

National Bank of the Republic of Macedonia



Quarterly Report July 2016



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Introduction

During the second quarter of 2016, the NBRM increased its policy rate by 0.75 p.p. to 4%. Amid sound economic fundamentals and absence of major imbalances in the economy, the increase in the policy rate was a response to the action of non-economic factors. Increased political instability in the domestic economy, accompanied by organized spreading speculations led to an increased uncertainty and worsened expectations of economic agents, resulting with increased demand for foreign currency and pressures on banks' deposit base. The NBRM intervened on the foreign exchange market with sales of foreign currency and increased the policy rate; additionally in support of the stabilization of expectations, during the second quarter, the NBRM also adopted other measures aimed at stimulating savings, especially in Denars¹. Timely and appropriate measures from the NBRM aimed at dealing with speculative pressures contributed to a gradual stabilization of the situation and reduction in the pressures on foreign reserves. Data on household savings and demand for foreign currency on the currency exchange market towards the end of the quarter provided evident signs of stabilization in the expectations and the confidence of the economic agents. However, the uncertainty remains high, and the risks regarding the future trajectory of the economy, same as in the April forecasting round, are assessed as unfavorable. The uncertainty associated with the domestic political crisis and possibilities for more pronounced spillover in the economic sphere remain high. The risks of the external environment are also negative, and refer to potentially lower growth of the European economy, and generally lower global growth, still present geopolitical tensions, and recent developments related to the United Kingdom referendum are an additional factor in the direction of increasing the uncertainty.

Most of the macroeconomic indicators, available during the second quarter of 2016, indicated retention of the solid fundamentals of the domestic economy. Thus, the decrease in **domestic consumer prices**, driven by the decrease in world prices of primary commodities, continued in this period. On the other hand, core inflation remained in the positive zone, indicating an assessment of the short-term nature of the downward adjustment of the general price level, without major risks to its incorporation in inflation expectations in the coming period. During the first quarter, **the gross domestic product** continued to grow at a solid pace, although relatively slower compared to last year's growth. The high frequency indicators in the second quarter indicated continuation of trends in individual sectors, but at a slightly slower pace. During the second quarter, economic activity was supported by solid **lending activity** provided by the banking sector. **Foreign reserves**, despite their decline because of the interventions of the NBRM, remained at an appropriate level, with enough buffer to deal with shocks.

Despite the continuity of relatively favorable developments, certain deviations from the baseline scenario of the April forecasting round were evident in some key macroeconomic variables. In the first quarter, **gross domestic product** registered an annual growth rate of 2%, which was lower than expected in the baseline scenario of the April forecasting round. This scenario expected real GDP growth of 3.5% and 4% in 2016 and 2017, respectively, where the export sector and the investments were assessed as main sources of the expected growth, which will generate positive spillover effects on the labor market and will further encourage household consumption. In the first quarter, the analysis of the GDP structure shows that the export is in line with expectations and is the main generator of the growth, which is mainly associated with the activity of capacities in the industrial development zones. Accelerated export growth in the first quarter, amid moderate growth of imports, led to a positive contribution of the net export demand to the growth. Among the components of domestic demand, private consumption made the highest positive contribution, amid favorable labor market developments, low consumer prices and further credit support to the households. Public consumption also registered growth in the first quarter. On the other hand, contrary to the expectations, gross capital formation decreased, which is the main factor explaining the downward deviation of GDP from the forecast. The fall in investments does not correspond to favorable developments in high-

¹ More detailed information is contained in Box 1. Timeline of the changes in the setup of the NBRM monetary instruments and selected supervisory decisions adopted in the period 2013 - 2015 from the publication Recent Macroeconomic Indicators - Review of the Current Situation, June 2016.



frequency indicators of investment demand. Most available high frequency data for the second quarter of the year point to keeping the economy in the growth zone, but probably slower than observed in the first quarter. **Same as in April forecast, risks around realization of the baseline macroeconomic scenario remain unfavorable**, referring to the uncertainty associated with the domestic political developments and the uncertain external environment. The materialization of these risks, amid simultaneously lower GDP performance in the first quarter and signals for deceleration of growth in the second quarter of the year, indicates possibility of lower GDP growth for 2016 compared to the forecasted with the baseline scenario. In such circumstances, the pace of growth of economic activity would be closer to the expected growth of 1.6%, in line with the alternative scenario of the April forecasts in which the negative effects of the continuation of the domestic political crisis were incorporated.

During the second quarter, domestic prices decreased annually by 0.7%, on average. This is a slight downward deviation from the April projections, caused by the higher than expected annual decline in food prices. Besides food prices, energy prices continued to decline in the second quarter. Changes in domestic food and energy prices are mainly attributable to factors on the supply side, i.e. to the decline in import energy and food prices, which directly affects domestic prices. In contrast, core inflation, same as in the first quarter, remained in the positive zone, though the pace of growth is somewhat slower. In line with the recent performances, amid ongoing global environment of low primary commodities prices, **prices for 2016 and 2017 are expected to increase by 0.5% and 1.6%, respectively**, without major expectations for deviating from the projected path of movement in the prices. The inflation projection is still accompanied by risks, mainly related to the movements in the world prices of oil and food, as well as to the growth of the domestic economy.

The external sector data indicate a small current account deficit of Euro 10.7 million (0.1% of GDP) in the first quarter of 2016, which is a slightly better performance compared to the baseline scenario the April forecast, mainly due to the balance of goods and services. On the other hand, the financial account registered net inflows of Euro 31.1 million (0.3% of GDP), which is in line with the April expectations. In the second quarter, **gross foreign reserves** declined on a quarterly basis, contrary to the April forecast for small growth, showing weaker balance of payments position compared to the forecast. The available external sector data for the second quarter are not still sufficient to draw complete conclusions about the balance of payments position compared to the April forecast. However, so far the available data show that in one part the deviation derives from the weaker current account, amid slightly higher than expected trade deficit and downward deviation in private transfers (smaller net purchase on the currency exchange market). In terms of transfers, the deviation in this period was largely due to non-economic factors associated with the escalation of the domestic political crisis. The unstable political environment influenced for emergence of speculations about the devaluation of Denar exchange rate and the stability of the banking system, which caused a high propensity of households for holding foreign currency. These movements are the reason for the high outflows in the category currency and deposits, which are one of the key factors for achieving lower than expected net inflows in the financial account. Amid increased demand for foreign currency from non-economic reasons, the NBRM intervened in the foreign exchange market by selling foreign currency from reserves, which closed the gap between supply and demand. Despite the realized decline, the assessments of adequacy indicators show that foreign reserves remain in the safe zone and they are at a sufficient level for dealing with possible future unforeseen shocks in the economy. **The basic April projection envisages moderate growth of foreign reserves on a cumulative basis for the period 2016-2017.** However, recent performances suggest materialization of part of the assumptions covered with the alternative scenario about the possible effects and the transmission channels of the negative shock of the political crisis. The alternative scenario assumes a decrease in foreign reserves, amid retention of all foreign reserves adequacy indicators in a conformal zone. Unfavorable external sector risks are still present and are attributable to the uncertainty associated with the political situation in the country and the intensity of recovery of the global economy.

In the second quarter of the year, **credit activity of the banking sector** registered a decline on a quarterly basis, which was concentrated in loans to the corporate sector, while credit support to households continued to grow. The reduction in the overall credit activity in this period resulted from the transfer of part of doubtful and contested claims of banks to off-balance sheet record, according to the



Decision of the NBRM from December 2015². The effects of this decision were felt most intensively in June, when total loans registered a significant decline on a monthly basis. If the effect of the transfer is isolated, in June, there was again solid growth of lending in both households and the corporate sector. Given these changes, the annual growth rate of total loans equaled 3.5% at the end of June, which is below the April projection for the second quarter of the year (of 7.6%). However, the estimates for loans without the transfer suggest significantly higher annual growth of loans of 7.7%. In the second quarter, **deposit base** decreased on a quarterly basis as a result of the deteriorating confidence of economic agents due to the political turmoil in the country. Analyzed by sector, the decline was mostly due to the withdrawal of household deposits from banks. Analyzed by months, reduction in household deposits was realized during April and May, while for June, there was modest growth for the first time after two months, signaling a gradual stabilization of the situation. On an annual basis, total deposits in June grew by 2.3%, which is still significantly below the forecasted growth of 6.6% for the second quarter of 2016. Assuming normalization of the political environment and stabilization of expectations and confidence of economic agents, total deposits are expected to grow at a rate of 6-7% in 2016-2017, which will enable strengthening of lending activity and credit growth of about 7% in this period. On the other hand, the incorporation of political risks within the alternative scenario results in significantly lower projections for the growth of loans (3% in 2016 and 5% in 2017) and deposits (2.3% in 2016 and 4% in 2017).

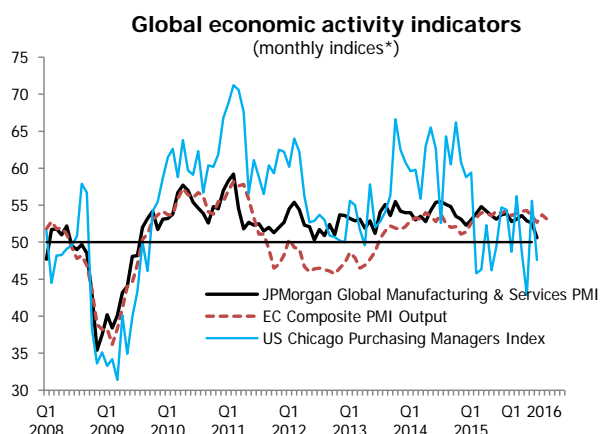
In summary, despite the indications of possible deviations from the baseline scenario for some key variables for the monetary policy, the assessments for soundness of the economic fundamentals remain positive. Economic activity data point to further growth, although slower compared to previous performances. Recent data on banks' deposit base and demand for foreign currency on the currency exchange market signal a gradual stabilization of expectations and confidence of economic agents, undermined by the domestic political instability. Foreign reserves continue to be maintained at an appropriate level despite the negative shock in the second quarter, amid prolongation of the resolution of the domestic political crisis and its spillover into the domestic economy. **The risks to the economy are still assessed as unfavorable** and are mainly associated with the domestic political crisis, along with the external risks previously highlighted in the April forecast. New risk in this context is the United Kingdom referendum voting to exit from the European Union, which could have adverse consequences for the British and European economy. **Taking all this into consideration, the NBRM will continue to closely monitor the developments in the period ahead, and if necessary, it will make further adjustments to the monetary policy conduct for the purpose of successful achievement of the statutory established goals.**

² On 17 December 2015, the National Bank Council adopted the Decision on amending the Decision on credit risk management that requires from banks by 30 June 2016 to write off (and to continue to write off) all claims that have been fully booked for more than two years, and where the bank has identified and fully covered the credit risk of default at least two years before. Despite the write-off of these claims, i.e. their transfer to the off-balance sheet record, banks reserve the right for their collection.

I. Macroeconomic developments

1.1. International economic surrounding³

The growth of the global economy continued in the beginning of 2016, but at a more moderate pace. In the first quarter, there are divergent developments in the group of advanced economies, amid acceleration of growth in the euro zone and a moderate slowdown of growth in the US economy. However, the recovery in the developed economies continues further, supported by low oil prices, relaxed monetary policy, improved labor market and alleviation of the adverse effects of the private sector deleveraging and the government. In terms of emerging economies, the economic outlook varies by countries, but in general the estimates for the whole group show further slowdown of the growth pace as a result of the weak performance of countries exporting primary commodities, slower growth of the Chinese economy, and due to the present political uncertainty in individual economies. Risks around global economy remain unfavorable and mainly associated with developments in the emerging economies, geopolitical risks, the normalization of the Fed's monetary policy, and the Brexit made great contribution to the unfavorable environment. Global inflation has still been maintained at a low level, whereby in a number of countries, inflation rates are below target rates of the central banks. The movements of market prices of primary commodities in recent period suggest possible upward pressures on the global inflation in the next period.



*The PMI index reflects the percentage of respondents that reported better business 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: Markit, ISM-Chicago.

Global economic activity continued to recover in the beginning of 2016, but at a more moderate pace. High-frequency survey indicators of economic activity - PMI⁴ suggest moderate deceleration of the world economic growth at the beginning of 2016, as well as increased economic volatility. Namely, in the period January - March 2016, the global composite PMI averaged 51.5 index points, which is lower than the average in 2015. The index continued to decline in the period April-May, pointing to still fragile economic recovery, especially in the manufacturing industry and the services sector.

In terms of the group of developed economies, economic performances vary by individual countries. Thus, there were positive developments in the dynamics of economic activity in the Euro area and Japan, while Great Britain and the US registered a moderate slowdown in the quarterly GDP growth in the first

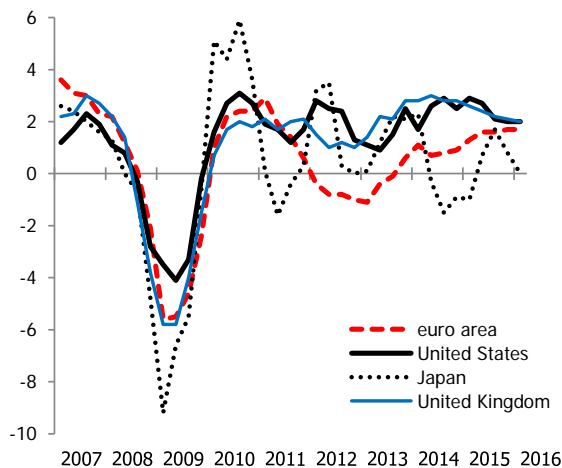
³ The analysis is based on the ECB's Economic Bulletin; the monthly reports of Deutsche Bundesbank; the announcements of "Markit Economics"; "Economic Prospects" of the OECD; "Roubini Global Economics" and "Capital Economics" reports and the weekly reports of the Bank of Greece.

⁴ PMI (Purchasing Manager's Index) is based on surveys of a representative sample of companies from the manufacturing and service sectors, and are often used as high frequency indicators for the current and future economic activity.



Real GDP growth in advanced economies

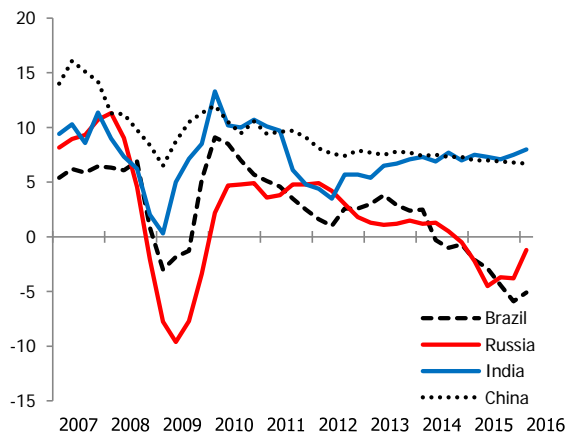
(year-on-year percentage changes; quarterly data)



Source: OECD.

Real GDP growth in emerging economies

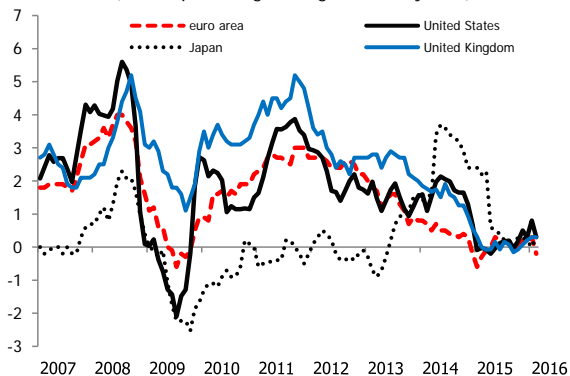
(year-on-year percentage changes; quarterly data)



Source: OECD and IMF.

Inflation in advanced economies

(annual percentage changes; monthly data)



Source: Eurostat and national statistical offices.

quarter. **There is heterogeneity in economic performance of emerging and developing economies**, which partly reflects the different impact of the growth in world prices of primary commodities on exporting and importing countries. The growth in the Chinese economy slowed down moderately, but is still high and supported by low energy price, the growth of private consumption and the relatively stable demand from developed countries. The Brazilian and the Russian economy still face challenges of low prices of primary commodities, as well as political instability, particularly pronounced in Brazil.

Risks around global growth in the next period, are mainly unfavorable and mostly related to developments in emerging economies. The slowdown of growth in China is one of the major adverse risks, complemented by the recession in some other emerging economies. This applies especially to Brazil, economy which in the beginning of 2016 entered into a deeper recession, as a result of the decrease in prices of stock exchange products, but also the political crisis that is faced with. Also, risk factors for the global growth in the next period include geopolitical risks associated with the developments in the Middle East, i.e. the threat of terrorist attacks, as well as the effects of the change of the Fed monetary policy on the financial markets. At the same time, the Brexit further increases the uncertainty and downward risks to growth, especially for European economies.

In the first quarter of 2016, the available data show a moderate acceleration of global inflation, present both in developed and in emerging economies and developing countries, mainly because of the rise in oil prices. The average global inflation equaled 3.2% in the first quarter, compared to 2.6% in the previous year. According to the latest estimates, starting from the second half of 2016, there are possible moderate inflationary pressures, especially after the decline in the base effect from the low energy price.

In the first quarter of 2016, economic activity in the euro area continued to recover, reaching the highest GDP growth from 2008. Real quarterly GDP growth equaled 0.6%, while on annual basis, the growth was 1.7%. The growth was mostly driven by growth of private consumption, supported by the higher purchasing power of households, primarily as a result of the favorable labor market



developments, low oil prices, as well as easing of the monetary policy by the ECB. As in the previous quarter, gross capital formation made a positive contribution to growth, but with less intensity. The unemployment rate in April 2016 further reduced to 10.2%, the lowest level since mid-2011. Yet, the unemployment rate has been declining slowly, so it is estimated that it requires a longer period before it reinstates to the pre-crisis levels. The deceleration of growth in the emerging economies and the reduction in global trade had repercussions on the demand for European products that had a negative contribution of net exports to growth. Analyzing individual economies, Spain has registered continuous trend of gradual economic recovery with solid quarterly GDP growth (0.8%), fueled by increased domestic demand. At the same time, Germany and France realized solid growth rates of 0.8% and 0.7% respectively, while Italy had a weaker quarterly performance with modest 0.3%.

In the second quarter of 2016, inflation in the euro area remained low and well below the targeted rate of 2%. Namely, in the second quarter, the average annual inflation rate amounted to -0.1%, and is lower compared with the annual growth in the first quarter of 2016. Such performance results mainly from the energy component of the index, while core inflation grew by 0.8% in this period. In the second half of 2016, the base effects from the low price of primary commodities are expected to be reduced, and hence the inflation rate to be positive.

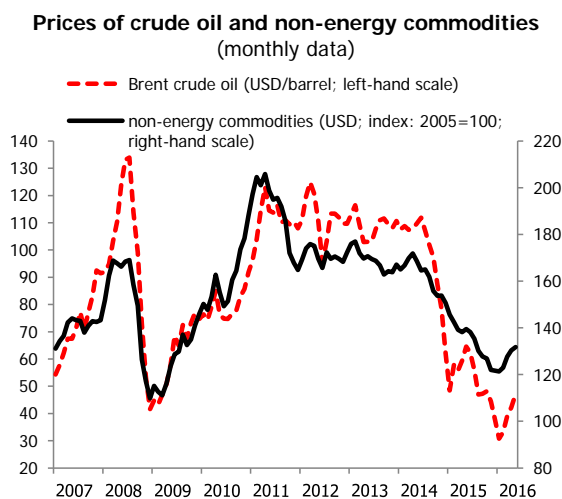
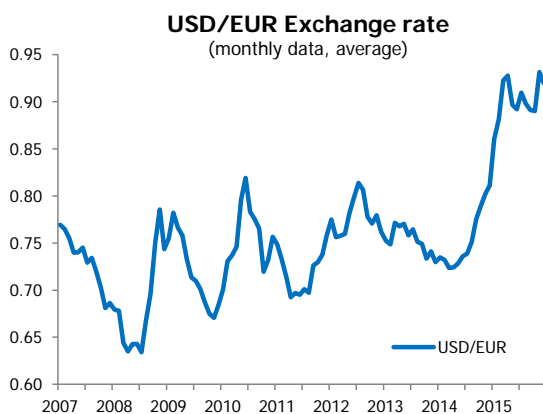
In the second quarter of 2016, the central banks of developed countries continued to implement accommodative monetary policy, whereby no major changes were made in the monetary setup. At the regular meetings in April and June 2016, Fed maintained its key interest rate unchanged, amid mild slowdown of the economic growth, improved conditions in the labor market and inflation rate significantly lower than expected. In the first quarter of 2016, the faster economic growth in the euro area countries, as well as the reduction of unemployment led the European Central Bank (ECB) to keep the level of the key interest rate unchanged and not to take further changes in the monetary policy setup. However, in the period April-June, the ECB implemented the package of measures announced at the meeting in March 2016, when several decisions aimed at further easing of the monetary policy were adopted in order to encourage economic



growth and bring the inflation closer to the target of 2%. Thus, in April, the amount of the monthly purchase of bonds under the quantitative easing program increased (from Euro 60 to Euro 80 billion), and from 8 June, the Corporate Sector Purchase Programme started to be implemented. The first targeted longer-term refinancing operation (TLTRO II) started to be implemented towards the end of June.

The Bank of England has not made significant adjustments in the monetary policy, i.e. it kept the level of 0.5% of the key interest rate, whereby there was no change in the asset purchase program. The Bank of Japan maintained its key interest rate at the same level, but at the meeting in March 2016, it took an additional measure aimed at easing of the monetary policy by increasing the amount of purchase of exchange traded funds in order to achieve the inflation target of 2%.

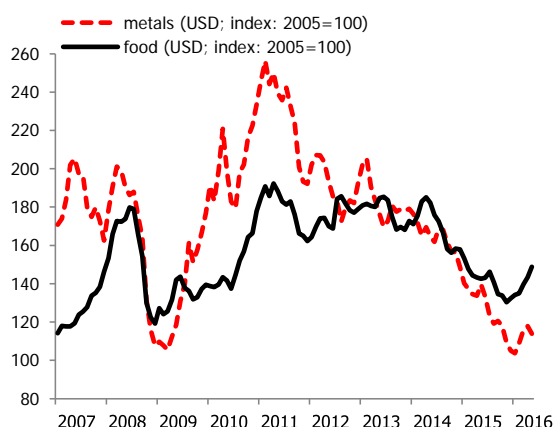
Volatile movements of the nominal exchange rate of the US dollar against the euro continued in the second quarter of 2016. Similar to the first quarter, when the US dollar depreciated by 0.6%, during the second quarter, the US dollar depreciated by 2.4%. Annually, the US dollar against the euro remained at the approximately same level, and in June 2016, one US dollar was exchanged for 0.8906 euros.



The upward trend in oil price that started in February 2016 continued in the second quarter of 2016. Namely, analyzed in euros, in the second quarter of 2016, the price of oil reached an average price of 40.7 euros per barrel, which is an increase of 30.6%, compared to the first quarter of 2016. The rise in oil prices is a result of the moderate reduction in the world oil supply (problems with production in Iraq, Nigeria and the United Arab Emirates), as well as higher demand than expected, especially in India and other Asian countries. However, the oil supply on the global market remains high, as a result of the disunity of the OPEC countries that most likely will not reach an agreement on significant production cuts, as well as the removal of sanctions on Iran by the United Nations. Starting from February 2016, prices of non-energy primary commodities in euros started to grow moderately. Thus, in the second quarter of 2016, the prices of non-energy primary commodities grew by 4.1%, compared to the first quarter of 2016. Analyzed by groups, in

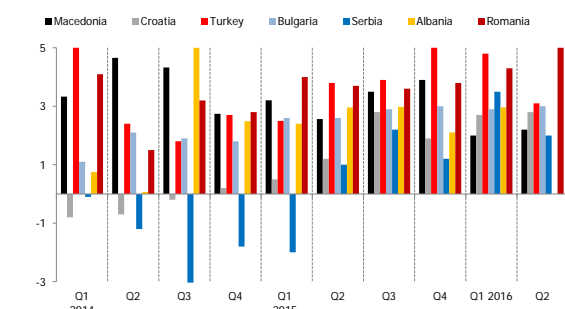


Prices of food and metals
(monthly data)



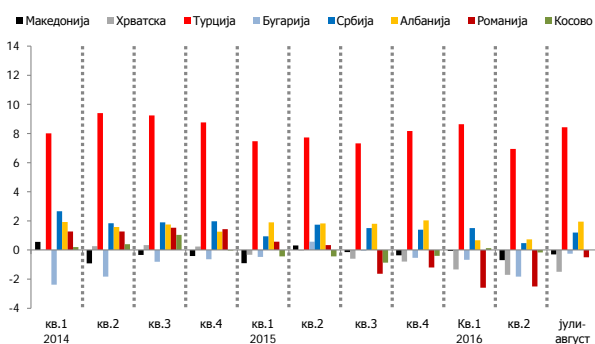
Source: IMF monthly database.

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



Source: Eurostat and national statistical offices.
* According to ESA 2010 methodology, except for Turkey and Albania.

Стапки на инфлација во земјите од регионот
(годишни процентуални промени)



Извори: Еуростат и национални статистички заводи.

the second quarter, growth was higher in food and amounted to 6.8%, while growth in metal prices was lower and amounted to 2.6%. Generally, the rise in metal prices is a result of the increased global demand.

The trend of recovery and strong economic performance in the region continued in the first quarter of 2016. Thus the Serbian economy registered an annual growth of 3.5%, which is the highest growth in the past two years. The growth is mostly driven by exports of goods and services by 11.4%, as well as gross capital formation by 7.9%, amid moderate growth of private consumption and government consumption. In the first quarter of 2016, similar to the Serbian economy, the Croatian economy recorded solid economic growth of 2.7%, driven by export and domestic demand. Same as in the preceding quarter, solid economic growth of 2.9% was also recorded in the first quarter of 2016 in Bulgaria, whereby, gross capital formation made the largest contribution to growth. The Romanian economy continued reporting solid performance (growth of 4.3%), the highest level in the European Union (with the exception of Malta).

Low inflation was characteristic of the region in the second quarter of 2016. Measured by consumer prices, most countries in the region reported negative inflation rates or rates close to 0%. Downward changes in the energy component are the underlying factor for the deflationary movements, but the deflation movements in the non-energy component also have a negative contribution (especially prices of food and transport).

1.2. Domestic supply

The growth of the domestic economy continued in the first quarter of 2016, but at a slower pace. Thus, in the first quarter, GDP registered real annual growth of 2%, while on a quarterly basis, a decline of 0.8% was registered. In terms of the growth structure, in the first quarter, construction sector was the driving force, whose growth is mainly associated with the activities in the field of road infrastructure, and trade, transport and communication sector and catering



sector. On the other hand, in the first quarter, data point to annual and quarterly decline in value added in the industrial sector, unlike the high-frequency indicators of the physical volume of industrial production which show solid growth of the activity in the industry. The available data for the second quarter signal a continuation of positive trends in the main economic sectors, but at a slower pace of growth.

In the first quarter of 2016, the gross domestic product registered decline of 0.8% on a quarterly basis (seasonally adjusted), while on annual basis increased by 2%, which is a significant slowdown of growth, compared to the previous quarter. Most economic sectors recorded growth of added value, and the highest positive contribution was made by trade, transport and communications and catering and construction. On the other hand, in the first quarter of the year, the industry registered a decline in the value added, contrary to the growth in the previous quarter.

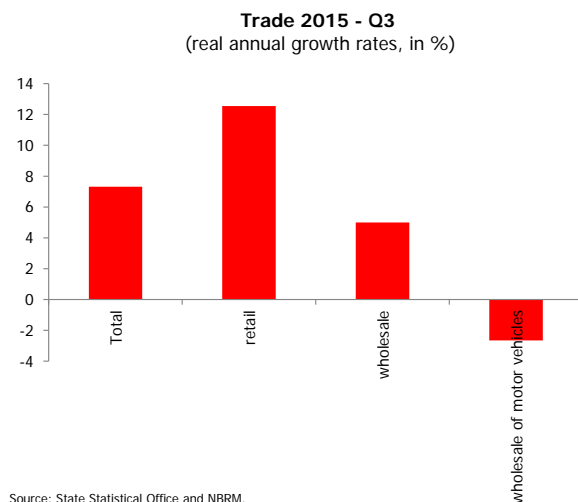
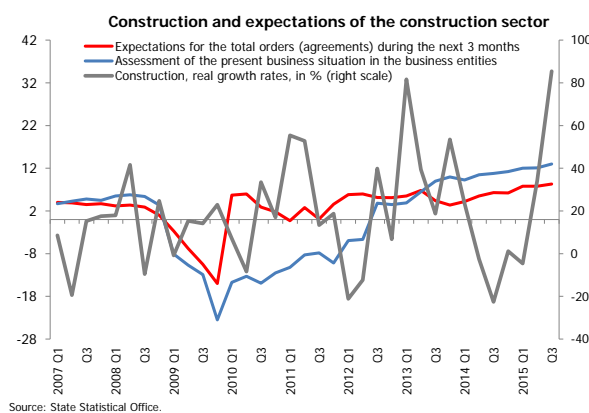
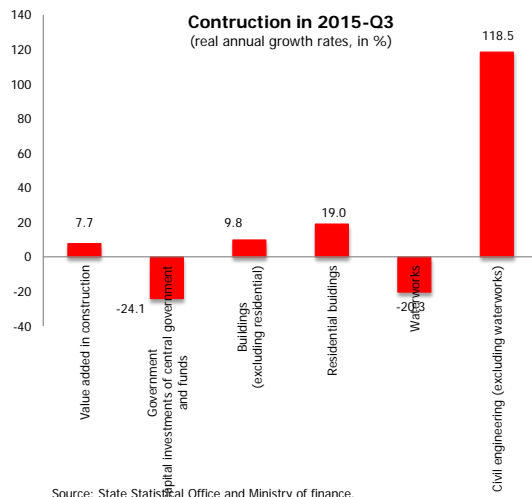
	2013	2014	2015	Q1 2016		2013	2014	2015	Q1 2016
Agriculture	8.6	2.2	-0.7	3.2		0.8	0.2	-0.1	0.2
Industry	3.7	20.1	1.4	-3.4		0.6	3.0	0.2	-0.5
Manufacturing	9.6	28.0	-2.0	-7.0		1.0	2.8	-0.2	-0.7
Construction	12.8	1.8	16.8	7.7		0.7	0.1	1.1	0.6
Trade and transport	11.1	1.8	7.3	5.7		1.9	0.3	1.4	1.0
Information and communication	4.8	14.6	4.6	0.2		0.2	0.5	0.2	0.0
Financial and insurance activities	-1.4	11.3	11.8	13.3		0.0	0.3	0.4	0.4
Real estate activities	-1.3	2.8	1.9	2.2		-0.2	0.3	0.2	0.3
Professional, scientific and technical activities	9.6	9.9	12.7	11.7		0.3	0.3	0.4	0.4
Public administration	-7.5	2.1	-2.0	-1.3		-1.1	0.3	-0.3	-0.2
Other service activities	12.7	12.4	-8.7	-17.3		0.3	0.3	-0.2	-0.5
Gross Domestic Product	2.9	3.5	3.7	2.0		2.9	3.5	3.7	2.0

Source: State Statistical Office and NBRM calculations.

