency, financial sustainability and delivery of targeted municipal services in selected municipalities. The high demand from the municipalities has led to a second Municipal Services Improvement Project (US$28.04 million), approved in January 2016, and effective as of July 2016. In addition to this, the EU has provided additional financing of US$17.72 million, to complement MSIP activities in rural municipalities. The World Bank is also active in the human development sector through the Conditional Cash Transfer Project (US$25 million), and the Skills Development and Innovation Support Project (US$24 million).

- The Local and Regional Competitiveness Project is financed by an EU Trust Fund of US$19.36 million, with the objective of enhancing the contribution of tourism to local economic development and improving the capacity of the government and public entities to foster tourism growth.

Macedonia–Bank and Fund Planned Activities in Macrocritical Structural Reform Areas June 2017–May 2018			
Title	**Products**	**Provisional Timing of Missions**	**Expected Delivery Date**
1. Fund work program	Article IV Report	September 2017	November 2017
	Technical assistance on Revenue Administration Reforms (Tax Compliance and Risk Management, Arrears Management, Large Taxpayers Office)	Short-term expert visits FY18	TA report after the mission
	Technical assistance on Revenue Administration Reforms	Regular short-term visits of region-based long-term expert FY2018	
	Technical assistance on Government Finance Statistics	Short-term expert visits FY2018	TA report after the mission
	Financial Sector Assessment Program (FSAP)	FY2018-19	FY2019
2. Bank work program	Southeastern Europe Regular Economic Update	Continuous and periodic missions	November 2017 and April 2018
	Skills Development and Innovation Support Project	Continuous	Project closing May 2019
	Conditional Cash Transfers Project	Continuous	Project closing December 2017
	Municipal Services Improvement Project	Continuous	Project closing March 2019
	Municipal Services Improvement Project 2	Continuous	Project closing March 2021
	Local and Regional Competitiveness Project	Continuous	Project closing December 2019
	National and Regional Road Rehabilitation Project	Continuous	Project closing September 2019
	Road Upgrading and Development Project	Continuous	Project closing December 2020

STATISTICAL ISSUES

(As of October 17, 2017)

I. Assessment of Data Adequacy for Surveillance
General: Data provision has some shortcomings but is broadly adequate for surveillance. Areas that would benefit most from further improvement are national accounts and government finance statistics.
National accounts: Quality of national account measurement need to be improved. In 2013, by Decision of the Government of the Republic of Macedonia, amendments were made to the National Classification of Activities—NKD Rev.2 and entailed significant changes in the decomposition of historical data. The primary objective of the Classification of Activities is to provide a basis for comparing statistical data of the Republic of Macedonia on European and world level, i.e. in its content and structure is completely harmonized with the European Classification of Activities NACE Rev.2. **Price statistics:** Improvements to the CPI have been introduced in accordance with international standards and EU regulations to align the Classification of Individual Consumption According to Purpose (COICOP).
Government finance statistics: Debt data on a disaggregated basis for the broader public sector are not available on a regular basis. Macedonia does not report government finance statistics to the Fund for publication in either the *Government Finance Statistics Yearbook* (GFSY) or the *International Financial Statistics* (*IFS*).
Monetary sector: EUR receives a monthly electronic report of monetary statistics, covering the balance sheet of the central bank, other depository corporations, and other financial corporations.
External sector: External sector statistics meet international standards. In additional to quarterly balance of payments data, the authorities compile and disseminate international investment position (IIP) data, reserve assets and foreign currency liquidity data, and external debt statistics.

II. Data Standards and Quality	
FYR Macedonia participates in the General Data Dissemination System (GDDS), and, since November 2011, in the Special Data Dissemination Standard (SDDS).	Data ROSC published on September 29, 2004.

