I. Country and Sector Background

1. The Former Yugoslav Republic of Macedonia (FYR Macedonia) has a consistent track record with regard to macroeconomic management and improving the business climate; yet the country’s good macroeconomic performance and improved business environment have not been sufficient to reduce poverty and long-term unemployment. The country embarked on a major reform program in 2002 that achieved fiscal consolidation, public sector reform, and labor market reforms. Prudent fiscal policies maintained government debt under 40 percent of GDP during the recent years of global financial turmoil. Recent reforms have also led to visible improvements in the business climate, as measured by international rankings. FYR Macedonia was the fifth most improved country among the top 50 economies in the world according to the Doing Business 2013 report, jumping from the 92nd position in 2006 to 25th in 2013, outstripping peer countries in the region. Key reform areas included improving the business registration and construction permitting process, making property registration easier, strengthening investor protection, facilitating access to finance and paying taxes.

2. Poverty and unemployment, however, have not declined, due to slow GDP growth relative to other Western Balkan and new European Union (EU) member states; and to the
uncertain economic environment in the Eurozone. Unemployment, at 29.9 percent in the first quarter of 2013 (State Statistical Office), remains among the highest in Europe, with long-term unemployment and youth unemployment of particular concern.

3. **The challenge facing FYR Macedonia is to transition the economy to a higher growth trajectory by developing more competitive and export-oriented enterprises.** To improve the competitiveness of major export-oriented sectors and jumpstart economic growth and job creation, the government of FYR Macedonia is embarking on a reform program that will make it easier for greenfield investors to locate in FYR Macedonia, strengthen the technological and exporting capabilities of manufacturing companies, stimulate upgrading of agriculture producers, address inefficiencies in key factor markets (land, labor, skills), and facilitate trade.

II. **Operation Objectives**

4. **The proposed Second Programmatic Competitiveness Development Policy Loan (DPL2) to the FYR Macedonia supports the government’s competitiveness development agenda.** This is the second of two DPL operations aimed at strengthening three key export-oriented economic sectors with strong potential for growth and employment—manufacturing, agribusiness, and trade logistics. Building on the reforms supported by the First Programmatic Competitiveness DPL (DPL1), the proposed operation advances the competitiveness agenda in several important ways.

5. **The Project Development Objective of the proposed DPL** is to strengthen the competitiveness of FYR Macedonia’s economy by incentivizing productive investment and technology upgrading in the manufacturing, agribusiness and trade logistics sectors, and establishing enabling conditions to progressively increase labor market flexibility and innovation capacity. The policy actions are expected to have positive poverty and social impacts by increasing total employment, and in some cases increasing the returns to employment.

III. **Rationale for Bank Involvement**

6. **The proposed operation will address aforementioned challenges by supporting reforms that incentivize investment and technology upgrading in the manufacturing, agribusiness, and trade logistics sectors.** Specific actions will be aimed at removing bottlenecks to the growth of exports in these sectors, and create an enabling environment for agricultural modernization and for private sector entry and technology transfer from foreign direct investments. The importance of these sectors and their dense linkages with the rest of the economy will ensure that the reforms have an economy-wide impact on poverty and unemployment.

7. **The crosscutting policy actions under DPL2 will lay the groundwork for increased labor market flexibility and innovation capacity in the key productive sectors.** Improving the efficiency of the labor market is essential to the competitiveness of FYR Macedonia’s economy, and is necessary to resolve the problem of long-term unemployment. The reforms will strengthen incentives for workers to participate in the formal labor market, which is characterized by a low participation rate by regional and European standards; and will also make it easier for employers to recruit seasonal workers. The DPL program will also support
comprehensive reforms in the innovation support framework to stimulate private R&D and technology transfer.

8. **The proposed operation is in line with the CPS (Country Partnership Strategy 2011-2014)** objective of achieving faster, greener and more inclusive growth, and will directly contribute to achieving many of the key goals of the Competitiveness, Inclusive Growth, and Green Growth pillars. Specifically, the DPL2 will support:

- the Competitiveness pillar goals of (a) increasing financing and investment in sectors where FYR Macedonia could become competitive; (b) establishing the legal framework for land privatization; and (c) lowering transport and freight costs by improving customs procedures and border crossing facilities.
- the Inclusive Growth pillar goal of improving employability by reducing impediments to hiring; and
- the Green Growth pillar goal of aligning agriculture sector and agricultural exports with EU requirements.

