



North Macedonia Diagnostic

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This diagnostic paper was prepared by Peter Sanfey and Jakov Milatovic from the Economics, Policy and Governance (EPG) Department at the EBRD, with inputs from Oleg Levitin, Peter Tabak and Sanja Borkovic, as well as other sector and governance experts in EPG. It is based on the Western Balkans diagnostic paper, published in February 2018, which draws on a number of EBRD background papers and notes on regional issues in the Western Balkans. See Peter Sanfey and Jakov Milatovic, “The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy”, available at: www.ebrd.com/news/2018/towards-higher-productivity-in-the-western-balkans.html.

Country diagnostics are an EBRD tool to identify the main obstacles to entrepreneurship and private sector development and to help shape the Bank's strategic priorities and project selection in new country strategies. Each diagnostic informs the EBRD's policy engagement with the authorities in the country.

Each country diagnostic assesses the progress and challenges of the country of operations in developing a sustainable market economy. Private sector development and entrepreneurship are at the heart of the Bank's mandate in the regions of operation of the bank, but the private sector in all EBRD countries faces a range of problems and obstacles. The diagnostic highlights the key challenges facing private companies and shows where each country stands vis-à-vis its peers in terms of six qualities of transition – competitive, well-governed, resilient, integrated, green, and inclusive – and points out the main deficiencies and gaps in each quality.

The diagnostics draw on a range of methodologies and best practice for assessing how big different obstacles are. Extensive use is made of in-house expertise across the EBRD, along with surveys such as the Business Environment and Enterprise Performance Survey (**BEEPS**) and the Life in Transition Survey (**LITS**), as well as other cross-country surveys and reports from institutions such as the World Bank, World Economic Forum and OECD. For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical for private sector development in the country.

The diagnostics are led by the EBRD's Country Economics and Policy team, drawing substantially on the expertise of sector, governance and political experts in the Economics, Policy and Governance department (EPG) and consulting widely with relevant experts across the EBRD when preparing the final product. The diagnostics are shared with the EBRD Board during the country strategy process and published during the public consultation period.

The views expressed in the diagnostic papers are those of the authors only and not of the EBRD.

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North Macedonia Diagnostic

Assessing progress and challenges in developing a sustainable market
economy

2019

Executive summary

North Macedonia has come a long way since independence in 1991 and has achieved remarkable successes in certain areas. An EU candidate since 2005, North Macedonia's progress towards EU membership has been stalled for many years, but in April 2018, having recognized significant progress in reforms and in improving relations with regional neighbours, the European Commission recommended opening of the EU accession negotiations with North Macedonia. The European Council, in June 2018, set out the path towards opening of accession negotiations in June 2019 pending further progress. The political crisis that engulfed the country up to mid-2017 adversely affected economic progress and contributed to a general stagnation and halting of economic growth. The establishment of the new pro-reform government in summer 2017 was conducive to an improvement in investors' sentiment, which received a further boost after the entry into force in the beginning of 2019 of the agreement with Greece on strategic partnership and the resolution of the name-related dispute. Economic growth picked up again in 2018 and short-term economic prospects are reasonably bright.

Further catch-up on EU living standards will depend on a major boost to productivity and investment. The private sector in North Macedonia still faces a range of obstacles to doing business, notwithstanding the country's strong performance in the World Bank's ease of doing business ranking. This paper highlights some of the main problems facing enterprises in the country. These include the large informal economy and the unfair burden this places on legitimate businesses, which illustrates the problems of weak levels of governance and enforcement of regulations. The enforcement of competition policy is weak and administrative capacity in this area needs to be improved. Lack of access to finance is also an issue for many firms, particularly as non-bank sources of finance are largely undeveloped. Problems with electricity supply reflect broader difficulties in

developing a more sustainable energy mix and improving resource efficiency. Lack of skills and relative under-performance in cross-country education tests point to the serious problem of mis-match in the labour market and contribute to the very high levels of youth unemployment and emigration. Other areas that need to be addressed include corruption, over-leverage at the firm level and the poor quality of certain public institutions.

North Macedonia has made significant progress towards a sustainable market economy, but has some distance to go. The average EBRD Assessment of Transition Quality (ATQ) score for the six qualities for North Macedonia is 5.6, on a scale of 1 to 10. The country has its lowest scores in the green and inclusive qualities (scores of 4.9 and 5.6 respectively). In the areas of integrated, competitive and well governed qualities, North Macedonia scores approximately equal to or higher than an "average EBRD country", while in the three other qualities, green, inclusive and resilient, it lags behind. Also, the country is generally ahead of its neighbours in the Western Balkans, with the exception of the green and resilient qualities where the country scores in line with the regional average. However, North Macedonia lags behind in all qualities when compared with peer countries in the 11 EU member states of central, eastern and south-eastern Europe (EU-11).

1. Political Economy

A landlocked Western Balkans country and one of the former republics of ex-Yugoslavia, North Macedonia has come a long way in its transition since independence in 1991. It started from a low point, being among the least developed republics in former Yugoslavia and has been exposed ever since to an unfavourable geopolitical environment. The latter included the negative impact of the name-related dispute with Greece and the legacy of uneven relations with various other neighbours who, at different times, questioned the nation's identity, history, name, religious autonomy, and borders. In 2001, the country went through an armed inter-ethnic conflict, the legacy of which has also affected its political and social life.

Under these difficult circumstances, North Macedonia has achieved remarkable success. It has moved further with privatisation than many other countries in south-eastern Europe (SEE). It has also developed some of the best practices in the region in attracting foreign direct investment (FDI), reforming its tax system, establishing a “regulatory guillotine” and other business-friendly practices, diversifying its exports and advancing in some other areas of economic reform. The country consequently became one of the “top performers” in the annual World Bank Doing Business reports and was the first Western Balkans country to obtain the formal status of EU candidate country, in 2005.

However, these economic achievements were accompanied over the years by gradual corruption of the political establishment which was in power from 2006 until mid-2017. The situation was aggravated by weak institutions, lack of a depoliticised, merit-based civil service, and a poor culture of political dialogue and consensus building. The wiretapping scandal of 2015 revealed massive wrongdoings, from interference into the judiciary and media to widespread corruption. At issue were systemic problems, behind which was the blurring of the line between the ruling party and the state or, de

facto, the “capture of the state” by a political party.

