National Bank of the Republic of Macedonia

Quarterly Report
November 2016

Introduction

After the increase in the policy rate of 0.75 percentage points in the second quarter and the additional monetary measures, during the third quarter of 2016, the NBRM made no changes in the monetary policy. Economic fundamentals were assessed to be solid, amid absence of imbalances in the economy, but still present uncertainty, mainly associated with domestic political developments. In the third quarter, the expectations of economic agents stabilized, reflecting the absence of demand pressures on the foreign exchange market and purchase of foreign currency by the NBRM, as well as moderate growth of household savings in the banking system. The real economy indicators point to continued growth in economic activity in the third quarter at a rate similar to that in the first half of the year, amid stable price level in the economy and solid credit support from the banking sector. While the effects of the current domestic political instability on the economy and the behavior of economic agents are assessed as limited, uncertainty arising from the domestic environment remains high. Risks arising from the external environment are also unfavorable and attributable to the potentially lower global growth and growth of the European economy, reflecting the decision of the UK to exit the EU (Brexit) as well as the slower growth of the US economy, and still present geopolitical tensions.

The latest October cycle of macroeconomic forecast for the current and the next two years indicates certain deviations in the April baseline[1] macroeconomic scenario. These differences are mainly in the areas hit by the political instability in the second quarter that were not incorporated in the baseline forecast, but were highlighted in the April alternative scenario. However, the materialization of risks was lower than expected in the alternative scenario. Key assumptions embedded in the October forecast remain similar to those in April, i.e. there are similar assessments about the factors that will prevail in the macroeconomic landscape in the next period. Furthermore, the latest projections assume that the effects of the political instability have been exhausted and will have no significant effects in the following period. Hence, the changes between the two forecasts are mostly a result of past performances. Overall, the October macroeconomic scenario shows solid economic and credit growth, gradual strengthening of the deposit potential, absence of price pressures, and balance of payment position that ensures further increase of foreign reserves.

Changes were made in the expected movements of the key external environment indicators in the period between both projections. Foreign effective inflation for 2016 and 2017 has been revised downwards, and assessed to be relatively low, with expectations for moderate acceleration in 2018. Changes were also made in the **foreign effective demand**, i.e. the growth for 2016 is slightly higher (due to improved performances), while for 2017, the pace of growth will be moderately weaker than previously expected, in part reflecting the economic effects of the Brexit. Slight acceleration of the growth is forecasted for 2018, which is in line with the estimates of boost of economic activity in the major trade partners. Analyzing the **prices of primary commodities**, the prices of energy sources have been adjusted slightly upwards, while food prices have been generally adjusted downwards. Seen dynamically, despite the decline in 2016, the prices of these commodities for 2017 and 2018 are expected to increase. However, similar to the previous forecast cycle, the October expectations are that the environment of generally low prices on world markets will remain the same in the next two years.

The latest forecasts for growth of domestic economy for 2016 and 2017 have been shifted downwards from 3.5% and 4% to 2.3% and 3.5%, respectively, with expectations for faster growth rate to around 3.7% in 2018. The downward adjustment of the expected economic growth for 2016 and 2017 is in line with the performances in the first half of

[1] In the April cycle, two forecast scenarios were developed, baseline and alternative. The baseline scenario assumed a rapid stabilization of the political situation and absence of significant effects of the political crisis on the economy. The alternative scenario assumed a continuation of the crisis for a certain period and its effects on the economic trends, primarily through increased propensity to hold foreign currency, increased restraint of households from spending and increased restraint of domestic and foreign investors.

the year that are significantly lower than expected. Yet, despite such shifts, the domestic economy will keep on increasing at a rate faster than the growth in the trading partners, reflecting the specific structural factors of domestic growth, i.e. the activity of the new export-oriented facilities with foreign capital and public investments in road infrastructure. In such conditions and with assumptions for gradual improvement of the global environment, cumulatively, exports and investments are expected to be leading growth factors in the next two years, similar to the April forecast cycle. Dynamically speaking, export demand for 2017 and 2018 is forecasted to slow down, partly reflecting the high base effect in 2016 and the lower expected contribution of the activity of some new companies for the purposes of achieving high utilization levels. Besides exports, same as in the April forecast, the growth in the forecast horizon will be supported by investment activity whose contribution, although slightly lower than previously forecasted, remains solid. These movements are expected to prompt further growth of private consumption by increasing wages and employment in the private sector. The growth of domestic demand components and exports is expected to increase imports moderately. However, estimates show that the increase in imports will be in line with the fundamentals, and will not disrupt the external balance. **In 2017 and 2018, credit activity of the banking sector will be a supporting factor for the growth of private consumption and investment**, and amid solid economic growth, annual credit growth of around 6%-7% is expected for the next two years, similar to the April forecast. On the deposit side, there is a significant downward correction primarily for 2016, largely reflecting the downward adjustment of deposits in the second quarter, when we witnessed a materialization of some risks associated with the deteriorating political situation, highlighted in the alternative scenario within the April forecast cycle. Despite the stabilization of the general economic and political situation in the domestic economy, the slow pace of return of withdrawn deposits led to downward correction of the expected deposit growth to around 2.6% by the end of the year (compared to 6% in the April projection). However, in line with the stabilization of the expectations of economic entities and increased economic activity in the next year, there are expectations for gradual increase in the propensity to save, and return of the withdrawn funds to the banking system, and hence acceleration of the growth of deposit base (by 7.5% in 2017 and 2018).

Regarding the future price trajectory in the domestic economy, the latest forecasts suggest maintenance of environment of low prices and absence of significant inflationary pressures. In line with the slightly lower performances than forecasted in April, slight downward correction was made for 2016, and the inflation is expected to be 0% (unchanged price level), versus 0.5% in the April forecast. **The price growth will accelerate moderately in 2017 and 2018, and the expected rates of inflation will be 1.3% and around 2%, respectively.** These estimates reflect the price movements in the previous period, as well as the expected movement of import energy and food prices, and foreign effective inflation. Positive effect on inflation is also expected from the domestic demand, amid gradual strengthening of the economic activity, and output gap estimated to be moderately positive during the entire forecast horizon.

According to the latest estimates of the balance of payments, **current account deficit has undergone upward correction for 2016 and 2017.** These changes are mainly driven by the higher expected deficit in primary income. **Thus, the current account deficit for 2016 and 2017 is expected to be 2.1% and 2.3% of GDP, respectively (unlike the April forecasts for deficits of 1.2% and 1.4% of GDP, respectively).** Dynamically speaking, current account deficit for 2016 is expected to remain at the level of 2015. Foreign trade in goods and services still registers positive developments, aimed to narrow the deficit. These favorable developments result from the relatively low energy prices on world markets, which caused continuous narrowing of the energy deficit, and from the positive effects of the new export capacities in foreign ownership and good performances in services. Trade deficit in goods and services is expected to stagnate in 2017. Higher market prices of crude oil on world markets are expected to deteriorate trade, amid further positive developments in non-energy trade deficit and balance of services. Secondary income surplus is expected to be lower this year, reflecting the weaker performance in the second quarter of the year due to the events on the domestic political scene. Considering the assumption for depletion of the effects of political instability by the end of 2016, net inflows of private transfers are expected to recover in 2017. In summary, the planned increase in the primary income deficit, amid stagnation in the balance of goods and services, in spite of the growth of current transfers, **will slightly deepen the current account deficit for 2017 to 2.3% of GDP. In 2018, the current account deficit**

it expected to further increase to 2.6% of GDP. The present path and amount of current account deficit and its structure do not suggest major imbalances in the economy for the next three years. **Observing the financial account, these three years, the current account is expected to be financed by long-term non-debt and debt financial flows, i.e. mainly foreign direct investment and external borrowing of the public and private sector.** In the period 2016-2018, the current account deficit is expected to be fully covered by financial flows, which will additionally increase foreign reserves. During the entire forecast horizon, foreign reserves adequacy ratios have ranged within the safe zone.

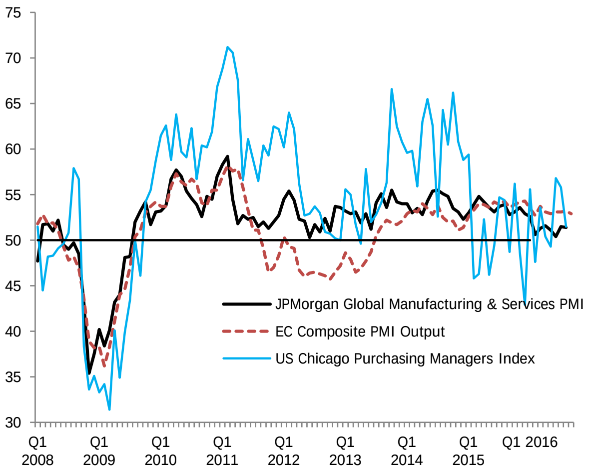
Within the April forecast cycle, an alternative macroeconomic scenario was also developed which assumed continuation of the political crisis, and hence significantly slower economic growth than forecasted with the baseline scenario, somewhat larger current account deficit, difficult access of the government and the private sector to new external borrowing and lower financial inflows. Between the two forecasts, some risks that were highlighted in the alternative scenario materialized. The worsened expectations of economic agents caused withdrawal of part of the savings from the banking system and increased preferences for foreign currency. Unstable political environment has probably influenced the domestic investment, taking into account the poor performance of gross capital formation and slower growth of economic activity in the first half of the year. **However, in general, the performance in the first nine months of the year points to more limited negative impact of the political crisis on the real economy than expected with the alternative scenario, both in terms of duration and transmission channels.** Notably, despite the worsened expectations of economic agents, in the first half of the year, the growth in consumer spending remained solid. After the implementation of measures by the National Bank at the beginning of May until the end of the second quarter, there was stabilization of the unfavorable movements in deposits and demand for foreign cash on the currency exchange market. Also, already in the third quarter, the NBRM intervened by purchasing foreign currency on the foreign exchange market, and along with the high external borrowing, replenished the foreign reserves. The situation in the external sector is also favorable compared to the alternative scenario, i.e. the flows of foreign direct investment are better than expected, and the external government borrowing is significantly higher than forecasted in the scenario.

Overall, recent developments suggest similar macroeconomic landscape as forecasted in April, with assessments for slightly slower, yet solid economic growth, absence of price pressures and balance of payment position that ensures maintenance of foreign reserves at an adequate level. Risks surrounding this macroeconomic scenario remain similar to those in April, and are mainly attributable to the uncertain domestic environment amid still unresolved political crisis, and negative risks of the external environment. Hence, the NBRM will continue to closely monitor the developments in the period ahead, and if appropriate, make adjustments to the monetary policy aimed at successful achievement of the monetary policy objectives.

