

ECONOMY AND FINANCE

#TenKeyPointsAbout:

THE BIG PICTURE: THE MACEDONIAN ECONOMY IN THE MEDIUM AND LONG TERM

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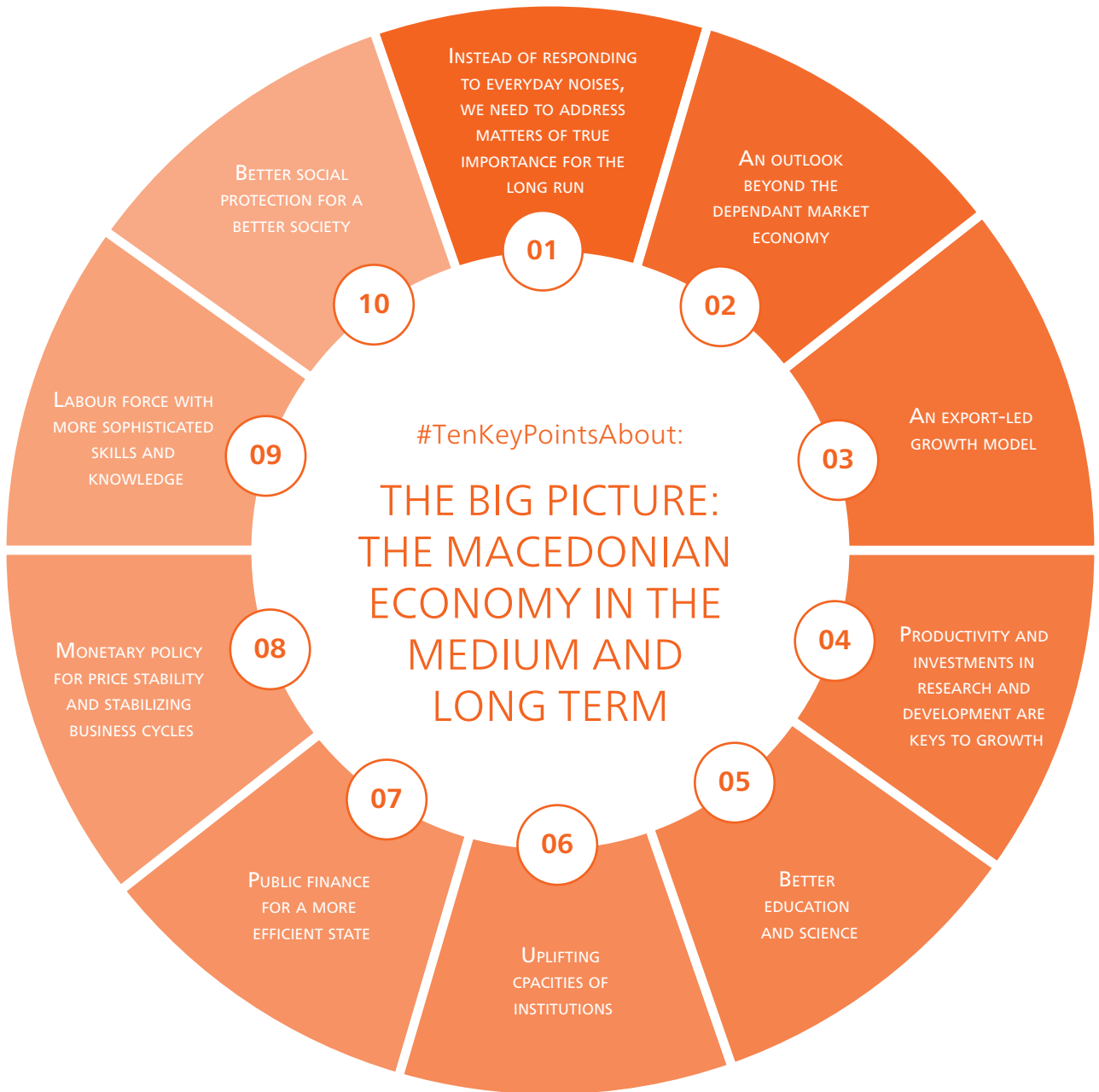
In a world deluged by irrelevant information, clarity is power.



In order to walk the right path, we need a consensus on where we want to be.



Instead of responding to everyday noises, we need to address matters of true importance for the long run.



1. INSTEAD OF RESPONDING TO EVERYDAY NOISES, WE NEED TO ADDRESS MATTERS OF TRUE IMPORTANCE FOR THE LONG RUN

“In a world deluged by irrelevant information, clarity is power” - Yuval Noah Harari, 21 Lessons from the 21st Century

The idea of the “Big Picture” is not to elaborate policies in great detail, nor to respond to the multitude of questions constantly raised in the media about economic and social policies; rather the idea is to distract attention from the noises of the present day and to focus only on issues which are truly important when we look at the broader perspective (“the big picture”).

To look at the “big picture” during “the crisis like no other” is quite a difficult task. The COVID-19 pandemic has caused serious shifts in many segments within a very short time period. The debt levels of many states soared sharply, and the value of public health was re-emphasised. It began to seem that the world of free trade would soon become a thing of the past. Many people started to work from home, whereas

inter-personal relations and contacts shifted to social media... And surely there will be many similar changes to challenge us in the future, as the world cannot be simply looked at from one perspective any longer. An economist alone cannot comprehend the world in full, nor a sociologist, or an engineer. The “big picture” cannot be seen by someone who only has leftist perceptions of politics, or by a person with only a right-wing orientation and viewpoints. Likewise, the “big picture” cannot be seen only by young people with their ideals and their faith in change, for it also needs the voice of adults who will not allow the same mistakes to be repeated again. Finally, the “big picture” cannot be comprehended only from within; it must also be looked at from the outside.

It is high time that Macedonian society reached a consensus on the key matters that are expected to bring economic and social prosperity in the long run!

