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## **Macedonia: from stability to growth**

Growth returned to Macedonia in the second half of 2004. Industrial production recovered somewhat in the last months of the year, though not enough to overcome the deep recession experienced during much of 2004. GDP was reported to have grown by more than 2%, though that implies quite high growth in the last quarter of 2004 as growth was negative in the first three quarters. These uncertainties about the developments in the real sector cannot be resolved satisfactorily at this time.

Foreign trade increased in 2004, and the trade and current account deficits widened. That also suggests that the economy did expand somewhat last year. Also, foreign direct investments came in at about EUR 100 million, which is not too low by historical standards. It is certainly lower than the country would need and the expectations are that there will be much more FDI this year and the next.

Last year's foreign trade figures show an increase in imports from Serbia. The recent change in the Serbian exchange rate policy, from a fixed peg to an unannounced crawling peg, may prove to be a problem for Macedonia, which is on a very hard peg with the euro. The free trade agreement between the two countries translated every depreciation in Serbia into a competitive disadvantage in Macedonia. As wages are already significantly higher in Macedonia than in Serbia, the pressure on the trade account may prove to be significant.

Employment in industry continued to decline, which is not surprising given the sharp drop in industrial production in 2004. Indeed, productivity in industry was negative because the loss of employment was much smaller than the decline of production. Unemployment, however, remained at approximately the same level, at around 37%. Even if industrial production continues to grow, which can be expected, it will take quite some time for this level of unemployment to start to go down decisively. In the meantime, public employment cannot grow; in fact it can be expected to decrease because of the planned reforms and restructurings in the public sector.

Probably the main disturbing element is the fiscal policy. A major fiscal adjustment has been underway in the past few years and the fiscal deficit was brought down to below 2% of GDP at the end of 2004 (from around 6% in 2002). Most of this fiscal adjustment took place in 2003 and that partly explains the recession in the first half of 2004. Fiscal austerity was deemed necessary in order to support the stability of the exchange rate and to maintain the very low inflation rate. In the first half of 2004 there was deflation again; inflation for the whole year was below 1%.

This fiscal adjustment was supported by a restrictive monetary policy. The spread between the lending and the borrowing rates are traditionally quite high. The central bank did not hesitate to increase the interest rates additionally at the end of 2004 fearing that the foreign exchange market could be destabilized. Central bank reserves declined and, though they are at a level sufficient to sustain possible shocks in the foreign exchange market, the central bank is fearful of an exchange rate crisis. Thus, the economy was treated to fiscal austerity and monetary tightening exactly when it was in recession.

The fiscal austerity over the years has led to Macedonia having a smaller state than most other transition economies. Its public expenditures are now well below 40% of GDP, which is low for a transition country of that size. The savings have been mostly on investments, but public services have suffered too. The social and political implications have been considerable, including a close encounter with a violent conflict that just stopped short of growing into a fully fledged civil war.

In 2004 Macedonia applied for membership in the EU. The EU has started the process of assessment of the application and will probably come up with an opinion by the end of this year. It is expected that the opinion will be positive, though conditions will be attached that will have to be fulfilled in order for negotiations to start. That may happen already in 2006 or at the beginning of 2007 at the latest.

A positive attitude of the EU towards Macedonia is crucial for the country to sustain its political and economic stability. A number of outstanding issues in the region, especially that of the political status of Kosovo, will have to be resolved in the next couple of years, and that may influence developments in Macedonia as well. Even if there were no other ones, It would be for that reason alone that a positive and engaged approach on the part of the EU would be crucial.