1. Macroeconomic developments

1.1. International economic surrounding[2]

In the first half of 2016, the global economic growth was 2.9%, which is a slowdown compared to 2015, and a slower growth than expected. In October, the IMF announced the global economy forecasts, which show moderate recovery and growth of 3.1% and 3.4% for 2016 and 2017, respectively, which is a minimal downward revision relative to the April forecasts. Key reasons behind the downward correction of expectations are the somewhat weak recovery of the US economy than expected, and the Brexit, which helped to materialize one of the adverse risks to global growth. Although the market reaction to the Brexit so far is limited, there is uncertainty about future economic and institutional ties to the UK and the EU, which in the medium run could have negative economic consequences. Risks surrounding the global economy remain unfavorable and mainly related to the Brexit, the weak growth in advanced economies, economic performance of the Chinese economy, but also to the geopolitical risks. Global inflation is still low, whereby in a number of countries, inflation rates are below central banks' targets. The decrease in the base effect of oil price and the movements of market prices of primary commodities in recent period suggest possible upward pressures on the global inflation in the period ahead.



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

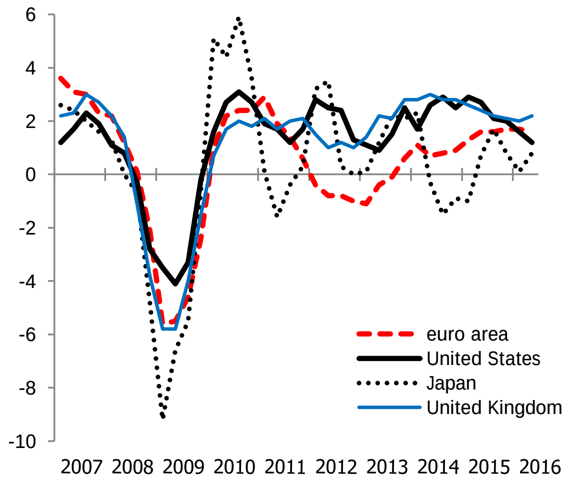
Global economic activity continued recovering in the second quarter of 2016, but more moderately. High-frequency survey indicators of economic activity - PMI[3] point to stable movements and moderate slowdown of growth of the global economy in the second quarter of 2016. Namely, in the period April - June 2016, the global composite PMI averaged 51.1 index points, which is lower than the last quarter and at a record low level since October 2015. In the third quarter of 2016, the index slightly increased, but the economic recovery is still fragile.

Observing developed economies, economic performance shows a slight slowdown of economic growth, except in the UK which reported positive trends in the pace of economic activity. The first signs of a slowdown as a result of the Brexit are expected in the third quarter of 2016. After the solid performance of the US economy in the first quarter of 2016, in the second quarter, the growth slowed down, primarily due to the

[2] The analysis is based on the IMF's *World Economic Outlook* of July 2015, the ECB's *Economic Bulletin*, the announcements of *Markit Economics*, the World Bank's *Global Economic Prospects*, Bloomberg, *Roubini Global Economics* and *Capital Economics* reports, the monthly reports of the International Energy Agency and the weekly reports of the Bank of Greece.

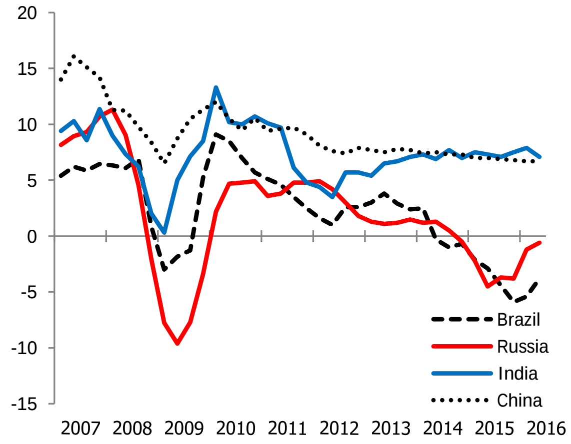
[3] PMI (Purchasing Manager's Index) is based on surveys of a representative sample of companies from the manufacturing and service sectors, and are often used as high frequency indicators for the current and future economic activity.

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

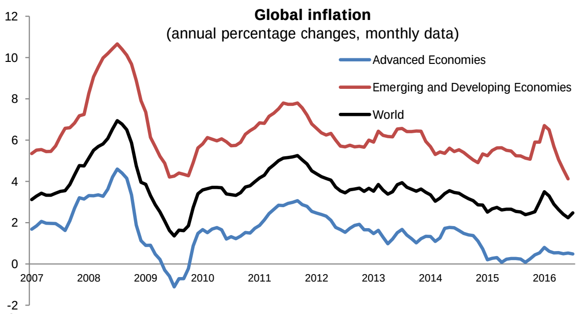


Source: OECD.

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



Source: OECD and IMF.



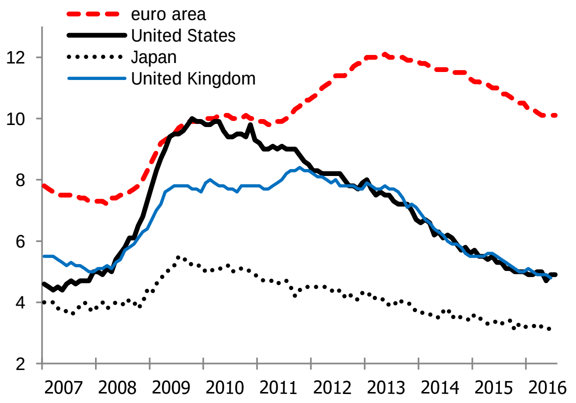
Source: IMF.

decrease in investment activity, especially in the energy sector. On a quarterly basis, minimal slowdown is registered in the Japanese economy, and the euro area. **As in the previous quarter, in the second quarter of 2016, the economic performance of emerging and developing economies is divergent**, which partly reflects the different impact of the movements in world prices of primary commodities on exporting and importing countries. The growth of the Chinese economy was at the same level as in the previous quarter, supported by low energy prices and relatively stable demand of developed countries. The Brazilian economy still faces challenges of low prices of primary commodities and political instability, while Russian economy shows signs of recovery.

Risks concerning global growth in the next period are mainly unfavorable and mostly related to the uncertainty about the effects of the Brexit, the lower growth of the US economy, as well as the developments in the emerging economies on the European and the global economy. In the long run, one of the key adverse risks is the risk of so-called secular stagnation as a result of the lingering low demand environment, which could lead to sustained lower growth and lower inflation. Low inflation in turn can shake inflation expectations, increase real interest rates and accordingly, decrease propensity for new investments. Also, the trend of establishing protectionist policies hots up, thus increasing uncertainty in the global economy. The relatively lower growth of China is also one of the major adverse risks, complemented by the recession in some other emerging economies. Moreover, risk factors for the global growth in the next period include geopolitical risks associated with the developments in the Middle East and refugee crisis, i.e. the threat of terrorist attacks, as well as the effects of the potential change of the central banks' monetary policy on the financial markets.

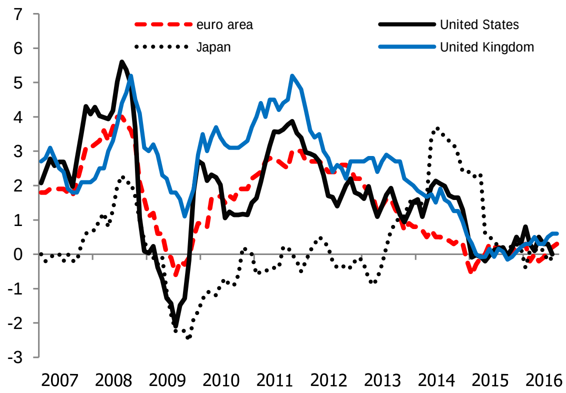
Available data show moderate slowdown of global inflation in the second quarter of 2016, present both in developed and in emerging economies and developing countries. The average annual global inflation was 2.4% in the second quarter (3.2% in the first quarter). Besides the lower oil price, low inflation also reflects the relatively low prices of primary non-energy commodities.

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



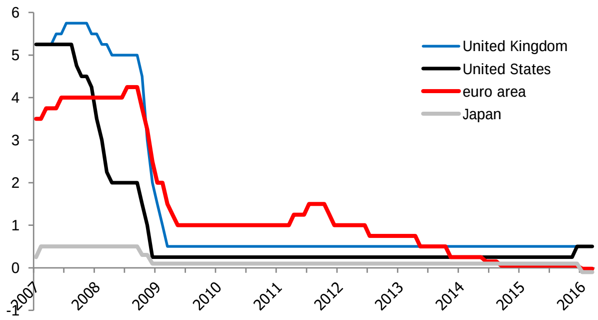
Source: Eurostat.

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



Source: Eurostat and national statistical offices.

Policy rates in advanced economies
(in %)



Source: Central banks.

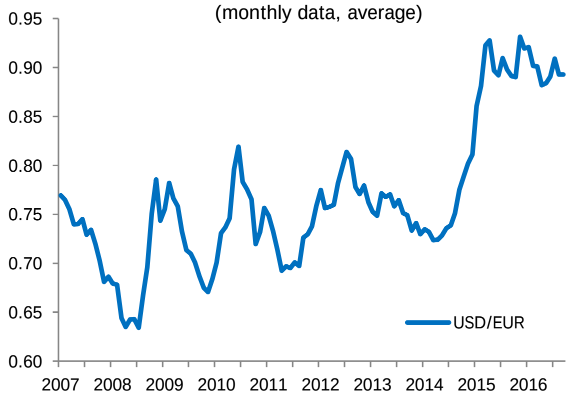
Food prices have a moderately positive impact. According to the latest estimates, since the end of 2016, there are possibility of moderate inflationary pressures, especially after the decline in the base effect of low energy price, and the possibility of increase in oil price on the global stock markets.

In the second quarter of 2016, economic activity in the euro area continued to recover, but more moderately compared to the previous quarter. The real quarterly GDP growth was 0.3%, and on annual basis, it was 1.6% (compared with 0.5% and 1.7% in the previous quarter, respectively). During this period, the growth was mainly supported by net exports and to a lesser extent, by private consumption. In the past, the growth of private consumption was supported by the higher purchasing power of households, primarily due to the favorable labor market developments, low oil prices, as well as easing of the monetary policy by the ECB. The unemployment rate in July 2016 further reduced to 10.1%, the lowest level since mid-2011. Yet, the unemployment rate has been declining slowly, so it is estimated that it requires a longer period to reinstate to the pre-crisis levels. Unlike the previous two quarters, when gross capital formation made relatively high positive contribution to the growth, in the second quarter of 2016, it reduced, primarily due to the reduced construction activity. Analyzing individual economies, the economic growth in the second quarter of 2016 was slightly higher than the growth in the first quarter in Germany, the Netherlands and Spain, while Italy and France reported almost the same growth as in the previous quarter.

In the third quarter of 2016, the inflation in the euro area remained low and far below the targeted rate of 2%. Namely, in the period July-August 2016, the average annual inflation was 0.2%, which is still an increase, compared to the first quarter of 2016, when it stood at -0.1%. Such performance results mainly from the energy component of the index (-6.1% for the period July-August, which is actual slowdown of the decrease), while core inflation grew by 0.9% in this period. Thus by the end of 2016, the base effect of the low price of primary products was expected to reduce, and accordingly, the rate of inflation to rise.

