March 2002
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Former Yugoslav Republic of Macedonia: 2001 Article IV Consultation—Staff Report and Public Information Notice on the Executive Board Discussion.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 Article IV consultation with the Former Yugoslav Republic of Macedonia, the following documents have been released and are included in this package:

- the staff report for the 2001 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **December 5, 2001** with the officials of the Former Yugoslav Republic of Macedonia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on February 15, 2002.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its March 4, 2002 discussion** of the staff report that concluded the Article IV consultation.

The document(s) listed below have been or will be separately released.

Selected Issues and Statistical Appendix

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the
2001 Consultation with the Former Yugoslav Republic of Macedonia

Approved by Susan Schadler and G. Russell Kincaid

February 15, 2002

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Executive Summary

The FYRM economy suffered a setback in 2001 because of the security crisis. GDP declined by about 4½ percent and inflation remained around 5½ percent. Owing primarily to additional spending on security operations but also some tax cuts and cyclical weaknesses, the general government recorded a deficit of 6 percent of GDP, implying an expansionary swing of 8½ percent of GDP relative to 2000. The external current account deficit (excluding grants) widened by 5 percentage points to nearly 11 percent of GDP, and the foreign exchange loss was heavy. But the impact on foreign reserves was cushioned by sizeable privatization inflows (9½ percent of GDP) in early 2001. As for structural reforms, notable progress was made on several fronts but the resolution of loss-making enterprises lagged expectations. In the aftermath of the crisis, the authorities requested the cancellation of the PRGF/EFF arrangements. Subsequently, the authorities requested, and management agreed, that the staff monitor for six months their economic program starting January 1, 2002.

A major challenge for the authorities is to strengthen the fiscal position over the medium term to safeguard external sustainability and government debt dynamics. In 2002, the authorities' aim is to bring down the general government deficit to 3½ percent of GDP. But, the adjustment measures are stopgap in nature and would not ensure compliance with the required medium-term fiscal consolidation. In the coming years, the budget will face incipient strains on the revenue side and spending pressures in a number of priority areas. The staff encouraged the authorities to introduce from 2003, if not sooner, permanent revenue-enhancing measures, including base-broadening and tax-rate adjustments for the VAT. Further strengthening of expenditure management and control is also a priority.

FYRM's external competitiveness is broadly appropriate, although efforts to enhance competitiveness through productivity gains from enterprise restructuring will improve export and growth performance. The staff endorsed the NBM's decision to continue with the de facto pegged exchange rate regime, but noted that continuation of this regime could be a challenge when capital and financial transactions are liberalized in mid-2002.

The authorities emphasized that, notwithstanding the uncertain political environment, they remain committed to implementing structural reforms. They plan to resolve the loss-making enterprises targeted under the World Bank's FESAL II operation by end-2002. They will enhance supervision and improve governance in the banking sector. The approach to public administration reform will have to be modified in light of provisions in the peace framework agreement for higher representation of minorities in the civil service and greater autonomy for municipalities. The staff stressed that the transfer of functions to municipalities should be undertaken in an orderly fashion, and that issues related to equity, access, and service delivery should be taken into account in planning the decentralization of education and health care.

FYRM will need balance of payments support from the international community in 2002. The staff calculations show a financing gap of US$163 million in 2002, excluding the costs of implementing the peace framework agreement.

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 27-December 5, 2001.[1] The staff met with President Trajkovski; Prime Minister Georgievski; Governor Trpeski of the National Bank of Macedonia (NBM); all economic ministers; key senior officials of the government, the NBM, major commercial banks, the Chamber of Commerce, and labor unions; and representatives of the international community.

2. The last Article IV consultation was concluded by the Executive Board on May 10, 2000 (SUR/00/39, 5/16/00). On that occasion, and subsequently during the approval of a PRGF/EFF-supported program on November 29, 2000 (EBS/00/231, 11/15/00), Directors noted the authorities' successful efforts in maintaining financial stability despite the difficult regional situation. However, they emphasized the importance of accelerating reforms and urged the authorities to firmly implement the reform agenda in the fiscal area and in the enterprise and financial sectors in order to underpin high economic growth.

3. The PRGF/EFF-supported program went off track in late-December 2000. The situation became further complicated as the country became embroiled in a security crisis for six months through August 2001, with far-reaching impact on the economy. A mission in June 2001 did not conclude the discussions for the first review under the PRGF/EFF arrangements. As the objectives of the program—on the macroeconomic side as well as the poverty reduction aspects[2] and participatory Poverty Reduction Strategy Paper—were unlikely to be achieved in the aftermath of the crisis, and there were concerns about a slowdown in key structural reforms, the authorities requested cancellation of the PRGF/EFF arrangements on November 22, 2001. Only SDR 2.87 million of the approved access of SDR 34.45 million was disbursed/purchased under the arrangements. Subsequently, the authorities requested, and management endorsed, staff monitoring of their program of economic policies for six months starting January 1, 2002. The letter of intent and the memorandum of economic policies of the staff monitored program (SMP) were issued to the Executive Board on December 26, 2001 (EBS/01/213).

4. The SMP is meant to provide a framework for donors to give financial assistance to FYRM until a follow-up program to be supported by an upper credit tranche arrangement with the Fund can be put in place. The donor community has indicated its willingness to support post-conflict reconstruction, balance of payments need, and measures for resolving

[1] The staff team consisted of Messrs. Banerjee (head), Zalduendo, and Darbar, Ms. Fernandez (all EU1), Mr. Sobolev (PDR), and Mr. Mikkelsen (Resident Representative). Mr. Nijsse, Assistant to the Executive Director for FYRM, and Ms. Bricknell, the World Bank Resident Representative in Skopje, attended some of the discussions.

[2] The latest available poverty data are for 2000, and are shown in Appendix IV. The authorities will carry out a poverty assessment in 2002, with assistance from the World Bank.

ethnic demands envisaged under a Peace Framework Agreement that was signed by the country's political leaders in mid-August 2001. However, the convening of a donor meeting—now scheduled for March 12, 2002—was held up because of delays in meeting two political preconditions: constitutional amendments to improve the civil rights of minority ethnic Albanians were ratified by the FYRM parliament only in November 2001, and a law on local government providing greater autonomy to municipalities was passed only in late January 2002.

5. While the security situation has improved significantly since the signing of the peace agreement, the political situation remains unsettled. Pressures are mounting on the government to hold elections ahead of the normal schedule of October/November 2002.

6. FYRM has accepted the obligations of Article VIII, Section 2, 3, and 4, with effect from June 19, 1998. The country maintains an exchange restriction subject to Article VIII, Section 2(a) arising from the treatment of former frozen foreign currency savings deposits (see paragraph 43). FYRM's relations with the Fund and the World Bank Group are summarized in Appendices I and II, respectively.

7. FYRM's statistical data, particularly in the areas of real sector, government finance statistics, and balance of payments, suffer from weaknesses that hamper analysis and program monitoring (Appendix III). The authorities have made efforts to redress the gaps, with technical assistance from the Fund and EuroStat, but progress has been slow. Reflecting institutional weaknesses, progress in the preparation of General Data Dissemination System (GDDS) metadata since the designation of a GDDS coordinator in March 2001 has been slow.

II. Background and Recent Developments

8. **After three consecutive years of generally favorable performance, the FYRM economy suffered a setback in 2001 because of the security crisis**. Output declined markedly. New outlays on security operations and weak revenues contributed to a large expansionary fiscal swing. Owing to a deterioration of the external current account position, the foreign exchange loss was heavy, though the impact on gross international reserves was cushioned by sizeable privatization inflows early in the year (Table 1). However, slippage on the stabilization front was discernible even before the eruption of the security crisis. The following end-December 2000 performance targets of the PRGF/EFF-supported program were not met: net bank credit to the general government (performance criterion), central government budget balance (indicative target), personnel expenditures financed from special revenue accounts (benchmark), and preparation of a plan for divestment of non-core government activities (structural benchmark).

9. **Real GDP declined by an officially estimated 4½ percent in 2001, though the labor market does not appear to have been adversely affected**. Economic activity weakened as a result of a sharp erosion of consumer and business confidence and a drought-induced agricultural slowdown. The contraction of output was broad-based, but excluded the government sector where activities were boosted by the security-related operations. Inflation

was driven mainly by higher food prices, and slowed only slightly to 5.3 percent for 2001 as a whole. The annual labor force survey, conducted in October 2001, indicates a fall of 1.7 percentage points in the unemployment rate to 30.5 percent. The number of jobseekers registered in the employment bureau dropped by about 3½ percent in the 12-month period ended September 2001. These trends reflect a buoyant informal economy and the recruitment of a large number of reservists in the police and the army. Employment in the registered enterprise sector fell by about 4 percent during the same period. Wage pressure in the registered enterprise sector was muted in 2001, as reflected in a decline in real wages of nearly 2 percent (Figures 1 and 2).

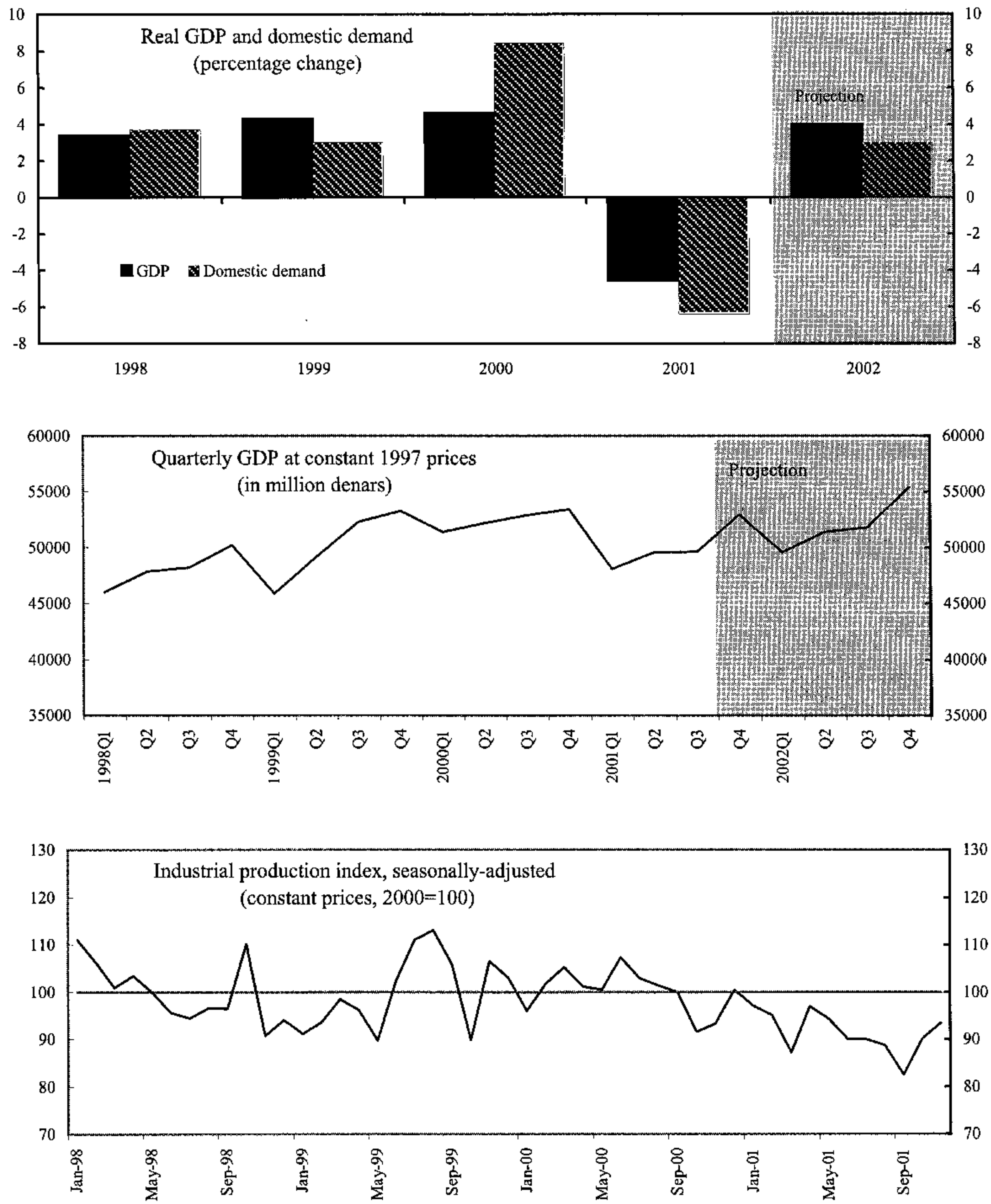
Summary of General Government Fiscal Developments, 2000-01

	2000	2001	
	Actual	Budget 1/	Actual
	(In percent of GDP)		
Total revenue and grants	36.7	32.6	34.4
of which: tax revenue (excl. financial transaction tax)	33.0	30.2	30.5
financial transaction tax	0.0	0.0	1.3
Total expenditures	34.2	33.7	40.4
Current expenditures	31.2	28.3	36.5
of which: security-related expenditures	3.3	3.3	10.3
Capital expenditures	2.7	3.6	3.4
of which: foreign-financed Road Fund expenditure	0.2	1.0	0.3
telecom projects	0.0	0.0	0.6
Other (includes net costs of structural reforms)	0.3	0.3	0.5
Room for new policies	0.0	1.5	0.0
Balance	2.5	-1.1	-6.0

1/ Figures for ratio to GDP for the 2001 budget are based on a nominal GDP that is calculated by applying the growth expected under the PRGF/EFF-supported program (EBS/00/231) to the actual 2000 GDP outturn.

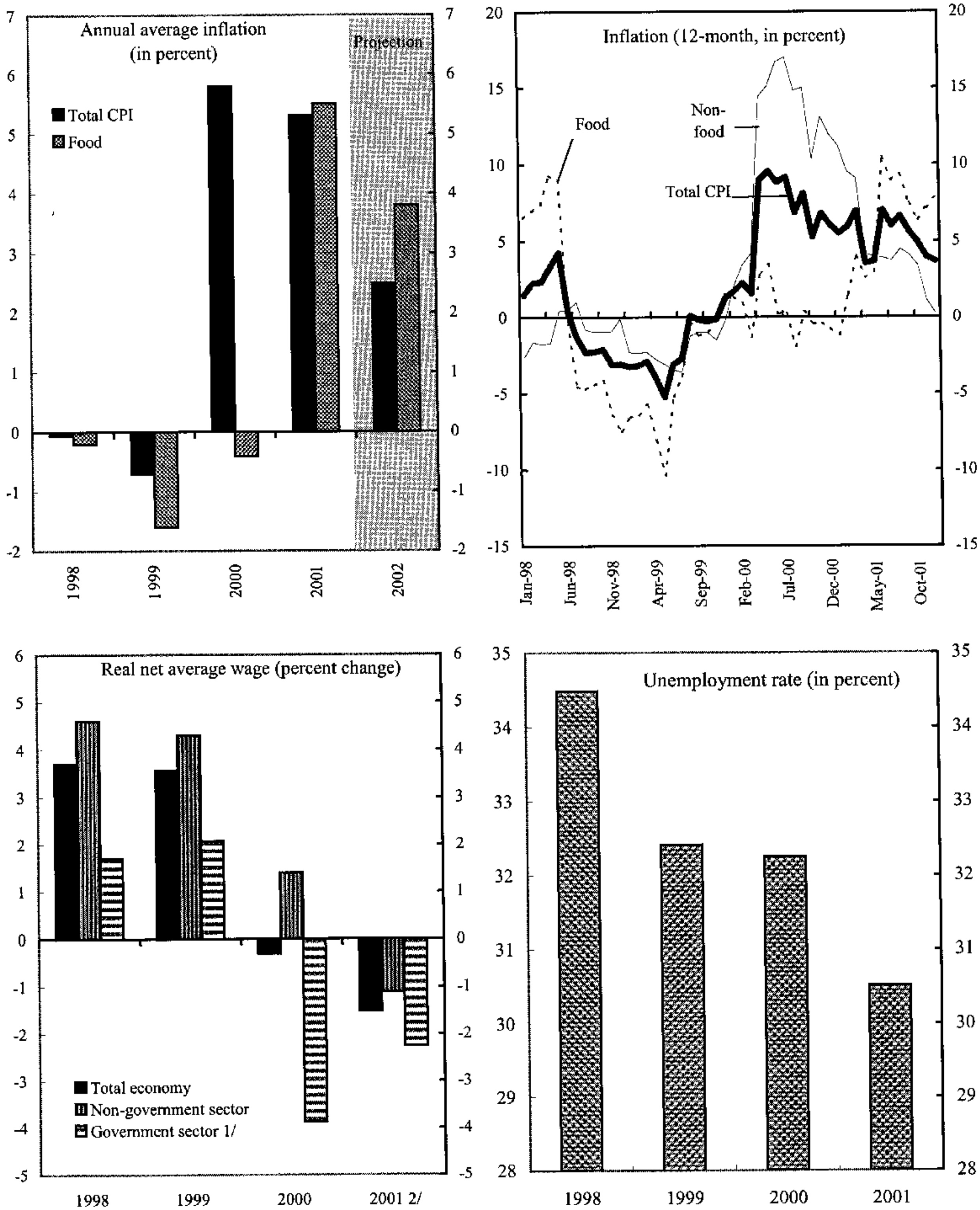
10. **The fiscal outturn in 2001 was substantially worse than anticipated in the original budget**. Because of the crisis, additional spending on military equipment and on security personnel amounted to 6¾ percent of GDP. Tax receipts were lower than forecast in the budget in nominal terms, reflecting a weaker economy, but roughly similar if measured as a ratio to GDP. In the second half of the year, the authorities embarked on a public investment program funded from privatization receipts, with outlays reaching about

Figure 1. FYRM: Economic Activity Indicators, 1998-02



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

Figure 2. FYRM: Prices, Wages, and Unemployment, 1998-01



Sources: Data provided by the FYRM authorities; and IMF staff projections.
1/ Includes education, science, culture and information; health and social security; and bodies of state administration, local administration, political parties, social organizations and associations.
2/ Covers the period January-September 2001.

