IMF COMMENDS MACEDONIA ON STRONG MACROECONOMIC PERFORMANCE

By Bert van Selm, IMF Resident Representative

Yesterday, the **IMF Executive Board commended Macedonia on its strong macroeconomic performance** and completed the Third Review of Macedonia's 2005-08 Stand-By Arrangement (see www.imf.org/skopje). Economic growth increased to 5 percent last year and is expected to remain at that level this year, in spite of recent international financial turbulence. The central government ran a small surplus last year, and this year's budget (which targets a deficit of 1.5 percent of GDP) provides a solid basis for continued macroeconomic stability. The external position is comfortable, with a small (2 percent of GDP) current account deficit last year. International reserves increased, even though large prepayments on Macedonia's external debt were made (of around €200 million to the Paris Club, World Bank, IMF and EIB). Foreign direct investment increased sharply in 2007 and is expected to increase further in the coming years.

The IMF Board emphasized that short-term macroeconomic pressures need to be carefully monitored and managed. Inflation increased to 9 percent in January—its highest level in many years. Most of the increase is due to higher food prices, but core inflation (which excludes the most volatile prices, for food and energy) also increased slightly, to 2.6 percent. Sound macroeconomic policies—the exchange rate anchor, and continued fiscal prudence—are expected to pull back inflation. However, the authorities should stand ready to adjust their plans if inflationary pressures persist or the current account deficit widens beyond projections. The NBRM's initial reponse—the increase in its key policy interest rate to 5.25 percent, announced last week—is appropriate, but this may need to be supported by additional measures, including in fiscal policy. Wage and pension increases have so far not jeopardized the government's fiscal targets, but they have reduced the flexibility of government spending, and appear hard to reconcile with the government's commitment to cut spending by 2 percent over the medium term. It is also important that government capital spending is spread over the year, and not heavily concentrated in the last quarter.

A second challenge identified by the Board is to further enhance economic growth potential and reduce unemployment, in particular through payroll tax reform. The average labor tax wedge (the difference between what an employer pays and what a worker actually receives) is just over 60 percent of net wages. This is clearly too high. Tax rates for part-time and low-wage workers are much higher still. By calculating health care contributions for part time workers on a per-hour basis (scheduled for April 2008), rather than assuming full-time work, an important obstacle to promoting formal sector activity and reducing unemployment will be addressed. However, the labor tax wedge for low income earners remains very high, due to the high minimum social contribution bases. This creates a bias in the economy against employment in low-wage sectors, such as textiles. Obviously, proposals to tackle this problem must be carefully studied for their revenue effects. But with official unemployment at 35 percent, reducing the overall labor tax wedge, and addressing anomalies in the system of labor taxation, must be a top priority.

In conclusion, while Macedonia's **macroeconomic performance has been good, inflation risks from higher food prices together with higher public sector wages need to be carefully monitored, and further reforms are needed to enhance growth potential and reduce unemployment**. The International Monetary Fund looks forward to continuing to assist the Macedonian authorities in these efforts.