

**FISCAL POLICY AND ASSESSING FISCAL SUSTAINABILITY IN
MACEDONIA**

by

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Background¹

After finishing University, I started working at Bearing Point- Fiscal Reform Project. This was my first job, and as for that I found it quite interesting. My job title was an intern in this project and a consultant for the Ministry of Finance. My job description was to be involved in all the current assignments and until the project finishes, I was supposed to write a paper in which I will put all my previous knowledge and stuff that I have learned while working on this project.

The usual current working included contacts with different people and organizations like, State Statistical Office, Ministry of Finance, Ministry of Economy and other non-government organizations, imputing data and working with those data. The data that I worked with was mostly about the net wages, production volume indices by activity, indices of final product stocks, indices of employees etc. Many commentaries and statements that were concluded during the processing of data were found useful among the above mentioned organizations.

The paper I am assigned to write has a fiscal issue. It is about the Fiscal Sustainability and assessing one in Macedonia. It is contemporary topic and has number of points from which it can be viewed. Even though it is difficult to embrace all the aspects of this challenging matter, I will try my best for the reader to understand the problems of fiscal sustainability of one national economy.

There are few points that should be stressed, why this paper might be useful:

- To spread the writer's knowledge
- To spread the reader's knowledge
- To give incentive for further similar writings
- To find internal and external use, if possible

¹ The sustainability model used in this paper was developed by John Anderason. See [6].

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2 Revised Code of Good Practices on Fiscal Transparency

3 International Monetary Fund, 2002. Macedonia Staff Report, Article IV

Introduction

As one of the most exposed problems in the economy is how should the theory of the macroeconomic policy such as monetary and fiscal policies be implemented. Their implementation is highly sensitive, so the national governments should be very careful, when bringing out the official fiscal policies into the country.

Nowadays, the term fiscal sustainability is widely known and the practice is welcomed in all the countries that want a stable, healthy and long-term growth in the national economy. Various issues can be considered while revising the implementation of the fiscal sustainability. Some of them are difficult to achieve, but with proper fiscal discipline, the task should not be as difficult as it seems.

This paper is about the fiscal policy and sustainability in developed countries and comparison with the fiscal policy and sustainability in Macedonia. It contains four parts in which different aspects of the fiscal economy are considered.

The first one is about the fiscal policy in general and the recent situation of the fiscal policy in Macedonia, its place among fiscal policies of developed countries and what are the differences and the aspects of those differences.

The second part is about the fiscal sustainability, what does it mean, how can we achieve it, what are the indicators that show us the path of the sustainability. In the second part of the paper the auto debt dynamics is also shown (IMF methodology), there are few simulations considered about the movement of the debt when certain elements are given (example: previous debt, interest rate, real GDP growth rate, GDP deflator etc.). The goal is to clear the understanding of how the fiscal sustainability assessment methodology works. The recent situation in Macedonia is presented and medium-term IMF forecasts are discussed.

The third part is about improving fiscal discipline in Macedonia. There will be one section where the fiscal discipline in EU is comprehended and a comparison with the situation in Macedonia will be made.

At the end of the third part IMF suggestions are given to improve fiscal policy and sustainability in Macedonia. Finally, we conclude.

1. Fiscal Policy

1.1 Basics of fiscal policy

Fiscal policy represents a part of the macro economical policy of one country. It is a macro economical instrument. The instruments are economical variables whose values and changes can control the bearers of the macro economical policies, such bearer is the government of the state. The fiscal policy functions combined with other policies (instruments) and its measures and targets are combined with the measures and targets of the monetary policy, the policy of balance of payments, price policy, investments, employment etc.

The two basic instruments of the fiscal policy are the public expenditures and revenues. Fiscal policy is a way of use of these taxes and expenditures of the country for achieving certain economical and social targets. Public expenditures are used usually for the administration, the army, health care, and education, and for the infrastructure of national economy.

The public expenditures represent important part of the total spending of the country (OECD public spending is 40% of GDP).

The public revenues represent the income from the taxes, customs and other public revenues paid by the individuals and the firms. The revenue influence is very important for the economical activities, considering their quantity as a percentage of the national product (OECD public revenues 40,5% of GDP, Macedonia 42,7% of GDP).

The fiscal policy with the help of the tax rates influences income, aggregate demand and macro economical balance. The height of the tax rates influences motivation of the firms for further investments, the taxes on the personal income influence the rate of employment. All of this can inflect on the total supply and long term rate of economic growth.

Fiscal policy has been associated with the economic theories of John Maynard Keynes and that is why the fiscal policy is called the traditional Keynesian analysis. Keynes said that the government had to increase aggregate demand; he believed that wages and prices were going downward and the thesis of the economy moving toward full employment was inaccurate.

From all of this we can see the main targets of the fiscal policy and those are: achieving economic growth and at the same time high rate of employment and stable

prices. Every national economy has its own budget that represents a one-year plan of the country's expenditures and revenues. The budget can have three different conditions; it can have deficit, surplus or it can be in balance.

The budget has a balance sheet form. From one side of the sheet stand the revenues provided by the taxes and customs and on the other side are the expenditures used for buying goods and services for the following year, settlements for unemployed, transfer payments (social services) etc. If the public revenues are totally covered with the public expenditures then we can say that we have balance in the budget, if the public expenditures are higher than the revenues we can say that we have deficit in the budget and the other way around (revenues > expenditures) we have surplus in the budget.

1.2. Fiscal policy in Macedonia

Fiscal policy in the Republic of Macedonia has always been targeted towards the economy that will provide medium and long-term sustainability. This is because of the so long wanted stabilization of the government public debt according to the international terms of how much the debt should be, as set arbitrarily by the IMF as (40% of GNP). That's why the government has to set off the kind of policy that will be restrictive and strengthening.

The basic targets for Macedonian fiscal policy will be:

- Increase of central budget revenues, as a result of improved collection of taxes
- Increase of central budget expenditures, as a result of the administrative reforms and strengthening the components of the budget.

The tax policy in Macedonia has constant position regarding the level of tax rates and total tax burden of taxpayer. The tax policy has to face the risk of reduction of tax revenues which will result from the termination of excise on import of cars and from the reduction of the customs rates for certain products pursuant to the accession of the Macedonia into WTO and the Stabilization And Association Agreement with EU.

