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Former Yugoslav Republic of Macedonia: Staff Report for the 2000 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of Former Yugoslav Republic of Macedonia on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with Former Yugoslav Republic of Macedonia, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of Former Yugoslav Republic of Macedonia; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports allows for the deletion of market sensitive information.

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FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Staff Report for the 2000 Article IV Consultation

Prepared by the Staff Representatives for the
2000 Consultation with the Former Yugoslav Republic of Macedonia

Approved by Susan Schadler and G. Russell Kincaid

April 25, 2000

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Executive Summary

The FYRM economy suffered a setback in the first half of 1999, owing to the Kosovo crisis. However, the post-conflict developments in Kosovo provided a sharp stimulus to economic activities in the second half of the year. Thus, GDP grew, inflation was absent, and foreign reserves increased substantially. The fiscal balance improved owing to buoyant tax collection, but there were lapses in expenditure management and control. The progress on structural reforms was slow.

The central government budget for 2000 is broadly balanced and includes an allocation for the costs of structural reforms. Outlays on wages are budgeted to return to the 1998 level. But, the authorities indicated that it would be difficult to reduce in the short run the wage payments financed from off-budget special revenues. The staff stressed that the authorities will need to press ahead in 2000 with downsizing of the bloated civil service and to integrate the special revenue accounts into the 2001 budget at the latest. The staff encouraged the authorities to adopt a medium-term budgetary framework, with a clear ordering of policy priorities.

Monetary policy will continue to be oriented toward maintaining the exchange rate anchor. The staff agreed with the National Bank of Macedonia's (NBM) assessment that external competitiveness was adequate at the current level of the exchange rate. The staff advised against the introduction of an exchange rate band at this stage. The high level of bank lending rates in FYRM is not due to support of the exchange rate anchor through an overly tight monetary policy. Rather, these high rates reflect a large share of nonperforming loans in the banks' portfolios, which has been perpetuated by bad lending practices and delays in banking sector reforms.

In recent months, the authorities have begun to direct more attention to structural reforms and have made notable strides. But, more discipline and vigor need to be introduced into the reform process. In the banking sector, a majority share in Stopanska Banka was sold to foreign investors in April 2000, and the NBM has taken initial steps to strengthen off-site monitoring ability. The NBM should also take prompt corrective actions against banks in noncompliance with supervisory guidelines and prudential regulations. In the enterprise sector, the authorities have dealt with a subset of the enterprises that were earlier targeted for sale or closure, and have identified additional lossmakers for inclusion in the reform agenda. A remedial action plan for these enterprises needs to be formulated quickly on the basis of a thorough analysis of the fiscal costs of different options. The authorities should also implement strictly the various amended laws on bankruptcy procedures and creditors' rights.

FYRM will need financial support from the international community over the medium term. The staff calculations show a residual financing gap of about US$80 million in 2000, which is expected to fall to about US$25 million by 2004.

I. Introduction

1. Discussions for the Article IV consultation with the authorities of the former Yugoslav Republic of Macedonia (FYRM) were held in Skopje during November 11–29, 1999 and January 26-February 3, 2000.[1] The staff met with Prime Minister Georgievski; Governor of the National Bank of Macedonia (NBM); all economic ministers; and key senior officials of government ministries, the NBM, major commercial banks, the Chamber of Commerce, and labor unions. Finance Minister Gruevski continued the discussions with management and staff at headquarters during March 13–15, 2000.

2. The last Article IV consultation was concluded on June 19, 1998, when the second annual ESAF arrangement (now the Poverty Reduction and Growth Facility (PRGF)) was also approved (EBS/98/91). On that occasion, Executive Directors commended the FYRM authorities for their successful efforts in maintaining financial stability. However, they noted that major structural weaknesses remained, and urged the authorities to implement the structural reform agenda vigorously (EBM/98/66).

3. Since then, macroeconomic performance has been generally satisfactory, but structural reforms have continued to lag. The midterm review under the second annual PRGF arrangement was not completed because of lack of progress in enterprise reform. Delays were caused initially by the parliamentary elections in November 1998, and subsequently the new multi-ethnic coalition government was confronted with the social and political ramifications of the Kosovo crisis. On August 5, 1999, the Executive Board approved a purchase in an amount equivalent to SDR 13.78 million (20 percent of quota) under the Compensatory and Contingency Financing Facility (CCFF) to compensate for a projected export shortfall arising from the Kosovo crisis (EBS/99/134). With the crisis over, negotiations were initiated in November 1999 on a program that could be supported by a new three-year arrangement. (The PRGF arrangement expired on April 10, 2000). The main focus of the discussions was on a macroeconomic framework and budget for 2000. Because of the unexpected political turmoil surrounding the presidential elections in November 1999 and the strained relations between the main ruling coalition partners, which necessitated a major cabinet reshuffle in late December, the authorities needed more time to fully specify their structural reform agenda and economic strategy for a three-year period. It was agreed that discussions with the staff would resume once the authorities had carried out this groundwork.

4. FYRM has accepted the obligations of Article VIII, Sections 2, 3, and 4 with effect from June 19, 1998. The freeze on certain foreign currency deposits of nonresidents, which

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[1] The staff team consisted of Mr. Banerjee (head), Mr. Marciniak, Ms. Cebotari (all EU1), Mr. Sekine (PDR), Mr. Young (FAD), and Ms. Williams (Assistant, EU1). Mr. Drummond, resident representative, assisted the staff team. Mr. Houtman, Advisor to the Executive Director for the FYRM, and Ms. Bricknell, the World Bank's resident representative in Skopje, attended some of the discussions.

constitutes a restrictive measure subject to Article VIII, Section 2(a), has been approved by the Board until April 30, 2000. FYRM's relations with the Fund and World Bank Group are summarized in Appendices I and II, respectively.

5. FYRM's statistical data suffer from weaknesses that hamper analysis and proper program monitoring. Real sector data are deficient in the coverage of the emerging private sector and informal activities. In the fiscal area, official data do not fully capture off-budget operations and domestic payments arrears. Trade data have been subject to sizeable revisions, and errors and omissions in the balance of payments have been consistently high and positive (Appendix III).

II. BACKGROUND

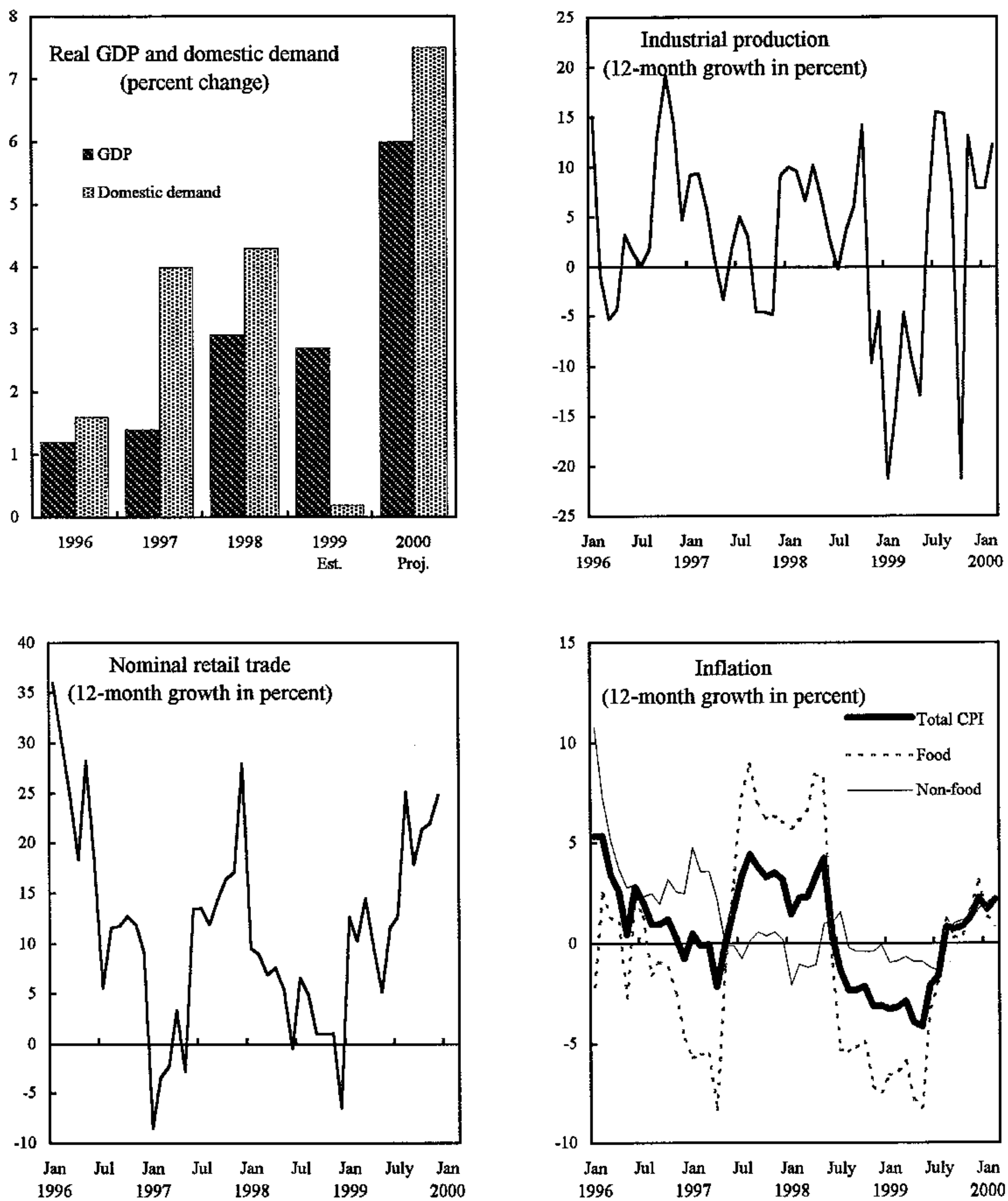
6. **After a generally favorable performance in 1998, the FYRM economy suffered a setback in the first half of 1999, mainly owing to deteriorating external markets and the Kosovo crisis**. However, the impact of this crisis was less severe than initially feared. With the ending of the conflict in early June 1999, economic activity picked up markedly and the balance of payments improved beyond expectations. The stance of financial policies was generally prudent in 1999, and inflation remained low. Structural reform initiatives resumed in the second half of 1999, but the follow-through was weak because of the uncertain political climate.

7. **A broad-based recovery in economic activity in the second half of the year was key to GDP increasing by an officially estimated 2.7 percent in 1999** (Table 1). The services sector suffered little during the Kosovo crisis, while output losses in industry were recouped quickly. Unlike the experience of the previous years, an improvement in net foreign demand was a major driving force behind this growth performance. Domestic demand was sluggish, mainly owing to erosion of investor confidence. Consumer prices declined in the course of the first seven months of 1999, largely because of lower food prices. Thereafter, inflation turned positive with the firming of food prices, higher oil prices, and increases in excise taxes on selected items (Figure 1).

8. **Labor market developments in 1999 had a positive overtone, but they did not represent a fundamental improvement**. The annual labor force survey indicates a fall of 2 percentage points in the unemployment rate, though it was still extremely high at 32½ percent. Employment in public administration increased, albeit without budgetary authorization. There was very little labor shedding in the enterprise sector during the Kosovo crisis, as employers forced workers to take leave at lower wages. With the rebound in activity, wage pressure emerged and employers also began to reduce wage arrears. For the year as a whole, the share of labor cost in output was virtually unchanged in industry and is likely to have increased in the monitored sector (Figure 2).

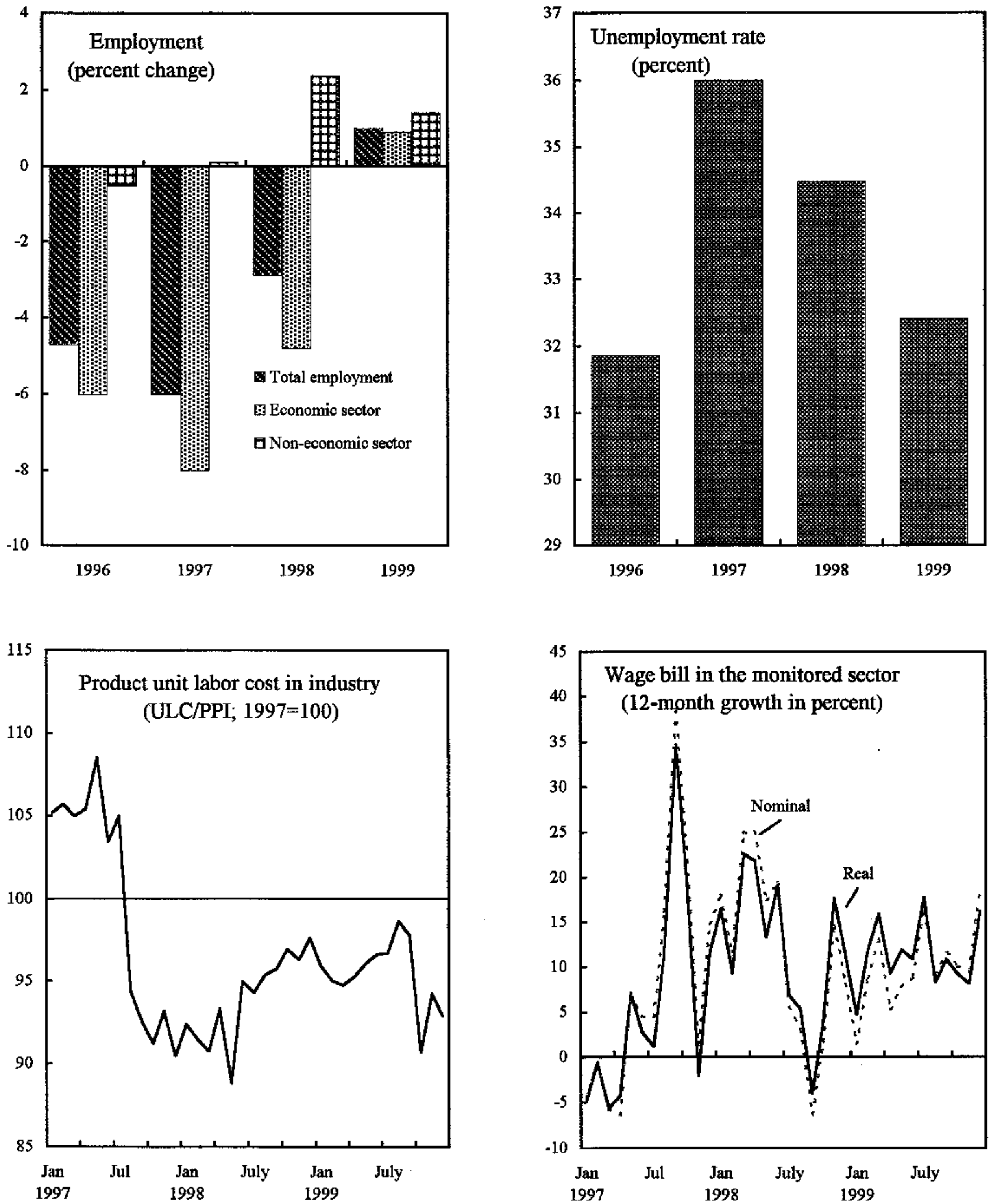
9. **The balance of payments position improved in 1999**. Initially, FYRM's trade was severely hit by the Kosovo crisis, but the ending of the hostilities and the rehabilitation of Kosovo under United Nations administration brought unforeseen gains in foreign exchange receipts. With the return of refugees, exports to the Federal Republic of Yugoslavia (mainly

Figure 1. FYRM: Economic Activity Indicators and Inflation



Sources: FYRM authorities; and IMF staff estimates.

Figure 2. FYRM: Employment and Wages 1/



Source: FYRM authorities.

1/ Employment data are based on administrative surveys; unemployment data are based on the labor force survey undertaken annually in April; and the nominal wage bill is based on data from the Payments Bureau (ZPP).

Kosovo) increased sharply, to nearly double the pre-crisis level. Consequently, the decline in export receipts in 1999 was limited to 8 percent, well short of the 27 percent fall projected at the height of the crisis in early June.[2] Imports declined by 6½ percent, mainly reflecting a drawdown of inventories by enterprises and the disruption of oil imports in the second quarter. Service receipts surged in the second half of the year, as FYRM served as a key transit route for travel and delivery of goods to Kosovo. Accordingly, the external current account deficit (excluding official grants) narrowed sharply to 6 percent of GDP (from 9½ percent of GDP in 1998). The capital account surplus also contracted, as the large foreign direct investment inflows experienced in 1998 were not sustained. However, with a sizeable amount of unrecorded inward transactions, many of them Kosovo-related,[3] gross official reserves increased by about US$125 million, to the equivalent of 2.7 months of next year's imports at end-December 1999 (Table 2; Figure 3).

10. **Indicators of external vulnerability remained satisfactory**. At end-1999, total external debt amounted to the equivalent of some 43 percent of GDP; the share of short-term debt was very small (3½ percent of GDP and 27 percent of official reserves).[4] Gross official reserves were nearly two-thirds the level of broad money. The average real effective exchange rate (both CPI-based and ULC-based) remained broadly unchanged in 1999 and near their most depreciated levels in five years (Table 3).

11. **The NBM faced contrasting challenges in the conduct of monetary policy during the Kosovo crisis and the post-crisis period**. With the onset of the crisis, banks experienced a liquidity shortage owing to large deposit withdrawals and delays in debt-service payments by enterprises. The NBM responded by injecting liquidity into the banking system through credit auctions and redemption of NBM bills. The liquidity position of banks improved dramatically in the post-crisis period, as residents began reconstituting their earlier deposit withdrawals and the NBM intervened in the foreign exchange market to neutralize appreciation pressures. This liquidity influx was largely sterilized, as banks wound down their credit lines with the NBM and invested in NBM bills. Official and money market interest rates peaked in May and fell sharply, to below pre-crisis levels, as liquidity in the banking system improved. However, notwithstanding the large swings in liquidity, the lending and deposit rates of banks remained virtually unchanged during the year (Tables 4 and 5; Figure 4).

