Investments in Macedonia

Strong investment growth, fuelled by public infrastructure projects and FDI (foreign direct investment) boosted domestic demand in 2014, which is expected to remain the only growth driver in 2015 and 2016. In spite of solid increases in merchandise exports, the foreign balance likely proves a drag on GDP growth, as investment-related import growth decelerates only slightly. The government relaxed its fiscal consolidation path, with targeted budget deficits declining less rapidly than originally planned. While the rise in government debt is moderate, financing needs of state-owned enterprises weighing heavily on the public debt level.

Domestic demand backs acceleration of output growth in 2014 and beyond

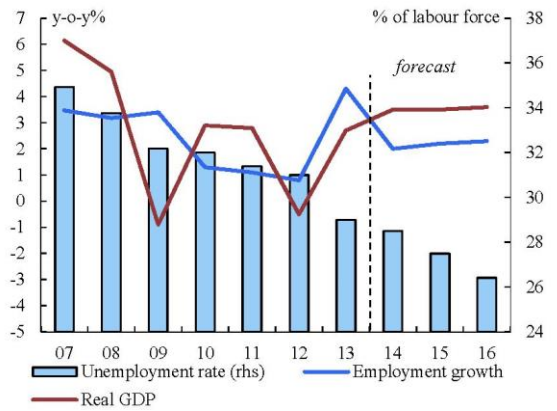
With strengthening domestic demand, growth became more balanced in 2014, as a significant surge in gross fixed capital formation supplemented a strong increase in merchandise exports. In the third quarter, output increased by 4.1% y-o-y in real terms, only slightly below the speed of the preceding three months. The surge in investment was carried by public infrastructure spending and by an expansion of FDI-related production capacities. A sizeable increase in imports, however, spurred by the investment boom, is likely to have led to a negative contribution of net exports to growth in 2014 - a marked difference from the preceding year, when net exports were the sole growth driver. While construction activity remained subdued, the manufacturing sector benefited from the strong export demand. Its output increased by some 10% y-o-y in the first eleven months of 2014.

The sizeable commitments for road and rail projects foreseen in the government's mid-term fiscal strategy are likely to further bolster investment growth, even though increases in overall gross fixed capital formation are expected to decline somewhat, mainly on account of the completion of ongoing FDI capacity extensions, and uncertain prospects of new projects in the pipeline. Household spending may well increase its contribution to domestic demand growth gradually over the forecast horizon, supported by steady rises in net wages - which returned to positive growth in spring 2014 - a benign price environment, further strengthening credit extension, and stable private transfers.

External balance remains a drag on growth

Export activity was surprisingly impressive in the first ten months of 2014, though heavily overcompensated by investment-related import growth in both, goods and services. Merchandise exports are expected to post significant growth rates also in 2015 and 2016, with new FDI production lines being exploited, and will continue to provide the biggest contribution to GDP growth, with the main downside risk stemming from fledgling external demand. Strong investment-related, and, gradually, also consumption-related import growth is likely to lead to a slight deterioration in the current account, even though private transfers are expected to remain stable.

External debt rose significantly during the third quarter, mainly on account of the government's 500mn Eurobond launch in July, and, to a lesser extent, disbursement of a World Bank loan in August. Their level diminished since, as the government started repaying IMF loans. Even with sizeable repayments scheduled in 2015, reserves are likely to remain adequate, bolstered by an expected revitalization of FDI inflows, and stable private transfer income.



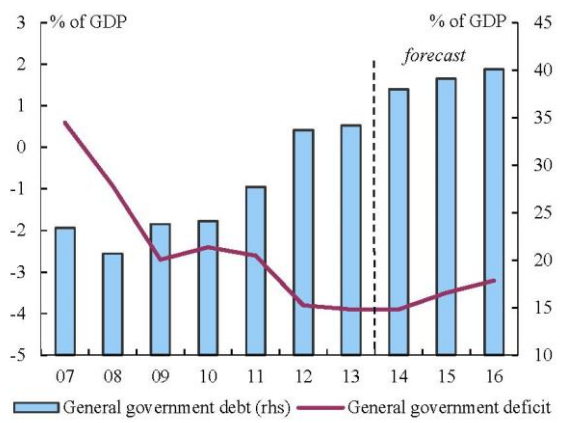
Graph 1: Republic of Macedonia - Labour market

Manufacturing carries Employment gains

Labour Force Survey figures for the third quarter bolstered expectations, that there was further improvement in the labour market in 2014, in annual terms, with additional employment gains, and a decline in the headline unemployment rate. Job creation was particularly strong in manufacturing, reflecting demand from public infrastructure projects and from export industries. In the same period, there was virtually no improvement in the high unemployment rate for young workers, as structural problems of the labour market persist. Further overall improvement is expected over the next two years, as domestic demand is strengthening, and export production in the FDI sector would remain robust.

Fiscal consolidation based on Revenue growth

Government revenue picked up strongly in the second half of 2014, reflecting a sizeable increase in both, direct taxes and VAT. However, given an unexpectedly strong surge in transfer payments in the fourth quarter, this is unlikely to have prevented an overshooting of the target for the general government deficit, which had been revised upwards by 0.2 pp, to 3.7% of GDP in the summer. The new medium-term fiscal strategy, adopted in autumn 2014, relaxed the deficit targets for 2015 and 2016 compared to the previous strategy, with consolidation based on faster growth of revenues than of expenditure. Given that the government has not yet laid out concrete consolidation measures on the expenditure side, keeping the deficit targets may prove a challenge.



Graph 2: Republic of Macedonia - Public

Debt Levels will remain elevated

While the rise in central government debt is likely to remain contained, state enterprises, in particular the Public Enterprise for State Roads, through which the government manages most of its road infrastructure spending, will require significant financing in 2015 and 2016. Hence, overall public sector debt is expected to increase to well over 50% of GDP over the forecast horizon.