

## Introduction

Economic and financial conditions have improved since the summer of 2009, the risks of instability have decreased, and Macedonia has weathered the global crisis better than most of the countries in the region. Macroeconomic policies have helped to achieve this relatively good outcome. At the same time, risks remain, stemming in particular from the still large current account deficit and from remaining uncertainties about the health and prospects of the global economy and world financial markets. Against this background, policies should remain geared towards reducing risks while supporting growth.

1. Mr. Tieman, some international agencies have already made downwards corrections in their projections for the Macedonian economic growth this year, and they now project a zero growth rate. What are the latest IMF projections for the Macedonian economy, will the country succeed in achieving 2% GDP growth, as it is planned by the Government?

Our projection is still for 2 percent growth for 2010. We will be reviewing this projection during our next staff visit to Macedonia in May. Our projection is that the economy will gradually recover in the course of the year, with growth in the second half of 2010 being higher than in the first half. This projection is based on growth in Macedonia's trading partners, improved financial conditions, and the relatively sound condition of the Macedonian banking sector. However, the strength of the current global economic and financial recovery remains uncertain, leading to unusually high uncertainty of the projection.

2. Economic experts already analyze that the Government will very soon face with the challenge to adopt a supplementary budget because the 7% projected higher revenue than the last year seems difficult to achieve due to general non-liquidity of the real sector. Should there be cuts in the budget and where should the government make savings?

The government budget envisages a 2.5% deficit for 2010. Given the projected slow economic recovery, such a budgetary stance appears to be appropriate. Behind the overall budget deficit number are revenue and expenditure projections. Given the modest economic recovery, the revenue projections indeed seem somewhat optimistic, with IMF staff projecting a revenue shortfall of 0.9 percent of GDP compared to the budget. One has to bear in mind though that part of the pressure on the budget stems from the planned reductions in social contributions, which are desirable from the viewpoint of fostering jobs and investment. In addition, the corporate income tax regime has been revised, leading to lower revenue.

The government appears committed to achieve its 2010 budget deficit target even if revenues fall short of the levels assumed in the budget. This would imply measures to control expenditures. The challenge will be to find non-essential areas to restrain spending, while

devoting sufficient resources to public investment to increase the long-term growth potential of the economy.

3. Macedonian budget remains social, with big expenditures in the public administration as well. These expenditures have been increasing every year. Until when, do you think the economy could support such a huge and social budget?

The level of the deficit, and of public debt, is relatively low, indicating that the balance between revenues and spending has been appropriate. As the economy and tax revenues recover, it will be important to reduce the deficit to preserve the virtue of low public debt. In addition, it is important that expenditures are sufficiently geared towards public investment to increase the long-term growth potential of the economy. This will require restraint on current spending. Financing of the deficits should primarily be done externally, as large net domestic government borrowing would crowd out loans to the private sector.

As to the level of taxation, the government is reducing social contributions and relaxing the corporate income tax regime. This reduces the cost of hiring employees, and will stimulate job creation and investment. Raising the growth potential of the economy requires investment in both physical infrastructure (roads, railways, airports), as well as development of the labor force through training and education. In addition, providing a stable and predictable legal and regulatory environment, so as to provide certainty to all economic agents, is vital for encouraging both domestic and foreign investment.

4. One of the main problems in Macedonia is the huge and unproductive public administration which employs mainly party members. What is the IMF stand on this problem and have you given the Government any suggestions?

Our view is that public administration in all countries, including Macedonia, should strive for the ideals of transparency and efficiency, which includes employment based on merit. Most countries fall short of this ideal, although this is something that is hard to measure and quantify, in Macedonia and elsewhere. This includes government at the local level, which is relevant for Macedonia in light of fiscal decentralization.

Of course, as in any other country, there are trade-offs in the composition of spending. Hence the budget has to ensure an appropriate balance between staffing resources needed to support government policies and projects, and public investment.

5. Usually over the years every government promised higher realization of capital investments from the budget, but at the end when the revenues didn't turn out as those planned before, this is the side which takes most of the cuts in order not to make the budget

deficit larger. Even one third of the planned capital expenditures were not invested last year. What is your comment on this politics and what are your suggestions to the Government?

It tends to be a reality in many countries, not just Macedonia, that when budget pressures arise capital spending is the first thing to be cut. Lessons from this include the need for realistic budgeting; good planning and prioritization of capital spending projects and transparency and efficiency in their execution; and restraint on non-essential expenditures, including avoidance of excessive spending on public administration.

In case of emerging pressures in meeting the budget deficit target, expenditure cuts need to be made. In such cases, capital expenditure will be subject to cuts, as will other expenditure categories. Realistic budgeting will minimize the need for such cuts. In addition, early and quick action upon the emergence of budgetary pressures would enable the government to come up with a broad package of measures, in which cuts to capital expenditures could be minimized

6. Recently the Government announced its plan to spend a lot of money on Skopje 2014 project, various campaigns, economic promoters and advertising. Do you think that this is the right way to spend budget money which will promote the economy?

