NATIONAL BANK OF THE REPUBLIC OF MACEDONIA

MONETARY POLICY AND RESEARCH DEPARTMENT

Recent Macroeconomic Indicators
Review of the Current Situation

August 2014

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Review of the Current Situation - Implications for the Monetary Policy

The review of the current situation aims to give an overview of the recent macroeconomic data (May - July 2014) and to make a comparison with the latest macroeconomic projections (April 2013). This will determine the extent to which the current situation in the economy corresponds to the expected movements of the variables in the previous cycle projections. The review focuses on the changes in external assumptions and performance with domestic variables and the effect of these changes on the environment for monetary policy conduct.

The global economic environment has not undergone major changes compared to the period of the last assessments. Recent developments in high frequency economic indicators for the euro area signal slow and uneven economic recovery in the second quarter of 2014. The ECB still assesses the risks about future economic outlook as largely downward. The preliminary inflation data for July further emphasize the absence of price pressures in the euro area and the risk of deflation. Annual inflation slowed down from 0.5% to 0.4%, mainly due to downward pressures from energy prices. The ECB assesses risks surrounding the future path of inflation as balanced. At the meeting in August, the ECB maintained the policy rate unchanged, stressing that the measures taken in the previous two months will provide better access of banks to long-term financing, will spur credit growth and will return inflation to a level close to 2%. In its communication, the ECB once again emphasized its readiness to conduct accommodative monetary policy and to take additional measures in case of prolongation of the period of low inflation. **Observed from a viewpoint of the individual quantitative external environment indicators for the Macedonian economy, the assessments for the foreign effective demand for the period 2014-2015 remain unchanged relative to the April projection. Changes in the expectations about the prices of primary commodities move in different direction.** The latest estimates for the **international oil prices** for 2014 still point to reduction of the cost of this fuel, at a similar pace compared with the April projection. New estimates for 2015 indicate higher oil price, vis-à-vis the expected decline in the April projection, associated mainly with the upheavals in Iraq and the prolongation of the conflict in Eastern Ukraine. The new assessments for **metal prices** point to more favorable developments in the terms of trade for this sector than projected in April. This movement is especially pronounced in the nickel prices, which is mainly associated with the factors on the supply side. Regarding the **food prices**, the latest estimations for 2014 indicate evidently smaller import pressures through this channel on the domestic inflation and the terms of trade, in comparison with the April projections. However, it should be borne in mind that given the intensifying political tensions between Russia and the US/EU and the introduction of trade barriers and economic sanctions, the estimates for future path of prices of some primary products could be volatile.

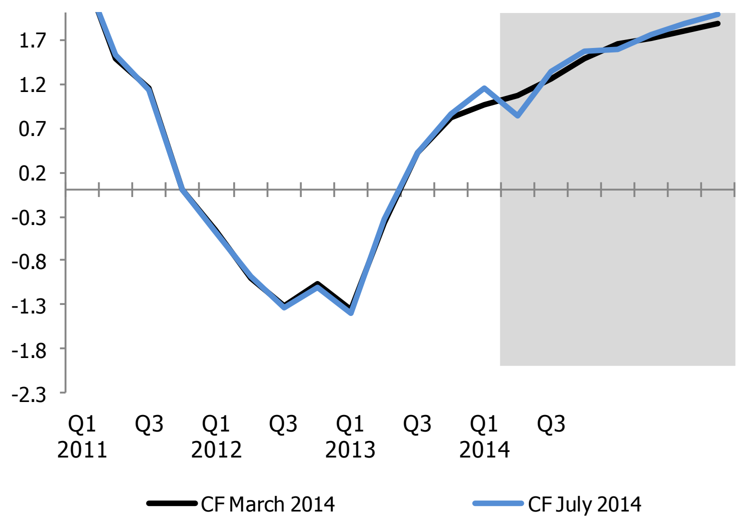
The comparison of latest macroeconomic indicators with their projected dynamics within the April cycle projections does not indicate larger deviation. From the aspect of individual indicators relevant for the monetary policy, **inflation data** as of July 2014 indicate further absence of larger price pressures and slightly lower inflation compared to the April projection. However, the gap between the actual and projected inflation in July significantly narrowed. The prices of food and energy component of prices generally moved within the projections, while the pressures through core inflation were lower than projected.

On a monthly basis, the price level recorded a moderate growth (0.2%), reflecting the increase in the prices of electricity, oil derivatives and cigarettes, along with the increase in excise duties in July. These developments, together with the stabilization of the base effect, contributed to a small annual price growth of 0.3% after three months of continuous fall. On a cumulative basis, the price change remains negative and amounts to 0.1%. Analyzing the reasons, currently, the price decline is regarded as temporary. This conclusion is also supported by the results of the last Inflation Expectations Survey, according to which inflation expectations for 2014 are in a positive zone. Core inflation surged in July, and remained at 0.7% on an annual basis. Lower initial conditions and revisions of external input assumptions point to downward risks to the inflation projection for 2014. On the other hand, there are also upward risks on energy and food prices (related to the geopolitical tensions in Iraq, reactualization of the Russian-Ukrainian conflict, and possible effects of flooding in the region). We estimate that **the balance of risks, in terms of the projected price movement, is still predominated by downward risks, although less pronounced compared to the previous period**.

According to the latest available data for the third quarter of 2014, foreign reserves (adjusted for price and exchange rate differences and price changes of securities) increased at a faster pace than projected in April. Most of this increase is due to the government borrowing from the international market, which was not included as an assumption in the projections for 2014. **Excluding the effect of the government borrowing, foreign reserves registered a moderate growth, given the favorable movements in the foreign exchange market and the purchase of foreign currency.** The number of available external sector indicators is still limited, making it impossible to identify accurately the factors of changes in foreign reserves. Observing external sector indicators, only data on net purchase from foreign exchange operations in July are available for the third quarter, which indicate that the remittances move within the projected level. Other external sector data relate to the period May-June and indicate lower current account deficit than expected, due to the weaker import pressures. On the other hand, flows in the capital and financial account point to possible slower performances. Generally, the overall position of the balance of payments for this period is as projected. The analysis of foreign reserves adequacy indicators shows that they continue to move in a safe zone. **The signals of high frequency data for the economic activity for the second quarter were favorable**. They suggest keeping of positive trends, with an opportunity in certain key sectors (industry and trade) for better performance compared to the first quarter. **With regard to monetary developments, the latest final data on credit market for June** show further solid growth of credit flows. The annual growth rate of loans reached 8.5% (versus 7.3% projected for the end of the second quarter), with stabilization of risk perceptions. On the other hand, the growth of savings is slower than projected, and may be a potential risk factor for the maintenance of the current sound pace of credit growth. The latest assessments **indicate lower EURIBOR for 2014 than projected in April, with significant downward revision of the expectations for 2015.**

The latest macroeconomic indicators and estimates do not indicate major changes in the environment and risks perceptions compared to the assumptions provided in the April projections. Foreign reserves rose moderately (without the government leveraging effect) and followed the projected path for the third quarter. Analyzing the indicators of foreign reserves adequacy, they continue to move in a safe zone. However, one should bear in mind that the risks from the external environment remain unfavorable. They additionally come to the fore with the political crisis between Russia and US/EU, which can be reflected on the economic growth and on some prices of primary products. Inflation in July deviates from the projected path and suggests price pressures lower than expected. The risks around the inflation projection are still perceived as predominantly downward. However, upward risks were identified, associated with domestic and external factors, which could cause instability and major price shocks that could, in turn, influence the future inflation. Currently, the divergence in inflation is explained by the divergence in the factors on the supply side. On the other hand, the demand moves within the expectations and does not indicate major deviations of the output gap from the estimated one. Thus, economic activity indicators suggest that the economy will continue to grow during the second quarter of 2014 as expected. New credit flows are solid, making the total credits exceed projections. Thus, the downward risks about the projection are less pronounced, but still present.

Foreign effective demand
(annual rates of change in %)



Source: Consensus Forecast and NBRM calculations.

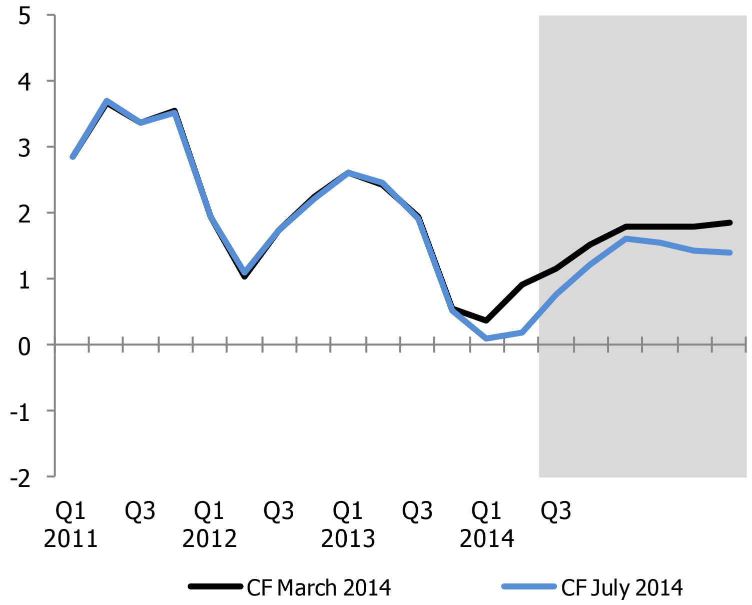
The latest assessment of the foreign effective demand for 2014 remained unchanged compared to last projection...

...and as projected in April, its growth is estimated at 1.2%...

...with minor upward revision of the projected rates of most of our trading partners, with the exception of Serbia, Italy, the Netherlands and Croatia where the adjustments are downward.

No changes have been made in the evaluations of foreign effective demand for 2015, i.e. same as in April, the growth is expected to speed up moderately to 1.8%.

Foreign effective inflation
(annual rates of change in %)



Source: Consensus Forecast and NBRM calculations.

The new assessment of the foreign effective inflation for 2014 compared with the April projection is significantly lower...

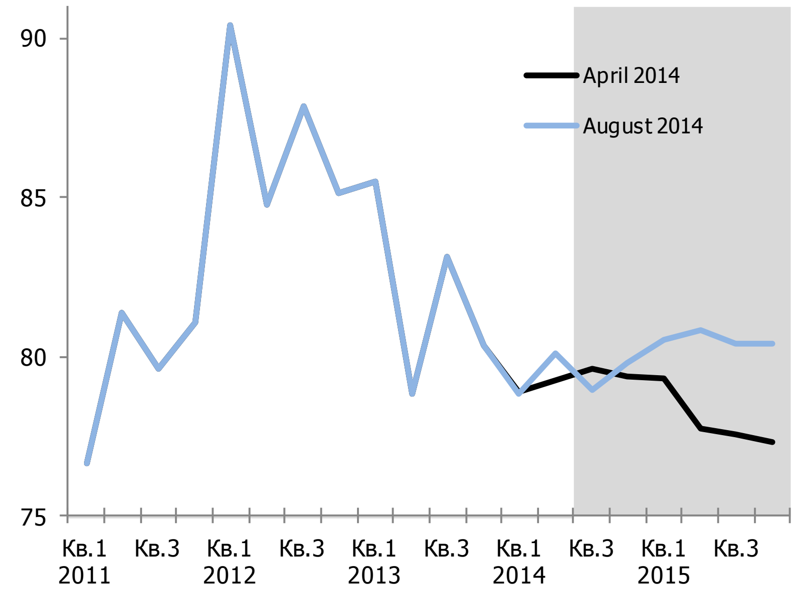
...i.e. currently, foreign prices are expected to increase by 0.6%, instead of 1% as projected in April.

The lower estimate results from the downward revisions of expected inflation rates for all trading partners...

...with the greatest contribution of Bulgaria, where, taking into account the current performance, prices are expected to decline rather than to rise. The downward revision of the expected rate of inflation in Germany also made major contribution to the correction.

