

National Bank of the Republic of Macedonia



Quarterly Report
July, 2013



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Introduction

During the second quarter of the year, the monetary conditions remained unchanged, i.e. the maximum interest rate on the CB bills auctions remained at the level of 3.5%. Although some of the economic and financial conditions indicated looser monetary environment, there were still certain risks during the quarter, which imposed a need of cautious monetary policy conduct. Namely, the inflationary risks significantly reduced, due to which in the April projection **the projected inflation was revised downwards**. Although during the quarter the total inflation moved within the projected course, the core inflation, however, remained high, indicating the transmission effects of the food and energy prices rise on the other prices. On the foreign exchange market, the NBRM intervened with a net sale of foreign exchange, which was in line with the expected dynamics. The indicators of the foreign reserves adequacy were favorable, with comfortable level for absorbing potential unpredictable shocks being estimated. The data on the economic growth in the first quarter of the year validated the expectations for gradual growth recovery. Notwithstanding the moderate intensification of lending, the credit support remained weak, registering mostly downward risks. Simultaneously, the slow recovery of the economic activity in the Euro area indicated that there are still risks coming from the external environment. In addition, during the quarter, the assessments of the foreign demand and situation on the metal market were constantly revised downwards. Having in mind that these changes meant also **potential risks for the external position of the economy**, and accordingly, the future foreign reserves path, no changes in the monetary policy layout were made.

The key macroeconomic parameters in the domestic economy mainly ranged with the projections in the April cycle. As expected, the recovery of the domestic economy continued also in the first quarter of 2013. **The gross domestic product** registered annual increase of 2.9%, mainly caused by the investments and the net export. The realized growth is slightly more intensive than expected, reflecting the better performances with the investment demand, smaller narrowing in the private consumption, as well as larger contribution of the net export than the one expected in the April projection. Such performances, together with the available data for the second quarter of 2013 indicate that the economy remained in the zone of solid annual increase as projected, given registered positive movements with part of the economic sectors. However, the expected recovery dynamics is moderate, indicating that the economy will remain below the potential once again, and thus there will be no higher inflationary pressures by the domestic demand.

The **inflation** moved on the projected track and in the second quarter, the annual inflation rate equaled 3.6%. However, the structure analysis shows divergence with individual inflation components. Thus, the food inflation is beyond the expectations for third consecutive month, indicating that risks for the inflation through this channel are still possible. On the other hand, the price growth in the energy component is smaller, in conditions of bigger decrease in the world oil prices and non-fulfillment of the assumption for higher price of electricity. The realized core inflation is lower than projected, but still relatively high, which indicate, in environment of no demand pressures, transmission effects of the food and energy price growth. There are additional and uncertain upward risks for the projected inflation on the side of domestic supply of agricultural products, but on the other hand, there is evident downward risk is the decrease in the price of electricity in July. In such conditions, and divergent movements with the exogenous assumptions, it is estimated that the risks in the April projection for the inflation are balanced for now, while the April assessments for the inflation are adequate.



Within the external sector, in the first quarter of the year, the current account registered a deficit in the amount of Euro 109.1 million, or 1.4% of GDP, which is slight upward deviation from the expected deficit, given higher trade deficit and just smaller net inflows based on current accounts. Simultaneously, net inflows in the amount of Euro 158.1 million, 2% of GDP on the capital and financial account were registered, thus exceeding the expectations. The non-fulfillment of the projections regarding the outflows for trade and short-term credits were the main factors for more favorable realization in the capital and financial account for the increase in the foreign reserves, which was higher than the one expected in the first quarter. After the additional increase in the foreign reserves in the first quarter of the year, in the second quarter **the gross foreign reserves** (adjusted for both price and exchange rate differentials) registered a decrease, a little bit larger than anticipated. According to the available indicators in the external sector, (for April and May) it can hardly be identified what flows are the main reason for the divergence, having in mind the higher current account deficit (weaker performances with the services) and smaller inflows on the capital and financial account than expected. Analyzed by current account components, the high frequency data once again show better realization with the trade balance, while the private transfers almost matches the projections. However, due to the higher uncertainty in the external environment and constant downward revision of the metal prices, the downward risks related to the foreign reserves projection are more obvious.

Within the monetary sector, the latest available data, as of the end of the second quarter, point to gradual movement of the credit activity and realization of the projected credit growth. However, despite the favorable performances in the last months, there are still downward risks related to the attainment of the projected credit growth for the entire 2013. The risks become more evident in conditions of still unfavorable risk perceptions of the banks and the conservative strategies at the level of the banking groups present in the Macedonian banking system.

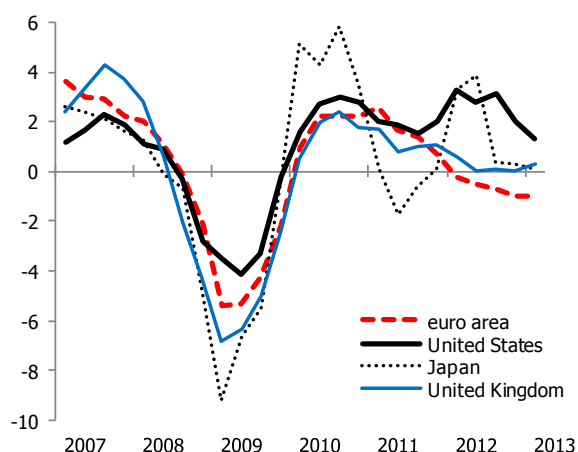
In order to mitigate part of the present risks in the economy, **in July**, the NBRM introduced **changes in the reserve requirement instrument**, in order to contribute to enlargement of the long-term foreign capital in the domestic economy, and to stimulate lending. Simultaneously, it is expected that the changes will reduce the risk of further narrowing of the spread between the yields from the Denar and foreign exchange savings, and thus contribute for maintaining the propensity to save. Given simultaneous estimations for maintaining the macroeconomic indicators within the projections, in July, **additional monetary relaxation by decreasing the key interest rate by 0.25 p.p. was made**. Thus the maximum interest rate on the CB bills reduced to the historically lowest level of 3.25%.

I. Macroeconomic developments

1.1. International economic environment¹

In the first quarter of 2013, the global economy continued to grow, although less intensively than expected, i.e. with an annual growth rate of about 3%, in place of the expected 3.3%. The growth dynamics differed with the emerging and the developed economies. Thus the growth acceleration trend, which began three quarters ago, pursued with most of the emerging economies and developing countries. Such a dynamics is due, to large scale, to the stimulating monetary and fiscal policies, which enhance the domestic demand in conditions of less intensive foreign demand. Within the group of developed countries, the economic performances are divergent. Unlike the recovery of the U.S. economy, the economic performances of the Euro area remain weak. These conclusions can be confirmed with the performances so far and the short-term growth projections. Thus in the first quarter of 2013, the U.S.A. registered annual GDP growth of 1.6%, while the activity in the Euro area fell by 1.1%. Such divergent performances are expected also in 2013, when the activity in the Euro area is expected to reduce by 0.6% and the GDP growth in U.S.A. of 1.7%². The risks related to the global economy growth still mainly refer to the conditions in the Euro area. Namely, the adjustment of the balance sheets of the public and the private sector in the Euro area is underway, thus causing restricted growth, simultaneously reducing the effectiveness of the adjustable monetary policy. From the viewpoint of the inflation movements, in the second quarter of the year the global inflation retarded compared to the increase in the preceding quarter, in conditions of reduced pressures of the increase in the prices of part of the primary products.

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



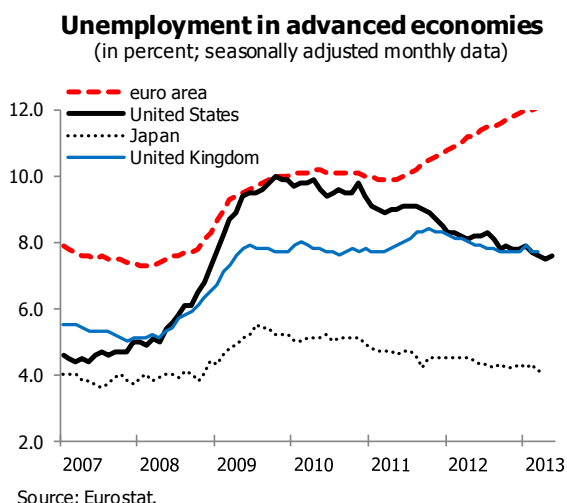
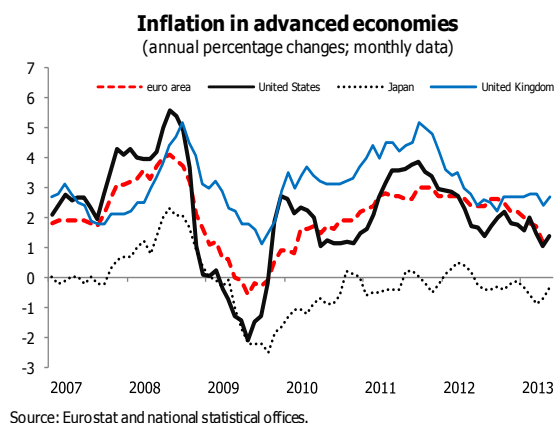
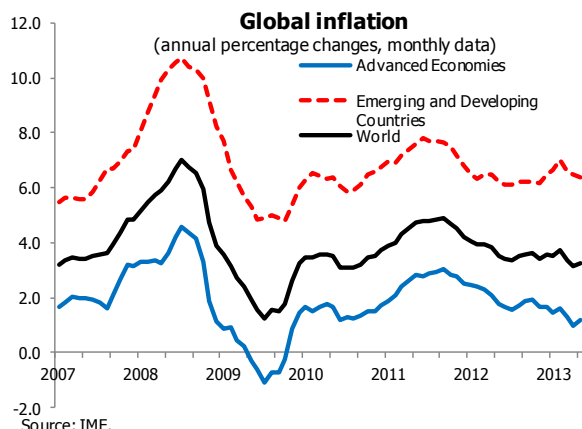
Source: Eurostat.

In the first quarter of 2013, the increase in the global economic activity was just smaller than expected and it equaled 3%, compared to the expectation for an annual growth of 3.3%. The perspectives for global economic activity are optimistic again, anticipating a global growth of 3.1%, with the downward risks related to the projection being the most common, while the revisions to the estimations downwards³. At the beginning of 2013, the economic activity in the Euro area reduced more than expected, and the negative economic growth for 2013 was revised downwards from -0.4% to -0.6%. On the other hand, the U.S. economy registered a quarterly increase in the GDP of 0.6%, validating the continuity of the economy recovery process. The U.S. GDP data show that it is higher

¹ The analysis is based on the ECB's monthly bulletin in April, May and June, 2013; "IMF World Economic Outlook", July 2013; "European Economic Forecast" of European Commission, June 2013; "Capital Economics" reports; publications of the "Market economics" and the monthly publications of IMF on the primary products market.

² "World Economic Outlook", IMF, July 2013.

³ "World Economic Outlook", IMF, July 2013.



by 3%, compared to the maximum reached in the pre-crisis period. In 2013, the U.S. economy is expected to increase by 1.7%, primarily as a result of the increase in the private sector activity and enlarged domestic demand. The survey indicators show further growth of the world economy, although with decelerated pace. In the first two months of the second quarter of 2013, the global composite PMI⁴ registered slight decrease compared to the previous quarter, but it still maintained in the positive zone, reaching 52.5 index points, contrary to 53.1 index points in the first quarter of 2013. Such a change arises from the small decrease in the activity in the manufacturing industry and in the service sector on a global level in this period.

During the second quarter of 2013, the global inflation decelerated compared to the preceding quarter. The average inflation rate⁵ equaled 3.1% in the first and in the second month of the second quarter of 2013. The decelerated global activity and the decrease in the oil prices and the prices of the non-energy primary products contributed towards lower inflationary pressures on a global level. In the developed economies, the inflation registered moderate slowdown of 0.3 p.p., given realized inflation of 1.1% in the first quarter, compared to 1.4% in the preceding quarter. The deceleration of inflation was registered also with both the emerging economies and the developing countries, and the inflation equaled 6.2%, compared to 6.7% in the previous quarter. The latest IMF projections for 2013 envisage slight decrease in the inflation in the developed and emerging economies and in the developing countries, which primarily arises from the lower global economic growth. Hence, the inflation rate for 2013 with the developed economies is estimated at 1.5%, i.e. 6% with the emerging economies and the developing countries (contrary to the realization of 2% and 6.1% in 2012). In comparison with the April projections, this is minor downward change in the estimations for the global inflation.

The economy in the Euro area is in the zone of recession also in the first quarter of 2013. Thus in the first quarter of 2013, the GDP in the Euro area fell by 0.2% on a quarterly

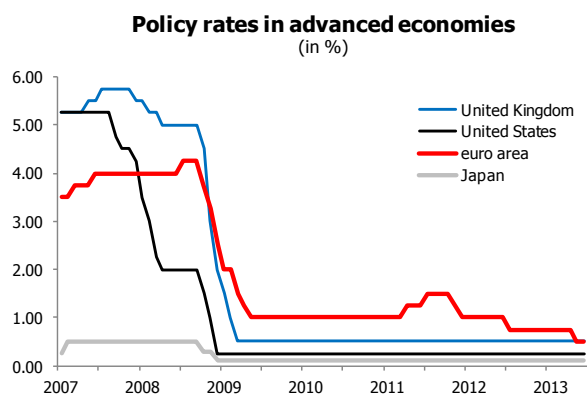
⁴ PMI (Purchasing Managers Index - PMI) is based on surveys of a representative sample of companies from the manufacturing and service sectors, and are often used as high frequency indicators of current and future economic activity.

⁵ Data source is the International Financial Statistics database of the IMF.



basis, and as a result the economic activity registers a consecutive decrease in the last six quarters. Such performances were expected for the peripheral economies. However, the unexpected unfavorable performances transmitted also in the core of the Euro area, and as a result France, which is the second largest economy in the monetary union, faced with a recession. Contrary to the recession movements in the Euro area, quarterly increase of 0.1% was registered in Germany, after the severe decrease in the last quarter of 2012. Such a positive performance was a result of the increase in the private consumption, with the net export having also positive contribution, given larger downward adjustment of the imports compared to the exports. On the other hand, despite the improvement of the financial conditions, the investment activity reduced. The current expectations show that the German economy maintained within the zone of positive growth rates in 2013. The activity in other European economies continued to depress, with Italy registering the second largest decrease after Cyprus. The poor performances in the Euro area are primarily due to the negative movements with the domestic demand and inventories, while the net export had slight positive contribution, given sharper decrease in the imports than exports. The fiscal consolidation measures and the deleverage process in some countries, as well as the elevated uncertainty affected the investments negatively, which in the first quarter of 2013 fell by 1.6% on a quarterly basis. The public consumption also plunged, as a reflection of the current fiscal consolidation in most of the Euro area countries. The unfavorable developments in the real sector had negative reflection on the labor market conditions, where there are no signs of recovery, yet. Thus the unemployment rate in the Euro area, after three-month stagnation, increased in May and reached the historical maximum of 12.2%.

The growth deceleration trend in the consumer prices in the Euro area continued also in the second quarter of 2013. Thus for the second consecutive quarter, the average annual inflation rate is below 2%, and it equaled 1.4% in the second quarter. The analysis of the consumer price index indicates pressures on the prices of the energy component, given certain growth acceleration in food prices.

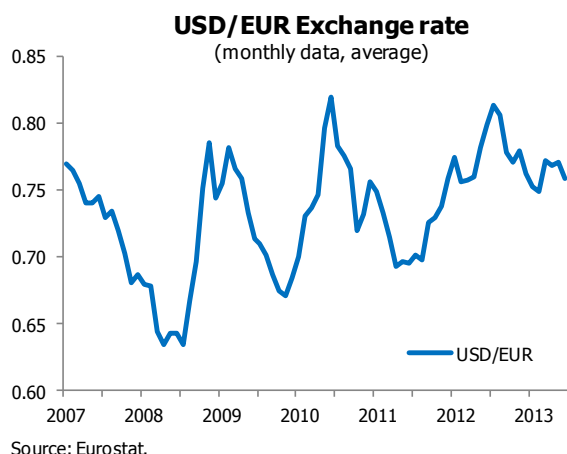


Source: Central banks.

The implementation of the stimulating monetary policy by the central banks in the developed countries continued in the second quarter of 2013, as well. The interest rates of FED, the Bank of Japan and the



Bank of England remained steady, at the level close to zero (0-0.25%, 0.1% and 0.5% respectively), and in May, the ECB adopted a decision on additional decrease in the interest rate of 0.25 percentage points, and as a result, it was positioned at the record low level of 0.5% thus approaching to the interest rate of the other developed economies. In April 2013, the bank of Japan presented the new monetary relaxation program. The latest operational framework developed in order to overcome the deflation and attain inflation of 2% within a two-year period, affects directly the increase in the prices on the capital market and the depreciation of the yen. In June, FED confirmed that it will pursue the quantitative relaxation through purchase of mortgage bonds and long-term Government bonds⁶, until the conditions on the labour market improve substantially. It was announced that the FED will probably lower the monthly amount of purchase of securities, and it is expected that the entire purchase program will be completed until the middle of the following year, when the unemployment rate should get closer to the level of about 7%. However, the decrease in the monthly purchase of securities will depend on the released macroeconomic indicators, including also the indicators for the monetary and financial conditions, and if the data are unfavorable, the planned reduction in the monthly purchase will be delayed, or additionally increased. On the other hand, the sooner the conditions on the labor market improve the faster the quantitative relaxation program will end than preliminary announced (more details about the exit strategy provided in Box 1). From the aspect of the inflation, FED expects that, on a medium run, it will move close to the target of 2%, with the inflation expectations remaining steady. Hence, it is estimated that these inflation perceptions justify the continuation of the adjustable policy, in order to underpin the economic recovery.

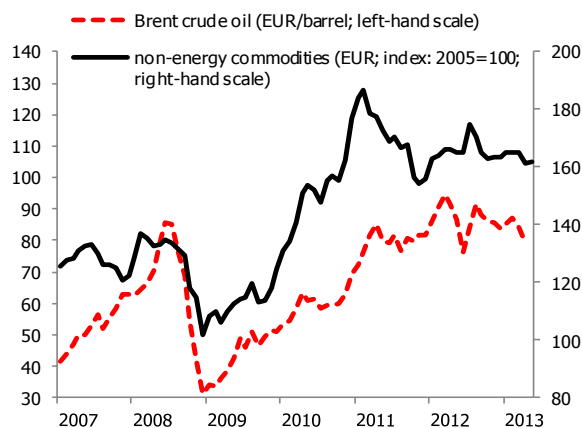


In the second quarter of 2013, the nominal exchange rate of the Euro relative to the US Dollar registered variable movements, but on average, the Euro registered moderate depreciation on a quarterly basis. The movements of the exchange rates were mainly associated with the changes in the market expectations for the economic developments in the Euro area, in comparison with the expectations for the other developed countries.

⁶ The monthly purchase of mortgage bonds and long-term government bonds equals US Dollar 40 billion and US 45 billion, respectively.

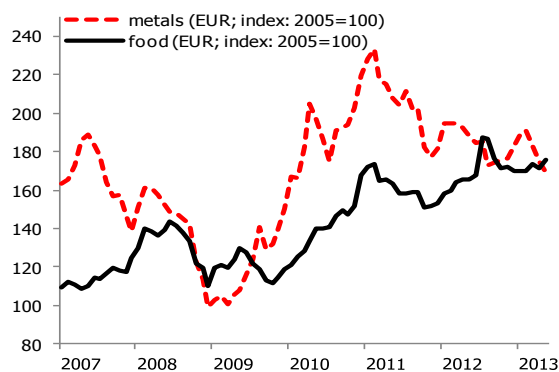


Prices of crude oil and non-energy commodities
(monthly data)



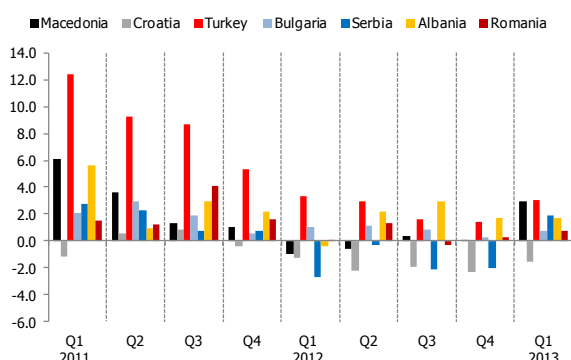
Source: IMF monthly database.

Prices of food and metals
(monthly data)



Source: IMF monthly database.

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



Source: Eurostat and national statistical offices.

The decrease in the interest rates of ECB and certain unfavorable economic data on Germany in the second quarter⁷ also had downward pressure on the Euro value. In June, one Euro was traded for US Dollar 1.32, which is an appreciation of 5.3% compared to June 2012.

In the first two months of the second quarter of 2013, the oil prices and the prices of the non-energy primary products⁸ presented in Euros registered a decrease compared to the preceding quarter. The average price of the crude "brent" oil fell by 7.4% in the first two months of the quarter, in comparison with the preceding quarter, and it equaled Euro 79.2 million per barrel, on average. During the second quarter, the oil prices ranged within Euro 75 to Euro 81 per barrel. The decrease in the oil price is mostly due to the enduring concern for the global macroeconomic condition and the increased supply by the non-OPEK countries, while there are still geopolitical tensions on the Middle East and Africa. **The prices of non-energy products in the second quarter reduced moderately relative to the preceding quarter, given moderate decrease in metal prices in April and May of 8.3% and average rise in food prices of 1.4%.** However, within the food price index, the corn and wheat registered a quarterly decrease. The fall in the metal prices, observed through the total metal price index is related to the lower demand by China than expected.

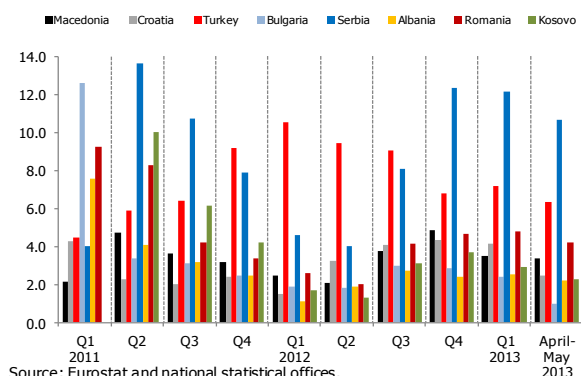
In the first quarter of 2013, most of the regional countries registered moderate acceleration in the economic growth. Croatia was exception registering reduction in the economic activity for second consecutive year. The negative economic growth in Croatia of 1.5% is explained with the constant decrease in the household consumption, related to the decrease in the disposable income, as well as with stagnation on the European markets, which have negative impact on the export performances. On the other hand, the Turkish and Serbian economies registered a growth. The growth in Turkey is due to the improved activity in the services sector, production and construction. In the case of Serbia, in the first quarter of 2013 the GDP incremented by 2.1% annually, which primarily emanates from

⁷ Data on higher unemployment than expected, lower import and less favorable data on the economy sentiment, the manufacturing activity and the retail sale.

⁸ Price index of non-energy primary goods includes: the prices of food, beverages, agricultural raw materials and metals.



Inflation in countries from the region
(annual percentage changes)



the fast recovery of the industrial output, under the influence of the boost in the car industry, oil and gas and electronics given low comparison base of the previous year.

In the first two months of the second quarter of 2013, moderate decrease in the inflation rate in all regional countries was registered. In almost all countries such movement of the inflation has been caused by the decelerated increase in food and beverages prices. In May 2013, the inflation in Serbia returned to the zone of one-digit growth, in conditions of moderate fall in the prices of oil derivatives and food products (except to fruits). The seasonal increase in the fruits and remedy prices had inflationary effect. The substantial decrease in inflation has also been registered in Bulgaria, where the fall emanates from the decrease in the prices of energy sources and housing prices.

Box 1: FED's exit strategy from the quantitative easing program

The FED's exit strategy was primarily elaborated in the minutes of the Federal Open Market Committee (FOMC) released in June 2011. Several elements of the strategy have been altered ever since, such as the implementation period of the exit strategy, having in mind that after the release of the exist strategy, another two programs (twist operation and LSAP3) were introduced. According to the released exit strategy, FED has several instruments on disposal that can be used in the forthcoming period for the following: 1) decrease in the assets purchase amount, 2) reinvestment of the due debt in new assets, 3) liquidity withdrawal operations, 4) increase in the interest rate simultaneously with the increase in the reimbursement for allocated liquid assets over the reserve requirement and 5) sale of assets (table 1). It is assumed that at the beginning of September or October or FED will begin reducing the monthly amount of purchase of assets by about US Dollar 10 to 20 million. After finalizing the purchase of assets, FED is going to maintain the volume of its balance at stable level, through reinvestment of the due amount in new assets. It is expected that the reinvestment will be competed until the end of 2014, when the FED balance will reduce as the bonds fall due. These changes will be followed by the increase in the key interest rate to the middle of 2015. However, the full normalization of the monetary policy will probably last about a decade. It is expected that the sale of assets will be performed as a ultimate measure, while its implementation will depend on the performances with the economic activity and inflation. According to the latest estimations of FED, it is expected that the balance will be normalized (at the level of about US Dollar 1-1.5 trillion, as it equaled in the pre-crisis period) before 2025.

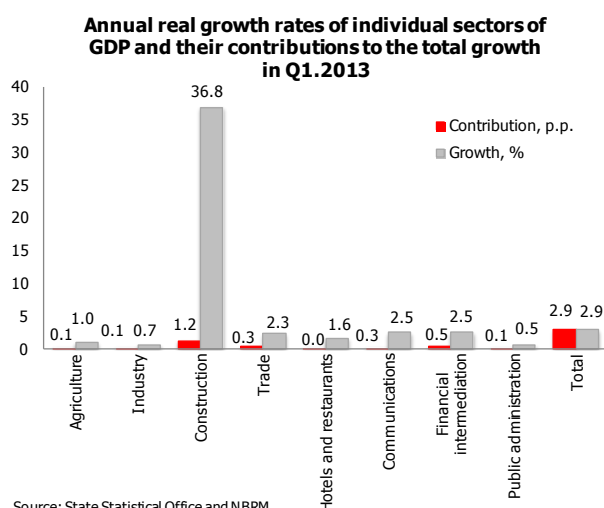
Table 1

Federal Reserve's exit strategy	
Timeline	Description
sept.-oct. 2013	Purchases of mortgage-backed securities and Treasuries are reduced at a rate of USD 10-20 million per month
Q1 2014	Asset purchases are ceased
Q1 2014-Q3 2014	Maturing principal is reinvested in order to maintain the size of the Fed's balance sheet
Q4 2014	Maturing principal is not reinvested and the size of the Fed's balance sheet is reduced
Q3 2015	Interest rate starts to be increased simultaneously with the rise in the interest paid on the excess liquidity over reserve requirement
after 2015	Optional: Should economic conditions warrant, the Federal Reserve could consider selling assets to normalize the size of the balance sheet

Source: Federal Reserve

1.2. Domestic supply

The recovery of the domestic economy continued also in the first quarter of 2013. Since the activity recorded a solid quarterly growth, the economy remained in the zone of positive quarterly changes for four consecutive quarters. On annual basis, in the first quarter the GDP grew by 2.9%, the highest growth in the past six quarters. Better economic performance was registered in all sectors of the economy. However, the construction activity had the largest contribution, partly as a result of the impulses of private investments in real estate and public infrastructure projects. In the first quarter, the reduced activity in industry, present in the last six quarters, was terminated. The increase in industry had additional positive impact on transport and communications, through intensification of the cargo air and rail traffic. The favorable developments in economic activity are perceived also through the degree of utilization of industrial capacity, which increased at the beginning of 2013 and is nearly to the long-term average. The business tendency surveys generally depict the economic agents' more positive estimations, both in terms of the current economic situation, and in terms of their expectations for the number of employees and purchases.



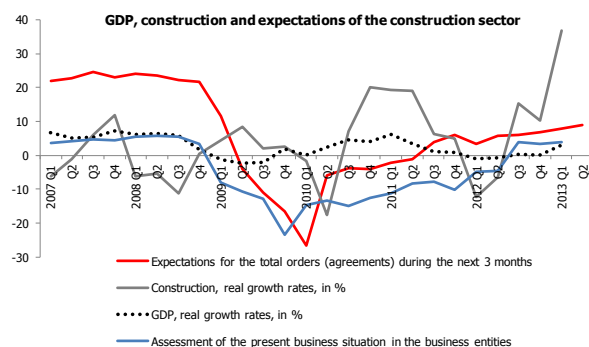
In the first quarter of 2013, the gross domestic products⁹ registered quarterly growth of 1.3% (seasonally adjusted), and the economy remained in the zone of positive quarterly changes for four consecutive quarters. On annual basis, the domestic output increased by 2.9%. The better quarterly performance in the first quarter of is mostly due to the increase in the value added in **industry and construction**, while the transport and communications, trade and financial intermediation, activities related to real estate, lease and business activities, other public utilities, general and service activities had slightly smaller contribution. From the aspect of the annual dynamics, the two-digit growth in **construction** sector contributed most to the annual increase in the domestic production, with constant rise in this period also being registered in the financial intermediation. Favorable dynamics was registered in the value added in the **trade** sector, the increase of which intensifies for third consecutive quarter, after the annual fall in the first half of 2012. The first quarter characterizes with favorable developments in **industry**, which exited the negative annual changes zone after three quarters.

⁹ The GDP data for 2012 are estimated data of SSO.

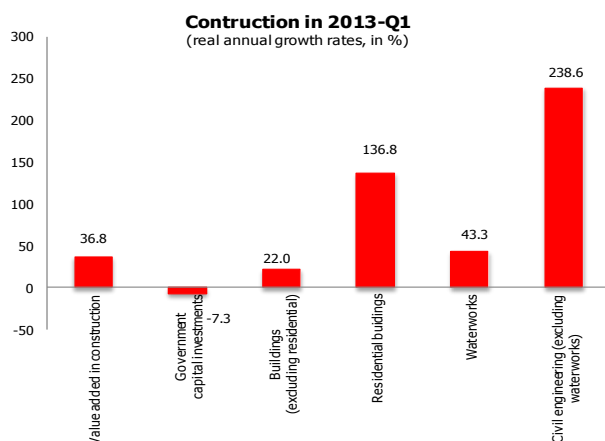


	annual growth rates, in %					contributions to GDP growth (in p.p.)						
	Q1 2012	Q2 2012	Q3 2012	Q4 2012	2012	Q1 2013	Q1 2012	Q2 2012	Q3 2012	Q4 2012	2012	Q1 2013
Agriculture	-1.5	1.7	0.4	2.4	1.0	1.0	-0.1	0.2	0.0	0.3	0.1	0.1
Industry	-11.8	-7.9	-7.3	-6.1	-8.3	0.7	-2.2	-1.3	-1.2	-0.9	-1.4	0.1
Construction	-12.4	-6.4	15.4	10.2	3.9	36.8	-0.5	-0.3	0.8	0.6	0.2	1.2
Trade	-0.1	-2.2	0.9	0.4	-0.3	2.3	0.0	-0.3	0.1	0.1	0.0	0.3
Hotels and restaurants	-0.6	3.5	3.8	2.9	2.7	1.6	0.0	0.0	0.1	0.0	0.0	0.0
Communications	5.8	-1.2	2.5	-1.7	1.2	2.5	0.6	-0.1	0.2	-0.2	0.1	0.3
Financial intermediation	4.0	4.2	1.8	2.5	3.1	2.5	0.7	0.7	0.3	0.4	0.5	0.5
Public administration	1.4	1.5	1.7	2.7	1.8	0.5	0.2	0.2	0.2	0.3	0.2	0.1
Value Added	-1.9	-1.5	0.4	0.4	-0.6	3.0	-1.7	-1.3	0.3	0.3	-0.5	2.6
Net taxes on products	6.9	5.9	0.7	-0.9	2.5	2.7	0.8	0.8	0.1	-0.1	0.4	0.4
Gross Domestic Product	-1.0	-0.6	0.4	0.1	-0.2	2.9	-1.0	-0.6	0.4	0.1	-0.2	2.9

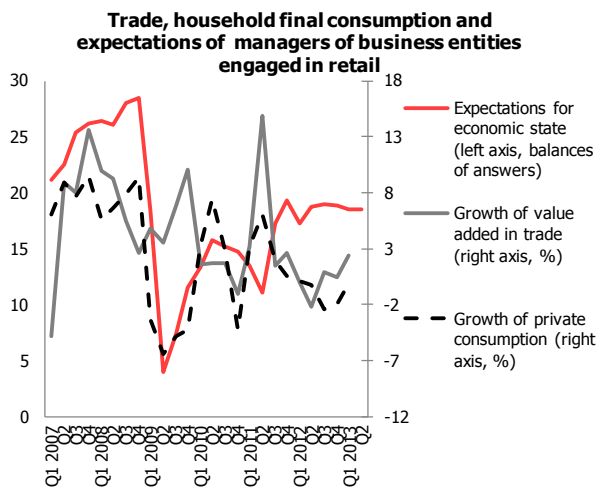
Source: State Statistical Office and NBRM calculations.



Source: State Statistical Office.



Source: State Statistical Office and Ministry of finance.



Source: State Statistical Office.

