National Bank of the Republic of Macedonia

Annual report 2012

Skopje, April 2013

Contents

Governor's foreword

Dear readers,

I am honored to deliver the Annual Report of the National Bank of the Republic of Macedonia for 2012, on the monetary policy, the foreign reserves management, the payment system operations and other activities.

On 26 April, last year, we appropriately celebrated the jubilee of 20 years of independence, one of the main features of the independence and statehood of the Republic of Macedonia. We celebrated the great anniversary in times of outburst of unfavorable developments in the global environment, when the European debt crisis reached its peak, which was certainly not in favor of reviving the domestic economy, especially its traditional sectors.

These problems in the euro area, which are largely institutional, should not distract us from the germs of structural changes in the Macedonian economy, including the growing resilience of employment and exports to external shocks, mainly due to the presence of new production facilities.

Given all this, I would like to briefly point out some trends presented in this annual report, which describes in more detail the growth potential of the economy and monetary policy, operations and foreign reserves, as well as other activities of the National Bank.

Looking at the objectives of the NBRM during 2012, the conduct of monetary policy was appropriate and the objectives were successfully achieved. The total average annual inflation of 3.3% in 2012 indicates inflation pace that is acceptable and under control. After the disinflation process in the first half of the year, in the third quarter, the shock of supply of wheat and corn on international commodity markets made pressure on the domestic food prices. The negative output gap and absence of pressure from domestic consumption quickly exhausted the effects of this supply shock and at the beginning of 2013, the inflation rate have been declining rapidly. In 2013, the inflation rate is expected to drop below 3%, and in 2014 to stabilize at the level of historical average.

Successful management of temporary mismatch between supply of and demand for foreign currency through NBRM interventions on the foreign exchange market contributed to the maintenance of a stable exchange rate of the Denar against the Euro, which equaled Denar 61.53 per one Euro, on average, for the year, as was the average for 2011. The movement of real effective exchange rate was also stable, showing almost unchanged price competitiveness. Foreign reserves registered significant increase in 2012 and at the end of the year reached the highest historical level of 29.2% of GDP. Adequacy ratios during the year indicated a comfortable level of foreign reserves. During the year, the NBRM lavished with reserves that were sufficient to absorb potential major shocks in the balance of payments. Given the sufficient foreign reserves and perceptions for absence of major pressures on inflation, exchange rate and reserves in the next period, in 2012, the NBRM took advantage of this opportunity and relaxed its monetary policy. Thus, the National Bank has provided support to the real sector.

However, the monetary transmission in 2012 was difficult due to the prevalence of several limiting factors on the side of banks. Real sector vulnerability, amid still insufficient external demand, affected the quality of banks' loan portfolio. In the last two years, "bad loans" of banks have an upward trend, which is a limiting factor for higher credit growth. The process of financial deleverage of some parent banks also tend to limit credit growth and reduce the effectiveness of monetary policy. Preferences of banks for low-risk instruments were high, and in spite of the positive margins when fulfilling the liquidity requirements, banks increased their investments in highly liquid instruments.

In 2012, the Macedonian economy registered a slight decline of 0.3%, mainly due to uncertainty in the external environment and reduced economic activity of the most important trading partners. For the first time since 2009, these factors made such great impact that contributed to the slight decline of GDP, with the unfavorable environment being particularly felt in the first half of 2012. Then, after a period of slight recovery of the global economy, European debt crisis hit with unexpected intensity, thereby affecting the environment and economic activity in the Republic of Macedonia.

However, it should be noted that the decline of economic activity in the Republic of Macedonia did not deteriorate the labor market. Rather, it is striking that in times of crisis, the unemployment rate fell by 1.2 percentage points and reduced to 30.6%. As for the labor market, it is influenced mainly by three interrelated domestic parameters: growth of wages, productivity and unit labor costs.

Wage growth was 0.3%, in 2012, leading to a real decline of 2.9%. This lowest growth rate in the last five years has contributed to maintaining the balance of the Macedonian economy. However, the 0.6% decline of labor productivity and the growth of unit labor costs by 0.8% is a challenge that should be taken into account in the future.

In 2012, public finances, in the absence of growth of the domestic economy, faced great challenges. The increase of budget deficit from 2.5% to 3.8%, imposed a greater need for funding that was met by the high liquidity in the domestic financial market. It enabled the central government to start changing the maturity structure of domestic debt by issuing more long-term bonds, which contributed to the development of the domestic market. The share of central government debt in GDP rose to 33.8% from 27.8% the previous year. Although the level is still moderate, this dynamic requires greater vigilance of monetary policy in the coming period.

Adverse changes in the external environment led to a moderate deterioration in the current account deficit compared to the previous year. The inflows in the capital and financial account decreased, whereas the net inflows of current transfers increased. By the way, the widening of trade balance was caused solely by the growing energy deficit, unlike the non-energy balance. Besides weak import pressures from domestic demand, favorable condition in non-energy trade deficit was a result of increased utilization of new export capacities. It can be expected that these new industries will be the central driver for the future growth of the Macedonian GDP and employment.

In 2012, the monetary growth, measured through the increase of broad money M4, significantly slowed down to 4.4% at the end of the year. Growth of currency in circulation was 4.2%, which in line with seasonal trends reached a peak during the summer months and during the pre New Year's period in December, while deposit growth equaled 4.9%. Strengthened confidence in the domestic currency had a positive effect on the currency structure of deposits and contributed to the continuing process of Denarization.

Given the structural features of the economy, the 5.4% growth of total loans was moderate. In addition to credit risk, a significant factor contributing to this result is the process of financial deleverage of European banks operating on the Macedonian market, which faced with the challenges in their home markets led conservative business policies that restrain the activities of their branch banks.

In 2012, the operational monetary policy undergone a thorough reform. The new operational framework relies upon four main pillars: managing structural excess liquidity in a long run, managing short-term excess liquidity, providing liquidity on a regular weekly basis and establishing an interest rate corridor. The aim of the reform was to encourage greater interbank activity, primarily to ensure greater participation of banks in the domestic capital market, including long-term bonds. Also, the volume of lending without the new measures would be more modest, taking into account the diverting of a portion of CB bills to lending activity.

In the area of foreign reserves management, the National Bank continues to follow the principles of safety, liquidity and yield. Thus, following the moves made by several central banks, it decided, besides investing in financial instruments denominated in Euros and U.S. Dollars, to invest a portion of foreign reserves in financial instruments in four new currencies.

Besides the international celebration of the 20 year anniversary of the independence of the Republic of Macedonia, especially important international event in 2012 was the signing of the Memorandum of Understanding between the National Bank and the European Central Bank (ECB) for implementation of the project "NBRM Needs Assessment" funded by the Instrument for Pre-Accession Assistance (IPA).

The main objective of the project is to prepare the National Bank to join the European System of Central Banks, and later, the Eurosystem, by assessing the needs for change in national legislation, organization and human resources at the National Bank in order to achieve the performance standards of the EU central banks.

In conclusion, it can be noted that the Macedonian economy and the National Bank, as its significant participant, must be facilitated to perform their potential. The greatest contribution that the National Bank, as a significant player in the economy, could make is to continue to be fully dedicated to achieving its main goal - maintaining price stability. However, within the activities of the National Bank, in particular, taking into account changes in the global economy caused by the debt crises, it would not be appropriate to think further about unconventional measures to stimulate economic growth. This dilemma is not unique only to the National Bank of the Republic of Macedonia. Most central banks are faced with the same challenge, bearing in mind that a fixed rate of the Denar means that the difference between Denar real interest rates and Euro real interest rates will remain, although it is possible to continue reducing as a result of the recovery or lack of recovery in the euro area.

Macedonia has numerous and decisive advantages: low taxes, skilled and inexpensive labor, high potential for development of agriculture and energy, population figures which are more favorable than many developed countries, and export-based companies. Therefore, these advantages must be used to increase productivity, employment and hence, GDP. The National Bank, achieving its primary and additional objectives, will continue to make a significant contribution to the utilization of the possibilities of the economy for the benefit of all our citizens.

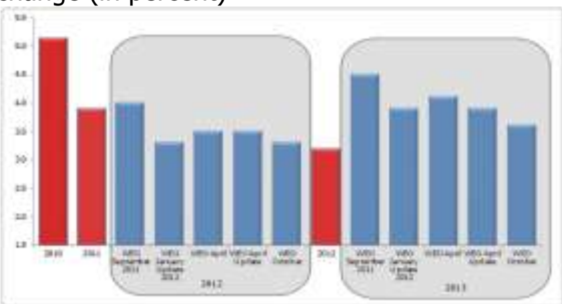
Skopje, April 2013

Dimitar Bogov
Governor and
Chairman of the NBRM Council

I. Monetary Policy in 2012

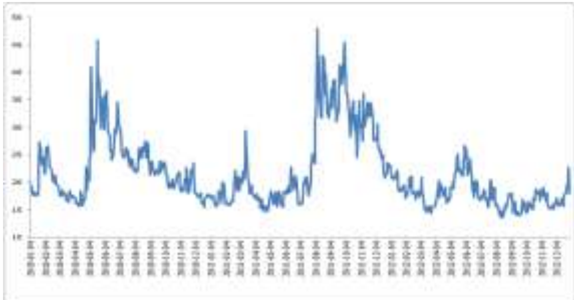
In 2012, monetary policy continued to be conducted in accordance with the accomplishment of the main monetary objective - maintaining price stability by maintaining a stable exchange rate of the Denar against the Euro. Monetary policy decisions in 2012 continued to be based on the current economic and financial conditions and on the assessments of the future prospects for the period relevant for the monetary policy. **The environment for conducting the domestic monetary policy was relatively favorable from a monetary viewpoint, but with significant risks, which increased the probability of deviations of the flows from their originally estimated path.** Hence, scenarios and forecasts for the economy changed during the year, largely reflecting the still uncertain and changing economic environment. *The uncertainty about the recovery of the global economy, was a key risk factor also in 2012.* In circumstances of a slow return of confidence of the private sector and when the financial sector and public finances were still vulnerable, global growth was mainly revised downwards. In such "non-stimulating" external environment, potential risks to the domestic economy were located in the export segment and the access of domestic entities to external sources of capital. Also, in these conditions the likelihood of outflow of capital from the country increased. The possible materialization of these risks could cause spillover effects on the expected path of foreign reserves, which in circumstances of a fixed exchange rate, means change in the conditions for monetary policy conduct. *Furthermore, despite these anticipated risks, there were unexpected changes during the year.* In the second half of the year, there was another *fast growth in world food prices,* causing inflationary pressures and deteriorating terms of trade. *Additional unanticipated factor in this period was the change in the fiscal position.* The poor economic growth affected the dynamics of tax revenues, which, together with the payment of government arrears led to a higher than initially expected budget deficit in the last quarter. Although these changes were made when there was space for sustainable domestic and external financing of the deficit, this implied change in the assumptions underlying the macroeconomic environment for the monetary policy conduct.

Figure 1
Revisions of the global economic growth, annual change (in percent)



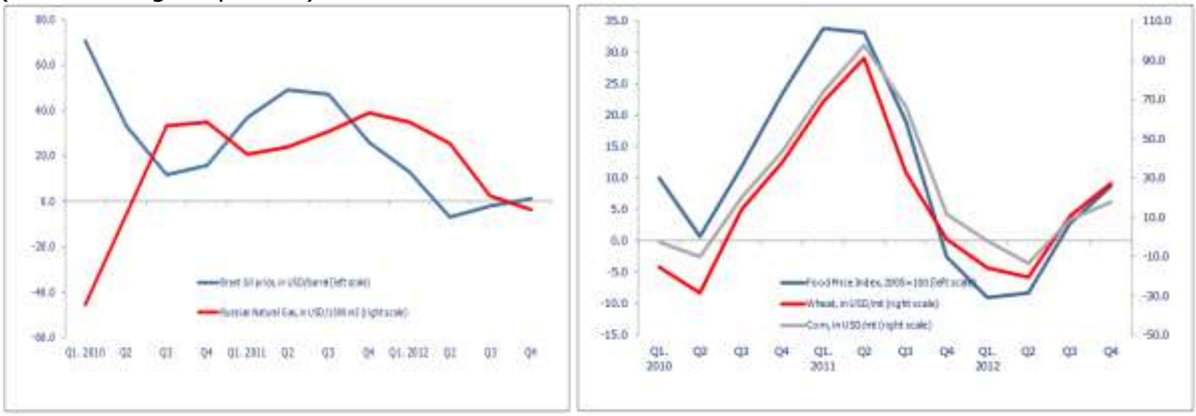
Source: World Economic Outlook (IMF WEO Database).

Figure 2
VIX index*



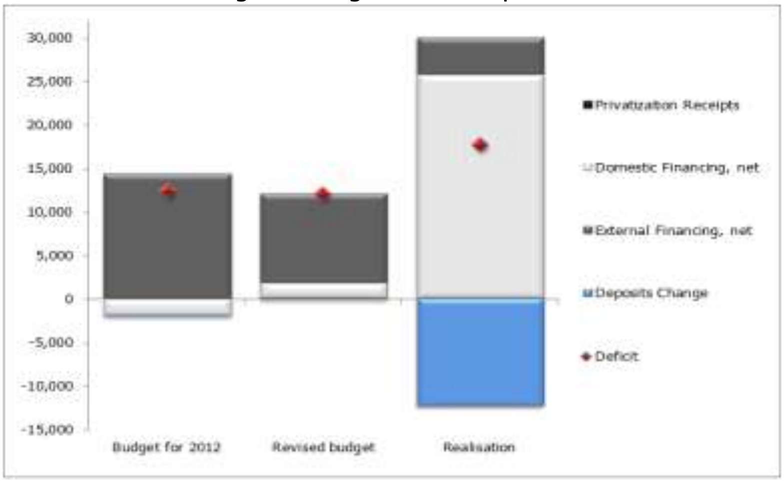
* Index of implied volatility of securities of the S&P500 index.
Source:Blumberg.

Figure 3
World prices of food and energy
(annual change in percent)



Source: IMF database.

Figure 4
Structure of financing the budget of the Republic of Macedonia



Source: Ministry of Finance.

During 2012 however, movements in the domestic economy and projections for the forthcoming period pointed to a room for relaxing the monetary conditions. Monetary policy was relaxed in the first half of the year. *In the first three months of the year, monetary conditions remained unchanged. The environment for conducting monetary policy was favorable, but there were risks of the external environment, which imposed a need of more cautious monetary policy.* The favorable movements were evident from several elements. In the beginning of the year, the level of foreign reserves was higher than expected. In large part, such an improved position was due also to factors associated with domestic entities' confidence in the domestic currency. The lack of confidence in the Euro by the end of 2011 caused a process of rapid denarization of households' financial assets. This process continued during the first months of 2012, contributing to favorable movements in the foreign exchange market and to interventions of the NBRM with purchasing of foreign currency. During the first quarter, inflation consistently decelerated, showing a significant reduction in inflationary risks. The dynamics of the labor costs, also indicated absence of risks for future inflationary pressures through wages and labor market. Indicators of economic activity signaled deterioration in the performance of the corporate sector and gradual transfer of the insufficient external demand on the domestic economy. Under such conditions, the likelihood of deeper negative output gap was estimated to be high compared to the expectations, thereby again reducing the risks of creating inflationary pressures through the demand. Although in the early months of the year lending on the credit market increased, it was still far below banks' lending potential.

Figure 5
Annual GDP growth

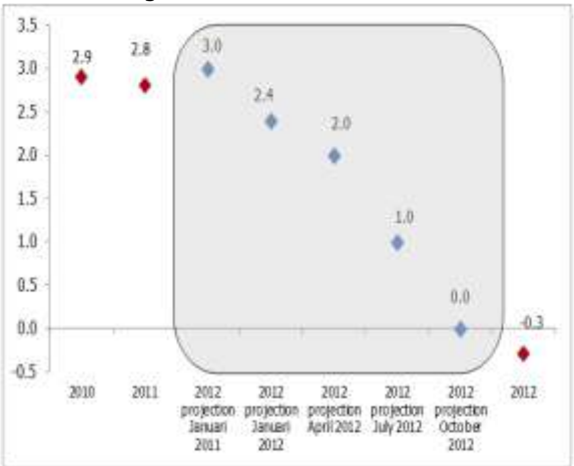
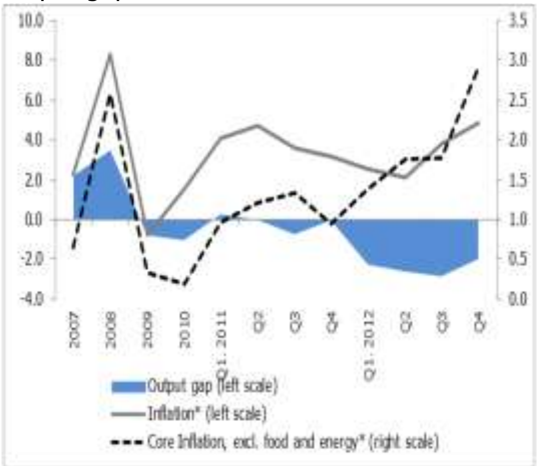


Figure 6
Output gap and inflation



* Average annual inflation in the quarter.
Source: SSO and NBRM.

Figure 7
Euroization level
(in %)

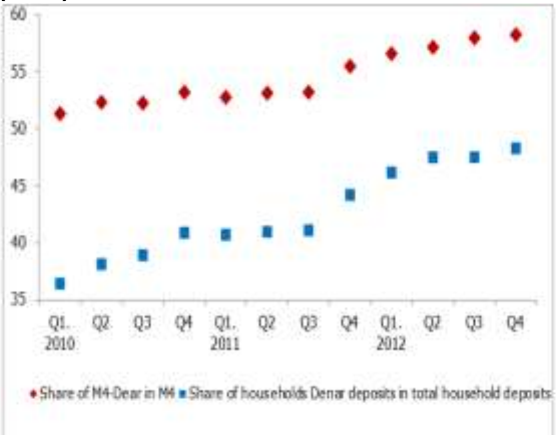
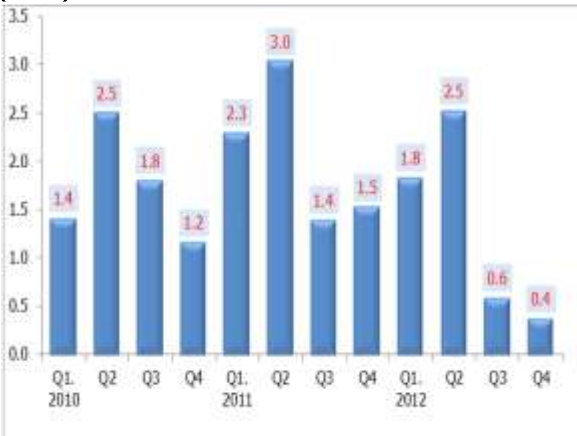


Figure 8
Quarterly growth rate of total loans
(in %)



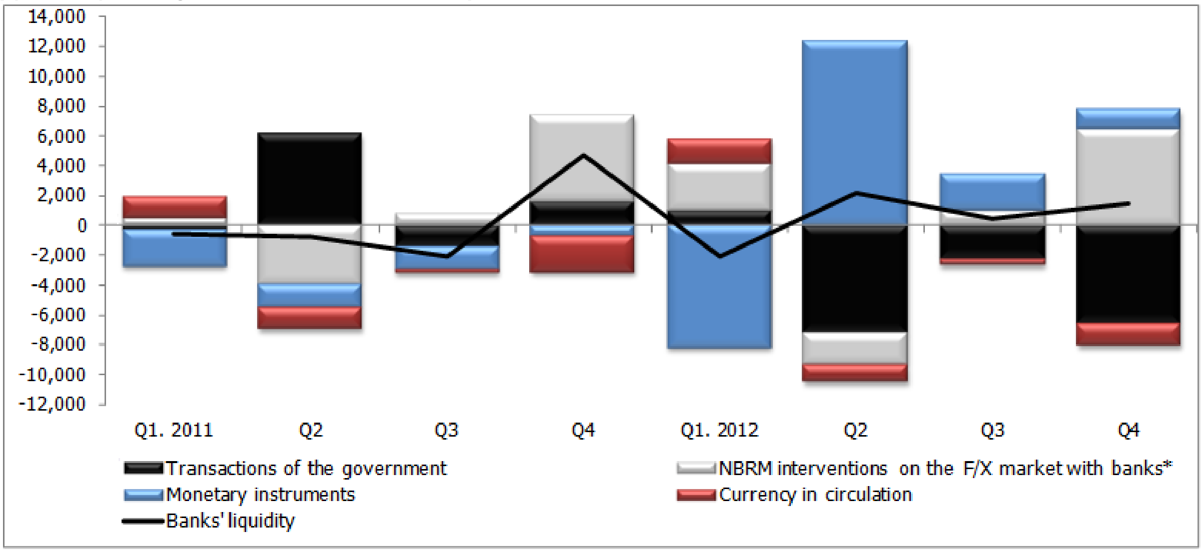
Source: NBRM.

Observed from the monetary viewpoint, favorable trends continued also during the second quarter. In the absence of external and internal imbalances and amid sufficient capacity to absorb the potential pressures on the exchange rate, in April the operational monetary framework was changed[1], which among other things meant injecting additional liquidity in the system, and thus more relaxed monetary conditions. The changes in the operational monetary framework in April, among other things, pertained to limiting the amount of offered CB bills to an amount that will ensure the stability of the weighted interest rate on the auctions close to the established maximum interest rate. Under such conditions, a significant liquidity of around Denar 6,285 million was injected through CB bills on annual basis (Denar 7,827 million with the other monetary instruments, i.e. deposit facility and repo transactions). In this way, NBRM sent a clear signal of more relaxed monetary conditions and opened a room for the

[1] Detailed explanation of the changes in the operational framework of the monetary policy is given in the section on monetary instruments.

banks for further lending to the private sector. Thus, in 2012, NBRM created additional liquidity into the system both through the set of monetary instruments, and through the interventions in the foreign exchange market.

Figure 9
Flows of liquidity creation and withdrawal*
(quarterly changes, in millions of denars)



* Positive change - liquidity creation; negative change - liquidity withdrawal.
Source: NBRM.

In the beginning of May the maximum interest rate on CB bills auctions was reduced from 4% to 3.75%. In this period, there were pressures on the demand for foreign currency on the foreign exchange market, but they were assessed as temporary and related to the payment of a larger amount of dividend to a foreign shareholder. At the same time, new assessments indicated that the external position of the economy is likely to be better than expected. Import pressures in the economy were smaller in conditions of insufficient demand and a decline in economic activity. Also, inflows through private transfers grew faster than expected, which was determined by the increased inflows from abroad and further increased propensity to hold domestic currency. In this period, prices in the domestic economy began to grow slightly faster than expected, mainly due to the resumed growth of world prices of energy and to domestic factors, in part seen as temporary. However, inflation continued to be maintained within acceptable and controlled frames, with no expectations of major transmission effects on the core inflation from the growth of energy prices. During this period, banks showed greater willingness to lend, but still the room for further funding remained relatively high, and the pace of lending activity was not sufficient to reduce the vulnerability of the real sector. *The accommodative monetary policy during this period indicated reduced risks in the domestic economy for the external position, a strong capacity for conducting the exchange rate policy through adequate level of foreign reserves and simultaneously had a countercyclical aim in conditions of low credit flows and weak utilization of the potential of the economy.*

Figure 10
Current account and its more important components
(% of GDP)

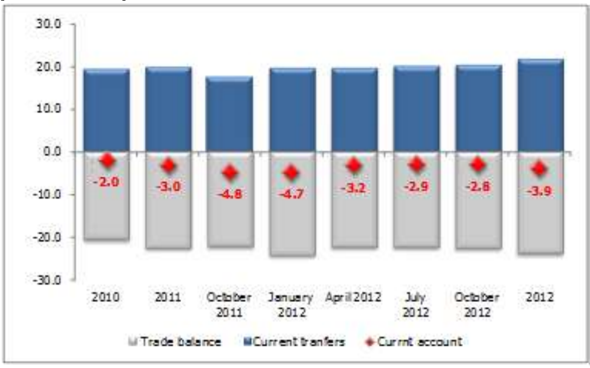
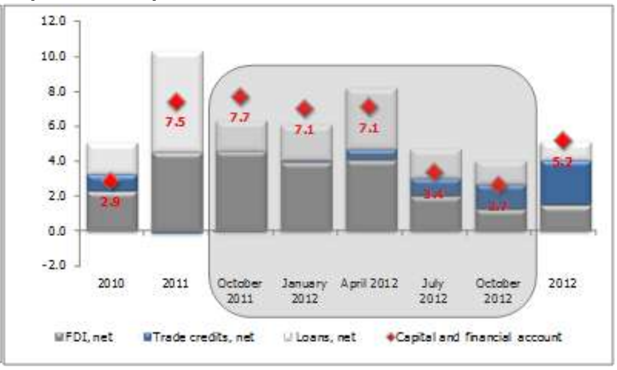


Figure 11
Capital and financial account and its more important components
(% of GDP)



Source: NBRM.

After the monetary policy easing in April and May, in the second half of the year, monetary conditions, as seen through the key interest rate, were not changed. Monetary policy easing was made through the reserve requirement at the end of the year. The measure is of an unconventional character and it was targeted only for banks with credit activity directed towards sectors whose growth reduces the external vulnerability of the economy[2]. Relaxed monetary policy of the ECB and the Fed and the reduction of "stress" on the financial markets in this period did not contribute to improved estimates for global growth. Rather, the projections for growth in the global and European economy were again revised downwards, which worsened the growth prospects also of our major trading partners. **Thus, risks to the external position of the domestic economy and monetary policy have increased.** The projections during the second half of the year showed that these changes in the global environment are likely to reflect in the assessments of the external position, primarily in the area of capital flows. Present distrust on the financial markets worsened the conditions for obtaining external financing, which was reflected by much lower than expected foreign government borrowing in this period. Also, the assumptions for non-debt external financing changed, with assessment for smaller direct investments in the country. In the second half of the year, there was an emphasized effect of capital outflows in the form of loans to parent companies by their daughter companies. Although this process was considered to be temporary bridging of the financial needs of the parent companies, it however increased the risks for the overall foreign exchange potential in the economy. Under these conditions also the estimates of the volume of capital flows and the level of foreign reserves were revised downwards, which indicated the need for caution in conducting monetary policy. **Rising inflation was an additional risk for the monetary policy in the second half of the year.** Besides the effect of the increased regulated prices in August, inflationary pressures have emerged also due to the resumed growth in world food prices, which began to grow rapidly. Growth of both the overall and the core inflation accelerated and exceeded the expectations. From a monetary viewpoint, inflationary movements were not assessed as high risk. The acceleration in inflation was not caused by the demand, and given the weak demand and underutilized potential, the creation of prices/wages spiral was unlikely. Also, in conditions of reduced confidence in the Euro, the likelihood that this price increase will cause increased preference for foreign currency was relatively small, thus no pressures on foreign reserves due to inflation growth were expected. However, taking into account the psychological dimension of inflation, there was a risk that higher inflation will by itself cause growth of inflationary expectations, which would mean spillover of price growth from the

[2] See more detail in the section on monetary instruments.

supply side on the other prices in the economy. *In the third quarter, a change in fiscal policy was announced, which meant an increase in the budget deficit from 2.5% of GDP to 3.5% for the current year, but also a policy of a budget deficit higher than previously expected also for the next year.* The possible increased liquidity creation and possible pressures on foreign reserves would be the monetary consequences of these changes. At the same time, toward the end of the year, the certainty of foreign exchange inflows on the basis of the projected government borrowing from abroad reduced, due to internal political tensions[3].

In the last month of the year, the movements on the foreign exchange market showed that the risks have not fully materialized. Contrary to expectations, the NBRM intervened by large purchase of foreign currency and at year-end foreign reserves were significantly above expectations. Deviations have been mostly due to the higher support for financing the current account deficit by commercial loans and by foreign assets of banks, compared with what was previously expected. At the same time, higher than expected inflows of portfolio investments also had a large effect, entirely due to disinvestment of domestic pension funds[4] in Macedonian Eurobonds and their redirecting into long-term government securities issued on the domestic market. Expected pressures on the foreign exchange market due to fiscal changes were also absent. The higher deficit was largely funded through borrowing on the domestic market, and the overall effect of the government was in the direction of net liquidity withdrawal. At the end of the year, inflationary pressures began to decline, banks' restraint from lending increased, which together with the favorable changes in foreign reserves indicated a room for more relaxed monetary conditions. **Under these conditions and amid reliable inflows of government foreign borrowing, at the beginning of 2013, NBRM again reduced the maximum interest rate on CB bills, down to 3.5%.**

Figure 12
NBRM interventions on the foreign exchange market and sterilization through monetary instruments

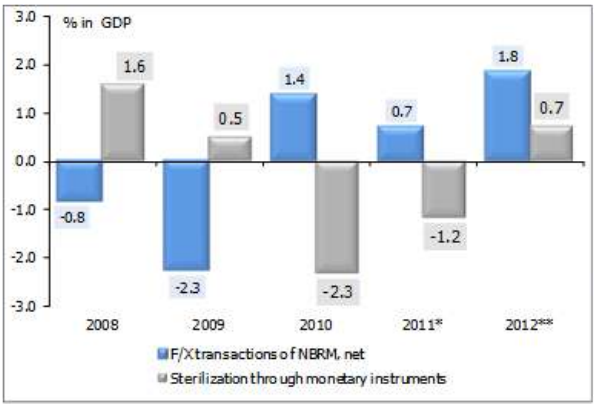
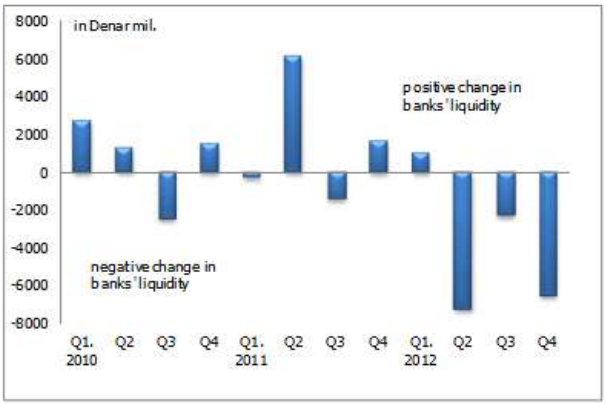


Figure 13
Government transactions (quarterly changes)



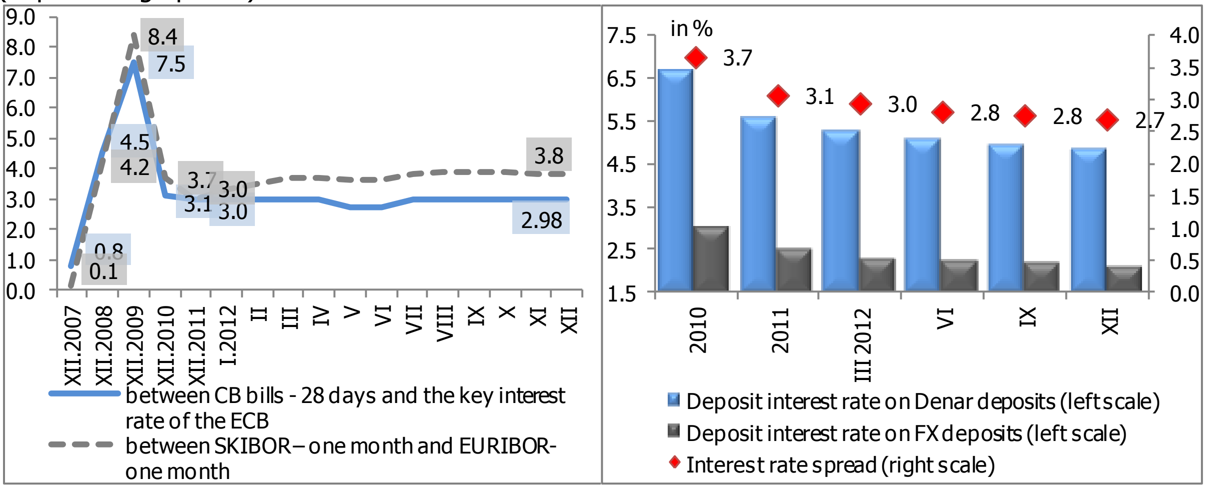
* Preliminary data. ** Estimated data.
Source: NBRM.

