THE MACEDONIAN ECONOMY AND THE EUROPEAN UNION

Igor Velickovski¹, Marjan Petreski², Branimir Jovanovic³

1. INTRODUCTION

The Republic of Macedonia is located in the central Balkan Peninsula in Southeast Europe. It is one of the successor states of the former Yugoslavia, from which it declared independence on the September 8, 1991. It became a member of the United Nations in 1993 under the provisional description of "the former Yugoslav Republic of Macedonia". It is a landlocked country, bordering Greece in the south, Albania in the west, Bulgaria in the east and Kosovo and Serbia in the north. The country's capital is Skopje. On 25,713 sq. km, a bit more than 2 million inhabitants live, according to the State Statistical Office.

However, as Macedonia lately faces fairly large emigration rates and in an absence of official census since 2002, it is believed that the total population is below that figure.

The country is organized as a parliamentary republic. It is a multi-ethnic country, with approximately 25 percent of the people with Albanian ethnic background, 4 percent with Turkish, 3 percent with Roma and 2 percent with Serbian. Macedonia was the only Yugoslav republic that was not involved in the wars after the breakup of Yugoslavia. However, there was an inter-ethnic internal conflict in 2001, which lasted for several months.

This chapter describes the structure and performance of the Macedonian economy and puts them in the context of the Macedonian accession to the EU. The chapter is organized in five sections. Section 2, which follows this introduction, presents information about the structure and performance of the Macedonian economy, since the introduction of the market economy. Section 3 gives an account of the process relating to Macedonia’s bid for EU membership. Section 4 discusses, through figures, the economic dependence of Macedonia on the EU. Section 5 assesses Macedonia’s prospects of forming part of the euro area. The last section concludes the chapter with some comments on future prospects.

2. THE MACEDONIAN ECONOMY

2.1. Developments and challenges in early transition

Macedonia was severely hit by the breakup of Yugoslavia. The fall in the GDP after the break up was more persistent than in other republics, despite the fact that it did not experience a war. Moreover, the recession following the transformation, was very prolonged

¹National Bank of the Republic of Macedonia; School of Business Economics and Management, University American College Skopje, velickovski@uacs.edu.mk.
²School of Business Economics and Management, University American College Skopje, marjan.petreski@uacs.edu.mk; corresponding author.
³University of Turin, branimir.jovanovic@uniroma2.it.
in Macedonia. The first year in which GDP started growing was 1996, whereas in Slovenia it started growing in 1993, in Croatia, Bosnia and Herzegovina and Serbia in 1994, and in Montenegro in 1995. Also, the loss in production in the early transition years was the highest in the region (excluding Bosnia and Herzegovina, Croatia, Serbia and Montenegro, which were involved in wars). Real GDP in 1996 was 14% lower than in 1990, which is a much bigger fall than in Slovenia, Albania, Romania and Bulgaria (Figure 1).

Figure 1 – Real GDP in 1996 compared to GDP in 1990 (in percent)

Several factors may help explaining the dismal performance of the economy in the early transition years. First, the Macedonian economy was heavily dependent on Yugoslavia for the placement of its products. The organization of production in Yugoslavia was such that Macedonia, as less developed and more agriculture-oriented republic, was mainly engaged in the production of intermediary goods, which were then used for producing final goods in the more developed republics, such as Slovenia. As a result, with the breakup of Yugoslavia and the subsequent wars, Macedonian firms lost their traditional markets. Second, Macedonia had a rather rapid privatization. Of all the countries from the region, only Croatia had a similar pace of privatization (Figure 2). This led to a collapse in production, employment and aggregate demand, which consequently depressed the economy (Daskalov et al. 2003). Indeed, of all the countries from the region, Macedonia had the highest increase in unemployment in the early transition (Figure 3). Finally, the country faced a trade embargo from Greece in 1994, which lasted for 19 months, and in addition severely felt the consequences of the UN embargo onto FR Yugoslavia.

Figure 2 – Large scale privatization index in 1996 (higher values = faster privatization)

Figure 3 – Change in unemployment between 1991 and 1996 (percentage points)
The early transition years were also marked by very high inflation. End-of-year retail price inflation (the official measure of inflation in that period) exceeded 200 percent every year until 1994 (Petrevski, 2005).

The high inflation rate during this period was fed by the persistent devaluation/depreciation of the currency. Although the country followed a policy of fixed exchange rate, as from the monetary independence in April 1992 until May 1993, the currency was devalued several times during this period. Then, in May 1993, the country moved to a policy of a floating exchange rate, which made the currency depreciate severely for several months. After the currency stabilized in 1994 and 1995, it was pegged to the German mark in October 1995, which resulted in low inflation in the subsequent years (Figure 4). It has remained fixed to the mark/euro ever since, with only one devaluation, in July 1997, by 16% (Figure 5).