The revenues, which have to be lowered, part of them has to be compensated by the economic activity of the country, improved tax collection, strengthening the

public revenue administration etc. There has to be efficient law enforcement of the Fiscal Laws.

The budget expenditure policy has to be directed towards creating conditions for reduction and change of the structure of total budget expenditures, promotion of the planning process and increased efficiency. In order to improve the structure of public expenditures there has to be a rationalization of the public administration, by creating small and efficient eligible parts. There have to be reforms in the pension and health system. The issuance of the short-term government bonds will be used as an instrument for financing the budget deficit.

The efforts for larger savings by the government sector are complemented with the policy for efficient and responsible public debt management; they are directed towards achieving sustainable level of indebtedness and stabilization of the net debt of the central government.

Together with the Public Debt Management Strategy, the Government will have to apply selective policy of government borrowing. The strengthening of mechanisms for public debt management means:

- Strengthening of the legal and institutional framework
- Assessment of the financial condition of borrowing depending on the fiscal capacity
- Assessment of the justification of the borrowing, given the purpose for which they are used
- Adoption of annual plans for the amount of funds from foreign sources that could be invested in separate sectors in the economy by the Government of Macedonia

There has got to be a limit to new borrowings from abroad and at the same time we have to service the due liabilities towards foreign creditors on regular basis, in order to gain additional confidence by foreign investors.

The effective public debt management imposes the need for development of efficient market of debt instruments i.e. development of the primary and secondary securities market. This should allow more efficient financing of budget needs on short term and on long term. At the beginning the efforts should be focused on developing the short-term government securities market to the end of more efficient budget

liquidity management, the maturity of which will be extended depending on the success of the country in gaining confidence of potential investors and development of institutional investors. The realization of this objective will enable market financing of the budget deficit in domestic currency while reducing the macroeconomic risk related to foreign financing.

2. Fiscal sustainability

2.1 On Fiscal Sustainability

Fiscal sustainability is an important long-run requirement for any government regime. Assessment of the sustainability of a current fiscal program is necessary and essential part of fiscal analysis. The assessment can reveal whether the current and anticipated program can be sustained over a long-term horizon, assuring the viability of the government's program. Fiscal sustainability analysis should be a regular and routine aspect of the fiscal analysis carried out by the Ministry of Finance in conjunction with the government.

The practice of the government about the fiscal policy contains a pattern of revenue collection and expenditures for goods and services over a period of time. Whether that program is sustainable or not depends on the relation between the revenues and expenditures. The notion of fiscal sustainability embraced in the Maastricht Treaty links fiscal variables and national income, with the public finances being regarded as sustainable when the General Government deficit-to-GDP ratio is below 3 per cent and the General Government debt-to-GDP ratio is below 60 per cent.

According to IMF, fiscal policies of a government are said to be unsustainable if they buildup a debt that will be on a constant change of the current policy, opposite of this definition there is a sustainable debt, where the government can continue to pursue its set of budgetary policies without endangering its solvency. Debt sustainability is a situation where the borrower continues to service its own debts and consequently not to count with unreal high future corrections of income and expenditure balance.

One question is always being asked: Why is assessment of sustainability needed? The answer is simple; we need to assess fiscal sustainability because of several things:

- In case of middle indebted countries- to consider potentially weak points;
- In case of countries with debt crisis- to formulate efficient stabilization programs;
- In case of countries not capable to return their debt- to consider alternative ways for reprogramming the debt.

The excessive debt is hard to calculate, the only one common approach is to rely that the debt ratio cannot rise or cannot exceed a specific limit. But this approach can provide a little guidance as to whether a particular debt ratio is a threat to macroeconomic stability, could lead to a loss of fiscal policy credibility, result in interest rate premium, etc. That is why; assessments of fiscal sustainability have to be made on a country specific basis.

At a technical level, assessments of fiscal sustainability involve decomposing the change in the debt ratio into components reflecting the primary balance (balance, excluding interest payments), the interest rate on debt, the growth rate of the economy and the initial debt stock. From a policy perspective, attention is focused on the change in the primary balance required to meet a debt target or to stay under a debt ceiling over a specified time period. This provides an indicator of the fiscal adjustment required for sustainability. More relevant for policymaker is the discretionary adjustment that has to be made, so it is important in the short to medium term that likely cyclical movements in fiscal aggregates are distinguished from necessary structural changes.

2.2 Assessing fiscal sustainability

The relationship between the government debt and the fiscal deficit is described by the following equation⁴:

$$B_t = B_{t-1} + r * B_{t-1} + X_t$$

where,

B- government debt

r- interest rate

X- primary deficit

t- time period

⁴ See Maxwell Fry, Chapter 2, "Emancipating the banking System and Developing Markets for Government Debt", 1997, Routledge, London.

If we want to express in terms of GDP ratio, the government debt will be:

$$db/dt = x + (r-g) b$$

where,

b- ratio of the government debt to GDP

x- ratio of primary deficit to GDP

g- growth rate

If we want the ratio of the government debt to stay constant, db/dt has to be constant. That is why, for the condition to maintain steady state of the debt to GDP ratio is written as:

$$x = (g-r) b$$

This equation is the core of the analytical framework. It shows that when the interest rate on the government debt r is higher than the GDP growth rate (g), the primary deficit should be negative. Thus the government should have a primary surplus, if the ratio of the government's debt to GDP (b) should stay constant. Otherwise, the ratio of the government's debt to GDP will continue to rise, leading to fiscal bankruptcy.

According to the all above, the fiscal policy need to avoid this situation and has to reduce government expenditure and increase tax revenue. All of this is possible in theory, but there will be some difficulties if we want to have that in practice. The question is: How are the developing countries managing to avoid fiscal bankruptcy? In many developing countries, the governments tend to choose the following options: the first one is to accelerate inflation, by taxation on the people's money holdings in the form of inflation, the second one is to lower the real interest rates by means of financial repression. This amounts to a reduction in the borrowing cost of the government or fiscal deficit. These policy options will lead to misallocation of resources, higher inflation and deterioration of the exchange rates, and on the long run the economy can lead to disastrous situation.

