FYR MACEDONIA: Country Assistance Strategy Progress Report

1. The Macedonia CAS Progress Report proposes an ambitious strategy for the final year of the current CAS. We understand that this is based on the Macedonian Government’s new commitment to reform, which took hold beginning in January. There are some accomplishments already, notably the recently adopted budget legislation, and we look forward to further results. We hope that the government is able to maintain this commitment, and to work closely with the Bank and the Fund to implement vital structural and other reforms for sustainable macroeconomic growth and stability.

Program for Remaining CAS Period

2. The three priority areas identified in the 1998 CAS seem to us to remain the right focus: promoting private sector growth and job creation, enhancing the state’s efficiency, and alleviating poverty and developing human capital. We support the proposed graduation from IDA at the end of FY01.

3. The Progress Report paints a somewhat troubling picture of a program where implementation did not match commitments. Missing 1998 ESAF targets and going off-track in early 1999 added to the economic setback from the Kosovo crisis. The description in Paragraph 28 and in the JPPR box (page 12) of portfolio performance suggests a need to proceed very cautiously with structural adjustment lending in view of "institutional and other absorptive capacity constraints for both investment and adjustment lending". We were pleased to learn from Bank staff that since this was drafted, problems have been resolved in the project rated as unsatisfactory, and there are clear signs of improvement in other areas. However, it would be useful to undertake a CPAR, especially in view of the procurement problems mentioned in paragraph 22, and we believe it crucial to put in place as rapidly as possible budgetary and auditing mechanisms to ensure that Bank funds are used for the intended purposes.
4. We commend the Macedonian Government for the strong interest shown in recent months in getting IFI relations back on track. Given the poor record on project implementation and the history of delays in enacting structural reforms, however, we agree with Staff that there should be a credible set of tough prior conditions for adjustment lending, followed up by strong program monitoring. Recent developments on the newly adopted pension law, where policy differences were inaccurately ascribed to a Bank/Fund divide, were a step in the wrong direction. We would encourage the Macedonian Government to cooperate with the Bank and the Fund to rectify any remaining issues relating to implementation of this law.

5. The progress report sets a wide gap between the high-case and low-case scenarios. The low-case scenario, where little is enacted in the way of structural reforms, presents a picture of low growth but macroeconomic stability that is possibly more optimistic than experience suggests. Such reforms would support continuation of the stability Macedonia has enjoyed. We note the supporting linkages between the structural reforms anticipated in an IMF program and the Bank’s proposed adjustment lending.

6. Private sector development will be vital for reducing unemployment and ensuring sustainable growth. A healthy, well-functioning financial sector is also important. The Fund’s Article IV review last month presented a sobering picture of the Macedonian banking sector. Macedonian authorities have barely begun to address the problems in the sector apart from Stopanska. While no other bank is large enough to pose a systemic risk, the failure of several banks at once could have a damaging impact on the banking system. We welcome the Bank’s intention under the forthcoming FESAL/C II to help strengthen the health of the banking sector and improve financial intermediation, including supporting the authorities as they move forward with restructuring remaining problem banks. For this, we urge an aggressive timetable. It will be important for improving the FDI enabling environment, as the high level of non-performing loans is a leading cause of Macedonia’s very high interest rates. Privatization is also crucial to creating the right environment for private enterprise growth, and for achieving more efficient allocation of public expenditures. Paragraphs 16 & 17 refer to "bold steps" in this area, but the cited examples of steps taken seem rather modest. Could staff give more concrete examples of what has been achieved?

7. The IFC and MIGA work in conjunction with the CAS seems to us to be on the right track. In particular, we urge that the Government implement the suggestions in MIGA’s investment promotion needs assessment.

8. We concur with the statement that social cohesion is another key to sustainable development, noting that “equal access to services and economic and social opportunities to all fYR Macedonian citizens is also an important challenge”. Macedonia has demonstrated some success in addressing interethnic tensions – despite the burden and potentially explosive impact of the large number of Kosovar refugees in 1999 – but it will need to support greater economic opportunity for all social groups to foster the political support for ongoing reforms. Better governance, which will be promoted through the PSMAL/II, could help put in place a virtuous cycle by encouraging movement from the informal to the formal economy, leading to increased revenues to support essential services.
9. We are also pleased to learn that the World Bank is sponsoring an Anti-Corruption Survey as part of the CAS (even in a low-case scenario), that will be carried out with USAID assistance by end-2000, and that a PEIR is in the works. Strengthening public trust in government and other institutions will be important to minimizing further erosion of the social fabric. The upcoming TTFSE project will also help to strengthen border enforcement and reduce the threat illicit trafficking poses to the social fabric.

10. It is extremely important that the GOM work to develop a strategy on the State’s role, and we concur with the high priority designation. The government will need to carefully allocate its expenditures to support the reform process (e.g., privatization) and the social support network for the poor. We understand from Staff that this should be completed by end-2000.

11. In the May Article IV report, the IMF noted the need for increased labor flexibility to reduce unemployment. The Bank also has been engaged on this front and has helped to push for needed legislation. The Bank and the Macedonian authorities should continue to address the issue of high unemployment and labor market distortions through the PRSP process and should include labor representatives in the participatory process. We would have liked analysis of core labor standards in this report, in keeping with IDA-12 commitments. We encourage the authorities and staff to consult with the ILO on labor market issues to ensure that changes in policy are implemented in a way that does not undermine key rights, such as the right of association and right to collective bargaining. Has staff discussed these issues with the ILO?

12. With respect to health issues, paragraph 24 emphasizes the difficulty of treating largely preventable or treatable disease. We recognize the difficulties entailed in developing more effective and efficient interventions. But we are glad that the 1996 project has been restructured ($12 million still undisbursed), and that water supply is on the Bank agenda. The Bank should also remain alert to opportunities for expanding efforts in the health area. Has there been any collaboration with UN agencies or NGOs?

**Interim PRSP**

12. We welcome the anticipated Interim PRSP, on which we understand the Macedonian Government is very much engaged. Even though Macedonia is a prospective IDA graduate, this seems to us a useful initiative, particularly in view of difficult relations between ethnic groups. Implementation of needed reforms must maintain pace during this process.

13. We look forward to the inclusion of the following elements in the Interim PRSP:
   -- Evidence that a participatory process has been initiated, with a detailed plan/timeline for future consultation and a description of what sectors of society are to be involved;
   -- Details on plans for finalizing the PRSPs, including clear institutional arrangements;
   -- Identification of key engines of growth to achieve macro and poverty targets;
   -- Preliminary monitorable indicators in priority areas;
   -- Demonstrated link between I-PRSP and the CAS.

14. As the PRSP/PRGF processes proceed, the rest of the international community must work with the Macedonian authorities to ensure that assistance to Macedonia – whether through
the EBRD, EU, Stability Pact, or bilaterally – is consistent and coordinated with the PRSP/PRGF.