Construction is among the leading sectors of economic growth for the third consecutive quarter. However, compared with developments in the previous quarter, the first quarter of 2016 registered a significant slowdown of the annual growth, while the value added in this sector registered a quarterly decline⁵. Analyzing structure, most of the growth is explained by the increased activity in civil engineering in the field of road infrastructure which probably, in part could be related to the ongoing implementation of several large public, infrastructure projects. The results of business tendency surveys in construction⁶ are in line with the good performance of this sector. Namely,

⁵ Seasonally-adjusted.

⁶ Refers to the surveys conducted in the first quarter of 2016, i.e. in the period before the escalation of the domestic political uncertainty.

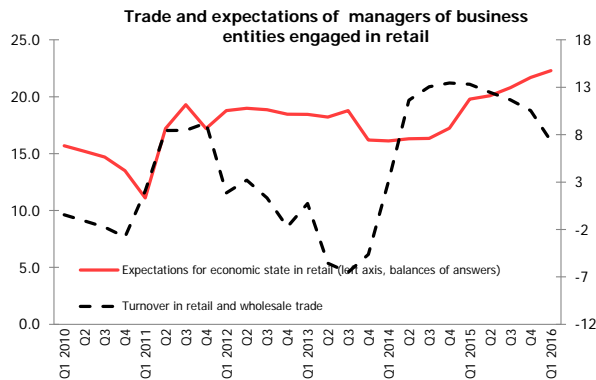


compared to the same period last year, respondents have more favorable assessments of the current business and financial situation in enterprises, and also highlight a significant alleviation of the limiting effect of unfavorable factors on the demand side and weather conditions. On the other hand, factors whose limiting impact increased in the first quarter are the lack of skilled labor and higher production costs (labor costs, materials and financial costs). **Construction activity is expected to keep on increasing in the second quarter**, taking into account the further double-digit growth in the value of completed construction works in April (although, compared to the first quarter, growth slowed down). The results of the survey conducted in the first quarter of 2016 also point to growth, amid more favorable expectations of company managers in the construction sector in terms of the future secured working period, orders and number of employees.

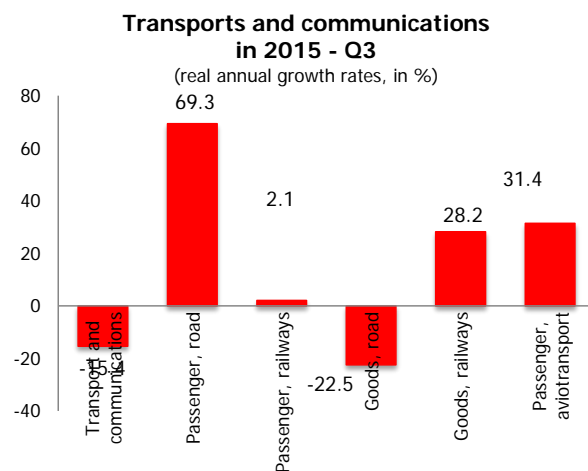
Favorable trends in the trade sector continued in the first quarter⁷, but at a slower annual pace reflecting the lower growth in the turnover of the wholesale trade and the fall in the turnover of the trade in motor vehicles. On the other hand, the retail trade registered intensification of the growth. Good performances of this sector are confirmed also by the results of the Business Tendency Survey in retail trade⁸ conducted in the first quarter. The results point to favorable assessments of the current business situation of companies, and in terms of the factors that influenced the activity in this sector, the managers emphasized the significant alleviation of the limiting effect of the weak demand of buyers. On the other hand, managers point to increased limiting effect of the shortage of qualified staff and increased competition (compared to the same period last year). **Favorable trends in trade are expected to continue in the second quarter**, amid continuing annual growth in the value of the turnover of the retail trade and wholesale trade during the period April-May 2016 (although growth is somewhat weaker compared to the first quarter). These trends are consistent with the more favorable expectations of the survey conducted in the first quarter, in terms of the number of employees and the business

⁷ The analysis of trends in trade is based on data on the trade turnover.

⁸ SSO's Business Tendency Survey in retail trade for the first quarter of 2016, i.e. in the period before the escalation of the domestic political uncertainty. The balance of responses is the difference between weighted positive and negative responses of corporate managers. The balance is designed to show the movement of the observed economic indicator rather than its true size, i.e. it provides qualitative rather than quantitative (numerical) data from corporate managers.



Source: State Statistical Office and NBRM.



Source: State Statistical Office.

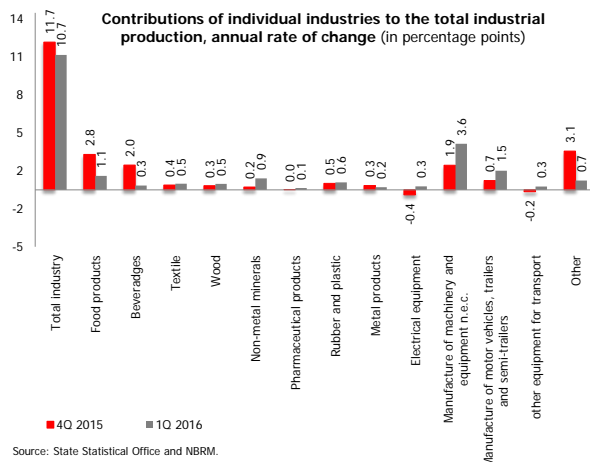
situation of companies in the next three to six months.

Observing the trends in the transport and communication sector, the indicators for the first quarter of the year gave divergent signals. Namely, the growth in rail traffic continued in the field of passenger traffic, and growth was also registered in air traffic. On the other hand, developments in passenger road and freight traffic are unfavorable. **The small number of high frequency indicators hinders any precise assessment of the developments in the transport and communications sector in the second quarter**, although the currently available data for April point to a decline in this activity, given the high annual decline in all types of rail traffic.

The first quarter registered annual and quarterly decline of value added in the industrial sector. Such shifts in the industry do not correspond⁹ with the movement of the high-frequency data in the same period that suggest high annual growth in the physical volume of industrial production. Manufacturing is the main generator of growth in the physical volume of industrial production. In terms of individual activities within the manufacturing industry, the production of machines and equipment and motor vehicles had a significant contribution to growth in the first quarter, i.e. activities where new companies with foreign capital are present. Also, some traditional economic sectors such as food industry, beverages, textiles and the manufacture of non-metal minerals contributed to growth. The improved performance of manufacturing industry has also been confirmed by the results of the **Business Tendency Survey in the manufacturing industry**¹⁰, where managers assess the economic standing of their businesses as more favorable, amid higher assessment of the output volume relative to the preceding three months and the higher average capacity utilization in the first quarter of the year. The good performances of companies in this sector are related to the reduced influence of some limiting factors, such as the lack of skilled labor and insufficient demand. On the other hand, respondents estimate more pronounced limiting effect of the uncertain economic environment and

⁹ The analysis by activity is based on the data on the physical volume of industrial production because of the availability of data for individual industrial sectors.

¹⁰ Refers to the surveys conducted in the first quarter of 2016.

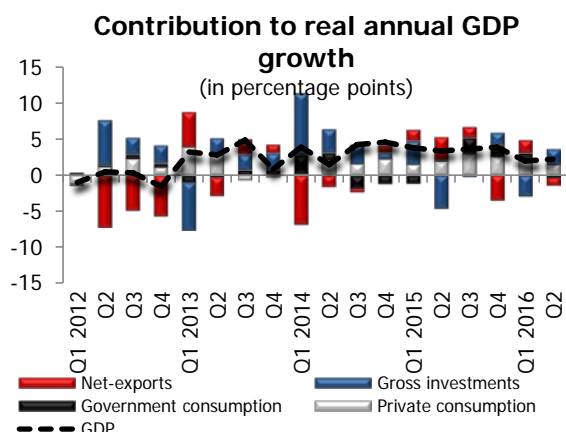


competitive imports. Contrary to the favorable trends in manufacturing industry, there was fall in production in **mining and electricity, gas, steam and air conditioning** sectors.

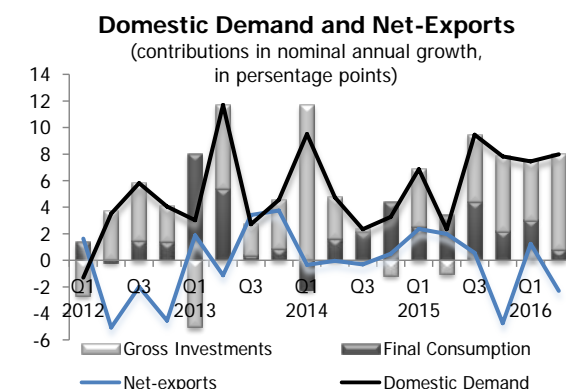
The available data for the period April - May suggest continuation of favorable trends in the industrial sector. Namely, in the first two months of the second quarter, industrial output recorded an average annual increase of 4.4%, which is still a slowdown of growth compared to the first quarter. The growth stems from manufacturing, while the production in electricity supply and mining recorded an annual decrease. The favorable trends in manufacturing industry are also supported by surveys conducted in April and May that indicate steady growth of the capacity utilization level, as well as more optimistic perceptions of the managers in the manufacturing sector about the output volume and the number of employees in the next three months.

1.3. Aggregate demand

In terms of the components of demand, in the first quarter, GDP growth of 2% entirely derived from net exports. The contribution of domestic demand is neutral, unlike the previous quarters, when it was the engine of growth. Observing individual components, export demand registered the highest annual growth and made the largest individual contribution to the growth of economic activity. The export growth was mainly attributable to the activity of the new industrial facilities. Among the components of domestic demand, private consumption made the highest positive contribution, amid favorable labor market developments, environment with low consumer prices and further credit support to the households. Public consumption also registered growth, although more moderate compared to the previous quarter. On the other hand, after the growth in the previous quarter, in the first quarter of 2016, gross capital formation decreased probably because of the fall in inventories, given the favorable movements in the indicative categories of investment in fixed assets.



Source: State Statistical Office and NBRM calculations.



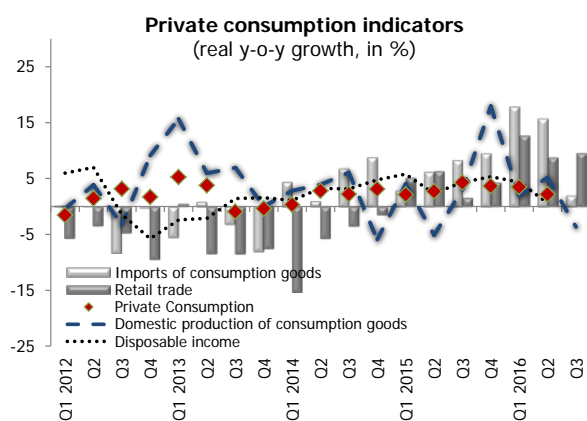
Source: State Statistical Office and NBRM calculations.

	Real annual growth rates (%)								Contributions to real annual growth (in p.p.)							
	2013-Q4	2014	2015	2015-Q1	2015-Q2	2015-Q3	2015-Q4	2016-Q1	2013-Q4	2014	2015	2015-Q1	2015-Q2	2015-Q3	2015-Q4	2016-Q1
Private consumption	-0.4	2.1	3.2	2.1	2.7	4.3	3.6	3.5	-0.3	1.5	2.2	1.5	2.0	2.9	2.5	2.3
Government consumption	4.3	1.0	4.6	-5.6	0.7	15.4	9.7	4.2	0.8	0.2	0.8	-1.1	0.1	2.3	1.6	0.7
Exports of goods and services	8.8	18.2	4.6	2.7	6.8	4.6	4.1	14.7	4.0	7.9	2.2	1.3	3.3	2.2	2.0	6.4
Imports of goods and services	4.5	16.0	2.4	-0.5	0.4	0.9	8.3	7.6	-2.9	-9.8	-1.6	0.2	-0.1	-0.8	-5.5	-4.6
Gross capital formation	7.3	13.1	0.1	11.0	-14.9	-1.1	5.5	-9.0	2.3	3.8	0.0	3.3	-4.6	-0.2	1.8	-2.9
Domestic demand	2.3	4.7	2.5	3.4	-2.2	4.1	4.9	0.0	2.8	5.5	3.0	3.7	-2.5	4.9	5.9	0.1
Net exports*	-4.5	10.1	-3.9	-8.2	-14.9	-14.9	20.4	-11.3	1.2	-1.9	0.6	1.5	3.1	1.5	-3.5	1.8
Statistical discrepancy												-1.4	2.7	-2.8	1.5	0.0
GDP	0.8	3.5	3.7	3.8	3.4	3.6	3.9	2.0	0.8	3.5	3.7	3.8	3.4	3.6	3.9	2.0

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

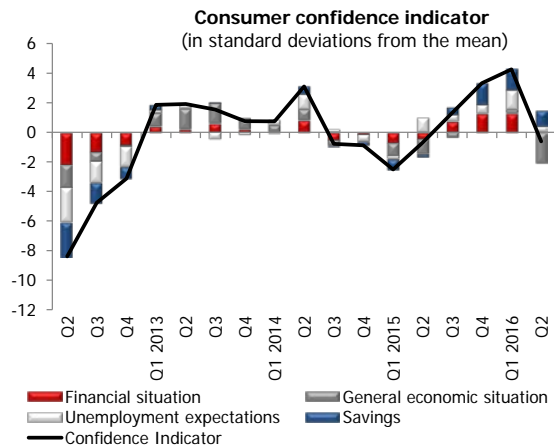
In the first quarter of 2016, the gross domestic product (GDP) decreased by 0.8% compared to the previous quarter (seasonally adjusted). Compared to the same period last year, growth amounted to 2.0%, which is slower than the annual growth in the previous four quarters. Amid almost unchanged domestic demand, the analysis shows that economic growth stems from net exports. Exports made the greatest individual positive contribution to growth. As before, these favorable developments in the export sector are mainly due to the activity of the new production facilities. In terms of the components of domestic demand, there was an increase in both private and public consumption, which was fully offset by the decline in gross capital formation. The reduction in investment does not correspond with the movement of most high frequency indicators that suggest growth of investment in fixed assets. Increased export demand intensified imports, but at a slower pace compared to exports.

1.3.1. Private consumption



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

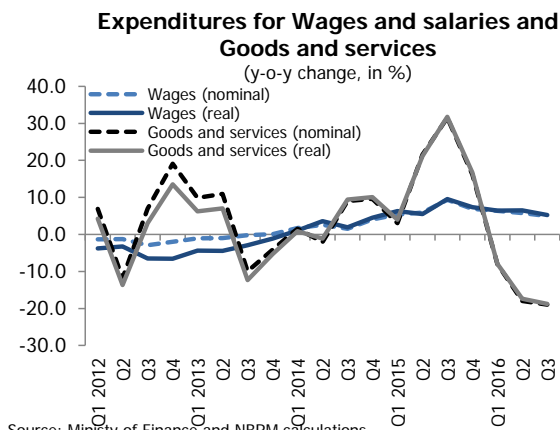
In the first quarter of 2016, household consumption registered a quarterly increase of 0.5% (seasonally adjusted) and real annual growth of 3.5%, which is similar to the growth of the previous quarter. Moreover, such growth of household consumption was supported by the growth of disposable income, amid favorable labor market developments, growth of pensions and inflows of private transfers from abroad. Also, the real growth of retail lending continued in the first quarter, mainly in the form of consumer loans, which represented additional support to the consumption in this period. Also, the environment of low consumer prices most probably positively affected household consumer sentiment.



Source: European Commission and NBRM's calculations.

Most of the latest high-frequency data have indicated higher private consumption in the second quarter of 2016¹¹. This is suggested by the growth of real wages and pensions, as components of disposable income and the stable growth of household lending, which according to the Bank Lending Survey¹², corresponds to the further easing of the overall credit conditions to households, as well as to the moderately increased demand for loans in this period. As for the remaining high-frequency data on private consumption, additional positive signals also come from the retail trade, from the imports of consumer goods, as well as from the domestic production of consumer goods. On the other hand, the signals from the surveys of consumer confidence¹³, conducted in the second quarter, point to worsened consumer sentiment, which is due to unfavorable expectations regarding the general economic situation. Also, the net purchase on the currency exchange market followed downward direction, which is the first signal for deteriorating expectations of economic agents reflecting the uncertain domestic political environment.

1.3.2. Public consumption



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

In the first quarter of 2016, public consumption recorded a quarterly decline of 2.3% (seasonally adjusted) and real annual growth of 4.2%. However, the dynamics of real annual growth was much slower compared to the growth of the previous two quarters. The growth of public consumption mainly stems from the increased health care transfers¹⁴ and the increased expenditures for wages of public sector employees.

Data for the period April-May 2016 indicate a small annual decline of public spending in the second quarter, given the high decline in expenditures for goods and services. On the other hand, expenditures for wages and health care transfers registered growth, but at a slower pace compared to the previous quarter.

1.3.3. Investment consumption

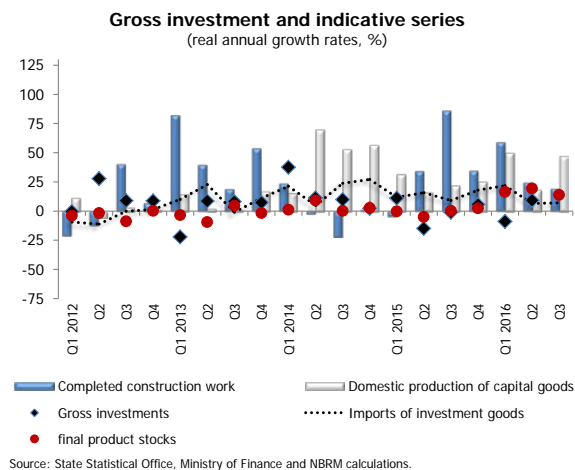
In the first quarter of 2016, the

¹¹ The analysis of wages and net private transfers was made using April data. Other factors have been analyzed as of May.

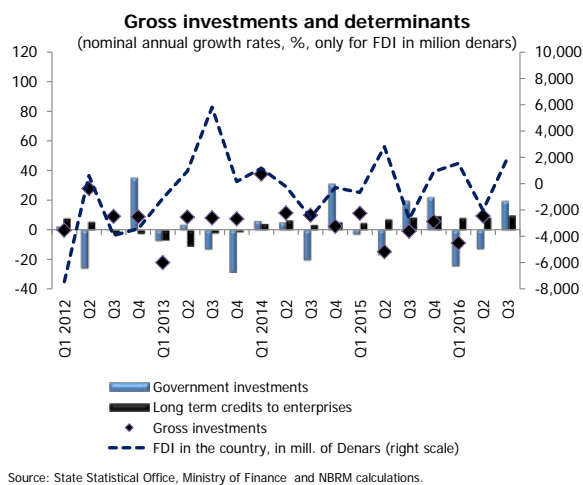
¹² NBRM's Lending Survey, second quarter of 2016.

¹³ European Commission's Consumer Survey as of May 2016.

¹⁴ Most of these assets relate to expenditures on goods and services.



gross capital formation registered a quarterly decline of 9.8% (seasonally adjusted) and an annual decline of 9.1%, following the solid growth in the previous quarter. On the other hand, data on short-term indicators of investment activity suggest growth in investments in construction and investments in machinery and equipment - the two most important components of investment in fixed assets. Construction activity, four consecutive quarters, registered high growth rates and is mainly a result of the growth in the field of civil engineering, which is mainly associated with investments in road infrastructure. Import of capital goods, which is an indicator of investment in machinery and equipment continued to grow in the first quarter. The first quarter registered growth in the domestic production of capital goods and corporate loans to banks. Among investment indicators, government expenditures for capital investments and inflows of foreign direct investment marked downward adjustment.



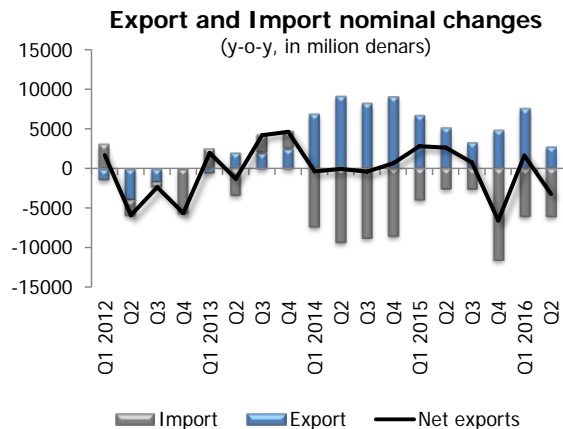
In terms of the movement of investments in the second quarter of 2016, most of the signals coming from the available high frequency data indicate their increase¹⁵. Construction activity is expected to have further positive impact on the overall investment demand in the next period, considering the optimistic expectations of construction sector managers in terms of total orders, selling prices and number of employees¹⁶. In April 2016, the realized double-digit growth of completed construction works was in this direction. The increased capacity utilization in the manufacturing industry also suggested future growth of investment in fixed assets, coupled with solid long-term corporate lending by banks amid further easing of the conditions for granting loans in this period¹⁷. Also, favorable movements were observed in the import of investment goods and in the domestic production of capital goods. Foreign direct investment and government expenditures for capital investments registered decline of the available short-term investment indicators.

¹⁵ Data on completed construction works and foreign direct investments have been analyzed as of April, while for the other indicative categories, the cut off date is May.

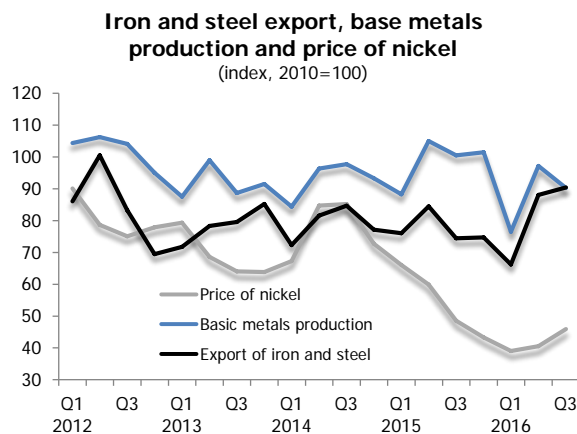
¹⁶ Refers to the surveys conducted in the first quarter of 2016, i.e. in the period before the escalation of the domestic political uncertainty.

¹⁷ NBRM's Lending Survey, second quarter of 2016.

1.3.4. Net external demand



Source: State Statistical Office.



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

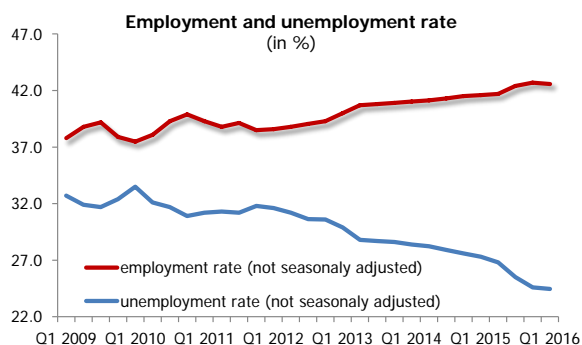
During the first quarter of 2016, there were favorable trends in the external sector. Namely, amid faster growth of exports than imports, the deficit in foreign trade declined, so that net exports in the first quarter made a positive contribution to GDP growth. **Real exports of goods and services** recorded an annual growth of 14.7% (acceleration of the annual growth pace) and a quarterly increase (quarterly growth of 5.1%, seasonally adjusted). The annual growth is mainly a result of the increased exports of new production facilities. On the other hand, the still weak global demand for metals and the fall of its price further affects unfavorably the export activity of the metal industry. **Import of goods and services** in real terms increased in the first quarter by 7.6% annually, which is slower compared to the dynamics observed in the previous quarter. Imports have registered a quarterly decrease of 2.3%, seasonally adjusted.

The trade deficit is expected to widen in the second quarter of 2016. The nominal data on foreign trade for the period April-May 2016 indicate a widening of the deficit in the second quarter of 2016. The increased trade deficit is a result of the slightly faster growth of imports than exports of goods.

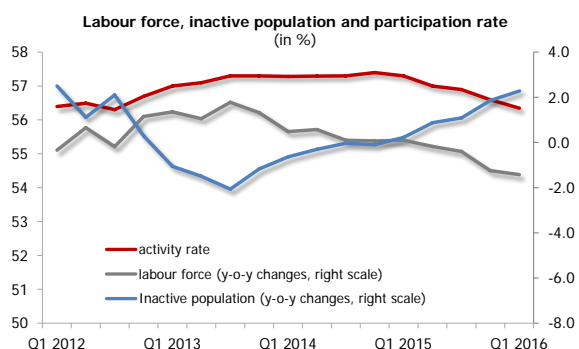
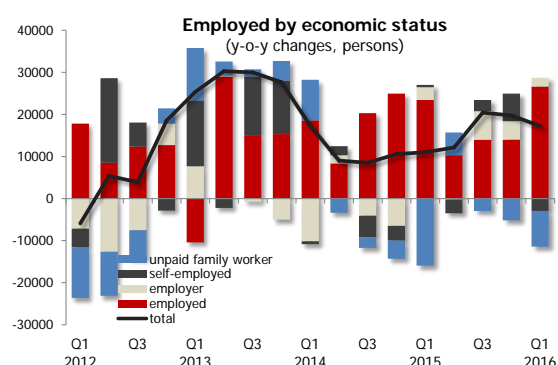
1.4. Employment and wages

Employment growth continued in the first quarter of 2016, and the unemployment rate amounted to 24.5%, which is a new historical minimum. Also, the aggregated signals from business tendency surveys point to stronger optimism about employment for the next three months. On the other hand, in the first quarter, there was a slowdown of the employment growth pace and reduction in the number of vacancies - signals that point to certain slowdown of recent positive labor market developments. At the same time, there was a decrease in total active population for the fourth consecutive quarter. However, it is still early to assess the nature of these developments. Certain deterioration was registered on the competitiveness indicators side, i.e. there was a significant slowdown of productivity growth which in turn affected the growth acceleration of labor costs, developments that reflect the deceleration of the economic activity, amid still solid employment growth.

The employment growth continued in the first quarter of 2016, but the growth pace is slightly slower. Thus, the number of employees increased by 2.5% on an annual basis, while on a quarterly basis, growth reduced to only



Source: State Statistical Office, Labour Force Survey.



Source: State Statistical Office, Labor Force Survey.

0.1%¹⁸ (compared to an annual growth of 2.9% and a quarterly growth of 0.5% in the fourth quarter of 2015). Analyzed by sectors of activity, most of the growth reflects trends in construction and several activities within the services sector (trade, broadly defined public administration¹⁹, professional, scientific and technical activities and other services). On the other hand, agriculture, manufacturing, transport and tourism registered a decrease in employment. In terms of the economic status²⁰, same as in the previous quarter, most employments are in the "employed population" category.

In the first quarter of 2016, the employment rate amounted to 42.6%, which is an annual growth of 1 p.p.. Dynamically speaking, the shift in the first quarter is a slight slowdown of the annual growth, but the rate remained at a level higher than the average in 2015. The results of the Job Vacancy Survey²¹ indicate somewhat less favorable trends in the labor market compared to the previous period. Namely, the number of vacancies, as an additional indicator of the movement of labor demand was lower by 1.5% in the first quarter, on an annual basis. The rate of vacancies also declined²², positioning itself at 1.38% in the first quarter. On the other hand, when it comes to employment prospects in the short run, the cumulative signals from the business tendency surveys²³ indicate stronger optimism among company managers for the next period. Having in mind that individual indicators of development of employment give different signals, it is still early to assess the nature of these developments.