2.2. Developments and challenges after 1996

Despite the achievement of macroeconomic stability by 1996, the economy continued to underperform in the following years. Average annual GDP growth for the period 1996-2014 was only 2.2 percent, which was the lowest in the region (Figure 6). This low growth rate was partially due to the internal inter-ethnic conflict in 2001. Growth, during this period, never exceeded 6 percent per annum, and exceeded 5 percent only in 2007 and 2008 (Figure 7).
In addition to being low, growth has also been very unequally distributed. Income distribution became increasingly uneven after independence and is currently by far the most uneven in the region (Figure 8). The inequality of income increased significantly in the early transition, and stabilized itself afterwards, until 1999. Then, it started rising again, especially after 2005 (Figure 9).

Unemployment has remained high during the period under consideration. It has fallen slightly in recent years, to 29 percent in 2013 (Figure 10), though this may be attributed to the shift from informal to formal employment (Jovanovic, 2015). The average rate of unemployment for the period 1991-2013 was 33%, which is much higher than in the other countries in the region (Figure 11).
The poor economic performances initiated a wave of emigration from the country. Approximately 220,000 people have left the country between 1990 and 2010, which is 11% of the current population (Petreski and Petreski, 2015). From the region, only Albania and Bosnia and Herzegovina have had higher emigration in the same period (Figure 12). Albania has one of the highest rates of emigration in the world, while Bosnia and Herzegovina had a severe war, which produced a wave of refugees.

Several observations may be helpful for gaining better insights in the causes of the poor economic performances of the Macedonian economy (Daskalov et al. 2003). To begin with, as a small economy with limited natural resources, Macedonia is very dependent on the external sector. The external sector itself has underperformed heavily since the independence. Exports, as a share of GDP, have increased during the course of time, but their increase has been more than offset by the increase in the imports. The overall result, hence, has been that the trade deficit widened (Figure 13), by far the highest widening in the region (Figure 14).
Furthermore, the country proved relatively unattractive for foreign direct investment, which may be due to its small size (see Jovanovic and Jovanovic, 2015). The average level of FDI in the 1995-2014 period was 3.8% of GDP, which is one of the lowest in the region (Figure 15).

On the positive side, the country receives sizeable amount of remittances every year, averaging 3.2% of GDP between 1996 and 2014, slightly lower than the FDI (which include several major privatizations, like those of the telecommunication and electricity companies). Furthermore, there has been an upward trend in remittances in recent years (Figure 16). Still, remittances are used mostly for consumption, and very little for investment. This may be attributed to the high poverty rate in the country (see Petreski and Jovanovic, 2014).

There has been no stimulus coming from the public sector, the size of which has remained modest, one of the smallest in the region (Figure 17). In addition to being small, it has also been rather ineffective, similar to that of Albania, Serbia and Romania, and better only than Bosnia and Herzegovina (Figure 18).

Source: World Economic Outlook Database, International Monetary Fund

Source: Worldwide Governance Indicators, World Bank
The need for greater involvement of the public sector in the economy becomes clear when one takes a look at the infrastructure. Macedonia has one of the poorest infrastructures in the region (Figure 19), better only than Romania, Albania and Bosnia and Herzegovina.

Macedonia has invested very little in infrastructure and the improvement in infrastructure is one of the lowest in the region (Figure 20), similar only to the improvements in Croatia and Slovenia, which have much smaller need for improvement, given the higher quality of their infrastructure.

Figure 19 – Quality of overall infrastructure in the region, 2006-2014 (index, higher value=better infrastructure)

Figure 20– Improvement in the infrastructure in the region during 2006-2014 (index, higher value=better infrastructure)

Source: Global Competitiveness Report, World Economic Forum

3. MACEDONIA AND THE EU

3.1. The Stabilization and Association Process

Macedonia approached the European Union in 2000, after 9 years of its independence from Yugoslavia, and after a decade of political and economic turmoil. The first step towards joining the EU was the initiation of the Stabilization and Association Process, the result of which was the Stabilization and Association Agreement (SAA) signed on the 9th of April 2001 in Luxembourg, which entered into force on the 1st of April 2004. The parts regulating trade and trade-related issues, entered into force earlier on 1 June 2001, through a special Interim Agreement between the Republic of Macedonia and the European Community.

