

National Bank of the Republic of Macedonia



**ANNUAL REPORT
FOR 2014**

Skopje, April 2015

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Governor's foreword

Dear readers,

As in previous years, 2014 as well was marked by expectations for post-crisis recovery of the global economy. From this aspect, we should highlight the faster recovery of the US versus European economy, followed by appropriate adjustments in their monetary policies. Fall in oil prices on the world market was yet another feature of the global environment, which slowed down inflation globally, mainly influenced by factors on the supply side. The low prices of primary commodities, the trend of weakening of the euro and the broader based quantitative easing in the euro area from March 2015, are expected to help the recovery of the European economy. However, risks surrounding the global recovery and trends in the prices of primary commodities present during 2014, are expected to continue in 2015.

In extremely dynamic and uncertain external environment, in 2013 and 2014, the Macedonian economy managed to depart remarkably from the dynamic conditioned by the growth pace of our major trading partners. Thus, despite the fragile recovery of the foreign effective demand, in 2014, the Macedonian economy substantially accelerated the real GDP growth to 3.8%, which was mainly generated by domestic factors, primarily investments and exports. Within the investment, one should note the contribution of public investment, particularly in infrastructure and foreign direct investments. Increased exports and reduced trade deficit mainly reflect the effect of new companies with foreign capital in the technological industrial development zones, which exceeded the expectations in our projections. In terms of macroeconomic performance, it is worth mentioning that the unemployment rate gradually declined further and that labor productivity increased in 2014.

Generally, the environment of conducting monetary policy was favorable, but still quite complex. Inflation during 2014 registered a trend of deceleration, so that in the second quarter it entered a zone of negative annual changes and reduced to -0.3% per annum, on average. The slowdown in inflation is mainly due to factors on the supply side, particularly the negative contribution of the prices of food and fuel, amid assessments for negative output gap and expectations for its closing in late 2014. At the same time, core inflation, which excludes food and energy, in 2014, averaged 0.5%, although it entered the zone of negative annual changes towards the end of the year. During 2014, the foreign exchange market generally remained balanced, with relatively small net interventions. The level of foreign reserves and their adequacy ratios were maintained at a solid level during the year. In 2014, fiscal policy kept its stimulating role and substantially supported the economic recovery. Also, credit support by the banking sector mainly strengthened during the year, inter alia, reflecting the banks' perceptions of reduced risks.

In such conditions, the regular analysis of the factors affecting monetary decisions during the year indicated that monetary authorities provided sufficient monetary stimulus and given the overall circumstances in the economy and the external environment, the key interest rate was kept unchanged. Consequently, in 2014, the monetary policy of the National Bank differed from the monetary policy in the euro area, as an anchor economy, in line with the separation of the economic cycle in the domestic economy from the cycle in the euro area. On the other hand, in order to strengthen the effects of the set of monetary instruments applied and further redistribute excess liquidity in the banking sector to support the economy, changes were made in some of the monetary instruments. Given the constant banks' interest to invest funds in deposit facilities, as opposed to their basic function of fine

tuning, their interest rates were gradually reduced, the mechanism of assessing the potential demand at CB bill auctions was revised and excess demand was redirected to non-interest bearing deposit facilities. In addition, the implementation of the measure for releasing from reserve requirement on newly granted loans made to export and energy sector was extended in September in order to further support credit growth.

The most significant monetary developments during 2014 include the continuing process of deeuroization and acceleration of credit growth to the private sector. In 2014, the upward trend of the share of Denar deposits in total deposits in accordance with the higher yield of Denar instruments continued, indicating the credibility of the monetary authority. At the end of 2014, the credit growth reached 10%, which is above the expectations in our latest projections. Also, worth noting is the revival of corporate credit growth, which is especially important for the further acceleration of investments and the economy. In general, the banking system remained stable and high capitalized, while the loan portfolio quality remained almost unchanged compared with the previous year, with 11.3% share of non-performing loans in total loans of the non-financial sector. In 2014, we continued seeking to further strengthen and improve the banking supervision, and to implement international regulatory requirements in the field of banking.

Strengthening of institutional capacity in all areas of operation is of paramount importance for the National Bank. In this light, investment in human resources through continuous training and strengthening of personnel are especially significant. Also, promotion of research activity and support for financial education project have wider positive effects for the overall economy. Permanent activities for timely recognition and effective management of operational risks contribute to achieving better results and a greater preparedness to face challenges in the future.

Overall, 2014 again brought to the fore the risks arising from the changing external environment, reinforced by geopolitical risks, and financial markets volatility. In such conditions, structural changes in the domestic economy are noteworthy, aimed towards greater export diversification, stronger competitive position and thus, greater resilience of the economy to external shocks. Accordingly, structural reforms in all fields of the economy should continue being a top priority.

During 2014, the monetary policy remained flexible under the current circumstances and amid continuing exchange rate stability and low inflation pressures determined by factors on the supply side, additionally supported the credit growth, mainly through the non-monetary measures and changes in other instruments. In 2014, amid stability and solid sources of financing, the banking sector showed solid responsiveness concerning the strengthening of credit supply. However, banks remained interested in non-risk placements with the central bank, which amid solid liquidity, points to increased room for crediting the private sector. Changes in other monetary instruments were in favor of redistributing excess liquidity to the private sector. Retaining solid credit growth rates and dealing with challenges of the new regulatory requirements globally continue to be the main challenges in the banking sector in the forthcoming period. In the area of foreign reserves management, in the light of fast-moving developments in international financial markets, the challenge of maintaining flexibility during market shifts and strengthening the professional expertise regarding the appropriate choice of investment opportunities remain.

The dynamic external environment, the associated risks and their potential impact on the domestic economy, including the positioning of other macroeconomic policies, create the need for comprehensive analysis and conduct of prudent monetary policy in the period

ahead. The National Bank remains ready for regular monitoring and timely response and adaptation of policies for the purposes of achieving the ultimate objectives and maintaining macroeconomic stability.

Skopje, April 2015

*Governor and Chairman
of the NBRM Council
Dimitar Bogov*

I. Monetary Policy in 2014

1.1. Monetary policy objectives

Maintaining price stability is the main legally defined objective of the NBRM monetary policy. Another objective of the NBRM, which is subordinate to the main objective, is to contribute to a stable and competitive market-oriented financial system. The NBRM supports the general economic policy without jeopardizing the achievement of the primary objective and in accordance with the principle of an open market economy with free competition. From a strategic point of view, since September 1995, the NBRM has applied the strategy of maintaining stable nominal exchange rate of the Denar, first against the Deutsche mark (until 2001) and then against the Euro.

Considering the legal provisions, during 2014, the NBRM tailored its monetary policy to ensure continuity in achieving its monetary objectives. Monetary policy objectives were successfully achieved, as perceived through the maintenance of price stability and exchange rate stability, at the same time maintaining favorable environment for economic activity and financial stability. Overall, the foreign exchange market was stable, and the NBRM intervened to overcome the occasional mismatch between supply of and demand for foreign currency. In addition, the exchange rate remained stable and foreign reserves went up. From the standpoint of adequacy ratios, foreign reserves were held at the appropriate level throughout 2014, providing sufficient room for cushioning any adverse shocks. In 2014, the inflation rate was low and slightly negative. Changes in domestic inflation during the year were mainly caused by factors on the supply side, i.e. lower import prices of food and energy. At the end of the year, core inflation decreased, but remained positive, on average. The domestic real sector performances were favorable, whereby domestic demand continued to recover and the negative output gap gradually narrowed. Hence, it was assessed that this is a temporary adjustment of the general price level that will neither create risks of prolonged deflation nor any adverse effects of the lower prices on the domestic economic activity in the period ahead.

Chart 1
Output gap and inflation[‡]

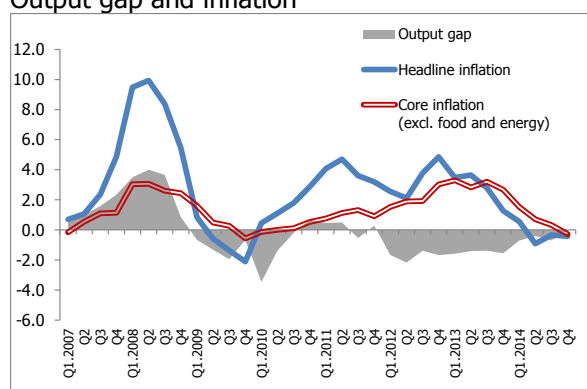
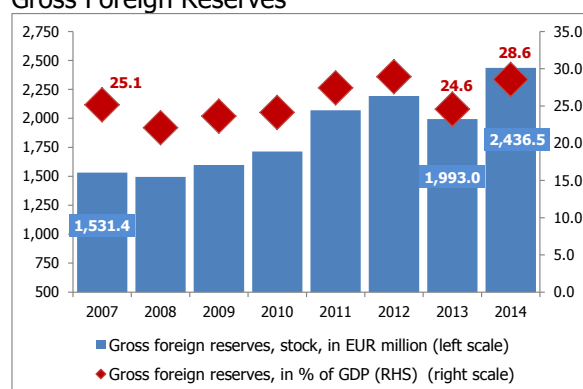
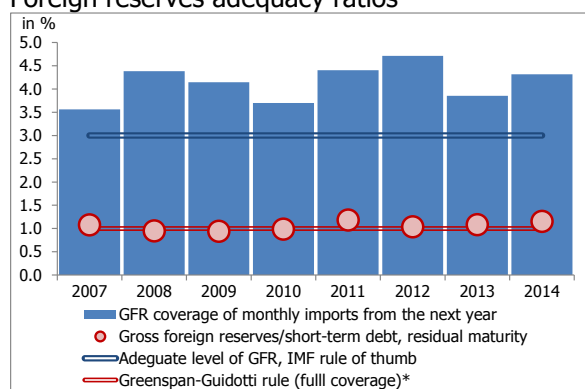


Chart 2
Gross Foreign Reserves



[‡]The productivity gap is an indicator of the cyclical position of the economy and it is calculated as the deviation of the realized from the potential level of GDP relative to the potential level of GDP ($GDP_a = \frac{GDP_a - GDP_p}{GDP_p}$). Average annual rate of inflation and core inflation for the quarter is presented.

Chart 3
Foreign reserves adequacy ratios



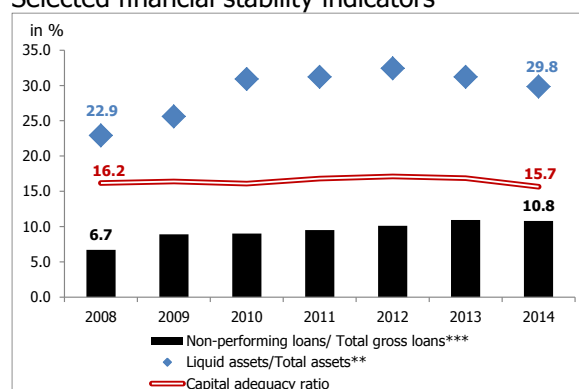
* According to the Greenspan-Guidotti rule, the country needs to keep full coverage of short-term debt (residual maturity) with foreign reserves.

** Liquid assets consist of highly-liquid assets and short-term deposits with foreign banks. Total assets do not include assets with domestic banks.

*** The indicator relates to loans to the financial and non-financial sector.

Source: the NBRM and the SSO.

Chart 4
Selected financial stability indicators



1.2. Monetary policy setup

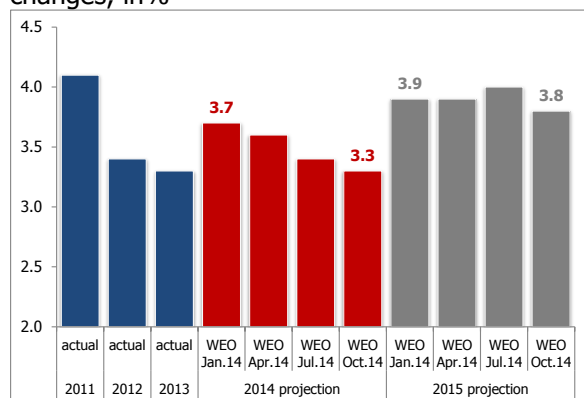
During 2014, the NBRM continued to conduct accommodative monetary policy, keeping the policy rate low at 3.25%. Furthermore, the NBRM made changes in other monetary instruments¹ and took certain macroprudential measures², which provide further support for the credit activity, contributing to the maintenance of a favorable environment for economic growth. Some of these measures were targeted, i.e. aimed at supporting corporate lending, as a segment of the credit market that registered slower recovery from the effects of the global crisis compared with the households. Namely, the presence of certain non-monetary factors (related to the banks' expectations, estimates for the risk of the credit demand, changes in the loan portfolio quality, strategies of the parent banking groups, etc.) impaired the monetary transmission in the years after the acute phase of the global crisis, thus preventing the full transmission effect of the monetary measures taken so far on lending. The performance during 2014 shown that these conditions have slowly faded away and the efficiency of monetary transmission has improved, and thus the cycle of monetary loosening present since late 2009 contributes to revival of the credit market and increased credit support. Thus, since the end of the previous year and particularly in 2014, the changes in the credit market were in line with an almost continuous acceleration of credit growth, especially to the corporate sector. The monetary policy remained being accommodative throughout the year, given the relatively favorable macroeconomic environment. Namely, in 2014, monetary policy environment was marked by further growth of domestic economic activity amid constant appropriate level of foreign reserves and absence of inflationary pressures. The risks to the domestic economy were also present during 2014 and were mainly related to the external environment.

¹ In 2014, the NBRM cut the interest rate on seven-day deposit facilities twice (February and October) and cut the interest rate on overnight deposit facilities once (in October). Consequently, interest rates on overnight deposit facilities and seven-day deposit facilities reduced to 0.5% and 1%, respectively. In September, the NBRM revised the mechanism of transferring the above-the-potential demand for CB bills to other instruments, i.e. seven-day deposit facility, and made a decision to extend the application of the non-standard measure for reducing the reserve requirement base of the commercial banks for the amount of newly granted loans to net exporters and domestic producers of electricity. For more details about these changes, see the section Monetary Instruments.

² In April, the NBRM passed a Decision amending the Decision on the methodology for determining capital adequacy, which besides the macroprudential aspect, also introduces amendments that are expected to contribute positively to the credit support of the commercial banks to the corporate sector.

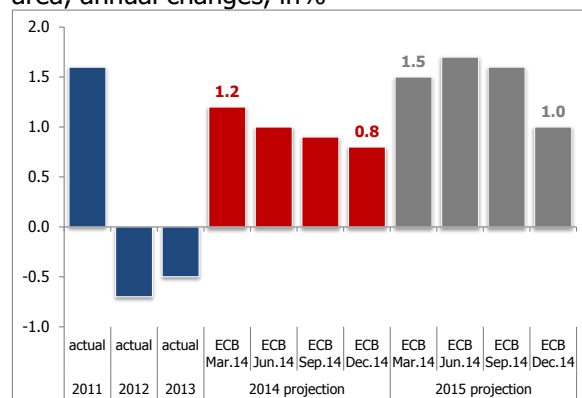
In the course of 2014, the NBRM continued its monthly reassessment of the monetary policy setup³. Monetary decisions made during the year draw on macroeconomic projections and analysis of the latest available data on key macroeconomic and financial indicators in the country and abroad, and their significance in the light of projections. The analyses took into account the assessed risks and the likelihood of their materialization, which helped making informative assessments about the impacts on the monetary policy.

Chart 5
Revisions of the global economic growth, annual changes, in%



Source: World Economic Outlook (WEO) of the IMF and the ECB

Chart 6
Revisions of the economic growth in the euro area, annual changes, in%



During 2014, the global environment remained vulnerable, accompanied by high uncertainty and downward risks in terms of expected economic growth. Initial forecasts for the global economic growth indicated its acceleration, based on the expectations for reduced pressure from fiscal consolidation and completion of the process of financial deleveraging of the private sector. Along with the looser monetary policy in most developed countries, these factors were expected to boost growth and create positive transmission effects on the developing countries, as well. However, the performance was weaker than projected and accordingly, the assessments of the global environment were downwardly revised. Unbalances present in several sectors, accumulated in the pre-crisis period and the period of global crisis, continued to restrict growth, showing that overcoming them will take longer than expected. The geopolitical turmoil, primarily associated with the Russian-Ukrainian conflict, posed additional risk. As a result, during the year, the global economic growth was revised downwards given the downward revision of growth in the euro area, as our major trading partner. The uncertain economic environment and geopolitical tensions caused uncertainty about the dynamics of prices of primary commodities, which were generally moved downward during the year. Besides the prices of food and energy, metal prices also registered volatile trends, which further increased uncertainty about changes in the terms of trade. In such circumstances, global environment continued posing risks to the domestic economy, thus creating uncertainty about the intensity of the economic recovery, the dynamics of inflation and foreign reserves. Consequently, during the 2014, the NBRM closely followed the global developments, seeking to timely identify potential risks and their effects on the domestic economy and the monetary policy.

Within the domestic environment, fiscal policy is one of the factors taken into account when making monetary decisions. Its setup during the year suffered some changes in terms of the initially announced trajectory. These changes are related to the size and the

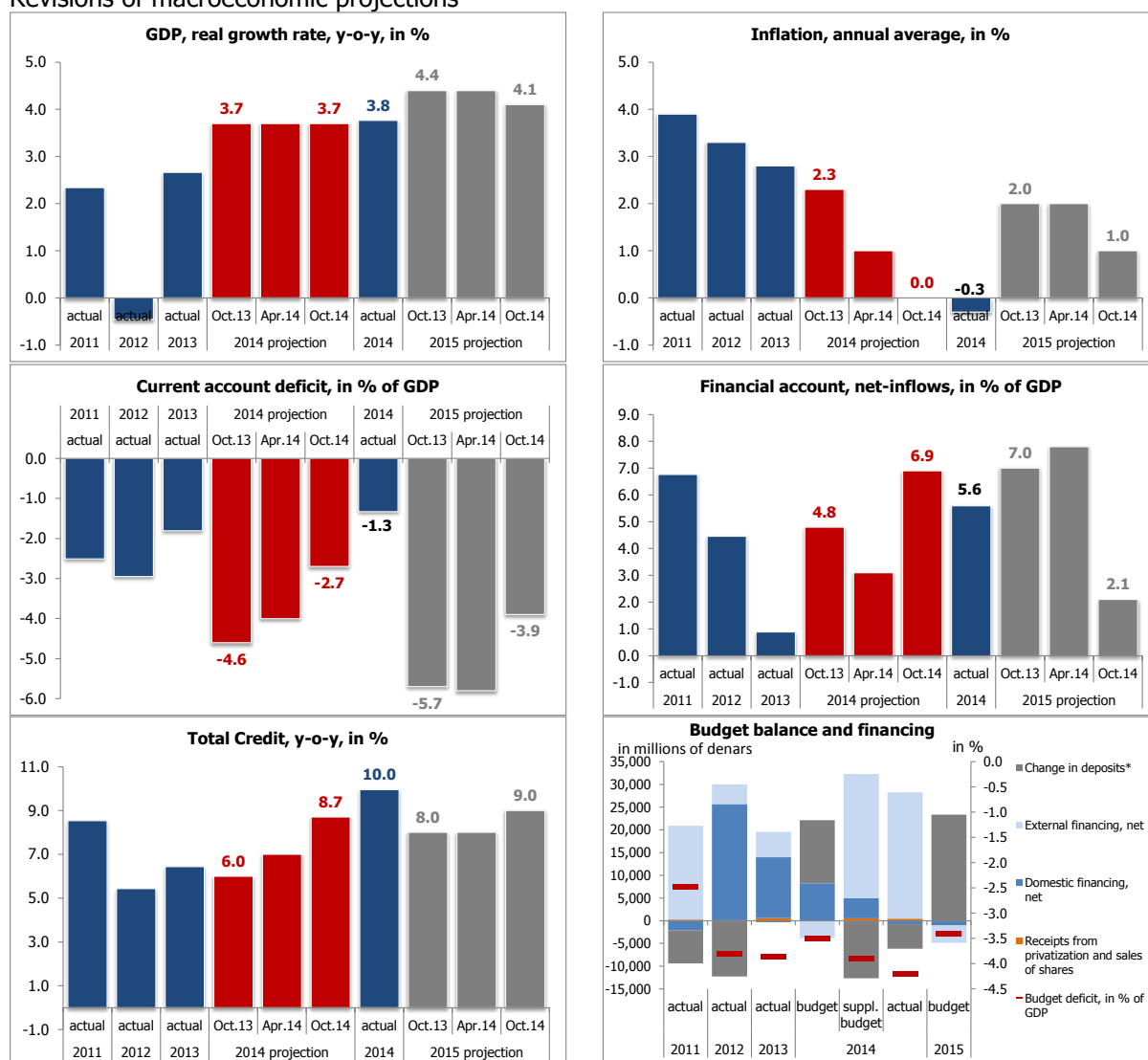
³ During 2014, the NBRM Operational Monetary Policy Committee held 12 meetings and adopted decisions on the policy rate. For press releases relating to the policy rate decisions made during the year visit: <http://www.nbrm.mk/?ItemID=CB52909D9FD4E14089BD66D493A5AF70>.

structure of financing the budget deficit. Thus, in July 2014, the government decided to borrow on the international capital market by issuing the third Eurobond⁴. That meant changes in the financing structure compared with the initial budget, which projected greater reliance of the domestic budget deficit on domestic sources of financing. The external government borrowing ensured additional support for the growth of foreign reserves, which was not forecast in the initial projections⁵. Furthermore, a revision to the 2014 budget was adopted in September that envisaged a cut of budget revenues and expenditures relative to the initial budget and a higher budget deficit of 3.7% of GDP (3.5% of GDP in the initial budget). The budget deficit for 2014 was higher, compared to the deficit projected with the budget revision, and equaled 4.2% of GDP. However, changes in the fiscal position had no significant effects on the general monetary policy environment, thus, in 2014, there was appropriate policy nexus as an important prerequisite for maintaining macroeconomic stability.

⁴ The Eurobond issued was worth Euro 500 million, with maturity of 7 years and rate of return of 4.25%, i.e. an interest rate of 3.975% per annum.

⁵ The issuance of the Eurobond was not planned with the initial budget for 2014, but with the budget revision adopted in September. Thus, the growth of foreign reserves was significantly higher than expected in the projections of October 2013 and April 2014.

Chart 7
Revisions of macroeconomic projections



Projections for all indicators are macroeconomic projections of the NBRM, except for the budget deficit and its financing, which was projected by the Ministry of Finance.
Source: NBRM, SSO and MF

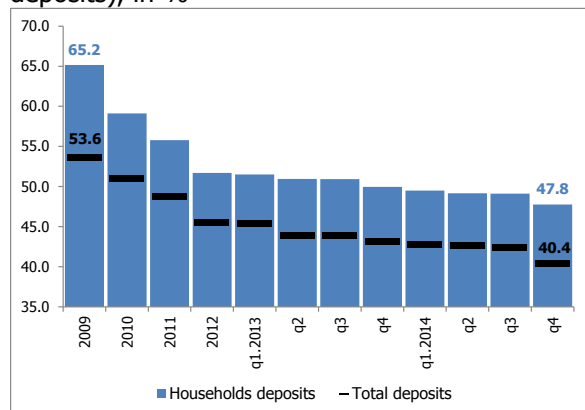
In such conditions, changing global environment was again the main source of uncertainty in the process of monetary decision-making during 2014. However, it is worth mentioning that the effects of global developments on the domestic economy remained limited. The key macroeconomic indicators during the year did not deviate much from the projected pace, with the movements of some indicators being better than expected. During the year, the foreign reserves were held at an appropriate level, whereby the year ended registering high growth of foreign reserves. Such developments in foreign reserves primarily result from the external government borrowing on the international capital market through the issuance of the third Eurobond in July. However, if one excludes the effect of government borrowing, the external sector developments were favorable and signaled no major external imbalances. Thus, during the year, the macroeconomic projections continuously indicated an adequate level of foreign reserves. Current account developments were more favorable than expected due to the better export performance, primarily of the new foreign facilities, the higher private transfers and to a lesser extent, the weaker import pressures than expected, partly due to lower food and energy prices. In such circumstances, when the current account deficit continued being at a relatively low level, the foreign

exchange market developments were relatively stable during the year, despite the worse than expected net capital inflows (excluding inflows from the Eurobond). Foreign exchange market developments in 2014 did not deviate much from the usual seasonal dynamics. Thus, in the first half of the year, the NBRM sold net amount of foreign currency, for the most part due to the performances in the second quarter⁶. In the second half of the year, net amount of foreign currency was purchased, mainly due to the higher seasonal inflows of private transfers in the third quarter. In such circumstances, in the transactions with market makers on the foreign exchange market, the NBRM sold insignificant net amount of foreign currency on an annual basis of Euro 5.5 million.

The foreign exchange market developments during 2014 confirmed the stable exchange rate expectations and stable inflation expectations. Inflation performance during the year showed weaker inflationary pressures than initially projected by the NBRM. The inflation projection during the year was revised downward mainly due to the lower pressures from import prices, in line with the downward trend of the prices of food and energy on the world markets. Throughout 2014, the average annual inflation equaled -0.3%, due to the two components, food prices and energy prices. Given that the inflation dynamics was depending on changes in volatile prices, it was assessed that this was a temporary adjustment in the general price level. During the year, the assumptions for the effect of the domestic demand on inflation did not suffer significant changes given the expectations for closing the negative output gap towards the end of the year, and as a result, gradual influence of the demand on prices. Core inflation (excluding food and energy), albeit tending to decrease during the year, remained positive on an annual basis and averaged 0.5%.

Chart 8

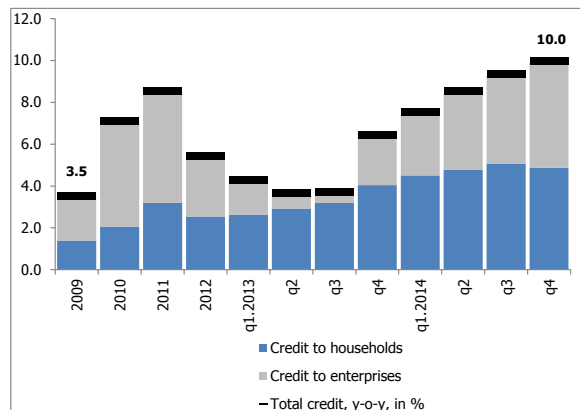
Level of euroization, share of foreign currency deposits in total deposits (including demand deposits), in %



Source: NBRM.

Chart 9

Contributions to the annual change in total credits (in percentage points)

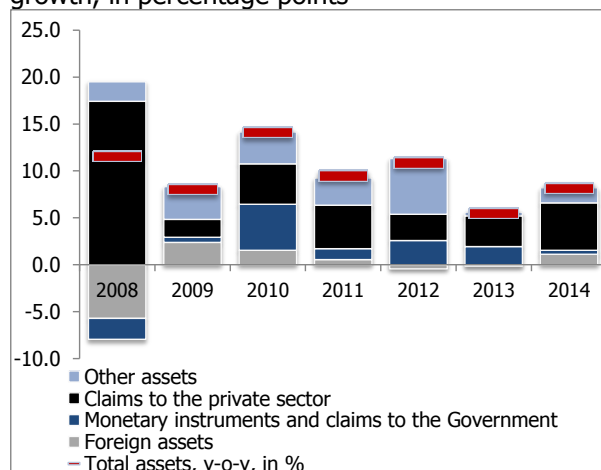


Amid stable expectations for exchange rates and inflation and more favorable risk perceptions of private agents, favorable changes were registered in the structure of the private sector savings. Namely, the growth of savings was again largely due to the growth of Denar deposits and long-term deposits. This particularly applies to the households, given that the level of euroization of household deposits continued to decline in December 2014 to 47.8% (50% in December 2013), while the share of long-term deposits in total deposits of

⁶ Every second quarter, a large domestic company usually repatriates dividend to a foreign investor. Since the dividend is paid from the company's deposits in the domestic banking sector (often in local currency), this operation usually requires a sale of foreign currency on the foreign exchange market by the NBRM. During the rest of 2014, other companies repatriated dividends, without having any significant effect on the foreign exchange market.

households was registering an increasing trend, reaching 32.3% in December (from 29.1% in December 2013)⁷.

Chart 10
Bank assets structure - contribution to the annual growth, in percentage points



Source: NBRM.

developments during the year were constantly favorable, and the banks' behavior showed improvement of their expectations and their assessments about the risk profile of credit demand. This was confirmed by the assessments in the NBRM lending surveys which showed easing of the terms of lending by the banks both to households and to the corporate sector (although less so), with simultaneous growth in demand for loans. Gradual normalization of credit flows was also indicated by the changes in the banks' risk perceptions, especially to the corporate sector, which since the second quarter of the year⁸ have been registering a significant improvement for the first time after the acute phase of the global crisis. During the year, lending grew at a stronger pace than expected, leading to an upward revision of the credit growth projection. The year ended with a higher credit growth than expected in the latest projection (October 2014), which was more voluminous than the growth achieved in the previous year by 1.6 times. Also, there were positive developments in the structure of credit growth, that is increased lending to the corporate sector.