In the first quarter, labor supply decreased by 1.4%, which is a further increase of the negative annual pace from

¹⁸ The analysis of quarterly dynamics of employment, unemployment and total active population was made using seasonally adjusted data.

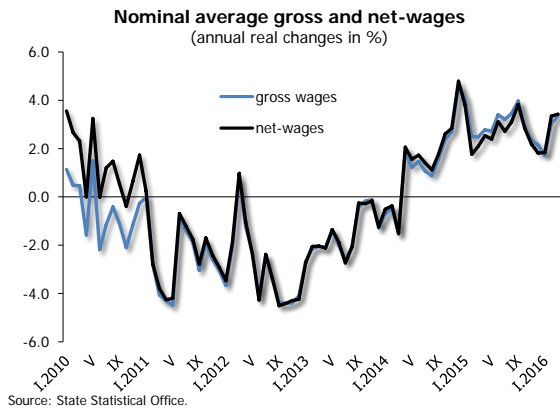
¹⁹ More precisely, public administration, defense and compulsory social insurance; education, as well as health and social work.

²⁰ The classification by economic status applies to the following groups: **employers** - persons who operate their own business entity or engages independently in their own shop, or farm owners who hire other employees; **employees** - persons who work in government institutions, business entities in public, mixed, cooperative and undefined ownership or for private employer; **own-account workers** - persons who operate their own business entity, company, engage independently in their own business and work on a farm in order to generate income, while not hiring other employees; **unpaid family workers** - persons who work without pay in a business entity, shop or farm (owned by a family member).

²¹ In 2012, the State Statistical Office began for the first time to conduct a Vacancy Survey as part of the labor market research. The purpose of this Survey is quarterly reporting on vacancies in companies in the Republic of Macedonia, as an important indicator for the macroeconomic developments and policies in the labor market.

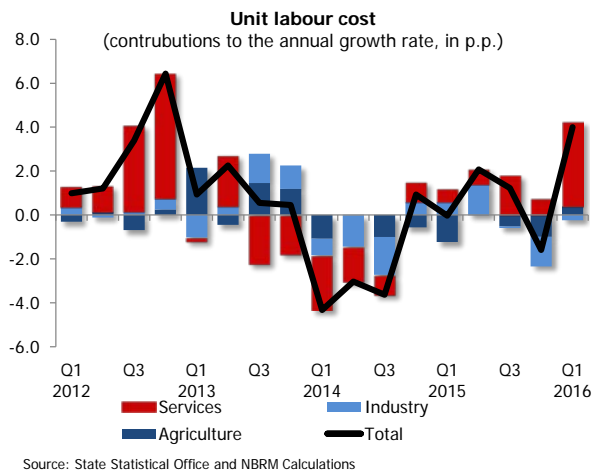
²² The rate of vacancies is defined as the ratio between the number of job vacancies and the total number of jobs, i.e. both vacant and occupied jobs.

²³ Source: State Statistical Office, business tendency surveys in manufacturing industry (March 2016), construction (first quarter of 2016) and trade (first quarter of 2016).

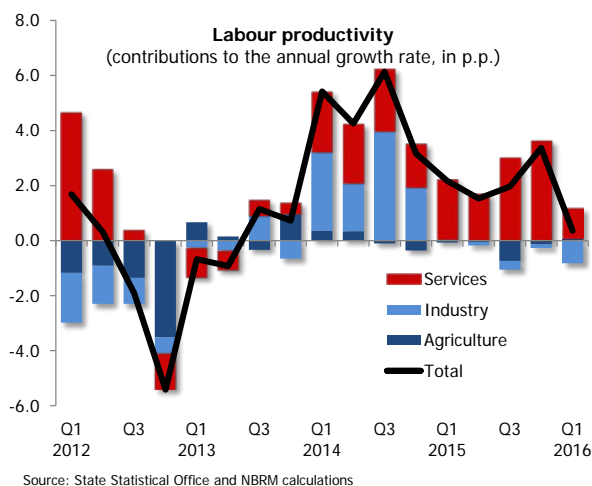


the previous three quarters. The decline of the number of economically active population, amid faster growth of inactive population led to a downward adjustment of the activity rate from 57.3% in the first quarter of 2015 to 56.4%, which is a record low in the last three years.

The growth of demand in the first quarter of the year, although decelerated, amid reduced labor supply has led to a further decline in unemployment. Namely, the number of unemployed in the first quarter decreased by 11.7% on an annual basis, similar to the previous quarter, while the unemployment rate positioned itself at a level of 24.5% (annual and quarterly decline of 2.8 p.p. and 0.1 p.p., respectively).



The average wages paid in the first quarter registered an annual growth of 2.8% (net wages) and 2.6% (gross wages), which is a moderate acceleration of the annual growth pace compared to the registered in the previous three months. The growth is distributed in most economic activities, and agriculture, construction, and administrative and support services stand out as activities with the highest wage growth. Compared to the previous quarter, the nominal net and gross wages declined. **In the first quarter, amid almost unchanged general price level, the real annual growth of wages is very close to the nominal (2.9% in net wages and 2.7% in gross wages)** which is a certain acceleration compared to the dynamics registered in the previous three months.



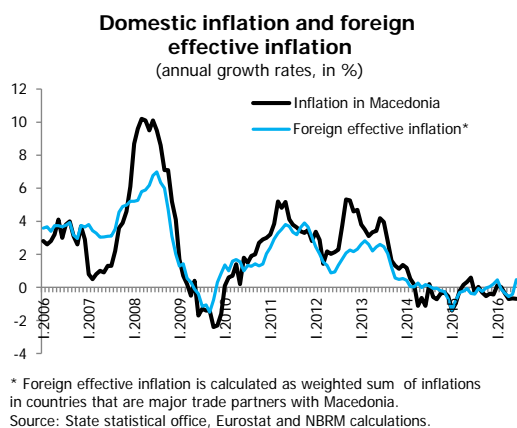
Labor productivity registered an annual growth of 0.4% in the first quarter²⁴, which is a significant slowdown of growth compared to the dynamics of the previous year. This shift is a result of the slowdown of the annual growth of economic activity, amid still solid employment growth. Observed by sectors, there was growth in the services sector, while the industrial sector experienced a decline in productivity. On a quarterly basis, productivity of the entire economy declined as a result of the quarterly decrease in economic activity in the first quarter of the year. The slower productivity growth affected **unit labor costs, which registered a significant**

²⁴ Total productivity is calculated as the ratio between the sum of added values of individual sectors included in the calculation and the number of employees in these sectors. The total GDP in the first quarter of 2016 recorded an annual growth of 2%, while the sum of added values of individual sectors increased by 2.6%. Employment in relevant sectors increased by 2.2%, and hence productivity has increased by 0.4%.

growth of 4% in the first quarter of the year (versus the decrease of 1.6% in the previous quarter). Unit labor costs increased the most in the services sector, a small increase was also observed in agriculture, while industry labor costs continue to decline. At the same time, labor costs increased on a quarterly basis, reflecting primarily the reduction in productivity.

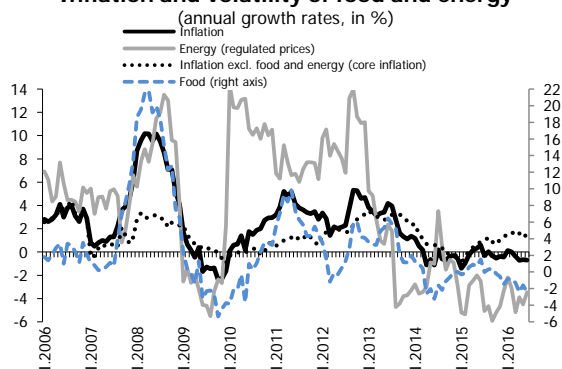
1.5. Inflation

In the second quarter of 2016, the global environment was generally marked by low prices of primary commodities. World prices of energy and food continued to decline, affecting domestic consumer prices of these categories. As a result, these price components also declined in the second quarter, maintaining the headline inflation in the negative zone for the fourth consecutive quarter. In the second quarter of 2016, annual prices declined by 0.7%, on average. Despite these developments in the energy component and food, core inflation was positive in the second quarter of the year, though slightly lower than the previous quarter. In the first two months of the quarter, producer prices in the domestic market slightly increased after ten quarters of continuous decline. In terms of the expectations for the future period, the Inflation Expectations Survey conducted in June in general pointed to unchanged inflation expectations relative to the previous quarter. Dynamically speaking, same as in the previous quarter, the respondents expect moderate acceleration of inflation to the end of the year and in 2017.



Domestic consumer prices continued to decrease in the second quarter of 2016, when prices reduced by 0.7%. Analyzing by component, the decrease in the second quarter was mainly due to food prices, generally reflecting lower prices of vegetables, and the energy component, primarily due to the lower prices of liquid fuels and lubricants, in line with the continuously low oil prices in world markets. On the other hand, core inflation in the second quarter remained positive, amid higher prices of several categories within the index, with the largest contribution of the higher tobacco prices²⁵.

²⁵ The annual increase in tobacco prices in the second quarter is a combination of several factors: increase in excise duty in July 2015 (from 1 July 2016 to 1 July 2023 the excise duty will increase by 0.20 denars each year), flat raise of cigarette prices of 5 denars per box in March 2016, and increase in prices of certain types of cigarettes in June 2016.

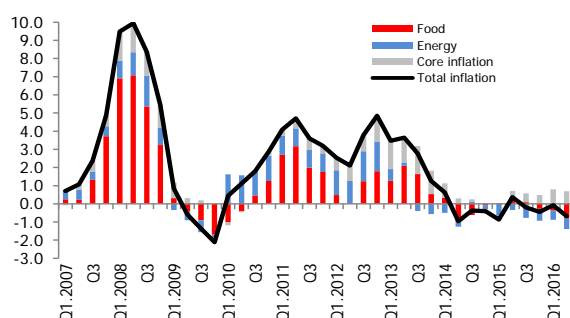
**Inflation and volatility of food and energy**

Source: State statistical office and NBRM calculations.

In the second quarter, the **foreign effective inflation²⁶** also decreased to -0.2% (0% in the previous quarter).

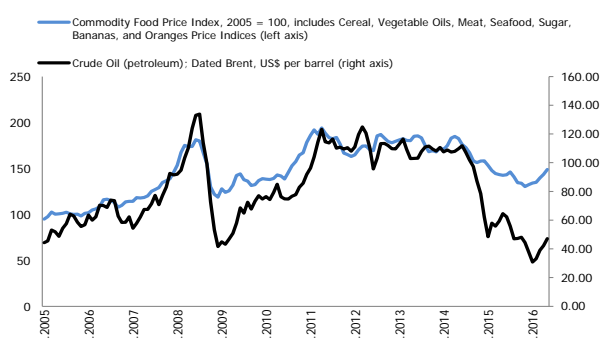
	2014	2015				2015	2016		2014	2015				2015	2016	
		Q1	Q2	Q3	Q4		Q1	Q2		Q1	Q2	Q3	Q4		Q1	Q2
Consumer price index - all items	-0.3	-0.9	0.4	-0.2	-0.4	-0.3	-0.1	-0.7	-0.3	-0.9	0.4	-0.2	-0.4	-0.3	-0.1	-0.7
Food	-0.9	0.1	1.0	0.2	-0.8	0.1	-1.0	-2.2	-0.3	0.0	0.4	0.1	-0.3	0.1	-0.4	-0.8
Energy	-1.4	-4.5	-2.3	-5.2	-4.4	-4.1	-3.5	-3.9	-0.2	-0.7	-0.3	-0.8	-0.6	-0.6	-0.5	-0.6
Electricity	0.4	3.6	3.6	-0.4	-0.4	1.5	-0.4	-0.4	0.0	0.3	0.3	0.0	0.0	0.1	0.0	0.0
Heat energy	-8.7	-3.7	-3.7	-8.8	-11.6	-6.8	-18.3	-18.3	-0.1	0.0	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Fuels and lubricants	-3.9	-20.1	-13.3	-17.1	-15.3	-16.5	-10.2	-11.8	-0.2	-0.9	-0.6	-0.8	-0.6	-0.7	-0.4	-0.4
Food and energy (volatile prices)	-1.1	-1.2	0.1	-1.3	-1.8	-1.1	-1.7	-2.6	-0.6	-0.6	0.0	-0.7	-0.9	-0.6	-0.9	-1.4
Core inflation (inflation excl. food and energy)	0.6	-0.5	0.7	1.0	1.0	0.6	1.7	1.5	0.3	-0.2	0.3	0.5	0.5	0.3	0.8	0.7

Source: State Statistical Office and NBRM calculations.

Volatile (food and energy) and core inflation
(contribution to inflation, in percentage points)

Source: State statistical office and NBRM calculations.

Analyzing the dynamics, the stronger annual decline in consumer prices in the second quarter, compared with the previous quarter, mostly reflects the rapid decline in food prices, and less the fall in the prices of energy component. On the other hand, core inflation remained in the positive zone, but its growth slowed down slightly. **Core inflation in the second quarter was 1.5%** (1.7% in the first quarter), and the shift is mainly explained by the slowdown in the growth of prices of home maintenance commodities, while the rapid growth of tobacco prices acted in the opposite direction.

Crude oil and food prices

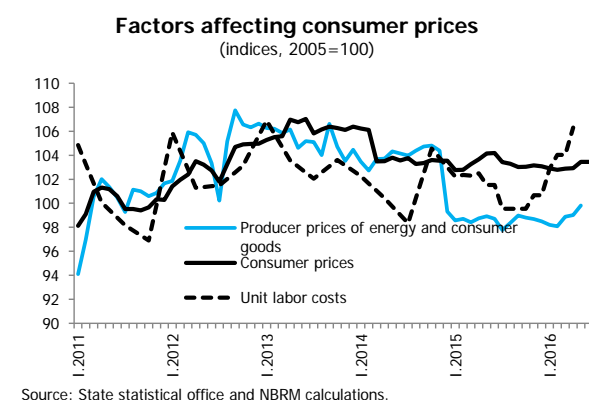
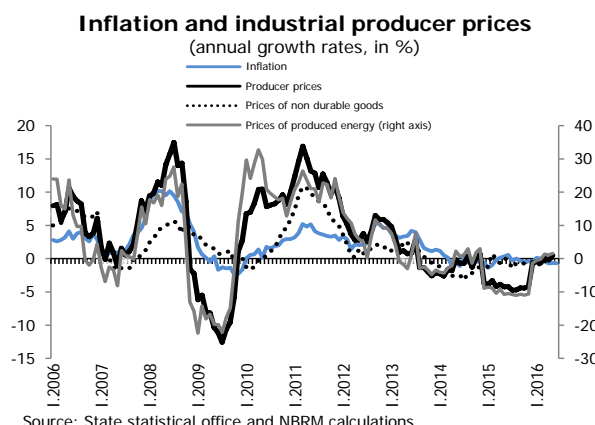
Source: IMF Primary Commodity Prices.

On a quarterly basis, in the second quarter of 2016, consumer prices were higher by 0.4%²⁷ (seasonally unadjusted rate), fully reflecting the small increase in energy prices and commodity prices within the core inflation, amid small decrease in food prices.

In the second quarter of 2016, producer prices slightly increased on a quarterly and annual basis, after ten consecutive quarters of decline. In the first two months of the second quarter, the annual

²⁶ The calculation of foreign effective inflation derives from the weighted sum of consumer price indices of countries that are major partners of the Republic of Macedonia in the field of import of consumer goods. The weight structure is based on the normalized shares of nominal imports from each country in the total nominal imports in the period 2010-2012. The calculation of this indicator includes Bulgaria, Germany, Greece, France, Italy, Austria, Slovenia, Croatia, and Serbia.

²⁷ Seasonally adjusted quarterly growth rate was negative and amounted to 0.5%.



increase in producer prices was 0.1% (versus the fall of 0.3% in the previous quarter). Within the index, producer prices in mining and electricity supply made positive contribution to the growth, while prices in the manufacturing industry registered a slight decline due to the lower producer prices of food, non-metallic mineral products, and metals. **Producer prices registered a quarterly increase of 0.8%** (seasonally adjusted rate of 0.2%). **In the second quarter of the year, producer prices that influence the domestic component of inflation²⁸ slightly increased** (annual growth of 0.6% compared to the annual decline in the previous quarter and quarterly²⁹ growth of 1.3%, despite the decline of 0.3 % in the previous quarter).

In the first quarter of 2016, unit labor costs grew by 4% annually. However, despite the growth of unit labor costs, the estimates for the output gap still do not point to significant pressures from the demand side³⁰, and for the time being, no inflationary pressures on prices of final products through this channel have been expected.

Box 1: Inflation Expectations Survey³¹

Inflation Expectations Survey includes three groups of respondents: economic analysts, companies, and financial institutions. The questionnaire contains two questions to measure inflation expectations, one qualitative and one quantitative in nature. For the first question on inflation expectations, the respondents indicate the direction and extent of price changes compared with the change in the previous 12 months³². Carlson and Parkin (1975) probability approach has been used for quantification of qualitative answers, which assumes that amid a sufficiently large number of respondents, the expected change in prices is normally distributed among the population. The second question requires from the respondent to quantify precisely the expected average rate of change of prices in the next two years³³. The overall expected rate is calculated as a simple average of the responses of all participants. The resulting indicator is useful for obtaining indications for the direction of the respondents' expectations.

²⁸ Consumer goods (durable and non-durable) and energy.

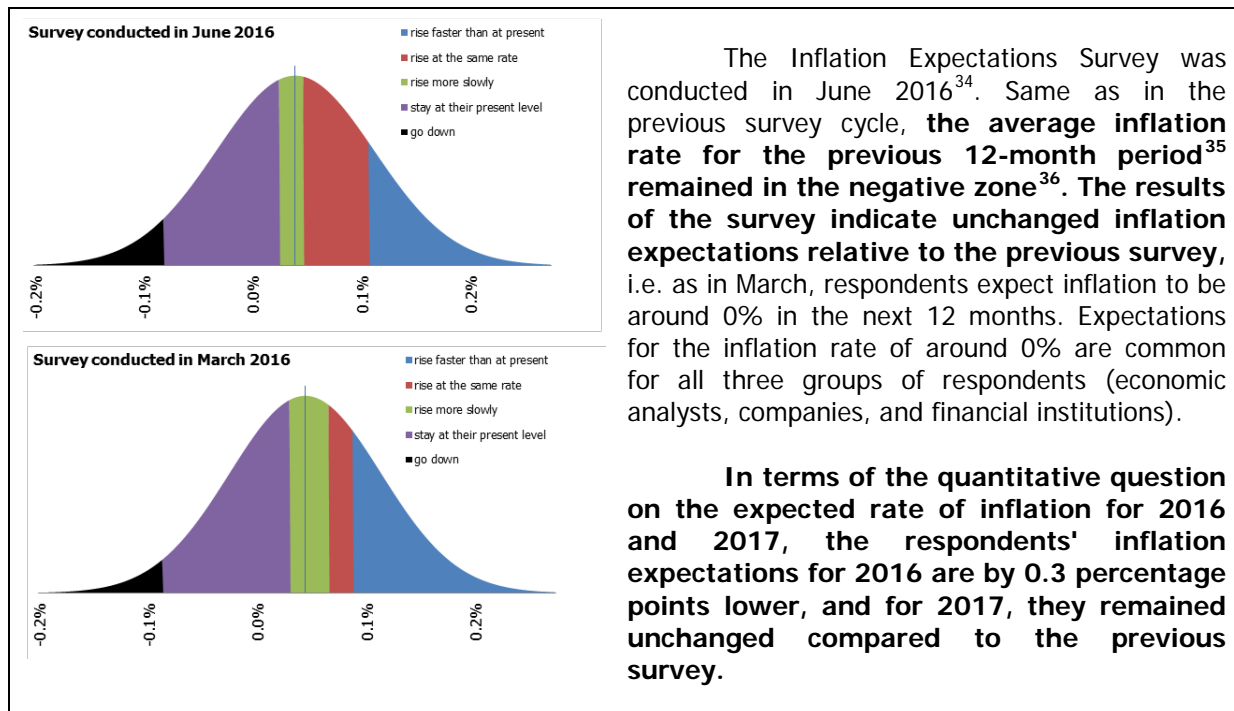
²⁹ The quarterly change has been calculated using seasonally adjusted data.

³⁰ The NBRM estimates show that in the first half of 2016, the output gap ranged around zero.

³¹ In order to improve the survey measure of inflation expectations, in 2013, the Monetary Policy and Research Department of the National Bank of the Republic of Macedonia started an in-depth analysis of the experiences of other central banks associated with conducting surveys. On that basis, the existing survey was redesigned and starting from October 2013, data were collected for the new survey, thus ensuring greater approximation to the European practice.

³² The qualitative question of expectations reads as follows: "Compared with the past 12 months, how do you expect consumer prices to change in the next 12 months? a) will have a faster growth; b) will grow at the current pace; c) will grow at a slower pace; d) will remain almost unchanged; e) will decrease; f) it is difficult to determine"

³³ The quantitative question reads as follows: "What are your expectations/forecasts for the average inflation rate for 2016 and 2017?"



1.6. Balance of Payments³⁷

In the first three months of 2016, current account balance recorded favorable quarterly movements and small deficit. These shifts entirely derived from the balance of trade in goods and services, despite the seasonal quarterly decrease of inflows in the surplus of secondary income. The improved trade deficit, coupled with higher inflows of secondary income, has improved the current account balance annually. Driving factors that narrowed the trade balance include the good export performance of the new facilities in the economy and the low prices of crude oil in world markets. In the period under observation, the financial account recorded moderate net inflows in the form of direct investment and financial loans, which were largely offset by net outflows in other short-term components. This position of the balance of payments slightly increased the foreign reserves in the first quarter.

³⁴ The percentage of responsiveness to the Survey conducted in June was 29.1%, which compared to the previous quarter, represents an increase of responsiveness. Analyzed by group of respondents, the financial institutions' responsiveness is 50%, followed by economic analysts with 35.3% and companies with 21.4%.

³⁵ Refers to the period June 2015 to May 2016.

³⁶ In circumstances of a negative price growth, the interpretation of the results of the survey can be blurred, and therefore, it is necessary to change the method of calculation of the indicator for inflation expectations. Thus, in the procedure for quantification, the negative rate is replaced with the last positive growth rate. This is the way to avoid the contradictory responses from the survey that assume a positive price growth. Taking into account that changes in the method are of a purely technical nature, the quantification of qualitative answers for the expected rate of inflation in periods of negative inflation should be taken with caution, while the indicator for inflation expectations as approximate.

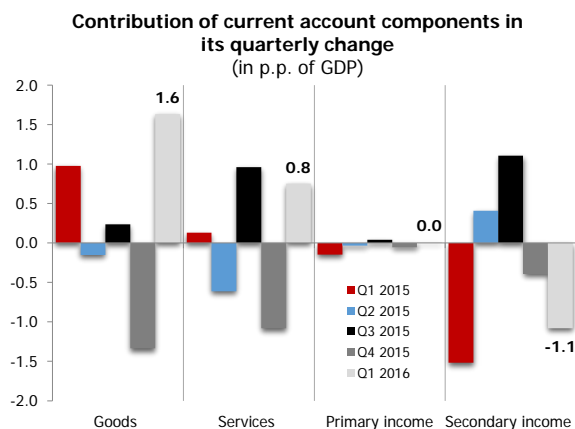
³⁷ Starting from the Quarterly Report, October 2014, the analysis of the movements in the balance of payments is based on data compiled under the Manual on the Balance of Payments and International Investment Position, sixth edition (IMF, 2009) (IMF, 1993). For more information on the methodological changes, visit the NBRM website at http://nbrm.mk/WBStorage/Files/Statistika_Informacija_za_promenite_vo_platniot_bilans_megunarodnata_investiciska_pozicija_i_nadvoresniot_dolg_koisto_proizleguvaat_od_primenata_na_novite_megunarodni_statisticki_standardi.pdf.



	2015			2016			2015			2016		
	Q1	IV	I-IV	Q1	IV	I-IV	Q1	IV	I-IV	Q1	IV	I-IV
I. Current account	-46.5	-57.1	-103.5	-10.7	-91.8	-102.5	-0.5	-0.6	-1.1	-0.1	-1.0	-1.1
Goods and services	-318.0	-174.5	-492.5	-293.1	-156.8	-449.9	-3.5	-1.9	-5.4	-3.1	-1.7	-4.8
Credit	988.2	327.3	1,315.6	1,105.2	383.4	1,488.5	10.9	3.6	14.5	11.7	4.1	15.7
Debit	1,306.3	501.8	1,808.1	1,398.3	540.2	1,938.4	14.4	5.5	19.9	14.8	5.7	20.5
Goods	-426.3	-186.6	-612.9	-407.5	-175.2	-582.7	-4.7	-2.1	-6.7	-4.3	-1.9	-6.2
Services	108.3	12.1	120.4	114.4	18.4	132.8	1.2	0.1	1.3	1.2	0.2	1.4
Primary income	-53.6	-18.1	-71.8	-59.6	-22.2	-81.8	-0.6	-0.2	-0.8	-0.6	-0.2	-0.9
Secondary income	325.2	135.6	460.8	342.0	87.2	429.1	3.6	1.5	5.1	3.6	0.9	4.5
II. Capital account	1.7	0.3	2.0	2.3	2.5	4.8	0.0	0.0	0.0	0.0	0.0	0.1
Net lending (+) / net borrowing (-) (balance from current and capital account)	-44.7	-56.8	-101.5	-8.4	-89.3	-97.8	-0.5	-0.6	-1.1	-0.1	-0.9	-1.0
III. Financial account	145.9	-52.5	93.4	-31.1	-18.3	-49.4	1.6	-0.6	1.0	-0.3	-0.2	-0.5
Direct investment	-68.0	-36.5	-104.6	-66.3	-34.6	-100.9	-0.7	-0.4	-1.1	-0.7	-0.4	-1.1
Portfolio investment	-11.5	-0.2	-11.8	8.3	-2.3	6.0	-0.1	0.0	-0.1	0.1	0.0	0.1
Currency and deposits	65.3	40.2	105.5	59.7	50.1	109.8	0.7	0.4	1.2	0.6	0.5	1.2
Loans	134.4	7.9	142.4	-55.0	-2.8	-57.9	1.5	0.1	1.6	-0.6	0.0	-0.6
Trade credit and advances	25.6	-63.9	-38.3	22.3	-28.8	-6.4	0.3	-0.7	-0.4	0.2	-0.3	-0.1
Other accounts receivable/payable	0.1	0.0	0.1	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Special drawing rights (Net incurrence of liabilities)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IV. Net errors and omissions	24.0	-0.8	23.2	-9.1	-3.7	-12.8	0.3	0.0	0.3	-0.1	0.0	-0.1
V. Reserve assets	-166.6	-5.1	-171.7	13.5	-74.7	-61.2	-1.8	-0.1	-1.9	0.1	-0.8	-0.6

Source: NBRM.

1.6.1. Current account



Source: NBRM.

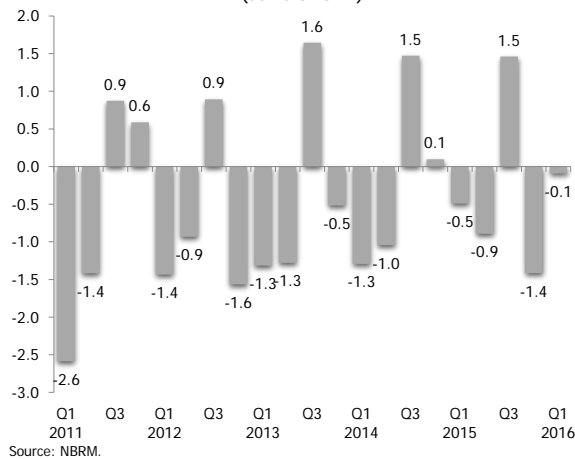
In the first quarter of 2016, the balance of payments current account registered a small deficit of Euro 10.7 million (0.1% of GDP). Compared to the previous quarter, the current account balance has improved by 1.3 percentage points of GDP³⁸. The favorable movement of the balance of trade in goods and services is the major generator of the positive quarterly change, despite the seasonal decline in net inflows of secondary income. The trade deficit narrowed quarterly by 1.6 percentage points of GDP, amid faster decline of imports compared to exports, while the surplus in services recorded a quarterly increase of 0.8 percentage points of GDP, influenced by good performance in construction, customization services and other business services. On the other hand, the surplus of secondary income decreased by 1.1 percentage points of GDP, amid lower net inflows of private transfers and lower amount of purchased net cash in the currency exchange market³⁹. The balance of primary income did not record significant quarterly changes.

³⁸ The calculations use the projected amount for the nominal GDP.

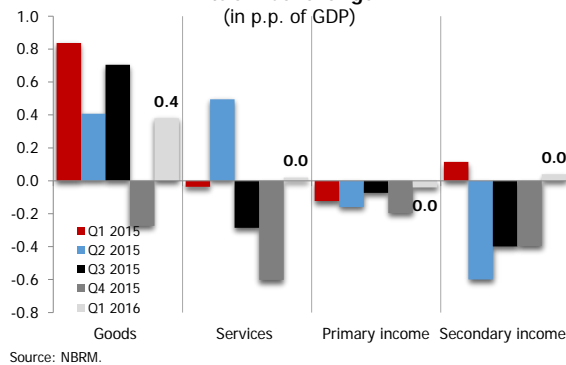
³⁹ Foreign cash purchased on the currency exchange market is used to estimate private transfers in cash.