A new pro-reform coalition government, led by the formerly main opposition party, the centre-left SDSM, was formed on 31 May 2017.

Although it faces many challenges, this represents a new opportunity for the country. The government's top priorities in foreign policy include acceleration of EU and NATO approximation, good neighbourly relations in the region, including establishment of a strategic partnership with Greece, and, in domestic policy, comprehensive reforms, including restoring checks and balances and democracy and strengthening of the rule of law and economic governance, as well as inter-ethnic reconciliation. The signing of the agreement with Greece on the resolution of the name-related dispute in summer 2018 and its subsequent entry into force in February 2019 were important milestones, which have provided a boost to investors' sentiment. It is also conducive to EU approximation.

There is a strong political will for reforms. The implementation of comprehensive structural reforms is a long term process, but there is a genuine desire on the side of the authorities and increasing support by the wider society. The European Commission (EC) has expressed its readiness to provide strong support to the new authorities provided they deliver on the reform course. The government's new reform programme (see below), has been prepared in close cooperation with the EC, and a number of strategies and new laws have been put in place in the last few months. In April 2018, having recognized significant progress in reforms, the EC recommended opening of the EU accession negotiations with North Macedonia. The European Council, in June 2018, set out the path towards opening of accession negotiations in June 2019, pending further progress. In February 2019, North Macedonia signed the NATO Accession Protocol. It is expected to join the Alliance in 2020, pending ratification of the

Accession Protocol by national parliaments,
which should further strengthen stability of the
country and of the wider region.

2. Reform Agenda

On coming to power, the government formulated a four-year development plan.

Some of the major development priorities include: 1) acceleration of EU and NATO integration, including by making institutions more transparent and efficient; 2) better social protection, by increasing the minimum wage and lowering the poverty rate; 3) stronger support for local companies, by allowing domestic firms to invest in the country's free industrial zones, which so far have been mostly occupied by foreign investors; and providing a series of employment and other incentives for local firms; 4) introduction of a more progressive tax system, by increasing the currently flat personal income tax rate of 10 per cent to 18 per cent for high earners; 5) boost the country's investments in road and railway infrastructure, including through a 10-year, €3 billion, investment scheme; 6) lower energy imports, by relying on better energy efficiency; and 7) diversify gas imports by connecting the country to the Trans-Adriatic Pipeline (TAP) gas project, as well as to gas connections with Greece and Bulgaria.

Among key achievements in reforms during the new government's first year in office are the adoption of the strategy of the public administration reform, steps designed to restore independence of judiciary, including through adoption of the new judicial reform strategy, as well as adoption of the new Energy Law, aimed at fully transposing EU energy legislation.

3. Structure of the private sector

Most economic activities are privately-generated, and the state's stake in the economy is relatively small compared to other Western Balkan countries. According to the latest EC Progress Report (from April 2018), full state ownership remains in 16 companies, and as a result the value of state assets in GDP amounted to 11.7 per cent, a share that has been steady over the past five years. Most economic activity is generated by the private sector, though the exact share of GDP is unknown, not least because of the large informal economy. The privatisation process is at a more advanced stage than in most other Western Balkan countries (WB6). However, the involvement of the state in the private sector, other than through ownership, remains significant and has at times been detrimental to businesses, including through an uneven application of rules and regulations, inspections, and public procurement procedures, as well as non-transparent information on the amounts and beneficiaries of state aid.

SMEs dominate the economy, but the environment for small businesses is often difficult. According to a recent OECD-led study¹, SMEs make up 99.8 per cent of all businesses, with a share of employment equal to 76.6 per cent, and they add an estimated two-thirds of the country's total annual value added, a proportion similar to the EU average. North Macedonia is more advanced than its peers in the Western Balkans in terms of policies to support SMEs; its average score on the OECD scale (across ten policy dimensions) is 3.42, on a scale of 1 to 5, compared to an average 3.07 in the Western Balkans. Some problematic areas remain, however, including: 1) entrepreneurial learning and women's entrepreneurship (including women's access to finance); 2) SMEs in the green economy; 3) enterprise skills; and 4) support services for SMEs and start-ups.

Five sectors account for most economic activity. The five sectors are: domestic trade, industry, public administration (including education, health care and social care), real estate activities and agriculture. Domestic trade, including transport and storage as well as accommodation and food services, is the largest sector in the economy, as it is in other Western Balkan countries, accounting for about one-fifth of overall economic activity. Industry, including mining, manufacturing and utilities, is the second largest sector, providing 18 per cent of annual value added. The share of public administration in the economy, at 15 per cent, is smaller than in other countries of former Yugoslavia. Agriculture is also an important sector, particularly the production of vegetables.

North Macedonia is rated highly among WB6 countries in terms of economic criteria for EU membership. In its latest EU progress report, North Macedonia is assessed at a good level of preparation in “the existence of a functioning market economy” and as moderately prepared in “the capacity to cope with competitive pressure and market forces within the EU”, two key economic criteria for EU membership. The scores are on a five-point scale: (1) at an early stage, (2) some level of preparation, (3) moderately prepared, (4) good level of preparation, and (5) well advanced. With regard to the country's readiness to cope with market forces within the EU, the EC report identifies weaknesses in education curricula, low innovation rates and major investment needs in public infrastructure as the main problems, although it recognizes progress made towards diversification of exports and higher-value added output in the manufacturing sector. Prioritising policy reforms towards higher quality education and increasing support for new labour market entrants could go far in addressing these concerns. In 2015, roughly two-thirds of secondary school pupils in North Macedonia

¹ SME Policy Index: Western Balkans and Turkey 2016, <http://www.oecd.org/countries/albania/sme-policy-index-western-balkans-and-turkey-2016-9789264254473-en.htm>

scored below level 2 (out of six levels) in the OECD's PISA study (compared with only one-fifth on average in OECD countries), indicating low performance in reading, science and maths.

