

National Bank of the Republic of Macedonia



Annual report 2010

Skopje, April 2011

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Dear Sirs and Mesdames,

The year that is now behind us might be given the attribute of a year of post-crisis global recovery. The developed economies have overcome the recession and began to move along the path of modest growth. Emerging economies continued to grow dynamically. They are again faced with the phenomenon of large scale capital inflows, enabled by loosened policies and high liquidity in developed economies, and stimulated by large interest rate spreads. **However, we cannot say that in this post-crisis period all "stains" from the crisis have been removed, nor that all risks have been exhausted.** In fact, as the Governor of the Bank of England says¹: "... success is measured by happiness ... and fortunate economies have a combination of growth, stable prices and stable financial system, fiscal sustainability, flexible supply and low unemployment." These criteria for economic success are still far from being fulfilled. We are witnessing serious problems with public finances in several Member States of the Euro-zone. The problem of unemployment remains one of the key problems in Europe and in the United States and represents one of the major potential limiting factors for dynamic growth. Financial markets, although more stable than in the crisis period, however, remain sensitive and react quickly to the latest macroeconomic information. Also, despite the danger of deflation in the period of crisis, at the end of the year in most economies, inflationary pressures have emerged. The growth of inflation was mainly caused by factors on the supply side, prices of food and energy. Given that demand in many economies is still weak, many analysts believe that this price growth will not be of an intensity similar to the shock of 2007. However, uncertainty about the duration of price growth and its secondary effects is not negligible. **Hence, the challenges that policy makers face with are still big.** Ensuring consistency of commenced growth and its balancing, further strengthening of the market confidence, putting public finances on a sound basis, monitoring of emerging inflationary pressures, are some of these challenges.

The process of economic recovery in 2010, was also typical for the Macedonian economy. The increasing activity of our most important trading partners had positive transmission effects on the domestic export sector. Simultaneously, during the year, metal prices continued to grow at a fast pace, improving the terms of trade and further stimulating exports. In such conditions, since the beginning of the year the export sector has made positive contribution to growth, and since the second quarter, positive trends were registered also in the domestic demand. Thus, as expected for a small and open economy, the positive impulses from the global recovery had a direct effect on the export sector, but also an indirect effect through the influence on expectations and confidence of domestic entities. Hence, after the fall in the previous year, in 2010, the activity in the domestic economy grew by 0.7%. **Economy's entering in the zone of positive growth was supported also by the growth of credit flows.** In conditions of expanding the deposit base and significantly improved expectations of the banking sector, new loans doubled during the year, providing additional financial support for new spending and investment decisions of domestic entities. **Trends in the labor market were also a stimulating factor for the domestic economy.** Namely, employment growth was registered on the labor market relatively soon after the crisis. From the second quarter until the end of 2010, employment grew consistently, positively influencing the total disposable income and the expectations. However, it is important to emphasize that given a minor economic growth, such relatively resistant labor market maintains the productivity of the economy at a lower level compared to that of the pre-crisis period. Thus, these shifts pose a risk to the future dynamics of the number of

¹ Speech of Mervin King, January 25, 2011, published on the web site of the Bank of England

employees in the labor market. Furthermore, the combination of lower productivity and simultaneous growth of labor costs leads to a rise in unit labor costs, potentially reducing the competitiveness of the economy. Given that the economic recovery involves a long period of steady, sound and solid growth, and for a small and open economy that implies the need for solid competitiveness in export markets, these potential problems must not be neglected.

The moderate economic growth in 2010, was not sufficient to ensure closing of the negative output gap. In such conditions no pressures were registered for deterioration of the balance of payments imbalances. In fact, 2010 is the second consecutive year in which a decline in the current account deficit was registered. These changes in the external position could be explained mainly by two factors. **First, the narrowing of the negative trade gap continued also during 2010.** In the export sector, the level of capacity utilization increased significantly, driven by external demand and the favorable terms of trade. On the other hand, the increase in import demand was not large enough to lead to a deepening of the deficit in foreign trade. **Second, stable environment, improved expectations of the agents, and the monetary credibility enabled further increase of the confidence in the domestic currency.** In such conditions, during 2010, there was still permanent steady growth in net inflows through private transfers, which provided financing to about 90% of the trade deficit. **Thus, after the narrowing of 6 percentage points of GDP in the previous year, the current account deficit in 2010 declined by about 4 percentage points of GDP and it was reduced to 2.8% of GDP.**

Despite the rising liquidity in the global capital market, capital inflows in the Macedonian economy during 2010 were relatively weak. Their level is reduced also compared with the previous year (2009). However, given the relatively small current account deficit, they were sufficient to secure its financing and creation of additional foreign exchange inflows in the economy. **Having in mind this position of the balance of payments, throughout most of the year supply of foreign currency exceeded the demand. So in 2010, no pressures on exchange rate stability were registered.**

During 2010, no major inflationary pressures were registered. In the first half of the year inflation was held below 1% and the core measure of inflation, was basically idle. These "benign" inflationary changes were expected. In fact, amid the still low capacity utilization, or low demand, the room for increasing the general price level was relatively small. **Although there were no stronger pressures by the demand even in the second half of the year, at this time inflation began to accelerate, exceeding 2% on an annual basis. Accelerated growth of prices in this period was common for many economies in the world.** Energy and food prices on world markets began to rise again, partly as a consequence of the signals of recovery of global demand, but largely as a result of reduced supply. In such conditions, the Macedonian economy has also felt pressures from import prices, although inflation growth was moderate and without significant impact on inflationary expectations.

Obviously, as far as the environment for the implementation of monetary policy is concerned, the post-crisis year 2010 could also be assessed as relatively favorable. In fact, in the absence of pressures on exchange rate stability, over the year we continuously relaxed the monetary policy. The key interest rate was reduced on seven occasions, whereby the interest rate on CB bills was reduced to historically lowest level. At the end of the year it was 4%. Such changes in the monetary policy were made possible by the low inflation and rising foreign reserves. At the end of

2010, foreign reserves exceeded the amount from the pre-crisis period, and they also exceeded the expectations, setting at the level of Euro 1,715 million and providing coverage of the imports of goods and services of about four months for the next year. **In 2010, the monetary policy stance was adjustable, i.e. the changes were aimed at supporting the initiated process of economic recovery.** In a post-crisis period, such support, except through the common transmission channel through stronger credit activity is accomplished also through the expectations channel. The loosening of monetary policy implied a signal for the economic entities of more favorable environment and reduced risks in the future. This signal should have an effect on their expectations and thus to act towards reducing the restraint from consumption and investment.

We entered this current year with assessments for a relatively favorable environment for conducting monetary policy, starting from the external position of the economy and with capacity to absorb any adverse shocks. For now, given the modest rate of recovery, we do not expect serious disturbance of the external position. In fact, in 2011 one of the common and difficult to predict external risks, the size of capital flows, has been significantly reduced, having in mind the concluded precautionary credit line with the International Monetary Fund. **However, this does not mean that the forthcoming period is free of risks or uncertainties.** For us, as a small and open economy, the usual sources of uncertainty arise from the global economy. That is confirmed by recent macroeconomic results. The growth of worldwide inflation, caused primarily by the growth of food and oil prices spilled on the level of domestic prices, a trend that began in the last two months of the year and remained in the first quarter of 2011. The materialization of one of the expected risks suggests that in 2011, monetary policy will be faced with the challenge of dealing with upward inflationary pressures which come from the rising prices of imports (food and oil) and uncertainty about further developments on the international markets. The other risk relates to the assumption for economic recovery of our most important trading partners. Although the recovery of economies is in progress, the problems with public finances and unemployment continue to create potential constraints to maintain and accelerate commenced growth. Also, the inflationary pressures that emerged, although being treated as temporary, bring to the surface the possibility of monetary tightening in case of possible secondary effects. It could further slow growth in these economies. **So, the risks still exist, but we as monetary policy makers continually monitor them. In case of their possible materialization we will take appropriate monetary measures that will ensure maintaining of the stability of the nominal exchange rate and domestic inflation.**

Ladies and Gentlemen,

The global economy is gradually emerging from one of the longest and deepest global recessions. But we must not forget that the recovery from such crises is neither quick nor risk-free. Therefore, not coincidentally, Mr. Dominique Strauss - Kahn, the IMF Managing Director said: "Although the recovery is underway, it is not the recovery we wanted. This recovery is burdened with tensions and constraints, which can even sow the seeds of the next crisis."² One of these problems or limitations is the problem of global imbalances. Developed economies are growing slowly, while among them there is a need for consolidation of financial systems and public finances as a short-term priority and undertaking structural reforms in the long run. This is expected to lead to faster growth and reduction of unemployment. In the emerging economies, growth is dynamic, capital inflows

² "The right kind of global recovery", Dominique Strauss - Kahn, a speech delivered at a public event organized by the monetary authorities of Singapore, published on the IMF's web site on February 1, 2011.

are high again and repeated risks of "economic overheating" appear on the horizon. Furthermore, this rapid growth creates ongoing problems with global dimensions, such as the growth of world prices of food and energy. Hence, in this group of countries the challenges lie in ensuring policies of macroprudential character, which will provide protection from so-called "hard landing". Certainly, simple solutions to these problems do not exist. But it is important that they be taken into account. In addition to having direct effects on us, they contain an important message. These problems show that the economic fundamentals must remain healthy, while growth in an economy, including ours, should aim at being as balanced as possible, with equilibrium between domestic and external demand. Thus, for healthy and sustainable growth it is necessary to conduct healthy and cautious policies that will prevent the occurrence of excessive internal and external imbalances. Our policies have followed this "recipe", and therefore as an economy, we endured the last crisis relatively well. However, it remains to continue along the same path of conducting healthy policies and providing a stable environment. In this context, as a monetary authority we will remain consistent with the policy of a stable price environment and maintaining financial stability, which are fundamental for achieving more dynamic and sustainable rates of economic growth.

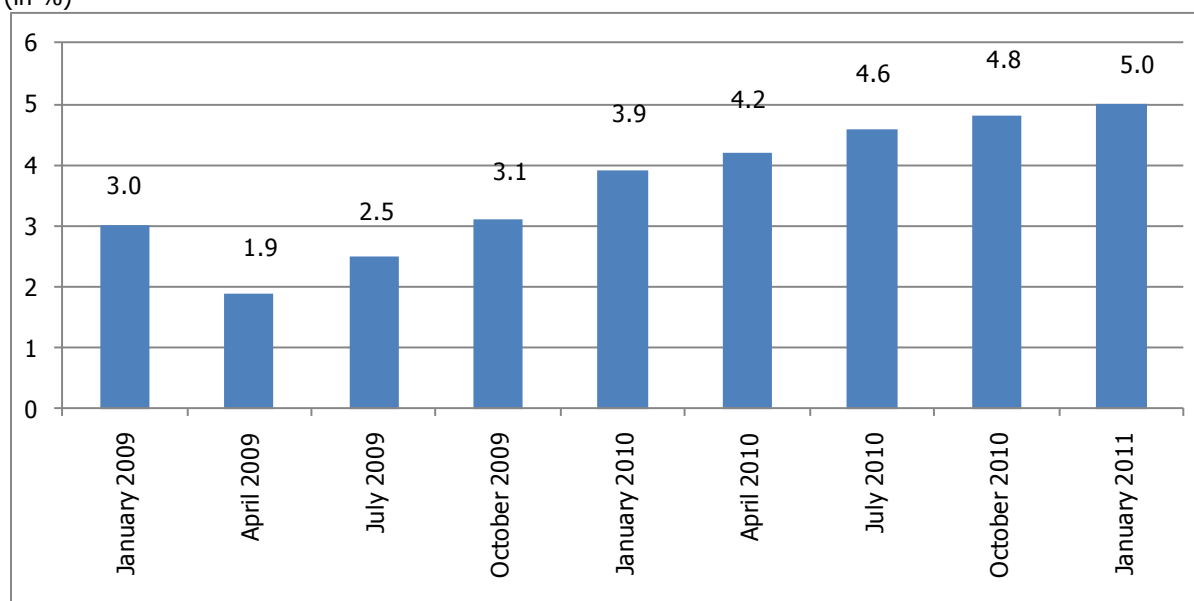
Skopje, April 2011

Governor and Chairman
of the National Bank
of the Republic of Macedonia Council
Petar Goshev, MSc.

I. International economic developments

During 2010, the global economy started to recover. After the 0.6% decline in 2009, the last assessments³ for 2010 point to 5% increase. Thus, the revitalization of the global economic activity during 2010 had more intensive pace compared to the initial expectations. Therefore, in the course of the year the revisions of the global economic growth assessments had mainly upward direction. There were positive developments also in the global trade volume which in 2010 increased by 12% on annual basis compared to the decline of 10.7% in 2009. The pace and factors which moved the global economic growth in 2010 significantly differ among individual groups of countries. Thus, one of the main characteristics for the global growth in 2010 is its disproportion. In the developed economies the growth was relatively slow, with significant downward risks regarding its continuity. The problems regarding public finances, unemployment growth, still present problems in the financial sector and the gradual return of confidence, were some of the factors which caused such growth dynamics in these countries. In the developing countries and the emerging economies, the growth pace was significantly faster, in a situation of quick recovery of the domestic demand, adjusted policies and high capital inflows.

Figure 1
Projections and assessments of global economic growth rates in 2010
(in %)

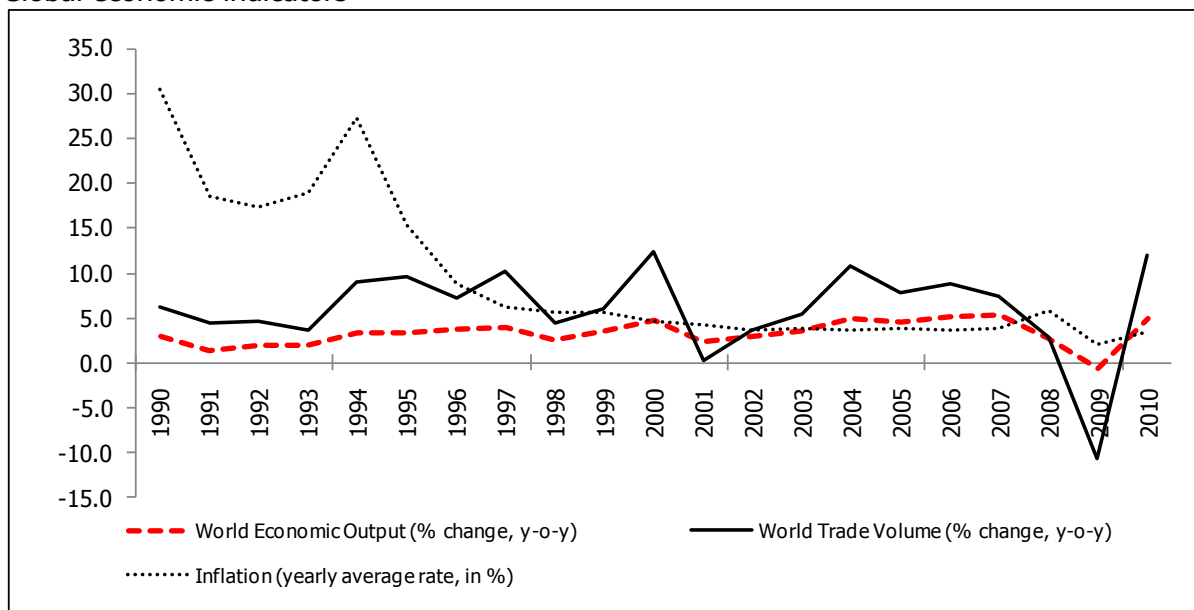


Source: World Economic Outlook (IMF World Economic Outlook January).

The analysis of the dynamics shows more intensive recovery of the economic activity during the first half of the year, while in the second half of the year the economic growth had slower pace. The gradual slowdown of the global economic activity in the last two quarters of the year, is partly explained by gradual slowdown of the domestic demand on the emerging markets in Asia. Additional factor is the reappearance of uncertainty on the financial markets in developed economies. Namely, the increased risk of being unable to repay the public debt in part of the Eurozone member countries (Greece, Spain, Portugal and Republic of Ireland) in the second half of the year again caused instability on the financial markets. Also, the slowing down of the growth pace in the developed economies can be partially explained by the gradual draining of the effects from the big fiscal and monetary stimuli, typical for the previous period.

³ Source: World Economic Outlook (IMF, World Economic Outlook Update, January 2011)

Figure 2
Global economic indicators

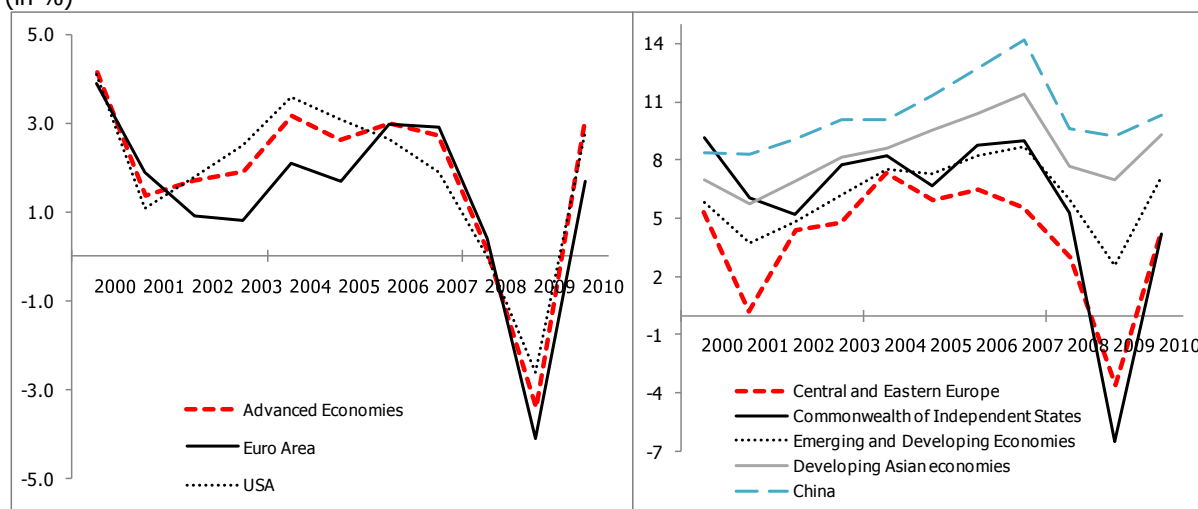


Source: World Economic Outlook (IMF World Economic Outlook database October and World Economic Outlook Update January)

Main carriers of the world economic growth in 2010 were the emerging economies in Asia (China, India and ASEAN -5⁴ countries) as well as some of the countries from Middle and South America (Mexico, Brasil and Argentina). Main generator of the economic activity in this group of countries was the relatively strong domestic demand, encouraged by the fiscal incentive during 2009 and 2010 but also by the high capital inflows during 2010. Namely, what is typical for this group of countries is that in 2010 they faced with high capital inflows, mainly in the form of portfolio investments as a result of high interest differentials relative to the developed economies. Thus, the high capital inflows were encouraged by the stable macroeconomic enviroment as well as the stable nominal foreign exchange rates, i.e. the so called "safe heaven" currencies. The exports also made additional contribution to the economic growth especially in countries that export raw materials, the prices of which began to move upwards in part of 2009 and during 2010.

⁴ Indonesia, Malaysia, Philippines, Thailand and Vietnam.

Figure 3
Real GDP growth
(in %)



Source: IMF (World Economic Outlook database October and World Economic Outlook Update January), Eurostat.

In the developed economies, the gradual stabilization of financial markets, consolidation of financial institutions' balances, as well as the effects from the undertaken fiscal and monetary measures, brought to a gradual regaining of the confidence by the economic entities, especially the corporate sector. Thus, the economic growth was mainly driven by investing in reserves and fixed assets, private consumption and net exports⁵. However, the private consumption recovery in the developed economies has significantly slower pace compared to the emerging economies in Asia. The reasons can be found in still relatively high unemployment as well as the uncertainty regarding the future expected income of the population. Additional factor which has impact on the depreciated private consumption is also the uncertainty linked to the forthcoming fiscal consolidation, i.e. the announced tax increases and decrease in public expenditures, partly through cutting the public administration's salaries⁶, which was typical for some of the Eurozone member countries.

⁵ The net exports had positive contribution to the Eurozone growth in the second, the third and the fourth quarters of 2010 while in the USA in the fourth quarter of the year.

⁶ Such measures were announced by the governments of Greece, Spain and Portugal.

Table 1
Global economy indicators

	2006	2007	2008	2009	2010*
<i>Gross Domestic Product, Global real growth rate</i>	5.2	5.3	2.8	-0.6	5.0
Advanced economies	3.0	2.7	0.2	-3.4	3.0
USA	2.7	1.9	0.0	-2.6	2.8
Euro-Area	3.0	2.9	0.4	-4.1	1.7
Japan	2.0	2.3	-1.2	-6.3	4.0
United Kingdom	2.8	2.7	-0.1	-4.9	1.7
Newly Industrialized Asian Economies	5.8	5.8	1.8	-0.9	8.2
Emerging and developing economies	8.2	8.7	6.0	2.6	7.1
China	12.7	14.2	9.6	9.2	10.3
India	9.7	9.9	6.4	5.7	9.7
Central and Eastern Europe	6.5	5.5	3.0	-3.6	4.2
CIS	8.8	9.0	5.3	-6.5	4.2
<i>World Trade Volumes (growth rate)</i>	8.9	7.4	2.9	-10.7	12.0
<i>Inflation rate, Global average annual rate (in %)</i>	3.6	3.9	5.9	2.2	3.4
Developed Countries	2.4	2.2	3.4	0.1	1.5
USA	3.2	2.9	3.8	-0.3	1.6
Euro-Area	2.2	2.1	3.3	0.3	1.6
Japan	0.3	0.0	1.4	-1.4	-0.8
United Kingdom	2.3	2.3	3.6	2.1	3.1
China	1.5	4.8	5.9	-0.7	3.5
India	6.2	6.4	8.3	10.9	13.2
Central and Eastern Europe	5.9	6.0	8.1	4.7	5.2
CIS	9.5	9.7	15.6	11.2	7.0
<i>Commodity Prices</i>					
Oil	20.5	10.7	36.4	-36.3	27.8
Nonfuel	23.2	14.1	7.5	-18.7	23.0
	<i>(in percent of GDP)</i>				
<i>Savings Rate</i>	24.1	24.3	24.1	21.8	23.0
<i>Investments</i>	23.2	23.7	23.8	21.6	22.6
<i>Nominal Exchange Rate (U.S. Dollar/EUR)</i>	1.2556	1.3705	1.4708	1.3948	1.3257

*Assessment

Source: IMF (IMF World Economic Outlook database October 2010, IMF World Economic Outlook Update January) and Eurostat.

- *Eurozone and USA*

The economic activity in the Eurozone during 2010 had a modest growth pace. The economic recovery which began in the middle of 2009 also continued in 2010 with the Eurozone annual growth rate reaching 1.7%. This growth was supported by the relatively more stable financial markets. Namely, although new turbulences appeared, caused by the problems with public finances in Greece and the Republic of Ireland, still the risk on the financial markets was significantly lower compared to the previous year. To some extent, such condition can be explained also with the financial support provided to these countries through the joined financial arrangement of the EU and the IMF, so called European Stabilization Mechanism. After this financial arrangement took place, a gradual returning of confidence among the economic entities, decrease of risk premium and slight relaxation of lending terms by the banks was noticed within the EU and the Eurozone.

Annex 1: Main characteristics of the European Stabilization Mechanism-ESM

As a result of the problems with repayment of the Greek public debt, which culminated in 2010, but also the risk of appearance of similar problems in other Eurozone Member-States (Spain, Portugal, Italy and the Republic of Ireland) in the beginning of May 2010 the EU Member-States established a European Stabilization Mechanism (ESM). The ESM represents an agreement between the EU countries and the Eurozone for surpassing financial problems with taking loans and repayment of public debt which some Member-State may face with. It consists of two parts, direct credit fund by all EU member countries in the amount of Euro 60 billion and financial agreement among the governments of the Eurozone member countries in the amount of Euro 440 billion so called European Financial Stability Facility, EFSF. The direct credit fund is available to all EU member countries that need financial assistance for repayment of the public debt or further borrowing. EFSF is a fund available only to Eurozone Member-States while the finances can be used only through a so called Special Purpose Vehicle, SPV. Namely, if some Member-State faces with problems in repaying its public debt the SPV will issue bonds guaranteed by Eurozone member countries, proportionally to their share in the ECB capital. Besides that, the IMF also has its part in these financial arrangements with additional Euro 250 billion. The IMF intervention will be on case-by-case basis and in the form of typical IMF assistance for the Member-States.

Source: ECB monthly report, May and June 2010 and the IMF World Economic Outlook, October 2010.

The annual growth dynamics in the Eurozone was more intensive in the course of the first half of the year while in the second half of the year there was a certain slowdown. The slowdown is connected with the increased uncertainty present on the financial markets but also with exhausting of the effects from the previously implemented fiscal measures. The economic growth within the Eurozone was unequal among its Member-States. The main carrier of the growth was Germany, then also France, Austria, Belgium and the Netherlands. The recovery of the Southeastern countries of the Eurozone (Spain, Portugal and Italy) has a slower pace, while in Greece the GDP fall grew deeper in 2010. The growth in the first half of 2010 in the Eurozone was pushed by the growth of reserves and private consumption and partly by public consumption, while in the second half of the year the net exports had the greatest contribution to the economic growth which corresponds with the growth of the global trade but also with the depreciation of the real effective foreign exchange rate of the Euro against the US dollar. However, the recovery of the private consumption in the Eurozone is still moving with slower pace than the one expected, which corresponds to the labour market developments. Namely, despite the slight increase in the total number of labor hours, the number of employed people is almost stagnating compared to the previous year thus the unemployment rate during the whole year remained at 10% relative to the average 9.5% in 2009. The inflation within the Eurozone during 2010 was relatively stable and low. The average annual inflation is 1.6% which is below the 2% midterm target. However, there was a certain higher growth of the general level of prices in the second half of the year as a result of the increase in the prices of oil and food, which made the annual inflation rate reach 2.2% in December. The annual core inflation in the Eurozone was stable and ranged between 0.8% and 1.1% while the core inflation average annual rate was 1%.

Table 2
Economic indicators of the emerging economies

	GDP (real growth rate in %)			Average Inflation Rate (in %)			Current Account Balance of the BOP (% of GDP)			Consolidated Budget Balance (% of GDP)			Unemployment Rate (in %)		
	2008	2009*	2010**	2008	2009	2010	2008	2009*	2010**	2008	2009*	2010**	2008	2009*	2010**
Advanced Economies	0.2	-3.4	3.0	3.4	0.1	1.5	-1.2	-0.3	-0.3	-3.8	-6.1	-6.8	/	/	/
USA	0.0	-2.6	2.8	3.8	-0.3	1.6	-4.7	-2.7	-3.2	-4.9	-7.2	-8.0	5.8	9.3	9.6
Japan	-1.2	-6.3	4.0	1.4	-1.4	-0.7	3.2	2.8	3.1	-3.6	-7.3	-7.6	4.0	5.1	5.1
United Kingdom	-0.1	-4.9	1.7	3.6	2.1	3.1	-1.6	-1.1	-2.2	-5.6	-8.3	-7.9	5.6	7.6	7.5
Euro-zone	0.4	-4.1	1.7	3.3	0.3	1.6	-0.7	-0.4	0.2	-2.6	-4.3	-4.5	7.5	9.5	10
Germany	1.0	-4.7	3.6	2.8	0.2	1.2	6.7	4.9	6.1	-0.3	-0.8	-3.1	7.7	8.2	7.7
France	0.2	-2.6	1.6	3.2	0.1	1.7	-1.9	-1.9	-1.8	-3.1	-5.0	-5.0	7.8	9.5	9.7
Italy	-1.3	-5.2	1.3	3.5	0.8	1.6	-3.4	-3.2	-2.9	-2.6	-3.9	-3.6	6.7	7.8	/
Greece	1.0	-2.0	-4.5	4.2	1.3	4.7	-14.6	-11.2	-10.8	-9.4	-15.4	-9.6	9.5	7.7	/

* Assessment

** Projection

Source: IMF (IMF World Economic Outlook database October 2010, January update), European Commission, while Eurostat data have been used regarding the inflation.

The US economy continued to recover in 2010 with a faster pace than that in the Eurozone, thus in the fourth quarter of 2010 the American GDP reached the pre-crisis level. The annual GDP growth rate was 2.8% in a situation of more intensive growth during the second half of the year. The revitalization of the economic activity was mainly generated by the domestic demand. The investment consumption (increased reserves and fixed assets investments), gradual revitalization of the private consumption, as well as the increased public consumption had positive influence on the growth. In this context it should be mentioned that the private consumption recovery has a relatively slower pace compared to the previous expectations. The main reason for such a pace is the uncertainty present in the labor market in a situation of a relatively high unemployment rate of 9.6%, slow wage increase, restricted terms of lending and tendency of households to reduce their debt load. The net exports' contribution was negative during the first nine months of the year, compared to the last quarter when its contribution to the growth was positive. The price level in 2010 was stable, with the average annual inflation rate being identical to the one of the Eurozone, reaching 1.6%. Moreover, the core inflation was also low, continuously decreasing in the course of the year (from 1.6% in January to 0.8% in December 2010). However, stronger inflation pressures also appeared in the USA during the second half of the year as a result of the increased energy and food prices.

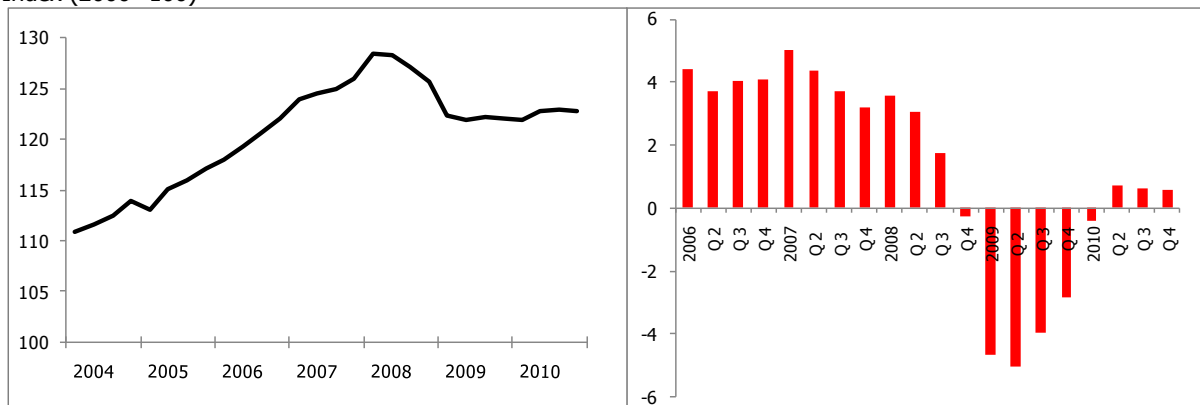
The global economy recovery, especially the modest economic growth of the Eurozone and the countries in Southeast Europe, affected also the intensity of the recovery of the foreign effective demand for Macedonian products⁷. After the sharp decline in 2009 by 4.1%, the foreign effective demand gradually started to recover during the year reaching 0.4% average growth in 2010. Analyzed by countries, the growth of the economies of Germany and Serbia had major contribution in the growth of the foreign effective demand in 2010.

⁷ The foreign effective demand is calculated as sum of weighted GDP indexes of the most important trading partners of the Republic of Macedonia. The weights have been calculated based on the share of these countries in the Macedonian exports. The GDP data for countries which are trading partners of Macedonia are from the EUROSTAT database (New Cronos database). In the calculation of the index the following countries have been included: Germany, Greece, Italy, the Netherlands, Belgium, Spain, Serbia, Croatia and Bulgaria.

Figure 4

Foreign effective demand
Index (2000=100)

Annual growth rates

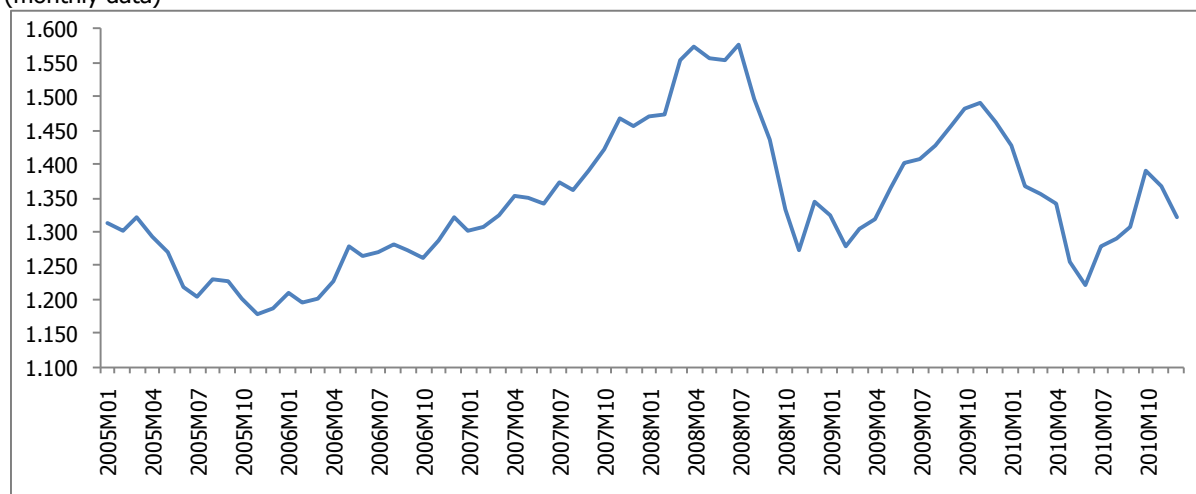


Source: EUROSTAT and State Statistical Office of Serbia and NBRM calculations.

- *World prices development*

The changes in the global economic activity, turbulent developments on the financial markets, as well as the implemented fiscal and monetary measures in the economies of the USA and the Eurozone also had impact on the movement of the nominal foreign exchange rate US dollar/euro. The average nominal foreign exchange rate dollar/euro was 1.33 US dollars for one euro, which represents 4.9% depreciation of the euro compared to the previous year. Analyzed by dynamics, significant fluctuations of the nominal foreign exchange rate dollar/euro can be noticed in the course of the year. In the first half of 2010, the euro was continuously depreciating against the US dollar. On June 8 the euro reached its lowest level in the last four years of 1.19 US dollar for one euro which is 17.1% euro depreciation relative to the end of 2009. Such a trend of the euro depreciation can be explained with problems linked to repayment of public debt of some of the countries in the Eurozone (especially Greece) as well as the slower pace of recovery of the economy in the Eurozone compared to the US economy. However, from mid-June until early November, the euro was continuously appreciating against the US dollar reaching a value of 1.42 US dollars for one euro. The euro appreciation during this time of the year is a result of the implemented fiscal and monetary measures by the EU member countries which led to gradual stabilization of financial markets and return of confidence of economic entities. The measure announced by FED for purchase of state securities, which began in November 2010 was an additional factor which influenced the depreciation of US dollar. This measure by FED influenced the rate of yield of US government securities which reduced the foreign currency inflow by foreign investors. However, since the beginning of November when new wave of problems appeared regarding public debt financing of some of the Eurozone member countries (Republic of Ireland) certain turbulences appeared again on the financial markets in the Eurozone which again resulted in euro depreciation against the US dollar. Therefore, at the end of 2010, the value of one euro was 1.34 US dollar.

Figure 5
US dollar-euro nominal exchange rate developments
(monthly data)



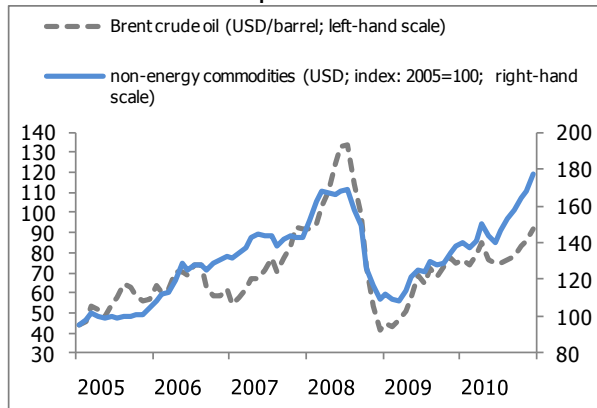
Source: ECB, February 2011

The revitalization of the global economy also increased the global demand for oil and primary (non-energy) commodities which is mainly due to the demand by emerging economies and developing countries. The average price of Brent crude oil in 2010 was US dollar 79.6 per barrel which is an annual increase of 28.7%. During the year, there was a more intensive growth of the oil price in March and April when it reached US dollar 85.7 per barrel, as well as in the last quarter of the year when it reached its peak in December with US dollar 91.8 per barrel. The increase in the crude oil price, besides the low comparison base from the previous year, is a result of the deepening of the gap between oil supply and demand. Namely, the continuous increase in oil demand⁸ was not adequately followed by either an increase in oil supply by OPEC countries, or with higher capacity engagement of oil processing facilities. The prices of primary (non-energy) commodities in 2010 also had a significant annual increase by 23.4% having more intensive growth of metal prices than food prices. The main reason for the increase in metal prices is the high demand by the emerging markets in Asia, especially China, which comes out as a result of the increased economic activity of these countries. In a situation of restricted production capacities the increased demand led also to a reduction of some metal reserves, especially copper. The prices of iron ore, tin, nickel and copper had the most intensive annual growth by 63.3%, 49.7%, 48.6% and 45.9%, respectively. The food prices were relatively stable in the first half of the year without significant fluctuations, while they had a more intensive growth in the second half of the year. The intensive growth of food prices in the last two quarters of 2010, having a relatively stable food demand is mainly due to the supply factors. The bad weather conditions in Russia and Ukraine during the summer period lowered the supply and influenced the substantial increase of wheat price. The bad weather conditions in south hemisphere in the last two months of the year also had the same effect. The most intensive increase was noticed in the prices of wheat, corn and sugar which also affected the rest of the food products.

⁸ During 2010 the International Energy Agency made several times an upward revision of the oil demand growth rate.

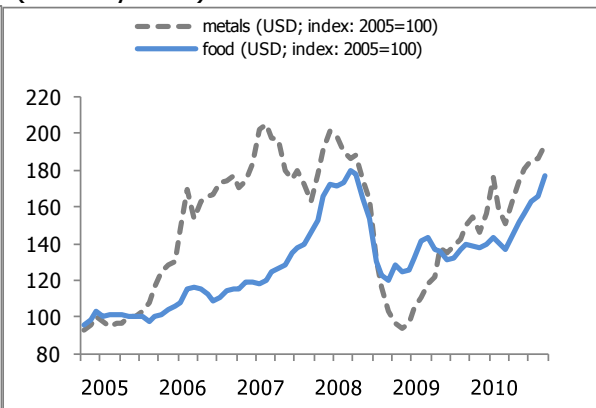
Figure 6

Crude oil and primary (non-energy) commodities developments (monthly data)



Source: IMF monthly database

Metal and food prices developments (monthly data)



Source: IMF monthly database

The increase of food and oil prices during 2010 resulted in global increase of consumption prices. The average global inflation in 2010 was 3.4% which is a 1.2 p.p. increase relative to the previous year. Analyzed from a viewpoint of individual economies in the world, the increased inflation pressures come from the emerging economies, where the strong domestic demand causes price pressures in most of the products. In the developed economies the inflation pressures in 2010 were relatively stable and low and mainly determined by supply factors.

- *Monetary policy*

As a result of divergent macroeconomic developments between emerging and developed economies, monetary policies between these groups of countries significantly differ in 2010. Relatively slow recovery of the domestic demand and low inflation pressures in developed countries led to conducting adjustable monetary policy. This provided stability of the financial markets and support of economic activity. The central banks in developed economies (FED, ECB and Bank of England) during 2010 kept their reference interest rates on a historically lowest level. FED has kept the key interest rate target on the same level since 2008 from 0% to 0.25% while ECB and Bank of England have kept their reference interest rates on the same level since May and March 2009 with 1% and 0.5%, respectively. Moreover, in the last quarter of 2010, FED implemented an additional quantitative measure towards relaxation of the monetary policy by purchasing long-term government securities in the amount of US dollar 600 billion which is anticipated to last until June 2011. In a situation of limited possibilities for taking additional quantitative measures, towards additionally relaxing the monetary policy, the central banks in developed economies took so called "qualitative" measures. Typical for these measures is the purchase of certain types of securities in order to return the confidence in certain segments of the financial markets. In that direction, since November 2010, ECB, in accordance with the Securities Markets Program adopted in May 2010, intervened through purchase of debt securities from private and public sector from the countries which have high public debt in the total amount of Euro 73.5 billion. Additionally, when problems with repayment of the public debt of the Republic of Ireland appeared, ECB, in order to support the Central Bank of Ireland, in mid-December 2010 concluded a foreign exchange swap agreement with the Central Bank of England in the amount of GBP 10 billion with validity period until September 2011. This agreement between the ECB and the Bank of England is a precautinary measure for potential liquidity needs in event of increased demand for GBP by the Irish banking system.

During 2010, the central banks of emerging economies took restrictive monetary measures according to the strong domestic demand and increased inflation pressures. Central banks of China, India and Russia during 2010 increased their reference interest rates several times, while the central banks of Brasil and Turkey increased the level of compulsory reserve. In a situation of high foreign capital inflow and thus appearance of pressures on the foreign exchange market towards appreciation of domestic currencies in the emerging economies in Asia, the central banks of these countries intervened on the foreign exchange markets by purchasing foreign currencies. After the appearance of increased inflation pressures the central banks in Central East Europe also tightened their monetary policies. The Central Bank of Hungary in the last quarter of the year made double increase of the reference interest rate, while the Central Bank of Poland increased the level of compulsory reserve. On the other hand, the monetary policy of the Czech Central bank was directed towards additional relaxation, thus in May 2010 it reduced the reference interest rate by 0.25 p.p. now being 0.75%. The reason for such reduction of the key interest rate is the additional boosting of the economic growth in a situation of relatively low inflation which in that period was under the 2% target.

- *Economic results of the countries in the region*

The revitalization of the global economy especially the economic activity in the Eurozone had an impact on the gradual recovery of the economies in the region. Except for Turkey, which registered high growth, the economic growth in this group of countries has mild and uneven pace among individual countries. The main generator of the growth in 2010 in most of these countries were the net exports as a result of the increased global trade and reduced imports due to still weak domestic consumption. Unlike the rest of the countries in the region the relatively high growth of the Turkish economy was driven by the domestic demand which caused import pressures and thus also a negative contribution to net exports. In 2010, there was a tendency of general price level growth in the countries from the region. Moreover, the inflation became more intensive in almost all countries compared to the previous year excluding Croatia, Montenegro and Serbia. The highest inflation rates had Turkey 8.6%, as well as Serbia and Romania 6.1% each.

Table 3
Economic indicators for countries in South East Europe

	GDP			Average Inflation Rate			Current Account Balance of the BOP			Consolidated Budget Balance			Unemployment Rate		
	(real growth rate in %)			(in %)			(% of GDP)			(% of GDP)			(in %)		
	2008	2009*	2010**	2008	2009	2010	2008	2009*	2010**	2008	2009*	2010**	2008	2009*	2010**
Albania	8.2	3.9	3.9	3.4	2.3	3.6	-15.4	-15.1	-9.2	-5.5	-6.8	-5.2	12.7	13.0	12.5
Bosnia and Herzegovina	5.7	-2.9	0.5	7.7	-0.3	1.8	-14.4	-6.8	-5.5	-2.2	-4.4	-5.0	23.4	24.1	29.9
Bulgaria	6.2	-5.5	0.2	12.0	2.5	3.0	-24.2	-9.5	-3.0	2.9	-3.9	-3.8	5.7	6.8	8.3
Kosovo	5.4	4.0	4.6	9.4	-2.4	3.5	-16.0	-18.6	-18.5	-0.2	-0.8	n.p.	47.5	45.4	n.p.
Macedonia***	5.0	-0.9	0.7	8.3	-0.8	1.6	-12.8	-6.7	-2.3	-0.9	-2.7	-2.5	33.8	32.2	32.1
Romania	7.4	-7.1	-1.3	7.9	5.6	6.1	-11.9	-4.5	-5.1	-5.4	-7.4	-6.8	4.0	6.3	7.2
Serbia	5.5	-3.1	1.8	12.9	8.1	6.1	-20.1	-7.0	-9.6	-2.6	-4.3	-4.8	13.6	16.1	18.2
Turkey	0.7	-4.8	8.9	10.4	6.3	8.6	-5.6	-2.3	-5.5	-2.2	-5.7	-3.7	11.0	14.1	12.2
Croatia	2.2	-6.0	-1.2	5.8	2.2	1.1	-9.3	-5.5	-2.8	-1.4	-4.1	-5.7	8.4	9.1	12.5
Montenegro	6.9	-5.7	-1.8	8.5	3.4	0.5	-50.7	-30.1	-17.0	-0.4	-4.4	-7.1	10.7	11.4	12.1

*Assessment

**Projection

*** Line official institutions are source for data about the Republic of Macedonia.

Source: Quarterly report by the European Commission for EU accession candidate counties and pre-accession countries, January 2011, IMF World Economic Outlook database October 2010, while for the inflation data have been used from respective state statistical offices.

The monetary policies of the countries in the region differ one from another depending on specific characteristics of the national economies. In direction towards relaxing the monetary policy were also the measures adopted by the central banks of the Republic of Macedonia, Albania and Romania through decreasing the key interest rates several times. The aim of these monetary measures was to encourage credit and economic growth in the absence of large inflation pressures. In same direction, but with different measures for stimulating the credit growth, acted also the monetary authorities in Bosnia and Herzegovina and Montenegro, by decreasing the compulsory reserve level or by implementing other temporary administrative measures to encourage the crediting by banks⁹. The central banks of Serbia and Turkey acted in the opposite direction. Due to the increased inflation pressures especially in the second half of the year when the inflation rates went beyond inflation targets, these central banks implemented several restrictive measures. Namely in the second half of the year the National Bank of Serbia increased the key interest rate several times while the Turkish Central Bank increased the obligation for allocation of compulsory reserve. However, in December 2010 the Turkish Central Bank decreased the key interest rate in order to decrease the interest differential relative to interest rates in emerging economies. It is expected that this measure will have destimulating effect on capital inflows thus reducing the pressures for appreciation of nominal foreign exchange rate of Turkish lira.

Table 4
Indicators for progress in transition for countries in South East Europe

	Enterprises			Markets and trade			Financial institutions		Infrastructure
	Large-scale privatisation	Small-scale privatisation	Governance and enterprise restructuring	Price liberalisation	Trade and foreign exchange system	Competition policy	Banking reform and interest rate liberalisation	Securities markets and non-bank financial institutions	Overall infrastructure reforms
Albania	4-	4	2+	4+	4+	2	3	2-	2+
Bosnia and Herzegovina	3	3	2	4	4	2	3	2-	3-↑
Bulgaria	4	4	3-	4+	4+	3	4-	3	3
Macedonia	3+	4	3-	4+	4+	2+	3	3-	3-
Romania	4-	4-	3-	4+	4+	3↑	3+	3	3+
Serbia	3-	4-	2+	4	4	2+↑	3	2	2+
Croatia	3+	4+	3	4	4+	3	4	3	3
Montenegro	3+↑	4-	2	4	4	2	3	2-	2+

Source: EBRD, Transition Report 2010

Still unstable macroeconomic environment slowed down the pace of institutional reforms in countries from southeast Europe relative to the pre-crisis period. Only four countries showed progress, where out of four improvements in total two refer to competition policy. Analyzed by individual countries, progress in infrastructure area was made by Bosnia and Herzegovina by amending regulations which enabled the beginning of construction of Corridor 5c as well as amendments to the regulations which refer to the railway structure, in order to improve their services. Romania and Serbia made progress in the area of competition. Namely in Romania the progress in this area was done through legal authorities reforms which increased the level of implementation of laws, as well as fight against corruption which according to the expectations should improve competition criteria on the markets. In Serbia the progress was made through liberalization of the telecommunication sector by adopting a law which is in line with the EU regulations. In Montenegro the most important progress was made in the area of privatization of large enterprises through privatization of the harbor operator as well as announcement of tender for privatization of the company for railway transport. In the Republic of Macedonia, although no progress was registered at any transitional indicator during 2010, still positive

⁹ The administrative measures by the Central Bank of Montenegro refer to providing restructuring of banks' credit portfolio which allows increase in share of credits placed for purchasing real estate in total credit portfolio of commercial banks as well as lower fees which apply to the banks for conducting payment operations and money transfers.

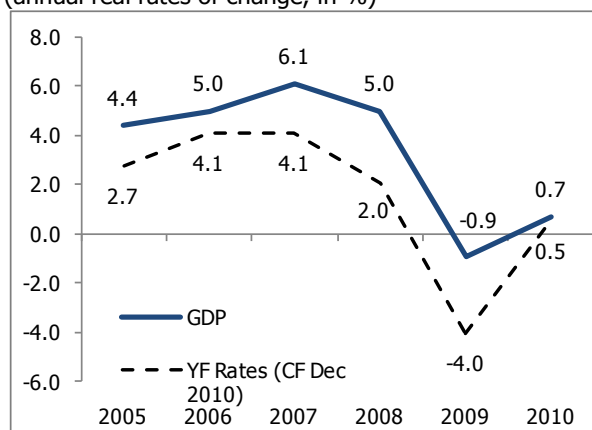
opinions were given in the area of improving the business environment according to the World Bank Doing Business Indicators. The positive opinions refer to shorter procedure and lower costs for starting business which contributed towards easier procedures and lower company taxes.

II. Economic developments in the Republic of Macedonia

2.1. Economic activity

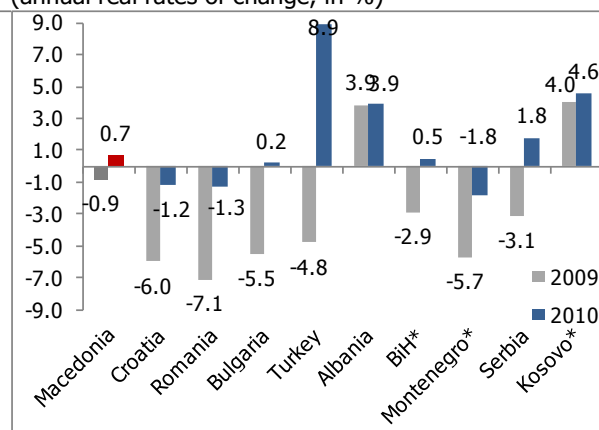
The gradual recovery of the global economy had positive transferred effects also on the activities in the domestic economy. After the mild fall from the previous year, in 2010 there was a 0.7% real GDP growth of the Macedonian economy. The positive developments in the beginning of the year noticed in the exports demand were not strong enough to neutralize the effect from the still weak domestic demand. Therefore in the first quarter of the year the economy was still in the zone of negative annual changes. The activity growth began in the second quarter when the continuity of positive achievements in exports was accompanied with gradual recovery also of the domestic demand. Namely, in a situation of improved and more stable global environment as well as increased exploitation of the domestic exports sector capacity, perceptions and expectations by domestic economic entities significantly improved. In this situation there was also an increase in the propensity to consume and new investments. The consumption and investment decisions were supported also by the gradual progress of credit market activities as well as by relatively fast improvement of the labour market conditions. Additional impulse in 2010 first of all for the domestic investments was provided also through input of new foreign investments and growth of public capital investments.

Figure 7
GDP and foreign effective demand
(annual real rates of change, in %)



Source: State Statistical Office and Consensus Forecast, December 2010. GDP data for 2009 are as previously and they are estimated for 2010.

Figure 8
Real GDP growth* by countries
(annual real rates of change, in %)



* 2010 projections
Source: EUROSTAT, IMF (IMF World Economic Outlook database October 2010) and state statistical offices of the countries.

The economic recovery process was also typical for the countries in the region although with various dynamics and intensity. However, common for most of the countries in the region is that the recovery is mainly due to the significant growth of exports demand in a situation of still weak domestic demand. Moreover, in most of the countries in the region during 2010 there was neither an increase of new capital inflows, crediting, investments nor improvement of the labour market conditions. The achievements of the Macedonian economy in 2010 although modest are still better than some countries in the region whose growth indicators are still in the negative zone. Such is the case with Romania which has 1.3% real GDP fall and Croatia with 1.2% fall while Bulgaria had minimal growth of 0.2%. Apart from these countries, the Turkish economy which was one of the hardest hit by 2009 recession, in 2010 had the highest growth rate in the region (8.9%). Besides the previously established solid

macroeconomic policies and strong banking regulations, its significantly lower dependence from the European market as main exports destination also had a contribution towards the extraordinary post-recession achievements of the Turkish economy¹⁰. The Serbian economy also had a positive growth rate in this period (1.8%) while Albania which is the only country in this region that was not hit by the global recession due to high state investments in 2010 had continuous moderate growth rates (3.9% on average).

2.1.1. Aggregate supply

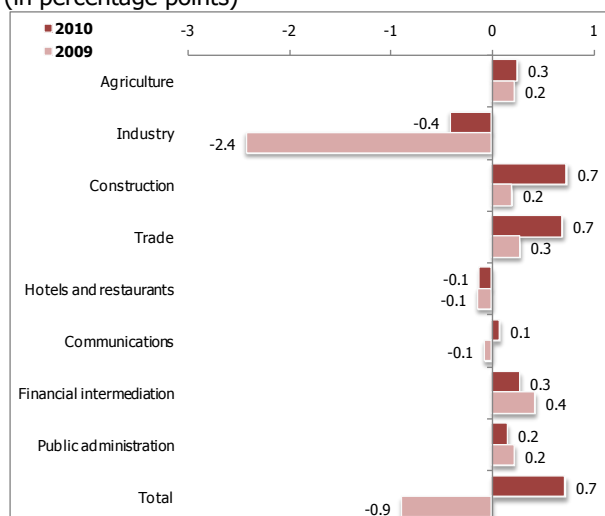
The gradual recovery of the domestic economy which began at the end of 2009 also continued in 2010 with exception of the first quarter of the year. However, the pace was relatively slow with a real GDP growth of 0.7% in 2010.

The domestic economic activity in the first quarter was still weaker than the previous quarter as well as the same period last year. The annual fall of domestic output in the first quarter of 2010 was 1.7% where the industry had the major contribution in such negative dynamics. The positive transferred effects from the gradual increase of foreign demand onto domestic supply were felt starting even from the second quarter of the year, when a minimal growth rate of 0.2% was achieved. Moreover, the exports growth was accompanied by gradual recovery of domestic demand, supported by increased financial assistance by banks and positive expectations of economic entities. Such positive developments in the demand contributed towards an increase in the output and higher exploitation of existing capacities of domestic producers. Thus in the third and the fourth quarters the GDP grew by 1.6% and 2.3%, respectively.

Analyzed by individual sectors from the output side, one can notice a dispersed economic growth. Namely, excluding industrial and catering sector, in 2010 there was a positive annual change in all other sectors. Growth was driven mainly by construction and trade, but there was a significant contribution also by financial intermediation and other business sectors as well as agricultural sector. Industry, as the most important sector for the domestic economy, has had negative input two years in a row. However, the dynamics of fall of industrial production is significantly slower, which points to a start of recovery process, but still relatively slow.

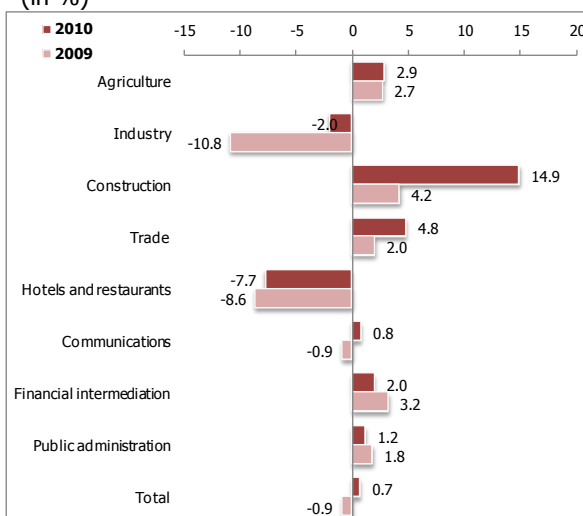
¹⁰ IMF Regional Economic Outlook, October 2010.

Figure 9
Components contribution towards GDP growth
(in percentage points)



Source: State Statistical Office and NBRM calculations.
Data for 2009 are preliminary and the data for 2010 are estimated.

Figure 10
Annual GDP growth rates and components
(in %)

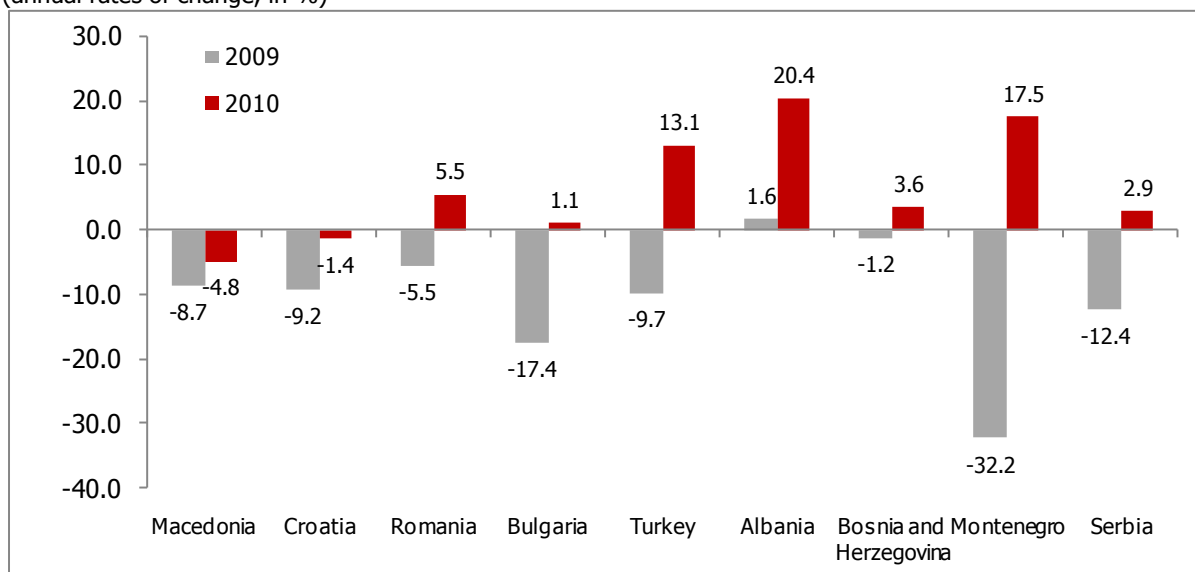


Source: State Statistical Office

The industrial sector in 2010 registered an annual fall of 2%¹¹, contrary to the significant fall from the previous year of 10.8%. The considerably lower negative growth rate of industry in 2010 is a result of favorable developments in foreign demand, which led to an increase in the output in the export-oriented sectors and significant slowdown of the annual decline in industry in the second and stagnation in the third quarter. Positive stimulus from our most important partners remained until the end of the year but still the high comparative base from 2009 results in fall of industrial sector in the fourth quarter. From the aspect of individual industry branches, in a situation of increased metal prices, especially nickel, the production of basic metals had positive achievements in 2010 with high annual growth of over 30%. There was a high growth also in the electricity production (around 15%) due to good hydrological conditions in the country. There was also growth in the tobacco industry, food industry and production of parts for transport equipment. However, there was an annual decline in the output in 2010 in fifteen out of twenty seven industrial branches, which comprises approximately 50% of total industrial output. The major negative contribution has the annual fall of production of metal products, electric equipment and publishing activity (due to the high comparative basis from 2009), then the products from non-metal mineral products (construction materials), beverages, clothing and chemical products.

¹¹ At the same time, there was 4.8% fall of the volume of industrial production.

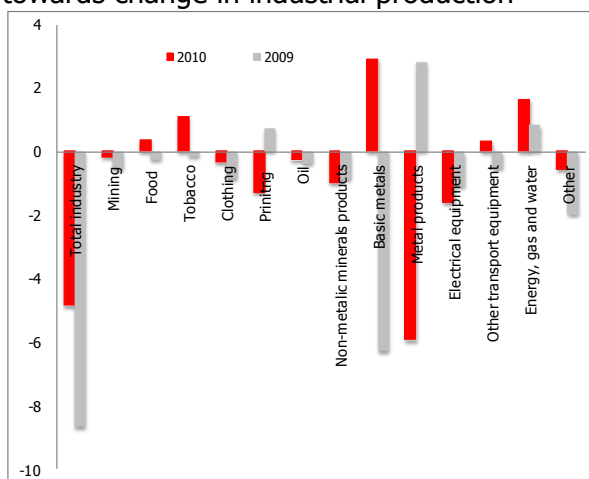
Figure 11
Industrial output volume index by countries
(annual rates of change, in %)



Source: EUROSTAT and statistical offices in those countries.

Compared to the industrial output of the countries in the region Macedonia is among the countries with lowest achievements in 2010 regardless of the significantly lower fall rate (almost double compared to 2009). This group of countries includes also Croatia with 1.4% decline in the output. There was recovery of the industrial activity in all other countries in the region, after the sharp fall rates in the previous year. Albania had the highest industrial growth rate of 20.4% and it is at the same time the only country in the region with positive results also in 2009, followed by Montenegro and Turkey.

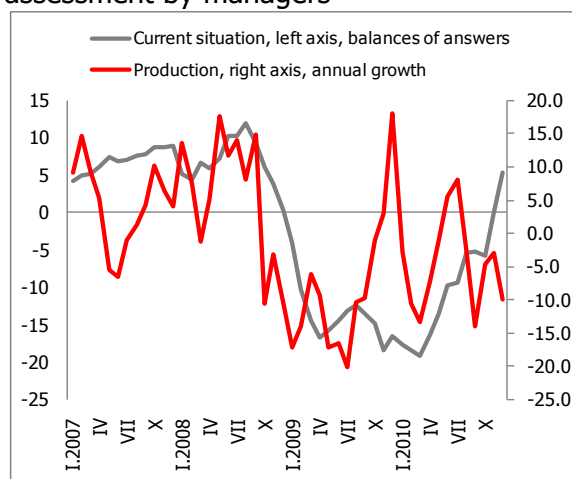
Figure 12
Contribution (in p.p.) by individual activities towards change in industrial production



Source: State Statistical Office and NBRM calculations.

Balances of the responses, presented on the left scale, show the development of indicators, and not the real size, i.e. they point out to improvement or deterioration of situation. The balances of responses are obtained by weighing of individual replies. The responses from managers are qualitative (good, bad, increase, decrease etc.) and not quantitative.

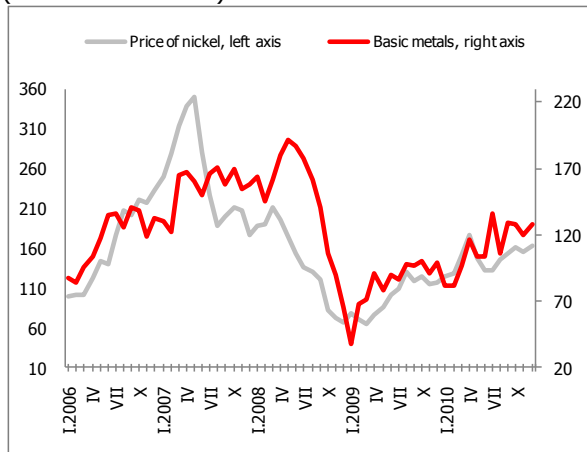
Figure 13
Industrial production and current situation assessment by managers



Source: State Statistical Office.

The achieved results in industry are generally confirmed by assessments from company managers in manufacturing industry¹² which had continuous improvement in the second quarter of 2010 from the aspect of the economic situation of companies and their production volume as well as from the aspect of average exploitation of capacities and current coverage of production in terms of orders. The insufficient foreign and domestic demand is given as less important restrictive factor for increasing of production. Significantly more important factor was the lack of qualified labor force as well as financial problems.

Figure 14
Production of basic metals and price of nickel
(indexes: 2005=100)



Source: State Statistical Office and the IMF.

Figure 15
Production and exports of textile and number of employed in textile industry
(indexes: 2006=100)

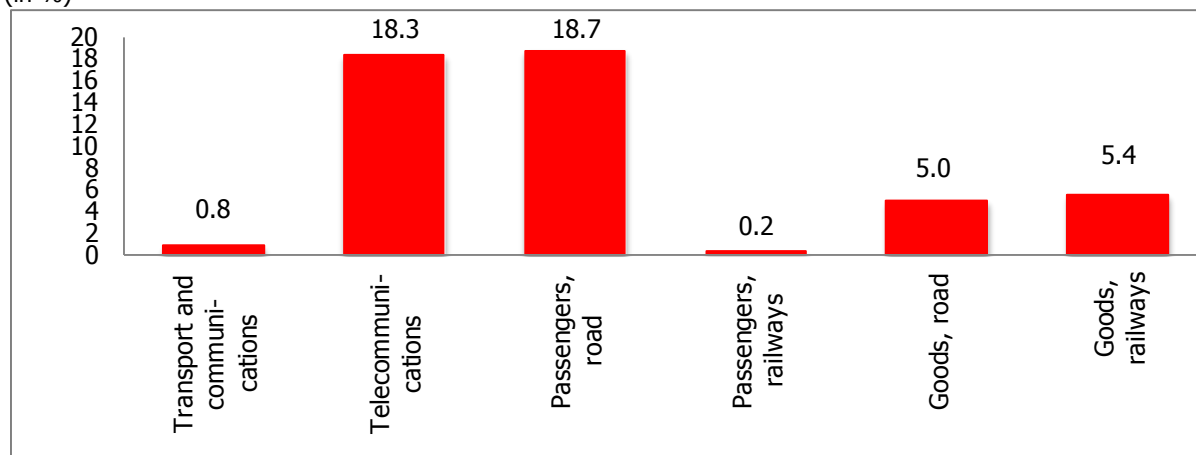


Source: State Statistical Office.

Traffic, storage and communications sector had 0.8% real annual growth relative to the 0.9% fall in 2009. The gradual recovery of the industry especially of branches oriented towards the exports generates positive transferred effects in this sector. The data show growth in all types of transport and the increase in cargo (railway and road) transport corresponds to the growth of domestic production as well as the exports. The telecommunication sector activities continued to grow also in 2010 as a result of expansion of mobile phones traffic, with further decrease of land line traffic.

¹² From the Survey on Business Tendencies in Manufacturing Industry of the State Statistical Office, December 2010.

Figure 16
 Real growth rate of activities in traffic and communications sector in 2010
 (in %)

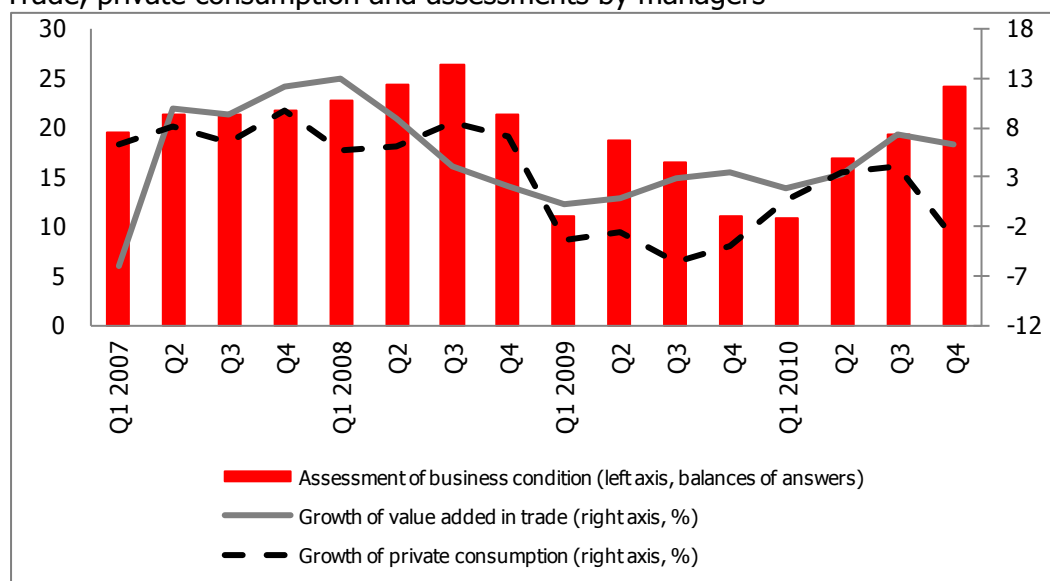


Source: State Statistical Office.

In 2010, the positive dynamics of trade continued, which significantly accelerated its growth especially in the second half of 2010. Namely, the trade sector in the first two quarters of the year increased by 2.6% while in the second half reached an average growth of 6.8%. Thus, the real growth of value added in trade for the whole 2010 was 4.8% (2% in 2009) and is one of the main generators of growth of the total output. In a situation of growth of disposable income and credit support of households, as well as the clear recovery of the labor market since the middle of the year, the private consumption was continuously increasing during 2010 (excluding the last quarter) stimulating the domestic output, imports of consumer goods and trade sector. The assessment by managers of trade companies this year are more favorable compared to those from the last year, from the aspect of current business and financial situation and sale prices, and within the limiting factors this year the importance of increased labor cost becomes stronger¹³. Apart from the trade, the **catering sector** registered a fall again, which slowed down in 2010 and is 7.7% on annual basis due to which this sector same as last year is among the sectors with negative contribution towards the economic growth.

¹³ Survey on Business Tendency in Retail Trade, State Statistical Office, fourth quarter of 2010.

