29. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA
A rebound in investment expected after the December elections

Amidst an extended political crisis, the economy expanded at a slower pace in the first half of 2016. Output growth is projected to pick up again on the back of a renewed surge in investment in 2017, and robust household spending, provided the political crisis recedes. This is projected to be supported by continuing fiscal stimulus. The government's plans for fiscal consolidation become increasingly elusive, given the lack of identified measures and repeated fiscal slippages.

Political uncertainties take their toll on growth

After accelerating to 3.7% (y-o-y) in 2015, carried by strong private and public consumption as well as exports, GDP growth slowed down markedly in the first half of 2016 (2.1% annualised), largely on account of weak investment expenditure and a slowdown in private consumption growth, reflecting a protracted political crisis. While labour market conditions improved further, and real net wages, supported by lingering deflation, continued to post solid gains, disposable income was negatively affected by weak private transfers from abroad. Private sector credit growth slowed down noticeably over the summer, in annual terms, amidst important deposit withdrawals prompted by the political crisis.

Prospect of receding crisis restores confidence

Looking ahead, assuming the political stalemate will be overcome following elections scheduled for December 2016, a gradual rebound in investment by private domestic and foreign companies is projected for 2017 and 2018. This expectation is supported by strong high-frequency indicators for the third quarter, such as industrial production, capital goods imports and production, and construction activity. Household consumption is likely to grow at a robust, but slower pace, as gains in both, employment and net wages decelerate, private transfers remain only slightly above 2015 levels, and the government's appetite for ad hoc increases in transfers and subsidies diminishes post-election. A modest rise in price pressures in 2017, on the back of firming oil prices and rising import prices contributes to this development. In spite of strong projected growth in exports, in particular from new and extended production capacities by foreign companies, the foreign balance is not likely to make a positive contribution to economic growth in 2016, given faster increase in imports related to investment and export production. In 2017 and 2018, the contribution is likely to be positive, but small.

External vulnerabilities remain contained

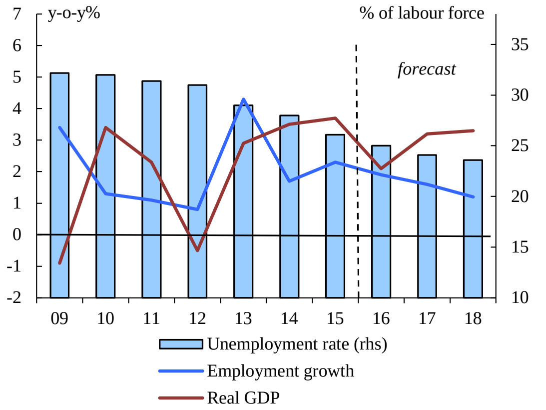
External vulnerabilities increased slightly in the first half of 2016, as the current account deficit widened in response to a deteriorating merchandise trade balance and a slowdown in private transfer inflows. Some potential foreign direct investors hesitated amidst political uncertainties, and FDI inflows in the year to July, at 1.3% of projected full-year GDP, were lower than one year earlier and markedly below their long term-average. Sustained outflows of investment income burdened the primary income balance, possibly reflecting recent changes to the taxation of retained earnings. Going ahead, the current account deficit is likely to remain modest and to widen only slightly in 2016, on account of strong import growth in relation with investment and production by FDI, and little pick up in private transfer growth. With a higher services surplus and an improved merchandise trade balance expected in 2017 and 2018, on the back of increased production capacities by foreign companies as well as projected recovery of demand in major trade partner economies, the external deficits are likely to diminish again.

These projections are subject to downside risks in case the political crisis lingers on. Negative confidence effects would constrain private consumption, reinforced by a drop in disposable incomes resulting from reduced private transfer inflows. Private sector investment would remain subdued. In case foreign currency inflows from direct and portfolio investment moderated, external vulnerabilities would increase.

Job creation continues with less speed

The situation in the labour market is likely to improve further, yet at a slower pace. Employment gains are projected to decelerate, against the background of some slowdown in government-sponsored employment programs after the elections. The likely further reduction in the overall unemployment rate by some 3.9 pps. over the forecast horizon comes on the back of an aggregate increase in employment of 5%, while the overall labour force is projected to decline.

