

# **Natonal Bank of the Republic of Macedonia**



## **Annual Report 2006**

Skopje, April 2007

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## *Governor's foreword*

Regarding the macroeconomics, we can view the year behind us as a continuity of the positive developments from the previous year. The inflation was maintained at a low level. The gross domestic product registered a solid growth rate. The banking sector grew at a fast pace, and the fiscal policy maintained the prudential character. At the same time, the external position was continuously improving, which is of great importance for a small and open economy such as Macedonia. The favorable macroeconomic developments also in 2006 enabled accumulation of the foreign reserves, as an important prerequisite for a successful exchange rate targeting strategy.

Price stability as the core monetary purpose was in the focus of the NBRM's monetary policy also in 2006. This year, however, price changes were to a large extent under the influence of factors outside the monetary sphere, whereby for the first time after four years, the average inflation exceeded 2% and reached 3.2%. The increase in the excise on tobacco and the introduction of other additional duties, the pass-through effect from the increase in the price of oil on the world markets, as well as the increase in the part of regulated prices, are the factors which had a dominant influence on the movement of domestic prices. If the changes in the price of tobacco, energy, and food are excluded from the general index for measuring inflation, the increase in the prices in 2006 was 1.1%, almost the same as the so-called core inflation in 2005, which actually excludes the influence of the prices of food and energy.

The main challenge for the Macedonian economy is still the acceleration of the economic growth rates, since also in 2006, regardless of the fact that in spite of the official announcement of the State Statistical Office that it equaled 3.1%, while the numerous indicators on the part of the consumption show that it might be somewhat above 4%, it is still well below the desired level and below the level in the other countries in transition. Such a growth dynamics still slows down the real convergence of the Macedonian economy toward the EU. Macedonian GDP per capita (PPP) is around one third of the GDP per capita (PPP) of EU-25. Although convergence is a long-term process and it is realistic to expect that it will speed up significantly after the admission to the EU, still the undertaking of the reforms towards a more flexible labor market, encouraging of the factors for achieving higher productivity, reducing the barriers for entering and exiting the market, modernization of the infrastructure, as well as increasing of institutions' efficiency have been our current key priority for acceleration of the economic growth and hence of the EU convergence process.

Both empirical and theoretical findings show that small and open economies such as Macedonia should to a large extent focus on creating dynamic and competitive export sector which will enable favorable external position. Therefore we monitor this sector very closely. Developments in this area during 2006 may be considered favorable. In spite of the increase in the trade deficit by 1.9 percentage points of the GDP, large portion of this increase is a result of the deteriorated energy trade balance, as a combined effect from the increase in the demand for energy and the rise of the world energy prices. The concentration of imports in the steel industry, whose performances are to a large extent caused by the conditions on the world market, energy-intensive economy and its import dependence, are the areas that require further efforts aimed at reducing the sensitivity of the domestic output and the exports to external shocks. The efforts for broader regional integration for the Macedonian economy are one of the directions toward acceleration of the trade and increase in the competitiveness, and hence toward improvement of the external position of the country. Participation of Macedonia in the so-called new CEFTA is a concrete effect of such a policy, which means integration of the free trade agreements of the south-east European countries, and it simultaneously represents an integrated international framework for improving not only the trade in goods, but also the trade in services, public procurements, investments, and intellectual property protection. In 2006, despite the deterioration in the trade balance, the further expansion of private transfers, and the postponement of the repatriation of a larger amount of dividend enabled historically lowest current account deficit of 0.4% of GDP. Inflows from FDI

(mostly from privatization) and portfolio investments significantly exceeded the current account deficit and enabled accumulation of foreign reserves at the level of 4.6-month coverage of the projected import of goods and services for 2007. On the other hand, net-borrowing in 2006 registered negative balance due to the higher debt repayments (mainly as a result of the early repayment of a portion of the debt), which enabled improvement of the debt profile of the country. There is no doubt that it contributes to positive perceptions of the stability and the potential of our economy.

During 2006, monetary policy was pursued in the strategic framework of targeting the nominal exchange rate of the Denar against the Euro. This monetary strategy still generates positive performances shown by the low and stable inflation and stable inflationary expectations, and also it does not contribute to the decline in the competitiveness of the Macedonian economy. In December 2006, compared with December 2005, the real effective exchange rate, which is an indicator of the competitiveness of the domestic economy relative to the economies of the foreign trade partners, calculated through the consumer price index appreciated insignificantly, while calculated through the producer price index it registered depreciation.

Pursuing a policy of stable exchange rate, in circumstances of further growth of foreign exchange inflows and banks' preferences to increase the share of the domestic currency in their currency portfolio, resulted in interventions of the NBRM on the foreign exchange market with a significant net purchase of foreign exchange and creation of Denar liquidity on this basis. The effects from the interventions on the foreign exchange market were sterilized through the monetary instruments, and pursuing prudent fiscal policy (with budget deficit of 0.6% of GDP and accumulation of government deposits) was a significant support for the process of sterilization of inflows. However, excess liquidity changes the classical relationship between the central bank and the commercial banks, i.e. makes the interest rates of the central bank an opportunity cost for the banks rather than a financing cost, reducing the efficiency of the monetary transmission. Hence, also in 2006, efforts were made for reducing excess liquidity, when in cooperation with the Ministry of Finance we introduced three-month Treasury bills for monetary policy purposes, which have solely monetary function and which, besides mopping up liquidity, enable further development and deepening of the financial market. In 2006, the total withdrawn additional liquidity through the main monetary instruments (CB bills and Treasury bills for monetary policy purposes) was 1.7% of GDP.

In circumstances of a stable environment, disciplined macroeconomic policy, and accumulation of foreign reserves, the trend of reducing the interest rates continued. The reference interest rate of the NBRM (interest rate on CB bills) registered annual fall of 3.8 percentage points in 2006. Interest rates on Treasury bills followed the dynamics of the interest rate on the CB bills auctions (the average weighted interest rate registered a decline of 1.8 percentage points). This enabled movement of the interest rates on the financial market and in the banking sector in the same direction, due to which in 2006 the real interest rates registered their historically lowest level. The monetary policy signals also led to a certain responsiveness of banks. The interbank interest rate dropped by 3.8 percentage points. Lending interest rate on Denar credits went down by 1.4 percentage points, while the deposit interest rate on Denar deposits registered a decline of 1.2 percentage points, narrowing the interest rate spread by 0.2 percentage points. Such a trend means increased accessibility of banks' credits to the corporate sector and the households, which through the investment and consumption channel contribute to the acceleration of the economic growth.

Banking sector continued to develop at a fast pace, following the trends in contemporary banking. In conditions of an additionally created available income from the domestic economy, and high level of foreign exchange inflows, also in 2006 a significant amount of deposits was attracted in the banking system, which reached 29.4% of GDP, or by 3.5 percentage points more relative to the preceding year. The increase in the deposit base, broadening of the banks' sources of financing, increased competition and banks' positive perceptions of the overall economic activity, enabled further increase in the credit supply, which reached 26.1% of GDP, or 3.8 percentage points more

relative to the preceding year, reflecting a significant deepening of the financial intermediation. However, comparisons with more advanced countries show plenty of room for its further strengthening. It is important to emphasize that the intensive credit growth was accompanied by a significant improvement of the credit quality indicators. The share of non-performing placements in the total placements reduced by 3.3 percentage points. Although the intensive credit growth and the increased competition are desirable, sometimes they may imply undertaking of high risk. Hence, it is very important the expansion of banks' credit activity to take place in parallel with the introduction of adequate risk management procedures and continuous monitoring of the credit portfolio quality.

In 2006, financial sector continued to develop, and it had a significant influence on the economic growth, especially in the economies with low initial level of financial development. The development and depth of the financial market are extremely important for an efficient resources allocation, as well as for preventing over excessive fluctuations in the demand. The financial market in the Republic of Macedonia continuously develops. It is evident from the following: the significant deepening of the government securities market and the introduction of financial instruments with longer maturity, improvement of the infrastructure of trading in short-term liquid assets (electronic trading platform was introduced in the interbank money market in May 2006), the acceleration of the activity on the Stock Exchange, as well as the development of the non-banking institutions. The start of the second pillar of the mandatory pension insurance at the beginning of 2006 and the establishment of the two new pension funds which actively participate in the government securities market, de facto mean beginning of the activities of the institutional investors. This will certainly act toward further development and deepening of the financial markets. By establishing the second pension pillar in the beginning of 2006, NBRM started to perform a new function - custodian of the private pension funds.

Ladies and Gentlemen,

Great privilege is the ability to register continuous macroeconomic stability, as a result of prudential and coordinated macroeconomic management. Actually, in the assessments of the realization of the concluded three-year Stand By Arrangement with the IMF (from August 2005), the macroeconomic stability is emphasized as a benefit which must not be put at stake, and the first Progress Report of the European Commission after receiving the candidate status points to the successful combination of macroeconomic policies in maintaining the price stability. At the same time, the international rating agencies, which continuously improve the country's credit rating, emphasize the history of low and stable inflation and macroeconomic stability, the moderate public sector indebtedness, and the moderate foreign debt of the country as main advantages of the Macedonian economy. Still, the need for speeding up the growth of the economy, and the reduction of the unemployment rate show that the macroeconomic stability is a necessary, yet not a sufficient precondition for prosperity of an economy. Implementation of reforms, which mean improvement of the business environment, and the support of the domestic and foreign investments are the key priority. Many steps have been undertaken in this field, such as: gradual flexibilization of the labor market; introduction of the one-stop-shop registration system; reforms in the judicial system; reforms in the tax system, etc. Their common objective is to improve the climate for investment and for the overall economic activities. Therefore, it is of key importance for them not only to continue but also to be carried out as effectively as possible. NBRM participates in the current reforms through continuous strengthening of the banking supervision, through establishment of the new regulations for the banking system compatible with the European standards, and by undertaking activities for further development of the financial system in all segments in which it, as a central bank, is competent. The macroeconomic stability, supported by adequate structural reforms, is a good formula for stimulating domestic and foreign investments, as the main precondition for accelerating the economic growth and for faster convergence towards the EU.

Governor  
and President of  
the NBRM Council

Skopje, May 2007

Petar Goshev, MSc.

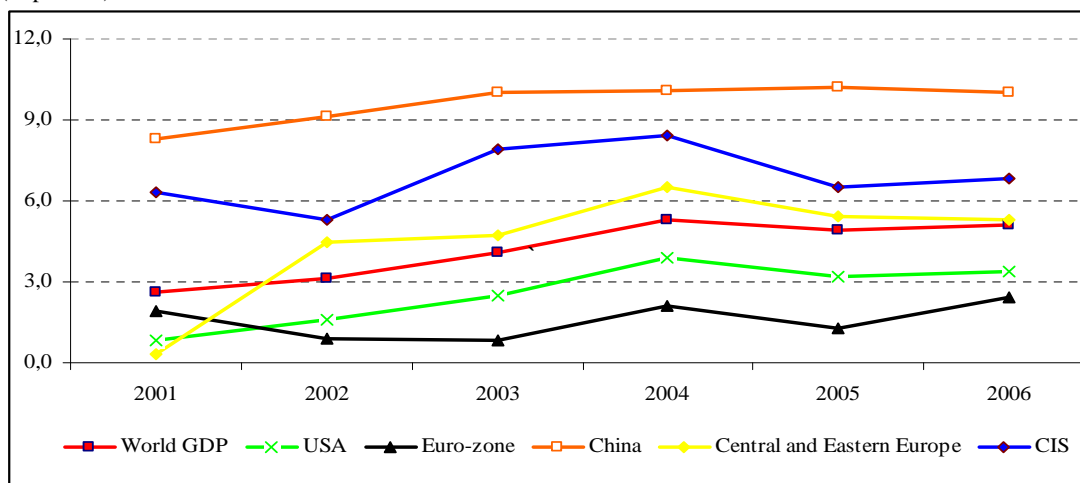


## I. Economic developments in the world<sup>1</sup>

Economic developments in the world indicate accelerated economic growth. The real growth rate of the global GDP is estimated at 5.1%, which relative to the preceding year is an increase of 0.2 percentage points, but the latest data indicate that this estimation is exceeded.<sup>2</sup> The continuous growth of the global output in the past four years has been the largest economic expansion since the beginning of the seventies of the preceding century. Such a tendency of acceleration of the global economic developments could be partially explained with the increased productivity, primarily in the USA, but also in the emerging Asian markets, such as China and India, where technological progress is the dominant factor for increasing their productivity. Oil-exporting countries and the countries rich in raw materials (especially metals), gave an additional contribution to the increase in global GDP, which was entirely a result of the rise in their prices on the world markets.

Observed from the viewpoint of the quarterly dynamics, global GDP registered its fastest increase in the first quarter of 2006, while in the following quarters the growth rate slowed down partially due to the high rise in the prices of oil and primary products (metals) on the world stock exchanges, which triggered an increase in the inflationary pressures and conduct of a more restrictive monetary policy. Reduced consumption of households in the developed countries (mainly USA) additionally contributed to the decline in the quarterly growth rate of GDP, which was primarily due to the fall in the prices on the real estate market and of securities.

Figure 1  
Real GDP growth by groups of countries and individual countries  
(in percent)



Source: Source: IMF World Economic Outlook, September 2006

In 2006, from the viewpoint of the individual economies, driving forces of the global GDP growth were the developed countries, primarily USA (increase of 3.4%), Southeastern Asia, especially China and India (increase of 10% and 8.3%, respectively), part of the countries of South America (such as Argentina and Brazil with an increase of 8% and 4.1%, respectively) and Russia with an increase of 6.5%<sup>3</sup>.

<sup>1</sup> The analysis is based mainly on the IMF World Economic Outlook, September 2006 and the EBRD Transition Report 2006.

<sup>2</sup> According to the IMF, WEO April 2006, global GDP registered an increase of 5.4%.

<sup>3</sup> Real GDP growth rates in these countries for 2006 are average.

## **Annex 1**

### **Adjustment of global imbalances**

In 2006, on a global level, intensive increase was registered also in the volume of the international trade in goods and services. In this context, it is important to mention the phenomenon of global imbalance between the countries which have been registering significant surplus for a longer period of time and countries which have a relatively high current account deficit. Thus, more important countries that register high surplus are China, Japan, Singapore, Germany, Russia and part of the Middle East oil-exporting countries. On the other hand, more important countries which register high deficit in their current accounts are the USA (where the high deficit is a result not only of the low level of saving of the US economy, but also of the slower growth rate in the European Union and Japan, whereby the export demand for US products is insufficient), Spain, Portugal and Australia. Although such imbalances do not jeopardize the stability of the world economy, it is very important whether in the future the gap between saving and investments will deepen and whether the high deficits in the aforementioned countries are sustainable in a long run.

According to the simulations of the Global economic model<sup>4</sup> *global imbalance may spontaneously decrease (scenario which assumes neutrality of the macroeconomic policies)* if due to a decline in the prices of securities and property in the USA private consumption would decrease, domestic saving would increase, but also the interest in foreign investments would reduce. These factors, combined with a depreciation of the exchange rate of the US Dollar would lead to a decline in the imports and more intensive increase in the exports, i.e. to a gradual reduction of the current account deficit, which in 2015 would be reduced down to 4% of GDP. On the other hand, reducing of the current account deficit in the USA would reflect the lower surplus mainly in emerging Asian markets. The decline in the high surpluses in the countries of Southeastern Asia would be accomplished through an increase in private consumption, through reduced domestic saving and through expected appreciation of the exchange rates. *The second scenario in the model assumes a more dynamic decline* in the inflows in the US economy and higher risk premium, which along with the depreciation of the US Dollar would extremely quickly shrink the deficit in the current account of the USA down to 2% of GDP, which in the end would lead to an increase in the interest rates in order to ease the inflationary pressures and slow down the economic growth. *The third scenario presumes active policies applied in various regions worldwide*, i.e. larger flexibility of the exchange rate in Asia, fiscal consolidation in the USA, structural reforms in the Euro-zone and in Japan, additional consumption of oil exporters. Such changes would reduce the USA current account deficit to 1% of GDP in 2015 and at the same time would generate fewer distortions and more balanced global economic growth.

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<sup>4</sup> Presented in the IMF WEO, September 2006.

Table 1  
Indicators for the world economy

	2001	2002	2003	2004	2005	2006***
	(in %)					
<i>Real growth of the gross domestic product</i>	2,6	3,1	4,1	5,3	4,9	5,1
Developed economies	1,2	1,5	1,9	3,2	2,6	3,1
USA	0,8	1,6	2,5	3,9	3,2	3,4
Euro-zone*	1,9	0,9	0,8	2,1	1,3	2,4
China	8,3	9,1	10,0	10,1	10,2	10,0
Central and Eastern Europe	0,3	4,5	4,7	6,5	5,4	5,3
CIS**	6,3	5,3	7,9	8,4	6,5	6,8
Russia	5,1	4,7	7,3	7,2	6,4	6,5
<i>Growth of the world trade</i>	-	3,4	5,3	10,6	7,4	8,9
<i>Rate of inflation</i>						
Developed economies	2,1	1,5	1,8	2,0	2,3	2,6
USA	2,8	1,6	2,3	2,7	3,4	3,6
Euro-zone*	2,3	2,2	2,1	2,1	2,2	2,3
China	0,7	-0,8	1,2	3,9	1,8	1,5
Central and Eastern Europe	19,4	14,7	9,2	6,1	4,8	5,3
CIS**	20,3	13,8	12,0	10,3	12,3	9,6
Russia	21,5	15,8	13,7	10,9	12,6	9,7
<i>Annual change of prices</i>						
Crude oil	-13,8	2,5	15,8	30,7	41,3	29,7
Primary commodities	-4,9	1,7	6,9	18,5	10,3	22,1
	(in % of GDP)					
<i>Rate of savings</i>	21,2	20,3	20,7	21,3	21,8	22,7
<i>Investment</i>	21,4	20,7	21,0	21,6	22,2	22,7
<i>Nominal Exchange Rate (US Dollar / EURO)</i>	0,896	0,944	1,131	1,243	1,246	1.250***

Source: IMF World Economic Outlook, September 2006.

\* Selected countries are the most important trading partners of the Republic of Macedonia.

\*\*Mongolia is included, even it does not belong to the group of countries known as CIS (Commonwealth of Independent States).

\*\*\*Estimate.

During 2006, inflationary pressures had a negative effect on the global economic development, primarily caused by the fast growth of the prices of crude oil and primary products, especially metals. Such inflationary pressures led to an increase not only in the general price level in the developed countries, but also in the core inflation, as a result of the higher inflationary expectations and the increase in the unit labor costs. As a reaction to these pressures, central banks of developed countries tightened their monetary policy by increasing the key interest rates. Thus, during 2006, the US Federal Reserve and the Bank of England increased their key interest rates, which at the end of 2006 equaled 5.24% and 5%, respectively. During 2006, the European Central Bank made another increase in the interest rate of 1.25 percentage points, and in December 2006 it equaled 3.5%. Also, the Bank of Japan increased the key interest rate by 0.3 percentage points, and for the first time after 2001 it was higher than zero. The upward trend in the key interest rates was followed by the central banks of Canada, Australia, Sweden, India and Argentina.

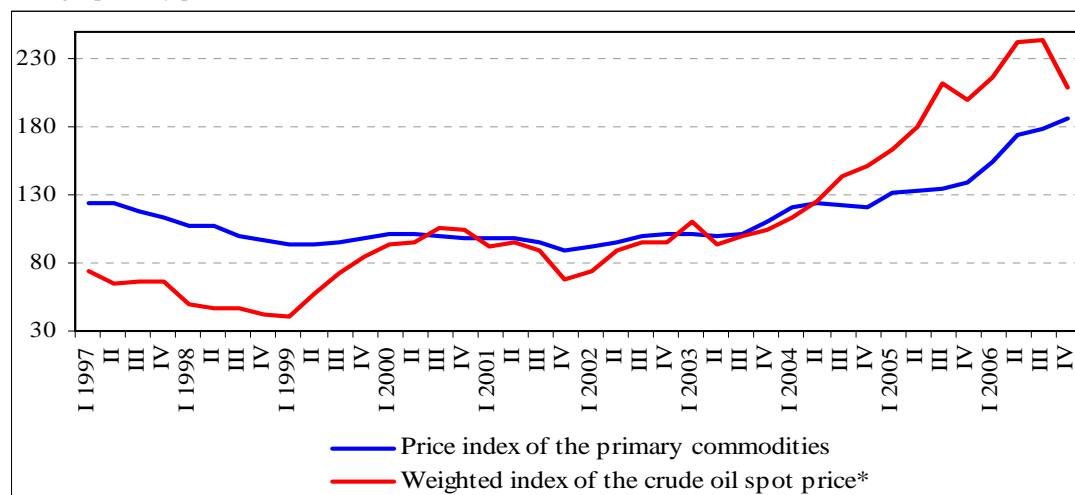
The prices of primary products (which have twice higher share in the world trade with respect to oil) registered an increase of 22.1% on annual basis, which was primarily triggered by the increase in the prices of metals on the world stock exchanges. More precisely, fast increase was registered in the prices of zinc, copper and nickel<sup>5</sup>. Main reasons for the rise in their prices<sup>6</sup> were

<sup>5</sup> The increase in the average prices in 2006 relative to 2005 is: 2.4 times for zinc, 1.8 times for copper and 1.6 times for nickel. Source: World Bank.

the fast growth of the demand which exceeded the supply in conditions of restricted and insufficient production capacities, as well as the increase in the costs for their production and processing caused by the increase in the prices of energy (primarily oil). Factors of speculative nature had only marginal influence. The fast increase in the demand for metals arises mainly from the emerging Asian markets, primarily China, which is caused by the high growth rates of the industrial output. Prices of metals are expected to decrease in a medium and long run due to the increased supply, where the investments in new production plants, given the increase in prices, are expected to be highly responsive.

Figure 2

Movement of the index of world prices of primary products and crude oil  
(average quarterly price index of US Dollar, with base 2000)



\* Spot price of the crude oil is a weighted average of the following types of oil: West Texas Intermediate, Brent and the prices of Dubai crude oil.

Source: IMF, IFS, February 2007.

In 2006, the average prices of crude oil on the world markets went up by 29.7% p.a., so that the trend of fast increase, which started in 2003, continued, however with lower intensity relative to the preceding year. One of the main factors for the increase in the oil prices was the disparity between the demand and the supply, caused by the continuous increase in the demand for oil which coincides with the dynamics of growth of the global output, accompanied with restricted production and processing capacities, and with occasional variability in the supply. The largest share in the global demand for oil is that of USA, Japan, and China. During 2006, the fastest increase in the global oil prices was registered in the first nine months of the year, so that in the beginning of August the nominal oil price reached a record high level of 76 US Dollars per barrel<sup>7</sup>. The fast increase in the oil price was under the influence of the increased demand for oil of 0.5 million barrels per day, the factors of speculative nature and the reduced supply. More precisely, factors of speculative nature were the announcements of OPEC for possible reduction in the output, the conflict between Iran and the international community regarding the nuclear capacities, and the danger of the beginning of the storm season in the Mexican Gulf. Factors which caused occasional reduction in the supply are the reduced production of oil in Iraq due to bad weather, the armed conflict between Israel and Lebanon, attacks on oil fields in Nigeria, and the closing of the production capacities of British Petroleum in Alaska. In the fourth quarter of 2006, significant decline in the average prices of oil was registered due to the relatively calmer geo-political situation, the increase in the stocks globally (especially in the countries members of the OECD), favorable weather conditions in the northern hemisphere, as well as the increased production by the producers outside of OPEC, despite the reduced supply by OPEC by 1.2 million barrels per day.

<sup>6</sup> According to the analyses presented in the IMF WEO.

<sup>7</sup> Spot price of the crude oil, which is a weighted average of the following types of oil: West Texas Intermediate, Brent and the prices of Dubai crude oil. Source: IMF WEO.

The expectations about the movement of the prices of crude oil in a short and medium run do not indicate their significant decline, having in mind the anticipations for further maintaining of the more intensive growth of the demand relative to the supply of oil.

### 1.1. Developed countries in 2006

The economic growth in the developed economies was additionally intensified in 2006 and it is expected to reach a rate of 3.1% p.a., which is an increase of 0.5 percentage points relative to 2005. Such an intensity of the economic activity caused a decline of the unemployment rate of 0.4 percentage points on annual level. On the other hand, the inflationary pressures, which implied conduct of more restrictive monetary policy, had a negative effect on the economic activities.

Table 2  
Economic indicators for the developed countries

	GDP (real rate of growth in %)			Inflation (in %)			Rate of unemployment (in %)			General government fiscal balances (% of GDP)			Current account balance of the balance of payments (% of GDP)		
	2004	2005	2006*	2004	2005	2006*	2004	2005	2006*	2004	2005	2006*	2004	2005	2006*
Developed Economies	3,2	2,6	3,1	2,0	2,3	2,6	6,3	6,0	5,6	-3,3	-2,7	-2,3	-0,8	-1,4	-1,6
Euro-zone	2,1	1,3	2,4	2,1	2,2	2,3	8,9	8,6	7,9	-2,7	-2,2	-2,0	0,9	-	-0,1
Germany	1,2	0,9	2,0	1,7	2,0	2,0	9,2	9,1	8,0	-3,7	-3,3	-2,9	3,7	4,1	4,2
France	2,0	1,2	2,4	2,3	1,9	2,0	9,6	9,5	9,0	-3,7	-2,9	-2,7	-0,3	-1,6	-1,7
Italy	1,1	-	1,5	2,3	2,3	2,4	8,1	7,7	7,6	-3,4	-4,1	-4,0	-0,9	-1,6	-1,4
Greece	4,7	3,7	3,7	3,0	3,5	3,6	10,5	9,9	9,7	-6,9	-4,5	-2,8	-6,2	-7,8	-8,1
USA	3,9	3,2	3,4	2,7	3,4	3,6	5,5	5,1	4,8	-4,6	-3,7	-3,1	-5,7	-6,4	-6,6
Japan	2,3	2,6	2,7	-	-0,6	0,3	4,7	4,4	4,1	-6,3	-5,6	-5,2	3,8	3,6	3,7

Source: IMF World Economic Outlook, September 2006.

\* Estimate

From the viewpoint of the individual economies, driving forces of the economic growth were USA and Japan with estimated growth rates of 3.4% and 2.6%, respectively. The fastest growth rate of GDP in the USA was registered in the first quarter of the year, which was reduced in the following quarters due to the higher prices of oil, increase in the interest rates, and drop in the prices on the real estate market. Such changes caused a decline in the private consumption and the investments of the business sector, especially in production equipment and computer software. The economic growth in the USA in 2006 resulted in a decline in the unemployment rate of 0.3 percentage points, and in a reduction of the budget deficit by 0.4 percentage points compared with 2005. However, despite such favorable economic developments and the small nominal depreciation of the US Dollar relative to some of the more important currencies<sup>8</sup>, the current account deficit in the USA is expected to increase additionally and to reach 6.6% of GDP.

The trend of depreciation of the US Dollar relative to the Euro continued in 2006<sup>9</sup>. Thus, the average annual nominal exchange rate Dollar/Euro equaled 1.26, which compared with the preceding year was a small depreciation of the US Dollar of 0.92%<sup>10</sup>. Main factors of depreciation of the US Dollar were the further deepening of the current account deficit in the USA, reduced asset prices in the USA (especially after the first quarter of 2006), accelerated economic activity in the countries of the Euro-zone, as well as the decline in the interest differential between the two-year government bonds in the USA and in the Euro-zone, in favor of strengthening of the exchange rate of the Euro.

The Japanese economy registered quarterly growth dynamics similar to that of the US economy. Thus, the strong increase in GDP in the first quarter of 2006, caused primarily by the

<sup>8</sup> There is a relatively small nominal depreciation of the US Dollar against the Euro and the British Pound. Source: IMF WEO.

<sup>9</sup> US Dollars per Euro.

<sup>10</sup> Source: Eurostat.

private consumption and the investments of the corporate sector in fixed assets, slowed down in the following quarters due to the decline in the stocks of the enterprises, the net-exports, and the public investments.

In 2006, the economic growth in the Euro-zone was estimated at 2.4%, which represents an increase of 1.1 percentage point, accompanied by a reduction in the unemployment rate of 0.6 percentage points relative to the preceding year, with the domestic consumption and investments being the main factor of the growth dynamics. On the other hand, inflationary pressures contributed to the 2% exceeding of the upper targeted inflation limit of the European Central Bank, with the inflation reaching 2.2%. In a medium and long run, one of the main challenges for the economy of the countries from the Euro-zone is the fiscal consolidation due to the phenomenon of aging population which causes a pressure for continuous increase of the costs for pensions and health care.

Within the countries from the Euro-zone which are the main trading partners of the Republic of Macedonia, it is estimated that Greece and Germany will accomplish the highest annual GDP growth rate in 2006 of 3.7% and 2%, respectively. Feature of the Greek economy is the fact that it has the highest unemployment rate (9.7%) and inflation significantly above the average in the Euro-zone (3.6%). Unlike Greece, the inflation in Germany is relatively lower and equals 2%, while the unemployment rate is expected to reduce by 0.7 percentage points compared with the preceding year and to equal 8%, accompanied by a relatively high surplus on the current account (4.2% of GDP).

## 1.2. Countries in transition in 2006<sup>11</sup>

Accelerated economic activity in 2006 was registered also in the countries in transition, with the real GDP growth rate being expected to reach 6.2%, which is a rise of 0.5 percentage points relative to the preceding year. Main generators of economic growth are the increase in the domestic aggregate demand, supported by the increased lending to the private sector by the banks, as well as the increase in exports, which particularly applies to the countries rich in natural resources.

Table 3  
Economic indicators for the countries in transition

	GDP			Inflation			Current account balance of the balance of payments			Foreign direct investment			General government fiscal balances		
	(real rate of growth in %)			(annual change in %)			(% of GDP)			(in millions US Dollars)			(% of GDP)		
	2004	2005*	2006**	2004	2005*	2006**	2004	2005*	2006**	2004	2005*	2006**	2004	2005*	2006**
<b>Transition Economies</b>	<b>6,7</b>	<b>5,7</b>	<b>6,2</b>	<b>6,4</b>	<b>7,0</b>	<b>6,4</b>	<b>-5,3</b>	<b>-3,8</b>	<b>-3,6</b>	<b>48.390</b>	<b>53.829</b>	<b>50.307</b>	<b>-1,2</b>	<b>-0,5</b>	<b>-1,2</b>
<i>Central and Eastern Europe</i>	5,2	4,7	5,3	4,3	3,3	3,6	-7,2	-6,3	-6,5	23.147	27.509	22.071	-2,2	-1,7	-2,8
<i>South-Eastern Europe</i>	6,9	4,7	5,9	4,9	5,7	5	-9,0	-8,9	-8,6	12.023	13.011	19.345	-1,7	-0,7	-0,7
Albania	6,7	5,5	5	2,9	2,3	2,3	-4,7	-6,6	-7,5	332	265	350	-5,1	-3,6	-4,1
Bosnia and Herzegovina***	6,0	5,8	5	0,3	1,9	6	-17,3	-17,3	-15,7	490	300	570	-1,9	0,7	-0,6
Bulgaria	5,7	5,5	6	6,1	5,0	3	-5,8	-11,8	-13,7	2.777	2.298	3.000	1,9	3,1	3
Macedonia****	4,1	3,8	3,2	-0,4	0,5	3,1	-7,7	-1,3	-0,4	156	97,1	327	0,7	0,3	-0,6
Romania	8,4	4,1	6,5	11,9	9,5	6,5	-8,4	-8,8	-10,1	6.368	6.587	8.652	-1,4	-0,8	-2,5
Serbia	9,3	6,3	6,5	9,5	17,2	13	-14,8	-10,0	-8,8	966	1.481	3.500	0,0	0,9	2,7
Croatia	3,8	4,3	4,6	2,1	3,3	3,5	-5,2	-6,6	-6,8	871	1.509	2.825	-4,9	-4,1	-3,0
Montenegro	3,7	4,1	5,5	2,2	2,6	3,5	-7,8	-8,6	-5	63	474	149	-2,6	-1,7	-0,3
<i>Commonwealth of Independent States</i>	8,0	6,6	6,9	8,5	9,9	8,8	-1,9	0,8	1,3	13.219	13.309	8.890	-0,2	0,4	-0,6

Source: EBRD Transition Report 2006

\* Estimate, except for the Republic of Macedonia

\*\* Projection

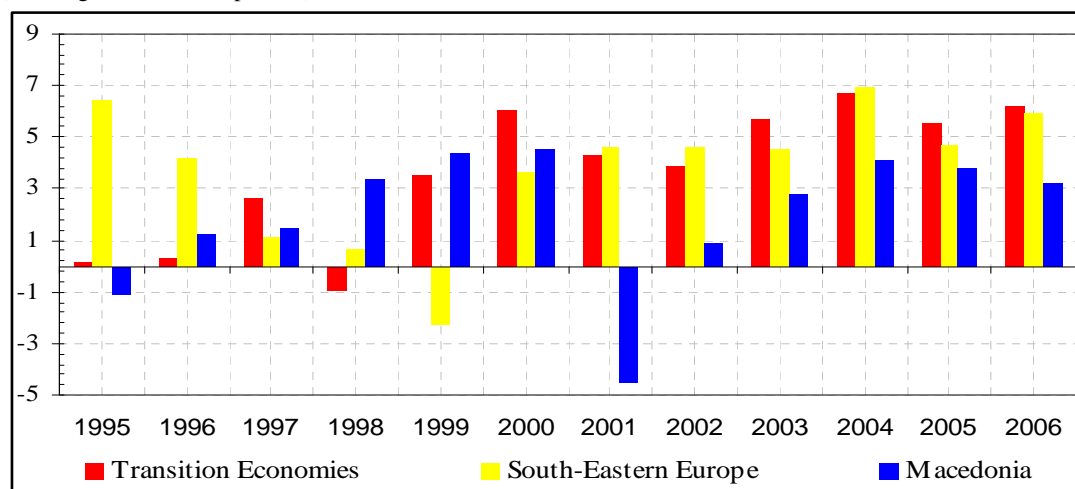
\*\*\* The data for inflation is taken from the IMF World Economic Outlook, September 2006.

\*\*\*\* The data for the Republic of Macedonia are taken from the official institutions.

Among the transition economies, the highest GDP growth rate of 6.9% was accomplished by the countries of the Commonwealth of Independent States (CIS), caused primarily by the increased foreign exchange inflow on the basis of export of natural resources (oil, gas, and metals) as a result of the increase in their prices on the world stock exchanges. Additional factors which stimulated the growth were the increase in private consumption, investments in fixed assets, and the increased inflow of private transfers from abroad. The group of countries of Central Eastern Europe and the Baltic States (CEB) registered real GDP growth rate of 5.3%, which is significantly above the average of the countries in the Euro-zone, caused mainly by the increase in the domestic demand, by the credit expansion of the banking sector, but also by the increased export to the EU markets. The countries of South-eastern Europe (SEE) accomplished a relatively higher growth rate of 5.9%, which compared with the preceding year is an increment of 1.2 percentage points and at the same time contributes to the acceleration of the process of real convergence to the EU countries. The accelerated economic activity is mainly a result of the following factors: a) restarting and growth of the industrial output, supported by the increase in foreign direct investments (FDI), especially in the metal processing capacities; b) increase in the domestic demand and credit expansion of banks and c) increase in the export to the EU markets. Among the individual countries of the SEE, Bulgaria and Romania accomplished the highest rates of economic growth, which partially reflects the reform processes and structural changes immediately before receiving EU membership, while in the group of countries of the Western Balkans, Serbia accomplished the highest growth rate, primarily caused by the inflow of FDI in tobacco and metal processing capacities.

<sup>11</sup> Pertains to the countries of Central Eastern Europe and the Baltic States (CEB), South-eastern Europe (SEE) and the Commonwealth of Independent States (CIS).

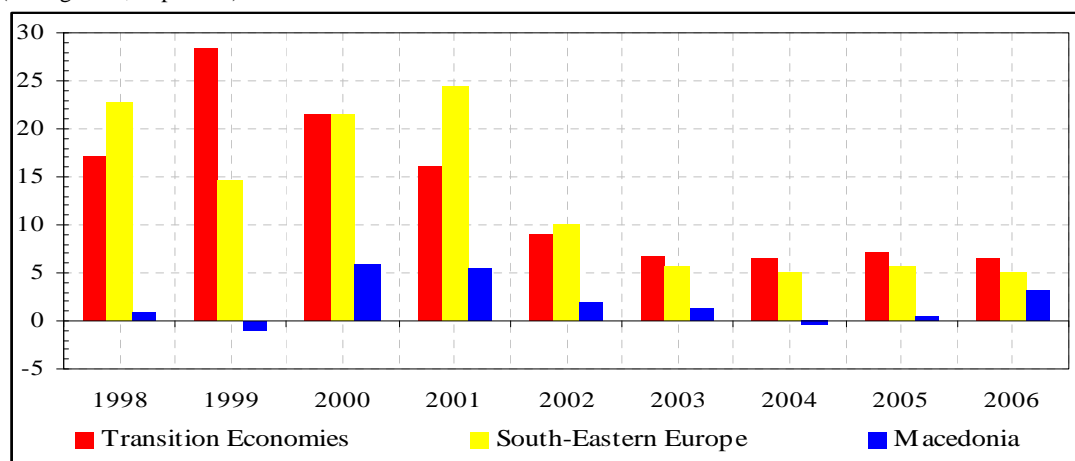
Figure 3  
Gross domestic product  
(annual growth rates, in percent)



Source: EBRD Transition Report, September 2006.

In 2006, inflation in the SEE countries was reduced to a relatively low level of 5%, which is at the same time a decline of 0.7 percentage points relative to 2005. Lowest rate of inflation was registered in Albania, i.e. it maintained the same level from the previous year (2.3%), while the highest inflation rate of 13% was registered in Serbia, which reflects the increase in wages, the credit expansion of banks and the monopolistic power of individual companies which still maintain the prices on a higher level relative to the foreign markets.

Figure 4  
Inflation  
(average rate, in percent)

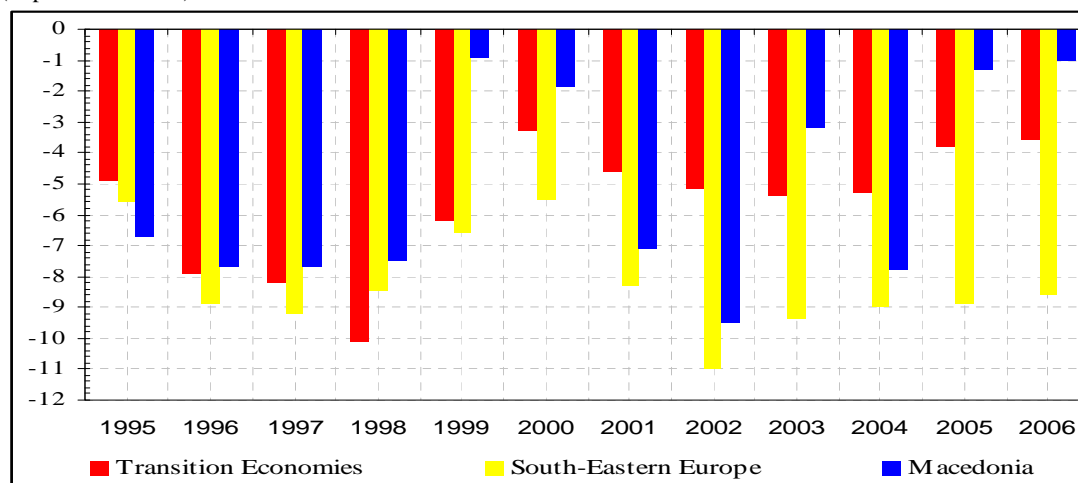


Source: EBRD Transition Report, September 2006.

The high current account deficit, which was common for the countries in transition in the last few years, in 2006 registered a slight decline. Thus the SEE countries are expected to register a decline of 0.2 percentage points relative to the preceding year. Observed from a viewpoint of the individual economies of SEE, the highest deficit of 15.7% of GDP was registered in Bosnia and Herzegovina, which is a result of the high import demand. On the other hand, Republic of Macedonia, which in 2005 registered the lowest current account deficit among the SEE countries, in 2006 faced a current account deficit of only 0.4% of GDP, mainly as a result of the increased inflow of private transfers, of the improved balance of services, and of the unrealized foreign exchange outflows related to capital investments (unrealized payment of dividend to foreign investors).



Figure 5  
Balance on the current account of the balance of payments  
(in percent of GDP)



Source: EBRD Transition Report, September 2006.

From the viewpoint of the foreign direct investments, which at the same time are one of the main sources of financing the high current account deficits in the countries in transition, in 2006 a reduced inflow was registered compared with the preceding year. Most significant decline in the inflow of FDI was registered in the CEE countries, as a result of the redirection of the capital of the foreign investors to the developed countries (USA, Japan, and countries of the Euro-zone), due to the increase in their interest rates. Still, on net-basis, this group of countries registered an increased inflow of capital in the form of portfolio and other types of investments which are generally bearing higher risk due to the possibility for sudden withdrawal of capital by the foreign investors. On the other hand, during 2006 the SEE countries registered an increased inflow of FDI which are expected to reach record level of US Dollar 19 billion. Such a trend of an inflow of FDI reflects the positive signals of the SEE countries directed to the foreign investors regarding their macroeconomic stability, reform processes, determination for Euro-integration, and improvement of the credit rating of some of them. Thus, the highest inflow of FDI was registered in Romania and in Bulgaria, which was in line with the preparation for EU membership, while in the group of countries of the Western Balkans the highest amount of FDI was registered in Serbia on the basis of the privatization of part of the industrial capacities.

Table 4  
Transition indicators for 2006

	Enterprises			Markets and trade			Financial institutions		Infrastructure
	Large-scale privatisation	Small-scale privatisation	Corporate & enterprise restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banks' reforms and liberalisation of the interest rates	Markets of Securities & and non-banking financial institutions	Infrastructural reforms
Albania	3	4	2+	4+	4+	2	3-	2-	2
Bosnia and Herzegovina	3-	3	2	4	4-	2-	3-	2-	2+
Macedonia	3+	4	3-	4+	4+	2	3-	2+	2
Serbia	3-	4-	2+	4	3+	2-	3-	2	2
Croatia	3+	4+	3	4	4+	2+	4	3	3
Montenegro	3+	3	2	4	3+	1	3-	2-	2-

Source: EBRD Transition Report 2006

In 2006, the countries in transition continued the process of structural and institutional reforms. The largest progress was made in the countries of SEE and CIS, while reforms with a relatively smaller intensity were made in the countries of CEB, having in mind that the initial stage

of reforms<sup>12</sup> in this group of countries has already finished, unlike the other transition economies. Among the SEE countries, most significant reform was made in the area of financial institutions, i.e. reforms were made in the banking sector, securities markets and in the non-banking financial institutions. Additional reforms were made in the area of policy of competition by reducing the barriers for entering and exiting the market, and in the corporate management and restructuring of enterprises. Among the countries of the Western Balkans, largest reforms were made in the Republic of Macedonia, pertaining mainly to the corporate management and restructuring of enterprises by adopting the new Law on Bankruptcy and by the significant simplification of the procedures for establishment and registration of a company. Additional reforms were made in the development of the securities market and the non-banking financial institutions by adopting and implementing the reforms in the payment system. Other reforms pertain to the changes in the area of infrastructure, encompassing the privatization of the energy and electricity supply sector (ESM), and in the water supply and the treatment of waste waters.

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<sup>12</sup> The initial stage of reforms pertains to liberalization, stabilization and privatization of small and medium enterprises, while the second, advanced stage pertains to improvement of the competition, restructuring of enterprises, development of financial institutions and infrastructural reforms.

## II. Economic developments in the Republic of Macedonia

### 2.1. Gross domestic product<sup>13</sup>

The initial estimations for the GDP indicate real growth of the Macedonian economy in 2006<sup>14</sup> of 3.1%, despite the initially projected economic growth of 4%. Although the GDP growth in 2006 indicates slower economic dynamics relative to the preceding two years, the accomplishment of positive growth rates is a signal of an economy which has a capacity to maintain the growth pace and to accelerate it further. Positive expectations for the future economic activity of the manufacturing as the dominant sector, and the banking industry as the most dynamic sector in the Macedonian economy, support such perceptions<sup>15</sup>. Such expectations, supported by the increasing competition in the banking sector created preconditions for further improvement of the access of the corporate sector and of households to bank credits as a significant source of financing the current and future economic growth. In 2006, external factors had divergent effects. Thus, the increase in the oil price on the world stock exchanges was an adverse shock while the favorable conditions on the metals market in 2006 had a positive effect on the domestic exporters which have a significant share in creating the value added in the Macedonian economy. At the same time, the indicators of the domestic demand indicate growth, so that in 2006, GDP in the Macedonian economy was created by a combined effect of both the domestic and external demand. Despite the positive developments in the economy supporting the acceleration of the economic growth, it is important to note the disadvantages the overcoming of which would contribute to faster convergence to the more dynamic and more developed economies. The low level of FDI, which is below the average for the SEE countries, the infrastructural problems and the insufficient institutional capacity are considered the main restrictive factors for a faster economic growth.<sup>16</sup>

The achieved real GDP growth rate in 2006, with faster increase being registered in the second half of the year, is a result of the accelerated activity in all sectors, except construction, where a decline in the activity was registered (of 0.4%), and stagnation in the sector "hotels and restaurants". Driving forces of the increase in GDP (with a contribution of 58.1%) were the *services sectors* in the economy, i.e. the sectors "trade" (increment of 5.5%, which caused 23.5% of the GDP growth); "transport, storage and communication" (increase of 7.5% or 19.1% of the GDP growth); "financial intermediation" (increase of 1.5% and contribution of 6.3%) and the sector incorporating public administration and defense, social security, education and health (increase of 2%, and contribution of 9.2%).

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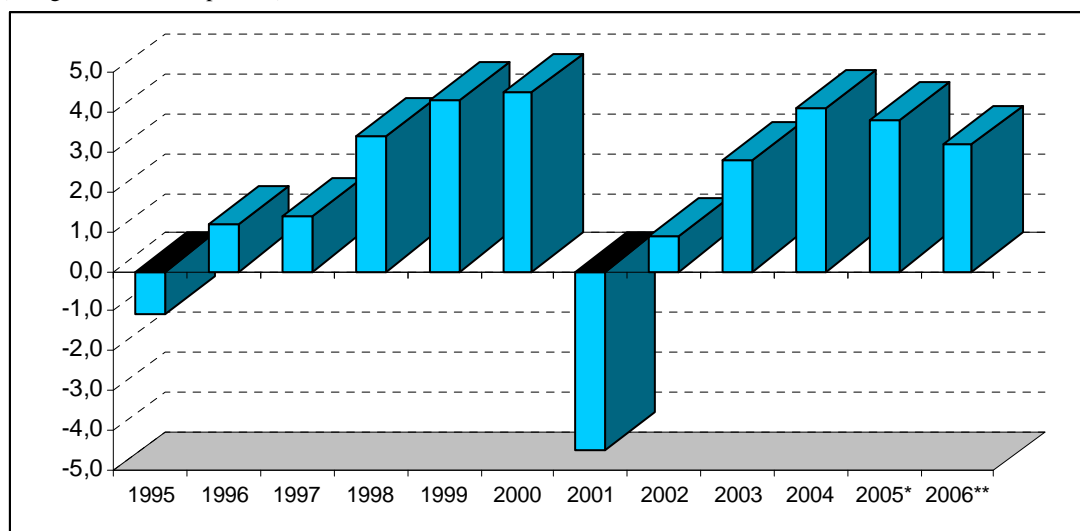
<sup>13</sup>Source: State Statistical Office of the Republic of Macedonia. Quarterly calculations of GDP are expressed at constant prices, in denars from 1997. The structure is in line with the National Classification of Activities (NCA).

<sup>14</sup> Estimated data of the State Statistical Office.

<sup>15</sup> Survey on Business Tendencies in Manufacturing (SSO) and Credit Activity Survey (NBRM).

<sup>16</sup> According to the EBRD Transition report 2006.

Figure 6  
Gross domestic product of the Republic of Macedonia  
(real growth rates, in percent)



\* Preliminary data

\*\* Estimated data

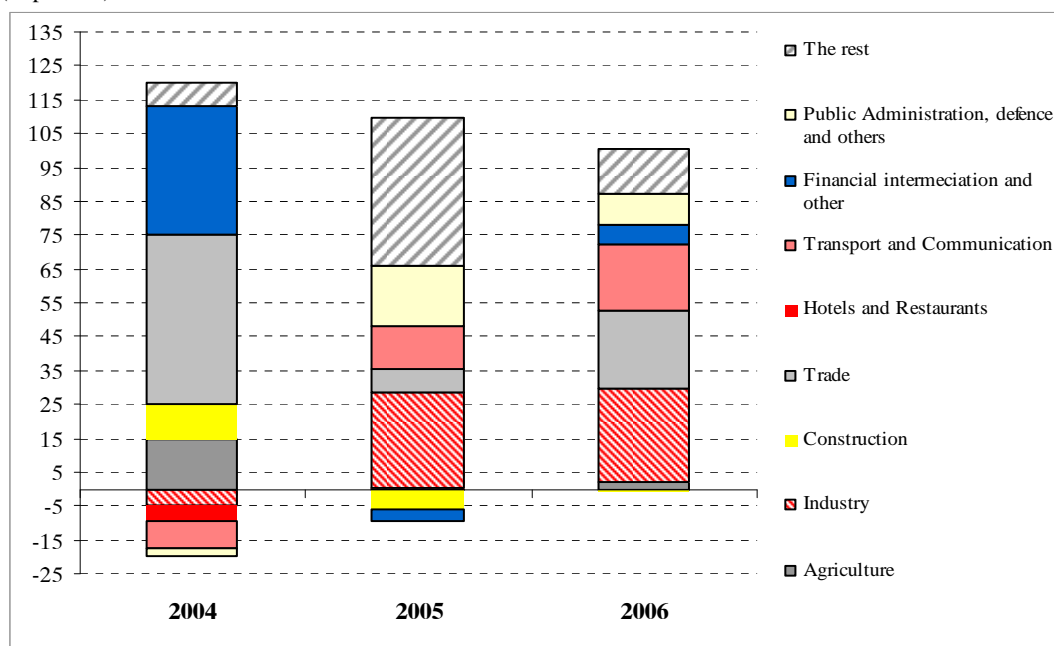
Source: State Statistical Office

From the viewpoint of the contribution to the GDP growth, if a comparison is made with the previous year, more significant positive developments were registered in the domestic trade and in the sector "transport, storage and communication". Here, one should have in mind that telecommunications comprise the larger portion of the value added in the sector "**transport, storage and communication**" (around 62% in the period 2001-2004, on average), which points to the fact that the growth in this sector was a result mainly of the increased utilization of the telecommunication services in the country (PSTN, mobile telephone network, internet, etc.), in conditions of their increased accessibility. The prices of telephone and telefax services in 2006 dropped by 4.8% relative to the preceding year<sup>17</sup>. Such developments were a result of the acceleration of the process of liberalization in this sector, which led to increased competition and decline in the prices of telecommunication services.

The sector **domestic trade** encompasses wholesale and retail trade, repair of motor vehicles, motorcycles, and personal and household goods. In 2006, the realized turnover in the retail trade registered high increase of 9.5%, as opposed to the reduced turnover in wholesales by 2%. Accordingly, the total trade turnover realized in the wholesale and retail trade went up by 2.5%. Of the total retail trade realized in 2006, 38% pertain to the trade in non-specialized stores (primarily trading in food, beverages, tobacco), 25% pertain to the sale of motor fuels, while 14.4% account for the trade in products in specialized stores (textile, clothing, footwear, furniture, household appliances, books and newspapers, etc.). Here, 90% of the retail trade turnover was realized in cash, while only 1.8% was on credit. These indicators point to a high share of cash in trade.

<sup>17</sup> Source: SSO-Consumer Price Index according to COICOP, December 2006.

Figure 7  
Contribution of individual components to the GDP growth  
(in percent)



Source: State Statistical Office \* Preliminary data

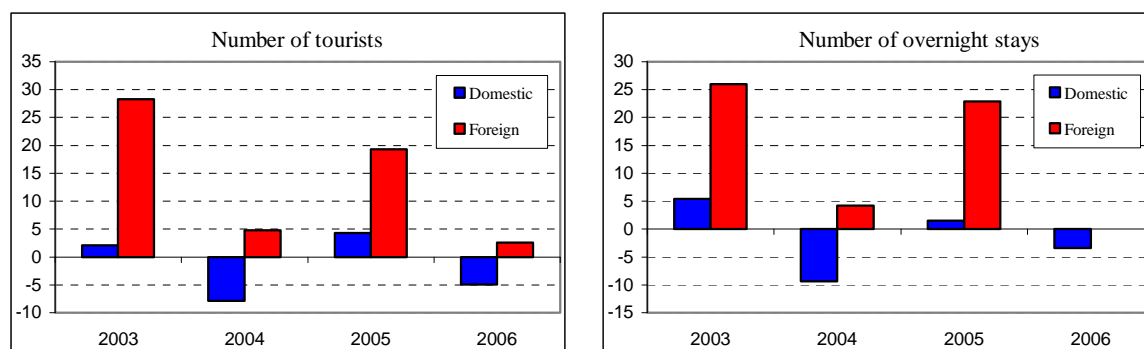
The lowest growth rate was registered in the sector *agriculture*, which had a marginal contribution to the total GDP growth of 1.8%. In the past two years, agriculture has been registering insignificant growth rates, which reduced the share of this sector in the growth of the Macedonian economy for this period. According to the estimations for the volume of the agricultural production in 2006, increase is registered in the production of fruit (3.7%) and livestock (1.5%), while the production of cereals and industrial crops and the production of grapes dropped relative to the preceding year (by 1.7% and 2.7%, respectively). If the export performances of this sector are observed, in 2006 the value of the export of fruit went up by 45%, of vegetables by 9%, of tobacco by 8.2%, and the export of seeds and other industrial crops increased by 34%. On the other hand, the value of the exported cereals is lower by 21% and that of cotton by 1.5%.

Reduced activity in *construction* follows the trend registered in the previous year, when the construction activity declined by 4.2%. Although the value of contracted construction works in 2006 was higher by 5.7% compared with the preceding year, completed construction works, hence the effective hours, registered sharp fall (12.3%). According to the reports of the construction companies, the number of employees in construction dropped by 6%, with a simultaneous nominal increase in net wages of 1.3% being registered<sup>18</sup>. Such developments could be partially explained with the insufficient statistical coverage of this activity. The main restrictive factors for improving the current construction activity also in 2006 are the insufficient demand, increased costs for materials and interests<sup>19</sup>, with an increasingly higher shortage of skilled workers (according to the Survey on Business Tendencies in Construction).

Figure 8  
Indicators for tourism in RM  
(rates of change, in percent)

<sup>18</sup>However, certain indicators give a different picture of the developments in this sector. Thus, according to the Labor Force Survey, this activity registers increase in employment of 22%, and the data on the industrial output indicate an increase in the production of construction materials in 2006 of 11.1%.

<sup>19</sup>Such an assessment could be a result of the increased indebtedness of the companies, and hence the increased expenditures for interests.



Source: State Statistical Office

In 2006, *tourism and catering* maintained the same level from the previous year. Regarding tourism, in 2006 the Republic of Macedonia was visited by 2.6% more foreign tourists, which spent the same number of nights as in 2005. The number of domestic tourists dropped by 4.9%, while the number of nights they spent was reduced by 3.4%. However, one should have in mind the relatively high comparison basis, as in 2005 the number of tourists and nights spent (especially of foreign tourists) registered a significant increase.

Table 5  
Gross domestic product - production side

	2006				2006 / 2005		2005	2006
	QI. 2006 / QI. 2005	QII. 2006 / QII. 2005	QIII. 2006 / QIII. 2005	QIV. 2006 / QIV. 2005	(growth rates, in %)	(contribution to growth, in %)	(share in total GDP, in %)	
	(growth rates, in %)							
<b>Gross domestic product</b>	2,2	3,4	4,0	2,6	3,1			
<b>Agriculture</b>	0,9	0,8	0,5	0,3	0,6	1,8	9,3	9,1
<i>Agriculture, hunting and forestry</i>								
<i>Fishing</i>								
<b>Industry</b>	-0,9	4,9	8,3	1,5	3,6	27,6	23,5	23,6
<i>Mining and quarrying</i>								
<i>Manufacturing</i>								
<i>Electricity, gas and water supply</i>								
<b>Construction</b>	-2,4	1,4	1,8	-3,2	-0,4	-0,7	5,4	5,2
<b>Wholesale and retail trade; repair of motor vehicles, motorcycles and of personal and household goods</b>	6,9	4,7	4,8	5,8	5,5	23,5	12,7	13,0
<b>Hotels and restaurants</b>	1,0	-1,6	-0,8	1,4	0,0	0,0	1,6	1,6
<b>Transport and communication</b>	8,4	7,2	5,1	9,4	7,5	19,1	7,5	7,8
<b>Financial intermediation; real estate; rental and business activities</b>	1,4	1,7	2,0	1,0	1,5	6,3	12,7	12,5
<b>Public administration and defense; compulsory social security; education; health and social work</b>	1,1	2,4	2,3	2,3	2,0	9,2	14,0	13,9

Source: State Statistical Office and calculations of the NBRM

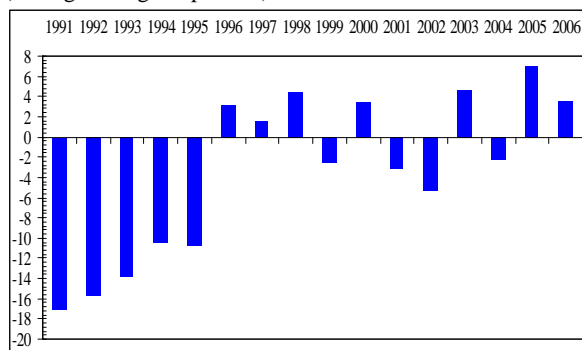
**Industry.** Industry, as the dominant sector contributes with 27.6% to the total GDP growth. Despite the relatively high share of industry in the GDP (24%), services sectors are the main generators of the growth of the economy in 2006, which partially indicates diversification of the sources of growth.