Because of the strategy of a de facto fixed nominal exchange rate against the Euro, an important component in the domestic monetary response is the change in the interest rates in the Eurozone, as an anchor economy. Thus, the reduction of the interest rate of the ECB from 1.25% to 1% in the last quarter of 2011, opened a room for relaxing also of the domestic monetary policy. According to the risk assessments of that

[3] Government borrowing from the World Bank and foreign commercial banks, guaranteed by the World Bank.
[4] With the adopted amendments to the Law on Mandatory Fully Funded Pension Insurance ("Official Gazette of RM" no. 98 from 01.08.2012) starting from 15.01.2013, investments of pension funds in bonds and other securities issued or guaranteed by the Republic of Macedonia have been limited only to securities issued on the domestic market, whereby the pension funds are not allowed to invest in government Eurobonds.

time, monetary easing was made in the first half of 2012. In this period, the ECB maintained the same interest rate, in conditions of mostly balanced risks[5] to price stability over the medium term. Due to the materialization of part of the downward risks in terms of the real economy at the end of the first half of the year and the signs of growing tensions in the financial markets, in July 2012 the ECB again cut the key interest rate by 0.25 percentage points. Taking into account the changes in the key interest rates of the NBRM and the ECB during 2012, contrary to the decline in the interest rate spread in the previous year, this year it expanded by 0.2 percentage points, on average. The expansion of the interest rate spread, in conditions of low yields on foreign instruments and high uncertainty on the European financial markets, increases the attractiveness of domestic instruments and may positively contribute to the growth of interest-sensitive inflows into the country.

Figure 14
Interest rate spread
(in percentage points)



Source: NBRM.

In light of the objectives of the NBRM, in 2012 the monetary policy conduct was appropriate and objectives were successfully achieved. *The total average annual inflation in 2012 of 3.3% is an inflation dynamics that is acceptable and is under control.* Although, overall, it is estimated that the growth in prices is due to factors on the supply side, during the year, monetary changes largely encompassed the transmission effects on other prices and wages and the possibility of transmission of the inflation into a demand for foreign exchange. *Although core inflation, which excludes volatile prices, accelerated, on average it only increased by 2%, which is a moderate growth.* The successful management of the temporary mismatch between supply and demand of foreign currency through interventions by the NBRM in the foreign exchange market, *contributed to the maintaining of a stable exchange rate of the Denar against the Euro, which on average for the year was Denar 61.53 per one Euro, as was the average for 2011. On the currency exchange market, Denar 61.45 per one Euro were exchanged on average (Denar 61.46 per one Euro on average in 2011).* At the same time, relatively stable was also the movement of the real effective exchange rate, showing almost unchanged price competitiveness. *Foreign reserves in 2012 registered high growth, and at the end of the year they reached the historically highest level of Euro 2,193 million, representing 29.2% of GDP. Thus, after the decline in reserves at the end of 2008, i.e. in the acute phase of the "Great Recession", starting from 2009 onwards foreign reserves have steadily increased. Adequacy ratios during the year indicated a comfortable level of foreign reserves.* During the year, NBRM had at its disposal foreign reserves that were sufficient to absorb any major shocks in the balance of

[5] Opening remarks by the ECB President Mario Draghi, at the press conference of the ECB held on 03.05.2012.

payments. Given this level of foreign reserves, as well as the regular and clear communication with the public about the projected path of the foreign reserves and the risks surrounding these projections in the context of making monetary decisions, it can be said that foreign reserves have also contributed to the protection from potential shocks (primarily they contribute to maintaining stable exchange rate expectations). **Unlike last year, when major factor for creating foreign reserves was the high amount of government external borrowing, in 2012, foreign reserves were mainly provided through NBRM's interventions on the foreign exchange market.** Except for the period April-June, during the year NBRM constantly intervened with a net purchase of foreign currency. The changes in foreign reserves showed that the current account deficit in the balance of payments is financed entirely by private capital inflows. Domestic banks' behavior had a major role in this situation on the foreign exchange market. In conditions of constant denarization of liabilities, banks had a room to finance a large part of the needs for foreign exchange in the economy through their foreign exchange assets. During 2012, sales of foreign exchange by domestic pension funds had a large direct effect on the net purchase on the foreign exchange market (accounting for about 75% of the total net purchase). **Government external borrowing from commercial lenders in July further strengthened the foreign reserves.** However, the total direct effect of the government[6] on the foreign reserves was negative, given that in 2012, government foreign currency deposits with the NBRM decreased on a net basis.

Figure 15
Factors of change of the gross foreign reserves
(in millions of euros)

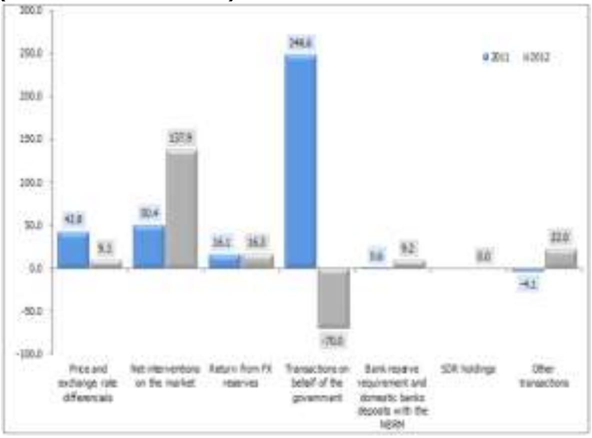
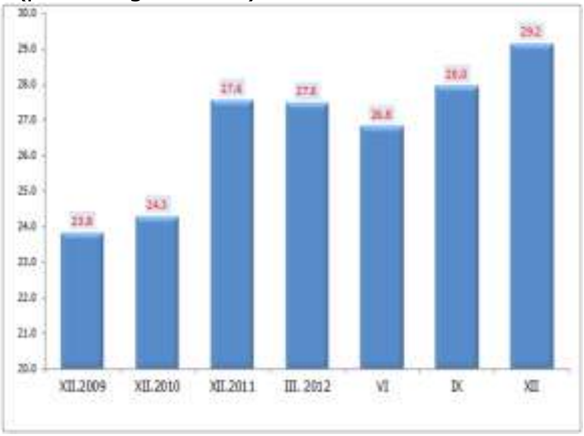


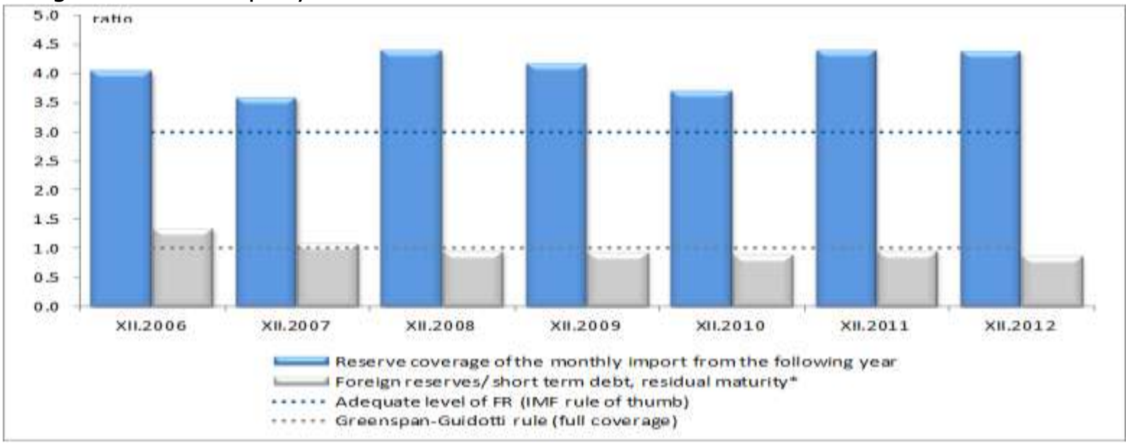
Figure 16
Gross foreign reserves
(percentage of GDP)



Source: NBRM.

[6] Refers to central government and funds.

Figure 17
Foreign reserves adequacy indicators



* According to Greenspan-Guidotti rule, the country needs to maintain full coverage of short-term debt (residual maturity) with foreign reserves.
Source: NBRM.

Against the background of sufficient foreign reserves and assessments of absence of major pressures on the exchange rate and foreign reserves in the next period, in 2012 NBRM used the room for accommodative monetary policy. These changes were intended to provide additional support to the real sector by facilitating the access to financing. However, it can be noted that the monetary transmission was difficult also in 2012. While on the one hand the continuing denarization increased the power of the monetary policy to act on financial and thus on economic trends, the banking system acted in the opposite direction. Vulnerability of the real sector, in conditions of still insufficient external demand was transmitted on the banks' credit portfolio quality. In the last two years, banks' "bad loans" have constantly increased, posing a limiting factor for higher credit growth. *Banks' preferences for low-risk instruments are high,* and despite the positive margins in meeting the mandatory liquidity ratios, banks are increasing their investments in highly liquid instruments. Hence, after the quantitative easing of the monetary policy in April, a significant portion of the released liquidity was directed toward the government securities market. *The process of deleveraging of some parent banks* also limited the credit growth and reduced the effectiveness of monetary policy. Credit demand grew, but with lower intensity compared to the previous year. **Hence, the improved effectiveness of monetary transmission and the transmission of monetary signals to the real sector in the next period will largely be determined by the normalization of the trust and expectations of the entities, and the reduction of the effect of currently present limiting factors.**

Figure 18
Liquidity ratios

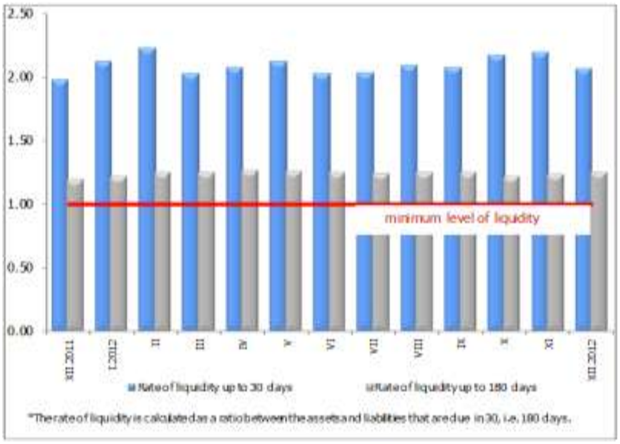
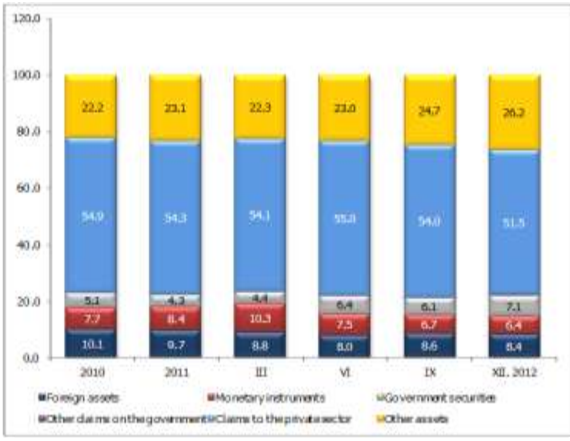
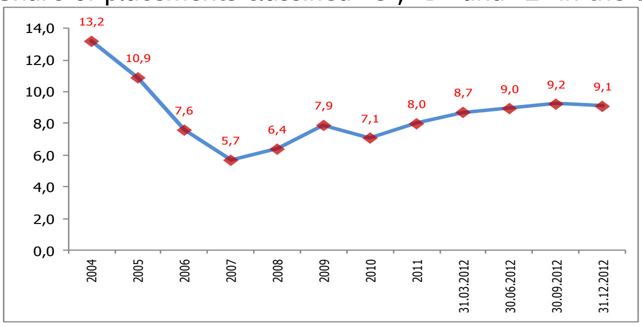


Figure 19
Banks' assets structure



Source: NBRM.

Figure 20
Share of placements classified "C", "D" and "E" in the total credit exposure



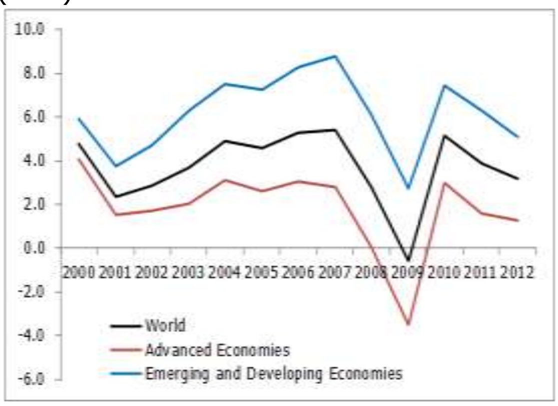
Source: NBRM.

II. Macroeconomic developments in 2012

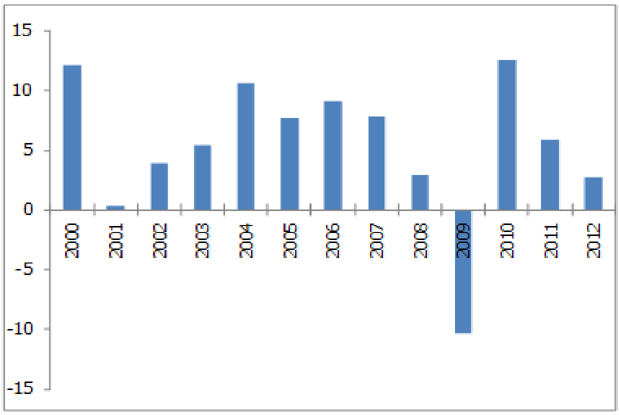
2.1. International economic surrounding

The growth of global economy slowed down in 2012, and with the rate 3.2%, excluding the crisis period, was the slowest in the last ten years. Global economic environment largely deteriorated due to the escalating debt crisis in the euro area in the first half of the year, but also the adverse effects of the ongoing process of deleverage of private economic agents and the fiscal consolidation of the public sector as well as the low confidence of households and businesses, which marked many of the developed countries during 2012. Given such developments in advanced economies, emerging economies and developing countries were again the main driver of growth, although their economic activity visibly decelerated compared to the previous two post-crisis years. The slower growth in these countries is generally due to their reduced export activity in conditions of unfavorable global environment, as well as the lagged effects of monetary tightening in these countries in 2011. Under these circumstances, the growth of world trade in 2012 was more than halved (2.8% vs. 5.9% in 2011).

Figure 21
Global economic indicators
Global economic growth
(in %)



Growth of global trade



Source: IMF World Economic Outlook Database, October 2012, IMF World Economic Outlook Update January 2013.

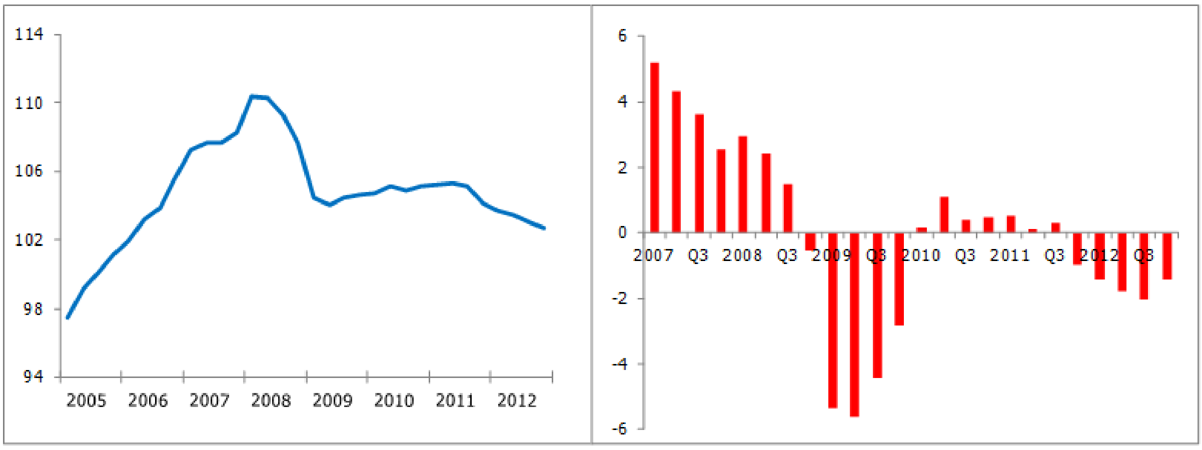
Suppressed global demand and declining prices of primary products on the global market in 2012 led to a moderate slowdown of global inflation, bringing it to the level of 4%, after the sharp rise of prices in 2011 (4,9%). Moreover, in developed economies, the annual inflation rate dropped to 2% from 2.7% in 2011, while in emerging economies and developing countries it decreased to 6.1% from 7.2%.

In such a global environment, foreign effective demand[7] dropped from 1.7%, for the first time since 2009, as a reflection of the actual negative economic growth in most of the major trading partners of the Republic of Macedonia. Analyzed in more detail, Greece, Italy and Serbia made the largest negative contribution to the annual growth rate of the foreign effective demand in 2012, while, due to the growing economic resilience, only the contribution of Germany and Bulgaria was positive.

[7] Foreign effective demand is calculated as the sum of the weighted indices of the gross domestic product of most important trading partners of the Republic of Macedonia. The weights are calculated on the basis of share of these countries in the Macedonian export. The calculation of the index includes Germany, Greece, Italy, the Netherlands, Belgium, Spain, Serbia, Croatia and Bulgaria.

Figure 22
Foreign effective demand
(in %)

Annual growth rates

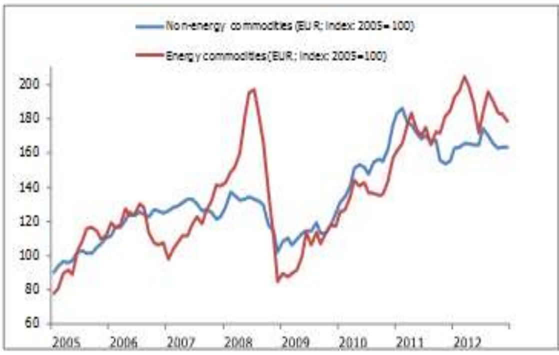


Source: NBRM calculations.

In 2012, global prices of primary commodities registered moderate growth compared to the previous year, which was significantly slower than the previous two years. Moreover, the total index registered adverse movements in its energy and non-energy component. The first component experienced a rise of prices, while the second witnessed a moderate price decline. During 2012, oil prices experienced upward changes which are mainly explained by fundamental geopolitical and exchange rate factors. At different times of the year, these factors include the effects of higher oil demand, reduced supply, increased tensions between the West and Iran over the embargo by EU and the U.S. sanctions on imports of Iranian oil, and the faster Euro depreciation due to the strengthening of the debt crisis in the euro area by mid-year. Hence, in 2012, the price of crude oil "Brent" rose by 9.3%, on average, compared to the substantial growth of 32.7% in 2011, and equaled Euro 87.1 per barrel. The reduction of price index for non-energy products resulted from the high rate of decline of metal prices (-11%). These performances correspond to the slower growth of global economy, especially the weaker demand in the European and Chinese economy. The appreciation of US Dollar also contributed to the fall of metal prices. On the other hand, in 2012, food prices increased by 6.4%. Thus wheat prices rose by 7.5%, while corn prices rose by 11%, largely due to the depreciation of the Euro. Moreover, in the mid-year, the prices of these cereals were under a price shock as a result of uncertainty about the harvest caused by the unfavorable weather conditions in the U.S. and the Black Sea. However, this shock is exhausted by the end of the year and caused no similar crisis as in 2008, thanks to the efficient international coordination and weaker demand for cereals.

Figure 23

Monthly movement of prices of primary energy and non-energy commodities



Monthly movement of prices of crude oil, metals and food

Source: IMF's database on primary commodity prices.

In 2012, the central banks of major developed countries continued to conduct stimulating monetary policy in order to neutralize, to some extent, the recession effect of the process of fiscal consolidation and financial deleverage of economic entities. The undertaken unconventional monetary measures were main characteristic of the policies. Thus, in order to contribute to reducing long-term interest rates, in 2012, the Fed kept on implementing the program to extend the maturity of assets in its balance sheet (Operation "Twist"). Also, in September, the bank began to implement the third quantitative easing through the purchase of mortgage bonds in the amount of US Dollar 40 billion every month, which aims to provide loans at lower interest rates as a way to stimulate the overall economy. Finally, in December, the Fed announced a new program to purchase treasury bills in the amount of US Dollar 45 billion dollars each month to support the mortgage market and easing of the financial conditions in the economy. In terms of interest rate policy, importantly, in December, despite inflation target, Fed also established for the first time an unemployment target, or a decision not to increase interest rate from 0 to 0.25% as long as the unemployment rate exceeds 6 5%, provided that the expected inflation is not higher than 2.5%, and inflation expectations to be stable. Given the relatively larger space, in July, the ECB decided to cut the policy rate from 1% to 0.75%, which is the lowest level since the existence of the bank. In addition, like the Fed, the ECB conducted unconventional monetary policy in order to prevent the occurrence of a liquidity crisis and to enable easier access to financing for the real economy. Therefore, in February, the ECB conducted the second of two long-term refinancing operations with a maturity of three years, when it provided additional liquidity to the European banking system. Also, in order to increase investor confidence in the Euro and to reduce the risks of financing, which led to a rise in required interest rates, mainly of the peripheral European countries, in July, the ECB announced the implementation of so-called outright monetary transactions, which consist of buying government bonds of those countries that will require formal assistance from the European funds for financial aid. This contributed to the reduction of risk premiums on government bonds of peripheral countries at the end of the year.

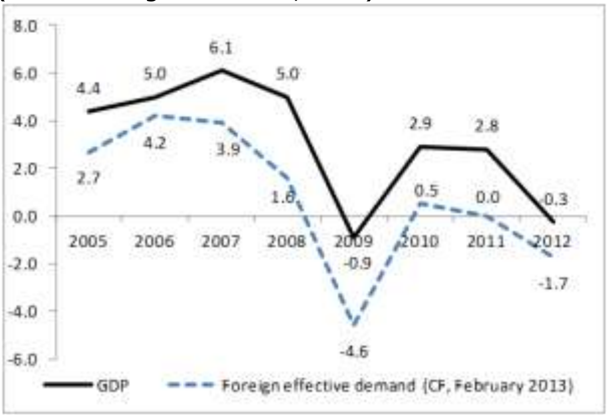
2.2. Macroeconomic developments in the Republic of Macedonia

2.2.1. GDP and inflation

After two years of relatively stable economic growth of about 3%, in 2012 the Macedonian economy registered a slight decline of 0.3%. Further uncertainty in the external environment and decelerated economic activity of the most important trading partners, as a result of the European debt crisis, was the major

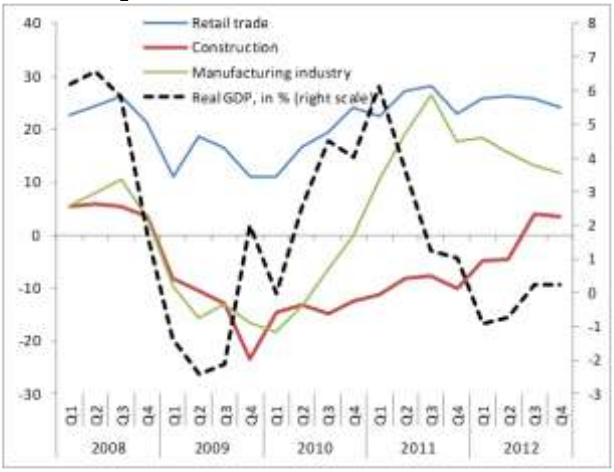
factor limiting the growth of the domestic economy in 2012. Adverse spillover effects were especially experienced in the first half of the year. Resurgence of the euro area debt crisis affected the growth rates of our major trading partners and led to a decline in the foreign effective demand for the first time since 2009. Reduced demand for Macedonian products, and lower world export prices, followed by the effects of extreme cold weather conditions, severely hit the domestic industry and export sector. As a result of these developments, the domestic economy entered a negative growth zone and dropped by around 0.8% on average, for the first half of the year. The economy began to recover gradually in the second half of the year, and amid still unfavorable external environment, in the second half of the year, the acceleration of domestic economy was entirely due to domestic factors. The government capital investments and the substantial amount of construction works by private investors were the main drivers of growth of domestic economic activity in the second half of the year (0.2% on average).

Figure 24
GDP and foreign effective demand
(annual real growth rates, in %)



Source: State Statistical Office and Consensus Forecast, February 2013. GDP data for 2011 are preliminary and for 2012 are estimated.

Figure 25
Perceptions for current economic activity of business agents



Source: State Statistical Office.

Deteriorated global economic and financial conditions led to lower utilization of domestic capacities, particularly in export-oriented activities, which contributed adversely to the growth. The decline of foreign demand and unfavorable trends in the prices of non-energy exports to global markets, for the most part affected the **industry which almost entirely determined the annual GDP decline**. Besides the drop of traditional export activities (production of electrical equipment, other non-metallic mineral products, manufacture of metals and clothing), the largest single contribution to the negative performance of the industry was made by the reduced production of domestic oil refinery[8]. Unfavorable economic environment also created less favorable perceptions of domestic economic agents about the future income, causing lower domestic demand and **a decline of total domestic trade**. Thus trade was the second GDP component that made a small negative contribution to the acceleration of real economic activity, mainly due to weaker results in the first half of the year. On the other hand, in 2012, the economic growth was supported by investment from the government and the private sector, primarily in the area of construction activity, typical for the second half of the year. Observing other

[8] Despite the relatively favorable global oil prices, during the year, the domestic oil refinery gradually reduced oil production, a trend that began in March 2012 when overhaul of this capacity was announced. After the overhaul, to the end of the year, this capacity was not operating, despite the announcements of its activation. This company, in accordance with its business policy, supplemented the lack of derivatives in the domestic economy through imports.

activities, services and agriculture made additional positive stimulus to the growth, achieving positive growth rates during the year.

Figure 26
GDP, industry and capacity utilization

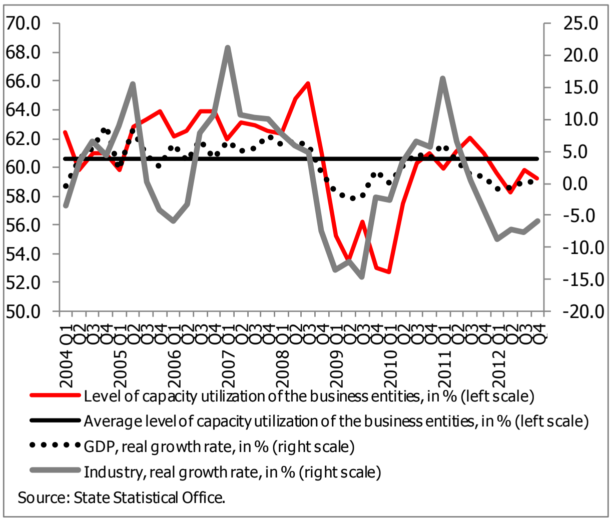
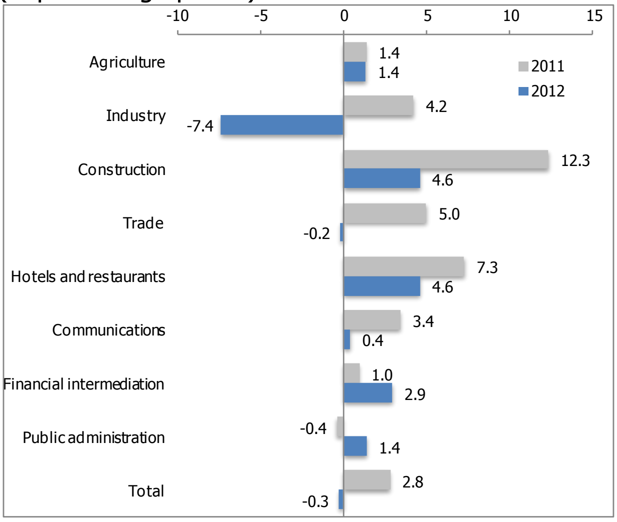


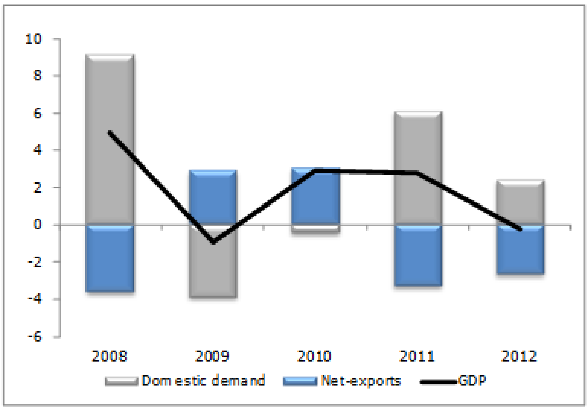
Figure 27
GDP annual growth rates
(in percentage points)

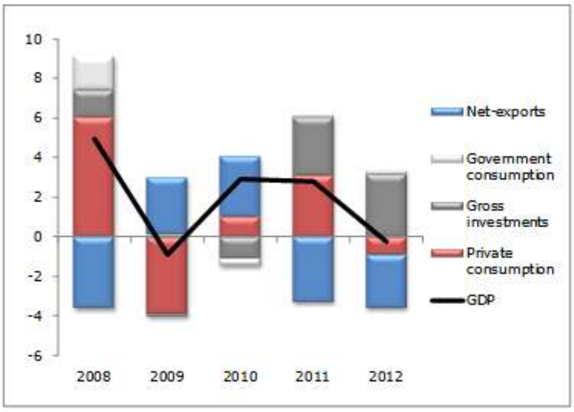


Source: State Statistical Office and NBRM calculations.
The data for 2011 are preliminary and for 2012 are estimated.