2. AN OUTLOOK BEYOND THE DEPENDANT MARKET ECONOMY

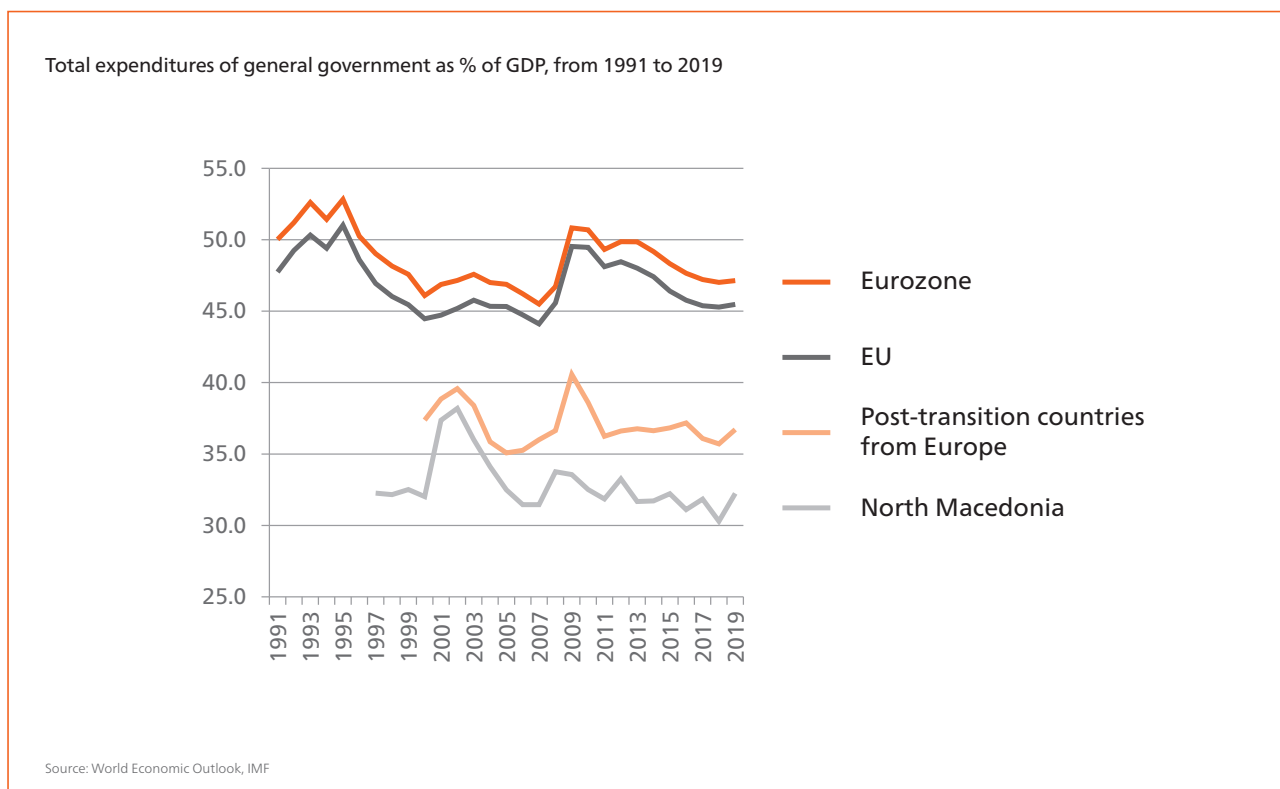
*„Alice: Would you tell me please, which way I ought to go from here? Cheshire Cat: That depends a good deal on where you want to get to. Alice: I don't much care where. Cheshire Cat: Then it doesn't matter which way you go”.
“Alice in Wonderland” – Lewis Carroll*

According to the theory of varieties of capitalism, the Macedonian economy is in the group of dependant market economies, where the main funding sources are not capital markets or national banks, but rather depend on foreign transfers in the form of remittances and the inflow of foreign investment. This is in contradiction to the two dominant varieties of capitalism: liberal market economy, where coordination is done through markets, and the coordinated market economy, where coordination is often done through networks and associations of companies and unions.

In a dependant market economy, the management of many important companies is exercised through

the formal hierarchy of transnational companies and control is exercised from their headquarters, located outside its state borders. Bargaining and determining of wages and working conditions is not market-based or based on collective agreements; instead this is done by contracts at the transnational company level. Foreign investment seek cheap labour and strong tax incentives, which is opposite to the development of heavily-funded public education or significant investments in training by transnational corporations. Innovations do not take place in a dependant economy, where work takes place on assembly platforms for semi-standardised industrial goods.

The gradual exit from the dependant market economy can only be achieved through structural reforms, which would aim at raising the potential economic growth of the Macedonian economy to a level of 4.3 to 5 percent in the 2020 – 2035 period. In such conditions, the Macedonian GDP per capita, measured according to the purchasing power parity of the dollar in



2035 would amount to 58.4 percent of the EU average, and employment would be 59 percent. However, it is not enough only to ensure the growth of the economy, as the manner in which the fruits of growth are distributed is equally important. It is important to reduce disparities in income and wealth, but for this to happen wages must grow for a majority of citizens who live only off their labour to make an income. In the medium term we need to work on reducing by half the poverty rate from its present level of 10 percent.

The capacity of the state has to be reinforced. The size of the state, measured as a percentage of GDP in North Macedonia is not only smaller compared to EU Member States, but is also lower than the average of the countries in the region. In order to improve state capacities, on one hand we need to limit the ability of political and business elites to manipulate the rules of economy and the society, and on the other hand, we need to improve the quality of health care and education, as the key pillars of the public sector.

3. AN EXPORT-LED GROWTH MODEL

Until now, economic growth has been overly concentrated on the models relying on the so-called exogenous growth factors. According to these models, the productivity factor is considered to come exclusively from outside through the import of knowledge. This is achieved in practice by increasing Foreign Direct Investment (FDI) through which foreign investors import sophisticated production equipment to the host country and train the workforce in specific specialized production. Clearly the economic growth model in North Macedonia, which is based upon arbitrage of labour costs and arbitrage in income tax rates, does not provide for a comprehensive inclusive growth which can generate significant added value and accelerated increase of living standards. Therefore, attracting FDI based on labour price arbitrage and tax incentives is unsustainable in the long run.