There is no doubt that economic growth is the basis necessary to restore fiscal sustainability. From the equation about the primary deficit to GDP, the higher growth rate over the real interest rate is the key to the determination of the permitted level of the primary balance. The growth helps reduce the ratio of debts to GDP by increasing the denominator without reducing the nominal amount of government debts. The

increase of GDP can provide a growing pool of resources to finance debt services and other government expenditures. Larger primary surplus, leads to the reduction of the government burden. The economic growth is the only way to maintain a high level of primary surplus without sacrificing the government's expenditure for development.

2.3 Fiscal sustainability indicators

Assessment of fiscal sustainability has one very important dimension as indicator of public debt. One standard part while assessing fiscal sustainability is the variety of measures of the fiscal deficit and public sector debt, as well as ratios such as debt-to-GDP ratio. The debt-stabilizing primary fiscal surplus is often used to assess current fiscal policy by judging whether the existing fiscal surplus is consistent with a stable debt-to-GDP ratio, or to indicate how much effort is required to achieve stable debt ratio. In using this indicator it is important to take account of differences in countries' ability to achieve high primary surpluses, both on technical grounds of political and social feasibility.

The usefulness of any fiscal indicators depends on the appropriate coverage of the public sector. For sustainability analysis, the fiscal framework should include all parts of the public sector that can accumulate debt including public enterprises, especially to the extent that their income and debt reflect mostly noncommercial obligations. Then the public debt will be discreet and a country's debt may look sustainable when it is not. This issue has become particularly important since more open capital markets have made public debt more likely to be contracted by sub national governments or public enterprises.

In the following section I will describe three different approaches for measuring fiscal sustainability. These approaches use various indicators to show us where the fiscal policy of one national economy is going and how far its fiscal policy departs from sustainability. All of these indicators, which will be shown further in this part of the paper, do not have typical definition of sustainability. Instead they rely on more intuitive notion of what distinguishes sustainable from unsustainable fiscal policy.

2.3.1 Government's inter-temporal and present value budget constraint

Both of these approaches represent a benchmark against which solvency of ones national fiscal policy is determined. The inter-temporal budget constraint is an indicator that shows us the constraint in budgetary means over time. The present value

budget constraint is the calculated current value of government's constraint over the expenditures. The government must satisfy both an inter-temporal budget constraint and, in every period, a static budget constraint. The static budget constraint is explained by this formula⁵:

$$B_{t+1} = R_t * B_t + D_t$$

where,

B_t - beginning period stock of government debt

$R_t = 1 + r_t$ the discount factor applying between periods t and $t+1$

D_t - the primary fiscal deficit

What is the most important to know about the PVBC is probably that it does not rule out large primary deficits or high debt, just as long as the future primary surpluses required to respect the PVBC are a viable policy option. The restrictive condition given by the government simply constrains the debt to grow no faster than the interest rate. If there are prolonged periods when the interest rate is high, the debt grow faster than the economy and there is a possibility to have vast ratio of debt an output to one's national economy, which can lead to greater economical problems.

The PVBC has other implications too. While permanent primary deficits are inconsistent with the PVBC, permanent overall deficits may be sustainable. This can be shown in a country where is kept a small surplus every period of time just to cover a part of the debt which is made from the interest of the debt. There will be an overall deficit in every period, but the debt will grow less than the interest rate and it will be considered sustainable.

Sustainability judgments based on the PVBC are made without reference to any economic variables except the stock of government debt, projected primary surpluses and deficits, and the interest rate on government debt.

2.3.2 Accounting approach

Second of these approaches is the accounting approach and here economic indicators as a percent of GDP are used to assess fiscal sustainability. In this approach pre-defined macroeconomic targets are specified for the rate of inflation, the real growth rate and the interest rate.

⁵ See Nigel Chalk and Richard Hemming, "Assessing Fiscal Sustainability in Theory and Practice", 2000, IMF Working Paper

IMF dept sustainability analysis typically focuses on the following measures:

- Debt-to-GDP ratio (the ratio of government debt to gross domestic product)
- NPV debt-to-GDP ratio (the ratio of the net present value of government debt to GDP)
- NPV debt-to-exports ratio (the ratio of net present value of government debt to exports)
- NPV debt-to-government revenue ratio (the ratio of NPV of government debt to government revenue)
- Debt service-to-exports ratio (the ratio of debt service to exports)
- Multilateral debt service-to-exports ratio (the ratio of debt service paid to multilateral creditors)
- Debt service-to-government revenue ratio (the ratio of debt service to government revenue)

Buiter⁶ argues that sustainable fiscal policy should maintain the ratio of public sector net worth to GDP at its current level. For this cause he calculates the *permanent primary deficit* necessary to achieve this objective, and is given by this formula:

$$d - dt = (rt - nt) wt \text{ where,}$$

$dt = Dt/Yt$ – ratio of primary deficit to GDP

$wt = Wt/Yt$ –ratio of net worth to GDP

nt – growth rate

rt – interest rate

The sustainability indicator suggested by Buiter is:

$$d - dt = (rt - nt) wt - dt$$

Which is the difference between the constant wealth primary deficit and the current primary deficit. A negative value suggests that the current primary deficit is

⁶ See Willem Buiter, "Guide to Public Sector Debt and Deficits", 1985, *A European Forum*

too large to stabilize the net worth ratio and that fiscal policy should thus be regarded as unsustainable.

2.3.3 The primary budget gap, medium-term tax gap and long-term tax gap approaches

Third of these approaches is proposing various indicators, such as the primary budget gap, tax gap indicator (medium and long-term). There is one problem with the Buiter indicator because it is difficult to obtain accurate information on the true size of government net worth. That is why Blanchard⁷ overcomes this problem by looking at the change in policies required to maintain the current debt ratio. He develops two indicators of sustainability. The primary gap indicator is based on the permanent primary deficit necessary to stabilize the debt ratio. It is given by

$$d = (n_t - r_t) b_t$$

where,

$$b_t = B_t/Y_t - \text{debt-to-GDP ratio}$$

The *primary gap* indicator is then,

$$d - d_t = (n_t - r_t) b_t - d_t$$

A negative value for this indicator suggests that the current primary deficit is too large to stabilize the debt ratio and that fiscal policy is thus unsustainable.