The high growth rate of the industrial output of 7% in 2005 was followed by a moderate growth of 3.6% in 2006. Although the accomplished growth rate was a continuation of the positive trend in industry after the unfavorable movements in 2004, it is significantly lower compared with the projected expected growth of the industrial activity in 2006 of around 5%.

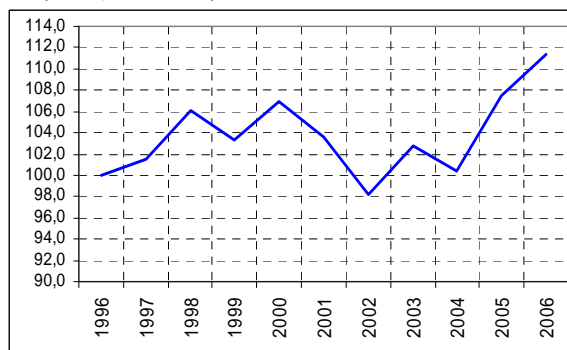
Figure 9

# Industrial output

(average change in percent)



(index, 1996=100)



Source: State Statistical Office and calculations of the NBRM

*Manufacturing sector* had the largest contribution to the rise in the industrial output in 2006, which is primarily a result of its dominant share, having in mind the moderate activity growth rate. The manufacturing industry produces 84% of the production of the total industry, and in 2006 it registered an average increase of 3.6%, reflecting the increased output in fourteen of twenty manufacturing branches, with a share of around 89% in the total manufacturing industry. Among them, production of basic metals, clothing, products of other non-metal minerals, oil derivatives, and fabricated metal products, had the largest contribution to the increase.

Driving force behind the growth of the industrial output in 2006 was the production of *basic metals*, primarily crude iron, steel and ferro nickel. This activity registered a growth rate of 8.8%, with the production being more intensive in the second half of the year. Having in mind that the largest portion of the production of this activity was intended for the foreign market, the value of the export of iron and steel and products thereof in 2006 went up by 27%.

Almost identical was the contribution of the production of *clothing* to the industrial growth in 2006, which is the third most significant manufacturing activity. This is a highly labor intensive activity, which in 2006 employed one-third of the total number of employees in the manufacturing industry<sup>20</sup>, with the lowest average monthly net wage of Denar 5,341. Here, one may assume that a larger portion of the realized production was placed on the domestic market, in circumstances of weaker export performances of the textile activity. The value of the export of clothing and textile in 2006 was lower by 0.7% compared to 2005.

The production of *products of other non-metal minerals* (glass, ceramics, bricks, tiles, cement, gypsum, concrete and similar products) is one of the main generators of the growth of the total industrial activity in 2006, with a high contribution arising also from the high growth rate of 11.1% and from the relatively significant share of 7.3%. Most significant is the contribution of fireproof ceramic products, ceramic tiles (starting of a new production capacity in October 2005), bricks and tiles for construction, cement and gypsum. The increased production of this activity favorably reflects in the balance of payments. The export of ceramic products in 2006 increased by 63% in value, while the export of construction materials went up by 26.3%.

In 2006, the production of *food products and beverages*, as an activity with the largest share in the total industry, registered a slight increase relative to 2005 (by only 0.5%). Specific feature for 2006 in this industry is the reduced production of wine, due to the lower purchase of grapes by the wine producers in 2006 and the higher export of grapes (the export of fruit in 2006 increased by 44.8% in value relative to 2005), which had a significant adverse effect on the production of beverages.

<sup>20</sup> According to the Labor Force Survey.

Table 6  
Industrial output

	structure	2006/2005	
		growth rates	contribution to growth
	in %		in p.p.
<b>Total</b>	<b>100,0</b>	<b>3,6</b>	<b>3,6</b>
<b><i>Mining and quarrying</i></b>	<b>3,9</b>	<b>11,5</b>	<b>0,4</b>
Mining of coal and lignite; extraction of peat	1,6	-3,3	-0,1
Mining of metal ores	0,7	18,4	0,1
Other mining and quarrying	1,5	23,8	0,4
<b><i>Manufacturing</i></b>	<b>83,9</b>	<b>3,6</b>	<b>3,0</b>
Food products and beverages	16,1	0,5	0,1
Tobacco products	5,7	2,0	0,1
Wearing apparel; dressing and dyeing of fur	11,1	8,6	1,0
Publishing, printing and reproduction of recorded media	3,1	8,4	0,3
Refined petroleum products	4,5	12,2	0,5
Chemicals and chemical products	4,6	0,6	0,0
Other non-metallic mineral products	7,3	11,1	0,8
Basic metals	11,2	8,8	1,0
Fabricated metal products, except machinery and equipment	3,3	15,7	0,5
Furniture; manufacturing n.e.c.	2,0	-34,1	-0,7
<b><i>Electricity, gas and water supply</i></b>	<b>12,2</b>	<b>0,8</b>	<b>0,1</b>

Source: State Statistical Office and calculations of the NBRM

*Mining sector*, which registered high average annual growth of 11.5%, contributed with 0.4 p.p. to the total growth of the industrial output due to the low share of this sector in the total industrial output. The growth in this sector was mostly a result of the increased production in the sector "mining and quarrying". The opening of a mine in May 2005, contributed to a high growth rate in the activity "mining of metal ores" in 2006 (18.4%), due to the low comparison basis, but the contribution of this activity is minor due to the small share. The activity of the mining capacities reflected favorably on the value of the exports in 2006: the export of ores, slag and ash went up by 2.3 times, the export of copper by 3.3 times, that of zinc by 2.6 times and the export of steel by 3.8 times.

*Energy sector*, which pertains to the production and distribution of electricity registered an increase of 0.8% in 2006, which is its minimum contribution (0.1 percentage point) to the total industrial growth. Typically, the activity in this sector is related to the activities in the other sectors, i.e. the increase in the production in the economy implies increased consumption of electricity and its greater production. This was not the case in 2006, when in circumstances of an increased economic activity in the other sectors (although it is a moderate increase), the production of electricity registered insignificant performances. Having in mind the fact that the largest consumers of energy are in the metal processing activity, where in 2006 an increase in the production and in the exports was registered, the increased needs for electricity in 2006 were satisfied by imports (imported quantities of electricity in 2006 were higher relative to 2005). The production of electricity in 2006 was under the influence also of the relatively warm winter, which caused smaller



consumption of electricity for heating towards the end of the year (which could partially be a result of the higher price of electricity since September 2006).

The parliamentary elections which were held in the Republic of Macedonia in 2006 reflected positively on the "publishing and printing activity". In election years, the production in this activity usually increases. Accordingly, production quantities of this activity in 2006 were higher by 8.4% (share of 3.1%).

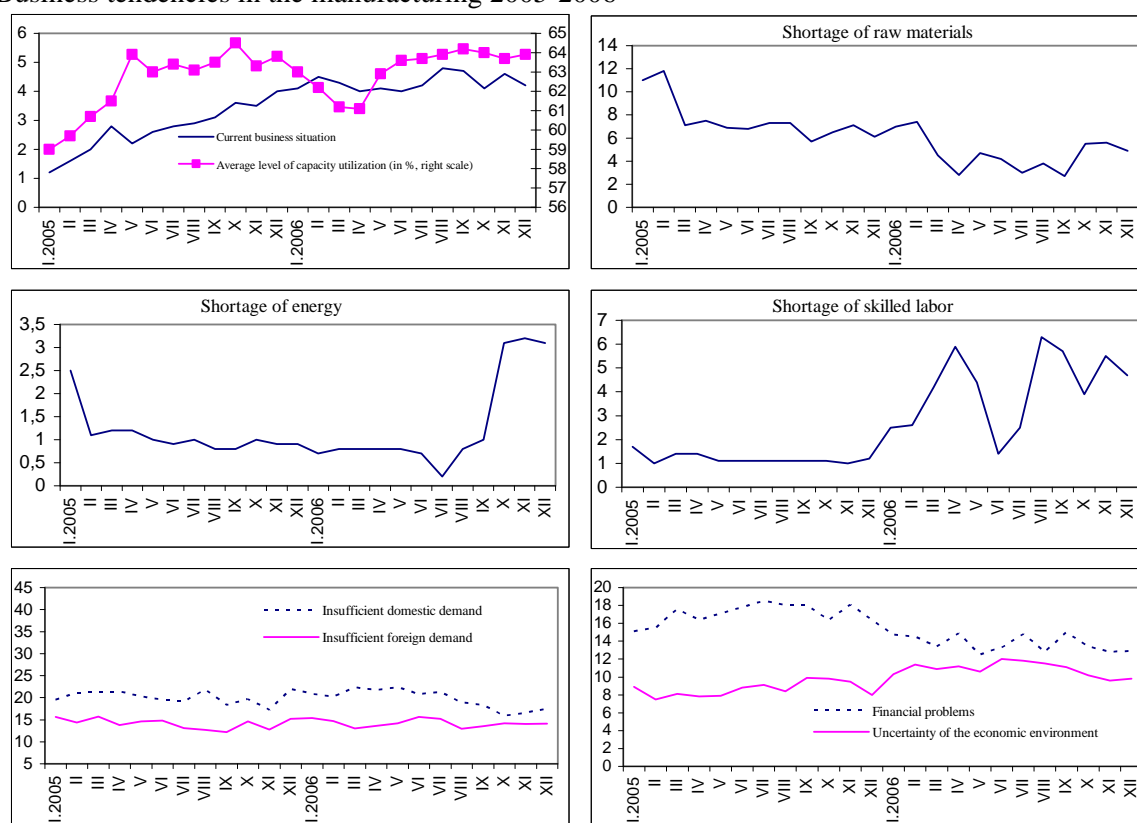
In 2006, decline in the output was registered in seven out of twenty-four industrial branches, which account for 11% of the total industrial output. The sharp decline in the activity encompassing production of furniture and other products (of 34%) had a more significant adverse effect.

Producers assessed the current economic condition in 2006 as significantly more favorable relative to 2005. The average utilization of the enterprises' capacities in 2006 reached 63.1% of the regular utilization, and it registered a slight increase compared with 2005 (62.4% of the regular utilization). The insufficient domestic demand continues to be the main restrictive factor for the increase in the volume of production, however not as significant as in 2005. The significance of the financial problems of the production enterprises as a restrictive factor significantly declined in 2006, although compared with the other factors they are still perceived as one of the more significant aspects. The lack of raw materials is almost twice less perceived as a restrictive factor compared with 2005. On the other hand, in 2006 the perception of a lack of qualified labor force, the lack of energy and the uncertain economic environment as restrictive factors, grew significantly.<sup>21</sup>

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<sup>21</sup> According to the Survey on Business Tendencies in Manufacturing, the Survey has been conducted by the SSO since April 2001 on a monthly basis, in order to obtain data on the current and expected developments in the enterprises.

Figure 10  
Business tendencies in the manufacturing 2005-2006



Source: State Statistical Office - Survey on Business Tendencies. Current economic condition is presented in the form of balances. Balance is the difference between the weighted positive and negative responses expressed in percent and shows the movement of the observed economic indicator, rather than its actual value.

The scale in the restrictive factors is a percentage of share of the weighted responses for each individual factor in the total number of weighted responses for all factors.

Available data on *expenditure components of GDP*<sup>22</sup> indicate nominal annual increase in all categories in 2006. *Public consumption* went up by 6.4%, having in mind the increased pre-election spending in the second quarter of the year (in July 2006 parliamentary elections were held in the Republic of Macedonia). In conditions of annual increase in the net wages (of 7.3%), in retail trade (of 9.5%), in lending to households (of 38.7% p.a.), in the import of consumption goods (of 11.9%) and in the income from value added tax (of 0.5%), it is estimated that in 2006 *individual consumption* also registered an increase. Increased individual and public consumption indicate an increase also in the *final consumption* in 2006. The category *investments in machines and equipment* registered a significant nominal increase of 18%. This category explains only one third of the *gross investments* in the country, the estimation of which requires certain indicative data. Thus, on the basis of the high growth rate of the investments in machines and equipment and the increased volume of corporate lending (by 19%), higher import of capital goods (by 19%) and the increased domestic production of capital products (by 9.2%) it is estimated that investment activity accelerated in 2006. Only the fall in the completed construction works (of 10%) contains the precision of the estimations, as the net change in gross investments is contingent upon the level of neutralization of the divergent movements in the abovementioned categories, which can not be determined precisely. However, having in mind that the larger part of the indicative data on the investment activity point to its increase, it is estimated that in 2006 an increase also in gross

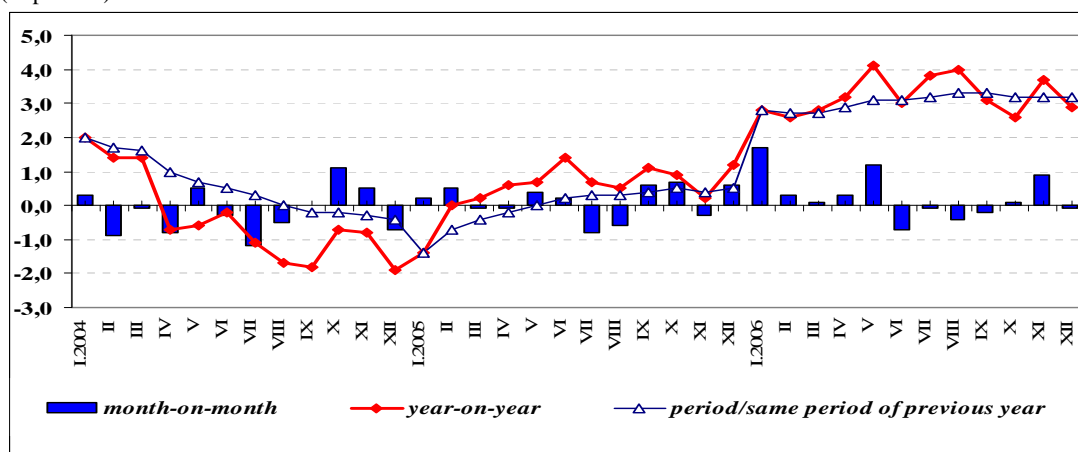
<sup>22</sup> In the announcements released by the State Statistical Office on the quarterly changes of GDP, on the expenditure side only public consumption, investments in machines and equipment, import and export of goods and services (all at current prices) are calculated. The State Statistical Office works on the development of a methodology for calculation also of the personal consumption, investments in construction buildings and changes in stocks. The information on individual (personal) consumption and gross investments are of high quality and the estimations are made in the NBRM. The analyses made in this context are based on estimations of available data on other categories of indicative importance and should be considered with precaution.

investments was registered. Higher domestic consumption in conditions of insufficient coverage with domestic production is satisfied from imports. *Net import of goods and services* was registered also in 2006, and it was by 14.3% higher relative to the net imports in 2005, despite the faster increase in the *export of goods and services* (by 18.1%) relative to the increase in the *imports* (of 17%). Having in mind such movements which indicate increase in the consumption in 2006, it is possible that the GDP estimated from the production side to be underestimated. At the same time, in line with such a dynamics of the indicators for the expenditure aggregates, in the forthcoming period it may be expected that the demand would create pressures on the domestic prices.

## 2.2. Prices<sup>23</sup>

In 2006, inflation<sup>24</sup> in the Republic of Macedonia reached 3.2%, which is a significant increase relative to the previous year when the average inflation rate equaled 0.5%. In circumstances of a prudent macroeconomic management, acceleration of the inflation is to a large extent result of supply side factors. The correction of the official inflation by the effect of these factors, indicates a significantly lower inflation and points to maintaining of the price stability as an ultimate monetary objective. The policy of stable exchange rate significantly contributes to maintaining low and stable inflation and creating stable inflationary expectations.

Figure 11  
Inflation in the Republic of Macedonia  
(in percent)



Source: State Statistical Office

Increase in the prices was registered in all main categories within the structure of the inflation index. The largest portion, or 39% of the realized inflation rate arises from the increase in the price of tobacco, caused by the higher excise on cigarettes (increase of 10% in January 2006 due to the harmonization with the EU Directives) and from the introduction of the additional duties in accordance with the amendments to the Law on Health Care<sup>25</sup> and the provisions of the Law on the Environment<sup>26</sup> (since January 1, 2006) and in accordance with the Law on Tobacco<sup>27</sup> (since April 1, 2006).

Higher prices of the food products explain 26% of the total inflation under the influence of the increase in the prices of raw vegetables (reduced supply on the domestic market due to the unfavorable weather conditions and increased export of early-maturing garden plants), of fresh and processed meat and of the import prices of sugar.

<sup>23</sup> Source: State Statistical Office and calculations of the NBRM.

<sup>24</sup> Since 2000, the inflation in the Republic of Macedonia has been measured through the consumer price index.

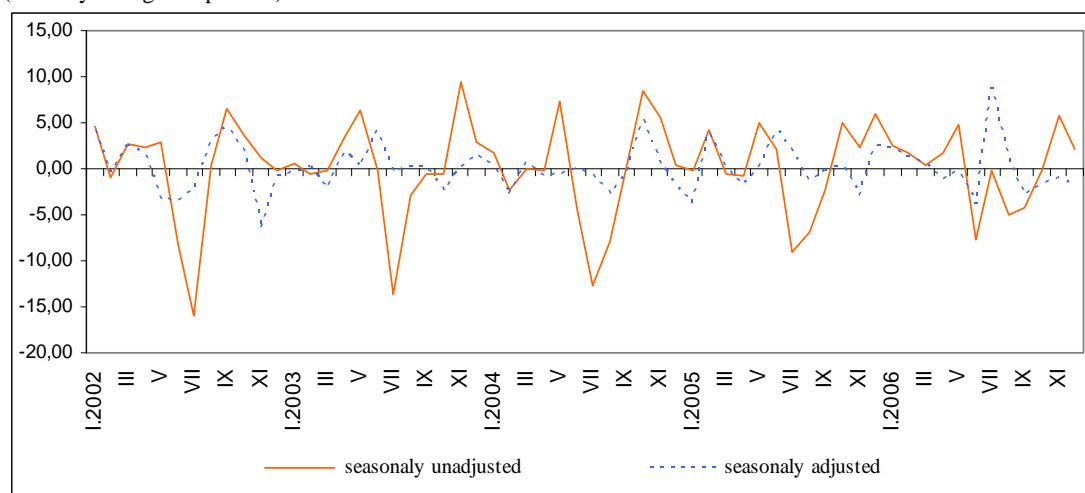
<sup>25</sup> Official Gazette of RM No. 111/2005.

<sup>26</sup> Official Gazette of RM No. 75/2005.

<sup>27</sup> Official Gazette of RM No. 24/2006.

Figure 12

Prices of agricultural products with and without seasonal component  
(monthly changes in percent)



Source: State Statistical Office. Deseasoning was made in the NBRM.

Increased prices of oil derivatives, caused by the higher prices of crude oil on the international stock exchanges (by 20% in 2006<sup>28</sup>) and the harmonization of the domestic market, had an additional contribution of 8%. The increased prices of the education means had an identical contribution, which is partially an effect transferred from the previous year (the prices of certain products and services for education went up in the second half of 2005), with an additional increment in the prices of books in September 2006.

In 2006, prices of the energy for heating<sup>29</sup> and prices of electricity picked up (by 9% in September). However, they did not have a significant inflationary influence, causing only 1.5% and 5.8%, respectively of the total inflation in 2006, which was mostly a result of the relatively small share of these expenditures in the total expenditures of households.

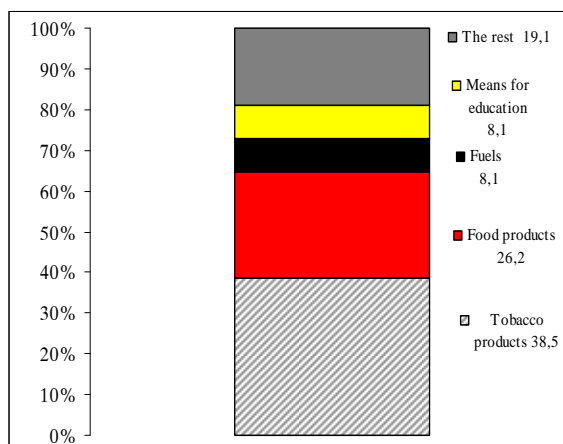
Here, 93% of the average inflation was caused by the increase in the prices of personal consumption goods, while the more moderate increase in the services caused the remaining portion of the inflation.

<sup>28</sup> For oil of the type brent, according to EIA.

<sup>29</sup> On January 23, the Energy Regulatory Commission (ERC) adopted a Decision on increasing the price of energy for heating which became effective on February 1, 2006 (Official Gazette of RM No.9/2006). The Decision of ERC on increasing the price of delivered energy for heating from the heating plant "Skopje-Sever" from 15.10.2006 was effective for only two months (October and November), i.e. it was annulled, and on 15.11.2006 the price was restored to the level before it was increased.

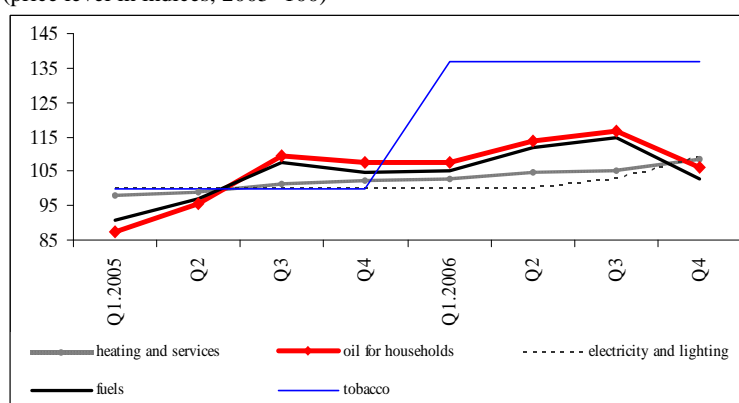
Table 7  
Inflation index components in 2006

	Average inflation (in %)	Contribution to total inflation (in %)
<b>CPI (total)</b>	<b>3,2</b>	<b>100</b>
Food	2,2	26,2
Tobacco and beverages	17,8	38,1
Tobacco	36,9	38,5
Clothing and footwear	0,2	0,6
Housing	2,0	9,4
Flat (rent, water, other services)	-0,7	-0,6
Fuel and lighting	3,7	10,8
Heating (central heating)	5,2	1,5
Electricity for households	2,9	5,8
Oil for households	11,2	1,5
Hygiene and health	2,0	5,1
Culture and entertainment	6,4	11,3
Means for education	9,0	8,1
Transport and communication services	1,8	9,4
Fuels	8,6	8,1
<i>Goods</i>	<i>3,7</i>	<i>93,3</i>
<i>Services</i>	<i>1,3</i>	<i>6,7</i>



Source: State Statistical Office and calculations of the NBRM.

Figure 13  
Regulated prices and prices of tobacco  
(price level in indices, 2005=100)



Source: State Statistical Office

the expectations that they will remain unchanged, as well as to the faster increase in the prices of oil derivatives (increment of 9% instead of the projected 4%).

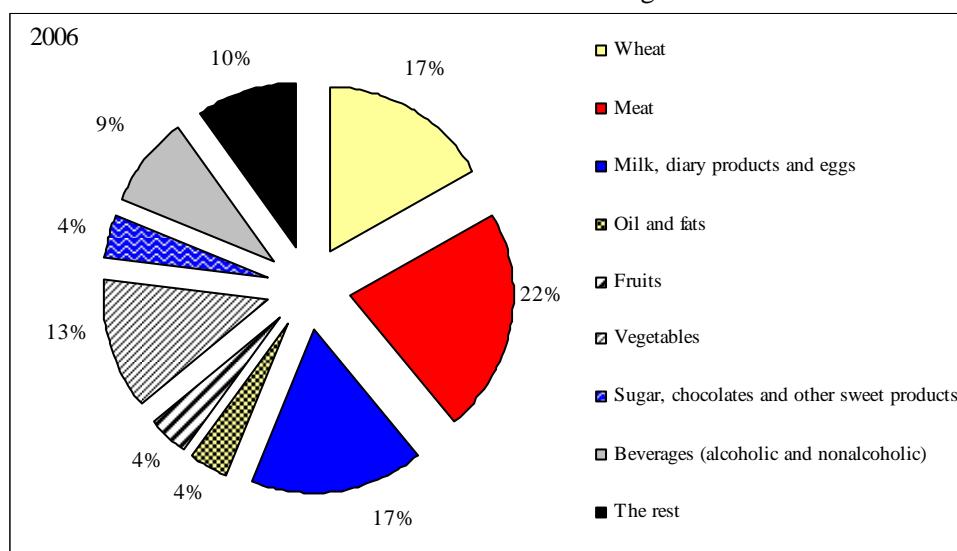
The core inflation rate, which excludes the effect of the increase in the prices of food products and the increase in the prices of energy, additionally corrected for the effect of the administrative increase in the prices of tobacco, in 2006 equaled 1%, on average. For comparison, the core inflation rate in 2005 equaled 1.2% (excluding food and energy).<sup>30</sup>

The total contribution of regulated prices, i.e. prices of oil derivatives, electricity and heating energy to the inflation was 15.4% in 2006. If the effect of the administrative increase in the prices of cigarettes is added, the influence of these non-monetary factors caused around 54% of the total inflation in 2006.

In 2006, the accomplished inflation rate of 3.2% was higher relative to the initially projected level of around 2%, which is due to the increased prices of food products by 2.2%, contrary to

<sup>30</sup> The calculation of the core inflation rate was made in the NBRM.

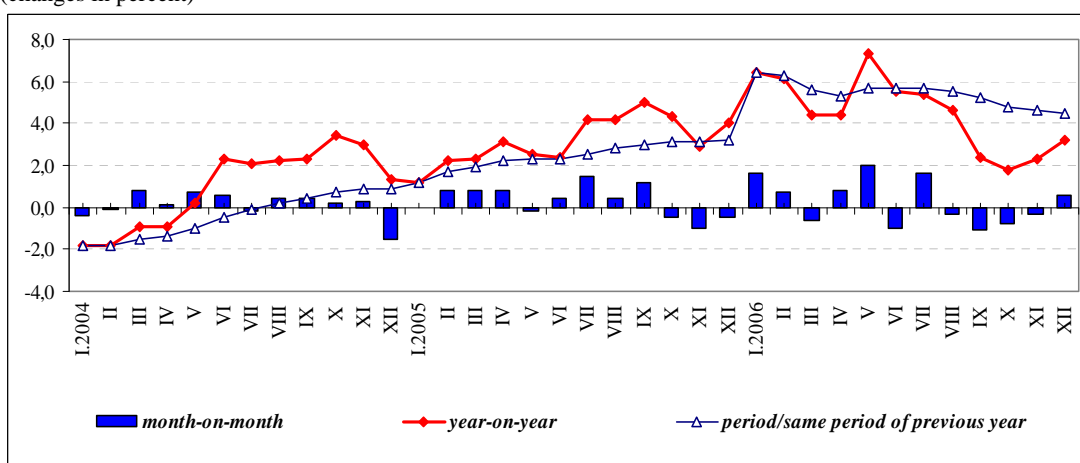
Figure 14  
Structure of the consumers' basket for food and beverages in 2006



Source: State Statistical Office

In 2006, the value of the *consumers' basket for food and beverages*<sup>31</sup> stood at Denar 10,278, on average. From the total costs for food and beverages, 22% pertain to the consumption of meat, 17% to cereals, 17% to milk and dairy products, 13% to the consumption of vegetables, while the consumption of alcoholic and non-alcoholic beverages took 9% of the value of the consumers' basket.

Figure 15  
Prices of the producers of industrial products  
(changes in percent)



Source: State Statistical Office

## Annex 2

### Inflation and the prices of the producers of industrial products

Producers' price index indicates the level of prices of finished products from domestic producers. To a certain extent, these prices directly influence inflation, through its domestic component, when the intensity of the influence will depend on the share of domestic prices in

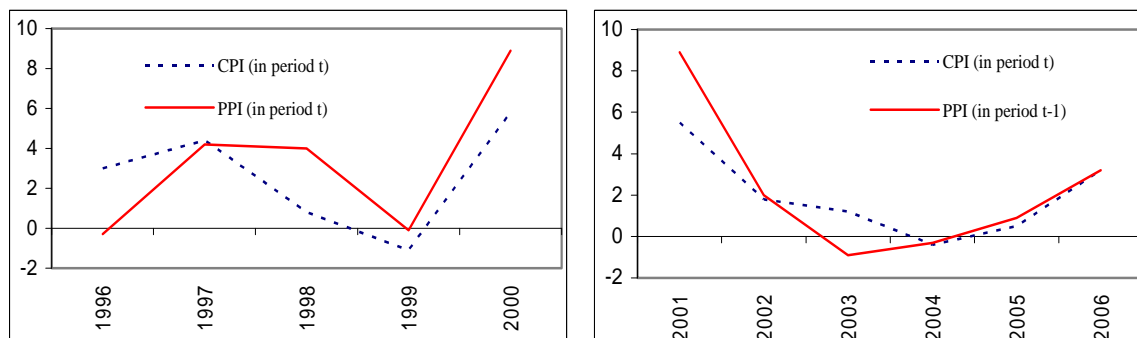
<sup>31</sup> All products of the category "food and beverages" that compose the basket are considered to be average monthly needs of a four-member non-agricultural household. The structure of the products is constant (same products – same quantities) within a year. In 2006, the calculation was based on a revised structure of products, wherefore comparison with previous years are inappropriate.

measuring inflation. Consequently, the producers' price index is a kind of indicator of the inflationary pressures, so that the increase in the production prices indicates potential future growth of inflation, where besides the partial pass-through effect, one should have in mind also the time lag with which this process is carried out.

Figure 16

Inflation and production prices

(average rate, in percent)



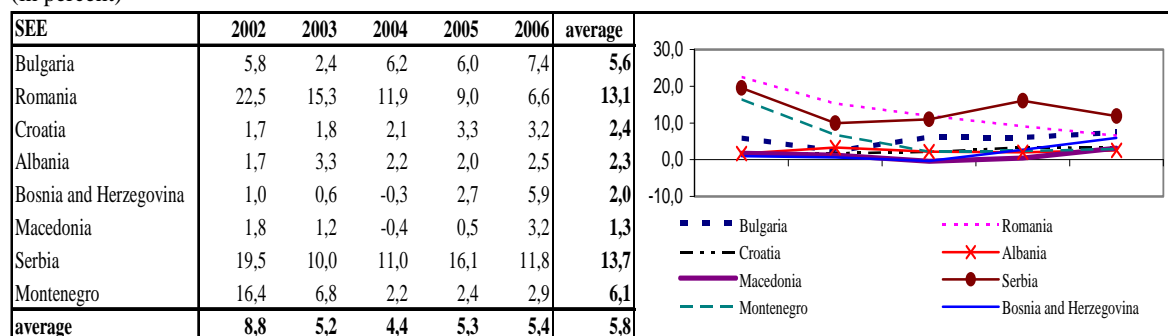
Source: State Statistical Office

If the link between the inflation and the movement of producers' prices in the Republic of Macedonia in the period 1996-2006 is observed, there is moderate positive correlation between them of 0.56 (movement in the same direction). If the period is divided into two sub-periods, the conclusions are different. In the period 1996-2000 there is a relatively strong and positive correlation of 0.7 between the accomplished average annual inflation rates and the producers' prices. The link between these two rates in the period 2001-2006 is characterized with different features, i.e. there is a strong and positive correlation of 0.9 between the accomplished rate of inflation in the current period and the realized change in the producers' prices in the previous period. This leads to a conclusion that lately the effect of the change in the producers' prices on inflation is being realized with a time lag of approximately one year. The average growth rate of producers' prices in 2005 equaled 3.2% and it was faster relative to 2004, when it equaled 0.9%.

In 2006, producers' prices registered an increase of 4.5% compared with 2005, with an increase being registered in all three industrial sectors, i.e. in sixteen out of twenty-three industrial activities. Manufacturing industry has the largest contribution (94%) to the registered average growth of the producers' prices (increase in the prices of 4.8%), as a result of the dominant influence of the increased prices of the producers of oil derivatives and tobacco products (contribution of 49.2% and 27.1%, respectively, in the total increase in the producers' prices). Prices of the domestically produced oil derivatives were higher by 16.7% and followed the increase in the world prices of crude oil. The increase in the prices of tobacco products of 21.6% was a result of the higher excises and of the additional duties intended for environment protection, health care, and stimulation of the agricultural production. The remaining portion, i.e. 6% of the registered average increase of the producers' prices, derives from the higher prices in the mining and energy sectors (by 3.3% and 2.1%, respectively). Higher prices in the energy sector reflect the increase in the price of electricity and heating energy in 2006.

Higher prices of the producers in 2006 correspond with the acceleration of the inflation, having in mind that this year they have common factors with dominant influence on their dynamics, such as the prices of tobacco and oil derivatives. If the effect from the higher prices of tobacco products is excluded (having in mind that this is a specific effect), producers' prices in 2006 were higher by 3.4% on average.

Table 8  
Inflation in the countries of Southeast Europe  
(in percent)



Source: State Statistical Office

Unlike 2005, when Macedonia registered the lowest inflation rate among the countries in the region, in 2006, the inflation rate in our country was the third lowest (together with Croatia). Lower inflation rates than the one registered in the Republic of Macedonia were only those registered in Albania and in Montenegro, where also slight acceleration of the inflation was registered. The highest inflation rate in 2006 was registered in Serbia and it is significantly lower than the one registered in the previous year. There is a notable trend of significant decline in the inflation in Romania, which continued also in 2006. Despite the accelerated inflation in Macedonia in 2006, in the period 2002-2006 our country still registers the lowest average inflation relative to the other countries in the region of 1.3%. Low average inflation rates in the observed period (below 3%) were registered in Bosnia and Herzegovina, Albania and Croatia, while the highest average inflation in the region were registered in Serbia and in Romania. In 2006, the average inflation rate in the countries of Southeast Europe equaled 5.4% and it was by 0.4 p.p. below the average for the period 2002-2006.

### Annex 3

#### Survey on the inflation expectations in the Republic of Macedonia

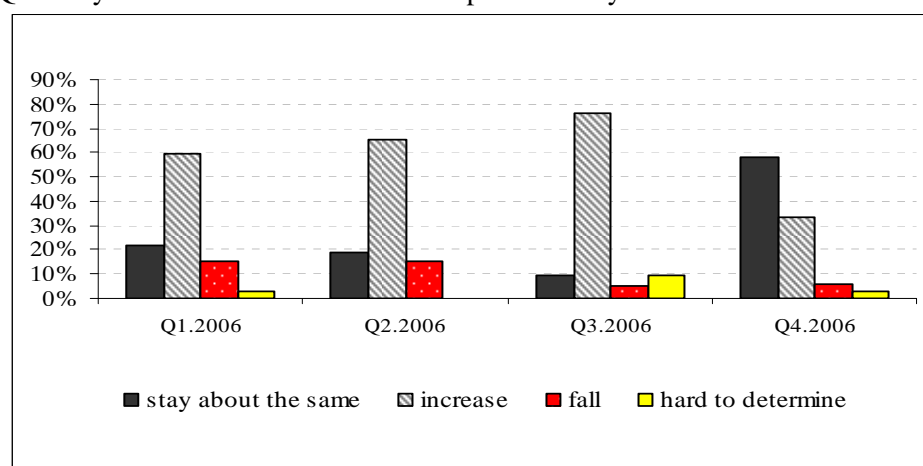
In March 2006, the NBRM started to carry out a Survey on the inflation expectations, which significantly contributes to the projections of the inflation and to the monetary policy conduct. The Survey covers three groups of respondents: enterprises, banks, and well-regarded economic analysts in the Republic of Macedonia. The selection of respondents was made on the basis of adequate criteria for a representative sample. The survey is conducted with a quarterly dynamics (at the beginning of each quarter), while the participation of the respondents is voluntary.

The analysis of the expectations of the economic entities about the dynamics of the inflation for 2006 indicated dominance and an upward trend in the percentage of entities which expect increase in the inflation in the first three surveys. In the Survey conducted in the last quarter, this percentage dropped significantly and lost its dominant position, with the largest percentage of the respondents having stable inflation expectations.



Figure 17

Quarterly distribution of the inflation expectations by end 2006



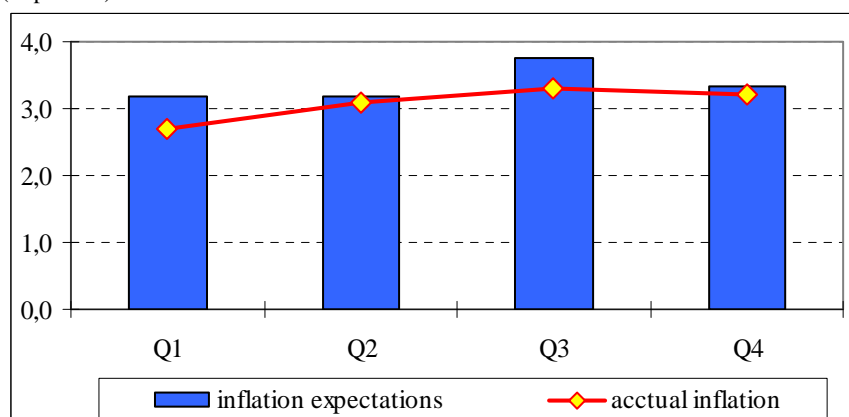
Created expectations for acceleration of the inflation rate in the first three surveys correspond with the period of the year when the inflation rate was significantly higher than the inflation in the preceding year, which was followed by a trend of slower growth. Dominant factors which contributed to the creation of expectations for inflation increase after its initial fast growth in the first month of the year (due to the increased price of tobacco products) are the increase in the price of oil on the world market, the expected increase in the price of heating, electricity, raw materials, and food products (perceived as a consequence from the increased prices of energy products). In the first two quarters, additional factor were the expectations for increased public consumption in the pre-election period, while in the remaining months of the year the inflation expectations were mainly based on the increased economic activity in accordance with the announced policy of the new government.

In the first two quarters, the entities which participated in the Survey expected the average inflation rate in 2006 to reach 3.2%. Their expectations intensified in the third quarter, which led to an expected average inflation of 3.8% for 2006, while in the last quarter expectations stabilized at the level of 3.3%. During the entire 2006, the expected inflation rate equaled 3.4%, which is very close to the accomplished inflation rate of 3.2%.

Figure 18

Movement of the inflation expectations for the average annual inflation rate for 2006 and the accomplished average inflation during 2006

(in percent)



Source: NBRM. Expected inflation rates are weighted average of the expectations for a decline and increment in the inflation and of the stable expectations. Expectations are weighted with the share of number of responses in an individual group (decline, increase, or unchanged inflation) in the total number of responses.

### 2.3. Labor market<sup>32</sup> and wages

In 2006, positive developments were registered on the labor market. According to the Labor Force Survey, the total number of employed persons went up relatively to the preceding year, which caused an increase in the employment rate of 33.9% to 35.2%. On the other hand, the minimum decline in the number of unemployed<sup>33</sup> persons interrupted the continuous four-year growth of the unemployment rate, which in 2006 was by 1.3 percentage points lower relative to the preceding year and equaled 36%. The faster increase in the number of employees relative to the minimum decline in the number of unemployed persons resulted in an increase in the labor force of 2.6%. Despite the fall in the unemployment rate, it is still high, and the problem with the unemployment in the Republic of Macedonia becomes even worse once the long-term unemployment is identified. The analysis of the duration of the unemployment from 1996 until 2005 indicates that the persons unemployed for more than one year and the persons unemployed for more than four years participate in the total unemployment with 84.3% and 58.4%, respectively. Having in mind that the relation between the duration of the period in which one person is unemployed is in inverse proportion to the possibility for their employment, such a structure significantly hinders the possibility for solving the problem with the unemployment.<sup>34</sup>

Table 9  
Results of the Labor Force Survey

	2003	2004	2005	2006
Total working age population	1.579.450	1.594.557	1.607.997	1.618.482
Labour Force	860.976	832.281	869.187	891.679
Employed	545.108	522.995	545.253	570.405
Unemployed	315.868	309.286	323.934	321.274
Inactive population	718.474	762.276	738.810	726.803
Activity rate	54,5	52,2	54,1	55,1
Employment rate	34,5	32,8	33,9	35,2
Unemployment rate	36,7	37,2	37,3	36,0

Source: Labor Force Survey, State Statistical Office

The increase in the employment in 2006 was a result of the increased number of employed persons in all sectors of the economy. The highest employment growth rate of 7.7% was registered in the agricultural sector, which employs 20% of the total number of employed persons in the economy. Significant increase of 5.8% in the number of employed persons was registered in the industrial sector<sup>35</sup>, which encompasses 33% of the total number of employed persons, with dominant influence of the increased number of employed persons in construction and manufacturing. More moderate increase in the number of employees of 2.5% was registered in the services sector, as the most important sector, as it employs 47% of the total number of employed persons. Of the total number of employed persons in the services sector, 27% are employed in the trade sector, where a decline in the employment of 2.2% was registered. Highest growth rates were registered in the activity "hotels and restaurants" (40.4%) and in "financial intermediation" (12.3%), which employ a significantly smaller portion of the total number of employees in the services sector (7% and 3%, respectively).

<sup>32</sup> The Labor Force Survey was conducted by the State Statistical Office of the Republic of Macedonia on the basis of a sample of 10,000 households on the whole territory of the country and it is in accordance with the methodological recommendations of the International Labor Organization (ILO) and the recommendations of the European Statistical Bureau (EUROSTAT). Starting from 2004, the results are being processed quarterly.

<sup>33</sup> In line with the ILO standards, the persons who fulfill the following three conditions are considered *unemployed*: had no job during the reported week (according to set criteria); were actively seeking for a job, i.e. undertook concrete activities to find one; were ready to accept a job in the reported week or in the following week. The *rate of unemployment* is the share of the number of unemployed persons in the total labor force (employed and unemployed).

<sup>34</sup> However, certain studies show that the real unemployment rate is significantly lower than the official one. For example, if the unemployment rate is adjusted for the estimated number of employed persons in the grey economy, it would equal 15%. (Source: IMF, Selected Issues, October 2006).

<sup>35</sup> The industrial sector includes construction.

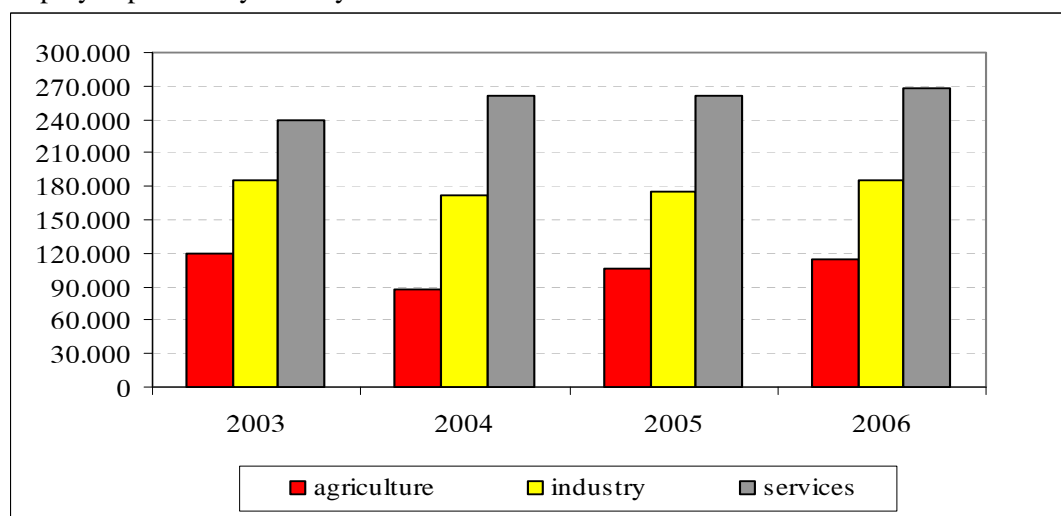
Figure 19  
Rates of employment and unemployment  
(in percent)



Source: Labor Force Survey, State Statistical Office

From the viewpoint of the number of employed persons most significant activity is manufacturing, which absorbs the largest portion, or 22% of the total number of employed persons in the economy.

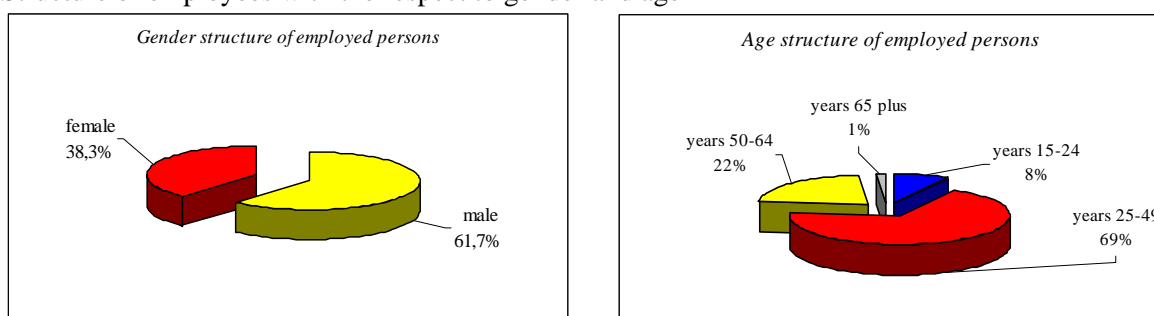
Figure 20  
Employed persons by activity



Source: Labor Force Survey, State Statistical Office

With respect to the gender structure, dominant in the total number of employees are males with a share of 61.7%. The male population registered higher rate of employment (43.5%) and lower rate of unemployment (35.3%) compared with the female population (27% and 37.2%, respectively). With respect to the age of the employed and the unemployed persons, the population aged between twenty-five and forty-nine years of age registered the highest employment rate (52%), while the highest unemployment rate was registered with the population aged between fifteen and twenty-four (59.9%).

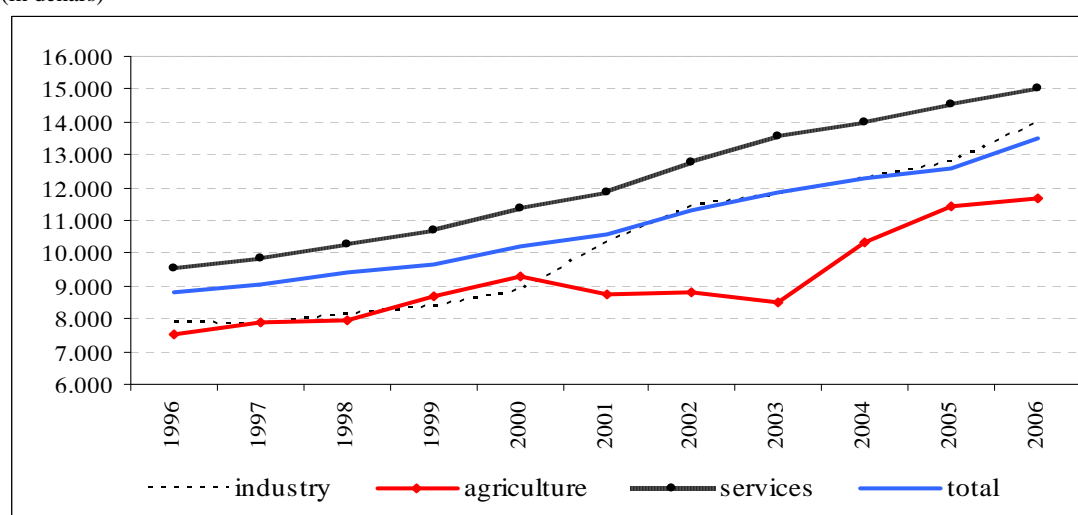
Figure 21  
Structure of employees with the respect to gender and age



Source: Labor Force Survey, State Statistical Office

The upward trend in the wages in the Republic of Macedonia continued in 2006, with higher wages being registered in both the private and the public sector. Thus, the increased share of the private sector, where the wages are freely established, as well as the gradual process of decompression of the wages of civil servants, acted toward increasing the average wage in the Republic of Macedonia.

Figure 22  
Average net wage paid per worker, in total and by sector  
(in denars)



Source: State Statistical Office

In 2006, the average gross wage<sup>36</sup> stood at Denar 23.037, which was a nominal increase of 8% compared with 2005. The average net wage paid per worker amounted to Denar 13,518 Denar, which is a nominal increase of 7.3% (real growth was lower and equaled 4%, in circumstances of average inflation rate of 3.2%). Such an increase was a result of the higher wages in all sectors of the economy. Faster nominal increase in the net wage was registered in the industrial sector<sup>37</sup> (9.9%), mainly due to the increased wages in the "electricity, gas, and water supply" and "mining and quarrying" (by 20.5% and 8.7%, respectively). In the remaining sectors of the economy, "services sector" and "agriculture" the nominal increase in the wages was more moderate (3.4% and 2.2%, respectively). Within the services sector, more significant increase in the wages was registered in the public sector, i.e. in "education", "public administration and defense" and "health and social work" (of 6.5%, 4.1% and 3.1% respectively), which is in line with the gradual process

<sup>36</sup> Source: State Statistical Office. Total paid gross wages include: paid net wages for the reporting month, paid personal income tax, and paid contributions (for pension and disability insurance, for health insurance, for employment, for professional illness and for water supply).

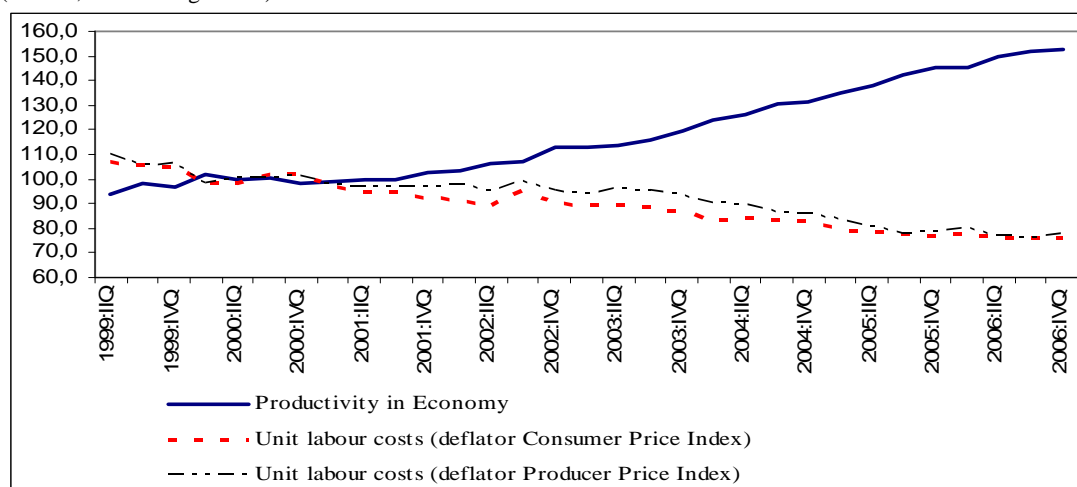
<sup>37</sup> The industrial sector includes construction.

of decompression of the wages of civil servants (and due to the statistical coverage of the data<sup>38</sup>). More significant increment was registered in the wages in "transport, storage and communication" (of 5.7%) and in "hotels and restaurants" (of 3.4%).

The favorable trend in productivity continued also in 2006. After the high growth rate of 9.5% in 2005, in 2006, productivity in the Macedonian economy registered an increase of 6.9% relative to 2005. The faster growth of productivity relative to the increase in the real gross wage in the economy, contributed to the reduction of the unit labor costs in 2006 by 2.2%, i.e. 2.8% (depending on whether gross wage is deflated with the consumer price index or the producers' price index, respectively).<sup>39</sup>

Figure 23

Productivity and unit labor costs in the Macedonian economy  
(indices, base average 2000)



Source: State Statistical Office, calculations and analyses of the NBRM

#### Annex 4

##### Comparative analysis of the wages in the countries of the region

In the Republic of Macedonia, the average net wage per employee is very low and amounts to Euro 221 (average level for 2006). Compared with the wages in the countries of the region, only in Bulgaria the wage level is lower, while Slovenia and Croatia paid the highest amount of average net wage per employee in 2006 of Euro 773 and Euro 628 Euro, respectively. The comparative analysis indicates moderate trend of increase in net wages, especially in Slovenia, Bulgaria, and Serbia, while in the other countries of the region, net wages are maintained at a relatively stable level.

The level of the wages in the country is one of the main determinants of consumption. The low level of net wages in the Republic of Macedonia determines a low level of living standard, low purchasing power, and relatively weak credit worthiness of the population, which adequately reflects on the growth, having in mind that personal consumption covers 70-80% of GDP, and hence represents a significant factor of economic growth.

<sup>38</sup> Source: State Statistical Office. Since January 2006, the number of employees in the activity "public administration and defense" for the first time includes the data about the Ministry of Internal Affairs and Ministry of Defense.

<sup>39</sup> The productivity index and the unit labor costs index for the whole economy are calculated on the basis of data on GDP, for the total number of employees according to SSO data obtained from the reports of the enterprises and for real gross wage. The indices take year 2000 as a cut off base.

Table 10  
Wages by country

Country	Average monthly wage per employee	Q1.2006	Q2.2006	Q3.2006	Q4.2006	2006	
		Amount in euros				Amount in euros	personal income tax and social security contributions, % of average gross-wage
Macedonia	gross wage	368	375	379	383	376	
	net wage	216	220	222	226	221	41,3
Slovenia	gross wage	1175	1185	1197	1292	1213	
	net wage	751	756	764	822	773	36,2
Croatia	gross wage	879	912	902	930	906	
	net wage	611	633	627	643	628	30,6
Bulgaria	gross wage	168	176	181	188	178	
	net wage	-	-	-	-	-	-
Bosnia and Herzegovina	gross wage	442	450	455	467	453	
	net wage	300	306	310	318	308	32,0
Serbia	gross wage	324	357	386	454	380	
	net wage	221	244	264	311	260	31,6
Romania	gross wage	301	316	-	-	309	
	net wage	226	238	-	-	232	24,8

Sources: Central banks and state statistical offices

Despite the low level of net wages, total costs for wages per employee (taxes and wage contributions) in the Republic of Macedonia are still high. Taxes and wage contributions in our country took 41.3% of the gross wage per worker in 2006, which is the highest percentage compared with the other countries in the region. From among the other countries, the highest costs for wages per employee were registered in Slovenia (36.2% of the gross wage), and the lowest in Romania (24.8% of the gross wage).

The high costs for wages make our country less attractive for the investors relative to the other countries in the region. Having in mind that the foreign investments are an important factor for the economic growth, towards end-2006 measures were undertaken for cutting the costs for wages in the Republic of Macedonia, so that the current rates of personal income tax of 24%, 18%, and 15% will be equalized at 12% starting from the beginning of 2007, while in 2008 this rate will be 10%.

## 2.4. External sector

Narrowing of the deficit in the balance of payments current account and reducing the level of country's indebtedness, as well as the significant inflows on the basis of foreign direct investments (primarily on the basis of privatization) were the main features of the external sector in 2006. Thus, in 2006, Republic of Macedonia registered historically lowest current account deficit of 0.4% of GDP (1 percentage point lower on annual basis), foreign debt dropped by 5 percentage points (1.8 percentage point if the effect from the Eurobonds issued in 2005 is excluded) in comparison with the previous year and in 2006 it equaled 36.9%, while FDI reached a share of 5.8% of GDP. The developments in the external sector led to a significant increase in the official foreign reserves, whose level in 2006 provided for 4.6 months of the projected import of goods and services for the following year.

Table 11  
Indicators for the external position of the Republic of Macedonia

	2003	2004	2005	2006
<b>External liquidity indicators</b>				
Gross official reserves/Import of goods and services in the current year (in months)	3,9	3,3	4,6	5,0
Gross official reserves/Import of goods and services projected for the forthcoming year (in months)	3,3	3,0	4,0	4,6
Gross official reserves/GDP (in %)	17,6	16,6	24,2	28,6
Long term debt servicing/GDP (in %)	5,4	4,6	4,1	8,3
Long term debt servicing/Export of goods and services (in %)	14,8	11,9	9,3	17,4
<b>External solvency indicators</b>				
Total external debt/GDP (in %) /1	35,9	35,3	41,6	36,9
Long term external debt/GDP (in %) /1	35,1	34,1	39,9	36,0
Total external debt/Export of goods and services (in %)	98,8	91,5	95,3	76,9
Long term external debt/Export of goods and services (in %)	96,5	88,3	91,4	74,9
<b>Financial risk exposure indicators</b>				
Foreign reserves/M2-Denar (in %)	17,1	18,1	19,0	23,4
Foreign reserves/Reserve money (in %)	242,8	247,7	336,1	348,2
<b>Openness of the economy (export+import)/GDP (in %)</b>	79,1	85,6	91,5	98,7
<b>Current account, deficit /GDP (in %)</b>	3,3	7,7	1,3	0,4
<b>Trade deficit/GDP (in %)</b>	18,3	20,7	18,4	20,6
<b>Private transfers, net/GDP (in %)</b>	13,7	13,4	17,5	18,7
<b>Foreign direct investments/GDP (in %) /2</b>	2,0	2,9	1,7	5,8

1/ If the effect of the issued Eurobonds is excluded, the share of the total external debt and the external long-term debt in the estimated GDP in 2005 equaled 38.4% and 36.7%, respectively.