Unfavorable global conjuncture in 2012 significantly affected demand in the domestic economy. Export sector directly suffered from the absence of external stimulus when the activity dropped for the first time since 2009. Such achievements in the export sector made their effect in other segments of the economy by worsening expectations for future income and also affected certain labor market segments and the access to funding. The significant slowdown in wages and worsening performance of domestic companies led to a gradual narrowing of the financial support from the banking sector, particularly evident in the second half of the year. Unfavorable movements in private consumption were largely offset by the more intensive public and private investment, as well as by the countercyclical fiscal policy. **Against this background, in 2012, private consumption and export demand declined and made a negative contribution to total growth, while investments and public consumption contributed to its increase. Imports registered a positive growth rate reflecting the investment pressures, leading to a negative contribution of net exports to economic growth in 2012.**

Figure 28
Contribution of domestic demand and net exports to the growth of GDP (left) and components (right) (in percentage points)





Source: State Statistical Office and NBRM calculations.

In 2012, the average annual inflation reduced to 3.3%, which is a slowdown compared to 2011 when it equaled 3.9%. The slowdown of inflation fully reflects the reduced pressure through **food component** (contribution by 1 percentage point compared to 2.4 percentage points in 2011), given the lower global food prices compared to the previous year. On the other hand, global energy prices continued increasing, which along with the twofold increase of domestic regulated prices[9], led to higher **energy component**, which was the main driver of the inflation growth (contribution to growth of 1.5 percentage points). Rise of energy and food prices and of regulated prices had spillover effects on the long-term component of inflation, which along with some one-off factors led to higher **core inflation** relative to 2011 (contribution of 0.9 versus 0.5 percentage points in the previous year). Moreover, these developments occurred in the absence of demand pressures, given the lower economic activity in relation to the potential level. Analyzing the dynamics, the first half of the year registered a slowdown of domestic inflation, reducing it to 2.3%. In this period, the slowdown was largely caused by the food component (drop of global food prices by 5.6%10), but also by the slower rise of energy prices once they increased at the beginning of the year due to the EU announcement for embargo on imports of oil from Iran. In the second half of the year, the inflation accelerated, reflecting the rise of world food prices. Spillover effect from import to domestic prices, and the effect of the increase in regulated prices in August affected the domestic inflation, which in the second half of the year recorded an average annual growth of 4.4%.

[9] In 2012, the Energy Regulatory Commission raised prices twice. The price of electricity was increased by 7.83% as of 1 January 2012, and by 10% in August. Also, in January 2012, the price of central heating was increased by 10.8%, and in August, the price of heating energy was increased by 4.1%.
[10] According to the global food prices index, adjusted for their share in our consumer price index.

Figure 29
Domestic inflation and foreign effective inflation*
(annual growth rates, in %)

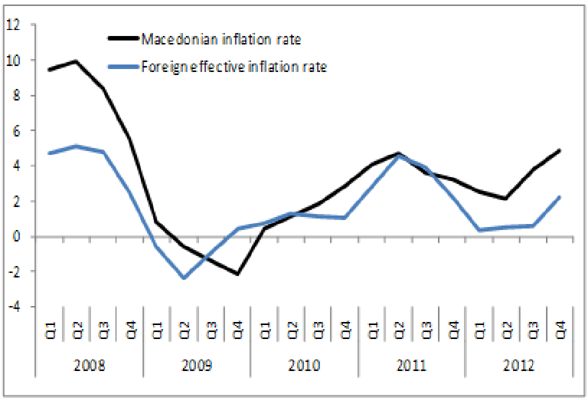
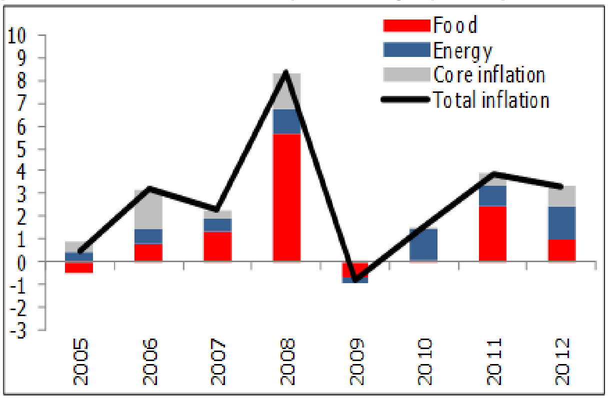


Figure 30
Volatile (food and energy) and long-term component of inflation
(annual contributions, in percentage points)



Source: State Statistical Office, EUROSTAT and NBRM calculations.

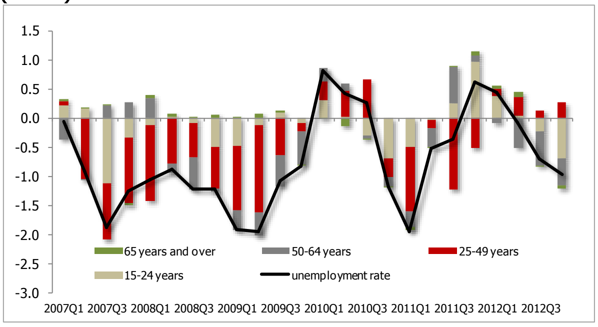
2.2.2. Labor market

Despite weak impetuses in the domestic economy, in 2012 the labor market reported favorable changes. The employment rate increased by 0.8 percentage points compared to the end of 2011 and reached 39.3%. At the same time, with almost unchanged supply of and increased demand for labor, the unemployment rate fell by 1.2 percentage points and reduced to 30.6%. Given the time lag in the adjustment of this segment, **the positive trends in the labor market** to some extent reflect the favorable momentum of economic activity in the previous period. Moreover, the presence of new production facilities also led to greater resilience of the employment, despite the deceleration of economic activity in 2012, with a contribution also made by the active labor market measures that also contributed to the mitigation of structural problems in the labor market[11]. Analyzing the dynamics, the labor market revival marked the second half of the year, which, to some extent, correspond to the impetuses from certain real economy sectors, which include a large contingent of employees, such as trade and construction. Favorable labor market developments are also observed **with respect to age groups**. The results of the Labor Survey showed continuing downtrend of unemployment of the most vulnerable group, and that is the age group between 15 and 24 and among persons aged 50 to 64 years, while the unemployment rate of the age group of 25 to 49 years is almost unchanged compared to the end of the previous year.

[11] During 2012, the Government of the Republic of Macedonia, through the Ministry of Labor and Social Affairs and the Employment Agency took further active measures to increase employment, such as self-employment program, financial support to legal entities for new jobs, employment subsidies , internship programs and many other measures

Figure 31
Selected labor market indicators
(in %)

Figure 32
Unemployment rate by age group
(in %)



Source: State Statistical Office, Labor Force Survey.

The slowdown of average net wage continued during 2012. The average nominal net wage in 2012 amounted to Denar 20,903 and was higher by 0.3% compared to the previous year, which is the lowest growth rate in the last five years. The average gross nominal wage[12] registered almost equal annual increase of 0.2%, which in 2012 amounted to Denars 30,670. Observed by sector, the growth slowed down was mainly due to wages in agriculture, and to a lesser extent, to the wages in industry and services. With inflation of 3.3%, net and gross wages registered a real decline of 2.9% and 2.6%, respectively. **Given the higher employment growth relative to the gross domestic product, in 2012[13], labor productivity decreased by 0.6%.** In 2012, the productivity decelerated after two consecutive years of annual growth, and backed away from the level of productivity in the pre-crisis period (productivity is lower by 2.6 percentage points compared to the average level of 2008). **The unit labor costs** again registered a moderate growth of 0.8%, influenced by the growth of gross wages amid decline of productivity.

Figure 33
Average gross and net wages
(annual changes, in %)

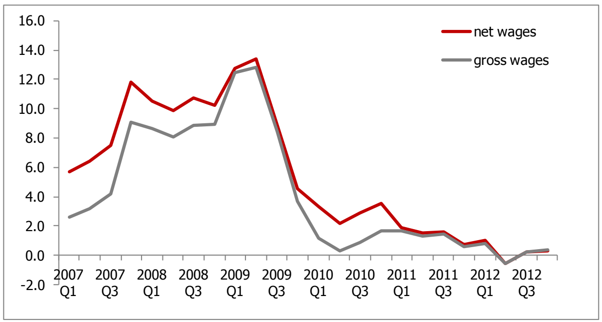
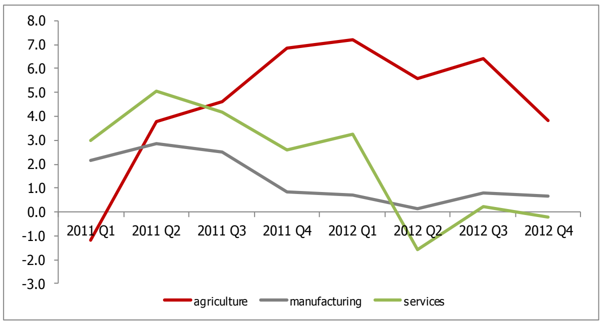


Figure 34
Average net wages, by sector
(annual changes, in %)



Source: State Statistical Office and NBRM calculations.

[12] The total gross paid wages include: paid net wages for the reporting month, paid income tax and paid contributions (pension and disability insurance, health insurance, employment, occupational disease and water supply). The data relate to paid wages.
[13] Productivity and unit labor costs for the overall economy are calculated on the basis of GDP data, the total number of employees, according to the Labor Survey of the State Statistics Office and the data on average gross wages.

Figure 35
Labor productivity and unit labor costs
(2005=100)

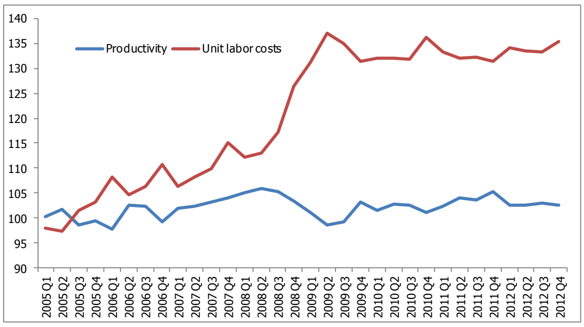
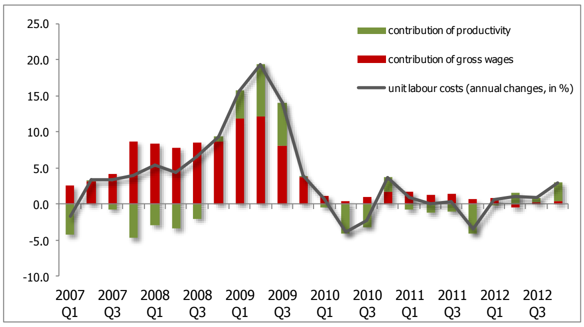


Figure 36
Unit labor costs
(annual changes, in %)



Source: State Statistical Office and NBRM calculations.

2.2.3. Public finances

In the absence of growth of the domestic economy, in 2012, the budget deficit increased, but the fiscal policy managed to remain prudential. The public finances during the year faced major challenges. Thus, in the first half of the year, the revenues performed lower than expected. This deviation created a need for downward adjustment of expenses to maintain the budget deficit target of 2.5%. Hence, in June, the budget was revised[14], reducing the total revenues and expenses by 4.6% and 4.5%, respectively, compared to the initial plan. However, despite these changes, in the second half of the year[15], the fiscal setup had to be readjusted, due to the need for settlement of arrears to the private sector[16] in the previous period, given the further underperformance of revenues compared to projections. Notably, the government did not adjust public spending to the slower than expected pace of revenue growth, but made the adjustment by increasing the fiscal target by 1 percentage point (from 2.5% to 3.5%). **In 2012, fiscal deficit equaled 3.8% of GDP, which is an increase of 1.3 percentage points compared to the previous year which is also one of the highest deficits ever.** Primary budget balance[17] also deteriorated, and in 2012, the primary deficit accounted for 2.9% of GDP, versus 1.7% in the previous year. Similarly, significant deterioration was registered in the current budget balance[18], where from a surplus of 0.1% in the previous year, moved to a deficit of 1.5%. **The growing need for deficit financing further increased the public debt, which at the end of the year amounted to 33.8% of GDP.**

[14] Amendments to the Budget of the Republic of Macedonia for 2012, ("Official Gazette of the Republic of Macedonia" no. 71/2012 dated June 7, 2012.

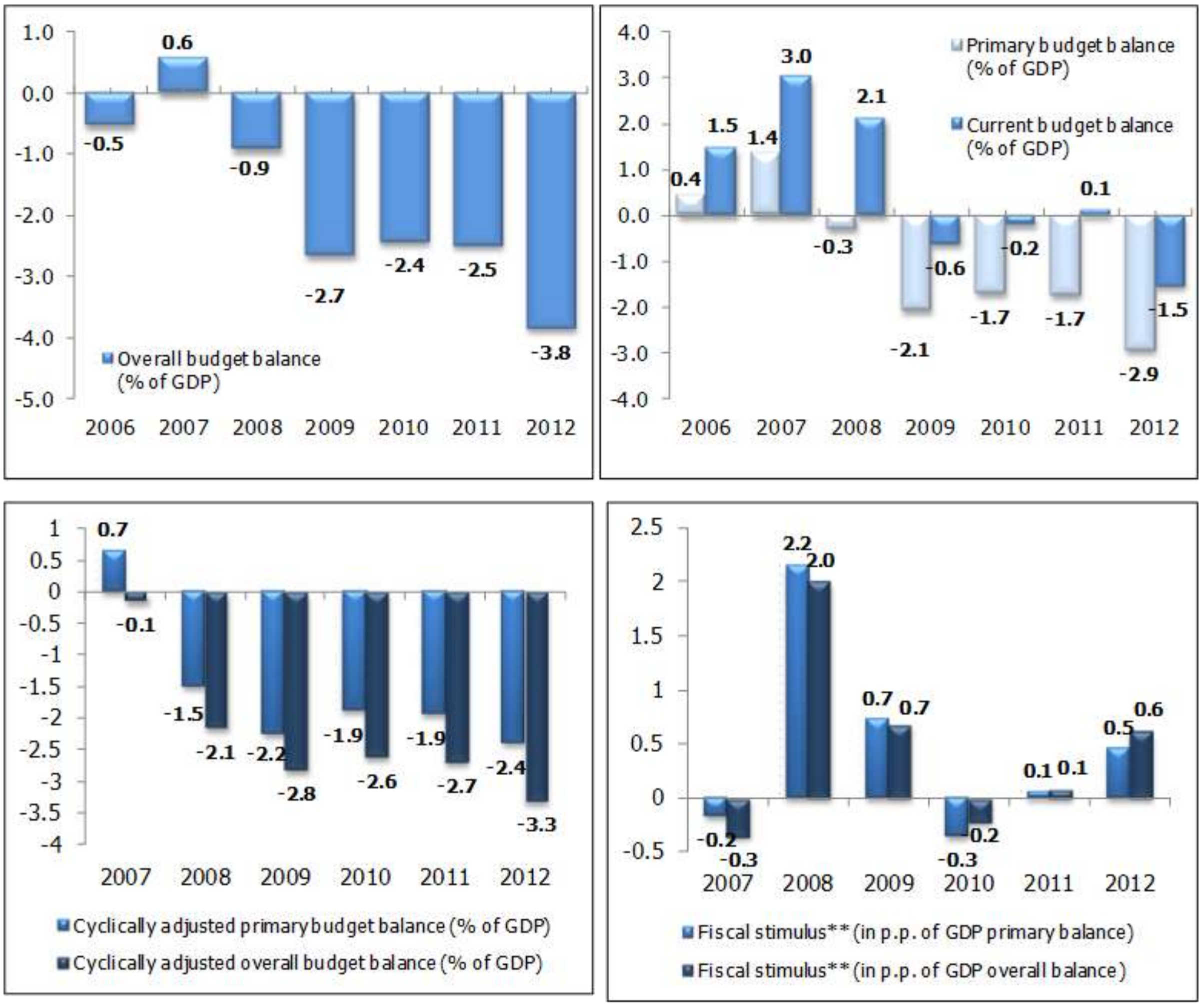
[15] In the last quarter of the year, the government disclosed the amount of overdue arrears based on a VAT refund and based on trade payables, and the intention to pay them off in the last quarter of 2012 and first quarter of 2013. Given that the budget data are cash flow data, these changes also meant an increase of budget expenses over the amount that would be realized if the settlement of overdue arrears had not happened.

[16] According to the Ministry of Finance, the outstanding debt on the basis of a VAT refund and on the basis of completed construction works and services totaled Denar 5,653 million in September 2012, and its full payment was anticipated to February 2013.

[17] Primary budget balance is the difference between total budget revenues and total expenses, net of repayment of current loan liabilities (interests). This fiscal indicator is considered more appropriate for the analysis of current policy course, due to the fact that it does not include fiscal costs related to past conduct of fiscal policy relative to the public debt.

[18] Current budget balance is the difference between current income (income taxes and non-tax revenues) and current budget expenses (wages and fees, goods and services, transfers and interests).

Figure 37
Fiscal indicators



* Calculations of current budget balance in historical frameworks exclude Telecom dividend from nontax revenues and includes it in capital revenues (under the methodological changes in 2011).
**Fiscal incentive is the difference between the cyclical adjusted balance in the previous and current year.
Source: Ministry of Finance of the Republic of Macedonia and NBRM calculations.

Analyzing the structural fiscal indicators, in 2012, deterioration was also noted in the structural fiscal balance. Thus, discretionary fiscal policy had a positive fiscal stimulus on the overall economy, with a similar intensity of that in 2009. The deterioration of budget position measured by cyclically adjusted balance implied an increase of structural deficit of 3.3% of GDP, from 2.7% in 2011. Moreover, since the structural primary deficit increased given the negative output gap, it could be perceived that in 2012, fiscal policy was countercyclical and aimed to support domestic demand.

Figure 38
Budget balance financing structure

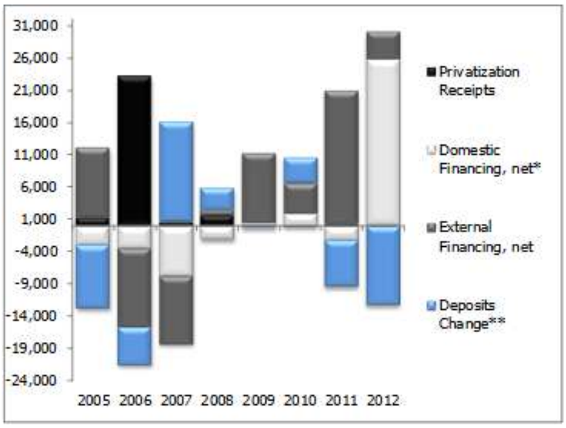
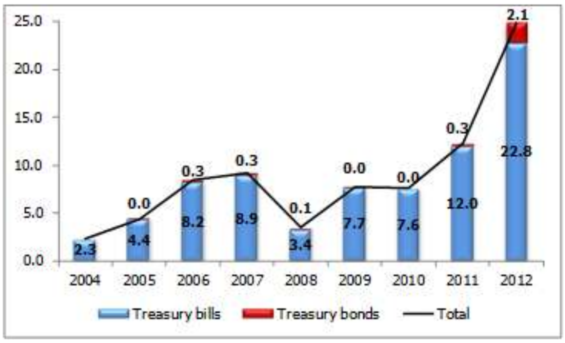


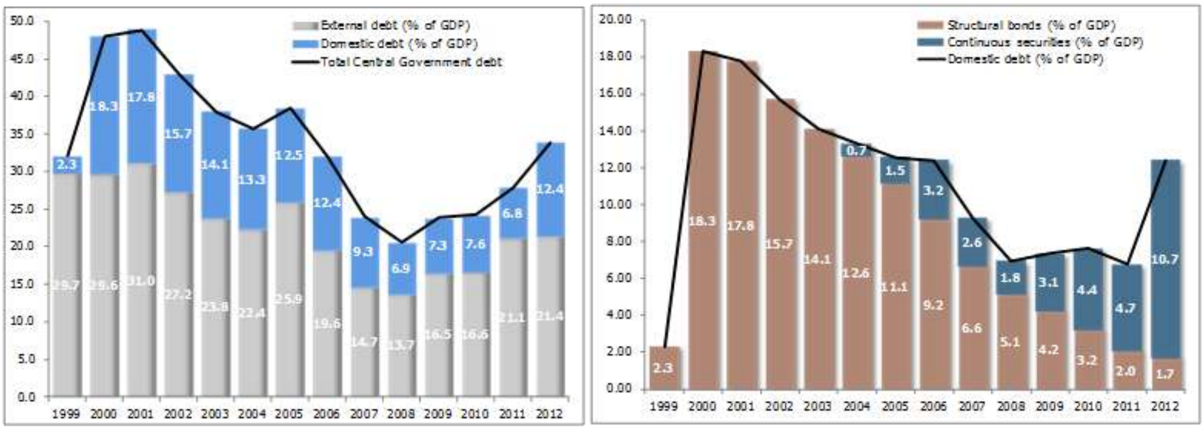
Figure 39
Government securities on primary market
(% of GDP)



* Difference between total inflows based on continuous and structural securities (treasury bills and bonds) and total outflows based on servicing of domestic debt.
** Negative change of government deposits implies that they have been deposited on account with the NBRM.
Source: Ministry of Finance of the Republic of Macedonia and the NBRM.

In 2012, budget deficit was mostly financed by domestic borrowing through new issues of government securities, while lower portion of the required inflows was provided by external borrowing[19], unlike initially planned in the Budget for 2012 and its revision. The increased need for deficit financing, given the unfavorable global environment and difficult access to international financial markets led to an increased presence of the government in the domestic capital market. Thus, the total performance on the primary government securities market in 2012 amounted to 24.9% of GDP, which is twice as high compared to the previous year. Against the backdrop of high uncertainty, the above indicates a high interest of domestic entities to invest in low-risk government securities, even at moderately lower interest rates from the previous year[20]. It is important to note that in 2012, the government, despite the increased borrowing through bills, stepped up the pace of issuing long-term bonds[21], too, and through this instrument it has provided funds by eight times more than in 2011.

Figure 40
Public debt structure



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

[19] In July 2012, Euro 75 million were borrowed from Deutsche Bank.
[20] The average weighted interest rate on treasury bills with different maturities was 4.1% (4.2% in 2011), while the average interest rate on government bonds equaled 5.4% (5.6% in 2011).
[21] In 2012, 29 auctions of three-year and five-year government bonds were held, whose volume of exercise equaled Denar 9,849 million, or 2.1% of GDP.

In 2012, the total central government debt[22] increased by 21.8% compared to 2011 and reached Euro 2,545 million. The share of central government debt to GDP rose to 33.8% from 27.8% the previous year. The annual debt growth mostly arises from the growth of domestic debt (about 83.9%), and the external debt recorded a minor annual growth of 1.9%. Regarding the debt structure, these changes resulted in a significant increase of the share of domestic debt to GDP (12.4% versus 6.8% in 2011) and a moderate increase in the share of external debt.

2.2.4. Balance of payments, IIP and external debt

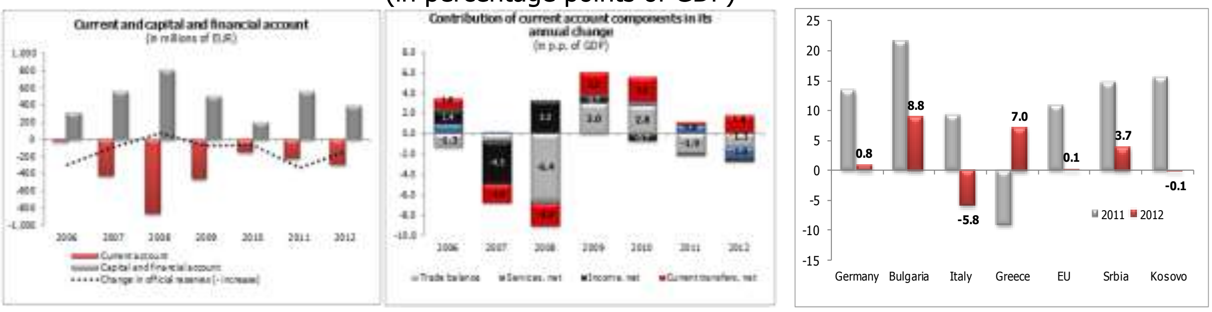
Negative changes in export demand and price movements on the international markets also affected the balance of payments, causing moderate deterioration of the current account deficit compared to the previous year (by 0.9 percentage points of GDP), when it equaled 3.9%. Deteriorating expectations for the global and especially the European economy were reflected by decreasing inflows in the capital and financial account, which was particularly evident in foreign direct investment and loans. The deterioration of current account deficit is largely due to the deterioration of the balance of goods and services, in conditions of higher net inflows of current transfers.

Figure 41

Current and capital and financial account (in millions of euros)

Contribution of individual components in the annual growth of current account (in percentage points of GDP)

Total import of most important trading partners (annual growth, in %)



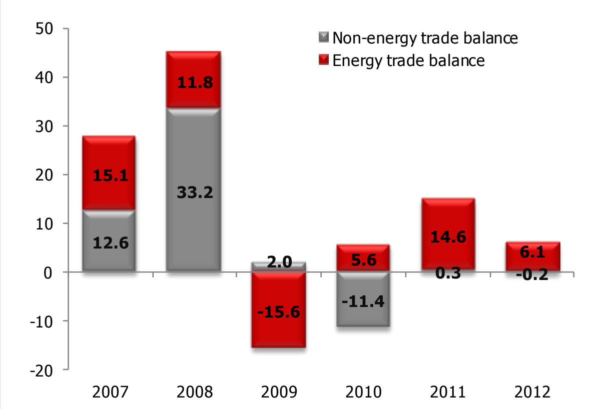
Source: NBRM.

The trade deficit increased by 1.3 percentage points of GDP in 2012. The expansion of **trade balance** was completely caused by the growing energy deficit, conversely to non-energy balance. Observing non-energy trade deficit, the unfavorable effect of the decline of external demand and unfavorable trading terms on traditionally vulnerable export sectors was offset by the increased utilization of new export capacities and still sluggish import pressures from domestic demand.

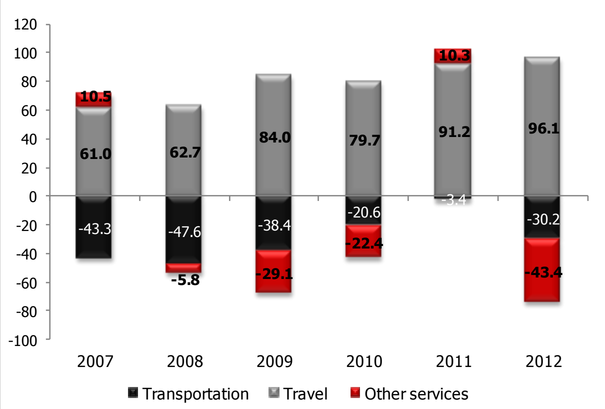
[22] Consolidated debt of central government and funds.

Figure 42

Energy and nonenergy trade balance (contribution to the annual change, in percentage points)



Services balance, by component (in millions of euros)

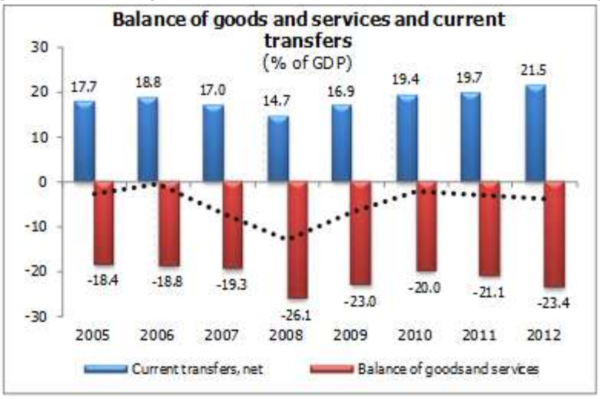


Source: SSO.