The growth intensification of construction activity on quarterly¹⁰ and annual basis continued also in the first quarter of this year. Beside the lower comparison base in the preceding year (due to the extreme weather conditions), the solid increase is due, to large extent, to the construction works¹¹, i.e. the public and private investments in the area of civil engineering and residential buildings. According to the surveys, the favorable construction activity is proven by the higher assessment for economic activity from the Business Tendencies Survey in **construction**¹². The positive perceptions of enterprises, according to the survey, come from the reduced impact of certain limiting factors for improvement of construction activity. Namely, lower negative impact on the amount of financial costs (interest rates), competition, lack of equipment and unfavorable weather conditions has been estimated. Also, as of the first quarter of 2012 there are more positive than negative perceptions about the financial situation of the enterprises. Regarding the expectations of the managers¹³ of the construction companies, bigger optimism than in the preceding quarter in the expectations for conclusion of new agreements and number of employees is evidenced, given almost unchanged expectations for increase in the selling prices.

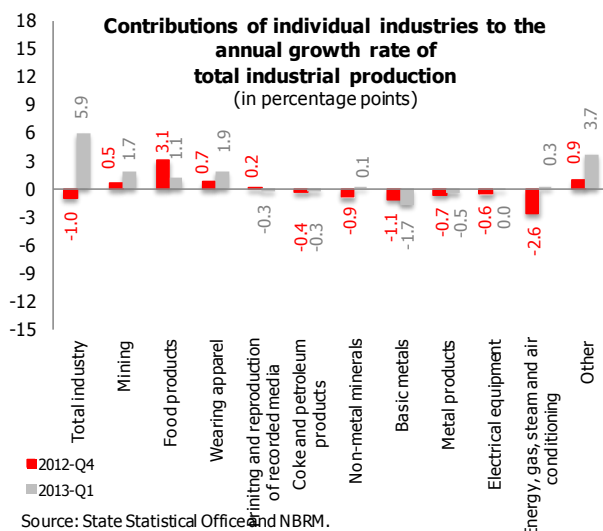
The added value of trade in the first quarter of 2013 registered rapid quarterly and annual growth. However, given the decline slowdown in private consumption in the first quarter, the trading activity, for the first time in a long time, was caused by positive performances in three service categories simultaneously. After one-year decrease, the retail trade recorded positive annual growth rate, while the positive growth in trade of motor vehicles to certain extent is influenced by one-time

¹⁰ Analyzed on seasonally adjusted basis.

¹¹ It encompasses the construction activities related to corridor X and construction of the skyscrapers in Aerodrom Municipality.

¹² It refers to the first quarter of 2013.

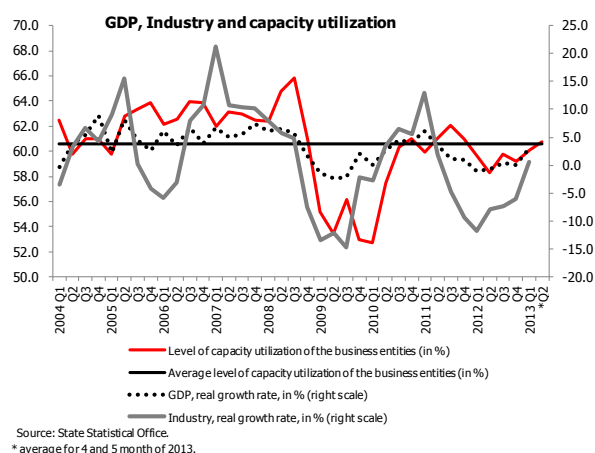
¹³ From the Business Tendency Survey in construction of the SSO for the first quarter of 2013.



factors¹⁴. The wholesale trade also registered an increase, although less intensive. The better performances with the retail trade are perceived also through the **retail trade** managers survey¹⁵, the assessments of which, compared to the assessments in the previous quarter, indicate improved current business condition of these enterprises. According to their perceptions, the limiting impact of competition, the market and the lack of trained staff have limiting influence. The expectations of the management of commercial enterprises are almost unchanged compared to the orders for the following three months, the number of employees and the business situation in the next six-month period.



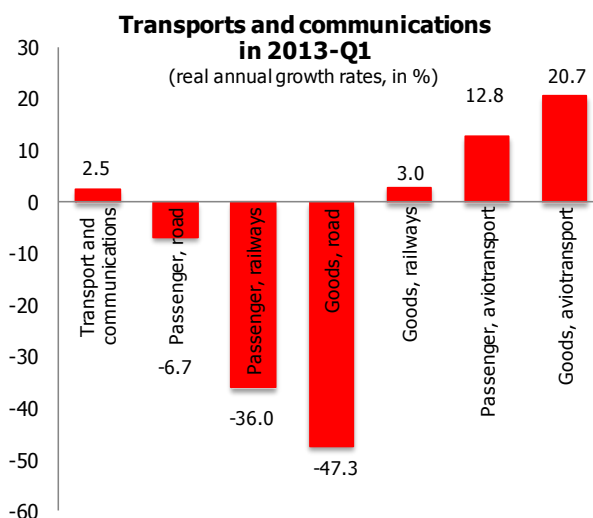
The recovery of the industrial activity, which commenced in the last quarter of 2012, continued in the first quarter of this year with intensified quarterly growth¹⁶, thus conditioning an increase on annual basis. The annual increase in industrial activity follows the decrease throughout 2012. This improved performance is associated with a slightly better global environment for certain segments of the domestic industry, the activity of new foreign manufacturing facilities, and improved hydrological conditions that contribute to larger electricity production. Thus, the greatest contribution to the annual growth in the first quarter accounted to manufacturing, where the increase in production of tobacco products, clothing, machinery and equipment, and food products largely contributed to higher value-added of industry. At the same time, a smaller positive contribution had mining and supply of electricity, gas, steam and air conditioning. Better performances in industry are confirmed in Business Tendencies Survey in **manufacturing industry**. The average utilization capacity in the first quarter registered an increase on both quarterly and annual basis. Thus, the average utilization is close to the historical average of the past eight years. Moreover, compared to the previous quarter, the enterprises evaluated the current economic situation more positively, as well as the current production volume. In terms of the factors that limit the increase in production, the Survey suggests smaller significance of the financial problems and the competitive imports, as well as the lack of raw materials, equipment and energy. The assessments in the surveys for the first two months of the second quarter of 2013



¹⁴ Purchase of new vehicles by the Government.

¹⁵ From the Business Tendency Survey in retail trade of the SSO for the first quarter of 2013.

¹⁶ Analyzed on seasonally adjusted basis.

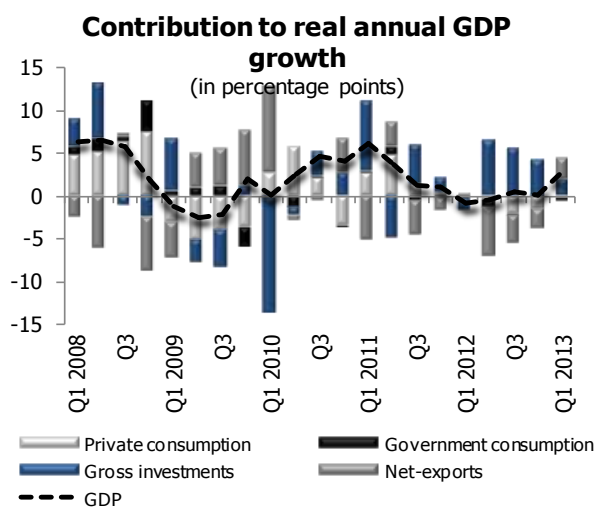


Source: State Statistical Office.

indicate increased optimism concerning the production volume, with the average capacity utilization exceeding the average of the previous eight years. However, reduced limiting impact of the uncertain economic environment, lack of raw materials and skilled labor has been registered. Such estimations resulted in more favorable assessment of the current order-based production, given higher expectations in terms of the number of employees in the next three months.

1.3. Aggregate demand

In the first quarter of 2013, the domestic demand continued to rise, thus having positive contribution to the change in GDP for four consecutive quarters. In this quarter, the main driver of domestic demand was investment activity. Also in this quarter, the investment activity was the main growth generator of the domestic demand. Namely, due to strong intensification of the construction activity in the country, the investments are once again one of the main factors for the economic growth, while other components of domestic demand have registered negative growth rates. But given the favorable developments on the labor market, the private consumption registered minimal decline, i.e. significant decrease slowdown was registered, while the private consumption returned to the negative performance path. As a result of the smaller demand of the foreign countries, as well as the fall in the metal prices, the export-oriented manufacturing sector decreased. Given the import dependence of the export sector, imports of goods and services also fell, but much more intensively than exports. Accordingly, the net exports and domestic demand had a positive contribution to growth.

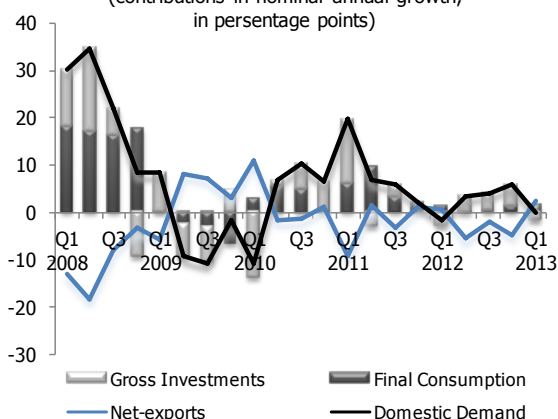


Source: State Statistical Office and NBRM calculations.

In the first quarter of 2013, the economic activity had an annual growth of 2.9%, in conditions of both positive contribution of net exports and domestic demand. The net exports contributed positively to the growth for the first time after three-quarter long of negative contribution, which was solely due to the stronger decrease in imports compared to exports. Namely, in conditions of further decrease in the foreign demand in the first quarter of 2013, the exports registered minimal real decline. The reduced export activity contributed also to lower demand for import of goods and services, as a result of which given the relatively high comparison base the imports registered an annual fall, for the first time in three quarters. Despite the decrease in the imports, the investments had a

**Domestic Demand and Net-Exports**

(contributions in nominal annual growth, in percentage points)



Source: State Statistical Office and NBRM calculations.

significant positive contribution to the economic activity, as in the previous three quarters, and their growth stems primarily from the substantial construction activity. The other categories of domestic demand register substantial slowdown in the decrease, given intensified increase in the number of employees and the slower decline in real wages, thus having a neutral effect on the overall economic growth. The public consumption, with exception to the minimal growth in the previous quarter, fell once again¹⁷, thus contributing negatively to the GDP growth for almost six consecutive quarters.

Real annual growth rates (%)

	2010-Q1	2010-Q2	2010-Q3	2010-Q4	2010	2011-Q1	2011-Q2	2011-Q3	2011-Q4	2011	2012-Q1	2012-Q2	2012-Q3	2012-Q4	2012	2013-Q1
Private consumption	3.3	7.4	2.8	-4.3	2.1	3.2	6.1	1.9	0.5	2.9	0.1	-0.3	-2.5	-2.0	-1.2	-0.1
Government consumption	-0.6	-7.1	0.7	-0.8	-2.0	0.7	4.9	-2.7	-0.2	0.6	-1.8	-5.4	-1.4	0.1	-2.2	-1.5
Gross investment	-47.6	-3.1	15.1	9.0	-6.7	55.4	-20.0	21.9	5.6	9.6	-5.8	34.7	22.9	13.1	16.0	9.4
Exports of goods and services	10.0	17.7	24.8	40.1	23.6	36.3	12.0	2.6	-0.4	10.5	0.2	0.7	-1.3	0.6	0.0	-0.3
Imports of goods and services	-10.2	12.8	18.8	16.0	9.5	33.3	3.6	8.6	2.2	10.4	-0.3	9.5	3.9	3.8	4.2	-3.7
Domestic demand	-8.3	3.0	4.5	-0.6	-0.3	9.2	0.7	4.8	1.8	3.9	-1.3	4.5	2.9	2.3	2.2	1.3
Net exports*	-35.1	3.6	2.9	-16.3	-13.8	27.1	-14.1	28.1	7.9	10.1	-1.2	33.8	17.4	10.5	14.2	-11.3
GDP	0.0	2.5	4.5	4.0	2.9	6.1	3.6	1.2	1.0	2.8	-1.0	-0.6	0.4	0.1	-0.2	2.9

*decrease represents lower deficit

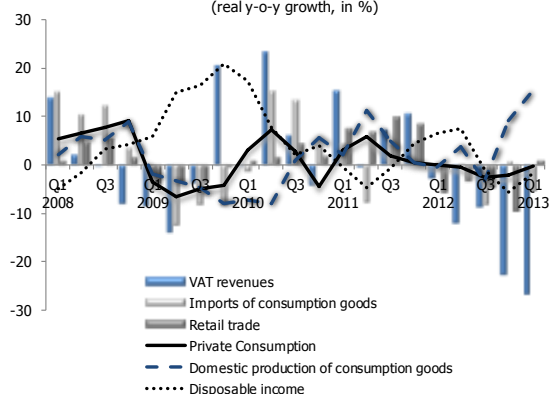
Source: SSO and NBRM calculations.

1.3.1. Private consumption

In the first quarter 2013, the private consumption registered a quarterly increase of 3.1% (seasonally adjusted), which led to minimal annual fall of 0.1%. Accordingly, the trend of deceleration of the real annual decrease in the household consumption, which began in the previous quarter, continued. The deceleration in the decrease in the private consumption can be explained by the faster decline in disposable income, which is due to the increase in the wages and retirements amount in comparison with the decrease in the previous quarter. The rise in the wage amount results from the favorable movements in the labor market, while the number of employees recorded strong growth. Meanwhile, the wages experienced slower decline in real terms, in conditions of faster nominal growth and slower growth in prices. Also, the lending to households continued intensively,

Private consumption indicators

(real y-o-y growth, in %)



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

¹⁷ Within the latest quarterly publication on the GDP data, the quarterly data for private consumption in 2011 have been substantially revised, resulting from the harmonization of the quarterly amounts (which are based on estimations) with the final annual amount (which is based on the annual accounts of the Budget), published in the annual publication of GDP in 2011 from May 2013. The change in final data for 2011 reflect appropriately on the data for 2012.



with most of it being focused on consumer loans, giving the loosening of the crediting terms for this type of loans¹⁸. These favorable developments caused real annual growth of retail trade, opposite to the decrease throughout 2012. Simultaneously, also the domestic production of consumer goods recorded intensified annual growth. In contrast, the imports of consumer goods has real annual decrease, as well as the net VAT income, which is mostly due to the servicing of the government liabilities to corporate sector.

The latest available data¹⁹ for the second quarter of 2013 indicate slightly more favorable developments with the private consumption. Namely, the lending to households continued to grow with nearly the same growth rate as in the previous quarter, and the bank expectations of banks in terms of ease of the crediting terms and increased demand for credit by households are optimistic²⁰. In addition, the intensification of the annual growth in pensions pursue²¹, while the net wages register almost identical fall in the first quarter. After the decrease in the preceding quarter, the increase in the import of consumer goods also indicates more favorable movements, with the domestic production also registering an increase, although slower. Simultaneously, also the net VAT income indicates higher consumption, consistent to the realized high increase. Only the data on the retail trade do not correspond to these movements. Namely, after the slight rise in the preceding quarter, the retail trade re-entered the zone of negative growth rates, with the deepest drop being registered in the trade of food, beverages and tobacco. Such movements are also adverse to the unchanged expectations of the managers from the aspect of the orders, number of employees, as well as the performance condition of the enterprises²². The private transfers also register real annual decrease, which emanates from the high comparison base caused by factors

¹⁸ Lending Survey of NBRM conducted in May 2013.

¹⁹ The data on the domestic production of consumer goods, pensions, VAT and the household loans are given as of May, while the data on the wages and retail trade are given as of April.

²⁰ From the Lending Survey of NBRM conducted in May 2013.

²¹ Starting from the pension for February paid in March 2013, the pensions have increased linearly by Denar 550, as a supplement to the regular harmonization of pensions with wages and inflation.

²² From the Business Tendencies Survey in retail trade of SSO conducted in the first quarter of 2013.



which are no, in most cases, related to the consumption²³.

1.3.2. Public consumption

In the first three months of 2013, the public consumption registered quarterly decrease of 2.2% (seasonally adjusted), and on annual basis it registered a decrease of 1.5%. Hence, according to the revised SSO data, after the minimal increase in the previous quarter, the government consumption is once again in the negative zone which it entered in the second half of 2011. The latest available data as of May 2013 indicate continuation of the dynamics of the real annual decrease in the public consumption in the second quarter, as well.

Box 2: Fiscal policy

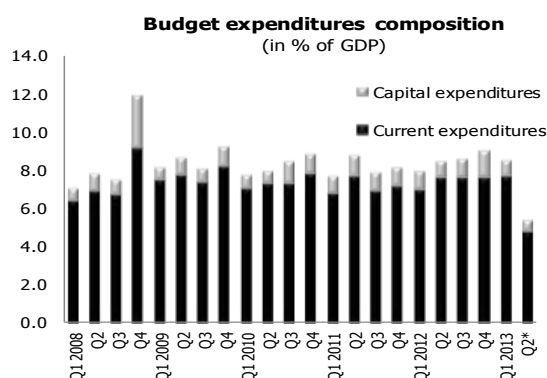
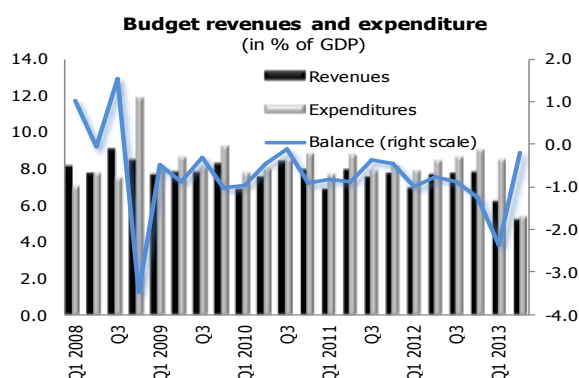
In January - May 2013 period, in the Budget of the Republic of Macedonia (Central Budget and the funds' budget) total budget revenues of 11.3% of GDP²⁴ were realized (12.1% of GDP in the same period of the preceding year). On nominal basis, the budget revenues in this period are lower by 1.3%. The tax income registered a decrease of 1.5% on annual basis, which arises from the lower VAT-based income, which fell by 7.3% on annual basis. The lower VAT income²⁵ is a combined effect of the arrears settlement by the Government to the private sector on VAT return basis, which commenced in September 2012²⁶ and the still feeble private consumption. The income from excise also plunged (6.2%), while the income and profit taxes, as well as the import duties registered an annual increase of 6.9%, 29.6% and 10%, respectively. The total contributions were higher by 3% on annual basis, given decrease in the non-tax income of 13.7% on annual basis.

²³ The high comparison base is due to the endurance of the trend of Euro-to-Denar conversion owing to the European debt crisis.

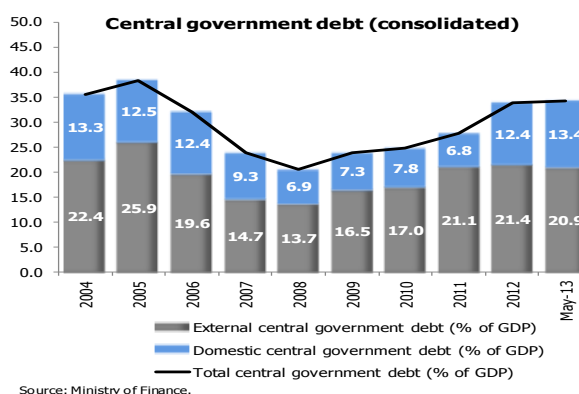
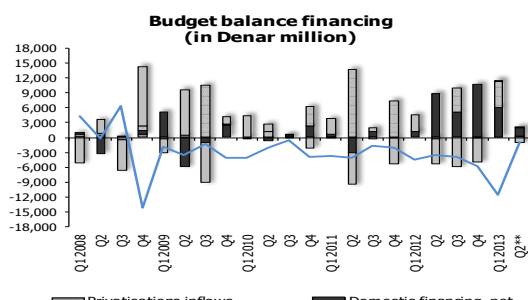
²⁴ Within the analysis, April NBRM projections for 2013 were used.

²⁵ In the Budget of the Republic of Macedonia, the VAT income is presented on a net basis, i.e. the total collected VAT reduced by the VAT return.

²⁶ During the meeting with the business community and chambers on September 23, 2012, the Prime Minister of the Republic of Macedonia in his address announced that the problem of late payment of obligations of the state towards the corporate sector based on VAT returns and other obligations as of to February 2013 will be fully overcome. The repayment of the liabilities has been carried out in the September 2012 - February 2013 period (<http://vlada.mk/node/4469>).



The total budget expenditures in January - May period equaled 13.9% of GDP, which is almost on the level of realized budget expenditures in the same period of the previous year (13.3% of GDP). On nominal basis, in comparison with the same period of the preceding year, the budget expenditures raised by 10.3%. Within expenditures, the current expenditures registered annual increase of 11.3%, mainly caused by the higher expenses based on transfers (by 13.1% on annual basis). The capital expenditures registered an increase of 1.8% on annual basis.



In January-May 2013 period, the budget deficit amounted to Denar 12.437 million, or 2.6% of GDP, while the projected budget deficit for 2013 is 3.5% of GDP. The budget deficit in this period was financed from both domestic and external sources. Thus, by borrowing on the domestic market through new issues of government securities, net inflows of total Denar 7,405 million were mobilized. In this period, inflows based on foreign borrowings in the total gross amount of 17,540 million were registered, in line with the performed withdrawal of funds of the loan from the Deutsche Bank under the Loan Agreement secured by a guarantee based on the World Bank policies (in the amount of Euro 250 million) and the First Program Loan approved by the World Bank policies aimed at developing competitiveness (in the amount of US Sollar 50 million).



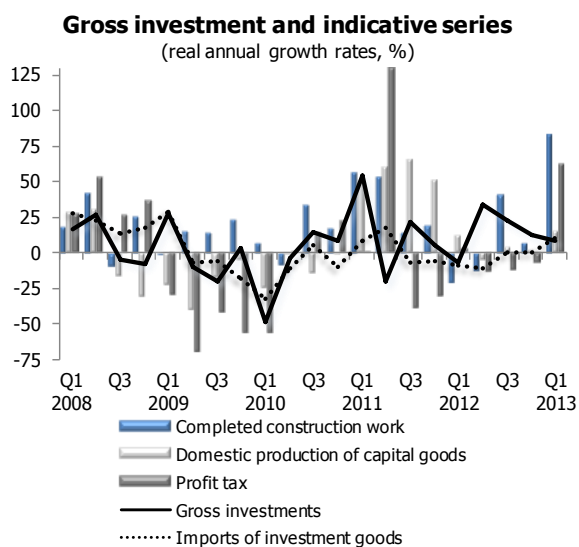
Table 1
Budget of the Republic of Macedonia (Central Budget and funds' budget)

	2013 Budget	Jan	Feb	Mar	Q1	Apr	May	Jan-May 2013	Jan-May 2013 / Jan-May 2012, in %	Jan-May realization, in % of Budget plan
	plan, in Denar million	realized, in Denar million								
TOTAL BUDGET REVENUES	147,958	10,651	8,278	10,972	29,901	14,657	10,555	55,113	-1.3	37.2
Revenues base on taxes and contributions	125,555	9,246	7,153	10,077	26,476	11,082	9,684	47,242	0.2	37.6
Tax revenues	81,685	6,346	3,617	6,544	16,507	7,092	6,409	30,008	-1.5	36.7
Contributions	42,842	2,811	3,445	3,464	9,720	3,913	3,205	16,838	3.0	39.3
Non-tax revenues	13,836	918	951	701	2,570	776	705	4,051	-13.7	29.3
Capital revenues	4,432	172	65	62	299	2,325	55	2,679	-20.5	60.4
Donations from abroad	3,535	278	89	89	456	456	55	967	2,2 times	27.4
Revenues of recovered loans	600	37	20	43	100	18	56	174	-7.4	29.0
TOTAL BUDGET EXPENDITURES	165,653	13,522	11,997	15,829	41,348	14,485	11,717	67,550	10.3	40.8
Current expenditures	146,944	11,771	11,193	14,339	37,303	12,656	10,828	60,787	11.3	41.4
Capital expenditures	18,709	1,751	804	1,490	4,045	1,829	889	6,763	1.8	36.1
BUDGET DEFICIT / SURPLUS	-17,695	-2,871	-3,719	-4,857	-11,447	172	-1,162	-12,437	2,3 times	70.3
Financing	17,695	2,871	3,719	4,857	11,447	-172	1,162	12,437		
Inflow	33,464	14,229	4,054	4,951	23,234	151	1,470	24,855		
Revenues based on privatisation	0	0	0	30	30	0	240	270		
Foreign loans	17,758	16,594	0	132	16,726	814	0	17,540		
Deposits	12,022	-6,628	2,060	4,867	299	-1,974	821	-854		
Treasury bills	3,589	4,197	1,992	-78	6,111	1,149	409	7,669		
Sale of shares	95	66	2	0	68	162	0	230		
Outflow	15,769	11,358	335	94	11,787	323	308	12,418		
Repayment of principal	15,769	11,358	335	94	11,787	323	308	12,418		
External debt	13,896	11,226	335	94	11,655	191	308	12,154		
Domestic debt	1,873	132	0	0	132	132	0	264		

Source: Ministry of Finance of the Republic of Macedonia.

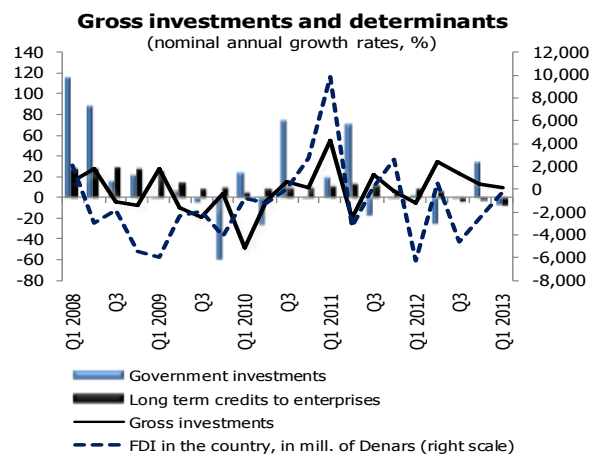
In January 2013, full payment of the Eurobond taken in 2009 (totaling Euro 183 million) was made, with the net income from external borrowing in this period being equal to total of Denar 5,386 million. Despite the higher payments based on regular repayment of liabilities based on the public debt, higher inflows than outflows of funds during the entire period were registered, which led to the increase in the deposits on the Government account to the NBRM in the amount of Denar 854 million. According to the latest available data, the debt of the Central Government (consolidated) as of May 31, 2013 totaled 34.2% of GDP.

1.3.3. Investment consumption



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

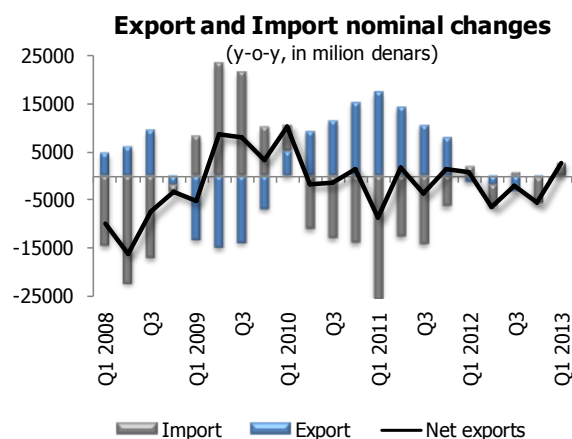
The gradual slowdown in the annual growth of gross investments continued also in the first quarter of 2013. On annual basis, the investments increased by 9.4% in conditions of quarterly decline of 5%, seasonally adjusted. Despite the slower annual growth, it is still relatively solid. These changes in investments stems, to large extent, to the intensive construction activity in the first quarter, which is partly due to the low comparison base of the previous year when extremely low temperatures have been registered. However, the high rise mirrors also the generally increased construction activity in the private and government sector, which is proven with the historically highest quarterly amount realized in the first quarter of 2013 in comparison with the first quarters of the previous years. However, the most important projects are the construction of part of the Corridor X highway, the construction of skyscrapers in the capital, and the construction of small hydropower plants. The building expansion had positive impact on imports and domestic production of capital goods, which also



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

experienced strong annual growth. Certain positive developments was registered with the foreign direct investments, which registered slower decline. On the other hand, the slowdown in the investment growth can be explained by enhanced fall in the corporate long-term lending, amid slower growth in credit demand, mainly intended for investments in fixed assets and debt restructuring and tightening of the crediting conditions in terms of interest rate²⁷. **So far, the available indicative data on the investment activity for the second quarter of 2013 mainly point to growth²⁸.** The growth in both the government capital investment and the foreign direct investment gives favorable signals, despite their decrease in the previous quarter. It contributed towards growth intensification of import of capital goods. Meanwhile, the increase in the construction activity continued, although slower, in conditions of almost the same value of building approvals issued in April and May compared to the same period of 2012. Moreover, the expectations of the managers in construction for the second quarter are more favorable compared to the first quarter, in terms of orders and the total number of employees. It is also expected that due to the longer duration of these projects, the construction activity will maintain in the positive zone growth rates. However, the corporate lending registered intensified decrease, thus registering a reduction for four consecutive quarters. The reduced lending is also consistent with the banks' expectations for tightened the lending conditions.²⁹ In addition, domestic production of capital goods recorded an annual decrease, notwithstanding it registered an increase in the previous quarter.

1.3.4. Net export demand



Source: State Statistical Office.

In the first quarter of 2013, the export of goods and services has a small annual decline realized in conditions of a slower recovery of the global economy than expected, and the intensified decrease in the world metal prices. The unfavorable changes in exports contributed to a decrease in import of goods and services, as well. Hence, given the more severe drop in imports than exports, the net exports recorded a positive input to the annual change in the GDP,

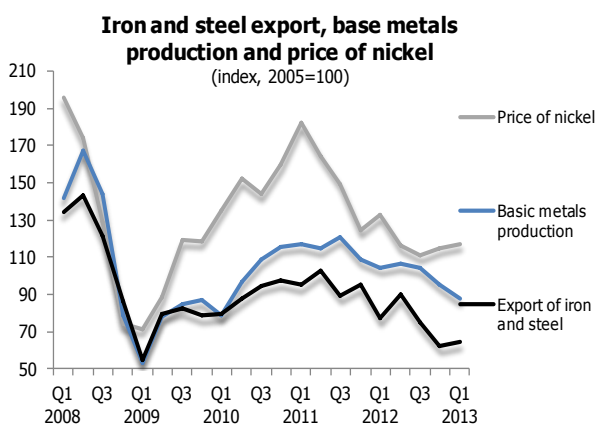
²⁷ Lending Survey of NBRM conducted in May 2013.

²⁸ The data on the completed construction activities and foreign direct investments are as of April, while the other data are given as of May.

²⁹ Lending Survey of NBRM conducted in May 2013

unlike the negative contribution in the previous three quarters.

In the first quarter of 2013 the exports registered a quarterly increase (of 2%, seasonally adjusted), while on annual basis it declined slightly by 0.3%, opposite to the increase in the preceding quarter. Namely, the enduring unfavorable environment in the Euro area, including Germany as its member and our most important trade partner, registers slow recovery, contributed towards smaller demand of our export products. This is proved also by the estimations of the managers in the manufacturing industry³⁰, which indicated the insufficient foreign demand as the most limiting factor for production boost. At the same time, in conditions of intensified decrease in the metal prices on the international stock exchanges, the domestic metal industry was one of the most affected sectors in the first quarter of 2013. However, in environment of export dependence of the domestic export sector, the decrease in the exports contributed towards demand of import goods, as well as lower need of foreign services, primarily related to the transport and other business services. Given high comparison base, the import of goods and services in the first quarter of 2013 registered annual fall of 3.7%, thus ceasing the trend of increase in three consecutive quarters, registering also a decrease on a quarterly basis, as well (of 1%, seasonally adjusted).



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

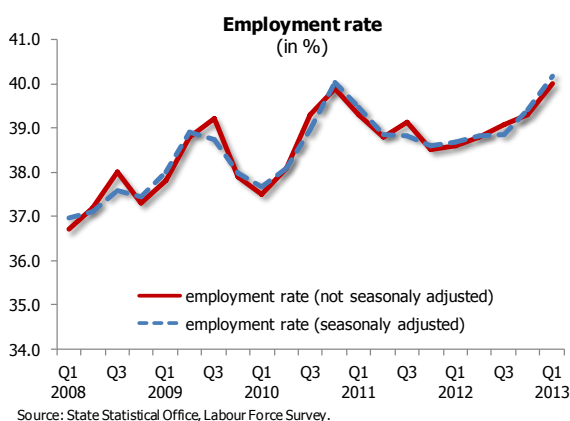
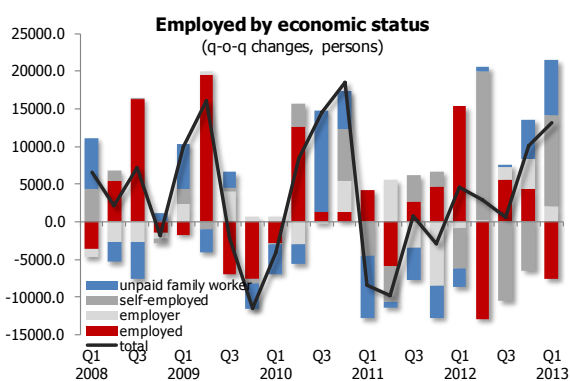
The available foreign trade data for the second quarter point to a further positive contribution of net exports to GDP, which would arise from the growth in exports, but also from the decrease in imports. Namely, in the April-May 2013 period, the nominal export of goods recorded high growth in conditions of slower decrease in foreign demand, thus resulting in slightly higher utilization of industrial capacity in the same period. Also, in expectations of the managers in the manufacturing industry for the second quarter are slightly more favorable compared to the previous quarter³¹. On the other hand, the data on the import of goods show slight slowdown of the nominal annual decrease, with the further decrease of the world metal and crude oil prices would result in decelerated decrease on real basis, as well.