½ percent of GDP by year-end. Partly to offset the pressures on the budget, the authorities postponed revenue-reducing measures originally envisaged for June (1½ percent of GDP), and introduced on July 1, for a six-month period, a new tax on financial transactions (which yielded the equivalent of about 1¼ percent of GDP). Also, foreign-financed expenditure on road construction was about ¾ percent of GDP lower than budgeted. Thus, the general government accounts recorded a deficit of 6 percent of GDP in 2001, compared with about 1 percent envisaged in the budget (Tables 2 and 3).[3] The fiscal outturn in 2001 represents an expansionary fiscal swing of 8½ percent of GDP relative to 2000. Of this swing, 1½ percentage points of GDP is accounted for by revenue-reducing measures that were introduced in the beginning of 2001 and another 1½ percentage points of GDP reflects the impact of cyclical factors.

11. **The external current account deficit (excluding grants) is estimated to have widened by about 5 percentage points of GDP to 10¾ percent of GDP in 2001**. A major contributory factor was a crisis-induced sharp drop in net inflows of private transfers. The trade balance improved, as imports were severely compressed on account of lower domestic demand and more than offset a marked decline in export earnings. Exports suffered in part because of the crisis but mainly on account of sector-specific problems in the steel industry that began in the last quarter of 2000. Excluding steel, exports were down by 4 percent. During the six-month crisis period, unrecorded inward transactions—reflecting in part purchases by KFOR and Kosovo residents during cross-border trips to FYRM—shrunk and trade credits turned negative as importers were asked to pre-pay their imports. Thus, since the beginning of the crisis in late February through end-December, gross official reserves declined by about US$160 million (about 22 percent of total reserves at the beginning of the year). However, owing to receipts of US$323 million (or 9½ percent of GDP) from the privatization of the telecommunications company in January 2001, gross foreign exchange reserves remained at a relatively comfortable level of US$779 million, equivalent to 4.7 months of next year's imports, at end-December 2001 (Figures 3 and 4, and Table 4).[4]

12. **The NBM was challenged in the conduct of monetary policy by the expansionary fiscal stance and an erosion of market confidence in the denar.** Pressure on the foreign exchange market, which initially appeared in early 2001 following a fiscal-policy induced expansion of liquidity, intensified with the onset of the security crisis. In mid-June 2001, the spreads between the official exchange rate and the rates in the inter-firm market and foreign exchange bureaus peaked at 7 percent and 12 percent, respectively (from 0.6 percent and

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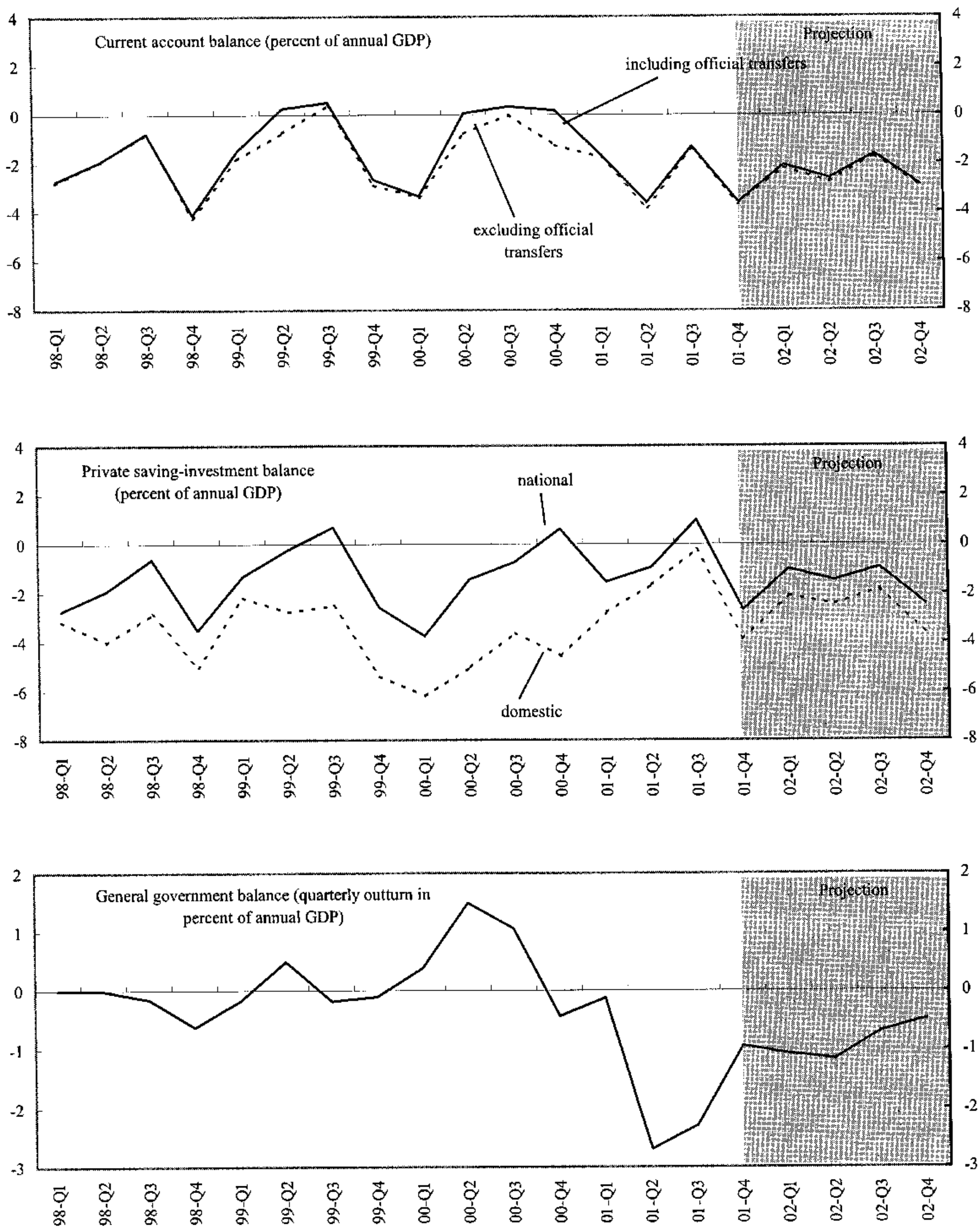
[3] The actual fiscal deficit outturn was lower than that anticipated during the discussions (and reported in EBS/01/213) by 0.7 percentage points of GDP. Much of this is explained by lower-than-appropriated spending on privatization revenue-funded projects.

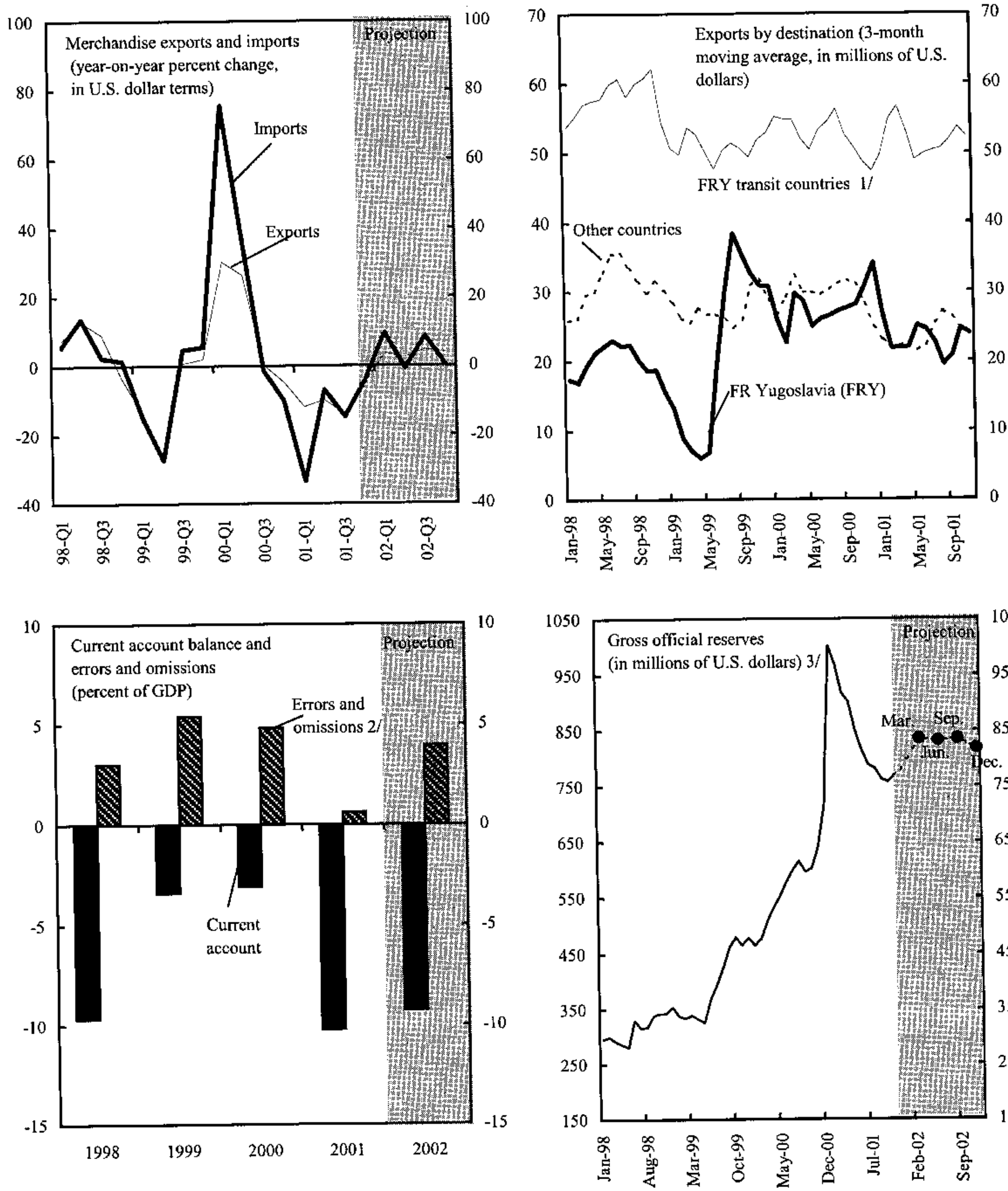
[4] Developments in the foreign exchange reserves position of the NBM in the last month of the year were stronger than anticipated during the discussions and reported in EBS/01/213.

Figure 3. FYRM: Saving-Investment Balances, 1998-02



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

Figure 4. FYRM: External Sector Developments, 1998-02



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

1/ Exports to all European countries (including Russia, Ukraine, and Belarus) other than Albania, Bulgaria, Greece, and Turkey.

2/ Includes unidentified short-term capital, such as trade credits, imports paid by drawdown of foreign-held accounts, and unrecorded remittances and exports.

3/ The increase in January 2001 reflects privatization receipts from the sale of a majority stake in the telecommunications company.

1.7 percent, respectively, at end-December 2000; Figure 5).[5] Experiencing substantial foreign exchange loss, the NBM began to tighten monetary policy after some hesitation. During May-June, the remunerated reserve requirement was increased in two steps by 2 percentage points and the interest rate on 28-day central bank bills was more than doubled to 20 percent. In addition, in August the period for surrendering export proceeds was shortened from 180 days to 30 days, with the aim of increasing the supply of foreign exchange. These initiatives and the signing of the peace framework agreement helped restore normalcy in the foreign exchange market by mid-August. Major banks followed the NBM by slightly raising deposit and lending rates, and cut back private sector lending in the third quarter after a relatively expansionary first half. During January-August, the NBM sold nearly US$140 million (or, slightly over 4 percent of GDP) through foreign exchange market intervention. Prompted by the subsequent calm conditions in the foreign exchange market and an increased demand for bills by commercial banks, the NBM lowered the interest rate on bills in two steps by 5 percentage points to 15 percent on November 19 (Figure 6).

13. **Appreciation pressures emerged in the foreign exchange market in December 2001**, as residents deposited cash foreign currency savings in banks to facilitate conversion into euros and as the demand for denars increased markedly. It is estimated that euro conversion boosted foreign exchange deposits in the banking system by about US$340 million (or, nearly 10 percent of GDP) toward the end of the year. Much of these deposits is expected to be temporary; an estimated 20 percent was withdrawn in January 2002. In a reversal of the pattern in the first three quarters of 2001, the NBM purchased US$51 million through intervention in the foreign exchange market during the fourth quarter as confidence in the denar grew and the balance of payments position improved.

14. **On the structural front, progress in civil service reform, strengthening bank supervision, and reforming the payments system was notable**. In the first half of 2001, gross employment in the public administration was reduced by 6½ percent (or, 4,500 persons) through voluntary separation and early retirement. In the banking sector, the regulatory framework of bank supervision was strengthened, the soundness rating of three out of the eight "problem" banks was upgraded as they showed improvement in their operation, and two problem banks merged with other banks. The reform of the Payments Operations Bureau (ZPP), including the implementation of a new payments system operated by the NBM for large transactions and the commercial banks for small transactions, was completed by end-2001. However, the progress toward divesting non-core government

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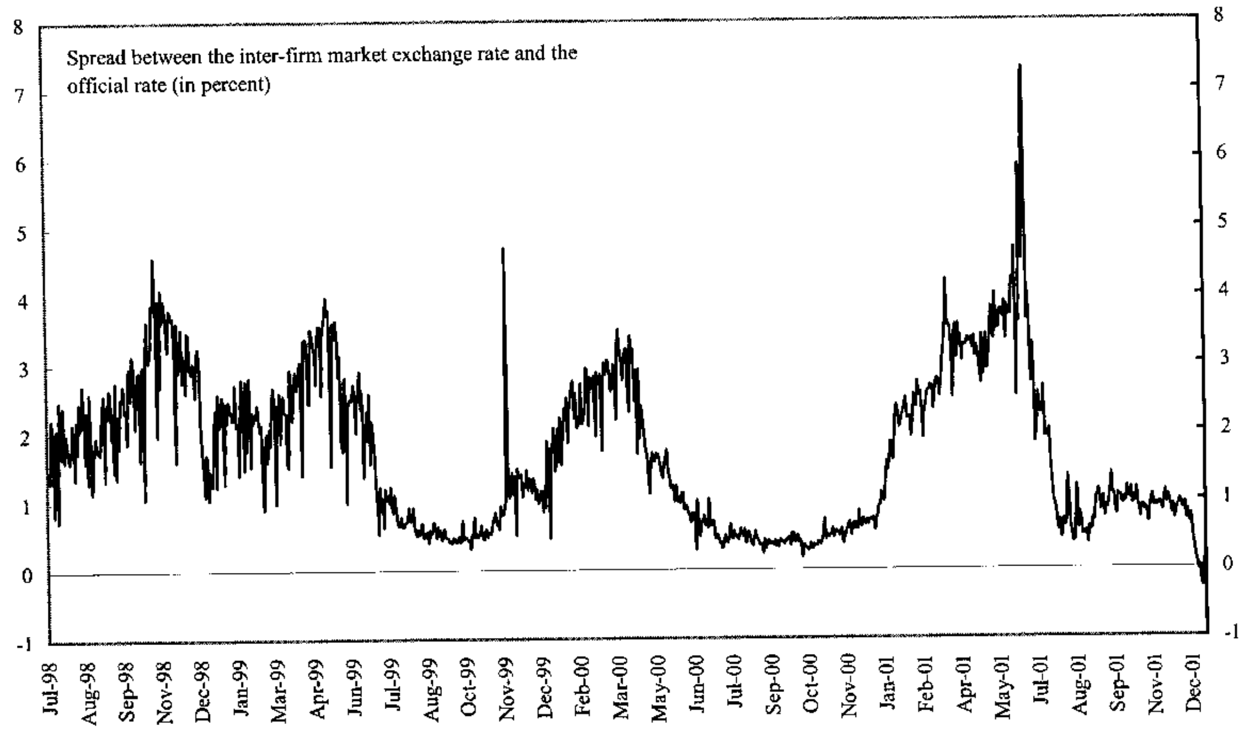
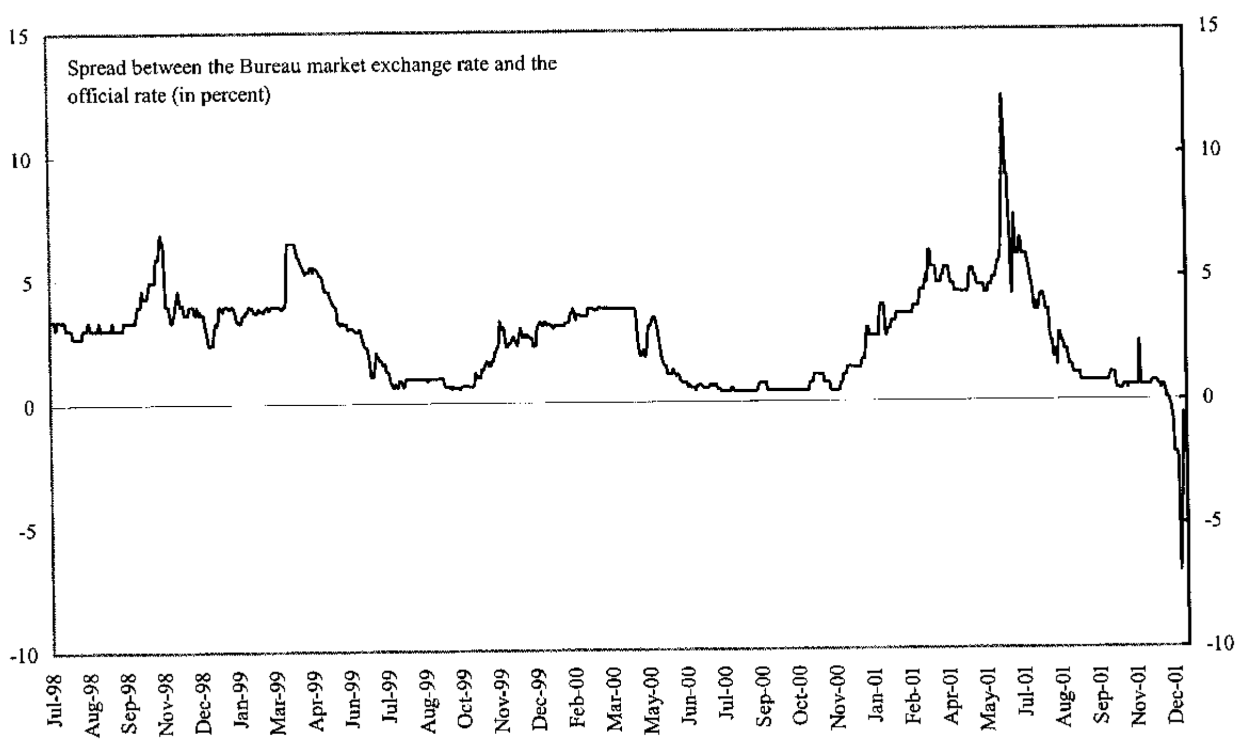
[5] The spreads reflect transaction costs and risk premium. A temporary restriction on the sale of foreign exchange to a few large firms and to foreign exchange bureaus at the height of the crisis was a contributory factor to the sharp jump in spreads. By mid-August, the spreads had returned to normal levels. The developments in spreads did not lead to a multiple currency practice as they arose without official action (Decision No. 6790, as amended by Decision No. 11728 (5/21/98))