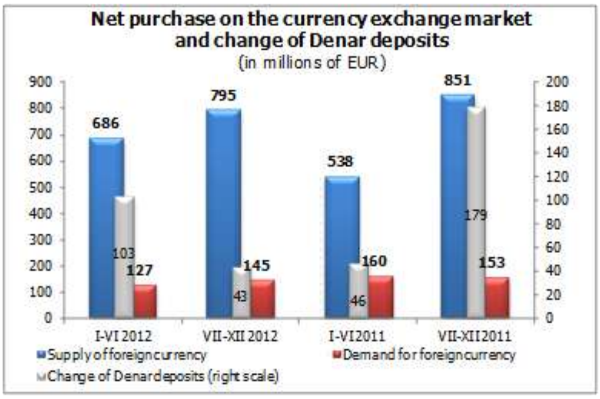
Trade surplus of **services**, after the substantial growth in 2011, in 2012 noted a significant reduction on a net basis. During the year, there were divergent trends in individual categories. Since the second half of the year, which is the start of the active tourist season, there has been a steady growth of net inflows of tourist services[23], but due to high outflows on the basis of certain business and transport services, the balance of services contributed to annual expansion of current account deficit by additional 1 percentage point of GDP. Expectations for improved financial performance of companies in foreign ownership led to a higher amount of reinvested earnings in 2012 and expansion of the **income** deficit by 0.4 percentage points of GDP. Net inflows from **current transfers** reached its highest historical level (21.5% of GDP) in 2012, making them a significant factor for trade and income deficit financing. Financing 92% of the negative trade balance, current transfers which were fully determined by net inflows of private transfers, are the only factor that contributed to the narrowing of the negative current account balance by **1.8 percentage points of GDP**.

Figure 43

Balance of goods and services and current transfers (in % of GDP)



Net cash on the currency exchange market and growth of Denar deposits (in millions of euros)



Source: NBRM.

[23] Higher services inflows generated by tourism also comply with the SSO data on significant increase of the number of foreign tourists in 2012 compared to the previous year. On an annual basis, inflows of foreign nationals traveling to the Republic of Macedonia registered an annual growth of 6.7%.

Intensified purchase of foreign currency on the currency exchange market, the most important private transfer component in the balance of payments, was a generator of positive changes. Volatility in the euro area and still present uncertainty about the future of the common currency have increased the confidence of the population in the Denar, causing faster growth of the supply of Euro on the currency exchange market, and significantly reduced demand. Positive changes were particularly pronounced in the first half of the year, which corresponds with the conversion of foreign currency deposits in Denar deposits, while the second half of 2012 was characterized by a change in the currency exchange market movements. Namely, in this period, net purchase declined on an annual basis, reflecting the particularly high base effect[24]. However, the demand for foreign currency continued to decline, although at a slower pace, and Denar deposits continued to increase. These trends indicated stabilization of expectations about the future of the euro, but without having to reduce confidence in the domestic currency[25].

Detailed **trade balance analysis using foreign trade data**[26] indicate expansion of 5.8%, and simultaneous annual reduction of total foreign trade by 0.7%. The decline of foreign trade is evident both within the overall global economy, and particularly pronounced in developed economies. Foreign trade trends in the domestic economy reflect changes in these economies, whose slower growth affected foreign trade. The decline in 2012 follows two consecutive years of growth, when outstanding exports and imports growth rates were registered. The more dynamic export and import changes in 2010 and 2011 were triggered by the significant start-up of major foreign facilities whose activities influenced the change in export and import structure and dynamics, an effect that stabilized during 2012. The reduction of import demand in developed economies affected the Macedonian **exports**, which fell by **2.6%** in 2012. Export of metal manufacturing industry, which depends on the price changes was mostly affected by the decline of metal prices, and the declining global demand for iron and steel. Also, a significant contribution to the annual decline in total exports was made by the energy, caused by the reduced production of domestic refinery during the year, despite the significant growth of export prices of oil derivatives[27]. On the other hand, diversification of exports as a result of structural changes[28] in the economy caused by the new production facilities in foreign ownership, and diverting part of exporters to markets in emerging economies have strengthened the resilience of exports, significantly alleviating the annual decline.

[24] The last quarter of 2011, particularly December, witnessed high purchase on the currency exchange market. Such trends generally resulted from the increased distrust in the Euro and strengthened speculation about its future.

[25] After the significant conversion of foreign cash, mostly Euros into Denars, and the conversion of foreign currency deposits into Denars upon stabilizing the expectations about the future of the Euro, no reversible process was observed, suggesting retained confidence in the domestic currency.

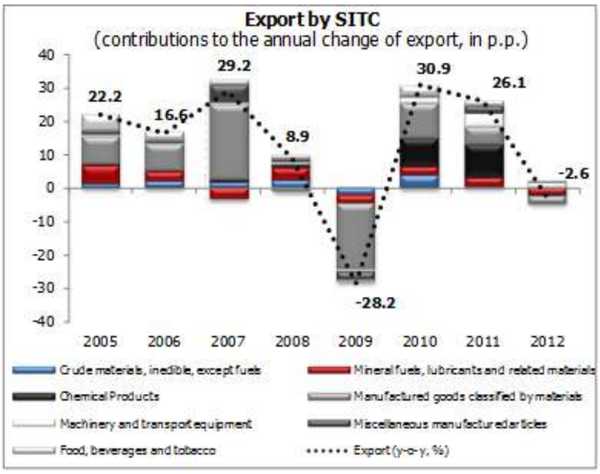
[26] According to the foreign trade methodology, data on exports are published on a f.o.b. basis, and on imports of goods, on a c.i.f. basis.

[27] Quantitative export of oil derivatives decreased by 36.7% in 2012, and therefore, the 11.4% rise of export prices was not sufficient for leveling the real decline in exports in this category. Lengthy repairs of refinery and its significantly reduced capacity caused significant annual decline of exports of oil derivatives (30%).

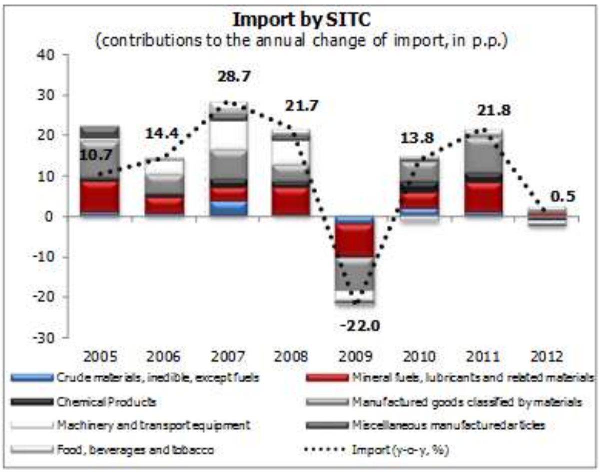
[28] The increase of export by the capacities in the free industrial zone is visible in the category of machinery and transport equipment.

Figure 44

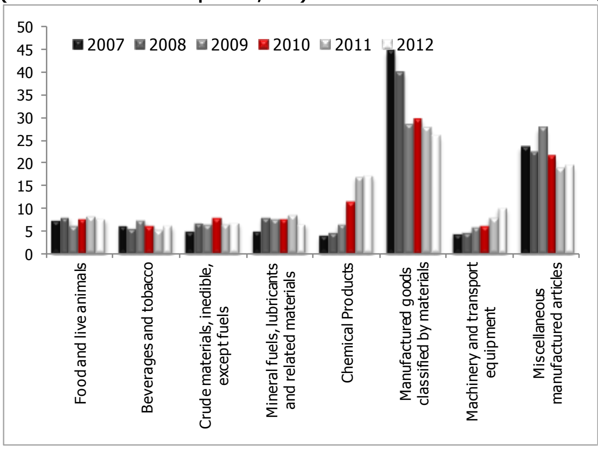
Contributions to the annual export growth
(in percentage points)



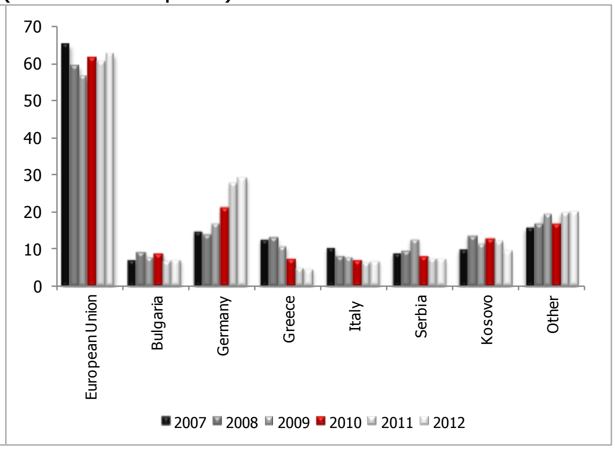
Contributions to the annual import growth
(in percentage points)



Changes in export structure
(share in total exports, %)



Export diversification, by trading partner
(% of total exports)



Source: SSO.

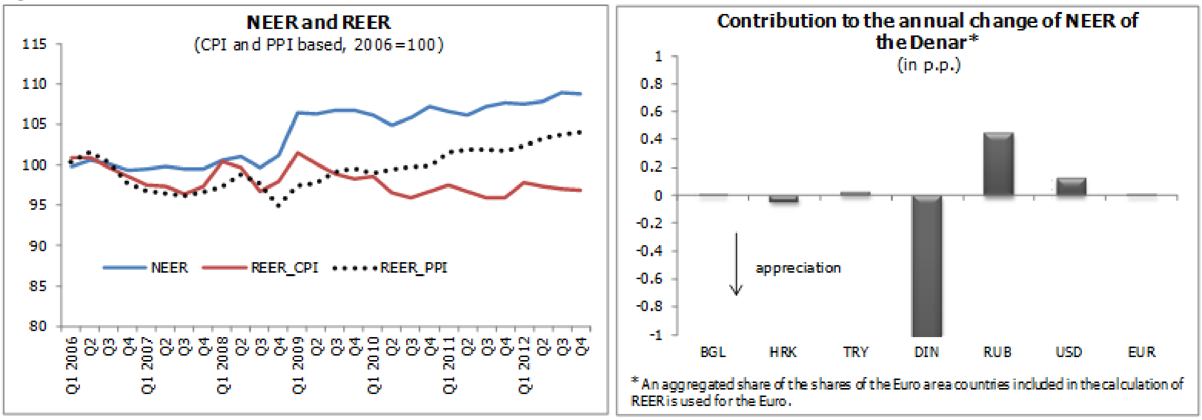
Downward trends in exports of industrial products caused reduction of raw materials on the import side. At the same time, the slowdown of investment activity during the year caused a reduction of investment imports. However, the rise in energy prices and still high food prices caused a more pronounced increase of imports of energy[29] and food and a nominal annual **growth of total imports by 0.5%** compared to 2011. Annual changes in exports and imports aggregately caused expansion of the trade balance, which resulted from adverse changes primarily in energy balance and the trade balance of iron and steel, and food.

Domestic economy competitiveness indicators suggest slight annual Denar **appreciation** in both the CPI-deflated REER (0.7%) and the PPI-deflated REER (1, 6%). The change was entirely caused by the movement of the nominal effective Denar exchange

[29] The increase of imports of energy is due to higher import of oil gases and electricity and the annual decline of import of oil and oil derivatives. Higher import of electricity is caused entirely by the increase of imported prices, especially in the first quarter of the year when weather conditions caused an energy crisis in Europe, while the increase of oil gases is due to the real quantitative growth and higher prices of Russian gas. Higher imported quantities were intended for the operation of the new gas facility in the first half of the year. On the other hand, reduced import of oil and oil derivatives is fully a quantitative effect (reduction of import volumes by 10.3%) in the year when the average annual price of oil has reached the highest level ever. Also, the depreciation of the Euro against the US Dollar by 7.6% exacerbated the price pressure.

rate (NEER), with minor changes in relative prices during 2012[30]. The NEER appreciated annually by 1.3%, entirely due to the increase of the value of domestic currency against the Serbian dinar.

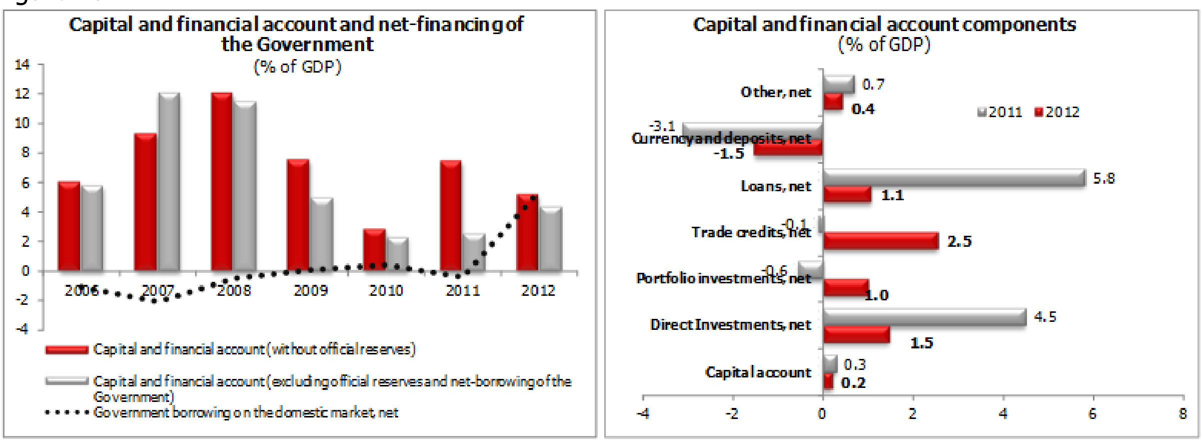
Figure 45



Source: NBRM.

In 2012, the current account deficit was fully financed by **capital and financial inflows (5.2% of GDP)**. Compared with the previous year, net inflows in the capital and financial account declined, mostly due to lower government foreign borrowing, in conditions of increased capital inflows of the private sector. Financial market volatility and increased risk aversion of investors, as well as the accelerated process of "deleverage" of the European banks made it hard for the government and the private sector to find external funding and caused reduction in foreign direct investments. Although the downward trend of long-term external borrowing in 2012 is evident in all sectors of the economy, it is most evident in the government[31] and the banking sector. Given the external financing difficulties, the financial needs of the government were met through further borrowing on the domestic market. The banks, besides the decreased withdrawal of new funds from abroad, also intensified the repayment of external liabilities.

Figure 46



Source: NBRM.

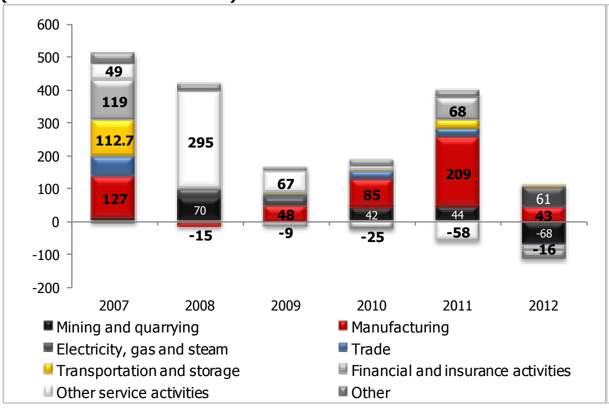
The capital inflows from foreign **direct investments** also significantly dropped. Against the backdrop of investment restraint, the standing form of investing, i.e. equity was

[30] The relative consumer prices in 2012 contributed to the depreciation of the CPI-deflated REER, by the annual decrease of 0.5% contrary to the relative producer prices, that is, their slight increase of 0.3% compared to the previous year contributed to appreciation of the CPI-deflated REER.
[31] The annual decline is due to the high base effect in 2011, when the government borrowed from the IMF using funds from the precautionary credit line and from the Deutsche Bank and the City Bank using the World Bank guarantee.

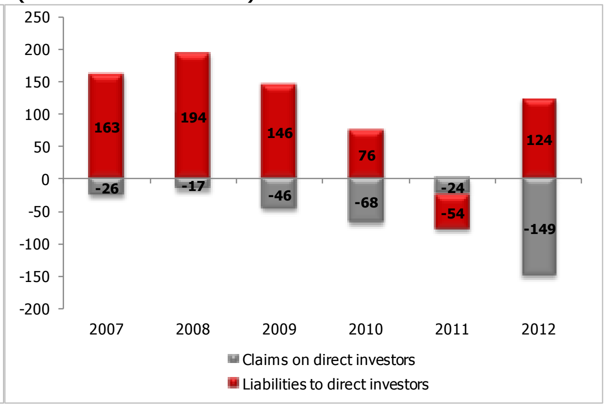
most affected. Net outflows based on intercompany borrowing continued, but at a slower pace. Analyzing on a gross basis, in 2012, the intercompany borrowing, as a component of foreign direct investments, registered enhanced lending to parent companies by branches in the domestic economy. On the other hand, the intercompany borrowing also registered inflows based on loans from parent companies, but on a net basis, the higher outflows caused negative trends in this category. In addition, in 2012, the net foreign investments were solely in the form of equity and reinvested earnings.

Figure 47

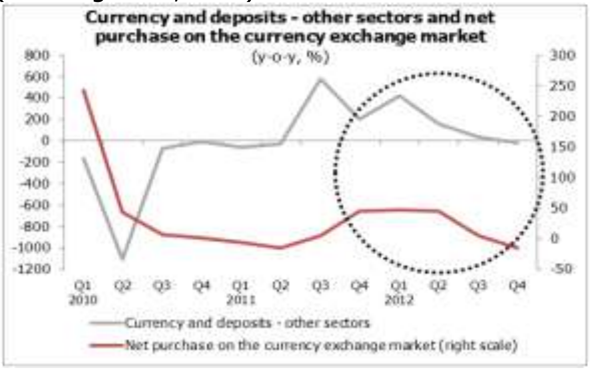
Foreign direct investments, by activity
(in millions of euros)



Intercompany lending
(in millions of euros)



Currencies and deposits - other sectors and net cash on the currency exchange market
(annual growth, in %)



Source: NBRM.

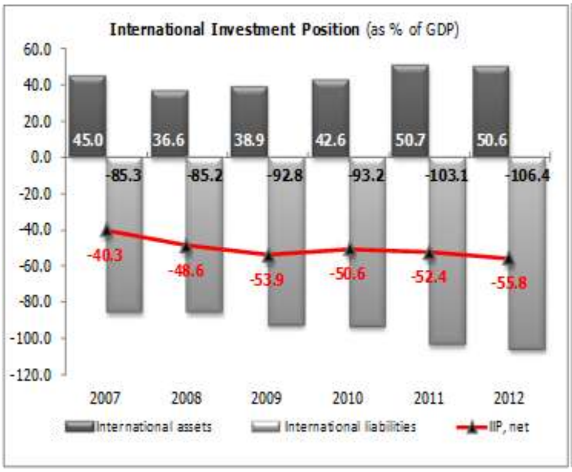
Other categories in the capital and financial account registered positive changes, with the most significant contribution made by **trade credits**. High net inflows in this category reflect the disaccord between exports and imports and hindered financing of export activities. High credit growth resulting from foreign trade was also observed in 2009, when the overall international trade has experienced a dramatic decline, leading to a change in the conditions of international trade. The currency and deposits continued registering net outflows during the 2012, but at a significantly slower pace. The uncertainty over the future of the Euro sparked further withdrawals of household foreign currency deposits from the banking system in cash, which was then mostly converted in Denars on the currency exchange market. Decreased interest in foreign currency household deposits caused a change in the behavior of banks[32], which in 2012 reduced their deposits with foreign banks and provided inflows in the capital and financial account on a net basis. Additional inflows

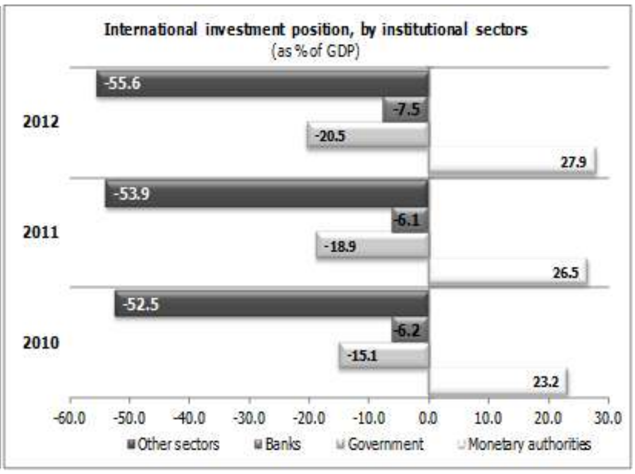
[32] The change in the banks' deposits in foreign banks, i.e. their reduction during 2012 somewhat is due to the amendments to the liquidity risk regulations. These changes ensure integrated monitoring of bank liquidity, regardless of the currency, by maintaining a single liquidity rate, rather than the previous monitoring of liquidity ratios separately for Denar and foreign currency.

were registered in portfolio investments, mainly from the sale of Eurobonds issued by the Republic of Macedonia held by domestic financial entities, mostly private pension funds.

Changes in flows in the capital and financial account in 2012 also changed the international investment position of the domestic economy. In fact, *in 2012, as a result of the increase in total international liabilities, with the international assets being almost unchanged, the aggregate negative IIP of the country deepened further by 6.8% on an annual basis.* **Thus, on 31 December, 2012, the negative net IIP reached Euro 4196.4 million, or 55.8% of GDP**. Deepening of IIP, with the exception of 2010, takes place continuously, reflecting the gradual financial integration of the economy and the need for additional capital to finance economic activity. Comparison of IIP to the end of 2007, or the year before the global crisis, shows that its increase is happening amid growth of liabilities, mainly caused by the increase of FDIs and external borrowing of the country. In fact, before the crisis, FDIs entered a phase of high growth, and continued to grow during the crisis, but at a slower pace. As for external borrowing, the effect on IIP began to feel stronger in 2010. The increase of fiscal deficits enhanced the funding needs of the country, which influenced its foreign borrowing.

Figure 48





Source: NBRM.

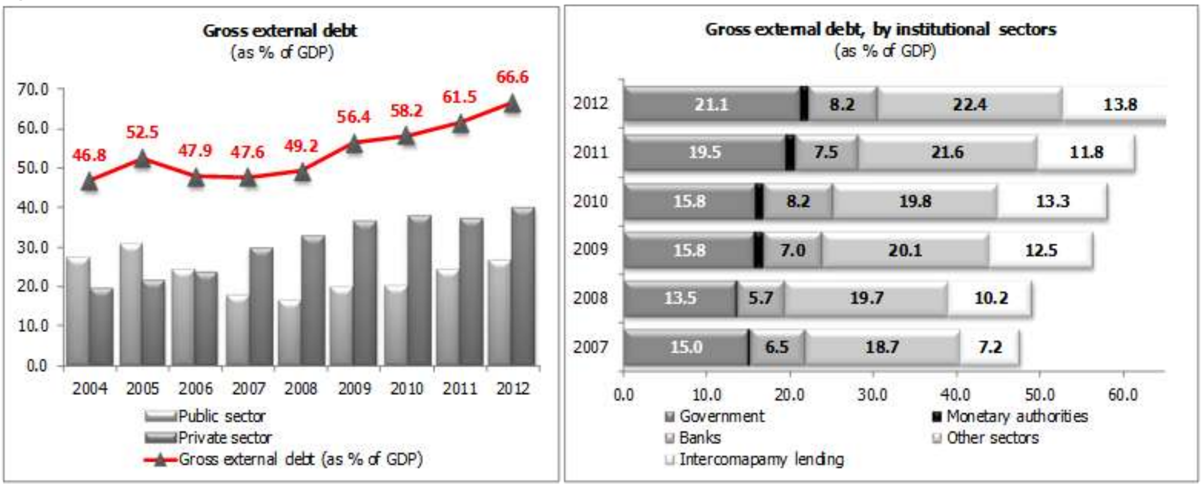
Expanding the net debt position of the country with the rest of the world in 2012 is due to the deepening negative position of all institutional sectors (other sectors, banks and state), except the monetary authorities which noted an increase in net assets. The largest contribution to the growth of international net liabilities of other sectors (non-banking private sector) was made by the higher liabilities to direct investors or increased direct investments, which is a positive indicator given their importance to economic activity in the country. The growth of government net liabilities is primarily due to the debt in the form of loans with a foreign commercial bank (Euro 75 million), and increased government liabilities to non-residents on the basis of debt securities due to the sale of Eurobonds, issued by the Republic of Macedonia, by residents. Deepening of negative investment position of banks results from the increase of liabilities based on non-resident deposits, and the withdrawal of deposits on accounts at banks abroad. *On the other hand*, higher net assets of the monetary authority relate to the increase of assets of foreign reserves, invested in securities.

In 2012, the trend of permanent increase of gross external debt went on. As of 31 December, 2012, it stood at Euro 5,163.2 million, or 68.6% of GDP[33]**,**

[33] In the second quarter of 2011, the NBRM began making repo and reverse repo transactions. The repo transactions create liabilities (classified under the category of "loans") that contribute to the increase of the level of gross debt. At the same time, when concluding reverse repo agreements, receivables created tend to increase the gross receivables. The NBRM concludes matched repo and reverse repo agreements, in almost identical terms. In general, since they are concluded simultaneously, on

which is an annual growth of 4.1 percentage points of GDP. *Excluding repo transactions, gross debt amounts to Euro 5,005.6 million (66.6% of GDP), representing an annual growth of 8.5%, or 5.1 percentage points of GDP.* During the year, greater contribution of about 55% of the gross external debt was made by the higher **private debt**, mostly due to the higher liabilities to direct investors in both long and short run. At the same time, the debt of other sectors in the economy has increased as a result of higher short-term liabilities based on other obligations and commercial loans (lending to foreign trade partners). Banks reported higher level of debt due to increasing short-term liabilities of non-resident deposits, which were partially offset by the reduction of long-term debt of banks. **Higher level of public external debt** reflects the new long-term government borrowing and the sale of government Eurobonds by residents to non-residents.

Figure 49



* Calculations use gross external debt, excluding repo transactions.
Source: NBRM.

Analysis of indicators of external indebtedness of the country, mainly shows that the gross debt is in the "secure zone". Namely, according to the ***solvency indicators*** under the World Bank methodology[34], according to the level of external debt, the Republic of Macedonia belongs to the group of low indebted countries, with the exception of the external debt to GDP ratio, which is the only indicator which places the country in the group of highly indebted countries. Observing the dynamics, almost all solvency indicators improved on an annual basis, with the exception of the gross external debt to GDP ratio, which deteriorated (by 2.9 percentage points of GDP). In this light, it should be noted that this indicator has been deteriorating for six years, and the moderation threshold has been exceeded since 2005. Significant improvements were noted in the gross debt to exports ratio and debt repayment to exports ratio (by 5.3 percentage points and 3.2 percentage points of GDP, respectively), interrupting the three-year growth trend as a result of the drastic increase of export of goods and services, in conditions of slower growth of gross debt and decline of debt repayment. At the same time, interest repayment to exports ratio also registered a minor positive change (reduction of 0.2 percentage points of GDP). External debt ***liquidity indicators*** generally indicate a relatively favorable position. The coverage of short-term debt (residual maturity) with foreign reserves is very close to the

the net basis these transactions have a neutral effect or occur in almost the same amount on the liabilities side, the receivables side, and therefore do not affect the overall net IIP and the total net external debt. *For these reasons, all data in the following section of the text are presented without repo transactions, unless otherwise stated.*

[34] The methodology of the World Bank involves using three-year moving averages of GDP and exports of goods and services and other inflows (which are covered in: inflows of investment income, compensation of employees and remittances) as denominators in the calculation of the indicators. This methodology defines the criteria of indebtedness, as reference values for the level of indebtedness.

required full coverage, although unlike the last year, in 2012, this indicator slightly deteriorated.

Table 1
Indicators for external indebtness

	Solvency				Liquidity		
	Interest payments/ Export of goods and services and other inflows	Gross debt/ Export of goods and services and other inflows	Gross debt/ GDP	Debt servicing/ Export of goods and services and other inflows	Foreign reserves/ Short-term debt	Foreign reserves/ Short-term debt, with residual maturity	Short-term debt/ Overall debt
	in %				ratio	ratio	in %
31.12.2004	2.24	120.1	49.3	11.5	1.14	0.89	30.3
31.12.2005	2.33	128.5	56.3	9.7	1.67	1.04	26.7
31.12.2006	2.88	109.8	51.8	18.2	1.95	1.34	29.0
31.12.2007	2.38	102.3	53.2	16.6	1.35	1.08	39.8
31.12.2008	2.30	101.1	55.3	8.8	1.29	0.95	35.2
31.12.2009	2.10	113.3	58.5	10.2	1.29	0.94	32.9
31.12.2010	2.78	121.1	60.1	11.9	1.31	0.90	32.0
31.12.2011	2.70	128.5	65.1	14.5	1.53	1.06	29.4
31.12.2012	2.46	123.2	68.0	11.3	1.40	0.93	31.3
Moderate indebtness criteria	*12 - 20%*	*165 - 275%*	*30 - 50%*	*18 - 30%*		*1.00*	

Developed in accordance with the „External debt statistics: Guide for compilers and users", issued by the IMF. Moderate indebtedness criterion is derived from the World Bank methodology for developing indebtedness indicators, that implies use of three-year moving averages of GDP and export of goods and services and other inflows, as denominators in the calculation of indicators.
* Greenspan-Guidotti rule indicates that the country should maintain full coverage of short-term debt (residual maturity) with foreign reserves.
Source: NBRM.

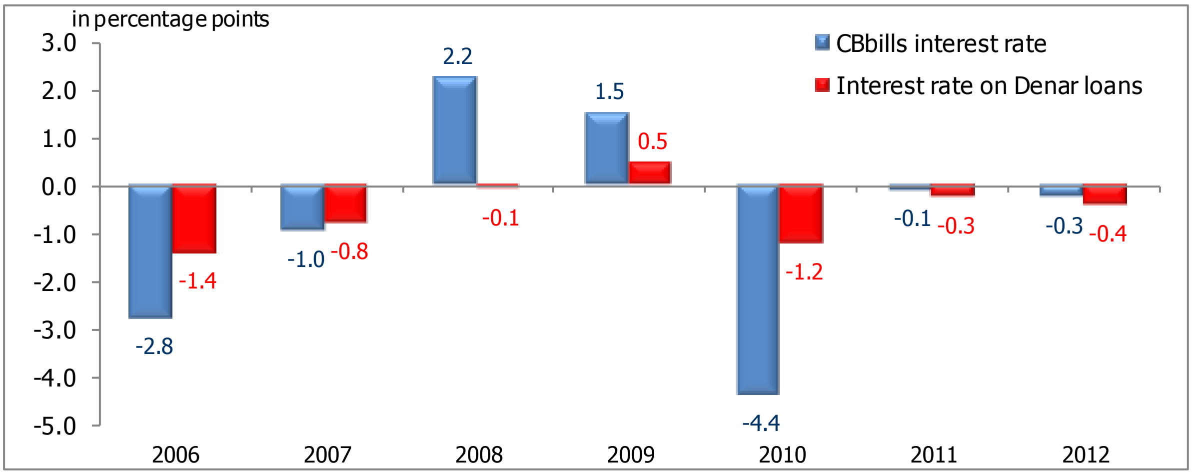
In 2012, **gross external claims** continued to rise and reached Euro 3.889 million, which is an annual increase of 4.3%. Despite the higher claims, the faster growth of gross external debt increased the level of net foreign debt. At the end of 2012, the net debt reached Euro 1,274 million, or 16.9% of GDP, or about 2 percentage points more compared to the previous year.