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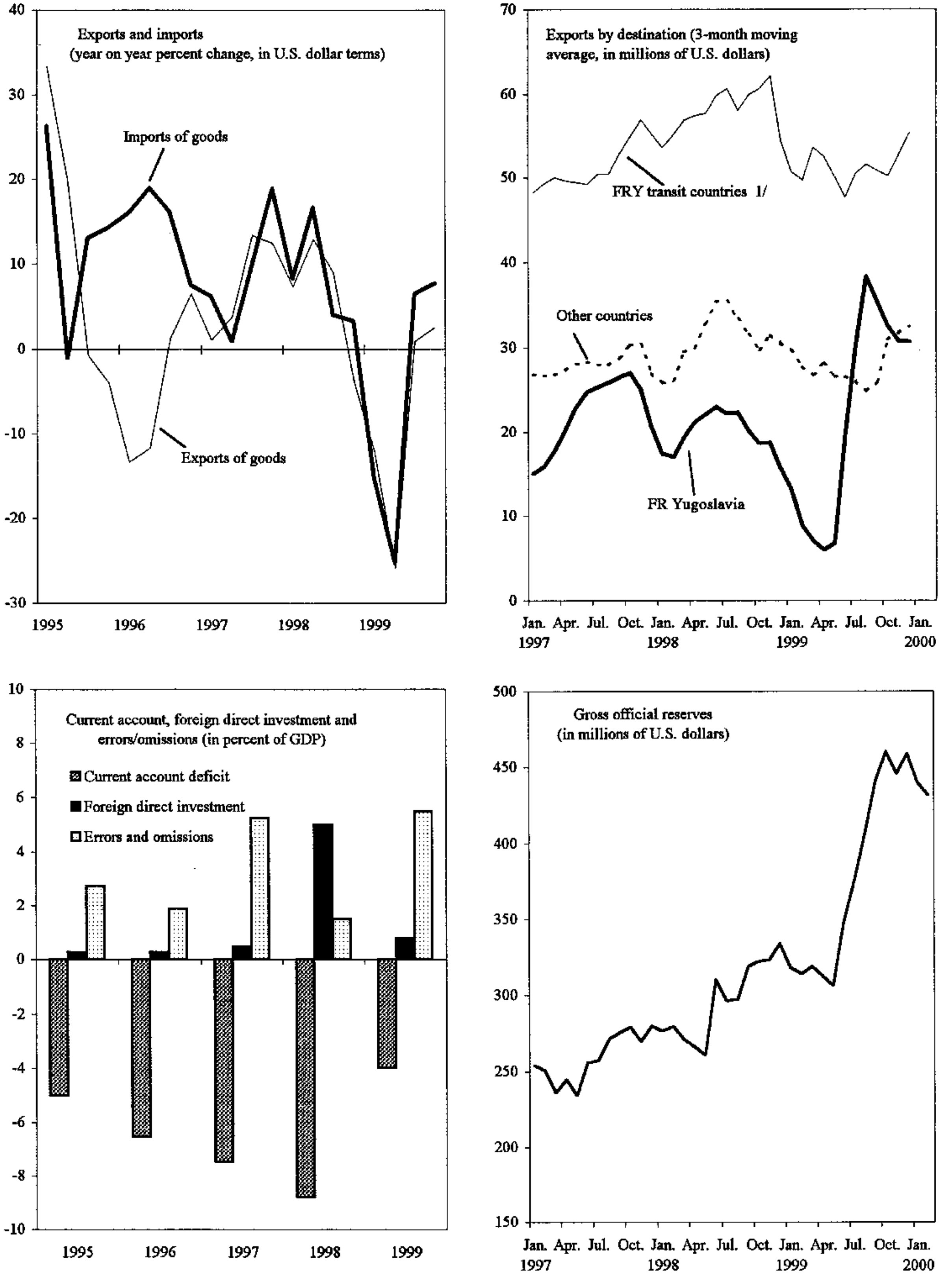
[2] While the shortfall in export earnings was much lower than originally anticipated, it still was higher than the amount purchased by FYRM under the CCFF. Thus, FYRM was not overcompensated.

[3] Examples of such transactions are domestic payments by humanitarian relief agencies, and purchases made by Kosovars during cross-border trips to FYRM.

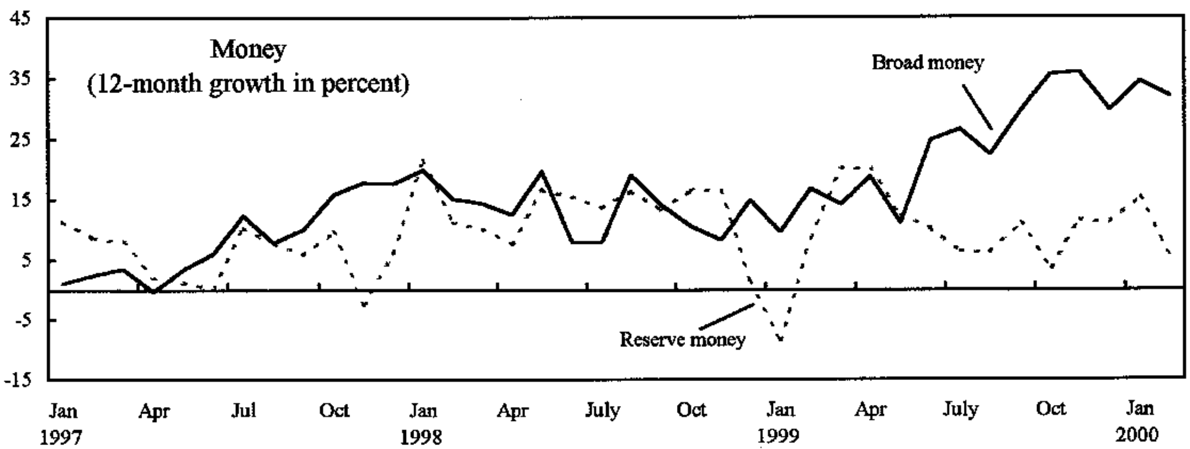
[4] The increase in the debt-to-GDP ratio during 1996-98 partly reflects the devaluation of the denar in mid-1997.

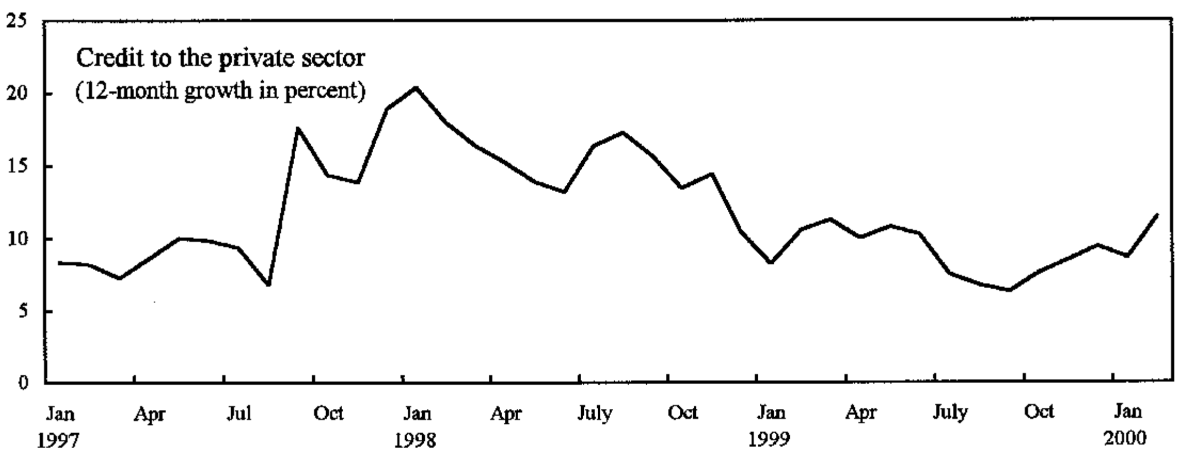
Figure 3. FYRM: External Sector Developments

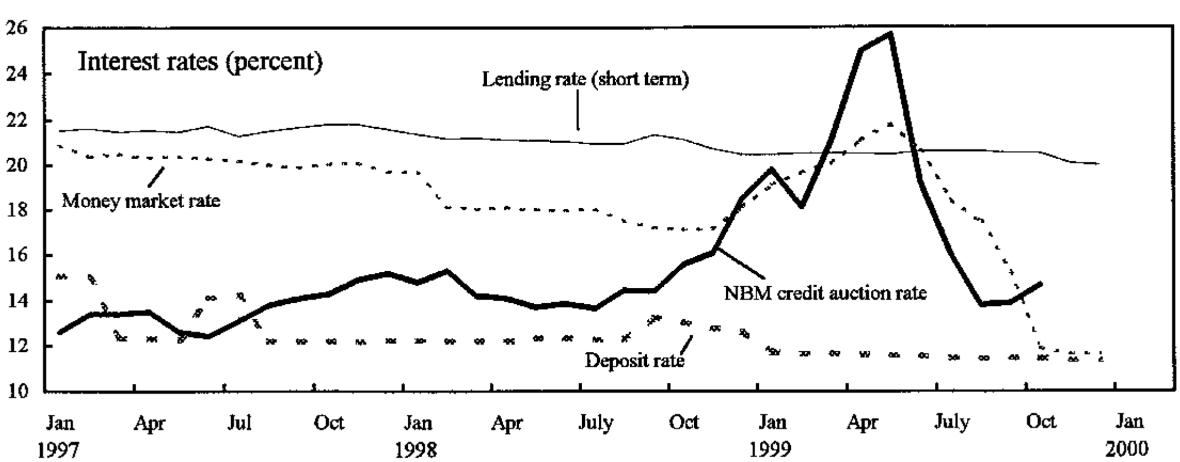


Sources: Data provided by the FYRM authorities; and IMF staff estimates.
1/ Exports to all European countries (including Russia, Ukraine, and Belarus) other than Albania, Bulgaria, Greece, and Turkey.

Figure 4. FYRM: Money, Credit and Interest Rates







Source: FYRM authorities.

12. **The fiscal situation improved in 1999 despite the Kosovo crisis, but there were lapses in expenditure management and control**. The central government accounts swung to a surplus of about 1 percent of GDP, compared with a deficit of 0.2 percent of GDP envisaged in the pre-crisis budget. The general government accounts, which include foreign-financed expenditure to build roads, were in approximate balance. Tax revenues were extremely buoyant—mainly on account of efforts to improve tax administration—and surpassed expectations. The FYRM budget incurred refugee-related expenditures of 1.3 percent of GDP, which were largely covered by donor support.[5] Aggregate expenditure on other categories was marginally higher than budgeted. There were slippages in outlays on wages, goods and services, and some social programs, but saving in other areas largely offset them. The breach of wage discipline was even more serious than indicated by budgetary data. Several line ministries made additional wage payments, totaling nearly 1½ percent of GDP, from their off-budget self-generated special revenues.[6] The payments were for salaries of staff recruited without budgetary authorization as well as wage increases (Tables 6 and 7; Figure 5).

Wage payments to Central Government employees

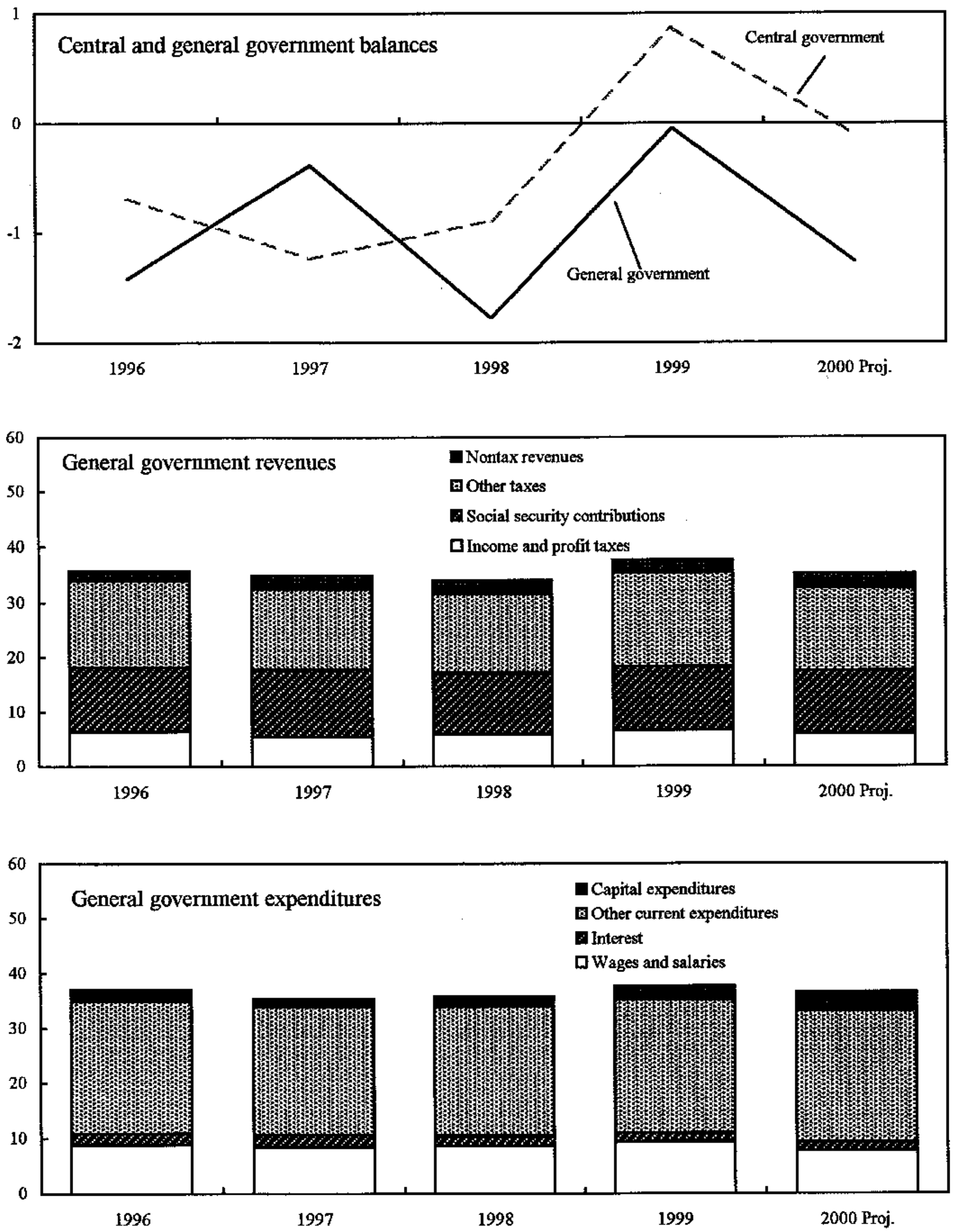
	1998	1999		2000
		Budget	Actual	Budget
		(In millions of denar)		
From the budget	15,940	15,860	17,757	15,955
From off-budget accounts	396	396	2,865	2,865 1/
Total	16,336	16,256	20,622	18,820
(In percent of GDP)	(8.6)	(7.9)	(10.6)	(8.8)

1/ Assuming unchanged policy.

[5] Because of delays in the arrival of aid from relief agencies, the government had to provide for the shelter and basic needs of the first wave of refugees. After humanitarian organizations took charge of refugee relief operations, the government continued to incur additional expenditures on utilities for camps, education, health care, special assistance to families hosting refugees, and operations to maintain social peace and border security.

[6] Off-budget expenditures of line ministries are constrained by the flow of self-generated special revenues. Thus, the consolidated fiscal balance including the off-budget operations would be similar to the balance of the budget accounts. Overall, special revenues amounted to 4.7 percent of GDP in 1999 (see the report on Recent Economic Developments).

Figure 5. FYRM: General Government Operations, 1996–2000
(Percent of GDP)



Sources: Data provided by the FYRM authorities; and official projections.

13. **On the structural front, a number of important measures were initiated in the second half of 1999 for reforming the tax system and addressing the problems of the enterprise and banking sectors.** A value-added tax (VAT) law was passed by parliament in mid-July 1999. However, because of the slow progress in administrative preparations, the introduction of the new tax was postponed from January to April 1, 2000. In the enterprise sector, attention was directed toward a subset of the 12 loss-making enterprises targeted for closure or sale under the Fund-supported program. After a sluggish start—only two enterprise cases had been resolved by end-1999—the pace picked up in the first quarter of 2000. By end-March, three enterprises were closed or liquidated, and five were sold.[7] In the banking sector, a majority share in Stopanska Banka, the largest commercial bank, was sold to a consortium of foreign investors in early April 2000. The government assumed liabilities equivalent to about 5 percent of GDP to help finance the restructuring of Stopanska Banka and several enterprises prior to their sale. The government received privatization revenues of about 1 percent of GDP for these sales.

III. Report on the Discussions

14. **The authorities' main objectives were to achieve sustained rapid economic growth, bring down the very high unemployment rate, and preserve macroeconomic stability.** The authorities recognized that the economic stimulus provided by the post-conflict developments in Kosovo was temporary. They hoped that a boost would come from the implementation of the "Stability Pact for Southeastern Europe", but were uncertain about the size and timing. While a few officials held the view that growth had been held back by lack of credit and deficient demand, there was a broad consensus that the supply response had been stifled by the structural weaknesses in the economy. Thus, the discussions focused on accelerating reforms to strengthen discipline and foster restructuring in the enterprise and banking sectors, to prioritize public expenditure and increase their delivery efficiency, and to improve labor market flexibility.

A. The Outlook for 2000 and the Medium Term

15. **The growth prospects for 2000 look favorable.** The authorities envisage an investment-led growth of 6 percent, though some downside risk has emerged because of the recent increase in the international price of oil. A rapidly improving regional environment should revive business confidence, and public infrastructure investment is set to increase markedly. The authorities also expect investment to be spurred by lower interest rates induced by banking sector reform. Average inflation is projected to rise to 4 percent in 2000, because of higher international prices of oil and non-fuel commodities, and taking into account the one-off impact of an increase in electricity tariffs and the introduction of the VAT.

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[7] In 1998, the losses of the 12 targeted enterprises amounted to 1.3 percent of GDP. The losses of the 8 enterprises which have been resolved amounted to 0.2 percent of GDP.

16. **The net contribution to growth from the external sector is likely to decline in 2000**. The authorities expect the extraordinary demand from Kosovo to persist, though with a somewhat lower intensity, and exports to other destinations to pick up. At the same time, however, imports are forecast to increase sharply, owing to special factors—such as the restoration of oil imports to normal levels, higher oil prices, and stock building—and higher investment demand. With the likelihood also of reduced official and private transfers following their Kosovo-associated peak, the current account deficit is expected to widen in 2000 to 9 percent of GDP (10 percent of GDP if official transfers are excluded).

17. **A modest external financing gap is foreseen for 2000**. The capital account is projected to remain unchanged. Also, domestic payments by humanitarian agencies (these are captured under the errors and omission item) should fall, as their activities wind down. The authorities indicated that their objective was to increase foreign exchange reserves to the equivalent of 3 months of next year's imports. They also agreed to apply the proceeds accruing to the government from the sale of Stopanska Banka toward the reserve cushion in 2000, since the deal involves assumption of foreign-currency-denominated liabilities that will have to be serviced. On this basis, a residual financing gap of about US$80 million would emerge, before new commitments from the World Bank and Fund. The authorities intend to seek assistance from the international community for filling the financing gap.