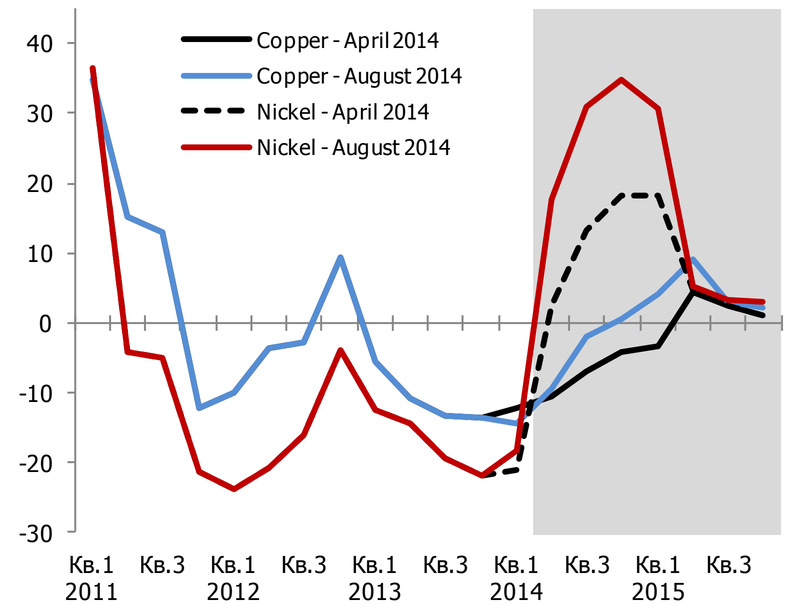
The latest assessment also caused downward revision of the foreign inflation for 2015, so currently, a lower growth is expected compared with the April projection (1.5% vs. 1.8%).

Brent oil
(quarterly average, EUR/Barrel)



Source: IMF, Bloomberg and NBRM calculations.

Nickel and copper prices in EUR
(annual changes in %)



Source: IMF, Bloomberg and NBRM calculations.

The latest assessment of the price of crude oil in 2014 does not differ significantly from the April projection...

...namely, oil price is expected to go down by 3.1% instead of 3.2% as projected in April...

...given the ample oil supply[1].

However, the upward risks to oil prices are still present and associated with the instability in Iraq and the prolongation of the conflict in eastern Ukraine[2].

The oil price for 2015 was upwardly adjusted, so currently, it is expected to increase moderately rather than to fall as expected in April (1.4% vs. -1.6%).

The latest assessments for the movement of prices of copper and nickel in 2014 indicate upward adjustments compared with the April projection.

Thus, the price of copper is expected to register a smaller decline of 6.6% (a decline of 8.5% as projected in April) given the solid growth of the Chinese economy.

Upward revision was also made in the price of nickel given the expected growth of 14.2% (versus 1.7% in April), which is mostly explained by the introduced ban on exports of nickel from Indonesia.

The latest assessment for 2015 predicts higher growth in metals prices compared with the April projection.

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[1] IMF Commodity Price Outlook & Risks, 21 July, http://www.imf.org/external/np/res/commod/pdf/cpor/2014/cpor0714.pdf
[2] OPEC Monthly Oil Market Report, June 2014.
http://www.opec.org/opec_web/static_files_project/media/downloads/publications/momrjuly2014. pdf
Upward oil price pressures are assessed as temporary and thus, not driven by fundamental factors.

Recent estimates of the movements in prices of wheat products for 2014 point to downward adjustments compared with the April projection.

Currently, the price of wheat is expected to drop by 9% (compared to the 5.8% increase in April) due to the improved prospects for the global supply and reduced concerns about the potential losses of the supply from Ukraine.

The corn price is expected to drop to 29.3% in 2014 (versus the expected decline of 13% in April), which is associated with the good yields from the last harvest in the United States and the expectations for growth in the global supplies of corn[3].

Given the changes for 2014, downward adjustments of the expected prices of cereals were made for 2015, when a lower rise is expected in the prices of wheat and a fall rather than rise in the corn prices compared with the April projection.

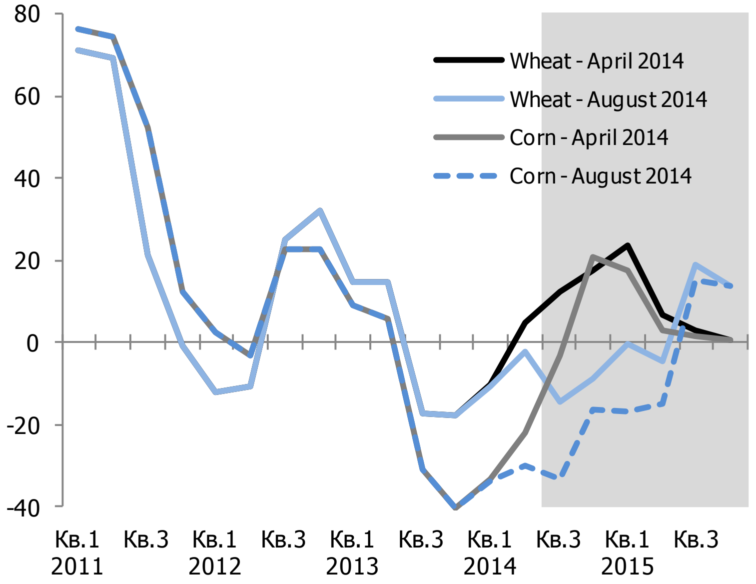
Expectations for the short-term interest rate EURIBOR in 2014 have been revised downwards compared with the April projection...

...where it is estimated that the one-month EURIBOR will average 0.16% (versus 0.23% in the April projection)...

...as a market reaction to the ECB's measures taken in early June 2014, to prevent deflation trends in the euro area, and to support the economic recovery[4].

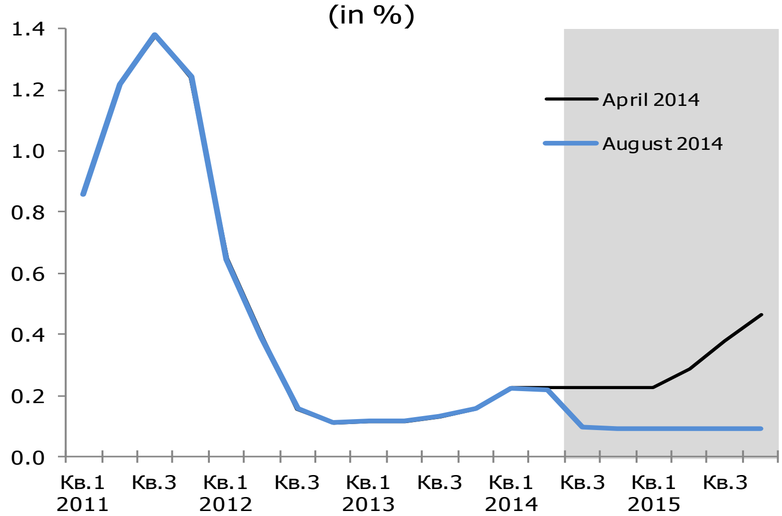
The latest estimates for 2015 indicate a further cut of EURIBOR, and predict an average level of 0.09% (versus 0.34% in April).

Wheat and corn prices in EUR
(annual changes in %)



Source: IMF, Bloomberg and NBRM calculations.

1M Euribor
(in %)



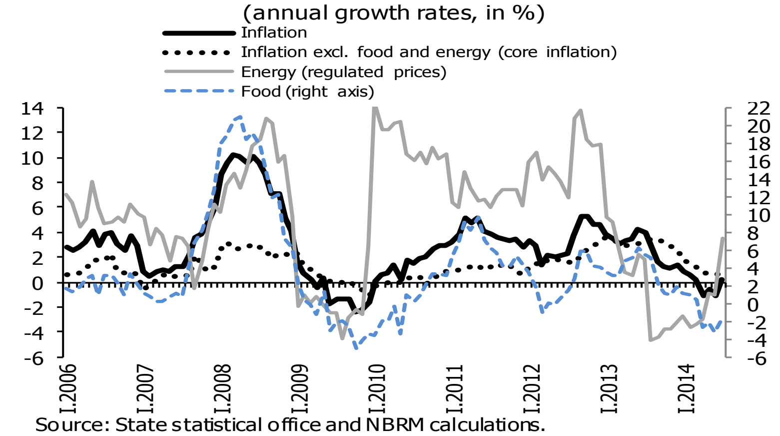
Source: Consensus Forecast and NBRM calculations.

[3] http://www.imf.org/external/np/res/commod/pdf/monthly/070114.pdf

[4] Reduction of the policy rate to 0.15%, reduction of the margin between interest rates on deposit facilities and overnight deposits and introduction of a negative rate on the excess funds deposited with the ECB.

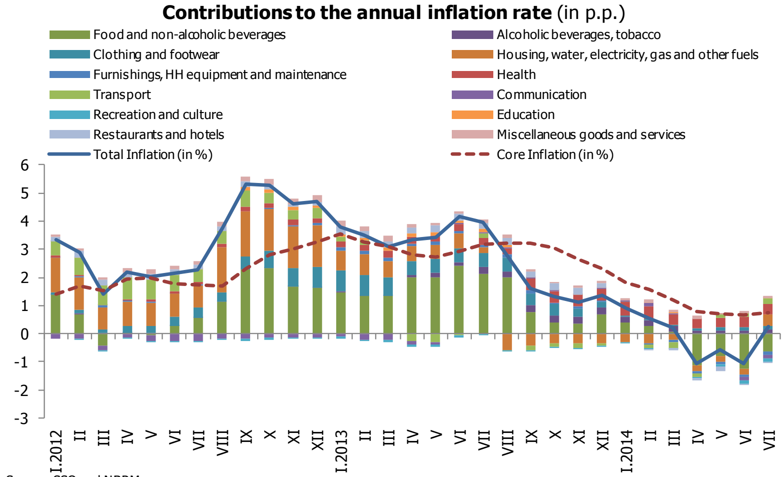
Inflation and volatility of food and energy

(annual growth rates, in %)



Source: State statistical office and NBRM calculations.

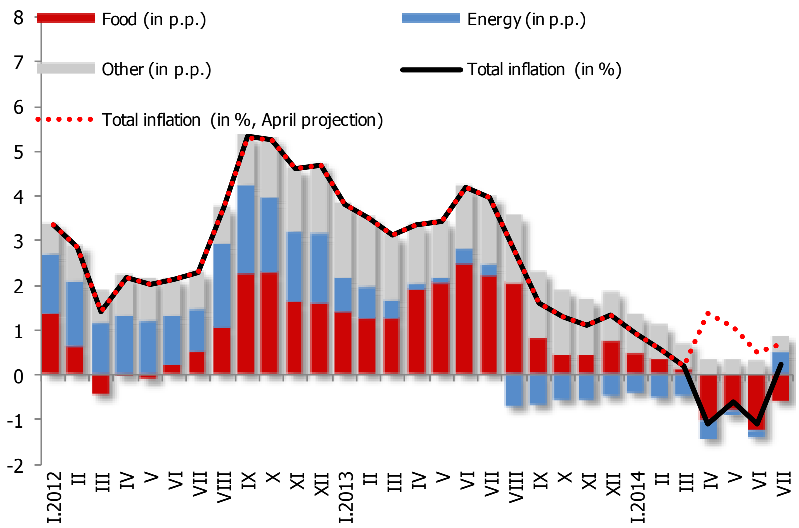
Contributions to the annual inflation rate (in p.p.)



Source: SSO and NBRM.

Inflation rate

(annual impacts to inflation, in p.p.)



Source: SSO and NBRM.

In July 2014, the consumer prices rose by 0.2% on a monthly basis...

...mostly reflecting the higher electricity prices (given the rise in household electricity) and cigarettes (upward adjustments of excise taxes), as well as the prices of liquid fuels[5].

On the other hand, the prices of vegetables registered a significant monthly decline.

The annual inflation rate in July was positive and amounted to 0.3%...

...which is lower inflation than expected in the April cycle projections...

