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(Original scientific paper)**

**MACROECONOMIC STABILITY AND GROWTH
DETERMINANTS OF THE REPUBLIC OF NORTH
MACEDONIA**

Abstract: This article addresses macroeconomic challenges and growth determinants of the Republic of North Macedonia. The overview of the Macedonian macroeconomic indicators in the period 2016-2021 serves as a basis for identifying the macroeconomics trends, as well as outlining the areas of policy-making where outstanding risk-management would be necessary in the mid/long term. The research indicate that major macroeconomic policy challenges relate to public debt management, budget deficit and inflation. The external shocks such as COVID-19, rising energy and food prices (as implication of the Russian invasion in Ukraine) have contributed the most to the imbalances.

The GDP growth has been largely affected by the global development. In purpose of acceleration of the GDP growth, several issues must be addressed - low productivity; low rate of innovations and technological development; unfavorable structure of the economy: mismatch among the labour market demand and supply, as well as education which does not reflect the needs of the economy. The paper provides recommendations about policy outlook and actions necessary for improvement of the state of affairs in the mentioned areas.

Key words: Macroeconomic stability; Competitiveness; Growth determinants

JEL Classification: E5; O1; O3

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Introduction

The global developments at the start of the third decade of 21st century have provoked shift from expansionary to contractionary monetary and economic policies, while at the same time strengthening the pressure on the national policy-makers to find ways to boost economic growth. Both challenges, elaborated from the perspective of the Republic of North Macedonia, are discussed below. More specifically, the paper identifies major risks with regards to the macroeconomic stability, as well as growth determinants pertinent to the increase of the competitiveness. The paper uses statistical data from official institutions and refers to the relevant studies and other documents.

1. The macroeconomic stability of the Republic of North Macedonia

The macroeconomic stability is usually measured by five variables: inflation; interest rates; public debt relative to GDP; fiscal deficit and currency stability. Macroeconomic stability provides overall outlook of the monetary, fiscal and financial stability. Table 1 represents data of the main macroeconomic indicators of North Macedonia necessary for understanding the macroeconomic outlook of the country.

Table 1. Macroeconomic indicators of the Republic of North Macedonia

	2016	2017	2018	2019	2020	2021	Q1 2022	Q2 2022
GDP rate	2.8	1.1	2.9	3.9	-6.1	4.0	2.4	2.8
Inflation (end of period)	-0.2	2.4	0.9	0.4	2.3	4.9	8.8	14.5
Inflation (average)	-0.2	1.4	1.5	0.8	1.2	3.2	7.7	12.3
Public debt* (% of GDP)	48.4	47.7	48.4	49.2	61.0	60.8	54.9	55.4
Public debt* (mil. EUR)	4711	4787	5202	5541	6483	7135	7170	7227
Basic interest rates (%)	3.75	3.25	2.50	2.25	1.50	1.25	1.25	2.0
Fiscal deficit	-2.6	-2.7	-1.8	-2.1	-8.1	-5.4	-0.8	-0.4

Exchange rate Den/EUR (average)	61.60	61.57	61.51	61.51	61.67	61.63	61.70	61.65
Current account balance (% of GDP)	-2.9	-1.0	-0.1	-3.3	-3.4	-3.5	-13.4	-7.1
Direct investment (mil. EUR)	316.9	180.0	603.7	363.3	154.7	435.2	107.5	138.8
Direct investment (% of GDP)	3.3	1.8	5.6	3.2	1.5	3.7	3.7	4.2
Gross foreign reserves (mil. EUR)	2613.4	2336.3	2867.1	3262.6	3359.9	3643.3	3272.5	3116.1
Unemployment rate	23.7	22.4	20.7	17.3	16.4	15.7	14.8	14.5

Source: National Bank of North Macedonia (https://www.nbrm.mk/osnovni_ekonomski_pokazатели.nspх)

* Public debt data were provided by the Ministry of Finance (<https://finance.gov.mk/stock-of-debt-2/?lang=en>)

According to the National Bank’s data,² North Macedonia had low inflation rate up till 2021, indicating strong price stability. The country’s inflation of 1.2% in 2020 was mostly due to the rise of prices of chemical and pharmaceutical products relative to Covid-19. In 2021, rising prices of crude oil and gasoline affected the prices of other commodities and contributed to average inflation of 3.2%. Following the Russian invasion to Ukraine in February 2022, the energy and food prices on the global level have surged up and activated the inflation chain, resulting in two-digit inflation rates that were unknown in most of the countries in the last two decades. In North Macedonia, the inflation rate in June 2022 reached 14.5% year on year. This poses serious pressure on the standard of living, as high food and energy prices are trickling down to real incomes; leading to a drop of purchasing power of the households and companies.