Former Yugoslav Republic of Macedonia: Table of Common Indicators Required for Surveillance

(As of October 17, 2017)

	Date of Latest Observation	Date Received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality – Methodological Soundness[8]	Memo Items: Data Quality – Accuracy and Reliability[9]
Exchange Rates	10/13/17	10/13/17	D	W	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	9/30/17	9/30/17	M	M	M		
Reserve/Base Money	Sep. 17	10/13/17	M	M	M	O, LO, LO, O	O, LO, O, O, O
Broad Money	Aug. 17	9/21/17	M	M	M		
Central Bank Balance Sheet	Aug. 17	9/21/17	M	M	M		
Consolidated Balance Sheet of the Banking System	Aug. 17	9/21/17	M	M	M		
Interest Rates[2]	Aug. 17	9/29/17	M	M	M		
Consumer Price Index	Sep. 17	10/09/17	M	M	M	O, O, O, LO	LO, O, LNO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Dec. 16	Mar. 17	A	A	A	LO, LNO, LO, O	LO, LO, LO, LO, LNO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Aug. 17	Sep. 17	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Jun. 17	Sep. 17	Q	Q	Q		
External Current Account Balance	Jun. 17	08/31/17	M	Q	Q	O, LO, O, LO	LO, O, LO, O, LO
Exports and Imports of Goods and Services	Jun. 17	8/31/17	M	Q	Q		
GDP/GNP	Jun. 17	Sep. 17	Q	Q	Q	O, LO, O, LO	LO, O, LNO, O, O
Gross External Debt	Jun. 17	Sep. 17	Q	Q	Q		
International Investment Position[6]	Jun. 17	Sep. 17	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

[2] Weighted interest rates on loans and deposits in domestic banks. Separately, data is submitted on the rates on central bank bills (policy rate) and treasury bills, notes, and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. Data including local governments is normally published annually but is also received on an ad-hoc basis during missions.

[5] Currency and maturity composition is reported only on request.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

[8] Reflects the assessment provided in the data ROSC or the Substantive Update (published on September 29, 2004; mission took place during February 18 – March 3, 2004). The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

[9] Same as footnote 8, except referring to international standards concerning source data, assessment and validation of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by Mr. Doornbosch and Mr. Clicq on Former Yugoslav Republic of Macedonia
November 13, 2017

The formation of a new government, led by the Social Democrat Alliance (SDSM) in June 2017, marked **a new beginning for Macedonia**. Political stability and optimism have returned and the economic and financial conditions are rapidly improving thanks to the authorities' strong commitment to the implementation of a reform agenda that will benefit all Macedonian citizens. The authorities wish to express their gratitude to the mission chief and her team for their informative and helpful assessment of the Macedonian economy and the frank discussions during the mission. They look forward to deepen their dialogue and intensify the cooperation with the Fund.

Political Developments

After a political crisis that lasted almost two years, marked by scandals and growing ethnic and political divisiveness, Macedonia had in June 2017 **a change in power after 11 years**. Mr. Zoran Zaev of SDSM secured a parliamentary majority committed to implement fundamental reforms including building a strong and independent judicial system, fighting corruption and improving the living standard for all citizens. More recently, the municipal elections of 15 and 29 October, confirmed the new wave of optimism in the country, giving a clear mandate to SDSM and their coalition partners, their new mayors and members of the municipal councils. The international community confirmed that the local elections in both rounds were competitive and held in an environment respecting fundamental freedoms. The formation of a new government has also revived the relations with the European Union and NATO and the authorities are keen to embark on membership negotiations with both institutions as soon as possible. In addition, there is cautious optimism that negotiations on the naming issue with Greece will be reinvigorated, in order to finally solve this key problem that is blocking the country's progress towards NATO and EU accession.

Latest Macro-Economic Developments

After the deceleration of economic activity during the second quarter, high frequency indicators and economic confidence surveys in the third quarter are positive signals that the expected positive impetus from political stabilization is within reach.

The authorities expect **growth for 2017 to reach between 0.5 percent (NBRM) and 1.6 percent(MoF)**, noting that the lower performance in the first half of the year resulted in downward revisions of the previous GDP forecasts. Real GDP growth for 2018 is projected, in line with staff's projections, at 3.2 percent, reflecting solid personal consumption, the intensification of investments and the increase of exports. **Inflation remains mainly within the forecasts** and September inflation data points to a deceleration in the annual inflation rate to 1.7 percent, and an average annual price growth in the first nine months of 1.1 percent. Risks surrounding the average inflation forecast for 2017 (1.3 percent) are balanced. The **yields on their euro-denominated bonds are at an all-time low** and the authorities are considering an international bond issuance in 2018 as one of the financing options given the favorable circumstances of the international financial markets and positive assessments of Macedonia among investors.