The objective of EU’s SAA was to establish bilateral contractual relationships between the European Commission and the countries of the Western Balkans, Macedonia being the first country to sign the Agreement. It provided a forum for political dialogue, strengthened regional cooperation and promoted economic relations. In particular, the SAA stipulated provisions concerning the free movement of goods, services, labour and capital. Hence, a free trade area (FTA) has been created between the EU and Macedonia, with a maximum transition phase of ten years.4

4Further details on SAA can be found in Daskalov et al. (2003).
3.2. **Recommendation to open negotiations for admission to the EU**

Having established the grounds for political dialogue and economic cooperation, the SAA also paved the way for submitting the application to join the European Union. This step was taken on 22 March 2004, in Dublin, Ireland. Later the same year, the government adopted the National Strategy for European Integration and commenced the procedure for answering the questionnaire of the European Commission relating to many aspects for country’s preparedness for accession and the compliance with the Copenhagen criteria. On 17 December 2005, after the successful completion of the questionnaire, the European Council officially granted the country a candidate status.

3.3. **Blockage of the accession process**

Since the official granting of a candidacy status in 2005, the European Council has been reiterating this decision each year until the present time, but the opening up of the negotiations was not possible because of country’s dispute with Greece about the name “Macedonia”. The official name of Macedonia is “the Former Yugoslav Republic of Macedonia” and it is the name used in the entire multilateral communication, including the one with the European Union. It is still considered to be only a “provisional reference” introduced by the United Nations in 1993.

The “name dispute” is a disagreement between Macedonia and Greece on who can rightfully use the name “Macedonia”. The Greek government argues that the use of the name “Republic of Macedonia” by Macedonia presents a direct expression of territorial intentions toward Greece, the northern region of which is also called Macedonia. The dispute commenced after the Republic of Macedonia’s independence from Yugoslavia in 1991 and continues to exist until the present day. Efforts to resolve the issue have been constantly under way under the auspices of the United Nations, but the opposing positions have not been reconciled. Hence, Greece vetoed the Republic of Macedonia’s membership in NATO in 2008 and continues to state that it will block its accession to the EU and the opening up of negotiations. Since 2008, the EU officially added the resolution of the name issue to the list of preconditions for accession. The European Commission recommended the opening up of negotiations between the EU and Macedonia in 2009, but, as anticipated, Greece vetoed this process in the European Council and has done so on six occasions.

Greece was not alone in hampering the opening up of negotiations between the EU and Macedonia. Some bilateral issues with Bulgaria on the shared part of the country history in the 19th and 20th centuries also emerged as an obstacle on the way to the EU accession. As an EU member, Bulgaria utilized its power to veto the commencement of negotiations between the EU and Macedonia in 2012.

3.4. **Advantages and disadvantages of joining the EU**

Despite the fact that the Macedonian dream for the EU membership has been fading out in recent years – due to various reasons including the non-resolution of the name issue and the European economic crisis – the advantages and disadvantages of joining the EU have been occasionally debated in Macedonian society.

On political grounds, undoubtedly, it is argued that EU membership would bring about a higher degree of stability and stronger governance. Macedonia is situated in a geographical area characterized by conflicts in the past: the 1992-1995 War in Bosnia, the 1999 Kosovo War and the subsequent refugee crisis, as well as the 2001 Internal Macedonian conflict. The
latter stemmed from ethnic Albanian claims for having larger constitutional rights, as they represent around a quarter of the entire population. This evolved into internal conflict in 2001 which was resolved by the Ohrid Framework Agreement of August 2001, largely accepting the claims and introducing ethnic Albanians as a constitutional nation in the country. The inter-ethnic tensions have now subsided, but fragilities remain, including that there are political instabilities originating from Macedonia’s relationships with the other neighbours.

The possible membership in the EU (as well as in NATO) would bring about a positive environment for settling the inter-ethnic conflicts, as could, as well, improve the relationships with Macedonia’s neighbours. In addition, EU membership could be a form of guarantee for the institutional quality and the governance, which should then translate into a better place to live for citizens, accompanied by better living standards.

On social grounds, it appears from public debate that there is a general belief that EU membership would usher in many social advantages. However, specific social attitudes, prevalent in many EU countries, are likely to find opposition in Macedonia, if the country were to join the EU, due to ideas rooted in the Macedonian mentality, often fed by government’s position on certain matters, including abortion, the rights related to the sexual orientation and other liberal attitudes.

From the economic perspective, EU membership could open up a vast export market for Macedonia. Despite the fact that the major part of tariffs and quotas have already been dismantled (not only due to SAA, but also due to Macedonia’s membership in the WTO) it is expected that the economy may further benefit from the complete opening up of the EU market, i.e. of the complete merging with the European Common Market. A support in this process may be lent by the nominal convergence the economy achieved due to the pegged denar (see Section 5.1), as well by the high trade and financial integration with the EU which might strengthen the business cycle synchronization (see Section 5.3).

