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Macedonia: Search for Stability without Growth

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Executive summary

Macedonia has enjoyed price stability, but not growth during transition. As a consequence, it has a very high unemployment rate. Thus, prudent demand management has not led to a positive supply response. There are several reasons for such a transition that can be characterized as: stability without growth.

There have been significant non-transition related shocks. Macedonia is a small, landlocked country that depends very much on the developments in its immediate neighbourhood, and those have been turbulent. In addition, internal social and political cohesion is not very strong and even deteriorated over time leading to the near civil war in 2001. These shocks have cemented the preference for stability over reform.

The macroeconomic policy mix chosen in 1994 and followed since then was adequate for stability but not for growth. Macedonia opted for a very strict fixed peg to the German mark and then to the euro. It devalued its currency, the denar, only once, in 1997. It supported the exchange rate with a restrictive monetary policy that kept interest rates high. Both proved to put up obstacles to internal and external liberalization. In addition, a policy of fiscal restraint was pursued, except for occasional surges in discretionary spending that required fiscal adjustments later on. Thus, the macroeconomic policy was not suited to a country that faced significant shocks because it effectively left Macedonia without any shock absorbers.

The end result is an under-monetized economy with a decreasing share of public expenditures in the GDP.

Trade policy was not a priority and Macedonia joined the World Trade Organization rather late. Of course, trade liberalization has consequences for an economy's competitiveness because the reduction of tariffs has the same effect as an appreciation of the currency. For that and other reasons, the main being that imports are rather high and exports somewhat stagnant, liberalization was delayed. Indeed, episodes of higher growth lead to an increase in imports rather than being export-led. Thus, further liberalization, which is inevitable, may have similar consequences for the competitiveness of the economy.

Privatization was more concerned with who gets what rather than with the efficient distribution of resources. The emerging product market is thus less than competitive and corporate governance leaves a lot to be desired.

Last but not least, because of the slow integration in the international institutions and especially in the European Union, institutional development has not progressed very fast. There are significant legislative problems, from the constitution to the particular laws. There are even more important problems with the implementation and with the functioning of the rule of law in general.

In that overall context, reforms are conceived and implemented in a rather slow fashion. For an economy that is small and functions in a turbulent political environment, the level of flexibility of its institutions and of its public governance structures is disappointing.

This is, in short, the state of affairs: there are issues of macroeconomic policy design, of institutional development and of the deepening of reforms. Here a short alternative proposal to the existing macroeconomic policy and the reform agenda will be offered.

The main goal is higher growth with a view to growing employment. This should be achieved without compromising the stability, but with the choice of different policy instruments.

The alternative economic policy starts from the following observations: public expenditures are quite low by comparative standards, public and foreign debts are moderate, and both the monetary and fiscal policies are restrictive though actual growth is well beyond potential growth. Also, the reforms ahead will lead to increased competition and liberalization. Those observations suggest the following set of policy changes.

Monetary policy should become more active. The way to do that is to move away from using the fixed peg as an anchor and with a view to adopting inflation targeting. The aim would be to retain price stability at a lower level of interest rates.

The exchange rate should allow for some nominal depreciation in order to improve the economy's competitiveness. The pass-through of the exchange rate to prices is not known, but an analysis of the Serbian and Croatian economies, which have some similarities with the Macedonian one, suggests that it is at most one third. Given the very low level of inflation in Macedonia, in particular of producer prices, an orderly depreciation of the denar should not lead to any significant hike in inflation.

Public expenditures should be increased to achieve development goals. Macedonia needs investments in infrastructure and in communal services. As a transit and a potential tourist country, these investments seem reasonable. In addition, investments in human capital, particularly in education at all levels, should be increased. Primary education is still a problem in some regions and that should be a priority.

Further foreign trade and generally foreign economic liberalization is also advisable. EU integration will mandate that anyway, but for a small economy liberalization of the current and capital transactions is advisable because that will increase competition in the product and financial markets. There is no reason why Macedonia could not increase its foreign debt by ten or even twenty percentage points, especially if that new debt is private and not public.

Institutional reforms should be pursued aggressively and rapidly. That will also shorten the time required for EU integration. The priorities are well known especially when it comes to the strengthening of the rule of law.

Privatization should be speeded up. While there are reasons to increase public spending, there is no reason to rely on the state as the manager and entrepreneur or supplier of goods and services of almost all kinds. Privatization of various state enterprises and services would go hand in hand with a strengthening of the administrative capacity of the state and all other public agencies.

These policies should lead to higher growth and employment and to increased macroeconomic stability, including price stability.

This report has two parts. In the first, a comparative approach is employed in order to draw some conclusions from the experience of transitions in general. In the second part, a more detailed description of Macedonia's economic development together with a discussion of various policies is to be found.

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Macedonia: Search for Stability without Growth

Introduction

The key problem with Macedonia's economic policy in the past decade has been the elusive growth. On average real GDP growth over the past ten years has been less than one per cent. At the same time, employment has been going down and unemployment has been increasing. Both in terms of GDP growth and of the level of unemployment, Macedonia is an exception among the transition economies. Though GDP has almost recovered to the level of 1990, it has recorded exceptionally low growth in the period after the year 2000.

Table 1

Gross domestic product

real change in % against preceding year

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 [1)]	2005 forecast	2006 forecast	Index 1990=100 2004	Index 2000=100 2004
Albania	8.9	9.1	-10.2	12.7	10.1	7.3	7.6	4.7	6.0	6	6.5	6.5	144	126.6
Bosn. & Herz.	50.0	86.0	37.0	15.6	10.0	5.5	4.5	5.5	3.5	6	5	5	.	120.9
Bulgaria	2.9	-9.4	-5.6	4.0	2.3	5.4	4.1	4.9	4.3	5.6	5	5	97.5	120.3
Croatia	6.8	5.9	6.8	2.5	-0.9	2.9	4.4	5.2	4.3	3.7	3.5	3.5	101.8	118.8
Macedonia	-1.1	1.2	1.4	3.4	4.3	4.5	-4.5	0.9	3.4	2	4	4	92.6	101.6
Romania	7.1	3.9	-6.1	-4.8	-1.2	2.1	5.7	5.0	4.9	7.8	5	5.5	105.6	125.5
Serb. & Mont. [2)]	6.1	5.9	7.4	2.5	-18.0	5.2	5.3	3.8	2.0	7	5	5	57.5	119.3

Notes: 1) Preliminary. - 2) Up to 1998 Gross Material Product; from 2001 only Serbia.

Source: wiiw Database incorporating national statistics, forecast: wiiw.

Industrial production has suffered even more than GDP growth. It is now less than half of what it was in 1990 and has declined significantly after the year 2000. This level of deindustrialization is quite unprecedented even by the standards of transition and even for countries that had experienced severe political or social conflicts. In the medium term, further problems with industrial production can be expected because of the yet unfinished process of restructuring. Though it is arguable that the statistics of industrial production as well as of most anything else are not to be trusted completely, it is unrealistic to expect that the true picture, if it were to be known, would be much different from the statistical one. There is significant informal activity, some of which is in industry, but it is reasonable to assume that these are small enterprises and thus do not contribute too much to the overall industrial production (except perhaps in some labour-intensive branches such as textiles).

Table 2

Gross industrial production

real change in % against preceding year

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 [1)]	2005 forecast	2006	Index 1990=100 2004	Index 2000=100 2004
Albania [2)]	6.0	13.6	-25.8	26.1	34.2	0.5	7.1	1.8	2.7	3.1	4	5	43.8	115.4
Bosn. & Herz.[3)]	.	.	.	23.6	8.0	7.9	4.9	5.7	5.1	12	10	10	.	130.5
Bulgaria	4.5	5.1	-18.4	-8.5	-8.0	8.3	1.5	6.5	8.3	17.8	12	10	73.2	138.0
Croatia	0.3	3.1	6.8	3.7	-1.4	1.7	6.0	5.4	4.1	3.7	3.5	3.5	77.4	120.6
Macedonia	-10.7	3.2	1.6	4.5	-2.6	3.0	-3.1	-5.3	4.7	-12.7	3	5	44.3	83.9
Romania	9.4	6.3	-7.2	-13.8	-2.4	7.1	8.3	4.3	3.1	5.3	5	5	75.2	122.7
Serbia and Montenegro	3.8	7.6	9.5	3.6	-23.1	11.1	0.0	1.7	-2.7	8	5	5	47.0	106.8

Notes: 1) Preliminary. - 2) According to gross value added. - 3) wiiw estimates based on weighted averages for the two entities (Federation BH and Republika Srpska).

Source: wiiw Database incorporating national statistics, forecast: wiiw.

Price stability has basically been preserved in the past decade. With some exceptions, the inflation rate has converged to that of the European Union in most years. This has clearly been the main target of the overall economic policy in Macedonia. The Macedonian denar (MKD) has been firmly pegged to the euro (previously to the German mark) since 1994 and was devalued only once, in 1997. The monetary policy has been mainly conducted with the aim to preserve the fixed exchange rate. The fiscal policy was also mostly restrictive, with the level of public expenditures being relatively low and declining (as a share of GDP) and with small budget deficits, except in some years. Finally, wages in the public sector have been at times frozen and in any case have been kept under tight control.

Table 3

Consumer price inflation

change in % against preceding year

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 [1)]	2005 Forecast	2006
Albania	7.8	12.7	33.2	20.9	0.4	0.1	3.1	5.2	2.3	2.9	4	3
Bosnia and Herzegovina [2)]	.	.	.	13.3	3.7	4.8	3.1	0.4	0.6	0.2	0.5	0.5
Bulgaria	62.1	121.6	1058.4	18.7	2.6	10.3	7.4	5.8	2.3	6.2	4	4
Croatia [3)]	2.0	3.5	3.6	5.7	4.2	6.2	4.9	1.7	1.8	2.1	2	2
Macedonia [2)]	15.9	3.0	4.4	0.8	-1.1	10.6	5.2	1.4	2.4	0.9	2	2
Romania	32.3	38.8	154.8	59.1	45.8	45.7	34.5	22.5	15.3	11.9	9	7
Serbia & Montenegro	78.6	91.5	21.6	29.9	44.9	86.0	88.9	16.5	9.4	10.8	10	10

Notes: 1) Preliminary. - 2) Retail prices. - 3) Up to 2001 retail prices.

Source: wiiw Database incorporating national statistics, forecast: wiiw.

Table 4

Producer prices in industry

change in % against preceding year

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 [1]	2005 forecast	2006 forecast
Albania [2]	.	.	.	.	2.8	6.5	-7.2	5.1	1.8	.	.	.
Bulgaria	53.4	130.0	971.1	18.7	2.8	17.5	3.8	1.2	4.9	5.9	.	.
Croatia	0.7	1.4	2.3	-1.2	2.6	9.7	3.6	-0.4	1.9	3.5	2	.
Macedonia	4.7	-0.3	4.2	4.0	-0.1	10.7	2.0	-0.9	-0.3	0.9	2	3
Romania	35.1	49.9	152.7	33.2	44.5	53.4	38.1	23.0	19.5	18.6	.	.
Serbia & Montenegro	57.7	90.2	19.5	25.5	44.2	106.0	85.1	8.7	4.6	9	10	10

Notes: 1) Preliminary. - 2) In manufacturing industry.

Source: wiiw Database incorporating national statistics.

Thus, the overall record of the Macedonian economy in about the past ten years can be summarized as one of price stability with stagnating production. It has also resulted in a very high unemployment rate, which is exceptional even among the worst performing countries in transition. Even if the figures were not reliable, the rate would be very high even if it were to be halved.

Table 5

Unemployment, LFS definition, annual averages

	in 1000 persons					rate in %			
	2000	2001	2002	2003	2004 [1]	2003	2004 [1]	2005 forecast	2006 forecast
Albania [2]	215	181	172	164	156	15.0	14.4	14	13.5
Bosnia & Herzegovina [2]	421	422	442	460	.	42.0	42.0	42	42
Bulgaria	567	664	592	449	400	13.7	12.0	11	10
Croatia	298	277	266	256	253	14.3	13.8	13.5	13
Macedonia	262	263	263	316	.	36.7	37	35	35
Romania [3]	821	750	845	692	800	7.0	7.5	8	8
Serbia & Montenegro	481	490	517	562	.	15.2	15	15	15

Notes: LFS – Labour Force Survey. - 1) Preliminary. - 2) Unemployment by registration, end of period. - 3) From 2002 new methodology in accordance with EU definitions.

Source: wiiw Database incorporating national statistics, forecast: wiiw.

Why has the supply response been so disappointing? The reason usually given is that structural reforms have not been undertaken or implemented. Another reason, also often given, is that the Macedonian economy has suffered a series of external shocks that have pushed the goal of preserving stability ahead of institutional reforms and development policies. Finally, there is also a possibility that the economic policy mix pursued so far has not been growth-friendly.

Clearly, all the three explanations are true in one sense or another. In the following they will be discussed in comparison with other transition economies and then alternative policies will be considered.

Transition, reforms, institutions

In most transition economies, initially GDP and employment tend to decrease, sometimes quite sharply. This has been called 'transitional recession'. There are debates why this has happened – and also, why in some cases transitional recessions were shorter and milder than in other cases. It is not against common sense, however, to expect that significant institutional changes will lead to a temporary reallocation of resources that may stop or reduce production and also employment. It is also to be expected that recession will put pressure on public expenditures, if for no other reason because of increased needs for social spending. And, given that public revenues might decline, fiscal deficits should be normally expected to increase. Finally, because of the need to monetize fiscal deficits and to let the domestic price level adjust after liberalization, higher inflation should be expected.

Thus, a stylized version of the early phase of transition includes a drop in GDP and in employment, higher inflation, and growing fiscal deficits.

Once transitional recession is over, growth should return, inflation should slow down and the fiscal balance should be restored. The latter may take a while because of faster productivity growth and thus a prolonged fall in employment. If the services sector or the informal sector expanded, fiscal reforms could help restore the fiscal balance somewhat more quickly. Indeed, with the exception of the fiscal balance, most transition economies have come out of the transitional recession in two to four years' time and have had relatively stable or stabilizing prices thereafter.

The recovery of production can be helped by improved access to foreign markets, for both goods and capital. Indeed, external liberalization has helped economies in transition. Exports have gone up as have imports and foreign investments. Because of rather fast changes in trade and investment patterns, exchange rate policies have proved to be quite important. Initially, explosive inflations have called for fixed exchange rate regimes. Over time, however, the need to find the appropriate level of the exchange rate has led to the latter's increased flexibility. In most cases, this has proved to be good for euro convergence, because of the possibility to adjust to a fixed exchange rate gradually.

Thus, external liberalization has led to increased foreign trade, increased foreign investments and sustainable external accounts.

These macroeconomic developments have been supported by microeconomic developments. The reason why initially there is a transitional recession is that the inherited state sector is collapsing in the face of competition from the emerging private sector and from imports. It takes time for assets to be reallocated and to be employed profitably. Once the new private sector and the privatized sector find their places in the domestic and foreign markets, their growth becomes faster than the rate of decline of the ailing state sector and production and exports start to grow. Critical to these developments are: competitive markets, adequate corporate governance and access to credits or other sources of finance. Significant reforms are needed to improve these structural features of the economy. Those have to go hand in hand with privatizations and the restructuring of the public sector. If these reforms are not done properly, transitions can be mismanaged with prolonged negative effects on the efficiency and competitiveness of the overall economy.

In more successful transitional economies, external liberalization together with the integration with and accession to the European Union have provided the needed impetus and direction for reforms. A significant inflow of foreign investments has also contributed to the improvement in corporate governance and in banking as well. Harmonization with EU legislation has contributed to the improvement in the public sector.

Thus, structural reforms of markets, firms and banks and of the public sector have contributed to the efficiency and the competitiveness of transition economies.

Here, it is useful to note that growth has mostly returned to the transition economies before the full implementation of the structural reforms. Even before the process of privatization was finished, sustainable growth had returned to the more successful transition economies. The recovery of industrial production, of exports and of GDP growth in general started rather quickly and proceeded in parallel with the structural reforms.

Thus, clearly, full structural reforms are not a precondition for the recovery of growth though they are certainly supportive of its sustainability.

There is an observable difference between more successful and less successful economies in transition that stems from factors influencing internal and external political stability. More successful economies in transition have democratized faster and have anchored themselves to the more stable political environments in Europe. Other countries in transition have delayed their democratization or internal political stabilization in general and have often been located in unstable political regions. That has increased the number of negative internal and external shocks that have delayed their transition and have depressed their economies for longer periods of time. Also, and most importantly, it has

often had negative influences on institutional developments and has sometimes led to institutional collapses with prolonged negative consequences.

Thus, democratization and political stability, both internal and external, have contributed to the speed and success of transitions.

These are the stylized facts for successful transitions. Deviation from those affects the path and the eventual outcome of transition. In the case of Macedonia, a number of deviations can be observed that will be looked at in the following.

External environment

There is no doubt that external shocks play a significant role in transition. Most transition economies were initially rather closed and their liberalization had to have significant consequences for the allocation of resources and for growth. In the case of Macedonia, liberalization was delayed because of the collapse of former Yugoslavia. Then, the imposition of the Greek embargo played an additional role, as did internal pressures to protect the economy from foreign competition. Thus, only after 1999 and indeed perhaps only after 2002, a more comprehensive and decisive foreign trade liberalization has been implemented. After 1999, the EU eliminated most of its tariffs and also limited the amount of goods on a quota regime. This significantly improved market access for Macedonian producers. In addition, a free trade agreement with Serbia – an important trading partner of Macedonia – has been in effect since the second half of the 1990s. This free trade agreement was continued with Kosovo too, which became an important market after the 1999 war. Macedonia also lowered its tariffs and liberalized its foreign trade regime when it entered the WTO, which was only in 2003.

With all that, exports have not surged as has been expected. After an improvement in 2000-2001, they deteriorated mainly because of the internal conflict in 2001. They have failed to recover sufficiently ever since. In fact, exports have mainly stagnated, indicating perhaps that the structure of exports is not changing very much. In all probability, the same goods are being exported year after year, with little improvements in quality and perhaps with some increase in quantity depending on the changed demand. This is especially the case in trade with the European Union, Macedonia's main trading partner. Trade in the region, which is also quite important for Macedonia, does not show too much improvement. Clearly, the performance of the external sector is the main challenge the Macedonian economy is facing.

Table 6

Trade of Southeast European countries with the EU-15, EUR million

(based on customs statistics)

		1998	1999	2000	2001	2002	2003	2004 [1]	2003	2004 [1]
									change in %	
Bulgaria [2]	Exports	1905	1942	2684	3129	3376	3770	4338	11.7	15.1
	Imports	2010	2486	3119	4011	4229	4767	5597	12.7	17.4
	Balance	-105	-544	-435	-882	-852	-997	-1259	.	
Croatia [3]	Exports	1927	1960	2619	2821	2746	2993	4117	9.0	37.5 I-XI
	Imports	4440	4136	4756	5844	6321	7092	9323	12.2	31.5 I-XI
	Balance	-2513	-2175	-2137	-3023	-3575	-4099	-5206	.	
Macedonia	Exports	516	506	612	632	603	659	688	9.2	4.3 I-XI
	Imports	620	677	866	803	947	889	1044	-6.1	17.4 I-XI
	Balance	-104	-172	-254	-171	-344	-231	-357	.	
Romania	Exports	4760	5236	7195	8623	9864	10571	12315	7.2	16.5 I-XI
	Imports	6068	6027	8046	9975	11033	12223	14459	10.8	18.3 I-XI
	Balance	-1307	-791	-851	-1352	-1169	-1652	-2144	.	
Serbia & Montenegro [4]	Exports	965	504	700	897	981	974	.	-0.7	.
	Imports	1847	1276	1610	2214	2833	3011	.	6.3	.
	Balance	-882	-772	-910	-1317	-1852	-2037	.	.	.

Notes: 1) Preliminary. - 2) From 1999 according to new methodology. - 3) From 2000 according to new methodology. - 4) From 1999 excluding Kosovo and Metohia.

Source: wiiw Database incorporating national statistics.