Competition policy enforcement is weak. The Commission for Protection of Competition (CPC)'s level of expertise and administrative capacity is not adequate. Its level of funding varies each year, raising concerns about its independence. In addition, the CPC's administrative capacity to deal with state aid remains inadequate. Also, corruption during the procurement process is frequent and little has been done to increase the cooperation between the CPC and the Commission for Prevention of Corruption.

North Macedonia scores exceptionally well in the World Bank's Doing Business report rankings but poorly on corruption rankings. The country was ranked 10th overall (out of 190 countries) in the 2019 Doing Business report, the second best position among all EBRD CoOs and far above all other Western Balkan peers. Enforcing contracts, as well as resolving insolvency and registering property, are among the remaining problematic areas (in terms of the distance to frontier). However, corruption perceptions have worsened sharply in recent years. According to the latest Transparency International Corruption Perceptions Index, the country is now ranked at 107th position globally out of 180 countries with a score of only 35 (on a scale from 0 to 100, where 100 represents the least corrupt). It is likely that the political crisis and scandals described above had a negative impact on corruption perceptions.

The sizeable informal economy is a major obstacle to doing business. According to estimates from the Statistical Office of North Macedonia, the informal or "grey" economy accounts for about 20 per cent of GDP, but other estimates suggest it is significantly larger – between 24 and 47 per cent according to one survey of different studies and methods used to estimate the share². Unfair competition from the informal economy is cited in the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS) as a major obstacle to doing business (see below for more details), with 26 per cent of respondents naming it as the top obstacle (from a menu of 15 potential obstacles).

North Macedonia is an intermediate knowledge economy, constrained by poor skill availability. The quality of secondary education lags behind EU levels, as shown by poor results on the PISA exams, which test skills and knowledge of 15-year-old students. This can also indicate a lack of understanding of how to use knowledge to solve practical problems, an important aspect for business development. The share of those with tertiary education is about half the EU average. Improving vocational education and training in line with private sector requirements is another area where more progress is needed. The firm-level evidence from the BEEPS survey points to the inadequately educated workforce as a serious business obstacle, with 14 per cent of firms saying they see it as a major or very severe problem.

² See "The Economics of Blurs and Shadows – The Hidden Economy in Macedonia," Centre for Research and Policy Making, Policy Brief No. 30, September 2014,

available at: <http://www.crpm.org.mk/wp-content/uploads/2014/12/Policy-Brief-N.30ENG1.pdf>.

4. Obstacles to private sector development³

The private sector in North Macedonia faces a range of obstacles in its day-to-day operations, notwithstanding the country's stellar ranking (noted above) in the World Bank's Doing Business scores. This section summarises the results of two EBRD papers that assess the relative severity of obstacles, and their impact on productivity and growth, in North Macedonia and other Western Balkan countries.

One paper uses the results of the BEEPS, the latest round of which was carried out in 2013.

The BEEPS includes questions about the subjective perceptions of business owners and senior managers about different potential problems, and as such it can be quite revealing about the actual situation on the ground. The survey approaches the issue in two ways: One method is to show respondents a card with 15 potential obstacles and ask them: Can you tell me which of the elements of the business environment included in the list, if any, currently represents the biggest obstacle faced by this establishment? Table 1 shows the results for the six Western Balkan countries. The second approach is to ask interviewees through the survey to rate the severity of each obstacle on a five-point scale, ranging from "no obstacle" up through "minor", "moderate", and "major" to

Table 1: Biggest obstacle to doing business, percentage vote by country

	ALB	BIH	MKD	KOS	MNE	SRB	Average
Competition from informal sector	16.8	4.1	26.0	23.3	12.5	9.8	15.4
Political instability	4.8	30.2	8.8	3.6	4.8	26.7	13.2
Access to finance	12.9	14.9	18.6	14.6	6.3	9.0	12.7
Tax rates	9.8	7.9	7.6	5.0	26.4	15.0	11.9
Corruption	6.3	7.8	1.4	9.8	0.9	10.9	6.2
Electricity	13.6	1.5	5.7	7.0	1.8	0.2	5.0
Customs and trade regulations	1.0	7.6	1.8	8.4	6.3	3.1	4.7
Tax administration	11.6	1.2	2.4	3.9	1.8	4.9	4.3
Inadequately educated workforce	1.9	2.0	5.9	6.3	1.9	5.7	3.9
Courts	0.2	3.3	4.5	1.3	0.2	4.2	2.3
Access to land	5.9	0.8	1.1	1.8	0.9	0.9	1.9
Labour regulations	0.1	6.5	0.6	0.4	3.0	0.1	1.8
Crime, theft and disorder	1.5	1.9	1.0	2.2	1.8	1.2	1.6
Transport	2.7	2.8	1.0	0.9	0.7	0.4	1.4
Business licensing and permits	1.3	3.7	0.4	1.3	0.3	1.2	1.3
Don't know	6.5	2.0	0.5	1.8	15.9	4.1	5.1
Refused to answer	0.0	1.4	9.9	8.0	9.1	1.1	4.9
Does not apply	3.3	0.5	3.0	0.5	5.6	1.7	2.4

Source: BEEPS V.

Note: All companies; no differentiation between the industries; individual observations weighted (strata weights). The categories sum up to 100.

"very severe". These results, showing the percentage of those who see an obstacle as major or very severe, are in Table 2.