Blanchard⁸ proposes a *tax gap* indicator, which is based on the permanent tax to GDP ratio necessary to stabilize the debt ratio. This is given by

$$t = g_t - (n_t - r_t) b_t$$

where,

g_t – government non-interest spending to GDP ratio

The tax gap indicator is

$$t_t - t = t_t + (n_t - r_t) b_t - g_t$$

⁷ See Olivier Blanchard, “ Suggestions for a new set of Fiscal Indicators” , 1990, OECD Working Paper

⁸ See Olivier Blanchard

which is the difference between the constant debt tax ratio and the current tax ratio. A negative value for this indicator suggests that current taxes are too low to stabilize the debt ratio given current spending policies. The primary gap and tax gap indicators are the same, but they differ in their emphasis. The former points to the reduction in the primary deficit required for sustainability of the debt, while the latter indicates the increase in the tax ratio required for sustainability of the debt given current spending policies.

Blanchard also suggests a *medium-term tax gap* indicator, which is the difference between the current tax ratio and that necessary to stabilize the debt ratio over the next N years (const. n_t and r_t). The debt-stabilizing tax ratio is,

$$t = 1/N \sum_{j=0}^N (g_{t+i} - (n_{t+i} - r_{t+i}) b_{t+i}) = 1/N \sum_{i=0}^N g_{t+i} - (n_t - r_t) b_t$$

and the medium-term tax gap is,

$$t_t - t = t_t + (n_t - r_t)b_t - 1/N \sum_{i=0}^N g_{t+i}$$

This indicator is the same like the others, but it is forward looking and requires a projection of future spending. It measures how much the tax ratio needs to rise over the next N years to stabilize the debt ratio given current and expected future spending policies.

2.3.4 Simulations

For these simulations, accounting approach will be used. The sustainability of the debt depends on the interest rate and the growth rate of the economy, as well as on the current primary balance. As long as the interest rate on the basis of the public debt exceeds the growth rate of the economy, the public debt will grow faster than the GDP growth. So, the higher the discrepancy between the interest rate and GDP growth rate is, the higher is the amount of the primary surplus necessary to stabilize the debt (as a part of GDP) at the desired level and when the growth rate exceeds the interest rate, the debt (as a part of GDP) will fall without finding resort in the primary surplus.

The table below provides a summary of the comparative static effects of changes in key economic parameters on debt. It expresses the effects when changing the key economic parameters, whether we have higher or lower interest rate, depreciation or appreciation of the currency, faster or slower GDP growth, higher or lower inflation etc⁹.

Table 1

	Comparative Static Effects on Automatic Debt Dynamics		
	Real interest rate contribution: $r - \rho(1+g)/$ $1+g+\rho+g\rho$	Real GDP growth contribution: $-g/1+g+\rho+g\rho$	Exchange rate depreciation contribution: $\alpha\varepsilon(1+r)/$ $1+g+\rho+g\rho$
Change in nominal interest rate r:	Direct effect :+		Secondary effect:+
Change in the rate of inflation ρ :	Direct effect:-	Secondary effect:-	Secondary effect:-
Change in real rate of GDP growth g:	Secondary effect:-	Direct effect:-	Secondary effect:-
Change in the nominal exchange rate depreciation ε :			Direct effect:+
Change in the share of foreign currency denominate debt α :			Direct effect:+

With the help of this table, and IMF (2003) Macedonia ‘Public Sector Debt Sustainability Framework’¹⁰ (Article IV- Staff report), certain alternative scenarios are given.

Firstly, we will show the table of the IMF projections about the public sector debt dynamic (Table 2). Then the changes will be made in the table itself, when we simulate four alternative scenarios according to the depreciation of the denar relative to \$, lowering the interest rate, faster GDP growth and lowering the inflation.

The table shows the IMF projections of the debt dynamics. Similar scenarios will be made by changing data from the once we have below (Table 2)¹¹:

9 Source: The table is taken from John Anderson’s paper , “ Fiscal Sustainability: A Review and Assessment for Macedonia”, 2003

10 Source: IMF’s Article IV- Staff report for Macedonia

11 IMF Public Sector Debt Dynamics, Table 9, Article IV, Public Sector Debt Sustainability Framework, 1998-2007

Table 2

Time, t	Previous debt, d_{t-1}	Interest rate, r	Growth rate of GDP deflator, ρ	Real GDP growth rate, g	Share of foreign currency denominated debt, α	Nominal exchange rate depreciation, ϵ	Auto debt dynamics	Contribution of interest rate	Contribution of growth rate	Contribution of interest rate-growth rate differential	Contribution of exchange rate depreciation
IMF Projections											
2002	0.516	0.030	0.023	0.003	0.972	-0.050	-0.023	0.003	-0.002	0.002	-0.025
2003	0.503	0.026	0.031	0.030	0.973	-0.100	-0.064	-0.003	-0.014	-0.017	-0.047
2004	0.448	0.028	0.024	0.040	0.976	0.000	-0.016	0.001	-0.017	-0.016	0.000
2005	0.413	0.029	0.024	0.045	0.977	0.000	-0.016	0.002	-0.017	-0.016	0.000
2006	0.393	0.034	0.025	0.050	0.954	0.000	-0.015	0.003	-0.018	-0.015	0.000
2007	0.388	0.041	0.025	0.050	0.896	0.000	-0.013	0.005	-0.018	-0.013	0.000

Alternative scenario I: Continued depreciation of Denar relative to \$

Time, t	Previous debt, d_{t-1}	Interest rate, r	Growth rate of GDP deflator, ρ	Real GDP growth rate, g	Share of foreign currency denominated debt, α	Nominal exchange rate depreciation, ϵ	Auto debt dynamics	Contribution of interest rate	Contribution of growth rate	Contribution of interest rate-growth rate differential	Contribution of exchange rate depreciation
2002	0.516	0.030	0.023	0.003	0.972	-0.050	-0.023	0.003	-0.002	0.002	-0.025
2003	0.503	0.026	0.031	0.030	0.973	-0.100	-0.064	-0.003	-0.014	-0.017	-0.047
2004	0.448	0.028	0.024	0.040	0.976	0.120	0.035	0.001	-0.017	-0.016	0.051
2005	0.413	0.029	0.024	0.045	0.977	0.060	0.007	0.002	-0.017	-0.016	0.023
2006	0.393	0.034	0.025	0.050	0.954	0.020	-0.008	0.003	-0.018	-0.015	0.007
2007	0.388	0.041	0.025	0.050	0.896	0.000	-0.013	0.005	-0.018	-0.013	0.000

Continued depreciation of denar relative to \$- The depreciation shows us the decrease of the value of the domestic currency relative to the foreign one. This alternative scenario shows the changes made in year 2004,2005 and 2006 by giving 12%, 6% and 2% of depreciation of denar versus \$, respectively. Comparing with the already given IMF projections, we can see that the dynamics of the auto debt rises and as the depreciation falls to 2%, the auto debt gets negative sign (-0,008). Now, by looking at the table of comparative static effects on automatic debt dynamics, changes in the nominal exchange rate have a direct effect in exchange rate depreciation contribution. The conclusion is that when we have continued depreciation instead of appreciation (which could be the case), the auto debt dynamics rises. Faster rate of depreciation of the currency causes debt to rise, but an increase in the share of debt that is foreign currency denominated has an identical effect. In this situation the fiscal policy is not sustainable and certain measurements should be taken into consideration.

