National Bank of the Republic of Macedonia

MONETARY POLICY AND RESEARCH DEPARTMENT

Recent Macroeconomic Indicators
Review of the Current Situation

March 2015

Recent Macroeconomic Indicators
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 (December 2014 - January 2015) and to make a comparison with the latest macroeconomic projections (October 2014). 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 of projections. The review focuses on the changes in external assumptions and performances of domestic variables and the effect of these changes on the environment for monetary policy conduct.

Generally, the global economic environment has not undergone major changes compared to the period of the last assessments. Uncertainties remain, yet the latest indicators suggest that some risks are reduced compared to the October projections. This is especially true for the euro area, where recent high frequency indicators of growth point to performance which is higher (0.3% in the fourth quarter, on a quarterly basis) than expected by the European Central Bank. As of the end of last year and the beginning of this year, the performance as well as the expectations for favorable knock-on effects of lower oil prices, the depreciation of the euro exchange rate and the impact of monetary measures taken by the ECB brought about upward revision of the growth of about 1 percentage point[1], cumulatively, for the euro area for the next two years. On the other hand, February is the third month in a row that registered negative annual growth rate of inflation of 0.3% (although at a slower pace), as a result of the fall in world oil prices. According to these performances, the inflation projections for 2015 were reduced along with the small upward revision of the expected price level in 2016[2]. Inflationary performance and expectations show that the probability of prolonged deflation will remain a key challenge for the monetary policy in the euro area, and the expected recovery of the economy is still not sufficient for greater use of the potential of the economy and for mitigating this risk. In this context, in the meeting in March 2015, the ECB decided to maintain its policy rate unchanged, focusing on the implementation of the set of non-standard measures which the ECB announced in the January meeting, which will become effective on 9 March 2015.[3] **Observed from a viewpoint of the individual quantitative external environment indicators for the Macedonian economy, the assessments regarding the foreign effective demand for the period 2014-2015 underwent minor changes relative to the October projection.** The new assessments indicate somewhat less intensive recovery of foreign demand, largely due to the weaker economic outlook of the neighboring economies, Serbia and Bulgaria. There are no changes in the expectations for growth in foreign demand in 2016. **Changes in the expectations for the prices of primary products move in different directions.** Latest developments and assessments for the **world oil prices** further indicate lower price levels of this energy source in relation to the October expectations, and accordingly, less pressure on inflation and terms of trade in 2015. Yet another rise in oil prices is expected in 2016, despite the expected stagnation in the October projections. Recent movements in **metal prices** suggest slightly more favorable changes in nickel and copper prices on average for 2015-2016, compared with the October projections. Regarding the **food prices**, recent data on cereals point to higher price levels for these products, indicating somewhat higher import pressures through this channel on the domestic inflation and the terms of trade, compared with the October projections. Frequent adjustments in the expectations about the prices of primary products confirm the high uncertainty about their future movements.

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[1] According to the latest ECB's projections from March 2015, the growth rate of real GDP for 2015, 2016 and 2017 is estimated at 1.5%, 1.9% and 2.1%, respectively. The previous (December) projections estimated that the growth will be 1% and 1.5% for 2015 and 2016, respectively.

[2] In the March forecast, the ECB projected the HICP inflation rates at 0%, 1.5% and 1.8%, for 2015, 2016 and 2017 respectively, compared to the December projections of 0.7% and 1.3% for 2015 and 2016, respectively.

[3] For more details see the *Recent Macroeconomic Indicators - Review of the Current Situation – Implications for the Monetary Policy,* February, p.2 detailing measures adopted in the January meeting of the ECB.

The comparison between the latest macroeconomic indicators and their projected dynamics within the October cycle projections does not indicate major deviations in the individual segments of the economy. Observing indicators relevant for the monetary policy, in January, the domestic prices continued to decline on an annual basis, but at a faster pace (decline in the prices of 1.5% versus 0.5% in December 2014), due to the reduction of all inflation components. However, the greatest contribution was made by the energy component, reflecting the declining world oil prices. Core inflation also decelerated, being in the negative zone on an annual basis for the fifth month in a row. After the stagnation in the previous two months, in January, the food prices declined again, reflecting the lower prices of most food categories. Given these inflation performances, as well as the changes in key assumptions for the prices of primary products, particularly the significant downward revision of the expected movement of energy sources (despite the expected higher prices of cereals), **the risks about the projected movement of domestic prices in 2015 are mainly downward.** However, changes in expectations about the prices of primary products indicate that the uncertainty about the future movement of these products is important, and the possibility of sudden changes in these categories is great. At the same time, the previously identified upward risk remains, attributable to the adverse weather conditions in the domestic economy, whose effect is still difficult to assess.

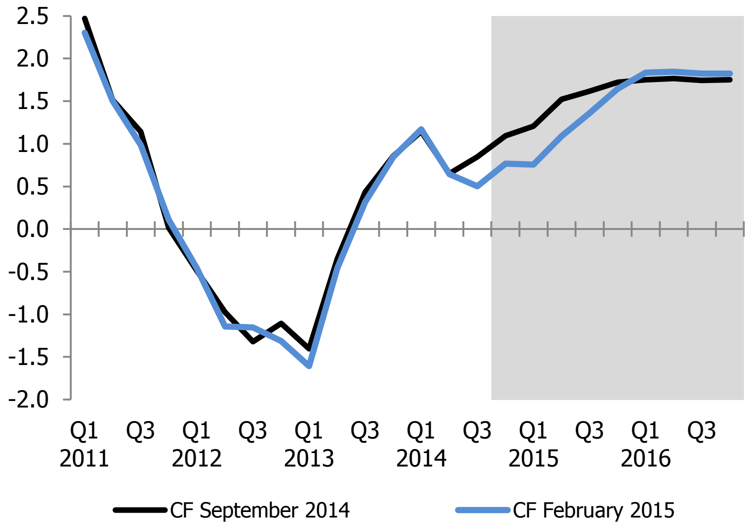
The latest data on foreign reserves show substantial decline since the beginning of the year (excluding the effects of price and exchange rate differences and changes in securities price). Analyzing through the change factors, the reduction of reserves in this period is a result of transactions for account of the government, with the greatest effect of the early repayment of the loan from the IMF, used within the Precautionary Credit Line. Observing the external sector indicators, balance of payments data for 2014 confirm the previous findings of lower than expected current account deficit in 2014 (1.3% of GDP, against a projected deficit of 2.7% of GDP). The better than expected export performance of new export-oriented facilities almost halved the projected deficit. On the other hand, incurred net liabilities on financial transactions have generated somewhat lower inflows than expected, largely due to the banks' accumulation of foreign currency. With regard to the latest available external data, foreign trade indicators for January suggest a smaller trade deficit, as a combined effect of the good performance of the new companies and smaller pressures from energy imports, due to the lower than projected oil prices. Net purchase from currency exchange operations as of the second ten-day period of February gives a signal for increasing private transfers and better performances than projected, which is probably largely due to the high purchase of Swiss francs, after the Swiss National Bank abandoned the exchange rate target and the strong appreciation in mid-January. The analysis of foreign reserves adequacy indicators shows that they continue to move within a safe zone.

The latest high frequency data for the economic activity for the last quarter of 2014 point to further growth of the domestic economy, probably at the similar pace as in the previous quarter. The continuous economic growth in the last quarter is perceived through most of the sector indicators, with positive annual developments being observed in the construction sector for the first time in half a year, with intensified activity in the area of infrastructure. Movements in the indicators of economic activity registered so far, suggest likelihood of a slightly faster than expected growth in 2014. **In terms of monetary movements, credit market data** for January show decreasing credit flows on a monthly basis, with weaker credit activity in the corporate segment. These movements are not unusual for this time of the year, yet it will take time to provide more reliable conclusions about the durability of these movements. Analyzing the deposit potential, January recorded a solid growth as projected in October. However, given the strong growth in loans and deposits at the end of last year, which also exceeded expectations, the stock of deposits and loans are above or close to the projections for the first quarter. The latest **EURIBOR assessments indicate its lower level in the 2015-2016 period, compared to the October projection.**

The latest macroeconomic indicators and assessments do not point to major changes in the conclusions about the environment for conducting monetary policy and about the

risks, compared to the assessments provided in the October projections. Foreign reserves have been decreasing since the beginning of the year, as expected. Foreign reserves adequacy indicators remain in the safe zone. Risks arising from external environment remain unfavorable, even though they are mitigated by recent amendments to the ECB's monetary policy. Inflation performance in January shows accelerating annual decline, and along with the fall in oil prices, reinforce the downward risks about the projection of the future dynamics of inflation. Indicators of economic activity for the last quarter of 2014 point to preservation of the growth pace and somewhat more solid performance than expected. Analyzing credit market, although the new trends as of the beginning of the year are negative, yet given the intense and over the expected credit growth at the end of the previous year, total credit support to the economy in the previous period is as expected. In terms of the latest trends, the time period is short to draw any reliable conclusions about their nature.

Foreign effective demand
(annual rates of change in %)



Source: Consensus Forecast and NBRM calculations.

According to the recent assessment, the growth rate of foreign effective demand[4] equaled 0.8% in 2014, which is close to the October projection of 0.9%.

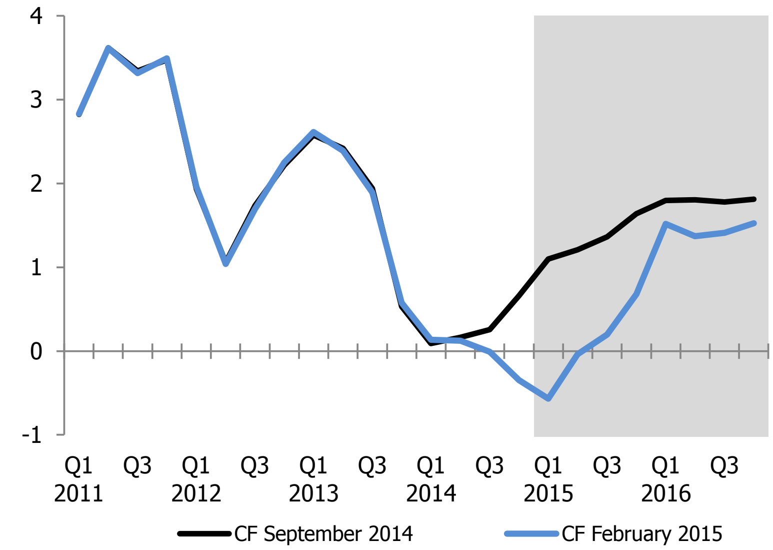
The economic growth in most of our major trading partners for 2015 was revised downward...

...and therefore, it is expected that the growth of foreign demand this year will be lower than the October projection (1.2% versus 1.5%).

The downward revision largely stems from the more pessimistic estimates for neighboring economies, or the expected economic stagnation in Serbia, and to a lesser extent, from the lower expected GDP growth of Bulgaria.

On the other hand, foreign demand is projected to increase by 1.8% in 2016.

Foreign effective inflation
(annual rates of change in %)



Source: Consensus Forecast and NBRM calculations.

In 2015, there were significant downward revisions of the projected inflation in all our import partners...

...which contributed to a significant reduction of the projection of foreign effective inflation from 1.3% as projected in October to 0.1%.

In terms of individual contributions, the downward revision is mainly associated with the significantly lower expected inflation in Germany, as well as the estimates of lower import price pressures from Serbia and Croatia[5].

Estimates show that the foreign effective inflation will be 1.5% in 2016, which is also a downward adjustment compared with the October projection of 1.8%.

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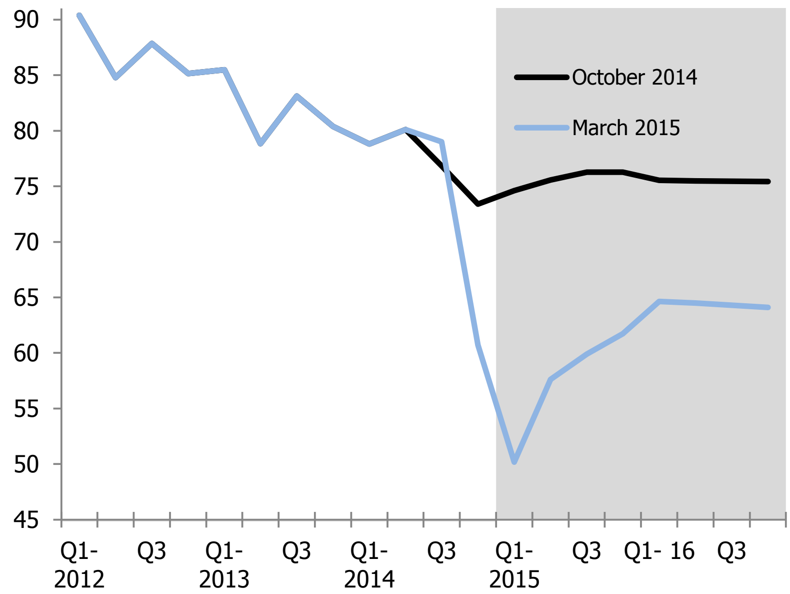
[4] Revisions to historical data partly reflect the use of the new series for the countries included in the calculation, which are prepared according to the European System of Accounts 2010 (ESA 2010).
[5] Inflation in Serbia and Croatia has been adjusted for the changes in the exchange rate.