Table 7

Trade of Southeast European countries with the EU-25, EUR million

(based on customs statistics)

		2000	2001	2002	2003	2004 [1]	2003	2004 [1]	2003	2004
							change in %		share of EU-25 trade in % of total	
Bulgaria [2]	Exports	2855	3323	3595	4010	4661	11.6	16.2	60.1	58.3
	Imports	3497	4447	4679	5319	6284	13.7	18.1	55.3	54.1
	Balance	-642	-1124	-1084	-1309	-1624	.	.	.	.
Croatia [3]	Exports	3338	3520	3407	3696	4120	8.5	11.5 I-XI	67.6	63.9
	Imports	6020	7330	8080	9028	9310	11.7	3.1 I-XI	72.0	69.8
	Balance	-2682	-3810	-4673	-5332	-5190	.		.	.
Macedonia	Exports	672	668	635	687	750	8.3	9	57.0	56.4
	Imports	1103	994	1157	1084	1140	-6.3	5	53.3	48.3
	Balance	-431	-327	-523	-397	-390	.	.	.	.
Romania	Exports	7816	9310	10609	11498	13740	8.4	19.5 I-XI	73.6	72.8
	Imports	9238	11525	12720	14250	16906	12.0	18.6 I-XI	67.2	65.0
	Balance	-1422	-2216	-2111	-2752	-3166	.		.	.

Notes: 1) Preliminary. - 2) From 1999 according to new methodology. - 3) From 2000 according to new methodology.

Source: wiiw Database incorporating national statistics.

Table 8

Trade of Southeast European countries with the new EU member states, EUR million

(based on customs statistics)

		2000	2001	2002	2003	2004 [1]	2003 change in %	2004 [1] change in %	2003 share of NMS-8 trade in % of EU-25	2004 [1] share of NMS-8 trade in % of EU-25
Bulgaria [2]	Exports	171	194	218	241	323	10.2	34.2	6.0	6.9
	Imports	378	436	451	552	688	22.6	24.6	10.4	10.9
	Balance	-207	-242	-232	-312	-365	.	.	.	.
Croatia [3]	Exports	719	699	661	703	3	6.3	-99.6	19.0	0.1 I-XI
	Imports	1264	1486	1759	1935	-13	10.1	-100.7	21.4	-0.1 I-XI
	Balance	-544	-787	-1098	-1233	16	.	.	.	.
Macedonia	Exports	60	35	31	28	62	-8.8	120.7	4.1	8.3
	Imports	237	191	210	195	96	-7.4	-50.8	18.0	8.4
	Balance	-177	-156	-179	-166	-33	.	.	.	.
Romania	Exports	621	687	745	927	1425	24.5	53.7	8.1	10.4 I-XI
	Imports	1192	1550	1687	2028	2447	20.2	20.7	14.2	14.5 I-XI
	Balance	-571	-864	-942	-1711	-382	.	.	.	.

Notes: 1) Preliminary. - 2) From 1999 according to new methodology. - 3) From 2000 according to new methodology.

Source: wiiw Database incorporating national statistics.

Table 9

SEE trade: change in import shares in percentage points, 2003/2001

of: / from:	AL	BA	BG	HR	MK	RO	CS
Albania (AL)		0.0	0.0	0.0	0.1	0.0	0.0
Bosnia and Herzegovina (BA)	0.0		0.0	0.2	0.0	-0.1	-0.1
Bulgaria (BG)	-0.5	0.0		0.2	**1.9**	-0.2	**-1.9**
Croatia (HR)	0.5	**3.4**	0.2		0.9	0.1	-0.6
Macedonia (MK)	-0.1	-0.3	-0.1	-0.2		0.0	**-4.1**
Romania (RO)	0.2	0.0	-0.2	0.7	-0.2		**-1.5**
Serbia and Montenegro (CS)	0.8	**1.6**	0.0	0.1	0.1	-0.3	
European Union	**-4.3**	**-1.3**	**6.6**	0.1	**4.6**	-0.2	0.6
SEE-7	**1.0**	**4.6**	0.0	**1.0**	**2.8**	-0.5	**-8.1**
Total change. USD billion	**0.5**	**1.2**	**2.8**	**5.2**	**0.0**	**8.0**	**2.9**

Note: All exports: f.o.b. – White and black boxes indicate an increase and decrease respectively in shares above 1 percentage point.

Source: IMF Direction of Trade Statistics, Croatian Bureau of Statistics, National Bank of Macedonia, National Bank of Serbia, Agency for Statistics of Bosnia & Herzegovina, Ukrainian Statistical Office, Czech Statistical Office.

Table 10

SEE trade: change in export shares in percentage points, 2003/2001

of:	AL	BA	BG	HR	MK	RO	CS
to:							
Albania		0.1	0.1	0.1	0.4	0.1	0.6
Bosnia and Herzegovina	0.0		0.0	**1.8**	-0.2	0.0	**2.9**
Bulgaria	0.0	0.0		0.2	0.3	0.0	0.2
Croatia	-0.1	**5.4**	0.4		0.8	0.5	**1.0**
Macedonia	0.5	-0.1	-0.1	0.0		-0.1	-0.4
Romania	0.0	**-1.0**	0.3	0.2	0.0		**-2.4**
Serbia and Montenegro	0.9	**-3.6**	**-1.2**	-0.2	**-6.9**	-0.5	
European Union	**-3.3**	**9.7**	**-2.0**	**-2.1**	**11.9**	**1.9**	**7.4**
SEE-7	**1.2**	0.8	-0.4	**2.1**	**-5.7**	0.0	**2.0**
Total change. USD billion	**0.1**	**0.2**	**2.1**	**1.8**	**0.0**	**5.7**	**0.6**

Note: All exports: f.o.b. – White and black boxes indicate an increase and decrease respectively in shares above 1 percentage point.

Source: IMF Direction of Trade Statistics, Croatian Bureau of Statistics, National Bank of Macedonia, National Bank of Serbia, Agency for Statistics of Bosnia & Herzegovina, Ukrainian Statistical Office, Czech Statistical Office.

The prospects for export growth cannot depend all that much any more on further liberalization and on a significant improvement of the market access. Perhaps the most important influences will come from the following sources:

- Accelerated growth in the region. Unlike most other Balkan economies, Macedonia depends on the regional market for more than a quarter of its exports. Most of the region is growing rather fast and the growth looks sustainable. That should provide for an increase of demand for Macedonian products.
- Infrastructure improvements could also help the growth of exports. After 2007, Bulgaria will be a member of the European Union so that improved access to its market through better infrastructure may prove to be increasingly important.
- Exchange rate movements. Most Macedonian trading partners are using the euro or are pegged to the euro, thus a Macedonian peg should be no problem, though a more flexible exchange rate may also be useful given that Macedonia's competitiveness does not seem to be altogether in line with the level of its exchange rate. One important partner, Serbia, has moved towards a crawling peg in order to boost its exports and slow down the growth of imports. That may hurt Macedonian exports to the Serbian market, which is an important one. The devaluation of the Serbian dinar has a similar effects as a tariff hike on Macedonian exports.

Overall, the external environment should be favourable to increased foreign trade, though investments in infrastructure may still be helpful as may certain adjustments in the macroeconomic policies.

Table 11

Macedonia: foreign trade with the EU-15

NACE rev. 1	Top 30 Macedonian exports, ths EUR	2002	shares in total
18.2	Other wearing apparel and accessories	214732	41.5
27.1	Basic iron and steel and of ferro-alloys (ECSC)	101880	19.7
27.4	Basic precious and non-ferrous metals	37218	7.2
19.3	Footwear	35852	6.9
15.9	Beverages	18855	3.6
15.1	Meat products	13413	2.6
31.3	Insulated wire and cable	10740	2.1
27.2	Tubes	9443	1.8
15.3	Fruit and vegetables	8337	1.6
17.7	Knitted and crocheted articles	6960	1.3
15.8	Other food products	5199	1.0
24.1	Basic chemicals	4661	0.9
18.3	Dressing and dyeing of fur; articles of fur	4062	0.8
17.1	Textile fibres	3724	0.7
26.1	Glass and glass products	3379	0.7
17.4	Made-up textile articles, except apparel	3346	0.6
28.1	Structural metal products	3343	0.6
28.7	Other fabricated metal products	2906	0.6
32.3	TV and radio receivers	2550	0.5
34.3	Parts for motor vehicles	2474	0.5
26.7	Cutting, shaping and finishing of stone	1993	0.4
20.1	Sawmilling, planing and impregnation of wood	1925	0.4
32.1	Electronic valves and tubes, other electronic comp.	1732	0.3
17.2	Textile weaving	1729	0.3
25.2	Plastic products	1336	0.3
29.2	Other general purpose machinery	1153	0.2
31.1	Electric motors, generators and transformers	1105	0.2
17.6	Knitted and crocheted fabrics	1089	0.2
36.1	Furniture	1040	0.2
31.5	Lighting equipment and electric lamps	843	0.2
	Total manufacturing exports to the EU	**516909**	**100**

NACE rev. 1	Top 30 Macedonian imports, ths EUR	2002	shares in total
17.2	Textile weaving	111856	11.9
23.2	Refined petroleum products	106157	11.3
34.1	Motor vehicles	71353	7.6
18.2	Other wearing apparel and accessories	41658	4.4
15.8	Food products	37094	3.9
29.5	Special purpose machinery	29670	3.1
30.0	Office machinery and computers	26195	2.8
29.2	Other general purpose machinery	24942	2.6
25.2	Plastic products	24305	2.6
24.1	Basic chemicals	24038	2.5
15.1	Meat and meat products	22918	2.4
32.2	TV, radio transmitters, apparatus for line telephony	19690	2.1
19.3	Footwear	18780	2.0
17.5	Textiles	18504	2.0
24.6	Chemical products	16994	1.8
17.6	Knitted and crocheted fabrics	15143	1.6
27.1	Basic iron and steel and of ferro-alloys (ECSC)	14953	1.6
21.2	Articles of paper and paperboard	13473	1.4
24.4	Pharmaceuticals	13434	1.4
29.1	Machinery for the production, use of mech. power	12974	1.4
27.4	Basic precious and non-ferrous metals	12838	1.4
24.5	Detergents, cleaning and polishing, perfumes	12604	1.3
15.9	Beverages	12290	1.3
28.7	Other fabricated metal products	11447	1.2
21.1	Pulp, paper and paperboard	11305	1.2
16.0	Tobacco products	10717	1.1
33.1	Medical equipment	9239	1.0
26.3	Ceramic tiles and flags	8453	0.9
17.1	Textile fibres	7934	0.8
36.6	Miscellaneous manufacturing	7716	0.8
	Total manufacturing imports from the EU	**942993**	**100**

Source: Eurostat Comext database.

Gross value added

The structure of value added shows a significant change from industry to services. Though the data can be questioned, it is clear that Macedonia is not altogether different from the other Balkan economies. The share of construction is in fact higher than in most other Southeast European economies while the share of agriculture is not all that high. Looking at the structure of value added, it is clear that industry, transport and services are the sectors that have to grow in order for the economy as a whole to grow. Within these sectors, there are those that have a greater potential than the others; for instance, tourism could play more of a role as its share is not very significant. Also, sectors that contribute to human capital – education and health – are laggards in the overall picture of Macedonia's economic development.

The development of agriculture is of course of interest, particularly in special branches in which Macedonia traditionally has comparative advantages. Still, agriculture is not to be expected to be the sector that will pull growth decisively.

Table 12

SEE: structure of gross value added by activities, 2004*

(per cent of total)

NACE Label		**BG** 2003	**HR**	**MK**	**RO** 2003	**CS** 2000
A-O	Gross value added at basic prices [1)]	100.0	100.0	100.0	100.0	100.0
A-B	Agriculture, forestry, fishing	11.4	7.9	13.9	13.1	21.1
C-F	Industry total	30.0	28.9	29.1	37.1	32.1
C-E	Industry	25.5	22.2	21.9	30.4	28.2
F	Construction	4.5	6.6	7.2	6.7	3.9
G-O	Services	58.6	63.2	57.0	49.8	46.8
G-K	Market services	42.9	26.4	37.1	37.1	32.0
G	Wholesale, retail trade, repair motor veh.	7.1	11.9	16.8	9.5	10.5
H	Hotels and restaurants	2.1	3.6	2.3	2.4	1.4
I	Transport, storage, telecommunications	14.1	10.9	10.7	10.6	7.1
J	Financial intermediation	3.7	.	3.0	2.6	4.6
K	Real estate, renting & business activities [2)]	15.9	16.9	4.2	12.0	8.5
L-O	Community services	15.7	20.0	20.0	12.7	14.6
L	Public admin., defence, compuls.soc.sec.	7.0	.	8.3	4.6	3.7
M	Education	4.1	.	4.5	3.2	4.4
N	Health and social work	2.9	.	4.6	2.2	3.6
O	Oth. community, social & personal serv.	1.7		2.6	2.7	2.9

Notes: * Preliminary. - 1) Excluding FISIM: Financial intermediation services indirectly measured. - 2) Croatia (HR): including financial intermediation.

Source: wiiw Database.

Table 13a

Macedonia: gross value added by activities

(per cent of total)

NACE Label		1997	1998	1999	2000	2001	2002	2003	2004*
A-Q	Gross value added at basic prices [1)]	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
A-B	Agriculture, forestry, fishing	13.2	13.6	13.2	12.4	12.1	12.8	14.4	13.9
C-F	Industry total	35.6	34.7	33.5	34.6	33.1	31.2	31.9	29.1
C-E	Industry	29.2	27.8	27.2	27.7	26.9	25.0	25.3	21.9
F	Construction	6.4	6.9	6.2	7.0	6.2	6.2	6.5	7.2
G-O	Services	51.3	51.8	53.3	53.0	54.7	56.0	53.8	57.0
G-K	Market services	30.4	31.5	32.3	33.8	35.3	35.3	33.6	37.1
G	Wholesale, retail trade, repair motor vehicles	13.7	13.3	12.8	13.2	13.8	14.3	14.1	16.8
H	Hotels and restaurants	1.8	1.9	2.3	1.8	1.8	2.1	2.2	2.3
I	Transport, storage, telecommunications	7.3	8.7	9.9	11.1	11.5	10.7	10.2	10.7
J	Financial intermediation	4.0	4.4	4.0	3.8	3.9	3.9	3.0	3.0
K	Real estate, renting & business activities	3.5	3.2	3.4	3.9	4.4	4.3	4.1	4.2
L-O	Community services	20.9	20.3	21.0	19.2	19.4	20.7	20.2	20.0
L	Public admin., defence, compulsory social sec.	7.3	7.3	8.2	7.5	7.6	8.4	8.2	8.3
M	Education	5.0	4.9	5.0	4.3	4.3	4.5	4.6	4.5
N	Health and social work	5.2	5.1	4.9	4.7	4.6	4.9	4.8	4.6
O	Other community, social & personal services	3.4	3.0	2.8	2.7	2.9	2.9	2.7	2.6

Notes: * Preliminary. - 1) Excluding FISIM: Financial intermediation services indirectly measured.

Source: wiiw Database.

Table 13b

Macedonia: gross value added by activities

(Index: 1997 = 100)

NACE label		1997	1998	1999	2000	2001	2002	2003
A-Q	Gross value added at basic prices [1)]	100.0	103.6	108.7	115.0	111.0	113.7	121.5
A-B	Agriculture, forestry, fishing	100.0	103.3	104.2	105.3	93.9	92.0	93.6
C-F	Industry total	100.0	102.6	106.2	115.3	107.6	107.1	117.0
C-E	Industry	100.0	101.5	103.2	113.6	108.4	107.5	116.7
F	Construction	100.0	107.7	118.9	122.0	104.4	105.1	119.6
G-O	Services	100.0	104.5	111.6	117.1	116.5	120.4	126.7
G-K	Market services	100.0	107.9	116.7	124.8	123.0	125.9	131.3
G	Wholesale, retail trade, repair motor veh.	100.0	100.4	103.4	106.5	105.7	111.4	118.6
H	Hotels and restaurants	100.0	107.3	133.8	118.7	113.3	132.3	150.5
I	Transport, storage, telecommunications	100.0	126.5	141.3	153.3	140.6	138.1	141.1
J	Financial intermediation	100.0	112.7	107.9	104.5	101.0	97.4	80.2
K	Real estate, renting & business activities	100.0	93.1	105.0	124.9	135.2	128.2	132.7
L-O	Community services	100.0	99.6	103.4	103.4	102.6	106.1	112.9
L	Public admin., defence, compuls. soc. sec.	100.0	101.1	109.9	111.5	110.1	116.9	123.0
M	Education	100.0	102.1	102.7	101.5	96.5	97.7	106.1
N	Health and social work	100.0	100.5	101.5	100.6	99.5	100.8	106.5
O	Oth. community, social & personal serv.	100.0	91.1	92.4	89.3	94.9	91.2	90.4

Note: 1) Excluding FISIM: Financial intermediation services indirectly measured.

Source: wiiw Database.

Industry

Industrial production, as has already been said, has proved to be quite volatile and has mostly been declining or rather not recovering fast enough. In the last year, it declined rather substantially, though the extent of the decline is not clear due to problems with the statistics. In any case, it is fair to say that after a period of significant deindustrialization, the process of reindustrialization is yet to start. This is not altogether different from the experience of the other Balkan economies, but is quite an opposite development of the one to be observed in the Central European transition economies. If their development is to be repeated in the Balkans, reindustrialization is certainly something that will be a significant part of it.

Industrial production shows negative developments in the last couple of years and that probably indicates that the restructuring has still not come to an end. Compared to the developments in the other Southeast European economies, Macedonia's development is exceptional. Though it is hard to argue that reindustrialization has started in the region, it certainly has yet to start in Macedonia. Indeed, as the table shows, the share of value added from industry and manufacturing in particular is declining steadily. Thus, the main source of GDP is at the same time that sector that is experiences very significant problems and does not appear to be recovering.

Table 14

Industrial value added as % of GDP, 1998-2004

	1998	1999	2000	2001	2002	2003	2004*
Bulgaria	23.0	20.6	22.6	22.2	21.7	22.3	.
Croatia	21.1	20.7	20.7	20.4	19.6	19.2	19.1
Macedonia	23.4	22.8	22.5	21.8	19.7	20.7	17.7
Romania	27.8	24.8	27.3	27.7	28.1	27.3	27.0
Serbia and Montenegro	28.4	27.9	25.5	.	.	.	.
Czech Republic	28.3	29.4	29.2	27.9	28.9	29.2	29.1
Hungary	24.8	24.2	25.1	23.0	22.0	22.1	.
Poland	22.8	22.3	22.1	20.8	20.7	21.3	23.2
Slovakia	24.4	26.2	25.5	25.2	23.5	24.3	.
Slovenia	27.0	26.2	26.9	27.1	26.5	26.8	.

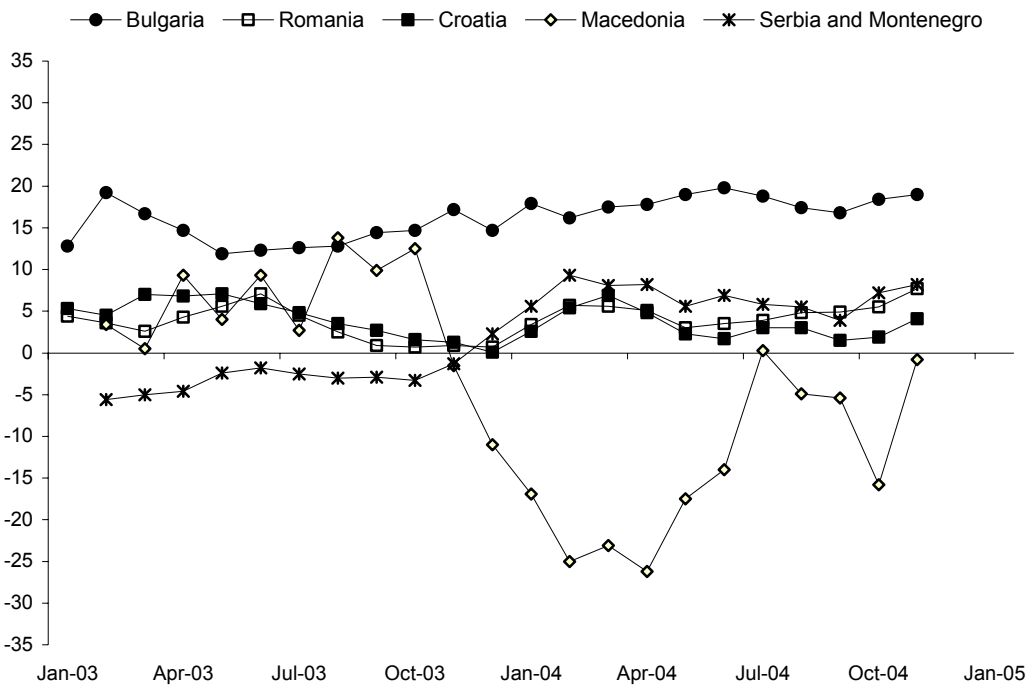
Note: * Preliminary.