2.2.5. Money supply and credits

In 2012, monetary and credit aggregates were adversely affected by business cycles in the economy and increased credit risk. Weak economic activity and reduced financial potential of households and companies affected both the creditworthiness and the savings that led to slower growth of both the deposits and the loans. Downward risks clouding the economic growth during the year and constant uncertainty surrounding the future, coupled with the upward trend of non-performing loans, contributed to deterioration of the perceptions of banks that responded with a certain tightening of credit conditions and limiting credit supply. In these circumstances, monetary measures as such, undertaken in 2012, were not sufficient to induce stronger credit activity. In fact, despite the great release of liquidity by the changes introduced in CB bill auctions, the credit supply was weaker than the previous year, while the reduction of lending rates was moderate. During the year, among other things, the banks' assets management was partially influenced by the trends in the domestic government securities market[35], which provided the government with most of its financing needs.

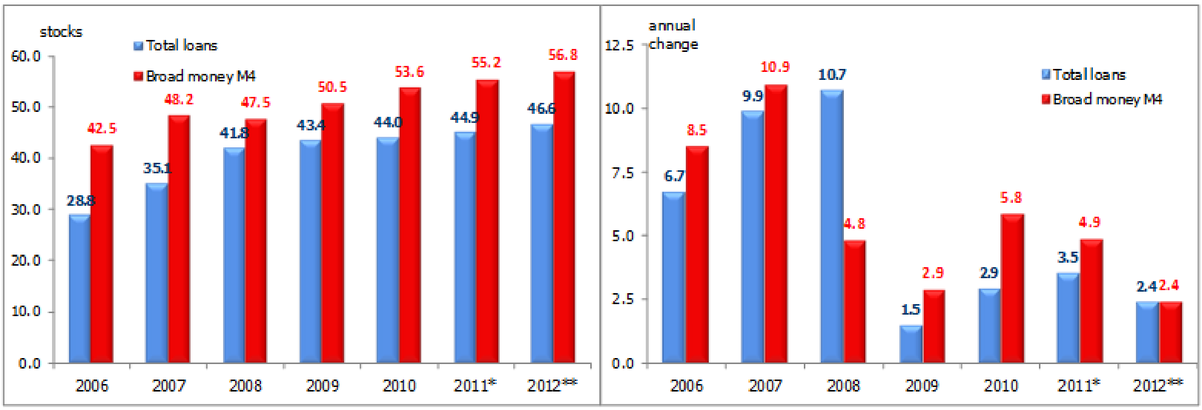
[35] In 2012, the share of banks in this market averaged about 64%.

Figure 50
Annual growth of CB bill interest rate and lending Denar interest rate



Source: NBRM.

Figure 51
Share of total credits and money supply M4 in GDP
(in %)



*Preliminary data. ** Forecast.
Source: NBRM

Monetary growth, expressed through growth of broad money M4, significantly slowed down in 2012 and dropped to 4.4% at the end of the year. Currency in circulation increased by 4.2%, and moved in line with seasonal trends reaching the peak in the summer months and during the period prior to the New Year's Eve in December, while deposit growth was 4.9%. The slowdown in deposit growth is likely due to unfavorable trends in the domestic economy and is primarily associated with weaker pace of disposable income and its distribution. The downward trend in wages and rising costs of living, contributed to the realocation of most of the income for basic consumption, at the expense of smaller savings[36]. At the same time, weak economic activity also contributed to reducing corporate deposits. Similar effect was made by the higher outflow of funds for payment of dividends and granting loans by companies to their parent companies abroad. Short-term savings (excluding demand deposits) showed to be the most sensitive category, whose growth rate by the end of the year became negative. At the same time, demand deposits, as the most liquid part of the deposit base, showed faster growth that is consistent with the preferences of economic agents to hold highly liquid assets in times of economic uncertainty and

[36] The category of private transfers proved resistant to unfavorable external conditions, and remained relatively stable in the structure of total gross inflows of the households (about 17% in the last five years (2008-2011)).

vulnerability. Long-term deposits continued to grow at a relatively steady growth rate and made the greatest contribution to the growth of money supply.

Table 2

Components of monetary aggregates

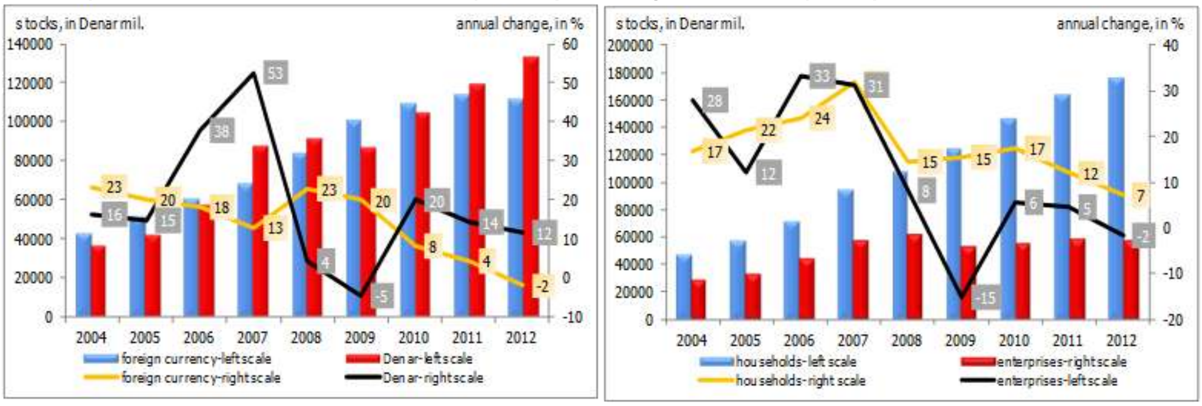
	Balance as of			Annual change			Contribution in annual growth of M4		
	31.12.2010	31.12.2011	31.12.2012	31.12.2010	31.12.2011	31.12.2012	31.12.2010	31.12.2011	31.12.2012
	in millions of denars	in millions of denars	in millions of denars	in %	in %	in %	in %	in %	in %
Currency in circulation	16,958	19,308	20,118	4.3	13.9	4.2	2.7	10.5	7.2
Demand money	40,404	41,993	45,824	12.4	3.9	9.1	17.6	7.1	34.0
M1	**57,362**	**61,288**	**65,941**	**9.8**	**6.8**	**7.6**	**20.3**	**17.5**	**41.3**
Short term denar deposits	51,296	58,293	57,543	12.2	13.6	-1.3	22.0	31.2	-6.7
Short term foreign currency	92,921	97,107	94,228	5.6	4.5	-3.0	19.3	18.6	-25.5
M2	**201,579**	**216,682**	**217,712**	**8.4**	**7.5**	**0.5**	**61.6**	**67.3**	**9.1**
Long term denar deposits	15,118	21,966	31,688	72.0	45.3	44.3	25.0	30.5	86.3
Long term foreign currency	15,872	16,372	16,887	27.1	3.2	3.1	13.4	2.2	4.6
M4	**232,568**	**255,020**	**266,287**	**12.2**	**9.7**	**4.4**	**100.0**	**100.0**	**100.0**

Source: NBRM.

Despite the slower growth of deposits, the stability of domestic banking system, contrary to the financial problems and massive balance sheet adjustments of European banks, caused to boost confidence in the domestic currency and positive impact on the currency structure of deposits. This contributed to maintain double-digit growth of Denar deposits versus the outflow of foreign currency deposits annually. Moderate contribution to the decline of foreign currency deposits was made by the spending from companies' foreign currency accounts, primarily for settlement of foreign trade liabilities. In 2012, similar influence was made by the higher outflow from companies' accounts based on intercompany financing and payment of dividends abroad. Against this background, the degree of Euroization of the economy (foreign currency deposits to total deposits) decreased from 61.5% on average in 2011 to 56.1% in 2012.

Figure 52

Currency and sector structure of total deposits (including demand deposits)



Source: NBRM.

With respect to individual sectors, deposit growth is entirely due to the increase of household savings. The need for adjustment of companies' balance sheets amid great uncertainty about future rates of return and lower current cash flows caused depletion of deposits, primarily short-term deposits.

Figure 53
Contribution to the annual growth of M4
(in percentage points)

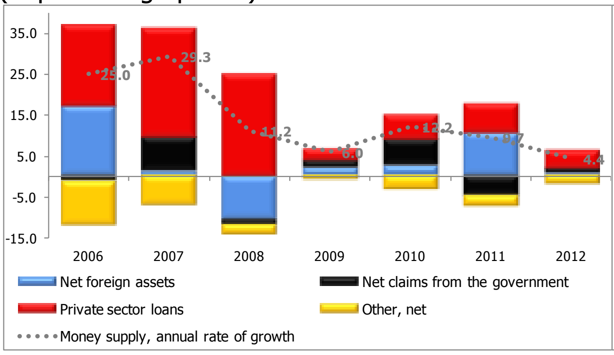
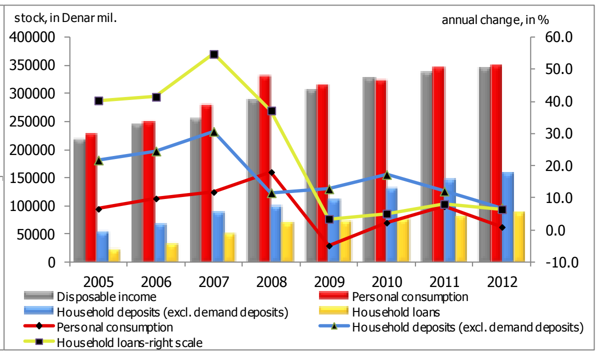


Figure 54
Developments of major household inflows and outflows



Source: NBRM.

Besides the preferences for saving, changing macroeconomic environment also influenced the credit flows. Total loans grew by 5.4%, making up 69.2% of the increase in 2011 and suggesting significant annual slowdown. Such slowdown of growth was achieved when the banks faced increased credit risk in their operations, which affected the supply of loans by tightening lending terms. The comparison of banks' responses in the lending surveys during this and previous year confirms this conclusion and identifies risk factors, including creditworthiness, as factors with reinforced adverse impact on banks' lending terms in 2012. In this light, the growing trend of nonperforming loans to total loans ratio (9.5% on average in 2011 to 10.3% on average in 2012) should be pointed out as the main indicator of the increased credit risk of banks. Another factor that affected the credit supply is the "deleverage" process of European banks present on the Macedonian market, which in conditions of limited opportunities for increasing equity are forced to reduce risky portfolio and to limit the activities of their branch banks. On the other hand, demand for loans also responded to the economic developments and increased at a slower pace compared to the previous year, most likely due to its procyclical nature. Adverse developments in the economy usually tend to reduce the demand for loans, on the one hand because of the real reduction of private sector creditworthiness and lower propensity to borrow, and on the other hand, due to the tightening of credit market conditions given the increased credit risk of banks. Namely, when credit risk management and limiting exposure to additional risk is the focus of the banks, even the higher growth of credit demand would not be sufficient to reinforce the credit growth.

Figure 55
Annual loan growth

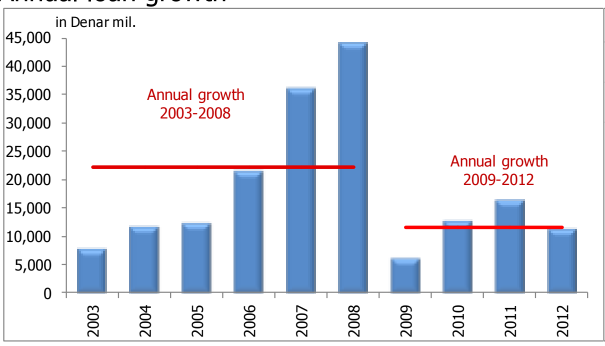
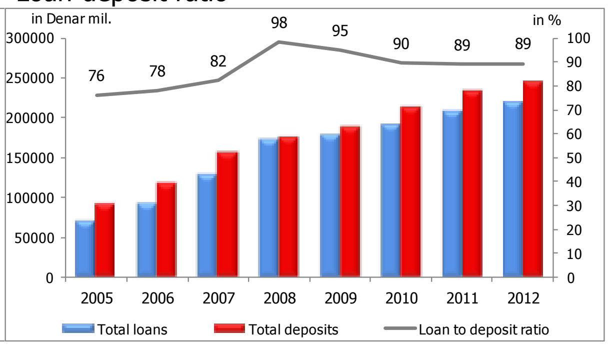


Figure 56
Loan-deposit ratio



Source: NBRM.

Although the average growth rates in the last three years of crisis did not moved to negative zone, credit flows are still weak if compared to pre-crisis levels. In environment of balance sheet crisis that currently faces the world, and whose resolution requires balance sheet restructuring of all economic agents (government, banks and the private sector), the return of rates to levels that are considered sustainable before the crisis still cannot be expected. In this light, the measures of monetary authorities caused release of funds in the system, but still, significant increase of lending activity and greater economic recovery requires strengthening of real sector fundaments, too.

Figure 57
Suspicious and contested claims, by sector

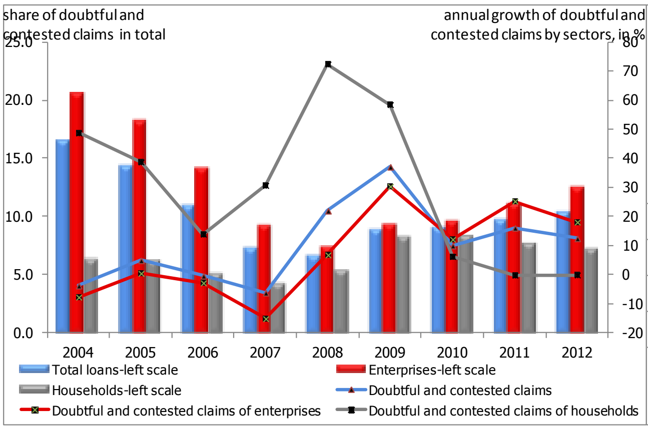
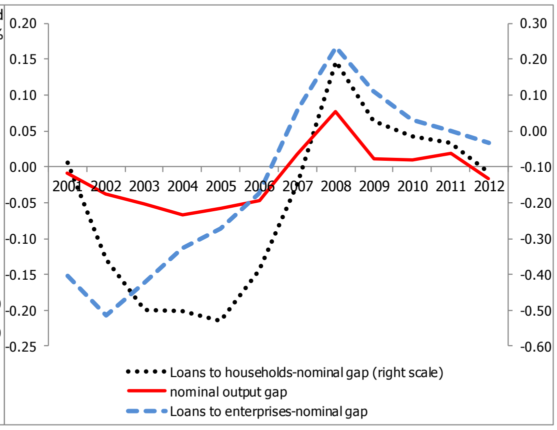


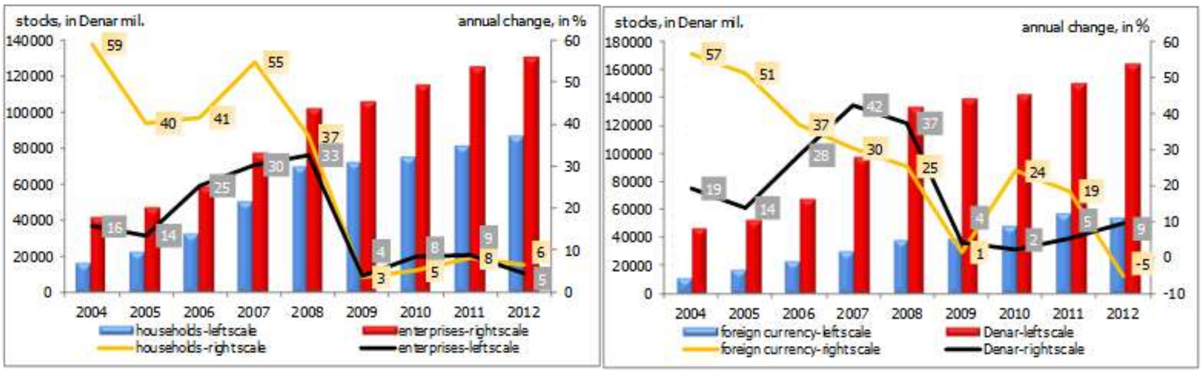
Figure 58
Credit growth by sector and economic cycle[37]



Source: NBRM.

Unlike the previous year, this year, loans were almost equally distributed to the corporate and household sectors[38]. This shows considerably lower lending by firms, which, according to the lending surveys, most commonly requested credits for servicing current liabilities and earlier loans, and less for investment. Standing decline of industrial production and weaker performance of construction industry (as the main drivers of economic growth) confirm such developments. On the supply side, banks indicated that there would be high risk to the corporate sector, and these perceptions partially materialized (seen through the growth rate of non-performing loans) which contributed to tightening of lending terms. The banks' risk perceptions to households, however, were milder, which adequately reflect the relatively improved lending terms and slower deceleration of credit growth.

Figure 59
Currency and sector structure of total credits



Source: NBRM.

[37] Sector-by-sector nominal gaps of loans and GDP are calculated on the basis of nominal amounts of loans to GDP, according to the following formula: GAP= $(X^a-X^p)/X^p$, where GAP is the corresponding nominal gap, X^a is actual level of the respective variable, while X^p is the potential level of the respective variable. Calculation of potential levels uses XP-filter.
[38] Since the onset of crisis, lending was mainly supporting the economy through the corporate sector.

III. Monetary policy in 2013 and 2014

Maintaining price stability in the economy will continue to be the main objective of the monetary policy. In this context, and considering the characteristics and specificities of the Macedonian economy, NBRM will continue to pursue the current monetary strategy of maintaining **a stable exchange rate of the Denar against the Euro, as an intermediate monetary target,** which serves as the main nominal anchor in the economy. The operational framework of the monetary policy, as before, will be set on a flexible basis in order to effectively manage liquidity in the banking system and maintain the balance in the foreign exchange market. Thus, **the monetary policy will continue to contribute to the overall macroeconomic stability as a key factor in creating a favorable environment for sustainable economic growth.**

It is expected that the monetary policy conduct in the next two years will take place in a relatively stable environment, in the absence of significant internal and external imbalances. In 2013, a gradual recovery of the domestic economy is expected, which will primarily be caused by exports and investment. These developments, coupled with expectations of higher consumption of households will lead to further strengthening of growth in 2014. It is expected that the condition of the external sector will be favorable in the next two years, despite the assessments for moderate expansion of the current account deficit in 2014, in line with the strengthening of economic activity. It is expected that capital inflows will increase and their level will enable funding of the current account deficit and increasing of foreign reserves, which are expected to remain on a comfortable level. Inflation will be moderate and move within controlled frames. In 2013, it is expected that higher global prices will keep inflation at around 3.2%, in the absence of demand pressures. However, this price effect will be temporary and will be exhausted in 2014, when stabilization of price growth and return of inflation to the historical average of about 2% is expected.

The achievement of the projected macroeconomic framework is accompanied by risks. Amid ongoing weak prospects for boosting growth in developed economies, slowing growth in developing countries, still inefficient financial markets and emphasized reticence of investors, the risks for the projection primarily result from the external environment. The uncertainty with regard to future developments in the global economy remains high, creating uncertainty and risk in terms of the expectations for external borrowing and other capital inflows and domestic export activity. Given the high energy dependence of the economy on imports, there could be a risk of future price movements of energy, primarily oil, given the uncertainty regarding the political turmoil in the Middle East and the effects on supply. Also, the weather conditions in the countries that are main producers of cereals are the major risk factor for possible re-emergence of upward trends in global food prices in the projected period, which, given the significant share of food in the households' consumption basket may lead to increasing inflationary pressure. The possible materialization of the aforementioned risks will mean a change in the environment for the monetary policy conduct, compared with the basic expectations.

Domestic inflation will gradually slow down in the next period and it will come closer to the historical average. In 2013, a moderate inflation rate of 3.2% is expected, and the main driver of price changes will be the moderate acceleration of the growth in food prices. On the other hand, despite the presumed increase in the regulated electricity prices, it is expected that during 2013, the slowdown in the growth of energy prices will continue. Economic growth will remain below the potential, hence no significant inflationary pressures from domestic demand are expected. In 2014, inflation rate will slow further to 2.3%, close to the historical average. No significant pressures from import prices are expected, but given the expected strengthening of the economic growth, demand will gradually recover. **The risks to the projected path of inflation are** mainly **downward.** They are basically associated with the possibly lower than expected influence of the prices on the international markets on domestic inflation, as well as the possibly more favorable condition on the supply side on the domestic market.

After the stagnation of the economy in 2012, in the next two years a gradual economic recovery is expected, with moderate positive growth rates. It is expected that the start-up of the new export-oriented production facilities and the announced expansion of the existing capacities in the country will contribute to the strengthening of the export activity in 2013 and 2014. Foreign demand, which is forecasted to recover by the end of 2013 and strengthen moderately in 2014, is expected to give an additional positive impetus to the revitalization of the export sector. It is expected that such an environment will stimulate domestic investors, which together with the expected public and foreign investments would lead to the strengthening of the investment cycle. In such favorable conditions in the domestic economy, household consumption is expected to recover, too. Domestic demand growth will be further supported through the banking sector by moderate strengthening of the credit growth. Stronger domestic and export activity will cause reinforcement of import activity and, consequently, the contribution of net export demand will remain in the negative zone. Consequently, **it is expected that GDP growth in 2013 will equal 2.2%,** and its main drivers will be the growth in exports and investment. **In 2014, economic growth will accelerate to 3%.** The main factor for further acceleration of economic growth will be household consumption. Namely, it is expected that export and investment activity of the corporate sector and the improved environment will have positive spillover effects on the labor market, and thus on the disposable income and consumer confidence. Consequently, private consumption will significantly strengthen. Given the trade openness of the economy and the sensitivity of the production and trade flows, **the risks to projected growth continue to arise from the global environment and the developments in the external environment, as important factors for the movement of foreign and domestic demand.**

In circumstances of sound liquidity and solvency of banks, it is expected that economic recovery, more stable environment, the growth of banks' deposit potential, and the measures already taken by the monetary policy will contribute to greater financial support for the domestic economy through the banking sector. Projections indicate a moderate acceleration of credit growth in 2013 and 2014. Thus, the growth of total loans in 2013 is projected at 7.5%, while by the end of 2014, credit growth will accelerate and will reach 8.1%. **The risks for the credit growth projection are downward.** The possible deterioration of the banks' perceptions regarding the developments in the real sector could lead to narrowing of the credit supply. Also, the process of "deleveraging" of foreign banks could have more pronounced negative effects on domestic banks in their ownership. The possible further deterioration in the banks' loan portfolio quality could also limit and jeopardize the projected credit growth.

Projections for 2013 and 2014 show that the external position should provide a further increase in foreign reserves and their maintenance at the level that meets the needs for maintaining stability in the foreign exchange market amid possible shocks. In 2013, current account deficit of 3.8% of GDP is expected, roughly as it was in 2012. The trade deficit will improve slightly, in the absence of major import pressures, due to the still weak domestic demand. Under such conditions, the maintenance of the current account deficit will mainly arise from the relative reduction of the inflows from private transfers, which traditionally cover a substantial part of the trade deficit. After the fast growth of transfers in 2012, when they reached the historically highest level reflecting the uncertainty and lack of confidence in the Euro, in 2013, normalized events and reduced uncertainty in the external environment are expected to contribute to stabilizing the amount of these flows. This nominal stabilization in conditions of expected growth in the economy, will actually mean their reduction, viewed as a percentage of GDP. The reduction of the relative importance of transfers will continue in 2014, but much more moderately. In 2014, further deepening of the current account deficit of 5.4% of GDP is expected, due to the anticipated increase in the trade deficit. The new direct investment and domestic demand growth will lead to faster growth in imports. Despite the moderate deterioration in the current account, its negative balance will be fully funded by capital inflows, mainly arising from government external borrowing and foreign direct investment. It is expected that foreign direct investment in the next two years will gradually increase and will reach 3% and 4.5% of GDP, respectively. This will come as a result also of the improved global environment, the stabilization of global financial markets and improved conditions in the domestic economy, which will cause more positive perceptions among investors. However, within these factors one may actually locate the main **risks** for the expected movements in the external position of the economy, in the case of slower than expected global, and hence domestic economic recovery.

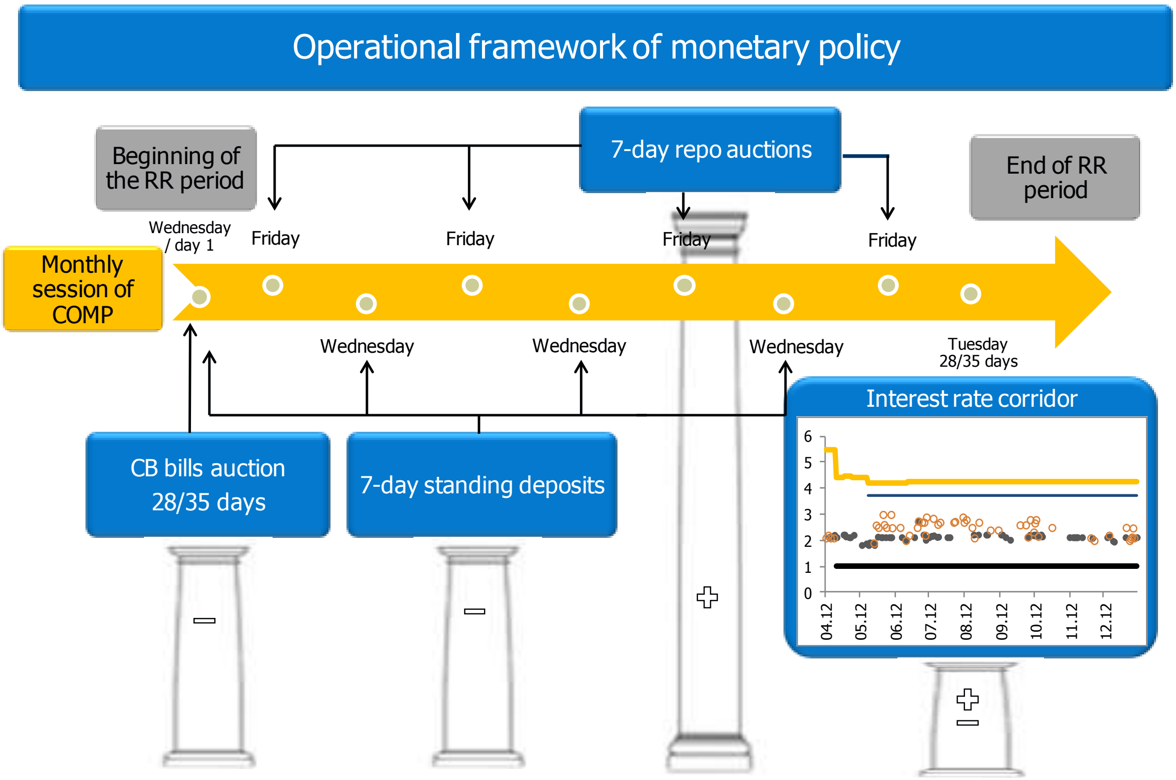
In the next two years, fiscal policy is expected to be prudent, with gradual consolidation of the budget deficit and relatively stable level of public debt[39]. Fiscal policy, primarily budget spending, is an important factor that affects the monetary policy stance, and the appropriate coordination of these policies is a key factor for ensuring and maintaining macroeconomic stability. After the rising level in 2012, it is expected that the **budget deficit** will gradually decline and that in the medium term it will stay around 3% of GDP. To that end, in 2013 it is expected that it will be 3.5% of GDP, and in 2014, 3.2% of GDP. It is expected that similar trends will be registered in the primary budget deficit, as a more realistic indicator of the direction of fiscal policy, which may be reduced to 2.7% and 2.4% of GDP, respectively, in the next two years. The planned deficit primarily reflects the anticipated growth of public capital investments. Namely, in the next period, realization of large investment projects in road and rail infrastructure, in the energy sector, agriculture, etc., is expected. It is planned that **deficit financing will** largely come from external sources. The government borrowing from commercial lenders with a guarantee from the World Bank, in early 2013, has fully secured the financing of the budget in 2013 and early 2014. Part of the financing needs will be provided from domestic sources by issuing government securities with longer maturity, which would contribute to strengthening and further development of the domestic securities market. It is expected that **public debt** in the next two years will stabilize at around 32% of GDP and thus it will have no adverse effect on the sustainable level of the country's indebtedness in the long run. Of course, such a fiscal policy setup is in significant part accompanied by **risks**, which as with monetary policy, stem mainly from the external environment and its impact on domestic economic activity, consumption and investment, and especially on the access to foreign financial markets.

[39] The projections in the area of fiscal policy are taken from the Pre-Accession Economic Programme of the Republic of Macedonia for 2013-2015, adopted in January 2013.

IV. Monetary instruments

The development of the new operational framework is an important mark of 2012 regarding the monetary policy conduct. The new operational framework is based on four main pillars:

Chart 1



- ***Managing structural excess liquidity in a longer run.*** *The National Bank mops up most of the structural excess liquidity by issuing* ***CB bills*** *at the beginning of the reserve requirement period. The frequency of CB bills auctions was reduced from once a week to once a month, which effectively extended the maturity of liquidity withdrawn within the reserve requirement period. This leaves room for more active use of other monetary operations and increased interbank activity.*
- ***Managing short-term excess liquidity.*** *For more flexible management of the liquidity in the banking system created under the influence of autonomous factors within the reserve requirement period, the National Bank introduced a new instrument -* ***seven-day deposit facility****, which allows banks to allocate funds in the short term, once a week (Wednesday).*
- ***Providing liquidity on a regular weekly basis.*** *In order to support longer-term investment of banks, the National Bank started to conduct regular* ***auctions of repo transactions*** *to provide liquidity in the banking system, once a week (Friday).*
- ***Establishment of an interest rates corridor.*** *For a stable movement in money markets interest rates, besides the current marginal lending facility (overnight credit), whose interest rate represents the upper limit of the movement of money markets interest rates, the National Bank has introduced a* ***overnight deposit facility****, the interest rate of which represents the lower limit of the corridor.*

4.1. Open market operations

The National Bank may use three instruments of the group of open-market operations to manage liquidity and interest rates: CB bills, auctions of repo transactions and outright transactions with securities. In 2012, the National Bank issued CB bills to withdraw liquidity, while auctions of repo transactions were used to provide liquidity. Outright transactions with securities and auctions of repo transactions for liquidity withdrawal have not been applied. On a net basis, through open market operations, the National Bank created Denar 8,985 million in the banking system.