³⁰ Business Tendency Survey in the manufacturing industry of SSO conducted in May 2013.

³¹ Business Tendency Survey in the manufacturing industry of SSO conducted in May 2013.

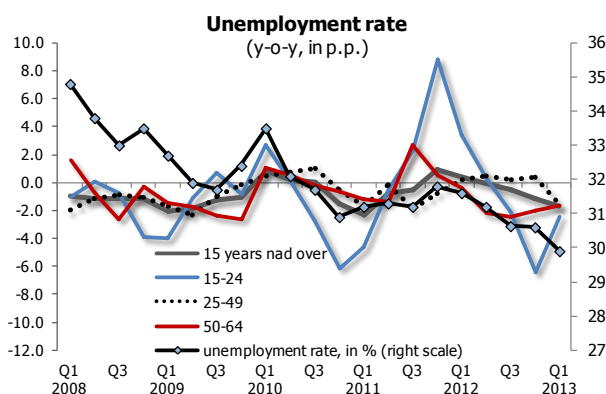
1.4. Employment and wages

In the first quarter, the labor market indicators showed further improvement. Thus, the number of employees continues to rise with substantially faster quarterly dynamics. This course leads to positive transmission effects of the recovery of the economic activity, which is constantly present since the second half of last year. Greater resilience of the domestic economy to the second recession wave in the Euro area and consequently, larger resilience of the process of opening new jobs are associated with the operation of new production facilities. At the same time, both, the private and the public investments in construction projects have significant role in the buffering of the negative effects on the labour market. Besides, also the active employment measures, which have been taken for several consecutive years, have appropriate additional positive effect on the labor market. In the first quarter of 2013, the increase in the number of employees in agriculture had high positive contribution to the growth in employment. In terms of labor cost, there is a moderate strengthening of annual nominal wage growth, as well as additional slowdown of their real decrease. In terms of future developments on the labor force market, according to the signals the business tendency surveys emit, the optimism about the number of employees for the next three-month period generally improved. Such estimations can be connected with the positive developments in the domestic economy, and partly with the forecasts for the gradual recovery of the global economy.

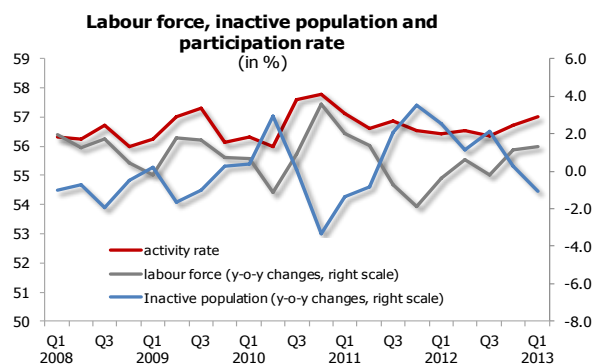


In the first quarter, the number of employees registered an increase of 2%, which is further intensification in the quarterly growth³². Such a course indicates positive transmission effects of the recuperation of the economic activity that is constantly present since the second half of the previous year. This can also be perceived through the employment rate, which increased by 0.7 p.p. on a quarterly basis. Thus, its constant upward trend, which commenced at the beginning of the previous year, continued. From the aspect of the economic status, the quarterly increase in the employment emanates from the larger number of unpaid family workers and employers. Analyzed by activity sectors, the increase is mostly due to the agriculture. Namely, in the first quarter, the employment in this sector registered the highest quarterly growth in the last seven years. **On annual basis, the number of employees registered an increase of 3.9%, which is significant intensification of the positive dynamics.** These development led to annual growth of 1.4 p.p. with the employment rate, reaching 40%, which is the historical peak. Analysed by sector, the annual employment

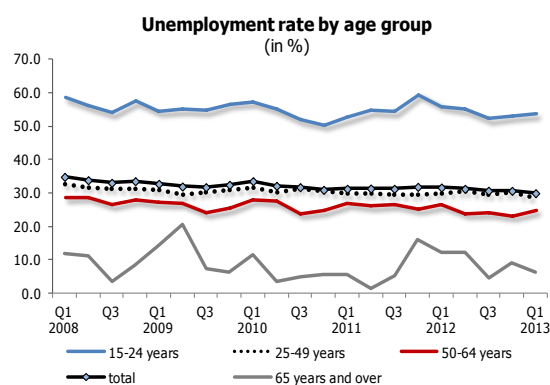
³² The analysis of the quarterly dynamics of employment, unemployment and total active population is made with seasonally adjusted data.



Source: State Statistical Office, Labor Force Survey.



Source: State Statistical Office, Labor Force Survey.



Source: State Statistical Office.

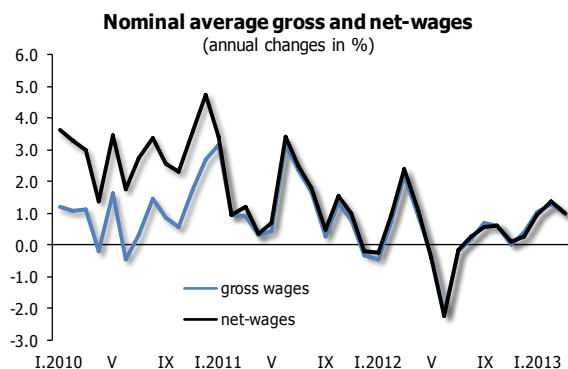
growth mainly comes from agriculture, followed by transport, storage and communications, as well as construction. The role of buffers of negative effects on the labor market from the last year recession, that some of these sectors have experienced, is mainly associated with the fiscal stimulus in form of publicly funded construction projects, as well as government support measures in agriculture. According to the Survey on Job Vacancies³³, about 25% of the newly opened or vacant jobs in the first quarter are related to the sectors with the largest contribution to the annual increase in the employment.

According to the aggregated signals from the business tendencies surveys³⁴ general strengthening of the optimism regarding the number of employees for the following three-month period can be evidenced. These expectations correspond to the positive developments in the domestic economy, as well as with the expectations for a gradual recovery of the global environment, which is mostly associated with the recovery of the U.S. economy. At the same time, despite the gradual stabilization of the European debt crisis, the economic growth in the Euro area still faces with difficulties. However, recently moderate encouraging improvement of the indicators of the business climate in Germany has been noticed, which probably has a significant effect on the optimism of the domestic managers.

The increase in the demand conditioned quarterly rise also in the supply of labour force. Thus the active population registered relatively high quarterly increase (of 0.8%), although slightly decelerated relative to the preceding quarter. The rise in the labour force, given simultaneous fall in the inactive population resulted in upward quarterly movement of the activity rate, which reached 57%. **The total active population registered an increase also in comparison with the same period of the previous year (of 1.4%).** Such development, given simultaneous decrease in the number of inactive population, conditioned further intensification of the annual growth of the activity rate.

³³ In 2012, the State Statistical Office for the first time began to conduct a Survey on Job Vacancies as part of the labor market research. The purpose of the Survey is obtaining quarterly information on job vacancies in the enterprises in the Republic of Macedonia as an important indicator of the macroeconomic trends and labor market policies.

³⁴ Source: State Statistical Office, surveys on the business tendencies in manufacturing industry (May 2013), construction (first quarter of 2013) and trade (first quarter of 2013).



Source: State Statistical Office.

The intensified increase in the demand than supply of labour force conditioned downward quarterly correction of the unemployment. Namely, after the stalemate in the preceding quarter, the number of unemployed persons registered a quarterly drop of 2%. The effectuation of the same factors is related to the decrease in the number of unemployed persons also on annual basis (decrease of 4.2%). The annual decrease (of 1.7 p.p.) was registered in the unemployment rate, as well, which reduced to the lowest level of 29.9%.

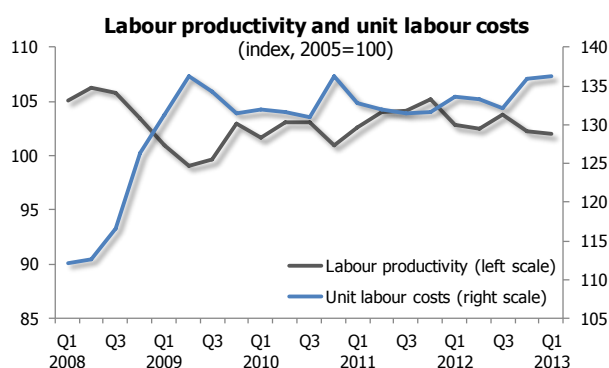
In terms of age groups, the decrease in the unemployment rate on a quarterly basis results from the fall registered in the group of 25 to 49 years of age and the oldest age group (65 years and over). The highest unemployment rate of over 50% and is still among the young population (15 to 24 years of age). Also, this age group registers unemployment increase for two consecutive quarters.

The average wages paid in the first quarter moderately enhanced the annual dynamics. Thus, the nominal net and gross wages recorded annual growth of 1.1%. The upward movement in wages is observed in each of the three main activity sectors. On a quarterly basis, both the net and the gross nominal wages remained almost unchanged. Given the quarterly inflation of 0.5%, the net real wages decreased by 0.4%, which was entirely determined by the downward adjustment of wages in agriculture. **The fall in the real annual wages continued in the first quarter of the current year, but slightly slower.** This change was largely associated with the retarded inflationary pressures. Thus, the average real net wage is lower by 2.3% on an annual basis. The last performance rounds the nine-quarter continuous maintenance of the annual dynamics of the real net wages in the negative zone. At the same time, it is considered that the slow movement of the nominal wages, in conditions of employment growth, results from the employers dealing with uncertain economic environment through the wage channel, not by reducing the number of employees.

The labor productivity continues to decline, although slightly slower on annual basis, while productivity is still below pre-crisis level. The decrease in the productivity of 0.8% reflects the stronger employment growth than the increase in the economic activity. The

Annual changes in average paid net wage by sectors in Q1.2013 (in %)		
	nominal changes	real changes
Agriculture, forestry and fishing	1.8	-1.6
Mining and quarrying	2.4	-1.0
Manufacturing	2.9	-0.5
Electricity supply	0.1	-3.3
Water supply	1.5	-1.9
Construction	6.4	2.8
Trade	1.6	-1.8
Transportation and storage	4.1	0.6
Accommodation and food service activities	2.5	-1.0
Information and communication	0.8	-2.6
Financial and insurance activities	0.0	-3.4
Real estate activities	1.4	-2.0
Scientific activities	-2.3	-5.6
Administrative activities	-2.1	-5.4
Public administration and defence	-0.7	-4.0
Education	-0.2	-3.6
Health and social work	3.7	0.2
Arts, entertainment and recreation	-0.6	-3.9
Other service activities	4.0	0.5

Source: State Statistical Office.



Source: State Statistical Office and NBRM calculations.

productivity, although slower, is reduced also on a quarterly basis for the same reasons as in the annual change. This change is conditioned by the faster growth of employees than the increase in the output. **The annual decrease in productivity, given simultaneous increase in the gross wages, conditioned annual growth in terms of labor costs per product unit (of 1.9%), but slightly lower than in the previous quarter.** Slight deterioration in competitiveness in terms of labor costs has been registered on a quarterly basis, as well, by increasing the labor costs per product unit by 0.3%.

Box 3: Index of skills supply and demand mismatch on the labour market

The skills supply and demand mismatch is one of the largest challenges the labour markets faces, especially after the global crisis which caused increase in the long-term unemployment, as well as lower specific significance of certain sectors. Thus the extensive job losses in individual Euro area countries and especially the concentration of this process in certain activities³⁵, led to larger mismatch between the skills supply and demand on the labour market in this economic region. In order to determine the scope of the problem, the task group of the Monetary Policy Committee within the European central banks system released a report³⁶, which, inter alia, shows the structure of the index of skills supply and demand mismatch for the Euro area countries and the consequences thereof on the unemployment rate. The analysis of the movement of the index indicates strong growth mismatch between supply and demand of skills from the beginning of the crisis. At the same time, the report concludes that the problem is very much caused by structural imbalance between supply and demand of skills rather than a lack of geographical mobility of labor within the Euro area. The report also lists some differences between the member states of the Euro area in terms of the nature and extent of the problem, but the general conclusion states that the mismatch between supply and demand of skills has a significant effect on the unemployment rate.

The issue of mismatch between supply and demand of skills is important and in terms of the structural changes that are taking place in countries, such as the case of the Macedonian economy. Namely, the mounting mismatch between supply and demand of skills would suggest deepening of the structural imbalance on the Macedonian labor market and would signal a lack of market flexibility to adjust to the changes in the economic environment. In order to calculate the index of skills supply and demand mismatch on the Macedonian labour market, methodology enclosed to the Report³⁷ of the European central banks system for calculation of such index for the Euro area countries has been applied. Data of the Labour Force Survey, which is conducted by the State Statistical Office, have also been used, especially those pertaining to the active population, as well as for the number of employed and unemployed persons according to the education³⁸.

³⁵ The job losses in the Euro area are mostly concentrated in industry and construction. The reduction of the number of employees in the construction sector is particularly evident in Estonia, Ireland and Spain, partly reflecting a downward correction in property prices after the registered price boom in the previous period.

³⁶ „Euro Area Labour Markets and the Crisis”, ECB Occasional Paper Series No. 138, October 2012.

³⁷ Ibid.

³⁸ This statistics has been harmonized with the six-degree International Standard Classification of Education (ISCED). For index construction purpose, the six educational levels are divided into three groups: the first group includes people with no education and those with completed and with incomplete

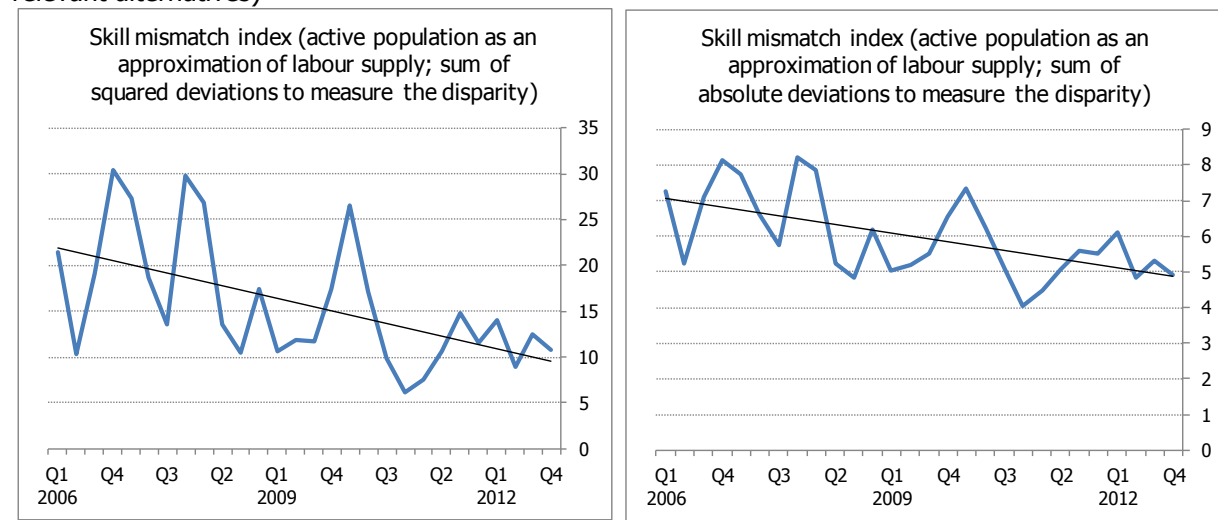
$$SMI_t = \sum_{j=1}^3 (S_{jt} - D_{jt})^2$$

j denotes the three levels of aggregation of the six education degrees; t denotes the period, the quarter the index refers to; D_{jt} is approximate value of the demand for labour and it is calculated as a share of the employees belonging to the education group j in the total number of employees in the period t .

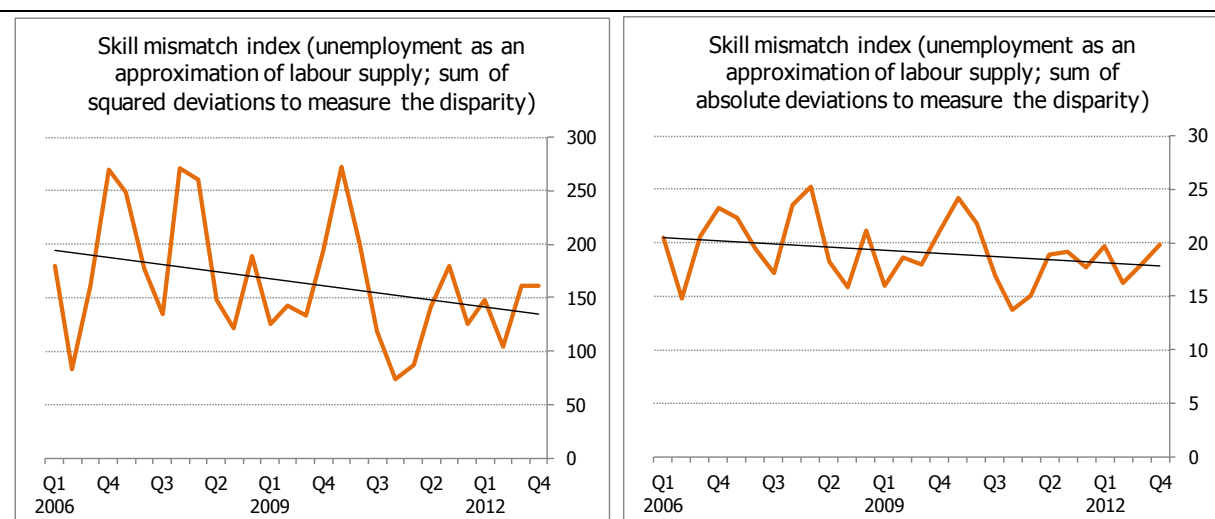
S_{jt} corresponds to the supply of labour and it is calculated as a share of the active population in the education group j in the total active population in period t . In order to check the soundness of the results, several alternative approaches to the calculation of the index based on changes in some of the basic elements in the formula presented above have been applied. **First**, except as the sum of squared deviations, the index can be calculated as a sum of absolute deviations. **Second**, except the active population, the number of unemployed people as part of the labor force that is considered available for work at any time can also be used as a measure for labor supply. Consequently, an index based on the distribution of skills of unemployed persons as an approximate value of the supply of skills on the labor market is created. The calculation of the index is based on data for the education of employed and unemployed persons, which although highly positively associated with the skills, it, however, did not evaluate the adequacy of the supply of relevant profiles, i.e. it fails to depict them absolutely. Hence the results should be interpreted with a certain caution.

Figure 1

Index of mismatch of skills supply and demand mismatch on the labour market (basic approach and relevant alternatives)



primary education and, second group includes those who have completed three and four years of high school, while the third group included persons who have completed tertiary or university education.



All results indicate a continuous lowering of the mismatch of supply and demand of skills in the labor market, with some deterioration in 2009 being registered as a reflection of the global recession. The downward trend suggests enhanced flexibility or improved ability of this market to the changes in the economic environment.

The further analysis in the text are based on the basic formula for calculating the index. Namely, after its creation, it is necessary to check whether it really gives an approximate value of factors related to structural imbalances between supply and demand of skills. If so, the index (SMI_t) should be related positively with other indicative categories of the structural unemployment, such as the trend level of the unemployment rate $U - HP$ ³⁹. Consequently, Table 1 shows the results of simple regression equation where the index mismatch of labor skills is regressed on the aforementioned variable. The coefficient before $U - HP$ is statistically significant and it has the anticipated sign. It verifies that our measure of skills mismatch encompasses factors that are related to the volume of the structural unemployment

Table 1

	Dependant variable
$U - HP$	SMI_t
	0,59*
	(6,86)
Adjusted R-squared	0,21

Note: the specification includes the artificial seasonal variables, which are not reported. t -statistics is given in the brackets. * The coefficient is statistically significant at the significance level of 1%.

The analysis of the Euro area, except the trend level of the unemployment rate in the specification of the equation includes the rate of long-term unemployment. No data on the Republic of Macedonia for long-term unemployment on a quarterly basis are available. However, having in mind

³⁹ The trend level of the unemployment rate is calculated by using the HP filter (Hodrick-Prescott) on the rate of unemployment. Namely, the calculated trend level in such a manner, identifies the equilibrium point where both inflation and unemployment are stable. Specifically, it identifies the rate of unemployment which can be more favorable only if undertake systemic reforms. Therefore, the trend level of the unemployment is considered an indicator of the labour market flexibility.

the high share of the long-term in the total unemployment⁴⁰, we find that also the trend value of the total unemployment is adequately selected variable for our estimations.

In addition, the relationship between the mismatch of supply and demand of skills in the labor market and the unemployment rate is analyzed. Specifically, the quarterly change in the unemployment rate is regressed to the quarterly changes in GDP and the quarterly change in the index of discrepancy. It is a kind of modified Okun's law, which has the following specification:

$$\Delta u_t = a_0 + a_1 \Delta y_t + a_2 \Delta smi_t + \varepsilon_t$$

where u_t presents the unemployment rate; y_t is the real GDP, while smi_t is the index of structural mismatch of the supply and demand of skills on the labour market.

Table 2

	Dependant variable
	Δu_t
$d \log(Y_t)$	- 0,17 (-0,03)
$d \log(SMI_t)$	0,65* (2,68)
Adjusted R-squared	0,44
F-statistics	5,01 (p-value: 0.00)

Note: the specification includes the artificial seasonal variables, which are not reported. t -statistics is given in the brackets. * The coefficient is statistically significant at the significance level of 1%.

The results indicate that after controlling the business cycle, the mismatch between supply and demand of skills on the labor market affect the unemployment positively and statistically significantly. The estimated coefficient of 0.65 indicates that nearly two-thirds of the movements in the mismatch between supply and demand of skills are transferring into changes in the unemployment rate. The coefficient before GDP is statistically insignificant. Even if specify a model which involves transfer of the effects of economic activity on the unemployment rate for a period of four quarters⁴¹, the coefficient that reflects the summary effect of the economic activity on the employment rate is once again statistically insignificant. However, the F - statistics indicates mutual significance and justification for inclusion of selected regressions of the equation.

Accordingly, this shows that on the Macedonian labor market there is certain discrepancy between supply and demand of skills. The assessments show that although some of the mismatch between supply and demand of skills in the labor market are cyclical and will be corrected with the economic recovery, however this discrepancy, to large extent, has a structural character. Observed from the dynamics, the estimations of the index mismatch of skills shows a trend of its decrease. These positive developments are probably a result of the persistent education reforms (especially the compulsory secondary education, as well as the opening the dispersed studies in several cities in RM),

⁴⁰ Over 80% of the unemployed have the status of long-term unemployed (more than one year). In 2011 the rate of long-term unemployment is 25.9%.

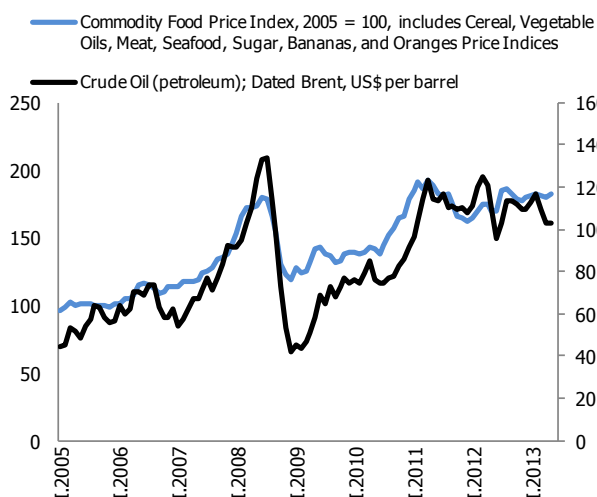
⁴¹In the MAKPAM structural model used for macroeconomic projections and monetary decision-making within the NBRM, it is estimated that the labor market responds to economic activity with a lag of four quarters. Such an assessment is retained also in case of classical specification of the Okun's law, published in Annex 2 "Is Okun's law applied in Macedonia," Quarterly Report of the Central Bank, January 2013.

as well as active employment programs and measures⁴². Hence, the further application of such active measures on the labor market will contribute to more efficient filling of vacancies available, for the creation of which it should be taken care that the relative wages (by sector and occupation) to remain sufficiently flexible to ensure adequate response to supply and demand in the event of a shortage of certain skills.

1.5. Inflation

After the decrease in the first quarter, in the second quarter of 2013, the domestic inflation registered quarterly growth of 0.8% on a seasonally adjusted basis. Most of the increase in inflation in the second quarter was due to the prices of fresh vegetables, which registered unusually high growth for this time of the year. These developments are largely associated with the flood damages that hit the southeastern part of the country in February, destroying the early gardening crops. Having in mind that the domestic agricultural production was affected by the new rough weather in June, as well as the further uncertainty about the dynamics of the world food and energy sources prices, volatility in the inflation because of these factors on the supply side also in the following period is possible. Notwithstanding these changes in the overall inflation, the long-term component of the inflation has shown signs of stabilization in the second quarter. Thus, in the second quarter, compared to the previous quarter on a seasonally adjusted basis the core inflation is higher only by 0.3% on average, compared to the previous four quarters when the growth interval ranged from 0.6 to 1.2%. These developments contributed to a slowdown in the annual growth rate of the core inflation from 3.3 % in the first to 3% in the second quarter. These changes, together with the further slowdown in annual growth in energy prices have neutralized the acceleration in the annual rise in food prices and contributed to maintainance of the total annual inflation on a stable level of 3.6%, on average, in the second quarter (3.5% in the first quarter).

Crude oil and food prices

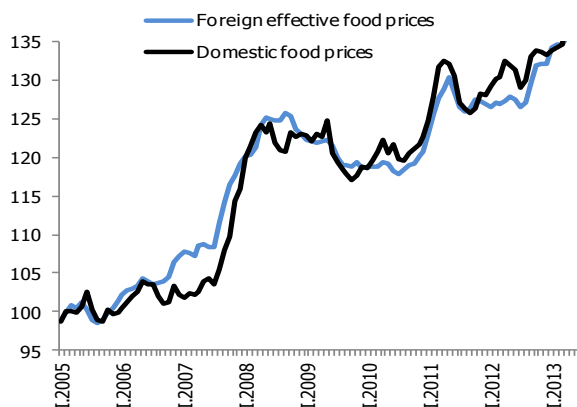


Source: IMF Primary Commodity Prices.

In the second quarter of 2013, the inflation rate recorded quarterly growth of 0.8% on a seasonally adjusted basis. The new increase in the level of consumer prices, after the perceived fall in the previous quarter, can be explained, to large extent, by the impact of the extraordinary factors created pressures for growth in prices of agricultural products with unusually high intensity for this period of the year. In fact, in

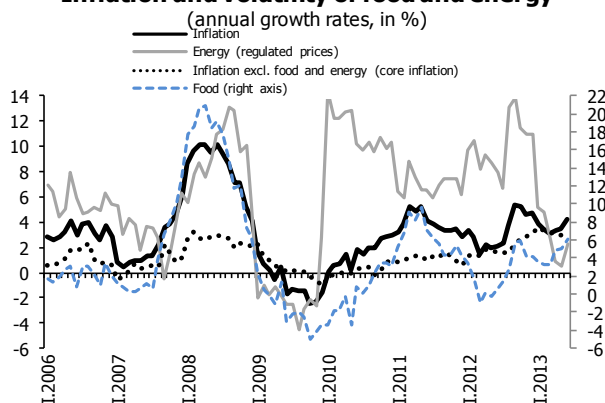
⁴² The employment strategies and policies of the Government of the Republic of Macedonia and the planned active measures for employment and mitigation of the unemployment is defined in several documents: the Program of the Government 2011-2015, the National Employment Strategy of the Republic of Macedonia 2015, the National Employment Action Plan of the Republic of Macedonia 2011 - 2013, the Action plan on Youth Employment 2015, National Strategy for Combating Poverty and Social Exclusion in the Republic of Macedonia 2010-2015, National Domestic Violence Protection Strategy 2008-2012, Demographic Development Strategy of the Republic of Macedonia 2008-2015, National Action Plan for Gender Equality 2007-2012, the Progress Report for the Republic of Macedonia, several-year Operational Programme for Human Resources Development 2007-2013, prepared under Component 4 of the Instrument the EU pre-accession assistance (IPA) and the Global Jobs Pact.

Foreign effective food prices* and domestic food prices



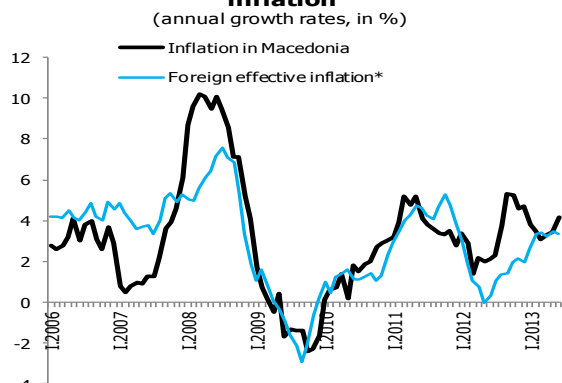
* Foreign effective food prices are calculated as weighted sum of food prices in countries that are major trade partners with Macedonia.
Source: State statistical office, Eurostat and NBRM calculations.

Inflation and volatility of food and energy



Source: State statistical office and NBRM calculations.

Domestic inflation and foreign effective inflation



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

February, the Strumica region, which is one of the most important agricultural regions in the country, was hit by extensive flooding that caused significant damage to agricultural land planted with early gardening and agricultural crops⁴³. In conditions of negative effects of the flooding on the yield of early vegetable production, the prices of fresh vegetables in the second quarter increased by 28.1%, seasonally adjusted, quarterly, thus becoming the biggest factor for the increase in the overall inflation. Because of such movements in the prices of fresh vegetables, the food component contributed again to the increase in the inflation rate (quarterly growth in food prices of 2.2% on a seasonally adjusted basis), following the perceived fall in these prices in the first quarter. On the other hand, the energy component, for the second consecutive quarter, contributes to a reduction in the inflation rate, given the decrease in energy prices of 1.5% on a seasonally adjusted basis. These movements correspond to the fall in the crude oil price on the world stock exchanges during the second quarter, as a combined effect of expectations for lower demand for the next period compared to the previous estimations and seasonal influence, in terms of increased production of major production facilities in U.S.⁴⁴. Downward trend was also registered in the world prices of primary food products, while the increase in the foreign effective food prices decelerated on a quarterly basis. The food prices dynamics is uncertain also in the following period, which creates an opportunity for fluctuations in domestic inflation, as a transmission effect of the changes in the import prices.

The seasonally unadjusted data indicate quarterly growth in consumer prices of 1.4%. This increase in consumer prices resulted mainly from the increase in the prices of fresh vegetables, suggesting that the seasonal influences have inflationary effect in the second quarter.

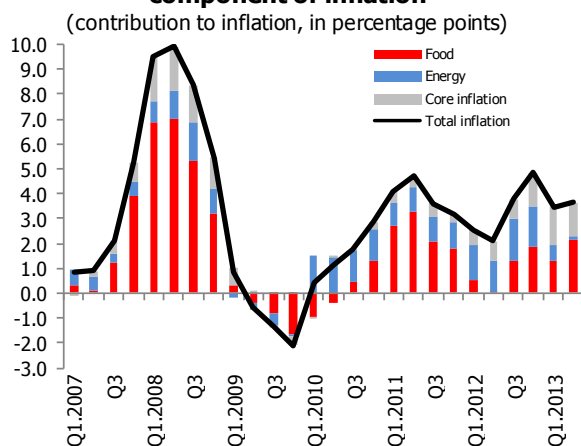
The annual inflation rate in the second quarter was 3.6%, on average, which is almost at the level of the previous quarter (3.5% on average). The growth intensification in food prices, mainly driven by higher prices of fresh vegetables was the main

⁴³ According to estimates by the Commission for evaluation and determining the damage amount caused by natural disasters and other accidents in the municipality of Strumica, in the floods that hit the Strumica region in the period of February 26, 27 and 28, 2013 damage on early vegetable production and autumn crops on an area of over 1,500 acres was inflicted.

⁴⁴ ECB Monthly Bulletin, June 2013.



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



Source: State statistical office and NBRM calculations.

reason for the termination of the slowdown tendency of the annual inflation rate, which was present in the first quarter. On the other hand, the prices of oil derivatives for the first time since 2009, acted deflationary on annual basis, which in absence of changes in the regulated prices (electricity and heating), contributed to the reduction of the positive contribution of the energy component to overall inflation. The core inflation contributed less to the growth, which is a change in the trends in the past five quarters, when the core inflation mainly registered larger contribution to the overall inflation rate. The foreign effective inflation accelerated moderately on annual basis, reaching 3.4% on average in the second quarter of 2013, compared to 3.1 % in the first quarter of 2013.

During the second quarter, signs of stabilization of the long-term inflation component were registered, after nearly constant annual acceleration in the past five quarters. Thus, the annual rate of core inflation (excluding food price component and energy) slowed down from 3.3 % in the first to 3% in the second quarter. The slower growth of core inflation was mostly explained by changes in the prices of clothing and footwear, which registered annual deceleration and therefore had reduced contribution to the core inflation. These developments suggest that the acceleration of core inflation was partly caused by one-off factors, the effect of which gradually exhausts. The growth slowdown was registered in the prices of hygiene and health, while prices of services in the catering sector remained stable. However, the core inflation remains relatively high, and in addition to the effect of one-off factors, indicates certain transmission effects of the increase in the food and energy prices on the other prices in the economy.