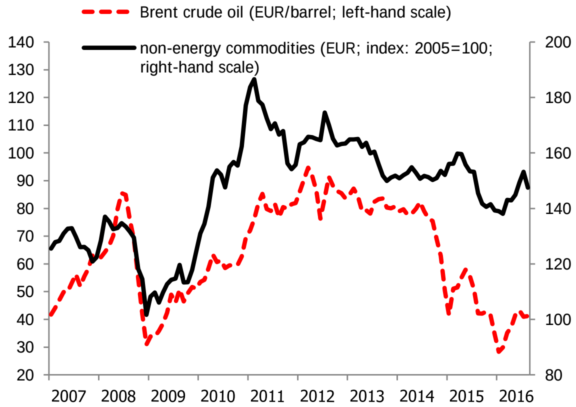
In the third quarter of 2016,

USD/EUR Exchange rate
(monthly data, average)



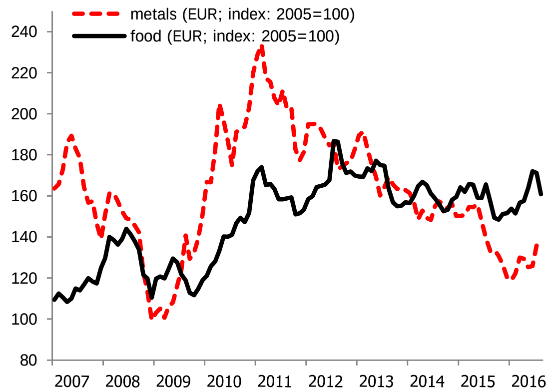
Source: Eurostat.

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



Source: IMF monthly database.

Prices of food and metals
(monthly data)



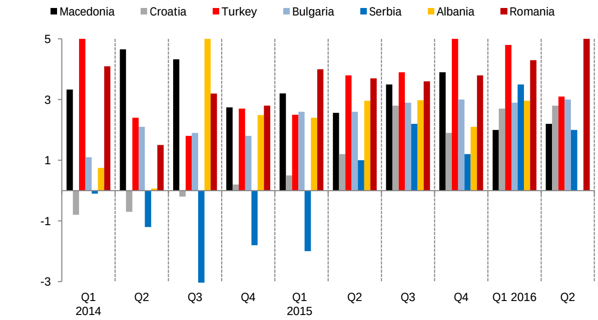
Source: IMF monthly database.

central banks of developed countries continued implementing accommodative monetary policy. After Brexit, Bank of England made significant changes to the monetary policy, and Japan made changes to the monetary setup. Namely, in the regular meeting in August, the Bank of England's Monetary Policy Committee took several measures to support growth and achieve inflationary target. The set of measures is aimed at further easing of monetary policy by cutting the policy rate by 25 basis points to 0.25%, and by increasing the amount of securities purchased by the central bank. The measures of the Bank of Japan were aimed the same target. The European Central Bank and the Fed made no changes to the monetary policy setup.

The movements of the nominal exchange rate of the US dollar against the euro in the third quarter of 2016 were relatively stable. In the period from July to September 2016, the US dollar appreciated by 1.4% compared to the second quarter of 2016. Annually, the US dollar against the euro remained at the approximately same level, and in August 2016, one US dollar was exchanged for 0.898 euros.

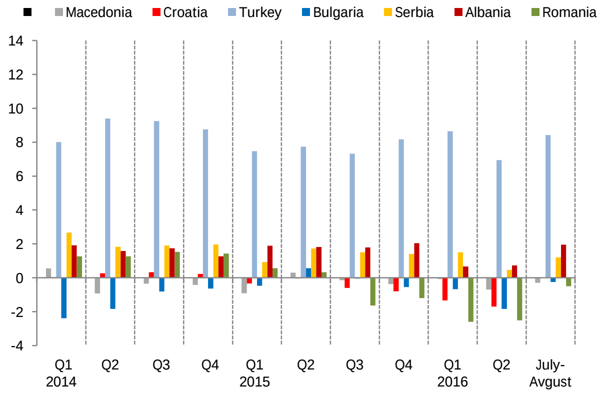
In the third quarter of 2016, the price of oil on world markets was relatively stable. Thus, in the period July-September 2016, oil price averaged 41.1 euros per barrel, which is an increase of 1.1%, compared to the second quarter of 2016. In the third quarter, oil prices decreased by 8.6%, annually. The shift of oil price was conditional on both the supply and the demand. Namely, in the analyzed period, the demand was moderately higher, but prices remained stable due to the increased production of Saudi Arabia (the highest ever), and the stabilization of the production in the United States and Canada. **Starting from February 2016, prices of non-energy primary commodities in euros started to grow moderately.** Thus, in the period July-September 2016, prices of non-energy primary commodities grew by 1.9%, compared to the second quarter of 2016. Analyzed by groups, in the period from July to September, growth was higher in metals (6%), while food prices registered a slight decline of 0.8%. The moderate growth in metal prices is mainly a result of increased

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



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

Inflation in countries from the region
(annual percentage changes)



Source: Eurostat and national statistical offices.

global demand, especially the growing demand in China.

Countries of the region reported different economic performances in the second quarter of 2016. The Serbian economy slowed down, and unlike the first quarter, when the growth was 3.5%, in the second quarter, it was 2%. The growth slowed down mostly due to the lower growth of gross capital formation, and partly exports. The Turkish economy also slowed down, largely due to the political crisis in the country. On the other hand, the Romanian economy grew by 6%, which is the highest growth in the European Union and the highest quarterly growth of the Romanian economy since 2008. The high growth mainly reflects increased private consumption, boosted by lower taxes. Other countries in the region (Albania, Bulgaria and Croatia) reported similar results as in the first quarter of 2016.

In the third quarter of 2016, the region was marked by low inflation, primarily due to the continued low energy prices. However, compared to the previous quarter, there was a moderate increase in inflation in most countries, mainly due to the reduction of the base effect of low prices in the energy component. Non-energy component also registered no significant inflationary pressures.

1.2. Domestic supply

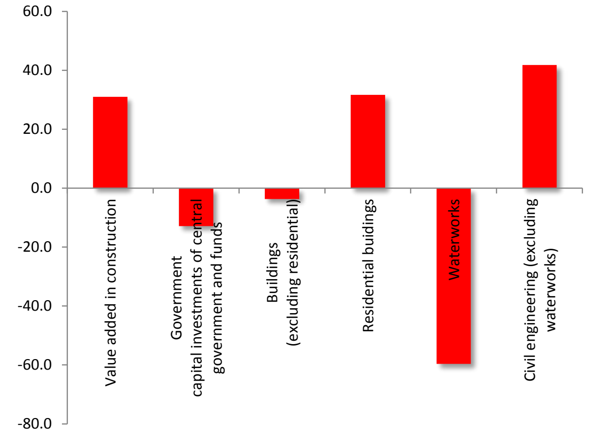
The growth of domestic economy continued in the second quarter of 2016, with intensity similar to that in the first quarter of the year. Thus, in the second quarter, GDP registered quarterly and annual growth of 0.7% and 2.2%, respectively. In terms of growth structure, in the second quarter, construction sector was considered the driving force, whose growth is mainly associated to the road infrastructure related activities. On the other hand, the value added in the industrial sector continued decreasing in the second quarter of the year. The available data for the third quarter signal continuation of positive trends in the main economic sectors, but at a slower pace.

In the second quarter of 2016, the gross domestic product increased by 0.7% on a quarterly basis (seasonally adjusted), while on an annual basis, it increased by 2.2%, similar to the first quarter of the year. Most economic sectors reported growth of value added, with the construction making the highest positive contribution. On the other hand, the decline in value added in the industry that began in the first quarter, continued in the second quarter, but at a slower pace.

	2013	2014	2015	Q1 2016	Q2 2016	2013	2014	2015	Q1 2016	Q2 2016
Agriculture	**8.6**	**2.2**	**-0.7**	**3.2**	2.3	**0.8**	**0.2**	-0.1	0.2	0.2
Industry	**3.7**	**20.1**	**1.4**	**-3.4**	-1.8	**0.6**	**3.0**	0.2	-0.5	-0.3
Manufacturing	**9.6**	**28.0**	**-2.0**	**-7.0**	-0.1	**1.0**	**2.8**	-0.2	-0.7	0.0
Construction	**12.8**	**1.8**	**16.8**	**7.7**	31.0	**0.7**	**0.1**	1.1	0.6	1.9
Trade and transport	**11.1**	**1.8**	**7.3**	**5.7**	0.2	**1.9**	**0.3**	1.4	1.0	0.0
Information and communication	**4.8**	**14.6**	**4.6**	**0.2**	1.3	**0.2**	**0.5**	0.2	0.0	0.0
Financial and insurance activities	**-1.4**	**11.3**	**11.8**	**13.3**	4.9	**0.0**	**0.3**	0.4	0.4	0.2
Real estate activities	**-1.3**	**2.8**	**1.9**	**2.2**	-1.3	**-0.2**	**0.3**	0.2	0.3	-0.1
Professional, scientific and technical activitiess	**9.6**	**9.9**	**12.7**	**11.7**	11.5	**0.3**	**0.3**	0.4	0.4	0.4
Public administration	**-7.5**	**2.1**	**-2.0**	**-1.3**	-2.9	**-1.1**	**0.3**	-0.3	-0.2	-0.3
Other service activities	**12.7**	**12.4**	**-8.7**	**-17.3**	-12.8	**0.3**	**0.3**	-0.2	-0.5	-0.3
Gross Domestic Product	**2.9**	**3.5**	**3.7**	**2.0**	**2.2**	**2.9**	**3.5**	**3.7**	**2.0**	**2.2**

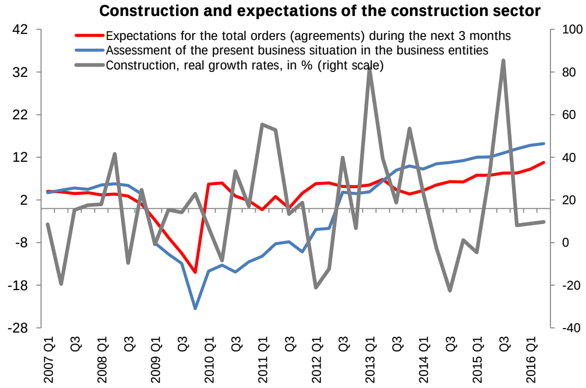
Source: State Statistical Office and NBRM calculations.

Contruction in 2016-Q2
(real annual growth rates, in %)



Source: State Statistical Office and Ministry of finance.