2/ Excluding the privatization proceeds the share of FDI in the projected GDP in 2006 was 1.2%.

Source: Calculations of the National Bank of the Republic of Macedonia, on the basis of data from the SSO (for the foreign trade and nominal GDP in Denars) and from the NBRM; All indicators, except for the second indicator for external liquidity, show ratios in the respective year.

#### 2.4.1. Balance of payments

In 2006, the downward trend in the deficit in the balance of payments current account continued, and it was reduced down to 0.4% of the GDP<sup>40</sup> (1.3% in 2005 and 7.7% in 2004). Such changes in the balance of the current transactions were caused mainly by the further growth of the foreign exchange inflows from private transfers, whose share reached 18.7% of GDP (17.5% and 13.4% in 2005 and in 2004, respectively). Positive developments were registered also in the exchange of services, where in 2006 positive balance was registered (of 0.4% of GDP), as opposed to the continuous deficit in the past five years. The postponed payment of a dividend to one major foreign investor had a significant contribution to the improved position on the current account (around 0.8% of GDP). On the other hand, the only component which had a negative contribution

<sup>40</sup> Estimated data on the gross domestic product for 2006, calculated in Euros at the average annual exchange rate of the Denar against the Euro.

to the current account balance was the balance of the trade in goods, which, in circumstances of faster growth of the imports relative to the growth of exports, registered deeper deficit by 2.2 percentage points of GDP (the share of the trade deficit in GDP in 2006 was 20.6%).

Net inflows in the capital and financial account in 2006 were lower relative to the previous year. From the viewpoint of the structure of financing, positive structural changes were registered, directed towards an increase in the inflows on the basis of non-debt financing and lower external borrowing. Thus, within debt financing, increase in the net outflows was registered, primarily as a result of the early repayment of the total debt to the London Club of Creditors in January 2006. On the other hand, in 2006 a significant inflow on the basis of foreign direct investments was registered (primarily as a result of the privatization of the Electricity Supply Company of Macedonia "ESM - Distribucija") in March 2006, as well as further inflow on the basis of portfolio-investments, which contributed to the increase in the share of these two categories in GDP (by 1.2 percentage points on annual basis), which reached 7.1%. Movements in the external sector generated further growth of the total foreign exchange potential of the country, and within that, at the end of 2006, gross foreign reserves reached a level which enables 4.6 months coverage of the projected import of goods and services for the following year.

Table 12

Balance of payments of the Republic of Macedonia /<sup>1</sup>

(in millions of euros)

	2003	2004	2005	2006
<b>Current account</b>	<b>-137,2</b>	<b>-333,6</b>	<b>-61,8</b>	<b>-18,9</b>
<b>Goods, net (f.o.b.)</b>	<b>-750,2</b>	<b>-894,0</b>	<b>-853,4</b>	<b>-1.020,6</b>
Export	1.203,2	1.343,1	1.642,2	1.902,6
Import /2	-1.953,5	-2.237,1	-2.495,6	-2.923,3
<b>Services, net</b>	<b>-9,0</b>	<b>-43,4</b>	<b>-27,2</b>	<b>19,7</b>
Inflow	288,2	327,8	380,6	477,3
Outflow	297,2	371,2	407,9	457,6
<b>Income, net</b>	<b>-28,2</b>	<b>-33,2</b>	<b>-44,4</b>	<b>-1,7</b>
o/w: interest, net	-27,8	-21,2	-20,7	-19,4
<b>Current transfers, net</b>	<b>650,3</b>	<b>637,0</b>	<b>863,2</b>	<b>983,7</b>
Official	89,4	55,4	52,5	58,7
Private	560,9	581,5	810,7	925,0
<b>Capital and Financial account</b>	<b>161,5</b>	<b>326,8</b>	<b>71,9</b>	<b>10,3</b>
<b>Capital account</b>	<b>-5,8</b>	<b>-3,8</b>	<b>-1,7</b>	<b>-0,8</b>
<b>Financial account</b>	<b>167,3</b>	<b>330,6</b>	<b>73,7</b>	<b>11,2</b>
Direct investments, net	81,1	126,2	77,1	285,9
Portfolio investments, net /3	3,0	11,3	198,0	65,5
Other investments, net	121,8	208,9	146,5	-42,7
Trade credits, net	68,9	136,4	21,1	31,6
Loans, net	35,0	47,9	125,0	-21,3
Currency and deposits, net	5,5	-2,3	-20,7	-83,7
Other, net /4	12,5	26,9	21,1	30,7
Gross official reserves ( - = increase) /5	-38,6	-15,9	-347,9	-297,6
<b>Errors and omissions</b>	<b>24,3</b>	<b>-6,8</b>	<b>10,1</b>	<b>-8,6</b>

\* Preliminary data

2/ Import is presented on f.o.b. parity in accordance with the fifth edition of the IMF's Balance of Payments Manual; the factor c.i.f.-f.o.b. equals 4.06%; for 2006 adjustment in the period of recording was made for the import of electricity.

3/ In 2005 with the inflows from the Eurobonds.

4/ Overdue liabilities.

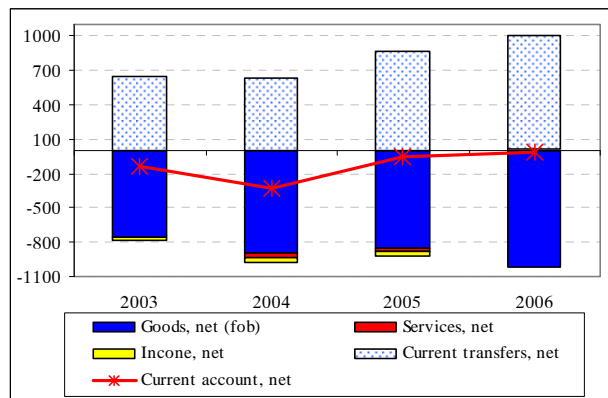
5/ Excluding monetary gold and foreign exchange differentials.

Source: National Bank of the Republic of Macedonia



Figure 24

Dynamics of the balance and components of the current account of the balance of payments of the Republic of Macedonia  
(in millions of euros)

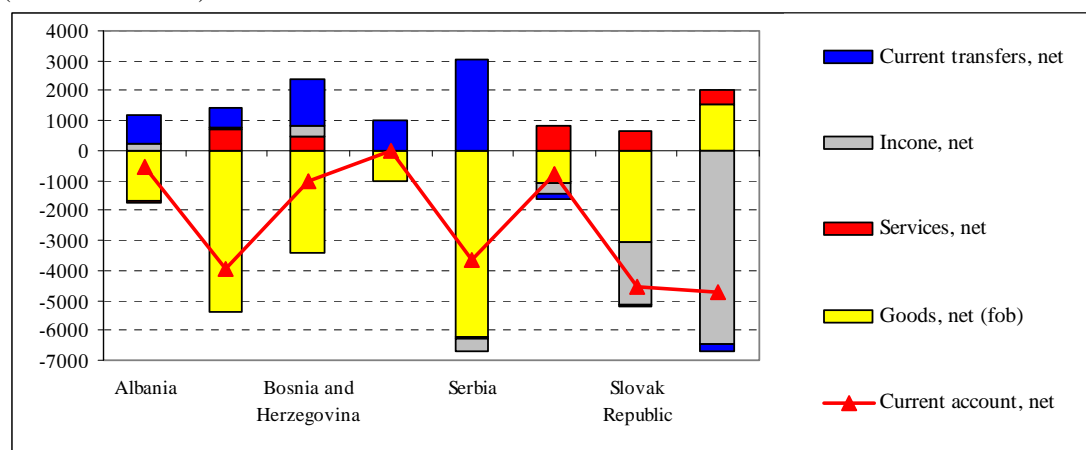


Source: National Bank of the Republic of Macedonia

private transfers. Unlike these countries, most of the analyzed countries are obviously under the influence of the other components on the current account balance. Thus, in Slovakia and the Czech Republic, the large net outflows of income, primarily on the basis of direct and portfolio investments, had a significant negative influence on the current account balance. The only country of the group of analyzed countries which registered surplus in the trade in 2006 is the Czech Republic, which simultaneously registered the highest deficit in the income balance. Unlike Macedonia, the Czech Republic, Slovakia, Slovenia, and Slovakia registered net outflows of current transfers in 2006. On the other hand, Albania, Serbia, Bosnia and Herzegovina, and Bulgaria registered net inflows of current transfers which financed 58.1%, 48.7%, 44.3%, and 12.1% of the trade deficit of the respective countries. In the case of the Republic of Macedonia, in 2006 this ratio was significantly higher and equaled 96.4%.

Figure 25

Balance and components of the current account of individual countries in 2006  
(in millions of euros) <sup>1/</sup>



1/ For Serbia and Slovakia it is expressed in millions of US dollars

Source: National Bank of the Republic of Macedonia (on the basis of data from the web-sites of the central banks of the respective countries).

The analysis of the *current account* components does not show more significant changes in the structure of the current account components, so that also in 2006 the trade in goods and the current transfers (primarily private transfers) were dominant in determining the current account balance.

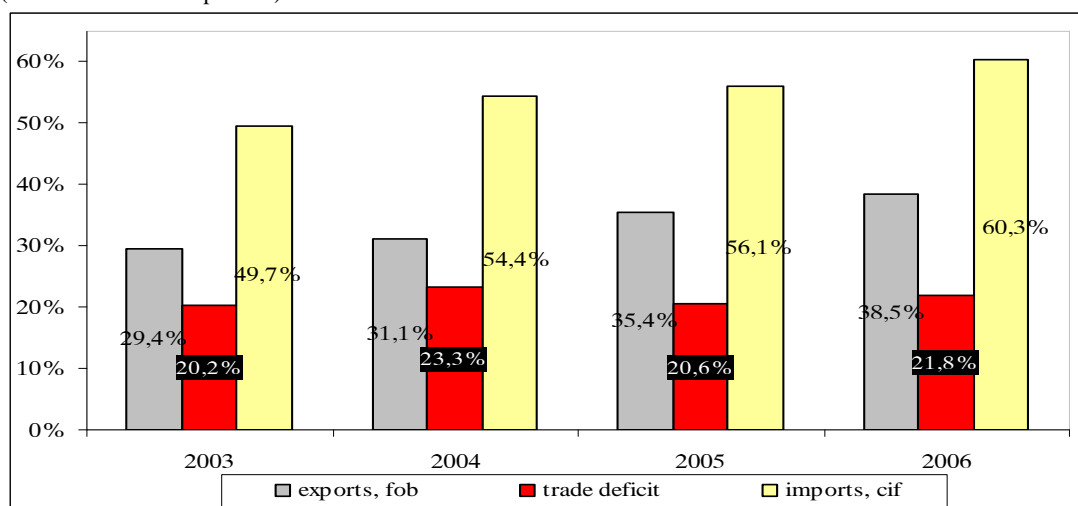
The comparative analysis of the payment balances of individual countries in transition (Albania, Bulgaria, Bosnia and Herzegovina, Serbia, Slovenia, Slovakia and the Czech Republic) in 2006, shows deficit in the current account in all analyzed countries. The lowest current account deficit in 2006 was registered in Macedonia and in Albania, in circumstances of high inflows of

#### 2.4.1.1. Foreign trade of the Republic of Macedonia

In conditions of accelerated export activity of the Macedonian economy and a simultaneous growth of the domestic demand for imported goods, *the total foreign trade*<sup>41</sup> of the Republic of Macedonia in 2006 went up by 15.3% and reached Euro 4,893.9 million. Thus, its share in the GDP in 2006 went up by 7.2 percentage points and equaled 98.7%, which indicates high level of openness of the Macedonian economy. From the viewpoint of the individual economies in transition, in 2006, significantly lower external orientation was evident in Albania (with a share of the trade in goods in GDP of around 40%), then in Croatia, Poland and Romania (with a share exceeding 70%), while on the other side is Slovakia (with a share of around 160%), followed by the Czech Republic, Bulgaria and Slovenia (with individual shares of around 130%).<sup>42</sup>

In 2006, in circumstances of faster increase in the imports relative to the exports of goods, the deficit in the foreign trade of the Republic of Macedonia increased by 13% on annual basis, and the degree of import-export coverage went up by 0.6 percentage points and equaled 63.8%.

Figure 26  
Export, import, and trade deficit  
(share in the GDP in percent)



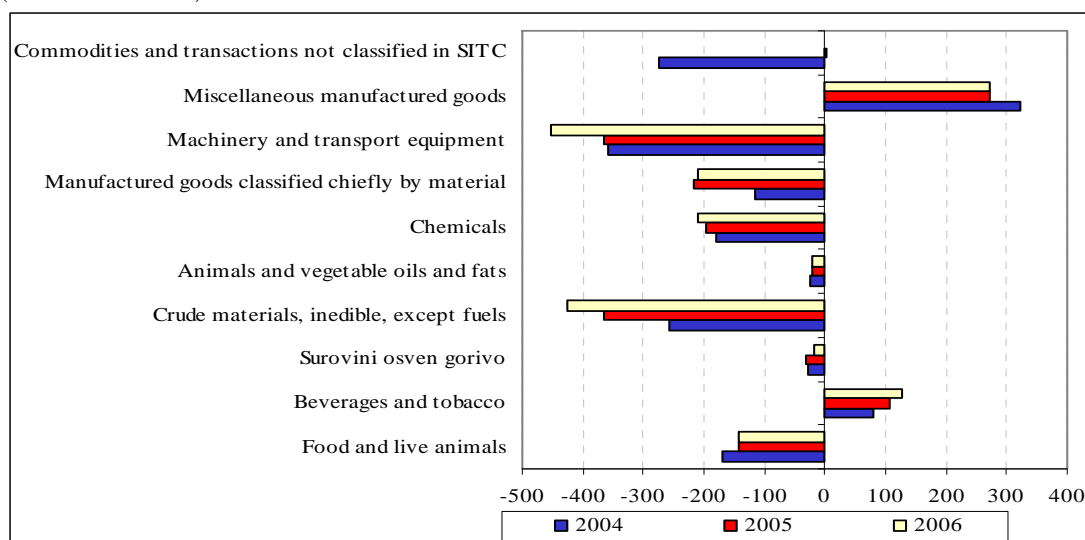
Source: State Statistical Office; the calculations were made at the NBRM.

From a viewpoint of the individual groups of products, the higher deficit in the trade in equipment and energy had the largest contribution to the deepening of the foreign trade deficit, whose share in the GDP in 2006 reached 9.2% and 8.6%, respectively (identical share of both groups of products of 7.9% in 2005), reflecting the increasingly higher level of technical and technological, and energy dependence of the Macedonian economy.

<sup>41</sup> Source: Preliminary data of the State Statistical Office. The export of goods is presented on f.o.b. basis, while the import of goods on c.i.f. basis. Export and import are different from the amounts in the balance of payments due to methodological reasons (the adjustment in the period of recording of the import of electricity in 2006 was included in the balance of payments statistics, unlike the data on the imports of the SSO, which have not been adjusted on that basis).

<sup>42</sup> Source: Calculations in the NBRM on the basis of IMF data, International Financial Statistics, February 2007, on the export and import of goods; EBRD, Transition Report 2006, for GDP (projection).

Figure 27  
Trade balance by group of products <sup>1/</sup>  
(in millions of euros)



1/ According to the Standard International Trade Classification (SITC).  
Source: State Statistical Office

Observed from a viewpoint of the individual components of the trade in goods, main factors which in 2006 caused an annual increase in the value of the *export of goods* (of 16%)<sup>43</sup>, were the accelerated production and export activity of the metal processing industry, and of the industry for production of oil derivatives, initiated by the growth of the prices of metals on the stock exchanges (copper, nickel, iron and steel<sup>44</sup>) and of oil derivatives. From the viewpoint of the individual categories of products<sup>45</sup>, the increased export of iron and steel had the largest contribution to the increase in the value of the export of goods in 2006 (of 39%), followed by the oil derivatives and metal ore (with contribution of 12.7% and 12.6%, respectively). Increased level of utilization of the capacities in the area of metallurgy, in circumstances of more favorable conditions on the international metal exchanges, resulted in an annual increase in the value of the export of iron and steel of 23.9% (the actual price at which the export and the placed quantities were realized registered an annual increase of 17.3% and 5.7%, respectively). The increased export of metal ore (mainly copper ores and concentrates) was entirely due to the accelerated production and export activity of one major mine after it was restarted in the second half of 2005. The increase in the value of the export of oil derivatives in 2006, in conditions of a decline of the exported quantities, was entirely a result of the price increase. Such a dynamics in these groups of export products led to movements in the overall exports towards increased share of the iron and steel, metal ore and oil derivatives (by 1.8, 1.5 and 0.7 percentage points, respectively) and reduced share of clothing (by 3.7 percentage points). From a viewpoint of the concentration of the export of goods and services from the Republic of Macedonia, measured by the Herfindahl-Hirschman index, in 2006, further upward trend was registered in the diversification of the export supply (0.244 in 2006, as opposed to 0.251 and 0.271 in 2005 and in 2004, respectively).

<sup>43</sup> The estimated growth of exported quantities of goods equaled 9.2% in 2006.

<sup>44</sup> Source: [www.worldbank.org](http://www.worldbank.org); commodity price index; the calculations were made in the NBRM. The average prices of copper and nickel in 2006 registered a significant annual increase of 82.7% and 64.5%, respectively, and at the same time the increase in the average prices of iron and sheet metal equaled 19%, respectively.

<sup>45</sup> Classified according to the sectors of the SITC.

Table 13

Contribution to the total increase in the export of goods by group of products <sup>1/</sup>

groups of products	2005	2006	2006-2005	2006/2005	2005	2006	2006/2005
	in millions of Euros		changes in absolute amount (in millions of Euros)	changes in (%)	structure (in%)		contribution to the growth of exports (in %)
<b>EXPORT OF GOODS</b>	<b>1.643,5</b>	<b>1.906,2</b>	<b>262,7</b>	<b>16,0</b>	<b>2.327,8</b>	<b>2.204,9</b>	
<i>Food and live animals</i>	135,0	151,8	16,8	12,5	191,2	175,6	106,1
of which: fruits and vegetables	70,6	86,5	15,8	22,4	100,0	100,0	100,0
<i>Beverages and tobacco</i>	131,3	152,7	21,4	16,3	186,0	176,6	134,8
of which: beverages	49,2	63,8	14,6	29,7	69,7	73,8	92,1
<i>Crude materials, inedible, except fuels</i>	55,0	88,6	33,6	61,0	77,9	102,5	211,8
of which: metalliferous ores and metal scrap	26,9	59,9	33,0	122,8	38,1	69,3	208,3
<i>Mineral fuels, lubricants and related materials</i>	132,6	178,4	45,8	34,6	187,8	206,4	289,2
of which: petroleum and petroleum products	128,2	161,5	33,4	26,0	181,5	186,8	210,5
<i>Manufactured goods classified chiefly by material</i>	546,7	676,0	129,3	23,6	774,3	781,9	815,8
of which: iron and steel	427,6	530,0	102,3	23,9	605,7	613,0	645,8
<i>Others</i>	642,9	658,7	15,8	2,5	910,6	762,0	99,6
of which: clothes	441,6	440,8	-0,8	-0,2	625,4	509,8	

1/ According to SITC.

Source: State Statistical Office

The high level of import dependence of the Macedonian economy in terms of technology, energy and raw materials, the increase in the price of oil and oil derivatives on the world stock exchanges, and the reduced customs burdening of the import since the beginning of the year in line with the SAA and WTO<sup>46</sup>, were the main factors which acted towards the increase of 14.9% in the *import of goods* in 2006. Regarding individual products, such a dynamics of the imports was caused mainly by the increased import of energy and of iron and steel (due to the import dependence of the metal processing capacities), whose contribution to the increase in the imports equaled 27.1% and 16.4%, respectively. At the same time, the increased import of vehicles contributed significantly to the increase in the imports (by 8.8%), partly initiated by the change in the regulation that allows for import of older used cars since June 2006. On the part of the import of goods in 2006, according to the Herfindahl-Hirschman index increased level of concentration was registered (0.120 in 2006, as opposed to 0.110 in 2005).

Table 14

Contribution to the total increase in the import of goods by group of products <sup>1/</sup>

groups of products	2005	2006	2006-2005	2006/2005	2005	2006	2006/2005
	in millions of Euros		changes in absolute amount (in millions of Euros)	changes in (%)	structure (in%)		contribution to the growth of imports (in %)
<b>IMPORTS OF GOODS</b>	<b>2.601,0</b>	<b>2.987,7</b>	<b>386,7</b>	<b>14,9</b>	<b>100,0</b>	<b>100,0</b>	
<i>Mineral fuels, lubricants and related materials</i>	499,1	603,8	104,6	21,0	19,2	20,2	27,1
of which: petroleum and petroleum products	398,1	497,4	99,4	25,0	15,3	16,6	25,7
- crude oil	320,4	426,2	105,7	33,0	12,3	14,3	27,3
volumes in tons	950.741,6	#####	127.996,1	13,5			
price in euro for 1 kg	0,34	0,40	0,06	17,2			
<i>Crude materials, inedible, except fuels</i>	86,4	106,4	20,0	23,1	3,3	3,6	5,2
of which: metalliferous ores and metal scrap	39,7	57,6	17,9	45,0	1,5	1,9	4,6
<i>Manufactured goods classified chiefly by material</i>	762,4	886,7	124,2	16,3	29,3	29,7	32,1
of which: iron and steel	230,3	293,8	63,5	27,6	8,9	9,8	16,4
non-ferrous metals, n.e.s.	36,0	53,6	17,6	48,7	1,4	1,8	4,5
manufactures of metals, n.e.s.	54,3	66,6	12,4	22,8	2,1	2,2	3,2
<i>Machinery and transport equipment</i>	453,8	547,4	93,6	20,6	17,4	18,3	24,2
of which: machinery specialized for particular industries	49,9	69,4	19,4	38,9	1,9	2,3	5,0
road vehicles	127,7	161,6	33,9	26,6	4,9	5,4	8,8
other transport equipment	10,1	22,3	12,2	121,2	0,4	0,7	3,2
<i>Others</i>	799,1	843,5	44,3	5,5	30,7	28,2	11,5

1/ According to SITC.

Source: State Statistical Office

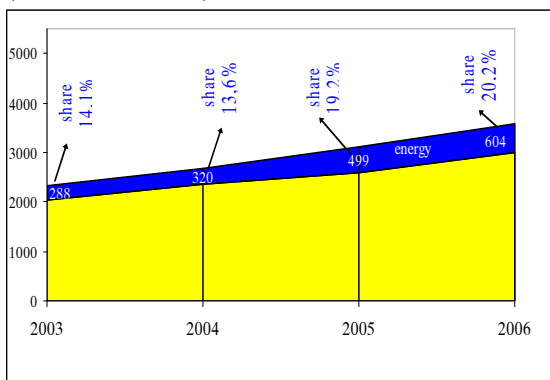
<sup>46</sup> In accordance with the admission of the Republic of Macedonia to the WTO and with the Stabilization and Association Agreement with the European Union, customs duties on individual products decreased further since January 01, 2006, with the average customs rate being reduced from 10.12% in 2005 to 9.78 in 2006. More significant decline was registered in the average customs rate on agricultural products (of 0.87 percentage points) which in 2006 equaled 17.28%, while in the industrial products it dropped from 7.68% in 2005 to 7.45 in 2006.

The increased level of energy import dependence of the Macedonian economy in 2006 (the import component of the consumption of energy in 2006 equaled 43%, as opposed to 39.5% in 2005<sup>47</sup>), in circumstances of further increase in the prices of energy products on the world markets, caused further increase in the import of energy in 2006 (of 21%) and its share in the total import of goods reached 20.2%.

Within the individual types of energy products, highest increase was registered in the import of crude oil (of 33% on annual basis), which is a combined effect of increased prices and quantities (annual increment of 17.2% and 13.5%, respectively)<sup>48</sup>. The consumption of oil, coke and natural gas in the Republic of Macedonia is fully covered from imports, having in mind that fact that the Republic of Macedonia does not have its own sources of these energy products. On the other hand, the consumption of oil derivatives, electricity and coal is to a certain extent satisfied from own production, while the production of firewood and geothermal energy is completely satisfied from own sources.

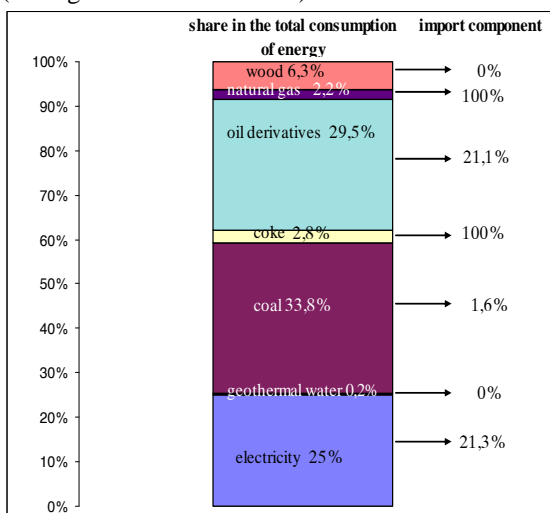
The consumption of energy per unit GDP (indicator of energy intensity) registered downward trend globally, as a result of the increased efficiency in using the energy, the increased level of substitution of the expensive fuels and the use of more cost-effective renewable sources of energy. According to this indicator, Republic of Macedonia is among the countries with relatively high consumption of energy, due to the high energy intensity of the capacities that are generators of the economic growth<sup>49</sup>.

Figure 28  
Dynamics of the imports of energy  
(in millions of euros)



Source: State Statistical Office

Figure 29  
Import component of the consumption of energy by types of energy in Republic of Macedonia  
(average from 2003 to 2006)



Source: Ministry of economy: Energy balances of Republic of Macedonia for 2004, 2005 and 2006; calculations made in NBRM

<sup>47</sup> Source: Ministry of Economy: Energy balances of the Republic of Macedonia for 2006 and 2007.

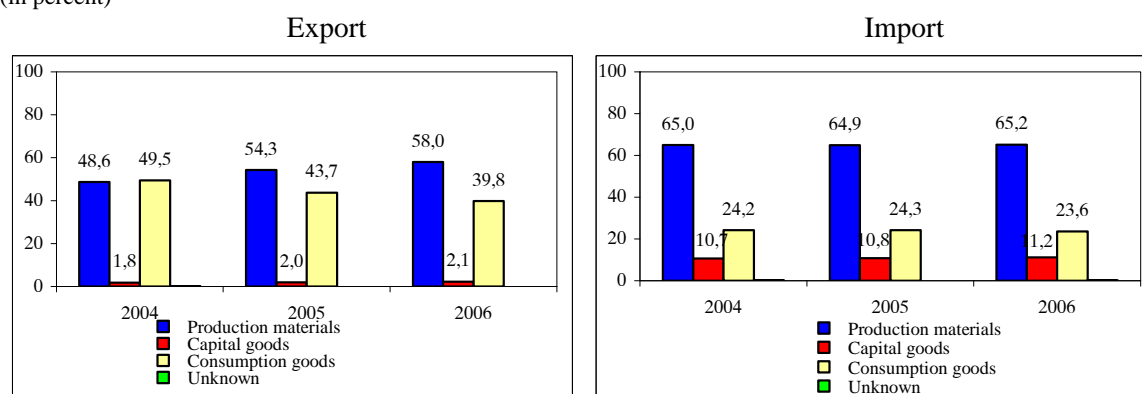
<sup>48</sup> In order to quantify the effect of the increase in the price of oil and oil derivatives on the trade deficit of the Republic of Macedonia in 2006, a simulation was made presuming that the current quantities of imported oil and derivatives and of exported oil derivatives in 2006 are realized at the average prices registered in 2004. The import and export of goods in 2006 would be lower by Euro 203.9 million and Euro 91.6 million, respectively. Consequently, the estimated net effect of the increase in the prices of oil and oil derivatives on the foreign trade balance in 2006 is deeper trade deficit by Euro 112.3 million.

<sup>49</sup> This indicator for the Republic of Macedonia in 2003 equaled 0,20 toe (ton oil equivalent) per 000 US\$, as opposed to Switzerland (0,12), Austria (0,14), Croatia (0,19), Slovenia (0,19), Romania (0,26), Bulgaria (0,34) and Serbia (0,80). Source: International Energy Agency: Energy Statistics and Energy Balances of OECD Countries 2003 - 2004 and Energy Statistics and Energy Balances of non-OECD Countries 2002 - 2003.

The increased orientation of the Macedonian economy toward less dynamic industrial branches for production and processing of raw materials at the expense of the manufacturing of final products, is confirmed with the increased presence of the production goods on the side of the exports in 2006 (by 3.7 percentage points), with a simultaneous decline in the final consumption products (of 3.8 percentage points). On the side of the imports, the increased level of dependence of the Macedonian economy in terms of technology, energy and raw materials, caused structural changes towards increased share of the means of production and production goods (by 0.4 percentage points and by 0.3 percentage points, respectively, on annual basis) and a decline in the share of consumption goods.

Figure 30

Trade in goods of the Republic of Macedonia by economic use of the products  
(in percent)

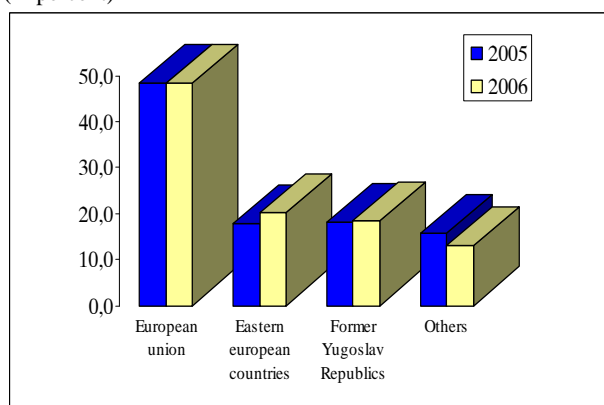


Source: State Statistical Office

Dominant currency in which the foreign trade of the Republic of Macedonia is realized is the Euro, which is present with 73.7% and 69% on the side of the exports and imports, respectively. The increased import of energy paid in US Dollars caused minor structural movements towards increased participation of the US Dollar in the total trade in goods (by 1.6 percentage points compared with the preceding year), whose share in the currency structure in 2006 equaled 28.1%.

Figure 31

Geographic distribution of the external trade of  
Republic of Macedonia  
(in percent)



Source: State Statistical Office

The geographical distribution of the foreign trade in 2006 indicates high orientation of the Macedonian economy toward the European Union, which has a dominant share in the export and import of goods (of 55.2% and 43.8%), and hence in the total foreign trade (of 48.3%). From the viewpoint of the degree of connection with the European market, the comparative analysis shows that the Republic of Macedonia lags behind the advanced economies in transition.<sup>50</sup> The high level of dependence of the Macedonian economy in terms of energy and raw materials increased the orientation towards the

<sup>50</sup> Source: Calculations in the NBRM on the basis of IMF data, Direction of Trade Statistics, March 2007. In 2003 the share of the trade with the EU in the total trade of certain countries in transition, before their admission to the EU equals: Slovakia (84%), Czech Republic (79%), Slovenia (73%), Poland (75%), Hungary (74%). On the other hand, the share of Bulgaria and Romania is lower and in 2005 it equaled 56% and 66%, respectively.



markets of the countries of Central and Eastern Europe, whose share in the total trade in 2006 went up by 2.4 percentage points on annual basis and equaled 20.2%. In 2006, the foreign trade of the Republic of Macedonia with the traditional markets of the Republics of former SFRY (excluding Slovenia) was intensive. Its share in the total trade in 2006 is higher by 0.3 percentage points on annual basis and equals 18.4%.

The analysis of the ten most important trading partners shows a relatively high concentration of the trade in goods of the Republic of Macedonia, i.e. a share of 36.8% of the traditional trading partners: Germany, Serbia and Greece, in 2006. With these countries the Republic of Macedonia realized positive trade balance, which was highest in Serbia (in the amount of Euro 218.2 million, primarily due to the increased export of oil derivatives). On the other hand, the Republic of Macedonia realized its highest deficit in the trade with Russia (in the amount of Euro 431.1 million) due to the high import of crude oil.

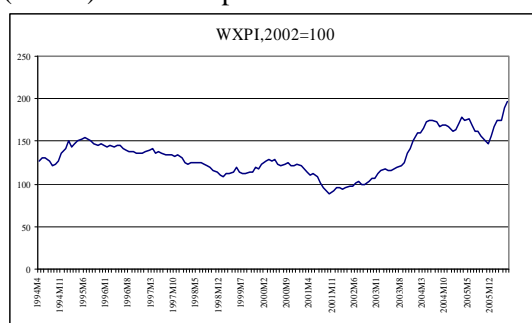
## Annex 5

### World Export Price Index-WXPI

*The World Export Price Index-WXPI* is a weighted price index the structure of which includes the indices of change of the world stock exchange prices of a certain group of raw materials (important for a country on the export side), with the normalized weighting structure being derived from the value of the export of the selected raw materials and the products the composition of which includes those primary products.

Figure 32

Movement of the World Export Price Index (WXPI) for the Republic of Macedonia



WXPI for the Republic of Macedonia is a weighted price index the structure of which includes the world stock exchange prices of the following raw materials<sup>51</sup>: cotton, tobacco, lamb, iron ore, nickel, steel products<sup>52</sup> and zinc. The normalized weighting structure was derived from the value of the Macedonian export of these raw materials and products whose composition of raw materials includes these primary products in 2005. The weighting scheme is fixed at 2005, in order the changes in the WXPI to reflect only the changes in the stock exchange prices of these raw materials. In that way the index becomes representative, as an

indicator of the favorable or unfavorable positioning of the world prices, with respect to the main Macedonian export raw materials, as well as to the products whose composition of raw materials includes these primary products.

<sup>51</sup> Data on the prices of the raw materials included in the index are originally taken from the IFS Database (Commodity prices), and pertain to the following categories: Cotton: Liverpool, Tobacco: United States, Lamb: New Zealand, Iron Ore: Brazil, Nickel: Canada and Zinc: United Kingdom, which means that the transaction prices on the markets in the countries that are the largest world producers of these raw materials, who also move the world price, are taken as reference prices.

<sup>52</sup> Prices of steel products are included through CRUs Global, which is a weighted price index whose value is calculated from the transaction prices of five types of steel products (hot-rolled coils, cold-rolled coils, hot-rolled zinc coated flat-rolled products, iron steel plated bars and steel constructions) realized at the largest consumer markets: North America, Europe and Asia. Reference regions whose transaction prices were included in the index are the central part and the western coast of North America, the German domestic price of these products and the import price of these products in the Far East.

The average world price of the main Macedonian export products (i.e. main export raw materials) measured through the **World Export Price Index** has been growing rapidly since 2002, with short periods of stagnation and decline. The level of the index in December 2006 was positioned at 213.9 index points, which is more than double compared with the average level of the index in 2002, indicating significant improvement of the world price condition regarding the main Macedonian export raw materials, as well as the products whose composition of raw materials includes these primary products. At the same time, during 2006, although with short periods of stagnation and mild decline, the index level registered significant upward movement compared with 2005 (increase of 19.5%). This indicates favorable prices of the most important export products of the Republic of Macedonia on the world markets. Except lamb, the average monthly price of which in 2006 registered a decline of 4.5% compared with the average monthly price of lamb in 2005, the average monthly prices of all other stock exchange raw materials included in the index increased significantly in 2006. Thus, the price of zinc went up by 2.4 times, of nickel by 63.3%, of iron ore by 19%, of tobacco by 9.9%, of steel products by 5.5% and of cotton by 5.2%.

The prices of some of the stock exchange raw materials comprising the index show high positive correlation with the movement of the industrial activity of the highly developed economies (such as the price of the nickel and of the iron ore). The correlation points out that the increase in the world prices, especially of nickel and of iron ore, in line with the accelerated industrial activity of the highly industrialized economies, potentially generates positive externalities for a significant part of the Macedonian export sector, primarily due to the fact that their stock exchange prices are sensitive to the increased demand on the global markets of these primary products.

Table 15

Correlation between the stock exchange prices of individual raw materials and the industrial output of the developed countries\*

STOCK EXCHANGE PRICES	INDUSTRIAL PRODUCTION
COTTON US LIVERPOOL	-0,585
IRON ORE BRAZIL (N.SEA.PORTS)	0,571
LAMB N.ZEALAND (LONDON)	0,373
NICKEL CANADA CAN/PORTS	0,545
TOBACCO US(ALL MARKETS)	-0,055
ZINC U.K.(LONDON)	0,392
GLOBAL STEEL PRICE INDEX	0,377
INDUSTRIAL PRODUCTION	1,000

Source: International Financial Statistics.

\* Correlation is calculated on the basis of monthly data on the stock exchange prices of the individual raw materials and the index of the industrial output of the developed economies in the period 1993-2006 (USA, Canada, Australia, and New Zealand).

On the other hand, the prices of those export raw materials which continue to grow on a world level even in conditions of a recession in the industrialized economies (such as the price of cotton), as well as those raw materials whose prices are not very sensitive to factors on the demand side (such as the world prices of tobacco, lamb, steel products and zinc), would potentially have a positive effect on the relevant segment of the Macedonian export sector even in episodes of recession in the highly developed countries (under the assumption that the negative influence of factors which act on the supply side are excluded, i.e. maintaining of a quality domestic production and its successful placement abroad). From a viewpoint of the trade balance, this would mean a possibility to offset one part of the potential negative effect on the Macedonian primary exports which would appear due to a recession on the markets for nickel and iron ore (caused by a reduced global demand for these raw materials), whose price is sensitive to the demand.

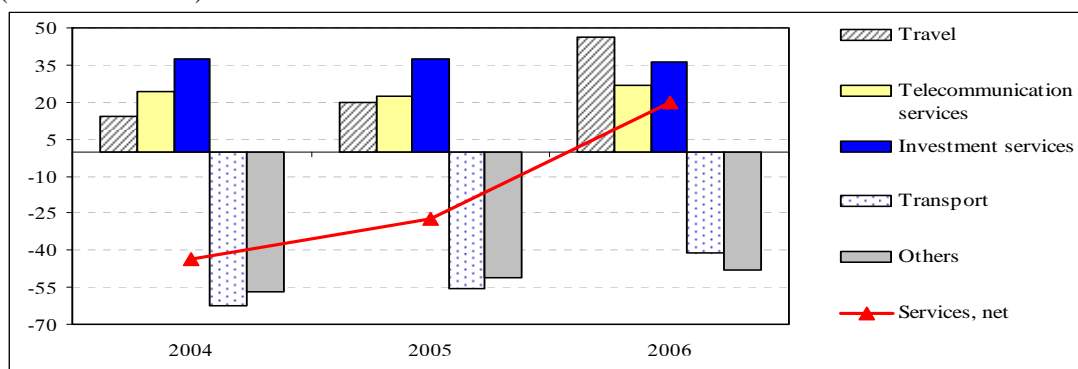


#### 2.4.1.2. Other current account components

Unlike the developments in the foreign trade in goods, in 2006, the developments in the trade in *services* had a positive contribution to the current account balance of the Macedonian economy. In circumstances of an accelerated dynamics of growth of the inflows relative to the growth of the outflows of services (of 25.4% and 12.2%, respectively), for the first time after several years of continuous trend of realized net outflows, in 2006 positive balance was registered in the amount of Euro 19.7 million. The increased net inflows from tourism - traveling (by Euro 26.6 million) had the largest contribution to such changes. Larger inflows were realized from the games of chance and from the turnover based on payment cards of non-residents, while the net outflows for business and transport services dropped (by Euro 17.6 million and Euro 14.8 million, respectively), which corresponds with the increase in the value added in the sector "transport and communications"<sup>53</sup>.

Figure 33

Dynamics of the services balance by individual category on net basis  
(in millions of euros)



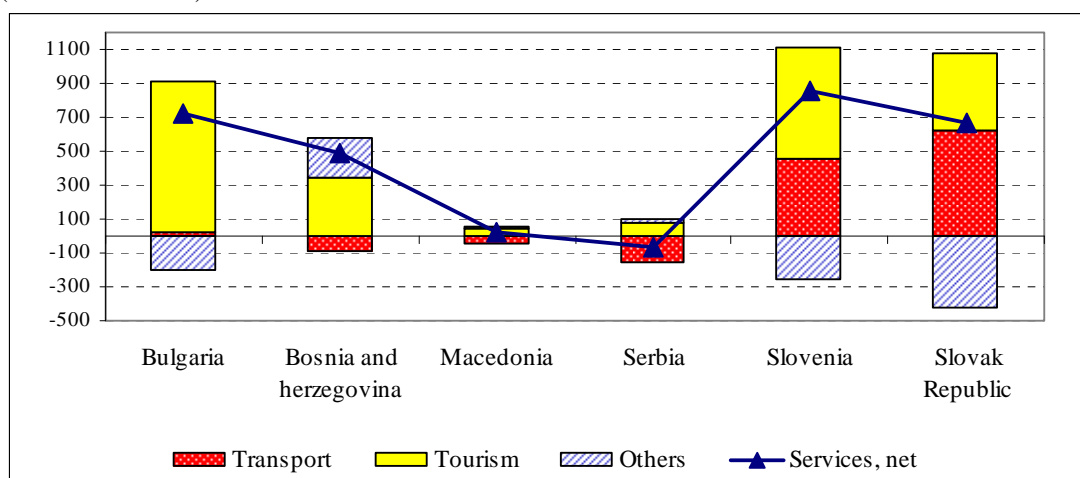
Source: National Bank of the Republic of Macedonia

The comparative analysis from a viewpoint of the balance in the balance of services shows that from among the analyzed countries (including Albania and the Czech Republic)<sup>54</sup> only Albania and Serbia registered deficit in the trade in services in 2006. Regarding the individual categories of services, all countries observed registered net inflows from tourism. Unlike Macedonia, which in spite of the decline in 2006 registered large net outflows for transport services, Slovenia, Slovakia, the Czech Republic and Bulgaria registered net inflows from this type of services. Thus, in Slovenia and in Slovakia the large net inflows from realized transport services finance 41% and 18.2% respectively, of the deficit in the trade in goods. In the category "other services", which incorporates a wide variety of services (communication, investment operations abroad, insurance, business, computer, financial, government and other types of services) positive balances were registered in Bosnia and Herzegovina, Macedonia and Serbia, in circumstances of realized net inflows from investment operations abroad and communication services. In the group of observed economies, Bosnia and Herzegovina is characterized with the largest net inflows from other services, which is due to the high presence of investment and communication services.

<sup>53</sup> According to SSO data, in 2006, increase of 6.8% on annual basis was registered.

<sup>54</sup> The Czech Republic is not presented in the Figure due to the high amounts of individual categories of services, and Albania due to non-availability of data for all categories of services.

Figure 34  
Balance of services by category of individual countries in 2006  
(in millions of euros) /<sup>1</sup>

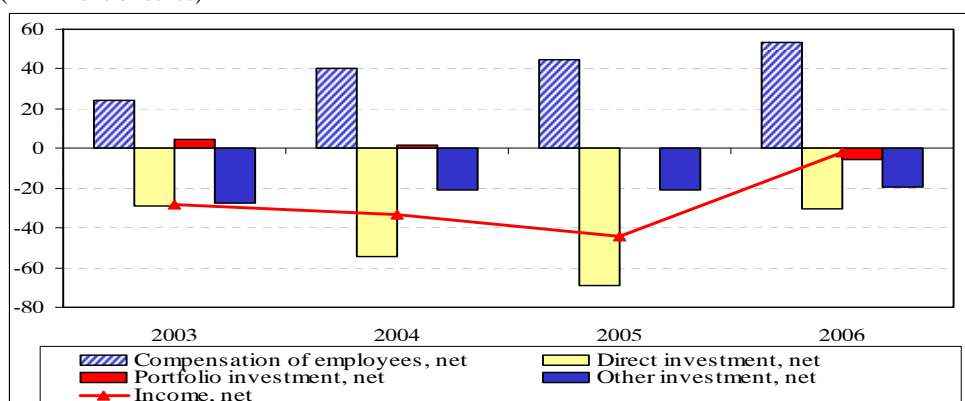


1/ For Serbia and Slovakia it is expressed in millions of US dollars

Source: National Bank of the Republic of Macedonia (on the basis of data from the web-sites of the central banks of the respective countries).

Transactions recorded in the *income sub-balance* in 2006 also acted towards reduction of the current account deficit of the Republic of Macedonia. The main factor which contributed to the realization of a significantly smaller deficit in the income balance (by Euro 42.7 million relative to 2005) was the postponed payment of a dividend to one major foreign investor. Thus, after the continuous dynamics of increase in the outflows on the basis of dividends to foreign investors in the past three years, in 2006 this category registered net outflows lower by Euro 39 million on annual basis. At the same time, in the category "income on the basis of portfolio investments" outflows in the amount of Euro 5.7 million were realized, which was primarily due to the first payment of interest in December 2006 (of Euro 7 million), on the basis of the Eurobonds issued in 2005. Simultaneously, in 2006 there was a continuation of the increasing trend in the foreign exchange inflows on the basis of compensations for employees - residents (by Euro 8.5 million on annual basis) on the one hand, while on the other there was a further decline in the net outflows of foreign exchange assets on the basis of interest (by Euro 1.3 million), in circumstances of faster increase in the inflows from interest on the official foreign reserves and on the foreign currency deposits of the commercial banks abroad relative to the increase in the interest paid to foreign creditors for the used long-term and short-term credits.

Figure 35  
Dynamics of the income balance by individual components on net basis  
(in millions of euros)



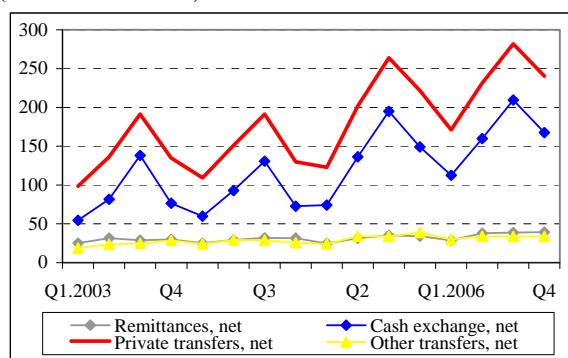
Source: National Bank of the Republic of Macedonia

In 2006, the increased inflows form *current transfers*, primarily private transfers, had the largest contribution to the decline in the balance of payments current account deficit. Although at a slower dynamics of growth, in 2006 the increased inflows of foreign assets (by Euro 114.3 million) in the form of private transfers reached 18.7% of GDP and financed 90.6% of the trade deficit of the Macedonian economy. Regarding the components, the increased net inflows on the basis of currency exchange operations had the largest contribution (of 83.1%) to the annual growth in private transfers, whereby their share in the total private transfers in 2006 reached 70.2%.

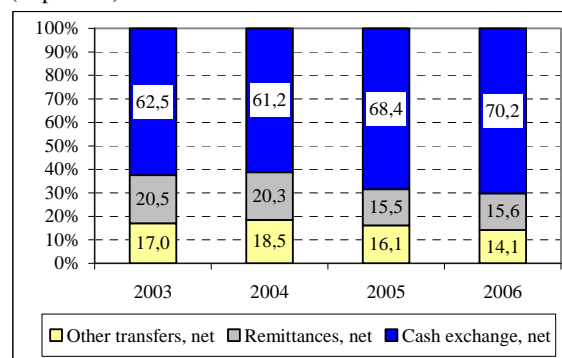
Figure 36

Dynamics and structure of private transfers by component

(in millions of euros)



(in percent)



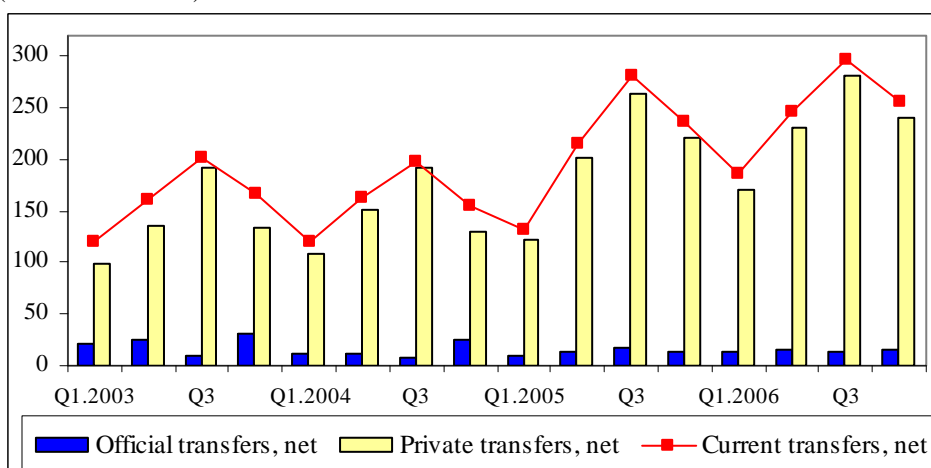
Source: National Bank of the Republic of Macedonia

Simultaneously, in circumstances of higher transfers in the form of goods and in circumstances of lower financial inflows from official donors, the total net inflows of official transfers went up on annual basis (by Euro 6.2 million). Accordingly, from a viewpoint of the structure, movements were registered towards smaller presence of assistance in the form of financial assets (share of 44.5% in 2006 as opposed to 53% in 2005 in the total official transfers).

Figure 37

Dynamics of current transfers by component

(in millions of euros)



Source: National Bank of the Republic of Macedonia

The comparative analysis of the balance in the current transfers of the analyzed countries indicates that more developed economies, which at the same time have higher level of employment (Slovakia, Slovenia and the Czech Republic) realize outflows on this basis, unlike the less developed economies (Serbia, Bosnia and Herzegovina, Macedonia, Albania and Bulgaria) which register net inflows of foreign assets in the form of current transfers, primarily private transfers.

## **Annex 6**

### **Recommendations of the IMF Technical Mission for improvement of the recording of the net purchasing of cash foreign currency from currency exchange operations**

Money transfers from workers abroad increasingly attract the attention of the international expert community, which is a result of the fact that these inflows are a significant and relatively stable category in the balance of payments in the countries with a large number of workers abroad, at the same time they are a kind of cushion for the economy against negative shocks and they are unique from the aspect of the benefits that arise for the households. Having in mind the aforementioned features, the international financial institutions show large interest in improving the recording of these inflows. In the framework of the commenced process of global consultations for improving the statistical coverage of the money transfers of emigrants, in October and in December 2006 the International Monetary Fund (IMF) sent a Technical Mission to the NBRM in order to improve internally the balance of payments statistics with respect to the category "private transfers". During the Mission the main determinants of the high level of net cash foreign currency purchased from the exchange offices in the Republic of Macedonia were identified, as part of the private transfers, and useful recommendations were obtained with respect to the following: how to continue with the efforts for obtaining data from additional sources in order to provide better coverage of the transfer of money from the Macedonian workers abroad to the home country, as well as recommendations for alternative approaches to the estimation of the undervaluation of the exports/imports in certain categories of products, and of the services related to the respective exports/imports.

It is evident that a significant portion of the net purchase of cash foreign currency by the exchange offices comes from the inflows from Macedonian workers abroad which enter the Republic of Macedonia "in cash", i.e. outside the banking system (not in the form of bank remittances and fast money transfer). At the same time, the increase in the net purchase of cash foreign currency by the exchange offices in the past few years is also a result of the following factors: (1) increased grey economy, (2) the fact that natural persons hold a significant amount of foreign savings outside the banking system, (3) double recording, to a small extent. In other words, the higher net purchase on the currency exchange market reflects not only the inflows from the Macedonian workers abroad who enter the Republic of Macedonia outside the banking system, but also other categories of transactions between residents and non-residents who, according to the *Balance of Payments Manual, fifth edition* of the IMF, should be recorded as export/import of goods, services, or as some other type of current transfer (i.e. categories in the balance of payments current account), or as a capital transfer in the balance of payments capital account.

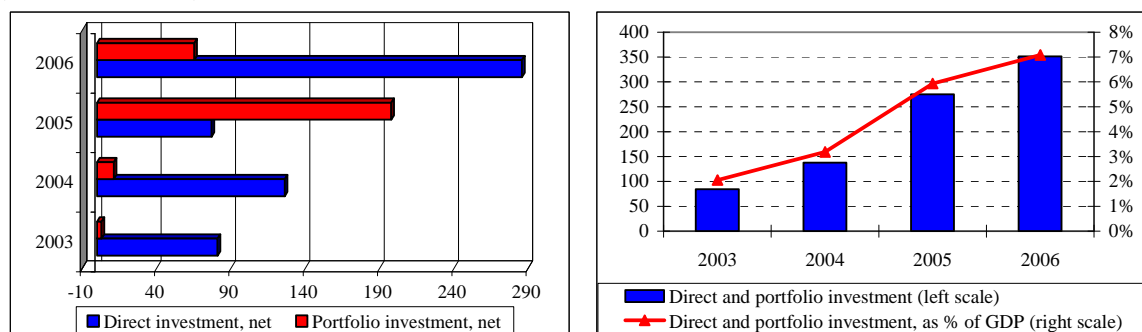
We point up the following recommendations which could be used in the efforts of the NBRM for improvement of the recording of the money transfer of the Macedonian workers abroad:

- Adequate reviewing of the questionnaire which is an integral part of the Survey on the Consumption of the Households in the Republic of Macedonia, conducted by the State Statistical Office with additional questions which would be useful for the balance of payments statistics;
- Adequate supplementing of the Labor Force Survey, conducted by the State Statistical Office in order to identify the type of absence of family members - information which could contribute to improve the quality of the assessment of the number and the scope of the money transfers from the workers abroad;
- Having in mind the fact that there is no systematic recording of the emigrants, and in order to improve the recording of the money orders of the Macedonian workers abroad, it would be of special importance to introduce a Survey which would provide reasonable explanations for the instruments, i.e. manners of transferring money to the home country, as well as the aim, i.e. the purpose of the money orders. NBRM intends to conduct such a Survey during 2007;
- Undertaking of measures for improvement of the valuation of the export of agricultural products, which would include correction in the exports of this category of products and in the transport services related to these exports.

### 2.4.1.3. Capital and financial account

In 2006, smaller net inflows of capital (by Euro 61.6 million) were realized in the **capital and financial account** of the balance of payments of the Republic of Macedonia. Such a dynamics is primarily a result of the repayment of the total debt to the London Club of Creditors in January 2006 with the foreign currency inflows from the Eurobonds issued in December 2005, when in the category loans, net outflows in the amount of Euro 21.3 million were registered (as opposed to the net inflows in the period 2003-2005). On the other hand, in 2006, a significant inflow on the basis of foreign direct investments was registered (primarily as a result of the privatization of the Electricity Supply Company of Macedonia - "ESM - Distribucija" in March 2006 in the amount of Euro 225 million), whereby their share in the GDP reached 5.8%. Having in mind this investment, the analysis from the viewpoint of the allocation of the foreign investments by activity indicates that in 2006, high level of concentration in the energy was registered (share of 76.9%), followed by production and trade (6.4% and 5.6%, respectively), while regarding the countries, the largest portion of the investments are from Austria (78.1%). At the same time, in conditions of increased interest of foreign investors in purchasing equity instruments, Macedonian companies registered further inflow on the basis of portfolio investments (increment of Euro 28.5 million, if the effect from the issued Eurobonds in the amount of Euro 149.2 million and the inflows from EBRD for the pre-privatization of the ESM in the amount of Euro 11.8 million in 2005 is excluded), whereby their share in the GDP in 2006 equaled 1.3%. Portfolio investments came mainly from Slovenia and Croatia. Accordingly, the structure of the financing in 2006 registered positive changes directed towards an increase in non-debt financing at the expense of foreign borrowings.

Figure 38  
Dynamics of direct and portfolio investments <sup>1/</sup>  
(in millions of euros)



1/ In 2005 with the inflows from the Eurobonds.  
Source: National Bank of the Republic of Macedonia

The favorable developments in the individual current and capital-financial transactions in 2006, resulted in a further increase in the foreign assets in the country. Gross official reserves of the Republic of Macedonia went up by Euro 297.6 million on annual basis<sup>55</sup>. At the same time, the category "currencies and deposits" registered increase in the assets on net basis (in the amount of Euro 83.7 million), which is primarily due to the increase in the foreign assets of the households by Euro 67.6 million (primarily cash withdrawn on the basis of fast money transfer, which reached Euro 62.5 million in 2006). At the same time, the assets of commercial banks went up by Euro 10.4 million on a net basis.