The National Bank has introduced measures to control the inflation, mainly through increase of the basic interest rate. It has been increased up to 2% in 2022. Previously, the basic interest rate was gradually lowered down to

² https://www.nbrm.mk/osnovni_ekonomski_pokazатели.nspх

1.25% in 2021 (from 3.75% in 2016) in purpose of stimulating the economic growth of the country through boost of the aggregate demand. The external shocks in 2022 forced shift from expansionary towards contractionary monetary policy, i.e. increase of the basic interest rates aims to limit the outstanding money supply and decrease inflation. The main issue related to the contractionary monetary policy is the tendency of slowing the growth, which is rather disadvantageous after economic slowdown caused by Covid-19 pandemic. Macedonian GDP rate experienced fall of 6% in 2020, as implication of the Covid-19 global lockdowns. A recovery rate of 4% growth was registered in 2021, indicating that pre-Covid-19 level has not yet been reached. In this context, creating the contractionary monetary environment at this stage has many backlogs for the businesses. It could contribute to stagflation – a situation of parallel decline of the economic growth and rising inflation.

The Macedonian National Bank has mostly followed the actions of the European Central Bank in shaping its anti-inflationary policy, which was expected due to the currency peg to Euro, country's status as an EU candidate and intense trade cooperation with EU. Apart of the interest rates, other monetary instruments were used, mostly referring to the increase of mandatory reserve of the banks and adjusting terms of auctions of treasury bills to restricting supply of money.

Apart of the inflation, the most challenging macroeconomic issue is related to the public debt (general government debt and public enterprises guaranteed debt and non-guaranteed debt). The public debt rose sharply in 2020, up to EUR 7.1bn or over 61% of GDP (from 47.7% or EUR 4.8bn in 2017), due to heavy external funding to bridge the government's crisis-induced financing gap in 2020. In absolute terms, the debt continued to rise in 2022 and reached EUR 7.2n in Q2, while in relative terms it decreased down to 55.4% of GDP in Q2 2022, owing to higher GDP over the period.

Further increase of the public debt is foreseen in the view of the economic projections for 2022 and 2023. In the April 2022 edition of its World Economic Outlook, the International Monetary Fund projected growth slow down to 3,2% in 2022, and a further slow down to 2.7% in 2023. Moreover, the country's average consumer price inflation is forecast at 6.9% in 2022 and 3.6% in 2023, compared to 3.2% in 2021.³

In April 2022, the Republic of North Macedonia submitted a request for a two-year Precautionary and Liquidity Line (PLL) to the IMF. This credit

³ <https://www.imf.org/en/Countries/MKD#>

line, available to member countries with sound economic fundamentals, policy frameworks, and policies, can help safeguard economies against external shocks by providing upfront access to IMF resources.⁴ PPL would certainly assist the country in coping with the crisis, while payback would be burdened with lower interest rate compared to other types of lending.

The fiscal deficit almost quadrupled in 2020, rising to 8.2% of GDP. This was due to the foregone tax revenues from the decline in economic activity and additional expenditures on anti-crisis measures to support households and companies. The fiscal deficit narrowed to 5.4% of GDP in 2021, which was attributable to less COVID-19 related measures in 2021. In the Q1 and Q2 of 2022, the fiscal deficit has been 0.8% and 0.4% of GDP, respectively, due to stabilization of the economy, as well as traditionally lower public spending in the first half of the year. Given the energy crises and rising inflation in the second half of 2022, along with the projections for 2023, the management of the fiscal stability of the country would remain a challenge in the upcoming years.

The national currency remained stable during the pandemic in 2020 and 2021, as well in 2022. The National Bank pursues long-term policy of currency peg to the euro, which significantly contributes to the macroeconomic stability. On the other hand, the gross foreign reserves, that registered upward trend up till 2021, even during the Covid-19 times, started to decrease in 2022. During the first half of the year, the reserves decreased to EUR 3.1bn, compared to EUR 3.6bn at the end of 2021. This is part of the anti-inflationary measures, as an increase in reserve holdings leads to an increase in the monetary base which, if the latter is not (or not fully) sterilised, leads to higher inflation.