Table 2: Obstacles to doing business, by percentage who see major or very severe problem

	ALB	BIH	MKD	KOS	MNE	SRB	Average
Competition from informal sector	19.9	16.0	34.6	58.9	11.2	12.6	25.5
Political instability	11.1	34.3	21.7	45.7	0.4	31.5	24.1
Corruption	17.0	26.4	13.3	51.0	3.2	24.5	22.6
Electricity	21.6	10.2	28.9	49.5	6.0	6.6	20.4
Tax rates	12.8	20.3	16.0	30.2	8.7	25.5	18.9
Access to finance	6.5	14.1	19.3	44.9	7.6	15.7	18.0
Tax administration	13.1	13.1	10.3	28.2	2.7	17.4	14.1
Crime, theft, disorder	3.8	7.2	9.1	46.6	4.1	7.4	13.0
Inadequately educated workforce	6.4	7.4	14.0	25.9	0.3	11.3	10.9
Customs and Trade regulations	2.0	5.7	6.6	34.2	3.0	4.9	9.4
Access to land	12.9	4.6	9.8	17.7	0.3	3.6	8.1
Telecommunications	3.1	4.9	16.3	13.0	4.0	3.9	7.5
Courts	1.5	8.2	6.7	13.0	1.1	13.9	7.4
Transport	4.1	3.7	5.4	22.7	2.0	4.6	7.1
Labour Regulations	1.8	11.1	4.0	4.9	0.4	6.9	4.9
Business licensing and permits	3.5	8.4	5.1	4.6	0.3	3.7	4.3

Source: BEEPS V.

The results in the two tables are broadly comparable, though with some differences.

Focusing on North Macedonia, three issues stand out: First, the results confirm that unfair competition from the informal sector stands out as a serious problem, with more than a quarter of all firms citing it as the number one obstacle, and more than one-third deeming it a major or very severe obstacle. This highlights the problem of inadequate enforcement of legislation and weak standards of governance, issues that hold back the competitiveness of the economy. Second, lack of access to finance is a major barrier, especially for SMEs. The problem is aggravated by the relatively undeveloped level of non-bank financial institutions. Third, an inadequately educated labour force is seen as a major or very severe problem by a significant number of firms, a result consistent with the evidence cited earlier on poor educational and skill outcomes compared against other countries.

³ This sections draws on two background research papers: "Firm performance and obstacles to doing business in the Western Balkans: evidence from the BEEPS" by Ana Kresic, Jakov Milatovic and Peter Sanfey (EBRD Working Paper No. 200), and "Productivity drivers in the Western Balkans" by Sanja Borkovic, Peter Tabak and Emir Zildzovic (EBRD draft Working Paper). See also Peter Sanfey and Jakov

Milatovic, "The Western Balkans in transition: diagnosing the constraints on the path to a sustainable market economy", available at: <http://www.ebrd.com/news/2018/towards-higher-productivity-in-the-western-balkans.html>.

Other obstacles to doing business also feature prominently, including political instability, tax rates and tax administration, and problems with electricity supply. The latter problem points to the need for further progress in developing a more sustainable energy mix and better resource efficiency. The problem of corruption also crops up prominently. Although very few firms name it as the top obstacle, 13.3 per cent of respondents in North Macedonia say it is a major or very severe problem.

The estimated monetary costs of some obstacles to private sector development are substantial. The combined losses from crime, corruption (i.e., informal payments to “get things done”), power outages and transport breakages and spillages (due to the inadequate state of transport infrastructure) is estimated by BEEPS respondents at more than 15 per cent of total annual sales revenues in North Macedonia. This is a higher share than in any other Western Balkan country aside from Kosovo, and is well above most countries in central Europe and the Baltic states (CEB).

An econometric analysis of the revealed costs of business environment deficiencies in North Macedonia and the wider Western Balkan region provides further insights. For example, unfair competition from the informal sector is a particular burden for smaller, local market- and service-oriented businesses, and corruption is especially detrimental to more innovative firms. The problems of high tax rates and lack of access to finance are more binding for firms in the manufacturing sector than in services. The econometric results also permit a more rigorous ranking of obstacles based on a “benchmark” company, taking into account the institutional setting of each country. However, the results are broadly similar to those based on unconditional means (cited earlier) and, once again, highlight the importance of tackling informality in the economy.

The second paper uses detailed firm-level data for three Western Balkan countries – North Macedonia, Bosnia and Herzegovina and Serbia. The purpose is to estimate total factor productivity (TFP) at the firm level, and then to estimate how TFP would be affected by changes in a range of exogenous factors. Although the data and methodology differ from the paper discussed above, the overall purpose is similar, namely, to understand what is holding back productivity and growth in North Macedonia (and other countries) and to see which obstacles are having the biggest impact.

The firm-level data in this study are drawn from the BvD ORBIS database. The number of observations is more limited in North Macedonia than in the other two countries, but still covers approximately 1,000 companies over the period 2007-15. These data are matched with sector- and country-level data covering a range of potential TFP determinants such as governance, infrastructure, access to finance and employment opportunities, among many others.

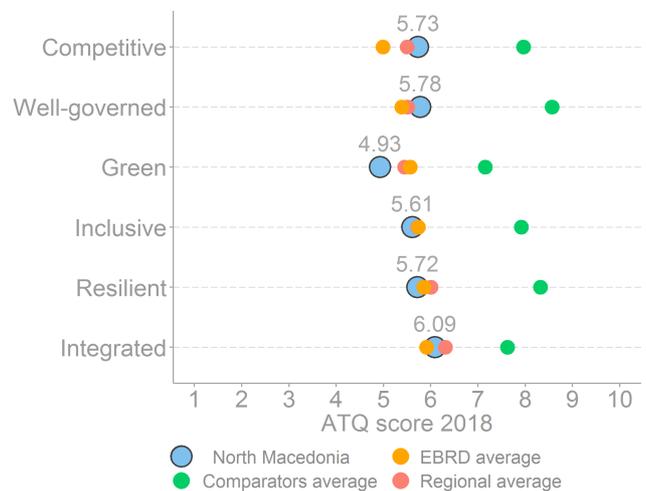
The methodology underlying this analysis can be summarised as follows: first, a standard production function (assuming a Cobb-Douglas form) is estimated by regressing sales on labour, capital and intermediate inputs (all in logs). Under certain assumptions, TFP can be calculated straightforwardly as a residual, using the estimated coefficients on the three explanatory variables. Second, these TFP estimates can then be used (in difference form) as the dependent variable in a second-stage regression, where the explanatory variables now include a variety of firm-specific, macroeconomic, institutional and business environment variables.