Alternative scenario II: Lower interest rate

Time, t	Previous debt, d_{t-1}	Interest rate, r	Growth rate of GDP deflator, ρ	Real GDP growth rate, g	Share of foreign currency denominated debt, α	Nominal exchange rate depreciation, ϵ	Auto debt dynamics	Contribution of interest rate	Contribution of growth rate	Contribution of interest rate-growth rate differential	Contribution of exchange rate depreciation
2002	0.516	0.030	0.023	0.003	0.972	-0.050	-0.023	0.003	-0.002	0.002	-0.025
2003	0.503	0.026	0.031	0.030	0.973	-0.100	-0.064	-0.003	-0.014	-0.017	-0.047
2004	0.448	0.025	0.024	0.040	0.976	0.000	-0.017	0.000	-0.017	-0.017	0.000
2005	0.413	0.020	0.024	0.045	0.977	0.000	-0.019	-0.002	-0.017	-0.019	0.000
2006	0.393	0.015	0.025	0.050	0.954	0.000	-0.022	-0.004	-0.018	-0.022	0.000
2007	0.388	0.010	0.025	0.050	0.896	0.000	-0.024	-0.006	-0.018	-0.024	0.000

Lower interest rate- Second alternative scenario shows the changes made in the interest rate. IMF projections about the interest rate are given for the time period of 6 years (2002-2007) and the interest rate increases, yearly. We can see (Table 1) what happens if the nominal interest rate rises. It has a direct effect of rising the debt through its influence on increasing interest rate contribution, assuming *ceteris paribus*. In other words, there has to be no change in the rate of inflation (growth rate of GDP deflator).

We continue further to see how changes of the key economic parameters effect on debt. Instead of increasing the nominal interest rate, we will try to set opposite scenario of decreasing the interest rate. The adjustments are being made in the last four years, where the interest rate drops slightly. When we decrease the interest rate of the IMF projections, it can be seen that lower interest rate has effect on the dynamics of the auto debt. It has a direct effect of decreasing debt through its influence on decreasing the real interest rate contribution. There is also a secondary effect, when we decrease the interest rate it also affects debt through the exchange rate depreciation contribution. From this we can conclude that if we want our fiscal policy to be sustainable we should keep the nominal interest rates at a level, which will not lead us to a debt that cannot be controllable. In order to control the overall level of public sector debt, the government must first hold the primary balance to a reasonable level. This includes important policy decisions about the revenue and expenditure of the country. The balance between them has an important function when debt dynamics is an issue.

Alternative scenario III: Faster GDP growth

Time, t	Previous debt, d_{t-1}	Interest rate, r	Growth rate of GDP deflator, ρ	Real GDP growth rate, g	Share of foreign currency denominated debt, α	Nominal exchange rate depreciation, ϵ	Auto debt dynamics	Contribution of interest rate	Contribution of growth rate	Contribution of interest rate-growth rate differential	Contribution of exchange rate depreciation
2002	0.516	0.030	0.023	0.003	0.972	-0.050	-0.023	0.003	-0.002	0.002	-0.025
2003	0.503	0.026	0.031	0.035	0.973	-0.100	-0.066	-0.003	-0.016	-0.019	-0.047
2004	0.448	0.028	0.024	0.045	0.976	0.000	-0.018	0.001	-0.019	-0.018	0.000
2005	0.413	0.029	0.024	0.050	0.977	0.000	-0.018	0.001	-0.019	-0.018	0.000
2006	0.393	0.034	0.025	0.055	0.954	0.000	-0.017	0.003	-0.020	-0.017	0.000
2007	0.388	0.041	0.025	0.060	0.896	0.000	-0.016	0.005	-0.021	-0.016	0.000

Faster GDP growth- the changes were being made in the real GDP growth rate, faster growing percentage of the growth rate compared to the one that IMF had made. From this scenario we can see that the debt dynamic is going toward decreasing the debt although with negative sign. The contribution of the growth rate does not change its negative sign, but the contribution of the growth rate differential decreases, too. Conclusion is that faster GDP leads to sustainable economy.

Alternative scenario IV: Lower inflation

Time, t	Previous debt, d_{t-1}	Interest rate, r	Growth rate of GDP deflator, ρ	Real GDP growth rate, g	Share of foreign currency denominated debt, α	Nominal exchange rate depreciation, ϵ	Auto debt dynamics	Contribution of interest rate	Contribution of growth rate	Contribution of interest rate-growth rate differential	Contribution of exchange rate depreciation
2002	0.516	0.030	0.023	0.003	0.972	-0.050	-0.023	0.003	-0.002	0.002	-0.025
2003	0.503	0.026	0.031	0.030	0.973	-0.100	-0.064	-0.003	-0.014	-0.017	-0.047
2004	0.448	0.028	0.022	0.040	0.976	0.000	-0.015	0.002	-0.017	-0.015	0.000
2005	0.413	0.029	0.020	0.045	0.977	0.000	-0.014	0.003	-0.017	-0.014	0.000
2006	0.393	0.034	0.020	0.050	0.954	0.000	-0.014	0.005	-0.018	-0.014	0.000
2007	0.388	0.041	0.019	0.050	0.896	0.000	-0.010	0.008	-0.018	-0.010	0.000

Lower inflation- decrease in the rate of inflation, other things being equal, has a direct effect on increasing debt in the real interest rate contribution. Changes in the growth rate of GDP deflator ρ , were made. We are going to try to lower the rate from 0,031 to 0,022 and decreasing to see what is going to happen. The auto debt dynamics slightly drops unlike when there is higher inflation. Visible changes can be seen in the contribution of interest rate and growth rate differential, where the results are tending positive sign, rather than when there is higher inflation and the contributions have positive sign. When there is a low rate of inflation, the economy is said to be sustainable.