Construction and expectations of the construction sector

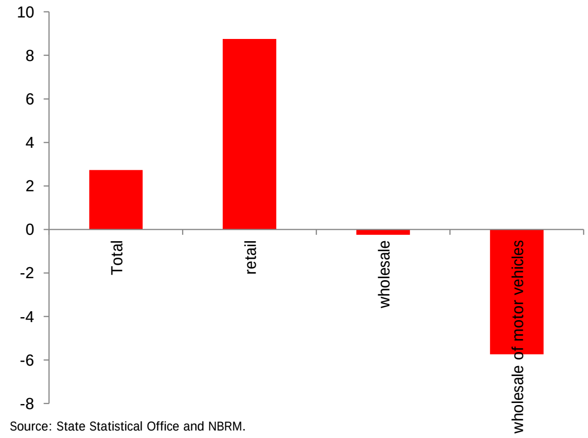


Source: State Statistical Office.

Construction is among the generators of economic growth for the fourth consecutive quarter. Thus, compared to the previous quarter, the second quarter of 2016 witnessed significant acceleration of the annual growth of value added of this sector[4], and a quarterly growth. Analyzing structure, most of the growth reflects the increased activity in civil engineering in the field of road infrastructure, which probably, in part could be related to the ongoing implementation of several large public infrastructure projects. Construction of residential buildings also registered a solid growth. The results of business tendency surveys in construction[5] confirm the good performance of this sector. Namely, compared to the same period last year, respondents' assessments of the current business and financial situation in companies are more favorable, stressing the significant alleviation of the limiting effect of the unfavorable weather conditions, labor costs and financial expenses, as well as the improvement concerning the lack of qualified staff. On the other hand, factors with increasing limiting effect in the second quarter include unfavorable demand and competitiveness in the sector. **Construction industry is expected to keep on increasing in the third quarter,** taking into account the further double-digit growth in the value of completed construction works in July. The results of the survey conducted in the second quarter of 2016 also point to growth, amid more favorable expectations of company managers in the construction sector in terms of the future secured working period, and number of employees.

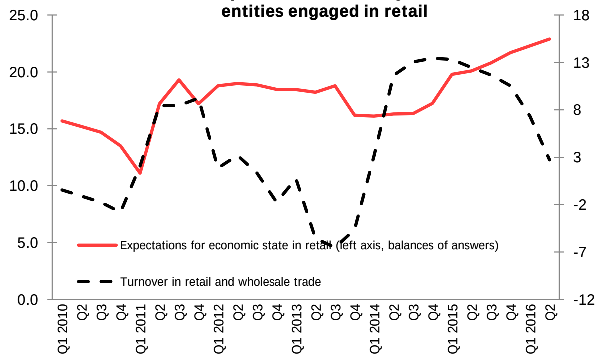
[4] Seasonally-adjusted.
[5] Surveys conducted in the second quarter of 2016.

Trade 2016 - Q2
(real annual growth rates, in %)



Source: State Statistical Office and NBRM.

Trade and expectations of managers of business entities engaged in retail



Source: State Statistical Office and NBRM.

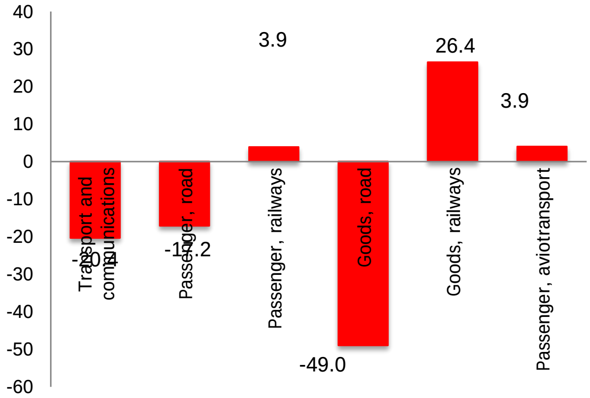
Favorable trends in the trade sector continued in the second quarter[6], but at a slower annual pace reflecting the lower turnover of the wholesale trade and the trade in motor vehicles. In the second quarter, the retail trade registered increased sales, although with slightly slower growth compared to the previous quarter. The Business Tendency Survey in retail trade[7], conducted in the second quarter, also confirms the good performance of this sector. The survey results show favorable assessment of the current business and financial standing of companies, and analyzing the factors that influenced the activity in this sector, the managers emphasized the significant alleviation of the limiting effect of the weak demand. On the other hand, managers point to significantly increased limiting effect of the competition and market supply factors (compared to the same period last year). Favorable trends in trade are expected to continue in the third quarter amid continuing growth in the retail trade value during July-August 2016 (somewhat stronger growth compared to the second quarter). These trends are consistent with the more favorable expectations of the survey conducted in the second quarter, in terms of the number of employees and the business situation of companies in the next three to six months.

Observing the trends in the transport and communication sector, the indicators for the second quarter of the year provide divergent signals. More significant growth was registered in passenger air traffic and favorable developments were observed in road freight and air transport. On the other hand, the movements in other types of traffic are unfavorable. The small number of high frequency indicators makes it difficult to have an accurate assessment of the developments in the transport and communication sector during the third quarter. Available data showed decline in the railroad transport in July, while rail freight traffic registered favorable developments.

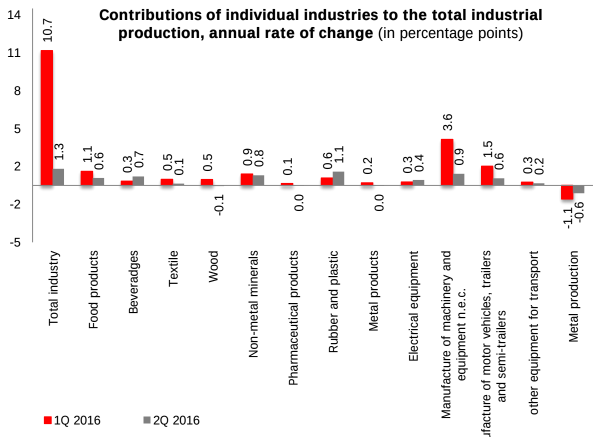
The value added in industry continued declining in the second quarter, but at a significantly slower pace compared to the previous quarter. On the other hand, the value added in industry increased on a

[6] The analysis of trends in trade uses data on the trade turnover.
[7] SSO's Business Tendency Survey in retail trade for the second quarter of 2016. The balance of responses is the difference between weighted positive and negative responses of corporate managers. The balance is designed to show the movement of the observed economic indicator rather than its true size, i.e. it provides qualitative rather than quantitative (numerical) data from corporate managers.

Transports and communications in 2015 - Q3
(real annual growth rates, in %)

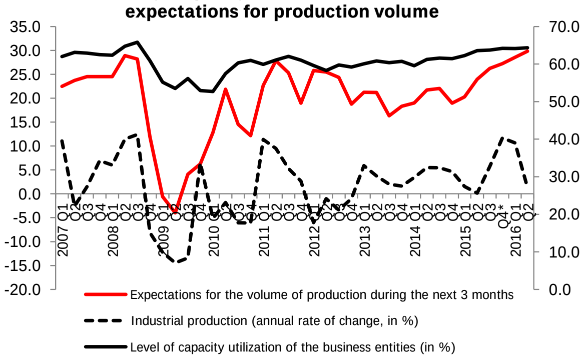


Source: State Statistical Office.



Source: State Statistical Office and NBRM.

Industry, capacity utilization and managers' expectations for production volume



Source: State Statistical Office.
* average of expectations for October and November of 2015.

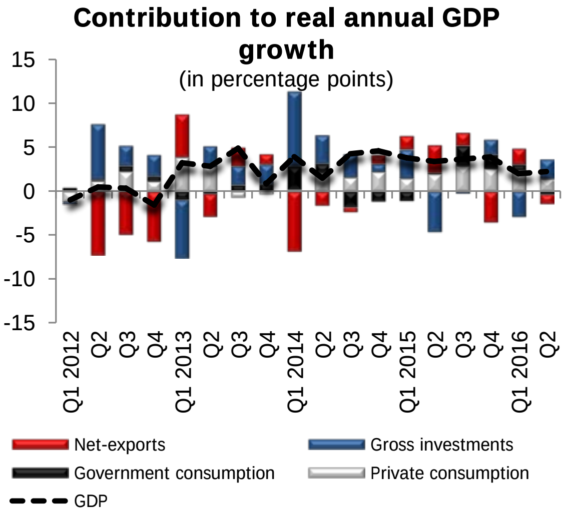
quarterly basis. Despite these trends in value added, high frequency data[8] point to a small annual increase in the volume of industrial output in the second quarter. Manufacturing is the main generator of growth in the physical volume of industrial production. Analyzing the activities in the manufacturing industry, the production of machines and equipment, and motor vehicles made a significant contribution to the growth in the first quarter, i.e. activities of the new foreign capital companies. Some traditional economic sectors such as food, beverages, textiles industries and the manufacture of non-metal minerals also contributed to the growth. The improved performance of manufacturing industry has also been confirmed by the results of the **Business Tendency Survey in the manufacturing industry[9]**, where managers assess the economic standing of their businesses as more favorable, amid higher assessment of the output volume relative to the preceding three months and the higher average capacity utilization in the first quarter of the year. The good performances of companies in this sector are related to the reduced influence of some limiting factors, such as the lack of skilled labor and insufficient demand. On the other hand, respondents find the uncertain economic environment and competitive imports to be stronger limiting effects. Contrary to the favorable trends in manufacturing industry, there was fall in production in **mining and electricity, gas, steam and air conditioning sectors**.

The available data for the July-August period suggest continuation of favorable trends in the industry in the third quarter. Namely, in the first two months of the third quarter, the industrial output recorded an average annual increase of 5.1%. The growth stemmed from the manufacturing sector and the electricity supply, while mining recorded an annual decrease. The favorable trends in the manufacturing sector are also supported by surveys conducted in July and August that indicate steady growth of the capacity utilization level, as well as more optimistic perceptions of the managers in the manufacturing sector about the output volume and the number of employees in the next three months.

[8] The analysis by activity is based on data on the volume of industrial production because of the availability of data for individual industrial sectors.
[9] It refers to the surveys conducted in the second quarter of 2016.

1.3. Aggregate demand

Observing the demand components, in the second quarter, GDP growth of 2.2% entirely derived from the domestic demand. The contribution of net export is negative, unlike the previous quarter when it was the engine of growth. Observing individual components, export demand registered the highest annual growth and made the largest individual contribution to the growth of economic activity. The export growth was mainly attributable to the activity of the new industrial facilities. Among the components of domestic demand, the highest positive contribution was made by gross capital formation, whose growth, according to the movements of high frequency indicators, are largely explained by increased construction activity and higher investment in road infrastructure in the first half of the year. Personal consumption also registered a growth in the second quarter amid favorable labor market developments, low consumer prices and further credit support to households, while public consumption decreased on an annual basis.



Source: State Statistical Office and NBRM calculations.