...given the greater downward deviation of the actual inflation from the projected one in the core inflation and the food component, while movements in the energy component are as projected.

July registered a positive monthly rate of core inflation of 0.4% (compared to June, when the core inflation remained unchanged) that largely results from the higher prices of tobacco.

The positive contribution of other categories is significantly lower, with an accelerated growth being registered in the categories of transportation and hotels and restaurants...

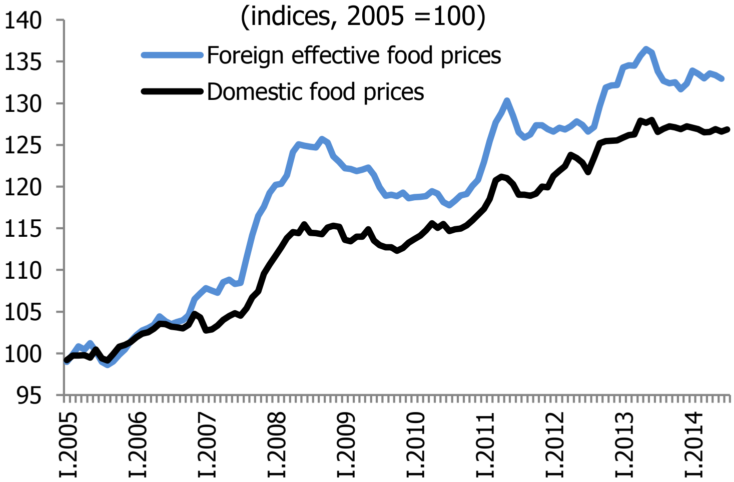
...while the prices of beverages, clothing and footwear, and non-durable products for apartment maintenance dropped on a monthly basis.

The annual rate of core inflation remains unchanged, i.e. 0.7% for the third consecutive month.

[5] Categories with the greatest individual contribution to the growth of the July consumer price index include electricity (monthly price increase of 3.6%), tobacco (monthly price increase of 5.5%) and liquid fuels and lubricants (monthly price increase of 2.0%). As announced in July, the price of bread and baked goods also increased, but at a slower pace than expected. However, the cost of the overall category of bread and cereals registered a slight decrease due to the lower prices of cereals and pasta, which reflects the downtrend of global prices of these primary commodities.

Foreign effective food prices* and domestic food prices

(indices, 2005 =100)



* Foreign effective food prices are calculated as weighted sum of food prices in countries that are major trade partners with Macedonia.
Source: State statistical office, Eurostat and NBRM calculations.

External input assumptions for 2014, which are included in the inflation projection, are generally revised downward.

Thus, the latest estimates for the prices of internationally traded primary food products indicate downward correction of prices of cereals in 2014, compared with the signals obtained during the April cycle projections, and reflect increase in yields and inventories from the previous year.

Downward revision was also made in the projection of foreign effective inflation by the end of the year.

On the other hand, the expected movement in the price of crude oil does not differ significantly from the April projection, which is minimally revised upward.

In the balance of risks about the projected movement of prices, downward risks are assessed as predominant, although dynamically speaking, they are less pronounced.

Lower initial conditions[6] and revisions of external assumptions point to possible downward pressures on inflation projection for 2014.

Risk factors that create upward pressures remain similar as in the previous information...

...while the fears of geopolitical risks still linger, and are attributable to the armed conflicts in Ukraine, the Middle East and North Africa...

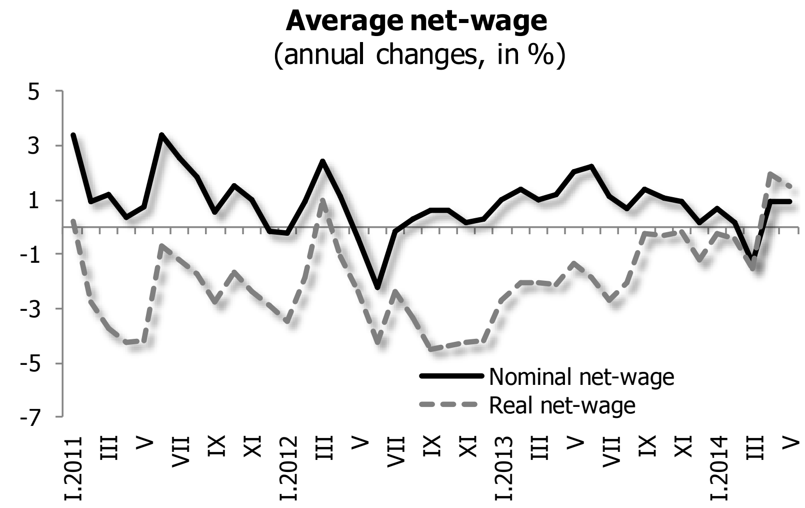
...thus resulting in temporary volatility of prices of some primary commodities.

Also, flooding that again hit the region can continue to generate upward pressures on domestic food prices[7].

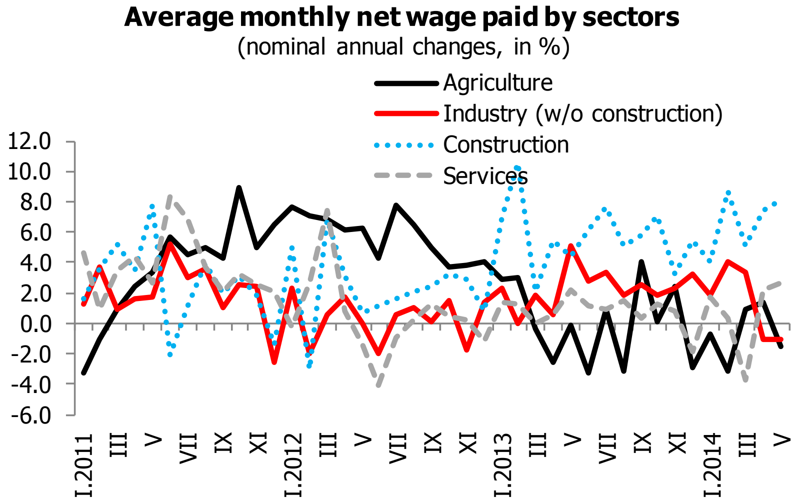
In the coming period, these risks could lead to upward price pressures via imported prices of food and energy.

[6] The last decision for reducing the price of central heating services by 4.7% since August 2014 is a certain downward risk.

[7] Taking into account the reduced export potential of food products from Serbia (cereals and grains, meat and meat products, fats and oils), there is a possibility for some upward price pressures as a result of the reduced supply from Serbia in the regional markets. Source: FAO GIEWS Country Brief on Serbia, http://www.fao.org/giews/countrybrief/country.jsp?code=SRB, 28 May 2014.
Additional pressures caused by flooding and wet weather in the region also include the decreased quality of wheat, which creates upward pressures on the price of flour.
The storm that swept the Resen region in the second half of July, according to the preliminary estimates, has destroyed about 3,000 hectares of fruit orchards, which is an upward price risk.



Source: SSO.



Source: SSO.

The average **net wage** in May 2014 recorded a nominal annual growth of 0.9%, which is identical to the growth in April...

...given the further growth of wages in the construction and service industries, where the highest increase was recorded in professional, scientific and technical activities, administrative and auxiliary service activities and in the information and communications sector...

...with stronger drop in wages being registered in hotels and restaurants and electricity supply sector.

Wage growth in the first two months of the second quarter corresponds with the April projection (expected growth of 1.0%).

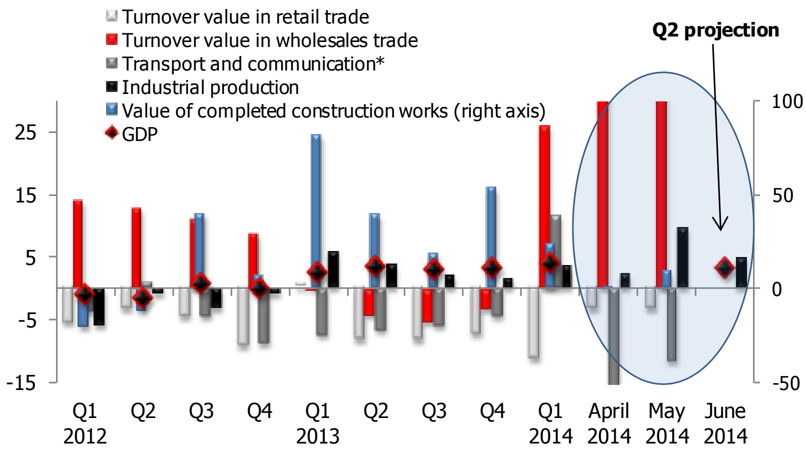
Amid negative annual change in consumer prices of 0.6%, the growth of **real wages** continued in May, when they recorded an annual growth of 1.5% (slightly slower growth than in the previous month).

The available data for the second quarter of 2014 indicate further annual growth of the national economy, given the constant positive performance in the key economic sectors.

Industrial production continued to grow in the second quarter, at a relatively high annual rate of 5.5%...

...given the increased production of machinery and equipment, motor vehicles, rubber products and plastic products, and electrical equipment, which largely reflects the growing production of the capacities in the technological industrial development zones...

Economic activities
(real annual changes, in %)



*Simple average of annual growth rates of the different types of transport and the telecommunications.
Source: SSO and NBRM calculations.

...with the growth of the production of clothing and increased mining of coal and lignite making additional positive contribution.

The annual growth of the industry is faster than the growth in the previous quarter, given the increased capacity utilization in the manufacturing industry[8].

Favorable developments can be observed in the **trade sector**, which registered rapid growth in the first two months of the second quarter, solely resulting from the growth of the wholesale amid annual fall of retail trade.

Activity in the **construction sector** continued to grow in the first two months of the second quarter, but at a slower pace of real annual growth (4.7%), versus the two-digit growth rates in the previous seven quarters.

The performances in the **hotels and restaurants sector** in the first two months of the second quarter of 2014 are also positive...

...while the high frequency data on **transport** indicate downward movements despite the high growth in the previous quarter.

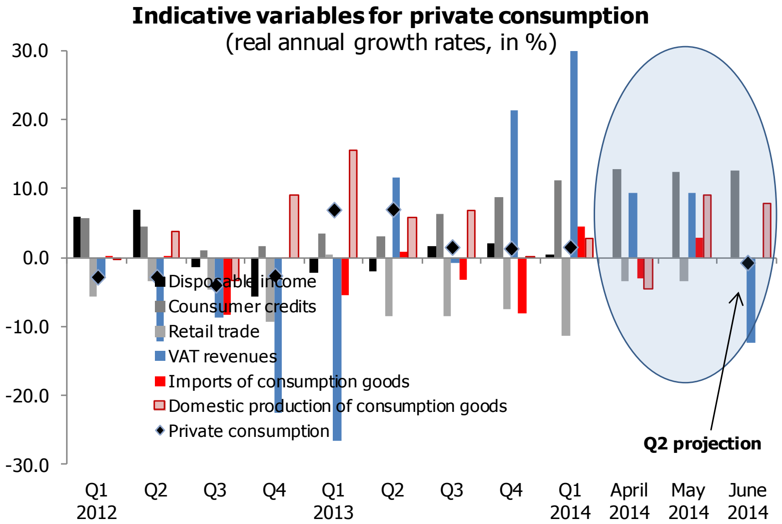
Available indicators of aggregate demand also point to economic growth in the second quarter of 2014, which is consistent with the April projection.

Indicators of **consumer spending are favorable** and indicate an increase in the second quarter...

...as a result of the intensified lending to the household sector in the second quarter...

...the continuing growth of pensions (although at a slower pace), and the rise in real wages in April and May...

[8] SSO's Business Tendency Survey in manufacturing industry.



Source: SSO and NBRM calculations.