Continued depreciation, lower interest rate, faster GDP growth and lower inflation

Time, t	Previous debt, d_{t-1}	Interest rate, r	Growth rate of GDP deflator, ρ	Real GDP growth rate, g	Share of foreign currency denominated debt, α	Nominal exchange rate depreciation, ϵ	Auto debt dynamics	Contribution of interest rate	Contribution of growth rate	Contribution of interest rate-growth rate differential	Contribution of exchange rate depreciation
2002	0.516	0.030	0.023	0.003	0.972	-0.050	-0.023	0.003	-0.002	0.002	-0.025
2003	0.503	0.026	0.031	0.035	0.973	-0.100	-0.066	-0.003	-0.016	-0.019	-0.047
2004	0.448	0.025	0.022	0.045	0.976	0.120	0.032	0.001	-0.019	-0.018	0.050
2005	0.413	0.020	0.020	0.050	0.977	0.060	0.003	0.000	-0.019	-0.020	0.023
2006	0.393	0.015	0.020	0.055	0.954	0.020	-0.015	-0.002	-0.020	-0.022	0.007
2007	0.388	0.010	0.019	0.060	0.896	0.000	-0.025	-0.004	-0.022	-0.025	0.000

In the table above all four simulations are shown at the same time and how they affect the auto debt dynamics, together. In the year 2003 we have changes only in the real GDP growth rate (faster GDP growth). Even though we have an increase in the GDP growth, the auto debt dynamic has risen. In following years (2004-2007) situation different from *ceteris paribus* condition. Here, all of the four key macroeconomic variables have been changed and we want to see the result of how these factors influence on the debt dynamics, combined.

In the year 2004 we can see that the debt dynamics gets a positive sign. If we continue with this trend of changing the indicators we will see that the contributions of the interest rate, growth rate and exchange rate change, too.

When we join all of these indicators our cause is to find the most suitable combination of how high the nominal interest should be, which is the optimal level of growth of the domestic product where we are not going to be forced to borrow from foreign countries, what is the level of the inflation rate that should be obtained to keep the economy at a sustainable point.

3. Improving fiscal discipline

3.1 Fiscal discipline in EU

The notion of fiscal discipline deals with the specific externalities associated to the adverse spillover effects of excessive deficits leading to potentially unsustainable debt accumulation in member countries. Economists and policymakers do not disagree for establishing certain rules or mechanisms to ensure fiscal discipline, but there are controversies on the proper design of those rules and mechanisms.

The policy coordination refers to other externalities that are not dealt with through mechanisms devoted to ensuring fiscal discipline. The main topic is whether national fiscal policies should be granted full autonomy, so they stand for fiscal discipline or there is need for further coordination in the economy in all, to avoid irresponsible fiscal behavior. Some economists say that coordination is not needed, but others say it is essential. Certain principles and designs should be considered here.

The European Union faces some problems, which have to come under security of the fiscal discipline and its coordination. Firstly, there is a great agreement on the need for fiscal discipline in EU but there is a problem defining it, EU still lacks generally accepted doctrine on the role of macroeconomic policy instruments in the Euro zone, the EU does not yet have a clear doctrine on why and when coordination is necessary, as the interaction between EU procedures and national decisions remains weak, implementation is not satisfactory and the structural reform ranks high on the agenda of the EU, but the interaction between structural reform and macroeconomic policy remains weak.

For these weak points of the EU, a certain proposals were given, such as: the Commission should publish structural deficits and output gaps measured according to a common methodology, the point for fiscal discipline should be shifted away from the year-by-year monitoring of the deficit to a more medium-term oriented approach that focuses on the long run sustainability, the stability programs should be developed into fully-fledged instruments of surveillance and coordination, coordination among the members of the Euro zone should be strengthen etc.

The main arguments for fiscal discipline rules are¹²:

¹² See Roel Beetsma, "Does EMU need Stability Pact?", 2001

- *Moral hazard*- although the provisions of the Maastricht treaty spell out that, EU members should not expect any form of bailout, the potential costs of a default on public debt by a member state could constrain its policy choices. For example, the central bank could be forced to refrain from raising interest rates if it anticipates that this would aggravate the risk of a financial crisis. Hence high, potentially unsustainable debt ratios are to be avoided.
- *Macroeconomic spillovers*- in an integrated capital market, public debt accumulation may exert an upward effect on the long-term interest rate. It also impacts short-term interest rates if monetary policy targets inflation and fiscal policy affects prices. Hence, there is an externality that national fiscal policy may fail to take into account. As a result, debt ratios and long-term interest rate both tend to be high. Fiscal rules are needed to correct this.
- *Political failures*- democratic governments are shortsighted and tend to run excessive deficits. With separate currencies, this political failure is taken care of by the threat of exchange crises or the inefficiency of fiscal refutation. In a monetary union, there is no automatic check on the risk of fiscal profligacy.

The first argument is most convincing, because it puts emphasis on a potential threat to monetary and financial stability. It is important to stress that the type of externalities it puts emphasis on are of a long run nature. The suitable analytical setting is the standard long run one in which prices is flexible and has level determined by monetary policy, while output is supply-determined. Like this, fiscal policies can be used independently provided the public debt remains sustainable. So, there is no case for coordination to go beyond avoiding the build up of unsustainable fiscal positions.

The second argument in a view of the distinction between discipline and coordination, has more to do with something that comes than something that was, because even though it is true that spill-over effects exist, there is no need to be focused on excessive deficit, in fact other problems should be considered too, such as, good market link, exchange rate, inflation rate of the Euro zone etc.

The third argument builds on evidence accumulated by the political economy approach to fiscal policy, but there is a difficulty to explain the reasons for political failures. It is true that the governments behave in a less responsible manner when the threat of a crisis is absent.

The main rationale for fiscal discipline rules is thus that excessive debt accumulation with possible consequences on other member states should be avoided. This admittedly rather narrow definition of the goal of fiscal discipline has the advantage of providing guidance to address the issues of design.