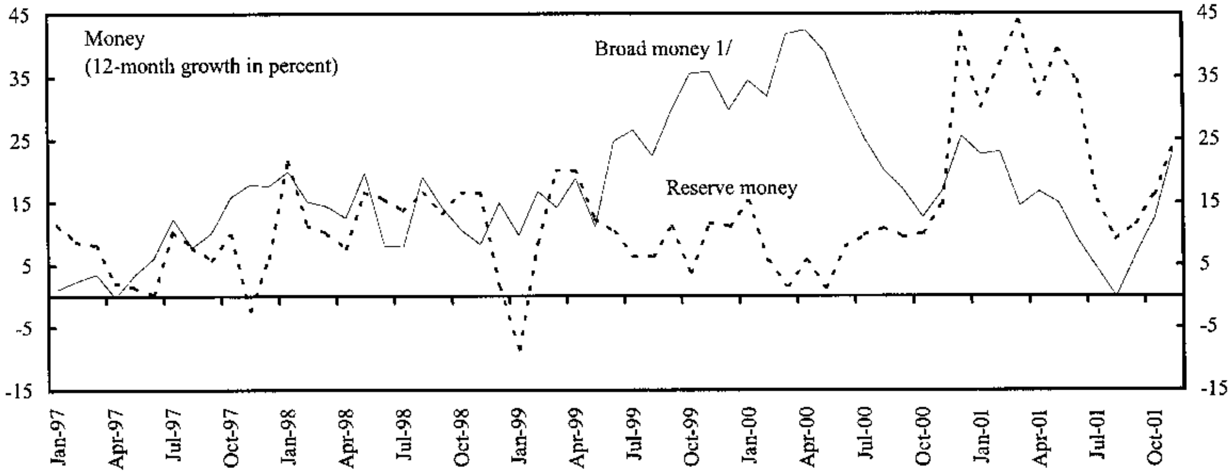
Figure 5. FYRM: Foreign Exchange Rate Spreads, 1998-01

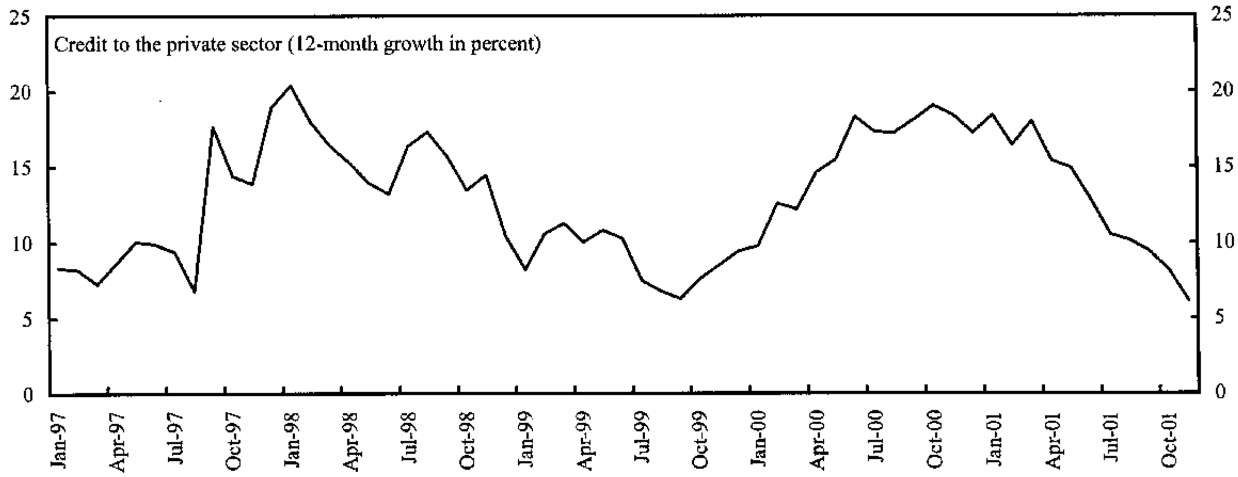


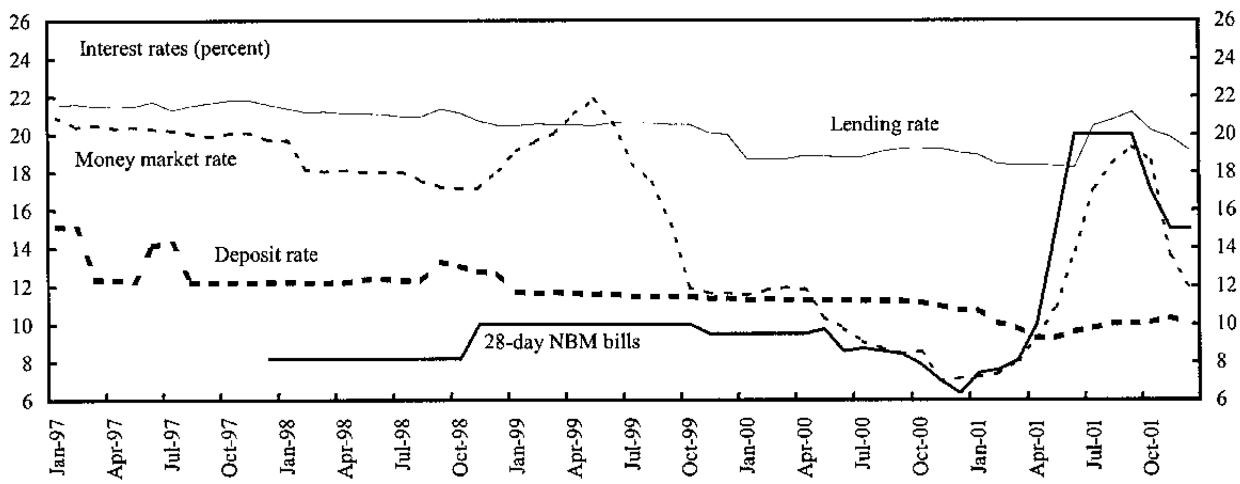


Sources: National Bank of Macedonia; and Exchange Bureaus.

Figure 6. FYRM: Money, Credit, and Interest Rates, 1997-01







Source: The National Bank of Macedonia.
1/ Includes foreign currency deposits.

activities and resolution of loss-making enterprises was slow, in part because of the complications created by the security crisis.

III. Report on the Discussions

15. **The authorities recognized that reversing last year's large expansionary fiscal swing and continuing to strengthen the fiscal position over the medium term would be a major challenge**. The likely availability of large donor financing in 2002 would ease the adjustment burden, but durable measures would be essential to rein in the fiscal deficit progressively so as to put the external current account on a sustainable footing. Such a policy stance also would be consistent with stabilizing the government's net debt as a ratio to GDP (projected at about 40 percent in 2002).[6] They emphasized, however, that over the medium term, tensions are likely to arise in formulating policy measures because of incipient strains on the revenue side[7] and spending pressures in a number of priority areas: security operations; reforms of the enterprise sector, public administration, and pension system; decompression of the wage structure of civil servants; and agreed measures under the peace framework agreement. Over the next three years, the government planned to draw down the substantial privatization receipts received in early 2001 for already earmarked expenditures. Ensuring efficient use of these resources would be vital for establishing a strong foundation for growth. The discussions with the authorities covered these issues as well as a stabilization program and external financing need for 2002. Quantitative benchmarks have been established for end-March and end-June 2002 for staff monitoring of the authorities' program (¶s 18, 20, and 26).[8]

16. **The policy framework for 2002 excludes new expenditures on implementing the peace framework agreement, except for a few minor items**. At the time of the discussions, only partial estimates of the fiscal costs of the peace framework agreement were available (see Box). A comprehensive assessment of the costs will be possible once a road map for

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[6] Staff calculations show that if the fiscal deficit/GDP ratio were maintained over the medium term at the 2002 budgeted level (3.4 percent of GDP), net debt-to-GDP ratio would increase by about 2½ percentage points of GDP annually, while the gross debt-to-GDP ratio would be broadly stable. The difference in the dynamics of gross debt and net debt ratios reflects the use of privatization revenues to finance expenditures and would not persist over the longer term. Once the privatization revenues were used up by 2005, both gross debt and net debt ratios would show a rising trend if the fiscal deficit/GDP ratio were maintained.

[7] The tax base and rates for import duties have fallen on account of ongoing trade policy initiatives, and this trend is expected to continue. Also, it is estimated that the elimination of the 1 percent fee for processing customs documentation on January 1, 2002 will result in a revenue loss of about 0.3 percent of GDP.

[8] All paragraph citations, denoted with a ¶ sign, refer to the Memorandum of Economic and Financial Policies for Staff Monitored Program (EBS/01/213, Attachment I).

implementation of the measures has been determined. The authorities stressed that without donor support to cover the bulk of these costs, the implementation of the peace agreement would suffer.

A. Outlook for 2002 and the Medium Term

17. **The outlook for economic growth and inflation in 2002 should improve with the cessation of hostilities**. The authorities envisaged real GDP growth of 4 percent, on the basis of a revival of business confidence, reconstruction spending by the donor community, and a return of favorable weather for agriculture. The staff agreed with this assessment. However, downside risks to the growth forecast have emerged, as latest available data indicate that the expected turnaround in industrial activity in the fourth quarter of 2001 was absent. Average inflation is expected to decline to 2½ percent in 2002, taking into account the projected recovery in agriculture and lower international oil prices.

18. **The impetus to growth in 2002 is likely to come mainly from domestic demand**. No significant recovery in export performance is expected in the near term, owing to the perception of FYRM's increased country risk and the economic slowdown in FYRM's main trading partners. Textile exporters experienced difficulties in renewing purchase contracts for the fall and winter production cycles, and some had to lower prices. They expected the forthcoming contract negotiations for the next production cycle to be difficult, but were hopeful of market conditions improving in the later part of 2002. Still, the steel sector's specific problems are unlikely to be resolved quickly. As for imports, a moderate increase is forecast. Consumption and investment goods should pick up with the rebound in economic activity and the sizeable decrease of excise duty on cars in November 2001. However, this pick up would be partly offset by a decline in security-related imports and lower oil prices. The recovery in private transfers receipts that began in the later part of 2001 is likely to carry over into 2002. Accordingly, the external current account deficit, excluding grants, is expected to narrow by 1 percentage point to 9¾ percent of GDP.

19. **A sizeable external financing gap is estimated for 2002**. An increase in identified financing from bilateral and multilateral sources is foreseen. But, foreign direct investment is expected to fall sharply from the exceptional levels of 2000-01, which were boosted by a few large privatization deals. With the return to peace, it is assumed that trade credit and unrecorded transactions would revert to their traditional positive pattern. The authorities indicated that their objective was to increase the underlying level of gross reserves (i.e., excluding the net saving of telecom privatization proceeds) to the equivalent of 4 months of next year's imports of goods and services. In view of the prevailing uncertainties and associated risks to the balance of payments, they considered this level of reserve coverage—which is comparable to that prevailing in other countries in the region—essential for sustaining confidence in the de facto exchange rate anchor. On this basis, an exceptional financing gap of US$163 million would emerge, before the financing need for implementing the peace agreement. The international community has indicated its willingness to help close

Box 1: The Implementation Costs of the Peace Framework Agreement

After months of hostilities between FYRM's security forces and ethnic-Albanian armed groups, a Peace Framework Agreement (PFA) was signed on August 13, 2001 between the four main political parties representing the two largest ethnic groups. The agreement aims at advancing the cause of minorities through

- establishing rules for the use of minority languages, including the use of these at different levels of government and the allocation of funds for a new TV and a new radio station in the Albanian language;
- ensuring non-discrimination and equitable representation of minorities in the public administration, including increasing the representation of ethnic-Albanians in the police force;
- improving the access of minorities to primary and secondary education in their own language; and
- promoting the development of local governments with increased responsibilities in the delivery of public services, in particular health and education.

The authorities have carried out a preliminary assessment of the costs of implementing the PFA. The degree to which the costs have been fully determined depends in large measure on how much detail the PFA provides on each reform area. In addition, in some areas, discussions are still ongoing among the signatories of the PFA.

In this context, the authorities' cost assessment in the first two reform areas listed above is well-advanced. Still pending are the identification of recurrent costs arising from the operation of the new TV and radio stations, and the maintenance costs of the new police stations. The costs of increasing the representation of minorities in the non-security-related public administration have not been completed, though resource needs have been identified to examine alternative modalities to achieve this objective (e.g. implementation timeframe and hiring policies).

By contrast, the cost assessment in the remaining two reform areas listed above is much more indicative than final, as the road map for these reforms is still being defined at a political level. The authorities have identified immediate financial and technical assistance needs, such as those required to train personnel in local governments. But key parameters of the decentralization process remain unknown. For example, the number of municipalities has yet to be defined and the modalities for decentralizing government functions have not been decided.

In sum, the costs that have been identified amount to US$70 million for the period 2002-04, or 1.8 percent of GDP over a three-year period, but many one-time and recurrent costs have yet to be identified. The costs of each reform area are listed in the table below, identifying one-time and recurrent costs. The authorities have indicated that implementation of the agreement may suffer if donors do not cover the bulk of these costs.

Peace Framework Agreement Costs (In millions of US$)

	2002			2003			2004			Assessment of	
	OT	R	T	OT	R	T	OT	R	T	Cost estimates	Reform agenda
A. Use of minority languages											
Translation services, census	1.6	0.2	1.8	0.6	1.3	1.9	0.1	1.3	1.3	C	C
TV and radio in Albanian	0.7	...	0.7	0.0	...	0.0	0.0	...	0.0	I	C
B. Non-discrimination, equitable representation, and confidence-building measures											
Albanians in the police	1.3	1.8	3.1	1.3	4.7	6.0	0.0	5.8	5.8	C	C
Police stations, demining	5.0	...	5.0	0.0	...	0.0	0.0	...	0.0	I	C
Representation of minorities in administration	0.8	...	0.8	1.1	...	1.1	0.9	...	0.9	I	I
Ombudsman for minorities	0.1	0.0	0.1	0.2	0.3	0.5	1.0	0.3	0.3	C	C
C. Improved access of minorities to education in their own language											
Education in minority language	3.0	...	3.0	1.0	...	1.0	...	1.0	1.0	I	I
D. Development of local governments											
Decentralization	8.8	1.2	10.0	12.0	3.4	15.4	5.0	5.3	10.3	I	I
TOTAL COSTS	21.2	3.2	24.4	16.2	9.7	25.8	6.1	13.7	19.7		
(In percent of GDP)	0.6	0.1	0.7	0.4	0.3	0.7	0.1	0.3	0.5		

Notes: OT refers to one-time expenses, R refers to recurrent expenses, and T refers to total expenses. C identifies cost estimates or reform agendas that are complete, and I denotes that these estimates and agendas are indicative or in the process of being finalized, in which case the cost estimates presented are subject to change.

the financing gap via a donor meeting (¶10). Some donors—notably the World Bank, EU, and the Netherlands—have already begun disbursing assistance ahead of the donor meeting.

20. **Looking beyond 2002, in the staff's view, sustaining high growth without recourse to exceptional foreign financing would require rising government saving.** Economic growth at 4–5 percent annually over the medium term appears feasible as perceptions of political and security risks recede and provided prudent macroeconomic policies are maintained and efforts to address the structural weaknesses of the economy are reinforced. The Stabilization and Association Agreement signed with the EU in 2001 and the recent free-trade agreements with a host of countries should enable greater market access to FYRM's exporters. A substantial increase in non-government investment—associated with the quest for new export markets, enterprise restructuring, and infrastructure development—is also seen as a major contributory factor to growth. Non-government saving is expected to rise, spurred by enterprise restructuring and improved governance, though not to the same extent as the increase in investment. It is further assumed that project lending by bilateral and multilateral parties will be forthcoming at the current nominal level, private borrowing and foreign direct investment will increase modestly, and that there will be no exceptional financing (except for covering the costs of implementing the peace framework agreement) from 2003 onward. On this basis, the external current account deficit (excluding grants) should reduce by 2 percentage points of GDP to 7½ percent of GDP by 2005. Under this scenario, total external debt ratio would fall slightly to 40½ percent in 2005 and debt service capacity would improve. Consistent with the external current account deficit path, the general government budget deficit would need to fall by 3 percentage points of GDP from 3.4 percent of GDP in 2002 to 0.3 percent of GDP in 2005 (Tables 5 and 6).

21. **The authorities were more optimistic about the medium-term growth prospects, though the business community did not share this sentiment.** FYRM exporters felt that gaining export market shares would be a challenge. They expressed concern that the rules of origin clause applied by the EU for FYRM's exports was more restrictive than for exports of several central and east European countries,[9] and that many of FYRM's other trading partners tended to follow the EU guidelines. In addition, the prevalence of agricultural subsidies in the EU and some neighboring countries put FYRM producers of agriculture and food products at a relative disadvantage in both the domestic and export markets.