The main driver of economic growth should be the export of goods and services, because we are a small economy, with a small market, a very limited domestic demand, limited resources and with a relatively low degree of economic development.

The selection of the export expansion as a long-term development strategy means that the economy should not remain (just) a “small open economy”; rather it should gradually transform into an internationally integrated economy. In order to achieve this, the share of export in GDP from the present 60 percent should be increased to 100 percent of the GDP ratio.

Presently the biggest part of Macedonian export -- as a (small) domestic component to the added value

-- contains unskilled and semi-skilled (hence cheap) labour. Therefore, the export expansion model should insist on changing this, meaning that there should be an increase in the export of goods and services with a larger component of domestic added value.

The growth of the economy ought not rely solely on the import of knowledge/technology, as has been the case so far, but it should be combined also with an endogenous growth model – the development of its own knowledge and innovations, for linking domestic companies in the FDI value chains that have ventured in North Macedonia, as well as in the regional and global value chains.

In order to optimise opportunities for linking domestic companies to already existing FDI, the policy of attracting FDI needs to be changed. It should not aim at FDI that produce low added value goods, such as vehicle parts or the like: rather it should target FDI producing final goods, which will open possibilities for domestic companies to offer raw materials and produce some of the inputs (final product components) needed for their production. Furthermore, in order to be more successful, technological modernisation of the national companies must be supported in parallel to these endeavours.

In the context of implementing an export-led growth model and the export expansion strategy, aside from keeping the focus on EU Member States as the most important export partners, it is very important to give due consideration to the process of development of regional economic integration with the Western Balkan region. Relevant studies show that the absence of deeper economic integration of the Western Balkans is “costing” the regional economies the loss of a substantial additional GDP. Hence,

there is justification for reforms in North Macedonia which will boost the freedom of movement of goods and services, people (labour), capital and knowledge throughout the region, just like in the development of regional value chains. Likewise, we must push harder for fully upgrading the existing national potentials, in order to catch up with the pace of the already initiated processes of nearshoring and reshoring of FDI from the EU, to whom the Western Balkans region is becoming increasingly interesting.

Government support should not be limited only to primary or secondary sectors, but should also encompass the tertiary sectors, namely the services. This is important, because presently around 40 percent of the Macedonian GDP is generated in production service sectors, which is three times more than the share of the entire manufacturing industry (13 percent), while systemic support to the sector does not suffice and needs to be further developed. Henceforth, the government needs to conduct a selection and solid defining of the support instruments. If it continues to give subsidies, they should be conditioned on a certain “output” (for greater quantity and higher quality), and not on “input” (as is the case now – whoever planted initiates something, however meagre, is automatically entitled to subsidies). However, in the mid-term, subsidies should be phased out as instrument of economic policy.

It is important to ensure a degree of self-sustainability of the Macedonian economy, in the context of future similar crises, above all in terms of food production, medical equipment, disinfectants, etc. They would ensure some “security” in the wake of a future crisis, however, given the limited capacity of the small economy, we should strive that such activities and sectors also become competitively capable of exporting their products.

4. PRODUCTIVITY AND INVESTMENTS IN RESEARCH AND DEVELOPMENT ARE KEY TO GROWTH

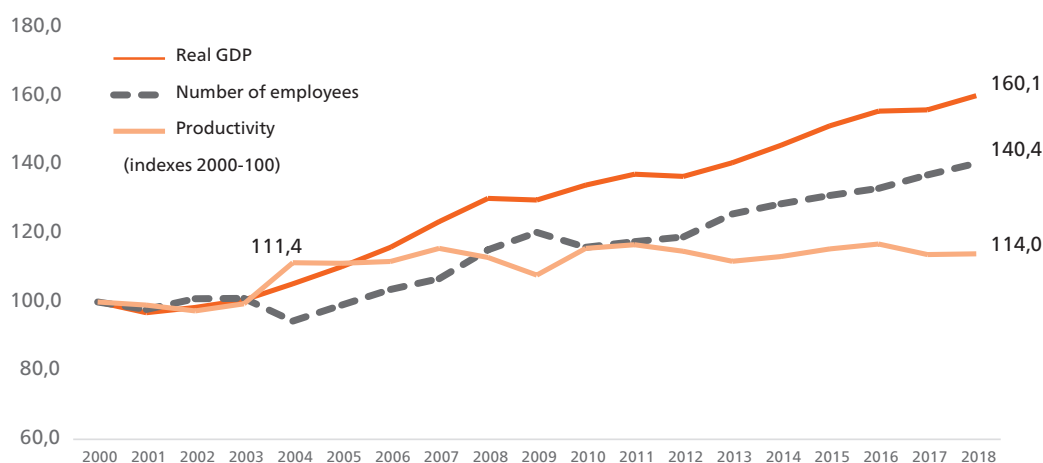
Moderate economic growth is highly correlated with low productivity growth. In the past two decades, economic growth was driven primarily by employment. The exception here is the 2000 – 2005 period (that is the period before the intensive promotion of free economic zones), when productivity growth was the leading factor of economic growth (with productivity growth of 2.4 percent on average per year). In the 2006 – 2018 period, productivity hardly contributed at all to the economic growth (productivity growth of 0.2 percent on average per year). During this period, employment increased by 3.1 percent per year, or cumulatively increased by 40 percent. This means that the economic growth in the past two decades has been labour-intensive in its nature, where the increase in employment was also driven, to some extent, by employments in the public sector.

In modern economies, investments in research and development are the key driver of growth. Innovations, defined as production improvements and the introduction of new products, are indispensable for the sustainable growth of productivity in the economy. However, North Macedonia confirms the paradox of innovation: developing countries invest less in innovation than developed countries. The level of basic and applied research in North Macedonia is extremely

low. Gross Domestic Expenditure for Research and Development in the four key sectors (companies, government agencies, higher education and non-profit organizations) altogether accounted for 0.36 percent of GDP in 2017. For the sake of comparison, in the EU countries towards which we aspire, on average they amounted to 2.13 percent of GDP in 2017 according to the World Bank. Additionally, our biggest problem is not that we lag behind the developed countries, but that we have lower levels of research and development than our neighbouring countries. To illustrate, R&D accounted for 0.87 percent of the gross domestic expenditure in Serbia, or 0.75 percent in Bulgaria, in 2017.