Brent oil
(quarterly average, EUR/Barrel)



Source: IMF and NBRM calculations.

Despite the October forecast for slight decline of oil price in 2015, the latest estimates suggest that the decline will be double-digit...

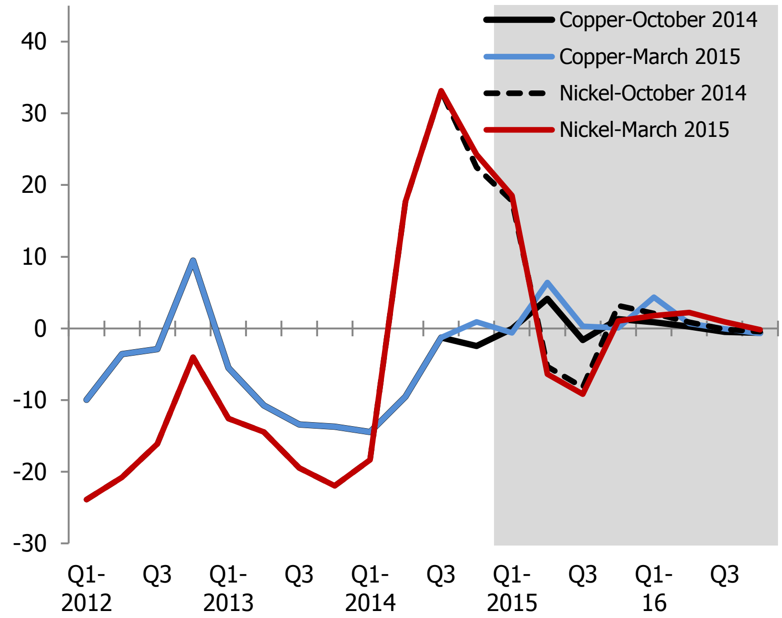
...taking into account the market saturation, which is largely caused by the higher oil shale production in the United States and high global oil supplies.

Besides the factors on the supply side, downward pressure on oil prices are also expected to arise from the lethargic global demand in 2015.

However, it is worth mentioning that in the recent period there have been certain upward fluctuations in the oil price, associated with the announced reduction in the number of oil platforms in the United States, which can be a risk factor for the projection for this year.

Projections show that oil prices will follow an upward trajectory and achieve significant growth in 2016 compared to the previous year, which is different from the October projection of a minimal decline. However, comparing the projections, by the end of 2016, the oil price will be positioned at a lower level than projected in October.

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



Source: IMF and NBRM calculations.

The trajectory of metal prices this year and next year is generally similar to the October projections.

Analyzed by year, projections say that the average price of nickel in 2015 will keep the level of the previous year, despite the October estimate of minor growth...

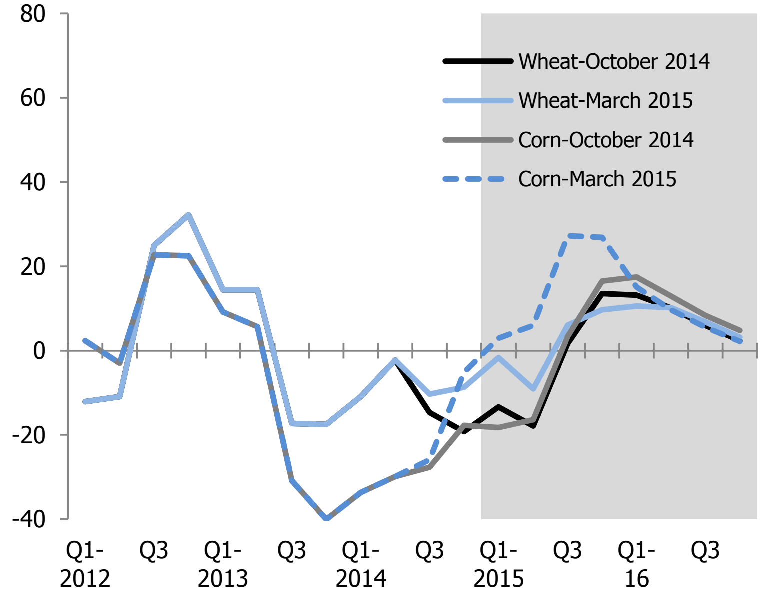
...associated with information for significant growth of inventories of this metal and the gradual substitution of the banned Indonesian export with the Philippine export...

...while the price of copper is now expected to note slightly higher growth than projected in October...

...as a result of expectations for positive effects of the possible additional incentives in China on demand.

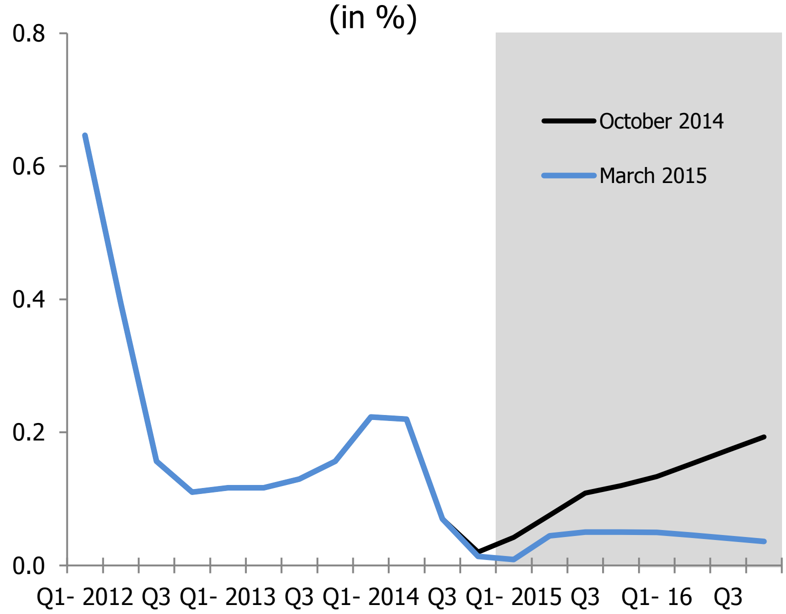
In 2016, the prices of observed metals were moderately revised upward, i.e. now they are expected to increase faster compared with the October projection.

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



Source: IMF and NBRM calculations.

1M Euribor
(in %)



Source: Consensus Forecast and NBRM calculations.

Higher prices of cereals in euros are now expected for 2015 unlike the October projections.

Notwithstanding high stocks at the end of 2014 and favorable prospects for this year's harvest, the current estimates point to higher prices of wheat and corn, despite the fall as projected in October...

...which in the absence of major changes[6] in the fundamentals, mainly reflects changes in the exchange rate of the US dollar against the euro.

The estimated rise in wheat price for 2016 remains as projected in October, while the expected rise in corn price was moderately revised downward.

In the first quarter of the year, the one-month EURIBOR has slightly deviated from the October projection, and this difference further increased during the projection period.

The main rationale behind is the ECB's[7] program of quantitative easing adopted at the end of January...

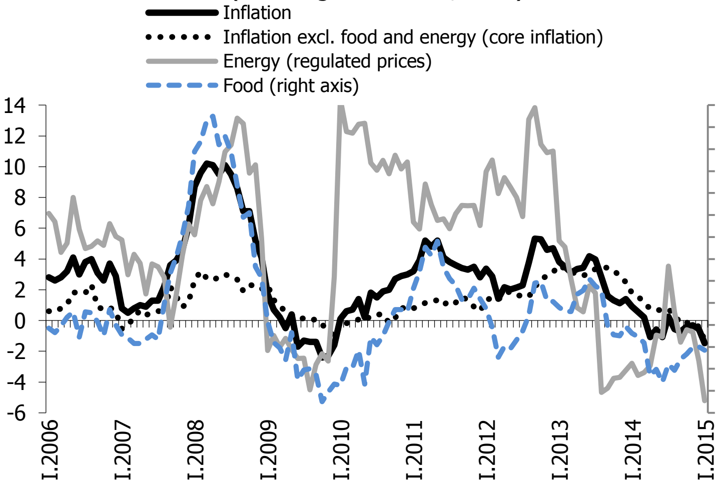
...which, coupled with the implementation of other measures for monetary easing, mainly long-term refinancing, and their effect on the increase of excess liquidity in the euro system, made the short-term interest rates drop to record lows.

Thus, given the time frame of these measures, it is now projected that foreign interest rate in 2015 and 2016 will remain low at 0.04%, on average, which is a downward revision of 0.09% and 0.16%, respectively compared to the October projection.

[6] On 1 February, Russia imposed export duty of 15% + 7.5 euros per ton for wheat by 30 June, but given the adequate global supplies, it is estimated that it will not affect its price.

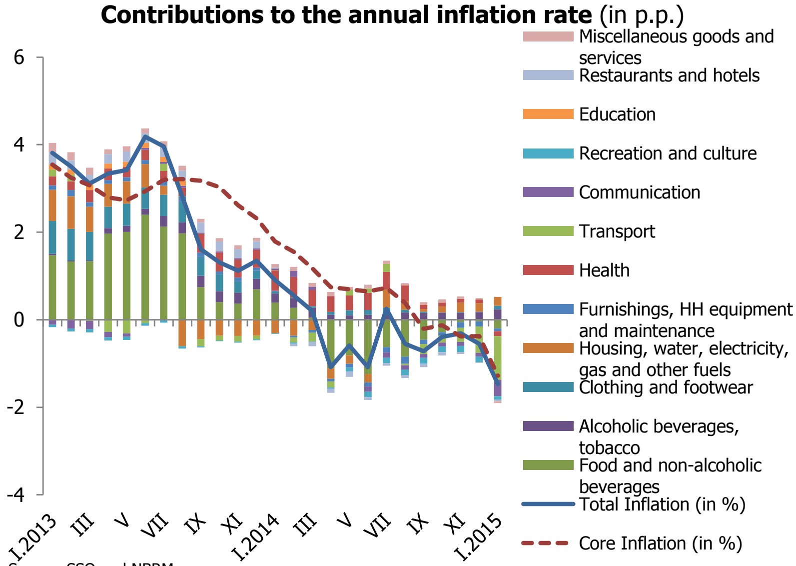
[7] For more details about the program, see *International Economic Surrounding* in the Quarterly Report, February 2015.

Inflation and volatility of food and energy
(annual growth rates, in %)



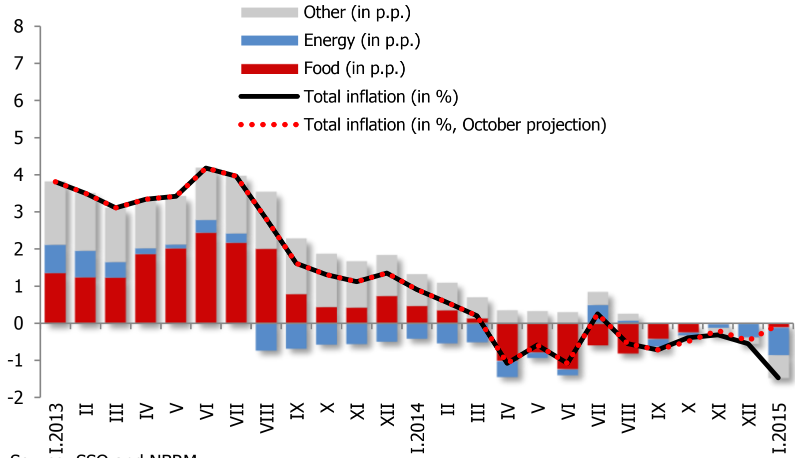
Source: State statistical office and NBRM calculations.

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.

After two months of stagnation in the price level, consumer prices in January 2015 declined by 0.8% on a monthly basis...

...mostly due to the lower prices of transport, communications, as well as food[8].

According to the monthly dynamics, the annual decline in inflation accelerated from 0.5% in December to 1.5% in January...

...which is a lower rate than expected in the October cycle projections...

...amid downward deviation of the actual inflation from the projected one in the energy component, the core inflation and the food component.

In January, **core inflation decreased by 1%, on a monthly basis** (compared to December when it remained the same)...

...while on annual basis, it continued to decline for the fifth consecutive month, and in January, its pace of decline accelerated and equaled 1.3% (despite the fall of 0.4% in December).

