FYR MACEDONIA

Highlights

- **EU approximation is advancing.** The European Council at its meeting in June 2018 set out the path towards opening EU accession negotiations with FYR Macedonia in June 2019, subject to further progress in reforms.
- **The economy has struggled in the aftermath of the political crisis.** Growth was negative in the first half of 2017 but recovered somewhat in the second half, leaving growth for the overall year at zero, and further growth has been modest so far in 2018.
- **Energy sector reforms are progressing.** A new Energy Law, which is fully transposing EU energy legislation, has been adopted.

Key priorities for 2019

- **Renewable energy capacity should be developed further.** The authorities face a window of opportunity in terms of attracting new investments following the introduction of the new energy law.
- **Consolidation in the banking sector should be pursued.** The banking sector has a large number of banks relative to the size of the economy, and a consolidation could help strengthen the sector overall and lending to the real economy.
- **Implementation of the government's digitisation strategy can help to attract investment and jobs.** Progress in areas such as e-governance can help further boost FYR Macedonia's reputation as a business-friendly environment.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	3.6	3.8	2.9	0.0	2.0
Inflation (average)	-0.3	-0.3	-0.2	1.4	1.8
Government balance/GDP	-4.2	-3.5	-2.7	-2.7	-2.9
Current account balance/GDP	-0.5	-2.0	-2.7	-1.3	-1.1
Net FDI/GDP [neg. sign = inflows]	-2.3	-2.2	-3.3	-2.3	-3.3
External debt/GDP	64.9	68.0	70.7	77.1	n.a.
Gross reserves/GDP	26.4	26.3	22.2	24.3	n.a.
Credit to private sector/GDP	48.2	49.9	47.0	48.0	n.a.

CONTINUES

Macroeconomic performance

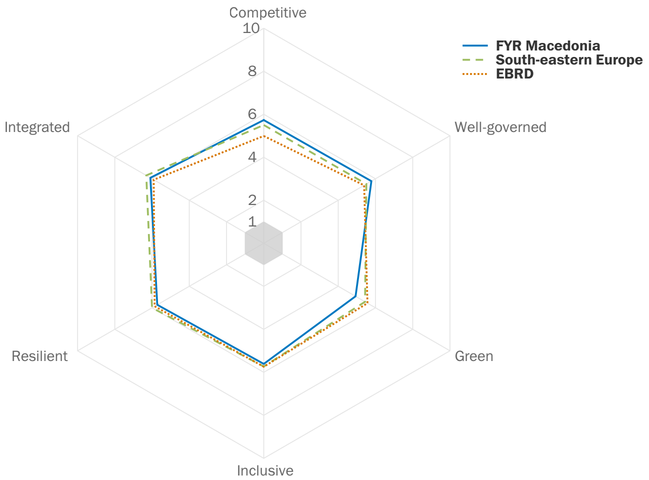
The economy has struggled in the aftermath of the political crisis. Following a few relatively good years of economic performance, the slow-down that began in 2016 continued through 2017 and into the first part of 2018. Growth in 2017 was zero, although a bad first half of the year, when the crisis was still in full swing, was balanced by a recovery in the second half following the formation of a new government. Government consumption also fell in 2017, but private consumption and net exports both increased, with gross exports rising by 18.0 per cent, helping to keep the current account deficit at low levels, of just about 1.0 per cent of GDP in 2017, among the lowest in the region. After a weak first quarter, economic activity picked up in the second quarter of 2018, driven by private consumption and net exports, bringing the overall growth in the first half of 2018 to 1.6 per cent year-on-year. The central bank cut its long-term policy rate by 0.25 percentage points to 3.0 per cent in March 2018. Inflation turned positive in 2017 after three years of price declines, averaging 1.4 per cent.

Public debt has been rising steadily amid continuous fiscal deficits. The government's fiscal deficit in 2017 was 2.7 per cent of GDP, slightly lower than 2.9 per cent planned when the budget was revised in August 2017 by the new government. The level of public debt is still relatively modest at 47 per cent of GDP, and within the Maastricht criteria of 60 per cent of GDP, but has been rising steadily in recent years, by 20 percentage points since 2009. A further rise is expected due to the measures adopted by the government, including business incentives for roll-out of additional employment and an increase in the minimum wage.

The credit outlook and investor confidence are improving. In February 2018, Fitch revised the outlook on its BB rating for FYR Macedonia from negative to positive to reflect the fact that the country's domestic political situation is stabilising. FYR Macedonia is rated BB-/Stable by Standard & Poor's and BB/Positive by Fitch (and not rated by Moody's). Meanwhile, international investors also appear to be showing increased confidence in the country's prospects, reflected to some extent in the historically low interest rate of 2.75 per cent on a seven-year €500 million Eurobond issued in January 2018.