Source: wiiw Database and National Bank of the Republic of Macedonia.

Figure 1

Gross industrial production in SEE

year-on-year growth in %, 3-month moving average

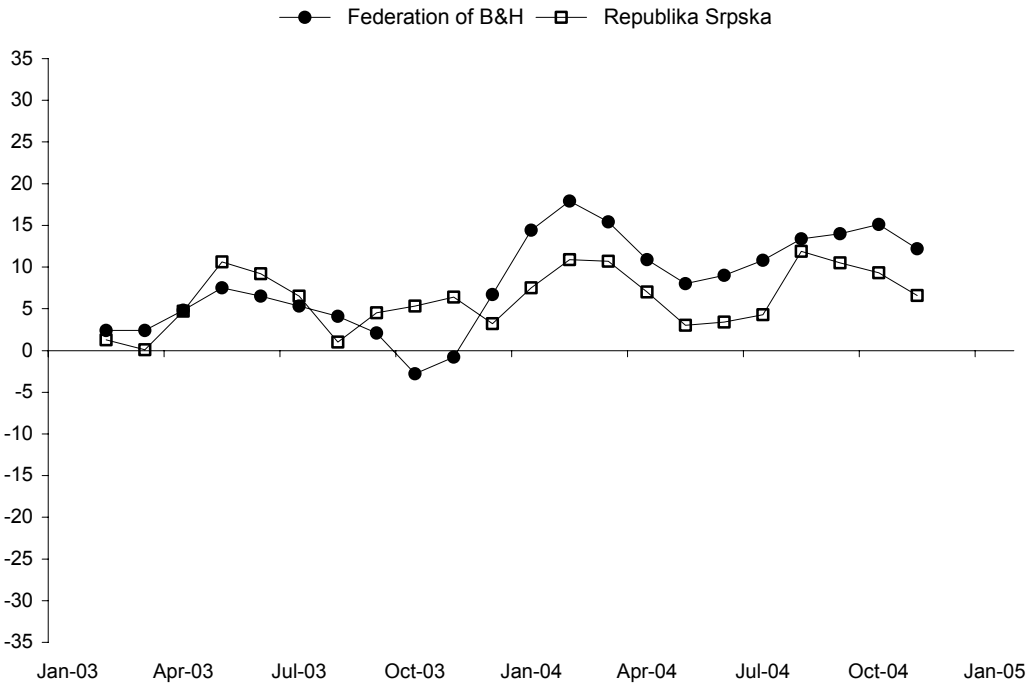


Source: wiiw Monthly Database incorporating national statistics.

Figure 2

Gross industrial production in Bosnia and Herzegovina

year-on-year growth in %, 3-month moving average



Source: wiiw Monthly Database incorporating national statistics.

Table 15

Employment in industry, in % of total, 1998-2003

	1998	1999	2000	2001	2002	2003
Bulgaria	26.5	24.6	24.0	23.8	23.8	23.5
Croatia	24.6	24.3	24.2	23.9	23.5	23.2
Macedonia [1)]	36.6	37.9	41.3	41.2	39.6	39.9
Romania	26.3	24.4	23.2	23.6	25.5	24.8
Serbia and Montenegro [2)]	40.7	40.4	39.9	39.5	38.0	37.0
Czech Republic [3)]	31.2	30.8	30.2	31.0	30.7	30.1
Hungary [3)]	28.1	27.5	26.9	27.3	27.1	25.7
Poland	23.4	22.3	21.5	20.8	20.1	22.9
Slovakia [3)]	23.4	24.1	22.4	23.3	22.7	21.6
Slovenia	34.5	33.3	32.7	32.4	32.6	32.2

Notes: 1) Employees. - 2) Employees excluding private sector. - 3) According to LFS.

Source: wiiw Database and Republic of Macedonia State Statistical Office.

Table 16

Macedonia: industrial value added, 1998-2004

	1998	1999	2000	2001	2002	2003	2004*
Value added, in EUR million							
Mining and quarrying	26	27	31	22	16	16	6
Manufacturing	576	607	674	650	622	647	570
Electricity, gas and water supply	145	152	171	165	150	192	189
Value added in % of GDP							
Mining and quarrying	1	1	1	1	0	0	0
Manufacturing	18	18	17	17	16	16	13
Electricity, gas and water supply	5	4	4	4	4	5	4
GDP at current prices, in EUR million	3193	3448	3893	3839	4001	4137	4314

Note: * Preliminary.

Source: National Bank of the Republic of Macedonia.

Table 17

Macedonia: selected indicators for industrial sectors

		Production at current prices, 2003		Value Added at current prices, 2003		Employment 2003	
		in EUR mn	in %	in EUR mn	in %	in pers.	in %
C+D+E	**Total Industry**	**2275.5**	**100.0**	**855.6**	**100.0**	**132614**	**100.0**
C	**Mining and quarrying**	**33.0**	**1.5**	**16.1**	**1.9**	**2231**	**1.7**
CA	Mining and quarrying of energy producing materials	0.8	0.0	-0.2	0.0	122	0.1
CB	Mining and quarrying except energy producing materials	32.2	1.4	16.3	1.9	2109	1.6
D	**Manufacturing total**	**1918.1**	**84.3**	**647.2**	**75.6**	**115278**	**86.9**
DA	Food products; beverages and tobacco	584.8	25.7	186.7	21.8	21766	16.4
DB	Textiles and textile products	204.7	9.0	96.7	11.3	39834	30.0
DC	Leather and leather products	17.6	0.8	9.1	1.1	2899	2.2
DD	Wood and wood products	25.4	1.1	10.2	1.2	3400	2.6
DE	Pulp, paper & paper products; publishing and printing	107.7	4.7	46.7	5.5	5844	4.4
DF	Coke, refined petroleum products & nuclear fuel	210.5	9.3	24.1	2.8	1055	0.8
DG	Chemicals, chemical products & man-made fibres	96.1	4.2	42.3	4.9	2630	2.0
DH	Rubber and plastic products	70.8	3.1	19.4	2.3	5581	4.2
DI	Other non-metallic mineral products	123.4	5.4	59.3	6.9	4390	3.3
DJ	Basic metals and fabricated metal products	301.6	13.3	90.0	10.5	15930	12.0
DK	Machinery and equipment n.e.c.	24.5	1.1	7.2	0.8	1799	1.4
DL	Electrical and optical equipment	78.6	3.5	27.6	3.2	4073	3.1
DM	Transport equipment	36.4	1.6	12.1	1.4	1961	1.5
DN	Manufacturing n.e.c.	36.0	1.6	15.7	1.8	4115	3.1
E	**Electricity, gas and water supply**	**324.4**	**14.3**	**192.3**	**22.5**	**15105**	**11.4**
EE	Electricity, gas and water supply	324.4	14.3	192.3	22.5	15105	11.4

Source: wiiw based on national statistics.

Table 18

Macedonia: development of industry, 2003-2004

			Production Volume Index 03/'02 % change	Production Volume Index 04/'03 % change
C+D+E			**4.7**	**-12.7**
C		**Mining and quarrying**	-39.1	-66.0
	10	Mining of coal	-3.2	-1.0
	13	Mining of metal ores	-91	-100.0
	14	Other mining and quarrying	53.4	-9.9
D		**Manufacturing**	**5.9**	**-11.6**
	15	Manufacture of food products and beverages	27	-12.4
	16	Manufacture of tobacco products	-2.1	-11.6
	17	Manufacture of textiles	-26.5	-26.8
	18	Manufacture of wearing apparel	-19.9	71.7
	19	Manufacture of leather products and footwear	-39.7	-42.4
	20	Manufacture of wood products	64	-10.0
	21	Manufacture of paper products	-20.4	-9.1
	22	Publishing and printing	-51.5	84.8
	23	Manufacture of coke and refined petroleum	44.2	-38.4
	24	Manufacture of chemicals	-27.2	-25.6
	25	Manufacture of rubber and plastics products	-22.7	-18.7
	26	Manufacture of other non-metallic mineral products	-16.8	-14.5
	27	Manufacture of basic metals	18.8	-3.7
	28	Manufacture of fabricated metal products	-36.8	-26.9
	29	Manufacture of machinery	-14.8	-32.3
	31	Manufacture of electrical machinery	-33.2	-42.1
	34	Manufacture of motor vehicles	-29	-48.9
	35	Manufacture of other transport equipment	247.8	27.9
	36	Manufacture of furniture	88.8	-10.7
	37	Recycling	28.8	10.4
E		**Electricity, gas and water supply**	**9.8**	**-3.1**
	40	Electricity, gas and hot water supply	9.8	-3.1

Source: wiiw Industrial Database based on national statistics.

Employment and wages

Wages in Macedonia are higher than in most other Balkan economies in transition (with the exception of Croatia and possibly Bosnia and Herzegovina). This is the consequence of the high price level. In principle, the price level in post-Yugoslavia countries is higher than in other countries in transition, especially those in the Balkans. In Central Europe, real appreciation has led to price convergence, so that now these countries have higher wages than Macedonia. In Serbia and Montenegro, wages declined dramatically during the 1990s for a variety of reasons. In Bulgaria and Romania, wages are still rather low, though for different reasons. In any case, Macedonia falls somewhere in between because it has inherited a higher price level, but has not experienced significant growth of wages in the meantime. Still, the competitiveness of Macedonian industry has suffered from relatively high wages.

High wages are not necessarily the cause of low employment and high unemployment. Greater flexibility of the labour market is perhaps desirable, but cannot be expected to increase employment: it would increase the competition for the existing employment, but would not necessarily increase the number of employed. The problem with the high wages, in comparison with those to be found in other countries of the region, is more connected with the lack of interest in investment and with slow growth of exports. Both are better addressed through the exchange rate and through monetary policy rather than through a reform of the labour market, which may be useful for its own sake, however.

Table 19

Average monthly gross wages, 2004*

	in EUR
Bulgaria	153
Croatia	798
Macedonia	339
Montenegro	303
Romania	204
Serbia	282
Czech Republic	565
Hungary	579
Poland	505
Slovakia	798
Slovenia	1190

Note: *) Preliminary.

Source: wiiw based on national statistics.

Table 20

Macedonia: average monthly gross wage paid per worker, 2004*

		EUR
C	**Mining and quarrying**	**379**
10	Mining of coal	187
14	Other mining and quarrying	383
D	**Manufacturing**	**289**
15	Manufacture of food products and beverages	429
16	Manufacture of tobacco products	357
17	Manufacture of textiles	179
18	Manufacture of wearing apparel	154
19	Manufacture of leather products and footwear	87
20	Manufacture of wood products	199
21	Manufacture of paper products	299
22	Publishing and printing	387
23	Manufacture of coke and refined petroleum	540
24	Manufacture of chemicals	549
25	Manufacture of rubber and plastics products	151
26	Manufacture of other non-metallic mineral products	422
27	Manufacture of basic metals	369
28	Manufacture of fabricated metal products	239
29	Manufacture of machinery	330
30	Manufacturing of office machinery and computers	378
31	Manufacture of electrical machinery	321
32	Manufacturing of radio, TV, communication	217
33	Manufacturing of precision instruments	498
34	Manufacture of motor vehicles	234
35	Manufacture of other transport equipment	343
36	Manufacture of furniture	179
37	Recycling	184
E	**Electricity, gas and water supply**	**423**
40	Electricity, gas and hot water supply	470
41	Collection, purification, distribution of water	332
Total economy average monthly gross wage		**339**

Note: * Preliminary.

Source: wiiw based on national statistics.

Table 21a

Macedonia: employment by activities – Labour force survey data

(annual average, 1000 persons, growth rates)

NACE Label		2001	2002	2003	2004*
A-O	Employed persons, total	599.3	561.3	545.1	523.0
	growth rate in %	9.0	-6.3	-2.9	-4.1
	NACE classification:				
A-B	Agriculture, forestry, fishing	149.5	134.3	120.2	88.1
	growth rate in %	.	-10.2	-10.5	-26.7
A	Agriculture and forestry	149.2	133.6	120.0	87.6
B	Fishing	0.3	0.7	0.2	0.4
C-F	Industry total	210.7	187.0	184.9	171.4
	growth rate in %	.	-11.3	-1.1	-7.3
C-E	Industry total	175.0	154.1	149.0	134.9
	growth rate in %	.	-11.9	-3.3	-9.5
F	Construction	35.6	32.8	35.9	36.5
	growth rate in %	.	-7.9	9.4	1.7
G-O	Services	237.9	238.9	238.5	261.8
	growth rate in %	.	0.4	-0.2	9.8
G-K	Market services	131.5	128.5	123.8	138.9
	growth rate in %	.	0.4	-0.2	9.8
G	Wholesale, retail trade, repair motor veh.	66.7	64.3	62.5	74.2
	growth rate in %	.	-3.6	-2.7	18.7
H	Hotels and restaurants	12.4	11.2	12.8	12.7
	growth rate in %	.	-9.7	14.0	-1.0
I	Transport, storage, telecommunications	33.2	32.6	30.6	30.8
	growth rate in %	.	-1.8	-6.1	0.5
J	Financial intermediation	8.8	8.4	7.1	7.7
	growth rate in %	.	-4.0	-15.7	8.5
K	Real estate, renting & business activities	10.4	12.0	10.8	13.6
	growth rate in %	.	14.6	-9.6	25.5
L-O	Community services	106.4	110.4	114.7	122.9
	growth rate in %	.	3.8	3.9	7.2
L	Public admin., defence, compuls.soc.sec.	33.9	33.0	34.7	39.7
	growth rate in %	.	-2.9	5.3	14.4
M	Education	27.0	33.7	32.0	33.6
	growth rate in %	.	24.9	-5.0	5.1
N	Health and social work	26.9	26.2	30.2	29.9
	growth rate in %	.	-2.5	15.2	-0.9
O	Oth. community, social & personal serv.	18.6	17.5	17.8	19.7
	growth rate in %	.	-5.6	1.6	10.4
	Other not elsewhere classified activities	1.3	1.3	1.5	1.7

Note: * Preliminary.

Table 21b

Macedonia: structure of employment by activities – Labour force survey data

(per cent of total)

NACE label		2001	2002	2003	2004*
A-O	Employment, total	100.0	100.0	100.0	100.0
A-B	Agriculture, forestry, fishing	24.9	23.9	22.1	16.8
C-F	Industry total	35.1	33.3	33.9	32.8
C-E	Industry	29.2	27.5	27.3	25.8
F	Construction	5.9	5.8	6.6	7.0
G-O	Services	39.7	42.6	43.8	50.1
G-K	Market services	21.9	22.9	22.7	26.6
G	Wholesale, retail trade, repair motor veh-icles	11.1	11.4	11.5	14.2
H	Hotels and restaurants	2.1	2.0	2.3	2.4
I	Transport, storage, telecommunications	5.5	5.8	5.6	5.9
J	Financial intermediation	1.5	1.5	1.3	1.5
K	Real estate, renting & business activities	1.7	2.1	2.0	2.6
L-O	Community services	17.8	19.7	21.0	23.5
L	Public admin., defence, compuls. soc. sec.	5.7	5.9	6.4	7.6
M	Education	4.5	6.0	5.9	6.4
N	Health and social work	4.5	4.7	5.5	5.7
O	Oth. community, social & personal serv-ices	3.1	3.1	3.3	3.8
	Other not elsewhere classified activities	0.2	0.2	0.3	0.3

Note: * Preliminary.

Source: wiiw Database.

External position

The Balkans as a whole runs a significant trade deficit. Macedonia is not an exception, though its coverage of imports by exports is better than in most other post-Yugoslav economies (except for Slovenia). In addition, Macedonia has inherited a relatively moderate level of debt from former Yugoslavia, so that its debt to GDP ratio has continued to be low, all the additional accumulation of debt notwithstanding. Still, its foreign debt development is not favourable mainly because of the low level of growth. Macedonia falls in the class of countries with an unsustainable foreign debt development, but not so much because of its significant current account deficit but rather because of its low growth rate. If it continues to run current account deficits similar to those in the past ten years and continues to grow at the historical rate, its debt to GDP ratio will explode and will prove not to be sustainable.

Thus, the key to the sustainability of the external position is a higher growth rate. This is also a precondition for the further liberalization of the capital account and the normalization of external financial relations. The credit rating is relatively low given the history of macroeconomic stability and clearly reflects the disappointing growth record.

Table 22

Foreign financial position

EUR billion, end of period

	Gross External debt[1)]				Reserves of National Bank (excluding gold)[2)]				Current account[3)] EUR billion				Current account[3)] in % of GDP			
	2002	2003	2004		2002	2003	2004		2003	2004	2005 forecast	2006 forecast	2003	2004	2005 forecast	2006 forecast
Albania	1.1	1.1	.		0.8	0.8	1.0	XI	-0.4	-0.3	-0.5	-0.4	-6.7	-4.3	-6.0	-5.0
Bosnia & Herzegovina	2.2	2.1	2.1	IX	1.3	1.4	1.7	IX	-1.9	-1.8	-1.7	-1.6	-30.2	-27.7	-24.3	-21.7
Bulgaria	10.8	10.7	12.4		4.2	5.0	6.4		-1.5	-1.4	-1.3	-1.3	-8.6	-7.2	-6.1	-5.6
Croatia	14.8	18.8	22.2		5.7	6.6	6.4		-1.9	-1.7	-1.6	-1.6	-7.3	-6.1	-5.6	-5.3
Macedonia	1.5	1.4	1.4		0.7	0.8	0.6	XI	-0.1	-0.3	-0.3	-0.3	-3.3	-7.1	-6.7	-6.5
Romania	14.7	15.7	17.5	XI	5.9	6.4	10.7		-3.1	-4.4	-5.5	-6.0	-6.1	-7.7	-7.7	-7.4
Serbia & Montenegro	11.4	10.9	10.2	XI	2.1	2.7	3.0		-1.7	-2.4	-2.5	-2.5	-11.7	-15.5	-17.3	-16.6

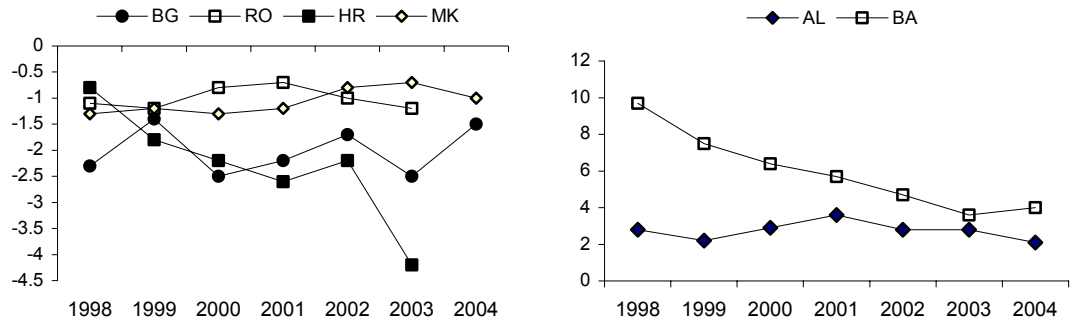
Notes: 1) General government foreign debt for Bosnia & Herzegovina; Macedonia and Romania medium- and long-term; for Serbia & Montenegro 2004 Serbia only. - 2) Albania: including gold; refer to total foreign assets of Bank of Albania. - 3) For Serbia & Montenegro Serbia only.