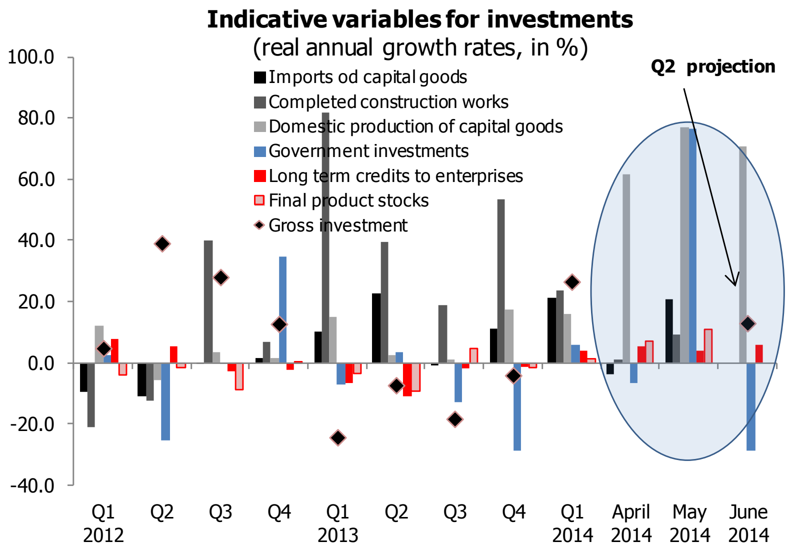
...with positive performances also being noticed in the domestic production of consumer goods and the net revenues from VAT.

On the other hand, the decline of retail trade continued in the first two months of the second quarter, although at a slower pace...

...with the remittances decreasing at a pace similar to the previous quarter...

...while imports of consumer goods registered a minor decline versus the growth of this category in the previous quarter.

Same as the consumer spending, the latest indicators of **investment activity** point to growth in the second quarter...



Source: SSO and NBRM calculations.

...given the accelerated growth of domestic production of capital goods and long-term lending to the domestic corporate sector in the second quarter of the year...

...and higher import of goods for investment and construction activity in the first two months of the second quarter (although at a slower pace, compared to the previous quarter)...

...continuing growth in government expenditures for capital investments...

...with favorable shifts being recorded in inflows of foreign direct investments, which increased on an annual basis.

After the expansion in the first quarter, the nominal **foreign trade data** show deficit reduction in the second quarter, compared to the same period last year...

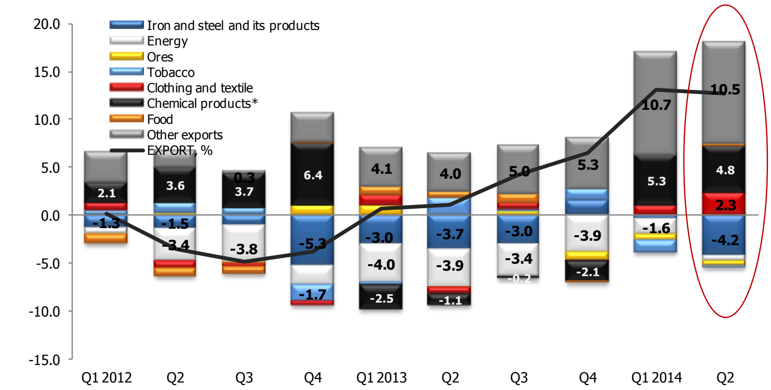
...in line with the expectations in the April projection for nominal narrowing of the trade balance.

Budget performance for the second quarter point to higher **public spending** as projected in April...

...given the higher transfers for health care[9] and wage expenditures on an annual basis.

[9] Most of these assets relate to expenditures for goods and services.

Exports by components
(contributions to the annual change, in p.p.)



Source: NBRM.
* *The following data depict the overall exports of one major export capacity in the free industrial zone.*

During the second quarter of 2014, the **foreign trade deficit narrowed by 8.6% on an annual basis** as a result of the higher growth in exports relative to the growth of imports of goods...

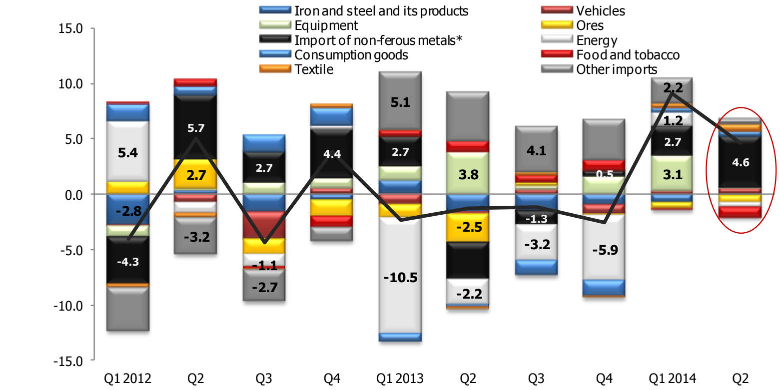
...which is sharper narrowing of the trade deficit relative to the expectations for the second quarter, as projected in April.

In the second quarter, the **exports of goods** registered an annual growth of 12.6%, which was mostly due to the intensified export activity of new export-oriented industrial capacities. Also, significant positive contribution to the growth was made by the export of clothing and textile, and to a lesser extent, the slightly higher export of food...

...while the fall of export of iron and steel, energy and ores acted in the opposite direction.

Compared with the April projection, in the second quarter, the exports is slightly lower than expected, with significant downward deviations in the export of iron and steel, while export performances of new capacities in the economy and the textile industry are higher than projected.

Imports by components
(contributions to the annual change, in p.p.)



Source: NBRM.
* *The following data depict the overall exports of one major export capacity in the free industrial zone.*

In the second quarter, **imports of goods** registered an annual growth rate of 4.7%, primarily driven by the growth of import of raw materials by the new export capacities. Additionally, the annual growth in imports also resulted from the higher import of raw materials for the textile industry, the import of vehicles and consumer goods...

...while the import of food, ores and energy recorded an annual decline.

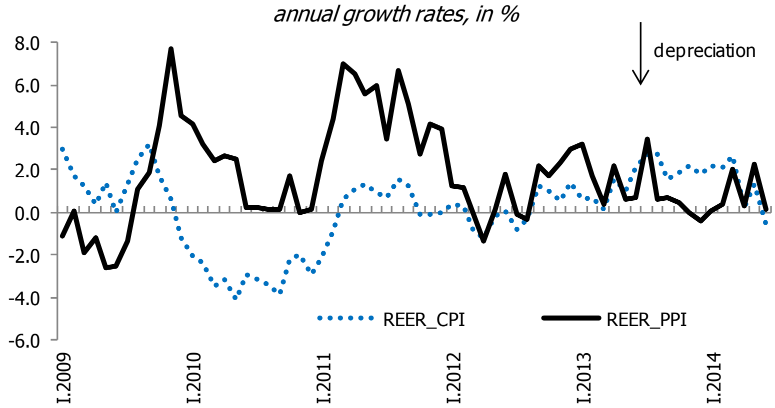
The imports in the second quarter are lower than projected, with the largest negative deviation being registered in other imports, food and ores. On the other hand, import of vehicles, consumer goods and energy imports is slightly larger than expected.

The smaller downward export deviations compared to downward import deviations in the second quarter of the year, led to lower than projected trade deficit for this quarter.

Recent assessments of the movement of global stock prices of copper and nickel suggest favorable conjuncture in the current and the next year, compared with the April projection. On the other hand, the expectations for the prices of crude oil in euros are unfavorable, given the assessments for slower than projected annual decline in prices in 2014 and growth, rather than decline, for 2015.

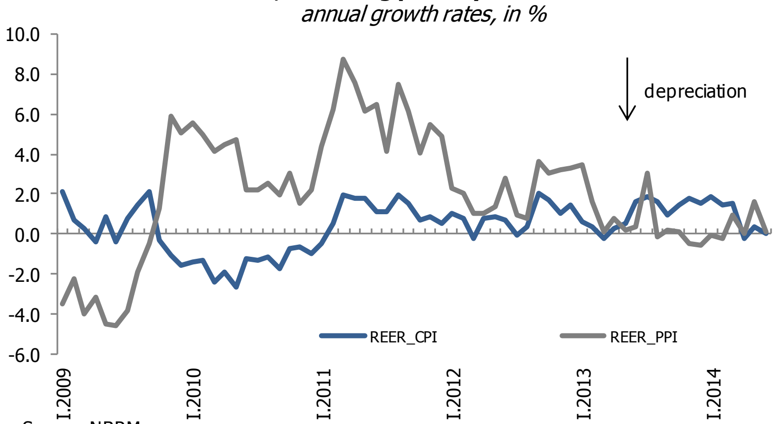
In June 2014, price competitiveness indicators of the domestic economy registered no significant changes compared to the same period last year. The changes in both indices are in the opposite direction. REER index deflated by consumer price index indicates improved competitiveness after a longer period, depreciating by 0.6% annually. On the other hand, REER deflated by producer price index appreciated by 0.2%. Thus, the trend of its appreciation, typical for the first half of the year continued, but at a significantly slower pace.

REER
annual growth rates, in %



Source: NBRM.

REER, excluding primary commodities
annual growth rates, in %

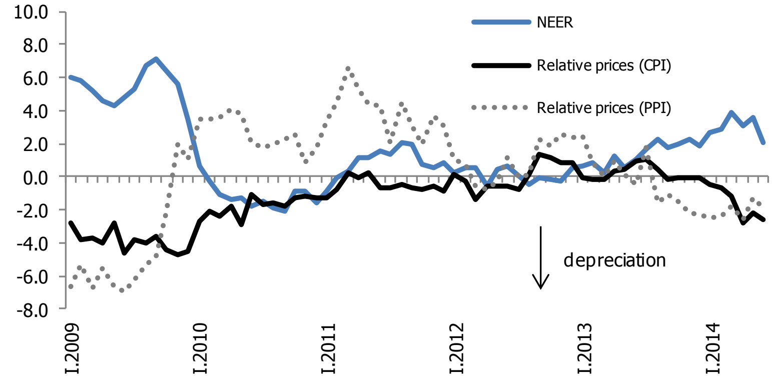


Source: NBRM.

The analysis of the movement of both REER indices calculated using weights based on foreign trade, **excluding primary commodities**[10]**,** again do not indicate significant annual changes. REER deflated by the consumer price index registered no changes compared to the same month last year, while REER deflated by the producer prices appreciated by 0.1%.

[10] Primary products excluded from the calculation include oil and oil derivatives, iron and steel, ores and imported raw materials for new industrial capacities in the free economic zones.

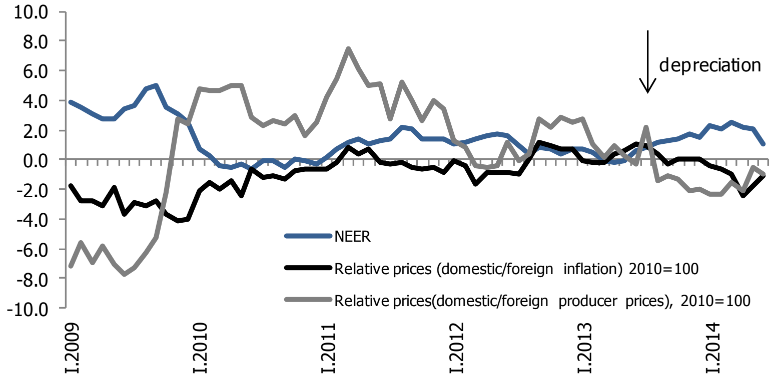
NEER and relative prices
annual growth rates, in %



Source: NBRM.

The appreciation of the nominal effective exchange rate caused upward pressures on REER on an annual basis (by 2.1%), caused by the rapid depreciation of the Ukrainian hryvnia, Russian ruble and Turkish lira against the denar. On the other hand, the annual decline in the domestic prices versus the rise of foreign prices registered in the consumer prices and in the domestic producer prices led to a decline in the relative prices of 2.6% and 1.9%, respectively.