CB bills were the main instrument for signaling the direction of monetary policy during 2012. With the introduction of the new operational framework, the monetary policy guidelines are being reviewed at the monthly meetings of the Operational Monetary Policy Commitee (COMP) of the National Bank, which coincide with the beginning of the period of fulfillment of the reserve requirement in Denars. Given the high interest of the banks in allocating liquidity in this instrument, during the first quarter of 2012, amid relatively stable inflation and slower credit growth, in April 2012, the National Bank limited the amount offered at the CB bills auctions. After four years of applying the tender with unlimited amount and a fixed interest rate, as of April 11, 2012, the National Bank started to use the interest rate tender (limited amount and maximum interest rate), which enabled issuance of Denar 6,285 million annually in the banking system. The signal for monetary policy easing was reinforced in May 2012, by reducing the maximum interest rate at CB bills auctions by 0.25 percentage points (from 4% to 3.75%).

CB bills maturity was 28 or 35 days depending on the length of the Denar reserve requirement periods. The frequency of CB bills auctions was reduced in May 2012, from once a week to once within the Denar reserve requirement maintenance period (once a month), for the purpose of more active use of the other monetary instruments and supporting interbank trading in money markets. During 2012, a total of 26 CB bills auctions were conducted. Since the beginning of the implementation of the interest rate tender in April, the demand exceeded the supply in six out of twelve auctions conducted, with the average bid-to-cover ratio being 1.02. Weighted average interest rate was maintained at a stable level close to the maximum interest rate set by the National Bank. Weighted average interest rate of the auctions held in 2012 was 3.84% and recorded an annual decline of 0.16 percentage points.

Figure 60
Movement of the stock of CB bills

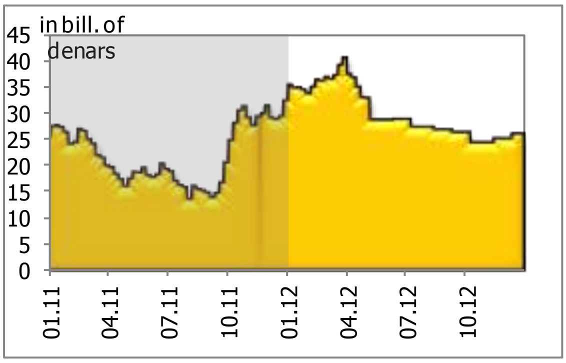
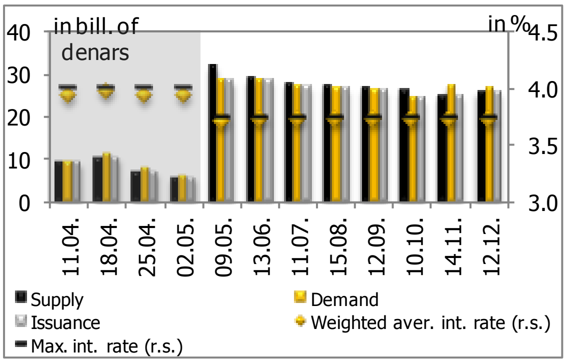


Figure 61
CB bills auctions



Source: NBRM.

In May 2012 , the National Bank started to conduct **auctions of repo transactions** on a regular basis, with the purpose of giving liquidity support to the banking system and encouraging longer-term investments[40]. Auctions for providing liquidity were conducted once a week, every Friday, with a maturity of 7 days. The National Bank applied the volume tender, at which the interest rate was set at the level of the weighted average rate of the last CB bills auction and equaled 3.73%, on average. In the course of 2012, 34 auctions were conducted, at most of which supply was higher than demand, and Denar 2,700 million were issued annually. Usually, banks used this instrument more frequently during the 21st to 7th day before the end of the reserve requirement period, which was conditioned by the impact of the autonomous factors, which in this period caused a reduction in liquidity.

Figure 62
Auctions of repo transactions in 2012

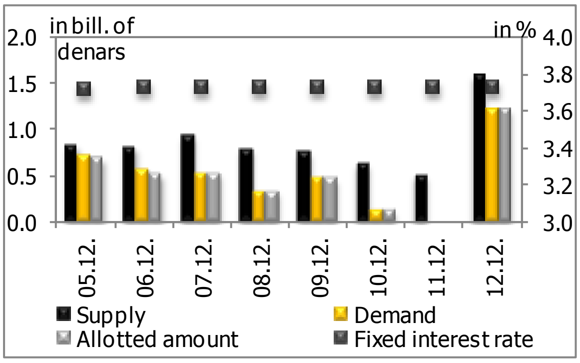
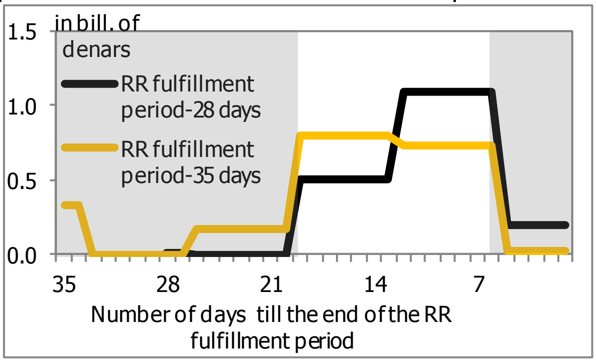


Figure 63
Average daily amount of provided liquidity by periods of fulfillment of the reserve requirement



Source: NBRM.

4.2. Reserve requirement

Reserve requirement maintained the standard features throughout 2012[41]. However, significant changes were made to the rates and to the basis for calculation of the reserve requirement. Starting from January 2012, a rate of 0% applies to the liabilities based on repo transactions in domestic currency and liabilities to natural persons with contractual maturity of over two years, in order to stimulate the development of the repo market and long-term savings of the households. As a result of this measure, the reserve requirement was lower by Denar 624 million annually.

Besides the introduction of the rate of 0%, at the beginning of 2012 the pre-determined Calendar of reserve requirement fulfillment intervals started to be implemented. Since January 2012, the beginning of the reserve requirement period corresponds with the day on which the auction of CB bills is held (settled). The reserve requirement period begins on the first Wednesday after retrieving the data on the reserve requirement basis, and covers 28 days or 35 days.

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[40] In May 2012, the National Bank organized a one day workshop for banks, entitled "Repo transactions: practical aspects." The workshop was attended by 36 participants from the specific departments of all banks that are directly involved in operational activities in the field of concluding transactions (front office), as well as settlement and recording transactions (back office). The workshop was organized in order to improve the theoretical and practical knowledge of colleagues from banks regarding the repo transactions, before the commencement of the regular repo auctions of the National Bank. In this sense, within the first part of the workshop the manner of conclusion, settlement and recording of repo transactions was presented, while in the second part of the workshop practical exercises on the computer were organized for all participants.

[41] The basis for calculation of the reserve requirement is the average liabilities' positions made during the calendar month. The basis for calculating the reserve requirements excludes interbank liabilities and liabilities to the National Bank. Reserve requirement ratios of banks are differentiated in terms of the currency structure. Reserve requirement ratio on liabilities in local currency is 10%, while reserve requirement ratios in foreign currency and in local currency with FX clause are set at a higher level - 13% and 20%, respectively. From the calculated reserve requirement in foreign currency, 23% are part of the reserve requirement in Denars, which is fulfilled on an average basis, while the remaining 77% comprise the reserve requirement in Euros, which is fulfilled on fixed basis on accounts of the National Bank abroad. Reserve requirement ratio of savings houses is 2.5% and it is fulfilled in Denars, on a fixed base.

In November 2012, the National Bank took non-standard measures in the reserve requirement in order to support the important sectors of the economy in terms of the balance of payments flows of the country and the developments on the foreign exchange market, and the further development of domestic financial markets. In this sense, in the beginning of 2013 the reserve requirement base was reduced by the amount of the newly granted loans and investments in debt securities issued by net exporters and/or non-financial corporations that use the funds to finance projects for domestic production of electricity. Also, in order to encourage banks to provide longer-term funding sources, the 0% rate of reserve requirement started to be applied also on the liabilities based on debt securities issued in domestic currency with an original maturity of at least two years.

At the end of 2012, banks' reserve requirement in Denars amounted to Denar 17,485 million and increased by Denar 910 million annually as a result of the increased propensity of economic agents to save in local currency. On the other hand, the reserve requirement in Euros (Denar 13,032 million) declined by Denar 1.099 million annually, due to the fall in the liabilities in foreign currency.

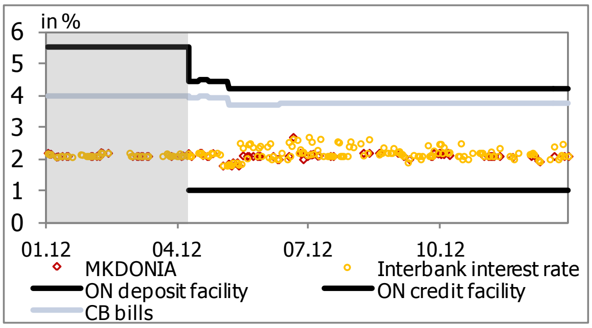
The National Bank pays remuneration on the reserve requirement in Denars, which in January 2012 was reduced from 2% to 1%, in line with the movement of market interest rates. The National Bank pays remuneration on the reserve requirement in Euros of 0.1%.

4.3. Marginal lending facilities (overnight credits) and overnight deposit facilities

Unlike open-market operations that are conducted at the initiative of the National Bank, banks may use marginal lending facilities (overnight credits) and overnight deposit facilities, on their own initiative. The main function of these instruments is stabilizing of liquidity dynamics and money market interest rates on a daily basis by establishing an interest rates corridor. The interest rate of **the marginal lending facility (overnight credit)** sets the upper limit on the movement of interest rates on the money markets, whereupon the interest rate is set by adding a percentage point above the interest rate of CB bills. In April 2012, the upper limit of the corridor was reduced, and the interest rate of the marginal lending facility (overnight credit) dropped from 1.5 percentage points to 0.5 percentage points above the interest rate at the last auction of CB bills. At the same time, the National Bank set the lower limit of the corridor by introducing the possibility for banks to allocate funds in the **overnight deposit facility** at an interest rate set at 1%. Money market interest rates were maintained at a relatively stable level in accordance with the movement of the key interest rate of the National Bank, and within the established interest rates corridor.

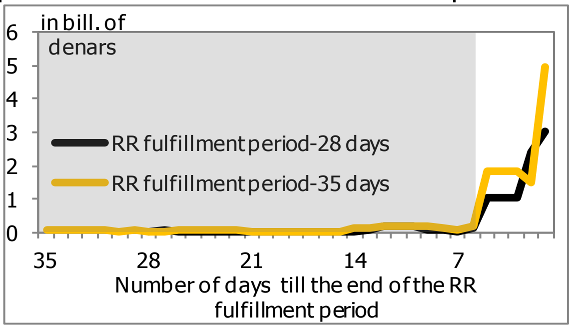
In order to overcome the daily excess liquidity, banks regularly used the standing overnight deposit during 2012. The average amount of funds allocated in this instrument since its introduction was Denar 338 million, with an increased interest by banks being registered at the end of the reserve requirement period (the maximum amount allocated in this instrument was Denar 7,110 million). On the other hand, the interest in the marginal lending facility (overnight credit) was minimal in 2012, when only two credits were granted totaling Denar 2,930 million, which was due to the high liquidity in the banking system.

Figure 64
Interest rate corridor



Source: NBRM.

Figure 65
Average daily amount of overnight deposits by periods of fulfillment of the reserve requirement

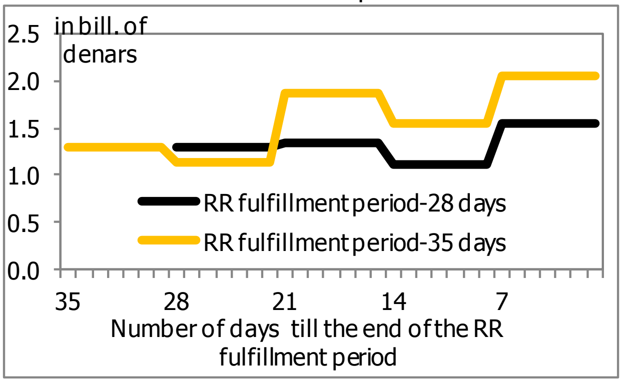


4.4. Other instruments

In conditions of reduced frequency of the main monetary instrument, in April 2012, the National Bank enriched the operational framework with another instrument whose primary function is to assist in the management of excess liquidity, if banks prefer to allocate funds in shorter term. The new instrument enables allocation of excess liquidity by banks on their initiative in a **deposit facility** with the National Bank every Wednesday, with **maturity of seven days.** The interest rate of the seven-day deposit facility was set at 2% in 2012.

Banks actively used this instrument for overcoming the excess liquidity in the short term, and at the end of 2012, the funds withdrawn by this instrument amounted to Denar 1,100 million. The average daily amount allocated with the National Bank since the introduction was Denar 1,411 million, with the highest interest being most evident in the last week within the reserve requirement period.

Figure 66
Average daily amount of 7-day deposits by periods of fulfillment of the reserve requirement



Source: NBRM.

4.5. Collateral in the implementation of monetary operations

Monetary operations of the National Bank for injecting liquidity in the banking system are collateralized with high-quality securities for the purpose of protection against credit risks. In February 2012, the National Bank made several significant changes in the instruments used as collateral for monetary operations. **First**, in order to increase the flexibility of the National Bank and the banks in managing liquidity, the National Bank has expanded the *List of securities for conducting monetary operations*, which besides the short-term securities (CB bills and Treasury bills) included the continuous government bonds and the government bonds issued for structural needs, as well. **Second**, the National Bank started to use the "value at risk" model in determining the haircuts, following the approach of the European Central Bank. The haircuts provide protection from market and liquidity risks in conducting monetary operations by establishing a higher amount of securities than the granted cash funds. **Third**, for more effective protection against market risks, the National Bank moved toward valuation of securities in the conduct of the monetary operations at market value, rather than the previous approach of valuation at nominal value. In the absence of market prices on primary or secondary market, the National Bank started a theoretical valuation of the collateral in accordance with current market trends and characteristics of the securities[42].

The total market value of the securities that banks may use to provide liquidity by the National Bank at the end of 2012 amounted to Denar 55,418 million. In terms of the maturity structure of the potential bank-owned collateral, the most common are short-term securities with 97.7%. During 2012, the average amount of daily indebtedness of banks with the National Bank was Denar 288 million, and represents only 0.5% of the potential liquidity that banks can obtain from the National Bank using the total available collateral.

[42] In order to strengthen the capacity of the employees of the National Bank regarding the theoretical valuation of securities used as collateral in monetary operations, the cooperation with Deutsche Bundesbank which started in 2011, continued throughout 2012. A two-day seminar on "Collateral valuation" was organized in the National Bank, which was given by two experts from the Deutsche Bundesbank and attended by several employees of the National Bank. During the seminar the results of the current model for the theoretical evaluation applied by the National Bank, as well as the possible application of alternative models were discussed. Also, for the development of the capacities for empirical analysis of financial markets and the information derived from their functioning, and which are important in the evaluation of the collateral for monetary operations, but also for analysis of macroeconomic trends associated with the adoption of the monetary policy measures, in collaboration with the Bank of England an international seminar on the "Topics in Empirical Finance" was held. The seminar which was held at the National Bank, was attended by 28 participants, including representatives from 11 central banks of the countries of Central and South Eastern Europe (Poland, Bosnia and Herzegovina, Albania, Bulgaria, Turkey, Serbia, Hungary, Montenegro, Kosovo, Lithuania and Armenia) and staff from three departments in the National Bank and the Ministry of Finance of the Republic of Macedonia.

V. Foreign reserves management

According to the Law on the National Bank of the Republic of Macedonia, one of the main tasks of the National Bank is managing the foreign reserves of the Republic of Macedonia (hereinafter: foreign reserves).

Foreign reserves management is closely linked to achieving the primary objective of the monetary policy, by providing liquidity to maintain the stability of the domestic currency in circumstances of applied monetary strategy of a de facto fixed exchange rate of the Denar against the Euro. Also, the foreign reserves management ensures sufficient liquidity for regular settlement of the financial liabilities of the Republic of Macedonia abroad. In that sense, it indirectly maintains high credibility of the Republic of Macedonia in the international financial markets. At the same time, foreign reserves are managed through dispersion of invested assets by countries, by financial instruments and currencies in order to protect the value of foreign reserves also in the broader sense, for the purpose of maintaining the national wealth.

5.1. Basic guidelines for managing foreign reserves

The basic guidelines for the foreign reserves management by the National Bank are subordinated to the proper application of the principles of safety, liquidity and profitability of the investment. Also, developments in international financial markets have a significant impact on the decisions of the National Bank in the management of foreign reserves and maintaining their value. For a longer period of time, trends in international financial markets have been influenced by the financial, economic and debt crisis in major developed economies, which has led to high credit risk aversion. In this sense, **diversification is still the basic strategic orientation** by dispersion of investments in multiple currencies, in order to reduce currency exposure to individual countries and currency areas.

Considering the current market conditions, and in accordance with the basic principles of foreign reserves management, the National Bank adjusted the strategy of investing foreign reserves, and identified the **following guidelines in the management of foreign reserves in 2012:**

- In terms of the currency structure, it was decided that besides investing in financial instruments denominated in Euros and US Dollars, part of the foreign reserves to be invested in financial instruments in four new currencies. With this decision, the National Bank reduces the credit risk exposure perceived with respect to the Euro zone;
- Regarding the gold, the strategic commitment to maintain the same level of this reserve asset within the foreign reserves, has remained;
- Foreign reserves continue to be managed within two broad portfolios, liquidity and investment portfolio, with different priorities. Under the liquidity portfolio, priority is given to respecting the principles of liquidity and safety, while within the investment portfolio, significant attention is paid to profitability, by respecting the principles of safety and liquidity.

Risk management is one of the key elements in the foreign reserves management, and this aspect of the management process is based on the system of investment limits and defined investment opportunities:

Table 3

Type of risk	Methods of limiting exposure
Credit risk	– *investment of foreign reserves in countries with high long-term ratings;* – *distribution of investments by setting quantitative limits on investments by country, by institution and by transactions with institutions, as well as quantitative limits on investments by types of securities;*
Liquidity risk	– *maintaining a certain amount of liquid assets in the form of short-term deposits (maximum maturity up to 14 days);* – *placing foreign reserves in securities that meet the liquidity criteria set (narrow spread between buying and selling price, a high level of primary emission, high demand);*
Currency risk	– *largest share of the Euro in the structure of foreign reserves;* – *quantitative limits on other currencies in the structure of foreign reserves: around 10% in US Dollars and 2.5% in each of the newly introduced currencies;*
Interest rate risk	– *placing part of the investment portfolio in Euros into securities held to maturity;* – *maintaining a relatively short target modified duration in individual investment portfolios composed of securities for trading.*

In order to improve the measures for limiting the *credit risk* exposure, the National Bank revised the manner of determining maximum levels of invested assets by country. Thus, besides the credit rating set by international rating agencies, **a framework for establishing internal credit assessment was developed,** which covers more macroeconomic indicators (public debt, budget balance, annual GDP growth rate, current account balance, inflation), market indicators (market determined ratings) and financial indicators (rating of the risk in the banking sectors of the countries assigned by the rating agency "Standard & Poor's"). The use of both scores allows differentiation of the countries where foreign reserves will be invested, especially regarding the European countries, whose market movements are closely related.

During the year it was identified that in the Eurozone and in the USA, as global financial markets, market conditions will be characterized by extremely low yields of financial instruments for a longer period of time. In such circumstances, and in order to maintain the profitability of the invested assets, in the second half of the year the modified duration of the portfolio of securities for trading increased.

5.2. Conditions for investment in international financial markets

Market conditions in the Eurozone and the United States were characterized by opposite movements in the first and second half of the year. At the beginning of the year, there was some easing of liquidity conditions in the Eurozone as a result of measures taken by the ECB. However, towards the end of the first quarter, market participants began to question the sustainability of economic growth in the Eurozone, given that published reports on business expectations showed reduced optimism about the economic growth in France and Germany. Besides economic information, market movements were influenced by the increased political uncertainty in the Eurozone[43]. Deteriorated market perceptions for the Eurozone were accompanied by the perception for slower economic growth in the USA, especially after the deteriorated data on the labor market were disclosed. In the second quarter, the GDP growth rate in the USA slowed down, while in the Eurozone it dropped. The slowdown in economic activity spread to the core countries of the Eurozone and several emerging economies, which previously registered faster growth.

[43] The Agreement on larger and more stable European fiscal integration, set at the beginning of the year, was still under consideration in the parliaments of several European countries, while in Ireland, a referendum on the acceptance of this agreement was scheduled. In Greece, despite the successful parliamentary elections, held on May 6, yields on government bonds were on the rise amid concerns about the country's possible exit from the Eurozone. Growth was registered also in the yields of the Spanish government securities, after Spain had submitted a formal request for financial assistance in banking system recapitalization.

In conditions of increased uncertainty regarding the resolution of the debt crisis in the Eurozone, market investors were withdrawing part of the investments from this financial market and diverted them to the markets which began to be perceived as safe heavens. In this context, the value of the Euro against most other currencies was declining in the first half of the year. More significant increase in value against the Euro registered the so-called commodities currencies, the Australian and Canadian Dollar, as well as the currencies of the Nordic countries[44]. In circumstances of strengthened value of the US Dollar, which is also considered a currency with the highest degree of safety in cases of economic and financial crisis, in the first half of the year the price of gold registered a moderate downward trend.

Figure 67
Gold price and USD/Eur exchange rate

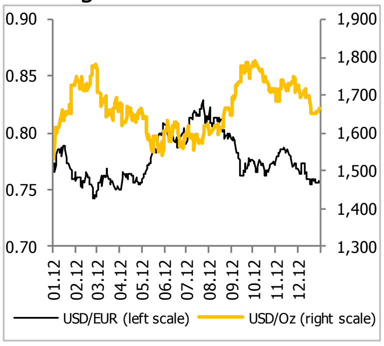


Figure 68
Movement of the exchange rates of selected currencies

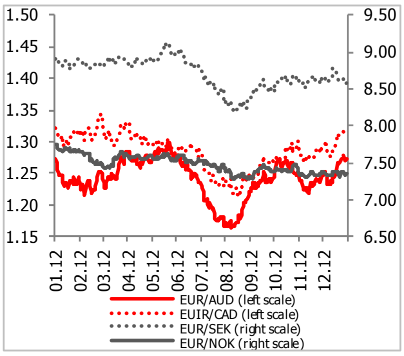
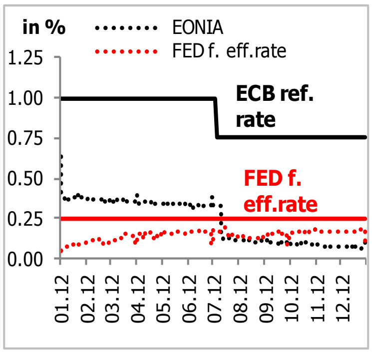


Figure 69
Key rates on the money market



Source: Bloomberg.

Against the background of increased likelihood of lower global economic growth, in the second half of the year, central banks took action to further loosen the monetary policy[45]. Thus, in early July the ECB reduced the key interest rate by 25 basis points, which dropped down to 0.75%, while the interest rate of overnight deposits was reduced to 0%. In developed economies where interest rates had already been reduced in the previous period, central banks (Fed, Bank of England, Bank of Japan) opted for extended use or reactivation of unconventional monetary measures.

Further easing of monetary policy by the most influential central banks caused directing of part of the investors' demand toward gold as a financial instrument for hedging against inflation, which contributed to the increase of the gold price in the second half of the year[46]. On the other hand, low interest rates and negative real yields of government bonds of several countries, encouraged investors to increase their investments in shares and other higher yield financial instruments. The growth of prices of higher-risk-bearing financial instruments continued until the end of the year, mainly as a result of the measures for reducing of the main downward risks to global economic growth[47]. Furthermore, market trends stabilized regarding Greece, given that in November a revised program with the IMF and the EU was agreed, which envisages measures for reducing public debt to a sustainable level over the medium term.

[44] At the end of 2012, the value of the Norwegian Krone was higher by 5.8%, while the value of the Swedish Krona was higher by about 4% against the Euro. The value of the Canadian Dollar registered a moderate increase of 0.7% against the Euro compared to the end of the previous year, while the value of the Australian Dollar against the Euro at the end of 2012 was at the level of the end of 2011.
[45] In the third quarter of 2012, the central banks of Brazil, China, Czech Republic, Israel, Korea, the Philippines and South Africa reduced the key interest rates, and in the fourth quarter a decline in interest rates was noted by the central banks of Colombia, Australia, Hungary, Sweden and Thailand.
[46] At the end of 2012, the price of gold was higher by 5.9% compared to the end of 2011.
[47] In September, the ECB announced that it plans to purchase government securities in order to stimulate the activity of this segment of the financial markets. The application of the new instrument is determined by submitting a formal request for financial assistance by the state which is facing increased financing costs. By the end of 2012, the new instrument of the central bank was not activated.

Figure 70
Stock exchange indices

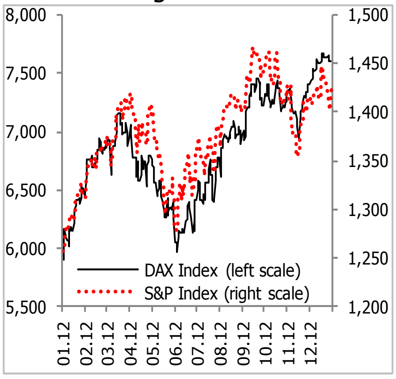
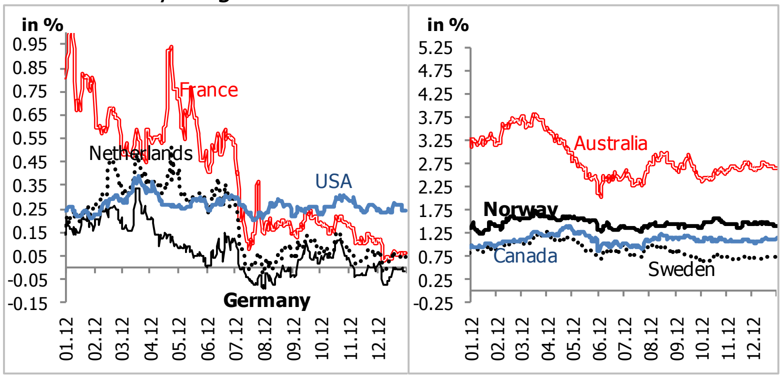


Figure 71
Yields of two-year government bonds



Source: Bloomberg.

However, despite the stabilization of market movements, yields of government bonds of core Eurozone countries did not notice significant changes, indicating that market participants still perceived long-term risk in relation to developments in solving the European debt crisis, overcoming of the fiscal problems in the USA and the uncertain outlook for the global economic growth.

5.3. Investment of foreign reserves

Following of the directions given in the foreign reserves management determined the structure of investments, which ensured low exposure to currency, credit, liquidity and interest rate risks.

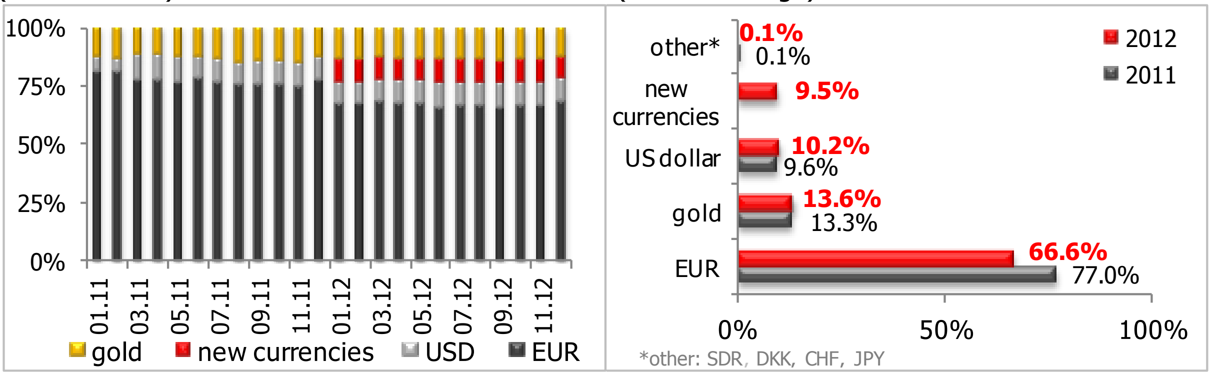
5.3.1. Currency structure

The funds invested in financial instruments denominated in Euros occupied most of the structure of foreign reserves by currency denomination. This investment commitment is consistent with the monetary strategy of a "de facto" fixed exchange rate of the Denar against the Euro applied by the National Bank. At the same time, such a currency structure of foreign reserves is in line with the currency structure of the debt of the Republic of Macedonia and the currency structure of foreign trade, where the Euro is also most commonly used. Compared with the previous year, the share of the Euro in the currency structure of foreign reserves was reduced by about 10 percentage points, due to the strategic orientation for distribution of reserves in four new currencies.

Within the guidelines given in the foreign reserves management, investments in US Dollars[48] are held at a stable level, in accordance with the maximum amount of eligible investments in this currency.