18. **Looking beyond 2000, the prospects should be bright if structural reforms are implemented and prudent macroeconomic policies are maintained**. Economic growth could be sustained at 6 percent annually through strong export demand and investment associated with structural transformation of the economy and development of infrastructure. Notwithstanding rising domestic saving and an improving saving-investment balance of the private sector, the share of foreign financed investment is expected to remain high (in part reflecting the implementation of the Stability Pact). In the staff's scenario, the external current account deficit (excluding grants) is projected to decline by 2½ percentage points of GDP to 7½ percent by 2004. It is assumed that project lending by bilateral and multilateral parties will be forthcoming at the current level and that enterprise borrowing and foreign direct investment will pick up progressively. Accordingly, given the authorities' aim to maintain a reserve cover of about three months of imports, financing gaps would persist but fall gradually to US$25 million by 2004. These would have to be financed by the international community. Total external debt and debt-service obligations are likely to remain modest over the medium term (Tables 8 and 9).

B. Fiscal Policy

19. **A tight fiscal stance has been a key element of FYRM's economic strategy in recent years**. Fiscal deficits have been relatively small, and mainly reflected externally financed (on concessional terms) capital expenditure. However, the overall fiscal position conceals a number of weaknesses. The taxation of labor income is very high, creating

disincentives for job creation.[8] With nondiscretionary spending—mainly wages, transfers, and social sector outlays—accounting for nearly four-fifths of total government expenditure, the scope for the budget to contribute to the restructuring of the economy is limited and fiscal management in the event of contingencies is difficult. The recourse to self-generated special revenues by line ministries that are not subject to the centralized budget allocation process results in possible misallocation of scarce resources as well as in weakened governance, transparency, and spending control.

20. **The central government budget for 2000 embodies the authorities' commitment to maintain financial discipline and implement reforms**. The budget is broadly balanced, reorients expenditure toward investment, includes an allocation for the recurrent costs of reform of the civil service and enterprise sector, and contains a small contingency reserve. On this basis, the general government accounts in 2000 would be in a deficit of about 1¼ percent of GDP. The difference between the central and general government balances mainly reflects expenditure on roads financed by the European Investment Bank (EIB).

21. **FYRM is likely to experience an overall drop in tax buoyancy in 2000**. The tax revenue-to-GDP ratio is expected to fall by about 1 percentage point, principally because of an increase in the share of duty-exempt imports on account of new free trade agreements; a one-time loss in tax collection in the transition from the sales tax to the VAT owing to a longer filing time under the VAT; and a decline in the shares in GDP of wages and consumption, which are the main tax bases. A part of these losses would be made up by higher excise tax collections, resulting from the government's decision to follow a flexible domestic oil price policy that would allow excises levied on oil derivatives to rise to their statutory level.

22. **The Ministry of Finance was worried that the heavy tax burden on excisable goods following the introduction of the VAT could trigger negative public reaction and encourage tax evasion.**[9] Only a month before the scheduled introduction of the VAT, they considered lowering excise tax rates and offsetting the revenue loss with increases in the VAT rates, but in the end they heeded the staff's advice to stay the course. The staff was concerned that a last-minute increase in the VAT rates would exacerbate an already tenuous situation, complicate tax administration, worsen the public's perception of the VAT, and could lead to a collapse in revenue collection. Even so, much remained to be done regarding staffing of a VAT unit and the education of taxpayers; a resident expert assigned by the Fund in October 1999 is helping the authorities with the implementation of the VAT. The staff advised the authorities that a review of changes in the tax structure should be undertaken only after it was clear that the VAT system, including the refund procedures, was fully

[8] Income taxes and social security contributions together amount to about 75 percent of take home pay.

[9] Goods subject to excise taxes were not subject to the sales tax but are now subject to the VAT.

functional. If it was determined that tax cuts were desirable, greater weight should be given to a reduction of payroll taxes, rather than of excise taxes, because of the high unemployment rate.

23. **Nondiscretionary expenditures will be held in check in 2000 to create room to finance the costs of reforms and an increase in public investment**. Outlays on wages are budgeted to return to the 1998 level, and transfer payments as a whole are slated to fall in nominal terms. A court-mandated increase in pension benefits would be more than offset by the saving from the expiration of the Program for Employment, which had been introduced by the previous administration for a two-year period and exempted new hires from tax and social security contributions. The authorities did not want the exemptions to become a permanent labor subsidy. They expressed concern that the net cost of this program had exceeded the budgeted level in 1999, and suspected that enterprises were declaring previously unregistered workers as new employees.

24. **While a scaling back of the wage bill allocation in the budget was welcome, it alone would not be sufficient to curb the upward drift in personnel costs**. Nor was this policy sustainable, as pressure was mounting from other ministries (without access to special revenues) to give matching wage increases. The authorities stated that it would be difficult to reduce wage payments financed by off-budget accounts in the short run, but that they would not accommodate pressures from the line ministries to shift these expenditures to the budget. Ultimately the solution lay in urgently addressing the long-standing problem of over-staffing in the civil service and implementing measures to enhance the Ministry of Finance's capacity for effective public expenditure management.

25. **The authorities noted that formulation of a public administration reform plan was already under way**, with assistance from PHARE. The authorities conducted a survey of all budget users and public administration personnel in the fourth quarter of 1999, with a view to preparing an employee register and identifying positions that could be eliminated in the short term without damaging public administration and public service provision capacities. On this basis, steps had been initiated to reduce employment in public administration by 6½ percent (or 6,000 workers) by June 2000 through early retirement. The staff advised the authorities to ensure that the benefit terms for early retirees were calibrated in accordance with the provisions of the existing pension law. The downsizing of the public administration would continue over the medium term through divestiture of noncore activities to the private sector and a consolidation of ministries; the authorities intended to seek assistance from the World Bank in this regard. The staff emphasized that the authorities should have an action plan ready soon and complete the identification of the core activities and responsibilities of the government quickly, in order to ensure that the special revenue accounts associated with the core activities were integrated into the 2001 budget. Until the noncore activities were divested, the use of their special revenues should be monitored closely.

26. **Technical assistance from the Fund and the World Bank is being provided to strengthen public expenditure management and install a full treasury function in the Ministry of Finance.** The authorities acknowledged that progress in developing expenditure management had been far short of the objectives elaborated in 1998 under the Fund-supported program. At their request, a resident treasury advisor was assigned by the Fund from January 2000 to facilitate an acceleration of reform in this area. The staff emphasized that the budget and treasury divisions at the Finance Ministry would need to be adequately staffed, in order for the tasks to be carried out effectively.

27. **The staff encouraged the authorities to adopt a medium-term framework for fiscal policy formulation.** A major challenge was maintaining fiscal restraint to ensure external sustainability, while making room for payroll tax cuts and additional priority expenditures. These expenditures include the following:

- **Cash servicing of frozen foreign currency deposits, which were taken over by the government shortly after independence, beginning in 2000.** The stock of these deposits at end-1999 amounted to about DM 1.1 billion (about 17½ percent of GDP). The authorities plan to settle the liabilities to small depositors in cash, and swap the liabilities to larger depositors for negotiable government bonds that would mature linearly over a 12-year period.[10] The proposed scheme would not increase the level of the commitment-basis fiscal deficit or outstanding public debt, as these obligations were explicitly recognized in the budget for previous years. The proposed grace period for amortizing the bonds (two years) is shorter than the staff's suggestion (five years), but the authorities agreed to take steps to ensure that earlier repayment did not pose an unmanageable burden on the budget. The authorities believed that this initiative would help rebuild public confidence in the domestic financial system and develop the domestic capital market.

  The bond swap scheme for frozen foreign currency deposits will not result in elimination of the exchange restriction subject to Article VIII, Section 2(a). While these deposits are believed to be predominantly related to capital transactions which do not fall within the scope of Article VIII, they also include some proceeds of current international transactions that are covered under Article VIII. To separate these two types of proceeds, the authorities could have put in place procedures that would limit amounts withdrawn and transferred abroad and required depositors to demonstrate that they are nonresidents and that amounts to be transferred represent proceeds from current international transactions. However, owing to the perceived administrative burdens, the authorities have not introduced such procedures. Given this, the exchange restriction embedded in these bonds would prevail until they were fully retired in 2012. The staff

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[10] Of the nearly 850,000 depositors, nearly four fifths had deposits at or below DM 200. Six depositors had more than DM 1 million in their accounts.

agreed with the authorities that this scheme was consistent with the budgetary and balance of payments constraints presently faced by FYRM.

- **The constitutional court's October 1998 ruling requires the government to make retroactive payments to pensioners**. The government's liability was estimated by various official sources to be in the range of 3 to 10 percent of GDP. The government was negotiating with the pensioners' association on the amount, the means of settlement, and timing of the payments.

- **Public administration reform and restructuring of enterprises and banks will involve both one-off and recurrent costs to the budget**. The staff emphasized that the modalities of reforms should be determined on the basis of a thorough costing exercise.

28. **External current account sustainability is likely the binding constraint on the fiscal stance in the medium-term.** If the current account deficit is to decline as projected in paragraph 18, and assuming an increase in the private saving rate, the general government deficit as a ratio to GDP will need to fall by nearly one half from 1.3 percent in 2000 to 0.7 percent in 2002 (Table 8). There is little room for complacency if the fiscal balance path is to be achieved. Non-interest current expenditure in real terms would have to be held constant in 2001, and it could increase by about 3½ percent in the succeeding years, taking into account the following: (i) the scheduled elimination from January 2001 of the fee for processing customs documentation; (ii) the interest obligations on the current level of outstanding debt (excluding the retroactive payments due to pensioners); and (iii) higher infrastructure investment. Further expenditure restraint would be necessary in order to accommodate a payroll tax cut or if the government was to assume additional liabilities on account of enterprise restructuring. Given the limits to sustainable expenditure cuts, the authorities would likely need to use privatization proceeds, including from the sale of Telecom, to cover retroactive payments to pensioners and the costs of reforms.

29. **Pressure has been mounting on the government to reimburse large depositors in the pyramid scheme of the TAT savings house that failed in 1997**. To take care of social concerns, the government had compensated small depositors soon after the savings house failed. Thus, the staff noted that quite apart from the cost—the outstanding liabilities to the depositors amounted to 1¾ percent of GDP—the moral hazard risks of a second bail out using budgetary resources could be very serious. The staff stressed that the government should adhere to its earlier commitment that any compensation to depositors should be financed from the sale of seized assets of the savings house.

C. Monetary and Exchange Rate Policy

30. **As forecasts for money demand remain subject to a high degree of uncertainty, the NBM will continue to orient monetary policy toward sustaining the exchange rate anchor**. The denar is de facto pegged to the deutsche mark (euro). The NBM considered the current level of the exchange rate to be appropriate. However, against the background of the complications faced in the conduct of monetary policy—after the Kosovo crisis on account

of unexpectedly large foreign exchange inflows—the NBM considered introduction of a band of ±5 percent around the central parity. This proposal was also backed by key policymakers, who felt that the denar should depreciate, to provide a cushion for loss-making exporters and to facilitate lower domestic interest rates.

31. **The staff agreed with the NBM's assessment that external competitiveness was adequate at the current level of the exchange rate**. The trends in the real exchange rate indices did not suggest a problem with competitiveness; both the CPI-based and ULC-based indices remained near their most depreciated levels in five years. The weak export market penetration, which was worrisome, could be attributed to structural factors (see Box). Accordingly, the staff considered that efforts to enhance competitiveness should focus on productivity gains from enterprise restructuring and cut in payroll taxes. External competitiveness (and the exchange rate regime) would, of course, need to be kept under close review because of the likelihood of change in the underlying fundamentals owing to structural transformation of the economy.

32. **The staff acknowledged that an exchange rate band might eventually be a useful exit mechanism from the fixed rate regime**. However, in the present circumstances—given the sentiment of key policymakers—the likelihood was that adoption of a band would translate into a nominal depreciation to the outer edge of the band. In that case, the NBM would need to respond by raising interest rates in order to preserve the credibility of the central parity and the exchange rate anchor. The staff advised the authorities that, should temporary foreign exchange inflows again generate appreciation pressures, sterilized intervention would be appropriate in the short run. If inflows proved persistent, the policy choice would be more difficult. The authorities would need to assess, in consultation with the Fund staff, whether an easier liquidity situation or tighter fiscal stance was appropriate or whether the negative impact of an appreciation could be absorbed.

33. **The staff supported the NBM's view that monetary policy had not been excessively tight**. Some officials pointed to the high real interest rates coupled with the recent price deflation as signs that credit policy could have been easier. The staff noted that the price deflation stemmed from temporary factors. The jump in the credit auction rate of the NBM during April-May 1999 was an unavoidable consequence of the Kosovo crisis. Official interest rates in real terms following the crisis were lower than comparable rates in neighboring countries (e.g., Albania and Romania). The key problem was not the aggregate availability of credit, but its poor allocation and high bank lending rates. A substantial amount of bank credit had been channeled to loss-making enterprises, often at the behest of the government and perhaps reflecting the banks' belief that a government bailout was bound to happen. This had perpetuated a large stock of nonperforming loans.[11] Lending rates were

[11] Nearly four-fifths of the credit expansion by the banking system during January-September 1999 was directed toward the 16 largest high-risk borrowers (i.e., those with debts classified in the substandard, doubtful, and loss categories). Nonperforming loans increased to 45 percent of total loan exposure at end-September 1999 from 33 percent at end-December 1998.

Box 1. FYRM: External Competitiveness

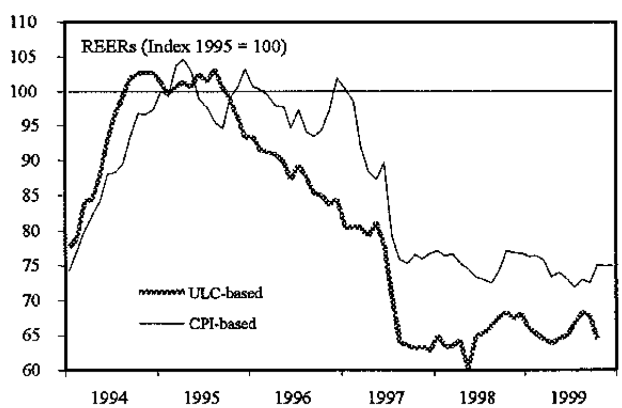
Competitiveness indicators in terms of real effective exchange rate (REER) indices show that FYRM's competitiveness has been broadly maintained since the devaluation of July 1997. The CPI-based and ULC-based REERs exhibit similar trends.[1] In terms of depreciation of REERs as well as of bilateral real exchange rates, competitiveness has improved much more for FYRM than for several other Balkan countries.

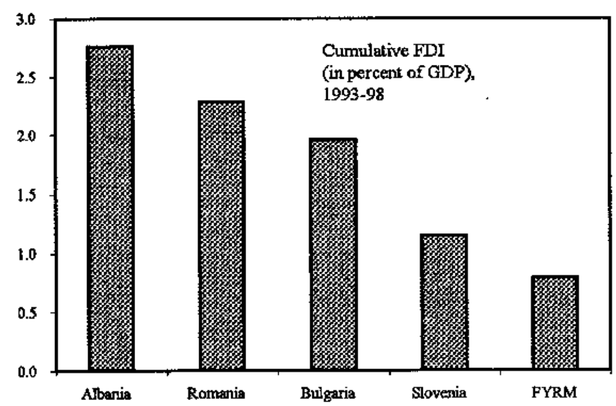
The shares of FYRM's exports in the markets of its major trade partners have not increased much since 1996. There was a gain in market share with Germany in 1998, which reflected the resumption of operations of a major iron and steel factory following its privatization, but the share remained well below the peak achieved in 1995. The share in the United States market rose significantly in 1996 after cessation of the Greek trade sanction, but there has been no gain in share since then. These trends are in sharp contrast to the more positive experience of Romania and Albania.

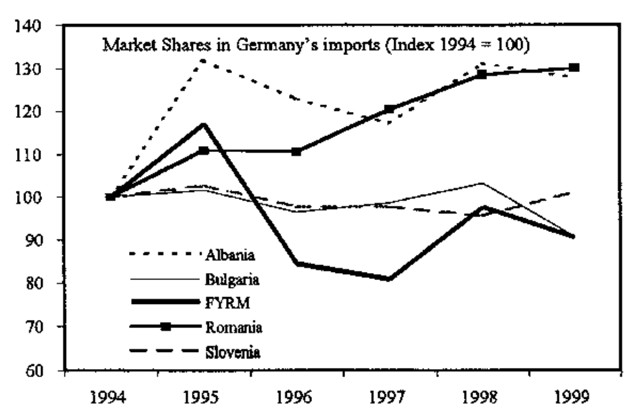
Structural factors seem to underlie this disappointing export performance. One factor may be FYRM's limited success in attracting foreign direct investment (FDI). Although there was some pick up in 1998, FYRM has absorbed far less FDI (relative to GDP) than other countries in the region. Albania and Romania, who had the largest gains in export market shares, were also the leaders in terms of FDI inflows.

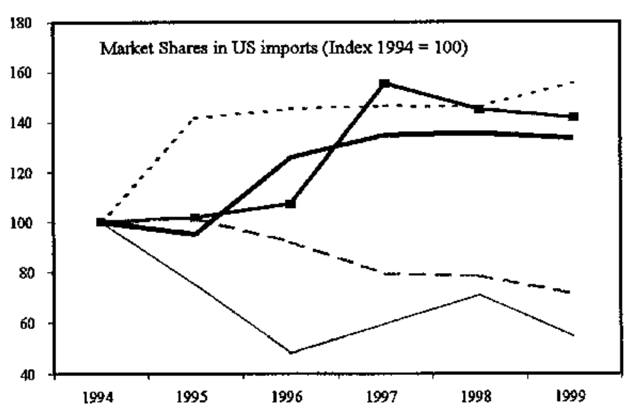
Under this circumstance, the authorities should refrain from exchange rate adjustment. The focus should be on enhancing competitiveness through productivity gains from enterprise restructuring and cut in payroll taxes. Premature introduction of flexibility in the exchange rate market, say by introducing an intervention band, would undermine credibility of the authorities' commitment to the current parity. In the future, FYRM may choose to exit from the current de facto DM peg policy if it is warranted by change in the underlying fundamentals owing to structural transformation of the economy.

[1] The calculations were based on the chain index method, where trade weights change each year.









high because of the consequent need for banks to make appropriate loan-loss provisions.[12] An easing of credit conditions in a situation where banks continued lending to high-risk borrowers would only further undermine the financial viability of banks, and would ultimately entail fiscal outlays associated with rescue efforts. Accordingly, the staff advised the authorities to focus on enforcing better lending discipline on banks and other initiatives that would reduce intermediation costs (see below).

34. **The NBM has formulated a monetary program for 2000, in consultation with the staff, consistent with the growth, inflation, and net foreign assets targets set out in Section III.A.** Quarterly quantitative targets have been established to monitor performance. The velocity of broad money is likely to decline further, as bank rehabilitation should increase public confidence in domestic monetary institutions and exchange rate stability would encourage greater holding of money balances. With banks acquired by strategic investors also receiving equity injection and the government building up its deposits with the NBM, there would be scope for an increase in private sector credit in 2000 of 16 percent, consistent with the large expected increase in investment and stock accumulation.