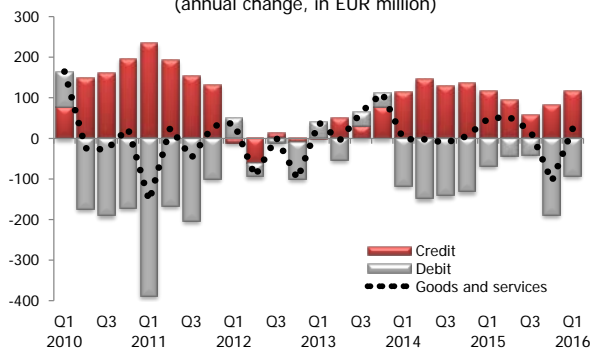
Current and Capital account
(as % of GDP)



Contribution of current account components in its annual change
(in p.p. of GDP)



Balance of goods and services
(annual change, in EUR million)

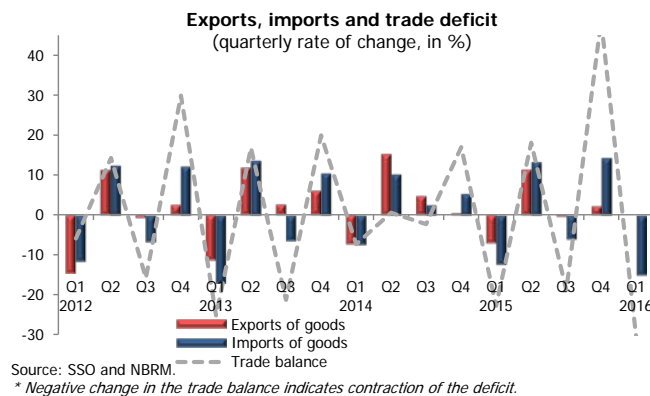


* Positive change in the import of goods mean it's decrease.
Source: NBRM.

Observing the annual changes, the current account balance indicates an improvement of 0.4 percentage points of GDP, reflecting favorable movements in the trade balance and in secondary income. Thus, the trade deficit in goods decreased by 0.4 percentage points of GDP on an annual basis, mainly due to the further contraction of the energy deficit due to low oil prices in world markets. Also, the favorable changes in trade balance reflect the positive net effect of the activity of the new facilities in the economy. The increased surplus in secondary income (of 0.04 percentage points of GDP) is due to the higher net inflows in the government sector amid almost unchanged net inflows in other sectors of the economy i.e. other current transfers. On the other hand, the balance of services and primary income did not record significant annual changes. Analyzing services, higher net inflows in telecommunications, computer and IT services, construction, transport and other business services, were almost entirely offset by the annual decline in manufacturing services. The fall in net inflows of manufacturing services was caused by the weak conjuncture in metal industry, as well as textile industry.

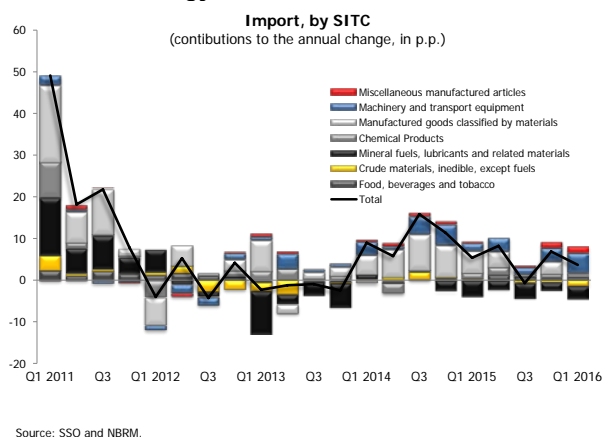
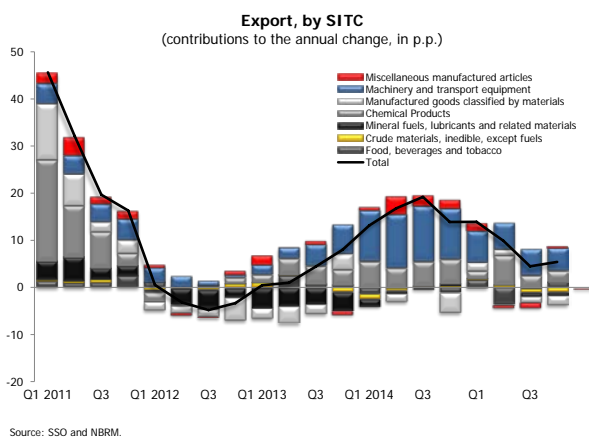
The recent balance of payments data show that in April 2016, the current account recorded a deficit of Euro 91.8 million. Compared to April 2015, this is a broadening of the negative gap in the current account balance. This annual change was mostly due to the fall in the surplus in secondary income, i.e. significantly lower purchased cash in the currency exchange market. Due to the uncertain domestic political environment, in April, economic entities preferred to hold foreign cash, thus significantly reducing the surplus in this category.

Box 2: Foreign trade of goods and movement of the Nominal and the Real Effective Exchange Rate (NEER and REER)⁴⁰



In the first quarter of 2016, the foreign trade amounted to Euro 2,339.9 million, or 24.7% of GDP, and compared to the same quarter of the previous year, it increased by 4.6%, registering growth in both its components. Thus, export of goods continued to increase, and in the first quarter of 2016, it registered an annual growth of 5.7% (slightly faster growth compared with 5.4% in the previous quarter). A key factor for higher export activity is the growing export of the new foreign facilities, followed by food

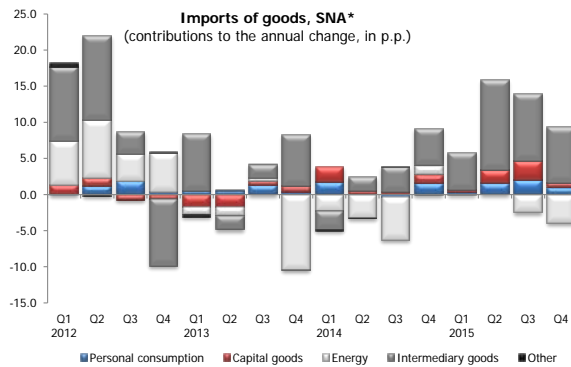
exports. On the other hand, the export of other traditional sectors has declined. Thus, a significant annual decline was recorded in the export of metal industry, which is a combined effect of lower export prices and the quantities of these goods, amid continuing unfavorable conditions in the world metal market. Negative contribution to the annual growth rate was also made by the export of tobacco, and clothing and textiles. **Import of goods continued increasing, though at a slower pace, and in the first quarter, the annual growth was 3.7%** (versus 6.9% in the previous quarter). Import growth was mostly due to the increased investment imports, higher imports of raw materials for the new industrial facilities, as well as the moderate increase in food imports. The categories that contribute most to the annual growth include machines and transport equipment, non-metallic manufactures, chemicals, and miscellaneous manufactured articles. On the other hand, reduced energy imports caused significant downward pressures, primarily due to the lower imports of oil products, reflecting the price effect of the fall in world oil prices, and to a lesser extent, the lower import of natural gas and electricity. **The faster growth in exports compared to that of imports of goods led to a slight narrowing of the trade deficit in the first quarter of 2016 by 1.3% on an annual basis.** The favorable developments in the trade balance result from the narrowing of the energy deficit, given the widening of the deficit in the non-energy balance.



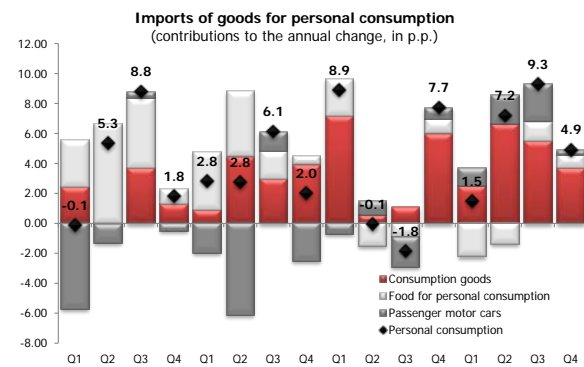
The analysis of the import of goods under the System of National Accounts (SNA) indicates that in the first quarter, the import of personal consumption goods made the dominant contribution to the annual growth of total imports. At the same time, import growth was driven by the higher import of both capital goods and intermediate goods, while the lower energy imports acted in the opposite

⁴⁰ According to the Foreign Trade Methodology, data on the export of goods are published on an f.o.b. basis, and on the import of goods, on a c.i.f. basis.

direction. In terms of imports for private consumption, the annual growth of this component reflects the higher imports of consumer goods and passenger vehicles, with relatively smaller positive contribution by the import of food. Overall, the annual growth in imports for private consumption remains moderate, although accelerating over the last two quarters, indicating presence of moderate pressures on imports by the private consumption.



* Classification: System of national accounts (SNA).
Source: NBRM.



Source: NBRM.

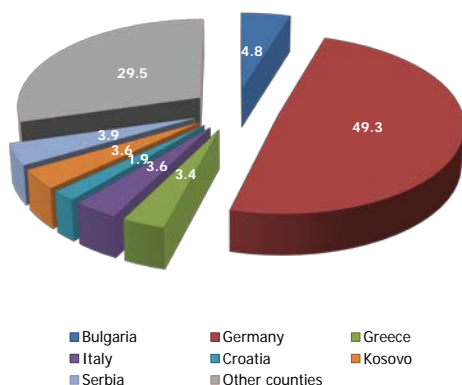
The latest available foreign trade data for April and May indicate an increase in both components annually. Export of goods registered an annual growth of 9.2%, which mostly stems from the improved performances of the new production facilities, despite the reduced export activity of the metal industry. The import of goods also registered an annual growth (9.4%), given the stronger import of raw materials for the new companies and the reduced energy imports.

The analysis of foreign trade, by trade partner, in the first quarter of 2016 shows that the European Union remains the most important trading partner, accounting for 71.7% of total trade in goods, which is higher than the average share of about 68% in the last three years. With respect to the structure of exports by country, the first quarter registered a significant growth in the share of exports to Germany and to a lesser extent, to Romania and Belgium, as part of the markets to which the export of the new foreign owned industrial facilities is targeted. On the other hand, exports to China, Bulgaria, Italy, and Switzerland⁴¹ have decreased. On the import side, in the analyzed period, the imports from Germany recorded the largest growth of the structural share, which is largely attributable to the raw materials for the new industrial facilities. Among other countries, the imports of goods from China⁴², Romania, and Turkey have increased their share in total imports. Conversely, reduced share was recorded in the imports from the UK, and Russia (lower imports of precious metals and inorganic chemical products, respectively), followed by Greece and Slovakia. Analyzing the balances, the further reduction in the trade deficit with the European Union made the largest contribution to the narrowing of the trade deficit, due to the increased surplus with Germany and the reduced deficit with the Great Britain, coupled with the reduced deficit with Russia. The deepening of the negative trade balance with China acted in the opposite direction, followed by the increased deficit with Bulgaria, the United States, and Italy.

⁴¹ In the first quarter, the exports to China, Bulgaria, and Italy decreased due to the decline in exports of products for the metal industry (iron and steel, metal ore), while the lower exports to Switzerland result from the reduced export of clothing and textiles.

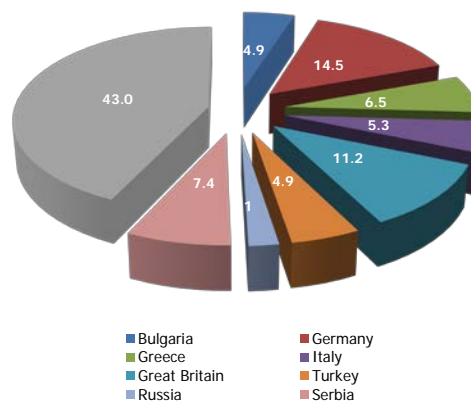
⁴² The imports to China in this period increased primarily due to the import of rolling stock or renewal of rolling stock in the railway transport by the government.

Export of goods, by countries in the first quarter of 2016 (share, in %)



Source: SSO.

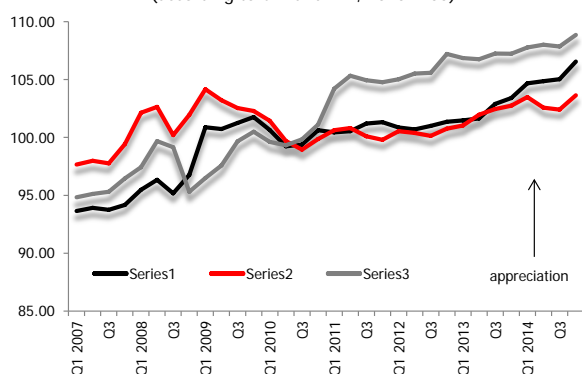
Import of goods, by countries in the first quarter of 2016 (share, in %)



Source: SSO.

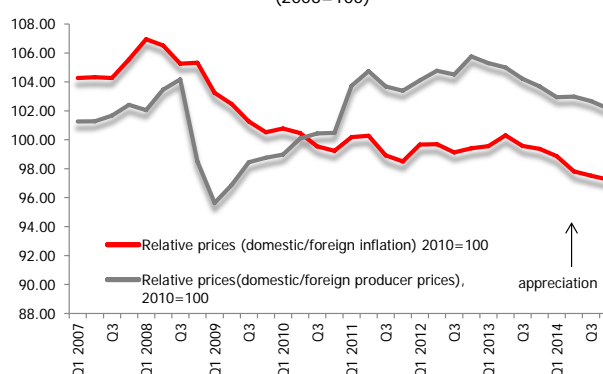
In the first quarter of 2016, price competitiveness indicators of the Macedonian economy point to moderate deterioration compared to the first quarter of 2015. Moreover, both price indices have appreciated on an annual basis. The REER deflated by consumer prices appreciated by 0.8%, while the REER deflated by producer prices appreciated by 4.4% compared to the first three months of the previous year. The nominal effective exchange rate created upward pressures, registering an annual growth of 2.5%, mostly as a result of the appreciation of the denar against the Russian ruble, the Turkish lira, the Ukrainian hryvnia, and the British pound. As for the relative prices, the relative consumer prices registered an annual decline of 1.6%, while the relative producer prices deteriorated, i.e. increased by 1.8%⁴³.

NEER and REER
(according to CPI and PPI, 2010=100)



Source: NBRM.

Relative prices
(2006=100)

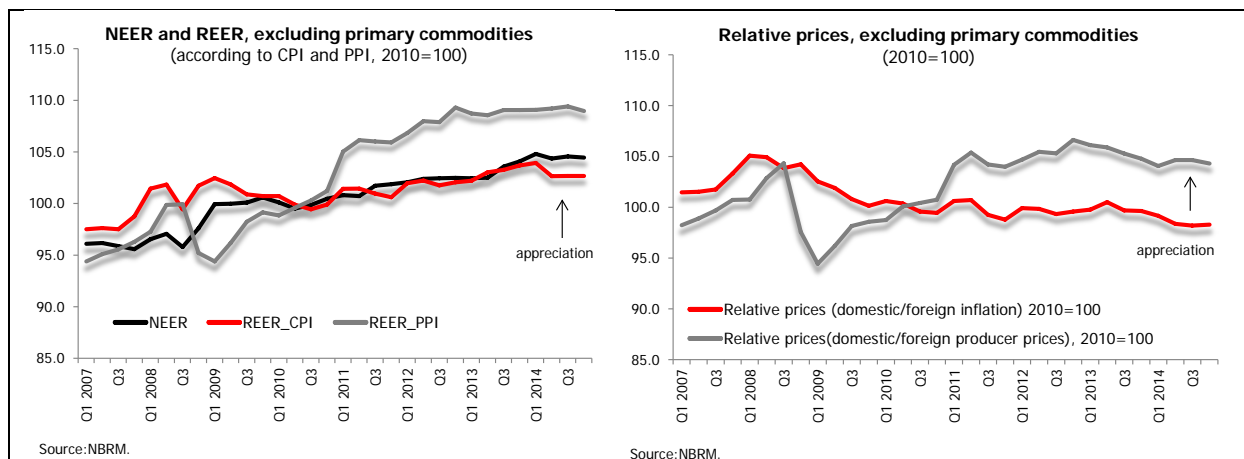


Source: NBRM.

The analysis based on REER indices calculated using weights based on foreign trade excluding primary commodities⁴⁴ also indicates a moderate deterioration in the price competitiveness of the domestic economy compared to the previous quarter. Namely, REER based on producer prices appreciated by 3.6% on an annual basis, while REER deflated by consumer prices appreciated by 0.3%. NEER appreciated by 1.1% amid higher relative producer prices and lower relative consumer prices.

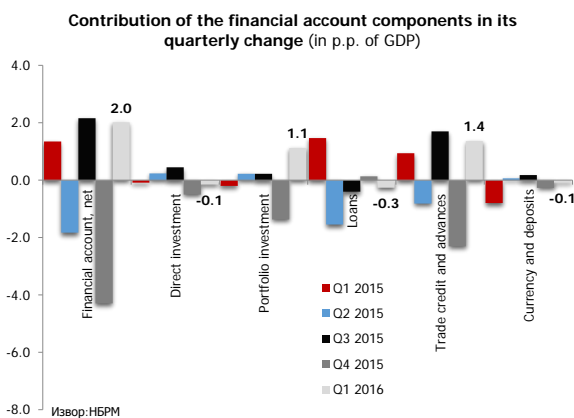
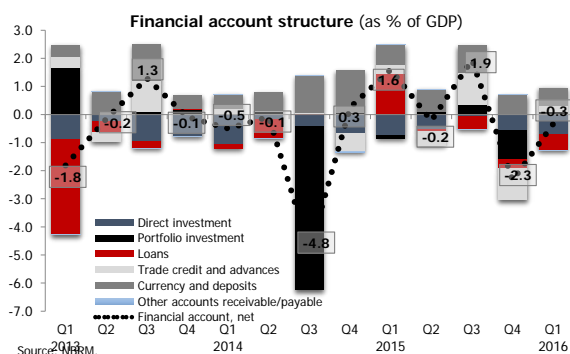
⁴³ The appreciation through relative producer prices may be overestimated. Namely, unlike the foreign prices which dropped, domestic prices have stagnated during 2016. However, it should be borne in mind that the weight structure of the domestic index still does not include the latest changes in the structure of domestic production, and therefore, probably the picture of price changes via this index does not depict appropriately the actual changes.

⁴⁴ Primary products not included in the calculation are: oil and oil derivatives, iron and steel, ores and imported raw materials for the new industrial facilities in the free economic zones. For more detailed information on the methodology for calculating the real effective exchange rate visit: http://nbrm.mk/WBStorage/Files/Statistika_REDK_Informacija_za_promenite_na_metodologijata_za_presmetuvanje_na_realniot_efektiv_devizen_kurs_na_denarot_mak.pdf



According to the latest data of price competitiveness, in the period from April to May, the REER, as measured using weights of the total trade of goods, and weights based on foreign trade without primary commodities, has appreciated compared to the same period in 2015. In general, annual changes derive from the appreciation of the nominal effective exchange rate (of 3.9% and 1.3%, based on the weights on the overall trade and foreign trade-based weight excluding primary commodities, respectively), whereas the movements of relative prices, according to the both calculations, are divergent. Within the REER, as measured using weights based on the total foreign trade, the index deflated by consumer prices has appreciated by 2.6%, and the index deflated by producer prices has appreciated by 6.9%. Similar trends have been registered in the REER measured using weights based on foreign trade excluding primary commodities, when the CPI-deflated index and the PPI-deflated index have appreciated by 0.4% and 5%, respectively.

1.6.2. Financial account



In the first quarter of 2016, the financial account of the balance of payments registered moderate net inflows of Euro 31.1 million or 0.3% of GDP. During this period, the long-term flows such as direct investment and financial loans were the main sources of funding, which were largely offset by net outflows in other short-term volatile components of the financial account. The positive developments in direct investment mainly arise from non-debt component, i.e. higher reinvested earnings and equity capital, with much lesser effect of debt instruments, i.e. intercompany debt. Net inflows in financial loans mainly result from the long-term net external debt of the public sector, i.e. the government and public companies, to support road infrastructure. On the other hand, the category of currency and deposits still registers adverse trends, mainly caused by outflows in other sectors of the economy. The decrease of accumulated trade credits also has a detrimental effect on the position of the financial account. The quarterly analysis points to lower net inflows compared to the previous quarter. These changes largely derive from the net repayment of trade credits (versus the significant net disbursements in the last quarter of 2015) and net outflows in portfolio investment (as

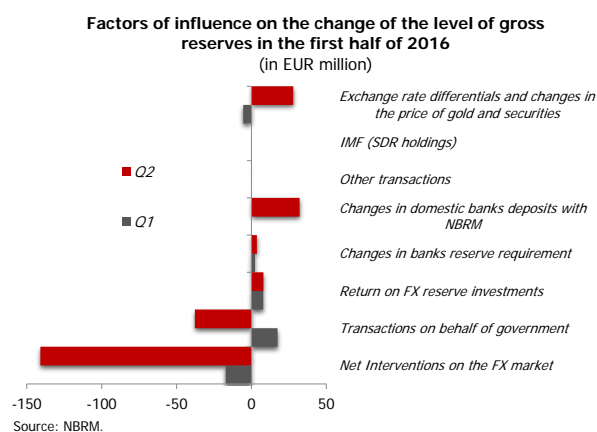
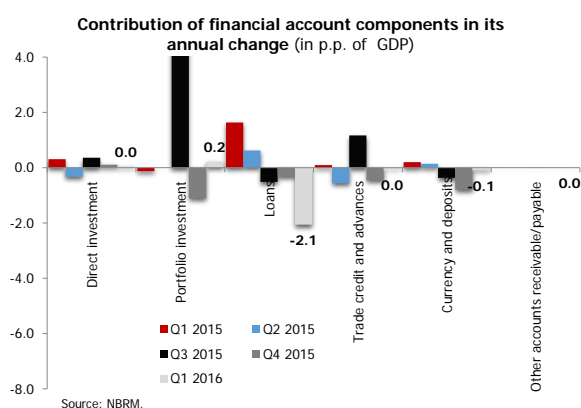
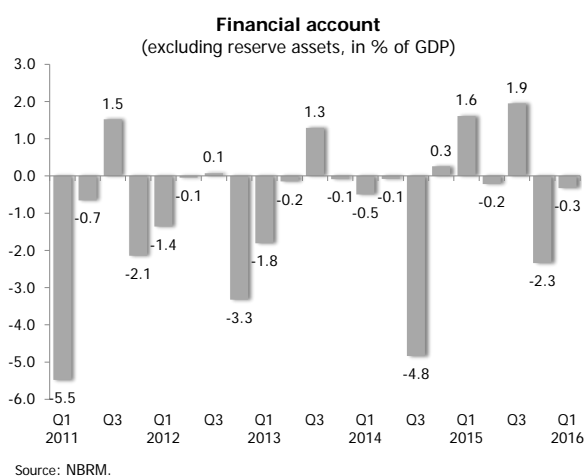


opposed to the net inflows in the previous quarter⁴⁵).

The annual analysis shows a more favorable position of the financial account compared to the first quarter of 2015, when it registered net outflows. The improvement was mainly due to the favorable annual changes in financial loans. In fact, it reflects the low base effect in government loans i.e. the high net outflows in the first quarter of 2015, due to the early repayment of the loan to the IMF⁴⁶.

The latest available balance of payments data as of April 2016 suggests net inflows of Euro 18.3 million in the financial account. These positive developments are mainly due to net inflows from direct investment, and trade credits and advances, amid higher net outflows reported in currency and deposits. Outflows were typical for other sectors which registered more pronounced withdrawal of foreign assets of the households from the banking sector. These shifts reflected the impact of unfavorable developments on the domestic political scene from the end of April 2016.

The gross foreign reserves at the end of the first quarter of 2016 amounted to Euro 2,266.3 million, registering a small quarterly increase of Euro 4.6 million. The increase in foreign reserves results from transactions on behalf of the government and from income from investment of foreign reserves, whereas the NBRM sales of foreign currency on the foreign exchange market, and the negative currency changes and changes in the price of gold acted in the opposite direction. ***According to the latest available data, as of 30 June 2016, the level of foreign reserves was Euro 2,158.8 million.*** Compared with the end of March 2016, this represents a decline in foreign reserves of Euro 107.6 million, mainly reflecting net sales of foreign currency of the NBRM in the foreign exchange market, influenced by events on the domestic political scene, followed by transactions on behalf of the government. The foreign currency deposits of domestic banks with the NBRM⁴⁷, the positive currency changes, and



⁴⁵ In December 2015, the government borrowed from the international markets by issuing the fourth Eurobond in the amount of Euro 270 million, at the same time servicing the due Eurobond of Euro 150 million issued in 2005.

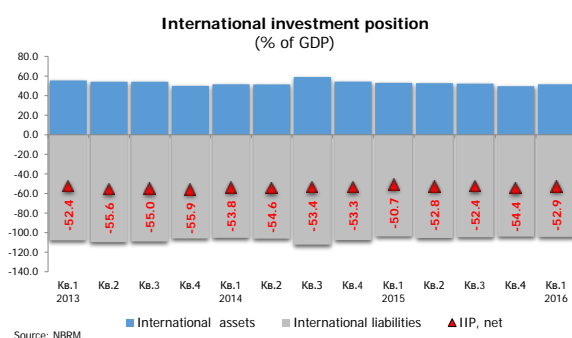
⁴⁶ In February 2015, an early repayment was made of the outstanding portion of the IMF Precautionary Credit Line, in the amount of Euro 153.4 million.

⁴⁷ The National Bank Council adopted the Decision on foreign currency deposit with the National Bank of the Republic of Macedonia for the purposes of maintaining and increasing deposits in the domestic banking system. Accordingly, starting from 13 May 2016,

changes in the price of gold, as well as the income from investing foreign reserves acted in the opposite direction. The analysis of foreign reserves adequacy indicators shows that they continue to hover in a safe zone.

1.6.3. International investment position⁴⁸ and gross external debt

At the end of the first quarter of 2016, the **negative IIP⁴⁹ of the Republic of Macedonia equaled Euro 5,002.8 million, or 52.9% of GDP**. On a quarterly basis, the IIP has improved by 1.5 percentage points of GDP, as a result of the stronger increase in the international assets compared to that of the international liabilities. Analyzing by sector, this quarterly shift is largely a result of lower net liabilities in other sectors in the economy (lower liabilities to foreign direct investors and increased funds in short-term trade credits), reduced net government liabilities, as well as the quarterly decline in net liabilities of depository institutions.



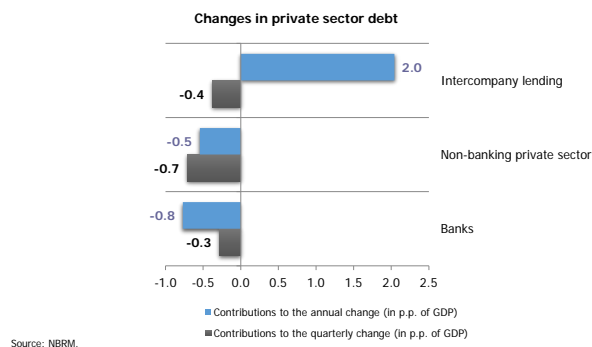
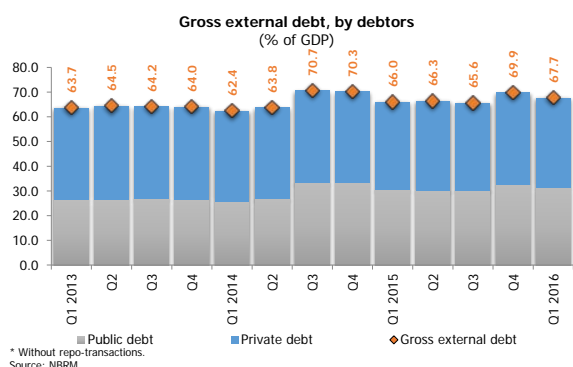
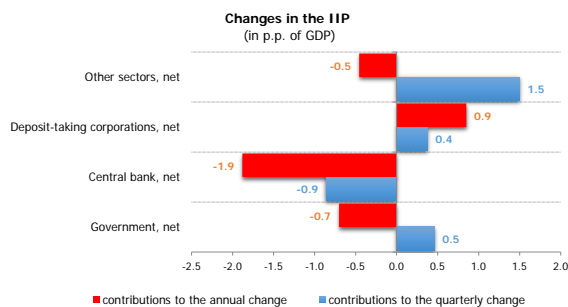
On annual basis, net liabilities to the rest of the world grew by 2.2 percentage points of GDP, given the decline in international assets (of 1.6 percentage points of GDP) and the growth in international liabilities (of 0.6 percentage points of GDP). *Analyzing individual sectors*, the higher net IIP results from the reduced net assets of the central bank (mainly as a result of the reduced foreign reserves), increased net government liabilities (amid reduced assets and higher liabilities on loans from abroad), and increased net liabilities in other sectors in the economy (mainly due to higher net liabilities on direct investment and long-term loans). On the other hand, the net liabilities of depository institutions declined on an annual basis.

As of 31 March 2016, the gross

the banks can place foreign currency deposits with the NBRM at interest rates higher than the current negative interest rates prevailing in the international financial markets.

⁴⁸ The analysis in this section relies solely on IIP data compiled under the new methodology. Namely, since July 2014, the NBRM started disseminating data on the international investment position (IIP) and gross external debt of the Republic of Macedonia, according to the new international statistical standards defined by the Balance of Payments and International Investment Position Manual (BPM6) and External Debt Statistics (2013). For more information on the methodological changes, visit the NBRM website (http://nbrm.mk/WBStorage/Files/Statistika_Informacija_za_promenite_vo_platniot_bilans_megunarodnata_investiciska_pozicija_i_nadvoresniot_dolg_koisto_proizleguvaat_od_primenata_na_novite_megunarodni_statisticki_standardi.pdf).