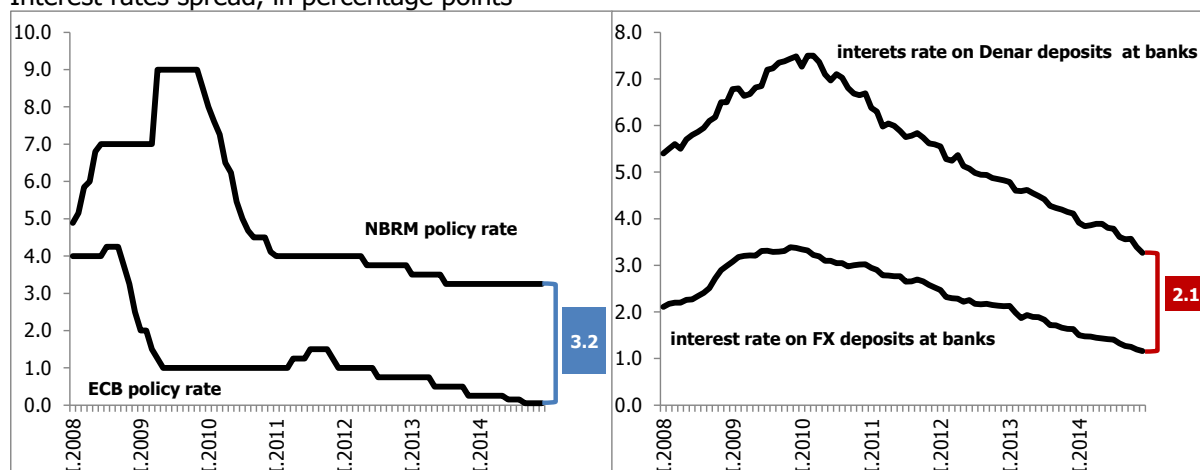
Performance in the external sector and inflation confirmed the existence of favorable environment in the domestic economy for solid economic growth, which creates no imbalances through inflationary pressures or pressures to reduce foreign reserves. Thus, in 2014, the economic growth accelerated as expected, fueled further by the maintenance of positive investment cycle and growth in export activity. Growth in 2014 was allocated among several economic sectors.

During 2014, the banks provided active support to the process of economic recovery through further strengthening of credit activity. The credit market

⁷ The analysis focuses on total household deposits including demand deposits.

⁸ Starting from the second quarter of 2014, the NBRM lending surveys show stabilization of the banks' risk perceptions in the area of lending to the corporate sector. All risk perception factors improved, whereby the factor that relates to expectations for economic activity in the last quarter tended to ease the terms of lending. Households' perceptions stabilized earlier, in late 2011. For more details about the NBRM Lending Survey also visit: <http://www.nbrm.mk/?ItemID=F7AC78DEE498764FBAF39049F726CE3C>.

Chart 11
Interest rates spread, in percentage points



NBRM policy rate - interest rate on CB bills
 ECB policy rate - interest rate on ECB's main refinancing operations
 Source: NBRM and ECB.

Amid de facto fixed nominal exchange rate of the Denar against the Euro, an important component in the monetary response is the change in interest rates in the euro area, as an anchor economy. During 2014, the ECB monetary policy was geared towards loosening of monetary conditions in the euro area. Thus, the ECB cut its policy rate twice (in June and in September) to 0.05%. Moreover, the interest rate on overnight loan facility and deposit facility was also cut to 0.3% and -0.2%, respectively. Besides the response that included interest rates, during the year, the ECB also took other non-standard measures⁹. The ECB monetary policy was loosened in conditions of low inflation, low economic growth, and further reduction of lending activity in the euro area. With this setup of the ECB's interest rate policy, in 2014, the interest rate spread between the policy rates of the NBRM and the ECB moderately expanded, and in December it reached 3.2 percentage points (3 percentage points in December 2013). On the domestic market, the banks' interest rate changes during the year were in line with a moderate narrowing of the interest rate spread between the interest rate on Denar deposits and the interest rate on foreign currency deposits. However, these changes did not have significant effects on the currency preference of depositors, who preferred to save in domestic currency in 2014.

⁹ For more details about the changes in the ECB's monetary policy see the section International economic environment.

II. International economic environment

Global economic growth in 2014 was 3.3%, with the pace of economic recovery remaining the same as in the previous year. The main feature of the global economy during this year was the "decoupling" of the process of economic recovery among developed economies. In fact, the US economy reported best performances, prompted by the growth of private consumption, amid further reduction in unemployment and conduct of accommodative monetary policy and neutral fiscal policy. Positive developments were observed in the UK, influenced by the improved property market conditions and increased lending activity. On the other hand, for the first time in two years, the euro area exited recession, but the recovery in 2014 was very slow compared to the US and UK, which partly reflects the still present implications of the debt crisis. Japan's economy entered a technical recession in the third quarter due to the weak private consumption, given the increased consumption tax. Both emerging economies and developing countries reported a lower annual growth, as a result of weaker export performance of oil-exporting countries, political uncertainty and structural problems, as well as the tightening of monetary and fiscal policy in some of them. The modest increase in economic activity was reflected in the world trade, which registered a slightly lower growth rate than last year and amounted to 3.1%.

Chart 12
Global economic growth (in %)

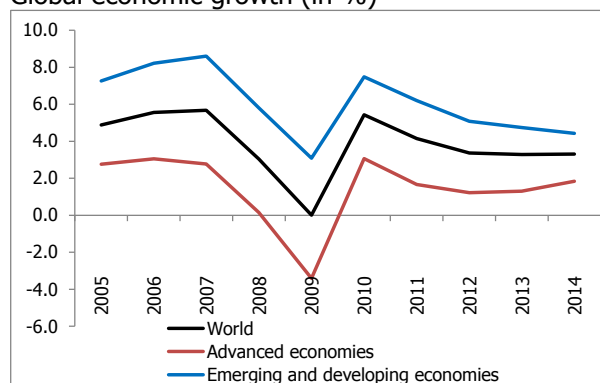


Chart 13
Global trade growth (in %)

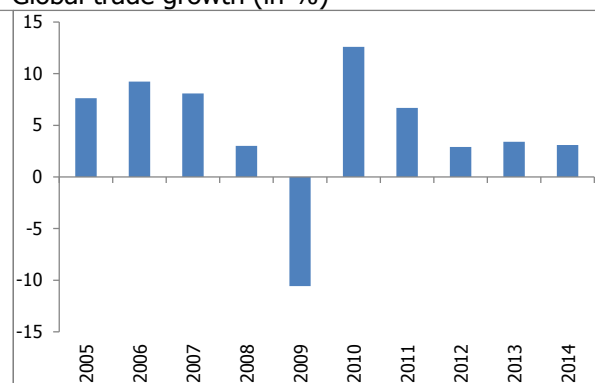
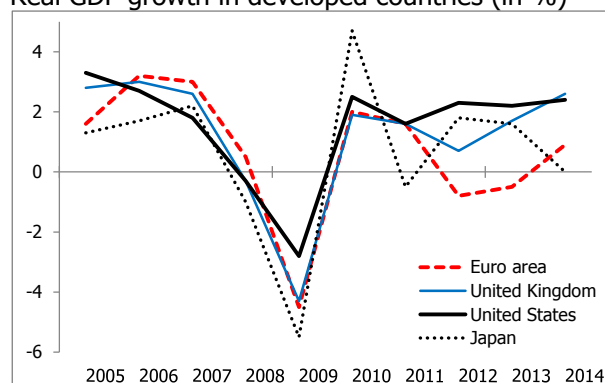


Chart 14
Real GDP growth in developed countries (in %)



Source: World Economic Outlook, 2014 and update January 2015, Eurostat.

Global inflation¹⁰ additionally slowed down and equaled 3.2%, compared to 3.6% last year. Such developments were observed amid continuing decline in oil prices, underutilization of production potential and stable inflation expectations. Moreover, on

¹⁰ Source: IMF (International Financial Statistics).

average, developed countries reported an inflation rate of 1.4%, while in the emerging economies and developing countries, the inflation equaled 5.3%.

Analyzing specific quantitative indicators that reflect the external environment of the Macedonian economy, the foreign effective demand¹¹ for Macedonian products in 2014 grew up by 0.8%, as opposed to the decline in the previous two years, given the moderate economic growth in some of the major trading partners. The greatest positive contribution to the annual performance was made by the economies of Germany and Bulgaria, opposite to the negative contribution of Serbia and Croatia.

Chart 15
Foreign effective demand (index, 2005=100)

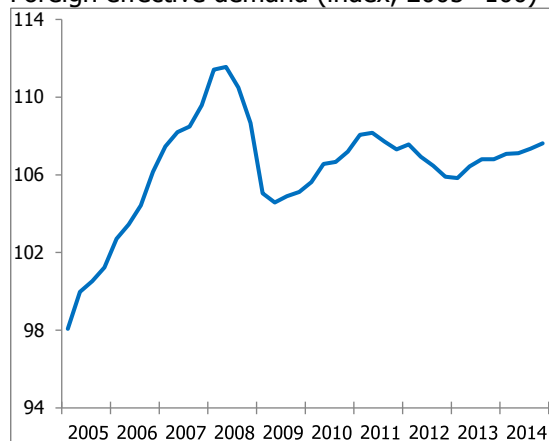
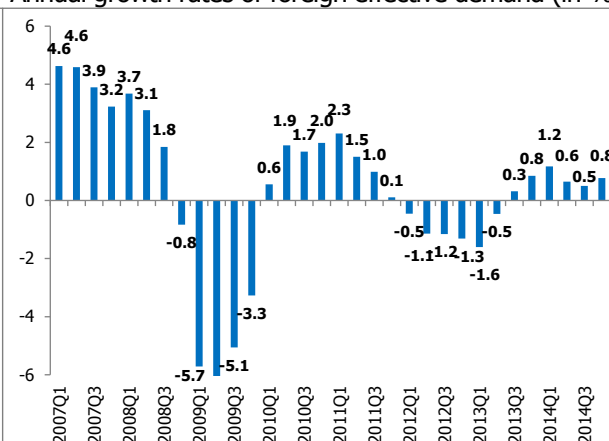


Chart 16
Annual growth rates of foreign effective demand (in %)



Source: NBRM calculations.

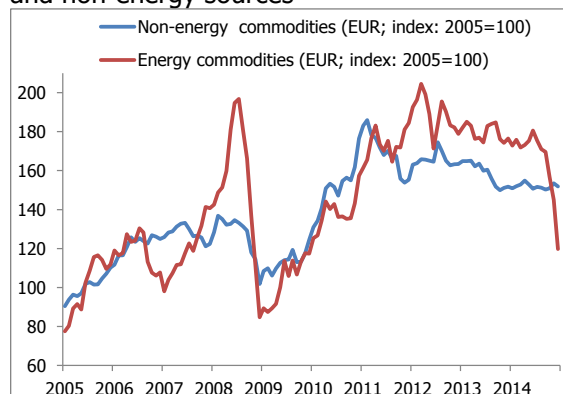
The primary commodity markets in 2014 continued registering downward trend in the prices of energy, metals and primary food commodities. The oil price registered the greatest downward correction, which after few years of high and stable level, nosedived during the second half of the year¹². Factors on the supply side play the leading role in such developments, which continuously increases. In part, these changes are of a structural nature, which mainly refers to the increase in unconventional production of shale oil by the United States and Canada. OPEC countries also increased the supply, and in November 2014, in order to retain their market share, decided not to respond to the price decline and to continue with high volume production. Also, the expected upward risks on oil prices that were associated with the geopolitical tensions in several regions of the world, did not materialize in 2014. On the other hand, weak economic activity of some developed countries, and increased use of alternative kinds of fuel made downward pressure on oil demand. Hence, on average, the price of crude oil "Brent" equaled Euro 74.2 per barrel, a decline of 9.5% on an annual basis. The annual decline in metal prices continued in 2014 at enhanced pace and equaled 10.3%, which was mainly due to the reduction in prices of copper and lead given the low industrial production in China and high inventories of metals globally. In contrast, nickel prices significantly rose in this period, mainly due to the ban on exports imposed by Indonesia earlier this year, which raised concerns of likelihood of shortages of this metal in the global market, when the demand experienced strong growth. In 2014, the food price index fell by 4.3% compared with the previous year, which resulted from the decline in prices for wheat products, cooking oils and other food products. Decline

¹¹ Foreign effective demand is calculated as the sum of the weighted indices of the gross domestic product of the most important trading partners of the Republic of Macedonia. The index calculation includes: Germany, Greece, Italy, the Netherlands, Belgium, Spain, Serbia, Croatia, Slovenia and Bulgaria. The weights are calculated on the basis of the share of exports to these countries in the total export.

¹² Recent fall in oil prices is considered the third steepest fall in the last thirty years. (Source: World Bank, Commodity Markets Outlook, January 2015)

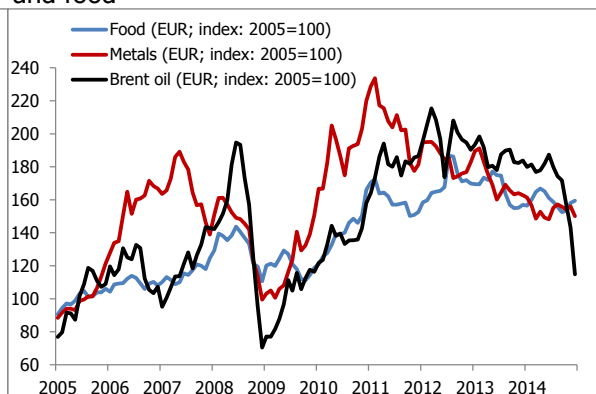
in prices of primary products denominated in euros was partially mitigated by the appreciation of the US Dollar against the Euro (0.9%), reflecting the expectations of divergent movement of the monetary policies of the United States and the euro area.

Chart 17
Monthly movement of prices of primary energy and non-energy sources



Source: IMF's database on primary commodity prices.

Chart 18
Monthly movement of prices of crude oil, metals and food



Changes in the setup of the monetary policy of the central banks of major developed countries in 2014 were diverging. Thus, the ECB and the Bank of Japan implemented measures for further monetary easing in order to support the process of economic recovery and reversal of inflation to levels consistent with the target. Analyzing interest rate policy, the ECB cut the interest rate on the main refinancing operations twice (June and September), when it hits a record low of 0.05%. Accordingly, the interest rate on overnight loan facility was downwardly adjusted (at a level of 0.30%), and a negative interest rate on deposit facility (-0.20%) was introduced. In terms of unconventional measures, in September and December, two of the announced eight targeted long-term refinancing operations (TLTRO¹³), took place, which enables long-term borrowing of banks in the euro area, in order to improve the monetary transmission and increase lending. Moreover, two programs for direct purchase of securities issued by the private sector were launched in the last quarter of 2014, which comprise of covered bond purchase program issued by financial institutions in the euro area denominated in euro (CBPP3¹⁴) and asset-backed securities purchase program (ABSPP¹⁵). Finally, in January 2015, the ECB announced a new expanded asset purchase program in the euro area (EAPP¹⁶), which includes the purchase of securities issued by public sector, respectively by the member states of the euro area and certain European institutions. This measure of quantitative easing tends to increase the ECB's balance sheet significantly, thus providing a strong economic stimulus by stabilizing inflation expectations, maintaining the real long-term interest rates low and improving corporate financing. In October, the Bank of Japan decided to expand the program for quantitative and qualitative easing, by increasing the regular purchase of Japanese government bonds, causing an expansion of its balance sheet. On the other hand, in line with the improved performance of the US economy, the Fed responded through the non-standard measures aimed at gradual reduction of the monetary stimulus. The monthly purchase of mortgage bonds and long-term government bonds continued to gradually reduce during the year until October, when it was decided to be completely terminated, and thus to end the third phase of the program of quantitative easing. The practice for reinvestment of matured debt in new assets continued in order to maintain favorable conditions of financing through solid Fed's

¹³ Targeted Longer-Term Refinancing Operations.

¹⁴ Third Covered Bond Purchase Programme.

¹⁵ Asset-Backed Securities Purchase Programme

¹⁶ Expanded Asset Purchase Programme.

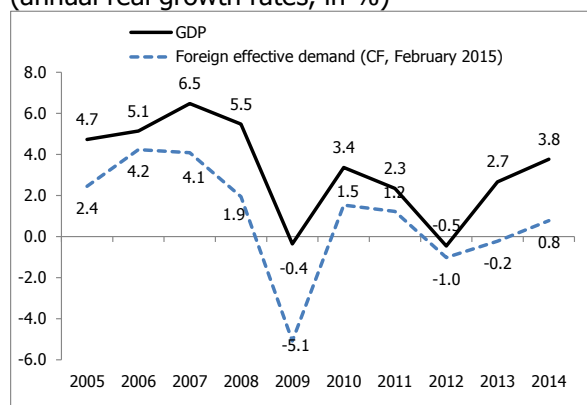
balance sheet. The Fed's policy rate remained unchanged, and therefore, it was estimated that the existing level would remain adequate over a longer period. The start of the increase of interest rates and the gradual normalization of monetary policy will depend on the further improvement of the economic outlook of the United States. In the previous year, the Bank of England did not make significant changes in monetary policy.

III. Macroeconomic developments in the Republic of Macedonia

3.1. GDP and inflation

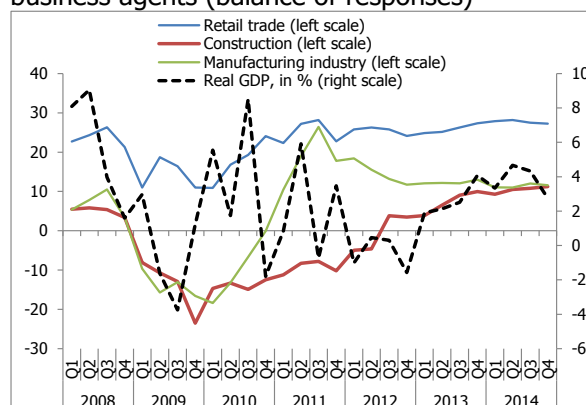
The growth of the domestic economy continued at a faster pace in 2014. According to the estimated data, the gross domestic product was higher by 3.8% in 2014. The acceleration of economic growth took place amid somewhat more stimulating external environment compared to the previous year. However, during this year, the growth of domestic economy was largely attributable to the operation of new export-oriented facilities, whose activity provided a significant increase in production and exports. In addition, the public infrastructural investments provided further positive stimulus for the growth. The improvement of external environment and the positive transmission effects of the activity of the new facilities improved the business environment in the domestic economy. This conclusion is confirmed in part by the increasing dispersion of growth in 2014, showing that many economic sectors are sources of increase in the value added in the economy.

Chart 19
GDP and foreign effective demand
(annual real growth rates, in %)



Source: State Statistical Office and Consensus Forecast, February 2015. GDP data for 2013 are preliminary, and data for 2014 are estimated.

Chart 20
Assessments for the current economic activity of business agents (balance of responses)*



Source: State Statistical Office.

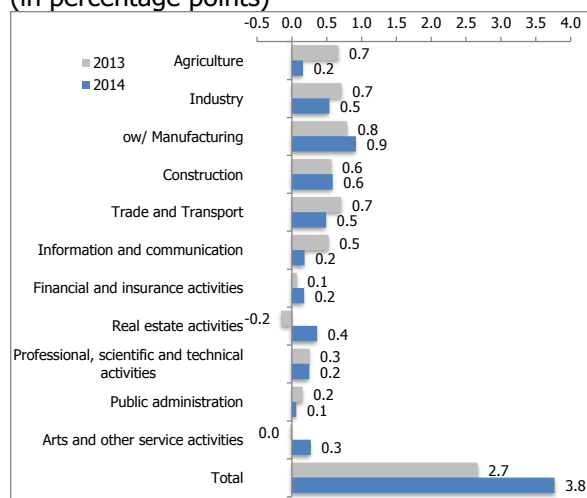
*The balance represents the difference between weighted positive and negative responses, expressed as a percentage. The balance shows the movement of the observed economic indicator rather than its real value.

In 2014, all sectors in the economy made a positive contribution to the total economic growth. The largest individual contribution was made by the manufacturing industry given the increased utilization of domestic and foreign export-oriented facilities. Considering the structure, the favorable changes in the manufacturing industry mostly reflect the increased production of motor vehicles, machinery and appliances, and electrical equipment. Also, a significant contribution to the growth in 2014 was made by the construction sector as a result of the more intensive construction activity in the field of housing construction and hydro construction. The growth of industrial output during the year had positive transmission effects on the trade, transport and communications, which collectively constitute a component with the third largest positive contribution to the economic growth. Most of the trade growth¹⁷ is due to the higher turnover in wholesale trade, while the growth of activity in the transport sector¹⁸ is associated with higher transport of passengers and goods.

¹⁷ The analysis of the trends in trade is based on data on the trade turnover.

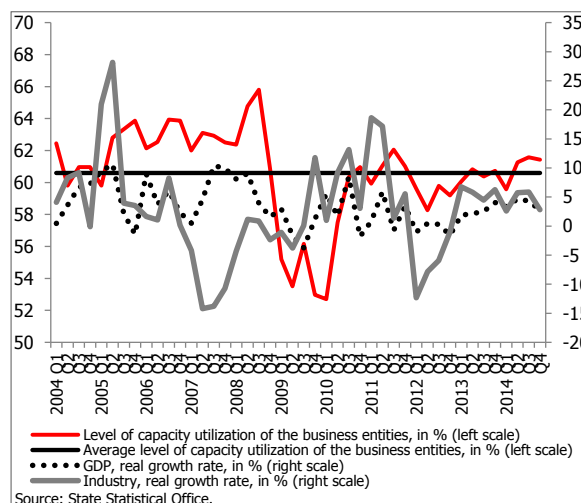
¹⁸ The analysis of the trends in transport is based on data on transported passengers and goods.

Chart 21
Contribution to the annual GDP growth
(in percentage points)



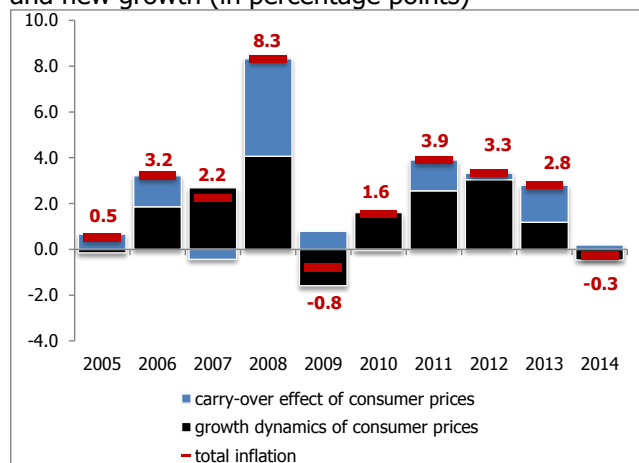
Source: State Statistical Office and NBRM calculations.
GDP data for 2013 are preliminary and data for 2014 are estimated.

Chart 22
GDP, industry and capacity utilization



Observing demand, economic growth in 2014 is explained by the concurrent growth of domestic demand and export activity. The continuation of structural changes in the economy related to the operation of the new production facilities is the main factor for increased exports in 2014, making the export a component with the highest individual positive contribution to growth. In 2014, the economic growth was supported by the increased domestic demand, with the most significant being the growth of gross investment, partly driven by the higher government investments. Also, the favorable labor market developments and growth in real wages during the year provided further support for the growth of household consumption. Public demand is the only component of the domestic demand that went down. Increased domestic demand and export activity led to higher imports, and hence, to negative contribution of the net export demand to the growth.

Chart 23
Average annual inflation (in %), second-round effect and new growth (in percentage points)



Source: SSO and NBRM calculations.

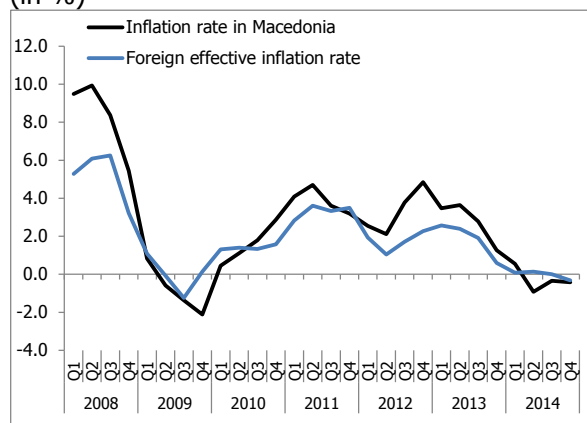
In 2014, the average annual change in consumer prices was negative and amounted to 0.3%, as opposed to the positive growth rate of 2.8% in 2013. Entering the zone of negative changes is mostly explained by shifts in the food component, which plunged (an increase during 2013). Core inflation acted in the same direction, and in 2014 continued to grow at a significantly slower pace compared to the previous year. Additional negative contribution was made by the energy component whose prices additionally decreased during 2014, amid further decline in domestic prices of oil derivatives. Analyzing the

dynamics, prices started to decline at the beginning of the year, thus, in the first half of the year, the average annual inflation rate was negative and amounted to 0.2%. This trend

continued in the second half of the year, when prices additionally declined (negative average annual inflation rate of 0.4%).

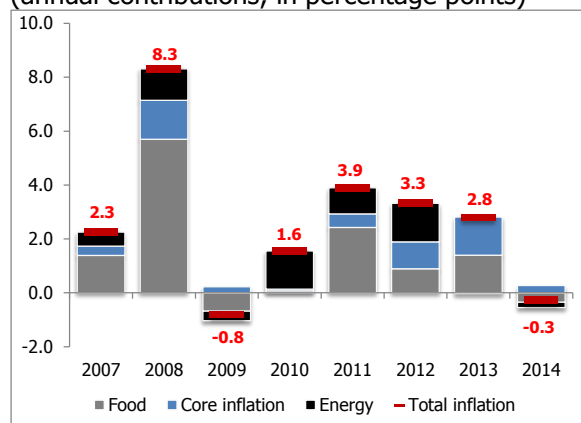
The trajectory of domestic prices in 2014 was mostly influenced by the movement of prices of primary commodities on the world market, which were generally decreasing in the last year. An additional factor is the price of imported private consumption goods, with a significant slowdown in the rise of foreign effective prices from 1.9% in 2013 to 0% in 2014¹⁹. Such shifts in the global environment reduced the domestic prices of food and energy. Thus, domestic food prices declined by 0.9% in 2014 (contribution of -0.3 percentage points to the overall price change). Besides the lower import prices, the high base effect of 2013 made additional contribution, amid significant increase in the prices of unprocessed fruits and vegetables due to the severe weather conditions in the eastern part of Macedonia. When it comes to the energy component, the prices of these products decreased by 1.4% in 2014 (contribution of -0.2 percentage points to total inflation), due to the lower domestic prices of oil derivatives²⁰ reflecting the trajectory of crude oil price, whose decline especially accelerated in the second half of the year. On the other hand, in 2014, the long-term price component remained positive and amounted to 0.5% (contribution of 0.3 percentage points) that, in the absence of demand pressures, mainly reflects the temporary one-off factors (growth in prices of pharmaceutical products in January and June, tobacco²¹ and alcoholic beverages). However, analyzing the dynamics, the growth of this price component decelerated during the year, and entered the zone of negative changes in the last quarter, in part reflecting the spillover effects of the downward movement in food and energy prices.

Chart 24
Domestic inflation and foreign effective inflation, annual growth rates (in %)



Source: State Statistical Office, Eurostat and NBRM calculations.

Chart 25
Volatile (food and energy) and long-term component of inflation (annual contributions, in percentage points)



¹⁹ The calculation of foreign effective inflation derives from the weighted sum of consumer price indices of countries that are major partners of the Republic of Macedonia in the field of import of consumer goods. The weight structure is based on the normalized shares of nominal imports from each country in the total nominal imports in the period 2010-2012. The calculation of this indicator includes: Bulgaria, Germany, Greece, France, Italy, Austria, Slovenia, Croatia and Serbia.

²⁰ The downward adjustment of domestic prices of oil derivatives fully offset the upward adjustment of electricity price (an increase of the electricity price by 3.5% since July 2014).

²¹ On 1 July 2014, the excise duty on cigarettes increased (Denar 0.15 per cigarette). According to the Law on Excise, this is part of the ten-year calendar for the gradual increase of excise duties, with planned increase in the excise duty each year, while starting from 1 July 2016 (until 1 July 2023), excise duty will increase by Denar 0.20 each year.

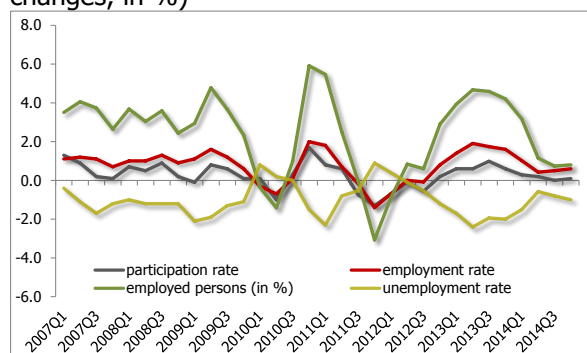
3.2. Labor market

In 2014, most of the labor market indicators point to retention of positive trends. These trends correspond to the favorable real sector developments. In fact, for several years in a row, the improvement of some of the key labor market indicators is associated with the operation of the new facilities in the technological industrial development zones, as well as with the influence of the fiscal policy through active employment measures²², publicly financed infrastructure projects as well as agricultural subsidy policies.

The number of employees increased by 1.7% in 2014, which is a slower growth compared to last year. Analyzing by sectors, employment growth was mostly associated with the services, particularly transport, storage and communications sector which is complementary to industry and construction, whose activity and further engagement of workforce is encouraged by the positive developments in these segments of the economy. At the same time, solid individual contribution to the growth was made by the increase in the number of employees in the public administration and defense, compulsory social insurance. The growth of employment in the industry continued in 2014, mainly driven by the manufacturing industry and construction. Also, after the exceptionally high performance last year, employment in agriculture slightly moved upward, making its contribution to total employment neutral.

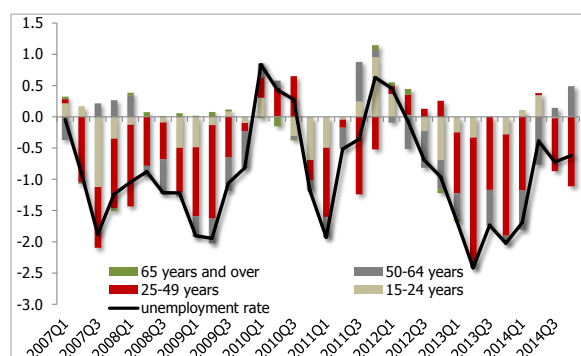
The higher demand increased the labor supply. Thus, in 2014, the number of total active population went up by 0.3%, which given the mild decline in the inactive population, brought about slight upward movement in the activity rate to 57.3%. The faster growth of labor demand compared to the growth of labor supply decreased the unemployment rate. Consequently, in 2014, the unemployment rate averaged 28%, while the employment rate increased and averaged 41.2%. Analyzing age groups, a major part of the reduction of the overall unemployment rate is attributed to the lower unemployment among population aged 25 to 49 years, an age group that constitutes over 60% of the total number of unemployed. Considering that over 80% of unemployed people in this age group are long-term unemployed, these developments point to a potential reduction in long-term unemployment.