The results for North Macedonia show a statistically significant and important impact of several variables on productivity. Most notably, overleverage at the firm level, defined as a ratio of net debt to EBITDA greater than four, lowers productivity, as does a high degree of market concentration. The impact of these two factors is higher in North Macedonia than in Bosnia and Herzegovina or Serbia. Another important finding is that a reduction in the share of state-owned enterprises would also imply a boost to productivity. The current low share of SOEs implies only limited potential gains from this channel; more substantive improvements, however, could come from an increase in the quality of public institutions, as implied by the econometric results.

5. Qualities of a sustainable market economy

The following pages consist of a quality-by-quality description of the main transition gaps in North Macedonia, according to the new EBRD transition concept and associated methodology for measuring progress in transition⁴. This methodology assesses for each country the six desirable qualities of a sustainable market economy: competitive, well-governed, green, inclusive, resilient and integrated. Each quality can be measured to give an average transition quality (ATQ) score. The scores for all EBRD countries, including North Macedonia, are published annually, as part of the EBRD Transition Report.

North Macedonia has made significant progress towards a sustainable market economy, but has some distance to go. The average ATQ score for the six qualities for North Macedonia is 5.64, on a scale of 1 to 10. The chart below shows that the country has its lowest scores in the green and inclusive qualities (scores of 4.93 and 5.61 respectively). The highest score is for integrated (6.09). In the areas of integrated, competitive and well governed qualities, North Macedonia scores approximately or higher compared to an “average EBRD country”, while in the three other qualities, it lags behind. Also, the country is generally at par or ahead of its neighbours in the Western Balkans. However, North Macedonia lags behind in all qualities when compared with peer countries in the EU-11.



Source: EBRD.

Note: Visit <https://2018.tr-ebd.com/reform/> for the list of indicators, data sources and methodological notes.

⁴ For more information on the EBRD's new transition concept, see: <http://www.ebrd.com/news/2016/ebd-updates-transition-concept.html>.

Competitive [ATQ = 5.73]

North Macedonia's economy is considered the most competitive among its regional peers, with good performance in international rankings. However, inadequate market structures for competition, high concentration and weak capacity to add value and innovate are major competitiveness constraints.

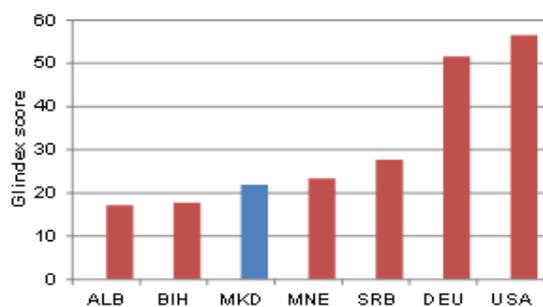
10th in ease of doing business 2019 among 190 countries (World Bank).

70th in economic complexity out of 124 economies (Harvard CID, 2014).

Ranked in the upper 50th percentile among EBRD CoOs on overall competitiveness.

- There is a relatively strong industrial base, with a comparative advantage in sectors such as machinery and equipment. Nevertheless, labour productivity across the economy is below the average level of WB-6, and at just 50 per cent of the levels in EU-11 countries.
- Most of the country's trade in goods is done within the framework of free trade arrangements, including with the EU (in place since 2004) and under the Central European Free Trade Agreement (since 2006). At ca. 1.1 per cent (weighted mean tariff rate at all products), North Macedonia has one of the smallest average tariff rates among EBRD CoOs.
- According to the EBRD's assessment of transition challenges in SME development, North Macedonia faces an overall medium gap across five dimensions captured in the analysis. However, two dimensions are particularly problematic: i) non-bank financing and ii) business skills and standards.
- New business density, measured as new registrations per 1,000 people of age 15-64, is 3.7, similar to the EBRD average, but well below the Baltic states, for example, where the average is close to 10.
- Access to finance is among the major obstacles to doing business, according to BEEPS. A quarter of surveyed firms in North Macedonia described themselves as credit-constrained. Credit to the private sector is about 55 per cent of GDP, and hence the financial penetration is only moderate.
- Quality of trade and transport-related infrastructure is poor, and North Macedonia is ranked 106th out of 160 countries on the World Bank's Logistics Performance Index (LPI) score. Also, the fixed broadband connection is relatively weak, as only 17 out of 100 people have it.
- The country is far from the innovation frontier (ranked 61st out of 127 countries on the Global Innovation Index). Particularly problematic areas are low knowledge outputs (i.e., knowledge creation, impact and diffusion – for example only 16 per cent of firms introducing new products to the market, compared with 23 per cent across EBRD) and human capital & research.
- In May 2018, the parliament adopted a new Energy Law aimed at fully transposing the EU Third Energy Law. The law envisages further liberalisation of the electricity market from 2019, allowing for the appointment of a universal service provider and allowing households and small firms to choose their supplier. Unbundling of the electricity and gas transmission system operators has progressed but is still ongoing.

Global Innovation Index
(ranking out of 127 economies)



Source: Global Innovation Index 2017.

Ease of doing business,
(ranking out of 190 economies)



Source: World Bank Doing Business 2018 Report.

Well governed [ATQ = 5.78]

North Macedonia is relatively highly ranked vis-à-vis regional comparators on the 'well-governed' transition quality, but businesses complain of a large informal sector creating unfair competition, frequent changes in the regulatory framework, and numerous para-fiscal charges at many administrative levels.

107th out of 180 countries in Transparency International's 2017 Corruption Perceptions Index.

31st out of 180 countries on the Heritage Foundation's Index of Economic Freedom (5th of EBRD's countries of operations).

Macedonians' support for both the market economy and democracy grew between 2010 and 2016, according to LiTS III.

Competition with the informal sector is a severe obstacle to firms' operation and growth in North Macedonia. According to BEEPS V, 56 per cent of firms reported competing against firms in the informal sector. While this has decreased from 74 per cent in BEEPS IV, it still exceeded the SEE average by almost seven percentage points.