Source: wiiw Database incorporating national statistics; forecast: wiiw.

Figure 3

Income balance

in % of GDP



Source: wiiw Annual Database incorporating national statistics.

Table 23

Sustainable foreign debt

	average annual euro nominal growth rate in % 2004/2000	Current account In % of GDP 2000-2004	Curr. account/GDP nom. growth rate GDP*
Albania	13.1	-5.8	45 %
Bosnia and Herzegovina	6.6	-26.2	394 %
Bulgaria	9.3	-6.9	74 %
Croatia	8.5	-5.8	68 %
Macedonia	2.2	-5.8	260 %
Romania	9.1	-5.2	57 %
Serbia and Montenegro	9.2	-10.7	116 %

* This is the level at which the debt to GDP ratio would stabilize (would remain constant).

Table 24

Standard & Poor's Sovereign Ratings

S&P Foreign Currency Sovereign Credit Rating, Long Term, 3 February 2005

	1999	**2000**	**2001**	**2002**	**2003**	**2004**
Bosnia and Herzegovina [1)]	.	.	.	.	.	*B3*
Bulgaria	B	B+	BB-	BB	BB+	BBB-
Croatia	BBB-	BBB-	BBB-	BBB-	BBB-	BBB- / BBB
Macedonia	.	.	.	.	.	BB
Montenegro	.	.	.	.	.	BB
Romania	B-	B-	B- / B	B+	BB- / BB	BB+
Serbia	.	.	.	.	.	B+
Czech Republic	A-	A-	A-	A-	A-	A-
Hungary	BBB	BBB+ / A-	A-	A-	A-	A-
Poland	BBB	BBB+	BBB+	BBB+	BBB+	BBB+
Slovakia	BB+	BB+	BBB-	BBB	BBB	BBB+ / A-
Slovenia	A	A	A	A	A+	AA-
Russia	.	B-	B / B+	B+ / BB- / BB	BB	BB+
Ukraine	.	.	B	B	B	B+

Notes: Standard & Poor's rating definition: AAA is better than AA; AA is better than A; "+" and "-" are the respective modifiers. - 1) The 2004 rating for Bosnia and Herzegovina is done by Moody's; the modifier 3 is comparable to a S&P "-".

Investment

The data on gross fixed capital formation are not altogether reliable and up-to-date. They are certainly not impressive. They also show the same type of volatility that can be found in the developments of the other real variables. Given that domestic consumption is rather subdued, it is really investment that should drive the growth rate (together with net exports). The volatility, however, does not help in that respect.

When it comes to foreign direct investments, similar developments can be observed. They are relatively low, happen occasionally, are connected with privatizations, are concentrated in few sectors, target the domestic market and do not tend to have significant spillover effects. Greenfield investments are rarer and certainly do not contribute all that much to the overall industrial and other development.

Table 25

Gross fixed capital formation

real change in % against preceding year

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 [1)]	2005 forecast	2006 forecast	Index 1990=100 2004	Index 2000=100 2004
Bulgaria	16.1	-21.2	-20.9	35.2	20.8	15.4	23.3	8.5	13.8	12.4 I-IX	.	.	144.7	171.1
Croatia	.	37.6	26.4	2.5	-3.9	-3.8	7.1	12.0	16.8	5.5 I-IX	5	4	35.0	147.8
Macedonia	10.2	6.5	-4.3	-2.6	-1.4	-1.5	-8.6	17.6	.	.	.	.		
Romania	6.9	5.7	1.7	-5.7	-4.8	5.5	10.2	8.2	9.2	13	10	8	158.8	147.1
Serbia & Montenegro [2)]	-3.7	-5.7	0.8	-2.2	-29.7	13.3	-4.1	.	.	.	.	.		

Notes: 1) Preliminary. - 2) Gross fixed investment.

Source: wiiw Database incorporating national statistics.

Table 26

Macedonia: gross fixed capital formation by purpose of investment and type of ownership

EUR million, current prices, year 2003

Description	NACE sector	**total**	social	private	cooperative	mixed	state	Shares in total
Agriculture, hunting and forestry	A	**22.4**	0.1	14.1	0.0	2.9	5.4	3%
Fishing	B	**0.0**	.	0.0	.	.	0.0	0%
Mining and quarrying	C	**1.9**	0.0	0.2	.	1.3	0.4	0%
Manufacturing	D	**125.4**	0.0	73.3	0.1	51.0	1.1	18%
Electricity, gas and water supply	E	**68.2**	2.0	.	.	0.8	65.4	10%
Construction	F	**186.3**	0.4	152.0	0.0	6.6	27.4	27%
Wholesale, retail trade, repair of motor veh.	G	**37.4**	0.1	36.5	.	0.7	0.1	5%
Hotels and restaurants	H	**14.6**	.	13.6	.	1.0	0.0	2%
Transport, storage and communication	I	**145.7**	0.2	82.9	.	58.3	4.3	21%
Financial intermediation	J	**26.0**	.	3.0	..	21.6	1.5	4%
Real estate, renting and business services	K	**7.0**	0.4	4.9	.	1.4	0.3	1%
Public administration, comp. social security	L	**20.1**	1.1	.	.	.	19.1	3%
Education	M	**7.1**	2.3	0.8	.	.	4.0	1%
Health and social work	N	**18.8**	1.9	2.1	.	0.0	14.7	3%
Oth. community, soc. and pers. activities	O	**6.3**	2.6	0.9	.	1.4	1.4	1%
Total		**687.3**	**11.1**	**384.1**	**0.1**	**146.9**	**145.1**	100%
In % of GDP (EUR 4,137.1 million)		**16.6%**	0.3%	9.6%	0.0%	3.7%	3.6%	

Note: Main components of total gross fixed investment were construction (56%), metal products and machinery (33%) and transport equipment (6%).

Source: State Statistical Office of the Republic of Macedonia.

Table 27

Inward FDI stock, USD million

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Albania	.	.	20	88	142	212	302	350	395	436	579	786	929	1107	1449
Bosnia and Herzegovina	.	.	.	.	.	.	.	.	67	244	390	509	774	1155	1652
Bulgaria	4	60	101	141	247	337	446	951	1597	2403	2257	2758	3662	5082	8200 [1)]
Croatia	.	.	.	120	237	352	862	1395	1940	2567	3568	4239	6910	10476	12989
Macedonia	.	.	.	.	24	33	45	75	203	235	410	851	929	1024	1175
Moldova	.	.	.	14	29	94	117	186	244	310	439	536	675	749	902
Romania	.	45	122	216	402	821	1097	2352	4418	5469	6480	7638	7799	12815	18002
Serbia	.	.	.	.	.	.	.	740	853	965	1015	1180	1655	3015	3981
Montenegro	.	.	.	.	.	.	.	.	.	.	.	10	94	139	201
SEE-9	**4**	**105**	**243**	**579**	**1081**	**1850**	**2869**	**6049**	**9715**	**12629**	**15137**	**18507**	**23427**	**35561**	**48551**
Czech Republic	72	595	2889	3423	4547	7350	8572	9234	14375	17552	21644	27092	38669	45287	56415
Hungary	569	2107	3424	5585	7095	11304	13282	17968	20733	23260	22870	27407	36224	48320	60328
Poland	109	425	1370	2307	3789	7843	11463	14587	22461	26075	34227	41247	48320	55268	68000 [1)]
Slovakia	.	.	.	.	897	1297	2046	2083	2890	3188	4746	5582	8530	11883	15000 [1)]
Slovenia	.	.	.	954	1326	1763	1998	2207	2777	2682	2893	2605	4133	6337	7500 [1)]
NMS-5	**750**	**3127**	**7683**	**12270**	**17654**	**29557**	**37361**	**46079**	**63236**	**72758**	**86380**	**103933**	**135876**	**167095**	**207243**

Notes: Country groups refer to sum over available data. - 1) wiiw estimate.

Remarks: Albania: equity capital; cumulated inflows.
Bosnia and Herzegovina: equity capital; cumulated inflows.
Bulgaria: equity capital + reinvested earnings from 1997 + loans from 1996; cumulated inflows until 1997.
Croatia: equity capital + reinvested earnings from 1997 + loans form 1997; cumulated inflows until 1997.
Macedonia: equity capital; cumulated inflows.
Moldova: equity capital + reinvested earnings from 1997 + loans from 1995.
Romania: equity capital + reinvested earnings from 2003 + loans from 1994.
Serbia: FDI net, cumulated. Up to 1999 Serbia and Montenegro.
Montenegro: FDI net, cumulated.

Czech Republic: equity capital + reinvested earnings from 1997 + loans from 1997.
Hungary: equity capital + reinvested earnings from 1995 + loans from 1995.
Poland: equity capital + reinvested earnings + loans.
Slovak Republic: equity capital + reinvested earnings + loans.
Slovenia: equity capital + reinvested earnings + loans.

Source: wiiw Database according to international investment position (IIP) of the respective National Banks. Cumulated inflow for some countries as mentioned in the remarks.

Table 28

Inward FDI stock per capita, USD

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Albania	.	.	6	27	44	65	91	104	117	128	169	253	295	347	451
Bosnia and Herzegovina	.	.	.	.	.	.	.	.	18	65	103	134	202	301	427
Bulgaria	0	7	12	17	29	40	53	115	194	293	277	349	467	651	1057
Croatia	.	.	.	26	51	75	192	305	431	564	804	955	1555	2358	2925
Macedonia	.	.	.	.	12	17	22	37	101	116	202	417	459	504	579
Moldova	.	.	.	3	7	22	27	51	67	85	121	148	187	208	251
Romania	.	2	5	9	18	36	49	104	196	244	289	341	358	589	829
Serbia	.	.	.	.	.	.	.	.		109	125	132	154	221	402	530
Montenegro	.	.	.	.	.	.	.	.	.	.	.		16	152	224	322
SEE-9	**0**	**2**	**6**	**13**	**24**	**38**	**59**	**126**	**173**	**224**	**270**	**333**	**428**	**649**	**887**
Czech Republic	7	58	280	331	440	712	832	897	1397	1708	2108	2654	3790	4435	5520
Hungary	55	203	330	540	686	1095	1289	1748	2022	2276	2242	2694	3572	4776	5975
Poland	3	11	36	60	98	203	297	377	581	675	886	1068	1264	1447	1781
Slovakia	.	.	.	.	167	242	380	387	536	591	879	1038	1586	2209	2786
Slovenia	.	.	.	480	666	886	1006	1112	1404	1349	1454	1306	2072	3174	3759
NMS-5	**11**	**47**	**116**	**184**	**265**	**444**	**561**	**692**	**950**	**1093**	**1299**	**1566**	**2061**	**2536**	**3146**

Source: wiiw Database.

Table 29

Inward FDI stock as a percentage of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Albania	.	.	2.8	7.2	7.2	8.8	10.0	16.2	14.4	12.7	15.7	18.5	19.2	18.1	17.8
Bosnia and Herzegovina	.	.	.	.	.	.	.	.	1.6	5.0	8.2	10.1	13.8	16.3	20.1
Bulgaria	0.0	0.7	1.2	1.3	2.5	2.6	4.5	9.1	12.5	18.6	17.9	20.3	23.5	25.6	34.0
Croatia	.	.	.	1.1	1.6	1.9	4.3	6.9	9.0	12.9	19.4	21.3	30.3	36.4	37.9
Macedonia	.	.	.	.	0.7	0.8	1.0	2.0	5.7	6.4	11.4	24.8	24.7	21.9	21.9
Moldova	.	.	.	.	.	6.5	6.9	9.7	14.4	26.5	34.1	36.3	40.5	38.2	45.1
Romania	.	0.2	0.6	0.8	1.3	2.3	3.1	6.7	10.6	15.4	17.5	19.0	17.0	22.4	24.6
Serbia	.	.	.	.	.	.	.	.	.	12.8	16.2	11.1	11.6	15.8	17.9
Montenegro									.	.	.	0.9	7.6	8.9	11.0
SEE-9	**0.0**	**0.2**	**0.6**	**1.1**	**1.8**	**2.4**	**3.9**	**7.8**	**11.0**	**14.2**	**17.1**	**18.6**	**20.3**	**24.3**	**27.1**
Czech Republic	0.2	2.3	9.7	9.8	11.1	14.1	14.0	16.4	23.6	29.8	38.8	44.5	52.4	50.1	52.7
Hungary	1.7	6.3	9.2	14.5	17.1	25.5	29.4	39.3	44.1	48.4	49.1	52.9	55.8	58.4	60.5
Poland	0.2	0.6	1.6	2.7	4.1	5.8	7.5	9.5	13.3	15.9	20.6	22.2	25.2	26.4	28.1
Slovakia	.	.	.	.	5.8	6.7	9.8	9.8	13.0	15.6	23.5	26.7	35.2	36.4	36.5
Slovenia	.	.	.	7.5	9.2	9.4	9.9	11.3	13.3	12.6	15.1	13.3	18.7	22.8	23.3
NMS-5	**0.5**	**2.0**	**4.4**	**6.7**	**8.6**	**10.9**	**12.4**	**15.5**	**19.8**	**23.2**	**28.0**	**30.7**	**36.1**	**37.7**	**39.7**

Source: wiiw Database.

Table 30

FDI inflow, USD mn

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Albania	.	.	20	68	54	70	90	48	45	41	143	207	143	178	341
Bosnia and Herzegovina	.	.	.	.	.	.	.	.	67	177	146	119	265	381	497
Bulgaria	4	56	41	40	105	90	172	645	537	819	1002	813	905	2097	2602
Croatia	.	.	.	120	117	114	511	538	935	1472	1087	1564	1126	2042	1076
Macedonia	.	.	.	.	24	9	11	30	128	33	175	442	78	95	151
Moldova	.	.	.	.	12	67	24	79	76	38	127	102	132	71	151
Romania	.	40	77	94	341	419	263	1215	2031	1041	1037	1157	1144	2212	5049
Serbia	.	.	.	.	.	.	.	740	113	112	50	165	475	1360	966
Montenegro	.	.	.	.	.	.	.	.	.	.	.	10	84	45	62
SEE-9	**4**	**96**	**138**	**322**	**653**	**770**	**1071**	**3294**	**3931**	**3732**	**3766**	**4578**	**4353**	**8480**	**10896**
Czech Republic	72	523	1004	654	869	2562	1428	1300	3718	6324	4986	5641	8483	2101	4463
Hungary	311	1459	1471	2339	1146	4741	3291	4167	3345	3311	2777	3949	3021	2202	4185
Poland	89	291	678	1715	1875	3659	4498	4908	6365	7270	9343	5714	4131	4123	6159
Slovakia	.	.	.	179	273	270	382	231	707	428	1925	1584	4141	717	1122
Slovenia	4	65	111	113	117	151	174	334	216	107	136	370	1686	337	516
NMS-5	**476**	**2338**	**3264**	**5000**	**4279**	**11383**	**9773**	**10940**	**14350**	**17439**	**19167**	**17259**	**21462**	**9481**	**16446**

Notes: Country groups refer to sum over available data.

Remarks: Albania: equity capital.
Bosnia and Herzegovina: equity capital.
Bulgaria: equity capital + reinvested earnings from 1997 + loans from 1996.
Croatia: equity capital + reinvested earnings from 1997 + loans from 1997.
Macedonia: equity capital.
Moldova: equity capital + reinvested earnings from 1997 + loans from 1995.
Romania: equity capital + reinvested earnings from 2003 + loans from 1998.
Serbia: FDI net (inflow minus outflow). Up to 1999 Serbia and Montenegro.
Montenegro: FDI net (inflow minus outflow).

Czech Republic: equity capital + reinvested earnings from 1998 + loans from 1998.
Hungary: equity capital + reinvested earnings from 1995 + loans from 1995.
Poland: equity capital + reinvested earnings + loans from 1991.
Slovak Republic: equity capital + reinvested earnings from 1995 + loans from 1995.
Slovenia: equity capital + reinvested earnings from 1994 + loans from 2001.

Source: wiiw Database according to balance of payments statistics of the respective National Banks.

Table 31

FDI inflow per capita, USD

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Albania	.	.	6	21	17	21	27	14	13	12	42	67	46	57	107
Bosnia and Herzegovina	.	.	.	.	.	.	.	.	18	47	39	31	69	99	130
Bulgaria	0	6	5	5	12	11	21	78	65	100	123	103	115	268	334
Croatia	.	.	.	26	25	24	114	118	208	323	245	352	253	460	242
Macedonia	.	.	.	.	12	5	6	15	64	16	86	217	39	47	75
Moldova	.	.	.	.	3	15	5	22	21	10	35	28	37	20	42
Romania	.	2	3	4	15	18	12	54	90	46	46	52	52	102	233
Serbia	.	.	.	.	.	.	.		14	14	7	21	63	181	128
Montenegro		.	.	.	.	.	.	.	.	.	.	16	137	72	99
SEE-9	**0**	**2**	**3**	**7**	**14**	**16**	**22**	**68**	**70**	**66**	**67**	**82**	**79**	**155**	**199**
Czech Republic	7	51	97	63	84	248	138	126	361	615	485	552	832	206	437
Hungary	30	141	142	226	111	459	319	404	325	323	272	387	297	217	414
Poland	2	8	18	45	49	95	116	127	165	188	242	148	108	108	161
Slovakia	.	.	.	34	51	50	71	43	131	79	357	294	770	133	209
Slovenia	2	32	56	57	59	76	87	168	109	54	68	186	845	169	258
NMS-5	**7**	**35**	**49**	**75**	**64**	**171**	**147**	**164**	**215**	**262**	**288**	**260**	**325**	**144**	**250**

Source: wiiw Database.

Table 32

FDI inflow as a percentage of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Albania	.	.		2.8	5.5	2.7	2.9	3.0	2.2	1.6	1.2	3.9	4.9	3.0	2.9	4.2
Bosnia and Herzegovina	.	.	.	.	.	.	.	.		1.6	3.6	3.1	2.4	4.7	5.4	6.0
Bulgaria	0.0	0.7	0.5	0.4	1.1	0.7	1.7	6.2	4.2	6.3	8.0	6.0	5.8	10.6	10.8
Croatia	.	.	.	1.1	0.8	0.6	2.6	2.7	4.3	7.4	5.9	7.9	4.9	7.1	3.1
Macedonia	.	.	.	.	0.7	0.2	0.3	0.8	3.6	0.9	4.9	12.8	2.1	2.0	2.8
Moldova	.	.	.	.	.		4.6	1.4	4.1	4.4	3.2	9.8	6.9	8.0	3.6	7.6
Romania	.	0.1	0.4	0.4	1.1	1.2	0.7	3.4	4.9	2.9	2.8	2.9	2.5	3.9	6.9
Serbia	.	.	.	.	.	.	.	.	.		1.5	0.8	1.6	3.3	7.1	4.3
Montenegro	.	.	.	.	.	.	.	.	.	.		.	0.9	6.9	2.9	3.4
SEE-9	**0.0**	**0.1**	**0.3**	**0.6**	**1.1**	**1.0**	**1.4**	**4.3**	**4.4**	**4.2**	**4.3**	**4.6**	**3.8**	**5.8**	**6.1**
Czech Republic	0.2	2.0	3.4	1.9	2.1	4.9	2.3	2.3	6.1	10.7	8.9	9.3	11.5	2.3	4.2
Hungary	0.9	4.4	4.0	6.1	2.8	10.7	7.3	9.1	7.1	6.9	6.0	7.6	4.7	2.7	4.2
Poland	0.2	0.4	0.8	2.0	2.0	2.7	2.9	3.2	3.8	4.4	5.6	3.1	2.2	2.0	2.5
Slovakia	.	.	.	1.5	1.8	1.4	1.8	1.1	3.2	2.1	9.5	7.6	17.1	2.2	2.7
Slovenia	0.0	0.5	0.9	0.9	0.8	0.8	0.9	1.7	1.0	0.5	0.7	1.9	7.6	1.2	1.6
NMS-5	**0.3**	**1.5**	**1.9**	**2.7**	**2.1**	**4.2**	**3.2**	**3.7**	**4.5**	**5.6**	**6.2**	**5.1**	**5.7**	**2.1**	**3.2**

Source: wiiw Database.

