FYR MACEDONIA

Highlights

- **Growth has remained strong in the past year.** GDP grew by nearly 3.5 per cent in 2014, the highest in the south-eastern Europe (SEE) region, driven primarily by gross capital formation and strengthening private consumption, as well as dynamic export activity as the country continues to benefit from important foreign investments in recent years.
- **Fiscal policy has loosened considerably over the past years;** however public debt still remains relatively moderate by regional standards. The deficit is expected to remain elevated in coming years on account of the government's continued high capital expenditure, and the rising trend in public debt is a cause for some concern.
- **Reform efforts to attract foreign direct investment (FDI) are paying off.** This reflects the strongly business-friendly policies of previous years. However, competition from the informal sector and a weak judicial system remain the major obstacles to doing business, according to surveys.

Key priorities for 2016

- **Fiscal discipline should be enhanced.** Public debt has grown sharply in recent years despite the strong economic growth rates. It will be important to maintain a prudent fiscal stance, as macroeconomic stability is one of the key attractions for foreign investors.
- **Regional linkages should be strengthened.** Progress on building infrastructure links in transport and energy with neighbouring countries should be stepped up in order to enhance the economic potential of the country.
- **Energy sector reforms need to advance further.** Key remaining challenges include strengthening the legal and institutional framework for renewable energy, improving private sector participation and completing the liberalisation of tariffs so that they are more cost-reflective.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	2.3	-0.5	2.7	3.5	3.5
Inflation (average)	3.9	3.3	2.8	-0.3	0.0
Government balance/GDP	-2.5	-3.8	-3.9	-4.2	-4.0
Current account balance/GDP	-2.5	-2.9	-1.8	-1.3	-3.2
Net FDI/GDP [neg. sign = inflows]	-4.6	-1.5	-3.3	-3.3	-3.1
External debt/GDP	64.2	68.2	64.3	69.8	n.a.
Gross reserves/GDP	27.4	28.9	24.6	28.6	n.a.
Credit to private sector/GDP	44.5	46.6	46.3	48.4	n.a.

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Macroeconomic performance

The economy has performed strongly over the past two years. After a good recovery in 2013, GDP rose in 2014 by 3.5 per cent. The construction sector was an important contributor to growth, with the "Skopje 2014" project one of the most visible manifestations of this. Exports continue to perform strongly, especially those associated with some of the large foreign investments in recent years in the car and car components sector. While the overall unemployment rate showed further marginal declines, the more vibrant economy has not been fully reflected on the labour market. The level of unemployment remained high (nearly 30 per cent). The construction of two key road projects (performed by a Chinese construction company using at least 49 per cent of local subcontractors and at least 51 per cent of the local workforce) should help alleviate the country's high level of unemployment and further strengthen economic recovery. The robust economic performance has continued into 2015, especially on the external side as exports were up nearly 10 per cent year-on-year in the first four months of the year.

Fiscal policy has loosened in recent years. The central government budget deficit has hovered at around 4 per cent of GDP over the past three years, with current expenditure accounting for 90 per cent of total spending. As a result, public debt, while still relatively moderate by regional standards, has risen sharply (by 20 percentage points) in the past five years, from 26 per cent of GDP in 2009 to 46 per cent of GDP by the end of 2014. According to the 2015-17 fiscal strategy, the government has imposed a constitutional ceiling on the budget deficit and the public debt at 3 per cent and 60 per cent of GDP, respectively, with the goal of signalling its determination to adhere to fiscal discipline and stability, which is vital to ensure medium-term fiscal sustainability. Nonetheless, in July 2015 and ahead of the announced elections in April 2016, the government adopted a revision of its 2015 budget, boosting the deficit target to 3.6 per cent of GDP from 3.3 per cent, mainly on the back of higher expenditure.

FDI continued to rise in 2014. After more than doubling in 2013, FDI continued to rise in 2014 to €262 million (net). The source of FDI is quite diverse, covering EU countries as well as the United States, Turkey and the Middle East, among others. The country has now become a major producer of car components and several investments are in this growing sector. Financial incentives, competitive wages and improvements in business environment, have successfully attracted FDI and contributed to export diversification and employment. However, recent preliminary data from the central bank show a drop in the first half of 2015 by 17.2 per cent year-on-year.