Figure 17
Trade, private consumption and assessments by managers

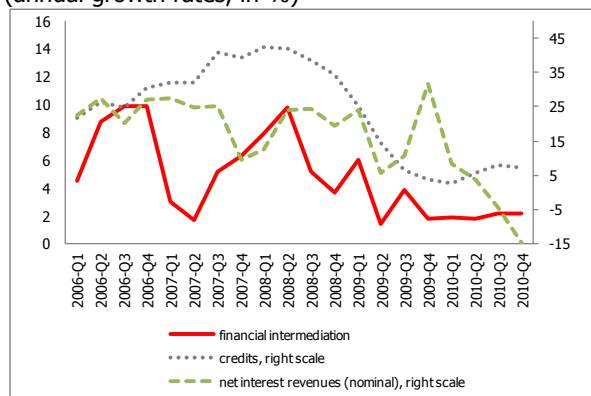


Source: State Statistical Office.

In a situation of gradual improvement of general conditions in the domestic economy the activities in the sector of financial intermediation, real estate properties and other business and service activities had accelerated annual growth in the second half of 2010 and a significant positive contribution in the GDP creation. However, during the whole 2010 the real annual growth in this sector slowed down slightly to 2% (compared to 3.2% growth in 2009). Indicators of *financial intermediation* (which is around one third of the total activity¹⁴) point to solid, but still lower achievements within this segment. Namely despite the moderate intensification of total credit activity of the banks at the end of 2010 (7.1%) the net interest income of the banks had negative dynamics (-2.4%, relative to 17.5% growth in 2009). **Besides this sector, the agricultural sector, which creates almost 10% of the total GDP, also had a significant positive contribution towards the whole economic growth.** The annual growth of the added value in agriculture of 2.7% in 2009 also continued in 2010 reaching 2.9%. The favorable developments in the agriculture are combination of many factors, mainly good weather conditions, extensive subsidies by the state, as well as the entrance of foreign investors in domestic production purchase and its placement on foreign markets. Thus, in 2010 the exports of fruits and vegetables increased by 35% and the exports of tobacco and its products by 18%.

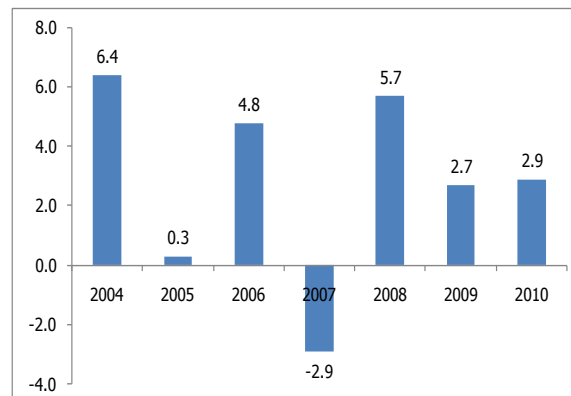
¹⁴ The data refers to the share calculated according to SSO data for 2008 GDP.

Figure 18
Added value in financial intermediation, credits and net interest income (annual growth rates, in %)



Source: State Statistical Office and NBRM

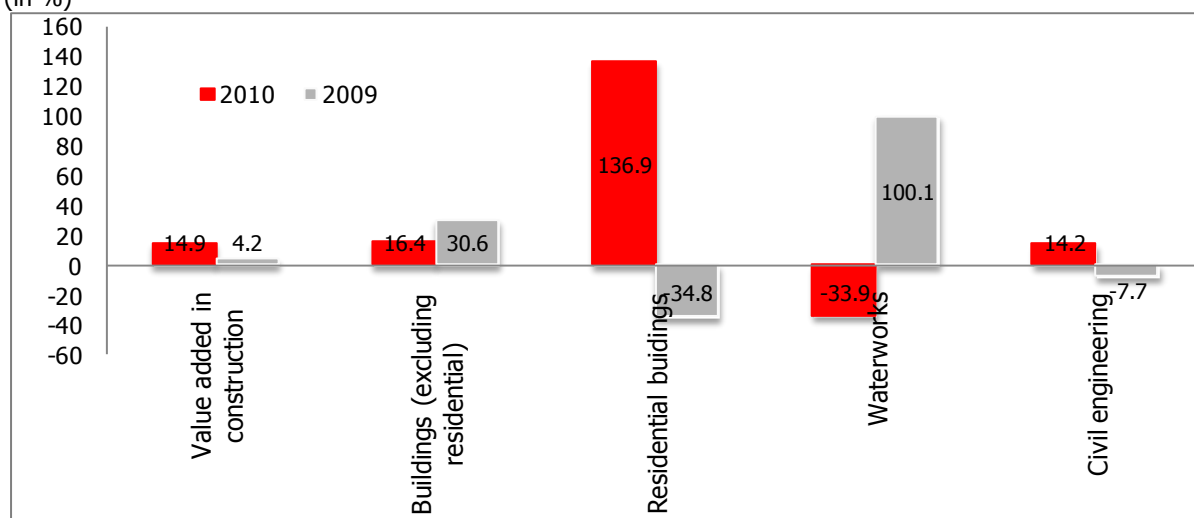
Figure 19
Annual real growth rates in agriculture (in %)



Source: State Statistical Office

The activities in construction, which with its growth in 2009 partially buffered the fall of the GDP, it continued to increase also in 2010. Thus, in 2010 the construction achieved real annual growth of 14.9% having especially high growth in the last two quarters of the year. Analyzed by construction sector's structure, in 2010 there was annual growth of building constructions (especially residential buildings) and civil construction works, while at hydroconstruction there was almost one third decrease compared to the same period last year. The increased construction of apartments during 2010 (by 2.4 times) is a reflection of favorable developments in domestic as well as global economy which create positive perception for future developments and return the confidence of the investors. Also, the state capital investments are important stimulus for the construction activity. The results in the construction area match the opinions of construction companies' managers¹⁵ according to whom the importance of lack of demand as limiting factor in the production declined during 2010.

Figure 20
Real annual growth rates of construction and nominal growth by individual types of construction (in %)



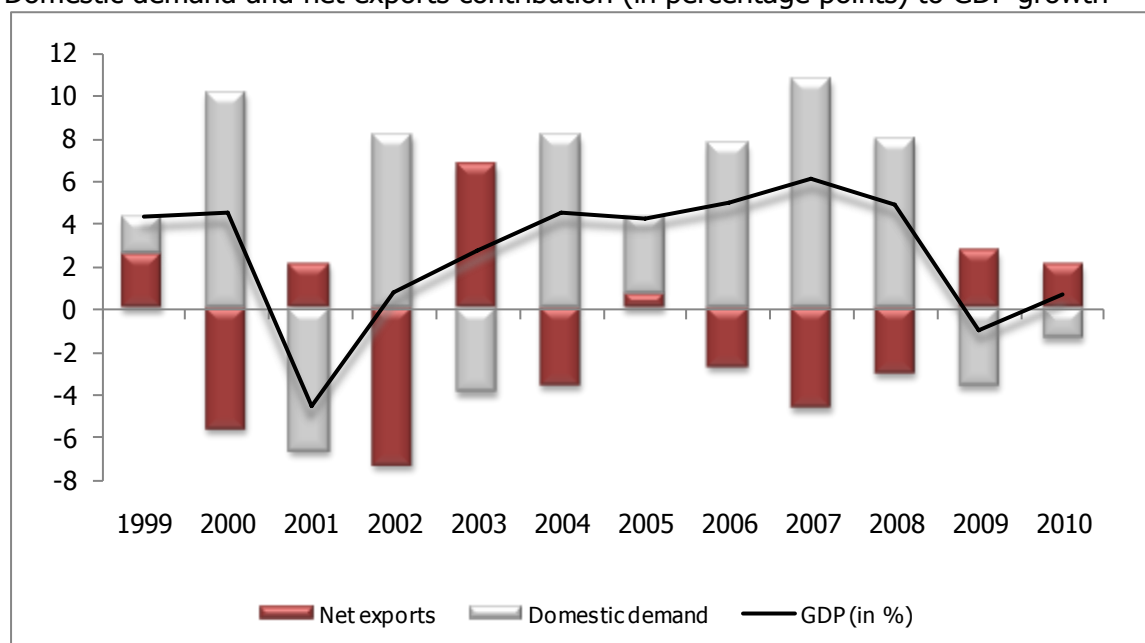
Source: State Statistical Office

¹⁵ From the Survey on the Business Tendencies in Construction , SSO, fourth quarter of 2010.

2.1.2. Aggregate demand

The process of recovery of domestic economy started in the beginning of 2010. The first positive impulses were created through improvement of the global conditions which even in the beginning of the year caused increase in exports volume. Namely, after the sharp fall in the previous year, in 2010 the economic activities of our most important trade partners began with mild positive growth rates. The strong growth dynamics of the emerging markets also had positive transferred effects on the increased exploitation of capacities of domestic exporters. Their increased demand improved the conjunction of the global metal market which had strong positive effects on this large exports segment. **The recovery of the domestic demand began in the second quarter, with positive achievements also in personal as well as investment consumption.** Thus, after the continuous decrease of the domestic demand during the whole year, it began its upward path in the second quarter. Such developments in the domestic demand can be partially explained by indirect effects created by growth of exports in small and open economy such as the Macedonian. Namely the recovery of exports has stimulating effects on future expectations of the entities, decreasing their refrain from consumption and new investments. The demand growth was supported by relatively solid labor market conditions, facilitated, although still limited access to financing as well as by the fiscal stimulus on the domestic investment activity.

Figure 21
Domestic demand and net exports contribution (in percentage points) to GDP growth

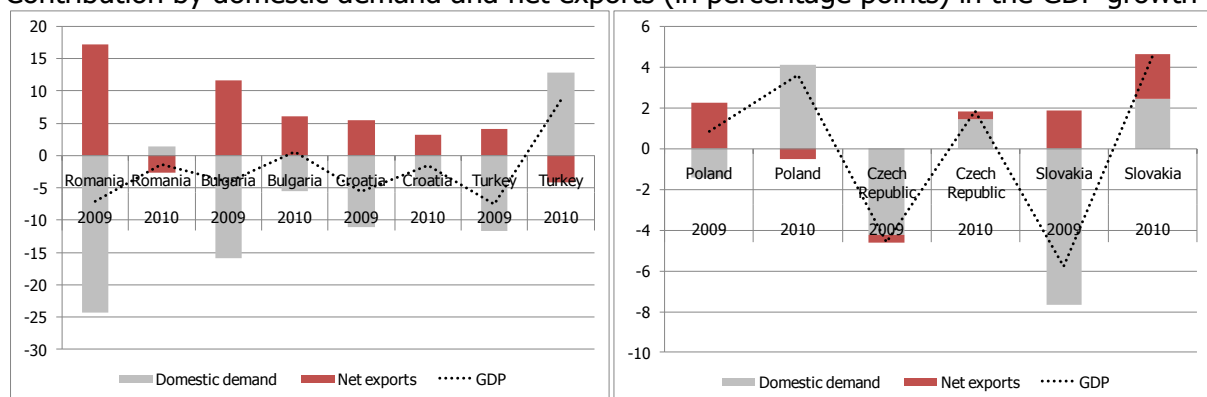


Source: State Statistical Office and NBRM calculations

Similar to the Macedonian economy also in the economies of the countries in Central and Eastern Europe the first impulses for the economic recovery in 2010 were mainly created by the external demand growth. This mainly refers to CEE countries the economies of which largely depend on the business environment in Germany. However, in some of them already in 2010, in the improved conditions, the domestic demand started to recover and to contribute positively to the economic growth. That is the case with CEE countries (Poland, Czech Republic, Slovakia) where in a situation of better expectations, improved labor market conditions and increased confidence the domestic

demand has large positive contribution to the growth. It is a similar situation with Turkey where in a situation of solid macroeconomic fundamentals, the confidence and expectations of domestic entities are favorable. In such conditions, the recovery of the economy in 2010 is driven by the strong domestic demand, whose growth is assessed as sustainable also in the following period. On the other hand, in some of the countries from the region (Romania, Bulgaria, Croatia) the process of emerging from the crisis goes relatively slowly where the domestic demand is either gradually increasing or is still in the negative zone. That shows that in these countries the economic recovery is not widely dispersed, and the conditions in the domestic economies are not enough stimulating in order to provide quick recovery of the domestic demand.

Figure 22
Contribution by domestic demand and net exports (in percentage points) in the GDP growth



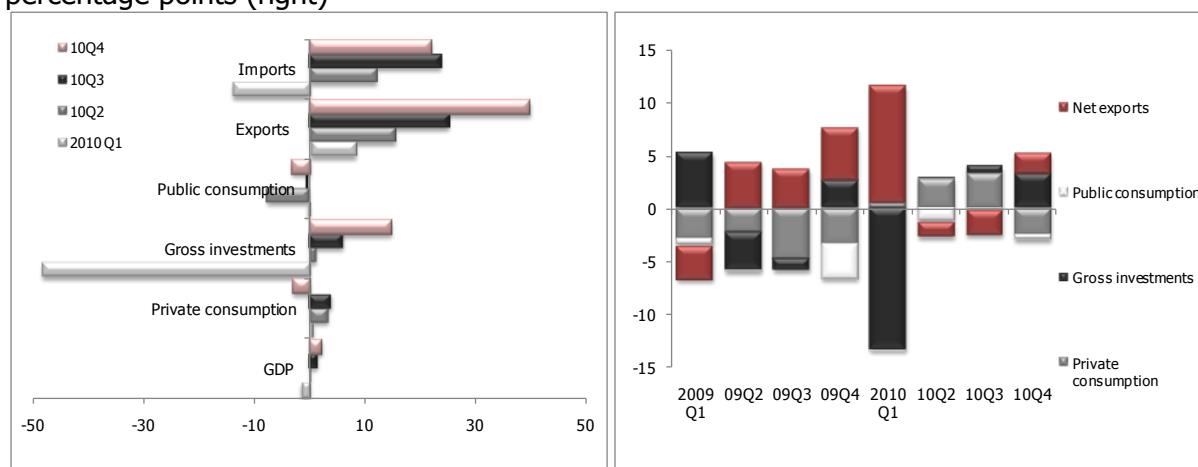
Source: State Statistical Office and NBRM calculations.

Note: The GDP growth for 2010 and the individual contribution of components in the GDP growth for Turkey and Croatia are based on data for current 2010 and previous 2009 year including the third quarter.

Structural analysis of the GDP growth of 0.7% for the whole 2010 points out to positive contribution for net exports and negative contribution of the domestic demand. The growth structure was changing during the year. In the first quarter of the year the domestic demand still did not show signs of major recovery, having a strong fall of the investment activity. Thus, the import pressures created through the domestic demand channel were low. At the same time, the achievements in the exports sector continued to improve, starting again the phase of exports volume increase. **In such conditions, the contribution of the domestic demand for the GDP change was negative, having a high positive contribution to the net exports. In the second and the third quarter** along with the growth of exports component there was a continuous strengthening of domestic demand component. Such trends had stimulating effect on the imports growth, where the contribution by the domestic demand towards GDP was positive, while the net exports demand had negative contribution to the growth. Thus, five quarters after the start of crisis, the GDP change structure was again identical with the structure typical for the period between 2004 and 2008, with a positive contribution of the domestic demand and negative contribution of the net exports. These movements ceased in the last quarter of 2010 when due to extremely high exports growth, the net exports demand had again positive contribution to the GDP growth with at the same time positive contribution also of the domestic component.

Figure 23

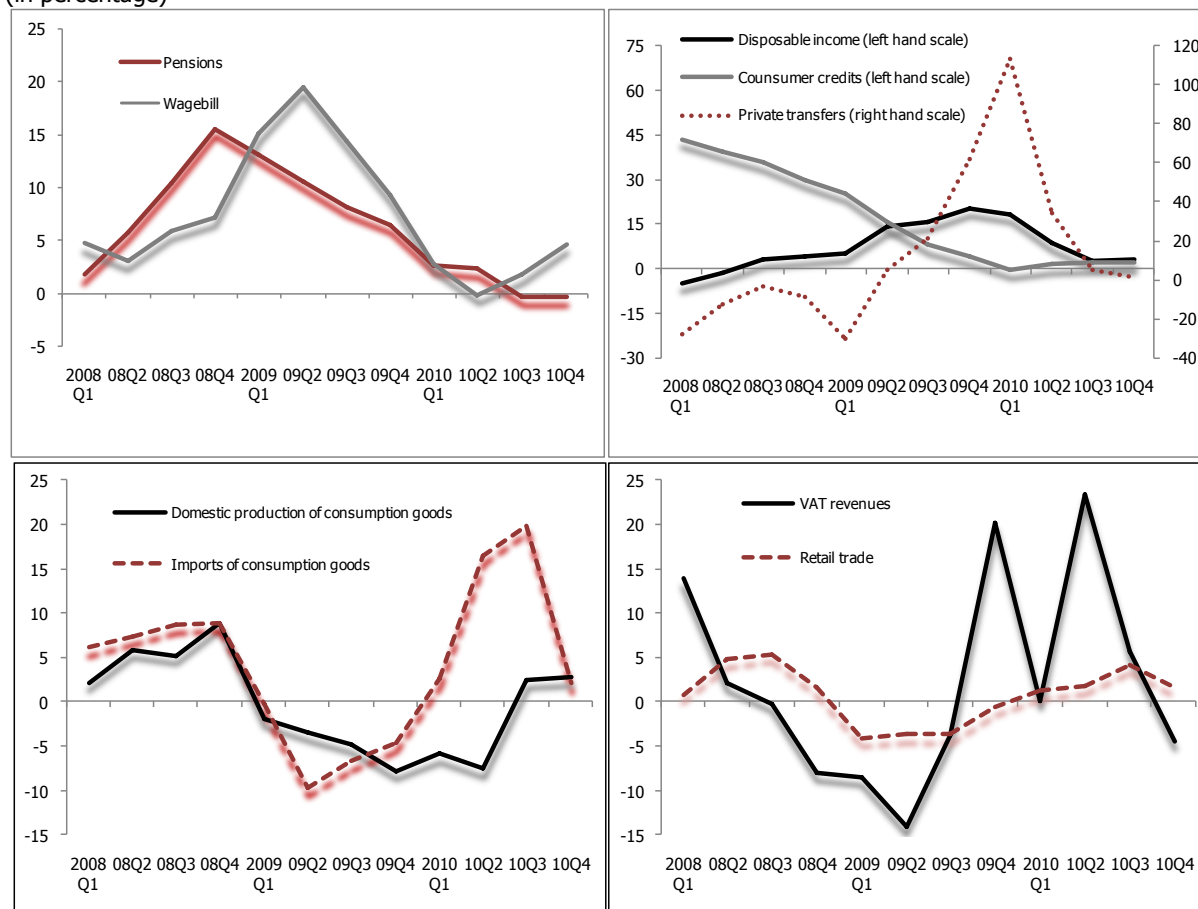
GDP by expenditure components: annual rates of change (left) and growth contribution, in percentage points (right)



State Statistical Office and NBRM calculations

In 2010, the private consumption entered into the zone of positive annual changes. For the whole 2010 the private consumption had 1.1% growth. The private consumption intensity growth was continuously rising until the third quarter. In the last quarter it was again positioned in the zone of negative changes. Such dynamics points out to a gradual, but still “cautious” post-crisis recovery of the consumption. Namely, during the previous year the household consumption was continuously decreasing. The unfavorable perceptions of the households in a situation of uncertainty regarding the duration of the global economic crisis and its effects on the domestic economy as well as the more difficult approach to financing were the main factors which influenced the consumption dynamics in this period. The annual growth of private consumption started in the beginning of 2010, signaling positive reaction by households to the improved global and domestic economic perspectives. However, the opportunities for additional financing of consumption through the credit market were higher compared to the previous year. At the same time, the data on individual components of disposable income point out to its slower, but still significant growth in 2010. Private transfers are the main generator of the disposable income growth. Thus, in 2010 the total wage bill increase continued which in a situation of slower growth dynamics of average net wage was a result of higher employment, especially in the last two quarters of the year. Namely, the employment was perceived as one of the main risks for maintaining the recovery of private consumption due to uncertainty about strength and duration of effects from the recession on the labor demand. However, it started to increase already in the second quarter of the year and the growth continuity was additionally strengthened until the end of the year. Such trends on the labor market had stimulating effect on the expectations and the household consumption. Despite the favorable achievements in factors which determine this component the data on the last quarter of the year show significant fall of the propensity of households to consume. In absence of indicators which would help explaining this development, the downward adjustment of consumption in the last quarter most likely reflects the perception of households for lower disposable future income in line with the inflation growth, which was more evident in the last quarter of 2010. This opinion can partially be supported by the Consumers Opinion Survey in which the households have more unfavorable expectations regarding the future financial situation.

Figure 24
Annual real rates of change of sources for financing of private consumption and similar categories of private consumption (in percentage)



Source: State Statistical Office, Ministry of Finance and NBRM.

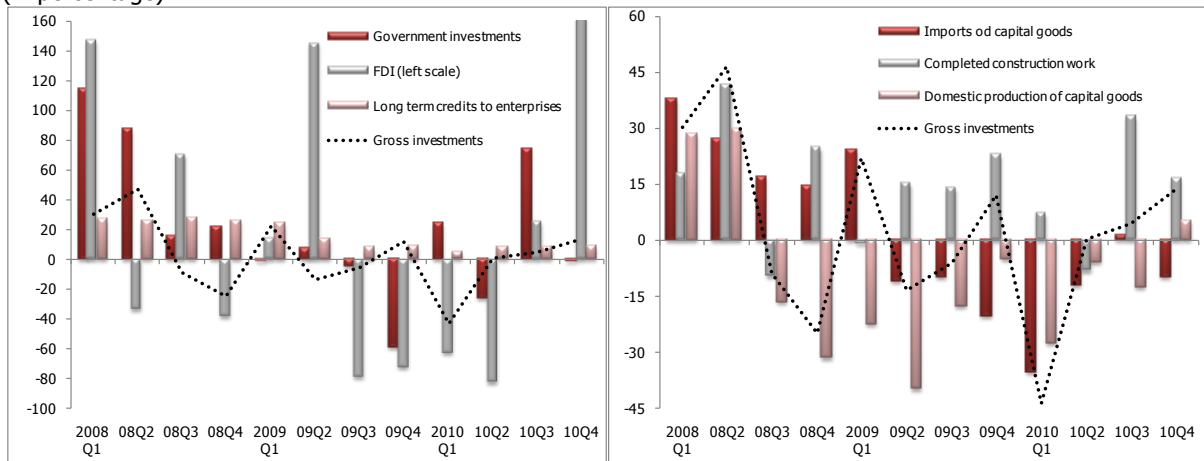
After the minimal growth in the previous year¹⁶ in 2010 the investments had real annual fall of 7.5%. The investment activity dynamics corresponds to the global environment for making new investment decisions during most time of the year. Namely, the main characteristic of the global environment in the first half of the year was the slow and unequal economic recovery. In the second half of the year, the global economic recovery was characteristic for most of the economies, although the growth pace varied by country and region. In such global surrounding, after a sharp fall in the first quarter even in the second quarter investments were positioned in the zone of moderate positive achievements. However, the indicative categories for the second quarter showed renewal of reserves, but not of investments in fixed assets. Cumulatively, in the first half of the year there was a fall of the investments. This fall in investments can be explained by the significantly decreased inflows from foreign direct investments as a reflection of still unstable global financial conditions, weak financial situation in the private sector, as well as by still insufficiently used capacities in most sectors. At the same time, the still not completely stable domestic credit market represented a restrictive factor for investment activity of the corporate sector. In the second half of the year especially in the fourth quarter there was revitalization of the investment activity. Such trend in this period can be explained by the high positive achievement of foreign direct investments¹⁷, then the mild acceleration of

¹⁶ The growth of investments in 2009 i.e. during the major effects from the global economic crisis is primarily explained by the effect from the previously started projects.

¹⁷ Which besides of the global economic recovery, is also a result of the low comparison basis from the second half of 2009.

growth rate of long-term corporate loans as well as with the positive effect on the investment activity created by the government capital investments whose real annual growth for the whole 2010 was 12.3%.

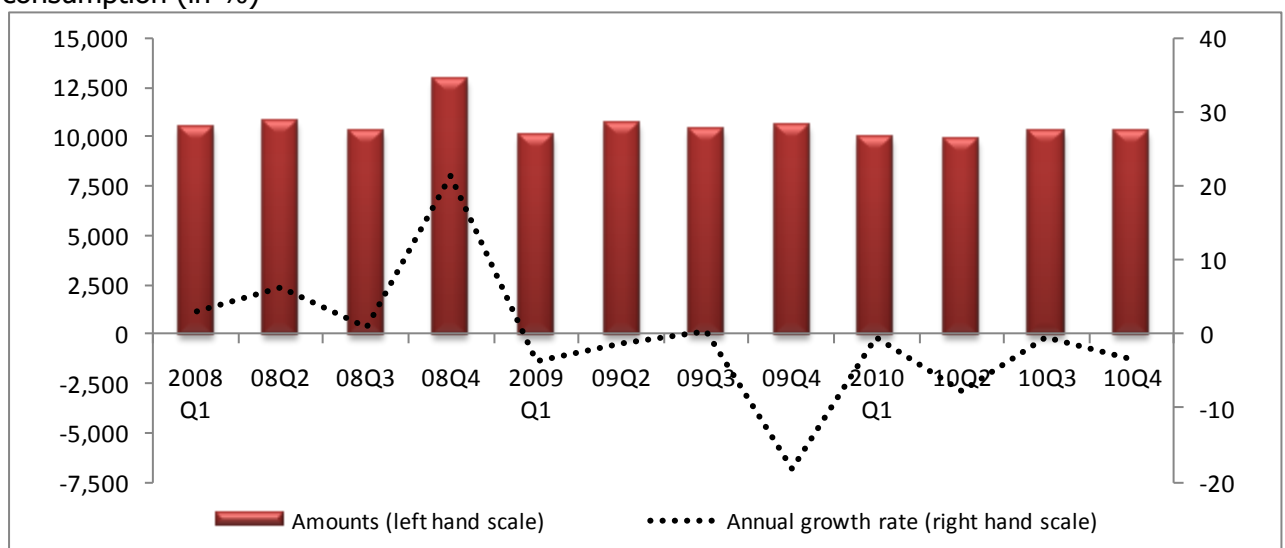
Figure 25
Annual real rates of change of sources for financing investments (left) and similar categories of investments (right)
(in percentage)



Source: State Statistical Office, Ministry of Finance and NBRM.

Government spending in 2010 was lower than in the previous year. In a situation of a nominal fall of 0.4%, the public consumption in 2010 had 3% real annual fall. The public consumption dynamics was unequal throughout the year. Thus, in a situation of almost neutral effect on the growth in the first and the third quarter (0.1 p.p. minimal negative contribution) in the second and the fourth quarter of the year the public consumption had more significant negative contribution, with a real annual fall of 7.7% and 3.3%, respectively. Thus, the fall of public consumption is primarily a reflection of reduced expenditures for commodities and services.

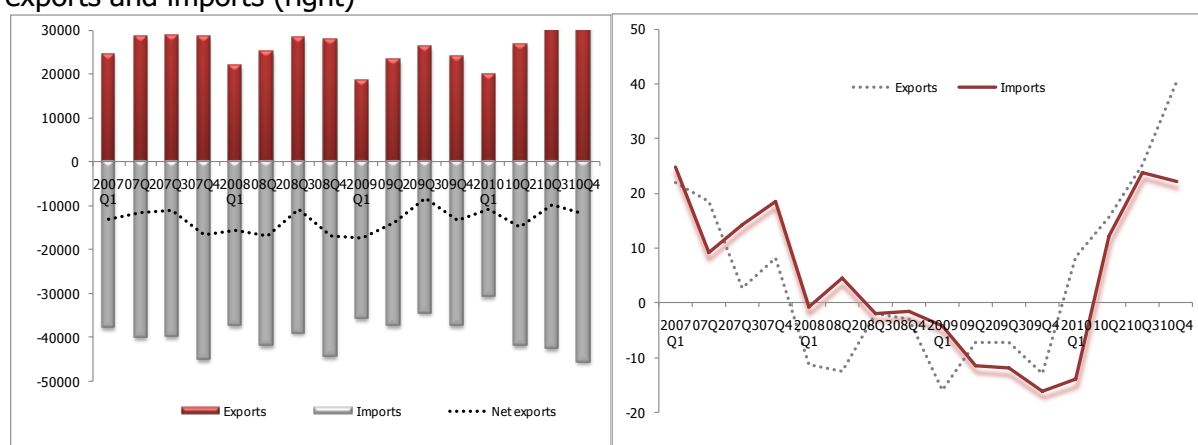
Figure 26
Real amount of public consumption (in million denars) and annual rates of change of public consumption (in %)



Source: State Statistical Office and NBRM.

The increase in the exports demand volume started in the beginning of 2010. The increased foreign demand and favorable market conjunction of our main export products are the factors which explain the positive exports dynamics. In a situation of still depreciated domestic demand such exports dynamic was not strong enough to cause upward movement of imports. Pursuant to that high positive contribution by net-exports was registered in the first quarter which was not sufficient enough to completely offset the negative contribution by domestic demand. With the gradual recovery of the domestic consumption and investments **the imports demand began to move upward** already in the second quarter. Thus, in the second and the third quarters the net exports had negative effect on the total GDP change. In the last quarter of 2010 due to more intensive exports growth, the net-exports demand was again positioned in the positive contribution zone. For the whole 2010 the real growth of exports and imports were 22.7% and 10.7%, respectively.

Figure 27
Real exports and imports amounts, in million denars (left) and annual change rates of exports and imports (right)



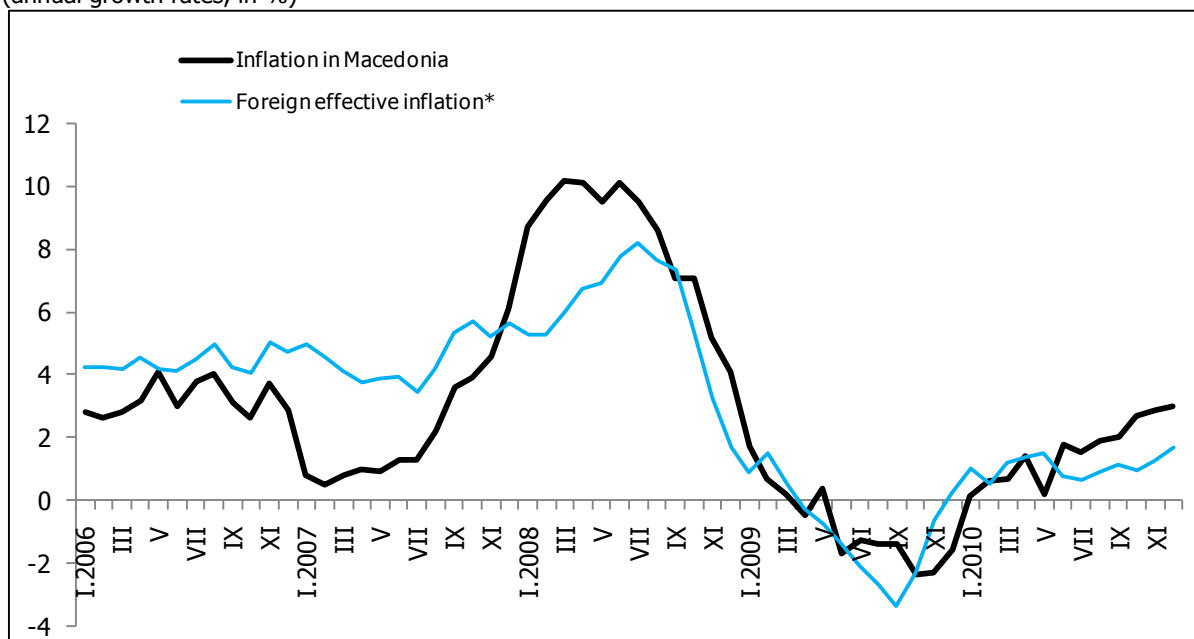
Source: State Statistical Office and NBRM.

2.2. Inflation

The average inflation rate in 2010 was 1.6% (negative rate of 0.8% in 2009). The increased energy prices, and in the second half of the year also the increased prices of food on the global market had the major effect on the inflation. In a situation of gradual recovery of the global demand and shocks on the supply side, the prices of energy and food quickly started to increase during 2010. The growth of inflation in the domestic economy was continuously increasing in the course of the year. In the first half of the year the annual inflation averaged 0.8% due to increase of some of the regulated prices¹⁸ and oil price growth on the global market. In this period, the food prices were still decreasing, thus neutralizing part of the increased energy prices. The domestic inflation growth accelerated in the second half of the year reaching 2.3%. Namely, the growing dynamics of the global energy prices was supported by the food prices growth, which gradually transferred on the domestic prices.

¹⁸ Electricity and heating energy price.

Figure 28
 Domestic inflation and effective foreign inflation*
 (annual growth rates, in %)

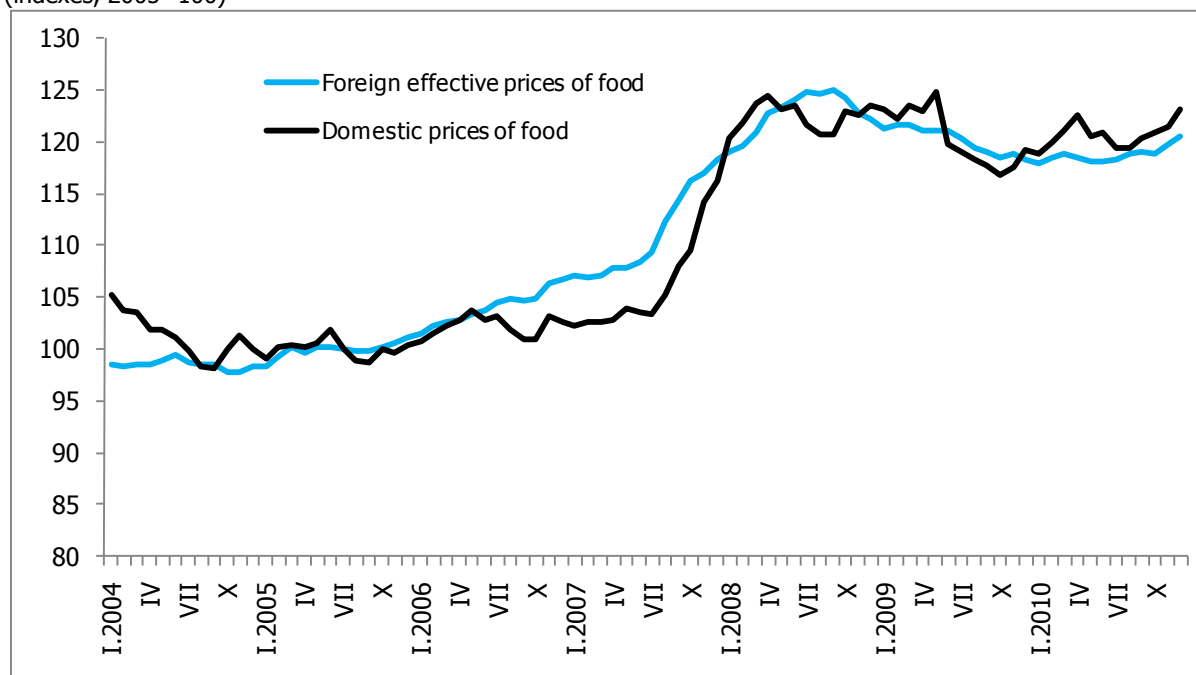


* The effective foreign inflation is the weighted sum of inflation in the countries which are the most important trade partners of the Republic of Macedonia.

Source: State Statistical Office and EUROSTAT.

Thus, the dynamics of domestic inflation in 2010 was mainly driven by the supply side factors. Although the economic recovery was slow and functioned below its potential, no inflation pressures were noticed through the demand channel. This can be also seen through the core inflation dynamics which excludes the food and energy prices effect. In 2010 the average core inflation modestly increased by 0.2% on average. However, towards the end of the year there was accelerated growth also of this inflation component which points out to appearance of potential secondary effects from the energy price growth.

Figure 29
Foreign effective* and domestic prices of food
(indexes, 2005=100)



* The effective foreign food prices are the weighted sum of food prices in the countries which are the most important trade partners of the Republic of Macedonia.

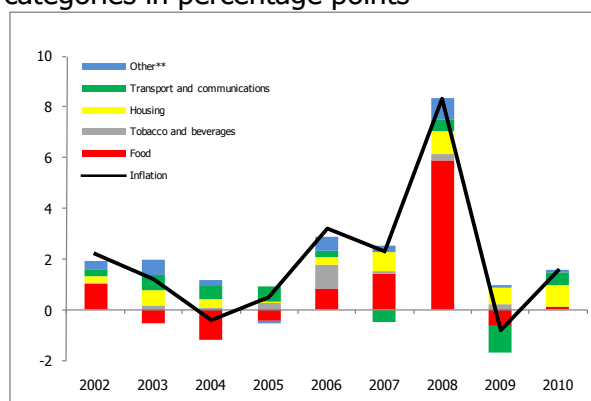
Source: State Statistical Office and EUROSTAT.

The analysis of domestic inflation growth structure proves the conclusion for presence of price pressures caused by import and regulated prices. Thus, with 11.2% growth the energy prices had the largest contribution of 1.4 percentage points in the average annual growth of costs of living. Hence, the growth of the domestic prices of oil products by 19.3% contributed with 0.6 percentage points to the total inflation growth. The upward correction of the electricity price in January 2010¹⁹ contributed with 0.6 percentage points while the increase of central heating price in January and August 2010 contributed with 0.2 percentage points in total²⁰.

¹⁹ On December 28, 2009 with a the decision by the Energy Regulatory Commission of the Republic of Macedonia the electricity average sale price according to which EVN Macedonia supplies tariff retail consumers for 2010 is denar 3.7871 per Kw/h (9.98% increase)

²⁰ In January and August 2010 the Energy Regulatory Commission increased the price of delivered heating energy by Toplifkacija AD – Skopje (1.5% and 11.3%, respectively) and by Skopje Sever AD – Skopje (7.5% and 15%, respectively).

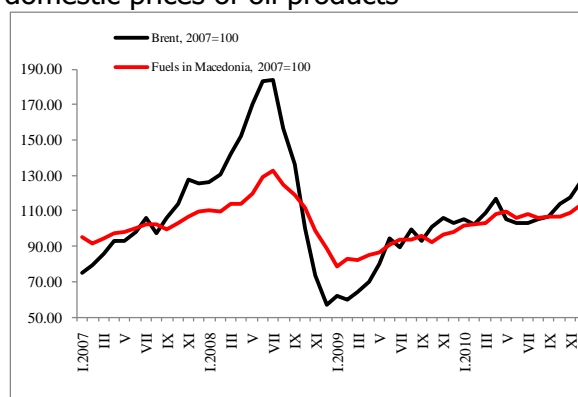
Figure 30
Inflation (in %) and contribution by main categories in percentage points



* "Other" includes the following categories: clothing and shoes, hygiene and health, education, culture and entertainment, restaurants and hotels and other not mentioned services.

Source: State Statistical Office and NBRM calculations.

Figure 31
Brent oil price on world stock exchanges and domestic prices of oil products



Source: State Statistical Office and IMF database.

Table 5
Individual price categories
(annual changes in %)

	2007	2008	2009				2009	2010				2010
			Q 1	Q 2	Q 3	Q 4		Q 1	Q 2	Q 3	Q 4	
Inflation (CPI)	2.3	8.3	0.8	-0.6	-1.4	-2.1	-0.8	0.4	1.1	1.8	2.9	1.6
Food	3.9	15.4	0.9	-1.0	-2.2	-4.2	-1.6	-2.4	-1.0	1.2	3.3	0.3
Fresh food	3.8	19.7	1.0	1.9	-0.2	-5.3	-0.6	-3.0	-2.4	0.2	1.6	-0.9
Processed food	4.1	12.0	1.4	-3.0	-3.4	-3.6	-2.2	-1.9	0.4	2.0	4.7	1.3
Energy	4.7	9.3	-1.6	-1.9	-3.4	-1.1	-2.0	12.6	11.8	9.9	10.3	11.2
Fuels and lubricants	1.4	14.6	-27.1	-27.7	-24.6	-4.0	-20.9	26.0	23.5	13.1	14.6	19.3
Electrical power	8.0	2.6	13.1	13.1	13.1	4.0	10.8	9.9	9.8	9.8	9.9	9.8
Heating power	2.2	16.0	4.2	3.6	-4.9	-6.2	-0.9	6.4	5.3	7.2	7.1	6.5
Food and energy (volatile prices)	4.1	13.9	0.3	-1.2	-2.5	-3.4	-1.7	1.1	2.1	3.3	5.1	2.9
Goods	3.0	9.2	0.8	-0.7	-1.3	-2.0	-0.8	0.6	1.4	2.0	3.5	1.9
Services	-0.3	5.1	1.2	0.0	-1.8	-2.4	-0.7	-0.2	-0.2	0.6	0.0	0.1
Core inflation (inflation excl. food and energy)	0.6	2.6	1.5	0.3	0.1	-0.6	0.3	-0.2	0.1	0.2	0.6	0.2
Industrial producer prices	2.5	10.1	-6.6	-10.0	-11.0	-0.8	-7.2	7.3	10.5	8.4	8.6	8.7

Source: State Statistical Office and NBRM calculations.

The total contribution of changes in food price component to the 2010 inflation index was insignificant. Thus, during 2010 the prices of food had slight average increase of 0.3% relative to 2009 and contributed with 0.1 percentage point to the total change in consumer prices. Analyzed by components this growth is completely due to increased prices of processed food (mainly meat and vegetable fats) in a situation of decreased average prices of fresh food (grinded wheat, eggs and fish). The dynamics analysis shows different movements of this component during the year, that is, negative annual rates of change of prices from food component in the first half of 2010 and their increase in the second half of the year. The decrease of domestic prices of food in this period corresponded to the same fall of foreign effective prices of food of 2.4%. Such annual fall typical for the first half of 2010 can be mainly explained with the base effect (higher comparison basis from the first half of 2009). On the other hand, the continuous growth in the second half of the year is a combination of the base effect and the increase in the food prices in line with the increase in the global and foreign effective prices of food (see Annex 2 on the influence of base effects and price dynamics on the inflation).

Table 6
Contribution to the inflation
(in percentage points)

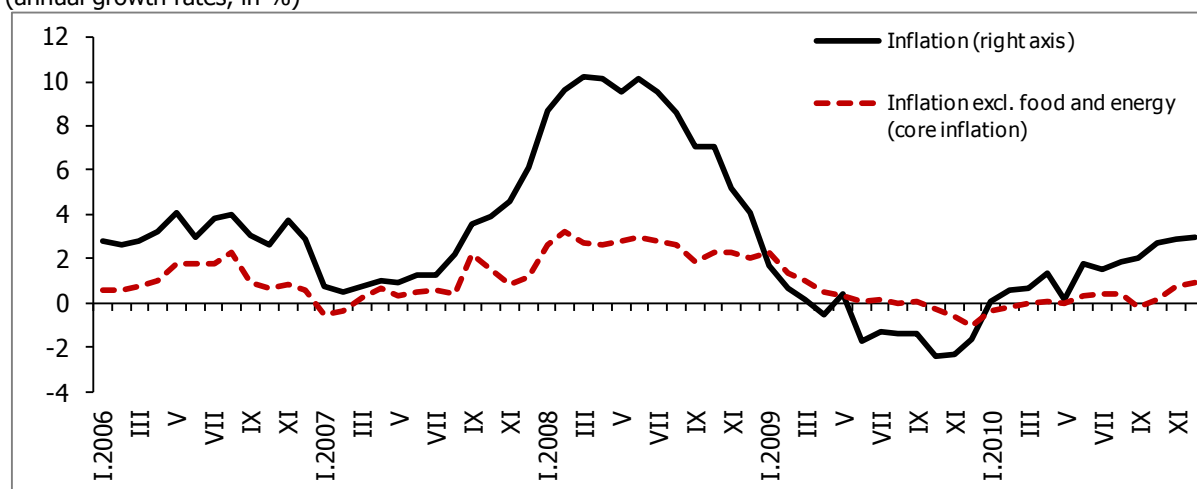
	2007	2008	2009				2009	2010				2010
			Q 1	Q 2	Q 3	Q 4		Q 1	Q 2	Q 3	Q 4	
Inflation (CPI)	2.3	8.3	0.8	-0.6	-1.4	-2.1	-0.8	0.4	1.1	1.8	2.9	1.6
Food	1.4	5.9	0.4	-0.4	-0.9	-1.7	-0.7	-1.0	-0.4	0.4	1.3	0.1
Fresh food	0.6	3.5	0.2	0.4	0.0	-1.0	-0.1	-0.6	-0.4	0.0	0.3	-0.2
Processed food	0.8	2.5	0.3	-0.6	-0.7	-0.8	-0.5	-0.4	0.1	0.4	1.0	0.3
Energy	0.6	1.2	-0.2	-0.2	-0.4	-0.1	-0.3	1.5	1.4	1.2	1.3	1.4
Fuels and lubricants	0.1	0.6	-1.1	-1.1	-1.0	-0.2	-0.9	0.7	0.7	0.4	0.5	0.6
Electrical power	0.5	0.2	0.7	0.7	0.7	0.2	0.6	0.6	0.6	0.6	0.6	0.6
Heating power	0.1	0.5	0.1	0.1	-0.2	-0.2	0.0	0.2	0.2	0.2	0.2	0.2
Food and energy (volatile prices)	2.0	7.1	0.2	-0.6	-1.3	-1.8	-0.9	0.5	1.1	1.7	2.6	1.5
Core inflation (inflation excl. food and energy)	0.3	1.3	0.7	0.2	0.0	-0.3	0.2	-0.1	0.1	0.1	0.3	0.1

Source: State Statistical Office and NBRM calculations.

The domestic inflation developments correspond with the foreign effective inflation dynamics. Thus, the foreign effective inflation in 2010 had average annual growth of 1.1% opposite to the decrease of 0.9% in 2009. However, the dynamics of domestic inflation developments in the second half of 2010 points out to its strengthening relative to the foreign inflation. The higher intensity of the domestic inflation compared to the foreign can be partially explained with the various share of food component in the total consumer price index.

In a situation when the inflation growth can be almost completely explained by the developments of energy and only small part through food component, the growth of the long-term inflation component in 2010 was insignificant. Thus, during 2010, the average annual growth of the core inflation was minimal and it was 0.2%. However, the quarterly dynamics shows constant modest increase of the core inflation having stronger acceleration in the last two months of the year. The transferred effects from the increase in energy prices are factors which partially can explain such tendency. From individual components aspect, the minimal growth of the core inflation is a result from increase of prices of shoes, medicines and catering services, while there was certain significant fall of telecommunication services and vehicle prices.

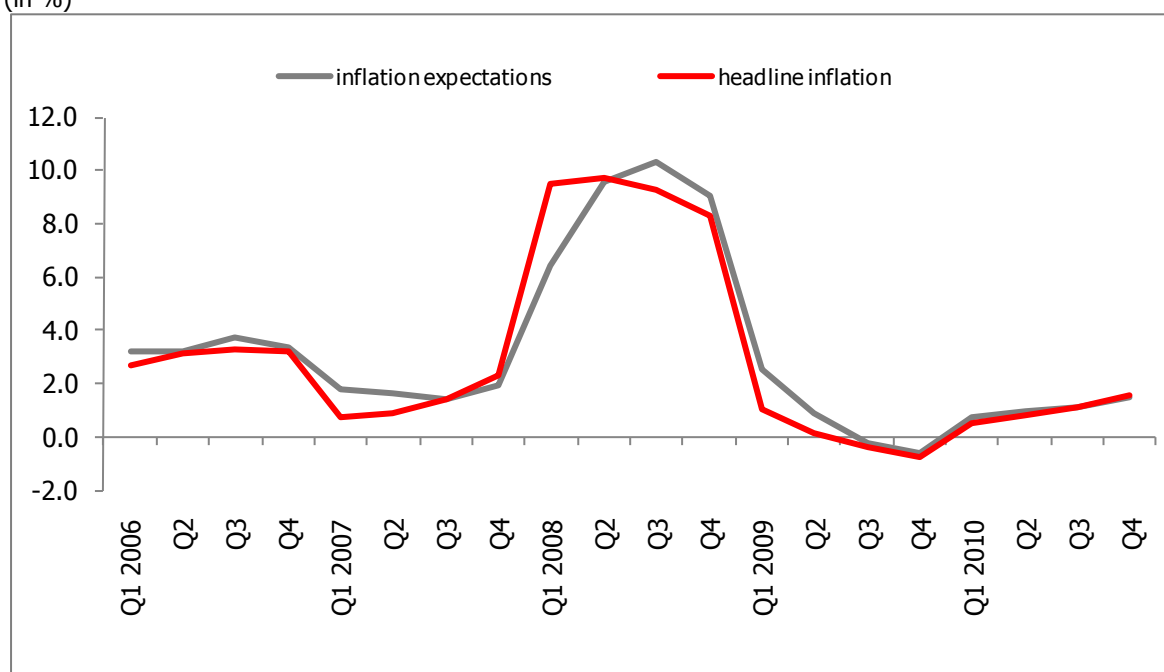
Figure 32
Inflation and core inflation
(annual growth rates, in %)



Source: State Statistical Office and NBRM calculations

The inflation outcome during 2010 mainly corresponded with the expectations of the economic agents. According to the results from the four surveys conducted by the NBRM the biggest percentage includes economic entities who expected the inflation to increase (58% of the respondents, on average). Smaller part of them (23%) expected a stable inflation, the percentage of participants who could not assess the inflation is 14%, while the rest of the respondents expected lower inflation. The analysis of the inflation expectations dynamics points to the fact that the highest number of respondents who had positive expectations for the inflation was in the last quarter (61%) in line with the strengthening of global prices of food and oil. The economic agents based their expectations on higher inflation due to energy price increase, the expectations for leaving the global recession and revitalization of the global economy, more relaxed monetary policy and revitalization of the domestic demand, expectations for easier approach to financial sources and increase of global prices of food and energy. According to some of the economic entities the slow recovery of the global economy and keeping the global energy prices on a stable level during most of the year are factors which conditioned the expectations for stable inflation.

Figure 33
Average annual inflation as of the current quarter and end of the year average annual inflation expectations
(in %)



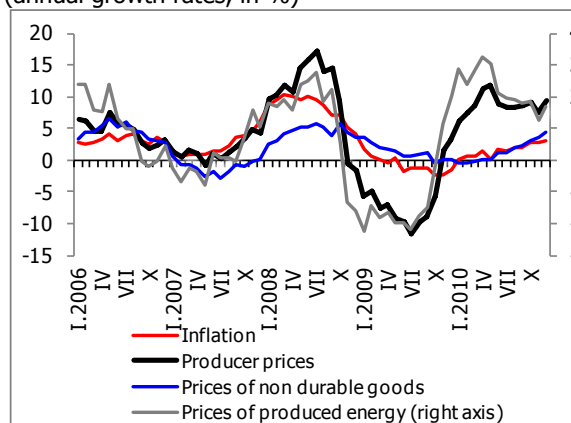
Source: State Statistical Office and Inflation expectations survey by the NBRM.

In accordance with the increase of prices of imported raw materials, the sale prices of producers of industrial products on the domestic market increased in 2010. Thus, after the fall in 2009 the production prices in 2010 grew by 8.7% mostly due to the increase in the prices of oil derivatives as well as higher prices of electricity, basic metals and beverages. Most of the other price categories had neutral effect on the price increase, including the food prices which in the first half of the year had negative growth rates, while in the second half they were back in the positive changes zone. From the production prices aspect that affects the domestic component of consumer prices, they increased in 2010 by 11.3%²¹ compared to the previous year. There was significant increase

²¹ Refers to prices of energy and durable and non-durable consumption goods.

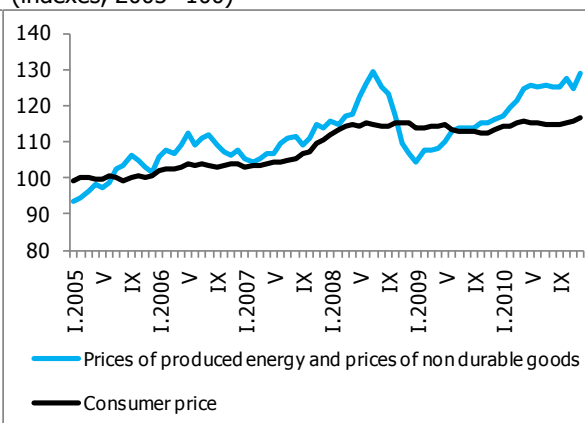
in the energy prices (22.1%) while the increase of prices of consumption goods²² was small (1.2%).

Figure 34
Inflation and prices by producers of industrial products
(annual growth rates, in %)



Source: State Statistical Office

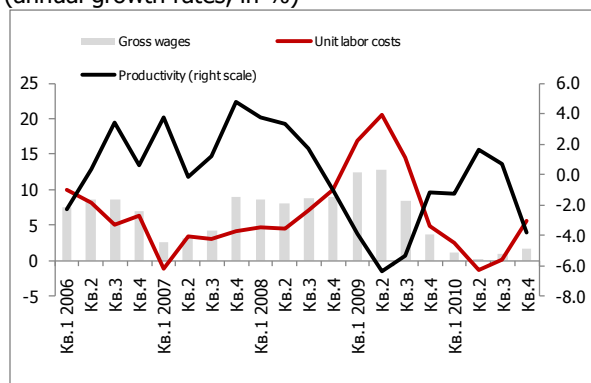
Figure 35
Production prices which affect consumer price
(indexes, 2005=100)



Source: State Statistical Office and the NBRM.

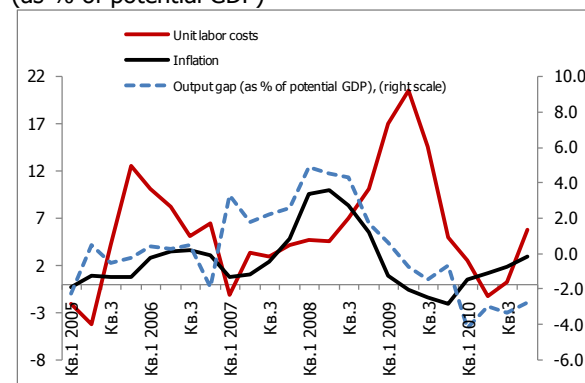
During 2010, the unit labor costs had 1.7% increase. Such development of the unit labor costs is a result of the mild wage increase of 1.0% in a situation of productivity fall (of 0.7%). Taking into account the productivity achievements in the last two quarters of the year (significant downward adjustment due to high employment growth, especially in the last quarter), a possible continuation of such dynamics of labor costs could lead to potential inflation pressures created through this segment.

Figure 36
Unit labor costs, economic productivity and gross salaries
(annual growth rates, in %)



Source: State Statistical Office and the NBRM calculations.

Figure 37
Inflation, labor costs (annual growth rates, in %) and production gap
(as % of potential GDP)



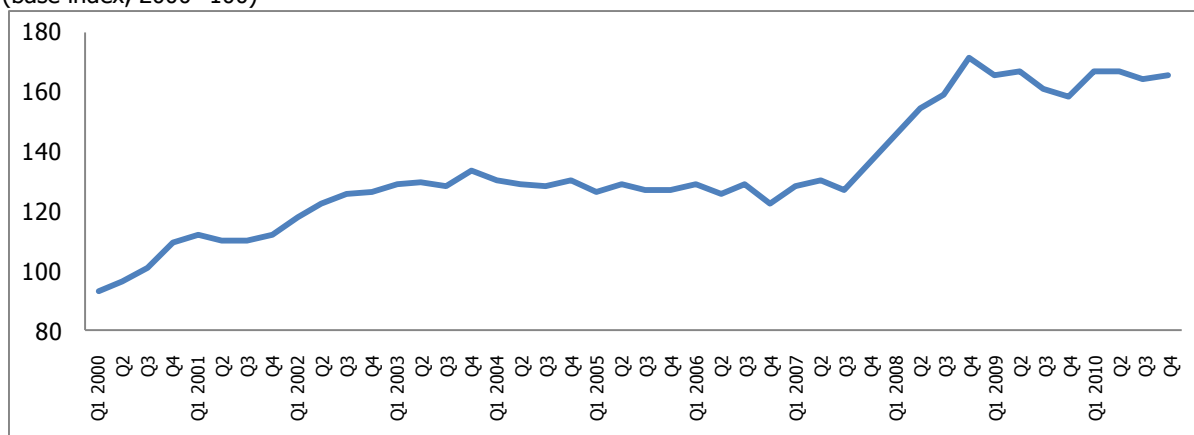
Source: State Statistical Office and the NBRM calculations.

After the downward adjustment during 2009, the real estate prices in 2010 had upward tendency. After reaching the peak in the last quarter of 2008, during 2009, in a situation of fall of the economic activity, these prices tended to decrease. In 2010, housing prices had mainly upward trend gradually reaching their historically highest level. At the end of 2010 relative to the end of the previous year the housing prices were

²² Durable consumption goods had 3.6% fall while the non-durable, which have higher weight, had 1.4% growth.

higher by 4.5%²³, while the average price in 2010 was higher than the average price in 2009 by 1.7%.

Figure 38
Housing price index²⁴
(base index, 2000=100)



Source: NBRM

After the low and stable inflation in the previous year in 2010 in the Southeast Europe countries and Turkey there was a modest increase of consumer prices. In accordance with the global inflation development the average inflation rate in the countries from Southeast Europe was 3.0% and is higher relative to the average from the previous year (2.3%). Turkey had the highest inflation rate (8.6%) and also Serbia and Romania had relatively higher inflation rates (6.1% each) compared to the other countries in the region. In the rest of the countries in the region and in the Eurozone, the inflation rates were mainly stable. Analyzed by quarters, in almost all selected countries there was higher inflation in the last quarter of the year, due to increased growth of global prices of oil and food.

Table 7
Inflation in the Eurozone and in the Southeast Europe countries
(in %)

	Inflation (CPI) (annual changes, in %)								
	2006	2007	2008	2009	2010				2010
					Q 1	Q 2	Q 3	Q 4	
<i>Eurozone</i>	2.2	2.1	3.3	0.3	1.1	1.5	1.7	2.0	1.6
<i>Southeast Europe</i>	4.9	4.1	8.4	2.3	2.2	2.3	3.4	4.2	3.0
Albania	2.5	2.9	3.4	2.3	4.4	3.4	3.4	3.1	3.6
Bosnia and Herzegovina	6.1	1.9	7.7	-0.3	1.0	1.9	1.6	2.4	1.8
Bulgaria	7.4	7.6	12.0	2.5	1.9	2.9	3.3	4.0	3.0
Montenegro	2.9	4.2	8.5	3.4	0.6	0.3	0.4	0.7	0.5
Croatia	3.2	2.7	5.8	2.2	1.1	0.8	1.0	1.4	1.1
Kosovo	0.6	4.4	9.4	-2.4	0.8	2.0	4.8	6.2	3.5
Macedonia	3.2	2.3	8.3	-0.8	0.4	1.1	1.8	2.9	1.6
Romania	6.6	4.9	7.9	5.6	4.6	4.3	7.5	7.8	6.1
Serbia	11.7	6.4	12.9	8.1	4.5	4.1	6.5	9.6	6.1
Turkey	9.6	8.8	10.4	6.3	9.3	9.2	8.4	7.4	8.6

Source: EUROSTAT and national statistical offices.

²³ According to the hedonic housing index, prepared by the NBRM. The housing prices are not included in the costs of living. The costs of living include the lease prices, which according to the SSO data in 2010 grew by 1.8%.

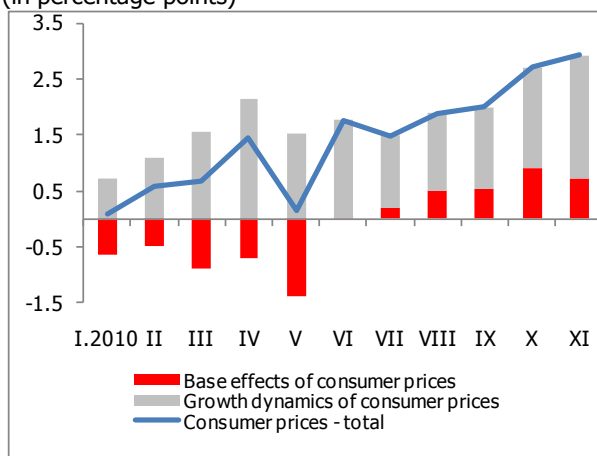
²⁴ Hedonic housing index prepared by the NBRM based on sale advertisements in the capital city published by real estate agencies.

Annex 2: Inflation development factors in 2010

The annual change of consumer prices in the second half of 2009 constantly remained in the negative zone. Since the beginning of 2010, there was annual inflation growth, which became stronger during the year. Actually, the annual rate of change of the total consumer price index from -1.6% as it was in December 2009 reached 3% in December 2010. The core inflation had a similar dynamics i.e. the total inflation excluding food and energy. **These changes in the inflation dynamics basically are due to two factors:** 1) transferred growth (effect from the comparative base)²⁵, where in the second half of 2009 the price level decreased due to global prices decrease after their increasing in part of 2008 and in line with global recession tendencies and 2) the new price increase mainly of food and energy in 2010 caused by negative shocks of the supply side and the simultaneous growth in global demand. **This annex contains breakdown of the annual inflation growth in 2010 into transferred inflation and into new price growth in the course of the year.**

Figure 39

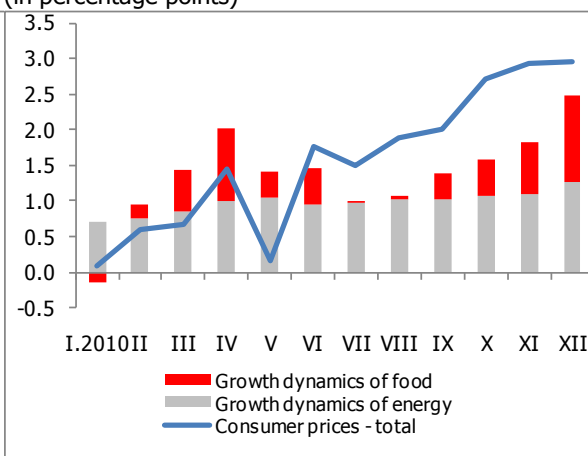
The influence of base effects and price dynamics on inflation (in percentage points)



Source: State Statistical Office and NBRM calculations.

Figure 40

The influence of growth dynamics of food and energy on inflation (in percentage points)

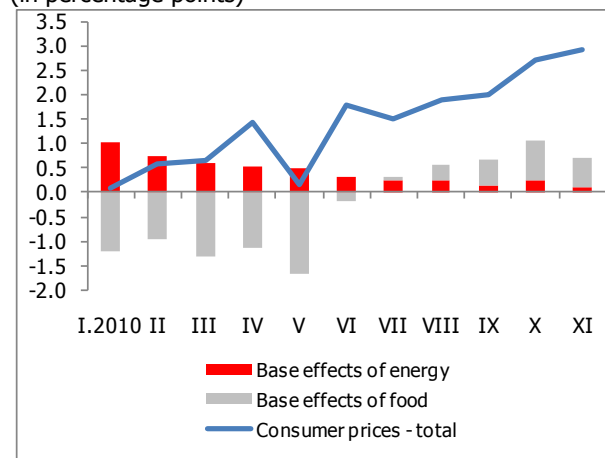


Source: State Statistical Office and NBRM calculations.

The analysis shows that the total price level in 2010 is mainly due to the new growth, while the influence of the transferred effects on average was neutral, having downward influence in the first half of the year and upward influence during the rest of the year. Analyzed by individual components the main part of the new price increase comes out from the increased price of energy component as a result of significant increase of oil prices (partially also due to the depreciation of the denar exchange rate against the US dollar) and the upward corrections of prices of electricity and central heating. On the other hand, the contribution of the new food price increase in the total inflation in 2010 was low. However, in the last quarter of the year this component had a stronger growth in line with the growth of the global prices of food.

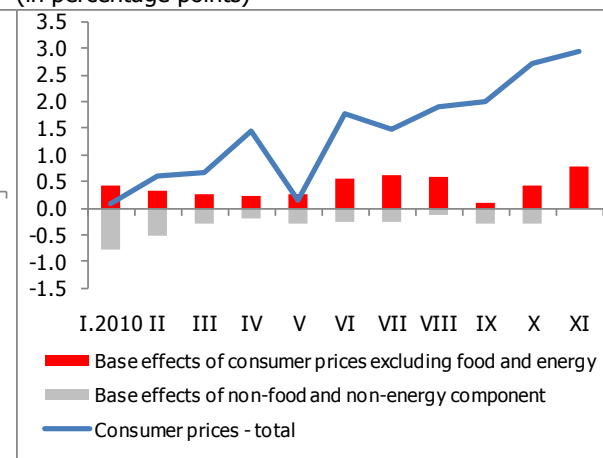
²⁵ Transferred effect is obtained under assumption that the price level reached in December 2009 will remain during the whole 2010.

Figure 41
The influence of base effects of food and energy on inflation
(in percentage points)



Source: State Statistical Office and NBRM calculations.

Figure 42
The influence of base effects and price dynamics of core inflation on total inflation
(in percentage points)



Source: State Statistical Office and NBRM calculations.

The transferred effects analyzed by sub-periods have different influence on the total inflation in 2010. In the first half of 2010 there were certain downward transferred effects which mainly derive from the food prices. Such effects on the food can be explained by the retained high level of food prices in the first half of 2009 after the global price "boom" which appeared in 2008. On the other hand, the upward transferred effects of the food in the second half of 2010 arise from the stronger downward adjustment of these prices in the same period in 2009. The annual growth rates of non-food and non-energy component accelerated at the end of 2010 reaching 0.9% in December 2010. The breakdown of the core inflation shows that its growth is completely due to the new price increase, while the transferred effects are always negative. The stronger new price increase can be explained by the possible indirect influence of the higher regulated prices. The higher prices of services (catering and utilities) as well as the higher prices of imported chemical products, textile and shoes had additional influence.

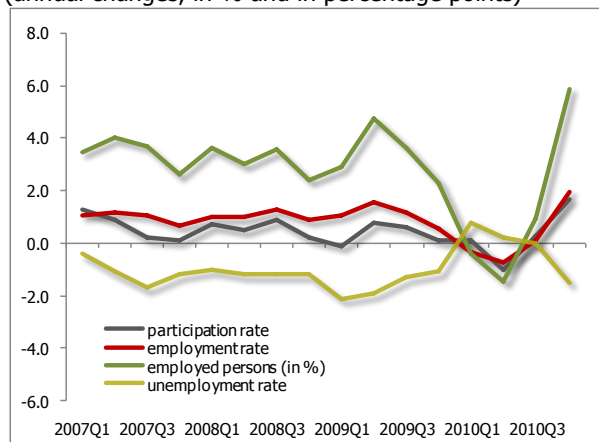
In general, the increase of the total level of domestic prices during 2010 mainly comes out from the new price increase. On the other side, on average, the transferred effects have neutral influence, but also in major part contributed in maintaining low (0.8%) inflation in the first half of the year. From the individual components aspect, the new increase of energy prices had larger influence compared to the effect from the new increase of food prices. Also, the core inflation growth is a result of the new price increase, in a situation of negative transferred effects.

2.3. Labor market and wages

In 2010, there were signals for post-crisis recovery of the labor market in the Macedonian economy, demonstrated through the 1.3% increase in the number of employees compared to 2009. After the fall in the first quarter of the year, the second quarter of the year witnessed the first signs of improvement of the labor market conditions, which particularly strengthened at the end of the year (from 1.2% quarterly growth of the number of employees in the second quarter, to 2.2% and 3.9% growth in the third and the fourth quarter,

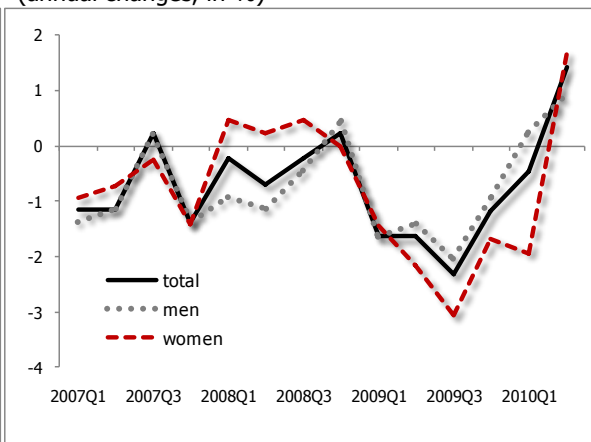
respectively²⁶). Other labor market indicators followed similar trajectories. Compared to 2009, the employment rate went up by 0.3 percentage points and reached 38.7%, registering the same quarterly dynamics as the number of employees. It started increasing in the second quarter, reaching 39.9% in the fourth quarter. The number of hours worked in the first six months of the year increased by 0.5% on annual basis. This indicator began recovering back at the end of the previous year, as a first signal of recuperation of demand and output, registering a steady upward trend, ever since.

Figure 43
Labor market indicators
(annual changes, in % and in percentage points)



Source: State Statistical Office of Macedonia.

Figure 44
Hours worked by employees
(annual changes, in %)



Source: ILO (International Labor Organization).

Favorable developments in the labor market during the year point to gradual recovery of this segment of the economy, in line with the improved economic situation and the increased aggregate demand. However, a portion of the employment increase could result from other factors, such as intensive transition of employees from the informal sector to the formal sector of the economy, under the stimulating policies, particularly the rural development policies. The accelerated growth, primarily in the fourth quarter, mainly reflects the higher number of agricultural workers. In the fourth quarter²⁷, the employment in the agriculture increased by 22% on annual basis, accounting for 67% of the annual growth of the total employment in the fourth quarter. The growth mostly reflects the higher number of persons working for their own account (individual farmers) and family workers in the agriculture who work for free, registering an annual growth of 34.2%, i.e. 23.1%, respectively, in the fourth quarter. This significant development most likely results from the effect of the stimulating rural development policies²⁸ that required a formal employment status²⁹ for obtaining financial aid, making some agricultural workers transit from the informal sector to the formal one. In spite of such assumption, it is difficult, however, to determine for sure whether and to what extent the

²⁶ Each quarterly change is being analyzed on seasonally adjusted employment, unemployment and total labor data. No seasonal adjustment is made of the total employable population.