⁴⁹ 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 incurs liabilities. At the same time, claims created from entering into reverse repo agreements tend to increase gross claims. The NBRM simultaneously carries out matched conclusion of repo and reverse repo agreements in nearly 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, and therefore do not affect the total net IIP nor the total net external debt.



external debt stood at Euro 6,707.4 million, or 70.9% of GDP, which is a quarterly increase of 1.1 percentage points of GDP. If we exclude the effect of repo transactions⁵⁰, the gross debt accounts for 67.7% of GDP, which is a quarterly decline of 2.2 percentage points of GDP⁵¹. This quarterly shift in the gross external debt was mainly due to the lower gross private debt, with a decrease being also registered in the public sector debt. Lower private debt is due to the decline of the debt of non-banking private sector, mainly due to the repayment of accumulated trade credits, lower intercompany debt, and reduced debt of banks, mostly based on currencies and deposits and long-term loans.

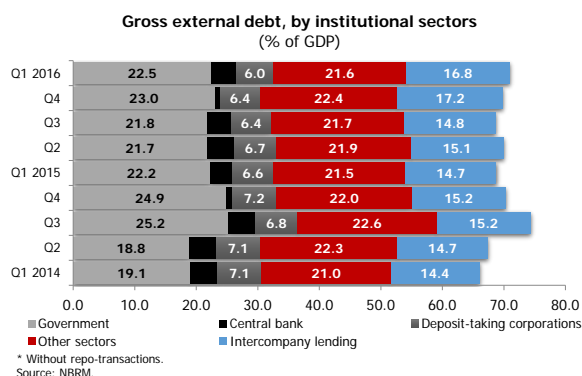
Compared to the end of the first quarter of 2015, gross external debt has increased by 1.8 percentage points of GDP, given the growth of public and private debt. The annual growth of public debt is mostly caused by the increase in government debt due to the issue of the fourth Eurobond in December 2015 and the further growth of the debt of public companies to support road infrastructure. The growth of private debt is predominantly driven by loans between related parties, i.e. there was a significant increase of intercompany debt. On the other hand, the level of debt of the banking sector on long-term instruments have reduced (currency and deposits, and loans), and a slight decline was also recorded in the debt of non-banking private sector.

In general, the external indebtedness indicators of the national economy still show that the gross external debt is in the safe zone. The only indicator that classifies the economy in the group of highly indebted countries is the gross external debt to GDP ratio. The dynamic analysis of external indebtedness⁵² indicates favorable trends in two solvency indicators on an annual basis (the share of gross debt and repayment of debt in the export of goods and services and

⁵⁰ The overall analysis below relates to gross external debt without the central bank liabilities based on repo transactions.

⁵¹ The analysis in nominal terms indicates a slight increase in gross external debt of 0.8% compared to the end of 2015, primarily due to the increased public sector debt, and less to the higher level of private sector debt.

⁵² The analysis of the external indebtedness indicators is prepared on the basis of balance of payments data in accordance with Balance of Payments and International Investment Position Manual (BPM6) and data on gross external debt according to the External Debt Statistics (2013). The methodological changes caused no changes in the overall level of external debt, but only affected the maturity and sector structure of the debt. Accordingly, under the new methodology, the level of short-term debt is lower on account of the increase in long-term debt component, which caused changes in the liquidity indicators, i.e. their improvement relative to the analyses based on data from the previous methodological framework. On the other hand, the methodological changes in the export of goods and services and other inflows caused deterioration of the indicators for the share of export of goods and services and other inflows in the gross external debt and debt service in relation to export of goods and services and other inflows, compared with the indicators relevant prior to the methodological changes.



other inflows), while the share of gross debt in GDP and the ratio between interest repayment and export of goods and services and other inflows registered a slight deterioration. Liquidity ratios show further coverage of short-term debt liabilities and short-term debt with residual maturity, with foreign reserves.

In the period under observation, net external debt, as an additional external debt indicator of the economy, amounted to Euro 2,397.1 million or 25.4% of GDP, which is a slight quarterly decrease of 0.6 percentage points of GDP.

Indicators for external indebtedness	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	2.41	129.3	49.3	12.4	1.14	0.89	30.3
31.12.2005	2.66	147.0	56.3	11.06	1.67	1.04	26.7
31.12.2006	3.44	131.3	51.8	21.7	1.95	1.34	29.0
31.12.2007	2.78	119.3	51.3	19.4	1.35	1.08	39.8
31.12.2008	2.66	116.9	54.1	10.2	1.29	0.95	35.2
31.12.2009	2.43	131.0	57.8	11.8	1.29	0.94	32.9
31.12.2010	3.22	140.4	59.7	13.9	1.49	0.99	27.9
31.12.2011	3.12	148.4	64.6	16.8	1.78	1.18	25.2
31.12.2012	2.92	142.1	67.6	13.1	1.64	1.03	26.7
31.12.2013	2.51	137.3	67.3	15.8	1.64	1.08	23.3
31.12.2014	3.02	149.4	74.1	17.3	1.82	1.13	22.3
31.03.2015	2.68	137.9	69.8	20.1	1.76	1.13	22.3
30.06.2015	2.68	138.6	70.2	20.1	1.63	1.07	22.9
30.09.2015	2.68	137.0	69.4	20.1	1.68	1.08	21.9
31.12.2015	2.68	146.1	74.0	20.1	1.62	1.10	22.0
31.03.2016	2.81	135.8	71.0	15.2	1.65	1.11	21.5
Moderate indebtedness criterion	12 - 20%	165 - 275%	30 - 50%	18 - 30%	1.00		

*The moderate indebtedness criterion is according to the World bank's methodology of calculating indebtedness 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.

*According to the "Greenspan-Guidotti rule", a country should maintain full coverage of short-term debt at remaining maturity with gross foreign reserves.

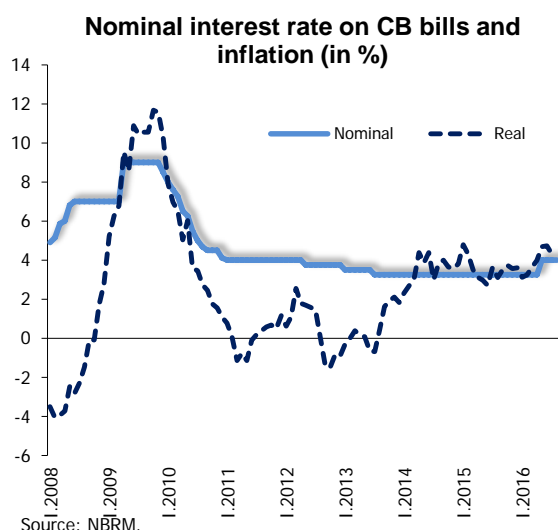
Source: NBRM.

II. Monetary policy

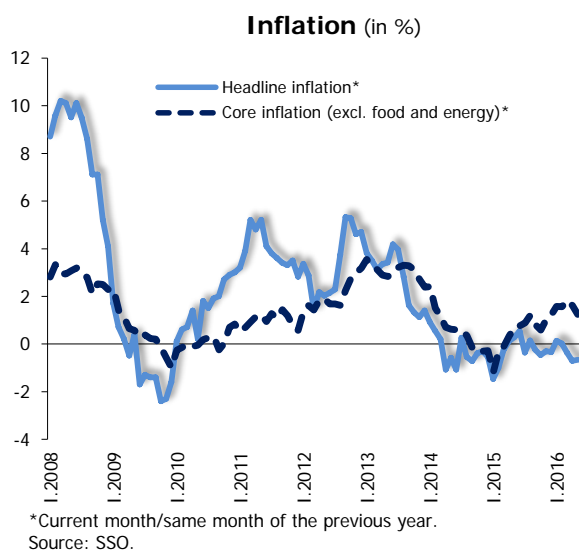
During the second quarter of 2016, the NBRM increased its policy rate by 0.75 p.p. to 4.00%. Amid sound economic fundamentals and absence of major imbalances in the economy, the increase in the policy rate was a response to the effect of non-economic factors. The monetary policy was tightened given the increased demand for foreign currency and pressures on banks' deposit base due to the deteriorating expectations of economic agents, caused by the unstable political situation in the country. The signal of change of the monetary policy stance through the basic instrument was further strengthened by changes in reserve requirements, aimed at further stimulating of the process of denarization of deposits, including further actions. Also, during the quarter, the gap between demand for, and supply of, foreign currency was complemented by the NBRM



interventions in the foreign exchange market. All foreign reserves adequacy indicators are within a comfortable zone. The uncertainty associated with the domestic political upheavals and the global surrounding is still present. In the period ahead, the NBRM will continue to monitor closely the situation for timely and appropriate adjustment of the monetary policy.

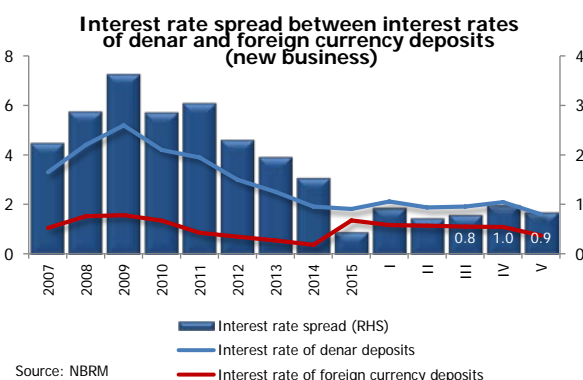
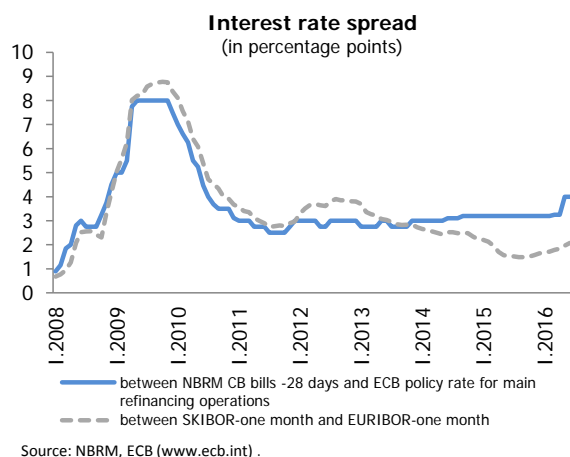
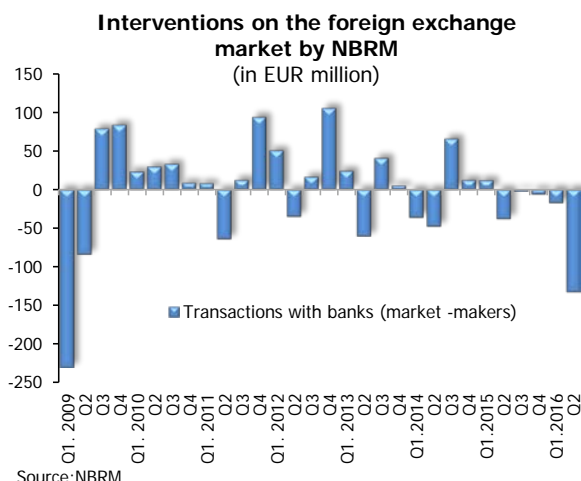


In the second quarter of 2016, the NBRM's Operational Monetary Policy Committee made a decision to increase the policy rate by 0.75 percentage points, from 3.25% to 4.00%⁵³. The decision to increase the interest rate was adopted given the increased demand for foreign currency and the pressures on the banks' deposit base, which were entirely due to the deteriorating expectations of economic agents, caused by the political developments in the country. To enhance the signal provided through the policy rate, and in order to further encourage the process of denarization of deposits and to strengthen confidence in the domestic currency, the NBRM increased the reserve requirement rate for banks' liabilities with FX clause from 20% to 50%, and also launched auctions of foreign currency deposits with more favorable interest rates for banks compared to the interest rates on international financial markets. It is expected that this measure will contribute to reduction of the cost of domestic banks, which consequently should contribute to higher interest rates on the deposits of their clients, domestic legal and natural persons.



The movements of the main macroeconomic indicators give a different picture when compared to the April projections. Thus, in the second quarter, the average annual inflation rate (for the period April-May) was negative (-0.7%), with lower food and energy prices, while core inflation remained in the zone of positive annual changes and averaged 1.4% in the second quarter. These performances are generally within the expectations in the April projections. Data on economic activity in the first quarter showed slower economic growth that amounted 2%, which is also lower than expected in the April projections. High frequency data on economic activity, available in the second quarter (April-May) indicate possible deceleration of activity, which can partly be attributed to the continued uncertainty about the ongoing political developments in the country. Foreign reserves declined in the second quarter, but are still at the appropriate level, enough to cope with any

⁵³ The decision was taken at the scheduled meeting of the Operational Monetary Policy held on 3 May 2016.

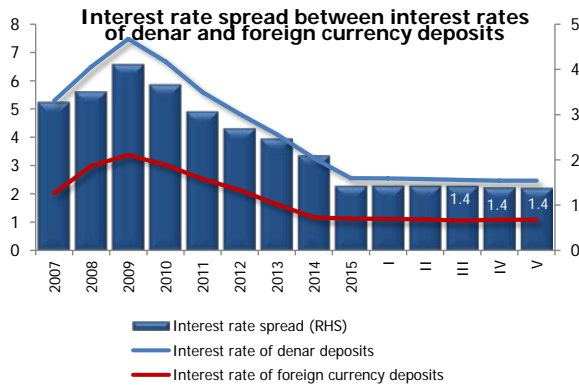


shocks. The fall in foreign reserves was mainly caused by the NBRM foreign exchange interventions. On the other hand, the foreign currency deposits placed with the NBRM increased the level of foreign reserves. As for the credit market, lending slowed down (from 8.4% in March to 3.5% in June), and is weaker than assessed for the second quarter. These performances might partly be a response to the uncertain environment and the lower deposit base, but mostly reflect the transfer of part of the doubtful and contested claims of the off-balance sheets under the decision of the NBRM adopted in December 2015⁵⁴. Namely, if we exclude the effect of the abovementioned transfer, the annual growth of total loans in June is significantly higher (7.7%). The uncertainty associated with the domestic political upheavals and the global surrounding is still present. In the period ahead, the NBRM will continue to monitor closely the situation for the timely and appropriate adjustment of monetary policy.

In the second quarter of the year, the interest rate spread of the policy rates (of the ECB and the NBRM) and short-term market interest rates moderately expanded. The increase of the NBRM policy rate in May 2016 expanded the interest rate spread between the interest rate on the ECB's main refinancing operations (0.00%⁵⁵) and the interest rate on CB bills (from 3.25 to 4.00 percentage points). Meanwhile, with further reduction of the one-month EURIBOR and moderate growth in the one-month SKIBOR, the interest rate spread between short-term market interest rates on the financial markets in the euro area and in the domestic economy moderately expanded in April-May compared to the first quarter of the year (from 1.7 to 1.9 percentage points, on average). Within the banking sector in the domestic economy, analyzing the newly accepted deposits, in May, the interest rate on Denar deposits moderately decreased, which amid a simultaneous moderate fall in the interest rate on foreign currency deposits, slightly expanded the interest rate spread to 0.9 percentage points from 0.8 percentage points in March. However, it should be born in mind that the interest rates on

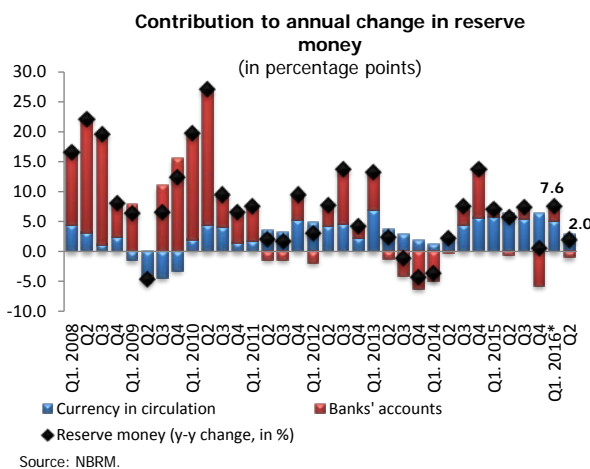
⁵⁴ On 17 December 2015, the National Bank Council adopted the Decision amending the Decision on credit risk management, which requires from banks, for the period from 1 January 2016 through 30 June 2016, to write-off any claim that has been fully provisioned for more than two years, and where the bank identified and fully covered the credit risk of default at least two years before.

⁵⁵ In March 2016, the European Central Bank decreased the interest rate on main refinancing operations from 0.05% to 0.00% which coupled with the other measures, has signaled further relaxation of the monetary conditions in the euro area.



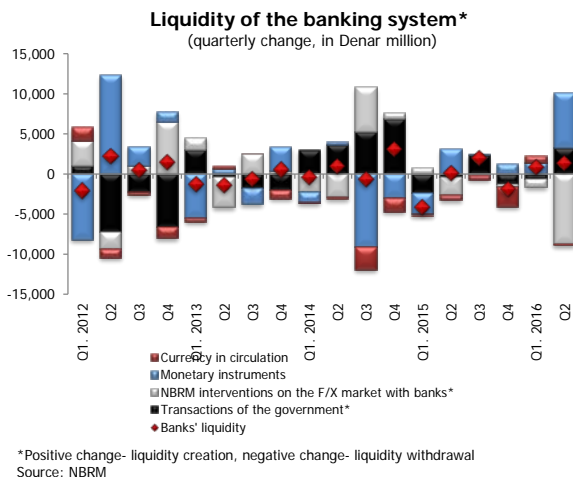
newly received deposits are volatile, which can result in frequent and temporary adjustments of the interest spread. Interest rate spread between interest rates on total Denar and total foreign currency deposits is stable at 1.4 percentage points in May, remaining at a relatively same level as at the end of the first quarter.

2.1 Banks' liquidity and Interbank Money Market developments



During the second quarter of 2016, bank liquidity⁵⁶ increased by Denar 1,376 million, compared to the first quarter of 2016. The latest available data show that in May, the growth of the reserve money⁵⁷ was 2.0% on an annual basis, considerably down compared to the end of the first quarter of 2016, when it was 7.6%.

Within the analyzed period, autonomous factors decreased the bank net liquidity (by Denar 5,490 million). Analyzed individually, the NBRM foreign exchange interventions (selling foreign currency to market makers) significantly reduced the banks' liquidity, with the currency in circulation acting in the same direction (an increase of Denar 223 million). On the other hand, government transactions contributed to the growth of bank liquidity of Denar 3,216 million.



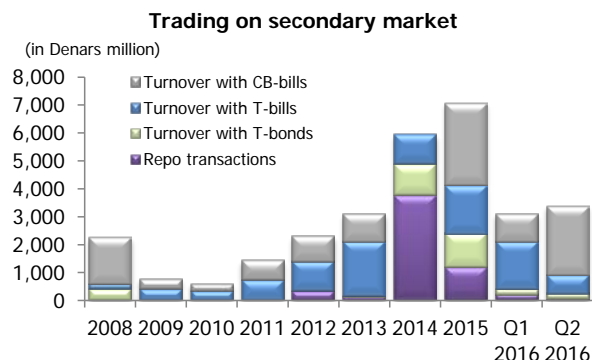
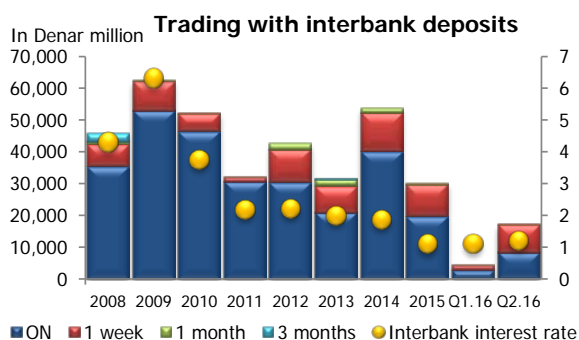
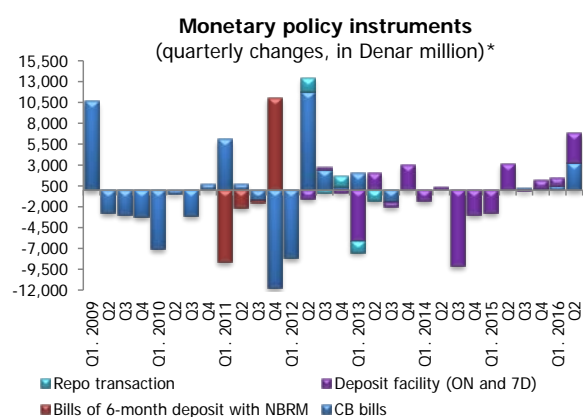
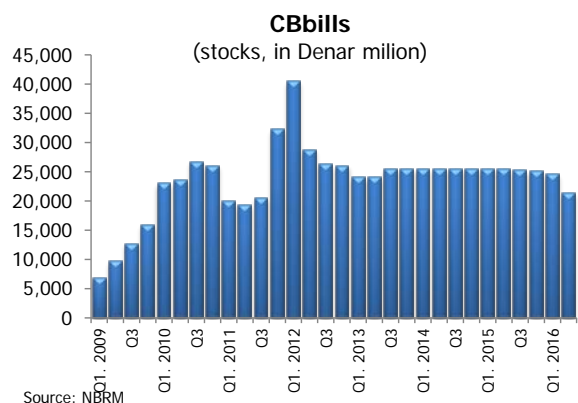
During the analyzed period, the stock of the NBRM monetary instruments decreased on a net basis, creating liquidity in the banking system of Denar 6,866 million. Three volume tender (limited amount) CB bill auctions with fixed interest rate⁵⁸ were held in the second quarter. Amid relatively lower level of liquidity in the banking system under the influence of autonomous factors, the CB bill auctions in May and June offered a lower amount of CB bills⁵⁹. Given the lower demand by banks,

⁵⁶ Refers to the change in banks' account balances with the NBRM.

⁵⁷ Includes reserve requirement in foreign currency.

⁵⁸ The CB bill interest rate at the April auction was 3.25%, while at the auctions in May and June, the CB bill interest rate was 4.00%.

⁵⁹ Decisions on the amount of CB bills to be offered at auctions are adopted in the monthly meetings of the Operational Monetary Policy Committee.



the stock of CB bills declined, and at the end of June amounted to Denar 21,330 million, creating liquidity of Denar 3.276 million in the banking system⁶⁰ through the basic instrument. Banks also shy away from the deposit facilities with the NBRM (overnight and 7-day deposits), which caused a decline in the stock of these instruments in the amount of Denar 3,590 million. Hence, the effect of autonomous factors (reduced liquidity by Denar 5,490 million) was fully offset through monetary instruments (creating liquidity in the amount of Denar 6,866 million), increasing the banks' liquid assets with the National Bank by Denar 1,376 million. Amid growing demand for liquidity, the NBRM also created liquidity through the scheduled repo operations in the amount of Euro 1,501 million and through overnight credit facilities, in the amount of Denar 400 million to Denar 800 million, whereby the approved liquidity was returned within the quarter. Analyzing the reserve requirement, in the second quarter, banks kept by 5.7% higher amount of liquid assets, on average, on the accounts with the NBRM, which is moderately lower than the excess liquidity in the previous quarter (6.6%).

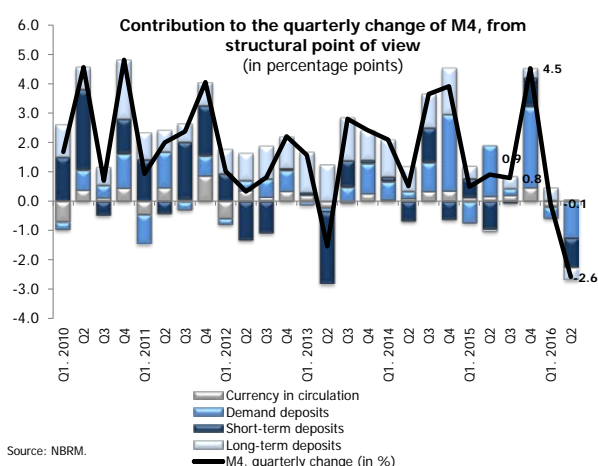
In the second quarter of 2016, banks actively traded in the unsecured deposit market, with increased trading being also registered on the secondary securities market. The structure of trade in unsecured deposits included mostly transactions with 1-day to 7-day maturity, with an almost equal share (50% and 49%, respectively). The interbank interest rate (MBKS) moderately increased and averaged 1.2%, (1.1%, in the previous quarter). On the other hand, the interbank interest rate on overnight transactions (MKDONIA) has remained stable and averaged 1.0%. In the second quarter of the year, there was also trading on the secondary securities market, with moderately higher trade of this segment compared to the previous quarter. The structure of trade in securities was predominated by CB bill transactions (73%), followed by trade in government securities. The share of repo transactions in total trade in securities was relatively low and amounted to 1.8% (6.8% in the previous quarter).

⁶⁰ The auctions of CB bills held in April, May and June registered lower demand than supply by Denar 881 million, Denar 1,286 million and Denar 670 million, respectively.

2.2. Monetary and credit aggregates

In the second quarter of 2016, the broad money M4 registered a significant decline on a quarterly basis. The decline in the money supply was caused by the uncertain domestic political environment, which worsened the expectations of economic agents and led to the withdrawal of deposits from the banking system. Also, in this period, there was speculation about devaluation of the Denar, which increased the propensity to hold foreign currency and caused changes in the currency structure of savings. These pressures were particularly pronounced during the second half of April and May, followed by gradual stabilization. In such circumstances, all money supply components decreased, with the exception of currency in circulation. Analyzed by sectors, both household and corporate deposits declined. In the second quarter of the year, the growth of loans to the private sector significantly slowed down due to the regulatory requirements of the NBRM against the banks. On a quarterly basis, total loans declined by 2%, but when controlled for the effect of regulatory changes, total loans grew by about 2.8%, which is a significant movement compared with the previous quarter. Compared to the same month last year, loans grew by 3.5%, and if we exclude the effects of new regulations, the annual growth rate is much higher, estimated at 8.5%.

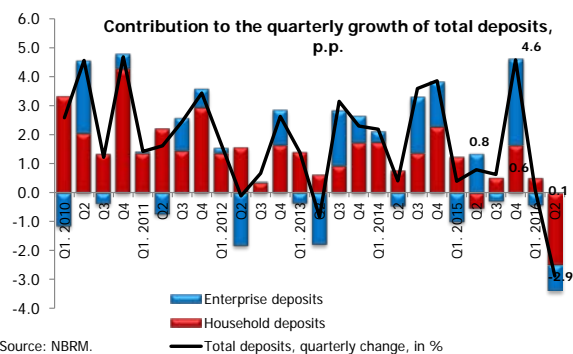
2.2.1. Monetary aggregates



In the second quarter of 2016, the money supply in the economy registered a significant quarterly decline of 2.6% (drop of 0.1% in the first quarter). The fall of broad money was mainly caused by the uncertain domestic political environment. The increased political uncertainty adversely affected the trust and expectations of economic agents, leading to withdrawal of deposits from the banking system, and also increased the propensity to hold foreign currency. In such conditions, the fall in money supply, from a structural point of view, was the result of the negative contribution of all components (demand deposits, short-term and long-term deposits), excluding currency in circulation which made small positive contribution. The most liquid monetary aggregate M1 dropped by 3.9% on a quarterly basis, at a more intensive pace compared to the previous quarter, amid significant decline in demand deposits. Observed by currency, the impact of these events was felt especially in the Denar component. Thus, in the second quarter of 2016, total Denar deposits with demand deposit decreased by 5.0% on a quarterly basis, mainly as a result of declining demand deposits, while foreign currency deposits registered a minor growth of 0.2%. As a result of the fall of Denar component in the structure of M4, the degree of euroisation i.e. share of foreign currency deposits in M4 money supply, rose to 38.6% at the end of June, from 37.5% in March. However, the Denar component of the money supply remained dominant. The developments in the second quarter led to a significant slowdown in the growth of broad money supply on an annual basis, which in June reduced to 2.5% from 6.2% at the end of the

Total deposits	2013		2014				2015				2016	
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	
	q-o-q growth, %											
Total deposits	2.3	2.2	0.4	3.6	3.9	0.4	0.8	0.6	4.6	0.1	-2.9	
	contributions to quarterly growth, p.p.											
Deposit money	1.1	0.7	0.3	1.1	2.8	-0.8	1.9	0.3	3.2	-0.4	-1.3	
Denar deposits	0.9	0.9	0.1	1.3	1.5	0.0	-1.1	0.3	0.3	0.01	-1.6	
Foreign currency deposits	0.3	0.6	0.0	1.3	-0.4	1.2	0.0	0.1	1.1	0.5	0.1	
Short-term deposits	0.1	0.3	-0.7	1.3	-0.7	0.7	-1.0	-0.1	1.1	0.03	-1.0	
Long-term deposits	1.1	1.3	0.9	1.2	1.7	0.5	-0.1	0.4	0.3	0.5	-0.5	

Source: NBRM.