Growth is expected to pick up in the short term. Prospects for short-term private and public investment are improving. The impact of the rising minimum wage and other social protection measures on private consumption is also expected to boost overall growth, while lending conditions are easing, helping businesses. A further rise in exports is also expected in the short term, following last year's strong performance, in light of the improved economic prospects in the European Union (EU), the country's key trading partner. As a result, the 2018 forecast for growth is 2.0 per cent, with a moderate increase to 3.0 per cent in 2019 on the assumption of continued political stability, the unblocking of further reforms and the arrival of much-needed investments. The key downside risk is the possibility of a resumption of political turbulence and uncertainty if progress in resolving the name dispute is not maintained.

Assessment of transition qualities (1-10)



CONTINUES

Major structural reform developments

EU approximation is advancing. In June 2018 the European Council set out the path towards opening EU accession negotiations with FYR Macedonia in June 2019, subject to further progress in reforms. This follows progress in resolving the name issue with Greece, which has held up FYR Macedonia's approximation progress for many years. The council underlined the need for FYR Macedonia to continue making further progress on areas such as judicial and public administration reform and the fight against corruption. Meanwhile, the EC has launched a screening process to evaluate the country's readiness to start accession talks in June 2019, with a particular focus on the crucial rule of law chapters 23 and 24.

Corruption perceptions appear to have worsened, despite the favourable business environment. FYR Macedonia is now ranked joint 107th (out of 180 countries), the lowest in the Western Balkans region, in Transparency International's Corruption Perceptions Index, down from 90th last year and 66th the previous year. On the positive side, the country continues to perform exceptionally well on the World Bank's Doing Business ranking, reaching 10th position in the 2019 report (published in late October 2018) compared with 11th position in the 2018 report.

A new Energy Law is in place. In May 2018 the parliament adopted a new Energy Law aimed at fully transposing EU energy legislation. The law envisages further liberalisation of the electricity market from 2019, foreseeing the appointment of a universal service provider and allowing households and small firms to choose their supplier. The law also encourages the production of electricity from renewable sources. In response, the Energy Community has formally closed several cases against FYR Macedonia. Starting from 2019, the state-owned power producer ELEM will be obliged to direct 80 per cent of its production to a universal supplier, which will be selected via a tender. Gradually this percentage will be lowered; by 2025 only 30 per cent of ELEM's production should be handed over to the universal supplier.

Cross-border energy integration is slowly improving. MEPSO, the country's transmission operator, is currently constructing the Macedonian portion of a 400 kV cross-border electricity interconnection between FYR Macedonia and Albania, the first interconnection between the two countries. Also, in April 2018 FYR Macedonia signed a Memorandum of Understanding (MoU) with Bulgaria that will allow the integration of the two countries' electricity markets. For the MoU to be implemented, FYR Macedonia should first establish an electricity market on a day-ahead trade principle, which is foreseen by the new Energy Law (see above). In the gas sector, FYR Macedonia has signed MoUs with both Greece and Bulgaria to explore the feasibility of developing further cross-border interconnectors, and thus diversifying its gas supply.

FYR Macedonia's regional connectivity agenda is progressing. The construction of the 28 km-long Demir Kapija-Smokvica motorway section in the southern part of the country, leading to the Greek border, was completed in April 2018. With this section and with the final works on the rehabilitation of the part between Negotino and Demir Kapija, the southern section of the pan-European road Corridor X, running between central Europe and Greece via Serbia and FYR Macedonia, has been finalised. Also, FYR Macedonia has invited tenders for the construction of a 34 km-long second section, Beljakovce-Kriva Palanka, of railway Corridor VIII, linking Bulgaria and Albania via FYR Macedonia. At the same time, FYR Macedonia and Kosovo have launched the construction of a new EU-funded joint border crossing which should facilitate enhanced cross-border trade.

Banking sector stability has been strong but the number of banks remains large relative to the size of market. Demand for credit fell sharply during the political crisis of 2016-17, but lending stayed positive, growing by approximately 3.0 per cent in 2017. This is however much lower compared with the previous years. Capital adequacy stood at 16.2 per cent as of the end of 2017, well above the regulatory requirement of 8.0 per cent. NPLs fell to 6.3 per cent, after being stable for the past three to four years at around 10.0 to 11.0 per cent of total loans, reflecting recent measures to write off NPLs that are fully provisioned for over two years. However, despite some consolidation over the years there are still 16 banks in FYR Macedonia, a large number for a small market.