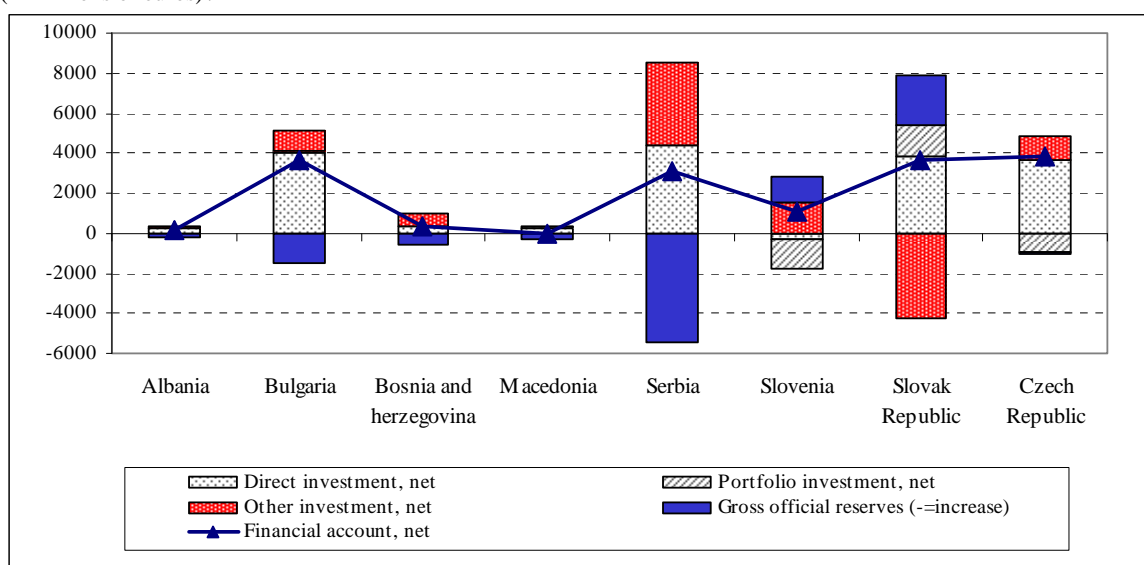
<sup>55</sup> The data on the gross official reserves showed in the balance of payments is different from the data on the gross foreign reserves of the country, as in the balance of payments statistics the cross-currency differences and the monetary gold are excluded.

The comparative analysis from a viewpoint of the balance on the capital and financial account shows that in 2006 all analyzed countries registered net inflows of financial assets. Regarding the financing structure, in 2006, countries attractive for the foreign capital in the form of direct investments were Bulgaria, Serbia, Slovakia and the Czech Republic. Simultaneously, although to a smaller extent, Bosnia and Herzegovina, Macedonia, and Albania registered net inflows of foreign direct investments. On the other hand, only Slovenia registered net outflows of foreign investments in 2006, which is a result of the twice larger outflow of capital in the form of direct investments abroad compared with the investments in the country. The capital flows in the form of portfolio investments were primarily directed toward the more developed economies which have entirely liberalized these capital flows, and at the same time have more developed financial markets and diversified forms of financial instruments. Leading country in this area is Slovakia, which registered net inflows of capital in the form of portfolio investments, and on the other hand Slovenia and the Czech Republic which realized net outflows of portfolio investments in 2006. Investment in diversified forms of financial derivatives was present in Slovenia, Slovakia, and the Czech Republic, which registered net outflows of capital in 2006. On the other hand, financing in a classical form through foreign borrowing created significant inflows of capital in Serbia, Slovenia, the Czech Republic, Bosnia and Herzegovina, Bulgaria, and Albania, while Slovakia and Macedonia registered net outflows of capital. In conditions of a smaller surplus in the capital and financial account and larger current account deficit, the gross foreign reserves of Slovakia and Slovenia declined in 2006.

Figure 39

Balance and components of the financial account of individual countries in 2006

(in millions of euros) /<sup>1</sup>



1/ For Serbia and Slovakia it is expressed in millions of US dollars. The category "other investments, net" is an aggregate presentation of loans (long-term and short-term), currencies and deposits and financial derivatives.

Source: National Bank of the Republic of Macedonia (on the basis of data from the web-sites of the central banks of the respective countries).

## Annex 7

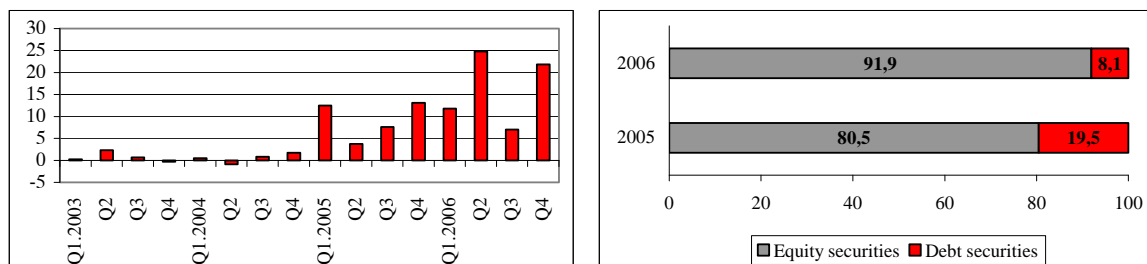
### Portfolio investments of non-residents

Macedonian economy is gradually being integrated in the international capital flows. The liberalization of the capital movement, envisaged in the Stabilization and Association Agreement with the EU (April 2001), is being carried out in two stages. With the enforcement of the new Law on Foreign Exchange Operations in October 2002, foreign direct investments, portfolio investments of non-residents and the international credit transactions have been fully liberalized. In spite of the liberalization, the inflows from portfolio investments are relatively low, and the trend of larger

foreign exchange inflows from abroad on the basis of portfolio investments started in 2005<sup>56</sup>. The still low inflows on the basis of portfolio investments could be partially explained with the shallow financial market, the small variety of financial instruments, and the perceptions of foreign investors. On the other hand, the candidate status of the Republic of Macedonia within the process of Euro-integration from 2005 and the favorable credit rating are factors which acted toward increasing of the attractiveness of the domestic financial market for the foreign investors in the past two years.

Figure 40

Nat inflows on the basis of foreign investments in the country and their structure  
(in millions of euros) (in percent)



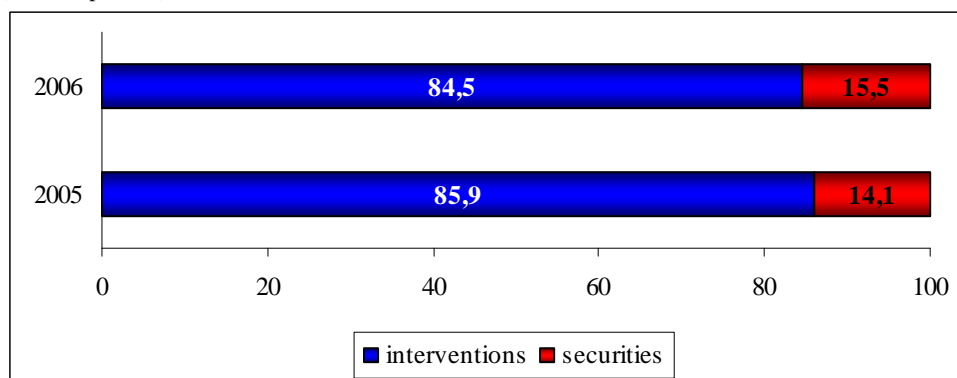
\* Inflows from the Eurobonds and inflows from the EBRD are not included.

Source: National Bank of the Republic of Macedonia

With respect to the portfolio investments on non-residents, the legislation envisages certain procedures for the foreign investors. Thus, when purchasing securities<sup>57</sup>, the non-resident is obliged to open a *custodian account* with the authorized bank where they should pay in the funds for their purchasing. At the same time, the non-resident may choose an option to withdraw the invested funds within one year and in that case *the bank is obliged for the amount of the securities on the custodian accounts to purchase rights with the NBRM for securing of foreign assets for which premium is paid*, which is an expenditure for the investor. The foreign currency purchased by the NBRM on the basis of securities, i.e. on the basis of portfolio investments which may be sold without time restriction stood at Euro 37.4 million in 2006, while in the previous year they amounted to Euro 22.1 million, so that their share in the total interventions in these two years was relatively stable.

Figure 41

Foreign exchange transactions of the NBRM with the commercial banks  
(share in percent)



Source: National Bank of the Republic of Macedonia

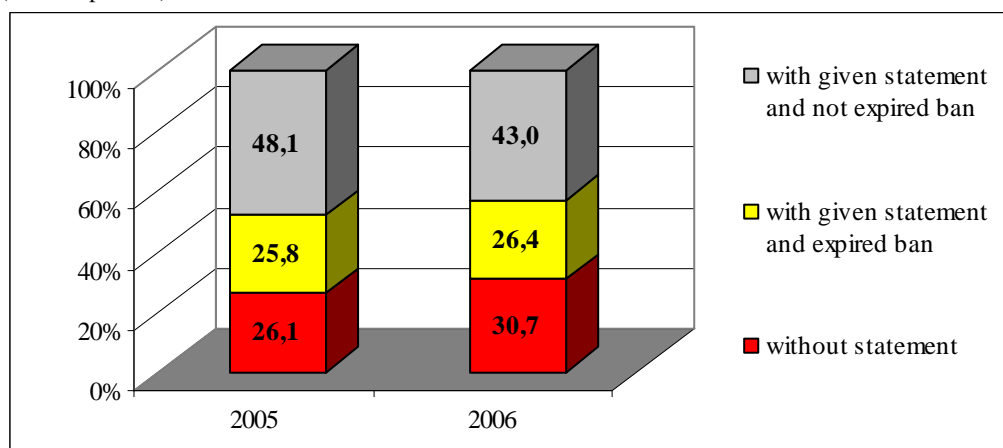
<sup>56</sup> In 2005, the inflows were in the amount of Euro 198 million, but if the inflows from the Eurobonds and the inflows from the EBRD on the basis of the pre-privatization of the ESM are excluded, they amount to Euro 36.9 million, and in 2006 they stood at Euro 65.5 million.

<sup>57</sup> Securities encompass debt securities, equity instruments (less than 10% of the equity of the shareholding company) and derivatives.



The analysis of the structure of the custodian accounts opened on the basis of portfolio investments could give indications about the stability of the investments and the short-term perceptions of the investors, as well as about the potential demand for foreign currency on the basis of outflow of capital from previously realized portfolio investments. Thus, the structure of the custodian accounts is dominated by investments accompanied by a statement for non-selling of the securities in a period shorter than one year (43% on average in 2006). At the same time, 26.4% of the investments are with an expired statement (and their share is relatively stable), but the investments are not sold. Although such a structure could be expected in circumstances when equity instruments are the dominant type of portfolio investments, *still this is an indicator of stable expectations of the investors. The potential demand for foreign currency within a year*, in order to have outflow of foreign capital from the country, could be estimated on the basis of the amount of the investments without a statement and the investments with an expired statement, as an amount of foreign currency which may at any time, without restrictions flow out of the domestic economy. At the end of 2006, such an estimated potential demand stood at Euro 63.7 million. At the end of 2005 this amount was Euro 38.9 million, which is a relatively small amount, compared with the total foreign exchange inflows in the economy.

Figure 42  
Structure of the custodian accounts  
(share in percent)



Source: National Bank of the Republic of Macedonia

#### 2.4.2. External debt of the Republic of Macedonia<sup>58</sup>

The changes in the external debt of the Macedonian economy in 2006 were to a large extent under the influence of the strategy for reducing the external public debt and improving its structure. Thus, as of December 31, 2006 the total foreign debt of the Republic of Macedonia stood at Euro 1,830.5 million, which is an annual decline in the amount of the external debt of Euro 97.8 million and it is due to the larger amount of repaid liabilities than the amount of used funds, so that in the beginning of 2006 the debt to the London Club of Creditors was fully repaid. On the other hand, the external debt of the private sector went up which indicates increased utilization of the external sources for financing the needs of the domestic entities. Basic indicators of external debt show that the country remains in the zone of low, i.e. moderate indebtedness, which creates positive perceptions for the economy as a whole.

<sup>58</sup> Preliminary NBRM data.



Table 16

## Indicators for the level of indebtedness of the Republic of Macedonia

Indicators	31.12.2001	31.12.2002	31.12.2003	31.12.2004	31.12.2005*	31.12.2005	31.12.2006
Total external debt/GDP							
(criterion: moderate indebttness 30-50%)	45,5%	40,3%	37,0%	36,9%	40,8%	44,3%	39,5%
Total external debt/Export							
(criterion: lower indebttness 0-165%)	107,8%	98,7%	98,3%	99,6%	102,9%	111,6%	90,4%
Debt servicing/Exports of goods and services							
(criterion: lower indebttness 0-18%)	14,7%	15,7%	14,9%	13,0%	11,0%	11,0%	20,5%
Repayment of interest/Exports of goods and services							
(criterion: lower indebttness: 0-12%)	4,4%	3,6%	3,2%	2,5%	2,6%	2,6%	3,2%

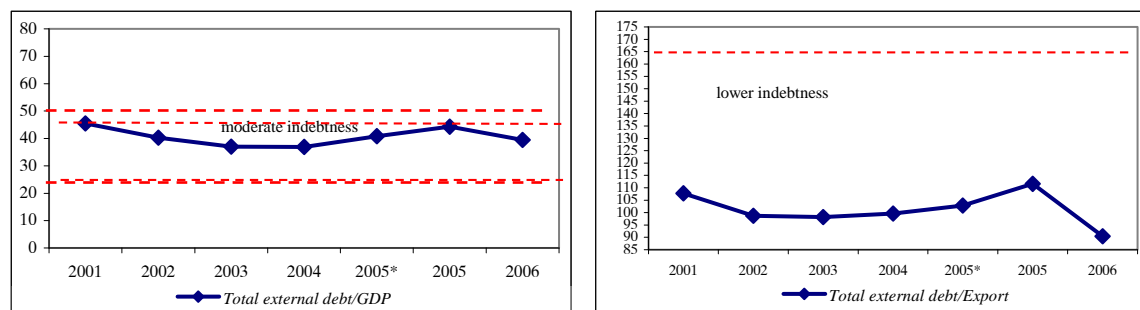
\* The total foreign debt as of December 31, 2005 was calculated excluding the Eurobonds.

Source: National Bank of the Republic of Macedonia

The indicators for the level of indebtedness for 2006<sup>59</sup> show that according to two indicators (total foreign debt, expressed as a percentage of the gross domestic product, and the ratio between debt servicing and the average export of goods and services) the Republic of Macedonia is in the group of moderately indebted countries. Change relative to the preceding year is registered in the indicator "debt servicing / export of goods and services", which is deteriorating and has entered the zone of moderate indebtedness. This change is primarily due to the increase in the amount of the debt serviced (one-time full repayment of the debt to the London Club of Creditors), i.e. the more intensive growth rate of the serviced debt than of the export of goods and services. Hence, this change in the indicator reflects the early debt repayment, in accordance with the strategy for gradual reduction of the external debt. According to the other two indicators, i.e. according to the total external debt expressed as a percentage of the average export of goods and services in the last three years and according to the ratio of interest repayment to the average export of goods and services in the last three years, our country is classified in the group of less indebted countries.

Figure 43

Total external debt / GDP and total external debt / export of goods and services  
(in percent)



\* The total foreign debt as of December 31, 2005 was calculated excluding the Eurobond.

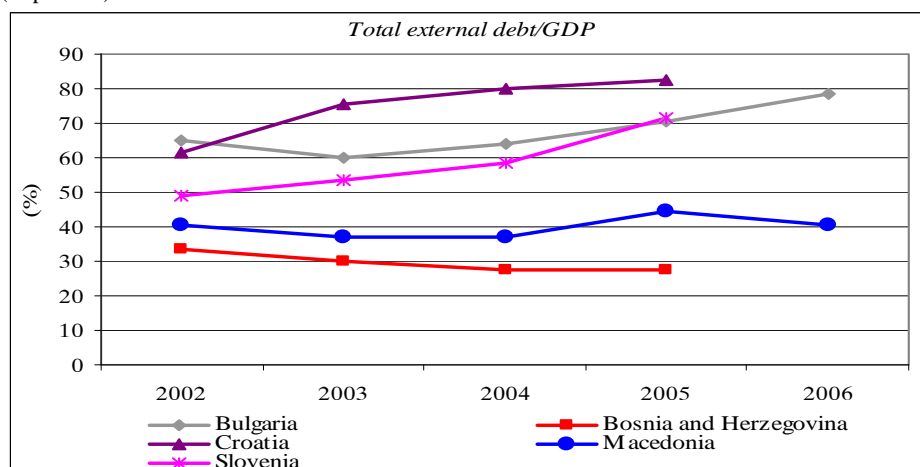
Source: National Bank of the Republic of Macedonia

The comparative analysis of the share of the total external debt in the gross domestic product of individual countries in transition indicates that the Republic of Macedonia, according to this indicator has a lower level of indebtedness compared with Bulgaria, Croatia, and Slovenia. With the full repayment of the debt to the London Club of Creditors and its maturity restructuring to 10 years, with the issuing of the first Eurobonds and the preparation for repayment of the debt to the Paris Club of Creditors (which is treated as a debt with unfavorable conditions), steps have been undertaken towards further decline and improvement of the external debt structure.

<sup>59</sup> Calculation of the NBRM according to the World Bank methodology.

Figure 44

Share of the total external debt in the gross domestic product  
(in percent)



\* In the total debt of Bosnia and Herzegovina the debt of the private sector is excluded.

Source: web-sites of the central banks of the respective countries, the calculations were made in the NBRM.

#### 2.4.2.1. Debt structure

The analysis of the maturity structure of the external debt indicates dominant share of the long-term liabilities with 97.4%, while the remaining 2.6% are liabilities on the basis of short-term credits.

Table 17

External debt of the Republic of Macedonia

	As of 31.12.2006 in millions of Euros	Structure (in %)	Annual change in millions of Euros	(in %)
Long term external debt	1.782,5	97,4	-66,6	-3,6
Short term external debt	48,0	2,6	-31,2	-39,4
<b>Total external debt</b>	<b>1830,5</b>	<b>100,0</b>	<b>-97,8</b>	<b>-5,1</b>

Source: National Bank of the Republic of Macedonia

At the end of 2006, long-term credits and loans (liabilities of residents to non-residents on the basis of credits and loans with maturity exceeding one year) registered a decline of Euro 66.6 million relative to the end of the preceding year, and stood at Euro 1,782.5 million. The decline in the liabilities on the basis of long-term

debt is a result of the reduced liabilities of the public sector - central government (full repayment of the debt to the London Club of Creditors), which was to a large extent offset with the increase in the debt of the private sector (primarily the non-banking private sector).

Table 18

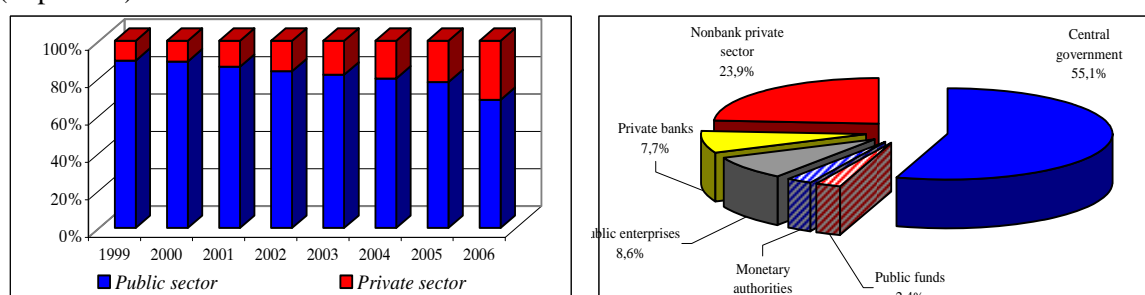
External debt structure

	As of		Changes		Structure	
	31.12.2005	31.12.2006	31.12.2006 / 31.12.2005		31.12.2005	31.12.2006
	(in milions of Euros)		in absolute amount	(in %)	(in %)	
<b>From the aspect of debtors</b>						
Public sector	1.441,2	1.220,4	-220,8	-15,3	77,9	68,5
Private sector	407,9	562,1	154,2	37,8	22,1	31,5
<b>From the aspect of creditors</b>						
Multilateral creditors	891,7	881,6	-10,2	-1,1	48,2	49,5
Bilateral creditors	174,0	166,4	-7,6	-4,4	9,4	9,3
Private creditors	783,3	734,5	-48,8	-6,2	42,4	41,2
<b>Long term credits and loans</b>	<b>1.849,1</b>	<b>1.782,5</b>	<b>-66,6</b>	<b>-3,6</b>	<b>100,0</b>	<b>100,0</b>
<b>Short term credits</b>	<b>79,2</b>	<b>48,0</b>	<b>-31,2</b>	<b>-39,4</b>		
<b>TOTAL:</b>	<b>1.928,3</b>	<b>1.830,5</b>	<b>-97,8</b>	<b>-5,1</b>		

Source: National Bank of the Republic of Macedonia

The analysis of the long-term credits and loans according to debtors still indicates an upward trend in the debt of the private sector, at the expense of the external public debt. Although the share of the debt of the private sector in the total external debt is relatively low, its increase from 10.5% in 1999 to 31.5% in 2006 indicates a gradually growing contribution of the private sector in the external debt. Such developments were expected, having in mind the gradual liberalization of the capital flows, the favorable rating of the country, and hence better access to the capital market, as well as the entrance of foreign investments which usually accelerate the integration in the international financial flows. The largest portion (75.7%) of the debt of the private sector pertains to the liabilities of the non-banking private sector. Dominant portion of the public external debt (55.1% of the long-term debt) pertains to the liabilities of the central government, primarily the credits taken from the International Development Association (IDA) and the International Bank for Reconstruction and Development (IBRD).

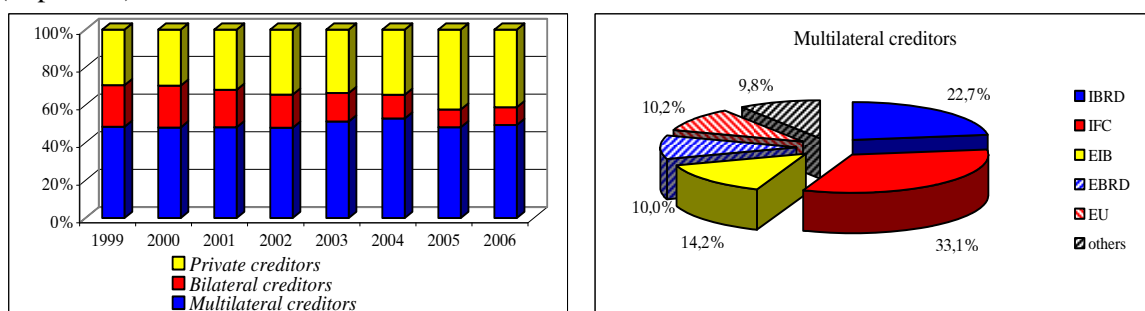
Figure 45  
Structure of the long-term debt by debtor  
(in percent)



Source: National Bank of the Republic of Macedonia

In 2006, no significant structural changes were registered in the external debt structure, regarding the creditors. Thus, multilateral creditors are dominant, followed by the private and bilateral creditors (49.5%, 41.2%, and 9.3%, respectively).

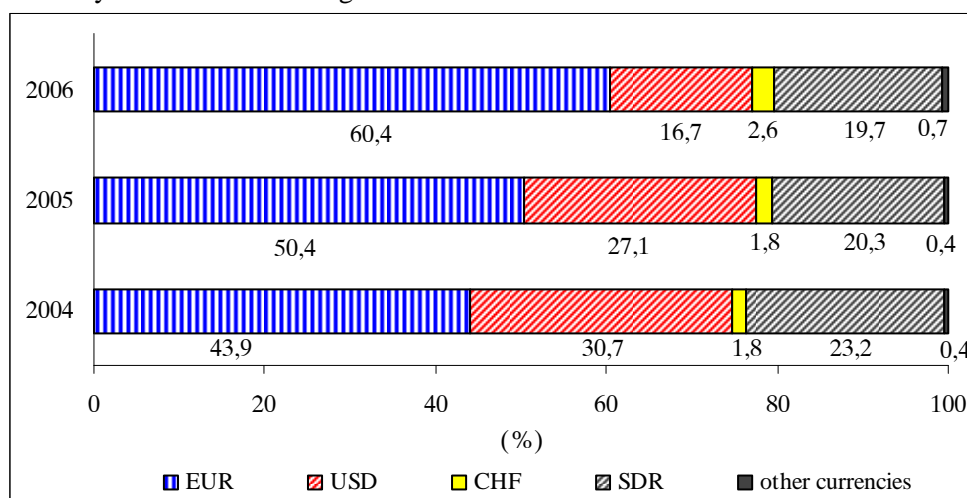
Figure 46  
Structure of the long-term debt by creditor  
(in percent)



Source: National Bank of the Republic of Macedonia

The structure of the debt to the *multilateral creditors* indicates dominant share of the International Development Association (33.1%) and the International Bank for Reconstruction and Development (22.7%). With respect to the *bilateral creditors*, almost equal distribution was registered among the rescheduled debt to the Paris Club of Creditors (4.4% in the total long-term debt) and the newly-concluded credits on a bilateral basis which had a share of 4.6% in the total long-term debt, at the end of 2006. In the group of *private creditors*, largest creditors were the banks and the non-banking private sector with a share of 15.8% and 17% in the total long-term debt, respectively.

Figure 47  
Currency structure of the long-term debt



Source: National Bank of the Republic of Macedonia

The currency of denomination structure of the long-term debt registered changes in terms of increasing the share of the debt denominated in Euros, which in 2006 equaled 60.4% or by 10 percentage points more relative to 2005. The remaining portion of the debt is primarily expressed in special drawing rights (19.7%), while the debt denominated in US Dollars equals 16.7%.

As of December 31, 2006, short-term external credits of the Republic of Macedonia (credits with maturity of up to one year) stood at Euro 48 million, which is a decline of Euro 31.2 million on annual basis, and is primarily due to the restructuring of the short-term credits into long-term credits with individual private enterprises. Regarding the short-term debt, which entirely pertains to the private sector, 99.6% are in the form of loans, while the remaining portion are commercial credits.

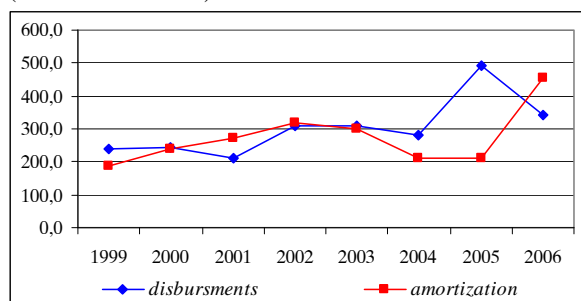
#### 2.4.2.2. Registered movements in 2006

The decline in the withdrawn funds, compared with the amount of the repaid liabilities, led to an annual decline in the total external debt. Thus, in 2006 the total withdrawn funds dropped by Euro 150.9 on annual basis and totaled Euro 340.7 million. Regarding their maturity, Euro 48.2 million were withdrawn on the basis of short-term credits and loans, while the withdrawals based on long-term credits and loans amounted to Euro 292.5 million. Compared with 2005, long-term used funds went down by 31.1%, which is a result of the higher comparison basis from the preceding year, which arises from the one-time withdrawal of funds obtained from the issuing of the first Eurobonds (Euro 150 million). If the effect from the Eurobonds is isolated, the funds withdrawn grew by 6.6%. In 2006, the use of short-term credits was reduced by Euro 19 million compared with the preceding year, with 90.9% of the withdrawals being made by the private sector, in the form of loans.

The analysis *by creditor* indicates maintained trend of dominant withdrawal of funds from private creditors (71.2%), while the share of multilateral and bilateral creditors is 19.7% i.e. 9.1%.

Figure 48

Total disbursements and amortization  
(in millions of euros)



Source: National Bank of the Republic of Macedonia

The structure of withdrawals *with respect to debtors*, shows that the private sector is dominant in using the long-term credits with 70.5% the largest part of which (52.2%) are intended for the non-banking private sector. The remaining 29.5% pertain to the public sector and they are presented in the following Table, according to the approved credit lines.

Table 19

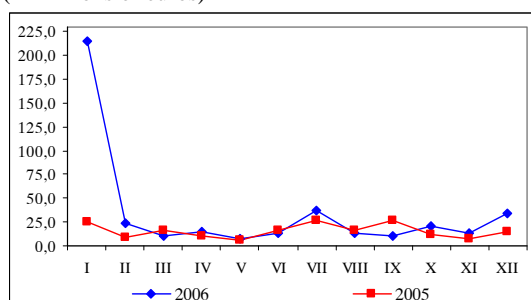
Withdrawn funds on the basis of extended credit lines in 2006

Withdrawn funds on the basis of long term credits and loans in 2006	Amount	Structure of disbursements in the public sector
	in millions of Euros	share in %
<b>PUBLIC SECTOR</b>	<b>86,4</b>	<b>100,0</b>
<i>Official creditors</i>	<i>65,1</i>	<i>75,4</i>
<i>Multilateral creditors</i>	<i>53,7</i>	<i>62,2</i>
<b>I. IBRD</b>	<b>8,9</b>	<b>10,4</b>
Project for reconstruction of the irrigation system	2,4	2,8
Project for implementing social security	1,6	1,9
Financing construction of power plants	2,2	2,6
Project for implementing reforms in the legal and judicial system	1,0	1,2
Others	1,7	1,9
<b>II EBRD</b>	<b>19,0</b>	<b>22,0</b>
Road project	11,1	12,9
MEAP	2,4	2,8
Project for reconstruction of the Ohrid airport	2,7	3,1
Power transmission project - MEPSO	2,8	3,2
<b>III IDA</b>	<b>4,3</b>	<b>5,0</b>
Community development and culture project	1,8	2,0
Municipalities development project	1,4	1,6
Others	1,2	1,4
<b>IV IFAD</b>	<b>2,3</b>	<b>2,6</b>
Rural development project	0,5	0,6
Project for financial services in agriculture	1,8	2,0
<b>V EIB</b>	<b>12,5</b>	<b>14,5</b>
Substation project	7,5	8,7
Roads project II	5,0	5,8
<b>VI CEDB</b>	<b>6,7</b>	<b>7,8</b>
Construction of social flats projects	1,7	2,0
Social support for new employments project	5,0	5,8
<i>Bilateral creditors</i>	<i>11,4</i>	<i>13,2</i>
Newly concluded credits	11,4	13,2
Project Lisice-ICO Spain	3,0	3,5
Project Zletovica	2,8	3,2
Project for reconstruction of the irrigation system-KFW	3,2	3,7
Others	2,5	2,8
<i>Other private creditors</i>	<i>21,3</i>	<i>24,6</i>
AD ELEM	21,0	24,3
PE Zelenilo i Cistota Kumanovo	0,2	0,3
<b>PRIVATE SECTOR</b>	<b>206,1</b>	
<b>TOTAL</b>	<b>292,5</b>	

Source: National Bank of the Republic of Macedonia

Total paid liabilities in 2006 rose by Euro 245 million, whereby the servicing of the debt to foreign creditors on the basis of the total used credits stood at Euro 455.6 million in 2006, of which Euro 413.7 million were paid on the basis of long-term credits (of which Euro 349 million are principal), and the remaining Euro 41.9 million are paid liabilities on the basis of the short-term debt (the principal is in the amount of Euro 40.9 million). The dynamics of the monthly debt servicing in 2006, except for the first month is not different from the dynamics in 2005. In 2006, largest repayments were registered in January due to the full repayment to the London Club of Creditors, in July due to the regular repayment of the debt to the Paris Club of Creditors and repayments of the non-banking private sector to the private creditors, and in December, as a result of repayments of the private sector.

Figure 49  
Debt servicing dynamics\*  
(in millions of euros)



\* Calculated according to the methodology of the World bank  
Source: National bank of the Republic of Macedonia

Relative to 2005, long-term paid liabilities registered an increase of Euro 225.1 million, with the full repayment of the debt to the London Club of Creditors being the main factor of the growth. The analysis of the paid liabilities *regarding the creditors* indicates that the largest portion of the liabilities (77.7%) was repaid to the private creditors, while 45.6% of them pertain to the London Club of Creditors. *Regarding the debtors*, the largest part of the debt (72.6%) was serviced by the public sector, i.e. the central government. Relative to the preceding year, repaid liabilities on the basis of short-term credits were higher by Euro 19.9 million in 2006.

Table 20  
Used funds and repaid liabilities

	<i>Disbursements</i>				<i>Amortization</i>			
	2005	2006	2005	2006	2005	2006	2005	2006
	in millions of Euros		structural share %		in millions of Euros		structural share %	
<i>From the aspect of debtors</i>								
Public sector	255,1	86,4	60,1	29,5	104,6	300,3	55,5	72,6
Private sector	169,3	206,1	39,9	70,5	84,0	113,3	44,5	27,4
<i>From the aspect of creditors</i>								
Multilateral creditors	120,3	57,7	28,4	19,7	58,9	60,7	31,2	14,7
Bilateral creditors	9,2	26,5	2,2	9,1	39,3	31,6	20,8	7,6
Private creditors	294,8	208,3	69,5	71,2	90,4	321,4	48,0	77,7
<i>Long term credits and loans</i>	<b>424,4</b>	<b>292,5</b>	<b>100,0</b>	<b>100,0</b>	<b>188,6</b>	<b>413,7</b>	<b>100,0</b>	<b>100,0</b>
Loans	66,3	48,2	98,6	100,0	21,9	41,7	99,6	99,5
Commercial credits	0,9	0,0	1,4	0,0	0,1	0,2	0,4	0,5
<i>Short term credits</i>	<b>67,2</b>	<b>48,2</b>	<b>100,0</b>	<b>100,0</b>	<b>22,0</b>	<b>41,9</b>	<b>100,0</b>	<b>100,0</b>
<b>TOTAL:</b>	<b>491.6</b>	<b>340.7</b>			<b>210.6</b>	<b>455.6</b>		

Source: National Bank of the Republic of Macedonia

Credits concluded in 2006 were lower by Euro 77.7 million on annual basis and stood at Euro 413 million. Of the total amount of newly-concluded credits, 81.8% pertain to long-term credits, while the remaining portion are short-term credits. Concluded long-term credits and loans pertain to the following creditors and projects:

- European Bank for Reconstruction and Development extended two credits for Projects for financing of small businesses in the amount of Euro 60 million;
- the International Bank for Reconstruction and Development extended a credit in the amount of Euro 30 million for the Project for reforms in the railways, the Project for reforms in the judiciary and for financing the construction of power stations;

- the European Investment Bank extended funds in the amount of Euro 10 million for the Project for financing of small businesses;
- Other foreign private creditors extended funds for the Project for construction of hydroelectric power plants - ELEM in the amount of Euro 41 million.

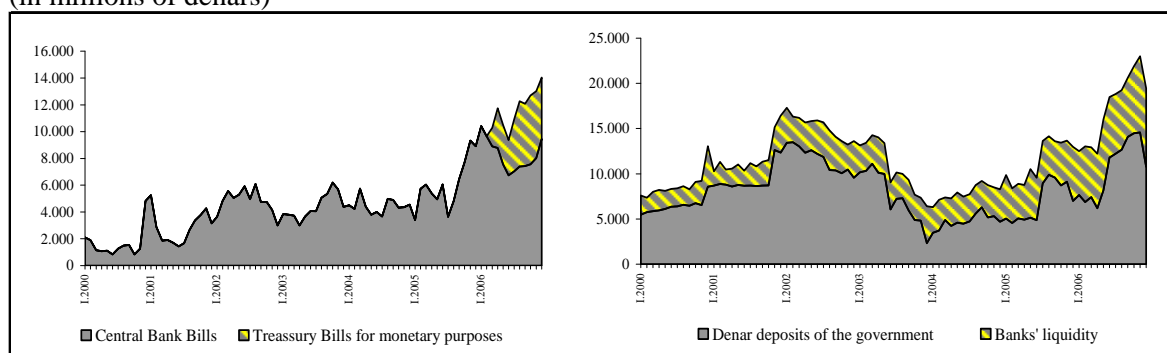
The newly-extended short-term credits almost entirely pertain to credits extended to the non-banking private sector in the form of loans.

## 2.5. Fiscal policy

The disciplinary fiscal policy and the active monetary and fiscal coordination, underlying the macroeconomic stability were typical for the Macedonian economy in 2006. Thus the budget deficit in 2006 equaled 0.6%, and the coordination between the two policies was illustrated by introducing treasury bills for monetary purposes (in March), as a new monetary policy instrument. In this year, the NBRM account accumulated considerable amount of Denar government funds, thus being a significant support of the NBRM policy for sterilizing the excess liquidity, created through the interventions on the foreign exchange market.

Figure 50

Banks' liquidity regulation instruments, government Denar deposits and banks' liquidity  
(in millions of denars)



Source: NBRM

Having a change in the initial presumptions, the Budget Revision was adopted in November<sup>60</sup>. The amendments to the Budget of the Republic of Macedonia for 2006, i.e. the respective impairment of the revenues and the expenditures were based on the following presumptions: higher generation of certain tax revenues; expected higher amount of dividend from AD Macedonian Telecommunications; inclusion of the compensations from additional tobacco production and trade taxes, which were not included in the initial budget projections; inclusion of the effect of the new legislative solution for decreasing the value added tax for agricultural raw materials, adopted on September 26, 2006 (entered into force on October 1, 2006); substantial inflows from privatization, enforcement of executive court decisions on payments charged to the Budget of the Republic of Macedonia; admission of many insured to the private pension funds and securing financial assets to address the energy problem.

Analyzing the government budget components<sup>61</sup>, at the end of 2006, the public revenues amounted to Denar 104,078 million cumulatively, i.e. 95.5% of the planned inflow for the year, whereas the total public expenditures reached Denar 105,782 million, making up 94.9% of the

<sup>60</sup> Source: "Official Gazette of the Republic of Macedonia" no. 120/2006.

<sup>61</sup> The analysis lays on the consolidated government budget that incorporates the central government budget and the funds.

planned government spending. Hence, the government budget, given the unpaid dividend from AD Macedonian Telecommunications, registered a deficit in the amount of Denar 1,704 million, which is 0.6% of the GDP<sup>62</sup>, thus fulfilling the deficit projection for 2006 (compared to the expected deficit of 0.8% of GDP after the budget revision). The comparison with the Southeast European countries shows that the low budget deficits and surpluses over the last years in the Republic of Macedonia (except for 2001 and 2002 due to the security crisis) indicate a restrained fiscal policy compared to most countries in the region (other than Bulgaria, which registered a surplus over most of the years, and Serbia registering a surplus over the last three years).

Table 21

Consolidated government budget balance (overall government) by country  
(% of GDP)

	General government fiscal balances as % of GDP						
	2000	2001	2002	2003	2004	2005	2006
Macedonia	1,8	-7,2	-5,7	-1,1	0,0	0,2	-0,6
Albania	-9,2	-8,5	-7,2	-4,3	-5,1	-3,6	-4,1
B&H	-3,1	-2,5	-4,1	-1,7	-1,9	0,7	-0,6
Bulgaria	-0,5	1,9	0,1	0,3	1,9	3,1	3,0
Croatia	-7,5	-6,8	-4,9	-6,2	-4,9	-4,1	-3,0
Czech Republic	-3,8	-5,8	-6,8	-6,6	-2,9	-2,6	-3,3
Romania	-3,8	-3,5	-2,0	-2,0	-1,4	-0,8	-2,5
Slovakia	-12,2	-6,5	-7,7	-3,7	-3,0	-2,9	-2,7
Slovenia	-1,3	-1,3	-2,9	-1,3	-1,4	-1,1	-1,5
Serbia	-1,0	-4,9	-8,3	-3,4	0	0,9	2,7

\*Except for the Republic of Macedonia, the data on other countries for 2005 are estimated, and for 2006 are projected.  
Source: EBRD, Transition Report 2006 and Ministry of Finance of the Republic of Macedonia.

Observing the government budget components, in 2006 compared to the preceding year, the total public revenues surged by 3.2%, and having a lower generation of non-tax revenues, it is primarily due to the higher tax revenues and contributions (jointly constituting 87% of the total public revenues) and to a lower extent, to the higher capital inflows and revenues from recovered loans. The tax revenues (as a predominant revenue category accounting for 57% of the total public revenues) registered an annual growth of 7%, mainly generated (almost half the growth) from the profit tax. In 2006 compared to the preceding year, 66% more funds were cumulated from the profit tax, with the fastest growth being registered in the first quarter of the year, corresponding with the regular collection of this tax<sup>63</sup>, implicitly indicating to highly profitable performances in 2005. Nevertheless, the other quarters of the year (particularly the last quarter) registered substantial inflows from this tax, thus proving the ascertainment that the companies register accelerated economic activity and profitable performances and that the collection of this tax improved. On the other hand, the income tax revenue in 2006 kept following the trend of moderate increase, thus being higher by 4% relative to the previous year, i.e. they generated 8% of the growth in the tax revenues.

<sup>62</sup> Estimated data on GDP for 2006.

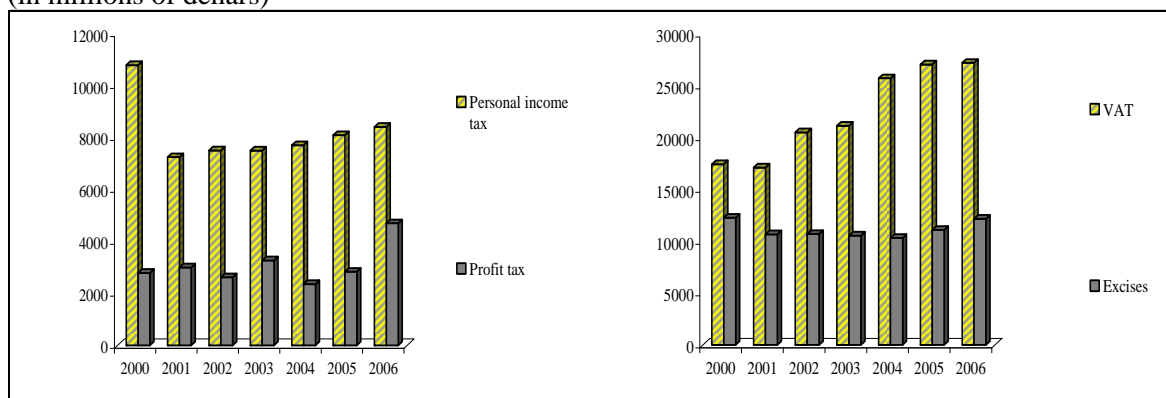
<sup>63</sup> The profit taxpayers pay-in the profit tax over the year in the form of monthly advances estimated according to the tax base set for the preceding years, corrected by the cumulative growth in the retail prices. Yet, if there is a difference between the advance paid-in and the actual liability on the calculated profit tax, the taxpayer is required to pay-in the difference within 30 days after the expiration of the deadline for submission of the annual accounts (Profit Tax Law. Source: Ministry of Finance).



Figure 51

Income and profit taxes  
(in millions of denars)

Domestic goods and service taxes



Source: Ministry of Finance of the Republic of Macedonia

Analyzing the domestic goods and service taxes, the excise revenues (as the second largest tax category making up 12% of the total public revenues) in 2006 registered a remarkable annual growth of 3.6%, generating 11% of the growth of the tax revenues. Such positive change fully corresponds with the annual growth in the import of automobiles (by 28%) and higher cigarette excise<sup>64</sup>. The income from the value added tax - VAT (dominant share of 26% in the total public income) surged inconsiderably by 0.6% on annual basis, given the higher turnover in the retail sales (by 8.8% annually). The other tax categories, customs revenues (which successively reduce their share<sup>65</sup> in the overall revenue structure) rose by 2.9% annually (along with the 15% import growth on annual basis), generating 8% of the growth in the tax revenues together with the VAT. In 2006, substantial portion of the growth in the tax revenues (or 25%) was generated by other taxes (fast annual revenue growth of 2.5 times), stemming from the introduction of the additional taxes on the domestic production of cigarettes and cigarette imports.<sup>66</sup>

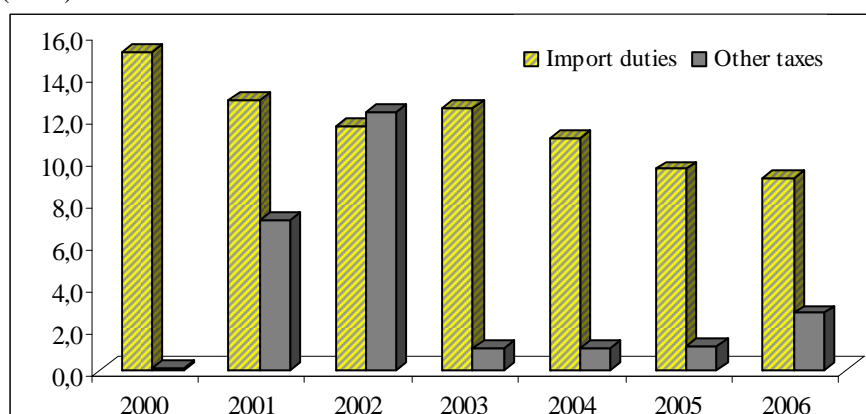
<sup>64</sup> Within the process of harmonization with the EU directives, the cigarette excise will increase by 10% each year from 2005 to 2007. Thus from January 1, 2005, the cigarette excise went up by 10%, i.e. by Denar 0.04 per piece of the domestic cigarettes and 33% of the retail price and by Denar 1.10 per piece of imported cigarettes and 8% of the retail price. On January 1, 2006, the cigarette excise also went up by 10%, i.e. by Denar 0.07 per piece of the domestic cigarettes and 34% of the retail price and by Denar 0.80 per piece of imported cigarettes and 19% of the retail price.

<sup>65</sup> The reduction of the share of customs revenues in the overall income structure is due to the fall in the customs rates as specified by the Agreement on Accession to the WTO and the free trade agreements.

<sup>66</sup> The Law on Amending the Health Protection Law ("Official Gazette of the Republic of Macedonia" no 111/2005) and the Decision on identifying the products subject to turnover compensation, import/export ("Official Gazette of the Republic of Macedonia" no.75/2005), emanating from the Environment Law dated January 1, 2006, requires calculation and payment of compensation in manufacturing or import of tobacco products. To finance the activities in the tobacco production and to additionally fund the primary agricultural production and to promote the export, the Tobacco Law ("Official Gazette of the Republic of Macedonia" no.24/2006) specifies calculation and payment of compensation for production and import of tobacco products of Denar 0.15 per piece for each manufactured or imported cigarette that contain a tobacco (that is, 3 denars per pack). This decision entered into force on April 1, 2006.

Figure 52

Share of customs revenues and other taxes in the tax revenue structure  
(in %)

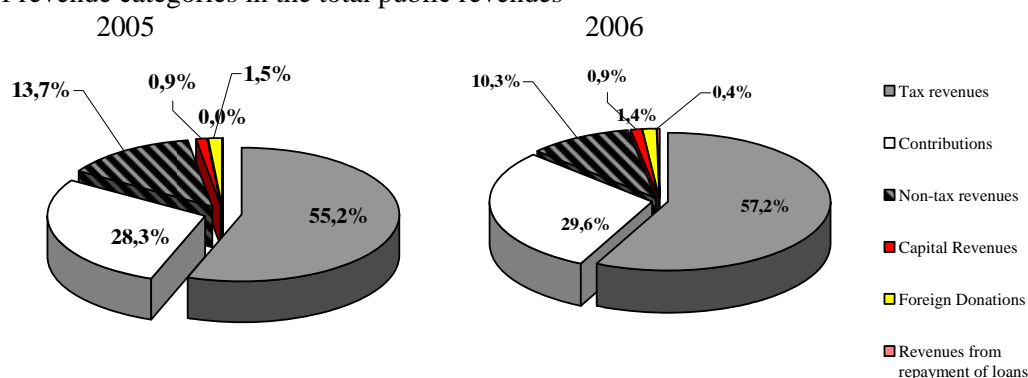


\*The high revenues from other taxes in 2001 and 2002 results from the introduction of the financial transaction tax.  
Source: Ministry of Finance of the Republic of Macedonia

Along with the growth in the tax revenues, the contribution revenues also registered an annual upsurge of 7.8%, mostly generated by the increase in the pension fund contributions (74%), and the health fund contributions (24%). Positive, but inconsiderable growth (of 1.6%) was registered in the capital revenues, which have a minor share in the total revenue structure (1%). On the other hand, the revenues from redeemed loans in 2006 registered a fast increase (of Denar 416 million), resulting in high share of this revenue category in the overall revenue structure.

Figure 53

Share of revenue categories in the total public revenues



Source: Ministry of Finance of the Republic of Macedonia

In 2006, however, most of the annual increase in the revenues was offset by the substantial annual fall in the non-tax revenues (of 23%). Almost all revenue categories of the non-tax revenues (making up 10% of the total revenue structure in 2006) went down on annual basis, with the revenues from public and financial institutions (of 75.2%, owing to the unpaid dividend from AD Macedonian Telecommunications) and the balances on the own revenue accounts registering the sharpest fall.

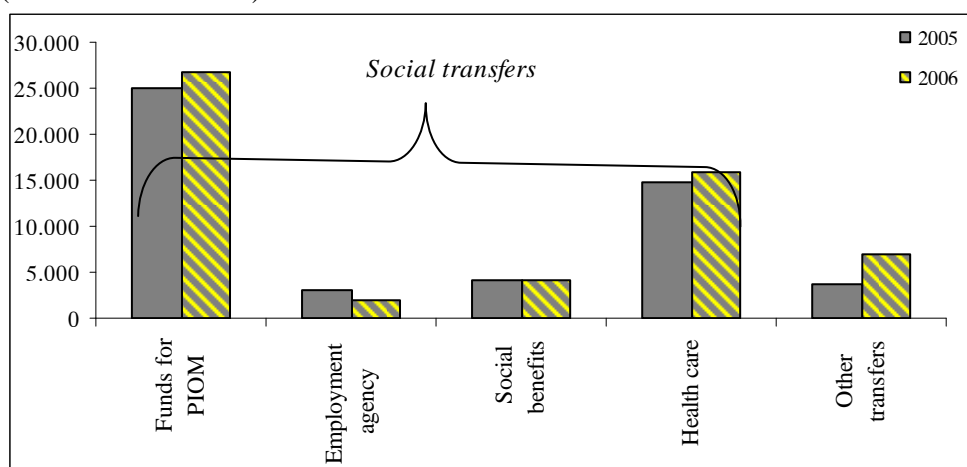
Table 22  
Consolidated budget (central government and funds)

	2005	2006	2006	2005	2006	2006
	amount	amount	change in %	structural share in %	structural share in %	fulfillment of projection (in%)
<b>Total Revenues</b>	<b>100.877</b>	<b>104.078</b>	<b>3,2</b>	<b>100</b>	<b>100</b>	<b>95,5</b>
<b>Revenues from taxes and contributions:</b>	<b>84.580</b>	<b>90.599</b>	<b>7,1</b>	<b>83,8</b>	<b>87,0</b>	<b>101,2</b>
<i>Tax Revenues (SRA)</i>	<i>304</i>	<i>199</i>	<i>-34,5</i>	<i>0,3</i>	<i>0,2</i>	<i>82,9</i>
<i>Tax revenues:</i>	<i>55.681</i>	<i>59.575</i>	<i>7,0</i>	<i>55,2</i>	<i>57,2</i>	<i>101,5</i>
- personal income tax	8.097	8.414	3,9	8,0	8,1	101,9
- profit tax	2.837	4.708	65,9	2,8	4,5	106,4
- value added tax (VAT)	27.082	27.239	0,6	26,8	26,2	99,5
- excises	11.748	12.174	3,6	11,6	11,7	104,5
- import duties	5.266	5.420	2,9	5,2	5,2	98,9
- other taxes	651	1.620	2.5 pati	0,6	1,6	108,0
<i>Contributions</i>	<i>28.595</i>	<i>30.825</i>	<i>7,8</i>	<i>28,3</i>	<i>29,6</i>	<i>100,8</i>
<b>Non tax revnues:</b>	<b>13.867</b>	<b>10.690</b>	<b>-22,9</b>	<b>13,7</b>	<b>10,3</b>	<b>66,8</b>
-non tax revenues (SRA)	6.322	5.771	-8,7	6,3	5,5	68,9
-profit from public financial institutions	3.319	824	-75,2	3,3	0,8	26,7
- administrative taxes and charges	1.657	1.493	-9,9	1,6	1,4	99,5
- healt co-payment	434	241	-44,5	0,4	0,2	42,1
- other administrative taxes	196	163	-16,8	0,2	0,2	54,2
- other non tax revenues	264	619	2.3 pati	0,3	0,6	121,8
-compensation for use of the motorway	1.676	1.580	-5,7	1,7	1,5	95,7
<b>Capital Revenues</b>	<b>933</b>	<b>948</b>	<b>1,6</b>	<b>0,9</b>	<b>0,9</b>	<b>135,4</b>
<b>Foreign Donations</b>	<b>1.494</b>	<b>1.423</b>	<b>-4,8</b>	<b>1,5</b>	<b>1,4</b>	<b>58,6</b>
<b>Revenues from repayment of loans</b>	<b>2</b>	<b>418</b>	<b>209 pati</b>	<b>0,0</b>	<b>0,4</b>	
<b>Total Expenditures</b>	<b>100.219</b>	<b>105.782</b>	<b>5,6</b>	<b>100</b>	<b>100</b>	<b>94,9</b>
<b>Current expenditures</b>	<b>90.027</b>	<b>96.523</b>	<b>7,2</b>	<b>89,8</b>	<b>91,2</b>	<b>97,0</b>
- wages and salaries	22.835	23.421	2,6	22,8	22,1	98,2
- goods and services	12.984	12.903	-0,6	13,0	12,2	89,7
- transfers	51.597	56.675	9,8	51,5	53,6	98,5
- interest	2.610	3.137	20,2	2,6	3,0	93,3
<b>Capital Costs</b>	<b>10.191</b>	<b>9.260</b>	<b>-9,1</b>	<b>10,2</b>	<b>8,8</b>	<b>77,7</b>
<b>Budget Balance</b>	<b>658</b>	<b>-1.704</b>				<b>69,9</b>
<b>Financing</b>	<b>-658</b>	<b>1704</b>				
External financing, net	10.618	-12.203				
Finanncing from domestic sources, net	-2.864	-3.368				
-sale of treassury bills	1.538	2.019				
Sele of shares	28	2.459				
Revenues from privatisation	1.433	20.697				

Source: Ministry of Finance of the Republic of Macedonia

Unlike the moderate increase in the total public revenues, in 2006, the total public expenditures registered a steeper annual growth of 5.6%, due to the higher current expenditures, having a lower capital government spending. Thus, the current expenditures (constituting 91% of the overall expenditure structure) went up by 7.2%, primarily due to the higher amount of transfer payments (an annual increase of 9.8%).

Figure 54  
Structure of social transfers and other transfers  
(in millions of denars)

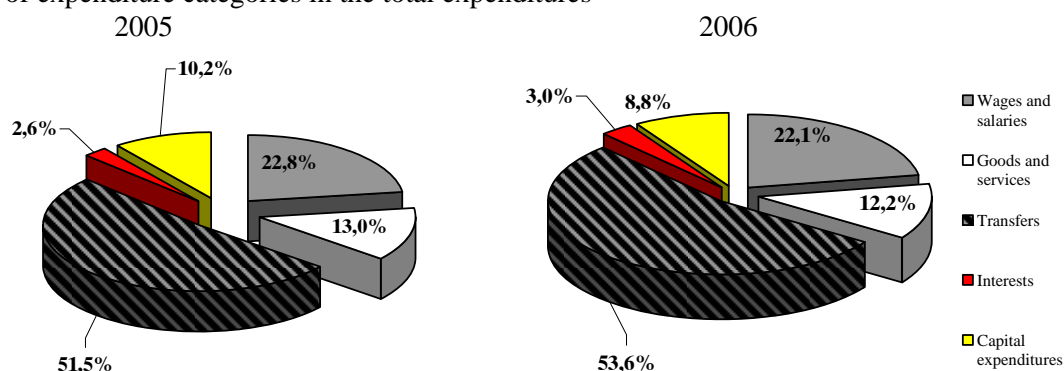


Source: Ministry of Finance of the Republic of Macedonia

The costs for salaries and wages (an increase of 2.6% on annual basis) and the costs for interest payment (an increase of 20.2% on annual basis, mainly due to the higher interest payments based on external debt) add to the increase in the current expenditures. Thus, if the budget balance is impaired by the costs for interest payment, in 2006 the budget deficit would be by Denar 1,433 million lower, showing the primary fiscal balance. The primary fiscal balance is an indicator for the effects of the current budget policy on the allocation of resources in the economy, insulating the implications of the former decisions related to the debt.

Analyzing the current expenses, the costs of goods and services that register moderate annual fall of 0.6% are an exception, which, having a high amount of allocated reserves, fully results from the lower expenditures from the own accounts. On the other hand, the fall in the capital expenditures was faster (9.1%), owing to the high comparison base of 2005.