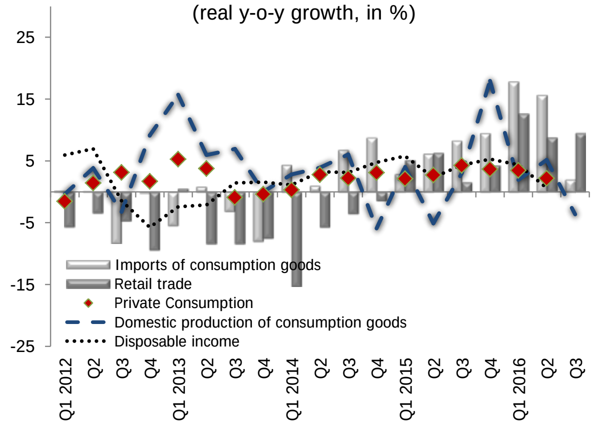
In the second quarter of 2016, the gross domestic product (GDP) increased by 0.7% compared to the previous quarter (seasonally adjusted), and by 2.2% compared to the same period last year, at a pace similar to the first quarter. The structural analysis shows that the growth in the second quarter reflects higher domestic demand, while net exports contributed negatively. Analyzed by component, exports made the highest individual contribution to the growth, a movement which as before mainly results from the activity of the new production facilities. Analyzing domestic demand components, gross capital formation registered significant growth, which is associated with the higher construction activity in the first half of the year. Household consumption also increased, although at a more moderate pace compared to the first quarter, while public consumption reduced in the second quarter. Increased export demand and higher domestic demand led to growth in imports.

	Real annual growth rates (%)								Contributions to real annual growth (in p.p.)							
	2014	2015	2015-Q1	2015-Q2	2015-Q3	2015-Q4	2016-Q1	2016-Q2	2014	2015	2015-Q1	2015-Q2	2015-Q3	2015-Q4	2016-Q1	2016-Q2
Private consumption	2.1	3.2	2.1	2.7	4.3	3.6	3.5	2.2	1.5	2.2	1.5	2.0	2.9	2.5	2.3	1.4
Government consumption	1.0	4.6	-5.6	0.7	15.4	9.7	4.2	-1.9	0.2	0.8	-1.1	0.1	2.3	1.6	0.7	-0.3
Exports of goods and services	18.2	4.6	2.7	6.8	4.6	4.1	14.7	7.1	7.9	2.2	1.3	3.3	2.2	2.0	6.4	3.5
Imports of goods and services	16.0	2.4	-0.5	0.4	0.9	8.3	7.6	6.9	-9.8	-1.6	0.2	-0.1	-0.8	-5.5	-4.6	-4.6
Gross capital formation	13.1	0.1	11.0	-14.9	-1.1	5.5	-9.0	9.2	3.8	0.0	3.3	-4.6	-0.2	1.8	-2.9	2.2
Domestic demand	*4.7*	*2.5*	*3.4*	*-2.2*	*4.1*	*4.9*	*0.0*	*3.3*	*5.5*	*3.0*	*3.7*	*-2.5*	*4.9*	*5.9*	*0.1*	*3.3*
*Net exports**	*10.1*	*-3.9*	*-8.2*	*-14.9*	*-14.9*	*20.4*	*-11.3*	*6.3*	*-1.9*	*0.6*	*1.5*	*3.1*	*1.5*	*-3.5*	*1.8*	*-1.1*
Statistical discrepancy											*-1.4*	*2.7*	*-2.8*	*1.5*	*0.0*	*0.0*
GDP	**3.5**	**3.7**	**3.8**	**3.4**	**3.6**	**3.9**	**2.0**	**2.2**	**3.5**	**3.7**	**3.8**	**3.4**	**3.6**	**3.9**	**2.0**	**2.2**

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

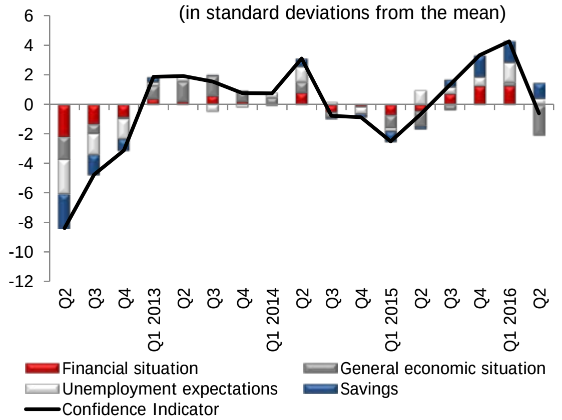
1.3.1. *Private consumption*

Private consumption indicators
(real y-o-y growth, in %)



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

Consumer confidence indicator
(in standard deviations from the mean)



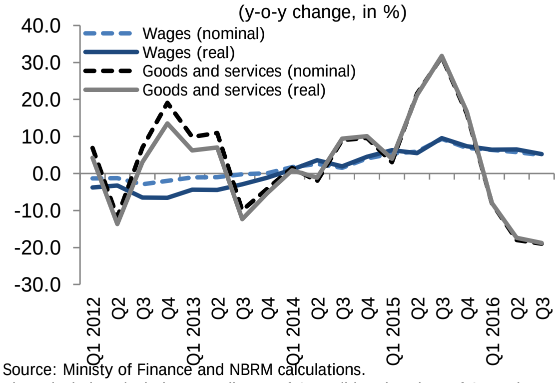
Source: European Commission and NBRM's calculations.

In the second quarter of 2016, household consumption increased quarterly by 0.3% (seasonally adjusted) and annually by 2.2% in real terms. The annual consumption growth is explained by favorable trends in the fundamentals of consumption. Namely, the second quarter of the year recorded an increase of bill of wages and pensions with similar intensity as in the first quarter, and a solid growth in consumer loans. On the other hand, the pace of annual growth is moderately lower than the previous quarter, which could partly be associated with the greater restraint from consumption in the second quarter when the political crisis in the country escalated. This conclusion is also supported by the results of consumer confidence surveys[10], which point to reduced consumer optimism in the second quarter primarily due to the unfavorable expectations about the general economic landscape. In the second quarter, the growth of retail slowed down which also confirms the greater restraint from consumption.

It is expected that consumer spending will continue growing in the third quarter of 2016[11], given the growth of average wages and pensions as components of the disposable income. Also, in the third quarter, there was a continuation of stable growth of household lending, which as shown in the Bank Lending Survey[12], corresponds to the banks' announcements of further moderate ease of the general credit standards to households and expectations for increased demand for loans in this period. Other high-frequency data on private consumption show additional positive signals from the retail trade and the imports of consumer goods. Also, signals from consumer confidence surveys[13] conducted in the third quarter, point to increased consumer optimism.

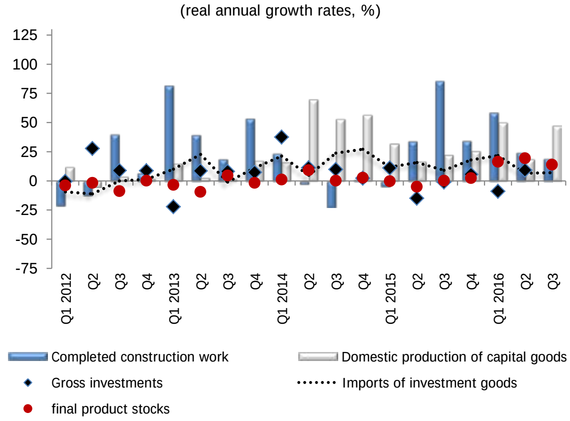
[10] European Commission's Consumer Survey as of September 2016.
[11] The analysis of wages was made using July data. Other factors have been analyzed as of August.
[12] NBRM's Lending Survey, July 2016.
[13] European Commission's Consumer Survey as of September 2016.

Expenditures for Wages and salaries and Goods and services
(y-o-y change, in %)



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

Gross investment and indicative series
(real annual growth rates, %)



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

1.3.2. Public consumption

In the second quarter of 2016, public consumption recorded a quarterly decline of 2.5% (seasonally adjusted) and real annual fall of 1.9%. The fall in public consumption is due to the decreased expenditures for goods and services, while wage expenses for the employees in the public sector and health care transfers[14] increased.

Data as of July and August 2016 indicate higher public spending in the third quarter, amid higher costs for wages and health care transfers.

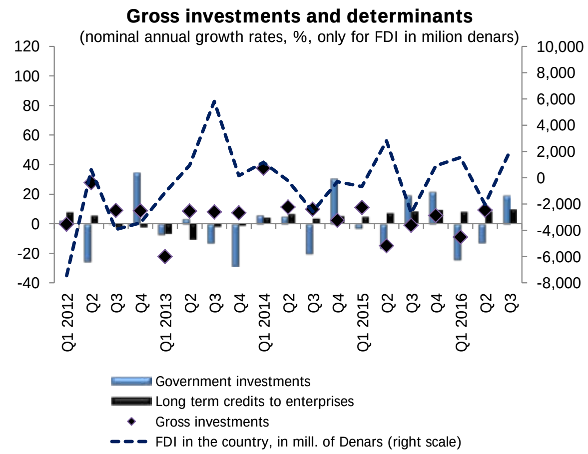
1.3.3. Investment consumption

In the second quarter of 2016, gross capital formation registered a quarterly decline of 2.2% (seasonally adjusted), and an annual increase of 9.2%. Moreover, as in the first quarter of the year, short-term indicators of investment activity point to a continuation of favorable trends in **gross fixed capital formation**. Construction activity has registered high growth rates for five consecutive quarters, mainly reflecting the growth in civil engineering, primarily due to the larger investments in road infrastructure. Import of capital goods, which is an indicator of investment in machinery and equipment continued to grow in the second quarter. The growth of fixed capital formation is also supported by the shift in the other short-term investment indicators. Thus, domestic production of capital goods, bank's corporate loans and inflows of foreign direct investment increased in the second quarter. Among investment indicators, only government expenditures for capital investments were downwardly adjusted.

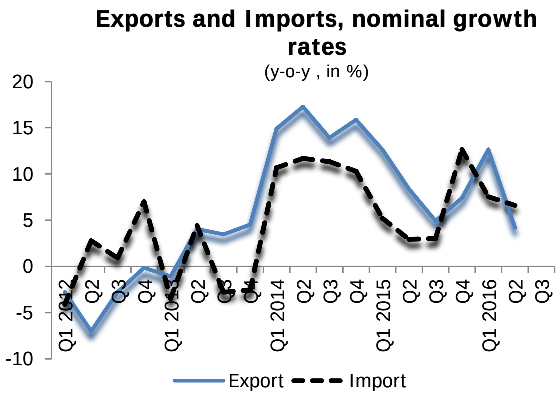
Analyzing the movement of **inventories,** the second quarter recorded a significant annual growth in the indicator of inventories of manufactured goods in the manufacturing industry, indicating a potential increase in inventories in the overall economy.