35. **From April 2000, the NBM has moved to a system of monetary control based solely on the use of indirect instruments.** Direct credit ceilings have been transformed into an instrument for supervisory control. Initially, NBM bills and repurchase operations would be the main indirect instruments. Treasury securities would become progressively important for conducting open market operations once a market for them had been developed, with technical assistance from the Fund; the proceeds from the sale of treasury securities would be deposited with the NBM. The authorities confirmed that interest rates on open market instruments would be flexible and market determined.

D. Structural Policies

Enterprise sector reform

36. **The slow progress in implementation of measures to improve governance and foster restructuring has resulted in a deterioration in the financial situation of state- and socially owned enterprises** (SSOE). Losses of enterprises targeted for action under the recent Fund-supported program have continued to mount. More generally, the proportion of SSOEs reporting losses and their contribution to the aggregate losses of the enterprise sector have increased. A sizable number of persistent loss-making enterprises are financed through arrears to workers, suppliers, the government, and banks. In recognition of these conditions, the authorities have intensified their efforts to find solutions for an identified subset of the targeted enterprises. They have also identified additional loss-makers for inclusion in the reform agenda, and have established a schedule for addressing their problems over the next

[12] While the spread between the nominal lending and deposit rates have been about 8-10 percent, the effective net interest margin of banks (i.e., based on interest actually collected by banks) as a ratio to total assets has fluctuated in the 1–5 percent range.

two years. The authorities have requested World Bank support for these reform efforts. Discussions on a possible Financial and Enterprise Sector Adjustment Loan will resume once the pre-appraisal conditions have been met.[13]

37. **The authorities stated that they had experienced difficulties in finding strategic investors for the loss-making enterprises**, for the following reasons: the enterprises were financially unviable, the sale to a foreign investor was often opposed by the trade union, and potential investors had a negative perception about FYRM. Trade union pressure and the desire to avoid unemployment had influenced the authorities to sell two of the targeted enterprises to employees, and to delay closures.

38. **The staff emphasized that a more structured and transparent cost-benefit approach should be taken to prepare remedial action plans for the remaining loss makers**, bearing in mind that the costs of restructuring would need to be contained at a level consistent with fiscal sustainability. Noting that substantial liabilities had been assumed by the government under the Special Restructuring Program in 1995 (12½ percent of GDP) and in the current round of bank and enterprise restructuring operations (thus far, 5 percent of GDP), the staff stressed that permanent shutdown of some loss-makers was unavoidable if the "flow problem" was to be arrested. It also would be important to refrain from adopting measures that would result in further injection of budgetary resources on an ongoing basis into enterprises sold or leased to strategic investors. The staff expressed concern that steps had not yet been initiated to operationally restructure and improve governance in the enterprises whose bad loans had been removed from the books of Stopanska Banka, and urged the authorities to take prompt action.

39. **As for the remainder of the privatization program, the emphasis would shift away from insider buyouts, mainly out of concern for governance issues**. Some 240 SSOEs, with a total appraised value of DM 513 million (7½ percent of GDP)—about 14 percent of the total number and 11 percent of the total appraised value of the SSOEs originally slated for privatization—remained to be privatized. The authorities indicated that these enterprises would be sold on the stock exchange or by public auction. The Privatization Agency would also create share packages with management rights by bundling minority interest shares of government agencies in already privatized enterprises with shares on which the purchasers had defaulted. In order to attract foreign investors, the authorities were determined to streamline regulations and implement the recommendations of a recent study by the Foreign Investment Advisory Service concerning the factors that inhibited foreign investment in FYRM. The authorities explained that the sale of a large equity position in

[13] Only one condition remains outstanding. This entails hiring an expert to undertake a cost-benefit analysis for the options concerning Feni, the second largest lossmaking enterprise, and acting upon the expert's recommendation to close or sell the company.

Telecom had been postponed because of the Kosovo crisis and the presidential elections. They envisaged that the preparatory steps for the sale would begin toward the latter part of 2000 and the deal could be finalized in the first half of 2001.

40. **The authorities recognized that a strengthening of the legal framework to enhance enforcement of creditors' rights was essential for improving enterprise governance**. Accordingly, amendments to the relevant laws would be introduced during the first half of 2000 with the aim of closing the loopholes currently open to debtors to delay bankruptcy proceedings, permitting creditors to take possession of collateral with the prior approval of the courts, and facilitating foreclosure on loans secured by real estate property. In this context, the staff expressed concern about a scheme announced by the government in early January 2000 that would provide relief to enterprises on overdue tax payments. This scheme would mark a reversal of the government's earlier commitment to take the lead in initiating bankruptcy proceeding in cases of tax arrears. The staff argued that the scheme would weaken enterprise governance and pose renewed moral hazard problems. The authorities indicated that for political reasons it would not be possible to withdraw the scheme altogether, but they scaled it down considerably. Although the monetary costs of the scaled back scheme are small—the unpaid tax obligations of the 4,000 enterprises covered under the scheme amount to 0.1 percent of GDP—the negative signal remains.

Banking sector reform

41. **FYRM's banking system is fragile.**[14] The quality of loan portfolios is poor, some banks are under-provisioned, and profitability of the system has deteriorated. As of September 1999, eight banks—accounting for over 50 percent of banking system assets—fell in the category of troubled banks, with CAMEL ratings of 4 or 5.[15] Stopanska Banka, the largest commercial bank with 35 percent of banking system assets, was in this group.

42. **Shortcomings in bank supervision have contributed to the banking sector's problems**. A joint Fund-Bank mission in November 1999 determined that the NBM had made notable progress in developing a regulatory and legal framework of bank supervision that was largely compliant with the Basel core principles. But, inadequate off-site supervision and weak regulatory enforcement had resulted in a wide gulf between the prudential regulations and the health of the financial sector. The staff expressed concern about the

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[14] An assessment of the soundness of FYRM's banking system is included in the report on Recent Economic Developments.

[15] A CAMEL rating is a measure of the relative soundness of a bank and is calculated on a scale of 1 to 5, with 1 being a strong performance. CAMEL stands for capital, asset, management, earnings, and liquidity.

NBM's forbearance toward noncompliance with prudential standards, noting that a troubled bank had continued to extend loans and issue uncovered letters of credit during 1999 to some high-risk borrowers despite the full-time presence of on-site inspectors.

43. **The NBM has taken initial steps to strengthen off-site monitoring ability**. A separate unit has been established in the supervision department to monitor the performance of individual banks under protocols or supervisory measures, and to undertake closer analysis of off-balance sheet returns. Technical assistance has been sought from the Netherlands Central Bank for the development of an early warning system.

44. **The authorities expected banking practices to improve significantly system-wide and a consolidation process to commence with the sale of Stopanska Banka**. A stronger Stopanska Banka under foreign ownership was likely to prompt other banks to attract foreign investors or to merge. There were already signs of heightened interest of foreign investors in FYRM's banks. The NBM was committed to facilitating the consolidation process through an enforcement of the minimum capital requirement[16] and a stricter enforcement of prudential regulations. It had already established a problem bank unit, and was preparing a problem bank resolution strategy that would lay out the role and responsibilities of this unit in the areas of both pre-failure corrective steps and actual bank failure resolution. The problem bank unit is in the process of establishing objective criteria for the provision of NBM or government support to troubled banks. The authorities confirmed that NBM or government resources would not be devoted to bail out nonviable banks, especially if their closure did not pose any systemic risk. In this regard, they noted the recent closure, although much delayed, of a small insolvent bank with 4 percent of banking system assets.

Poverty reduction and labor market reform

45. **The authorities will soon initiate preparation of a draft Interim Poverty Reduction Strategy Paper (PRSP), in consultation with the civil society and donor community**. About one-fifth of FYRM's population was estimated to be living below the poverty line (defined consistent with OECD norms) in 1996, which was somewhat less than in neighboring countries (Appendix V). Two-thirds of the poor lived in rural areas, and nearly one half of all poor lived in households with at least one unemployed person. FYRM has a well developed social safety net for alleviating poverty. In the 2000 budget, an amount equivalent to 3½ percent of GDP has been allocated for social programs (unemployment benefit, means-tested social assistance, and child allowance). The authorities have sought technical assistance from the World Bank to better target social assistance benefits to the poorest households.

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[16] The minimum capital requirement is scheduled to increase from DM 15 million to DM 18 million on April 1, 2000, and to DM 21 million on April 1, 2001.

46. **The authorities considered labor market reform and employment promotion as key elements of their poverty reduction strategy**. Efforts to tackle the unemployment problem are at an early stage.[17] The authorities feared that many of the registrants with the Employment Bureau were already employed and were abusing the social safety net provisions. A program would therefore be launched soon to check the prevalence of unregistered workers at enterprises.

47. **The authorities recognized that increasing labor market flexibility was important**. Toward this end, they had amended the labor law to decentralize the system of collective bargaining to the enterprise level, and to improve the ability of firms to hire and fire workers. They had also revised the employment law to restrict the eligibility for special lifetime unemployment benefits. The staff encouraged the authorities to reduce the net benefit replacement ratio and limit the duration of unemployment assistance (both of which were among the highest in the region) in order to enhance the incentive for job search.[18] The authorities indicated that such a proposal was likely to be opposed by the trade unions.

48. **To generate employment opportunities, the authorities were keen to foster a dynamic small and medium-sized enterprise sector and promote investment in economically underdeveloped regions**. External financing was available for this purpose, but its utilization had been slow because of weaknesses in the financial sector infrastructure and the inability of businesses and the government to identify sound projects. The authorities agreed with the staff that a reduction of payroll taxes would also encourage job creation.

Pension reform

49. **Benefits and eligibility criteria have been changed recently to improve the financial position of the pay-as-you-go pension system**. These changes include increasing the retirement age; reducing the replacement rate; and changing the basis of indexation from wages to wages and prices. The authorities have also established the legal framework for introducing a fully-funded mandatory second pillar to the pension system by September 2001. The staff noted that further strengthening of the pension system was necessary, because the recent changes were not predicated on a likely cut in payroll taxes.

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[17] The dimensions of the unemployment problem are discussed in the report on Recent Economic Developments.

[18] In FYRM, unemployment benefit is paid for as long as 18 months (and even indefinitely for some groups), whereas in most other countries in the region the maximum duration is 12 months or less. The net benefit replacement rate in FYRM is 40-50 percent, which is similar to that in Greece but higher than in Albania (38 percent), Romania (27 percent), and Bulgaria (20 percent).

Trade and exchange system

50. **FYRM has a fairly open trade regime, following the reform measures implemented in 1996.**[19] Recent initiatives have been directed toward negotiating free trade agreements with countries in the region and with EFTA countries. Negotiations started in April 2000 on a stabilization and association agreement with the European Union. FYRM's request for accession to the World Trade Organization is in process. Import restrictions on selected consumer goods introduced at the onset of the Kosovo crisis have been totally eliminated. The government is preparing amendments to the tariff law with a view to lowering the rates on raw materials and increasing the rates on agricultural products. These adjustments would leave the average tariff rate broadly unchanged. This issue will be revisited in the context of the preparation of the PRSP and also during FYRM's discussions on the association agreement with the European Union.

E. Other Issues

51. **The staff conducted a technical consultation with the authorities to assess the effectiveness of past technical assistance provided by the Fund and identify possible future needs** (Appendix IV). The experience with implementation of advice has been mixed. In the areas of monetary and balance of payments statistics, the recommendations have been successfully implemented. However, in several other areas—for example, government finance statistics, public expenditure policy and management, and monetary operations—there has been only minimal or no progress with implementation. The authorities attributed these deficiencies to earlier capacity and staffing constraints, and noted that corrective steps were being taken. They identified the following areas for future technical assistance: development of quarterly national accounts; compilation of government finance and debt statistics; introduction of Treasury securities and repurchase operations for conducting open market operations; improving compliance of banking regulatory and supervisory framework to the Basel core principles; and adherence to the Fund's General Data Dissemination System.

IV. Staff Appraisal

52. **Macroeconomic developments in FYRM were positive in 1999, despite the Kosovo crisis**. The post-conflict developments in Kosovo provided a sharp stimulus to economic activities in the second half of the year. Thus, real GDP grew, inflation was absent, the fiscal position improved owing to buoyant tax collection, and foreign exchange reserves increased substantially. The outlook for the near term looks bright, as the demand stimulus from Kosovo is likely to persist and the Stability Pact for Southeastern Europe is in prospect.

[19] The overall restrictiveness of the trade regime is quantified as 3 in the Fund's 10-point classification index (where 1 is the lowest level of restrictiveness and 10 is the highest).

53. **If the near-term potential is to be realized and strong economic growth sustained, the authorities will need to continue pursuing prudent financial policies and to strengthen the supply response of the economy through structural reforms.** The progress on structural reforms under the recently expired Fund-supported program was disappointing. The authorities have begun to direct their attention toward addressing the unfinished agenda and have made notable strides. But, more discipline and vigor need to be introduced into the reform process. To demonstrate their commitment and to steer public expectations, the authorities should urgently lay out the key components and timetable of their structural reform program for the next few years.

54. **The central government budget for 2000 provides a signal of the authorities' commitment to maintain financial discipline and implement reforms.** The focus now should be on strict execution of the budgetary plans. The authorities should resist firmly pressure from interest groups for specific relief or support. In this regard, the recently announced scheme providing tax relief to enterprises on overdue tax payments sends a negative signal. Given last year's experience with a breach of wage discipline, keeping a tight lid on personnel expenditure in 2000 will be a challenge. While the authorities' decision to begin downsizing the bloated civil service in 2000 through early retirement is an important first step toward addressing this issue, they will need to press ahead with divestiture of noncore activities to the private sector and consolidation of ministries. It is also important that special revenue accounts are integrated into the 2001 budget at the latest.

55. **The authorities should develop a comprehensive medium-term fiscal framework, with a clear ordering of priorities.** Room will have to be created within the appropriate fiscal targets for the additional claims on budgetary resources that will arise from repayment of the frozen foreign currency deposit bonds, the court-mandated retroactive payments to pensioners, and the restructuring of enterprises and banks. Given the high unemployment rate, it would also be desirable to create budgetary space for a cut in payroll taxes.

56. **The prevailing exchange rate regime has served FYRM well, and the current level of the rate appears to be appropriate.** The introduction of an exchange rate band would likely lead to a depreciation to the outer edge of the band, and could undermine the credibility of the authorities' commitment to the current parity. The high level of bank lending rates in FYRM is not due to support of the exchange rate anchor through an overly tight monetary policy. Rather, these high interest rates reflect a large share of nonperforming loans in the banks' portfolios, which has been perpetuated by bad lending practices and delays in banking sector reform.

57. **Banking sector reform is key to a better allocation of resources.** The sale of Stopanska Banka to foreign investors represents a major stride toward a more sound and more competitive banking sector. The NBM has taken steps in the right direction to develop its off-site monitoring capacity and to establish a problem bank unit. Prompt corrective actions against banks in noncompliance with supervisory guidelines and prudential regulations will help facilitate the orderly exit of troubled institutions, and reduce moral hazard.

58. **An acceleration of the pace of enterprise sector reform is paramount**. The authorities have made appropriate decisions to expand the list of loss-makers for inclusion in the reform agenda and to sell to non-insiders the minority shares of government agencies. A remedial action plan for loss-making enterprises needs to be formulated quickly on the basis of a thorough analysis of the fiscal costs of different options, and bearing in mind that the costs to the budget would need to be consistent with macroeconomic stability. Loss-making enterprises that are judged to be viable should be sold to strategic investors within a strictly time-bound framework. Enterprises whose financial status has deteriorated beyond the point where restructuring can restore viability should be closed forthwith. Corporate governance and enterprise performance will not improve unless there is strict implementation of the various amended laws on bankruptcy procedures and creditors' rights.

59. **FYRM will need financial support from the international community over the medium term**. The path of the external current account in the balance of payments is broadly consistent with rapid growth as well as adjustment. The financing gaps in the staff's medium-term balance of payments scenario are modest and are predicated on the authorities' desire to maintain the level of foreign exchange reserves at the equivalent of three months of imports.

60. **The authorities' bond-swap scheme for frozen foreign currency deposits will not result in the elimination of the exchange restriction subject to Article VIII, Section 2(a), as the deposits include some proceeds of current international transactions**. It is recognized that the maturity structure of these bonds is consistent with the present budgetary and balance of payments constraints faced by FYRM. However, in view of the long expected duration of these bonds and hence the exchange restriction, the staff does not recommend approval of the exchange restriction. Other than this exchange restriction, the exchange system of FYRM is free of restrictions subject to Article VIII, Section 2(a).

61. **There is an urgent need to improve the quality, scope, and timeliness of statistics—especially in the areas of national accounts, government finance statistics, and the balance of payments—to help in economic policy formulation and surveillance.** Efforts also need to be made to utilize technical assistance more effectively.

62. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. FYRM: Selected Economic Indicators, 1996–2000

	1996	1997	1998	1999 Pre-crisis Estimate	1999 Kosovo Scenario	1999 Prel. Actual	2000 Projection
Real economy				(Percent change)			
Real GDP	1.2	1.4	2.9	5.0	-4.0	2.7	6.0
Consumer prices, period average	2.3	2.6	-0.1	1.0	2.0	-0.7	4.0
Real wages, period average	0.5	0.2	3.8	2.0	-0.5	3.6	-0.3
Employment							
Monthly series on monitored sector	-4.7	-6.0	-2.9	1.0	-6.0	1.0	1.4
Labor force survey	...	-4.7	5.4	...	...	1.0	...
Unemployment rate (average) 1/	31.9	36.0	34.5	34.3	36.5	32.4	32.4
Government finances 2/				(In percent of GDP)			
General government revenues and grants	36.5	34.9	34.0	33.5	33.7	37.7	35.3
General government expenditures and net lending	37.0	35.3	35.8	35.6	41.5	37.7	36.6
General government balance (accrual)	-0.5	-0.4	-1.8	-2.1	-7.7	0.0	-1.3
Central government balance (accrual)	-0.7	-1.2	-0.9	-0.2	-5.6	0.9	-0.1
Government debt 3/	41.5	48.1	45.7	...	...	53.2	53.3
Money and credit				(Percent change, end of period)			
Broad money M3 4/	0.3	15.8	14.9	8.4	-3.7	29.7	11.3
Private denar M2	2.3	13.2	11.1	11.4	0.0	33.5	11.2
Total credit to private sector	19.0	18.9	10.4	11.8	7.6	9.4	15.9
Short-term lending rate	23.2	21.6	20.5	...	...	20.0	...
Credit auction rate 5/	11.0	15.2	18.5	...	...	14.7	...
Balance of payments				(In millions of U.S. dollars)			
Exports	1,147	1,237	1,292	1,396	961	1,192	1,345
Imports	-1,464	-1,623	-1,711	-1,791	-1,484	-1,601	-1,831
Trade balance	-317	-386	-418	-395	-524	-409	-486
Current account balance	-288	-277	-308	-251	-489	-136	-321
(in percent of GDP)	-6.5	-7.4	-8.8	-6.7	-14.5	-4.0	-9.0
Overall balance	-96	16	44	-3	-309	99	-147
Official gross reserves	267	280	334	373	373	458	528
(in months of current year's c.i.f. imports)	2.0	1.9	2.1	2.3	2.7	3.1	3.1
(in months of next year's c.i.f. imports)	1.8	1.8	2.2	...	...	2.7	3.0
External debt service ratio 6/	11.1	8.7	10.1	12.9	17.1	13.0	13.8
External debt to GDP ratio (in percent) 7/	25.4	31.5	41.1	40.9	44.2	43.3	43.3
Exchange rates 8/				(Percent change, period average)			
Nominal effective exchange rate	12.4	24.2	-3.6	...	...	5.7	...
Real effective exchange rate (CPI-based)	-2.6	-13.1	-11.0	...	...	-1.2	...

