NORTH MACEDONIA

Highlights

- **An historic agreement with Greece on the country's new name has been reached.** Although this can help facilitate North Macedonia's European Union (EU) approximation and NATO membership, the opening of EU accession negotiations has been delayed.
- **The economy has been recovering after the resolution of the political crisis.** GDP expanded by 2.7 per cent in 2018 and a further 3.6 per cent year-on-year in the first half of 2019.
- **The NPL ratio is on the rise.** Liquidity is ample and capital adequacy is relatively high, but the share of non-performing loans (NPLs) increased somewhat in the first half of 2019.

Key priorities for 2020

- **Further measures are needed to improve the business climate.** The focus should be on implementing measures to reduce the informal economy, in accordance with the government's 2018-22 strategy and 2018-20 action plan, but also on balancing formal enforcement with measures targeting underlying incentives for informality, such as simplifying the rules for the establishment and operation of businesses (especially in the case of entrepreneurs and micro enterprises).
- **The labour market needs to become more competitive.** Addressing skills shortages and aligning better vocational training with business needs are necessary in order to enhance the country's competitiveness.
- **To ensure the sustainability of public finances, more ambitious fiscal consolidation measures are needed.** The public debt is relatively high and the structure of government spending worsened further in the past year, shifting from capital to current expenditures. The government should further improve revenue collection, reduce tax exemptions, rationalise subsidies and ensure long-term pension sustainability. The introduction of fiscal rules is also needed; North Macedonia is the only Western Balkans country lacking such rules.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.9	2.8	0.2	2.7	3.2
Inflation (average)	-0.3	-0.2	1.4	1.5	1.2
Government balance/GDP	-3.5	-2.6	-2.7	-1.8	-2.5
Current account balance/GDP	-2.0	-2.9	-1.1	-0.1	-1.0
Net FDI/GDP [neg. sign = inflows]	-2.2	-3.3	-1.8	-5.6	-2.5
External debt/GDP	69.3	74.7	73.6	73.1	n.a.
Gross reserves/GDP	24.9	27.1	23.4	26.7	n.a.
Credit to private sector/GDP	50.9	47.9	48.6	48.8	n.a.

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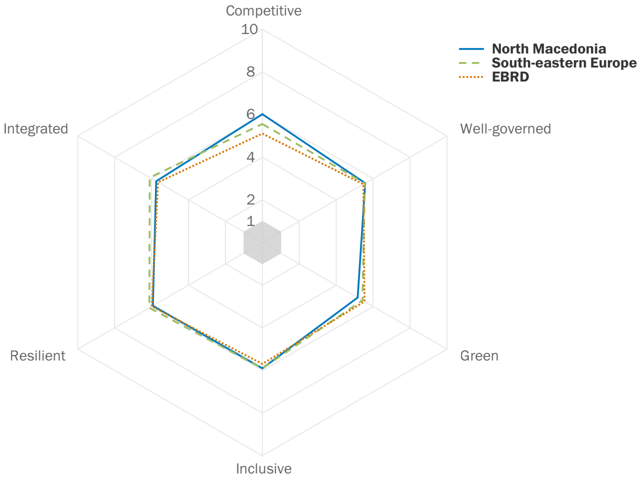
Macroeconomic performance

The economy has been recovering after the resolution of the political crisis. Growth recovered to 2.7 per cent in 2018 after just 0.2 per cent in 2017, driven mainly by strong exports but also private consumption. Robust export performance came as a result of stronger activity of both foreign direct investment-related and traditional industries (machinery and transport equipment, chemicals, iron and steel, furniture), helping to reduce the current account deficit to 0.4 per cent of GDP. However, total investments declined due to the postponement of large infrastructure projects and stagnating construction. The growth rate accelerated in the first half of 2019, to 3.6 per cent year-on-year, driven primarily by investment recovery. Despite declining, unemployment stayed high over the past year, at close to 20.0 per cent, and especially for young people for whom the unemployment rate is about 40.0 per cent. Inflation remained subdued at 1.5 per cent in 2018 and 1.0 per cent in the first nine months of 2019.

Public debt increased slightly in 2018. The general government deficit decreased to 1.8 per cent of GDP in 2018, after 2.7 per cent in 2017. Lower spending on public investment, instead of restraint on current expenditures, and higher tax revenues have been major drivers of the adjustment. Government arrears, including in VAT refunds, have continued to decline and measures were taken to prevent their build-up in the future. Public debt increased in 2018 by 0.7 percentage points, to 48.5 per cent of GDP. Financing of public enterprises and large infrastructure projects is often non-transparent, adding to medium-term fiscal risks.