Chart 26
Selected labor market indicators (annual changes, in %)



Source: State Statistical Office and NBRM calculations.

Chart 27
Unemployment rate (in %) by age group

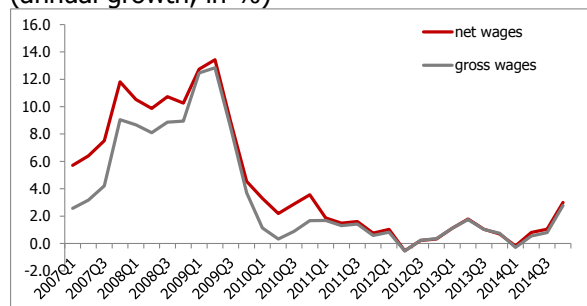


In 2014, the average wages paid increased in nominal terms, at almost unchanged pace compared to last year. Also, for the first time after three years of decline, wages

²² Also, in 2014, the Government of the Republic of Macedonia, through the Ministry of Labor and Social Affairs and the Employment Agency, continued implementing active measures and programs designed to increase employment, such as self-employment programs, financial support to micro and small enterprises and craftsmen for opening new jobs, subsidized employment programs, work-readiness programs, community service programs, etc.

increased in real terms, as well. Thus, the nominal net and gross wages²³ registered an annual growth of 1.2% and 1%, respectively, with an upward correction being observed in all sectors. Given the downward adjustment in the general level of consumer prices of 0.3%, net and gross wages registered a real growth of 1.5% and 1.3%, respectively. In 2014, the competitiveness indicators also improved²⁴. Thus, labor productivity increased by 2% given the higher growth rate of economic activity compared to that of the employment. Moreover, the unit labor costs decreased by 1% given the faster growth of productivity compared to that of the gross wages.

Chart 28
Average gross and net wages
(annual growth, in %)



Source: State Statistical Office and NBRM calculations.

Chart 29
Average net wages, by sector
(annual growth, in %)

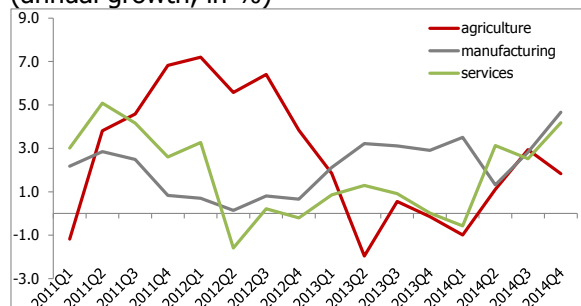
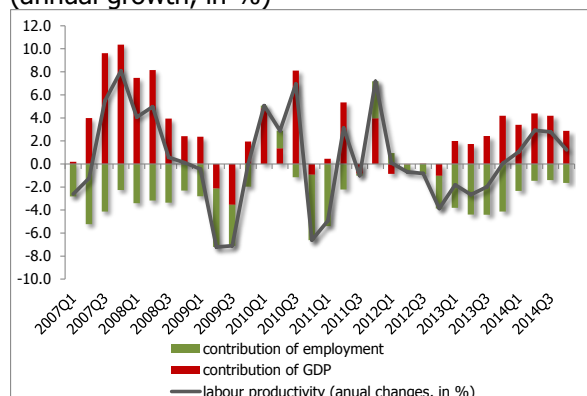
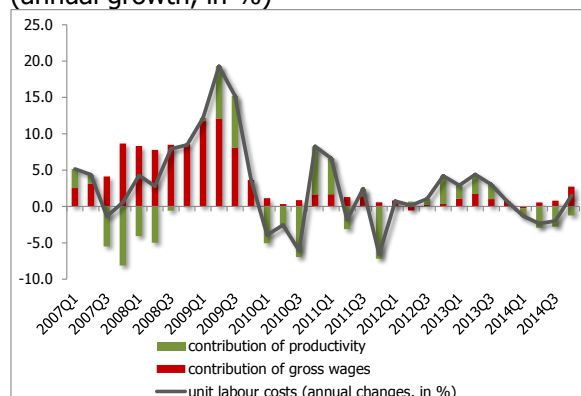


Chart 30
Labor productivity
(annual growth, in %)



Source: State Statistical Office and NBRM calculations.

Chart 31
Unit labor costs
(annual growth, in %)



3.3. Public finances

In 2014, the budget deficit continued to rise and reached 4.2% of GDP, which exceeds both the initial budget plan and the budget revision passed during the year. Namely, during this year, a significant part of the deficit was again realized at the beginning of the year²⁵, with a high percentage of incurred budgetary costs associated with the payment of agricultural subsidies, the increase in funds paid to vulnerable groups²⁶, and the intensification of infrastructural activities. Given that the dynamics of realization of the expenditure side of the budget in the following period was faster, compared to the pace of

²³ Total gross wages paid include: net wages paid for the reporting month, paid income tax and paid contributions (pension and disability insurance, health insurance, employment, occupational disease and water supply). The data relate to wages paid.

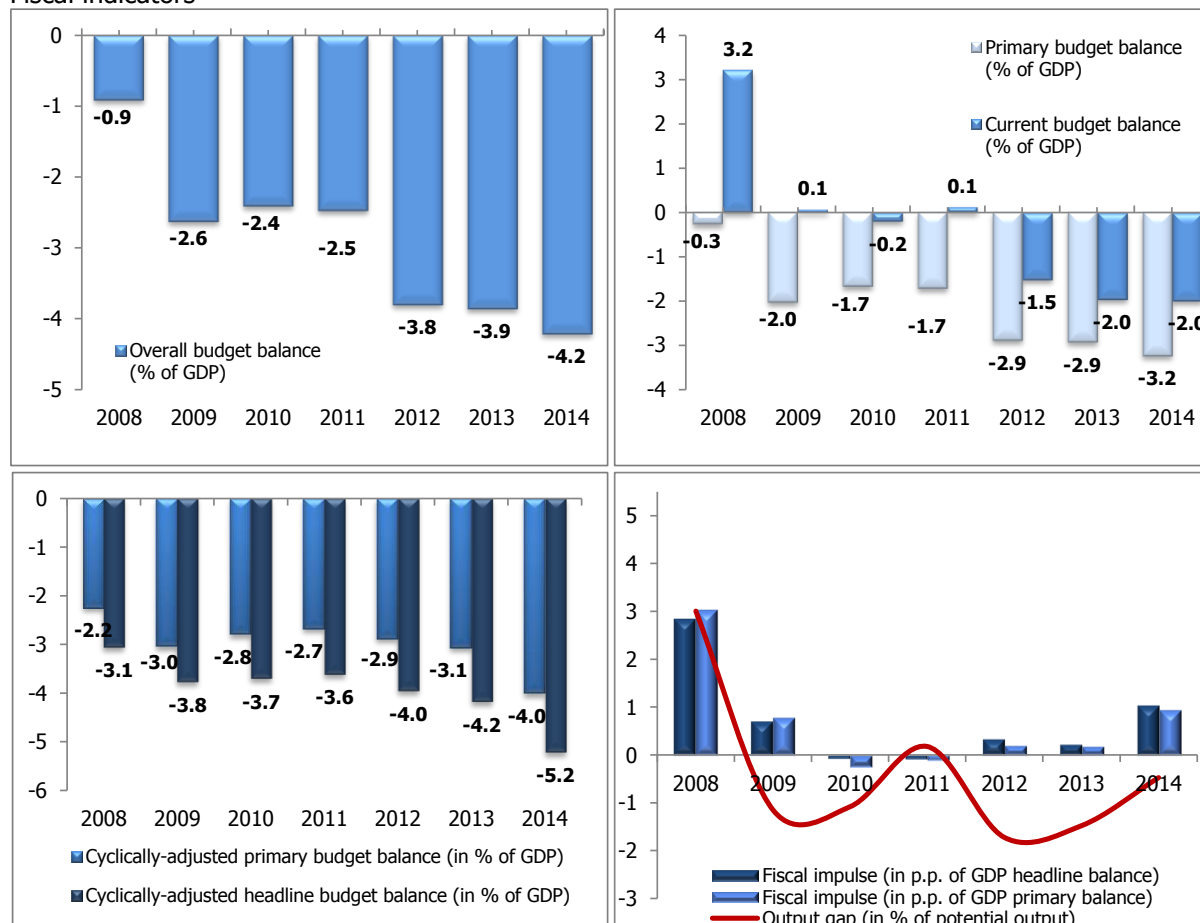
²⁴ Productivity and unit labor costs for the overall economy are calculated on the basis of GDP data, for the total number of employees, according to the Labor Survey of the State Statistical Office and the data on average gross wages.

²⁵ Around 3/5 of the planned deficit of the budget of the Republic of Macedonia were realized in the first quarter of 2014.

²⁶ This includes the increase of pensions and social welfare by 5%, paid in February i.e. March 2014.

planned revenues, and given the nearly full realization of the planned annual deficit in the first eight months of the year²⁷, there was a need to adopt Budget Revision for 2014²⁸. The budget revision passed in September made downward correction of both revenues and expenditures (by 1.7% and 0.8%, respectively). Because of the unbalanced adjustment of budget parameters, the deficit projected in the budget revision increased to 3.7% of GDP, compared to 3.5% as projected in the initial budget.

Chart 32
Fiscal indicators



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

Along with the deterioration of the overall budget deficit, the primary budget deficit also worsened²⁹ and increased by 0.3 percentage points compared to 2013 and reached 3.2% of GDP. In contrast, the current budget deficit³⁰ was kept at 2% (as in the previous year) amid similar growth of current revenues and expenditures as a percentage of GDP. The growing budget deficit contributed to further growth of the central government debt and total public debt, whose share in GDP in 2014 reached 38% and 45.9%, respectively. Part of the debt growth was due to the government borrowing in the international financial

²⁷ Since the beginning of the year until August, about 93% of the planned budget deficit for 2014 were realized.

²⁸ "Official Gazette of the Republic of Macedonia" no. 133/2014 of 9 September 2014.

²⁹ Primary budget balance is the difference between total budget revenues and total budget expenses, less the repayment of current loan (interest) liabilities. This fiscal indicator is considered more appropriate for the analysis of the current policy course, due to the fact that it does not include fiscal costs related to past conduct of fiscal policy relative to the public debt.

³⁰ Current budget balance is the difference between current revenues (tax revenues and non-tax revenues) and current budget expenses (for wages and fees, goods and services, transfers and interests). Calculations of the current budget balance in historical framework, exclude the dividend of Telecom from the non-tax revenues and include it in the capital revenues (according to the methodological changes in 2011).

market, in order to make use of the favorable conditions for securing funds for pre-financing of liabilities falling due in 2015.

In 2014, changes in discretionary component of fiscal policy were again positive, stimulating the aggregate demand. Thus, the total structural deficit³¹ increased by 1 percentage point compared with the previous year and reached 5.2% of GDP, while simultaneously worsening the structural primary deficit (from 3.1% in 2013 to 4% in 2014). Thus, using these simple indicators one can conclude that the fiscal impulse³² in 2014 was again positive and stronger than the previous year. Having the output gap gradually narrowing, but remaining in a negative zone, one can conclude that fiscal policy in 2014 was aimed at supporting the domestic economy within the current economic cycle.

Chart 33
Budget balance financing structure (in millions of denars)

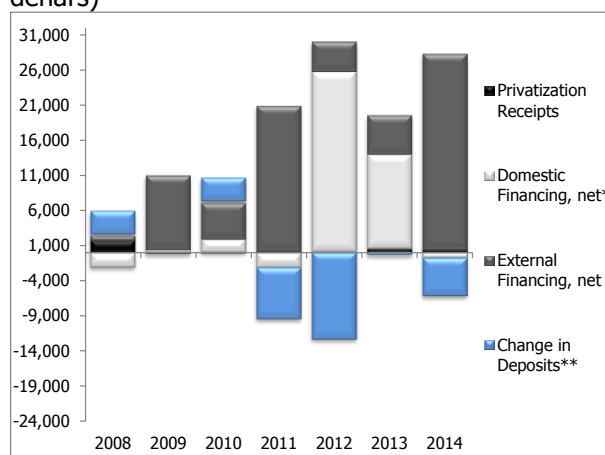
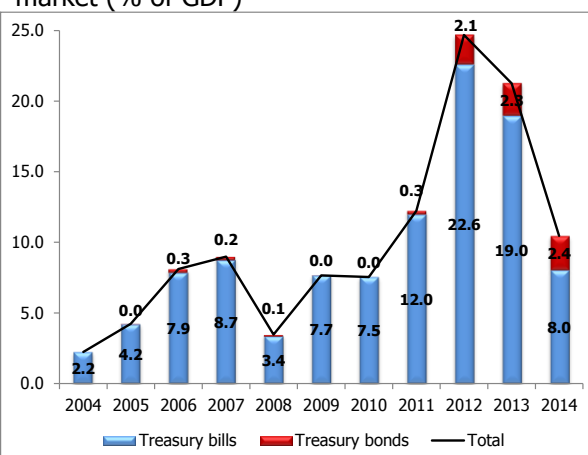


Chart 34
Trade in government securities on primary market (% of GDP)



* Difference between total inflows of continued and structural securities (treasury bills and bonds) and total outflows based on domestic debt repayments.

** The negative change in government deposits implies that they have been deposited on the account with the NBRM.

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

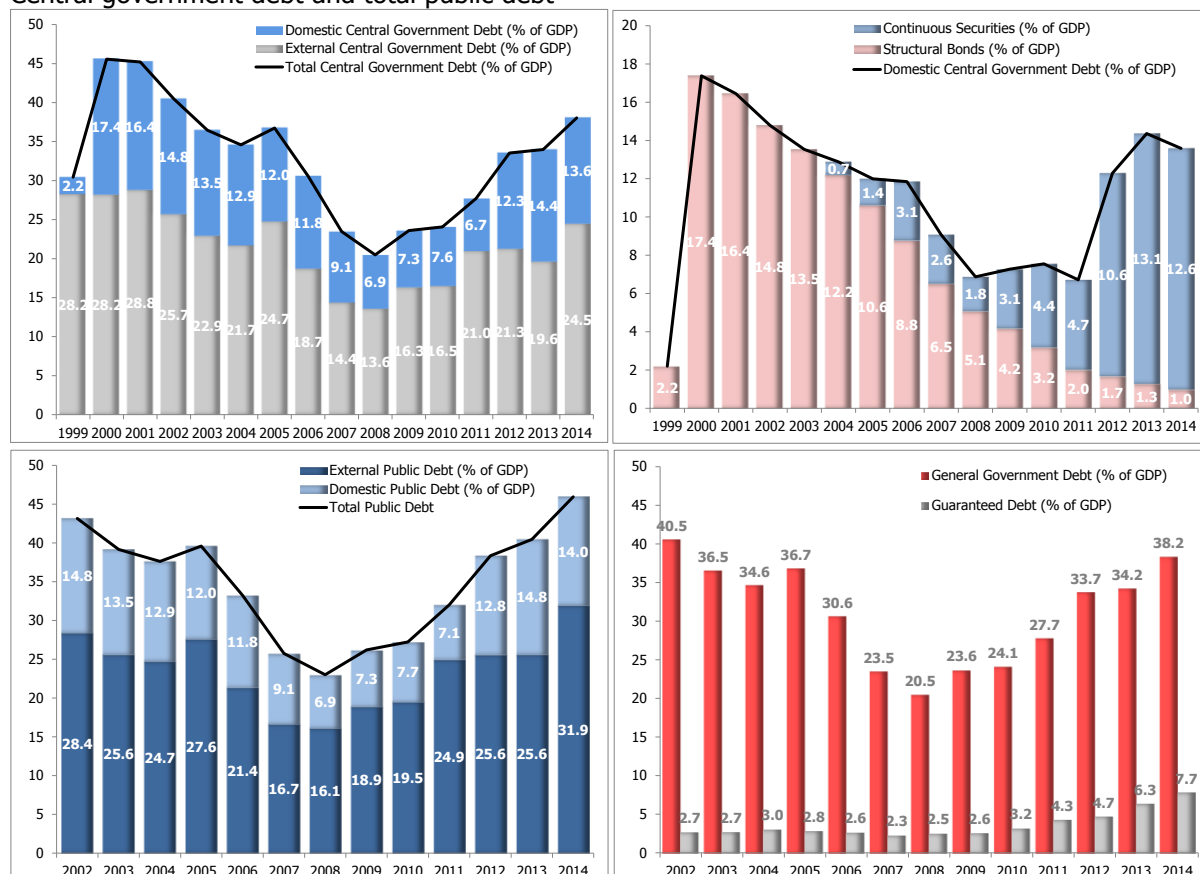
In 2014, budget deficit was solely financed through net foreign borrowings, despite the assumptions in the Budget Revision that projected a part of the budget gap to be covered by domestic sources. However, if we analyze the subperiods of the year, we get a different picture regarding the structure of sources of financing. Thus, in the first half of 2014, government deposits with the NBRM were the main source of financing followed by the funds mobilized in the domestic financial market, unlike the latter part of the year, when the foreign borrowings were the only source of net inflows of funds, given the negative net domestic borrowing and the significant accumulation of deposits. This structural difference resulted from the high inflows from the external borrowings generated in this period. The largest borrowing was made in July, when in order to cover the financing needs for the current and the following year the third Eurobond was issued on the international capital market, which generated inflows of Euro 491 million. Large repayments of the existing domestic debt were made on an annual basis, even though, in some periods, the government borrowed on the domestic market. Consequently, the overall performance of

³¹ The total structural deficit is obtained when the cyclical budget component is removed from the actual budget deficit. It is calculated as the difference between the actual budget revenues adjusted for the effect of the deviation of the potential from the actual GDP with elasticity of 1 and actual budget expenditures adjusted for the effect of the deviation of the potential from the actual GDP with elasticity of 0. The structural primary deficit is equal to the total structural deficit reduced by the effect of the interest expenses.

³² The fiscal impulse is defined as the difference between the cyclically adjusted balance in the previous and in the current year.

the primary government securities market halved in 2014 and amounted to 10.5% of GDP, compared to 21.3% in 2013, which was solely due to the reduced issuance of treasury bills. On the other hand, the trend of increased borrowing through government bonds continued in 2014³³, which is consistent with the commitment to extend the maturity of the government securities portfolio.

Chart 35
Central government debt and total public debt



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

The central government debt³⁴ totaled Euro 3,246.4 million in 2014, which is an increase of 17.8% compared to the previous year. Central government debt to GDP ratio reached 38% (34% in 2013). The debt increase is entirely due to the significant increase in external debt (contribution of 18 percentage points), which resulted from the debt based on the issuance of the new Eurobond, unlike the domestic debt, which reported a marginal decline. On the other hand, the total public debt³⁵ increased by 19.5% in 2014 to Euro 3,921 million. The nominal growth of public debt increased its share in GDP to 45.9% (40.5% in 2013). Such public debt dynamics mainly results from the increased government debt³⁶, that is the increased external debt of the central government, and less from the growth of external guaranteed debt of public enterprises and joint stock companies in state ownership. Analyzing these two public debt components, the government debt to total debt ratio

³³ The average weighted interest rate on government bonds hit a record low of 3.8% (4.6% in 2013).

³⁴ Refers to the debt of the central government including public funds, excluding municipalities.

³⁵ The public debt is defined under the Law on Public Debt (Official Gazette of the Republic of Macedonia No. 165/14), according to which it is the sum of the government debt and the debt of public enterprises established by the state or municipalities, municipalities within the city of Skopje and the city of Skopje, and companies that are entirely or predominantly owned by the state or by the municipalities, the municipalities within the city of Skopje and the city of Skopje, for which the Government has issued a state guarantee.

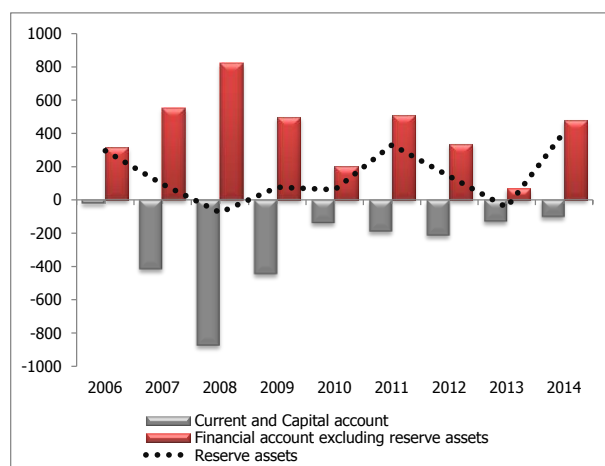
³⁶ Government debt is defined as a sum of debts of the central and the local government.

continued decreasing (from 84.5% in 2013 to 83.2%), whereas the guaranteed debt ratio increased (from 15.5% to 16.8%). Observing the residential structure of public debt, the external public debt to GDP ratio rose by 6.3 percentage points compared to 2013 and reached 31.9%, while the domestic debt ratio decreased for the first time after several years, to 14% (14.8% in 2013).

3.4. Balance of payments, IIP and external debt

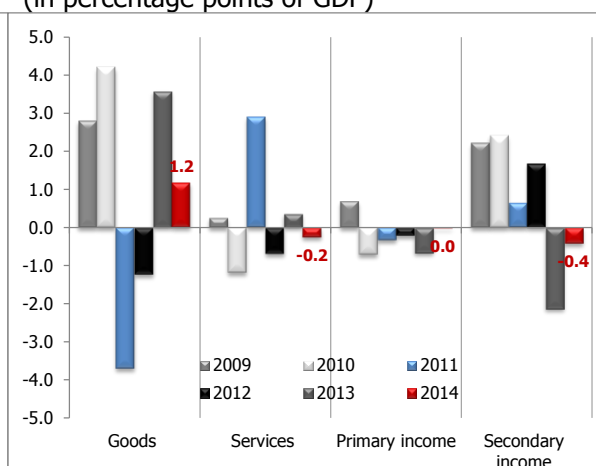
In 2014, the current account deficit continued to narrow, hitting a record low in eight years of 1.3% of GDP (by 0.5 percentage points of GDP less than the previous year). The main reason behind the narrowing of the current account deficit is the improving trade balance in goods, amid slight deterioration in the secondary income and services. These favorable foreign trade developments largely stem from the structural changes in the export sector, supported by the moderate recovery of external demand, and the decline in stock prices of energy sources in the second half of the year that contributed to lower import pressures. Factor that contributes to this "benign" external position is the negative output gap. Thus, there are no major pressures on imports from domestic demand. Financial flows in 2014 were sufficient for financing the current account deficit, but also for rapid buildup of foreign reserves during the year. The government debt was the chief financial flow. Namely, the stabilization of financial markets created favorable grounds for government borrowing on the international financial markets through the issuance of the third Eurobond in 2014. However, in 2014, there was a solid net inflow in the form of foreign direct investments, which was stable, i.e. unchanged compared to the previous year.

Chart 36
Current, capital and financial account
(in millions of euros)



Source: NBRM.

Chart 37
Contribution of individual components in the annual change in the current account
(in percentage points of GDP)



The analysis of individual components of foreign trade in 2014 points to a significant growth in both categories, with faster growth of exports compared to that of the imports. Export activity resulted from the increasing exports of the new facilities of foreign investors, whose increased capacity and higher added value remain the driving force for the growth of exports while the traditional export sectors, particularly the metal industry, again made negative contribution. Import performance largely reflected the export movements, i.e. the growth of import component significantly derived from import of raw materials by new industrial facilities in the economy. The higher import of raw materials for the industry was complemented with the higher investment imports, which is expected in conditions of higher foreign direct investment and intensive investment activities of the public sector. On the

other hand, energy imports registered no significant change compared to the previous year, despite the favorable movements in stock prices of crude oil. Such trends in import demand for energy are due to the higher quantity of import of electricity during 2014, given the reduced domestic production of this important energy source.

Chart 38
Contributions to the annual export growth (in percentage points)

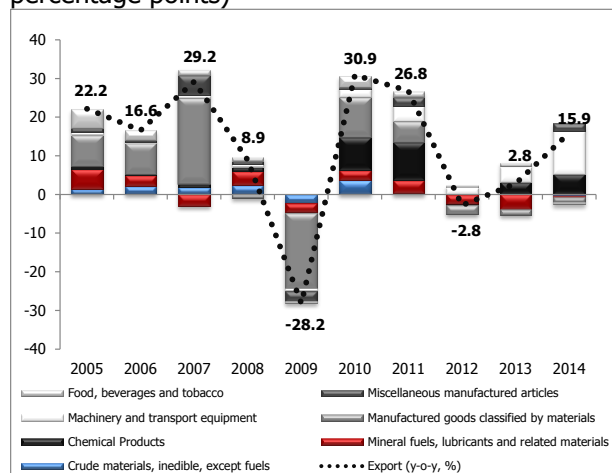
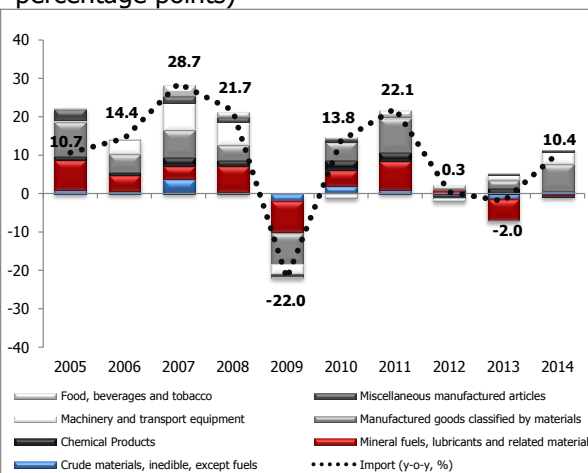


Chart 39
Contributions to the annual import growth (in percentage points)

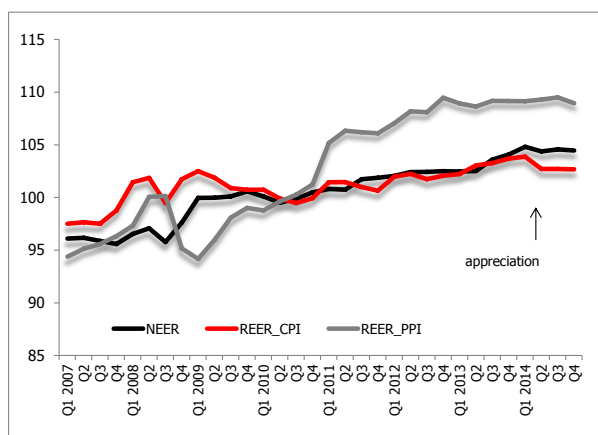


Source: SSO.

Upon significant improvement of services surplus in the previous year, this category recorded a moderate deterioration of 0.2 percentage points of GDP in 2014. The lower positive services balance is mainly due to the net outflows in the construction services³⁷, amid higher net inflows in customization services and tourism services. At the same time, secondary income, as the most important component for financing trade deficit, recorded an annual decrease of the relative share of net inflows in gross domestic product by 0.4 percentage points of GDP. Compared to 2013, the reduction of the relative share is particularly pronounced in the private sector transfers, as perceived through the lower purchased foreign currency in the exchange market. However, analyzing in nominal terms, net inflows in this category increased compared to 2013, sufficient to fully cover the trade deficit in goods and services generated during the year. The change in primary income had a neutral effect on the annual change in the current account, given the unchanged net outflows in direct investment income.

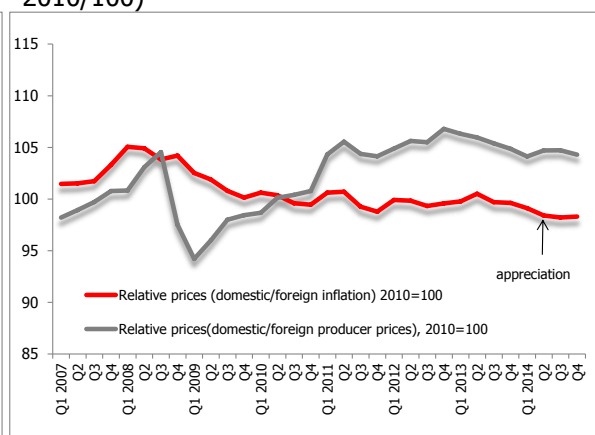
³⁷ High outflows in construction services during 2014 were due to advances paid for construction works on highway construction projects. This transaction was simultaneously recorded in the financial account, as net incurrence of liabilities on the basis of loans earmarked for financing road infrastructure, in the same amount as in the services.

Chart 40
NEER and REER (CPI and PPI based, 2010=100)



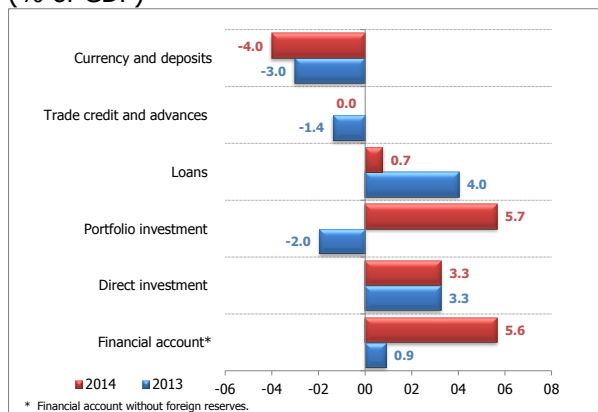
Source: NBRM.