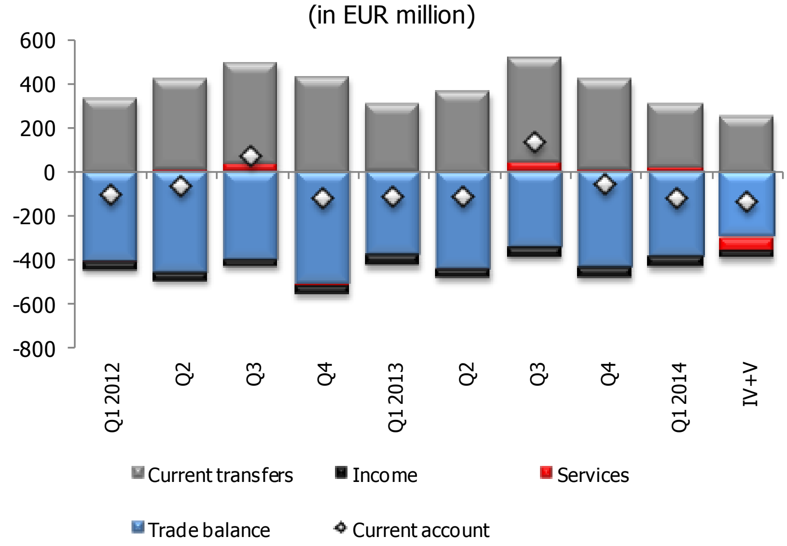
NEER and relative prices, excluding primary commodities
annual growth rates, in %



Source: NBRM.

The annual change in REER, calculated without primary commodities, is driven by the appreciation of the nominal effective exchange rate (of 1.1%), determined by the depreciation of the Turkish lira, the Serbian dinar and the US dollar against the denar, given the favorable changes in the relative prices. The relative CPI registered an annual decline of 1%, and the relative prices of industrial products declined by 0.9%.

Main components of the current account
(in EUR million)

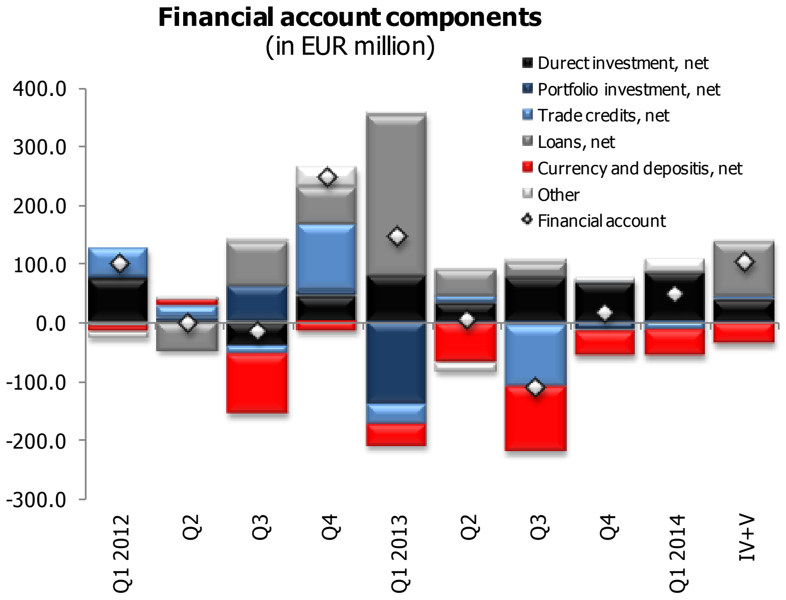


Source: NBRM.

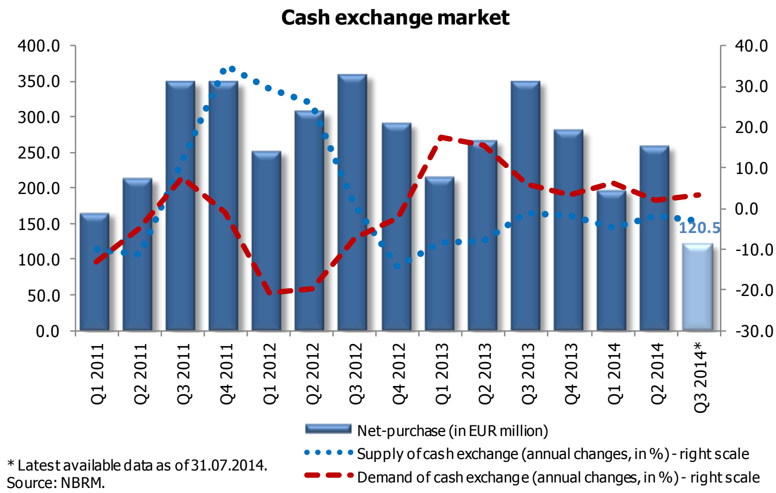
The current account of the balance of payments in April and May 2014 recorded a deficit of Euro 137.7 million (or 1.7% of GDP). The high current account deficit in this period is due to the outflow of services[11] provided in April, as a onetime outflow in the second quarter, anticipated in the April projections. **The current account deficit for these two months indicates better performance in the current account than expected for the second quarter of the year.**

The analysis of individual current account components indicates better performance in the balance of goods and services than projected, while other components did not register significant deviations.

[11] The balance of services deficit in April and May is due to the high losses in construction services based on advances for construction works related to highway construction projects. Simultaneously, during April, the capital and financial account registered inflows of foreign borrowing to finance road infrastructure, in the amount of the outflows generated in the services, with the net effect on the balance of payments in April to May being neutral.



Source: NBRM.



* Latest available data as of 31.07.2014.
Source: NBRM.

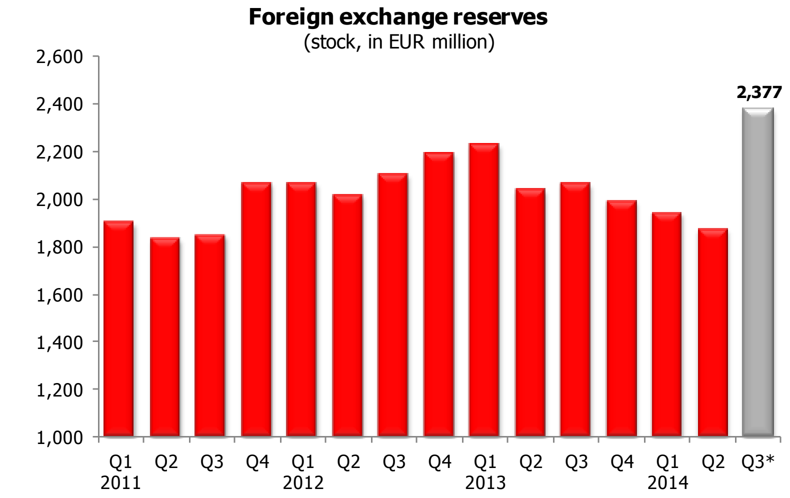
In April-May, the capital and financial account registered net inflows of Euro 105.8 million (or 1.3% of GDP), which is less than projected for the second quarter of the year.

The deviations are mostly due to the higher net outflows in currency and deposits of other sectors, as well as the lower than expected net inflows of long-term financial loans.

On the other hand, during April and May there were net inflows in trade credits, despite the expectations in the April projection for small outflows in this category. Performance of foreign direct investment also indicates the possibility of somewhat higher net inflows than projected.

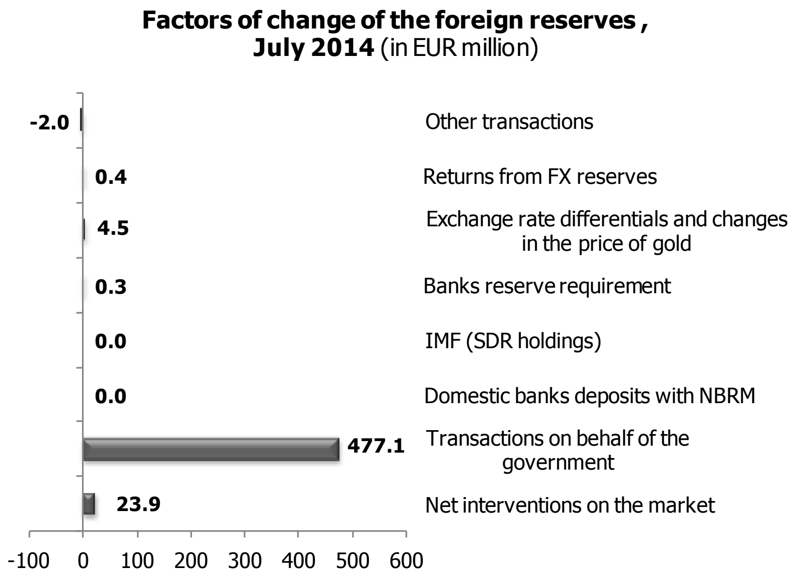
The currency exchange operations data as of July 2014 suggest intensifying decline in the supply of foreign currency on an annual basis, and higher demand for foreign currency.

The net purchase in the foreign exchange market in July totaled Euro 120.5 million, which is an annual decline of 4.6%. The latest information from the currency exchange market do not indicate significant deviations of remittances from the expectations for the third quarter of 2014. However, data refer to a very short period and are not sufficient to reach reliable conclusions.

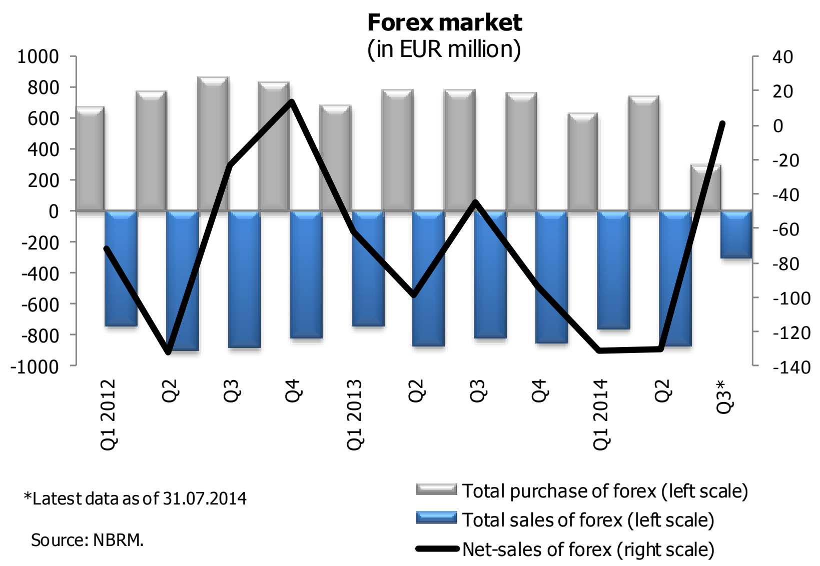


* Latest data as of 31.07.2014.
Source: NBRM.

As of 31 July 2014, the gross foreign reserves totaled Euro 2.377 million, up by Euro 504.2 million compared to the end of the second quarter of 2014. The high growth in foreign reserves is mostly due to transactions for the account of the government, i.e. foreign exchange inflow from the Eurobond[12], with additional positive effect of the net purchase of foreign currency by the NBRM in the foreign exchange market.



Source: NBRM.



*Latest data as of 31.07.2014

Source: NBRM.

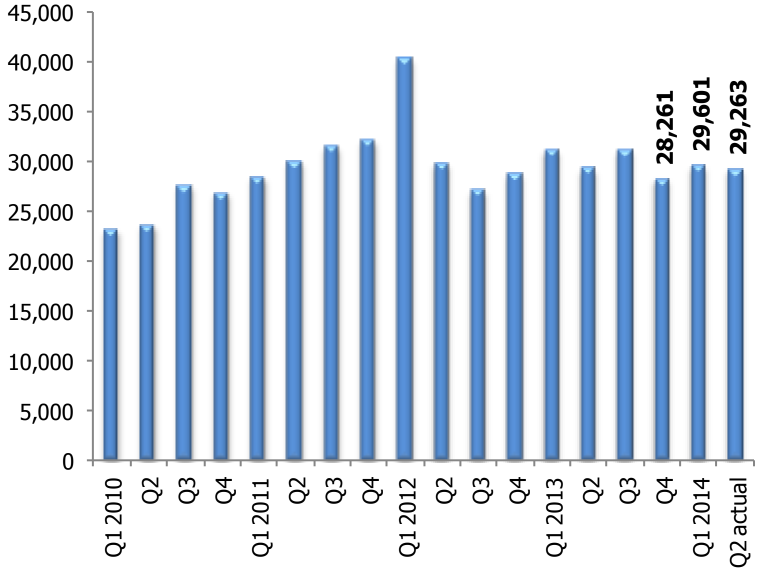
In July 2014, the **foreign exchange market** with the banks registered a net purchase of Euro 1.3 million, versus the net sale of Euro 7 million in the same period last year. This annual change is a combined effect of the annual growth in supply and the fall in demand for foreign currency (1.7% and 1.1%, respectively).