B. Fiscal Policy

22. **The authorities pointed to the 2002 budget as evidence of their commitment to reversing the fiscal expansion in 2001.** The budget envisages a deficit of 2¾ percent of GDP, before expenditures on implementation of the peace agreement.[10] Taking into account

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[9] Namely, Bulgaria, Czech Republic, Hungary, Poland, and Slovenia.

[10] The budget includes only a few small aspects of the costs associated with implementation of the peace framework agreement: the wage bill costs for the hiring of 500 ethnic Albanians (continued)

foreign-financed expenditures by the Road Fund, the general government deficit would be about 3½ percent of GDP—a decline of 2½ percentage points of GDP from 2001. The authorities noted that the fiscal consolidation would be facilitated by a decline in security-related spending with the ending of the hostilities. However, they planned to keep these outlays above the pre-crisis level. Also, given the likelihood of lower import duties and non-tax revenues, the authorities have adopted a host of measures in support of their fiscal deficit objective. These measures include: extending the tenure of the financial transactions tax by one year; postponing the planned implementation of a new wage structure for civil servants as well as the planned increase in child allowances; and foregoing a general wage increase in the public sector (¶s 13 and 16).

23. **The authorities' position on revenue measures was influenced by the political and economic uncertainties.** They acknowledged the deficiencies of a prolonged implementation of the financial transactions tax (FTT), but were concerned that alternative durable revenue-enhancing measures would likely trigger a more negative public reaction and increase political instability. They also thought it premature to consider new revenue measures at this stage. They preferred to wait until mid-2002 and make a determination based on revenue performance in the first half of the year and the revised economic outlook. The Fiscal Affairs Department (FAD) technical assistance mission on tax policy and tax administration that was fielded in the first half of December 2001 found that the FTT in FYRM had the characteristics of a cascading turnover tax, and recommended its elimination at an early date. It suggested a combination of indirect tax policy measures to replace the revenue currently raised by the FTT: reductions in the number of goods and services preferentially taxed or exempt under the VAT and increase in the preferential VAT rate; an increase in the excise tax on tobacco to the EU minimum; and introduction of a small excise on wine (currently exempt).

24. **The authorities perceived the risks to tax administration on account of the dismantling of the Payments Operations Bureau to be small.** In preparation for this systemic change, the staffing in the Public Revenue Office (PRO) had been increased, the computer systems of the PRO and the treasury system had been integrated, and a separate unit had been established to enforce collection from delinquent taxpayers. The FAD mission on tax policy and tax administration found that VAT collection arrears had increased sharply in 2001.[11] The FAD mission recommended that the PRO should strengthen collection procedures, rigorously implement its enforcement powers, and re-focus its audit strategy from reviewing refund applications to the in-depth audit of VAT returns.

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in the police force by mid-2002 and a part of the costs of a TV channel dedicated to ethnic Albanians.

[11] VAT arrears doubled during April-November 2001. At end-November, VAT arrears amounted to 1.4 billion denars (0.6 percent of GDP or 15 percent of the domestic VAT payments for the previous twelve months).

25. **On the expenditure side, the authorities have given priority to security-related expenditures, financing reform costs, and investment financed from telecom privatization proceeds**. The authorities explained that reservists in the police would be maintained until mid-2002, or even later, if the security situation did not normalize by then. Also, the government had begun to implement a phased program to expand and modernize the armed forces according to NATO standards. Taking into account these aspects and the carry-over effect of selective wage increases granted to security personnel at the height of the crisis, security-related expenditures would be about 2½ percent of GDP above the pre-crisis level, but 4 percent of GDP lower than in 2001. As for reform costs, the authorities have allocated about ½ percent of GDP in the budget to cover the recurrent cost of civil service downsizing undertaken in the first half of 2001[12] and severance payments for employees laid off in 2002 owing to enterprise restructuring. The authorities agreed with the staff that, in the event of a shortfall in outlays on structural reforms, the earmarked funds would not be assigned to other uses.

26. **Throughout the past year, discussions with the authorities on the use of privatization receipts have focused on efficient utilization of resources and good governance**. The original plan was for the US$323 million telecom privatization receipts to be spent over 3 to 4 years on debt reduction, financing pension reform and court-mandated payments to pensioners, and on public investment projects. However, some US$65 million of the receipts was spent on security during 2001. The public investment projects focus on public infrastructure, rehabilitation of schools, and equipment for health centers, and will be implemented in phases. Notwithstanding delays in the start of the projects, the authorities were reluctant to reassess and scale back the large spending plans in Q4, 2001, when it was quite evident from earlier experience—and subsequently confirmed by the smaller actual outturn—that line ministries did not have the implementation capacity to fully spend the appropriated level efficiently within the short time frame. The staff urged the authorities to undertake a pace of spending that ensured resource efficiency. The authorities accepted the staff's suggestion to put in place by March 2002 mechanisms for reviewing implementation of the projects selected thus far, and to define new projects only after completion of the review (¶15).

27. **The authorities noted that significant improvement had taken place in expenditure management during 2001**. The Ministry of Finance has established budget authorization and payment functions at the Treasury, assisted by a FAD resident advisor. Since February 2001, line ministries have been required to submit for treasury approval their monthly expenditure plans. From 2002, cash management would improve further as all bank accounts of line ministries and their subordinate units are consolidated into a single treasury account (¶17). The authorities acknowledged that the present expenditure management

[12] This covers mainly pension payments for early retirees until they reach normal retirement age and become eligible for payments from the Pension Fund.

system did not have proper control over expenditure commitments and payments arrears.[13] They agreed that monitoring of pre-payment stages of expenditure should be installed in the treasury during its next phase of development, hopefully in 2003. The mission urged the authorities to implement, in the interim, the short-term measures suggested by a recent FAD technical assistance mission to regain control of existing stock of payment arrears. Two USAID-financed resident advisors are currently assisting the authorities with budget management and treasury operations.

28. **Even with expenditure restraint, sizeable measures would be needed over the medium term to achieve the fiscal consolidation consistent with external current account sustainability**. Revenues are expected to come under strain as the financial transactions tax is eliminated at end-2002 and certain tax bases grow by less than nominal GDP. However, some relief will be forthcoming from a few expenditure categories. Although security-related spending will remain above the pre-crisis level, a decline of 1 percentage point of GDP is expected in 2003, reflecting the release of reservists. Also, a saving of 0.4 percent of GDP will emerge upon the completion of the court-mandated payments to pensioners in January 2005. If the annual increase in other non-interest current expenditures was limited to 1 percent in real terms, the achievement of the fiscal consolidation path specified in paragraph 20 would require permanent revenue measures yielding 2 percent of GDP annually in 2003 (Table 6).[14] A greater revenue effort would likely be needed as the authorities may find it difficult to keep a tight lid on overall current expenditures, for several reasons.

- The wage bill projection in the staff scenario assumes that there is no general or selective increase in nominal salaries of public sector employees. The pressure for wage increase and decompression of the salary structure is mounting as wages have remained virtually frozen for several years and the government is experiencing difficulties in retaining and attracting high-quality staff.

- Fiscal saving would need to cover the administrative expenses for introducing a fully funded second pillar to the pension system in 2004 as well as higher borrowing costs to finance the deficit.[15]

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[13] At end-October 2001, the aggregate payments arrears were estimated at 1.4 billion denars (0.6 percent of GDP), of which slightly over 0.5 billion denars represented payments arrears outstanding for over sixty days.

[14] The medium-term fiscal scenario is discussed in detail in an accompanying paper titled Selected Issues and Statistical Appendix (SM/ /02). The exercise includes sensitivity analysis with respect to GDP growth and wage increase in the public sector.

[15] The contribution rate for the pay-as-you go pension system is currently 20 percent. With the two-pillar system, the contribution rates would be 13 percent for the pay-as-you-go system and 7 percent for the second pillar. Thus, the budget will face the task of financing

(continued)

- The recurrent costs of implementing the peace framework agreement could be substantial, and may not be covered by donors on a continuing basis.

29. **The structure of the budget will undergo substantial change over the medium term as fiscal responsibilities are devolved to municipalities**. The law on local governments enables municipalities to assume responsibilities in education, health, social care, utilities, urban planning, and culture. It also sets a deadline of end-2003 for completing the transfer of responsibilities. Ministry of Finance officials expressed concern that a short transition period could lead to a break down of service delivery and difficulties with financing. In their view, decentralization should be implemented gradually over 3 to 5 years. World Bank staff stressed that issues related to equity, access, and service delivery should be taken into account in planning the decentralization of education and health care. Otherwise, the ongoing reforms in these two sectors risked being undermined. The staff echoed these concerns with senior policy makers, who noted that political considerations would likely determine the final shape of the legislation. The authorities are currently preparing supporting legislation on financing of local governments, with assistance from external experts. They authorities have requested the Fund staff to be involved; a mission, perhaps with a World Bank staff also participating, is planned in the near future.

C. Monetary and Exchange Rate Policy

30. **The NBM indicated that it would continue to orient monetary policy toward sustaining the exchange rate anchor**. The denar is de facto pegged to the euro. The NBM argued that this exchange rate regime had served FYRM well and provided the basis for maintaining price stability. It considered alternative monetary policy frameworks less suitable at this juncture. As forecasts of money demand remain subject to a high degree of uncertainty, monetary targeting would not be desirable. As for adopting an inflation targeting framework, the NBM had limited capability to model and forecast inflation. While the staff endorsed the NBM's position, the staff noted that maintaining the de facto exchange rate peg could pose major challenges for FYRM's policymakers when capital and financial account transactions are liberalized in mid-2002 (see paragraph 42). If foreign inflows were heavy and there were constraints to the degree of flexibility that fiscal policy as well as the labor market could show to resolve tension between domestic and external objectives, the authorities might have to consider giving up exchange rate fixity. To help cope with the exigencies over the medium term, the staff urged the authorities to give greater operational independence to the NBM, improve its transparency, and strengthen monetary research capability. However, the NBM was not overly concerned about the risks. In the event of large inflows or outflows, the law empowered the NBM to impose temporary capital controls (for up to six months). Also, the NBM was considering preparing foreign exchange by-laws,

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pensioners from the pay-as-you-go system but without full access to the existing 20 percent contribution rate. Immediate revenue loss associated with the reclassification of public to private pensions does not imply an underlying weakening in the fiscal stance from the perspective of national saving.

modeled after the Slovenian experience, which would provide disincentives for nonresidents to hold FYRM securities for short durations.

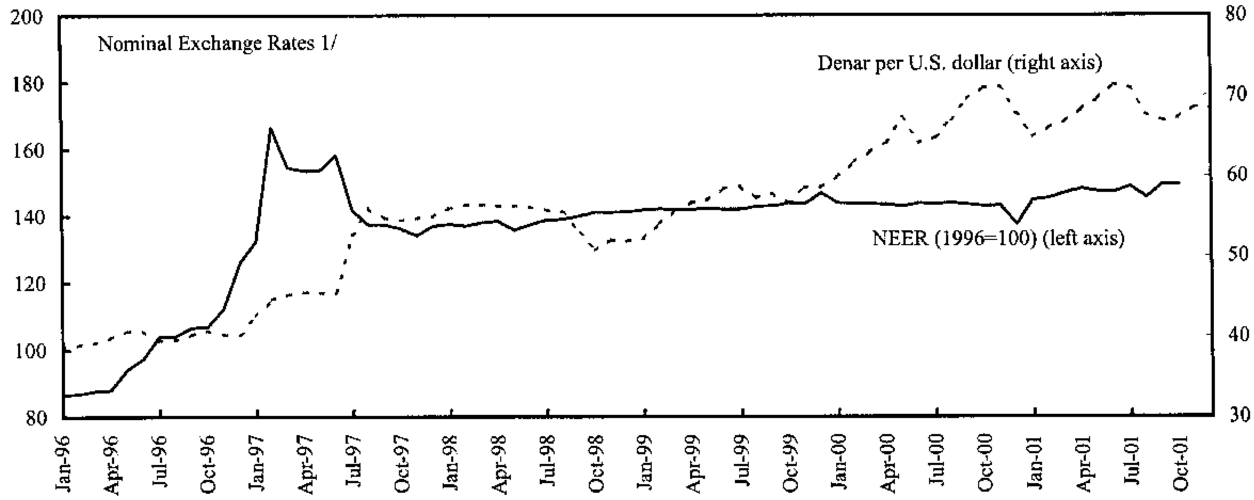
31. **The staff agreed with the NBM's assessment that external competitiveness was broadly adequate at the current level of the exchange rate.** Though, it needed to be watched in light of a possible deterioration in other aspects of FYRM's attractiveness as an investment location if the security concerns persist. While domestic prices of non-tradables have increased faster than those of tradables, the CPI-based real effective exchange rate (REER) has remained near its most depreciated level in the past few years. Although the ULC-based REER has appreciated mildly since 1999 (probably reflecting larger productivity gains in industrial partner countries), the share of labor cost in industrial output in FYRM has remained unchanged in the past few years (Figure 7).

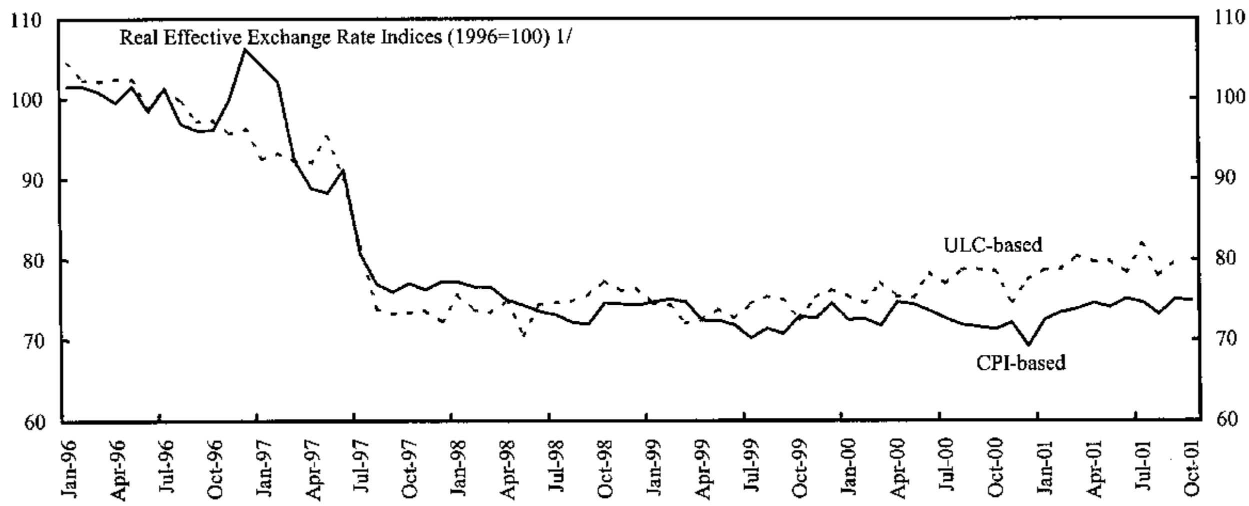
32. **Nevertheless, the share of FYRM's exports in the markets of its major trading partners has declined since 1997, in stark contrast to the positive experience of some countries in the Balkan region.** This trend does not necessarily reflect erosion of cost competitiveness—within the region, FYRM's competitiveness has eroded only vis-à-vis Bulgaria since 1999 (Figure 8). Structural factors seem to underlie FYRM's disappointing export performance. The likely factors are the slow progress in enterprise restructuring and the inability of FYRM's producers to attract foreign investors and secure marketing arrangements. Enterprises that currently have links with a foreign partner or have restructured have been able to maintain or expand their exports notwithstanding the security crisis. Accordingly, the authorities agreed with the staff that efforts to enhance competitiveness should focus on productivity gains from enterprise restructuring (see paragraph 36).

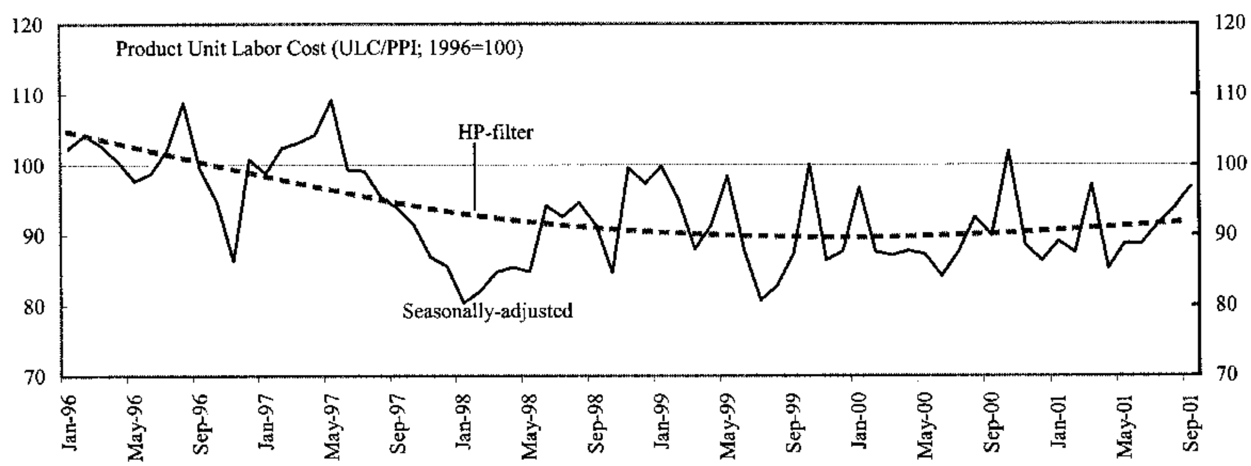
33. **Indicators of external vulnerability remain satisfactory** (Table 7). At end-September 2001, total external debt amounted to about 41½ percent of GDP; the share of short-term debt (remaining maturity basis) was small (6 percent of GDP and 26 percent of gross official reserves). Gross official reserves were 50 percent higher than the level of denar broad money. External debt service payments were about 19 percent of exports of goods and services in 2001, and are projected to fall over the medium term.