Figure 55  
Share of expenditure categories in the total expenditures



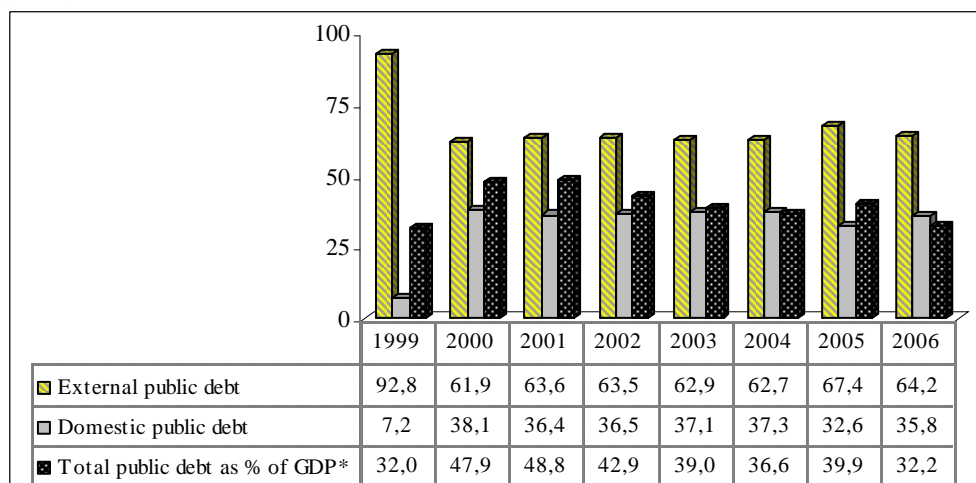
Source: Ministry of Finance of the Republic of Macedonia

In 2006, having net-outflows from the external and domestic indebtedness, the revenues from privatization and the inflows from the sale of government shares were dominant categories that financed the budget deficit. This year registered considerable inflow of funds from the privatization of ESM-Distribution (in the first quarter of the year, in the amount of Denar 13,899 million) and from the sale of a portion of the government shares in AD Macedonian Telecom, the government shares of JZU Gradska apteka (City Pharmacy) and the government shares of several domestic banks (total amount of Denar 3.867 million in the second quarter of the year). Also, there

was an additional inflow from the sale of a set of shares in PIOM ownership (in the second quarter of the year, in the amount of Denar 2,433 million) and through the government securities market (in a net amount of Denar 2.019 million). On the other hand, 2006 witnessed a substantial repayment of the external debt principal (the early repayment of the debt to the London Club of Creditors was made in the first quarter of the year) and the regular repayment of the domestic debt (based on structural bonds), which, having a moderate external and domestic debt, contributed to reducing the public debt<sup>67</sup>. Thus, at the end of 2006, the public debt (of the central government and funds) dropped, reducing to 32.2% of GDP (compared to 39.9% of GDP in 2005).

Figure 56

Structure of public debt and share of the total public debt in GDP  
(in %)



\*Preliminary data for 2005, estimated data for 2006 on GDP in Euro.

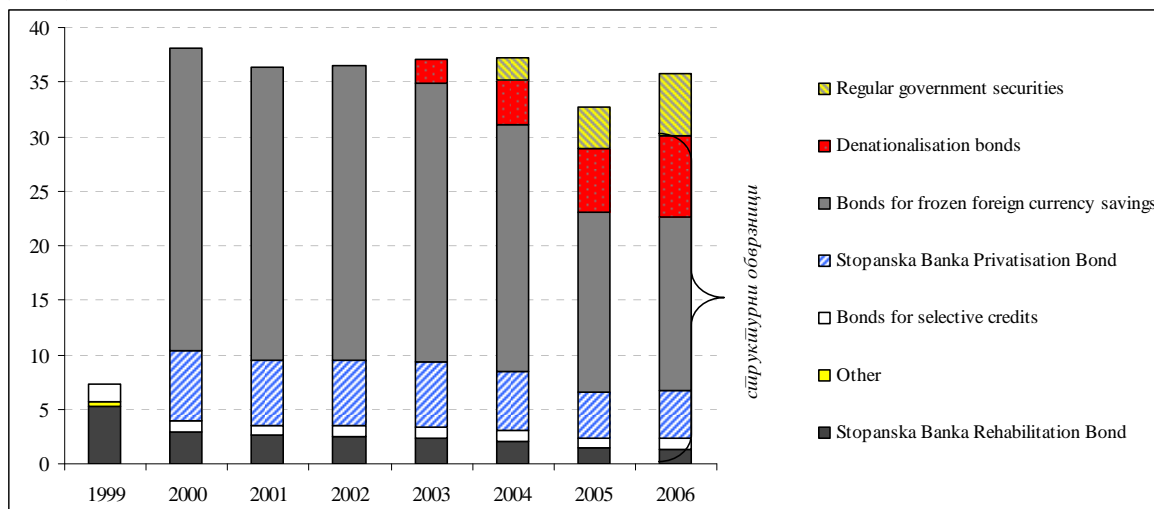
Source: Public Debt Management Office, Ministry of Finance of the Republic of Macedonia.

In 2006, the early repayment of the debt to the London Club of Creditors and the regular repayment of the debt to the Paris Club of Creditors reduced the share of the external public debt in the total public debt by 3.2 percentage points (64.2% in December). The funds intended for repayment of the debt to the London Club of Creditors were provided through the first issue of Eurobonds (in December 2005, initially triggering the increase in the share of the external debt in the total public debt at the end of 2005). On the other hand, the higher issue of continuous government securities and the fifth issue of denationalization bonds in 2006 led to higher percentage of domestic debt in the total public debt structure.

<sup>67</sup> For consistency of the analysis, the public debt is based on the debt of the central government and the funds (the consolidated debt of the government authority without the NBRM debt, the municipalities and the public enterprises). Such analysis does not correspond with the national methodology for estimating the public debt that includes also the debt of the municipalities and the public enterprises (without the NBRM debt) and with the statistics of the government finances (of IMF) that includes the NBRM debt. On the other hand, the domestic debt of the central government covers the structural and continuous securities.

Figure 57

Share of structural bonds and continuous securities in the total public debt  
(in %)



The reduction in the share of the external debt at the expense of the domestic debt is in line with the strategy of the Ministry of Finance for debt portfolio restructuring and improving, i.e. for providing financial assets with lowest cost, on a medium and long run, at sustainable risk level, and for strengthening and maintaining efficient domestic financial markets.

### III. Monetary developments in the Republic of Macedonia

In 2006, the monetary policy was conducted within the strategic framework of targeting the nominal exchange rate of the Denar against the Euro. This monetary strategy further generates positive performances, demonstrated through the low and stable inflation and stable inflation expectations. However, given the policy of stable exchange rate and the high amount of foreign currency inflows in the economy (typical for the last two years), the appreciation of the real effective exchange rate (REER), i.e. lowering the competitiveness of the domestic economy on the international market, thus deepening the trade deficit, is a potential risk, which has monetary implications. Hence, the REER is also an essential issue, the central bank should focus on. The analysis of the Denar REER development does not show evident appreciation trend, i.e. this indicator does not signal any problem in this area.

#### **Annex 8**

#### **Summary of the "Monetary policy and exchange rate policy in the Republic of Macedonia" - IMF Staff Report, Article IV Consultation, October 2006**

The IMF Staff Report of October 2006 provides an assessment of the current monetary policy and the exchange rate regime in the Republic of Macedonia. The IMF analysis primarily shows structural problems in the area of competitiveness, and generally adequate exchange rate level. This conclusion was underpinned by the results of the quantitative analysis indicating compliance of the exchange rate level with the economic fundamentals. On the other hand, the concentration of the export in sectors with low added value and downward share on the international market reveals structural problems in the competitiveness, and their overcoming depends on the elimination of the structural problems and on the foreign direct investments.

The Report also includes analysis of certain determinants, assessing the need, if any, of fixed exchange rate.<sup>68</sup> These determinants include the trade orientation, financial integration, economic diversification, macroeconomic stabilization, credibility and "fear of fluctuations". The analysis shows that there is no need of changing the exchange rate regime, primarily since the economy is small and open, the foreign trade is oriented to countries that use Euro, and the economic cycle is widely conformed to that of the Euro-zone. Also, the poor financial integration, the domination of the nominal over the real shocks and the high level of euroization underpin such ascertainment.

Although the future expectations for diminishing the "fear of fluctuations" (due to the expectations for reducing the foreign currency debt) and for increasing the capital inflows (particularly since the perspectives for admission to the EU are major institutional anchor) are potential factors that diminish the need of the exchange rate as a nominal anchor, this monetary strategy, however, has been considered adequate, at least for now.

Source: Macedonia: Article IV Consultation - Staff Report, October 2006.

In 2006, the Macedonian economy registered inflation higher than 2% for the first time after four years. The average inflation rate equaled 3.2%, thus being within the projected level (3.3%)<sup>69</sup>. In environment of prudent macroeconomic management, the inflation developments in 2006 were primarily triggered by non-monetary factors, such as the higher tobacco price (higher excise at the beginning of the year and introduction of other additional taxes), the higher food prices, owing to the delay of the early-garden products and the higher oil price on the international

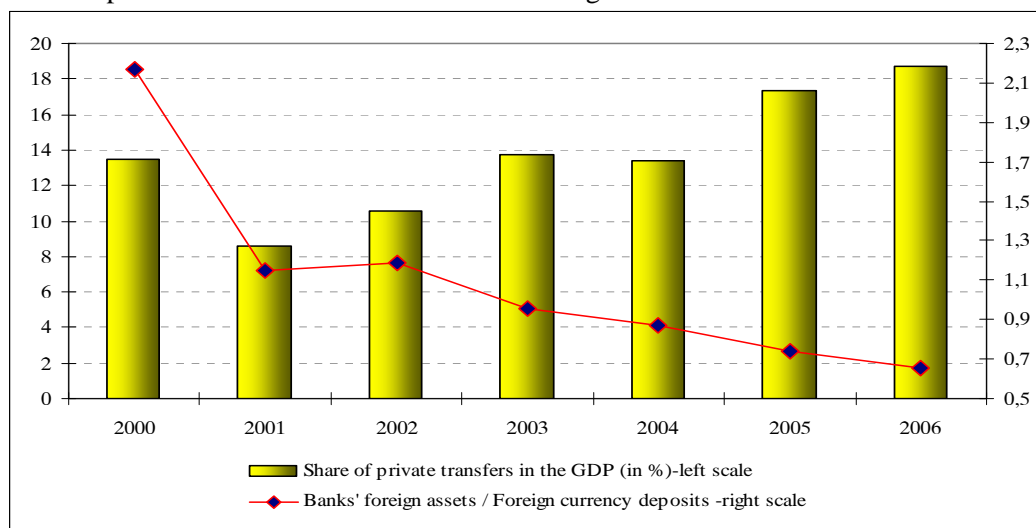
<sup>68</sup> IMF WP 06/54.

<sup>69</sup> According to the initial projection, the average inflation rate in 2006 is expected to be 2%. However, the higher food products, unlike the expectations to remained the same, and the faster growth in the oil prices on the international markets compared to the expected, in the first three quarters of 2006 caused inflation rate higher than the expected, therefore in November 2006, the projected inflation rate for 2006 was being revised to 3.3%.

exchanges. The core inflation rate, estimated by excluding the most variable categories from the index (food and energy prices), additionally corrected by the effect of the higher cigarette excise, was notably lower and equaled 1.1%<sup>70</sup>.

The environment of the monetary policy in 2006, is largely a continuity of the performances of the preceding year. In 2006, same as in the previous year, the high level of foreign currency inflows (particularly private transfers) was typical for the Macedonian economy, which, due to the positive expectations of the banks and the active credit policy, resulted in higher supply of foreign currency by the banks on the foreign exchange market and high net-purchase by NBRM.

Figure 58  
Share of private transfers in GDP and bank's foreign assets



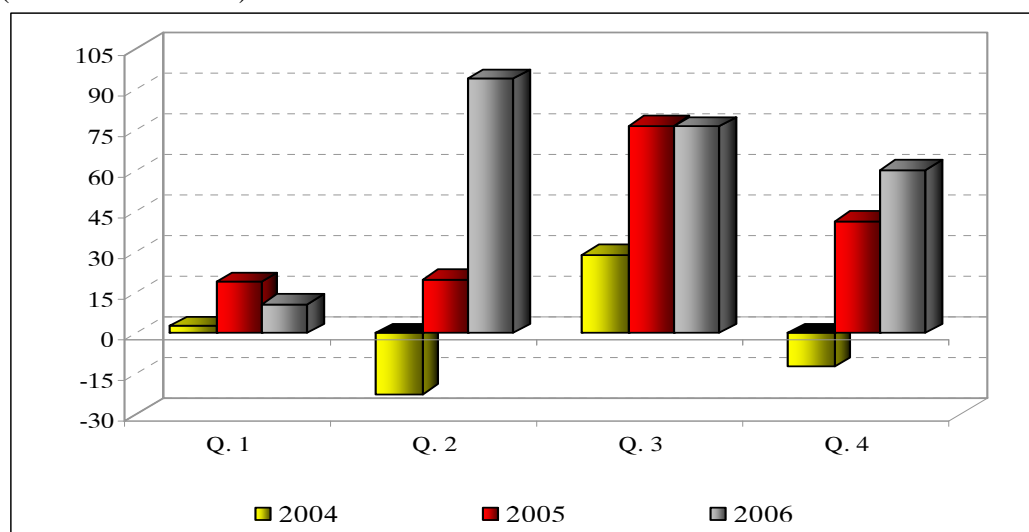
Source: National Bank of the Republic of Macedonia.

The net-purchase of foreign currency on the foreign exchange market ensured accumulation of foreign reserves (the high inflows from the privatization of the energy sector also made their contribution), which at the end of 2006 covered 4.6 months of the projected import of goods and services for the next year. The high level of foreign reserves, as a key factor for the credibility of the fixed exchange rate regime, the prudent fiscal policy and the stable environment in 2006, created preconditions for reductions in the NBRM interest rates, which accordingly affected the interest rate development on the financial markets and in the banking system.

<sup>70</sup> Estimation of the core inflation rate made on the basis of the NBRM methodology.



Figure 59  
NBRM interventions of the foreign exchange market  
(in millions of euros)



Source: National Bank of the Republic of Macedonia.

Only the interventions on the foreign exchange market were directed towards creating liquidity in the banking system in 2006. The effects of the foreign currency transactions, as a part of the overall NBRM liquidity management, were sterilized through the monetary instrument (additional sterilized liquidity in 2006 of 1.7% of GDP), and through other autonomous factors (Denar government deposits with NBRM and currency in circulation).

In 2006, the government Denar account with NBRM registered large inflow from the privatization of state capital<sup>71</sup>, which is a liquidity withdrawal from the banking system. Only the last month of the year, in order to execute the planned budget expenditures from the adopted budget revision (in November 2006), registered considerable government spending, thus creating liquidity in the banking sector. In this year, the currency in circulation followed the common seasonal pace, and on annual basis it acted towards withdrawing liquidity (the seasonal increase in the currency in circulation at the end of the year was faster than usual, due to the overlapping of the holiday Kurban Bajram with the New Year holiday and Christmas and due to the payment of subsidies to the farmers). The monetary instruments (CB bills and treasury bills for monetary purposes<sup>72</sup>) in 2006 were aimed at sterilizing the liquidity from the banks, and the NBRM partially offset the effects of the autonomous factors. Structurally observed, the treasury bills for monetary purposes, as a new instrument in the NBRM operational framework, played a central role in the liquidity withdrawal, withdrawing 28.3% of the total liquidity in 2006. Liquidity was also withdrawn through the CB bills, in substantially lower volume (3.3% of the total withdrawn liquidity), which corresponds with the NBRM determination to sterilize the structural excess liquidity on a longer run.

<sup>71</sup> The residual government shares in the health sector (pharmacies), telecommunication sector and shares in PIOM ownership were sold in the second quarter of 2006.

<sup>72</sup> On March 7, 2006, NBRM in cooperation with the Ministry of Finance started issuing three-month treasury bills for monetary purposes.

Table 23  
Liquidity creation and withdrawal\*  
(in millions of denars)

	Balance as of 31.12.2005	I Q	Changes by quarters			Total	Balance as of 31.12.2006
			II Q	III Q	IV Q		
<b>Banks' liquidity (banks' account with the NBRM)</b>	4.626	-114	1.164	-186	1.669	2.533	7.159
<b>Liquidity creation</b>						<b>18.834</b>	
1. Net foreign assets	66.282	5.625	5.349	4.808	3.052	18.834	85.116
<b>Liquidity withdrawal</b>						<b>-16.301</b>	
1. Net domestic assets	-45.843	-6.872	-3.274	-4.717	481	-14.382	-60.225
<i>of which:</i>							
CB bills	-8.921	18	2.169	-688	-2.034	-535	-9.456
Government denar deposits with the NBRM	-6.993	-1.814	-5.610	-4.311	3.402	-8.333	-15.326
<i>of which: Treasury bills for monetary purposes</i>	—	-1.377	-1.250	-2.029	83	-4.573	-4.573
Government foreign currency deposits with the NBRM	-15.286	-4.959	832	1.004	778	-2.345	-17.631
Other items, net	-17.974	-117	-354	-722	-946	-2.139	-20.113
2. Currency in circulation	14.439	739	-880	-230	-1396	-1.767	16.206
3. Banks' vault cash	1.374	394	-31	-47	-468	-152	1.526

\*Positive change - liquidity creation, negative change - liquidity withdrawal.

Source: National Bank of the Republic of Macedonia.

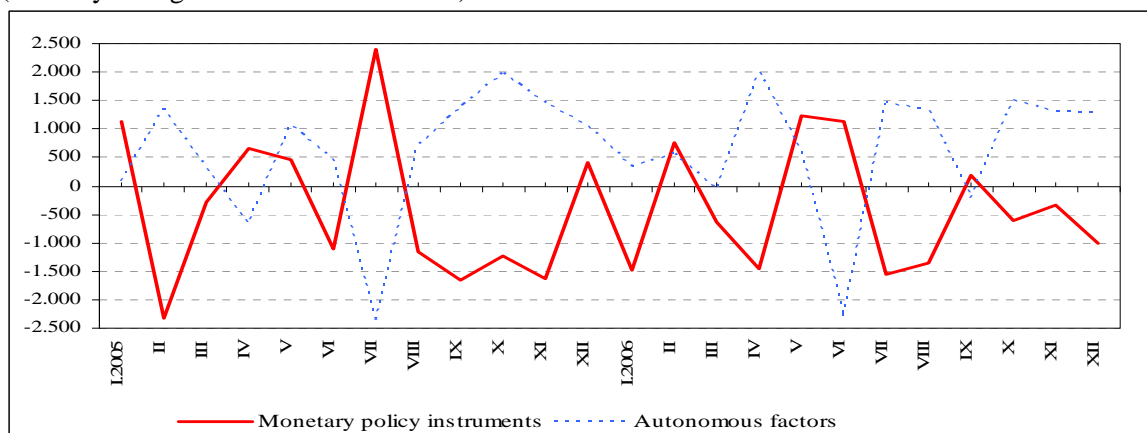
The analysis of the liquidity position of the banking system in 2006 indicates more efficient liquidity forecast and management by the banks, i.e. maintenance of satisfactory liquidity position. In 2006, NBRM made several changes in the monetary instruments design, directed towards more active liquidity management and less unused excess liquidity on the banks' accounts. Thus on January 11, 2006, the NBRM Decision entered into force (adopted on November 2005), according to which the cash in the vault as a means for fulfilling the reserve requirement would no longer be accepted. In addition, the interest rate on Lombard credits was also cut, thus narrowing the spread between this interest rate and the interest rate on CB bills. In 2006, the banks allocated 10.5% over the reserve requirement (in Denars) on average<sup>73</sup>, which is virtually identical to the average of the previous year (10%). However, if the excess liquidity is corrected by the exceptionally high excess liquidity witnessed over the last two months of the year, primarily as a preparation of the banks for the potential payment of dividend by one larger company, in 2006, the allocated excess liquidity would equal 8.4%<sup>74</sup>.

<sup>73</sup> The period for maintaining (fulfilling) the banks' reserve requirement covers the period from the 11<sup>th</sup> in the current month to the 10<sup>th</sup> in the following month. The excess pertains to funds allocated to the banks' accounts with NBRM over the reserve requirement.

<sup>74</sup> In November and December 2006, expecting the potential payment by one large company, the banks allocated 22.2% and 19.3%, respectively, over the reserve requirement, thus causing higher average amount of allocated liquidity in the second half. The 8.4% corrected excess was derived through a simulation, which is excess liquidity over the last two months, equal to the average excess liquidity in the January - October 2006 period.

Figure 1

Monetary policy instruments and autonomous factors of liquidity creation and withdrawal\*  
(monthly changes in millions of denars)



\*Positive change - liquidity creation, negative change - liquidity withdrawal.

Source: National Bank of the Republic of Macedonia.

At the end of 2006, the reserve money (monetary base), as a basis for creating the reserve money, surged by 21.8% compared to the end of the previous year. Observing its components, the banks' total liquid assets and the cash in the vaults are relevant contributors to the increase in the reserve money, accounting for 60.3% of the annual change in the reserve money.

Table 24

NBRM Survey

(in millions of denars)

	Balance as of 31.12.2005	Changes by quarters				Total	Balance as of 31.12.2006
		I	II	III	IV		
Reserve money	20.439	-1.247	2.075	91	3.533	4.452	24.891
Currency in circulation	14.439	-739	880	230	1.396	1.767	16.206
Banks' account with the NBRM	4.626	-114	1.164	-186	1.669	2.533	7.159
Banks' vault cash	1.374	-394	31	47	468	152	1.526
Net foreign assets	66.282	5.625	5.349	4.808	3.052	18.834	85.116
Foreign assets	69.504	5.572	5.105	4.775	2.805	18.257	87.761
Foreign liabilities	3.222	53	244	33	247	577	2.645
Net domestic assets	-45.843	-6.872	-3.274	-4.717	481	-14.382	-60.225
1. Banks' credits, net	-8.880	-1.359	915	-2.717	-1.954	-5.115	-13.995
- credits	41	0	-4	0	-3	-7	34
-instruments <sup>/1</sup>	-8.921	-1.359	919	-2.717	-1.951	-5.108	-14.029
2. Net Government position with the NBRM	-18.989	-5.396	-3.835	-1.278	3.381	-7.128	-26.117
-Claims on the Government	3.290	0	-307	0	-716	-1.023	2.267
-Government deposits <sup>/2</sup>	-22.279	-5.396	-3.528	-1.278	4.097	-6.105	-28.384
3. Other items, net <sup>/3</sup>	-17.974	-117	-354	-722	-946	-2.139	-20.113

<sup>/1</sup> Includes CB bills and treasury bills for monetary purposes.

<sup>/2</sup> Excludes treasury bills for monetary purposes.

<sup>/3</sup> The substantial increase in the category of other items, net, in the fourth quarter of 2006 indicates the early payment of the Continuous bond no.2, issued for covering the NBRM loss from 2004, made on December 29, 2006.

Source: National Bank of the Republic of Macedonia.

Analyzing the NBRM balance sheet, the higher level of reserve money resulted from the NBRM net foreign assets, which in 2006 were directed towards creating reserve money. Observing the pace, the level of NBRM net-foreign assets was steadily increasing in 2006. The outflows from the regular service of the debt to foreign creditors<sup>75</sup>, were fully offset by the net-purchase of foreign currency on the foreign exchange market and by the foreign currency inflows from the privatization of ESM-Distribution in March 2006. The changes in the NBRM foreign liabilities in

<sup>75</sup> The debt to the London Club of Creditors was fully repaid in January 2006.

2006 resulted from the regular repayment of the liabilities to the IMF. In 2006, in environment of accumulation of assets by the government, and increase in the level of monetary instruments, the NBRM net-foreign assets were directed towards withdrawing reserve money.

### **3.1. Monetary instruments**

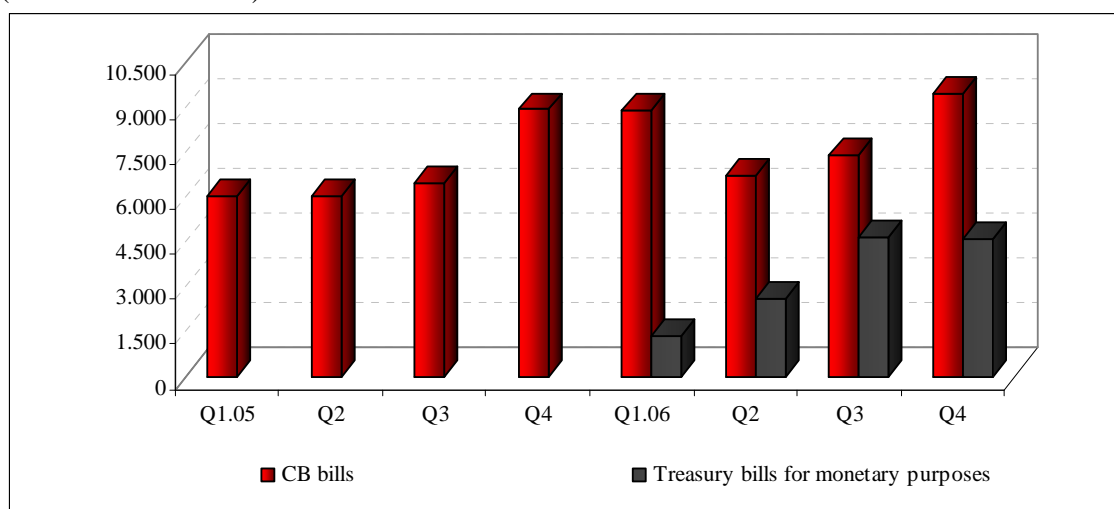
The NBRM set of monetary instruments lay on market and flexible basis, thus ensuring persistent change and adjustment of the existing instruments, and introducing new instruments for the purpose of increasing their efficiency and successful achievement of the set goals. Having structural excess of Denar liquidity in the banking system, underdeveloped and shallow financial market and under-diversified securities portfolio, the 28-day CB bills are the major liquidity management instrument. Such structural excess liquidity impedes the conduct of monetary policy, i.e. reduces the operability of the monetary transmission. Hence, on March 7, 2006, the NBRM in cooperation with the Ministry of Finance started issuing 3-month treasury bills for monetary purposes in order to reduce the structural excess liquidity, i.e. to sterilize it on a longer run. The treasury bills for monetary purposes, as a new monetary instrument, besides their sterilizing function, provided for concentration of the supply and the demand on the short-term securities market, more efficient liquidity management and improvement of the monetary policy transmission mechanism.

According to the plan for introduction of treasury bills for monetary purposes, in February, NBRM reduced the frequency of holding CB bills auctions (from twice to once a week) and started reducing the supply of CB bills to make the banks invest in treasury bills for monetary purposes. As a result of such changes, the treasury bills for monetary purposes permanently played the role of dominant contributor to the total liquidity withdrawn through the monetary instruments. Only in the fourth quarter of 2006, given the uncertainty related to the payment of the dividend of one large company, the banks were reluctant to invest in financial instruments on a longer run, resulting in reduction in the level of treasury bills for monetary purposes on a quarterly basis, and increase in the level of CB bills. The interest rate on the CB bills auctions, held in 2006, in environment of almost equal supply and demand for CB bills, was 6% compared to 9.8% of the preceding year (volume tender and fixed interest rate was applied over the most of 2005<sup>76</sup>). The interest rate on 3-month treasury bills was by 3.5 percentage points lower on annual basis, equaling 6.4% on average in 2006.

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<sup>76</sup> On October 26, 2005, NBRM switched from volume tender to interest rate tender CB bills auction, and no changes in the CB bills auction design was made in 2006.

Figure 61  
Monetary instruments  
(in millions of denars)



\*Shows the discounted amount of CB bills.

Source: National Bank of the Republic of Macedonia.

Analyzing the reserve requirement, the NBRM Decision (adopted in November 2005) entered into force on January 11, 2006 according to which the cash in the vaults is no longer acceptable as a means of meeting the reserve requirement. Such decision is aimed at improving the banks' liquidity management and reducing the unused excess liquidity on the banks' accounts.

In 2006, the NBRM cut the interest rate on Lombard credits twice<sup>77</sup>, in February (by 2 percentage points) and in May (by additional 1.5 percentage points), thus reducing it to 9.5%. Such two-time cut of the interest rate on Lombard credit was necessary for its adjustment to the market interest rates. Since there was a high level of liquidity, Lombard credits were not used in 2006.

## Annex 9

### Chronology of changes in the monetary instrument design in 2006

#### January 11, 2006

The NBRM Decision (adopted in November 2005) entered into force, according to which the cash in the vaults is no longer acceptable as a means of meeting the reserve requirement.

#### February 1, 2006

NBRM reduced the frequency of holding CB bills auctions from twice to once a week.

#### February 16, 2006

The NBRM Council adopted a Decision on reducing the interest rate on Lombard credit from 13% to 11%.

#### March 7, 2006

The NBRM, in cooperation with the Ministry of Finance, started issuing 3-month treasury bills for monetary purposes, and for regulating the interrelations, the both institutions concluded an

<sup>77</sup> Collateralized short-term credits for overcoming the temporary liquidity problems of the banks that belong to the group of monetary instruments - standing facilities.

Agreement on Treasury Bills for Monetary Purposes.. The treasury bills for monetary purposes have been issued at the regular government securities auctions, enjoying the same features as the regular government securities, intended for financing the needs of the Budget of the Republic of Macedonia. Observing the potential investors, the both types of government securities have entirely equal features (same maturity, same method of sale, payment). The main difference between these two types of securities is that, as specified by the Public Debt Law, the government securities for monetary purposes are not considered a part of the public debt since issued for the purposes of the monetary policy. In addition, the government is not entitled to hold the funds withdrawn through issuing treasury bills for monetary purposes (funds mobilized through the issue of treasury bills for monetary purposes have been deposited on a special account with the NBRM, opened especially for the needs of the monetary policy). The interest on treasury bills for monetary purposes is charged to the NBRM, at the average interest rate achieved at the auctions of the 3-month treasury bills.

#### **May 31, 2006**

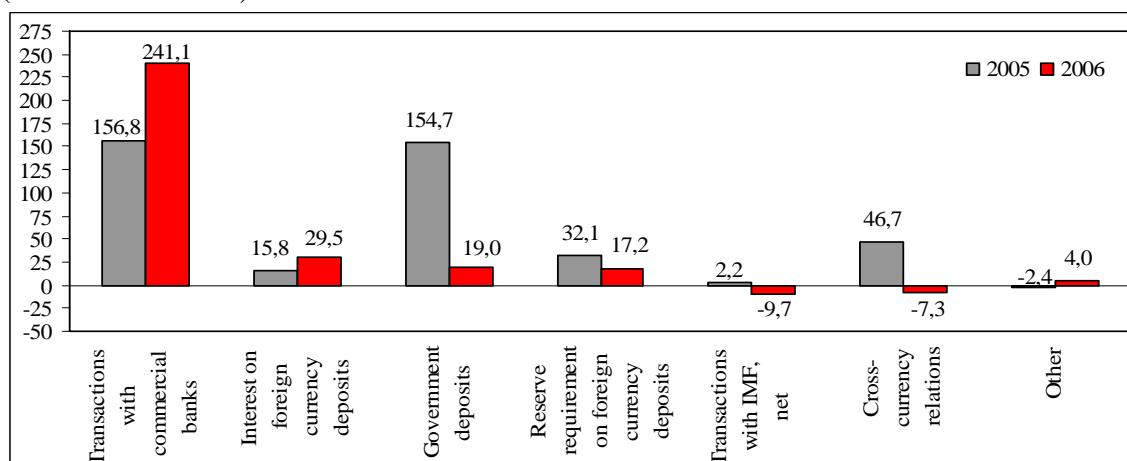
The NBRM Council adopted a Decision on amending the Decision on NBRM interest rates, thus reducing the interest rate on Lombard credit from 11% to 9.5%.

### **3.2. Foreign reserves and exchange rate**

In many countries in transition, the foreign currency inflows played a major role in strengthening the productive potential of the economies. The inflow volume and nature vary depending on the evolution stage, the institutional features and the specifics of the economy itself. Over the last two years, one of the basic features of the macroeconomic framework of the Macedonian economy is the high volume of foreign currency inflows. Such trend was expected given the gradual liberalization of the capital account, stabilization of the environment, and the EU member candidate status. Yet, unlike some developed countries in transition, where the inflows have been generated from foreign direct investments and portfolio-investments, most of the foreign currency inflows in the Macedonian economy are private transfers, which in combination with the high amount of used foreign credits and loans by the private sector, the faster export activity, the growth in the portfolio-investments and the sale of government shares in 2006, enabled higher supply of foreign currency on the foreign exchange market. Thus the supply of foreign currency on the foreign exchange market, over the year (except in January), exceeded the demand for foreign currency, leading to pressures for appreciation of the domestic currency, particularly in the second (the demand for Denars due to the sale of government shares) and in the third quarter (high foreign currency inflows from the currency exchange operations due to seasonal factors).

Figure 62

Factors of change in the gross foreign reserves in 2005 \* and 2006  
(in millions of euros)



\* Government deposits in 2005 include inflows from Eurobonds.

Source: National Bank of the Republic of Macedonia.

Such developments on the foreign exchange market, in the environment of stable exchange rate policy, resulted in a net purchase of foreign currency by the NBRM in the amount of Euro 241.1 million, which is 82.1% of the total change in the foreign reserves. Thus, on December 31, 2006, the gross foreign reserves reached Euro 1,416.7 million, registering an annual growth of Euro 293.7 million. Taking into account the one-time effect of the inflows from the Eurobonds (issued in December 2005, with the acquired funds in January 2006 being used for full repayment of the debt to the London Club of Creditors) worth Euro 149.2 million, on the foreign reserves at the end of 2005, the growth in the gross foreign reserves in 2006 was faster, totaling Euro 442.9 million.

Table 25

Quarterly dynamics of the gross foreign reserves of the Republic of Macedonia  
(in millions of euros)

	31.12.2005	Q1	Q2	Q3	Q4	01.01- 31.12.2006
<b>Amount of the foreign reserves of the Republic of Macedonia</b>	<b>1.122,9</b>	<b>1.157,8</b>	<b>1.241,3</b>	<b>1.370,1</b>	<b>1.416,7</b>	
<b>Net increase in the foreign reserves</b>		<b>34,8</b>	<b>83,6</b>	<b>128,7</b>	<b>46,6</b>	<b>293,7</b>
Transactions with commercial banks		10,6	94,0	76,3	60,2	241,1
Purchase and sale		5,6	85,8	69,5	43,0	203,8
Securities		5,0	8,3	6,8	17,2	37,4
Interest on foreign currency deposits		5,4	5,9	8,8	9,4	29,5
Government deposits <sup>1/2</sup>		9,7	-8,8	40,4	-22,3	19,0
Reserve requirement on foreign currency deposits		3,0	2,6	5,6	6,0	17,2
Transactions with IMF, net <sup>3</sup>		-0,5	-4,0	-0,6	-4,6	-9,7
Cross-currency relations		6,5	-6,2	-2,7	-4,8	-7,3
Other		0,1	0,1	1,0	2,7	4,0

1/ Within the government deposits, in January 2006, the debt to the London Club of Creditors was fully repaid, and the liabilities based on the first regular installment of the debt to the Paris Club of Creditors were repaid, while March 2006 registered inflows from the sale of ESM-Distribution.

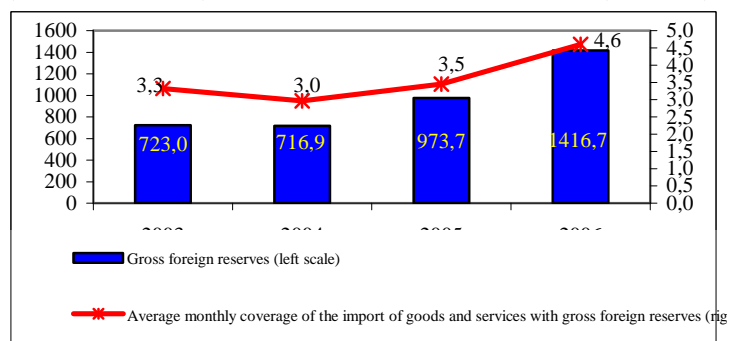
2/ On August 8, 2006, the funds of EBRD were transferred on the government account from the privatization of ESM-Distribution in the amount of Euro 49.8 million, previously placed on a special account, since the EBRD had not made a decision whether to act as a shareholder in the sale (it acquired its shareholder status by providing funds for the privatization) or to yield the funds from the sale to the government, and the previously invested funds to be returned as specified by the Agreement on deferred conditional purchase and sale of shares in relation with the pre-privatization of ESM.

3/ Since the funds from the Stand-by arrangement (prudential) were not withdrawn, the outflow of foreign currency is due to the reduction of the liabilities on the basis of paid principal and interest (Euro 7.5 million and Euro 2.3 million, respectively).

Source: National Bank of the Republic of Macedonia.

Figure 63

Gross foreign reserves and monthly export-import coverage ratio (f.o.b.) of the following year by gross foreign reserves  
(in millions of euros) (in months)



Source: National Bank of the Republic of Macedonia.

National Bank of the Republic of Macedonia<sup>79</sup>, reached Euro 1,434.6 million, which is by Euro 298.5 million more compared to the end of the preceding year. The structural analysis of the total foreign assets shows dominant structural share of 81.3% of the foreign currency deposits in foreign banks. Also, essential structural developments were noticed, particularly in the securities (positive change of 8.5 percentage points) and the foreign currency deposits in foreign banks (reduction of 7.7 percentage points).

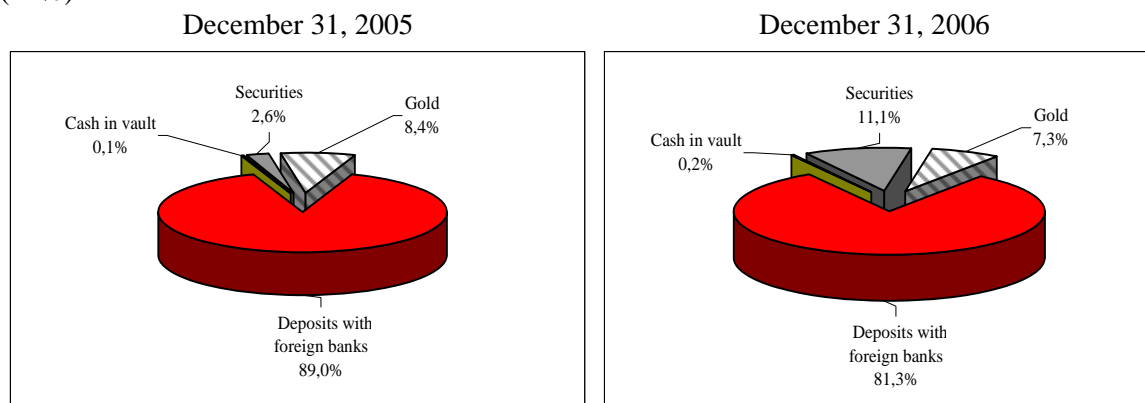
The steady increase in the gross foreign reserves over the year resulted in adequate average monthly export-import coverage ratio. Thus, at the end of 2006, the gross foreign reserves ensured 4.6 month coverage of the import of goods (f.o.b.) and services of the following year<sup>78</sup>, compared to the average coverage of 3.5 months at the end of 2005 (gross foreign reserves void of inflows from Eurobonds).

On December 31, 2006,

the total foreign assets of the

Figure 64

Structure of total foreign assets  
(in %)



Source: National Bank of the Republic of Macedonia.

The NBRM interventions on the foreign exchange market, with the supply of foreign currency exceeding the demand, contributed to alleviating the pressures for appreciation of the domestic currency. Thus, the average exchange rate of the Denar against the Euro equaled Denar 61.19 per one Euro in 2006, thus registering a slight annual appreciation of 0.2% (Denar 61.30 per one Euro in 2005). In 2006, the exchange rate of the Denar against the Euro on the currency exchange market appreciated by 0.2% compared to 2005.

<sup>78</sup> According to the balance of payments projection prepared within the IMF mission of February 2007.

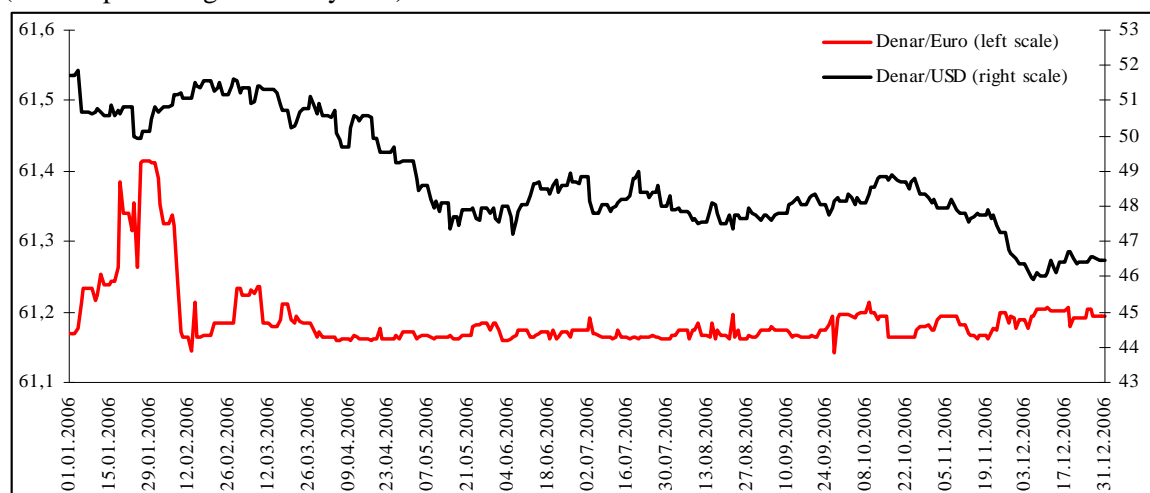
<sup>79</sup> The total foreign assets differ from the gross foreign reserves by the amount of foreign assets offered as collateral in foreign banks and from the funds allocated on a special account, included in the total foreign assets, but not in the gross foreign reserves.



Figure 65

Nominal exchange rate of the Denar relative to the Euro and the US Dollar on the foreign exchange market

(Denars per foreign currency unit)



Source: National Bank of the Republic of Macedonia.

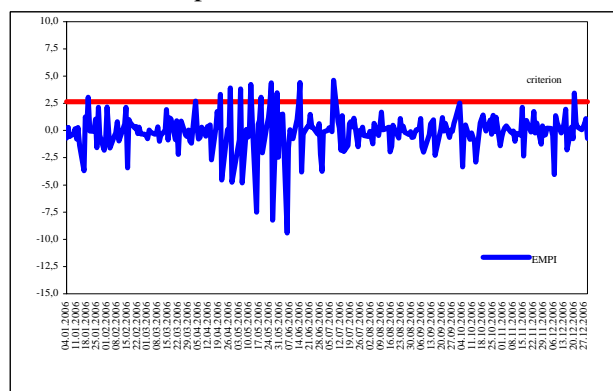
## Annex 10

### Exchange market pressure management

*The Exchange Market Pressure Index - EMPI*<sup>80</sup> as an indicator of currency crisis (if any), is a useful tool for evaluating the gravity of the turbulences on the foreign exchange market, ensuring location of the changes that result from the exchange market pressures.

Figure 66

EMPI for the Republic of Macedonia



Source: NBRM.

nominal exchange rate.

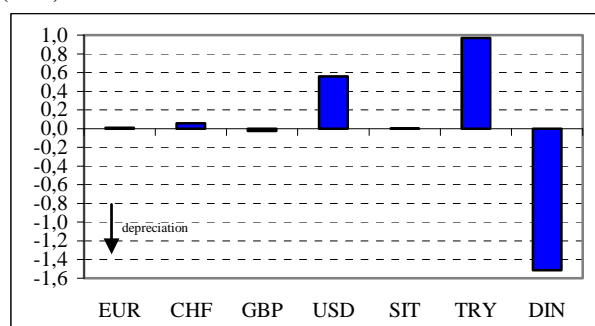
The 2006 analysis shows that most of the signals were registered in the first half of the year (primarily in the second quarter). Two thirds of the total signals registered in 2006 resulted from the change in the interest rate. However, we should take into account that in the aforementioned period the changes in the MBKS were not caused by the change in the interest rate on CB bills, which is relatively stable. In the second quarter of 2006, the interbank money market registered frequent (weekly) trading between two banks using higher interest rate, bringing about substantial fluctuations in the weighted MBKS on a daily basis.

Comparing the resulting EMPI values with the set criteria, in 2006, in 12 of 252 observations in total, the index values were above the set criteria, i.e. 12 signals were registered alerting presence of currency crisis. It indicates to an extremely low percentage of crisis events in 2006 (only 4.8%), i.e. the period under observation generally did not register any extreme, long-lasting change in the monetary policy, the NBRM intervention policy or in the

<sup>80</sup> The EMPI calculation for the Republic of Macedonia uses the daily nominal MKD/EUR exchange rate, the daily average weighted interbank interest rate (MBKS) and the ratio of the daily NBRM interventions on the foreign exchange market to reserve money.

The exchange rate of the Denar against the US Dollar is determined by the exchange rate of the US Dollar against the Euro on the world exchanges. Considering the appreciation of the Euro against the US Dollar on the international markets in 2006, the Denar also appreciated relative to the US Dollar. Thus the average exchange rate of the Denar against the US Dollar on the exchange market in 2006, equaled Denar 48.79 per one US Dollar, compared to Denar 49.29 per one US Dollar in 2005 (annual appreciation of 1%). In the April-May period, the appreciation was faster, with the level reached being preserved at a relatively stable level in the summer. In the middle of the last quarter, the Denar reinforced its value, with the exchange rate of the Denar against the US Dollar at the end of 2006 equaling Denar 46.45 per one US Dollar, appreciating by 10.2% on annual basis (Denar 51.73 per one US Dollar on December 31, 2005). On the exchange market, the average annual exchange rate of the Denar against the US Dollar for 2006 equaled Denar 48.83 per one US Dollar, appreciating by 0.8% on annual basis (Denar 49.24 per one US Dollar in 2005).

Figure 67  
Contribution to the change in the Denar NEER\*  
(in %)



\* The Euro uses aggregated weigh of the weighs of the of the countries in the Euro-zone, included in the REER calculations.  
Source: National Bank of the Republic of Macedonia.

The real effective exchange rate (REER) is one of the indicators for the competitiveness of the economy. Calculated as a ratio of the index of the nominal effective exchange rate (NEER)<sup>81</sup> to the relative price index<sup>82</sup>, the REER shows the changes in price competition of the national economy compared with the economies of the most important foreign trade partners.

In December 2006, the Denar NEER slightly depreciated by 0.1% compared to December 2005. The depreciation of the Denar relative to the Serbian Dinar was offset by the appreciation of the Denar relative to the new Turkish Lira and the US Dollar.

In December 2006, the Denar REER index, calculated according to the consumer price index appreciated by 0.2% compared to December 2005, exclusively owing to the fall in the relative prices, i.e. the faster annual growth in the domestic prices relative to the foreign prices (growth of 3.1% and 2.8%, respectively<sup>83</sup>). On the other hand, the Denar real effective exchange rate, calculated by using the producer price index shows improved export performances of the domestic products on the international markets. The REER index depreciated by 1.3% on annual basis, owing to the faster annual growth in the foreign producer prices compared to the domestic prices (growth of 4.5% and 3.2%, respectively<sup>84</sup>).

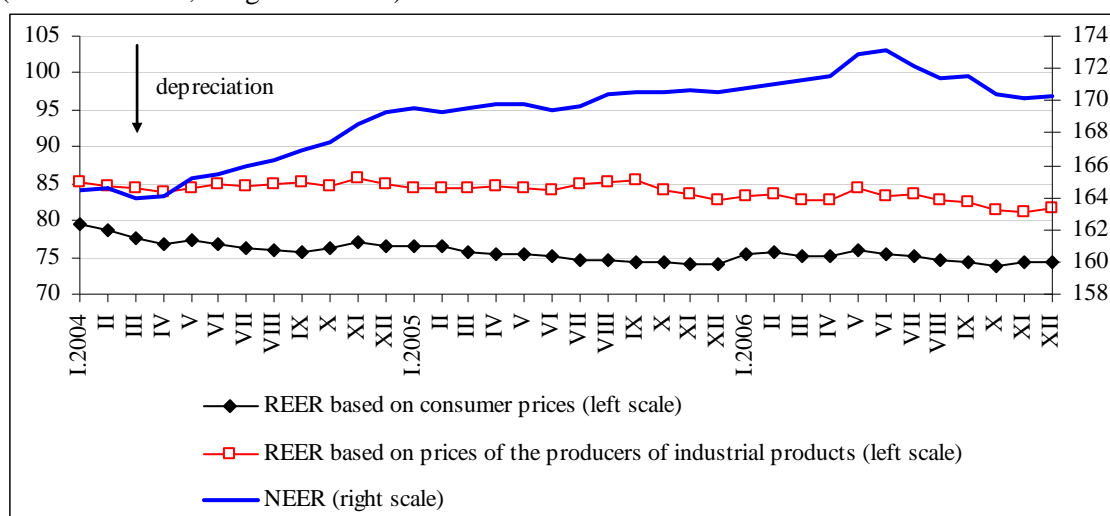
<sup>81</sup> Represent weighted geometrical average of the average exchange rates on bilateral basis (currency unit of the economies of the most important foreign trade partners per domestic currency unit).

<sup>82</sup> Foreign - to - domestic prices ratio.

<sup>83</sup> Price changes, base 1995=100.

<sup>84</sup> Price changes, base 1995=100.

Figure 68  
Denar REER and NEER Index  
(base 1995=100, weighs FT 2003)



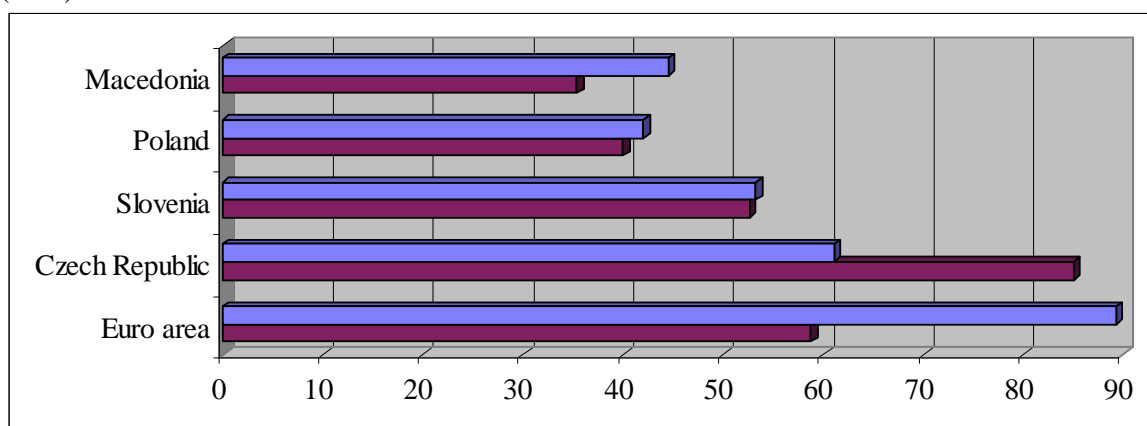
Source: National Bank of the Republic of Macedonia.

### 3.3. Monetary aggregates<sup>85</sup>

The high monetary growth rates in 2006 also show the potential of the domestic economy to generate additional available income and greater propensity to save in the banking system. Also, the banks' deposit base was also supplemented through the payment of the regular installments of the government bonds for the old foreign currency savings, and typical for this year also were the one-time effects. Thus the first half of the year registered a substantial amount of outflow of deposits from the banks to the government budget, in the process of sale of government equity in certain companies. On the other hand, the effect of payment of the dividend to the government and one foreign investor by one large company which was typical for 2005, was absent in 2006. The increase in the deposits in the banks ensured further increase in the monetization degree, as a pertinent indicator for the depth of the financial system. However, the comparisons with some developed economies indicate a space for further improvements in this segment.

<sup>85</sup>The monetary statistics data are preliminary.

Figure 69  
Share of the broadest money supply M4 in GDP\*  
(in %)



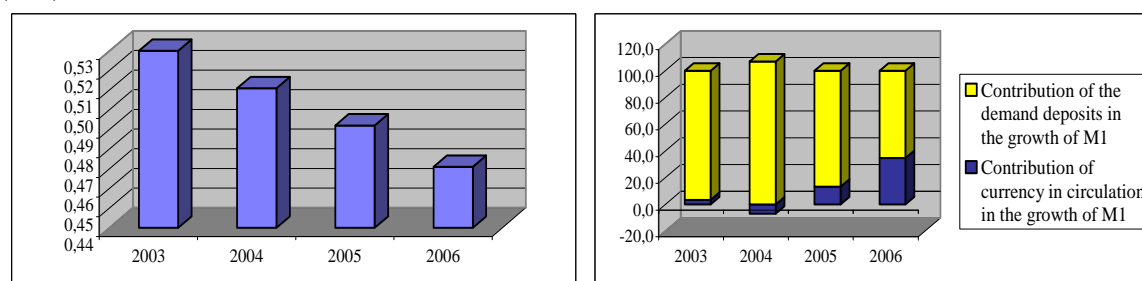
Source: IFS, IMF, February 2007.

\*The data on Macedonia refer to 2006, and those on the other countries to 2005.

\* The data are on annual basis, as of period-end.

The monetary aggregate M1 (currency in circulation and demand deposits) in 2006, registered an annual growth of 17.1%, given the increase in the demand deposits and the demand for currency in circulation of 21.7% and 12.1%, respectively. Such developments resulted in lower average monthly share of the currency in circulation in the money supply M1, which in 2006 accounted for 47.2%, i.e. by 2.1 percentage points less compared to the average of the preceding year.

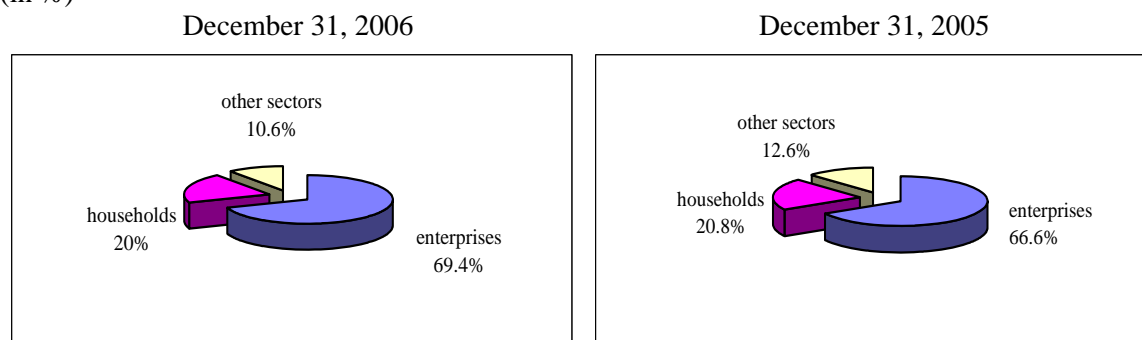
Figure 70  
Average share of currency in circulation in M1  
(in %)



Source: National Bank of the Republic of Macedonia.

The uptrend of the total demand deposits went on in 2006, given the simultaneous increase in the demand deposits of both corporate and household sector. The corporate demand deposits registered a faster growth, registering a growth rate of 26.7% at the end of 2006 (compared to 12.9% of the previous year). The annual growth rate of the household demand deposits at the end of 2006 equaled 16.7%, with the level of transaction deposits of the households permanently fluctuating.

Figure 71  
Structure of demand deposits by sector  
(in %)



Source: National Bank of the Republic of Macedonia.

The faster growth in the reserve money compared to the growth in the money supply M1 resulted in slower money multiplication process. Thus the money multipliers of the money supply M1, at the end of 2006 equaled 1.40 (1.45 in the previous year).

Table 26  
Components of monetary aggregates\*  
(in millions of denars)

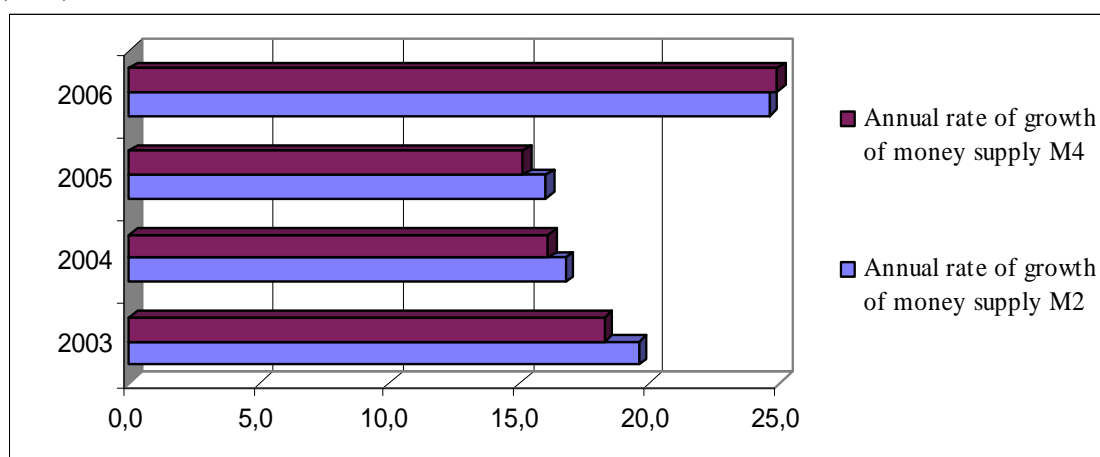
	Balance as of					Changes by quarters				total
	31.12.2005	31.03.2006	30.06.2006	30.09.2006	31.12.2006	I	II	III	IV	
Currency in circulation	14439	13700	14580	14810	16206	-739	880	230	1396	1767
Demand deposits	15224	14262	16188	17280	18527	-962	1926	1092	1247	3303
Money supply M1	29663	27962	30768	32090	34733	-1701	2806	1322	2643	5070
Quasi denar deposits	24364	27889	28062	30638	36316	3525	173	2576	5678	11952
Quasi foreign exchange deposits	49107	50756	52815	55224	57430	1649	2059	2409	2206	8323
Money supply M2	103134	106607	111645	117952	128479	3473	5038	6307	10527	25345
Non-monetary denar deposits	3057	3123	3255	3243	3630	66	132	-12	387	573
Non-monetary foreign exchange deposits	1983	2182	2433	2674	3008	199	251	241	334	1025
Money supply M4	108174	111912	117333	123869	135117	3738	5421	6536	11248	26943

\* The foreign exchange categories have been estimated at current exchange rate.