For improving fiscal discipline certain proposals were given. The Stability Pact is an asset because it embodies the commitment of the EU to fiscal discipline. Reforms should build on what has been achieved, and be phased in a way that preserves the credibility of the system. The proposals are next¹³:

Cyclical adjustment- is to rely on a common methodology for measuring the output gap and the budgetary impact of cyclical factors. Structural deficits, now, serve as a basis for the evaluation of the budgetary situation in the member states. The methodology should also be communicated to the markets and the public. An independent panel should regularly observe the methodology.

A debt-based approach- The focus should be more on debt sustainability and to reward countries whose public finance situation is fundamentally sound with a relaxation of short term constraints. This is in accordance with the essential rationale for fiscal discipline. For this approach two difficulties must be addressed. First, the Maastricht debt criterion as it is measured is much too crude to be relied upon to assess the soundness of public finance in the member states. The second difficulty is that even when the debt ratio is made the target variable, the deficit remains the control variable.

*Debt Sustainability Pact-*The countries that will sign this Pact will have to publish comprehensive public finance accounts according to improved EU accounting standards that allow to assess the potential future impact of off-balance sheet liabilities, to keep their public debt ratio (50% of GDP), to set a five years target for this ratio, that would serve as a benchmark for assessing their budgetary policy. The target level should take into account the existence of implicit liabilities and be subject of multilateral surveillance, as for the Stability programs. It would then become part

¹³ See Jean Pisani-Ferry “Fiscal Discipline and Policy Coordination in the Eurozone: Assessments and Proposals”, 2002

of the medium term commitments of the member state's Stability program. The consistency between current fiscal policy and this medium term commitment would be assessed annually in the framework of budgetary surveillance.

The next paragraph shows, how should the fiscal discipline be executed in Macedonia. According to the previous given situation in the European Union, we should consider revising and adopting our fiscal policy and discipline close to the one that is in the Community.

3.2 Fiscal Discipline in Macedonia

3.2.1 Strengthening the capacity to do analysis

The maintenance of fiscal discipline is crucial for the credibility of the fiscal and monetary policy and sustained economic growth in the context of price stability. In order to do the analysis of the fiscal policy, the Government of Macedonia should strengthen its capacity to conduct such researches. The assessments of the long-term programs depend on that ability. One of the studies can be computing debt-to-GDP ratios and examining the ratios to consider their meaning regarding long-term viability of the government's program. However, there is one problem concerning such informal analysis and that is, there is no well-defined benchmark for the debt-to-GDP ratio, which can show us if there is a need for assessing fiscal discipline. There are arbitrary benchmarks that have been suggested, but their very arbitrariness makes them less than useful in designing a long-term fiscal policy.

Other analysis important for consideration should be done on the models of the government's inter-temporal budget constraint. The IMF uses such model to assist governments in assessing their fiscal program sustainability.

Two alternative methods have also been considered; one is involving time series estimation of key measures of sustainability and other method involving simulations of sustainability. These methods are based on the same conceptual basis as the IMF method the inter-temporal budget constraint facing the government.

3.2.2 Discipline towards budget execution¹⁴

Macedonia should place its fiscal discipline toward better executing of the Budget. As one of the most important fiscal issues that the Government should pay

¹⁴ Revised Code of Good Practices on Fiscal Transparency

attention to, is to have a proper replacement of the budgetary means for the next fiscal year. For that cause the Government should have several roles and responsibilities.

For fiscal economists, the key issues on budget execution are always whether deficit targets are likely to be met, and whether any budget adjustments (both on the revenue and expenditure sides) agreed at the preparation stage (or in-year) are being implemented as planned. On the expenditure side of the budget, the key issues are whether the outturn is likely to be within the budget figure; whether any changes in expenditure priorities (as against past patterns) are being implemented in specific areas as planned; and whether any problems are being encountered in budget execution, such as the buildup of payment arrears.

Fiscal economists therefore need to fully understand any weaknesses in the country's budget execution process. Is it transparent? Are there clear lines of accountability? Is information on execution of the budget available on a timely, reliable, and accurate basis? Is it thus consistent with the principles of good governance? Based on this understanding, where are problems likely to arise, and how might they be avoided or overcome? Sometimes, action may be needed through budget execution procedures to bring expenditures back on track to the budget provision; hold expenditures below budget, in response to below-target revenue developments; or bring irregularities to the attention of the decision makers.

The government sector should be distinguished from the rest of the public sector and from the rest of the economy. The policy and management roles within the public sector should be clear and publicly disclosed. The structure and function of government should be clearly specified. The responsibilities of different levels of government, and of the executive branch, the legislative branch, and judiciary, should be well defined. Clear mechanisms for the coordination and management of budgetary and extra budgetary activities should be established. Relations between the government and non-government public sector agencies should be based on clear arrangements. Government involvement in the private sector should be conducted in an open and public manner. There should be a clear legal and administrative framework for fiscal management.

During the execution of the budget certain preparations and objectives should be done, so there will not be any confusion about the way the budget is going to be executed. The budget documentation should specify fiscal policy objectives, the macroeconomic framework, and the policy basis of the budget and to identify major

fiscal risks. Thus a statement of fiscal policy objectives and an assessment of fiscal sustainability should provide the framework for the annual budget. Budget information should be presented in a way that facilitates policy analysis and promotes accountability. While the procedures for the execution and monitoring of approved expenditure and for collecting revenue should be clearly specified. There should be regular fiscal reporting to the legislative and the public.

There are some problems that can occur while executing the budget, they are as following¹⁵:

- The multiplication of exceptional procedures that bypass expenditure control arrangements;
- The difficulty in reconciling bank statements with budget accounts and thus in obtaining reliable and timely data on cash expenditures;
- The accumulation of payment arrears;
- The lack of fund consolidation;
- Difficulty in managing and accounting for aid flows.

Thus, certain measurements should be considered and implemented in order to prevent the unsustainability to prevail in the economy. In order to do this, definite stages of control should be added. Next paragraph is about the budget control.