As mentioned above, the challenge going forward is to strive for maximum transparency and efficiency in public spending, and to focus public investment on projects which will increase the long-term growth potential of the economy. Transparency helps to ensure that voters can exercise their voice in deciding how public money should be spent.

7. The Government also this year decided to run an expansionary fiscal policy, while the NBRM is still practicing a more restrictive monetary policy. Analysts say that this is the worst possible combination of the both key economic policies in Macedonia. What is your comment on this non-coordination between the Government and the NBRM?

We view both fiscal and monetary policy as appropriate in the current economic circumstances.

A fiscal policy that offers some measure of support to the economy in a period of recession or slow growth stimulates public demand at a time when private sector demand is lacking. In fact, when the government's fiscal policy is adjusted for the economic cycle (i.e. taking into account that the economy was in recession in 2009 and will grow only modestly in 2010), it is not expansionary. The budget supports the economy by lowering social contributions, reforming corporate taxation, and increasing agricultural subsidies, but has also consolidated

expenditures on other items in order to achieve a deficit target that is financable and moves towards a sustainable medium-term debt position.

At the same time, a stable exchange rate against the Euro has been a policy anchor for the Macedonian economy for over a decade. The National Bank of the Republic of Macedonia's objective is to protect this exchange rate peg. It hence responded to the large and rapid losses of foreign exchange reserves in late 2008 and early 2009 by raising interest rates and imposing tighter reserve and liquidity requirements. These measures protected the peg and helped to contain the loss of reserves, which have since rebounded from a trough below € 1.2. bn in May 2009 to above € 1.6 bn currently.

#### 8. Is there a room for the Governor to loosen monetary policy?

In December 2009, the NBRM council started to ease monetary policy on the back of increased reserves and an improved outlook, including a lower current account deficit. Since then, the bank has continued a policy of cautious easing, which has led rates to decrease from 9% to 7.5% between December 2009 and February 2010. Such a cautious policy is appropriate and balanced in light of the still elevated level of external risk. Looking forward, if favorable trends in international reserve and the balance of payment continue, there will likely be room for continued easing of monetary policy.

#### 9. Although in time of recession, many countries decided to fight against the crisis with a help by the IMF with signing an arrangement, and Macedonia which also faces financial problems has remained on its stand not to conclude such arrangement but to issue a Eurobond with 9.8% interest rate. This has made the public debt even higher by 32.9% of GDP. What is your comment on this move by the Government and is there a need or any interest by the Macedonian side for a possible arrangement?

Public sector debt as a percentage of GDP currently stands at some 26 percent, up from 21.5 percent in 2008. Still, the Macedonian public sector debt was reduced considerably from almost 40 percent to just above 20 percent of GDP between 2005 and 2008.

The Macedonian government has not requested an IMF arrangement. The decision on requesting an IMF program loan is entirely up to the government. While some countries in the region have chosen to ask for IMF support during the crisis (for instance, Serbia, Hungary, Romania), others have not (e.g., Bulgaria, Albania). A government can request an IMF program loan at any time. There are tradeoffs involved. On the one hand, being able to issue a Eurobond on the international capital markets in the middle of a global financial crisis can be interpreted as a signal of market confidence, which stems in part from the relatively

low level of public debt. On the other hand, the IMF is also available to provide support when market conditions are unfavorable. Ultimately the choice is up to the government.

10. If there were talks about an arrangement between the Government and the IMF, what would be the key requirements and suggestions by the Fund?

No such talks are currently underway. Consequently, it would not be appropriate to speculate on the contents of such negotiations. However, in broad terms the objectives would be to provide temporary support based on an economic program that helps ensure stability and a return to growth.

11. What do you think, how much the Macedonian Government has succeeded in protecting the economy from the world crisis by the so called anti-crisis measures. Do you think the Government should have acted differently at the first negative signs and when do you expect the domestic economy to recover?

We expect the recovery to start this year. However, economic growth will likely resume only gradually, on the back of slow growth in Macedonia's main trading partners. Economic growth is hence projected to stay below potential for some time to come.

It is hard to know with any precision to what extent the government's anti-crisis measures have contributed to Macedonia's economic performance. However, it is noteworthy that Macedonia's economy was less affected by the global economic crisis than most other countries in Europe. Reasons for this include the (foreign reserves and fiscal) buffers built up in the past and the stability of the banking system. Over the past years, the Macedonian authorities had built up a substantial foreign exchange reserve, which served to protect the exchange rate peg when the crisis hit. In addition, past fiscal consolidation translated in a public debt level which was relatively low by emerging market standards. Lastly, as the Macedonian's banking system has financed itself domestically, Macedonian banks have been relatively isolated from the global financial system. As such the main effect of the crisis on the banks was through lower growth rather than from external funding pressure.