Source: National Bank of the Republic of Macedonia.

In 2006, the broader monetary aggregate rose. Thus the monetary aggregate M2 (money supply M1, sight deposits and deposits with maturity of up to one year) went up by 24.6% annually, being the greatest contributor to the growth in total short-term deposits of 80%, primarily in domestic currency. The monetary aggregate M2 - Denar components surged by 31.5% on annual basis, whereas the broadest money supply M4 (money supply M2, restricted deposits and long-term time deposits), at the end of 2006, rose by 24.9%. The money multipliers of the money supply M2 and M4, at the end of 2006 equaled 5.16 and 5.42, being by 0.11 and 0.13, respectively, higher compared to the end of the preceding year.

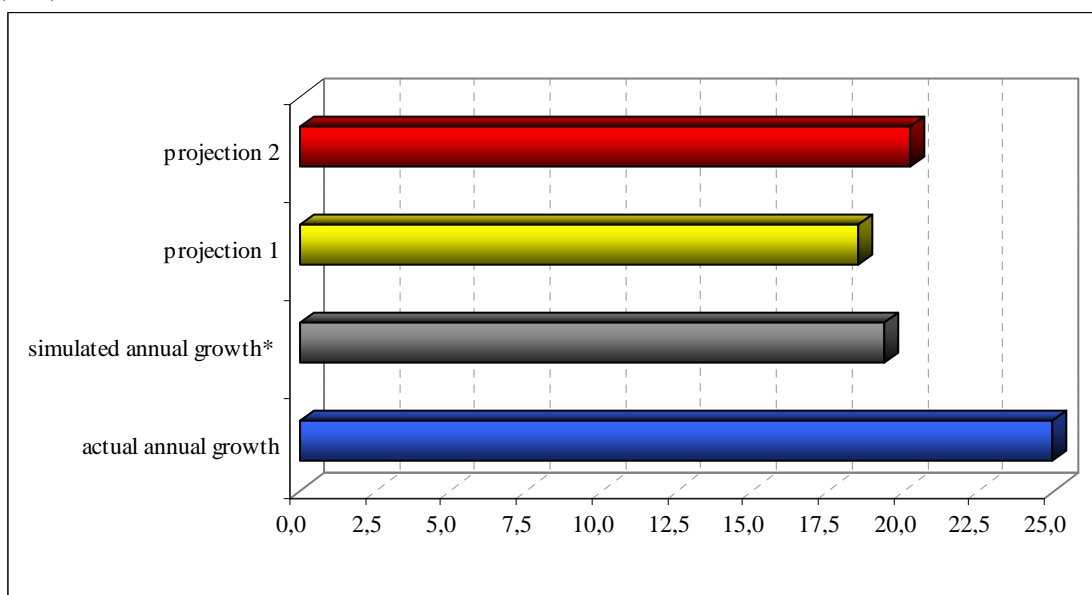
Figure 72  
Average annual growth rates of M2 and M4  
(in %)



Source: National Bank of the Republic of Macedonia.

Such pace of the broadest money supply M4 is partially due to the unrealized payment of dividend to the government and to the foreign investor by one large domestic company, i.e. to the lower comparison base of the previous year when this effect was registered. However, even by insulating the effect of the unpaid dividend, the money supply M4 in 2006 registered a growth faster than expected. Thus, the simulated annual growth in the money supply M4 (under assumption that the dividend will be paid) would equal 19.3%, compared to the initial projection of 18.5%.

Figure 73  
Annual growth rate of the money supply M4 in 2006  
(in %)



\* Simulated annual growth of the money supply M4 under assumption that the dividend to the government and to the foreign investor by one large domestic company will be paid.

Projection 1 - initial monetary projection from December 2005; Projection 2 - last revised projection from November 2006.

Source: National Bank of the Republic of Macedonia.

## Annex 11

### Comparative country-by-country analysis of the level of currency in circulation

The currency in circulation and the demand deposits are components of the money supply M1. The level of using the cash is a sort of indicator for the volume of transactions in the consumption. Indicators for the relative importance of the currency in circulation to the economy are the share of currency in circulation in the money supply and the ratio of currency in circulation - to - nominal gross domestic product. The comparison analysis of the first indicator in the Republic of Macedonia with the respective indicators of other countries, we could conclude that the volume of cash transactions in our country is notably higher relative to other countries of the comparative analysis (except for Albania). The high level of cash, in turn, contributes to the increase in some costs, such as the central bank's costs of their issuance and distribution, and costs of the cash holders (losing income from such assets in the form of interest if held in a bank).

Table 27

Share of currency in circulation in the money supply M1

(in %)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Romania	47,8	48,9	52,0	58,6	55,5	55,4	51,6	51,2	48,8	46,4	42,8
Slovakia	25,1	29,5	33,9	37,5	36,1	35,9	34,4	26,0	24,9	25,6	25,0
Albania		79,3	81,6	79,0	80,0	83,3	90,9	89,5	87,0	81,8	/
Bosnia and Herzegovina		45,6	52,6	47,6	47,2	63,6	58,7	52,6	48,7	42,9	39,8
Bulgaria		42,1	48,9	51,7	52,6	53,5	51,1	49,0	47,3	43,9	39,1
Croatia		38,7	42,3	43,0	36,8	35,9	31,4	31,2	31,7	31,3	30,1
Czech Republic		28,5	31,6	35,3	34,5	30,9	24,0	23,0	23,1	22,7	22,3
<b>Macedonia</b>		<b>51,0</b>	<b>47,0</b>	<b>41,5</b>	<b>43,1</b>	<b>55,8</b>	<b>53,9</b>	<b>51,8</b>	<b>51,3</b>	<b>48,7</b>	<b>46,7</b>
Poland		44,2	42,2	43,3	41,3	42,4	37,4	37,0	34,8	32,7	/
Slovenia		34,0	32,8	34,5	31,3	30,9	21,2	20,4	17,2	17,0	/
Euro Area		22,4	20,6	20,4	19,1	12,9	16,1	16,7	17,8	17,0	17,5

Source: IMF, IFS March 2007.

In the 1997-2006 period, the average share of currency in circulation in the money supply M1 in the Republic of Macedonia equaled 49.1%, which is by 11.9 percentage points over the average of the group of Central and East European countries, included in the comparative analysis (2006 data). Observing individually the average use of cash, in the period from 1997 to 2006, Macedonia follows Albania, with the similar level being registered in Romania, Bosnia and Herzegovina and Bulgaria. In the recent years, however, the cash transactions in Macedonia have been registering a downtrend, due to the higher usage of payment cards. In the 1997-2006 period, the average share of currency in circulation in the money supply M1 in the Republic of Macedonia was by 31.1 percentage points above the average in the Euro-zone.

The second indicator provides a different picture. The average share of currency in circulation in the gross domestic product for the 1997-2005 period equaled 4.8%, which is by 2.7 percentage points below the average level in the group of countries under observation, mirroring the permanent level of monetization of the country. The level of the Republic of Macedonia is similar to that of Croatia and Poland, and compared to Slovenia, the average share of currency in circulation in GDP in the Republic of Macedonia is by 2 percentage points higher. Comparing with the Euro-zone average, the share of currency in circulation in GDP in our country is by 1.2 percentage points below the European level.

Table 28  
Share of currency in circulation in GDP  
(in %)

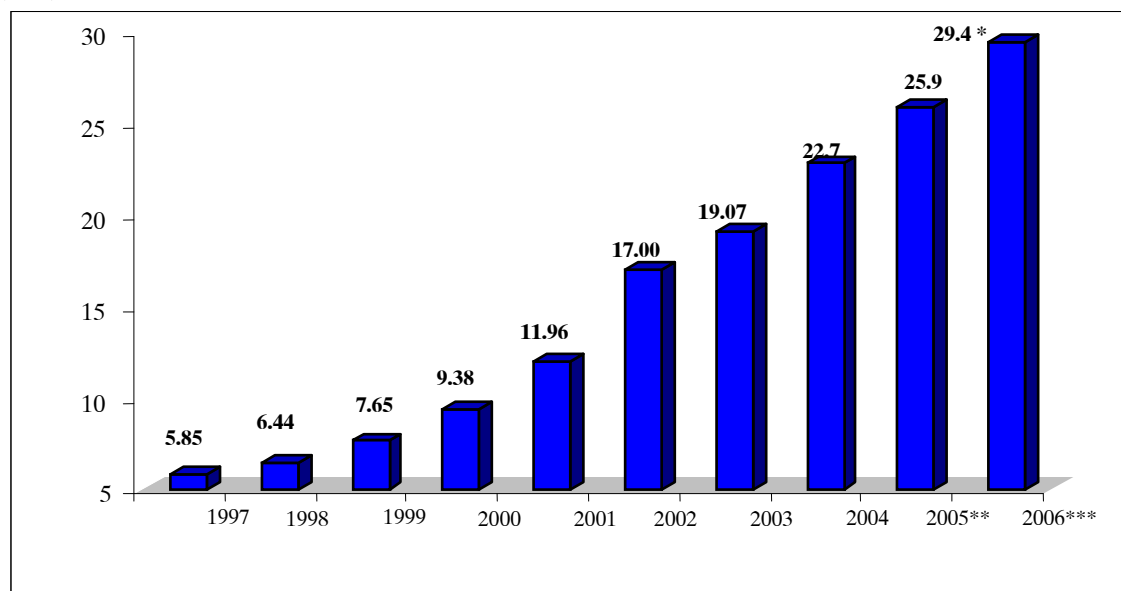
	1997	1998	1999	2000	2001	2002	2003	2004	2005
Albania	22,6	16,6	17,1	18,7	20,3	20,9	18,3	18,4	18,2
Bosnia and Herzegovina	1,8	2,2	5,7	6,5	15,3	14,9	13,0	12,4	11,7
Croatia	4,3	4,2	4,2	4,4	5,1	5,3	5,3	5,1	5,3
Czech Republic	6,6	6,4	7,6	7,8	7,7	8,0	8,6	8,5	8,9
<b>Macedonia</b>	<b>3,8</b>	<b>3,7</b>	<b>3,9</b>	<b>4,0</b>	<b>6,0</b>	<b>5,8</b>	<b>5,6</b>	<b>5,3</b>	<b>5,1</b>
Poland	5,3	5,0	5,7	4,6	4,9	5,2	5,9	5,5	5,8
Romania	3,6	3,1	3,2	3,2	3,0	3,0	2,9	3,0	4,0
Slovakia	6,7	6,3	6,7	7,1	7,9	7,6	7,6	7,4	8,1
Slovenia	2,5	2,7	3,2	2,8	3,0	2,7	2,7	2,7	2,8
Bulgaria	7,6	7,8	8,2	8,9	10,4	10,3	11,2	12,1	12,9
Euro area	/	6,1	6,4	6,1	4,2	5,4	6,0	6,7	7,3

Source: IMF, IFS, February 2007.

### 3.3.1. Total deposits

In 2006 (except for June) the total banks' deposit potential was constantly increasing, which is an indicator for the greater confidence of the economic agents in the banking sector. Also, the higher level of deposits is a basis for strengthening the financial intermediation of the banking sector and the overall investment activity in the country. The positive developments are illustrated by the increase in their share in the gross domestic product (GDP), which in 2006 equaled 29.4%, being by 3.5 percentage points higher compared to the end of 2005.

Figure 74  
Share of deposits in GDP  
(in %)



\* Arithmetical monthly average of the total deposits in GDP.

\*\*Previous data.

\*\*\* Estimated data.

Source: National Bank of the Republic of Macedonia.

At the end of 2006, the total deposit potential of the banking system surged by 27.9%. The maturity structure analysis shows dominant contribution of the short-term deposits to the creation of additional deposit base (92.7%). However, 2006 registered greater propensity for long-term savings, leading to an increase in the long-term deposits (of 31.7%), which is a 7.3% contribution



to the increase in the total deposits. Observing the currency of denomination structure, unlike 2005, when the foreign currency deposits were the major contributors to the increase in the total deposits, in 2006, the domestic currency deposits increased in a faster pace. Thus, at the end of 2005, the Denar deposits went up by 45.7%, contributing with 57.3% to the increase in the total deposits.

Table 29

Total deposits of the banking system\*  
(in millions of denars)

	Balance as of						annual change (in %)	structure of the total deposits		contribution in growth of the total deposits 2006
	31.12.2005	31.03.2006	30.06.2006	30.09.2006	31.12.2006	total		31.12.2005	31.12.2006	
Total deposits of non-government sector	78511	83950	86565	91779	100384	21873	27.9	100%	100%	100%
- in denars	27421	31012	31317	33881	39946	12525	45.7	34.9	39.8	57.3
- in foreign exchange	51090	52938	55248	57898	60438	9348	18.3	65.1	60.2	42.7
Short-term deposits	73471	78645	80877	85862	93746	20275	27.6	93.6	93.4	92.7
- in denars	24364	27889	28062	30638	36316	11952	49.1	33.2	38.7	54.6
- in foreign exchange	49107	50756	52815	55224	57430	8323	16.9	66.8	61.3	38.1
Long-term deposits	5040	5305	5688	5917	6638	1598	31.7	6.4	6.6	7.3
- in denars	3057	3123	3255	3243	3630	573	18.7	60.7	54.7	2.6
- in foreign exchange	1983	2182	2433	2674	3008	1025	51.7	39.3	45.3	4.7

1/ Short-term deposits include sight deposits and deposits with maturity of up to one year.

2/ Long-term deposits include deposits with over one year maturity and restricted deposits.

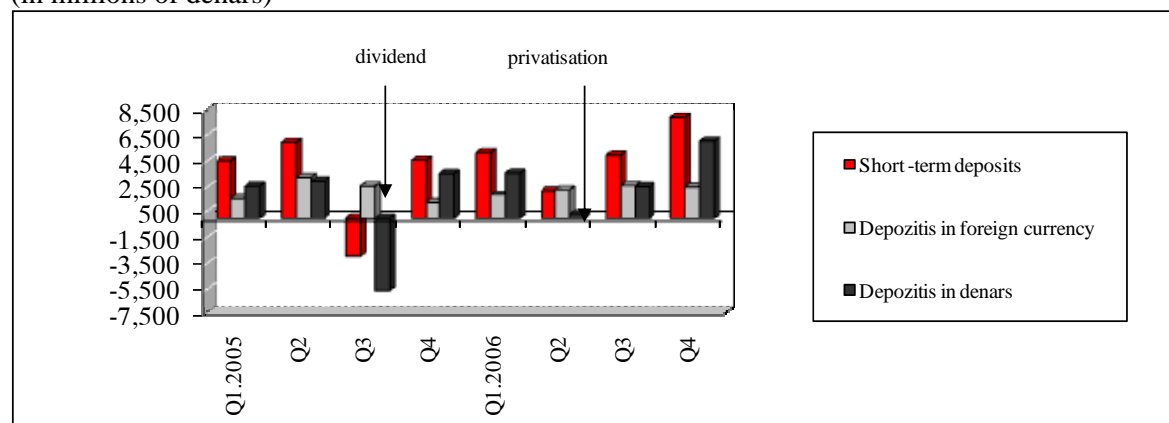
\* Foreign exchange categories are estimated at current exchange rate.

Source: National Bank of the Republic of Macedonia.

The monitoring of the quarterly developments of some deposit components with respect to maturity and currency of denomination in 2005 and 2006 indicates that they were maintained within the growth zone, except for the periods when some individual large-value transactions (payment of dividend to the government and to foreign shareholders, privatization) lead to substantial narrowing of the deposit base. Furthermore, typical for most of this period is the identical and faster growth pace of the Denar savings compared to the foreign currency savings, which shows stable expectations regarding the exchange rate and the inflation.

Figure 75

Quarterly changes in some components of the total deposits  
(in millions of denars)



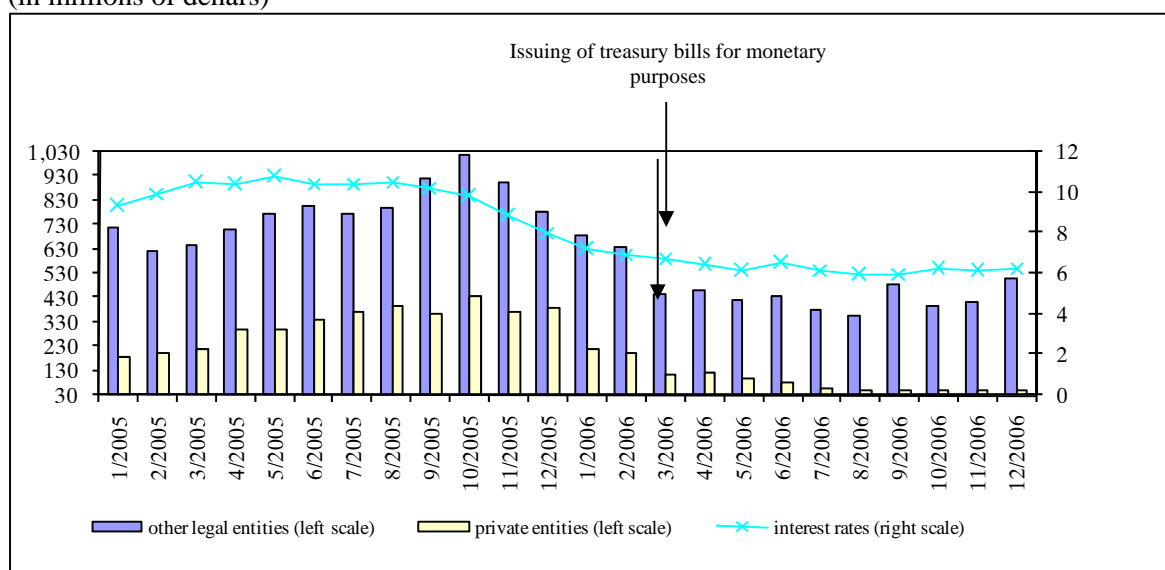
Source: National Bank of the Republic of Macedonia.

The high annual growth rate of the household deposits in 2006 indicates a further growth in the inflows in this sector and their retaining to the banking system. Thus, on December 31, 2006, the total household deposits went up by 24.5% compared to the end of the preceding year. Most of the increase was generated from the additional inflows on the household accounts based on payment of the bonds for the old foreign currency savings, which remained in the banking system as short-term deposits (sight deposits and deposits with maturity of up to three months). In addition, the increase in the household deposits corresponds with the nominal wage growth, the further growth in the credits disbursed to the households (transfer of the extended funds to the household accounts), and could partially be explained with the fast increase in the private transfers. The channels of directing such funds to the deposits may be direct (transfer of remittances from

abroad to bank accounts) and indirect (conversion of the foreign currency savings outside the banks to Denars and their depositing to bank accounts). The increase in the household Denar deposits was a dominant factor for the increase in the household total deposits (of 51.9%) contributing with 57.8% to the increase in the total household deposits, given the 6 percentage points lower share of the household foreign currency deposits in the total household deposits, thus directly showing the higher credibility of the domestic currency and the NBRM policy. Observing the maturity, the short-term savings were still a dominant form of savings of the households, constituting 91.5% of the increase in the household total deposits. Observed quarterly, the total household deposits were steadily increasing in all four quarters of the year, with the fastest pace being registered in the first and the fourth quarter.

Figure 76

Corporate and household investments on the 3-month treasury bills market  
(in millions of denars)



Source: National Bank of the Republic of Macedonia.

The launch of the government securities in 2004 implied an introduction of alternative forms of household and corporate investments, besides the deposits in banks as a classical form of savings. In 2006, however, the investments of these sectors in government securities reduced. Thus the share of the household and the corporate sector in the 3-month treasury bills market dropped by 15 percentage points and 23 percentage points, respectively at the end of 2006, compared to the previous year. Such behavior on this market segment, could be largely explained with the cut in the government securities interest rates, demonstrating greater sensitivity to the changes in the return on securities, relative to the changes in the return on deposits (which is somehow expected, taking into account the role of the deposits as an underlying investment form, and the auction-based setting of interest rates on treasury bills, opposite of the pre-determined return on deposits). On the other hand, the introduction of treasury bills for monetary purposes in March 2006 and the increase in their supply at the expense of the demand of CB bills resulted in redirecting the demand of the banks to the new financial instrument, thus additionally reducing the share of the household and the corporate sector in the government securities market.

Table 30

## Total household and corporate deposits

(in millions of denars)

	Households				Enterprises			
	31.12.2006	annual change (in%)	contribution to the growth in total deposits	share in total deposits	31.12.2006	annual change (in%)	to the growth in total deposits	share in total deposits
Total	67.352	24.5	60.6	67.1	30.774	36.4	37.5	30.7
-Short-term	63.458	23.7	55.5	63.2	29.438	38.5	37.4	29.3
-Long-term	3.894	40.7	5.1	3.8	1.336	2.5	0.14	1.3
-in denars	22.446	51.9	35.1	22.3	15.515	40.6	20.4	15.4
-in foreign exchange	44.906	14.3	25.6	44.7	15.259	32.4	17.1	15.2

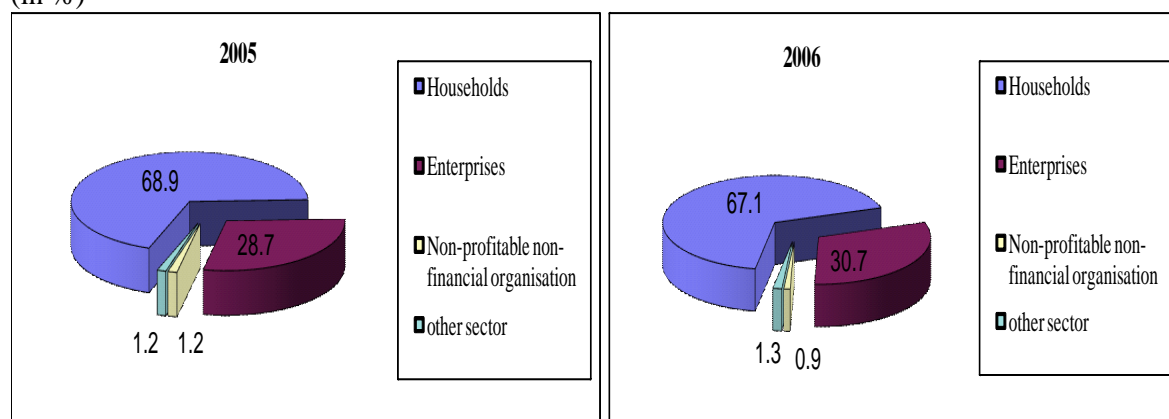
Source: National Bank of the Republic of Macedonia.

At the end of 2006, compared to the end of the preceding year, the corporate deposits surged by 36.4%, illustrating accelerated economic activity. The positive annual change primarily showed the preferences of the corporate sector to restrict their deposits on a short run, and unlike the preceding year when foreign currency deposits dominated, 2006 registered a considerable increase in domestic currency deposits. Such picture, however, partially results from the unpaid dividend in 2006 by one large company. If the level of Denar deposits is adjusted by this effect, the annual increase in the total corporate deposits would be 9.8%. Analyzing the maturity structure, the short-term deposits were the major contributor to the increase in the total corporate sector (99.6%), and from the aspect of currency of denomination structure, the Denar deposits made up 54.5% to the growth in the corporate deposits.

Figure 77

## Share in total deposits

(in %)



Source: National Bank of the Republic of Macedonia.

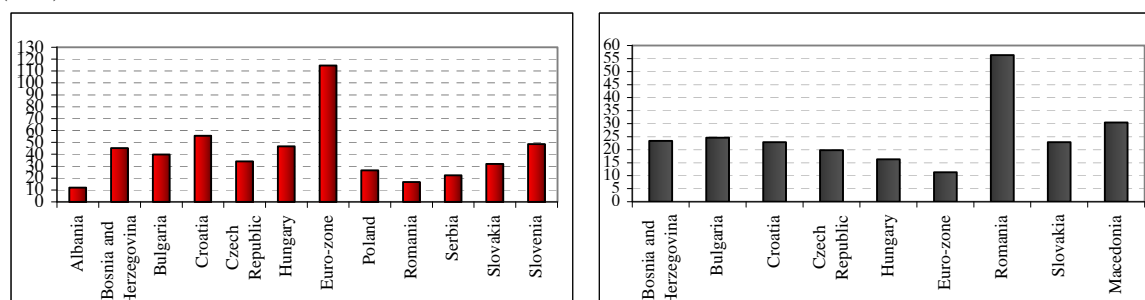
### 3.4. Bank placements

The trend of banks' credit expansion, typical for the last three years, went on in 2006. Thus, at the end of 2006, the total credits extended to the private sector surged by 30.5%. The active role of the banks on the credit market was a significant financial support for the households' consumption needs and for the corporate investments and indicates further deepening of the financial intermediation. The credits extended to the private sector make up 26.1% of GDP, as an indicator for the depth of the financial intermediation in 2006<sup>86</sup>, which is by 3.8 percentage points higher<sup>87</sup> compared to the preceding year.

The analysis made within the EBRD Transition Report 2006 shows an interconnection between the economic development of the country and the development of the financial system. However, typical for the economies in transition, is that the level of financial markets development and the degree of financial intermediation does not correspond with the generated income. Some institutional factors such as the length of lawsuits for unsettlement of debt, the insufficient protection of the creditors' rights and (non)existence of credit registries are indicated as major factors for the underdevelopment of their financial intermediation. The analysis also includes an assessment of the potential share of the credits in GDP, i.e. the level which is likely to be achieved in the case of implementation of the required institutional reforms. The estimations show that from 1999 to 2003 in the Republic of Macedonia, the gap between the current and the potential level of credits to the private sector, as a percentage of GDP equaled approximately 6 percentage points, indicating the need of implementation of additional institutional reforms. Taking into account, however, that the credit expansion started in 2003, and 2003-2006 period also witnessed institutional reforms, there is a great likelihood that such estimated gap is substantially narrowed.

Figure 78

The share of total banks' placements in GDP in 2005 and annual credit growth rate in 2006 by country  
(in %)



Source: IFS.

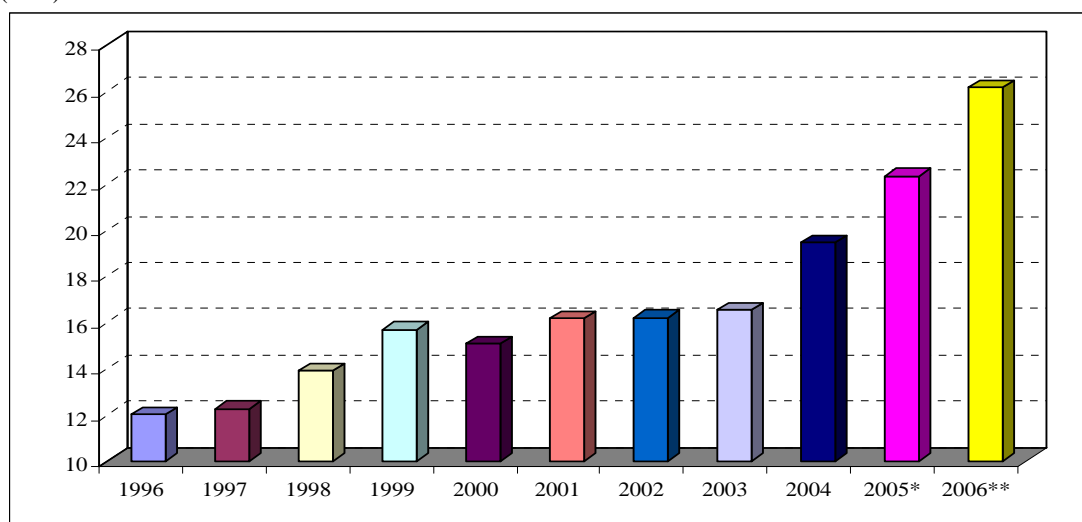
The comparative analysis of the credit market development shows that in spite of the permanent trend of deepening the degree of financial intermediation in the Republic of Macedonia,

<sup>86</sup> Estimated as a share of the average monthly stock of credits in this year in GDP. If this indicator is estimated as a share of the stock of the credits at the end of the year in GDP, for 2006 it would be 29.6%, which is by 5.4 percentage points more relative to the preceding year.

<sup>87</sup> The GDP data for 2006 is estimated, and for 2005 it is preliminary. Source: State Statistical Office.

relative to more advanced countries in transition, the credits to the private sector are still maintained at a relatively low level. According to the last available data, in 2005, the Republic of Macedonia, together with Albania and Romania belongs to the countries with lowest degree of financial intermediation, perceived through the relatively low share of credits in GDP. Yet, in 2006, in Romania and Macedonia, the credits to the private sector register the highest annual growth rates, which primarily show the initially high level of financial intermediation. Hence, the possible further acceleration of the credit growth in the Republic of Macedonia is expected go generate simulative effects on the overall economic activity in the country, without negative macroeconomic implications.

Figure 79  
Share of credits in GDP  
(in %)



\* Preliminary data on GDP value.

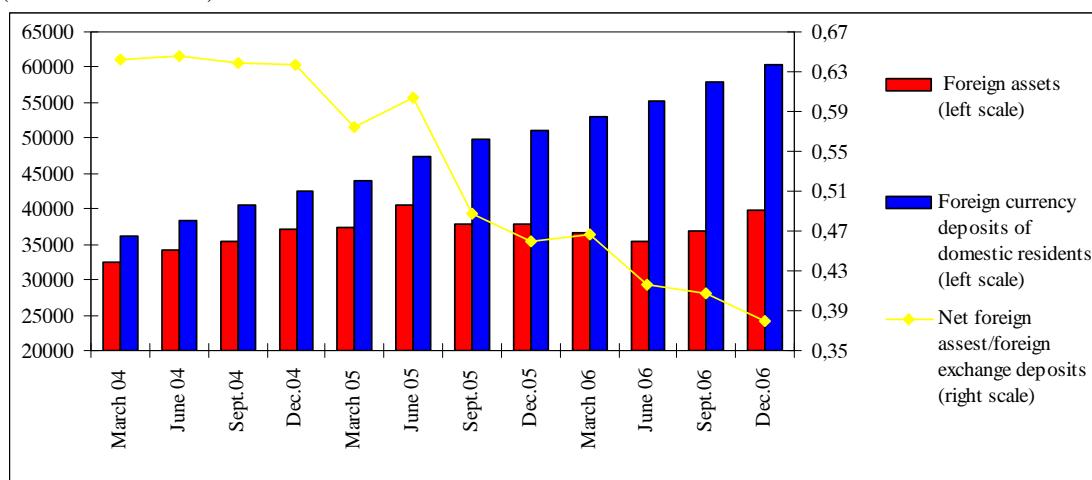
\*\*Estimated GDP value.

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

Most of the accelerated credit activity of the banks in 2006 could be explained with the permanent expansion of the banks' deposit base, and the tendency for gradual loosening of the lending terms. Thus, major factors that contributed to loosening the lending terms are the higher competition in the banking sector, the optimistic expectations for the overall economic activity in the future and the improvement of the banks' liquidity position. Loosening of the lending terms primarily implies lower interest rates and lending fees, which largely results in higher demand for credits by the corporate sector, predominantly for investments of the households in fixed assets and consumer credits<sup>88</sup>. The more active exploitation of the available foreign exchange potential by the banks could be considered an additional factor that contributed to the acceleration of the banks' lending activity, and at the end of 2006, the share of funds on the accounts with foreign banks in the total assets of the banking sector reduced by 2.3 percentage points on annual basis. Furthermore, 2006 also registered exploitation of external sources of funds by the banks, and recapitalization of one of the largest banks in the Republic of Macedonia, which was expected to have positive effect on the further acceleration of the credit activity in 2007. In line with such developments, the net foreign assets of the banking system dropped by 2.3% relative to 2005, given the faster increase in the foreign liabilities of the banks (of 17.2% on annual basis), compared to the increase in their foreign assets (of 5.1% on annual basis). Hence, the net foreign assets - to - total foreign liabilities ratio in the banking system at the end of 2006 equaled 0.38 (0.46 in December 2005).

<sup>88</sup> The information on factors that contributed to loosening the credit terms are obtained from the banks' credit activity survey for June, September and December 2006.

Figure 80  
Resident foreign assets and foreign deposits in banks  
(in millions of denars)



Source: National Bank of the Republic of Macedonia.

Observing the quarterly dynamics, the fastest increase in the total bank credits was registered in the second and the fourth quarter of 2006 (growth rated of 9% and 9.4%, respectively), with 31.2%, i.e. 36.6% of the total annual credit growth being realized. The first quarter registered 6.2% slower growth pace, whereas the lowest growth rate of 3.2% was registered in the third quarter, due to the reduction in the non-performing credits in September and the lower amount of total credits.

The 2006, the currency of denomination structure analysis shows faster increase in foreign currency placements relative to Denar placements<sup>89</sup> (36.6% and 28.5%, respectively). However, taking into account the dominant share of Denar credits (74%) in the total credits, the growth in the total placements (70.2%) mainly results from the higher Denar lending. The growth in the Denar placements (56.1%) primarily results from the preferences of the households for Denar credits, and typical for the first half of 2006 was the gradual shift of the corporate sector from borrowing in foreign currency to borrowing in Denars. Nevertheless, one should take into account that Denar credits include foreign currency indexed credits, accounting for 26.4% in the total credits on December 31, 2006 (22.2% in 2005). The foreign currency credit growth primarily arises from the increased lending to corporate sector, constituting 84.7% of the growth in the banks' total foreign currency placements.

<sup>89</sup>Includes foreign currency indexed credits.

Table 31  
Domestic credits of deposit banks\*  
(in millions of denars)

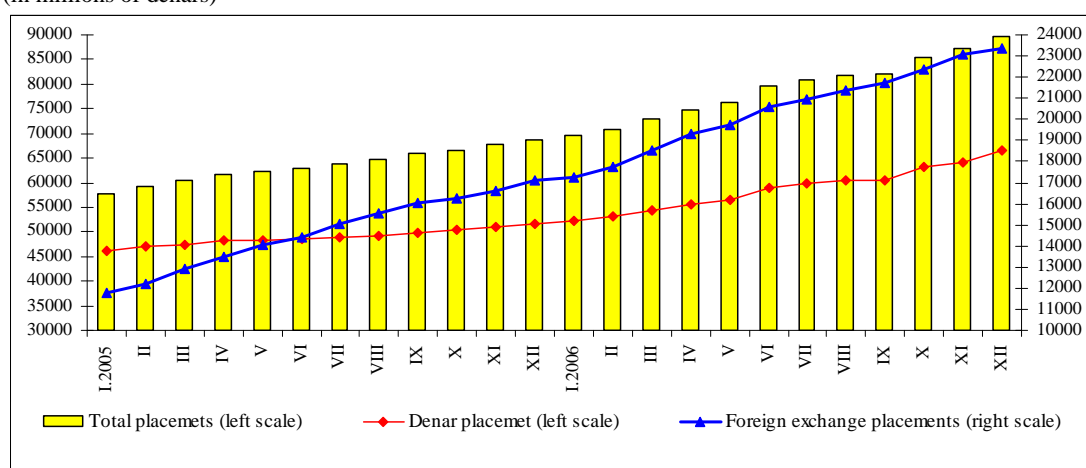
	Balance as of 31.12.2006	Annual change		Contribution to growth in total placements (in )
		in millions of Denars	in %	
Total placements of banks to private sector	89.780	21.003	30,5	
In Denars	66.413	14.741	28,5	70,2
In Foreign Currency	23.367	6.262	36,6	29,8
Short-term	36.459	5.544	17,9	26,4
Long-term	53.321	15.459	40,8	73,6
Enterprises	58.820	11.833	25,2	56,3
Households	30.855	9.230	42,7	43,9

\*The foreign exchange categories are estimated at a current exchange rate.

Source: National Bank of the Republic of Macedonia.

With respect to maturity, long-term credits dominated in 2006 registering fast annual growth of 40.8%, constituting 73.6% of the growth in the total credits. In line with such developments, the share of long-term credits in the total credits reached 59.4%, which is by 4.3 percentage points more compared to 2005. On the other hand, the short-term credits registered milder annual growth rate of 17.9%. Most of the total long-term and short-term credits (56.7% and 78.5%, respectively) were allocated to the corporate sector.

Figure 81  
Bank placements  
(in millions of denars)



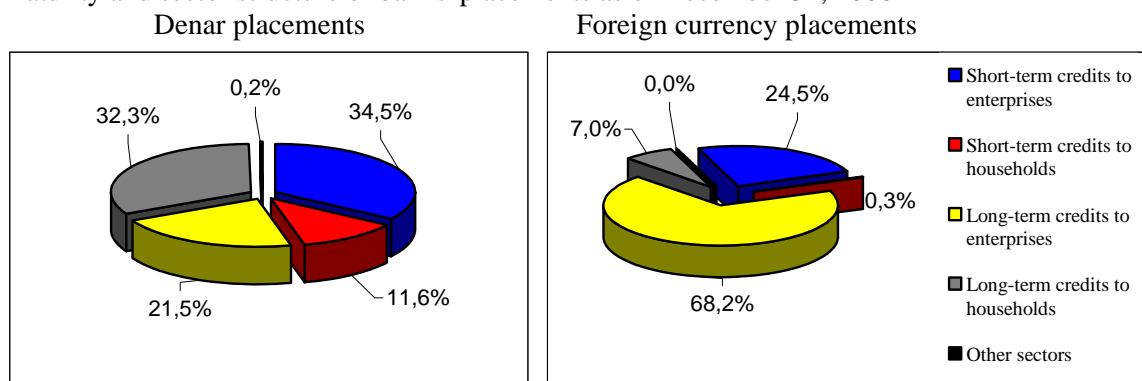
Source: National Bank of the Republic of Macedonia.

The sector-by-sector analysis of placements indicates that the banks furthered the intensive funding of the needs of both corporate and household sector in 2006, thus encouraging the investment and private consumption and consequently, the economic growth. In 2006, the banks were predominantly focused on lending to the corporate sector, where the credits extended to the corporate sector accounted for 56.3% of the total credit growth. In line with such developments, the lending to the corporate sector became a relevant factor in the total credit structure, which is also an indicator for the higher investment consumption, unlike the preceding year when the banks were mainly focused on lending to households. On the other hand, in 2006, the lending to households

increased in a faster pace, owing mainly to the increase in the long-term Denar credits, aimed at inducing the consumption of durable goods.

Figure 82

Maturity and sector structure of banks' placements as of December 31, 2006



Source: National Bank of the Republic of Macedonia.

The total placements to household at the end of 2006 registered a fast annual growth of 42.7%. The currency of denomination analysis indicates an annual increase in the Denar placements of 39.6%, which constitute 89.5% of the growth in the total placements to households. Moreover, fast annual growth of 2.3 times was also registered in the foreign currency placements to households, accounting for 5.5% of the total placements to households in 2006 (3.4% in 2005). The analysis of the maturity structure shows higher preferences of the households to borrow on a long run, so that the long-term credits, making up 74.9% of the total credits to the households, constituted 72.2% of their total growth. Observing the long-term credits to households, the long-term Denar credits for housing and other purposes<sup>90</sup> registered the fastest annual growth (of 40.1% and 35.4%, respectively). The long-term credits for other purposes constituted the main component of the increase in the total long-term credits to the households, accounting for roughly 50% of the increase in the total placements to households. On the other hand, the fastest annual growth of 49.3% was registered in the short-term credits to households, particularly the credit commitments<sup>91</sup> (twice, on annual basis).

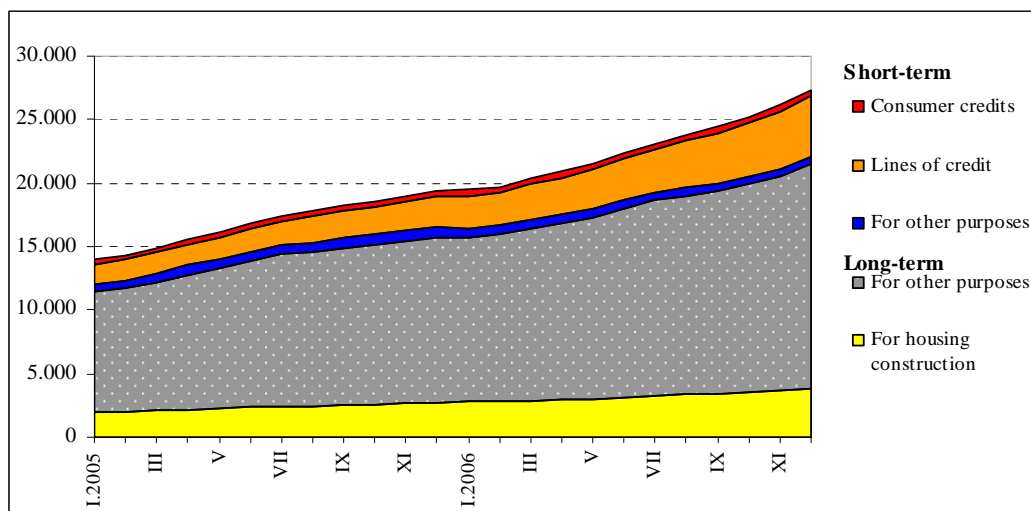
<sup>90</sup> Credits for other purposes include consumer credits, housing credits, automobile credits, education credits and credits for other purposes.

<sup>91</sup> Negative current account balances.



Figure 83

Distribution of Denar credits to households by type of credits  
(in millions of denars)

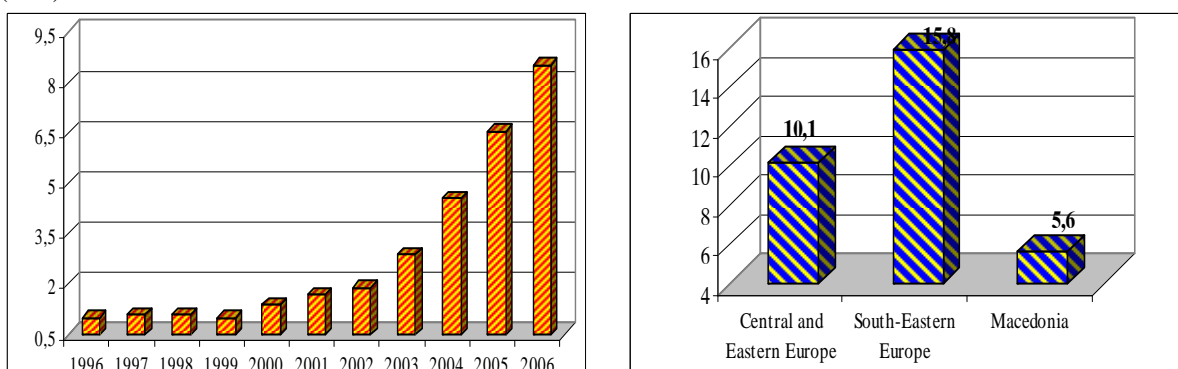


Source: National Bank of the Republic of Macedonia.

The increase in the credits to the household sector, as a sector that is dispersed and ensures greater diversification, resulted in exceptionally significant growth in their share in GDP. It contributes to narrowing the gap in the level of financial intermediation between Macedonia and the more advanced countries. However, the comparison of the trends in the other economies in transition shows that the absorption capacity on this market segment in our country is still underexploited. Thus, in the 2003-2006 period, these credits constituted 5.6% of GDP on average, which is by 10.1% and 15.8%, below the average of CEB and SEE countries, respectively (average for 2000-2005 period).

Figure 84

Share of credits to households to GDP\*  
(in %)



\*CEB (Central Europe and Baltic countries), SEE (Southeast Europe). As for these countries, the figure shows the average share for 2000-2005 period, whereas the data on Macedonia shows the geometrical average for 2003-2006 period.

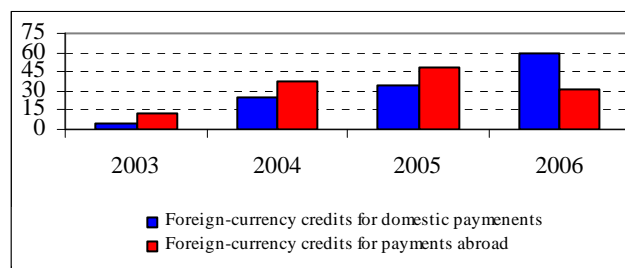
Source: NBRM, SSO, EBRD Transition Report 2006.

In 2006, the bank credits extended to the corporate sector went on supplementing the needs of finances of the corporate sector. Thus, at the end of December 2006, the total placements to enterprises registered an annual growth of 25.2%. Observing the currency of denomination structure, the fast annual growth in the total placements primarily arises from the higher preferences of the enterprises to borrow in domestic currency. The Denar credits to the corporate sector went up by 21.3% on annual basis, making up 55.2% of the increase in the total placements to the corporate sector, and, unlike the preceding year, in 2006 the enterprises gradually switched

towards borrowing in domestic currency. The foreign currency placements also registered a fast annual growth rate of 32.4%, which corresponds with the fall in the price of these credits. Most of the total foreign currency placements to the corporate sector (59.2%) were intended for repayment of domestic liabilities (foreign currency credits disbursable and repayable in domestic currency).

Figure 85

Share of foreign currency credits to corporate sector for domestic and international payments, compared to the total foreign currency placements to the enterprises (in %)



Source: National Bank of the Republic of Macedonia

Analyzing the maturity, the total long-term credits to the corporate sector registered an annual growth of 41.1%. In line with such developments, in 2006 the enterprises shifted towards long-term borrowing. Hence, the share of long-term credits in the structure of total credits to the enterprise sector equaled 51.4% (45.6% in 2005), which is an indicator for the accelerated investment activity of the enterprises in fixed assets<sup>92</sup>, in particular. As a result of the preferences of the enterprises to

borrow on a long run, the total short-term credits registered relatively lower annual growth rate of 11.9%, given the slower growth pace of the short-term Denar credits.

The downtrend of the banks' overdue claims and suspicious and contested claims<sup>93</sup> kept on in 2006, which is a positive signal for their adequate credit portfolio management, and for greater financial discipline and higher financial reliability of clients.

## Annex 12

### Credit Activity Survey

Taking into account the significance of the credits to the economic activity, the availability of specific qualitative information on the lending terms considerably facilitates the understanding of the method of credit market functioning. Therefore, in July 2006, the NBRM started conducting a Banks' Credit Activity Survey on a regular quarterly basis, designed virtually the same as the Survey of the European Central Bank. The questions included in the Survey refer to the household and corporate sector, including analysis of the lending terms, factors that contribute to the change in the terms, the expectations for the future changes in the lending term and the current developments and the expectations for the future developments in the demand for credits. Primary objective of the Survey is to provide specific qualitative information on the factors that affect the supply of and demand for credits, and better anticipation of the future developments on the credit market. The information obtained from the Survey should ensure more adequate interpretation of the regular statistical data on the banks' credit activity. The statistical data rather show the amount of credits extended and the changes within a certain time period, than the factors that affect such developments.

The results from the three surveys indicate a constant trend of partial loosening of the *terms of lending* to the corporate and household sector, mainly owing to the cut in the interest rates. Major factors that contributed to loosening the lending terms are the competition of other banks and the perceptions for the overall economic activity, as well as the expectations for the perspective of the branch the company belongs to, in the area of lending to corporate sector, i.e. the perspectives of the housing and durables consumption market, in the segment of lending to household sector.

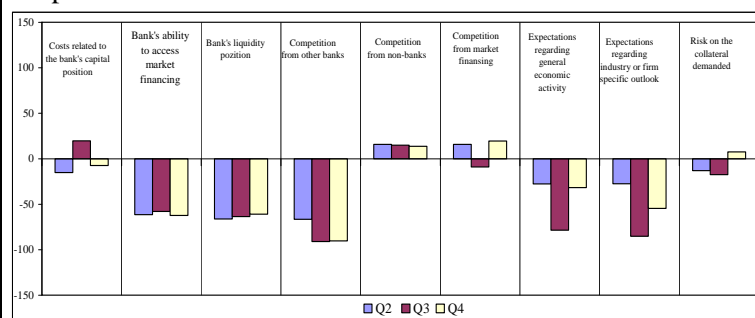
<sup>92</sup> According to the results obtained from the Banks' Credit Activity Survey for June, September and December 2006.

<sup>93</sup> At the end of 2006, the share of C, D and E placements in the total banks' credit exposure equal 7.6%, which is by 3.3 percentage points less compared to the previous year.

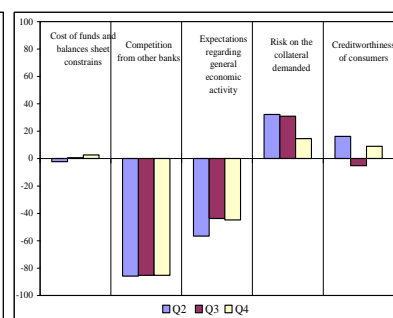
Figure 86

Factors that contributed to loosening the lending terms to the corporate and household sector - net percentage of banks that expect loosening of the lending terms\*

## Corporate sector



## Household sector



\*\*The net-percent is a difference between the sum of "--" (considerably contribute to more conservative lending terms) and "-" (partially contribute to more conservative lending terms) and the sum of "+" (partially contribute to loosening the lending terms) and "++" (considerably contribute to loosening the lending terms).

With respect to the *demand for credits* by the corporate sector, over the last three quarters of 2006, the demand for short-term and long-term credits by the small-, medium-size and large enterprises generally remained unchanged, except in the fourth quarter, when the banks point out that there was an increase in the demand for all types of credits for financing the investments in fixed assets, and the investments in inventories and working capital.

Table 32

Change in the demand for credits by the companies over the last three quarters of 2006

(% of banks)

	Loans to small and medium -sized			Loans to large enterprises			Short-term loans			Long-term loans		
	Q2	Q3	Q4	Q2	Q3	Q4	Q2	Q3	Q4	Q2	Q3	Q4
Decreased considerably	0,0	0,0		0,0	0,0		0,0	0,0		0,0	0,0	
Decreased somewhat	0,0	0,0		0,0	0,0		0,0	0,0		3,5	0,0	
Remained basically unchanged	65,9	66,7	26,5	73,4	71,5	15,0	68,6	69,4	37,4	59,3	39,6	9,3
Increased somewhat	34,2	33,3	73,3	26,7	28,5	84,8	31,5	30,6	62,4	37,3	34,1	90,5
Increased considerably	0,0	0,0		0,0	0,0		0,0	0,0		0,0	0,0	
n/a	0,0	0,1		0,0	0,1		0,0	0,1		0,0	26,4	
Total	100	100	100	100	100	100	100	100	100	100	100	100
Net percentage	34,2	33,3	73,3	26,7	28,5	84,8	31,5	30,6	62,4	33,8	34,1	90,5

Most of the banks-respondents point out that there is increase in the demand for credits, consumer credits in particular on the market segment of lending to households. The banks point to the strengthening of the confidence of the consumers and the needs for financing the consumption of durable goods, as contributors to the higher demand and factors that contributed to partially relaxed demand for consumer credits.

Table 33

Change in the demand for credits by the households over the last three quarters of 2006

(% of banks)

	Housing loans			Consumer loans			Other lending		
	Q2	Q3	Q4	Q2	Q3	Q4	Q2	Q3	Q4
Decreased considerably	0,0	0,0		0,0	0,0		0,0	0,0	
Decreased somewhat	0,0	0,0		0,0	0,0	0,9	0,0	0,0	
Remained basically unchanged	17,6	23,5	63,2	44,6	14,9	13,2	14,0	17,0	27,8
Increased somewhat	67,3	66,6	26,8	53,2	71,9	72,2	80,8	83,1	72,2
Increased considerably	0,0	0,0		2,2	13,3	13,7	2,2	0,0	
n/a	15,1	10,0	10,0	0,0	0,0		3,0	0,0	
Total	100	100	100	100	100	100	100	100	100
Net percentage	67,3	66,6	26,8	55,4	85,2	85,0	83,0	83,1	72,2

The expectations of most of the banks regarding the direction of the change in the lending terms to the corporate and household sector in this year were relatively stable, and with respect to the demand for credits, most banks expect continuation of the positive trend, i.e. higher demand which

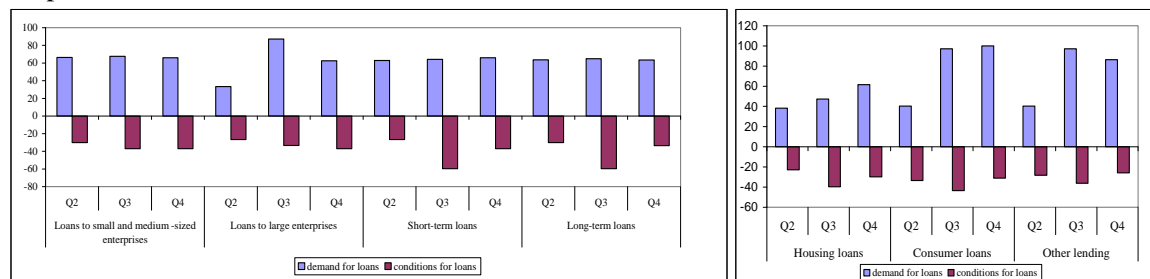
is in line with the expectations and the perceptions of the banks for the future economic developments.

Figure 87

Net-percentage\* of banks that expect stable lending terms and higher demand for credits

Corporate sector

Household sector



\* The net-percentage of the lending terms is a difference between the sum of the percentages of "will be considerably tightened" and "will be partially tightened" and the sum of the percentages of "will be considerably loosened" and "will be partially loosened". The net-percentage of the demand for credits is a difference between the sum of the percentages of "will increase considerably" and "will increase partially" and the sum of the percentages of "will decrease considerably" and "will decrease partially".

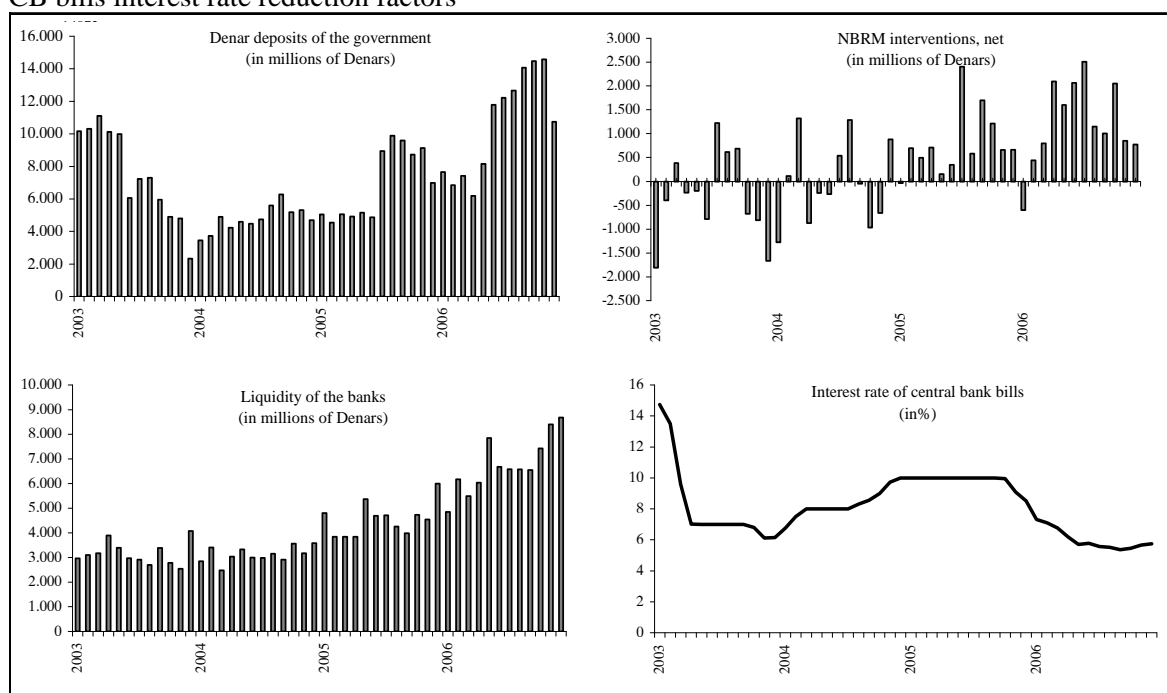
### 3.5. Interest rates

The favorable movements on the foreign exchange market, and thus the substantial accumulation of foreign reserves, and the prudential fiscal policy, in 2006 created conditions for interest rates reduction. CB bills interest rate tender auctions were held over the entire year, which, given the higher average demand relative to supply resulted in lower interest rates. Such changes affected the money and government securities market accordingly, with moderate decrease being also registered in the bank interest rates. Over the year, apart from the changes in the operational framework<sup>94</sup>, the NBRM cut the interest rate on Lombard credit twice<sup>95</sup>.