Sources: Data provided by the FYRM authorities; and IMF staff projections.

1/ Persons seeking employment as percent of total labor force, based on official Labor Force Survey.
2/ Excludes revenue and expenditure of the special revenue and expenditure accounts of line ministries.
3/ Total debt of central government and external debt of general government; includes liabilities assumed by the government upon the sale or closure of loss-making enterprises and associated with the cleaning up of Stopanska Banka's balance sheet prior to its sale.
4/ Includes foreign currency deposits.
5/ Data for 1999 is for October.
6/ Debt service due, including IMF, as a percentage of exports of goods and services.
7/ Including IMF.
8/ Partner countries exclude FR Yugoslavia. The effective exchange rate calculations are based on the chain index method, where the partner country weights are not fixed.

Table 2. FYRM: Balance of Payments, 1996–2000
(In millions of U.S. dollars)

	1996	1997	1998	1999			2000
				Pre-crisis estimate	Kosovo Scenario	Prel.	Proj.
Current Account	**-288**	**-277**	**-308**	**-251**	**-489**	**-136**	**-321**
Trade balance (fob)	-317	-386	-418	-395	-524	-409	-486
Exports	1,147	1,237	1,292	1,396	961	1,192	1,345
Imports	1,464	1,623	1,711	1,791	1,484	1,601	1,831
Non-factor services (net)	-155	-147	-173	-147	-206	-75	-127
Receipts	154	128	131	158	145	248	199
Payments	309	275	304	304	351	324	325
Income, net (including interest)	-30	-55	-44	-23	-23	-43	-52
Transfers (net)	213	311	327	314	264	392	344
Official	52	7	28	43	30	65	37
Private	161	304	299	271	233	327	307
Capital account	**108**	**98**	**299**	**212**	**125**	**46**	**74**
Disbursements	122	156	228	251	179	165	213
Public	122	146	120	150	149	118	143
Private	0	10	108	101	30	47	70
Amortization	86	47	74	101	109	106	123
Direct/Portfolio Investment	12	18	175	70	30	27	45
Commercial banks' position (net)	61	-29	-31	-8	26	-40	-62
Errors/omissions and short-term capital 1/	84	195	53	36	55	188	100
Overall balance	**-96**	**16**	**44**	**-3**	**-309**	**99**	**-147**
Financing	96	-16	-44	3	309	-99	147
Net foreign assets (increase, -)	21	10	-44	-32	-38	-123	-90
Change in gross foreign assets (increase, -)	7	-13	-53	-40	-40	-125	-69
IMF purchases	14	22	12	26	19	19	0
IMF repurchases	0	0	-2	-17	-17	-17	-20
Change in arrears	37	-106	0	0	0	1	0
Rescheduling 2/	38	80	0	0	0	24	20
Financing gap	**0**	**0**	**0**	**35**	**347**	**0**	**217**
Identified financing	0	0	0	35	223	0	139
World Bank	0	0	0	35	95	0	25
European Union	0	0	0	0	27	0	0
Privatization proceeds 3/	0	0	0	0	0	0	84
Bilaterals 4/	0	0	0	0	78	0	30
Residual financing gap	**0**	**0**	**0**	**0**	**124**	**0**	**78**
Memorandum items:							
Current account (in percent of GDP)	-6.5	-7.4	-8.8	-6.7	-14.5	-4.0	-9.0
excluding official grants (in percent of GDP)	-7.7	-7.6	-9.6	-7.9	-15.4	-5.9	-10.0
Export growth rate (fob)	-4.7	7.8	4.5	5.6	-27.3	-7.8	12.8
Import growth rate (fob)	2.7	10.9	5.4	4.0	-13.8	-6.4	14.4
Debt service ratio	11.1	8.7	10.1	12.9	17.1	13.0	13.8
External debt (in percent of GDP) 5/	25.4	31.5	41.1	40.9	44.2	43.3	43.3
Gross reserves	267	280	334	373	373	458	528
(in months of c.i.f. imports)	2.0	1.9	2.1	2.3	2.7	3.1	3.1
(ratio to next year's debt service)	2.2	2.0	1.9	...	...	2.1	3.0
(ratio to base money)	1.5	1.8	2.4	...	...	3.1	3.3
(ratio to M3)	0.5	0.5	0.6	...	...	0.6	0.7

Sources: Data provided by the FYRM authorities; and IMF staff projections.

1/ Includes changes in currency and deposit of private sector and unidentified short-term capital, such as trade credits, imports paid by drawdown of accounts held abroad, and unrecorded remittances.
2/ Figures for 1999 and 2000 refer to a non-concessional deferral (five years maturity, including one year grace) of debt service payments due to the Paris Club creditors during April 1999-March 2000. The FYRM authorities have requested an extension of the consolidation period of the deferral. The debt-service payments due during April-December 2000 amount to US$24 million.
3/ Represents proceeds from the sale of Stopanska Banka and Okta to foreign investors. Of this, US$38 million will accrue to the government.
4/ Japan, US$8 million; and USA, US$22 million.
5/ An increase in debt-to-GDP ratio from 1996 to 1997 is attributable to the 1997 devaluation.

Table 3. FYRM: Indicators of External and Financial Vulnerability, 1996–2000

	1996	1997	1998	1999 Prel.	2000 Proj.
Financial Indicators					
Public sector debt (end of period, in percent of GDP)	41.5	48.1	45.7	53.2	53.3
Broad money (end of period, percent change)	0.3	15.8	14.9	29.7	11.3
Private sector credit (end of period, percent change)	19.0	18.9	10.4	9.4	15.9
Share of non-performing loans in total bank exposures (end of period, in percent) 1/	42.8	35.6	32.9	44.8	...
Foreign currency deposits (end of period, in percent of broad money)	16.2	18.5	21.2	19.2	19.8
Foreign currency credits (end of period, in percent of domestic credits)	12.2	17.7	17.9	37.9	43.2
Credit auction rate 2/					
(Period average)	12.3	13.6	14.9	18.6	...
(End of period)	11.0	15.2	18.5	14.7	...
Money market rate					
(Period average)	24.3	20.4	17.9	17.4	...
(End of period)	20.9	19.7	18.1	11.6	...
External Indicators					
Exports (percent change, in terms of US$)	-4.7	7.8	4.5	-7.8	12.8
Imports (percent change, in terms of US$)	2.7	10.9	5.4	-6.4	14.4
Current account balance (in percent of GDP)					
(Including official grants)	-6.5	-7.4	-8.8	-4.0	-9.0
(Excluding official grants)	-7.7	-7.6	-9.6	-5.9	-10.0
Foreign direct investment (in percent of GDP)	0.3	0.4	4.8	0.7	1.3
Portfolio investment (debt securities, etc.; in percent of GDP)	0.0	0.1	0.2	0.1	0.0
Other investment (loans, trade credits, etc.; in percent of GDP)	4.1	8.7	5.4	0.5	4.2
Gross official reserves (in US$ millions, end of period)	267	280	334	458	528
(In months of current year's c.i.f. imports)	2.0	1.9	2.1	3.1	3.1
(In months of next year's c.i.f. imports)	1.8	1.8	2.2	2.7	3.0
(In percent of broad money)	45.5	51.4	58.2	64.4	70.1
Total external debt (in percent of GDP) 3/	25.4	31.5	41.1	43.3	43.3
of which: public sector (in percent of GDP) 3/	22.9	27.1	34.9	37.9	39.4
Short term debt 4/ 5/					
(In percent of GDP)	1.1	2.0	3.0	3.6	2.9
(In percent of official reserves)	17.6	26.4	31.7	26.8	19.6
Total external debt (in percent of exports of goods and services)	86.2	85.7	101.0	103.2	100.3
External interest payments (in percent of exports of goods and services)	5.4	3.5	5.4	8.5	9.3
External amortization payments (in percent of exports of goods and services)	5.7	5.3	4.7	4.5	4.6
Exchange rate (denar per U.S. dollar)					
(Period average)	39.9	49.8	54.5	56.9	...
(End of period)	41.4	55.4	51.8	60.3	...
REER (average percent change; (-) depreciation)					
CPI-based	-2.6	-13.1	-11.0	-1.4	...
ULC-based 6/	-11.8	-18.1	-9.5	1.1	...

Sources: Data provided by the FYRM authorities; and IMF staff projections.

1/ Figure for 1999 refers to end-September.

2/ Figure for 1999 refers to October.

3/ Increases in external debt-to-GDP ratios from 1996 to 1997 are attributable to the 1997 devaluation.

4/ Includes short-term trade credits.

5/ Calculated as the ratio of next year's amortization to reserves.

6/ Figure for 1999 refers to January-October compared to the same period of the previous year.

Table 4. FYRM: Accounts of the National Bank of Macedonia, 1997–2000 1/

	1997	1998	1999				2000
	Dec.	Dec.	Mar.	June	Sept.	Dec.	Dec. Proj.
	(In millions of denars)						
Net foreign assets (NFA)	8,683	10,518	10,530	12,729	16,712	18,699	23,500
Net domestic assets	-1,127	-2,859	-2,826	-5,465	-8,956	-10,184	-14,029
Banks (net)	942	526	1,186	34	-1,693	-2,858	-4,532
Credits	2,720	2,557	2,775	1,918	1,132	984	-1,046
Instruments	-1,778	-2,031	-1,589	-1,884	-2,825	-3,842	-3,486
Mandatory reserves	-1,039	-1,122	-864	-968	-1,466	-1,795	-1,439
Others	-739	-909	-725	-916	-1,359	-2,047	-2,047
Government (net)	2,789	1,902	1,791	-182	-1,533	-2,597	-4,768
Credit	5,839	5,518	5,518	5,477	5,193	5,205	4,898
Deposits	-5,067	-6,166	-7,135	-8,590	-9,288	-9,684	-10,882
External 2/	2,017	2,550	3,408	2,931	2,562	1,882	1,216
Other items (net) 3/	-4,858	-5,287	-5,803	-5,317	-5,730	-4,729	-4,729
Reserve money	7,556	7,659	7,704	7,264	7,756	8,515	9,471
Currency in circulation	7,130	7,137	7,311	6,780	7,303	8,169	9,086
Other	426	522	393	484	453	346	385
	(Percentage change from end-of-previous year)						
Reserve money	6.2	1.4	0.6	-5.2	1.3	11.2	11.2
Of which: currency in circulation	6.4	0.1	2.4	-5.0	2.3	14.5	11.2
	(Absolute change from end-of-previous year)						
NFA (in millions of U.S. dollars)	4.8	34.7	-0.5	37.0	105.7	140.1	80.0
External financing	-35.8	-9.0	-15.2	-7.2	1.5	13.3	11.1
Market purchases	33.1	35.0	12.4	39.5	97.4	116.8	60.3
Other	7.5	8.7	2.4	4.7	6.8	10.0	8.6
	(In percent)						
Memorandum items:							
Credit auction rate	15.2	18.5	21.1	19.2	13.9	...	...
NBM bill rate	8.2	10.0	10.0	10.0	10.0	10.0	...

Sources: The National Bank of Macedonia; and IMF staff projections.

1/ Foreign currency denominated items exclude effects of exchange rate gains/losses.

2/ Net credit to the government for external debt service, adjusted for collection of loans from the original debtors.

3/ Includes non-financial sector deposits.

Table 5. FYRM: Monetary Survey, 1997–2000 1/

	1997	1998	1999				2000
	Dec.	Dec.	Mar.	June	Sept.	Dec.	Dec. Proj.
	(In millions of denars)						
Net foreign assets (NFA)	13,245	14,105	12,552	15,939	23,556	26,120	31,026
National Bank of Macedonia (NBM)	8,683	10,518	10,530	12,729	16,712	18,699	23,500
Domestic money banks (DMB)	4,562	3,587	2,022	3,210	6,843	7,421	7,527
Net domestic assets	13,909	17,103	16,770	15,552	14,094	14,362	14,023
Domestic credit	29,479	33,733	33,661	31,935	31,493	36,249	38,299
Banks	26,690	31,831	31,870	32,117	33,026	38,846	43,067
In denars	21,484	25,786	25,594	25,005	25,408	25,119	26,534
Government	1,781	1,284	1,203	1,047	947	1,285	1,141
Private	19,703	24,502	24,391	23,958	24,461	23,834	25,393
In foreign currency	5,206	6,045	6,276	7,112	7,618	13,727	16,533
Government	0	0	0	0	0	7,286	7,286
Private	5,206	6,045	6,276	7,112	7,618	6,441	9,247
NBM credit to government	2,789	1,902	1,791	-182	-1,533	-2,597	-4,768
Other items (net)	-15,570	-16,630	-16,891	-16,383	-17,399	-21,887	-24,276
Broad money (M3)	27,154	31,208	29,323	31,491	37,650	40,482	45,049
Currency in circulation	7,130	7,137	7,311	6,780	7,303	8,169	9,086
Government denar deposits	1,370	1,748	1,608	1,945	2,410	2,378	2,378
Government foreign currency deposits	5	0	0	0	0	0	0
Social and private denar	13,637	15,700	15,125	17,135	20,090	22,156	24,644
Demand deposits	6,855	8,041	7,658	9,277	11,336	11,525	12,819
Quasi deposits	3,887	4,683	4,457	4,713	5,392	6,815	7,580
Non-monetary deposits	2,895	2,976	3,010	3,145	3,362	3,816	4,244
Private foreign currency deposits	5,012	6,623	5,279	5,631	7,847	7,779	8,941
	(Percent change from end-of-previous year)						
Broad money (M3)	15.8	14.9	-6.0	0.9	20.6	29.7	11.3
Of which: private denar deposits and currency in circulation	11.6	10.0	-1.8	4.7	20.0	32.8	11.2
Memorandum items:							
Implicit velocity of M3	9.3	8.7	8.1	7.9	7.3	6.9	6.8
Money multiplier (private M3)	3.4	3.8	3.6	4.1	4.5	4.5	4.5
Total credit to government	3,195	1,438	1,386	-1,080	-2,996	3,596	1,281
Excluding external accounts 2/	1,178	-1,112	-2,022	-4,011	-5,558	1,714	65
Total private sector credit (adjusted) 3/ 4/ 5/	29,053	32,080	32,164	32,827	33,971	35,107	40,672
(Percent change from end-of-previous year)	18.9	10.4	0.3	2.3	5.9	9.4	15.9
Total private denar credit (adjusted) 3/ 4/ 5/	23,847	25,262	25,115	24,942	25,587	26,859	29,618
(Percent change from end-of-previous year)	14.4	5.9	-0.6	-1.3	1.3	6.3	10.3
Interest rates (in percent)							
Banks' deposit rate	12.21	12.64	11.65	11.55	11.45	11.35	...
Banks' lending rate (short term)	21.59	20.47	20.52	20.61	20.52	19.98	...

Sources: The National Bank of Macedonia; and IMF staff projections.

1/ Foreign currency denominated items exclude exchange rate effects.

2/ Net credit to the government for external debt service, adjusted for collection of loans from the original debtors.

3/ Adjusted for the removal of fully provisioned loans from banks' books.

4/ Adjusted for the November 30, 1999 reclassification of denar 6.271 million of Stopanska Banka's loans from other items (net) and foreign currency credits into denar credits.

5/ Adjusted for the recapitalization operation of Stopanska Banka through a swap of nonperforming loans for Government bonds in the amount of DM 235 million, as of December 31, 1999.