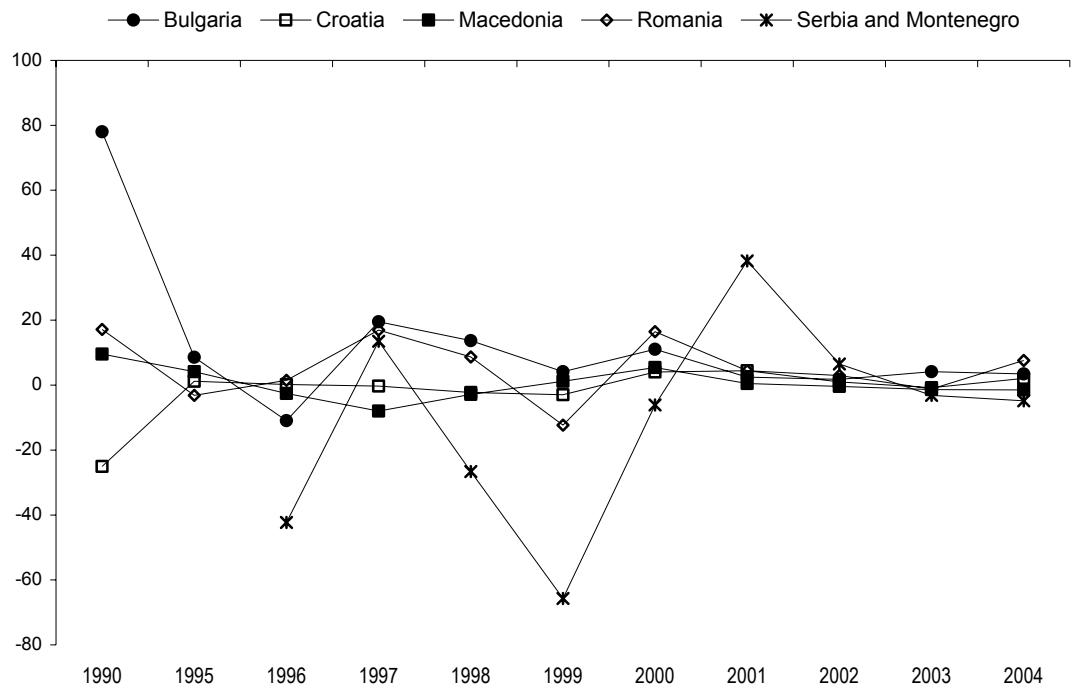
Exchange rate

The key policy variable is the exchange rate. It is pegged at a fixed rate to the euro (previously to the German mark). Macedonian exchange rate has not appreciated in real terms as much as have some other currencies in transition economies. Thus, the real issue is whether the level is appropriate. One way to assess that is to look at the interest rate difference between the denar and euro financial instruments. Clearly, the difference is very significant. The pegged exchange rate makes sense if the interest rate in the target and in the domestic currencies converge. Then, it can be argued that the monetary policy of the target or anchor country is being imported. If that is not the case, the implication is that there is a misalignment of the exchange rate. If, for instance, the inflation has converged, but the interest rate is several times higher in denar than in euro, that must mean that the exchange rate is misaligned. What is the real level of misalignment is not easy to determine, because of the dynamics of expectations, but the misalignment is certainly present.

Figure 4

Real appreciation*

EUR per NCU, PPI-deflated, in %



* Increasing line indicates real appreciation.

Up to 2000 Serbia had multiple exchange rates. Up to 1998 official exchange rate, 1999 and 2000 black market exchange rate.

Source: wiiw Annual Database incorporating national statistics.

Table 33

Real exchange rates in NCU per EUR (PPI-deflated)

annual change in %

	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Bulgaria	78.0	8.6	-10.9	19.5	13.7	4.1	11.0	2.5	1.8	4.1	3.4
Croatia	-25.0	1.2	0.2	-0.3	-2.3	-3.0	4.0	4.4	1.0	-0.8	2.1
Macedonia	9.6	4.1	-2.6	-8.0	-2.9	1.2	5.4	0.5	-0.4	-1.4	-1.5
Romania	17.1	-3.2	1.5	16.9	8.7	-12.3	16.5	4.4	3.0	-1.2	7.6
Serbia and Montenegro[1)]	.	.	-42.3	13.5	-26.6	-65.7	-6.1	38.2	6.5	-3.2	-4.8

Notes: Minus sign indicates real depreciation. NCU: National currency units. PPI: Producer price index. - 1) Up to 2000 Serbia had multiple exchange rate. Up to 1998 official exchange rate, 1999-2000 marker exchange rate.

Source: wiiw Annual Database incorporating national statistics.

Table 34

Nominal exchange rates per EUR, 2003-2004

growth rate year-on-year[1)]

	I Q 2003	II Q 2003	III Q 2003	IV Q 2003	I Q 2004	II Q 2004	III Q 2004	IV Q 2004
Bulgaria	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Croatia	101.6	102.3	102.0	102.5	101.6	102.3	102.0	102.5
Macedonia	100.6	100.5	100.4	100.4	100.6	100.5	100.4	100.4
Romania	125.7	122.1	115.1	118.8	113.9	108.7	109.6	100.4

Note: 1) Quarterly data are averages of monthly rates.

Source: wiiw Monthly Database incorporating national statistics.

Real exchange rates per EUR, PPI-based, 2003-2004

growth rate year-on-year[1)]

	I Q 2003	II Q 2003	III Q 2003	IV Q 2003	I Q 2004	II Q 2004	III Q 2004	IV Q 2004
Bulgaria	-5.6	-3.5	-3.2	-3.6	-1.0	-4.1	-4.3	-1.3
Croatia	0.9	1.5	1.3	2.8	-1.2	-3.5	-3.7	-2.7
Macedonia	1.1	2.9	2.4	2.2	2.4	-0.8	-3.7	-8.6
Romania	4.0	1.2	-1.2	-0.4	-4.1	-9.1	-7.0	-12.7

Note: 1) Minus means real appreciation.

Source: wiiw Monthly Database incorporating national statistics.

Real exchange rates per EUR, CPI-based, 2003-2004

growth rate year-on-year[1)]

	I Q 2003	II Q 2003	III Q 2003	IV Q 2003	I Q 2004	II Q 2004	III Q 2004	IV Q 2004
Bulgaria	2.8	1.0	-1.3	-3.2	-4.0	-4.4	-3.7	-1.7
Croatia	3.9	3.3	2.4	3.8	-1.7	-2.1	-0.4	-2.1
Macedonia	1.3	1.2	-0.6	-0.4	0.0	0.9	2.1	2.6
Romania	9.4	6.9	2.9	6.0	0.7	-2.0	-0.1	-6.8

Note: 1) Minus means real appreciation.

Source: wiiw Monthly Database incorporating national statistics.

Privatization

Privatization is for the most part finished. As can be seen from the tables below, the Macedonian economy is mostly in private hands. There is, however, a significant state sector in utilities, both central and communal. Those should be restructured and privatized.

Table 35

Macedonia: firm distribution by legal form, 2003

Legal Form	Number of firms	Share
Private	140713	96.93%
Mixed (part private and part socially-owned)	1931	1.33%
Cooperative	1467	1.01%
State owned	66	0.05%
Socially owned	998	0.69%
Total	**145175**	**100.00%**

Source: National statistics.

Table 36

Macedonia: sector distribution of privatized firms, 2003

Sector	Share in number of firms	Share in total employment	Share in total equity (EUR mn)
Manufacturing	29.3%	59.7%	63.4%
Agriculture	25.4%	8.9%	8.7%
Construction	7.3%	13.8%	5.2%
Trade	21.0%	8.3%	11.0%
Transport and traffic	3.1%	3.1%	1.7%
Finance and services	6.9%	3.2%	4.9%
Crafts	3.3%	1.3%	1.1%
Catering and tourism	3.7%	1.8%	4.0%
Total	**100.0%**	**100.0%**	**100.0%**

Source: National statistics.

The post-privatization process, however, is a different story. Capital markets are not very developed and there is not too much competition for corporate governance. That is to a large extent the consequence of the fact that firms were mostly privatized through management by-outs. That has also led to a weak governance structure and to few changes in the structure of the particular industries.

A new private sector is emerging in some services and in some sectors in which Macedonia has comparative advantages, such as in textiles. But this is not a very dynamic process. Unlike in some other transition economies, the Macedonian economy is still mostly dominated by the privatized sector, that is former social or state sectors, which is not proving to be very innovative.

Given the internal structure of the product market, external competition may turn out to be the main promoter of a more dynamic development. The efficiency and the innovativeness of Macedonian firms will probably be increased once competition from abroad increases due to the speed-up of EU and regional integrations. Continued growth in the neighbourhood will put pressure on the competitiveness of the local firms not only externally but at home as well.

Unlike in most other economies in transition, there are no strong local firms, at least not in industry and especially in manufacturing. There were hardly any to begin with, and those had failed to emerge in the meantime. The process of concentration is not very advanced either, which is also a reflection of the rather weak corporate structure as well as of the under-development of the capital market and concerning local and foreign investors. A strengthening of the local firms and local market for managers is necessary if development is to proceed.

Table 37

Macedonia: major acquisitions by foreign investors, 1995 to 2002

COMPANY	Investor's country	Investor	Branch	USD total	Company shares acquired	Investment's share in the year's total	Investment's share in the end-2002 stock
Maktrans-Skopje	Marshall Islands	Energy Group AG, Majuro	Transport	1,744,700	51%	40%	0%
Makedonija sport-Skopje	Germany	Westfra Trade GmbH-Frankfurt/M	Textile	1,046,300	81%	24%	0%
Tehnogas-Skopje	Italy	SOL Spa-Monza	Technical gas	1,008,000	34%	23%	0%
Total in 1995				**4,392,700**		**100%**	**1%**
Centro-Skopje	Austria	East West Trade-Vienna	Trade	11,004,000	60%	79%	2%
Bargala-Stip	San Marino	Maripel S.A. San Marino	Shoes	1,441,000	78%	10%	0%
Total in 1996				**13,917,000**		**100%**	**2%**
Ladna valalnica-Skopje	Liechtenstein	Balcan steel-Liechtenstein	Black metallurgy	21,000,000	34%	52%	4%
Makstil-Skopje	Liechtenstein	Duferco Skop Investment LTD	Black metallurgy	11,500,000	54%	29%	2%
Radika-Debar	Austria	KNAUF Gmb	Gypsum	3,483,000	51%	9%	1%
Jugotutun-Kavadarci	Netherlands	Intabex Netherlands	Tobacco	2,413,000	82%	6%	0%
Transkop-Bitola	Germany	BALTH.PAPP-Munich	Transport	1,058,000	51%	3%	0%
Total in 1997				**40,118,000**		**100%**	**7%**
Pivara-Skopje	Greece	Balkanbrew Holding LTD	Brewery	34,000,000	51%	53%	6%
Usje-Skopje	Greece, Switzerland	Titan, Holderbank Financiere Glaris	Cement	30,000,000	94%	47%	5%
Total in 1998				**64,000,000**		**100%**	**11%**
OKTA-Skopje	Greece	Hellenic Petroleum	Oil refinery	32,000,000	54%	90%	5%
Tutunski kombinat-Skopje	Slovenia	Tobacna-Lubjljana	Tobacco	3,000,000	95%	8%	1%
Total in 1999				**35,593,115**		**100%**	**6%**

(Table 37 contd.)

Table 37 (contd.)

COMPANY	Investor's country	Investor	Branch	USD total	Company shares acquired	Investment's share in the year's total	Investment's share in the end-2002 stock
Stopanska banka-Skopje	Greece, EBRD, IFC	National bank of Greece (65%), EBRD (10%), IFC (10%)	Banking	46,422,710	85%	55%	8%
ADOR Makedonija	United Kingdom	QBE Inter.Insurance LTD-London	Insurance	14,822,900	55%	18%	3%
Mermeren kombinat-Prilep	Greece	FHL.Kirijakidis S.A.	Marble	9,607,800	78%	11%	2%
FZC Kumanovo	Germany	KUPP.BALL und Transthandel Frankfurt/D	Metal pipes	3,345,120	48%	4%	1%
Fabrika za kabli-Negotino	Germany	Alskop GmbH-Frankfurt/M	Cables	2,865,590	46%	3%	0%
Feni-Kavadarci	France	SCMM	Ferro-nickel mine/smelter	2,000,000	100%	2%	0%
Bucim-Radovis	USA	EurAm Partners LLC, Washington DC	Copper mine	1,616,364	82%	2%	0%
Pivarnica-Bitola	Switzerland	Kenrich GmbH	Brewery	1,330,000	76%	2%	0%
Komuna-Skopje	Slovenia	Valkarton-Logatec	Paper	1,051,850	67%	1%	0%
Total in 2000				**84,447,260**		**100%**	**14%**
Makedonski Telekomunikacii – Skopje*	Hungary,	Matav consortium-Hungary	Telecommunication	315,000,000	51%	95%	54%
Zito Luks-Skopje	Greece	Elbisko SA Atika	Baked foods	14,009,000	52%	4%	2%
Skopski saem-Skopje	Slovenia	ERA d.d.-Velenje	Trade fair	2,890,000	51%	1%	0%
Total in 2001				**332,951,340**		**100%**	**57%**
Idnina – Kratovo	Slovenia	Comet Umetni Brusi in Nekovine DOO	Processing of other non-metal minerals	1,917,820	65%	23%	0%
AD Teal – Tetovo	Germany	Raku Export-Import	Processing of aluminium	1,388,722	51%	17%	0%
Total 2002				**8,226,111**		**100%**	**1%**
Total stock				**583,645,520**			**100%**

Notes: *USD 315 million; a further 235 million pledged in network investment over the next two years.

Source: Investment Promotion Agency, Skopje.

The policy mix

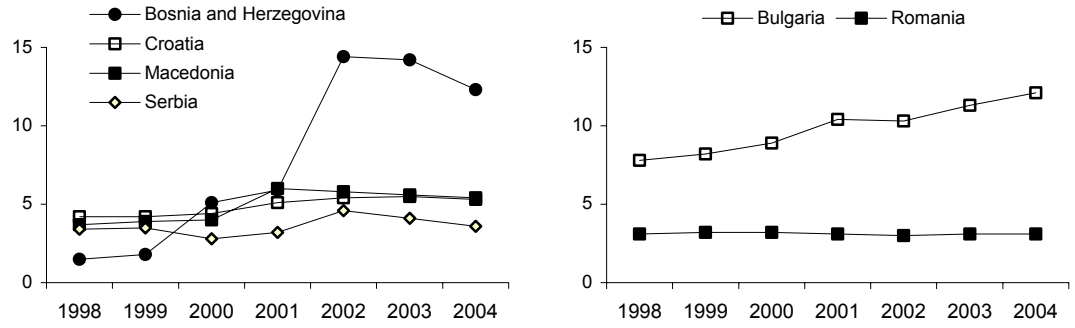
If a case is encountered where stability seems sustainable, but growth proves elusive, it is reasonable to reconsider the policy mix that the policy makers are pursuing. Macedonia is such a case. What is the policy mix that has been applied by the policy makers sine 1994? It is one of a fixed exchange rate with a restrictive monetary policy and responsible fiscal policy (i.e., a policy of a balanced budget). Growth was expected to come from investments and exports with some contribution from personal consumption to the extent that it reflected the growth of wages in the private sector. In short, the supply response to price stability was to come from improved efficiency (and greater productivity), growth of investments and growth of exports. None of these three sources of growth have materialized to the extent expected.

There are at least two ways to look at the restrictiveness of monetary policy. The first is to look at the money supply. Macedonia is under-monetized when compared to the other countries in transition. This is clear if M1 and broad money measures are compared across transition economies. In both, Macedonia is close to the bottom, together with Serbia and Romania. It would take some econometric analysis to determine the causes for the development of the money supply in Macedonia, but it seems reasonably clear from the inspection of the data that most monetary aggregates have remained flat in relation to the GDP.

Figure 5

Currency outside banks

in % of GDP

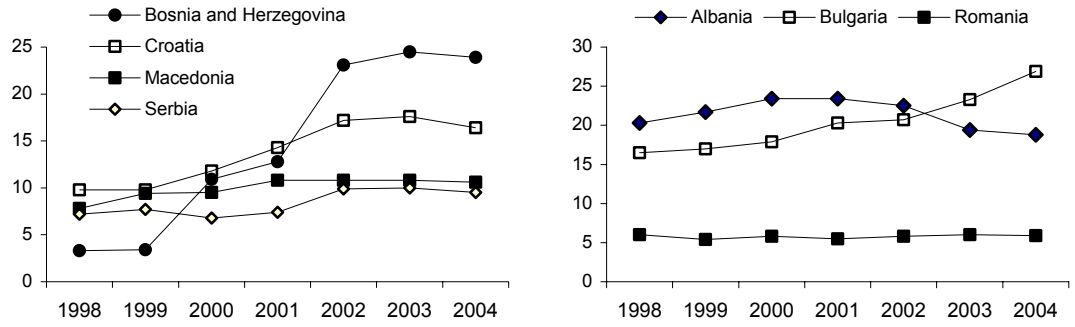


Source: wiiw Annual Database incorporating national statistics.

Figure 6

M1, Narrow money

in % of GDP

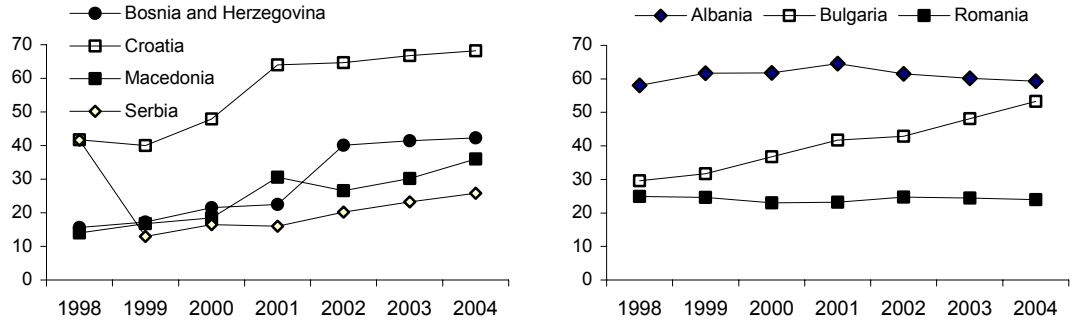


Source: wiiw Annual Database incorporating national statistics.

Figure 7

Broad money

in % of GDP



Source: wiiw Annual Database incorporating national statistics.

There is some indication that the periods of growth are also characterized by an increase in the level of money and that the periods of stagnation or low growth (which is most of the time) are characterized by stagnation in the monetary aggregates also. The other indicator of the tightness of the monetary policy is the level of interest rates and their volatility. A policy of fixed exchange rate makes sense if there is free movement of capital and thus the interest rate of the anchor currency is imported and an independent monetary policy, i.e., interest rate policy, cannot be conducted. If, however, capital markets are not integrated, interest rates for loans in Macedonian denar can be significantly and persistently higher in order to keep the necessary level of reserves in the central bank and in the banking system to stem off possible runs on the currency and a collapse of the exchange rate. Then, the difference between the interest rate in euro and in denar can be an indication of the tightness of the monetary policy. Given that interest rates are rather high in Macedonia and do not converge with those in the euro zone even after years of price stability, that is an

indication that monetary policy is too tight and does not contribute to the development of the real sector.

The last point can be supported by two other indicators. One is the frequency and the size of interventions in the foreign exchange market. The other is the level of the compulsory reserves in the banking sector. Currency pegs are characterized by frequent interventions by the central bank and by high compulsory reserves that commercial banks have to hold with the central bank. This is the way in which liquidity is kept under control in the fixed exchange rate regime. In Macedonia, the reserve requirements are high and the interventions in the foreign exchange market are frequent. Again, these are indications that the monetary policy is quite restrictive.