Analysis by component shows that improved performances on an annual basis are mainly due to the lower net sale of companies compared with net sale in this category in the same period last year.

[12] In June, the government borrowed from the international financial markets by issuing a seven-year Eurobond in the amount of Euro 500 million.

Data as of June showed an insignificant liquidity creation through monetary instruments relative to the end of the first quarter, versus the expected slight withdrawal of liquidity as projected in April...

Monetary policy instruments, in MKD million

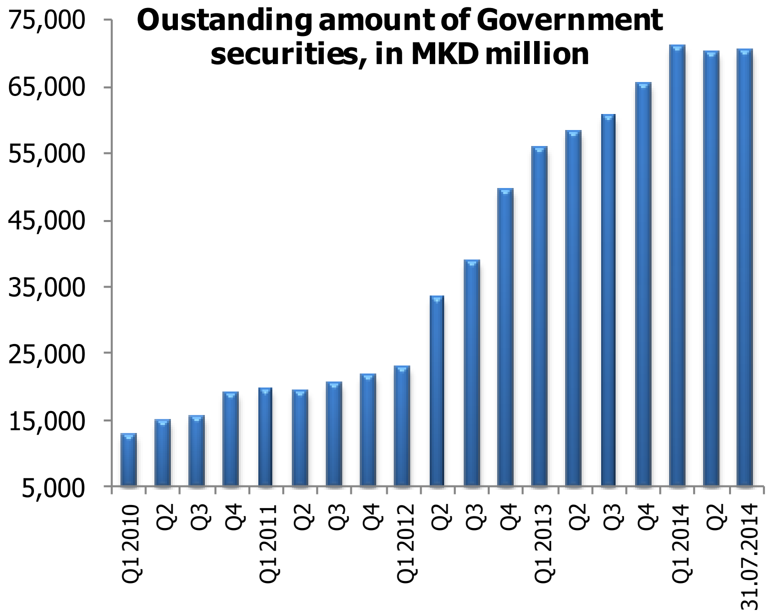


Source: NBRM.

...given the higher quarterly decline in net foreign assets of the NBRM, compared with the April projection...

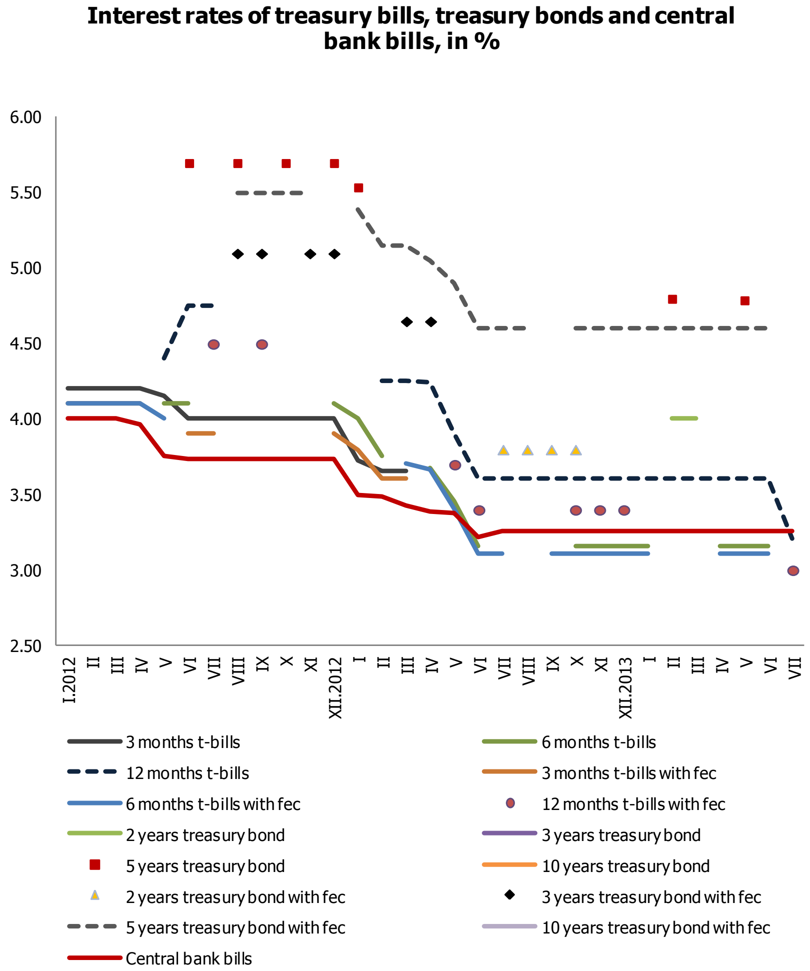
...while the total government deposits with the NBRM created higher liquidity than projected for the second quarter.

In the second quarter, most of the budget funding needs was covered using government deposits. The latest budget balance data show budget deficit of Denar 14,758 million in the first half of the year, or 80.8% of the projected budget deficit for 2014. In July, the government passed a draft budget revision that enables downward adjustments of revenues and to a lower extent, of budget spending. In such circumstances, the projected budget deficit for 2014 was upwardly revised to 3.9% of GDP (3.5% of GDP in the initial budget). The budget revision also implies altered structure of financing the budget deficit i.e. increased share of foreign sources of funding. Moreover, in July, the government borrowed from the international capital market by issuing a Eurobond in the total amount of Euro 500 million, thus providing additional support for the foreign reserves.

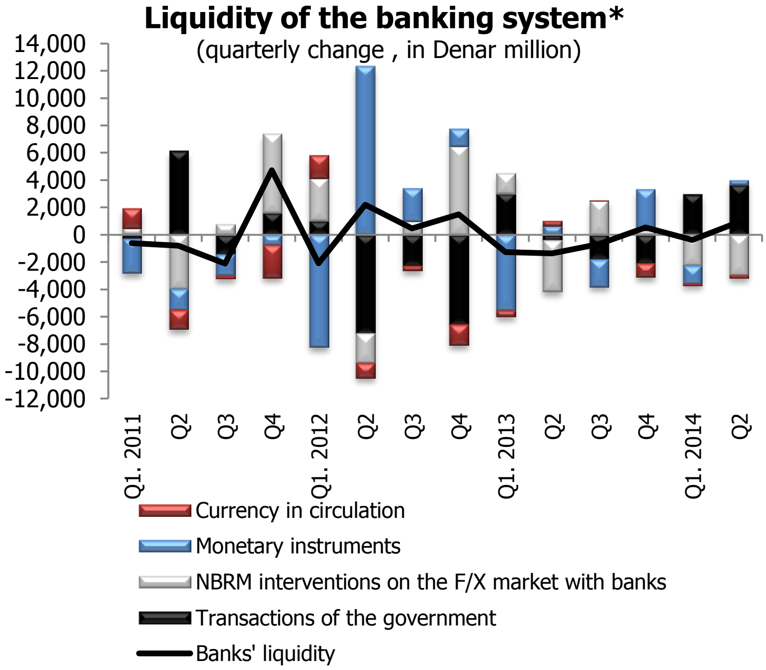


Source: NBRM.

The stock of government securities in the domestic market amounted to Denar 70,496 million at the end of July, and compared to June 2014, it is higher by Denar 282 million.



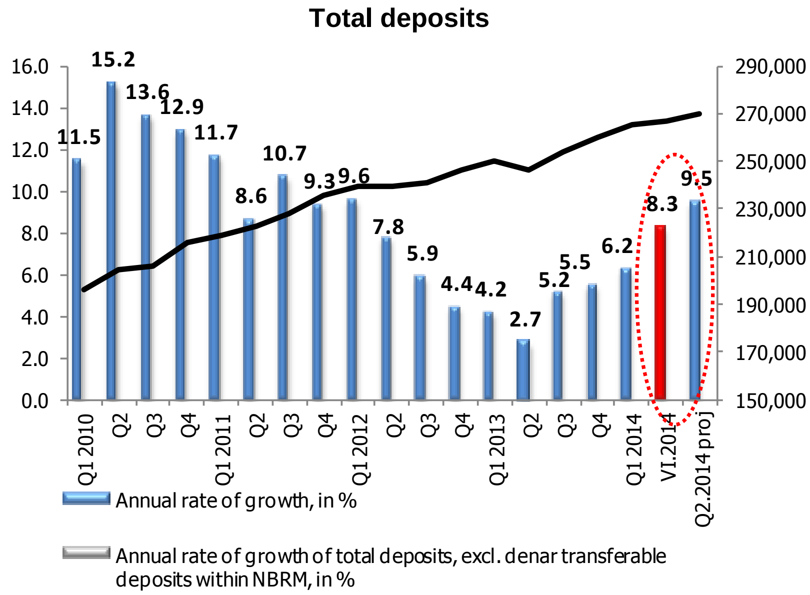
The interest rates at the government securities auctions in July ranged from 3% on 12-month treasury bills with FX clause, 3.2% on 12-month treasury bills to 5% on 10-year government bonds. These changes entailed moderately lower interest rates (by 0.4 percentage points) on 12-month treasury bills, with and without FX clause, compared with the previous auctions.



*Positive change- liquidity creation, negative change- liquidity withdrawal .
** april and may
Source: NBRM.

In late June, the level of reserve money is a bit higher than the projected level for the second quarter...

...given the somewhat faster quarterly growth in currency in circulation and total liquid assets of banks compared with the April projection.

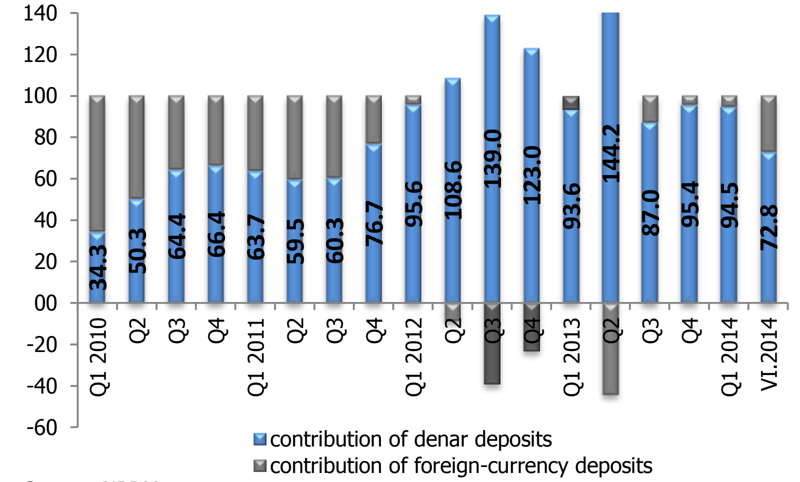


*Includes demand money
Source: NBRM.

According to the data as of June, total deposits registered a significant monthly increase compared with the previous month due to the simultaneous increase in denar and foreign currency deposits. Analyzing by sector, the monthly growth rate of total deposits is predominantly driven by the growth of corporate deposits amid moderate growth of household deposits...

...with **the annual growth rate of total deposits equaling 8.3% at the end of June, which is below the projection for the second quarter (9.5%).** On a quarterly basis, total deposits increased by Denar 1,153 million, which is below the projected growth for the second quarter, according to the April projection.