Chart 41
Relative prices
2010/100)



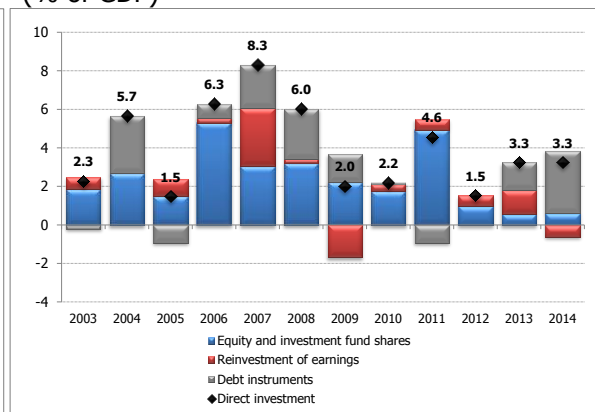
The analysis of price competitiveness indicators of the Macedonian economy³⁸ indicates no significant changes compared to the previous year. Namely, the REER deflated by consumer prices slightly depreciated by 0.1%, while the REER deflated by producer prices recorded a slight appreciation of 0.2%. These annual changes are greatly influenced by the appreciation of the nominal effective exchange rate of the Denar as a result of the appreciation of the domestic currency against the Turkish lira and the Serbian dinar, given the favorable movements in the domestic prices relative to the foreign prices in both price indices.

Chart 42
Financial account
(% of GDP)



Source: NBRM.

Chart 43
Direct investment
(% of GDP)



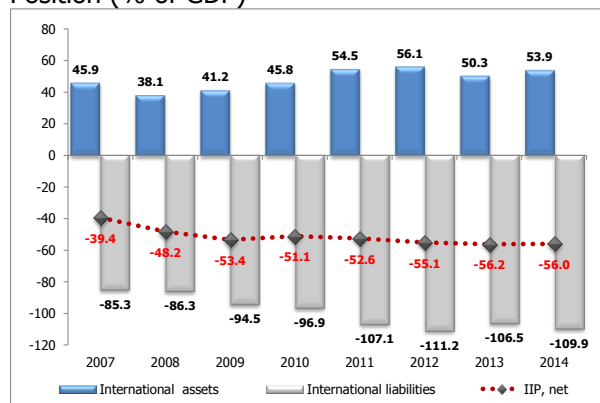
In 2014, high inflows of 5.6% of GDP were registered through the financial account of the balance of payments, which is an annual increase of 4.8 percentage points of GDP. The government external debt was a major factor for creating these flows (around 5.4% of GDP). Foreign direct investment made significant contribution to the financial account flows, which in 2014 equaled 3.3% of GDP, largely in the form of loans from parent companies, with a smaller contribution of equity. Analyzing *by activity*, most of the foreign direct investments were placed in the manufacturing industry (food, beverages and tobacco, but

³⁸ The analysis of indicators of price competitiveness are based on REER indices, calculated using weights based on the foreign trade without primary commodities. Primary products that are not included in the calculation are: oil and oil derivatives, iron and steel, ores and imported raw materials for the new industrial facilities in the free economic zones.

also in the automotive industry) and in the services sector, primarily financial and insurance activities. Net external borrowing of the private sector (1.2% of GDP) was mainly due to loans to other sectors in the economy, largely because of the indebtedness of the public companies that finance construction of road infrastructure. Such performances were largely offset by the increase in net assets in the category of foreign currency and deposits, mainly due to the increased funds of other sectors, and the growth of funds of depository institutions.

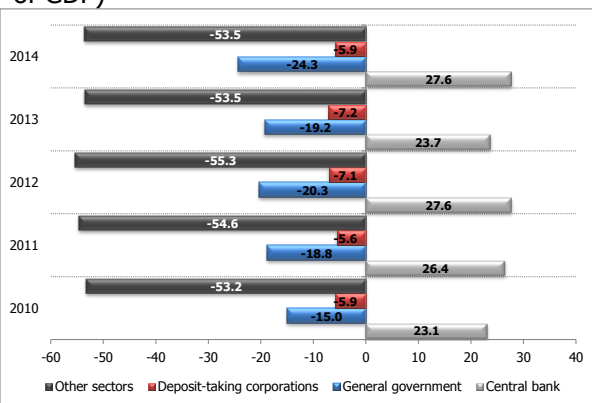
At the end of 2014, the negative international investment position of the Republic of Macedonia amounted to Euro 4,781.6 million, or 56% of GDP. Compared to the end of the previous year, net liabilities to the rest of the world slightly declined by 0.2 percentage points of GDP, due to the faster growth of international assets compared to the growth of international liabilities. Sector-by-sector analysis of the international investment position of the economy indicates improvement in the central bank and depository institutions, while changes in the "government" sector and "other sectors" acted in the opposite direction. The favorable change in the central bank is due to the high annual growth in net assets as a result of the higher foreign reserves. Also, a positive annual change was registered in depository institutions, where the lower net liabilities mainly resulted from the growth of assets in the form of currency and deposits. Notwithstanding performances in these two sectors, the annual deterioration in the government sector was fully caused by the growth of liabilities based on debt portfolio investments³⁹, while slightly higher net liabilities in "other sectors" are due to the higher net liabilities to foreign direct investors and liabilities based on long-term loans.

Chart 44
International Investment Position (% of GDP)



Source: NBRM

Chart 45
International investment position, by sector (% of GDP)

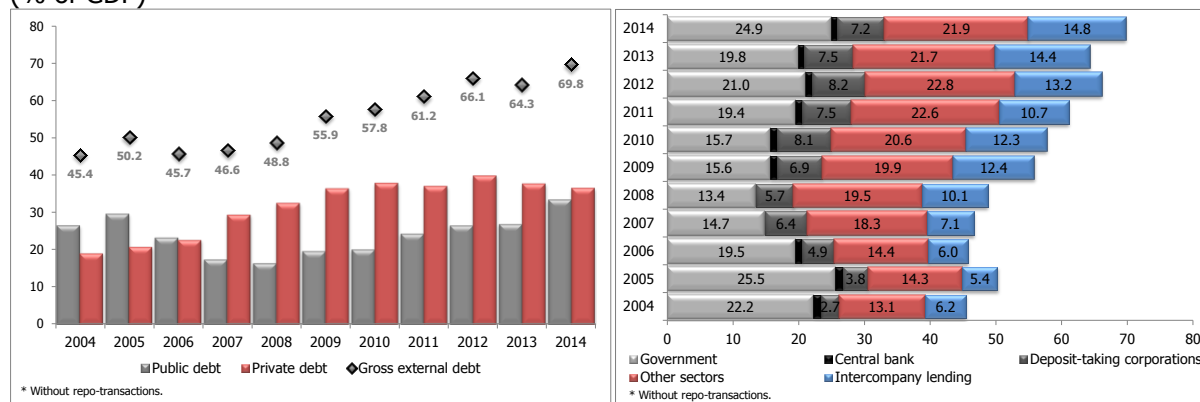


At the end of 2014, the gross external debt stood at Euro 5,954.4 million, or 69.8% of GDP, which is an increase of 5.4 percentage points of GDP, compared with the end of 2013. The growth of gross external debt stems solely from higher public debt, amid annual drop of private sector debt. High growth in public debt is primarily due to the intensive growth of long-term liabilities of the central government in the form of debt securities as a result of the issued Eurobond, with additional contribution of the growth of the debt on long-term financial loans to public companies⁴⁰.

³⁹ During the third quarter of 2014, the state borrowed on the international financial markets through the issuance of the third Eurobond worth Euro 500 million, which increased the state liabilities on the basis of portfolio investments. At the same time, despite the increase in liabilities, it also caused high accumulation of foreign reserves, and accordingly, higher net assets.

⁴⁰ Higher liabilities on the basis of long-term foreign loans are mainly due to the borrowing of public enterprises for financing the construction of road infrastructure.

Chart 46
Gross external debt, by debtor and institutional sector
(% of GDP)



Source: NBRM.

The external indebtedness indicators of the national economy generally show that the gross external debt is in the safe zone. The only indicator that classifies the economy in the group of highly indebted countries is the gross external debt to GDP ratio. The analysis of the dynamics of foreign indebtedness indicates⁴¹ moderate deterioration in all solvency indicators for 2014, compared to end of 2013. On the other hand, liquidity indicators suggest a more favorable external position, given the improvement in the provided indicators and full coverage of short-term debt liabilities with residual maturity with the foreign reserves.

The level of net external debt, as an additional indicator of the external position of the economy amounted to Euro 1,812.8 million or 21.2% of GDP at the end of 2014. Compared to 31 December 2013, this indicator slightly worsened, i.e. the net external debt increased by 2.6 percentage points of GDP. The slower growth of net external debt relative to the growth of gross debt is due to the higher level of gross external claims (by 2.9 percentage points of GDP), due to the higher foreign reserves, indicating that part of the inflows from external borrowing at this time remained in the form of foreign reserves.

⁴¹ The analysis of external indebtedness indicators uses the balance of payments data in accordance with the Balance of Payments and International Investment Position Manual (BPM6) and data on gross external debt according to the External Debt Statistics (2013). The methodological changes caused no changes in the overall level of external debt, but only affected the maturity and sector structure of the debt. Accordingly, under the new methodology, the level of short-term debt is lower at the expense of the increase in long-term debt component, which caused changes in the liquidity indicators, i.e. their improvement relative to the analyses based on data from the previous methodological framework. On the other hand, the methodological changes in the export of goods and services and other inflows caused deterioration of the indicators for the share of export of goods and services and other inflows in the gross external debt and debt service in relation to export of goods and services and other inflows, compared with the indicators relevant prior to the methodological changes.

Table 1
External debt indicators

	<i>Solvency</i>				<i>Liquidity</i>		
	Interest payments/ Export of goods and services and other inflows	Gross debt/ Export of goods and services and other inflows	Gross debt/ GDP	Debt servicing/ Export of goods and services and other inflows	Foreign reserves/ Short-term debt	Foreign reserves/ Short-term debt, with residual maturity	Short-term debt/ Overall debt
	in %				ratio	ratio	in %
31.12.2004	2.41	129.3	47.3	12.4	1.14	0.89	30.3
31.12.2005	2.66	147.0	54.2	11.06	1.67	1.04	26.7
31.12.2006	3.44	131.3	49.8	21.7	1.95	1.34	29.0
31.12.2007	2.78	119.3	51.3	19.4	1.35	1.08	39.8
31.12.2008	2.66	116.9	54.1	10.2	1.29	0.95	35.2
31.12.2009	2.43	131.0	57.8	11.8	1.29	0.94	32.9
31.12.2010	3.22	140.4	59.7	13.9	1.49	0.99	27.9
31.12.2011	3.12	148.4	64.6	16.8	1.78	1.18	25.2
31.12.2012	2.92	141.9	67.6	13.1	1.64	1.03	26.7
31.12.2013	2.51	137.6	67.4	15.8	1.64	1.08	23.3
31.12.2014	3.00	149.2	73.7	17.1	1.88	1.15	21.7
<i>Moderate indebtedness criterion</i>	<i>12 - 20%</i>	<i>165 - 275%</i>	<i>30 - 50%</i>	<i>18 - 30%</i>	<i>1.00</i>		

* The moderate indebtedness criterion is taken from the World Bank methodology for compiling indebtedness ratios, which implies using three-year moving averages of GDP and export of goods and services and other flows as denominators in the calculation of the ratios.

"Developed in accordance with the *External Debt Statistics: Guide for Compilers and Users*, issued by the IMF.

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

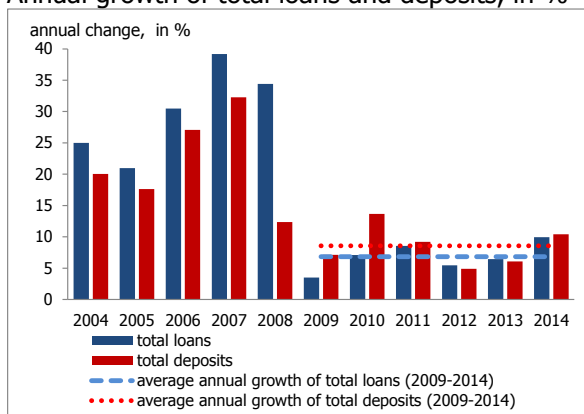
Source: NBRM.

3.5. Monetary and credit aggregates

During 2014, the acceleration of real sector activity, along with the improved banks' perceptions of credit risk and the favorable expectations for the coming period enabled faster increase in the deposit base and accelerating credit support of the banks to the private sector. In 2014, the monetary and credit growth was higher than the average increase of these aggregates in the period after the acute phase of the crisis in 2009. Especially visible improvement was observed in the credit market, which experienced the highest growth of loans for the period after the onset of the crisis. Also, there were positive developments in the structure of credit growth, that is increased lending to the corporate sector. These developments indicated a gradual improvement of the banks' expectations and their perception of the risk profile of the credit demand, as confirmed by the NBRM lending surveys. Monetary policy also continued to stimulate credit growth by keeping the interest rates low. Additional support to lending was provided through the non-standard measures⁴² and the changes in macroprudential policy that were adopted during the year. The positive credit market developments were backed up by the changes in the quality of credit portfolio, in line with the slowing growth of non-performing loans.

⁴² In 2014, the new loans approved within the non-standard measure for encouraging the credit activity of net exporters and producers of electricity amounted to Denar 2,883 million.

Chart 47
Annual growth of total loans and deposits, in %



Source: NBRM.

Chart 48
Loan to deposit ratio

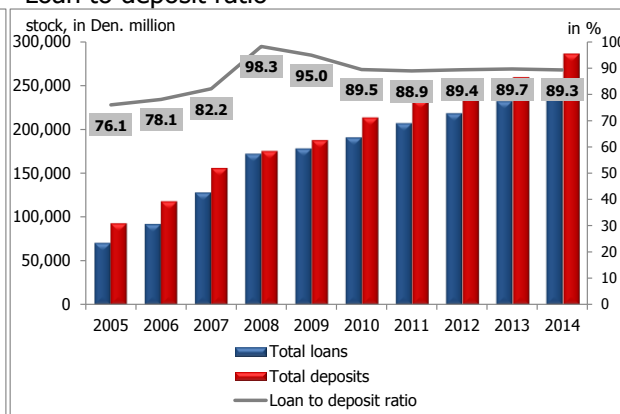
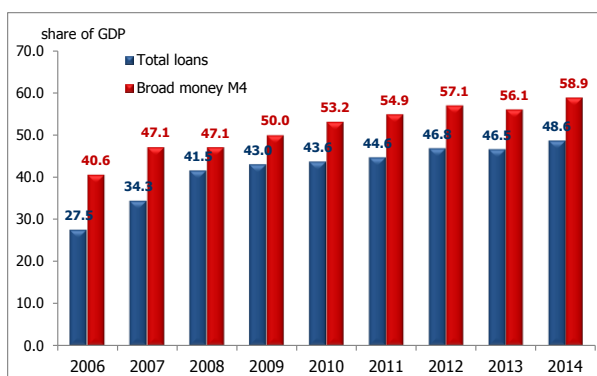
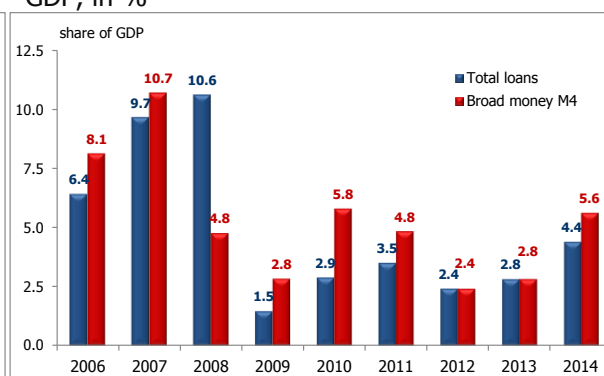


Chart 49
Share of total loans and M4 in GDP, in %



Source: NBRM.

Chart 50
Share of annual growth of total loans and M4 in GDP, in %



The annual growth rate of broad money M4 significantly accelerated from 5.3% in 2013 to 10.5% at the end of 2014. This intensification of the monetary growth rate mainly reflects the increase in deposits of the banking sector as a major source of funding for banks. Namely, in conditions of relatively high growth rates of the domestic economy and favorable labor market developments, the ability of the corporate sector and households to create additional income and placement of these available funds in the banking system improved. Thus, 2014 was marked by faster deposit growth rate of the households, and especially the corporate sector, which is indicative of improved liquidity of companies, with positive effects on the creditworthiness of the corporate sector. In terms of structure, long-term deposits are the driving force of the deposit growth for the third consecutive year, which further contributes to the stability of the deposit base. The stable expectations for the next period, the confidence in the domestic banking system and the higher yields on long-term savings are factors that contribute to the growth of long-term savings in recent years. Short-term deposits registered a moderate growth in 2014, which comes after the decline of this deposit category in the previous two years. Currency in circulation, as the most liquid component of money supply, significantly increased compared to last year, in part as a cumulative effect of the higher paid salaries, pensions and subsidies from the Budget of the Republic of Macedonia.

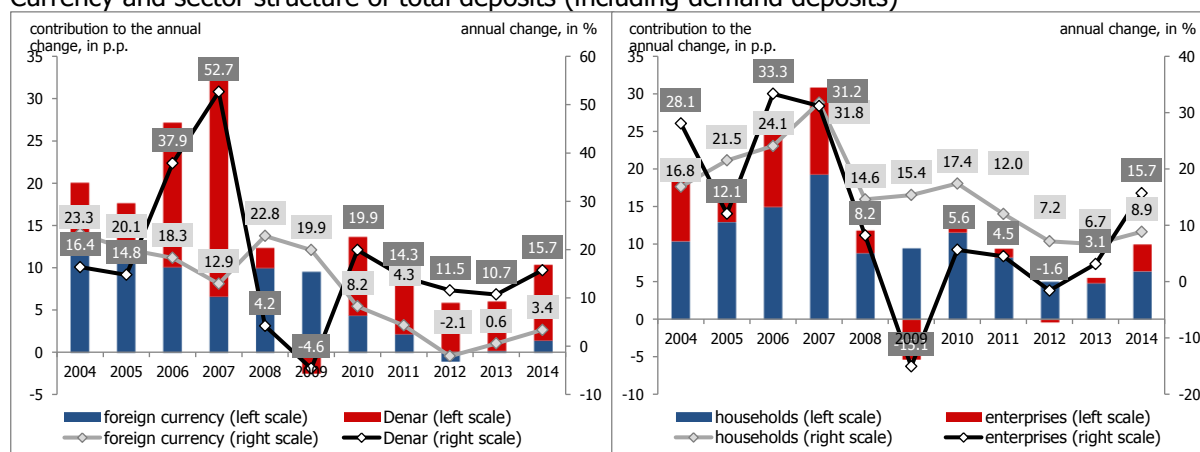
Table 2
Components of monetary aggregates

	Balance as of			Annual change			Contribution in annual growth of M4		
	31.12.2012	31.12.2013	31.12.2014	31.12.2012	31.12.2013	31.12.2014	31.12.2012	31.12.2013	31.12.2014
	in millions of denars	in millions of denars	во милиони денари	in %	in %	во %	in %	in %	во %
Currency in circulation	20,118	20,706	23,222	4.2	2.9	12.2	7.2	4.2	8.5
Demand money	45,824	49,299	62,326	9.1	7.6	26.4	34.1	24.7	44.1
M1	65,941	70,005	85,549	7.6	6.2	22.2	41.4	28.9	52.7
Short term denar deposits	57,543	57,112	57,151	-1.3	-0.7	0.1	-6.7	-3.1	0.1
Short term foreign currency	94,228	90,949	90,980	-3.0	-3.5	0.0	-25.6	-23.3	0.1
M2	217,712	218,066	233,679	0.5	0.2	7.2	9.2	2.5	52.9
Long term denar deposits	31,688	41,509	51,673	44.3	31.0	24.5	86.4	69.8	34.4
Long term foreign currency	16,887	20,788	24,527	3.1	23.1	18.0	4.6	27.7	12.7
Total deposits (without demand money)	200,346	210,358	224,330	3.4	5.0	6.6	58.8	71.1	47.3
Total deposits (including demand money)	246,170	259,657	286,656	4.4	5.5	10.4	92.8	95.8	91.5
M4	266,287	280,363	309,879	4.4	5.3	10.5	100	100	100

Source: NBRM

The analysis of the currency structure of the annual growth of the deposit base indicates continued growth in the Denar deposits, which confirms the confidence of depositors in the stability of the exchange rate. In 2014, growth of foreign currency deposits registered certain acceleration compared with the previous year, which in part can be explained by changes in the corporate sector deposits as a volatile category, which is under the influence of the liquidity needs of the corporate sector⁴³. The growth of household foreign currency deposits moderately accelerated, which could also indicate gradual exhaustion of the effect of extraordinary factors that acted towards increasing the denarization in the domestic economy in the previous period⁴⁴ and normalization of currency preference for saving of the private sector. Despite these developments, the propensity to save in domestic currency continued, as suggested by the high contribution of the Denar deposits to the total deposits growth, which in 2014 accounted for 86%. The faster increase of Denar deposits compared to the growth of foreign currency deposits further reduced the level of euroization (as measured by the share of foreign currency deposits in total deposits) from 44.4% on average in 2013 to 42.4% in 2014. The same applies if we analyze the currency structure of total deposits, excluding demand deposits. Thus, the share of foreign currency deposits in total deposits (excluding demand deposits) in 2014 averaged 52.6% (in 2013 it averaged 54.1%).

Chart 51
Currency and sector structure of total deposits (including demand deposits)



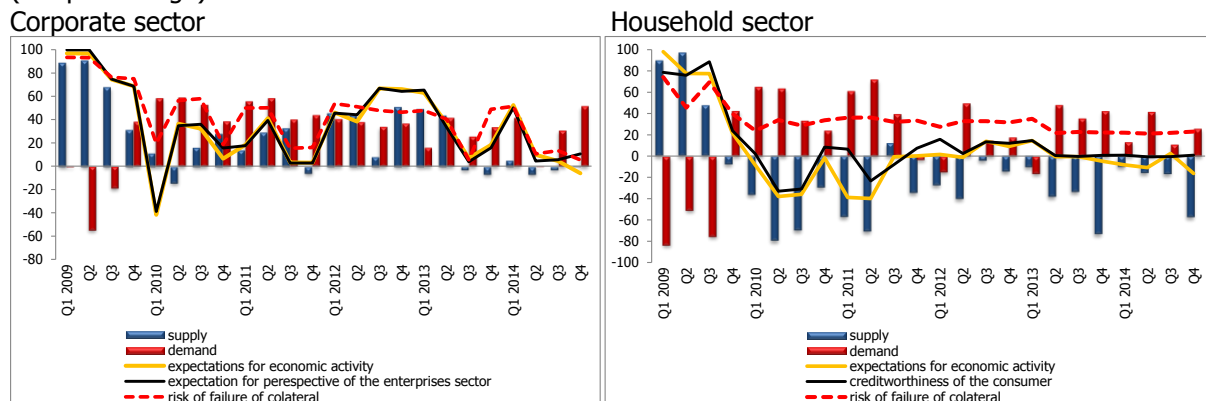
Source: NBRM.

⁴³ The payment of dividend by one large domestic company to the government and the foreign investor had a significant effect on corporate deposits, which in various years is made by a different structure of deposits, thus shifting the currency structure of deposits of the corporate sector.

⁴⁴ This primarily pertains to the effects of the escalating European debt crisis in late 2011, which decreased the confidence in the Euro and increased the savings in domestic currency.

Solid credit support of the banking sector to the domestic economy continued during 2014 at an accelerated pace compared to the average annual growth in the period after the acute phase of the crisis (2009-2013). At the end of December, the annual growth rate of total loans equaled 10% (6.4% at the end of 2013). Annual loan growth in 2014 exceeds the growth in the previous year by 1.6 times, which is the highest for the period after the onset of global crisis. In addition to the acceleration of the credit growth, 2014 was also marked by changes in its structure. Namely, in 2014, the banks provided almost equal support to the corporate sector and the household sector, unlike the previous year, when loans to households made up a larger part of the growth in total loans. Positive trends in lending activity are also confirmed by the results of the lending surveys that indicated easing of the banks' terms of lending to households and to a smaller extent, to the corporate sector, with simultaneous growth in demand for loans. The surveys showed increased optimism of banks in terms of their expectations for the overall economic activity and improved risk perceptions compared with the previous two years, which is especially true of the corporate sector⁴⁵. Namely, after a longer period, starting from the second quarter of 2014, NBRM lending surveys show a stabilization of banks' risk perceptions in the area of lending to the corporate sector. Improvement was observed in all risk perception factors, with the factor that relates to the expectations for economic activity in the last quarter contributing towards easing the terms of lending. Household perceptions stabilized earlier, in late 2011. Such developments also imply reduced influence of risk factors toward limitation of the lending activity. Improvement was also noted in the loan portfolio quality. Thus, in 2014, the annual growth rate of doubtful and contested claims slowed down from 18.5% on average in 2013 to 7.5% in 2014. At the end of December, non-performing loans to total loans ratio equaled 11.1% (11.3% in 2013).

Chart 52
Supply, demand and banks' risk perceptions⁴⁶
(net percentage)



Source: Lending Survey, NBRM.

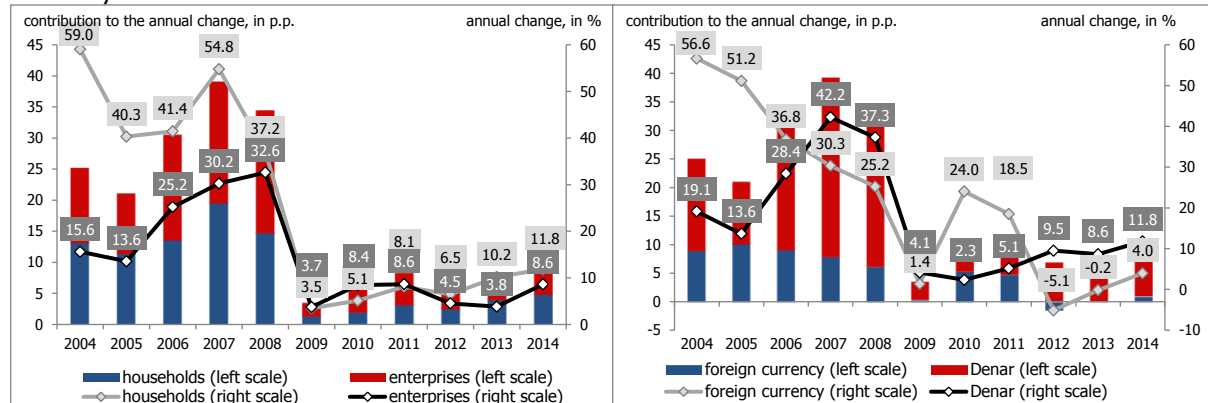
The performance in lending activity in 2014 is a good signal for the revival of credit activity and accelerated credit market recovery. It also points to the spillover effect of the recent monetary loosening and accommodative nature of the monetary policy in 2014. This is especially true of the corporate sector, in which the volume of loans granted in 2014 was

⁴⁵ For more details about the NBRM Lending Survey also visit:
<http://www.nbrm.mk/?ItemID=F7AC78DEE498764FBAF39049F726CE3C>.

⁴⁶ Explanation: the supply refers to the change in the lending terms (if the net percentage is positive, then the lending terms are tightened, while if it is negative, they are relaxed); the credit demand (if the net percentage is positive, the demand is higher, if it is negative, the demand is lower), the risk factors influencing the lending terms (if the net percentage is positive, then they aim towards tightening the lending terms, while if it is negative, they act towards easing the lending terms). The chart that pertains to households presents the average of the net percentage of the risk factors influencing the lending terms when extending housing loans and those that influence consumer loans. For more details on the lending surveys, please visit the NBRM website.

most intense since the inception of the crisis. Also, the long-term corporate loans increased compared to the previous year when the long-term lending stagnated on an annual basis. However, despite the positive developments, it should be borne in mind that it is a relatively short period of intensification of lending to the corporate sector. Hence, it will take time to draw robust conclusions about any major change in the behavior of domestic banks to this segment.

Chart 53
Currency and sector structure of the total loans



Source: NBRM.

IV. Macroeconomic environment and monetary policy in 2015 and 2016

In accordance with the legal provisions, in the period ahead, the NBRM monetary policy will seek to maintain price stability as a primary monetary objective, and will continue contributing to a stable and competitive market-oriented financial system. The NBRM will also support the general economic policies without jeopardizing the achievement of the ultimate objective and in line with the principle of an open market economy with free competition. Analyzing the monetary strategy, the NBRM will continue implementing the strategy of maintaining a stable nominal exchange rate against the euro. The role of the exchange rate as a nominal anchor stems from the features of the domestic economy as a small and open economy highly dependent on import of primary products. Such environment increases the importance of the exchange rate for maintaining price stability and stable inflation expectations of economic agents. As expected, in the next two years, the monetary policy will be conducted in a relatively stable environment, in the absence of significant internal and external imbalances. The recent NBRM projections from October 2014 envisage that the economy will continue to grow at a rapid pace, primarily due to exports and investments. The banking sector is expected to continue to support economic growth through increased lending activity. Favorable external sector developments are expected in the next two years, despite the estimates for moderate expansion of the current account deficit in line with the strengthening of economic activity. The projected path of foreign reserves still indicates that the reserve adequacy indicators are in a safe zone. Inflation will be moderate, ranging around the historical average of about 2%, with present downward risks due to movements in import prices. Under such favorable economic conditions, in the period ahead, the NBRM will mainly be focused on monitoring the achievement of the projected levels of foreign reserves and foreign exchange market developments, and will adjust the monetary policy accordingly.

The implementation of the projected macroeconomic framework is accompanied by risks stemming mainly from the external environment. The risks that could spill over the domestic economy through various channels mainly relate to the dynamics of recovery of global economic growth, and movements in the prices of primary commodities in world markets. This is especially true of the euro area, as our major trading partner, where the economic recovery takes place at slower pace and suggests prolonging of the recovery. The latest measure taken by the ECB in January 2015⁴⁷, aimed towards significant quantitative easing, mitigates the adverse risks to the growth of the European economy. However, it takes time to perceive the extent to which this policy will spill over the real sector of the economy of the euro area. The effects of geopolitical turmoil remain risk factors, primarily related to the situation in the Middle East and Ukraine. Risks arising from these developments could materialize through instability and difficult predictability of prices of energy and grain products, and could also affect the expected economic recovery. Any materialization of the mentioned risks will also mean change in the environment for conducting monetary policy, compared with the basic expectations.