Observing investments in the second quarter of 2016, most signals coming from the available high frequency data indicate

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



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



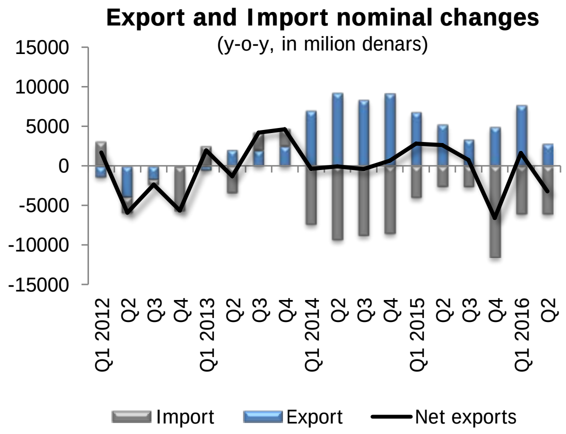
Source: State Statistical Office.

an increase[15]. Construction activity is expected to have further positive impact on the overall investment demand in the period ahead, considering the growth of construction works in July and the optimistic expectations of construction sector managers for the orders, selling prices and number of employees[16]. The future growth of fixed capital formation is also confirmed by the increasing utilization of the manufacturing capacities[17]. The funding environment is also favorable given the further solid growth in long-term corporate lending by banks. As shown in the survey, this is in line with the banks' expectations for increased demand for corporate loans amid eased credit standards in this period[18]. Analyzing other high frequency indicators of investment, growth was registered in imports of investment goods, domestic production of capital goods, inflows of foreign direct investment, and government capital expenditures.

1.3.4. Net external demand

External sector developments in the second quarter of 2016 were less favorable compared to the previous quarter. Namely, amid growth of exports and similar imports, foreign trade deficit increased, and accordingly net exports made a negative contribution to GDP growth in the second quarter of 2016, unlike the previous quarter, when the effect was positive. These developments mainly derive from the slower growth in exports, though, analyzing the individual GDP components, exports still make the greatest individual contribution to growth. Thus, **real exports of goods and services** recorded an annual growth of 7.1% (14.7% in the first quarter of the year), while quarterly, exports decreased (quarterly decline of 1.7%, seasonally adjusted). The annual growth mainly results from the increased exports of new production facilities. On the other hand, the still weak global demand for metals and the low metal price still have adverse effect on the export activity of the metal industry. **Import of goods and services** in real indicators increased by 6.9% in the second quarter (7.6% in the first quarter of the year) on an annual basis and by 0.8% on a quarterly basis (seasonally adjusted).

[15] Data on completed construction works and foreign direct investments have been analyzed as of July, while for the other indicative categories, the cutoff date is August.
[16] Survey conducted in the second quarter of 2016.
[17] Survey conducted in August 2016.
[18] NBRM's Lending Survey, July 2016.

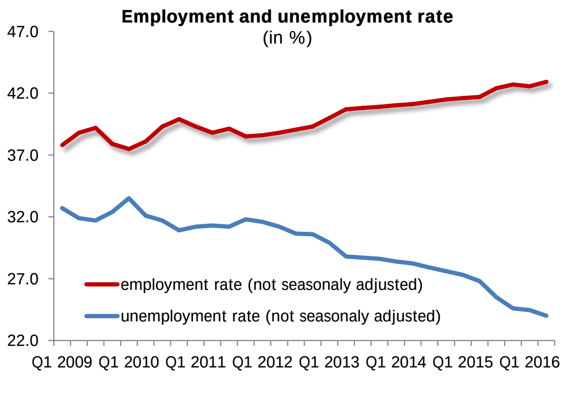


Source: State Statistical Office .

Trade deficit is expected to slightly narrow in the third quarter of 2016. Nominal foreign trade data for the period July-August 2016 indicate narrowing of the deficit in the third quarter of 2016. The trade deficit decreased as a result of the higher exports than imports of goods.

1.4. Employment and wages

Labor market continued registering favorable developments in the second quarter of the year. Thus, the number of employees increased by 3%, while the unemployment rate was 24%, which a new record low. Also, the aggregated signals from business tendency surveys show stronger optimism about employment for the next three months. In the second quarter, there was a decrease in the number of vacant posts and continued reduction in the total economically active population for fifth consecutive quarter. However, it is still early to assess the nature of these shifts and their impact on the labor market. The shifts in the competitiveness indicators are similar to those in the first quarter of the year. The economic slowdown in the first half of the year, amid still solid employment growth, resulted in relatively high growth in unit labor costs and continued modest productivity growth in the second quarter.

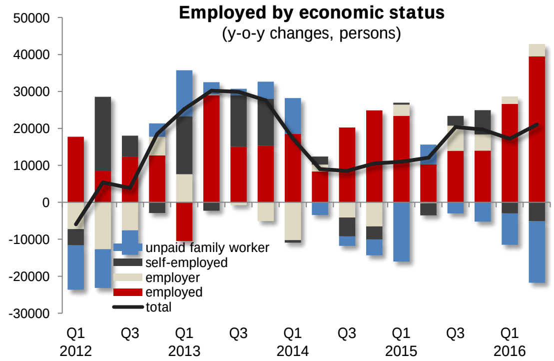


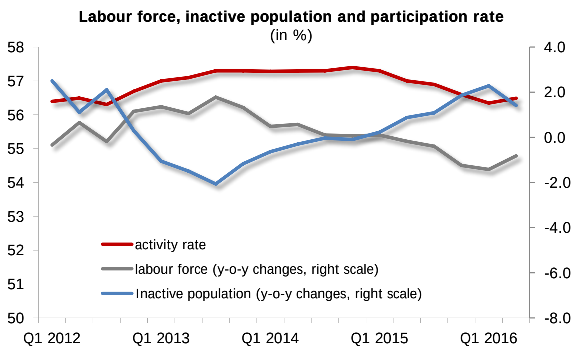
Source: State Statistical Office, Labour Force Survey.

In the second quarter of 2016, employment continued increasing and slightly accelerated the annual growth. Thus, the number of employees increased by 3% on an annual basis and 0.9%[19] on a quarterly basis (compared to an annual growth of 2.5% and a quarterly fall of 0.2% in the first quarter of 2016). Observed by sector, most sectors recorded an increase in the number of employees, mostly pronounced in trade, construction, administrative and support services, as well as in public administration and defense, and compulsory social insurance. Employment declined only in agriculture, mining, information and communications, and in arts, entertainment and recreation. In terms of the economic status[20], the

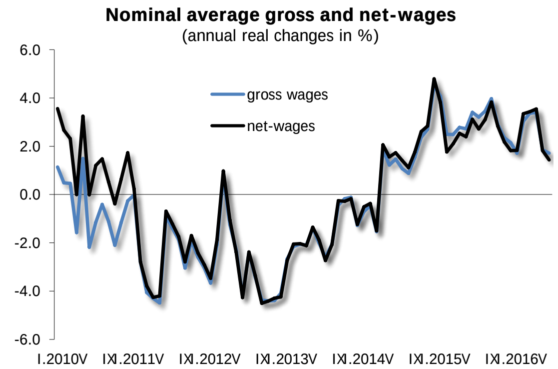
[19] The analysis of quarterly dynamics of employment, unemployment and total economically active population was made using seasonally adjusted data.

[20] The classification by economic status applies to the following groups: **employers** - persons who operate their own business entity or engages independently in their own shop, or farm owners who hire other employees; **employees** - persons who work





Source: State Statistical Office, Labor Force Survey.



Source: State Statistical Office.

same as in the previous quarter, most employments were registered in the category of employed population.

In the second quarter of 2016, the employment rate amounted to 42.9%, which is an annual growth of 1.2 percentage points. Considering the dynamics, the shift in the second quarter is a slight acceleration of the annual growth. In addition, when it comes to **employment prospects in the short run, the cumulative signals from the business tendency surveys[21] indicate stronger optimism among company managers for the period ahead.** On the other hand, the results of the Job Vacancy Survey[22] indicate less favorable trends in the labor market compared to the previous period. Namely, the number of vacancies, as an additional indicator of the movement of labor demand, in the second quarter, was lower by 0.9% annually. The rate of vacancies also reduced[23] to 1.38% in the second quarter. Given that individual employment indicators provide different signals, it is still early to assess the nature of these developments.

In the second quarter, labor supply decreased by 0.8%, which is a continuation of the negative annual pace from the previous four quarters. The decline in the economically active population, with a simultaneous increase in the inactive population, downwardly adjusted the activity rate to 56.5% (compared to 57% in the second quarter of 2015).

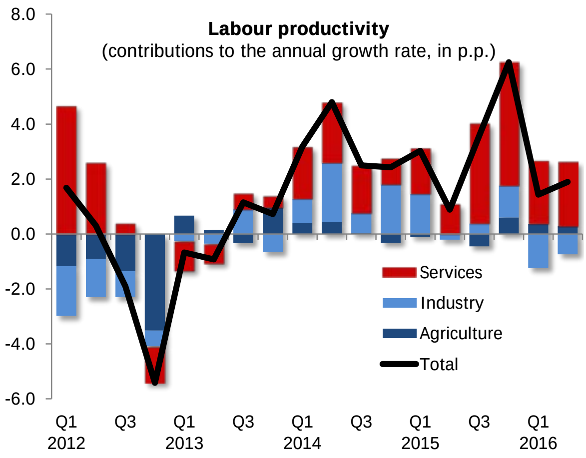
The higher demand in the second quarter of the year, amid reduced labor supply has further declined unemployment. Namely, the number of unemployed in the second quarter decreased by 11.3% on an annual basis, similar to the previous quarter, with unemployment rate of 24% (annual and quarterly decline of 2.8 percentage points and 0.5

in government institutions, business entities in public, mixed, cooperative and undefined ownership or for private employer; **own-account workers -** persons who operate their own business entity, company, engage independently in their own business and work on a farm in order to generate income, while not hiring other employees; **unpaid family workers** - persons who work without pay in a business entity, shop or farm (owned by a family member).

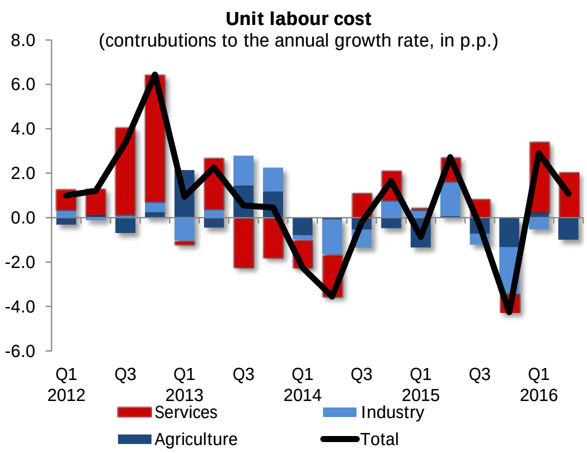
[21] Source: State Statistical Office, business tendency surveys in manufacturing industry (June 2016), construction (second quarter of 2016) and trade (second quarter of 2016).

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

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



Source: State Statistical Office and NBRM calculations



Source: State Statistical Office and NBRM Calculations

percentage points, respectively).