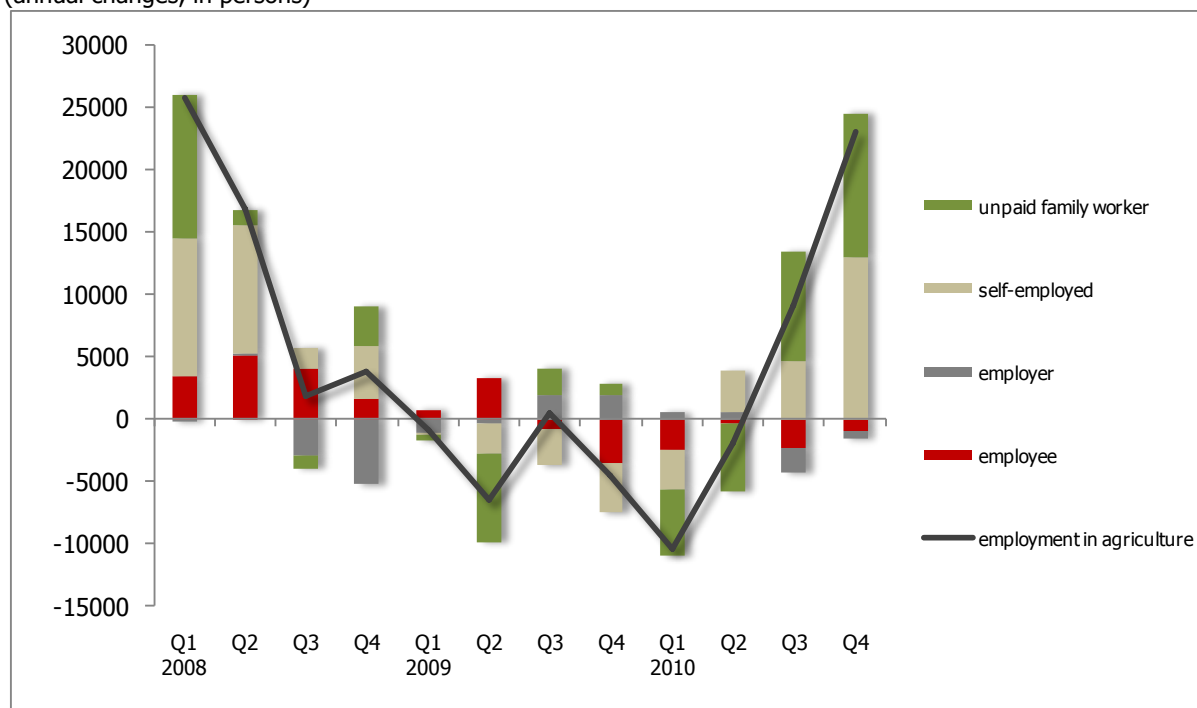
²⁷ In the fourth quarter, the agricultural employment increased by 10% on quarterly basis. The quarterly growth rates of persons working for their own account (individual farmers) and of family workers in the agriculture who work for free, equal 20.8% and 8%, respectively.

²⁸ The Rural Development Program for 2010 (February 2010) is conducted by the Rural Development Agency.

²⁹ To become eligible for acquiring funds under the 2010 Rural Development Program, the applicant should provide one of the following documents: decision for registering in the Farmers Registry, confirmation that the person is an insured as individual farmer, issued by the Pension and Disability Insurance Fund, confirmation by the Pension and Disability Insurance Fund for pension eligibility, employment confirmation issued by the Employment Agency or confirmation for submitted insurance and employment registration/deregistration form (M1/M2 forms). The benefit from the range of terms, as a basis for obtaining credits, and particularly the status of insured as an individual farmer with a confirmation issued by the Pension and Disability Insurance Fund, increased the interest of such persons to register.

employment growth results from these factors, and what is the percentage of new employments.

Figure 45
Agricultural employment
(annual changes, in persons)



Source: State Statistical Office of Macedonia.

All sectors of the economy reported employment growth, except for the industry. The increase in the number of agricultural workers (0.8 percentage points) made the greatest contribution to the average annual growth, following the last quarter developments. Sectors with dominant government ownership also reported higher employment (0.5 percentage point contribution to the annual growth). Service sector employment³⁰ recorded no significant changes compared to the previous year, thus making a minor positive contribution to the growth. **Employment developments throughout the year mainly reflect the developments in the agriculture and the service sector.** After the fall in the first quarter, the agriculture employment increased by 3.5%, 9.3% and 10% in the second, the third and the fourth quarter, respectively. The quarterly employment growth also accelerated in the service sector from roughly 2% in the second and the third quarter, to 4.6% in the fourth quarter, primarily resulting from the increased demand for labor in the trade sector. The sectors with dominant government ownership (public administration and defense, education and health³¹), after the quarterly growth of 2.4% in the first quarter, reported no considerable developments to the end of the year.

Considering the export orientation of the industry, this sector suffered the most from the global recession, which also spilled proportionally over the employment. The lower number of employees in the manufacturing industry and in the electricity and water supply sector led to 1.4% reduction of the employment in the industry in 2010. Certain improvement signs could be registered in the quarterly dynamics, given the

³⁰ Service sector, excluding public administration and defense, education and health and social work (L, M and N).

³¹ Roughly 90% of the total number of employees in these three sectors work in non-private sector (other ownership: social, combined, cooperative, government).

employment growth in the manufacturing industry and in the water supply of 0.7% and 7.8%, respectively in the fourth quarter.

Figure 46
Contributions of employees by sector to the total employment growth (in % and in percentage points)

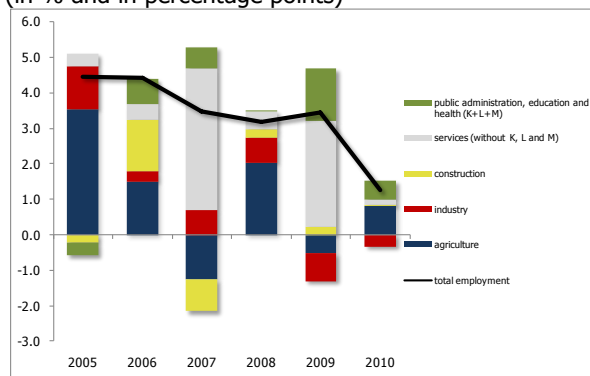
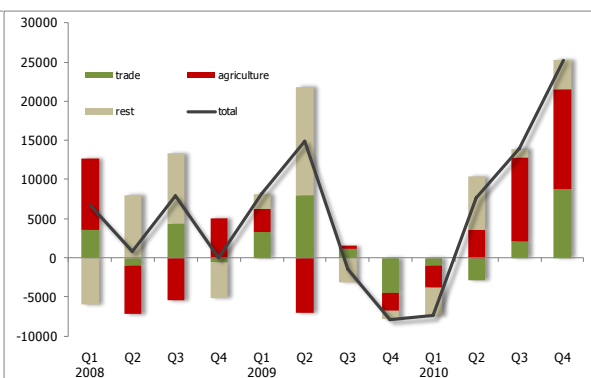


Figure 47
Employment in the agriculture and trade (quarterly changes, in persons)



Source: State Statistical Office of Macedonia and NBRM calculations.

In 2010, the employment was increasing along with the growth of active population. Active population registered an annual growth of 1%, almost solely reflecting the growth of employable population. In consistence with the general trends on the labor market, the growth of active population was accelerating throughout the year. In the first six months of the year, the total active population remained the same as in the last quarter of the preceding year, and the second half of 2010 reported a quarterly growth of around 2% in the third and in the fourth quarter, respectively. The acceleration of the growth of active population reflects the fall of inactive population (quarterly fall of inactive population of 2.4% and 2.3% in the third and the fourth quarter, respectively). The activity rate reached 57.8% in the fourth quarter of the year, which is the highest activity level since 1996.

In 2010, the average unemployment rate, given the increase in both the demand for and the supply of labor, reduced by 0.1 percentage points, equaling 32.1%. Observing by age group, the annual fall of unemployment rate was due to the higher unemployment rate of the young (reduction of 1.5 percentage points), while the unemployment rate of other age groups registered a moderate growth. The downtrend of unemployment rate started in the second quarter of the year, and accelerated in the third and the fourth quarter. The fourth quarter of the year witnessed an unemployment rate of 30.9%³², which is the lowest unemployment rate since 1996.

³² Exception is 2001 which recorded an unemployment rate of 30.5% due to the engagement of a number of security forces.

Figure 48
Employable population, workforce and inactive population*
(annual changes, in persons)

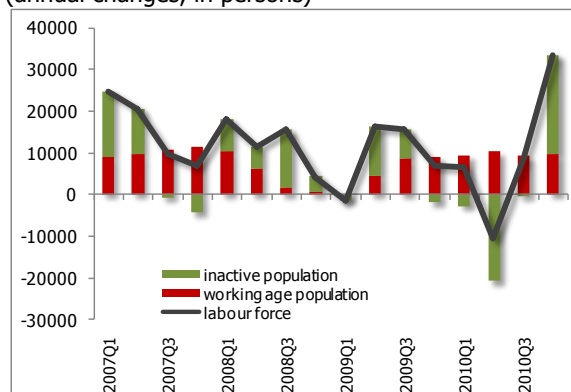
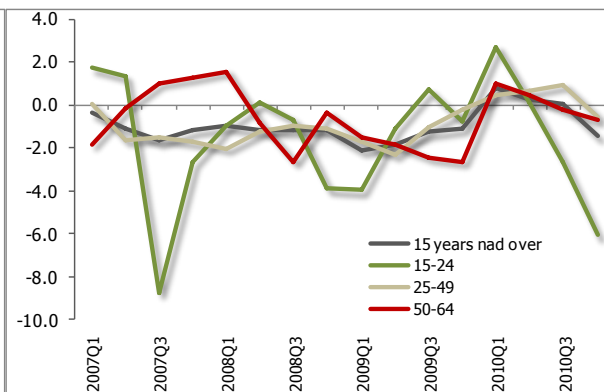


Figure 49
Unemployment rate - age structure
(annual changes, in percentage points)



Source: State Statistical Office of Macedonia

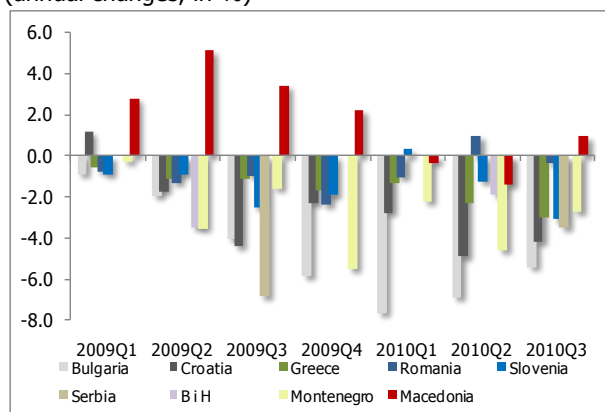
*Positive change in inactive population implies its reduction, and tends to increase the active population (workforce).

Perceptions show that labor market in Macedonia responded to the lower aggregate demand with time lag of three quarters. The total crisis-based employment fall equals 16,784 persons (2.6%), and the number of unemployed persons went up by 8,552 persons (2.9%)³³. **Comparatively analyzed, several elements are typical for the labor market in Macedonia relative to the region. First, longer time lag of downward adjustment.** Analyzing the quarterly changes in the number of employed persons, the labor market in Macedonia started deteriorating since the third quarter of 2009, i.e. three quarters after the initial fall of economic activity. On the other hand, the average time lag of the downward adjustment of the labor markets in the region was around one quarter³⁴, with some countries witnessing the start of employment and GDP fall almost simultaneously (Bulgaria and Slovenia). **Second, relatively fast recovery of the labor demand compared to other economies.** The second quarter of 2010 reported a quarterly growth in the number of employed persons in Macedonia. As a comparison, the labor markets in most of the economies in the region have still been deteriorating. **Third, relatively slower fall of the number of employees.** The cumulative employment fall compared to the period before the crisis equaled around 2.6%. Almost all countries in the region reported a faster cumulative fall of over 4%, with the fastest fall registered in Serbia (10%) and in Bulgaria (9%).

³³ The calculation has been made using seasonally adjusted data on the number of employed and unemployed persons. The calculation of total reduction covered the quarter after which the employment fall / unemployment increase started to the quarter after which the trend switched. More precisely, as to the number of employed persons, the change between the first quarter of 2010 (as a quarter that witnessed the lowest number of employed persons) and the second quarter of 2009 (as a pre-crisis level after which the employment started reducing) has been calculated. As to the number of unemployed persons, the change between the first quarter of 2010 (reporting the highest number of unemployed persons) and the first quarter of 2009 (as the last period of unemployment reduction) has been calculated.

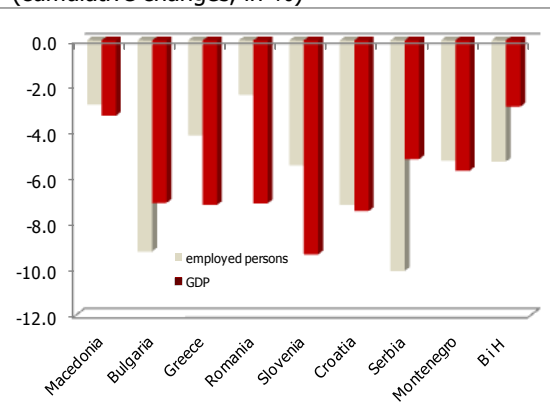
³⁴ This calculation does not include Montenegro, Bosnia and Herzegovina and Serbia, due to the unavailability of quarterly data.

Figure 50
Employment - regional comparison
(annual changes, in %)



Source: Eurostat and national statistical offices. NBRM calculations.

Figure 51
Employment and GDP- regional comparison
(cumulative changes, in %) ³⁵



Such developments partially reflect the relatively slower contraction of economic activity in Macedonia relative to the region. The average reduction of economic activity in the region equals about 6.5%, while the Macedonian GDP is by 3.7% lower compared to the pre-crisis level³⁶. The slower GDP fall was accompanied by a slower employment fall. The slight downward adjustment of the employment and the subsequent increase over a short time period create a need of prudent interpretation of the favorable labor market developments throughout the year, and of the perceptions for its recovery.

The average paid wages kept on growth in 2010, but in a substantially slower pace over most of the year³⁷, with similar changes being registered analyzing the net wage development in each economic sector. The last month of the year was an exception, reporting rapid acceleration of the wage growth. The average nominal net wage paid in 2010 totaled Denar 20,554, which is by 3% more compared to the same period of the preceding year. For comparison purposes, the annual growth of the average nominal net wage paid in 2009, equaled 9.8%. The analysis of monthly wage developments just reconfirms the trend of deceleration of the wage growth in 2010, except for the last month. The average monthly growth rate of the nominal net wages paid in the January - November 2010 period equaled 0.1%, compared to 0.4% in 2009. In December 2010, compared to the rest of the year, the nominal net paid wages increased by around 4.7% compared to the same month of the preceding year. Relative to the previous month, the nominal net wage paid in December was by roughly 4% higher. The drastic increase partially reflects the bonus payment in some economic sectors in the last month of the year.

The announced changes in the social contribution system aimed towards reducing the contribution rates, continued in 2010. With the new changes, the share of contributions in the gross wage reduced to 26.5% in 2010, compared to 27.9% in 2009³⁸. This resulted in

³⁵ Cumulative changes are calculated using seasonally adjusted data as a percentage difference between the pre-crisis levels (the quarter after which the employment and GDP started reducing) and the lowest level (the quarter after which the employment and GDP started growing) for each country. Since there are no available quarterly data for Serbia, Bosnia and Herzegovina and for Montenegro, the data are on annual basis.

³⁶ The first quarter of 2010 was taken as a quarter with the lowest GDP.

³⁷ Wage source: State Statistical Office.

³⁸ Changes in the social contribution system are being planned to the 2009 - 2011 period aimed to decrease the social contributions and health insurance contributions. In 2010, the pension insurance contribution was reduced from the existing 19% in 2009 to 18% , the health insurance contribution went down from 7.5% to 7.3%, and the employment contribution remained the same as in 2009 (1.4%). These changes reduced the encumbrance of the gross wage with compulsory social insurance contributions from 27.9% in 2009 to 26.5% ("Official Gazette of the Republic of Macedonia" no. 156 dated December 25, 2009).

further deceleration of the nominal growth of the average gross wage. **In 2010, the nominal average gross wage³⁹ increased by merely 1% and equaled Denar 30,226.**

Having a cumulative inflation rate of 1.6%, the net wages increased by 1.4% in real terms in 2010, whereas the real growth of gross wages was negative, and equaled 0.6%. The quarterly dynamics of real growth rates indicates improvement of the real purchasing power in the economy. After the real fall of both net and gross wages in the first quarter, the second and the third quarter registered a moderate growth that accelerated in the last three months of the year.

Figure 52
Average nominal net and gross wage
(corrected for methodological change, annual changes, in %)

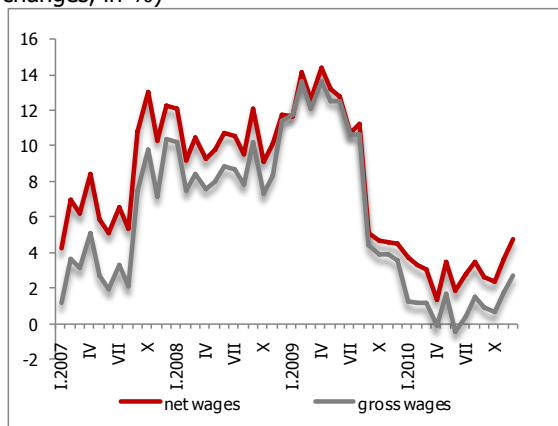
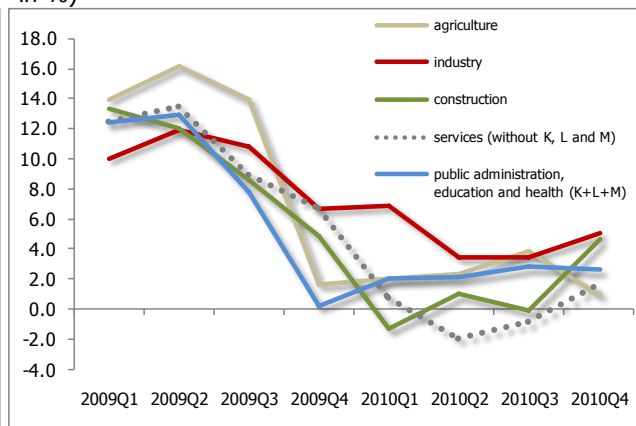


Figure 53
Nominal net wages, by sector
(corrected for methodological change, annual changes in %)



Source: State Statistical Office of Macedonia and NBRM calculations.

Almost all countries in the region reported a moderate nominal growth of net wages. Exception is Serbia, where the nominal wages decreased, and Bulgaria, where they significantly increased. However, the higher inflation rate in the region decelerated the real wage growth. In some economies, the average net paid wages went down in real terms (Bosnia and Herzegovina, Serbia and Romania). Changes in the share of allocations for income tax and social insurance contributions in the gross wage were registered in Croatia (reduction) and in Romania and Montenegro (increase).

³⁹ The total paid gross wages include paid net wages for the reporting month, paid income tax and paid contributions (for pension and disability insurance, for health insurance, for employment, for professional illness and for water supply). The data pertain to paid wages.

Table 8
Wages, by country

		2009	2010	nominal increase of wages, in %	real increase in wages, in %	personal income tax and contributions, % of the average	
						2009	2010
Macedonia	average gross wage	488	491	0.6	-0.9	33.3	32.1
	average net wage	326	334	2.5	0.9		
	unemployment rate	32.1	32.4	0.3			
Slovenia	average gross wage	1439	1495	3.9	1.7	35.4	35.3
	average net wage	930	967	3.9	1.8		
	unemployment rate	5.7	7.1	1.4			
Croatia	average gross wage	1050	1054	0.3	-0.8	31.1	30.4
	average net wage	723	733	1.3	0.2		
	unemployment rate	9.0	11.8	2.8			
Bulgaria	average wage	299	328	9.7	6.4	-	-
	unemployment rate	6.8	10.2	3.4			
Bosnia and Herzegovina	average gross wage	615	625	1.6	-0.1	34.2	34.2
	average net wage	405	411	1.5	-0.2		
	unemployment rate	24.1	29.9	5.8			
Serbia	average gross wage	470	461	-1.9	-7.4	28.1	28.0
	average net wage	338	332	-1.8	-7.3		
	unemployment rate	16.6	19.2	2.6			
Montenegro	average gross wage	643	714	11.0	10.5	28.1	33.0
	average net wage	463	479	3.5	3.0		
	unemployment rate	19.0	19.6	0.6			
Romania	average gross wage	446	460	3.3	-2.2	26.9	27.4
	average net wage	326	334	2.6	-2.8		
	unemployment rate	6.7	7.3	0.6			

Wages are expressed in euros.

The unemployment rate is equal to the average rate in the first three quarters of the year.

In 2010, the labor productivity⁴⁰ went down by 0.7% having a faster employment growth compared to the growth of aggregate demand. The two-year downtrend resulted in substantial output contraction in the economy, reducing by around 6.8% in the fourth quarter of 2010 compared to its level before the crisis. Such situation indicate that the future growth of the economy could be based on the increase of productivity, rather than on the increase of employment, which tends to slowdown the growth of the number of employees. **The sector-by-sector analysis shows divergent movements.** Most sectors in the economy registered lower productivity due to the faster employment growth compared to the added value. Exceptions are the industry and the tourism, where the labor productivity went down due to the output contraction. The labor productivity is perceived to be higher in the construction, transport and trade.

⁴⁰ The productivity and labor unit costs for the overall economy are calculated on the basis of data on GDP, total number of employees, according to the SSO Labor Survey and according to the data on average gross wages.

Figure 54
Labor productivity
(annual changes, in %)

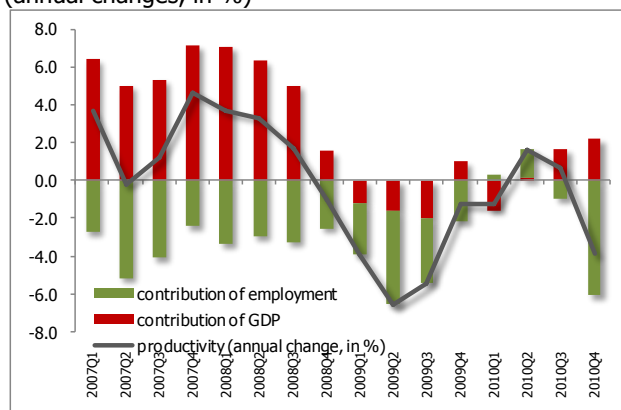
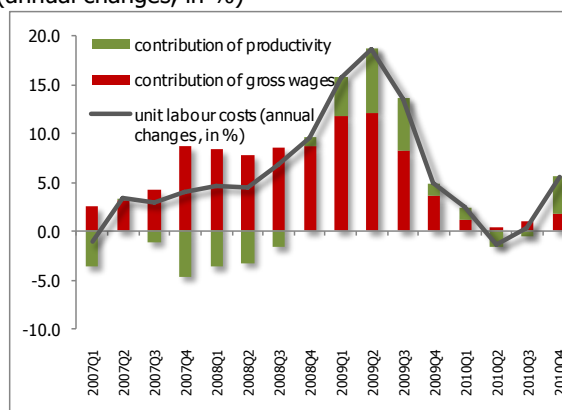


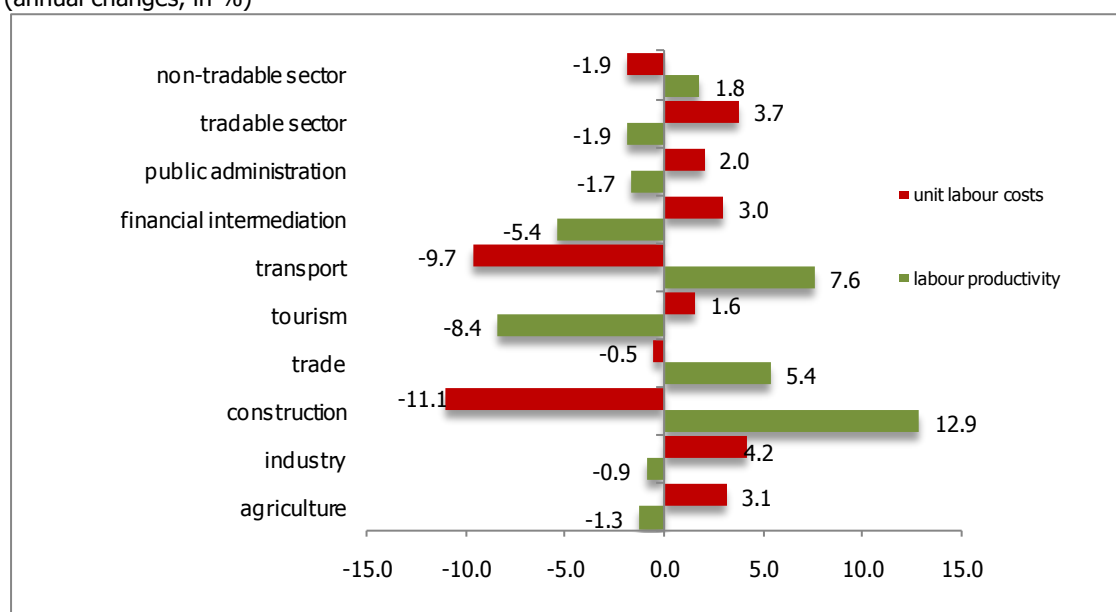
Figure 55
Labor unit costs
(annual changes, in %)



Source: State Statistical Office of Macedonia and NBRM calculations.

After the intensive growth of labor unit costs in the year before as a result of the significant wage increase and lower productivity, the developments calmed down in 2010. The labor unit costs went up by 1.8%, following the dynamics of productivity and average gross wages. The moderate growth of labor costs for 2010 arose from the growth of agriculture, industry, tourism, finances and public administration and defense. On the other hand, the analysis of changes in the labor unit costs throughout the year indicates steady acceleration of the growth pace. The first three quarters of the year witnessed an average quarterly growth of the labor unit costs of 0.6%, and in the fourth quarter this growth accelerated to roughly 4%. The continuation of such dynamics in the future, in environment of further growth of domestic demand, tends to spill the higher labor costs over the final prices.

Figure 56
Labor productivity and labor unit costs, by economic sector
(annual changes, in %)

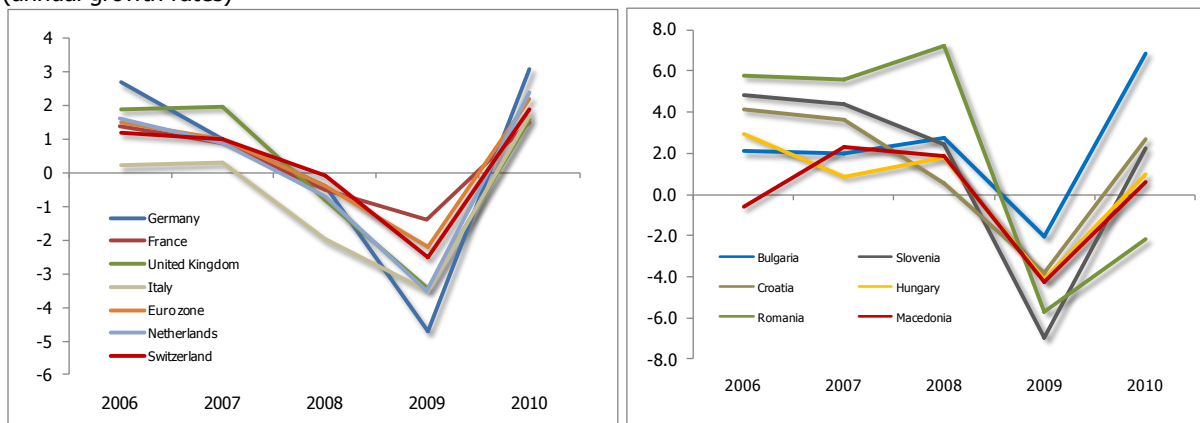


Source: State Statistical Office and NBRM calculations.

Annex 3: Development of productivity and labor unit costs⁴¹ - comparison by country

After the rapid fall in 2009, in 2010 the labor productivity improved in both the West European countries and the economies in the region. The higher productivity is mainly due to the late adjustment of the labor demand in environment of higher aggregate demand. There are certain differences between economies in terms of the size of this effect that arises from the differences in the level of recovery of the economic activity and employment. Thus, the West European countries expect⁴² the productivity to increase by roughly 2% (average productivity growth in the observed sample). On the other hand, in the countries from the region, the productivity growth will range from -2.2% in Romania to significant annual growth of 6.9% in Bulgaria.

Figure 57
Labor productivity - by country
(annual growth rates)



Source: Consensus Forecast (February, 2010)

Source: Eurostat and NBRM calculations.

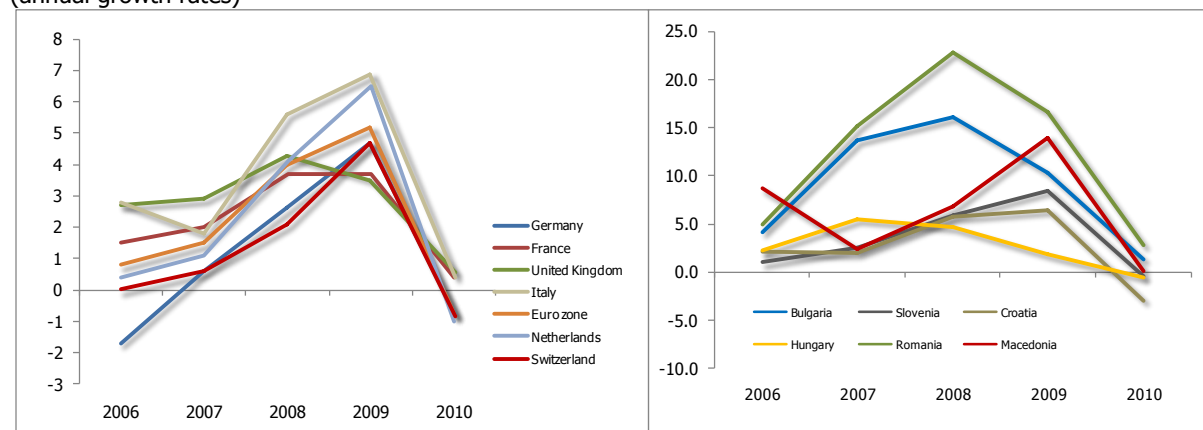
The annual growth of labor unit costs slowed down in 2010 following their dramatic increase in the previous year. The improvement of productivity is resulted in growth reduction and stabilization of labor unit costs. The labor unit costs in the Euro-area were projected⁴³ to reduce by about 0.8%. In the region, substantial fall is expected in Croatia (annual fall of 3%), and other countries under observation are perceived to witness significant growth deceleration, making the labor unit costs slightly higher compared to 2009.

⁴¹ The data on West European countries are taken from the Consensus Forecast (March 2010), with the annual data on productivity and labor unit costs being an estimation based on the data on GDP for 2010 and the employment growth in the first three quarters. The productivity data for the countries from the region were calculated by using data on GDP and on the employment from Eurostat to the third quarter of 2010, and the data on labor unit cost is a projection of the European Commission.

⁴² According to the projections of Consensus Forecast (February 2010).

⁴³ According to the projections of Consensus Forecast (February 2010).

Figure 58
Labor unit costs - by country
(annual growth rates)



Source: Consensus Forecast (February, 2010).

Source: European Commission.

2.4. External sector

2.4.1. Balance of payments

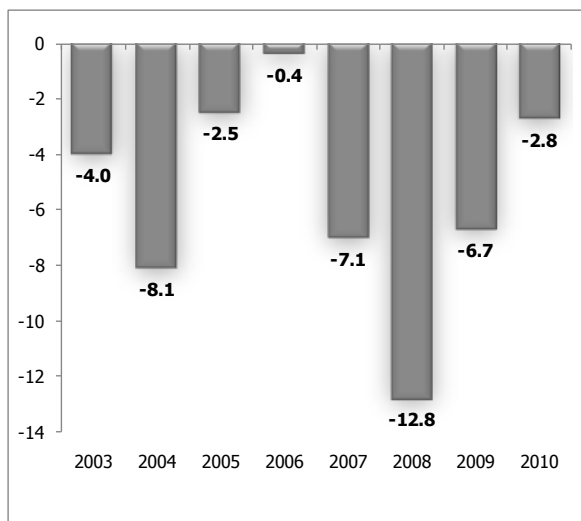
The external position of the Macedonian economy kept on improving in 2010. The gradual recovery of external demand and the improvement in the trading conditions had positive transmission effects on the exploitation of domestic export facilities. On the other hand, in spite of the signs of gradual recovery of the domestic demand, it was not sufficiently intense to create greater import pressures. In such circumstances, the negative trade gap kept on shrinking in 2010, solely due to the lower non-energy trade deficit. Having stable environment and positive expectations, in 2010, the private transfers followed an upward trajectory. **Considering all these developments, the current account deficit reduced in 2010.** Accordingly, the need for funding the current transactions in 2010 was relatively low. **Hence, notwithstanding the annual decrease, the capital inflows in 2010 were sufficient enough to ensure funding of the trade deficit and additional accumulation of foreign reserves.** The further decrease of net capital inflows showed that the global investment conditions are volatile, given the still present perceptions for relatively high risk. Yet, it is encouraging that in 2010 direct investments were registered in the Macedonian economy, in a volume larger compared to the preceding year. **Additional capital inflows were also created through external borrowing, thus increasing the gross external debt.** However, the external debt indicators and its structure still indicate a relatively favorable debt position of the economy.

2.4.2. Current account

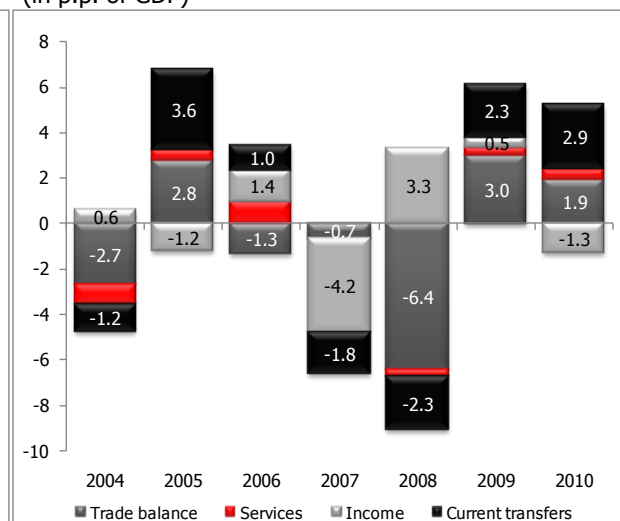
In 2010, the current account deficit reduced to Euro 191.1 million, or 2.8% of GDP, which is a reduction of 4 percentage points of GDP compared to the preceding year. Thus, the negative current account gap kept on shrinking for a second consecutive year. Such current account adjustment is due to the further growth of net inflows through private transfers and favorable foreign trade developments. In 2010, the net inflows from current transfers went up by 2.9 percentage points of GDP, due to the higher net purchase on the exchange market. Having stable expectations of economic agents, in 2010 the pressures on the demand for foreign currency were significantly milder,

and the supply of foreign currency registered a moderate annual growth. Additional factor for deficit reduction was also the lower trade deficit. In 2010, the trade deficit went down by 1.9 percentage points of GDP, reflecting the faster recovery of the exports compared to the imports. The improved trade conditions, the substantial exploitation of the existing production capacities and the additional enhancement of the export capacity of the domestic economy resulted in higher exports since the beginning of the year. On the other hand, the imports started going up in the second quarter, mainly due to the import of raw materials for the exports, and the influence of the oil price growth in the global markets. On the other hand, the pressures of the domestic demand on the import segment related to the investment activity and the personal consumption were relatively low during the year. Observing other current account components, the higher service surplus (of 0.4 percentage points) made lower positive contribution, and the income deficit enlarged on annual basis (by 1.3 percentage points).

Figure 59
Current account balance
(% of GDP)



Contribution of current account components
in its quarterly change
(in p.p. of GDP)

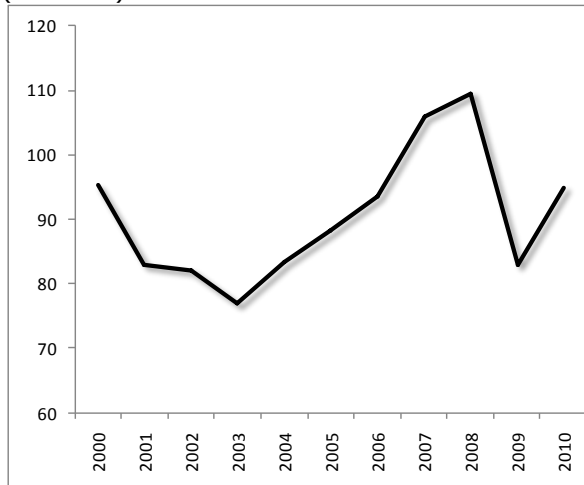


Source: NBRM.

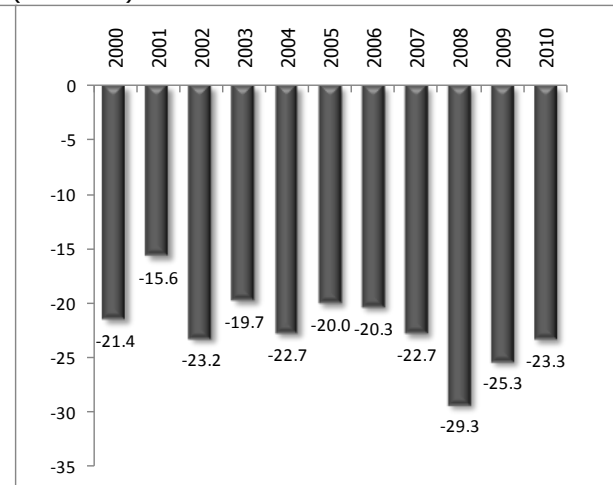
2.4.2.1. Foreign trade

Unlike the fall of the foreign trade in 2009, in 2010, the total foreign trade increased. On annual basis, the value of foreign trade was by 19.4% higher, reaching Euro 6,616.6 million, or 96% of GDP. The revival of global economic activity and expansion of the export capacity of the domestic economy in 2010 resulted in significant exports growth. On the other hand, in environment of still fragile domestic demand, the import was increasing in a slower pace. **With the exports growth exceeding the imports growth, the trade deficit shrank (by 4.1% annually), reducing to Euro 1,621.6 million or to 23.5% of GDP.**

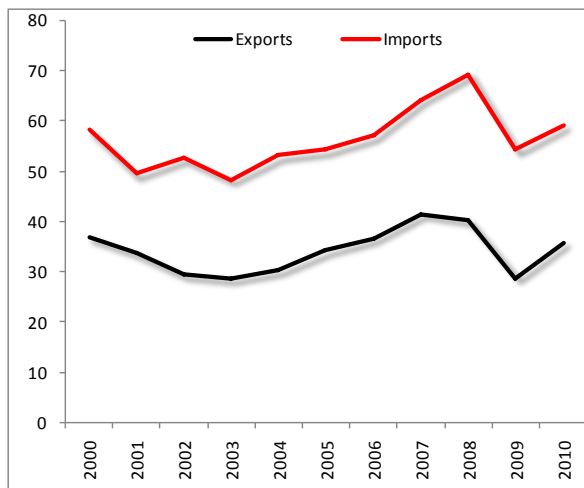
Figure 60
Foreign trade and balance
Value of total external trade of goods
(% of GDP)



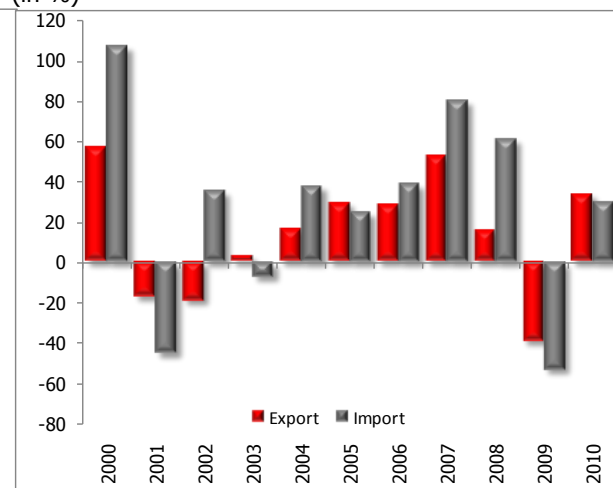
Trade Balance
(% of GDP)



Exports and imports
(% of GDP)



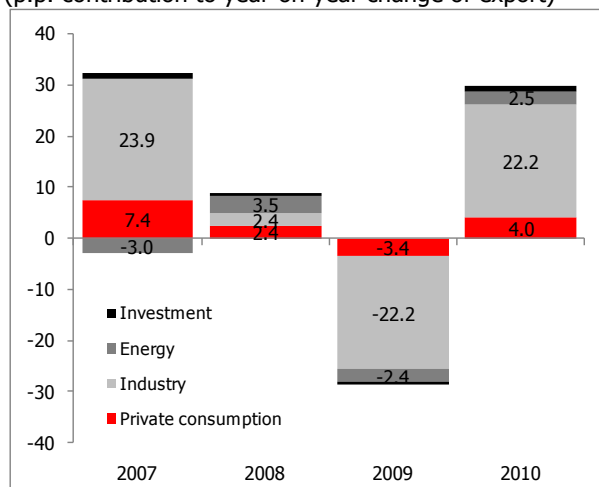
Contributions to the y-o-y change
of Trade Balance
(in %)



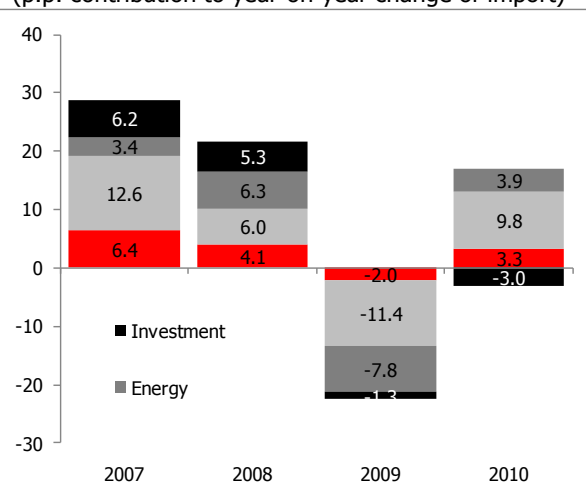
Source: SSO and NBRM.

With respect to the economic purpose of trade, the trade deficit reduced due to the lower trade deficits in investment products (machines and transport equipment) and in industrial primary and intermediary products, while the higher trade deficits in energy and personal consumption goods enlarged the deficit.

Figure 61
 Contributions by economic purpose
 Exports according to economic purpose
 (p.p. contribution to year-on-year change of export)



Imports according to economic purpose
 (p.p. contribution to year-on-year change of import)



Source: SSO and NBRM.

Favorable developments of external effective demand, higher metal prices in the global markets and launching of a new Greenfield investment in the free economic zone contributed to enhanced export activity in 2010. The export of goods went up by 29.7%, reaching Euro 2,497.5 million or 36.2% of GDP. Analyzing the economic purpose of the exports, the highest export of raw materials and intermediary goods of the domestic industry contributed the most to its growth. Within this category, the favorable conditions in the metal market and the higher export demand made almost equal contribution to the growth of the export of iron and steel, thus this export segment making up most of the total export growth. Moreover, the exploitation of the new export facility added impetus to the growth that resulted in higher export of chemical substances and products, with a contribution also made by the higher exports of metal ore and metal waste. Export of personal consumption goods registered a moderate annual growth, mostly due to the higher export of food products. In 2010, most of the food export included fruits and vegetables, and slower portion pertained to grain and grain products, in environment of lower export prices and higher export volume. In addition, the export of tobacco and tobacco products went up on annual basis, making considerable contribution to the exports growth. The energy export also made positive contribution, with the export of oil and oil products registering an annual growth (given the higher export prices, and lower export volume), with the export of electricity reaching the highest level ever (given the higher volume of domestic output of the hydro power plants and higher export prices). The smallest contribution to the total exports growth was made by the export of investment products, yet being above the level of the preceding four years.

Table 9
Exports according to SITC

Export of goods	2009	2010	y-o-y change		contributions	
	in millions of EUR		in millions of EUR	%	percentage points	%
Total	1,925.2	2,497.5	572.3	29.7	29.7	100.0
Food and live animals	202.4	248.8	46.4	22.9	2.4	8.1
<i>of which:</i>						
- meat and meat preparations	26.0	27.9	1.9	7.2	0.1	0.3
- cereals and cereal preparations	30.7	36.3	5.6	18.3	0.3	1.0
- fruits and vegetables	101.5	137.3	35.8	35.3	1.9	6.3
Beverages and tobacco	141.3	153.5	12.2	8.6	0.6	2.1
- beverages	62.1	60.0	-2.1	-3.4	-0.1	-0.4
- tobacco and tobacco preparations	79.2	93.5	14.3	18.0	0.7	2.5
Crude materials, inedible, except fuels	122.6	196.4	73.9	60.3	3.8	12.9
<i>of which:</i>						
- metalliferous ores and metal scrap	91.8	153.5	61.6	67.1	3.2	10.8
Mineral fuels, lubricants and related materials	144.5	195.1	50.6	35.0	2.6	8.8
<i>of which:</i>						
- petroleum and petroleum products	136.3	164.9	28.5	20.9	1.5	5.0
- electric energy	3.9	26.2	22.2	6,7 times	1.2	3.9
Animal and vegetable oils and fats	5.9	8.4	2.5	42.4	0.1	0.4
Chemical Products	122.9	288.2	165.3	134.5	8.6	28.9
<i>of which:</i>						
- medical and pharmaceutical products	51.7	57.8	6.1	11.9	0.3	1.1
- chemical materials and products	8.9	172.5	163.7	19,4 times	8.5	28.6
Manufactured goods classified by materials	550.8	749.8	199.0	36.1	10.3	34.8
<i>of which:</i>						
- iron and steel	381.3	589.2	208.0	54.5	10.8	36.3
- non ferrous metals	4.9	6.1	1.2	24.2	0.1	0.2
- manufactures of metals	53.1	42.4	-10.6	-20.1	-0.6	-1.9
Machinery and transport equipment	102.7	115.6	12.9	12.5	0.7	2.2
<i>of which:</i>						
- general industrial machinery and equipment, n.e.s.,	15.0	33.6	18.6	123.7	1.0	3.2
- electrical machinery, apparatus and appliances, n.e.s.,	47.7	36.4	-11.3	-23.6	-0.6	-2.0
- road vehicles	16.0	22.4	6.4	39.9	0.3	1.1
Miscellaneous manufactured articles	531.4	539.9	8.4	1.6	0.4	1.5
<i>of which:</i>						
- furniture and parts thereof	22.9	25.8	2.8	12.3	0.1	0.5
- articles of apparel and clothing accessories	418.6	424.4	5.8	1.4	0.3	1.0
- footwear	56.8	56.7	-0.1	-0.1	0.0	0.0

Source: SSO and NBRM.

Given the high exports dependence on import of raw materials and intermediary products and higher import price of oil and oil derivatives, in 2010, the imports registered an annual growth of 13.9%. Classified by materials, imports went up, given the significant increase of the import of non-ferrous metals, iron and steel, and textile yarns. The dependence of the new export facility on import of raw material base was a driving force behind the higher import of non-ferrous metals and nonorganic chemical products. Observing the energy imports, in 2010, the import of oil and oil products increased on annual basis, given the higher import price and lower import volume. On the other hand, the higher domestic output of the hydro power plants underlies the lower import of electricity. Discretionary fiscal policy measures⁴⁴ had additional effect on the total imports growth in 2010, stimulating the import of passenger cars (annual rise of 50.2%). Moreover, import of food products also increased, primarily due to the adverse effect of the growth of sugar prices, and to minor extent, to the higher import demand for these products. Unlike these upward tendencies, import of investment products (machines and transport

⁴⁴ The amendments to the Excise Law of March 11, 2010, the excise duties on passenger cars reduce and change progressively to their value. Moreover, the amendments to the Customs Tariff Law of March 12, 2010, customs duties on import of used passenger cars decreased from 10% to 5%, i.e. the customs duty on new and used passenger cars was equaled. Also, an interim measure (March to September 2010) allowed import of cars used up to 15 years of age with Euro 1 standard. These reliefs resulted in import of 51,399 used passenger vehicles in 2010, compared to the total of 6,529 imported used vehicles in 2009.

equipment) has recorded annual decline for second consecutive year. Analyzing this category, the import of electrical machines is an exception, reporting a growth on annual basis.

Table 10
Import of goods

Import of goods	2009	2010	y-o-y change		contributions	
	in millions of EUR		in millions of EUR	%	percentage points	%
Total	3,615.8	4,119.1	503.3	13.9	13.9	100.0
Food and live animals	402.0	420.6	18.5	4.6	0.5	3.7
<i>of which:</i>						
- meat and meat preparations	101.0	94.8	-6.2	-6.2	-0.2	-1.2
- cereals and cereal preparations	58.7	59.7	1.0	1.7	0.0	0.2
- fruits and vegetables	50.3	50.7	0.4	0.7	0.0	0.1
- sugar, sugar preparations and honey	32.5	45.3	12.8	39.4	0.4	2.5
- coffee, tea, cocoa, manufacturers there of	46.0	50.7	4.7	10.3	0.1	0.9
Beverages and tobacco	36.9	43.7	6.8	18.5	0.2	1.4
<i>of which:</i>						
- beverages	23.9	25.1	1.2	5.2	0.0	0.2
- tobacco and tobacco preparations	13.0	18.6	5.6	42.8	0.2	1.1
Crude materials, inedible, except fuels	140.3	218.3	78.0	55.6	2.2	15.5
<i>of which:</i>						
- metalliferous ores and metal scrap	79.7	155.5	75.8	95.1	2.1	15.1
Mineral fuels, lubricants and related materials	582.2	729.3	147.2	25.3	4.1	29.2
<i>of which:</i>						
- petroleum and petroleum products	444.1	563.5	119.3	26.9	3.3	23.7
- natural or industrial gas	40.2	55.9	15.7	39.1	0.4	3.1
- electric energy	89.2	85.9	-3.4	-3.8	-0.1	-0.7
Animal and vegetable oils and fats	32.8	39.1	6.3	19.1	0.2	1.2
Chemical Products	407.1	500.1	93.0	22.8	2.6	18.5
<i>of which:</i>						
- inorganic chemical products	15.8	96.5	80.7	6 times	2.2	16.0
- medical and pharmaceutical products	104.4	104.5	0.0	0.0	0.0	0.0
- chemical materials and products	43.3	48.1	4.7	10.9	0.1	0.9
Manufactured goods classified by materials	859.4	1,039.0	179.7	20.9	5.0	35.7
<i>of which:</i>						
- textile yarn, fabrics, and related products	277.3	305.1	27.8	10.0	0.8	5.5
- non metallic mineral manufactures	80.7	96.3	15.6	19.4	0.4	3.1
- iron and steel	215.4	267.2	51.8	24.0	1.4	10.3
- non ferrous metals	36.8	127.0	90.2	244.9	2.5	17.9
- manufactures of metals	83.2	74.8	-8.4	-10.1	-0.2	-1.7
Machinery and transport equipment	869.0	825.9	-43.1	-5.0	-1.2	-8.6
<i>of which:</i>						
- power generating machinery and equipment	56.0	25.3	-30.7	-54.8	-0.8	-6.1
- general industrial machinery and equipment, n.e.s., and	123.2	97.4	-25.8	-21.0	-0.7	-5.1
- road vehicles	212.5	280.3	67.9	31.9	1.9	13.5
- other transport equipment	48.1	17.0	-31.1	-64.6	-0.9	-6.2
Miscellaneous manufactured articles	281.8	299.3	17.5	6.2	0.5	3.5
<i>of which:</i>						
- furniture and parts thereof	28.0	29.8	1.8	6.5	0.1	0.4
- articles of apparel and clothing accessories	53.4	48.8	-4.6	-8.6	-0.1	-0.9
- footwear	25.2	25.0	-0.2	-0.9	0.0	0.0

Source: SSO and NBRM.

The analysis of trade in the Republic of Macedonia, by trading partner, in 2010 indicates significantly improved trade with the European Union (EU), with the trade deficit being reduced by Euro 147.3 million on annual basis, or by

18.3%. Of 27 EU member state, the Republic of Macedonia registered a surplus with seven, while with 21 EU member states the balances improved. Given the significantly higher exports, the Republic of Macedonia gained back its position of a net exporter to Germany, Spain and the Netherlands, with substantial trade deficit shrinkage being recorded with Slovenia, Italy, Poland, Lithuania, Austria and Romania. On the other hand, outstanding trade deficit enlargement was registered with Great Britain, due to the import of non-ferrous metals. While the trade with the EU improved, the trade deficit with the developing countries widened in 2010, mostly due to the higher import of crude oil from Russia, and of hot rolling products from Ukraine. The surplus with the West Balkan countries increased insignificantly, primarily due to the higher trade surplus with Kosovo.

Table 11
Balances, by trading partner

<i>External Trade by trading partners</i>	2009	2010	2009	2010	y-o-y change		contributions	
	<i>Total Trade in millions of EUR</i>		<i>Trade Balance in millions of EUR</i>		<i>in millions of EUR</i>	<i>%</i>	<i>percentage points</i>	<i>%</i>
Total	5,541.0	6,616.6	-1,690.6	-1,621.6	69.0	-4.1	-4.1	100.0
European Union	2,967.8	3,718.8	-803.5	-656.2	147.3	-18.3	-8.7	213.5
Germany	695.0	984.5	-47.4	60.0	107.4	-226.4	-6.4	155.7
Greece	521.5	521.8	-105.0	-150.3	-45.4	43.2	2.7	-65.7
Spain	62.1	101.9	-7.3	10.7	18.0	-246.6	-1.1	26.0
Italy	414.5	425.9	-103.5	-69.6	33.9	-32.7	-2.0	49.1
Slovenia	161.2	177.2	-112.3	-72.0	40.3	-35.9	-2.4	58.5
Bulgaria	327.9	450.5	-19.8	-5.9	13.9	-70.1	-0.8	20.1
Belgium	49.9	84.0	1.8	36.5	34.7	1,902.4	-2.1	50.3
United Kingdom	74.9	258.1	-13.8	-168.8	-154.9	1,118.7	9.2	-224.6
Other developed countries*	229.2	219.6	-180.1	-177.4	2.8	-1.5	-0.2	4.0
EFTA	105.9	90.4	-78.8	-59.5	19.3	-24.5	-1.1	28.0
Western Balkans	1,143.0	1,245.1	288.0	296.4	8.4	2.9	-0.5	12.2
Developing countries**	1,031.6	1,297.2	-902.7	-985.0	-82.3	9.1	4.9	-119.3
Low income countries	63.6	45.5	-13.4	-39.9	-26.5	197.9	1.6	-38.4

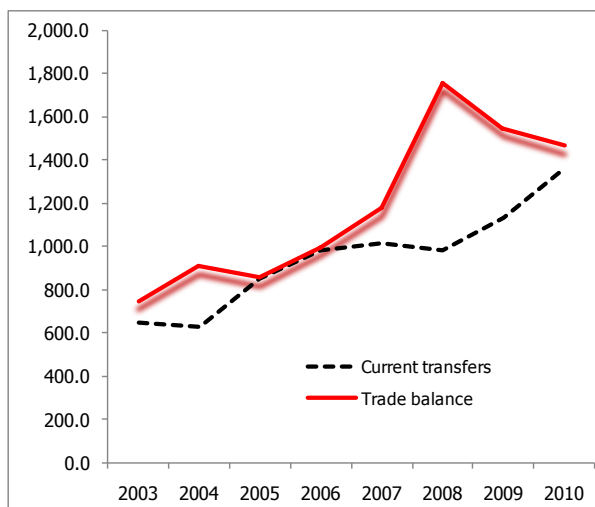
* USA, Japan, other developed countries

** Russia, Ukraine, Turkey, other developing countries

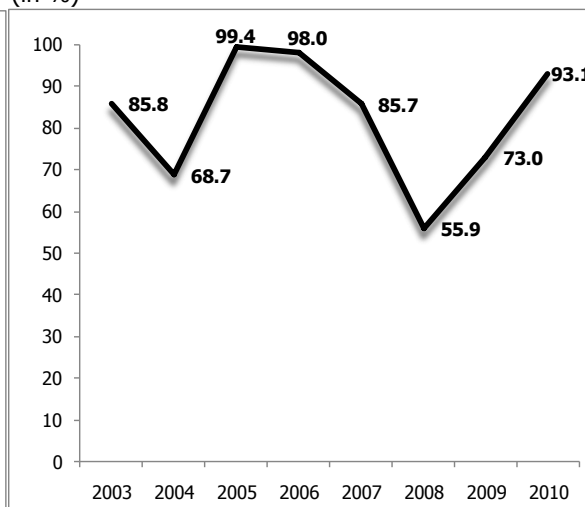
2.4.2.2. Other current account components

In 2010, current transfers, as major source of trade deficit coverage reached Euro 1,366 million, or 19.8% of GDP. Comparing with the preceding year, current transfers went up significantly by 20.6% or by 2.9 percentage points of GDP. In 2010, the trade deficit - current transfers coverage ratio improved substantially, rising from 73% in 2009 to 93.1% in 2010, demonstrating higher transfers and lower trade deficit.

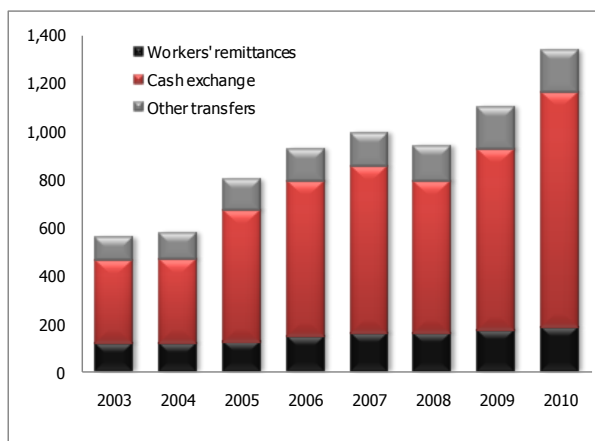
Figure 62
Trade balance and current transfers
(in EUR million)



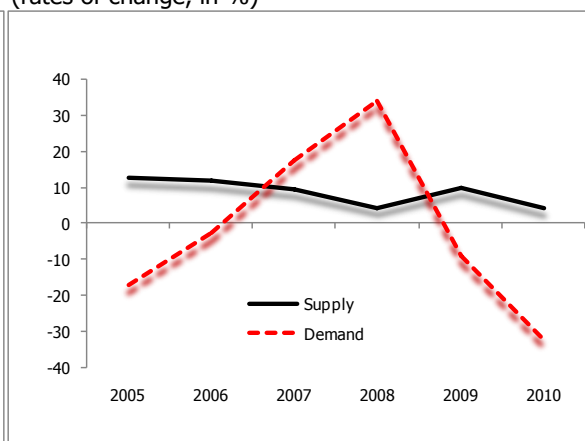
Coverage of the trade deficit with current transfers
(in %)



Components of the private transfers
(in EUR million)



Supply and demand on the currency exchange market
(rates of change, in %)



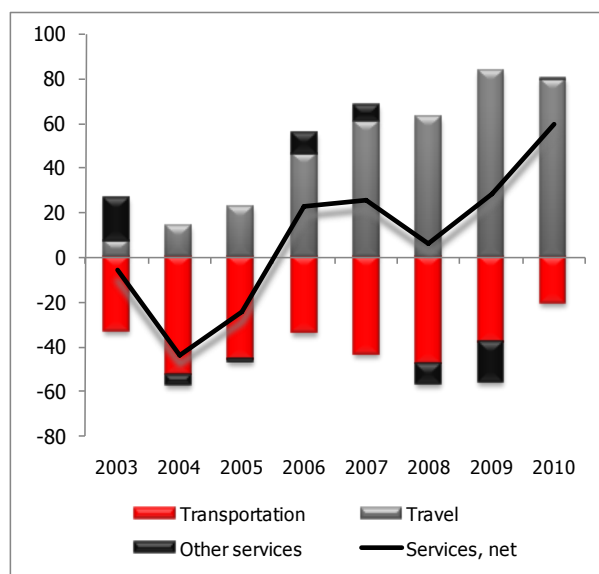
Source: NBRM.

The favorable dynamics of current transfers is solely due to the growth of private transfers, and the net inflows from official transfers registered annual fall. Analyzing private transfers, the most important item - the net-cash climbed to Euro 979.3 million, or 14.2% of GDP, which is the highest level ever. The favorable dynamics of these net inflows was registered in conditions of steep fall of the demand for foreign currency and moderate growth of the supply of foreign currency (by 32.5% and 4.3% on annual basis, respectively). Other components of private transfers, official remittances and other transfers (rents, pensions, etc.) registered no significant annual change.

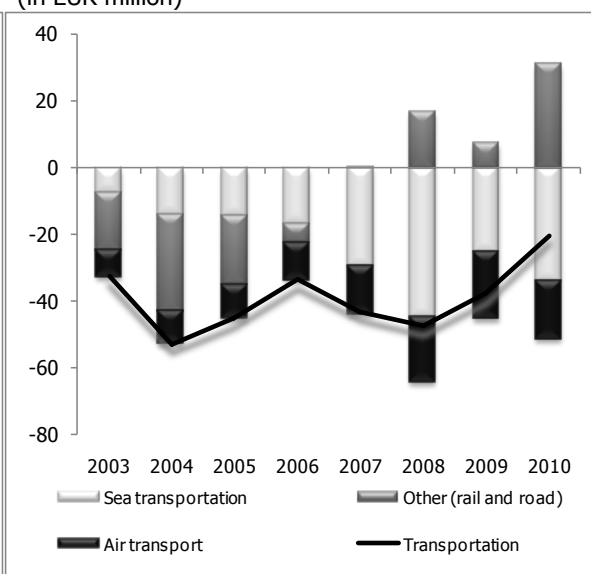
Observing the foreign trade in services, in 2010 the positive balance mounted to Euro 59.9 million, or 0.9% of GDP, which is an increase of more than twice compared to the previous year. Observing the main categories, such improvement resulted almost equally by the improved trade balance of other services and lower trade deficit of transport services. In spite of these favorable tendencies, the surplus of travelling services went down on annual basis, due to lower inflows from trips of foreign tourists. Analyzing the category of other services, the business service balance switched from negative in 2009 to positive (mainly a result of the higher export of trade

intermediation services), whereas the negative balance of computer and IT services narrowed significantly. With respect to this category, however, the construction service trade reported unfavorable tendencies, i.e. the lower export of construction works abroad shrank the surplus of this category. Observing the balance of transport services, the surplus of passenger transport services went up, unlike the trade deficit of naval services that expanded on annual basis.

Figure 63
Structure of the balance of services
(in EUR million)



Structure of the balance of transportation services
(in EUR million)



Source: NBRM.

While most of the current account components registered positive tendencies, in 2010, the income balance registered a deficit of Euro 149.2 million, or 2.2% of GDP. Compared to 2009, the deficit went up by 2.6 times, or by 1.3 percentage points of GDP, which having a moderate increase of employee allowances, is solely due to the expanded income deficit based on capital. In 2010, net outflows based on income from foreign direct investments went up (according to the perceptions⁴⁵ for higher profit of the foreign investors in 2010 compared to 2009). Also, net inflows from portfolio investment income were lower on annual basis, primarily due to the payment of the interest for the second Eurobond in July. Net outflows based on payments of interest on financial loans went up mostly due to the higher net payments by the corporate sector.

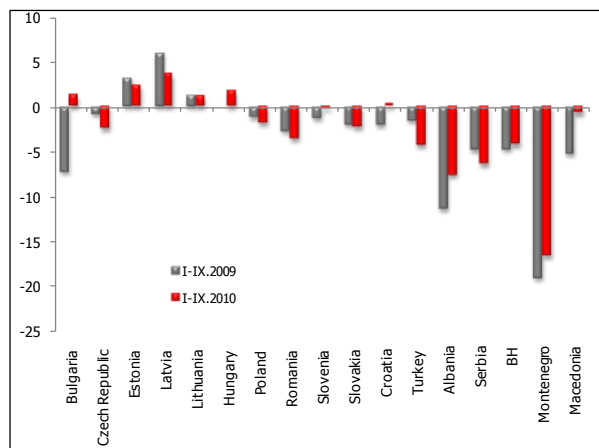
The comparative current account analysis for the January - September 2010 period⁴⁶ indicates deficit reduction in the countries of this region (except for Serbia and Turkey). On the other hand, current account balances of some CEE countries deteriorated during the year. In the *countries from the region*, the trade deficit development has significant influence on the growth of the current account balance. In general, the export demand of these countries recorded faster recovery compared to that of the domestic demand, with the exports growth exceeding the imports growth. Trade deficit of Albania, Bosnia and Herzegovina and Montenegro reduced on annual basis, thus improving the current account deficit. Such changes in Croatia and Bulgaria switched the current account balance from deficit to surplus. Turkey reported current account deficit

⁴⁵ This opinion is based on the Survey of Financial Performance of Corporations with significant foreign direct investments.

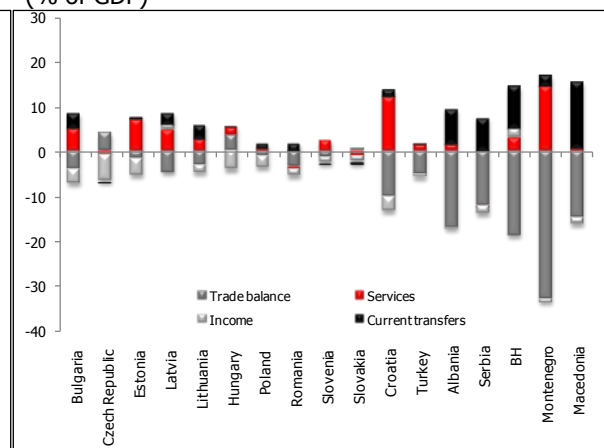
⁴⁶ Latest available data.

enlargement, driven by the relatively strong domestic demand. In Serbia, the lower net inflows from private transfers and higher net outflows of income from direct investments played a leading role in the expansion of the current account deficit. Most of EU member states from CEE reported deteriorated current account balance, driven by various growth factors. The lower surplus of Baltic economies was mostly due to the deterioration of the income balance, while Poland and Slovakia pointed to the change in the trade balance as major driver for the higher deficit. Compared to the countries under observation, in the first three quarters of 2010, Macedonia reported higher deficit in the balance of commodities compared to the average of the CEE countries (14.6% of GDP, compared to 1.1% of GDP), and lower compared to the average for the countries in the region (16% of GDP). In this period, the trade deficit was fully covered by net inflows from current transfers (14.9% of GDP), also registered in Poland and Lithuania. Also, analyzing the region, current transfers are particularly important source of current account inflows in Bosnia and Herzegovina, Albania and Serbia.

Figure 64
Current account balance, by countries
(% of GDP)



Components of the current account, by countries
(% of GDP)



Source: NBRM, Eurostat, central banks of Albania, Serbia, Bosnia and Herzegovina and Montenegro and WEO October 2010.

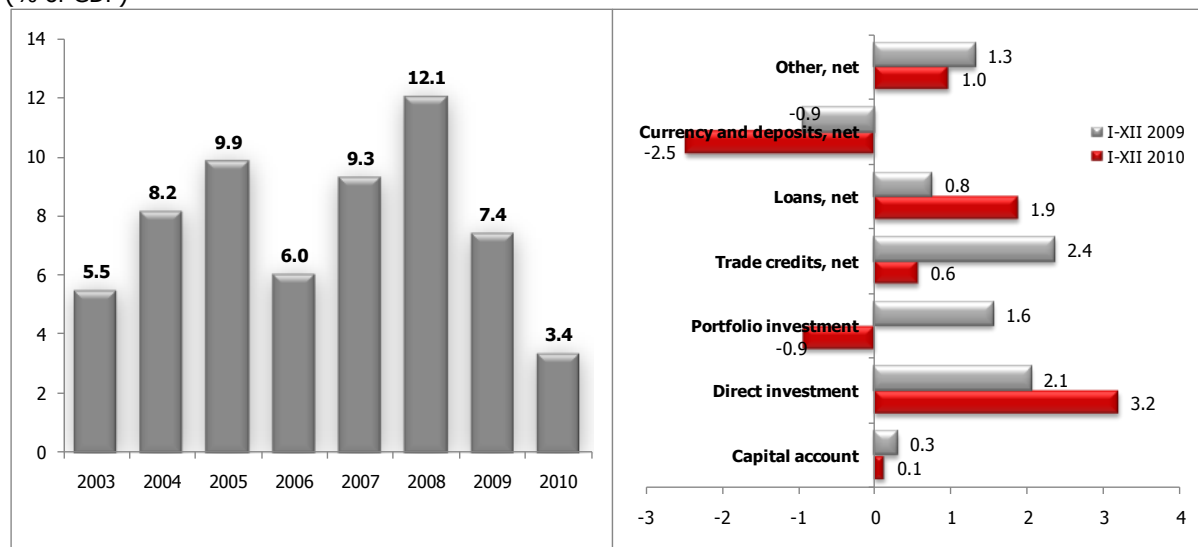
2.4.3. Capital and financial account

Net inflows of the capital and financial account (excluding official reserves) were valued at Euro 231.6 million, or 3.4% of GDP) in 2010, ensuring full coverage of the current account deficit and additional accumulation of foreign reserves. On annual basis, the capital net inflows were lower by 53.3% or by 4.1 percentage points of GDP, partially resulting from with the base effect, i.e. the high comparison base of 2009 that witnessed inflows from the issue of second government Eurobond on the international capital market and funds disbursement from the IMF quota. If we ignore this effect, the capital net inflows in 2010 were by roughly 10% lower on annual basis. Observing the structure, most of the net inflows originate from foreign direct investments and borrowings from abroad, whereas net outflows were registered in currencies and deposits.