In April 2022, Fitch rating agency affirmed North Macedonia's Long-Term Issuer Default Ratings (IDR) at 'BB+' with a Negative Outlook.⁵ It confirmed the ratings as of 2021. Affirmation of the credit rating serves as a recognition of the state's efforts to maintain macroeconomic stability during times of crises, while negative outlook mostly relates to the risks noted above. In addition, Fitch referred to the risks related to further widening of the current account deficit, which surged up to 13.4% of GDP in Q1 2022 and 7.1% in Q2 2022, due to reduced export demand and higher energy import costs. However, according to the Fitch projection on the current account deficit, it should ease

⁴ <https://www.imf.org/en/News/Articles/2022/04/20/pr22124-imf-executive-board-receives-request-for-liquidity-line-north-macedonia>

⁵ [https://www.fitchratings.com/research/sovereigns/fitch-affirms-north-macedonia-at-bb-outlook-negative-29-04-2022#:~:text=Sovereign%20Rating%20Model%20\(SRM\)%20and,\(LT%20FC\)%20IDR%20scale.](https://www.fitchratings.com/research/sovereigns/fitch-affirms-north-macedonia-at-bb-outlook-negative-29-04-2022#:~:text=Sovereign%20Rating%20Model%20(SRM)%20and,(LT%20FC)%20IDR%20scale.)

to 4.7 of GDI in 2023, in line with reduced energy imports and weaker fiscal impulse.⁶

Fitch outlook on North Macedonia is very relevant with regards to the perception of the macroeconomic stability by the foreign investors. In the first half of 2022, the FDI inflows in the country totaled EUR 246.3 mil., which is a relatively stable indicator compared to earlier years. Nevertheless, the global economic slowdown in 2022, along with the projections for 2023, point toward general decrease of the ventures – foreign or domestic. That might affect the number of the new jobs, although, it would not necessarily affect the rate of unemployment in the country. It was continuously declining over the analyzed period and dropped to 14.5% in the Q2 2022 from 23.7% in 2016. The rate of unemployment is mostly affected by other factors, primarily emigration that led to shrinking of the labour force contingent and its quality. In this context, the unemployment is unlikely to be a serious problem in the short/mid run. On the contrary, it seems that the lack of qualified labour force would be more challenging, given the emigration movements from the country.

The indicators discussed above show that macroeconomic stability in North Macedonia has been maintained for a longer period of time. Covid-19 and Russian invasion to Ukraine in 2022 that triggered energy crisis and global rise of the food prices, acted as external shocks to the macroeconomic setting in North Macedonia, demanding substantial state interventions. The state interventions in response to the Covid-19 have implied high fiscal deficit and widening of the public debt in 2020, while inflationary pressures in 2022 triggered implementation of the contractionary monetary policy's instruments. As projections with regards to the global economic trends foresee ease of the burdens in 2023, the macroeconomic stability of North Macedonia could be preserved with cautious risk management in these three mentioned areas.

2. Competitiveness and growth determinants of the Republic of North Macedonia

The competitiveness of the national economy is very complex to be measured. The World Economic Forum "Global Competitiveness Report" makes an effort to compare national economies according to their specifics in 12 pillars relevant for competitiveness. The pillars include: Institutions; Infrastructure; ICT adoption; Macroeconomic stability; Health; Skills; Product

⁶ Ibidem

market; Labour market; Financial system; Market size; Business dynamism and Innovation capability. In the Global Competitiveness Report 2019,⁷ the Republic of North Macedonia was ranked 82nd out of 141 country. The 2019 Report is the latest one providing detailed analysis according to the pillars and therefore, served as basis for this analysis. More specifically, North Macedonia scored lowest with regards to the pillars Market size (109) and Innovation capability (110), while best scores were noted with regards to Business dynamism (65) and ICT adoption (70). The market size is predefined category and poses limits to the country, but, the regional market of the Western Balkans could be considered as an option. All Western Balkan countries have similar characteristics in the field of competitiveness, confirmed by their rankings in the scope of 72nd (Serbia) to 92nd (Bosnia and Herzegovina).

Apart of the market size, other pillars in the competitiveness profile of North Macedonia indicate that the country should put serious efforts to improve the situation. The primary issues that should be considered in purpose of increase of the competitiveness are related to productivity, structural transformation of the economy in favour of the sectors producing higher value added, increase of the rate of innovation and technological development and encouraging new investment – domestic and foreign.

Productivity is the major problem in the Republic of North Macedonia. This term encompasses labour productivity; value added per worker and total factor productivity (labour and capital, i.e. technology as factors). The total factor productivity (TFP) could be simply explained as economic growth through technological innovations and higher efficiency as a result of higher skills and better capital management.