The other side of the policy mix is the fiscal policy. It is generally believed that the fiscal policy should be under tight control in case a country is relying on a fixed exchange rate regime. In this respect, there is no difference between the fixed peg and the currency board. It is, however, not always obvious what that means. Clearly, there should be some room for automatic stabilizers. If a country is going into a recession, it may have to run a budget deficit in order to preserve the desirable level of consumption. If taxes are proportionate to the national income, then a fall in income will lead to a fall in tax receipts and the difference will have to be borrowed. The reverse is, or should be, the case when growth is accelerating.

Also, public expenditures on wages and on consumption in general need not be treated in the same way as interest payments and as investments in general. Clearly, public investments may push upwards the growth rate and the fiscal deficit may not present a problem if the primary balance is sustainable. There is no doubt that public investments as well as public consumption carry with them some deadweight losses, but those may be unavoidable in case there are pervasive market failures as will often be the case in developing and transition economies.

Macedonia has conducted a responsible fiscal policy, except at times of crisis. Compared to other countries in transition, Macedonia exhibits a smaller public sector, a lower fiscal deficit and smaller influence of the political business cycle. Its public expenditures are below 40% of the GDP. The general budget deficit is below 2% of the GDP and significant increases in public expenditures were observed mainly in the wake of the 2000 election. Thus, it could be argued that Macedonia's fiscal policy has been, by and large, prudent.

The structure of public expenditures is another matter however.[1] Social security, health and education together with security are the main positions in the general government

[1] More on that in the appendix.

budget. Also, Macedonia was fiscally quite centralized, until the recent law on decentralization, and thus local communities usually do not have enough money to invest in communal services and in other areas of communal and public interest. This has led to the state being absent where it should in fact have been present and to it being present in areas in which it should rather yield to the private sector.

Table 38

General government budget revenues in % of GDP[1)]

Revenues

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 [2)]
Albania	23.9	16.4	18.3	24.9	26.0	24.6	23.9	22.8	22.4	22.3
Bosnia and Herzegovina	.	.	.	.	57.7	53.8	49.7	44.1	43.3	.
Bulgaria	37.3	32.9	31.8	39.7	40.7	41.4	39.8	38.7	40.9	41.5
Croatia	.	.	47.7	51.1	48.4	46.2	44.7	45.2	44.9	.
Macedonia [3)]	37.9	36.5	.	40.1	42.1	43.9	34.4	34.9	33.2	33.4
Romania	.	29.9	30.3	31.7	32.8	31.2	30.1	29.6	29.8	.
Serbia and Montenegro	.	.	43.4	41.0	41.4	35.0	41.0	53.6	52.6	.

Expenditure

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 [2)]
Albania	34.3	27.8	31.3	34.3	34.9	32.1	30.5	28.4	27.0	27.5
Bosnia and Herzegovina	.	.	.	.	65.5	60.7	53.1	44.2	42.6	.
Bulgaria	42.9	43.3	34.8	38.4	40.6	42.0	40.7	39.4	40.9	39.7
Croatia	.	.	50.1	54.6	56.6	52.7	51.5	50.0	49.5	.
Macedonia [4)]	39.0	36.9	.	40.7	41.1	41.5	40.8	40.5	34.8	34.7
Romania	.	33.8	33.9	35.3	34.7	35.2	33.3	32.1	31.9	.
Serbia and Montenegro	.	.	50.6	47.2	.	35.9	42.4	58.1	56.8	.

Deficit (-) / surplus (+)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 [2)]
Albania	-10.4	-11.4	-13.0	-9.5	-9.0	-7.5	-6.9	-6.0	-4.6	-5.2
Bosnia and Herzegovina	.	.	.	.	-7.8	-7.0	-3.3	-0.2	0.8	.
Bulgaria	-5.6	-10.4	-3.1	1.3	0.2	-0.6	-0.9	-0.7	0.0	1.7
Croatia	.	.	-2.3	-3.5	-8.2	-6.5	-6.8	-4.8	-6.3	.
Macedonia [3)]	-1.0	-0.4	.	-0.5	0.9	2.3	-6.3	-5.6	-1.6	-1.3
Romania	.	-3.8	-3.5	-3.6	-1.9	-4.0	-3.2	-2.5	-2.0	-1.0
Serbia and Montenegro	.	.	-7.2	-6.3	.	-0.9	-1.4	-4.5	-4.2	-1.7

Notes: 1) National definition, for Croatia IFM definition. - 2) Preliminary. - 3) From 2001 excluding privatization incomes. - 4) From 2001 excluding financing items.

Source: wiiw Database incorporating national statistics; wiiw forecasts.

Clearly, the policy mix followed by the successive Macedonian governments that have relied on the advice of the IMF has been characterized by excessive restrictiveness in the monetary and in the fiscal policy. This has resulted in some kind of macroeconomic stability, but a disappointing record of growth and development. Indeed, the key problem of

Macedonia is the lack of sustained growth and thus a deteriorating economic and social situation.

Alternative policy: brief proposal

Restrictive monetary and fiscal policies in an economy with a low growth rate and a very high unemployment rate do not seem to be an appropriate policy mix. What are the alternative policy mixes that could be considered?

It is sometimes suggested that the problem of the lack of an adequate supply response is the consequence of slow or non-existent structural reforms. It may be true that the structure of corporate governance that has emerged from privatization is not the best possible one. It is certainly true that public governance leaves a lot to be desired. In that, the rule of law can certainly be strengthened and made more efficient. Finally, the regulation of the markets can be improved so that they can be more competitive and more flexible. All in all, institutional reforms as well as other structural reforms and their efficient implementation are clearly necessary.

That, however, does not mean that there is nothing that economic policy can do. There are three strategic adjustments that could be looked at.

Public investments. Macedonia spends less on public investments than most other transition economies. This is not because there is no need to improve roads, railroads and other aspects of infrastructure. Macedonia is a transit region and also has significant possibilities to develop tourism. Those sectors cannot be expected to grow as fast as they could without an upgrading of infrastructure. In addition, there are even reasons connected with post-conflict reconstruction to be considered. Finally, there is a need to improve investment in human capital through the improvement of education and of the whole health sector.

The issue that is most often be raised in this context is whether the level of public debt is such that it makes it difficult for Macedonia to borrow. Looking at the debt level and its structure, however, it becomes clear that Macedonia is not a severely indebted country. Indeed, it is moderately indebted by the standards of developing countries and not necessarily by the standards of the transition economies that are on the path to EU integration.

It is true, however, that within the structure of public expenditures, a certain redistribution between the generations may be necessary (cf. pensions vs. expenditures on education). Pension reform is an issue in itself and should be considered separately. But it is clear that the state cannot provide for the type of social protection that is to be found in a more

advanced country. Irrespective of the debates on the privatization of the pension system, there is no doubt that the family will continue to play a significant role in the area of social protection in Macedonia.

Exchange rate. On the side of monetary policy, there are two thing that could be done. One is an increase in the flexibility of the exchange rate. There are three reasons for that. First is that the current exchange rate looks as being maladjusted because (i) it has constantly to be supported by a rather high interest rate and (ii) it delivers high current account deficits without significant turnaround in the export performance and without significant boost to foreign investments. Thus, a soft landing strategy that leads to the introduction of an inflation targeting policy should be explored. The second reason is that the fixed exchange rate tends to sap the development of the money market. There is a constant need to intervene and to keep a tight watch over the foreign currency reserves. That leads to the under-monetization of the economy and less then adequate financial intermediation. The third reason is that some of the important markets for Macedonian exports are on flexible exchange rate regime, e.g., the Serbian market. That makes Macedonian products less than competitive in those markets.

Capital account liberalization. The other thing that could be done to reform monetary policy is to fully liberalize the capital account. That would lead to an increased competition between domestic and foreign banks and will support development of the money market. If short term capital inflows are considered a problem, those could be regulated in one way or the other.

In conclusion: fiscal policy should support investment and human capital accumulation and monetary policy should deliver an interest rate that is supportive of Macedonia converging to its potential growth rate with stable prices.

Silvana Mojsovska and Vladimir Gligorov

Appendix: supporting analysis

Introduction

In this appendix a more detailed analysis of the various aspects of the Macedonian economy and its development will be given. At the beginning, the IMF strategy for Macedonia is reviewed and then an historical and analytical account of macroeconomic and microeconomic developments is given. The appendix provides a more detailed support for the claims and policy analysis given in the body of the report.

1 Summary of the IMF papers

The latest IMF Country Report on Macedonia was released in August 2004.[2] The Country Report refers to the macroeconomic achievements and economic development of the Republic of Macedonia, from the perspective of the set targets and accomplishments of the Fund-Supported Programmes. The Report consists of: Second Review Under the Stand-By Arrangement and Ex Post Assessment of Performance Under Fund-Supported Programs – Staff Report; Staff Supplement; Ex Post Assessment of Longer-Term Program Engagement – Staff Report; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Former Yugoslav Republic of Macedonia.

For the purpose of this report, the following papers were analysed: Second Review Under the Stand-By Arrangement, Ex Post Assessment of Performance Under Fund-Supported Programs, and Ex Post Assessment of Longer-Term Program Engagement.

In the ***Review Under the Stand-By Arrangement***, the IMF focuses on fiscal and monetary policy, budget implementation, financial sector and structural policies. The Fund expressed general satisfaction that the Macedonian authorities met the fiscal and monetary targets set within the latest stand-by arrangement (April 2003 to August 2004).[3] The key objective of the stand-by arrangement was to regain a sustainable fiscal position after the crisis in 2001. The IMF mission stated that fiscal stability was achieved in 2003, and though the fiscal outcome was tighter than originally planned, it did not provoke an overheating of the economy. In 2003, the general government deficit was -1.6% of GDP, instead of the projected -2.5%. Growth was picking up (3.2%), the external current account deficit had narrowed compared to 2002 and inflation was kept at a low level (1.2%), but

[2] IMF Country Report No. 04/276, August 2004, http://www.imf.org/external/pubs/ft/scr/2004/cr04276.pdf.

[3] Ibid., p. 5.

unemployment was rising to 36.7%.[4] Bank placements were increasing rapidly, though from a very low base, and the debt dynamic was good.

Along with that, the IMF stressed the risk of the poor practice of fiscal spending in Macedonia, characterized by an unequal dispersion of expenditures throughout the fiscal year, i.e. low spending in the first half and an explosion of public spending in the second half of the year. The threat of economic distortion that may be caused by poor fiscal management was avoided in 2003, but poor fiscal spending was pursued again in 2004., Although macroeconomic stability was maintained during the stand-by arrangement, the IMF mission criticized the 'non-timely' reaction of the National Bank of the Republic of Macedonia (NBRM) concerning the interest rate changes in response to the fiscal spending impulses in the last quarter of 2003. The Fund's main remark was that the NBRM had not raised the interest rates in order to sterilize the budget's injection of liquidity. Therefore, in spring 2004, the IMF urged the NBRM to raise interest rates, in spite of the authorities' concerns that this measure would slow down the economic recovery of the country. According to the Fund, the interest rate hike yielded the desired effects and resulted in an increase of international reserves, and in strengthening the macroeconomic stability.

Apart from the poor budget policy on the expenditure side, the IMF also criticized the budget implementation on the revenue side, in particular problems in VAT collection in 2003. But, it was assumed that these problems were of a temporary nature, as they occurred due to the problems in implementation. On the other hand, the launching of the Treasury bill market at the beginning of 2004 was regarded as a very important and promising instrument for deficit financing that should alleviate the government's dependence on external finance and privatization receipts. As for medium-term issues, the IMF declared its further support of the ongoing public sector reforms, but it warned that little attention had been paid to the phasing of reforms, to the interaction between the reforms, and to limiting their cost. The Fund's main concern focused on three major public sector reforms that present a risk for the budget: decompression of civil service salaries, ethnic minority employment, and government decentralization. Therefore, the IMF recommended to focus on the implementation of the Peace Framework Agreement (concluded in Ohrid in August 2001), but to refrain from further initiatives until overall public sector employment and wage policies had been assessed in a comprehensive multiyear framework.

As for financial sector issues, the IMF insisted on a tough supervision of the exchange rate risks, considering the euroization of the banking system and the upsurge in foreign currency lending. The rapid growth of bank deposits and credits signals a return of confidence in banks, but, according to the Fund, it also highlights the need to strengthen

[4] Ibid., p. 7.

bank supervision. In assessing the progress in the overall banking system, which is still anchored by large banks that appear stable, the IMF mentioned important weaknesses of the small banks that should be addressed.

While the IMF noted mixed achievements in the above-mentioned areas, the main criticism was addressed to weak structural policies. Of paramount importance is the reform of the judiciary system: the government has made judiciary reform a high priority, and support has been provided by the World Bank and USAID, but the reform is still at an early stage. The judiciary reform is considered very important by the IMF for the overall functioning of the system, with great influence on the business climate in the country. The other problematic reform is that of the health sector, where the IMF noted only limited progress in cutting costs, increasing transparency, and improving governance. The authorities had followed the Fund's recommendation to cut transfers to the Health and Insurance Fund from the general budget (from 0.2% of GDP in 2002-03 to 0% in 2004)[5], but the mission still has doubts whether the financial adjustment is sustainable so far. The Fund considers the reform of the health sector an important test of the authorities' commitment to fighting corruption and to improving basic social services.

In its ***Ex Post Assessment***, in view of the successful macroeconomic stabilization on the one hand and the weak implementation of structural reforms on the other, the Fund identified two possible areas of further support through an extended arrangement. Firstly, the implementation of ambitious medium-term structural reforms, and secondly, a change in the exchange rate regime if that should be necessary due to increased capital mobility. The authorities agreed that a new programme should give priority to structural reforms and possibly to a change in the exchange rate regime, but they expressed their reluctance to establishing a currency board arrangement.

With regard to the Review and Ex Post Assessment, the ***IMF Staff Appraisal*** emphasized the Fund's concern about the slowdown of economic growth and the wide external current account deficit. Therefore, the IMF recommended once more steady macroeconomic management and structural reforms bold enough to transform the business and investment climate. The biggest challenge for the Macedonian authorities was now to ensure that upcoming fiscal reforms would not reverse the macroeconomic stability. The structural reforms should contribute to political stability and more effective government, but there was a substantial danger of weakening the administrative capacity and of cost increase. Also, the IMF called for a prudent budget implementation as essential to avoid speculative outflows of foreign exchange, and a flexible NBRM interest rate policy that would promptly respond to changing financial market conditions.

[5] Ibid., p. 13.

Almost all recommendations are consistent with the IMF policy towards Macedonia pursued for a longer period of time, based on rigid fiscal and monetary conditionality. The only significant change in this Report could be noted regarding the exchange rate regime. Instead of maintaining the fixed exchange rate regime, the Fund suggests a review and possible change of the exchange rate regime. The currency peg to the euro is assumed to continue to serve Macedonia well, but a change in the exchange rate mechanism could be beneficial for the growth of investment, in particular domestic investment.

A broader perspective of the country's economic development in the period related to the IMF programmes is elaborated in the ***Ex Post Assessment of Longer-Term Program Engagement.*** It gives a brief overview of economic developments in the Republic of Macedonia since its independence in 1991, with special regard to the achievements related to IMF Arrangements. The IMF's general assessment is that notable success has been achieved in macroeconomic stabilization, while structural reforms have recorded limited progress, and overall economic results have been disappointing. Three periods are analysed: the post-transition slump and the restoration of economic stability (1991-1996); a period of hesitant structural reform (1996-2001); and a period of post-conflict stabilization and renewed reform (2001-2004).[6]

The first period was characterized by a massive decline in economic activity and acute financial instability and inflation. By 1996, the authorities were successful in stabilizing the economy, inflation was brought down to single digits, the local currency was stabilized and pegged to the German mark, and growth turned positive. In the period 1996-2000, several reforms were undertaken: the privatization process was underway (although the method of privatization has been criticized), trade liberalization measures were introduced, financial sector reforms were focused on the restoration and confidence building of the banking system, a tax reform was implemented, and various restrictions in the labour market were abolished. The economic results were more or less positive, with growth picking up to an average 3% during 1996-2000, a stable pegged exchange rate regime, and inflation staying at a low level of an average 2%.[7] Of major concern, however, were the widening of the current account deficit (up to 8% of the GDP), mostly as a consequence of the growing trade deficit, as well the high interest rates.

The crisis in 2001 severely affected the Macedonian economy and undid the economic achievements of the previous period. GDP dropped by about 4%, while the general government fiscal deficit rose to over 5%, and the external current account deficit to over 8% of GDP.[8] Despite that, inflation remained low, and the exchange rate was kept stable.

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6 Ibid., p. 60.

7 Ibid., p. 61.

8 Ibid.

Also, Macedonia managed to avoid an unsustainable run-up of debt, keeping both the external and public debt dynamic at a reasonable level. The period after 2001 was devoted to restoring stability, reactivating economic growth, pushing forward with reforms and, especially, implementing the Peace Framework Agreement.

Macedonia's economic policies were set in the context of the Fund-supported programmes through much of the analysed periods. The limited progress and disappointing results in many spheres raised questions about programme design, conditionality and implementation. So far, Macedonia has had seven arrangements with the Fund. The first two – the Systemic Transformation Facility (STF) of 1993 and the Stand-By Arrangement (SBA) of 1995 – are considered successful: the main goal – to achieve macroeconomic stability, especially a stable exchange rate regime and a reduction of inflation – was accomplished. The next Enhanced Structural Adjustment Facility (ESAF) arrangement, signed in 1997, was initially focused on further restructuring of the economy and stimulating growth, as well as on reducing unemployment and poverty, but it failed. The Compensatory and Contingency Facilitating Facility (CCFF) was approved and used in 1999, in order to overcome the implications of the Kosovo crisis. In 2000, the Extended Fund Facility/Poverty Reduction and Growth Facility (EFF/PRGF) arrangement was approved with similar goals, but was also unsuccessfully implemented. In 2002, the country was put under a six-month Staff Monitoring Programme, which was supposed to serve as a preparation for a new arrangement. The latest arrangement – the Stand-By Arrangement approved in April 2003 – aimed at fiscal restructuring of the government budget and the balance of payments, as well as at generating growth and employment; it was completed, but with mixed results. Success was achieved mainly in the fiscal sphere, while the unemployment rate increased.

The reasons for the generally unsatisfactory results of the Programmes have been partially located by the IMF in the authorities' and institutions' weaknesses in implementing the reforms, and partially in the programme design and its appropriateness to the country's needs and capacities. With regard to monetary policy, the exchange rate peg against the euro was central to maintaining macroeconomic stability, and the IMF insisted on it for a longer period of time. The Fund was encouraging the euroization of the financial assets and liabilities, but now the question arises whether the peg may also have contributed to vulnerabilities that will become increasingly important with the liberalization of capital flows. The other sensitive issue is related to inflation: did the programmes' success – or even overachievement – on inflation come at the expense of other objectives? The IMF briefly debates two theoretical counterarguments of the role of inflation in transition economies, without any deeper analysis regarding the Macedonian case.

The Fund locates responsibility for the weak implementation of the structural reforms mainly with the authorities and inefficient institutions, although there is a consideration

about the IMF's role in strengthening the governance capacity, as well the effectiveness of the Fund's technical assistance. With regard to that, the IMF raises the question whether its programme engagement continued to play a constructive role once the economy had successfully been stabilized. Apparently, the Fund's conditionality was not very effective in stimulating and supporting the reform processes, and the discussion about a future programme engagement of the Fund is focused on the needs related to the balance of payments, change in the exchange rate regime, and more effective help in structural reforms.

2 Overview of main economic developments

a) GDP and inflation

Economic growth in Macedonia since the country's independence in 1991 may be analysed in three different periods: 1991 to 1996, 1996 to 2000, and 2001 to present.