Figure 65

Capital and financial account, without official reserves (% of GDP)

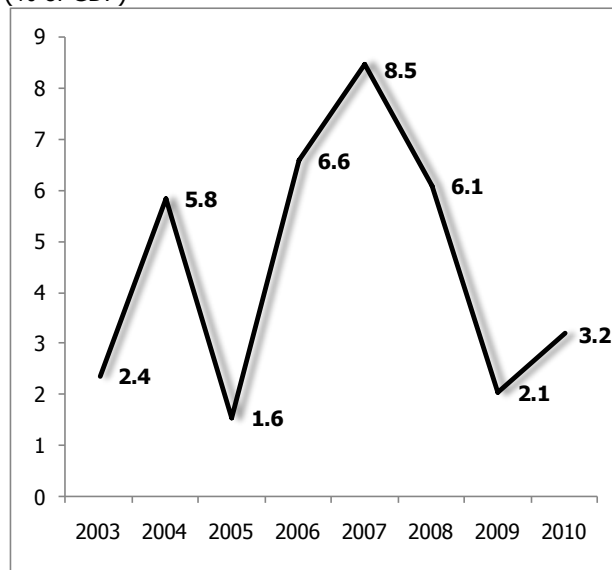
Capital and financial account components (% of GDP)



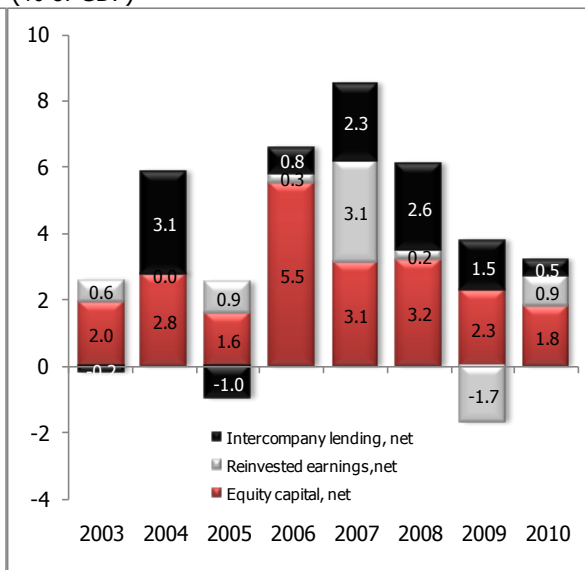
Source: NBRM.

In 2010, foreign direct investments (FDI) inflows, on net basis, amounted to Euro 219.9 million, of 3.2% of GDP, thus registering significant annual growth of 60.6%, or 1.1 percentage point of GDP. The analysis of annual dynamics shows that FDI growth is solely due to the higher reinvested profit, whereas intercompany loans and equity went down on annual basis. Structurally observed, more than half of FDIs originate from new investments in equity, followed by reinvested profit, and smaller portion results from intercompany borrowing. Accordingly, the structure is favorable, and FDI growth sent signals that the perceptions for investment risk are lower, i.e. that the foreign investors interest to invest in the domestic economy increased. **The current account was additionally financed through loans that reached Euro 129.4 million on net basis, or 1.9% of GDP.** Net loans went up by 2.5 times or by 1.1 percentage point of GDP compared to 2009, mostly due to the increased private sector debt (77%), and smaller portion due to the higher long-term government debt. Private sector loan growth is solely due to the growth of long-term loans of banks, while other sectors registered net repayments of loans. Observing the maturity, long-term loan growth exceeded the short-term loan growth.

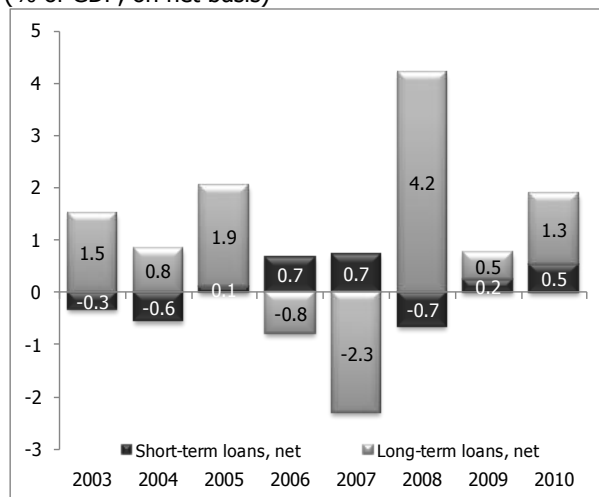
Figure 66
Foreign direct investment
(% of GDP)



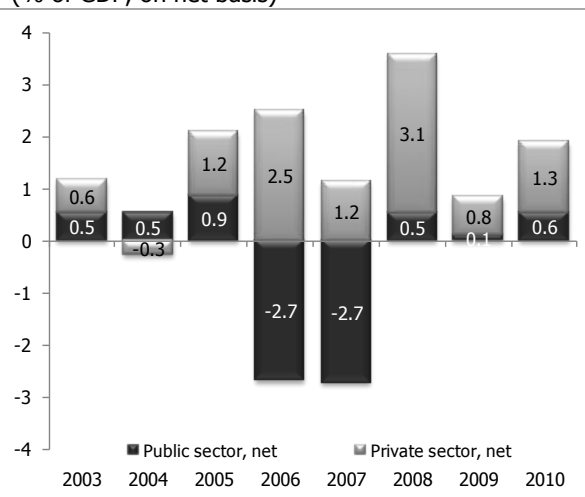
Structure of direct investment, net
(% of GDP)



Structure of the loans by maturity
(% of GDP, on net basis)



Structure of the loans by sectors
(% of GDP, on net basis)



Source: NBRM.

Although the flows based on foreign direct investments and loans registered annual growth, **in 2010, trade credits, and currencies and deposits considerably decreased.** Trade credits amounted to Euro 39.3 million, or 0.6% of GDP (fall of 1.8 percentage points of GDP on annual basis), while currencies and deposits registered high net outflows in the amount of Euro 169.9 million, or 2.5% of GDP (which is by 1.5 percentage points of GDP more, on annual basis). Such currency and deposit growth is due to the higher cash disbursement by domestic banks to other sectors, and of the deposit withdrawal by nonresidents. **Observing the portfolio investments, the net outflows of Euro 63.6 million, or 0.9% of GDP were by 10.5% lower on annual basis** (ignoring the effect of high inflows based on the second Eurobond issue in 2009). Investment portfolio registered lower investment of the domestic pension funds in foreign equities. On the other hand, government sector liabilities based on debt securities decreased due to the repurchase of the Eurobond on the global capital markets by residents - institutional investors.

2.4.4. Price competitiveness

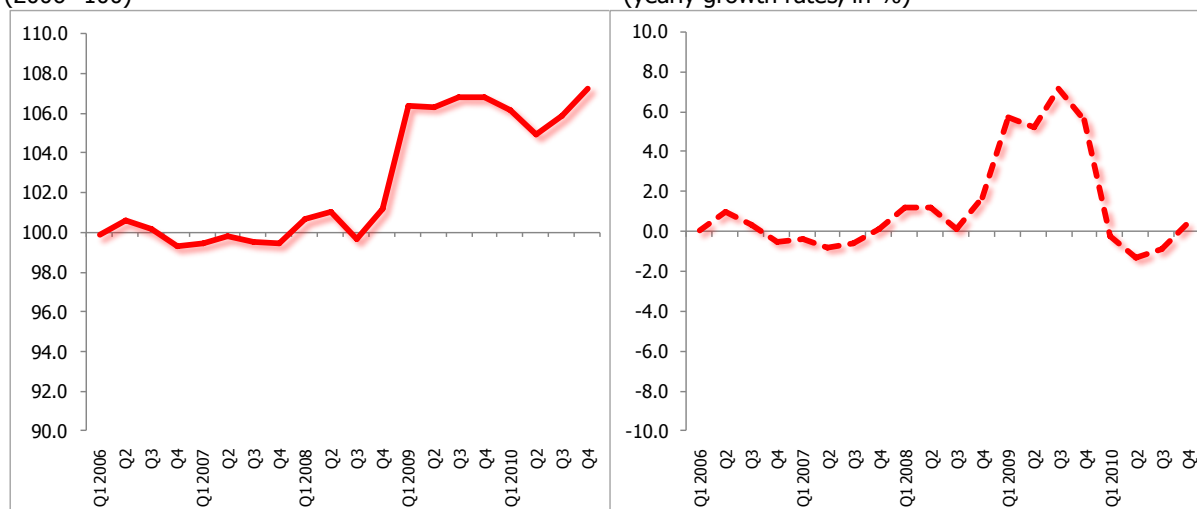
In 2010, real effective exchange rate (REER), measured by consumer prices and producer prices showed various indications for changes in the level of domestic price competitiveness. Various signals for the REER development reflect the changeable movement of the relative price ratio, whereas the nominal effective exchange rate (NEER) tended to moderately depreciate the REER. In the first three quarters, NEER depreciated on annual basis, whereas in the last quarter it marginally appreciated, with the cumulative annual depreciation equaling 0.5% in 2010.

Figure 67

NEER (2006=100)

Nominal effective exchange rate - NEER
(2006=100)

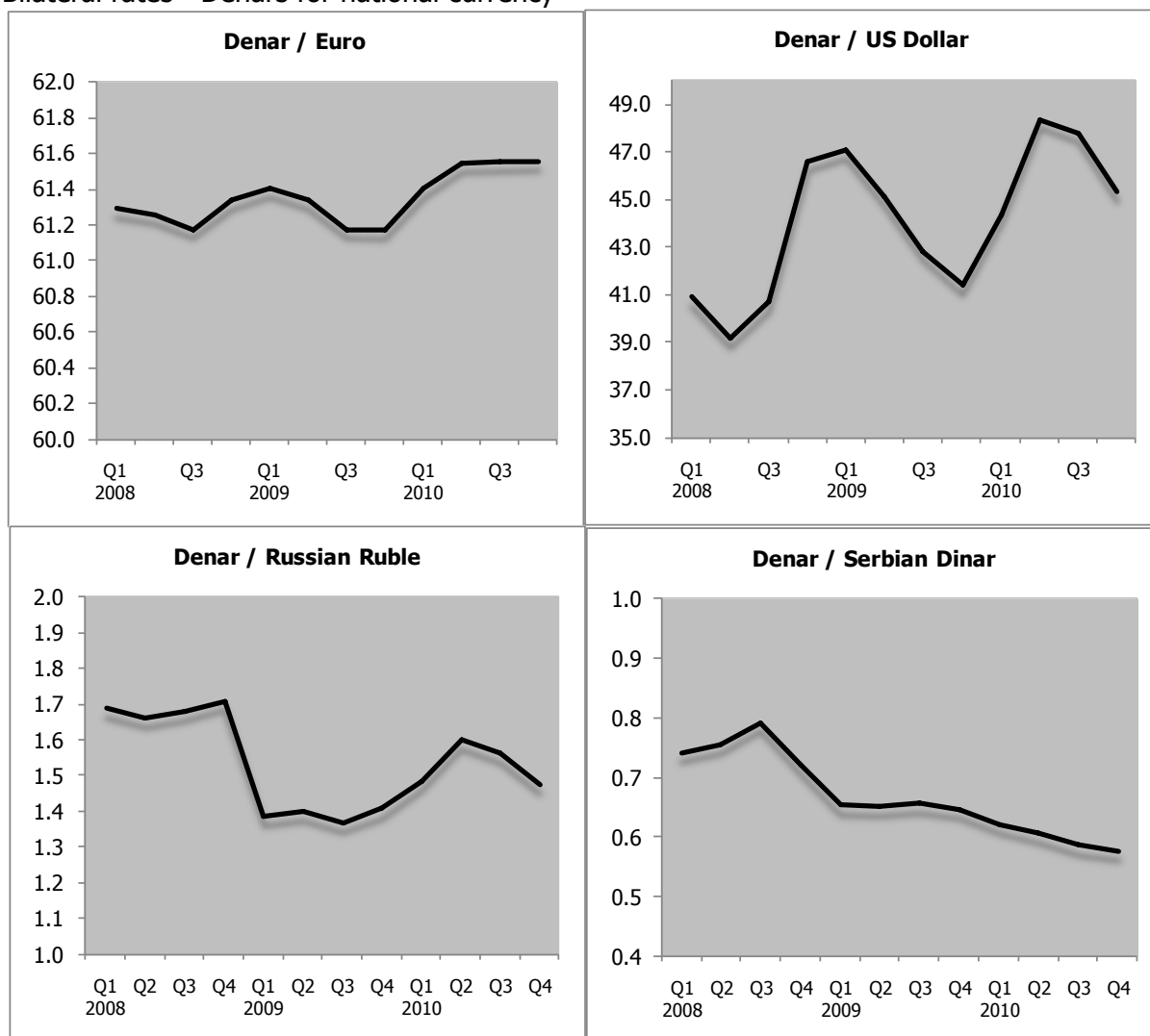
Nominal effective exchange rate - NEER
(yearly growth rates, in %)



Source: NBRM and IFS for March 2011. Countries for which no available data could be found from IFS, the data were taken from the website of the respective central banks or from the EUROSTAT.

In 2010, Denar depreciated against almost all currencies in the selected basket for NEER calculation, except for the Serbian Denar. Taking into account the Euro-pegged Denar exchange regime, large portion of the Denar depreciation against other currencies reflects the depreciation of Euro against the US Dollar (by 4.9% on annual basis). At the beginning of 2010, fears of spillover of the government debt crisis in the EU member states (Greece, Ireland, as well as Spain and Portugal) undermined the trust in Euro. Thus, in the first half of 2010, compared to the end of 2009, the Euro depreciated against the US Dollar by roughly 11%. The pressures surrounding the Euro alleviated once the financial assistance mechanisms to countries facing problems with the public finances were provided. On the other hand, the Russian Ruble and the Turkish Lira appreciated against the US Dollar (by 4.3% and 3% respectively, on annual basis) that resulted in faster depreciation of the Denar against these currencies. On the other hand, the Serbian Dinar depreciated against the Euro and against the US Dollar, with the depreciation against the latter being more dramatic. Taking into account that Serbia is an important trading partner of the Republic of Macedonia, the appreciation pressures by the Serbian Dinar largely offset the depreciation effect of other currencies in the NEER index.

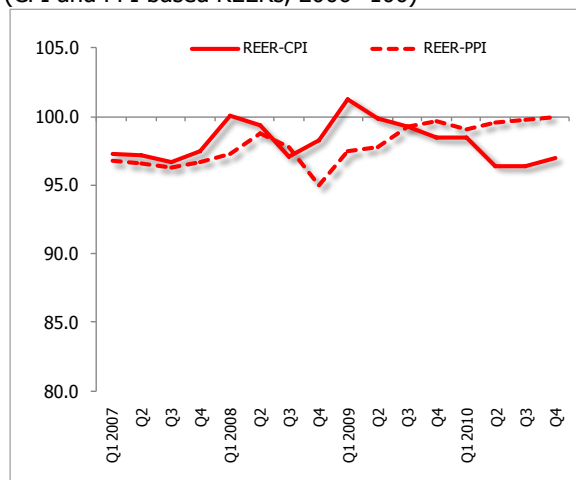
Figure 68
Bilateral rates - Denars for national currency*



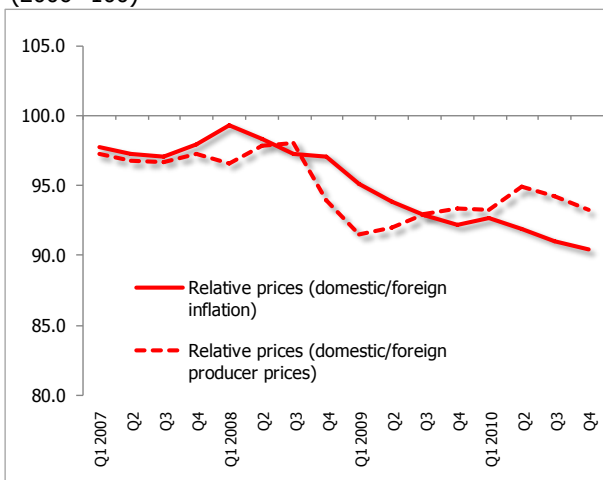
*Upward rate trajectory indicates depreciation of the Denar against the respective currency.
Source: IFS and NBRM.

The Denar real effective exchange rate calculated using the consumer price index (REER-CPI) registered annual depreciation of 2.6% in 2010. Having moderate NEER effect, such development of REER-CPI is due to the favorable price ratio, i.e. the foreign effective inflation exceeds the domestic one. Most of our important trading partners reported faster price growth compared to the domestic price growth. Faster inflation growth was registered in Turkey, Serbia, Russia and Greece, while in Germany and Croatia the inflation was slower than the domestic one. On the other hand, **REER-PPI registered annual appreciation of 0.9%.** However the REER-PPI dynamics was not flat during the year. The first half of the year it appreciated, and the second half of the year it depreciated on annual basis. The effect of unfavorable price ratio, i.e. faster growth of domestic producer prices compared to the growth of foreign producer prices was partially offset by the annual NEER depreciation.

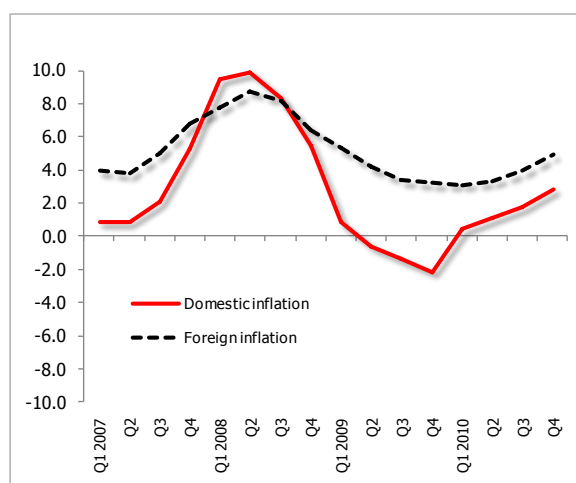
Figure 69
Prices, relative prices and REER
REER
(CPI and PPI based REERs, 2006=100)



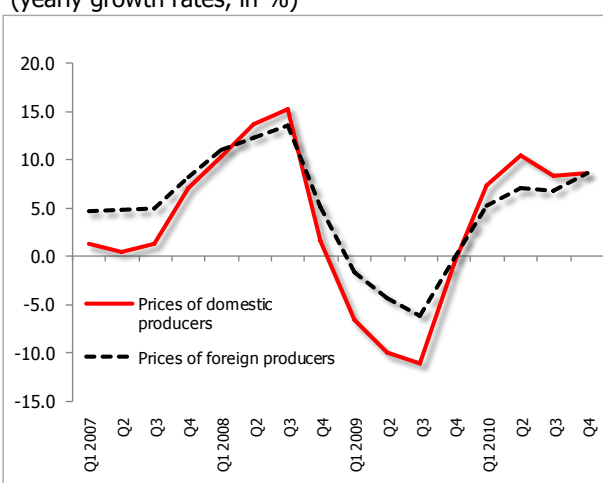
Relative prices
(2006=100)



Domestic and foreign inflation
(yearly growth rates, in %)



Prices of domestic and foreign producers of industrial products
(yearly growth rates, in %)



Source: NBRM, IFS for March 2011 and State Statistical Office of Macedonia. For countries lacking available data in IFS, the data were taken from the website of the respective central banks or from the EUROSTAT.

2.4.5. Gross external debt

The net debt position of the Macedonian economy was valued at Euro 1,417.8 million, or 20.6% of GDP at the end of 2010 (1.4 percentage points of GDP higher compared to December 31, 2009). Such change in net debt is due to the fast growth of gross debt of the domestic economic agents abroad, relative to the higher gross demands. The growth of gross demands in 2010 is primarily due to the short-term trade credits approved by the corporate sector to foreign partners and of the foreign reserves investments in long-term bonds outside the country.

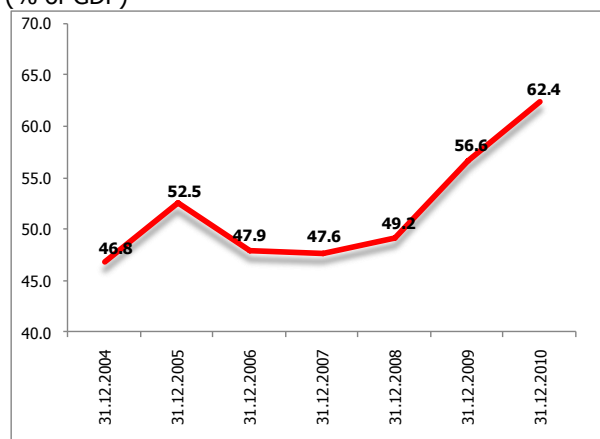
Table 12
Gross and net external debt

	31.12.2004	31.12.2005	31.12.2006	31.12.2007	31.12.2008	31.12.2009	31.12.2010
In EUR million							
Gross external debt	2,080.2	2,528.2	2,503.4	2,841.1	3,304.2	3,780.4	4,299.3
General Government	1,016.5	1,282.8	1,065.6	897.7	906.3	1,055.8	1,104.1
Monetary Authorities	55.5	62.8	52.0	9.0	9.2	71.7	76.4
Banks	123.2	192.0	269.9	387.9	384.1	468.2	576.5
Other Sectors	600.4	721.0	786.7	1,115.7	1,321.9	1,347.0	1,562.8
Direct investment: Intercompany lending	284.5	269.6	329.3	430.8	682.7	837.6	979.5
Gross external claims	1,530.0	2,026.2	2,427.4	2,634.9	2,392.1	2,498.5	2,881.5
General Government	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Monetary Authorities	664.7	1,040.5	1,327.0	1,416.3	1,361.2	1,366.9	1,482.5
Banks	619.6	635.9	668.3	648.1	390.6	496.8	572.7
Other Sectors	197.8	253.9	336.5	447.4	507.0	440.2	561.8
Direct investment: Intercompany lending	48.0	95.9	95.6	123.1	133.3	194.6	264.6
Net external debt	550.2	502.0	76.0	206.2	912.1	1,281.9	1,417.8

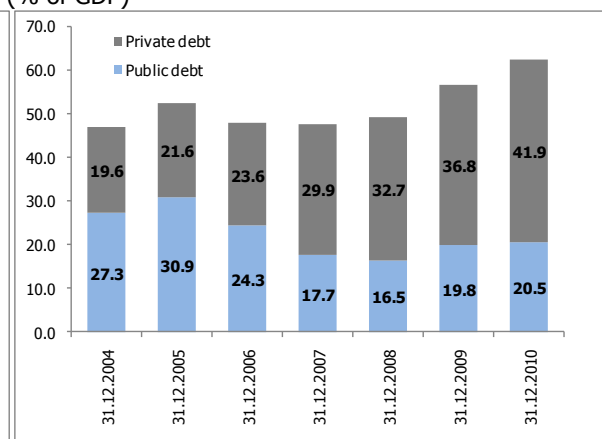
Source: NBRM.

In 2010, the gross external debt registered cumulative growth of 13.7%, or by 5.8 percentage points of GDP, thus the gross external debt being valued at Euro 4,299.3 million or 62.4% of GDP on December 31, 2010. Thus, the uptrend that started in 2007 continued in 2010, and equaled around 15% on average (2007-2009). Compared to 2009, when the growth of gross debt was almost equally due to the increase in both public and the private sector debt, in 2010, its growth was primarily driven by the increase in the private sector debt.

Figure 70
Gross external debt
(% of GDP)



Gross external debt, by debtors
(% of GDP)



Source: NBRM.

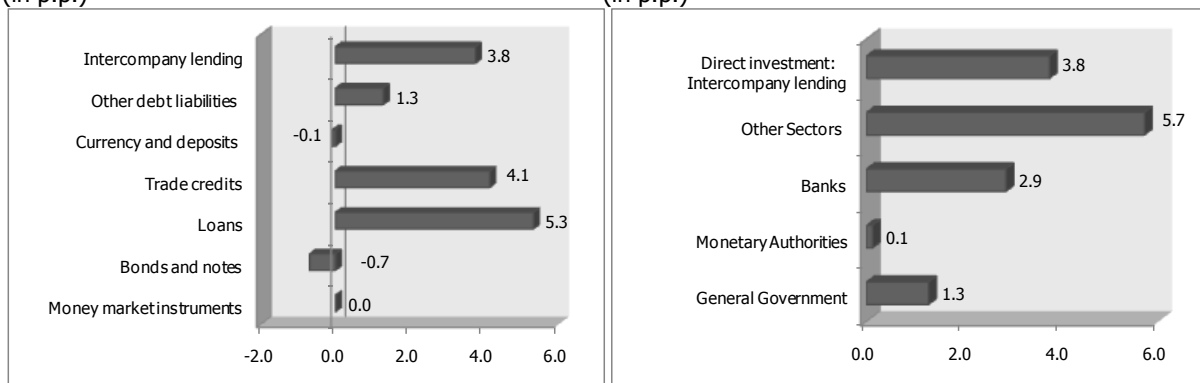
In 2010, most of the new debt was created by the private sector⁴⁷ (contribution of 82.5% to the growth), and only small portion reflect the growth of the public sector debt⁴⁸. At the end of the last quarter of 2010, the debt constituted 41.9% of GDP (5.1 percentage point growth compared to the end of 2009), while the public sector debt reduced to 20.5% of GDP (or growth of 0.7 percentage points). Analyzing the *instruments*, the rise of financial loans made the greatest contribution to the debt increase,

⁴⁷ The private sector debt includes bank debt (excl. the Macedonian Bank for Development Promotion), the debt of other sectors (excl. public companies) and intercompany debt.

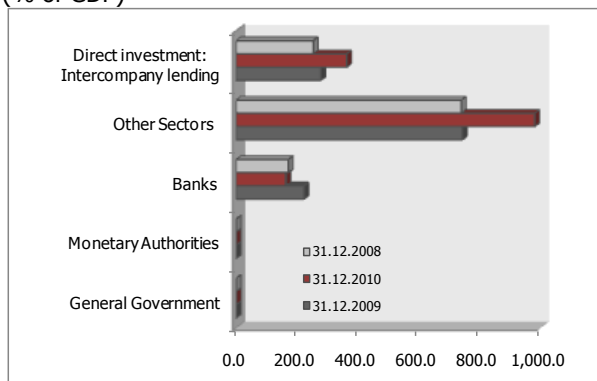
⁴⁸ The public sector debt includes the debt of the central government and funds, the monetary authorities, the public companies and the Macedonian Bank for Development Promotion.

primarily the long-term loans by the banking sector. Significant portion of the debt increase was due to the higher liabilities based on trade credits and liabilities based on intercompany debt. Smaller portion of the debt increase was due to the higher overdue liabilities valued at Euro 33.4 million in 2010, and since the beginning of the crisis (last quarter of 2008) it reached Euro 50.4 million, cumulatively. In spite of these trends, debt based on bonds and on currencies and deposits (with banks) registered annual decrease. Observing the *maturity structure*, the new debt was almost equally on both short and long run (contribution of 50.8% and 49.2%, respectively). Thus, the long-term debt accounted for 40.5% of GDP, and the short-term debt was lower by almost two times, i.e. 21.9% of GDP. The short-term debt structure primarily consists of trade credits (51.8%), followed by intercompany debt (about 24.1%). Such structure of short-term debt, mostly based on liabilities arising from import of goods (as in trade credits) or are related to connected entities (in the case of intercompany debt) makes the domestic economy less sensitive to external shocks. These liabilities are less risky for the maintenance of solvent position of the domestic economy, compared to liabilities arising from bilateral financial loans or government debt.

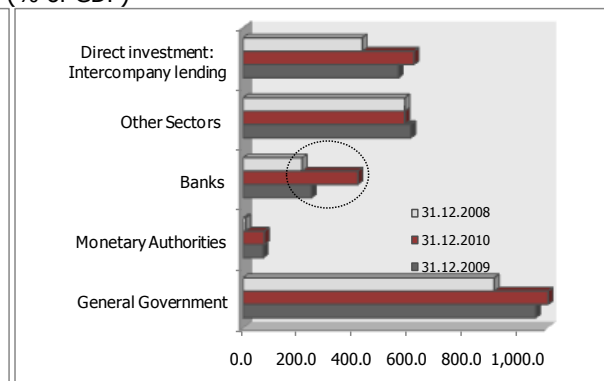
Figure 71
 Contribution to the annual change of gross external debt, in 2010, by instruments (in p.p.) Contribution to the annual change of gross external debt, in 2010, by sectors (in p.p.)



Gross external debt (% of GDP)



Gross external debt, by debtors (% of GDP)



Source: NBRM.

The sector-by-sector analysis of the gross debt shows that most of the debt growth (41.6%) was created on the basis of the debt of other sectors⁴⁹ in the economy. This category registered shift in the maturity of liabilities, from long-term financial loans to short-term trade credits and overdue liabilities. The higher trade credits result from the foreign partner preferences to keep the market share in export markets,

⁴⁹ The category of other sectors includes nonbanking financial intermediaries, nonfinancial trade companies, households and nonprofit institutions.

regardless of the fall of liquidity position of domestic companies, if any, (perceivable through the increase in overdue liabilities). Second considerable contribution (of 27.4%) to the external debt growth was made by intercompany debt of connected entities. Most of these flows of direct investments (roughly 83%) refer to companies at the metal industry and automobile spare parts manufacturing industry, facilities that acted as major drivers for the recovery of the domestic export based economic activity. In 2010, the higher bank borrowing was additional factor for the debt growth (20.9% contribution). The shift in the maturity structure of liabilities in this sector varies from other sectors, i.e. banks registered lower short-term liabilities and higher long-term liabilities. Most of the new bank debt includes long-term loans, one third of which originating from parent banks in the form of credit lines.

The perception of the external debt sustainability level is based on the analysis of some ratios between the debt and the key macroeconomic variables that could identify potential risks. Note that the indicator analysis should primarily be dynamical, as the direction of the indicator movement within a certain time period fairly depicts the real debt risks, than the analysis of the static ratio with fixed benchmark.

The analysis of indicators of the Republic of Macedonia shows that the debt level of the Macedonian economy generally dwells in "safe" zone, with deterioration being registered in some indicators. Such claim is additionally underpinned by the structure of gross debt, predominantly made of share of intercompany debt and trade credits, types of lower risk indebtedness compared to the purely financial loans.

Table 13
External debt indicators

	<i>Solvency</i>				<i>Liquidity</i>	
	Interest payments / Export of goods and services	Gross debt / Export of goods and services	Gross debt / GDP	Debt service / Export of goods and services	Foreign reserves / Short-term debt	Short-term debt / Total debt
	in %				ratio	in %
31.12.2004	2.60	121.74	46.83	11.87	1.14	30.27
31.12.2005	2.55	122.78	52.52	9.15	1.67	26.67
31.12.2006	3.20	104.69	47.86	15.05	1.95	28.98
31.12.2007	2.98	92.64	47.63	16.33	1.35	39.82
31.12.2008	2.62	97.74	49.17	7.28	1.29	35.19
31.12.2009	3.34	148.88	56.62	9.94	1.29	32.86
31.12.2010	3.45	134.96	62.40	9.31	1.14	35.03
<i>Moderate indebtedness criterion</i>	<i>12 - 20%</i>	<i>165 - 275%</i>	<i>30 - 50%</i>	<i>18 - 30%</i>		

*Prepared in consistence with "External debt statistics: Guide for compilers and users", issued by IMF. Criterion on moderate debt was taken using the World Bank methodology for development of debt indicators.
Source: NBRM.

Solvency indicators, observed individually, provide various images for the indebtedness of the Macedonian economy. Thus, one of the basic external debt sustainability measures, i.e. *gross external debt -to- exports ratio* for the respective year shows an upturn (13.9 percentage points shrinkage on annual basis) compared to the permanent growth of this indicator since 2007. This indicator reflects the higher capability of domestic economy to generate foreign currency inflows from abroad through export of goods and services that could be used for servicing the debt liabilities. Marginal uptrend was also registered in the *principal repayment -to- exports ratio* (by 0.6 percentage points), whereas other two solvency indicators worsened. *The share of gross debt in GDP*

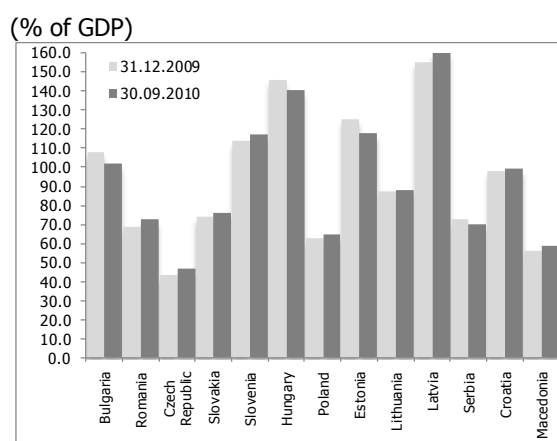
deteriorated by 5.8 percentage points, due to the intense increase of gross debt compared to the GDP nominal growth. *The interest servicing -to- exports ratio* deteriorated marginally, of 0.1 percentage points. **The gross external debt liquidity indicators** show excessive (full) funding of short-term debt with foreign reserves that makes roughly one third of the total external debt. In spite of the slight deterioration of 2.2 percentage points on annual basis of the second indicator, the favorable structure of short-term debt (76% of the total short-term liabilities are based on trade credits and intercompany debt) indicates lower external risk to the domestic economy, in real terms.

Annex 4: Comparative analysis of the gross external debt, by country

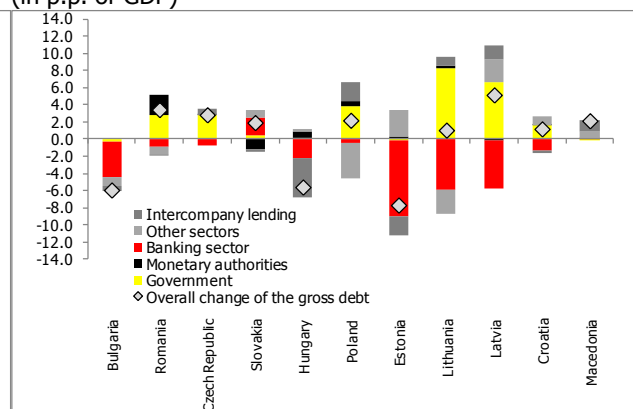
The comparison of the relative share of gross external debt in GDP with the Central and Southeast European countries and the Baltic region, shows that the Republic of Macedonia (with 62.4% of GDP) belongs to the group of countries with the lowest debt, together with the Czech Republic (46.5% of GDP). The average debt indicator in this group of countries is high, equaling 93.4%, where five countries exceed the full coverage of external debt with the gross domestic product.

In general, 2010 witnessed a moderate uptrend of the external debt of these countries. Most of the countries pointed to the higher government external debt as major driver for the growth, followed by the intercompany debt. The increase of government debt in some countries (the Czech Republic, Poland, Lithuania and Croatia) is due to the issuance of long-term government securities aimed to finance budget deficits. Such situation, in spite of the unfavorable conditions in the global capital markets, results from the positive perception of foreign investors for the credit rating of these countries. On the other hand, given the lower exposure of parent banks to foreign branches, the bank debt significantly reduced. Latvia reported the fastest cumulative growth of the gross debt (5.1 percentage points of GDP), solely due to the fall of the domestic GDP, with the slowest growth being registered in the external debt of Croatia (1.1 percentage point of GDP).

Figure 72
Gross external debt, by countries



Contributions to the change of the gross external debt, by countries (in p.p. of GDP)



Source: NBRM, Eurostat and central banks' web sites.

Four countries registered deviation from the general trend (Bulgaria, Hungary, Estonia and Serbia) where the gross external debt went down. Main reason behind such changes is the reduction of bank debt and intercompany debt, in the case of which it has not been compensated with an increase in the government debt. Most dramatic cumulative fall was registered in Estonia (of 7.8 percentage points of GDP), while the Hungarian debt

reduction was due solely to the faster GDP growth compared to the growth of the gross debt of this country.

The comparative analysis of the gross external debt solvency indicators shows that according to the share of gross debt in the exports, Macedonia is again enlisted among the first four countries (together with Czech Republic, Slovakia and Lithuania) reporting the lowest debt. The average value of this indicator in the analyzed group of countries is high (177.3%). Such situation, in conditions of relatively moderate increase of external debt reflects the slow recovery of exports, i.e. still weak foreign demand of the EU countries, which are most frequently their most important trading partners. Within this category, Latvia is the most indebted country, with gross external debt exceeding the import values by as much as three times. *However, observed dynamically, note that this indicator equaled 196.6% on average, during the 2009 crisis i.e. it went down by about 20 percentage points this year. Thus, in 2010, almost all countries under observation (excl. Poland) increased their capability to service the external debt liabilities, by generating higher foreign currency inflows from abroad.*

Table 14
Debt indicators, by countries

	Gross debt/ GDP	Gross debt/ Export od goods and services	Interest payments/ Exports of goods and services	ST debt/ Total gross debt
	in %			
Bulgaria	101.9	188.1	1.1	32.1
Romania	72.5	217.1	3.9	19.8
Czech Republic	46.5	62.0	0.1	n.a
Slovakia	76.2	99.3	0.7	58.5
Slovenia	117.1	188.8	1.3	n.a
Hungary	140.4	169.5	2.5	n.a
Poland	64.9	163.2	2.3	24.2
Estonia	117.7	148.8	0.8	n.a
Lithuania	88.2	137.5	2.4	n.a
Latvia	160.5	317.2	2.3	n.a
Serbia	70.3	211.7	6.7	5.6
Croatia	99.4	263.8	6.5	10.1
Macedonia	58.7	137.5	3.5	32.5
<i>Average value</i>	<i>93.4</i>	<i>177.3</i>	<i>2.6</i>	<i>26.1</i>

* Developed in consistence with "External debt statistics: Guide for compilers and users", issued by IMF. The gross external debt data are as of September 30, 2010, and balance of payment data are taking on a rolling basis (Q. 4 2009 and the first three quarters of 2010).

Source: NBRM, Eurostat, websites of central banks.

According to the remaining two debt indicators, Macedonia exceeds the average level in the group of countries. The share of short-term debt in the total external debt, that equals around one third of the total debt for our country, was by 6.4 percentage points above the average indicator, and the paid interest as an exports percentage, exceeds the average of the group of country by marginal 0.9 percentage points.

Annex 5: IMF Precautionary Credit Line - basic features and specificities of the arrangement with the Republic of Macedonia

In January 2011, the Republic of Macedonia concluded a new financial support arrangement with the International Monetary Fund (IMF) in the form of Precautionary Credit Line (PCL). This is a new IMF instrument, introduced in

August 2010 for the first time, as a part of the IMF lending policy reform. The global financial and economic crisis cast a light on the flaws of the IMF's available set of lending instruments. During the crisis, the Fund's traditional lending tools enabled timely response to support member states facing immediate funding needs. However, the Fund's capability to act preventively and to mitigate systemic risks proved to be limited, due to the unsuitable design of the set of precautionary lending instruments and in general, failure to adapt the available resources to the rapid trade and financial integration, in global terms (IMF 2010). In such circumstances, in March 2010, the IMF Executive Board of Directors adopted a comprehensive reform of the Fund's lending policies, primarily focused on designing efficient anti-crisis tools. The reform was aimed to adjust the financial role of the Fund to the new conditions of rapid globalization, thus enabling further successful fulfillment of the basic IMF mandate, to ensure global financial "protection net" and efficient assistance to the member states to cope with external shocks. Within the reform, first a Flexible Credit Line (FCL) was introduced intended for member states having very strong fundamentals and sound macroeconomic policies. However, the relatively rigorous FCL standards implied limited number of candidates among the IMF member states eligible to qualify for using this instrument. For these reasons, in August 2010 PCL was introduced, filling-in the gap in the IMF's set of lending instruments.

The precautionary credit line is IMF's alternative anti-crisis tool intended for countries with mainly solid fundamentals and history of conducting generally sound macroeconomic policies, but show moderate vulnerabilities in some fields, which makes them ineligible for the FCL. The PCL arrangement works on the principle of renewable credit line and can be concluded for a period of up to two years. The amount of funds that could be approved within this arrangement could reach 500% at the most of the IMF quota for the respective country, for the first year, with possibility to increase the available amount up to 1000% of the quota in the second year of the using the arrangement. The function of this arrangement is to protect the country against potential adverse shocks that could initiate urgent need from external financing within the arrangement period. This means that the funds cannot be disbursed immediately. They are only made available, and the country could make prompt withdrawal in case of adverse risk. This is a financial support without specified purposes that could be used as needed and in consistence with policies of the given country.

PCL arrangement uses qualification process similar to the FCL, where one member state becomes eligible for this arrangement if it meets the following basic standards: 1) have sound economic fundamentals and adequate institutional framework for conducting economic policies; 2) history of conducting sound and responsible policies and 3) commitment to practice sound macroeconomic management in the next period. The eligibility for PCL arrangement is determined by analyzing five general fields, as follows: 1) external position and access to external markets; 2) fiscal policy; 3) monetary policy; 4) soundness of the financial sector and the supervision, and 5) adequacy of statistical data. The eligibility for using PCL requires from a country to be given positive performance ratings in each of these five fields, although PLC allows access to funds for member states with basically sound macroeconomic policies that show moderate vulnerability in one or two of the indicated fields. This makes PCL more flexible and available to the IMF member states, compared to FCL. Countries that conclude PCL arrangement commit to conduct policies aimed to overcome the existing vulnerabilities identified in the qualification process. To monitor the country progress in meeting the specific policies, quantitative indicative targets are defined, subject to IMF evaluation on semiannual basis. PLC arrangement is subject to same costs and fees as the classical arrangements (the credit interest is pegged to the so-called IMF key cost interest rate), with the only difference that the PLC disbursement costs vary,

depending on the amount and duration of financing. More precisely, higher amount of funds means higher premium over the IMF key interest rate, and if the funds are not used, the country is charged for the credit line availability.

Republic of Macedonia is the first country that was approved a precautionary credit line in the amount of SDR 413.4 million, or about Euro 475.6 million, which is 600% of the IMF quota for the Republic of Macedonia. The PCL arrangement was concluded for a two-year period, in an available amount of 500% of the quota for the first year and additional 100% of the quota for the second year of the arrangement period. Interest rate in the amount of the rate of charge, determined by the International Monetary Fund shall be applied on the amount disbursed under the credit line up to 300% of quota. Interest rate in the amount of the rate of charge plus 2 percentage points, determined by the International Monetary Fund, shall be applied on the disbursed amount above 300% of quota. For the undisbursed amount, the Republic of Macedonia shall pay only commitment fee of 0.15% to the first 200% of quota and 0.3% commitment fee for above 200% of quota on annual basis.

With the conclusion of this arrangement, the Macedonian authorities committed themselves to continue conducting responsible and sound policies, with the IMF monitoring the performances of the Republic of Macedonia in this field through two indicative targets, the fiscal deficit and the net foreign reserves, as defined in the conclusion of the arrangements. In February 2011, the Law on Borrowing Precautionary Credit Line by the Republic of Macedonia from the IMF⁵⁰ was adopted.

Taking into account the PCL features, the approval of this arrangement is a confirmation by the IMF for the quality of macroeconomic policies conducted in the country. Thus, in the qualification process, the Republic of Macedonia received positive ratings on all parameters, with moderate vulnerability being identified merely in the field of external sector, primarily as a result of the high exposure of the country to external shocks. PCL arrangement provides for a sort of security against such risks, and along with the soundness of the domestic macroeconomic policies confirmed by the IMF, is expected to send a positive signal to the international investors. The arrangement with the IMF also generate direct positive effect on the conduct of monetary policy in the following period, as it provides larger security compared to the security of the necessary additional external financing, suggesting lower risks to the exchange rate stability.

In March 2011, the Government of the Republic of Macedonia was disbursed Euro 220 million of the total available Euro 390 million under the PCL arrangement for the first year. The Government of the Republic of Macedonia justified such withdrawal by the less favorable conditions on international financial markets after the arrangement approval, and the changed political situation in the environment, i.e. the expectations for early elections that created a need for postponement of the issuance of the planned Eurobond.

References:

1. Modhadam R. et al, "The Fund's Mandate - Future Financing Role" IMF, 2010;
2. IMF Macedonia Country Report No. 11/42, IMF;
3. Many IMF press releases, www.imf.org.

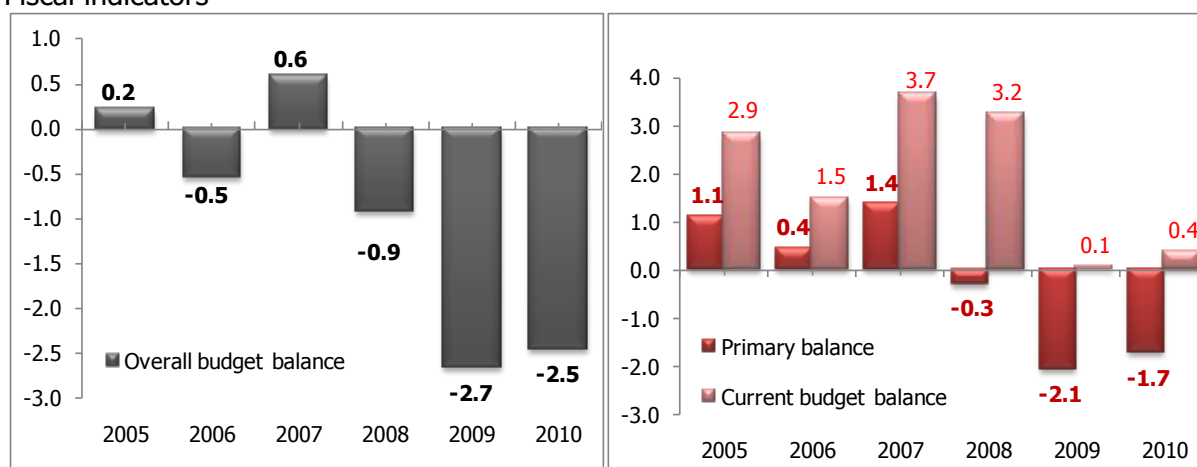
⁵⁰ "Official Gazette of the Republic of Macedonia" no. 17/2011.

2.5. Fiscal policy

Globally speaking, main feature of the 2010 fiscal policy was the launch of consolidation process. This made the focus on the fiscal policy to be switched from demand stimulation to gradual budget deficit and public debt reduction. According to the last assessments⁵¹, the budget deficit, in global terms, is expected to swing around 6% of GDP, compared to 6.8% the year before. The public finances consolidation, however, is mostly considered to result from the cyclical position of economies, and in some countries, from the pressures on financial markets. Hence, depending on economic and financial terms, the fiscal adjustment varied from country to country. Notwithstanding the adjustment of the overall fiscal position, the structural fiscal indicators⁵², particularly in advanced economies, showed positive fiscal spur in 2010. This is a signal that discretionary fiscal measures in some economies continued stimulating the economic activity (see Annex 6).

Once the deficit opened by 1.7 percentage points of GDP in 2009, **in 2010, the budget deficit remained almost the same as the year before, i.e. it reduced by 0.2 percentage points of GDP.** However, note that the prudential nature of fiscal policy, typical for a longer time period, was also preserved in the "acute stage" of the crisis and in the post crisis period. In 2009, the deficit enlarged in a relatively moderate pace, compared to the experience of other countries. Moreover, the fiscal adjustment started relatively swiftly, and in 2010, and registering further reduction of the income share in GDP, the total public consumption was adjusted. Hence, with respect to the budget deficit and the amount of public debt, the Republic of Macedonia was among economies that showed relatively favorable fiscal policies during the crisis and in the wake of the crisis.

Figure 73
Fiscal indicators



Source: Ministry of Finance of the Republic of Macedonia and NBRM calculations.

In 2010, the fiscal position improvement policy resulted in annual reduction of the total budget deficit by 0.2 percentage points, and reduced it to 2.5% of GDP, thus being kept under control. The primary budget balance registered faster downward correction⁵³ (by around 0.4 percentage points) which is a more realistic

⁵¹ IMF, Fiscal Monitor Update, January 2011.

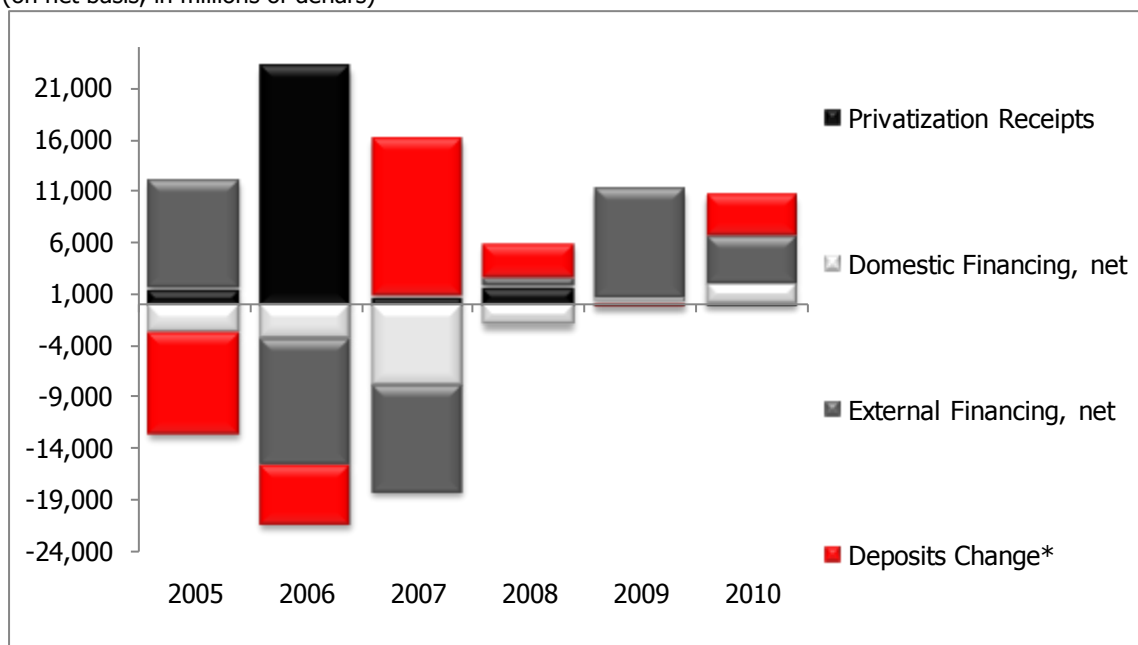
⁵² Fiscal balances corrected for the cyclical position of the economy.

⁵³ Primary budget balance is the difference between total budget revenues and total budget expenses, less the service of current liabilities on loans (interests). This fiscal indicator is considered to be more adequate for the analysis of current course of policy, due to the fact that it does not integrate fiscal costs related to past behavior of the fiscal policy towards the public debt.

indicator for the current course of fiscal policy. The current budget balance⁵⁴, even though significantly disturbed in the first quarter of the year, remained acceptable to the year-end, showing considerable improvement in the third quarter. Thus, the current transaction balance was positive and higher during the entire 2010 compared to 2009 (by around 0.3 percentage points).

The room of the fiscal policy to give powerful impetus for the economy by was also limited due to the unfavorable conditions for budget deficit financing on the international capital market. Greek crisis that started in the mid-year again disturbed the capital markets. In such circumstances, the external debt price went up, thus changing the plan for financing a portion of the budget deficit by issuing Eurobond. Thus, during the year, the government actively used the funds on account with NBRM, the domestic securities market instruments, and in the last quarter, the IMF quota for the Republic of Macedonia. In other words, as in most economies worldwide, in 2010, the deficit was mostly financed from domestic sources of funding. In conditions of uncertainty, the domestic entities demand for risk-free government securities was significant. Thus, given the deteriorated conditions on international markets and high demand of domestic investors for risk-free investments, during the year the government also increased the debt amount on the domestic financial market, compared to the initial plan.

Figure 74
Funding structure
(on net basis, in millions of denars)



*Positive change in government deposits implies their withdrawal from the account with NBRM.

Analyzing the gap between the savings and the government investments, in 2010, the government savings⁵⁵ went up annually, in conditions of stagnation of the total government revenues⁵⁶ and lower public consumption. The government savings, however, is still significantly lower compared to the period before the crisis, basically resulting from the lower level of available income given the unfavorable economic conjuncture. Also, in 2010,

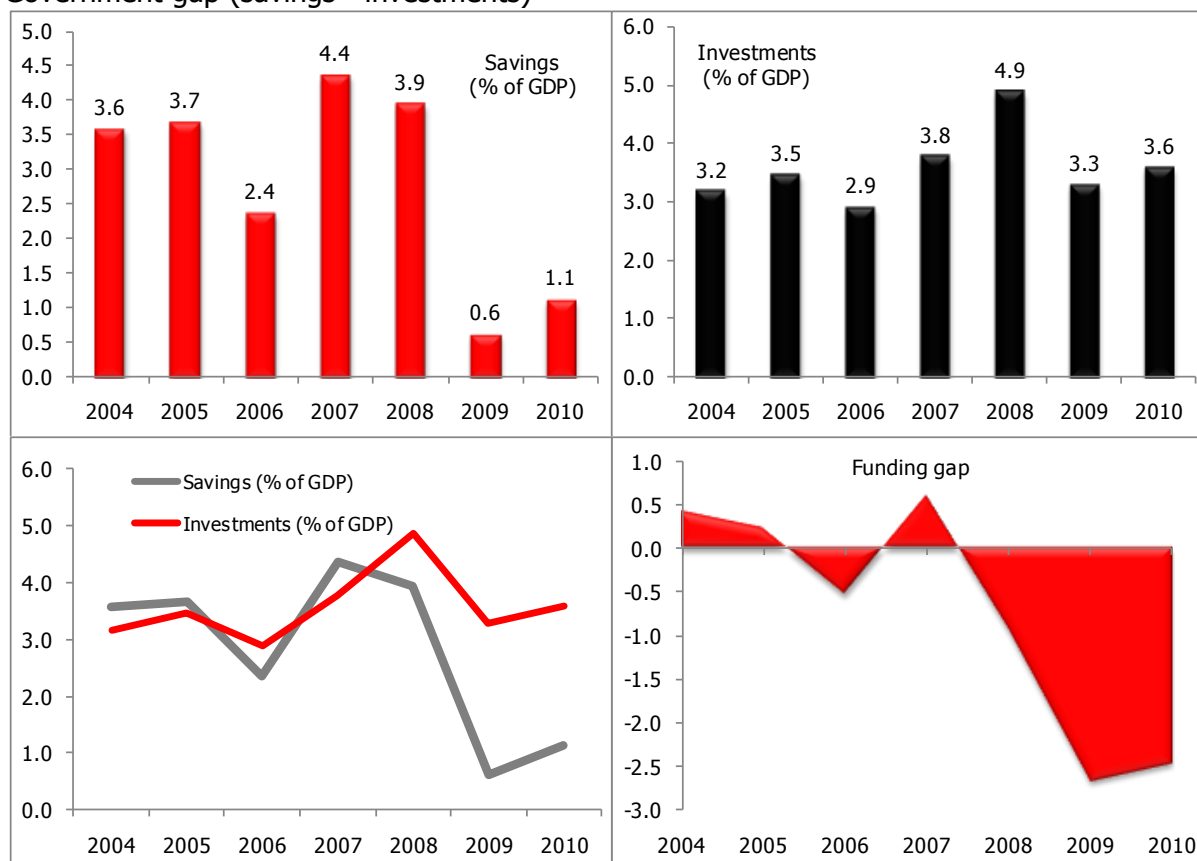
⁵⁴Current budget balance is the difference between current revenues (from taxes and contributions and nontax revenues) and current budget expenses (for wages and compensations, for goods and services, transfers and interests).

⁵⁵ Savings is a residue when public consumption (current expenditures minus transfers minus interest repayments) is deduced from the available income.

⁵⁶ Total government income is the difference between total budget revenues and transfers and interest repayments.

the government investments went up⁵⁷, but in a slower pace compared to the savings growth. Expectedly, government investments dropped compared to the 2007-2008 period, when the economy exceeded its capacities. Note, however, that even in slow economic recovery, the government investments of 3.6% of GDP in 2010 are at the average level of the past decade. Such changes in the government savings and investments in 2010 narrowed the gap, i.e. reduced the budget deficit by 0.2 percentage points on annual basis.

Figure 75
Government gap (savings - investments)



Taking into account the change in trends of the domestic economy, the public finances management in 2010 could be divided into two sub periods. The first quarter of the year, in conditions of unfavorable economic tendencies, the Government of the Republic of Macedonia adopted so-called anti-crisis measures. Also, in this period, revenues generated were lower than planned. Significant deviations from the 2010 Budget were registered in the profit tax revenues, excises and contributions from the Pension and Disability Insurance Fund. Such deviations on the revenue side created a need of proportionate downward correction on the expense side, aimed to preserve the target level of budget deficit of 2.5% of GDP. **Thus, in July 2010⁵⁸, the budget was revised,** reducing the total revenues and expenses by 3.3% and 3%, respectively, compared to the previously projected. However, in spite of the improved revenue generation in the second quarter of the year, the negative performances in the first three months resulted in annual fall of total revenues of 2% **in the first half of the year.** Most of the fall was triggered by lower generation of nontax revenues (due to the base effect of the previous year when

⁵⁷ Government investment data for this purpose refer to capital budget expenses. They integrate the government spending for procurement of fixed assets and capital transfers.

⁵⁸ "Official Gazette of the Republic of Macedonia no. 95/2010" Decree for promulgation of the amendments to the Budget of the Republic of Macedonia for 2010.

dividend was paid in the first half of the year, and due to the lower profit inflows of public financial institutions) and to a smaller extent, to the decrease in profit tax revenues and contributions from the Pension and Disability Insurance Fund. In such situation, notwithstanding the reduction of public consumption in terms of procurement of goods and services (by 16.2% on annual basis), the semiannual deficit equaled 1.4% of GDP. **In the second half of the year**, the total revenues went up by 7.5% annually, which apart from the effect of the dividend payment in the third quarter of the year, is also due to the effect of the discretionary measure related to the purchase of yard land⁵⁹ and the higher tax revenues and contributions. If we ignore the effect of dividend payment, the discretionary measure and the recovery of tax revenues and contributions would account for roughly one half of the annual growth of total revenues in the second half of the year. The total budget revenues in the second half of the year exceeded the level in the first half by 13.7% (given the positive developments in the domestic commodity and service taxes, profit tax and contributions), while expenses went up by 10.1%, primarily due to higher capital spending for fixed assets. In the second half of the year, the total revenues and expenses generally followed the projections, with some revenue positions exceeding significantly⁶⁰.

Analyzing the entire 2010, in conditions of moderate economic growth, total budget revenues for 2010 registered moderate increase of 2.8%, reaching Denar 132,150 million. The share of total revenues in GDP went down by 0.6 percentage points, and reduced to 30.8% of GDP, being the lowest budget encumbrance of GDP since the independence. The annual revenue growth was mostly (roughly 78%) due to the improved performances of source revenues, and to some extent, to the growth of revenues from foreign donations and collected loans. Observing source revenues, current revenues went up (by 2.2%) annually, whereas capital revenues decreased (by 0.7%) on annual basis. The greatest contribution to the current revenue growth was made by the increase in tax revenues and contributions, with the nontax revenues swinging around the 2009 level.

⁵⁹ "Official Gazette of the Republic of Macedonia no. 115/2009, "Decree on amending the Decree on the fee for privatization of construction land subject to privatization, the method and procedure for payment of the construction land privatization fee". This Decree reduced the fee for privatization of individual and collective housing, public institution buildings, sports and recreation facilities and infrastructural facilities to Denar 61 for 1m². "Official Gazette of the Republic of Macedonia no. 46/2010, "Decree on amending the Decree on the fee for privatization of construction land subject to privatization, the method and procedure for payment of the construction land privatization fee". The amendment to the Decree, in April 2010, reduced the fee for privatization of construction land of commercial and business buildings, and of economic and output facilities.

⁶⁰ Significant exceeding was registered in other property revenues, collected loan revenues, tax revenues on own accounts and profit tax revenues.

Table 15
Consolidated budget (central government and funds)

	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	percentage of realization of the revised budget
	in millions of denars		% of GDP		annual changes in p.p. of GDP		annual changes (in %)		contribution to annual changes (in p.p.)		
TOTAL REVENUES	128,498	132,150	31.4	31.2	-1.7	-0.2	-5.8	2.8	-5.8	2.8	95.3
regular revenues	127,428	130,169	31.1	30.7	-1.6	-0.4	-5.5	2.2	-5.5	2.1	96.2
Current revenues	126,261	129,010	30.9	30.4	-1.6	-0.4	-5.4	2.2	-5.3	2.1	97.3
Taxes and Contributions	109,860	112,440	26.9	26.5	-1.1	-0.3	-4.6	2.3	-3.8	2.0	98.6
Tax Revenues (SRA)	269	815	0.1	0.2	0.0	0.1	-8.8	3 times	0.0	0.4	over 2.3 times
Taxes	70,754	72,938	17.3	17.2	-1.3	-0.1	-7.6	3.1	-4.3	1.7	99.1
Income tax revenues	13,144	12,562	3.2	3.0	-1.0	-0.2	-23.9	-4.4	-3.0	-0.5	101.3
Personal Income Tax	8,710	8,872	2.1	2.1	0.0	0.0	0.2	1.9	0.0	0.1	95.0
Profit Tax	4,434	3,690	1.1	0.9	-1.0	-0.2	-48.3	-16.8	-3.0	-0.6	120.2
Income from domestic taxes on goods and services	49,706	52,619	12.2	12.4	12.2	0.3	-1.5	5.9	-0.5	2.3	100.2
VAT	35,173	37,694	8.6	8.9	-0.2	0.3	-2.8	7.2	-0.7	2.0	100.0
Excises	14,533	14,925	3.6	3.5	0.1	0.0	1.8	2.7	0.2	0.3	100.8
Import Duties	5,229	4,712	1.3	1.1	-0.2	-0.2	-16.7	-9.9	-0.8	-0.4	82.5
Other Taxes	2,675	3,045	0.7	0.7	0.0	0.1	4.5	13.8	0.1	0.3	101.5
Contributions	38,837	38,687	9.5	9.1	0.2	-0.4	1.5	-0.4	0.4	-0.1	96.5
Pension and Disability Insurance Fund	26,281	26,137	6.4	6.2	0.2	-0.3	2.7	-0.5	0.5	-0.1	97.5
Employment Bureau	1,848	1,651	0.5	0.4	0.0	-0.1	3.2	-10.7	0.0	-0.2	99.2
Health Fund	10,708	10,899	2.6	2.6	0.0	0.0	-1.5	1.8	-0.1	0.1	93.8
Non Tax Revenues	16,402	16,570	4.0	3.9	-0.5	-0.1	-10.9	1.0	-1.5	0.1	89.7
Non Tax Revenues (SRA)	6,859	6,436	1.7	1.5	-0.1	-0.2	-4.2	-6.2	-0.2	-0.3	78.4
Other Income From Private Sector	3,807	4,479	0.9	1.1	-0.4	0.1	-31.4	17.7	-1.3	0.5	133.1
From Individual Agricultural Producers	1,161	408	0.3	0.1	0.0	-0.2	-9.9	-64.9	-0.1	-0.6	100.0
Unemployment Contributions	132	0	0.0	0.0	0.0	0.0	-49.2		-0.1	-0.1	
On Salaries	3	1,494	0.0	0.4	0.0	0.4	-70.0	498 times	0.0	1.2	over 6 times
On Self Employed	111	64	0.0	0.0	0.0	0.0	-39.0	-42.3	-0.1	0.0	30.5
On Salaries Abroad	2,400	2,513	0.6	0.6	-0.3	0.0	-36.9	4.7	-1.0	0.1	100.7
Health Insurance Contributions	1,897	1,775	0.5	0.4	0.0	0.0	2.1	-6.4	0.0	-0.1	82.6
Non Tax Revenues	312	315	0.1	0.1	0.0	0.0	-20.0	1.0	-0.1	0.0	67.7
Non Tax Revenues (SRA)	514	543	0.1	0.1	0.0	0.0	-8.4	5.6	0.0	0.0	77.6
Other non-tax revenues	1,265	884	0.3	0.2	0.1	-0.1	34.3	-30.1	0.2	-0.3	90.3
Compensations for the Road Fund	1,747	1,827	0.4	0.4	0.0	0.0	-10.1	4.6	-0.1	0.1	103.4
Capital Revenues	1,167	1,159	0.3	0.3	-0.1	0.0	-16.0	-0.7	-0.2	0.0	40.9
Foreign Donations	833	1,459	0.2	0.3	-0.1	0.1	-37.2	75.2	-0.4	0.5	47.4
Revenues from repayment of loans	237	525	0.1	0.1	0.0	0.1	24.1	2.2 times	0.0	0.2	over 3.3 times
TOTAL EXPENDITURES	139,393	142,692	34.1	33.7	0.0	-0.4	-0.6	2.4	-0.6	2.4	95.7
Current Expenditures	125,965	127,358	30.8	30.0	1.6	-0.7	4.8	1.1	4.1	1.0	96.9
Wages and Allowances	22,699	22,638	5.5	5.3	0.5	-0.2	9.0	-0.3	1.3	0.0	98.3
Goods and Services	16,220	14,681	4.0	3.5	-0.6	-0.5	-13.5	-9.5	-1.8	-1.1	91.3
Transfers	84,601	86,865	20.7	20.5	1.7	-0.2	8.5	2.7	4.7	1.6	97.4
Transfers (SRA)	1,505	1,185	0.4	0.3	0.1	-0.1	17.3	-21.3	0.2	-0.2	59.7
Social Transfers	61,742	63,786	15.1	15.0	1.0	0.0	6.3	3.3	2.6	1.5	99.0
Pension and Disability Insurance Fund	36,455	37,614	8.9	8.9	0.8	0.0	9.3	3.2	2.2	0.8	100.3
Employment Agency	2,271	2,194	0.6	0.5	0.2	0.0	39.6	-3.4	0.5	-0.1	97.1
Social assistance	4,305	4,674	1.1	1.1	0.1	0.1	7.9	8.6	0.2	0.3	97.8
Health care	18,711	19,304	4.6	4.6	-0.1	0.0	-2.1	3.2	-0.3	0.4	97.0
Other transfers	21,296	21,843	5.2	5.2	0.7	-0.1	15.2	2.6	2.0	0.4	96.0
Refugees	58	51	0.0	0.0	0.0	0.0	-13.4	-12.1	0.0	0.0	
Interest payments	2,445	3,174	0.6	0.7	0.0	0.2	-7.6	29.8	-0.1	0.5	99.8
Interest on domestic debt	1,011	1,019	0.2	0.2	0.0	0.0	7.2	0.8	0.0	0.0	100.6
Interest on external debt	1,434	2,155	0.4	0.5	-0.1	0.2	-15.7	50.3	-0.2	0.5	99.4
Capital Expenditures	13,428	15,334	3.3	3.6	-1.6	0.3	-33.1	14.2	-4.7	1.4	86.7
Investments in fixed assets	9,453	11,127	2.3	2.6	-1.0	0.3	-29.8	17.7	-2.9	1.2	83.0
Capital transfers	3,975	4,208	1.0	1.0	-0.6	0.0	-39.7	5.9	-1.9	0.2	98.0
BUDGET BALANCE	-10,895	-10,542	-2.7	-2.5	-1.7	0.2					99.9

Source: Ministry of Finance of the Republic of Macedonia and NBRM calculations.

Tax revenues registered an annual growth of 3.1%, most of which due to favorable performances of commodity and service taxes. The VAT revenues went up by 7.2% on annual basis, given the VAT revenue growth from import of goods and stagnation of VAT revenues from domestic trade. The total imports in 2010 increased by 13.9% on annual basis, while the imports related to household consumption went up by about 12%. Half of the growth of this segment is due to the higher import of passenger cars (by 50.2% on annual basis), being an effect of the discretionary measure aimed to reduce

the customs duty on import of used passenger cars⁶¹. While this measure had a positive effect, the law amendments to passenger car excises⁶² had adverse effect on revenues, i.e. the revenues on this basis registered annual decrease of 19.5%. On the other hand, oil excise revenues went up by 5.9% (given the 27% annual increase of the import of oil and oil derivatives), which is the main reason behind the 2.5% growth of total **excises**. Besides the positive performances of the largest revenue categories (VAT and excises jointly making up 12.3% of GDP) for second consecutive year, the crisis has adverse effects on income taxation. This refers to **profit tax** revenues, which went down annually by 16.8% in 2010 (given the lower corporate profits in 2009). **Personal income tax** revenues increased by insignificant 1.9% on annual basis. The crisis caused the income taxation of 2.9% of GDP to be the lowest ever (in the last decade, the historical average was 4.1% of GDP). Along with such structural change, the revenues from **import duties** have been decreasing their relative share in GDP over a longer time period, reducing it to 1.1% of GDP in 2010 (3.3% of GDP in 2000). Thus notwithstanding the import growth, revenues from import duties went down (by 9.9% on annual basis) due to the process of gradual reduction of customs tariffs (under the Agreement with the World Trade Organization – WTO and the Stabilization and Association Agreement with the EU⁶³), and to the further decrease and abolishment of some customs tariffs by the Government⁶⁴. In 2010, even though the labor market trends stabilized, the 2009 reform of the social contribution system that further reduced the contribution rates⁶⁵ in 2010 resulted in lower tax encumbrance on the gross wage. Thus, in 2010, the total **contributions** went down by 0.4% compared to 2009, and their share in GDP reduced to 9% (1 percentage point below the historical average for the last decade).