34. **However, the staff expressed concern about the prevalence of bank loans in foreign currency or indexed to the exchange rate.** Such loans accounted for nearly 40 percent of the total bank lending to the private sector at end-September 2001. Borrowers were attracted by interest rates 4–7 percentage points lower than on denar loans; also the share of foreign currency/indexed loans tended to rise during tighter monetary conditions. Only a small proportion of the borrowers were exporters, and anecdotal evidence suggests that exchange risk may not be adequately hedged. The NBM noted that the overall lending behavior of banks had improved enormously since the Kosovo crisis in 1999, and that about

Figure 7. FYRM: Exchange Rate and Competitiveness, 1996-01

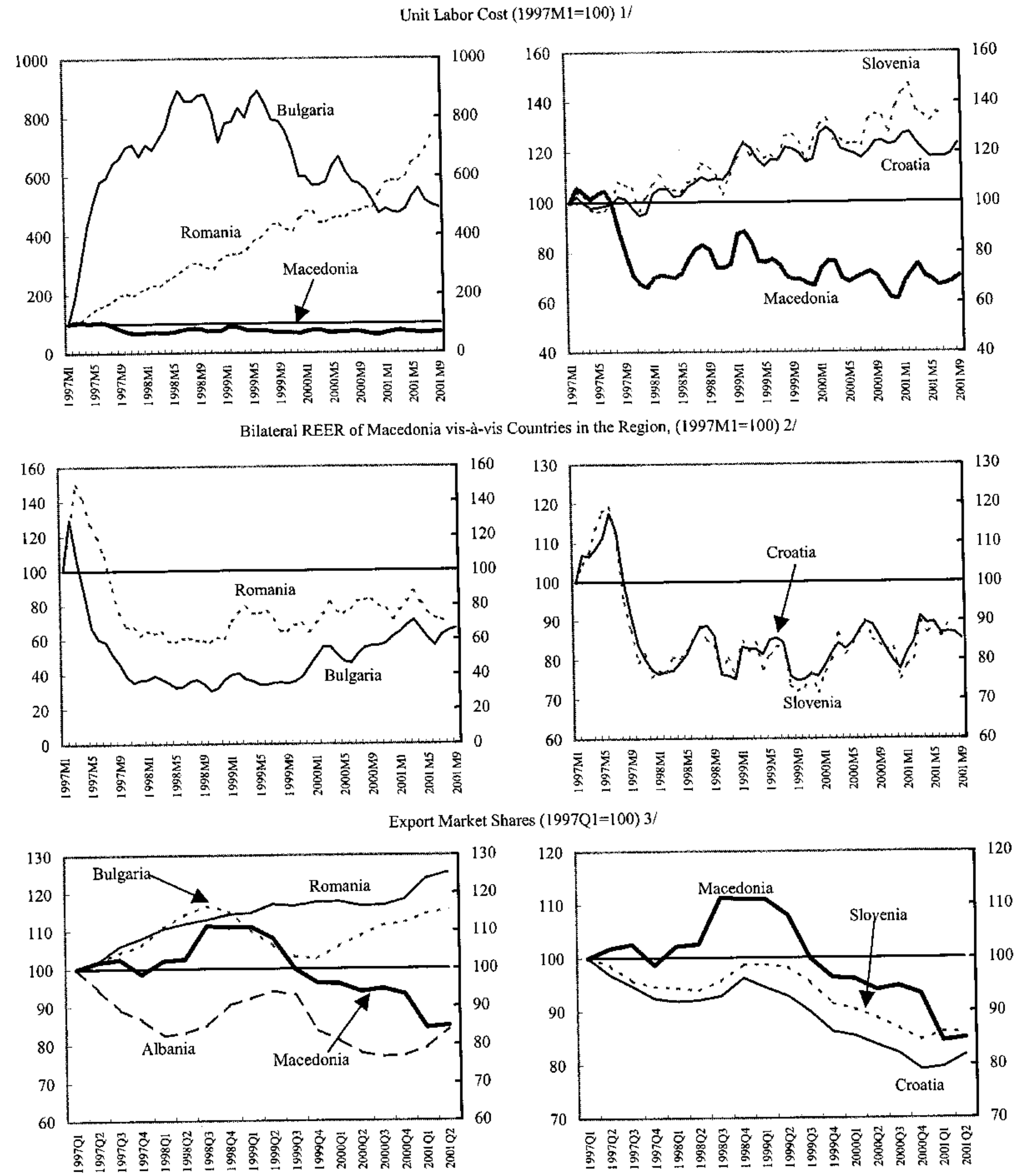






Source: IMF staff calculations based on data provided by the National Bank of Macedonia.
1/ An increase in the index means appreciation of the denar.

Figure 8. Competitiveness and Export Market Shares: FYR Macedonia vis-à-vis Countries in the Region, 1997-01



Sources: DOT statistics; and IMF Staff calculations based on data from national authorities.

1/ The three-month moving average of unit labor cost measured in national currencies.

2/ Three-month moving average of the ratio of dollar unit labor costs between FYR Macedonia and countries in the region; an increase means appreciation of the denar.

3/ Calculated as the share of exports of individual countries in the Balkan region in the combined imports of the United States and the European Union. In each panel the market share of FYR Macedonia is compared with those for the specified countries.

95 percent of all new loans and rolled-over credits in 2000 and 2001 were accounted for by enterprises with the highest credit ratings (A and B).[16] It attributed the improvement to stricter bank supervision and the privatization of the largest commercial bank in April 2000. The NBM also considered the large unutilized lines of foreign credit as evidence of proper risk analysis being undertaken by the banks. Representatives of the largest commercial banks stated that their borrowers of foreign currency/indexed loans had the capacity to withstand the negative impact of a modest depreciation. To clarify the situation, the staff encouraged the authorities to carry out a financial sector assessment. Subsequent to the mission, the NBM expressed interest in participating in a Financial Sector Assessment Program (FSAP).

35. **The NBM has formulated a monetary program for 2002, in consultation with the staff, consistent with growth, inflation, and external sector objectives** (¶20). A relatively stable velocity has been assumed for denar money, while much of the increase in foreign currency deposits in late 2001 related to the euro conversion is expected to be withdrawn in the first quarter of 2002. With net credit from the banking system to the general government projected to increase moderately, there would be scope for an increase in private sector credit in 2002 of 7 percent, or equivalent to a 4 percent real increase (Table 8). The authorities recognized the uncertainties surrounding the assumption of money demand, and stood ready to take corrective action as necessary. With pressures on the foreign exchange market absent, the staff advised the NBM to gradually lower interest rates on central bank bills to the pre-crisis level as fiscal consolidation efforts took hold.

D. Structural Policies

Enterprise sector reform

36. **The authorities emphasized that, notwithstanding the uncertain political environment, they remain committed to addressing the problem of loss-making enterprises.**[17] During the past year, they had carried out financial and economic cost-benefit analyses for nine large loss-making enterprises (including Jugochrom, now the largest loss maker) to determine whether they should be sold or liquidated. However, the subsequent follow-through was hampered by the security crisis. Because of heightened country risk, investors did not show interest in any of the three enterprises offered for sale. However, World Bank staff participating in the discussions noted that the tender process had not been well designed and that the authorities had not allowed sufficient time for potential buyers to carry out due diligence activities. The authorities emphasized that they plan to meet the

[16] In contrast, nearly four-fifths of the credit expansion by the banking system in 1999 was directed toward high-risk borrowers (i.e., those with debts classified in the substandard, doubtful, and loss categories).

[17] Direct budgetary support and new bank credit to loss-making enterprises have been small in the last two years. Most of the persistent lossmaking enterprises were financed through arrears to workers, suppliers, and the government.

second tranche conditionality of the World Bank's Financial and Enterprise Sector Adjustment loan operation—the sale or closure of Jugochrom and four other loss makers—by end-March 2002, and resolve the remaining subset of 40 selected lossmakers by end-December 2002. Toward this end, they had decided to reissue sale tenders for the three loss makers, and were considering further amendments to the bankruptcy law that would allow for automatic initiations of bankruptcy for illiquid firms and set time limits for duration of bankruptcy. Financial and economic cost-benefit analysis of the enterprises that would be tackled in the final phase is currently underway.

Financial sector reform

37. **The quality of loan portfolio and profitability indicators of commercial banks deteriorated in 2001 on account of the security crisis, though not to the same extent as experienced during the Kosovo crisis in 1999.**[18] Considering it likely that the full impact of the crisis would emerge with a lag, the NBM indicated that it would step up supervision and ensure strict enforcement of the supervisory and prudential regulations. The three "problem" banks whose soundness rating had been upgraded would continue to remain in the problem bank unit, to confirm that their improvement in banking operation and practice was durable. On-site examinations were planned in the coming months for the other "problem" banks whose soundness rating remained below the acceptable level (¶22).[19] The staff stressed that the NBM should not hesitate to impose sanctions on problem banks, including revoking their operating licenses, if they failed to implement within a specified time frame corrective actions proposed on the basis of the on-site examination.

38. **The NBM has experienced difficulty in properly monitoring the changes in the shareholding structure of banks since early 2001**. Following an increase in the asset share threshold for prior approval by the NBM for investment in banks from 3 percent of share capital to 10 percent, there have been transactions of 9.9 percent in at least three banks. Sharing the NBM's concerns about the need for oversight on the "quality" of owners, the staff persuaded the Ministry of Finance to seek parliamentary approval before end-March 2002 of an amendment to the Banking Law that requires the NBM to approve changes in the share holding structure of commercial banks only after adequate information is provided regarding the legitimacy of the sources of the funds used to purchase shares (¶22).

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[18] The share of nonperforming loans in total credit increased by about two percentage points in the third quarter to 34 percent at end-September, 2001. The increase in the share of nonperforming loans was about 8 percentage points during the Kosovo crisis. During January-September 2001, the ratio of net income to assets, corrected for under-provisioning for loan losses, turned negative (-1 percent), from barely zero in the same period of 2000. On the basis of the quarterly bank reports, the NBM instructs banks to ensure that they are fully provisioned for loan losses.

[19] As of end-September 2001, these five "problem" banks accounted for 9 percent of total banking sector assets and 13 percent of the nonperforming loans.

39. **The Fund's Stage One safeguards assessment found deficiencies in the NBM's audit mechanisms, implementation of accounting standards, and governance oversight.** The external audit of the financial statement of the NBM for 2000, as recommended by the Stage One assessment, has been undertaken but its release has been pending explicit legislative authorization. Following the parliamentary approval in January 2002 of the amendment to the Central Bank Law that stipulates the publication of externally audited financial statements, the NBM informed the staff that it would publish the 2000 and 2001 audit reports by end-April 2002.

40. **A law on prevention of money laundering was adopted by parliament in August 2001 and will go into force on March 1, 2002.** The law defines actions constituting money laundering, establishes subjects of the law, and stipulates the measures aimed at combating money laundering as well as the modalities for application of the measures, notification procedures, and access to information. FYRM has signed the relevant United Nations treaties in effect with regard to illicit traffic in narcotic drugs and psychotropic substances, suppression of the financing of terrorism, and tackling transnational organized crime.

Trade and exchange system

41. **FYRM's trade regime is fairly open, and further progress in openness was made during 2001.** A Stabilization and Association Agreement (SAA) was signed with the EU, and bilateral free-trade agreements with EFTA countries, Ukraine, and Albania entered into force. Under the terms of the SAA, the EU has eliminated import duties and quantitative restrictions on FYRM's exports with immediate effect, and FYRM has started a phased reduction of import duties. As for FYRM's accession to the World Trade Organization (WTO), required documentation has been submitted to the WTO secretariat, and the FYRM authorities are working toward eliminating the areas of noncompliance with the WTO regulations. Significant initiatives in this regard will include elimination of the 1 percent customs processing fee from January 1, 2002, the planned elimination of the remaining import licensing requirements (except for oil and oil derivatives) by mid-2002, the planned liberalization of import of oil and oil derivatives by end-2003, and equalization of excise taxes on imported and domestically produced tobacco. With the elimination of the customs processing fee and the import-licensing requirement, FYRM's index of trade restrictiveness will fall from 3 to 2 on the Fund's scale (where 10 represents the most restrictive regime).

42. **A new foreign exchange law that provides for a gradual liberalization of capital and financial account transactions was adopted in May 2001, but its implementation was postponed to August 2002 in the wake of the security crisis.** In the first phase, liberalization would cover trade credits, direct investment, and non-resident portfolio investment. Liberalization of real estate transactions, and portfolio investment and deposit transactions abroad by residents would follow in the second stage. The authorities believed that capital account liberalization would help attract foreign investors and would put the economy on a more competitive footing in an integrated Europe.

43. As in the case with other successor republics to the former Socialist Federal Republic of Yugoslavia, **FYRM, at the time of independence, imposed restrictions on withdrawals and transfers from certain foreign exchange accounts of residents and nonresidents that also contained proceeds from current international transactions**. In the context of the 2000 Article IV consultation with FYRM, it was determined that this exchange restriction subject to Fund approval under Article VIII, Section 2(a) remained in place despite the conversion of the former frozen deposits into government bonds. The authorities, in consultation with the staff, have now agreed on a schedule to eliminate this exchange restriction by April 2006.

IV. Staff Appraisal

44. **The security crisis that began in early 2001 inflicted enormous economic costs on FYRM and created severe social and political disruption.** Output declined across all sectors, the budget came under strain as security-related expenditures soared and tax revenues weakened, and the erosion of confidence in the denar fueled a heavy loss of foreign exchange reserves. The authorities took fiscal and monetary policy measures to contain the negative impact of the crisis. Nevertheless, the crisis undermined the prospects for achieving the objectives of the PRGF/EFF-supported program, prompting the authorities to request cancellation of the PRGF/EFF arrangements.

45. **The peace framework agreement provides a foundation for a return to political and security normalcy and for economic recovery**. Since the signing of the agreement in mid-August 2001, the deterioration of macroeconomic performance has been arrested, and the authorities have followed up by formulating a six-month stabilization program. The authorities have requested, and management has agreed, that the Fund staff monitor their program starting January 1, 2002. Also, the authorities have met the preconditions for receiving financial assistance from the donor community to cope with the effects of the security crisis.

46. **Even so, significant challenges remain**. The implementation of the measures envisaged under the peace framework agreement is critical for a rebound of public confidence. Preparation of a road map for enactment and effectiveness of associated enabling legislation are urgent priorities. The fiscal costs are likely to be substantial, and must be incorporated in the authorities' framework once these costs have been fully estimated. The authorities will need to address these new demands, as well as the planned higher security-related spending, while continuing to pursue policies aimed at maintaining macroeconomic stability and strengthening the supply side of the economy. The authorities should not allow the parliamentary elections scheduled in 2002 to deflect them from staying the course.

47. **The fiscal position must be strengthened over the medium term to safeguard external sustainability and government debt dynamics and to foster private sector growth.** The government's 2002 budget aims for a desired reversal of last year's large expansionary fiscal swing. However, the adjustment measures are stopgap in nature and would not ensure compliance with the required medium-term fiscal consolidation. The financial transactions tax, which has proved to be a productive revenue source since its

introduction in July 2001, has a number of serious weaknesses and should not be maintained for an extended period. The long-standing wage freeze in the public sector has created staffing problems in the highly skilled positions, and it may not be feasible to sustain it much longer. Room also has to be created within the appropriate fiscal targets for the additional claims on budgetary resources that will arise on account of pension system reform and the implementation costs of the peace framework agreement not covered by the donor community. Thus, the authorities should consider introducing from 2003, if not sooner, permanent revenue-enhancing measures—including base-broadening and tax-rate adjustments for the VAT as well as strengthening its administration—along the lines recommended by a recent FAD technical assistance mission.

48. **Further strengthening of expenditure management and control is a priority**. The treasury system reforms to date have enhanced the transparency and accountability of budget users. Efforts should now expand to the management of expenditure commitments. To ensure efficient use of resources and good governance in the public investment program, including projects funded by privatization receipts, it is essential to undertake proper appraisal of projects and track their implementation closely. Spending plans should be formulated in accordance with the implementation capacity of line ministries, and these plans should be reassessed on the basis of regular reviews of project implementation.

49. **FYRM's external competitiveness is broadly appropriate, although efforts to enhance competitiveness through productivity gains from enterprise restructuring will improve export and growth performance**. Monetary policy initiatives at the height of the crisis helped restore confidence in the exchange rate anchor. With speculative pressures on the foreign exchange market now absent, the NBM should continue to lower interest rates on its bills to pre-crisis levels as fiscal consolidation efforts take hold. The continuation of the fixed exchange rate regime, however, could be a challenge when capital and financial transactions are liberalized in mid-2002. In the liberalized environment, flexibility from fiscal policy as well as the labor market to support the exchange rate anchor would be desirable. To cope with the exigencies over the medium term, efforts should be initiated to increase the operational independence of the NBM, improve its transparency, and strengthen monetary research capability.

50. **Notwithstanding improvements in the regulatory framework and the lending behavior of banks, the health of the banking system remains fragile**. The share of nonperforming loans is high, profitability after correcting for under-provisioning for loan losses is negative, and a small number of banks do not meet the minimum soundness standards. Hence, the NBM's continued vigilance will be essential to ensure that banks strictly adhere to supervisory guidelines and prudential regulations. Sanctions should be imposed on banks that fail to become compliant within a specified time frame. The next stage of banking reforms should focus on consolidation of the banking system and improvements in governance. The authorities' decision to empower the NBM to require information on sources of funds before approving the changes in the share holding structure of banks is appropriate and should improve governance and transparency in the banking system. The NBM's interest in carrying out financial sector assessment under the FSAP is welcome.

51. **Continuing with structural reforms is paramount for enhancing the prospects for strong economic performance over the medium term.** Finding solutions for five lossmakers by early 2002 and for the remaining subset of 40 selected lossmaking enterprises by end-2002—as envisaged by the authorities—will require a concerted effort. The authorities should ensure that the chosen strategy for sale or closure of the lossmakers is in accordance with the guidelines of the World Bank's FESAL II operation and conducive to sustainable enterprise restructuring. As for public administration reform, the approach for downsizing the civil service will have to be modified in light of provisions in the peace framework agreement for higher representation of ethnic Albanians in the civil service and greater autonomy for municipalities. The transfer of functions to municipalities should be undertaken in an orderly fashion, with due care not to undermine ongoing sector reform efforts or compromise delivery of services.