Given the strengthening of the domestic economic growth, inflation is expected to gradually increase in the coming period, and according to the October projections, will range around 1% in 2015 and around 2% in 2016. The rise of prices in 2015 will primarily reflect changes of food price, and to a lesser extent the further growth of domestic demand.

⁴⁷ For more details about the measures for quantitative easing adopted by the ECB in January, see the section International Economic Surrounding.

Energy prices are expected to have a negative contribution to inflation in 2015⁴⁸. Inflation will continue to moderately accelerate in 2016 amid expectations for stabilization of import prices and increased price pressures from demand. Inflation risks are mainly exogenous and attributable to the uncertainty of the effects of the weather factors and geopolitical relations - the crisis in the Middle East and the Ukrainian crisis. The latest available information point to generally downward risks to inflation in the period ahead. Such assessments are attributable to the changes in the projections for world prices of primary commodities, primarily energy prices, which in the period after the October projection were revised significantly down. However, it should be borne in mind that the external assumptions are subject to frequent adjustments and the possibility of sudden changes in these categories is large, which increases uncertainty about future trends in import prices and therefore, their effects on domestic inflation. Analyzing domestic factors, the adverse weather conditions in the domestic economy since the beginning of 2015 have been an additional risk factor for inflation that could act upward, although their effect is hard to assess so far.

It is expected that favorable economic trends typical for 2014 will continue in the next two years, with a gradual acceleration of the rate of economic growth. Namely, higher utilization of the capacities of the foreign investors, as well as the entry of new investors and the fiscal impulse⁴⁹, are expected to further stimulate exports and investments. These factors positively affect the labor market and the consumer expectations, thus expecting consumer spending to continue to grow and have a strong positive contribution to the economic growth. Under such assumptions, domestic demand is still expected to be a generator of the economic growth, amid significantly more intensive investment activity, with a negative contribution of the net exports. However, by the end of the period of projections, assessments show a gradual balancing of the growth structure, and gradual diminishing of the negative contribution of net exports. In such conditions, the GDP growth is estimated to be 4.1% in 2015 and to further accelerate to 4.5% in 2016. Given the high openness of the economy, the risks to the projected growth still arise from the global environment and developments in the external environment.

Given the solid liquidity and solvency of banks, it is expected that economic recovery, stable environment, banks' deposit growth, and measures taken by the monetary authorities will contribute to greater financial support for the domestic economy through the banking sector. In 2014, there was a solid annual credit growth of 10%, which also exceeds the October projections. The total credit growth in 2015 is projected at 9%, while at the end of 2016, it is estimated to accelerate to 10%. The expected credit growth reflects the positive signals on the sides of both supply and demand. Namely, the expected growth in domestic consumption will increase demand for loans. Also, the expected acceleration of economic growth is expected to further increase the main source of funding for banks - deposit base, which will increase the credit supply of banks. Also, the sound risk perceptions of banks, as well as the recent measures taken by the NBRM will act in this direction. Observing risks, the dynamics of lending activity in the coming period, as before, continues to be determined by the level of economic recovery as a prerequisite for the growth of the deposit potential and a factor that influences the banks' expectations and the propensity of private sector for borrowing.

Projections for 2015 and 2016 show an external position that will ensure adequate level of foreign reserves. The current account deficit is expected to expand to 3.9% of GDP in 2015 and 4.6% of GDP in 2016. Such assessments draw on the assumptions for lower

⁴⁸ These expectations draw on the assumption that there will be no increase in the price of electricity. The estimated effect on the average annual inflation of any increase in the price of electricity in mid- 2015 of 10% would equal 0.4 percentage points.

⁴⁹ In line with the Fiscal Strategy for 2015-2017.

relative share of secondary income (current transfers) in GDP. On the other hand, trade deficit in goods and services is expected to stabilize, and there are positive risks in this area for greater effects of the new export companies than expected. Such projected path of the current account deficit and its structure do not suggest major imbalances in the economy. Thus, in the medium run, the deficit is expected to narrow as a positive effect of the increasing value added of foreign investments. In terms of financing, in the next period, the structure of capital inflows is expected to be a combination of debt and non-debt flows. Direct investment is expected to gradually increase and reach 3.8% of GDP in 2015 and 4% of GDP in 2016. Observing the foreign reserves, after their increase in 2014, in 2015, the balance of payments transactions are expected to reduce foreign reserves. Such dynamics of foreign reserves was largely determined by the state, i.e. the high amount of external debt repayments of this sector that fall due in 2015, while the government was securing funds for repayment of these liabilities by borrowing on the international capital market in 2014⁵⁰. Based on assumptions for gradual increase in foreign investments and financial indebtedness of the private sector, and based on the additional debt inflows for the government (in line with the structure of financing budgetary needs, presented in the last fiscal strategy for 2015-2017) there will again be room for buildup of foreign reserves during 2016. The projected path of foreign reserves still indicates that the reserve adequacy indicators are in a safe zone. The main risks surrounding the external position of the economy in the next period still come from the pace of the global recovery, and therefore, of the domestic economic growth and their impact on the investors' perceptions.

Prudent fiscal policy, with gradual consolidation of the budget deficit and relatively stable level of public debt is expected in the next two years⁵¹. Fiscal policy is an important factor that affects the monetary policy setup, with the policy nexus being a key factor for achieving sustainability of the external position of the country and maintaining macroeconomic stability. In the coming period, the budget deficit is expected to gradually narrow to 3.2% of GDP in 2016. Public investments remain a priority of the fiscal policy. Namely, in the coming period, there is an intention to implement large investment projects in road and railway infrastructure, in the communal infrastructure and in the energy sector, agriculture, etc. The deficit is intended to be financed from external and domestic sources. Moreover, as for the domestic sources, the government intends to use part of the accumulated deposits with the NBRM, as well as to issue government securities with longer maturities, which is expected to strengthen and further develop the domestic securities market. Such a fiscal framework tends to ensure a moderate growth of government debt in the next period, without jeopardizing the sustainability of public finances. The fiscal policy setup is accompanied by risks, same as the monetary policy, mainly arising from the external environment and its impact on domestic economic activity, as well as the accessibility to foreign financial markets.

⁵⁰ In 2014, the government issued the third Eurobond worth Euro 500 million, with maturity of 7 years and rate of return of 4.25%, i.e. an interest rate of 3.975% per year. At the beginning of 2015, the government made early repayment of the liabilities based on the precautionary credit line from the IMF.

⁵¹ The fiscal policy projections have been taken from the Fiscal Strategy of the Republic of Macedonia for 2015-2017, October 2014.

V. Monetary instruments

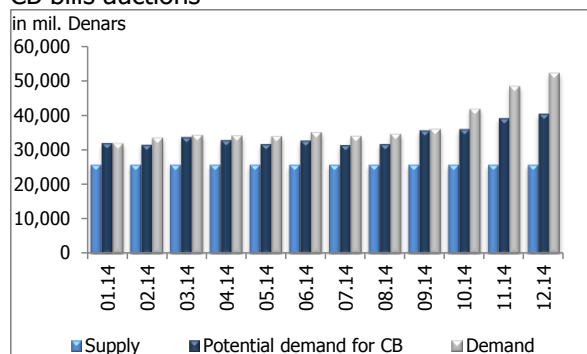
In 2014, the National Bank maintained the key interest rate and the supply of CB bills at the auctions unchanged, and for the purpose of channeling excess liquidity to the non-financial private sector it lowered the interest rates on the standing deposit facilities. Given the positive contribution of the non-standard measure of the banks' reserve requirement⁵² in the past year, as well as in order to provide additional support to systemically important sectors of the domestic economy, the National Bank extended the application of this measure for another year, until the end of 2015.

5.1. CB bills

In 2014, at the auctions of CB bills the National Bank continued to apply a volume tender (offer with limited amount and fixed interest rate)⁵³. To the end of gradual and sustained recovery of the private sector, the National Bank kept the amount of CB bills at the level of Denar 25,500 million. Amid solid economic growth, absence of price pressures and favorable balance of payments position, which created conditions for holding the foreign reserves at an adequate level, the National Bank maintained the interest rate on the main instrument at the same level of 3.25%⁵⁴.

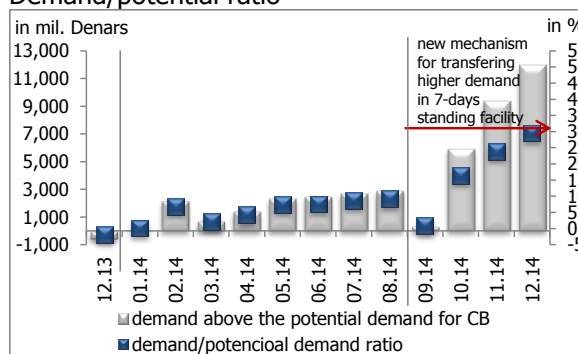
In the first half of 2014, the interest of banks in CB bills remained relatively stable in terms of their liquidity potential. The demand of banks for CB bills averaged Denar 33,860 million and was higher than their potential liquidity by 10%⁵⁵.

Chart 54
CB bills auctions



Source: NBRM

Chart 55
Demand/potential ratio



In the second half of the year the banks' interest in investing in CB bills increased. In order to direct the excess liquidity to the non-financial private sector, in September, the National Bank revised the mechanism for transfer of the higher demand for CB bills over the potential into seven-day deposit facility, and started to apply an interest rate of 0% on the funds allocated on this basis. This change resulted in a one-time reduction of the demand for CB bills at the level of the potential liquidity. By the end of the year, amid continued

⁵² The measure, which enables a reduction in the reserve requirement base of banks for the amount of new loans and investments in debt securities in domestic currency without currency clause issued by net exporters and domestic producers of electricity, was introduced in late 2012 and started to be implemented from 2013.

⁵³ Auctions of CB bills are held on the first day of the periods of reserve requirement (Decision on CB bills, "Official Gazette of RM" no. 166/13).

⁵⁴ The last change in the interest rate on CB bills was made in July 2013, when a volume tender started to be applied (offer with limited amount and fixed interest rate).

⁵⁵ The potential liquidity of banks is calculated according to the Methodology for determining the potential demand for CB bills. The Methodology was introduced in December 2013, in order to determine the demand for CB bills by banks at the level of potential liquidity of banks.

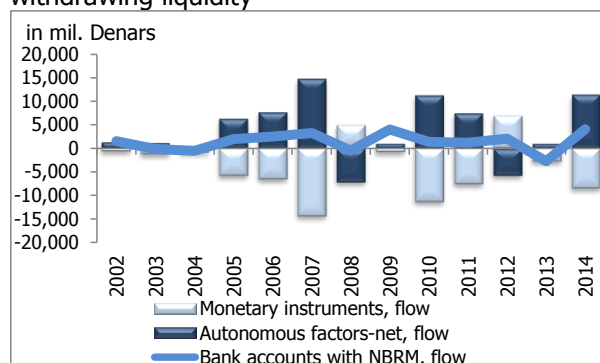
growth of the potential liquidity of banks under the influence of autonomous factors, banks had an increased interest in the CB bills of the National Bank, and made a significant bid over their liquidity potential.

Annex 1. Review of the flows of creating and withdrawing liquidity in 2014

Liquidity in the banking system, analyzed through the banks' balances on the accounts with the National Bank amounted to Denar 19,908 million at the end of 2014 and was higher by Denar 4,088 million compared with the end of 2013. Analyzing the dynamics, faster growth of bank liquidity was registered in the last quarter of the year, when the liquidity of banks increased by Denar 3,061 million.

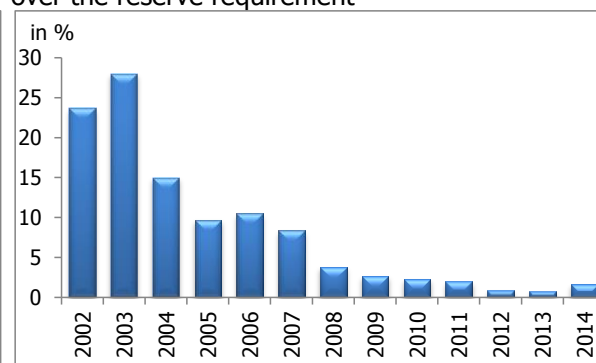
The impact of autonomous factors in 2014 was in the sense of increasing the liquidity of banks by Denar 11,449 million. Within their framework, government transactions affected the increase of banks' liquidity⁵⁶, while the growth of currency in circulation⁵⁷ and foreign currency interventions of the National Bank with market-makers acted toward reducing bank liquidity.

Chart 56
Flows of creating and withdrawing liquidity



Source: NBRM

Chart 57
Average excess liquidity over the reserve requirement



In conditions when the autonomous factors influenced the growth of liquidity and the supply of CB bills at the auctions during 2014 was maintained at the level of 2013, part of the excess liquidity of banks was placed in the deposit facilities with the National Bank, whereby, through the monetary instruments Denar 7,361 million were withdrawn in 2014. The average surplus of liquid assets over the reserve requirement for 2014 was 1.7% and compared to 2013 it was higher by 0.9 percentage points. The higher average surplus was influenced by a one-off effect in the first quarter of the year⁵⁸. If the effect of this factor is isolated, the average liquidity surplus on the banks' accounts over the reserve requirement for 2014 would amount to 0.6% (lower by 0.2 percentage points compared to 2013), indicating a continuous trend of reduction of the average excess liquidity of banks relative to the reserve requirement, as an indication of increased efficiency in the liquidity management.

⁵⁶ In 2014, budget deficit of 4.2% of GDP was realized.

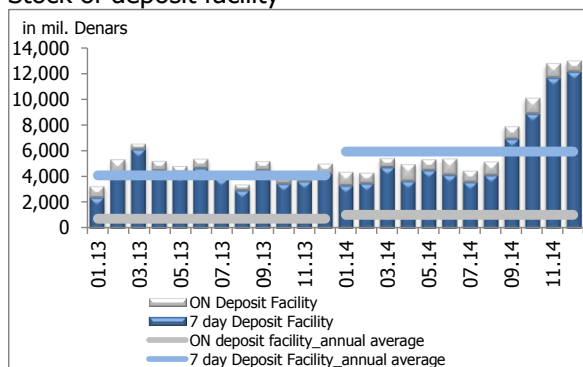
⁵⁷ The growth of currency in circulation, which was faster on an annual basis, was mostly influenced by the increased private consumption, supported mainly by: the growth of real net wages in the country (as opposed to the constant decline in the past three years), higher budget expenditures for support of the agricultural production, increased pensions and faster annual growth in consumer loans.

⁵⁸ Keeping a relatively high level of liquid assets was mainly a reflection of the strategy of one medium bank for limiting the amount of placements with the monetary and government authorities.

5.2. Deposit and credit facilities with the National Bank

In 2014, banks actively used the deposit facilities with the National Bank for liquidity management within the period of reserve requirement⁵⁹. Faster growth of banks' deposit facilities with the National Bank was registered at the end of the year, which corresponded with the increased liquidity of banks under the influence of autonomous factors. Also the amount of seven-day deposit facilities was influenced by the significant propensity of banks to increase their share in the stock of CB bills⁶⁰, which meant a change in the dynamics of this instrument within the period of reserve requirement. In 2014, the stock of deposit facilities with seven-day maturity averaged Denar 5,934 million and it was higher by Denar 1,862 million (or 46%) compared to the average stock in 2013.

Chart 58
Stock of deposit facility



Source: NBRM

Chart 59
Dynamics of seven-day deposits

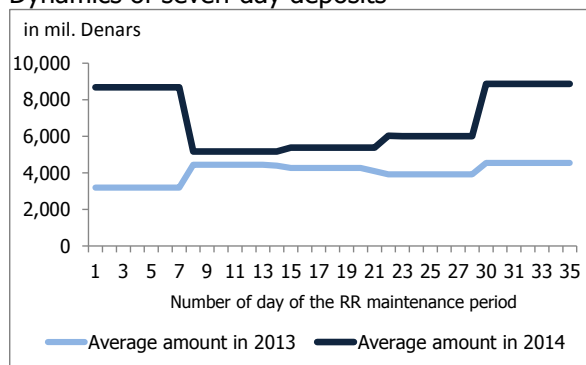
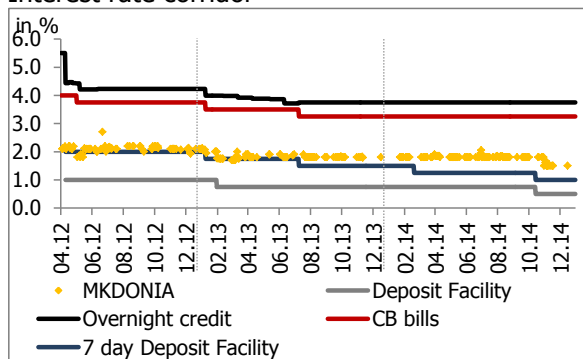
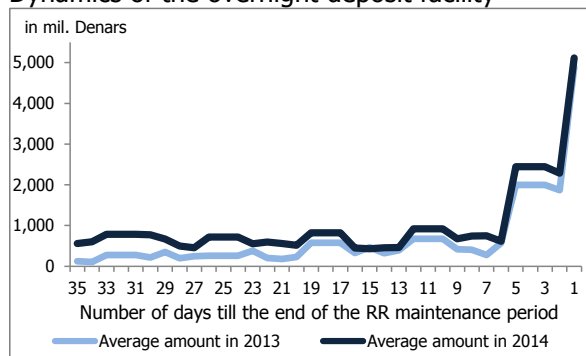


Chart 60
Interest rate corridor



Source: NBRM

Chart 61
Dynamics of the overnight deposit facility



Banks used the overnight deposit facility for placing excess liquidity at the end of the working day, with the banks' interest in this instrument being greater at the end of the period of reserve requirement. In 2014, the stock of banks' liquid assets placed in overnight deposits averaged Denar 999 million, which is a moderately higher amount (by Denar 297 million) compared with the previous year.

⁵⁹ Placing liquid assets in deposit facilities with the National Bank is on the initiative of banks. Unlike overnight deposit facilities that are available to the banks every day, the possibility of placing liquid assets in deposits with maturity of seven days is available to banks once a week, i.e. every Wednesday.

⁶⁰ Given the application of a rule of proportional distribution of CB bills, banks auctioned with larger amounts in order to achieve greater share in the amount of CB bills.

In order to strengthen the mechanism for directing the excess liquidity of banks in longer-term investments, bearing in mind that the main function of the deposit facility is to offset short-term fluctuations in liquidity within the period of reserve requirement, in 2014, the National Bank cut the interest rates on the deposit facilities. In February 2014, the interest rate on the seven-day deposit facility was reduced from 1.5% to 1.25%, while in October 2014, the interest rates on both instruments were simultaneously reduced by 0.25 percentage points, to the level of 1.0% and 0.5%, respectively.

In 2014, banks used overnight credit facility only twice, totaling Denar 1,100 million. The interest rate on this instrument in 2014 remained unchanged and amounted to 3.75%.

5.3. Reserve requirement

In 2014, the National Bank continued to apply differentiated rates of reserve requirement⁶¹, which resulted in further support for saving in domestic currency. Banks' liabilities in domestic currency had a stable and dominant contribution (of 7.3 percentage points) to the annual growth of total liabilities that comprise the reserve requirement base (8.4%). The relative share of liabilities in domestic currency in total liabilities of banks increased by 2.7 percentage points annually and at the end of 2014 it reached its highest historical level of 55.1%⁶², indicating a continuation of the trend of de-euroization.

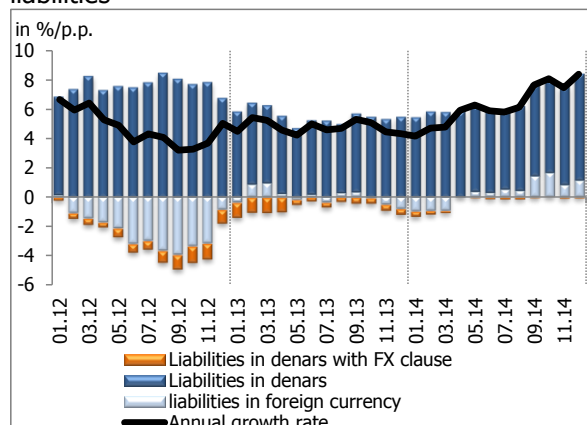
The application of the reserve requirement ratio of 0% on part of the liabilities of natural persons⁶³ contributed to further improving the maturity structure of banks' liabilities. Thus, in 2014 the growth of household deposits was mostly due to the increased long-term deposits (in domestic and foreign currency) on which a reserve requirement of 0% is applied, while short-term deposits had a marginal contribution to the change in the deposits of natural persons. On the other hand, the application of 0% on the liabilities to non-residents had relatively limited effects on the reserve requirement, given the further deleveraging of banks based on credit lines from abroad. In accordance with these trends, the application of the reserve requirement ratio of 0% on part of the banks' liabilities in 2014 influenced the release of liquidity in the banking system totaling Denar 66 million.

⁶¹ Reserve requirement ratio for liabilities in domestic currency amounted to 8%, for the liabilities in foreign currency it is 15%, while the rate of 20% is applied to liabilities in domestic currency with foreign currency clause. Zero percent reserve requirement ratio is applied for banks' liabilities to natural persons, with contractual maturity of over two years; liabilities based on repo transactions in domestic currency; liabilities based on debt securities issued in domestic currency and original maturity of at least two years, and liabilities to non-residents - financial institutions in domestic currency, in domestic currency with FX clause and in foreign currency, with contractual maturity of over one year and liabilities to non-residents in domestic currency, in domestic currency with FX clause and in foreign currency, with contractual maturity of over two years. Moreover, 30% of the reserve requirement in foreign currency is fulfilled in denars. Since February 2014, the National Bank has not been remunerating the reserve requirement.

⁶² The effects of the application of differentiated rates of reserve requirement are assessed on the basis of data on the banks' liabilities included in the basis for calculating the reserve requirement.

⁶³ Since the beginning of 2012, reserve requirement ratio of 0% was applied for these deposits.

Chart 62
Contribution to the annual growth rates of bank liabilities



Source: NBRM

Chart 63
Contribution to the annual growth rates of household deposits

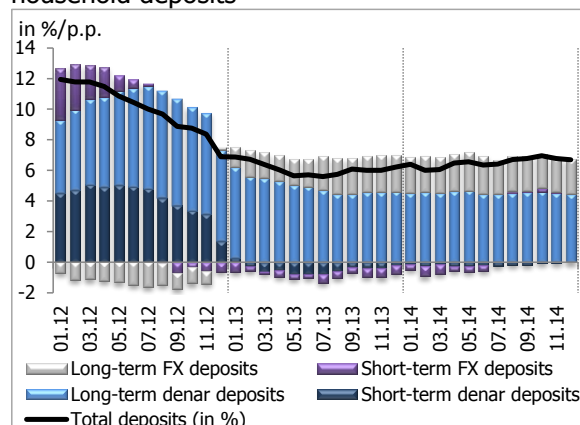
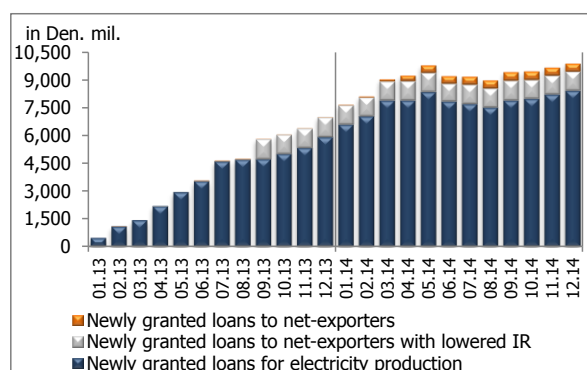
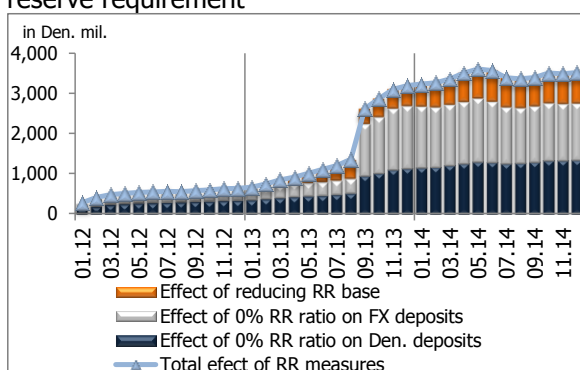


Chart 64
New loans to selected sectors



Source: NBRM

Chart 65
Cumulative liquidity effect of measures in the reserve requirement

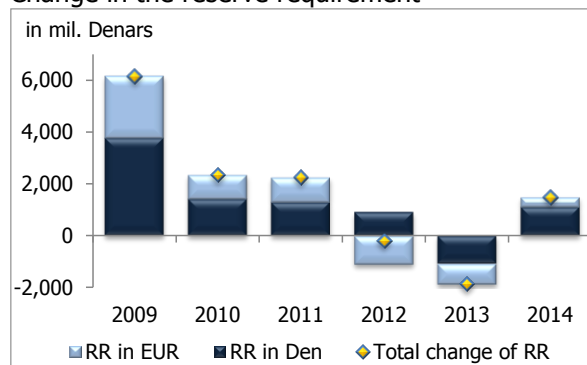


Given the further implementation of the non-standard measure in the reserve requirement, the amount of loans extended to systemically important sectors for the domestic economy in 2014 rose by Denar 2,883 million (to Denar 9,878 million), so that this measure had an additional contribution to the growth of banks' lending activity. Analyzing the structure, the annual growth (of 41%) of total loans extended to these sectors (net exporters and manufacturers of electricity) was due to loans to net exporters, which have a dominant share (of 96%) in the loans to sectors that are systemically important for the domestic economy. Relatively favorable trends were registered in the currency structure of loans extended to net exporters and producers of electricity, so that in 2014 Denar loans registered faster growth (by Denar 2,573 million), whose relative share in the amount of newly extended, targeted loans reached 59% at the end of the year. Analyzed by bank, large banks, which account for 83% in the total amount of newly granted loans, were most interested in using the measure, while medium and small banks have significantly lower activity in this segment of lending. As a result of the reduced base of the reserve requirement in denars for the newly approved loans to net exporters and producers of electricity, in 2014 the reserve requirement in denars was lower by Denar 262 million.

The application of these macroprudent measures in the reserve requirement in 2014 resulted in releasing liquidity in the banking system in the amount of Denar 328 million, whereby the cumulative effect of these measures from the beginning of their application until December 2014 amounted to Denar 3,519 million. The combined effect of the

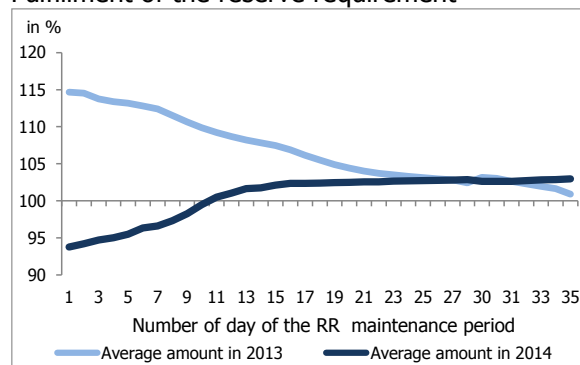
application of non-standard measures in the reserve requirement and the growth of banks' liabilities in 2014, resulted in an increase in total reserve requirement of banks by Denar 1,494 million.

Chart 66
Change in the reserve requirement



Source: NBRM

Chart 67
Fulfillment of the reserve requirement



In 2014, the dynamics of fulfillment of the reserve requirement was different compared with the previous year. Thus, unlike in 2013, when the banks accumulated excess liquidity at the beginning of the periods of reserve requirement, in 2014 banks started the periods of fulfillment with lower level of liquid assets in relation to the reserve requirement, and by the end of the period they accumulated liquid funds in order to meet the reserve requirement. The biggest impact toward changing the strategy for fulfillment of the reserve requirement was that of the increased interest of banks in CB bills and the high amount of funds placed in seven-day deposit facility at the beginning of the period of reserve requirement.

5.4. Repo operations for liquidity creation in the banking system

In 2014, the National Bank continued to conduct regular weekly auctions for repo transactions in order to provide liquidity support and ultimately stimulate long-term placements of banks⁶⁴. At the auctions for repo transactions, the supply averaged Denar 520 million, and banks showed interest only in 6 auctions, at which liquid assets in the average amount of Denar 312 million (from Denar 50 million to Denar 1,200 million) were approved.

5.5. Collateral in the conducting of monetary operations

In 2014, the National Bank expanded the List of securities for conducting monetary operations by including government bonds with maturities from three to ten years⁶⁵ and reviewed the coverage ratios. Thus, with the extension of the maturity of issued government securities in the primary market and growth of banks' investments in longer-term instruments, greater flexibility in banks' liquidity management is provided.

Annex 2. Money market

In 2014, banks actively traded on the money markets⁶⁶, whereby the turnover in interbank deposits was the highest in five years, while the turnover in securities reached its

⁶⁴ Auctions for providing seven-day liquidity are conducted once a week, i.e. every Friday.

⁶⁵ In 2014, the Ministry of Finance first issued government bonds with maturity of ten years.

⁶⁶ Money market in Macedonia includes the following segments: the uncollateralized deposit market, secondary market of short-term securities and long-term securities, secured deposits market (repo market).

historically highest level. Amid unchanged monetary policy stance, and in circumstances of lowered interest rates on banks' standing deposits with the National Bank and growth of liquidity under the influence of autonomous factors, market interest rates registered a moderate decline.

The role of money markets in the process of transmitting the effects of the monetary policy measures is of particular importance for central banks. In 2014, the money markets in the Republic of Macedonia registered increase in the trading volume, so that the total annual turnover was higher by 71%, mainly due to increased trading on the interbank market for uncollateralized deposits.