The first period (1991-1996) was characterized by a sharp economic decline, a hyperinflationary breakdown of the existing monetary system, a fragile fiscal and financial system, and several strong external shocks. The most harmful external influence was represented by the United Nations' sanctions against Macedonia's northern neighbour, Serbia and Montenegro (at that time the Federal Republic of Yugoslavia, FRY) in the period 1992-1995, as well as by the total trade embargo imposed by Greece (1994-1995). All that resulted in isolation of the country, and deep economic hardship, illustrated by the cumulative decline of GDP of more than 25% in the period 1991-1994.[9] Along with the GDP slump, the Macedonian economy was facing extremely high annual rates of inflation: 1639% in 1992; 362% in 1993; and 128% in 1994.

In these circumstances, macroeconomic stabilization was an absolute priority to the national authorities, and a stabilization programme was launched in 1992. The stabilization strategy was based on a slowdown of monetary expansion, an abrupt tightening of the fiscal policy and limitations on credit expansion to state enterprises. The programme was successfully implemented and resulted in a significant decrease of inflation, down to an average annual rate of 15.9% in 1995. The GDP decline slowed down to -1.2% in 1995. In 1996, growth turned positive: the GDP increased by 1.2%, and the annual inflation rate dropped to 2.3%. In this manner, a reasonable degree of macroeconomic stability was achieved. Therefore, the authorities decided to continue the monetary policy with a stable exchange rate and stable prices as its main objectives. In this context, the coordination between the monetary and the fiscal policies was regarded as particularly important, and the strategy of pegging the local currency (the Macedonian denar, MKD) exchange rate to

[9] Ibid., p. 60.

the German mark (later to the euro) was implemented from October 1995. This was done in order to eliminate possible inflationary pressures and to preserve long-term price stability.

The macroeconomic stabilization achieved in 1996 enabled the country to move further. In 1996-2000, GDP continued to grow, reaching 4.5% annual growth in 2000. Inflation continued to fall; there was even deflation of -0.1% in 1998 and -0.7% in 1999. In 2000, the inflation rate rose to 5.8%, but the increase was mostly due to changes in the methodology of inflation measuring, as well as changes in the tax system. Until 1999, inflation was measured by the retail prices index, whereas starting from the beginning of 2000, it has been measured by the index of the costs of living.

The 4.5% GDP growth in 2000 was the highest growth rate achieved since the country's independence. It was primarily the result of an increase in industrial output (9.5% in 2000), but reforms in the fiscal sphere, such as the introduction of the value added tax (VAT) in April 2000, contributed to the economic expansion. The VAT introduction had strong psychological effects that led to a significant increase in personal consumption and investment, and total domestic consumption in Macedonia increased by 8.3% in 2000.

The positive trends in the Macedonian economy ended in 2001, due to the internal security crisis. The conflict caused a decrease of economic activities, and implicated high budget expenditures for security purposes. The crisis affected all economic sectors, and GDP declined by 4.1% in 2001 (in real terms). The inflation rate did not change much compared to 2000, and was 5.5% in 2001. In view of the non-monetary character of the destabilizing factors and their short-term effect on prices, there was no deterioration in the fundamental generation of inflation. In 2002 the inflation rate dropped to 1.8%, in 2003 to 1.2%. The low average rate of inflation in 2003 can be explained by significantly lower costs of food, especially agricultural products, compared to the previous year. Considering the dominant share of food and beverages (more than 40%)[10] in the total index of the costs of living, as a measure for inflation, their decline largely neutralizes the increase in other categories (oil and electricity prices, telecommunication services etc.).

After the 2001 crisis, a modest recovery of economic activity took place in the last months of 2002 that resulted in GDP growth of 0.9%. Industry is the most important sector in the economy, with the largest share, about one quarter, in GDP. Thus the dynamic of industrial output is an essential determinant of GDP growth. In 2001, as a result of the civil war crisis, economic subjects faced a variety of problems such as hampered supply of raw materials and intermediate goods, cancelled contracts by foreign partners and, therefore, limited

[10] State Statistical Office of the Republic of Macedonia, *Statistical Yearbook 2003*, pp. 282-283.

possibilities to export to international markets, etc. As a consequence, industrial output decreased by 4.6% on an annual basis.

In 2002, the decline of industrial output continued (-0.8%), mainly reflecting the slow recovery from the consequences of the security crisis. In 2003, the negative developments of the post-crisis period were overcome, and the volume of industrial output registered an annual increase of 4.5%. The latter was partly due to the intensification of the production of basic metals, which resulted in a significant increase in export of iron and steel and products thereof. In 2004, however, the favourable trend in industrial production diminished: industrial output plunged by more than 20% in the first half of the year and by more than 10% for the year as a whole.[11] There have been many speculations about the correct percentage and the reasons for that decline, but evidently it indicated serious problems in the industrial sphere.

b) Enterprise sector

The enterprise sector has been crucial in the process of Macedonia's economic transition. The main features of that process are: liberalization of the market, privatization, and enterprise restructuring. Privatization started by transforming socially owned capital into private one. The Macedonian model of privatization favoured the sale of discount stock shares to enterprises' employees, which resulted in a dominant share of 'insiders' in stockholders. The process of privatization of socially owned companies was mainly conducted in the period 1995-2002, when most of the enterprises were privatized. Initially, the sector of public services was excluded from privatization; the privatization of services such as telecommunications and electricity supply was only introduced later, in 2000/2001. The model of privatization of public services was complemented with international tender procedures, direct negotiations and sale of residual shares on the stock exchange. The complete process of privatization should have been finished by the end of 2004.

As a result of the privatization, most enterprises in Macedonia are now private. On 31 July 2004, the total number of registered economic subjects was 16,2409, out of which 89.6% were private.[12] According to the legal form of economic subjects, 67,334 or 41% were registered as enterprises, 38% as trade companies, 12% as individual merchants, and 9% had some other form. Regarding the origin of capital, 96% of the capital in Macedonian enterprises is domestic, and only 1.7% is foreign capital, while 2.3% represent joint ventures. This structure mirrors the low level of foreign investment in the country as recorded in the balance of payments.

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[11] State Statistical Office of the Republic of Macedonia, *Short-term Statistical Data*, No. 1.3.4.08, p. 12.

[12] State Statistical Office, *Short-term Statistical Data*, No. 1.3.4.08/2004, p. 30.

More than half (52%) of total economic subjects registered by the State Statistical Office are involved in trade activities (wholesale and retail sale as well as related services such as repair and maintenance, etc.), 12% in the processing industry, about 9% in traffic, storage and communications, while 7% are performing some communal, cultural, general or personal services. The dominance of companies involved in trade activities and the low share of processing industry companies illustrate the problematic structure of Macedonia's economy, the core of which is trade, not industry. An analysis of the industrial output structure presents an even worse picture: the dominant share (over 40%)[13] is accounted for by just a few branches: the power sector (electricity, etc.), basic metals, basic chemical products, textiles, and food processing, while the share of other industrial branches (metal processing, electronics, electro industry, manufacturing of transport means, chemical-pharmaceutical industry and the like) is quite low. Implicitly, the export-import structure of the Macedonian economy is not very favourable and results in high and persisting trade deficits.

As for company size, most of them are micro, small or medium-size enterprises. The criterion for the definition of company size is the number of employees: up to 10 employees – micro enterprise; 10 to 30 employees – small enterprise; and 30 to 250 employees – medium-size enterprise.[14] In view of the small size of the Macedonian market, as well the limited access to foreign markets due to companies' low competitiveness, the potential for a successful existence of large enterprises is small, and thus more than 95% of all enterprises in Macedonia are small ones.[15] Therefore, the focus of government programmes for restructuring the economy in the past few years has been on the development and promotion of small and medium-size enterprises, with the aim to create new jobs and launch credits lines for the start-up of new businesses, on the development of management skills and on an increase of SMEs' effectiveness and efficiency. However, judging by the current macroeconomic performance and labour market indicators, the reforms have so far not turned out to be very successful.

c) Fiscal developments

Macedonia's fiscal policy is primarily designed to maintain a sustainable fiscal position and macroeconomic stabilization. In the past few years, the IMF has had a crucial role in targeting fiscal aims, and the national authorities' fiscal activities are closely monitored by the Fund. In that regard, fiscal policy is highly restrictive, especially concerning expenditures related to public administration salaries, transfers to social funds, as well public expenditure management. The deficit level of the central government budget

[13] State Statistical Office, *Monthly Statistical Report*, No. 1.2.4.08/2004, p. 46.

[14] Data from the Ministry of Economy of the Republic of Macedonia, Small and Medium-Size Enterprise Department.

[15] Ibid.

operations is kept at a relatively low level – with the exception of the years 2001 and 2002, when due to the crisis it was -5.5% and -3.1% of GDP, respectively. Up to the crisis, the central budget balance was positive, equalling 3.1% of GDP in 2000. That was mainly the result of the domestic consumption expansion, boosted by the introduction of VAT in April 2000, which led to a significant increase in tax revenues. In 2003, the deficit level was stabilized and amounted to -1.6% of GDP, and in 2004 the deficit was even lower, 1.3% of GDP.

Tax revenues are the most important source of central budget incomes, with an average share of 90% of total revenues. There are several sources of tax revenues in the central government budget: taxes on income and profits, value added tax (VAT), excises, import duties, etc. Among them, the most important is VAT, with the largest share in total revenues, 39.8% in 2003. Although VAT is the most important source of budget revenues, the introduction of the VAT system was not conducted smoothly, and tax evasion is still a big problem in certain sectors. Import duties tend to decrease along with the trade liberalization (WTO membership, free trade agreements with most important trading partners). Non-tax revenues have a relatively low share in total revenues, about 7.7% in 2003, and they consist of administrative fees, incomes on the basis of state shares in some enterprises, etc.

As for expenditures, most of them are classified as current expenditures. These account for a share of about 90% in the total expenditures of the central government budget. Out of these, wages and salaries had the largest share (36%) in total expenditures in 2003, or 73% in current expenditures, and annual budget spending on wages and salaries was about 8% of GDP. Transfers, another significant item, amounted to 38% of total expenditures in 2003. Transfers include transfers to the Pension and Disability Fund, Employment Agency, Social Fund, war invalids, structural reforms and other transfers. In the general government budget, transfers equalled 19.2% of the GDP in 2003 (MKD 48,811 million); however, the general budget includes revenues of the Social Funds in its total revenues, and these incomes are then calculated into transfers back to the Funds (on the expenditure side), plus additional transfers from the central budget.

In that regard, transfers from the central budget realistically present a heavy burden on the state concerning social assistance, assistance to unemployed persons in different programmes, etc. The allocation of budget finances for social funds or programmes is higher than the allocation for capital expenditures which, on the one hand, reflects the poor economic situation but, on the other hand, also reflects the fiscal policy focus on acute problems and the lack of a medium-term strategic approach aimed at stimulating economic development. Capital expenditures accounted for an average 12.7% of total expenditures in 2000-2002 and for 9.8% in 2003. About 30% of capital expenditures are spent on purchasing capital assets, and almost the same percentage is transferred to the road fund.

The share of capital expenditures in GDP ranged from 2% to 3.4% in 2000-2003. It should be noted that these capital expenditures come from the central budget of Macedonia, which excludes foreign-financed projects. But, the amount of foreign-financed capital expenditures is not very large either, amounting to 1.2% and 0.6% of GDP in 2001 and 2003, respectively, thus confirming the overall low level of capital expenditures in the country.

The structure of budget expenditures indicates that fiscal policy is focused on reducing the central budget deficit, but it is still inefficient as concerns the realization of the development component of the central budget. The other weakness of the budget is the poor dynamic of fiscal spending. In 2003, about 40% of budget finances were spent in the first eight months of the year. Implicitly, public spending escalated in the last four months of the year, threatening the stability of the exchange rate. The same happened again in 2004. The reasons may be located in the mismanagement of budget planning and budget execution in public administration.

At present, the main priorities of the Macedonian government are: implementation of the Ohrid Framework Agreement, structural reforms, fiscal decentralization, and decompression of public administration employees' salaries (a policy of 'frozen' salaries had been pursued in Macedonia for a few years). The planned level of revenues and expenditures for the period 2005-2007 allows for a central budget deficit not higher than 1% of the projected GDP, in continuation of the policy of restrictive budget expenditures. According to the authorities the planned level of the budget deficit would make possible the smooth execution of the functions of government administration bodies and would provide a positive framework for monetary policy and economic development.

The central budget deficit is financed mostly from foreign credits, as well as from domestic sources. The latest IMF stand-by arrangement was approved for strengthening the fiscal position and maintaining fiscal stability. Also, revenues from the privatization of state capital and the disbursement of government deposits at the NBRM serve as sources of deficit financing; an additional source is represented by government Treasury bills, which were introduced in January 2004 in order to finance public expenditures in a timely and non-inflationary way.

d) Monetary developments

The monetary policy of the Republic of Macedonia is focused on preserving the exchange rate stability. The local currency, the Macedonian denar (MKD), is pegged to the euro (before 2002 it was pegged to the German mark) and the exchange rate is relatively stable

(annual average 1 EUR = 61 MKD),[16] with minor oscillations, within a 1% band. Therefore, the interest rate policy of the National Bank of the Republic of Macedonia (NBRM) is relatively passive. The money supply aggregates in Macedonia are of an endogenous character, serving as an absorber of the monetary and financial effects that could provoke exchange rate instability. Interest rates are kept at a relatively high level, and CB bills auctions are the major instrument of the monetary authorities. In the set of NBRM monetary instruments, the compulsory reserve and Lombard credits are also important. Both instruments have been created in order to provide greater efficiency and flexibility of banks in liquidity management.

Monetary developments in Macedonia have been strongly influenced by external and internal shocks. The internal security crisis in 2001 implicated a considerable fiscal expansion, which in combination with the psychological effects of the crisis, created pressures on the foreign exchange market and threatened to disturb the exchange rate stability. In order to preserve a stable exchange rate, the NBRM directly intervened on the foreign exchange market, and also intervened on the demand side, by organizing CB bills auctions. The level of interest rates and the auction layout were changing during the year, in response to overall economic developments and particularly the movements on the foreign exchange market. Therefore, in line with the stabilization of economic flows, the interest rate on CB bills was gradually falling from 20% in June to 12.2% in December 2001.[17]

CB bills auctions also remained a basic monetary regulation instrument in the period 2002 to 2004. The average weighted interest rates on CB bills ranged from 15.2% (December 2002) to 6.2% (December 2003).[18] The 'interest rate tender' and the 'volume tender' auctions were organized according to the NBRM assessments to offset excess or shortage of liquidity and to influence the interest rates. The efficient mop-up of liquidity through the CB bills auctions acts towards a reduction of the demand for foreign exchange. It alleviates the need of direct NBRM interventions on the foreign exchange market and allows for the foreign exchange reserves to be maintained at a stable level that does not endanger the liquidity in payments towards abroad.

The crisis in 2001 also affected the dynamic of the monetary supply. The first two quarters of the year saw massive deposit withdrawals from the banks. But the situation changed by the end of the year. The introduction of the euro, starting from 2002, and the need for conversion resulted in a considerable increase in banks' deposit potential in the last quarter of 2001. Thus, along with an increase of currency in circulation because of the reform of

[16] National Bank of the Republic of Macedonia (www.nbrm.gov.mk).

[17] National Bank of the Republic of Macedonia, *Annual Report 2001*, p. 70.

[18] National Bank of the Republic of Macedonia, *Bulletin*, No. IV, 2003, p. 75.

the payment operations system in 2001, monetary aggregates reached exceptionally high annual growth rates. The money supply M1 registered an annual increase of 13.1% in 2001, while the monetary aggregates M2 and M4 were higher by 66.3% and 64%, respectively. Along with that, the share of the monetary aggregates in GDP rose to 29.8% (M2) and 33% (M4).

Although most of the deposits placed in banks at the end of 2001 were for the purpose of conversion of the currencies substituted by the euro, only one third was withdrawn, and total deposits in the first three months of 2002 decreased by 22.5%.[19] That indicates the strengthened credibility of the banking system, and the country's gradual stabilization after the crisis. Also, additional deposits were registered in 2002, and the monetary aggregates remained relatively high. A further increase of monetary aggregates was noted in 2003, as a result of accelerating economic activity, increased credibility of the banking system, and because of the delay in servicing the bonds issued to cover the frozen foreign currency savings. The annual growth rates of the monetary aggregates M2 and M4 equalled 18.4% and 15.9%, respectively.

With the rise of deposits from 2001 onwards, the deposit potential of the Macedonian banks has significantly increased, although it is still far from satisfactory. In 2000 the share of total deposits in GDP had been 10.7%, in 2001 it rose to 22.2%. In 2002 and 2003 it was stabilized at 18.1% and 19.1%, respectively, of GDP.[20] However, despite the increase in the banks' deposit base, the deposit structure is not favourable. In the period 2001-2004, the share of short-term deposits in total deposits was about 90%, which is no adequate basis for financing long-term investments that are needed for economic development. As for the currency structure, the share of foreign exchange deposits is high (73% in 2003), although with a decreasing trend as compared to 2001 and 2002. That indicates the insufficient credibility of the domestic currency, despite the stable exchange rate.

As a reflection of the increased level of total deposits, bank placements have considerably increased from 2002 onwards. Most bank placements take the form of long-term credits. The share of credits in total bank placements rose from 67.5% in 2000 to 74.9% in March 2004. More than half of those (51.8% in 2003 and 53.1% in March 2004) were long-term credits, which is incompatible with the maturity structure of the deposits. Further, most of the credits were claims on enterprises (88% in 2002 and 78% in 2003).[21] (The expansion of household credits in the past three to four years explains the decline of the share of enterprises credits.) More than 80% of credit claims are in denar (82.6% in 2002 and 83.1% in 2003), which does not match the deposit currency structure.[22]

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[19] National Bank of the Republic of Macedonia, *Annual Report 2002*, p. 58.

[20] Calculations on the basis of data from the National Bank of the Republic of Macedonia, www.nbrm.gov.mk.

[21] National Bank of the Republic of Macedonia, *Monthly Information*, No. 12, 2003, p. 44.

[22] Ibid., p. 45.

The increased volume of banking credit activities also reflects the changes in the NBRM's interest rate policy. There are four basic interest rates of the NBRM: discount rate, interest rate on Lombard credits, interest rate on CB bills and interest rate on allocated compulsory reserve.

Table A1

Macedonia: money placements (MKD million, end of period)

	Dec. 2000	% of total	Dec. 2001	% of total	Dec. 2002	% of total	Dec. 2003	% of total	March 2004	% of total
Credits	**25602**	**67,5**	**25806**	**68,3**	**28634**	**71,4**	**34010**	**74,3**	**36050**	**74,9**
short-term	13592	35,8	15967	42,3	15741	39,1	16377	35,8	16980	35,2
long-term	12010	31,7	9838	26,0	12983	32,3	17633	38,5	19070	39,7
Securities	**1207**	**3,2**	**753**	**1,9**	**782**	**1,9**	**688**	**1,5**	**700**	**1,5**
short-term	124	0,3	58	0,1	64	0,2	92	0,2	93	0,2
long-term	1083	2,9	695	1,8	718	1,7	596	1,3	607	1,2
Other placements	**778**	**2,0**	**532**	**1,4**	**331**	**0,8**	**93**	**0,2**	**105**	**0,2**
short-term	778	2,0	532	1,4	331	0,8	93	0,2	105	0,2
long-term	0		0	0	0	0	0	0	0	0
Overdue claims	**10360**	**27,3**	**10698**	**28,4**	**10382**	**25,9**	**11001**	**24**	**11290**	**23,4**
Total	**37947**	**100,0**	**37790**	**100,0**	**40129**	**100,0**	**45792**	**100,2**	**48145**	**100**

Source: National Bank of the Republic of Macedonia.

The discount rate is treated as a basic rate. The changes in the discount interest rate have primarily a signalling effect, while the interest rate on Lombard credits is considerably higher than the discount rate and is an indicator for the maximum level of interest rates in the economy. Due to the security crisis, the discount rate was raised to 10% in 2001, and the Lombard credits rate picked up to 23%. In 2003, these rates were significantly decreased, to 6.5% (discount rate) and 14% (interest rate on Lombard credits), respectively. The decrease was mainly the consequence of the normalization of the level of public expenditures in 2003, as well the intensification of foreign exchange market activities, and the mitigated pressure on the exchange rate. On the other hand, the interest rates on CB bills largely influence the movement of the interest rate on the money market.