⁶¹ "Official Gazette of the Republic of Macedonia no. 35/2010, "Law on amending the Law on Customs Tariff". The amendments to this Law allows for reduction of customs duties on import of used passenger vehicles from 10% to 5%, i.e. the customs duty on new and used passenger cars becomes equal."

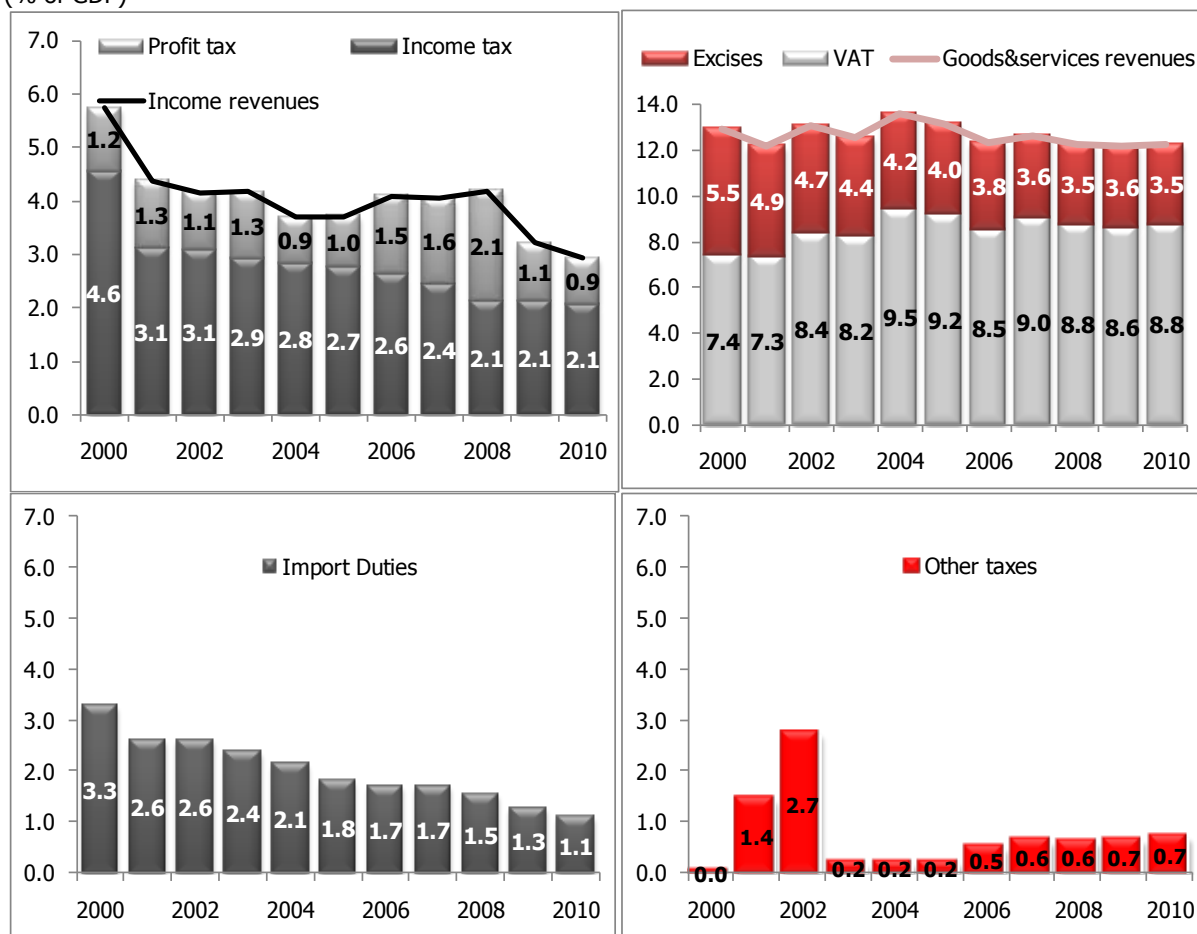
⁶² "Official Gazette of the Republic of Macedonia no. 34/2010, "Law on amendments to the Excise Law". The law amendments reduce and change progressively the passenger car excise rates. The amendments specify the basis for calculating the passenger car excise that includes: 1) selling price less VAT and 2) customs value at imports plus the customs duty, instead of the engine capacity, as specified previously.

⁶³ "Official Gazette of the Republic of Macedonia no. 155/2009, "Decision on harmonization and modification of Customs Tariff for 2010". The average non-weighted rate equaled 8.77% in 2010, and 8.99% in 2009.

⁶⁴ „ Official Gazette of the Republic of Macedonia no. 35/2010, "Law on amendments to the Law on Customs Tariff". This measure reduced or abolished customs tariffs of 20 groups of products, 19 of which referring to reduction of customs tariffs of passenger motor vehicles from 10% to 5%, and full relief of one tariff number from the group of ceramic products for laboratory purposes.

⁶⁵ "Official Gazette of the Republic of Macedonia no. 156/2009, Law on amendments to the Law on Mandatory Social Insurance Contributions", Article 31. The pension insurance contribution was reduced from 19% in 2009 to 18% in 2010; the health insurance contribution was reduced from 7.5% to 7.3%, and the employment contribution was reduced from 1.4% to 1.2%. Additional contribution for professional health insurance of 0.5% became mandatory, i.e. in 2009 it was included in the group of mandatory social contributions. This means that the gross wage encumbrance with contributions of 28.4% in 2009 was reduced to 27% in 2010.

Figure 76
Tax revenues
(% of GDP)

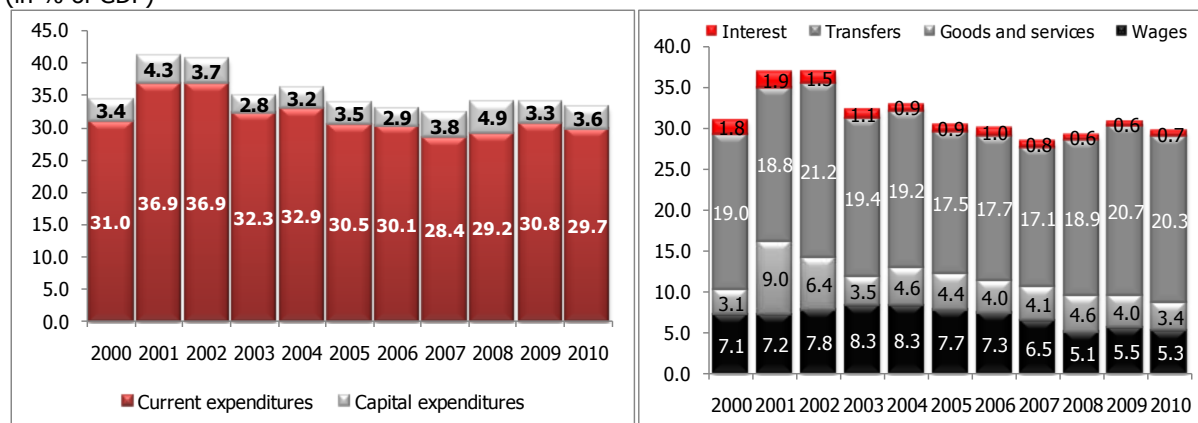


In 2010, **nontax revenues** increased slightly by 1% on annual basis. However, structurally observed, significant developments were registered aimed to increase the property revenues and decrease the profit revenues of public financial institutions, administrative fees and other nontax revenues. The measure that allowed for reduction of the fee for purchase of yard land had positive effect on the property revenues. Accordingly, the general conclusion is that the cumulative effect of discretionary fiscal policy measures on the revenue side was positive, contributing to total revenue growth in 2010. To the year-end, 95.3% revenues were generated compared to the projections, with the July budget revision, given the significant underperformance of nontax revenues (particularly revenues on own accounts and administrative fees), followed by capital revenues, foreign donations, contributions and import duty revenues. In spite of such underperformances, other property revenues, profit tax revenues, tax revenues on own accounts and revenues from collected loans over-performed.

In 2010 compared to 2009, total budget expenses increased by 2.4%, and amounted to Denar 142,692 million. However, the relative share of expenses in GDP went down by 0.8 percentage points, and reduced to 33.3%, being the lowest share since the independence (after 2007 and 2006). Observing the expense structure, the relative shares registered positive developments, aimed to decrease the current spending (by 1.1 percentage point) and to increase the capital spending (by 0.3 percentage points). Most of the total expense growth (around 60%) was due to the higher government **capital**

expenses (by 14.2% annually), concentrated in the second half of the year, and was by 13% lower than projected with the budget revision.

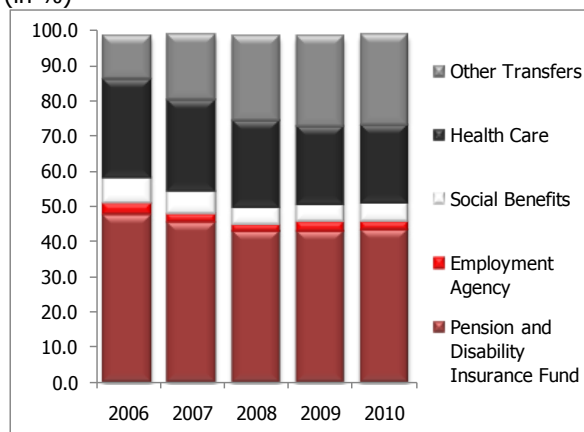
Figure 77
Expense structure
(in % of GDP)



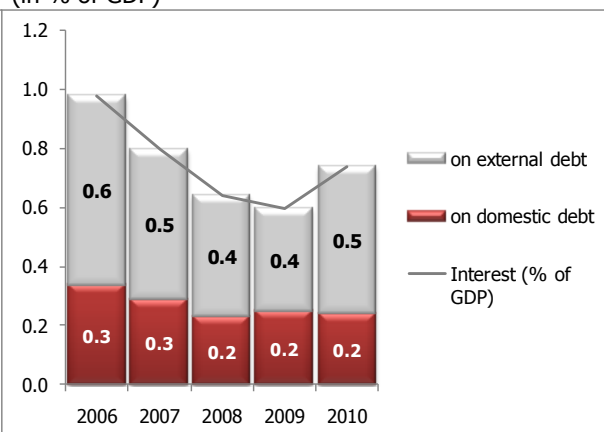
Source: Ministry of Finance of the Republic of Macedonia and NBRM calculations.

Unlike the growth of capital expenses, in conditions of still fragile tax base, the government increased moderately the **current spending** (by 1.1%). The increase of **transfers** (of 2.7% on annual basis) made the most significant contribution to the growth of current expenses, mostly due to the higher social transfers, and to a lower extent, to the growth of other transfers (transfers to local authorities, subsidies, etc.). Analyzing the social transfers, higher outlays were incurred by the Pension and Disability Insurance Fund (given the regular pension adjustment and marginal growth of age pension beneficiaries), the health and social welfare fund, whereas the transfers made through the employment agency registered annual decrease. Other transfers registered annual growth of 2.6%, given the further support of farmers by payment of subsidies and higher transfers to local authorities in the form of block donations, due to the higher number of municipalities that entered the second stage of decentralization (from 68 to 74 municipalities). The higher external debt **interest payments** made marginal, but important contribution to the growth of current expenses (by 50.3%, due to the payment of interest on the second Eurobond). While transfers and interest expenditures increased, the **expenditures for goods and services** went down on annual basis (by 9.5%), and **wage expenditures** remained at the 2009 level (minor fall of 0.3% on annual basis). To the year end, the total incurred current expenditures reached 96.9%, with the transfers on own accounts, commodity and service expenditures and other transfers registering significant underperformance.

Figure 78
Structure of transfers
(in %)



Structure of interest payments
(in % of GDP)



Source: Ministry of Finance of the Republic of Macedonia.

In 2010, most of the budget deficit (Euro 171 million) was financed through external loans, Treasury bill auctions and government deposit withdrawal from the account at the NBRM. In 2010, the government used the funds from the IMF quota for the Republic of Macedonia (in the amount of Euro 65.6 million) disbursed in 2009, and borrowed by the means of loans in the amount of roughly Euro 51 million. Should the external debt repayments be taken into account, the net external government debt amounts to Euro 75 million (excluding the quota funds, the effect is merely Euro 9 million). Moreover, during the year (except for the last quarter), the government used the funds deposited on account with NBRM (around Euro 65 million disbursement, mostly provided through the second issue of Eurobonds). Additional funds were mobilized through the domestic primary government securities market, with the net effect of the domestic debt reaching Euro 31 million.

Table 16
Budget deficit funding

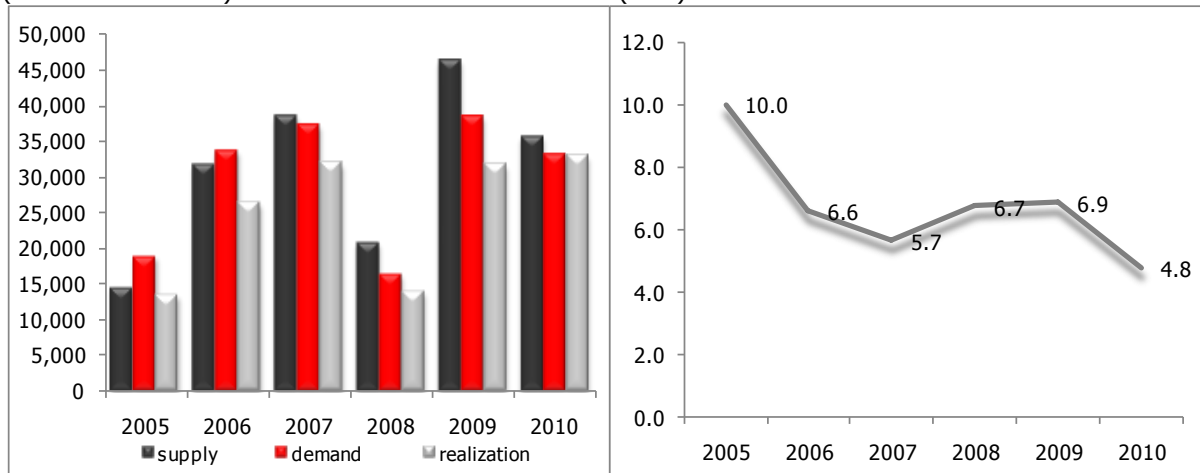
	in millions of denars				% of GDP			
	2007	2008	2009	2010	2007	2008	2009	2010
Financing	-35	62	178	171	-0.6	0.9	2.7	2.5
Inflow	315	176	309	293	5.3	2.6	4.6	4.2
Privatization revenues	11	27	0	0	0.2	0.4	0.0	0.0
Foreign loans	60	44	213	117	1.0	0.6	3.2	1.7
Deposits	252	54	-4	65	4.2	0.8	-0.1	0.9
Treasury bills	-8	50	100	110	-0.1	0.7	1.5	1.6
Sale of shares	1	2	1	1	0.0	0.0	0.0	0.0
Outflow	351	114	131	122	5.9	1.7	2.0	1.7
Principal repayment	351	114	131	122	5.9	1.7	2.0	1.7
External debt	232	31	38	42	3.9	0.5	0.6	0.6
Domestic debt	119	83	93	80	2.0	1.2	1.4	1.1
Domestic financing, net	-126	-34	7	31	-2.1	-0.5	0.1	0.4
Foreign financing, net	-172	13	174	75	-2.9	0.2	2.6	1.1
Government deposits	252	54	-4	65	4.2	0.8	-0.1	0.9
Inflows from privatization and sale of government shares	12	29	1	1	0.2	0.4	0.0	0.0

Source: Ministry of Finance of the Republic of Macedonia.

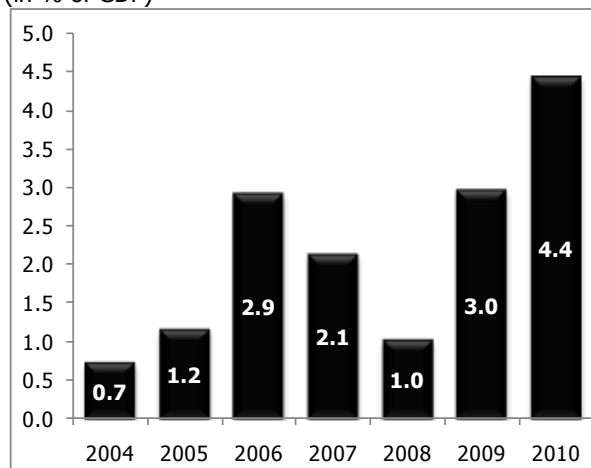
The needs for higher Budget funding for second consecutive year, resulted in expanded activity on the primary government securities market. The total

performance on this market segment equaled 7.7% of GDP in 2010, (7.8% of GDP in 2009), fully based on short-term government borrowing, i.e. mobilization of funds by issuing short-term securities. No new continuous government bonds were issued during this year. The effectuation of treasury bills increased by 3.9% on annual basis, with the decrease of total supply being faster than the decrease of total demand (by 23.1% and 13.9%, respectively). The average weighted interest rate on all short-term government securities (with various maturities) went down by 2.1 percentage points compared to 2009, and reduced to 4.8%. Also, in environment of further economic uncertainty, government securities market investors showed propensity to invest in treasury bills with FX clause. During the year, most of the funds (roughly 80%) were mobilized through 6-month treasury bills with FX clause, and the remainder was secured equally through 3- and 6-month treasury bills in Denars. Additionally, higher percentage of treasury bills with FX clause was effectuated (93% of the bid) with the effectuation of Denar treasury bills being lower (90% of the bid). In line with such developments, and also taking into account the repayments of due government securities, the treasury bill stock went up by Denar 6,917 million on annual basis (roughly Euro 112 million). Banks remained the top investors on this market segment, increasing their share by (6.5 percentage points) in the total government securities. In addition, Deposit Insurance Fund also increased its investments (by 6.8 percentage points), with the corporate investments in treasury bills decreasing on annual basis (by 11.9%).

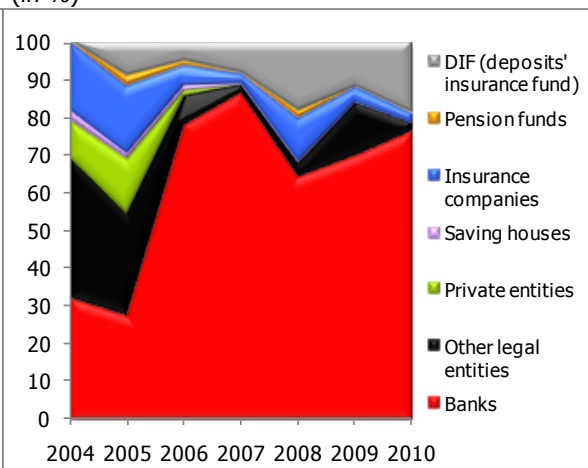
Figure 79
 Primary securities market
 Short-term government securities
 (in millions of denars)



Government securities
(in % of GDP)



Shares for investors
(in %)

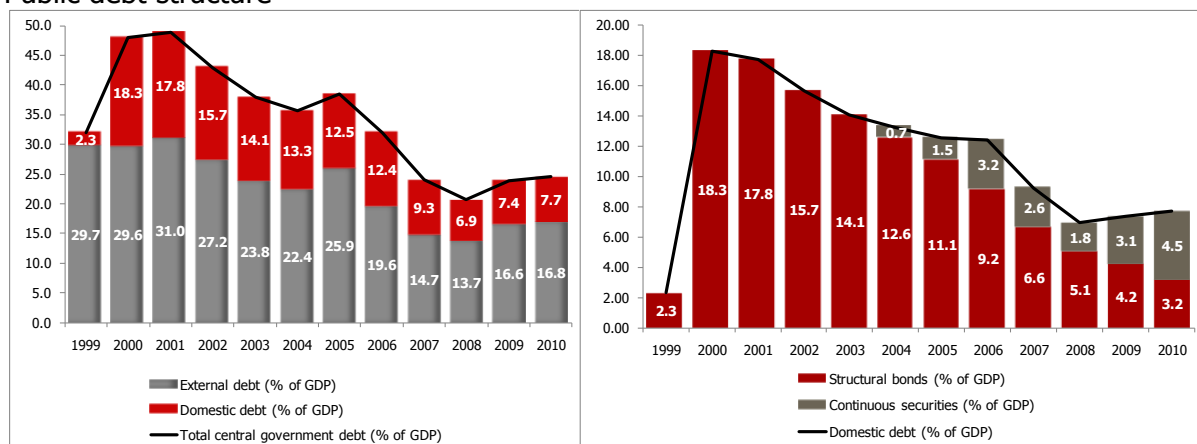


Source: NBRM and Ministry of Finance of the Republic of Macedonia.

Analyzing the external and domestic debt developments, the central government debt⁶⁶ increased by 7.1% in 2010 compared to 2009, and scaled to Euro 1,711 million. Thus, the share of central government debt in GDP equaled 24.5%, of GDP, compared to 23.9% of GDP in 2009.

Most of the annual increase of public debt (roughly 60%) was due to the growth of external debt (by 6.2% on annual basis), and to a lower extent, to the growth of the domestic debt (by 9.2% on annual basis). However, its structure registered an increase in the share of domestic debt (by 0.6 percentage points). Observing the domestic debt, the debt stock based on issued continuous securities went up by 48.5%, and the debt based on structural bonds went down by 20% on annual basis. In 2010, the liabilities on issued bonds for old foreign currency savings (in the amount of Euro 50.9 million) and for the bond for rehabilitation of Stopanska Banka (in the amount of Euro 8.9 million) were repaid, with the denationalization bonds being additionally issued (in the amount of euro 3.3 million). Such developments decreased the share of debt created on the basis of structural bonds (by 15 percentage points on annual basis) in the total domestic debt.

Figure 80
Public debt structure



Source: Ministry of Finance of the Republic of Macedonia.

⁶⁶ Consolidated debt of the central government and funds.

Annex 6: Analysis of cyclical behavior of the fiscal policy in 2010⁶⁷

The determination of the cyclical character of fiscal policy, i.e. whether it is pro/contra-cyclical, requires a distinction to be made between the fiscal policy discretionary component and automatic stabilizers. The total budget balance integrates both elements, i.e. the effect of discretionary measures and of the stage of economy. Therefore, it could be divided into two parts: a) cyclically-adjusted budget balance (structural balance) and b) cyclical part, that automatically respond to the economic cycle (automatic stabilizers). As theoretical concept, cyclically-adjusted budget balance or structural balance is the one that would be effectuated when GDP is at the level of its potential, i.e. excludes the effect of the stage of economy (or the influence of automatic stabilizer). The so-called "aggregated approach" is generally accepted for its estimation, also used by the International Monetary Fund (IMF), the Organization for Economic Cooperation and Development (OECD) and the European Commission (EC). According to this approach, the revenue elasticity is 1 i.e. assuming that the changes in revenues do not represent the discretionary measures, i.e. that they solely result from the effect of the stage of economy. Our calculation uses single elasticity of tax revenues and contributions, implying that if the stage of the cycle (e.g. economic recovery) has positive effect, it gets ignored in order to identify the pure effect of discretionary measures. On the expense side, the assumption is that their elasticity of the stage of cycle is 0, i.e. that the expense response refers only to discretionary measures, and does not result from automatic stabilizers. This is illustrated with the claim that most of the automatic stabilizers on the expense side include compensations for unemployed persons, that constitute only a small segment of the total expenses. The difference between structural budget balances (expressed as percentages of the potential GDP) in two consecutive years, gives the fiscal stimulus. The cyclical behavior of discretionary fiscal policy could be determined by estimating the structural balance –to- output gap ratio. Thus, a positive structural balance –to- output gap ratio implies counter-cyclical fiscal policy. Under such circumstances, the reduction of negative output gap (or opening of positive output gap) is accompanied by the increase of cyclically-adjusted positive budget balance (or by reduction of the negative one). On the other hand, a negative structural budget balance –to- output gap ratio implies pro-cyclical fiscal policy. In such conditions of reduced negative output gap (or enlarged positive output gap), the cyclically adjusted positive budget balance increases (and the negative one expands). In the case of the latter, the fiscal stimulus is positive in the stage of economic recovery, or in the stage of expansion.

The analysis of the change in cyclically-adjusted budget balance (expressed as a percentage of the potential GDP) and the stage of economic cycle indicates that the fiscal policy in the key developed economies in 2009 was counter-cyclical (sizeable fiscal stimuli during economic contraction), and in 2010, it was pro-cyclical (increase of the fiscal stimulus, in environment of ongoing economic recovery). The fiscal consolidation process slowed down in the United States and Japan, due to the adoption of new stimulating measures. The position of discretionary fiscal policy at the Euro area, on average, became neutral. In 2010, some Euro area countries reported significant fiscal stimulus (Germany), and some of them that experienced deterioration of their fiscal positions, reported faster implementation of the fiscal consolidation process (Spain).

Generally speaking, the average total deficit of advanced economies shrank compared to 2009 by roughly 1 percentage point, and reduced to around 8% of GDP (0.3

⁶⁷ Based on IMF, Fiscal Monitor Update, January 2011.

percentage points lower than projected). Deficits of Germany and the United States are lower compared to projections of November, reflecting the improved revenue performances and lower consumption. In Germany, such performances are perceived to result from favorable labor market developments, and in the United States, from certain legal postponements of the approval of costs and the lower support to the financial sector. The Euro area countries that were focused on enormous fiscal consolidation, generally managed to meet the projected budget deficit reduction. However, if we ignore the effect of the growth and support of the financial sector, the cyclically adjusted budget balance would enlarge. In the meantime, the gross general government debt of advanced economies kept on increasing dramatically, and reached 96.5% of GDP in 2010.

In 2010, the fiscal policy of emerging economies was counter-cyclical, on average. Same as the developed economies, the revenue collection exceeded the expectations, mainly due to the faster growth and higher commodity prices, and in some cases, to the voluminous one-time revenues (particularly the sale of oil subsidies in Brazil and the auction of telecommunication licenses in India). However, the higher revenues were generally used for funding the high budget spending, bringing some countries (especially Brazil, China and India) into fiscal disequilibrium higher than projected in November. On the other hand, some countries are expected to produce total and cyclically-adjusted deficits lower than previously projected due to the effect of the higher commodity prices (Russia and Saudi Arabia) and late implementation of capital projects (Turkey).

Table 17
Fiscal indicators

	Total budget balance (% of GDP)			Cyclically-adjusted budget balance of general government (in% of potential GDP)			Gross debt of general government (% of GDP)		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
Developed economies	-3.6	-8.8	-7.9	-3.3	-5.5	-5.9	79.2	91.4	96.5
USA	-6.5	-12.7	-10.6	-4.6	-6.7	-7.5	71.2	84.6	91.2
Euro-zone	-2.1	-6.4	-6.4	-2.8	-4.6	-4.7	69.6	78.9	84.3
France	-3.3	-7.6	-7.7	-3.2	-5.6	-6	67.5	78.1	84
Germany	0	-3	-3.5	-1	-1	-2.8	66.3	73.5	76.6
Italy	-2.7	-5.2	-5	-2.4	-3.3	-3.4	106.3	116	118.7
Spain	-4.1	-11.1	-9.3	-5.2	-9.7	-7.5	39.8	53.2	63.1
Japan	-4.1	-10.1	-9.4	-3.6	-6.8	-7.6	195	217.4	220.7
UK	-4.9	-10.3	-10.3	-5.6	-8.3	-8.1	52	68.3	77.2
Canada	0.1	-5.5	-5.9	0	-3.2	-4.3	71.3	82.5	83.9
Emerging economies	-0.7	-4.8	-4.1	-2.4	-4.6	-4.3	35.4	37.2	36.9
China	-0.4	-3.1	-3.1	-0.8	-3.4	-3.4	17	17.7	18.4
India	-7.9	-10.2	-9.8	-10	-10.9	-10.3	74	77.8	75.7
Russia	4.3	-6.2	-4.2	3	-3.4	-2.4	7.8	10.9	10.4
Brazil	-1.4	-3.1	-2.6	-2.1	-2	-2.8	70.7	67.9	65.7
Mexico	-1.4	-4.8	-3.5	-1	-2.7	-2.7	43	44.6	44.5
Saudi Arabia	-0.5	-5.3	-5.8	-2.1	-4.9	-5.1	27.3	31.5	35.9
Developed economies G-20	-4.2	-9.4	-8.3	-3.4	-5.5	-6.1	84.5	97.6	102.7
Emerging economy G-20	-0.4	-4.8	-3.9	-2.3	-4.5	-4.3	35.2	36.4	35.6

Source: IMF, Fiscal Monitor Update, January 2011.

In the Republic of Macedonia, the analysis of change in the cyclically-adjusted budget balance and the stage of domestic economy indicates counter-cyclical fiscal policy in 2009. In environment of significant narrowing of the positive output gap (or its closing, and more important, entering into the negative zone in the second half of the year), the structural balance expands, i.e. the fiscal impetus is positive. Such role of fiscal policy in 2009 in the stabilization of the economic cycle corresponds with the policies conducted worldwide. The negative effect of automatic stabilizers (particularly in early 2010), the

determination to strengthen the fiscal position and the hard terms of financing created no room for maintenance of counter-cyclical character, particularly early in the year. Nevertheless, taking into account the gradual narrowing of the negative output gap to the end of the year, the fiscal consolidation process initiated in 2010 could be regarded as timely.

Table 18
Structural fiscal indicators for the Republic of Macedonia

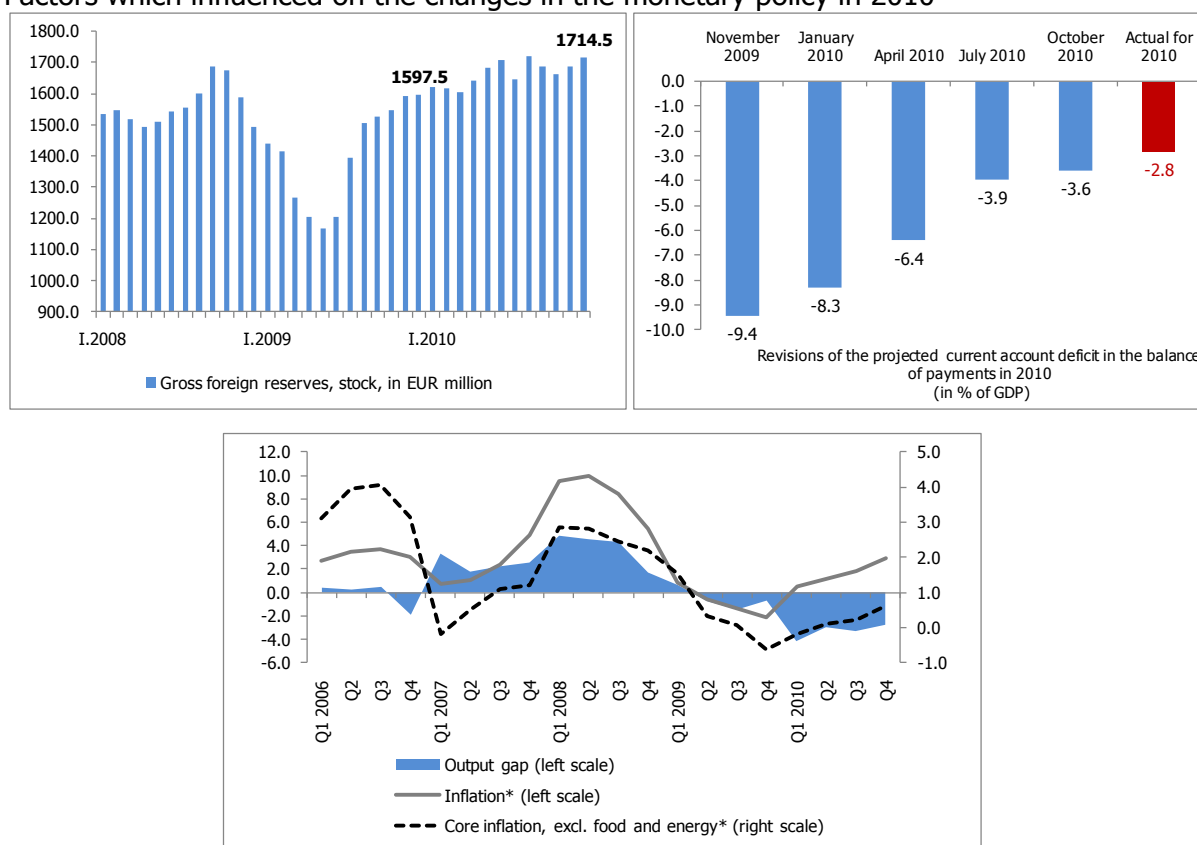
IMF (% of GDP)	2009	2010
Primary budget balance	-2.1	-1.8
Total budget balance	-2.7	-2.5
Cyclically adjusted primary budget balance	-2.5	-1.2
Cyclically adjusted total budget balance	-3.1	-2.0
Fiscal stimulus (in p.p. primary balance)	-0.2	-1.3
Fiscal stimulus (in p.p. total balance)	-0.3	-1.1
NBRM (% of GDP)		
Primary budget balance	-2.1	-1.7
Total budget balance	-2.7	-2.5
Cyclically adjusted primary budget balance	-2.4	-1.4
Cyclically adjusted total budget balance	-3.0	-2.2
Fiscal stimulus (in p.p. primary balance)	0.7	-0.9
Fiscal stimulus (in p.p. total balance)	0.7	-0.8
NBRM (% of potential GDP)		
Cyclically adjusted primary budget balance	-4.0	-2.4
Cyclically adjusted total budget balance	-5.0	-3.7
Fiscal stimulus (in p.p. primary balance)	1.2	-1.6
Fiscal stimulus (in p.p. total balance)	1.0	-1.3

Source: Staff Report for the 2010 Article IV Consultation and Request for an Arrangement under the Precautionary Credit Line and calculations of the NBRM Research Department.

III. Monetary policy

In 2010, the changes in the monetary policy were directed towards gradual relaxation of the monetary conditions. The interest rate on the CB bills fell in seven occasions for totally 4.5 percentage points, and in December it reduced to the historically lowest level of 4%. Such a character of the monetary policy was enabled by the continuous improvement in the trends and the rates for the external sector indicators and the low inflation. Namely, the improvement in the global conjuncture and the trading conditions contributed to a revitalization of the demand for the domestic export. In environment of smaller import growth, the deficit in the trade balance registered a downward trend. Namely, pursuant to the steady expectations of the domestic entities, the inflows from private transfers were continuously mounting. These movements resulted in further downward correction of the current account deficit, with the capital flows being sufficient for its coverage and additional accumulation of foreign reserves. **In such conditions, in 2010, NBRM has almost continuously been realizing a net purchase of foreign assets on the foreign exchange market, which contributed to rise in the foreign reserves during the year.**

Figure 81
Factors which influenced on the changes in the monetary policy in 2010



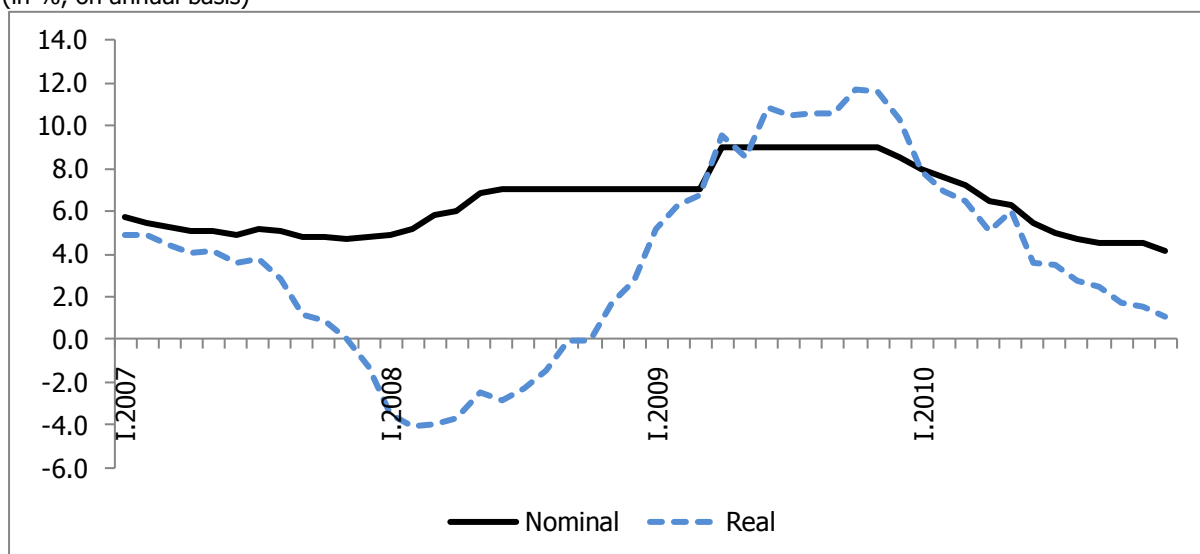
*Average annual inflation in the quarter.

Source: National Bank of the Republic of Macedonia and State Statistical Office.

Having fixed foreign exchange rate strategy in place, the upward path of the foreign reserves meant larger capacity of the monetary policy for buffering the possible unfavorable shocks in future. Together with the continuous improvement in the forecasts for the external sector during the year, it pointed to lower risks on the stability of the foreign exchange rate and possibility for

monetary conditions relaxation. The monetary policy relaxation was consistent also with the performances in the real sector of the economy, in accordance with the slow recovery of the domestic demand and maintenance of low and stable inflation. Thus in 2010, average annual inflation rate of 1.6% was registered, while the core inflation (without food and energy) equaled 0.2% on average, annually, confirming the estimates for the still poor domestic demand. Simultaneously, the behavior of the banks since the beginning of the year pointed to slow regaining of confidence and the still conservative risk assessment. In such conditions, when the economy pursued to function below the potentials, and the indicators of the banking sector showed partial use of the sources of funding for private sector crediting, the decrease in the key interest rate of NBRM was aimed at improvement of the optimism and intensification of the credit activity.

Figure 82
Interest rate on CB ills
(in %, on annual basis)



Source: National Bank of the Republic of Macedonia

The decrease in the key interest rate of NBRM was performed gradually during the year, in order to maintain the balance between the positive signals arising from the dynamics of the key macroeconomic parameters from one hand, and still present uncertainties and risks from another. Namely, despite the generally improved environment, 2010 was followed by high uncertainty about the sustainability and the intensity of the global recovery. The problems of several member states of EU with the government debt to the mid of the year emphasized the risk of possible new tremors on the global financial market. It creates additional risks to the global recovery, and thus about the recovery of the domestic economy and the volume of new capital inflows. In such conditions, there was a need of cautious monitoring of the developments and cautious adjustment of the monetary policy during the year. The intensity of the monetary relaxation was higher during the first half of the year when the key interest rate was reduced by totally 3.5 percentage points in five occasions. In the second half of the year, correction of 1 percentage point, in two occasions, was made. Beside the present uncertainty about the future developments on global plan related to the fiscal crisis of several EU member states, the larger restraint of NBRM in the second half of the year was conditioned also by the influence of two additional factors: a) emergence of signs for growth acceleration of the general price level in the domestic economy, under the influence of the increase in the world prices of the energy sources and food, with risks of possible upward pressure on the prices

also in the following period; b) narrowing of the interest rate spread between the interest rates on both the domestic and the European financial market.

Figure 83

Interest rate spread between CB bills - 28 days and the key interest rate of ECB (in percentage points)

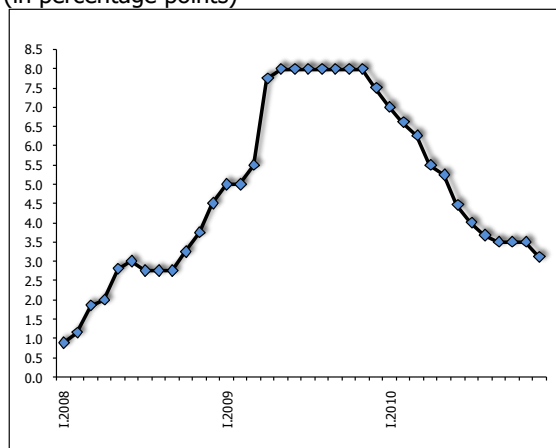
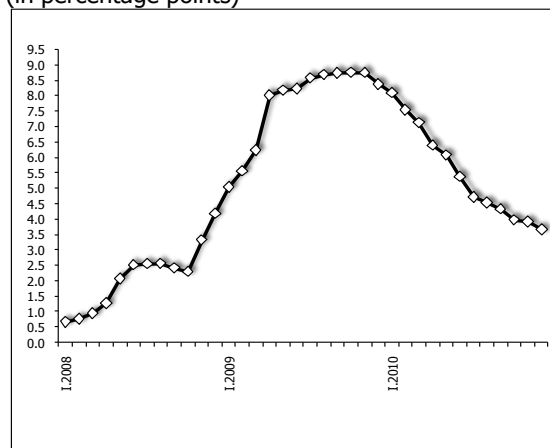


Figure 84

Interest rate spread between SKIBOR - one month and EURIBOR - one month (in percentage points)

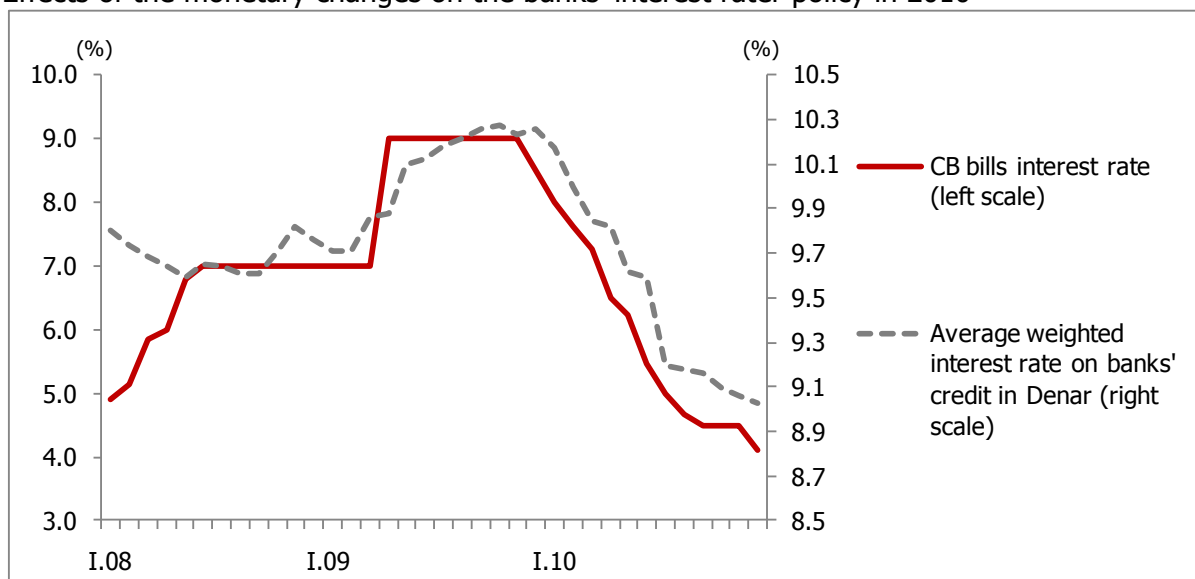


Source: National Bank of the Republic of Macedonia, European Central Bank (www.ecb.int) and Central Bank of the Netherlands (www.statistics.dnb.nl).

The fall in the reference interest rate of NBRM, in conditions when the ECB preserved the reference interest rate unchanged, contributed to significant narrowing of the interest rate spread between the key interest rates of NBRM and ECB. Thus, in accordance with the gradual relaxation of the domestic monetary policy, the interest rate spread between the key interest rates of NBRM and ECB during the year continually narrowed, and in December 2010 it reduced to 3.1 percentage point (opposite to 7.5 percentage points as it equaled in December 2009). On the domestic financial market, the one-month SKIBOR⁶⁸ followed the changes with the key interest rate of NBRM, registering continuous decrease during the year. On the European financial market, the one-month EURIBOR was relatively stable, with tendencies of slight increase in the second half of the year, mainly because of the uncertainty connected to the development of the debt crisis in several member-states of EU. In such conditions, the interest rate spread between the one-month SKIBOR and one-month EURIBOR of 8.3 percentage points as it equaled in December 2009, reduced to 3.7 percentage points in December 2010. Such a narrowing of the interest rate spread between the domestic and the foreign financial instruments generated risks for the monetary policy for potential destabilization of the foreign exchange market. Consequently, the limiting effects of the narrowing of the interest rate spread are inevitably taken into consideration when adopting monetary decisions, which was especially evident in the second half of the year, when EURIBOR commenced registering moderate upward trend. However, in 2010 no outflows of capital based on interest rate spread were registered, which can be explained with the still stimulating interest rate spread in favor of the domestic instruments and the stable expectations for the foreign exchange rate.

⁶⁸ Interbank interest rate for Denar deposits, calculated from the quotations of the reference banks.

Figure 85
Effects of the monetary changes on the banks' interest rater policy in 2010



Source: National Bank of the Republic of Macedonia

The monetary policy relaxation during the year caused certain changes in the behavior of the domestic banks, although with smaller intensity than expected. Thus the effects on the dynamics of the interest rates on the credits, which moved downwards during the year, were evident. Also, certain redirecting of the banks from the non-risk instruments market on behalf of intensified crediting of the private sector was registered, with exception to the last quarter of the year, when larger investments of the bank in Treasury bills were registered, while the CB bills acted towards larger liquidity of the banking system. In such conditions, in 2010 credit growth accelerated to 7.1% in December, opposite to 3.5% as this rate equaled in December 2009. However, despite the positive movements, the recovery of the credit market was slow and below the expectations. This can be explained with the influence of other factors, outside the monetary policy domain, such as the risks and the need of preserving the credit portfolio quality, which are getting larger in post crisis period when commercial banks adopt investment decisions.

Figure 86
Investments on the foreign exchange market by NBRM with banks
(cumulative amount in the quarter, in millions of euros)

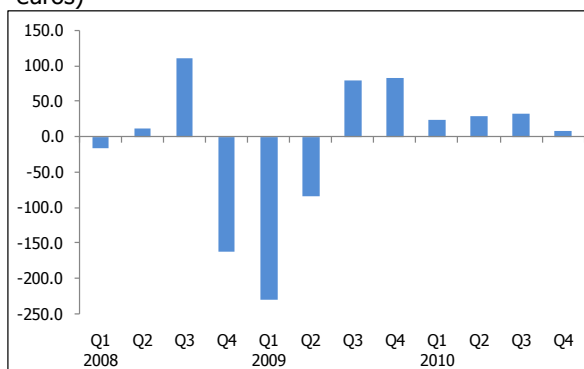
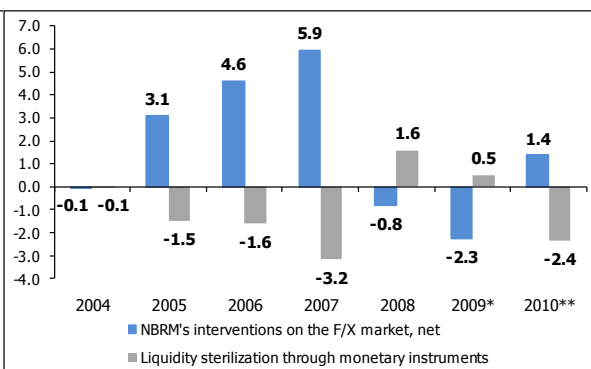


Figure 87
Foreign exchange transactions and sterilization through monetary instruments
(share in GDP, in %)



*Preliminary data on GDP.

**Estimated data on GDP.

Source: National Bank of the Republic of Macedonia and State Statistical Office.

In 2010, the liquidity of the banking sector was generally maintained on adequate level. The main flow of liquid assets creation in 2010 was the foreign currency transactions of NBRM with both the market makers and the Government, with net purchase of foreign exchange in the total amount of 1.4% of GDP with the transactions with the market makers being realized. Most of the liquidity created in such a manner was withdrawn through the CB bills, through which liquid assets in the total amount of 2.4% of GDP in 2010 were sterilized. The largest effect of the CB bills on the banks' liquidity reduction was registered in the first quarter (realized 71% of the total withdrawn liquidity during the year), and in the following two months, the effect with the liquidity withdrawal fell cumulatively, while in the last quarter, the change with the CB bills was directed towards liquid assets creation. The liquidity withdrawal, on cumulative basis, was made also through the Government Denar deposits with NBRM, with the currency in circulation also having moderate contribution in this direction.

Table 19

Changes on the bank accounts with NBRM under the influence of autonomous factors and monetary regulation instruments*
(in millions of denars)

	Quarterly changes				Total
	I	II	III	IV	2010
Banks' accounts with NBRM /1	-484	2,538	-2,496	1,856	1,415
Government deposits	-1,666	1,462	-1,530	-1,556	-3,291
Treasury account	-1,708	1,452	-1,559	-1,559	-3,375
Foreign aid and FFD	42	10	29	3	84
Currency in circulation	1,487	-468	-417	-1,294	-691
F/X market interventions	5,802	1,654	1,055	3,557	12,068
Banks	1,424	1,822	2,034	525	5,804
Other	4,378	-168	-979	3,032	6,264
CB bills	-7,105	-497	-3,155	702	-10,055
Compulsory deposit with NBRM	169	0	0	0	169
Lombard	0	0	0	0	0
Other items	829	387	1,551	447	3,214

*Positive change - reserves growth; negative change - reserves reduction.

¹ Without reserve requirement on foreign currency deposits.

Source: National Bank of the Republic of Macedonia

At the end of December 2010 relative to the end of the previous year, the reserve money⁶⁹ incremented by 6.2%, given simultaneous growth of both components. Thus the banks' Denar liquid assets augmented by 9.9%, annually, while the demand for cash (currency in circulation outside the deposit institutions and cash in vault of the deposit institutions) was higher by 3.5%⁷⁰. From the aspect of the balance sheet of NBRM, in December 2010 the net foreign currency assets incremented by Denar 7,363 million, while the net domestic assets fell by Denar 5,257 million.

⁶⁹ It refers to the reserve money without reserve requirement on the foreign currency deposits. If include this component, the annual growth of the reserve money in 2010 would equal 6.6%.

⁷⁰ If the average of the daily balances for the calculation of the demand for cash and liquid assets of the banks during the year are used, the increase would equal 5.1% and 29.4%, respectively. The high increase in the banks' liquid assets calculated according to the average of the daily balances is due to the intensive growth rates in the first half of 2010, in accordance with the lower comparison base in 2009. Namely, in May 2009 NBRM adopted a Decision on Reserve Requirement, which increased the reserve requirement allocation rate of the liabilities in domestic currency with FX clause. The Decision became effective in June 2009.

Table 20
NBRM survey
(in millions of denars)

	As of 31.12.2009	Quarterly changes				Вкупно	As of 31.12.2010
		I	II	III	IV		
Reserve money ¹	33,727	-1,971	3,006	-2,079	3,150	2,106	35,832
Currency in circulation	16,266	-1,422	818	283	1,013	692	16,958
Banks' accounts with NBRM	14,245	-484	2,538	-2,496	1,856	1,415	15,659
Banks' cash in vault	3,216	-65	-350	134	281	-1	3,215
Net foreign assets	93,246	968	6,129	-999	1,265	7,363	100,610
Foreign assets	97,807	1,128	6,311	-1,086	1,335	7,688	105,495
Foreign liabilities	4,561	161	182	-87	70	325	4,886
Net domestic assets	-59,519	-2,938	-3,123	-1,081	1,886	-5,257	-64,777
1. Banks, net credit	-16,829	-6,355	-459	-3,958	751	-10,021	-26,850
- credit	16	0	0	0	0	0	16
-monetary policy instruments ²	-16,845	-6,355	-459	-3,958	751	-10,021	-26,866
2. Net Government position with NBRM	-11,365	4,470	1,514	351	1,514	7,849	-3,516
-Claims to the Government	1,327	20	46	4,012	87	4,166	5,493
-Government deposits	-12,692	4,450	1,467	-3,660	1,426	3,683	-9,008
3. Other items, net	-31,325	-1,053	-4,178	2,525	-379	-3,085	-34,410

¹ Without reserve requirement on foreign currency deposits.

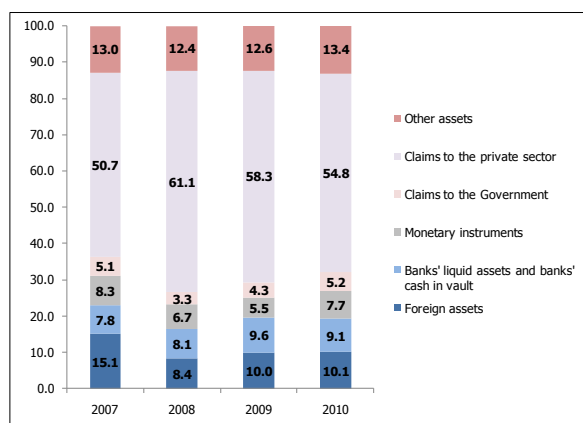
² It includes CB bills, compulsory deposits with NBRM and foreign currency deposits with NBRM. CB bills at discounted value.

Source: National Bank of the Republic of Macedonia

3.1. Monetary instruments

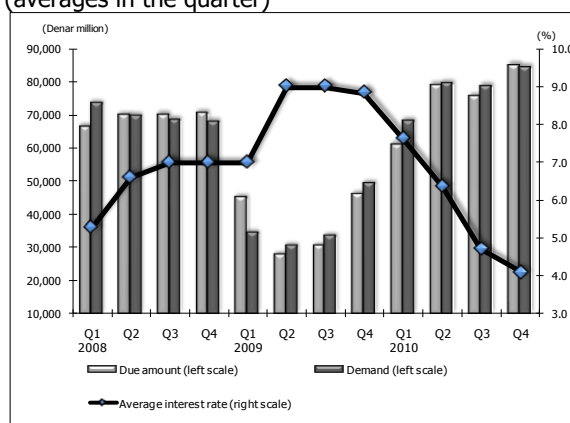
In 2010, the CB bills were the main instrument in the operational monetary policy framework of NBRM. The main function of the CB bills is liquidity management in the banking system and indirect prevention of potential pressures on the demand for foreign exchange on the foreign exchange market. Namely, through adequate harmonization between the supply of and the demand for liquid assets by the banks, possible redirecting of the excess Denar liquidity of the bank towards higher demand for foreign exchange and destabilization of the foreign exchange market is prevented. Consequently, the monetary instrument, CB bills of NBRM, plays significant role for maintaining the balance on the foreign exchange market, because of which the changes in its layout are critically conditioned by the degree of present and estimated risks on the foreign exchange rate stability.

Figure 88
Structure of the banks' total assets
(end of period, in %)



Source: National Bank of the Republic of Macedonia

Figure 89
Due amount, demand and interest rate on
CB bills of NBRM
(averages in the quarter)



In 2010, in line with the improvement of the macroeconomic environment, on both, the global and the domestic plan, the changes in the layout of the basic monetary instrument, the CB bills, were directed towards relaxation of the monetary conditions in the country. NBRM did not change the type of tender of the CB bills auction, i.e. it pursued with the volume tender and fixed interest rate auctions. The lower risks for the foreign exchange rate stability created a room for monetary policy relaxation, thus acting towards economy recovery support. In December 2010, the key interest rate of NBRM reduced to the level of 4%, which is the historically lowest level. Analyzed by the dynamics, in the first quarter, the banks showed relatively high interest for investment in CB bills. The demand for CB bills exceeded the due amount by 11.7%, with total Denar 7,105 million being withdrawn. In the second quarter, the withdrawn amount equaled only Denar 497 million, given the higher demand than the due amount by 0.6%. In the third quarter, when through foreign currency transactions of NBRM the highest net purchase of foreign exchange was realized, the demand for CB bills went up by 4.2% relative to the due amount, with the total of Denar 3,155 million being withdrawn. In the last quarter of the year, the change of the CB bills was toward liquid assets creation of total Denar 702 million, given smaller demand than the due amount by 0.8%. Thus annually, total Denar 10,055 million through CB bills were withdrawn, 71% of which were realized in the first quarter. In such conditions, the share of the monetary instruments in the banks' total assets increased annually by 2.2 p.p.

In 2010, the monetary instrument "reserve requirement" preserved the same characteristics of the previous year (after the last changes in May 2009). Thus the reserve requirement allocation rate for the banks' liabilities in domestic currency equals 10%, for the banks' liabilities in foreign currency it equals 13%, while in case of the banks liabilities in domestic currency with FX clause the reserve requirement allocation rate equals 20%. Regarding the reserve requirement in Denars, the average system of meeting⁷¹ the requirement is used, with the banks having a possibility for full utilization of the reserve requirement for meeting their liquidity needs on a daily basis. With the reserve requirement in foreign exchange, the system of fixed fulfillment is used, without a possibility for assets disposal on a daily basis. However, part (23%) of the reserve requirement in foreign exchange the banks allocate in Denars. In 2010, until the end of the calculation period, the banks, on average, allocated 2.3% over the reserve requirement (in Denars), opposite to 2.7%, which was the last year average. Parallel to the decrease in the interest rate on CB bills during the year, the interest rate on the disposable overnight credit was adjusted downwards by default during the entire year, and at the end of the year it reduced to 5.5% (from 9.5% at the beginning of the year). However, in conditions of constant maintenance of liquidity in the banking system on adequate level, in 2010 no disposable overnight credits in 2010 were used.

⁷¹ The period for maintaining (fulfilling) the banks' reserve requirement covers the period from the 11th in the current month to the 10th in the following month.

Chronology of changes in the NBRM instruments in 2010

Interest rate policy of NBRM

Type of change	Date of change	Direction and intensity of change	Interest rate after the change
Interest rate on CB bills and on overnight standing facility	04.01.2010	-0.5 p.p. respectively	Cb bills -8% overnight standing facility -9.5%
Interest rate on CB bills and on overnight standing facility	04.02.2010	-0.5 p.p. respectively	Cb bills -7.5% overnight standing facility -9%
Interest rate on CB bills and on overnight standing facility	25.03.2010	-1 p.p. respectively	Cb bills 67.5% overnight standing facility -8%
Interest rate on CB bills and on overnight standing facility	12.05.2010	-0.5 p.p. respectively	Cb bills -6% overnight standing facility -7.5%
Interest rate on CB bills and on overnight standing facility	15.06.2010	-1 p.p. respectively	Cb bills -5% overnight standing facility -6.5%
Interest rate on CB bills and on overnight standing facility	13.08.2010	-0.5 p.p. respectively	Cb bills -4.5% overnight standing facility -6%
Interest rate on CB bills and on overnight standing facility	06.12.2010	-0.5 p.p. respectively	Cb bills -4% overnight standing facility -5.5%

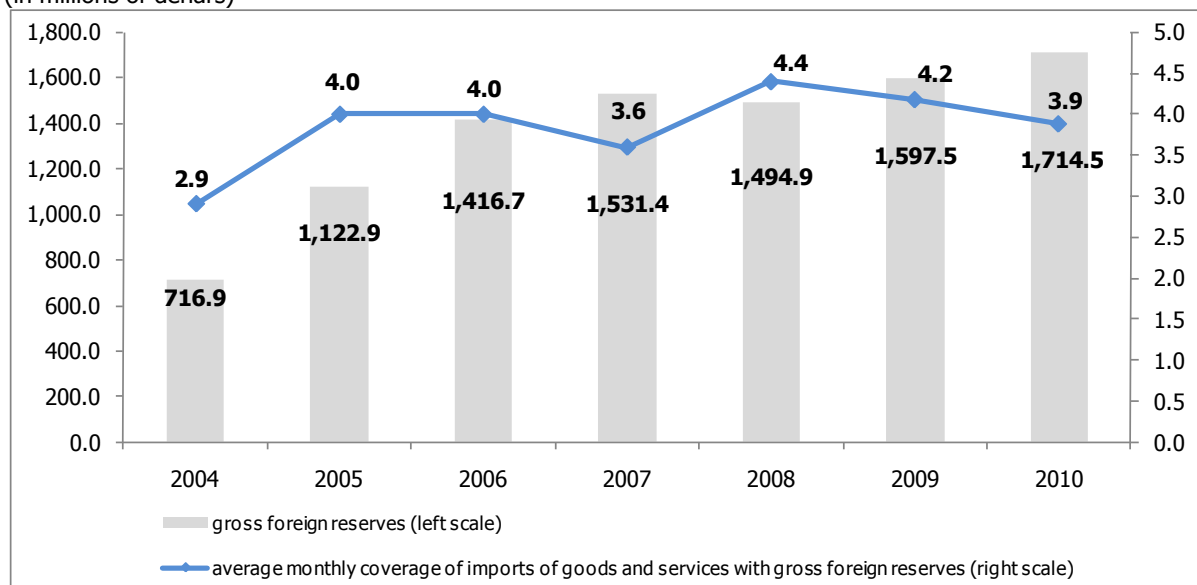
*The interest rate on the available overnight credit is changed by default, by applying interest rate on CB bills.

3.2. Foreign reserves and foreign exchange rate

In 2010, the gross foreign reserves in the Republic of Macedonia were mounting almost continuously, and as of December 31,2010 the gross foreign reserves equaled Euro 1,714.5 million which was higher by Euro 117 million compared to the previous year. The upward trend of the gross foreign reserves in 2010 contributed to smaller external vulnerability of the domestic economy, enabling a reaction by monetary policy relaxation during the year. Also, at the end of the year the amount of the gross foreign reserves was higher than expected, which created favorable starting position for the monetary policy in the following year. Namely, in conditions of strategy of fixed foreign exchange rate of the Denar relative to the Euro, the availability of adequate level of gross foreign reserves is of crucial significance for the maintenance of the foreign exchange rate stability. In 2010, the indicators for the foreign reserves adequacy maintained on adequate level almost continuously, suggesting lower risks to the monetary policy. **As of December 31,2010, the foreign reserves ensure coverage of the import of goods**

(f.o.b.) and services of 4 months of the following year. Also, the balance of the gross foreign reserves provides also sound coverage of the liabilities of the domestic monetary system to the private sector, which also means capability for successful dealing with possible extreme scenarios of massive withdrawal of the deposit liabilities from the banking sector. This can be perceived through the indicator for the correlation of the gross foreign reserves and the broadest money supply M4, which equals 45%⁷², with the balance of these components as of December 31,2010.

Figure 90
Gross foreign reserves and monthly coverage of the import of goods (f.o.b.) and services of the following year with gross foreign reserves*
(in millions of denars)



*Data on the import of goods (f.o.b.) and services of the following year for 2005 - 2010 period are according to the realized amounts and for 2011 the data are projected.

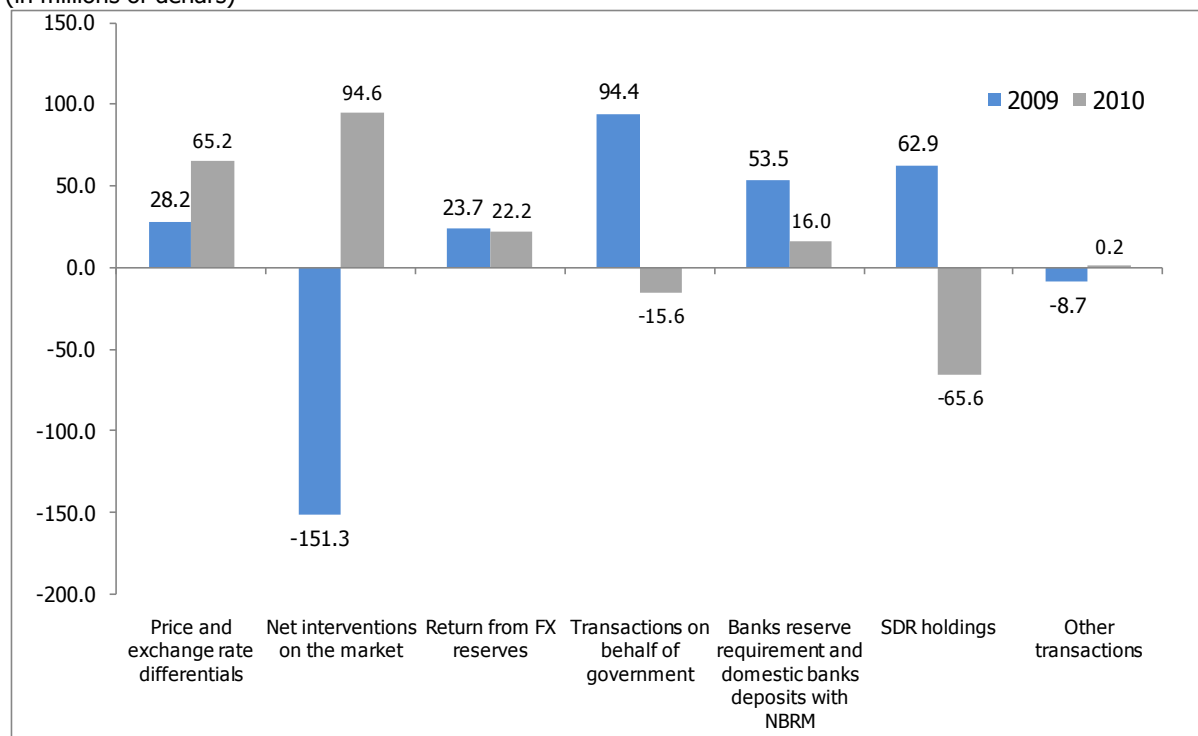
Source: National Bank of the Republic of Macedonia

Additional positive aspect for the monetary policy is the fact that in 2010 the improvement of the gross foreign reserves was partially driven by the improvement in the economy's fundamentals. Accordingly, it was more stable compared to 2009, when the accumulation of the foreign reserves was enabled by the influence of single effect factors (debiting of the Government with Eurobond and utilization of the IMF quota). Namely, given narrowing of the current account deficit, the need for the external financing of the economy also reduced. In such conditions, despite the lower volume of realized capital inflows compared to the previous year, they exceeded the current account deficit, with NBRM realizing net purchase of foreign exchange on the foreign exchange market. **Thus the NBRM interventions on the foreign exchange market in the total amount of Euro 94.6 million represent main flow of foreign reserves creation in 2010.** Additional significant contribution to the foreign reserves growth in 2010 also had the increase in the gold price on the international stock exchanges and the strengthening of the value of the US Dollar against the Euro in the first half of the year, which enabled increase

⁷² In the economic theory and practice, there is no generally accepted view on what is the acceptable level of coverage of the broadest money supply with foreign reserves. Wjinholds and Kapteyn (2001) suggest interval of 5-20%, as minimal acceptable level for this indicators, which as an adequate benchmark is accepted also by IMF (Macedonia IMF Country Report No. 10/20, p. 4). The bottom limit of this interval is considered as adequate coverage with the flexible foreign exchange rate regime, while the upper limit represents minimal acceptable level for the countries with fixed foreign exchange rate. In the Republic of Macedonia, as of December 31,2010 the gross foreign reserves provide more that twice higher coverage of the broadest money supply relative to the minimal level.

in the market value of the foreign reserves on the basis of currency and price changes in this period.

Figure 91
Factors of change of the gross foreign reserves in 2009 and 2010
(in millions of denars)



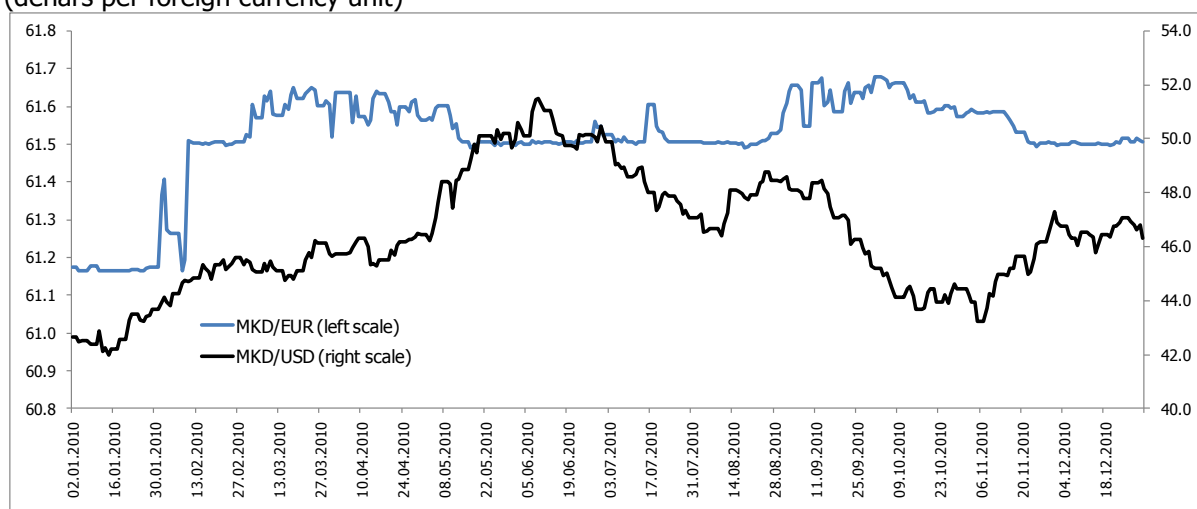
Source: National Bank of the Republic of Macedonia

From the aspect of other important flows, the Government transactions and the use of SDR allocation of IMF acted towards decrease in the foreign reserves in 2010. Namely, the inflows based on Eurobond, which were realized in July 2009 (in the total amount of Euro 175 million) in 2010 in largest portion was used for financing the negative budget balance. However, no massive pressures of the higher outflows from the foreign exchange account of the Government on the misbalance in the balance of payments were registered, which can be explained with the fact that the largest position of the withdrawn foreign assets of the Government were used for settlement of liabilities in the domestic economy (realized high purchase of foreign assets in NBRM transactions with securities). As a result of the emergence of new instability of the global financial market, caused from the debt crisis of several member states of EY, the Government delayed the plans for issuance of another Eurobond, as envisaged source of funding of the budget balance in 2010. In such conditions, as alternative source of funding of the budget deficit in 2010 SDR allocation was used, which the Government withdrawn from IMF during August and September 2009.