Fiscal Policy

The authorities can **broadly agree with staff's fiscal recommendations**, and are carefully considering them, taking into account adequate sequencing as well as the best timing of implementation. The Fund's technical assistance, already received or in the pipeline, is very welcome to build a solid tax and revenue administration. The authorities wish to express their appreciation for the Fund's work and expertise in this area. In addition, there are ongoing discussions for further technical assistance that is of interest to the authorities, particularly in areas of public finance management, budget law and tax reforms.

The authorities are confident that the **fiscal deficit** in 2017 will be below 2.9 percent of GDP as predicted in the Supplement Budget, mainly due to underspending, which more than exceeds the revenue shortfall in absolute terms. **Public debt**, including government and guaranteed debts, amounted to EUR 4.69 billion in the third quarter, or 45.8 percent of GDP.

The **2018 budget** has been recently submitted to the Government, and is expected to be submitted to the Parliament on November 9. It illustrates the authorities' determination to slightly lower the deficit compared to 2017 (from 2,9 percent to 2,7 percent of GDP) and the commitment to gradual fiscal consolidation.

In the authorities' view, staff's medium term fiscal projections are somewhat too pessimistic and insufficiently take into account the potential to increase efficiency by controlling and decreasing less productive expenditures, strong budget control and improvements in revenue administration.

The authorities are developing plans to implement **greater social justice** and reduce inequality by replacing the current 10 percent flat personal tax with a progressive one. Due to the complexity of the issues, these changes will take place in 2019.

Also, **fiscal transparency** is high on the agenda of the Minister of Finance. The Ministry has provided access on its website on budget execution, public debt and state debt, macroeconomic indicators and statistical data and has also started to publish a monthly report on revenues and expenditures of the different budget users. The Minister of Finance is involved on a daily basis in outreach and available for media interviews and questions.

Monetary and Financial Sector Issues

The current economic and financial conditions as well as the existing risks suggest that the **current monetary setup so far is appropriate**. The banking sector is liquid, sound and resilient. There is also a clear trend towards increased denars savings illustrating the growing trust of the citizens in the domestic currency. After almost 10 years of waiting, the authorities are looking forward to the **upcoming FSAP**, which will kick-off in early 2018. We are convinced that the FSAP will illustrate the strength of the financial sector and supervisory processes and will provide an interesting opportunity for the authorities to assess and learn about the future challenges and potential vulnerabilities of their financial system.

External Sector

The external position, seen through the performances in the current account of the balance of payments, is generally within expectations and shows clear signs of sound economic fundamentals. **Foreign reserves** data for September show a decrease compared to the end of June data, which is mainly due to the regular settlement of government liabilities on external debt, but all foreign reserves adequacy indicators show that they remain in a safe zone.

Structural Policies

Addressing the structural high unemployment rate is essential to the successful long-term development of Macedonia. By the end of the term, the authorities' ambition for the **labor market** are: (i) to create 64,000 new jobs in the private sector, (ii) to raise the minimum wage to MKD 16,000 and to stimulate employers to pay higher wages to achieve average net salaries of MKD 30,000.

The authorities will also continue to pursue an active policy towards **foreign direct investments** and have recently launched a public consultation to enhance this program with the objective to prioritize the development of domestic enterprises - primarily small and medium business and better connecting domestic and foreign enterprises in the economic industrial development zones. The **2018 Doing Business Report** of the World Bank ranked Macedonia at the 11th place in the world and best in the region.

The authorities agree with staff that **pension reform** is necessary and have started to work closely with the World Bank experts on this.

Conclusion

We are confident that the new political stability, the commitment of the authorities to sound and transparent policies and the renewed prospects for EU and NATO membership provide positive momentum for Macedonia.