According to the calculations in the Systematic Diagnostic of the World Bank 2018,⁸ over the periods 1993-2001 and 2009-2017, Republic of North Macedonia registered continuous decrease of the total factor productivity. “Decomposing growth by factors of production shows that GDP growth has been driven by the accumulation of capital and labor, the latter measured by the increase in employment. Meanwhile, since independence the contribution of TFP, which captures how efficiently and intensively capital and labor are utilized in production, has been negative, except in 2002–08 when the external environment was favorable and structural reforms were underway. The contribution of human capital, using years of schooling as a proxy for the quality of

⁷ World Economic Forum, “The Global Competitiveness Report 2019.”, WEF 2020

⁸ World Bank, *Seizing a Brighter Future for All; Republic of Macedonia, 2018*, Report Number 121840-MK

labor, has been low or negative since 2002 as education and skills formation deteriorated.”⁹

The labour productivity in North Macedonia, measured according to the value added per worker, has been 80% of the value added per worker in the Western Balkan region and 40% of the value added in the EU members states that joined as of 2004.¹⁰ In addition to the low(er) productivity, the Republic of North Macedonia faces serious emigration of the labour force that causes labour market’s erosion. According to the World Bank, the labour force is projected to fall by 20 percent in the next 35 years, from 1.47 million in 2015 to 1.16 million by 2050.¹¹ Moreover, although emigration is draining the country of many of its most productive workers, remittances are minimal. This implies that the “exported” human capital has insignificant or zero contribution to the growth. Having in mind that the investment in the human capital is immense, the emigration triggers huge losses to the country.

In the World Bank’s document “North Macedonia: Action Plan for recovery of Growth and Jobs”,¹² a reference has been stated that both, domestic and foreign investors in the country, complain not only about the disconnect between their needs and skills taught in the education system, but also about the shortage of vocational and management skills. Firms singled out skills as biggest obstacle—outranking wage expectations, the cost of social security, and labor regulations. The state aid aiming to support jobs creation in FDI has incorporated training of the workers, tailored to the needs of the companies and conducted at their premises. Apart of that, the authorities provide programmes for general training of computer and other skills, widely accessible to young and unemployed persons. Although these trainings provide some general knowledge, the gap of specific skills could be prevailed only by closer cooperation among education institutions and companies, through serious programmes for internships and vocational training.

⁹ Ibid, p. 44

¹⁰ Ibid, p. 0-8

¹¹ Ibid, p. 0-7

¹² <https://documents1.worldbank.org/curated/en/809991603810854005/pdf/Republic-of-North-Macedonia-Action-Plan-for-Recovery-of-Growth-and-Jobs.pdf>

Table 2. GDP structure in the Republic of North Macedonia (in %)

Sectors	2018	2019	2020	2021
Agriculture, forestry and fishing	8.5	8.0	8.6	7.2
Mining and quarrying; Manufacturing; Electricity...	18.6	18.0	17.4	16.9
Construction	5.4	5.5	5.3	5.4
Wholesale and retail trade...	19.9	20.3	19.5	19.3
Information and communication	3.4	3.7	4.0	4.3
Financial and insurance activities	2.9	2.8	3.1	3.1
Real estate activities	10.0	9.9	10.5	10.5
Professional, scientific and technical activities; Administrative and support service activities	3.6	3.8	3.6	4.0
Public administration...	11.6	11.9	13.3	12.9
Arts, entertainment and recreation...	2.8	2.9	2.6	2.8

Source: State Statistical Office BDP News Release 3.1.20.16/2020; BDP News Release 3.1.22.15/2022

Changes in the education system should be done in purpose to serve and economy better. The structural transformation of the economy in favour of the sectors that produce higher value added is crucial for increase of the competitiveness, as sectors with low(er) value added dominate in the GDP and employment. As presented on Table 2, the sector wholesale and retail trade had largest share in GDP of 19.3% in 2021, while manufacturing industry participated with 16.9%. Agricultural sector had share of 7.2% in GDP, but, it has a high number of low paid employees, creating a spiral that decreases the economic growth potential. At the same time, the manufacturing sector has declining share over the analysed period, which indicates that structural transformation of GDP is necessary.