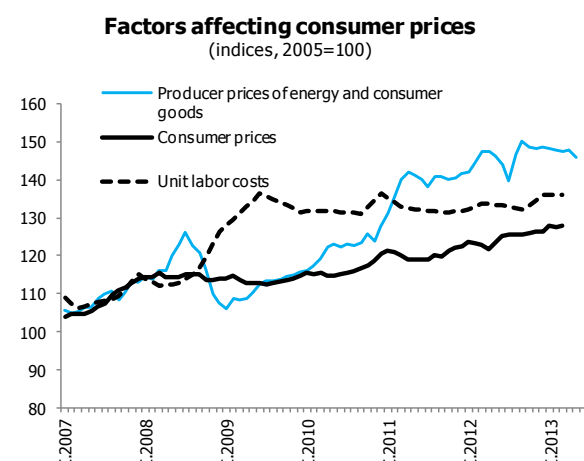
Individual price categories

	(annual growth rates, in %)												(contributions to annual growth rates, in p.p.)											
	2011				2011	2012				2012	2013				2011	2012				2012	2013			
	Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4
Consumer price index - all items	4.1	4.7	3.6	3.2	3.9	2.5	2.1	3.8	4.9	3.3	3.5	3.6	4.1	4.7	3.6	3.2	3.9	2.5	2.1	3.8	4.9	3.3	3.5	3.6
Food	7.1	8.4	5.4	4.7	6.4	1.4	0.2	3.4	4.7	2.4	3.3	5.4	2.7	3.2	2.0	1.8	2.4	0.6	0.1	1.3	1.9	1.0	1.3	2.1
Fresh food	4.6	6.7	1.7	2.9	4.0	0.7	-0.4	6.2	7.4	3.5	4.8	9.4	0.8	1.2	0.3	0.5	0.7	0.1	-0.1	1.1	1.3	0.6	0.9	1.7
Processed food	8.5	9.9	8.4	6.2	8.3	2.0	0.6	1.1	2.6	1.6	2.1	1.8	1.7	2.0	1.8	1.3	1.7	0.4	0.1	0.2	0.6	0.3	0.4	0.4
Energy	7.1	6.9	7.0	7.2	7.1	9.4	8.7	11.2	11.1	10.1	4.2	1.2	0.9	0.9	0.9	1.0	0.9	1.4	1.2	1.6	1.6	1.5	0.6	0.2
Fuels and lubricants	18.4	10.9	12.2	12.4	13.5	7.9	10.5	8.0	5.1	7.9	0.2	-6.7	0.6	0.4	0.4	0.5	0.5	0.4	0.5	0.4	0.2	0.4	0.0	-0.3
Electrical power	1.8	5.4	5.4	5.4	4.5	11.5	7.7	14.9	18.4	13.1	9.9	9.9	0.1	0.4	0.4	0.4	0.3	0.8	0.5	1.0	1.3	0.9	0.7	0.7
Heating power	6.3	5.7	4.2	4.9	5.3	7.6	7.7	7.7	4.0	6.7	-2.8	-6.3	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.1	0.2	-0.1	-0.2
Food and energy (volatile prices)	7.1	8.0	5.8	5.4	6.6	3.5	2.4	5.5	6.5	4.5	3.6	4.2	3.6	4.1	3.0	2.7	3.4	1.9	1.3	3.0	3.5	2.4	2.0	2.3
Core inflation (inflation excl. food and energy)	1.0	1.2	1.1	0.7	1.0	1.4	1.8	1.8	2.9	2.0	3.3	3.0	0.5	0.6	0.6	0.5	0.5	0.6	0.8	0.8	1.3	0.9	1.5	1.3

Source: State Statistical Office and NBRM calculations.

The prices of the producers of industrial products are getting lower also in the second quarter⁴⁵. The quarterly fall in these

⁴⁵ The data refer to the first two months of the analyzed quarter.



Source: State statistical office and NBRM calculations.

prices equals 0.6% (2.1% on a seasonally adjusted basis), with the largest individual contribution to the decrease accounting to the production price of the refined oil derivatives. On an annual basis, the prices of the producers of industrial products increased by 1%, which is further deceleration in the annual growth. The largest contribution to the annual growth accounts for the metal prices, followed by the prices of the food products, while the prices of the producers of the oil derivatives recorded a negative contribution to the annual growth. **The movement of the production prices that include the domestic inflation component⁴⁶ indicate lessening of the inflationary pressures in the forthcoming period.** Namely, given the quarterly decrease of 2.6% on a seasonally adjusted basis, on annual basis, these prices slowed down from 2.3% in the previous to 0.7% in the current quarter. In the first quarter of 2013, **unit labor costs** registered an annual increase of 1.9%, which if compare with the previous quarter, is a deceleration of the annual increase. At the same time, their increase slowed down also on a quarterly basis. Having in mind the endurance of the negative output gap, as it is so far, no inflationary pressures through this channel are expected.

Box 4: Inflation expectations of the economic agents in the Republic of Macedonia

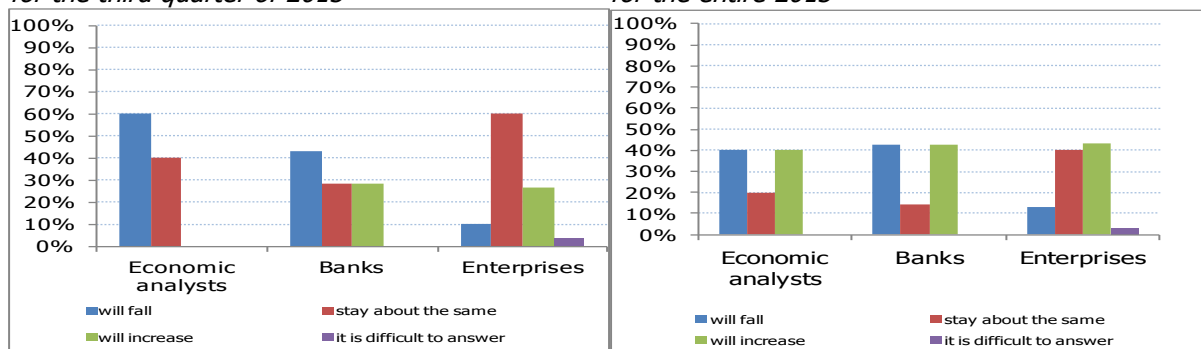
The most common expectations in the **Inflation Expectations Survey conducted in July 2013⁴⁷**, are those for the unchanged inflation (52.4% of the respondents), while smaller part expects higher inflation (23.8%), i.e. its decrease (21.4%)⁴⁸. From the aspect of the individual groups of respondents, the largest share (60.0%) of the surveyed **economic analysts** expects lower inflation, unlike the others, who expect stable inflation. With similar expectations are the surveyed **banks**, where the expectations for lower inflation prevail (42.9%), while the expectations for stable and higher inflation with the other are equally divided. Regarding the **enterprises**, the most frequent are the expectations for stable inflation (60.0%), expectations for higher inflation have 26.7% of the surveyed enterprises, while 10.0% expect lower inflation.

⁴⁶ Consumer goods (durable and nondurable) and energy.

⁴⁷ The responsiveness of the survey was 57.5%. Looking at the groups surveyed, the responsiveness with the banks equals 100%, followed by enterprises with 56.6% and the economic analysts with 38.5%.

⁴⁸ The remaining percentage to 100%, in the whole text, refers to respondents who chose the option "difficult to determine".

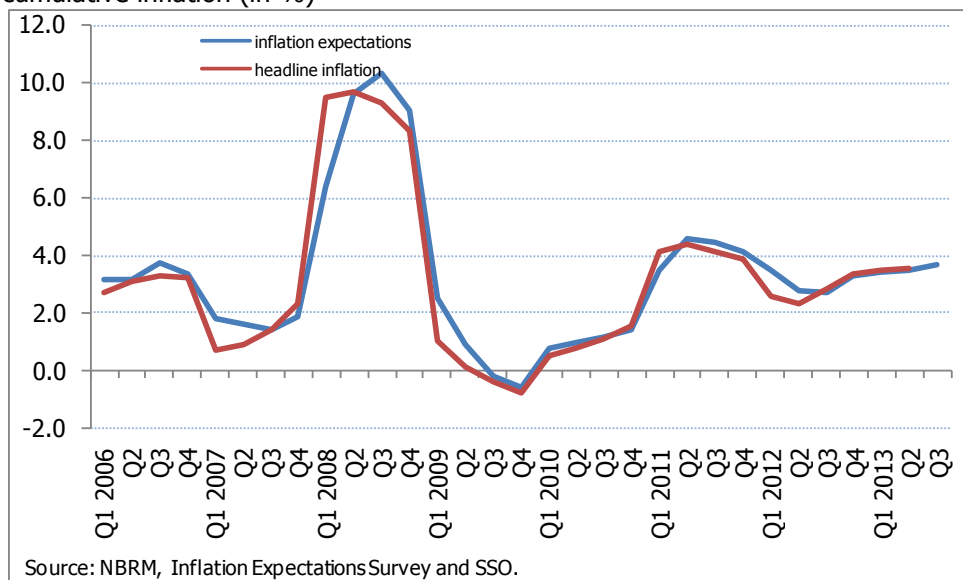
Distribution of the responds about the expectations on the inflation by groups of respondents
for the third quarter of 2013



Source: NBRM, Inflation Expectations Survey.

Regarding the entire 2013 respondents, responses for higher inflation prevails. In fact, 42.9% of respondents expect higher inflation than the average registered in the first half of 2013, 33.3% expect retained inflation rate by the end of the year, while 21.4% expect lower inflation. Among the surveyed **economic analysts**, the expectations for higher and lower inflation rate are evenly divided (by 40.0%), while the rest (20.0%) expect stable inflation. A similar division is evidenced among the surveyed **banks**, where the expectations are equally divided (42.9 %) between the lower and higher inflation, while 14.3% expect that the rate of inflation in the first half of the year will be retained until the end of the year. Among the **surveyed enterprises**, the most common expectations are those for higher inflation rate than in the first half of the year (43.3%), slightly lower percentage of respondents expect stable inflation (40.0%), while a small proportion (13.3%) expect a decrease. *The average expected inflation rate in 2013 based on the responses of economic agents is 3.7%, which is minimal upward movement of the expectations (0.2 percentage points) compared to the previous survey conducted in April this year .*

Expectations for the average inflation rate for the entire year and realized average cumulative inflation (in %)



Source: NBRM, Inflation Expectations Survey and SSO.

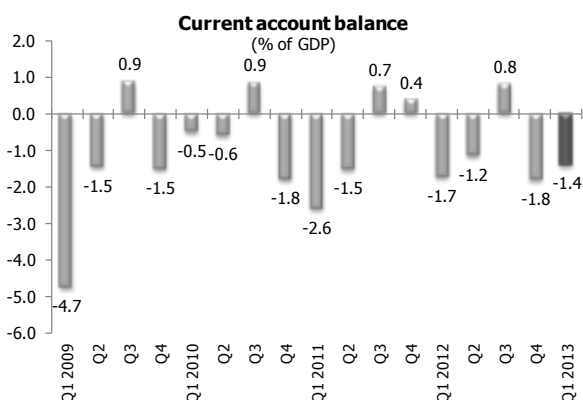
Source: NBRM, Inflation Expectations Survey and SSO.

As the main factor that contributed towards creation of inflation expectations of the economic agents, transmission effect of higher world energy and food prices on the domestic prices, given higher excise taxes on tobacco and alcohol is indicated. On the other hand, the respondents point to expectations of downward pressures on the domestic consumer prices by the lower electricity price and reduced public spending than realized in the first half of 2013.

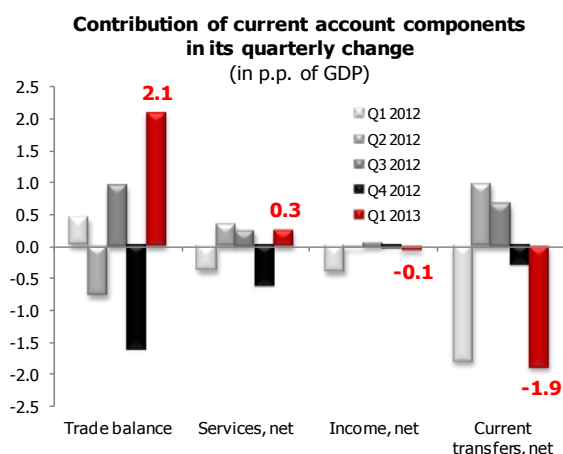
1.6. Balance of payments

During the first quarter of the year, in line with the usual seasonal dynamics, the balance of payments' current account recorded a deficit. There was also an improvement in the balance compared to the previous quarter, which is atypical and stems from the narrowed balance in the trade of goods and services. Namely, the significant downward movement in the imports, particularly evident in the import of energy sources, caused narrowing of the trade deficit and accordingly, contributed to the reduction of the current account deficit in the previous quarter. A smaller current account deficit was registered on an annual basis, also as a result of improved performances in the trade of goods and services. The movements in the balance of payments in the first quarter were characterized by high net inflows in the capital and financial account, mainly caused by the external borrowing. After the payment of the Eurobond which fell due in January, the state withdrew a large amount of funds from two separate credits aimed at budget support and enhancement of the competitiveness of the economy. The foreign direct investments contributed additionally to increase in the capital inflows, while regarding the trade loans, after the high growth in the last quarter of 2012, in the first quarter of the current year there were net repayments of accrued liabilities. The movements in current and capital and financial account provided further accumulation of foreign reserves and their further maintenance of an adequate level.

1.6.1. Current account



Source: NBRM.



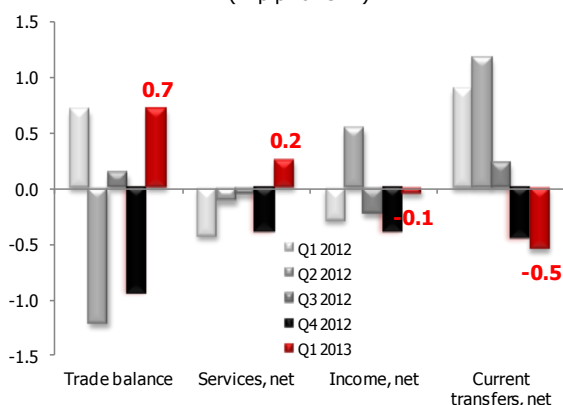
Source: NBRM.

In the first quarter of the year, the current account recorded a deficit of Euro 109.1 million, or 1.4% of GDP. From the aspect of the usual seasonal dynamics, the positive change is atypical, compared to the previous quarter, i.e. the realized deficit is lower by 0.4 p.p. of GDP, which is due to significantly lower trade deficit in the trade of goods and services in conditions of lower net inflows with the current transfers. The trade balance is again the most important driver of the change with the current account, contributing with significant 2.1 p.p. of the GDP to the deficit contraction. The faster decrease in the imports compared to exports caused significant quarterly decrease in the deficit in the trade of goods, in conditions of lower energy and non-energy deficit⁴⁹. The balance of services contributed positively to the reduction of the quarterly current account deficit, where in the first quarter net inflows contrary to outflows in the last quarter of 2012 were registered. These movements are the result of lower outflows in other services, particularly in the category of "other business services", as well as the significantly smaller outflows in construction

⁴⁹ More details are provided in the part pertaining to the foreign trade.



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



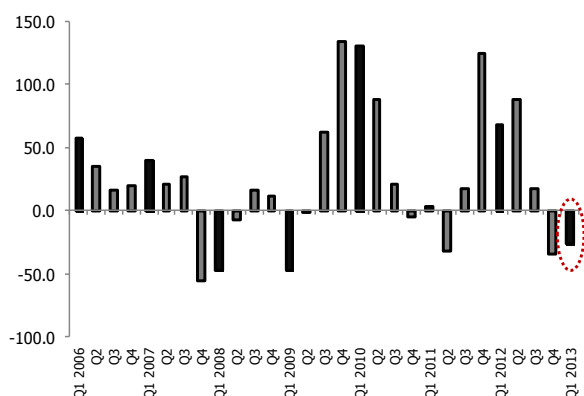
Source: NBRM.

services⁵⁰. The current transfers contributed to the deepening of the current account deficit. The decrease in net inflows compared to the previous quarter is mostly due to private transfers, although the smaller number of official transfers had also a certain influence.⁵¹ Such quarterly change is not surprising, because of the seasonal dynamics of the private transfers, i.e. the cash private transfers estimated through net foreign assets purchased on the exchange market, which as the most important item in current transfers, usually have the ineffectual performance in the first quarter of the year.

The annual change in the current account shows a slight narrowing of the deficit of 0.3 p.p. of GDP.

The factors affecting the annual change correspond to the quarterly factors of change. As in the quarterly analysis, the narrowing of the trade balance (by 0.7 p.p. of GDP) is the most important factor for the annual decrease in current account deficit, caused by the significant annual change in energy balance. The annual changes in the services balance were largely caused by the reduced use of foreign services, and given the unchanged export in flows have led to a surplus in trade of services, despite the perceived deficit in the first quarter of 2012. The lower outflows with the services are due to the changes in the transport⁵² and other services. The negative annual change in current transfers is caused by the lower private transfers in cash, perceived through the net purchase of cash on the currency exchange market. The decrease was heavily influenced by the high base effect, when the instability in the Euro area and the increased risk for the future of the common currency increased the demand for domestic currency, leading to higher supply of Euros on the currency exchange market, given the simultaneous decrease in the demand. According to the analysis of the annual changes on the currency exchange market by currency, stabilization of the expectations for the joint currency of the Euro area is perceived. Namely, in comparison with the first quarter of the

Current transfers
(annual change, million of Euros)



Source: NBRM.

⁵⁰ In the last quarter of 2012, outflow based on construction services provided in the country by non-residents was registered. The funds were intended for the Corridor X project, and they were provided in form of official transfers through IPA - III component.

⁵¹ In December 2012, high inflow with the official transfers based on assets of IPA -III component, was registered.

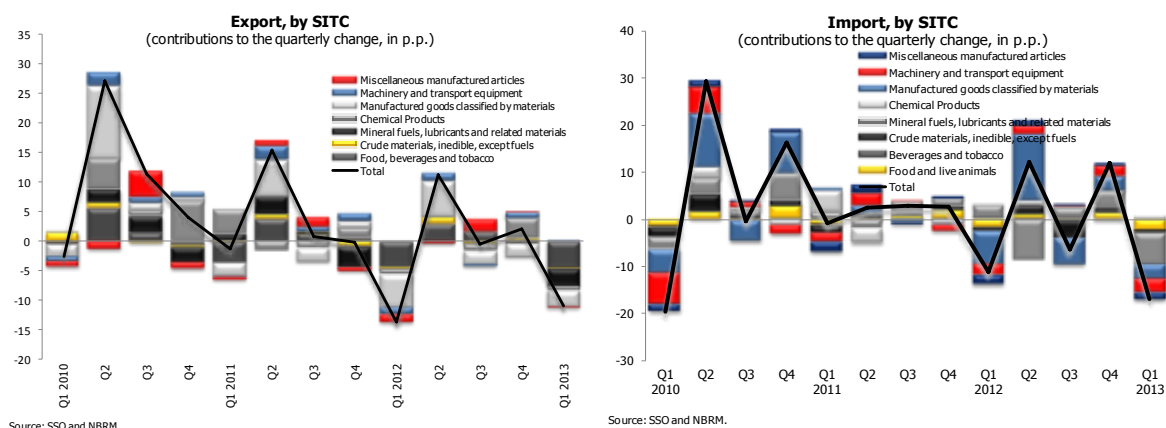
⁵² The reduced import of transport services is due to lower utilization of pipeline transport services and transportation, which corresponds to the lower volumes of imported crude oil (annual fall of 60.5%). Namely, the crude oil is transported through the pipeline, and thus recorded in the balance of services as part of transport services.

previous year, increased demand for Euros was registered, given the simultaneous reduction in the supply of this currency. Regarding the income, slight increase in the net outflows on annual basis was registered, which is solely due to lower fees on domestic citizens temporarily working abroad, and the constant flows with investment income.

According to recent data, the balance of payments' current account in April recorded a deficit again in the amount of Euro 57.4 million. This deficit is smaller than the deficit registered in the same month last year, and this improvement is due to lower deficit in the trade balance, caused by better export performance. On the other hand, the current transfers, caused by the changes in the private transfers in cash and services, contributed to the widening of the deficit on annual basis.

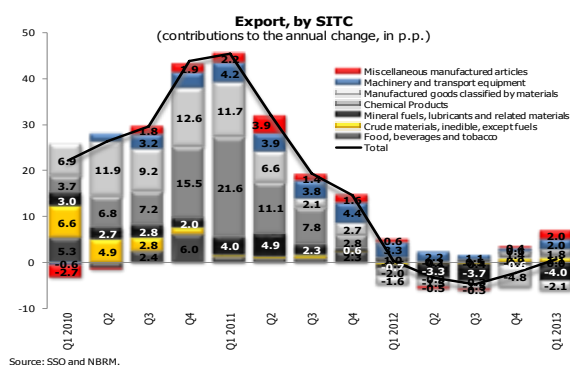
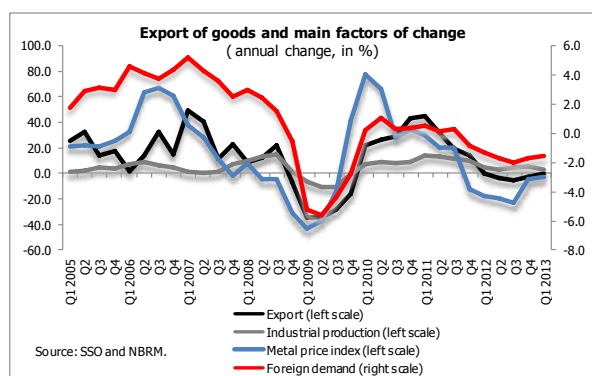
Box 5: Foreign trade of goods and movement of the nominal and real effective exchange rate (NEER and REER)

In the first three months of 2013, **foreign trade declined on a quarterly basis, amid a decline in both its components, which is a movement typical for this time of the year.** The sharper decline in the imports of goods (of 16.9%), compared to the quarterly decline in the exports of goods (of 11%) reflected in the **narrowing of the negative trade balance by 25.4%.** In terms of individual balances, lower non-energy balance and decreased energy deficit almost equally contributed to the quarterly improvement in the trade deficit. Underlying factors of the positive change in the non-energy deficit are the lower investment imports reflected through the reduced imports of equipment and machinery, the fall in the imports for the textile industry and the growing surplus in the category "miscellaneous final consumption products" (higher surplus in clothing). Moreover, it is important to mention that such movements in all the above categories are seasonal trends common for the first quarter of the year. On the other hand, the lower energy balance, which is almost entirely related to the lower deficit in oil and oil derivatives, reflects the significantly lower quantity of imports of crude oil and petroleum products, given the fall in import prices. This atypical movement in the energy balance, i.e. fall in the import of crude oil, derives from the reduced volume of operations of the domestic refinery, and thus the reduced export activity during the first three months.

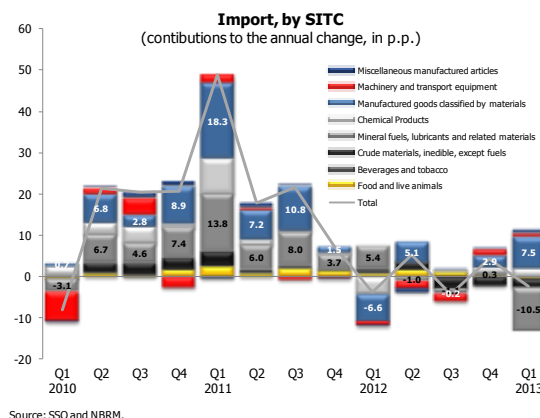
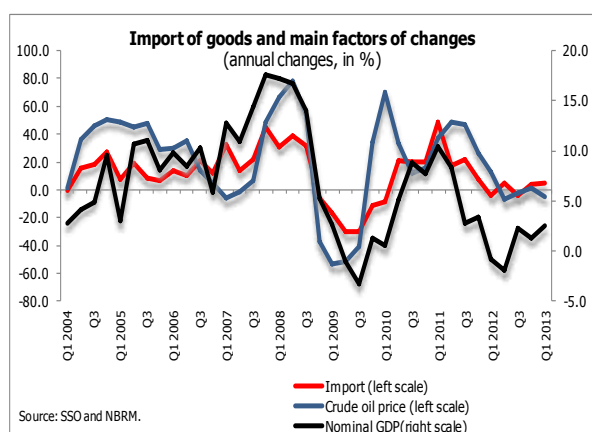


The annual analysis also indicates a decline in the total foreign trade, which in conditions of slow growth in exports fully reflects the annual decline in the imports of goods. After three consecutive quarters, **in the first quarter of the year, export of goods entered the zone of**

positive growth rates, i.e. it registered a minimum increase of 0.6%. These positive developments mainly reflect the increased activity of the new foreign export capacities and the still relatively good economic performance of one of our major export partners - Germany. Hence, the largest contribution to the growth of exports is that of the increased export of equipment and machinery, export of miscellaneous finished products (mainly clothing and footwear) and the growth in the export of chemical products (by 21.1%, 9.7% and 9.7%, respectively). On the other hand, a significant reduction in the exports was observed in some of our traditional export products with high share in the export structure. Thus, beside the decline in the export of petroleum products of 55.4%, a significant decline was registered also in the export of iron and steel of 14.4%. The continued trend of decline in nickel prices on the international markets (at a slower pace), and the slower activity of one larger metal processing plant, partly contributed to this dynamics of exports.



On an annual basis, in the first quarter of 2013, imports of goods decreased by 2.4%. The annual decline in imports is primarily due to the lower energy imports (oil and oil derivatives and electricity by 41.7% and 43.2%, respectively), followed by the reduced import of raw materials, in particular metal ore and metal scrap, by 44.3%. The decline in the imports of oil and oil derivatives results from the sharp decline in the imported quantities of crude oil and oil derivatives, amid simultaneous low price of crude oil on world markets. Conversely, increased import was registered in the raw materials for one larger plant in the free economic zone (increased import of non-ferrous metals and import of non-organic chemical products, by 89.6% and 50.8%, respectively) and in iron and steel (by 38.3%). The discrepancy between the decline in the exports and rise in the imports of iron and steel could be interpreted as preparation of metal processing facilities for future exports (making inventories), in conditions of lower metal prices on world markets. Such movements in the foreign trade components **caused a narrowing of the trade deficit in the first quarter of the year by 7.2% on an annual basis.** The analysis of individual balances shows that the annual improvement in the trade deficit fully reflects the narrowed energy balance, in conditions of further expansion in the non-energy balance. The change in the energy balance is due to the narrowing of deficits in almost all types of energy products, with the largest contribution of oil and oil derivatives, while the negative change in the non-energy balance is mainly caused by the increased deficit in non-ferrous metals and the lower surplus in iron and steel.

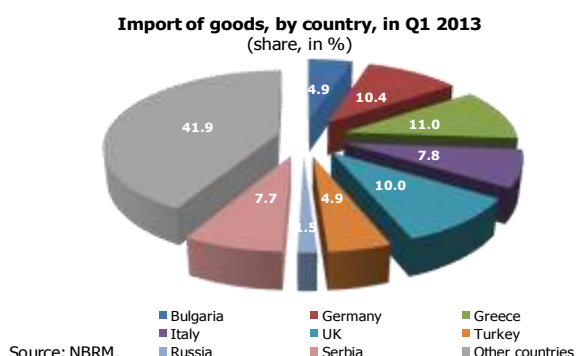
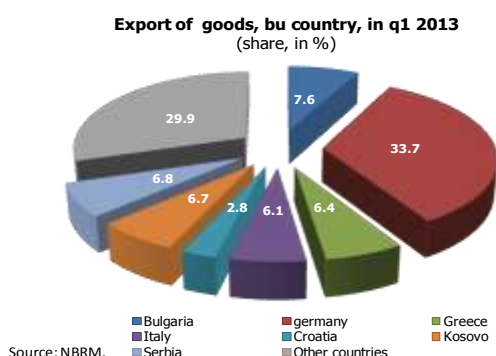


The latest available data show that the favorable movements in foreign trade continued **in the period April-May 2013**. The trade deficit was further reduced, by 8.3% on an annual basis, as a result of the growth in the exports of goods, given the fall in the imports of goods. The annual growth in the exports of goods (of 2.5%) is due to the increased exports of machinery and equipment, chemical products and materials, and to a lesser extent to the increased exports of food, beverages and tobacco. The decline in the imports of goods (by 2.2%) is a result of the lower imports of raw materials for one larger plant in the free economic zone, the reduced imports of metal ores and scrap and the fall of energy imports.

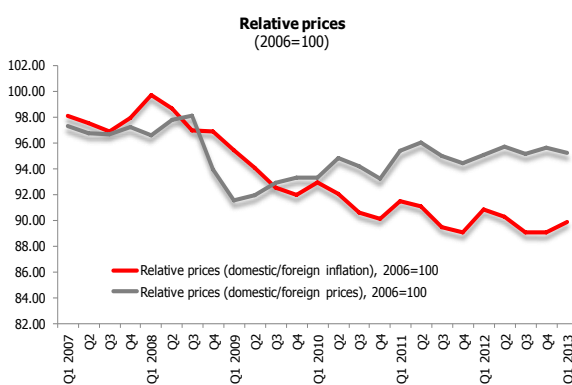
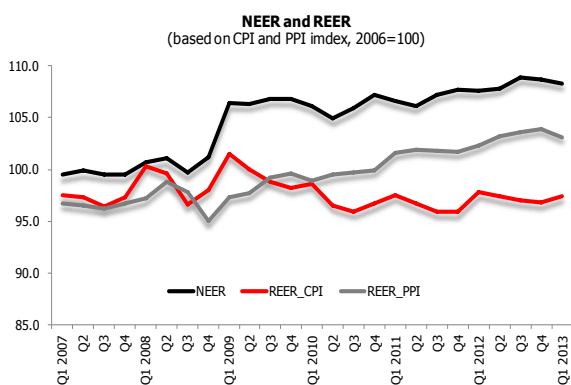
The analysis of foreign trade by countries⁵³ in the first quarter of 2013, shows no change in the structure of trade by country, i.e. the European Union (EU) remains our major trading partner (accounting for 62.6% of total trade). In terms of dynamics, the annual narrowing of the trade deficit is mainly a result of the reduced trade deficit with Russia (mainly due to reduced imports of crude oil), followed by the lower deficit in the trade with the EU and in the trade with the Association of Southeast Asian Countries. The improvement in the balance with the EU is due to the narrowed trade deficit with Greece (drop in the imports of mineral fuels), the increased surplus with Germany (increased export from the plants in the free industrial zone and iron and steel) and the annual decline in the deficit with Bulgaria (increased export of ores, amid a simultaneous reduction in

⁵³ As of the first quarter of 2013, SSO started to apply a classification of the foreign trade by economic groups of countries, in accordance with the Geonomenklature of countries by the EUROSTAT. The classification includes the following economic groups of countries: African, Caribbean and Pacific countries; Association of the Countries of Southeast Asia, the European Union, the European Free Trade Association, the South American Common Market; the South Asian Association for Regional Cooperation; the Mediterranean Union, the New industrialized Asian Countries; The Organization of Petroleum Exporting Countries (OPEC), the Organization for Economic Cooperation of the Countries of the Asian-Pacific Region; the Organization for Economic Development and Cooperation, the North American Free Trade Area (NAFTA), the Commonwealth of Independent States, the Western Balkans and the countries not mentioned elsewhere.

the imports of iron and steel and mineral fuels). The lower trade deficit with the countries from Southeast Asia is mainly due to the decline in the annual import of ore from Indonesia.



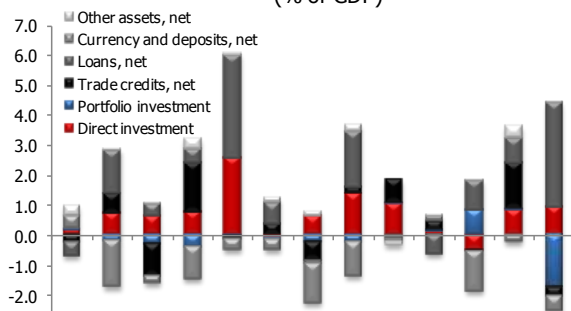
In the first quarter of 2013, the movement of the price competitiveness indicators again give different directions of changes in the competitiveness of the domestic economy. Thus, the REER index, calculated according to consumer prices, appreciated by 0.6% on a quarterly basis, after the depreciation it registered in the previous three quarters. This change, in conditions of depreciated NEER (by 0.3%), is due solely to the increase in relative prices, i.e. higher growth of domestic relative to foreign inflation. In the first quarter, the REER index, deflated by the prices of the producers of industrial products, registered a quarterly depreciation of 0.7%, after the quarterly appreciation observed throughout 2012. In this direction are both integral components, i.e. depreciated NEER and fall in relative prices (of 0.4%), i.e. lower domestic prices of industrial products relative to foreign. The quarterly change in NEER is mostly due to the depreciation of the Denar against the Serbian Dinar. The latest data on the price competitiveness indicators for the period April-May 2013, point to continuation of the trends from the previous quarter. Namely, in the period April - May, REER, deflated by consumer prices, slightly appreciated by 0.01 percentage points, compared with the first quarter of 2013, due to higher relative prices, i.e. higher domestic relative to foreign inflation, despite the further depreciation of the NEER. On the other hand, the REER index calculated according to the prices of the producers of industrial products, continued to depreciate, by 0.3 percentage points in the analyzed period, as a result of the depreciated NEER (by 0.4 percentage point), in conditions of higher relative prices.