<sup>94</sup> The possibility for the cash in the vaults to be used as a means for fulfilling the reserve requirement was abolished in January 2006, with a new instrument being launched in March - treasury bills for monetary purposes.

<sup>95</sup> Collateralized short-term credits for addressing the temporary liquidity problems of the banks that belong to the group of monetary instruments - "standing facilities".

Figure 88  
CB bills interest rate reduction factors



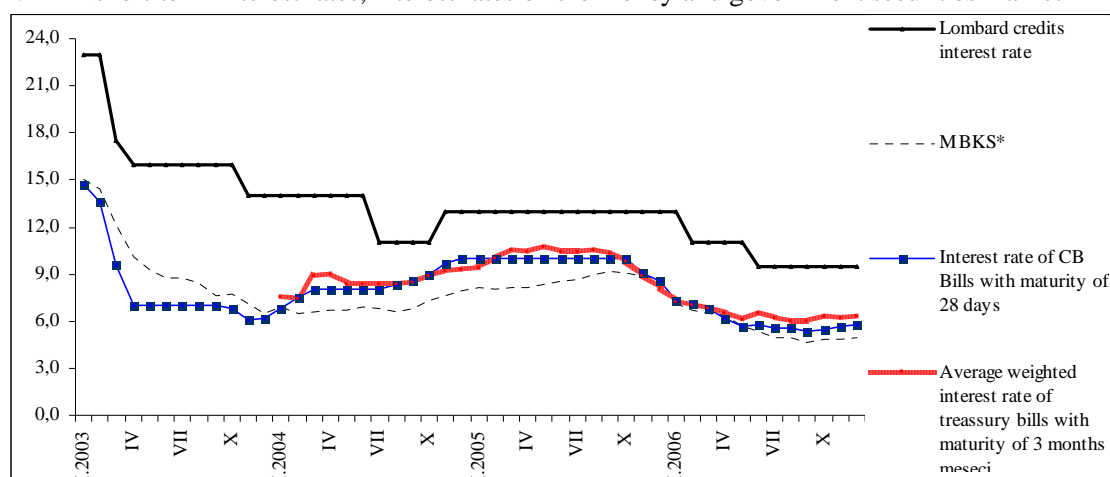
Source: NBRM.

The interest rate on 28-day CB bills, as a reference rate in the set of NBRM interest rates, was set on a market basis over the whole year, which means holding of interest rate tender auctions. The higher average demand relative to supply of CB bills resulted in interest rate reduction, with the reference interest rate from 8.52% in December 2005 reducing to 5.74% in December 2006 (the real interest rate equals 2.54%, with an average inflation of 3.2%). The lower frequency of auctions (from twice to once a week in February) and the steady reduction of the supplied amount of CB bills<sup>96</sup> is in line with the determination to make the banks invest in treasury bills for monetary purposes, thus gradually replacing the CB bills. This approach is aimed at sterilizing the excess liquidity on a longer run and development of the government securities market, also contributing to the implementation of the classical open market operations, as a monetary instrument. Considering that the treasury bills market, unlike the CB bills market, is non-segmented market (access available for both banks and non-banking entities), its development is expected to gradually strengthen the connection and the interdependence of the interest rates and more efficient monetary policy transmission through the interest rate channel.

<sup>96</sup> Except for November and December 2006.

Figure 89

NBRM short-term interest rates, interest rates on the money and government securities market

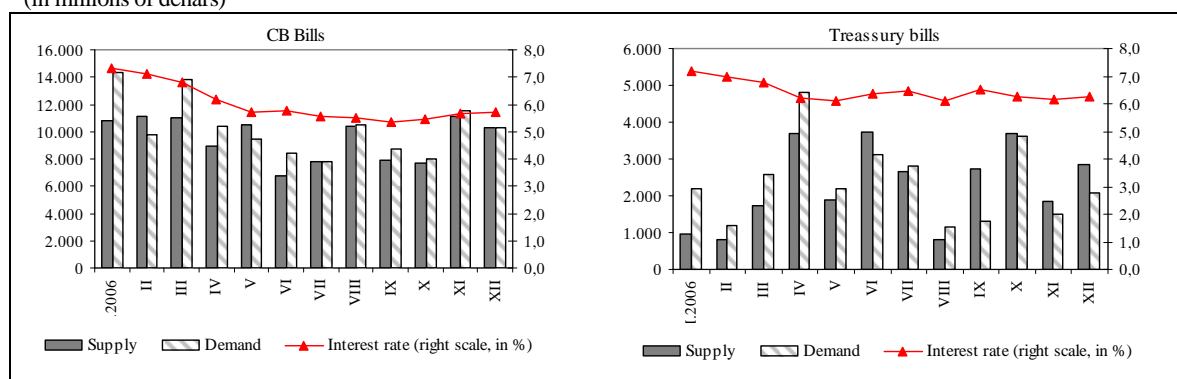


\*MBKS- interbank interest rate

Source: NBRM, Money and Short-term Securities Market and Ministry of Finance.

Over the year, the treasury bills interest rates followed the pace of the interest rate on the CB bills auctions. Thus the three-, six- and twelve-month treasury bills interest rates reduced from 8%, 6.3% and 9.6%, respectively in December 2005 to 6.3%, 7% and 8.9%, respectively at the end of 2006. The average weighted interest rate on treasury bills dropped from 1.8 percentage points, and in December 2006 equaled 6.7% (the real rate equal 3.5%). However, notwithstanding the higher attractiveness of treasury bills (due to the higher interest rate), over the whole year, the demand for CB bills remained at a constantly high level. It indicates the still present preferences of the banks to invest in short-term instruments and still high liquidity position. The high level of liquidity accordingly affected the money market developments, with the MBKS<sup>97</sup> being cut by 3.8 percentage points, thus reducing it to 4.9% at the end of the year.

Figure 90

28-day CB bills auctions, 3-month treasury bills auctions and interest rates development  
(in millions of denars)

Source: NBRM, and Money and Short-Term Securities Market.

In environment of excess liquidity in the banking system, and in order to make the banks manage the liquidity more actively, on February 16, 2006 and May 31, 2006, the NBRM reduced the interest rate on Lombard credit by 2 and 1.5 percentage points. As a result, the interest rate on Lombard credits reduced from 13% in December 2005 to 9.5%, thus narrowing the spread between

<sup>97</sup>To April MBKS refers to an interest rate on the banks' bilateral trade and the trade on the institutional money market, and from May onwards, it refers only to the first market segment. After the permanent drop in the turnover on the official money market, on May 15, 2006, the Shareholder Meeting made a decision on cessation of this market segment, so that the trade in liquid assets is made through bilateral transactions of the banks via e-platform.

the interest rate on CB bills and the interest rate on Lombard credit from 4.5 percentage points in December 2005 to 3.8 percentage points in December 2006.

Table 34

Reference nominal interest rate of the central banks by country

(in %)

	Central Bank key interest rate						
	2000	2001	2002	2003	2004	2005	2006
Macedonia	6,80	12,16	15,21	6,15	10,00	8,52	5,74
Albania	10,82	7,00	8,50	6,50	5,25	5,00	5,50
Bulgaria	4,63	4,65	3,31	2,83	2,37	2,05	3,26
Croatia	5,90	5,90	4,50	4,50	4,50	4,50	4,50
Czech Republic	5,25	4,50	2,75	2,00	2,50	2,00	2,50
Romania	35,00	35,00	29,02	18,84	20,27	9,59	8,56
Slovenia	11,00	12,00	10,50	7,25	5,00	5,00	4,50
Serbia	-	18,67	9,72	10,63	17,21	19,16	15,35
Euro-zone	4,75	3,25	2,75	2,00	-	2,25	3,50

Source: IFS, European Central Bank and NBRM.

Observing the banks' interest rate policy, 2006 witnessed a moderate responsiveness of the banks to the NBRM monetary signals. The cut in the CB bills interest rate and market interest rates was not followed by a proportional reduction in the bank interest rates. Thus, the lending interest rate<sup>98</sup> on Denar credits fell by 1.4 percentage points, and reduced to 10.7% at the end of the year (i.e. to 7.5% after correction of the average inflation), while the Denar deposit interest rate<sup>99</sup> dropped by 1.2 percentage points, and reduced to 4.4% at the end of the year (the real interest rate equals 1.2%). The accelerated credit demand of the private sector, in environment of extended deposit base and improved liquidity position of the banks, the strengthened competition pressure, the higher access of the banks to market sources of financing and the positive expectations of the banks for the overall economic activity, were the major drivers for the reduction in the lending interest rate. In line with such developments, the interest spread, compared to the end of the preceding year, registered a minor decrease of 0.2 percentage points, and in December 2006 equaled 6.3 percentage points. The comparative analysis shows that only Albania and Croatia have higher bank interest spread relative to Macedonia, whereas the spreads of other economies in transition swing around 4 percentage points. The above points to the need of further narrowing of the banks' interest spreads by improving the banks' efficiency and increasing the competitiveness in the banking sector.

Table 35

Interest spreads by country

(in percentage points)

	Interest rate margins						
	2000	2001	2002	2003	2004	2005	2006
Macedonia	8,3	9,2	8,5	7,8	5,5	6,5	6,3
Albania	13,8	11,9	6,8	5,9	5,2	8,0	7,7
B&H	15,8	-	8,2	6,8	6,6	6,1	4,3
Bulgaria	8,4	8,2	6,6	5,9	5,8	4,8	5,0
Croatia	8,3	6,3	11,0	10,1	9,9	9,5	8,2
Czech Republic	3,7	4,3	4,7	4,6	4,8	4,6	4,4
Serbia	72,4	30,4	17,1	12,7	11,9	13,1	-
Slovakia	6,4	4,8	3,6	3,1	4,9	4,2	4,1
Slovenia	5,7	5,2	4,9	4,8	4,8	4,6	4,6

Source: IFS and NBRM.

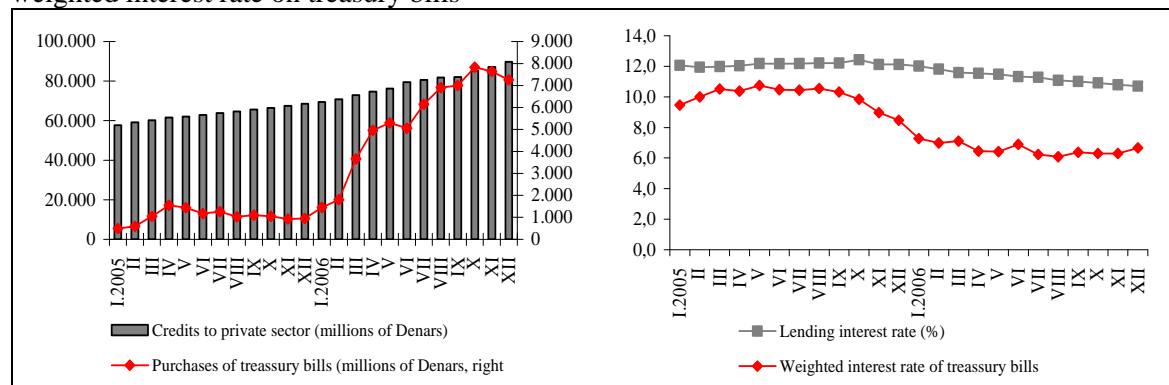
<sup>98</sup> Average weighted Denar lending interest rate for all maturities and all sectors.

<sup>99</sup> Average weighted Denar deposit interest rate for all maturities and all sectors.

Analyzing the interest income, as an incentive for alternative investments of available funds of the banking sector indicates that the disciplined fiscal policy does not create pressures for phasing out the banks' placements to the private sector through the interest rate channel.

Figure 91

Bank credits to the private sector, banks' investments in treasury bills, lending interest rate and weighted interest rate on treasury bills

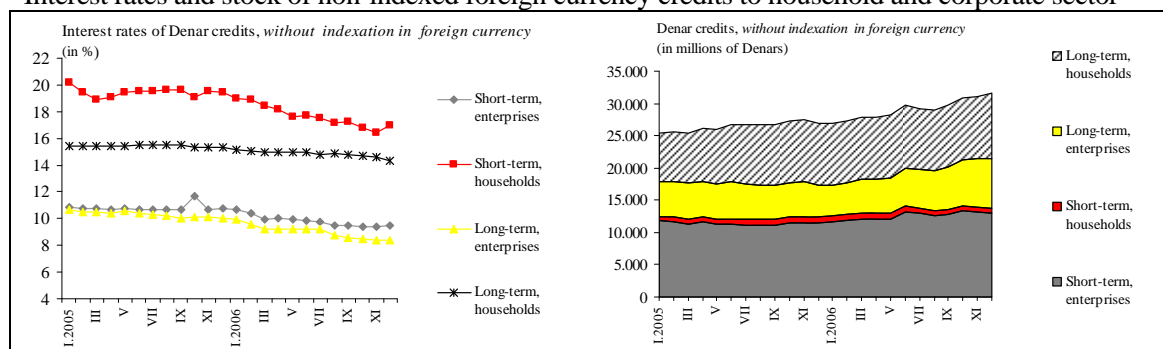


Source: NBRM.

Analyzing the structure of Denar lending interest rate, the interest rates of all categories of Denar credits to the household and corporate sector went down. The cut in the interest rates on short-term and long-term *foreign currency non-indexed credits* to the corporate sector corresponds with the fast credit demand by this sector. The steepest drop was registered in the interest rate on short-term non-indexed foreign currency credits to the household sector<sup>100</sup> (from 19.4% at the end of 2005 to 16.9% at the end of 2006). The sector-by-sector analysis shows that the households pay significantly higher interest rate on short-term and long-term non-indexed foreign currency credits compared to the corporate sector, and observing the maturity, the interest rate on short-term credits to the households exceeds the interest rate on the long-term credits. This indicates that the banks, when setting the interest rate on non-indexed foreign currency credits to households, take into account the high demand and the low interest elasticity of this sector. In addition, the higher supply of low-value collateralized short-term credits to the households is accompanied by an interest rate with high risk premium.

Figure 92

Interest rates and stock of non-indexed foreign currency credits to household and corporate sector



Source: NBRM.

The interest rates on indexed foreign currency credits are generally lower than the indexed ones. The interest rates on such short-term and long-term credits to households dropped in a faster pace compared to the fall in the interest rates that apply to the corporate sector. The cut in the

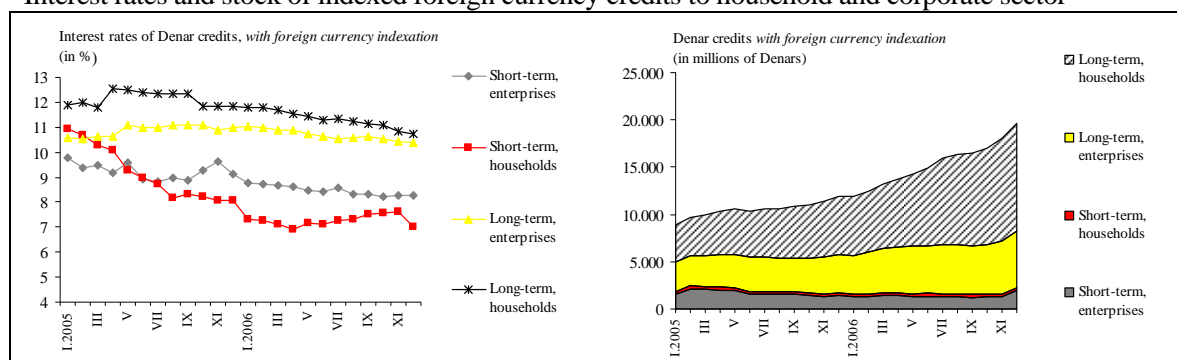
<sup>100</sup>The analysis of the stock of credits lays on the methodology for calculating the weighted interest rates, according to which the short-term Denar credits to the households do not include credit commitments which in 2006 notably surged.



interest rates to short-term Denar credits to the household and corporate sector correlates with the growth in these credits.

Figure 93

Interest rates and stock of indexed foreign currency credits to household and corporate sector

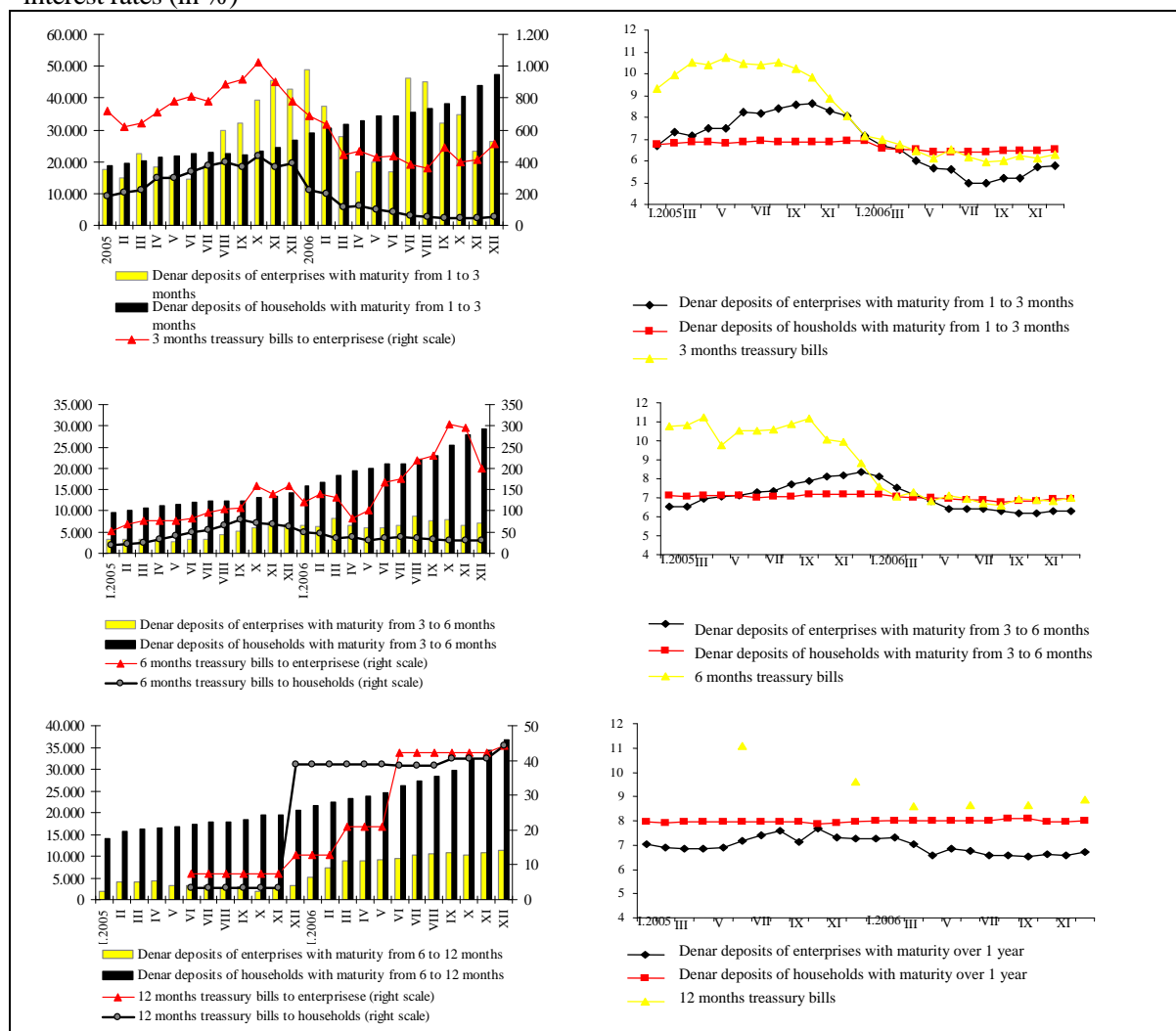


Source: NBRM.

Along with the cut in the lending interest rates, there was also a reduction in the Denar deposit interest rates. Significant interest developments were registered in the interest rates applied to corporate sector (given the fast drop in the interest rates on short-term time non-indexed foreign currency deposits), whereas in the household sector, the deposit interest rates registered no noticeable changes relative to the preceding year. The development of the deposit bank interest rate could be discussed in respect to their relation to the interest rates on the government securities market. Thus, the diversification of the government securities portfolio and the lending interest rate (particularly in 2005) provided a suitable alternative for investing the available assets of the private sector. The high spread between the deposit bank interest rates and the market interest rates on treasury bills was notably narrowed since the beginning of 2006, with convergence being registered in the both types of interest rates. Thus, 2006 still registers a trend of intensive household savings within the banking system, whereas the placements in government securities decreased proportionately to the interest rate reduction (except for the investments in 12-month treasury bills). Hence, the banks still have a room for accelerating the credit activity, conditioned upon the disciplined fiscal policy and the sustainable budget imbalance (therefore, a moderate amount of issued government securities). It should be underlined that the banks partially responded to the development of the interest rate on treasury bills, as a competitive form of investing compared to the bank deposits, particularly regarding the attraction of the corporate deposits. The interest rates on corporate deposits show larger flexibility, and regarding the 6-month maturity, within a specific period of 2006, the banks' interest rate on corporate deposits was maintained above the level of interest rate on 6-month treasury bills.

Figure 94

Denar deposits and investments in treasury bills by maturity (in millions of denars) and respective interest rates (in %)



Source: NBRM.

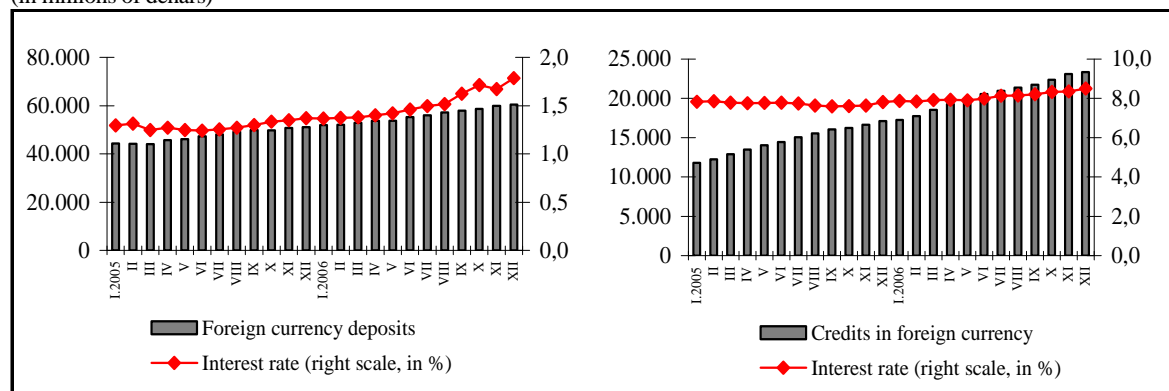
Unlike the cut in the interest rates on Denar credits and deposits, 2006 registered a moderate uptrend of the interest rates on foreign currency credits and deposits, in line with the developments of the interest rates on the international financial markets. Thus, at the end of 2006, the interest rate on foreign currency credits<sup>101</sup> and the interest rate on foreign currency deposits<sup>102</sup> equaled 8.5% and 1.8%, respectively (7.8% and 1.4%, respectively, in December 2005).

<sup>101</sup> Average weighted foreign currency lending interest rate for all maturities and all sectors.

<sup>102</sup> Average weighted foreign currency deposit interest rate for all maturities and all sectors.

Figure 95

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

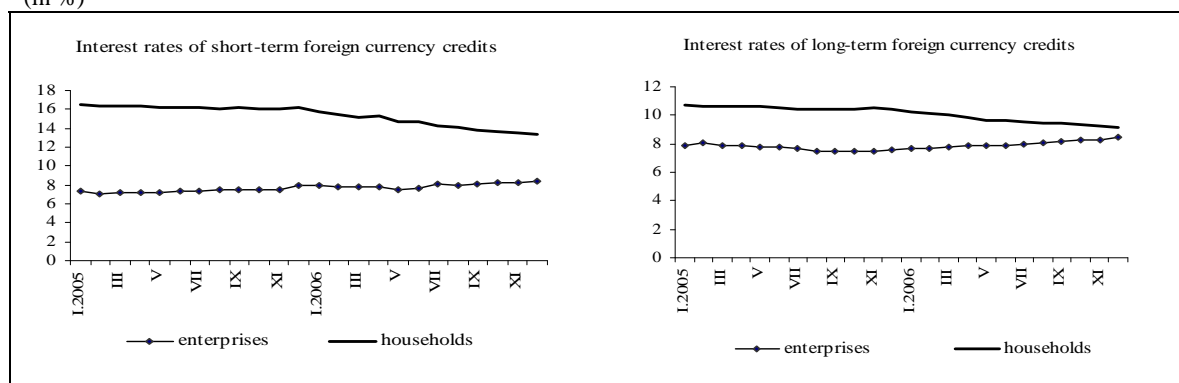


Source: NBRM.

The increase in the interest rate on foreign currency credits fully relates to the higher price of short-term and long-term credits to the corporate sector, unlike the short-term and long-term Euro credits to the households, the price of which at the end of 2006 was significantly lower (13.3% and 9.2% in December 2006, and 16.2% and 10.4% in December 2005).

Figure 96

Interest rates on foreign currency credits to corporate and household sector  
(in %)



Source: NBRM.

Along with the growth in the interest rates on foreign currency credits, 2006 registered higher interest rates on foreign currency deposits of both corporate and household sector. Thus, at the end of 2006, relative to the end of 2005, the increase in the interest rates on foreign currency deposits of the household and corporate sector was identical (by 0.4 percentage points, thus reaching 1.7% and 2.1%, respectively in December 2006).

## IV. Financial markets in the Republic of Macedonia

### 4.1. Money market

In 2006, the banks' infrastructure of the trade in liquid assets was subjected to robust changes. Thus, given the low volume of activities on the official money market over a longer time period, on May 15, 2006, the General Meeting of Shareholder adopted a Decision on cessation of the Money and Short-term Securities Market. Consequently, since the second half of May, all transactions were executed through immediate bilateral trade, which, in May 2006, was supplemented by the introduction of electronic system for interbank trade in deposits and securities (Tenfore)<sup>103</sup>.

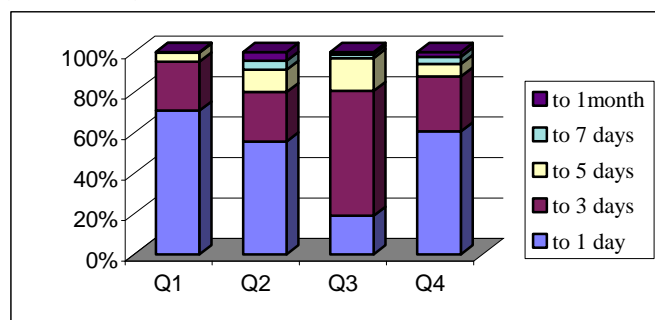
In 2006, observing the activity, given the high level of liquidity in the banking system and the introduction of new instruments on the financial market, the trade on the money market significantly dropped compared to the preceding year. The total interbank transactions (institutionalized and bilateral interbank trade) amounted to Denar 9,647 million, which is by 43.8% less compared to 2005. Of the total interbank transactions, 98.7% were executed through bilateral trade, whereas transactions in a total amount of Denar 123 million were executed on the institutional market in February and March.

Table 36  
Turnover and interest rate on the money market in 2006

	total turnover (in thousands of denars)	quarter change (%)	interest rate (%)	by maturity (in %)		
				to 1 day	to 3 days	from 5 days to 1 month
Q1	1.574	-30,4	6,8	71,0	24,2	4,8
Q2	3.250	106,5	5,8	55,8	24,3	19,9
Q3	2.717	-16,4	4,9	19,0	61,8	19,2
Q4	2.106	-22,5	4,8	60,7	27,2	12,1
Total	9.647	33,8	5,6	49,0	35,5	15,5

Dynamically observed, the interbank turnover intensified in the second quarter, with 43% resulting from the agreement concluded between two banks on depositing sight deposits by the end of the business hours, at a pre-specified interest rate. The higher turnover in the second quarter also corresponds with the period of holding higher amount of liquid assets by the banks as a precautionary measure prior to the expected outflows from the banking system based on the privatization of state capital in June 2006. The money market activity was slower in the other quarters.

Figure 97  
Maturity structure of the turnover on the interbank money market in 2006  
(share in %)



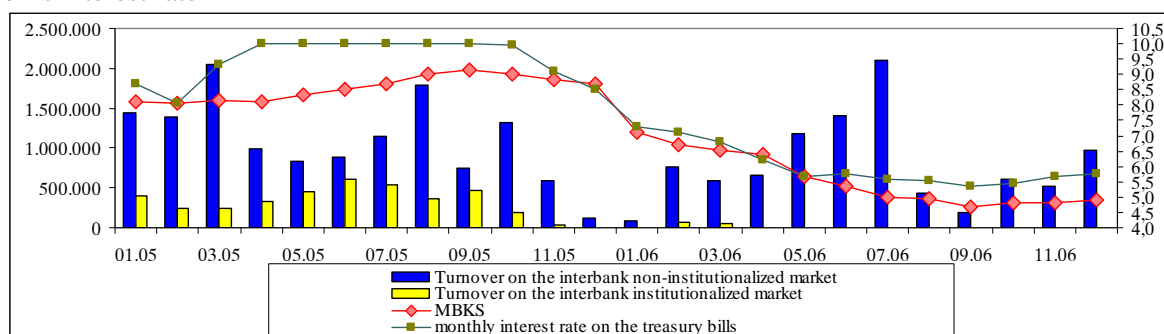
The average daily turnover of interbank transactions stood at Denar 62.2 million (only in days of executed purchase and sale transactions). Analyzing the transaction maturity, in 2006, 49% of the total transactions were one-day transactions, 35.4% were three-day transactions, 10.3% were five-day transactions and 2.8% and 2.3%, respectively were seven-day and one-month transactions, which registered the lowest share.

<sup>103</sup> On May 8, 2006, the electronic system for interbank trade in deposits and securities (Tenfore) was commissioned.

With respect to interest rate development, the average weighted interbank interest rate (MBKS) on the both money market segments equaled 5.6% in 2006, which is by 3 percentage points lower compared to the preceding year. The month-by-month analysis shows that the interbank interest rate fluctuated from 7.1% to 4.9%, indicating responsiveness to the changes in the CB bills interest rate.

Figure 98

Turnover on the interbank money market, interbank interest rate (MBKS for all maturities) and CB bills interest rate



Source: Money market and National Bank of the Republic of Macedonia.

## 4.2. Stock Exchange

In 2006, the Macedonian Stock Exchange was distinguished by the accelerated activity and faster growth in the turnover. Analysis of the factors relevant to the Stock Exchange developments shows that most of them had positive effects on the organized secondary securities market in the Republic of Macedonia. The business environment of the Stock Exchange in 2006, was under predominant influence of the following factors:

- favorable macroeconomic environment (low inflation and stable exchange rate) and positive expectations of the domestic and foreign investors,
- inflow of foreign portfolio-investments, leading to more realistic evaluation of the market prices of the shares at the Stock Exchange and higher local demand, as well as adjustment of other market participants to the new situation,
- announcements for strategic takeovers of some listed companies,
- positioning of the domestic and foreign investors, prior to the official start of the private pension funds,
- consolidation of the equity structures in the companies,
- abolishment of the capital profit tax release<sup>104</sup> generated from securities, on January 1, 2006, and reduction in the tax benefit on profit tax of the listed companies<sup>105</sup>. The fiscal reforms, (particularly, the capital profit tax release) initially acted towards decelerating the Stock Exchange turnover, especially since the smaller investors, which traditionally invest in shares to make capital profit, hesitated to invest. The effect of the tax reforms were particularly evident in March, as a month which is distinguished by its high trade volume of the small investors, due to the fact that most companies held their general meetings of shareholders in March. The monthly increase in the classical stock trade in March 2006 accounted for only 45.6% of the monthly growth in the classical trade registered in March 2005. Yet, the slower exchange activity in March 2006 does not result from the effect of the abolished capital profit

<sup>104</sup> The capital gain as a positive difference from the sale of securities, between their ask and bid price, by the end of 2005 was tax released to induce the securities market development in the Republic of Macedonia. Since January 2006, the capital gain has been taxed at a rate of 15%, and the tax benefit is only 25% of the estimated tax.

<sup>105</sup> From 50% (as of the moment of listing in the next three years) to only 30% benefit in the first year and 15% in the second year, as of the moment of listing.

tax release, compared to the same month of the preceding year. The stock prices (the high prices of shares of many listed companies in the previous year remained the same), thus lowering the opportunity to generate profit from the trade in shares.

Table 37  
Stock Exchange indicators

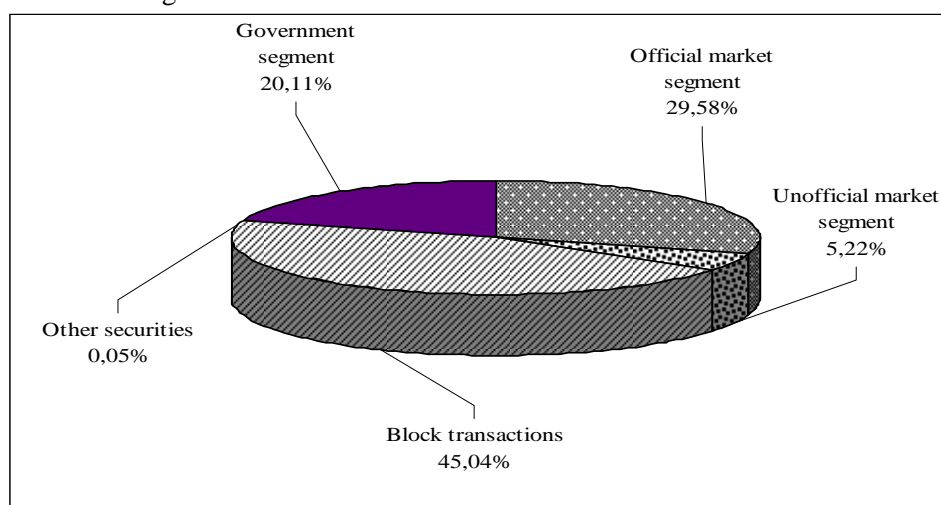
	January-December 2005	January-December 2006	% change
<b>Turnover (in Denar)</b>			
<b>Turnover carried out through classical stock trade</b>	<b>6.701.682.415</b>	<b>10.794.815.753</b>	<b>61,08</b>
Securities	4.625.430.914	8.564.838.251	85,17
Bonds	2.076.251.501	2.229.977.502	7,40
Average daily turnover (in Denar)	33.341.704	42.836.570	28,48
Average daily number of transactions	159	208	30,82
<b>Block transactions</b>	<b>1.744.277.253</b>	<b>13.970.939.088</b>	<b>700,96</b>
<b>Government segment</b>	<b>443.607.845</b>	<b>6.237.256.707</b>	
Securities	35.672.350	5.442.215.152	
Shares	407.935.495	795.041.555	
<b>Other securities</b>	<b>-</b>	<b>14.921.940</b>	
<b>Total</b>	<b>8.889.567.513</b>	<b>31.017.933.488</b>	<b>248,93</b>
<b>Market capitalization (in Denar)<sup>1/</sup></b>			
Market capitalization of securities-listed companies	33.171.013.757	51.021.283.559	53,81
Market capitalization of bonds	23.972.382.237	22.436.317.815	-6,41
<b>TOTAL MARKET CAPITALIZATION</b>			
<b>MBI-10<sup>1/</sup></b>	<b>2.292,04</b>	<b>3.702,54</b>	<b>61,54</b>
<b>OMB<sup>1/</sup></b>	<b>-</b>	<b>99,06</b>	
<b>Number of listed companies<sup>1/</sup></b>	<b>57</b>	<b>43</b>	<b>-24,56</b>

1/ As of the end of the period.

Source: Macedonian Stock Exchange AD Skopje.

The total Stock Exchange turnover (including block-transactions and government segment), registered in 2006 surged by 3.5 times compared to 2005. The exceptionally high Stock Exchange activity in 2006 primarily results from the executed block-transactions on the official and unofficial market segment on the Stock Exchange, and from transactions conducted on the government trade segment. Structurally observed, in 2006 the conducted block-transactions made up 45%, the transactions on the official market segment - 29.6%, while the government segment constituted 20.1% of the total Stock Exchange turnover.

Figure 99  
Stock Exchange structure in 2006



Source: Macedonian Stock Exchange AD Skopje.

In the first quarter, the government shares in AD ESM - Distribucija were sold to foreign investor through a block transaction on the unofficial market segment<sup>106</sup>. On the other hand, the high Stock Exchange turnover in the second quarter is particularly due to the turnover on the government segment in public exchange auctions, i.e. the sale of one set of shares (9.9%) of Macedonian Telecommunications AD Skopje. On May 13, 2006, the Ministry of Economy announced the sale of 45.125% common shares of Macedonian Telecommunications AD Skopje in government ownership, offered at public auctions on the Macedonian Stock Exchange from June 5 to 9, 2006. Of the four offered set of shares (with individual share of 9.9% in the offered shares), only one set of shares was sold in the amount of Denar 3.6 billion (Euro 60.3 million, where the buyer is the same company). Of the remaining 5.525% shares offered on a free sale, 0.9% were sold in the amount of Denar 153.8 million. In addition, the government stakes in JZU Gradska apteka Skopje, the sets of shares owned by the PIOM Fund, and government shares in several banks were sold at public exchange auctions.

In the third and the fourth quarter, the Securities and Exchange Committee of the Republic of Macedonia passed several decisions on the exchange activities of the banks listed on the Stock Exchange, primarily on approving new securities issues, i.e. market recapitalization<sup>107</sup>. Although the new securities are not issued through the Stock Exchange, but directly through registration of the ownership of the newly placed securities in the Central Securities Depository, they indirectly show the higher potential for secondary trade on the Stock Exchange. The higher turnover on the official Stock Exchange segment in the third and the fourth quarter mainly resulted from the higher demand of the investors for shares of the banks listed on this exchange segment, primarily after the announcement for investments of some eminent foreign banks in some domestic banks.

At the beginning of November, the Stock Exchange registered a negative trend, caused by the failed sale of one entity via public bid of a foreign strategic investor, due to which on November 8, 2006 the Macedonian Stock Exchange adopted a Decision on reducing the allowed static daily price fluctuations in the trade in securities from +/-10% +/-5% relative to the official average price of the preceding trading day, aimed at stabilizing the Stock Exchange, and a Decision on temporary termination of the trade in common and preference shares of this entity as a prevention measure against drastic price cut, and protection of the investors from great losses. On November 21, 2006 the former restrictions of +/-10% were back in force.

In 2006, *the turnover made by classical stock trade (excluding block transactions and government segment)* surged by 61.1% relative to the same period of the preceding year, and the average daily turnover<sup>108</sup> stood at Denar 42.8 million, with 208 transactions a day being conducted on average. The rapid growth in the stock prices of numerous listed companies did not reduce the investors' interest in such securities. Significant contributor to the higher exchange turnover was the trade in government bonds, particularly the trade in the Denationalization Bond from the fifth issue, sold at relatively high market price compared to its nominal value. At the end of December 2006, 46 joint stock companies were listed on the official market segment of the Stock Exchange, which is by 14 less compared to the end of 2005.

As of December 31, 2006, , the foreign investors made up 66.3% on the purchase side and 17.6% on the sale side<sup>109</sup> of the total turnover on the Stock Exchange, which is the highest share

<sup>106</sup> Transaction worth Denar 10,722,8 million conducted on March 24, through which the government shares in AD ESM - Distribucija were sold to EVN AG from Austria.

<sup>107</sup> At the session held on July 4, 2006, the Securities and Exchange Committee approved Ohridska Banka AD Ohrid to sell equity shares intended for known buyer, constituting 1.63% of the total issued common shares of the Bank. At the session held on October 13, 2006, the Securities and Exchange Committee approved the second issue of TTK Banka AD Skopje intended for EBOR which became a holder of 25% of the equity. At the session held on October 19, 2006, the Securities and Exchange Committee approved the seventeenth issue of shares of Investbanka AD Skopje in order to acquire Makedonska Stedilnica AD Skopje to Investbanka AD Skopje. At the session held on October 24, 2006, the Securities and Exchange Committee approved Komercijalna Banka AD Skopje to sell common shares at a public bid.

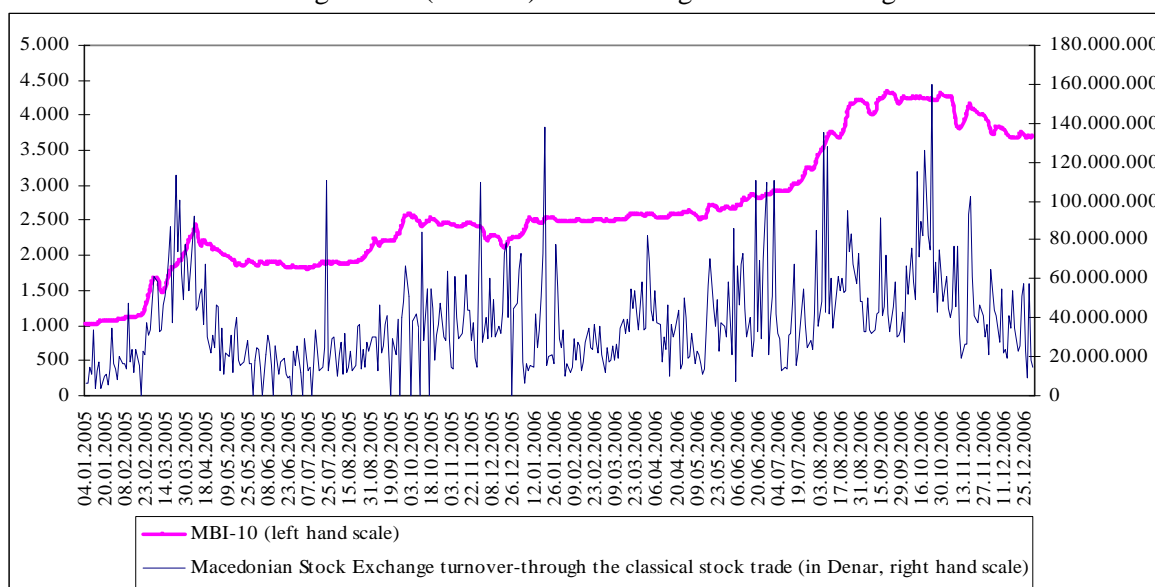
<sup>108</sup> Since January 1.,2006 the Macedonian Stock Exchange operates in all five business days (previously, only from Monday to Thursday), which is to be taken into account in the comparative analysis of the average daily indicators.

<sup>109</sup> According to data from the Central Securities Depository.

recorded in this year. The share of non-resident investors on the purchase side made in 2006 ranges from 7.6% at the end of June to 66.3% at the end of December, whereas the share of foreign investors in the sales registered on the Stock Exchange ranges from 1.5% at the end of June to 17.6% at the end of December. At the end of December 2006 compared to the end of January 2006, the share of foreign investors in the total capital of all companies listed on the official Stock Exchange market and in the total nominal value of the listed bonds<sup>110</sup> (18.2% in December, 14.2% at the end of January 2006) went up.

Figure 100

Macedonian Stock Exchange Index (MBI-10) and exchange turnover through classical stock trade



Source: Macedonian Stock Exchange AD Skopje.

In the first three months of 2006, the developments of the Macedonian Stock Exchange Index (MBI-10)<sup>111</sup> registered no significant fluctuations, but yet, the index value was maintained high. In April and May, MBI-10 generally registered an uptrend, with certain periods of stagnation or decline. On the other hand, June<sup>112</sup> registered a rapid index growth, with short-term falls in the value being registered only in the periods after the excessive index growth. In the third quarter of 2006, MBI-10 registered an uptrend, with short periods of stagnation and negative deviation from the trend. On September 20, 2006, the index reached record value (4,351.10) since its introduction in 2005. In the fourth quarter of 2006, MBI-10 registered a downtrend with notable oscillations in its level, particularly in November, caused primarily by the failed sale of one large entity. The rapid downtrend of the index value that started in November kept on in the first half of December in a faster pace, when the market value of five out of the ten shares comprising the MBI-10<sup>113</sup> dropped. Thus, at the end of 2006, the index value equaled 3,702.54 index points, reflecting an average growth of 61.5% of the prices of shares of the ten companies comprising the index, compared to December 31, 2005. In 2006, the market capitalization of the ten most liquid companies listed on the official market segment amounted to Denar 37,621.4 million (Denar 21,966.1 million in 2005).

<sup>110</sup> According to data from the Central Securities Depository.

<sup>111</sup> Price index weighted by market capitalization, constructed on the basis of common shares of ten companies listed on the official market.

<sup>112</sup> Since June 15, 2006 ZK Pelagonija AD Bitola has been included in the MBI-10 instead of Evropa AD Skopje.

<sup>113</sup> The market value of the shares of Granit AD Skopje, Makpetrol AD Skopje, Stopanska Banka AD Bitola, Ohridska Banka AD Ohrid and Beton AD Skopje dropped. Since December 16, 2006, Beton AD Skopje, and Makstil AD Skopje constitute a part of MBI-10, thus becoming a part of the Index structure as a replacement of the shares of Fersped AD Skopje and Makedonija Turist AD Skopje. The changes in the index structure result from the regular index revision, made semiannually. After being revised, the common shares of the following 10 listed companies constitute a part of MBI-10: Komercijalna banka AD Skopje, Alkaloid AD Skopje, Granit AD Skopje, Stopanska banka AD Bitola, Toplifikacija AD Skopje, Makpetrol AD Skopje, Makstil AD Skopje, ZK Pelagonija AD Bitola, Ohridska banka AD Ohrid and Beton AD Skopje.

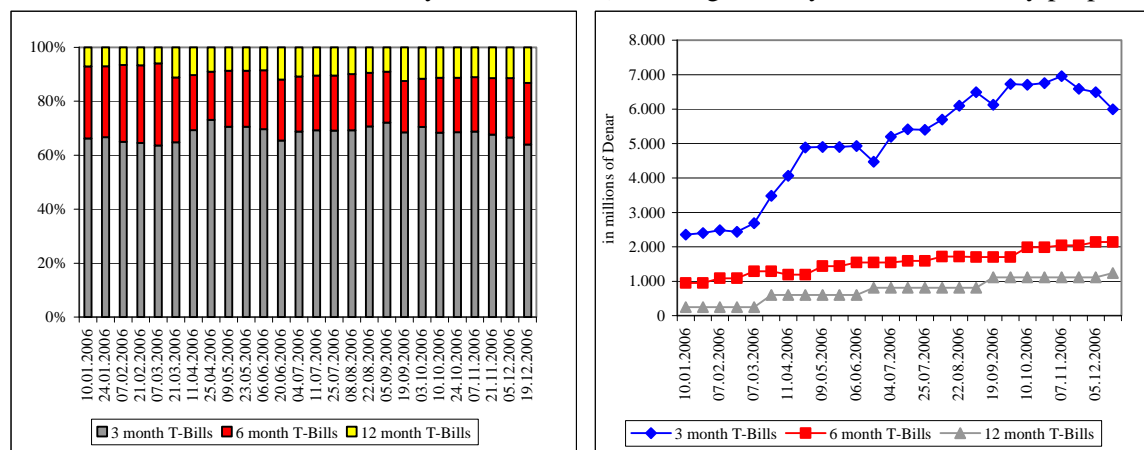


### 4.3. Government securities market

The treasury bills market further deepened in 2006. In 2006, according to the pre-specified calendar of government securities issue<sup>114</sup>, 26 auctions of 3-month treasury bills were held on the government securities market<sup>115</sup>, with realization of 82.4% of the offered amount. Twelve auctions were held on the 6-month treasury bills, with 84.6% of the total offer being realized on this market segment, and 4 auctions of 12-month treasury bills were held, with a realization of 91.5% of the total offer.

Figure 101

Structure and stock of undue treasury bills in 2006 (including treasury bills for monetary purposes)



Source: Ministry of Finance of the Republic of Macedonia.

In 2006, the total realized amount of 3-, 6- and 12-month treasury bills (including treasury bills for monetary purposes<sup>116</sup>) equaled Denar 26,323.2 million (56.1% of which for monetary purposes), whereas the amount that fell due in 2006 totaled Denar 20,417.2 million (49.6% of which for monetary purposes), so that the net withdrawal through treasury bills amounted to Denar 5,906 million. Thus, on December 31, 2006, the stock of issued, undue 3-, 6 and 12-month treasury bills (including treasury bills for monetary purposes) stood at Denar 9,370.12 million. The 3-month bills dominate with 64%, 77.5% of which are 3-month treasury bills for monetary purposes.

<sup>114</sup> The calendar of government securities auctions is made public in advance for a period of six months, and the precise amount for each auction is made public four days prior to the auction.

<sup>115</sup> In the fourth quarter of 2006, in spite of the six auctions held according to the pre-specified calendar, on October 3, 2006 an already held auction was reopened (on September 19, 2006).

<sup>116</sup> The stock of 3-month treasury bills includes the amount of 3-month treasury bills for monetary purposes launched in March 2006. Difference between these two types of government securities is that according to the Public Debt Law, the government securities for monetary purposes are not a part of the public debt since issued for the purposes of the monetary policy.

Table 38

## Supply, demand and interest rate on the primary treasury bills market

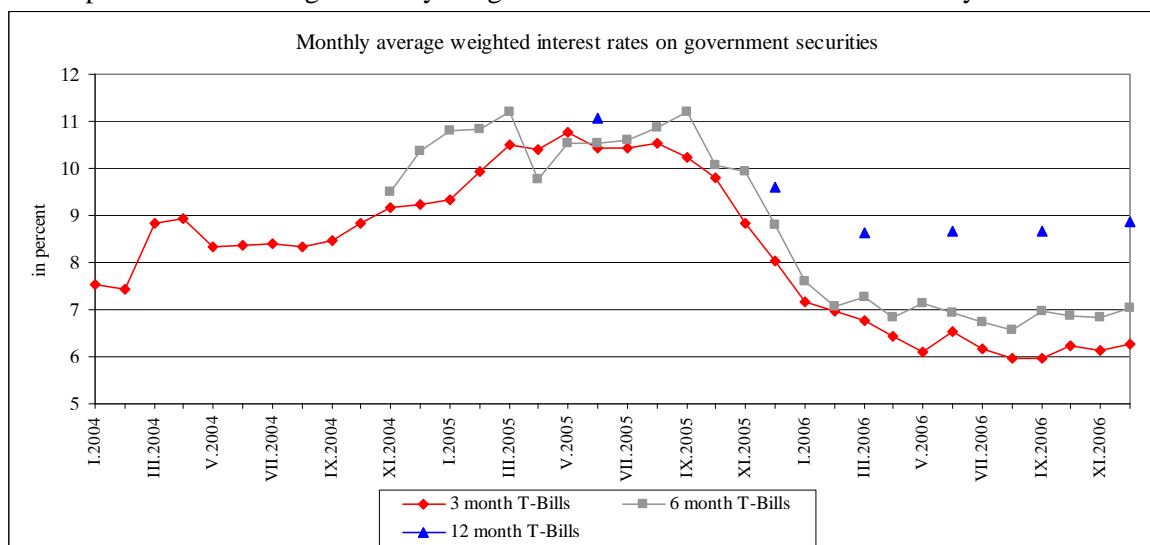
<b>3 month T-Bills</b>		Amount offered for sale	Amount of bids submitted	Amount of bids accepted	Average weighted interest rate
		<i>(in Denar)</i>			
I Q.2006		3.500.000.000	6.000.160.000	3.482.780.000	6,92
II Q.2006		6.219.830.000	5.286.890.000	4.469.710.000	6,41
III Q.2006		7.850.000.000	8.631.140.000	6.857.680.000	6,07
IV Q.2006		8.395.000.000	7.232.630.000	6.594.980.000	6,22
<b>Total:</b>		<b>25.964.830.000</b>	<b>27.150.820.000</b>	<b>21.405.150.000</b>	<b>6,33</b>
<b>6 month T-Bills</b>		Amount offered for sale	Amount of bids submitted	Amount of bids accepted	Average weighted interest rate
		<i>(in Denar)</i>			
I Q.2006		900.000.000	1.608.530.000	826.440.000	7,34
II Q.2006		1.150.000.000	1.042.680.000	716.430.000	7,02
III Q.2006		1.150.000.000	1.176.680.000	989.310.000	6,74
IV Q.2006		1.150.000.000	1.405.430.000	1.150.000.000	6,91
<b>Total:</b>		<b>4.350.000.000</b>	<b>5.233.320.000</b>	<b>3.682.180.000</b>	<b>6,98</b>
<b>12 month T-Bills</b>		Amount offered for sale	Amount of bids submitted	Amount of bids accepted	Average weighted interest rate
		<i>(in Denar)</i>			
I Q.2006		350.000.000	461.320.000	350.000.000	8,62
II Q.2006		350.000.000	261.670.000	261.670.000	8,66
III Q.2006		300.000.000	300.840.000	300.000.000	8,66
IV Q.2006		350.000.000	324.160.000	324.160.000	8,86
<b>Total:</b>		<b>1.350.000.000</b>	<b>1.347.990.000</b>	<b>1.235.830.000</b>	<b>8,70</b>

Source: Ministry of Finance of the Republic of Macedonia.

The cut in the NBRM reference interest rate, as well as the higher investors' demand for treasury bills implied lower interest rates on this market segment. Thus, at the auctions held over the year, the average weighted interest rate on 3-month treasury bills equaled 6.33% (10.08% in 2005). The average weighted interest rate on 6-month treasury bills at the auctions held in 2006 equaled 6.98% (10.16% in the preceding year), while the average weighted interest rate at the 1-year treasury bills auctions in 2006 equaled 8.70%, (9.89% in 2005). The treasury bills interest rates were steadily dropping over the year, and the weighted annual interest rates were reduced by 1.19-3.75 percentage points on average, depending on their maturity. The fastest fall was registered in the average annual weighted interest rate on 3-month treasury bills (3.75 percentage points).

Figure 102

Development of the average monthly weighted interest rates on short-term treasury bills

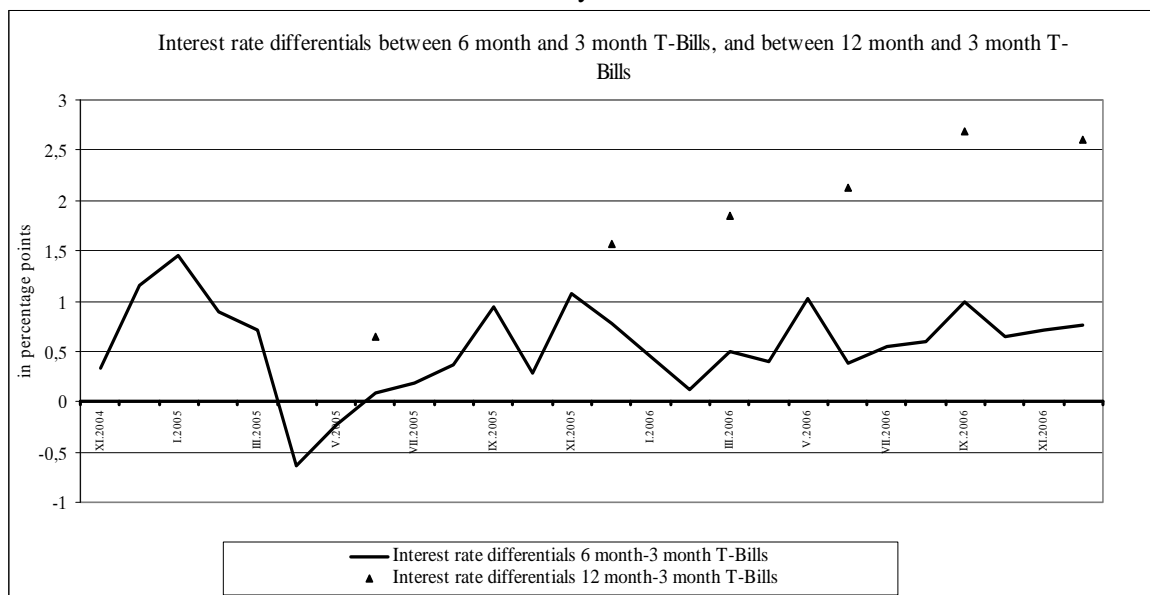


Source: Ministry of Finance of the Republic of Macedonia.

The treasury bills with longer maturity bear higher yield, in accordance with the higher risk premium. In 2006, the short-term treasury bills interest rates curve registers an uptrend, thus being regarded as a "normal curve". Such curve shape, when the interest rates increase progressively with the length of the maturity period, indicates that investors expect the economy to grow without major shocks, in one-year perspective (since the treasury bills are short-term, i.e. 12-month investment horizon). Compared to the same period of the preceding year, it is evident that the shape of the short-term treasury bills interest rates curve becomes more straightened (the curve slope increases), due to the more rapid decrease in the 3-month treasury bills interest rates relative to the decrease in the 12-month treasury bills interest rates. In December 2006, the interest rate on 12-month treasury bills (8.86%) dropped by 0.73 percentage points relative to December 2005, whereas the interest rate on 3-month treasury bills in December 2006 equaled 6.26%, which is by 1.77 percentage points lower on annual basis. Considering the above, the curve registers faster uptrend, which is a positive indicator for the economy. It should be noted that the curve slope was increased in environment of cut in the interest rates.