The research and development process might be boosted in North Macedonia if steps are taken on the supply and demand side of innovation. On the supply side, the key players are universities, where human capital needs to be strengthened for scientific research. A necessary step that needs to be taken is to tighten the selection criteria for awarding academic titles, but also to reassess the overly large number of universities and faculties. This will improve the efficiency of resources invested in the national scientific system and will ensure much better reward for those who are truly engaged in science.

PRODUCTIVITY OF LABOUR, GDP GROWTH AND EMPLOYMENT



Source: WEO October, IMF and SSO, and calculations

The second important step is linking universities to demand in innovation, that is, to the enterprises. An important tool that would incentivize such linking are national grants for scientific projects.

Public policies for supporting the development of enterprises should give priority to fostering the rewarding of process results, rather than subsidizing inputs. For example, the programmes of the Ministry of Economy are orientated towards input resources at the enterprise level, such as the procurement of equipment and tools, logo and visual identity of products

or services, advertising materials, and participation in fairs. Moreover, policies need to be coordinated and spearheaded towards the same common goal. For years, the Ministry of Economy has been implementing around ten programmes for improving the capacity of domestic enterprises, which are not properly coordinated with the initiatives of the Agency for Entrepreneurship, the Agency for Foreign Investments and Export Promotion and the Fund for Innovation and Technology Development. Additionally, stronger tax incentives could be considered for companies which decide to open research and development centres.

5. BETTER EDUCATION AND SCIENCE

Education is not only the pillar of society, but also the factor of productivity of the future labour force. This is why priority must be given to improving the quality of education. There are many initiatives which can bring about positive changes in education, which do not necessitate funding.

The first thing that can be done is to change the assessment and grading system. The inexistence of a fair grading system in the Macedonian education system is the reason we have inflation of grades, inflation of degrees and general mistrust in the system. This can be overcome by introducing grading on a Gaussian curve. The idea behind such assessment is that in each larger group of students the distribution of knowledge is on a normal (Gaussian) curve, so those who know more than average will deserve a higher grade, and those who know less than average will receive a lower grade. In such a case, the teacher's task is not to determine who has met the criteria for an A, but only to decide what grade the average students will receive and how much better than average they should perform in order to get the maximum grade. The usual strategy is for 20 percent of students to get an A, 60 percent to get a B, about 20 percent to get a C or less, but the distribution of grades is in the hands of the teacher or the educational institution. Such assessment is almost ubiquitous in Western education systems and has three advantages: a) It eliminates the danger of the teacher setting very high criteria which no student would be able to meet; b) students themselves have a lower tolerance to cheating; and c) it stimulates students to compete with each other, creating a culture of meritocracy. Nevertheless, there are countries which believe that the education system should be freed from pressures for higher grades, and there is also documented evidence of negative impacts of grading on a Gaussian curve.

The introduction of standardised tests from the earliest age can be an effective tool for helping the country rise from the rock bottom of international rankings, because the sooner children are exposed to

such assessment systems, the less pressure they will feel when they grow up.

Unless we restore respect to the teaching profession, there will be no improvements in the quality of education. Starting from kindergartens, the reputation of teachers should be higher, and teaching staff should be better rewarded for their work. The Faculty of Pedagogy should be one of the most prestigious institutions in the country, and its graduates should be well paid and respected. Only this way will their students learn to express themselves in writing, to approach problems analytically and to learn for knowledge, and not for grades. If we put things in lower education on a sound footing, we will develop new generations who are ready to face the challenges of modern times.

Our education must not be stranded in the 20th century and to make very little use of the digital resources available to us. The emphasis in education must be put on critical thinking and not on memorising.

As a country we cannot allow ourselves not to have a university ranked among the top 1,000 on the Shanghai list. Perhaps one of the biggest mistakes in our higher education is that we are attempting to educate staff in all scientific disciplines. A small country needs only a handful of faculties, but they must be of high quality. National strategies need to be developed and we need to make best use of the already available human resources, which is our already acclaimed academic staff, but also our scientific diaspora which works at world-renowned universities.

The Law on Higher Education must no longer have flexible definitions of what qualifies as a scientific publication and must not recognise works published in the so-called predator journals, i.e. journals that do not follow the rules of scientific publishing. The Law must clearly stipulate the types of publications taken into consideration for the selection of scientific and academic titles. Under the Shanghai methodology,

scientific publications are the key criterion when assessing quality of research, which needs to be peer-reviewed and indexed in the Web of Science.

The country's investments in education and science must increase. The funds invested by our state in education in the 2015 – 2018 period amounted to 3.7 percent of the GDP, which is among the lowest in Europe. For the sake of comparison, Serbia has allocated 4 percent of the GDP, and Slovenia has allocated 4.9 percent. The allocations for education were constantly declining in the past decade due to two main reasons. First, in the few past years state budgets have been decreasing. More specifically, the state budget in 2012 was 36 percent of GDP, while in 2018 it dropped to 32 percent. The second reason is the declining spending of the projected allocations for education. More specifically, in the 2017–2018 period 11 percent of the projected funds for education remained unused, whereas in the previous seven years the percentage was 6 percent. According to OECD assessment, a low level of investments impacts the weak education results. Moreover, one third of the schools in the state are in dire need of major renovation.

In addition to investments being low, their structure is also assessed as unfavourable. According to a study published by the World Bank, the inefficiency of spending on education in our country is about 20 percent, which is much higher than in other countries in the region. In Albania this figure is about 7 percent, in Croatia and Bulgaria about 6 percent, and in Serbia about 5 percent. Examples of expensive projects such as "Computer for Every Child" or textbooks with CDs are well known. In higher education, the state constantly spends large amounts of money on new universities which do not breed any quality. also produce results. On the other hand, the value funds invested in science is declining. For example, the share for scientific and research work in the national budget of North Macedonia amounts to a meagre 0.04 percent. Hence, it is necessary to increase investments in education and science, both by increasing budget allocation and by improving the absorption of funds. Furthermore, it is of utmost significance to improve efficiency of education investments, that is, to invest funds in well planned projects.