1.6.2. Capital and financial account

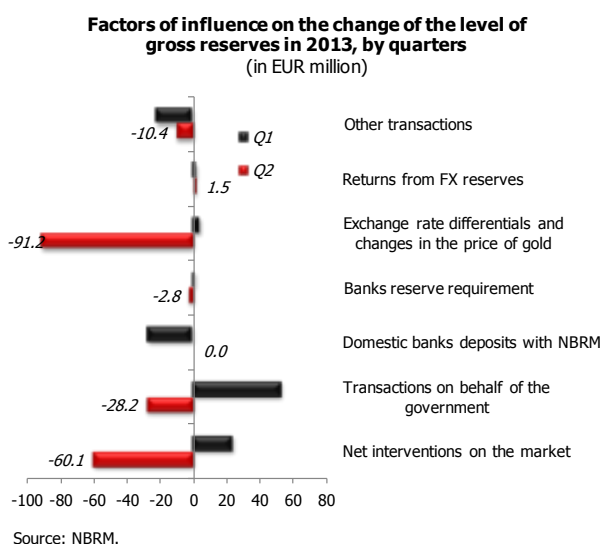
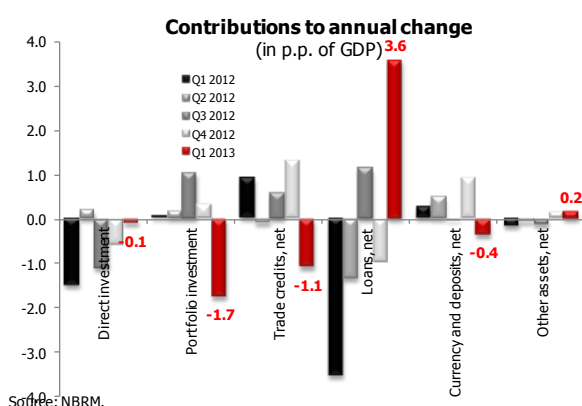
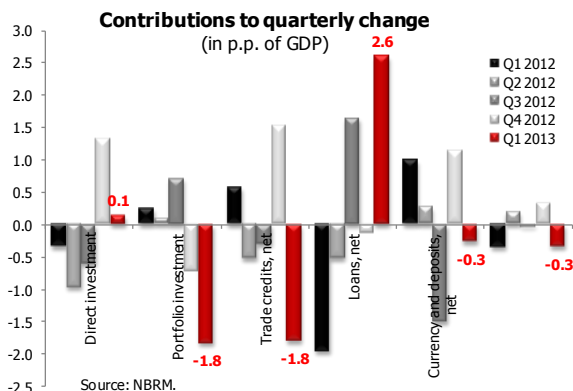
During the first quarter, substantial net inflows of Euro 158.1 million, or 2% of GDP were generated in the capital and financial account. The inflows were sufficient to finance the current account deficit, and provided further accumulation of foreign reserves. The

Financial account, by components
(% of GDP)



analysis of the movements in individual categories suggests that during the first quarter of the year, most of the inflows were generated from debt instruments, i.e. they were in the form of loans from abroad, while the contribution of net inflows of foreign direct investment was more modest. On the other hand, outflow of funds was registered in portfolio investments and currency and deposits, on net basis, caused by changes in currency and deposits of households. Also, after the fast growth of trade credits in the fourth quarter of 2012, in this quarter part of previously accumulated liabilities were repaid. The analysis of capital flows by sector in the first quarter, indicates that the government was the most important factor for the movements in the capital and financial account. Namely, in January the government borrowed from foreign creditors, mostly through withdrawals of the loan with the Deutsche Bank, using a guarantee from the World Bank, and from the loan with the World Bank intended for development policies and fostering competitiveness⁵⁴. At the same time, in January, there was an outflow of funds for payment of the Eurobond issued in 2009, whereby the government paid out the nominal amount of the bond of Euro 175 million. However, at the time of maturity, a certain portion of the Eurobond was owned by domestic investors, mostly domestic pension funds, so the outflow of funds stood at Euro 131.7 million. On net basis, the government registered capital inflows in the amount of Euro 141.7 million, or 1.9% of GDP. On the other hand, long-term external debt of the private sector in the first quarter was significantly lower, achieving net inflows of only Euro 7.4 million. Foreign direct investments were a result of the reinvested earnings and debt incurred with the parent companies in the form of intercompany

⁵⁴ According to the Law on Borrowing a Loan by the Republic of Macedonia at Deutsche Bank under Loan Agreement secured by policy-based guarantee by the International Bank for Reconstruction and Development – World Bank ("Official Gazette of RM" no. 171 of 28.12.2012), the loan is in the amount of Euro 250 million, while the borrowing from the World Bank is in the amount of Euro 38.7 million (Law on Borrowing a Loan by the Republic of Macedonia at Deutsche Bank under Loan Agreement secured by policy-based guarantee by the International Bank for Reconstruction and Development – World Bank under the Loan Agreement for the First Programmatic Competitiveness Development Policy Operation "Official Gazette of RM" no. 171 of 28.12.2012).



loans, with modest investments in the most enduring form - equity.

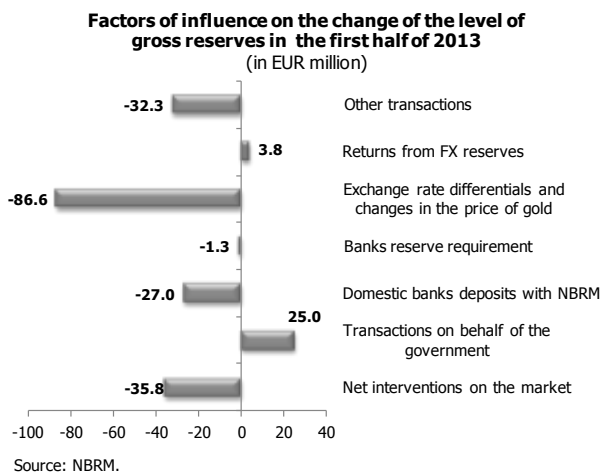
In the first quarter of the year, there were lower capital inflows relative to the previous quarter, whereas compared to the same period last year, an improvement was registered in the capital and financial account. The quarterly change indicates deterioration in the capital and financial account by 1.5% of GDP as a result of the higher outflows in portfolio investments, due to the payment of the Eurobond in January, reduced trade credits, which after the fast growth in the fourth quarter of 2012 began to decline in the analyzed period, as well as the increased outflows in currency and deposits. Compared to the previous quarter, significant increment in lending is registered, due to the increased external funding of the government, despite the lower net borrowing of the private sector. The annual analysis of the movements in the capital and financial account indicates higher realized capital flows in the first quarter of 2012, by 0.4% of GDP. The increase is due solely to the significantly higher inflows from long-term loans, i.e. increased indebtedness of the government and of the private sector⁵⁵. Other categories deteriorated on annual basis, which was most pronounced in portfolio investment, which is again due to the payment of the Eurobond and the negative trends in trade credits. Changes in currency and deposits are caused by both sectors, i.e. the neutral position of the banks, as opposed to the withdrawals of deposits from foreign banks in the domestic economy recorded in the first quarter of 2012 and increased outflows of households. Lower foreign direct investments are due to lower investments in the form of equity. In the first quarter of 2012, there were high inflows of FDI in this category, due to the funds intended for recapitalization of a foreign-owned bank.

According to the latest data on the movements in the balance of payments, in April, capital net inflows of Euro 3.4 million were realized. Larger inflows were registered in the category "loans", which are due to short-term external indebtedness of the banking sector. The increase in short-term loans with one foreign-owned domestic bank is a result of the withdrawal of funds from a credit line from the parent bank in order to provide foreign currency liquidity in support of the payment of the annual dividend to a

⁵⁵ In the first quarter of 2012, the long-term net debt of the private sector was negative.

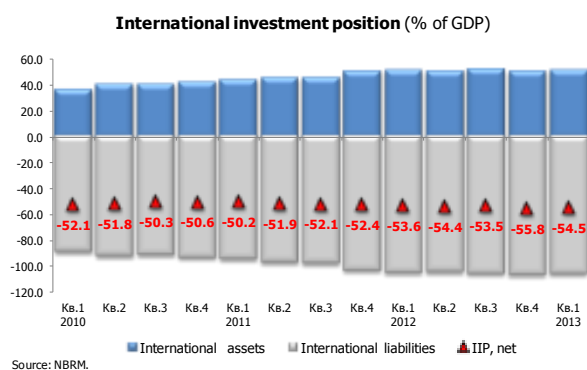


larger foreign-owned company. Dividend paid to this company caused significant outflows of foreign direct investment in the category "reinvested earnings", while other categories, equity and intercompany debt, registered net inflows of Euro 34.5 million. The other categories registered net outflows in April.



At the end of the first quarter of 2013, **gross foreign reserves** amounted to Euro 2,230.4 million. Compared with the end of the last year, foreign reserves increased by Euro 37.1 million, mostly due to the transactions on behalf of the government and the net purchase made by the NBRM in the foreign exchange market. The withdrawal of foreign currency deposits of banks with the NBRM, as well as the adverse changes in the category other transactions contributed to the depletion of foreign reserves. According to the latest available data, at the end of June foreign reserves amounted to Euro 2039.2 million, which is by Euro 154.1 million less compared to the end of 2012. The fall in foreign reserves was mostly due to the negative currency and exchange differences, as well as the net sales that the NBRM made in the foreign exchange market and the negative changes in the category "other transactions". Transactions on behalf of the government contributed to the accumulation of foreign reserves.

1.6.3. International investment position⁵⁶ and gross external debt



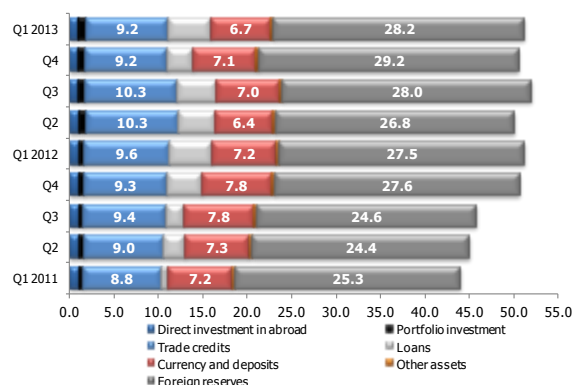
In the first three months of 2013, the **negative international investment position of the Republic of Macedonia against the rest of the world** widened, and as of **March 31, 2013, it amounted to Euro 4,309.6 million or 54.5% of GDP⁵⁷**. On a quarterly basis, net

⁵⁶ In September 2012, the NBRM started disclosing data on the international investment position (IIP) of the Republic of Macedonia, by quarter. IIP data are available on the website of the NBRM: (www.nbrm.mk/statistika/eksterni_statistiki).

⁵⁷ In the second quarter of 2011, the NBRM started concluding repo and reverse repo transactions. These transactions represent an investment opportunity of using the securities portfolio for generation of additional income. The conclusion of repo transactions produces liabilities. The conclusion of reverse repo transactions creates claims that contribute to the increase of gross claims. The NBRM simultaneously conducts

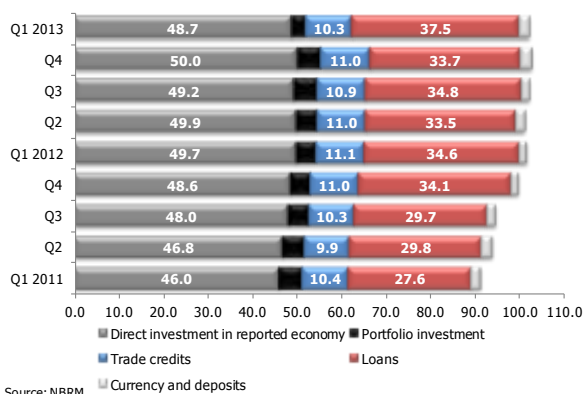


International assets, by instruments (% of GDP)



Source: NBRM.

International liabilities, by instruments (% of GDP)



Source: NBRM.

liabilities in absolute amount increased by Euro 113.2 million, while analyzed as a share of GDP⁵⁸, net liabilities decreased by 1.3 percentage points as a result of the faster growth of economic activity relative to the increase in the net debt position of the country.

Deepening of the negative investment position of the country against the rest of the world is entirely due to the **growth of international liabilities** (liabilities to non-residents) of 4.5%, while **international assets** increased by 6.6%. **The quarterly growth in assets** was mostly due to the higher claims of the monetary authority based on loans (repo transactions), followed by the increased gross foreign reserves in the part of securities, and the increased claims based on trade credits in the other sectors of the economy. The **quarterly growth in liabilities** is primarily due to the increased liabilities in the form of loans, i.e. long-term borrowing of the government (loan taken from a foreign private bank guaranteed by the World Bank and the program loan for development policies and competitiveness (DPL) from the World Bank) and short-term borrowing of the monetary authorities (repo transactions), as well as to the higher liabilities to foreign direct investors. This high amount of debt was partially offset by the repayment of the second Eurobond (issued by the government in July 2009, in the amount of Euro 175 million).

The analysis of the international investment position by sector, shows that the further deepening of the negative quarterly net liabilities of the country mainly arise from the increased net government debt, a significant portion relates to higher net liabilities of other sectors in the economy (foreign direct investment

matched conclusion of repo and reverse repo agreements, in almost identical amount. Overall, since they are concluded concurrently, on net basis these transactions have neutral net-effect, i.e. they appear in almost identical amount on the side of both liabilities and claims, thus having no effect on the total net IIP and the total net external debt. These transactions further expanded in 2012 and included the swap transactions backed by gold. In certain transactions, the effect on the MIP is not always neutral, i.e. time discrepancy may occur.

⁵⁸ Projected nominal GDP for 2013, in line with the April projection.



and increased net liabilities based on loans), as well as higher net liabilities of banks (increased net borrowing from abroad). On the other hand, monetary authorities register an increase in the net claims on a quarterly basis, in foreign reserves and repo transactions.

	Q4 2011	Q3 2012	Q4 2012	quarterly change			annual change		
	in EUR million			difference	contribution	in %	difference	contribution	in %
IIP, net	-4,031.3	-4,196.4	-4,309.6	-113.2	2.7	2.7	-278.4	6.9	6.9
<i>Government, net</i>	-1,407.3	-1,543.9	-1,641.0	-97.2	2.3	6.3	-233.8	5.8	16.6
<i>Monetary authorities, net</i>	1,992.5	2,095.8	2,154.4	58.6	-1.4	2.8	161.9	-4.0	8.1
<i>Banks, net</i>	-518.6	-562.7	-583.9	-21.2	0.5	3.8	-65.3	1.6	12.6
<i>Other sectors, net</i>	-4,098.0	-4,185.7	-4,239.1	-53.4	1.3	1.3	-141.1	3.5	3.4

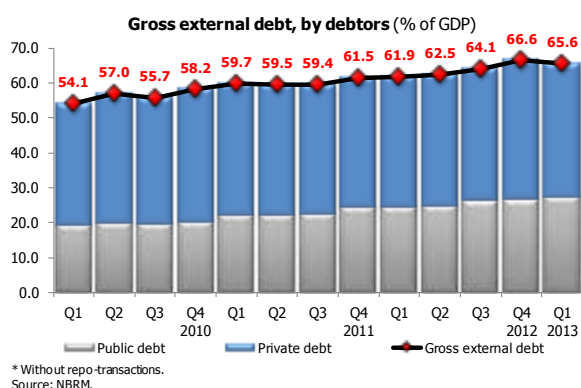
The annual growth of net liabilities in the first quarter of the year is a continuation of the constant deepening of the net debt position of the country (except the last two quarters of 2010). Thus, **in the first quarter of 2013**, amid faster annual growth of international liabilities in relation to the growth of international assets (6.1% and 5.3%, respectively), **the negative net IIP increased by Denar 278.4 million, or 0.9 percentage points of GDP, on an annual basis.**

The annual growth in international assets was mostly due to the increased gross foreign reserves (higher claims on the basis of invested securities), followed by the increased claims on the basis of portfolio investments (equity securities of the non-bank private sector) and higher borrowing in the form of loans in almost all sectors of the economy. Regarding **international liabilities**, an essential factor for the high annual change is government external borrowing in the form of loans. The growth in liabilities was backed also by the increased direct investment in the country, increased liabilities of banks based on deposits of non-residents, as well as the increased short-term other liabilities.

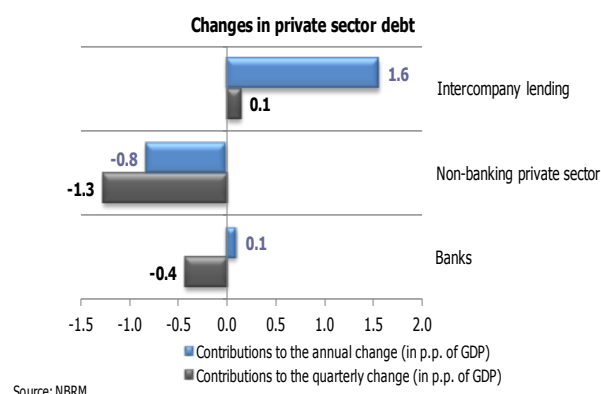
The analysis according to individual institutional sectors shows that the annual expansion of the negative gap in the international investment position of the country is due to the higher net liabilities in all sectors, with the exception of the monetary authority.

At the end of the first quarter of 2013, gross external debt of the country reached the level of Euro 5,496.8 million, or 69.5% of GDP. If repo transactions of the monetary authority are excluded, the gross

external debt amounted to Euro 5,193.1 million, or 65.6 % of GDP⁵⁹.



The quarterly analysis shows an increase in the gross debt of the country by additional Euro 187.5 million, of which approximately 82% are related to the growth of the public sector debt. The quarterly increase in **public debt**⁶⁰ primarily reflects the long-term external borrowing⁶¹, followed by the higher debt of MBPR (long-term loans from the EIB for SMEs) and increased long-term external borrowing of public enterprises. Within the **private sector** debt, realized quarterly growth was due entirely to the higher inter-company borrowing (increased liabilities to direct investors) amid lower level of debt with banks and non-bank private sector.



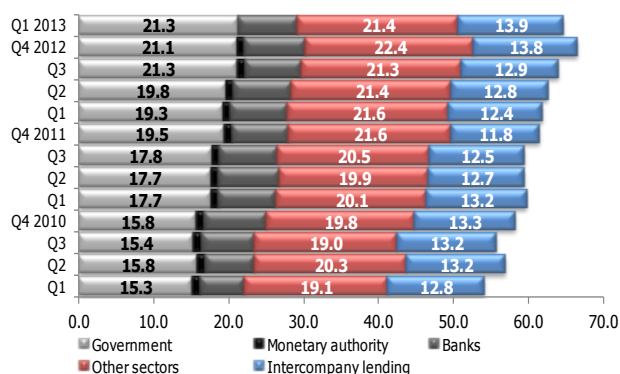
Gross debt increased also on an annual basis. The annual growth of external debt in the first three months of the year amounted to Euro 539.1 million, or 3.8 percentage points of GDP. Factors of the annual change are almost identical to the factors of the quarterly change in debt. The increased government liabilities on the basis of long-term loans from abroad largely explain the sharp rise in the public debt, while the generator of growth of the private sector debt, is the higher level of the inter-company debt.

The analysis of the dynamics of the external indebtedness of the country through the **solvency ratios** indicates deterioration in almost all indicators on an annual basis, with the

⁵⁹ The overall further analysis refers to the gross external debt without the liabilities of the monetary authority based on repo transactions.

⁶⁰ In January 2013, by Government decision, the Agency for State Roads was ceased, and the Public Enterprise for State Roads was established as its legal successor. This restructuring will have no impact on the total public debt, but there will be a change in the structure of the debt by institutional sectors. Thus, the government debt will be reduced, amid simultaneous increase in the debt in other sectors of the economy (which include public companies) by an equal amount of Euro 35.5 million.

⁶¹ Long-term loan from one foreign private bank (guaranteed by the World Bank) and the Loan Agreement for the First Programmatic Competitiveness Development Policy Operation with the World Bank.


Gross external debt, by institutional sectors (% of GDP)


* Without repo-transactions.
Source: NBRM.

exception of the indicator for servicing of interest covered with exports of goods and services, which registered an annual improvement of 0.1 percentage point. Deterioration in other indicators (gross debt to exports of goods and services ratio, gross debt to GDP ratio and the indicator of debt covered with export of goods and services), which is around 4.9 percentage points annually, on average, mainly reflects the new long-term government borrowing in the first three months of the year. Regarding the debt criteria set by the World Bank, according to the level of its gross external debt the Republic of Macedonia remains in the group of low indebted countries, with the exception of the external debt to GDP ratio, according to which it is categorized in the group of highly indebted countries. **Liquidity indicators** point to favorable external position, i.e. full coverage of liabilities based on short-term debt with residual maturity, with foreign reserves. On an annual basis, this indicator has improved by 0.1 percentage point.

Indicators for	Solvency				Liquidity		
	Interest payments/ Export of goods and services and other inflows	Gross debt/ Export of goods and services and other inflows	Gross debt/ GDP	Debt servicing/ Export of goods and services and other inflows	Foreign reserves/ Short-term debt	Foreign reserves/ Short-term debt, with residual maturity	Short-term debt/ Overall debt
	in %				ratio	ratio	in %
31.12.2004	2.24	120.1	49.3	11.5	1.14	0.89	30.3
31.12.2005	2.33	128.5	56.3	9.7	1.67	1.04	26.7
31.12.2006	2.88	109.8	51.8	18.2	1.95	1.34	29.0
31.12.2007	2.38	102.3	53.2	16.6	1.35	1.08	39.8
31.12.2008	2.30	101.1	55.3	8.8	1.29	0.95	35.2
31.12.2009	2.10	113.3	58.5	10.2	1.29	0.94	32.9
31.12.2010	2.78	121.1	60.1	11.9	1.31	0.90	32.0
31.03.2011	2.70	124.9	63.2	14.5	1.46	1.05	29.1
30.06.2011	2.70	124.4	63.0	14.5	1.40	1.00	29.3
30.09.2011	2.70	124.2	62.9	14.5	1.42	0.99	29.1
31.12.2011	2.70	128.5	65.1	14.5	1.53	1.06	29.4
31.03.2012	2.46	114.5	63.2	11.3	1.48	0.93	30.0
30.06.2012	2.46	115.8	63.9	11.3	1.40	0.91	30.7
30.09.2012	2.46	118.6	65.5	11.3	1.48	0.96	29.5
31.12.2012	2.46	123.2	68.0	11.3	1.40	0.93	31.3
31.03.2013	2.40	119.3	67.9	16.4	1.34	1.01	32.1
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. Data for 2012 are according to BoP projection October 2012.

In compliance with "External debt statistics: Guide for compilers and users," published by the IMF.

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

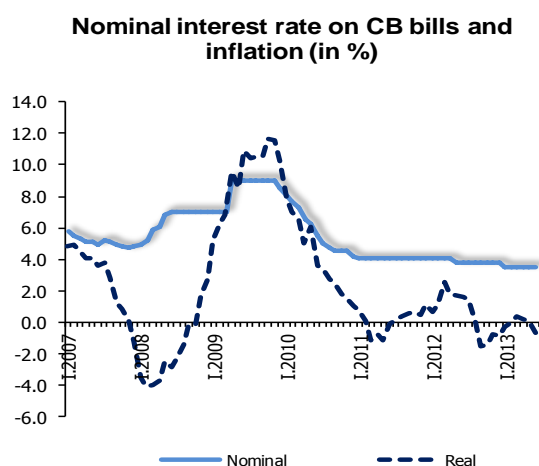
Source: NBRM.

II. Monetary policy

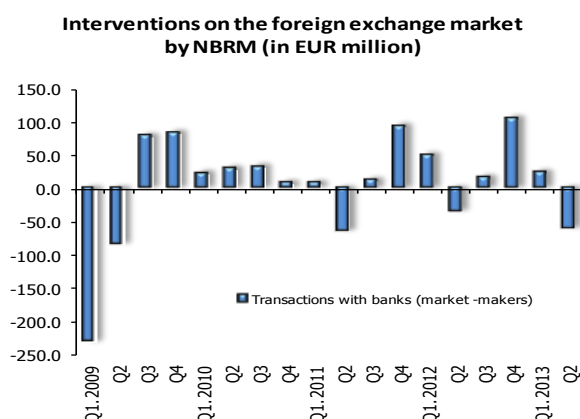
After the NBRM lowered the key interest rate in the first quarter of 2013, in the second quarter it remained unchanged at the level of 3.5%. In terms of the indicators relevant for the monetary policy, some of them indicated more relaxed monetary environment, yet some of them headed to the need for greater caution. Inflationary risks were significantly reduced, which led to consequent downward revision of projected inflation. However, core inflation is still high, indicating relatively high second-round effects of the increased prices of food and energy. Indicators of economic growth were favorable, however still without assessments for strong recovery, and risks related to credit flows are still mostly downward. During the quarter, foreign reserves depleted, with an intensity similar to that expected under the projections, and inventories were kept at an



adequate level. However, in this period the assessments for the total foreign demand and terms of trade in the metal-processing export segment constantly deteriorated. In such conditions, the risks for the external position of the economy increased. Assessments of economic and financial conditions and the risks present, as well as the new economic forecasts during the quarter pointed to the need for changes in the existing monetary stance. However, during July, NBRM changed the reserve requirement toward increasing the attractiveness of savings in Denars and contributing to the inflow of long-term foreign capital. In circumstances when part of the existing risks were mitigated by the changes in the reserve requirements, amid simultaneous assessments for movement of the macroeconomic indicators within the projected frames during July, NBRM estimated that there is room for further monetary easing by lowering the interest rate by 0,25 percentage point. Thus, the maximum interest rate on CB bills was reduced to the historically lowest level of 3.25%. NBRM will continue to closely monitor the situation in order to make an adequate adjustment of the monetary policy, also in the next period.

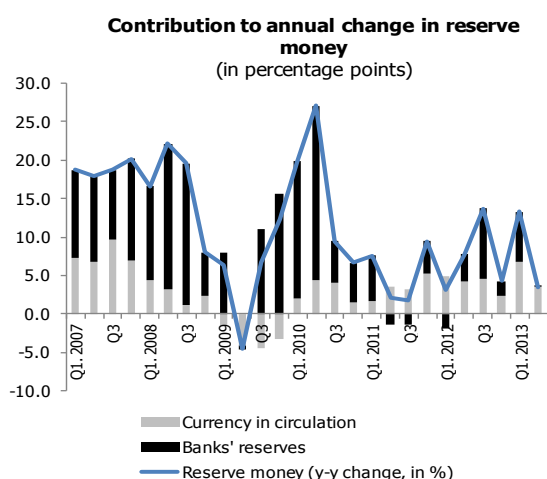
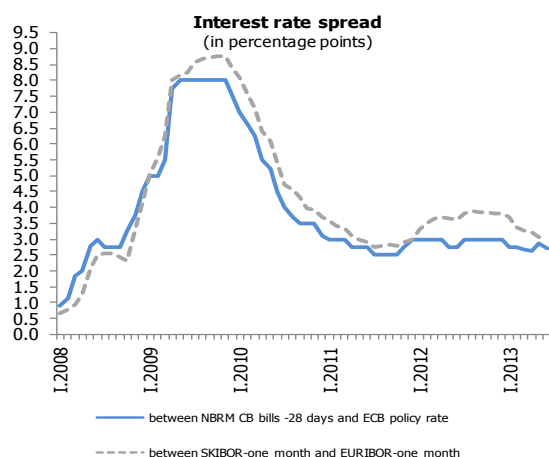
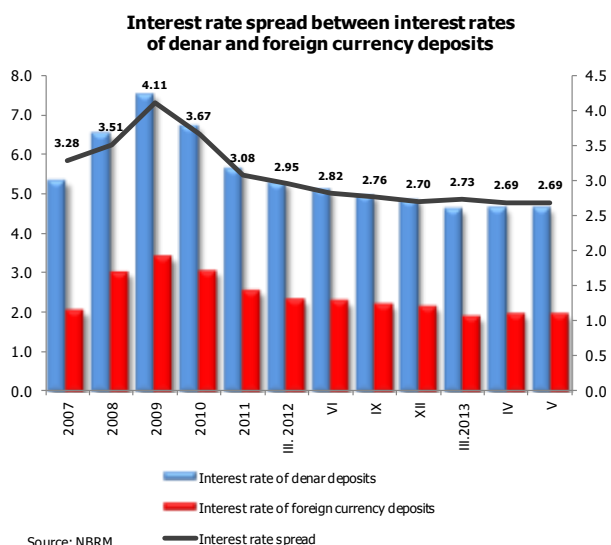


Source: NBRM.



Source: NBRM.

During the second quarter of 2013, NBRM maintained the same key interest rate of 3.5%. Assessments of economic and financial flows in the economy, and economic forecasts made during the quarter indicated suitability of existing monetary conditions. **In terms of the key indicators for the monetary policy, their movements during the quarter were basically within expectations.** Namely, in the April-June period, foreign reserves depleted, but at a pace close to the expectations within the projections. These changes were largely due to seasonal movements, and in conditions of relatively lower foreign exchange positions of banks, part of the needs for foreign exchange were covered by interventions of the NBRM. In the April-June period, NBRM made net sales in the amount of Euro 60 million, which is a common seasonal movement. Most of the sales of foreign exchange took place in April, when there was also a payment of a larger amount of dividend of a large company to a foreign shareholder. Indicators of adequacy of foreign reserves have consistently shown a sufficient level of foreign reserves to cope with potential shocks. Projections for the external position of the economy, made in April, also pointed to adequate projection for foreign reserves. Inflationary risks decreased at the beginning of the second quarter, due to the lower than projected realized inflation in the first quarter and estimates for smaller pressures from import prices than originally expected. In such conditions, forecasts for inflation in April were revised downwards. The realized average annual inflation in the April-June period of 3.6% is within the anticipated trajectory. In this period, lending showed signs of recovery, but it is still estimated



as weak, with mostly downward risks. Downward risks are pronounced in conditions of still unfavorable banks' perceptions of risk, conservative strategies of the banking groups present in the Macedonian banking system and in conditions of slower growth of the primary source of funding for banks - the deposit base. Indicators of economic activity were in line with expectations, but the economy is still below its potential.

Despite such developments, during the quarter there were still some risks, which created a need for more cautious monetary policy. The uncertain and slow recovery of the economic activity in the Euro area pointed to the still present risks from external environment. During the quarter, assessments for foreign demand were revised downwards, and the assessments of the conditions on the metals market were also less favorable. Such changes in the assessments also meant potential risks to the external position of the economy. Despite lower inflation risks, core inflation remains high, amid present one-off factors but also second-round effects of the rise in food and energy prices on the other prices. **The presence of these risks imposed a need for caution in the monetary policy conduct, and therefore the key interest rate of the NBRM in this period remained unchanged.**

Interest rate spread between the effective⁶² interest rate on CB bills and the key interest rate of the ECB was raised to 2.71 percentage points at the end of the second quarter. The expansion of the interest margin is a result of reduction in both interest rates, with a sharper decrease observed in the interest rate of the ECB. The decision of the ECB to cut the interest rate in May 2013 was made amid falling inflation and slow credit and deposit growth. According to the ECB, the goal of monetary easing at this time is the realization of their expectations for the stabilization and improvement of the economic activity of the Euro area in the second half of 2013. Despite the reduction in the key interest rate of the ECB, the one-month EURIBOR in this period was stable, remaining at the level of 0.1%. On the domestic financial market, SKIBOR⁶³

⁶² The effective interest rate refers to the interest rate earned on the CB bills auctions. Moreover, in the second quarter of 2013, this interest rate has been steadily decreasing.

⁶³ Interbank interest rate on Denar deposits, calculated using the quotations of referent banks.

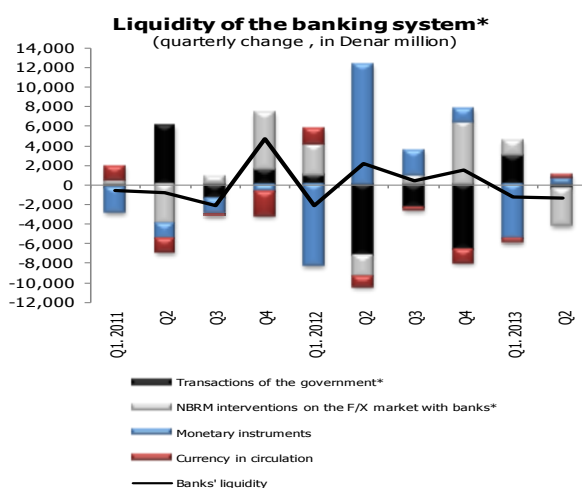


followed the direction of the key interest rate, with the one-month SKIBOR being reduced to 3.15% in June. In such conditions, the interest rate spread between one-month SKIBOR and one-month EURIBOR narrowed, and in June it equaled 3 percentage points (3.3 percentage points in March).

Box 6: Changes in the reserve requirement in July 2013

On July 04, 2013, the NBRM Council adopted a Decision amending the Decision on the reserve requirement⁶⁴. The purpose of these amendments is to provide further support to the growth of savings in domestic currency, and also to contribute to increasing the long-term foreign capital in the domestic economy. Thus, the amendments to the Decision introduced changes in the reserve requirement allocation rate, i.e. the reserve requirement ratio on foreign currency liabilities was raised by 2 percentage points, from 13% to 15%, amid simultaneous reduction in the reserve requirement ratio for the liabilities in domestic currency from 10% to 8%. This contributed to further maintain and increase the attractiveness of saving in Denars. Also, the amendments introduced the allocation of a reserve requirement rate of 0% for banks' liabilities to non-residents - financial companies, with contractual maturity over one year, and for all liabilities to non-residents with contractual maturity over two years. For short-term liabilities to non-residents - financial companies in foreign currency with contractual maturity of one year, the rate of 13% is still being applied. In order to keep the reserve requirement in Denars and in Euro relatively stable, the amendments envisage increment of the part of the reserve requirement in Euro, which is fulfilled in Denars, from 23% to 30%. The main goal of these changes in the reserve requirement is to encourage primarily the long-term inflow of foreign capital into the domestic economy, which would contribute to an additional income in the balance of payments, would increase banks' funding sources and would act countercyclically, supporting the lending activity.