52. **FYRM will need sizeable balance of payments support from the international community in 2002, before the costs of implementing the peace framework agreement.** The financing gap is predicated on the authorities' desire to maintain foreign exchange reserves, excluding net saving of privatization receipts, at the equivalent of 4 months of imports of goods and services, a level that the staff considers to be a lower bound.

53. **The staff recommends approval of the exchange restrictions arising from the treatment of former frozen foreign currency savings deposits,** as the restrictions are imposed for balance of payments reasons, are non-discriminatory, and the authorities have agreed on a schedule for their elimination by April 2006.

54. **There is a need to further improve the quality, scope, and timeliness of statistics**—especially in the areas of national accounts, government finance statistics, and balance of payments. Consistent with the authorities' decision to participate in the GDDS, efforts should be made to expedite the preparation of relevant metadata.

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

Table 1. FYRM: Selected Economic Indicators, 1999-2002

	1999	2000	2001 Program 1/	2001 Jan-Sep Prel.	2001 Year Est.	2002 Proj.
Real economy			(Percent change)			
Real GDP	4.3	4.6	6.0	-6.0 *a*	-4.6	4.0
Consumer prices						
period average	-0.7	5.8	2.2	5.6	5.3	2.5
end of period	2.6	6.1	1.2	2.9 *b*	3.7	2.7
Real wages, period average	3.6	-0.3	2.3	-1.8 *a*	-1.5	1.0
Employment, monthly data	1.0	-0.5	1.0	-3.9 *a*	-4.1	1.0
Unemployment rate (average)	32.4	32.2	31.8	...	30.5	30.5
Government finances			(In percent of nominal GDP)			
General government revenues and grants	35.4	36.7	32.6	24.2 *c*	34.4	33.4
General government expenditures	35.4	34.2	33.7	29.3 *c*	40.4	36.8
General government balance	0.0	2.5	-1.1	-5.1 *c*	-6.0	-3.4
Central government balance	0.8	2.7	-0.2	-4.7 *c*	-5.7	-2.7
Government debt 2/						
Gross	49.1	48.3	...	46.9 *c*	46.9	48.8
Net	45.6	41.1	...	35.7 *c*	36.9	39.2
Money and credit			(Percent change, end of period)			
Broad money (M3) 3/	29.7	25.6	12.7	-7.8 *b*	54.4	-20.8
Total credit to private sector	9.4	17.2	13.1	6.7 *b*	7.8	7.1
Short-term lending rate (percent)	20.0	19.0	...	21.2	19.2	...
Interbank money market rate (percent)	11.6	7.2	...	19.3	11.9	...
Balance of payments			(In millions of U.S. dollars)			
Exports	1,191	1,319	1,558	872	1,183	1,225
Imports (fob)	1,584	1,875	2,163	1,125	1,580	1,643
Trade balance	-392	-556	-605	-253	-397	-417
Current account balance						
excluding grants	-187	-202	-328	-236	-363	-354
(in percent of GDP)	-5.1	-5.6	-8.3	-7.0 *c*	-10.8	-9.7
including grants	-125	-110	-295	-221	-345	-339
(in percent of GDP)	-3.4	-3.1	-7.4	-6.6 *c*	-10.2	-9.3
Overall balance	117	204	-30	56	79	-115
Official gross reserves 4/	478	714	752	762	779	818 *d*
(in months of current year's imports of goods and non-factor services)	3.0	3.8	3.6	4.7	4.9	4.9
(in months of next year's imports of goods and non-factor services)	2.6	4.5	3.4	4.6	4.7	4.6
External debt service ratio 5/	13.9	13.1	10.7	...	19.0	11.9
External debt to GDP ratio (percent)	40.5	41.5	44.0	41.5	40.7	42.4
Exchange rates 6/			(Percent change, period average)			
Nominal effective exchange rate	2.9	0.1	...	2.5 *a*	...	...
Real effective exchange rate (CPI-based)	-2.3	-0.6	...	1.6 *a*	...	...
Real effective exchange rate (ULC-based)	-1.0	3.7	...	3.6 *a*	...	...

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

a Percent change relative to the same period of the previous year.
b Percent change relative to December of previous year.
c Percent of the annual GDP.
d Assumes that financing gap is filled by donor support.

1/ Data as reported under the PRGF/EFF-supported program (EBS/00/231), except ratios to GDP that are based on a nominal GDP calculated by applying the growth expected under the program to the actual 2000 outturn.
2/ Total debt of the 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.
3/ Includes foreign currency deposits.
4/ Includes receipts from privatization of telecommunications company of US$323 million in January 2001.
5/ Debt service due, including IMF, as a percentage of exports of goods and services.
6/ An increase means appreciation of the denar. Partner countries exclude Federal Republic of Yugoslavia.

Table 2. FYRM: Central Government Operations, 2000-2002

	2000	2001		2002 1/			2000	2001 2/		2002		
		Budget	Year Prel.	Budget	Jan-Jun Proj.	Jul-Dec Proj.		Budget	Year Prel.	Budget	Jan-Jun Proj.	Jul-Dec Proj.
	(In millions of denars)						(In percent of GDP)					
Total revenues and grants	57,805	53,779	51,905	53,089	25,538	27,552	24.5	20.9	22.1	21.2	10.2	11.0
Tax revenues	51,115	49,718	47,566	50,010	23,849	26,162	21.6	19.3	20.3	19.9	9.5	10.4
Individual income tax	10,793	7,789	7,248	7,384	3,479	3,905	4.6	3.0	3.1	2.9	1.4	1.6
Profit tax	2,793	3,026	3,006	3,031	1,630	1,401	1.2	1.2	1.3	1.2	0.6	0.6
VAT	17,452	18,254	17,132	17,898	8,052	9,846	7.4	7.1	7.3	7.1	3.2	3.9
Excises	12,281	12,994	10,680	10,942	5,241	5,702	5.2	5.0	4.6	4.4	2.1	2.3
Import duties	7,733	7,595	6,111	5,321	2,731	2,591	3.3	2.9	2.6	2.1	1.1	1.0
Other taxes 3/	63	60	3,389	5,434	2,717	2,717	0.0	0.0	1.4	2.2	1.1	1.1
Non-tax and capital revenues	3,452	3,617	3,924	3,043	1,671	1,372	1.5	1.4	1.7	1.2	0.7	0.5
Grants	3,239	444	415	36	18	18	1.4	0.2	0.2	0.0	0.0	0.0
Total expenditures	51,520	54,319	65,384	59,979	30,807	29,172	21.8	21.1	27.9	23.9	12.3	11.6
Current expenditures	45,027	41,894	56,686	50,053	26,008	24,045	19.1	16.3	24.2	19.9	10.4	9.6
Goods and services	22,422	21,463	36,232	29,685	15,488	14,197	9.5	8.3	15.4	11.8	6.2	5.7
Wages and salaries	16,285	15,270	16,407	17,709	8,865	8,844	6.9	5.9	7.0	7.1	3.5	3.5
Of which : new security-related	0	0	213	996	402	594	0.0	0.0	0.1	0.4	0.2	0.2
Goods and nonlabor services	6,137	6,193	19,825	11,976	6,623	5,353	2.6	2.4	8.4	4.8	2.6	2.1
Of which : new security-related 4/	0	0	15,309	5,393	4,086	1,307	0.0	0.0	6.5	2.1	1.6	0.5
Refugee expenditures	1,482	468	582	236	206	30	0.6	0.2	0.2	0.1	0.1	0.0
Transfers	17,174	15,796	15,672	16,503	8,506	7,997	7.3	6.1	6.7	6.6	3.4	3.2
Interest	3,949	4,167	4,200	3,629	1,808	1,821	1.7	1.6	1.8	1.4	0.7	0.7
Domestic	1,183	1,116	1,066	1,232	616	616	0.5	0.4	0.5	0.5	0.2	0.2
Foreign	2,767	3,051	3,134	2,397	1,192	1,205	1.2	1.2	1.3	1.0	0.5	0.5
Capital expenditures	5,751	6,645	7,178	8,342	3,796	4,546	2.4	2.6	3.1	3.3	1.5	1.8
Of which : new security-related	0	0	156	0	0	0	0.0	0.0	0.1	0.0	0.0	0.0
Of which : telecom projects	0	0	1,346	3,169	1,800	1,369	0.0	0.0	0.6	1.3	0.7	0.5
Gross costs of reforms	404	1,815	1,183	1,414	952	462	0.2	0.7	0.5	0.6	0.4	0.2
Other	338	170	337	170	52	118	0.1	0.1	0.1	0.1	0.0	0.0
Room for new policies 5/	0	3,796	0	0	0	0	0.0	1.5	0.0	0.0	0.0	0.0
Balance	6,285	-540	-13,479	-6,890	-5,269	-1,620	2.7	-0.2	-5.7	-2.7	-2.1	-0.6
Financing	-6,285	540	13,479	6,890	5,269	1,620	-2.7	0.2	5.7	2.7	2.1	0.6
Domestic	-11,780	-4,040	-5,945	-3,318	-4,761	1,443	-5.0	-1.6	-2.5	-1.3	-1.9	0.6
Foreign	2,872	4,193	-5,169	8,736	8,909	-173	1.2	1.6	-2.2	3.5	3.6	-0.1
Privatization receipts	2,622	387	24,593	1,471	1,121	350	1.1	0.2	10.5	0.6	0.4	0.1
Memorandum item:												
Security-related expenditures 6/	7,861	8,415	24,092	14,720	8,653	6,067	3.3	3.3	10.3	5.9	3.4	2.4
Of which: new security-related	0	0	15,677	6,389	4,488	1,901	0.0	0.0	6.7	2.5	1.8	0.8
Nominal GDP	236,211	257,489	234,718	250,942	250,942	250,942						

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

1/ Excludes most of the costs of implementing the Peace Framework Agreement.
2/ Figures for ratios to GDP for the 2001 budget are based on a nominal GDP that is calculated by applying the growth expected under the PRGF/EFF-supported program (EBS/00/231) to the actual 2000 outturn.
3/ Other taxes includes revenues from the tax on financial transactions.
4/ The Ministry of Finance records wages and allowances of reservists under goods and non-labor services.
5/ This amount refers to the second round of policy measures that were scheduled to be implemented in June 2001.
6/ Includes expenses by the Ministry of Defense and by the Ministry of Internal Affairs.

Table 3. FYRM: General Government Operations, 2000-2002

	2000	2001 Budget	2001 Year Prel.	2002 1/ Budget	2002 1/ Jan.-Jun. Proj.	2002 1/ Jul.-Dec. Proj.	2000	2001 2/ Budget	2001 2/ Year Prel.	2002 Budget	2002 Jan.-Jun. Proj.	2002 Jul.-Dec. Proj.
	(In millions of denars)						(In percent of GDP)					
Total revenue and grants	86,583	83,825	80,652	83,876	40,089	43,787	36.7	32.6	34.4	33.4	16.0	17.4
Tax revenues	78,059	77,692	74,800	78,957	37,552	41,405	33.0	30.2	31.9	31.5	15.0	16.5
Taxes on income and profits	13,586	10,815	10,254	10,415	5,108	5,307	5.8	4.2	4.4	4.2	2.0	2.1
Social insurance contributions	25,091	26,087	25,465	27,153	12,815	14,338	10.6	10.1	10.8	10.8	5.1	5.7
Local taxes	1,050	1,050	1,050	1,050	525	525	0.4	0.4	0.4	0.4	0.2	0.2
Domestic indirect taxes	30,537	32,085	28,531	29,584	13,656	15,928	12.9	12.5	12.2	11.8	5.4	6.3
Import duties	7,733	7,595	6,111	5,321	2,731	2,591	3.3	2.9	2.6	2.1	1.1	1.0
Other taxes 3/	63	60	3,389	5,434	2,717	2,717	0.0	0.0	1.4	2.2	1.1	1.1
Non-tax and capital revenues	5,284	5,689	5,346	4,883	2,519	2,364	2.2	2.2	2.3	1.9	1.0	0.9
Grants	3,239	444	506	36	18	18	1.4	0.2	0.2	0.0	0.0	0.0
Total expenditures	80,678	86,663	94,812	92,429	45,702	46,727	34.2	33.7	40.4	36.8	18.2	18.6
Current expenditure	73,748	72,757	85,650	81,107	40,533	40,574	31.2	28.3	36.5	32.3	16.2	16.2
Goods and services	24,053	23,484	37,770	31,426	16,139	15,287	10.2	9.1	16.1	12.5	6.4	6.1
Wages and salaries	16,863	15,874	16,921	18,294	9,130	9,164	7.1	6.2	7.2	7.3	3.6	3.7
Of which: New security-related	0	0	213	996	402	594	0.0	0.0	0.1	0.4	0.2	0.2
Goods and nonlabor services	7,191	7,610	20,850	13,132	7,009	6,123	3.0	3.0	8.9	5.2	2.8	2.4
Of which: New security-related 4/	0	0	15,309	5,393	4,086	1,307	0.0	0.0	6.5	2.1	1.6	0.5
Refugee expenditures	1,482	468	582	236	114	122	0.6	0.2	0.2	0.1	0.0	0.0
Transfers, including health fund	44,051	44,504	42,967	45,481	22,293	23,188	18.6	17.3	18.3	18.1	8.9	9.2
Interest	4,161	4,300	4,330	3,964	1,987	1,976	1.8	1.7	1.8	1.6	0.8	0.8
Domestic	1,183	1,116	1,066	1,232	616	616	0.5	0.4	0.5	0.5	0.2	0.2
Foreign	2,978	3,185	3,264	2,732	1,371	1,360	1.3	1.2	1.4	1.1	0.5	0.5
Capital expenditures	6,327	9,253	7,995	9,870	4,101	5,769	2.7	3.6	3.4	3.9	1.6	2.3
Of which: New security-related	0	0	156	0	0	0	0.0	0.0	0.1	0.0	0.0	0.0
Of which: Telecom projects	0	0	1,346	3,169	1,800	1,369	0.0	0.0	0.6	1.3	0.7	0.5
Net costs of reforms	233	688	875	1,282	924	358	0.1	0.3	0.4	0.5	0.4	0.1
Other	369	170	292	170	52	118	0.2	0.1	0.1	0.1	0.0	0.0
Room for new policies 5/	0	3,796	0	0	0	0	0.0	1.5	0.0	0.0	0.0	0.0
Balance	5,905	-2,838	-14,160	-8,553	-5,612	-2,941	2.5	-1.1	-6.0	-3.4	-2.2	-1.2
Financing	-5,905	2,838	14,160	8,553	5,612	2,941	-2.5	1.1	6.0	3.4	2.2	1.2
Domestic	-11,993	-4,040	-6,247	-3,358	-4,781	1,423	-5.1	-1.6	-2.7	-1.3	-1.9	0.6
Foreign	3,450	6,461	-4,347	10,339	9,222	1,118	1.5	2.5	-1.9	4.1	3.7	0.4
Privatization receipts	2,637	417	24,755	1,571	1,171	400	1.1	0.2	10.5	0.6	0.5	0.2
Memorandum item:												
Security-related expenditures 6/	7,861	8,415	24,092	14,720	8,653	6,067	3.3	3.3	10.3	5.9	3.4	2.4
Of which: New security-related	0	0	15,677	6,389	4,488	1,901	0.0	0.0	6.7	2.5	1.8	0.8
Nominal GDP	236,211	257,489	234,718	250,942	250,942	250,942						

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

1/ Excludes most of the costs of implementing the Peace Framework Agreement.

2/ Figures for ratios to GDP for the 2001 budget are based on a nominal GDP that is calculated by applying the growth expected under the PRGF-EFF-supported program (EBS/00/231) to the actual 2000 outturn.

3/ Other taxes includes revenues from the tax on financial transactions.

4/ The Ministry of Finance records wages and allowances of reservists under goods and non-labor services.

5/ This amount refers to the second round of policy measures that were scheduled to be implemented in June 2001.

6/ Includes expenses by the Ministry of Defense and by the Ministry of Internal Affairs.

Table 4. FYRM: Balance of Payments, 1999-2002
(In millions of U.S. dollars)

	1999	2000	2001 Q1-Q3 Prel.	2001 Year Est.	2002 Year Projections	2002 H1 Projections	2002 H2 Projections
Current account	-125	-110	-221	-345	-339	-173	-166
Excluding official transfers	-187	-202	-236	-363	-354	-182	-172
Trade balance (fob)	-392	-556	-253	-397	-417	-203	-215
Exports	1,191	1,319	872	1,183	1,225	594	631
Imports	1,584	1,875	1,125	1,580	1,643	797	846
Non-factor services (net)	-75	-55	-76	-97	-74	-46	-28
Income, net (including net interest)	-46	-46	-36	-54	-77	-47	-30
Transfers (net)	389	546	143	203	229	123	106
Official	62	92	15	18	15	10	6
Private	327	454	128	185	213	113	101
Capital account	44	141	403	404	78	23	55
Disbursements	164	136	63	91	137	70	67
Amortization	106	120	129	187	110	58	52
Direct and portfolio investment	27	175	402	445	71	39	32
Of which : Direct investment	24	175	402	445	71	39	32
Euro conversion effect	...	...	...	340	-306	-306	0
Commercial banks' position (net)	-40	-50	67	-285	287	279	8
Errors and omissions and short-term capital 1/	199	173	-126	21	145	65	80
Overall balance	117	204	56	79	-115	-84	-31
Financing	-117	-204	-56	-79	115	84	31
Net foreign assets (increase:-)	-142	-237	-69	-87	-47	-55	8
Change in gross foreign reserves (increase:-)	-145	-235	-48	-65	-39	-52	14
IMF (net)	3	-16	-6	-8	-9	-3	-6
BIS (net)	0	14	-14	-14	0	0	0
Change in arrears 2/	1	14	13	8	0	0	0
Rescheduling 3/	24	18	0	0	0	0	0
Financing gap	0	0	0	0	163	139	24
Memorandum items:							
Current account (in percent of annual GDP)	-3.4	-3.1	-6.6	-10.2	-9.3	-4.7	-4.5
excluding official transfers	-5.1	-5.6	-7.0	-10.8	-9.7	-5.0	-4.7
Export growth rate (percent)	-9.1	10.7	-12.0	-10.3	3.6	3.0	4.2
Import growth rate (percent)	-7.4	18.4	-19.6	-15.8	4.0	4.1	3.9
Gross reserves	478	714	762	779	818	831	818
(in months of next year's imports of GNFS) 4/	2.6	4.5	4.6	4.7	4.6	4.8	4.6
underlying cover (next year's imports of GNFS) 5/	2.6	4.5	...	3.7	4.0	4.0	4.0
External debt service ratio (in percent) 6/	13.9	13.1	...	19.0	11.9	...	...
External debt to GDP ratio (in percent) 7/	40.5	41.5	41.5	40.7	42.4	41.6	42.4
Nominal GDP (in million US$)	3,675	3,585	...	3,372	3,659	...	...