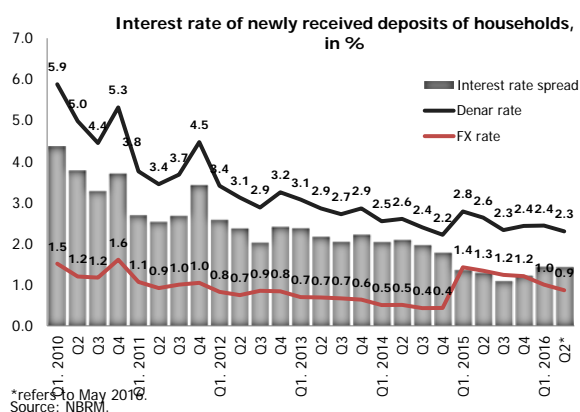


Household deposits													
	2013			2014			2015			2016			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2		
	quarterly change, in %												
Total household deposits	2.4	2.4	1.1	1.9	3.2	1.8	-0.7	0.7	2.3	0.8	-3.5		
	contribution to quarterly change of total deposits, in p.p.												
Deposit money	1.0	0.5	0.2	0.2	1.9	0.1	-0.2	0.3	1.8	0.1	-0.9		
Denar deposits	1.1	1.2	0.7	0.9	1.1	0.7	-0.4	-0.1	0.1	0.3	-2.6		
FX deposits	0.3	0.7	0.2	0.9	0.2	1.0	-0.1	0.6	0.4	0.4	0.0		
Short-term deposits	-0.2	0.2	-0.2	0.2	-0.2	1.1	-0.7	0.1	0.2	0.1	-1.8		
Long-term deposits	1.6	1.7	1.1	1.5	1.4	0.6	0.1	0.4	0.3	0.6	-0.8		

Source: NBRM.

Enterprise deposits													
	2013		2014				2015				2016		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2		
	квартални промени, во %												
Total household deposits	4.1	1.7	-2.0	8.8	6.8	-4.2	5.9	-1.2	12.7	-1.7	-3.6		
	contribution to quarterly change of total deposits, in p.p.												
Deposit money	1.9	1.1	0.2	3.3	7.6	-4.3	8.1	0.6	8.3	-2.3	-3.4		
Denar deposits	1.6	0.2	-1.8	2.8	1.3	-1.7	-2.6	-0.4	0.7	-0.1	0.0		
FX deposits	0.7	0.4	-0.4	2.7	-2.1	1.8	0.5	-1.4	3.7	0.6	-0.3		
Short-term deposits	2.1	0.3	-2.0	4.8	-2.4	-1.1	-1.6	-1.2	4.3	-0.2	0.7		
Long-term deposits	0.2	0.3	-0.2	0.6	1.5	1.2	-0.6	-0.6	0.1	0.8	-0.9		

Source: NBRM.



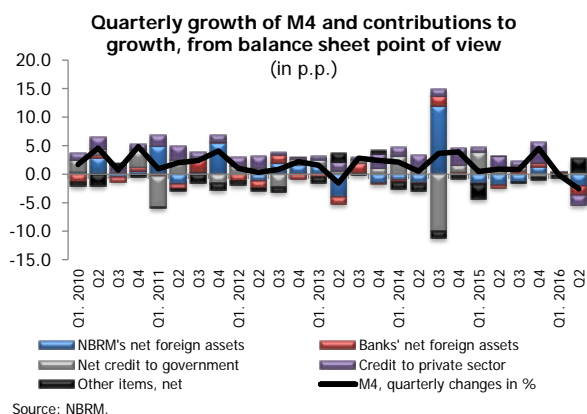
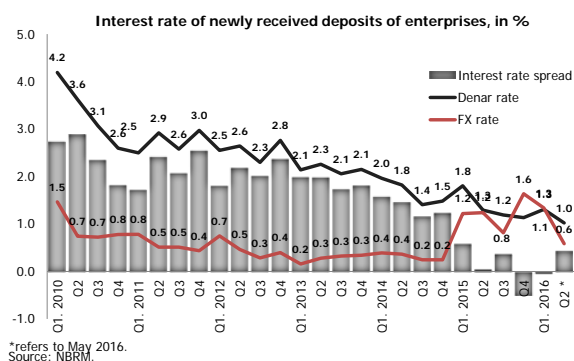
previous quarter.

The deteriorating confidence of economic agents in the domestic economy hit the banks' deposit base. The total banks' deposit potential in the second quarter of 2016 decreased by 2.9% on a quarterly basis. Observing currency, denar deposits have decreased, while foreign currency deposits have been marginally increasing on a quarterly basis. Analyzing by sector, in the second quarter of 2016, banks' deposits decreased primarily due to the fall in **household deposits** (3.5% on a quarterly basis). April and May registered more intensive reduction in total household savings, while in June, they moderately increased for the first time in two months. The performance in June was positive and brought about a gradual stabilization of the situation. Analyzing the maturity structure, there was a decrease in the quarterly contribution of long-term and short-term deposits to total deposit growth. Observing the currency, the quarterly decline is mainly due to the reduction of deposits in local currency. Minor reduction was also registered in foreign currency deposits. **On an annual basis**, the growth of total household deposits further slowed down to 0.2% in June compared with 3.1% in March 2016.

The corporate deposits in the second quarter of the year fell on a quarterly basis by 3.6%, despite the decline of 1.7% in the first quarter. This pace of corporate deposits is common for this period and is probably attributable to their business cycle and the method of financing their operations, as well as the seasonal payment of dividends. The increased domestic uncertainty probably had some effect, as well. In terms of currency structure, the quarterly decline is primarily due to the reduction of demand deposits, while foreign currency deposits decreased at a slower pace. Observing the maturity structure, the quarterly decline in corporate deposits is due to the reduction of long-term deposits, amid moderate growth of short-term deposits. **On an annual basis**, corporate deposits increased by 5.6% at the end of June, which is a slower increase than that at the end of March (16% annually).

According to data on interest rates on new savings⁶¹, the interest rates on newly accepted Denar and foreign currency household

⁶¹ As of January 2015, interest rate data of banks and savings houses have been collected under the new interest rate methodology, while data for the previous period were collected under the old methodology. For more information see Quarterly Report, May 2015, p 53.



deposits registered a moderate decrease of 0.1 percentage points at the end of May, and the interest rate spread remained at the same level as in the previous quarter (1.4 percentage points). Analyzing the newly accepted corporate deposits, given the relatively faster interest rate cuts in the foreign currency deposits compared to Denar deposits, the interest rate spread expanded to 0.4 percentage points. In terms of total deposits, interest rates on Denar and foreign currency household deposits in May amounted to 2.3% and 0.9% respectively, while on Denar and foreign currency corporate deposits they equaled 1.0% and 0.6%, respectively.

The analysis of the structure of money supply, from balance sheet aspect, shows that the fall of the money supply in the second quarter of the current year is mainly due to the net foreign assets of the NBRM (as a result of the NBRM interventions on the foreign exchange market and the fall in foreign reserves), the net foreign assets of banks, and loans to the private sector, while net government loans and other items contribute to increasing money supply.

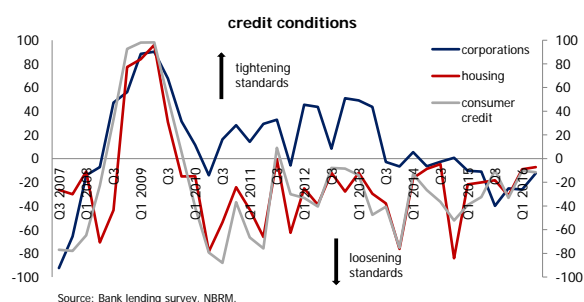
2.2.2. Lending activity

The lending of the banking sector in the second quarter decreased by 2%, as opposed to the small increase of 0.1% in the preceding quarter. The reduced lending in this period results from the transfer of part of the banks' doubtful and contested claims to the off-balance sheet record, according to the NBRM decision adopted in December 2015⁶². The effects of the NBRM decision were the strongest in June 2016, when loans registered a significant monthly fall (of 1.5%) in both sectors. However, if we isolate this effect, the total loans register an increase of about 2.8% on a quarterly basis, which is a significant revival compared to the preceding quarter. According to the results of the latest Bank lending Survey⁶³, in the second quarter, decrease in the demand for corporate and housing loans is evident, as well as further relaxation of the total lending terms.

From a structural point of view, the reduction in lending to the private sector in the

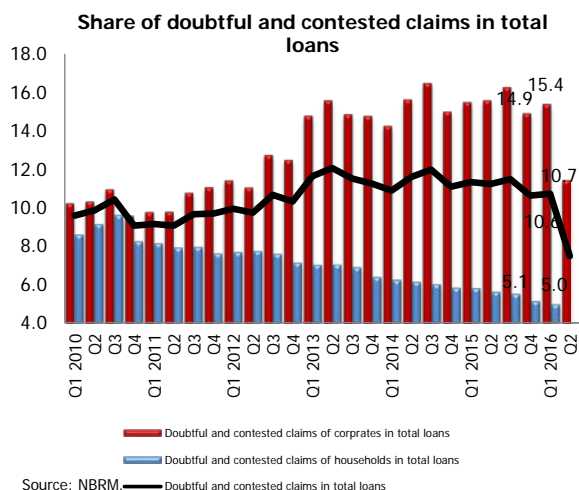
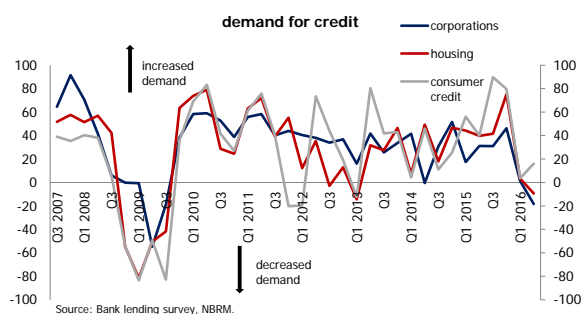
Total credits of private sector									
	2014				2015				2016
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
quarterly change, in %									
Total credits of private sector	1.8	2.9	1.4	3.6	1.1	2.7	1.2	4.2	0.1
Contribution in quarterly change of total credits (in p.p.)									
Denar credits	1.6	2.7	1.3	3.1	0.7	3.2	1.6	3.7	0.6
Foreign currency credits	0.2	0.1	0.1	0.5	0.4	-0.5	-0.3	0.5	-0.6
Short-term credits	0.7	0.4	0.0	1.7	-0.5	0.0	-0.4	1.8	-1.1
Long-term credits	1.2	1.3	0.9	2.4	1.2	2.5	0.3	2.9	1.0
Households	0.9	1.6	1.2	1.0	1.0	1.8	1.4	1.1	1.1
Corporations	0.9	1.2	0.2	2.6	0.1	0.9	-0.2	3.2	-1.0

Source: NBRM.



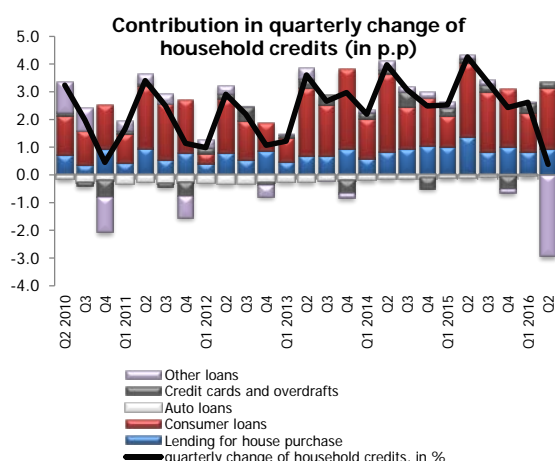
⁶² On 17 December 2015, the National Bank Council adopted the Decision on amending the Decision on credit risk management that requires from banks by 30 June 2016 to write off (and to continue to write off) all claims that have been fully booked for more than two years, and where the bank has identified and fully covered the credit risk of default at least two years before. Despite the write-off of these claims, i.e. their transfer to the off-balance sheet record, banks reserve the right for their collection.

⁶³ For more information, also see Lending Survey at <http://nbrm.mk/?ItemID=F7AC78DEE498764FBAF39049F726CE3C>.



Total credits of households	2014				2015				2016	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
quarterly change, in %										
Total credits of households	2.1	3.9	2.9	2.4	2.4	4.2	3.3	2.5	2.5	0.2
Contribution in quarterly change of household credits (in p.p)										
Denar credits	2.1	3.9	3.0	2.3	2.3	3.9	3.2	2.4	2.5	0.1
Foreign currency credits	0.0	0.1	0.0	0.1	0.1	0.2	0.1	0.1	0.1	0.2
Short-term credits	0.2	0.3	0.4	-0.4	0.2	0.2	0.2	-0.3	0.2	0.2
Long-term credits	1.8	3.5	2.5	2.8	2.0	3.9	3.0	3.0	2.4	3.1

Source: NBRM.



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

second quarter was affected by the drop in corporate loans, while loans to households registered moderate quarterly growth. These changes are a result of regulatory changes, and if we ignore this effect, the lending activity to both sectors in this quarter grows solidly. In terms of currency structure, there is a decrease in both Denar and foreign currency loans, with larger intensity in Denar loans. The analysis of the maturity structure on a quarterly basis indicates further decline of short-term loans, for the second consecutive quarter. Long-term loans continue to grow on a quarterly basis much intensively than in the previous quarter. In terms of doubtful and contested claims, at the end of June, they decreased quarterly in both enterprise and household sector, as a result of the decision of the National Bank for obligatory transfer of the banks' doubtful and contested claims to the off-balance sheet records. The share of doubtful and contested loans in total loans equals 7.5% and decreased significantly by 3.2 percentage points compared to March.

On an annual basis, the total deposits in June grew by 3.5% which is lower compared to the annual increase in March (8.4%). Excluding the effect of the write-off, the total loans in June registered annual increase of about 8.5%, thus keeping up with the pace registered so far. The credit-to-deposit ratio indicator⁶⁴ equaled 92.7% at the end of June (97.2% excluding the decision's effects), which means larger use of the deposit potential for lending to the private sector compared to the previous quarter.

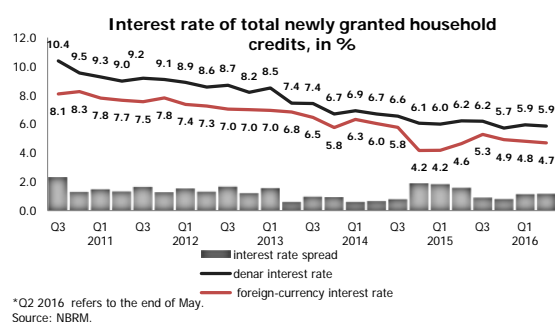
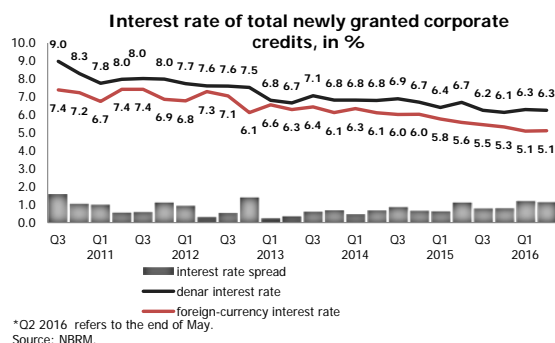
In the second quarter of 2016, the lending to the households sector registered an increase of 0.2% on a quarterly basis, i.e. about 3.7%, without the effects of the regulatory changes. As a result, the household crediting continued to increase. The Bank lending Survey shows decrease in the demand for housing loans, given further intensified demand for consumer loans. The lending terms are still moderately relaxed. The structural analysis shows that the main carriers of the increase in the household loans are the foreign currency loans, given moderate rise in the loans in domestic currency. As for individual types of household loans, the growth continues to be predominantly driven by the rising consumer loans, the contribution of which increased. **Annually**, at the

⁶⁴ According to monetary statistics data.

**Total credits of corporations**

	2014				2015				2016	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
quarterly change, in %										
Total credits of corporations	1.5	2.0	0.3	4.5	0.1	1.6	-0.4	5.7	-1.8	-3.8
Contribution in quarterly change of corporation credits (in p.p)										
Denar credits	1.2	1.9	0.1	3.7	-0.5	2.7	0.3	4.7	-0.7	-2.0
Foreign currency credits	0.3	0.2	0.2	0.8	0.6	-1.1	-0.7	0.9	-1.1	-1.8
Short-term credits	1.0	0.6	-0.3	3.2	-1.1	-0.1	-0.9	3.4	-2.0	-0.8
Long-term credits	0.7	-0.2	-0.2	2.2	0.6	1.4	-0.1	2.8	0.0	1.4

Source: NBRM.



end of June, total household loans increased by 8.8% (13% at the end of March). However, if we isolate the effect of the Decision, the total loans register annual increase of about 12.5%.

The loans of the corporate sector registered quarterly decrease of 3.8%, which was higher compared to the previous quarter (decrease of 1.8%), but fully due to the changes in the regulatory requirements. Without this effect, the lending to the corporate sector increases on a quarterly basis by 2.1%. According to the Bank lending Survey, in the second quarter the demand for corporate loans registers a decrease, amid further net easing of the overall lending terms, but at significantly smaller pace. From the viewpoint of currency, the changes in the total loans are almost equally a result of denar and foreign currency loans. **On annual basis**, at the end of June the corporate loans went down by 0.5%, but excluding the effect of the decision, the total corporate loans register an increase of about 5.5%.

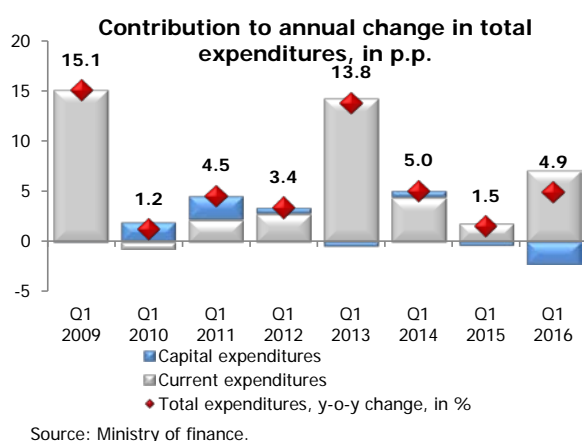
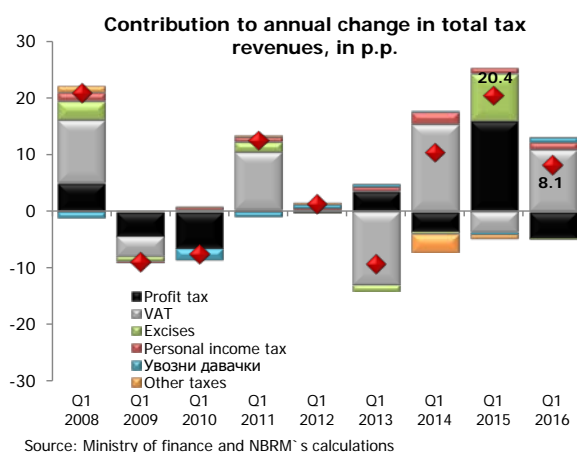
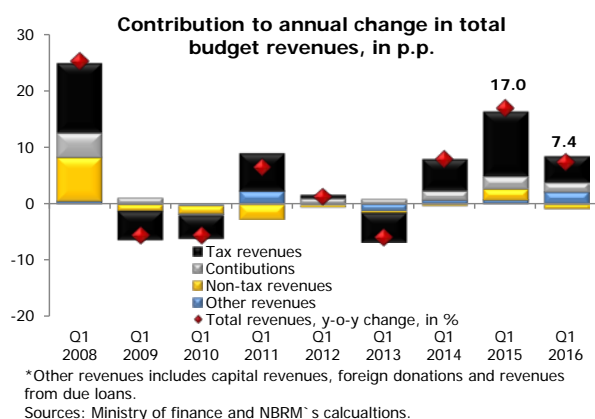
According to the data on the interest rates on the newly approved loans as of May⁶⁵, the interest rates on denar and foreign currency loans to households and enterprises remained at the same level as in the previous quarter. The interest rate on foreign currency loans to households are exception, since they registered minimal quarterly decrease.

III. Public finances

During the first quarter of 2016, the total revenues and expenditures in the Budget of the Republic of Macedonia (central budget and budgets of funds) were higher on an annual basis by 7.4% and 4.9%, respectively. Most of the increase in the budget revenues is a reflection of the higher VAT revenue, with the revenues based on contributions also having a positive contribution. Regarding the budget expenditures, their increase in the first quarter is fully due to the higher current expenditures, while the capital expenditures continued to decrease. The budget deficit registered in the first quarter of the year equaled 1% of GDP, or 30% of the plan with the Budget for the current year, which is moderately lower than the level registered last year (1.1% of GDP). The budget deficit in this period was financed through government borrowing on the domestic financial market and less through foreign borrowings. Cumulatively, in the period April - May 2016 the

⁶⁵ As of January 2015, interest rate data of banks and savings houses have been collected under the new interest rate methodology, while data for the previous period were collected under the old methodology. For more detailed information see Quarterly Report, May 2015, p 53.

budget deficit equals 1.1% of GDP, which constitutes 33% of the projected budget deficit for 2016 according to the Budget for 2016⁶⁶. Most of the budget deficit in this period was financed through funds withdrawal from the government account with the NBRM.



During the first quarter of 2016, the annual increase in the total revenues in the Budget of the Republic of Macedonia⁶⁷ equals 7.4%. The increase in the budget revenues is mostly a reflection of the higher tax revenue, mainly based on VAT (with a contribution to the annual increase of 6.3 p.p.), while the share of the revenues based on contributions was relatively lower (1.7 p.p.). Also the contribution of other revenues in the Budget is moderately positive, and in one part, it originates from the payment of dividend of a domestic company to the Budget of RM, while the non-tax income has minor negative contribution to the change in the total revenues. Compared to the performance in the same period of the previous year, the annual increase in the total budget revenues in the first quarter is slower, which is mostly explained with the tax revenues' dynamics, mainly in the profit tax. The realization in the revenues based on contributions is moderately lower as well.

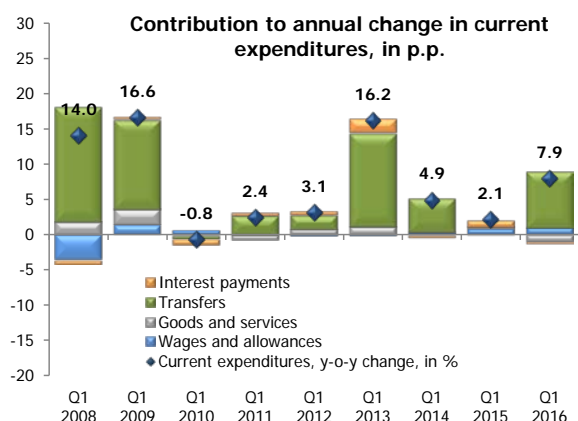
In the first quarter of 2016, the total tax revenues in the Budget of the RM registered an annual rise of 8.1%. The tax income growth generator are the VAT-based revenues, which grew by 25.6%, annually. The revenues based on personal income tax and import duties have positive contribution to the total tax revenues growth, as well, and they increased by 9.1% and 19.3% on an annual basis. On the other hand, profit tax registered negative annual growth rate, which is partly explained with the high comparison base⁶⁸, while the excise revenues also had moderate negative contribution.

The total budget expenditures augmented by 4.9%, annually. The growth of budget expenditures in the first quarter of the year is entirely driven by higher current expenditures, while capital expenditures had negative contribution. In the first quarter of the

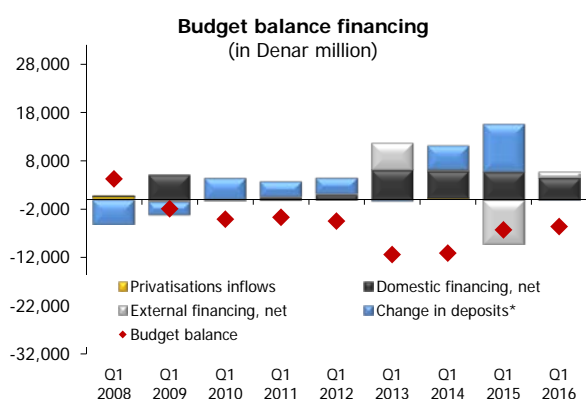
⁶⁶ In June 2016, the Government of the Republic of Macedonia adopted the Draft Budget Revision for 2016, which envisages reduction of the total budget revenues and expenditures compared to the preliminary plan, and realization of higher budget deficit compared to the preliminary budget.

⁶⁷ Central budget and budgets of funds.

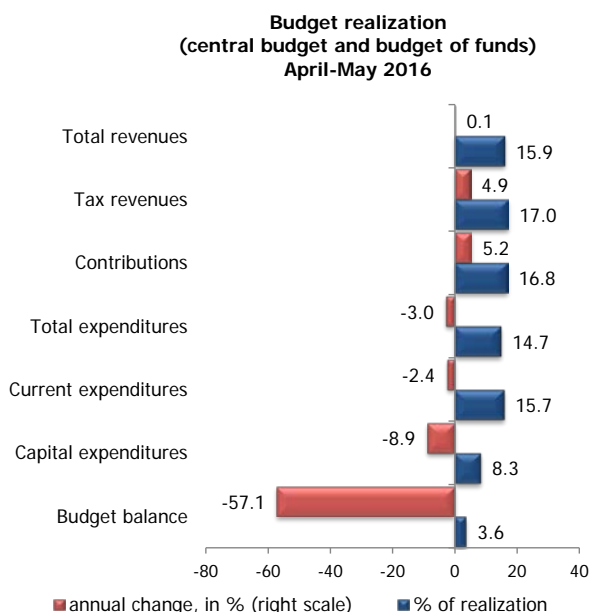
⁶⁸ The high annual growth rate of revenues based on profit tax in the first quarter of 2015 was the result of the abolition of the anti-crisis measure where the retained earnings of the companies were exempted from taxation.



Source: Ministry of finance and NBRM's calculations.



* Positive change- deposits withdrawal; negative change-deposits accumulation.
Source: MoF.

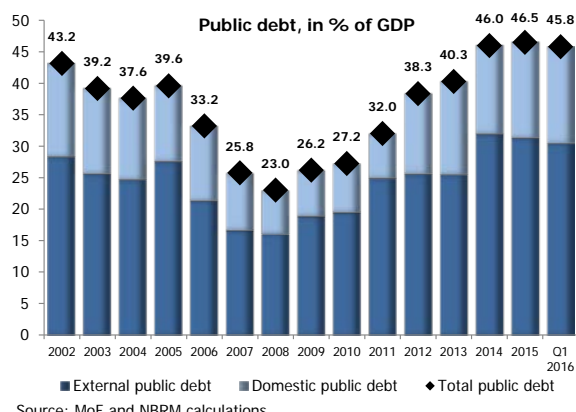


Source: Ministry of finance and NBRM's calculations.

year, the main generator of the increase in the total budget expenditures were transfers (with a contribution to the annual growth of 7.3 p.p.), especially the social transfers, which explain about half of the increase in the current expenditures. Other transfers category, which includes subsidies, has a small positive contribution to the increase, and is at the level of the performance registered in the first quarter last year. Moderately positive was the contribution of the expenses for wages and compensations, while the expenditures for goods and services and the expenditures for interest payments have small negative contribution to the increase in the current expenditures. Compared with the performance in the same period last year, the registered annual growth of the total budget expenditure is higher and mostly explained by a higher realization of transfers.

In the first quarter of 2016, deficit in the amount of Denar 5,635 million in the Budget of the Republic of Macedonia was registered, or 1% of GDP, which is moderately lower compared to the same period last year (1.1% of GDP). The deficit was financed through the net issuance of government securities on domestic financial market and to a lesser extent through funds provided by country borrowing abroad.

In April - May 2016 period, the total budget revenues are slightly higher compared to the last year ones (annual increase of 0.1%). The tax revenues are higher by 4.9%, with the increase being dominantly driven by the VAT inflows and import taxes. Annual increase (of 5.2%) has been also registered in contributions, while the realization in the capital revenues is relatively lower. On the other hand, **the budget expenditures decreased by 3%, annually.** Lower annual increase in total expenditures in the period April - May is mainly due to the lower annual current expenditures by 2.4% (contribution to the annual growth of 2.3 percentage points), with the realization of capital expenditures being also lower by 8.9%. Within operating expenditures, lower growth is mostly due to lower expenditures based on goods and services, while the expenditures for wage and compensation have moderate positive contribution. **With the performance in April - May 2016, the budget deficit totals Denar 6,317 million, which is 33% of the planned deficit for 2016.** Most of the budget deficit in this period is financed through funds withdrawal from the government's



Source: MoF and NBRM calculations.

account with the National Bank.

On 31 March 2016, the total public debt⁶⁹ is lower by 0.7 p.p. of GDP compared to the level registered at the end 2015 and it equals 45.8% of GDP⁷⁰. The analysis of its components indicates that the decline is due to the decrease in the external debt (of 0.9 p.p. of GDP), given simultaneous increase in the internal debt of 0.2 p.p. of GDP. At the end of March 2016, the share of the external and internal public debt in GDP equals 30.5% and 15.4%, respectively. At the end of the first quarter, the total government debt⁷¹ equals 37.5% of GDP (38.0% of GDP at the end 2015), while the public enterprises debt⁷² equals 8.3% of GDP (8.5% of GDP at the end of 2015).