9. The operation will also contribute to deepening competitiveness reforms, one of the main strategic priorities in the 2012 Europe and Central Asia (ECA) Regional Strategy of the World Bank.

IV. **Tentative financing**

<table>
<thead>
<tr>
<th>Source:</th>
<th>($m.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borrower</td>
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<tr>
<td>International Bank for Reconstruction and Development</td>
<td>50</td>
</tr>
<tr>
<td>Borrower/Recipient</td>
<td></td>
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<tr>
<td>Others (specify)</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>50</strong></td>
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V. **Institutional and Implementation Arrangements**

10. **The Ministry of Finance will be responsible for overall implementation of the proposed operation and for coordinating actions among other concerned ministries and agencies.** Other agencies involved include the Cabinet of the Deputy Prime Minister of Economic Affairs, the Ministry of Economy, the Ministry of Agriculture, Forestry and Water Economy, the Ministry of Education and Science, the Ministry of Labor and Social Policy, the Ministry of Transport and Communications, the State Inspectorates responsible for inspections at the border, InvestMacedonia and the Directorate of Technological Industrial Development Zones. The monitoring and evaluation capacity is generally deemed adequate, and is being reinforced through several of the DPL policy actions.

11. **At the same time, the overall status of the program will be monitored during supervision to determine whether the specific conditions of the proposed operation have changed.** The Bank will monitor actions and review progress of the implementation of the proposed operation, as well as the subsequent operations through frequent visits to the country and constant communication with authorities. Implementation Status Reports (ISRs) will be prepared to assess compliance of the authorities with contractual undertakings under the program.
and the loan agreement. An Implementation Completion Report (ICR) will be completed within six months of the closing date of the DPL series.

VI. Risks and Risk Mitigation

12. The overall risk rating level of the proposed DPL is moderate.

13. Political risks are moderate. The program of structural reforms to be supported by the proposed DPL has strong ownership within the Government, as demonstrated by the recent adoption of laws, strategies, and action plans that map out concrete steps to be taken over until 2015. More broadly, the Government and the opposition have signed the Report of the special Commission formed to investigate the December 2012 incidents in the Macedonian parliament; and steps have been taken to improve relations with Bulgaria and Greece.

14. Governance risks are moderate. As the initiative to establish special economic zones (Technology Industrial Development Zones, TIDZ) matures, good corporate governance will become more important. The inclusion of private sector representation on the Managing Board has created checks and balances in how the zones are administered. A stronger monitoring framework is needed to ensure that recipients of aid incentives remain in compliance with national legislation, which establishes ceilings for aid intensity that are aligned with the EU State Aid rules. The DPL actions and results indicators will serve as mitigating measures for these governance risks.

15. Macroeconomic risks are moderate. While growth is expected to recover in the medium term, downside risks remain significant. The uncertain external environment in the Eurozone affected FYR Macedonia’s exports and weighed heavily on the business environment. Real GDP growth is expected to be 2.5 percent in 2013 but is forecast to accelerate to 3 and 3.5 percent in 2014 and 2015, supported by a public investment program and strong export growth. The fiscal deficit is projected to decline gradually as the economy recovers and the government implements measures of fiscal consolidation. Central government debt is projected to stabilize over the medium term as a share of GDP, while public debt is projected to increase. Debt burden indicators will significantly improve if key economic variables assume their historical values; but will significantly deteriorate in the event of further shocks. External economic risks are somewhat mitigated by buffers currently in place, including a solid reserve coverage. The IMF continues to endorse the Government’s macroeconomic policies. The proposed Competitiveness DPL is supporting structural reforms to boost competitiveness and sustain FDI inflows, which will support the medium-term outlook.

16. Operational design, implementation and sustainability vary from low to substantial depending on the prior action. Implementation of the proposed DPL program will strain the capacity of some public sector institutions. The major capacity risk lies with the Ministry of Agriculture, Forestry and Water Economy, which needs to implement the multi-annual Program for Development of Agriculture and Rural Development adopted in 2012; and initiate the privatization program for state-owned agricultural land. The implementation risks are mitigated by technical assistance provided through the Bank’s Competitive Industries and Innovation Policy Support Program.
17. **Environmental and social risks are low.** The proposed operation has been screened against OP 8.60, Environmental, Forest and Natural Resources Aspects. No direct negative impacts are expected. However, some policy actions could have indirect impacts, for which mitigation measures are in place. Continued high unemployment may directly affect the social balance in the country, provoke social tensions, and undermine support for the reform program. The proposed program is focused on strengthening the labor market, and supports interventions in social protection and skills development with the aim of translating economic growth and the recent increases in labor participation into more and better jobs for all Macedonians.