6. UPLIFTING CAPACITIES OF INSTITUTIONS

Institutions have an enormous impact on economic growth and development. Even the contemporary economists such as Acemoglu and Robinson consider that the "success" of some countries, much like the "failure" of others, is owed primarily to the institutions.

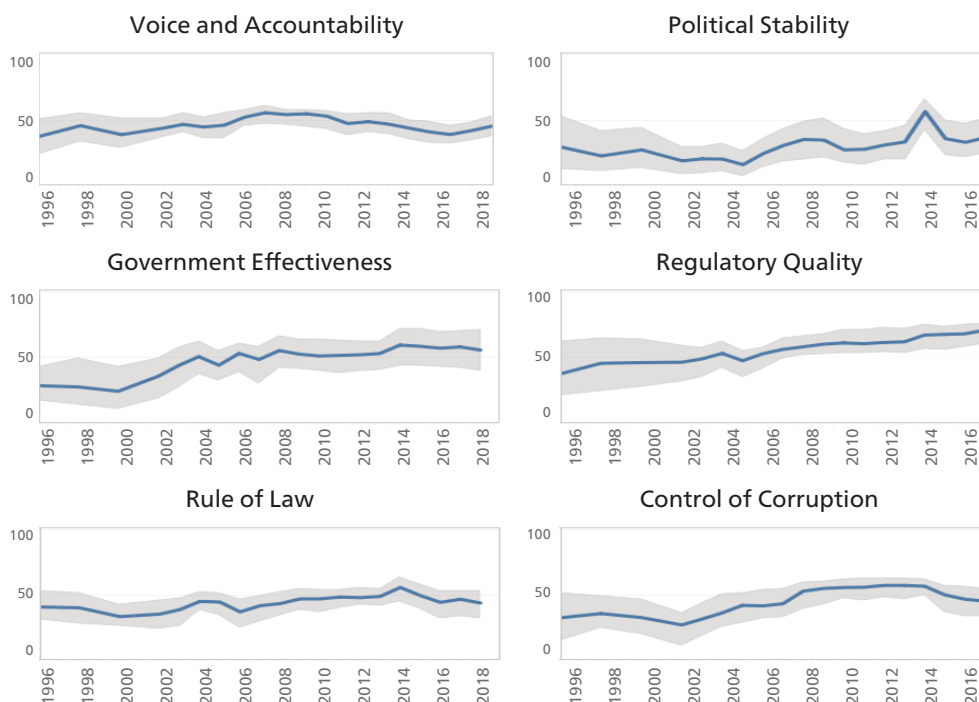
The World Economic Forum, in its Global Competitiveness Report, pointed out that the accelerated growth of the Macedonian economy in the future depends primarily on the capacity of institutions, and not on the availability of resources.

According to the six main indicators of quality of institutions developed by the World Bank, North Macedonia has achieved progress only in two of them

-- Government Effectiveness and Regulatory Quality
-- but with the remaining four indicators (Voice and Accountability, Political Stability, Rule of Law and Control of Corruption) there has been no progress in the 1996 – 2018 period.

Such a stalemate of the situation with the quality of institutions over a longer time is explained in literature with the "see-saw effect", and the "Iron Law of Oligarchy". The point is that without a real disruption (change) in the relationship between political power de jure and de facto, the mere de jure reform of the institutional "set-up" will not lead to a de facto change in the quality and functionality of the institutions. However, the belief remains that the process of accession of North Macedonia to the EU might accelerate this process.

Changes in the six basic indicators on the quality of institutions



7. PUBLIC FINANCE FOR A MORE EFFICIENT STATE

We need to increase public spending in the country, as a percentage of GDP. Although in public debates we can often hear that the budget of our country is large, this is not true at all. The total budget expenditures of our general government in recent years amounted to 30-31 percent of GDP, which is among the lowest in Europe. For comparison, in 2018, in Serbia they accounted for 41 percent of GDP, in Croatia 46 percent, in Denmark 51 percent and in France 56 percent.

An increase in expenditures should be focused on the segments that are the worst in the country, and where investments are lowest, such as social protection, education, health and environmental protection. The share of pensions and public order and safety is relatively high and should not increase significantly. The increase of expenditures should be visible especially in the area of capital expenditures, above all in the so-called green growth.

In parallel with the increase of expenditures, their efficiency must be improved, as well as the level of the realization of budgets. This is closely related to the

quality of state institutions, and therefore the need for reforms in this area must be emphasised again. Further to the reform of state institutions, there is a need for accountability of public officials who act irresponsibly with public finance, that is, who have a high degree of cost inefficiency or a low degree of realization. This can be achieved by stipulating a clause in the Ethical Code of Civil Servants, according to which officials with low expenditure efficiency or poor performances will have to resign or explain to the Government or Parliament why they have been inefficient or did not enact their budgets.

Budget revenues in North Macedonia, just like expenditures, are among the lowest in Europe, and have been continually on the decline in the past two decades. In addition, the structure of revenues is also unfavourable. Social security contributions and indirect taxes (VAT and excise taxes) which are regressive, dominate. Contributions are regressive because of the ceiling on the amount of contributions that a person can pay, which makes persons with the highest incomes pay lower contributions, relative to their income. For example, a person making 250,000 EUR a month pays contributions amounting to around 1

percent of income, while a person making 250 EUR a month pays contributions of around 28 percent of the income. The VAT is regressive because its amount is nominally (in denars) the same, both for persons with higher and lower income, but it is higher for the latter group when expressed as a percentage of their income. The remaining two important taxes, personal income tax and corporate income tax, are proportional, that is, they are flat – the rate is 10 percent, regardless of the income amount.

