Interview KAPITAL (May 8, 2015)

Q1.*Mr. Gitton, the latest IMF projection for the Macedonian economy is 3.8% growth this year which is actually the most optimistic in within the region. What is this optimism based on? Where will this growth come from?*

A1. The projected growth is indeed robust. It is supported by public investment in infrastructure, the continued recovery in private credit and a sustained decline in unemployment. Supportive monetary and fiscal policies contribute to these developments. On the external front, new export capacities created by recent foreign direct investment and lower oil prices will also provide support to growth. In the region, only Montenegro is projected to grow at a faster pace this year.

Q2.*How much can this economic growth improve the living standard of the people? Can we say that they will live better than the year before?*

A2. Economic growth is necessary to improve living standards but does not always bring equal benefits to all. Periods of strong growth can also be periods of increase in inequality. That is what happened in the region in the early 2000s. Income inequality remains high in Macedonia by regional comparison. The ongoing decline in unemployment will best contribute to raise income and reduce poverty if jobs are created in high productivity sectors.

Q3.What are the biggest dangers that the Macedonian economy could face?

A3.There are some risks of various likelihood and with various impact. For a small open economy such as Macedonia, external shocks are always an important risk to the outlook. These mainly relate to the strength of the economy in the euro area and to uncertainties regarding the future path of oil prices. Based on the IMF's World Economic Outlook latest projections, both risks are more on the upside, as growth in the euro area is projected to strengthen supported by low oil prices. However, possible spillovers from the Greek crisis could be a negative shock. There are other global downside risks but these are much more indirect for Macedonia: those relate to geopolitical tensions, possible surprises in the path of monetary normalization in the United States, and stagnation and low inflation in advanced economies. On the domestic side, a prolonged political uncertainty could negatively affect confidence.

Q4. *How much are you worried by the political crisis in Macedonia and to which extent can that jeopardize the economy?*

A4. We hope the Macedonian parties will resolve the political crisis so as to prevent putting economic growth at risk. The current situation generates uncertainty and uncertainty is generally not congenial to investment and consumption. At this moment, we do not see any tangible effect of the political blockade but if this goes on for a protracted period of time, some FDI projects and domestic investments will likely be put on hold and that will hurt the supply side of the economy. Political uncertainties are also likely to further complicate prospects for EU accession.

Q5.*Is the IMF concerned over the contents of phone conversations revealed by the opposition regarding the condition of the state budget and the way of spending public funds?*

A5. Improving public financial management remains on the agenda. This implies a fiscal reporting of good quality, a comprehensive and credible fiscal forecasting and budgeting, and a strong framework for fiscal risk analysis and management. These guiding principles underpin the IMF's new Fiscal Transparency Code.

Q6. How much do you think the budget can stand all recent promises by the government about new public sector employments, social assistance increase, computer tablets for students, higher scholarships?

A6. The budget targets have been missed over the past years. This illustrates the need for a credible fiscal forecasting and strong discipline in budget execution. With respect to these announced new expenditures, either the current budget passed by the Parliament provides for them, or it does not. If it does not, some room will have to be made within the existing current spending ceiling so as to avoid any cut in investment spending, as it happened in the past. One of our recommendations is that if revenues perform better than expected, the money should be used to reduce the fiscal deficit rather than boost spending. Why do we call for fiscal consolidation? Because the improved economic outlook is the right time to do it. If an economic shock arrives in the future, the government will need some margins for stimulating demand without running additional deficit and making public debt pass up to unsustainable levels. Also, from a more structural perspective, policies should prepare for the inevitable pressures for permanent spending stemming from pensions and healthcare due to the ageing of the population. Macedonia's pension spending as a share of total government spending is already one of the highest in the region. This puts an additional constraint on fiscal policy and calls for fiscal prudence.

Q7.The government have recently paid off completely the debt toward the IMF, however, the Fiscal Strategy reveals that borrowings in the next two years will drastically increase. The Ministry of Finance plans to borrow EUR 1.25 billion by 2017, can this money be provided without a problem?

A7.The financing will likely come from a mix of issuance of domestic government securities (although banks' capacity to hold public securities have limits), lending from international and European public financial institutions, and lending from commercial international creditors including through the subscription of Eurobonds as the authorities' intention is to increasingly rely on external financing. The financing needs for this year are covered.

Q8.These borrowings, according to the government's Fiscal Strategy, will increase the public debt in the following two years over EUR 5 billion, i.e. 50% of GDP. How much you are worried about this indebtedness level?

A8.The right level of a safe public debt depends on country-specific circumstances, including on what is behind the increase in debt. On current policies, the general government debt and public sector debt levels may not prove unsustainable, but we see risks increasing in the following context: persistent low inflation which increases the debt burden in real terms, high ratio of foreign currency-denominated debt, still high annual financing needs, and a slower return to low deficits. In the context of a fixed exchange rate policy, prudence is warranted for a small open, energy dependent economy, with a significant share of the financial system's assets and deposits denominated in foreign currency. Since the country imports much more than it exports and private capital inflows remain low, the level and the currency composition of public sector borrowing are key factors for fiscal and external sustainability.

Q9. What is your assessment on the way the government have been spending the borrowed money? Can it be said that these borrowings are economically justified given the fact how much the government have been investing in capital objects?

A9.Borrowing should primarily finance high productive spending which has higher growth payoffs when comes the time to pay back the debt. We call for a consolidation of public finances which should target unproductive expenditure and leave space for spending more on things that Macedonia critically needs, such as development projects, education, and health services. If there is no change in the tax policy to boost revenues, this calls for a comprehensive review of spending. The forthcoming World Bank-led Public Finance Review could usefully guide decisions in this respect. Also, a critical area for optimizing the economic return of borrowing is a strong public investment framework: clear and transparent procedures to assess, select, prioritize, and monitor public investment projects should enable higher long-term economic return.

Q10. *In one of the IMF recent reports on Macedonia it says that companies work in extremely tough financial conditions. How can this liquidity problem be solved?*

A10. Liquidity problems of domestic private companies represent a risk to private investment and can hamper the transition to a more domestic private sector-led growth. In the IMF report, we actually refer to some recent work done by the NBRM which reveals that corporate balance sheets, particularly those of SMEs, remain strained. It shows that corporate sector debt stands at about 65 percent of GDP and is mostly foreign-currency denominated and at variable interest rates. The difficulty to service debt appears more pronounced for the leveraged micro enterprises group, which continued to post losses in 2013. More generally, firms appear to operate under strong liquidity constraints, needing to wait about four months on average to collect claims. Construction and real estate were the most affected sectors. In addition to easier access to bank financing, timely payment between private companies and from public institutions would alleviate this liquidity problem.