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

1/ Includes trade credits.
2/ Private sector arrears.
3/ Refers to deferral of debt service to Paris Club creditors from April 1999 through March 2000.
4/ Goods and nonfactor services (GNFS).
5/ Underlying reserves exclude net saving from privatization receipts.
6/ Debt service due including IMF as percent of exports of goods and services.
7/ Including IMF.

Table 5. FYRM: Medium-Term Balance of Payments, 1998-2005
(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005
				Est.		Projections		
Current account	-346	-125	-110	-345	-339	-333	-333	-329
Excluding official transfers	-353	-187	-202	-363	-354	-348	-348	-344
Trade balance (fob)	-400	-392	-556	-397	-417	-457	-490	-519
Exports	1,311	1,191	1,319	1,183	1,225	1,316	1,395	1,478
Imports	1,711	1,584	1,875	1,580	1,643	1,773	1,885	1,997
Non-factor services (net)	-171	-75	-55	-97	-74	-66	-65	-57
Income, net (including net interest)	-52	-46	-46	-54	-77	-67	-63	-64
Transfers (net)	277	389	546	203	229	258	285	311
Official	7	62	92	18	15	15	15	15
Private	270	327	454	185	213	243	270	296
Capital account	285	44	141	404	78	152	196	208
Disbursements	216	164	136	91	137	182	195	184
Amortization	75	106	120	187	110	94	86	81
Direct and portfolio investment	175	27	175	445	71	77	101	120
Of which: Direct investment	168	24	175	445	71	77	101	120
Euro conversion effect	...	...	...	340	-306	...	...	...
Commercial banks' position (net)	-31	-40	-50	-285	287	-14	-14	-15
Errors and omissions and short-term capital 1/	107	199	173	21	145	170	172	174
Overall balance	46	117	204	79	-115	-11	34	52
Financing	-46	-117	-204	-79	115	11	-34	-52
Net foreign assets (increase:-)	-44	-142	-237	-87	-47	11	-34	-52
Change in gross foreign reserves (increase:-)	-53	-145	-235	-65	-39	20	-17	-43
IMF (net)	10	3	-16	-8	-9	-20	-17	-8
BIS (net)	0	0	14	-14	0	0	0	0
Change in arrears 2/	-2	1	14	8	0	0	0	0
Rescheduling 3/	0	24	18	0	0	0	0	0
Financing gap	0	0	0	0	163	0	0	0
Memorandum items:								
Current account (in percent of GDP)	-9.7	-3.4	-3.1	-10.2	-9.3	-8.5	-8.0	-7.3
excluding official transfers	-9.9	-5.1	-5.6	-10.8	-9.7	-8.9	-8.3	-7.6
Export growth rate (percent)	6.0	-9.1	10.7	-10.3	3.6	7.4	6.0	6.0
Import growth rate (percent)	5.4	-7.4	18.4	-15.8	4.0	7.9	6.3	6.0
Gross reserves	334	478	714	779	818	787	804	848
(in months of next year's imports of GNFS) 4/	2.1	2.6	4.5	4.7	4.6	4.2	4.0	4.1
underlying cover (next year's imports of GNFS) 5/	2.1	2.6	4.5	3.7	4.0	3.9	3.9	3.9
External debt service ratio (in percent) 6/	9.9	13.9	13.1	19.0	11.9	10.8	10.0	9.6
External debt to GDP ratio (in percent) 7/	40.1	40.5	41.5	40.7	42.4	41.5	40.9	40.0

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

1/ Includes trade credits.

2/ Private sector arrears.

3/ Refers to deferral of debt service to Paris Club creditors from April 1999 through March 2000.

4/ Goods and nonfactor services (GNFS).

5/ Underlying reserves exclude net saving from privatization receipts.

6/ Debt service due including IMF as percent of exports of goods and services.

7/ Including IMF.

Table 6. FYRM: Macroeconomic Framework, 1998–2005

	1998	1999	2000	2001	2002	2003	2004	2005
	Official		Staff estimate		Projections			
			(In percent of nominal GDP)					
Foreign saving 1/	9.7	3.4	3.1	10.2	9.3	8.5	8.0	7.3
excluding official grants	9.9	5.1	5.6	10.8	9.7	8.9	8.3	7.6
Gross national saving 2/	13.7	19.0	21.3	9.0	12.0	14.6	15.4	16.3
Government	0.1	2.3	5.2	-2.6	0.5	2.0	2.3	2.9
Non-government	13.6	16.7	16.1	11.6	11.5	12.5	13.2	13.4
Gross domestic saving 3/	7.4	9.7	7.3	4.6	7.8	9.7	10.1	10.8
Of which: Non-government	7.3	7.4	2.2	7.2	7.3	7.6	7.8	7.9
Gross domestic investment	23.3	22.4	24.4	19.3	21.3	23.1	23.4	23.6
Government	1.8	2.3	2.7	3.4	3.9	4.2	3.3	3.2
Non-government	21.6	20.2	21.7	15.8	17.3	18.9	20.1	20.4
Fixed investment	17.4	16.6	18.5	13.3	15.3	17.1	17.4	17.6
Change in stocks	5.9	5.8	5.9	5.9	6.0	6.0	6.0	6.0
Non-government national saving minus investment	-8.0	-3.4	-5.6	-4.2	-5.8	-6.4	-6.9	-7.0
Fiscal indicators (general government)								
Revenue and grants	33.3	35.4	36.7	34.4	33.4	30.7	30.0	29.2
Total expenditures	35.0	35.4	34.2	40.4	36.8	32.9	31.0	29.6
Of which:								
Fiscal measures 4/	0.0	0.0	0.0	0.0	0.0	-2.1	-2.1	-2.1
Non-interest current expenditure	31.4	31.7	29.5	34.6	30.7	28.9	27.9	26.4
Interest expenditure	1.9	1.5	1.8	1.8	1.6	1.5	1.5	1.6
General government balance	-1.7	0.0	2.5	-6.0	-3.4	-2.1	-1.1	-0.3
Central government balance	-0.8	0.8	2.7	-5.7	-2.7	-1.5	-0.4	0.0
Government debt 5/								
Gross	44.8	49.1	48.3	46.9	48.8	46.3	43.5	40.2
Net	44.8	45.6	41.1	36.9	39.2	40.5	40.6	39.7
Memorandum items:			(Percent change in real terms)					
Consumption expenditure	3.4	3.8	10.1	-2.5	1.1	1.9	4.0	4.1
Of which: Non-government	3.3	3.6	15.1	-10.1	5.7	4.2	5.0	5.2
Gross capital formation	4.9	-0.5	0.7	-24.9	14.7	16.7	7.9	8.4
Fixed investment	-2.6	-1.4	14.9	-29.9	18.6	19.7	9.1	9.1
Non-interest government current expenditure	0.5	3.9	1.3	13.1	-7.6	-2.4	0.8	-0.6
Domestic demand	3.7	3.0	8.4	-6.4	3.0	4.2	4.7	4.9
Total demand	4.8	2.6	9.2	-8.3	3.2	4.4	4.3	4.5
GDP	3.4	4.3	4.6	-4.6	4.0	4.0	4.5	5.0
Nominal GDP (millions of denars)	194,981	209,010	236,211	234,718	250,942	267,483	286,540	308,248

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

1/ External current account deficit, including grants (+).
2/ Equal to gross domestic investment minus foreign saving.
3/ Equal to gross national saving minus net factor income and transfers from abroad.
4/ Negative figure implies that revenue-enhancing or expenditure-reducing measures are required.
5/ Includes domestic debt of central government and external debt of general government. Figures include bonds issued in 2001 for the frozen foreign currency deposits, as well as 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 7. FYRM: Indicators of External and Financial Vulnerability, 1999-2002

	1999	2000	2001		2002
			Sep.	Year Est.	Proj.
Financial indicators					
Broad money (end of period; percent change from end of previous year)	29.7	25.6	-7.8	54.4	-20.8
Private sector credit (end of period; percent change from end of previous year)	9.4	17.2	6.7	7.8	7.1
Share of non-performing loans in total bank exposures (end of period, in percent) 1/	41.3	34.8	33.9	...	...
Foreign currency deposits (end of period, in percent of total broad money)	19.2	22.8	23.8	45.6	25.7
Indexed loans to private sector					
(end of period, in percent of denar credit to private sector)	...	...	28.1	...	...
Foreign currency credit to private sector					
(end of period, in percent of total credit to private sector)	21.3	14.0	15.5	15.3	...
Indexed loans and foreign currency credit to private sector					
(end of period, in percent of total credit to private sector)	...	...	39.2	...	...
Central bank short-term foreign liabilities (in millions of US dollars)	102	14	0	...	...
Short-term foreign assets of commercial banks (in millions of US dollars)	372	421	294	...	...
Short-term foreign liabilities of commercial banks (in millions of US dollars)	188	172	101	...	...
Money market rate (end of period; in percent)	11.6	7.2	19.3	...	...
External Indicators					
Exports (percent change, in terms of US$)	-9.1	10.7	-12.0	-10.3	3.6
Imports (percent change, in terms of US$)	-7.4	18.4	-19.6	-15.8	4.0
Current account balance (in percent of GDP)					
(Including official grants)	-3.4	-3.1	-6.6	-10.2	-9.3
(Excluding official grants)	-5.1	-5.6	-7.0	-10.8	-9.7
Foreign direct investment (in percent of GDP)	0.7	4.9	11.9	13.2	1.9
Gross official reserves (in millions of US dollars; end of period)	478	714	762	779	818
(In months of next year's imports of goods and services)	2.6	4.5	4.6	4.7	4.6
(In percent of private denar broad money)	95.1	127.0	151.6	140.2	134.0
Total external debt (in percent of GDP)	40.5	41.5	41.5	40.7	42.4
Of which: Public sector (in percent of GDP)	35.5	37.1	38.6	38.8	41.1
Short-term debt (by remaining maturity)					
(In percent of GDP)	4.8	5.3	5.9	7.5	4.9
(In percent of official reserves)	37.1	26.8	26.2	32.4	21.9
External debt service payments (in percent of exports of goods and services)	13.9	13.1	...	19.0	11.9
Exchange rate (denar per U.S. dollar, period average)	56.9	65.9	68.1	68.8	...
REER (average percent change; (-) depreciation)					
CPI-based	-2.3	-0.6	1.6	...	...
ULC-based	-1.0	3.7	3.6	...	...

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

1/ Excludes fully provisioned loans that have been removed from banks' balance sheets.

Table 8. FYRM: Monetary Survey, 1999-2002

	1999	2000	2001			2002		
	Dec.	Dec.	Mar.	Jun.	Dec.	Mar.	Jun.	Dec.
					Est.	Projections		
	(In millions of denars)							
Net foreign assets	32,482	53,851	70,454	62,437	82,891	67,041	66,927	65,114
Net domestic assets	8,000	-3,011	-22,871	-17,259	-4,383	-7,666	-7,707	-2,915
Credit to the government	5,927	-4,977	-26,136	-21,372	-9,554	-13,549	-14,315	-11,233
Banks	8,524	7,090	7,193	7,439	7,577	7,577	7,059	7,059
NBM (net)	-2,597	-12,067	-33,329	-28,811	-17,131	-21,126	-21,374	-18,292
Credit to the private sector	30,267	35,749	36,382	36,350	36,614	37,325	38,051	39,761
In denars	23,834	30,737	31,959	31,545	31,005	31,305	31,808	32,780
In foreign currency	6,433	5,012	4,423	4,805	5,609	6,020	6,243	6,980
Other items (net)	-28,195	-33,783	-33,117	-32,237	-31,443	-31,443	-31,443	-31,443
Broad money (M3)	40,482	50,840	47,583	45,178	78,509	59,374	59,221	62,199
Currency in circulation	8,169	9,521	10,886	10,100	14,411	11,742	11,369	13,152
Government deposits	2,378	2,541	2,390	2,523	4,289	4,299	4,309	4,329
Private denar deposits	22,156	27,178	23,558	22,454	24,014	28,223	28,133	28,708
Private foreign currency deposits	7,779	11,600	10,749	10,101	35,795	15,110	15,410	16,010
Memorandum items:								
Broad money (M3)								
(Percent change from end of previous year)	29.7	25.6	-6.4	-11.1	54.4	-24.4	-24.6	-20.8
M3 private	38,104	48,299	45,193	42,655	74,220	55,075	54,912	57,871
(Percent change from end of previous year)	29.3	26.8	-6.4	-11.7	53.7	-25.8	-26.0	-22.0
Implicit velocity of M3 (private; end of period)	5.5	4.9	4.8	5.4	3.3	4.2	4.4	4.5
Net credit to government	3,549	-7,518	-28,526	-23,895	-13,842	-17,847	-18,623	-15,561
Total private sector credit (adjusted) 1/	35,099	41,148	42,576	43,824	44,340	45,051	45,777	47,487
(Percent change from end of previous year)	9.4	17.2	3.5	6.5	7.8	1.6	3.2	7.1
Total private denar credit (adjusted) 1/	26,859	34,322	36,339	37,205	36,917	37,217	37,720	38,692
(Percent change from end of previous year)	6.3	27.8	5.9	8.4	7.6	0.8	2.2	4.8

Sources: Data provided by the National Bank of Macedonia; and IMF staff projections.

1/ Adjusted for the removal of fully provisioned loans from banks' balance sheets.

FYRM: Fund Relations
(As of January 31, 2002)

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	96.23	139.7
III.	**SDR Department**:	SDR Million	Percent of Allocation
	Net cumulative allocation	8.38	100.0
	Holdings	1.77	21.2
IV.	**Outstanding Purchases and Loans**:	SDR Million	Percent of Quota
	Extended Arrangements	1.15	1.7
	Contingency and Compensatory	13.78	20.0
	Systemic Transformation Facility	12.40	18.0
	PRGF Arrangements	29.00	42.1

V. **Latest Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	12/18/2000	11/22/2001	10.34	1.72
EFF	11/29/2000	11/22/2001	24.12	1.15
ESAF/PRGF	04/11/1997	04/10/2000	54.56	27.28

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

	Overdue	Forthcoming				
	01/31/2002	2002	2003	2004	2005	2006
Principal	0.0	6.8	15.6	13.7	6.9	6.2
Charges/Interest	0.0	1.0	0.8	0.4	0.3	0.2
Total	0.0	7.8	16.4	14.1	7.2	6.4

VII. **Safeguards Assessments:**

A Stage One safeguard assessment of the NBM was completed on September 20, 2000. The assessment concluded that high risks may exist in the NBM's financial practices and internal control systems and recommended that a Stage Two (on-site) examination be undertaken once the 2000 audited financial statements have been published.

The NBM plans to publish the externally audited financial statements for both 2000 and 2001 by end-April 2002.

VIII. **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 Euro, 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 30 days. Bureaus can hold overnight foreign exchange positions equivalent to 50 percent of the preceding day's purchases. The effective reserve requirements on resident foreign currency deposits range from 0 to 75 percent, depending on the type and maturity of the deposit. At end-January 2002, the official exchange rate was denar 70.53 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 FYRM maintains an exchange restriction subject to the Fund's approval under Article VIII, Section 2(a) arising from restrictions imposed on the transferability of proceeds from current international transactions contained in former frozen foreign currency saving deposits.

IX. **Article IV Consultations**:

The first consultation with the FYRM was concluded in August 1993. The last consultation was concluded on May 10, 2000 (SM/00/81). The FYRM is on the standard consultation cycle.

X. **Technical Assistance (since 1999)**:

Purpose	**Department**	**Date**
Balance of Payments Statistics	STA	June-August, 2000
Value-Added Tax	FAD	February 1999 October 1999 October 2000
Development of a Treasury System	FAD	October 2000 November 2001
Tax Policy	FAD	December 2001

Monetary Policy and Banking Supervision	MAE/ World Bank	October 1999
	MAE	December 1999
		May 2000
Article VIII	MAE/LEG	September 2000
Safeguards Assessment	TRE	November 2000
Resident Experts		
Value-Added Tax	FAD	October 1999-April 2001
Development of a Treasury System	FAD	January 2000-July 2001

XI. Resident Representative

The Fund has had a resident representative in Skopje since 1995.
Mr. Jan Mikkelsen assumed the post on May 15, 2000.

FYR Macedonia—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$611 million have been made by IBRD and IDA. These include the approval of (i) five adjustment operations and two emergency operations, totaling approximately US$370 million; and (ii) sixteen investment operations totaling approximately US$241 million (of these, fourteen are ongoing). Total disbursements through December 31, 2001 amount to approximately US$422 million.

3. In December 2000, the Government's Interim Poverty Reduction Strategy Paper (I-PRSP) was presented to the Board along with the Joint IDA-IMF Staff Assessment of the I-PRSP, and a Second Financial and Enterprise Sector Adjustment Loan/Credit of US$50 million to support further reforms in the enterprise and financial sectors was approved.

4. FYR Macedonia graduated from blend (combined IDA and IBRD) to IBRD-only status on July 1, 2001, but as a result of the crisis in 2001 the country is temporarily not considered creditworthy for new IBRD lending. In September 2001, the Bank's Board discussed a Transitional Support Strategy (TSS) that proposes rapid Bank intervention in the post-conflict period, including emergency recovery assistance. The TSS also proposes that FYR Macedonia have access in FY02, on an exceptional basis, up to US$35 million of IDA resources on hardened terms. In this context, the Bank's Board approved an Emergency Economic Recovery Credit of SDR 11.6 million (US$15 million) in December 2001. The Government of the Netherlands is cofinancing this project with a US$25 million grant. Discussions with the authorities on a Public Sector Management Adjustment Credit is at an advanced stage. This lending operation will focus on: (i) public expenditure management; (ii) civil service reforms; (iii) health sector reforms; and (iv) social protection reforms.