Chart 68
Turnover on the interbank market

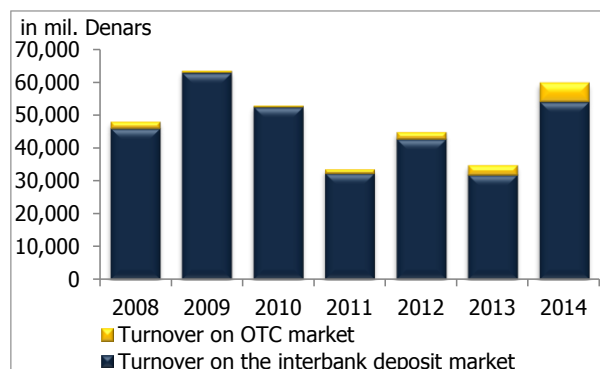
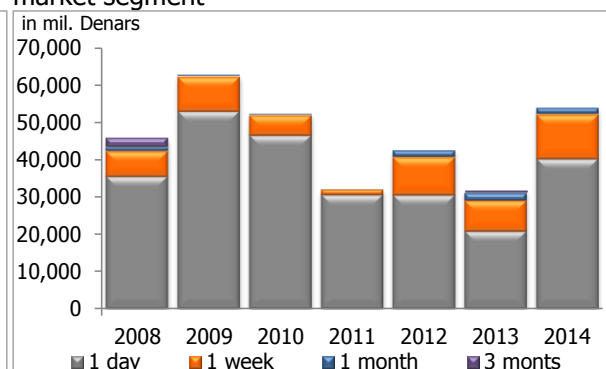


Chart 69
Structure of turnover on the uncollateralized market segment

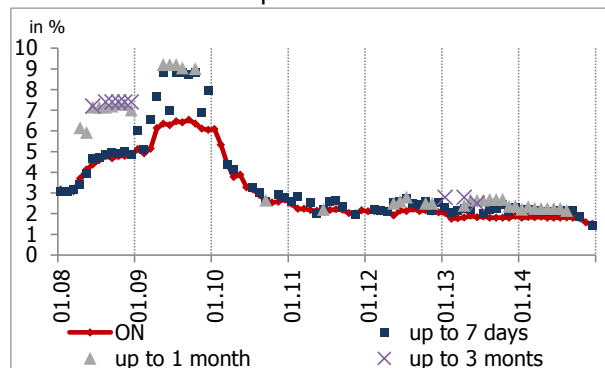


Source: NBRM

Analyzing the dynamics of the market of uncollateralized deposits, trading registered an upward trend in the first seven months. By the end of the year, amid growth of bank liquidity, the demand for liquid assets halved. Analyzing the maturity structure of the turnover on the interbank market for uncollateralized deposits, the turnover was dominated by transactions with overnight maturity, with simultaneous increase in the share of transactions with maturities longer than one day.

Amid relatively high liquidity in the banking system, interest rates on the interbank market of uncollateralized deposits registered a moderate downward trend. In 2014, the average interest rate MKDONIA equaled 1.79% and was lower by 0.07 percentage points relative to the level registered in the previous year. Also, lowering the interest rate on the standing deposits with seven-day maturity by cumulative 0.5 percentage points had a certain influence on the formation of market interest rates on uncollateralized deposits with corresponding maturities, so that at the end of the year, the interest rate on interbank deposits with maturity up to one week (1.4%) was lower by 0.9 percentage points annually. Quoted interest rates SKIBOR registered a downward movement along the yield curve in 2014.

Chart 70
Interest rates on the market
of uncollateralized deposits



Source: NBRM

Chart 71
Quoted interest rates SKIBOR

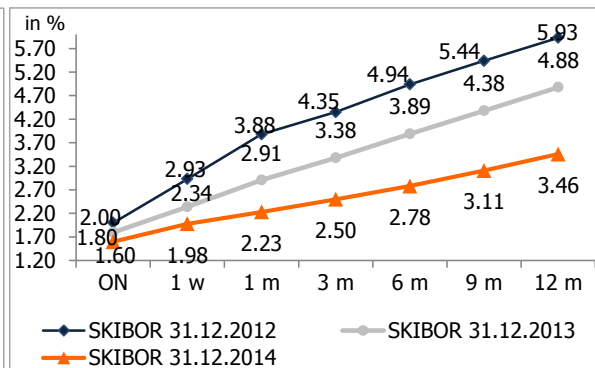
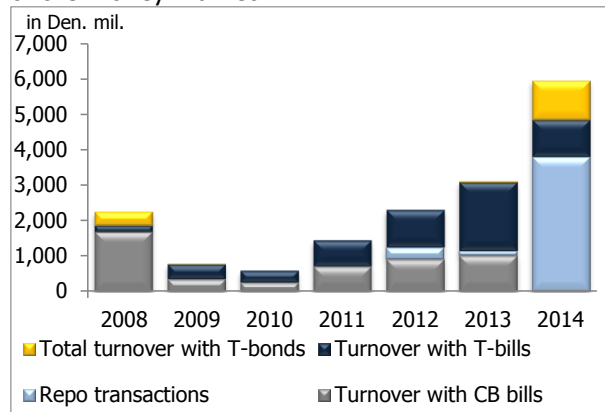
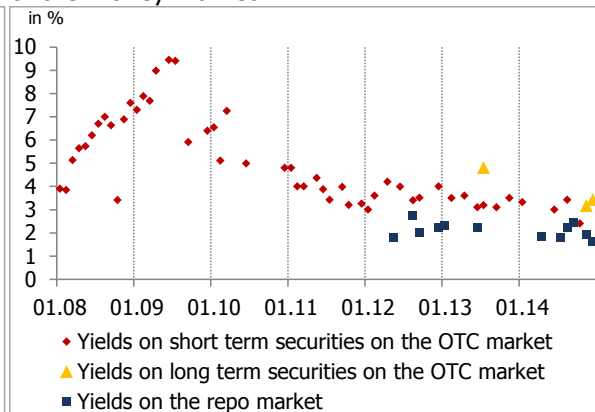


Chart 72
Structure of the collateralized segment
of the money market



Source: NBRM

Chart 73
Yields of the collateralized segment
of the money market



In 2014, annual growth in turnover was registered also on the secondary money market, i.e. there was a significantly increased trading in securities. Trading on this market segment reached 10% of the total trading in the money market, which is an important indicator of deepening of the market and was almost twice higher on an annual basis, thus reaching its historically highest level (of Denar 5,939 million). The growth in turnover was registered in repo transactions conducted with long-term government securities, amid increased share of this type of securities in the portfolios of market participants. Given the reduced interest rates on government securities in the primary market in 2014, yields on the secondary market of government securities moved in a downward direction.

VI. Foreign reserves management

The management of the foreign reserves of the Republic of Macedonia (hereinafter referred to as: foreign reserves) is one of the main functions of the National Bank in accordance with the Law on the National Bank of the Republic of Macedonia. Given the low yields and significant volatility in the international financial markets, the strategic allocation of foreign reserves in 2014 was set in a way that provides an optimal balance of compliance with the principles of safety, liquidity and profitability of the foreign reserves management.

Foreign reserves management is closely related to the monetary policy conduct, and in this context, the euro has a predominant share in the currency composition of foreign reserves, aimed at supporting the applied monetary strategy of a de facto fixed exchange rate of the denar against the euro. Maintenance of adequate level of liquidity of the foreign reserves is achieved by managing two portfolios - liquidity and investment portfolio where:

- The liquidity portfolio aims to provide sufficient funds on disposal to be able to meet the daily liquidity needs for intervening on the foreign exchange market and executing Government transactions abroad.
- The investment portfolio aims to invest funds in the longer term in order to generate higher return, with most of the investments being diversified into liquid securities, which in case of need for additional liquidity could be easily converted into liquid assets without additional costs.

Also, in order to preserve the national wealth, within the foreign reserves a steady amount of gold is held, as a strategic commitment to maintain assets with the highest level of security.

6.1. Basic guidelines for managing foreign reserves

In 2014, movements in the international financial markets were influenced by divergent monetary policies of the central banks of the USA and the Euro area. The sluggish performance of the economy of the Euro area contributed to maintaining extremely low yields on financial markets in both the European Monetary Union and in other countries to which the Euro area is the main trading partner. In this context, and in accordance with the main principles of managing foreign reserves, the investment strategy was adjusted to market conditions. The structure of the liquidity portfolio and the currency composition of foreign reserves were revised, simultaneously **enhancing the diversification of foreign reserves** by their allocation in a wider range of financial instruments. In this context, the National Bank envisaged the **following modifications to the main guidelines in the foreign reserves management in 2014:**

- In terms of placement of funds from the liquidity portfolio, the scope of eligible instruments was expanded by introducing placements in government debt securities with residual maturity of up to one year.
- Regarding the currency structure, investments in US dollars and British pounds were increased, according to the movements of these currencies against the movements of the euro (where the euro has maintained its dominance).
- Within the investment portfolios, investment in German and French collateralized⁶⁷ securities based on claims on the government authorities were made possible.

⁶⁷ The secured bonds are debt securities collateralized by cash flows from mortgages or loans extended to the public sector.

In the context of the adjustment of investment strategy, the framework for managing risks of foreign reserves investment underwent appropriate changes, as well:

- By expanding the scope of eligible instruments within the liquidity portfolio, criteria for long-term credit rating for government securities which are part of the liquidity portfolio were revised and simultaneously limits on short-term credit rating for these investments were introduced, having in mind the maturity of up to one year;
- In order to achieve optimal investment structure and adequate control over the credit risks, also the quantitative restrictions by type of security and issuer were revised, by increasing the share of securities issued by countries in a currency other than their national currency, and by government agencies;
- Given the perceptions of an improved regulatory framework and stability of the banking sectors in the economies where foreign reserves are invested, placing short-term deposits in commercial banks was allowed;
- In order to manage interest rate risk more effectively, a portfolio of securities held to maturity in US dollars was established;
- The reference portfolios were adjusted to mirror more realistically the basic strategic framework of investment of foreign reserves.

6.2. Investment conditions at the international financial markets in 2014

In 2014, the US economy recorded a solid growth rate of GDP (of 2.4% annually), primarily due to the positive contribution of private consumption and investments, confirming the strong economic fundamentals of the country. In circumstances of reducing the rate of unemployment and revival of the economic activity in the United States, during the year the Fed continually reduced the amount of monthly purchase of securities and at the end of October a decision was made to discontinue the monthly purchase of securities, according to the third program for quantitative easing (QE3).

The Euro area was on the path of economic recovery and achieved moderate growth (0.9% annually), which is still low compared with the growth of the United States. Despite the slow economic recovery, an additional challenge in the Euro area was also the reduction in inflation, which has been declining steadily and fell significantly below the target in the medium run (2%). In such conditions, in June, the ECB applied a package of stimulating measures, which included reduction of key interest rates⁶⁸, increased liquidity in the short run and introduction of targeted long-term refinancing operations. In order to further improve credit flows and thereby economic activity, as well as to increase inflation expectations, in September the ECB announced the start of the application of non-standard monetary measures in the form of programs for purchase of securities, which will last at least two years⁶⁹.

Given the divergent policies conducted by the ECB and the Fed during the year, expanded spread between yields on government bonds of these countries was registered. Namely, the spread between the yields on ten-year government bonds of the euro area and the United States increased from about 105 basis points to 167 basis points at the end of the year, mainly reflecting the differences in the expected economic growth and divergent

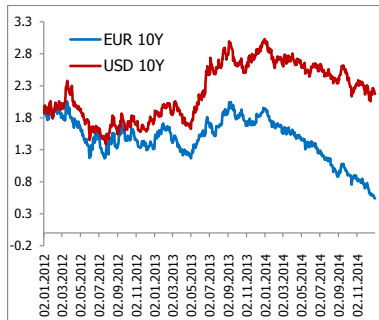
⁶⁸ On 05 June 2014, the ECB cut the interest rates: interest rate on the refinancing operations from 0.25% to 0.15%, the interest rate on overnight credits from 0.75% to 0.40%, the interest rate on overnight deposits from 0% to -0.10%. Also, on 4 September the ECB again decided to reduce the interest rate on refinancing operations (to 0.05%), on the interest rate on overnight credits (to 0.30%) and on the interest rate on overnight deposits (to -0.20%).

⁶⁹ In October the covered bond purchase programme (CBPP3) was launched, and in November was the initiation of the asset-backed securities purchase programme (ABSPP).

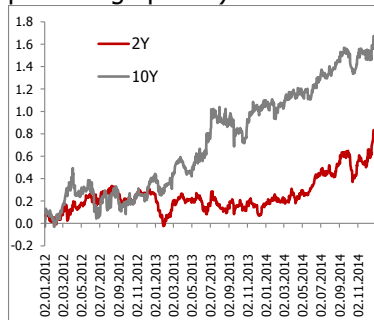
trajectories of interest rates and yields. At the same time, within the Euro area, narrowing of the spread between yields on government bonds of core countries in the Euro area relative to the yields on the bonds of peripheral economies was registered⁷⁰, given the search of market participants of higher-yielding instruments.

Chart 74

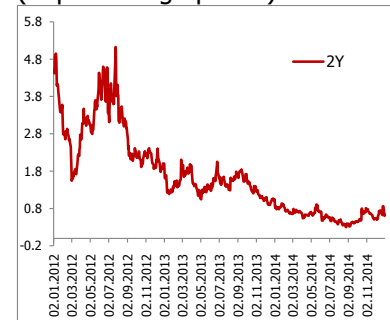
Yields on government bonds (%)



Spread of the yields of US and European government bonds (in percentage points)



Spread of the yields of German and Italian government bonds (in percentage points)

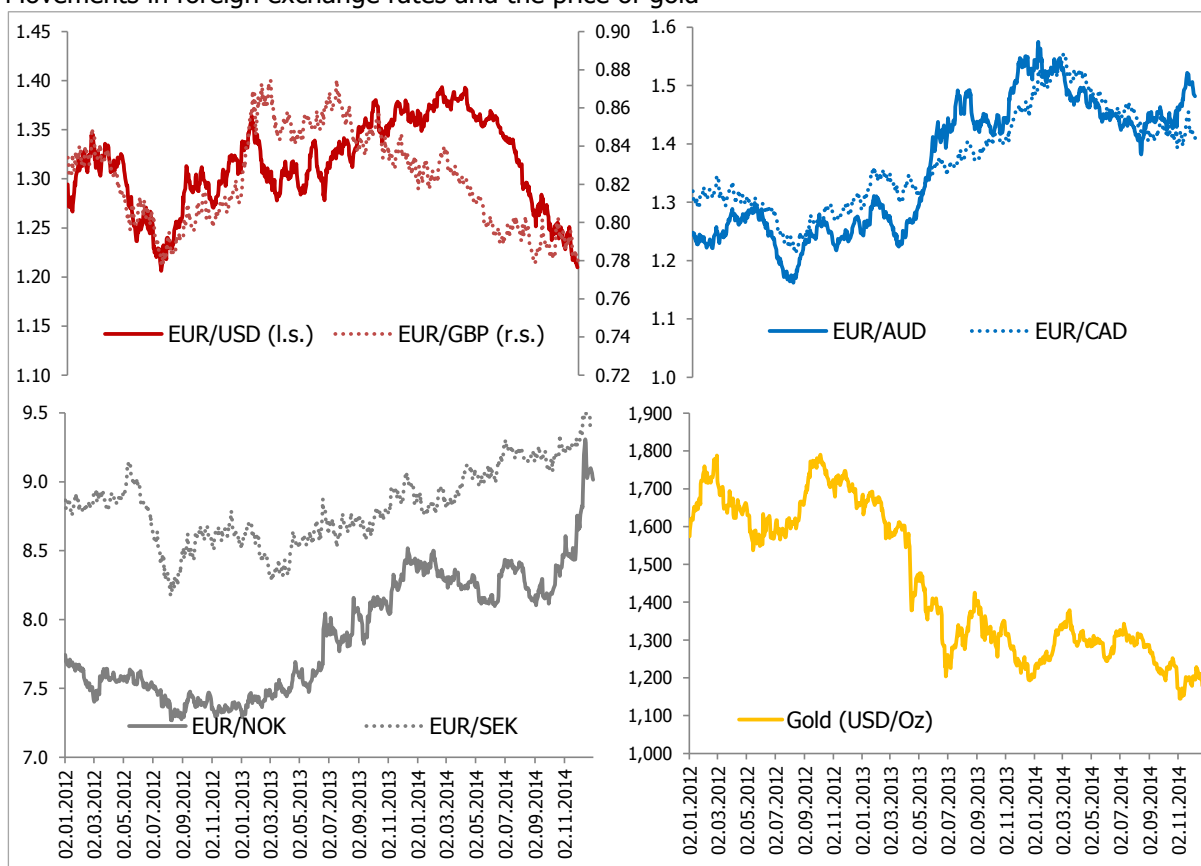


Movements in global foreign exchange markets were influenced by the appreciation of the US dollar against the leading world currencies. Thus, the relaxed monetary policy of the ECB on the one hand and the abandoning of the quantitative easing by the Fed on the other, led to appreciation of the US dollar against the euro. Considering that the leading currencies in the foreign exchange market are traded through the US dollar, their relationship to the euro is determined by their performance in relation to the US dollar. The Norwegian krona and Swedish krona registered the highest depreciation against the euro⁷¹. On the other hand, British pound, Australian dollar and Canadian dollar registered more moderate depreciation against the US dollar compared to the euro, which led to their appreciation against the euro.

⁷⁰ The spreads of the yields on two-year bonds fell from about 225 basis points to 134 basis points, influenced by the reduced risk premium in the euro area.

⁷¹ The depreciation of the Norwegian crown was stronger in the second half of the year because of the increasingly emphasized speculation for easing of the monetary policy by the Norwegian central bank, which materialized at the end of the year when the central bank of Norway cut its benchmark interest rate from 1.5% to 1.25%. The depreciation of the Swedish krona was affected by the significant easing of the monetary policy by the Swedish central bank which reduced the policy rate twice, in July and October, bringing it to the level of 0%.

Chart 75
Movements in foreign exchange rates and the price of gold



In 2014, the price of gold remained almost unchanged on annual basis⁷², but during the year it registered some changes. In the first half of the year, the price of this precious metal was variable, with upward tendencies being present because of the increased political tensions in Ukraine and increased demand from China, while the downward adjustment was mainly due to the favorable economic indicators for the US economy. In the second half of 2014, gold prices generally registered a downward trend, which mainly reflected the favorable macroindicators for the US economy and the appreciation of the US dollar, so that at the end of the year the price stabilized at a level similar to that registered at the end of the previous year. Also, during 2014 rising demand for gold by central banks continued. On a net basis they purchased 477 tons, i.e. 17% more than in 2013⁷³. This is the second year of the highest net purchasing of gold by central banks in the past 50 years, since 2012 when central banks purchased 544 tones, net.

6.3. Investment of the foreign reserves

When managing foreign reserves, the structure of investments is determined by the basic strategic framework and the appropriate actions taken in order to maintain flexibility in the management of foreign reserves, amid volatile movements in international financial markets.

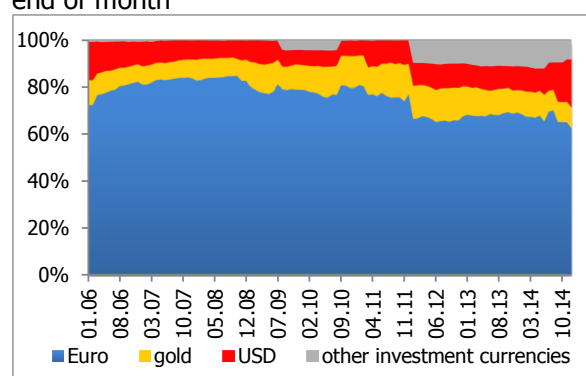
⁷² At the end of 2014, the price of gold was 1,199.3 US dollars/ounce, which is lower than the price at the end of last year only by 2.25 US dollars.

⁷³ World Gold Council.

6.3.1. Currency structure

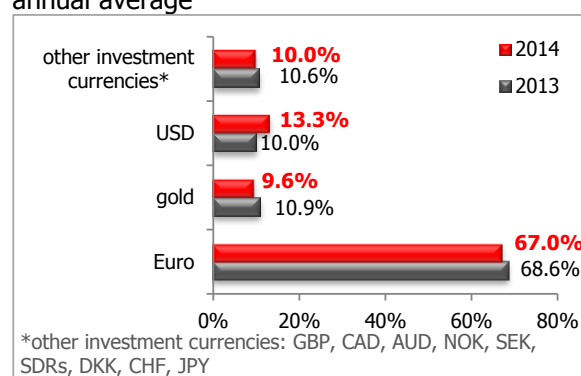
During 2014, currency diversification, which was conducted in the framework of foreign reserves investment in the past two years, was carried out with due observance of the basic strategic orientation in terms of the currency structure of foreign reserves. In this context, predominant in the composition of foreign reserves by currency are the assets invested in financial instruments denominated in euros with an average share of around 67%. The share of US dollar in the currency structure registered moderate growth, with an average share of around 13% of the reserves. The average annual share of other investment currencies was 9.8%, and compared with the previous year it registered a moderate decline. The investments in US dollars and other currencies in 2014 are in accordance with the envisaged investment restrictions.

Chart 76
Currency structure of the foreign reserves
end of month



Source: NBRM

annual average



In 2014, the share of gold in the currency composition of foreign reserves registered a moderate decline, which came as a result of the moderate reduction in the price of gold on international markets but which is primarily due to the rising amount of foreign reserves⁷⁴, amid unchanged quantity of gold within the reserves.

6.3.2. Credit exposure and liquidity of investments

The safety of the foreign reserves investment is very important in profiling the investment strategy that the National Bank applies in managing foreign reserves. For that purpose, when defining the scope and the quantitative restrictions of the investments by country, the internal credit rating is taken into consideration, besides the high long-term credit rating given by the international rating agencies⁷⁵.

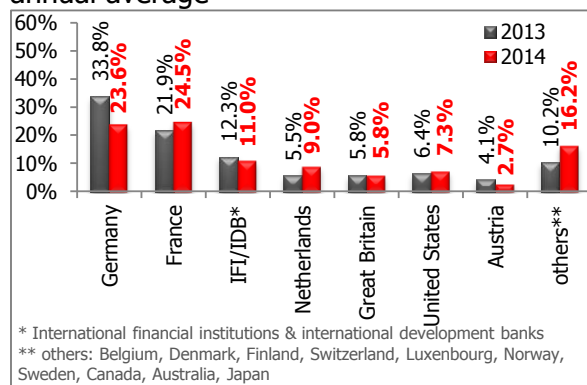
In accordance with the envisaged investment framework, the largest share of the foreign reserves (about 57% on average, during the year) was invested in financial instruments of the Euro area core countries - Germany, France and the Netherlands, as well as international financial institutions and international development banks (11%). The profile of the founders of these institutions, the level of capital they manage, as well as the

⁷⁴ During 2014, foreign reserves increased by Euro 443.5 million. The growth of foreign reserves which was mostly due to the inflow of funds based on the issuing of the Eurobond in the amount of Euro 491.1 million, significantly exceeded the outflows for regular servicing of public debt and payments of the government liabilities abroad. Also, the market value of foreign reserves increased by Euro 70 million, mainly due to the rising value of the US dollar.

⁷⁵ The framework for determining internal credit rating covers more macroeconomic indicators (public debt, budget balance, annual GDP growth, current account balance, inflation), market indicators (a rating determined by the market) and financial indicators (a rating for the risk of the banking sector given by the rating agency "Standard & Poor's").

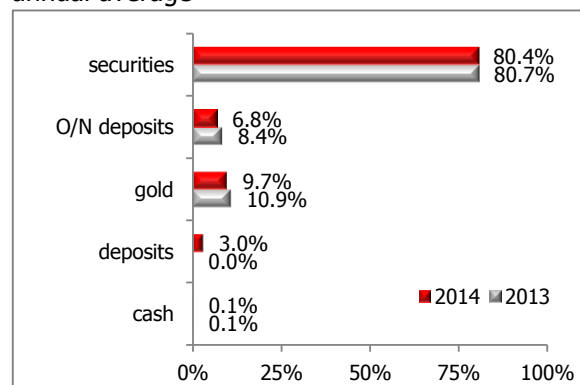
precautionary operating and financial policies applied, encourage the market participants to perceive these international financial institutions as issuers of financial instruments with a high degree of security and safety.

Chart 77
Geographical structure of foreign reserves, annual average



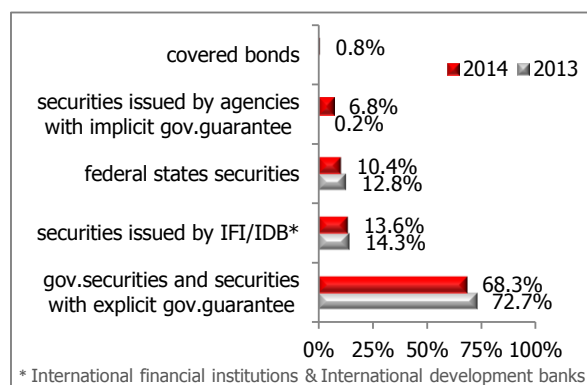
Source: NBRM

Chart 78
Investments structure, by instrument annual average



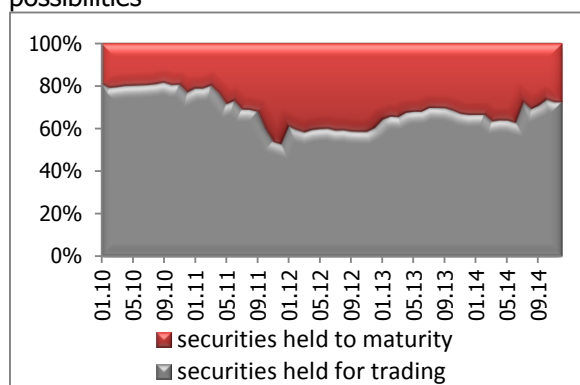
The liquidity of the foreign reserves has been provided primarily by maintaining the liquidity portfolio in euros and US dollars, in short-term liquid assets - mainly sight deposits and liquid short-term government securities. The liquidity of the foreign reserves is also provided through investments in securities, which with an average share of 80.4% dominate in the foreign reserves' structure by instrument. During 2014, most of the investments in securities, i.e. approximately 68.3%, were directed towards government securities and securities with an explicit government guarantee, which allows optimal compliance with the principles of safety and liquidity of placements. Investments in instruments issued by international financial institutions⁷⁶ also had a more significant share (13.6%). Beside the high level of safety of the invested funds, they also bring higher yield compared to government securities. At the end of the year, within the process of diversification of investments by financial instrument, investment in collateralized securities was introduced.

Chart 79
Structure of securities by issuer, annual average



Source: NBRM

Structure of securities according to trading possibilities



In line with the strategic commitment to limit price changes caused by the movements on international financial markets on the performances from the investment of

⁷⁶ European Bank for Reconstruction and Development (EBRD), European Investment Bank (EIB), International Bank for Reconstruction and Development (IBRD), International Finance Corporation (IFC), the Nordic Investment Bank (NIB).

foreign reserves⁷⁷, during the year, one third of the investments in securities were within the portfolio of securities held to maturity. At the same time, in order to limit the effects of price fluctuations, foreign reserves have been invested in securities with a relatively short target modified duration (of about one year), which was revised during the year.

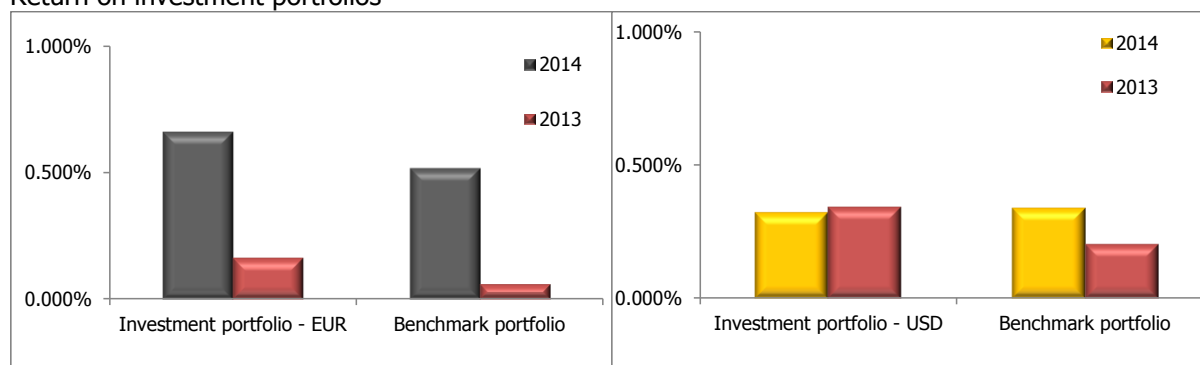
In 2014, the National Bank continued to use the lending securities transactions that are carried out by simultaneous concluding of repo and reverse repo transactions⁷⁸. Gold, which is usually a financial instrument with lower market yield, during the year was placed in the short-term deposits with foreign commercial banks. When selecting banks that perform such transactions, besides the long-term ratings, also the additional indications for perceiving short-term credit position of foreign banks are analyzed.

6.3.3. Results from investments of foreign reserves

In 2014, the yields on financial instruments in which the National Bank invests were held at low levels, however, the achieved performance of the investment of foreign reserves justify the investment strategy applied. The performance in investment portfolios in euros exceeded the return of the referent market indices⁷⁹, confirming the decisions of the National Bank in terms of diversification of the financial instruments' structure the foreign reserves were invested in. The performance in the investment portfolio in US dollars slightly deviates from the return on the reference market indices, due to the composition of the index under which the participation of agency securities is higher and includes issuers of securities which are not covered by the investment strategy of the National Bank. In relation to the decision to invest part of the reserves in other currencies, this year too, the justification of the investment decision is confirmed, with the return on investments in original currency ranging from 0.97% to 3.59%.

The total rate of return on foreign reserves in 2014, which in addition to the realized income also includes the estimated price change, was 0.89% annually.

Chart 80
Return on investment portfolios



Source: NBRM

⁷⁷ Securities held to maturity, in accordance with international accounting practices, are stated at amortized cost and are not subject to unpredictable fluctuations in price.

⁷⁸ As collateral of borrowed securities from the National Bank's portfolio, securities that meet the criteria for investment of foreign reserves are obtained.