12. The companies complain that in a time of crisis they have been exposed to big financial pressure by the state through different taxes and other fees and penalties and on the other hand they can't collect their claims from the state. What could be the price of such non-liquidity and do you have any information about how alerting is this because the government doesn't say the numbers?

We do not have specific information on the extent of payment arrears, but we agree they should be avoided.

Liquidity is the grease of the economy. If a client does not pay a company, it, in turn will not be able to pay its suppliers or employees. These effects hence cascade through the economy. It is therefore important to maintain liquidity and if, indeed, payment arrears are increasing, it is important to fight this tendency by taking decisive measures. Collecting data on arrear and monitoring their development is a crucial first step to assess the scope of the problem.

In terms of the level of taxation, over last years, tax revenues have actually fallen as a share of GDP. This is due in part to government policies cutting social contributions – thus stimulating job creation – and relaxing the corporate income tax regime.

13. Greece is currently facing with serious financial problems. What is the danger from this crisis to spillover into our economy?

The spillover from Greece's economic trouble to Macedonia is likely to be contained. We do not see a spillover through the financial system, as the Macedonian banking system is stable and does not depend on financing from Greece. However, Greece is one of Macedonia's major trading partners. Slow Greek economic growth will hence affect Macedonia through the trade channel: Greek demand for Macedonia products will be lower than it would be in the case of a booming Greek economy. In addition, the Greek strikes may affect the transport links for some large Macedonian companies which depend on the port of Thessaloniki for bulk im- and exports. Another, indirect, spillover channel presents itself in the international capital markets. Investor's increased worries about credit risk in the region will likely result in tougher and more volatile borrowing conditions, i.e., higher and less predictable interest rates.

14. There is a huge unemployment rate in this country of 32.4%, around 600,000 people leave in poverty, and on the other side there are relatively low economic grow rates, low level of FDI. What is your recommendation to the Government in order to improve the economic performances?

To reduce unemployment and poverty it is important to generate inclusive economic growth. Inclusive growth consists of two challenges.

The first and most important one is to create economic growth through increasing the long-term productive potential of the economy. This can be done through structural reform, combined with the attraction of Foreign Direct Investment (FDI). In order to boost Macedonia as a destination for FDI, it is important to promote a stable and predictable legal

and regulatory environment. That way, potential investors can be certain of the regulatory environment they will be facing over the long-term horizon, and hence of the potential payoff of their investment.

The second challenge is to make sure that the benefits of economic growth are shared between the entire population. Growth that does not accrue to the poorest segments of the population will increase inequality. Keeping a stable macroeconomic environment in which the creation of jobs can be stimulated will go a long way towards making sure growth is inclusive. In addition, attention needs to be paid to education and health care, as lacking facilities in these sectors tend to hurt the poorest part of the population disproportionately hard. Education and training will also ensure that the demand for skilled labor, which will come with growth, can be met.

The government is implementing several policies to stimulate inclusive growth. The reduction in social contributions, for instance, stimulates job creation. Lower social contribution rates, together with successful revenue administration reform in the PRO, work to reduce the size of the informal economy. This, in turn, benefits the population, as social benefits apply to formal jobs, and a larger tax base leads to increased revenues without having to resort to higher tax rates.

**15. What do you think is the medium-term perspective of the Macedonian economy compared to the other countries in the region?**

The medium-term perspective of the Macedonian economy is good. The perspective depends on managing risks to the economy, while at the same time increasing its growth potential. On both accounts, Macedonia has the potential to do well.

First, it is important to safeguard macroeconomic stability, and hence to be aware of and manage any risks to this stability. The authorities have built up buffers to preserve such stability in the form of ample foreign exchange reserves and a relatively low public debt. Going forward, they are committed to maintaining a stable macroeconomic environment. Such stability is a necessary precondition for growth, as it facilitates the operations of any business, both domestic and foreign-owned.

Second, the growth potential of the economy looks good. The medium-term potential for private sector domestic investors looks promising. In addition, as an EU accession country, Macedonia could become an interesting destination for foreign investors. Attracting both domestic and foreign investment crucially depends on presenting investors with a stable and predictable legal and regulatory environment. Strengthening such an environment does not

have to await the start of formal EU accession negotiations. Instead, the earlier a push in this direction is started, the more time there is to build up a positive track record with investors. Any resulting FDI will not only bring jobs, but also increase the level of knowledge and skills in Macedonia.

In the medium-term, a stable macroeconomic environment, with stable, clear, and predictable laws and regulations that are properly enforced, together with investment in education and infrastructure, will create a flourishing economy. By making sure that all its citizens benefits from such growth, Macedonia can reduce poverty, and further boost its potential.