Furthermore, the utilization of EU structural funds may bring faster restructuring of the economy and support regional development, hence increasing productivity and competitiveness. Moreover, EU membership may improve the functioning of the institutions through better public governance and lower corruption, although this remains questionable, given the experiences of some new member states (e.g. Bulgaria and Romania), that did not manage to make significant progress in the fight of corruption after they joined the EU.

Finally, if EU membership is assumed to bring larger political stability in the country, hence reducing country risk, then EU membership would bring higher credit rating for the economy, lower interest rates imposed on the foreign debt, downward pressure onto domestic interest rates, as well larger inflow of FDIs, which all together would benefit for the growth, investment, export and public finance.

Disadvantages may be a few, though. First, if EU membership, supported by the usage of structural funds, pushes the economy more than FDI and government investment, then under a pegged exchange rate, prices may be pushed up, which if not cooled by exchange rate appreciation, or blocked by preventing wage growth, may actually lead to a deterioration of economic conditions and threaten macroeconomic stability. Second, the prospective full liberalization of the capital account could pose potential problems for the sustainability of the fixed exchange rate regime also. Third, complete EU integration may further stir emigration from the country, possibly leading to a brain drain. Fourth, the EU Common Agriculture
Policy (CAP) may prevent the government from distributing subsidies for agricultural production, a system which became quite popular during the last decade.

Overall, there are both advantages and disadvantages of Macedonia’s prospect EU integration, but public debate would seem to assign more weight to the former.

4. DEPENDENCE OF THE MACEDONIAN ECONOMY ON THE EU

4.1. Trade, remittances and financial dependence

As discussed in Section 1, Macedonia is small, landlocked and open economy. As such, it is heavily dependent on the European Union in economic terms. Table 1 presents the trade shares (export plus import) of Macedonia with the EU and the Western Balkans countries. It is evident that the share has grown over the decades: first, because over time Macedonia became more and more dependent on the EU in trade terms, substituting for the traditional lost eastern markets after gaining independence from Yugoslavia; second because the EU has been enlarging itself (mainly with the large wave of enlargement in 2004). Presently, the trade share with the EU amounts to about two thirds of the whole trade volume. Interestingly, an additional 12% to 25% of total trade is conducted with the other countries of the Western Balkan, which now form CEFTA-2006. Given that these countries are themselves very much dependent on the trade with the EU, it appears that in trade terms Macedonia is almost entirely dependent on the EU. Germany tops the list, with a growing share approximating a fourth of total trade volume, and followed by Great Britain, Italy, Greece and Bulgaria (Petreski, 2013a).

Table 1 – Trade shares of Macedonia with the EU and the Western Balkans

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<th></th>
<th>1994</th>
<th>2004</th>
<th>2014</th>
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<tbody>
<tr>
<td><strong>European Union</strong></td>
<td>36.2%</td>
<td>67.9%</td>
<td>68.8%</td>
</tr>
<tr>
<td><strong>out of which: Germany</strong></td>
<td>15.6%</td>
<td>20.1%</td>
<td>23.3%</td>
</tr>
<tr>
<td><strong>Western Balkans</strong></td>
<td>18.1%</td>
<td>25.0%</td>
<td>11.8%</td>
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</table>

Source: State Statistical Office of Macedonia

Macedonia heavily depends on the EU in financial matters also. The banking system is composed of 15 banks, of which 11 are dominantly owned by foreign banks. These hold about 75% of banking assets, of which more than 80% originate from the EU. The largest bank is, though, domestically owned. The second-largest bank is Greek owned, while the third-largest is Slovenian-owned. France, Bulgaria, Austria and Germany hold the ownership of the remaining part of the banking system (NBRM, 2015). Similarly, the insurance system, albeit being considerably smaller than the banking system, is dominated by foreigners as 14 out of 15 insurance companies are foreign-owned, of which 11 are owned by insurance groups residing in the EU (ISAM, 2014).