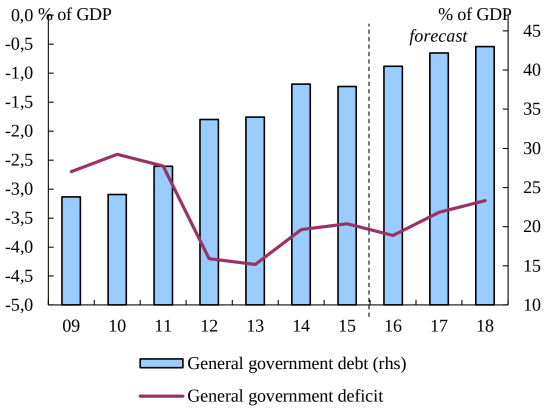
Graph II.29.1: **The former Yugoslav Republic of Macedonia - Labour market**



Persistent fiscal slippages prevent consolidation and weigh on debt

The government resorted twice to the adoption of a supplementary budget this year, motivated by lower growth projections for 2016 as well as by a decision to provide EUR 35 mn in relief payments to flood victims. As a result, the original 2016 deficit target was raised by 0.8 pps. to 4% of GDP. However, as some additional expenditures are transferred to 2017, the 2016 deficit may remain below target. The government plans to reduce the budget deficit to 2.2% by 2019. This appears unrealistic in the absence of specified consolidation measures. With primary balances remaining elevated, debt stabilisation during the forecast years is unlikely.

Graph II.29.2: **The former Yugoslav Republic of Macedonia - Public finances**



Rather, rises in government spending on capital projects, goods and services and social transfers including the additional 5% average increase in pensions scheduled for December, are likely to continue to provide a stimulus to the economy over the forecast horizon.

Table II.29.1:

Main features of country forecast - THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

	2015				Annual percentage change					
	bn MKD	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP		560.1	100.0	2.8	2.9	3.5	3.7	**2.1**	**3.2**	**3.3**
Private Consumption		379.3	67.7	3.1	1.9	2.1	3.2	**2.4**	**2.5**	**2.5**
Public Consumption		93.6	16.7	1.2	0.5	1.0	4.6	**2.6**	**2.5**	**2.4**
Gross fixed capital formation		129.1	23.0	-	3.5	13.7	3.5	**1.8**	**3.5**	**4.0**
of which: equipment		-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)		271.8	48.5	7.4	6.1	18.2	4.6	**7.1**	**6.7**	**6.3**
Imports (goods and services)		363.0	64.8	7.5	2.2	16.0	2.4	**5.6**	**4.9**	**4.6**
GNI (GDP deflator)		542.4	96.8	-	2.7	4.1	2.2	**2.5**	**3.4**	**3.3**
Contribution to GDP growth:	Domestic demand			-	2.3	4.9	3.8	**2.5**	**2.9**	**3.0**
	Inventories			-	-0.7	0.5	-0.8	**-0.2**	**0.2**	**0.2**
	Net exports			-1.2	1.3	-1.9	0.6	**-0.2**	**0.1**	**0.1**
Employment				-	4.3	1.7	2.3	**1.8**	**1.6**	**1.5**
Unemployment rate (a)				33.7	29.0	28.0	26.1	**24.4**	**23.2**	**22.2**
Compensation of employees / head				-	-4.2	1.5	1.1	**0.4**	**2.5**	**3.2**
Unit labour costs whole economy				-	-2.8	-0.3	-0.3	**0.1**	**0.9**	**1.4**
Real unit labour cost				-	-7.0	-1.4	-3.0	**0.1**	**-0.1**	**-1.3**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				3.0	4.5	1.1	2.8	**0.0**	**1.0**	**2.7**
Consumer-price index				2.5	2.8	-0.3	-0.3	**0.1**	**0.9**	**2.4**
Terms of trade goods				-	-0.8	4.9	-0.1	**-0.1**	**-0.1**	**-0.1**
Trade balance (goods) (c)				-20.6	-22.8	-21.8	-20.0	**-20.7**	**-20.8**	**-19.9**
Current-account balance (c)				-5.3	-1.6	-0.5	-2.1	**-2.2**	**-1.7**	**-1.6**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	-	-	-	**-**	**-**	**-**
General government balance (c)				-	-4.3	-3.7	-3.6	**-3.8**	**-3.4**	**-3.2**
Cyclically-adjusted budget balance (d)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				-	34.0	38.2	37.9	**40.5**	**42.2**	**43.0**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.