2.1. Bank liquidity and developments on the interbank money market

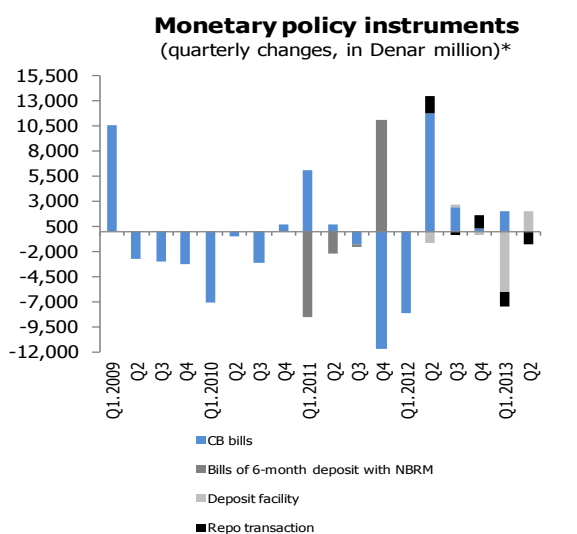


At the end of June 2013, the liquidity of banks fell by Denar 1,361 million, compared to the end of the first quarter. Thus, by the end of June, the balance on the banks' accounts with the NBRM⁶⁵ amounted to Denar 15,966 million.

In the April-June period, autonomous factors, net, acted toward withdrawing liquidity in total amount of Denar 2,029 million. Within government transactions, by increasing the deposits on the Denar account of the government with the NBRM, liquidity in the amount of Denar 2,738 million was withdrawn, while through the foreign exchange market the government provided for additional liquidity in the system in the amount of Denar 2,318 million. Foreign exchange transactions of the NBRM with market makers, according to the realized net sales

⁶⁴ "Official Gazette of RM" no. 98/2013.

⁶⁵ Refers to Denar accounts of banks, obliged to allocate reserve requirement.



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

of foreign exchange on the foreign exchange market, contributed to a withdrawal of liquidity of Denar 3,709 million. In the second quarter, currency in circulation contributed to creating liquidity of Denar 360 million, unlike the previous period.

In the April-June period, the monetary instruments of the NBRM contributed to creating liquid assets in the total amount of Euro 668 million. In the second quarter, three auctions of CB bills were held. At the auctions, NBRM determined the size of the supply of CB bills within the due amount, with the demand by banks, on average, being higher than the amount offered, due to the still present preference of banks to invest in non-risk instruments. In conditions of higher demand, the realized interest rate was lower than the maximum interest rate set by the NBRM and equaled 3.32% on average. Moreover, in June, the lowest interest rate of 3.21% was recorded. **As in the previous period, repo transactions contributed to the withdrawal of liquidity also during the period April-June. The interest in investments in standing deposits with the NBRM continued in this period, but with less intensity.** They contributed to the creation of liquidity in the amount of Denar 1.968 million. Also, during the second quarter, banks continued the trend of maintaining a relatively lower level of excess liquidity over the reserve requirement. Thus, in the period April-June 2013, the average excess liquidity over the allocated reserve requirement was 0.8% on average (around 1% on average in the first quarter).

In the period April-June 2013, a turnover of Denar 6,163 million was realized on the interbank market, which is almost twice less compared to the previous quarter. Compared with the same period last year, the activity on the interbank market in the April-June period was lower by 46.5%. The comparison of interbank activity by individual maturity segments still indicates highest interest in trading with shorter maturities (one day and seven days). However, characteristic of this period is the increased interbank trading in the longer term (up to one and up to three months), compared with the previous quarter. The interbank interest rate (MBKS)⁶⁶ in the period April-June 2013 amounted to 2.03% on average (1.94% on average in the

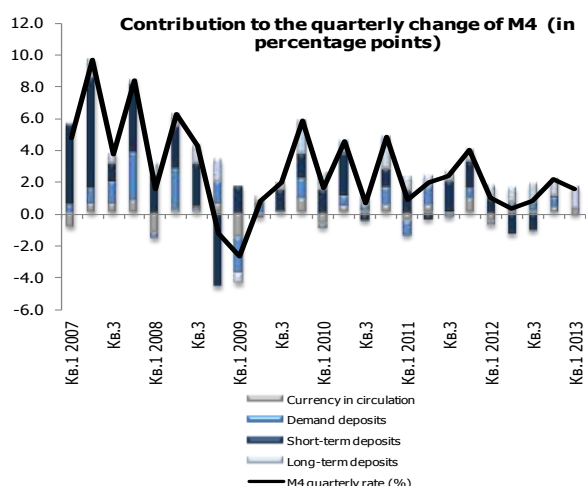
⁶⁶ Average interest rate on the interbank money market.



first quarter). The interbank interest rate for overnight transactions (MKDONIA) was 1.84%, on average, in the April- June period, which is about the same as in the previous quarter (1.85%). On the **secondary money market**, as in the previous period, a high turnover of Denar 1,409 million was realized in the second quarter, entirely as a result of trading in Treasury bills.

2.2. Monetary and credit aggregates

Broad money M4 continued to grow on a quarterly basis also in the first quarter of 2013, but slightly slower than in the previous quarter. The slowdown in the quarterly growth of the money supply is a result of seasonal factors, while maintaining the positive growth corresponds with the relatively favorable economic developments, as well as the surplus position of the balance of payments in the first quarter. Considering the structure, the slower monetary growth is a consequence of the smaller positive contribution of the most liquid component and of the short-term savings, while the positive contribution of long-term savings further strengthened. The observed acceleration in the quarterly growth rates of household savings corresponds with the favorable trends in all indicators on the labor market and with the continued foreign exchange inflows from abroad. On the other hand, corporate deposits register small quarterly decline. In the first quarter of 2013, moderate acceleration of lending on the credit market was registered, with the credit growth rate being almost double compared to the previous quarter. However, the credit market activity remains moderate, at a time when banks are still conservative, due to the uncertain economic environment, the further growth of non-performing claims on the private sector, as well as the process of deleveraging of part of the parent banks. The indicator for the utilization of the banks' deposit potential for lending to the private sector continues to decline, reaching the lowest value since late 2011. By sectors, in the first quarter banks provided financial support to both the household sector and the corporate sector. Thus, typical for this period is the significant acceleration of the activity in the corporate segment, which can be partially linked to the use of the funds from the EIB intended for corporate lending and to the non-standard monetary policy measures taken in support of lending. In the period April-May 2013, a more rapid quarterly growth of total lending to the private sector was observed again.



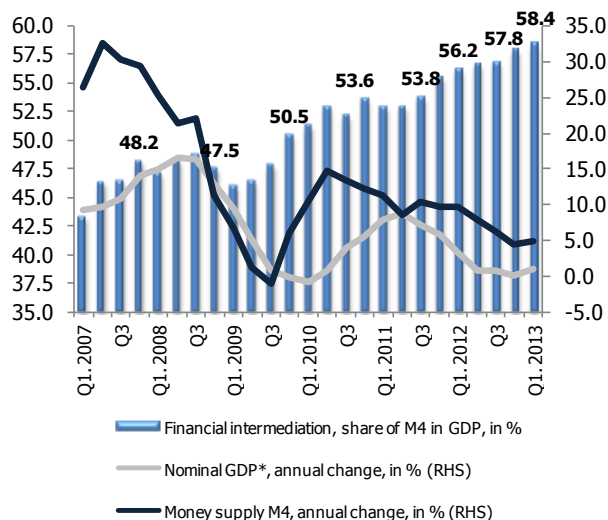
Source: NBRM.

2.2.1. Monetary aggregates

The broad money M4 registered a quarterly increase (1.6%) also in the first quarter of 2013, but at a slower pace than in the previous quarter (growth of 2.2%). The slowdown in the quarterly growth of the money supply is a result of seasonal factors common for the first quarter of the year, while maintaining of the positive growth is enabled by the favorable economic activity and foreign exchange inflows through the balance of payments. Regarding the structure, with the exception of demand deposits, all components had a positive contribution to

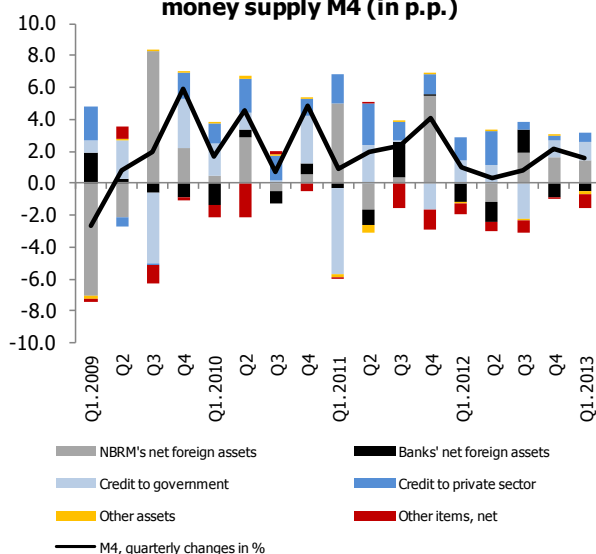


Money supply M4 and nominal GDP



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

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



Source: NBRM.

monetary growth. The intensity of the positive contribution of the most liquid assets (currency in circulation and demand deposits) declined, while the contribution of the deposit potential increased. With this, the total savings contribute positively to monetary growth for the second quarter in a row. Within overall deposits, in this period, the growth of long-term deposits of the private sector intensified. According to the balance sheet, the largest contribution to the quarterly growth of M4 in the first quarter was that of the net foreign assets of the NBRM, and the contribution of the loans to the private sector and to the government was also positive. The rate of monetization⁶⁷ registered a moderate growth from 57.8% to 58.4%, on a quarterly basis, due to the faster growth of the money supply relative to the nominal GDP. **Analyzed on an annual basis, the growth of the broad money M4 in March 2013 is 5.0% (4.4% in December) and is caused by the growth of all components.** The most liquid monetary aggregate M1 has the largest contribution to the monetary growth (with increased participation in the growth of 53.6% versus 41.3% in December), while total deposits account for 46.4% in the growth (58.8% in December). As in the previous quarter, the positive contribution of total deposits entirely stems from long-term deposits, in conditions of further negative contribution of short-term deposits.

In the first quarter of 2013, accelerated growth of total deposits⁶⁸ was registered, from 1.5% to 1.9% on a quarterly basis. Quarterly growth and accelerated savings are entirely a result of the long-term deposits, given the minimal decline in short-term deposits. Regarding the currency, both Denar and foreign currency deposits have positive contribution to the growth of total deposits. Unlike the previous quarter, when foreign currency deposits had a greater contribution, in this period Denar deposits have more significant contribution to the growth of total deposits. These developments contributed to the continuation of

⁶⁷ Measured by the share of money supply in GDP (annualized nominal GDP, calculated as the moving sum of the past four quarters).

⁶⁸ Refers to the total deposits excluding demand deposits. If demand deposits are included, the quarterly growth of total deposits in the first quarter of 2013 amounts to 1.4%, versus 2.6% in the previous quarter.

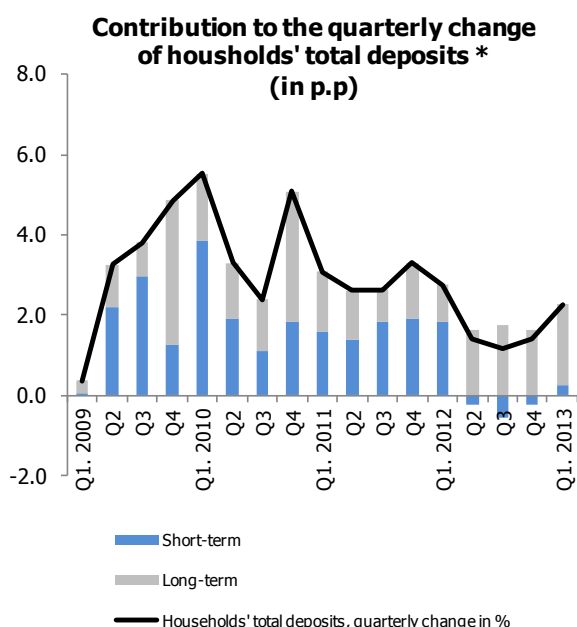


the downward trend in the rate of Euroization⁶⁹, present in the past two years. **After the common seasonal increase towards the end of 2012 of 4.4%, in the first quarter of 2013, the narrowest and most liquid monetary aggregate M1 registered a slowdown in its quarterly growth to 0.4%.** The absence of negative quarterly change in M1⁷⁰ is associated with the growth of currency in circulation, which is uncommon for this period and is partially related to the payments of government subsidies.

In terms of sectors, the quarterly increase in total household deposits (excluding demand deposits)⁷¹ increased by 2.3% versus 1.4% in the previous quarter.

The growth of the household saving in this period corresponds with the more favorable trends in all indicators on the labor market, and with the continued foreign inflows from abroad (mainly from private cash transfers estimated through net cash purchased on the currency exchange market). New credit flows towards this sector also contributed to the growth of household deposits.

In terms of currency, the quarterly growth of household deposits results from the growth of both foreign currency and Denar savings. The quarterly growth of foreign currency savings points to further stabilization of the process of strong denarization of this part of households' financial assets, for the third consecutive quarter. Thus, the contribution of foreign currency deposits in total deposits growth increased from 32% to 40% on a quarterly basis. However, Denar savings continue to have the largest contribution to the growth of total household deposits. **In terms of maturity structure,** the quarterly growth of household deposits largely arises from long-term deposits, given the minimal increase in short-term deposits (after the decline in three consecutive quarters). However, for four quarters in a row, long-term deposits are the main drivers of the growth in total household deposits, amid higher yields from long-term savings and high confidence in the banking sector stability.



*Excluding demand deposits.
Source: NBRM.

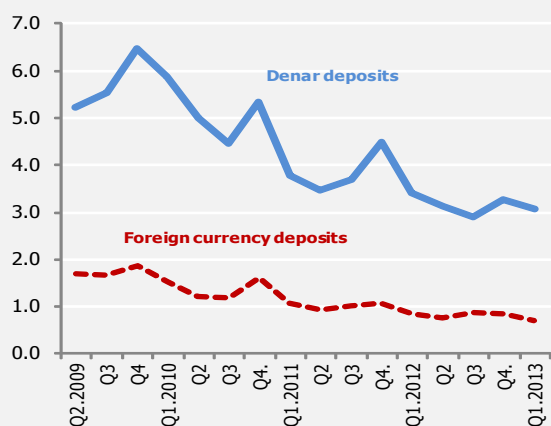
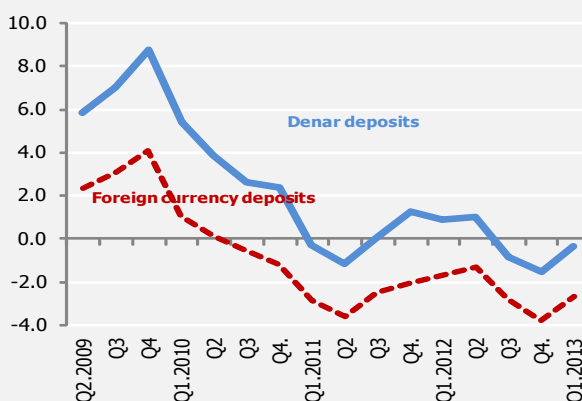
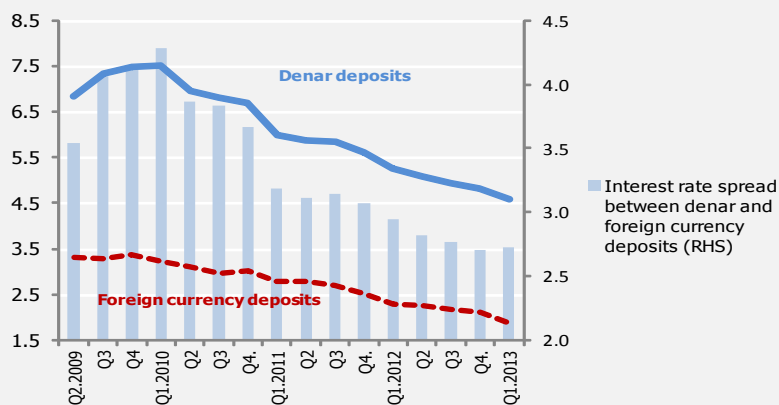
⁶⁹ Expressed through the share of foreign currency deposits in broad money M4.

⁷⁰ A seasonal feature common for this time of the year, when the cash in circulation reduces after the growth during the New Year and Christmas holidays.

⁷¹ With demand deposits included, the quarterly growth rate of total household deposits in the first quarter of 2013 is 2%, versus 2.3% in the previous quarter.

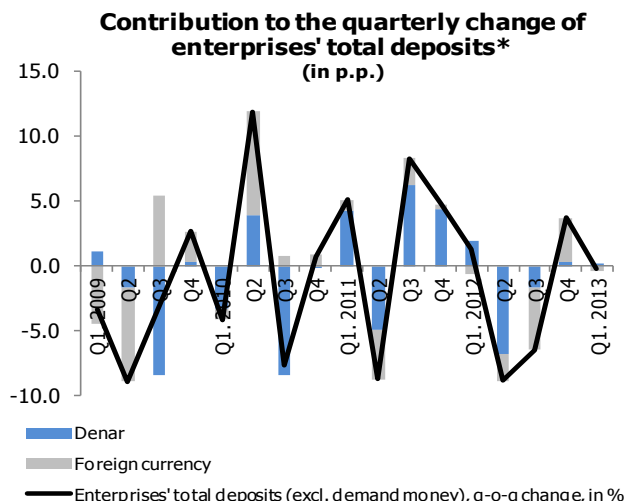


In terms of the interest rates on new Denar and foreign currency deposits of the household sector, there is minimal reduction in their yields compared with the previous quarter. Thus, the yields on new domestic and foreign currency deposits declined at the same pace, on average (by 0.1 percentage points), and the interest rate spread remained unchanged compared to the previous quarter. The real yield on Denar and foreign currency deposits remains negative, in conditions of further retention of inflation rate above the level of interest rates. However, given the stronger deceleration in the inflation rate than in nominal yields, in the first quarter there was a significant reduction in the negative real yield on Denar and foreign currency deposits.

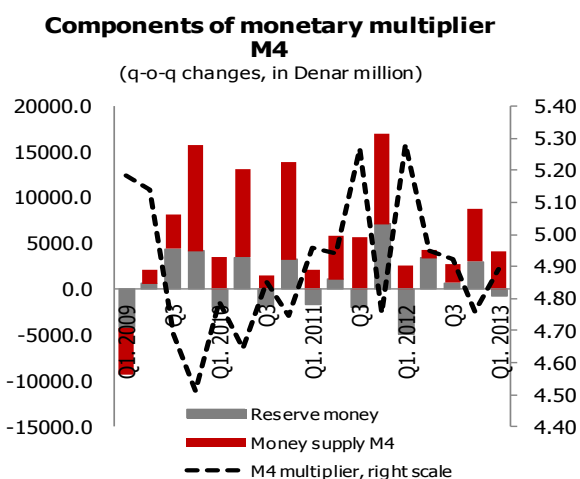
Banking conditions - Households deposit market**Interest rates on newly received deposits of households, in %, on annual level****Nominal****Real****Interest rates on outstanding amount of total deposits, in %, on annual level**

Source: NBRM.

After the growth observed in the last quarter of 2012, in the first quarter of 2013,



*Total deposits and denar deposits don't include demand money.
Source: NBRM.



Source: NBRM.

corporate deposits registered minimal quarterly decline of 0.2%. In conditions of increased economic activity in the country, such changes can be partially explained by the base effect from the previous quarter, when most of the outstanding government liabilities towards this sector were repaid. In terms of the currency structure, the sharper decline of foreign currency deposits relative to the increase in the Denar deposits contributed to the reduction of corporate deposits in the first quarter of 2013. Regarding the maturity, the decline in the total corporate deposits fully emerged from the decline in the short-term deposits, as opposed to their growth in the previous quarter.

In the first quarter of 2013, the trend of slowing down the process of monetary multiplication, common for the previous three quarters, was interrupted. Thus, the monetary multiplier of the M4 money supply was 4.89, versus 4.76 in the previous quarter. The growth of the monetary multiplier in the first quarter of 2013 results from the average quarterly increase in the total money supply, in conditions of average reduction of reserve money.

The latest monetary data for the period April-May 2013, indicate a slowdown in the monetary growth to 2.6% in May, amid slower annual growth of total deposits in the banking sector and slower growth of the monetary aggregate M1 on an annual basis.

Box 7: Analysis of the dynamics of interest rates on deposits in the Republic of Macedonia

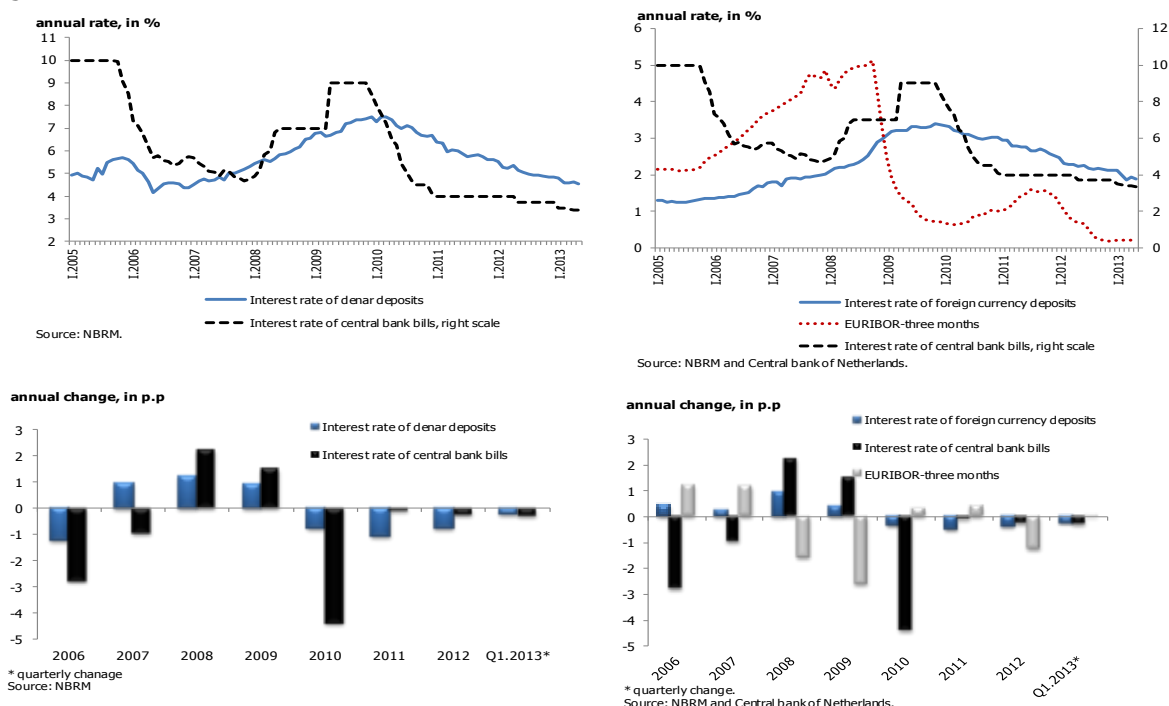
The offer of deposit instruments through which the financial assets of the economic entities registering surplus are mobilized is the basis of the financial intermediation as the main function of banking institutions. Hence, it may be concluded that the deposits of private entities are of particular importance for banking institutions, and banks pay special attention when defining the characteristics of deposit products, especially when determining their price, i.e. interest rate. **The literature lists several factors that affect the level of the interest rate on deposits.** Examples include the dynamics of the key interest rate of the central bank, which is related to the dynamics of market interest rates, the degree of concentration of the banking sector and the competitive power, current and expected macroeconomic developments. Furthermore, there is a whole sequence of individual factors related to the characteristics of individual banks, such as bank size, the level of capitalization and liquidity, operational efficiency and the like. Of course, when defining deposit interest rates, banks take care to ensure a balance between their incentive to maximize profits and the need to maintain the stable deposit base and attract new deposits.

In this Box, we are making an effort to identify some of the factors that cause the changes in Denar and foreign currency deposit interest rates in the Macedonian banking system. The main motivation for the analysis stems from the different intensity of adjustment of the yields on Denar and on foreign currency saving, which in recent years has led to a narrowing of the difference between them. The interest rate spread between

interest rates on Denar and on foreign currency deposits affects the preferences for saving in domestic and in foreign currency, and it has an effect on the demand for foreign currency and on the monetary policy. Of course, the pricing of both Denar and foreign currency deposits is an integral part of the process of managing the overall balance sheet position of banks, and it depends on many factors. **In this Box, the focus will be primarily on the assessment of the effects of the macroeconomic environment and the monetary policy on the yields on Denar and foreign currency savings.** The conclusions that can be derived by monitoring the dynamics of interest rates and the intersection of these movements with the environment and the monetary policy are crosschecked with the opinion of banks. For the purpose of this Box we carried out a survey among the banks, which gives a picture of the factors that banks consider crucial in forming the price of Denar and foreign currency deposits.

The analysis of dynamics, which covers the period 2005-2013, shows that, basically, the change in the Denar and foreign currency interest rates is in the same direction, and both interest rates follow the direction of change in the interest rate on CB bills. However, an exception to this trend are the early years of the analysis. Thus, in 2006, amid high foreign exchange inflows into the economy, the interest rate on CB bills was significantly reduced and followed by the interest rate on Denar deposits. On the other hand, foreign interest rate continued to grow moderately, following the dynamics of foreign interest rates. **These asymmetric changes led to a significant narrowing of the interest rate spread between the Denar and foreign currency interest rate to the level of 2.6 percentage points in 2006 (Figure 2).** This period is the period in which the propensity for saving in Denars increased, but still it was difficult to assess the durability of these changes in the currency preferences. Under such circumstances and with simultaneously increasing competition in the deposit market, banks were likely more focused on foreign currency savings, trying to be competitive in this segment.

Figure 1

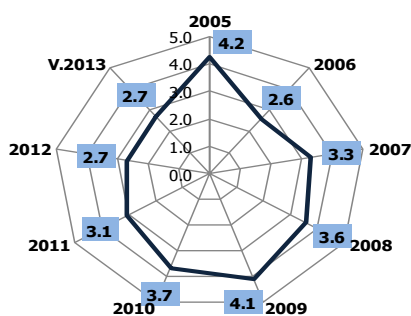
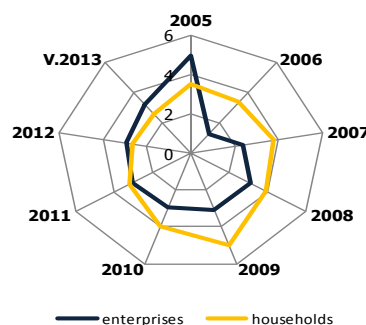


At the same time, this was influenced by the increased lending in foreign currency⁷², which imposed a need for the banks to retain the foreign currency deposits for the purpose of adequate

⁷² In July 2003, amendments were made to the Law on Foreign Exchange Operations that allow lending in foreign currency to all interested legal

currency match. **In the 2007-2009 period, the changes in the monetary policy were divergent.** After the loosening in 2007, in 2008 and 2009 there was a cycle of monetary tightening, initially in order to pin down the inflationary pressures, and later to cushion the adverse effects of the global economic crisis. **However, throughout this entire period both Denar and foreign currency deposit interest rates continued to grow.** In the pre-crisis period (until the emergence of the global financial and economic crisis at the end of 2008), banks' strategies were aimed at increasing the attractiveness of deposit products in order to provide a larger potential for lending, amid high demand for loans and accomplished credit growth of about 37%, on average, in 2007 and 2008. When it was clear that there is a growing tendency of entities to save in Denars (continuous fast growth of Denar deposits in the 2006-2007 period), these pressures from the competition were particularly pronounced in the segment of Denar savings. With the onset of the global crisis, fears of possible withdrawal of deposits from banks, as well as the simultaneous significant increase in the interest rate on the CB bills, led to a continuous rise in the yields on deposits. Upward adjustment of Denar interest rates was greater than that of foreign currency interest rates, and exception is 2008 when their changes were relatively close. This year is the year when given the present inflation, preferences for foreign currency deposits temporarily increased again, which contributed to the rise in their interest rates, at a pace close to the growth in the Denar yields. **However, during the period 2007-2009, on aggregate basis, interest rates on Denar deposits increased by 3 percentage points, while interest rates on foreign currency deposits were adjusted by half of this growth. Thus, during this period the interest rate spread between the Denar and foreign currency interest rates expanded significantly (see Figure 2).** Both interest rates reached their maximum in this period, with the Denar deposit interest rate being twice the foreign currency interest rate, leaving a greater space for its downward adjustment. By sectors, movements in Denar interest rates in relation to the foreign currency interest rates were largely consistent with the previously analyzed dynamics of interest rates on total deposits. Faster upward adjustment of Denar interest rate relative to the foreign currency interest rate was recorded in both sectors, but with a slightly more pronounced difference in the household sector (which accounts for 70% of total deposits). Also, in this period, the expansion of the interest rate spread between the Denar and foreign currency deposit interest rates for the household sector was greater than that for companies.

Figure 2

Interest rate spread between interest rates of total denar and foreign currency deposits of the banks

Interest rate spread between interest rates of denar and foreign currency deposits of households and enterprises


The period from 2009 to 2013 was a period of continuous decline in deposit interest rates, as well as a period of continuous loosening of the monetary policy and reduction of the key interest rate of the NBRM. After the end of the "acute phase" of the crisis and reduction of the risks for the external sector, in late 2009, the NBRM launched a cycle of loosening of the monetary policy. At the same time, amid banks' perceptions of mounting risks, their investments in low risk and less yielding instruments increased. Against the background of increased

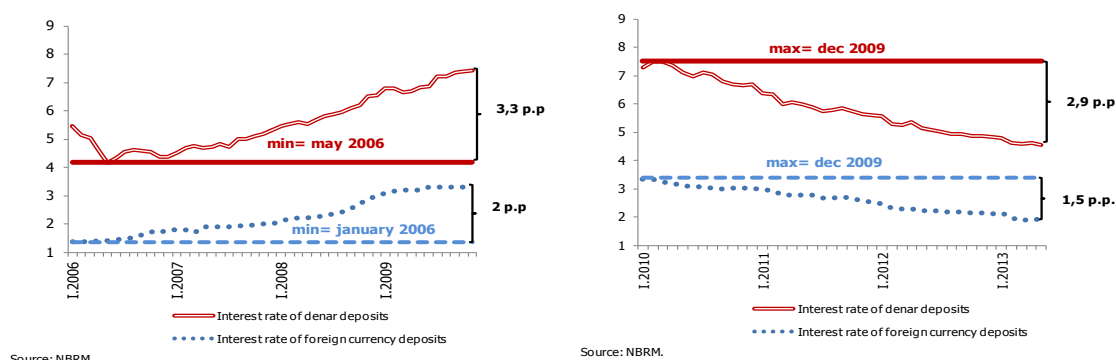
and natural persons, regardless of purpose. These changes stimulated increased foreign currency lending in the next period.

investment in this type of assets and simultaneous decline in the yield on this type of investments, banks were faced with lower interest income. The banking system reduced the downturn, among other things, by reducing the deposit interest rates. Amid weak economic and lending activity, competition in the deposit market was weaker, so this factor did not create upward pressure on the yields on deposits. **Intensity of reduction of Denar interest rates was twice higher than the decline in the foreign currency interest rates, which caused constant narrowing of the interest rate spread between these interest rates.** In this period a decline was registered in the interest rates on both corporate and household deposits, amid constant narrowing of the interest rate spread in both sectors. However, **in the household sector** in this period, greater intensity of narrowing the spread between the Denar and foreign currency deposit interest rates was observed. This can partly be explained by the fact that in 2010, the Law on Obligations was adopted, which set a mechanism for limiting the level of the lending interest rates, imposing the need for an appropriate downward adjustment of lending interest rates in both sectors. However, as a result of the traditionally higher interest rates that banks offer on household loans, compared to corporate loans, the interest rates for the household sector were subject to stronger downward adjustment, especially on Denar loans, which caused a respective adjustment also of deposit interest rates. **There are two main explanations for the varying intensity of change. First,** one part of this period is characterized by a sudden increase in the demand for Denar deposits, in conditions of increased distrust in the Euro, as a result of the European debt crisis. Given the high demand for Denar saving, banks were in a position to reduce the price of the increasingly larger Denar deposits, without risk for reduction of the savings in Denars. The data show that economic agents were looking for greater yields within the Denar deposits, through reallocation of savings from short-term to long-term Denar savings that bring higher yield. **Second,** the room for reduction of the Denar interest rates, given the high initial level, was significantly larger than the room for reduction of the foreign currency interest rates. Foreign currency interest rates had significantly lower initial position and thus considerably more limited room for their downward adjustment. According to the latest data on the interest rate on the newly collected foreign currency deposits, the interest rate in May 2013 was 0.5%, which is certainly low. Further reduction may possibly adversely affect savers who traditionally save in foreign currency. **However, it should be noted that although the intensity of reduction of both interest rates was different, their adjustment relative to the pre-crisis maximum is almost identical, showing some sort of consistency in the banks' policy through time when determining the price of Denar and foreign currency deposits.**

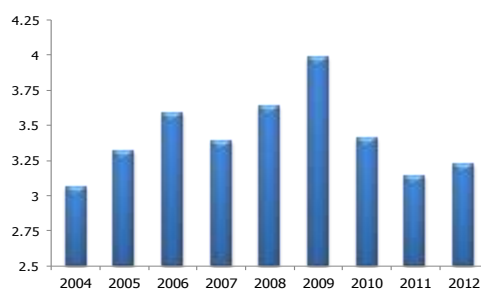
The Survey (from the total number of 13 banks, responses were submitted by 10 banks which account for approximately 90% of the total deposit potential) largely confirms the previous findings about the factors that affect the intensity and movement of deposit interest rates. In fact, when asked **which factors mainly influence the formation of interest rates on Denar and foreign currency deposits**, all banks say it is the monetary policy of the NBRM, the movement of the reference interest rates in the country and abroad, the competition policy of other banks, the provision of an adequate interest rate margin, the volume of supply and demand for deposits, and the macroeconomic environment. Additional factors that are mentioned in the Survey in some banks are the cost for insurance of the deposits of natural persons (two of the banks), and the amount of compensation for the allocated reserve requirement (several of the banks surveyed). One of the banks highlights the need to monitor the trend of the inflation rate, amid analysis of the cost of deposits. Also, some banks point to laws and by-laws (fulfilling the liquidity indicators, the effect of the Law on Obligations). One of the banks surveyed, indicated the importance of matching the assets and liabilities on the balance sheets of banks, in terms of maturity, amounts and currencies. When asked about **the reasons for the stronger adjustment of the interest rate on the Denar against the foreign currency deposits**, most banks responded that they follow the movement of the reference interest rate of the NBRM, but also highlight the greater room for adjustment in the Denar interest rates that are significantly higher than foreign currency interest rates (in conditions of faster growth of Denar saving at the expense of foreign currency saving). When asked **what is the impact of the key interest rate of the National Bank in setting the deposit interest rates**, all banks say that the impact of the interest rate of the NBRM is crucial. One of the banks points to the interest rates on Treasury bills, and another stresses that the impact of the changes in the key interest rate is felt only when setting the interest rates downwards. When asked **what is the impact of foreign**

interest rates when setting the deposit interest rates, all banks, beside the impact of the reference interest rate, indicate the impact of the international interest rate - EURIBOR, the structure of the asset items in the bank's balance sheet in foreign currency and in Denars with FX clause, and the price of the same or similar products with competing banks. One of the banks indicated that the impact of these interest rates in setting the deposit interest rates is smaller relative to that of the key interest rate of the NBRM. Finally, when asked **about the extent to which banks are guided by the interest rate spread between active and passive positions in different currencies when defining the interest rate policy**, the Survey confirmed that this is a significant factor in defining the interest rate policy of banks that adjust in order to maintain adequate liquidity and profitability positions.