3.2.3 Budget Control

For the government to set up a proper budget control has to follow certain steps to a confining budget policy. The government has to make an action list of guiding points. As a start the government has to be sure about the budget that was prepared to have all the key indicators, which are going to be controlled. The responsibility for budget items should be given only to individuals with the authority to control the outcome. The government should schedule regular reviews of budget performance and to review budgeted figures to identify cash flow or other problems, which can be anticipated and tackled in advance. The key ratios as margins, working capital should be identified how performance is expected to improve or deteriorate. The government should carry out a sustainability activity to see the effect of outcome. Also, focusing on controlling items, which could have a significant effect on overall performance and as figures become available, should be compared with the previous

¹⁵ Revised Code of Good Practices on Fiscal Transparency

data. The government should determine how fixed costs differed from budget and whether any changes are likely to be permanent. Analyzing the extent to which variances in variable costs reflect sales variances, or whether prices or efficiency have changed. Certain actions should be taken in order to sort out underperformance, which can be controlled. The priorities should be determined when unexpected favorable changes occur. At the end the government should revise future budgets in the light of the information that are available to us.

Budget controlling is one of the essential issues when fiscal sustainability is about to be obtained. It can be said that budget control is an instrument for controlling and stabilizing the fiscal sustainability.

3.2.4 IMF suggestions for Macedonia's fiscal policy and sustainability¹⁶

Assessment of the fiscal sustainability and practicing good fiscal policy are one of the key elements in IMF countries. The IMF suggestions on macroeconomic policies are taken from the information of the sustainability of the country's external debt and its public debt. Judgments about debt sustainability-whether a country's debt can be serviced without an unrealistically large future correction in the balance of income and expenditure-underpin the IMF's decisions in program context, in particular by helping to determine when financing is appropriate, what might be a sensible level of access, and whether a debt restructuring may be needed. These suggestions become very crucial and very finely balanced in cases of emerging market economies that are highly integrated into global capital markets and may have large financing needs.

Many countries already present basic fiscal and economic policy statements. In this connection, a distinction needs to be drawn between statements based on medium-term projections of fiscal aggregates, and those based on integrated, consistent, medium-term estimates broken down by individual spending agencies. The latter is sometimes referred to as a medium-term budget framework. The elements of this budget are administratively and politically demanding, and have been implemented mainly in advanced economies, but there are some other countries that implemented them very successfully.

¹⁶ International Monetary Fund, 2002. Macedonia Staff Report, Article IV

A number of aspects of the Fund's existing work are relevant to assessing sustainability. Medium-term projections of the balance of payments and of fiscal developments are an affix of the Fund's work on member countries. Such suggestions have potentially important bearing on assessment of debt sustainability, when there is significant foreign currency denominated debt. An important advantage of a medium term budget framework for developing countries and countries in transition is that it helps link the capital and current budgets. Without the coordination that results from such a link, the usefulness of budget information is limited, and there is often inadequate provision made for operating and maintenance costs. For many developing countries and countries in transition, only an aggregate forecast will be feasible. This will nonetheless provide a useful starting point for considering medium-term changes in budget policy. Best practice is that comprehensive, rolling medium-term budget framework should be published as a central basis of fiscal management. Financial sector stability assessments may have important implications for the contingent claims on the government. Even though all these elements are present in the Fund's work, their application has not been sufficiently consistent and disciplined to always ensure the credibility of the Fund's overall assessment of sustainability.

A staff team visited Skopje November 2003, to hold previous discussions and reach understandings on policies for fund-supported program. The conclusions they came up to are as followed:

IMF agreed that the fiscal policy should target public debt at about 40 percent of GDP. There is evidence where it is shown that the debt crises rise high when the external debt-to-GDP ratio exceeds 40 percent. IMF noted that the existing debt-to-GDP ratio is not very high comparing with the other EU countries, but we cannot judge Macedonia's debt by EU standards because of the currency composition and the shocks that Macedonia goes through. Being this case, IMF referred to standard sustainability analysis indicating that either a depreciation of the currency or a slowdown in growth combined with disappointing foreign direct investments could push debt onto an unsustainable path.

IMF recommended a two-step fiscal adjustment to decrease the *central government deficit*, which will decrease the *general government as well*. This strategy reflected mainly the non-recurrence in 2003 of exceptional spending in 2002 and if this were the case a larger deficit in 2003 would either starve the private sector of needed credit or result in an excessive drain of reserves.

The composition of fiscal adjustment was important for the IMF mission, too. The winding down of crisis-related spending and revenues and lapsing of other non-recurrent items would reduce the deficit relative to GDP by 2 percentage points. In formulating policies for the Fund-supported program the authorities found it difficult to achieve the adjustment with spending cuts alone. IMF proposed a mix of cuts in goods and services spending and an increase in VAT collection. This would be achieved by reforming the rate structure. The mission was concerned that these cuts might be unsustainable, but the authorities noted that they would cut non-essential items, returning the real level of spending per employee to the pre crisis level.

4. Conclusions

Fiscal sustainability presents an important issue for all the countries on different level of development. It is a long-run requirement and it is a necessary and essential part of fiscal analysis. When assessing fiscal sustainability we can see and anticipate if the current fiscal policy can be sustainable over long-term period and there would be no need to change the government's fiscal program. Fiscal sustainability analysis should be practice of the Ministry of Finance with the help of the budget office of the government.

There are many direct and indirect costs of high debt in low income and developing countries. Empirical evidence suggests that there is likely a link between debt levels and growth, but that exact relationship remains unclear. High debt does indirectly contribute to a negative policy dynamic and frequently threatens the sustainability of economic reforms that might have succeeded in the absence of high debt. High debt levels put a heavy administrative burden in the country, exacerbating capacity constrains and slowing the development of capable public institutions.

When European Union is taken into consideration, it has to support the achievements in the field of democracy by strengthening the institutional and administrative capacity of the state and of the actors of the civil society. It has to assist the government at central and local level to facilitate the process of economic and social transformation towards a market economy.

The EU aims to bring Macedonia closer to EU standards and principles, to assist the country in the framework of the Stabilisation and Association Process and to support the country in its efforts to give full implementation to all the agreements that will come in the way and to pull out the maximum of the country's potential.

On the other side the connection between the IMF and Macedonia can be seen in the effort in establishing macroeconomic stability, economic growth and poverty reduction. The Fund's engagement is long-term and might include institution building in public finances, monetary policy and the financial sector. IMF financing should, where possible, be kept at minimum level. IMF's suggestions are to implement an fresh instrument called Post Program Monitoring for new emerging market economies.

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