Table 6. FYRM: Central Government Operations, 1998–2000

	1998	1999			2000	1998	1999			2000
	Actual	Budget	Kosovo Scenario 1/	Prel. Actual	Budget	Actual	Budget	Kosovo Scenario 1/	Prel. Actual	Budget
	(In millions of denar)					(In percent of GDP)				
Total revenues and grants	39,818	41,393	38,571	47,281	46,961	20.9	20.2	20.4	24.2	22.0
Tax revenues	36,861	38,053	35,572	41,851	43,396	19.3	18.6	18.8	21.4	20.3
Individual income tax	9,177	9,425	8,690	10,233	10,033	4.8	4.6	4.6	5.2	4.7
Profit tax	1,752	1,871	1,650	2,559	2,613	0.9	0.9	0.9	1.3	1.2
Sales tax	8,804	9,127	8,605	9,959	9,700	4.6	4.5	4.6	5.1	4.5
Excises	10,237	10,820	9,975	10,673	12,309	5.4	5.3	5.3	5.5	5.8
Import duties	6,810	6,810	6,557	8,303	8,600	3.6	3.3	3.5	4.3	4.0
Other taxes	81	0	95	124	141	0.0	0.0	0.1	0.1	0.1
Non-tax and capital revenues	2,957	3,340	2,999	2,876	3,565	1.5	1.6	1.6	1.5	1.7
Foreign grants	0	0	0	2,554	0	0.0	0.0	0.0	1.3	0.0
Total expenditures	41,518	41,768	49,197	45,581	47,174	21.8	20.4	26.1	23.3	22.1
Current expenditure	38,729	38,804	46,705	43,080	38,906	20.3	18.9	24.7	22.1	18.2
Goods and services	21,542	20,957	20,954	22,947	21,504	11.3	10.2	11.1	11.8	10.1
Wages and salaries	15,940	15,860	16,054	17,757	15,955	8.4	7.7	8.5	9.1	7.5
Goods and nonlabor services	5,602	5,097	4,900	5,190	5,549	2.9	2.5	2.6	2.7	2.6
Refugee-related expenditure	24	405	6,298	2,456	148	0.0	0.2	3.3	1.3	0.1
Transfers	13,862	13,959	16,090	14,621	14,178	7.3	6.8	8.5	7.5	6.6
Pension Fund	3,618	3,250	4,145	3,302	3,890	1.9	1.6	2.2	1.7	1.8
Social programs	7,702	8,548	9,674	8,911	7,572	4.0	4.2	5.1	4.6	3.5
Of which: social assistance program	2,550	2,625	2,953	2,990	3,187	1.3	1.3	1.6	1.5	1.5
program for employment	597	1,091	1,091	1,287	110	0.3	0.5	0.6	0.7	0.1
Other transfers	2,542	2,161	2,271	2,407	2,716	1.3	1.1	1.2	1.2	1.3
Interest	3,302	3,483	3,364	3,056	3,076	1.7	1.7	1.8	1.6	1.4
Capital expenditure	2,616	3,311	2,766	2,957	4,897	1.4	1.6	1.5	1.5	2.3
Reserves	100	100	100	107	734	0.1	0.0	0.1	0.1	0.3
Arrears (increase + / repayment -)	-289	-447	-374	-494	0	-0.2	-0.2	-0.2	-0.3	0.0
Allocation for structural reforms	0	0	0	0	1,617	0.0	0.0	0.0	0.0	0.8
Allocation for administrative reforms	0	0	0	0	1,020	0.0	0.0	0.0	0.0	0.5
Discrepancy	362	0	0	-68	0	0.2	0.0	0.0	0.0	0.0
Balance	-1,700	-375	-10,626	1,700	-213	-0.9	-0.2	-5.6	0.9	-0.1
Cash balance	-1,153	131	-10,047	2,159	-213	-0.6	0.1	-5.3	1.1	-0.1
Financing	1,700	375	10,626	-1,700	213	0.9	0.2	5.6	-0.9	0.1
Domestic financing	77	52	-706	-4,117	-2,311	0.0	0.0	-0.4	-2.1	-1.1
National Bank of Macedonia, net	-869	-268	-1,013	-4,331	-2,167	-0.5	-0.1	-0.5	-2.2	-1.0
Commercial banks, net	-476	-186	-272	-595	-144	-0.2	-0.1	-0.1	-0.3	-0.1
Other domestic financing 2/	875	0	0	350	0	0.5	0.0	0.0	0.2	0.0
Interest arrears on frozen foreign currency deposits	836	953	953	953	0	0.4	0.5	0.5	0.5	0.0
Payments arrears	-289	-447	-374	-494	0	-0.2	-0.2	-0.2	-0.3	0.0
Foreign financing, net	1,623	323	11,332	2,418	2,523	0.9	0.2	6.0	1.2	1.2
Memorandum items:										
Primary balance	1,602	3,108	-7,262	4,756	2,863	0.8	1.5	-3.8	2.4	1.3
Balance, excluding grants	-1,700	-375	-10,626	-854	-213	-0.9	-0.2	-5.6	-0.4	-0.1
Government debt 3/	87,140	...	...	103,913	113,971	45.7	...	...	53.2	53.3
Defense and security expenditures	8,357	8,560	...	...	9,524	4.4	4.2	...	...	4.5
Nominal GDP	190,827	204,839	188,800	195,284	213,833	...	...	...	...	...

Sources: Ministry of Finance; National Bank of Macedonia; and IMF staff estimates.

1/ As reported in EBS/99/134

2/ Includes privatization receipts in 1998.

3/ Total debt of central government and external debt of general government; includes liabilities assumed by the government upon the sale or closure of loss-making enterprises and associated with the cleaning up of Stopanska Banka's balance sheet prior to its sale.

Table 7. FYRM: General Government Operations, 1998–2000

	1998	1999			2000	1998	1999			2000
	Actual	Budget	Kosovo Scenario 1/	Prel. Actual	Budget	Actual	Budget	Kosovo Scenario 1/	Prel. Actual	Budget
	(In millions of denar)					(In percent of GDP)				
Total revenue and grants	64,908	68,579	63,719	73,534	75,542	34.0	33.5	33.7	37.7	35.3
Total revenue	64,908	67,556	63,276	70,980	75,542	34.0	33.0	33.5	36.3	35.3
Current revenue	64,770	67,404	63,132	70,766	75,187	33.9	32.9	33.4	36.2	35.2
Tax revenue	60,237	62,419	58,568	66,148	69,846	31.6	30.5	31.0	33.9	32.7
Taxes on income and profits	10,929	11,296	10,340	12,792	12,646	5.7	5.5	5.5	6.6	5.9
Social insurance contributions	21,675	22,562	21,312	22,720	24,572	11.4	11.0	11.3	11.6	11.5
Local taxes	1,006	1,067	983	983	1,050	0.5	0.5	0.5	0.5	0.5
Sales and excises taxes	19,736	20,684	19,280	21,226	22,837	10.3	10.1	10.2	10.9	10.7
Import duties	6,810	6,810	6,557	8,303	8,600	3.6	3.3	3.5	4.3	4.0
Other taxes	81	0	95	124	141	0.0	0.0	0.1	0.1	0.1
Non-tax and capital revenues	4,671	5,136	4,709	4,832	5,696	2.4	2.5	2.5	2.5	2.7
Foreign grants	0	1,024	443	2,554	0	0.0	0.5	0.2	1.3	0.0
Total expenditure	68,289	72,934	78,326	73,617	78,255	35.8	35.6	41.5	37.7	36.6
Current expenditure	64,642	65,747	71,918	69,308	67,503	33.9	32.1	38.1	35.5	31.6
Goods and services	22,876	22,278	22,280	24,184	22,799	12.0	11.1	11.8	12.4	10.7
Wages and salaries	16,476	16,401	16,595	18,225	16,489	8.6	8.0	8.8	9.3	7.7
Goods and nonlabor services	6,400	5,877	5,685	5,958	6,310	3.4	3.1	3.0	3.1	3.0
Refugee-related expenditure	24	405	6,298	2,456	148	0.0	0.2	3.3	1.3	0.1
Transfers	26,440	26,294	27,228	26,615	27,927	13.9	12.8	14.4	13.6	13.1
Social programs	6,006	6,021	7,121	6,280	6,032	3.1	2.9	3.8	3.2	2.8
Pensions and disability payments	17,908	17,874	17,848	17,927	19,179	9.4	8.7	9.5	9.2	9.0
Other	2,527	2,149	2,259	2,407	2,716	1.3	1.0	1.2	1.2	1.3
Interest	3,566	4,134	3,437	3,161	3,196	1.9	2.0	1.8	1.6	1.5
Other current expenditure	11,737	12,635	12,677	12,893	13,433	6.2	6.2	6.7	6.6	6.3
Capital expenditure	3,561	7,534	6,681	5,006	7,381	1.9	3.7	3.5	2.6	3.5
Reserves	100	100	100	107	734	0.1	0.0	0.1	0.1	0.3
Arrears (increase + / repayment -)	-379	-447	-374	-494	0	-0.2	-0.2	-0.2	-0.3	0.0
Allocation for structural reforms	0	0	0	0	1,617	0.0	0.0	0.0	0.0	0.8
Allocation for administrative reforms	0	0	0	0	1,020	0.0	0.0	0.0	0.0	0.5
Discrepancy	365	0	0	-311	0	0.2	0.0	0.0	-0.2	0.0
Balance	-3,381	-4,354	-14,606	-83	-2,713	-1.8	-2.1	-7.7	0.0	-1.3
Cash balance	-2,924	-3,848	-14,027	376	-2,713	-1.5	-1.9	-7.4	0.2	-1.3
Financing	3,381	4,354	14,606	83	2,713	1.8	2.1	7.7	0.0	1.3
Domestic financing	847	345	-413	-4,319	-2,311	0.4	0.2	-0.2	-2.2	-1.1
National Bank of Macedonia, net	-869	-268	-1,139	-4,499	-2,167	-0.5	-0.1	-0.6	-2.3	-1.0
Commercial banks, net	-185	7	-146	-629	-144	-0.1	0.0	-0.1	-0.3	-0.1
Other domestic financing 2/	1,444	100	293	350	0	0.8	0.0	0.2	0.2	0.0
Interest arrears on frozen foreign currency deposits	836	953	953	953	0	0.4	0.5	0.5	0.5	0.0
Payments arrears	-379	-447	-374	-494	0	-0.2	-0.2	-0.2	-0.3	0.0
Foreign financing, net	2,534	4,009	15,019	4,402	5,023	1.3	2.0	8.0	2.3	2.3
Memorandum item:										
Nominal GDP	190,827	204,839	188,800	195,284	213,833	...	...	...	...	...

Sources: Ministry of Finance; National Bank of Macedonia; and IMF staff estimates.

1/ As reported in EBS/99/134.

2/ Includes privatization receipts in 1998.

Table 8. FYRM: Macroeconomic Framework, 1996–2002

	1996	1997	1998	1999 Est.	2000 Projections	2001	2002
	(In percent of nominal GDP)						
Foreign saving 1/	6.2	7.5	8.8	4.0	9.0	7.8	7.5
Gross national saving 2/	13.9	16.0	16.7	17.4	17.6	18.5	19.0
Gross domestic saving 3/	9.8	9.1	8.6	7.1	9.4	11.3	12.5
Government	2.0	1.0	0.1	1.2	2.2	3.1	3.3
Nongovernment	7.8	8.1	8.5	5.9	7.2	8.2	9.2
Gross domestic investment	20.1	23.5	25.5	21.4	26.5	26.3	26.6
Government	2.5	1.4	1.9	2.6	3.5	4.1	4.1
Nongovernment	17.6	22.1	23.6	18.8	23.1	22.2	22.5
Fixed investment	17.4	17.4	17.8	17.9	22.5	22.8	23.1
Change in stocks	2.7	6.1	7.7	3.5	4.1	3.5	3.5
Non-government saving-investment	-5.7	-7.1	-7.0	-4.0	-7.7	-6.8	-6.8
Fiscal Indicators (General Government)							
Revenue and grants	36.5	34.9	34.0	37.7	35.3	34.5	33.9
Total expenditure	37.0	35.3	35.8	37.7	36.6	35.5	34.6
of which:							
Non-interest current expenditure	32.5	31.7	32.0	33.5	31.6	29.6	28.9
Interest	2.0	2.2	1.9	1.6	1.5	1.8	1.6
Balance	-0.5	-0.4	-1.8	0.0	-1.3	-1.0	-0.7
Government debt 4/	41.5	48.1	45.7	53.2	53.3	49.8	45.9
Memorandum items:	(Percent change in real terms)						
Consumption expenditure	2.4	2.0	3.6	4.5	3.0	4.4	5.0
Gross capital formation	-1.7	13.2	7.4	-16.5	29.6	5.6	7.8
Fixed investment	6.5	-4.3	1.5	1.2	30.9	8.2	8.1
Non-interest government current expenditure	...	0.4	2.8	6.5	0.6	0.0	3.6
Domestic demand	1.6	4.0	4.3	0.2	7.5	4.6	5.6
Total demand	-1.7	9.2	6.0	0.8	7.2	5.3	6.1
GDP	1.2	1.4	2.9	2.7	6.0	6.0	6.0
Nominal GDP (in million of denars)	176,444	184,982	190,827	195,284	213,833	232,638	252,905

Sources: Data provided by the FYRM Statistical Office; Ministry of Finance; and IMF staff projections.

1/ External current account deficit (+). A small discrepancy between the national accounts and the balance of payments occurred in 1996.
2/ Equal to gross domestic investment minus foreign saving.
3/ Equal to gross national saving minus net factor income and transfers from abroad.
4/ Includes domestic debt of central government and external debt of general government. Figures include frozen foreign currency deposits and liabilities assumed by the government as of end-March 2000 on account of bank and enterprise restructuring, but exclude obligations for retroactive payments to pensioners.

Table 9. FYRM: Medium-Term Balance of Payments, 1998–2004
(In millions of U.S. dollars)

	1998	1999 Prel.	2000	2001	2002	2003	2004
			Projections				
Current Account	**-308**	**-136**	**-321**	**-307**	**-329**	**-344**	**-355**
Trade balance (fob)	-418	-409	-486	-465	-483	-497	-509
Exports	1,292	1,192	1,345	1,459	1,585	1,727	1,883
Imports	1,711	1,601	1,831	1,924	2,068	2,224	2,392
Non-factor services (net)	-173	-75	-127	-128	-130	-130	-130
Receipts	131	248	199	210	226	244	263
Payments	304	324	325	338	356	374	393
Income, net (including interest)	-44	-43	-52	-56	-56	-58	-57
Transfers (net)	327	392	344	341	341	341	340
Official	28	65	37	35	35	35	35
Private	299	327	307	306	306	305	305
Capital account	**299**	**46**	**74**	**190**	**228**	**276**	**300**
Disbursements	228	165	213	230	245	265	275
Public	120	118	143	140	140	140	140
Private	108	47	70	90	105	125	135
Amortization	74	106	123	104	116	132	144
Direct/Portfolio investment	175	27	45	94	129	173	199
Commercial banks' position (net)	-31	-40	-62	-30	-30	-30	-30
Errors/omissions and short-term capital 1/	53	188	100	95	95	90	90
Overall balance	**44**	**99**	**-147**	**-22**	**-6**	**22**	**35**
Financing	-44	-99	147	22	6	-22	-35
Net foreign assets (increase, -)	-44	-123	-90	-48	-49	-62	-60
Change in gross foreign assets (increase, -)	-53	-125	-69	-40	-40	-40	-40
IMF purchases	12	19	0	0	0	0	0
IMF repurchases	-2	-17	-20	-8	-9	-22	-20
Change in arrears	0	1	0	0	0	0	0
Rescheduling 2/	0	24	20	0	0	0	0
Financing gap	**0**	**0**	**217**	**70**	**55**	**41**	**25**
Identified financing	0	0	139	0	0	0	0
World Bank	0	0	25	0	0	0	0
Privatization proceeds 3/	0	0	84	0	0	0	0
Bilaterals 4/	0	0	30	0	0	0	0
Residual financing gap	**0**	**0**	**78**	**70**	**55**	**41**	**25**
Memorandum items:							
Current account (in percent of GDP)	-8.8	-4.0	-9.0	-7.8	-7.5	-7.2	-6.8
excluding official grants (in percent of GDP)	-9.6	-5.9	-10.0	-8.7	-8.4	-7.9	-7.5
Export growth rate (fob)	4.5	-7.8	12.8	8.5	8.6	9.0	9.0
Import growth rate (fob)	5.4	-6.4	14.4	5.1	7.5	7.5	7.5
Debt service ratio	10.1	13.0	13.8	10.5	10.5	11.2	10.7
External debt (in percent of GDP)	41.1	43.3	43.3	42.9	42.4	41.5	40.7
of which: public sector (in percent of GDP)	34.9	37.9	39.4	38.1	36.5	34.7	33.1
short-term debt (in percent of GDP) 5/	3.0	3.6	2.9	2.9	3.0	3.0	3.0
Gross reserves	334	458	528	568	608	648	688
(in months of current year's c.i.f. imports)	2.1	3.1	3.1	3.2	3.2	3.1	3.1
(in months of next year's c.i.f. imports)	2.2	2.7	3.0	3.0	3.0	2.9	2.9
(ratio to the next year's debt service)	1.8	2.1	3.0	3.0	2.8	2.8	2.8

Sources: Data provided by the FYRM authorities; and IMF staff projections.

1/ Includes changes in currency and deposit of private sector and unidentified short-term capital, such as trade credits, imports paid by drawdown of accounts held abroad, and unrecorded remittances.

2/ Figures for 1999 and 2000 refer to a non-concessional deferral (five years maturity, including one year grace) of debt service payments due to the Paris Club creditors during April 1999-March 2000. The FYRM authorities have requested an extension of the consolidation period of the deferral. The debt-service payments due during April-December 2000 amount to US$24 million.

3/ Represents proceeds from the sale of Stopanska Banka and Okta to foreign investors. Of this, US$38 million will accrue to the government.

4/ Japan, US$8 million; and USA, US$22 million.

5/ Calculated as the next year's amortization to GDP.

FYRM: Fund Relations
(As of March 31, 2000)

I.	**Membership Status**:	Joined 12/14/92; Article VIII	
II.	**General Resources Account**:	SDR Million	Percent of Quota
	Quota	68.90	100.0
	Fund holdings of currency	111.90	162.4
III.	**SDR Department**:	SDR Million	Percent of Allocation
	Net cumulative allocation	8.38	100.0
	Holdings	0.80	9.6
IV.	**Outstanding Purchases and Loans**:	SDR Million	Percent of Quota
	Stand-By Arrangements	9.59	13.9
	Contingency and Compensatory	13.78	20.0
	Systemic Transformation Facility	19.63	28.5
	PRGF Arrangements	27.28	39.6

V. **Financial Arrangements**:

	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR Million)
PRGF	04/11/1997	04/10/2000	54.56	27.28
Stand-by Arrangement	05/05/1995	06/04/1996	22.30	22.30

VI. **Projected Obligations to the Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Overdue	Forthcoming				
	03/31/2000	2000	2001	2002	2003	2004
Principal	0.0	10.8	6.0	6.8	15.6	13.7
Charges/Interest	0.0	1.9	2.0	1.7	1.3	0.7
Total	0.0	12.7	8.0	8.5	16.9	14.4

VII. **Exchange Arrangement**:

The currency of the FYRM is the denar. The FYRM maintains a managed floating exchange rate system with a de facto peg to the Deutsche Mark, where enterprises and households deal in separate markets. Whereas households can transact only through commercial banks or through foreign exchange bureaus that act as agents of banks, enterprises can sell foreign exchange to each other in addition to transacting through the banking system. Enterprises must use or sell export proceeds within 90 days. Commercial banks' holdings are limited. Bureaus can hold overnight foreign exchange positions equivalent to 50 percent of the preceding day's purchases. In June 1998, the National Bank of Macedonia reduced the effective reserve requirements on foreign currency deposits by individuals from 100 percent to between 20 and 70 percent, depending on the maturity of the deposit. On March 31, 2000, the official exchange rate was denar 63.51 per U.S. dollar. The FYRM has accepted the obligations of Article VIII, Sections 2, 3 and 4 with effect from June 19, 1998. The freeze on certain foreign currency deposits of non-residents, which constitutes restrictive measure subject to Article VIII, Section 2(a), was approved by the Board until December 1999. A short-term extension of approval of this restriction was granted until the forthcoming Article IV conclusion or April 30, 2000, whichever is earlier.

VIII. **Article IV Consultations**:

The first consultation with the FYRM was concluded in August 1993. The last consultation was concluded on June 19, 1998. The FYRM is on the standard consultation cycle.

IX. **Resident Representative**

The Fund has had a resident representative in Skopje since 1995. Mr. Drummond's term expired on April 30, 2000. He will be replaced by Mr. Jan Mikkelsen on May 15.