Figure 3



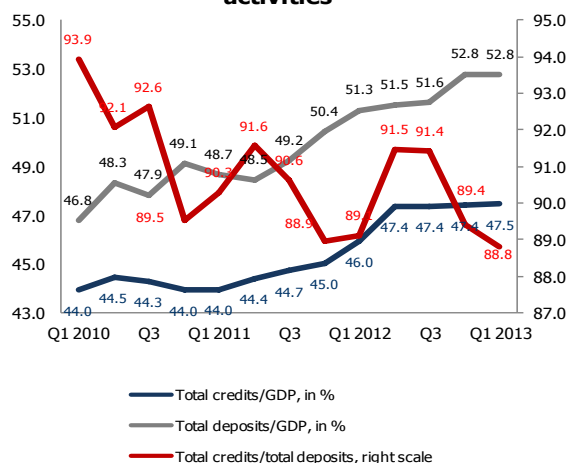
Net interest earnings on deposits/Total assets, in %



This analysis shows that when defining the interest rates on deposits, banks are largely guided by the interest rate policy of the NBRM and by the macroeconomic and financial conditions, and except for maintaining a certain profit margin, they also take care of maintaining the attractiveness of deposits as investment instruments for the economic entities. Besides for the Denar interest rates, the key interest rate of the NBRM in many cases proves to be a reference rate for defining the dynamics also of the foreign currency interest rates, which is partially explained by the fact that domestic entities are still not able to save in foreign banks. In the entire period of the analysis there are differences in the intensity of adjustment of Denar and foreign currency interest rates. Stronger adjustment in the Denar interest rates is made in both directions, in both the cycles of increasing and the cycles of decreasing the interest rates. The reasons for these asymmetric changes are different at different times, and for the last period, when there is also a narrowing of the interest rate spread, the reasons are to be found in the increased demand for Denar deposits, and in the larger room for adjustment of Denar interest rates.



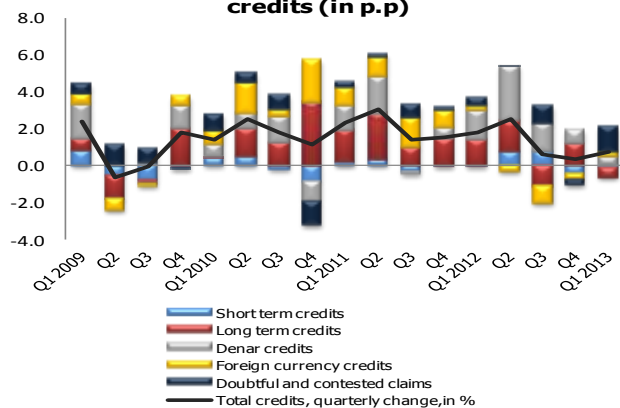
Total credit and deposit potential of the private sector and the economic activities



Source: NBRM.

	Q1. 2012	Q2	Q3	Q4	Q1. 2013
Total credits (in million denars)	210,912	216,246	217,537	218,368	219,952
quarterly change, in %	1.8	2.5	0.6	0.4	0.7
Doubtful and contested claims (in million denars)	20,967	21,040	23,178	22,551	25,584
quarterly change, in %	4.5	0.3	10.2	-2.7	13.4
Short term credits (in million denars)	52,668	54,240	55,791	54,787	54,504
quarterly change, in %	0.0	3.0	2.9	-1.8	-0.5
Long term credits (in million denars)	134,941	138,513	136,068	138,614	137,371
quarterly change, in %	2.1	2.6	-1.8	1.9	-0.9
Denar credits (in million denars)	153,024	159,123	162,423	164,001	164,972
quarterly change, in %	2.2	4.0	2.1	1.0	0.6
Foreign currency credits (in million denars)	57,888	57,123	55,114	54,367	54,980
quarterly change, in %	1.0	-1.3	-3.5	-1.4	1.1
Households credits (in million denars)	82,288	84,544	86,172	86,916	87,840
quarterly change, in %	0.8	2.7	1.9	0.9	1.1
Enterprises credits (in million denars)	128,127	131,069	130,634	130,697	131,304
quarterly change, in %	2.5	2.3	-0.3	0.0	0.5

Contribution in quarterly change of total credits (in p.p)



Source: NBRM.

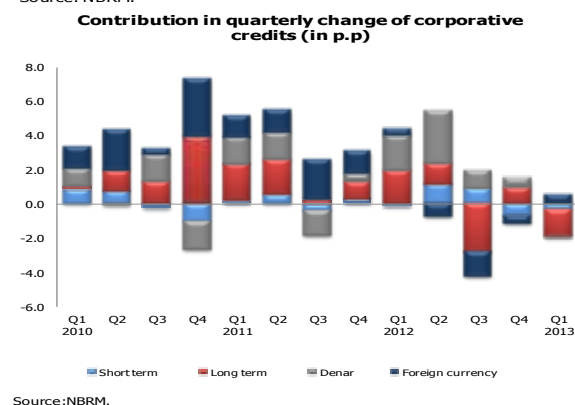
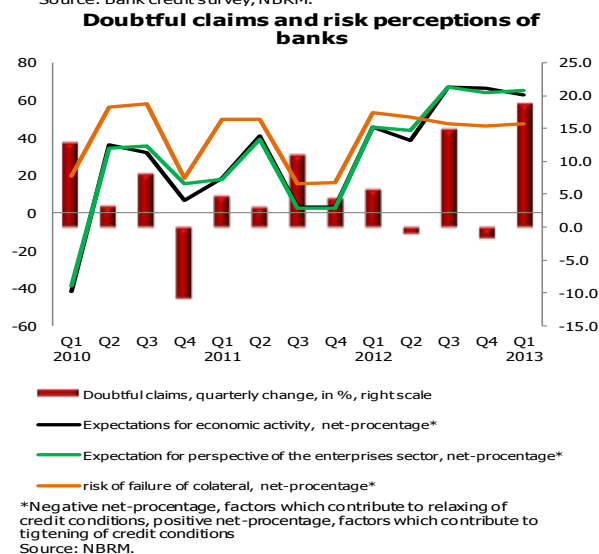
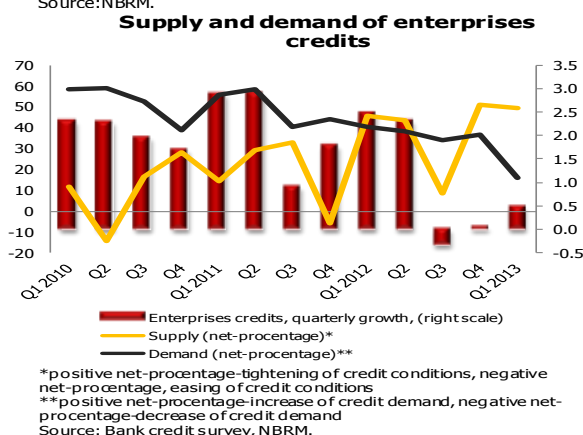
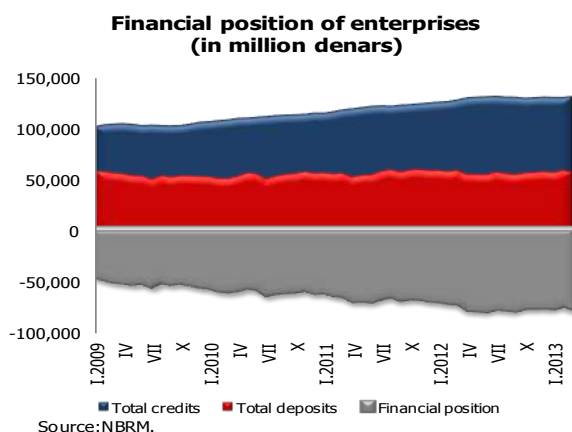
2.2.2. Lending activity⁷³

After a slowdown in the previous two quarters, in the first three months of 2013, the quarterly growth rate of total loans of banks accelerated, reaching 0.7%. The increase of credit flows in the economy took place along with the improvement of indicators of economic activity. However, given the lagging effect of the real sector developments on the quality of loan portfolio, the first quarter was marked by a rise of the non-performing loans to gross loans ratio from 10.3% to 11.6%. These adverse developments suggest that there are still risks and uncertainties that affect the risk perceptions of banks and their behavior on the credit market. Against this background, banks remain conservative and still prefer to place a great deal of their potential liquidity in less profitable, but safe investments such as treasury and CB bills. Regarding the banks' main source of funding, in the first quarter of 2013, the deposit base further expanded, but at a weaker pace than in the previous quarter. Loan/deposit ratio further indicates that deposits are insufficiently used for lending to the private sector. Thus, in the first quarter, this ratio decreased to 88.8% from 89.4% in the previous quarter. In terms of the *cost of total loans* (in Denars and in foreign currency), in the first quarter, the interest rate was marginally reduced on a quarterly basis, from 7.9% to 7.8%, reflecting the monetary easing.

The analysis of maturity structure shows reduction of both long-term and short-term loans, while the group of doubtful and contested claims increased. Such movements were last seen in the third quarter of 2009. In terms of currency structure, the positive contribution of Denar loans was lower compared to the previous quarter. Positive contribution to the overall credit growth was also made by foreign currency lending, unlike the previous quarter, when foreign currency loans decreased.

In the first quarter, the corporate loans further rose by 0.5%, or Denar 608 million, against the modest growth of Denar 62 million in the previous quarter. Given the

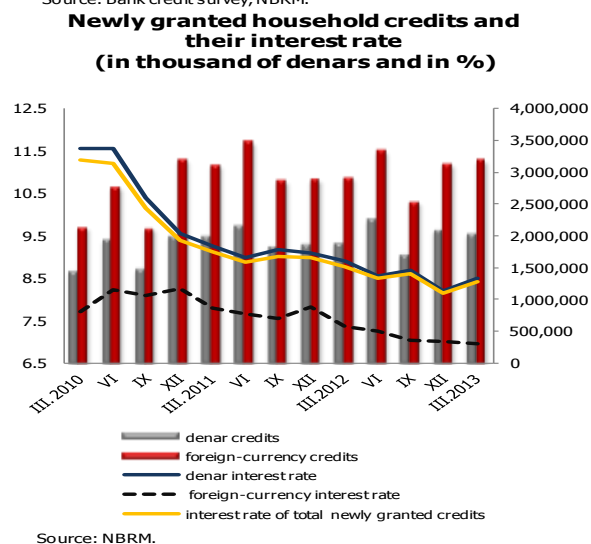
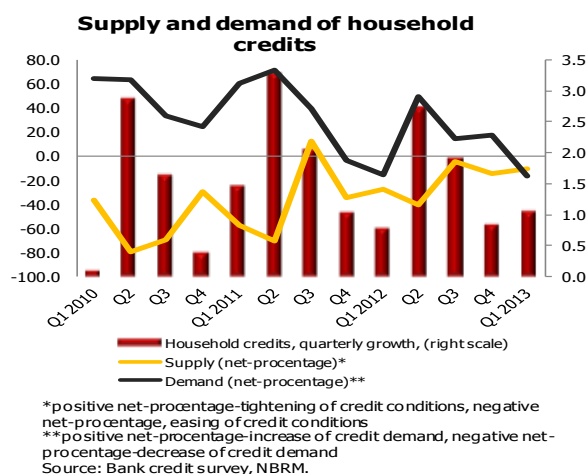
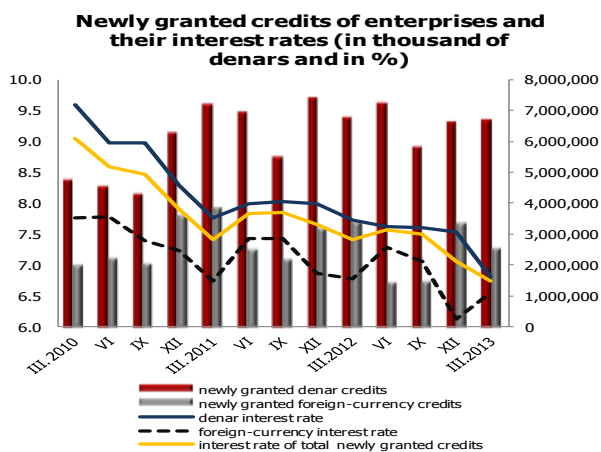
⁷³ Data on loans include loans to non-government sector provided by banks and savings houses. They include claims based on loans, accrued interest on loans, and doubtful and disputed claims on loans. The data are compiled under the international recommendations and standards for monetary statistics provided by the International Monetary Fund (IMF) and the United Nations.



increase of new loans to the corporate sector and the decline of their deposits, this quarter experienced a worsening of the negative financial position⁷⁴ of the corporate sector, despite its improvement during the previous quarter. Analyzing the *supply*, in the first quarter of 2013, the Lending Survey showed that banks reaffirmed that the terms of lending to the corporate sector tightened, pointing to the factors of the risk perception group as an underlying reason for this conservative policy. Over 60% of banks find that the risks of future trends in the overall economic activity and the prospects of the company contribute to tightening the terms of lending, and 48% of the banks find the inability to sell the collateral to have the same effect. With respect to specific terms of lending, in the first quarter, the interest rate increased. Requirements for security, indicated by banks to be a tightening factor of the lending terms in the previous quarter were assessed to be a neutral impact factor in this quarter. Regarding the credit demand, banks indicate that the demand for corporate loans is higher, but with a lower intensity compared to the previous quarter. In terms of specific factors, over half of the banks indicate that the needs for investments in inventories and working capital and debt restructuring are factors that contribute to the increasing credit demand by companies. Loans from other banks have the same effect, but with less intensity. Investments in fixed assets have negligible negative impact on demand, unlike the previous two years when banks found this factor to be a stimulating factor. In terms of the cost of new loans to companies, in the first three months of 2013, the interest rate was again cut by 0.3 percentage points, to 6.7%. This decline of interest rate on new loans in the first quarter entirely reflects the cut of Denar interest rates, unlike the previous quarter when the decrease resulted from the fall of foreign currency interest rates. In the first quarter, the foreign currency loan interest rates increased by 0.4 percentage points.

The analysis of maturity structure showed reduction of both long-term and short-term loans to the corporate sector, while the group of doubtful and contested claims increased. In the previous quarter, the growth of total corporate

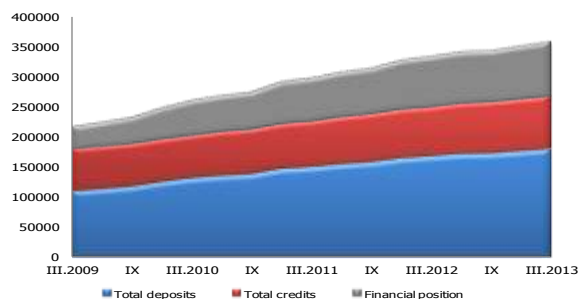
⁷⁴ It is defined only in terms of deposit and credit position of companies, without taking into account other components of their portfolios. Financial position represents the difference between the total corporate deposits and total corporate loans. If the difference is negative, the corporate sector is a debtor to the system, and if positive, it is a creditor in the system.



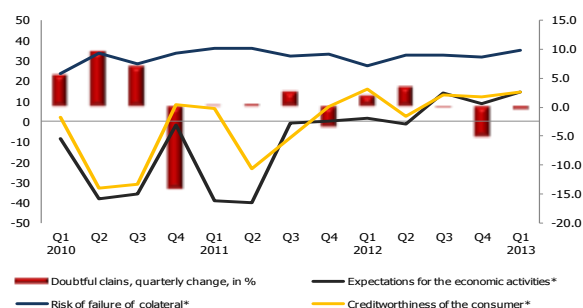
loans was entirely due to the increase of long-term loans. The analysis of currency structure shows that the rise of total loans to companies in the first quarter, results solely from foreign currency lending, unlike the previous quarter when they triggered the decline of total loans. Denar loans slightly declined on a quarterly basis, unlike the previous period when they increased.

In the first quarter of 2013, the growth of household loans equaled 1.1%, which comparing to the previous quarter, points to an acceleration of the quarterly growth (0.9% in the previous quarter). The positive trends in the labor market, employment growth and stability of net wages improved the financial position of the households⁷⁵ because of the stronger growth of the household deposits, and moderate growth of new debt. In terms of *supply*, according to the Lending Survey, the trend of generally unchanged terms of lending to households continues in the first quarter of 2013. However, compared with the previous period, the percentage of banks that indicate partially eased lending terms for loans for house purchase and other loans, decrease. Observing the factors that affect the terms of lending, most of the banks indicate that all factors mainly make the terms of lending remain unchanged. However, one third of the banks find the risk of inability to sell collateral to be a tightening factor of the lending terms. Analyzing the terms of lending, most banks generally consider them to be unchanged for both loans for house purchase and consumer loans. In terms of *demand*, majority of banks assess that the credit demand in the first quarter is unchanged, although there are an increasing number of banks that show reduced demand for all types of loans. Banks point to consumer confidence as a factor that contributes to the increase of demand, while loans from other banks reduce the demand for loans for house purchase and consumer loans. From the viewpoint of total cost of newly approved loans to households, it increased by 0.3 percentage points on a quarterly basis, unlike the decrease in the previous period, bringing the overall interest rate to 8.4%. This increase generally results from the rise of Denar interest rate.

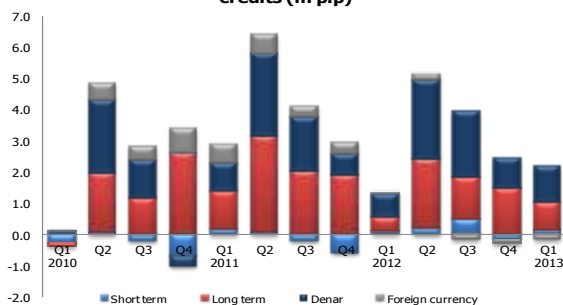
⁷⁵ Difference between total household deposits and total household loans. If the difference is negative, the household sector is a debtor to the system, and if positive, it is a creditor in the system.

**Financial position of the households (in million denars)**

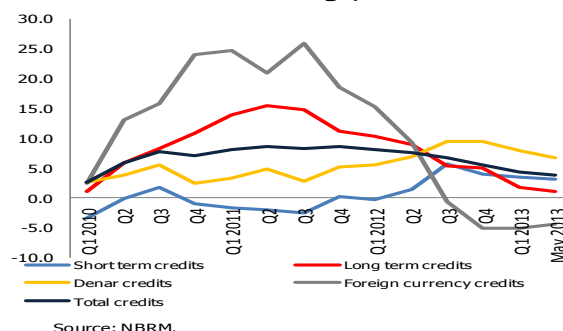
Source: NBRM.

Doubtful claims and risk perceptions of the banks

*Negative net-percentage-the influence of the factors is in direction of realizing the credit conditions, positive net-percentage-the influence of the factors is in direction of tightening of the credit conditions
Source: NBRM.

Contribution in quarterly change of household credits (in p.p)

Source: NBRM.

Total credits of the private sector, annual change, in %

Source: NBRM.

Analysis of the structure of loans to households shows that the growth of total loans in the first quarter of 2013 is mainly due to the growth of long-term loans, although their contribution to the growth of total loans slows down. These developments marginally increased the prevailing share of long-term loans in total loans from 71.7% to 71.8% on a quarterly basis. In terms of currency structure, the growth of loans to households is solely attributable to Denar loans, demonstrating a moderate acceleration of the growth on a quarterly basis. Foreign currency loans still reduce on a quarterly basis.

Analyzed on an annual basis, in March 2013, the credit growth of the domestic economy reached the lowest rate since the second quarter of 2010 and reduced to 4.3% (5.4% in December). The total credit to GDP ratio⁷⁶ is almost the same as in the previous three quarters (47.5%). The latest monetary data for the period April-May indicate a further slowdown of the annual growth rate of total loans, which in May equaled 3.7%. Loan/deposit ratio in May shows a strong increase and higher utilization of deposits, equaling 91.7%, versus 88.8% in March. Recent data indicate further deceleration of the annual growth of corporate loans, while household loans registered an accelerating annual increase.

Box 8: Relation between credit supply and demand and their effects on the overall credit activity

Credit movements are important drivers of economic trends in a country, largely influencing the directions of the monetary policy. In order to provide quality information on the banks' terms of lending and credit demand, since 2003, many central banks started conducting a quarterly Lending Survey. The qualitative responses from the Survey provide a better understanding of the banks' lending behavior and the role of loans in the monetary transmission mechanism. Most

⁷⁶Annualized nominal GDP, calculated as a moving sum of the respective four quarters.

European countries, the European Central Bank, the central banks of the U.S. and Japan conduct lending survey. The questions in the Survey are divided into two main categories: corporate loans and household loans. The banks provide assessments of the current and future trends in the terms of lending and the credit demand in each category, and the factors that influence their movement. This structure of survey provides a clearer picture of supply (as terms of lending) and demand on the credit market in a given period. The overall results for all survey questions are based on net-percent or diffusion index, commonly calculated as the difference between the optimistic and the pessimistic assessments of banks.

The results of the analysis, which uses data from lending surveys, aims to evaluate the quantitative relationship between credit supply and demand, as well as their effect on the overall credit activity is presented below. Hence, the analysis focuses exclusively on these three categories and therefore we use three indicators: *total net percentage of lending terms*, obtained as an average of the net percentages of terms of lending to companies and households, *total net percentage of credit demand*, obtained as an average of the total net percentage of credit demand by companies and households and *total loans in the country*.⁷⁷ The analysis mainly covers the period from early 2007 to mid 2012, with special attention given to the period of the peak of the global financial crisis from 2007 to 2009. The crisis directly influenced the banks' credit policies, on the one hand, and the financial positions of companies and households, on another. Banks were forced to make prudent credit policies, with solvency and security being their top priorities. Yet, given the increased vulnerability of the real sector and the weakening of the financial markets, many of the loans were used to address liquidity problems and for debt restructuring. In addition, some borrowers found themselves in default. Accordingly, the quality of credit portfolios deteriorated, making the banks shy away from approving loans. The impact of financial crisis on the banks' behavior is presented in the ECB study⁷⁸, which states that changes in the terms of lending are becoming important driver of credit growth during the crisis, and the liquidity position of the banks and the need to funding slow down the credit growth in this period, unlike before. This was the case with the banks in our country, as well. Namely, even though Macedonia, compared with other countries, was not directly hit by the financial crisis, yet it affected the real sector, and indirectly, the banking sector.

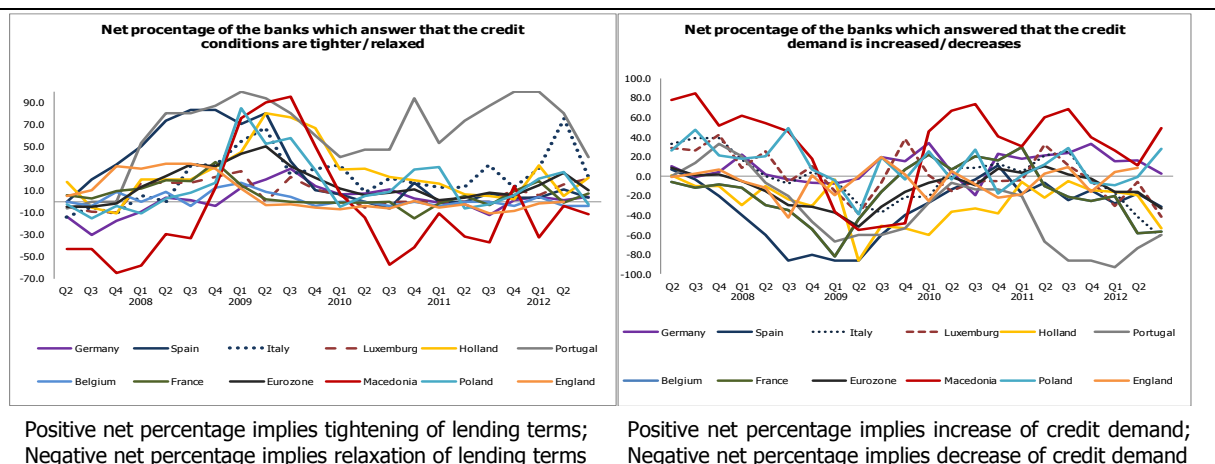
Impact of credit supply on the credit demand

In the first part, we assess the impact of the credit supply (as terms of lending) on the credit demand, according to the information received from lending surveys in several countries⁷⁹ analyzed for the period from the first quarter of 2007 to the second quarter of 2012. The descriptive analysis shows a similar trajectory of credit supply and credit demand, indicating that the changes in the lending terms of the current quarter are accompanied by the changes in the movements of credit demand as early as the next quarter. However, it is worth mentioning that this is a heterogeneous group of countries, where data should be analyzed with certain reservation, considering that each country stands out with its special features.

⁷⁷ Net percentages are taken from the lending surveys of individual countries, using websites of central banks and of the European Central Bank. The amounts of total loans are mostly taken from Eurostat, with the exception of Macedonia.

⁷⁸ The impact of supply constraints on bank lending in the euro area crisis induced crunching?, WP No 1262, ECB, November 2010.

⁷⁹ Austria, Albania, England, Belgium, Germany, Ireland, Italy, Luxembourg, Macedonia, Norway, Poland, Portugal, Hungary, France, the Netherlands, Spain, ECB, FED.



Data from the surveys show that banks began gradually tightening the terms of lending in mid-2007, with the greatest strain being noticed at the end of 2008, when the financial crisis burst out (bankruptcy of one of the largest investment banks in the U.S. - Lehman Brothers Holding Inc. in September 2008). Severe tightening of lending terms also weakened the credit demand. The credit demand in most countries registered the steepest drop at the beginning of 2009, one to two quarters after the greatest tightening of lending policy by the banks. However, in the aftermath, the gradual reduction of intensity of the financial crisis in the European countries because of the numerous measures implemented by the monetary and fiscal authorities directly influenced the movements of both credit supply and demand. Thus, in the period from late 2009 until early 2011, the terms of lending were tightened with less intensity, while the credit demand was unstable. Some countries in certain periods reported modest easing of the lending terms. In the second half of 2011, with the resurgence of the debt issues of several European countries, the banks' risk perceptions deteriorated again, with some of the banks facing financial constraints from their parent banks. Therefore, the terms of lending further tightened and the credit demand dropped. In the first half of 2012, the credit market developments partially stabilized. Macedonia is exception to these trends. In fact, in early 2010, Macedonia reported a net easing of the lending terms because of the changes in the terms of lending to households.

Besides visual assessment of data, there has been an attempt to make an empirical estimation of the impact of lending terms on the credit demand for a given group of countries⁸⁰ for the period from the second quarter of 2003 to the second quarter of 2012, using the panel⁸¹-estimation method. In order to make the comparability level between countries higher, only one data source has been used here, i.e. the common database of the ECB that hosts the results of lending surveys of a group of countries in the euro area (the descriptive analysis uses websites of each central bank). The panel-assessment shows that 1 percentage point tightening of lending terms in a given quarter slows down the credit demand by 0.78 percentage points in the next quarter.

Table 1
Explanation of variables used

variables	definitions	calculations
CRED_STAND	total credit conditions	average of total credit conditions of households and enterprises
CRED_DEM	total credit demand	average of total credit demand of households and enterprises
CRED_VOL	total credits	total credits on the end of period

⁸⁰ Given the need for a lengthy series of data, and identical calculation of the net percentage, the panel-estimation used smaller group of countries: Germany, Spain, Italy, Luxembourg, the Netherlands, Portugal, Belgium, France, Macedonia.

⁸¹ An unbalanced panel is used, because the series of data from surveys in individual countries have different starting date.

Table 2

Impact of lending terms on credit demand (period 2003-2012)

Dependent Variable: CRED_DEM/100

Method: Panel Least Squares

Sample (adjusted): 2003Q2 2012Q2

Total panel (unbalanced) observations: 320

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.077	0.012	6.278	0
CRED_STAND(-1)/100	-0.780	0.045	-17.364	0

If the analyzed period is divided into two sub-periods, one can determine that the impact of the terms of lending on the credit demand is more intensive during the financial crisis. Namely, under the same assumption that the lending terms will tighten by 1 percentage point, the credit demand in the next quarter before the crisis would decelerate by 0.62 percentage points (in the pre-crisis period, from the second quarter of 2003 to the second quarter of 2008) while during the crisis, this indicator would increase to 0.75 percentage points (for the period from the third quarter of 2008 to the second quarter of 2012). These results are expected, given that the financial crisis has increased the sensitivity of financial market participants. The companies and households were forced to follow closely the developments on financial markets, due to the losses they suffered during the global financial crisis. Accordingly, it is expected that they will quickly respond to signals from banks in order to protect better their financial positions.

Table 3

Impact of lending terms on credit demand (prior and after the financial crisis)

Dependent Variable: CRED_DEM/100

Method: Panel Least Squares

Sample (adjusted): 2003Q2 2008Q2

Total panel (unbalanced) observations: 176

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.106	0.012	8.557	0
CRED_STAND(-1)/100	-0.618	0.070	-8.825	0

Dependent Variable: CRED_DEM/100

Method: Panel Least Squares

Sample: 2008Q3 2012Q2

Total panel (balanced) observations: 144

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.028	0.024	1.200	0.232
CRED_STAND(-1)/100	-0.747	0.075	-9.975	0.000

Impact of lending terms and credit demand on credit growth

Given that credit trends are determined by the joint effect of factors on the supply side and the credit demand, in the second part, we analyze the conditionality of total loans by the terms of lending and the demand based on data obtained from surveys. Thus, tightened terms of lending tend to reduce or decelerate credit growth, while improved credit demand contributes to faster credit growth. Moreover, in this part of the analysis, an attempt has been made to assess the effects of lending terms and the credit demand on total loans, using the panel-estimation method⁸². According to the results, the lending terms affect the overall credit growth, with a certain time lag of four quarters. On the other hand, the transmission of the effects of changes in the credit demand is faster, while the impact on the overall credit growth occurs in the next quarter.

According to the panel-estimation of the period from the second quarter of 2003 to the second quarter of 2012, when the lending terms tighten by 1 percentage point in the current quarter, total loans decelerate by 0.02 percentage points in 9 to 12 months. On the other hand, if credit demand increases by 1 percentage point in the current quarter, the next quarter, total loans increase by 0.01 percentage point. A similar study⁸³ was done by the ECB in order to determine the interdependence of lending terms and credit demand to total loans, based on data from lending surveys of the European countries. The results are similar to those received. Thus, according to the analysis of ECB, 1 percentage point tightening of the terms of lending (specifically to companies)

⁸² See footnote 81.

⁸³ The Euro Area Bank lending survey matters, empirical evidence for credit and output growth, Working Paper Series No. 1160, February 2010, ECB.

tends to reduce the total loans by 0.023 percentage point after four quarters. On the other hand, if the credit demand increases by 1 percentage point, the total credits would increase by 0.018 percentage points in the next quarter.