Such a taxation system breeds inequality, the reasons being twofold. The first is that it fails to prevent social disparities from escalating, meaning it fails to impose higher taxes on those who earn more. The second reason is that it fails to provide enough revenues for the state, which prevents it from providing higher quality social protection, which deteriorates the income of those who earn less. This is why progressive personal income tax has to be reinstated in the shortest period possible. Moreover, we need to abolish or to significantly raise the ceiling for the contributions, so that they are not regressive. Further on, progression could be introduced on all property taxes - property tax, real estate sales tax, and inheritance and gift tax. Serious thought should be given to introducing progressive corporate income tax for companies with the highest profits. One possibility is to cover companies with a profit of over 1 million EUR, which would affect about 200 companies in the country, or to encompass companies making higher than average profits as a result of some type of rent.

It is important to underline that direct taxes should remain sectorally neutral, meaning that there should be no lower tax rates introduced for certain sectors. If support to certain sectors is needed, this should be done within the framework of an industrial strategy, and not through taxes.

All these changes need to be made as part of a comprehensive state tax strategy, which will be long-term and widely supported, that is, it will refer to a period of at least 10 years and will not depend on the personal will of individuals, but will be a strategic commitment of the country, such as, for example, the commitment for EU accession. Additional elements that could be introduced are: increasing taxes on polluters, such as the excise on diesel fuel, introducing excise on coal, as well as a gradual introduction of the ETS (Emissions Trading System) system of the EU; VAT rates should not be changed, except perhaps for certain products; slowly to start abandoning the practice of offering tax exemptions to foreign investors, and to achieve this through regional cooperation for a

coordinated tax policy that would avoid the “race to the bottom” in the Western Balkan countries; to follow and quickly accept European and world practices related to some new taxes and practices, such as digital taxation, tax on non-recycled plastics, tax on financial transactions, wealth tax, etc; to audit various utility and administrative fees, as well as other similar public duties that are publicly referred to as “para-fiscal” fees, in order to assess whether some of them should be eliminated or reduced.

Considering the growth of public debt, we have to mention that North Macedonia must not enter the zone of highly indebted countries, which means that every year it would have problems with ensuring high amounts of funds for servicing this public debt. The control and reduction of the level of public debt should not be done with its rigorous absolute reduction, but with a mathematical combination of future projections of budget deficits and growth rates. What is needed is statutory creation of numerical fiscal rules and the establishment of a Fiscal Council that will cater for the implementation of rules, analysing the state of affairs and proposing solutions. The situation with the pandemic and its blow to the economy should be resolved with great care, because the enormous fiscal incentives in the form of newly created deficits may not breed the desired results but may significantly increase the level of public debt.

Further development of the infrastructure of public finance system needs to continue. It needs to be based on Public Finance System Management Program which places emphasis on improving the medium-term budget framework by linking the fiscal strategy closer to the budget, changing the budget calendar, but also introducing new tools for planning new programmes among budget users. The reform should also improve the hierarchical structure of budget users, setting up a clear structure of the ministry which formulates policies, and under which there will be agencies and inspectorates tasked with implementing them. Moreover, it is also important to set up an efficient system for the establishment and monitoring of the concessions and public private partnerships (PPP).

Fiscal transparency must be sustained. We need to ensure that all electronic platforms and tools which enable this are fully functional. A step forward might be the publication of tax returns of every citizen on the website of the Public Revenue Office on a specified day of the year (for example, October 1st), so that citizens would get a full insight and thus prevent abuses in the system, for instance owners of companies with large movable and fixed assets reporting low income.

8. MONETARY POLICY FOR PRICE STABILITY AND STABILIZING BUSINESS CYCLES

The currency area of North Macedonia is not an optimum currency zone in the sense of the requirements of the Mundell-McKinnon model. It is a small, open and a price-taker economy, with high currency substitution (share of foreign currency deposits in the total amount of deposits of 41.2 percent), with high transfers in remittances on the average of 17 percent of GDP.

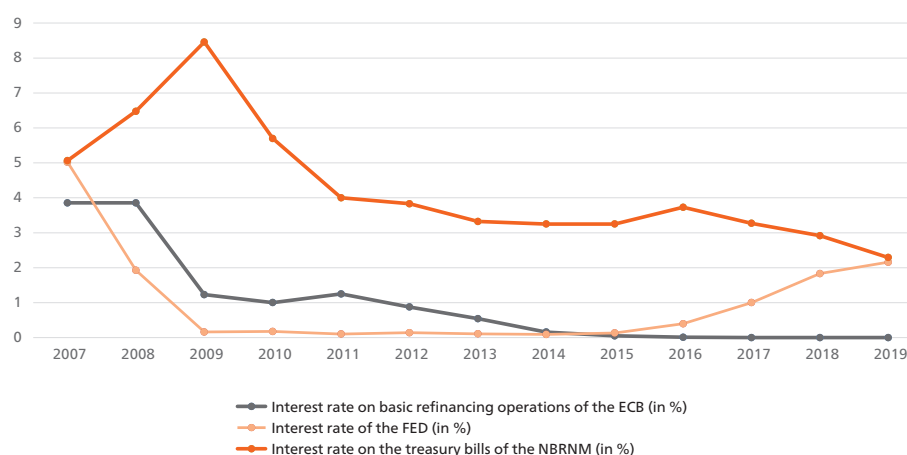
Monetary policy creators have officially announced, since the fourth quarter of 1995, that they have been pursuing a strategy of targeting the denar exchange rate against the German mark and since 2001 against the euro. Although two preconditions for targeting the foreign exchange rate were not met -- free inflows and outflows of capital from/to foreign countries, and developed capital markets -- the belief was that high foreign currency substitution and high share of remittances from abroad would help eliminate these shortcomings. This strategy was successful in tackling inflation and suppressing inflation expectations, with the exception of the 2004 – 2008 period, when economic growth was below the potential, and interest rates slowly converged towards interest rates in the euro area.

In times of crisis, when monetary policy needs to be accommodated quickly, due to the growth of currency substitution driven by uncertainty and flight to secure currencies, and the termination of foreign capital inflows, monetary policy “went against the wind”

by increasing restrictiveness, thus reinforcing the effects of the crisis. Hence, during the Great Recession 2008 – 2009, when interest rates and the monetary policy in the Eurozone, which is the anchor of monetary policy, started to relax, in North Macedonia they were tightened and interest rates increased, due to the need to protect the foreign exchange rate and the loss of foreign exchange reserves. Monetary policy was accommodating with a two-year delay, following the defreezing of international financial markets and the increase in foreign capital inflows. Yet, this strategy delivered the solid growth of loans, favourable for the private sector, averaging to 6.5 percent per year in the 2009 – 2019 period. However, the growth of corporate loans (4.7 percent, on average per year) was almost twice lower than the growth of household loans (8.6 percent on average per year).