The continuous presence of NBRM on the foreign exchange market in function of closing the gap between the supply and demand for foreign exchange contributed toward further maintenance of the stability of the Denar exchange rate relative to Euro, as basic nominal anchor of the monetary policy of NBRM. In the first half of 2010, higher variations in the value of the Denar exchange rate relative to Euro were registered, which is a result of the methodological changes in the manner of establishing the foreign exchange rate. Namely, in February 2010, Decision on the manner of establishing and publishing exchange rates of the National Bank of the Republic of

Macedonia was enforced⁷³. Pursuant to this decision, the middle exchange rate of the Euro is calculated as a medium value of the listed bid and offer exchange rates per Euro in Denars between the market makers on the foreign exchange market. Previously, NBRM determined the Denar exchange rate against the Euro as weighted exchange rate of the performed transactions and the achieved exchange rates on the interbank foreign exchange market, including also the NBRM interventions. In case of such changes, in the first half of the year, larger variations in the value of the Denar exchange rates relative to Euro were registered. In the second half of the year, the movements with the Denar exchange rate relative to Euro were relatively stable, with slight occasional oscillations in certain periods, so the average foreign exchange rate of the Denar relative to Euro on the foreign exchange market in 2010 equaled Denar 61.51 per Euro, opposite to Denar 61.27 per Euro, as the average in 2009. In 2010, on the currency exchange market, average of Denar 61.45 per one Euro were traded, compared to Denar 61.52 per one Euro, on average, in the previous year, which points to stabilized expectations of the domestic entities regarding the foreign exchange rate.

Figure 92
Nominal foreign exchange rate of the Denar relative to Euro and US Dollar on the foreign exchange market
(denars per foreign currency unit)



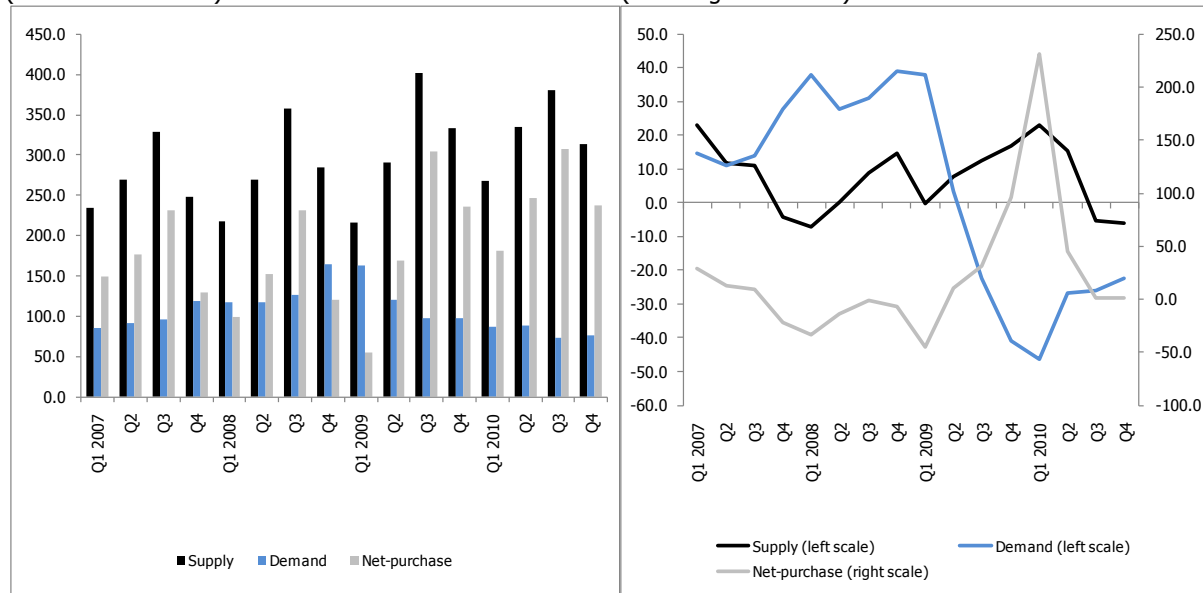
Source: National Bank of the Republic of Macedonia

In conditions of maintenance of stable Denar value relative to Euro, the movement of the Denar foreign exchange rate relative to the US Dollar was conditioned by the changes in the cross currency relations between the Euro and the US Dollar on the international stock exchanges. Thus in the first quarter of 2010, in conditions of intensified tensions in the Euro area, related to the negative perceptions of the investors as a result of the escalation of the Greek debt crisis and possibility for its spillover also in other EU member states, the Euro depreciated almost constantly relative to the US Dollar. The second half of the year was characterized by generally adverse movements, influenced by the slower recovery of the US economy relative to the previous expectations, as well as to the investors' expectations for initiation of new cycle of quantitative relaxation by FED through purchase of Government securities, which was realized in November 2010. However, the strengthening of the Euro value relative to the US Dollar in the second half of the year was less intensive compared to the realized attenuation of its value in the preceding period, which resulted in a depreciation of the Denar relative to

⁷³ "Official Gazette of RM" no.13/10.

the US Dollar in 2010 of 5.3%, on average. In such conditions, the average Denar foreign exchange rate relative to the US Dollar on the foreign exchange market equaled Denar 46.45 per one US Dollar, while Denar 46.29 per one US Dollar, on average, were traded on the currency exchange market (opposite to Denar 44.21 per one US Dollar, on average in the previous year).

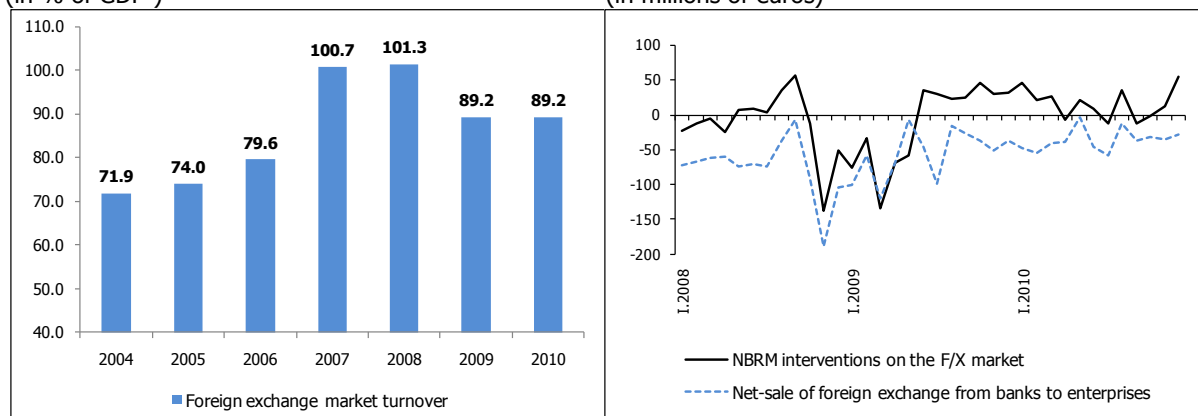
Figure 93
 Dynamics of the component on the currency exchange market
 (in millions of euros) (annual growth rates)



Source: National Bank of the Republic of Macedonia

In 2010, the improvement of the global and the domestic macroeconomic environment and stabilized expectations of the domestic entities, reflected adequately on the dynamics on both the currency exchange and the foreign exchange market. During the year, in the foreign exchange transactions with households on the currency exchange market, net purchase of foreign assets was continuously realized, which is an indicator for stable expectations of the domestic entities. The households' currency preference, regarding the new savings in the banking sector, also supported this statement. In 2010, they were directed towards more intensive growth in the Denar deposits, opposite to 2009, when increase in the degree in the deposit base Euroization was registered, with adequate effects also on the currency exchange operations. In such conditions, on the basis of the currency exchange operations in 2010, the historically highest net purchase of foreign exchange in the total amount of Euro 972.7 million was realized, which is high above the average annual net purchase realized within 2005 - 2007 period, as a period of economic expansion. Relative to the previous year, the realized net purchase on the currency exchange operations in 2010 was higher by 27.4%. Such movements on the currency exchange operations can be comprehended as an indicator for lowering of the uncertainty degree, evident in the two previous years. In favor of the stabilization of the expectations of the domestic entities is also the intensive decrease in the demand for foreign exchange on the currency exchange market in 2010 (of 32.5%, annually), which contributed to the decrease in the total realized turnover on the currency exchange market on annual basis of 5.9%, and it equaled Euro 1,619.8 million.

Figure 94
 Movements on the currency exchange operations
 (in % of GDP¹) (in millions of euros)



¹ Preliminary data on GDP for 2009 and estimated data on GDP for 2010.
 Source: National Bank of the Republic of Macedonia

On the foreign exchange market⁷⁴, in 2010 turnover in the amount of Euro 6,147.5 million was realized, which is an increase of 3.2% compared to the previous year. In "bank-client" transactions, higher turnover on annual basis was realized, given more intensive increase in the supply of relative to demand for foreign exchange. Such movements resulted in smaller volume of realized net sale of the clients' foreign exchange by the banks on annual basis (of 36.7%), which equaled Euro 435 million in 2010. In such conditions given simultaneous high rise in the inflows from private transfers during the year, 2010 characterized with considerable lower shortage of foreign exchange on the interbank market, which was mostly covered from the own foreign currency positions of the banking sector, enabling NBRM interventions towards net purchase of foreign exchange.

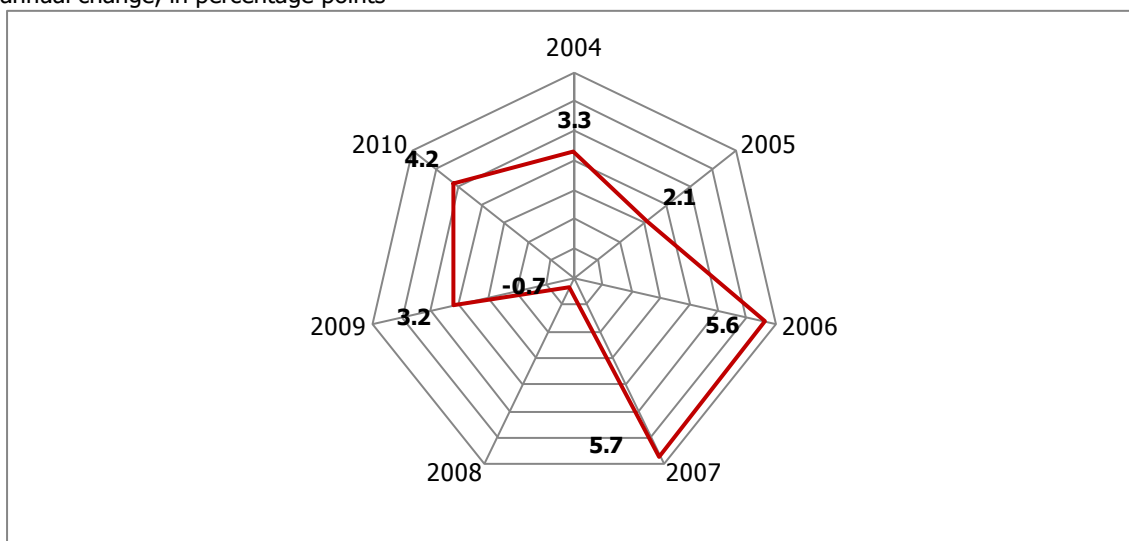
3.3. Monetary aggregates

The increase in the money supply continued also in 2010, although considerably more intensively, compared to the increase in the preceding year. Thus, in 2010, the new money supply in the economy was twice bigger compared to the preceding quarter. The annual rise in the broadest money supply M4 at the end of the year equaled 12.2%, compared to 6% at the end of 2009. **Such a dynamics of the money supply is consistent with the economic and financial conditions in the domestic economy, the post crisis recovery of which continued also in 2010.** Namely, after the decrease in the previous year, in 2010 the activity in the real sector registered a moderate growth. The movements in the external position of the economy were also favorable, which enabled creation of additional supply of money through new foreign currency inflows. Also, in conditions of better environment, the confidence of the economic entities continued to mount, increasing the savings in the banking system. The money supply creation was additionally impacted by the banks' larger crediting of the economy. **In case of fast money supply growth relative to the nominal GDP, the monetization degree⁷⁵ elevated from 50.7% in 2009 to 54.9% in 2010.**

⁷⁴ It refers to the transactions realized on the foreign exchange market between banks-banks, banks-clients and NBRM with banks and ministries.

⁷⁵The share of the money supply M4 at the end of period in the annualized GDP (sum of nominal GDP from the last four quarters)

Figure 95
Monetization degree
annual change, in percentage points



Source: National Bank of the Republic of Macedonia

Figure 96
Contribution to the annual growth of M4
(in percentage points)

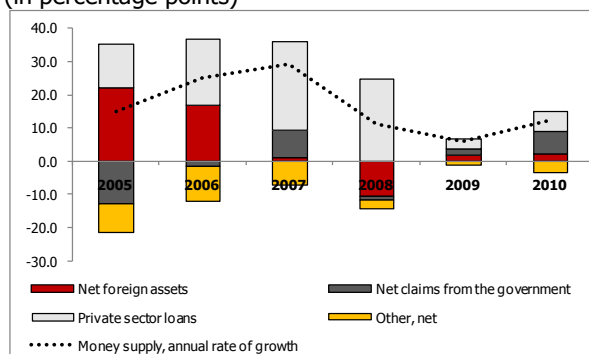
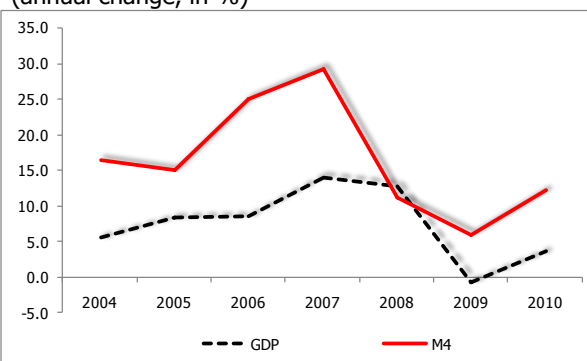


Figure 97
Nominal GDP and M4
(annual change, in %)



Source: National Bank of the Republic of Macedonia

In 2010, the dynamics of the broadest money supply was influenced also by certain single effect factors. Namely, in April and October, funds on the households' deposit accounts on the basis of the payment of the regular installment of the bond for the old foreign exchange saving were transferred, which contributed to rise in the banks' total deposits. Also, in July, part of the banks' deposit potential was used for payment of one larger company to the Government and the foreign investor. This withdrawal of the funds from the banks' accounts ceased the trend of continuous acceleration of the money supply's annual growth rate that commenced at the end of 2009.

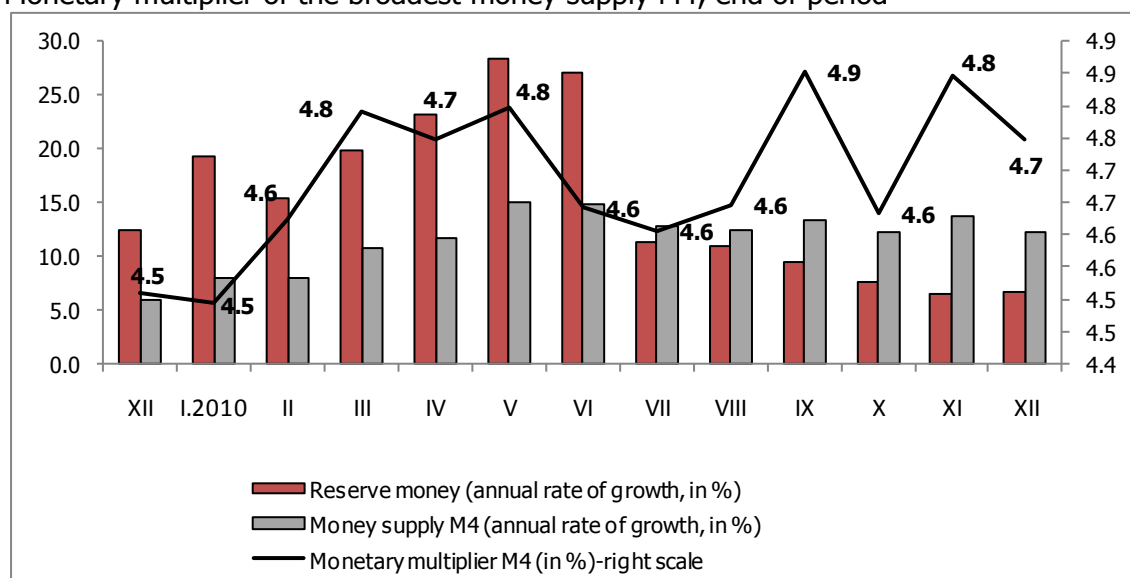
Table 21
Annual growth rates of M4 by countries
(in %)

	2003	2004	2005	2006	2007	2008	2009	2010
Macedonia	18.6	16.5	15.0	25.0	29.3	11.2	6.0	12.2
Romania	23.3	39.9	33.8	28.1	33.5	17.5	9.0	6.9
Albania	8.7	13.5	13.9	16.3	13.7	7.7	6.8	12.5
Croatia	11.0	8.6	10.5	18.0	18.3	4.3	-0.9	4.4
Bosnia and Herzegovina	8.4	24.3	18.2	24.2	21.7	3.5	2.1	7.4
Bulgaria	19.6	23.1	23.9	26.9	31.2	8.8	4.2	6.2
Serbia	27.8	31.9	42.1	38.3	42.5	9.8	21.5	12.9
Euro area	6.4	6.3	8.6	9.4	11.4	8.4	-0.4	2.0

The analysis of the monetary indicators in the regional countries and in the Euro area, generally points to moderate recovery of the monetary growth. In 2010, the annual growth rates of the broadest money supply are within positive zone, compared to the previous year, when part of the countries registered negative rates. The largest acceleration of the monetary growth during the year was registered in Serbia, in conditions of higher GDP, intensified crediting of the private sector, as well as increase in the banks' deposit potential. However, at the end of 2010, the monetary growth in Serbia slowed down, mainly as a result of the reduced economic activity, as well as high comparison base at the end of 2009. In Romania, the monetary growth slowdown during the year was registered, in conditions of still poor economic activity. In Croatia and in Euro area, in 2010, the monetary growth abandoned the negative zone of changes. Such a change of the monetary movements is in conditions of gradual improvement of the economic and credit activity. However, the pace of the increase in the supply of money in the economy in the Euro area was slow, i.e. during the year low annual growth rates were registered. At the end of 2010, the annual monetary growth in the Euro area was almost one sixth of the increase registered in the pre-crisis period (2007).

In 2010, the monetary multiplication accelerated, with the monetary multiplier being incremented on annual basis from 4.55 to 4.7%. The acceleration of the monetary multiplier can be explained with the intensified increase in the money supply M4, relative to the increase in the reserve money. During the year, the dynamics of the monetary multiplication was relatively variable. Thus in the first five months of 2010 (except in April), the monetary multiplication accelerated, given the intensified growth of the money supply relative to the reserve money. However, in June, monthly acceleration of the monetary multiplier was registered, with the level being preserved during the third quarter. This change can be explained with the slower growth in the money supply in this period, mainly as a result of the higher outflow of the banks' deposits. In the last months of 2010, the monetary multiplier registered different movement dynamics, given continuous increase in the money supply in the economy and variable movements with the reserve money.

Figure 98
Monetary multiplier of the broadest money supply M4, end of period



Source: National Bank of the Republic of Macedonia

Table 22
Components of the monetary aggregates
(in millions of denars)

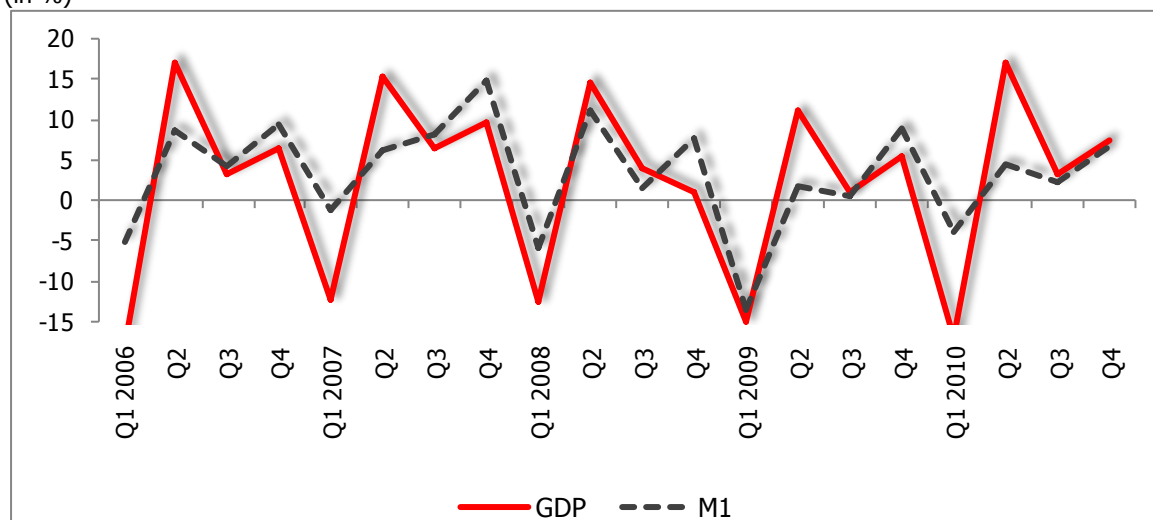
	Current			Annual change			Contribution in annual growth of M4		
	31.12.2008	31.12.2009	31.12.2010	31.12.2008	31.12.2009	31.12.2010	31.12.2008	31.12.2009	31.12.2010
	in millions denars	in millions denars	in millions denars	in %	in %	in %	in %	in %	in %
Currency in circulation	17,601	16,266	16,958	-1.7	-7.6	4.3	-1.6	-11.4	2.7
Demand money	36,518	35,957	40,404	24.4	-1.5	12.4	36.3	-4.8	17.6
M1	54,119	52,223	57,362	14.5	-3.5	9.8	34.8	-16.2	20.3
Short term denar deposits	49,584	45,735	51,296	-10.8	-7.8	12.2	-30.5	-32.8	22.0
Short term foreign-currency	75,182	88,025	92,921	17.3	17.1	5.6	56.1	109.4	19.3
M2	178,885	185,983	201,579	7.1	4.0	8.4	60.4	60.5	61.6
Long term denar deposits	7,990	8,791	15,118	71.0	10.0	72.0	16.8	6.8	25.0
Long term foreign currency	8,650	12,488	15,872	108.0	44.4	27.1	22.8	32.7	13.4
M4	195,525	207,262	232,568	11.2	6.0	12.2	100.0	100.0	100.0

Source: National Bank of the Republic of Macedonia

After the decrease in the preceding year, in 2010 the most liquid monetary aggregate M1⁷⁶ registered annual increase of 9.8%, with a contribution in the rise in the total money supply of 20.3%. The positive dynamics in the money supply M1, is mainly a result of the increase in the funds on the transaction accounts. Such a dynamics of the money supply components connected to transaction motives, corresponds to the higher activity in the economy.

⁷⁶ It includes the currency in circulation and transaction deposits.

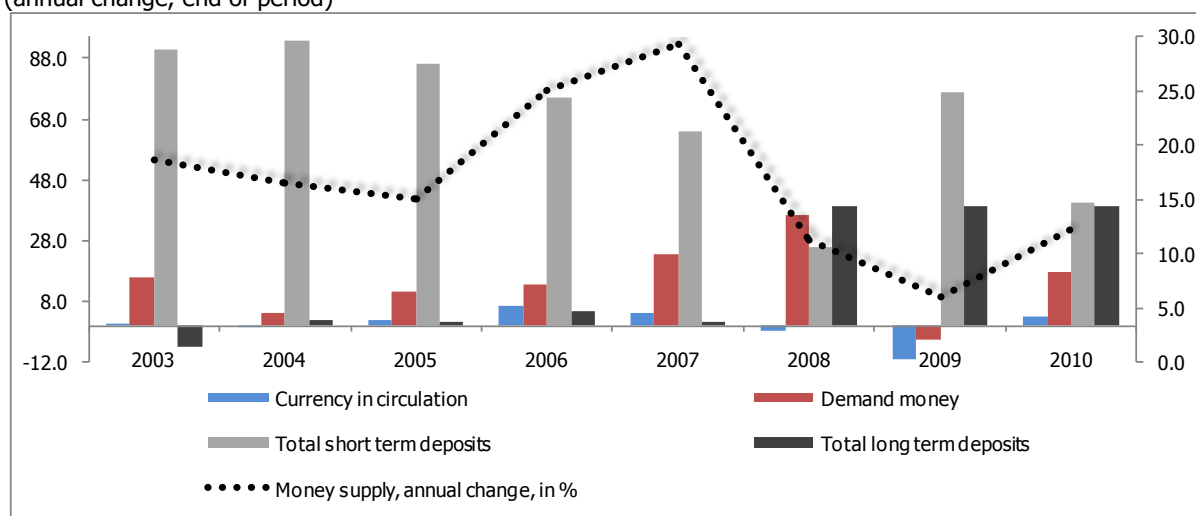
Figure 99
 Quarterly change of the nominal GDP and money supply M1
 (in %)



Source: National Bank of the Republic of Macedonia

In 2010, the contribution of the total deposits (without transaction accounts) in the money supply growth fell. During the year, the total deposits participated in the money supply widening with approximately 80%, compared to the previous year when the increase of M4 was fully conditioned by the banks' deposit potential. This annual change can be explained with the increase in the funds on the transaction accounts (compared to 2009 when it registered annual drop) and their positive contribution to the money supply growth. From the aspect of the maturity structure, the private sector preferences for long-term saving augmented, which corresponds to the better expectations of the domestic entities. Thus the share of the long-term deposits in the broadest money supply M4 increased given the decrease in the share of the short-term deposits. In line with such movements, the annual contribution of the short-term deposits to the increase in the broadest money supply fell from 76.6% to 41.3%, annually.

Figure 100
 Contribution of the main components in the change in the money supply M4
 (annual change, end of period)

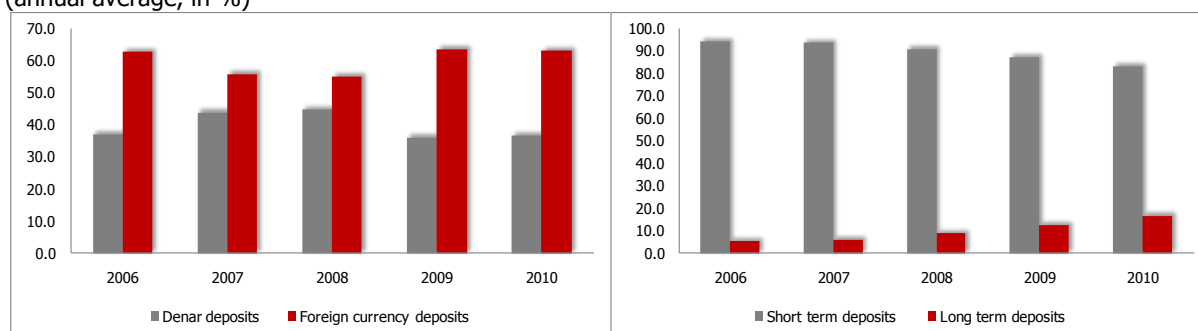


Source: National Bank of the Republic of Macedonia

The annual growth rate of the total deposit potential (without demand deposits) in December 2010 equals 13%, compared to 9.6% in the previous year. Generally, the widening of the banks' deposit base corresponds to the dynamics of the economic and financial parameters. However, despite the slower recovery pace of the domestic economy in the first half of the year relative to the second, the growth dynamics of savings in the banks was more intensive in the second half. Thus in the first half of the year, the semiannual deposits growth equals 8.3%. In the second half of the year, the increase was halved to 4.4%. Such a change in the growth pace of the deposit base is explained with the high outflows of deposits in July, as a result of the payment of dividend by one large company to the Government and to the foreign investor. If eliminate this effect, the pace of the savings growth is almost identical in both the first and the second half of the year.

Figure 101

The share of the main components in the total deposits
(annual average, in %)



Source: National Bank of the Republic of Macedonia

The changes in the currency structure of the total deposits in 2010 showed that the confidence in the domestic currency is mounting. Consequently, after the decrease in the two previous years, in 2010 the deposits in the domestic currency registered high increase. On the other hand, after the two-year period of two-digit annual growth rates, the rise in the savings in foreign currency considerably slowed down. The share of the Denar deposits in the annual total deposits growth equaled 58.9%, compared to their negative contribution in the previous year. On the other hand, gradual diminishing of the role of the foreign currency deposits in the creation of the total deposits from 64.8% to 62.1%, annually, was registered. These trends showed depletion of the effects of the factors that contributed to larger Euroization in the preceding period, as a form of safeguard of the disposable income value. Namely, in a post crisis environment and gradual recovery of the global and domestic economy, the expectations and the confidence of the entities considerably improved. This resulted in gradual restructuring of their currency portfolios in favor of instruments in domestic currency, which generate higher yield. In such conditions, the Euroization degree (substitutions of means measured through the share of the foreign currency deposits in the total money supply) in 2010 reduced from 48.5% to 46.8%. Despite the downward trend of the Euroization degree, however, it is still higher than it was in the period before the commencement of its growth.

Figure 102

Eurization degree presented through the share of the foreign currency deposits in the broadest money supply

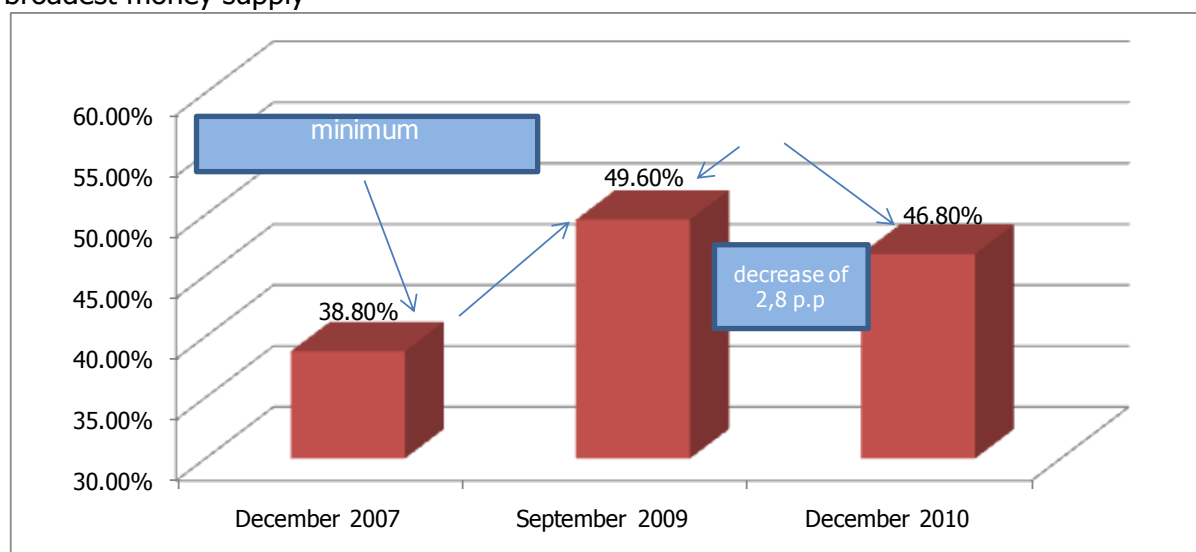


Table 23

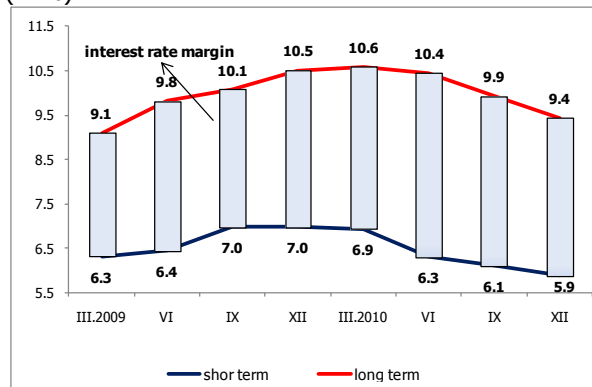
Structure of the total deposits of the private sector
(in millions of denars)

	Current			Annual change			Contribution in annual growth of total deposits		
	31.12.2008	31.12.2009	31.12.2010	31.12.2008	31.12.2009	31.12.2010	31.12.2008	31.12.2009	31.12.2010
	in million denars	in million denars	in million denars	in %	in %	in %	in %	in %	in %
Total deposits of the private sector	141,406	155,040	175,207	10.0	9.6	13.0	100.0	100.0	100.0
Maturity structure									
Short term deposits	124,766	132,071	142,297	4.2	5.9	7.7	39.4	53.6	50.7
Long term deposits	16,640	22,969	32,910	88.4	38.0	43.3	60.6	46.4	49.3
Currency structure									
Denar deposits	57,574	54,526	66,414	-4.5	-5.3	21.8	-20.9	-22.4	58.9
Foreign currency deposits	83,832	100,513	108,793	22.8	19.9	8.2	120.9	122.3	41.1
Sector structure									
Enterprises	39,317	34,437	34,353	5.1	-12.4	-0.2	14.7	-35.8	-0.4
Households	99,088	111,783	131,105	11.6	12.8	17.3	79.9	93.1	95.8

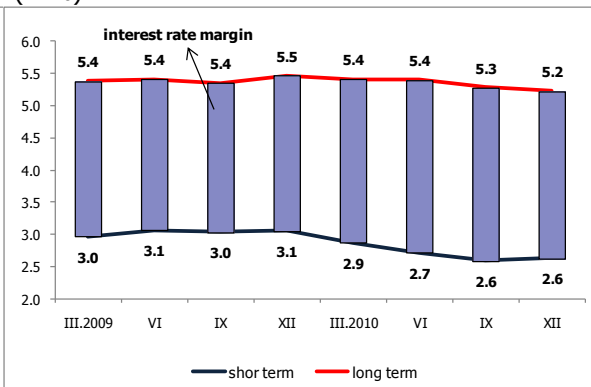
Source: National Bank of the Republic of Macedonia

From the aspect of the maturity structure, the contribution of both, the short-term and the long-term savings to the total deposits growth is almost equilibrated. Although this statement is basically characteristic for the previous year, however, in 2010 moderate increase in the contribution of the long-term savings was evident. Thus in 2010 the share of the long-term deposits in the creation of new deposit potential equals 49.3%, compared to 46.5% in the previous year. **Such movements can partially be explained with more stable macroeconomic environment and thus more stable expectations and larger confidence.** In such conditions, larger preference for long-term savings is expected. **Additional factor is probably the widening of the interest rate spread between the yields of the long-term and short-term savings.** It is considered that the stimulating effect of the higher yield intensifies in conditions of more stable economic environment. Regarding the deposits' maturity structure, although the short-term deposits still dominate, the significance of the long-term savings continuously elevates. The share of the long-term in the total deposits in 2010 equals 18.8%, opposite to 14.8% in the previous year. In 2010, the annual growth rates of both the short-term and the long-term deposits accelerated. Thus, the short-term and the long-term deposits registered an annual increase of 7.7% and 43.3%, respectively, opposite to 5.9% and 38%, respectively in the previous year.

Figure 103
Interest rates on Denar deposits
(in %)



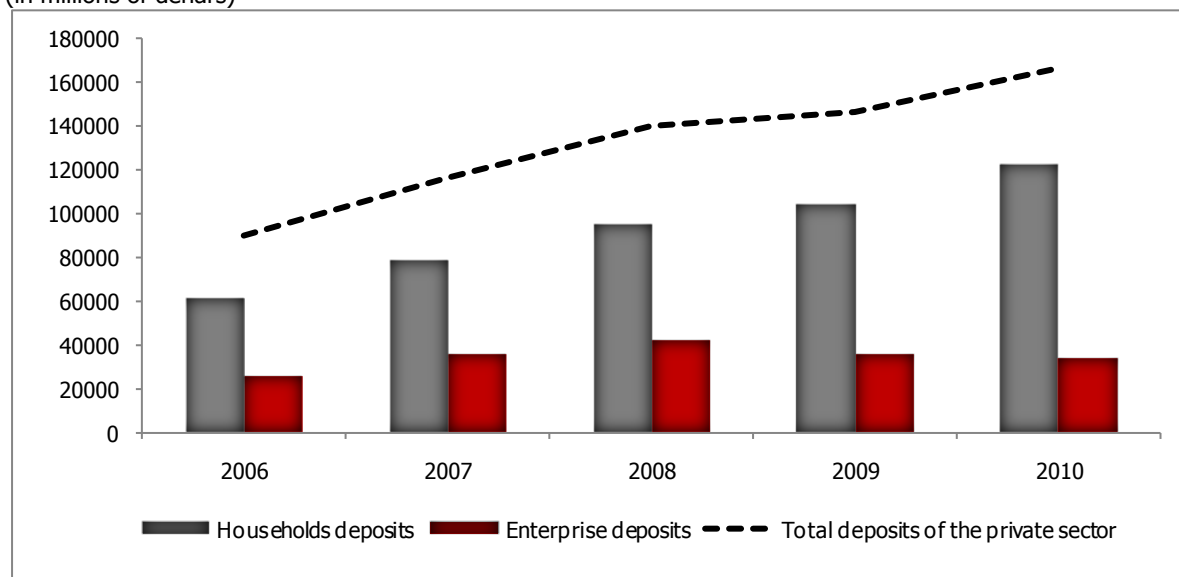
Interest rates on foreign currency deposits
(in %)



Source: National Bank of the Republic of Macedonia

Observed from sector aspect, in 2010, as in the previous year, the dominant contribution to the increase in the banks' deposit potential accounted for the households' deposits. Thus the household's preference for saving continuously increased, preserving the dominant share of 95.8% in the increase in the total deposits (opposite to 93.1% in the previous year). On the other hand, despite the fact that the annual rates of the corporate deposits entered also in both negative and positive zone, however, certain improvement with the savings in this sector is evident. Opposite to 2009, when the enterprises' deposits contributed for lowering of the deposit potential with approximately one third, during this year, their negative contribution reduced to 0.4%.

Figure 104
Average deposits of the private sector without demand deposits
(in millions of denars)

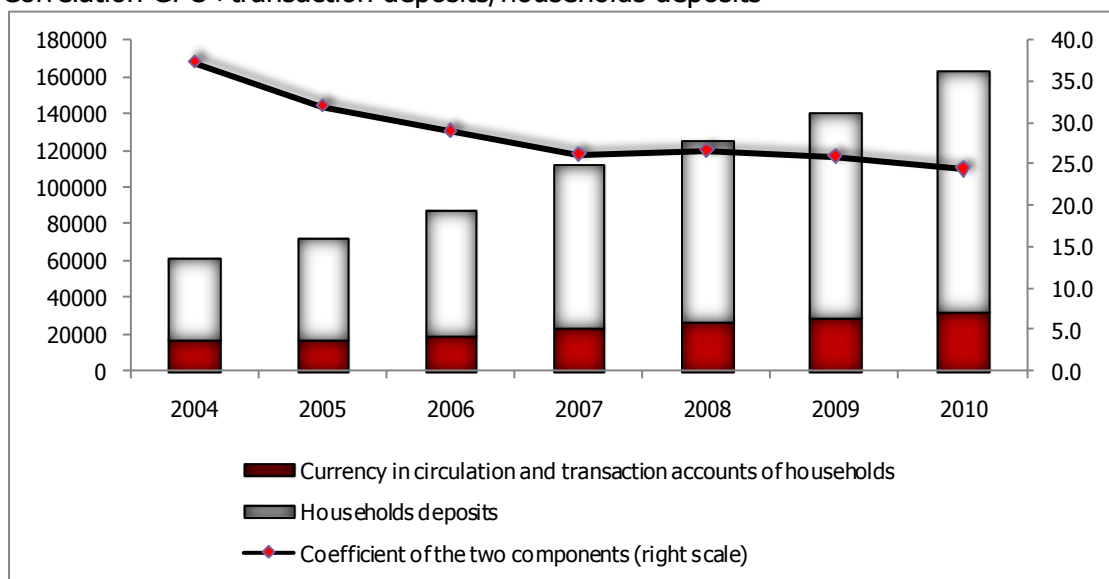


Извор: National Bank of the Republic of Macedonia

In 2010, acceleration in the growth of the households' deposits was registered. Thus, on annual basis, the households' deposits registered an increase of 17.3%, compared to 12.8% in the previous year. If demand deposits are taken into consideration, the annual increase in the households' deposits would equal 17.7%. The increase in the households' deposits was supported by the

favorable conditions on the labour market, i.e. increase in the net wages, as well as the faster recovery of the demand for labor on the labor force market. Namely, the larger amount of inflows based on private transfers also acted towards additional accumulation of funds on the households' savings accounts. The households' assets were also impacted by the regular installment of the bond for the old foreign exchange saving in April and October. The analysis of the correlation between the households' funds for transaction purposes (currency in circulation⁷⁷ and demand deposits) and the households' savings shows its reduction in 2010. This is an indication for higher preference of the households for saving in the banking system, in conditions of more stable economic environment. From the aspect of the savings' structure, in 2010 the households' higher preference to save in domestic currency and on a long-term basis is evident. Namely, the share of the Denar deposits in the annual total deposits growth equaled 73%, compared to their negative contribution in the previous year. The share of the deposits on a long-term basis is almost identical to that registered in 2009, with a share of about 47% in the widening of the deposit potential of the households. Such changes point to considerably stabilized expectations of the households. Observed from the aspect of the annual changes, in December 2010, the Denar and the foreign currency deposits realized annual increase of 45.8% and 6.5%, respectively, compared to -14% and 27.9%, respectively in 2009. Observed from the aspect of maturity, the short-term and long-term deposits registered an increase of 10.9% and 48.7%, respectively (opposite to 7.7% and 47.6%, respectively in the previous period).

Figure 105
Correlation GPO+transaction deposits/households deposits

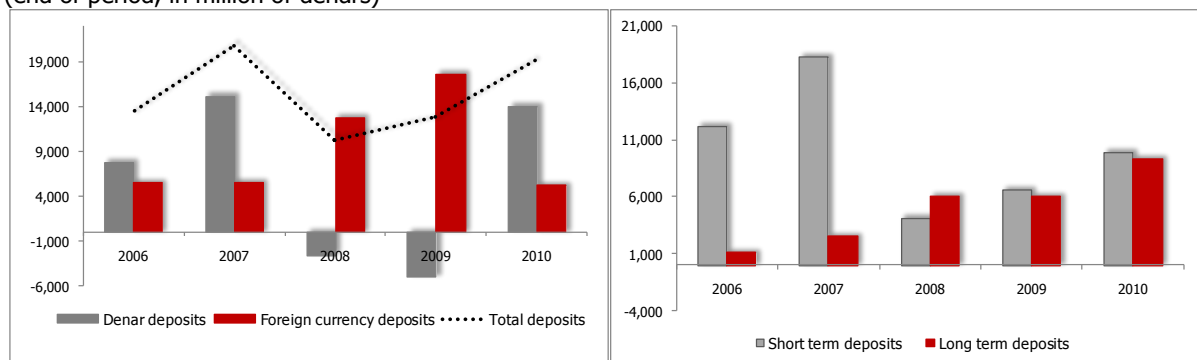


Source: National Bank of the Republic of Macedonia

⁷⁷ This is simplified assumption, according to which it is considered that the total amount of the Denar cash refers to the households.

Figure 106

Annual change of the main components of the households' deposits
(end of period, in million of denars)

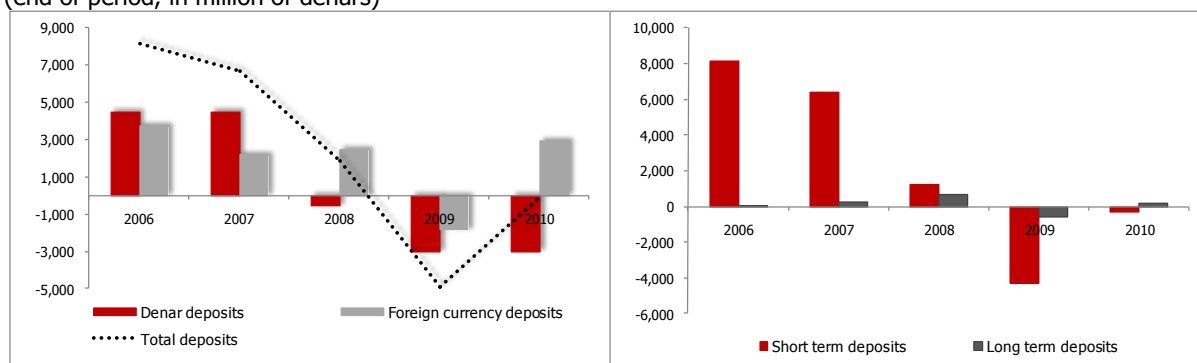


Source: National Bank of the Republic of Macedonia

Concerning the corporate deposits, in 2010 the annual rates of decrease registered a slowdown. Thus in December 2010, the corporate deposits fell by 0.2%, compared to the decrease of 12.4% in the previous period. If the funds on the transaction accounts of the enterprises are taken into consideration, the enterprises' deposits registered annual growth of 5.6%. The decrease in the corporate deposits basically results from the withdrawal of funds from the enterprises' accounts for payment of dividend of one large company to both the Government and the foreign investor. If isolate the dividend effect, the enterprises' deposits will be higher by 14.6%⁷⁸ on annual basis. Such changes in the disposable assets of the corporate sector in the banks are consistent with the process of gradual recovery of the domestic economy and with the increase in the value of the foreign trade. More detailed analysis shows change in the structure of the corporate deposits. Namely, in 2010, the foreign currency deposits and the long-term deposits contributed to increase in the enterprises' deposits, compared to the previous year when their contribution was negative. On the other hand, the Denar deposits preserved the dominant role in the withdrawal of the corporate deposits, registering smaller negative contribution of the short-term deposits. On annual basis, the Denar deposits decreased by 18.3%, given the increase in the foreign currency deposits of 16.2% (compared to -15.6% and -9%, respectively in December 2009). Observed from the aspect of maturity, the short-term deposits declined by 0.9%, while the long-term deposits incremented by 12.3% (-11.6% and -26.1%, respectively in the previous period).

Figure 107

Annual change of the main components of the corporate sector deposits
(end of period, in million of denars)



Source: National Bank of the Republic of Macedonia

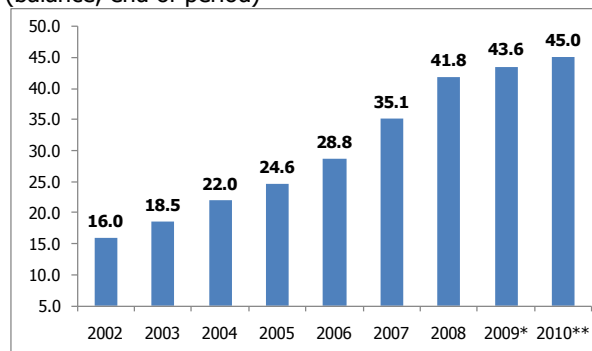
⁷⁸ The calculation is made by excluding the effects of the paid dividends in 2009 and 2010.

3.4. Bank placements

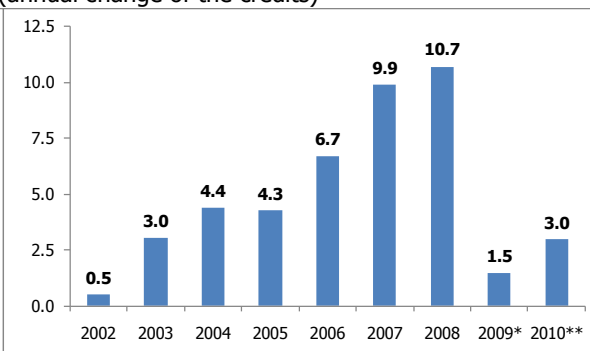
In 2010, the recovery of the banks' credit activity, which began at the end of 2009, continued. The total credits extended to the private sector in 2010 surged by 7.1%, annually, which is significant movement compared to the previous year, when annual credit growth of 3.5% was registered. Such movements were expected, after the crisis year 2009, when the banks' credit market generally stagnated, as a reflection of the high uncertainty and instable macroeconomic environment. The stabilized global and domestic macroeconomic environment, the constant widening of the banks' deposit base during the year and the better expectations of the banking and private sector and factors that contributed to termination of the "stage of restraint" from crediting and beginning of new stage of larger credit support to the real sector. These factors had stimulating effect also on the banking sector's readiness for crediting and the private sector's "appetites" for new borrowings. The total deposit potential, as primary source for funding of the domestic banks during the year was continuously increasing. In direction of credit activity stimulation, changes in the monetary policy were made, by increasing the key interest rate in several occasions during the year.

Figure 108

Share of the total credits in GDP, in %
(balance, end of period)



(annual change of the credits)



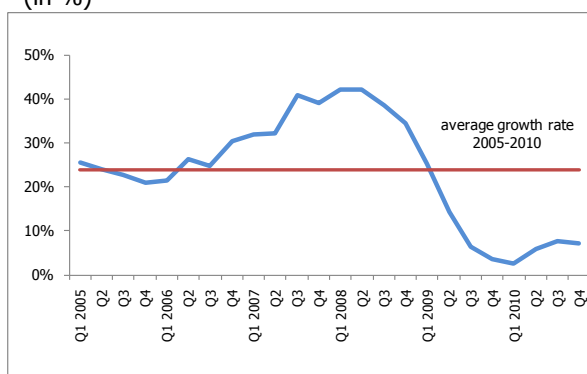
*Preliminary data on GDP.

**Estimated data on GDP.

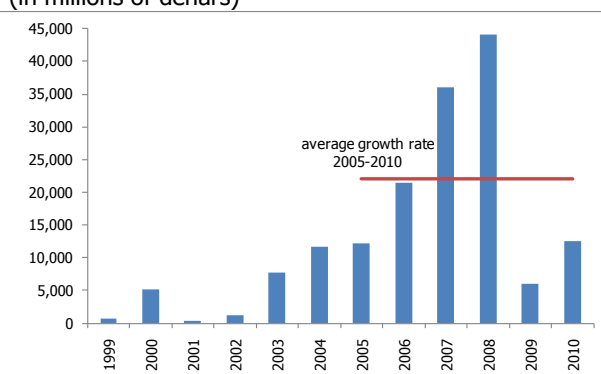
Source: NBRM and SSO.

The statement for the developments on the credit market in 2010 can be verified also through the changes in the indicators for the degree of financial intermediation. Thus the share of the annual change in the credits in 2010 equaled 3% of GDP which was twice more compared to the realization in the previous year. Also, the share of the total credits in GDP at the end of 2010 equaled 45% and it is higher by 1.4 percentage points on annual basis, which is still slightly smaller change compared to 2009.

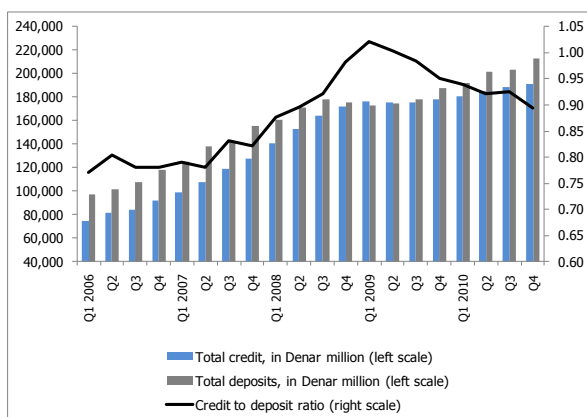
Figure 109
Annual changes in the total credits
(in %)



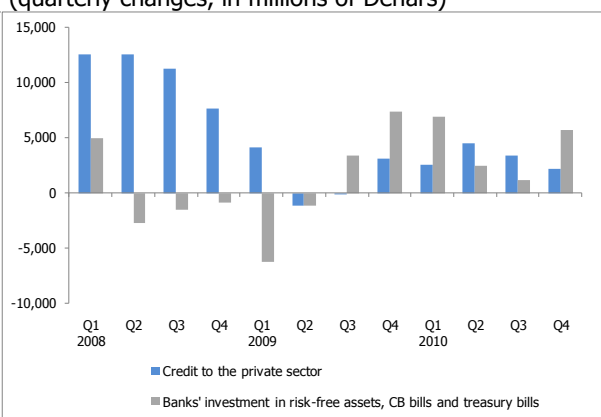
(in millions of denars)



Credits - deposits correlation



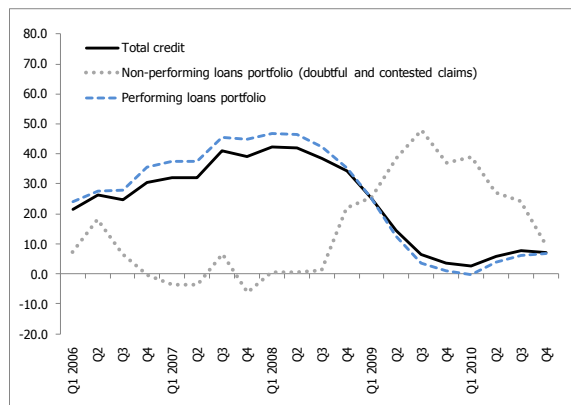
Banks' investments in non-risk and credit instruments
(quarterly changes, in millions of Denars)



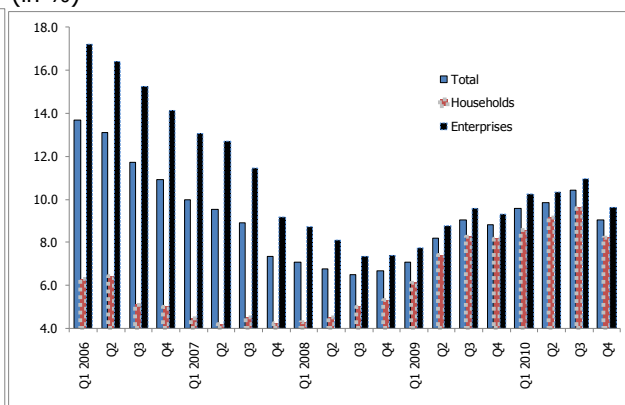
Source: NBRM.

However, although in 2010 the banks' credit market began to recover, certain indicators show that the opportunity for increasing the credit activity is not fully used yet. Thus the credit/deposits correlation continued to register generally downward path up to the level of 0.89 at the end of the year (0.95 in December 2009), suggesting incomplete use of the available deposit potential for the private sector crediting. Also, the banks' interest for investment in non-risk instruments remained relatively high despite the continuous reduction of their contribution during the year. Such movements showed that the economic crisis impacts the behavior of the domestic banks and the credit users, the overcoming of which will be time consuming. In such conditions and given simultaneous rise in the non-performing loans, the stability and the maintenance of the credit portfolio quality is the focal point of the domestic banks in the last two years. This policy is a change relative to the pre-crisis period of credit expansion, when the banks' main focus was the enlargement of the credit portfolio scope and ensuring larger market share.

Figure 110
Annual growth rates
(in %)



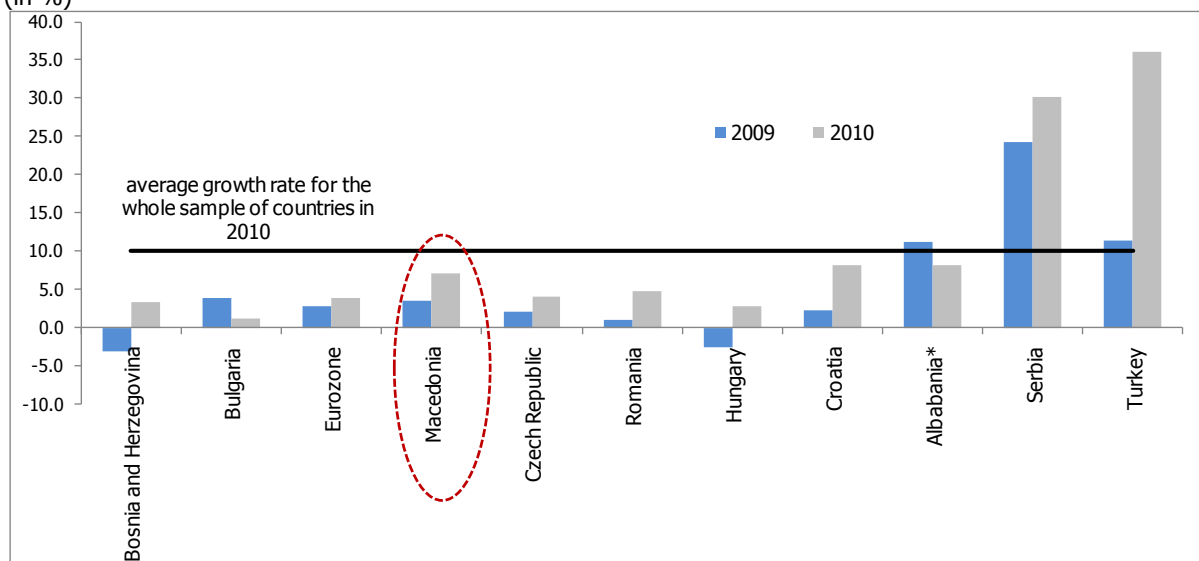
Share of suspicious and contested claims in the total credits, adequately by sectors
(in %)



Source: NBRM.

Part of these changes can be explained as "natural" reorganization of the credit market, under the influence of the global crisis. The materialization of the expected crediting turnover will most likely be time consuming, followed by further sustainable recovery of the economic activity and further reduction of the risk perceptions of the domestic banks.

Figure 111
Annual growth rates of the total credits by countries
(in %)



*The data on the credits in Albania for 2010 is given as of November 2010.
Source: EUROSTAT, NBRM and the web sites of the respective central banks.

Similar to the Macedonian economy, in most of the analyzed countries the recovery pace of the banks' credit activity in 2010 was moderate. Thus despite the general improvement in the macroeconomic environment, the recovery of the credit activity within the Euro area was fairly small, which can be explained with the still present vulnerability of the European financial system. Namely, the escalation of the Greek debt crisis and the risk of possible "infection" of few EU member states, stirred new doubts about the risk position of the European banking sector. These risks were partially mitigated after the publishing of the stress tests results, conducted by the European Banking Supervisory Committee. Also, together with the slow restoration of the credibility and the conservative

risk assessment, the behavior of the European banks was impacted also by the tightening of the supervisory standards and continuation of the "cleaning" of the banks' balance sheets from bad placements⁷⁹. In such conditions, despite the preserving of the accommodative character of the monetary policy by ECB, the liquidity and the financial position of the European banking system continued to suggest banks caution and continuation of the deleveraging process. Similar movements were registered also with the more developed former transitional economies, as well as with the regional countries. Turkey is an exception, registered relatively high credit growth, which can be explained with the larger readiness of the banks for private sector crediting, in accordance with the fast and intensive recovery of the economic activity and the consequent improvement in the credit risk indicator. The credit growth intensification was registered in Serbia, as well, also as a result of the better perspectives of the economy. **If exclude these two most attractive economies, from the aspect of the credits, the realized credit growth in Macedonia in 2010 will exceed the average of the other sample countries (together with Croatia and Albania), suggesting the comparatively more attractive credit support of the banks to the domestic private sector in this post crisis period.**

Table 24
Total bank credits
(in millions of denars)

	As of 31.12.2009	As of 31.12.2010	Annual changes		Share in the annual growth of total credit	
			in Denar million	in %	2009	2010
Total credit	178,195	190,816	12,621	7.1	100%	100%
Denar*	139,197	142,457	3,260	2.3	91.3	25.8
Foreign currency**	38,998	48,359	9,361	24.0	8.7	74.2
Short-term	53,087	52,565	-522	-1.0	-20.0	-4.1
Long-term	107,381	118,954	11,573	10.8	35.1	91.7
Doubtful and contested claims	15,724	17,284	1,560	9.9	70.3	12.4
Households	71,859	75,525	3,666	5.1	39.7	29.0
Denar	68,048	70,452	2,404	3.5	48.2	19.1
Foreign currency	3,811	5,073	1,262	33.1	-8.6	10.0
Short-term	17,612	16,814	-797	-4.5	20.2	-6.3
Long-term	47,105	51,231	4,126	8.8	-29.9	32.7
Doubtful and contested claims	5,856	6,219	363	6.2	35.7	2.9
Enterprises	106,160	115,109	8,949	8.4	63.2	70.9
Denar	71,025	71,858	833	1.2	46.6	6.6
Foreign currency	35,135	43,251	8,115	23.1	16.7	64.3
Short-term	35,418	35,705	287	0.8	-39.6	2.3
Long-term	60,159	67,592	7,433	12.4	63.9	58.9
Doubtful and contested claims	9,867	11,061	1,193	12.1	38.0	9.5

*Denar credits include also the credits with FX clause.

** Foreign currency categories are evaluated at current foreign exchange rate.

Source: NBRM.

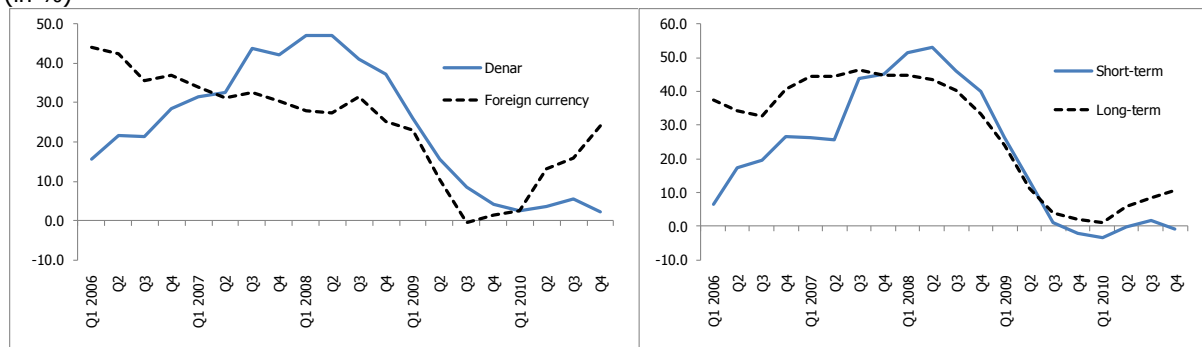
From the aspect of the currency structure, 2010 characterized with intensification of the growth in the foreign currency credits from 1.4% in 2009 to 24% in 2010. Thus their contribution to the increase in the total credits equaled 74.2%, which is not the case with the previous several years. The increase in the foreign currency credits during the year was driven by the intensified lending to the corporate sector, which in accordance with the higher external demand, can originate from the bigger demand for credits by the export sector, as a sector that generate income in foreign currency. Another factor that could explain the larger foreign currency crediting is the enterprises' motive for general costs rationalization within the post crisis period including

⁷⁹ Estonian Economy and Monetary Policy 2/2010, Bank of Estonia.

also the interest payments. In such conditions, in line with the lower interest rates, the foreign currency credits became more competitive, having adequate effects on the new credit agreements. Also one part of the increase in the enterprises' foreign currency credits in 2010 probably arises from the utilization of larger part of the EIB credit line (as part of the anti-crisis Government measures), as foreign currency source of financing of the domestic banks. The Denar crediting augmented (with included Denar credits with FX clause), but with more moderate intensity relative to the growth in the foreign currency lending of 2.3%, annually.

Figure 112

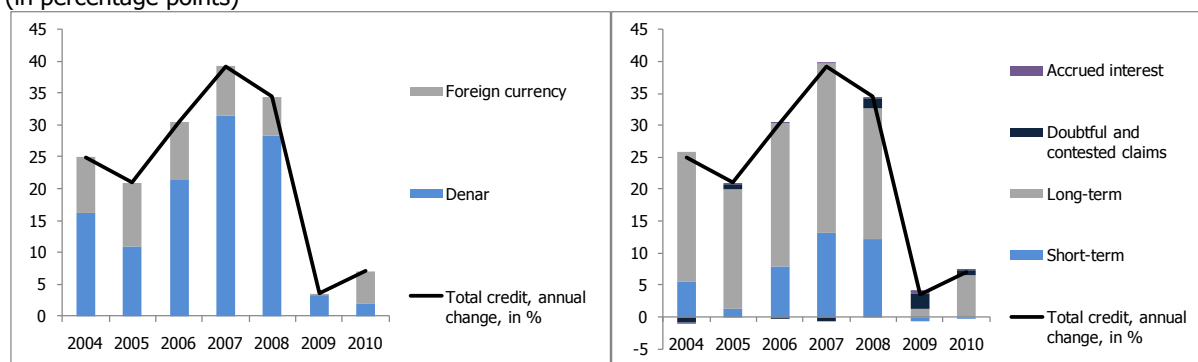
Annual growth rates of the credits from the aspect of the currency structure (left) and maturity structure (right) (in %)



Source: NBRM.

Observed from the aspect of the maturity structure, in 2010, the growth generator in the banks' total credit portfolio were the long-term credits, with a share of 91.7% of the increase in the total credits. On annual basis, the long-term credits were higher by 10.8%, given the registered decrease in the short-term credits by 1%, annually. Significant part of the newly extended long-term credits in 2010 was placed with the enterprises, which shows that part of the companies used some of the financial support for investments in modernization, or extending of the existing capacities. This can be proved also with the results of the lending Surveys conducted in 2010, which show that the investments in fixed assets as one of the basic factors with stimulating effects on the demand for corporate credits, together with the investments in stocks and working capital and debt restructuring. Also in 2010 the households' long-term credits augmented on annual basis (opposite to the decrease in the preceding year), which is additional positive impulse for the economic activity in the country. In 2010, the volume of the suspicious and contested claims continued to increase on annual basis, although with slower dynamics at the end of the year. In such conditions, at the end of 2010 the share of the suspicious and contested claims in the total credits equaled 9.1%, which is annual rise of 0.2 percentage points, opposite to 2.2 percentage points as it augmented in 2009. Although such movements can partially be explained with the more active "recovery" process of the banks' credit portfolio with new credits during the year, they probably arise, to certain extent, from the better discipline in the collection of the credit demand, as well as the improved economic position of the clients.

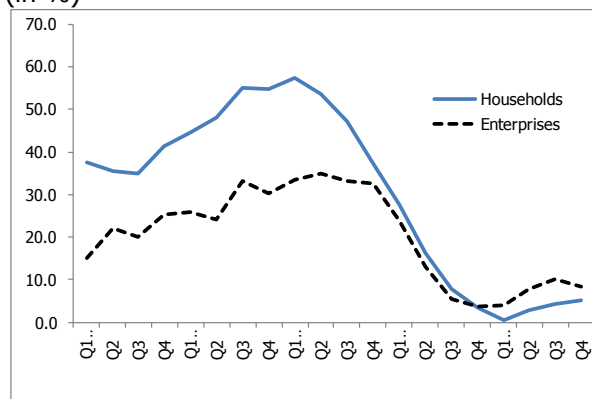
Figure 113
Contribution in the annual increase in the total credits
(in percentage points)



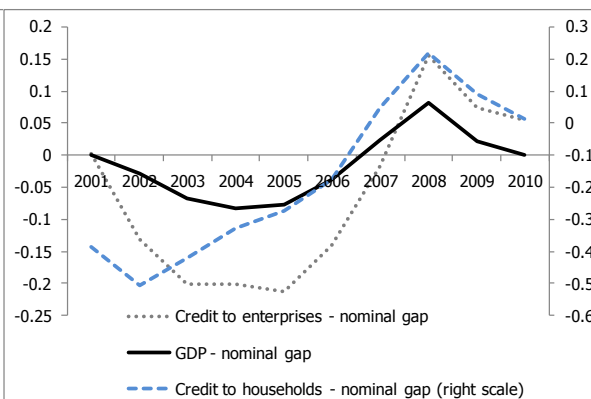
Source: NBRM.

In 2010, the activity intensified in both segments of the credit market, with the total credits of the enterprises being higher by 8.4% on annual basis, contributing with 70.9% to the increase in the total credit portfolio. The households' credits augmented by 5.1% annually and their share was smaller compared to the preceding year (29%, opposite to 39.7% in 2009), but with considerable qualitative improvement. Namely, in 2010 the increase in the households' credits contributed towards rise in the banks' functional portfolio, compared to 2009, when the growth in the households' credits was due to the suspicious and contested claims.

Figure 114
Annual growth rate of credits from the
aspect of the sector structure
(in %)



Credits dynamics by sectors and the
economic cycle*



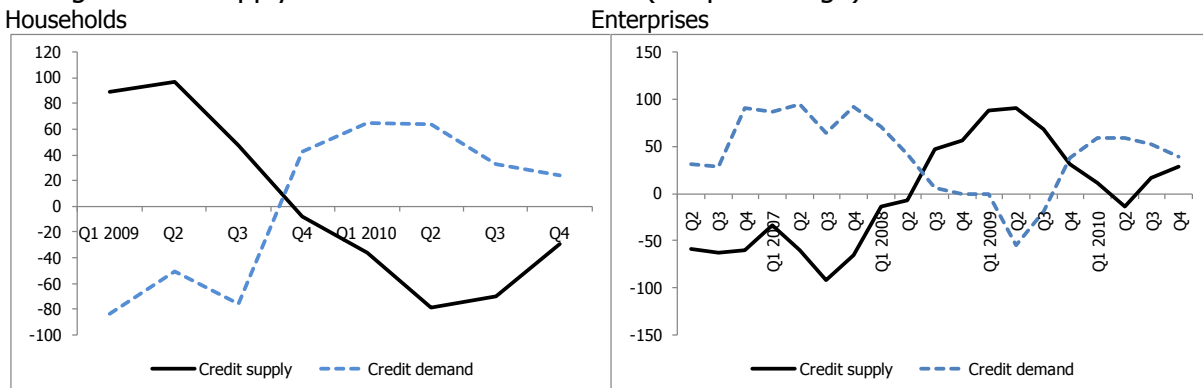
*Nominal gaps of the credits by sectors and GDP are calculated on the basis of the nominal amounts of the credits and GDP, according to the following formula: $GAP = (X^a - X^p) / X^p$, where GAP is the adequate nominal gap; X^a is the realized level of the adequate variable, while X^p is the potential level of the adequate variable. For calculation of the potential levels, HP-filter was used.