Figure 103

Differences in interest rates on short-term treasury bills with various maturities

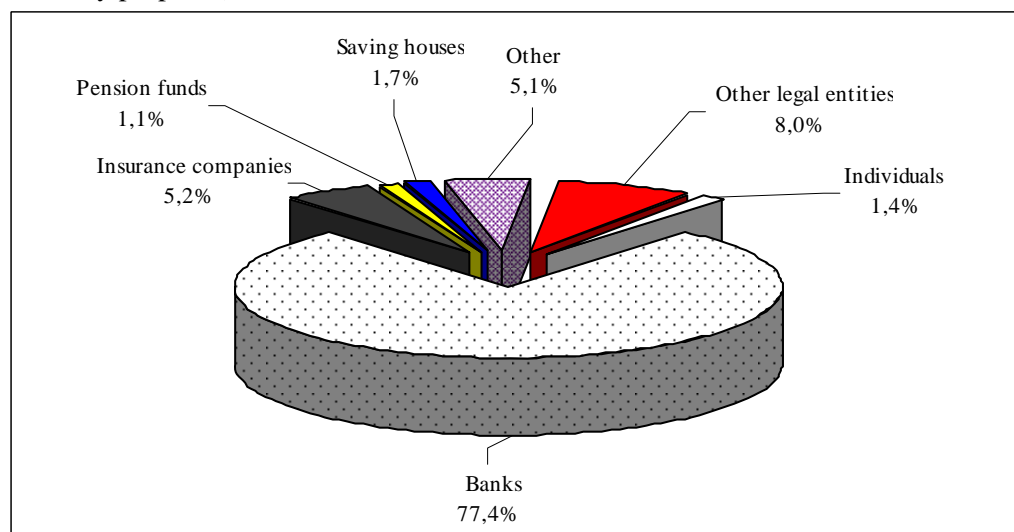


Source: Ministry of Finance of the Republic of Macedonia.

Observing the ownership structure, the banks own most of short-term treasury bills, making up 77.4%, followed by non-financial legal entities, accounting for 8% and insurance companies that constitute 5.2%. The two private pension funds jointly constitute 1.1% of the investment in short-term treasury bills. The primary short-term government securities market efficiently promotes the institutional savings, creating instruments that ensure risk diversification. In the first year of existence of the private pension funds, on December 31, 2006, their investments in short-term treasury bills equaled 6.9% of the total assets of the funds.

Figure 104

Ownership structure of treasury bills (3-, 6- and 12-month treasury bills including treasury bills for monetary purposes) as of December 31, 2006



Source: Ministry of Finance of the Republic of Macedonia.

Under the Public Debt Management Strategy for 2006-2008 period<sup>117</sup>, one of the objectives of the Ministry of Finance is to ensure gradual extension of the maturity of the domestic public debt, primarily through the policy of maximizing the maturity of the newly issued government securities when the basic interest rates are low, since the depreciation of the existing long-term structural bonds make the profile of the domestic public debt maturity less favorable. Consequently, two 2-year and one 3-year government bonds were issued in 2006.

Table 39

Review of issued and earlier purchased continuous government bonds in 2006

	Continuous government bond no.1 in 2006	Continuous government bond no.2 in 2006*	Continuous government bond no.3 in 2006**	Continuous government bond no.2 in 2005***	
Date of auction:	27.04.2006	26.10.2006	23.11.2006	Date of premature purchase:	29.12.2006
Maturity (in years):	2	2	3		
Maturity date:	03.05.2008	30.10.2008	27.11.2009		
Amount offered for sale (in millions of Denar):	250	300	300		
Amount of bids submitted (in millions of Denar):	307,5	552,6	290,8		
Amount of bids accepted (in millions of Denar):	250,0	300,0	290,8	Nominal amount (in millions of Denar):	716
Coupon interest rate:	9% p.a	9% p.a	9% p.a		
Repayment of coupon interest:	03.05.2007, 2008	30.10.2007, 2008	27.11.2007, 2008, 2009	Due coupon interest (in millions of Denar) on benefit of the only owner-NBRM:	53
Accepted on the Macedonian Stock Exchange listing:	28.06.2006	22.11.2006	01.03.2007	Accepted on the Macedonian Stock Exchange listing:	14.03.2006
Trading on the Over the Counter Market:	01.07.2006	In conformity with the amendments to the Rulebook on the Manner and the Procedure for Trading and Settlement of Transactions in Securities on the Over the Counter Market	In conformity with the amendments to the Rulebook on the Manner and the Procedure for Trading and Settlement of Transactions in Securities on the Over the Counter Market	Trading on the Over the Counter Market:	In conformity with the amendments to the Rulebook on the Manner and the Procedure for Trading and Settlement of Transactions in Securities on the Over the Counter Market

\* The ownership structure of the 2-year Continuous government bond no.2 in 2006 consists of banks - 70%, and 30% - clients.

\*\* The ownership structure of the 3-year government bond issued on November 23, 2006 consists of banks - 79%, and 29% - clients.

\*\*\* The Ministry of Finance made an early purchase of the government bonds for covering the NBRM loss. The early purchase is in line with the Public Debt Law and the Prospectus for issuing and trade in Continuous government bond no.2 in 2005, made in a period of favorable budget position, aimed at reducing the interest expense.

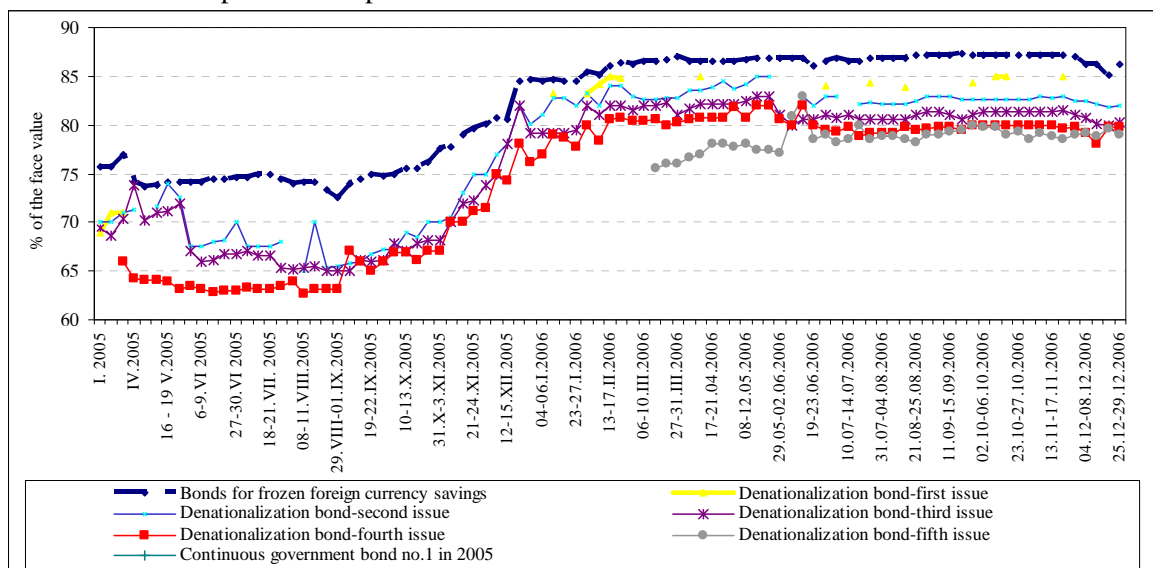
In 2006, *government bonds* were traded on the official Stock Exchange market in the amount of Denar 2,230 million, which is by 7.4% more relative to the amount traded in 2005. The increase is primarily due to the listing of a new, fifth issue of the denationalization bond<sup>118</sup>, constituting most of the trade in government bonds (40.7%), and the investments of the private pension funds, whose total investments in listed government bonds equaled 72.4% of the total assets of these Funds as of December 31, 2006. In 2006, the government bonds were traded in at a

<sup>117</sup> "Official Gazette of the Republic of Macedonia" no. 39/2006.

<sup>118</sup> On March 14, 2006, the Macedonian Stock Exchange made a decision on listing the fifth issue of the denationalization bond (worth Euro 34 million) and government bonds for covering the loss of the National Bank of the Republic of Macedonia, issued by the Republic of Macedonia, i.e. Continuous bond no.2 in 2005 worth Denar 716 million.

price from 75.5% (Denationalization bond from the fifth issue) to 100.3% of the nominal value<sup>119</sup> (Continuous bond no.1 in 2005). No purchase and sale transactions were registered in the Continuous bond no.2 in 2005, the Continuous bonds no.1 and no.2 in 2006, and in the older government bonds<sup>120</sup> (launched on the Stock Exchange on June 28, 2006).

Figure 105  
Government bond price development



Source: Macedonian Stock Exchange AD Skopje.

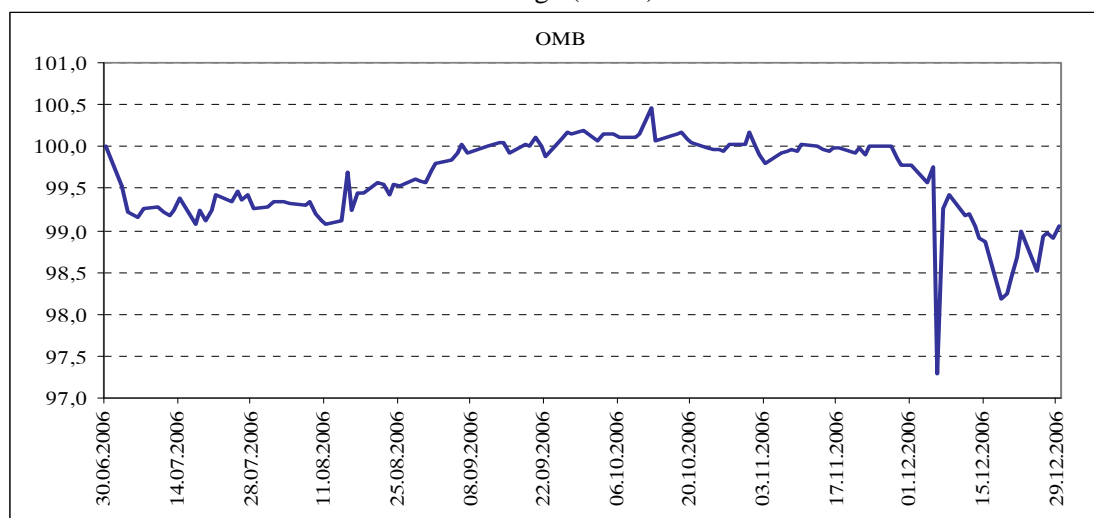
On June 30, 2006, the Stock Exchange started determining and publishing a Bond Index of the Macedonian Stock Exchange AD Skopje (OMB).<sup>121</sup> Since its introduction on June 30, 2006 to September 5, 2006, the OMB value was permanently maintained below its initial value, i.e. below 100 index points. Over the most of the fourth quarter of 2006, the value of the OMB index gravitates around its initial value, while from December 6, 2006, to the end of December it registered higher volatility and general downward trend. At the end of 2006, OMB was positioned at 99.06 index points, which is by 0.9% less compared to its initial value as of June 30, 2006.

<sup>119</sup> The interval has been set in accordance with the latest average weekly price of trade in the bonds within the quarter under observation.

<sup>120</sup> The bonds for rehabilitation of Stopanska Banka AD Skopje and the Bonds for compensating selective credits of the NBRM were issued by the Republic of Macedonia in 1995.

<sup>121</sup> The OMB index is composed of bonds for old foreign exchange savings and denationalization bonds of the 1st, 2nd, 3rd, 4th and 5th issue, and the initial value of the OMB is 100. The OMB is a price index weighted by the turnover, with a restriction according to which the share of none of the bonds within the index structure is not allowed to exceed 30%. The Bond Index of the Macedonian Stock Exchange includes the listed bonds of the Macedonian Stock Exchange subject to trade of at least 30 trading days prior to be included in the index and that fall due within at least one year. The choice of bonds included in the OMB composition is made by the Stock Exchange Index Committee, taking into account the following factors: interest rate; bond maturity and other factors. The index is regularly revised once a quarter, and under extraordinary circumstances, the Stock Exchange Index Committee may revise the index extraordinarily.

Figure 106  
Bond Index of the Macedonian Stock Exchange (OMB)



Source: Macedonian Stock Exchange AD Skopje.

In 2006, purchase and sale transactions in short-term government securities were concluded on the Over the Counter Market<sup>122</sup> in the amount of Denar 70.1 million, as follows: Denar 40 million in treasury bills with residual maturity from 6 to 12 months, Denar 19.7 million in treasury bills with residual maturity from one to three months, and Denar 10.4 million in treasury bills with residual maturity of up to one month. In the second half of 2006, no purchase and sale transactions in treasury bills were concluded on the Over the Counter Market, meaning that all aforementioned transactions were concluded in the first half of the year.

The secondary long-term government securities market was created with the adoption of the Rulebook on the manner and the procedure for trade in and settlement of securities transactions. Thus, in the second half of 2006, the long-term government securities, other than on the Macedonian Stock Exchange, were also traded on the Over the Counter Market, prior to their maturity date. In the third quarter, the total trade in long-term government securities (with residual maturity of up to two years) equaled Denar 115.2 million. In the fourth quarter of 2006, the total trade in long-term securities market on the over the counter market amounted to Denar 392.5 million, where more than half of the trade (55%) was in government bonds with residual maturity of up to three years, and the remaining was in government bonds with residual maturity of up to two years.

### Annex 13

#### Pension private funds as institutional investors

On January 1, 2006, two pillar pension system was established in the Republic of Macedonia, regulated by the Law on Fully Funded Pension Insurance ("Official Gazette of the Republic of Macedonia" no. 29/02, 85/03, 40/04 and 113/05). According to this law, the insured may pay their pension insurance contributions in the both pillars, which are mandatory. The first pillar consists of the Pension and Disability Insurance Fund of Macedonia (PIOM), and the second pillar consists of two private pension companies: Nov Penziski Fond (NPF) and KB Prv Otvoeren

<sup>122</sup> The over-the-counter market was officially commissioned on April 25, 2005, and the first transaction was concluded on May 18, 2005. The over the counter market serves for concluding purchase and sale transaction in securities outside the Stock Exchange and the Money and Short-term Securities Market. Till June 30, 2006, all short-term securities issued by the Republic of Macedonia were traded on the Market, and since July 1, 2006, in line with the amendments to Rule for the manner and procedure for trade in and settlement of securities transaction ("Official Gazette of the Republic of Macedonia" no.71/2006), the NBRM extended the regulations governing the trade in government securities on the over the counter markets and on long-term government securities (other than bonds for the old foreign currency savings and denationalization bonds).

Penziski Fond (KB Prv). Also, all insured employed prior to January 1, 2003 are given the opportunity, to choose by their own discretion, whether to be included in the second pillar, and for those insured for the first time after January 1, 2003 and all newly employed, the membership in the second pillar is mandatory, and they are entitled to make their own choice of a private fund. The total contributions for pension and disability insurance (21.1% of the gross salary) of all insured who are members of the second pillar are divided into two parts, with 13.78% of the gross salary being apportioned to the first pillar, and the remaining 7.42% to the second pillar.

According to the data of the Agency for Supervision of the Fully Funded Pension Insurance (MAPAS)<sup>123</sup>, as of December 31, 2006, 128.031 insured were registered in the second pillar, 47.2% of which are voluntary, and the remaining 52.8% are mandatory insured. The total funds paid in the second pillar as of the end of 2006 stood at Denar 1,325.3 million, almost equally distributed in the two funds. Thus, at the end of the year, 55% of the funds were paid in KB Prv, and the remaining in NPF.

According to the Law on Fully Funded Pension Insurance, the private pension funds may fructify the funds collected from contributions, by investing in various financial instruments. Also, there are some restrictions on the portion of the collected funds that could be invested in instruments, in order to protect the insured's funds, and most of the funds may be invested in instruments that bear the lowest risk.

Table 40

Types of instruments and the maximum percentage of funds allowed to be invested by the pension funds

Types of instruments	max % of pension fund's assets
Instruments of foreign issuers (EU, Japan or USA)	20%
Bonds, securities with constant yield and shares of foreign issuers	5%
Shares and other securities of foreign issuers	5%
Bonds and other securities guaranteed by the Government or NBRM	80%
Deposits, certificates, other mortgage securities of domestic commercial	60%
Securities and commercial bills of first class domestic companies	40%
Shares of domestic companies on the Stock Exchange	30%
Shares of domestic investment funds	20%

Source: Law on Fully Funded Pension Insurance ("Official Gazette of the Republic of Macedonia" no. 29/02, 85/03, 40/04 and 113/05).

Although the pension funds are entitled to place these funds in foreign instruments, in 2006 there was no outflow of funds abroad on this basis. This means that all funds were invested in domestic financial instruments, thus contributing to further development and deepening of the financial markets in the Republic of Macedonia. The assets invested by the private funds in government bonds nearly reached the permitted limit of 80%, constituting roughly 40% of the turnover in 2006 on the Stock Exchange segment that trades in government bonds. Furthermore, the pension funds invested their assets in the Continuous Bond no.1 since 2005, in the bonds for old foreign currency savings and in Denationalization bonds, as most traded bonds on the Stock Exchange in 2006.

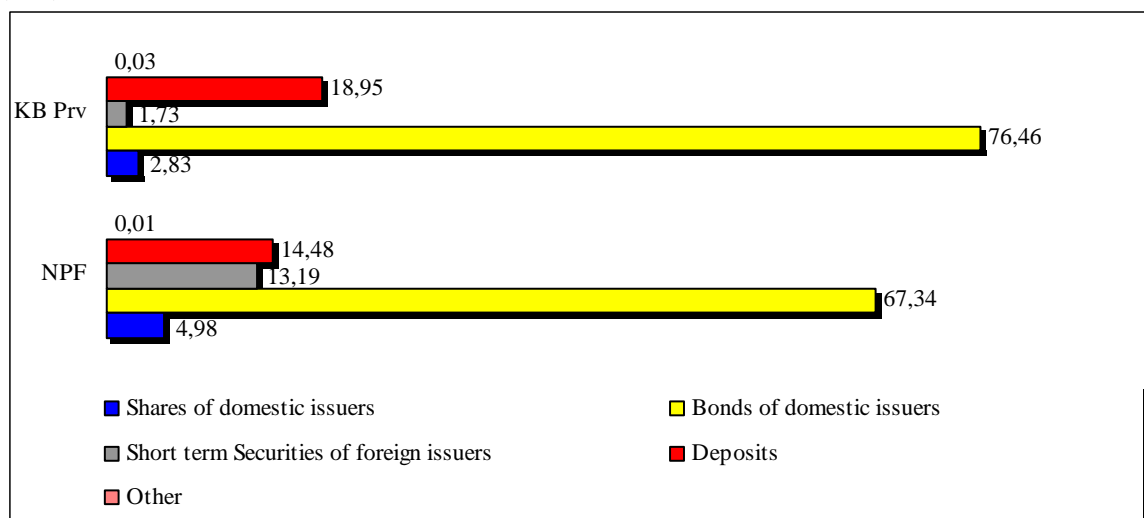
<sup>123</sup> *Conditions in the Fully Funded Pension Insurance*, Annual Statistical Report for 2006, Agency for Supervision of the Fully Funded Pension Insurance.



Figure 107

Structure of assets invested by the private pension funds as of December 31, 2006

(in %)



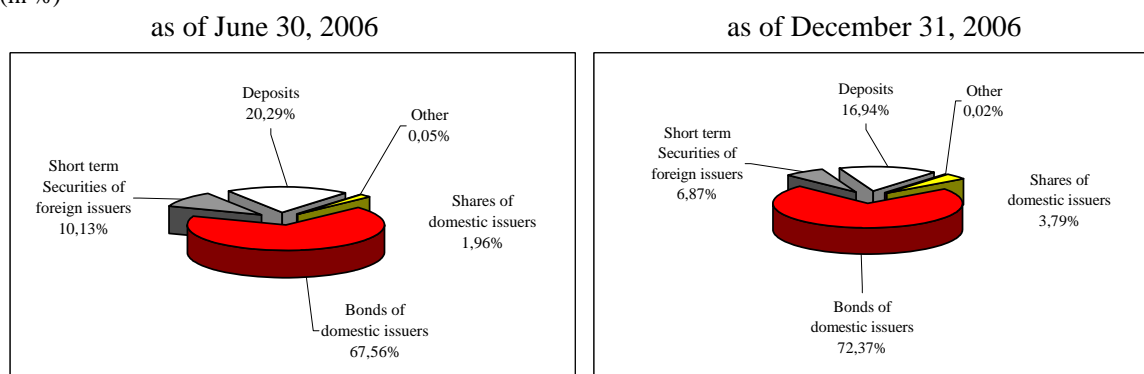
Source: Agency for Supervision of the Fully Funded Pension Insurance (MAPAS).

The portfolio of the pension funds of the second pillar also includes short-term securities, i.e. treasury bills in all maturities (3-, 6- and 12-month) and a smaller portion of shares of six companies listed on the Stock Exchange, half of which invested in banking institutions.

Figure 108

Structure of assets invested by private pension funds

(in %)



Source: Agency for Supervision of the Fully Funded Pension Insurance (MAPAS).

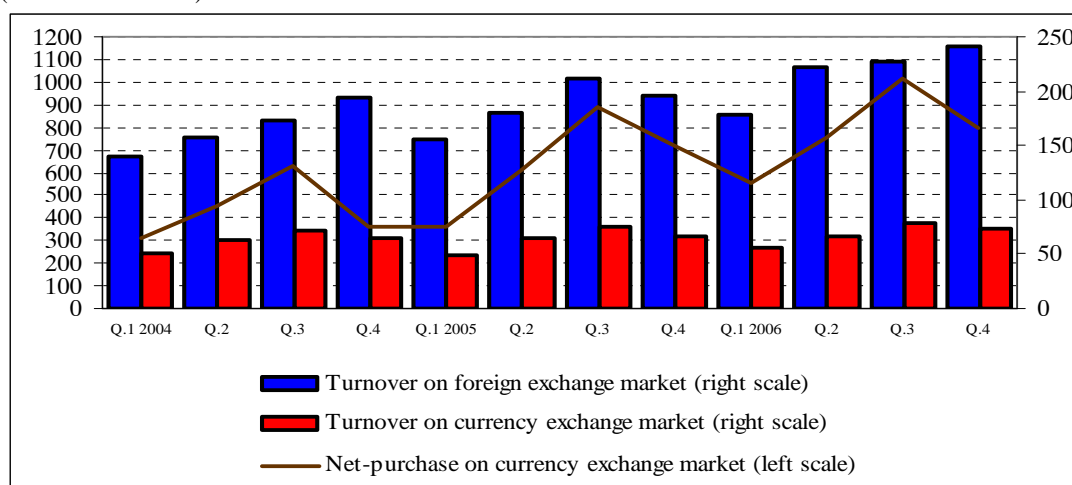
This year registered some developments in the investment structure of the both private pension funds. On December 31, 2006, the structure of assets invested by the private pension funds showed positive developments in favor of the government bonds and shares (increase of 4.8 percentage points and 1.8 percentage points compared to June 30, 2006), implying that the pension funds seek to invest their assets in long-term securities that bear higher rate of return on assets, which also contributes to further development of some market segments on the Stock Exchange. On the other hand, although the investments in short-term securities and deposits in absolute amount grew, their share in the portfolio structure of the funds slowed down in same pace as at the end of June 2006, i.e. by 3.3 percentage points.

### 4.3. Foreign exchange and currency exchange market<sup>124</sup>

The foreign exchange market developments in 2006 primarily arose from the high inflows from private transfers from abroad, the external debt of the private sector and the accelerated foreign trade. In 2006, the total value of transactions conducted on the foreign exchange market reached Euro 4,163 million, which is an increase of Euro 598.7 million or 16.8% compared to the preceding year. The average monthly turnover in the observed period totaled Euro 346.9 million (Euro 297 million in 2005). Analyzing the segments, the transactions between banks and enterprises<sup>125</sup> made up 83.7% of the total turnover (87.4% in 2005).

Figure 109

Turnover on foreign exchange and currency exchange market  
(in millions of euros)



Source: National Bank of the Republic of Macedonia.

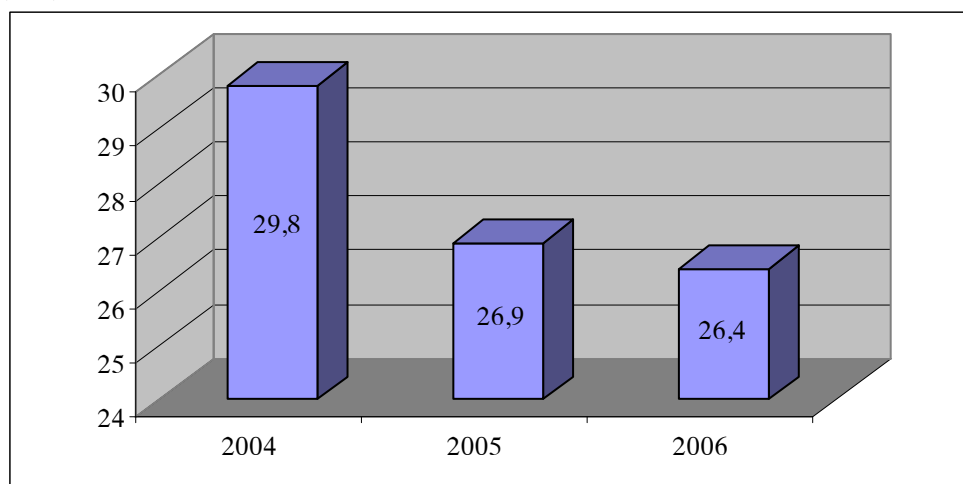
In 2006, on the dominant market segment of trade between banks and enterprise, the demand constantly exceeded the supply of foreign currency of the enterprises. This discrepancy equaled 26.4% on average (approximately the same as in the preceding year). The higher demand for relative to the supply of foreign currency by the enterprises in 2006 was covered by a net-sale of foreign currency by the banks in the amount of Euro 406.7 million (annual growth of Euro 38 million).

<sup>124</sup> Foreign exchange market includes trade between banks-market makers and NBRM, interbank trade, and trade between banks and enterprises. The currency exchange market includes the currency exchange operations of the banks and private exchange offices with the household sector.

<sup>125</sup> Includes transactions in foreign currency between authorized banks and exchange offices and between authorized banks and non-resident companies.

Figure 110

Ratio of the demand - to - the supply of foreign currency of the corporate sector  
(in %)



Source: National Bank of the Republic of Macedonia.

Notwithstanding the net-sale of foreign currency in the transaction of the banks with the corporate sector, the high net inflows from currency exchange operations, the positive expectations, and consequently, the banks' Denar investments in the domestic economy, and the non-realization of the expected higher outflow of foreign currency for repatriation of dividends enabled the NBRM to purchase high amount of foreign currency. The trade segment of the NBRM registered a net-purchase in the amount of Euro 241.1 million (increase of 53.8% compared to 2005). In the first quarter of 2006, net foreign currency was purchased in the amount of Euro 10.6 million, and only January registered a net-sale of foreign currency, which is a common seasonal development resulting from the needs of the domestic importers to repay their liabilities, which is in line with the seasonally higher import at the end of the preceding quarter. In the second quarter of 2006, the net foreign currency inflows in the banking system, effectuated through the currency exchange operations, the active usage of foreign assets of the banks and the demand for government shares contributed to additional net-purchase of foreign currency by the NBRM, in the amount of Euro 94 million.

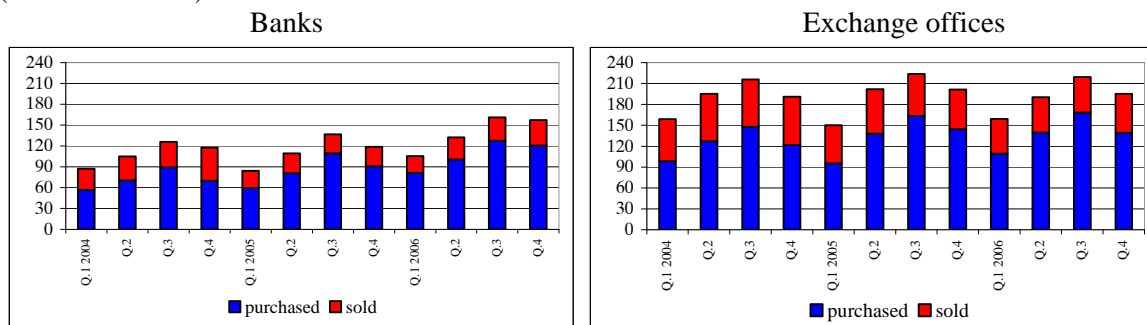
In the third quarter of 2006, given the higher supply of foreign currency due to the higher seasonal inflows of foreign currency based on currency exchange operations, particularly evident in July, the NBRM made a net-purchase of foreign currency on the foreign exchange market in the amount of Euro 76.3 million. The trend of purchasing foreign currency continued in the last quarter of the year, where the net-purchase of foreign currency reached Euro 60.2 million.

In 2006, the currency exchange market registered a turnover of Euro 1,320 million. Compared to the preceding year, it is an increase of 7.7%, which is a result of the 11.8% higher supply of foreign currency, and simultaneous decrease in the demand of 2.8%. With the supply exceeding the demand for foreign currency, the currency exchange market registered a net-purchase of foreign currency in the amount of Euro 651 million (net-purchase of Euro 537.1 million in 2005).

The monthly demand for foreign currency ranged from Euro 22.5 million in February to Euro 32.4 million in December. Observing by quarter, the fastest demand for foreign currency was registered in the fourth quarter. On the other hand, the supply of foreign currency on the currency exchange market was the lowest in February (Euro 57.6 million), and the highest in August (Euro 101.7 million). The quarterly analysis shows the highest supply of foreign currency in the third quarter, which is in line with the seasonally high foreign currency inflows, as a result of the summer vacations and the arrival of the Macedonian immigrants in this period.

In 2006, 62.2% of the total demand for foreign assets by the natural persons<sup>126</sup> was covered through the exchange offices, and the remaining 37.8% through the commercial banks. The share of the exchange offices and banks equals 56.4% and 43.6%, respectively on the purchase side of the supplied foreign currency.

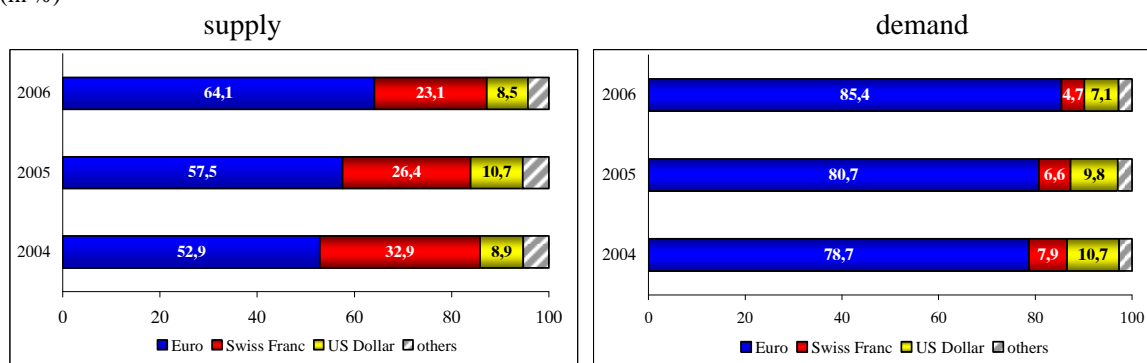
Figure 111  
Developments of the turnover on the currency exchange market  
(in millions of euros)



Source: National Bank of the Republic of Macedonia.

Observing the currency structure of the supply and the demand of foreign currency in 2006, the Euro dominates with 64.1% and 85.4%, respectively. Unlike the higher share of the Euro, the share of the US Dollar and the Swiss franc went down.

Figure 112  
Currency structure of the turnover on the currency exchange market  
(in %)



Source: National Bank of the Republic of Macedonia.

<sup>126</sup> Including residents and non-residents.

## **V. Other activities of the NBRM**

### **5.1. Payment system in the Republic of Macedonia**

In 2006, the payment system in the Republic of Macedonia continued successfully performing its function and development. The NBRM is owner and manager of the Macedonian Interbank Payment System (MIPS) that perform the function of real time gross settlement, with the banks being institutions responsible for conducting the payment operations.

In 2006, the National Payment Systems Council of the Republic of Macedonia held four sessions, focusing on the higher efficiency and smooth functioning of the payment system in the Republic of Macedonia, as well as full cooperation and coordination with the institutions directly or indirectly related with the payment system.

#### *5.1.1. NBRM role in the payment operations*

For ensuring efficient and safe payment system in the Republic of Macedonia, the NBRM acts its role in the payment operations through the following functions:

- a) operational function,
- b) regulatory function, and
- v) oversight function.

#### *a) Operational function*

In the performance of its operational function, the NBRM manages the settlement system - MIPS. In 2006, MIPS operated in a real time during the all 252 business days, with accessibility of 99.80%, i.e. it was inaccessible only 290 minutes of the planned 145.400 minutes over the whole year. Furthermore, the System was processing 9.734 orders a day, on average, and the maximum number of orders processed a day equaled 20.969.

Participants in MIPS are the banks (including the NBRM), the clearing institutions and the Ministry of Finance. At the end of 2006, the total number of participants in MIPS equaled 24.

Apart from the above, while performing its operational function, in 2006, the NBRM received and processed 2.844 execution orders and decisions on forced collection 1.627 of which fully executed, with the remaining being partially or fully unexecuted due to lack of debtors' funds, postponement by the authority which adopted them, or since incomplete and returned to the courts or the authorized executors for their further completion.

In 2006, out of 2.453.169 transactions settled in MIPS, 99.380 transactions were queuing, which is 4.05% of the total number of transactions settled in MIPS, or 394,4 transactions a day, on average. The average queuing time is 13,28 minutes. The insignificant reduction of the queuing time compared to 2005 (14,19 minutes), is due primarily to the lower number of authorizations needed for some transactions in MIPS for the purposes of performing the NBRM oversight function. The reasons are provided in details in the analysis of the queues in MIPS for 2006.

#### *b) Regulatory function*

In 2006, NBRM performed its regulatory function in the area of payment systems by adopting decisions that fall within its competence. Thus, the following acts were adopted:

1. Decision on determining the method of maintaining and the contents of the Single Accountholders Registry;
2. Decision on assigning sorting code to the institutions responsible for conducting payment operations.

The Decision on determining the method of maintaining and the contents of the Single Accountholders Registry (ERIS) specifies the liability for updating the ERIS and clearly defines its contents. Also, with respect to transparency, it includes an obligation for the clearing house to notify the National Bank of the Republic of Macedonia on the amendments to the instructions which are responsibility of the clearing house.

The banks' sorting codes are crucial for efficient payment execution. They constitute the first three numbers of each account, showing the bank where the account is maintained, enabling fast and efficient directing of the funds.

The assigning of the sorting codes was regulated by the Decision on assigning sorting codes to the institutions responsible for conducting payment operations ("Official Gazette of the Republic of Macedonia" no. 41/01), adopted on the basis of Article 5 paragraph 1 item 7 of the Payment Operations Law. With the reform of the payment system of the Republic of Macedonia in 2001, the National Bank of the Republic of Macedonia initially assigned the sorting codes which became an integral part of this Decision. Over the time, however, some banks ceased operating, some merged or changed their names, etc. Thus, on a first glimpse, the Decision gives a wrong impression on the existing banks in Macedonia, since some changes were made under item 2 of this Decision, but there is no place where they could be resented. Therefore, the new decision is of a general nature. It also requires regular updating of the list of sorting codes of the institutions responsible for conducting payment operations, which is available on the web site of the National Bank of the Republic of Macedonia.

#### *c) Oversight function*

As a part of its payment systems oversight function, in 2006, the NBRM conducted on-site and off-site oversight of the banks and the clearing house. The payment system was monitored through the IT system, developed on the basis of the Instructions for internal and external clearing, requiring day-to-day electronic submission of data on the banks' payment system. In addition, the blocked accounts are monitored indirectly, on a daily basis, by comparing the blocked accounts reports submitted by the bank and the blocked accounts reports across the banking system, generated from the data the NBRM receives from the clearing house. In 2006, special attention was paid on the off-site oversight of the institutions responsible for conducting payment operations. Only one on-site oversight was made on request of a participant in the payment operations.

Furthermore, in 2006, the NBRM continued gathering and distributing payment operations data on a monthly basis, as specified by the Decision on submission and distribution on payment operations data.

In 2006, the NBRM oversight function in the area of payment system was performed through the National Payment Systems Council. For that purpose, the work group established by the National Payment Systems Council of the Republic of Macedonia in 2005, continued operating in 2006. In the performance of its tasks conferred by the National Payment Systems Council, the work group established international cooperation with representatives of the developed central banks responsible for the oversight of the payment systems.

In 2006, the NBRM played an active role in the implementation of the Law on Execution in the part concerning the payment systems and in the training programs for executors organized by the Ministry of Justice.

### 5.1.2. Indicators for the operations of the payment systems in the Republic of Macedonia

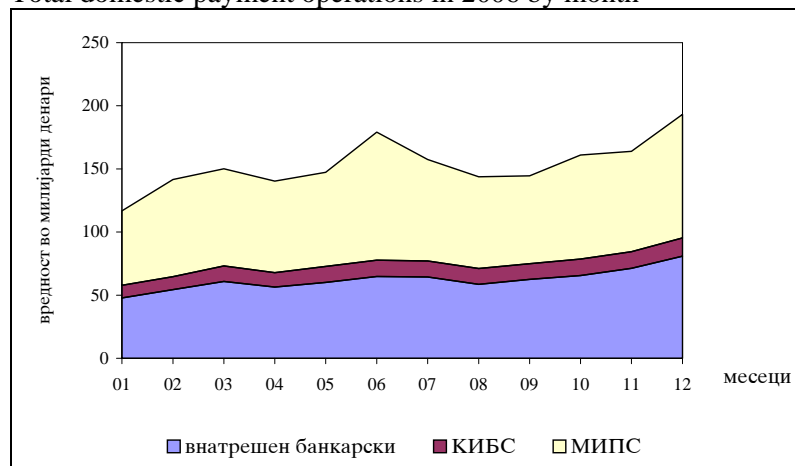
#### a) Opened accounts

In 2006, 144.404 new accounts were reported to the Single Accountholders Registry with the institutions responsible for conducting payment operations in the Republic of Macedonia (banks and the NBRM), and 8.951 were closed. Thus, the total amount of accounts opened in the Single Accountholders Registry reached 281.255 at the end of the years. Holders of these accounts are 210.165 different entities (natural persons and legal entities), 73.42% of them holding only one account, with the average number of opened accounts equaling approximately 1.34 accounts per entity.

From the launching of the new payment system to the end of 2006, the number of registered blocked accounts totaled 12.583. In 2006, 10.182 blockings were initiated, 6.730 of which were unblocked, making up 66.1% of the total number of initiated blockings.

#### b) Total payment operations in the Republic of Macedonia

Figure 2  
Total domestic payment operations in 2006 by month



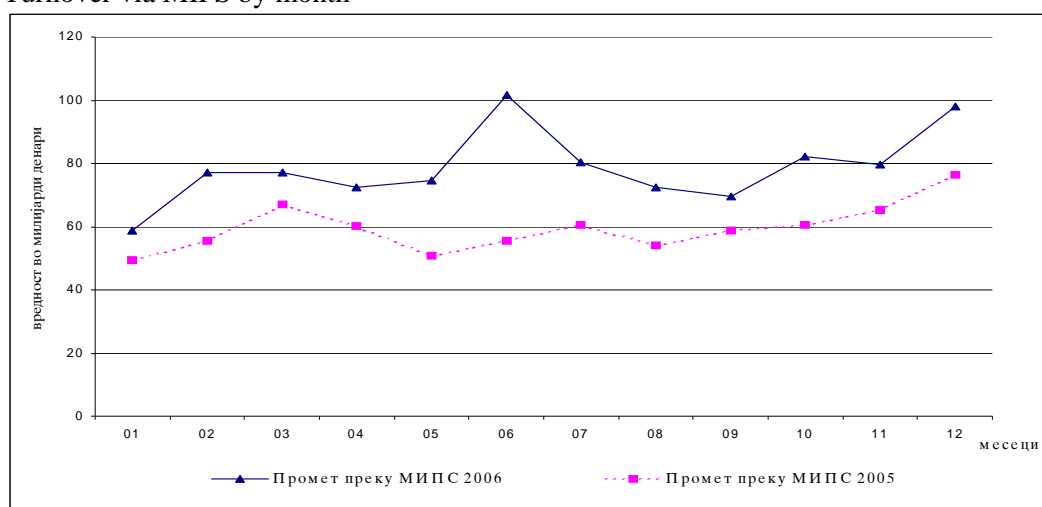
In 2006, the executed payment operations totaled Denar 1,839.48 billion. The total payment operations do not include transactions on settlement of the net balance of the clearing house KIBS. Thus, 40.65% are inland operations of the banks (between accounts in a same bank), 51.31% relate to interbank payment operations through MIPS and 8.04% are interbank operations through KIBS.

In 2006, the number of executed transactions in the domestic payment operations totaled 23.145.296, 10.58% of which via MIPS, 45.27% via KIBS, and 44.15% via the internal clearing.

#### c) Turnover and number of transactions executed via MIPS in 2006

In 2006, total turnover of Denar 1,019.46 billion was conducted via the NBRM's MIPS in a total number of 2.453.169 executed transactions including the transactions of the settlement of net-balances of the clearing house KIBS. In 2006, the turnover made through MIPS went up by 29.42%, relative to the previous year. Of the total turnover conducted via MIPS, 50.49% is interbank turnover initiated by other payment operations institutions, and 49.51% is turnover initiated by government institutions (NBRM, Treasury system, etc.).

Figure 3  
Turnover via MIPS by month



In 2006, the number of executed transactions dropped by 12.96% relative to the preceding year. Of the total number of transactions executed via MIPS, 65.02% are interbank transactions initiated by other payment operations institutions and 34.98% are transactions initiated by government institutions (NBRM, Treasury system, etc.).

#### *d) Internal banking payment operations in 2006*

The analysis of the payment operations in 2006, between depositors' accounts opened in the system of a same institution responsible for conducting payment operations shows 12.99% higher value of internal bank payment operations relative to the preceding year. It amounts to Denar 747.7 billion, in 10.218.589 executed transactions, which is by 11.31% more compared to the preceding year.

## **5.2. Cash management operations**

### *5.2.1. Currency in circulation*

The National Bank of the Republic of Macedonia is required by law to issue coins and banknotes as a legal means of payment. On December 31, 2006, the banknotes and the coins accounted for 98.6% and 1.4%, respectively, of the total currency in circulation, and observing quantitatively, their share is 31.9% and 68.9%, respectively.



Figure 4  
Currency in circulation



Source: NBRM.

At the end of 2006, the number of banknotes in circulation equaled 53 million which is by 6.8% more relative to the end of 2005, and their value (Denar 16.1 billion) increased by 11.8%. The currency in circulation structure, by banknotes and coins is as follows:

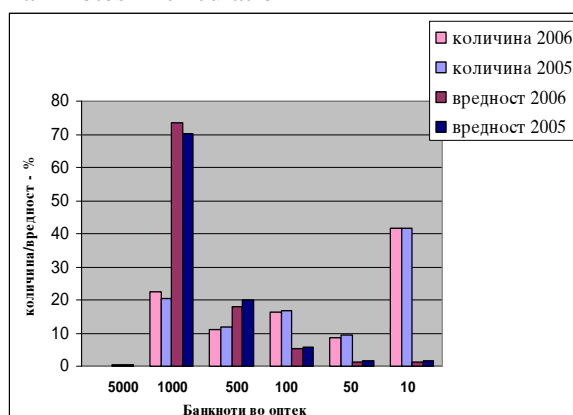
Table 1  
Currency in circulation by year

	Banknotes in circulation		Coins		Total currency in circulation in mil. den
	mil. den	quant.mil.	mil. den	quant.mil	
1999	8.052	30,6	116,1	60,2	8.168
2000	9.424	36,0	135,2	68,7	9.559
2001	14.141	44,9	145,9	74,2	14.287
2002	13.945	44,4	160,9	80,9	14.106
2003	14.004	45,4	175,2	87,8	14.179
2004	14.049	46,9	192,6	96,2	14.241
2005	14.401	49,6	211,2	104,1	14.612
2006	16.109	53.0	233,0	113.4	16.341

Source: NBRM.

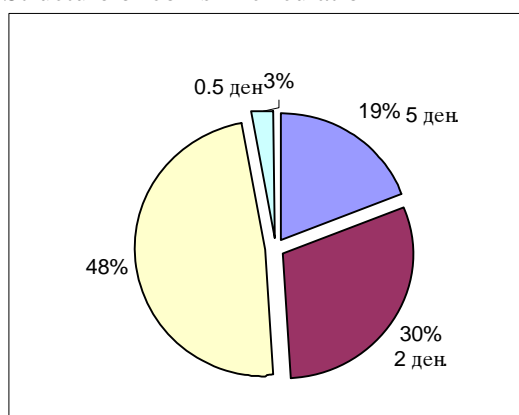
Analyzing the value, the denominations of Denar 1000 and Denar 500 were dominant category in the banknotes in circulation. The denomination of Denar 1000 made up 73.3% (70.4% at the end of 2005), and the denomination of Denar 500 constituted 18.0% of the value of the banknotes in circulation (20.1% at the end of 2005). The other denominations of banknotes account for only 8.7% of the total value of banknotes in circulation, which is by 0.8 percentage points less compared to the end of 2005.

Figure 5  
Banknotes in circulation



Source: NBRM.

Figure 6  
Structure of coins in circulation

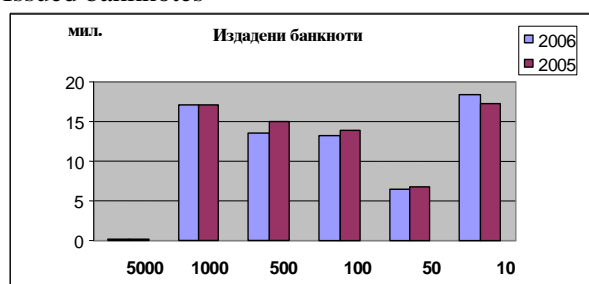


Source: Cash Management Department.

### 5.2.2. Supplying banks with cash

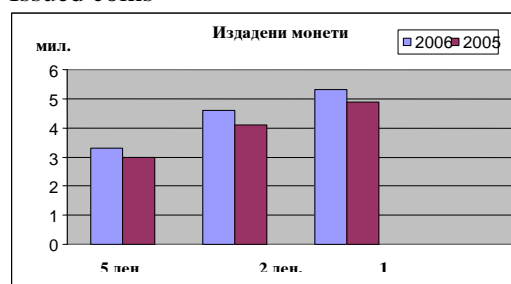
In 2006, the central vault of the NBRM and the two subunits for handling cash issued Denar 26.1 billion in cash to the banks (68.6 millions of banknotes and 13.2 millions of coins), which is by 5.4% less compared to 2005. Furthermore, Denar 24.2 billion were received from the banks (64.0 millions of banknotes and 3.8 millions of coins), which is by 9.0% less compared to 2005.

Figure 7  
Issued banknotes



Source: Cash Management Department

Figure 8  
Issued coins



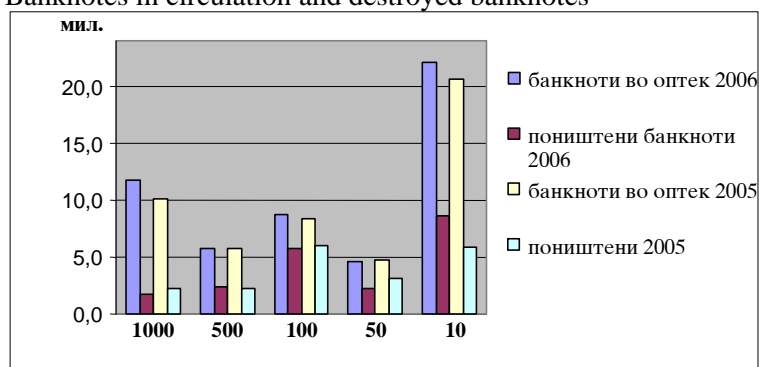
### 5.2.3. Banknote processing and withdrawal

In 2006, the central banknote processing machine processed total of 34.5 millions of banknotes (40.1 millions in 2005). Total of 25.4 million of worn out and damaged banknotes were destroyed (19.6 millions in 2005).

### 5.2.4. Expertise on suspicious/forged banknotes

In 2006, the

Figure 9  
Banknotes in circulation and destroyed banknotes



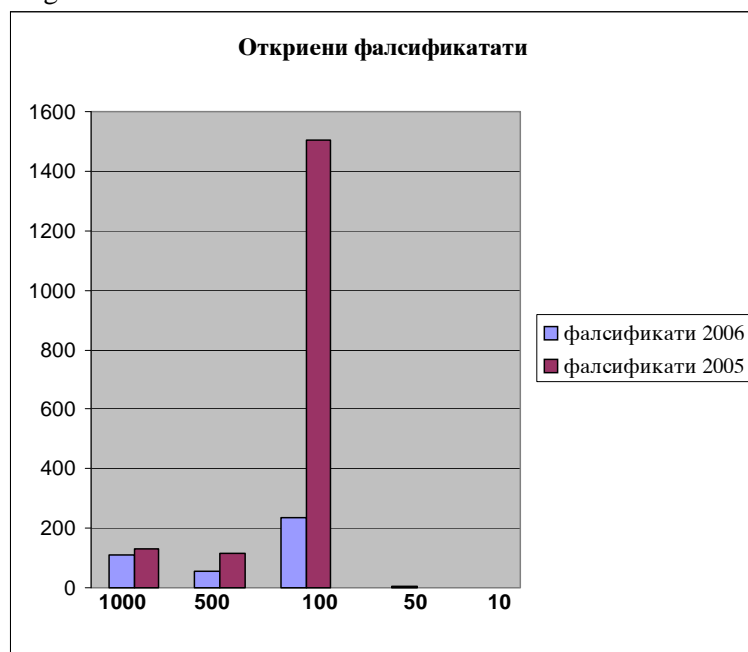
Source: Cash Management Department.

expertise showed total of 404 forged Denar banknotes discovered and confiscated in the Republic of Macedonia by the Ministry of Interior, which is by 77% less compared to the forgeries in 2005 (1,756).

The lower number of forgeries is due to the lower number of copied banknotes in denomination of Denar 100 (from 1503 in 2005 to 234 in 2006), and other denominations. Of the other banknotes, there were 110 forged banknotes in denomination of Denar 1000 (131 in 2005) and 56 banknotes in denomination of Denar 500 (115 in 2005). The value of forged Denars (Denar 171,500) is marginal compared to the value of currency in circulation. The discovered forgeries were primarily made by computer (scanning and printing) or by color Xerox machines on a regular paper, without protection elements. In 2006, the National Bank sent three banknotes of forged Euros to the Ministry of Interior for an expertise, reported by individuals.

Figure 10

Forged Denar banknotes



#### 5.2.5. Printing banknotes and other value papers

In 2006, 25 millions of banknotes in denomination of Denar 10 and 10 million banknotes of Denar 50 were printed for the purposes of

supplementing the reserves of banknotes. Total of 200 pieces of blank bills of exchange were printed for the account of Ministry of finance.

#### 5.2.6. Other cash management operations

In 2006, alcohol and cigarettes banderoles were stored in and issued from the vault, for the account of the Public Revenue Office. There were total of 171 transactions of issuing cigarettes banderoles and 48 transactions of receiving banderoles in the vault, which is approximately the same as in 2005. There were total of 468 transactions of issuing alcohol banderoles, which is by 18% more compared to 2005.

In 2006, 11.4 millions of pieces (12.1 million in 2005) of ATMs and STMs and notes in all denominations in a total amount of 232,600 (135,400 in 2005) were sold for the account of the Ministry of Finance.

Thirty transactions of depositing foreign assets temporary confiscated by the competent bodies in the National Bank's vault were executed in 2006 (52 in 2005). Twelve payments were executed on the basis of court decisions (112 in 2005).

As a result of the regular foreign currency vault operation, there were 2,322 payments of cash foreign currency of government bodies from the vault (2170 in 2005) and 250 receipts of cash foreign currency (288 in 2005).

Also, the number of previously minted golden and silver anniversary coins sold in 2005 was 279 (276 in 2005).

### **5.3. Internal audit**

With the implementation of the Internal Audit Program in 2006, the internal audit fulfilled its ultimate task to identify risks the National Bank is exposed to in the performance of its functions, to establish and efficiently apply adequate internal control system. The work processes in the Bank should have achieved the following goals: credibility and integrity of the financial and other information, compliance of the operations with the laws and bylaws, the internal policies and the operating procedures, safeguarding of assets, and rational and efficient resource employment.

The regular audits of the NBRM operating processes provided an assessment on the adequacy of the internal control system in place, which is subject of regular reporting to the NBRM management. Recommendations were given for overcoming the identified weaknesses, if any, presented in the audit reports. The audits were planned, not only with respect to the risk assessment, but also the importance of the performed functions, the time interval from the last audit and the changes made in the processes.

The internal audit also undertook some activities aimed at improving the operations by greater implementation of the international internal audit standards, and consequently, development of NBRM Internal Audit Policy, revision of the Operating Manual of the Internal Audit Department and revision of the existing internal operating procedures.

Sixteen regular and five extraordinary audits were conducted in 2006, with the implementation of the recommendations given in the audit reports, which were to be completed by 2006, being closely monitored on a regular quarterly basis. The monitoring showed that the recommendations were observed and implemented within the given periods. The audits of 48 work processes in NBRM 2006, resulted in 112 recommendations for improvement of the internal control system.

The internal control systems in the departments, whose individual operating processes were subjected to audit in 2006, were regarded as generally satisfactory, with a need of their further development and improvement.

### **5.4. Strengthening of the NBRM institutional capacity**

In January 2006, the National Bank of the Republic of Macedonia adopted the Supervision Development Plan. In the first quarter of 2006, foreign consultant was engaged to help the NBRM in the process of transition to risk-based supervision.

The implementation of the development plan started in May 2006 by categorizing the recommendations given in the Supervision Development Plan in ten critical areas. Furthermore, the risks the banks are exposed to were identified, including the definition of the approach of the National Bank of the Republic of Macedonia to the assessment of such risks.

The new supervisory framework that includes the definition of the approach and the processes applied during the bank supervision was drafted on the basis of the existing procedures and processes applied by the National Bank of the Republic of Macedonia in the bank supervision. Such defined approach and procedures for assessment of the risk exposure and the quality of risk management, have been subject to testing by the National Bank of Macedonia since the fourth quarter of 2006. The results of the testing, which will continue in 2007, will be a basis for determining the applicability of the draft procedures within the defined approach of the risk-based supervision.

In 2006, the NBRM organized two one-day workshops discussing interesting and current topic. The first workshop was held on April 14, 2006 at a topic: *High Level of Currency in Circulation in the Republic of Macedonia*, focusing on the problem of high level of currency in circulation, the Republic of Macedonia has been facing with over a longer time period and identifying the key areas of possible improvements for overcoming the problem. The second workshop was held on November 23, 2006 covering the topic: *Energy Consumption in the Republic of Macedonia and its Effect on the Balance of Payments*, with the purpose to identify the measures and alternative solutions to reduce the high energy import dependence of the Republic of Macedonia and improvement of the balance of payments. The workshops were attended by representatives of relevant institutions and associations in the country that tackle the specific problems. The workshops were a source of useful ideas and suggestions to the institutions concerned. All workpapers and presentations of the above workshops are available at the NBRM web site.

On October 20-21, 2006, the NBRM hosted its first international conference: *Monetary Policy Challenges under Current Account Deficit*, organized on the occasion of the 60th anniversary of central banking in the Republic of Macedonia. The Conference discussed the contemporary challenges in the achievement of the ultimate objective of the monetary policy - price stability, such as financial market globalization, balance of payments deficit and accelerated trade liberalization and capital flows. The quality and the significance of the Conference was demonstrated by the presence of eminent experts, governors and central banks' representatives from many countries worldwide, and high officials of relevant international institutions.

The development of new econometric techniques for estimation of the time series in the 80's and their employment in the software applications in the 90's had a great effect on the promotion of the empirical work, particularly in the macroeconomy and the finances. Hence, the understanding of the econometric techniques and methods is one of the key elements in the empirical researches, thus becoming a core feature of a modern central bank. For this purpose, in December 2006 and January 2007, the NBRM organized an internal training *Bases of the Econometrics* intended for the NBRM staff having no prior formal knowledge in this area. Purpose of the training was strengthening of the analytical capacity of the NBRM staff, who by applying the statistical and econometric techniques would improve the quality of the work tasks in the future, thus improving the process of decision making within the central bank. The knowledge acquired in this area represents a further approximation of the NBRM to the modern central banks, by training staff that would make analysis, models and projections by greater application of econometric techniques.

In 2006, the NBRM established cooperation with the Central Bank of Austria in the area of technical assistance. Thus, in November 27-29, 2006, the NBRM hosted a foreign consultant, expert in this central bank.

The cooperation between the National Bank of the Republic of Macedonia and the Dutch Central Bank in the area of technical assistance continued in 2006. The NBRM technical assistance project launched by the Dutch Central Bank back in 2000 continued being successfully implemented in 2006. The Project has encompassed almost all core functions and activities of the National Bank of the Republic of Macedonia. Also, in 2006, the National Bank actively cooperated in the area of technical assistance with the European Central Bank, the Deutsche Bundesbank and the International Monetary Fund.