Contribution of denar and foreign currency deposits to the growth in total deposits (in %)

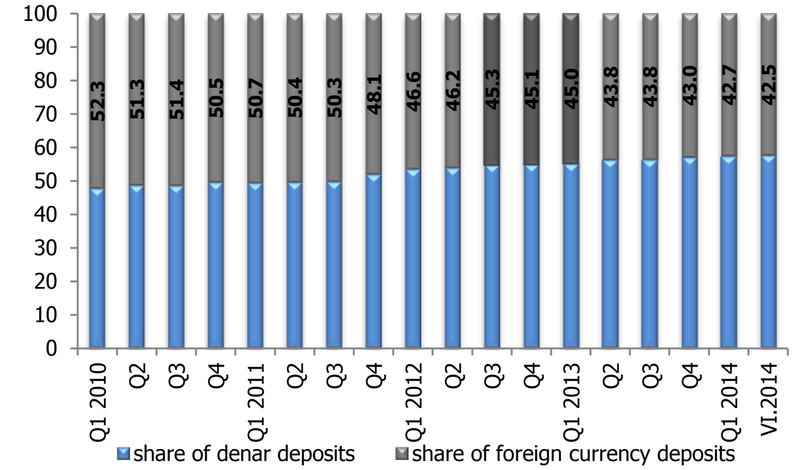


Source: NBRM.

*Includes demand deposits.

The annual deposit growth is still largely due to the growth in denar deposits. However, in the second quarter of 2014, the contribution of foreign currency deposits that accounts for 27% of the annual growth as of June significantly increased. These developments largely reflect the lower base effect of the second quarter of 2013[13]. In the second quarter of 2014, foreign currency deposits registered a slight quarterly growth.

Share of denar and foreign currency deposits in the total deposits (in %)

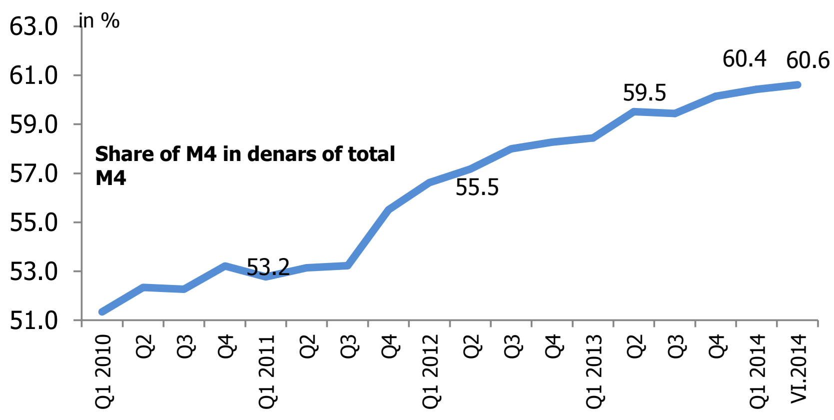


Source: NBRM.

*Includes demand deposits.

The currency structure of total deposits registered no significant changes compared to the previous quarter, i.e. the domestic currency savings continued to have a greater share in total deposits.

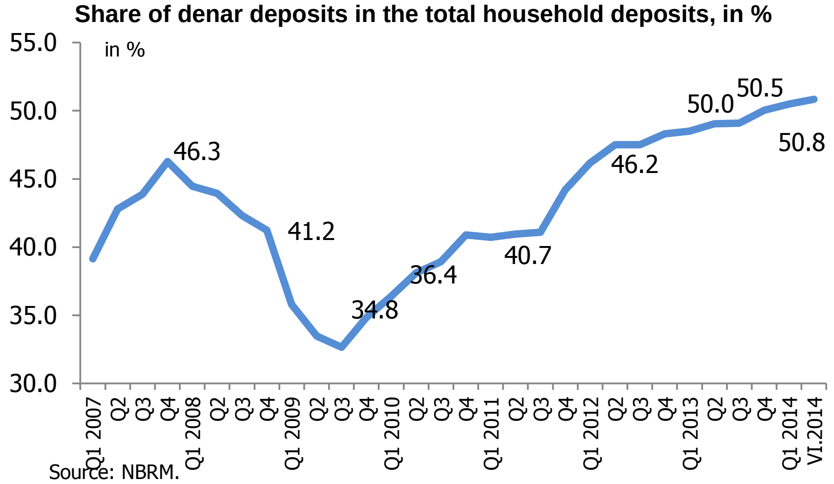
Share of M4 in denars in total M4 (in %)



Source: NBRM.

13 High outflows of foreign currency corporate deposits in April 2013, mainly due to the payment of dividend by a company. In 2014, the amount of dividend paid was lower (again in April), mainly through denar corporate deposits.

Share of denar deposits in the total household deposits, in %

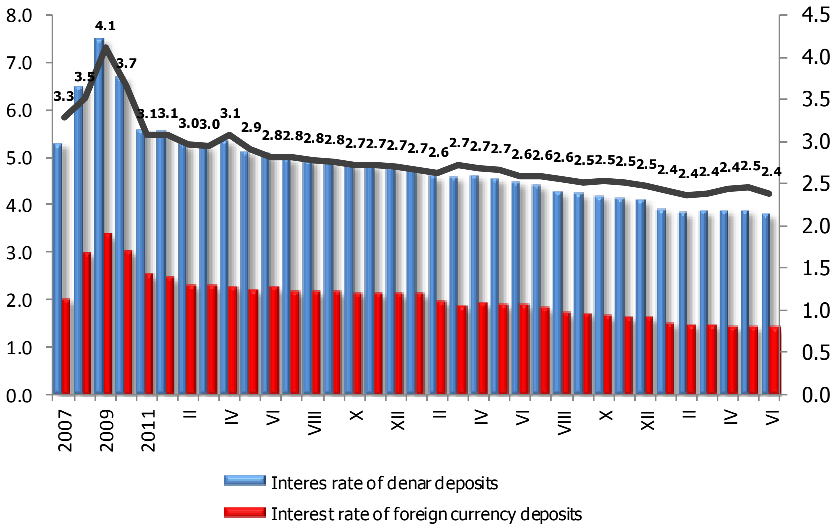


Source: NBRM.

*Includes demand deposits.

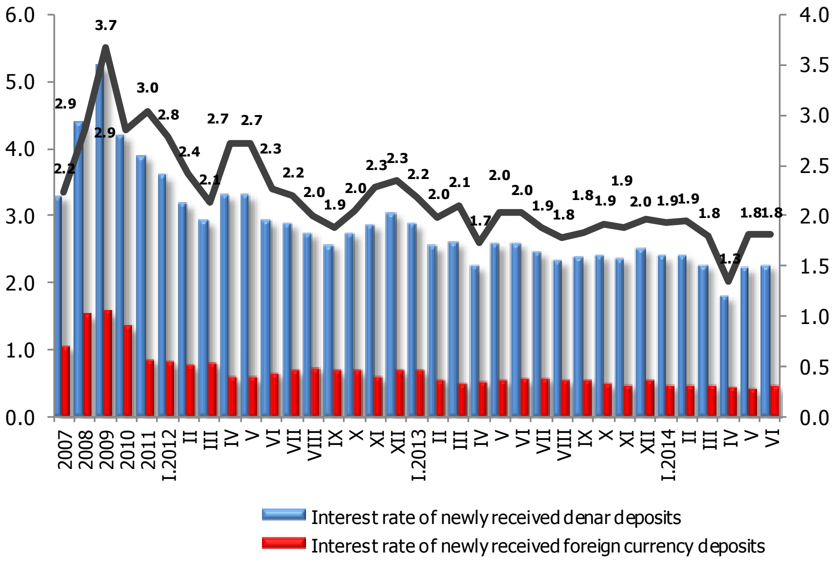
The total deposits in June registered a moderate monthly growth, which is solely due to the growth in denar deposits, amid slight monthly decrease of foreign currency deposits. Thus, the share of denar deposits in total household deposits registered no significant changes and equaled 50.8% in June.

Interest rates on denar and foreign currency deposits, in%



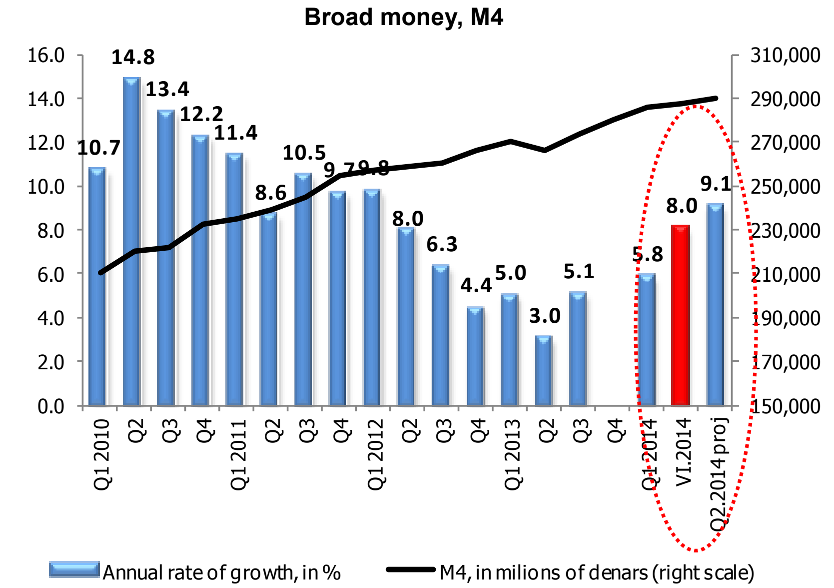
Source: NBRM.

Interest rate of newly received denar and foreign currency deposits, in %



Source: NBRM.

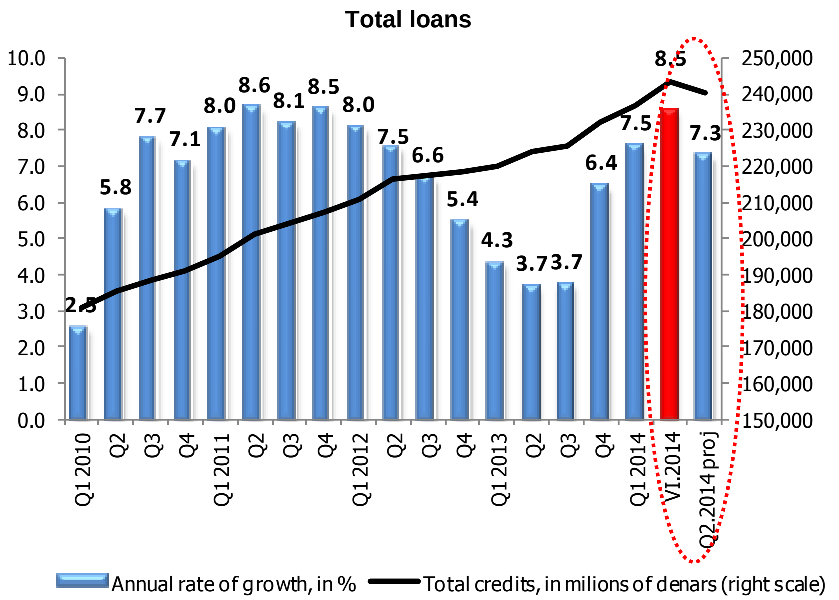
In June, interest rates on denar and foreign currency deposits (total and new deposits) registered no significant changes compared to the previous month, resulting in retention of relatively stable interest rate spread between the denar and foreign exchange savings as compared to the total deposits, as well as to new deposits.



Source: NBRM.

The money supply performance as of June indicates lower than projected monetary growth...