5. As of September 30, 2001, IFC's portfolio consisted of nine projects for a total of approximately US$61 million (US$86 million including syndication), making FYR Macedonia one of IFC's largest per capita exposures worldwide. Total net disbursements through end-September 2001 on IFC's account amount to approximately US$45 million.

6. MIGA issued one guarantee in FYRM, totaling US$19 million in coverage to a manufacturing project against the risks of war and civil disturbance.

FYRM: Statistical Issues

The authorities, with technical assistance from the Fund, and other bilateral and multilateral agencies, have made significant progress in upgrading the country's statistical system in recent years. Continued efforts are being undertaken to further improve the quality and data availability of the country's statistical system. Data reporting to the Fund remains timely (Table 9) and an IFS page is available.

Real sector data has improved, but remaining deficiencies need to be addressed. Ongoing efforts to improve surveys and techniques to harmonize GDP data from the production and expenditure approaches in line with international practices are expected to reach completion in early 2002. Quarterly GDP estimates, based on a set of production indicators, are being produced on a regular basis. These estimates are being revised later to be consistent with the final annual GDP figures. Quarterly GDP data using the expenditure approach is not available. Calculations of deflators should be reviewed, as historical deflators appear to be out of line with price developments elsewhere in the economy. Consumer, retail, and producer price statistics are compiled on a timely basis. However, the procedures for determining the weights and adjusting for seasonality should be reviewed. Employment statistics continues to be unreliable. The labor force survey scheduled for April 2001 was postponed following the outbreak of the security crisis.

The compilation and coverage of balance of payments data, in particular on external debt, have improved in recent years. However, a large portion of private transfers and short-term capital flows is unrecorded, which manifests itself in significant and fluctuating errors and omissions. Kosovo-related non-resident purchases are recorded as a separate item under exports of goods and services in the national income accounts but are not fully captured in the exports of goods and services under the balance of payments statistics. The last technical assistance mission from the Fund in June-August 2000 identified the following areas where improvement was needed: (i) recording of external assets and liabilities of the monetary authorities in accordance with the BPM5 methodolology, and (ii) correcting the overstatement of private transfers due to transactions involving foreign currency accounts.

No government finance statistics (GFS) data have been reported to STA since the annual data for 1995–96 were provided by the Ministry of Finance and published in IFS. However, satisfactory sources exist for central government fiscal data from which GFS can be compiled. The data for extra-budgetary funds are less reliable. Off-budget operations and special revenue and expenditures of line ministries have been compiled with a lag since February 2001. Data on domestic arrears are not fully reliable.

Money and banking data are reported to the Fund on a regular basis. Since mid-2000, the National Bank of Macedonia (NBM) has broadened its coverage of foreign reserve assets recorded in its balance sheet to include the counterpart of government foreign currency deposits held at the NBM. The institutional coverage of monetary statistics could be improved by including all other depository corporations, such as savings houses. Improvement of the analytical usefulness of interest rates could be made by compiling weighted average lending and deposit rates. Other improvements could also be made in the data reported by the commercial banks to the NBM for specific analytical and supervisory purposes, such as reporting of data on credit by economic activity, and monthly data on full financial statements of the banks.

The authorities have expressed their intention to participate in the General Data Dissemination System (GDDS) and designated a GDDS coordinator in March 2001. However, they have not yet compiled metadata for posting on the Data Standards Bulletin Board (DSBB).

FYRM: Core Statistical Indicators
(as of February 15, 2002)

	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	Feb. 8	Jan.23	Nov. 30	Feb. 7	Nov. 30	Dec. 31	December	November	September	Nov. 30	September	December
Date Received	Feb. 8	Feb. 7	Dec. 27	Feb. 8	Dec. 27	Jan. 14	Jan. 8	January	December	Jan. 9	January	Jan. 30
Frequency of Data	Daily	Daily	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly
Frequency of Reporting	Weekly	Weekly	Monthly	Weekly	Monthly	Monthly	Monthly	Variable	Variable	Monthly	Quarterly	Variable
Source of Update	NBM	NBM	NBM	NBM	NBM	NBM	SOM	NBM	NBM	MOF	SOM	MOF/NBM
Mode of Reporting	Fax	Fax	Fax	Fax	Fax	Fax	Fax	E-mail	E-mail	E-mail	Mission/ E-mail	Mission/ E-mail
Confidentiality	UR	UR[1]	UR[1]	UR[1]	UR	UR	UR	UR	UR[1]	UR[1]	UR	SB
Frequency of Publication	Daily	Quarterly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Monthly	Monthly

List of abbreviations:

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

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

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	1.9	2.3	8.5
Population density (people per sq km)	79.5	123.2	74.2	97.5	81.8
Population					
Total population (1999, in thousands)	2,022	3,375	8,208	22,458	10,538
Average annual population growth (1999, in percent)	0.6	1.1	-0.6	-0.2	0.2
Life expectancy at birth (1999, in years)	72.8	72.1	71.1	69.5	77.8
Male	70.6	69.2	67.6	65.7	75.2
Female	75.1	75.1	74.8	73.4	80.6
Under 5-years mortality rate (1999, per 1,000 live births)	17.0	30.6	17.0	24.0	7.0
Crude birth rate (1999, per 1,000 persons)	14.5	16.2	8.0	10.5	9.4
Crude death rate (1999, per 1,000 persons)	8.4	5.2	14.4	12.2	9.8
Income and poverty					
GDP per capita (1999, in U.S. dollars)	1,818	1,089	1,511	1,515	11,870
Poverty rate (2000, in percent) 1/	22.3	29.6	11.7	21.5	...
Urban	18.8	17.2	...	20.4	...
Rural	27.2	36.8	...	27.9	...
Health					
Physicians (1995, per 1,000 persons) 2/	2.3	1.4	3.3	1.8	4.0
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	95.4	90.2
Secondary 5/	55.8	37.5	74.2	73.1	86.5

Sources: World Development Indicators, 2001, World Bank; FYRM: Statistics Office; Bulgaria: Poverty Assessment Update, 2001, World Bank; World Development Report 2002, World Bank; and Albania: National Strategy for Socio-Economic Development, Medium-term Program of the Albanian Government "Growth and Poverty Reduction Strategy", November 2001.

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 70 percent of median monthly 2000 consumption. Data for Romania refer to 1994. For Bulgaria, data refers to 2001 and the poverty rate is the proportion of individuals with consumption below two-thirds of median consumption in 1997. Data for urban Albania refer to 1998.
2/ Data for Bulgaria is for 1999 and Romania and Greece are for 1996.
3/ Data for Albania and Bulgaria are for 1995, and for Greece is for 1994.
4/ Data for Albania is for 1995.
5/ Figure for Albania is gross enrollment ratio.

INTERNATIONAL MONETARY FUND
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2001 Article IV Consultation with the former Yugoslav Republic of Macedonia

On March 4, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the former Yugoslav Republic of Macedonia (FYRM).[1]

Background

After three consecutive years of generally favorable performance, the FYRM economy suffered a setback in 2001 because of a six-month security crisis. Output declined markedly. New outlays on security operations and weak revenues contributed to a large expansionary fiscal swing. Owing to a deterioration of the external current account position, the foreign exchange loss was heavy. However, the impact on reserves was cushioned by sizeable privatization inflows in early 2001. In the aftermath of the crisis, FYRM requested cancellation of the Poverty Reduction and Growth Facility/Extended Fund Facility arrangements. Subsequently, the authorities requested, and management agreed, that the IMF staff monitor their economic program for six months starting January 1, 2002.

There was a broad-based decline in real GDP of 4½ percent in 2001. Inflation, driven mainly by higher food prices, slowed only slightly to 5.3 percent. The unemployment rate fell by 1.7

[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.

percentage points to 30.5 percent, reflecting a buoyant informal economy and recruitment of a large number of reservists in the security forces.

The fiscal outturn in 2001 was substantially worse than anticipated in the original budget. Because of the crisis, additional spending on military equipment and on security personnel amounted to 6¾ percent of GDP. Tax receipts were lower than forecast in the budget in nominal terms, reflecting a weaker economy. In the second half of the year, the authorities embarked on a public investment program funded from privatization receipts. Partly to offset the pressures on the budget, the authorities postponed revenue-reducing measures originally envisaged for June, and introduced on July 1, for a six-month period, a new tax on financial transactions. Thus, the general government deficit in 2001 is estimated at 6 percent of GDP, implying an expansionary fiscal swing of 8½ percent of GDP relative to 2000. Of the swing, about 3 percentage points can be attributed to revenue-reducing measures introduced in early 2001 and the impact of cyclical factors.

The external current account deficit (excluding grants) is estimated to have widened by about 5 percentage points of GDP to 10¾ percent of GDP in 2001. The trade balance improved, as imports were severely compressed on account of lower domestic demand and more than offset a marked decline in export earnings, but there was a sharp drop in net inflows of private transfers. Thus, since the beginning of the crisis in late February through end-December, gross official reserves declined by about US$160 million (about 22 percent of total reserves at the beginning of the year). However, owing to receipts of US$323 million from the privatization of the telecommunications company in January, gross foreign exchange reserves remained at a relatively comfortable level of US$779 million, equivalent to 4.7 months of next year's imports, at end-December 2001.

The National Bank of Macedonia (NBM) was challenged in the conduct of monetary policy by the expansionary fiscal stance and an erosion of market confidence in the denar. Pressure on the foreign exchange market, which initially appeared in early 2001 following a fiscal-policy induced expansion of liquidity, intensified with the onset of the security crisis, and peaked in mid-June. Experiencing substantial foreign exchange loss, the NBM tightened monetary policy during May-June: the remunerated reserve requirement was increased and the interest rate on 28-day central bank bills was more than doubled to 20 percent. In addition, in August, the period for surrendering export proceeds was shortened from 180 days to 30 days. These initiatives and the signing of the peace framework agreement helped restore normalcy in the foreign exchange market by mid-August. Subsequently, the NBM lowered the interest rate on bills by 5 percentage points to 15 percent.

There was notable progress on the structural front. As part of civil service reform, in the first half of 2001, gross employment in the public administration was reduced by 6½ percent, through voluntary separation and early retirement. In the banking sector, the regulatory framework of bank supervision was strengthened further and "problem" banks took steps to improve their operations. The reform of the Payments Operations Bureau (ZPP) was completed by end-2001. However, the progress toward divesting non-core government activities and resolution of loss-making enterprises was slow, in part because of the complications created by the security crisis.

Executive Board Assessment

Executive Directors noted the enormous economic costs of the six-month security crisis in 2001: output declined markedly; the fiscal position deteriorated, owing to new outlays on security operations and weak revenues; and foreign exchange reserve loss was heavy. Moreover, despite the authorities' fiscal and monetary measures in mid-year to contain the negative impact, the crisis had made it difficult to comply with the PRGF/EFF-supported program, leading the authorities to cancel the arrangements.

Directors welcomed the authorities' formulation of a six-month stabilization program—being monitored by the Fund staff from January 1, 2002—and the prospects of substantial donor assistance. However, they observed that the FYRM faced significant challenges over the medium term. They stressed the importance of firm implementation of the Staff-Monitored Program, and hoped that the authorities would put together a policy package that could be supported by a successor arrangement with the Fund. Directors noted the importance of regional cooperation to strengthen the foundations for progress over the medium term.

While welcoming the authorities' commitment in the 2002 budget to reverse the large fiscal swing of the previous year, Directors underscored the need for further consolidation over the medium term to safeguard external sustainability and government debt dynamics. Spending pressures are likely in the coming years for modernization of the armed forces, realigning of the wage structure of civil servants, reform of the pension system, and for agreed measures under the peace framework agreement. Moreover, Directors stressed the need for durable measures to follow the current temporary adjustment measures in the 2002 budget. In this regard, Directors urged the authorities to eliminate the financial transaction tax by end-2002 and to consider introducing from 2003, base-broadening and tax rate adjustments of the VAT as well as strengthening its administration.

Directors also stressed the importance of further strengthening expenditure management and control. They encouraged the authorities to set up a framework for monitoring the budget's expenditure commitments and payment arrears. Directors saw efficient use of privatization receipts, especially on public investment programs, as vital to establish a strong basis for growth.

Noting that monetary policy initiatives at the height of the crisis had helped to restore confidence in the exchange rate anchor, Directors recommended that the central bank should continue to lower interest rates on its bills, as fiscal consolidation efforts take hold.

Directors agreed that FYRM's external competitiveness is broadly appropriate, but recommended that the exchange rate level and regime be kept under close review, especially if exports do not respond quickly as the peace framework agreement is implemented. In particular, Directors observed that maintaining the exchange rate anchor could be a challenge, once capital and financial transactions are liberalized later in the year. In these circumstances, greater flexibility in fiscal policy and the labor market will be needed to address any shocks to the economy. Directors encouraged the authorities to increase the operational independence of the central bank to cope with such exigencies over the medium term.

Directors noted that the health of the banking system remains fragile, notwithstanding improvements in the regulatory framework and supervision. They considered it important that the next stage of banking reforms focus on consolidating and improving transparency and governance. Directors welcomed the measures taken so far to combat money laundering and tackle the financing of terrorism, and encouraged the authorities to continue their efforts. They also welcomed the central bank's interest in a Financial Sector Assessment Program.

Directors stressed that continuing structural reforms would be key to improving the prospects for strong economic growth over the medium term. They welcomed the authorities' plans to find an early solution for loss making enterprises through sale or closure, and emphasized the need to do so in a transparent manner that ensures sustainable enterprise restructuring. Directors cautioned that the envisaged devolution of fiscal responsibilities to municipalities must be done in an orderly fashion, so as not to undermine fiscal soundness and the ongoing reforms or compromise delivery of services.

Directors recommended the authorities to improve further the quality, scope, and timeliness of statistics, and encouraged the authorities to expedite the preparation of relevant meta data for participating in the General Data Disseminating System.

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. The Staff Report for the 2001 Article IV Consultation with the former Yugoslav Republic of Macedonia is also available.

FYRM: Selected Economic Indicators, 1999–2002

	1999	2000	2001			2002
			Program 1/	Jan-Sep Prel.	Year Est.	
Real economy			(Percent change)			
Real GDP	4.3	4.6	6.0	-6.0 *a*	-4.6	4.0
Consumer prices						
period average	-0.7	5.8	2.2	5.6	5.3	2.5
end of period	2.6	6.1	1.2	2.9 *b*	3.7	2.7
Real wages, period average	3.6	-0.3	2.3	-1.8 *a*	-1.5	1.0
Employment, monthly data	1.0	-0.5	1.0	-3.9 *a*	-4.1	1.0
Unemployment rate (average)	32.4	32.2	31.8	...	30.5	30.5
Government finances			(In percent of nominal GDP)			
General government revenues and grants	35.4	36.7	32.6	24.2 *c*	34.4	33.4
General government expenditures	35.4	34.2	33.7	29.3 *c*	40.4	36.8
General government balance	0.0	2.5	-1.1	-5.1 *c*	-6.0	-3.4
Central government balance	0.8	2.7	-0.2	-4.7 *c*	-5.7	-2.7
Government debt 2/						
Gross	49.1	48.3	...	46.9 *c*	46.9	48.8
Net	45.6	41.1	...	35.7 *c*	36.9	39.2
Money and credit			(Percent change, end of period)			
Broad money (M3) 3/	29.7	25.6	12.7	-7.8 *b*	54.4	-20.8
Total credit to private sector	9.4	17.2	13.1	6.7 *b*	7.8	7.1
Short-term lending rate (percent)	20.0	19.0	...	21.2	19.2	...
Interbank money market rate (percent)	11.6	7.2	...	19.3	11.9	...
Balance of payments			(In millions of U.S. dollars)			
Exports	1,191	1,319	1,558	872	1,183	1,225
Imports	1,584	1,875	2,163	1,125	1,580	1,643
Trade balance	-392	-556	-605	-253	-397	-417
Current account balance						
excluding grants	-187	-202	-328	-236	-363	-354
(in percent of GDP)	-5.1	-5.6	-8.3	-7.0 *c*	-10.8	-9.7
including grants	-125	-110	-295	-221	-345	-339
(in percent of GDP)	-3.4	-3.1	-7.4	-6.6 *c*	-10.2	-9.3
Overall balance	117	204	-30	56	79	-115
Official gross reserves 4/	478	714	752	762	779	818 *d*
(in months of current year's imports of goods and non-factor services)	3.0	3.8	3.6	4.7	4.9	4.9
(in months of next year's imports of goods and non-factor services)	2.6	4.5	3.4	4.6	4.7	4.6
External debt service ratio 5/	13.9	13.1	10.7	...	19.0	11.9
External debt to GDP ratio (percent)	40.5	41.5	44.0	41.5	40.7	42.4
Exchange rates 6/			(Percent change, period average)			

Nominal effective exchange rate	2.9	0.1	...	2.5 *a*	...	...
Real effective exchange rate (CPI-based)	-2.3	-0.6	...	1.6 *a*	...	...
Real effective exchange rate (ULC-based)	-1.0	3.7	...	3.6 *a*	...	...

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

a Percent change relative to the same period of the previous year.
b Percent change relative to December of previous year.
c Percent of the annual GDP.
d Assumes that financing gap is filled by donor support.

1/ Data as reported under the PRGF/EFF-supported program (EBS/00/231), except ratios to GDP that are based on a nominal GDP that is calculated by applying the growth expected under the program to the actual 2000 outturn.
2/ Total debt of the 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.
3/ Includes foreign currency deposits.
4/ Includes receipts from privatization of telecommunications company of US$323 million in January 2001.
5/ Debt service due, including IMF, as a percentage of exports of goods and services.
6/ An increase means appreciation of the denar. Partner countries exclude Federal Republic of Yugoslavia.