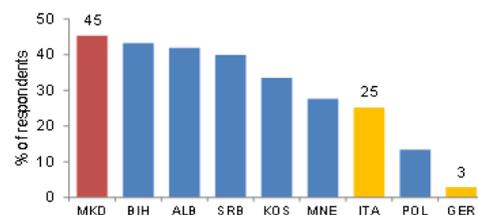
Political instability was identified by firms as their second most significant obstacle in BEEPS V. Since the survey, there was a protracted political crisis (resolved only in mid-2017) which affected policymaking and resulted in a sharp drop in investment and economic growth.

The rule of law has improved significantly in North Macedonia in recent years but problems remain; the country scores relatively poorly on the World Bank's governance indicators. Individuals' experience of corruption in healthcare and education is among the lowest in

the SEE region. The courts system has improved significantly in recent years; as a result, the courts have fallen from 4th to 12th among the business environment obstacles reported by firms in the country.

Successful administrative reforms in recent years have significantly reduced the administrative and regulatory burdens on firms. As a result, firms report that labour regulations, customs and trade, and business licensing are the least significant obstacles to their operations. However, the government has acknowledged in its Economic Reform Programme that there has been some deterioration in the area of enforcing contracts.

Political connections as a factor behind success



Source: EBRD/World Bank Life in Transition Survey III.

Political connections are seen by many people as key to success in life, according to the Life in Transition Survey (LiTS III), with 45 per cent rating this factor as more important than either effort and hard work, or intelligence and skills.

Corporate governance is better in North Macedonia than in many regional peers. In the EBRD's 2016 assessment, conducted by the Office of the General Counsel, the country scored well on protection of shareholder rights. However, weaknesses remain in the oversight and transparency role played by corporate boards, and (to a lesser extent) in transparency and disclosure.

Governance indicators



Source: The World Bank's Worldwide Governance Indicators database.

Green [ATQ = 4.93]

A green economy transition of North Macedonia requires renewed focus on the following areas: energy efficiency, exploring the role renewables could play in the future energy mix, and deepening the policy response to air quality and climate change adaptation

Most electricity is generated in **outdated thermal power plants** with an efficiency of **32 %**, fuelled by low-quality coal. Electricity generation is dominated by coal (**58%**) and hydro power (**33%**).

Largest electricity users are residential (**48%**), followed by industry (**30%**) and services (**22%**).

Electric production system consists of two thermal power plants with a total of **800 MW installed capacity**, eight large and several small hydro power plants with **650 MW installed capacity**.

Oil and gas supply is entirely imported and net imports supplied more than half of gross inland energy consumption.

Energy efficiency measures are needed to sustainably meet growing energy demand. The country ranks among the most energy-intensive economies in the region due to the high share of coal and oil in primary energy production.

On the supply side, there is significant scope for efficiency upgrades targeting existing thermal power plants to reduce energy losses during production and distribution, while demand-side efficiency measures are needed to address energy-intensive local industries, poorly insulated buildings, and inefficient electrical appliances.

Around half of country's generation capacity (both thermal and hydro power plants) is scheduled to close in the next 15 years. Other renewable energy sources, especially hydro and solar, should become more important in the production of electricity.

Approximately 1,350 lives are lost annually due to fine particulate matter (PM), costing the economy EUR 253 million, or 3.2 per cent of GDP. Over 90 per cent of PM is generated by five economic activities and 92 per cent in the largest industrial facilities.

The country is vulnerable to climate change and is at a high risk of natural disasters, which will shift from floods to heat wave and wildfires according to climate models. Significant barriers to vulnerability assessments and adaptation strategies include lack of reliable data and relevant institutional structures, and shortage of trained personnel for monitoring and data processing.

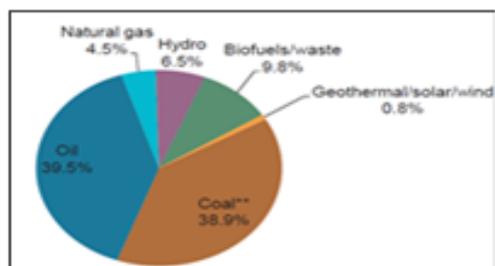
North Macedonia's policy commitments as an EU accession state provide an opportunity to deliver a green economy transition. According to the Energy Community Secretariat, the country's National Renewable Action Plan (NREAP) is not designed to achieve the country's legally binding renewable energy target of 28%, instead only a 24% target in 2020 is foreseen.

The country currently supports renewable energy projects with feed-in tariffs via a PPA with the market operator. An auctioned feed-in-premium is being considered, but first requires the development of a liquid day-ahead market to establish a reference price.

Water and wastewater infrastructure is aged and in poor condition and needs urgent reconstruction and replacement. The efficiency of public water and sanitation service providers is a serious issue with nonrevenue water levels at 63%, due to both commercial and technical losses. Although North Macedonia has made

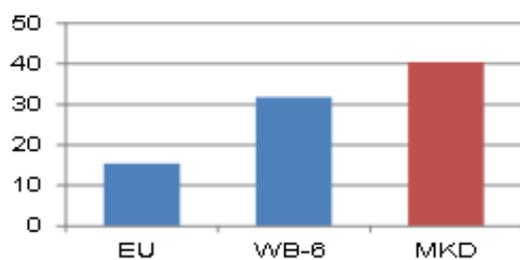
considerable efforts to transpose the EU waste acquis, further improvements in waste management practices are needed.

Share of total primary energy supply



IEA, 2015.

Ambient air pollution PM2.5



World Bank, 2015.

Inclusive [ATQ = 5.61]

Very high youth unemployment and low labour participation among women, combined with a projected decline in the working age population, constitute the main threats to prospects for inclusive growth in North Macedonia.

24 per cent of young people are not in education, employment or training. Youth unemployment is 49 per cent.

77 per cent of working age women are economically inactive.

Gender gaps are large in access to finance and labour practices.

The skills mismatch is exacerbated by weak work-based learning opportunities

Skills mismatch is one of the key drivers of youth inactivity. One-third of young people are either under-educated (15 per cent) or over-educated (19 per cent) for the demands of the labour market. The incompatibility of the skills supplied through the education system and those demanded by employers imposes significant costs on firms. In BEEPS V, 14 per cent of respondents deemed an inadequately educated workforce to be a major or severe obstacle to growth.