Also, a major part of the total FDIs flowing into the economy originate from the EU. As Table 2 suggests, the share of EU-based FDIs in Macedonia has been increasing over time (even if the enlargement in 2004 is controlled for), suggesting that the dependence of Macedonia on the EU in financial terms has been also strengthening.
Table 2 – FDI shares of Macedonia with the EU

<table>
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<th>1997</th>
<th>2004</th>
<th>2014</th>
</tr>
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<tbody>
<tr>
<td>European Union</td>
<td>39.0%</td>
<td>77.1%</td>
<td>84.3%</td>
</tr>
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</table>

Source: National Bank of the Republic of Macedonia

Last but not the least, Macedonia has a large diaspora and hence is a recipient of a large amount of remittances. Petreski and Jovanovic, eds. (2013) estimate that the pure cash transfers entering the economy each year range between 4 and 10% of GDP, outweighing the size of FDIs (which is less than 4% of GDP) and totalling between USD 400 million and USD 1 billion. Out of these, it has been estimated that about half originate from the EU, as the largest part of Macedonian diaspora is based in Germany, Italy, Sweden and other EU Member States. However, the dependence on the EU here is not dominant as with the trade and financial flows, since large contingents of Macedonians also live in the US, Canada, Australia, Switzerland, and more recently in Iraq and Afghanistan.

4.2. European Sovereign Debt Crisis

Given the large trade and financial exposure of the Macedonian economy towards the economy of the European Union, the business cycles between the two has synchronized to an extent over time (as discussed in Section 5.3), leading to almost immediate transmission of any shocks hitting the European Union (and more precisely, the economy of the Eurozone) onto the Macedonian economy. The Great Recession of 2007 was first felt in Macedonia in the last quarter of 2008, being mainly transmitted through the halting of export and overall reduction of trade. The foreign demand, especially the one stemming from the EU dwindled and remained depressed over the subsequent European Sovereign Debt Crisis (since 2010).

Contrary to trade, the Macedonian banks remained quite unaffected by the Global Financial Crisis/European sovereign debt crisis due to the predominance of traditional banking activities, the conservative lending policies and the high capital ratios. However, the period of the Great Recession and the European sovereign debt crisis coincided with increased government spending and intense government campaign to attract FDIs under favourable conditions in the so called technological-industrial development zones. These efforts have to an extent compensated for the lost foreign demand, preventing large output drops that might have been caused by the crisis. However, in the wake of the crisis, institutional investors, mainly within the region and mostly Slovenian, immediately withdrew.

4.3. The Greek crisis and the Macedonian economy

The European sovereign crisis was of major concern for Macedonia, not that much because of the impact on trade and financial flows in general, but rather because of Macedonia’s neighbourhood and economic relationships with the most severely hit economy – Greece. Despite the name dispute that Macedonia has with Greece, economic cooperation with Greece since the economic embargo of 1994 has been expanding. The trade volume with Greece ranks it third or fourth place of Macedonia’s trade partners. Despite the decline in Greek FDI into Macedonia in recent years, Greece still remains important investor in the economy. The second-largest bank, the oil refinery, large concrete factory and other important companies in Macedonia are Greek-owned.

However, trade with Greece has been severely hit (Table 3), first shortly after the Great Recession, and second, after 2012 till the present, when Greece encountered major liquidity problems and a potential exit from the common currency.
Table 3 – Trade volume with Greece (% of total trade)

<table>
<thead>
<tr>
<th>Year</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
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<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
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<tbody>
<tr>
<td></td>
<td>11.6%</td>
<td>10.8%</td>
<td>9.7%</td>
<td>9.6%</td>
<td>9.4%</td>
<td>7.9%</td>
<td>6.8%</td>
<td>9.4%</td>
<td>8.4%</td>
<td>7.3%</td>
</tr>
</tbody>
</table>

Still, while many believe that the riskier channel for contagion of the Greek crisis is the banking sector, this is precluded through Greek-owned banks being regulated by the domestic jurisdiction, which prevents a direct withdrawal of the company’s capital except through open sale. Still, to further shield the economy, the National bank of Macedonia disallowed other transactions to be conducted until the crisis is resolved and the Greek economy stabilized.

Overall, the exposure of the Macedonian economy toward the economy of the European Union, and in particular towards that of the Eurozone, remains high judging by the trade and financial linkages. As a result, shocks hitting the European economy directly are swiftly transmitted onto the domestic economy, primarily through reduction of trade and capital inflows. However, direct withdrawal of the capital base out of the economy is not possible, acting as a shield to the current turmoil going on in the Eurozone.

5. MACEDONIA AND THE EURO

5.1. Nominal and real convergence criteria

Reaching the high degree of sustainable nominal convergence defined in the Maastricht Treaty is a necessary condition for joining the euro area. Assessment of the nominal convergence is conducted on the basis of fulfilment of the four main Maastricht criteria: (i) price stability; (ii) long-term interest rate convergence; (iii) exchange rate stability; and (iv) public finance sustainability.