Source: NBRM.

The increase in the enterprises level, which began at the end of 2009, continued to intensify in 2010 in continuity. During the year, credit volume placed with the corporate sector was higher by slightly more than twice. Such a credit dynamics of the corporate sector mainly corresponds to the changes in the real economy trends, the recovery of which also commenced in the last quarter of 2009, suggesting connection of the enterprises' credit growth with the economic cycle. On the other hand, the activity of the households' segment followed the economic recovery with certain delay, having in mind the fact that in 2009 the households' credit market generally stagnated. The slower recovery of the credit activity

towards the households can be explained with the poorer income position of the households and the uncertain dynamics on the labor market influenced by the crisis. Certain limiting effects on the intensity of the households' crediting can also be registered with the demand. This can be explained with the fact that in conditions of uncertainty and economic recession, the households usually become cautious, so their preference to save increases, and certain consumption plans are postponed. This can be proved also with the results of the Lending Surveys conducted in 2010, which showed certain recovery of the credit demand by the households in the first half of the year, while in the second half, it remained unchanged.

Figure 115
Changes in the supply of and demand for credits (net percentage)*

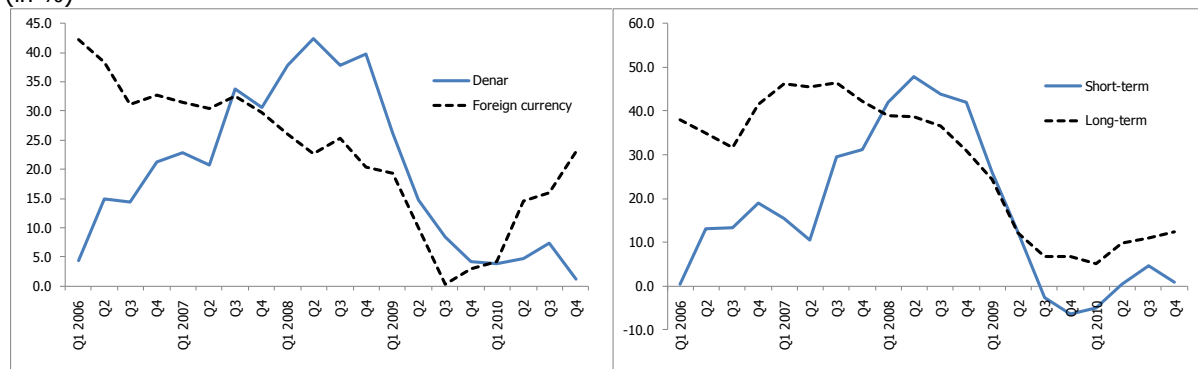


*The changes in the supply of credits refer to the net percentages of the banks' answers to the question for the change in the crediting terms. The increase in the net percentage means smaller credit offer and vice versa. The changes in the credit demand refer to the net percentages of the answer to the question about the direction of the change of the credit demand. The increase in the net percentage means larger credit demand, and vice versa.
Source: Lending Survey, NBRM.

Although the growth rate of the enterprises' credits in 2010 is twice bigger than in 2009 (3.7%), in comparison with the pre-crisis period, 2006 - 2008, the ensured credit support to the corporate sector by the banks in 2010, is expectedly more moderate, i.e. it equals 50% of the average placed credits in that period. However, it can be assessed as solid, having in mind that in this period the domestic banking sector was in a phase of credit expansion. On the other hand, the amount of placed credits with the enterprises in 2010 is twice higher than the average for the preceding three-year period 2003 - 2005, when the credit market of the banks began to develop more intensively. Such movements indicate that it is temporary adjustment of the banks in extraordinary economic circumstances caused by the crisis. With further recovery of the global and domestic economic activity, intensification of the credit support of the corporate sector can be expected.

Figure 116

Annual growth rates of the enterprises' credits from the aspect of the currency structure (left) and maturity structure (right) (in %)

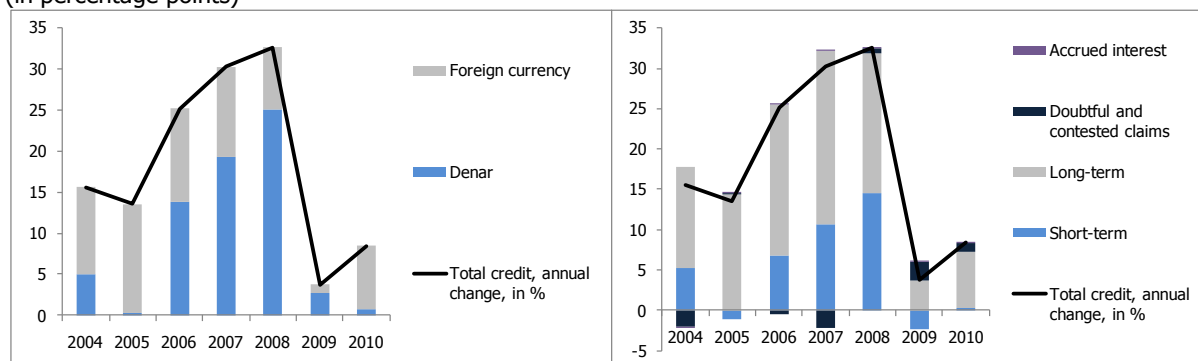


Source: NBRM.

The analysis of the currency structure of the enterprises' credits shows dominance of the foreign exchange crediting, which incremented by 23.1%, annually, contributing with 90.7% to the annual increase in the total enterprises credits in 2010. Also the credits in domestic currency registered slight increase, which equaled 1.2%.

Figure 117

Contributions to the annual increase in the enterprises' credits (in percentage points)

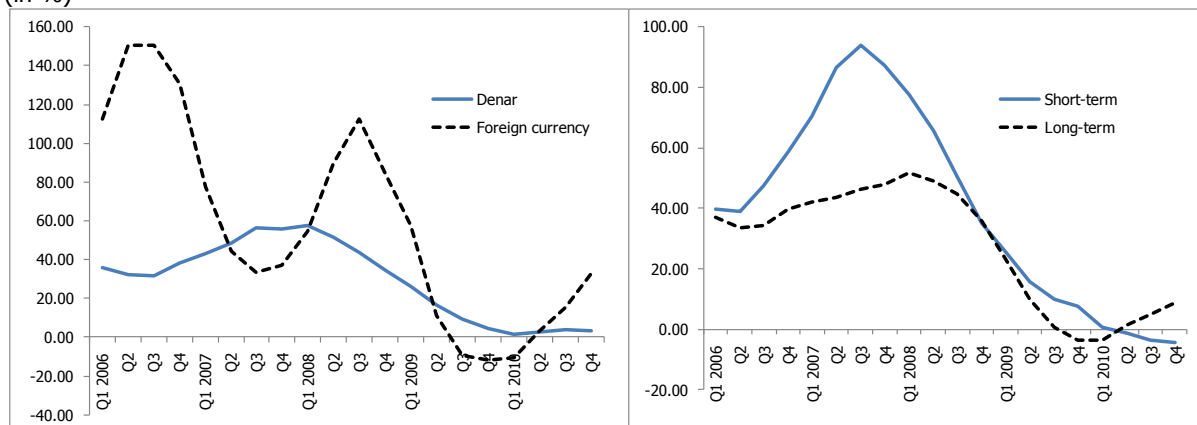


Source: NBRM.

Analyzed from the maturity aspect, dominant contribution accounts for the long-term credits (of 83.1%), which surged by 12.4%, annually. The short-term credits in 2010 registered annual growth of 0.8%. Although the growth is small, it is positive movement compared to the previous year, when decrease in the short-term credits on annual basis was registered. Namely, although the banks did not extend a lot of new credits, in 2010 they renewed the already concluded agreements for short-term credit lines, which is of large importance for the normal functioning of the corporate sector. Another positive movement is the fact that the growth rate of the suspicious and contested claims related to the corporate sector credits in 2010 began to decelerate slowly, especially at the end of the year and in December 2010 the suspicious and contested claims were higher by 12.1% annually, compared to 30.3% as this increase equaled in the previous year. In such conditions, the share of the suspicious and contested claims in the total enterprises' credits in December 2008 equaled 9.6%, compared to 11%, at the end of the third quarter and 9.3% in December 2009.

Figure 118

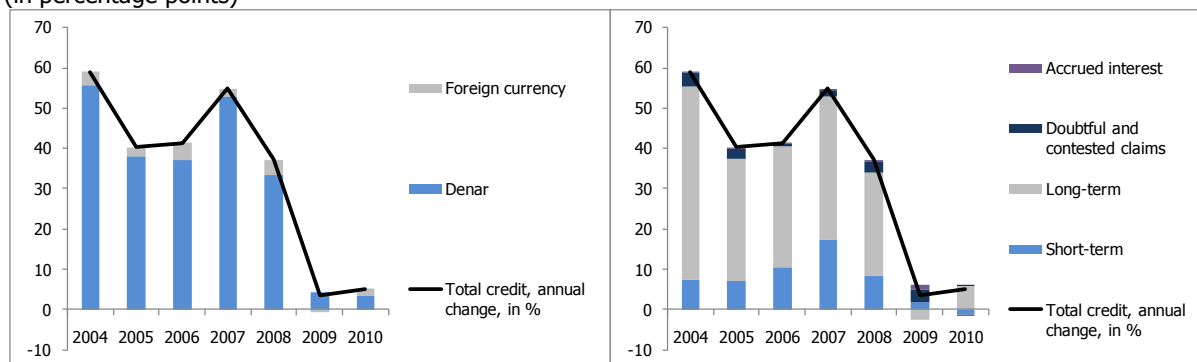
Annual growth rates of the households' credits from the aspect of the currency structure (left) and maturity structure (right) (in %)



After the general stagnation in 2009, 2010 was marked with the recovery of the households' credit market. Thus at the end of 2010 compared to the preceding year, the households' total credits were higher by 5.1%, compared to 3.5% in the previous year. Such movements show gradual normalization of the relations between the banking and the households' sector, as well as return of confidence. However, the banks facilitated, to certain extent, the crediting terms for the households sector⁸⁰. Parallel to such movements, the households' propensity to borrow, began to intensify⁸¹, although moderately. In such conditions, the volume of placed credits with the households in 2010 was more than 50% higher compared to the preceding year.

Figure 119

Contributions in the annual increase in the households' credits (in percentage points)



Source: NBRM.

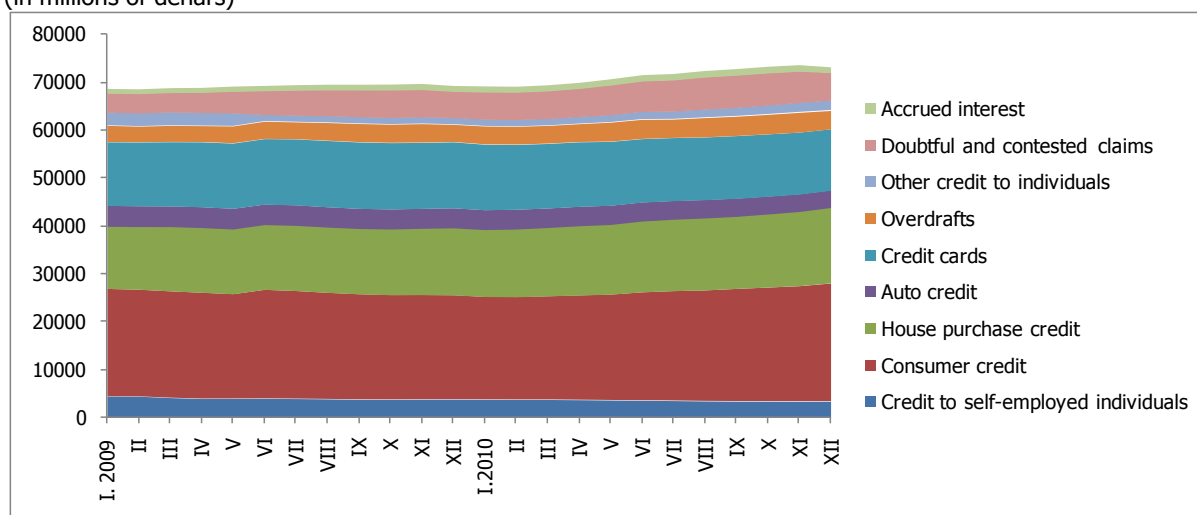
The analysis of the currency structure of the households' total credits shows more significant contribution of the Denar loans to the annual increase in the households' total credits (of 65.6%), which is in conformity with the trends registered in the several previous years. However, the Denar loans increased by 3.5% on annual basis, while the relative increase in the foreign currency credits was more positive and it equaled 33.1%. From the aspect of the maturity structure, in 2010 adverse movements compared to the previous period were registered. Thus, regarding the long-term credits, growth of 8.8% on annual

⁸⁰ Pursuant to the Lending Surveys conducted in 2010.

⁸¹ Pursuant to the Lending Surveys conducted in 2010, which show higher demand of credits in the first half, given its general steadiness in the second half of the year.

basis was registered, whereas the decrease in the short-term credits of 4.5%, opposite to the trends in 2009. In 2010, the suspicious and contested claims were getting higher with considerably slower dynamics and at the end of 2010, compared to the end of the previous year, they mounted by 6.2% (compared to 58.5% as this annual growth increased in the preceding year). Thus at the end of 2010 the share of the suspicious and contested claims in the total households' credits is almost at the level registered at the end of the previous year and it equals 8.2%.

Figure 120
Households' credits by use*
(in millions of denars)



*It refers to credits extended to households by the banking sector, without savings houses.
Source: NBRM.

With respect to the purpose, in 2010 the most frequently extended loans were the consumer ones, which registered annual increase of 13.1%, contributing with 78.5% to the annual increase in the total households' credits, opposite to the registered decrease in the previous year⁸². They were followed by the housing credits, which registered growth intensification compared to the preceding year and annually they went up by 11.8%, thus explaining 45.3% of the annual increase in the total households credits. High relative increase of 46% was registered also with the loans for other purposes, opposite to their decline in the previous year. On the other hand, the car loans and credit cards registered annual drop of 12.2% and 6.7%, respectively (annual decrease with the car loans was registered also in 2009, while the credit cards in 2009 registered positive annual change).

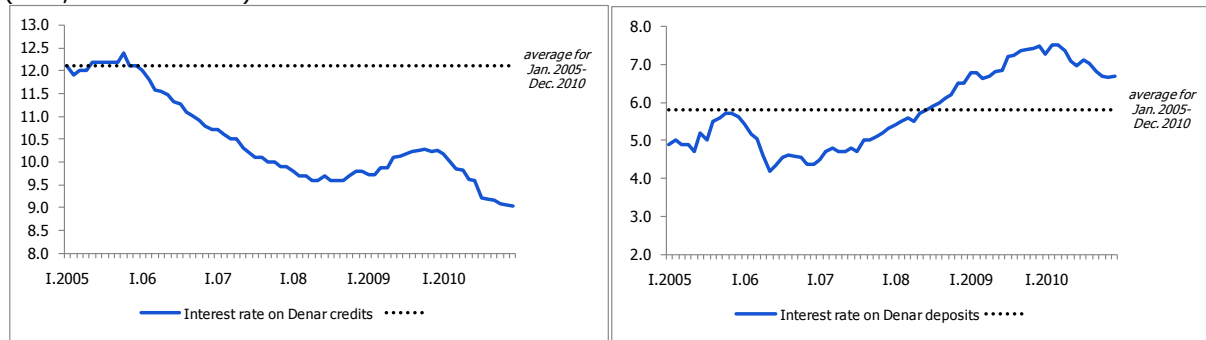
3.5. Interest rates

Opposite to the increase in the preceding year, in 2010 the interest rates on the financial markets and in the banking sector registered trend of decrease. Such movements correspond to the monetary policy relaxation during the year. The key interest rate of NBRM reduced by 4.5 percentage points, cumulatively, which was aimed at stabilization of the private sector expectations, more dynamic credit flows and thus support to the recovery process of the economy. The relaxation of the monetary terms affected also the banks' policy within the crediting terms domain. Thus during the year the banks performed downward correction of the lending interest rate. Beside the changes in the monetary policy, the crediting terms relaxation was also influenced by the recovery of the

⁸² Pursuant to the data availability, the analysis of the households' credits by use in 2009 refers to the change in December 2009 /January 2009.

domestic economic activity and thus smaller uncertainty and smaller risks, the stable growth in the sources of financing, as well as the positive global economic perceptions. Simultaneously, correction was made also with the yields that the clients generate from the deposit products, although with smaller intensity. Namely, observed on annual basis (December 2010 / December 2009) the lending interest rate fell by 1.2 percentage points, while the deposit interest rate declined by 0.8 percentage points.

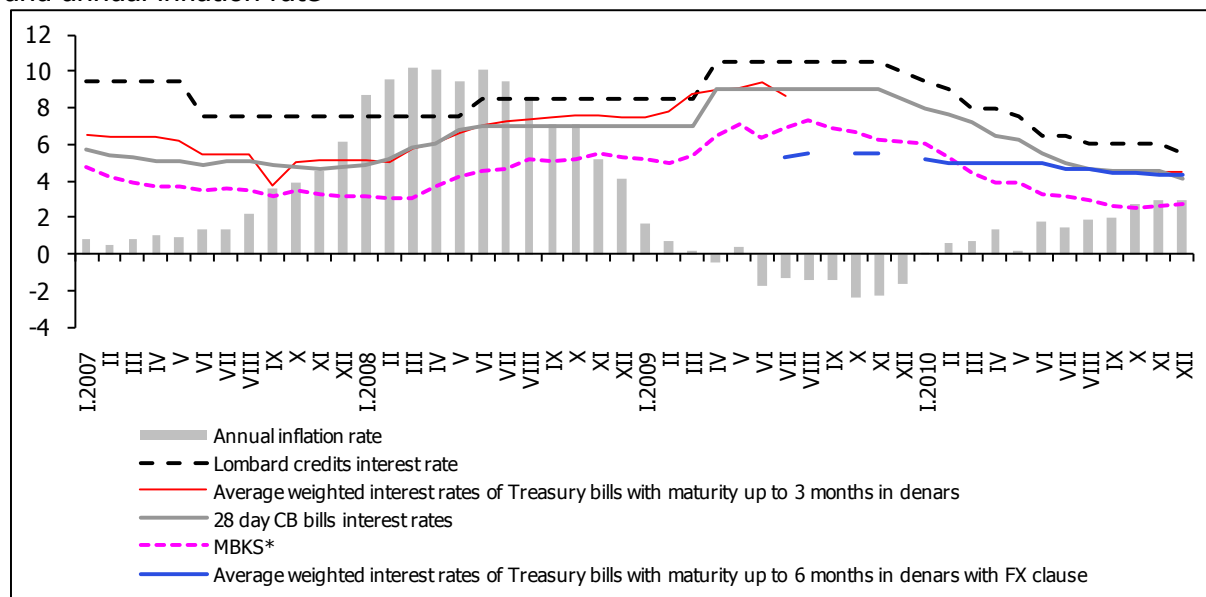
Figure 121
Lending and deposit interest rates of the banks
(in %, on annual basis)



Source: NBRM.

The changes in the monetary policy had direct impact on the interbank deposits market, where the average weighted interbank interest rate (MBKS) declined by 2.6 percentage points and returned almost to the pre-crisis level. Thus in 2010 this interest rate equaled 3.75%, while in 2007 it equaled 3.60%. The dynamics analysis by months points to constant downward trend of MBKS during the entire year, with it reducing from 6.08% in January to the historically lowest level of 2.69% in December 2010.

Figure 122
Short-term interest rates of NBRM, interest rates on the money market, securities market and annual inflation rate



*MBKS - interbank interest rate.
Source: NBRM and Ministry of Finance.

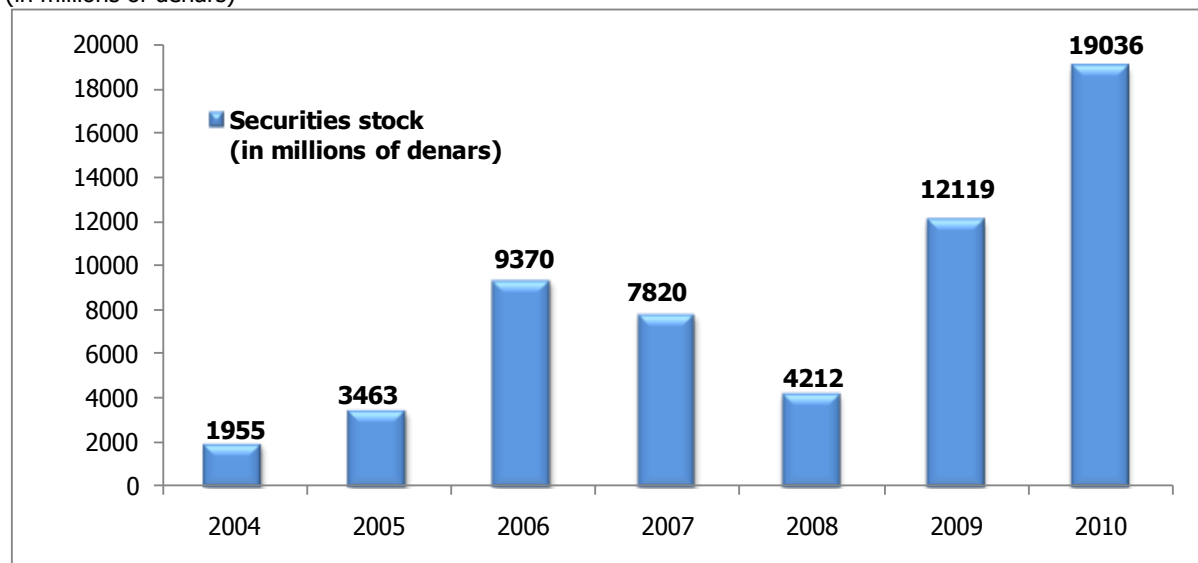
Downward movement of the interest rates in 2010 is evident on the Government securities market, as well. On this market, in 2010 the most common were the auctions with six-month Treasury bills with FX clause, with an interest rate of averagely 4.75% (5.44%, on average in 2009). In the second half of the year, the Government supplemented the supply of Government securities with three-month and six-month bills with foreign currency clause, the interest rate of which equaled averagely 4.48% and 4.73%, respectively. The interest for non-risk Government securities remained high also in 2010, with a degree of realization of the offered amount during the entire year of 92.5%.

Table 25
Movements on the securities market in 2010

	<i>Treasury bills, total</i>				<i>Treasury bills in denars</i>								<i>Treasury bills with FX clause</i>				
	Supply	Demand	Realization	Average weighted interest rate (%)	Three-month Treasury bills				Six-month Treasury bills				Supply	Demand	Realization	Average weighted interest rate (%)	
					Supply	Demand	Realization	Average weighted interest rate (%)	Supply	Demand	Realization	Average weighted interest rate (%)					
Q 1 2010	5400	5481	5264	5.06	0	0	0	0	0	0	0	0	0	5400	5481	5264	5.06
Q 2	8950	8678	8678	4.99	0	0	0	0	0	0	0	0	0	8950	8678	8678	4.99
Q 3	7362	6449	6449	4.70	0	0	0	0	2665	2665	2665	4.85	4697	3784	3784	4.60	
Q 4	13936	12587	12587	4.40	3340	3185	3185	4.48	873	352	352	4.60	9723	9050	9050	4.33	

Source: Ministry of Finance.

Figure 123
Securities stock
(in millions of denars)



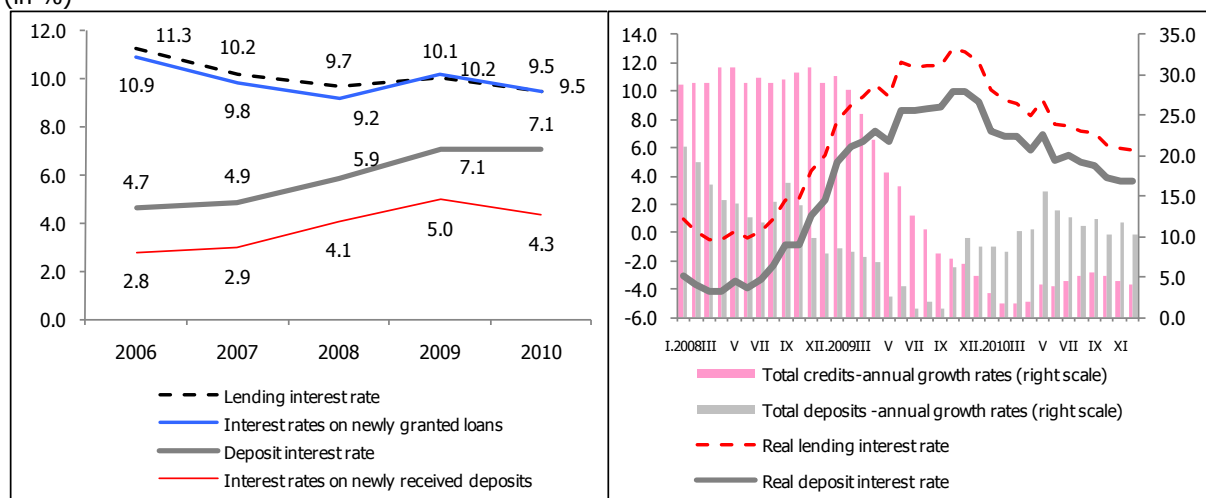
Source: Ministry of Finance.

The change in the trend of the movement during 2010 is evident also with the banks' interest rate policy, which was in direction of reduction of the credit price of the private sector, opposite to its upward trend in 2009. The interest rate on the Denar loans in December 2010 equaled 9%, compared to 10.2% in December last year. The relaxation of the interest rate terms during the year mirrors the influence of several factors. **First**, with the gradual improvement in the macroeconomic indicators of the country and the bigger optimism on the foreign exchange markets, the banks' perceptions for risk began to normalize. It contributed to bigger readiness of the banks for crediting which was followed by certain relaxation of the crediting terms. **Second**, the risk related to possible future deterioration of the economic situation in the country reduced, which is

partially mitigated the uncertainty about the financial position of the credit applicants and the risk of bigger deterioration of the credit portfolio quality. This contributed towards its increase on the side of the demand on the credit market, which was upheld with the higher supply of credit offer and facilitation of the interest rate demands. **Third**, the solid growth of the domestic sources of financing of the banks enabled larger activity of the banks and together with the smaller pressure of the on-balance limitations⁸³ created room for interest rate reduction. **Fourth**, the undertaken monetary measures through decreasing the reference interest rate, together with the amendments to the Law on Obligatory Relations which prescribes how to regulate the highest contractual interest rate⁸⁴ are important factor for the decrease in the banks' lending interest rates during the year.

Figure 124

Denar lending and deposit interest rates and annual growth rates of the total credits and deposits (in %)



Source: National Bank of the Republic of Macedonia

Despite the fact that the banks adhered to the monetary policy guidelines and acted adequately on the improved macroeconomic trends, however, there are indications for the still present limiting factors for bigger interest rate relaxation. Thus the banks have adjusted to the recovery of the economy only partially, leaving unused substantial part of the financial capacity for bigger crediting⁸⁵. This points to the conclusion that the banks still perceive the risk level in the economy on a relatively higher level than the usual one in the pre-crisis period. Hence the banks' focus on ensuring certain collection of the credit demand and prevention of further worsening of the credit portfolio quality is factor which failed to ensure larger decrease in the interest rates. Such signals were also perceived from the lending surveys conducted during the year. Although they showed evident relaxation of the crediting terms during the year, however, this process stagnated at the end of the year.

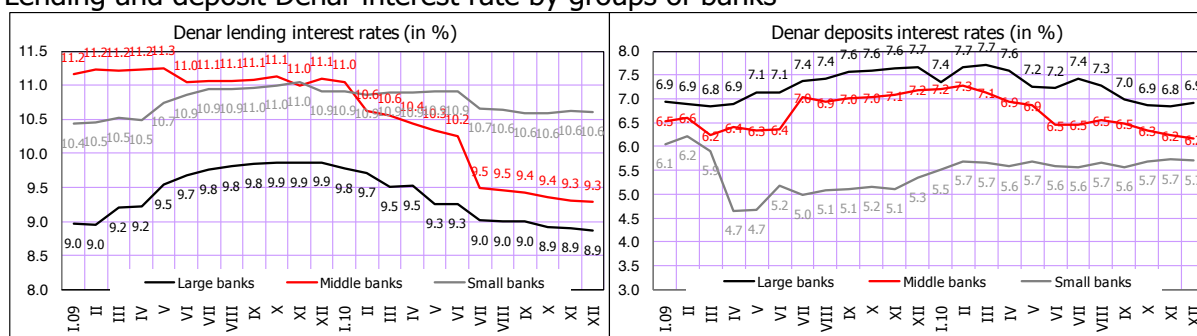
⁸³ Lending Surveys conducted in 2010.

⁸⁴ The Law on Amending the Law on Obligatory Relations that is effective since February 1, 2010, amends the manner of determining the penalty interest rate, also setting the requirement for the contractual interest rates on the bank credits not to exceed the penalty interest rate. The rate of the penalty interest is set for each half, in the amount of the interest rate on the CB bills valid on the last day of the half that precedes the current half of the year, incremented by 10 percentage points in the trade agreements and the agreements between traders and the persons from the public law, i.e. increased by 8 percentage points in the agreements in which at least one person is not a trader (previously, this interest rate was determined according to the discount rate of the NBRM). NBRM is obliged to publish its reference rate on every January 2 and July 1 on its web site and it is applied for the current six months (until the end of the half).

⁸⁵ During the year, the credits/deposits correlation was continuously falling up to 89.5% in December (95 in December 2009), given significantly more intensive deposits growth and smaller rise in the credits of the private sector.

The downward trend in 2010 was characteristic also for the deposit interest rates. However, the intensity of their decrease was smaller compared to the decrease in the banks' lending interest rates. In December 2010, the interest rates on the Denar deposits equaled 6.7%, compared to 7.5% at the end of preceding year. If analyze the average level of lending and deposit interest rates for the entire year compared to the pre-crisis period, the effect of the decrease is evident only with the interest rate on Denar credits (decline of 0.6%), while with the deposits, the average interest rate remained on the average from 2009. One of the reasons for the smaller transmission effect is the banks' policy to preserve, or to additionally increase the deposit core, as the main source of financing of the activities.

Figure 125
Lending and deposit Denar interest rate by groups of banks



Source: NBRM.

The dynamics of decrease of the banking interest rates was not identical among the sectors. The downward correction of the lending and deposit interest rates was more evident with the sector "households". Large portion of these changes mirrors the need for harmonization with the new provisions of the Law on Obligatory Relations, which became effective since February 01,2010. Namely, larger portion of the interest rates on the households' credits that were extended before the introduction of the amendments to the Law were beyond the prescribed highest contractual interest rate. Pursuant to these regulations, the banks were forced to make larger downward correction. In such conditions, in 2010 the interest rate on the total Denar loans extended to households reduced, on average, by 1 percentage point, compared to the average in the preceding year and it equaled 10%. Analyzed by months, the decrease in the price of the households' credits was characteristic for the first seven months, with its largest intensity being recorded in July. In this month, because of the necessary compliance with the amendments to the law, the interest rate on the total households' credits fell by 0.9 percentage points⁸⁶ and it reduced to the level of 9.4%. Until the end of the year, the price of the households' credits remained unchanged. Downward trend was also characteristic for the interest rates on the newly extended credits to the households, although with more apparent intensity⁸⁷. Thus the average interest rate on these credits equaled 10.9%, which is lower by 1.2 percentage points compared to the average in the previous year. At the end of 2010, it reduced to 9.5%, compared to 12.4% at the end of 2009. Beside the effect of the change in the monetary policy and the legal adjustments, the downward trend with the lending interest rates of the households incorporates

⁸⁶ On July 01,2010 NBRM announced the reference interest rate for calculation of the rate of the penalty interest which was lower by 350 base points compared to the level in January.

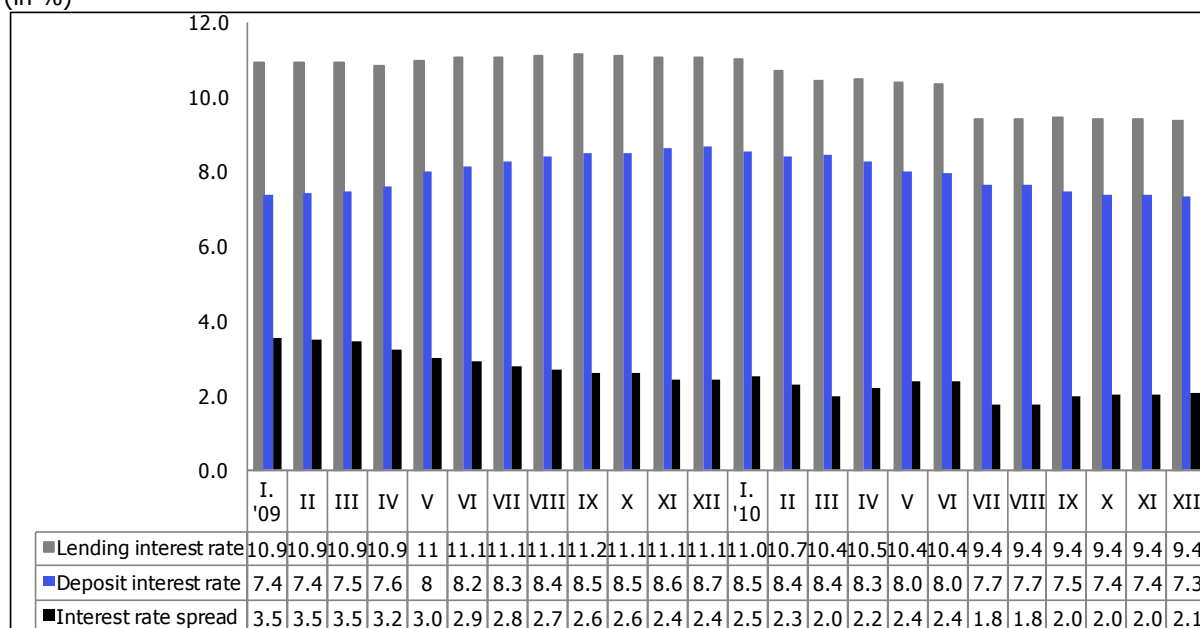
⁸⁷ The changes in the interest rates on the newly extended credits and the newly accepted deposits are considerable having in mind that they fastest reflect the changes in the monetary conditions. However, the changes in these interests are more emphasized, since they are influenced by the type of the credits or deposits which were most present during the respective month, and they can considerably differ from the previous credits and deposit structure.

also the more stable perceptions of the banks regarding the risks. In context of the aforementioned are also the results of the banks' Lending Surveys conducted in 2010. The banks indicate the favorable environment for conducting more relaxed interest rate policy, in conditions of smaller limitations regarding the financial costs and on-balance sheet positions and improved expectations for the total economic activity in the country. Also, compared to the previous year, the competitiveness factor was pointed out as factor acting for relaxation of the interest terms for the households.

Despite the positive movements with the interest terms for the households sector, the activity of this market segment is still small. According to the banks' perceptions, the risk of foreclosure failure and partial credit worthiness are some of the factors of higher significance which contribute to such movements. This shows that the perceptions for the risk degree, related to the households, failed to change considerably in 2010. Also, this shows that the decrease in the risk premium for this market segment will mostly depend on the recovery of the financial position of the households and the increase in the permanent part of the disposable income.

Figure 126

Weighted Denar lending and deposit interest rate for households (in %)

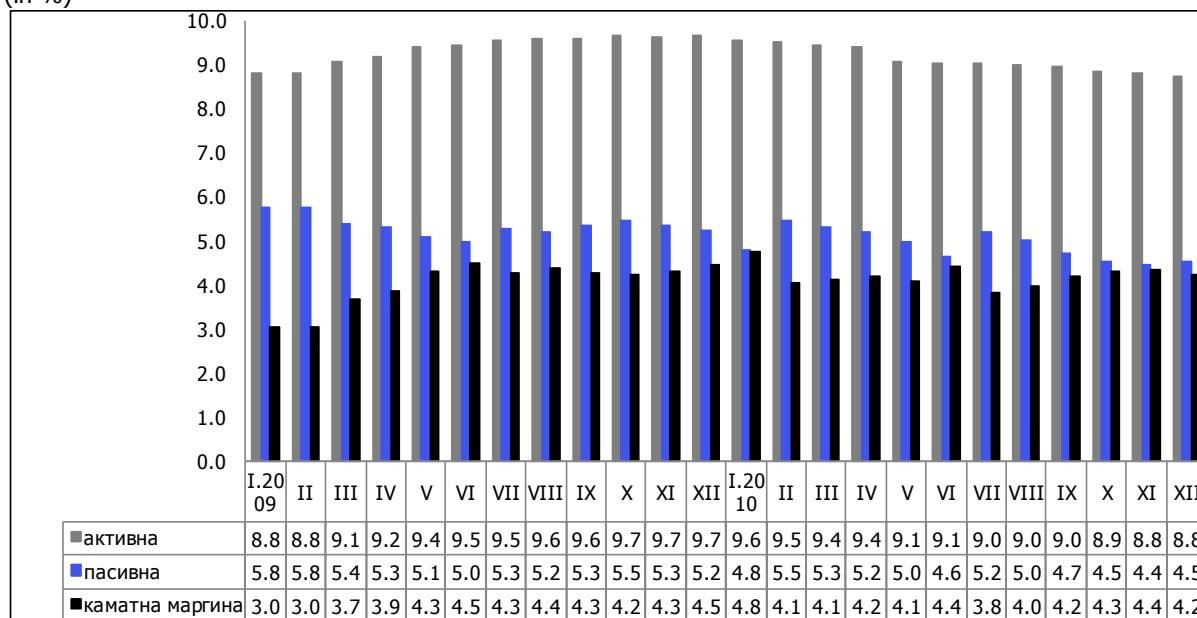


Source: NBRM.

In line with the downward corrections to the lending interest rate for the households, the banks decreased the deposit interest rates, as well, although with more moderate intensity. Thus the **average weighted interest rate on the Denar deposits** of households decreased on average by 0.2 percentage points and it equaled 7.9%. Analyzed by months, the interest rate had stable downward trend, and at the end of the year this interest rate reduced to 7.3%, compared to 8.7% in December 2009. The movements with the **newly accepted deposits** were similar, with average weighted interest rate being reduced by 0.2 percentage points and it equaled 5.1%, on average for 2010. However, the decrease in this interest rate is most evident in the first five months of the year, followed by more moderate decline in the following four months, while in the last quarter of the year, the yield of the newly placed deposits by the households registered an increase of 0.3 percentage points, on average. This shows that the competitiveness pressures on the deposit market returned during the year. However, such policy of the

banks is more expected with the households' deposits, which comprise approximately 70% of the total deposit base. Having in mind the different intensity and movement direction of the lending and deposit interest rates during the year, the interest rate spread for the sector "households" varied in certain months. However, on average, the interest rate spread narrowed on annual basis by 0.8 percentage points and it equaled 2.1 p.p.

Figure 127
Weighted Denar lending and deposit interest rate for enterprises
(in %)



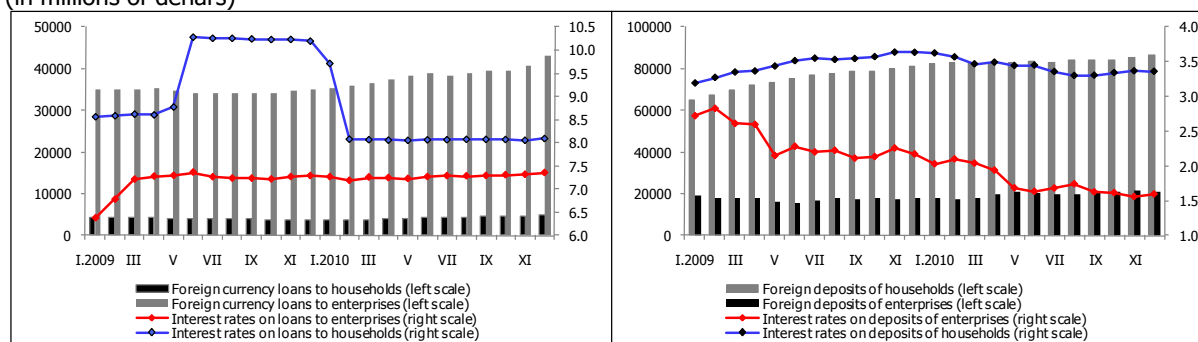
Source: NBRM.

With the corporate sector, the average lending and deposit interest rates registered almost identical decrease of 0.3 percentage points and 0.4 percentage points, respectively and they equaled 9.4% and 4.9%, on average for 2010. In comparison with the "households" sector, the decrease in the lending interest rates is smaller almost by twice, while the deposit interest rate registered twice bigger decrease. The monthly analysis points to more significant variability with the deposit interest rates in both directions, which contributed towards larger monthly oscillations also with the interest rate spread. However, on average, the interest rate spread with the enterprises augmented by 0.2 percentage points and it equaled 4.2 p.p. At the end of 2010, **the weighted interest rate on the Denar corporate credits** equaled 8.8% (9.7% in December 2009), while the **weighted interest rate on the Denar deposits** equaled 4.5% (5.2% in December 2009). The moderate decrease in the price of the corporate credits is in line with the banks' perceptions stated in lending surveys conducted during 2010. Namely, despite the general assessment for more stable perceptions and smaller restrain of the banks, the risk of foreclosure failure, as well as the risks related to the future economic situation are the main factors that influenced on the maintenance of the banks' behavior regarding the interest rate terms and the credit offer to the enterprises. The interest rates on the newly extended credits and newly accepted deposits also fell, with the decrease in the deposits price being more evident compared to the decrease in the credit price. Thus the **average weighted interest rate on the newly extended credits** decreased by 0.6 p.p. and it equaled 9% on average for 2010, while the **average weighted interest rate on the newly accepted deposits reduced** by 1.2 p.p. and it equaled 3.5%. At the end of the year, the interest rate on the newly extended credits equaled 8.3% (9.6% in December

2009), while the interest rate on the newly accepted deposits equaled 2.6% (4.2% in December 2009).

Figure 128

Monthly dynamics of the foreign currency credits and deposits of the private sector and of the lending and deposit foreign exchange interest rate (in millions of denars)



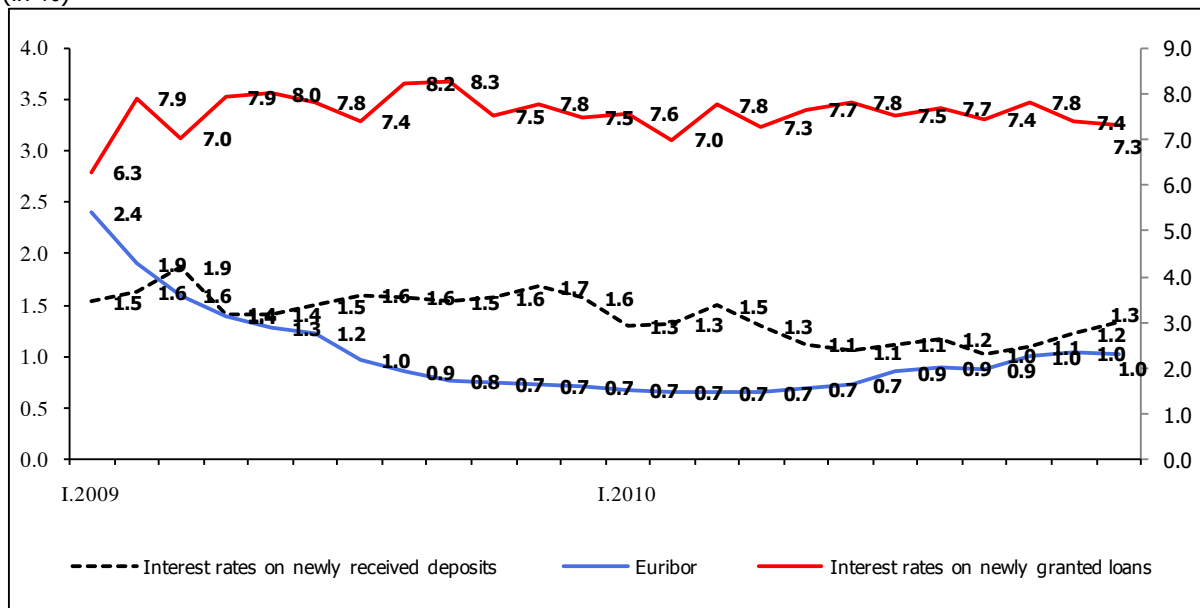
Source: NBRM.

Opposite to the movements related to the Denar interest rates, the interest rates on the foreign currency credits and deposits registered minimal change, mainly registered with the interest on total and newly accepted deposits. Thus the average weighted interest rates on the total and newly accepted deposits decreased by 0.2 p.p. and 0.44⁸⁸ p.p. and it equals 1.2% and 0.8%, respectively. On the other hand, the average weighted interest rate on the foreign currency credits retained the average from 2009 and it equaled 7.4%, while minimal average annual growth (of 0.1 p.p.) was registered by the interests on the newly accepted foreign currency credits, the average interest rate of which equaled 7.5%. From the aspect of the individual sectors, generally, the sector "households" characterized with a decrease in the lending interest rates (of 1.4 p.p., on average), given unchanged level of deposit interest rates. Regarding the corporate sector, the deposit interest rates fell by 0.6 p.p. on average, opposite to the moderate increase of 0.1 p.p. on average for the lending interest rates.

⁸⁸ In 2010, the three-month EURIBOR dropped by 0.4 percentage points, on average for the entire year.

Figure 129

Foreign exchange lending and deposit interest rate and three-month EURIBOR
(in %)

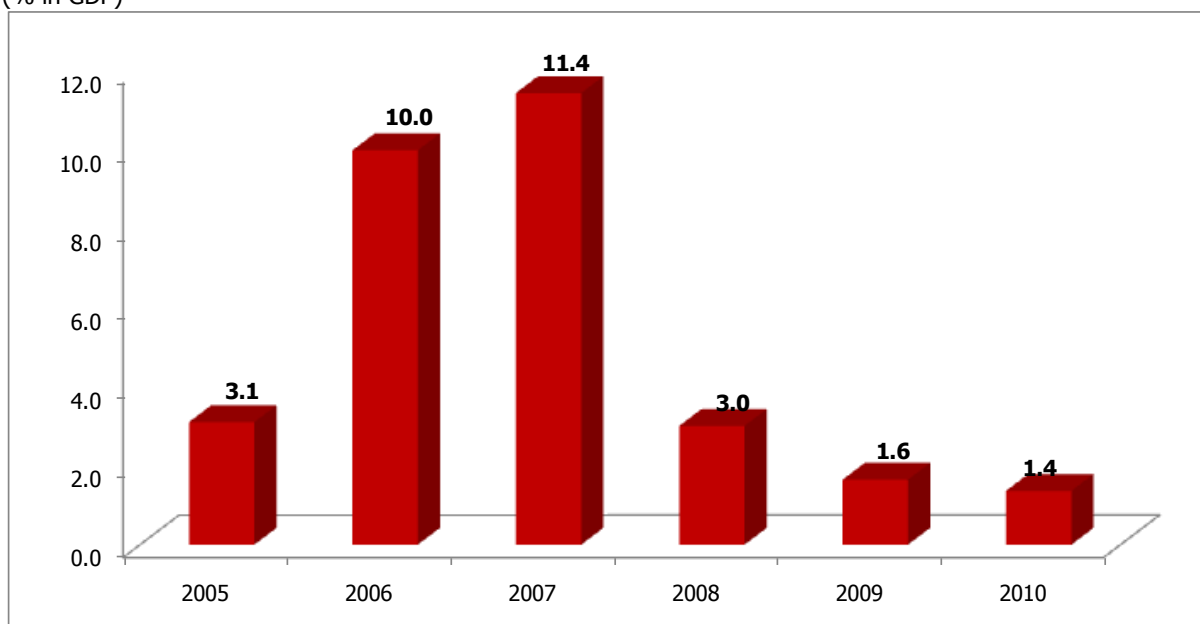


Source: NBRM.

IV. Capital market

The Macedonian capital market in 2010 characterizes with small trading volume and annual drop in the turnover in almost all stock exchange segments. Thus the total stock exchange turnover continued to decrease for third consecutive year. Such movements show relatively slow stock exchange reaction to the gradual economic recovery and the considerable decrease in the macroeconomic risks. Namely, despite the relative stabilization of the macroeconomic environment, however the investors during the year were not ready to take risk and make bigger investment decisions. Parallel to the smaller turnover on the stock exchange, the Macedonian stock exchange index also lowered. The participation of the foreign investors on the stock exchange was relatively small in 2010, as well, which resulted in twice smaller turnover relative to the preceding year.

Figure 130
Stock exchange turnover by years
(% in GDP)



In 2010, the Macedonian stock exchange index (MBI-10) registered annual decrease of 1.3%, on average, given changes in the direction and the dynamics of its movement during the year. Thus until mid-February, MBI-10 registered mainly upward trend, when it reached the highest level for 2010⁸⁹. Until the end of the year, the value of the index moved mainly downwards, in conditions of still poor interest for investments in financial instruments on the stock exchange and low risk tolerance. In the third quarter, despite the certain recuperation of the turnover (mainly as a result of the increase in the block transactions), MBI-10 continued to decrease, and at the end of September, it reached its lowest level for 2010⁹⁰. Certain positive movements were registered in November, after which the stock exchange, basically, stagnated. Despite the

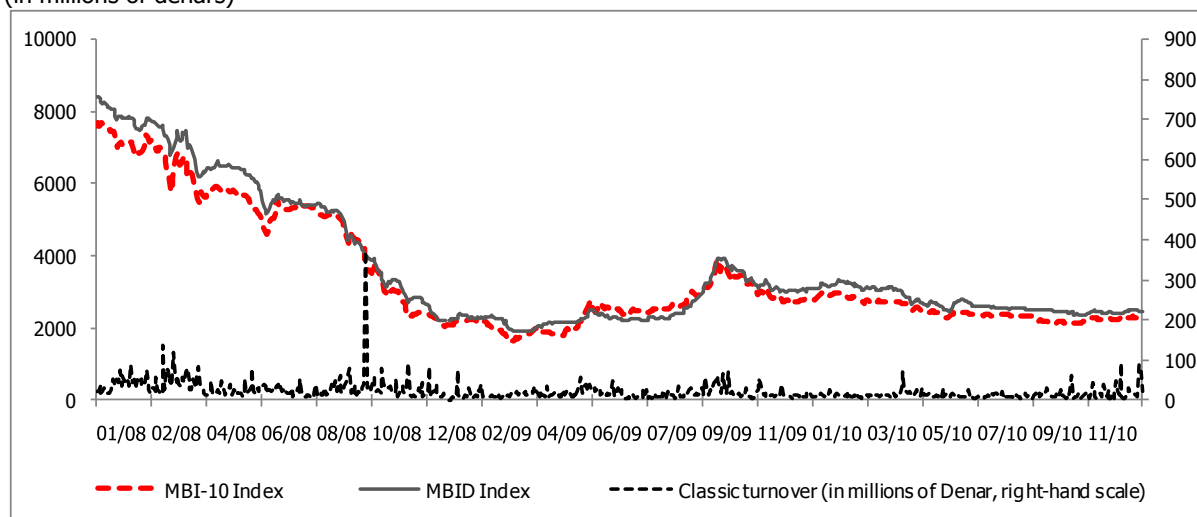
⁸⁹ MBI-10 the highest level on February 04, 2010 of 2,978.3 index points.

⁹⁰ MBI-10 the highest level on September 30, 2010 of 2,084 index points.

fact that the index of the publically owned companies MBID⁹¹ in 2010 basically followed the daily movements of MBI-10, however on average it registered annual increase of 7.1%.

Figure 131

MBI-10, MBID and stock exchange turnover realized based on classical trading
(in millions of denars)



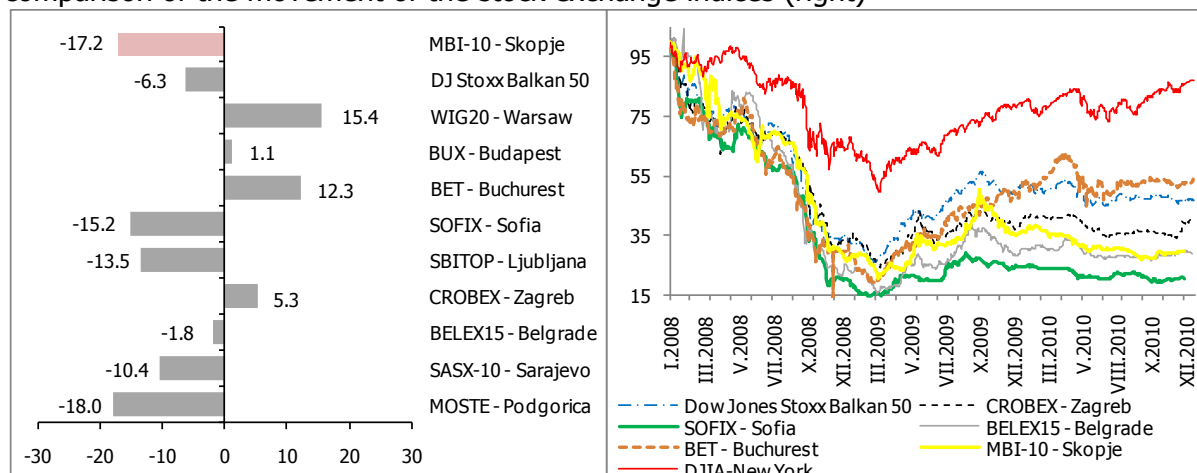
Source: Macedonian Stock Exchange AD Skopje.

The activities dynamics on the capital market in the group of SEE countries was variable. It was mainly driven from the information obtained from the movements on the stock exchange capital market, as well as from the situation on the European financial system. The analysis shows that the regional stock exchanges commenced in 2010 with positive movements. These movements mainly resulted from the improved expectations for recovery from the global financial crisis, and the regain of confidence of the investors. However, the unfavorable situation regarding the public finance of Greece and the debt situation of Ireland resulted in new bigger constraint of the investors and worsening of the regional stock exchange indices in the following period. Moderate recovery of the stock exchange at the end of 2010 was registered, as a reaction to the established mechanism by the European Union, thus ensuring financial support to the countries with current or potential problems with the public finance. **Such movements on the regional stock exchanges in 2010 conditioned worsened stock exchange indices at the end of the year compared to 2009.** Namely, part of the stock exchanges registered deceleration of the annual growth rate of the stock exchange index, and another its decrease. The severest annual decrease was registered with the stock exchange indices of Montenegro and Hungary, while improvement was registered only with the stock exchange index of Bosnia and Herzegovina. At the end of 2010, the highest annual growth rates of the stock exchange indices was registered by the Polish Warsaw Wi of 15.4% and Romanian BET Bucharest of 12.3%.

⁹¹ Price non-weighted index, the composing part of which are selected by taking into consideration the number of trading days and the realized turnover between two index revisions.

Figure 132

Annual growth rates of the national and composite regional stock exchanges⁹² (left) and comparison of the movement of the stock exchange indices (right)



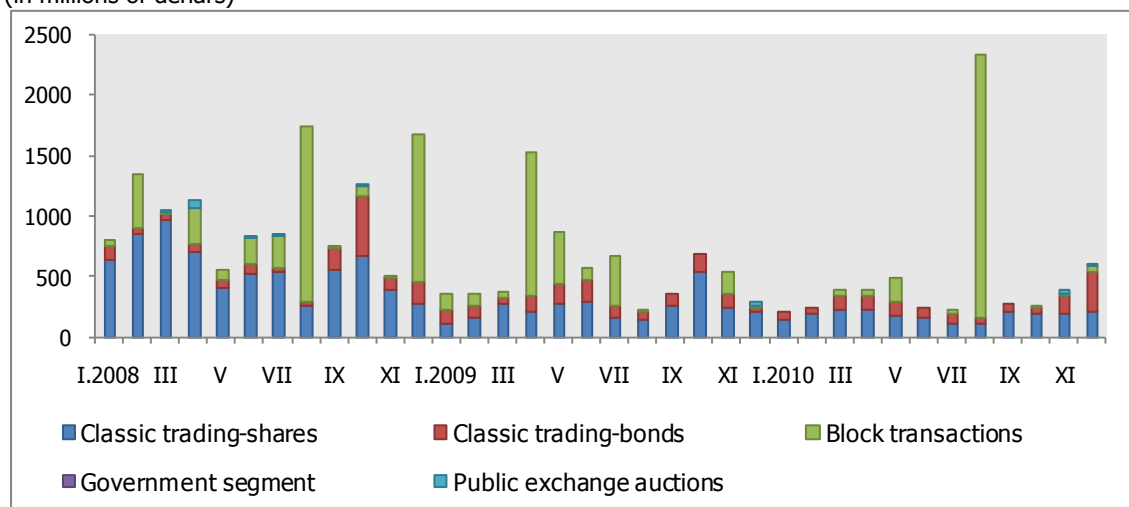
Source: Bloomberg, Macedonian Stock Exchange AD Skopje, national stock exchanges.

In 2010, the total stock exchange trading totals Denar 5.8 billion, which is decrease of 13.2% compared to the previous year. Smaller trading was registered with all stock exchange segments, except to the public stock exchange auctions. However, the reduced stock exchange turnover is primarily a result of the smaller volume of classical trading with shares, which declined by 27.8%, annually. During the year, the dynamics of the classical trading with shares was divergent, i.e. simultaneous decrease, i.e. increase in the trading was registered. At the end of 2010, the largest turnover with the classical trading with shares since the beginning of the year was registered. The largest participation in the stock trading in 2010 accounted for the companies from the banking system and the pharmaceutical industry. Also, in the last two months of 2010, for the first time since the beginning of the year, turnover through public stock exchange auctions was realized. Regarding the turnover through the block transactions, annual decrease of 2.9% was registered, with the largest turnover of this stock exchange segment being realized in August, as a result of the double block transaction.⁹³

⁹² Dow Jones Stoxx Balkan 50 includes shares of the 50 largest and most liquid companies from eight Balkan stock exchanges.

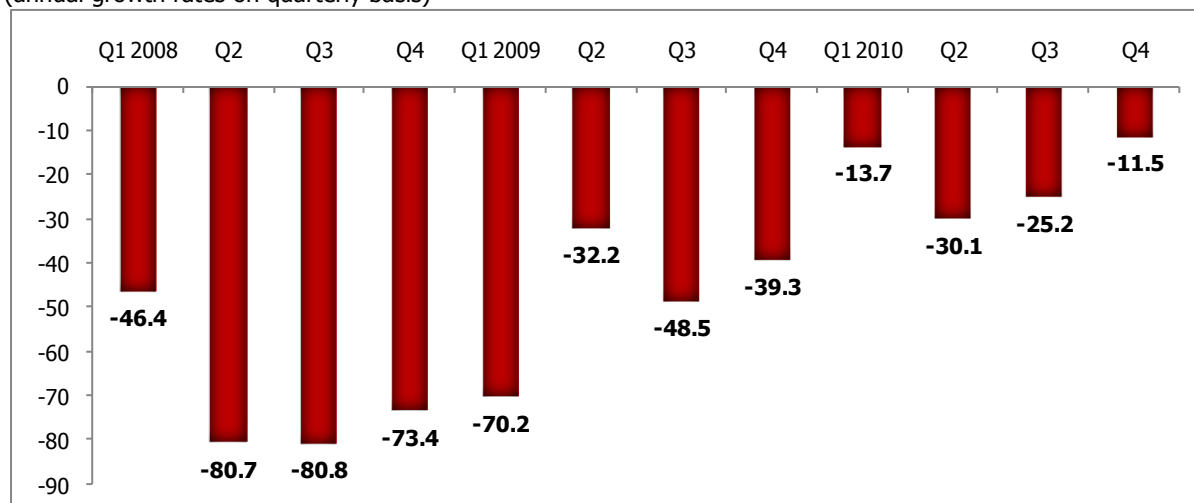
⁹³ On August 17, 2010, two block transactions referring to the ownership transfer of part of the stakes (about 21%) of one bank in the country were realized, from the International Financial Corporation (IFC) and the European Bank for Reconstruction and Development (EBOR) towards its dominant foreign shareholder, the National Bank of Greece.

Figure 133
Structure of the stock exchange turnover⁹⁴
(in millions of denars)



Source: Macedonian Stock Exchange AD Skopje.

Figure 134
Stock exchange turnover realized through classical trading
(annual growth rates on quarterly basis)



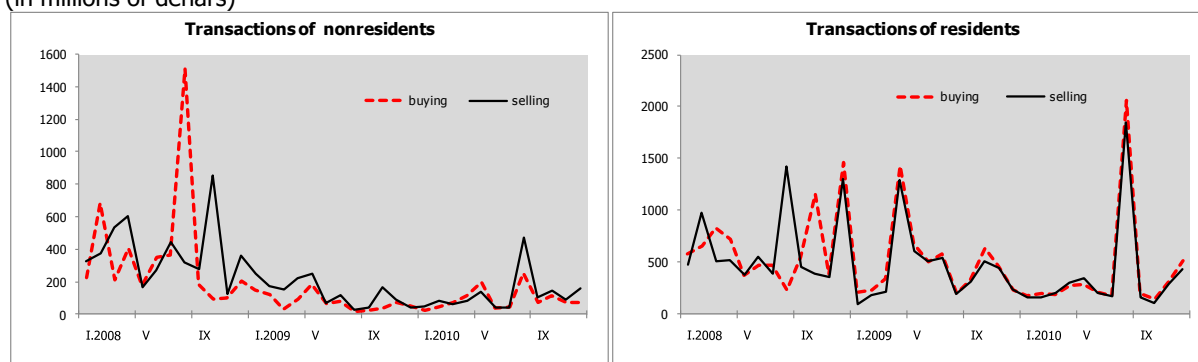
Source: Macedonian Stock Exchange AD Skopje.

⁹⁴ **Classical trading** on the stock exchange implies trading through "BEST" (stock exchange electronic trading system) on the Macedonian stock exchange. The turnover realized with classical trading does not include the turnover realized on the public stock exchanges and the registered bloc transactions; **The public stock exchange auctions** are conducted on a special stock exchange segment within the "BEST". The subject of auctions is the state capital in form of shares in the joint stock companies in the Republic of Macedonia owned by the Republic of Macedonia and the Government authorities, which are sold by the authorized Government authorities, as well as the shares owned by the Pension and Disability Insurance Fund of Macedonia. Shares offered by the National Bank of the Republic of Macedonia, on a manner and terms defined by the law, can be subject of auction; **Bloc transaction** is a security transaction which is concluded with intermediation of one or more members of stock exchange out of the regular trading at "BEST". The bloc transaction can be concluded only with shares. The members of the stock exchange can conclude bloc transaction only if the value of block transaction amounts at least Denar 5.000.000.00. The price of the registered bloc transaction for the shares that are traded on the official and regular market on the stock exchange shall not deviate more than $\pm 10\%$ of the weighted average price of all transactions with these shares on the stock exchange in the last 30 calendar days, including the trading day of registration of the block transaction. If the shares which are traded on the official and regular market on the stock exchange, which are subject of bloc transaction, were not traded in the last 30 calendar days, including the trading day of registration of the block transaction, the price of auctions in the bloc transaction is freely created.

The transactions with nonresident were lower in 2010, as well, and the foreign investors reduced the investments in securities on net basis, on the Macedonian capital market in the amount of Denar 352.2 million. At the end of the year, the foreign investors participated with 24.61% in the total principal of the companies and 2.27% in the total nominal value of the bonds (26.91% and 3.57%, respectively, at the end of 2009). The poor activity of the foreign investors on the Macedonian Stock Exchange shows that their readiness and capacity for new investments remain small. Hence, longer period of continuous and sustainable economy growth and positive performances of the companies is needed for return of the foreign investors on the domestic capital market. As for the domestic investors, in 2010 the domestic natural persons reduced the investments in the amount of Denar 785 million on net basis, while the domestic legal entities invested Denar 1,136.1 million, net.

Figure 135

Turnover on the stock exchange in 2010, according to the investors and the direction of the transactions
(in millions of denars)



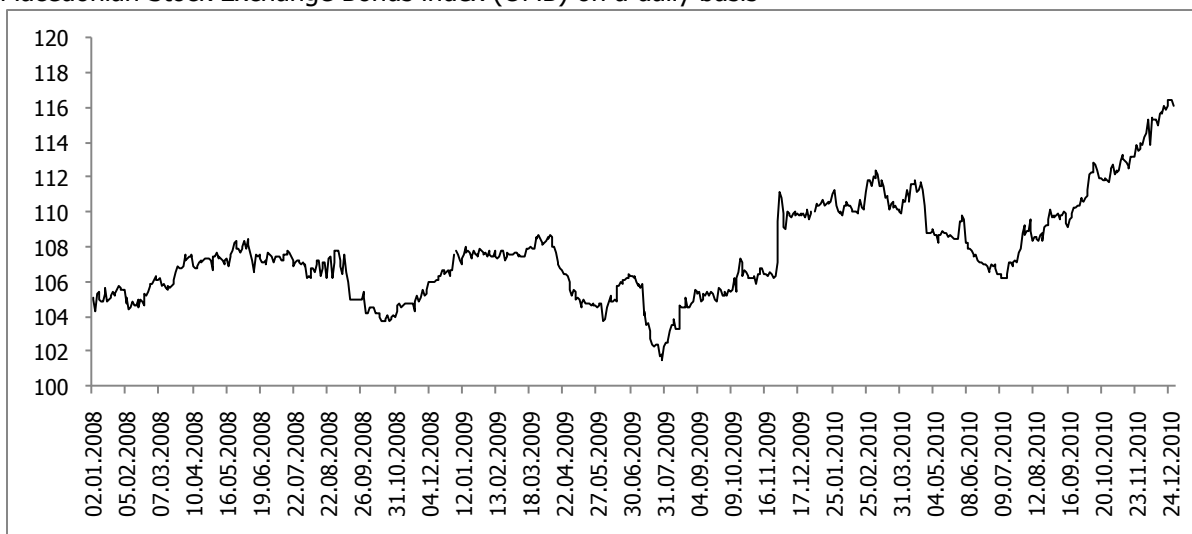
Source: Macedonian Stock Exchange AD Skopje and NBRM calculations.

The registered bonds turnover on the Stock Exchange official market⁹⁵ in 2010 equals Denar 1,252.2 million and it is lower by 4% compared to the previous year. The most traded were the denationalization bonds of ninth issue (50.8% of the total bonds turnover). During the year, the bonds price ranged from 87% (denationalization bond from seventh issue) to 100% (cooperative bond of NLB Tutunska Banka AD Skopje) of the nominal value. Upward trend of the Macedonian Stock Exchange Bonds Index⁹⁶ (OMB) was registered in the second half of the year. Such movement corresponds to the increase in the bonds turnover. In December this index reached its maximal value of 116.5 index points. On annual basis, the OMB index registered an increase of 5.5% compared to the previous year.

⁹⁵ Listed securities are traded on the **official market on the stock exchange**. Listing of securities represents procedure of introduction of a security on the official market in accordance with certain criteria prescribed by the stock exchange and the liability for regular public disclosure of financial and non-financial information and data vulnerable to price change. On the official market there is a classification of **stock exchange listing** and **super listing**. The second segment on the stock exchange is the regular market where there is division: market of publicly held joint stock companies and free market. **The market of publicly held joint stock companies** is a segment where the non-listed securities are introduced issued by the joint stock companies with special responsibilities for notification, in accordance with the Law on Securities. Since 10.09.2009, the name of the market segment "market of publicly held joint stock companies" is changed in **market of joint stock companies with special responsibilities for notification**. **The free market** is the market segment where all other securities are traded except for the one being traded on the official market and the market of publicly held joint stock companies.

⁹⁶ The OMB index is composed of bonds for old foreign exchange saving and the Denationalization bonds from the first, second, third, fourth, fifth, sixth, seventh and eighth issue. OMB is price index weighted with the turnover, with limitation that the stake of any of the bonds composing the index should not exceed 30%.

Figure 136
Macedonian Stock Exchange Bonds index (OMB) on a daily basis



In 2010, smaller trading on the over the counter market compared to the previous year was registered. Thus transactions with Treasury bills in nominal amount of Denar 333.8 million were realized on this market (Denar 428.9 million in the preceding year) and transactions with CB bills in nominal value of Denar 250 million (compared to Denar 340 million in 2009).

V. Management of foreign reserves in 2010

Pursuant to Law on the National Bank of the Republic of Macedonia, one of the main tasks of the National Bank is management of foreign reserves of the Republic of Macedonia (hereinafter referred to as: foreign reserves). The National Bank manages foreign reserves in conformity with the best international practices and the main objective - attaining and maintaining the price stability.

The foreign reserves the National Bank manages consists of gold, foreign exchange in the vault of the National Bank, foreign assets abroad (foreign assets on the current accounts abroad, deposits and certificates for deposits, debt coupon and discount securities) and special drawing rights with the International Monetary Fund.

The basic principles in the foreign reserves management are providing security, liquidity and profitability of the invested funds.

The security is provided through maintenance of the foreign reserves value with adequate management of credit and interest rate risk.

The liquidity is ensured through investment of the foreign reserves in liquid financial instruments that ensure fast conversion in the most liquid assets at minimal costs.

Adhering to the principles of security and liquidity, the profitability is provided through investment of foreign reserves for the purpose of maximum return on a long term basis.

5.1. Main guidelines in the foreign reserves management in 2010

The foreign reserves management is determined by the implementation of the monetary strategy of maintenance of Denar foreign exchange rate stability relative to the Euro, as well as by the need for timely and regular settlement of the Government liabilities to abroad.