Apart of the overall GDP structure, the structure of the manufacturing industry deserves specific attention. The major Macedonian industries are metal, textile and food processing industry. The latter two are high-intensive labour industries that produce low value added products, implying that only the metal one brings higher effects to the GDP. In the past decade, FDI entrance provoked changes in the structure with chemical and other industries allied to automotive industry, being the leading ones. The FDI inflow implied changes in the export structure with dominance of the higher value added products. However, the net effect of such change is not considerable, as most of the

inputs for FDI production are imported. FDIs have not initiated the effect of integration of the local companies into the global supply chains, which is one of the expected benefits for the national economy from the FDI attraction.

Structural transformation is closely related to innovation. The statistics indicate that the investment in research and activity are very low in North Macedonia – only 0.4% of GDP in 2019, while private sector's share is only 0.1% of the GDP. This is rather disappointing, particularly if analysed from the TFP perspective. In purpose of improvement of the state of affairs in this field, the Fund for Innovation and Technical Development (FITD) was established in December 2013. Up till 2021, FITD articulated investment of over EUR 43 million in 600 companies in purpose of ITC adoption and innovation enhance.¹³ FITD is an excellent mechanism for support of the companies and should be combined with other programmes, such smart specialisation strategy, in terms of achieving optimal rate of investment and results. Also, through these programmes, the policy-makers should seriously tackle the problem of low productivity.

Another growth determinant refers to the terms of financing the investment in the country. Access to finances in North Macedonia is related to rigid criteria set by the commercial banks. Fulfilling the criteria is particularly difficult for the small companies, in particular those having intention to start production business. There is Development Bank of the Republic of North Macedonia that provides certain support to the companies, but, wider financial platform is necessary to boost the investment of small companies. This is particularly relevant, as most of the economic operators (82% in 2021) are small companies with 1-9 employees.¹⁴ In this respect, it must be noted that foreign investors had preferential treatment for the longer period of time in terms of subsidies granted by the state to FDIs on various basis. As of 2018, the Government has adopted Plan of Economic Development¹⁵ that has enabled domestic companies to be eligible for state assistance. FDIs remain very important segment of the economic development of the country, and the efforts should be focused on the integration of the domestic companies with the foreign ones.

In 2021, the number of active business entities in North Macedonia was 72992.¹⁶ Around 30% of the companies operate in the wholesale and retail sector; 10.9% in the manufacturing sector and 10.7% in the sector of professional,

¹³ FIDT, Performance analysis of companies co-funded by FIDT, September 2021, p. 7

¹⁴ State Statistical Office, Business Entities – News Release 2021, No 6.1.22.14/2022

¹⁵ <https://vlada.mk/PlanEkonomskiRast>

¹⁶ Ibid

scientific and technical activities. The number of the companies experienced decrease of 3.8% (2853 entities) in 2020 due to the Covid-19 crisis,¹⁷ implying to the high vulnerability of the small companies. This points out the need for better and consistent policy-response to boost the economic growth. It also includes coordination among policies regulating the macroeconomic stability (monetary and fiscal policy) with policies dealing with growth determinants, as both categories are interconnected and ad-hoc solutions could not provide sustainable results.

Conclusion

The macroeconomic stability in North Macedonia has been successfully maintained for a longer period of time. The pressures that were posed by Covid-19, followed by the outbreak of the energy crisis due to the Russian invasion to Ukraine in 2022 have triggered monetary and state interventions that posed public debt, fiscal deficit and inflation as major challenges that need to be addressed in the short-mid run. As projections with regards to the global economic trends have foreseen ease of the burdens in 2023, the macroeconomic stability of North Macedonia could be preserved with cautious risk management in these three mentioned areas.

In terms of competitiveness and growth determinants, the major issues that should be addressed by the policy makers in North Macedonia refer to:

- Increase of productivity, in particular labour productivity which is seriously lagging behind the potential competitors in the Western Balkans region;
- Structural transformation of the domestic industry in favour of the sectors producing value added products. The manufacturing industry is dominated by the FDIs in automotive industry, while domestic industries are mainly low value added and high labour intensive industries that could not provide rapid boost to the GDP growth.
- Increase of the innovation rate and technological advancement in the country; and
- Encouraging new investment through ensuring easier access to finances for domestic companies.

The macroeconomic stability is crucial condition for economic growth of the country, along with the external environment that determines national economy's actions on the global market. In case of disturbances of these two

¹⁷ .State Statistical Office, Business Entities – News Release 2020, No 6.1.21.15/2021

categories, state interventions are usually focused on setting the balance back. However, there is a parallel challenge of boosting the economic growth, in purpose to alleviate the consequences of the crisis. The national economies with higher competitiveness would be more prepared for the latter challenge, while less advanced economies would need to reconsider their growth determinants and approach towards building higher resilience to crises.

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