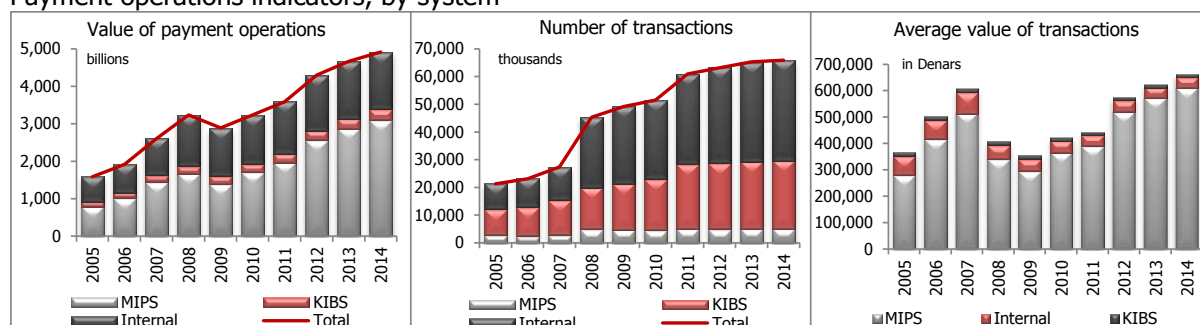
⁷⁹ Referent index of securities' prices and money market index, comprised of real financial instruments, with modified duration, which corresponds to the target modified duration of the investment portfolio.

VII. The role of the National Bank in the payment systems

One of the primary functions of the National Bank is to create conditions for stable, reliable and efficient operations of the payment systems. To exercise this function, the National Bank, pursuing the best practices of central banks of the EU member states, performs four primary roles in the payment systems: *operational, oversight, development and catalyst role*.

The National Bank performs the operational role in payment systems by managing and operating the Macedonian Interbank Payment System (MIPS), which is a real-time gross settlement system of the National Bank. The total number of direct participants⁸⁰ in MIPS in 2014 decreased by one, as a result of the merger of two banks, and as of December 2014 there were twenty-three direct participants. During 2014, the system operated with availability of 100.0%. The system processed averagely 20,403 transactions per day and the maximum number of processed transactions per day reached 67,022. In 2014, the annual growth of total number of settled transactions in MIPS equaled 1.1%, while the average value per transaction went up by 6.9% annually, to Denar 609,450.

Chart 81
Payment operations indicators, by system



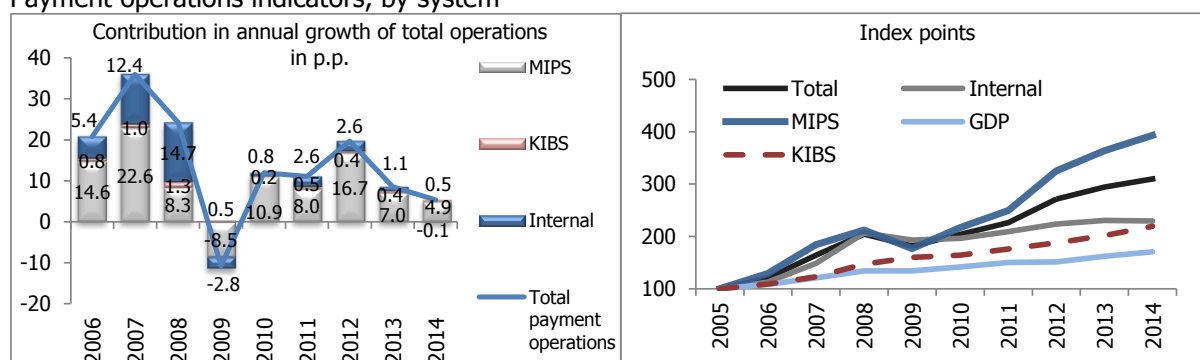
Source: NBRM

In 2014, the total value of realized payment operations in the Republic of Macedonia went up by 5.3% annually, mainly due to the increased turnover carried out through MIPS, which registered an annual growth of 8.0%. The growth in the total value of payment operations is identical with the growth of the nominal GDP in 2014⁸¹ (5.3%). The high correlation of the total payment operations (0.98), the turnover of its segments MIPS (0.95), KIBS (0.99) and internal payment operations (0.95) with the nominal GDP indicates that the current revival of the economic activity in the country reflects positively on the developments in payment operations.

⁸⁰ MIPS participants at the end of 2014 include: the National Bank, fourteen commercial banks, the Macedonian Bank for Development Promotion - AD Skopje, the Ministry of Finance of the Republic of Macedonia, the Health Insurance Fund of Macedonia, the Interbank Clearing Systems - AD Skopje, the Central Securities Depository - AD Skopje, International Card Systems - CASYS, MasterCard International and Fershped Broker AD Skopje.

⁸¹ Estimated data, source: State Statistical Office.

Chart 82
Payment operations indicators, by system

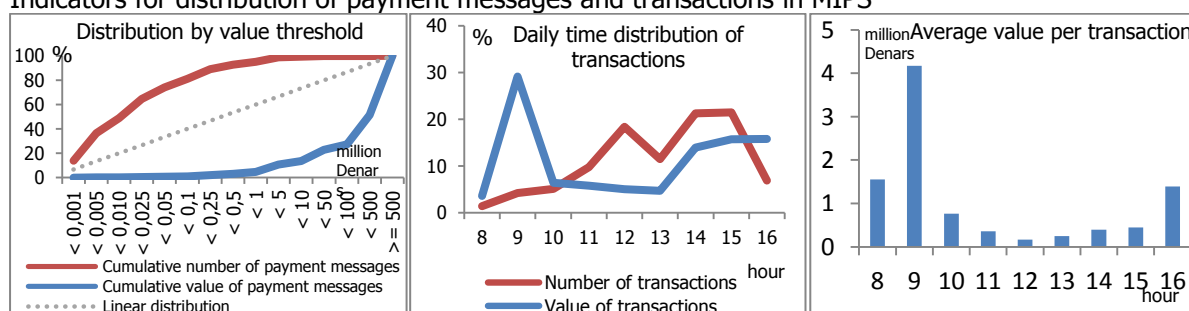


Source: NBRM

In 2014, the distribution of the number of payment messages carried out by the MIPS according to defined thresholds of the value of an individual payment message shows the largest share (22.7%) of payment messages worth Denar 1,000 to Denar 5,000, with about 95% of the total number of payment messages being worth below Denar 1 million. The distribution of value of payment messages carried out by MIPS shows the largest share (48.4%) of payment messages worth over Denar 500 million, with payment messages worth over Denar 1 million accounting for 95% of the total turnover carried out through MIPS.

Daily time distribution of transactions through MIPS shows that most of the transactions (21.5%) were settled between 15:00 and 16:00, with about 80% of transactions being settled between 11:00 and 16:00. Analyzing the value of transactions, the highest value of transactions (with an average value per transaction of Denar 4.2 million) was settled between 9:00 and 10:00 (29.1% of the total value of transactions during the day), while, the smallest value of transactions (3.6%) was settled between 8:00 and 9:00 (with an average value per transaction of Denar 1.5 million).

Chart 83
Indicators for distribution of payment messages and transactions in MIPS⁸²



Source: NBRM

In order to strengthen the oversight role of the National Bank in the payment systems during 2014 the Principles for Financial Market Infrastructure, the Disclosure Framework and the Methodology for Assessment were translated⁸³. Also, technical cooperation was carried out between the National Bank and the central banks of EU member states in order to exchange experiences on the application of these principles through the adjustment of the regulatory framework for oversight in the forthcoming period.

⁸² Payment message is an electronic form of payment instrument that can contain multiple individual transactions (e.g., summary payment order PP32 that allows transfer of funds from one payer to more beneficiaries).

⁸³ Principles for Financial Market Infrastructure are defined by the Committee on Payment and Settlement Systems at the Bank for International Settlements in Basel and the International Organization of Securities Commissions in April 2012.

In terms of achieving the development and catalyst role of the National Bank in the payment systems, during 2014, through the National Payments Council, the National Bank was actively involved in the process of implementation of the "Strategy for development of the payment system of the Republic of Macedonia in the period 2013 -2017". In this respect, the National Bank developed a new methodology for collecting data on payment statistics in compliance with the methodological framework of the European Central Bank, which is expected to be incorporated into the by-laws during 2015.

Continuing the practice of transferring knowledge and information to the country's financial sector regarding trends and developments in the field of payment systems at the international level, the National Bank, in cooperation with the central banks of the Netherlands and Portugal, in 2014 organized the Seventh Conference on Payment Systems and Securities Settlement. The conference was international and attended by representatives from the banking sector, payment system operators and regulators of financial market infrastructure in the Republic of Macedonia, as well as representatives from the central banks of Central and Southeastern Europe. At the conference the "Red Book for the payment, clearing and settlement systems in the Republic of Macedonia" was promoted, issued by the Bank for International Settlements in cooperation with the National Bank of the Republic of Macedonia. In addition, at the conference the latest trends in the payment area were presented, with special emphasis on financial inclusion, distribution and availability of payment services, as well as panel discussions on card and mobile phone payments and e-commerce. In this regard, the conference contributes to further enrich the knowledge of domestic experts in the field of payment systems and has a positive impact on increasing the capacity to improve the operational readiness of the National Bank to join the European System of Central Banks in the field of payments.

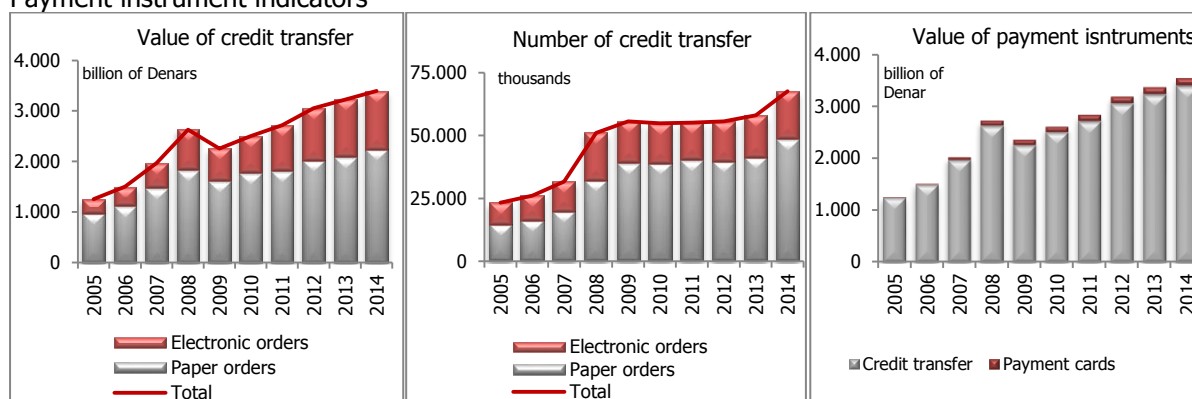
Annex 3. Trends in non-cash payments

Advances in technology in the field of payments in the world is rapidly transferred to the domestic payment operations by offering new technical and technological solutions for executing payments. Important innovation in credit transfers in 2014 was the introduction of the service "micropayment", i.e. use of mobile phone when buying products and services in a single amount not greater than Denar 1,000.00. Also, credit transfers initiated by mobile phone aimed at carrying out different types of payments by legal entities and natural persons, which the banks first offered in the second half of 2013, continued to grow rapidly. Regarding card payments, 2014 was marked by high rates of annual growth in the number (318%) and value (353%) of transactions initiated through the Internet.

In terms of types of payment instruments, also in 2014, credit transfers⁸⁴ had a dominant share in the total value realized by cashless payment instruments, which accounted for 96%, compared to payment cards, the share of which was 4%. Thus, in 2014 the total value of credit transfers (paper and electronic orders) amounted to Denar 3,392 billion, recording an annual growth of 5.2%. The number of credit transfers in 2014 amounted to Denar 67.6 million, which is an annual increase of significant 16.6%. Despite the higher share of paper orders in carrying out credit transfers (72% in the number and 66% in the value of credit transfers), the number of electronic credit transfers also shows high annual growth rate of 12.9%, while the value of electronic credit transfers recorded a more moderate annual growth of 1.2%.

⁸⁴ With the methodological changes in 2014, standing orders, including executive decisions, are covered under the credit transfers which consequently reflects in the number and value of credit transfers and their annual growth rates.

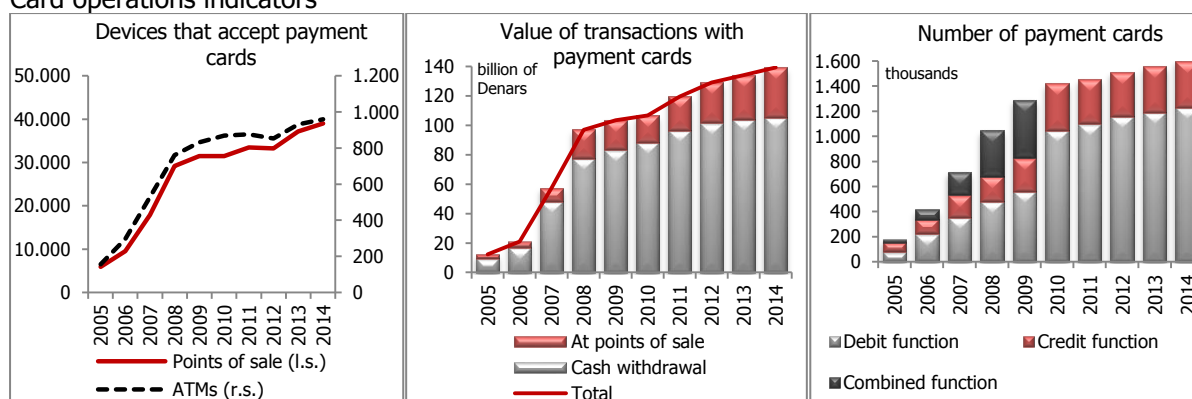
Chart 84
Payment instrument indicators



Source: NBRM

At the end of 2014, the total number of cards in circulation issued by commercial banks in the Republic of Macedonia was 1,601,445, of which 76.9% are debit cards and 23.1% are credit cards. The debit cards accounted for 86.3% of the total value of card-based transactions. In 2014, the value of card-based transactions totaled Denar 139.3 billion, which is a growth rate of 3.8% similar to that registered last year. Analyzing the structure, the share of non-cash payment in trade through points of sale in the value of card-based transactions increased, witnessing a trend of reduction of raising cash through ATMs. The constant expansion of the network of POS terminals confirms the existing uptrend of the use of payment cards in trade by households. In 2014 the value of transactions for the payment at points of sale in trade increased by 11.5% on annual basis, with relatively low annual growth of cash withdrawal through ATMs of 1.6%.

Chart 85
Card operations indicators

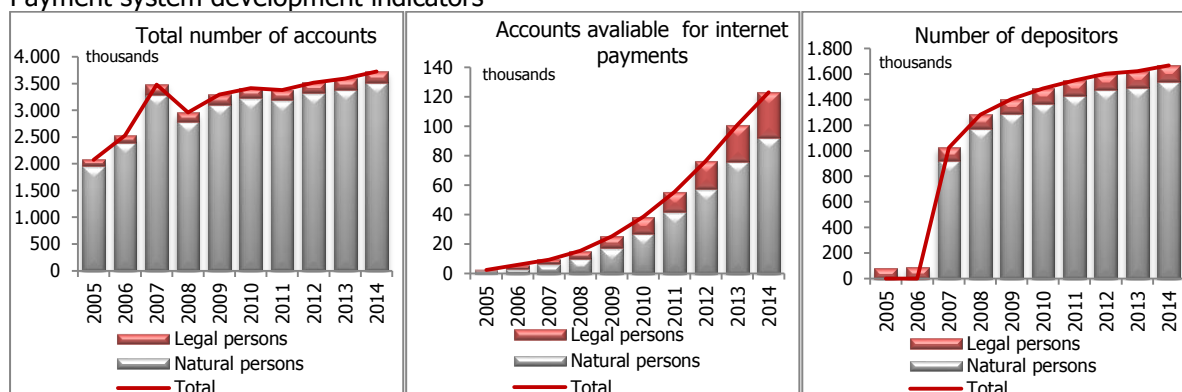


Source: NBRM

During 2014, the total number of open accounts recorded a moderate growth of 3.5%. The number of accounts of natural persons registered an annual growth of 3.8%, keeping the dominant share with 94.6% in the total number of open accounts. On the other hand, the number of open accounts of legal entities in 2014 registered a moderate decline of 0.5%, as a result of the coordinated activity of the National Bank, the banks, the Central Registry of the Republic of Macedonia and the "Clearing Interbank Systems" AD Skopje for deleting the accounts of closed legal entities. In 2014, the high growth of opening accounts available for Internet payment continued, with an annual growth rate of 22.0%. Of the total number of on-line payment accounts, 75.1% are accounts of natural persons, and 24.9% are accounts of legal entities, which registered faster annual growth (23.7%) compared to

the growth of the accounts of natural persons (21.4%). However, the share of on-line payment accounts in the total number of opened accounts is low (3.3% at the end of 2014).

Chart 86
Payment system development indicators⁸⁵



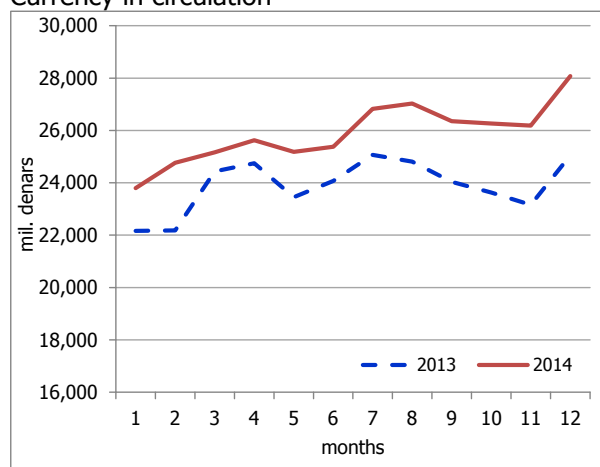
Source: NBRM

VIII. Issuance and management of the banknotes and coins of the Republic of Macedonia

8.1. Currency in circulation

As of 31 December 2014, the currency in circulation amounted to Denar 28,080 million, which is by Denar 3,035 million or 12.1% more compared to the end of 2013.

Chart 87
Currency in circulation



Source: NBRM

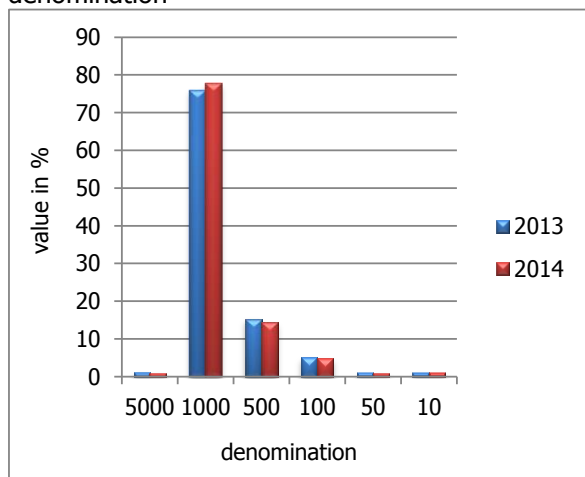
At the end of the year, banknotes and coins make up 97.4% and 2.6%, respectively of the total value of the currency in circulation.

In terms of the number of pieces of currency in circulation, the share of banknotes equals 28.0% (76.7 million pieces), and the share of coins equals 72.0% (197.3 million pieces).

Banknotes in denomination of Denar 1000 (77.7%) and Denar 500 (14.5%) account for the most of the total value of banknotes in circulation. Other banknotes account for 7.8% of the total value of banknotes in circulation. In 2014, coins in denominations of Denar 10 (27.5%), Denar 50 (23.5%) and Denar 5 (22.1%) had the largest share in the value of coins.

⁸⁵ Data on the number of depositors, natural persons, are available starting from 2007.

Chart 88
Value share of banknotes in the turnover, by denomination



Source: NBRM

Value share of the coins in the turnover, by denomination

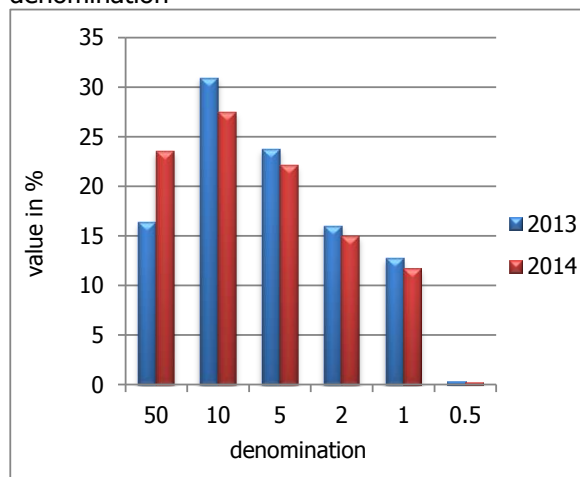
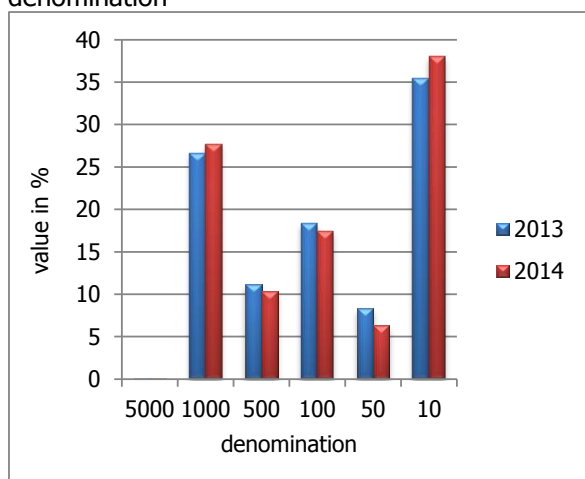
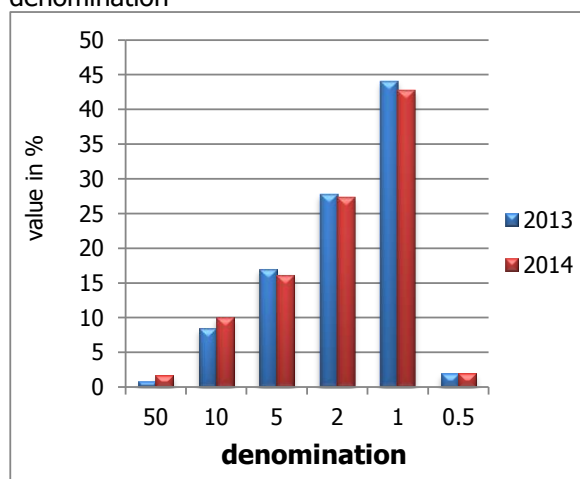


Chart 89
Quantity share of banknotes in the turnover, by denomination



Source: NBRM

Quantity share of coins in the turnover, by denomination

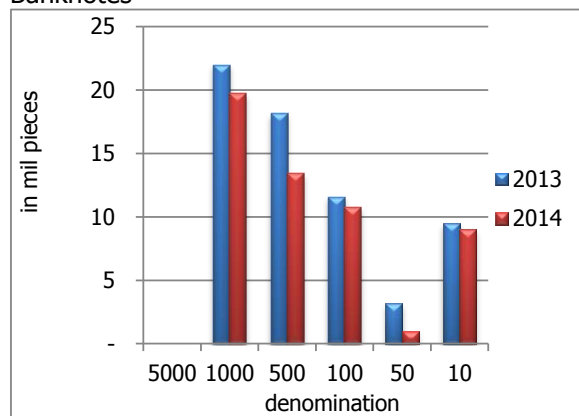


According to the number of issued pieces, the share of banknotes in denomination of Denar 10 (38.1%), Denar 1000 (27.7%) and Denar 100 (17.5%) was the largest. Other banknotes constitute 16.7% of the total quantity of banknotes in circulation. The coin in denomination of Denar 1 (42.8%) constitutes the most of the total coins in circulation.

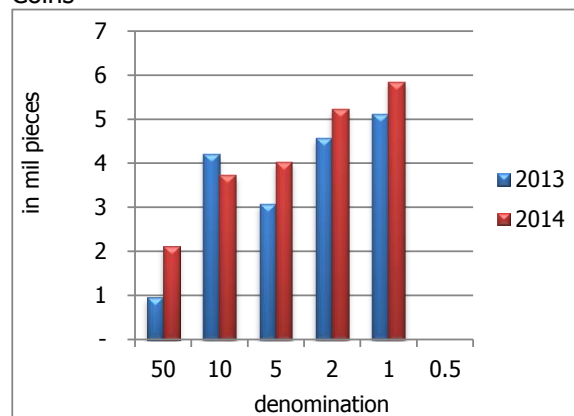
8.2. Supplying banks with banknotes and coins

During 2014, the central vault of the National Bank and the five sections for handling cash outside Skopje, distributed cash to banks amounting to Denar 27.9 billion (decline of 14.7% compared to 2013). At the same time, they received cash from banks in the amount of Denar 24.9 billion (decline of 21.2% compared to 2013). The analysis of the denomination structure of banknotes and coins suggests that, when issuing and receiving banknotes and coins, the most common banknote is the denomination of Denar 1000 with a share of 36.2% in 2014 (i.e. 34.7% in 2013) and the most common coin is the denomination of Denar 10 with a share of 24% in 2014 (versus 29.1% in 2013).

Chart 90
Quantity of cash issued to banks
Banknotes



Coins



Source: NBRM

8.3. Processing and destroying banknotes and coins

During 2014, the quality control process of banknotes in circulation in the central vault and in the subunits for cash operations in the country covered all received banknotes. Of the total processed banknotes, 13.6 million banknotes (13.9 million in 2013) were destroyed due to wear-out or damage. Most destroyed banknotes were denominated in Denar 1000 and Denar 100 (57.3%). In 2014, all coins in denominations of 1, 2, 5, 10 and 50 Denars that were received were processed, 154 thousand pieces of which being labeled as worn-out.

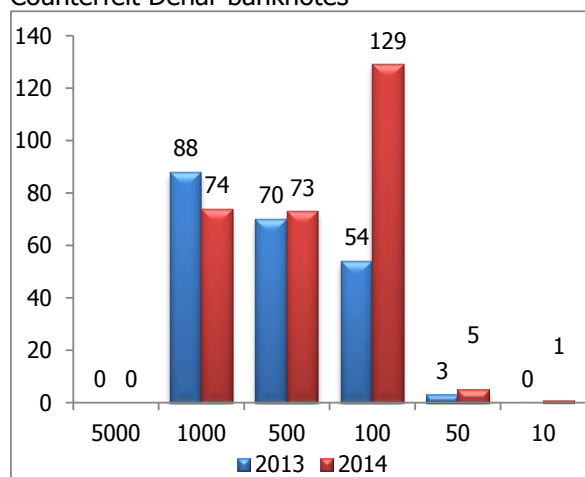
8.4. Expertise of suspicious/counterfeit money

In 2014, the National Bank, as a single institution authorized to identify the authenticity of banknotes and coins denominated in denars or in foreign currency, continued to perform expert analysis of counterfeit money successfully. In order to strengthen the capacity for accurate detection of suspicious and counterfeit money, in 2014, the National Bank continued with the training of staff in banks. Through presentations and direct handling of authentic and counterfeit money, expertise is shared with the participants.

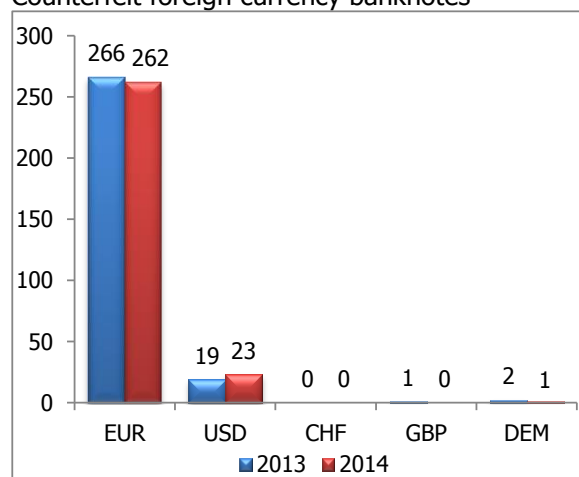
As for the number of expert analyses committed during 2014, of the total 297 suspicious Denar banknotes received, the expert analysis carried out found that 15 banknotes were genuine, while the remaining 282 were counterfeit banknotes. In 2014, the number of identified counterfeit banknotes increased by 31.2% compared to 2013. Of the total number of detected counterfeit Denar banknotes in 2014, the most common are the denominations of Denar 100, 500 and 1000. The total value of Denar counterfeits in 2014 amounted to Denar 123,660.00, which is a negligible share compared with the value of the currency put into circulation.

Chart 91

Counterfeit Denar banknotes



Counterfeit foreign currency banknotes



Source: NBRM

Concerning counterfeit foreign currency, 319 expert analyses of suspicious banknotes were made in 2014, identifying 286 counterfeit and 33 original banknotes. Of the total number of counterfeit banknotes, the Euro banknotes prevailed (262 pieces).

The general conclusion is that counterfeit banknotes are of relatively poor quality, allowing simple and easy identification of their features. The expert analysis of the technique of making counterfeit banknotes found that they are mostly made on a plain paper without security features, by using computer (scan and print) or color copy machine.

8.5. Issuance of collector coins

During 2014, the National Bank put into circulation two series of collector coins ("Icons of Saints" and "Zodiac Signs").

The collector coins are unique, representative and of great artistic value that contributes to the promotion of the Republic of Macedonia. The interest in buying collector coins is significant and since they were launched on 1 August 2014, until the end of the year 333 pieces were sold.

IX. Statistics

The National Bank is one of the authorized bodies for carrying out statistical surveys within the national statistical system in the Republic of Macedonia. The statistical function of the National Bank is defined by the Law on the National Bank of the Republic of Macedonia and the Law on State Statistics. Statistical research carried out by the National Bank is presented in the Statistical Survey Program. Currently, the National Bank produces comprehensive data on monetary statistics and interest rate statistics, balance of payments, international investment position, direct investments, external debt and claims, foreign reserves and foreign currency liquidity. The statistics are the basis for informing the public about the financial and macroeconomic environment and trends in the Republic of Macedonia, but also represent a key support to the decisions related to the core functions of the central bank.