Budget of Republic of Macedonia (Central budget and budgets of funds)

			Annual changes, period in 2016 over the same period in the previous year, in %		Contributions in annual changes, period in 2016 over the same period in the previous year, in %	
	Plan, in Den. million	Realization, in Den. million	Q1 2016	Apr.-May	Q1 2016	Apr.-May
TOTAL REVENUES	177,292	40,590	28,164	7	0	7
Tax revenues and contributions	150,718	35,650	25,185	7	5	6
Taxes	99,543	23,714	16,945	8	5	5
Contributions	49,187	11,585	8,240	6	5	2
Non-tax revenues	18,387	3,426	1,754	-9	-5	0
Capital revenues	3,155	614	165	213	-86	1
Foreign donations	4,232	815	705	4	-7	0
Revenues from repayments of loans	800	85	92	8	-34	0
TOTAL EXPENDITURES	196,276	46,225	28,846	5	-3	5
Current expenditures	170,698	43,083	26,727	8	-2	7
Capital expenditures	25,578	3,142	2,119	-24	-9	-2
BUDGET DEFICIT/SURPLUS	-18,984	-5,635	-682			
Financing	18,984	5,635	682			
Inflow	40,546	7,545	1,761			
Privatisation receipts	0	46	8			
Foreign loans	22,861	2,122	137			
Deposits	-1,209	-113	3,882			
Treasury bills	18,860	5,490	-2,277			
Sale of shares	34	0	11			
Outflow	21,562	1,910	1,079			
Repayment of principal	21,562	1,910	1,079			
External debt	12,381	811	779			
Domestic debt	9,181	1,099	300			

Source: Ministry of Finance and NBRM's calculations

⁶⁹ The public debt is defined under the Law on Public Debt (Official Gazette of the Republic of Macedonia No. 165/14), according to which it is the sum of the government debt and the debt of public enterprises established by the state or municipalities, municipalities within the City of Skopje and the City of Skopje, and companies that are entirely or predominantly owned by the state or by the municipalities, the municipalities within the City of Skopje and the City of Skopje, for which the Government has issued a state guarantee.

⁷⁰ The calculation of the public debt has been made relative to the projected GDP by the NBRM in the April projections.

⁷¹ Government debt is defined as a sum of debts of the central and the local government.

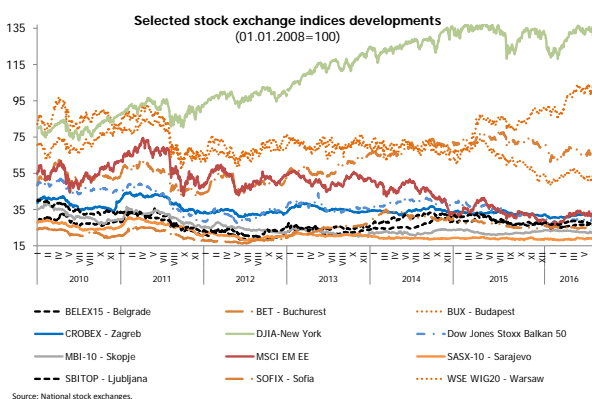
⁷² Refers to guaranteed debt of public enterprises and joint stock companies owned by the state, according to the public debt definition under the Law on Public Debt (Official Gazette of the Republic of Macedonia No. 165/14).

IV. Stock exchange indices and real estate prices

In the second quarter of 2016, the Macedonian stock exchange index MBI-10 registered quarterly decrease, and downward trend was registered also in the value of the OMB index. The trends in most regional markets are also downward, mostly associated with country-specific factors, and less to the referendum outcome in the United Kingdom for exiting EU. Real estate prices on the domestic market, after the increase in the two previous quarters, in the second quarter of the year recorded slight decrease, which in the absence of significant changes in supply and demand for real estate, may be temporary.



During the second quarter of 2016, the value of the Macedonian MBI⁷³ registered quarterly fall of 4.2%, whereby the index reached the value of 1706.97 at the end of the quarter (compared to 1781.03 as it was at the beginning of the quarter). Such movements of the index could reflect the lack of interest of domestic investors and the absence of major foreign institutional investors, as well as increased risk aversion, taking into account the current uncertain political situation in the country. The total stock exchange turnover increased by 29.6% compared to the previous quarter, with substantial rise in the trade also being registered in block transactions. However, the increased turnover is largely initiated by the higher trade in bonds in conditions of new issue of denationalization bonds⁷⁴. The OMB index followed similar path as the MBI-10, and at the end of June 2016, it decreased by 1.5% (compared to 0.3% previous quarter).



At the end of the second quarter of 2016, most of the regional stock indices decreased, except those in Sofia and Sarajevo. The downward trend of indices could partially be attributed to the increased volatility in global financial markets, and uncertainty in the external environment, however, most of the shifts in the regional stock markets have been influenced by country-specific factors⁷⁵. The outcome of the UK referendum for exiting the EU had downward impact on the indices, although with a short-time effect.

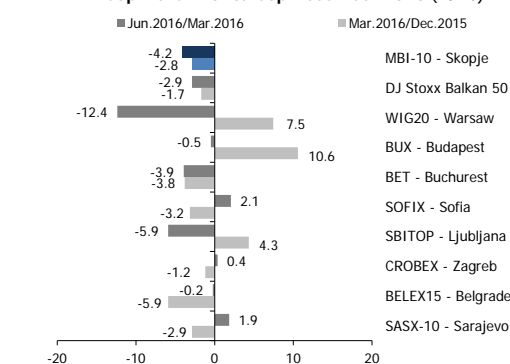
⁷³ On 15 June 2016, the MBI-10 index was revised, and as of 30 June 2016, the index includes the following companies: Komercijalna Bank AD Skopje, Granit AD Skopje, Alkaloid AD Skopje, Stopanska Bank AD Bitola, Makpetrol AD Skopje, Makedonijaturist AD Skopje, Replek AD Skopje, Makedonski Telecom AD Skopje, NLB Banka AD Skopje and Stopanska Banka AD Skopje.

⁷⁴ It is the denationalization bond of fifteenth issue from 20 June 2016 in the total amount of Euro 12,000,000.

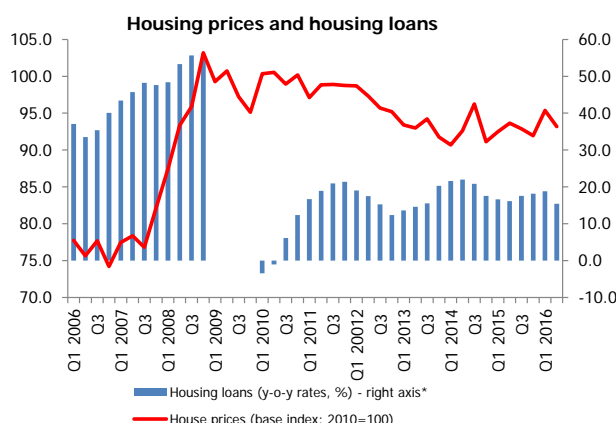
⁷⁵ <http://wire.seenews.com/>



Changes of the regional stock exchange indices, eop June
2016/eop March 2016 and
eop March 2016/ eop December 2015 (80 %)



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 methodology.

After the moderate intensification of the annual increase in the housing prices⁷⁶ in the first quarter of the year, in the second quarter the prices slightly declined. Thus the price index registered annual drop of 0.5% (increase of 3.1% in the previous quarter). However, considering that last year real estate prices registered slight divergent movements, it is difficult to conclude whether this change is permanent or temporary. This is also supported by the fact that after the considerable downward trend in the previous years, last year, the apartment prices stabilized. Real estate supply and demand indicators do not point to significant changes. The construction of residential properties continues registering double-digit growth rate (average annual growth rate of construction of residential properties in the first quarter of 2016 of roughly 19%), with similar rate of approvals for construction of residential properties, as shown by relevant data. In terms of demand for apartments, the permanent solid growth in housing loans continued in the second⁷⁷ quarter of 2016 and suggests further strengthening of demand.

⁷⁶ Hedonic index of housing prices, prepared by the NBRM on the basis of the notices of sale in the capital city, and published by the agencies dealing with trade in real estate. The price of the apartment is a function arising from the size of the apartment, the neighborhood in which it is located, the floor, whether the apartment has central heating and whether the apartment is new.

⁷⁷ Available data for the first two months of the quarter.

V. Analytical appendices

Box 1: Short-term GDP projection models in the National Bank of the Republic of Macedonia

The projection of the future economic trends is of large importance in the process of macroeconomic policies decision-making. This especially refers to the monetary policy having in mind the significant time lag in the today's monetary measures and the moment they start influencing the economy. Hence the efficiency of the monetary policy is related to the projection quality, and one segment of the projection system are the short-term projections of the macroeconomic variables. The use value of the short-term projections is related to the fact that most of the macroeconomic data are published with a certain delay. The best example for this is the data on the gross domestic product (GDP) that are published with a delay of about 70 days. Also, the short-term projection models are characterized with high accuracy in the short-term projecting, which stems from the combination of a large number of various high frequency data most of which are not subject to future revisions and changes. This box contains short review on the models used in the NBRM and refers to the short-term GDP projection.

There are several models that are adequate for short-term GDP projection. The main features of the short-term projection models are that they are based on historical features of the projected series, and lean less on certain economic theory. The most popular short-term projection methods are AutoRegressive Integrated Moving Average - ARIMA models, Vector Autoregressions - VAR models, BVAR models, State Space – SS models valuated by Kalman filter, statistical and dynamic factor models (Factor models) etc. Jovanovic and Petrovska (2010) give detailed overview on the features, advantages and flaws of part of these projection models⁷⁸.

The short-term GDP projection is an integral part of the macroeconomic projection process which the NBRM prepares twice a year (in April and October). To prepare a short-term projection of the total GDP, several models are used - Bayesian VAR - BVAR model, small structural model, a combined VAR - CVAR model and dynamic factor model. However, the first two approaches (BVAR and the small structural model) are theoretical, while the other two models (CVAR model and dynamic factor model) are clearly statistical, atheoretical approaches.

1. **The BVAR model** is theoretically model, which assesses the BDP as a function of the inflation rate, the credit growth, the number of employees and the wages. The model, as stated above, is rated by Bayesian techniques - an approach that has advantages over conventional econometric techniques when it comes to short time series and series with a number of structural breaks.
2. **The small structural model** consists of three equations that relate to the creation of added value in three key sectors of the economy - industry, construction and retail trade. In the model, the three sectors of the economy depend on each other, and they are affected by other explanatory variables.

industry = f(electricity consumption, ESI indicator⁷⁹, import of industrial products, total turnover of payment operations)

construction = f(retail trade, production of nonmetal minerals, issued construction approvals, number of effective working hours in construction)

retail trade = f(industry, household loans, ESI indicator)

⁷⁸ Jovanovic, B., Petrovska, M. (2010), "Forecasting Macedonian GDP: Evaluation of different models for short-term forecasting", NBRM working paper.

⁷⁹ ESI indicator refers to the Economic Sentiment Indicator published by the European Commission.

The data on the included explanatory variables are relatively timely, but if some of them are not available, then their value is obtained by using simple ARRIMA projection models.

Upon obtaining of projections for different sectors, four indices are created: index with the projection for industry, construction, retail and a composite index projection for industry and construction. The following step in the application of this method is the combined projection of the total GDP. For that purpose, additional equations are estimated⁸⁰ where the GDP is a dependent variable, while the indices obtained are the explanatory variables. The final projection is a weighted average of the GDP projections from the estimated equations, where instead of a simple average, each of the results from the models obtain different weight depending on the forecast errors⁸¹ – the models with lower error have higher weight and vice versa.

3. **SVAR model** is statistical, or atheoretical model. The GDP evaluation is a combination of the results of several VAR models. The first step is estimation of a lot of VAR models that contain GDP and maximum two other indicators. Once they are evaluated, we get the projection of the total GDP, which represents a weighted average of all possible models' combinations. The base used for this approach mainly uses data from business trends surveys produced by the European Commission, both for the national economy and for the euro area and is composed of 38 indicators.
4. **The dynamic factor model** for GDP projection is based on several so called non-quantifiable factors (Principal Components) which aggregate information contained in a base of over 70 data (exchange rates, domestic and foreign prices, data on trends in the labor market, monetary and financial data, foreign trade data, data from the real sector including national accounts data, etc.)⁸².

What matters most in the projections of these models is their accurateness. In addition, the prediction ability of the models is tested by comparing the GDP projection one quarter ahead of each model with actual data, and the time frame covers the period from the first quarter of 2014 to the fourth quarter of 2015.

More specifically, the process of forecasting by using each of the four models presented above starts from the first quarter of 2014, then makes comparison with the realized GDP in that quarter and calculates the error. This procedure is repeated for each subsequent quarter until the fourth quarter of 2015. This performance verification method is known as pseudo-out of sample forecasting. It should be emphasized that within the analysis, all of the explanatory variables are taken from the currently available databases rather than use the series that were available in the quarter projected⁸³. The results of the GDP projection with individual models are presented in Chart 1.

⁸⁰ The total number of estimated equation is eight. Four of the equations include GDP and four indices as growth rates, while the other four include the variables as change in their growth rates.

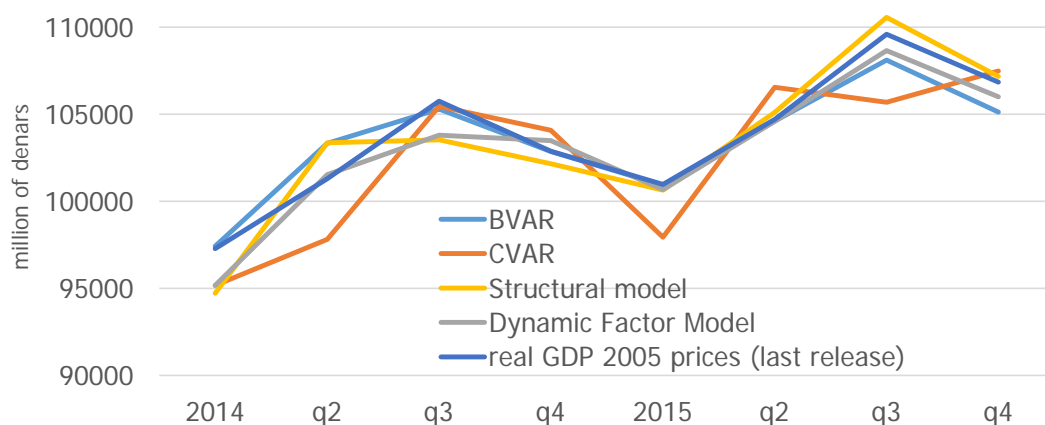
⁸¹ Projection errors refer to Mean Squared Error (MSE).

⁸² Stock, J. H., Watson, M. (2002), "Forecasting using principal components form a large number of predictors", *Journal of the American Statistical Association* 97, 1167-1179.

⁸³ The use of the currently available databases in this case does not cause serious limitation since most of the data used as explanatory variables in the models for short-term projection of GDP are not subject to revision.

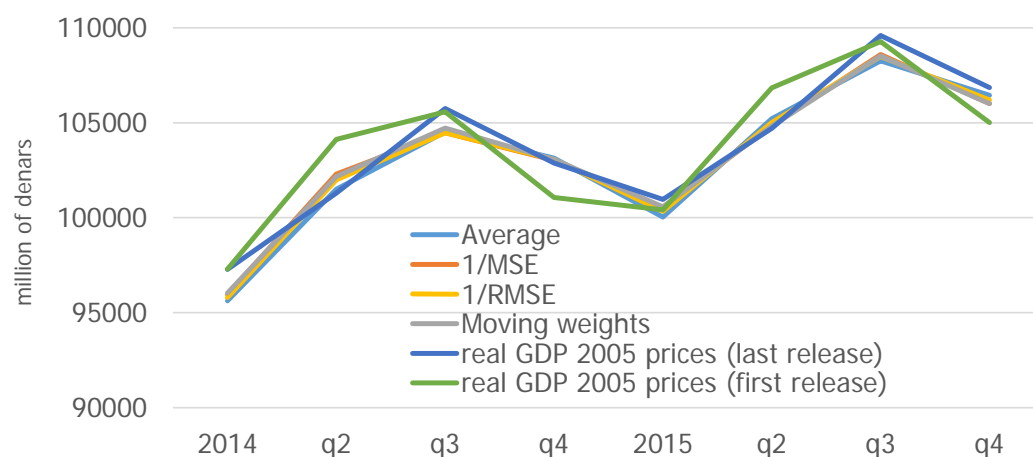


Chart 1



As evident from the chart, the individual models at different time points gave different projections for GDP. In other words, each model has its advantages and disadvantages that affect the projection accuracy of the model. **For these reasons, the common practice is not to base the central GDP projection only on one model but rather to combine the results of several models (combined projection).** The combined projection essentially is a weighted average of projections from different models where there are several approaches for determining the weights. Detailed overview of part of approaches for weight selection is given in Stock and Watson (2006)⁸⁴. Generally, the approaches vary from application of simple average and median, to models that enable evaluation of moving weights. The Chart 2 shows four combined projections, differing from each other by the different defining of weights. Thus, the first three approaches use a constant weight - simple average and inverse value of the forecasting errors ($1 / \text{CEF}$ / RMSE)⁸⁵ – while the fourth approach uses moving weights calculated according to the inverse value of the forecasting error ($1 / \text{CEF}$) in each period. The combined projections are compared with the official GDP data by comparing the first and the last available publication of the data.

Chart 2



⁸⁴ Stock, J. H., Watson, M. (2006), "Forecasting With Many Predictors", In: Elliot G., C.W.J. Granger, and A. Timmermann (eds.) Handbook of Economic Forecasting, Vol. 1, Elsevier, Amsterdam, pp. 515-554.

⁸⁵ $1/\text{MSE}$ refers to the inverse MSE value (Mean Squared Error – MSE), while $1/\text{RMSE}$ refers to the inverse RMSE value (Root Mean Squared Error – RMSE).



The overview of the results of the combined projections indicates two conclusions. First, when it comes to projecting the Macedonian GDP, the combined projections reflect the dynamics of the published GDP more closely compared to the individual models (Chart 2 and Chart 1). Interestingly, despite the differences in defining the weights, the combined projections are almost identical. Second, the combined projections are much closer to the last available data on GDP, not the first publication. This result confirms the preciseness and the power of the models for short-term prediction of the actual economic situation in the actual economy.

The Box gave a brief overview of the short-term GDP projection models used in the NBRM.

The results indicate that the presented models forecast the GDP relatively well, and the combined approach could be emphasized as the most accurate. The use of the short-term projection model allows consistent and systematic processing of a large number of available data and thus giving a clear picture of the situation of the economy on the short run, which is of great importance in the preparation of medium-term macroeconomic projections and the decision-making process regarding the setup and changes in monetary policy. However, it should be kept in mind that the models, ultimately, are just tools and no model can fully capture the complex reality. Hence, usually in practice, the model projections are further modified by including estimates, opinions and views of economic experts.

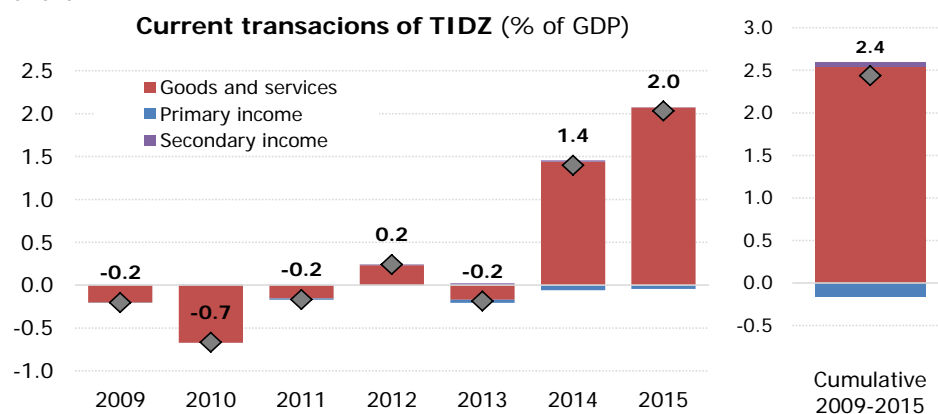
Box 2: Effects of the companies' activity in the technological and industrial development zones on the balance of payments of the Republic of Macedonia

Technological and Industrial Development Zones (TIDZs) or free economic zones, are traditionally an important tool in the economic growth strategies of the developing countries, especially in terms of strengthening their industrial competitiveness, as well as attracting foreign direct investment. Mostly, the free economic zones are aimed at development and diversification of exports, creation of new jobs and promotion of new and more effective policies and approaches to various customs aspects, some aspects in the field of the labor market, and new practices in the field of public-private partnership. Free economic zones are significant also from the aspect of establishing relations with local businesses, or in other words are significant in terms of indirect effects on the economies in which they operate. By strengthening their integration with the national economy, the effects of their operations are maximized, with the ultimate aim of achieving more balanced economic development, which is particularly important for countries whose economies are concentrated on only a few traditional activities.

The benefits of the development of free economic zones are static and dynamic. *Static are those directly observable and measurable, such as:* direct creation of employment and income generation; increasing exports and its diversification; inflow of foreign capital in the form of foreign direct investment; and growth of revenues. *Dynamic or indirect effects* are more complex and their importance is mostly manifested through their long-term contribution to the economic development. The most important are the indirect job creation and technology transfer and upgrading the skills of the workforce.

In Macedonia in recent years the focus was put on the development of free economic zones, as well as attracting foreign direct investment. The activity of the zones, as well as their added value register a continuous growth, and the increase in the number of companies reinforces the positive direct and indirect effects on economic growth and on the external position of the country. *The purpose of this short note is to analyze the effects of the activity of new foreign-owned companies on the external position of the domestic economy in the period from 2009 to 2015.* The analysis includes 15 new large companies with foreign capital established in the technological industrial development zones, as well as several other major industrial facilities with foreign capital out of the zones that are significant in terms of trade operation. As sources, data on the international payment operations and foreign trade statistics of individual companies were used, with an attempt for their systematization and classification (their mapping) in their respective categories in the balance of payments being made⁸⁶. Consequently, the data are an approximation of the main categories in the balance of payments and do not cover all flows, i.e. the calculation lacks data on reinvested gain, accrued interest, currency and deposits, loans in goods etc., nonetheless, they represent a pretty good indicator on the total balance of payments transactions. The summarized data are categorized as current transactions and net financial flows.

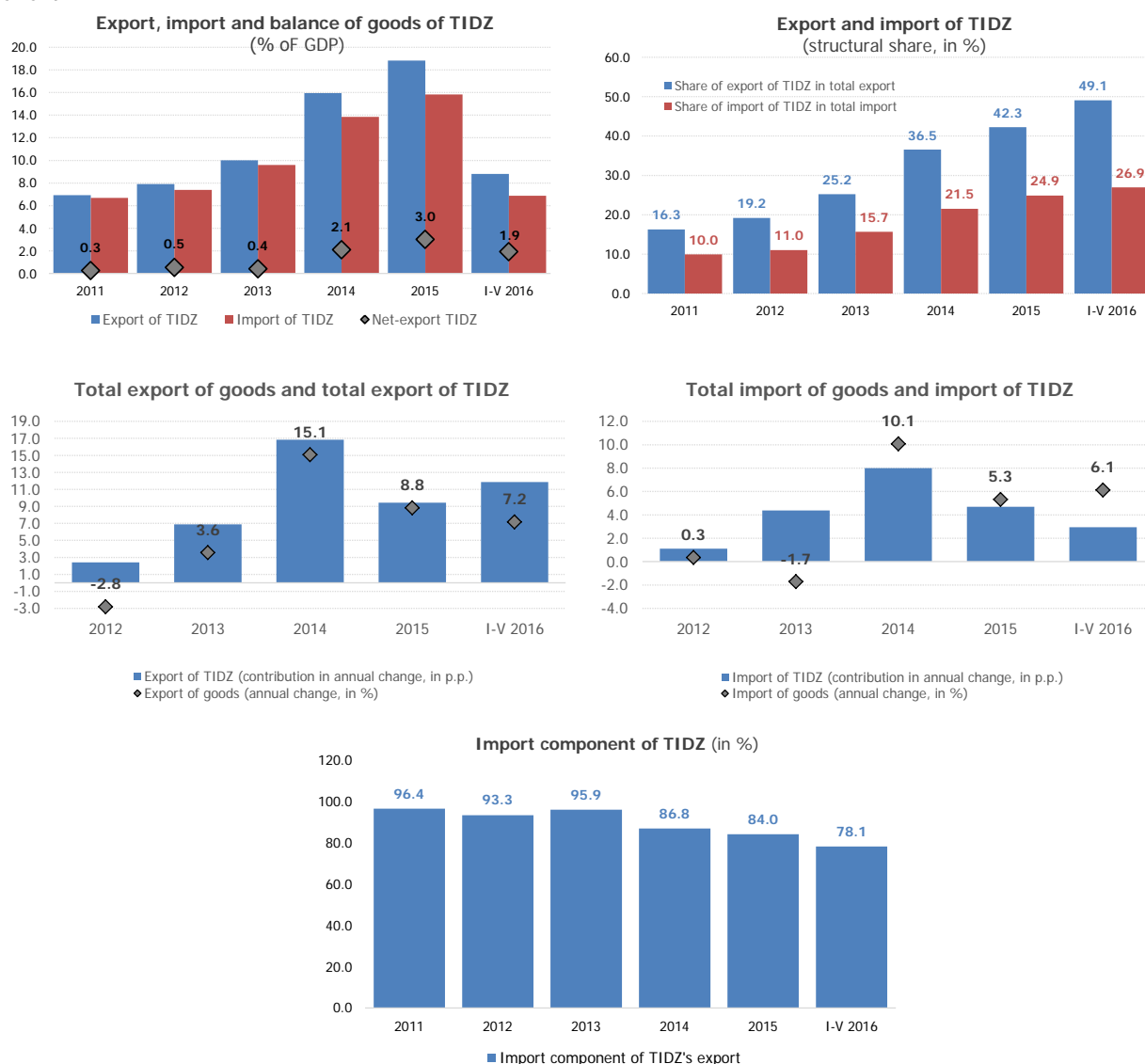
Chart 1



⁸⁶ Calculations are made based on the data on the payment operations with adjustments for goods and trade credits based on data from foreign trade statistics (customs declarations).

The results show that in the past seven-year period (2009 - 2015), net inflows in current transactions with these companies from around 2.4% of GDP on a cumulative basis were registered. Such movements almost entirely stem from the positive performance in foreign trade, i.e. the realized net export of goods and services (cumulatively, 2.5% of GDP). By dynamics, in the first years of operating, these companies registered a deficit in the trade balance (due to the initial import of equipment and raw materials), which gradually passes into surplus, reaching a peak in 2015 (2.1% of GDP). In the coming years it can be expected further increase in the surplus in the balance of goods and services considering that some of the companies have not yet started their export activity, while some of them are yet to attain maximum use of their capacity. Within the balance of goods and services of the new industrial facilities with abroad, the trade in goods dominate.

Chart 2



Source: NBRM.

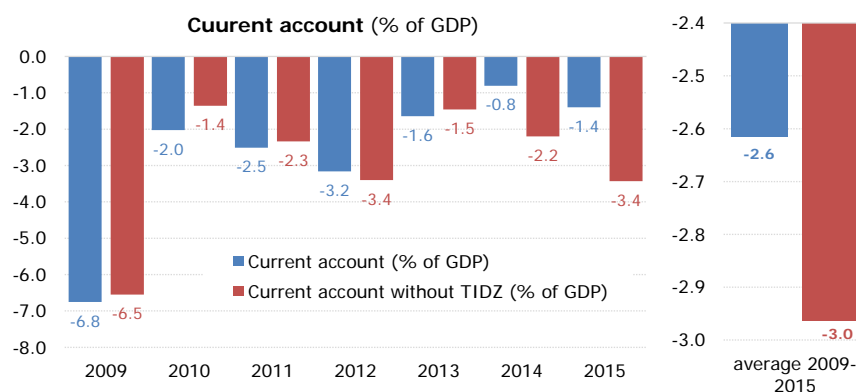
The trade of the new companies in foreign ownership can be analyzed in details through the foreign trade statistics data⁸⁷. So, in the analyzed period the TIRZ companies registered a positive added value,

⁸⁷ The data in the charts are presented according to foreign trade statistics (customs declarations), where the export of goods is presented on f.o.b. basis, while imports of goods is on c.i.f basis.



which accelerated in the last three years. Namely, in 2014 and 2015, the average net export of these companies amounts to 2.6% of GDP, and this trend continues with intensified dynamics in the first five months of 2016 (a positive balance of 1.3 p.p. of GDP higher than the same period last year). The share of exports of the TIDZ companies in the total export of goods in the economy is constantly increasing, reaching nearly 50% of total exports in the first five months of 2016. Thus, export growth of the new companies is the major driving factor for the increase in the overall export activity of the country, in conditions when the contribution of other traditional export sector is small or negative. On the other hand, given that these companies import raw materials and equipment from abroad, the share of imports of these facilities in total imports of goods also continues to grow, but at a slower pace than the growth of exports (accounting for 26.9% in total imports for the first five months of 2016). These developments in export and import of selected companies in the analyzed period, condition also continuous reduction in the export's import component i.e. steady growth in the value added of the export of goods.