The National Bank of the Republic of North Macedonia (NBRNM), following the great financial crisis, accepted that monetary policy should play a more substantial role in stabilising business cycles. Despite the fact that central banks have expanded their arsenal of monetary policy measures: a) quantitative easing: directly injecting funds into the credit and capital markets and influencing long-term interest rates and repurchasing securities (asset purchases); according to the targeting strategy of the foreign exchange rate of NBRNM it cannot use this instrument on a large scale, due to the fact that under this strategy, the purchased assets are foreign currency - euros, b) long-term

BASE INTEREST RATES OF EUROPEAN CENTRAL BANK (ECB), FEDERAL RESERVE OF THE USA (FED), AND THE NATIONAL BANK OF THE REPUBLIC OF NORTH MACEDONIA (NBRNM)



Source: NBRNM Bloomberg

(2-3 years) of forward guidance and thus coordinating and influencing the shaping of long-term expectations regarding the state of monetary policy, especially the movements of long-term interest rates and macroeconomic developments. Due to the use of interest rates as a primary instrument for stabilizing the exchange rate, the timeline of monetary projections of the NBRNM is limited to 12–18 months.

The Covid-19 crisis forced central banks to face new challenges: how to further accommodate the monetary policy in cases of negative interest rate in highly developed countries and to avoid the trap of excessive debts of the private sector. A new wave of unconventional monetary policy instruments was launched in order to maintain liquidity of financial markets and institutions and to increase the capacity of capital markets to absorb budget deficits. The reaction of the international financial markets after the outset of the corona crisis followed the same pattern as in the previous economic crises: increased uncertainty, increase of interest rate risk premium, escape to safe and low-risk securities, and decrease of capital movement in developing countries.

The Central Bank faced the dilemma of whether to defend the foreign exchange rate by raising the domestic denar interest rates which the investors demanded, or to try to relax monetary policy in the long run by reducing foreign exchange reserves and/or significantly increasing foreign borrowing. North Macedonia has accommodated its monetary policy through

borrowing foreign exchange assets from abroad: from international financial institutions and private financial markets. For the first time, the NBRNM had a counter-cyclical first monetary reaction in times of crisis. Thus, from the end of February 2020, the Central Bank started non-sterilized interventions on the foreign exchange market, and finally, in March 2020, it reduced its base interest rate by 25 basis points (to 1.75 percent). In the March – May 2020 period, the Central Bank intervened with around 200 million EUR in the foreign exchange market. At the end of May 2020, the monetary policy was further accommodated by reducing the NBRNM base interest rate by additional 25 basis points to 1.5 percent. Concurrently, liquidity was increased by reducing the amount of treasury bills offered at auction by 30 percent.

In order to equip the NBRNM to adjust monetary policy to neutralise economic shocks more effectively, in the future, it must have an instrument for the rapid lending of assets in the form of unconditional swap arrangement with the ECB or the IMF.

The shift of the monetary policy regime towards a currency board or towards inflation targeting, in the conditions of the Covid-19 crisis, is not recommended. The first regime would make the accommodation of monetary policy even more rigid, and the second regime might undermine confidence in monetary policy. Most probably North Macedonia will keep its foreign exchange rate targeting regime until its integration into the EU.

9. LABOUR FORCE WITH MORE SOPHISTICATED SKILLS AND KNOWLEDGE

Before the outset of the Covid-19 pandemic, the labour market in North Macedonia evidenced upward trends, which could be reflected in the growing activity rate, employment rate (both in general and for women), declining total unemployment, and also in the youth unemployment rate, as well as increased labour supply, i.e. number of vacancies.

According to the Labour Force Survey (LFS) more than half of employments in the Macedonian economy (65 percent) is concentrated in three economic activities: “Wholesale and retail trade, transport, accommodation and food services”, followed by “Agriculture, forestry and fisheries” (21.9 percent) and “Industry without construction”.

Most of the labour force is not engaged in economic activities with high added value due to the relatively lower level of education and skills it possesses. Its transformation towards a workforce with an

outstanding level of human capital must be one of the major tasks of the economic and especially of the educational policies in the medium and long term.

The lack of a high quality labour force and human capital in the future may further deteriorate due to the trends of reduced and even negative natural increase and the migratory trends that cause negative balance. Along with the constant natural process of population ageing, this could be one of the key factors that will affect the country’s labour market conditions through the long-term disruption of labour supply and demand levels by the economy. We should also not rule out the fact that North Macedonia will need additional labour forces, especially those with lower skills and qualifications for certain traditional activities, but it will also need profiles with the highest qualifications and skills in the most modern industries which are in high demand on the regional and global markets, and certainly in demand on the labour market.

LABOUR MARKET INDICATORS IN NORTH MACEDONIA

	2016	2017	2018	2019	2020/I
Activity rate	56,5	56,8	56,9	57,2	57,4
Employment rate	43,1	44,1	45,1	47,3	48,1
Unemployment rate	23,7	22,4	20,7	17,3	16,2
Activity rate for women	43,8	44,3	44,6	46,6	46,4
Employment rate for women	33,8	34,6	35,8	38,1	39,1
Unemployment rate for youth (15 - 24)	48,2	46,7	45,4	35,6	34,9
Rate of job vacancies	1,3	1,5	1,6	1,6	/

Source: State Statistical Office MAKStat Workforce Survey, 2019

Such conditions can be partially overcome by making accelerated and significant structural changes in the economy that will be supported by active state -- but also induced market -- targeting of the supply of a labour force towards an increased offer of high quality labour force with sophisticated knowledge and skills. For this radical changes are needed in the formal and non-formal education process, which will help compensate for the lack of labour force in some activities and branches (low-income and labour-intensive) with increased supply in high-income activities and branches that absorb labour which is knowledge-intensive.