In line with these objectives, and having in mind the adherence to safety, liquidity and profitability principles, in 2010 the basic guidelines for the foreign reserves management were the following:

1. Maintenance of the established foreign reserves' currency structure, where the dominant share accounts for the Euro, with simultaneous maintenance of the level of US Dollar and other currencies⁹⁷, in conformity with the currency structure of the liabilities for payments abroad;
 - *Ensuring safety of the foreign reserves through determining of both levels of maintenance of low credit exposure of the investments:*
 - *placement of foreign reserves in countries, financial institutions and instruments with higher credit rating according to the rating-agencies "Standard and Poors", "Moody's" and "Fitch".*
 - *distribution (diversification) of the investments in foreign reserves by countries, by institutions and individual types of securities, with implementation of the set limits according to certain macroeconomic and market indicators.*

⁹⁷ Other currencies include: Australian Dollar, Canadian Dollar, Swiss Frank, Danish Crone, Norwegian Crone, British Pound, Japanese Yen, Swedish Crone and Special Drawing Rights.

2. Maintenance of adequate level of liquidity of foreign reserves through management of two portfolios - liquidity and investment portfolio.
 - *The liquidity portfolio is aimed at disposing enough funds for satisfying the daily liquidity needs for performing interventions on the foreign exchange market and of Government transactions abroad. Within the liquidity portfolio, the most common are the investments in short-term deposits with the central banks.*
 - *The investment portfolio provides high level of foreign reserves liquidity through investment mostly in liquid Government securities, which can easily be converted, if needs additional liquidity, in liquid funds without additional costs. The level of investment portfolio is relatively stable during the year, which enables investment of funds on long-term term and attainment of higher return.*
3. Limitation of the exposure of the foreign reserves to intercurrency changes through:
 - *maintenance of the level of the US Dollar and other currencies within the set maximum limits of their share in the foreign currency structure. The part of the foreign reserves which is invested in Euro is not subjected to currency changes, having in mind "de facto" fixed exchange rate of the Denar relative to Euro;*
 - *maintenance of constant quantity of gold, as strategic investment assets for satisfying the needs for maintenance of foreign reserves liquidity in conditions of global economic and political instability.*
4. Maintenance of low exposure of the foreign reserves to the price changes of the securities within the foreign reserves investments through:
 - *placement of investment portfolios in securities for trading with target modified duration in order to enable more efficient adjustment of the investments in case of yield growth;*
 - *placement of part of the investment portfolio in Euros in securities, with explicit commitment for their keeping until maturity for the purpose of mitigation of the effects of the price changes.*

During the year, the foreign reserves management was realized in conformity with the basic principles. Depending on the current market conditions, timely perception of possible deviation from the envisaged frameworks and need of undertaking activities towards realization of the priorities in determining the foreign reserves was provided.

Annex 7: Undertaken activities for improvement of the foreign reserves management

For the purpose of better efficiency in the liquidity risk management, in 2010 the National Bank establish operational framework for realization of repo transactions with securities from the foreign reserves portfolio. In that direction, the National Bank concluded repo agreements with several reputable foreign commercial banks which had high credit rating, according to the criteria for credit risk management. The concluded repo agreements are in conformity with the international association standards on the securities market (ISMA). ISMA provides security for the contracting parties since it imposes implementation of high standards of market practices and adequate and uniform regulatory basis, which supports the trading.

The repo transactions ensure providing of short-term liquid assets through temporary sale of securities, with requirement for their repurchase on certain previously determined

date at previously agreed price. This manner provides bigger flexibility in the management of the liquidity of the foreign reserves. Simultaneously, this framework enables implementation also of transactions for lending (the so-called Securities lending,) as investment possibility for using the portfolio of securities for generating higher income.

Additionally, for the purpose of ensuring profitability, in conditions of instable market movements, possibilities for broadening of the instruments spectrum the foreign reserves are invested in were analyzed, without distracting the safety and liquidity of the investments. In that direction, it was decided to enlarge the placements in Germany, as a leading country in the Euro zone, enabling, beside the investment in Government securities, larger investments in securities issued by the financially most powerful federal countries.

For the purpose of adequate monitoring of the performances resulting from the foreign reserves management, possibility for application of external indices with characteristics more similar to those of the investment portfolio in Euros was examined. The applied external index, comprised exclusively from Government debt securities issued by Germany, failed to reflect adequately on the investment portfolio in Euros due to the established quantitative limitations by countries, which do not allow full exposure of the foreign reserves to one country.

In order to exceed these limitations, at the end of 2010, the constant external index was replaced with new composite index, the basic target modified duration of which corresponds to the target modified duration of the investment portfolio in Euros, with the geographic allocation of the index simultaneously clearly depicting the quantitative limits of the National Bank by countries. In that manner, the application of the new index will enable better consistence, representativeness and measurability of the results of the foreign reserves investment.

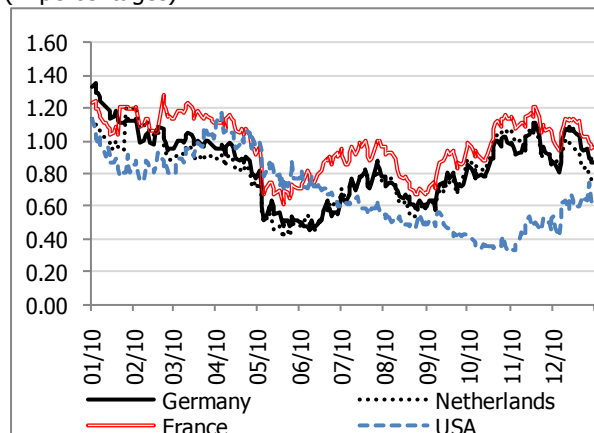
5.2. Conditions for investment on the international financial markets

In 2010, the conditions on the international financial markets have been changing fast and frequently, leaving only few certain investment options to the investors. The recovery from the financial crisis impact and the undertaking of comprehensive financial measures for supporting the banking system in 2009 caused increase in the public debt and emergence of state debt crisis with the so-called "periphery" Euro area member states. In such conditions, need for introduction of extensive and controversial measures for ensuring financial stability⁹⁸ imposed. Thus for the purpose of ensuring financial support to the countries facing with fiscal problems, European Financial Stability Facility was established, while the European Central Bank was continuously providing liquidity on the financial markets through purchase of debt securities. These measures resulted in temporary stabilization of the market movements, additionally stimulated from the positive economic indicators for growth of the gross domestic product in the Euro area and adoption of the new banking regulations "Basel 3".

However, during the year, the investors' general perception of the financial markets remained unchanged having in mind the uncertainty related to the debt crisis of the periphery Euro area member states. In such circumstances, the investor preferred safe Government securities, focusing the demand to the securities issued by Germany, France, the Netherlands and the USA which influenced towards decrease in their yields.

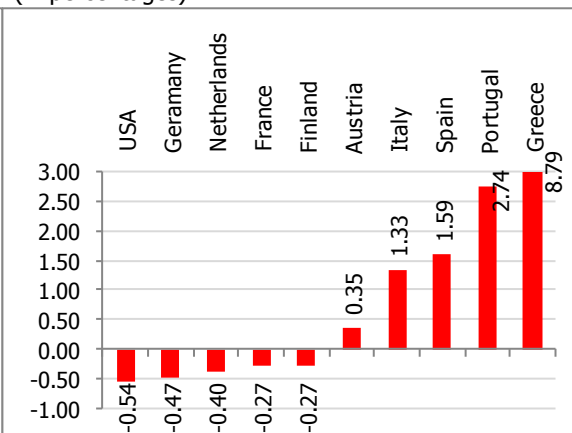
⁹⁸ Danmarks Nationalbank, Monetary review 4th Quarter 2010 - The crisis in European Sovereign Debt Markets

Figure 137
Movement of the yield from two-year securities
(in percentages)



Source: Bloomberg.

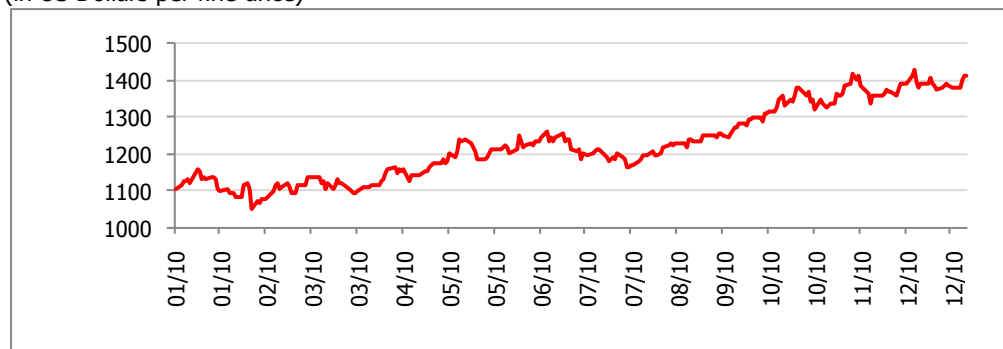
Figure 138
Annual changes of the yields of two-year Government bonds
(in percentages)



The bigger uncertainty related to the overcoming the fiscal deficits problems with part of the Euro area countries contributed towards bigger instability of the value of the common currency of the Euro area relative to the US Dollar. Observed on annual basis, the value of the US Dollar mounted by 7.8% relative to the Euro⁹⁹, as a result of the larger demand of the investor for this currency, which is considered safe haven currency in conditions of crisis.

The gold was the only financial instrument the price of which registered continuous growth trend during the entire year. The increase in the gold price resulted from the investors' larger demand which were in quest of protection from possible escalation of the debt crisis in Europe, the mounting consumer prices and reduced currencies value.

Figure 139
Gold price
(in US Dollars per fine ounce)



Source: Bloomberg.

5.3. Foreign reserves investment

The adhering to the given guidelines for foreign reserves management determined the investments' structure, which provided low exposure to the currency, credit, liquidity and interest rate risk.

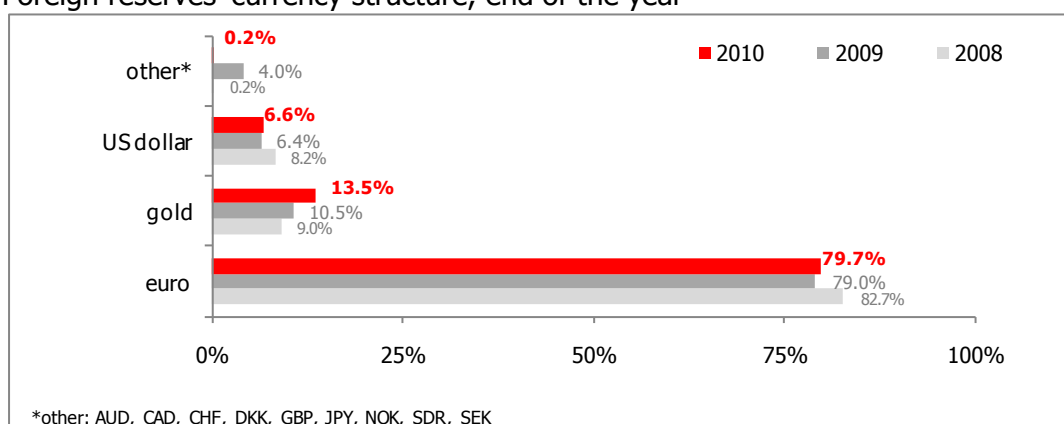
⁹⁹ At the end of 2009, the value of the US Dollar equaled US Dollar 1.4406 per Euro, while at the end of 2010, US Dollar 1.328 per Euro were traded.

5.3.1. Currency structure

Having in mind the de facto fix foreign exchange rate of the Denar relative to Euro, the National Bank maintained stable currency structure of the foreign reserves, where the Euro has dominant share with 79.7% in the foreign reserves.

The share of the US Dollar remained stable, while the share of the gold increased by 3 percentage points, as a result of the increase in its market value. The level of other currencies in the foreign reserves' structure reduced as a result of the use of the Special Drawing Rights, which were sold for Euros. As a result of this transaction, the relative share of other currencies in the foreign reserves went down by 4 percentage points and it reduced to the level registered in 2008.

Figure 140
Foreign reserves' currency structure, end of the year



According to the currency structure layout, the level of exposure of the foreign reserves to cross currency changes maintained low. Thus according to the "value at risk" concept¹⁰⁰, on December 31, 2010 the exposure of the foreign reserves to currency risk equals 1.36% (Euro 23.31 million). Within the currency exposure to currency risk of the foreign reserves, the movements of the gold price caused 81.42% of the possible changes of the foreign reserves, while the changes in the value of the US Dollar relative to Euro participated with 18.1%.

5.3.2. Credit exposure and liquidity of the investments

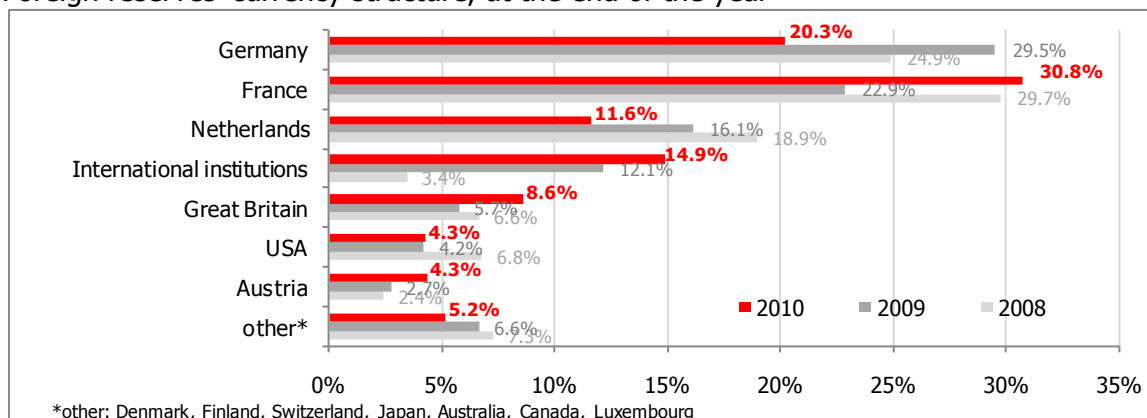
The foreign reserves security was ensured through maintenance of the investments in the Euro area countries with stable macroeconomic policies, which are rated AAA/Aaa according to the rating agencies Standard and Poors, Moody's and Fitch. The largest portion of the foreign reserves (67%) was invested in France, Germany and the Netherlands, while the share of the investments in the Great Britain and USA was also considerable.

Additionally, considerable share accounts for the investments in instruments issued by the international financial institutions (European Bank for Reconstruction and Development and European Investment Bank). The profile of the founders of these

¹⁰⁰ The value at risk shows the possible maximum change of the foreign reserves (with 99% probability), which can occur as a result of the prices and foreign exchange rates fluctuations, for ten-day period. For calculating the value at risk for certain date, historical data about the movements of the prices and the foreign exchange rates for the one year backwards, relative to the date the calculation refers to.

institutions¹⁰¹, the level of capital they manage with, as well as the applied prudent operational and financial policies, contribute these market instruments to perceive these international financial institutions as issuers of financial instruments with high degree of safety and soundness.

Figure 141
Foreign reserves' currency structure, at the end of the year

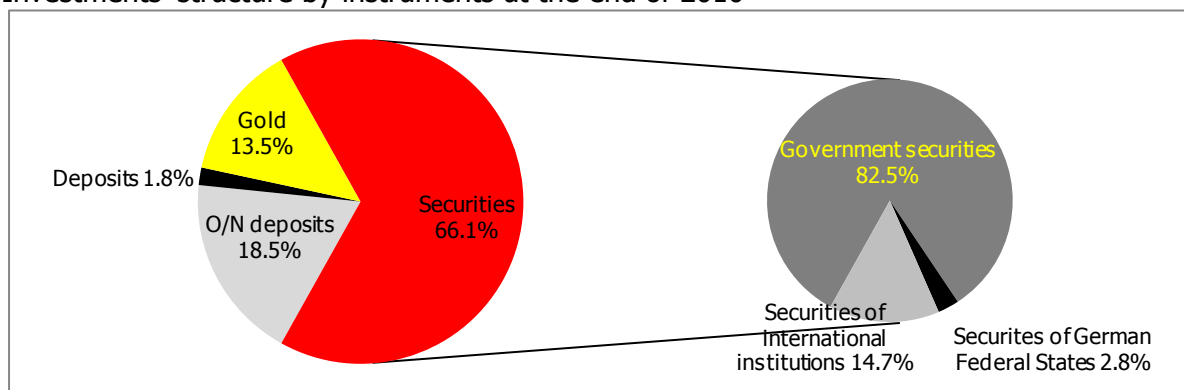


After the time foreign currency deposits in gold matured in the second half of the year, the gold was deposited with the Bank of England and with the Bank for International Settlements. In that manner, perceiving the higher risks on the international financial markets, the gold was kept with institutions with low credit risk.

The liquidity of the foreign reserves was provided through maintenance of the liquidity portfolio in form of short-term liquid assets, which at the end of 2010 were dominated by the sight deposits with 18.5% and short-term deposits up to one month with 1.8% of the foreign reserves.

The most significant part of the foreign reserves investments was directed to securities. The investments in securities also provided high liquidity, having in mind the possibility for fast mobilization of the assets with sale on the secondary markets. The largest share of these investments, i.e. 82.5%, was directed towards Government securities.

Figure 142
Investments' structure by instruments at the end of 2010



¹⁰¹ The European Investment Bank has been established by the European Union member states, while the European Bank for Reconstruction and Development has been established by 61 countries and two international institutions (European Bank and EIB).

Considerable level of investments in high quality securities contributed for more flexible liquidity management and adequate management of credit exposure of the foreign reserves. For the account of that, the securities portfolio was exposed to price fluctuations caused as a result of the movements on the international financial markets. In that direction, in order to limit the price fluctuation effects, the foreign reserves were invested in securities with relatively short basic modified duration, which equaled nine months for the investment portfolio in Euros, while the invested portfolio in US Dollars equaled seven months¹⁰². Additionally, part of the securities portfolio, i.e. 23% was invested in securities kept up to maturity. The investments in securities up to maturity, pursuant to the international accounting practices are shown at depreciated purchase value, by applying the method of effective interest rate and fail to succumb to unpredictable negative price changes.

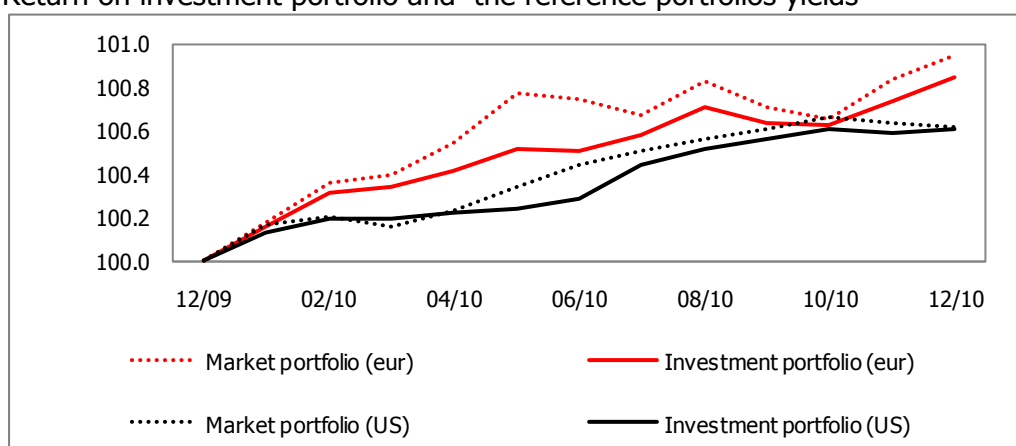
In line with such manner of foreign reserves investment, the exposure of the foreign reserves to price risk remained high and according to the value at risk concept of the foreign reserves on December 31,2010, it equaled about Euro 0.98 million, Euro 0.91 of which accounts to the exposure to change of the instruments prices, while the exposure to change of the instruments prices in US Dollars equaled Euro 0.07 million.

5.4. Results of the foreign reserves investment

The movements on the international financial markets and the high demand for safe Government securities influenced towards maintenance of low rates of return of the invested assets.

Thus the rate of return of the reference market index for Euros equaled 0.945% thus registering the historically lowest level. The realized rate of return of the investment portfolio of the National Bank in Euros was lower compared to the realization of the reference portfolio by 10.1 base points. This difference is primarily due to the structure of the reference index which is composed exclusively of the debt securities issued by Germany for which there was large demand in the last period.

Figure 143
Return on investment portfolio and the reference portfolios yields



Additional reason is the strategy for maintenance of shorter basic modified duration of the investment portfolio expecting the increase in the securities yields.

¹⁰² The basic modified duration for the investment portfolio in US Dollars reduced from eight months in 2009, to seven months in 2010.

The rate of return of the investment portfolio of the National Bank in US Dollars equaled 0.604% and it was at the level of the total return of the reference portfolio in US Dollars (0.615%).

The total rate of return¹⁰³ from foreign reserves investment equaled 0.82% on annual basis, with the National Bank attaining income from foreign reserves investment in the amount of Euro 22.2 million in 2010.

¹⁰³ The total rate of return encompasses the realized income and the non-realized price changes.

VI. The monetary policy in 2011

In 2011, the National Bank of the Republic of Macedonia will continue to practice the policy of realizing price stability, by keeping the current monetary strategy. The monetary policy in 2011 as well shall be aimed at maintenance of stable foreign exchange rate of the Denar against the Euro, as a nominal anchor for the anticipations of the economic entities and maintenance of the price stability. Therefore, **the stability of the nominal foreign exchange rate in 2011 as well shall remain the indirect monetary goal.** The operating framework of the monetary policy, as so far, will be based on the application of a group of monetary instruments through which the liquidity of the banking system will be managed, so the balance of the foreign exchange market and the foreign exchange rate stability will be indirectly maintained.

The environment for conducting the monetary policy in 2011 will be relatively favorable with respect to the external position of the economy, with expectations for recovery of the international economy and gradual strengthening of the external demand being registered. The deficit on the current account will register broadening, in conditions of deepened trade balance and lower inflows from private transfers. However, **the inflows on the capital account**, mainly from direct investments and indebtedness of the government, will be sufficient to cover the gap on the current account and **shall enable additional rise in the foreign reserves, which in 2011 as well will remain at the adequate level.** In conditions of expectations for global inflation growth, the monetary policy in 2011 will be facing with the challenge for managing with the upward inflation pressures, which result from the growing import prices (mainly the food and oil) and the uncertainty about the further developments on the international stock exchanges. Therefore, **intensified price growth is anticipated for 2011, but the domestic inflation will remain under control.** The rise in the economy will still be lower than the potential, so no pressures on the domestic prices are expected. **With the depletion of the inflation pressures by the rise in the international prices, in 2012 we anticipate for the inflation to reduce at a level lower than 3% again.**

The projections are accompanied with certain risks, and their eventual materialization can mean worsening of the environment for conducting the monetary policy. Namely the still slow recovery in the developed economies in the post crisis period, the political riots in the countries of the Middle East, as well as the global natural disasters create exquisitely uncertain global environment. In such conditions, the main risks for the projections result from the uncertainty about the growth dynamics of the international prices, the recovery dynamics and intensity of the foreign demand and the capital inflows, which are hardly assumable component. Considering the mentioned risks, a need for their continuous monitoring and reassessment is imposed in the process of adopting the monetary decisions, in order to eventual undertaking of adequate measures in function of stabilizing the expectations and maintaining of the stable foreign exchange rate.

In 2011, by the current assumptions, it is anticipated for the average inflation to reach up to the level of approximately 5%. However, the rise in the domestic prices was anticipated to be temporary and under control, without causing any considerable deviations in the long-term component of the inflation (core inflation) and in the expectations of the domestic entities. The international prices of food and oil will give the largest effect on the domestic inflation, and they are anticipated to reach up to two-digit growth rates in 2011. Simultaneously, inflation growth was anticipated in the economies of our most important trade partners, which will also

reflect in the economy through the import prices. Namely, according to the latest prognosis for growth in the mentioned economies, in 2011 foreign effective inflation of 3.2% is expected, opposite to 1.2% in 2010. The higher prices of electricity and heating energy, which rose at the beginning of the year, will have additional effect on the domestic inflation in 2011. With respect to the demand, despite the assessments for domestic activity revival in 2011, the economy growth will still be lower than the potential. Therefore, no pressures on the inflation caused by the demand are expected so far, i.e. the core inflation in 2011 was anticipated to be relatively stable and to reach up to about 1.5%. The risks concerning the inflation in 2011 result from the eventual larger growth in the international prices relative to the anticipated one, as well as from the eventually more intensive transmission effect of the import prices on the domestic prices.

The recovery of the domestic economy will continue in 2011 as well, with real annual GDP rise of about 3%. Such moderate growth rate of the economic activity will still not be sufficient to close the negative output gap during the year, which represents absence of larger pressures through this channel on the current account and the inflation. Observed with respect to the structure, the rise in the domestic economy will be driven by the domestic demand, whereas the net export will have negative contribution. *The investment activity* will be the main generator of the economic growth, supported by the planned Government investments, by the growth expectations in the industrial output and foreign investments, as well as by the larger credit support to the corporate sector by the banks. Small, but positive contribution was anticipated through the channel of the *personal consumption*. Despite the expectations for moderate income rise, the growth in the inflation and the uncertainty on the future income are anticipated to cause larger restraining from consumption and lower rise in the personal consumption relative to the previous year. *The public consumption* will also give an additional contribution to the economic activity in 2011, with moderate real growth. *The export* will continue to grow in 2011 as well in accordance with the assumption for more intensive foreign demand, but still more moderately, because of the slower growth in the demand for metals and with relatively smaller improvement in the relative export prices relative to the previous year. The more intensive domestic demand and the export will contribute to real *import* growth in 2011. The risks concerning the growth projection for 2011 mainly pertain to the export demand. Namely, the recurrent instability on the financial markets and the debt crisis with some countries from the Euro area can cause slower rise in the economies of our most important trade partners, i.e. slower recovery of the export demand. It would mean lower export than the anticipated one and mainly slower performances in the export sector (lower use of capacities, lower output and unemployment). This would potentially result in larger restraining of the domestic entities from more intensive consumption and investment activity. If the assessment of exports proves to be incorrect, it could imply downward correction of projections of other GDP categories and total GDP. In the same time the more intensive rise in the food and energy prices, as well as the more intensive fall in the transfers than the expected one, can cause fall in the real available income, which would reflect on the projected dynamics of the personal consumption.

The more gradual recovery of the domestic economy and the activity of the private sector in 2011 will be supported by the growth in the banks' credits as well. The improved macroeconomic situation in 2010, as well as the changes in the monetary policy enabled gradual recovery of the credit activity. **This development with the credits will strengthen additionally in 2011, so the credit growth is anticipated to be by 4 to 6 p.p. higher relative to the rise in 2010.** With respect to the sources of funding, we assess that the credit growth in 2011, as so far, will be mostly funded by the banks' deposit potential. However, the movements in the global financial flows will enable larger external indebtedness of

the domestic banks and additional strengthening of their financial lending capacity. The risks which concern the projected monetary and credit flows arise from the realization of the assumption for continuous recovery of the domestic and global economy. The eventually smaller performances in the real sector would directly affect the financial standing of the enterprises and the households, and therefore the quality of the credit portfolios of banks and their risk perceptions. Considering the fact that the banks will continue to follow the need for maintaining the stability and safety in the process of asset management, this could result in lower crediting relative to the planned one.

The projection of the balance of payments indicates to relatively favorable environment for the monetary policy in 2011 as well. In 2011 broadening in the deficit on the current account is anticipated, mainly as a result to the deepening of the trade balance, with lower inflows from private transfers being registered. The assessment for slower rise in the transfers in 2011 was based on the expectations for gradual depletion of the high growth which started in the middle of 2009. The capital inflows are assessed at considerably higher level than in 2010, enabling full coverage of the deficit on the current account and additional rise in the foreign reserves, which are anticipated to maintain an adequate level. Namely, the stabilization of the global financial flows, the increased trust of the foreign investors, but also the higher need for additional finances are the factors which will act towards rise in the private financial flows (mainly the foreign direct investments). In the same time, considerable rise was expected with the Government indebtedness, in accordance with the projected budget deficit and the financial construction for its funding. There are several risks about this scenario. First, non-realization of the expectations for rise in the foreign demand. Second, the eventually higher rise in the domestic prices than the projected one can give negative effects on the anticipations of and on the dynamics of the private transfers and to create pressures on the foreign currency demand. Third, the uncertainty from the prolonged transmission effects by the price growth of the oil and food on the international stock exchanges on the trade balance. Fourth, the projection of the capital inflows, which is usually accompanied with the high risk level, and the eventual non-realization of the assumptions on the volume of capital flows can change the conditions for conducting the monetary policy. Therefore, the risks in the external sector will still be in the focus of the monetary policy, in order to provide monetary reaction on time if required, and the satisfactory level of the foreign reserves will increase the capacity of the monetary policy for alleviation of the eventual negative shocks.

VII. Other activities of NBRM

7.1. Payment system in the Republic of Macedonia

The payment system of the Republic of Macedonia enabled smooth performance of the payment transactions in 2010 as well. NBRM, as owner and operator of the Macedonian Interbank Payment System (MIPS), through which real time gross settlement is performed, successfully conducted its operating function in the payment system. Also, the other components of the payment system, the Clearing House "KIBS" AD Skopje, "CaSys" AD Skopje and the banks' internal systems, through their operating contributed to stable, smooth and efficient performance of the payment transactions in the Republic of Macedonia.

In 2010, the National Council for Payment Systems of the Republic of Macedonia was focused on implementation of the Payment System Development Strategy in the Republic of Macedonia 2007-2011. The work groups of the National Council for Payment Systems of the Republic of Macedonia in 2010 continued their activities regarding the recommendations from the National Council for Payment Systems. Through the National Council for Payment Systems of the Republic of Macedonia was realized full cooperation and coordination with the institutions which are indirectly and directly related with the payment system and which are liable for implementation of the strategic guidelines.

7.1.1. The role of the NBRM in the payment operations

When performing the operating function, the NBRM manages with the settlement system - MIPS. In 2010, the MIPS operated in real time with availability of 99.93% of the envisaged operating time during the year. The system processed 18.708 transactions on average per day, whereas the maximal number of processed transactions per day amounted to 61.534. The introduction of the most modern technical and technological solutions in the MIPS's infrastructure in 2009 and in 2010 contributed to non-existence of queuing resulting from technical reasons.

The banks (including NBRM), the clearing institutions, the brokerage houses and the Ministry of Finance are participants in MIPS. At the end of 2010, the total number of direct participants in MIPS amounted to twenty five.

In 2010, the NBRM received and processed 4.470 execution orders and decisions for forced collection, out of which 326 are returned to further processing at court or executor, and the others are totally or partially executed, or they are blocked because of deficient assets with the debtors and they are delayed by the body that adopted them.

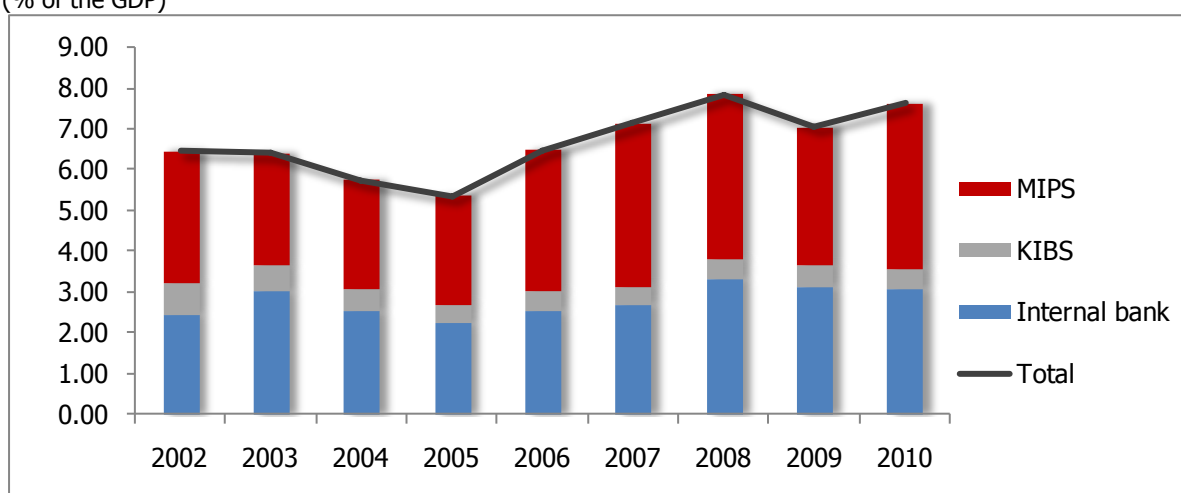
7.1.2. Indicators on the payment system's operating in the Republic of Macedonia

In 2010, in the Single registry of the transaction accounts of the payment operation careers in the Republic of Macedonia (the banks and the NBRM), total of 492.785 new accounts of natural persons and legal entities were registered, and 373.886 accounts were closed, so the total number of opened accounts in the Single registry of transaction accounts reached up to 3.412.409 at the end of the year. The owners of these accounts are 1.488.167 different entities (natural persons and legal entities), so 44.55% have only one account, whereas the average number of opened accounts was approximately 2.29 accounts per entity.

The total number of blocked accounts registered at the end of 2010 amounted to 89.232. In 2010 164.437 blockages are initiated, and in the same period 88.253 are unblocked, which represented 53.67% of the total number of initiated blockages. Compared to 2009, the total number of blocked accounts rose by 58.46%, the total number of initiated blockages - by 130.98% and the total number of unblocked - by 201.54%.

In 2010 payment operations in total amount of Denar 3.231,75 billion were realized, which compared with the total value of the realized payment operations in 2009 of Denar 2.887,35 billion represented rise of 11.93%. 40.3% of the total amount represents internal payment operations of banks (among accounts in a same bank), 52.8% are interbank payment operations performed through MIPS and 6.9% are interbank payments operations through KIBS.

Figure 144
Total domestic payment operations by years
(% of the GDP)

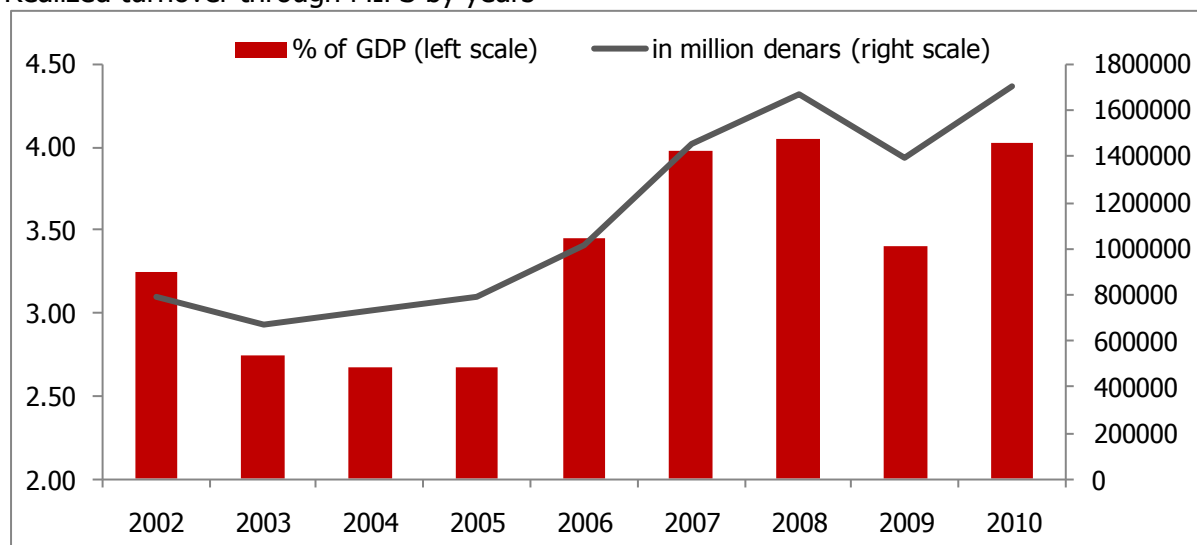


Source: National Bank of the Republic of Macedonia.

The operations performed through MIPS rose by 22.6% relative to the previous year. Out of the total operations through MIPS, 55.2% represented interbank operations realized from payment operation careers - banks, whereas 44.8% represented operations ordered by Government institutions (NBRM, Treasury system), clearing and brokerage houses.

Figure 145

Realized turnover through MIPS by years



Source: National Bank of the Republic of Macedonia.

In 2010, the total number of the realized transactions in the domestic payment operations amounted to 51.561.024, out of which 9.1% were performed through MIPS, 35.3% are performed through KIBS, and 55.6% are transactions performed through the internal clearing system in the banks. In 2010, the number of performed transactions through MIPS reduced by 0.9% relative to the previous year. Out of the total operations through MIPS, 37.9% represented interbank operations realized from payment operation careers - banks, whereas 62.1% represented transactions ordered by Government institutions (NBRM, Treasury system), clearing and brokerage houses.

7.2. Report on the oversight on the payment systems in 2010

7.2.1. Regulatory framework, method and methodology for performing oversight on the payment systems

The payment systems are one of the most vital components of the financial and economic structure. Through their efficient functioning, save and timely completion of the financial transactions is enabled, thus creating a key contribution to the performances of the national economy. But, on the other side, the payment systems can also include considerable risk exposure for the participants and they can represent a transmission channel for shocks from one into another segment of the financial, i.e. the economic system. This so called system risk is the key reason for larger interest of the National Bank of the Republic of Macedonia for the payment systems oversight area.

The oversight on the payment systems in the Republic of Macedonia is performed by the National Bank of the Republic of Macedonia pursuant to the Law on the National Bank and the Law on Payment Operations. In accordance with the Law on Payment Operations (Article 44), the National Bank performs oversight on the payment systems in the Republic of Macedonia, and the manner and the methodology for oversight are prescribed by the NBRM's Council. Article 2 item 17 of the Law on Payment Operations reads the following definition: „Oversight on the payment system represents a function aimed at achievement of the goals related with the safety and efficiency of the payment systems through process of monitoring of the current and planned arrangements, assessing them against the goals and policies“.

The manner and the methodology for performing the oversight are regulated by the following decisions of the National Banks' Council:

- *Decision on the Manner and the Methodology of Payment System Oversight ("Official Gazette of RM" No. 159/07);*
- *Decision on the Criteria and Standards for Payment Systems Operating ("Official Gazette of RM" No. 159/07);*

The methodology is elaborated in details in the Instructions on the assessment of the compliance of the payment systems with the core principals No. 6309 dated October 3, 2008 prescribed by the Governor of the National Bank.

The National Bank performs an oversight on the following payment systems:

1. The Macedonian Interbank Payment System (MIPS), as the only system for real time gross settlement through which the large and urgent payments are processed;
2. The Clearing Interbank Systems ad Skopje (KIBS) for determining and netting the small interbank payments on multilateral basis and
3. International Card System AD Skopje (CaSys) - system for differed net settlement for processing of card payments.

The tasks of the oversight include monitoring of these systems, assessment of their compliance with the internationally recognized standards and if required, implementation of the recommendations arising from the performed oversight. For the assessment of the systems which are subject of oversight the Core Principles for the Systematically Important Payment Systems, prescribed by the Bank for International Settlements in Basel, are applied, and they are part of the Decision on the Criteria and Standards for Payment Systems Operating ("Official Gazette of the RM" No. 159/07), as internationally recognized standards for payment systems operations.

7.2.2. Risk analysis and classification of the payment systems

The risk analysis and the classifications of the payment systems is conducted in accordance with certain algorithmic scheme for each payment system, which is defined by the Decision on Criteria and Standards for Payment Systems Operating ("Official Gazette of the RM" No. 159/07). The weight factors for the risk carried over by certain payment system to the total payment system are determined by the defined criteria which are crucial factors for classification of each system which is subject of oversight.

In the assessment of the relevance of the payment systems, the **market participation** has specific weight factor. On those locations where there is no available alternative system for small mass payments, the number of transactions which shall be processed through RTGS (real time gross settlement payment system) is very large, which represents high risk if the system fails. The situation is similar when there are several similar systems for small payments. Namely, the failure of the system where most of the small payments are processed endangers the public trust in the payment system of the country. In that case the high market participation (>75%, in accordance with the stated decision) of system for small payments shall indicate the larger interest of the oversight institution.

The total financial risks are the key factor for assessing the systemic importance of a given payment system. Within this, there is a positive correlation between the height of the processed amount in the payment system and the level of credit and liquidity risk. Although the payment systems are not leading with respect to the aggregated value, the

aggregated value may have crucial importance and consequences for the financial stability. In that regard, in order to assess the risk, the participation of the aggregated value of the payment transactions performed through the individual payment system against the total value of the payment transactions performed through RTGS is calculated. In accordance with the Decision, the participation of the aggregated value which is higher than 10%, or average daily value over Denar 60 billion, is the key criterion.

Also in the stated Decision the **risk of "domino effect"** was taken into consideration, i.e. the incapability of one participant to pay its liabilities in the system, which can cause serious consequences for the other participants. Therefore, the individual problems of one participant transfer to other participants. The risk from domino-effect was most evident with the payment systems based on netting, but it can also emerge with the payment systems which operate on RTGS principles, where the bankruptcy of one participant can cause liquidity deficiency in the whole system. The elements which are causing risk of domino effect are the following: net correlation, value concentration and the largest net negative stock of the participant in the payment system after the netting. In this regard, although the systems for small payments process relatively small payments compared to the systems for large payments, they should be carefully assessed with respect to the net correlation - is it lower than 10% or does the largest net negative stock of a participant in the payment system after the netting exceed Denar 6 million.

In accordance with the Decision on the Criteria and Standards for the Payment Systems Operating ("Official Gazette of RM" No. 159/07), payment systems are classified in the following categories:

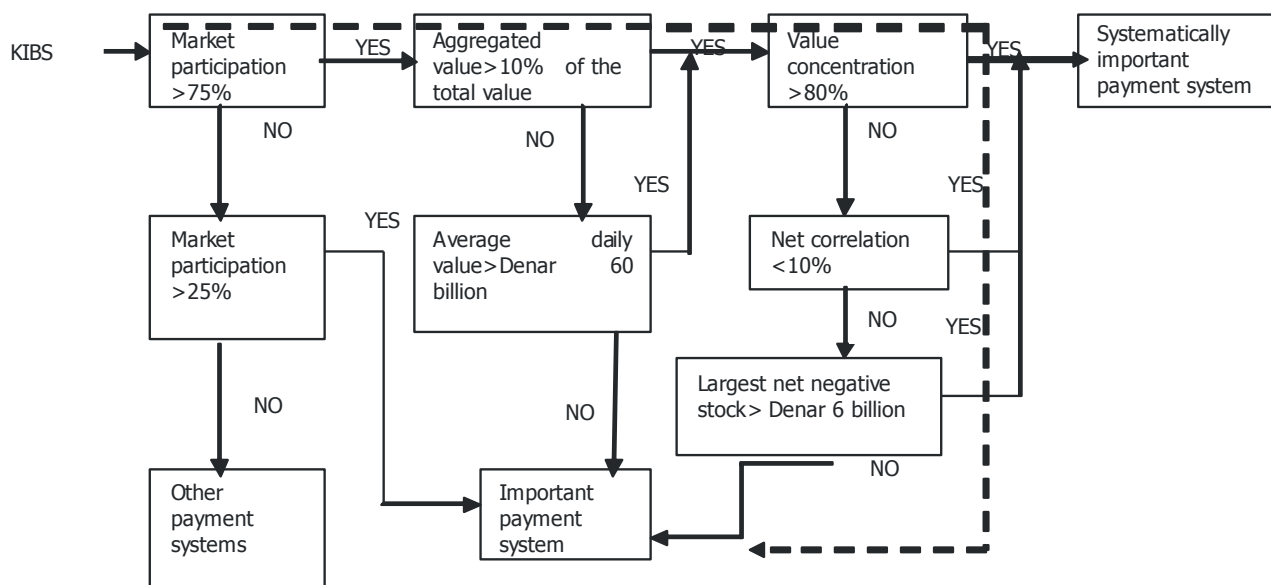
- a) Systematically important payment systems;
- b) Important payment systems;
- c) Other payment systems.

The classification of individual payment systems is performed by the National Bank based on the previously stated criteria.

The Macedonian Interbank Payment System (MIPS) is not subject of classification in accordance with the stated criteria, and it represents systematically important payment system in the Republic of Macedonia or the only payment system in the country through which the payment transactions with large values are performed and settled, the payment transactions from other payment systems are settled, as well as the transactions from the financial markets.

On the basis of the stated criteria for classification of the payment systems and the results from the performed calculations, in accordance with the Decision on the Criteria and Standards for the Payment Systems Operating ("Official Gazette of RM" No. 159/07), the payment system of the Clearing House KIBS AD Skopje is classified in the category **important payment system** and therefore it shall be complied with the core principles no.: 1, 2, 7, 8, 9 и 10.

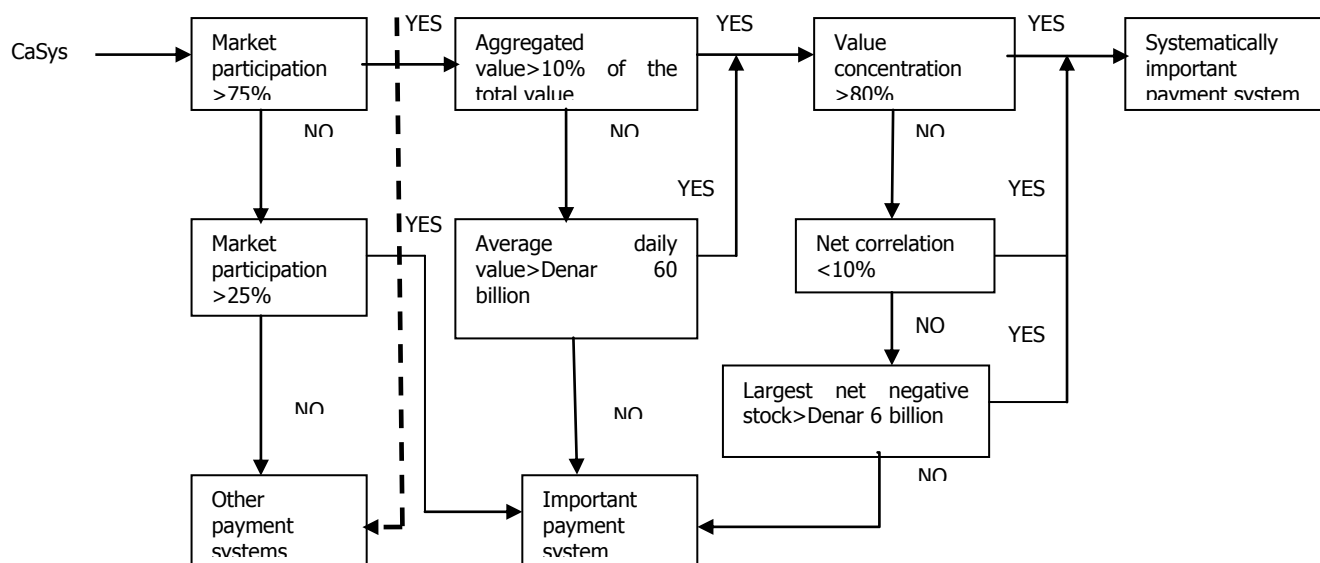
The Classification of KIBS is sketched on the following manner:



The dashed line shows the classification of KIBS AD Skopje. In accordance with item 5, indent 1 of the Decision on the Criteria and Standards for Payment Systems Operating, KIBS AD Skopje was classified in the category **important payment system**.

In 2010 risk classification and analysis was made for International Card System CaSys AD Skopje as well and it was classified (on the basis of the already defined classification criteria in accordance with the Decision on the Criteria and Standards for the Payment Systems Operating ("Official Gazette of RM" No. 159/07) in the category **other payment systems** and therefore it shall be complied with the core principles no.: 1, 2, 7, 9 and 10.

The classification of CaSys AD Skopje is sketched on the following manner:



The dashed line shows the classification of CaSys AD Skopje. In accordance with item 6 of the Decision on the Criteria and Standards for the Payment Systems Operating, CaSys AD Skopje is classified in the category **other payment systems**.

Annex 8: Payment systems operating standards

The payment systems operating standards are the core principles¹⁰⁴ for the systematically important payment systems which are internationally recognized payment systems operating standards and they are an integral part of the Decision on the Criteria and Standards for the Payment Systems Operating ("Official Gazette of RM" No. 159/07):

Core principle No. 1: The system should have a well-founded legal basis under all relevant jurisdictions.

Core principle No. 2: The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.

Core principle No. 3: The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.

Core principle No. 4: The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.

Core principle No. 5: A system in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.

Core principle No. 6: Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk.

Core principle No. 7: The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.

Core principle No. 8: The system should provide a means of making payments which is practical for its users and efficient for the economy.

Core principle No. 9: The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.

Core principle No. 10: The system's governance arrangements should be effective, accountable and transparent.

The determination of the level of compliance with the Decision is made by the following assessment scale:

- **Complied:** *all key points shall be fulfilled;*
- **Generally complied:** *there can be irregularities which have no considerable influence on the fulfillment of the key points, and subsequently on the safety and/or efficiency of the system;*
- **Partially complied:** *there are considerable irregularities which have large influence on the fulfillment of the key points, and therefore on the safety and/or the efficiency of the system, but such irregularities shall be overcome by the system owner/operator in a reasonable period of time;*
- **Non-complied:** *there are considerable irregularities which have larger influence on the fulfillment of the key points, and therefore on the safety and/or the efficiency of the system, and the system owner/operator is not capable to overcome these*

¹⁰⁴ CPSS (Committee on Payment and Settlement Systems). 2001. Core Principles for Systemically Important Payment Systems. Bank for International Settlements. Basel, Switzerland (January)

irregularities in a reasonable period of time.

7.2.3. Results from oversight activities

In 2010 the oversight was focused on the operating of the clearing house „Clearing Interbank System“ AD Skopje, which represents a system for differed net settlement.

The oversight activity for 2010 which was aimed at assessment of the compliance of the „Clearing Interbank System“ AD Skopje in accordance with the international standards showed positive reflection, i.e. it showed general compliance with the Principle No. 7 and full compliance with the principles no. 1, 2, 8, 9 and 10.

The compliance of the system of KIBS AD Skopje with the core principles is shown in the following table:

Table 26
Assessment of the compliance of KIBS AD Skopje with the core principles for 2010

Core principle number	Short description of the principle	Compliance degree
1	Legal infrastructure	C
2	Financial risks perception	C
7	Safety and operating security	GC
8	Efficiency	C
9	Participation criteria	C
10	System management	C

Scale for assessment of the system compliance:

1. C - complied
2. G - generally complied
3. PC - partially complied
4. NC - non-complied

After the completion of the oversight, KIBS AD Skopje was given a recommendation by the Governor of the National Bank for overcoming of the non-compliances of the payment system with the core principles determined in the Report on the performed on-site oversight.

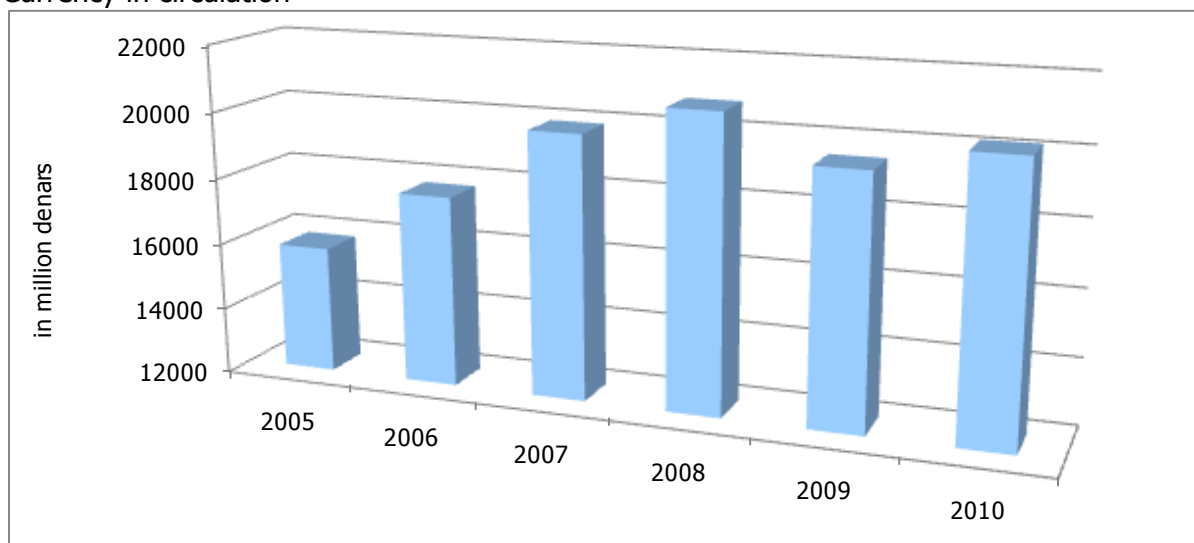
After receiving the recommendations, KIBS AD Skopje submitted a plan with deadlines for implementation of the recommendations in order to achieve full compliance of the operating of KIBS AD Skopje with the core principles.

7.3. Cash management operations

7.3.1. Currency in circulation

On December 31, 2010, the currency in circulation amounted to Denar 20.173 million and relative to the end of 2009 they registered rise of Denar 691 million, or by 3.6%. With respect to the structure, the participation of banknotes amounts to 98%, whereas the participation of the minted coins amounts to 2%. The comparison with the previous year shows inconsiderable fall in the participation of the banknotes in the value structure of the currency in circulation. Observed by the number of pieces, the participation of banknotes in the currency in circulation amounts to 28.9%, i.e. 71.1% of the minted coins.

Figure 146
Currency in circulation



Source: National Bank of the Republic of Macedonia.

With respect to the value, the banknotes in denomination of 1000 denars and 500 denars participated mostly. The denomination of 1000 denars participated with 74.8%, opposite to 73.1% at the end of 2009, whereas the denomination of 500 denars participated with 15.3% in the value of banknotes in circulation, opposite to 16.7% at the end of 2009. The other banknotes participated with 9.9% in the total value of the banknotes in circulation. Regarding the coins, the denomination of 5 denars participated mostly in their value (35.1%) as well as the denomination of 2 denars (22.3%). The denomination of 1 denar participated with 17.5% in the value of the coins, the denomination of 10 denars with 13.7% in the value of the coins and the denomination of 50 denars participated with 11.0% in the coin value. The banknotes in the denomination of 10, 100 and 1000 denars participated mostly by the number of pieces. The denomination of 10 denars participated with 40.7% (on December 31, 2009 with 41.7%), the denomination of 100 denars participated with 17.3% (17.0% on December 31, 2009), and the denomination of 1000 denars participated with 23.4% in the total number of pieces of banknotes (22.4% on December 31, 2009). The other banknotes participated with 18.5% in the total quantities of currency in circulation. The denomination of 1 denar had the largest participation (46.0%) in the quantity of coins in circulation.

7.3.2. Supplying banks with banknotes and coins

In 2010, the central vault of the National Bank and the subunits for handling cash in the Republic, performed payment of cash to banks in the amount of Denar 29.9 billion, with 3.156 realized transactions (58.7 millions of banknotes and 18.4 millions of coins are issued). In the same time, cash from banks in the amount of Denar 29.2 billion is received, through performed 4.823 transactions. The analysis of the denomination structure of the banknotes and the coins showed that when issuing and receiving, the denomination of 1000 denars participated mostly (36.6% in 2010, i.e. 35.7% in 2009).

7.3.3. Banknote and coin processing and destroying

In 2010, in the process of banknotes in circulations quality control, in the central vault and the subunits for handling cash in the Republic all received banknotes were processed. Out of the total received banknotes, as a result of wearout and damage 17.2

millions were destroyed (opposite to 19.0 millions of banknotes in 2009). The denominations of 10, 50 and 100 denars had largest participation in the destroyed banknotes (75.8%). In 2010 all received coins in denominations of 1, 2, 5, 10 and 50 denars were processed, out of which 254 thousands of pieces were found damaged.

7.3.4. Expertise on suspicious money / money counterfeits

Within its responsibilities as the only authorized institution, the National Bank performs the function of expertise on Denar counterfeits. In 2010 total of 3.387 counterfeits were found, detected by the commercial banks or confiscated in Republic of Macedonia by the Ministry of Interior (MOI). Out of the total number of detected money counterfeits, in 2010 the denomination of 100 denars dominated (total of 2.385 pieces, or 70.4% of the total number of counterfeits), followed by the denomination of 1000 denars (total of 821 pieces, or 24.2% of the total number of counterfeits) and the denomination of 500 denars (total of 169 pieces, or 4.9% of the total number of counterfeits). The total value of the Denar counterfeits in 2010 amounted to Denar 1.149.510 and it has marginal participation of 0,001% relative to the total value of the currency in circulation.

7.4. Internal audit

Through the realization of the Program for Activities in 2010, the Internal Audit Department fulfilled its ultimate task. This pertained to improvement of the performance of NBRM activities, through systematic and regular assessments and improvement of the risk management, the internal control system and the managing and operating processes. The achievement of this goal was performed through giving an assurance to the managing bodies of NBRM that the risk management, the internal control systems and the managing processes, designed and implemented by the management, are adequate and that they function on a manner that enables credibility and integrity of the financial and other information, compliance of the operating with the laws and bylaws, the internal policies and the operating procedures, safeguarding of assets, and rational and efficient resource employment.

The largest part of the regular activities pertained to the regular audits, the performance of which was planned, not only with respect to the level of inherent, business risks, but also to the importance of the functions performed, the interval from the last audit performed, as well as the changes made in the operating processes. The audit reports provided an opinion on the adequacy of the established internal audit system, on which the NBRM management was regularly informed. Recommendations were given for overcoming the identified weaknesses, if any, presented in the audit reports together with the accomplishment of the given recommendations

In 2010, 15 regular and audits were conducted, and on a regular quarterly basis the implementation of the recommendations given in the audit reports was monitored, which were to be completed in 2010. The monitoring mainly showed that the recommendations were observed and implemented within the given deadlines. The audits of 35 work processes in NBRM in 2010, resulted in 50 recommendations for improvement of the internal control system.

Despite the regular activities, the internal audit also undertook some other activities aimed at improving its own operation quality and efficiency through commenced activities for implementation of the international internal audit standards for professional internal audit. With respect to this, in 2010 eight internal operating procedures were revised, in

order to achieve further compliance with the international internal audit standards, participation in the creation of the Risk Management Policy in the NBRM, in order to improve the efficiency and effectiveness of the risk management process in NBRM, implementation of the Internal and External Program on Assessment of the Operating Quality of the Internal Audit, through performance of internal periodical self assessment and continuation of the cooperation with the internal audit of the Central Bank of Netherlands in the area of IT audit improvement.

7.5. Strengthening of the NBRM institutional capacity

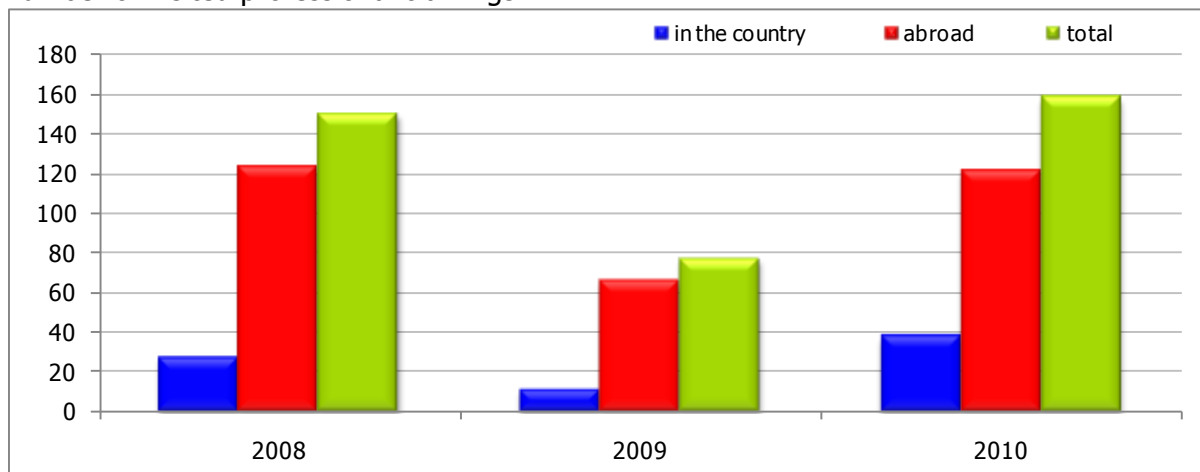
7.5.1. Activities towards building the institutional capacity through human resource development

The building of the institutional capacity of the National Bank of the Republic of Macedonia (hereinafter referred to as: the National Bank) is performed, inter alia, through continuous performance of activities for professional development of staff in the Bank.

In order to develop the skills and to acquire new professional knowledge for more successful and more quality performance of the operating tasks, the National Bank in 2010 as well continued with the organized professional development of the employees.

The professional development of staff was performed through realization of professional trainings in the country and abroad, as well as through co-financing of the upgrade of professional education for achieving higher qualification degree. Upgrades of professional education with special certificates were financed as well.

Figure 147
Number of visited professional trainings



The main organizers of the professional trainings visited by the employees in 2010 were the central banks of other countries, and this year the European Central Bank was most visited through the given grant for technical assistance. Most of the seminars were realized based on annual training programs of the European central banks and other significant international institutions. Considering the tradition and the high level of organization of different trainings from all segments of the central banking, which is initiated by the stated organizers, the National Bank regularly sends its representatives on the events. The possibility for exchange of experiences with other central banks, which are always available for direct contacts on such events, is considered to be a great advantage for our institution. In 2010 part of the professional trainings were organized in the country,

by the government authorities, as for example the State Statistical Office and the Lawyers Association.

With respect to the organizers, most of the visited seminars in 2010 were organized by the European Central Bank (24%), the International Monetary Fund (14.5%), by the German Central Bank (13%), Central Bank of Netherlands (7.7%), Bank of England (6.4%), Central Bank of Austria (6.4%), followed by the seminars organized by the Bank for International Settlements - BIS - Financial Stability Institute - FSI (5.1%), and smaller share, but not less significant share of the total professional training for the employees pertains to the seminars organized by other central banks as: the Bank of France, Bank of Italy, Bank of Greece, National Bank of Serbia, Central Bank of Albania, etc. **The priority areas which were included in the professional training** of employees are the following:

- Supervision (on-site and off-site), with participation of 30% in the total number of professional trainings, opposite to 15% in 2009 and 13.5% in 2008. This change mainly results from the technical assistance from the European Central Bank, which enabled professional trainings in the supervision area.

- Financial stability, banking regulation and methodologies with participation of 6.9% in 2010, opposite to 10.2% in 2009 and 8.7% for 2008.

Annex 9: Development of the supervision staffing - professional training organized by the European Central Bank

In 2010, fifteen employees from the Division of Supervision, Banking Regulations and Financial Stability participated in the trainings organized within the European Central Bank's project "Strengthening Macro and Micro-Prudential Supervision". The training was part of the two-year IPA project, the realization of which is in 2010 and 2011. This project covers the banking supervisory bodies of eight candidate countries or potential candidate countries for EU accession (Albania, Bosnia and Herzegovina, Croatia, Macedonia, Kosovo, Montenegro, Serbia, and Turkey). In 2010 the first part of the project, which pertained to training of the employees in the Division of Supervision, Banking Regulations and Financial Stability, was successfully finalized. The trainings discussed the following topics: 1) Home - host cooperation; 2) Macro - prudential supervision; 3) Micro - prudential supervision; and 4) Regulations.

In 2010 two applications for TAIEX were approved - one study visit and one workshop (this shall be realized in the second half of 2011). The study visit will be focused on the discussions about the calculation of the risk exposure values using the Internal Rating-Based Approach (IRB) and its further application, whereas the workshop shall enable professional upgrade of supervisors from the National Bank regarding the adequate application of the regulations in this area.

- Monetary economy (monetary policy, macroeconomic projection and central banking operations), with participation of 16.4% in the total professional trainings in 2010, opposite to 37.2% in 2009 and 35.5% in 2008.

- Statistics, the participation of which registers constant rise from 7.3% in 2008 up to 9% in the participation to the total fund in 2009 and to 12.6% in 2010.

- The following areas participated with smaller share to the total fund: internal audit, law, human resource management, cash management, finances and accounting, payment systems, Euro-integration processes, information technology and other.

It is significant to be mentioned that the larger number of professional training were envisaged for building the institutional capacities for fulfilling the most important functions

of the central bank. Other areas were included in the realization of the professional training but with lower participation to the total fund of realized professional trainings.

7.5.2. Professional training organized by the National Bank

The organization of trainings in the premises of the National Bank became even more popular method of professional training. This enables fall in the costs for professional training of employees, as well as simultaneous attendance of higher number of employees. In 2010, total of 74 employees from the National Bank participated on the seminars and workshops for professional training organized by the National Bank, with total 4 professional trainings being organized. The events organized by the National Bank in 2010 are stated below.

1. Regional seminal on topic "Economic Modeling for the Central Bankers"

In September 2010 the Research Department in the NBRM in cooperation with the Bank of England hosted a three-day regional seminar on topic "Economic Modeling for Central Bankers". The seminar was held in the period from September 29, 2010 to October 1, 2010 and it discussed the dynamic stochastic models of global balance. The lectures were held by experts from the Bank of England - Francesco Zannetti, PhD and Haroon Mumtaz, PhD. This seminar focused on the role of models as a significant tool in the process of adopting monetary decisions. The models represent a coherent and stable framework for economic analysis and for projections and they enable consistent image of the transmission mechanism of the monetary policy and the shocks which influence the economy. On the seminar, the dynamic stochastic models of global balance were presented - the latest generation of models which are actively used in the central banks. The seminar was attended by total of 23 persons out of which 14 from the NBRM and 9 from the countries from the area.

2. Training for development of the management skills on topic "Team Work and Communication"

In 2010 specialized training for development of the management skills was realized with the topic "Team Work and Communication", which lasted for three working days, in November 2010. The training was organized by an external training center, in the premises of the National Bank, attended by the managers of the departments. The goal of the training was to contribute to increasing of the communication in the team operating, through development of the communication skills with the managers and increasing the knowledge for the benefit of the team culture. The training was attended by 16 participants, out of which 14 managers of departments.

3. Training on topic "Project Management"

The training was organized in the premises of the National Bank, intended for all managers, including the staff required to manage with project on a daily basis. The training lasted for three working days in October 2010. The assets for realization of the training were provided within the technical assistance received in the bilateral cooperation with the Central Bank of Netherlands. The training was visited by total of 25 employees.

4. Forum/workshop on topic "IT in Central Banks"

In the period from June 1, 2010 to June 3, 2010, The National Bank of the Republic of Macedonia organized regional IT forum. The forum was attended by 27 participants from the central banks of 9 countries from the region and beyond, discussing topics from the area of IT organization in a central bank, IT services and IT infrastructure. The forum on topic "IT in Central Banks" was realized as interactive workshop with exchange of experiences among experts from the central banks, through presentation of various subjects from the area of information technologies in central banks. Representatives of the central banks of Serbia, Albania, Bulgaria, Romania, Poland, Netherlands and Italy participated on the forum, as well as 19 employees from the Information Technology Department of the National Bank.

5. The National Bank - moderator and host of the 23th Annual Conference of the Group of Bank Supervisors from Central and Eastern Europe (BSCEE)

In the period from June 15 to June 17, 2010, the National Bank hosted the 23th Annual Conference of the Group of Bank Supervisors from Central and Eastern Europe (BSCEE)¹⁰⁵. The key goal of this group is support of the cooperation among its members, as well as their training and improvement, and simultaneously it represents a forum for exchange of knowledge and experiences among members. One of the goals of the Group is to alleviate the integration process of the supervisory bodies of its members towards the European banking supervision system. The Conference was attended by the top management of the banking supervisory bodies from Austria, Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Estonia, Lithuania, Poland, Russia, Slovenia, Slovakia, Serbia, Ukraine, Hungary, Croatia, Montenegro, Czech Republic. Representatives from the Bank for International Settlements (BIS) from Basel, Switzerland, the European Central Bank and from one international banking group participated as guests and presenters.

On the Conference, the participant exchanged their experiences for two, exquisitely popular topics at that moment: (1) Lessons learned from the global economic crisis and the measures undertaken for strengthening the resistance of the banking system and (2) the Standards and measuring of the liquidity risk, focusing the national measures undertaken during the crisis and after it. During the Conference, in the Bank for International Settlements (BIS) in Basel, international discussions were held¹⁰⁶ for these two topics, the goal of which was to identify the most adequate methods for improvement of the banking regulations and strengthening of the resistance of the banking systems.

7.5.3. Qualification structure of the staff in the National Bank

The upgrading of the professional education is evidently directed towards improvement of the qualification structure of the Bank. The dynamic analysis of the qualification structure of the staff in the National Bank indicates to its improvement (Table 27).

¹⁰⁵ Republic of Macedonia is member of the Group since 1996.

¹⁰⁶ The final version of the measures for increasing of the banking systems resistance, by BIS, was published in December 2010.

Table 27
Qualification structure

(by education degree)	31.12.2008	31.12.2009	31.12.2010	Annual change in 2010
Total number of employees:	434	434	445	+2.53%
1. Elementary education	14	12	11	-9.09%
2. High school	162	159	157	-1.27
3. High school - degree V	4	4	3	-33
4. Higher education	18	15	15	/
5. University degree	189	196	207	+5.61%
6. M.Sc.	41	42	46	+9.52%
7. PhD	6	6	6	/

The qualification structure of the National Banks at the end of 2010 is showing that most of the employees in the National Bank are with finished university education. Namely, the participation of these employees (including M.Sc. and PhD) amounts to 58% of the total number of employees. The participation of the employees with high school degree amounts to 36% and it mostly pertains to the employees from the technical assistance units of NBRM.

Figure 148
Qualification structure on December 31, 2010