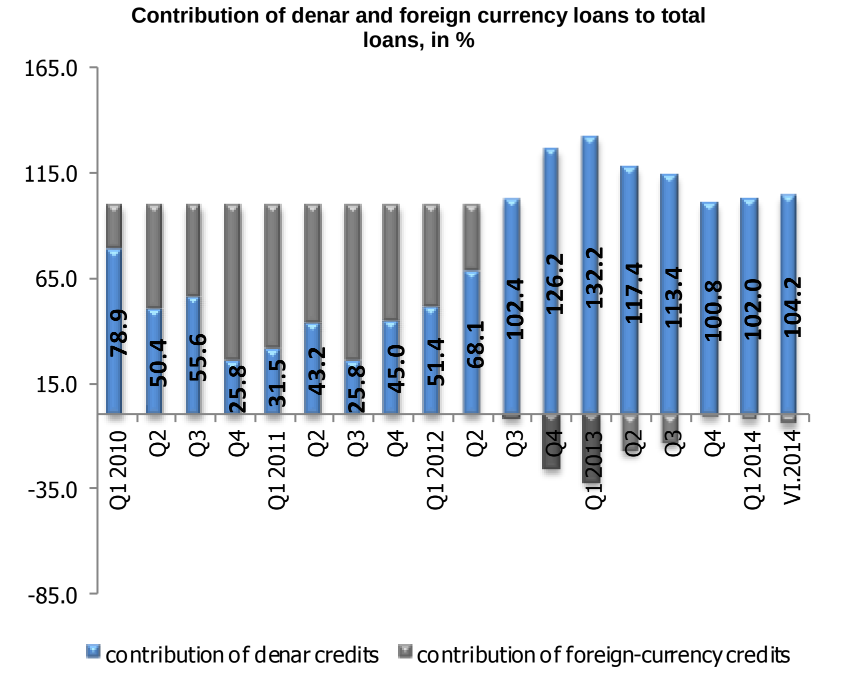
...given the slightly higher performance of currency in circulation and weaker trends in total deposits, as projected in April.



Source: NBRM.

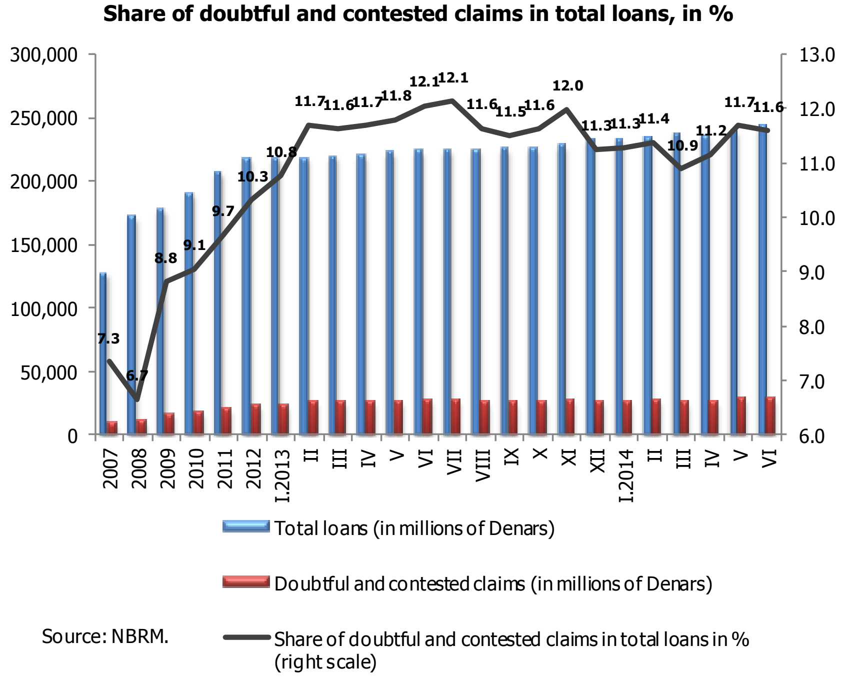
According to the data as of June, the credit market registered further favorable movements, i.e. the monthly growth rate is somewhat lower than the previous month (a month of highest monthly growth since the launch of the crisis). During June, corporate lending continued to be stronger compared to household loans, with the corporate loans making up 54% of the total monthly increase.

At the end of June, the annual growth rate of total loans equaled 8.5%, which is above the projected annual growth of 7.3% for the second quarter of 2014. On a quarterly basis, the increase of Denar 6,742 million is 1.7 times higher than the April projection for the second quarter of 2014.



Source:NBRM.

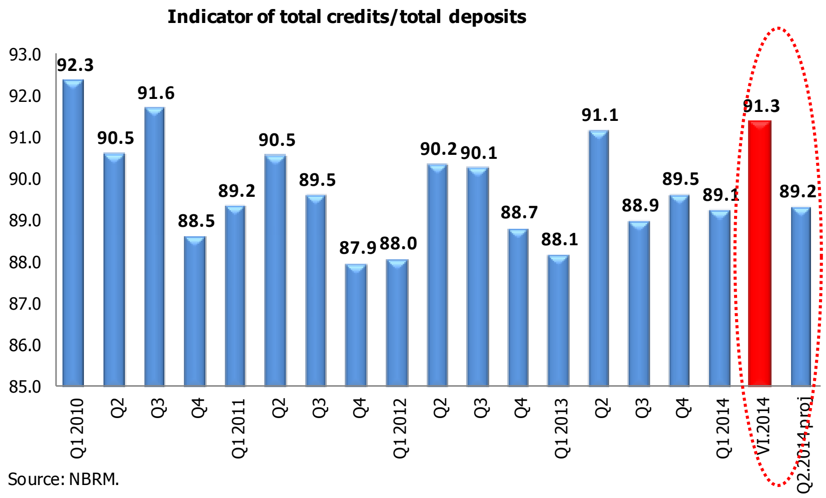
The annual growth of total loans still solely stems from the increased denar loans, and the continuing decline of foreign currency loans.



Source: NBRM.

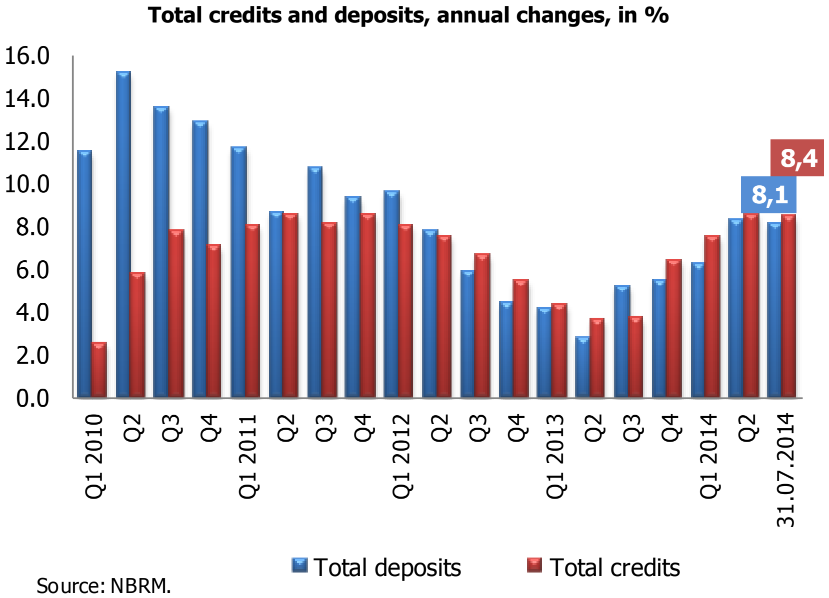
In June, there was a minimal decrease in the share of doubtful and contested claims to total loans[14] despite the increase registered in the previous two months. Changes in this indicator remain predominantly driven by the corporate sector. The doubtful and contested claims of the corporate sector in June registered a small monthly increase, after the relatively faster increase in the previous two months.

[14] The indicator refers to the total loans to the financial and non-financial sector.



The utilization of the deposit potential for lending to the private sector in the second quarter is higher than in the previous quarter, and above the projection...

...mainly due to the more intensive quarterly increase in total loans, amid moderate growth in the deposit base.



Recent preliminary data as of July 2014 show further credit growth (although at a slower pace than the previous two months), given the deposit growth, driven by the increased household savings. In such conditions, the total loans in July rose by 8.4% on an annual basis, while the annual growth of deposits equaled 8.1%.

Box 1: Timeline of changes in the monetary instrument setup of the NBRM and selected supervisory decisions adopted in the period 2013-2014

January 2013

- A Decision amending the Decision on reserve requirement (adopted in November 2012) came into force, allowing reduction of the reserve requirement base of banks for the amount of new loans to net exporters and domestic producers of electricity, as well as for the investments in debt securities in domestic currency without a currency clause, issued by the aforementioned companies. This decision fully exempts the banks from allocating reserve requirement for liabilities based on debt securities issued in local currency with an original maturity of at least two years. The Decision will apply throughout 2014, after which, depending on the results, the need for further application will be reconsidered.

- A Decision on reducing CB bill interest rate was adopted to cut the policy rate from 3.75% to 3.5%. At the same time, the interest rate on seven-day deposit facility and on overnight deposit facility was cut from 2% to 1.75% and from 1.0% to 0.75%, respectively.

March 2013

- A Decision on credit risk management was adopted, which applies from 1 December 2013.

July 2013

- A Decision reducing CB bill interest rate was adopted to cut the policy rate from 3.5% to 3.25%. At the same time, the interest rate on seven-day deposit facility was cut from 1.75% to 1.5%.

- A Decision amending the Decision on reserve requirement was adopted, which reduces the reserve requirement rate for banks' liabilities in domestic currency from 10% to 8% and increases the reserve requirement rate for liabilities in foreign currency from 13% of 15%. In addition, the amendments stipulate a reserve requirement rate of 0% for banks' liabilities to nonresident financial companies with contractual maturity of over one year, as well as for all liabilities to nonresidents with contractual maturity of over two years. A rate of 13% still applies to short-term liabilities to nonresident financial companies in foreign currency with contractual maturity of up to one year. To maintain the reserve requirement in denars and in euros relatively stable, the amendments increase the reserve requirement in euros that is fulfilled in denars from 23% to 30%.

October 2013

- A Decision amending the Decision on banks' liquidity risk was adopted. This decision reduces the proportion of time deposits assumed to outflow from banks, from 80% to 60%, and applies from 1 December 2013. This amendment makes more space for long-term bank lending to the real sector.

November 2013

- A Decision amending the Decision on reserve requirement was adopted, which exempts the NBRM from paying reserve requirement remuneration (previously, this remuneration equaled 1% for denar reserve requirement and 0.1% for euro reserve requirement). The Decision applies from 1 January 2014.
- A Decision on CB bills was adopted, which introduces a methodology for determining the potential demand for CB bills. In accordance with the established mechanism, if there is a higher demand than the potential across the overall banking system, banks that bid higher amounts of their own liquidity potential will be required to place this difference in seven-day deposits.

February 2014

- A Decision on reducing interest rate on seven-day deposit facility from 1.5% to 1.25% was adopted.

April 2014

- A Decision amending the Decision on the methodology for determining capital adequacy was adopted, introducing two amendments in the current decision that are expected to contribute positively to the credit support for the commercial banks to the corporate sector. In fact, the performance guarantees in this decision (in accordance with the amendments to the new EU Regulation no. 575/2013 on prudential requirements for credit institutions and investment firms) are of medium/low risk, since they take lower conversion factor (20%) instead of 50%. It would imply that the calculation of capital adequacy would to a lower extent, treat these off-balance sheet items as on-balance sheet items, which would improve capital adequacy and encourage lending to the corporate sector. There is another innovation motivated by the international practice of establishing funds by low-risk subjects (central governments or multilateral development banks) whose main goal is funding development projects. These projects are mostly funded through one or more commercial banks, which also contribute funds by dividing the exposure into a defined ratio between the bank and the fund or by providing guarantees or other similar instruments used by the fund (warranty provider) to guarantee covering part of the credit risk in the event of default by the debtor. In order to cover these cases, this decision also introduces a more favorable regulatory treatment of the funds established by one or several central governments, multilateral development banks or public institutions. These funds will take 0% risk weight, and the requirement will be that the funding is executed by payment in stakes, i.e. on-balance sheet and off-balance sheet activities to be covered by the fund's equity.