THE CASE FOR FISCAL PRUDENCE

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Yesterday, the Executive Board of the International Monetary Fund commended Macedonia on its successful efforts to boost economic growth and completed the 2008 'Article IV' economic consultation (see www.imf.org/skopje). Growth increased to 6 percent this year, but the IMF reduced its projection for next year to 4 percent, owing to the global economic slowdown. However, given the extent of the current international financial turmoil, this projection is subject to greater than usual uncertainty, and there is a risk the outturn could be lower. On the positive side, the exchange rate anchor is expected to bring inflation down to low single digit levels in 2009.

However, Macedonia's current account deficit—essentially the trade balance plus remittances—has widened sharply. This article addresses three related questions: (1) what caused this rapid increase in the current account deficit? (2) why is this a problem? and (3) what should the Macedonian authorities do about this?

First, the origins of the problem. Macedonia's trade deficit is increasing rapidly (from 21 percent of GDP in 2007 to 28 percent in 2008), and remittances are declining sharply (from 18 percent of GDP in 2007 to 15 percent in 2008). Together these have pushed up the current account deficit to around 14 percent of GDP. Higher prices for imports (fuels, electricity, food) and lower prices for exports (nickel) have not helped. But there are other reasons too:

higher imports of investment goods, partly related to higher foreign direct investment; and higher imports of consumer goods, supported by rapid growth of credit to households, as well as substantial pension and wage increases.

The recent international financial turmoil could further increase Macedonia's external deficit, and make it more difficult to finance it. While the direct impact of the crisis on Macedonia's financial sector has been limited, the indirect impact is growing. Export demand has started to fall, with the metals sector laying off workers. Lower capital inflows (due to tighter international credit markets) and weaker remittances (driven by lower world growth) could create additional pressures. Against this, the sharp drop in oil and food prices will help. But we project that the fall in metals prices—a key export—will outweigh this.

Second, what's the problem? A current account deficit means that a country spends more than it earns—that is, it borrows from the rest of the world. Now, borrowing to finance higher growth is normal—desirable, even—for an emerging economy. As long as debt levels remain sustainable, and sufficient international reserves are saved in case of a rainy day, a temporary double digit current account deficit need not spell trouble. The problem is that, under current government plans for increasing budget deficits, the current account deficit is projected to remain high for quite a long time. This could lead to external debt rising and reserves falling short of internationally accepted comfort levels. Conventional wisdom is that for emerging economies, a safe level of external debt is up to around 40 percent of GDP, with 3 months of imports cover the accepted rule of thumb for international reserves. However, using the most recent assumptions for international prices and the government's

announced policy of higher budget deficits, Macedonia's external debt (including both public and private debt) would increase to almost double the 40 percent norm by 2011, while reserve coverage would linger below 3 months over the entire 2008-12 period.

Third, how should the authorities respond? Given Macedonia's fixed exchange rate regime, the most powerful macroeconomic policy instrument is fiscal policy. This should now be used to reduce macroeconomic pressures. By running a budget surplus in 2008, and a budget close to balance in 2009, the government would help reduce the external deficit. To its great credit, the government is already running a 3 percent of GDP budget surplus through the first ten months of this year. Our advice is to save some of this, not to blow it in a year-end rush of spending. There is also some scope for further tightening of monetary policy, given that rapid credit growth has contributed to the increased current account deficit.

In conclusion, while the reform efforts of the Macedonian government have boosted growth, in our view more prudent fiscal policies are now needed to reduce the external deficit to a sustainable level. The International Monetary Fund looks forward to assist the Macedonian authorities in this effort.