There is a lack of vocational graduates for low- and medium-skill occupations. This is particularly acute in growing sectors such as manufacturing, which offer the largest potential for job creation. However, skills-related challenges are felt at higher-skill occupations as well. In terms of its capacity to retain and attract talent, North Macedonia ranks 115th and 128th,

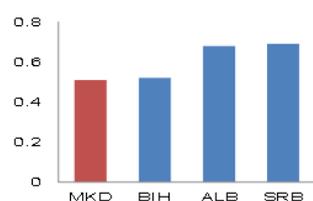
respectively, across 138 countries surveyed under the WEF Competitiveness Index 2017.

Enhancing work-based learning schemes is key to improving skills matching. Although regulations are in place to incentivise employers to offer practical training at the workplace, implementation mechanisms do not function effectively.

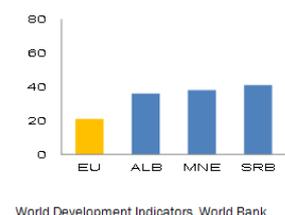
Women's participation in the economy is significantly low compared to that of men (42 per cent for women compared with 68 per cent for men – see ILO 2017). The integration of women into the labour market is vital to counter the expected reduction in the working age population by more than 20 per cent until 2050.⁵ This requires not only an increase in the provision of affordable childcare and more flexible parental leave policies, but also an expansion of access to finance for female entrepreneurs, where substantial gender gaps remain. The female/male ratio for saving in a formal institution is 0.74, use of credit cards is 0.66 and borrowing from financial institutions to start a business is 0.51.

Gender discrimination in law and in practice is evident. While women are granted equal rights and opportunities under the law, restrictions in the Labour Code limit women from working in mining, in factory, and in construction industries in the same way as men and limit women's night labour. This is reinforced by strong stereotypes about women's traditional role in society

Female/male ratio in borrowing for business purposes



Unemployment, youth total (% of total labour force ages 15-24)



Global Findex, World Bank 2014.

⁵ United Nations Department of Economic and Social Affairs. The World Population Prospects: 2015 Revision.

Resilient [ATQ = 5.72]

The financial sector appears stable, with ample liquidity buffers, supported by a well-anchored monetary policy. The capital position of banks is relatively strong. The central bank has maintained the currency peg to the Euro (previously to the DM) for more than 20 years (currently at 61.5 Denars to the Euro). At present, foreign exchange reserves are at relatively comfortable levels, helping to maintain the currency peg. Energy resilience is adversely affected by insufficient domestic generation capacity.

The financial sector has withstood deposit runs during the period of the political crisis, thanks to the authorities' swift and strong policy actions, such as higher policy rates and targeted macro-prudential measures. The banking sector is relatively well capitalised (at ca. 16 per cent), although the country slightly lags behind some of its better capitalised Western Balkan peers.

The non-performing loans ratio (NPLs) fell to ca. 5 per cent as of end-2018, having been nearly 11 per cent of total loans two years previously. The reduction partly reflects measures to write off NPLs that are fully provisioned for over two years.

The banking sector is profitable. Banks' profitability, measured by return on average equity (ROAE) was 13.5 per cent at end-2017, at ca. the same level as in 2016, and stood at 19.5 per cent at end Q3 2018. Return on average assets (ROAA) was 1.4 per cent in end-2017, rising to 2.2 per cent as of Q3 2018. The four largest banks accounted for almost 90 per cent of total profit.

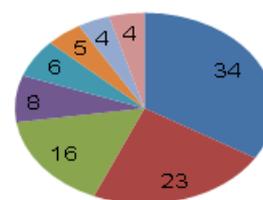
Credit activity is picking up in recent months, following its deceleration in H2016-H12017. Growth in credit to the private sector averaged just 3 per cent y/y in 2017, although it accelerated to ca. 6 per cent in H1 2018. Private sector credit amounts to 55 per cent of GDP, in line with the regional average, implying moderate banking penetration.

Euroization is moderate and largely stable; around 43 per cent of loans and 40 per cent of deposits are denominated in foreign currency. The central bank has been using macroprudential measures effectively to contain further euroisation.

The development of non-banking financial services such as leasing, factoring and insurance is at an early stage, albeit above Western Balkan peers, and **stock market capitalisation is low, at only 5 per cent of GDP.** The SEE Link platform linking regional stock exchanges is now operational although trading is at a low level.

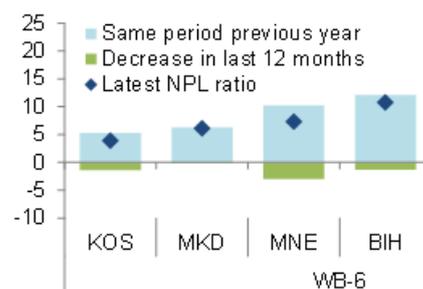
With an aging fleet of thermal and hydro power plants, domestic generation capacity is insufficient to meet peak demand. As the difference is met by imports via HVDC interconnection, the country is vulnerable to price spikes as hydrological conditions are generally correlated regionally. Distribution losses were 14.7 per cent in 2016, haven fallen since the privatisation of the network in 2006.

Ownership of banking sector assets, %



Source: Bankscope.

Non-performing loans, % of total loans



Source: National authorities.

Integrated [ATQ = 6.09]

Overall, North Macedonia has a middling score in the integrated quality, driven by medium gaps in the areas of FDI and portfolio investment openness, and sometimes inadequate quality of domestic and cross-border transport and energy infrastructure. The country is assessed to have a small gap in openness to trade and a negligible gap for the quality of ICT infrastructure.

North Macedonia joined the **World Trade Organization (WTO)** in 2003.

Stabilisation and Association Agreement, which establishes a **free trade arrangement**, between North Macedonia and the **EU** is in place since 2004.

North Macedonia has been an **EU candidate** since 2005; however, the opening of accession talks was delayed by the name dispute with Greece.

North Macedonia is a member of the **free trade arrangement (CEFTA 2006)** with its neighbouring **Western Balkans**

North Macedonia's measure of **trade openness** ((exports + imports)/GDP) is 107 per cent, well above the EBRD average of 92 per cent and close to the EU average (120 per cent). The country has tariff-free access to the EU, as well as to its neighbouring Western Balkans non-EU members under the CEFTA. Further progress is needed, however, in reducing non-tariff barriers.