Growth is projected to pick up to 3.2 per cent in 2019 and 2020. It will be supported primarily by a rebound in investment. The resolution of the name issue with Greece was expected to speed up EU accession progress, thus strengthening investor confidence and growth, as confirmed by Fitch's upgrade in June 2019 of the country's sovereign rating to BB+. However, current risks to the projection are more on the downside. These are mainly related to the delayed start of EU accession talks, which may weaken the reform momentum within the country, and the economic slowdown of the European Union.

Assessment of transition qualities (1-10)



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Major structural reform developments

The opening of EU accession negotiations has been delayed. Based on assessment of the progress in the implementation of the comprehensive EU reform agenda, the Council of the European Union in its Conclusions on the Enlargement adopted in June 2018 set out the path towards opening the accession negotiations with North Macedonia in June 2019. In May 2019, the European Commission issued a strong unconditional recommendation to the Council to launch EU accession negotiations with North Macedonia. The latter was based both on its assessment of the progress in reforms and on the country's achievements in normalisation of relations with regional neighbours, including the historic agreement on the resolution of the name issue and establishment of a strategic partnership with Greece. However, at the European Council meetings in June and October 2019 no consensus had been reached on this issue. Consequently, on 18 October 2019 the European Council decided to postpone the decision and to revert to this issue again before the EU-Western Balkans Summit in May 2020. The decisions of the Council triggered early general elections in North Macedonia, expected in April 2020.

Despite a high Doing Business ranking, the business environment needs to improve further. For many years, North Macedonia has ranked near the top of the annual World Bank *Doing Business* rankings, above many of the world's richest and most advanced economies. In the 2020 report the country dropped six places from the year before and ranked 17th out of 190 economies. The areas with the most room for improvement were starting a business (78th) and getting electricity (68th). In the World Economic Forum's 2019 Global Competitiveness Index (GCI), however, the country is relatively low-ranking, at 82nd out of 141 countries. While North Macedonia has advanced a lot in its business legislation and processes, in other institutional elements the country still has a lot of gaps to fill, including in improving the quality of the transport infrastructure and education, levelling the playing field for businesses, removing distortive taxes and subsidies and strengthening innovation. Political connections are also perceived to be important for success in life, according to the EBRD/ World Bank Life in Transition Survey III.

The government is working on measures to reduce the informal economy. A government strategy and action plan to reduce informal employment, adopted in 2018, focuses on the formalisation of jobs and on mitigating incentives to do business informally. Competition from the informal sector and access to finance (more than in other Western Balkans economies) are significant obstacles to doing business and weigh on competitiveness of the formal private sector, according to the latest round of the EBRD-European Investment Bank-World Bank Group Enterprise Survey. The size of the informal economy is estimated to range between 20 and 40 per cent of total output, depending on the method applied.

Work is ongoing on improving energy security and efficiency. The government plans to adopt an energy sector strategy up to 2040, based on the principles of the EU Energy Union. A new draft law on energy efficiency has also been prepared. The energy law, adopted in May 2018, allows small and medium-sized enterprise and households to install photovoltaic electricity generation facilities for their own consumption, transferring the surplus to the network. ELEM, the state-owned electricity company is also investing in its first 10 MW photovoltaic power plant. Construction of a national gas distribution system and connection to regional gas pipeline systems are among the government's priorities. The first ever auction for a feed-in premium for 35 MW photovoltaic plants on state-owned land was successfully published in June 2019, with the EBRD's support.

The banking sector is liquid and well-capitalised but the share of NPLs is increasing. Liquid assets make up more than 30 per cent of total assets, while capital adequacy was at 17.4 per cent at the end of June 2019, exceeding the regulatory minimum. Lending growth picked up on the back of corporate lending to 8.4 per cent year-on-year in the first half of 2019 (from 6.7 per cent in 2018). NPLs had declined from 6.1 per cent at the end of 2017 to 4.9 per cent in September 2018, mainly due to the collection of corporate claims, but have increased thereafter. In June 2019, the NPL ratio stood at 5.4 per cent. Foreign currency (euro) lending declined substantially since 2012 (from around 60 per cent of total loans), but at close to 40 per cent in mid-2019 remains high.