The NBRM interest rates should serve as a transmission medium of monetary impulses to the banking and real sectors, but the banks' responsiveness to the NBRM signals was relatively poor until 2003. Among the major factors that contributed to the banks' rigid interest rate policy were the high proportion of so-called bad loans; inefficiency of court procedures; concentration and insufficient competitiveness in the banking sector; external shocks; and the low level of banks' deposit potential. In the first half of 2004 the banks' weighted interest rates were between 6.5% on average for the borrowing interest rate and

14% on average for the lending interest rate.[23] These margins indicate the positive effects of the restructuring of the banking sector, an expansion of the banks' deposit base, as well as the higher degree of competitiveness in the banking system.

The NBRM recent CB bills interest rate policy has not contributed to further growth of credit activities. In August 2004 the NBRM raised the CB bills interest rate by 0.5%, and in September 2004 by an additional 0.5%, so the CB bills interests rate (with maturity of 28 days) is currently 9%.[24] That increase was to ensure exchange rate stability in view of the expected intensive fiscal spending in the last four months of the year, but it threatened to suppress the banks' credit expansion, as well investment activities.

e) Labour market

The high rate of unemployment in Macedonia has been one of the most acute problems for a longer period of time. Under the influence of many problems in the process of transition, as well as other limiting factors (the economic crisis, the refugee crisis, the internal security crisis, etc.), the unemployment rate has been constantly over 30% in the past decade. It was 34.5% in 1998 and decreased to 30.5% in 2001 (owing to labour force hiring for security purposes), but reached an historical high in 2003: 36.7%. These rates are taken from the Labour Force Survey (LFS), which – apart from the formal sector – also comprises economically active population in the informal sector and agriculture. However, there are two main weaknesses of the LFS methodology used in Macedonia: (1) working-age population includes those 15 to 80 years old, which is a very high upper limit, and (2) the LFS considers as employed: persons who worked and earned money for at least 1 hour per week, persons who help in family businesses free of charge, as well as persons active in agriculture.[25] That is definitely a very broad pool of economically active population, still LFS data are considered to be more realistic as compared to the evidence of the Employment Agency of the Republic of Macedonia (with a working-age population frame of 15-64), due to the weak system of unemployment registration in the Employment Agency. The main problem of that system is its attachment with the health insurance system for unemployed persons. Therefore, apart from people who are unemployed and actively seeking a job, there are also those who have a job but are not officially registered as employed, or people who are not actively seeking a job, who register as unemployed to get the health insurance beneficiary status.

The total number of registered unemployed persons also includes persons obtaining unemployment benefits whose employment was terminated due to bankruptcy, or

[23] National Bank of the Republic of Macedonia, *Monthly Information*, No. 7, 2004, www.nrbm.gov.mk.

[24] National Bank of the Republic of Macedonia, www.nbrm.gov.mk.

[25] State Statistical Office, *Monthly Statistical Report*, No. 1.2.4.08/2004, pp. 4-5.

economic, technological, structural and similar changes. In March 2004, there were 53,273 unemployment beneficiaries or 13.5% out of the total registered unemployed persons. Most of the registered unemployed persons (62.9% of the total) are health insurance beneficiaries through the Employment Agency.[26]

The unemployment figures according to the LFS on the one hand and the Employment Agency on the other differ considerably. The unemployment rate according to Employment Agency data reached as much as 59% in 2003. Such an enormously high rate would have definitely provoked serious social tensions in the country, most probably accompanied by massive starving and by violence, and cannot be regarded as realistic. However, the LFS unemployment rate is also very high, 36.7% in 2003, and a similar unemployment rate of about 38% was calculated from the 2002 census data. The latter two rates are similar, and even if we presume that there is a considerable number of labour force working on the black market (which is very difficult to measure), the rate of unemployment could probably drop to a more realistic 30%, but not less, according to the projections of local labour market experts. An unemployment rate of 30% is definitely a painful problem for the country, especially if the situation lasts for a decade and more.

The educational structure of unemployment deserves special attention. The share of the non-qualified and semi-qualified, as well as of persons with lower education than secondary school, is persistently more than half of the total number of unemployed (57.7% in April 2003, LFS data). The share of those who have completed four years of secondary school is 34.3%, while the shares of persons with a university degree and of those with a college degree are quite low (5.6% and 2.4% respectively). Out of the total number of registered unemployed persons, 60.1% are men and 39.9% are women. As for the age structure of registered unemployed, those up to 30 years of age account for 33.6%; the age group 30-40 has a share of 26.7%, that of 40-50 a share of 21.3%; and 18.3% are over 50 years of age.[27]

The duration of unemployment exhibits another particularly unfavourable feature of the Macedonian labour market. The share of persons registered as unemployed for more than eight years is 26.6% (March 2004), while an additional 17.8% have been registered as unemployed for five to seven years.[28] Long-term unemployment represents a huge danger and loss for the country, causing flux and brain-drain of human capital, as well as a significant deterioration of one of the crucial components for economic development.

[26] Employment Agency of the Republic of Macedonia, www.zvrm.gov.mk.

[27] Ibid.

[28] Ibid.

On the employment side, the educational structure is also unfavourable, although better than the educational structure of the unemployed. The share of employed with college and university degrees is much higher as compared to the unemployed: it was 20.3% in the total employed in 2003. However, the share of non-qualified and semi-qualified persons in the total number of employed is again very high, about 42.5% in 2003 (LFS data). Approximately 35% of the employed work in the industrial sector, about 21% in education and health services, while the shares of other sectors are smaller: construction 8%, traffic and telecommunications 7%, public defence about 5%, agriculture 4%, etc.[29] The ratio between the employed in industry and those employed in other sectors is not favourable, as education, health and defence services are paid from the general government budget, while industry is mainly labour-intensive and has so far failed to stimulate a fast economic recovery.

The average labour cost per hour was about 2.60 USD in 2003. Labour costs ranged from 2.20 USD in manufacturing to 5.40 USD average labour cost per hour in financial services.[30] The labour cost is calculated as expenditures to gross wages, while wages are paid in net amount. Based on the existing legislation, the employer is obliged to pay pension and disability insurance, health insurance, personal tax, etc. on every employee. The total amount of contributions is about 80% of the net salary, i.e. the labour cost per hour would be about 60% of the calculated cost on gross level. Minimum wages are only set for the public sector, and the wage policy pursued in Macedonia is mainly applied to this sector. For a few years the so-called policy of frozen salaries was followed in the public sector, in the framework of the overall efforts to maintain macroeconomic stability, and according to IMF and World Bank recommendations. Starting from April 2004, the salaries have been 'decompressed', and that process will last until April 2006, in order for civil servants' salaries to be more attractive and to better conform to living expenses.

The real growth rates of salaries of 5% and 3.6% in 2002 and 2003, respectively, are mainly the result of the salary rises in the services sector, but this increase does not alleviate the economic hardship, considering that 23.7% of the total number of employed had not received a salary for June 2004.[31] Although the level of the inflation rate and prices have been kept relatively stable in the past few years, the changes in the income structure, the rise of unemployment and irregular salary payments to a significant number of workers have visibly deteriorated the living standard of the population. Total costs of living increased by 12.8% in the period 1998-2002, while real net salaries rose by about 7% in the same period, pointing to the widening gap between salaries and expenditures.[32]

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[29] State Statistical Office, *Monthly Statistical Report*, No. 1.2.4.08/04, p. 66.

[30] Own calculations based on data from the State Statistical Office of the Republic of Macedonia, www. stat.gov.mk.

[31] National Employment Agency of the Republic of Macedonia, www.zvrm.gov.mk.

[32] State Statistical Office of the Republic of Macedonia, *Statistical Yearbook 2003*, p. 295.

In spite of this alarming situation, persisting for several years already, there has been no sound employment-oriented strategy in Macedonia, founded on a coordinated and integrated approach of macroeconomic policies. Only partial and short-term employment-related measures have been taken in some policy areas, mainly of a passive labour market policy nature. In 2004 a National Employment Action Plan was prepared for the first time, with its main focus on active and preventive measures for the unemployed and economically inactive persons, on the promotion of human capital and long-lasting learning, and – most importantly for the time being – on the creation of new jobs. The main aim of the Plan is an annual employment increase of 3%. The activities under the action plan include: improvement of regulations, reconstruction of the Employment Bureau in order to provide better services, stimulation of flexible employment forms, entrepreneurship and investment promotion by reducing costs and administrative barriers to opening up and running a business, measures for incorporating informal-sector employees in the official labour market, etc. [33] This process is still at an early stage, and it will take some time for it to take effect and yield noticeable results.

f) Balance of payments

The restructuring process of the Macedonian economy in the past decade, as well as the external and internal shocks that the country experienced, were visibly reflected in the balance of payments. There was a persisting deficit on the current account of the balance of payments, with the lowest level registered in 1999 and 2000 (0.9% and 2.0% of GDP, respectively) and the highest in 1996 and 2002 (7.7% and 9.6% of GDP, respectively).

The current account deficit is mainly the result of the high and persisting trade deficit. Overall imports considerably exceed overall exports, due to the trade openness of the country and the low competitiveness of domestic producers. The negative balance of services and incomes, although much lower in volume, also influences the increase in the current account deficit. On the other hand, the current account deficit is alleviated by current transfers, especially private ones. Private transfers had a share of 13.4% of GDP in 2000, while the trade deficit was -19.2% of the GDP. In 2001, due to the security conflict, private transfers registered a decline (of 39%) for the first time in the period since Macedonia's independence. That caused an increase in the current account deficit to -7.1% of GDP, although the trade deficit was lower as compared to 2000 (-15.3% of GDP).

The current account deficit deepened in 2002, reaching USD 362 million, or 9.6% of GDP. This was primarily the result of the increased deficit in the exchange of goods and services (annual increase of 50%), while current transfers registered an increased surplus, due to

[33] National Employment Agency of the Republic of Macedonia, www.zvrm.gov.mk.

higher official transfers (inflows based on donations approved at the Donor Conference for the Republic of Macedonia in Brussels), and higher inflows of private transfers.

Table A2

Macedonia: balance of payments

	1999	2000	2001	2002	2003	1999	2000	2001	2002	2003
	In USD millions					% of GDP				
I. Current account	-32,35	-72,38	-243,61	-361,92	-276,17	-0,9	-2,0	-7,1	-9,6	-6,0
Goods, net	-495,80	-690,41	-526,38	-804,34	-851,47	-13,3	-19,2	-15,3	-21,3	-18,4
Exports, f.o.b.	1189,98	1320,73	1155,43	1112,15	1359,04	31,9	36,8	33,6	29,5	29,3
Import, f.o.b.	-1685,79	-2011,14	-1681,81	-1916,49	-2210,52	-45,2	-56,0	-48,9	-50,8	-47,7
Services, net	41,96	48,70	-19,16	-24,65	-2,56	1,1	1,4	-0,6	-0,7	-0,1
Income, net	-42,27	-45,62	-40,71	-31,38	-32,00	-1,1	-1,3	-1,2	-0,8	-0,7
o/w: interest, net	-41,33	-39,15	-33,50	-20,54	-31,56	-1,1	-1,1	-1,0	-0,5	-0,7
Current transfers, net	463,75	614,96	342,65	498,44	607,86	12,4	17,1	10,0	13,2	13,1
Official	72,69	132,47	49,01	100,50	103,36	1,9	3,7	1,4	2,7	2,2
Private	391,06	482,49	293,64	397,95	504,51	10,5	13,4	8,6	10,5	10,9
II. Capital and Financial Account	-127,32	10,48	241,21	386,31	212,63	-3,4	0,3	7,0	10,2	4,6
Capital Account, net	0,00	0,31	1,30	8,26	-6,69	0	0	0	0,2	-0,1
Financial Account, net	-127,32	10,17	239,91	378,05	219,32	-3,4	0,3	7,0	10,0	4,7
Direct Investment, net	32,40	175,13	440,66	77,72	94,26	0,9	4,9	12,8	2,1	2,0
Portfolio Investment, net	0,00	-0,09	0,36	0,35	3,39	0	0	0	0	0
Other Investment, net	-16,38	99,61	-124,11	169,42	170,81	-0,4	2,8	-3,6	4,5	3,7
Trade credits, net	8,22	147,39	-60,23	114,05	85,29	0,2	4,1	-1,7	3,0	1,8
Loans, net	77,80	13,51	-107,18	-26,28	22,46	2,1	0,4	-3,1	-0,7	0,5
Currency and deposits, net	-120,47	-108,82	21,27	53,18	41,72	-3,2	-3,0	0,6	1,4	0,9
Other, net	18,08	47,53	22,02	28,48	21,34	0,5	1,3	0,6	0,8	0,5
Gross official reserve assets (- = increase)	-143,35	-264,48	-77,00	130,57	-49,15	3,84	7,4	2,2	-3,5	-1,1
III. Errors and omissions	159,68	61,89	2,39	-24,39	65,54	4,26	1,7	0,1	-0,6	1,4

Source: National Bank of the Republic of Macedonia.

The gradual consolidation of the economy in 2003 resulted in lowering the current account deficit (USD 278.2 million, or 6% of the GDP). The high trade deficit, however, has remained a serious problem. In 2002, the trade deficit in absolute terms (USD 851 million) was the highest since independence, with a tendency to grow even further in 2004. Macedonia's official gross reserves doubled in the period 1999-2003 (in absolute terms), from USD 450 million in 1999 to USD 903 million in 2003, sufficient to cover 2.4 months of imports in 1999 and 4 months in 2003.[34] That represents noticeable progress, but the

[34] National Bank of the Republic of Macedonia, www.nbrm.gov.mk.

current trend of widening trade deficits is an alarming sign for the further restructuring of the economy, considering the high import dependence of Macedonia's economy for raw materials and intermediate goods, and the (realistic) expectations of a further import increase due to trade liberalization.

The current account deficit is financed from several sources: inflows of foreign direct investment, credits from bilateral or multilateral creditors, and also unrecorded inflows presented as positive errors and omissions. Significant inflows of foreign direct investment were noted in 2000 and 2001 (USD 178.5 million or 5% of the GDP and USD 445.1 million or 13% of the GDP, respectively) due to the process of privatization of state-owned capital in the banking sector, in insurance, the non-metal industry, wire production, trade, telecommunications, the oil industry, etc. In general, however, the level of foreign direct investment in Macedonia is low, reflecting the high investment risk in the country and in the region as a whole. Thus, new indebtedness in the form of foreign loans and credits is a considerable source of financing the current account deficit.

g) Foreign debt

Macedonia's overall foreign debt as of 31 December 2003 amounted to USD 1812.57 million, on the basis of used short-term and long-term credits. Short-term debt accounted for only 2.3% of the total external debt, while long-term debt had a share of 97.7% of the total.

Long-term foreign debt is debt of residents towards non-residents, with an original maturity of over one year. Public debt amounted to USD 1487.38 million or 84% of the overall foreign debt. The share of private debt in overall debt was 16%, i.e. USD 283.27 million. Private debt consists of the debt of commercial banks in Macedonia and the debt of the non-banking private sector in Macedonia towards abroad.

In accordance with the OECD methodology for indebtedness measurement and IMF estimations, Macedonia belongs to the group of less indebted countries with a medium height of income. Among the favourable indicators that have categorized the country as less indebted are the following: the overall foreign debt in relation to the average export of goods and services is about 122%; the overall debt service in relation to the average export of goods and services is about 16%; and the total repayment of interest in relation to the average export of goods and services is about 3.56%.[35] On the other hand, the ratio of overall foreign debt to GDP is relatively high – about 39% in 2003; in view of the critical level (ceiling) of 50% as estimated by the OECD, that indicates the need for careful debt management.

[35] Ibid.

Table A3

Macedonia: degree of foreign indebtedness (end of period)

	1999	2000	2001	2002	2003
Degree of indebtedness as % of GDP	39.9	41.5	43.8	42.8	39.1
Overall foreign debt in USD million (short- and long-term)	1490	1488	1506	1613	1817

Source: National Bank of the Republic of Macedonia.

From the perspective of the debtors, public foreign debt includes the indebtedness of the Government of the Republic of Macedonia, the National Bank and of public enterprises, while private debt encompasses the liabilities of the private banks and of the non-banking sector. The government's share in public debt is the highest, reaching up to 83.5% in 2003, while the commercial banks' indebtedness is very modest. In terms of currency distribution, the US dollar had a share of 35.8% in 2003, the euro 33.1%, and SDRs had a share of 29.7% in long-term public debt. As for long-term private debt, the euro dominated with a share of 67%, while the US dollar participated with 32%.[36] The share of other currencies in both public and private debt is small.

Multilateral creditors had a share of 52.3% in total public long-term debt in 2003, bilateral creditors accounted for 15.4%, while private creditors for 32%, of which more than half were liabilities towards the London Club of creditors. The share of banks, financial institutions and enterprises was about 18.5% in 2003. Among the multilateral creditors, Macedonia's indebtedness is highest towards the IDA and IBRD, with shares of 20% and 10% respectively in total public long-term debt in 2003. [37]

As for private debt, the largest share of long-term private debt, 83.5%, fell on private creditors in 2003, while official creditors had a share of 16.5%. Greece has the biggest share among private creditors: 16.1%, followed by Germany with 12.2%, Switzerland with 9.5% and Slovenia with 8.2%.[38] Financial credits account for most of the private debt, about 69% in 2003, commercial credits for 23.6%, while other credit types take just a small share. Financial credits are used for investment purposes, import of equipment, raw materials and intermediate products, repayment of previously used credits, etc.

Debt is serviced on a regular and timely basis, i.e. Macedonia services its matured liabilities towards foreign creditors on time, while outstanding liabilities were kept at a tolerable level. Liabilities in a total amount of USD 1389 million were paid in the period 1995-2003, of which 68.3% in principal debt and 31.7% in interest. Over the years, the share of interest in total debt repayment shows a downward trend, decreasing from 57% in

[36] Ibid.

[37] National Bank of the Republic of Macedonia, *Bulletin*, No. IV, 2003, p. 101.

[38] National Bank of the Republic of Macedonia, www.nbrm.gov.mk.

1997 to 21% in both 2002 and 2003. The funds for servicing foreign debt are provided from budget revenues based on privatization receipts, from concessions and also from foreign donations and credits intended for macro-financial aid.

3 Current developments

In 2004 GDP and industrial production performed disappointingly. Although the reported growth rates were not as bad as were reported for the better part of the year, they were certainly not impressive (2.2% decline of industrial production and 2.9% growth of GDP).[39] In the first quarter of 2005, industrial production expanded by almost 5%, but given its decline in the first quarter of 2004, it is hard to tell whether that is an indication of more sustained growth. Both exports and imports expanded and the current account deficit widened significantly in 2004, to close to 8% of GDP. Monetary policy was under pressure to keep the foreign currency reserves at an appropriate level. Fiscal policy was also restrictive for the better part of the year. Thus, it was a difficult year in which, again, stability had to be preserved at the expense of growth.

Inflation has remained subdued, which is a consequence of the stagnant economic activity and of the significant increase in imports of goods and services. Other indicators of competitiveness are also favourable, i.e., labour and other costs are not rising.

As in the other countries in East and Southeast Europe, the private sector increasingly borrows both at home and abroad. The supply of funds is probably driving this credit expansion, but that has yet to result in a lowering of the interest rate. This is certainly the main policy issue. Foreign direct investments are growing as well, though the numbers are still not too impressive. Inflows should increase in the future, particularly in view of the expected positive avis from the European Commission, so the issue of proper monetary and financial policy in general will become quite important.

Employment in industry has continued to decline and the unemployment rate has remained at a very high level, about 37%. This is socially and politically difficult to sustain. There is, as argued in this report, clearly a need to target growth rather than stability in the future.

[39] In the first part of the report we use the figures for industrial production and GDP compiled according to the old methodology that indicates a much steeper decline.

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