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Macedonia: slowly improving

GDP growth in 2007 may have accelerated to around 5%. Inflation has edged up and further acceleration has been recorded at the beginning of 2008. Macroeconomic stability, however, is not threatened as the fiscal deficit is small and the current account almost balanced. The short-term prospects, therefore, are good and the medium-term prospects should even improve.

These developments are due to a large extent to the change in economic policy that has been implemented rather gradually in the past couple of years. The growing sense of political stability has allowed the government to feel more relaxed when designing fiscal policy. Thus, taxes have been lowered, while expenditures have been increased. Given that public debt is relatively low by regional standards, a small fiscal deficit has become almost the norm thus replacing the previous dogged commitment to fiscal balance.

On the other hand, the central bank has been feeling more secure in relaxing monetary policy because of the remarkable improvement in the current account. It is still not clear whether this is the consequence of improved statistics, which is quite probable, or reflects growing exports, in particular of iron and other metals, and soaring remittances. In any case, the main worry that pushed the central bank to pursue a tight monetary policy in the past, which was the worry about the sustainability of the fixed exchange rate, has gone. With that, the improvement in the banking sector, due to increased competition, has led to a continuous decrease of interest rates. Macedonia did not experience the credit boom that has been pervasive in the region. This can be expected in the future.

Apart from the improved external balance, investments have also been growing. An important source of growth has been the rise in wages. The government realized that Macedonian wages have been depressed for too long and decided to raise public sector wages by 10% in the second half of 2007. This will have positive effects on growth, though it is obviously spilling over into rising prices too. Given that stable prices or even deflation have been the rule in the past few years, the acceleration of inflation may start to worry the central bank, though the correction is probably needed.

The government's key target is to attract foreign investments. Those have not been targeting Macedonia in the past. That was partly the consequence of the high risks for internal and external reasons. Also, structural reforms have not been pursued with the necessary determination and the implementation has often been worse than the declaration. It is still not altogether clear how committed is the government to structural reforms. It has been trying to improve the business climate and to offer advantages to foreign and investors in general. The results should be expected in the short and medium run.

The key to the removal of the residual political and policy risks is the speed-up of European Union integration. Macedonia is a candidate country, but the EU has been reluctant to set a date for the commencement of negotiations due to slow institutional improvement in Macedonia. It is expected that negotiations could finally start in the course of this year, perhaps as part of a more general speed-up of the process of EU integration in the wake of Kosovo independence. The latter event, if it goes smoothly, should also be beneficial to growth because economic improvement in Kosovo will be beneficial to Macedonia, Kosovo being an important economic partner.

Medium-term prospects are favourable due to macroeconomic stability and few sources of vulnerability. The one serious problem is in the labour market, as employment remains low