The annual decline in prices is largely due to the fall in prices of communications, soft drinks, and IT equipment.

[8] Categories with the greatest individual contribution to the January price level include liquid fuels and lubricants (monthly price decline of 10.1%), handsets and services (monthly price decline of 0.9%) and vegetables (monthly price decline of 1.8%).

External input assumptions for 2015, which are included in the inflation projection, have been revised in divergent directions.

Thus, according to the latest assessments, lower **foreign effective inflation** is expected by the end of 2015.

Also, the assessments for **oil price** movement for 2015 have been downwardly adjusted...

...reflecting the OPEC's November decision not to reduce the volume of production in the next period, the release of geopolitical tensions, and the increasing production and inventories in the markets, notwithstanding further strengthening of the value of the US dollar.

On the other hand, the recent estimates of the prices of internationally traded primary food products indicate upward adjustments of the prices of cereals in 2015, compared with the signals registered during the October cycle of projections.

Amid high supplies and favorable prospects for crops this year, the growth in the price of cereals is largely explained by the appreciation of the US dollar.

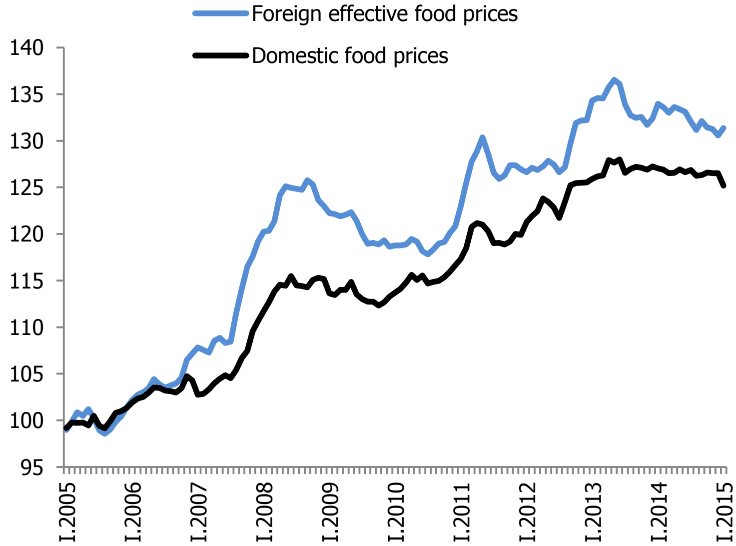
Risks surrounding the projected movement of domestic prices in 2015 are mainly downward, amid downward deviation of the actual compared to the projected movement of prices in January and significant downward revision of the expected movement of energy sources...

...despite the upward revisions of prices of cereals.

However, one should bear in mind that there is great uncertainty about the future movement in world oil prices and the possibility of sudden changes in this category. Also, floods that swept

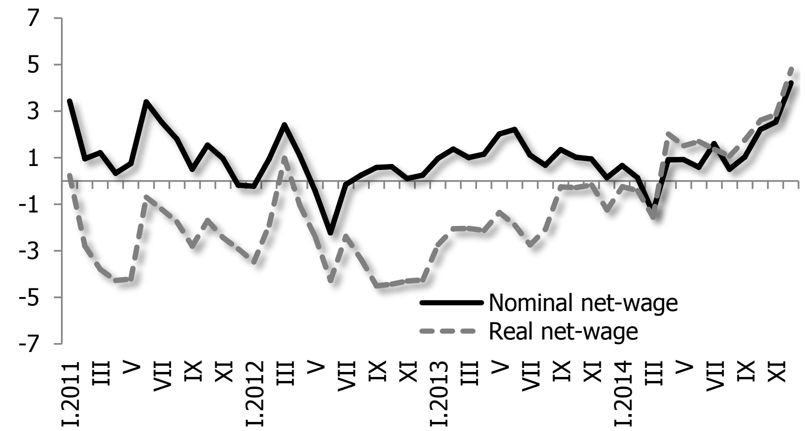
Foreign effective food prices* and domestic food prices

(indices, 2005 =100)



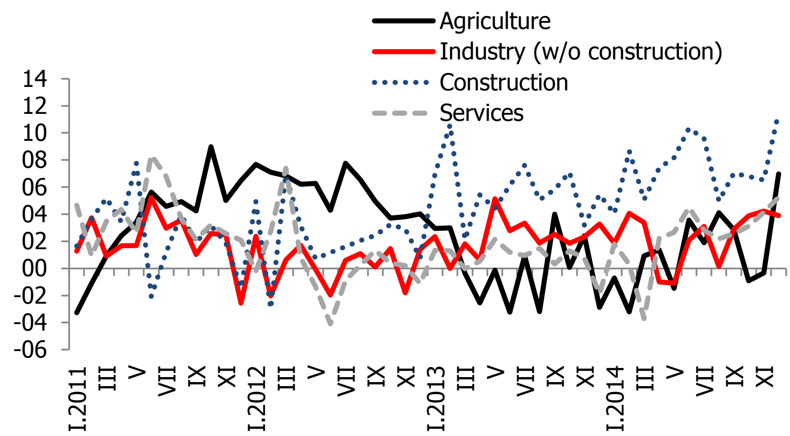
* Foreign effective food prices are calculated as weighted sum of food prices in countries that are major trade partners with Macedonia.
Source: State statistical office, Eurostat and NBRM calculations.

Average net-wage
(annual changes, in %)



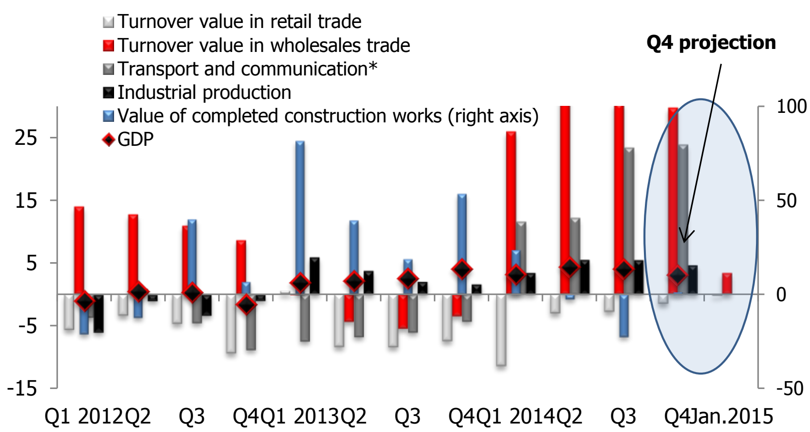
Source: SSO.

Average monthly net wage paid by sectors
(nominal annual changes, in %)



Source: SSO.

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.

Macedonia at the beginning of the year could generate upward pressures on prices of early vegetables and cereals.

In December 2014, the average **net wage** recorded a nominal annual growth of 4.2%...

...which is an acceleration of 1.7 percentage points compared to November.

Wages in almost all economic sectors increased...

...with the highest annual wages being recorded in construction, manufacturing, agriculture, activities related to real estate and in the sector of professional, scientific and technical activities.

Thus, the nominal average wage in the fourth quarter was by 3% higher, annually, which is upward deviation compared to the projected growth of 1.4% in the October projection.

The acceleration of nominal growth in December hastened the growth of real wages which in December rose by 4.8%, compared to the growth of 2.9% in November...

...which was also higher than expected in the October cycle projections.

The indicative high-frequency data for the fourth quarter of 2014 indicate growth of the national economy at a similar pace as in the previous quarter, given the continuation of positive performance in major economic sectors.

Namely, **industrial production** kept on growing in the fourth quarter (annual growth of 4.7%), albeit at a somewhat slower pace compared to the previous quarter...

...mostly attributable to the growth in production of motor vehicles, as well as production of machinery and devices, mainly reflecting the operating of new facilities in the technological and industrial development zones.

Favorable trends have been noticed in the **trade sector**, whose annual growth rate slightly accelerated in the fourth quarter...

...given the continuous strong double-digit growth in the wholesale trade and trade in motor vehicles and further slowdown of the decline of retail.

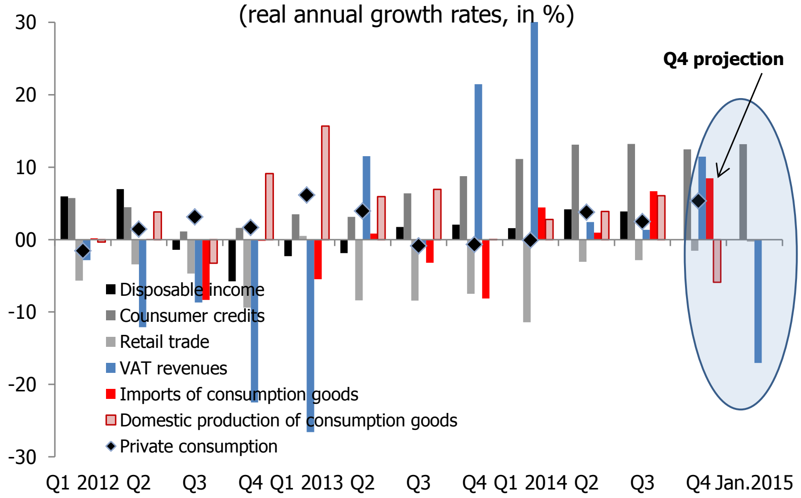
Economic activity in the fourth quarter is further supported by the **hotels and restaurants** sector given the accelerated growth in the turnover in this sector...

...as well as the positive developments within the **transport and storage** sector.

Despite the fall in the previous six months, the fourth quarter of 2014 recorded an increase in the value of **completed construction works**. The favorable shift in the last quarter of the year stems solely from the high growth of completed construction works in December (an annual growth rate of 24%) given the accelerated activity in infrastructure projects.

Available high-frequency indicators of aggregate demand also point to further economic growth in the last quarter of 2014, which is consistent with the expectations in the October projection.

Indicative variables for private consumption
(real annual growth rates, in %)



Source: SSO and NBRM calculations.

Indicators of **private consumption** are favorable and indicate its increase in the last quarter of 2014...

...as a result of the acceleration of annual growth of real wages and remittances...

...continuation of double-digit growth in loans to the household sector...

...and restraining the growth of pensions paid (although at a slower pace) in the last quarter of the year.

The accelerated growth in net revenues from VAT and import of consumer goods also point to higher household spending in the fourth quarter of the year.

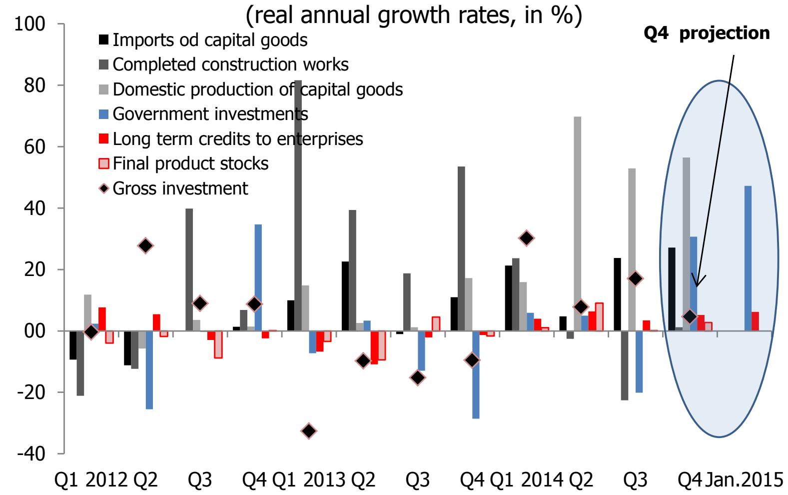
Analyzing indicative categories for the movement of private consumption, a fall was registered only in the domestic production of consumer goods (compared to the previous quarter) and in retail trade (albeit at a slower pace).

In the fourth quarter, according to the available high frequency data for this period, **investment activity** is expected to increase...

...against the backdrop of intensive growth in the import of capital products and in the domestic production of capital goods...

...while accelerated growth in the last quarter was also registered in the long-term lending to the corporate sector.

Indicative variables for investments
(real annual growth rates, in %)



Source: SSO and NBRM calculations.

The government spending for capital investment and the value of completed construction works registered favorable trends in the last quarter, despite their decline in the previous quarter, which also indicates growth of investment demand in this period.

The available nominal **foreign trade** data show rising trade deficit in the last quarter compared to the same period last year...

...in line with the expectations from the October projection for widening the trade balance, although with less intensity than expected.

Budget performances for the last quarter point to an increase in **public consumption,** rather than a decline, as projected in October...

... with a rapid increase of costs for goods and services, as well as wage costs...

...with additional influence of the growth of the transfers for health care[9], versus their fall in the previous quarter.

Most data for January 2015 indicate a continuous growth of economic activity. However, note that these estimates are based on very few data available, which leaves room for greater uncertainty about the findings.

January data suggest positive trends in **private consumption** in the first quarter of 2015 as projected in October...

...given the accelerated growth of loans to households and pensions paid...

...and the further slowdown of the decline of retail trade.

On the other hand, January registered a decline in revenues from VAT.

The first quarter of 2015 could witness higher **investment demand**...

...given the double-digit growth of government capital investments...

...and moderate acceleration of the growth of corporate loans.

Foreign trade data for January 2015 indicate a significant deficit reduction, despite the expectations for its expansion in the October projection...

...given the high growth in exports and decline in imports of goods.

The January budget execution currently provides prospects for upward deviation in **public spending**, despite the expectations for its decline in the first quarter of the year, as projected in October.

These findings about the public spending are associated with the higher costs for wages and for goods and services, as well as the higher transfers for health care.

[9] Most of the transfers for health care relate to expenditures for goods and services.

In the first month of 2015, **the foreign trade deficit registered significant annual contraction of 47.9%,** driven by the high annual growth of exports and the simultaneous reduction of import component...

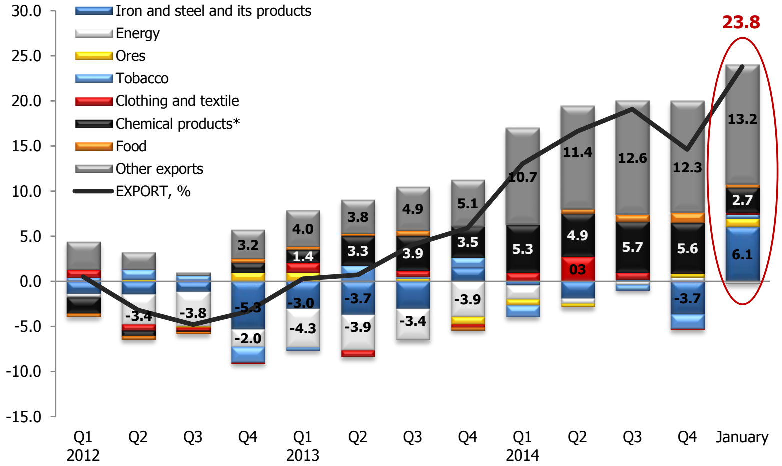
...which is contrary to the expected annual widening of the trade deficit in the first quarter, according to the October projection.

Export of goods recorded a remarkable annual growth of 23.8% in January, driven by the improved export performance of the new facilities in the economy, and the recovery of exports of the metal industry...

... with significantly lower, but positive contribution of other export categories, with the exception of energy sources, which registered an annually reduction.

Compared with the projection, export in January was higher relative to the expectations for the first quarter. The positive deviation is mostly due to the improved export performance of the new facilities, while minor downward deviation was registered in the export of tobacco and energy sources.

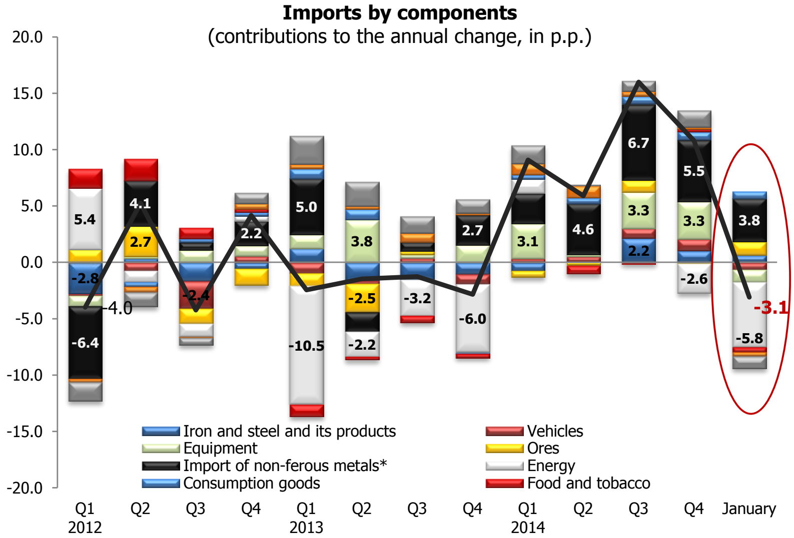
Exports by components
(contributions to the annual change, in p.p.)



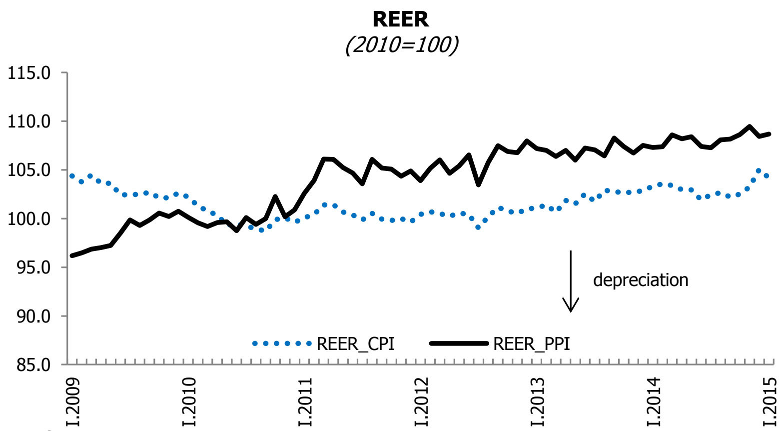
Source: NBRM.
** The following data depict the overall exports of one major export capacity in the free industrial zone.*

In January, **the import of goods** decreased annually by 3.1%, due to the rough decline in energy imports, and less to the lower investment import of equipment, machinery and vehicles. The prolonged decline in the price of crude oil brought about lower prices of imported energy sources and accordingly, lower energy imports despite the higher imported quantities of oil derivatives and natural gas...

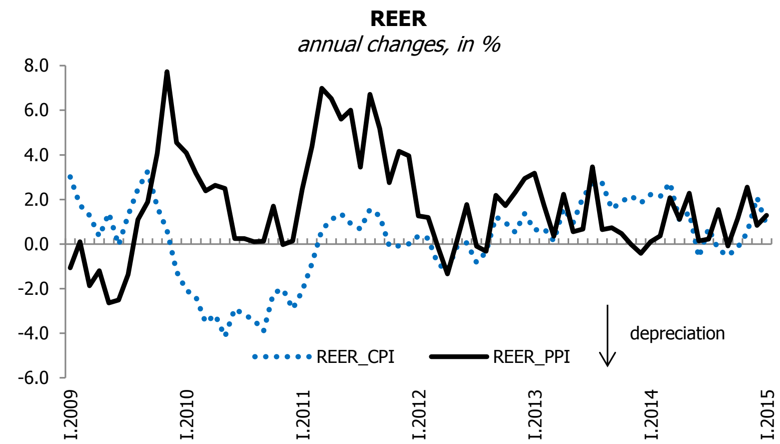
Imports by components
(contributions to the annual change, in p.p.)



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



Source: NBRM.



Source: NBRM.

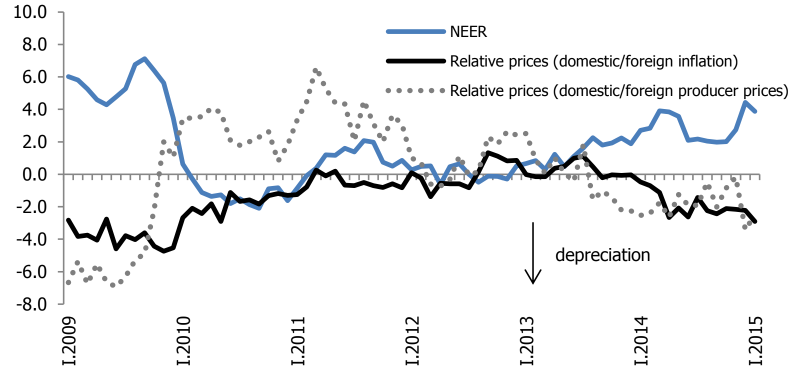
...while imports of raw materials for the new facilities recorded a significant annual growth.

Import performances in January were significantly lower than that projected for the first quarter of the year. Downward deviation was observed in most import categories, particularly in the energy imports, and import of iron and steel, other import and import of vehicles.

Latest movements in world stock prices do not indicate significant changes in expectations about the prices of nickel and copper by the end of the year, compared to the October projection. Expectations for the price of crude oil undergone significant changes, and currently point to much greater annual decline in the price expressed in euros for the period under observation, which again suggests more favorable terms of trade.

In January 2015, price competitiveness indicators of the domestic economy continued deteriorating moderately on an annual basis, given the 0.8% appreciation of the REER deflated by consumer price and the simultaneous 1.3% appreciation of the REER deflated by producer prices, compared to the same period last year.

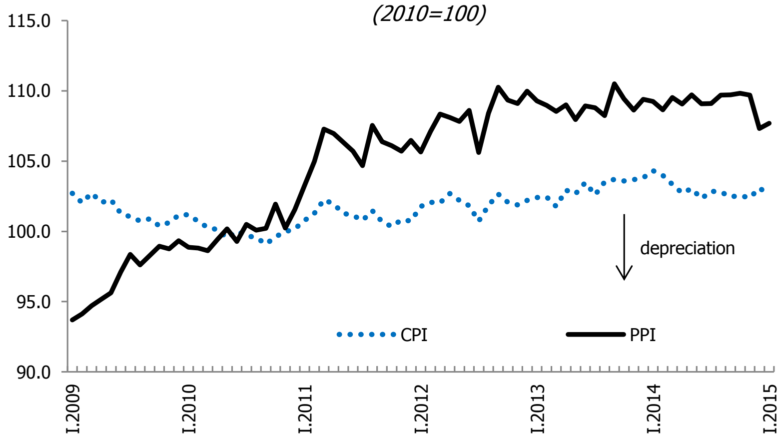
NEER and relative prices
annual growth rates, in %



Source: NBRM.

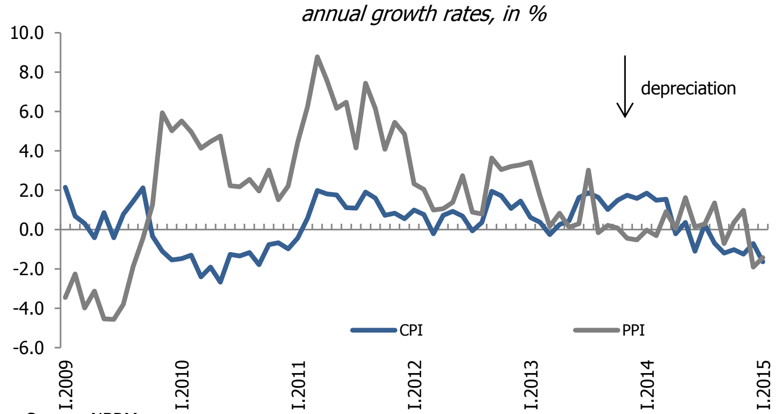
The annual appreciation of the nominal effective exchange rate (of 3.9%) was yet again driven by the depreciation of the Russian ruble and Ukrainian hryvnia against the denar, causing upward shifts in both REER indices. On the other hand, the growth of foreign consumer prices, as opposed to the simultaneous annual decline in domestic prices, as well as the sharper decline in domestic versus foreign prices of industrial products, led to a decline in the relative prices of 2.9% and 2.5% respectively.

REER, excluding primary commodities
(2010=100)



Source: NBRM.

REER, excluding primary commodities
annual growth rates, in %

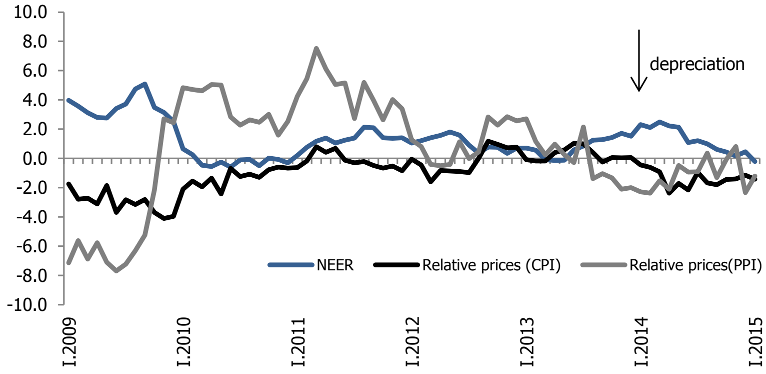


Source: NBRM.

The analysis of the movement of the REER indices, as measured using weights based on the foreign trade without primary products[10], still indicates improvement in the price competitiveness of domestic economy. The REER deflated by consumer prices depreciated by 1.6%, while the REER deflated by producer prices depreciated by 1.4% on an annual basis.

[10] 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.

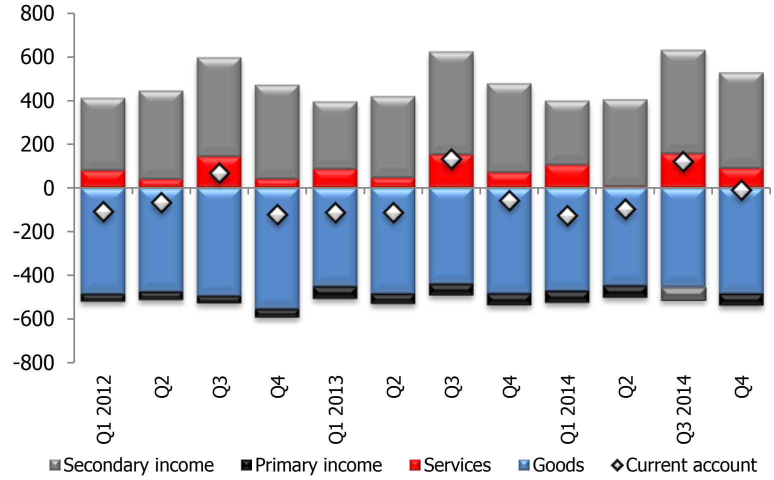
NEER and relative prices, excluding primary commodities
annual growth rates, in %



Source: NBRM.

The improvement in both REERs is largely due to the annual decline in relative prices, i.e. more intensive annual decline in domestic prices relative to foreign prices (by 1.4% in consumer prices and by 1.2% in producer prices). Additionally, after a long period of NEER appreciation, in January it recorded a small depreciation (of 0.2%), thus improving the competitiveness of the economy.

Main components of the current account
(in EUR million)

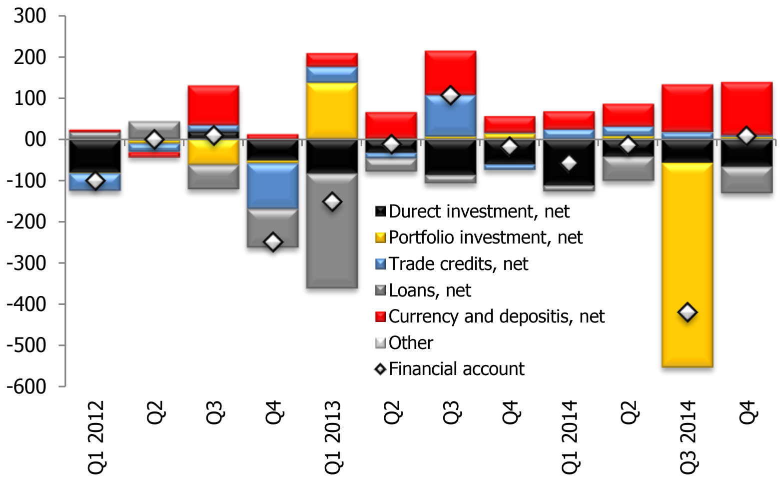


Source: NBRM.

In the fourth quarter of 2014, the current account registered a deficit of Euro 9.7 million (or 0.1% of GDP), which is substantially lower than that projected in October...

...mainly due to the increased balance of goods and services, and the higher surplus in secondary income and the lower deficit in primary income compared to the October projection.

Financial account components
(in EUR million)



Source: NBRM.

In the last quarter of 2014, the financial account registered net outflows of Euro 8.4 million (or 0.1% of GDP), rather than net inflows as projected in October[11].

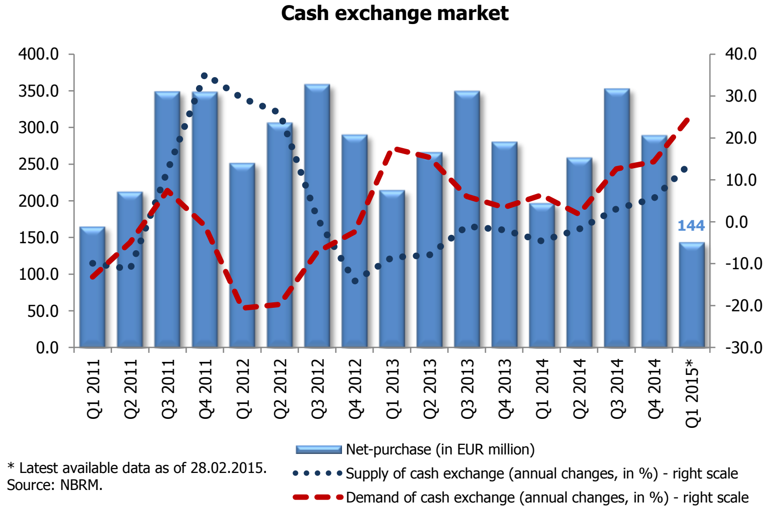
Such deviations arise from larger net outflows than expected in currency and deposits, coupled with weaker performances of direct investments (less net incurrence of liabilities than expected) and net outflows in loans, contrary to the expected small net inflows. Trade loans acted in the opposite direction and registered higher net inflows than projected.

[11] According to the new methodology for compilation of the balance of payments (BPM6), the terms net inflows and net outflows denote net incurrence of liabilities and net acquisition of financial assets, respectively.

Recent data on currency exchange operations, as of the second ten-day period of February 2015 indicate significant further increase in the supply of and demand for foreign currency on an annual basis.

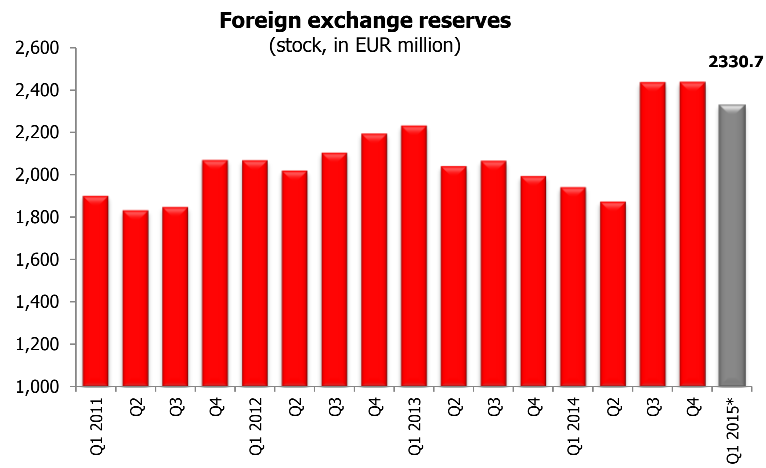
In the period 1 January – 20 February 2015, the net amount of Euro 126.9 million was purchased in the foreign exchange market, which is an annual increase of 13.7%. Net inflows make up 62.8% of the October projections for the first quarter of 2015 for this category. Moreover, these performances mainly arise from the movements in the second ten-day period of January, when there was an increased purchase of Swiss francs in the currency exchange market.

The latest information from the currency exchange market indicates that the performances are mainly within the expected net inflows of remittances in the first quarter of 2015, as projected in October.



* Latest available data as of 28.02.2015.
Source: NBRM.

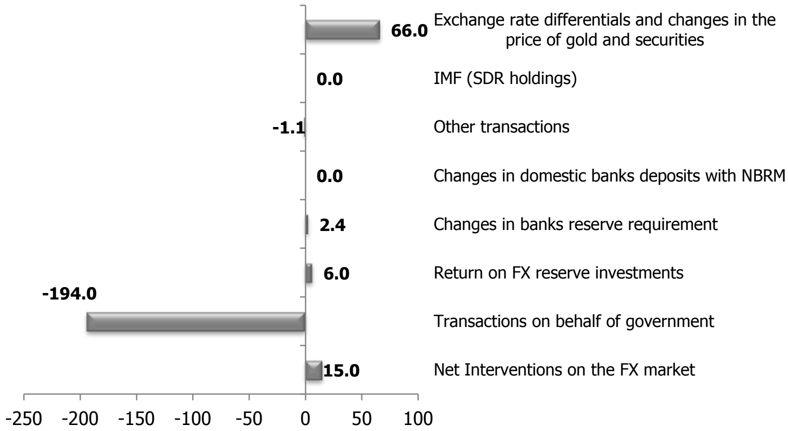
As of 28 February 2015, the gross foreign reserves stood at Euro 2,330.7 million, down by Euro 105.7 million compared to the end of the previous year. The reduction of foreign reserves is due to transactions for the government account[12], with the currency changes and the changes in the price of gold and the net purchase of foreign currency in the foreign exchange market by the NBRM acting in the opposite direction.



* Latest available data as of February 2015.
Source: NBRM.

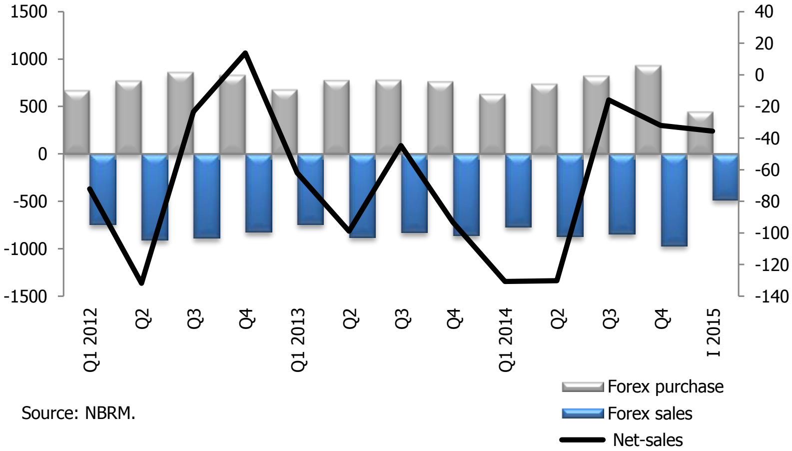
[12]On 27 February 2015, the government made early repayment of the liabilities to the IMF, based on the Precautionary Credit Line (PSL), which decreased the foreign reserves by Euro 153.4 million.

Factors of change of the foreign reserves in january-february period
(in EUR million)



Source: NBRM.

Foreign exchange market
(in EUR million)



Source: NBRM.

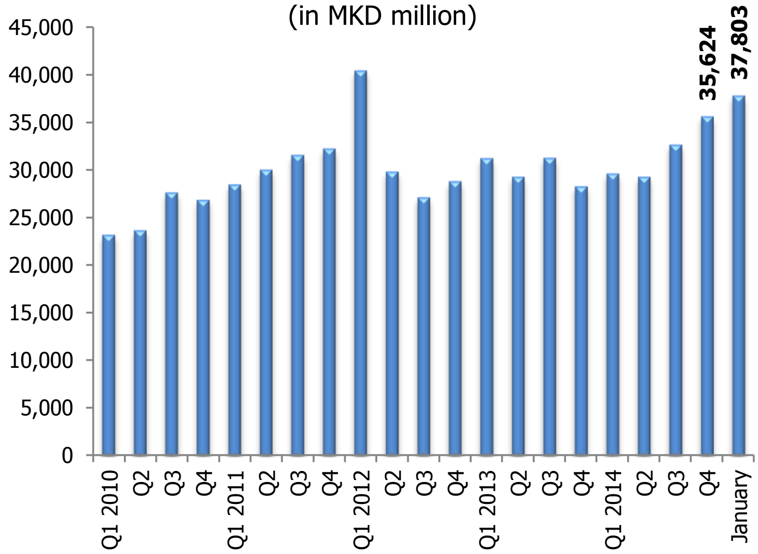
In the first two months of 2015, the **foreign exchange market** of banks reported a net sale of Euro 35.6 million, which is by Euro 27.6 million lower compared to the net sale in the same period last year. This annual change is a result of the annual growth in the supply (of 6.3%), despite the slight decline in the demand for foreign currency (of 0.3%).

The sector-by-sector analysis suggests that the annual performances improved mainly due to higher net purchase of exchange offices and lower net sales of companies, compared with the performances of these categories in the same period last year.

Data as of January indicate withdrawal of liquidity through monetary instruments compared to December (through the deposit facility), where this flow exceeds the October projection for the first quarter, due to the lower than projected level of instruments at the end of the previous year.

Analyzing flows of creating and withdrawing liquidity (from balance sheet aspect) in January, net foreign assets of the NBRM went up, mainly driven by exchange rate and price changes. Having this effect excluded, net foreign assets decreased on a monthly basis, which corresponds to the projected pace of the first quarter. Total government deposits with the NBRM decreased on a monthly basis, which also corresponds to the projected path of government deposits for the first quarter, but in significantly lower volume than projected.

Monetary policy instruments
(in MKD million)



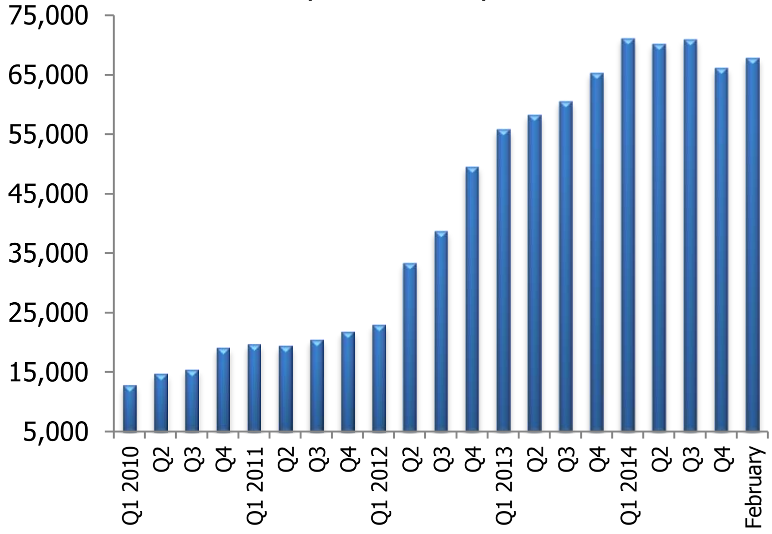
Source: NBRM.

Hence, with respect to the balance sheet, the divergence in monetary instruments, compared with the projection, corresponds to the divergence in reserve money, which in January dropped on a monthly basis, despite the growth in the first quarter as projected in October.

According to the latest available data as of January, in the first month of 2015, the Budget of the Republic of Macedonia registered a deficit of Denar 2,203 million (or 0.4% of GDP[13]), making up 12% of the budget deficit projected for 2015, according to the adopted Budget the Republic of Macedonia. In terms of its funding, the budget deficit was financed from domestic sources by withdrawing deposits from the denar account with the NBRM and new issues of government securities.

[13]According to the NBRM projection for nominal GDP for 2015. The Ministry of Finance's budget deficit projection also equals 0.4% of GDP.

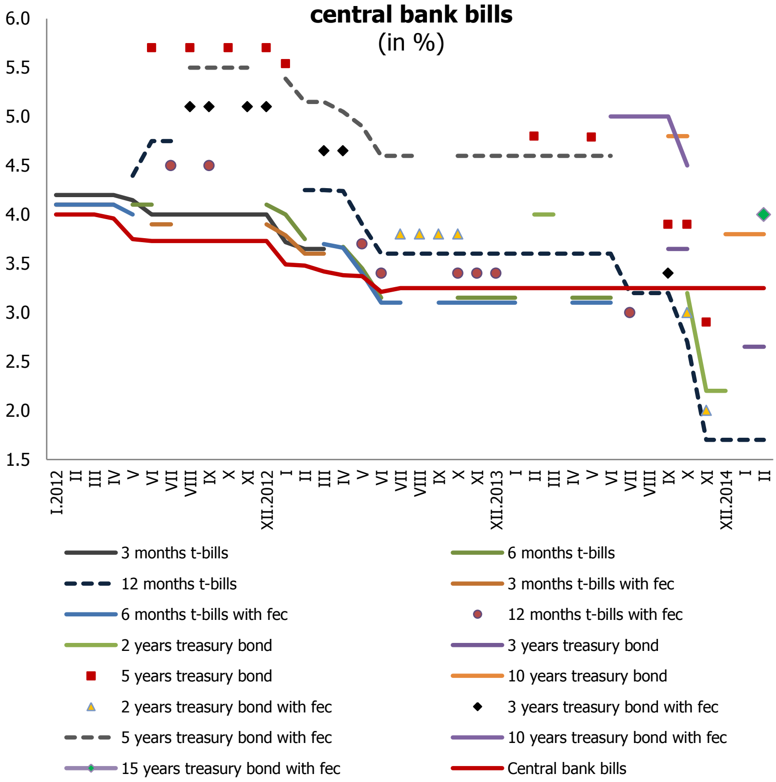
Oustanding amount of Government securities
(in MKD million)



Source: NBRM.

The stock of government securities on the domestic market totaled Denar 67,860 million at the end of February, which is by Denar 1,699 million more compared to the end of 2014.

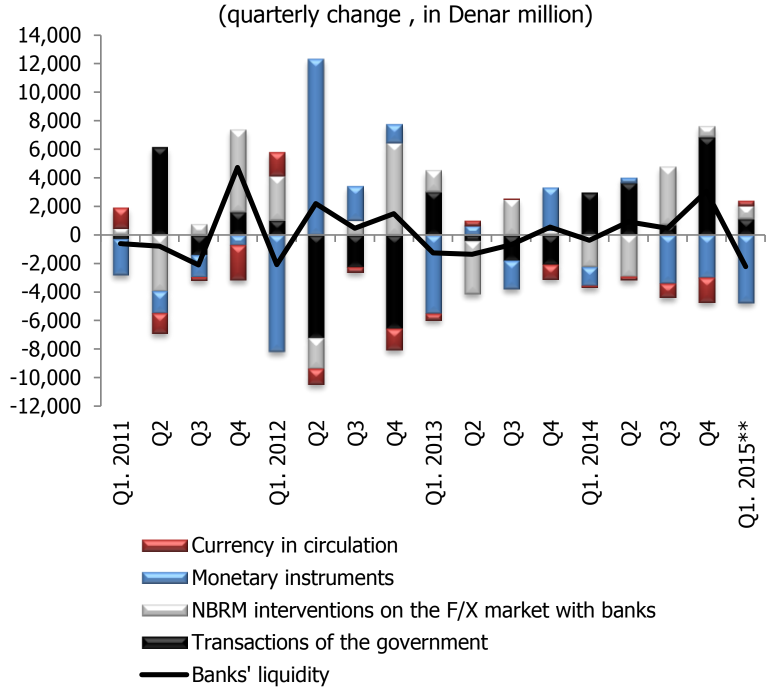
Interest rates of treasury bills, treasury bonds and central bank bills
(in %)



Source: NBRM.

Interest rates on government securities at the auctions held in February ranged from 1.7% for the 12-month treasury bills, 2.2% for the 2-year government bonds without foreign currency clause and 2.65% for the 3-year government bonds without foreign currency clause, to 3.8% for the 10-year government bonds without foreign currency clause. Also, in February, the government issued 15-year bond (with FX clause) in the domestic market with an interest rate of 4% at two auctions of government bonds. Interest rates on government securities issued in February remain unchanged compared with the previous auctions.

Liquidity of the banking system*
(quarterly change , in Denar million)

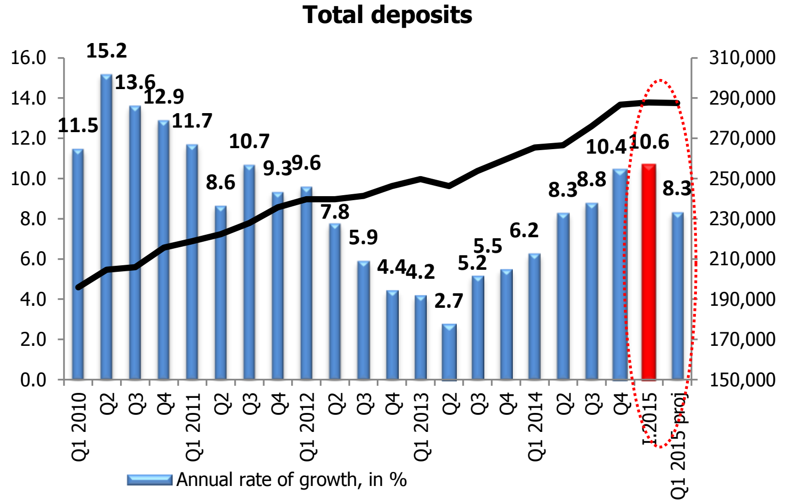


*Positive change- liquidity creation, negative change- liquidity withdrawal.
**refers to January and February
Source: NBRM.

Regarding the flows of creating and withdrawing liquidity, in February liquidity was mostly created through government transactions, which is solely due to the withdrawals from government denar deposits with the NBRM. Currency in circulation also acted in this direction, but to a lesser extent. In February, the NBRM made no interventions in the foreign exchange market in the transactions with market makers, and therefore, the foreign exchange transactions had a neutral effect on liquidity. Liquidity was withdrawn through monetary instruments (solely through the deposit facility). In such conditions, in February, the total liquidity recorded a monthly decline.

In late January, reserve money dropped compared to the end of 2014, as opposed to the moderate increase projected for the first quarter of 2015. Yet, the reserve money in January is higher than the expected level for March according to the October projection, mainly due to the performance at the end of 2014 (a higher level of reserve money than projected in December).

Reserve money decreased in January due to the simultaneous decline in the currency in circulation, and growth of banks' total liquid assets, as opposed to the growth of the two components in the first quarter as expected in the October projection.



*Includes demand money
Source: NBRM.

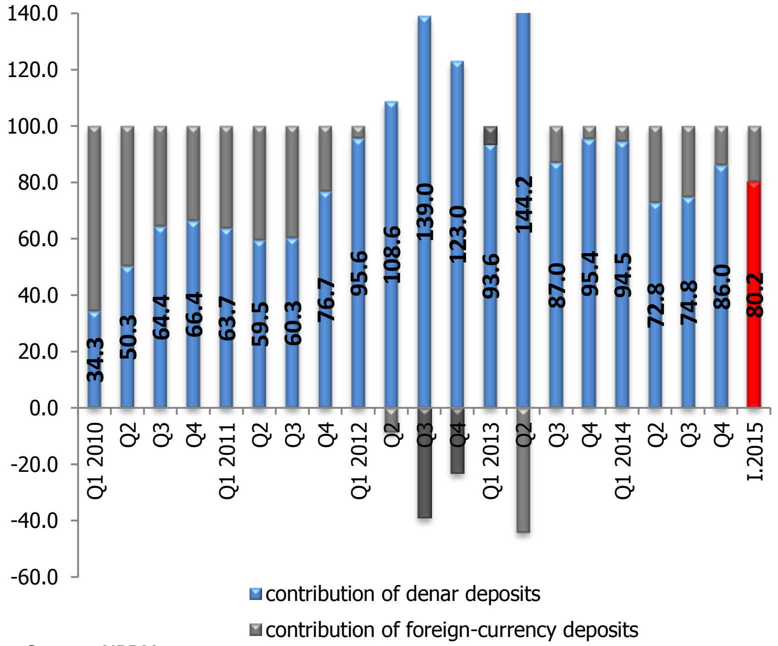
During January, there was further expansion of the deposit base, at a significantly slower pace compared to the previous month that registered untypical high growth. Compared with the January performances in previous years, the monthly growth in January 2015 was solid, indicating further retention of positive trends in total savings in the banking sector. The increase was due primarily to the growth of household deposits, and deposits of other financial institutions[14]. Corporate deposits registered a slight monthly decrease, unlike the previous month when they accounted for half of the growth in total deposits.

At the end of January, the annual growth rate of total deposits equaled 10.6%, which is above the growth of 8.3% projected for the first quarter of 2015. In January, the growth of total deposits equaled around 24% of the growth projected for the first quarter. The annual growth rate and the level of total deposits in January are higher than projected for the first quarter mainly due to the performance as of the end of 2014 (a higher than projected level of deposits).

[14] Other financial institutions include investment funds, pension funds, insurance companies, investment funds management companies and pension funds management companies.

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

*Includes demand deposits.

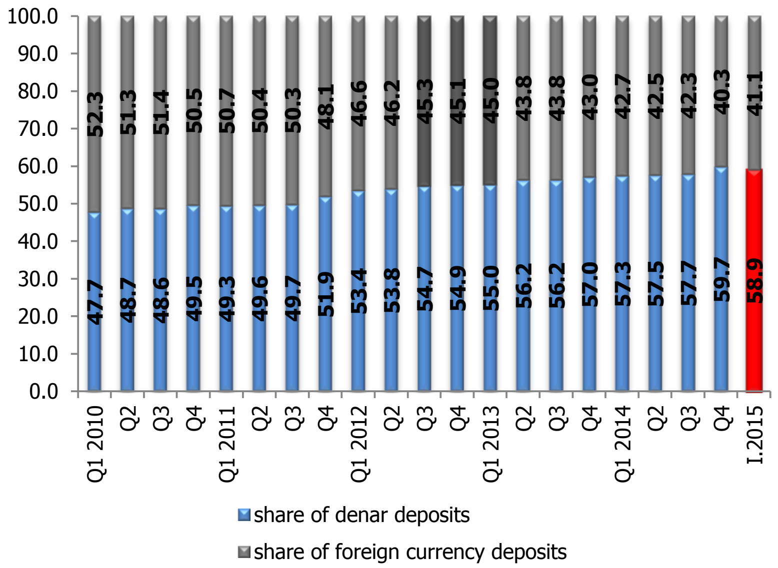


Source: NBRM.

The annual growth of total deposits still stems mainly from the increased denar deposits, amid moderate positive contribution of foreign currency deposits. However, January registered higher foreign currency deposits on a monthly basis, vis-à-vis the decrease in the previous three months...

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

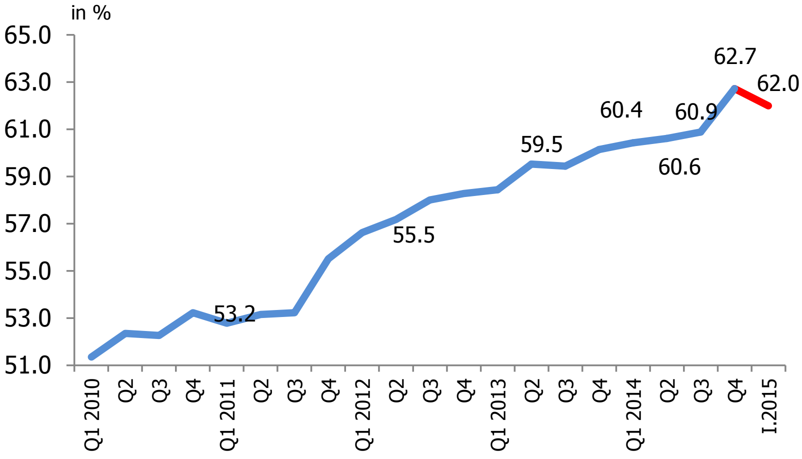
*Includes demand deposits.



Source: NBRM.

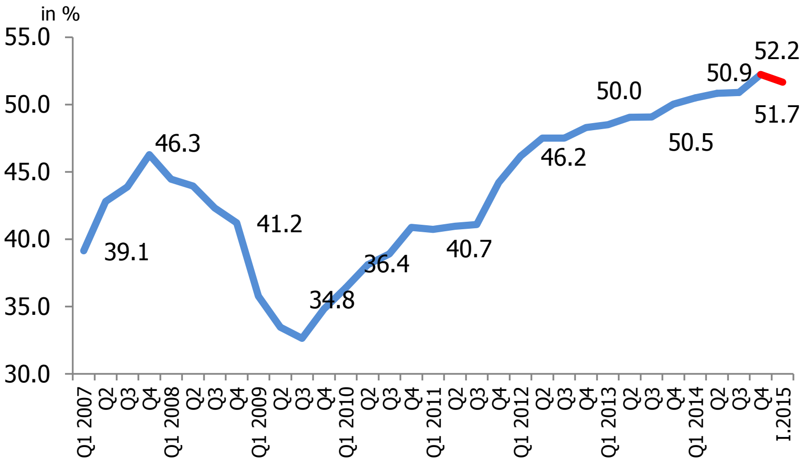
...resulting in a slight increase in their share in total deposits.

Share of denar M4 in total M4 (in%)



Source: NBRM.

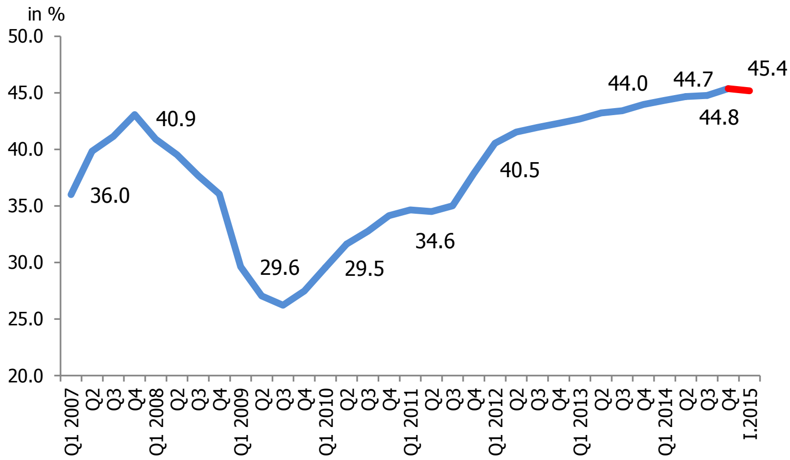
Share of denar deposits in total household deposits (in %)
*Includes demand deposits.



Source: NBRM.

During January, there was a moderate monthly growth of total household deposits, generated by the increased savings in foreign currency amid fall in the local currency deposits[15]. These developments have contributed to decreasing the share of denar deposits in total household deposits (accounting for 51.7%).

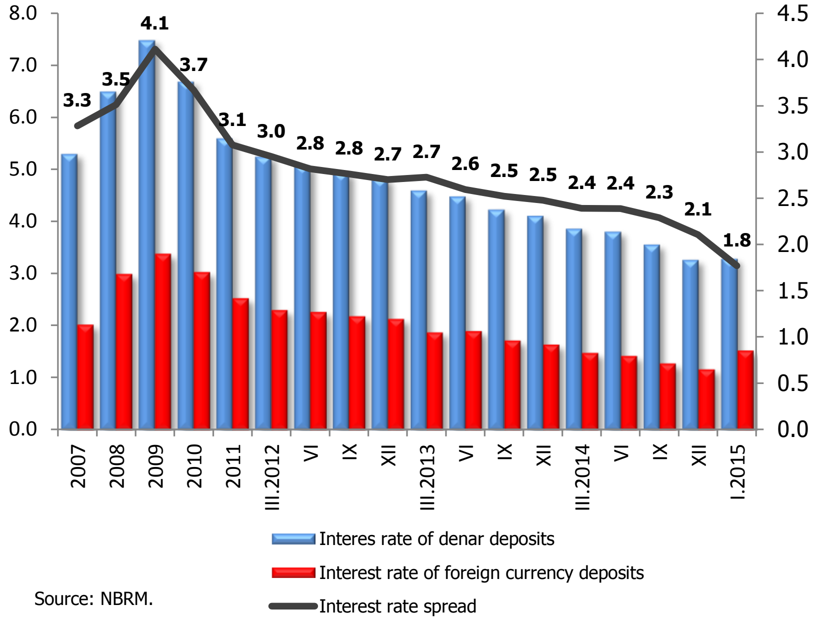
Share of Denar deposits of households in total deposits of households (excluding demand money)



Source: NBRM.

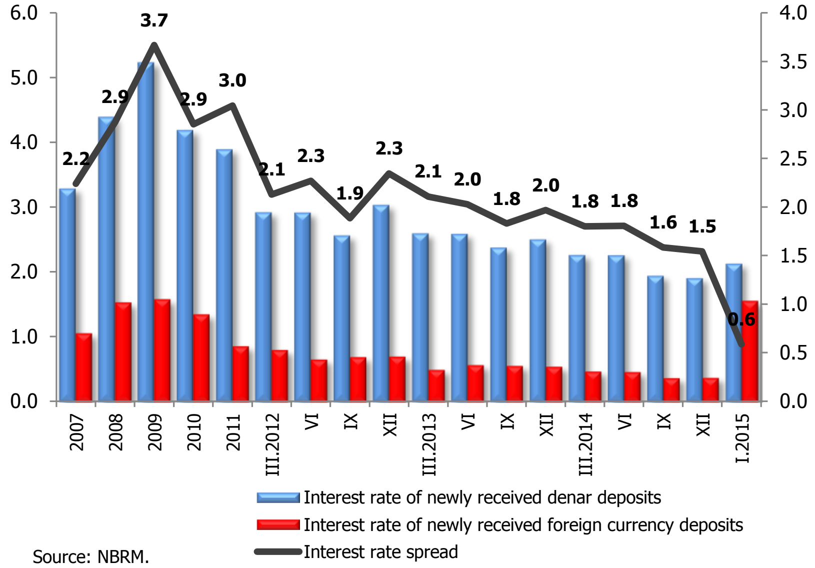
[15] Household denar deposits went down in January due to the lower level of demand deposits, while time denar deposits registered a moderate monthly growth.

Interest rates on denar and foreign currency deposits (in%)



Source: NBRM.

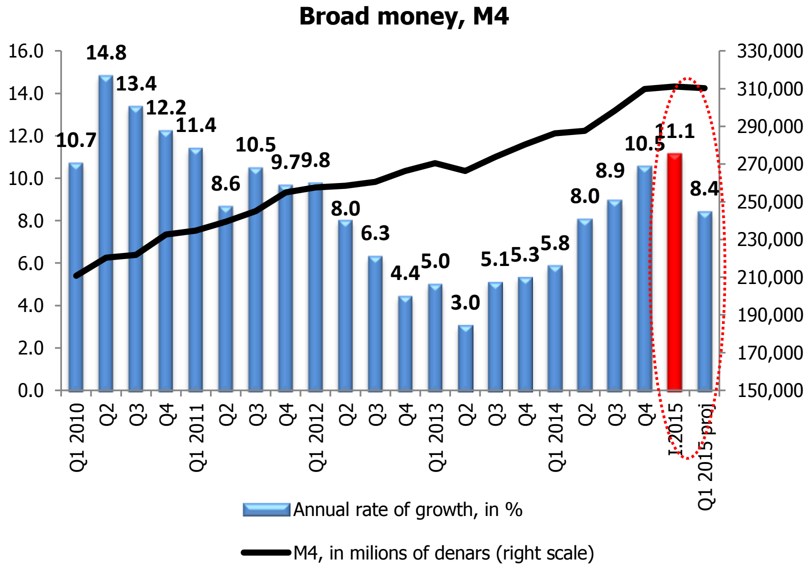
Interest rates on new denar and foreign currency deposits (in %)



Source: NBRM.

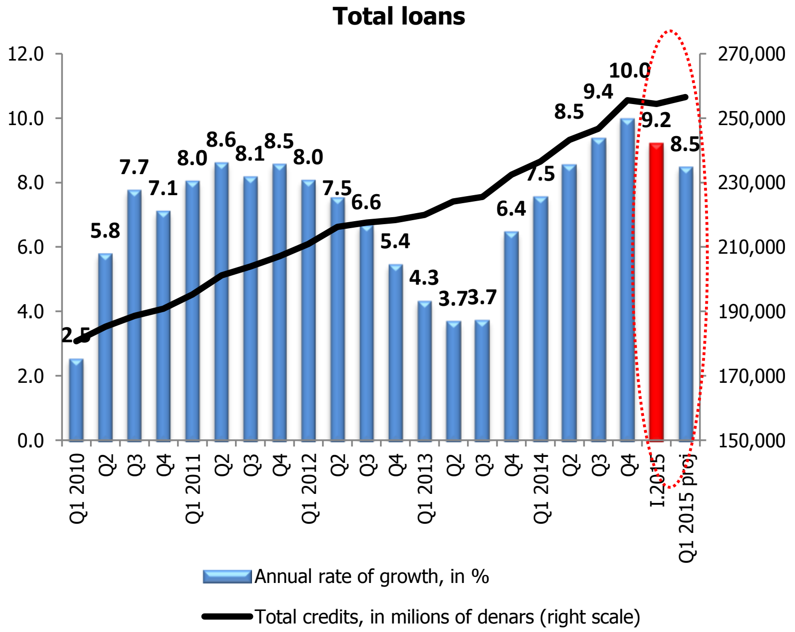
In January[16] , the interest rate on denar and foreign currency deposits equaled 3.3% and 1.6%, respectively. In January, the interest rates on new denar and foreign currency deposits equaled 2.1% and 1.5%, respectively.

[16]As of January 2015, interest rate data of banks and savings houses have been collected under the new interest rate methodology, while data for the previous period were collected under the old methodology. Data collected under the two methodologies are not fully comparable, so the monthly difference for January 2015 and the annual differences between interest rates for the entire 2015, despite the change in relevant interest rate, include the effect of the methodological difference. Differences between the old and the new methodology include: 1) banks and savings houses are now considered reporting entities, unlike previously when this function was performed only by banks; 2) household sector, besides natural persons and self-employed professionals, includes non-profit institutions serving households, unlike the old methodology; 3) inclusion of financial lease in the financial instrument - loans; 4) interest rates on sight deposits and overnight deposits are not included in the calculation of total deposits as in the old methodology, but are being reported in a separate form; and 5) revolving loans are not included in the calculation of interest rates on overdrafts (as was the case in the old methodology), but are reported in a separate form.
Also, the new methodology provides more analytical data used for monitoring and analyzing the interest rate movements, especially in case of new loans and deposits in terms of sector, maturity, initial rate fixation period, currency structure and purpose of the loans.



Source: NBRM.

According to the data as of January, the broad money registered a moderate growth compared to the previous month due to the moderate increase in total deposits and the minor growth of currency in circulation. In January, the growth of money supply equaled around 25% of the projections for the first quarter. In January, the annual growth rate of the broad money equaled 11.1%, which is above the projection for the first quarter of 2015 (projected annual growth of 8.4%). Also, the level of money supply exceeds the projected level for the first quarter of 2015, mostly reflecting the faster growth of M4 than projected in 2014.

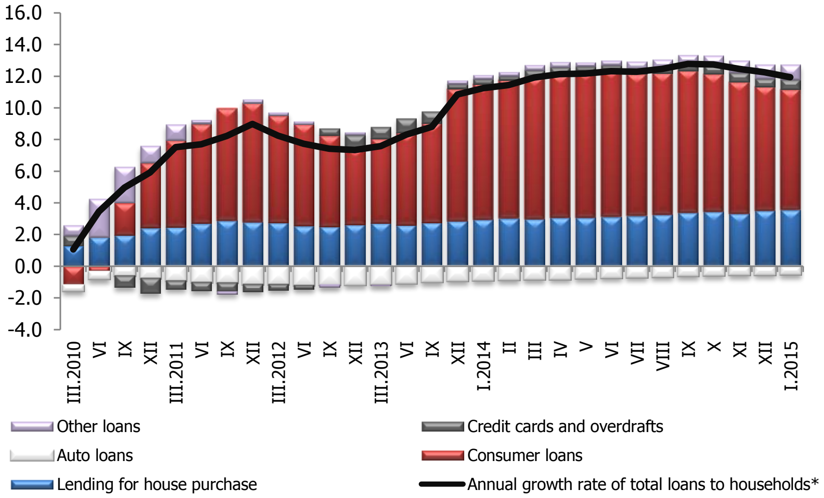


Source: NBRM.

In January, total loans to the private sector registered a monthly decline, after the intensive growth in the previous month. This reduction in lending activity is entirely due to the fall in corporate loans, which is rather usual movement for the first month of the year. Loans to households recorded a moderate monthly increase.

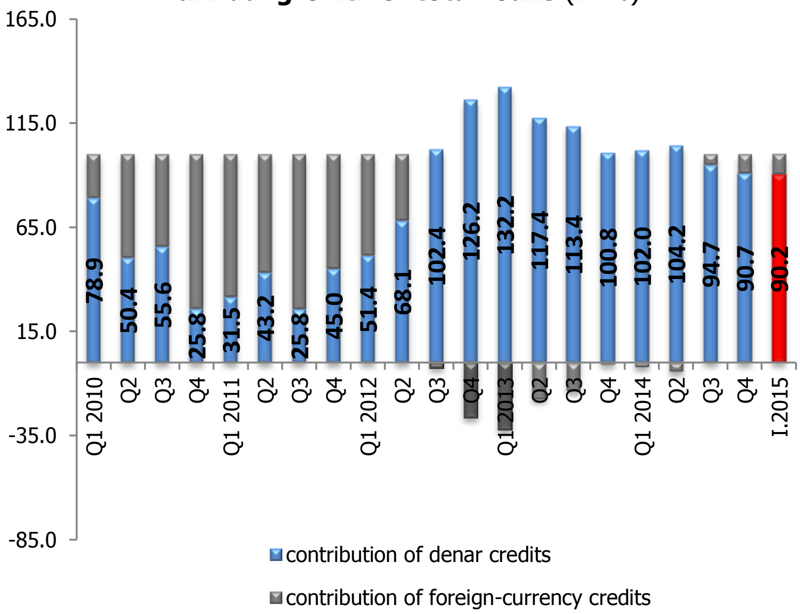
At the end of January, the annual growth rate of total loans equaled 9.2%, which is above the annual growth of 8.5%, projected for the first quarter of 2015. Notwithstanding the lower lending activity in January, the higher annual growth rate results from the accelerated lending as of the end of 2014 relative to the projection. Higher total loans of about Denar 4,000 million for the first quarter was projected in October.

Loans of banks and savings houses extended to households (contribution to the annual change in loans to households*, in percentage points)



*Total loans to households do not include loans to self-employed individuals.
Source: NBRM.

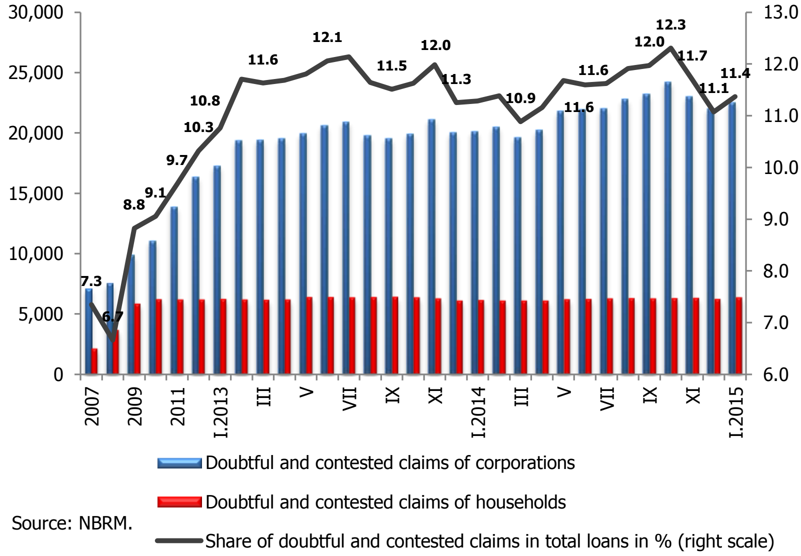
Contribution of denar and foreign currency loans to the annual growth of total loans (in %)



Source:NBRM.

The annual growth of total loans still mostly results from the growth of denar loans, amid moderate positive contribution of foreign currency loans.

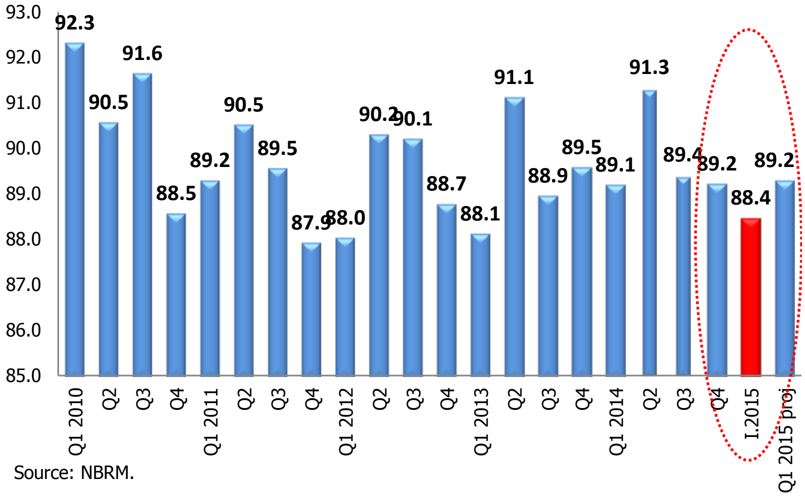
Share of doubtful and contested claims in total loans (in %)



Source: NBRM.

January registered a moderate monthly increase of doubtful and contested claims, despite their decline in the previous two months. The increase primarily stems from the increase of doubtful and contested corporate claims, and their growth in households. Given the monthly increase of the stock of doubtful and contested claims, in January, their growth accelerated on an annual basis. The share of doubtful and contested claims in total loans equaled 11.4% in January versus 11.1% in December.

Loan-deposit ratio (in %)

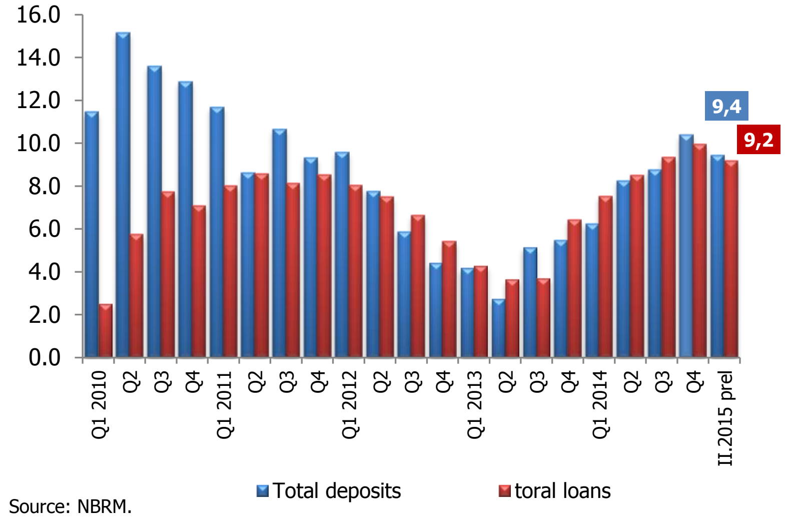


Source: NBRM.

At the end of January, the utilization of the deposit potential for lending to the private sector slightly decreased due to the moderate increase in deposit base and slowdown of lending activity.

Initial ten-day data as of February 2015 show a further increase in the total deposits on a monthly basis, at a similar pace to that in the previous month. Growth of total deposits in February was driven by the increased household savings whose monthly growth accelerated compared to the previous month. Unlike the previous month, when new household savings resulted solely from the growth of foreign currency deposits[17], in February, denar deposits again became a dominant factor for the deposit growth. Corporate deposits in February decreased on a monthly basis (second month in a row), with an increased intensity compared to the previous month. Preliminary data show higher total loans in February on a monthly basis, after their decline in the previous month. The increase of total loans largely stems from the higher level of loans to households, and the moderate growth of corporate loans, despite their decline in the previous month. On an annual basis, total deposits and total loans rose by 9.4% and 9.2%, respectively in February.

Total loans and deposits, annual changes (in %)



Source: NBRM.

[17] In January, household denar deposits decreased on a monthly basis due to the fall in demand deposits, while time denar deposits registered a moderate growth.

Annex 1 Timeline of the changes in the setup of the monetary instruments of the NBRM and selected supervisory decisions adopted in the period 2013 - 2015

January 2013

- A Decision amending the Decision on the 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 on 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 room 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 is being applied since 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 of the commercial banks to the corporate sector. Namely, with this Decision (and in accordance with the amendments to the new EU Regulation no. 575/2013 on prudential requirements for credit institutions and investment companies), performance guarantees or warranties that guarantee completion of works, stand out as items with low-intermediate risk, and therefore bear lower conversion factor (20%), instead of 50% as it has been so far. That would mean that in the calculation of capital adequacy, smaller part of these off-balance sheet items would be treated as a balance sheet items, which could affect the improvement of 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 such 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.

September 2014

- In order to further channel banks' excess liquidity to the non-financial sector, in September the NBRM revised the mechanism for transfer of the demand for CB bills, which is above the banks' potential into another instrument, i.e. seven-day standing deposit facility. According to these changes, for the seven-day standing deposit facility that banks are obliged to allocate if on the CB bills auctions they demand an amount higher than the potential[18], an interest rate of 0% is determined. For the other assets that banks will voluntarily place into a seven-day standing deposit facility the regular interest rate will apply.

September 2014

- The National Bank of the Republic of Macedonia Council adopted the Decision amending the Decision on the reserve requirement, which extends the application of the non-standard measure for reduction of the base for the reserve requirement of commercial banks for the amount of new loans extended to net exporters and domestic producers of electricity. The main objective of the Decision is to provide further support to the two systemically important sectors of the economy. The current implementation of this measure has generated positive effects on the dynamics of lending and thus the overall economic growth, contributing to a reduction of the cost of funding of companies from both sectors, although with lower intensity than the potential. In such circumstances, and given the data that indicate some uncertainty about the pace of lending to the corporate sector in the next period, this Decision envisages continued application of this non-standard measure until December 31, 2015.

October 2014

- A Decision on reducing the interest rate on overnight deposit facility from 0.75% to 0.5% and on seven-day deposit facility from 1.25% to 1% was adopted.

February 2015

- The Council adopted the Decision amending the Decision on reserve requirement and the Decision amending the Decision on CB bills. When limited amount tender is applied at CB bill auctions, it is noticeable that in the last quarter of 2014 and early 2015, commercial banks regularly begin the period with low fulfillment of the reserve requirement, while participating in the auction with high amounts over their liquidity potential. The amendments to the decisions require that the commercial banks start the reserve requirement period with amounts on their accounts in the National Bank of at least the reserve requirement amount. Additionally, a second measure is proposed that provides restricting the use of the reserve requirement during the entire maintenance period, thus, the banks will be required to maintain daily liquidity of at least 50% of the reserve requirement. These measures do not reduce banks' flexibility in liquidity management; they are expected to contribute to lower reliance on reserve requirement when establishing the demand for CB bills.

[18]For the method of determining the potential demand for CB bills see the Decision on CB bills, Official Gazette of the Republic of Macedonia no. 166/13).