X. **Technical Assistance**:

Purpose	**Department**	**Date**
Multisector Statistics	STA	August–September 1993
National Accounts and Price Statistics	STA	January 1995
		June 1995
		September 1995
		February 1997
Government Finance Statistics	STA	April 1997
Balance of Payments Statistics	STA	February–March 1995
		October 1998
Money and Banking Statistics	STA	May 1994
		February 1996
Multitopic	FAD	June–July 1993
Budget Classification, Fiscal Reporting, and Debt Management	FAD	September–October 1993
		October 1993
		September 1996

Public Expenditure Management	FAD	April–May 1994
		September–October 1997
		November 1997
Value-Added Tax	FAD	November 1996
		April 1998
		February 1999
		October 1999
Development of a Treasury System	FAD	January 1995
		March 1996
		May 1996
Customs Administration	FAD	April 1995
		April 1998
Central Bank Organization and Operation	MAE	April 1994
		June 1994
		September 1994
	LEG	September 1995
Monetary Policy and Banking Supervision	MAE	September 1997
		December 1998
	MAE/WB	October 1999
	MAE	December 1999
Payments and Settlements System	MAE	November 1995
		February 1997
Article VIII	MAE/LEG	April 1998
Institute Training Courses	INS	
Introduction to Financial Programming		February 1994
Macroeconomic and Financial Policies		January 1997
Resident Experts		
Central Bank Accounting	MAE	July–December 1994
Bank Supervision	MAE	August 1994–February 1997
Monetary Policy Implementation	MAE	September 1994 –September 1996
Customs Administration	FAD	October 1995
Value-Added Tax	FAD	October 1999-September 2000
Development of a Treasury System	FAD	January 2000-February 2001

FYRM—Relations with the World Bank Group

1. The former Yugoslav Republic of Macedonia (FYR Macedonia) became a member of the World Bank, IDA, and IFC on February 25, 1993, and a member of MIGA on June 28, 1994.

2. Since 1993, commitments totaling approximately US$500 million have been made by IBRD and IDA. These include the approval of (i) four adjustment and one emergency operation, totaling US$304 million; and (ii) twelve investment operations totaling US$195 million (of these, nine are ongoing). Total disbursements through December 31, 1999 amount to approximately US$347 million.

3. In August 1998, the Bank's Board endorsed the new Country Assistance Strategy prepared jointly with the IFC, which is expected to be updated by endFY00. A Country Economic Memorandum was released to the Government in November 1998, and a Poverty Assessment study was released in June 1999. Preparations are currently underway for (i) a Public Expenditure and Institutional Review to provide advice on short and medium-term budget management measures; and (ii) a second Financial and Enterprise Sector Adjustment Loan to support further reforms in the enterprise and financial sectors.

4. In response to the Kosovo crisis, the Bank undertook the following activities to help ease the effect of the crisis on the economy: (i) a *Joint Emergency G24 -Consultative Group Meeting,* with the European Commission on May 5, 1999; (ii) the disbursement of the *Emergency Recovery Credit* of US$50 million (approved on May 13, 1999) for maintaining macroeconomic stability and growth, through the financing of imports and through budget support; (iii) a US$1 million *Post-Conflict Fund,* approved in May 1999, to support the transition between an emergency and medium-term social development of FYR Macedonia; and (iv) a US$10 million *Emergency Social Support Project,* approved on June 29, 1999, to help mitigate the negative social and economic impact of divestiture of state owned enterprises and the economic disruption caused by the Kosovo conflict.

5. As of December 31, 1999, IFC's portfolio consisted of eight projects for a total of US$61million (US$86 million including syndication), making FYR Macedonia one of IFC's largest per capita exposures worldwide. Total disbursements through December 1999 on IFC's account amount to US$32 million.

6. MIGA currently has applications for coverage of investments in the manufacturing sector totaling US$20 million.

FYRM: Statistical Issues

The quality and availability of statistical data have improved in recent years, reflecting the authorities' efforts to strengthen the country's statistical capabilities, with the assistance of the Fund, the Bank, and donors. Quality of key macroeconomic statistics, however, remains generally deficient and hampers proper program monitoring. Data reporting to the Fund is timely (Table 11) and an *IFS* page is available.

Real sector data remain particularly deficient. Since 1994, national accounts estimates are being compiled on the basis of *1993 SNA*. Attempts have been made to account for the unrecorded activities, especially in the emerging private sector and informal sector. Efforts are under way to upgrade surveys and techniques to generate consistent GDP estimates from the production and expenditure approaches in line with international standards and to develop quarterly GDP estimates. Compilation of consumer and producer price statistics is timely but is affected by outdated weighting structures - updated weights are expected to be introduced in early 2000. Employment statistics are unreliable, even in respect to employment in the formal economy.

The compilation and coverage of balance of payments data have improved over the last five years. However, trade data have been subject to sizeable revisions, inward personal transfers are underrecorded, and errors and omissions have been consistently high and positive. The authorities received technical assistance from the Fund to address these weaknesses in November 1998, and a further follow-up mission is planned during FY2001.

Regarding government finance statistics, no data are being reported to STA in accordance with *GFS* concepts. Off-budget operations, special revenue and expenditure, and domestic payments arrears are not fully captured in official data. Money and banking data are reported to the Fund on a regular basis, but provide only a partial aggregation of domestic and external financial flows because of the sizeable transactions that are settled outside the domestic banking system.

Table 10. FYRM: Core Statistical Indicators
(as of April 14, 2000)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt/ Debt Service
Date of Latest Observation	Apr. 7	Mar. 31	Feb. 29	Feb. 29	Feb. 29	Mar. 31	March	February	December	Jan.31	1999	Dec. 31
Date Received	Apr. 10	Apr. 7	Apr. 11	Apr. 11	Apr. 11	Apr. 7	Apr. 5	Mar. 30	Apr. 12	Feb. 25	December	Apr. 12
Frequency of Data	Daily	Daily	Daily	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Annually	Monthly
Frequency of Reporting	Weekly	Weekly	Weekly	Weekly	Monthly	Monthly	Monthly	Variable	Variable	Monthly	Annually	Variable
Source of Update	NBM	NBM	NBM	NBM	NBM	NBM	BOS	NBM	NBM	MOF	BOS	NBM
Mode of Reporting	Fax	Fax	Fax	Fax	Fax	Fax	Fax	Fax	Fax	Fax	Mission	Mission
Confidentiality	UR	UR[1]	UR[1]	UR[1]	UR[1]	UR	UR	UR	UR[1]	UR[1]	UR	SB
Frequency of Publication	Daily	Quarterly	Quarterly	Quarterly	Quarterly	Quarterly	Monthly	Monthly	Quarterly	Annually	Annually	NA

List of abbreviations:

NBM: National Bank of Macedonia
MOF: Ministry of Finance
BOS: Bureau of Statistics
UR: Unrestricted use
SB: For use by staff and the Executive Board

[1] Preliminary data received by Fund staff before it has been published by the authorities should be treated as confidential.

FYRM—Review of Fund Provided Technical Assistance

This appendix summarizes the technical assistance (TA) provided to FYRM and presents an assessment of its outcome from the perspective of each of the TA-providing departments. It also notes the future needs for technical assistance as indicated by the authorities.

A. Statistics Department (STA)

Real Sector Statistics

Technical assistance in national accounts statistics was provided to the Statistical Office (SO) on four occasions during September 1993–to February 1997. The national accounts are prepared following the guidelines of the *System of National Accounts 1993*. The authorities indicated that most of the outstanding issues identified by the February 1997 mission have been or are being addressed. Work is still underway on (i) the preparation of the business register, expected to be finalized by end-2000, and (ii) quarterly GDP estimates, planned to be introduced, on an experimental basis, in 2000. The authorities have requested further technical assistance on quarterly GDP estimation.

Prices

Two STA missions in 1995 reviewed price statistics compiled by the SO and assisted in enhancing the CPI to deal with new varieties of goods and services and growing markets. The methodologies for price indices are sound though the index calculations procedures are unduly complex. The authorities would like to have further technical assistance to review and build on the progress made in price statistics since 1995.

Money and Banking Statistics

Technical assistance in money and banking statistics was provided on three occasions in 1993, 1994 and 1996. The National Bank of Macedonia (NBM) began regular reporting of monetary data to STA in July 1995. Steps to improve reported data were subsequently undertaken in accordance with STA's recommendations. These revisions led to the introduction of the page for Macedonia, FYR in the June 1998 issue of *International Financial Statistics (IFS)* and its inclusion in the 1998 *IFS Yearbook*. There are no major outstanding issues in the reported data. The NBM staff maintains close contact with STA on issues of methodology for compiling monetary statistics. The authorities indicated that further technical assistance will be needed in preparation for subscription to the Special Data Dissemination Standards.

Government Finance Statistics (GFS)

The 1997, a mission found that satisfactory GFS annual data could be compiled from the national data sources if the coverage was expanded to include data on own revenue, foreign grants and loans, and the operations of the extrabudgetary funds. The improvements recommended by the mission were not implemented, and subsequent Article IV consultation missions have also found deficiencies in the availability of information on domestic payment arrears. The authorities indicated that further technical assistance will be needed in this area.

Balance of Payments Statistics

FYRM received one technical assistance mission in balance of payments statistics in October–November, 1998. The mission recommended that steps be taken to improve (i) the coverage, timing, and classification of the international transactions reporting system (ITRS); and (ii) the estimation procedures for travel, private transfers, direct investment, and transactions of commercial banks. While most of the recommendations of the mission have been or are being implemented, the authorities have requested long-term technical assistance for further improving the ITRS. However, STA has been unable to meet this request. Instead, a short-term mission has been tentatively scheduled for April–May 2000.

B. Fiscal Affairs Department (FAD)

Tax Administration and the VAT

Extensive technical assistance on VAT implementation was provided during November 1996–October 1999. The November 1996 mission advised on draft VAT legislation and implementation. The VAT law adopted in July 1999 is generally appropriate. Progress on VAT preparations has been slow. Missions in February and October 1999 found serious deficiencies, including (i) lack of clear responsibility for the Public Revenue Office in all aspects of tax administration; (ii) absence of tax reports or tax accounts for sales and excise tax-payers; (iii) lack of clear procedures for processing and auditing refunds; (iv) lack of personnel assigned to collect tax arrears from legal persons; (v) need for essential upgrading of tax office premises. As a result of the slow progress, the implementation date was postponed from January 1 to April 1, 2000.

A resident expert has been assigned since October 1999 to help the authorities with VAT implementation. The authorities have been very receptive to the resident experts' assistance and, at their request, the expert's assignment has been extended.

Public Expenditure Management and the Treasury

During 1993–96, FAD provided technical assistance to the Ministry of Finance (MOF) in public expenditure management by fielding missions and assigning short-term experts. The recommendations of the missions were, in general, successfully implemented. The work resulted in the enactment of an organic budget law; the introduction of economic and functional classifications in the budget; the activation of the Payments Bureau (ZPP) as treasury office to the MOF; and the establishment of a linked fiscal information system using the ZPP network and facilities. However, the off-budget agency-raised revenues and their corresponding expenditures—special revenues and expenditures—continued to be excluded from government fiscal reports.

In October 1997, an FAD mission evaluated the state of developments on public expenditure management and prepared a detailed work plan for further improvements. It was recognised at that time that further technical assistance would be required to implement the work plan, more specifically, in the integration of the ZPP with the MOF to introduce a new system for executing government payments; enhancing other treasury functions such as in-year financial planning, cash and debt management; and the inclusion of special revenues and expenditures in the fiscal reporting system. More recently, the World Bank has been engaged in public expenditure reforms, mainly in the areas of expenditure review and analysis, and budget preparation. However, most of these activities are in the preliminary stages.

At the request of the MOF, a one-year resident treasury expert was assigned in January 2000 to advise on, among other things, introducing (i) a comprehensive fiscal reporting system to include both budget activities and special revenues and expenditures of budget institutions; (ii) monthly expenditure ceiling releases; and (iii) expenditure commitment controls.

Public Expenditure Policy

The extensive technical assistance provided by the FAD culminated in a comprehensive report on restructuring government expenditures in February 1998. The authorities have adopted some of the recommendations with respect to pensions, but otherwise little has been done. The civil service remains large and there has been no downsizing in the education and health sectors, although the government has committed to a civil service reform in the context of the 2000 budget. In the past, the absence of a high-level commitment has stalled reforms. FAD is no longer involved in providing technical assistance on public expenditure policy, having left the area to the World Bank.

Customs Administration

FAD provided technical assistance in modernising customs administration, financed under a World Bank trade facilitation project, during April 1995–July 1998. The objectives of the project were to develop the legislation, systems, and procedures that would provide the administration with the ability to collect revenues effectively. The recommendations of the missions were successfully implemented including simplification of procedures, introduction of ASYCUDA computer system, and enactment of new customs code compatible with European Union standards. The authorities have expressed interest in receiving further technical assistance in investigating money laundering as a result of increased activity following the Kosovo crisis.

C. Monetary and Exchange Affairs Department (MAE)

Monetary Operations

Two technical assistance missions were provided in the area of monetary operations in December 1998 and December 1999. The first mission focused on monetary operations and instruments, and recommended that (1) bank-by-bank credit ceilings be removed; (2) reserve requirements be unified; (3) minimum interest rate on central bank credits be eliminated; (4) the central bank develop indirect instruments of monetary policy, particularly central bank bills; and (5) the central bank execute repurchase agreements with banks. An action plan for implementing these recommendations was developed together with the authorities. Minimal progress on mission's recommendations was, however, made by the time of the follow-up mission in December 1999. The recommendations were reiterated and advice on the authorities' draft reform package on monetary instruments was offered.

The December 1999 mission also recommended, on the foreign exchange market, that (1) a continuous interbank foreign exchange market be established; (2) the central bank change the calculation of the indicative exchange rate; and (3) the minimum coverage of foreign exchange liabilities be reduced to no more than 100 percent. An action plan for implementing these recommendations was developed together with the authorities.

Further technical assistance might be needed, in particular in the area of monetary operations (deploying indirect instruments) and developing securities markets. However, the authorities are increasingly developing the capacity to design and use indirect monetary instruments, so the need for hands-on technical assistance is tapering off. The authorities indicated, however, that further technical assistance will be needed in the area of repurchase operations.

Banking Supervision and Restructuring

A joint MAE/World Bank technical assistance mission took place in October 1999 that aimed to undertake an assessment of compliance with the Basel Core Principles (CP) for Effective Banking Supervision; provide technical assistance in banking supervision and evaluate the soundness of the banking system in the aftermath of the Kosovo conflict. The CP review found that Macedonia complies favorably with the principles that relate to the regulatory and legal framework for banking supervision. In contrast, substantial efforts would be required to comply with the principles that relate to timely and rigorous regulatory enforcement and offsite monitoring and supervision. With regard to the soundness of the banking system, the mission found that Macedonia's financial system is still very fragile and highly susceptible to shocks—perhaps more than official banking statistics reveal. Because of the favorable economic environment, the mission recommended that the authorities embark on a proactive banking consolidation strategy.

Further technical assistance would be needed to assess improvements in the banking supervision function; assist the authorities in the consolidation strategy; and bring the compliance of the regulatory and supervisory framework closer to the EU norms.

FYRM: Selected Social and Demographic Indicators

	FYRM	Albania	Bulgaria	Romania	Greece
Area characteristics					
Total land area (sq km)	25,430	27,400	110,550	230,340	128,900
Of which: used for crops (in percent)	1.9	4.6	1.8	2.4	8.4
Population density (people per sq km)	77.9	119.9	75.6	98.2	81.3
Population					
Total population (1997, in thousands)	1,997	3,324	8,312	22,554	10,522
Average annual population growth (1997, in percent)	0.8	1.2	-0.5	-0.2	0.4
Life expectancy at birth (1997, in years)	72.4	71.7	70.7	69.0	77.7
Male	70.3	68.8	67.2	65.2	75.1
Female	74.7	74.7	74.4	73.0	80.5
Under 5-years mortality rate (1997, per 1,000 live births)	17.2	40.0	23.5	26.4	9.2
Crude birth rate (1997, per 1,000 persons)	15.9	19.3	8.7	10.2	9.8
Crude death rate (1997, per 1,000 persons)	7.9	6.6	13.8	12.5	9.5
Income and poverty					
GDP per capita (1998, in U.S. dollars)	1,740	906	1,482	1,843	11,497
Poverty rate (1996, in percent) 1/	18.1	...	36.0	21.5	...
Urban	10.2	19.6	33.0	20.4	...
Rural	25.7	28.9	41.0	27.9	...
Health					
Physicians (1995, per 1,000 persons) 2/	2.3	1.4	3.5	1.8	3.9
Hospital beds (1996, per 1,000 persons) 3/	5.2	3.2	10.6	7.6	5.0
Education					
Net enrollment ratios (1996, in percent) 4/					
Primary	95.3	101.7	91.8	94.4	90.1
Secondary 5/	51.4	37.5	74.9	73.0	86.6

Sources: World Development Indicators, 1999, World Bank; FYRM: Focusing on the Poor, 1999, World Bank; Bulgaria: Poverty Report 1997, World Bank; World Development Report 1999/2000, World Bank; and staff estimates.

1/ Percentage of population below the national poverty line. For FYRM, the poverty rate or the incidence of poverty is the proportion of individuals with an income (consumption) below 60 percent of median monthly 1996 consumption (denars 33,061 per year or denars 2,755 per month). Data for Romania refer to 1994 and Bulgaria refer to 1997. Data for urban Albania refer to 1995 and rural Albania refer to 1994.
2/ Data for Bulgaria and Romania are for 1996.
3/ Data for Albania and Bulgaria are for 1995, and for Greece is for 1994.
4/ Data for Albania and Greece are for 1995.
5/ Figure for Albania is gross enrollment ratio.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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700 19th Street, NW
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IMF Concludes Article IV Consultation with FYR of Macedonia

On May 10, 2000, the Executive Board concluded the Article IV consultation with FYR of Macedonia.[1]

Background

After a generally favorable performance in 1998, the FYRM economy suffered a setback in the first half of 1999, mainly owing to the Kosovo crisis. The impact of the crisis, however, was less severe than initially feared. With the ending of the conflict in early June, economic activity picked up markedly and the balance of payments improved beyond expectations. The stance of financial policies was generally prudent in 1999, and inflation remained low. Structural reform initiatives resumed in the second half of 1999, but the follow-through was weak because of the uncertain political climate.

A broad-based pickup in economic activity in the wake of the Kosovo crisis was key to an estimated GDP growth of 2.7 percent in 1999. Unlike the experience of the previous years, an improvement in net foreign demand was a major driving force behind the growth performance. Domestic demand was sluggish, mainly owing to erosion of investor confidence. Consumer prices declined in the course of the first seven months of the year, largely because of lower food prices. Thereafter, inflation turned positive with the firming of food prices and higher oil prices. Unemployment fell slightly, but the rate remained high at 32½ percent.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

The balance of payments position improved in 1999, and indicators of external vulnerability remained satisfactory. The current account deficit (excluding grants) narrowed sharply to 6 percent of GDP (from 9½ percent in 1998), as both exports and imports declined for the year as a whole. After a severe trade disruption during the Kosovo crisis, exports and imports picked up strongly with the ending of the conflict. Service receipts also surged in the second half of the year, with FYRM serving as a key transit route for travel and delivery of goods to Kosovo. The capital account surplus contracted as the foreign direct investment inflows experienced in 1998 were not sustained. With a sizable amount of unrecorded inward transactions, many of them Kosovo-related, gross official reserves increased by about US$125 million, to the equivalent of 2.7 months of next year's imports at end-1999.