Table MK

## Macedonia: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004 <sup>1)</sup>	2005	2006
	forecast								
Population, th pers., mid-year	2007.5	2017.1	2026.4	2034.9	2020.2	2027.0	.	.	.
Gross domestic product, MKD mn, nom.	194979	209010	236389	233841	243970	253454	260800	276700	288000
annual change in % (real)	3.4	4.3	4.5	-4.5	0.9	3.4	2	4	4
GDP/capita (EUR at exchange rate)	1590	1709	1921	1887	1981	2041	2095	.	.
GDP/capita (EUR at PPP – wiiw)	4550	4830	5170	5000	5210	5400	5620	.	.
Gross industrial production									
annual change in % (real) <sup>2)</sup>	4.5	-2.6	3.0	-3.1	-5.3	4.7	-12.7	3	5
Gross agricultural production									
annual change in % (real)	4.3	1.0	1.0	-10.2	-2.3	1.8	.	.	.
Construction output, value added									
annual change in % (real)	7.7	10.4	-1.1	-14.4	0.6	4.1	.	.	.
Consumption of households, MKD mn, nom.	141078	145693	175965	163788	188179	.	.	.	.
annual change in % (real)	3.3	3.6	11.2	-11.7	12.5	.	.	.	.
Gross fixed capital form., MKD mn, nom.	33982	34710	38332	34716	40448	42110	.	.	.
annual change in % (real)	-2.6	-1.4	-1.5	-8.6	17.6	.	.	.	.
LFS – employed persons, th. avg.	539.8	545.2	549.8	599.3	561.3	545.1	.	.	.
annual change in %	5.4	1.0	0.8	9.0	-6.3	-2.9	.	.	.
Reg. employees in industry, th pers., avg. <sup>3)</sup>	113.6	119.8	114.4	122.5	110.9	106.7	101.8 <sup>1-x</sup>	.	.
annual change in % <sup>3)</sup>	-3.4	5.5	-4.5	-4.8	-9.5	-3.8	-5.6 <sup>1-x</sup>	.	.
LFS – unemployed, th pers., average	284.1	261.5	261.7	263.2	263.5	315.9	.	.	.
LFS – unemployment rate in %, average	34.5	32.4	32.2	30.5	31.9	36.7	37	35	35
Reg. unemployment rate in %, end of period	.	.	.	.	.	.	.	.	.
Average net monthly wages, MKD	9394	9664	10193	10552	11279	11824	12272 <sup>1-xi</sup>	.	.
annual change in % (real, net)	3.8	3.6	-0.3	-1.9	5.0	3.6	4.2 <sup>1-xi</sup>	.	.
Retail prices, % p.a.	0.8	-1.1	10.6	5.2	1.4	2.4	0.9	2	2
Producer prices in industry, % p.a.	4.0	-0.1	10.7	2.0	-0.9	-0.3	0.9	2	3
Central governm. budget, nat.def., % GDP									
Revenues	21.9	24.2	26.7	22.6	23.8	21.3	.	.	.
Expenditures	21.9	23.8	24.4	28.0	26.8	22.3	.	.	.
Deficit (-) / surplus (+), % GDP	0.0	0.3	2.3	-5.5	-3.0	-1.0	.	.	.
Public debt in % of GDP	.	.	.	.	.	.	.	.	.
Discount rate, % p.a., end of period	8.9	8.9	7.9	10.7	10.7	6.5	6.5	.	.
Current account, EUR mn <sup>4)5)</sup>	-240.5	-30.4	-78.5	-272.1	-379.9	-135.0	-300	-300	-300
Current account in % of GDP	-7.5	-0.9	-2.0	-7.1	-9.5	-3.3	-7.1	-7	-6
Gross reserves of NB, excl. gold, EUR mn <sup>5)</sup>	260.5	428.0	461.5	845.5	692.8	786.9	646.1 <sup>xi</sup>	.	.
Gross external debt, EUR mn <sup>5)6)</sup>	1190.3	1431.9	1545.2	1638.3	1486.3	1417.0	1439.0	.	.
FDI inflow, EUR mn <sup>5)</sup>	113.9	30.7	189.4	493.2	82.6	83.8	100 <sup>7)</sup>	.	.
FDI outflow, EUR mn <sup>5)</sup>	0.0	0.3	-0.7	1.0	0.1	0.3	0 <sup>7)</sup>	.	.
Exports of goods, BOP, EUR mn <sup>5)</sup>	1152	1117	1433	1291	1181	1205	1350	1400	1400
annual growth rate in %	5.0	-3.0	28.3	-9.9	-8.5	2.0	12.1	4	0
Imports of goods, BOP, EUR mn <sup>5)</sup>	1611	1582	2182	1879	2035	1959	2338	2400	2450
annual growth rate in %	11.9	-1.8	37.9	-13.9	8.3	-3.7	19.3	3	2
Exports of services, BOP, EUR mn <sup>5)</sup>	133	256	344	273	269	289	305	.	.
annual growth rate in %	8.7	92.4	34.2	-20.5	-1.5	7.4	5.6	.	.
Imports of services, BOP, EUR mn <sup>5)</sup>	186	217	291	295	292	291	347	.	.
annual growth rate in %	-23.8	16.3	34.1	1.3	-0.9	-0.3	19.0	.	.
Average exchange rate MKD/USD	54.45	56.90	65.89	68.04	64.74	54.30	49.41	.	.
Average exchange rate MKD/EUR (ECU)	61.07	60.62	60.73	60.91	60.98	61.26	61.34	62	62
Purchasing power parity MKD/USD, wiiw	18.07	18.32	19.40	19.63	20.00	19.76	19.55	.	.
Purchasing power parity MKD/EUR, wiiw	21.36	21.46	22.57	22.97	23.18	23.15	22.88	.	.

Notes: 1) Preliminary. - 2) Excluding small enterprises. - 3) From 2001 according to NACE. - 4) Including grants. - 5) Converted from USD to EUR. - 6) Medium- and long-term. - 7) wiiw estimate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.