[48] In 2012, the average value of the US Dollar against the Euro was 1.2860 and was 7.7% higher than the average value in 2011. In circumstances of positive market perceptions regarding the resolution of the debt crisis in the Eurozone, the value of the Euro against the US Dollar at the end of the year increased, so that at the end of 2012, the value of the US Dollar was lower by 1,8% compared to the end of the previous year.

Figure 72
Currency structure of foreign reserves
(end of month) (annual average)



Source: NBRM.

Diverting part of foreign reserves in financial instruments in four newly-determined currencies (Australian Dollar, Canadian Dollar, Norwegian Krone and Swedish Krona) was made at the beginning of 2012, and during the year their share was fluctuating as a result of changes in the value of these currencies against the Euro. The average annual share of the new currencies within the foreign reserves stood at 9.5% and was in line with the planned investment limits. At the same time, within the guidelines set for foreign reserves management, the individual participation of new currencies averaged 2.4% of the foreign reserves.

The level of gold within the foreign reserves was unchanged, while its relative share fluctuated as a result of the fluctuations in the price of gold on the international financial markets.

Expanding the range of currencies within the currency structure of foreign reserves increases the risk of exchange rate differentials. However, the limited share of other currencies enabled the exposure of foreign reserves to exchange rate differentials to be kept under control. Namely, according to the concept of "value at risk"[49], as of 31.12.2012 exposure to currency risk equaled 0.9% (Euro 20.8 million). Within the total exposure of foreign reserves to currency risk, fluctuations in the price of gold caused 67.3% of the possible changes in foreign reserves, while changes in the value of the US Dollar against the Euro accounted for 21.9%. Fluctuations in the value of other currencies against the Euro caused 10.6% of the possible changes in the market value of foreign reserves.

5.3.2. Credit exposure and liquidity of investments

The safety of investments of foreign reserves is very important in profiling the investment strategy that the National Bank has applied in managing foreign reserves. The principle of safety of investments is further highlighted amid uncertain market developments in the international financial markets.

In 2012, investments of foreign reserves were directed towards countries with the highest credit ratings awarded by international rating agencies, consistent with the commitment to provide low credit exposure of foreign reserves. Thus, a significant portion of foreign reserves (58%) was invested in Germany, France and the Netherlands, while

[49] Value at risk indicates the maximum possible change in foreign reserves (with a probability of 99%), which may occur as a result of fluctuations in the prices of instruments and exchange rates, in an interval of ten days. In calculating the value at risk for a particular date, historical data are used on the movements in prices and exchange rates in the period of one year, relative to the date for which the calculation is made.

investments in the UK and USA also had a high share (13%). Moreover, in accordance with the investment limits set out under the defined investment strategy, investments were appropriately allocated by country, in accordance with the established maximum amounts at the level of investments by country.

In the beginning of the year, monetary gold was mostly deposited in the Bank of England. Beginning from the second quarter of the year, in order to increase the efficiency of gold management within the foreign reserves and to realize higher revenues from investment, the National Bank has started to place part of the gold in short-term deposits with foreign commercial banks (with up to 1 year maturity). When choosing the banks with which to perform these transactions, beside the long-term credit rating, the National Bank also analyzed a group of additional indicators, which give a more accurate picture of the short-term credit position of foreign banks.

Figure 73
Geographical structure of foreign reserves, annual average

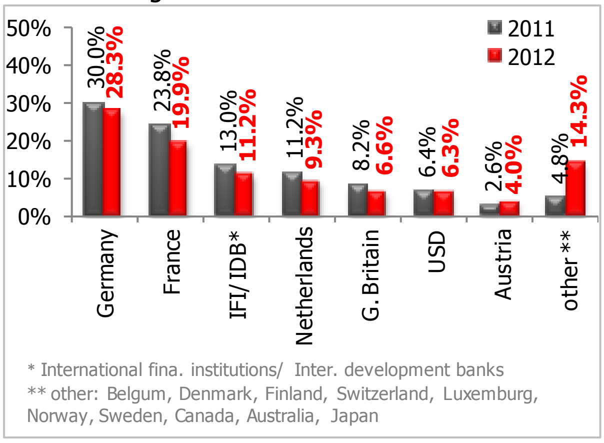
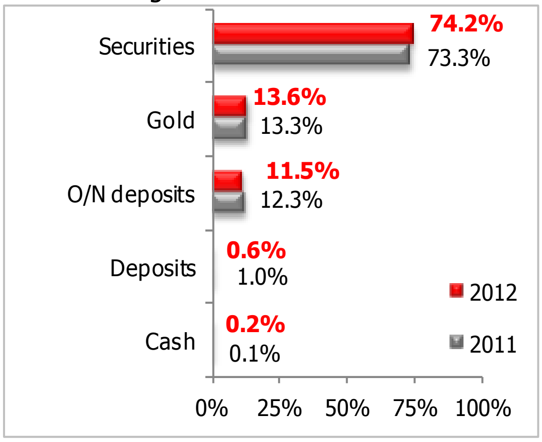


Figure 74
Structure of investments by instruments, annual average



Source: NBRM.

Liquidity of foreign reserves was primarily provided by maintaining liquidity portfolio in Euros and in US Dollars, in short-term liquid assets, mainly sight deposits. Liquidity of foreign reserves is provided also through investments in securities that are mostly represented in the structure of foreign reserves by instrument (74%). When selecting the securities, liquidity criteria were met, so that investments were made in securities for which there are most liquid and deep markets even amid turbulent market movements. Thus, these financial instruments make it possible to quickly mobilize resources in order to meet specific liquidity needs at low transaction costs. Also, foreign reserves management envisages uniform distribution of maturity of the invested financial assets (such as deposits and securities), which provides additional liquidity in the event of unforeseen liquidity needs.

Most of the investments in securities, or 79.6% annually on average were directed towards government securities and securities with an explicit government guarantee. Some of the investments were made in securities issued by the German federal states, in line with market movements, and for the purpose of some comparative advantage in terms of yield, compared with the government securities.

More significant share (12.6%) was that of the investments in instruments issued by international financial institutions (European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC)) and multilateral development banks (Nordic Investment Bank (NIB)). The profile of the founders of these institutions, the level of capital they dispose of, as well as the prudent operating and financial policies applied, lead the market participants to perceive these international financial institutions as issuers of financial instruments with a high degree of safety. In this regard, investments in securities issued by international financial institutions provide high level of safety of invested financial assets and have a higher yield compared to government securities.

Figure 75
Structure of securities by issuers, annual average

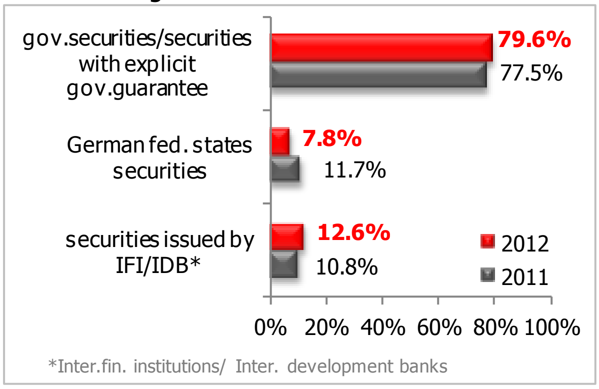
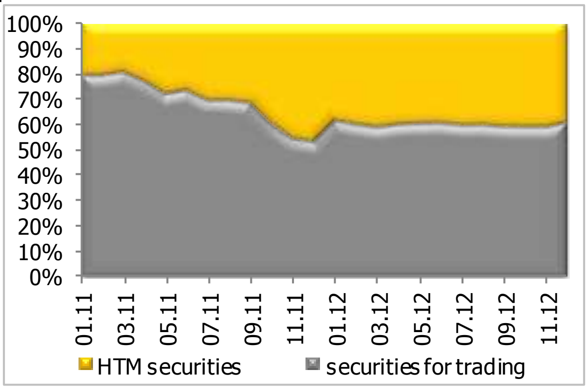


Figure 76
Structure of securities according to trading possibilities



Source: NBRM.

Investments in securities are exposed to price fluctuations caused by the movements in the international financial markets. In accordance with the strategic commitment to limit the price changes on the results from the investments of foreign reserves, year round an average of 40% of investments in securities were maintained within the portfolio of securities held to maturity. In accordance with international accounting practices, securities held to maturity are presented at amortized cost and are not subject to unpredictable fluctuations in price.

In addition, to limit the effects of price fluctuations, foreign reserves were invested in securities with relatively short target modified duration, which was revised during the year. Given the perception that the yields of high-quality government securities would be maintained at a low level at least until mid-2013, the modified duration of the investment portfolio in Euros was increasing, and at the end of the year it reached the level of 12 months. The modified duration of the investment portfolio in US Dollars also increased gradually, and at the end of the year it reached the level of 11 months. Regarding the investment portfolios in the new currencies, in the second half of the year the target modified duration increased and reached up to 14 months.

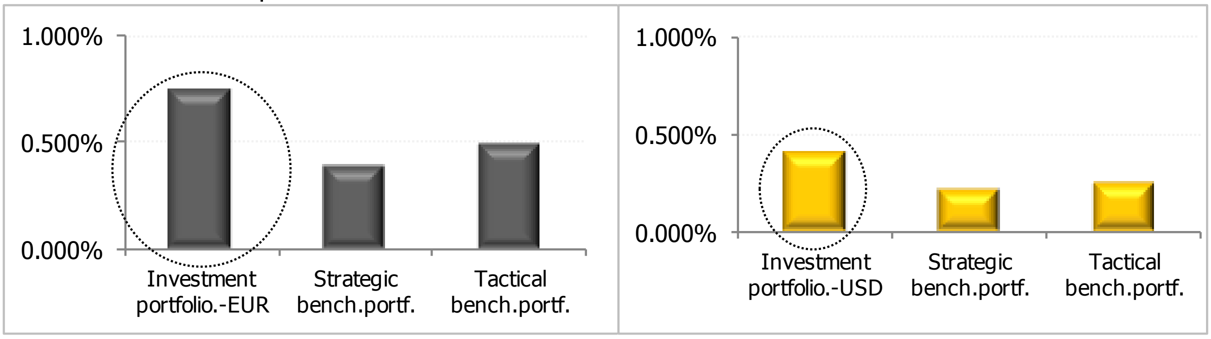
Exposure to the risk of price changes remained low and according to the concept of "value at risk" of foreign reserves, as of 31.12.2012, it amounted to about Euro 1.1 million, of which the exposure to price changes of instruments in Euros amounted to Euro 0.34 million, while the exposure to price changes of instruments in US Dollars amounted to Euro 0.13 million. According to this indicator for the level of risk exposure, price changes of debt securities within the investment portfolios in other currencies were Euro 0.62 million.

Given the high level of securities within the investment portfolio, for which there is high demand as collateral on global money markets, the National Bank continued to use the transactions of securities lending. These transactions are carried out by simultaneously concluding repo transactions and reverse repo transactions, while securities that meet the criteria for investment of foreign reserves are being received as collateral for the lent securities from the portfolio of the NBRM. Transactions for lending of securities further expanded in 2012 and included also the swap transactions collateralized by gold. Securities lending transactions covered about 18%, on average, of the investments in securities, and contributed to the increased efficiency of the foreign reserves management.

5.3.3. Results from investment of foreign reserves

In 2012, the returns on financial instruments in which the National Bank invests, had a trend of further reduction, compared with the previous year and registered new record lows. However, the results achieved from investment of foreign reserves justify the investment strategy applied during the year.

Figure 77
Return on investment portfolios



Source: NBRM.

Achievements in investment portfolios in Euros and US Dollars were relatively higher than the return on the reference market indices[50]. Also, investments in other currencies noted relatively high rates of return, whereupon the return in the original currency moved within a range from 0.95% to 3.61%. These achievements confirm the decisions of the National Bank in relation to the structure of financial instruments in which foreign reserves are invested, primarily referring to justification of taking the strategic decision to further diversify foreign reserves by currency denomination.

In addition to interest income, during 2012, income from exchange rate differentials of arbitrage, as well as income from lending securities transactions were realized, which had enabled the total income from the investment of foreign reserves to amount to Euro 30.2 million. The total rate of return on foreign reserves, which in addition to realized revenues also includes the unrealized price changes, was 0.9% on annual level.

Appendix 1: Further actions for maintaining efficiency in the foreign reserves management

It is envisaged that the commenced process of currency diversification of foreign reserves into new currencies, which will allow balancing of exposure to credit risk on the one hand, and maintaining the level of purchasing power of foreign reserves in the long term, on the other, will continue in the coming year. To this end, in 2013 it is planned to shift additional 1.25% of the foreign reserves into financial instruments denominated in new currencies, which are characterized by higher rates of return, but also by high liquidity and safety of investments.

Besides currency diversification, in the coming year it is planned to expand the scope of the types of securities within the investment portfolios. For this purpose, an analysis of the issuers of debt securities from the segment of supranational, sub-sovereign and agency issuers (SSA issuers) was made. The analysis showed that according to their credit

[50] Referent index of securities prices and money market index, comprised of real financial instruments, with modified duration which corresponds to the target modified duration of the investment portfolio.

characteristics, these issuers are between the issuers of government bonds and the issuers of corporate bonds. Bonds issued by the SSA segment issuers are treated as surrogates of government bonds, because they are considered reliable and high-quality instruments due to their special status provided by law or as a result of the built-in guarantee mechanisms.

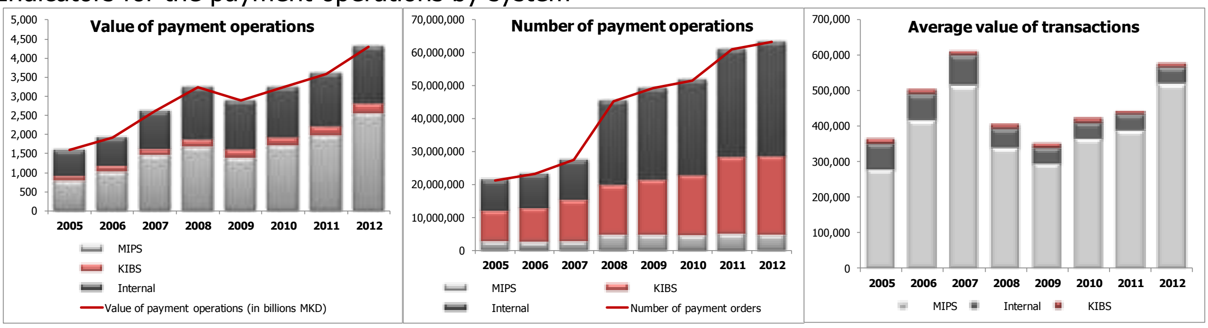
VI. Other activities of NBRM

6.1. The role of the National Bank in the payment system of the Republic of Macedonia

Pursuant to the legal provisions, the National Bank has operational, oversight and development function in the payment system of the Republic of Macedonia. In this context, the National Bank contributes towards maintenance of stable financial market infrastructure, safe and effective conduct of the transactions of the economic agents and towards development of domestic payment systems in accordance with international trends.

The National Bank fulfills the operational function through governance and management of the single real time gross settlement payment system - Macedonian Interbank Payment System (MIPS). The total number of participants in MIPS[51] in 2012 equaled twenty-four, and the system worked in real-time availability of 99.9%. Moreover, the system averagely processed 19.803 transactions per day, while the maximum number of executed transactions per day reached 57,983. In 2012, despite the annual reduction in the total number of settled transactions (by 2.3%), the average value per transaction recorded high annual growth (33.5%) and amounted to 519,847.00 Denars.

Figure 78
Indicators for the payment operations by system



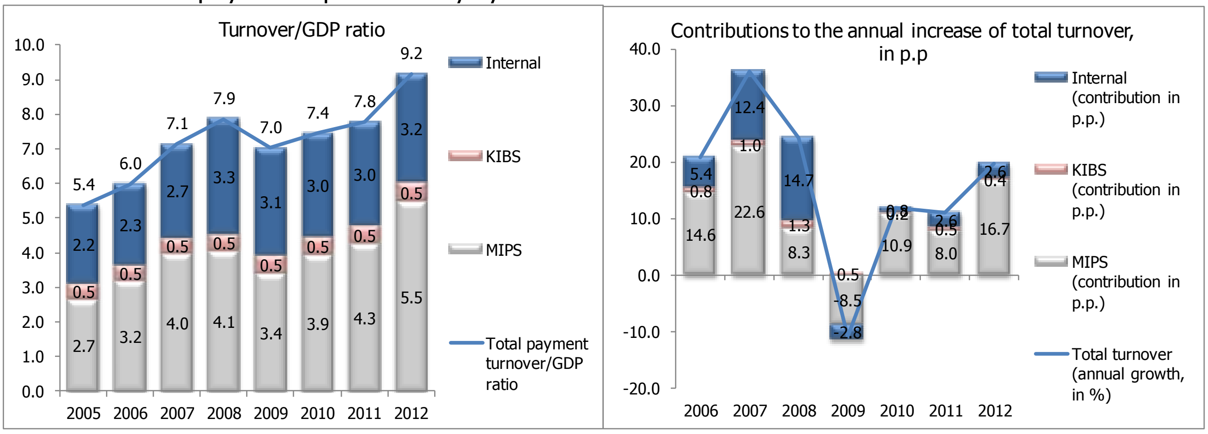
Source: NBRM.

Furthermore, the total value of the realized payment operations through all payment systems in the country grew by 19.7% annually, while the largest contribution to the growth was due to the increase in the turnover through MIPS. The value of the payment operations through MIPS in 2012 increased by 30.4% compared to the previous year, largely due to the turnover on the accounts managed by the National Bank, the accounts of commercial banks and the turnover on the accounts of the Ministry Finance of the Republic of Macedonia. Namely, the relative ratio of the total payment operations realized on the territory of the Republic of Macedonia relative to GDP has increased from 7.8 in 2011 to 9.2 in 2012, influenced by strong growth in turnover through MIPS. This indicator suggesting significant trends in the domestic economy, in the 2006-2008 period tended to increase, given significant growth in the economic activity and high annual growth rates of the total turnover. However, if analyze the growth structure in that period, it was conditioned not only by the increase in the turnover through MIPS, but also by the increase in the turnover through the banks' internal systems. However, in 2009, affected by the negative effects of the global economic crisis and amid a decrease in the domestic economic activity, the turnover has registered negative growth rate, given more significant reduction in the MIPS

[51] Participants in MIPS are: the National Bank, fifteen commercial banks, the Macedonian Bank for Development Promotion AD Skopje, Ministry of Finance of the Republic of Macedonia, the Health Insurance Fund of Macedonia, the Interbank Clearing Systems - AD, the Central Depository of Securities AD, the International Card Systems - CASYS, MasterCard International, Fershped broker AD Skopje.

turnover, as well as in the banks' internal systems. In the following period, with a gradual recovery of domestic economic activity, this indicator gradually increased, mainly due to the increase in the turnover through MIPS, while the contribution of the growth of the banks' internal turnover has decreased, indicating a reduced activity of banks in relation to their clients.

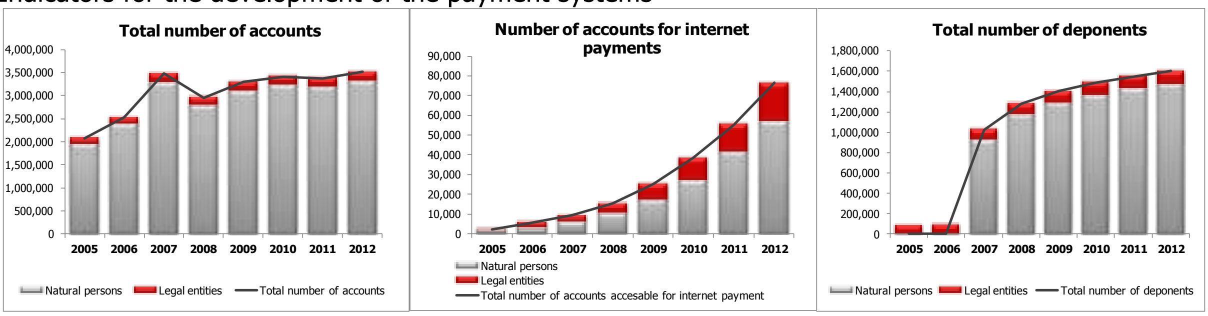
Figure 79
Indicator for the payment operations by system



Source: NBRM.

In 2012 the intensive trend of opening internet payment accounts continued, with a rate of annual increase of 38%. Namely, 73.8% of the total number of accounts for internet payments as of December 2012 are accounts owned by natural persons, while 26.2% of these accounts are owned by the legal entities.

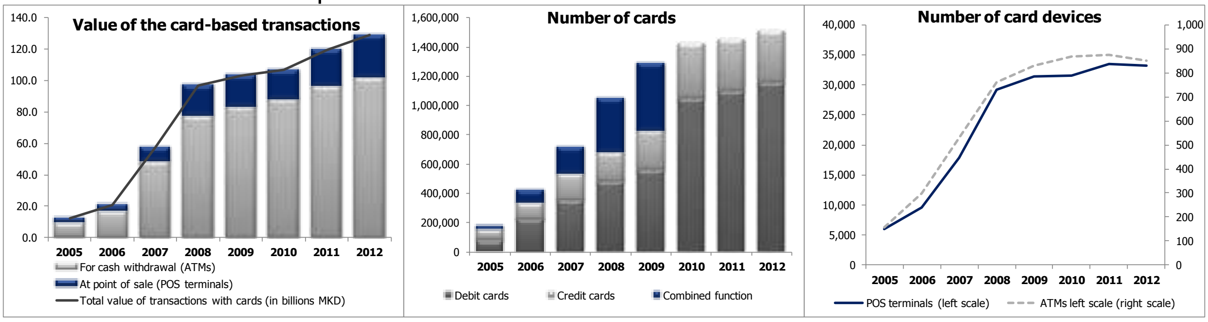
Figure 80
Indicators for the development of the payment systems



Source: NBRM.

In December 2012, the total number of cards in circulation equaled 1,507,142, 76.7% of which are debit cards, while 23.3% are credit cards. The debit cards participate with 85.5% in the total value of card-based transactions realized on the territory of the Republic of Macedonia. In 2012, the total value of card-based transactions equaled Euro 2,099 million, an increase of 7.9% compared to last year. If analyze the structure of the value of the card-based transactions in 2012 and 2011, increase in the share of the non-cash payment in trade through POS terminals by 2 percentage points, i.e. tendency of constant downward trend of cash withdrawal through ATM has been registered. Also, despite the current trend of improving the propensity of people to use the cards for payment in trade, the constant expansion of the network of POS terminals, allow the value of transactions for payment through POS terminals to increase by 19% annually.

Figure 81
Indicators for card-based operations

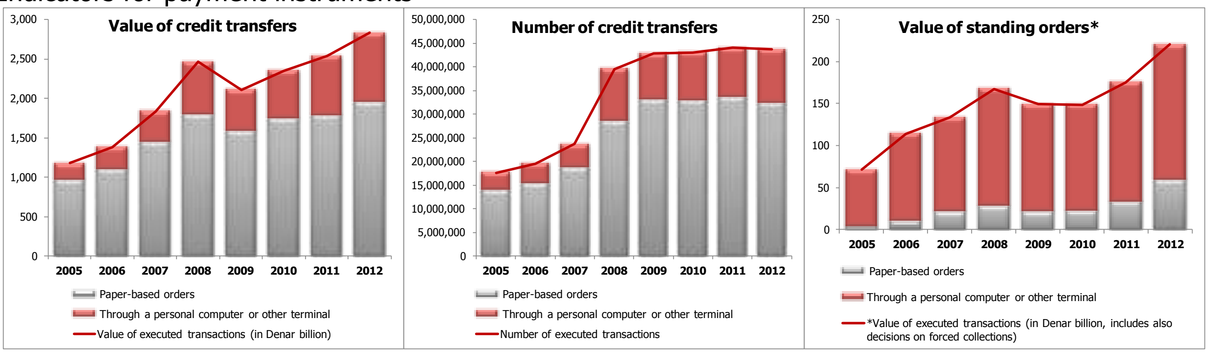


Source: NBRM.

In 2012 the total value of non-cash payments in form of paper or PC-based credit transfer, or other through terminal, equaled Denar 2.832 billion, representing a high annual growth of 11.6% compared to last year. On the other hand, the number of credit transfers amounted to 43,707,134 and decreased by 0.7% on annual basis. If analyze the structure of the number and the value of the credit transfer transactions in 2012 compared to 2011, it can be seen that despite the largest share of the paper orders in the execution of credit transfers, the number of credit transactions through a personal computer or another terminal has a tendency to an annual increase of 9.7%. This indicator shows the constant changing culture of the bank clients - holders of accounts in order to use the benefits offered by e-banking.

In 2012, the total value of the non-cash payments made through permanent orders (including enforcement decisions) in hard copy and through PC or other terminal equaled Denar 220 billion, an annual increase of 25.7% compared to last year.

Figure 82
Indicators for payment instruments



Source: NBRM.

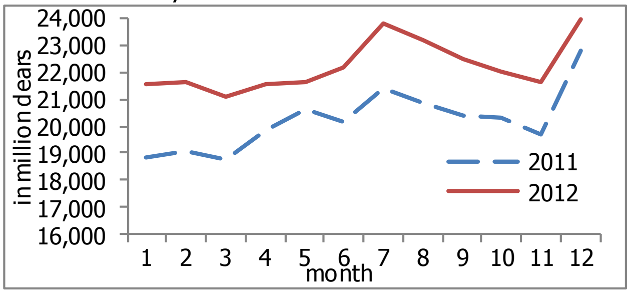
Besides the operational function in the field of payment systems, the National Bank conducts oversight function on both the real time gross settlement system - MIPS and deferred net settlement systems Interbank Clearing Systems AD - KIBS and International Card Systems - CASYS. The purpose of the National Bank oversight is to provide safe and efficient operation of the payment, settlement and clearing system. The oversight is conducted through monitoring, analyzing and encouraging change (by taking appropriate measures or recommendations, where payment systems do not meet the requirements and standards), and all in order to ensure systemic stability, mitigate systemic risk and maintaining public confidence in these systems. In 2012, oversight over the individual operating segments of MIPS operations was conducted, in order to assess its harmonization with the seventh core principle[52] - security and operational reliability of the system. During the oversight, it was determined that MIPS meet general requirements for safety and operational reliability, with recommendations for further improving the operational reliability being given.

Regarding the implementation of the development function of the National Bank, in 2012, several activities were performed in order to improve payment systems and move towards modern trends. In 2012, draft of the "Strategy for development of the payment system of the Republic of Macedonia 2013-2017" was prepared, which sets the strategic direction for the next five-year development of the national payment system of the Republic of Macedonia. The implementation of the strategy is coordinated by the National Payment Systems Council of the Republic of Macedonia, governed by the National Bank. For promotion of the payment system in the Republic of Macedonia purposes, the document "Red Book" (Red Book - "Payment, clearing and settlement systems in Macedonia") was prepared for the first time and it was submitted for publication to the Bank for International Settlements - BIS. In order to achieve harmonization of national payment methodology of statistics of the National Bank of payment statistics of the National Bank with the one of the European Central Bank, "Comparative analysis of payment statistics of the European Central Bank - ECB with the payment statistics of the National Bank - NBRM" was developed, which will be a guideline for the preparation of a new methodology that will enable international comparability of the trends in the domestic payment transactions with those in the European Union.

6.2. Vault operations

6.2.1. Issued currency in circulation

Figure 83
Issued currency in circulation



Source: NBRM.

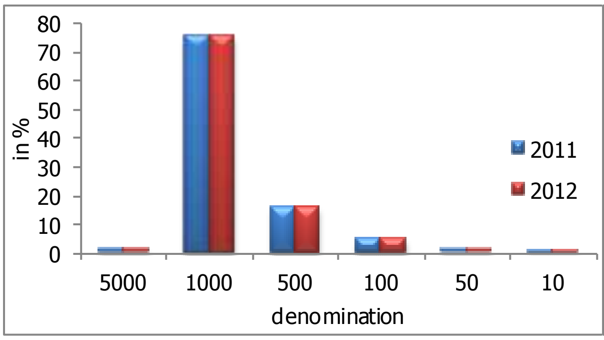
As of December 31,2012, the issued currency in circulation amounted to Denar 23,979 million, which is an increase of 1,212 million, or 5.3%, compared to 2011. The structure of the issued currency in circulation indicates that at the end of the year, banknotes participate with 97.5%, while coins with 2.5% of the total value. From the aspect of the number of issued currency in circulation, the banknotes and coins participate with 27% (65.7 million pieces), and 73% (176.8 million of pieces), respectively.

The largest share in the total value of the issued banknotes accounts for the banknotes in denomination of Denar 1000 (75.6%) and Denar 500 (15.9%). The other banknotes with smaller denomination participate with 8.5% in the total value of the banknotes in circulation. In 2012, the largest share in the value of coins accounts for the coins of Denar 10 (32%) and Denar 5 (23.5%).

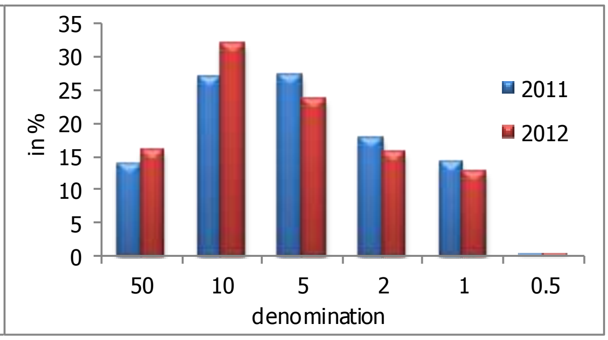
[52] For assessing systems that are subject to oversight, the Core Principles for Systemically Important Payment Systems adopted by the Committee on Payment and Settlement Systems at the Bank for International Settlements in Basel, are applied, which are an integral part of the Decision on the criteria and standards for the payment systems operations ("Official Gazette" no. 159/07), as internationally accepted standards for payment system operations.