The National Bank of Macedonia (NBM) faced contrasting challenges in the conduct of monetary policy during and immediately after the Kosovo crisis. With the onset of the crisis, the NBM provided liquidity support to banks experiencing difficulties on account of deposit withdrawals and delays in debt-service payments by enterprises. The liquidity position of banks improved dramatically in the post-crisis period, as residents began reconstituting their earlier deposit withdrawals and the NBM intervened in the foreign exchange market to neutralize appreciation pressures. A large part of this liquidity influx was sterilized. Official and money market interest rates peaked in May and fell sharply, to below pre-crisis levels, as liquidity in the banking system improved. However, notwithstanding the large swings in liquidity, the lending and deposit rates of banks remained virtually unchanged during the year.

The fiscal situation improved in 1999 despite the Kosovo crisis, but there were lapses in expenditure management and control. The central government accounts swung to a surplus of about 1 percent of GDP, compared with a deficit of 0.2 percent of GDP envisaged in the pre-crisis budget, and the general government accounts were in approximate balance. Tax revenues were extremely buoyant, mainly on account of efforts to improve tax administration. There were slippages in outlays on wages, goods and services, and some social programs, but these were largely offset by saving in other areas. The breach of wage discipline was more serious than indicated by budgetary data, as several line ministries made additional wage payments (totaling nearly 1½ percent of GDP) from their off-budget self-generated special revenues.

The pace of structural reforms picked up from end-1999. A value-added tax (VAT) was introduced on April 1, 2000, after the slow progress in administrative preparations forced the authorities to postpone its introduction in January. In the enterprise sector, 8 out of the 12 loss-making enterprises targeted for closure or sale under the recently expired Fund-supported program had been dealt with by end-March 2000. In the banking sector, a majority share in Stopanska Banka, the largest commercial bank, was sold to a consortium of foreign investors in early April 2000.

Executive Board Assessment

Executive Directors noted the overall favorable macroeconomic developments in 1999, despite the Kosovo crisis: real output had increased, inflation was subdued, the fiscal position had improved, and foreign exchange reserves had strengthened substantially. Moreover, the post-conflict demand stimulus and the prospects for further financial assistance under the Stability Pact for Southeastern Europe provided for a relatively bright near-term outlook. However, Directors stressed that the economy's prospects for sustained growth would hinge critically on a vigorous implementation of structural reforms as well as on a continuation of prudent financial policies. While acknowledging the difficulties that the former Yugoslav Republic of Macedonia (FYRM) has faced and the significant steps that have been taken in the recent past, Directors urged the authorities to spell out, without further delay, a complete medium-term structural reform agenda and economic strategy.

Directors welcomed the authorities' commitment, embodied in the central government budget for 2000, to maintain financial discipline. They stressed the importance of further strengthening fiscal performance by firmly resisting pressures from interest groups for specific relief or support and by adhering to a strict execution of the budgetary plans. Directors also welcomed the recent introduction of the value-added tax.

On the expenditure side, Directors stressed the importance of containing personnel expenditure, and welcomed the authorities' decision to begin downsizing the civil service in 2000. They urged the authorities to press ahead with the divestiture of noncore activities and the consolidation of ministries. Directors considered that prompt integration of the off-budget special revenue accounts into the budget was crucial for ensuring proper fiscal management. They underscored the need to develop a comprehensive medium-term fiscal framework that would clearly order expenditure priorities while taking full account of expenditure liabilities, including those arising from enterprise and bank restructuring.

Directors noted that the prevailing exchange rate regime had served the FYRM well, and agreed with the authorities' assessment that the current level of the exchange rate was appropriate. They did not see a benefit of changing the exchange rate regime at this stage. Nevertheless, Directors recommended that the appropriateness of the exchange rate level and the regime be kept under close review.

Regarding the financial system, Directors remarked that high real interest rates reflected largely the sizable share of nonperforming loans in banks' portfolios, which were the result of poor lending practices and delays in banking system reform. They viewed the recent sale of Stopanska Banka to a foreign investor as well as the ongoing efforts to strengthen bank supervision, as crucial steps toward establishing a sound and competitive banking sector and reducing intermediation costs. However, Directors emphasized that a lasting and effective response to the financial system's problems would not be possible without addressing the underlying weaknesses of the enterprise sector. They also welcomed the recently completed Basel Core Principles Assessment, and encouraged the authorities to implement its recommendations in those areas where additional improvements are still needed.

Directors welcomed the recent progress in addressing the situation of several loss-making enterprises. They noted, however, that remedial action for the largest loss-makers still remained to be taken and that the list of loss-makers for inclusion in the reform agenda needed to be expanded. Directors urged the authorities to accelerate the momentum of enterprise reform through the liquidation of unviable enterprises. They emphasized the need to contain the fiscal costs of enterprise reform in order to maintain macroeconomic stability. Directors stressed the need to improve corporate governance and enterprise performance through strict implementation of newly amended laws on bankruptcy procedures and creditors' rights. Noting the high level of unemployment, Directors also stressed the importance of increasing labor market flexibility to generate employment opportunities, and encouraged the authorities to reduce payroll taxes and limit unemployment benefits in order to enhance the incentive for job search.

Directors looked forward to the authorities' early announcement of their medium-term economic strategy and their plans for structural reform. They stressed that concrete and timely actions, in particular public enterprise and banking sector reforms as well as the preparation of a draft Poverty Reduction Strategy Paper (PRSP) would facilitate the mobilization of resources needed in support of the authorities' reform effort, and attract foreign direct investment. Directors welcomed the upcoming discussion on a program that could be supported by the use of Fund resources.

Directors noted that further improvements in the reliability, coverage, and timeliness of economic data were warranted in order to ensure proper economic policy formulation and surveillance. They recommended that the authorities participate in the Fund's General Data Dissemination System.

Directors welcomed the authorities' intention to release the staff report for the Article IV consultation, and saw this as an indication of their commitment to improved transparency.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. As part of a pilot project, the staff report for the 1999 Article IV consultation with FYR of Macedonia is also available.

FYRM: Selected Economic Indicators, 1996–2000

	1996	1997	1998	1999 Pre-crisis Estimate	1999 Kosovo Scenario	1999 Prel. Actual	2000 Projection
Real economy				(Percent change)			
Real GDP	1.2	1.4	2.9	5.0	-4.0	2.7	6.0
Consumer prices, period average	2.3	2.6	-0.1	1.0	2.0	-0.7	4.0
Real wages, period average	0.5	0.2	3.8	2.0	-0.5	3.6	-0.3
Employment							
Monthly series on monitored sector	-4.7	-6.0	-2.9	1.0	-6.0	1.0	1.4
Labor force survey	...	-4.7	5.4	...	...	1.0	...
Unemployment rate (average) 1/	31.9	36.0	34.5	34.3	36.5	32.4	32.4
Government finances 2/				(In percent of GDP)			
General government revenues and grants	36.5	34.9	34.0	33.5	33.7	37.7	35.3
General government expenditures and net lending	37.0	35.3	35.8	35.6	41.5	37.7	36.6
General government balance (accrual)	-0.5	-0.4	-1.8	-2.1	-7.7	0.0	-1.3
Central government balance (accrual)	-0.7	-1.2	-0.9	-0.2	-5.6	0.9	-0.1
Government debt 3/	41.5	48.1	45.7	...	...	53.2	53.3
Money and credit				(Percent change, end of period)			
Broad money M3 4/	0.3	15.8	14.9	8.4	-3.7	29.7	11.3
Private denar M2	2.3	13.2	11.1	11.4	0.0	33.5	11.2
Total credit to private sector	19.0	18.9	10.4	11.8	7.6	9.4	15.9
Short-term lending rate	23.2	21.6	20.5	...	...	20.0	...
Credit auction rate 5/	11.0	15.2	18.5	...	...	14.7	...
Balance of payments				(In millions of U.S. dollars)			
Exports	1,147	1,237	1,292	1,396	961	1,192	1,345
Imports	-1,464	-1,623	-1,711	-1,791	-1484	-1,601	-1,831
Trade balance	-317	-386	-418	-395	-524	-409	-486
Current account balance	-288	-277	-308	-251	-489	-136	-321
(in percent of GDP)	-6.5	-7.4	-8.8	-6.7	-14.5	-4.0	-9.0
Overall balance	-96	16	44	-3	-309	99	-147
Official gross reserves	267	280	334	373	373	458	528
(in months of current year's c.i.f. imports)	2.0	1.9	2.1	2.3	2.7	3.1	3.1
(in months of next year's c.i.f. imports)	1.8	1.8	2.2	...	...	2.7	3.0
External debt service ratio 6/	11.1	8.7	10.1	12.9	17.1	13.0	13.8
External debt to GDP ratio (in percent) 7/	25.4	31.5	41.1	40.9	44.2	43.3	43.3
Exchange rates 8/				(Percent change, period average)			
Nominal effective exchange rate	12.4	24.2	-3.6	...	...	5.7	...
Real effective exchange rate (CPI-based)	-2.6	-13.1	-11.0	...	...	-1.2	...

Sources: Data provided by the FYRM authorities; and IMF staff projections.
1/ Persons seeking employment as percent of total labor force, based on official Labor Force Survey.
2/ Excludes revenue and expenditure of the special revenue and expenditure accounts of line ministries.
3/ Total debt of central government and external debt of general government; includes liabilities assumed by the government upon the sale or closure of loss-making enterprises and associated with the cleaning up of Stopanska Banka's balance sheet prior to its sale.
4/ Includes foreign currency deposits.
5/ Data for 1999 is for October.
6/ Debt service due, including IMF, as a percentage of exports of goods and services.
7/ Including IMF.
8/ Partner countries exclude FR Yugoslavia. The effective exchange rate calculations are based on the chain index method, where the partner country weights are not fixed.

Statement by J. de Beaufort Wijnholds, Executive Director for Former Yugoslav Republic of Macedonia May 10, 2000

The staff has produced a lucid and candid assessment of the economic situation and policies of the Former Yugoslav Republic of Macedonia (FYRM). Indeed, it would be highly desirable if the degree of frankness, indispensable for this Board to focus on the most pressing issues, were copied in the staff reports for all other countries, including larger ones. The authorities' intention to publish the staff report is testimony to Macedonia's increasing transparency and its continuing dialogue with the international community as to the optimal policies to be followed. I believe this report provides a good basis for proceeding with the discussions on a Fund-supported program, which the authorities hope could be in place by late summer. I would also like to take the opportunity to thank the staff for its perseverance in continuing the dialogue with Macedonia and its relentless efforts to assist the country in trying to cope with the very difficult external circumstances of 1999. In this respect, it is worth noting that staff missions to FYRM took place five times since the beginning of 1999, including during the height of the Kosovo crisis. On top of that, the authorities are grateful for the substantial technical assistance they have received from the Fund, in the form of two missions by our Monetary & Exchange Affairs Department, two missions by our Fiscal Affairs Department (FAD) and two FAD resident advisors.

The staff report presents a mixed picture. It should be taken into account, however, that FYRM has faced daunting economic and political challenges over the last decade in its transition to a market-based economy. In this light, the sustained and successful stabilization efforts by the authorities, both fiscal and monetary, are remarkable. Moreover, in spite of the Kosovo crisis, the government was able to continue fiscal discipline and largely retain in 1999 the gains of fiscal adjustment that had been achieved over the period since 1995. In a similar vein, inflation was kept low, foreign exchange reserves increased and the exchange rate remained stable. Notwithstanding these not insignificant accomplishments, the authorities recognize that many difficult further steps have to be taken to put economic growth on a sustainable footing.

These further steps lie mainly in the field of structural adjustment. Progress in this area was delayed in 1999. The new government coalition that had come into power in December 1998 was immediately confronted with the social, political and economic repercussions of the Kosovo crisis, which developed in early 1999. In this environment, it proved impossible for the government to reach agreement on additional structural measures to be taken, in view of possible social impact and the already extremely high unemployment. Nevertheless, with the Kosovo crisis abating, Macedonia continued to remain the island of peace and stability it had been since its independence in 1991 in an otherwise tumultuous region.

In the second half of 1999 the Macedonian authorities were able to focus again on the economic policy agenda. Since then, a number of important initial steps toward reaching agreement on a Fund-supported program have been taken. This process has been reinforced by a government reshuffle at the end of last year. The authorities intend to demonstrate their commitment to further adjustment by taking concrete steps in the next weeks, which would allow for a staff visit in June to discuss a Fund-supported program.

As the staff points out, **macroeconomic policy** has been generally adequate over the last two years. Fiscal policy has remained tight, with the general government achieving a balanced budget in 1999. Efforts to improve the tax administration were highly successful, with actual collections exceeding those budgeted by 6.5 percent (3.4 percentage points of GDP). The Finance Minister acknowledges that the problem of off-budget accounts held by other ministries should be addressed and public expenditure management should be further improved. At his request, the Fund has provided a resident advisor for the current year to set up a centralized treasury function in order to improve on the Finance ministry's oversight function. In addition, a World Bank Public Expenditure Review mission is presently in the field. For 2000, the central government is also budgeting a balanced budget.

A major step this year has been the actual introduction of a **Value Added Tax** as per April 1, with a technical delay of three months. This was a condition under the expired ESAF and also formed a key precondition for the resumption of negotiations on a new Fund program. The first indications are that the implementation of the VAT law has gone smoothly and that resulting price hikes have been less than expected.

It is clear that there are substantial inefficiencies in the **civil service** and that a **reform of the public sector** is required, including a downsizing of the civil service. As an initial but crucial step, the authorities have prepared a register of all public sector employees with a view to assessing the usefulness of individual positions. It should be noted, however, that major lay-offs of civil servants are difficult to defend in social terms, when the unemployment rate is a staggering 32 percent. As a result, there have been delays in taking adequate measures. Nevertheless, parliament has recently passed a law on early retirement, which should allow for a reduction in the civil service that goes a long way in the direction of the policies advised by Fund staff.

On the **monetary** side, the **policies** pursued have had generally favorable effects, with negligible inflation, a stable exchange rate and increasing foreign exchange reserves. It is also very welcome that the National Bank of Macedonia (NBM) has now moved to a system of monetary control based solely on the use of indirect instruments.

The discussion of **exchange rate issues** in the report is frank but fair. I believe that at some point in the future a floating exchange rate regime might be preferable. The authorities have indicated that they would only consider such a step in consultation with the staff.

The staff makes some quite critical observations on **banking sector supervision**. The shortcomings in this field should be seen in the light of the persistent losses in some of the publicly owned industrial enterprises, which has made it extremely difficult for commercial banks to apply proper credit risk considerations in extending credit exposure. In addition, the legacy of pre-independence central planning has been a weak banking sector. This problem has exacerbated in 1999, due to the Kosovo crisis and the resulting social effects. Since that time, positive steps have been taken, however. The largest commercial bank, Stopanska Banka was finally restructured and sold to a foreign investor. This significant measure will have a beneficial impact for the economy as a whole. Another insolvent bank has been closed, in spite of strong domestic resistance. In the field of banking supervision, it should also be pointed out that Macedonia complies favorably with the Basle Core Principles that relate to the regulatory and legal framework. The problem lies with implementation and enforcement. In order to tackle this, the NBM is strengthening its off-site monitoring abilities and increasing minimum capital requirements.

In the area of **structural reform**, I am happy to report that considerable progress has been made recently. Eight out of twelve loss-making enterprises targeted for action under the recent Fund-supported program have now been closed, liquidated or sold. While a few big problem cases remain, it is expected that the pre-appraisal conditions set by the World Bank for a FESAL loan can be met in the near future. This would allow the authorities to reinforce their commitment for reform of the state- and socially owned enterprise sector with World Bank support. In addition, the authorities are determined to improve the investment climate in order to attract foreign investors, including a streamlining of the regulatory framework. Also, a domestic stock market is being developed and the Privatization Agency has been playing a increasingly professional role in divesting state-owned enterprises by adhering to generally accepted standards of transparency and governance.

In sum, the challenges that FYRM faces are enormous, but the authorities have certainly shown their willingness to tackle the problems. Moreover, the authorities regret that the previous ESAF went off-track, but they are determined to conclude an agreement with the Fund during the summer.

Finally, I am afraid I have to take issue with paragraphs 4, 27 and 60 of the staff report concerning the **freeze of certain foreign currency deposits** which constitute a restrictive measure subject to **Article VIII, section 2(a) of the Articles**. This is an issue that also repeatedly comes up in the context of Article IV discussions of other former Yugoslav republics, and which has been dealt with by the staff in a rigid manner. Foreign exchange arising from household foreign exchange savings deposits was not available to Macedonian banks after the breakup of Yugoslavia, since these funds remained in the former National Bank of Yugoslavia. To prevent a bank run, the Macedonian government took over the claims of the former central bank and transformed them into time deposits back in 1992 (see Box 1 of the Recent Economic Developments paper). According to staff, this gives rise to an exchange restriction because it prevents nonresidents holding such deposits from transferring abroad proceeds of current international transactions – mainly interest accruing on these deposits. After the authorities intended to accept the obligations of Article VII, section 2(a), staff determined that this was the case in June 1998, upon which the Board approved the restriction until the next Article IV discussion or April 30, 2000. Staff now just notes that the approval has expired, but it does not recommend approving it again.

Meanwhile the authorities have tried to devise a system to solve the problem of the frozen deposits, taking into account the country's ability to repay the large stock of foreign currency deposits (DEM 1.05 billion at the end of 1999) and without unduly affecting the balance of payments. The broad content of the legislation, which is described on page 62 of the Recent Economic Developments report, has been developed since November 1999 after consultation with staff. However, only in March 2000 did staff advise the authorities that they would need to issue two classes of bonds, with the obligations to non-residents being serviced with a much shorter maturity, in order to comply with Article VIII. The authorities on their part contended that it would be extremely difficult to make this distinction; that it would be hard to administer and could be easily circumvented; and that this would constitute unequal treatment between domestic and foreign depositors. It appears to me that these objections are valid. In addition, the authorities find that it is extremely difficult, if not impossible, to determine if, among the outstanding frozen deposits, income is included that was generated from current account transactions. The staff's proposal therefore comes across as a too narrow interpretation of the situation. Also, in the authorities' view, the proposed law does not contain any provision that imposes restrictions on the transfer of interest. For this reason, the authorities have asked staff and management to reconsider their finding that Macedonia maintains an exchange restriction.

If the Board nevertheless decides that there is a restriction, I believe the authorities have now set out a clear timetable for resolving the issue. Staff itself points out that the budgetary and balance of payments constraints do not allow for a quicker resolution. In fact, staff had advised the authorities to even further extend the maturity and the grace period of the proposed bond-swap scheme. I therefore believe the proposed twelve-year period is entirely reasonable. I do not think it is helpful to let a member country remain in violation of the Fund's Articles of Agreement for the next twelve years.