**VII. Poverty and Social Impacts and Environment Aspects**

18. **Overall, the policies supported under the DPL series are expected to have neutral or positive poverty and social impacts, predominantly by increasing total employment and in some cases increasing the returns to employment.** A detailed Poverty and Social Impact Assessment (PSIA) has been undertaken with a focus on the distributional impacts and potential risks of the policies in the agribusiness pillar (Pillar 2).

19. **The reform of agricultural support supported in DPL1 is expected to have neutral or positive poverty and social impacts**, although there is a possibility of negative impacts on small/low-income farmers in the medium or long term. Since the Government’s new reform programs have been introduced recently, distributional impacts of higher compliance are still difficult to gauge. However, as Macedonia moves towards EU accession, and standardization and enforcement become more advanced, small farmers may not be equipped to adapt to these policies. The PSIA analysis suggests small farmers could face barriers to applying and qualifying for rural development support, which include access to finance (found to be the most important perceived barrier), lack of advisory support, legal issues, long processing times and limited incentives to invest and modernize.

20. **The reforms aimed at strengthening the land policy and invigorating the agricultural land market in FYR Macedonia are expected to have positive social impacts** in the form of increased opportunities for competitive land sales, a more dynamic land market, and access to finance for land owners. A number of assessments of the agriculture sector in FYR Macedonia carried out to date have identified the excessive division of privately owned land as the major structural deficiency that hampers sector competitiveness. The gradual privatization of state-owned land, combined with land consolidation initiatives, is likely to bolster market participation and underpin the privately owned land rental markets. Further PSIA considerations will be included following appraisal.

21. **Reforms aimed at improving incentives for formal work under Pillar 4 are expected to have positive poverty and social impacts.** The legislative framework that facilitates seasonal employment contracting is expected to increase demand for seasonal labor by reducing hiring costs for employers of seasonal workers, while at the same time improving conditions and benefits for seasonal workers. The introduction of income disregards for social assistance beneficiaries is also expected to have positive poverty impacts, as it will increase incentives to formal employment for low-wage earners and thus potentially also improving their benefits and work conditions. The effect of this reform is generally more pronounced for households’ “second earners”, who are usually women.
22. The gender dimension is being mainstreamed into the PSIA so that policymakers and the team can better articulate gender-specific responses and monitor the gender effectives of the reforms. The supported reforms directly address several of the key issues raised in the recently completed Country Gender Assessment.

Environment Aspects

23. As with DPL1, none of the policy reforms to be supported by DPL2 are expected to result in significant direct negative environmental impacts, and most reforms will continue to have to have a neutral or positive environmental impact. However, for policy actions that could have an indirect impact on the environment, mitigation measures are in place: (a) investments in existing Technological Industrial Development Zone (TIDZs), and the development of new zones, could increase pressure on the environment. Potential impacts will be mitigated through higher environmental standards in the zones and oversight of the activities in the TIDZs by state authorities; (b) the new National Program for Agriculture and Rural Development is intended to accelerate the growth of agriculture production, which could lead to increased use of fertilizers to increase the intensity of cropping. This risk will be mitigated by promoting compliance with the CGAP; (c) in addition to capacity building and training, potential environmental impacts will continue to be mitigated, as they were under DPL1, by the quality of the institutional and legal framework.

24. FYR Macedonia is making sustained progress in aligning its legislation with the EU’s environmental acquis and to effectively implement and enforce EU environment standards in the medium term.

VIII. Contact point

World Bank
Contact: John Gabriel Goddard
Title: Senior Economist
Tel: (202) 458-8623
Fax: 2024583687
Email: jgoddard@worldbank.org

Borrower
Contact: Ms. Dejan Nikolovski
Title: Head of International Financial Relations and Debt Management Department at the Ministry of Finance, Macedonia, former Yugoslav Republic of
Tel: (389-2) 311-7288 Fax: (389-2) 311-7280
Email: dejan.nikolovski@finance.gov.mk

IX. For more information contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop