NATIONAL BANK OF THE REPUBLIC OF MACEDONIA

Quarterly Report

April 2014

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Introduction

During the first quarter of the year, the interest rate at CB bill auctions remained 3.25%. Assessments of economic and financial conditions in this period showed no major changes in the environment for conducting monetary policy. Most macroeconomic indicators moved along with the projected trajectory. Deviations were registered in certain segments, but they caused no major change in the macroeconomic picture. **Inflation** slowed down in the first quarter of the year, showing a significantly lower price pressures than expected. Lower inflation than projected can be explained by factors on the supply side, i.e. deviations in the dynamics of world prices and their knock-on effects on the domestic prices. Indicators for **economic growth** confirmed expectations for economic recovery of the Macedonian economy, at a pace very close to expectations. In the **credit market** banks provided financial support to the real sector in the first quarter, as well. Given the improved perceptions and expectations, the sufficient sources of funding and the solid fundamentals, bank credit growth accelerated and the level of loans exceeded the expectations. Moreover, during this period, the banks have kept their credit policy of active support to the corporate sector since the end of last year. In the first quarter, **foreign reserves** declined, which was entirely consistent with the October assessments. Thus, it was assessed that the balance of payments position confirms the projections. However, available data indicated a possibly lower current account deficit and lower capital inflows than expected. Indicators of foreign reserves adequacy remained favorable, with estimates for a sufficient level of foreign reserves to absorb contingent shocks. **In terms of risks about future developments,** in this period, the uncertainty about global recovery was on the map of potential risks. Moreover, the crisis in Ukraine emerged as a new risk. The effects of geopolitical tensions on the Macedonian economy mainly relate to possible price shocks in the world market of food and energy. However, the crisis could also imply deterioration in the economic environment and in the growth estimates of the European economy, which can create adverse effects through multiple channels. **In such conditions and measures already taken by the NBRM in the previous period with an easing effect, in the first quarter, the monetary setup was assessed as adequate.**

Besides changes in the initial conditions for some of the indicators for the domestic economy, certain changes between the two projections occurred in the estimates of indicators that define the external environment. This statement mainly refers to the **import prices**, which are mostly revised downwards. On the other hand, the assumptions for foreign effective demand were not substantially altered. After the fall of the previous year, in 2013, it stagnated, indicating a start of the process of economic recovery in our key trading partners. **No changes have been made in the expected path and pace of growth of foreign demand for the next two years.** In more stable global environment, the recovery of key economies for Macedonian exports will continue, leading to higher foreign demand in the next two years. "Decoupling" between speed and intensity of the recovery of the Macedonian economy and foreign effective demand was evident in 2013, and was expected to carry on in the next two years. Thus, in 2013, domestic GDP registered a solid growth of 3.1% (as projected), given the factors that increased resilience of the Macedonian economy to adverse shocks. One factor relates to the presence of new companies - foreign investments that gradually and continuously increase capacity utilization, and diversify the production and export structure of the economy. Fiscal stimulus had a strong effect on the growth of infrastructure investments. In addition, amid positive shifts in the labor market and credit support, the private consumption was an important growth factor, and its recovery was greater than expected. **Amid same initial conditions, and retention of assumptions for further support of the growth through foreign and**

public investments, the growth estimates for 2014 and 2015 of these cycle projections were not changed. The projected growth rate for 2014 is maintained at 3.7%, with further expectations that the export sector will provide the main impetus for growth. These estimates emerge from the expected effects resulting from the increasingly growing utilization of foreign investors' capacities, but also from the recovery caused by the improved external environment. Besides, strong support of the growth is expected by the investment cycle underpinned by the strong fiscal stimulus and private investments. Such circumstances indicate strengthening of the corporate position and increasing labor demand and price. These assumptions lead to projections for increasing household consumption to support the process of economic recovery. **For 2015, the rate of economic growth is expected to accelerate and reach 4.4%,** with a similar growth structure as in 2014. **In the next two years, similar to 2013, it is estimated that some investment and consumption decisions of economic agents will be funded by bank loans**. After the credit growth of 6.4% in 2013, in the next two years it will step up and reach 7% and 8%, respectively (similar to the previous projection). These projections depend on the realization of assumptions for economic recovery and growth in foreign exchange inflows to the economy over the next two years. In fact, these conditions will determine the space for deposit growth, further stabilization of the banks' perceptions and increase of credit supply and the willingness of households and companies to increase the debt in the financing structure.

In terms of inflation, it is expected that the growth of domestic prices in 2014 will slow down considerably, with average inflation for 2014 of roughly 1% (2.3% in the previous forecast). These estimates are based on the lower performance of inflation since late 2013 and the first quarter of 2014, and the latest external assumptions that show lower pressures from world prices of oil and food than previously expected. There are no major changes in the current assumptions about the effect of domestic demand on inflation in 2014. The last assessment show narrowing of the negative output gap in the third quarter of 2014 and accordingly, a gradual effect of the demand on prices. Identified inflation risks mainly relate to changes in exogenous assumptions, caused by the uncertainty of effects of weather factors and the effects of the political crisis between Ukraine and Russia on the price of primary products. Currently, however, risks about the projection are assessed as predominantly downward. The strengthening of domestic economy in 2015 will cause a gradual increase in inflation, and as expected, would range around 2%, which is close to the historical average.

Recent assessments of the balance of payments position point to opportunity for lower current account deficit than previously expected for 2014, i.e. a deficit of 4%, instead of 4.6% as projected in October. Changes between the two projections reflect the improvement in the trade balance, which is due to more optimistic expectations for the export segment of the economy, associated with the increasingly growing utilization of the new foreign investors' capacities. Considering the dynamics, the new projections for 2014 point to an increased current account deficit, compared with 2013, given the higher trade deficit and reduction in the relative share of current transfers. As projected in October, **for 2014, it is expected that the assessed expanding of current account deficit will be predominantly caused by stronger import pressures** created by the import-dependent exports and investments, which will be further strengthened by the expected growth of private consumption. Further expansion of the current account deficit is expected due to the reduction of current transfers, mainly related to private transfers, whose pace is hardly predictable. **Changes in these two current account components are also the main drivers of the further expansion of current account deficit in 2015, which is expected to reach 5.8%** (5.7% in the October projection). The present path of current account deficit and its structure suggest no major imbalances in the economy. As in the previous forecast, current assessments show that the structure of capital inflows will be a combination of debt and non-debit flows. Considering the dynamics, in 2014, the projected movements in current, and capital and financial transactions will reduce foreign reserves, while in 2015, the higher capital inflows, largely from the state sector, will lead to further accumulation of foreign reserves. Namely, the April macroeconomic scenario also includes the assumption that foreign borrowing will cover most of the gross financing needs of the country. The projected path of reserves for 2014-2015, still indicates retention of the indicators of reserve adequacy at an appropriate level.

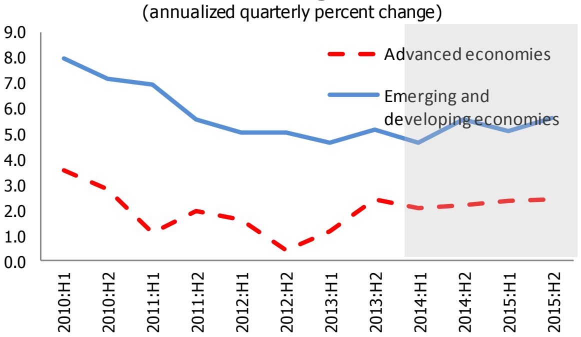
Generally, recent developments suggest keeping a similar macroeconomic picture as in the October projections, with a balance of payments position that provides growth and further maintenance of foreign reserves at an adequate level. Risks surrounding the realization of this macroeconomic scenario continue to be mainly of external nature, and are associated with the possible changes in the pace of recovery of global economic growth and movements in the prices of primary commodities in world markets. In this context, the Ukrainian crisis is a new risk factor that may have adverse effects on import prices and terms of trade. In the next period, the NBRM will continue to monitor closely the developments and if necessary, will make the appropriate changes in monetary policy for successful achievement of monetary objectives.

I. Macroeconomic Developments

1.1 International Economic Environment[1]

Global economy was still recovering at an accelerated pace of growth. In the second half of 2013, the global growth equaled 3.7% annually, which is a significant acceleration compared to the first half of the year, when it increased by 2.5%. The acceleration of global growth in the second half of the year is due to the faster pace of recovery in advanced economies in this period, despite the slowdown in the growth of emerging economies and developing economies. The main driver of better economic developments in this period is the U.S. economy, whose growth accelerated given the accommodative monetary policy, the higher private consumption and the improved export performance. Indicators for the Euro area pointed to a continuous moderate recovery, amid improved performance of the core countries and stabilization of the situation in peripheral economies. IMF's April projections remain unchanged and follow the October expectations. Moderate growth acceleration to 3.6% and 3.9% is still projected for 2014 and 2015, respectively. Downward risks surrounding the projections, although reduced, remain the most common. Global inflation is low again, at a time when economic activity remains below potential. The inflation has been declining steadily, under the pressure of lower world prices of energy and food.

Global GDP growth
(annualized quarterly percent change)

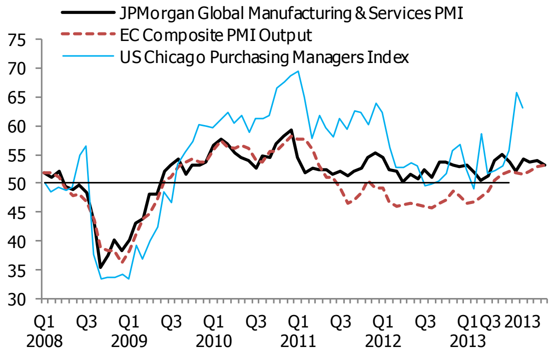


Source: IMF.

In the second half of 2013, the global economy grew by 3.7%[2] annually, which is a significant acceleration compared with the growth in the first half of the year. Analyzing by group of countries, these achievements result from the acceleration of the pace of growth in advanced economies, while emerging economies and developing economies grew, but more moderately. From the perspective of advanced countries, the U.S. economy was the main driver of the accelerated global growth, whose activity increased annually by 3% in the second half of 2013. The recovery of private consumption, amid higher real estate and stock prices, higher exports and a temporary increase in demand for inventories are the main factors that explain economic performance in the United States. Labor market indicators show further decline in the unemployment rate, which in February 2014 dropped to 6.7%, largely reflecting the reduced activity rate. The latest economic developments for the first quarter of 2014 indicate accelerated growth of the world economy, as measured by the

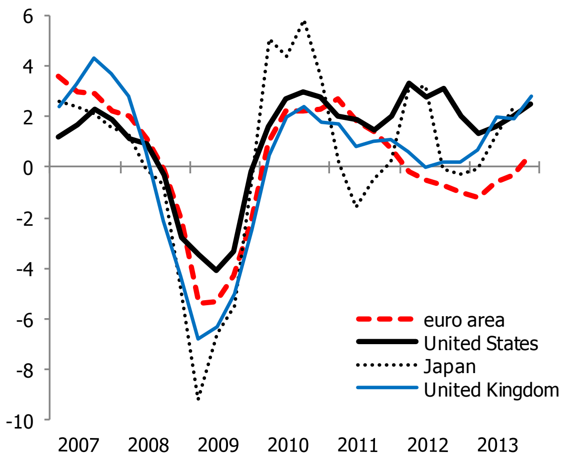
[1] The analysis is based on the ECB Monthly Bulletin, January, February and March 2014; IMF World Economic Outlook, April 2014; press releases of Markit Economics; weekly press releases of the Bank of Greece, Monthly Reports of Deutsche Bank and the IMF's monthly press releases on the market of primary commodities.
[2] IMF World Economic Outlook, April 2014.

Global economic activity indicators
(monthly indices*)

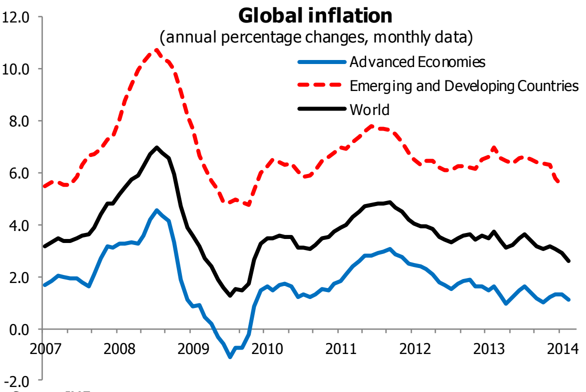


*The PMI index reflects the percentage of respondents that reported better bussiness conditions compared to the previous month and it can take values between 0 and 100. PMI=50 is considered as a reference value, indicating unchanged economic conditions. A PMI value over 50 is taken to indicate that the economy is expanding, while a PMI value below 50 suggests that the economy is contracting.
Source: Bloomberg.

Real GDP growth in advanced economies
(year-on-year percentage changes; quarterly data)



Source: Eurostat.



Source: IMF.

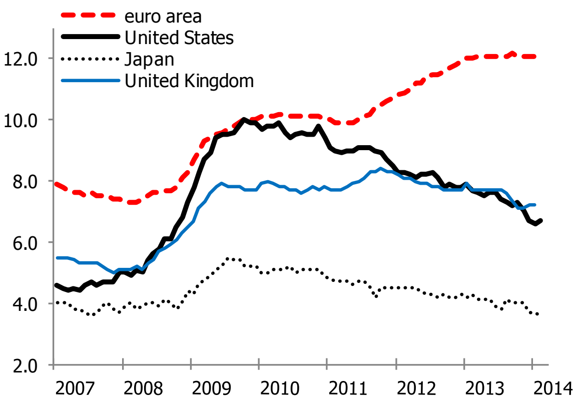
leading indicators of economic activity - PMI[3]. Global composite PMI registered a minor growth (of 0.1 percentage points) compared to the previous quarter, reaching 53.5 index points, amid improved performance in the manufacturing industry and the service sector. **The latest IMF projections of the April Report suggest expectations for faster growth of global economy, i.e. growth projections of 3.6% for 2014 and 3.9% for 2015.** The risk balance has improved, and the downward risks have declined, but they remain the most common. Despite the lower uncertainty regarding the pace of resolving fiscal problems in the United States, the risks associated with the normalization of the Fed's monetary policy, as well as the low inflation rates globally, surged. The risk of slow implementation of reforms in the euro area and accordingly, prolonged financial fragmentation and distrust of financial markets is still present. In addition, new risks include the emerging geopolitical tensions in Ukraine, which could cause lower production or termination of transport of natural gas and residual fuel oil, as well as reduced production of corn and wheat. In emerging economies, risks arise from the changed external surrounding, greater sensitivity of investors to risks in these economies, deteriorating terms of funding and accordingly, possible volatility in capital flows. However, emerging economies and developing economies still account for more than two thirds of global economic growth, with growth projections of 4.9% for 2014 and 5.3% for 2015, versus the growth of 4.7% in 2013.

In 2013, the global annual inflation equaled 3.3%, and slowed down compared to the previous year, given the downward pressures from declining prices of food and oil worldwide. At the beginning of 2014, global inflation was slightly decreasing on a quarterly basis. In the first two months of 2014, the global inflation equaled 2.7% (by 0.4 percentage points lower performance compared with the previous quarter). Emerging economies and developing economies reported a significant slowdown in inflation. In advanced countries, the rate of inflation was back to the level of the previous quarter. According to the latest IMF projections, during 2014 and 2015, the global inflation will slow down amid negative output gap

[3] PMI (Purchasing Manager's Index - PMI) is based on surveys of a representative sample of companies from the manufacturing and service sectors, and are often used as high frequency indicators of the current and future economic activity.

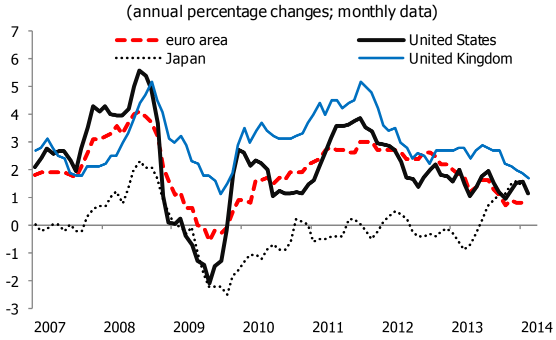
in most of the advanced economies, weaker domestic demand in emerging economies and expected decline in food prices.

Unemployment in advanced economies
(in percent; seasonally adjusted monthly data)



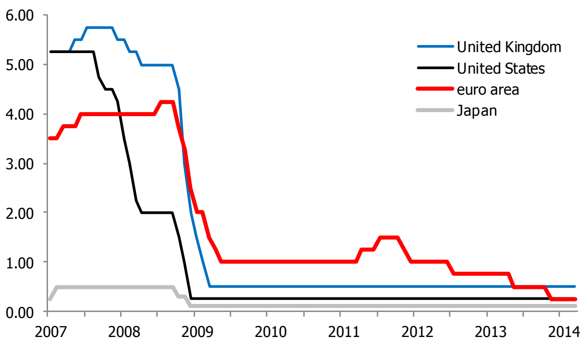
Source: Eurostat.

Inflation in advanced economies
(annual percentage changes; monthly data)



Source: Eurostat and national statistical offices.

Policy rates in advanced economies
(in %)



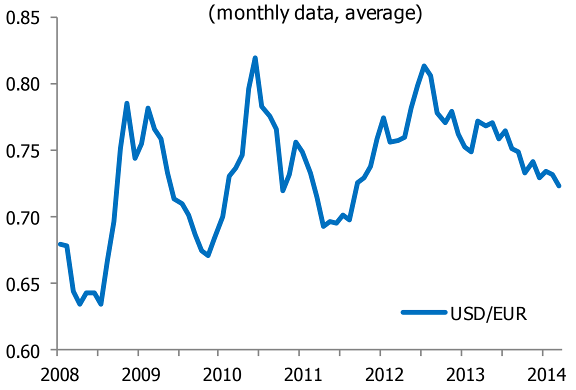
Source: Central banks.

The economy of the euro area grew in the last quarter of 2013, thus increasing for the third consecutive quarter. Compared with the previous quarter, the economic growth accelerated from 0.1% to 0.3%, and contributed to a positive annual growth of 0.5%, for the first time in seven quarters. Economic growth resulted mainly from the growth in exports, which significantly exceeded the growth in imports in the same quarter, last year. Looking at the components of domestic demand, economic growth is mainly due to the higher private consumption and investment demand. Data indicate that in the fourth quarter of 2013, all key economies made a positive contribution to the overall growth. The strongest growth was registered in the Netherlands (0.7%), Germany (0.4%), followed by the growth of France (0.3%) and Spain (0.2%). Looking at the components of domestic demand, in the fourth quarter of 2013, the economic growth was largely driven by the increased private consumption and investment demand, while public consumption hit the growth. On the supply side, a growth was registered in the value added in industry, trade, construction and agriculture. The growth of manufacturing sector is in line with the strengthening of the export growth compared with the previous quarter. In the first quarter of 2014, the labor market is again the weakest segment of the economy of the euro area, as reflected by the high rate of unemployment, which in February 2014 remained 11.9%[4]. **The annual inflation in the euro area remained below the targeted rate of 2%.** In the first two months of the first quarter, there was a downward trend of annual inflation, which was at the level of 0.8%, on average. Observing the components of the consumer price index, this is mainly due to the decline in the prices of energy component, reflecting the movement of oil prices during this period, while simultaneously slowing the growth of food prices.

The policy rates of the FED, the ECB and the Bank of England remained unchanged in the first quarter of 2014 at close-to-zero level (0% - 0.25%, 0.25% and 0.5% respectively). At the March meeting, the Fed's Federal Open Market Committee (FOMC) decided from April 2014, to additionally reduce the

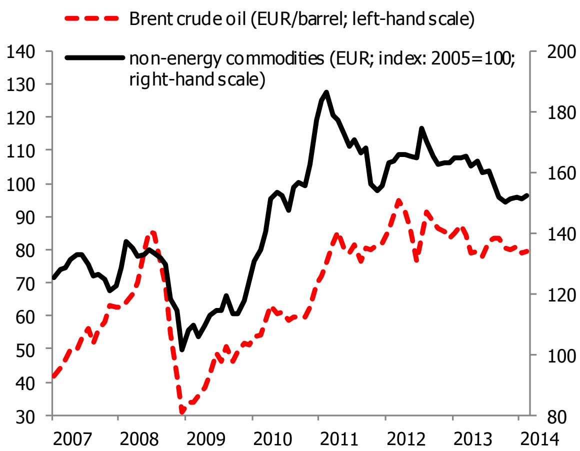
[4] According to the latest revised data.

USD/EUR Exchange rate
(monthly data, average)



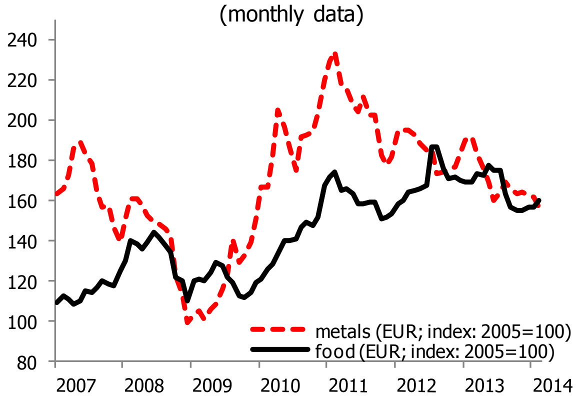
Source: Eurostat.

Prices of crude oil and non-energy commodities
(monthly data)



Source: IMF monthly database.

Prices of food and metals
(monthly data)



Source: IMF monthly database.

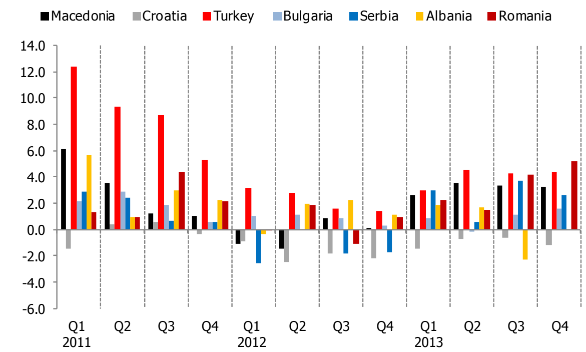
purchase of mortgage bonds to 25 billion U.S. dollars (from the current 35 billion U.S. dollars) and to reduce the monthly amount of purchase of long-term government bonds to 30 billion U.S. dollars (from the current 40 billion U.S. dollars). This decision was taken in accordance with the perceptions of a moderate acceleration of economic activity, improved conditions in the labor market and reduced price pressures. In addition, the FED stated that it will continue to implement accommodative monetary policy, and the future pace of repurchase of securities will depend on assessments of the economic situation. In January 2014, the ECB, in cooperation with the central banks of Japan, England and Switzerland decided from April 2014 to suspend the quarterly operations of providing liquidity in U.S. Dollars, taking into account the improved conditions for funding in U.S. Dollars. However, the weekly operations to provide liquidity in U.S. Dollars will continue at least until 31 July 2014. In March 2014, the European Parliament and the European Council endorsed the proposal to establish a centralized resolution mechanism for banks dealing with serious problems. This so-called Single Resolution Mechanism creates conditions for completing the banking union in the euro area[5].

In the first quarter of 2014, the nominal exchange rate of the euro against the U.S. dollar generally followed the path of moderate appreciation. Only the euro depreciated in January by 0.7% on a monthly basis, while in February and March, the euro appreciated by 0.4% and 1.2%, respectively. Such developments are primarily due to the reduction of uncertainty within the euro area, rising domestic demand and absence of further monetary easing measures by the ECB. In March 2014, one euro was exchanged for 1.38 U.S. dollars, appreciating by 6.6% compared to March 2013.

In the first two months of the first quarter of 2014, oil prices fell at a slower pace compared to the previous quarter. Thus, the price of Brent oil in this period averaged Euro 79.4 per barrel, down by 1.3% compared with the previous quarter. The fall in oil prices is mainly due to weaker seasonal demand and increased supply from the United States. However, the lack of oil from Libya, and rising geopolitical tensions over Ukraine made upward pressures on oil prices. **On the other hand, the price index of primary**

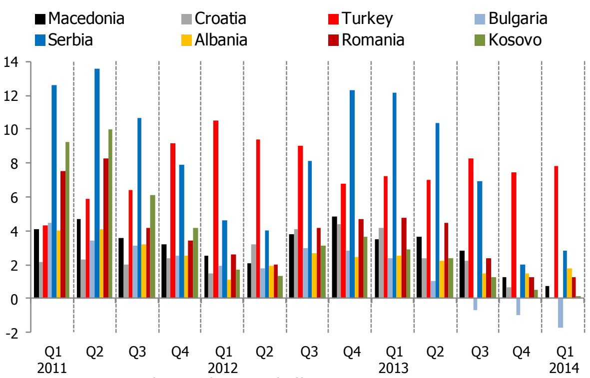
[5] europa.eu/rapid/press-release_STATEMENT-14-77_en.htm

Real GDP growth in countries from the region
((annual percentage changes, quarterly data



Source: Eurostat and national statistical offices.

Inflation in countries from the region
(annual percentage changes)



Source: Eurostat and national statistical offices.

non-fuel commodities[6] **registered a minor growth in the first two months of the first quarter compared to the previous quarter,** with an average decline of metal prices in January and February of 2.7% and an average increase in food prices 1.6%. The decline in metal prices is primarily due to the decreased global demand, particularly because of the weak economic performance of China, leading to a decline in imports of metals. Upward pressure on the price of cereals reflects the decreased exports from Canada and Argentina, the dry weather in the United States during the cultivation of winter crops, as well as the tension between Russia and Ukraine, given that Ukraine is among the major manufacturers of these products.

In the fourth quarter of 2013, most of the countries of the region reported stronger economic activity compared with the previous quarter, although its pace differed from one country to another. Specifically, Romania and Bulgaria reported a strong growth, Turkey reported a moderate growth, while Serbia's economic activity slowed down. On the other hand, the decline in economic activity in Croatia, which began two years ago, continued in the fourth quarter of 2013.

In the period January-February 2014, most of the countries registered a moderate slowdown in the rate of inflation, whereas Bulgaria reported higher deflation. This movement in nearly all countries is a consequence of the moderate decline in prices of food and energy. In the case of Bulgaria, deflation pressures arise primarily from the drop in the prices of electricity and food.

Box 1: The Crisis in Ukraine and its Effects on the Macedonian Economy

Geopolitical crisis that occurred in Ukraine rattled the food and energy markets, the world financial markets and leading economies, triggering drastic measures by the Western world powers in order to protect the sovereign and territorial integrity, and the financial stability in Ukraine. With this in mind, the question arises about the reasons for the importance of Ukraine for both the global and the European economy. The first reason is the **strategic economic position of Ukraine, which enables efficient and effective transit of crude oil and natural gas from Russia to Europe that fulfils 25% of gas needs of Europe**. Export of oil and gas generates more than 50% of Russia's budget revenues, which means that the negative scenarios for possible suspension of gas delivery to Europe and consequently, higher gas price will lead to a significant deterioration of the fiscal position of Russia. Second, Ukraine is the third country in the world in the export of corn and among the top ten countries in the export of wheat. Hence, its impact on prices of cereals is more than significant. According to the U.S. Ministry of Agriculture, this year, Ukraine is expected to be the

[6] The price index of primary nonenergy commodities includes: prices of food, beverages, agricultural raw materials and metals.

fifth largest wheat exporter and the third largest exporter of corn. Ukraine has placed the bulk of its cereals in the markets in Egypt, the world's largest importer of wheat, and the rest in other countries in the Middle East and Africa. Consequently, if Ukraine begins to reduce its share in global exports, it will significantly affect the prices of these primary food commodities, also taking into account the fact that Ukraine is a very cheap seller of wheat. Thus, Ukraine's withdrawal from the global market would deprive it from its role as a determinant of the price threshold in international trade, which would lead to an increase in the price of wheat.

The aforementioned factors illustrate the importance of this country especially for the world pricing of primary products. Hence, to stabilize the situation and restore political and financial stability in Ukraine and Russia, as well as to preserve the territorial and sovereign integrity of Ukraine, the U.S. and the EU came forward with a range of sanctions including: visa travel ban on prominent Russian and Crimean government officials and individuals responsible for undermining the democratic processes and institutions in Ukraine and freezing of their assets and properties in some of the Member States of the European Union, as well as a ban on American companies to cooperate with the Bank of Russia (Bank Rossiya), because of the higher ownership share of close associates of the Russian President Putin. In addition, President Barack Obama signed an executive provision that the U.S. has the authority to allow, in case of deterioration of the situation in Ukraine and Crimea, taking additional sanctions not only on individuals but also on key Russian sectors, such as energy, metals and ores sectors.

Geopolitical crisis undoubtedly affected the Ukrainian economy. The events have led to further deterioration of the already fragile fiscal and economic position of the country, creating a need of urgent financial assistance from international financial institutions for stabilizing the economy and avoiding potential balance of payments crisis. **Thus, on 30 April 2014, the IMF provided a two-year financial support in the form of stand -by arrangement7 for Ukraine worth U.S. dollar 17 billion in order to avoid the risk of occurrence of balance of payments crisis and inability to repay the public debt denominated in foreign currency**. Balance of payments situation in Ukraine prior to the geopolitical crisis was unfavorable. Foreign capital inflows were insufficient to finance the high current account deficit, which in 2013 reached almost 9% of GDP. Moreover, to defend the fixed exchange rate of the Ukrainian Hryvnia against the U.S. Dollar, the central bank of Ukraine intervened in the foreign exchange market by selling foreign reserves, the reserves reduced to a low level, creating a need for urgent international bailout.

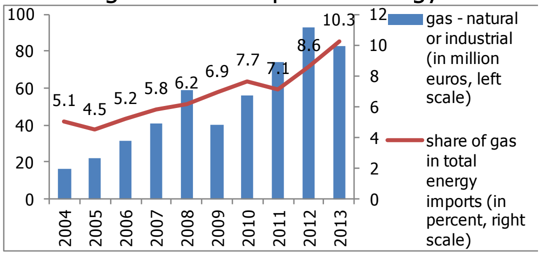
[7] Obtaining a **stand-by arrangement** with the IMF is conditional upon the immediate fulfillment of **four key reforms**. First, **the central bank of Ukraine will allow free initial fluctuation of hryvnia, while introducing the strategy of inflation targeting.** It involves gradual depreciation of hryvnia from the current 11 to 13 hryvnias per dollar. This reform aims to increase the export competitiveness, move domestic consumption from imports to domestic production and avoid the risk of default by the banking sector whose external liabilities significantly exceed foreign assets. Second, **there will be reforms of the financial sector, which include improving the regulatory framework and reducing the burden of "bad loans", which are currently unofficially estimated at 40% of total loans**. Third**, fiscal policy will tighten to decrease the fiscal deficit from 4.5% of GDP last year to 2.5% of GDP in 2016.** In addition, the Fund will seek to reduce losses of Ukrainian "Naftogaz", a state-owned gas company, through increase of tariffs for household electricity. Eventually, **the IMF program will include reforms of the business environment to support investments and output growth over a long period of time.**

Table 1
Foreign direct investments (in millions of euros)

Year	Foreign direct investments from Ukraine in Macedonia	Total foreign direct investments in Macedonia	Share of Ukranian FDI in Total FDI (in percent)
2008	-0.24	399.9	-0.1
2009	-0.23	145.0	-0.2
2010	-14.98	160.0	-9.4
2011	-4.82	336.8	-1.4
2012	0.16	89.8	0.2
2013	0.04	251.5	0.0

Source: NBRM

Chart 1
Share of gas in total import of energy



Source: NBRM

The crisis in Ukraine should not have any major immediate effects on the Macedonian economy due to the low share of Ukraine in the total foreign trade of 1.1% in 2013. Food and metallurgy are main export sectors, while for the imports, semi-finished products are of utmost importance, as a very important part of the manufacturing process of metallurgical capacities. In terms of **second-round effects, they are mostly associated with the risks created by this crisis over the price of primary food products, as well as the price of oil and gas on the world markets, which are of immense importance for the Macedonian economy**. Crucial to their achievement is the question whether the United States and the European Union would impose more economic sanctions on Russia, by targeting the key sectors of the Russian economy, and the question whether Ukraine will continue to be one of the "major players" in the global market of corn and wheat, or will it reduce the share of this market segment, thus contributing to lower global supply. In addition, the risk of potential gas crisis in Macedonia should not have major impact on the energy stability in the country, because the gas still has a minor role in the energy supply of Macedonia, i.e. it still serves only as fuel for industrial use in a few companies. The risk of spillover of the crisis in Ukraine through financial channels is assessed as insignificant, because of the weak financial ties with Ukraine.

Table 2
Export and import to and from Ukraine, by product

Exports to Ukraine, by products

	Iron and steel	Fruits and vegetables	Medicaments	Machinery and transport equipment	Tobacco	Wine	Other
	in million euros						
2008	0.0	0.2	0.1	1.0	0.0	0.0	0.7
2009	5.6	0.1	0.5	0.3	0.2	0.0	0.6
2010	13.6	0.7	1.2	0.2	0.0	0.1	0.4
2011	57.2	0.4	0.3	8.7	0.0	1.3	0.5
2012	9.3	1.2	1.3	1.2	0.6	0.3	0.2
2013	13.2	2.0	0.6	0.6	0.2	0.0	0.5
	share in total exports to Ukraine, in %						
2008	0.0	8.4	6.3	50.4	0.0	0.0	34.8
2009	76.4	1.5	6.6	4.7	3.2	0.0	7.6
2010	83.5	4.6	7.4	1.3	0.0	0.5	2.7
2011	83.7	0.6	0.4	12.7	0.0	1.9	0.7
2012	66.5	8.5	9.1	8.3	4.3	2.2	1.1
2013	77.4	11.9	3.3	3.7	1.0	0.0	2.7

Imports from Ukraine, by products

	Iron and steel	Energy	Copper	Vehicles	Other
	in million euros				
2008	111.5	9.5	2.1	0.1	13.2
2009	46.7	0.6	0.9	0.0	11.9
2010	73.1	10.8	0.8	0.0	4.3
2011	77.4	11.3	6.4	10.3	7.3
2012	57.9	2.7	1.9	0.0	4.8
2013	62.7	0.3	0.6	0.0	6.0
	share in total imports from Ukraine, in %				
2008	81.7	7.0	1.6	0.1	9.7
2009	77.8	1.0	1.5	0.0	19.8
2010	82.2	12.1	0.8	0.0	4.8
2011	68.7	10.0	5.7	9.2	6.5
2012	86.1	4.0	2.8	0.0	7.1
2013	90.1	0.4	0.8	0.0	8.7

Source: SSO.

Table 3
Foreign trade with Ukraine

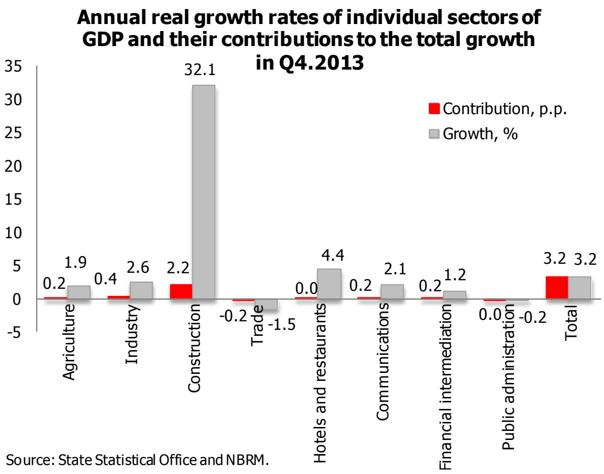
External trade data

	in million euros				share, in %	
	Exports, total	*Imports, total*	*Exports to Ukraine*	*Imports from Ukraine*	*Share in total exports*	*Share in total imports*
2008	2697.6	4664.4	2	136.5	0.1	2.9
2009	1937	3636.8	7.4	60.1	0.4	1.7
2010	2534.9	4137.1	16.3	88.9	0.6	2.1
2011	3214.9	5052.9	68.3	112.8	2.1	2.2
2012	3124	5070.6	14.1	67.3	0.4	1.3
2013	3211.8	4968.4	17	69.6	0.5	1.4

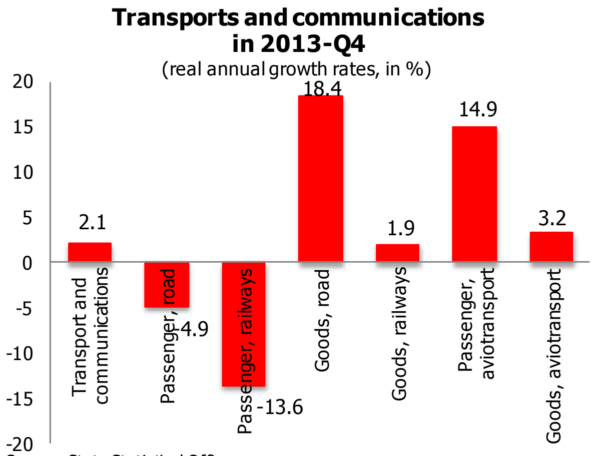
Source: SSO.

1.2. Domestic Supply

Macedonian economy continued growing in the last quarter of 2013. Amid positive quarterly developments, GDP registered an annual growth of 3.2%. As in the past three quarters, in this quarter, the growth of the construction sector continued to be the main driver, with positive results being registered by other activities, with the exception of the service sector ("trade" and "public administration"). Construction continued making the highest individual contribution to the growth, where public and private sector investments have contributed to historically highest added value of construction for the quarter and the whole year. In the last quarter, the industry registered an annual growth, caused by the activity of export-oriented domestic and foreign capital facilities, amid improved global macroeconomic outlook and growth of foreign effective demand in the second half of 2013. The assessment of the economic situation and the degree of utilization of industrial capacity in the fourth quarter also improved. According to the latest reviews from business tendency surveys, in January and February, the economic agents of the manufacturing industry retained the optimism (from the fourth quarter of 2013) for output volume in the next three months.



Source: State Statistical Office and NBRM.



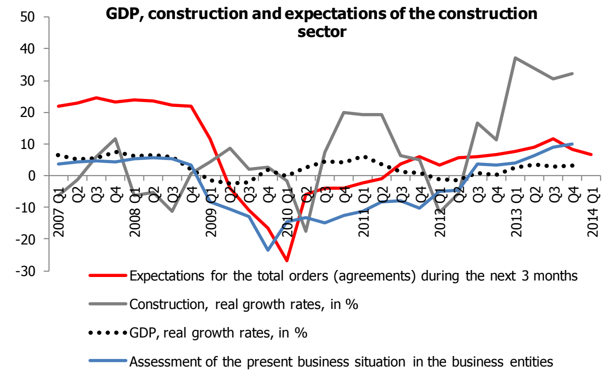
Source: State Statistical Office.

In the last quarter of 2013, economic activity continued growing, with a quarterly GDP[8] growth of 0.4% (seasonally adjusted). Thus the economy has remained in the zone of positive changes for six consecutive quarters. On annual basis, the growth of domestic output registered a slight acceleration and equaled 3.2%. The growth of value added of **construction** contributes most to the quarterly performance of the national economy. Positive, but smaller contribution was also made by **hotels and restaurants, industry, public administration** and **financial intermediation**. On the other hand, the quarterly decline in the value added of **agriculture, trade,** and **transport and communications** made an adverse contribution to the performance of the national economy in the fourth quarter. In regard to the annual dynamics, the construction sector has been a major driver of growth in the national economy for a long period. Nearly all sectors reported improved performance, with the exception of **trade and public administration**, which in the last quarter declined on an annual basis.

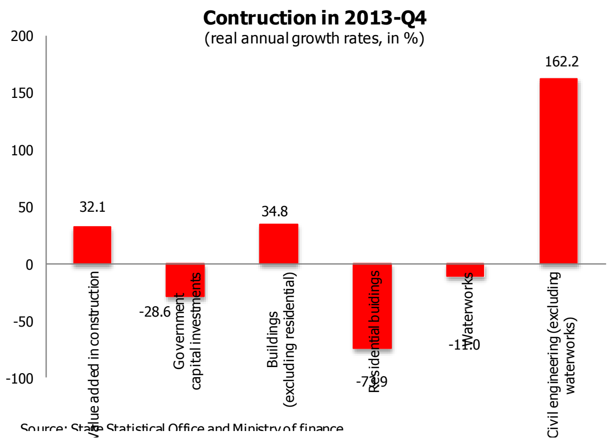
[8] Data on the annual change in quarters for 2013 are based on preliminary data for 2012.

	annual growth rates, in %										contributions to GDP growth (in p.p.)									
	Q1 2012	Q2 2012	Q3 2012	Q4 2012	2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	2013	Q1 2012	Q2 2012	Q3 2012	Q4 2012	2012	Q1 2013	Q2 2013	Q3 2013	Q4 2013	2013
Agriculture	-7.1	-7.0	0.0	-10.1	***-6.2***	-2.9	-0.3	1.6	1.9	***0.5***	-0.6	-0.6	0.0	-1.2	***-0.6***	-0.2	0.0	0.2	0.2	***0.0***
Industry	-5.0	2.6	5.6	7.8	***2.8***	8.9	6.9	1.6	2.6	***4.9***	-0.9	0.4	0.9	1.2	***0.5***	1.6	1.2	0.3	0.4	***0.8***
Construction	-11.7	-5.7	16.5	11.3	***4.8***	37.3	33.7	30.5	32.1	***32.7***	-0.4	-0.3	0.9	0.7	***0.3***	1.2	1.7	1.9	2.2	***1.8***
Trade	-2.6	-6.7	-4.2	-5.1	***-4.8***	-0.7	-1.1	2.8	-1.5	***-0.1***	-0.4	-1.1	-0.6	-0.7	***-0.7***	-0.1	-0.2	0.4	-0.2	***0.0***
Hotels and restaurants	-0.8	3.1	3.4	2.4	***2.3***	4.2	2.3	-1.1	4.4	***2.1***	0.0	0.0	0.1	0.0	***0.0***	0.0	0.0	0.0	0.0	***0.0***
Communications	4.7	-2.9	0.2	-4.2	***-0.8***	0.7	6.6	1.9	2.1	***2.8***	0.5	-0.3	0.0	-0.4	***-0.1***	0.1	0.6	0.2	0.2	***0.3***
Financial intermediation	3.4	3.3	0.6	0.7	***2.0***	1.4	0.9	1.9	1.2	***1.3***	0.6	0.5	0.1	0.1	***0.3***	0.2	0.2	0.3	0.2	***0.2***
Public administration	0.5	0.3	0.2	1.0	***0.5***	-0.2	-0.2	-0.9	-0.2	***-0.4***	0.1	0.0	0.0	0.1	***0.1***	0.0	0.0	-0.1	0.0	***-0.1***
Value Added	-0.8	-0.9	1.5	0.0	***0.0***	2.8	3.9	3.5	3.6	***3.5***	-0.7	-0.8	1.3	0.0	***0.0***	2.5	3.4	3.0	3.0	***3.0***
Net taxes on products	-2.0	-5.1	-3.5	-1.0	***-2.8***	1.0	1.1	0.2	1.3	***0.9***	-0.2	-0.7	-0.5	-0.2	***-0.4***	0.1	0.1	0.0	0.2	***0.1***
Gross Domestic Product	***-1.1***	***-1.5***	***0.8***	***0.0***	***-0.4***	***2.6***	***3.5***	***3.0***	***3.2***	***3.1***	***-1.1***	***-1.5***	***0.8***	***0.0***	***-0.4***	***2.6***	***3.5***	***3.0***	***3.2***	***3.1***

Source: State Statistical Office and NBRM calculations.



Source: State Statistical Office.

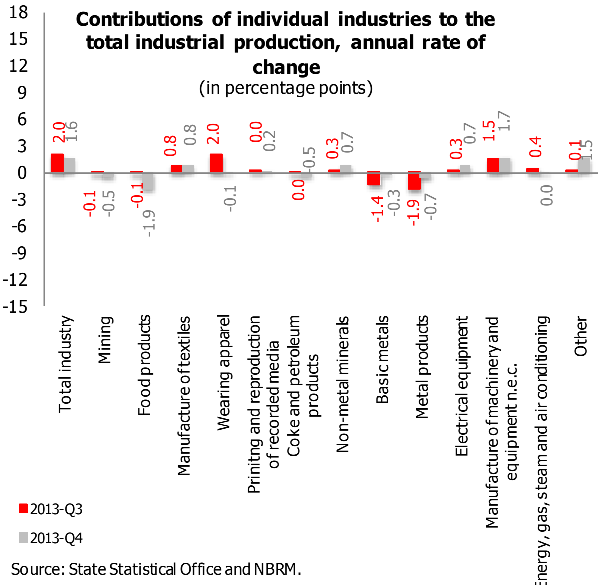


Source: State Statistical Office and Ministry of finance.

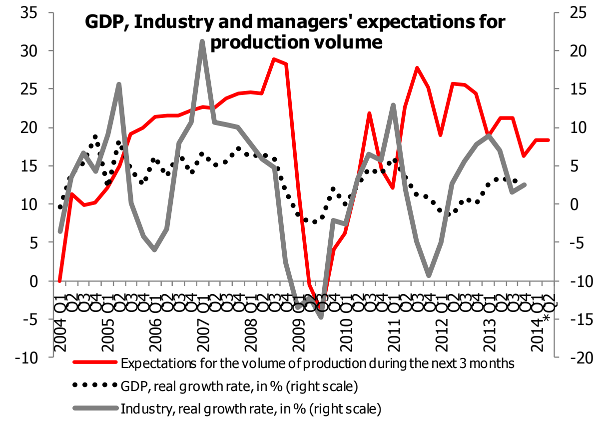
Solid growth in construction on both quarterly[9] and annual basis continued in the fourth quarter of 2013. Although the quarterly construction growth slowed down, this activity in the quarter made the largest individual contribution to the overall growth of the economy. Strong double-digit annual growth continues to be largely due to public[10] and private investments in transport infrastructure, and in housing and nonhousing construction. This performance has led to historically highest added value of construction for the quarter and for the year. Construction sector managers also confirm the positive environment by the historically highest assessment for the economic situation of the corporate sector in the Business Tendency Survey in **construction**[11]. Positive perceptions of companies, according to the survey, derive from the reduced impact of certain limiting factors for improving construction activity. The lack of demand, the competition, the materials and the labor costs and the lack of equipment and materials are estimated to have less limiting impact. Also, since the first quarter of 2012, the positive perceptions outnumbered the negative ones regarding the financial situation of companies, while compared with the third quarter, companies assess more favorably the situation of late payments from clients (both public and private sector). Considering the expectations of construction managers for the next three months, they have less optimistic expectations about the conclusion of new contracts and number of employees and lower expectations for increase in selling prices compared to the previous quarter.

After the fall in the third quarter, in the last quarter of the year the industrial activity was back in the zone of positive quarterly changes[12], leading to a slight strengthening in the annual growth of value

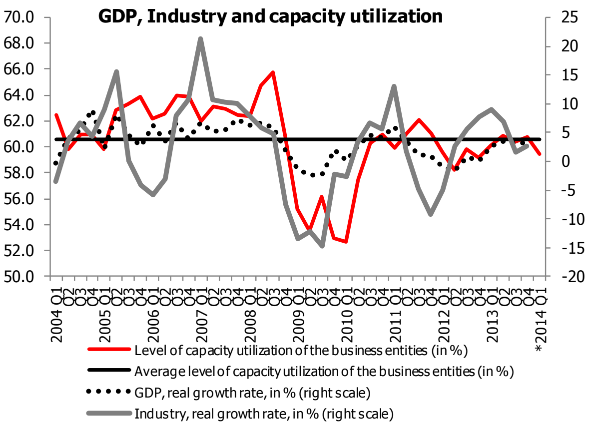
[9] Analyzed on seasonally-adjusted basis.
[10] Refers to capital investments of the central government.
[11] Refers to the fourth quarter of 2013.
[12] Analyzed on seasonally-adjusted basis.



Source: State Statistical Office and NBRM.



Source: State Statistical Office.
* average of expectations for 1 and 2 month of 2014.



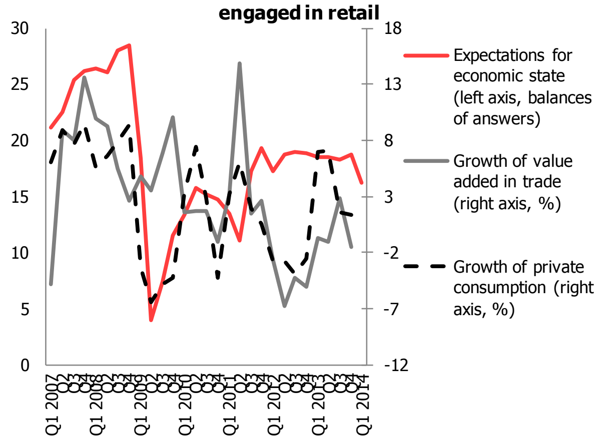
Source: State Statistical Office.
* average for 1 and 2 month of 2014.

added in the industry. The improved performance is associated with the improved global macroeconomic outlook, the annual growth of foreign effective demand in the second half of 2013, and the utilization of local capacities and capabilities whose activities take place in the technological industrial development zones. Manufacturing industry continued to make the largest contribution to the annual growth in the fourth quarter, where more than half of businesses make positive contribution, particularly the manufacture of machinery and equipment, textiles, beverages and electrical equipment. In the last quarter, the mining activity kept on declining on an annual basis, after the improved performance in the first half of the year. The industrial performance is consistent with the estimates given in the Business Tendency Survey in **manufacturing industry**[13]. In the fourth quarter, the average capacity utilization increased on a quarterly and annual basis. Thus, the average utilization exceeded the average of the previous eight years. Moreover, compared to the previous quarter, the companies evaluated the current economic situation and the output volume more positively. Analyzing the factors that limit the output increase, the survey points to reduction of the impact of financial problems, lack of raw materials, as well as the uncertain economic environment. Assessments of the surveys conducted in the first two months of 2014 point to reduced optimism of companies in terms of output volume, and reduced average capacity utilization. They also point to reduced limiting impact of insufficient foreign and domestic demand, competitive imports, uncertain economic environment and financial problems. These perceptions have not changed the managers' expectations of the output volume in the next three months, but have raised expectations for higher purchase prices of inputs and higher selling prices of finished products.

The value added in trade in the last quarter of 2013 decreased quarterly again[14]. This performance also caused a decline on an annual basis (after the recovery in the third quarter), as explained by lower wholesale and retail trade, despite the growth of trade in motor vehicles. Unfavorable performance in retailing are partly noticed through the survey of **retail**[15] managers, whose assessments, compared

[13] Refer to surveys conducted in the fourth quarter of 2013.
[14] Analyzed on seasonally-adjusted basis.
[15] SSO's Business Tendencies Survey in retail for the fourth quarter of 2013.

Trade, household final consumption and expectations of managers of business entities engaged in retail



Source: State Statistical Office.

with the assessments from the previous quarter, point to stronger factors that limit the improvement of the current operations of companies. In fact, compared with the third quarter, there is stronger limiting impact of higher labor costs, ability to provide credits and weak demand from consumers. For the next period, less trade managers have positive expectations about the business climate in the next six-month period, with reduced optimism for rise of selling prices, orders and the number of employees in the next three to four months.

After the marginal decline from the previous year, the domestic economy in 2013 was back in the zone of positive growth rates with a solid growth of 3.1%. Amid slow recovery of the external economic environment, the growth largely resulted from the construction sector and industry. The private and public[16] investments in the **construction sector** provided double-digit annual growth throughout the year, and made the largest individual contribution to the GDP growth. The gradual recovery of economies in the euro area and the annual growth of foreign effective demand in the second half of 2013 led to increased activity of domestic capacities and capabilities whose businesses take place in the technological industrial development zones, thus increasing the added value of the **industry**. The growth of industrial output had a positive impact on the development of the **transport** sector, which is the third GDP component with the largest positive contribution to the growth.

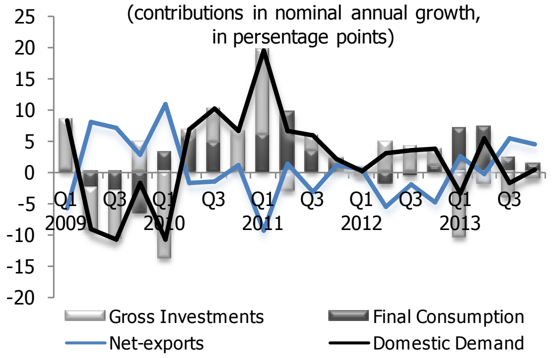
1.3. Aggregate Demand

Concerning demand, in the fourth quarter, the annual growth of gross domestic product also results from the positive contribution of net export demand, while domestic absorption dropped annually. The positive contribution of net exports almost entirely stems from the high growth of exports, with a small contribution of the fall in import of goods and services. Exports continued to grow, primarily as a result of the exports of new capacities in the technological industrial development zones. Imports recorded a minimum annual decline, primarily due to the reduced energy imports. Household consumption is the only component of domestic demand, which has positively contributed to the GDP growth given the further favorable developments in the labor and credit markets. Gross capital formation and public spending continued to decline, but slowly.

As in the previous quarter, the solid annual growth in GDP in the fourth quarter

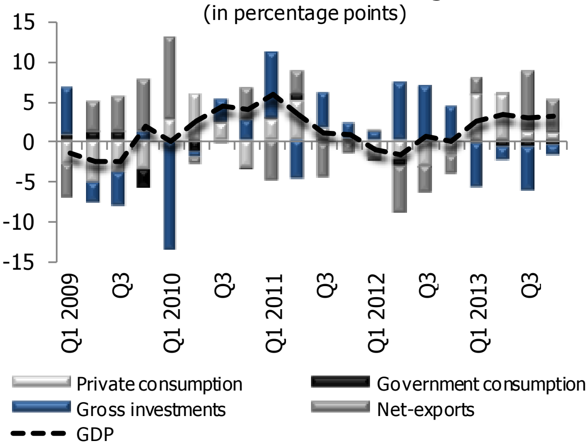
[16] Refers to investments of the central government.

Domestic Demand and Net-Exports
(contributions in nominal annual growth, in persentage points)



Source: State Statistical Office and NBRM calculations.

Contribution to real annual GDP growth
(in percentage points)



Source: State Statistical Office and NBRM calculations.

of 2013 is due to the positive contribution of net exports. Conversely, domestic demand made a negative contribution. Export of goods and services continues to be a component with the largest positive contribution to growth, mainly resulting from the effect of the increased production of new capacities in the technological industrial development zones. In terms of external factors, world metal prices further dropped and dampened the domestic metal industry. On the other hand, foreign effective demand slowly recovered, yet favorably shifting the domestic exports sector. These exports developments led to higher import of raw materials. However, the drop in import of energy sources contributed to a negligible decline in import of goods and services, thus positively contributing to the GDP growth. The household consumption also made a positive contribution to the growth, given the further positive developments on the labor market, partly as a knock-on effect of new export capacities. Other components of domestic demand, public spending and gross capital formation decreased as in the previous three quarters, thus hitting the GDP growth.

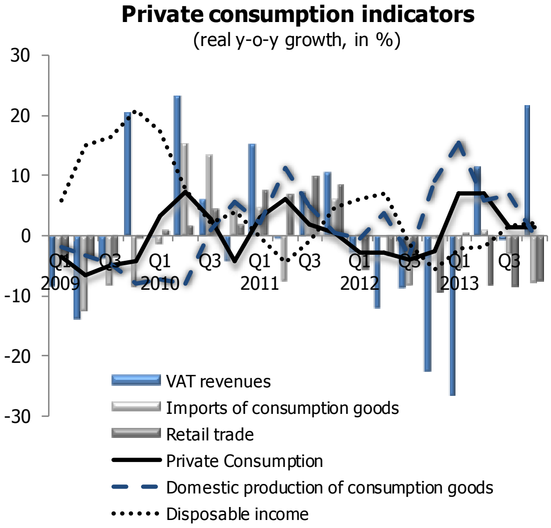
Real annual growth rates (%)

	2010-Q1	2010-Q2	2010-Q3	2010-Q4	2010	2011-Q1	2011-Q2	2011-Q3	2011-Q4	2011	2012-Q1	2012-Q2	2012-Q3	2012-Q4	2012	2013-Q1	2013-Q2	2013-Q3	2013-Q4	2013
Private consumption	3.3	7.4	2.8	-4.3	2.1	3.2	6.1	1.9	0.5	2.9	-2.7	-2.7	-3.9	-2.6	-3.0	7.0	7.1	1.6	1.4	4.2
Government consumption	-0.6	-7.1	0.7	-0.8	-2.0	0.7	4.9	-2.7	-0.2	0.6	-1.1	-4.7	-0.6	0.8	-1.4	-2.3	-4.3	-4.4	-3.2	-3.6
Gross investment	-47.6	-3.1	15.1	9.0	-6.7	55.4	-20.0	21.9	5.6	9.6	4.8	39.1	28.0	12.7	20.0	-23.4	-6.6	-17.8	-3.6	-11.5
Exports of goods and services	10.0	17.7	24.8	40.1	23.6	36.3	12.0	2.6	-0.4	10.5	0.2	0.7	-1.3	0.6	0.0	-3.0	2.5	9.5	8.4	4.5
Imports of goods and services	-10.2	12.8	18.8	16.0	9.5	33.3	3.6	8.6	2.2	10.4	-0.3	9.5	3.9	3.8	4.2	-4.9	1.6	-4.4	-0.8	-2.1
Domestic demand	-8.3	3.0	4.5	-0.6	-0.3	9.2	0.7	4.8	1.8	3.9	-1.2	3.6	3.1	2.0	2.0	-0.1	2.6	-4.2	-0.7	-0.6
*Net exports**	*-35.1*	*3.6*	*2.9*	*-16.3*	*-13.8*	*27.1*	*-14.1*	*28.1*	*7.9*	*10.1*	*-1.2*	*33.8*	*17.4*	*10.5*	*14.2*	*-9.2*	*-0.2*	*-34.5*	*-18.3*	*-15.8*
GDP	**0.0**	**2.5**	**4.5**	**4.0**	**2.9**	**6.1**	**3.6**	**1.2**	**1.0**	**2.8**	**-1.1**	**-1.5**	**0.8**	**0.0**	**-0.4**	**2.6**	**3.5**	**3.0**	**3.2**	**3.1**

**decrease represents lower deficit*
Source: SSO and NBRM calculations.

1.3.1. Private Consumption

In the fourth quarter of 2013, household consumption kept the level of the previous quarter, registering a marginal decline of 0.5% on a quarterly basis (seasonally adjusted). Hence, the annual rate of real growth registered a slight slowdown to 1.4% (1.6% in the previous quarter). Growth in private consumption corresponds with growth of available funds. Thus, the positive export developments and the effect of



Source: State Statistical Office , Ministry of Finance and NBRM calculations.

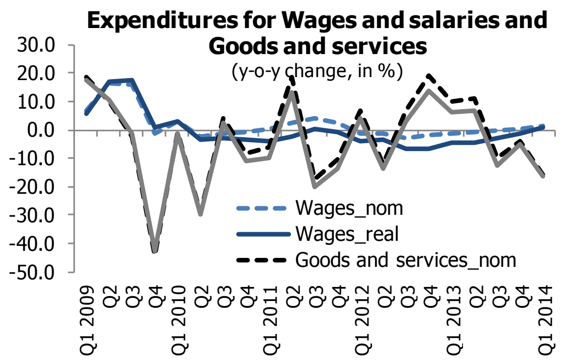
active employment measures[17] taken by the government triggered further favorable developments on the labor market in the fourth quarter. The employee number again recorded a solid growth, while real wages experienced a slower decline due to the lower inflation, which led to a rapid growth of wage bill. At the same time, pension growth rate accelerated, while private transfers still decline. Hence, the wage bill and the pensions are factors that contributed to the rapid real annual growth of disposable income. Lending to households, mainly in the form of consumer loans is an additional support to the consumption. This is consistent with the banks' estimates of net easing of lending terms, primarily in consumer loans, and further increase in the demand for loans on a net basis[18]. Yet, consumption indicators do not confirm such shifts. Thus, retailing declined annually, at a slower pace though, which is consistent with the assessments of managers in this sector for a higher quantity of inventories than usual for this season[19]. Imports of private consumption goods dropped again, at a faster pace though, and domestic production of these goods remained unchanged compared to the same period last year, despite the solid growth in the previous four quarters. The developments of high frequency indicators move in the same direction with the growth of household deposits, which may reflect slower spending.

The latest available data[20] for the first quarter of 2014 indicate slightly more favorable developments in consumer spending. The household lending registered a strong growth, with pensions still recording a significant real annual growth. Moreover, real wages show slower decline amid slowing inflation. Positive changes have been observed in domestic output and imports of consumer goods, which are back in the zone of positive growth rates. For the first time in five quarters of real decline, in January, the net private transfers increased on an annual basis mainly due to the higher inflows from abroad. Nevertheless, data on net currency exchange transactions for February and March, which indicate the volume of private transfers points to their reduction. Net VAT income registered a high real growth, but this is due

[17] For more detail see Attachment 4: *A review of Active Programs and Employment Measures in the Republic of Macedonia*, published in the Quarterly Report, January 2014.
[18] NBRM's Lending Survey conducted in January 2013.
[19] SSO's Business Tendencies Survey in retail conducted in the fourth quarter of 2013.
[20] Wage data are as of January, while other data are as of February.

primarily to the low base effect[21]. In contrast, retail notes amplification of real annual decline, which is consistent with the managers' expectations for the first quarter of 2014 about the number of orders, selling prices, the number of employees and the business conditions, which are less favorable compared to the previous quarter[22].

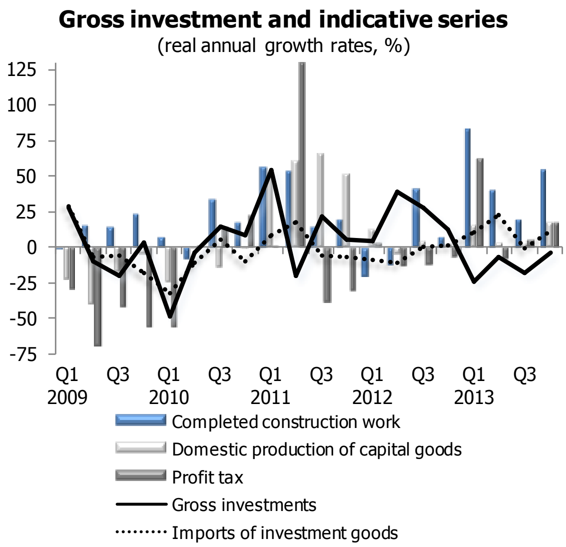
1.3.2. Public Consumption



Source: Ministy of Finance and NBRM calculations.
The calculations include expenditures of Consolidated Budget of Central Government and Funds, deflated by CPI.

In the last quarter of 2013, government spending recorded a quarterly growth of 1.9% (seasonally adjusted), so that the annual decline slowed down and reduced to 3.2% (4.4% in the previous quarter). The slowdown in the annual decline mainly results from the slower decline in goods and services. However, the latest available data for the period January-February 2014 indicate an **annual decline of public spending in the first quarter of 2014,** with a significant real decline in costs of goods and services.

1.3.3. Investment Consumption

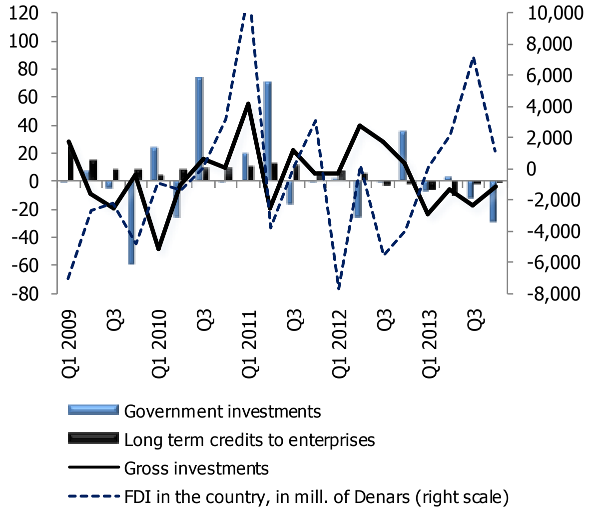


Source: State Statistical Office, Ministry of Finance and NBRM calculations.

In the fourth quarter of 2013, gross capital formation registered a real quarterly growth of 4.2% (seasonally adjusted), while on an annual basis, they dropped by 3.6%, which is a significant slowdown of the decline (decline of 17.8% in the third quarter). The annual decline in gross capital formation probably results from the fall in inventories, given the higher investments in construction and machinery and equipment. In the last quarter, same as in the previous three quarters, the construction recorded a high annual real growth (over 30%) that largely attributes to investments in road infrastructure. These construction developments are consistent with the assessments of managers in this sector[23], whose assessments of current economic activity of companies are more favorable than in the previous quarter. Domestic output and import of capital goods significantly improved. Namely, the output growth rate substantially accelerated, while the import is back into the zone of positive growth rates. Such developments in investments in equipment and machinery are partly associated

[21] The low base effect in 2013 is mostly due to the completed settlement of arrears due from the state to the private sector based on VAT return.
[22] SSO's Business Tendencies Survey in retail conducted in the fourth quarter of 2013.
[23] SSO's Business Tendencies Survey in construction conducted in the fourth quarter of 2013.

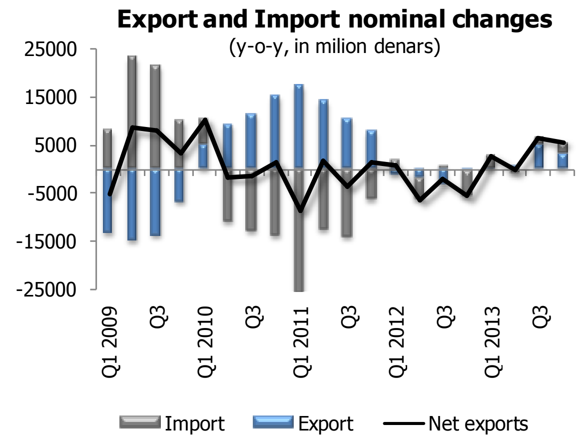
Gross investments and determinants
(nominal annual growth rates, %)



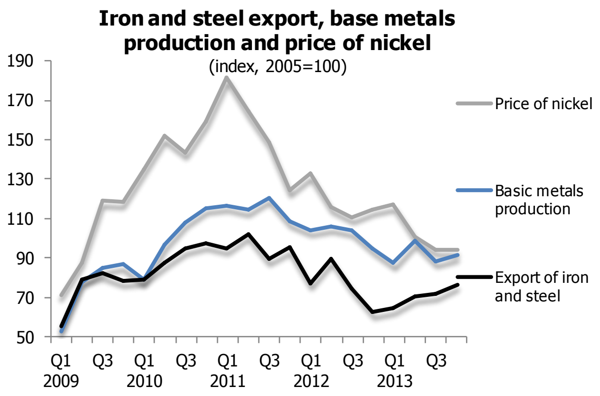
Source: State Statistical Office, Ministry of Finance and NBRM calculations.

with the entry of foreign direct investments in the country, which continue to increase in the last quarter. Slightly more favorable trends are observed in lending, where long-term corporate lending registers a slower real annual downtrend, which is consistent with the banks' lending assessments in the fourth quarter[24]. The banks indicated further net easing of lending terms, where more significant change was observed in lending interest rate, and also pointed to the increasing demand for loans on a net basis, with a significant positive shift being registered in the demand for loans for fixed capital formation. Regarding investment indicators, only the cost of capital investments within the consolidated budget of the central government and funds registered a stronger downward shift. **The latest available indicators of investment activity for the first quarter of 2014 indicate a positive change[25].** Thus, imports of investment goods and domestic production of capital goods recorded a significant annual real growth, which is an acceleration of the growth. The growth of value of completed construction works also accelerated, which again showed high annual real growth. This is consistent with the long-term implementation of major infrastructure projects, as well as the increased value of construction licenses on an annual basis, particularly in building construction, indicating a growth in the construction. On the other hand, expectations of managers of construction companies for the first quarter are less favorable compared with the previous quarter, in terms of the possible period of providing works, orders and the number of employees[26], which implies a likelihood of slowdown of the growth. Long-term corporate lending by the banks registered a real annual growth for the first time in six quarters of decline. These developments are in line with the banks' expectations for the first quarter of 2014[27], indicating a moderate net easing of lending terms and increased corporate demand for loans on a net basis. In contrast, government capital spending declined again, at a slower pace though, while the inflows of foreign direct investments registered an annual decline.

[24] NBRM's Lending Survey conducted in January 2013.
[25] Data on completed construction works and foreign direct investments are as of January, while other data are as of February.
[26] SSO's Business Tendencies Survey in construction conducted in the fourth quarter of 2013.
[27] NBRM's Lending Survey conducted in January 2013



Source: State Statistical Office .



Source: State Statistical Office, IMF monthly database and NBRM calculations.

1.3.4. Net Export Demand

Net exports have been making a positive contribution to GDP growth for fourth quarter in a row. In the fourth quarter of 2013, the positive contribution almost entirely derives from the growth of export of goods and services, which again registered a high annual real growth. The growth is mainly due to the export activity of new production facilities in the technological industrial development zones, amid a slow recovery of external demand and the still unfavorable dynamics of metal prices. The increased domestic output led to imports of raw materials, machinery and equipment, yet, without offsetting the effect of reduced energy imports, as a major factor for the fall of total imports of goods and services.

After the poor performance during 2012 and early 2013, exports of goods and services have been registering growth rates since the second quarter. The exports significantly increased in the second half of 2013, thus being a major driver of the overall economic growth. In the fourth quarter, real exports of goods and services increased quarterly (seasonally adjusted) and annually by 2.5% and 8.4%, respectively. Increased exports due to higher production of the facilities operating in technological industrial development zones are a major factor for the growth of exports. Moreover, after declining in the previous period, exports of iron and steel increased, which amid adverse movements in the international metal prices and still depreciated production, as well as gradual recovery of the foreign effective demand, is probably due to the low base effect last year and reduced inventory. Having an import-based domestic output, in the fourth quarter of 2013, the imports of raw materials for the metal manufacturing industry, equipment and machinery went up. However, the downward trends in import of oil and oil derivatives continued intensively, thus reducing the imports. Therefore, in the last quarter of 2013, imports of goods and services recorded a negligible annual real decline of 0.8%, and a small quarterly increase of 0.6% (seasonally adjusted).

Available data on exports and imports for the first quarter of 2014 indicate similar trends as in the previous two quarters, leading to minor narrowing of the foreign trade deficit. In January and February 2014 there was a nominal annual growth of exports of goods, mainly due to the increased exports of chemical products and industrial and electrical machinery, as a result of the production of facilities operating in the technological industrial development zones. These developments are consistent with the estimates for foreign effective demand, indicating a gradual strengthening of growth, which is supposed to stimulate the total domestic output, primarily in the export sector. This is confirmed by the growth of industrial output in the first two months, with the manufacturing facilities' managers articulating more favorable expectations compared with the previous quarter, in terms of prices and constant expectations for the output volume[28]. Imports also registered a nominal annual growth, primarily due to the increased import of equipment and machinery, as well as raw materials of one important export facility.

The economic growth throughout 2013 was due to the positive contribution of net exports, while total domestic demand contributed negatively to the change in GDP. Structural changes in the economy due to foreign investments in the free economic zones, as well as the moderate and gradual recovery of foreign demand had an appropriate positive effect on the export sector, with the reduced imports having an additional effect, primarily because of the lower energy imports. Household consumption, which registered the largest individual contribution to the overall GDP growth, is the only component of domestic demand that grew in 2013, given the favorable labor market developments and higher lending to households. The negative contribution of domestic demand to the economic activity is mainly due to the decline in investments, which can probably be explained by lower inventories, with a smaller negative contribution of the public consumption whose decline was due mainly to lower real costs of wages and goods and services.

Box 2: Summary Comparative Analysis of the Added Value in Construction[29]

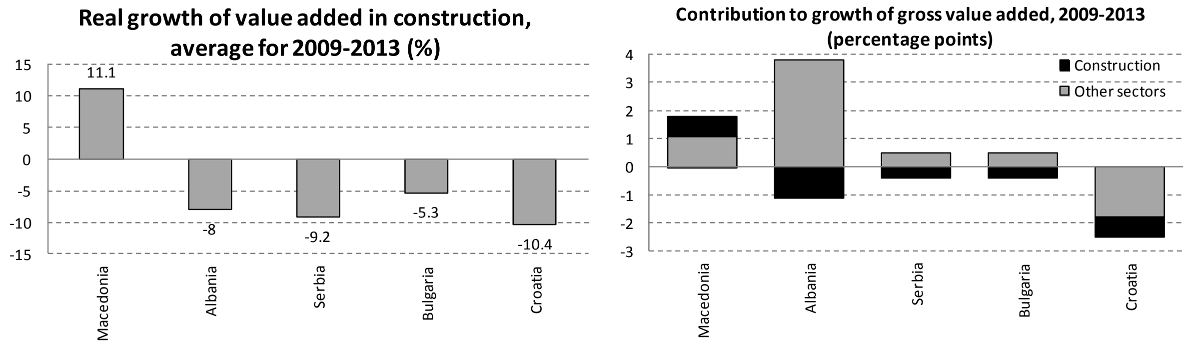
Historical data on construction activity in the Macedonian economy show constant growth, with the exception of the crisis in 2001 and 2008. Thus, the construction industry almost always positively contributes to the growth of overall economic activity. Even in the years of

[28] SSO's Business Tendencies Survey in the manufacturing industry conducted in February 2014.

[29] This summary aims to present trends in construction in recent years in Macedonia and to make comparisons with them in selected countries in the region. It has no ambition to make a conclusion about the sustainability of construction activities and the effects of current developments on the overall economy. Such evaluations require more thorough and systematic analysis.

decline in value added of the overall economy (2009 and 2012), construction activity followed the path of positive annual changes. The individual contribution of construction industry to the growth until 2012 was relatively modest, and in 2012, the relevance of construction, in terms of contributions to growth, strengthened (the contribution of value added to GDP growth in 2012 equaled 0.3 percentage points, amid decline of total GDP). **In 2013[30], value added in construction in Macedonia began to grow even stronger, and therefore, in the first three quarters, the annual growth rate averaged 34%.** The individual contribution to the total growth significantly increased, **whereby the growth in construction makes up half of the growth in the overall economy.** These construction industry developments are partly attributable to the entry of foreign capital in the real estate sector. However, these changes are mostly associated with the public investments in infrastructure projects. **Unlike Macedonia, the construction in the countries of the region (Albania, Serbia, Bulgaria and Croatia) declined during the same period.** Consequently, the contribution of the construction to the economic growth[31] in the recent period is positive in Macedonia, and negative in the countries of the region.

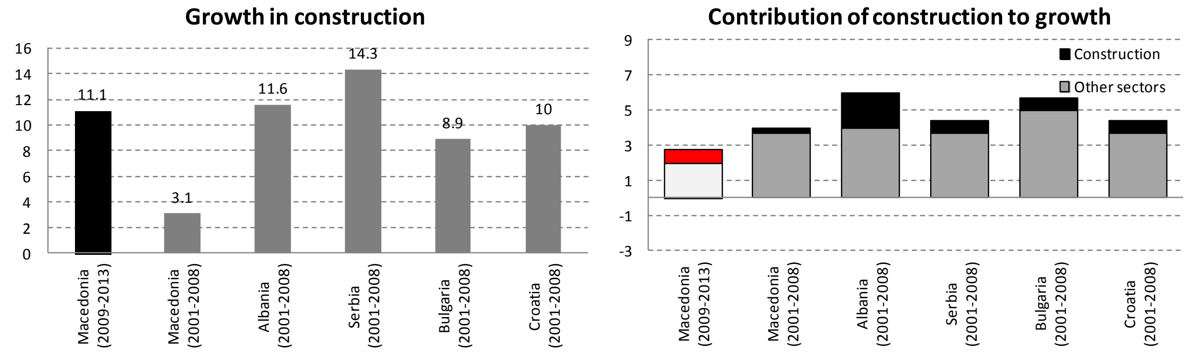
Chart 1
Real growth of value added in construction sector and contributions (2009-2013)



Source: Eurostat and Statistical Office of Albania. Data for 2013 refer to the first three quarters. Data on Albania are as of 2012.

Considering these developments, the growth of construction in Macedonia in the period 2009-2013, on average, is significantly higher than the growth in the period 2002-2008, when it equaled a mere 3.1%. **A comparison of the current pace of construction growth in the Macedonian economy to pre-crisis construction performance in the countries of the region shows high resemblance.** Moreover, the contribution of construction to the economic growth in Macedonia recently is similar to the contribution of construction industry in neighboring countries before the crisis.

Chart 2
Growth of construction in Macedonia (2009-2013) and countries in the region (2001-2008)

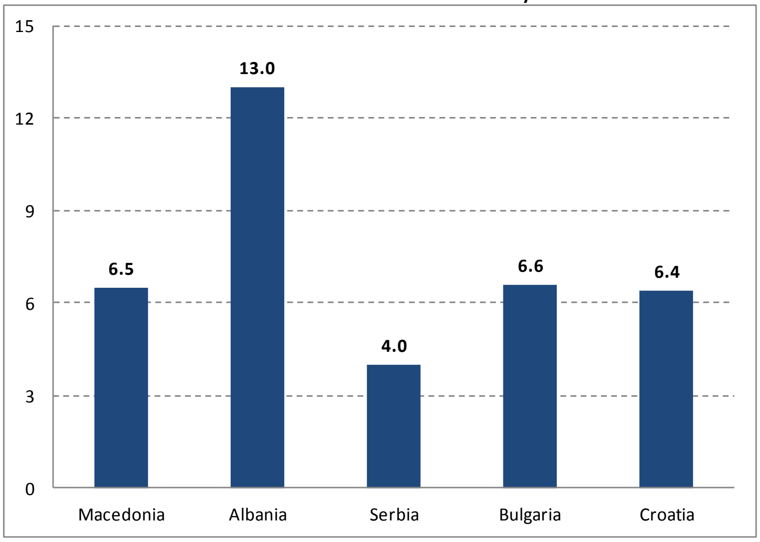


[30] It should be borne in mind that the data for 2013 are only preliminary estimates, which may be revised.
[31] For unification of data by country, rather than by GDP, gross value added is used. GDP equals gross added value plus taxes.

Source: Eurostat and Statistical Office of Albania. Data for 2013 refer to the first three quarters.

The slowdown in construction industry in the countries of the region after the crisis triggers the question of whether we can expect something like that in Macedonia. Therefore, the boom-bust cycle assessments in construction are important, with the first checkpoint being to consider the share of construction in total value added[32]. Viewed from this perspective, the share of construction in the gross value added in Macedonia in the last five years is about 6.5%, which is similar to Croatia and Bulgaria, higher than Serbia and significantly lower than Albania.

Chart 3
Share of construction in the economic activity in Macedonia and the region

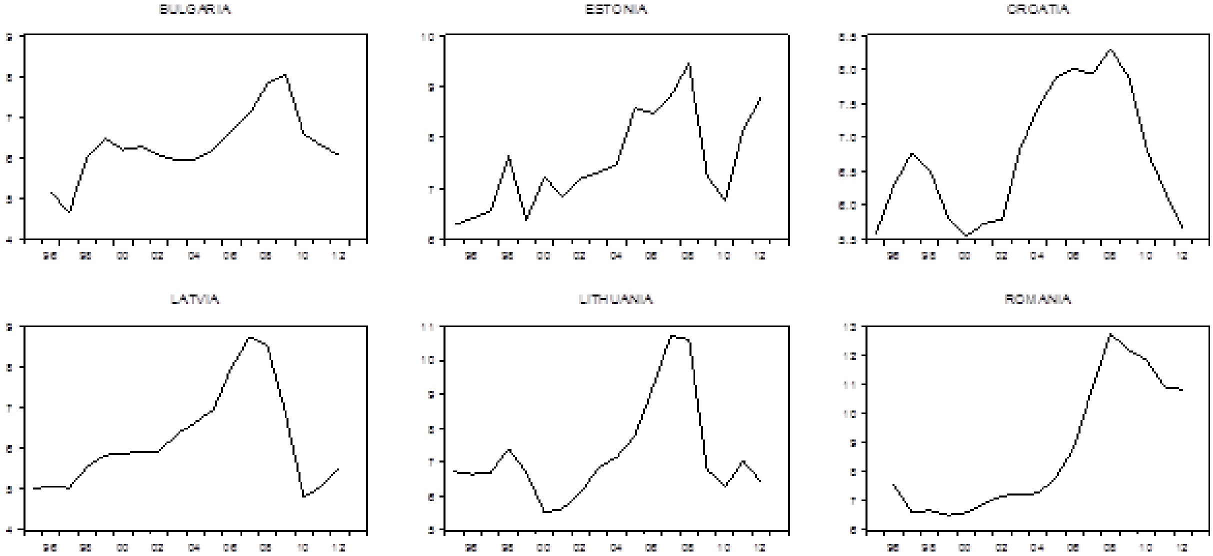


Source: Eurostat and Statistical Office of Albania. Data for 2013 refer to the first three quarters. Data on Albania are as of 2012.

Of course, the growth pace of this share is more important than the level itself. Thus, analyzing the movements in the share of construction in economic activity of some countries of Eastern Europe, which went through such boom-bust cycle (Bulgaria, Croatia, Romania, Estonia, Latvia and Lithuania), one can notice that in the boom phase this share increasingly rises by a few percentage points for several years. Then, in the bust phase, the share of construction falls sharply (within one year) by a few percentage points, upon which it usually fluctuates around that level.

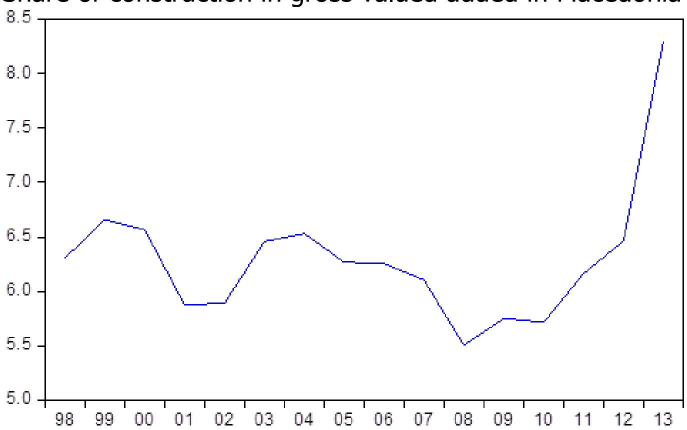
32 Sun, Yan, Pritha Mitra, and Alejandro Simone (2013), "The Driving Force behind the Boom and Bust in Construction in Europe", IMF Working Paper 13/181.

Chart 4
Boom-boost cycle in construction sector of selected countries of East Europe



Source: Eurostat. The chart presents shares of value added in construction in the grow value added.

Chart 5
Share of construction in gross valued added in Macedonia (%)



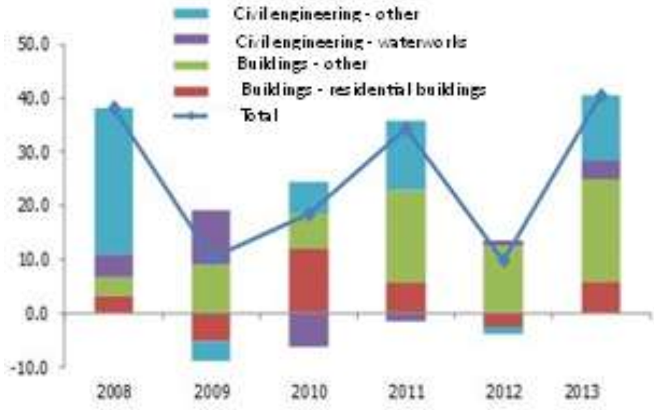
Source: Eurostat. Data for 2013 refer to the first three quarters.

Until 2013, the share of construction in gross value added in Macedonia registered no major changes. Since 2001, it has averaged about 6%, with a relatively high degree of stability. In 2013, the share of value added of construction in total value added increased, with data for the third quarter showing a share of about 9%, which is historically the highest share of construction in the value added. This change resembles the changes that took place in some of the aforementioned countries. **However, growth in Macedonia has happened in a relatively short period (within one year),** and therefore, it is not easy to determine whether Macedonia is currently going through this stage of growth, or the latest trends are only temporary. **A partial answer to this question can be obtained by analyzing the structure of the completed construction works.** Structural analysis shows that the contribution of housing construction, which is usually a major reason behind so-called boom-bust cycles, to the total growth of construction, is relatively modest. With the exception of 2010, this statement applies to the entire period since 2008. On the other hand, the contribution of nonbuilding construction (which may partly relate to government and foreign investments), as well as civil engineering (largely road infrastructure) is high.[33] **Hence, it can be**

[33] Considering the ownership structure, the growth of completed construction works in the recent period is due to government construction projects. According to the State Statistical Office data, about two-thirds of the growth in

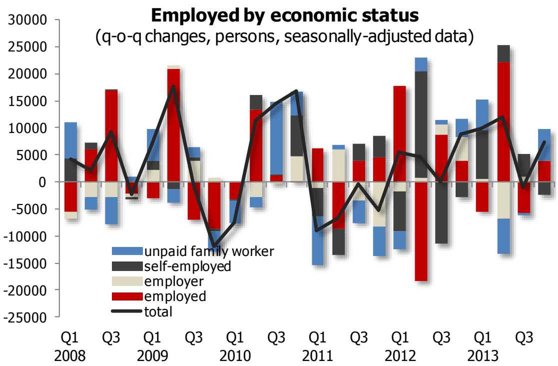
concluded that the durability of current changes in construction will largely depend on the presence of fiscal stimulus and the dynamics of foreign investments. Anyway, the qualitative structure of construction shows that, in a part, the growth in construction is productive and improves competitiveness of the economy in the long run.

Chart 6
Completed construction works by type (contributions to annual growth rate, in p.p.)



1.4. Employment and Wages

Permanent favorable economic performance also corresponds with the shifts in some labor market indicators. Employment was still growing, and unemployment continued decreasing in the fourth quarter of 2013, due to the fiscal stimulus, i.e. publicly funded construction works and agricultural subsidies, as well as job creation by new capacities operating in the technological and industrial development zones. Surveys of businesses suggest continuation of positive trends in the future. The fourth quarter also witnessed a quarterly increase in wages that corresponds with the constant growth of labor demand in the last two years. Amid moderate economic growth, such labor market developments have led to changes, specifically to further reduction in labor productivity and increased labor costs.

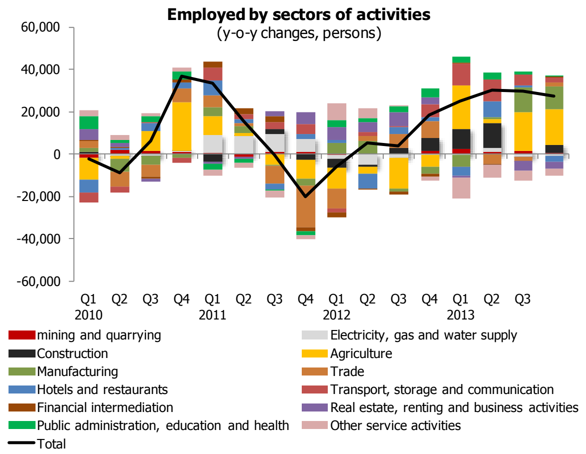


Source: State Statistical Office, Labor Force Survey

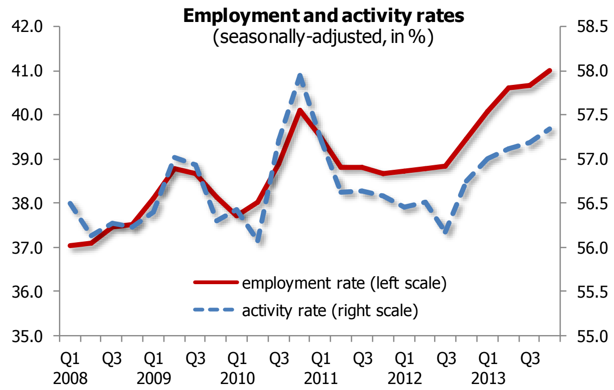
In the fourth quarter, the number of employed persons increased by roughly 8,000 (1.3%) compared to the previous quarter, seasonally adjusted[34]. Analyzed by economic status, the highest increase in employment was registered in unpaid family

completed construction works in 2012 is due to construction of publicly owned buildings, unlike the previous two years, when the public construction works constituted only one third of the growth. Data for 2013 are not available. Note that these data differ from the figures that are shown in chart 5.

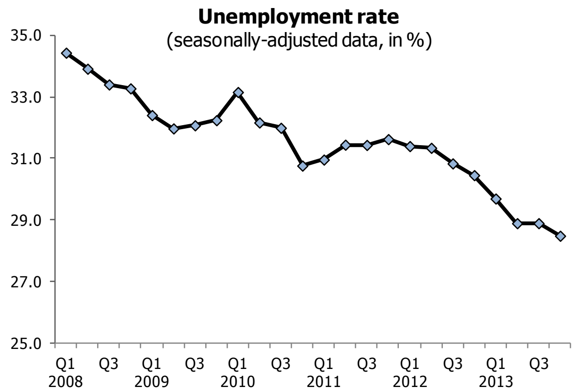
[34] Analysis of quarterly dynamics of employment, unemployment and the total active population is made by using seasonally adjusted data.



Source: State Statistical Office, Labor Force Survey.



Source: NBRM calculations od data from State Statistical Office, Labour Force Survey.



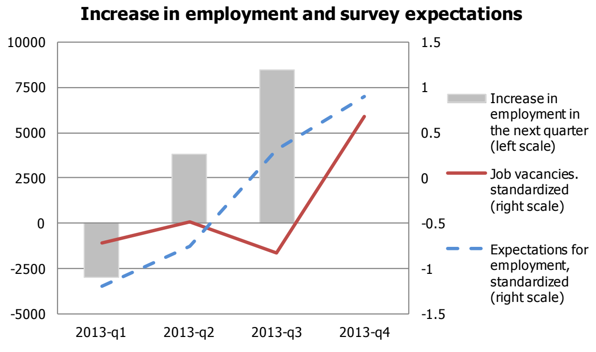
Source: NBRM calculations od data from State Statistical Office

workers and employees[35]. After three quarters of growth, self-employed professionals recorded a slight decline, but their number remains high in historical terms (about 100,000 persons), and reflects the effects of active employment measures and encouragement of entrepreneurship and the improved business environment (simplified procedures for launching and running a business). Analyzed by activity, most new employees are registered in construction, followed by agriculture. Such quarterly shifts still indicate the impact of the most important factors in the last period, such as the impetus of publicly financed works and inflows of foreign direct investments, as well as the policies of subsidizing agricultural production. **The employment rate increased by 0.1 percentage points quarterly and reached 40.9%. On annual basis, the number of employees grew by 4.2%, which is similar to the growth in the previous two quarters, when it equaled 4.3%.** The employment rate rose by 1.6 percentage points annually. The sectoral analysis shows that activities that cause quarterly change in the economy, agriculture and construction also contribute to a positive annual change in employment. Manufacturing industry has such influence, as well, which is attributable to the operation of new facilities in the free economic zones, which further absorbed a part of the available labor force.

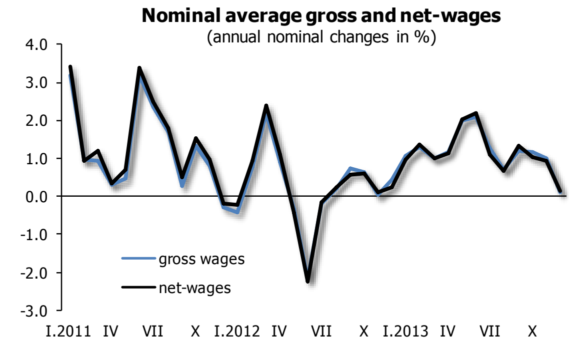
In the fourth quarter, the supply of labor increased along with the growth in demand. Thus, the labor force recorded a quarterly growth of 0.5%, or 5,000 persons. Amid a similar increase in the working age population, the activity rate equaled 57.3%, which is identical to the previous quarter. **Annually, the growth of labor force registered a slight slowdown, reducing to 1.3%, amid an annual increase in the rate of activity.**

With the growth in labor demand exceeding the supply growth, the number of unemployed persons decreased by 0.9%. In addition, the unemployment rate further reduced

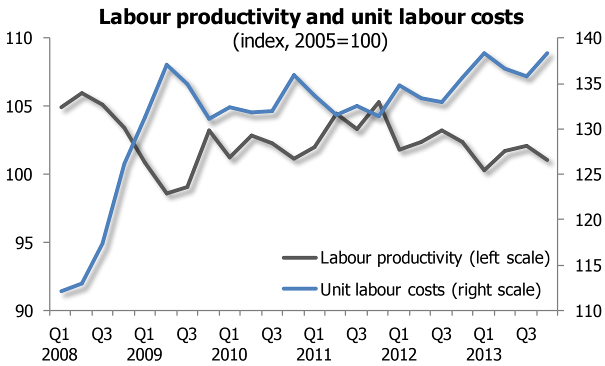
[35] SSO's classification of employees includes several groups: **employers** - persons that manage own business entity or owners working in their own shop, or farm owners who employ others; **employees** - persons who work in government institutions, business entities in public, mixed, cooperative and undefined ownership or private employer; **self-employed professionals** - people who have their own firm, business, run their own business and work on a farm in order to generate income, while not employing others; **unpaid family workers** - persons who work without a pay in a firm, shop or farm (owned by a member of their household).



Source: State Statistical Office



Source: State Statistical Office.



Source: State Statistical Office and NBRM calculations.

to 28.6%. On annual basis, the reduction in the number of unemployed persons equals 5.2%.

In the fourth quarter, the Vacancy Survey[36] shows that the number of vacancies was approximately 5,800, which is up by 1,000 compared to the previous three quarters, when the number of vacancies was stable. This movement can be interpreted as a signal for higher employment in the future. Observed by sectors, most of the vacancies (35%) are in the industry. Signals for further employment growth are present in the Business Tendency Survey[37] - the expectations for the number of employees in the next period are the highest since the beginning of the year.

With the growth in labor demand exceeding the supply growth, the average net paid wage in the fourth quarter increased on a quarterly basis, but slowly. Notably, despite the 0.3% decline in the third quarter, the last quarter of the year witnessed a resurgence of wages in nominal and real terms of 1% and 0.8%, respectively. All sectors registered positive trends, with the largest contribution of the industry wages (all industries except the manufacturing industry). Analyzing individual sectors, in addition to the manufacturing industry, wages of information technology and financial sector also recorded slight downward movements. **Observed annually, in the fourth quarter, nominal wages also grew slowly (0.7%).** In real terms, in the fourth quarter, wages kept on declining by 0.6%, which is still the slowest decline in the period after 2010, when the decrease averaged 2.5%. The highest annual growth was recorded in the wages in mining, construction and transport, contrary to the fall in information technology.

Movements in the number of employees and GDP decreased the productivity of domestic economy in the fourth quarter. On a quarterly and annual basis, the decline equaled 1% and 1.3%, respectively. **Consequently, unit labor costs increased by**

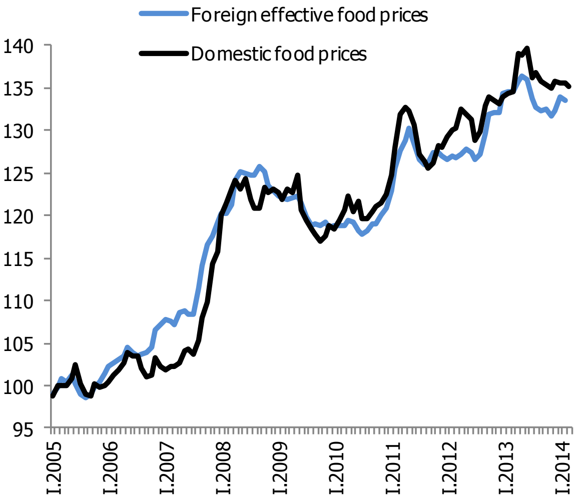
[36] For the first time in 2012, the State Statistical Office began to conduct Vacancy Survey as part of the labor market research. The aim of the survey is quarterly information on vacancies in companies in the Republic of Macedonia as an important indicator of macroeconomic developments and labor market policies.
[37] Source: State Statistics Office, business tendency surveys in the manufacturing industry (November 2013), construction (third quarter 2013) and trade (third quarter 2013).

2% in the last quarter of 2013, both quarterly and annually.

1.5. Inflation

In the first quarter of 2014, domestic consumer prices registered a minimal reduction of 0.2%. The quarterly decrease in consumer prices was mainly due to the long-term component of inflation (core inflation), amid almost constant prices of food and energy. Annual inflation slowed down significantly in the first quarter of 2014, reducing to 0.6%, given the slower rise in food prices and long-term inflation component. The long-term inflation component recorded a stronger annual slowdown, as explained by the exhaustion of the effects of one-off factors and the second-round effects of the last rise in food and energy prices. In contrast to the stronger deceleration in domestic inflation, the slowing increase in foreign effective prices was more sluggish in the first quarter. Producer price still goes down on a quarterly basis, dwelling in the negative growth zone on an annual basis for second consecutive quarter, after three years of positive growth rates.

Foreign effective food prices* and domestic food prices
(indices, 2005 =100)

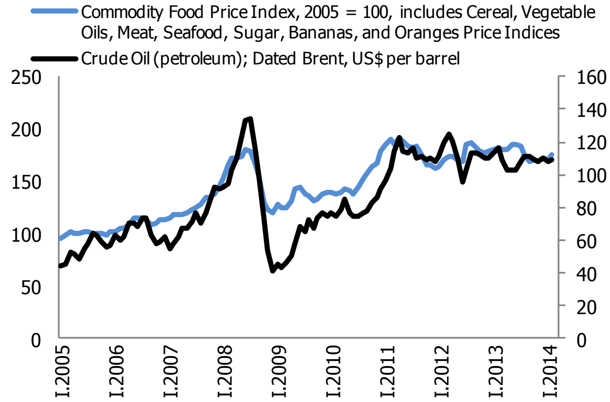


* Foreign effective food prices are calculated as weighted sum of food prices in countries that are major trade partners with Macedonia.
Source: State statistical office, Eurostat and NBRM calculations.

After the minimum quarterly growth of 0.1%, in the last quarter of 2014, domestic consumer prices experienced a slight quarterly decrease of 0.2% in the first quarter of 2014. Amid nearly unchanged prices of domestic food and energy inflation, the decline in consumer prices is mainly due to the long-term inflation component. In the first quarter of 2014, the long-term price component registered a quarterly decline of 0.4%. The energy component also recorded a marginal reduction (0.1%), after the proportional increase in the previous quarter. The reduction is solely due to the fall in domestic prices of oil derivatives, in line with the fall in the price of crude oil on world markets. The food price component of domestic consumer prices registered no changes in the first quarter, at a time when the fall of prices of fresh food and oil[38] was offset by the quarterly increase of prices of fresh vegetables. The downward adjustment of some domestic food prices correspond with the fall in prices of internationally traded primary food products, and the effective international food prices[39], which register a quarterly decrease for two quarters in a row.

[38] In subcomponents, the most significant contribution to the quarterly fall of prices was made by prices of unprocessed fruit, typical for this time of the year, and the price of cooking oil. On the other hand, unprocessed meat recorded a quarterly decline which is not typical for this time of the year, reflecting the downward pressure from the supply side.
[39] Data on foreign effective food prices refer to the first two months of the quarter.

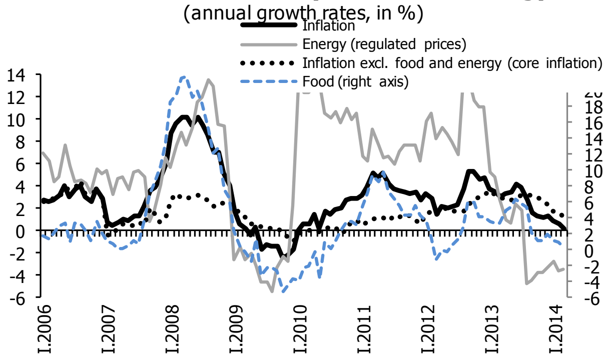
Crude oil and food prices



Source: IMF Primary Commodity Prices.

Inflation and volatility of food and energy

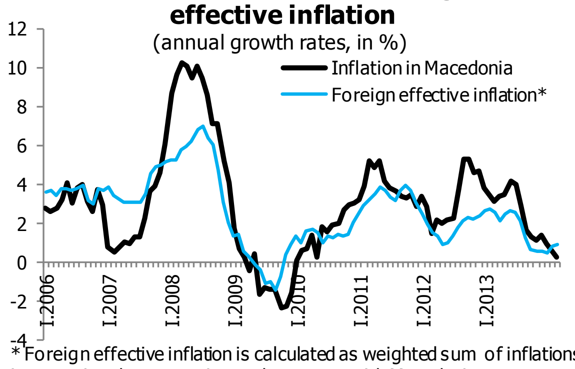
(annual growth rates, in %)



Source: State statistical office and NBRM calculations.

Domestic inflation and foreign effective inflation

(annual growth rates, in %)



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

Seasonally adjusted data also point to a decreased price level, caused by different drivers and slightly stronger (quarterly decline of 0.5%). The quarterly decrease in prices, after removal of seasonal effects, is determined by the food and energy component of consumer prices, with neutral contribution of the long-term component.

In the first quarter of 2014, the annual inflation slowed down considerably (for the third consecutive quarter) and reduced to 0.6% (1.3% in the previous quarter). This inflation rate is the lowest rate recorded in the period since early 2010. Amid insignificant quarterly changes, the substantial slowdown in the annual rate of inflation is due to the slower growth of the long-term and food component of inflation. The slowdown in the long-term component is largely due to the significantly slower rise in prices of clothing and footwear, while prices of restaurants and hotels services dropped. An additional contribution to the downward path of inflation was made by the slower growth of food component (slower increase in prices of unprocessed meat and a drop in prices of eggs, and bread and pastries). The energy component of inflation continued to decrease on an annual basis, a trend present since the third quarter of 2013. The downward trajectory of this component is due to the downward correction of the price of electricity (in the third quarter of 2013), as well as the lower fuel prices, caused by the fall in prices of crude oil on world markets. Unlike domestic consumer prices, a strong slowdown in foreign effective inflation[40] was recorded in the previous quarter, while in the first quarter this year, it registered a minor slowdown, which reduced to 0.4% annually (0.5% in the previous quarter).

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

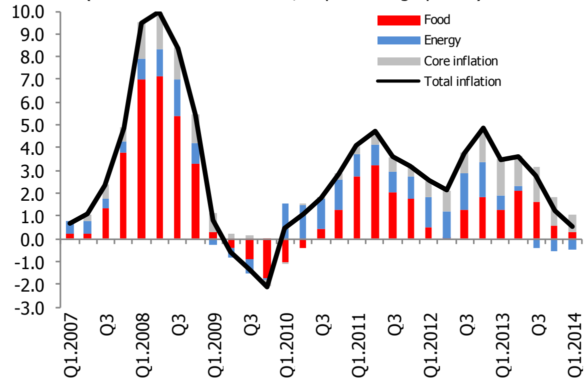
Individual price categories

	(annual growth rates, in %)						(contributions to annual growth rates, in p.p.)					
	2013				2013	2014	2013				2013	2014
	Q1	Q2	Q3	Q4		Q1	Q1	Q2	Q3	Q4		Q1
Consumer price index - all items	**3.5**	**3.6**	**2.8**	**1.3**	**2.8**	**0.6**	**3.5**	**3.6**	**2.8**	**1.3**	**2.8**	**0.6**
Food	*3.4*	*5.6*	*4.4*	*1.4*	*3.7*	*0.8*	*1.3*	*2.1*	*1.7*	*0.5*	*1.4*	*0.3*
Energy	*4.3*	*1.3*	*-2.6*	*-3.6*	*-0.2*	*-3.3*	*0.6*	*0.2*	*-0.4*	*-0.5*	*0.0*	*-0.5*
Electricity	10.0	10.0	-1.0	-3.1	3.7	-3.1	0.7	0.7	-0.1	-0.2	0.3	-0.2
Heat energy	0.2	-10.3	-14.4	-16.3	-10.3	-12.3	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Fuels and lubricants	0.2	-6.7	-2.3	-4.2	-3.3	-4.3	0.0	-0.3	-0.1	-0.2	-0.1	-0.2
Food and energy (volatile prices)	*3.6*	*4.4*	*2.4*	*0.0*	*2.6*	*-0.3*	*1.9*	*2.3*	*1.3*	*0.0*	*1.4*	*-0.2*
Core inflation (inflation excl. food and energy)	*3.3*	*2.8*	*3.2*	*2.7*	*3.0*	*1.5*	*1.6*	*1.3*	*1.5*	*1.3*	*1.4*	*0.7*

Source: State Statistical Office and NBRM calculations.

Volatile (food and energy) and long-term component of inflation

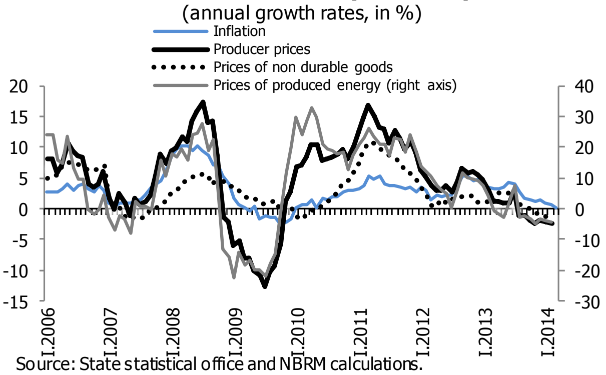
(contribution to inflation, in percentage points)



Source: State statistical office and NBRM calculations.

Inflation and industrial producer prices

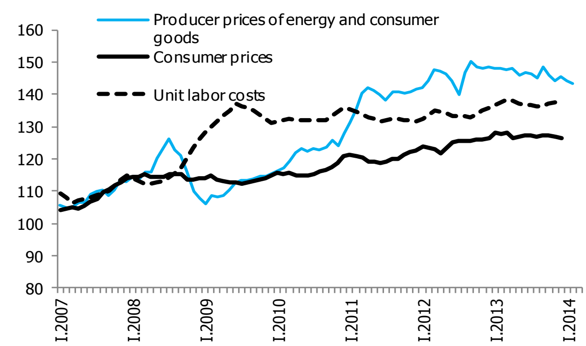
(annual growth rates, in %)



Source: State statistical office and NBRM calculations.

Factors affecting consumer prices

(indices, 2005=100)



Source: State statistical office and NBRM calculations.

The long-term inflation component significantly slowed down in the first quarter. Thus, the annual rate of core inflation (price component excluding food and energy) slowed down from 2.7% in the fourth quarter to 1.5% in the first quarter. The slower growth in core inflation mostly reflects changes in the prices of clothing and footwear, whose annual growth has still been slowing down for the fourth consecutive quarter, contributing to further deceleration of core inflation. These developments suggest a partial depletion of the effects of factors that contributed to the previous intensification of core inflation. In addition, lower prices of restaurant and hotel services were major factor for the slower growth. Observing by individual component, this change is due to the slower growth of catering services and the stronger annual decline in accommodation services.

The prices of the producers of industrial products continued falling during the first quarter of 2014[41]. The production prices fell by 0.5% quarterly (down from 1.2%, seasonally adjusted), due to the lower production cost of food, clothing and electricity, amid upward impact of higher production rates of non-metal mineral products. Annually, after three years of positive growth rates, the decline of production prices continued for the second consecutive quarter and amounted 2.5%. Production prices of oil derivatives, food, and production cost of electricity and metals made the largest contribution to the annual decline. **The movement of production prices that affect domestic inflation component**[42] **indicates lower inflationary pressures in the period ahead.** In fact, amid further quarterly reduction of prices (seasonally adjusted data), these prices show an annual decline of 3.0% in the first quarter (an annual decline of 0.7% in the previous quarter).

[41] The data relates to the first two months of the analyzed quarter.
[42] Consumer goods (durable and non-durable) and energy.

Unit labor costs increased in the last quarter of 2013 (a quarterly growth of 1.6%). Given the high base effect, this shift did cause a slowdown in the annual growth to 2.0%. Considering that there is a negative output gap[43], still no inflationary pressures through the labor cost channel are expected.

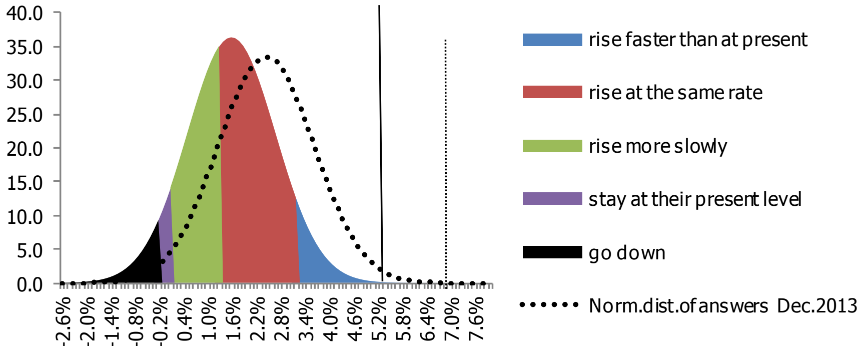
Box 3: Survey of Inflation Expectations

In order to improve the survey measure of inflation expectations, in 2013, the National Bank of the Republic of Macedonia made a more detailed analysis of the other central banks' experiences in conducting surveys. On this basis, the existing survey was redesigned and converged to the European practice.

The new format of questionnaire contains two questions, qualitative and quantitative. The first question of inflation expectations is of qualitative nature, i.e. respondents do not provide a quantitative answer, but indicate the direction and extent of changes in prices compared with the change in the previous 12 months. The procedure for measuring qualitative responses uses the probability approach of Carlson and Parkin (1975), which assumes that at a sufficiently large number of participants, the expected price change is normally distributed in the population. The quantitative question requires from the respondent to state accurately the expected average rate of change of prices in 2014 and 2015.

As always, the Inflation Expectations Survey covers three groups of respondents: economic analysts, companies and financial institutions. The qualitative question of expectations reads: "What change do you expect in consumer prices over the next 12 months compared with the past 12 months? a) they will have a faster increase; b) they will increase at the current pace; c) they will increase more slowly; d) they will remain almost the same; d) they will decrease; f) it is difficult to determine", while the quantitative question reads: "What are your expectations/forecasts for the average inflation rate in 2014 and 2015?".

Chart 1. Normal distribution of answers of the respondents



Source: NBRM, Inflation Expectations Survey.

Inflation Expectations Survey was conducted in March 2014[44]. The results of the survey show that most respondents expect unchanged pace of inflation. Thus, 50.6% of respondents expect that

[43] The NBRM estimates show that domestic output is still below the potential level (negative output gap).
[44] The total number of respondents is 188. Proportion of responsiveness to the survey conducted in March was 45.2%. Analyzing by group of respondents, the responsiveness of financial institutions is 83.3%, followed by economic analysts with 55.2% and companies with 32.0%.

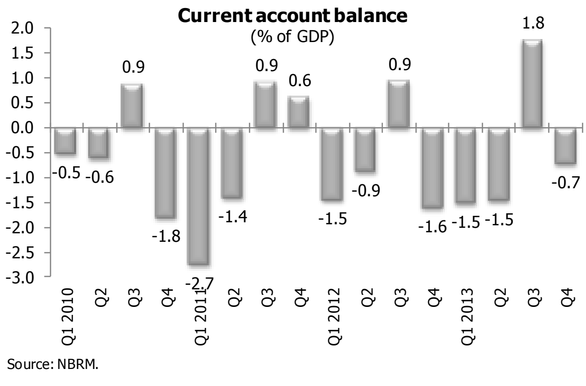
prices will rise at the current pace in the next 12 months. Moreover, 31.8% of respondents expect slowdown of the inflation, 7.1% expect it to grow faster, while the same percentage of respondents, i.e. 4.7% for each, expected unchanged prices and reduced prices for the next 12 months. In conditions of average inflation in the previous 12-month period (2.3%), respondents' expectations indicate deceleration of inflation by 0.7 percentage points on average in the next 12-month period, i.e. **expect an average inflation of 1.6%.** Observing the individual surveyed groups, ***companies*** expect the fastest slowdown (with expected inflation of 1.5%), followed by ***economic analysts*** (1.6%), while financial institutions expect that inflation will slow down to 1.8%.

Respondents explain these expectations with the downward pressures of the low international inflation on domestic consumer prices, the decline in producer prices, and the favorable performance of agriculture, both domestically and globally, in the absence of significant pressures from the demand side. Respondents expect the average inflation rate of 2.7% and 2.9% in 2014 and 2015, respectively. Compared with the previous survey, those expectations are slightly higher for 2014 and lower for 2015 (expected inflation of 2.5% and 3.3% in 2014 and 2015, respectively) and reflect upward inflation risks from the crisis in Ukraine on world prices of food and oil.

1.6. Balance of Payments

Unfavorable seasonal dynamics of the balance of trade in goods and services and current transfers in the fourth quarter of the year led to a current account deficit (surplus in the previous quarter). The negative quarterly growth was mostly due to changes in the trade deficit, whose expansion in the fourth quarter is caused mainly by import pressures created by the import of raw materials and investments. However, the current account deficit is significantly lower compared to the deficit generated in the fourth quarter last year. The lower trade deficit in goods and services is driver of positive annual changes, i.e. the lower negative trade balance and the trade surplus in services (vs. minor deficit in the fourth quarter of 2012). Current transfers caused by the reduction in official transfers declined annually. Capital and financial account registered moderate net inflows as a result of the improved performance of foreign direct investments in the fourth quarter of the year. However, the generated net capital inflows were not sufficient to fully finance the current account deficit, and therefore, a major portion of the current transaction deficit was financed by foreign reserves, which despite the changes, was kept at an adequate level at the end of 2013.

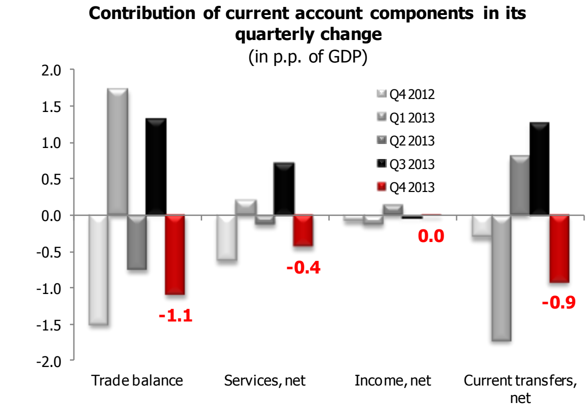
1.6.1. Current Account



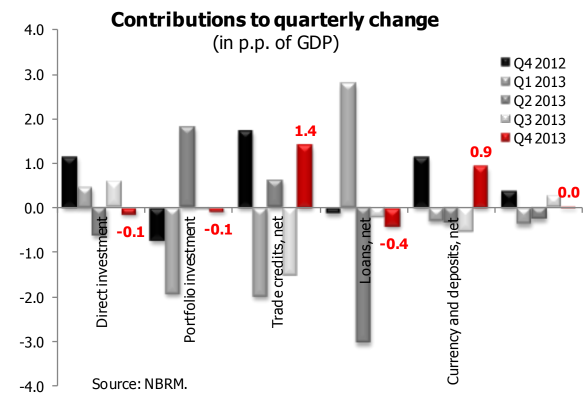
Source: NBRM.

In the last quarter of 2013, the current account of the balance of payments recorded a deficit of Euro 56.3 million, or 0.7%[45] of GDP, which is a negative change of 2.5 percentage points of GDP compared to the previous quarter, when the current account registered high surplus. ***The quarterly expansion results from all current account components, with the exception of income whose contribution is neutral. Moreover, these developments largely result from the***

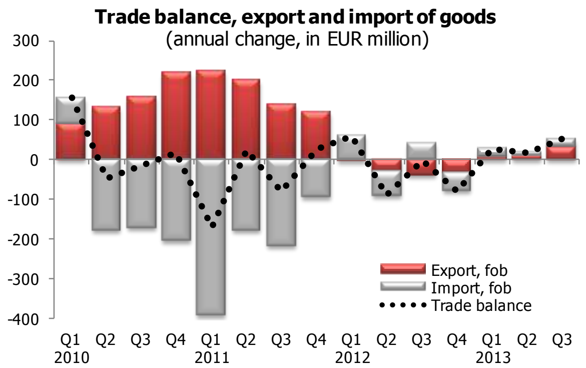
[45] The calculations use annualized GDP, which is the sum of actual nominal GDP over the past four quarters.



Source: NBRM.



Source: NBRM.



* Postive change in the import of goods mean it's decrease.
Source: NBRM.

seasonal movements of the underlying current account components (trade balance and current transfers), which account for 80% of the quarterly change. *The quarterly expansion of trade deficit*[46] (of 1.1 percentage points of GDP) is caused by the greater imports of industrial raw materials and investment goods, leading to a quarterly growth of total imports. Moderate growth was registered in the export component of foreign trade in goods. The quarterly decline in *current transfers* (of 0.9 percentage points of GDP) is due to lower private transfers in cash, i.e. reduced inflows of foreign assets purchased in the currency exchange market, a change typical for the last quarter of the year. Additional contribution to the quarterly expansion of the current account balance was made by the reduced trade surplus in *services* due to the lower inflows from travel. Income experienced no significant changes compared to the previous quarter.

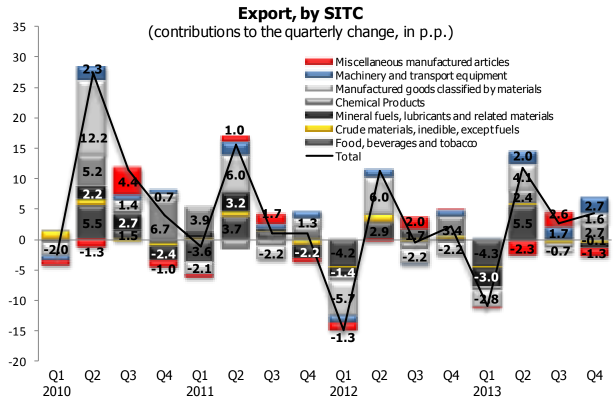
The annual analysis points to favorable movements in the current account, i.e. reduction of deficit of 0.9 percentage points of GDP. Driver of positive annual changes is the lower negative trade balance in goods and services. The *trade deficit* narrowed (of 1.2 pp of GDP) due to the simultaneous contraction of the energy and non-energy deficit of trade in goods. The positive momentum of the industrial recovery caused a stronger increase in exports of industrial and investment goods, amid reduced import demand. The positive contribution of services (by 0.4 percentage points of GDP) to the reduction of current account deficit, for the most part was caused by shifts in other services. Namely, during the fourth quarter of 2012, there was an outflow of funds based on construction services intended for the construction of Corridor X[47], which significantly affected the base effect for this service category. Factor that changed the services simultaneously influenced the annual change in *current transfers* (by 0.6 percentage points of GDP). The annual decrease was largely due to lower inflows of official transfers, as a result of the high base effect due to inflows of IPA funds allocated for construction of Corridor X in the fourth quarter of 2012. Slight annual expansion of *income* deficit of 0.1 percentage points of GDP was

[46] For more details, see the foreign trade section.
[47] Funds for construction of the road Demir Kapija - Smokvica of Corridor X were partly secured through a grant provided by IPA - component III. The remaining assets for full funding of the project have been provided through financial loans from the EIB and EBRD, as well as funds from the state budget.

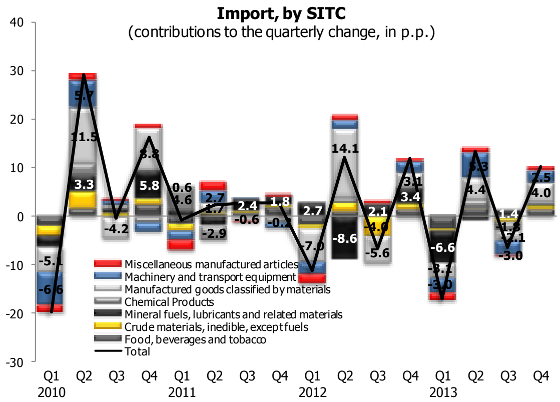
caused by the reduced net inflows of workers' compensations. **Recent balance of payments data from January 2014 show current account deficit of Euro 16.8 million**. Compared with the first month of the previous year, the current account deficit significantly narrowed by 65.3% as a result of the favorable annual changes in all current account components, with the significant contribution of the higher surplus in services.

Box 4: Foreign Trade and Nominal and Real Effective Exchange Rate (NEER and REER)

In the last quarter of 2013, according to the usual seasonal dynamics, foreign trade registered a quarterly increase. Both export and import component registered upward trends, with quarterly growth rates of 4.3% and 10.3%, respectively. With the growth of imports exceeding the growth of exports, trade balance deficit widened by 23.3% compared with the previous quarter. Analyzing balances, the quarterly expansion of trade deficit is largely due to the non-energy balance, primarily the industrial and investment balance. Changes in industrial balance mostly result from the higher import of raw materials for the new export facilities in the economy and the growth of imports of raw materials for the textile industry. Import pressures created by foreign-owned export-oriented facilities affected exports through the increase in their exports. Quarterly increase in investment activity in the economy boost investment imports of equipment and machinery, thus widening the investment balance deficit. The negative trade balance in energy sources slightly deteriorated compared to the previous quarter, caused by the higher imports of electricity and natural gas.

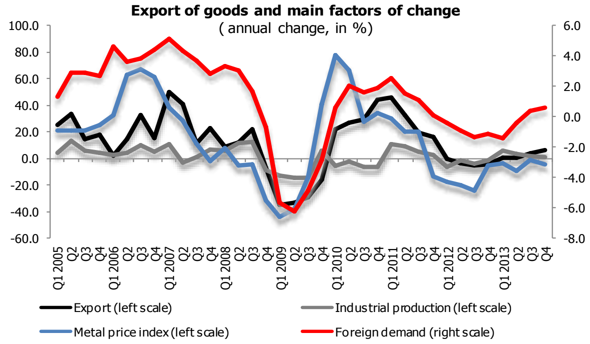


Source: SSO and NBRM.

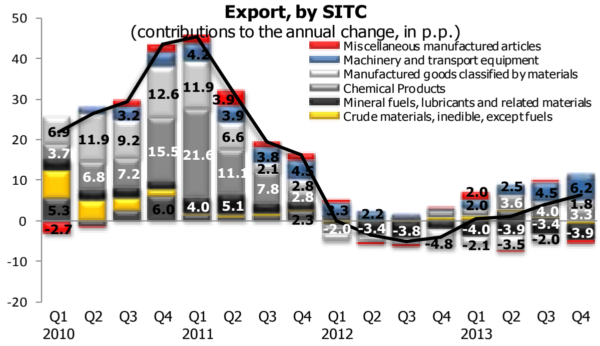


Source: SSO and NBRM.

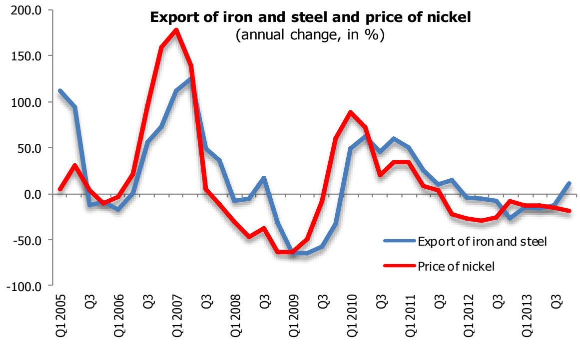
On annual basis, total foreign trade slightly resurged, which amid annual decline in imports of goods, is entirely due to the increase of the export component. **The growth of exports from the previous three quarters intensified in the fourth quarter of 2013, with an annual growth rate of 6.5%.** As previously, most significant positive contribution to the growth was made by the increased export activity of new export capacities in foreign ownership, as seen through the annual growth of investment exports of equipment and machinery and exports of chemical substances and products. Export growth was also favorably stimulated by the export of iron and steel, which, for the first time in seven quarters of constant negative annual growth, registered positive annual growth rates. In traditional export sectors, despite the good export performance of the metal manufacturing industry, exports of tobacco also recorded an annual growth. On the other hand, exports of oil and oil derivatives further annually declined. Export results in the fourth quarter again confirmed the positive effects of export diversification and exporting upstream industrial products on the export resistance.



Source: SSO and NBRM.

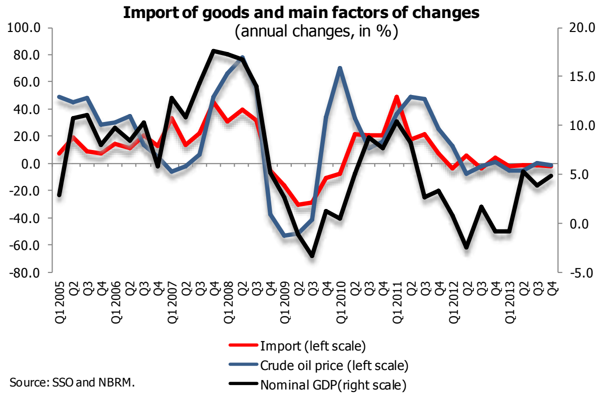


Source: SSO and NBRM.

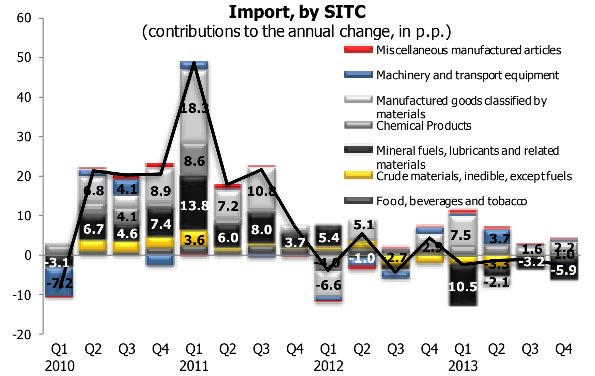


Source: SSO and NBRM.

In the fourth quarter, the annual decline in imports of goods accelerated and equaled 2.6%. These movements were mostly caused by the further decline in imports of energy sources. The reduction of energy import again derives from lower import of crude oil as a major factor for the annual change, coupled with lower import of electricity. Contribution to the annual reduction of import component was made by the lower import of vehicles, a change caused by the high base effect in the fourth quarter of 2012[48]. On the other hand, the annual growth of import of industrial raw materials and import of investment goods acted in the opposite direction. Faster growth was recorded in imports of non-ferrous metals, a basic raw material component in the production of a large export capacity. Given the strengthening of export activity and prolonged decline in import demand, **in the fourth quarter, trade deficit significantly narrowed (by 15.6%) on an annual basis**. The favorable trade balance developments are due to the narrowing of all individual balances, with the largest contribution made by the energy balance and the balance of investment goods.



Source: SSO and NBRM.

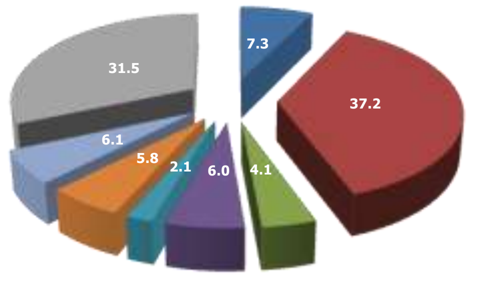


Source: SSO and NBRM.

48 During the fourth quarter of 2012, the Ministry of Transport and Communications imported buses, which caused a one-time increase in imports in the category of vehicles.

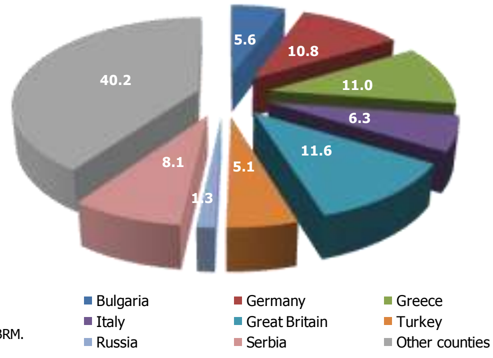
*The latest available foreign trade data **in the first two months of 2014** show a slight narrowing of the trade deficit (1.1%) compared with the same period last year, given the positive annual growth rates of both export and import component.* Exports continued increasing rapidly, at an annual growth rate of 10.9%, mainly due to the improved performance in exports of equipment and machinery and chemical substances and products. After continual decline in imports in the past four quarters, the latest data for January and February indicate an annual growth of import component of 6.4%, mainly driven by higher investment imports in the economy and increased import of raw materials by a significant export capacity operating in a free economic zone.

Export of goods, by countries in the fourth quarter of 2013 (share, in %)



Source: NBRM.

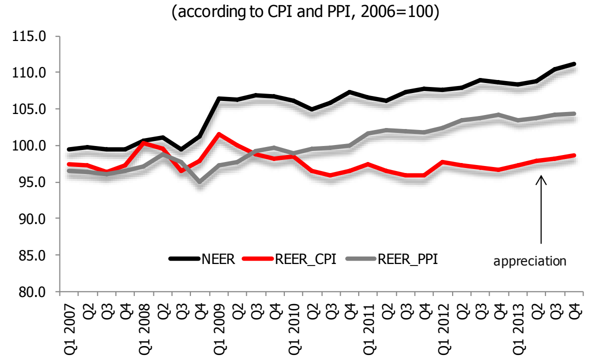
Import of goods, by countries in the fourth quarter of 2013 (share, in %)



Source: NBRM.

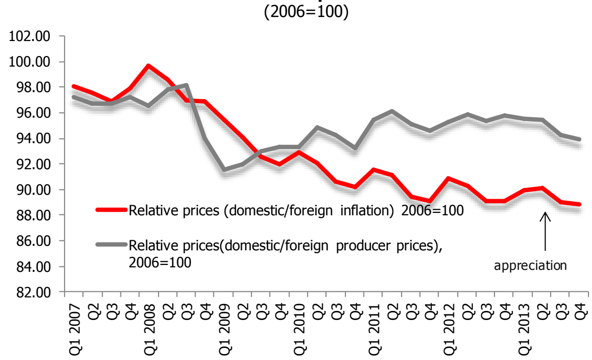
The foreign trade analysis by trading partner shows that in the fourth quarter of 2013, trade with the EU countries continued to grow, preserving the largest share in total foreign trade (of 67.3%). The trend of further growth of share of trade with the EU in the total foreign trade of the economy derives from the higher exports to Germany and Belgium[49], which despite the growth of imports from Great Britain was able to narrow further the trade deficit with the EU countries. Rapid lowering of import of crude oil from Russia again narrowed the trade deficit in goods, thus diminishing the relative importance of this economy as a trading partner. On the other hand, the trend of narrowing the trade surplus with the Western Balkans continued in the last quarter of the year, resulting from the further decline in export of oil derivatives to Kosovo and the declining exports to Serbia[50].

NEER and REER
(according to CPI and PPI, 2006=100)



Source:NBRM.

Relative prices
(2006=100)



Source:NBRM.

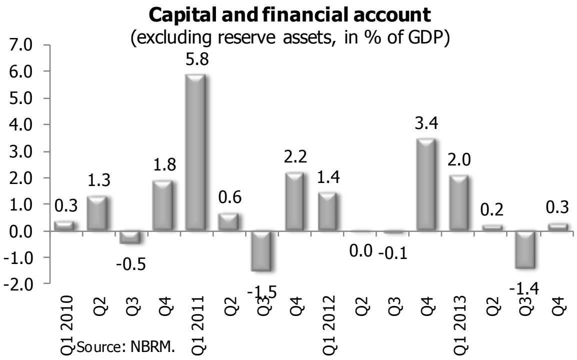
In the fourth quarter, price competitiveness indicators of the national economy continued showing a slight decrease, as in the previous two quarters. In fact, compared to the previous quarter, the REER index deflated by consumer prices appreciated by 0.5%, while the

[49] Higher exports to Belgium result from the commencement of export activity of a new export capacity, whose export mainly focuses on this European economy.

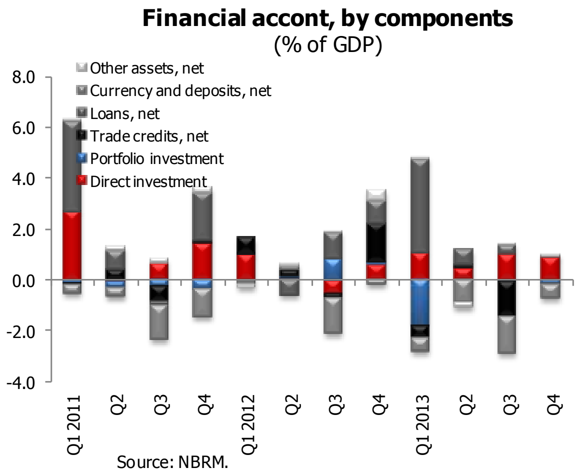
[50] The decline in exports to Serbia is due to the decline in exports of iron and steel and exports of drugs to this economy.

REER index deflated by producer prices appreciated by 0.2%. This entirely results from the appreciation of the nominal effective exchange rate, which went up by 0.6% quarterly, as a result of the depreciation of the Turkish lira and the Russian ruble against the denar. Launching of exit strategy from quantitative easing by Fed has put pressure on currencies of some emerging economies, especially the currencies of Turkey and Russia, which led to their significant depreciation against the U.S. dollar[51]. On the other hand, the relative prices, as a domestic price to foreign price ratio, acted in the opposite direction, given the 0.2% slower rise in domestic prices compared to foreign consumer prices, and the 0.4% lower domestic producer prices relative to foreign producer prices. *The latest price competitiveness data of the Macedonian economy in January and February indicate its further reduction.* REER deflated by consumer prices appreciated (by 1.9%) compared to the fourth quarter of 2013, due to the NEER appreciation (of 1.3%) and the concurrent slight increase in relative prices. REER deflated by producer prices also appreciated, but the weaker change (of 0.6%) is due to the stronger reduction of domestic prices to foreign prices.

1.6.2. Capital and Financial Account

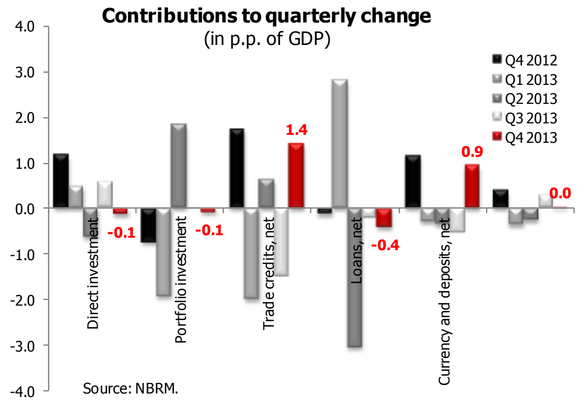


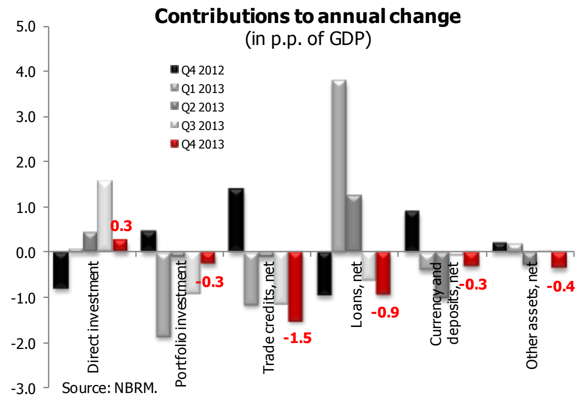
The fourth quarter of 2013 registered moderate net inflows of Euro 19.4 million in the capital and financial account of the balance of payments, or 0.3% of GDP. Positive net inflows are typical for this time of the year, except their low intensity. In fact, typical for the last quarters of the year are the high capital net inflows caused by external borrowing in the form of financial and trade loans. *In the fourth quarter of 2013, these seasonal trends were absent, and therefore, foreign direct investment in the form of reinvested earnings and intercompany debt were an essential financial account component that created net inflows.* A significant part of the capital inflows of FDIs was offset by *net outflows in the category of currencies and deposits, due to the net outflows in other sectors,* while the banking sector created inflows by withdrawing deposits from foreign banks.



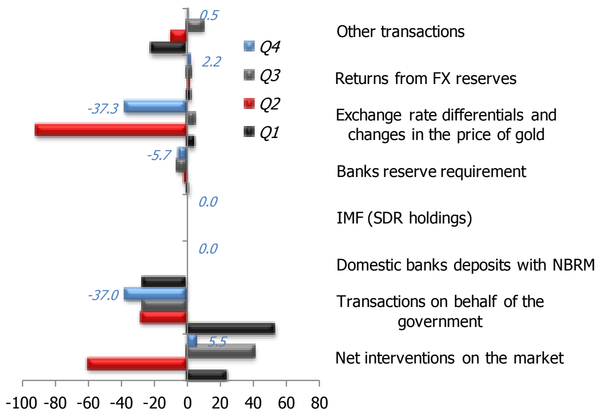
Compared with the previous quarter of high net outflows in the capital and financial account, this quarter the capital flows are significantly more favorable (by 1.7 pp of GDP). Most of the quarterly change is due to movements in trade loans, which registered insignificant net inflows in the fourth quarter. Yet, this pace is expected considering the exceptionally high negative trends in the previous quarter. Furthermore, the stabilization of outflows in trade loans corresponds with the quarterly expansion in trade deficit, thus ceasing the reduction of liabilities created by foreign trade. Also, the withdrawal of deposits from foreign banks in the domestic economy by the banking sector offset a portion of net outflows in the category of currencies and deposits of the households sector

[51] Source: http://www.bloomberg.com/news/2014-01-24/contagion-spreads-in-emerging-markets-as-crises-grow.html

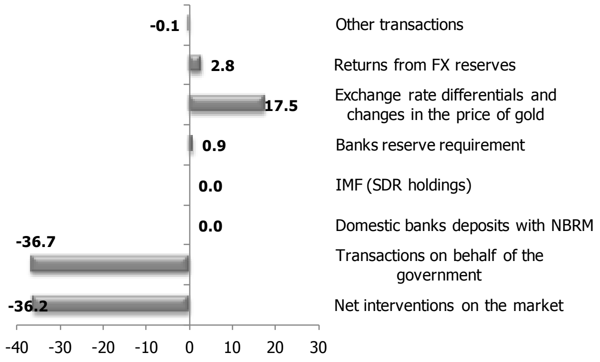




Factors of influence on the change of the level of gross reserves in 2013, quarterly
(in EUR million)



Factors of influence on the change of the level of gross reserves in 2014
(in EUR million)



Source: NBRM.

and led to a quarterly fall of total net outflows based on currencies and deposits. Despite the positive contribution of these two categories, loans recorded negative quarterly changes as a result of net outflows from the external debt of the economy in the fourth quarter. Lower withdrawals of long-term loans by the private sector, with higher repayments compared to the previous quarter, led to a negative contribution of this category to the quarterly change in capital flows. Net inflows of foreign direct investment were slightly lower. However, compared to the previous quarter, the FDI structure noticeably changed, increasing the share of reinvested earnings as a major source of foreign investment in the last quarter of the year.

The annual analysis of capital and financial account indicates a significant reduction in net inflows of 3.2 percentage points of GDP. The decrease largely derives from changes in other investments, due to the lower net inflows in trade loans, negative net debt versus net inflows in the fourth quarter last year, and higher net outflows in currencies and deposits category. Significantly slower growth of liabilities created by foreign trade stems from the high base effect in the last quarter of 2012, when a large portion of trade deficit was financed by an increase in liabilities on trade loans, thus creating high capital inflows. Only foreign direct investments registered higher net inflows annually, caused by the higher investments in the form of reinvested earnings.

According to the latest balance of payments data, in January 2014, the capital and financial account recorded minor net outflows of Euro 21.6 million. Capital outflows are caused by the negative net debt of both public and private sector in the economy, and further net outflows in the category of currencies and deposits. On the other hand, the performance of foreign direct investment contributed to net capital inflows.

At the end of 2013, the gross foreign reserves stood at Euro 1,993 million, down by Euro 71.8 million in the fourth quarter. Major factor for the change are transactions for the account of the government, while the NBRM net purchase in the foreign exchange market contributed to the creation of reserves, but at a much slower pace. Price changes and currency differences had additional adverse impact on the foreign reserves. *According to recent data, at the end of the first quarter of 2014, the foreign reserves totaled Euro 1,941.2 million.* Compared to

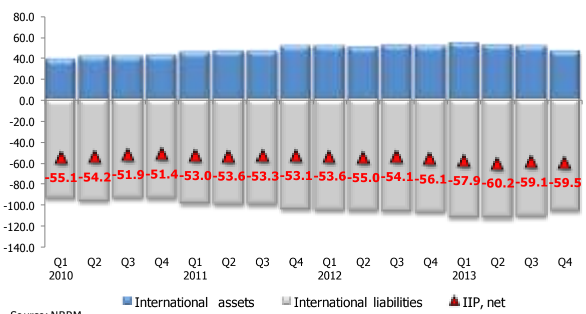
31 December 2013, foreign reserves declined by Euro 51.8 million as a result of the outflows observed in transactions for the account of the government and the NBRM's net sales in the foreign exchange market. The positive price changes and currency differences during the first quarter of 2014 contributed to the growth of foreign reserves.

1.6.3. International Investment Position[52] and Gross External Debt

At the end of the fourth quarter of 2013, **the negative international investment position of the Republic of Macedonia amounted to Euro 4,582.9 million or 59.5% of GDP[53]**. *Compared to the previous quarter, net external liabilities increased by Euro 91.8 million. As a share of GDP, net liabilities increased by 0.5 percentage points of GDP[54].*

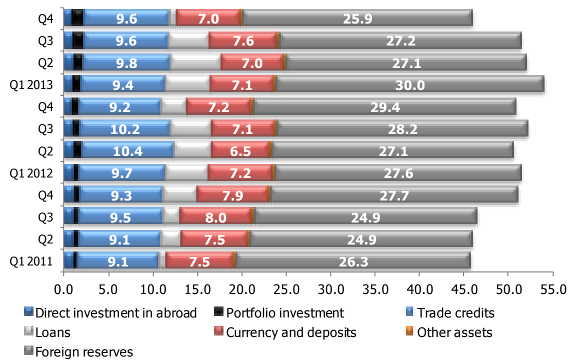
The expansion of negative investment position of the country to the rest of the world is solely due to the 9.5% **fall in international assets,** and the simultaneous reduction of international liabilities by 3.3%. **The quarterly fall in assets** was caused by lower claims of monetary authorities based on short-term lending (repo transactions), as well as changes in foreign reserves and lower claims based on currencies and deposits of the banking sector. **The quarterly fall of liabilities** is due to the lower liabilities on debt instruments or financial loans and trade loans, coupled with the lower banks' liabilities on currencies and deposits. The quarterly change in the loan category is due to the reduction in short-term loans of the monetary authority (repo transactions), and lower long-term liabilities on

International investment position (% of GDP)



Source: NBRM.

International assets, by instruments (% of GDP)



Source:NBRM.

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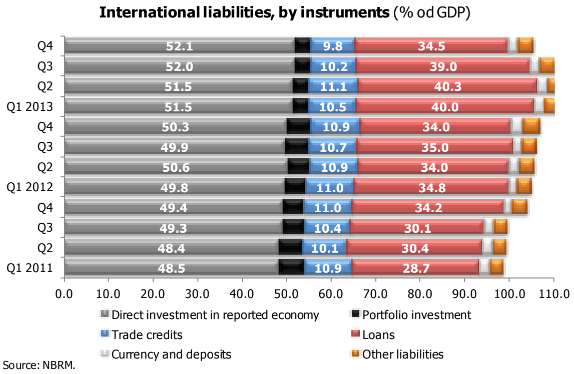
[52] Since September 2012, the NBRM started to disseminate quarterly data on the international investment position (IIP) of the Republic of Macedonia. IIP data are available on the NBRM website (www.nbrm.mk/statistika/eksterni statistiki).

[53] In the second quarter of 2011, the NBRM began concluding repo and reverse repo transactions. These transactions represent an investment opportunity to use portfolio securities to provide additional income. Conclusion of repo transactions creates liabilities. At the same time, when concluding reverse repo agreements, the created receivables increase the gross receivables. The NBRM simultaneously carries out matched conclusion of repo and reverse repo agreements, in almost identical amounts. In general, as they are concluded concurrently, these transactions have a neutral net effect, i.e. they appear in almost identical amount on both liabilities and assets side, thus having no effect on the total net IIP and the total net external debt. Transactions for borrowing securities further expanded in 2012 and encompassed swap transactions with gold as collateral.

[54] The calculations use annualized GDP, which is the sum of nominal GDP from the past four quarters.



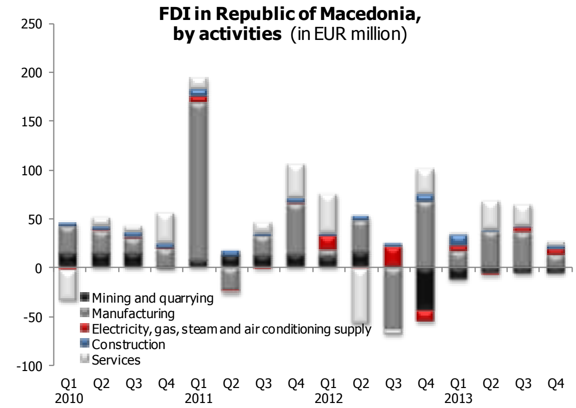
Source: NBRM.

loans of the government and banks. Again, in the fourth quarter, only liabilities to foreign direct investors went up.

Analyzed by sector, monetary authorities and banks made contribution to the quarterly expansion of the negative net liabilities in the international investment position, due to the faster fall of assets compared to that of liabilities, while the contribution of other sectors to the quarterly expansion is due to the faster growth of liabilities, amid increase in assets. On the other hand, the Government reduced its net liabilities to the rest of the world.

	Q3 2012	Q2 2013	Q3 2013	*quarterly change*			*annual change*		
		in EUR million		*difference*	*contribution*	*in %*	*difference*	*contribution*	*in %*
IIP, net	**-4,181.5**	**-4,491.1**	**-4,582.9**	**-91.8**	**2.0**	**2.0**	**-401.3**	**9.6**	**9.6**
Government, net	-1,543.9	-1,586.4	-1,565.0	21.4	-0.5	-1.4	-21.1	0.5	1.4
Monetary authorities, net	2,095.8	1,991.5	1,920.4	-71.1	1.6	-3.6	-175.4	4.2	-8.4
Banks, net	-536.6	-533.4	-541.7	-8.3	0.2	1.6	-5.0	0.1	0.9
Other sectors, net	-4,196.8	-4,362.8	-4,396.6	-33.8	0.8	0.8	-199.8	4.8	4.8

The annual expansion of net debt position of the economy continued in the last quarter of 2013, under the influence of the fall of international assets (of 6.6%), amid a minor growth of international liabilities (of 1.9%). Compared with the same period last year, **the negative IIP increased by Euro 401.3 million, or 3.4 percentage points of GDP.**

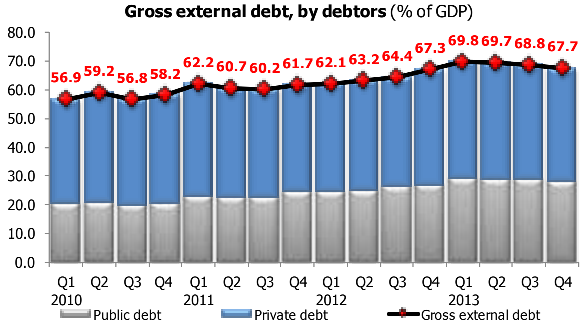


Source: NBRM.

The annual fall of international assets is due to the reduction of monetary authority claims based on short-term loans[55] (reduction of repo transactions) and reduced gross foreign reserves, while an increase was recorded in the claims based on trade loans and portfolio investments in the form of equity securities of nonfinancial private sector. Annual growth of **international liabilities** arises from the increase in liabilities to direct investors in the economy and increased liabilities on loans to state and nonfinancial private sector. On the other hand, their portfolio investment liabilities in the form of debt instruments, liabilities on trade loans to other sectors and liabilities on currencies and deposits of the banking sector decreased compared to the fourth quarter of 2012. In addition, there is a decline in monetary authorities' liabilities on short-term loans, as an effect of the switch in repo transactions. *The annual sector-by-sector analysis shows that the expansion of the negative IIP gap of the Republic*

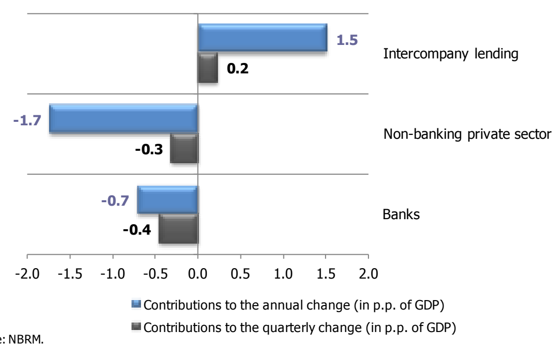
[55] In the fourth quarter of 2013, assets and liabilities of monetary authorities based on repo transactions amounted to zero, causing a significant annual change in both categories of the international investment position of the economy, thus offsetting the net investment position.

Gross external debt, by debtors (% of GDP)



* Without repo-transactions.
Source: NBRM.

Changes in private sector debt



Source: NBRM.

of Macedonia is due to the higher net liabilities of all institutional sectors, with particularly high contribution of other sectors and monetary authority.

At the end of 2013, gross external debt amounted to Euro 5,210.1 million, or 67.7% of GDP[56].

Compared with the previous quarter, gross external debt of the country decreased by Euro 19.7 million, given the lower external debt of the public sector. The quarterly public debt reduction is due to the lower government liabilities on long-term financial loans. On the other hand, the external debt of the private sector remained almost identical as in the previous quarter, with a simultaneous decrease of the debt of the banking sector and increase of the debt to foreign direct investors.

On an annual basis, gross external debt resurged, but much slowly. Compared with the fourth quarter of 2012, the debt rose by Euro 196 million, or 0.4 percentage points of GDP. The annual growth of gross external debt results from the increase in the public debt, due to the higher foreign borrowings of the government, public enterprises and public banks in the form of long-term financial loans. External debt of the private sector slightly decreased due to the reduction of liabilities on currencies and deposits of the banking sector and liabilities in the form of trade and financial loans in other sectors, while liabilities to direct investors continue to increase on a year-over-year basis.

The external debt analysis of the economy confirms that the Republic of Macedonia remains low indebted country according to the World Bank indebtedness criteria. Only the external debt to GDP ratio continues to classify the economy in the group of highly indebted countries. Analysis of solvency ratios suggests an annual improvement in the ratio of gross debt to exports and other inflows and the ratio of interest payments to exports and other inflows annually, with a simultaneous deterioration of other two ratios (debt repayment to exports and other inflows[57] and external debt to GDP). Liquidity ratios also moderately deteriorated, particularly the short-term debt to total gross external debt ratio. However, the coverage of

[56] As of 31 December 2013, the debt based on repo transactions of the monetary authority equaled zero.
[57] This indicator deteriorated due to the high one-off payment of Eurobond in 2013.

short-term liabilities with residual maturity with foreign reserves is almost full, although this ratio moderately deteriorated on an annual basis.

Indicators for external indebtness	*Solvency*				*Liquidity*		
	Interest payments/ Export of goods and services and other inflows	Gross debt/ Export of goods and services and other inflows	Gross debt/ GDP	Debt servicing/ Export of goods and services and other inflows	Foreign reserves/ Short-term debt	Foreign reserves/ Short-term debt, with residual maturity*	Short-term debt/ Overall debt
	in %				ratio	ratio	in %
31.12.2004	2.24	120.1	49.3	11.5	1.14	0.89	30.3
31.12.2005	2.33	128.5	56.3	9.66	1.67	1.04	26.7
31.12.2006	2.88	109.8	51.8	18.2	1.95	1.34	29.0
31.12.2007	2.38	102.3	53.2	16.6	1.35	1.08	39.8
31.12.2008	2.30	101.1	55.3	8.8	1.29	0.95	35.2
31.12.2009	2.10	113.3	58.5	10.2	1.29	0.94	32.9
31.12.2010	2.78	121.1	60.1	11.9	1.31	0.90	32.0
31.03.2011	2.70	124.7	63.3	14.5	1.46	1.05	29.1
30.06.2011	2.70	124.3	63.1	14.5	1.40	1.00	29.3
30.09.2011	2.70	124.1	63.0	14.5	1.42	0.99	29.1
31.12.2011	2.70	128.4	65.2	14.5	1.53	1.06	29.4
31.03.2012	2.53	114.3	63.4	11.3	1.49	0.94	29.9
30.06.2012	2.53	115.6	64.2	11.3	1.40	0.92	30.6
30.09.2012	2.53	118.3	65.7	11.3	1.49	0.96	29.4
31.12.2012	2.53	123.2	68.4	11.3	1.39	0.93	31.4
31.03.2013	2.10	119.1	68.8	13.7	1.35	1.02	31.7
30.06.2013	2.10	120.5	69.6	13.7	1.20	0.90	32.4
30.09.2013	2.10	120.0	69.3	13.7	1.34	0.97	29.4
31.12.2013	2.10	119.6	69.1	13.7	1.27	0.91	30.1
Moderate indebtedness criterion	*12 - 20%*	*165 - 275%*	*30 - 50%*	*18 - 30%*		*1.00*	

*The moderate indebtness criterion is accordng to the World bank's methodology of calculationg indebtness indicators, which implies 3-year moving averages of GDP and exports of goods and services in the calculation of the indicators.

In compliance with "External debt statistics: Guide for compilers and users," published by the IMF.
*According to the "Greenspan-Guidotti rule", a country should maintain full coverage of short-term debt at remaining maturity with gross foreign reserves.

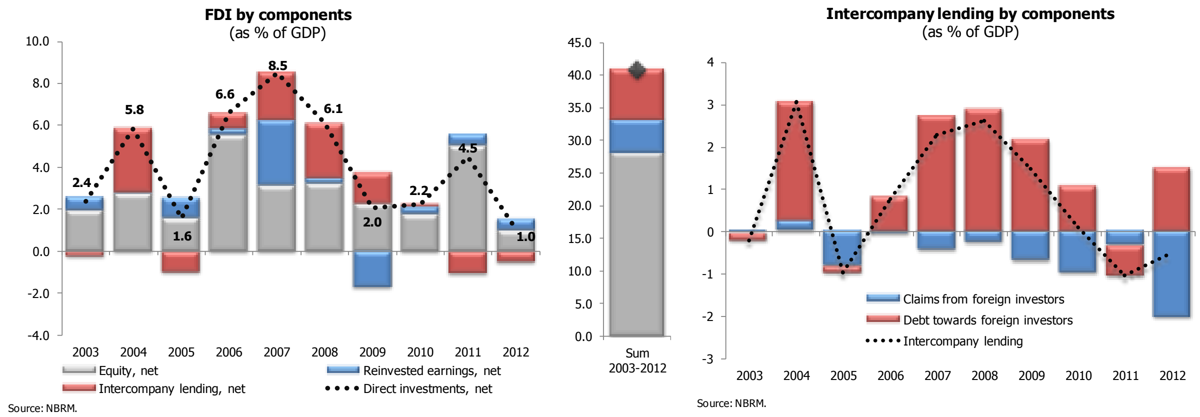
Source: NBRM.

Box 5: Effects of Foreign Direct Investments on the Balance of Payments of the Republic of Macedonia

This box provides an analysis of the effects of foreign direct investments (FDIs) on the balance of payments of the Republic of Macedonia in the period 2006 - 2012. The analyses of FDIs' effects often focus on the relevance of foreign direct investments as a source of financing the deficit created by the current transactions in the balance of payments, and the assessment of the effects on investments and economic growth in the domestic economy. This box tackles additional aspect of the traditional macroeconomic analysis - **assessing the impact on foreign exchange flows in the economy,** which is particularly important for small open economies with a fixed exchange rate regime. Despite the trade integration, FDIs inevitably lead to financial integration, which can increase the sensitivity of the economy to the financial inflows and outflows. Hence, assessing the overall effect of FDIs on the external position of the domestic economy is critical.

The FDI theory suggests that FDIs are one of the key prerequisites for economic development, particularly for developing countries. However, despite the numerous evaluations, economic theory and practical experiences have not provided a unified answer for the net effect of these investments in the host country. From macro perspective, FDIs are treated as employment generators in the host economy, thus increasing output, competitiveness and launching new and advanced technology. This is particularly relevant for less developed countries, where FDIs also increase exports, improve access to international markets, and are an important funding source. On the other hand, FDIs may crowd out local businesses and have an adverse effect on economic activity, or are concentrated in monopoly sectors (exploitation of the so-called market imperfections). Moreover, FDIs, despite being relatively more stable source of funding, could to certain extent, increase "vulnerability" of the external position of the host country to foreign outflows, through multiple channels, such as imports of goods and services, repatriation of profits and granting loans to parent companies. Also, if most FDIs are intercompany debt (withdrawal of short-term or long-term loans from the parent company), the stability of investments considerably reduces. This form of FDIs increases the level of indebtedness of the national economy, which is significantly more risky capital flow, which can drain from the economy quickly and easily. All these factors point to the conclusion that the potential positive or negative effect of FDIs in the economy will largely depend on the type of investments, the method of financing (debit or non-debit) and their sectoral structure.

Chart 1
Direct investments, by component,% of GDP

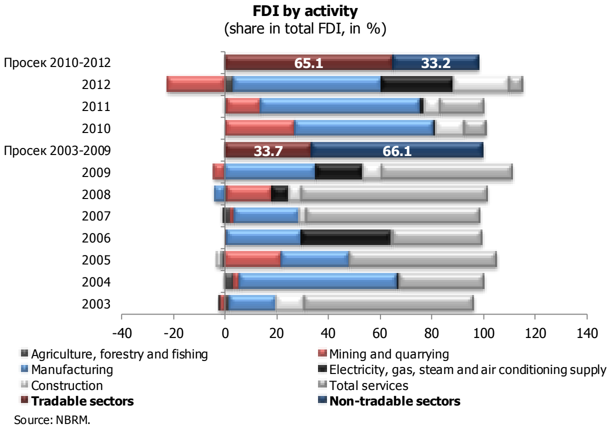


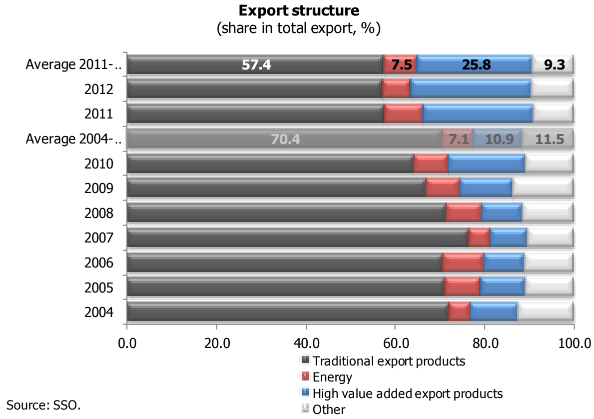
FDIs represent a significant capital inflow to finance current account deficit in the Macedonian economy. Namely, in the period 2003-2012, they made up 81% of the deficit generated by current transactions, with average share in GDP of 4.1%, with equity capital dominating the structure. The analysis of dynamics of annual data by component show significant amounts of FDIs in the period before the onset of global financial crisis in 2008[58] and the highest share of equity in the structure, followed by intercompany lending[59] and reinvested earnings. Deteriorated external environment in the period after the onset of the crisis reduced the inflow of FDIs, largely due to the declining flows in the form of intercompany loans due to the increased claims of foreign investors on parent companies, i.e. losses from loans granted to ownership-related entities. These trends are expected in lucrative multinational companies, which have credited their branches, thus causing volatility in flows associated with long-term and short-term financing through financial loans and trade loans.

The FDI structure by activity indicates a high concentration of investments in utilities and energy sectors (highly monopolistic and oligopolistic sectors) as a result of the privatization process. However, the last three years have witnessed favorable and dynamic shifts in the FDI structure. Thus, **despite the dominant share of foreign investments in the services and the energy sectors for the period 2003 - 2009, in the period 2010-2012 investments in trade sectors[60] boost,** particularly, manufacturing activities.

[58] High flows in 2006 were largely due to the privatization of a public company in the energy sector.
[59] Category of other capital contains FDIs in the form of intercompany loans.
[60] The definition of tradable and non-tradable sectors uses traditional approach, i.e. tradable sectors include mining and manufacturing, while other activities are classified as non-tradable.

Chart 2
FDI structure (by activity) and export structure, share in the total amount

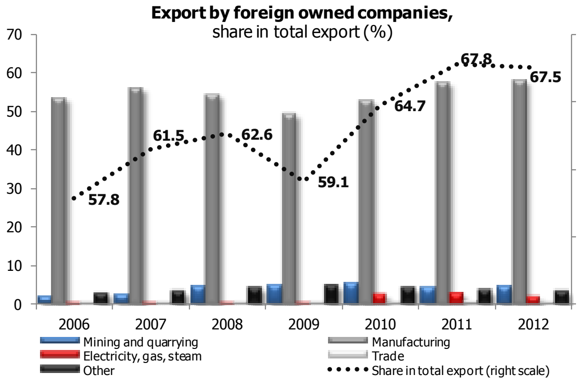




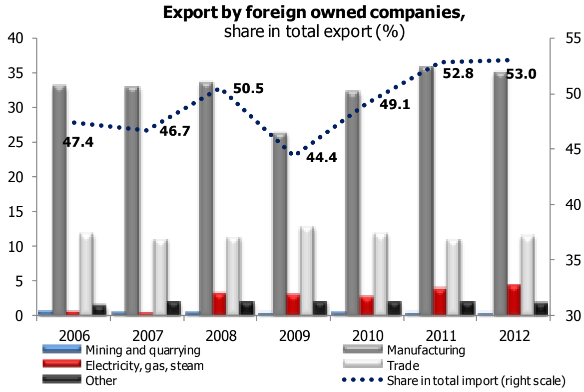
Positive structural changes are due to the entry of several multinational companies aimed at export manufacturing sectors, respectively changing the export structure, in favor of non-traditional products, or upstream industrial products and greater added value compared to traditional Macedonian export products. For illustration, the average share of traditional export[61] products for the period 2004-2010 reduced from the 70.4% to 57.4% in the next two years at the expense of an increasingly larger share of export upstream industrial products. **Synthesized data on total exports of foreign-owned companies[62] further emphasize the positive effects of new companies on the export performance of the economy.** The share of exports of these companies in total exports of the economy reached nearly 68%[63], compared to a share of 58% in 2006[64], which confirmed the assumptions of the theory of multinational companies that in the case of small and open economies, the effects of direct investments of these companies on exports are positive[65]. On the other hand, **majority of new investments depend on import of raw materials and energy and import of equipment and machinery.** This is shown in the analysis of the imports as a second trade component, according to which the higher export activities of foreign companies increase the share of their import component in total imports, but slowly compared to the growth on the export side.

[61] Traditional export products include iron and steel, ores, textiles, food and tobacco.
[62] Analyzed foreign-owned companies include only companies classified as foreign direct investments, excluding portfolio investments.
[63] The analysis uses data on nominal exports and imports, whose changes are influenced by world prices of metals and crude oil, which may partly explain deviations from the general trend in 2009.
[64] The share for the analyzed period averaged 63.5%.
[65] Markusen (2002).

Chart 3
Exports and imports of foreign-owned companies



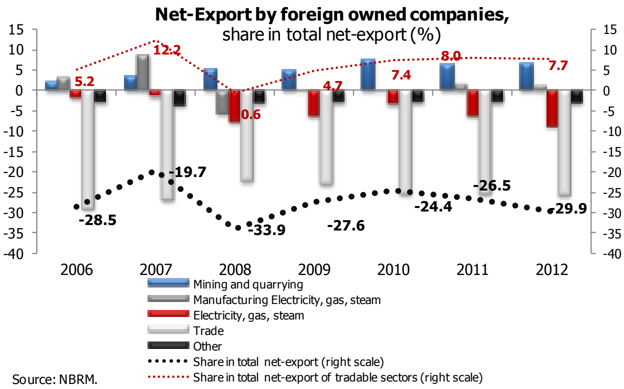
Source: NBRM.



Source: NBRM.

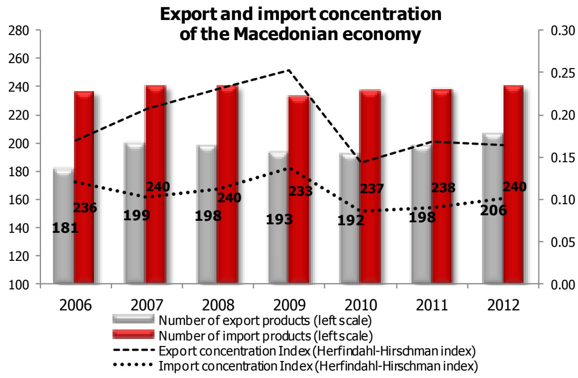
Foreign-owned companies account for nearly 30% of the total net trade deficit of the national economy. Considering the dynamics, the trade balance is negative for the entire period under observation, with significant deviations from the average only in 2007 and 2008.

Chart 4



Source: NBRM.

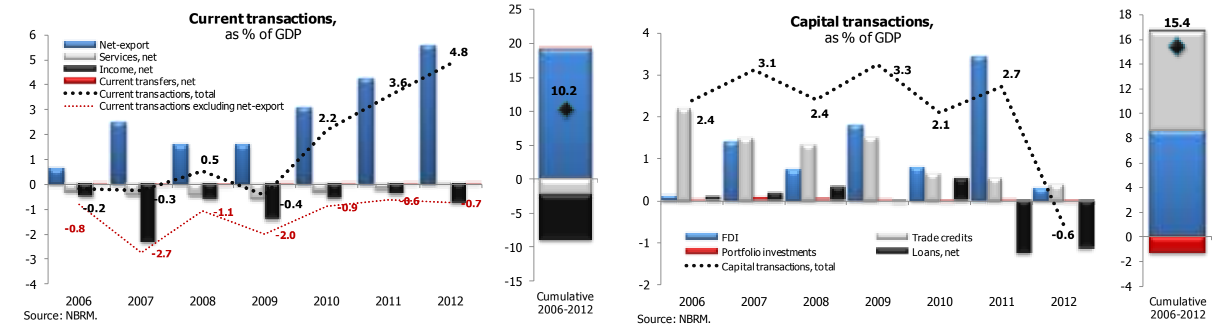
Chart 5



However, the trade deficit analysis provides merely a general, summary image of movements, thus hiding a part of the changes that are observed in the so-called sector-by-sector (tradable/nontradable) analysis of FDIs. In fact, looking at individual industries, favorable developments have been noticed in the sectors that are treated as producers of tradable goods and services (mainly manufacturing and mining) and activities aimed at manufacturing non-tradable goods and services (energy, trade activities and most service industries). **Tradable sectors contribute to positive net exports throughout most of the period 2006-2012, while companies classified in other industries have a permanent negative effect on the trade balance,** notably among foreign companies in the trading business. This, to some extent, confirms the thesis that the effect of FDIs on net exports is strongly predetermined by the type of investments and their target industry. **In the case of Macedonia, direct investments aimed at manufacturing and mining sectors as expected, reduce total trade deficit, while investments in services and energy sector have a negative effect on net export position of the economy.** Apart from the positive effects of FDIs in manufacturing industries on the size of exports, there are also increasingly noticeable effects on the export diversification. Measured by export concentration index[66], since 2010, the exports concentration index has been decreasing, with a simultaneous increase in the number of products exported by all companies from the domestic economy in a year. The period of changes in export structure coincides with the start-up of new export-oriented foreign facilities.

[66] Herfindahl-Hirschman Index based on UNCTAD calculations.

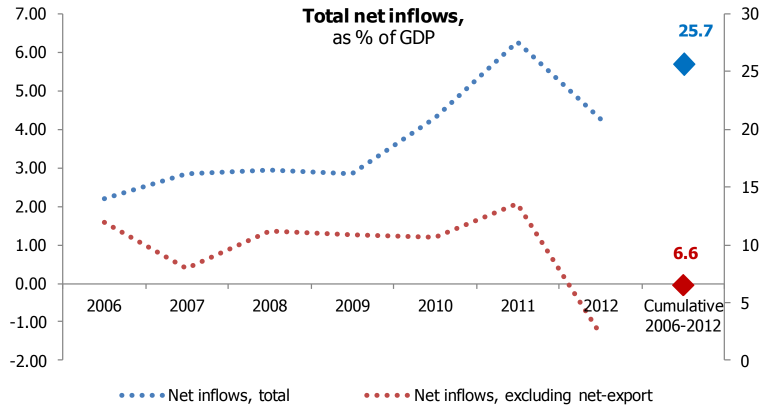
Chart 6
Current and capital transactions of selected companies, as % of GDP



Structural changes in the Macedonian economy in recent years, caused by the activity of foreign companies is an impetus for the section below in this box, **whose objective is to assess the total impact of FDIs on the external position of the national economy for the period 2006-2012, using a representative group of 30 companies treated as foreign investments.** Companies have been selected by the amount of investment (in the form of share capital or intercompany loan) and the relative importance of foreign trade companies, with selected companies performing various businesses in the economy[67]. International payment operations data of individual companies have been used as a source, and based on individual data, an attempt has been made to systemize and classify individual flows into categories that correspond to the categories in the balance of payments. Summarized data are classified as current and capital net flows. The results suggest that the **cumulative effect of selected companies on the current account balance is moderately negative for the period 2006-2009,** which is basically due to net outflows in income and results from the repatriation of profit and the negative net services. Findings have significantly changed over the last three years. **The period 2010-2012 experienced high net inflows of current transactions with these companies, solely caused by net exports of goods, given that other current transactions generate net flows. The cumulative effect of current transactions for the entire period is positive and equals 10.2% of GDP.** The dynamics of international capital transactions of selected companies is more stable, without major deviations from the general trend. **Average net capital inflows constitute 2.2% of GDP, mostly stemming from inflows based on equity[68] and trade loans.** Net outflows from loans in 2011 and 2012 reflect the increased outflows in intercompany borrowing of these companies and correspond with the balance of payments for the period. These changes highlight the risk of foreign investments, despite the abovementioned positive effects. **For the entire period under observation, the cumulative net effect of capital transactions of companies is positive and makes up 15.4% of GDP.**

[67] The analysis does not include companies from the financial sector, because of the specificity of the activity.
[68] The presentation of FDIs in the chart refers mostly to foreign investments in the form of share capital and does not include reinvested earnings and intercompany loans. Debt transactions between related parties are recorded within the category "loans".

Chart 7



Source: NBRM.

In general, the effect of current and capital transactions of 30 selected companies throughout the period is positive (cumulative effect of 25.7% of GDP), suggesting generation of net foreign currency inflows in the domestic economy, thus supporting the balance of payments position[69].

The microanalysis largely confirms expectations based on macroeconomic trends and findings of empirical research. The positive effects of foreign investments in the Macedonian economy are the strongest in the export sector, through both the growth of market share and through the greater diversification, and accordingly, the increasing resistance to price shocks. **The higher trade and financial integration, as a result of the economic activity of foreign companies constantly contributes to a net foreign exchange inflows to support the external stability of the economy.** However, this form of financing carries certain risks by creating foreign exchange outflows from import of goods and services and repatriation of profits in the form of dividends and financing of parent companies (loans and trade credits), indicating the potential risks and need of extra caution by macroeconomic policy makers. Furthermore, it is important to underline the high amount of foreign direct investments in the automotive business, which has large positive effects (introducing new technologies and creating upstream industrial products), but still represents a high concentration of investments.

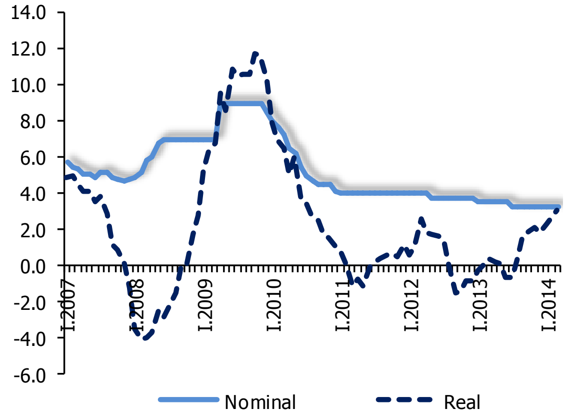
II. Monetary Policy

During the first quarter of 2014, the NBRM has maintained its policy rate stable at 3.25%. The latest available information indicated no significant changes in the environment of implementing monetary policy compared to October projections. Foreign reserves declined, which is usual and expected for this time of the year. The headline inflation slowed down significantly, and estimates indicate mostly downward risks to the inflation projection. At the same time, core inflation significantly slowed down, indicating gradual depletion of the influence of one-off factors and knock-on effects. As expected, the growth of economic activity continued during the last quarter of 2013, with continuation of positive trends since early 2014. The banking sector was still providing support to the economic recovery, and as of February, the credit growth is above the projection for the first quarter. On the other hand, the global economic environment was

[69] The findings should be viewed with a certain amount of attention, primarily because of the structure of the selected companies (the largest share of companies from the manufacturing and mining activities), but also because of the source of data, which does not comply fully with the sources of data on the balance of payments statistics.

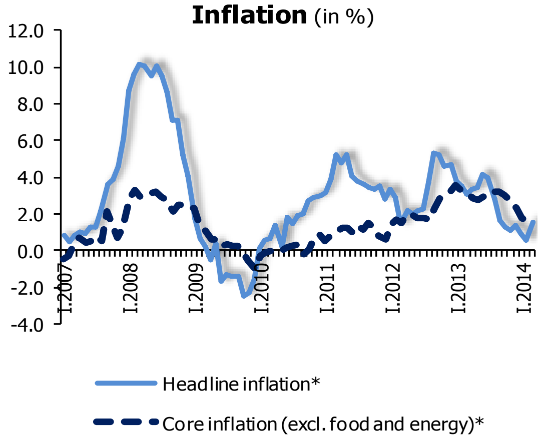
again uncertain, pointing to the still present risks. In these circumstances, and taking into account previous measures taken by the NBRM, which are supposed to take effect in the next period, the NBRM decided to keep the policy rate at the same level during the first quarter. In the period ahead, the NBRM will continue to monitor closely the situation for the purposes of timely and appropriate adjustment of monetary policy.

Nominal interest rate on CB bills and inflation (in %)



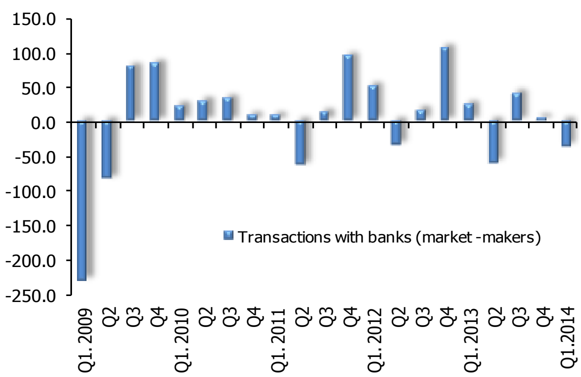
Source: NBRM.

Inflation (in %)



*Current month/same month of the previous year.
Source: SSO

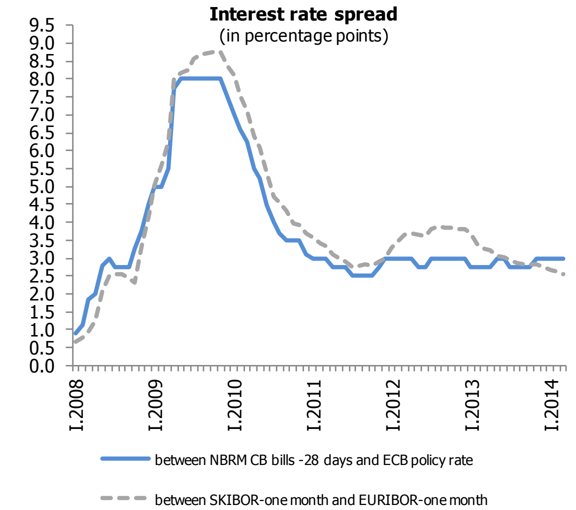
Interventions on the foreign exchange market by NBRM (in EUR million)



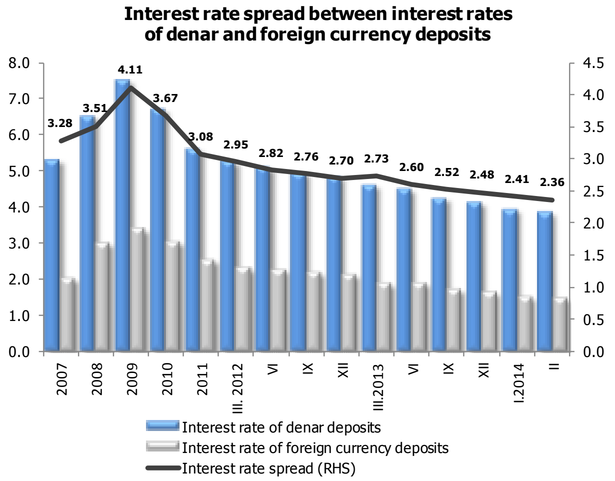
Source:NBRM

Based on the regular assessment of recent macroeconomic and financial developments, at the meetings held during the first quarter of 2014, the NBRM Operational Monetary Policy Committee[70] decided to maintain the CB bill interest rate at 3.25%. Short-term indicators, which became available during the quarter, indicated no significant changes in the environment for conducting monetary policy compared to the October projections. In the first quarter, the NBRM sold net foreign assets (of Euro 36.2 million) in the foreign exchange market. The fall in foreign reserves was as expected, however preserved at the appropriate level. The increase in domestic prices slowed down in the first quarter, with the annual inflation rate averaging 0.6%. This performance have contributed to significantly lower inflationary pressures than expected, largely due to the food component and less to the core inflation. In the first quarter, the core inflation slowed down significantly to 1.5%, on average. Growth in economic activity continued during the fourth quarter, with the construction sector still being the main generator of growth. Available high frequency indicators of economic activity pointed to further positive trends from the beginning of 2014. Banks still support the private sector growth through higher lending. Thus, as of March, the lending pace of banks was faster than projected in October. The new lending in the first quarter was almost equally distributed among households and the corporate sector, suggesting further credit support to corporations by the banking sector, after the strong growth in total loans to the corporate sector in the last quarter of 2013. However, the loan projection for the next period is still accompanied by risks associated with the banks' perceptions, as well as the conservative strategies of large banking groups present in the domestic market through their subsidiaries. The latest information from the international environment indicate expectations for accelerating growth of the global economy during 2014 and

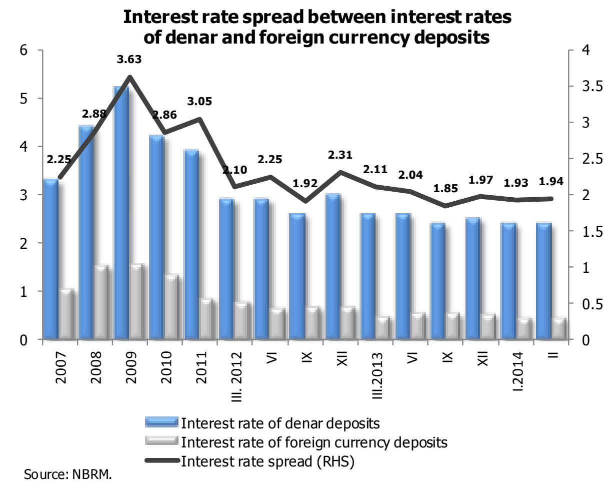
[70] During the quarter, the NBRM Operational Monetary Policy Committee held three sessions discussing the monetary policy, as follows: on 15 January 2014, 12 February 2014, and 12 March 2014.



Source: NBRM, ECB (www.ecb.int) and De Nederlandsche Bank (www.statistics.dnb.nl).



Source: NBRM.



Source: NBRM.

2015, with the downward risks being alleviated. The assessments for the euro area are positive and indicate further growth in the period ahead. Namely, although the beginning of the year was marked by instability of financial markets in emerging economies and developing countries and geopolitical turmoil in Ukraine, currently, the effects of these tensions are being evaluated as geographically limited without significant consequences for the global perspectives. However, uncertainty about future developments suggests possible occurrence of risks from the global environment. In such conditions and amid more NBRM's measures with an effect of loosening, which would have effect in the next period, the policy rate has remained the same. In addition to the recently adopted Methodology for determining the potential demand for CB bills[71], in February, the NBRM reduced the interest rate on seven-day deposit facility from 1.5% to 1.25%, bringing it closer to the interest rate on overnight deposit facility. In fact, this methodology prescribes a mechanism for determining the potential demand for CB bills, which takes into account liquidity needs of banks, on the one hand, and their real liquidity potential, on the other. According to the established mechanism, if the demand of the overall banking system is considered to have been higher than the potential, banks that bid with amounts higher than their own liquidity potential will have to place the difference above their potential in seven-day deposits. By cutting the interest rate on seven-day deposit facilities, the NBRM stressed the role of these instruments to balance short-term liquidity fluctuations, and this is expected to contribute to the further placement of banks' excess liquid assets in long-term investments.

After the last cut of policy rate (to 0.25%) in November 2013, during the first quarter of 2014, the ECB kept the same monetary policy setup. This decision was explained by the absence of estimates of risks of deflation in the euro area in the medium run and gradual convergence of inflation to the target level of 2%, given the slow recovery of economic activity. Consequently, in March, the interest rate spread between the CB bill interest rate and ECB's policy rate was at the level of December 2013 and equaled 3 percentage points. Movements in short-term interest rates in the domestic and European financial markets were relatively stable, thus

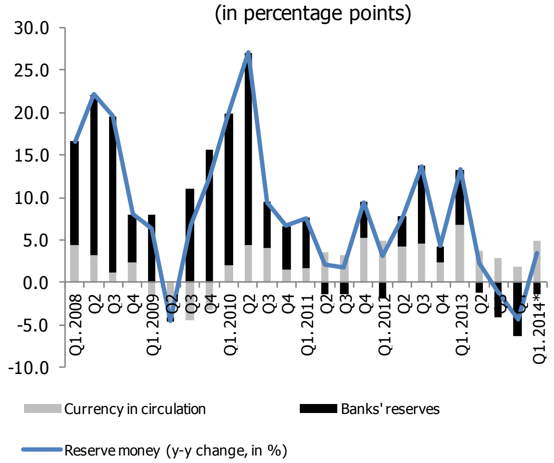
[71] For more details of the new Methodology for determining the potential demand for CB bills, see Box 7, Quarterly Report, January 2014.

maintaining stable interest rate difference between one-month EURIBOR and one-month SKIBOR[72] of 2.6 percentage points in March.

2.1 Banks' Liquidity and Interbank Money Market

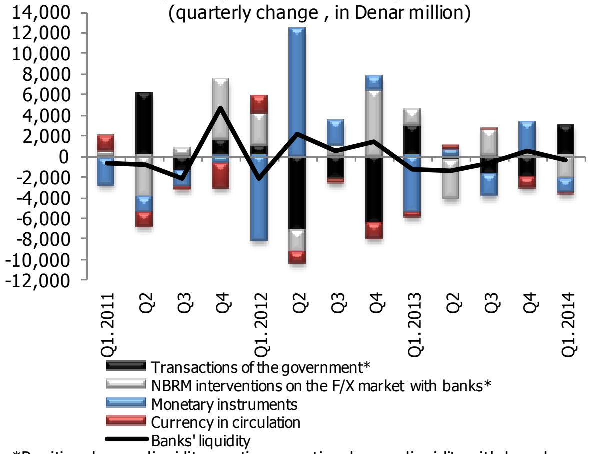
At the end of March 2014, the liquidity of banks fell by Denar 372 million compared to the end of December 2013. Thus, at the end of March, banks' account balances with the NBRM[73] amounted to Denar 15,448 million. In February, reserve money[74] increased by 3.5% annually, compared to December 2013 when they dropped by 4.4%.

Contribution to annual change in reserve money
(in percentage points)



*Refers to February 2014.
Source: NBRM

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



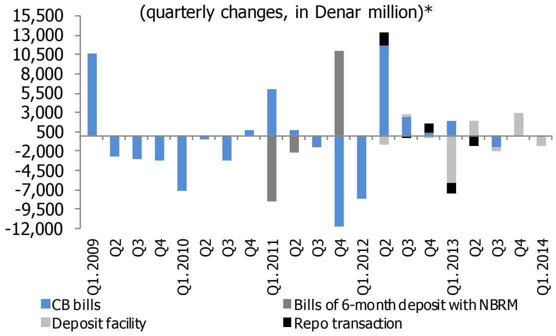
*Positive change- liquidity creation, negative change- liquidity withdrawal .
Source: NBRM.

During the first quarter of 2014, the autonomous factors contributed to creating net liquidity of Denar 954 million. Among them, government transactions made the largest contribution to the increase in liquidity (of Denar 2,969 million), solely due to the withdrawals from the government Denar account with the NBRM. Analyzing the NBRM's net sales of foreign currency in the foreign exchange market with market makers, the NBRM's foreign currency transactions in the first quarter contributed to withdrawal of liquid assets (of Denar 2,235 million). Moreover, Denar 115 million of liquid assets were withdrawn through cash in circulation.

In the first quarter, Denar 1,326 million of liquidity was withdrawn through the NBRM's monetary instruments. Given the further stabilization of CB bills, the change in total monetary instruments in this period entirely results from changes in the NBRM's deposit facility instrument. Three CB bill auctions were held in the first quarter, where at volume tender and fixed interest rate of 3.25%, the NBRM determined the supply of CB bills at the level of due amount. Thus, CB bills had a neutral effect on the liquidity level in the banking system. The demand exceeded the offered amount of CB bills at all auctions. Demand for CB bills exceeded the potential demand established in the NBRM's methodology, given the increased liquidity created by autonomous factors[75]. Consequently, some banks were required to allocate funds in seven-day deposits with the NBRM. In these circumstances

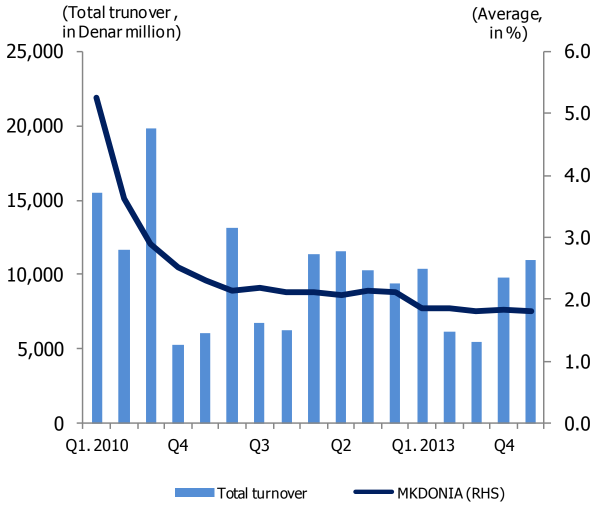
[72] Interbank interest rate on Denar deposits, calculated from the quotations of reference banks.
[73] Refers to Denar accounts of banks required to allocate reserve requirements.
[74] Includes foreign currency reserve requirement.
[75] During the quarter, demand for CB bills was stabilized at a level that is higher by 4.4%, on average, compared to the potential demand established by the NBRM's Methodology.

Monetary policy instruments
(quarterly changes, in Denar million)*



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

Interbank deposit market



Source: NBRM

and active use of this short-term liquidity management tool by the banks, the seven-day deposit facility increased by Denar 2,321 million, quarterly. On the other hand, the overnight deposit facility decreased by Denar 995 million, on a quarterly basis, thus creating liquidity in the system. Consequently, in the first quarter, liquidity was withdrawn from the banking sector through the total deposit facilities in the net amount of Denar 1,326 million. In March, banks used repo auctions to ensure liquidity in order to overcome short-term liquidity shortages to meet the reserve requirement. Due assets were repaid in full, so that this instrument had a neutral liquidity effect during the month. In the first quarter of 2014, banks allocated excess liquid assets of 4.7% on average over the reserve requirement (about 1% on average in the fourth quarter of 2013), due to temporary factors related to liquidity management of certain banks. On the other hand, the reserve requirement measures taken by the NBRM in the first quarter (as of the March period of fulfillment of reserve requirement) reduced the reserve requirement by Denar 168 million[76].

In the first quarter of 2014, the turnover in the interbank deposit market totaled Denar 10,934 million, up by 12% compared to the last quarter of 2013. Compared with the same period last year, in the first quarter of 2014, the activity in the interbank money market rose by 5.3%. Higher turnover in the interbank deposit market in the first quarter explains the need of some banks to supplement temporary shortages of liquidity and to meet reserve requirements. Analyzing maturity buckets, intraday transactions had the highest share in the total turnover in the interbank money market in the first quarter, accounting for 56% of total executed transactions, followed by transactions with maturities of up to seven days with a share of 36%. The interbank interest rate on overnight transactions (MKDONIA) concluded in the first quarter averaged 1.81% (1.82% on average in the

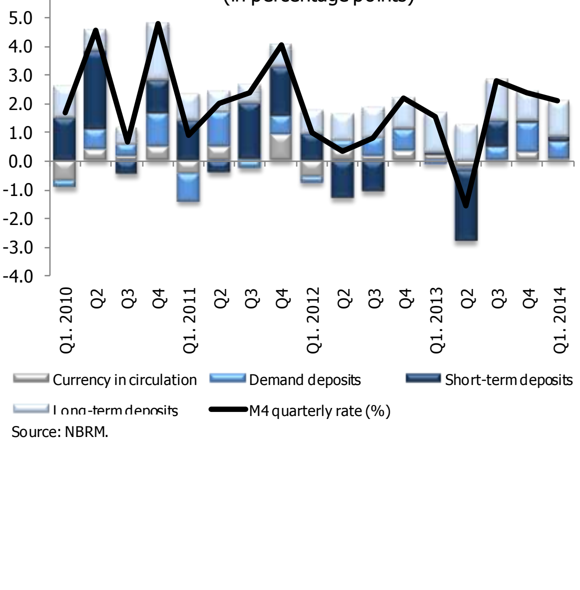
[76] Includes the effect of 0% reserve requirement on liabilities to natural persons with contractual maturity of over two years, liabilities on transactions in local currency, banks' liabilities to nonresident financial companies with contractual maturity of over one year and all liabilities to nonresidents with contractual maturity of over two years, and the effect of non-standard measures aimed to reduce the banks reserve requirement base for the amount of new loans to net exporters and companies to finance projects for domestic production of electricity for own and/or commercial use and investments in debt securities in domestic currency issued by the abovementioned nonfinancial companies, as well as complete exemption of banks from allocation of reserve requirement for issued debt securities in domestic currency and original maturity of at least two years.

fourth quarter). In the first quarter, the interbank interest rate (MBKS)[77] averaged 2.03% (2.02% on average in the last quarter of 2013). In the first quarter of 2014, a transaction in treasury bills[78] was executed **on the secondary money market,** in a total amount of Denar 610 million.

2.2. Monetary and Credit Aggregates

In the first quarter of 2014, the broad money M4 was still growing on a quarterly basis, but moderately compared to the previous quarter, as a seasonal pattern typical for this time of the year. However, the seasonal adjustment of money supply was significantly lower compared with the average for the first quarter, which corresponds to the further positive economic performance, further supported by increased budget spending. Structural analysis of money supply shows a growth in all of its components, with the highest share of long-term deposits, amid slower growth in highly liquid assets. The sector-by-sector analysis indicated further growth in total household deposits, but stronger compared to the previous quarter, while corporate deposits continued growing slowly, which can be explained by seasonal factors. Favorable trends in the credit market continued in the first three months of 2014, given the further growth of total loans, but at a slower pace compared to the previous quarter. However, the actual growth exceeds the average quarterly growth registered after the onset of the global crisis (2009-2013), partially supported by the solid performance in the domestic real sector and further positive economic trends in the euro area as our most important trading partner. Analyzing sectors, banks have provided nearly equal financial support to the household and the corporate sector, in contrast to the previous quarter, when corporate loans made a significant contribution to the growth of total loans. However, further stir-up of activity of the corporate sector points to improved banks' risk perceptions of this segment for the second consecutive quarter. Moreover, some positive developments can be attributed to the non-standard measures taken by the monetary authorities and the utilization of assets from the EIB. The cumulative effect of these factors and conditions accelerate the annual growth rate of total lending, which equaled 7.5% in March 2014.

Contribution to the quarterly change of M4
(in percentage points)



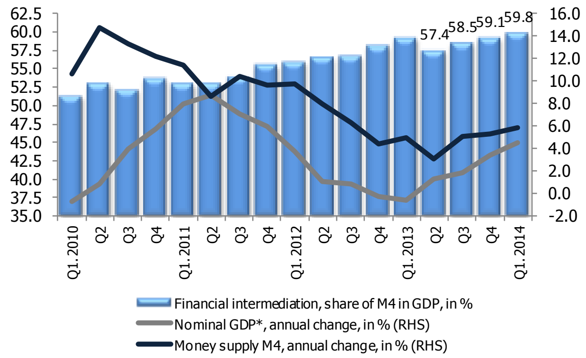
Source: NBRM.

2.2.1. Monetary Aggregates

In the first quarter of 2014, the broad money M4 went up quarterly by 2.1%, at a slightly slower pace compared to the previous quarter (2.4%). The absence of pronounced seasonal adjustment in the money supply, which is below average for the first quarter, corresponds with the further positive economic trends since the beginning of 2014. The increased budgetary spending contributed to the maintenance of relatively strong growth in the money supply, which contributed to additional monetization. Observing *balance sheets*, loans to

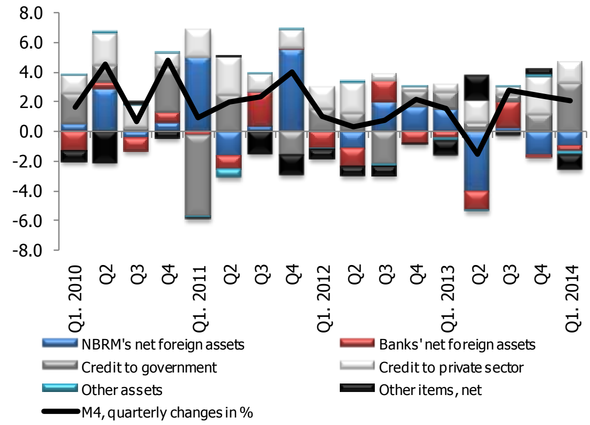
[77] Average interest rate on the interbank money market.
[78] A transaction concluded between non-resident and domestic bank.

Money supply M4 and nominal GDP



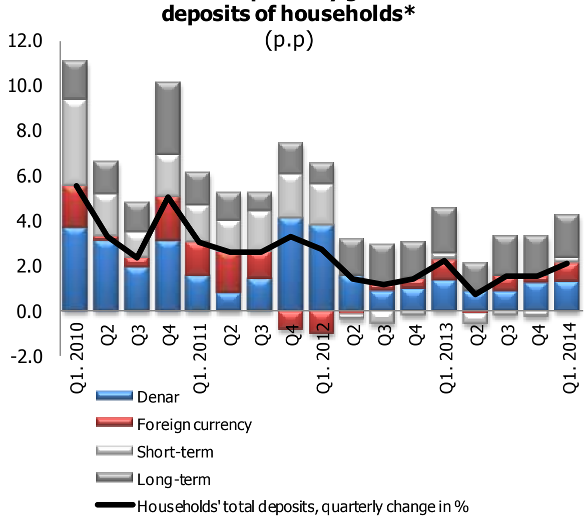
* Annualizied nominal GDP calculated as moving sum of 4 consequent quarters.
Source: NBRM and SSO

Contribution in quarterly changes of money supply M4 (in p.p.)



Source: NBRM.

Contribution in quarterly growth of total deposits of households*
(p.p)



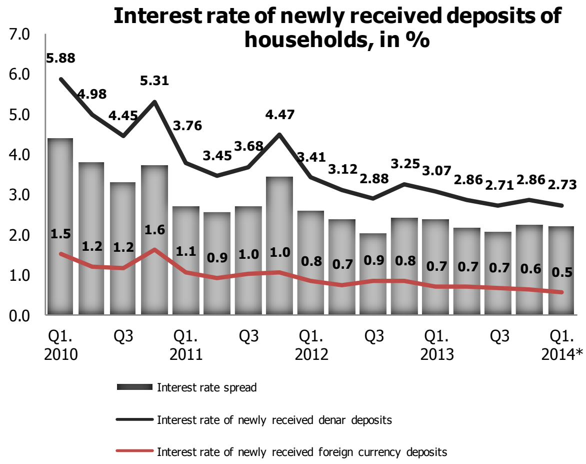
*deposit money are not included
Source: NBRM

the private sector also contributed to the quarterly growth of M4. From a *structural point of view*, the growth of broad money results from the moderate intensification of the growth of savings, amid further growth of liquid assets (cash in circulation and demand deposits), but slower compared to the previous quarter. Thus, in the first quarter, highly liquid asset constitute 32.3% of the growth in the money supply, versus 53.5% in the previous quarter. Such shifts are typical for this period of stabilization of the movements of currency in circulation and demand deposits, following the seasonal increase towards the end of the year as a result of New Year and Christmas holidays. In the first quarter, long-term deposits made significant contribution to the growth of total deposits, which is typical for the deposit movements since the beginning of 2012. **Observed annually, the broad money growth is stronger than the growth in the previous period (5.8% in March versus 5.3% in December).** All M4 components made a positive contribution to the annual growth, with the exception of short-term deposits, which still decline annually. In such conditions, in the first quarter of 2014, the rate of monetization[79] equaled 59.8%, which is higher than the level of the fourth quarter (59.1%).

In the first quarter of 2014, total banks' deposit potential (excluding demand deposits)[80] recorded a quarterly growth of 1.9%, versus 1.5% in the previous quarter. From a currency perspective, the increase in total deposits in this quarter results from Denar deposits, but with a reduced contribution to the growth of 62%, versus 77% in the previous quarter. On the other hand, the growth rate of foreign currency deposits recorded a moderate quarterly acceleration (from 0.6% to 1.4%). Thus, the euroization rate[81] in the economy in the first quarter was also stable, with about 40% share of foreign currency deposits in broad money. Observing maturity, the positive dynamics of total deposits still primarily results from the increase in long-term savings (contribution of about 83%), with simultaneous growth in short-term savings. There is a moderate increase in the contribution of short-term deposits to total deposits growth (from 6% to 17%) compared to the previous quarter, as

[79] As measured by broad money to GDP ratio (annualized nominal GDP, calculated as a moving sum of the last four quarters). The projected amount of nominal GDP is used for the first quarter of 2014.
[80] Including demand deposits, the quarterly growth in total deposits equals 2.2%, versus 2.3% in the previous quarter.
[81] As measured through the share of foreign currency deposits in broad money M4.

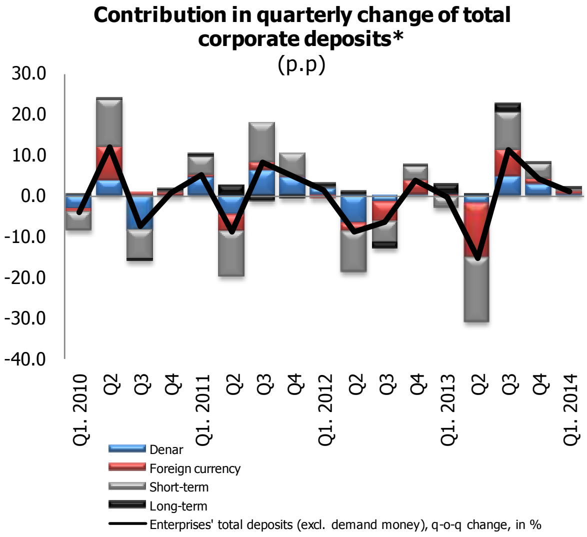
a result of their moderate quarterly growth. **On an annual basis,** in March, total deposits (excluding demand deposits)[82] increased by 4.9%, versus 5% in December 2013.



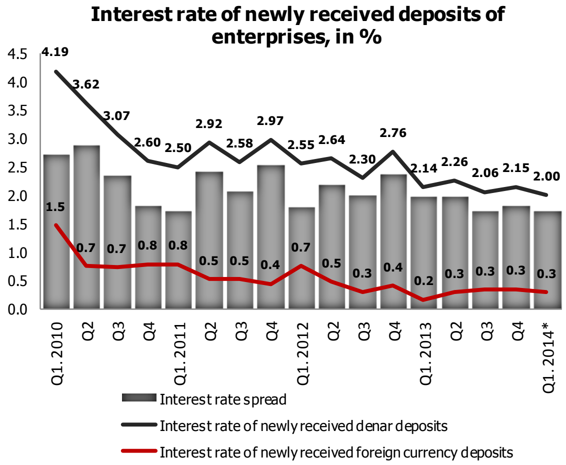
*Q4 refers november
Source: NBRM

Sectoral analysis shows an increase in total household deposits (excluding demand deposits)[83] of 2.1% in the first quarter of 2014, versus 1.5% in the previous quarter. Analyzing by **currency**, the positive trend of growth of Denar deposits continued in the first quarter, at a similar pace as in the previous quarter. Thus, they continued to contribute the most (61%) to the building of deposit base of the households. Foreign currency deposits continued to rise, but at a stronger pace, which caused a greater contribution to the quarterly growth in total deposits. Foreign currency deposits registered significant quarterly acceleration, mainly reflecting the faster growth in January (in the remaining two months, the growth is negligible). Analyzing maturity structure, in the first three months of 2014, short-term deposits increased by 0.3%, after three quarters of quarterly decline, with a constant increase of long-term deposits. **The analysis of interest rates on newly accepted Denar and foreign currency deposits of the household sector** indicates mostly stable movements in yields on savings instruments. Thus, interest rates on Denar and foreign currency deposits in February compared to December were lower by 0.1 percentage points, respectively. This quarterly dynamics led to unchanged interest rate spread between the Denar and foreign currency deposit interest rate. With respect to the maturity structure[84], significant downward shift is observed in the interest rates on short-term and long-term Denar deposits without an FX clause (by 0.4 percentage points, respectively), as well as on short-term and long-term foreign currency deposits (by 0,3 percentage points, respectively). **Annually,** total deposits (excluding demand deposits)[85] were by 6.1% higher in March, versus 6.2% in December.

[82] Including demand deposits, in March, the annual growth of total deposits equals 6.9% versus 6.1% in December.
[83] Including demand deposits, in March, the quarterly growth in total deposits equals 2.4%, same as in the previous quarter.
[84] The analysis of household and corporate interest rates by currency structure does not take into account interest rates on sight deposits.
[85] Including demand deposits, in March, the annual growth equaled 7.2%, versus 6.7% in December 2013.



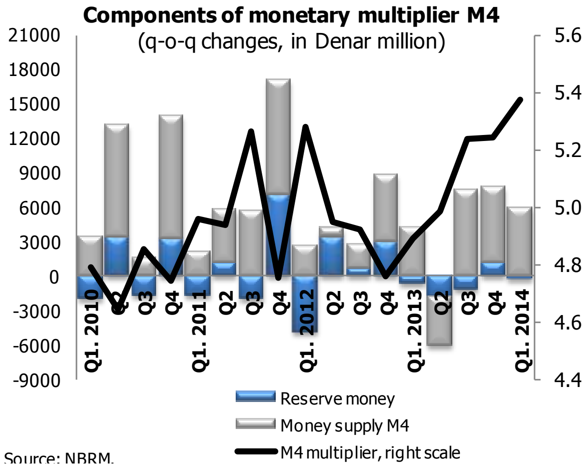
*deposit money are not included
Source: NBRM

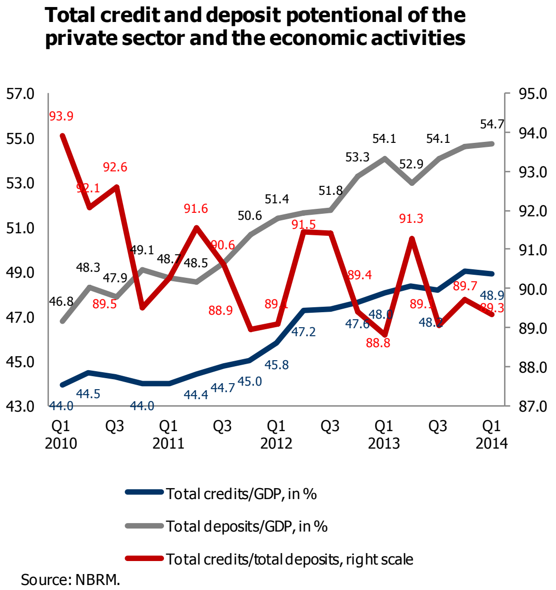


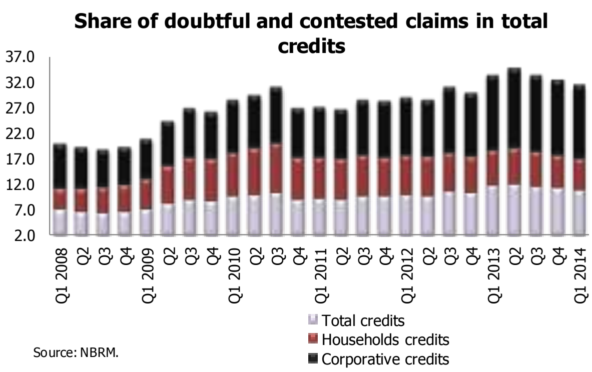
*Q4 refers to november
Source: NBRM

In the first quarter, corporate deposits (excluding demand deposits)[86] continued increasing on a quarterly basis, but slowly compared to the previous quarter (1.1% vs. 4.1%, which can partly be explained by seasonal factors). The favorable economic trends maintain the capacity to place deposits by the corporate sector. The further growth in banks' lending to this sector in the first quarter could be regarded as an additional factor that contributes to the growth of deposits. Analyzing by **currency**, in this quarter the growth of corporate deposits is largely due to the growth of foreign currency deposits, with a contribution of about 61%, versus 31% in the previous quarter, with simultaneous growth of Denar deposits. Despite such quarterly performance, no changes in the currency structure of total deposits have been noted. Observing **maturity**, in the first quarter, the contribution of short-term deposits to the development of corporate deposit potential decreased at the expense of long-term deposits. Thus, the contribution of long-term deposits, compared to the previous quarter, increased from 8% to 45%. **Interest rates on newly received domestic and foreign currency deposits of companies registered no significant changes in the first quarter (January and February).** In fact, in February, compared to the end of last year, the interest rate on Denar deposits dropped by 0.1 percentage points, while the interest rate on foreign currency deposits remained unchanged. In such conditions, the interest rate spread between Denar and foreign currency interest rate insignificantly narrowed by 0.1 percentage points. Analyzing the maturity structure, significant changes were observed in interest rates on Denar deposits without an FX clause, in both short-term (down 0.2 percentage points) and long-term deposits (up 0.5 percentage points), as well as in the interest rate on short-term deposits with an FX clause (growth of 1.3 percentage points). Significant changes were observed in the interest rates on short-term and long-term foreign exchange deposits (fall of 0.5 percentage points and increase of 2.7 percentage points, respectively). Analyzing **annually**, in March, total corporate deposits (excluding demand deposits)[87] declined by 0.9%, versus a 2.1% decline in December, which is significant slowdown of the trend of negative annual growth rates.

[86] On a quarterly basis, including demand deposits, corporate deposits increased by 1.7% versus 4.1%.
[87] On an annual basis, total corporate deposits (including demand deposits) rose by 6.5% in March compared to 3.1% in December.





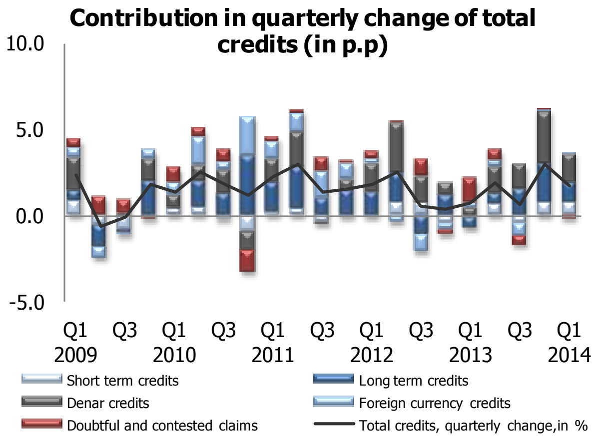


In the first quarter of 2014, the money multiplier M4 averaged 5.2, versus 5.3 as in the fourth quarter. The monetary multiplication process slightly decelerated amid fluctuations in the monthly pace of both broad money and reserve money. Compared with the previous quarter, in the first quarter of 2014, the broad money registered a weaker monthly growth, on average, while the monthly average of reserve money indicates a slight decline versus the growth in the previous quarter.

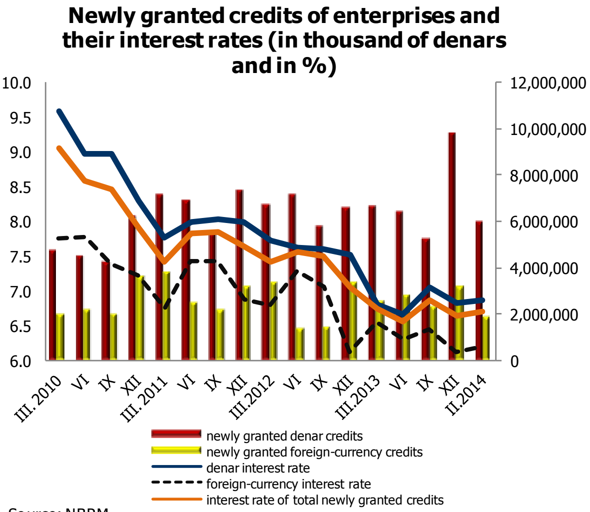
2.2.2. Lending

The quarterly growth rate of total credit activity in the first quarter of 2014 slowed down to 1.8%, after accelerating by 3.0% in the previous quarter. However, credit flows in the first quarter of 2014 were higher than the average quarterly credit growth in the post-acute phase of the crisis, which probably refers to higher confidence of banks in the recovery of the domestic economy, and favorable expectations for the economic growth in the euro area. Also, banks' risk perceptions for the corporate sector and its creditworthiness further improved, demonstrated by the larger banks' exposure to this sector for the second quarter in a row. Thus, in the first quarter, the growth rate of corporate loans contributes to half of the new loans approved to the private sector. This structural change in credit flows is also supported by the dynamics of nonperforming loans of companies, which dropped on a quarterly basis. Under these conditions and amid moderate fall in nonperforming loans of households, in March, the share of total doubtful and contested claims to total loans registered a slower growth rate of 10.9% (11.3% in December). The strong expansion of deposit base relative to the growth of total loans disbursed in the first quarter of 2014, **reduced the utilization of deposits as a main source of funding.** Thus, loans/deposits ratio reduced to 89.3%, versus 89.7% in the previous quarter, suggesting a space for greater use of deposits for lending to the private sector.

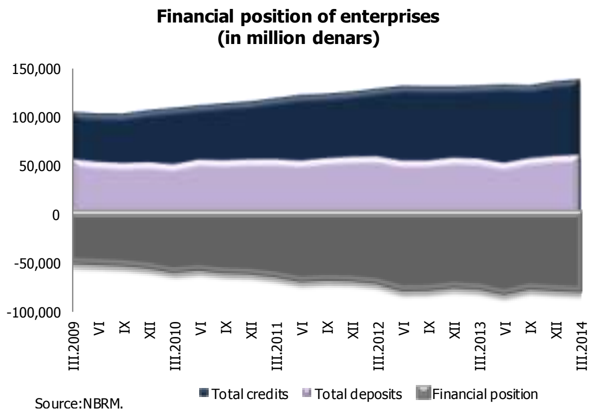
An analysis of maturity structure of total loans indicates a positive contribution of short-term and long-term loans to total credit growth in the first quarter of 2014, while the growth rate of long-term loans significantly reduced compared with the previous quarter. **With respect to the currency structure,** Denar credits continued increasing, while foreign currency loans were increasing moderately compared to the previous quarter. However, Denar



Source: NBRM.



Source: NBRM.



Source:NBRM.

loans are of an utmost importance, contributing 91% to the quarterly growth.

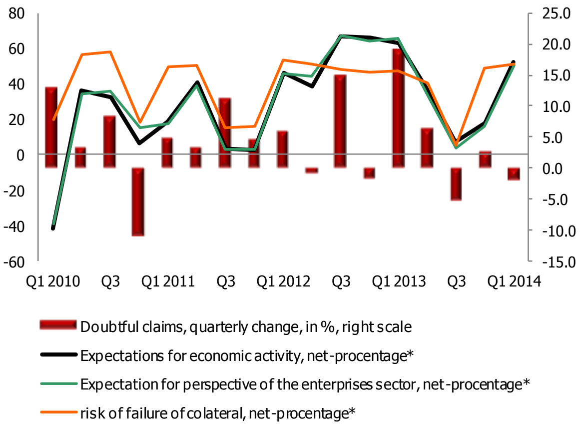
After accelerating in the last quarter of 2013, in the first three months of 2014, the quarterly growth rate of corporate loans by banks slowed down from 3.2% to 1.5%. Credit flows in this period make up half of the growth in the previous quarter of significant boost of the credit growth to the corporate sector. However, credits to this sector constitute 50% of the new loans to the banking system in the first quarter, which, to a certain extent, indicate further optimistic perceptions of banks for the risk profile of companies and their creditworthiness. Moreover, majority of the performance in this period is explained as a cumulative effect of the NBRM's nonstandard measures aimed at encouraging lending to net exporters and producers of electricity. In fact, on this basis, in the first two months of 2014, banks marketed new Denar 1.113 million, and as of February, these loans (since launching the measure in January 2013) totaled Denar 8,108 million. Also, during this period, credit performance was supported by the inexpensive credit line from the EIB for financing projects of small and medium enterprises in the amount of Euro 6.3 million. Such support should continue in the future through the implementation of the fourth stage of the EIB credit line of Euro 100 million[88]. The growth of new corporate debt in the first quarter is more than twice the flow of deposits received, which slows down for the second consecutive quarter, contributing to further expansion of the negative financial position of companies[89].

Performance in corporate loans in the first quarter of 2014 mainly corresponds to the banks' responses given within the Lending Survey. In fact, most of the surveyed banks point to the interest rate as a contributing factor to ease **lending terms**, which is consistent with the reduction in the cost of total corporate loans to 7.0% as of February (7.1% in December). The interest rate on new loans (both Denar and

[88] On 31 December 2013, the MBDP and the EIB signed a Loan Agreement in the amount of Euro 100 million to finance small and medium enterprises and priority projects. Signing of this contract launches the implementation of the fourth stage of the EIB credit line.

[89] It is defined only in terms of deposit and credit position of companies, and does not take into account other components of their portfolios. Financial position is the difference between total corporate deposits and total corporate loans. If the difference is negative, the corporate sector is a debtor to the system, and if it is positive, it is a creditor in the system.

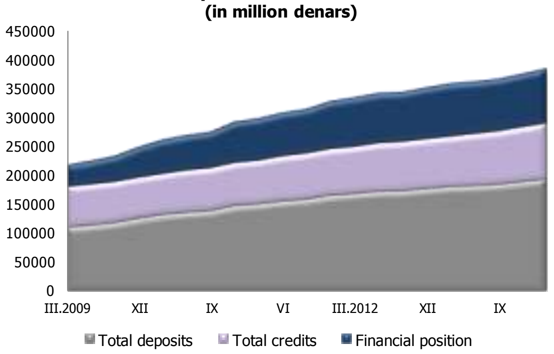
Doubtful claims and risk perceptions of banks



*Negative net-procentage, factors which contribute to relaxing of credit conditions, positive net-procentage, factors which contribute to tigtening of credit conditions
Source: NBRM.

foreign currency) marginally increased (by 0.1 percentage points) and in February climbed to 6.7%. However, compared with the previous quarter, banks indicate moderate net tightening of the overall lending terms due to the increased number of banks that expect unchanged terms of lending. Also, certain deterioration was registered in the perceptions for expectations for the economic activity and the prospects of the industry of the respective company. At the same time, banks indicate a growing **demand** for all types of corporate loans. The moderate net tightening of lending terms reported for the first quarter deviates from the banks' expectations for net easing of lending terms given in the previous survey. In the next three months, banks expect moderate net easing of lending terms, given the assessments for increasing, although slower, demand for all types of corporate loans.

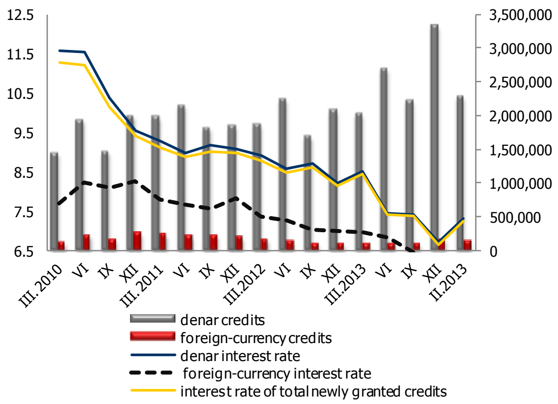
Financial position of the households
(in million denars)



Source: NBRM.

In the first quarter of 2014, credit growth of the household segment equals 2.1%, which compared to the end of the last year, indicates a slower rate of quarterly growth (2.8% in the previous quarter). Given the lower new borrowing of the households compared to the previous quarter, and further deposit growth (at nearly the same pace as in the previous quarter), the positive financial position of households has improved[90]. **Credit market developments directed to the households correspond with the banks' estimates given within the Lending Survey for the first quarter of 2014.** Thus, the surveyed banks indicate moderate net easing of **lending terms**, with a simultaneous increase in the demand. However, in the first quarter, the intensity of assessed changes in both factors is significantly lower compared with the assessments given in the previous survey. The results of the survey indicate large compliance of the banks' expectations given in the last survey with the assessed performance in terms of lending and the demand for loans in the first quarter. For the next quarter, banks suggest further net easing of lending terms and increased demand, but at a significantly stronger pace compared with the previous survey.

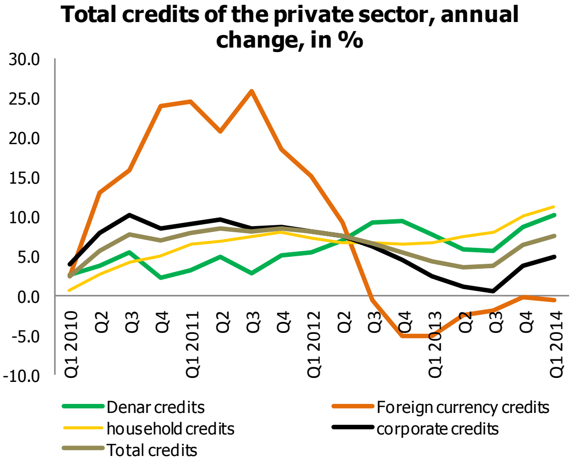
Newly granted household credits and their interest rate
(in thousand of denars and in %)



Source: NBRM.

Analyzing the cost of new household loans, in the first two months of 2014, there was an increase in the interest rate on Denar and foreign currency loans by 0.6 percentage points

[90] Difference between total deposits and total loans of households. If the difference is negative, the household sector is debtor to the system, and if it is positive, it is a creditor in the system.



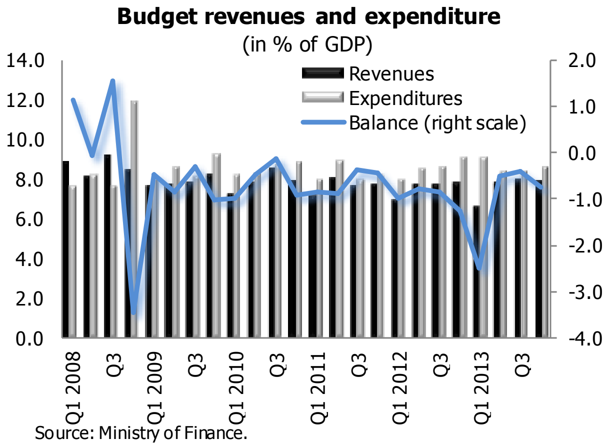
Source: NBRM.

and 0.2 percentage points, respectively, while the interest rate on the total newly approved household loans in February equaled 7.2% (6.7% in December).

The annual analysis shows further acceleration in the annual growth of total loans, which in March amounted to 7.5% (6.4% in December). In such conditions, the total credits to GDP ratio[91] was still relatively stable and equaled 48.9% in March. The analysis of currency structure of total loans indicates accelerated growth rate of the Denar loans, with further decline in foreign currency loans. Analyzing the performance of individual sectors of the economy, there is a simultaneous acceleration of the annual growth of loans to households and corporations by 1.1 percentage points, compared to the end of 2013, reaching 11.3% and 4.9%, respectively, in March 2014.

III. Public Finances

During the last quarter of 2013, the Budget of the Republic of Macedonia (central budget and budgets of funds) generated by 4.3% higher revenues, compared to the same period last year, amid reduction of budget expenditures by 1.7%. In that period, the budget deficit amounted to 0.7% of GDP, predominantly financed from domestic sources. In such conditions, the 2013 budget deficit equaled 4.1% of GDP (3.9% of GDP projected with the budget revision), with a revenue growth of 1.6% annually and by 2.4% higher budget expenses. Total revenues continued increasing in the period January-February 2014, but strongly, thus contributing 13.3% of total projected budget revenues for the year. Moreover, 16.2% of the total projected budget expenditures for 2014 were generated in the same period. In such circumstances, the budget deficit in the first two months of the year amounted to about 1.4% of GDP, making up 41.4% of the projected deficit for the year.

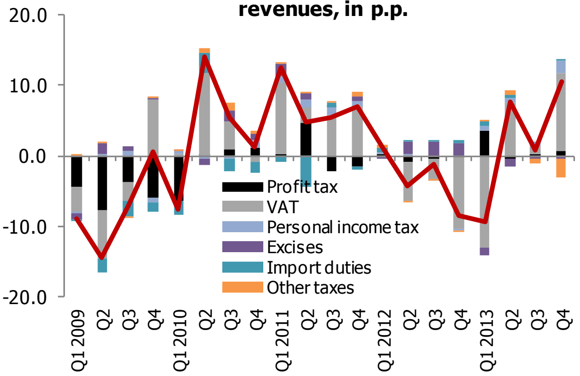


Source: Ministry of Finance.

During the fourth quarter of 2013, the budget of the Republic of Macedonia (central budget and budgets of funds) generated total revenues of 7.9% of GDP[92], almost to the level of revenues generated in the same period last year (7.8% of GDP). In nominal terms, in the fourth quarter, the revenues increased by 4.3%, on an annual basis. Tax revenues made utmost contribution to the growth of total revenues in the last quarter (of 5.5 percentage points), which annually increased by 10.5%. VAT revenues grew by 23% annually and made the greatest contribution to the growth

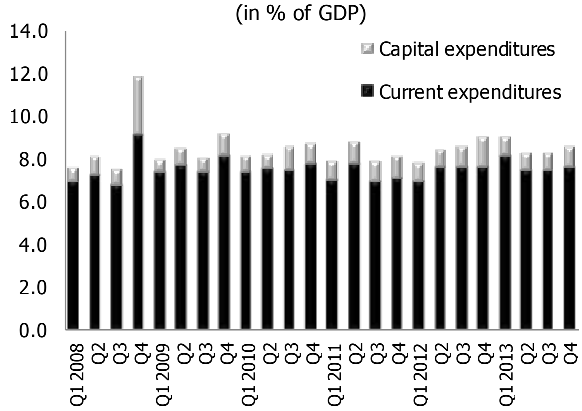
[91] Annualized nominal GDP, calculated as a moving sum of the respective four quarters.
[92] The analysis uses annualized GDP.

Contribution to annual change in total tax revenues, in p.p.



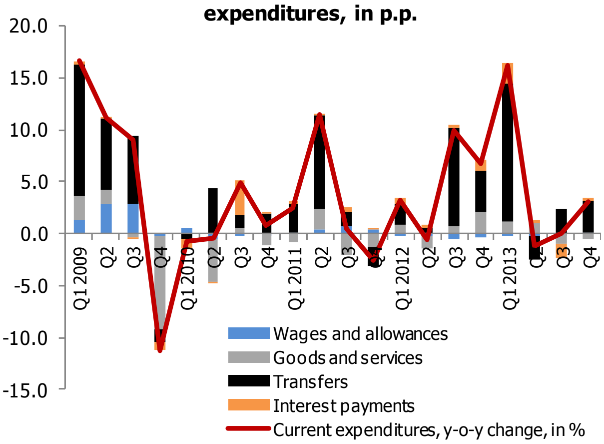
Source: Ministry of Finance.

Budget expenditures composition (in % of GDP)



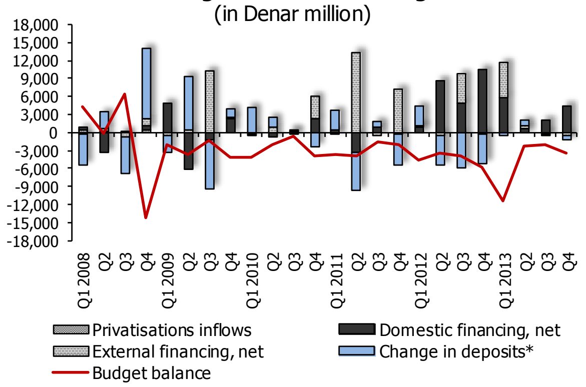
Source: Ministry of Finance.

Contribution to annual change in current expenditures, in p.p.



Source: Ministry of Finance.

Budget balance financing (in Denar million)



* Positive change- deposits withdrawal; negative change-deposits accumulation.
Source: Ministry of finance of the Republic of Macedonia.

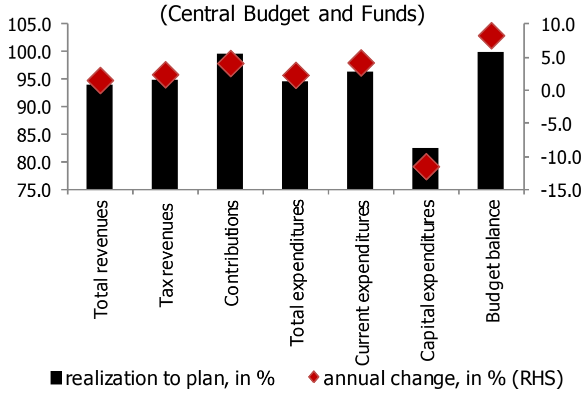
of tax revenues in the last quarter. Increasing growth was observed in income tax revenues (11.5% on an annualized basis), which corresponds to the constant growth of the number of employees during 2013. Compared with the same period last year, profit tax revenues in the fourth quarter increased by 18.7%, annually, with a simultaneous growth being registered in the revenues from import duties of 1.7%. On the other hand, excise taxes decreased by 1.9%. The total annual contributions were higher by 5.6%, contributing 1.7 percentage points to the growth of total revenues, amid decrease in the non-tax revenues of 12.7% on an annual basis.

During the fourth quarter of 2013, the total budget expenditures amounted to 8.6% of GDP, compared to 9% of GDP in the same period last year. In nominal terms, in the fourth quarter, the total budget expenditures were lower by 1.7%, annually. From a structural point of view, current expenditures increased by 3% annually, which mainly stems from the higher level of transfers with an annual growth of 4.5%. Here, social transfers increased by 6.2% annually, with the largest amount of transfer payments being made to the Pension and Disability Fund of Macedonia. Expenditures based on salaries and wages were almost identical to the previous year, while the cost of goods and services registered an annual decline of 4.1%. In the last quarter, interest expenses surged (by 10.8% annually), arising entirely from the payment of due interest liabilities on domestic borrowing. **In the last quarter, the capital expenditures decreased by 27.7%,** making up 11.4% of total expenditures (10.1%, on average in the previous three quarters).

During the fourth quarter of 2013, the budget deficit amounted to Denar 3,483 million, or 0.7% of GDP. In this period, the budget deficit was financed through domestic sources in the form of new issues of government securities in the net amount of Denar 4.550 million. Insignificant net outflows of Denar 426 million were registered through foreign borrowing. In the fourth quarter, inflows exceeded outflows of assets, thus increasing the deposits on the government account with the NBRM by Denar 705 million.

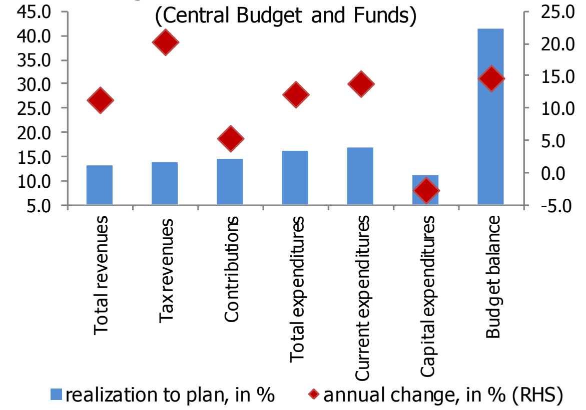
For the entire 2013, compared with the previous year, the budget of the Republic of Macedonia (central budget and budgets of funds) registered an increase in total revenues and total expenditures by

Budget realization for 2013
(Central Budget and Funds)



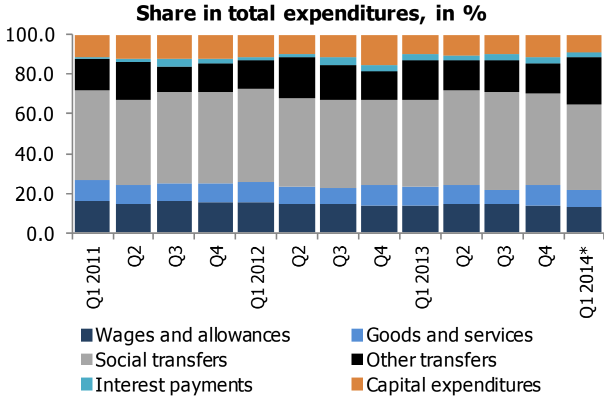
* With respect to Supplementary Budget for 2013.
Source: Ministry of Finance.

Budget realization for Jan-Feb 2014
(Central Budget and Funds)



* With respect to Budget plan for 2014.
Source: Ministry of Finance.

Share in total expenditures, in %

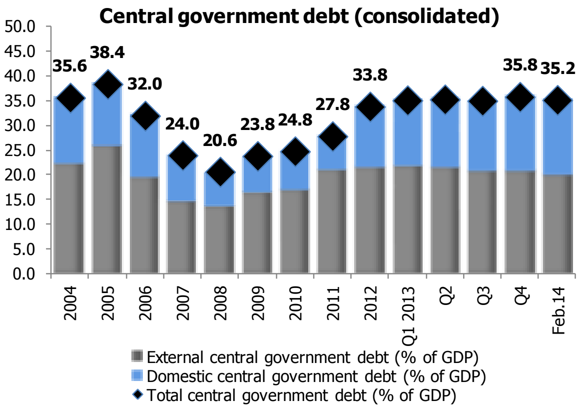


*Refers to January and February 2014.
Source: Ministry of Finance.

1.6% and 2.4%, respectively. In 2013, the budget deficit constituted 4.1% of GDP, which is slightly higher than 3.9% of GDP, as projected in the Budget Revision in November 2013[93]. In 2013, the budget deficit was funded on a net basis through auctions of government securities, and the remaining net inflows were provided through external sources. Early this year, high inflows were registered from borrowing abroad[94], but due to the full repayment of the second Eurobond (Euro 175 million) the share of net inflows based on foreign borrowing in the financing was low.

In the period January-February 2014, total budget revenues were still growing intensively and compared to the same period last year, they were higher by 11.3%. The largest contribution to the acceleration of the growth of total revenues[95] in this period was made by the higher generation of tax revenues (an annual growth of 20.3%). Growth was also registered in contributions (of 5.4% annually), while non-tax revenue decreased annually, by 4.5%. **Total expenditures grew in this period by 12.2% on an annual basis,** as a result of the 13.8% higher current costs incurred on an annual basis. Capital costs dropped by 2.7% annually. The structural analysis of total expenditures in the period January- February shows significant growth in the share of the category "other transfers", partly due to the payment of subsidies to farmers in this period. Regarding the plan for 2014, in the first two months of the year, 13.3% of the projected revenues were generated and 16.2% of the projected expenditures were incurred for the year. **During the period January-February, budget deficit totaled Denar 7,558 million (or about 1.4% of GDP),** representing 41.4% of the projected deficit for 2014. In the period January- February, the budget deficit was mostly financed from domestic sources by withdrawing deposits from the government Denar account with the NBRM and new issues of government securities. According to the latest available data, as

[93] In November 2013, amendments were made to the 2013 budget, projecting boost in total budget revenues and expenditures than originally projected and by 3.9% higher budget deficit of GDP (3.5% of GDP in the initial budget).
[94] Due to the disbursement of loan from Deutsche Bank under the Loan Agreement secured by a policy based guarantee by the World Bank (of Euro 250 million) and the First Programmatic Competitiveness Development Policy Loan approved by the World Bank (of U.S. dollars 50 million).
[95] In this period, the growth of total budget revenues, including tax revenues as a part thereof, is partly due to the base effect, taking into account that in the period January-February 2014, the government kept on settling overdue liabilities based on VAT returns (a process that started in September 2012).



Source: Ministry of Finance

of 28 February 2014, the central government debt (consolidated) totaled 35.2% of GDP.

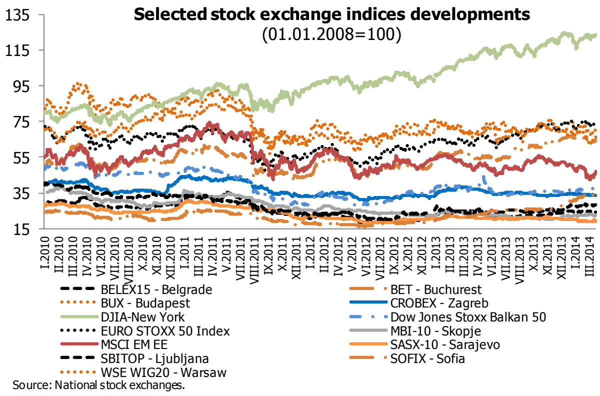
	Budget for 2013	Supplementary Budget for 2013	Q1	Q2	Q3	Q4	2013	Budget for 2014	Jan-Feb	Y-o-y changes, 2013 period over the same period of the previous year, in %					Contribution to y-o-y change, 2013 period over the same period of the previous year, in p.p.					Y-o-y changes, 2014 period over the same period of the previous year, in %	Contribution to y-o-y change, 2014 period over the same period of the previous year, in p.p.
	planned, in Denar million	planned in denar million	realized, in Denar million					planned, in denar million	realized, in Denar million	Q1	Q2	Q3	Q4	2013	Q1	Q2	Q3	Q4	2013	Jan-Feb	Jan-Feb
TOTAL BUDGET REVENUES	**147,958**	**149,291**	**29,931**	**36,121**	**36,983**	**37,232**	**140,267**	**158,243**	**21,072**	**-5.9**	**2.8**	**4.3**	**4.3**	**1.6**	**-5.9**	**2.8**	**4.3**	**4.3**	**1.6**	**11.3**	**11.3**
Revenues base on taxes and contributions	125,555	125,752	26,476	30,665	31,075	32,795	121,011	133,859	18,789	-5.0	5.9	2.3	8.7	3.1	-4.4	4.8	2.0	7.3	2.6	14.6	12.6
Tax revenues	81,685	81,700	16,507	20,015	20,194	20,762	77,478	87,222	11,987	-9.4	7.7	0.9	10.5	2.5	-5.4	4.1	0.5	5.5	1.3	20.3	10.7
Contributions	42,842	42,624	9,720	10,436	10,671	11,631	42,458	45,153	6,592	2.9	2.5	5.3	5.6	4.2	0.9	0.7	1.5	1.7	1.2	5.4	1.8
Non-tax revenues	13,836	14,094	2,600	2,135	4,479	2,653	11,867	14,973	1,785	-6.5	-30.7	21.6	-12.7	-5.7	-0.6	-2.7	2.2	-1.1	-0.5	-4.5	-0.4
Capital revenues	4,432	4,444	299	2,461	293	329	3,382	5,290	142	-59.9	-8.8	-53.0	-10.4	-23.7	-1.4	-0.7	-0.9	-0.1	-0.8	-40.1	-0.5
Donations from abroad	3,535	4,401	456	752	1,008	1,235	3,451	3,521	237	62.9	154.1	69.4	-34.1	13.3	0.6	1.3	1.2	-1.8	0.3	-35.4	-0.7
Revenues of recovered loans	600	600	100	108	128	220	556	600	119	-15.3	11.3	-27.7	-7.2	-11.6	-0.1	0.0	-0.1	0.0	-0.1	108.8	0.3
TOTAL BUDGET EXPENDITURES	**165,653**	**168,541**	**41,348**	**38,513**	**38,944**	**40,715**	**159,520**	**176,514**	**28,630**	**13.8**	**-0.4**	**-1.2**	**-1.7**	**2.4**	**15.8**	**-0.4**	**-1.4**	**-2.0**	**2.7**	**12.2**	**16.4**
Current expenditures	146,944	148,387	37,303	34,533	34,990	36,083	142,909	154,137	26,143	16.2	-1.2	0.0	3.0	4.2	16.3	-1.1	0.0	2.9	4.2	13.8	16.8
Capital expenditures	18,709	20,154	4,045	3,980	3,954	4,632	16,611	22,377	2,487	-4.0	7.1	-10.5	-27.7	-11.4	-0.5	0.8	-1.3	-5.0	-1.6	-2.7	-0.4
BUDGET DEFICIT / SURPLUS	**-17,695**	**-19,250**	**-11,417**	**-2,392**	**-1,961**	**-3,483**	**-19,253**	**-18,271**	**-7,558**	**152.0**	**-32.0**	**-50.7**	**-39.3**	**8.4**						**14.7**	
Financing	17,695	19,250	11,417	2,392	1,961	3,483	19,253	18,271	7,558												
Inflow	**33,464**	**35,030**	**23,204**	**4,455**	**2,593**	**4,318**	**34,570**	**29,131**	**8,348**												
Revenues based on privatisation	0	273	30	240	0	27	297	0	14												
Foreign loans	17,758	19,150	17,322	1,041	432	277	19,072	5,276	973												
Deposits	12,022	5,497	-327	873	-168	-705	-327	13,915	4,589												
Treasury bills	3,589	9,840	6,111	2,116	2,329	4,682	15,238	9,840	2,503												
Sale of shares	95	270	68	185	0	37	290	100	269												
Outflow	**15,769**	**15,780**	**11,787**	**2,063**	**632**	**835**	**15,317**	**10,860**	**790**												
Repayment of principal	15,769	15,780	11,787	2,063	632	835	15,317	10,860	790												
External debt	13,896	13,907	11,655	600	500	703	13,458	9,133	658												
Domestic debt	1,873	1,873	132	1,463	132	132	1,859	1,727	132												

Source: Ministry of Finance

IV. Stock Exchange Indices and Real Estate Prices

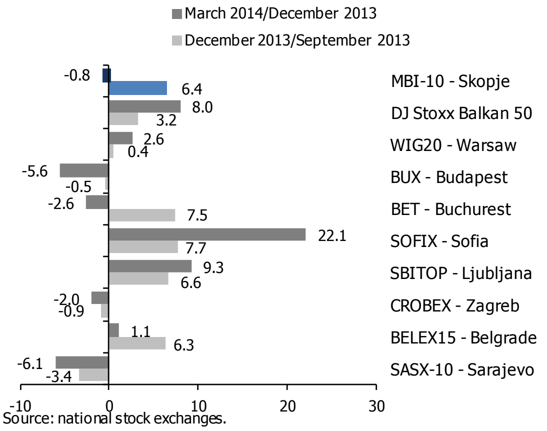
After the growth in the previous quarter, in the first quarter of 2014, MBI-10 dropped. However, in February until late March, the index moved upward, which corresponds to the information on payment of dividends, as well as the favorable developments of the majority of high frequency domestic economic indicators. On the other hand, the bond index value (OMB) followed the upward trajectory. Regional stock exchange indices moved in different directions, as influenced by the signals from the leading markets, the relevant economic data of developed economies, and the crisis in Ukraine. Downward movements in property prices in the Macedonian economy, in the past three years, continued in the first quarter of 2014.

After the positive shift in the previous quarter, the value of MBI-10 decreased in the first quarter of 2014. At the end of March 2014, MBI-10 index was at a level that is by 0.8% down compared to the end of December 2013. However, analyzing the dynamics, various periods of movement were noticed during the first quarter of 2014. The stock exchange index had variable movement until early February, and from this

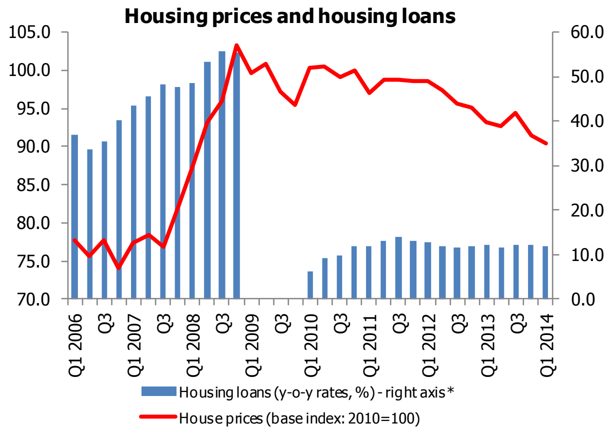


Source: National stock exchanges.

Changes of the regional stock exchange indices, eop March 2014/eop December 2013 and eop December/eop September 2013 (in %)



Source: national stock exchanges.



Source: NBRM. Index of housing prices is calculated by the employees of the NBRM based on the data from the daily newspapers.
*Annual changes for 2009 are not calculated due to changes in the methodology.

period until mid-March, the index moved upwards. In the second half of March, MBI-10 again began to move downward. Factors that raised the index include the usual information about payment of dividends at this time of the year, continuing favorable economic developments in the economies in the euro area (quarterly GDP growths for the third quarter in a row), favorable developments of most high frequency domestic economic indicators and growth of the domestic economy. However, positive shifts of MBI-10 did not take place and the slow resurgence of the stock market is further explained by the absence of foreign institutional investors in the stock market, as well as the disinterestedness of domestic investors. The total stock exchange turnover decreased by 10.6% compared to the previous quarter, while the turnover based on traditional trading grew by 30.7% on a quarterly basis, resulting from increased trade in shares as a result of the released information on payment of dividends. Unlike the MBI-10, the bond index (OMB) has continued moving upward, with its value registering a slight increase of 0.2% at the end of March 2014 compared to the end of December 2013.

Signals from leading markets, relevant economic data of developed economies, and crisis in Ukraine caused divergent trends in regional stock indices in the first quarter of 2014. Thus, stock markets in Sofia, Ljubljana, Warsaw and Belgrade reported higher value of stock indices. Positive changes in these indices are due to the released data for the continuation of favorable economic developments in the economies in the euro area and the further growth of the U.S. economy. Optimism in these regional markets was further supported by the disclosed favorable macro-indicators of the respective countries[96], as well as the positive signals from leading markets. On the other hand, the stock exchanges of Sarajevo, Budapest, Bucharest and Zagreb reported lower values of stock indices, influenced by local factors and possible higher reflection of the crisis in Ukraine on the stock exchange developments.[97]

Downward movements in real estate prices over the past three years, continued in the first quarter of 2014. The price index for

[96] Weekly reports of Raiffeisen Research (Raiffeisenbank Austria d.d. Zagreb).
97 Analyzing selected countries, the Russian Federation has invested mostly in Bulgaria and Serbia, followed by the BiH, Croatia and Romania whose indices fall.

apartments dropped by 1.2% on a quarterly basis. However, the fall in prices is slower than the quarterly price decline of 3% in the previous quarter. These quarterly developments contributed to the annual drop in prices, but slower (decline of 3.1%, after falling 3.8% in the last quarter of 2013). Permanent high supply on the real estate market gathered in the past few years is the main factor for the continuation of the downward movements in prices of apartments. Thus, only in 2013, the supply on the real estate market, as seen through the construction of residential buildings, grew by 25% driven by foreign and public investments. However, the slower decrease in the price of apartments corresponds with the movement of construction costs, i.e. the rising cost of materials after the constant quarterly decline in the past five quarters (according to the index of construction costs[98]). Also, the sudden drop in construction of residential buildings in the last quarter of 2013 further slowed down the decline in the price of apartments. The demand also reduced the price of apartments, amid steady growth in housing loans in the first two months of the first quarter. However, compared to the past quarters, the quarterly growth of housing loans is slower, which corresponds to the slower decline in the price of apartments.

On an annual basis, real estate prices continued to decline in 2013 by 3.8% on average, which is certain acceleration of the fall compared to 2012, when it equaled 1.7%.

V. Macroeconomic Forecasts and Risks

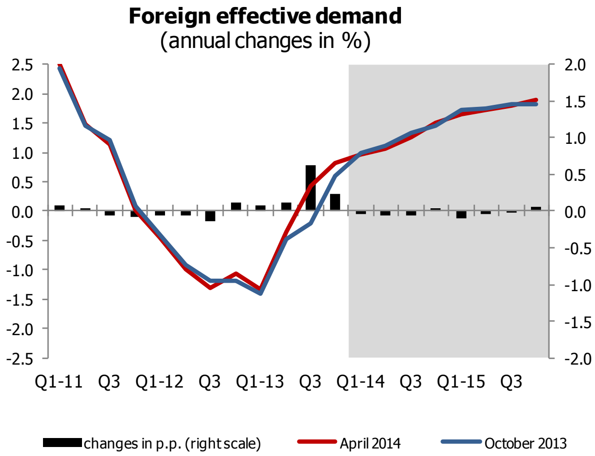
In 2013, the growth in domestic economic activity equaled 3.1% as projected in October. The latest indicators for the first quarter of 2014, and estimates for the future path of key external and internal factors point to a dynamics of economic growth that does not deviate from October expectations. Hence, ***estimates for economic growth in the future two-year period have not changed compared to the previous projection, implying acceleration to 3.7% in 2014 and 4.4% in 2015.*** *Growth is still expected to be driven by export and investment demand, which corresponds with the assessments for improving external economic environment, new entry and increased utilization of existing export-oriented capacities, and positive momentum from public investments. Also, solid positive contribution to growth, especially in 2015, is expected from household consumption, given the improving labor market, credit support and stable expectations. In 2013, due to the improved trade balance in services and higher current transfers, the current account deficit was lower than estimated and equaled 1.9%.* ***Despite the improved exports, it is expected that the growing import demand and declining share of remittances in GDP will increase the current account deficit to 4.0% and 5.8% in 2014 and***

[98] Source: Index of construction costs for new residential buildings, SSO.

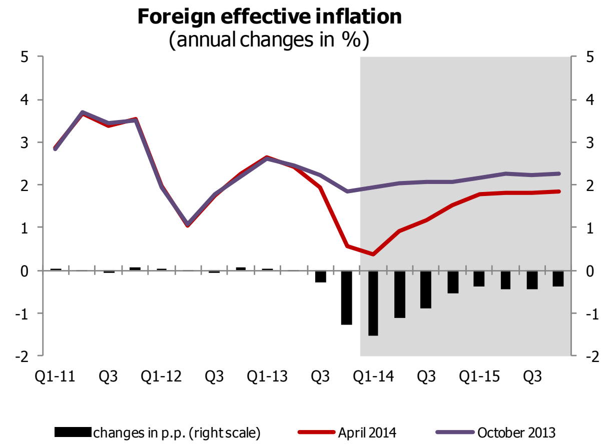
***2015, respectively.** The capital and financial account still expects debt and non-debit flows, which will be **sufficient for the growth of foreign reserves by the end of 2015 and their maintenance at an appropriate level.** At the end of 2013 and beginning of 2014, inflation was consistently lower than projected. **Lower initial conditions and downward shifts in external input assumptions caused a downward revision of inflation for 2014, whereas now it is estimated to reduce to about 1% (2.3% in the previous forecast).** The risks around the inflation projection are assessed as being predominantly downward. For 2015, the inflation rate is expected to swing around 2%.*

5.1. Assumptions in the External Surrounding Forecast[99]

Global economic activity strengthened in late 2013 with the new projections indicating its further improvement in 2014 and 2015[100]. The growth pace differed from one group of countries to another, amid rapid growth in the advanced economies and slower growth in emerging economies. Observing the assumptions about external economic environment, the effectuation of October projections for gradual recovery of the euro area amid continuous stimulating monetary policy and gradual deceleration of the pace of fiscal consolidation, is of particular relevance.



Recent estimates assume no changes in the foreign effective demand compared with the October expectations throughout the projection period. Thus, 1.2% annual increase in foreign demand is still expected for 2014, with projections for largest contribution (0.75 percentage points) of the German economy. Amid preserved expectations for positive economic developments in all our export partners, for 2015, it is estimated that the growth of foreign demand next year will be 1,8%, same as projected in October.



On the other hand, the foreign effective inflation suffered significant downward revisions compared with the October projections. Thus, the assessment of foreign inflation in 2014 has been halved compared to the October projection, i.e. now it is

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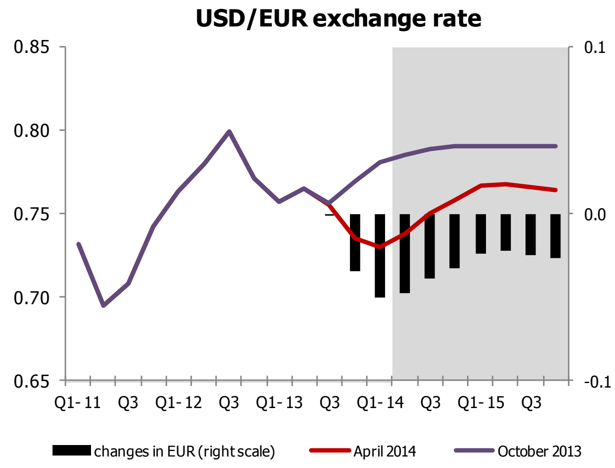
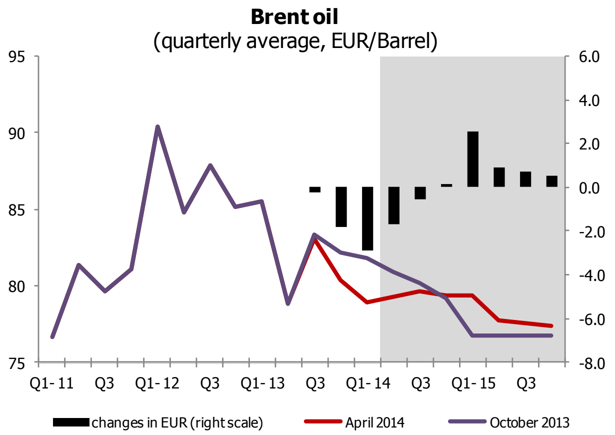
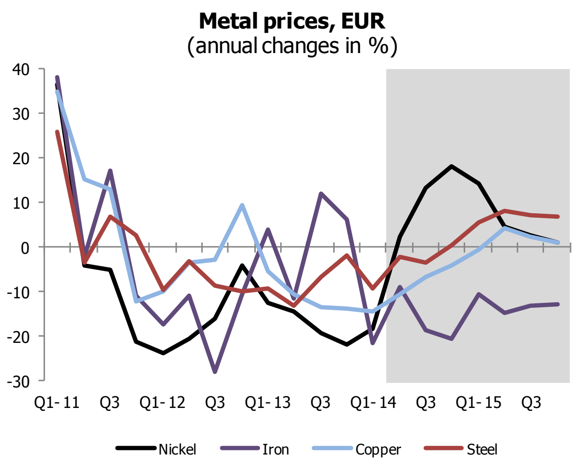
[99] Source of historical data on foreign demand, foreign inflation and exchange rate of the U.S. Dollar against the Euro includes Eurostat and national statistical offices of the countries, while IMF statistics is a source of these data on prices of oil, food and metals. Estimates of foreign demand, foreign inflation and foreign exchange rate of the U.S. Dollar are based on Consensus Forecast, while projections of prices of oil, food and metals are based on the Bloomberg's projections.
[100] World Economic Outlook, IMF, April 2014.





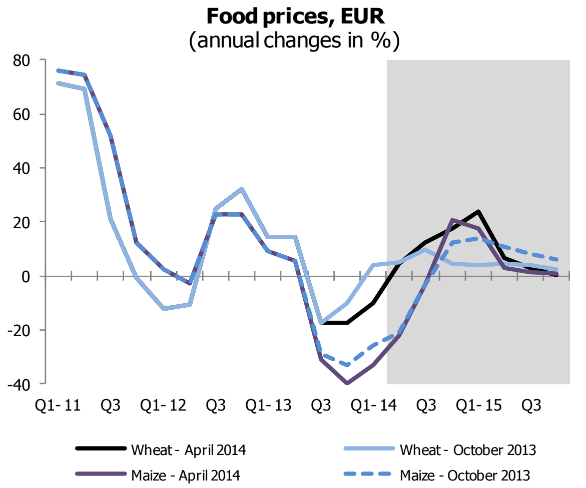


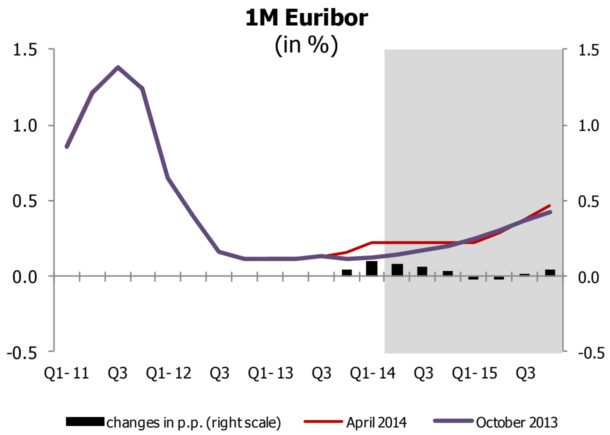
expected that foreign prices will increase by 1%, instead of 2% as expected earlier. This deviation is due to the downward shift in inflation projections for all of our import partners. Moreover, taking into account their individual significance, the largest contribution to the downward revision comes from Serbia, followed by Croatia, Germany and Bulgaria. It is expected that foreign inflation in 2015 will be moderately lower than projected in October. Thus, instead of 2.2%, it is expected to be 1.8% amid lower contribution of almost all partner countries to the headline inflation.

Compared to October, there are significant differences in the projection of the U.S. Dollar/Euro exchange rate in 2014, which is now expected that the U.S. Dollar will depreciate by 1.2% against the Euro, rather than appreciate by 3.2% as previously assessed. This corresponds with the significantly lower inflation in the euro area than in the U.S. and increased capital flows within the monetary union. However, expectations for gradual tightening of monetary policy by the Fed in 2015 would contribute to appreciation of the U.S. currency, which would be higher than the October projection (0.6%) and would equal 3%.

In the first quarter of 2014, the oil price was lower than projected in October, despite the pronounced geopolitical tensions and disturbances on the supply side. Moreover, given that the crisis in Ukraine have not actually caused distortions in the production and delivery of oil, the price of crude oil is expected to decline steeply throughout the year than assessed in October (-3.2% vs. -2.3%). This projection largely relies upon market fundamentals, i.e. sufficient supply and lower demand for oil. Concerns about the effects of the slow pace of China's economic growth on global oil markets continued to have downward impact on oil prices. Furthermore, it is expected that the decline in oil prices will continue in 2015, but slowly than expected in October (-1.6% vs. -4.7%). In nominal terms, in 2014, oil price is expected to amount to Euro 79.3 per barrel, and to reduce to Euro 78 in 2015. Upheavals in Ukraine and possibly tighter international sanctions to Russia would increase the risk of potential distortions in global oil markets, which is one of the major risk factors for instability in world energy prices in the future.

In the first quarter of 2014, metal prices dropped faster than projected in October, amid sluggish demand from China and tight lending terms. Moreover, compared with October, downward revisions of growth rates





of prices of most analyzed metals were made for 2014. The largest change was made in the projection of the price of iron, which is expected to be greatly reduced compared to October, mainly due to highly accumulated stocks. Strong decline, rather than the projected growth will be registered by prices of steel and copper, given the weaker demand and higher supply. In 2014, only the nickel price is expected to rise, rather than fall as projected, due to the export ban imposed by Indonesia and concerns of a possible reduction of supply from Russia. As in October, further favorable developments in the global metal market are expected for 2015, where it is expected that all metal prices will rise strongly than projected. The exception is iron, which will decline faster than assessed recently.

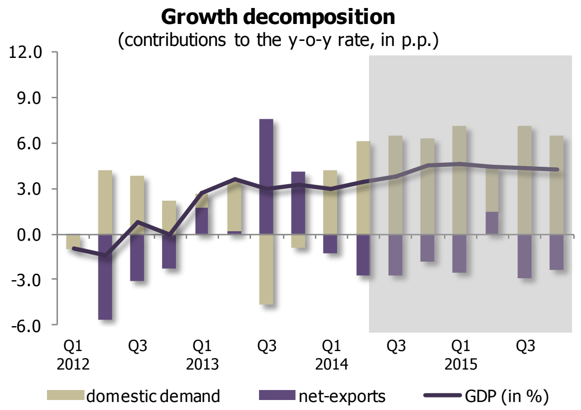
Downward trend in food prices, which began in the second half of last year continued in the first quarter of the year. Annually, in 2014, it is expected that prices of certain foods will change in a different direction. Thus, it is projected that the price of corn will go down slightly faster than projected in October, given the improved yield prospects for the new crop. On the other hand, the price of wheat will go up as projected in October. Major risks to food prices this year relate to the effects of drought in parts of the U.S., geopolitical tensions between Ukraine and Russia, and adverse weather conditions in parts of South America. According to the recent assessments, for 2015, it is expected higher growth in wheat prices and lower growth in prices of corn, compared with the October projection.

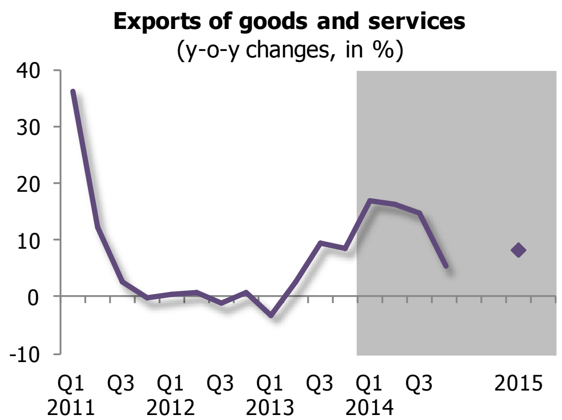
After the growth at the end of last year and early this year, **EURIBOR**[101] is expected to be stable for the remainder of 2014, but will be little higher than projected in October. In accordance with the stabilization of money market, EURIBOR will gradually increase in 2015, and on average, it is expected to be slightly lower than the October projection.

5.2. Forecast and Effects on Monetary Policy

The latest projections indicate absence of major changes in the monetary policy setup. The new estimates for the external sector also show a space for growth

[101] Historical data were taken from Eurostat. Consensus Forecast was a source for the projection for 2014, and Bloomberg was used for 2015.

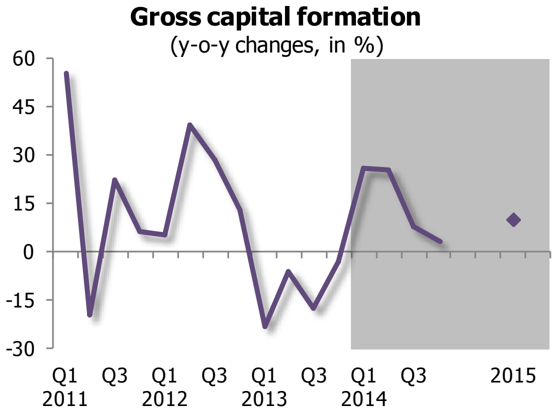


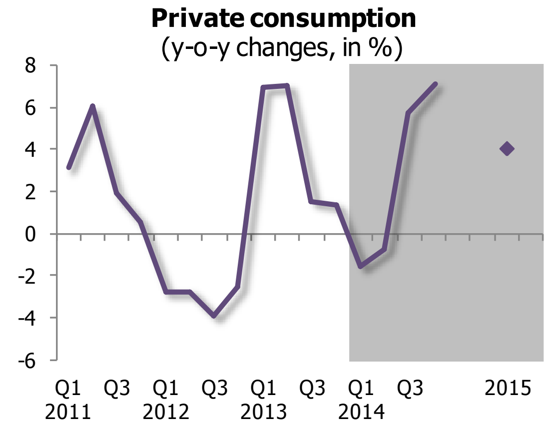


of foreign reserves in the next period and their maintenance at an appropriate level. Although it is expected that in the further period the stronger demand in the economy will create an import pressures, however, they are not expected to cause major external imbalances. Also, it is estimated that the increasing utilization of the potential of new facilities with foreign capital will, to some extent, mitigate the effects on imports caused by the growth of exports and by the growing investment and personal consumption. For the next two-year period, borrowings and direct investment are expected to be sources of funding the needs for external financing, in a volume sufficient for further accumulation of foreign reserves. Therefore, it is expected that capital inflows will help to maintain an adequate level of foreign reserves. **No major changes have been registered in this projection of foreign interest.** Given the low levels of inflation in the euro area and the ECB's firm assurance to keep on with extremely relaxed monetary policy, EURIBOR is expected to remain well below the historical average, gradually increasing in the period ahead, similar to the October assessments. Risks to the baseline macroeconomic scenario are similar to those of the October cycle projections. Amid still present uncertainty about global recovery, there are risks to the external position of the economy, which could spill over through multiple checkpoints. These risks point to the need for continuous monitoring of possible changes in the external and domestic economic conditions in the future and taking prompt and appropriate measures.

In the last quarter of 2013, the growth of economic activity continued, with the GDP growth being within the projections and reached 3.1%. Considering the available high frequency indicators, it is assessed that economic activity will also increase at a similar pace in the first quarter of this year. Thus, on average, **for 2014, the GDP growth is projected at 3.7%.** Given the positive contribution of all components of domestic demand and exports, **it is expected that growth will accelerate in 2015 and reach 4.4%.**

Export activity has been enhancing for several quarters in a row, which is consistent with structural changes and diversification in the export sector. Consequently, **it is expected that the increasing real export will be the major driver of economic growth this year and in 2015,** given the increasing utilization of existing capacities and opening new production facilities in the free economic zones, but also due to the



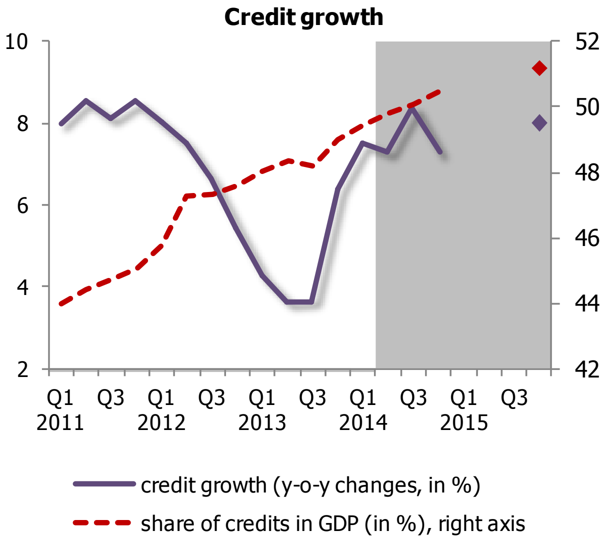


revival of economic activity among major trading partners, after the unfavorable movements in previous years.

After the decline in 2013, domestic demand is expected to recover in 2014, and almost all of its components will make relatively high positive contribution to economic growth. Analyzing individually, the assessment is that after dropping last year (due to reduced inventory) **investment spending will achieve double-digit growth,** which will contribute the most to the growth of domestic demand. It is expected that the growth of investment will largely be supported by ongoing and announced investments in public infrastructure, as well as the expected entry of foreign direct investments and their positive effect on investments in equipment and machinery. The growth of investments in construction is also illustrated by data on high annual real growth in the value of construction works in the first quarter. Expectations for higher investments are also based on the assessments for more visible improvement in global economic activity and, consequently, the expectations for positive knock-on effects on the demand for domestic exports. The lower base in 2013 will have some effect on the high growth of investments.

In 2014, private consumption is expected to rise, but somewhat slowly than in 2013. In terms of private consumption determinants, the growth is largely explained by the expected positive labor market developments or the rise of real wages and employment. These estimates derive from announcements for wage increases in public administration, which amid low inflation, will increase the purchasing power of this category, as well as from the expectations for increase of employees in the private sector, given the strengthening economic activity. In addition, household consumption will be further supported by the linear increase of pensions in March and the announced second increase in pensions in June. Another factor that will increase the propensity to consume is lending to households through local banks. On the other hand, the reduced inflow based on private transfers will discourage personal consumption in 2014. **In 2015, it is expected that domestic demand growth will enhance amid further growth and increasing positive contribution from personal consumption, which would become one of the key drivers of domestic growth.** Job creation by foreign and domestic companies, as well as through active measures on the labor market, and the growth of

wage bill in the economy and pensions, are factors that will contribute to achieving the high projected growth of household consumption. Given the allocation of public investments in many years and the further strengthening of domestic and external demand, **it is expected that gross investments formation during 2015 will continue to report solid growth rates. After the substantial decline in 2013, it is expected that public spending will moderately increase, which would make a positive contribution to GDP growth during the period of projections.**



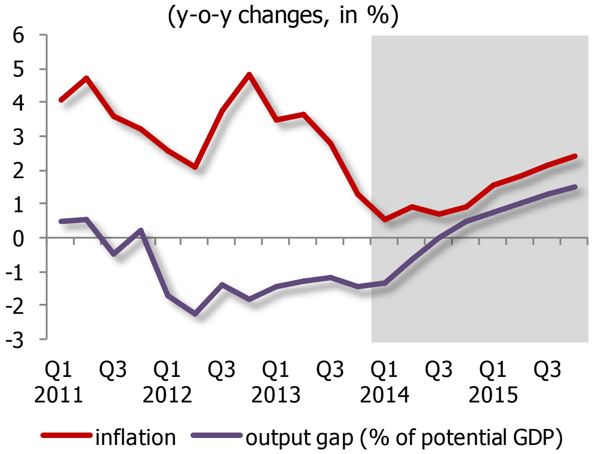
It is expected that the gradual strengthening of domestic economic activity will also accelerate lending activity of the banking sector in the period ahead. Namely, **at the end of 2014, credit growth is expected to reach 7.3% (vs. 6.4% in 2013), while in 2015, the total credits would increase by additional 8%.** Strengthening of credit growth is in line with the estimates for the banks' greater confidence in the recovery of the domestic real economy and improved perceptions for the risk profile and creditworthiness of economic agents. Moreover, it is expected that the current NBRM's stimulating standard and non-standard measures will provide additional positive impulses for lending in the future. Credit support will also result from the exercise of the fourth stage of the EIB credit line of Euro 50 million during 2014. There are also signals for greater need for lending coming from the demand side, given the improving labor market and consequently, increasing consumer spending and corporate investments. **In terms of deposit potential, as a major source of loan funding, it is expected that in 2014 and 2015, the deposits in the banking system will further grow.** After the deposits growth of 5.5% in 2013, in 2014, they are expected to increase by 9.2%, while in 2015, the total deposits would increase by 10.3%, which is consistent with the expected favorable trends in the national economy.

In 2014, real imports are expected to register a significant growth, compared to the decline in 2013. Key factors for the growth of imports would include the rising export and investment demand, and the growth of consumer spending. **Certain deceleration in imports and a decline in its negative contribution to the growth is expected in 2015. During the period of projections, there were expectations that the contribution of net exports to the growth will constantly be in**

Balance of Payment Forecast (% of GDP)

	2010	2011	2012	2013	2014	2015
Current account	**-2.0**	**-2.5**	**-3.0**	**-1.9**	**-4.0**	**-5.8**
Balance of goods & services	-20.0	-20.8	-22.9	-19.6	-20.9	-21.3
Goods, net	-20.5	-22.1	-23.6	-20.6	-21.1	-21.3
Services, net	0.5	1.3	0.6	1.0	0.2	0.0
Income, net	-1.4	-1.8	-2.0	-2.4	-2.3	-2.9
Current transfers, net	19.4	20.0	21.9	20.0	19.2	18.4
Private transfers, net	18.9	19.0	21.1	19.5	18.5	17.7
Capital account	**0.2**	**0.1**	**0.3**	**0.2**	**0.0**	**0.0**
Financial account	**1.9**	**6.0**	**4.0**	**0.7**	**3.1**	**7.8**
FDI, net	2.2	4.5	1.0	3.3	4.0	4.5
Portfolio Investment, net	-0.8	-1.0	1.0	-2.1	-0.3	-1.7
Other Investment, net	0.4	2.6	1.9	-0.5	-0.6	5.0

Inflation
(y-o-y changes, in %)



the negative zone, but that it will moderately reduce between the two years.

During 2014 and 2015, the balance of payments expects widening of the current account deficit to 4.0% and 5.8% of GDP, respectively. The increase of current account deficit is partly due to the expected ***increase of foreign trade deficit (20.9% of GDP, compared to 19.6% of GDP in 2013).*** Namely, in this period, import demand is expected to boost, given the higher import of row materials for exports, and the second-round effects on imports from the stronger domestic demand. On the other hand, the expectations of higher output and improved export performance of new industrial facilities, as well as the gradual economic recovery globally, indicate the possibility of nominal growth of *exports of goods and services*. Amid assessments for stabilization of current transfers, it is expected that their share in GDP will decline in the next two years and will further deteriorate the current account deficit.

Main sources of financing the current account deficit in 2014 are long-term stable capital flows, i.e. expected foreign direct investments and projected net borrowing abroad in the long run. It is expected that direct investment will reach 4% of GDP (compared with the 3.3% of GDP in 2013). **Main risks** to the external position of the economy in this period still come from the pace of global, and thus, domestic economic recovery and its impact on the perceptions of investors. However, the possible greater amount of funding from external sources for government financing may be a positive risk to the size of capital inflows. **Higher capital inflows are expected for 2015, as well,** which would be generated amid further moderate growth of direct investments (of 4.5% of GDP), and significantly higher external borrowing, primarily by the government.

In 2014, it is expected that higher current account deficit relative to the projected capital inflows will lead to a moderate reduction of foreign reserves. Given the growth of capital inflows, in 2015, foreign reserves are expected to resurge.

It is expected that the inflation of the domestic economy in 2014 will significantly slow down and swing around 1%. During this year, changes in inflation are primarily attributable to the spillover effects of changes in world prices, at a time when domestic demand is still not creating price pressures. The reduction of pressures on domestic prices reflects the lower pressure from foreign effective prices and the downward trend in prices of food and energy. The current projection for domestic inflation does not include the growth assumption of regulated price of electricity. The risks clouding inflation projection for the most part incorporate the uncertainty of the effects of weather factors and the resolution of the political crisis in Ukraine on the price of primary products[102]. However, for now, the concerns about the projected risks are assessed as predominantly downward. **By strengthening the domestic economy, it is expected that inflation in 2015 will gradually increase, and would range around 2%, on average, i.e. would be close to the historical average.**

5.3. Comparison with the Previous Forecast

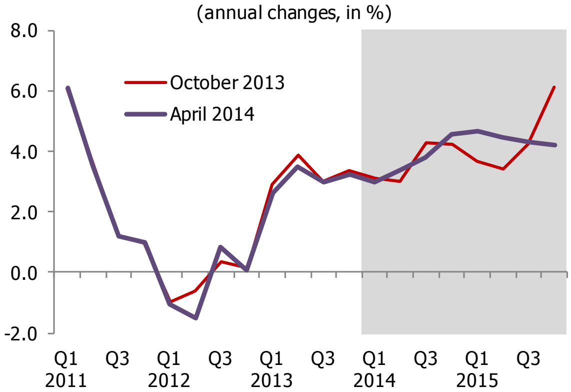
The projections for the growth of domestic economy in the period 2014-2015 remain unchanged compared with October assessments. On the other hand, recent developments and assessments indicate a lower rate of inflation in 2014 and its maintenance at the assessed level for October 2015. As in October, in this cycle projections, assessments again suggest expanding of the current account deficit in 2014 and 2015, with changes in the size of expected deficit. Also, the assessments for growth of capital inflows over the next two years are still valid. Their aggregate share of GDP in the period of projections is similar to October assessments, but with change in time allocation. The cumulative growth of foreign reserves in 2014 and 2015 are now assessed as slightly lower than projected in October.

Forecast of selected macroeconomic variables

annual rates of change (in %)	**2014 forecast**		**2015 forecast**	
	Oct.	**Apr.**	**Oct.**	**Apr.**
GDP	**3.7**	**3.7**	**4.4**	**4.4**
Personal consumption	3.9	2.6	3.9	4.0
Gross capital formation	11.0	14.6	9.9	9.7
Public consumption	0.5	0.5	1.0	1.0
Exports of goods and services	11.8	13.1	11.7	8.2
Imports of goods and services	11.8	12.6	10.5	8.1
Inflation	**2.3**	**1.0**	**2.0**	**2.0**
Current account deficit (% of GDP)	**-4.6**	**-4.0**	**-5.7**	**-5.8**

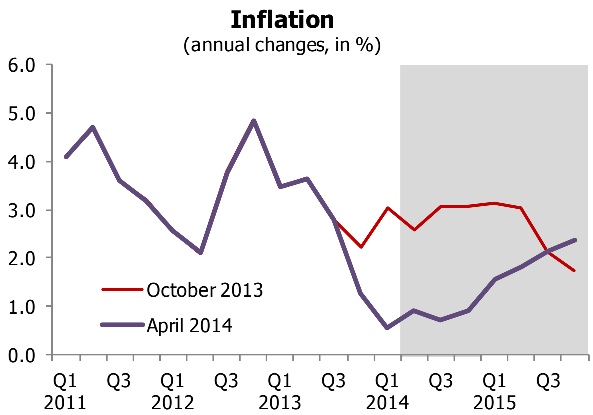
When the economic growth for 2013 is as projected and amid unchanged prospects for the future path of the main factors that affect economic activity, **expectations for GDP growth in 2014 and 2015 remain unchanged compared with October projection, with positive growth rates of 3.7% and 4.4%, respectively.** However, certain change was made within the expenditure components of GDP. Thus, although it is still expected that domestic demand will be the main driver of growth, its contribution will be slightly lower during the projection period. Within the domestic demand, a significant upward

GDP
(annual changes, in %)

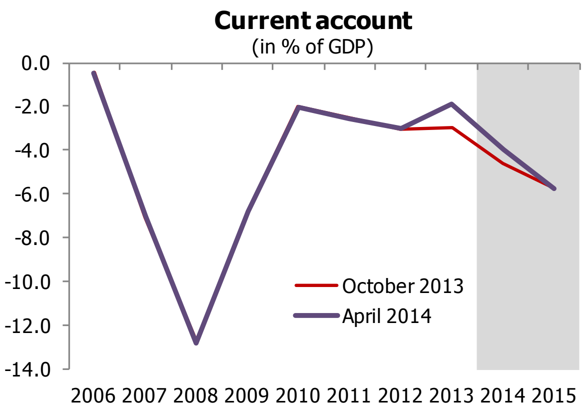


[102] Escalation of the Russian-Ukrainian conflict could greatly destabilize the global market for primary food products, given that Ukraine is the sixth largest exporter of wheat in the world and the third largest exporter of corn in the world. Also, any tougher economic sanctions on Russia and countersanctions could cause shock in energy prices, since Russia is one of the largest producers of oil and gas worldwide.

revision was made in gross investments formation for 2014, making it the main driving force of the overall demand. Investments are minimally revised downward for 2015. On the other hand, slightly slower growth in consumer spending is expected for the entire 2014, amid downward revision of the expected growth in real wages and negative contribution from private transfers. For 2015, it was revised minimally upward. Throughout the period of projections, no changes were made in the estimated growth of public spending. On the other hand, compared with the October projections, the contribution of *net exports* will be less negative in 2014 and 2015.



At the beginning of 2014, the inflation was lower than assessed, due to the more substantial slowdown of the growth of food prices and core inflation and the continued decline in energy prices. Lower performance and expectations for further downward movements in food prices and core inflation, amid persistent downward pressures from import prices, caused **downward revisions of inflation for the entire 2014 compared with the October projection.** Moreover, it is expected that the inflation rate in 2014 will be about 1%, compared to the previous assessments of 2.3%. Amid strengthening of domestic economic activity as projected in October, **the inflation assessment for 2015 remained the same as projected in October, i.e. it is still expected that next year, the rate of inflation will equal 2%.**



Recent estimates for the current account deficit suggest slight downward revision compared with the October cycle projections. Thus, **in 2014 it is expected that the deficit will be 4.0% of GDP, compared to the previously expected 4.6% of GDP.** Such revisions in the current account estimates mainly derive from the projected improvement of trade deficit, amid assessments for improved export performance than previously expected. More optimistic estimates for the export segment of the economy are mainly due to expectations of higher capacity utilization of foreign investors than initially assessed. **In 2015, the current account deficit would be 5.8% of GDP, and compared with October projections (5.7%) it is almost unchanged.** Small corrections were made in the current account structure, i.e. neutral position in the services surplus is expected versus the October projection and increased income deficit. These changes, for the most part, are offset by higher share of private transfers in GDP and improved trade balance.

Within the capital and financial account, lower net inflows are expected in 2014, compared to the October projection. Current assessments of reduced net inflows are explained by less favorable movements in short-term capital flows (currencies and deposits), which given their volatility and uncertainty, are difficult to assess. Despite the improvement in the current account, the assessment of lower capital inflows leads to the expected decline in foreign reserves in 2014, despite the expected low growth as projected in October. For 2015, the level of foreign reserves is expected to continue increasing, at a stronger pace though, compared to the October projection.

Comparison of GDP and inflation forecasts for Macedonia from various organisations

Organisation	Month of publication	**Real GDP growth, %**		**Inflation (average rate, %)**	
		2013	2014	2013	2014
IMF	April 2014	3.2	3.4	1.8	2.3
World Bank	January 2014	3.0	3.5	-	-
European Commission	May 2014	3.0	3.2	2.5	2.3
EBRD	January 2014	3.0	-	2.1	-
Consensus Forecast	April 2014	2.9	3.4	2.5	2.6
National Bank of Greece	April 2014	3.0	3.5	-	-
Ministry of Finance of the Rep. of Macedonia	September 2013	3.2	3.8	3.3	2.7
National Bank of the Republic of Macedonia	April 2014	3.7	4.4	1.0	2.0

Source: IMF World Economic Outlook, April 2014; World Bank Global Economic Prospects, January 2014; European Commission European economic forecast - spring 2014; EBRD Regional Economic Prospects, January 2014; Consensus Forecast, April 2014; NBG Southeastern Europe and Mediterranean Emerging Market Economies, April 2014; Ministry of Finance of the Republic of Macedonia, 2014 Budget of the Republic of Macedonia and Fiscal Strategy 2014-2016, September 2014; and the National Bank of the Republic of Macedonia.