Starting from around two thousand percent annual inflation in 1992, when the Republic of Macedonia proclaimed its independence, the inflation rate was successfully reduced to the one-digit level within a few years. Since 1996, when price stability was achieved, the inflation rate has averaged 2.4%, reaching its highest value of 8.3% in 2008 due to the one-off transmission effect of the rise of food and energy prices worldwide. Inflation rate has been fluctuating closely around the reference value of inflation calculated according to the requirement of the Maastricht Treaty since the inception of the euro (Figure 21). The recorded low inflation has been achieved by the maintenance of a stable exchange rate in an environment of relatively low credibility of monetary policy at the initial stage of transition, high level of openness and a euroized economy. However, on the basis of historical data, it cannot be fully concluded that the fulfilment of the price stability criterion will not be a challenge in the future. Indeed, the expected speed-up of the real convergence of Macedonia toward the EU is expected to set in motion the Balassa-Samuelson effect which may drive inflation rate to a higher level exceeding the Maastricht reference value.
Inflation convergence is expected to enhance the interest rate convergence, since inflation expectations are a component of nominal interest rates. Thus, relatively low inflation rate contributed to maintaining lower yields of the Macedonian government securities since the inception of 5-year bonds in Macedonia in 2011 in comparison with the reference interest rate calculated according to the Maastricht criterion (Figure 22). Although the maturity of the government securities in Macedonia is shorter and thus not completely appropriate for comparison with the reference interest rate (10-year maturity), it may still be indicative for the future movement of interest rates. In 2014, the government issued for the first time a 10-year bond yielding 4.65% which is below the reference interest rate as well.

Regarding the criterion of exchange rate stability, the National Bank of the Republic of Macedonia has been maintaining a stable exchange rate since 1995 by pegging the denar to euro (Figure 23). Having the exchange rate maintained within the narrow band of less than 2% since the inception of the euro, suggests that Macedonia is not expected to face substantial difficulties in fulfilling the criterion of exchange rate stability. However, there are potential challenges for achieving this criterion in the future as discussed in the section 5.2.

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5 The price stability criterion requires the average rate of inflation observed over a period of one year before the examination not to exceed the average rate of inflation of, at most, the three best performers by more than one and half percentage points.

6 The criterion for convergence of long-term interest rates requires that the level of the average nominal long-term interest rate on government bonds of the euro area candidate country over the 12 months before the examination does not exceed by more than two percentage points that of the unweighted arithmetic average of the three best-performing member countries in terms of price stability.
In assessing the sustainability of the public finance, attention is paid to the ratio of government deficit to GDP and the ratio of public debt to GDP, which should not exceed the Maastricht reference values of 3% and 60%, respectively. As for the fiscal deficit criterion, the government of Macedonia achieved a ratio of below 3% of GDP most of the time since 1999 (Figure 24). The first exception occurred in 2001 and 2002 as a result of rising budgetary expenses associated with the inter-ethnic conflict. Nevertheless, the budgetary position was consolidated in the following years and maintained close to a balanced budget until the beginning of the global crisis. However, since 2012, the budget deficit has constantly exceeded the ceiling of 3%. Furthermore, the April 2015 edition of the World Economic Outlook predicts that the deficit will persistently remain above 3% until 2020. The low budget deficit before the crisis contributed to the reduction of the public debt-to-GDP ratio, which registered the lowest value of 23% in 2008 (Figure 25). Then, a sharp reversal happened during the crisis resulting in doubling the level of the public debt-to-GDP ratio to 46% in 2014. Although the indicator was below the reference value of 60% during the analysed period, its sharp increase in the aftermath of the crisis may compromise the fulfilment of this criterion in the future.

Despite the relatively satisfactory status on the nominal side, some indicators of real convergence reveal a different picture. Macedonian GDP per capita based on purchasing power standard was only 36% of the EU27 average in 2011 (Figure 26). Although a degree of real convergence has been under way during the recent decade, its pace is quite slow and much remains to be done to achieve full real convergence in the long run. In addition, the comparative price level indicator reveals a similar conclusion since the Macedonian price
level in terms of final consumption expenditure is around 40% of the average price level in the EU28 (Figure 27).