The current and medium-term problems with the existence of low and medium-skilled labour forces will have to be offset by the maintenance of labour-intensive activities until the remaining existing low-skilled labour is naturally transformed and replaced by a new labour force with a higher level of human capital.

In the field of labour rights, many changes are needed in the medium term, including, among others, the adoption of a new Law on Labour Relations in order to ensure greater protection for workers. The two

biggest problems that workers are facing are working on fixed-term contracts which only prolongs their uncertainty, and overtime work which is not paid. Moreover, it is necessary to invest in the State Labour Inspectorate, both in equipment and in new employments, in order to improve its staffing and technical capacities, so that it could discharge its duties more professionally. Of course, the focus on improved efficiency of courts in the field of labour law is inevitable.

In order to improve possibilities for analysing the labour market, relevant state institutions need to upgrade national representative research and data. Other than the Labour Force Survey, we need to conduct and publish additional research based on a harmonised international methodology, as well as actuarial projections. Additionally, nationally representative assessments of the possible lack of skills and qualifications in the labour market are needed, based on projections of future movements in the national and global economy, rather than on the subjective perceptions of current employers. And certainly, conducting a population census is urgently needed, as the basic prerequisite for assessing the scope and structure of the population.

10. BETTER SOCIAL PROTECTION FOR A BETTER SOCIETY

The reforms of the social protection and social insurance systems in North Macedonia were typical for the beginning of 2000 (introduction of the capital-funded pension and disability insurance, changes to the length of insurance in case of unemployment, etc.); in the last few years, as the amendments to the system of social and child protection new rights were introduced, the scope was expanded and reference scales were equalised between different rights, thus improving equality of treatment among beneficiaries. However, the need for further changes is inevitable. In the medium term, social protection and social insurance systems in North Macedonia need to undergo transformation, in order to: cover new social risks, include non-standard forms of employment in social insurance schemes, increase funding and diversify funding sources, expand universality of social rights, as well as to digitalise social protection and social insurance.

The scope of social risks should be expanded, by introducing long-term care. The reason for this need is the continuous growth of the population aged over 65, which increased by 22.3 percent in the 2010 – 2019 period, as well as from the emphatic need for long-term protection of this age category which almost tripled in the 2010 – 2018 period. Moreover, unemployment insurance should also be expanded, so that it should become available to all unemployed persons for whom contribution was paid, regardless of the reasons for job termination.

It is important to include all non-standard forms of employment in the social insurance schemes because they are increasingly present on the labour market. Data on non-standard forms of employment in North Macedonia in 2019 indicate that the percentage of self-employed persons was 16.2 percent; 13.2 percent were employed on temporary employment contracts and 4.0 percent were employed on part-time arrangements. Self-employment displays a bigger growth than the conventional full-time employment, whereby the share of agricultural self-employed workers is highest. According to Labour Force Survey analysis, self-employment is most often not a matter of choice, but of lack of available well-paid jobs. It is more a matter of economic survival which can be concluded from the fact that most self-employed people live with income below the average wage amount. Therefore, it is necessary to open the system of social protection and social insurance to all forms of employment, considering the hybrid nature of working statuses. In that

regard, in addition to effective monitoring and inspection over the implementation of provisions on formal access for non-standard employees, it is necessary to adjust the access criteria, the amount and length of contributions according to the specifics related to the length of working hours and job characteristics (occasional, seasonal work, etc.).

With regard to spending on social protection, despite the public perception that the country spends a lot on social protection, North Macedonia is classified in the group of Central and Eastern European countries with low consumption. Social protection expenditure in North Macedonia amounted to 14.3 percent of GDP, and is lower than in Croatia (21.2 percent), Serbia (19.1 percent), Bosnia and Herzegovina (17.8 percent) and Montenegro (16.8 percent). Pensions have the largest share in social protection expenditures, whereas housing, unemployment and social exclusion expenditures have the smallest share. However, reaching the EU average amount for social protection expenditure (26.9 percent) is unrealistic, but allocating between 18 and 20 percent of the GDP on social expenditures in the medium term should be a priority target. Likewise, there is a need for improved diversification of social security funding sources. Dominant sources are contributions (8.5 percent of GDP) and tax revenues (6.7 percent of GDP), while other sources (co-financing, participation, private insurance, etc.) are negligible (0.3 percent of GDP) and do not represent a significant factor in the total revenues for social protection. With a view to improving the ratio of contributions versus tax revenues, and in order to reduce the latter, it is necessary to avoid public measures and policies that promote exemptions from the payment of contributions, as a way of improving labour competitiveness or as an active employment policy measure.

The wider impacts of Covid-19 have highlighted the need for transformative and accountable social and child protection systems. The initial step towards expanding universality can be taken by making access to child allowance universal, but it is of utmost importance not to establish an arbitrary threshold.

The digitalisation of social insurance offers many advantages, such as the easier incorporation of non-standard forms of employment, increasing transparency, but also lowering the risks from an ethical point of view or from the aspect of dehumanizing the activity.

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THE BIG PICTURE: THE MACEDONIAN ECONOMY IN THE MEDIUM AND LONG TERM



The selection of export expansion as a long-term development strategy means that the economy of the state should not remain (just) a “small open economy”, rather that it should gradually develop into an internationally integrated economy. This is not the same at all. It means that there should be an increase in export and goods, but also of services with a larger component of domestic added value.



The future model of economic development of North Macedonia should have a sectoral approach in terms of the attracting of FDI, and domestic companies should not be left out. They need to join both the regional and global value chains. The regional (joint) market is a vast potential for domestic companies where they demonstrate higher competitiveness compared to the European level. Herein lie the opportunities created by the disrupted global economic flows caused by the pandemic which will make this region all the more interesting for FDI from the EU and will enable better linking of the domestic companies to the mentioned value chains.



It takes investments in order to promote further the qualifications of the existing labour force, and to ensure the growth of innovations. In this way Macedonian companies would be the first followers of the technological leaders, which will help them to integrate more easily into the regional and international value chains of the big companies.