Figure 84

Value share of the banknotes in the turnover, by denomination



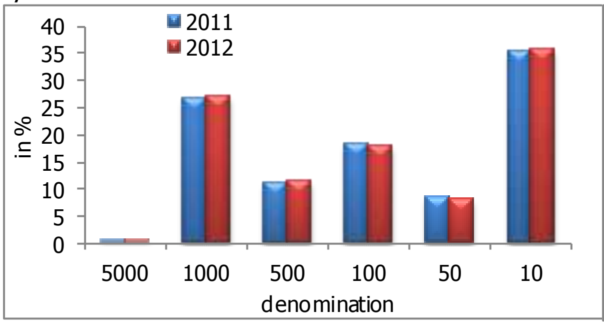
Value share of coins in the turnover by denomination



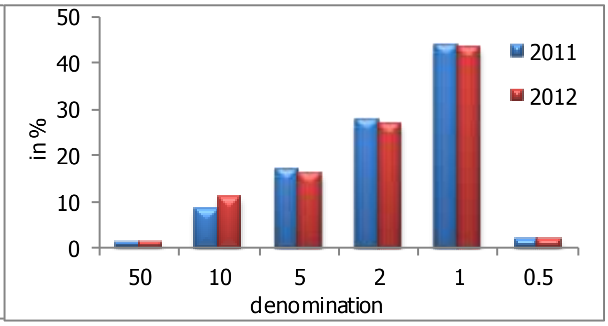
Source: NBRM.

Figure 85

Quantity share of the banknotes in the turnover, by denomination



Quantity share of coins in the turnover, by denomination



Source: NBRM.

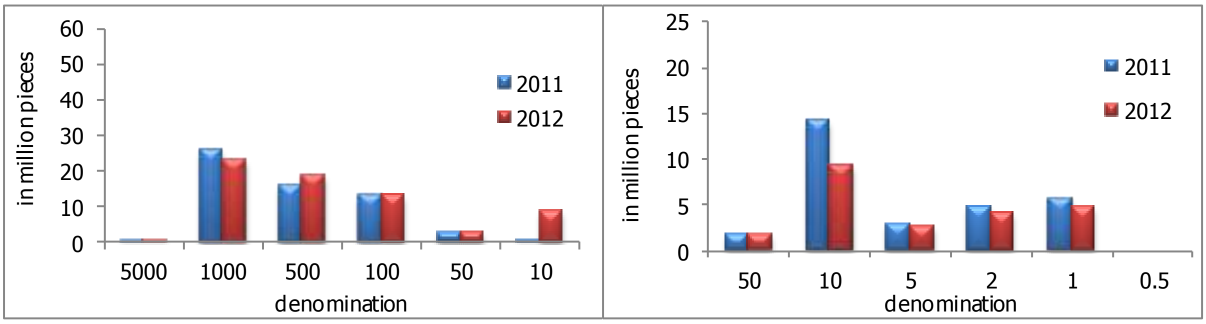
According to the number of issued pieces, the most numerous were the banknotes in denomination of Denar 10 (35.8%), 100 (17.8%) and 1000 (26.9%). The other banknotes take 19.5% of the total amount of banknotes in circulation. The largest share in the total issued coins accounts for the coins with denomination of Denar 1 (43.2%).

During 2012, efforts were made to improve the quality of currency in circulation with lower denomination structure by increasing the coins in circulation in denomination of Denar 10 and 50, which circulate together with the banknotes in same denomination. This effect is due to the fact that the coins have a longer economic life, i.e. they are less damageable. In contrast, the banknotes, especially those with lower denomination structure and greater frequency of use, have shorter economic life and they significantly faster damage.

6.2.2. Supply of banks with banknotes and coins

The central National Bank vault and the five sub-units for cash turnover outside Skopje in 2012 made payments of cash to banks in the amount of Denar 34.1 billion (decrease of 4.3% compared to 2011). At the same time, the banks received cash in the amount of Denar 33.0 billion. The analysis of the denomination structure of the banknotes and coins indicates that regarding the issuance and receipt, the largest share, with the banknotes, accounts for the banknotes in denomination of Denar 1000 of 34.5% in 2012 (i.e. 44.7% in 2011) and with the coins, the denomination of Denar 10 from 35.6% in 2012 (versus 48.5% in 2011), prevails.

Figure 86
Issued quantity of cash to banks
Banknotes Coins



Source: NBRM.

6.2.3. Processing and destroying of banknotes and coins

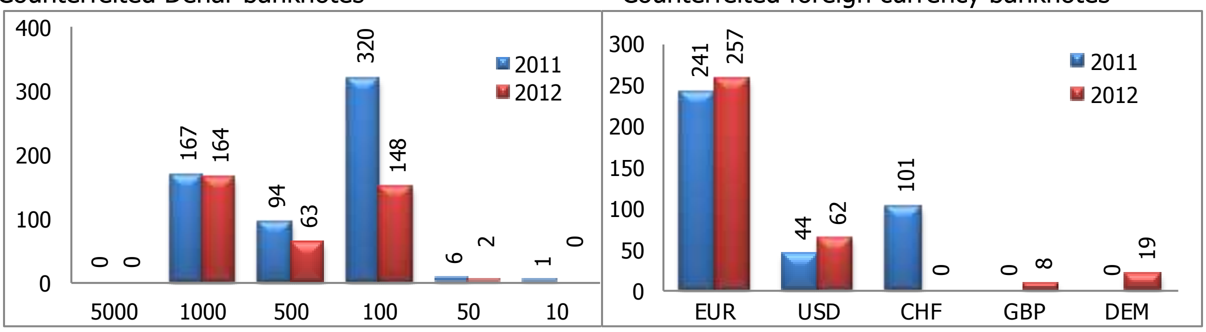
During 2012, the quality control process of banknotes in circulation, in the central vault and in the sub-units for cash operations in the country, covered all received banknotes. Out of the total processed banknotes, 17.8 million were destroyed due to wear-out or damage (18.2 million banknotes in 2011). The largest share in the destroyed banknotes accounted to the denominations of Denar 10, 100 and 1000 (76%). In 2012, also all received coins in denomination of Denar 1, 2, 5, 10 and 50 were processed, 385 thousand pieces of which were selected as wore-out.

6.2.4. Expertise on suspicious money / money counterfeits

Within its competence as the sole authorized institution, the National Bank continues to perform the function of expertise on Denar and foreign currency counterfeits in 2012, as well.

In 2012, out of the 381 suspicious Denar banknotes, detected by the banks or confiscated by the Ministry of Interior, after the expertise in the National Bank it was determined that 4 banknotes are original, while the remaining 377 banknotes are counterfeits. The number of the determined counterfeited banknotes reduced by 35.9% compared to 2011. Out of the total number of detected Denar counterfeits, in 2012 the denomination of Denar 1000 dominated (total of 164 pieces), followed by the denomination of Denar 100 (total of 148 pieces) and the denomination of Denar 500 (total of 63 pieces). The total value of the Denar counterfeits in 2012 amounted to Denar 210,400 and it has marginal share relative to the total value of the issued currency in circulation.

Figure 87
Counterfeited Denar banknotes Counterfeited foreign currency banknotes



Source: NBRM.

Regarding the foreign currency counterfeits, in 2012, expertise on total 414 submitted suspicious banknotes was made, detecting 346 counterfeits and 68 original banknotes in foreign currency. In the total number of counterfeits, the most common are the Euro counterfeits (257 pieces), US Dollar (62 pieces) and counterfeits of German Mark (19 pieces).

It is general assessment that the production quality of the counterfeited banknotes is bad, which enables simple and easy detection of their features. The expertise of the counterfeited banknotes preparation technique showed that they are made mainly by using regular paper, without protection marks, by using computer (scanning and printing), or by using a copying color machine.

In 2012, the interest for jubilee gold and silver coins continued, so despite the maintenance of the high gold price on the international stock exchanges, the National Bank sold 161 pieces.

6.3. Statistics

The National Bank is one of the authorized bearers of statistical surveys within the national statistical system in the country. The statistical function of the National Bank is defined by the Law on the National Bank and the Law on State Statistics. The Law on the National Bank defines the independence of the National Bank in the exercise of its functions, including the performance of the statistical function in order to attain the goals and tasks of the National Bank. The Law on State Statistics, however, includes the National Bank as one of the authorized bearers of statistical surveys, while the Programme of Statistical Surveys, as a basic document for the competence of individual institutions for statistical surveys conducted in the country, defines the surveys, primarily in the monetary and external statistics area, for which the National Bank is entitled to collect and required to disseminate data thereof. The statistical activities regarding the data dissemination are used to inform the general public about financial and macroeconomic trends in the Republic of Macedonia, simultaneously representing a support in decision making related to the basic functions of the National Bank.

Currently, the National Bank produces comprehensive data for Monetary Statistics and the Statistics of Interest Rates, Balance of Payments, International Investment Position, Direct Investment, External Debt and Claims, Foreign Exchange Reserves and Foreign Currency Liquidity. As a source of data, the National Bank uses a range of direct and indirect reports from financial institutions and non-financial companies, as well as institutional reporters, such as the Central Securities Depository or the Customs Administration of the Republic of Macedonia (for foreign trade of goods).

The National Bank, in the framework of the statistical surveys within its competence, continuously undertakes activities for following and complying with the international statistical standards. For that purpose, it cooperates with the International Monetary Fund, the World Bank, the Bank for International Settlements, through regular submission of statistical data on the one hand and continuous improvement in the quality of available data, on the other.

Closer cooperation between the main bearers of the national statistical system is realized on the basis of the Memorandum of Understanding in the field of macroeconomic statistics between the Ministry of Finance, the State Statistical Office and the National Bank, signed in 2009. Observing the Programme of Statistical Surveys, this Memorandum shall designate the primary bearers of individual macroeconomic statistical surveys and also define the manners of cooperation and mutual exchange of data required for the preparation of individual statistical surveys. This important document was prepared as part of the process of approximation of the national statistical system to the European national statistical systems.

During 2012, further progress in the area of statistical surveys within the competence of the National Bank was attained. This progress was noted also in the EC Progress Report for the Republic of Macedonia in 2012.

In order to improve the quality of external statistics in 2012, the following activities were realized:

- time series with quarterly data on the international investment position have been disseminated for the first time,, while the regular quarterly dissemination of this report has begun since September 2012;
- in order to improve data availability to end users, the deadline for dissemination of the Balance of Payments has been decreased from t +75 days to t +60 days . In this way, appropriate shortening of the deadlines for data dissemination also with other bearers of statistical surveys was enabled, primarily the deadline for preparation of quarterly national accounts;
- in September 2012, additional data on the external debt were disseminated on the website of the National Bank. This allows access to more detailed data on the public, the publically guaranteed and the private external debt, the debt currency structure, the short-term debt according to residual maturity and the debt-service payment schedule. The production of these data stems from the participation of the Republic of Macedonia in the Special Data Dissemination Standard - SDDS, also based on the inclusion of the Republic of Macedonia in the system for reporting Quarterly External Debt Statistics to the World Bank.

Also, within the permanent activities to comply with the new international standards in the field of external statistics, new questionnaires for investments to and from abroad were introduced. These questionnaires will expand the scope of foreign direct and portfolio investments in accordance with the international recommendations. Furthermore, a detailed report was prepared and an action plan set out for activities regarding required adjustments in all items of the Goods and Services components, which, according to the new international recommendations are subject to change. In the second half of the year, on the basis of the additional information about the latest statistical requirements of the IMF, EUROSTAT and ECB, on the concept of the standard presentation of the Balance of Payments were made, by introducing the so-called Data Structure Definition.

In 2012, further steps to improve the availability of the data on the monetary statistics and the interest rates statistics to end users were taken. Namely, the deadline for dissemination of the monetary surveys has been decreased from t +30 to t +21 days. Furthermore, additional data on interest rates were disseminated on the website of the National Bank, including: (1) new data on interest rates of overdrafts on current accounts and credit cards, were disseminated for the first time, (2) total interest rates at the level of instruments were published (for the total loans and total deposits), and (3) periodic interest rates were calculated and published (quarterly, annual). Also, in order to improve the quality of the published data, a new comprehensive document with methodological explanations of the basics of monetary statistics and the statistics of interest rates has been published, as well as the complete set of disseminated reports of these two statistics on the National Bank website.

Regarding the reporting by Other Financial Institutions, in 2012 the first reports from Other Financial Institutions were received. Accordingly, preliminary balance sheets and surveys of the Other Financial Institutions were prepared, as well as the consolidated survey of the financial sector.

In March 2012, an inter-institutional consensus has been reached, delegating the National Bank with the responsibility to be the primary bearer of Financial Accounts Statistics. Based on this common stand, the preparation of the second annex to the "Memorandum of understanding and cooperation in macroeconomic and financial statistics" began. With its signing, regular exchange of data among institutions and production of statistical data on Financial Accounts in the initial phase, is expected.

Within the inter-institutional cooperation, in 2012, representatives of the National Bank took an active part in the initiative on amendments to the Law on State Statistics. Also in 2012 active work has been dedicated to the preparation of the new five-year Programme of Statistical Surveys for the period 2013 - 2017, within which the National Bank as an authorized bearer of statistical surveys has a separate section.

During the year, the National Bank continued to improve the quality of existing statistical surveys, analysing also the opportunities for introducing new ones. In this regard, the activities to further comply with European legislation and statistical requirements of the European institutions have also been pursued.

6.4. Internal audit

In 2012, the Internal Audit Department fully implemented its Annual Audit Program. By systematically evaluating and giving recommendations on improving risk management, internal controls and governance processes, internal audit contributed towards improvement of the performance of the activities of the National Bank.

The Internal Audit has been achieving its goal by giving assurances to the management of the National Bank that the risk management, internal controls and governance processes are adequate and are being implemented towards achieving the following main objectives:

- efficient and economical use of resources;
- safeguarding of assets;
- reliability and integrity of financial and other information, and
- compliance of the operations with the laws and bylaws, internal policies and operating procedures.

Most of the regular activities refer to the planned regular audits. The audits were planned according to the following criteria:

- the assessed level of risk of the processes, in accordance with the applied methodology;
- importance of the functions that are performed;
- period elapsed since the last audit, and
- changes made in the working processes.

The audit reports provided an opinion on the adequacy and effectiveness of the established system of internal controls. Whenever weaknesses are detected, recommendations to overcome them within specified deadlines are given.

During 2012, fifteen regular audits have been conducted. The implementation of the recommendations given in the audit reports was monitored on regular quarterly basis. The findings from the performed observations suggest that the main recommendations are followed and implemented within the given deadlines. The audits on 31 working processes in the National Bank in 2012 produced 31 recommendations to improve the system of internal controls.

In addition to regular, the internal audit had other activities to improve the quality and efficiency of its own operations. In 2012, there was an external Quality Assessment of the Internal Audit Department activities, being concluded that it generally conforms with the International Standards for the Professional Practice of Internal Auditing.

In this respect, during 2012 efforts were made in the following: the application of the Program for Internal and External Assessment of the Internal Audit Department activities, preparation of the Guidance on Performing Consulting Audit and continuation of the technical cooperation with the Internal Audit of the Central Bank of the Netherlands (DNB) in the field of promotion of IT audit.

The operation of the Internal Audit Department was closely supervised by the Audit Committee, which held five meetings during 2012.

6.5. Museum, library and historical and archive activity

As a significant supporter of the preservation, study and promotion of the country's cultural heritage, in 2012, the National Bank implemented a series of activities within its museum, library and historical and archive activity, organizing several research projects and cultural events, which were largely associated with the celebration of the 20th anniversary of the monetary independence of the Republic of Macedonia.

Over the past year, the Museum of the National Bank began operating on the international scientific research project in the field of museum conservation, simultaneously working on the final phase of scientific research project for the reconstruction of the Roman mint operating at the ancient city of Stobi.

Within the operations of the Library of the National Bank, in 2012 the Library of the National Bank was significantly enriched with the latest literature within the area of the institution's operations.

In 2012, the National Bank started implementing also the activities for the preparation of the Historical Archive, setting the basic framework of this unit and which is expected to become operational during 2013.

6.6. Celebration of the 20th anniversary of the monetary independence of the Republic of Macedonia

The National Bank of the Republic of Macedonia celebrated a significant anniversary in 2012 - 20 years of the monetary independence of the Republic of Macedonia.

As part of the activities associated with the celebration of the jubilee, a Formal Academy was organized, at which the President of the Assembly of the Republic of Macedonia, Trajko Veljanoski and the Governor of the National Bank of the Republic of Macedonia, Dimitar Bogov made a speech.

Also, a conference titled as "Challenges of SEE countries into the existing economic and financial turbulence in the euro area", which was attended by a number of foreign and domestic experts, was held. As part of this event, the annual award of the National Bank for best thesis in the field of macroeconomics from a young researcher was awarded.

During the celebration of the 20th anniversary of the independence of the Republic of Macedonia, the Museum of the National Bank set up two important exhibitions, the first of which was the restoration of the permanent exhibition at the National Bank, opened to public on April 27, 2012. This exhibition includes the most important examples of money from the rich numismatic collection of the National Bank and a chronological display of a long and complex monetary history of Macedonia, as of 6 BC until today. The opening of the exhibition was followed also by and promotion of Macedonian and English edition of the exhibition catalog "Money and the Money Systems in Macedonia."

The National Bank hosted a temporary exhibition "Early Christian Frescos from the Episcopal Basilica in Stobi", which was set up in cooperation with the National Institution Stobi. The exhibition was opened on May 18, 2012, and this cultural event enabled, to present, for the first time, to the Macedonian public, the oldest surviving parts of the outstanding fresco decoration of the most important early Christian church of the ancient city of Stobi.

The Museum of the National Bank issued the publication "Macedonian Coins and Banknotes 1992-2012," as a review of cash issues in circulation in the Republic of Macedonia country for the past 20 years.

On the occasion of the 20th anniversary of the monetary independence and the introduction of the Denar, a new stamp representing one Denar coin was issued, using a motif of an old coin of Macedonia.

6.7. International cooperation

6.7.1. International relations

During 2012, the National Bank continues with activities to promote and strengthen cooperation on multilateral basis through participation in regular meetings of international institutions and international forums, as well as on bilateral basis, achieving cooperation with other central banks. In this respect, the Governor, the Vice-Governors and some employees actively participated as speakers and presenters at numerous international conferences and panels.

In 2012, the Governor and the Vice-Governors of the National Bank participated in regular spring meetings and the Annual Meeting of the IMF and World Bank, as well as the meeting of the Dutch constituency.

The National Bank is a member of the Bank for International Settlements, the role of which is to promote cooperation among central banks to strengthen the international monetary and financial cooperation. During 2012, the Governor of the National Bank participated in part of the regular meetings of the Bank for International Settlements in Basel, which are held every two months, and the annual meeting.

As a member of the Central Bank Governors' Club of the Black Sea Region, the Balkans and Central Asia, the National Bank took participation in the meetings also this year by sending its representatives.

Also, in 2012, the continuity of organizing seminars in the field of payment systems was retained. Thus, in Ohrid from 4 to 6 June 2012, the Fifth International Conference on Payment and Securities Settlement Systems" was held, which was attended by representatives of central banks in the region and beyond.

In addition, the National Bank, in cooperation with the Center for Central Banking Studies within the Bank of England, organized an international seminar on the topic "Topics in Empirical Finance". The seminar was devoted to the empirical analysis of financial markets and the information derived from their work, and which are important for the analysis of macroeconomic trends, the adoption of measures of economic policy, as well as the calculation of the effects of the market risks. The seminar was attended by 28 participants, including representatives of 11 central banks of Central and Southeastern European countries, as well as employees of the National Bank and the Ministry of Finance of the Republic of Macedonia.

6.7.2. Relations with the European Union

Participation of the National Bank in the process of accession of the Republic of Macedonia to the European Union

In 2012 the National Bank continued to actively participate in activities related to the process of accession of the Republic of Macedonia to the European Union.

Regarding the implementation of the obligations arising from the Stabilization and Association Agreement (SAA), the National Bank in the previous period was actively involved in fulfillment of the obligations of the first phase of SSA within its competencies. Further engagements of the National Bank are associated with the transition to the second stage of the Agreement. At this point, the National Bank is fully prepared for the responsibilities that lay ahead after crossing into the next phase of the Agreement and regularly participates in ongoing activities arising from the process. For that purpose, in 2012, representatives of the National Bank participated in the regular meetings of the working groups within the SSA, i.e. the Subcommittee on Economic and Financial Issues and Statistics, Subcommittee on Internal Market and Competition and theStabilization and Association Committee.

Concerning the preparation and implementation of the annual National Programme for the Adoption of the Acquis Communautaire (NPAA), the National Bank took appropriate participation by reviewing NPAA parts, which are within its competence and attending the meetings of the Working Committee for European Integration of the Government of Republic of Macedonia. Also, the nominees of the National Bank regularly participate in working groups established to fulfill the obligations of the NPAA. National Bank participates in eight working groups: economic criteria, free movement of capital, financial services, economic and monetary union, statistics, justice, freedom and security in the area to combat counterfeiting of the euro, as well as common foreign and security policy.

As in previous years, the National Bank participated in the preparation of Pre-Accession Economic Programme (PEP). In April, the chief economist of the National Bank participated in a working meeting of the Economic and Financial Committee at the EU Council, PEP was discussed at (2012-2014). Also on May 15, Ministerial Dialogue between ECOFIN (ministers of finance of the EU member states) and the ministers of finance and representatives of the central banks of the candidate countries was held, at which conclusions on pre-economic programs of EU candidate countries were made. The National Bank Governor Dimitar Bogov participated in the ministerial dialogue. In the last quarter of 2012, in coordination with the Ministry of Finance, activities related to the preparation of the Pre-Accession Economic Programme 2013-2015 (PEP 2013-2015) have begun. To this end, the National Bank prepared professional materials as a contribution to Pre-Accession Economic Programme 2013-2015.

Pre-accession assistance

Instrument for Pre-Accession Assistance (IPA). Given the strategic goal of the Republic of Macedonia for membership of the European Union in October 2012, with the signing of the Memorandum of Understanding between the National Bank and the European Central Bank (ECB), the implementation of theNeeds Analysis Project for the NBRM, financed by the EU Instrument of Pre-Accession Assistance commenced.

The main objective of the project is the preparation of the National Bank for joining the European system of central banks, and later in the Eurosystem, by determining the needs for changes in national legislation, organization and human resources at National Bank necessary to achieve the operating standards of the central EU banks.

The project has been funded by the European Union, which awarded Euro 405,000 from the Instrument for Pre-Accession Assistance and the National Bank, which provided Euro 45,000 as co-funding. ECB implements the project in partnership with the German Central Bank, the Central Bank of Estonia, the Central Bank of Ireland, Bank of Spain, Bank of Italy, the Central Bank of Malta, the Netherlands Central Bank, Central Bank of Austria, the Central Bank of Slovenia, the Central Bank of Slovakia and the Central Bank of Bulgaria.

The project includes the following areas of the central banking operations: economic analysis and research, monetary and exchange rate policy, payment systems, statistics, accounting, banknotes, human resources, legal services, information technology, internal audit and library and publishing operations.

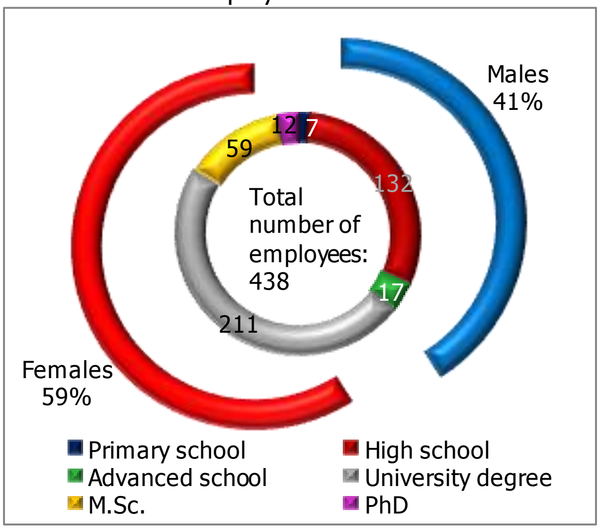
Technical Assistance for Information Exchange (TAIEX instrument). During 2012, regarding the use of TAIEX assistance, five projects were realized, i.e. two or three expert missions and study visits, in the area of statistics, treasury operations, as well as in the area of financial stability, banking regulations and methodologies.

6.8. Improvement of the institutional capacity of NBRM

6.8.1. Initiation of the strategic planning process

In 2012, the National Bank initiated the strategic planning activities as an integrated, two-way process and primary management function, which provides the strategic vision of the National Bank in the next three years. In February, after the adoption of the Rulebook for Planning, many activities related to strategic planning were initiated. In this sense, in June the three-year Strategic Plan was passed, upon which Guidelines for work in 2013 were adopted. At the end of 2012, the Council adopted the Operating Program of the National Bank in 2013, which is based on the general guidelines contained in the Plan and a concretization of the basic strategic objectives to be achieved by organizational units of the National Bank.

Figure 88
Structure of the employees in NBRM



Source: NBRM.

6.8.2. Development of human resources

At the end of 2012, the total number of employees of the National Bank equaled 438, meaning that it remained almost unchanged compared to 2011, when it equaled 440. According to the professional structure, the number of employees with university education degree (VII, VIII and IX level) is almost twice higher than the number of employees with primary, secondary and higher education and tends to rise. Thus, in 2012, the share of employees with university education degree (VII, VIII and

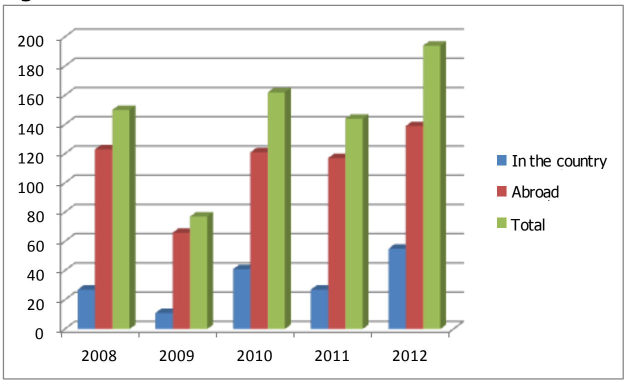
IX level) increased from 61.8% to 64.4%. In terms of gender balance, the number of working women is higher than men. Also, in case of new employments, special attention is paid to the equitable representation of the ethnic communities.

Activities towards building institutional capacity through training and development of human resources

The continuous process of professional development of the employees of the National Bank encourages the institutional capacity building and human resources development. In 2012, the actual professional training of staff in the country and abroad intensified. The crucial for the National Bank employees participating in specialized training programs organized by other central banks, international financial institutions or training centers is, despite training, and the opportunity to exchange experiences with representatives from other central banks, that participate of the training.

During 2012, compared to 2011, the number of visited professional development trainings in the country has increased by 103%, while overseas it has increased by 18%. Overall, professional development trainings realized in 2012 register an increase of 34.7% compared to 2011.

Figure 89
Number of visited professional trainings with foreign organizers



Source: NBRM.

The main organizers of professional development and training for the National Bank employees in 2012 were the International Monetary Fund, the Joint Vienna Institute, the Financial Stability Institute, and seminars that were held on the basis of annual training programs of the central banks of Germany, Austria, Poland, the Netherlands, the Czech Republic and the European Central Bank.

The professional developments in 2012 were aimed at strengthening the institutional capacity of the National Bank to fulfill its basic functions, i.e. mostly in the area of monetary policy, macroeconomic projection and central banking operations, statistics, supervision, financial stability and banking regulations. The following areas were included less: internal audit, law, human resources, cash management, financial and accounting operations, payment systems, integration processes, information technology and others.

Apart from professional trainings in order to gain new knowledge about quality of operations, during 2012, the National Bank has supported the employees who requested co-financing for the completion of formal vocational education.

Management of successful execution of the operations and care for the staff motivation and development

During 2012, the performance evaluation process of the National Bank improved and strengthened by introducing and promoting the career development of employees depending on demonstrated work efficiency. The process, which is conducted the third consecutive year, included application of established criteria for evaluating employees by different profiles and needs of posts at organizational unit level.

To raise the motivation of the employees, the National Bank introduced a system of rewarding employees by introducing variable part of the salary and began organizing events for team development and strengthening.

In order to identify areas of internal management of the National Bank that could be improved, a comprehensive study on job satisfaction of employees of the National Bank was conducted for the first time. The aim of the research is to identify areas where measures for improvement in the work processes, teamwork and communication can be undertaken, as well as enhancing the opportunities for training and other aspects of human resource development and leadership in the institution.

For greater transparency and better informing of the employees about the introduction of innovations in human resources processes, several employees intended presentations were held, where they had the opportunity to actively participate by raising specific questions and dilemmas for discussion.

Because of the introduction of the changes and the establishment of the desired style in human resources management, training for leadership within the organization of the development and team building intended for strategic and tactical managers was organized.

6.8.3. Development of information technology

On the field of information technology, further enhancement of the capacity of the National Bank has been achieved through:

- **Improving the process to ensure business continuity**. The potential disruption of operations at the main location, the overall operation of the National Bank may, without loss of data, continue on the secondary location. During 2012, significant improvement in the level of data replication between primary and secondary location was reached.
- **Increase in the performance and capacity of IT systems of the National Bank for more efficient use of IT infrastructure and greater flexibility in operations**. Following the trends in the IT industry, the National Bank has introduced additional servers for virtualization and robust additional disk space for development of the system of private cloud, which allows its users a constant access to information regardless of their position in the physical infrastructure and smooth execution of the business processes.
- **Further development of applications for the National Bank needs**. Pursuant to the requirements of the National Bank departments and their requirements in 2012, it was worked on more than 1,222 business cases, on the basis of which new applications were developed, the existing applications have been upgraded with new functionalities, or repaired. The changes have been made in a separate development environment, tested by the end users in a separate test environment and finally, after verification by the departments (end users) they have been placed in a production environment, where actively being used.

At the end of 2012, the National Bank operated 239 different applications in the field of supervision, statistics, financial markets operations, general management etc.

6.9. Financial Education

In order to increase the level of financial literacy and informing the public in the Republic of Macedonia on the finances and economy, in 2012 the National Bank launched the "Financial Education" project. The official start of the project was on October 31,2012 on the occasion of World Savings Day, under the motto "I know how to save money, too." The

"Financial Education" provides preparation and printing of educational materials (brochures, leaflets, manuals, books, comics) that cover many aspects of the economic sphere: the central bank and its role and functions, key financial institutions, economic terms, savings, financial products and the protection of consumers of financial services.

In 2011, the National Bank became a member of the International Network on Financial Education OECD, while in 2012, it became a partner institution of Child and Youth Finance International.