Figure 26. GDP as a percentage of EU27 total (based on PPS per inhabitant)  
Figure 27. Price level index (EU28=100) in terms of final consumption expenditure

Source: Eurostat

5.2. Fixed exchange rate of the denar

After acquiring monetary independence in April 1992, the National Bank of the Republic of Macedonia chose a managed float supported by monetary targeting which proved successful in curbing hyperinflation. However, this monetary policy strategy was not completely successful in anchoring inflation expectations given the high level of trade openness and euroisation, which led consequently to higher exchange rate pass-through (Velickovski and Pugh, 2011). Therefore, in October 1995, the monetary policy switched to a de facto pegged exchange rate regime, pegging the Macedonian denar initially to the Deutsche Mark and, since 2001, to the euro. Anchoring inflation expectations by pegging the exchange rate appears to have been a key factor in stabilizing and maintaining low inflation. Since 1995, only one devaluation has taken place, in July 1997. The 16.1 percent devaluation still maintained low and stable inflation rate, which consequently supported the exchange rate stability in the following period. Since 1999 when the euro currency was launched, the exchange rate has fluctuated on a daily basis as well as over longer periods largely within ±1%, which is narrower than the ERM II fluctuation margins around central rates.

Figure 28. Real effective exchange rate (CPI-based; 2007M12=100)

Source: Bruegel

Stable nominal exchange rate accompanied by low and relatively stable inflation rates contributed to remarkable stability of the real effective exchange rate (Figure 28). At the same time, the equilibrium real effective exchange rate was estimated as broadly in line with the fundamentals (Gutierrez, 2006). On the other hand, Jovanovic (2007) suggests that the
fundamental equilibrium exchange rate of the denar exhibits a tendency to appreciate over time which is driven by the rise in the net current transfers. Yet, strong evidence for misalignment of the denar has not been provided by other studies (Petrevski, 2007; Êgert et al. 2008).

The empirical evidence supports the existing exchange rate regime given that pegs and intermediate regimes significantly outperform floats in terms of economic growth in transition countries, including Macedonia, according to Petreski (2014b)7.

However, some specifics of the Macedonian economy create uncertainty about the continued sustainability of the exchange rate. The most apparent is the high trade deficit as a percentage of GDP, which has been around 20% for a long period, as explained above, exposing the economy to external shock vulnerability. Although, the current account deficit as a percentage of GDP fluctuated around a sustainable level most of the time (Unevska and Jovanovic, 2011), the trade deficit is largely covered by private transfers, which are not a stable source of finance, thereby putting pressure on the foreign exchange reserves and jeopardizing exchange rate stability. Moreover, the high level of euroization of the banking balance sheets influenced by the volatile sentiment of their depositors – households – brings significant risks reflected in foreign exchange market pressures. The success in attracting foreign direct investments, which were low in the past albeit improving slightly during the last few years, will be crucial for facilitating the task of the National Bank of the Republic of Macedonia of maintaining a stable exchange rate in the future.

5.3. Advantages and disadvantages of adoption of the Euro

Due to the blockage of the Macedonian integration in the EU, as explained above, a vivid debate about the costs and benefits the country may face from potential monetary integration has not started yet. Nevertheless, having a de-facto pegged exchange rate to the euro inspires a discussion on whether the advantages outweigh the disadvantages of joining the euro area. On microeconomic ground, the Macedonian highly-open economy is expected to benefit from the elimination of transaction costs arising from foreign exchange transactions. One type of transaction costs is financial costs, which are related to the fees in the form of the bid-ask spreads for conversion of domestic into foreign currency. Moreover, elimination of transaction costs in combination with disappearance of the exchange rate risk can reduce uncertainty of importers’ and exporters’ future profit, leading to greater trade activity. However, the additional trade-enhancing effects of the euro may not be substantial given the already achieved high level of trade integration which was influenced to some extent by the fixed exchange rate.

The microeconomic gains would obviously translate into macroeconomic effects affecting economic growth via various channels such as trade intensity, trade and production structures as well as lower interest rates and encouraged foreign direct investments due to eliminated exchange rate risk and likely credit risk. Although the trade and financial linkages with the EU increased over time as discussed in Section 4, yet trade and production structures are far from converged to the euro area. Thus, the Krugman index of specialization supports

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7 There are, however, in both the empirical papers and the public debate, advocates of the introduction of inflation targeting, which may bring some benefits over tight exchange rate pegging, especially if the Balassa-Samuelson process gains intensity in Macedonia in the future (e.g. Petreski, 2013b; 2014b).
convergence of the production structure of Macedonia towards that of the EU in terms of both value added and employment, but substantial differences are still evident (Figure 29).

On the other hand, trade with the EU is dominantly one-way (inter-industry) while the two-way (intra-industry) trade does not register a convergence trend, which fluctuated around 20% during the analysed period (Figure 30). The largest part of the two-way trade is of vertical type whereas the horizontal intra-industry trade which is more relevant for the business cycle/shock synchronization is small.