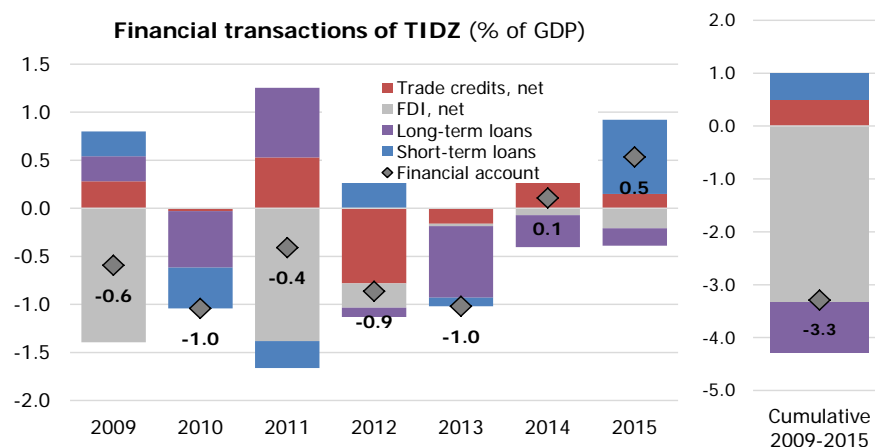
Chart 3



Source: NBRM.

The comparison with total generated data on the current account of the balance of payments points to the conclusion that the operation of new companies, improves (narrows) the current account deficit by an average of 0.3 percentage points of GDP in the past seven years. Namely, the average current account deficit in the period 2009-2015 amounted to 2.6% of GDP, while if we exclude the activity of the new companies it would be 3.0% of GDP. The dynamic analysis of the current account deficit shows that the effect of TIDZ in the first five-year period generally is small and negative (except in 2012). Such dynamics of the current account balance results from higher initial import of equipment and materials at the time of the founding of new facilities and the initial investment cycle. Significant positive effects are registered in the last two years, when the effect on the deficit is positive and contributes to narrowing of the negative gap in the current account by an average of 1.7 percentage points of GDP.

Chart 4



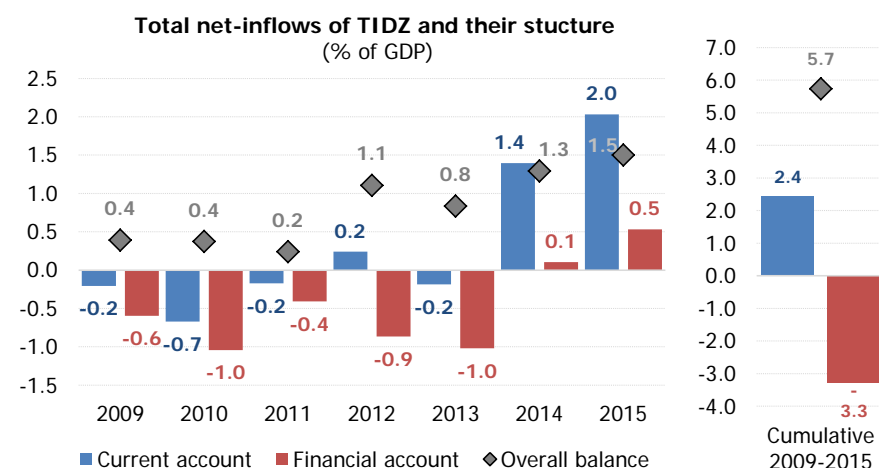
*Financial transactions by BPM6 (minus net inflows).

Source: NBRM.

Regarding the financial transaction of the selected companies, cumulatively for the analyzed period, net inflows of 3.3% of GDP were registered. In the context of financial transactions, the most valuable part refers to net inflows of long-term trends or founding capital⁸⁸ and loans. The most commonly, the net inflows based on loans reflect the increased inflows based on long-term intercompany debt of these companies. On the other hand, the new facilities recorded net outflows (though significantly lower than the net inflows) based on short-term flows mainly based on trade credits required for regular trade operations of the companies. From the dynamics point of view, positive developments in the financial account are opposite to those in the current account. Namely, the financial net inflows were dominant in the first five years of analysis, at the time of the establishment of new facilities and the initial investment cycle, while in the last two years, financial flows are smaller and negative on a net basis.

By individual companies, it should be emphasized that all analyzed 15 companies, registered net inflows in the financial transactions, cumulatively. Moreover, in the companies present in the domestic economy for a longer period it may be noted that the initial investment was made through equity, while in subsequent years net outflows based on loans i.e. intercompany debt, was registered. On the other hand, other companies, formed later, are mainly funded through loans between connected entities i.e. by the parent company.

Chart 5



*Balance of payments by BPM6.
Source: NBRM.

In summary, the effect of current and financial transactions of the 15 new companies during the entire period is positive (cumulative effect of 5.7% of GDP), t.e. it leads to the creation of net foreign exchange inflows in the domestic economy, which is a significant support to the balance of payments position⁸⁹.

⁸⁸ The FDI presented in the chart refers mostly to foreign investment in the form of equity and do not include reinvested gain and intercompany loans. The debt transactions between connected entities are recorded within loans category.

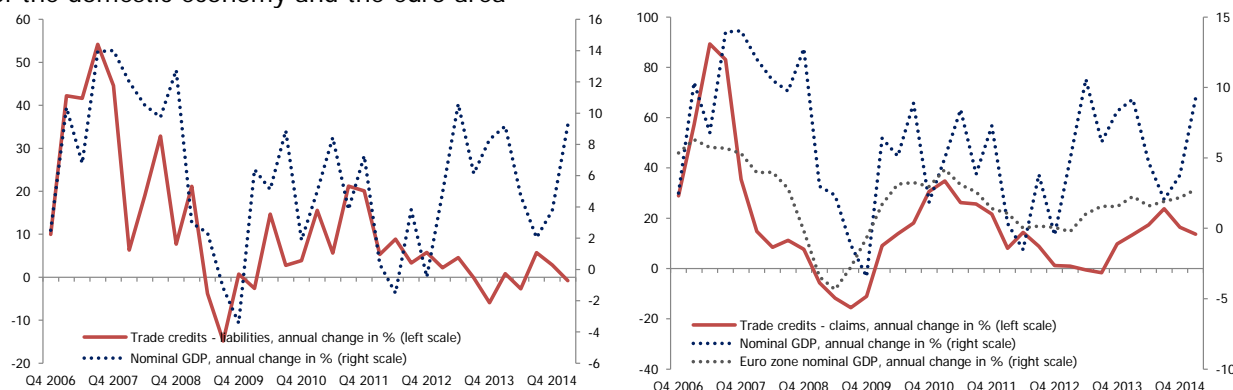
⁸⁹ The findings should be accepted with a certain precaution, primarily because of the structure of the selected companies, as well as because of the source of the data, which does not correspond completely with the sources of the balance of payments statistics data.

Box 3: Stocktaking of the trade credits of the Macedonian economy

The world trade collapse after the crisis in 2008 and the difficult access to funds increased the interest in trade credits and their role in the financing of foreign trade between economies. The research in recent years confirms the growing importance of trade credit as facilitators of international trade of goods and services, which is especially important for a small, open economy, like Macedonia. Trade credits allow smooth transactions between exporters and importers in the trade, thus increasing their efficiency. As a form of external financing they are mostly used by small and medium-size companies, which further emphasizes the importance of this instrument for Macedonian companies. This is evident also through **the structure of the gross external debt, where the trade credits on average create a fifth of the total debt of the Macedonian entities abroad and more than a third of the total external debt of the private sector.** The analysis of the financial flows in the balance of payments also proves that. Namely, **cumulatively, in the period from 2009 to 2014, the trade credits created 34% of net financial inflows excluding government transactions.** Hence there is a need for more detailed analysis of trade credits by reexamining their connection with certain macroeconomic variables, as well as analysis of their sectoral and geographical structure.

Trade credit is defined as a form of financing, which stems from the time difference between the moment of delivery of goods and services and the time of its payment⁹⁰. Due to its nature as sources of funding beyond the financial system, trade credits play an important role in external financing of companies, especially in conditions of limited access to funding from credit institutions. Accordingly, the trade credits have similar features with short-term loans, so in a loose interpretation, they can be defined as short-term loans granted by the supplier to the purchasing company from the moment of delivery of goods to the payment, as well as from the purchaser to the supplier in case of advance payment of goods.

Chart 1 Synchronization of the liabilities, claims and net trade credits with the nominal economic growth of the domestic economy and the euro area



Source: NBRM, SSO and EUROSTAT.

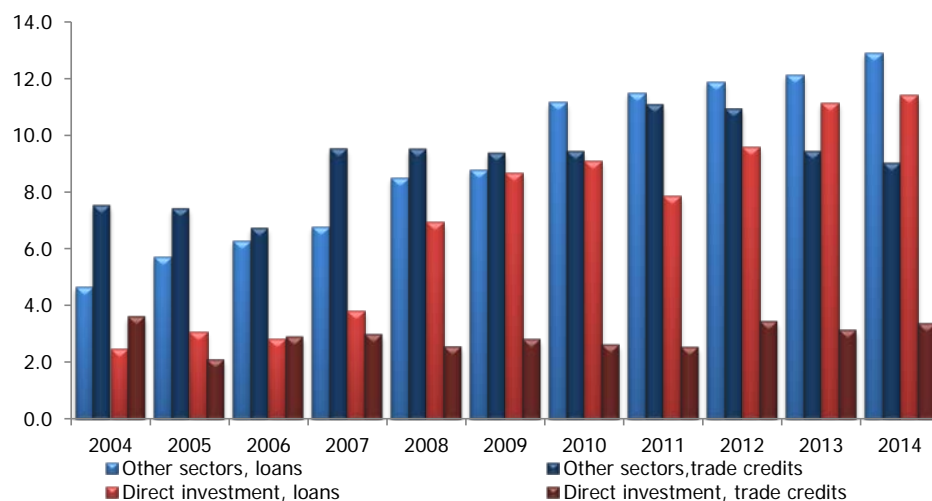
For further analysis of trade credits in the Republic of Macedonia, data on the statistics on external debt are used, i.e. disaggregated data on liabilities and claims on the basis of trade credits⁹¹. **The data on the Macedonian economy indicate some synchronization between claims and liabilities based on trade credits and the economic cycle.** On the liabilities side, the connection with the movement of economic activity is characteristic for the period before 2012, after which the movement of these two variables separates. As a possible explanation for this change is the launching of larger companies with foreign capital in the Macedonian economy, which significantly alter the structure of the economic structure and affect the dynamics of economic growth, without simultaneous significant influence on increase in liabilities based on trade credits. Namely, the new companies, which are the key drivers of economic growth in the period after 2012, in terms of external financing, mostly rely on financial borrowing from the parent entity, which is evident from the increasing share of these liabilities in

⁹⁰ Brennan MJ, Miksimovic V and Zechner J, 1988, Vendor financing. The Journal of Finance 43.

⁹¹ The further analysis is based on the share of individual categories in GDP.

the gross external debt. Regarding claims based on trade credits, during the analyzed period there is certain connection with the trend of domestic economic activity, although recent observations in the analysis of the claims do not follow the trend of domestic GDP.

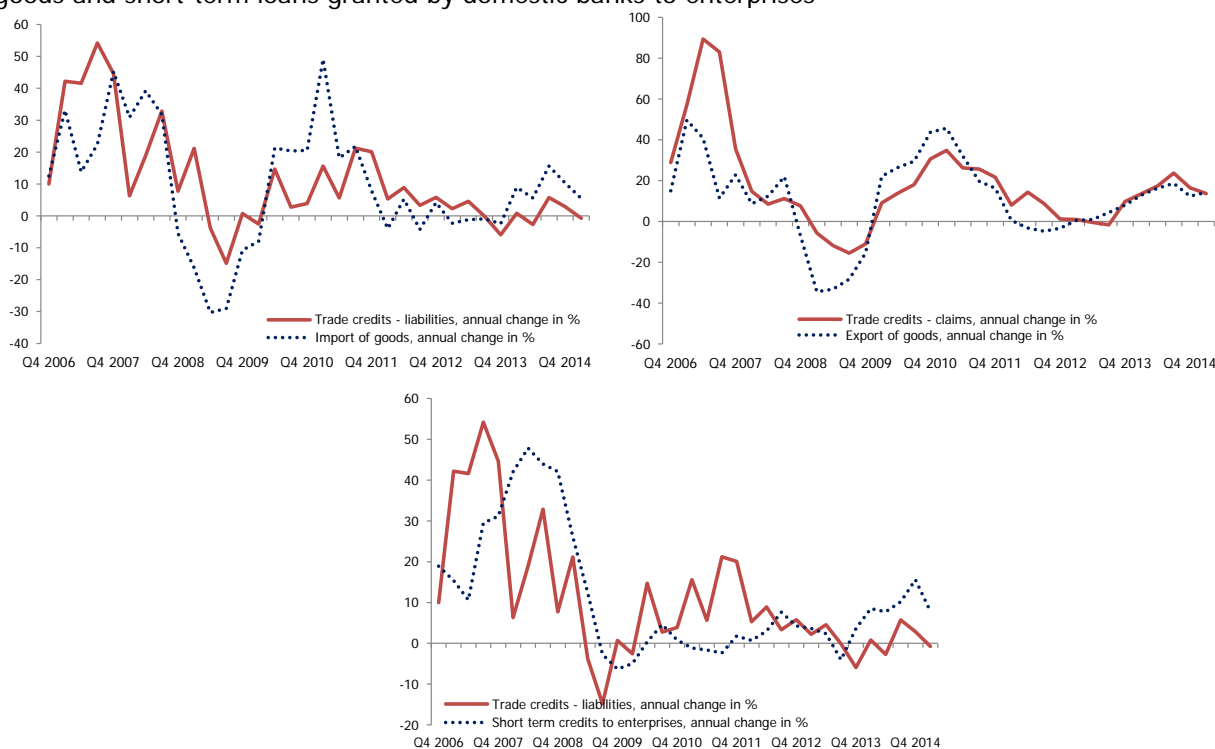
Chart 2 External finance of the private corporate sector - liabilities based on financial loans compared to liabilities based on trade credits, share in GDP



Source: NBRM.

On the other hand, during the entire analyzed period, **there is high synchronization between the claims of the domestic companies on the basis of trade credits and the movement of the economy in the euro area**, as the most important export market, with an average share in the total Macedonian export of over 50% in the past seven years.

Chart 3 Relation between the liabilities and claims based on trade credits and the import and export of goods and short-term loans granted by domestic banks to enterprises



Source: NBRM, SSO and EUROSTAT.

Having in mind the nature of the trade credits, as financial flows arising from the foreign trade, expectedly, there is connection between these variables. Moreover, the change in the

liabilities of the domestic companies based on trade credits corresponds to the development of the import of goods⁹² on a quarterly basis, while the changes in the claims on their foreign trade partners are almost fully synchronized with the changes in the export component.

As previously mentioned, trade credits as a form of financing trade between economic agents by their nature are very close to short-term financial loans. Namely, trade credits are often defined as supplements of short-term bank financing, **indicating growth of liabilities based on trade credits in periods of restrictive financing by financial intermediaries, and oppositely, their reduction when financial institutions are ready for intensive short-term financing of corporate sector.** In the case of the Macedonian economy both variables show correlated movement in the period until 2010. Adverse trend of the trade credits and short-term loans to the corporate sector is evident between 2010 and 2012, a period when the banking sector was restrained in short-term financing and simultaneous growth of liabilities based on trade credits, acting as substitutes for short-term loans granted by financial intermediaries. The negative effects of the crisis largely reflected on the traditional Macedonian production sectors. During this period of restraint to fund from the domestic banks, the foreign business partners intensified their funding of the Macedonian companies by additional approval of trade credits, probably in an attempt to support the normal functioning of trade and maintenance of business relations.

Table 1 ⁹³

	Correlation coefficient			
	Export of goods	Import of goods	Euro zone nominal GDP	Nominal GDP
Trade credits - claims	0.89		0.93	0.87
Trade credits - liabilities		0.87		0.83
Trade credits - liabilities*		0.04		-0.12

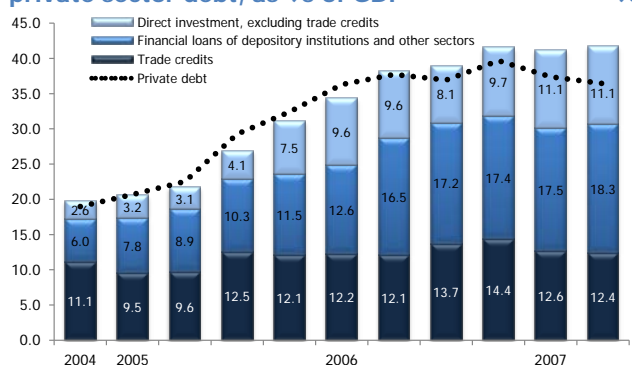
* For the period Q1 2012 - Q1 2015.

The significance of trade credits except through their correlation with the movement of the economy is also analyzed through their effect on the dynamics of foreign indebtedness. Historically, the share of these credits in the private gross external debt is declining, while their share in GDP is relatively stable. The image is quite different when analyzing the individual movements of the claims and liabilities arising from the foreign trade and the corresponding effect on net external debt of the economy. Historical data on the movement of these variables indicate some synchronization until 2013, when a more dynamic decrease in external liabilities based on trade credits starts, in conditions of further growth in demand, **causing nearly neutral net debt position in this category at the end of 2014 year.** In order to provide more analytical diagnostics of such changes, below we present the sectoral structure of the trade credits, as well as their geographical distribution and distribution by activity.

⁹² The analysis compares the export and import of goods based on foreign trade statistics, due to greater synchronization in the movements.

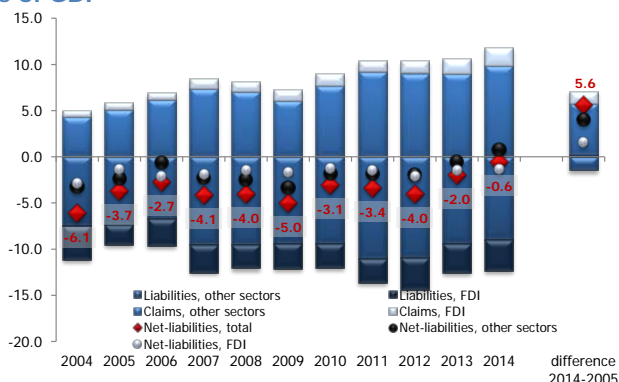
⁹³ The sample after 2012 denotes the periods of active functioning of the new capacity in the economy.

Chart 4 Structure of the gross external private sector debt, as % of GDP



Source: NBRM.

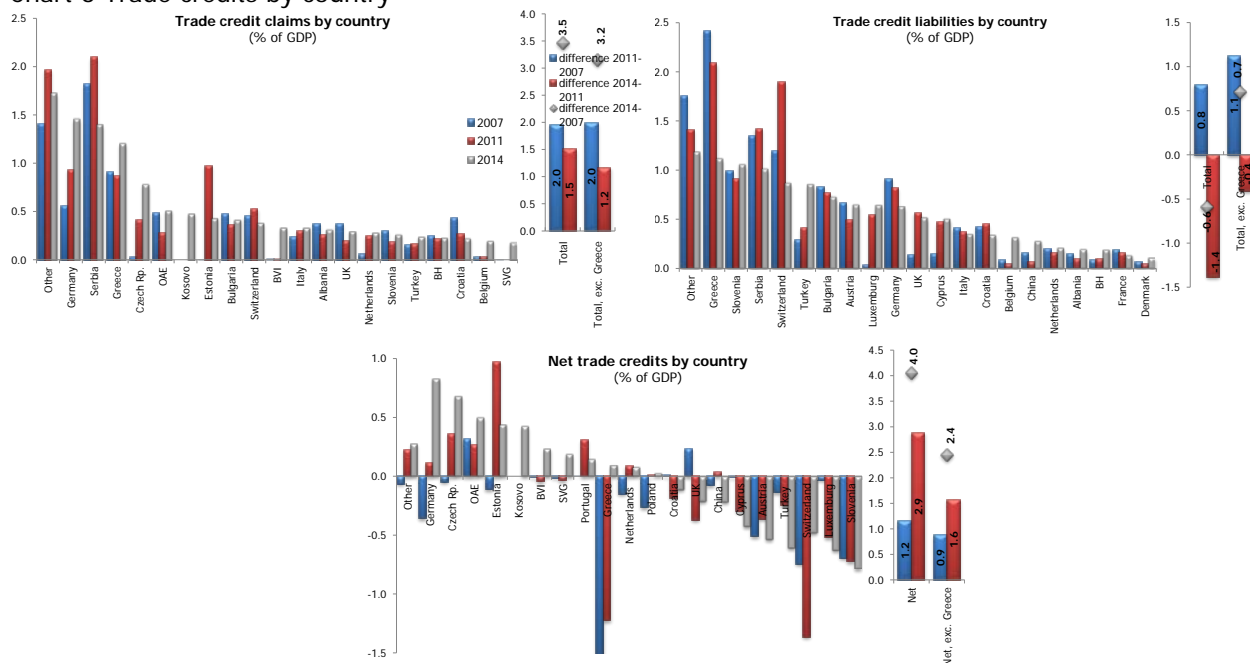
Chart 5 Trade credits by sector, as % of GDP



Due to its nature, the trade credits are characteristic for the private sector in an economy, i.e. the non-financial corporate sector (below - other sectors) as the carrier of foreign trade. Such a sectoral structure is characteristic also in the case of Macedonian economy, through the **dominant share of trade credit as an instrument of other sectors⁹⁴** and **smaller contribution of the foreign direct investors**, on both, the liabilities and the claims side. On the side of the liabilities abroad based on trade credits and advances the liabilities of other economic sectors prevail. In the analyzed period, their increase is noticeable at the end of 2011 and during 2012, a period in which the industrial sector of the economy, especially the metal sector faced financial challenges due to more restrictive behavior of the domestic banks, as well as more significant challenges to place products on foreign markets. The gradual relaxation of crediting terms in the economy and stabilization of external demand, eased the financial pressures on companies and accordingly reduced the need for using trade credit as a form of financing, causing gradual reduction of liabilities of other sectors based on the instrument, as a share in GDP. **At the end of 2014, their amount was higher by 1.5 p.p. compared to the balance at the end of 2004, while simultaneously the amount of liabilities of direct investors between the two periods remained unchanged.** More intensive change in this period was recorded on the side of claims, where evident continuous growth, excluding the crisis period, has been registered. Other sectors dominate on the claims side as well, but in this case, the dynamics indicates that after the fall at the beginning of the crisis in 2008 and 2009, in the following period the domestic companies increasingly extend trade credits to their foreign buyers. Additionally, in direct investment there is a certain accumulation of claims arising from foreign trade transactions with the parent companies. Such behavior of domestic entities resulted in **rise in the claims based on trade credits by 6.8 percentage points of GDP in the past ten years, creating a narrowing of the negative net debt position of the Republic of Macedonia by 5.6 percentage points of GDP at end of 2014⁹⁵.**

⁹⁴ It includes non-financial private corporations which are not treated as foreign direct investments.

⁹⁵ The comparison is made on the basis of the balance at the end of 2004, as an initial year in the analysis.

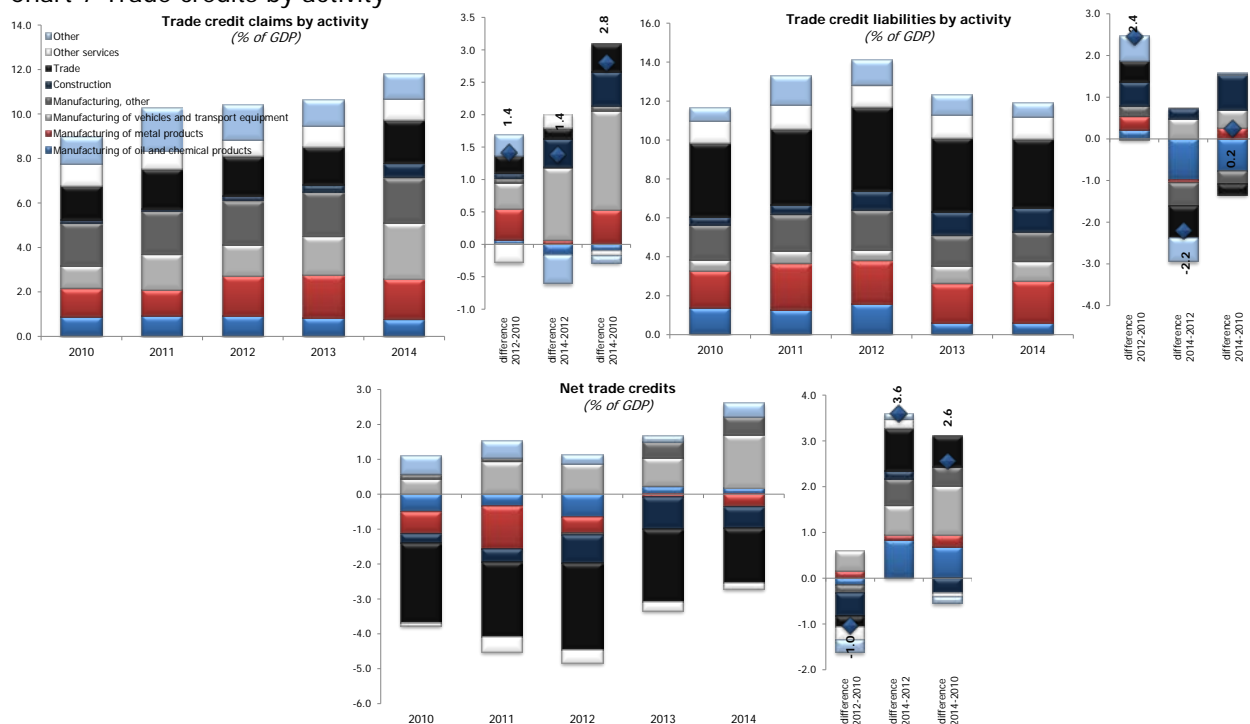
Chart 6 Trade credits by country⁹⁶


Source: NBRM.

Additional inspection in the trade credits' dynamics can be made through the analysis of the geographical distribution of liabilities and claims⁹⁷. **Generally, the most important export and import partners of Macedonian companies dominate the structure of trade credits.** On the liabilities side, the European Union countries participate with nearly 70% for the period from 2007 to 2014, on average, which corresponds to the importance of this market for Macedonian imports. The largest share in other liabilities based on trade credits are to Serbia, Switzerland and Turkey. The largest share of the claims are also placed in the European Union countries (average 55%), followed by the Western Balkan countries and Switzerland. **Dynamic analysis on individual partners indicates that the change between 2014 and 2007 was predominantly caused by two major trading partners, such as Greece, due to the reduction on the side of liabilities, and Germany due to the continuing growth in demand.** Moreover, in the case of Greece the withdrawal of approved trade credits to domestic companies and companies with the status of direct investments in the period after 2011 is concentrated in companies in the predominantly Greek ownership. On the other hand, the more intensive focus of Macedonian exports to the German market led to a significant rise in trade credits granted to economic entities in Germany, expecting this dynamics to continue with the intensification of the economic activity of the new facilities. **The changes in the balance of the trade credits with those two countries explain 70% of the improvement in the net debt position in the analyzed period,** which equals 4 percentage points of GDP. If we ignore the impact of developments in the Greek economy on the trade credits dynamics, the reduction in net liabilities between the two periods equals 2.4 p.p. of GDP. This shows that despite macroeconomic conditions which are the driving force of change in trade credits, in small economies like Macedonian, the impact of microeconomic factors on the movement of trade credits, i.e. firm specific factors is also important.

⁹⁶ UAE is abbreviation for United Arab Emirates, BVI -British Virgin Islands, UK – United Kingdom; BA – Bosnia and Herzegovina, SVG - Sent Vincent and Grenadines.

⁹⁷ Due to data availability, the geographical breakdown of trade credits is focused on the period 2007-2014.

Chart 7 Trade credits by activity⁹⁸


Source: NBRM.

Regarding the analysis by activity, the shorter time series⁹⁹ represents a limiting factor for adequate comparability between geographical and structural factors. However, despite the limited dynamics, the data offer a more specific view in the trade credits' features. From structural aspect, **most of the liabilities are created by trade as a driving force during the entire period**, followed by production of metals and other production¹⁰⁰. On the side of claims, there is larger dispersion concerning individual activities. On average for the entire analyzed period, the traditional activities, such as production of food and tobacco, metal and textile industries and trade, are activities that extend most of the trade credits abroad. **The dynamics on the side of liabilities is driven by construction and manufacture of vehicles, which is the main activity of the new foreign facilities in the economy.** The growth of liabilities in these activities is almost fully compensated by downward correction of liabilities in the industry for oil processing and less by the correction in the activity of producing of food and tobacco. On the other hand, **the continued growth in claims based on trade credits and advances is largely driven by the car industry, i.e the activity of the new capacity in the economy**, with the additional effect of the metal industry, construction and trade.

This simplified analysis of trade credits except the confirmation of certain theoretical aspects of trade credits, points also to certain specifics resulting from the features of the Macedonian economy. Observed through the dynamics of its share in GDP, the gradual increase in claims and the simultaneous decline in liabilities in the past years led to a gradual closing of net debt position in this instrument. Geographical analysis and analysis by activity indicate that structural changes in the economy reflect also on the movement of trade credits through higher exposure to the German market and more dominant role of the car industry as a driver of change in this segment as well. Accordingly, amid further increase in the capacity of the new companies in the economy and growth of their export potential, further increase in demand in trade loans should be expected, as well as higher importance of funding through loans from parent entities as a source of financing of these companies on the medium term.

⁹⁸ "Other" category includes the activities agriculture, forestry and fishing; mining and quarrying; and electricity and gas.

⁹⁹ Time series of the trade credits by activity is for the period from 2010 to 2014, and the differences relate to the difference in the end of 2014 compared to the balance at the end of 2010.

¹⁰⁰ Within other production, most of the liabilities are created by industry for production of food, beverages and tobacco.