The National Bank, within the statistical research in its jurisdiction, permanently undertakes activities for monitoring and compliance with international and European statistical standards. For this purpose, the National Bank constantly cooperates with the International Monetary Fund, the World Bank, the Bank for International Settlements, the European Central Bank and Eurostat, for improving the quality of available data, on the one hand, and for regular dissemination of statistical data to these institutions, on the other. More significant activities conducted during 2014 were the compliance with the new international statistical standards⁸⁶ in the field of external statistics, and in accordance with these activities, also in the EU Member States. Significant activities for further harmonization with European regulations were undertaken also within the interest rates statistics. This significant progress in the field of statistical research was confirmed by the evaluation in the Progress Report for the Republic of Macedonia in 2014, of the European Commission, where also the progress in establishing the statistics of financial accounts was noted. Special emphasis in the Report was placed on the fact that the new external statistics are published in consistent time series from 1998 to 2014.

In particular, progress was made in the statistics of following areas:

- in June 2014, the National Bank published a new set of standard reports in the area of external statistics (balance of payments, international investment position (MIP) and gross external debt and gross external claims), prepared in accordance with the new international standards defined by the International Monetary Fund in the Balance of Payments and International Investment Position Manual (BPM6) and the External Debt Statistics Guideline (2013). In order to ensure comparability of data, the National Bank also published revised time series, as well as new methodological explanations. In order to improve the communication with users, detailed information on presentational changes, methodological changes and their effects, were published on the website. At the same time, the international institutions (IMF, World Bank, BIS, Eurostat) submitted new time series data on external statistics, with an appropriate detailed presentation.
- also, in the area of external statistics, activities related to improving the coverage and detailed presentation of data on intercompany debt based on trade credits, were undertaken. In order to ensure further methodological harmonization of data sources for external statistics with the new international statistical standards, new bylaws were adopted which provide more detailed reporting on the assets and liabilities by type of capital relations with non-residents and entirely new software application for collecting and processing of data was developed. According to the plan of activities for improving the communication with reporters, the new application software introduced digital signing of data with electronic certificates. Also, training for reporters was conducted, which should facilitate reporting and contribute to a better quality of statistical reporting;
- as part of the activities for establishing securities statistics, new by-laws for resident investors trading on foreign financial markets on security-by-security principle were adopted. For this purpose, cooperation has been established with the regulating bodies of pension funds, insurance companies and investment funds, for reporting on investment in securities of the institutions they regulate. For this purpose, a new application software was created for data collection and processing, trainings for reporting entities were conducted, and the regular reporting starts in January 2015;
- in the area of monetary statistics, the National Bank announced new data on the interest rates statistics, consistent with the European standards⁸⁷. The new data set provides access to more detailed information on interest rates on loans and deposits

⁸⁶ Balance of Payments and International Investment Position Manual, Sixth Edition IMF in 2009 (BPM6)

⁸⁷ EU regulation on interest rates statistics ECB/2009/7

and extends the data coverage. To ensure time comparability of data, time series data for the period from 2005 onwards have also been published. Within these activities, an entirely new system for electronic transmission of data was established, which beside the banks, also includes savings houses as reporting entities.

- during 2014, in the area of financial accounts statistics, a series of activities was taken to establish new and more rationally use the existing data sources for the needs of the financial accounts. Within these activities, in cooperation with the State Statistical Office (SSO), the National Bank hosted the training courses organized for reporting companies. Also, the activities for composing the matrix of cash flows continued, with on-going efforts for ensuring greater consistency of the data on the individual institutional sectors;
- within the strategic commitment for improving the quality of communication, and in accordance with the action plan set up on the basis of surveys for customer and reporter satisfaction conducted in 2013, a number of activities in the part of the communication with the reporters and users were taken. In this regard, the National Bank increased the data set available to users, including: for monetary statistics - more detailed quarterly data on balance sheets and on surveys of other financial institutions, by sub-sector; and for external statistics - detailed data on the external debt (by residual maturity) and the repayment schedule (by sector and instrument) and the quarterly information on external debt and the IIP started to be regularly published on the website of the National Bank
- in October 2014, the National Bank launched the project for developing a single statistical data warehouse, which is to provide optimal management of statistical databases in the NBRM, as well as prospective dissemination of more detailed data to the Eurostat and other international organizations.

To perform its statistical function, the National Bank cooperates with other authorized bodies for statistical surveys. The cooperation between the National Bank, the SSO and the Ministry of Finance (MF) regarding the exchange of data and information needed for developing financial accounts by sector, has advanced and intensified during 2014. Additionally, based on the new agreement on the exchange of data between the National Bank and the SSO, concluded in January 2014, regular exchange of data on sectorization of institutional units was initiated, as a significant step towards improving the consistency of statistical data at the national level.

The practice of constant improving of the capacity of the National Bank in the area of statistics, continued this year. Therefore, the practice of training and collaboration with several central banks of the EU Member States through the Instrument for Pre-Accession Assistance of candidate countries for EU membership - TAIEX continues.

X. Supervisory and regulatory function of the National Bank

In order to maintain a sound and stable banking system as a basic prerequisite for financial stability, in 2014, the National Bank continued to perform regular supervision of the operations of banks and other regulated institutions⁸⁸, by conducting full-scope and targeted on-site controls, as well as permanent off-site supervision of their operations. Along with the microprudential supervision, the central bank implements permanent macroprudential analysis

⁸⁸ According to the Law on the National Bank of the Republic of Macedonia, the Central Bank supervises and controls banks, savings houses, exchange offices, companies performing fast money transfer companies issuing electronic money and intermediaries in micropayments.

and in particular, analysis of the trends and assessment of the most important risks in the banking system. Of course, the adequate regulatory framework currently in effect, based on the best international standards and practices, is a basic prerequisite for effective banking supervision and a stable and reliable banking system. Over the past year a new regulation was adopted on the role and content of the external audit of banks, which among other things, brings harmonization with the new Basel standards. In addition, the activities for prescribing the so-called Basel 3, continued in the following areas: 1) new liquidity standards, i.e. analysis of the items that are part of the positions of the liquidity coverage ratio; and 2) further harmonization of domestic legislation with the requirements regarding the components of the bank's own funds. The National Bank continued to further test the draft methodology for determining systemically important banks, due to its adjustment to the characteristics of the Macedonian banking system.

10.1. On-site and off-site supervision

Supervisory activities of the National Bank are based on the so-called supervisory approach oriented towards evaluation of the risks in banks' operations. This approach was introduced in 2008 and has been repeatedly improved in recent years.

Along with the assessment of risks, within its controlling activities the National Bank assesses the compliance of banks' operations with the regulations⁸⁹, especially in the area of payment operations, foreign exchange operations and the protection of consumers who use consumer loans from banks.

During 2014, the National Bank conducted 24 controls of banks, 4 controls of savings houses, 2 controls of providers of fast money transfer, 42 controls of subagents and 123 controls of authorized exchange offices. Of the controls of banks and savings houses, twelve were controls of risks. Other controls pertained to the compliance with the regulations. In this period, one control of a company providing auxiliary services in the information system of a bank was conducted.

Controls of the risks focused on the credit risk, given the importance of this risk for the risk profile of banks⁹⁰ in the Republic of Macedonia, but also the amendments to the by-laws which regulate the management of this risk, the application of which began in 2014. Also, certain banks were subject to assessment of the adequacy of the systems for preventing money laundering and financing of terrorism, information security management, liquidity risk, interest rate risk, operational risk, profitable operations and corporate governance.

Controls have shown that banks have satisfactory systems of risk management and that they have responded to the corrective measures imposed by the National Bank. In order to improve the established rules and practices for risk management appropriate recommendations were given, which in terms of credit risk relate to: improving the criteria in the approval process, strengthening of the controls designed to ensure proper usage of approved loans, improving the systems for identifying and monitoring the related parties, systems for determining the impairment losses, systems for customer monitoring and improving the operations of the Internal Audit Department. In terms of the risk of involvement in money laundering activities and financing of terrorism, the recommendations

89 Control of compliance with the Law on the National Bank of the Republic of Macedonia, the Law on Foreign Exchange Operations, the Law on Consumer Protection in Consumer Loan Agreements, the Law on Fast Money Transfer and Payment Operations Law.

⁹⁰ The analysis of risks in the banking sector is covered in the Report on the risks in the banking sector in 2014.

pertained to the following: improving the process of determining the risk profile of clients in the establishment and monitoring of business relations, appropriate adjustment of the measures and activities that banks need to take towards their clients depending on the determined level of risk, and further definition of internal regulations and practice in terms of the indicators for detecting suspicious transactions.

In order to improve the operational risk management systems, recommendations were given regarding: the processes of risk assessment, administrative, technical and physical controls, especially in the area of cash management, the manner of reporting on adverse events, regular reviewing of the plans for continuity of operations, improving the commitment of the bank bodies in relation to this risk. In terms of information security, recommendations were made to improve the process of risk analysis, reinforce the control measures, improve the systems of audit trail and recommendations for more appropriate allocation of responsibilities of those involved in the operational management of information security.

In order to improve the information security management, an analysis of the risks from using outdated operating system by the banks in the country was made, standards for information security for savings houses were defined and standards for information security in systemically important banks were analyzed, with particular reference to the tests of continuity in their operations.

Within the regular activities in the area of licensing of banks and savings houses in accordance with the Banking Law, during 2014 the National Bank conducted 49 procedures for issuing licenses and approvals. A license for status change was issued - acquisition of "Postenska Banka" AD Skopje by "Eurostandard Banka" AD Skopje, when "Postenska Banka" AD ceased to exist as a legal entity. Other procedures conducted during the year are shown in the table below.

Table 3
Licensing procedures conducted in 2014

Type of license/approval (banks)	issued	rejected	halted
Approval for acquiring 100% of the total shares in a bank	1	/	/
Approval for statute amendment	5	/	/
Approval for appointment of a Supervisory Board member	27	/	2
Approval for appointment of a Management Board member	9	/	3
Type of license/approval (savings hoses)	issued	rejected	halted
Approval for the transformation of a savings house into a financial company	1	/	/
Total	43	/	5

Source: NBRM

The National Bank conducted two licensing procedures under the Law on Payment Operations, so that two companies were issued approvals for conducting micropayments.

In 2014, the National Bank was actively involved in the preparation and defending of the report of "Moneyval" (Committee of Experts of the Council of Europe) in the fourth round of assessment of the system of the Republic of Macedonia for anti-money laundering and combating the financing of terrorism (hereinafter: AMLCFT). In the report of the

"Moneyval" progress was noted in terms of the compliance of the legislation with international standards and its practical application by the entities authorized to implement AMLCFT measures and actions. Based on the recommendations of the "Moneyval", in September 2014 a new Law on AMLCFT was adopted whose preparation took into account the proposals of the National Bank.

In May 2014, the process of national assessment of the risk of money laundering and financing of terrorism started. The assessment is performed in accordance with the methodology of the World Bank, and its implementation involves several oversight bodies and entities which have obligations under the Law on AMLCFT.

XI. Internal audit

In 2014, the Internal Audit Department (IAD) fully implemented its work program. Through a systematic evaluation and giving recommendations for improvement of the risk management process, adequacy and effectiveness of internal controls and management processes, the internal audit exercised its primary objectives by giving assurance on:

1. Efficient and economical use of resources;
2. Safeguarding of assets;
3. Reliability and integrity of financial and other information, and
4. Compliance of operations with laws and regulations, internal policies and work procedures.

In 2014, 18 regular audits were carried out for 35 business processes, giving 61 recommendations to improve the internal control system. The recommendations were monitored on a regular quarterly basis and the findings of the monitoring suggest that the recommendations are mainly observed and implemented within the given deadlines. In 2014, 96.4% of the recommendations were implemented.

In addition to regular audits, IAD carried out additional activities aimed at improving the quality and efficiency of its own operations. From this perspective, during 2014, Rules of Procedure of the IAD and the internal working procedures were revised, detailed Guidelines for operation of IAD were developed, the Program for internal evaluation of the operation of the IAD was applied, and technical cooperation was established with the Central Bank of the Netherlands for the implementation of the new structure of the audit report, the implementation of short audits and in the field of IT governance.

The operation of the Internal Audit Department was closely supervised by the Audit Committee, which held four meetings during 2014.

XII. Improving the institutional capacity of the National Bank

12.1. Strategic planning

According to the established practice, during the year the Strategic Plan of the NBRM for 2015 - 2017 was adopted. Based on the Strategic Plan, the Guidelines and the Work Programme for 2015 were adopted, which is a detailed elaboration of the established

objectives and targets for the next period, in terms of the units responsible, the deadlines and the status of their implementation.

In the following three-year period, the National Bank will continue to focus on the successful realization of the already established basic strategic goals, low and stable inflation through the strategy of maintaining a stable exchange rate of the denar against the euro, maintaining financial stability as an integral element of macroeconomic stability and precondition for achieving economic growth and prosperity. In addition, the Strategic Plan for the following three years is a continuation of previously established strategic objectives in the area of establishment and implementation of monetary policy and support of financial markets, management of foreign reserves, financial stability maintenance, issuance and management of banknotes and coins, payment systems, statistics, research and internal audit. In addition, the National Bank will continue to develop corporate governance and deepen the system of values. In this regard, the process of creating modern and competent human capital, establishment of the latest technological innovations in business processes and development of cooperation with domestic and foreign institutions will carry on.

12.2. Managing operational risks and ensuring business continuity

During 2014, efforts were made to establish a structured framework for identifying and managing operational risks in achieving the strategic objectives and tasks of the National Bank. In this respect, practices and standards were studied, prescribed by the international standard COSO II ERM, Enterprise Risk Management - Integrated Framework, the risk management standard ISO 31000:2009, the principles of the Basel Committee on Banking Supervision, and the experiences of several central banks, primarily the European Central Bank, the Dutch Central Bank, the Bank of Poland and the Bank of Italy.

At the end of the year an Operational Risks Management Policy was developed, which is further elaboration and clarification of the risk management system established in the National Bank. The main objective of the Operational Risk Management Policy is to establish a system of coordinated, comprehensive and systematic operational risk management in order to identify events that may affect the functioning of the National Bank, to ensure maintenance of the exposure to risks within acceptable limits and to ensure effective accomplishment of the objectives of the National Bank.

The Operational Risk Management Policy contains a methodological framework that includes: risk classification, operational risk tolerance and operational risks management procedure.

Starting from the defined strategic objectives, the development of operational risk management should enable:

- 1) increasing the efficiency of operations by improving the system of allocation of funds depending on the acceptable level of risk and cost of dealing with risk;
- 2) better forecasting and utilization of available resources by determining the most important risks in the realization of the basic functions and mobilizing the available resources for dealing with identified risks; and
- 3) better decision-making.

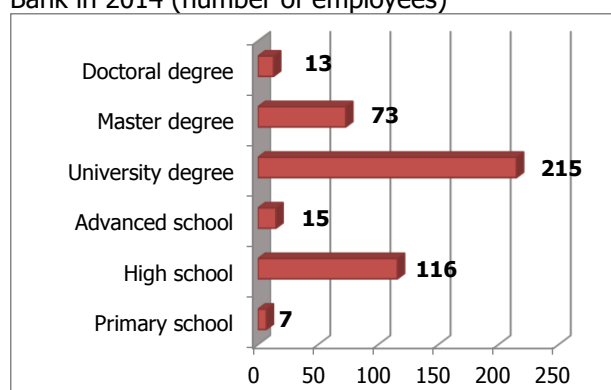
The National Bank conducts a structured and regular process of planning, revising and testing of measures necessary to ensure business continuity in crisis. During 2014, the organizational units of the National Bank revised the plans for ensuring business continuity of 120 processes. Furthermore, to confirm the feasibility of business continuity plans, in

2014, testing documentation was developed, staff was trained and several business processes were tested for business continuity in various crisis scenarios.

12.3. Human resources management

The National Bank is an institution that takes constant care and invests in its employees, in order to strengthen their skills and competencies and increase the expert knowledge aimed at creating highly educated staff that will adequately meet the challenges of successfully achieving its goals. During 2014, the Human Resources Management Department conducted a number of activities aimed at the improvement of the processes in human resources management.

Chart 92
Qualification structure of employees in the National Bank in 2014 (number of employees)



Source: NBRM

In 2014, the total number of employees was 439, versus 441 employees in 2013. In 2014, there was no change in terms of gender and age structure of the employees in the National Bank compared with the previous years.

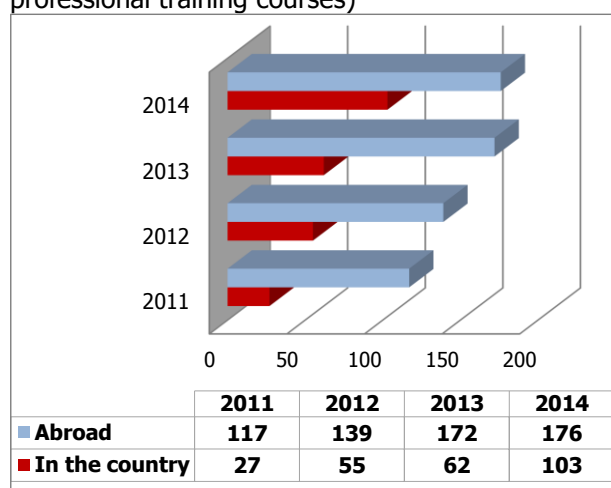
In 2014, the percentage of women was 59%, and the percentage of men was 41%. In terms of age structure, the average age of employees was 44.8 years in 2014, despite the average age of 44.6 years in 2013. The qualification structure registered a decline in the number of employees with secondary education by 7.2%, while an increase of 8.9% is noticed in the number of employees who have earned masters degree. No significant changes were registered in the other categories.

The processes of professional development, employee evaluation and remuneration are processes that affect the development of the career of the employees in the National Bank. The process of employee evaluation was improved, as one of the main objectives in the strategic plan for 2014. For that purpose, changes were made in the by-laws and internal regulations, evaluation forms were revised, presentations were made for all employees, and professional advice was given at the level of an organizational unit. Employee evaluation and remuneration is made on the basis of criteria such as quality of work, volume, interpersonal skills and communication, as well as demonstrated innovation, creativity and independence in the work of the employees. This system is used as a tool for greater engagement, productivity, utilization of creative potential in the institution. Carrying out of these processes called for an intensive development of the management skills of all managers in the institution.

During 2014, 279 professional training courses were organized in the country and abroad. Compared to the previous year, the number of professional training courses increased by 19.2%, while the number of employees who attended such courses has increased by 1.2%. Particular growth was recorded in the realized number of professional training courses in the country, which increased by 66.2%, due to trainings on the current amendments to the legal regulations in the area of operations of the National Bank, as opposed to the slight growth of the professional training abroad of 2.3%.

The main organizers of external professional training courses are the International Monetary Fund and the central banks of the European Union, with which the National Bank is in close cooperation through mutual cooperation programs, while the main organizers of the professional training courses in the country are domestic centers providing education in the field of personal data protection and change of legislation (in the area of operations of the National Bank).

Chart 93
Completed professional training (number of professional training courses)



Source: NBRM

organized at sector level. The aim of the team-building events is to develop team spirit, provide synergy and culture of knowledge sharing in the work processes, as an important organizational value of the institution.

The National Bank of Macedonia follows the trends in the human resources management, stimulates continuous learning and development of employees, especially young professionals. In 2014, there were 16 two-day internal training courses, covering eight topics related to strengthening the soft skills of the employees in the National Bank. Total number of 209 employees took part, and part of the training courses were devoted to the development of the managerial skills of managers.

In order to stimulate better professional communication and better networking of workers in the National Bank, seven team-building events were

The analytical and reporting functions of human resource management were also greatly upgraded, by developing comprehensive annual reports that summarize the analyses of processes and activities that are under its jurisdiction.

12.4. Research activity

In 2014, the National Bank's research activities were directed towards areas important for achieving the basic goals and strengthening institutional capacity. In this regard, the conducted research projects supported the decision-making process in the National Bank and contributed to timely consideration of future challenges. During 2014, nine research projects were carried out, that were related to: analysis of the policy of setting prices and wages in Macedonia, empirical assessment of the sustainability of external and public debt, the impact of fiscal policy on the post-crisis recovery in the European countries, the impact of fiscal policy on the current account, assessment of a balanced level of credit growth for the Macedonian economy, the impact of monetary policy on the real sector of the economy, an assessment of the informal economy in the Republic of Macedonia, the efficiency of the banking system. The research program for the period 2015-2017, adopted in May 2014, was supplemented with new projects in the area of monetary policy and monetary transmission, financial stability and the banking system, as well as in other areas. At the end of the year activities were taken for improvement of the framework of research activity aimed at further developing and stimulating research.

On 28 and 29 April 2014, on the occasion of celebrating the anniversary of the monetary independence of the Republic of Macedonia, the Third Research Conference was held: "Towards recovery and sustainable growth in the altered global environment". The conference was organized in six sessions covering topics important for the central banks, academic and research institutions. At the conference, research papers of representatives of central banks and academic institutions in the region and the EU were presented. At this event, the National Bank awarded an annual prize for best paper in the field of macroeconomics written by a young researcher.

In 2014, the Club of Researchers continued operating as a part of the activities to support the development of research and analytical work, in four quarterly sessions where participants presented and discussed several research papers that addressed the following research topics: multipliers of public investment and public spending, exchange rate regimes and economic growth, determinants of excess capital of banks, mutual actions of monetary and fiscal policy, cost efficiency of banking systems, indices of bank stability and lending activity in the crisis period. During 2014, aimed at further development of the research activity, the National Bank had technical cooperation with other central banks in the various areas of central-banking operations, with particular emphasis on the cooperation with the Austrian Central Bank and the Dutch Central Bank. Employees of the National Bank participated in many conferences and international events with their papers and presentations.

XIII. Other activities

13.1. International cooperation

During 2014, the National Bank continued to promote and strengthen multilateral cooperation, through participation in regular meetings of international institutions and international forums, and bilateral cooperation with other central banks.

Representatives of the International Monetary Fund (IMF) visited the National Bank during regular consultations under Article IV of the IMF's Articles of Agreement, as well as within the post-program monitoring after the expiration of the IMF's Precautionary Credit Line. On the other hand, the Governor and Vice-Governors of the National Bank participated in the Spring Meetings and the Annual Meeting of the IMF and World Bank Group, as well as the meeting of the Dutch Constituency. The technical cooperation with the IMF for improving macroeconomic modeling and forecasting in the National Bank, and the improvement of the monetary and financial statistics continued in 2014. Within the cooperation with the World Bank, a number of meetings were held with representatives of this institution related to the current arrangements, development of regular reports and publications of the World Bank, and also technical assistance was provided in the area of financial stability. During 2014, the National Bank took part in the regular meetings of the Bank for International Settlements in Basel and in the meetings of the Central Bank Governors' Club of the Black Sea Region, the Balkan Countries and Central Asia. Upon receipt of the National Bank in Vienna Initiative 2, a representative of the NBRM participated in the meetings held by this forum. The National Bank's membership in this forum enables active participation and exchange of experiences in order to maintain financial stability in the region.

Within the cooperation with the central banks, the National Bank continued the technical cooperation with De Nederlandsche Bank, Deutsche Bundesbank, the National Bank of Poland, as well as other central banks of the EU and the countries in the region. This year too, the National Bank continued the fruitful collaboration with De Nederlandsche Bank, as the most important strategic partner. In order to promote bilateral cooperation, during 2014, the National Bank signed a Memorandum of Understanding with the National Bank of Croatia.

In 2014, the National Bank continued to take active participation in the process of accession of the Republic of Macedonia to the European Union through its participation in the performance of its obligations arising from the Stabilization and Association Agreement (SAA) in relation to the development and implementation of the Annual National Programme for the Adoption of the Acquis (NPAA), and within the development of the National Economic Reforms Programme (NERP). Also in May, the Governor participated in the Ministerial Dialogue (ECOFIN) with the candidate countries.

Within the Multi-beneficiary program of the Instrument for Pre-Accession, IPA, in 2014 several projects were financed. The National Bank was included in the Regional Programme for cooperation between the ECB and the central banks of the Western Balkans, which aims to strengthen the institutional capacities and to prepare them for accession to the European System of Central Banks. Also, financial support was provided for participation of representatives from the NBRM in the regular meetings of Eurostat in the field of balance of payments statistics and financial accounts statistics. Within the EU-funded TAIEX instrument, the European Commission has approved 17 projects. Moreover, during the year, 15 projects were successfully delivered, of which nine are study visits, two are expert missions and four are workshops in various areas of central banking operations.

13.2. Public relations

In 2014, the National Bank continued to conduct a transparent policy for timely informing the general public about its work. The NBRM regularly communicated with the media, in the form of issuing press releases, answering journalists' questions, organizing interviews, press conferences, giving brief information intended for the press, and publishing content on the website (www.nbrm.mk).

The opening page on the website is updated with the regular communications from the sessions of the National Bank Council and the Operational Monetary Policy Committee of the National Bank, as well as information on the application of monetary policy instruments in Macedonian and in English. At the same time, there was an increase in the number of other communications with different content, which are related to the operations of the NBRM. During 2014, the Governor and the Vice-Governors of the National Bank took an active part in numerous events with their presentations and speeches.

The National Bank communicates directly with the public through electronic mail info@nbrm.mk posted on the website of the National Bank. Also, on the website a link is posted leading to free access to public information, as well as the addresses contact.statistika@nbrm.mk and supervizija@nbrm.mk for questions and answers from the relevant fields.

During 2014, the content of the website in Macedonian and in English was regularly updated. In order to make faster translation in English of higher quality, in 2014, new software for translation started to be used. Besides the regular content, the scope of the

new content on the website was expanded. A new section "Collector coins" was added, which contains information on the coins issued by the National Bank (which are legal tender in the Republic of Macedonia).

The National Bank communicated with the public also through the "Annual Report for 2013", which is an annual publication on the operations of the National Bank in printed form. This, and other annual, quarterly, monthly and other reports on the Bank's operations are published in an electronic form on the website of the National Bank.

13.3. Financial education

Within the project "Financial Education" in 2014, several activities were conducted aimed at familiarization of the population in the Republic of Macedonia with finance and economics. Educational materials were developed, which cover many aspects of the role and functions of the central bank, the key financial institutions, savings, financial products, and the protection of consumers of financial services, and also events of national and international character were organized.

In cooperation with the best selling magazines for primary school children, financial and economic texts were published in the form of short comics adjusted to the age of the pupils.

A Financial Education Policy was developed, which is a strategic document arising from the work of the Coordinating Body of regulatory institutions for financial education in the Republic of Macedonia.

Financial education is closely related to informing the public, as education is meant precisely for the public. During the Global Money Week held in March 2014, the Coordinating Body organized a public event, which was attended by most of the media. Also, the public is regularly informed about the activities related to the Project for financial education through press releases.

Cooperation is established with several renowned international organizations and institutions, such as: Child and Youth Finance International, Alliance for Financial Inclusion and the Organization for Economic Cooperation and Development. The National Bank, as a partner institution of these international organizations, implements initiatives, organizes activities and participates in various international events. In cooperation with the Child and Youth Finance International, a public event was organized: Third regional meeting on financial education for Europe and Central Asia, held on 2 and 3 October 2014 in Skopje. Organizer of the conference was the Child and Youth Finance International, and the host was the National Bank.

On the occasion of the World Savings Day, the National Bank of the Republic of Macedonia and the Agency for Insurance Supervision announced a competition for children and youth, on the following topics: "I can save, too" or "What does insurance of home and family mean to me." On the Savings Day, on the premises of the Agency 12 equal money prizes were awarded, of which six for the art work of pupils in primary school and six for the literary work of students of secondary education.

13.4. Museum, Library and Historical Archives

In accordance with the planned activities, over the past year, the Museum of the National Bank intensively worked on the research project for the reconstruction of the monetary flows in southwestern Macedonia in a wide time range starting from IV century BC, until the end of the Middle Ages. Currently this project is in the final stage prior to its publication as a co-publishing venture with the Museum and the Institute for Protection of Cultural Monuments in Ohrid. Regarding the research in the field of applicative and research conservation, the examination of the composition of the metals of which the minting products of Byzantium from the beginning of the XIII century were made, was completed.

The activities of the Library and Archives of the National Bank last year defined the research framework for digitalization of documentation on the work of the National Bank Council for the period 1991 to 1994, which are archived in the National Bank, and the process for their archiving selection and description began.

13.5. IT development

Within the activities undertaken to achieve the Annual Plan of Activities of the National Bank for 2014, and in order to fulfill the needs of the organizational units in the Bank and through them of the general public, during 2014 in the area of information technology (IT) more than 4,500 working cases were processed. Of these, the majority, or 65%, were requests for services from the catalog of IT services, 24% relate to resolving incidents and assistance during the work of staff regarding the application of IT, while 11% account for the regular maintenance of information infrastructure and its improvement.

Within the implemented projects for IT improvement in 2014, one of the most important is the project for the migration of the entire application software to the new IT infrastructure that uses the current version of system software such as "Windows 2012" and the SQL server 2012 and which is fully virtualized.

In addition, in July the National Bank Council adopted the Decision on connecting to the information system of the National Bank of the Republic of Macedonia. This Decision regulates the connection of entities that communicate electronically with the information system of the National Bank. The most significant benefit of this Decision is the prescribing of the following aspects of electronic communication: formal communication between the National Bank and the entities, electronic communication links and the criteria which should be fulfilled by entities in electronic communications to provide secure access to the information system of the National Bank. This concept is essential for the provision of fast, secure and controlled access, where institutions can choose from many different channels of communication.

After the Decision entered into force, administrative contacts were defined with 27 institutions from the Republic of Macedonia, which communicate with the National Bank, over 150 electronic communication links were conducted in accordance with the parameters defined in the Decision, training and presentations were organized for the persons involved in implementing the Decision, from both the National Bank and the institutions it communicates with.