Figure 29. Krugman index of specialization of the production structure with the EU28

Figure 30. Indices of the structure of trade with the EU28

All these factors affect the business cycle synchronization of Macedonia with the euro area. The economic developments in the euro-zone have significant and relatively strong output and inflation effects on the Macedonian economy (Petrevski et al. 2015), which supports to some extent the business-cycle synchronization with the euro area as estimated by Petrovska (2012). Yet, only a small portion of domestic output variation can be explained by the euro area demand (Andonova and Petkovska, 2011), inducing low synchronization between shocks hitting the Macedonian economy and the euro area on both the supply and the demand side, as estimated by Velickovski (2010) and Velickovski and Stojkov (2014). This indicates there will be potentially high costs of losing independent monetary policy for Macedonia.

Although the need for an independent monetary policy at this stage is accentuated by the finding of a very low synchronization of supply and demand shocks between Macedonia and the euro area, the ability to conduct an independent monetary policy is also relevant when assessing the disadvantages of adopting a single currency. Empirical research in this area suggests that the effectiveness of domestic monetary policy measured via the interest rate channel is quite limited (Bogoev and Petrevski, 2012; Velickovski, 2013). In addition, the exchange rate channel has also been constrained due to the de facto pegged exchange rate regime which restrains monetary policy, in particular, in times of crisis (Jovanovic and Petreski, 2014). Nevertheless, despite the fixed currency, monetary policy conduct

8The index takes value zero if a country has an industrial structure identical to the reference group of countries, indicating that country is not specialized, and takes a maximum value of 2 if it has no sectors in common with the reference group, reflecting strong sectoral specialization. The indicators are constructed using annual national accounts data compiled in accordance with the European System of Accounts 2010 (ESA 2010) based on the Statistical classification of economic activities in the European Community (NACE Rev. 2) and detailed breakdown into ten aggregates.

9 The indices of intra-industry trade are calculated according to Fontagné and Freudenberg (1997) using annual data at the five-digit level, which gives 3,530 commodity groups.
strengthened over time, enlarging the space for the possibility of achieving other domestic objectives, apart from inflation, such as output stabilization (Jovanovic and Petreski, 2012).

In general, despite the relatively tight room for independent monetary policy in the past due to the fixed exchange rate, relinquishing the interest rate and exchange rate instrument might be costly for Macedonia at this stage since the shock synchronization with the euro area is still low. In this light, the problems that Greece is experiencing currently due to its inability to depreciate the currency is very relevant evidence for the size of costs a country may face when abandon its monetary independence.

Overall, it appears that the benefits may outweigh the costs of the adoption of the euro if appropriate structural reforms are undertaken resulting in longer-lasting financial inflows, which would diminish the differences in production structures and trade patterns. This would not only enhance the shock synchronisation, but it would also improve the country riskiness profile which is expected to ease the fiscal governance which is indispensable when independent monetary policy is given up.

6. CONCLUSION

The chapter has given an overview of the performance of the economy of the Republic of Macedonia and put them in the context of the accession of the country to the EU, as well the prospective accession in the common European currency. The chapter explained the thorny road Macedonia went through after gaining independence from Yugoslavia, faced with bad privatization, trade collapse, high inflation and stagnant economy, flavoured with intense corruption, political instability, embargo and internal conflict later. It argued that a light at the end of the tunnel has been the dedication to accede to the EU, although it remained stuck as an EU candidate country, facing continuous blockade by Greece, due to the name dispute.

It has been argued that EU membership would likely be beneficial for the country, due to its trade and financial integration with the EU, and in particular, with the Eurozone, as well reaping the benefits of higher political stability and better governance that the membership may bring in. In addition, as nominal convergence has been already achieved to a sufficient extent, while real convergence also benefited a progress, further structural reforms in the economy may smooth the way to adopting the euro after the country has become a member of the EU into the future. This is, however, questioned by the problems that Greece is experiencing currently with the inability to depreciate its currency.

The Macedonian prospects for EU membership will depend on its progress in the establishment of a functioning society and economy. Corruption still represents a big problem in the society, as well as bad governance, which then leads to severe misuse and abuse of public resources. Intensified and more productive and efficient public investments are needed in order to improve the infrastructure. These two, coupled with an improved business regulation, may stimulate investment, both domestic and foreign, which may contribute to stronger export diversification and sustainable employment. The latter will particularly depend on a better alignment of workers’ skills with labour demand which can be achieved through proper reforms of the education system. All these will enhance the economy’s strength to cope with competitive pressures within the EU in the medium-term.

Yet, the key challenges for Macedonia going forward the European integration road is overcoming the domestic political uncertainties and, especially, resolving the ‘name issue’
with Greece. Although the domestic political challenges are mounting, their resolution seems more likely than the exit from the Greek ‘name issue’ deadlock.

REFERENCES