The average wages paid in the second quarter registered an annual growth of 1.6% (both net and gross wages), which is a deceleration of the annual growth compared to the previous three months. Growth is distributed among most of the economic activities, with agriculture, construction, and administrative and support services standing out as activities with the highest wage growth. Compared to the previous quarter, the nominal net and gross wages slightly increased by about 1%. **In the second quarter, amid lower consumer prices, the real annual wage growth is higher than in nominal terms** (2.3% in both net and the gross wages).

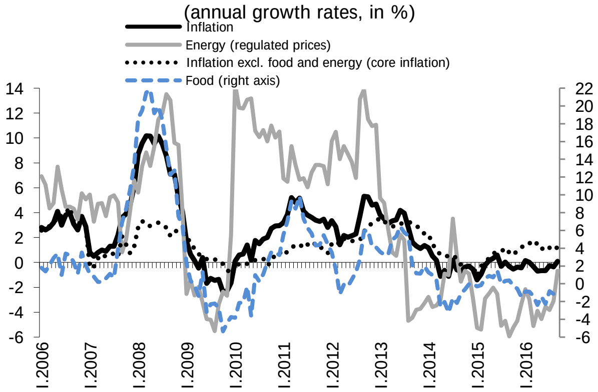
Labor productivity[24] in the second quarter increased by 0.4%, the same as in the first quarter. However, compared with the dynamics of the previous year, this is a significant slowdown in the growth. This shift reflects the relatively strong deceleration of the annual growth of economic activity in the first half of the year, amid still solid employment growth. Observed by sectors, growth was registered in the services sector, while the industrial output declined. The output in the economy increased on a quarterly basis. **Unit labor costs in the second quarter of the year increased by 2.5%, which is still a slowdown in the annual growth** (growth of 4% in the previous quarter). The slower growth is mostly due to the slower growth of gross wages in this period. Unit labor costs increased the most in the services sector, a small increase was also registered in industry, while labor costs in agriculture decreased. On the other hand, labor costs decreased on a quarterly basis, reflecting primarily the quarterly increase in productivity.

[24] Total productivity is the ratio between the sum of value added of economic sectors to the number of employees in these sectors. The total GDP in the second quarter of 2016 increased annually by 2.2%, while the sum of values added (GDP without the category of net taxes on products) increased by 3.3%. Employment in relevant sectors increased by 2.8%, and hence productivity has increased by 0.4%.

1.5. Inflation

Domestic prices continued to decline in the third quarter of 2016, being lower on average by 0.1% on an annual basis. However, such developments represent a significant slowdown of decline compared to the previous quarter, when prices fell by 0.7% annually. The significant slowdown in the fall in domestic prices results from the slower annual decline in food and energy component of inflation. Such developments reflect gradual changes in the global environment of prices of primary commodities, where there was a steady annual growth in world food prices and significant slowdown in the fall of world energy prices first after nearly two years of strong reduction. Core inflation (price component without food and energy) was positive in the third quarter of the year and slightly lower compared to the previous quarter. In the first two months of the quarter, producer prices registered a small increase in the domestic market, at the same annual pace as in the previous quarter. In terms of expectations for the future period, the Inflation Expectations Survey conducted in September mainly pointed to unchanged inflation expectations relative to the previous quarter. Dynamically speaking, same as in the previous quarter, the respondents expect moderate acceleration of inflation until the end of the year and in 2017.

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



Source: State statistical office and NBRM calculations.

Domestic consumer prices continued to decrease in the third quarter of 2016, when prices reduced annually by 0.1% on average. This movement of consumer prices represents five consecutive quarters of annual decline, although the decline in this period is significantly slower. Analyzed by component, the minor price decline in the third quarter is explained by the food and energy components of the inflation index that made equal negative contributions. Thus, lower food prices mainly reflected lower prices of vegetables, fruits and grain products, while lower energy prices are mainly due to lower prices of liquid fuels and lubricants, in line with the lower oil prices on world markets. On the other hand, analyzing the major components, only core inflation registered a further increase (but slower) in the third quarter, amid higher prices of several index categories, with the largest contribution made by the higher tobacco prices[25].

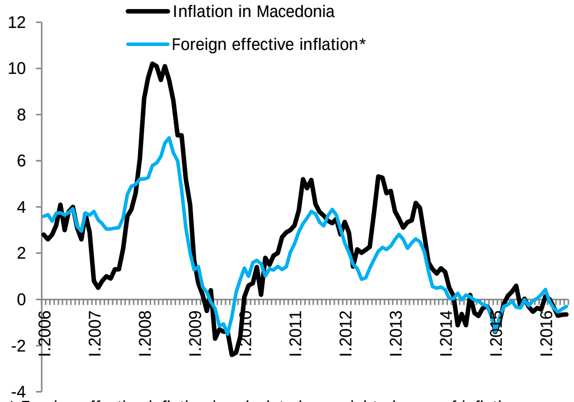
Unlike domestic, **foreign effective inflation[26] followed an upward path.** In the third quarter, it was 0% (decline of 0.4% in the

[25] The annual growth of tobacco prices in the third quarter is a combination of the flat increase in cigarette prices by five denars per box, in March 2016 and the increase in price of certain type of cigarettes in June 2016. In July 2016, the cigarette excise additionally increased (from 1 July 2017 to 1 July 2023 the excise duty will increase by 0.20 denars each year), but the monthly and quarterly change in tobacco prices did not show any price adjustment.

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

previous quarter).

Domestic inflation and foreign effective inflation
(annual growth rates, in %)

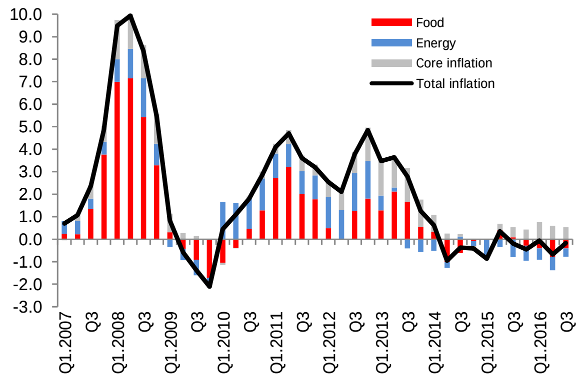


* Foreign effective inflation is calculated as weighted sum of inflations in countries that are major trade partners with Macedonia.
Source: State statistical office, Eurostat and NBRM calculations.

	2015					2016			2015					2016		
	Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q1	Q2	Q3	Q4		Q1	Q2	Q3
Consumer price index - all items	**-0.9**	**0.4**	**-0.2**	**-0.4**	**-0.3**	**-0.1**	**-0.7**	**-0.2**	**-0.9**	**0.4**	**-0.2**	**-0.4**	**-0.3**	**-0.1**	**-0.7**	**-0.2**
Food	*0.1*	*1.0*	*0.2*	*-0.8*	*0.1*	*-1.0*	*-2.0*	*-1.1*	*0.0*	*0.4*	*0.1*	*-0.3*	*0.1*	*-0.4*	*-0.8*	*-0.4*
Energy	*-4.5*	*-2.3*	*-5.2*	*-4.4*	*-4.1*	*-3.5*	*-4.0*	*-2.5*	*-0.7*	*-0.3*	*-0.8*	*-0.6*	*-0.6*	*-0.5*	*-0.6*	*-0.4*
Electricity	*3.6*	*3.6*	*-0.4*	*-0.4*	*1.5*	*-0.4*	*-0.4*	*-0.2*	*0.3*	*0.3*	*0.0*	*0.0*	*0.1*	*0.0*	*0.0*	*0.0*
Heat energy	*-3.7*	*-3.7*	*-8.8*	*-11.6*	*-6.8*	*-18.3*	*-18.3*	*-13.6*	*0.0*	*0.0*	*-0.1*	*-0.1*	*-0.1*	*-0.1*	*-0.2*	*-0.1*
Fuels and lubricants	*-20.1*	*-13.3*	*-17.1*	*-15.3*	*-16.5*	*-10.2*	*-11.8*	*-8.1*	*-0.9*	*-0.6*	*-0.8*	*-0.6*	*-0.7*	*-0.4*	*-0.5*	*-0.3*
Food and energy (volatile prices)	*-1.2*	*0.1*	*-1.3*	*-1.8*	*-1.1*	*-1.7*	*-2.6*	*-1.5*	*-0.6*	*0.0*	*-0.7*	*-0.9*	*-0.6*	*-0.9*	*-1.4*	*-0.8*
Core inflation (inflation excl. food and energy)	*-0.5*	*0.7*	*1.0*	*1.0*	*0.6*	*1.7*	*1.3*	*1.1*	*-0.2*	*0.3*	*0.5*	*0.5*	*0.3*	*0.8*	*0.7*	*0.6*

Source: State Statistical Office and NBRM calculations.

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



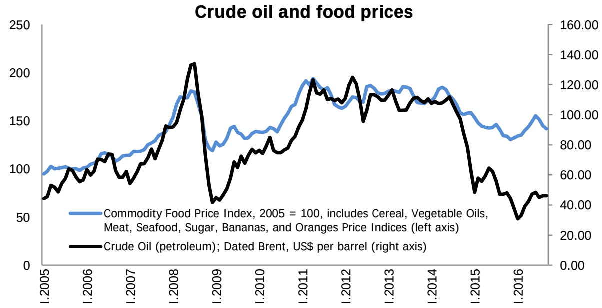
Source: State statistical office and NBRM calculations.

Analyzing the dynamics, the annual decline in consumer prices significantly slowed down in the third quarter of the year compared to the previous quarter, for the most part reflecting the slower decline in food prices, and particularly the slower decline in prices of energy component, which is in line with the latest trends in world prices of primary products. Core inflation acted in the opposite direction, which remains positive, at a slower growth though, compared to the previous quarter. **Thus, in the third quarter, the core inflation was 1.3%** (1.5% in the second quarter), and the shift is mainly explained by the slowdown in the growth of prices of IT equipment, tobacco, and the rapid decline in prices of pharmaceuticals, with opposite effect of the rapid growth in prices of home maintenance products.

On a quarterly basis, consumer prices were lower by 0.2%[27] in the third quarter of 2016 (seasonally unadjusted), which is mainly explained by lower food prices, and to a certain extent by declining energy prices, amid higher prices of products within the core inflation.

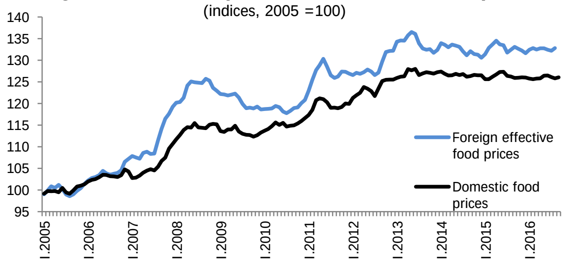
[27] Seasonally adjusted quarterly growth rate is positive (0.3%).