Further growth is likely in the short term. The combination of strong export performance, mainly from the special economic zones, and domestic investment in public infrastructure projects is expected to drive growth of around 3.5 per cent in 2015 and 2016. However, the country has faced significant domestic political uncertainties, which might slow down the growth momentum as confidence weakens and some investors hold off investment decisions. Economic difficulties and uncertainties in neighbouring Greece, as well as a protracted period of weak growth in the eurozone, are another source of risk for the growth outlook. On the other hand, persistently low oil prices should have a positive growth impact.

Major structural reform developments

No progress has occurred in EU approximation in the past year. Although FYR Macedonia has been a candidate country for EU membership since 2005, progress towards accession negotiations remains blocked by the name dispute and by other institutional deficiencies. FYR Macedonia has been allocated up to €664.2 million under the EU's new Instrument for Pre-Accession Assistance (IPA II) in 2014-2020. Compared with the 2007-2013 IPA period, the funding has been increased by 8 per cent. The assistance will support reforms in preparation for EU membership, socio-economic and regional development, social policies and rural development.

Two telecommunications operators are being merged. In July 2015, the regulator approved the merger between Telekom Slovenia's Macedonian unit, One, and Telekom Austria's unit, Vip Operator. Telekom Austria Group will hold 55 per cent, and have control over the new entity, while Telekom Slovenije Group will hold 45 per cent. Completion of the merger is expected by the end

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of 2015. The deal will lead to the merger of the second and third largest mobile operators in the country and reduces the number of players in this market to just two. Makedonski Telekom, a member of Deutsche Telekom Group, is the country's leading telecommunications company, with the government holding a 35 per cent stake.

FYR Macedonia continues to promote a business-friendly environment. The country continues to score highly on international rankings of ease of doing business and low tax burden. The World Bank *Doing Business 2016* report ranks FYR Macedonia 12th out of 189 economies, far higher than many other EU and neighbouring countries. Among other developments in the past year, the Commercial Law was amended in 2015 and will reinforce minority shareholder rights, improve corporate governance and increase the transparency of financial results reporting. As the quality of legislation is improving, the focus is now on building institutions capable of ensuring effective implementation of the legislation.

The Energy Community referred FYR Macedonia for failing to adopt renewable action plans. Adoption of a renewable action plan is one of the requirements under the EU directive on the promotion of the use of energy from renewable sources. Signatories to the Energy Community treaty (which aims to bring prospective EU members into line with EU energy policy), have committed to a binding target for renewable energy to be reached by 2020. A key step towards this goal is adopting renewable action plans which break down the overall target into sectoral targets and detail measures to be taken.

FYR Macedonia has made progress on improving gas interconnections. The country signed a joint declaration on strengthening energy cooperation in the region together with Greece, Serbia, Hungary and Turkey by improving the cross-border interconnections. All five countries have also shown interest in pursuing a plan to carry Russian gas arriving via "Turk Stream" to central Europe. The unbundling of gas transmission and gas distribution has also been completed, but third-party access to the gas distribution network remains limited, restricting competition in the sector.

The financial sector continues to show resilience. The NPL ratio has stabilised at around 10-11 per cent of total loans, somewhat lower than its post-crisis maximum of 11.8 per cent in mid-2013, but much lower in comparison to several neighbouring countries. Spillover risks from Greece to the financial sector are being closely monitored, and additional preventive capital flow measures have been adopted (see below). Greek subsidiaries have nearly a quarter of the market share. Since 2010, the authorities have strengthened their supervisory framework and crisis management tools to contain possible spillovers. Enhanced monitoring and prudential measures as well as effective communication and exchange of information within the European Single Supervisory Mechanism (SSM) are currently in place. Other financial services such as insurance and leasing remain low relative to EU standards.

The central bank has adopted (temporary) preventive capital flow measures. The measures adopted in June 2015 include a restriction of capital outflows from FYR Macedonian entities to Greek entities based on newly concluded capital transactions as well as a request to FYR Macedonian banks to withdraw all loans and deposits from Greek banks (in Greece or elsewhere), regardless of the agreed maturity (with an exception for the funds on the corresponding accounts with those banks). These restrictions are complemented by an explicit ban on all residents to invest in Greek securities. The measures have a validity of six months maximum.