Table 4

Impact of lending terms and credit demand on total loans

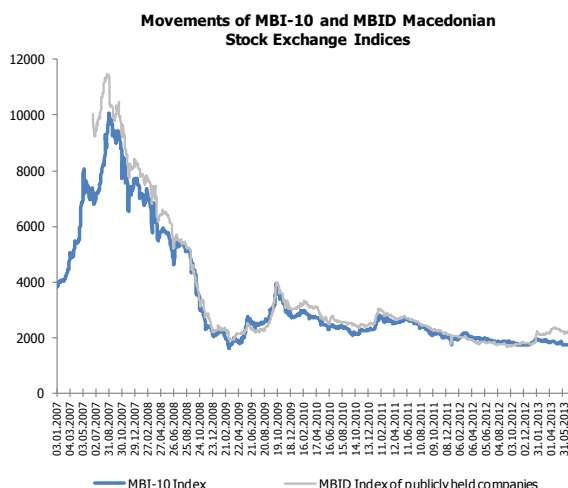
Dependent Variable: D(LOG(CRED_VOL))				
Method: Panel Least Squares				
Sample (adjusted): 2004Q1 2012Q2				
Total panel (unbalanced) observations: 293				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.018	0.00	13.01	0
CRED_STAND(-4)/100	-0.018	0.01	-3.24	0
CRED_DEM(-1)/100	0.013	0.00	2.61	0

The analysis leads us to the conclusion that lending surveys generally represent good indicators of the interdependence between the lending terms and the credit demand, and their mutual impact on the total loans. Thus, information from lending surveys suggest that the transmission channel between lending terms and the credit demand is very short, that they follow each other with a distance of one to two quarters, whereas this relationship is stronger after the financial crisis. At the same time, terms of lending and credit demand condition the development of total loans, with the impact of the credit demand being faster than the impact of the terms of lending. Thus, we can conclude that while each country stands out with its own unique, lending surveys represent a solid basis for defining the relationships on the credit market and for making assumptions about future trends in loans.

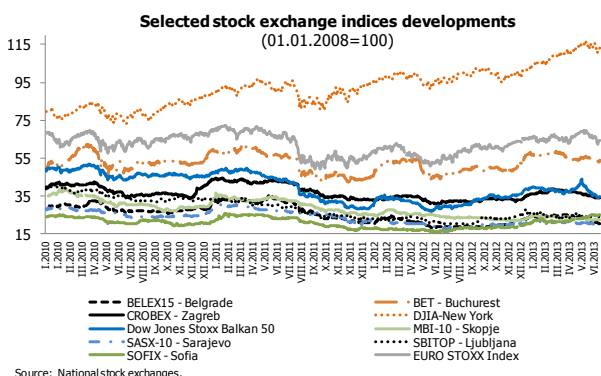
III. Stock indices and real estate prices

After the quarterly increase of the Macedonian Stock Exchange Index, MBI-10, in the first quarter of the year, in the second quarter, the index has returned to the zone of negative growth. MBID index followed a similar trajectory, while the value of OBM index continued increasing moderately on a quarterly basis. In the same period, similar to the domestic capital market, the regional stock indices were generally moving downward, amid weaker than expected economic performance of the euro area and China and uncertainty about global growth. An exception to this trajectory are the indices of Sofia, Ljubljana and Budapest stock exchanges, whose value surged amid more favorable expectations of investors given the acceleration of Bulgarian and Hungarian economy and the growth of trade surplus of Slovenia and Hungary. Real estate prices on the domestic market decline for the fifth consecutive quarter on an annual basis. It is considered that these trends on the real estate market are a combined effect of factors on the supply and demand sides.

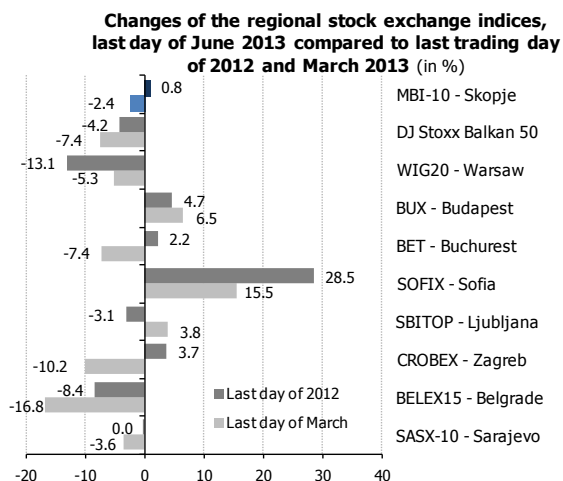
During the second quarter of 2013, the Macedonian Stock Exchange Index, MBI-10 registered a quarterly decline of 2.6%. This index follows the downward trajectory since the end of January, when it reached its peak for this year. Analyzing the months of the quarter, the index followed a downward trajectory in the first two months of the quarter, while in June it rose. The quarterly decrease of MBI-10, despite the



pessimism of investors, the adverse global economic environment and absence of foreign institutional investors in the stock exchange, can also be explained by the abstinence of investors before the mandatory listing⁸⁴ of companies, which is expected to galvanize the activities on the Macedonian Stock Exchange. Observing annually, at the end of June, MBI-10 was lower by 6.1%. The value of this stock index has followed a trend of annual decline since the second half of 2008 (with the exception of a few periods of recovery), given the anemic economic activity and risk aversion of investors. The index of publicly owned companies (MBID) declined slightly, and at the end of June, it was virtually unchanged (down 0.1%) compared to the end of March 2013, while on an annual basis, it grew by 17.6%. Only the bonds index (OMB) soared on both quarterly and annual basis by 0.4% and 1.3%, respectively.



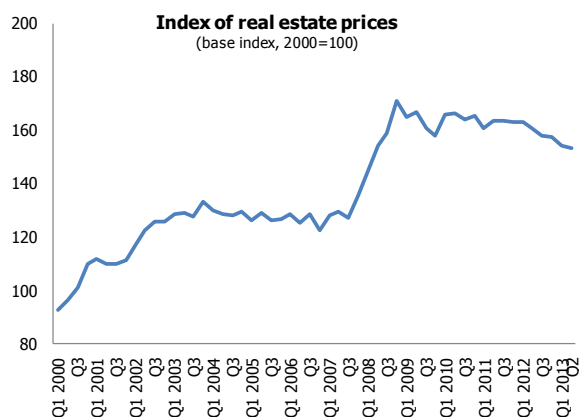
During the second quarter of 2013, the regional stock indices mainly moved downward, with the exception of some indices, whose value increased. Unfavorable movements of most regional indices are partly a reflection of the deepening recession in the euro area, and slight deterioration of the conditions on the U.S. labor market in May 2013, after the steady improvement since February this year. The data from May showing a weak economic performance of the euro area and China had a negative impact on the confidence in the region and on the regional stock indices. A similar effect in the second quarter was observed by the ECB's decision to cut policy rate again, and the Fed's announcement of possible gradual reduction of its stimulating measures, depending on the forecasts for the labor market and inflation. These announcements, as interpreted by the markets as a contraction of monetary policy, rather than as a gradual reduction of monetary stimulus, had an effect on the world stock markets. Against this background, the indices on Zagreb, Belgrade, Bucharest and Sarajevo Stock Exchange markets declined, with the most pronounced being the downtrend of the Zagreb Stock Exchange index. On other markets, the index registered a positive trend, on average,



⁸⁴ In accordance with the amendments to the Law on Securities of January 2013, new rules for listing on the stock exchange came into force in March this year, introducing a new market sub segment on the official market of the Stock Exchange - Mandatory Listing, where the aforementioned amendments require listing of securities not currently listed on the official market and whose issuers meet the criteria. As of July 1, 2013, shares of 76 companies were listed on the sub segment of Mandatory Listing.



with the fastest growth being recorded by the Budapest Stock Exchange index.



Source: calculations by the employees of the NBRM based on the data from the daily newspapers.

The decrease of real estate prices that began in the second quarter of last year, continued in the second quarter of 2013. The apartment price index⁸⁵ has slowed down by 0.5% on a quarterly basis, which contributed to a slight deceleration of the decline on an annual basis (decline of 4.7% versus 5.5% in the first quarter of 2013). In conditions of annual growth of construction costs in 2011 (according to the construction cost index⁸⁶), the prolonged downward trend in the apartment prices can be explained by the higher supply on the real estate market. The high supply reflects the high annual growth of construction of residential buildings in the first quarter (real annual growth of 136.8%, stimulated by foreign investments), after the 18.2% decline of construction, in real terms, during 2012. The lower number of issued construction licenses in the first four months of the year, compared to last year, also suggests relatively high supply. Analyzing demand indicators, loans for house purchase continued growing in the first five months of 2013, at a moderate pace.

IV. Current situation and implications for the monetary policy

This section of the Report aims to provide an overview of recent macroeconomic data and to make a comparison of these achievements relative to macroeconomic projections made in April 2013. The comparison refers to the latest developments in domestic variables, as well as changes in the external environment assumptions. This shows the extent to which the current situation in the economy corresponds to the expected movements of the variables in the previous projection cycle and how the changes in assumptions affect the environment of conducting monetary policy.

In the period since the April projections, the key macroeconomic parameters in the domestic economy generally moved in line with expectations. The performances in the first quarter and the available data for the second quarter point to maintenance of the economy within the zone of solid annual growth as projected, with more pronounced risks in the export-based segment of the metal industry. Credit support is as expected, but risks remain downward. Inflation performance and the balance of currently assessed risks indicate that the April projections for inflation are appropriate and foreign reserves are at an

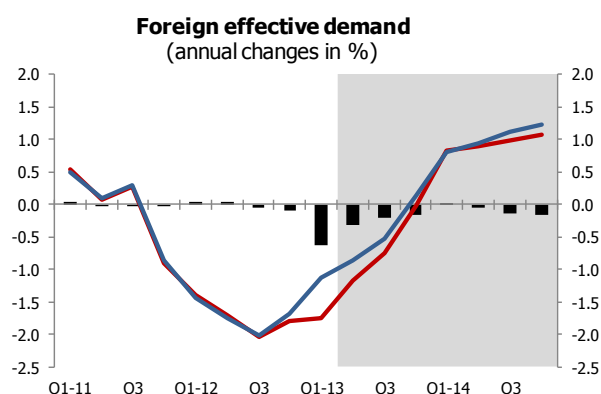
⁸⁵ Hedonic Apartment Price Index prepared by the NBRM on the basis of notices of sales in the capital city, published by agencies dealing with trade in real estate. The price of apartment is a function of its size, neighborhood, floor, whether the apartment has central heating and year of construction.

⁸⁶ Source: Construction cost index for new residential buildings, SSO.

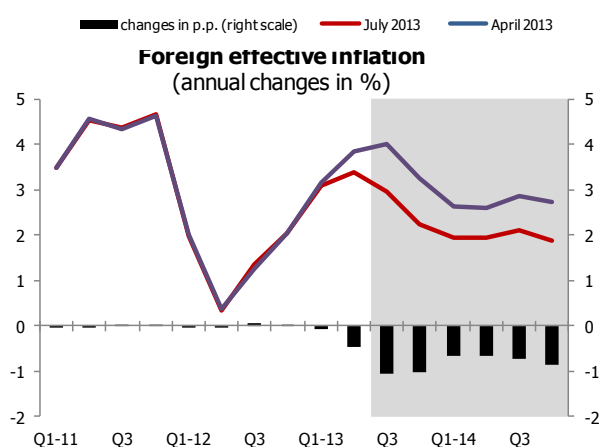


adequate level. In addition, in the meantime, there were no significant changes in the projections for global economic prospects. Recent expectations indicate unsatisfactory foreign effective demand for Macedonian products, weaker conjuncture of metal prices, and lower inflationary pressures through import prices of energy compared to the April projections. Given that during the quarter, the key risks were located in the external sector and lending activity, monetary measures for their mitigation were taken in July. These measures, underpinned by information on further maintenance of macroeconomic indicators within the projections, opened room for further monetary easing by lowering the policy rate, thus hitting record low.

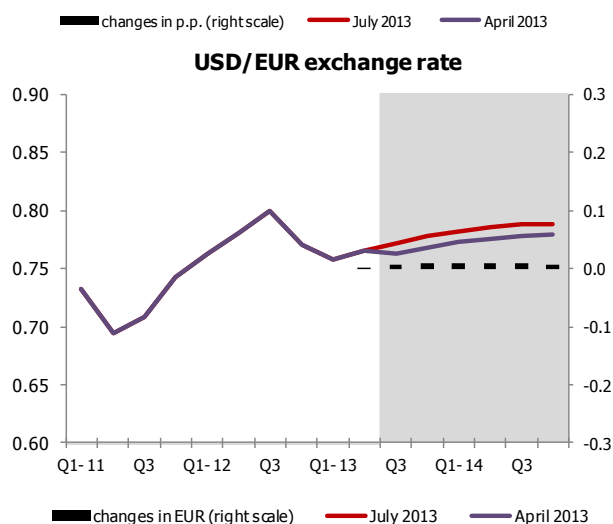
4.1. Assumptions about the external environment



The latest projections⁸⁷ for global economic trends indicate weakened global economic activity in 2013, amid slower growth of key emerging economies and prolonged recession in the euro area. In 2014, the expectations for strengthening of global economic growth continue, but at a slower pace than projected in April. Such expectations appropriately affect the assumptions about the external economic environment of the Macedonian economy⁸⁸.



The current expectations for 0.9% decrease of foreign effective demand in 2013 are moderately worse than the expected 0.6% fall in the April projection. The more negative assessment results from the downward changes of expected economic growth in almost all of our most important trading partners, with the highest contribution being made by the downward correction for Germany and Italy. On the other hand, the current projection suggests no changes in the recovery of foreign effective demand in 2014, whose growth is expected to be 1%.

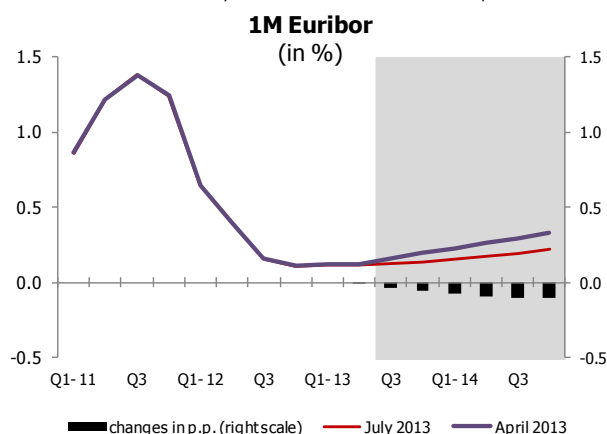
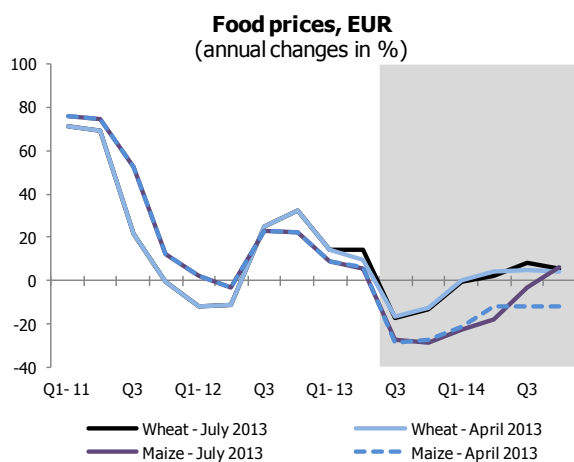
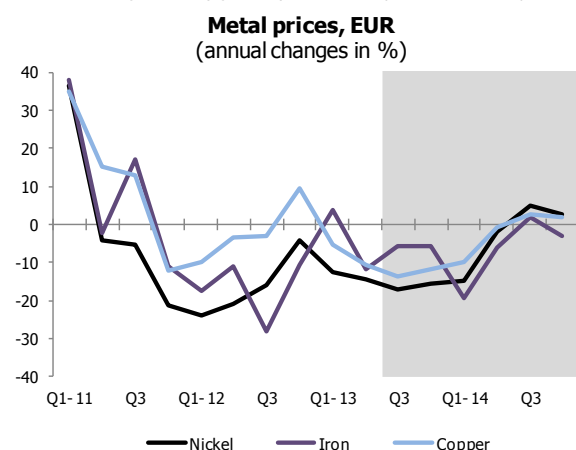
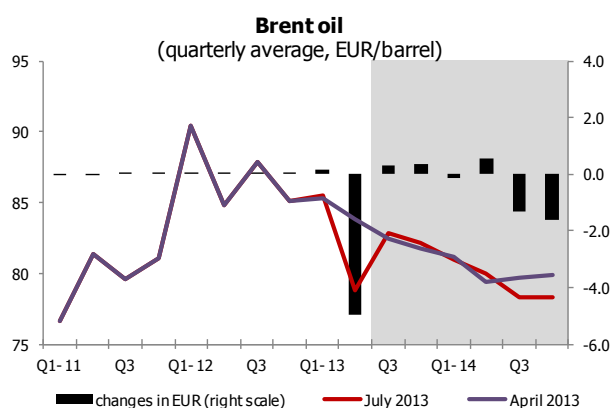


According to the latest data, in 2013, the pressures from import prices measured by the foreign effective inflation will be lower than those projected in April. Thus, the current assessment of 2.9% inflation this year is moderately lower compared with the April projection of 3.6%, which is largely explained by the lower projections for inflation⁸⁹ in Serbia and expectations for deflation rather than inflation in Greece. Similarly, the expected foreign inflation for 2014 was downwardly adjusted at 2% rather than at 2.7%, as previously projected.

⁸⁷ Updating of the IMF World Economic Outlook, July 2013.

⁸⁸ 22 July 2013 is the cut-off date for external assumptions.

⁸⁹ Inflation adjusted for the effects of the exchange rate.



In 2013, the **depreciation of U.S. Dollar against the Euro is expected to be slightly lower**, compared with a previous projection (1.3% instead of 1.9%), while in 2014, the U.S. Dollar is expected to appreciate more than the appreciation expected in the April projection (2.3% instead of 1.7%).

In 2013, the oil price is expected to decline moderately faster than projected in April. This forecast includes the lower prices registered in the second quarter of the year and the expected adverse movements in fundamental factors (still suppressed demand and solid supply). Hence, in 2013, the average oil price will be Euro 82.3 per barrel, while in 2014, it is expected to be further reduced to Euro 79.4. Observing the relative changes, now it is expected that in 2013 and 2014, the price will decrease by 5.4% and 3.5% respectively, versus the April projections of decrease of 4.3% and 4%, respectively.

In 2013, metal prices were subject to downward revision compared with the April projection. This change mainly reflects the expected slower growth of Chinese economy and excess quantity of metals produced and supplied on the global market. Analyzed by metal, prices of nickel and copper will register twice as fast decline in 2013, while prices of iron will fall rather than rise as projected in April. Less favorable movements in the prices of metals are projected for 2014, so it is expected that on an annual basis, they will remain in the zone of negative growth.

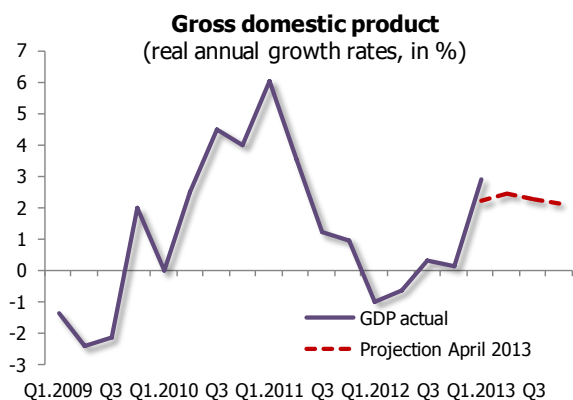
It is expected that the **price of wheat** in 2013 will fall at slightly slower pace compared with the previous forecast, while the **price of maize** will drop at the same pace as projected in April. The main price reduction factor is the existence of sufficient supply of cereals globally. On the other hand, in 2014, expected price changes were subject to upward revision, compared with the April projection, resulting in expectations for slightly faster rise of wheat prices and moderately slower decline of maize prices.

The **one-month EURIBOR** is revised downward for 2013 and 2014. This revision follows the announcement of a lower than expected economic performance in the euro area at the beginning of the year and the additional relaxation of the ECB interest rate policy in the second quarter. The current projection includes slower

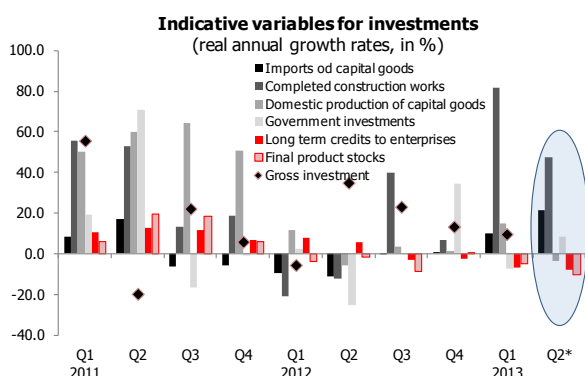


growth of foreign interest rate, compared with April expectations.

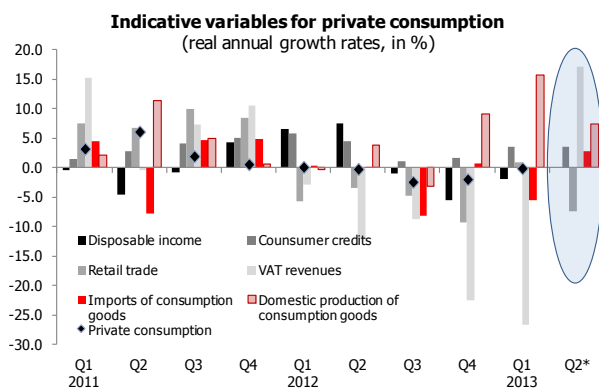
4.2. Performances and effects on the environment for conducting monetary policy



Source: SSO and NBRM projections.



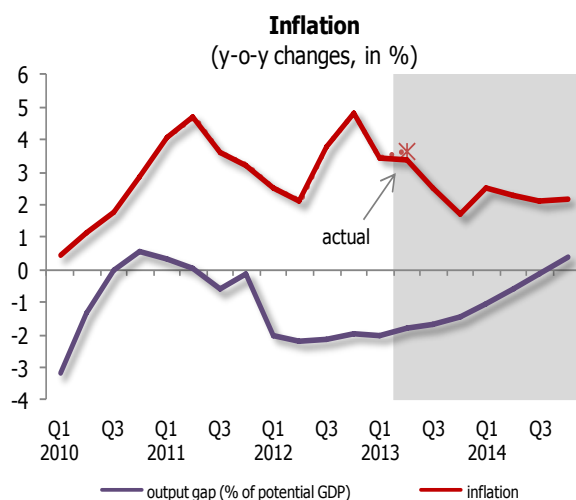
*Average of available monthly data in Q2.2013.
Source: SSO and NBRM calculations.



*Average of available monthly data in Q2.2013.
Source: SSO and NBRM calculations.

The 2.9% **acceleration of economic activity** in the first quarter of 2013 was slightly faster than that projected in April, with positive deviations in both domestic demand and net exports. Deviations in the domestic demand are due primarily to the favorable performances of investments, as well as personal consumption that registered a lower rate of decline than expected (higher than expected growth of the number of employees). The positive deviation in net exports arises from the steeper decline of imports than expected, given the weaker performance of exports than expected.

Available high frequency data for the second quarter of 2013 point to a continuation of the growth pace, which is **within the April projection**. Observing the individual components of domestic demand, the recent high frequency data on **household consumption** are consistent with the expectations for its recovery. This is confirmed by the slower decline of real wages and rapid growth of pensions, as well as by the further banks' credit support to the household sector. Available **investment** indicators also point to a positive growth rate, which is consistent with the April projection, but it is expected to slow down. With regard to individual indicators, an increase was registered in imports of investment goods and government capital investments that recorded a positive growth rate after the drop in the previous quarter. On the other hand, the slower growth of construction activity and the faster decline of long-term lending to the corporate sector point to a slowdown of investments. Data on **export demand** suggests stronger growth than expected, given the more intensive industrial production taking into account the better utilization of industrial capacities. Despite the ongoing more favorable than expected performances of exports and private consumption, the available **imports** data suggest slightly lower performance than expected (a decrease rather than the expected growth). Hence, net exports are likely to make a positive contribution, given the better than expected performance of the trade balance. **Risks to the GDP projections** mainly arise from the still unfavorable global environment, which can have an adverse spillover effect on the domestic



factors, as well. Furthermore, given the downward revision of foreign effective demand and prices of metals, the external environment creates downward risks to the export-based sector, particularly the metal industry. As for the domestic factors, the upward risks would arise from the labor market through the faster increase of the number of employees, as perceived through the strengthened optimism about the number of employees reported in the surveys on business tendencies.

In the second quarter of 2013, the domestic inflation rate equaled 3.6%, as projected in April. However, the analysis of components points to some divergence from the expectations. Thus, there was a greater upward deviation in the food component, in terms of higher growth of prices of fresh fruits and vegetables than expected. In contrast, the energy component rose slower than expected, mainly due to the failure of the assumption of higher price of electricity in June⁹⁰, as well as the steeper decline of world oil prices than expected. Core inflation is also below the projection and is maintained at a relatively stable level, due to the absence of significant pressures from imported consumer prices and domestic demand. The recent external input assumptions for 2013 are divergent, namely, the foreign inflation and oil prices have been revised downward, the price of maize remained unchanged, and the price of wheat is slightly revised upward. **Risks** to future path of inflation, which is mainly associated with future movements of prices on the international markets and their spillover effect on domestic inflation are regarded as balanced. In addition, new risks have occurred since the April projection. Upward risks include the increase of excise duty on beer, alcoholic drinks and tobacco⁹¹, as well as the potential adverse effects on vegetables and industrial crops of the summer storms in late June, which hit several regions in the country. On the other hand, downward risks are associated with the decision to reduce the price of electricity, which came into

⁹⁰ April cycle of projections assumed a 10% monthly increase of electricity prices in June 2013. In contrast, the ERC decided to reduce the price of electricity by 4.48% for tariff customers, which took effect on 1 July.

⁹¹ With the announced amendments to the Law on Excise in effect since 1 July, beer excise duty increased from 3 to 4 denars per liter of alcohol level, and excise duty on pure alcohol increased from 300 to 340 denars per liter. Excise duty on cigarettes, cigars and cigarillos is projected to increase gradually over the next 10 years. Rates of specific and minimum excise duty on cigarettes will be increasing by 0.15 denars per piece, each year until 2015, and by 0.20 denars per piece each year until the end of 2023.



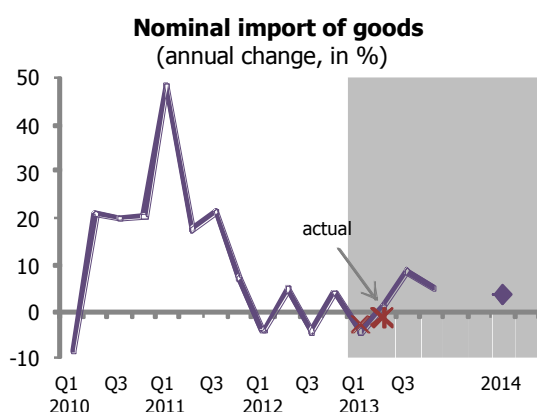
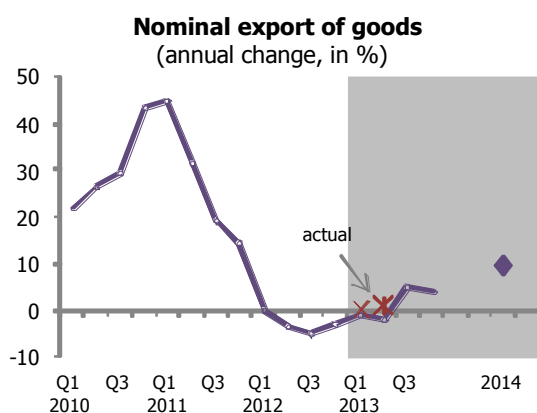
force on 1 July, the expected increase of domestic production of cereals amid favorable weather conditions for cultivating these crops.

In the first quarter, the external sector performances did not deviate significantly from the April projections. The current account registered a slightly higher deficit than expected for the first three months of the year. This is due to the trade deficit, which is higher than expected, and the slightly lower remittances, amid improved performance in services. Within the capital and financial account, the net inflows were higher than projected, largely due to the lower repayments of trade credits than projected.

In the second quarter, **the latest available data on the balance of payments** (April and May) indicate a higher **current account deficit** than expected, caused by the deterioration of services balance and the slightly lower inflows from transfers than expected. Income performances are as projected, and the trade deficit is lower than expected.

Improved performances in the trade balance are also confirmed by the latest high frequency data on **foreign trade**, as at June 2013. Both trade components improved relative to the April projection. On export side, almost all export categories improved their performance relative to the expectations. Export of iron and steel is an exception, where given the constant downward revisions (in the last three months) of metal prices, the export was lower than expected. Meanwhile, the second quarter registered lower import pressures than expected, mainly due to the energy performance. High frequency data on the **currency exchange market** in the second quarter, indicate no significant risks to the projection of current transfers.

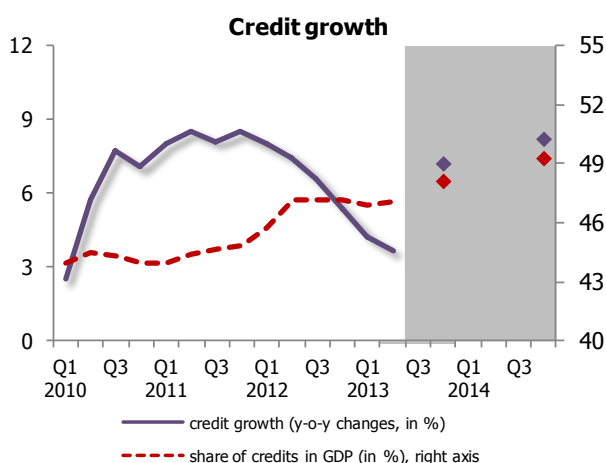
Recent developments in the **capital and financial account** (April-May) indicate slightly lower net inflows in the second quarter than expected, due to the higher than expected withdrawals in other sectors. On the other hand, analyzing the components, signs of improvement have been noticed in foreign direct investment, as well as financial loans and trade credits. However, since the trends in the categories of capital and financial account significantly vary, it is difficult to provide more precise assessment.





Recent external sector developments indicate no significant divergence from projections, which is proved by the **foreign reserves** whose level is slightly lower than projected for the second quarter. However, risks remain downward and associated with the worsening expectations for growth in the euro area, the reducing foreign demand and the lower metal prices.

The latest available monetary sector data as of the end of the second quarter indicate a credit growth of 3.7%, which according to the April projections, is expected to amount to 7.2% by the end of 2013. In the second quarter, total loans of banks were higher by 1.9% on a quarterly basis, unlike the previous three quarters when the quarterly growth rate swayed around 0.6%. However, the banks primarily provided credit support to the household sector, suggesting conservative banks' risks assessment of the corporate sector, which in turn, is a focal point for sustainable economic growth. Furthermore, the trends of lending in the second quarter partly reflect the seasonal effects, since the acceleration of the quarterly credit growth rate is almost typical for the second quarter. Hence, it can be concluded that **notwithstanding the favorable performance, there are still downward risks surrounding the credit growth projection.** Against the backdrop of still vulnerable economic recovery, both globally and domestically, factors such as banks' assessments of creditworthiness of their customers and the quality of offered projects, further changes in the quality of loan portfolio and conservative strategies of large banking groups present on the domestic market through their branches, will probably have the greatest impact on the dynamics of lending in the period ahead. The trends in the deposit base in the first half of the year suggest slightly weaker deposit growth than projected in April. Given the usual dynamics of deposit growth, in the second half of the year the inflow of deposits in the banking sector is expected to rise. However, weaker deposit performance as of the second quarter, further pronounced the downward risks to credit growth by year's end.



Generally speaking, not much has been changed in the environment for conducting monetary policy since April projections. The **external sector** is still considered to be stable, and the reserves adequacy indicators still confirm that foreign reserves level is sufficient to deal with sudden



shocks. **Economic activity** accelerated, following the projected path. As expected, no significant inflationary and import pressures have been noticed by the domestic demand and inflation is within expectations. The **lending activity** of banks follows the projected dynamics, but surrounded by downward risks, given the problems of some parent banks and the quality of corporate credit portfolio and deposit trends. Since April, the risks have varied. Namely, some of the risks emphasized in the April projections have become more pronounced. This is primarily attributable to the less favorable expectations of foreign demand and metal market conjuncture as potential negative risks to the external position of the economy and the future path of foreign reserves. On the other hand, the measures taken by the NBRM in July⁹² are expected to mitigate some of the external sector risks by making changes in the design of the reserve requirement instrument to encourage inflow of long-term foreign capital in the domestic economy, which would contribute to strengthening the external position. This is to mitigate a part of the risk to the lending activity as well. Namely, the inflows would increase the banks' funding sources, would act counter-cyclically and would support lending. At the same time, it is expected that these changes will reduce the risk of further narrowing the spread between yields on Denar and foreign exchange savings, and thus would tend to maintain the propensity to save in the denars. Amid mitigated risks in the economy and macroeconomic indicators that remained as projected, in July further monetary easing was made by reducing the policy rate from 3.5% to 3.25%, which would encourage credit growth and accordingly, spur economic activity.

⁹² Changes in the reserve requirement instrument are explained in detail in Box 4.