Foreign direct investment levels are low; the FDI stock per capita is ca. €2,000, compared with an average of ca. €6,000 in EU-11. However, business-friendly policies in recent years have had positive results, attracting

investments in important sectors such as car components.

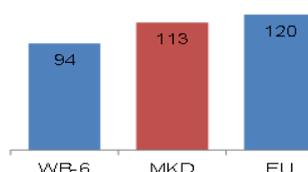
The quality of **transport infrastructure** is ranked in the WEF's GCI as higher on average than in other Western Balkan countries, with the highest score in air transport, and the smallest in the railways sector.

Liberalization in the railway transport and opening of the market for the entry of a new operator(s) has not been implemented yet, and more than ten years have passed since the former Public Enterprise Macedonian Railways (MRT) was divided into two separate independent entities.

Cross-border energy integration is slowly improving. MEPSO, the Macedonian TSO, is currently constructing the Macedonian portion of a 400 kV cross-border electricity interconnection between North Macedonia and Albania, the first interconnection between the two countries. As of January 2017, allocation of interconnection capacities is performed by SEE CAO on the border with Greece. In gas, North Macedonia has signed MoUs with both Greece and Bulgaria to explore the feasibility of developing further interconnectors. The country has also begun a major project of gasification, with the first section completed in August 2016.

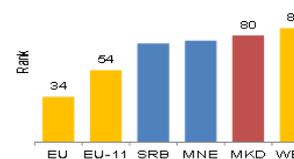
North Macedonia enjoys a relatively high level of **ICT infrastructure** as well as a fully competitive market for retail Internet access services. About 18 per cent of the population have a broadband subscription.

Trade openness, % GDP



Source: IMF's World Economic Outlook; Authors' calculations.

Quality of infrastructure (ranking out of 137 economies)

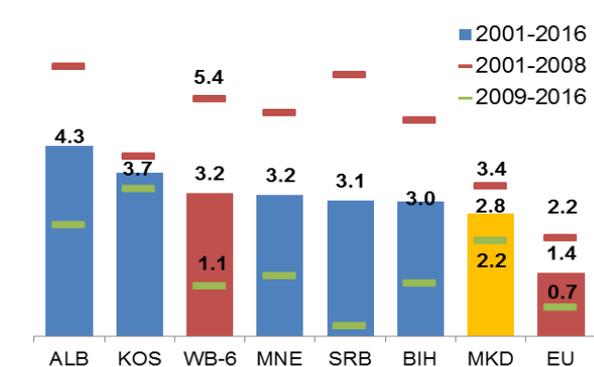


Source: World Economic Forum's Global Competitiveness Index 2016-17.

6. Annex : Macroeconomic performance and outlook

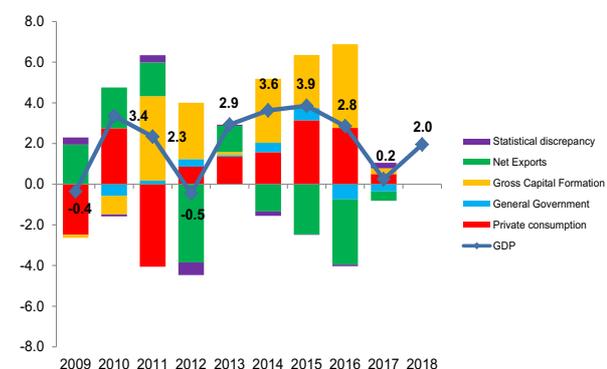
North Macedonia has experienced the lowest GDP growth rate over the past 15 years among its Western Balkan peers. Average economic growth in North Macedonia in the period of 2001 – 2016 was 2.8 per cent, compared to a 1.4 per cent in EU, suggesting that North Macedonia has been catching up only gradually towards EU standards of living. Moreover, the country also experienced the lowest average growth rate in the region over the boom of the pre-crisis 2001-2008 period, of just 3.4 per cent.

Chart 1: GDP growth rates, 2001-2016



Source: IMF World Economic Outlook; authors' calculations.

Chart 2: GDP growth drivers, by expenditure



Source: State Statistical Office of North Macedonia, EBRD Regional Economic Prospects (May 2018), and authors' calculations.

The post-crisis period of 2009-2016 was characterized by a double-dip recession. The first drop in GDP was in 2009, of only 0.4 per cent, following the world financial crisis, and the second of 0.5 per cent in 2012, following the Eurozone debt crisis. Then, the country experienced three relatively good years, with an average growth rate of 3.5 per cent, helped by rising private consumption and public investment.

Growth slowed down to negligible levels in 2017 due mainly to the political crisis. The prolonged political crisis, which started in 2015, but escalated in H1 2017, came to affect the country's economic performance by having a measurable negative impact on confidence and investment. The economy was in recession in the first half of the year but recovered somewhat in H2, leaving growth for the year as a whole at almost zero per cent. The prolonged crisis over a couple of years at one point threatened the stability of the local currency vis-à-vis the euro, and the central bank had to react to currency pressures during 2016 by increasing the policy rate to 4 per cent. However, in February 2017, the central bank cut the rate back to its long-term rate of 3.25 per cent. Further cuts continued in 2018 to the current rate of 2.5 per cent.

Growth is likely to stay moderate in the short term. A recovery started in 2018, helped by political stability and the impact of the rising minimum wage and other social protection measures on private consumption. GDP growth for the year is estimated at 2 per cent. Credit to the economy is expected to rise further as lending conditions ease amid the accommodative monetary policy. A further rise in exports is expected in the short term in light of the strengthening of economic prospects in the EU, the country's key trading partner. As a result, the 2019 forecast for growth is 3 per cent, on the

assumption of continued political stability, the unblocking of further reforms and the arrival of much-needed investments, with a similar or even slightly higher rate in the years to come. However, downside risks remain significant and investor sentiment could deteriorate if political uncertainty were to increase.



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