Crude oil and food prices



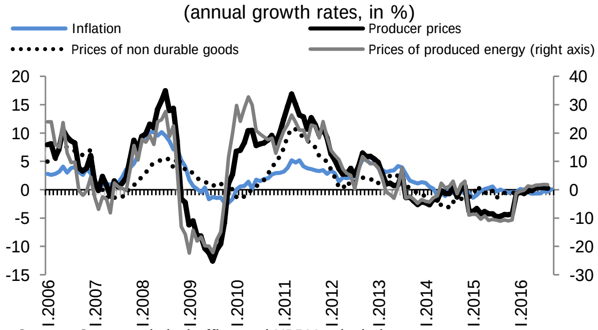
Source: IMF Primary Commodity Prices.

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



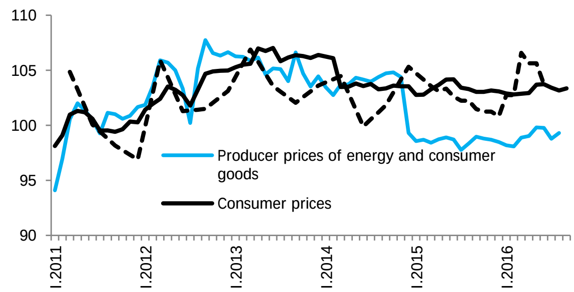
* Foreign effective food prices are calculated as weighted sum of food prices in countries that are major trade partners with Macedonia.
Source: State statistical office, Eurostat and NBRM calculations.

Inflation and industrial producer prices
(annual growth rates, in %)



Source: State statistical office and NBRM calculations.

Factors affecting consumer prices
(indices, 2005=100)



Source: State statistical office and NBRM calculations.

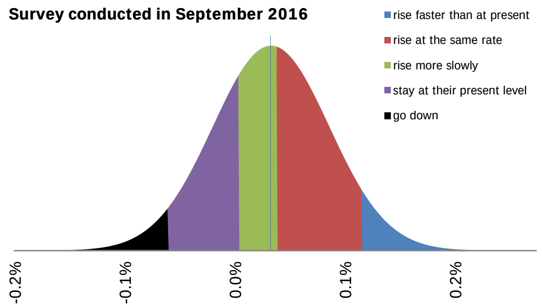
The annual growth of producer prices on the domestic market registered in the previous quarter that interrupted the two and a half year downward trend, continued in the third quarter of 2016. In the first two months of the third quarter, the annual increase in producer prices was 0.3%, which is the same annual growth rate as in the previous quarter. Within the index, the same as in the previous quarter, producer prices in mining and electricity supply made positive contribution to the growth, while prices in the manufacturing industry registered a slight decline due to the lower producer prices of food, non-metallic mineral products, and metals. Significant positive contribution to the processing industry was registered in the producer prices of beverages. **Producer prices registered a quarterly decrease of 0.7%** (seasonally adjusted rate of decline of 0.5%). **In the third quarter, further increase was also observed in the annual growth of prices of products that influence the domestic component of inflation**[28] (growth of 1.0%, compared to growth of 0.8% in the previous quarter). On a quarterly basis[29], these prices registered a slight decline of 0.4%, compared to the growth of 0.2% in the previous quarter. The annual shift of these producer prices in the last two quarters corresponds to the significant slowdown in the annual decline in consumer prices in the third quarter. Although the growth of these prices is moderate, their further maintenance in the positive zone could put certain upward pressures on the overall consumer prices in the future.

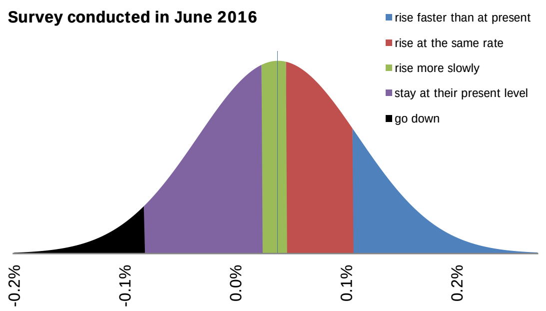
In the second quarter of 2016, unit labor costs rose by 2.5% annually, which is slower growth compared to the first quarter (annual growth of 4% in the previous quarter). Considering the estimates for positive output gap[30], the growth of labor costs indicates potential upward pressures on prices of final products through this channel in the future period.

[28] Consumer goods (durable and non-durable) and energy.
[29] The quarterly growth has been calculated using seasonally adjusted data.
[30] The NBRM assessments show that domestic output is above the potential level (positive output gap) in the second half of 2016.

Box 1: Inflation Expectations Survey

Inflation Expectations Survey includes three groups of respondents: economic analysts, companies, and financial institutions. The questionnaire contains two questions to measure inflation expectations, one qualitative and one quantitative in nature. For the first question on inflation expectations, the respondents indicate the direction and extent of price changes compared with the change in the previous 12 months[31]. Carlson and Parkin (1975) probability approach has been used to quantify qualitative answers, which assumes that amid a sufficiently large number of respondents, the expected change in prices is normally distributed among the population. The second question requires from the respondent to quantify precisely the expected average rate of change of prices in the next two years[32]. The overall expected rate is calculated as a simple average of the responses of all participants. The resulting indicator is useful for obtaining indications for the direction of the respondents' expectations.





The Inflation Expectations Survey was conducted in September 2016[33]. The same as in the previous survey cycle, **the average inflation rate for the previous 12-month period[34] remained in the negative zone[35]. The results of the survey indicate unchanged inflation expectations relative to the previous survey,** i.e. the same as in June, respondents expect inflation of around 0% in the next 12 months. Expectations for the inflation rate of around 0% are common for all three groups of respondents (economic analysts, companies, and financial institutions).

In terms of the quantitative question on the expected rate of inflation for 2016 and 2017, the respondents' inflation expectations for 2016 are unchanged, and for 2017, they are by 0.3 percentage points lower compared to the previous survey.

---

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

[32] The quantitative question is as follows: What are your expectations/forecasts for the average inflation rate for 2016 and 2017?.

[33] The percentage of responsiveness to the Survey conducted in June was 24.9%, which compared to the previous quarter, represents an increase of responsiveness. Analyzed by group of respondents, the financial institutions' responsiveness is 38.9%, followed by economic analysts with 25.2% and companies with 20.6%.

[34] Refers to the period September 2015 to August 2016.

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

1.6. Balance of Payments[36]

In the second quarter of 2016, the current account deficit increased quarterly as a result of the less favorable performance in the balance of foreign trade in goods and services, as well as the lower surplus in secondary income. Changes in these two components caused a deterioration of the current account on an annual basis. Unfavorable developments on the domestic political scene, which escalated in April and May, largely reflected in secondary income. The political crisis has led to a higher propensity of households to hold of foreign currency and consequently reduced purchase of foreign currency cash on the currency exchange market, compared to the usual. The higher deficit in foreign trade of goods, which resulted from the growth of the non-energy deficit, amid a significant narrowing of the energy component, also caused an annual deterioration. The financial account registered moderate net inflows, in the form of financial loans, trade credits and foreign direct investments, which were partly offset by net outflows in currency and deposits. Such movements of the components of the balance of payments led to a decrease in the foreign reserves. Despite the realized decline, the adequacy assessments show that foreign reserves remain in the safe zone and they are at a sufficient level for dealing with any shocks in the economy.

	2015				2016				2015				2016			
	Q1	Q2	VII	I-VII	Q1	Q2	VII	I-VII	Q1	Q2	VII	I-VII	Q1	Q2	VII	I-VII
	euro mil.								% GDP							
I. Current account	**-62**	**-97**	**22**	**-137**	**-25**	**-184**	**69**	**-140**	**-0.7**	**-1.1**	**0.2**	**-1.5**	**-0.3**	**-1.9**	**0.7**	**-1.5**
Goods and services	**-319**	**-388**	**-124**	**-830**	**-292**	**-433**	**-71**	**-796**	**-3.5**	**-4.3**	**-1.4**	**-9.1**	**-3.0**	**-4.5**	**-0.7**	**-8.3**
Credit	988	1,095	382	2,465	1,105	1,148	444	2,697	10.9	12.0	4.2	27.1	11.5	11.9	4.6	28.1
Debit	1306	1,482	506	3,295	1,397	1,581	516	3,493	14.4	16.3	5.6	36.2	14.5	16.4	5.4	36.4
Goods	-427	-440	-173	-1,041	-407	-508	-140	-1,055	-4.7	-4.8	-1.9	-11.4	-4.2	-5.3	-1.5	-11.0
Services	109	53	49	211	115	74	69	259	1.2	0.6	0.5	2.3	1.2	0.8	0.7	2.7
Primary income	**-70**	**-74**	**-23**	**-167**	**-75**	**-72**	**-24**	**-172**	**-0.8**	**-0.8**	**-0.3**	**-1.8**	**-0.8**	**-0.7**	**-0.3**	**-1.8**
Secondary income	**327**	**364**	**168**	**859**	**342**	**321**	**165**	**828**	**3.6**	**4.0**	**1.9**	**9.5**	**3.6**	**3.3**	**1.7**	**8.6**
II. Capital account	**2**	**1**	**2**	**5**	**2**	**3**	**0**	**5**	**0.0**	**0.0**	**0.0**	**0.1**	**0.0**	**0.0**	**0.0**	**0.1**
Net lending (+) / net borrowing (-) (balance from current and capital account)	-60	-96	24	-132	-23	-182	69	-135	-0.7	-1.1	0.3	-1.5	-0.2	-1.9	0.7	-1.4
III. Financial account	**-40**	**-107**	**34**	**-113**	**-34**	**-185**	**69**	**-150**	**-0.4**	**-1.2**	**0.4**	**-1.2**	**-0.3**	**-1.9**	**0.7**	**-1.6**
Direct investment	-79	-61	7	-133	-103	-27	-25	-156	-0.9	-0.7	0.1	-1.5	-1.1	-0.3	-0.3	-1.6
Portfolio investment	-11	5	20	14	7	-6	-424	-424	-0.1	0.1	0.2	0.2	0.1	-0.1	-4.4	-4.4
Currency and deposits	65	71	45	180	60	46	52	158	0.7	0.8	0.5	2.0	0.6	0.5	0.5	1.6
Loans	135	-5	-3	127	-56	-33	13	-76	1.5	-0.1	0.0	1.4	-0.6	-0.3	0.1	-0.8
Trade credit and advances	16	-54	13	-25	46	-32	20	34	0.2	-0.6	0.1	-0.3	0.5	-0.3	0.2	0.4
Other accounts receivable/payable	0	0	0	0	0	0	0	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Special drawing rights (Net incurrence of liabilities)	0	0	0	0	0	0	0	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
IV. Net errors and omissions	**20**	**-10**	**10**	**19**	**-11**	**-3**	**-1**	**-15**	**0.2**	**-0.1**	**0.1**	**0.2**	**-0.1**	**0.0**	**0.0**	**-0.2**
V.Reserve assets	**-167**	**-62**	**-48**	**-277**	**14**	**-133**	**433**	**313**	**-1.8**	**-0.7**	**-0.5**	**-3.0**	**0.1**	**-1.4**	**4.5**	**3.3**

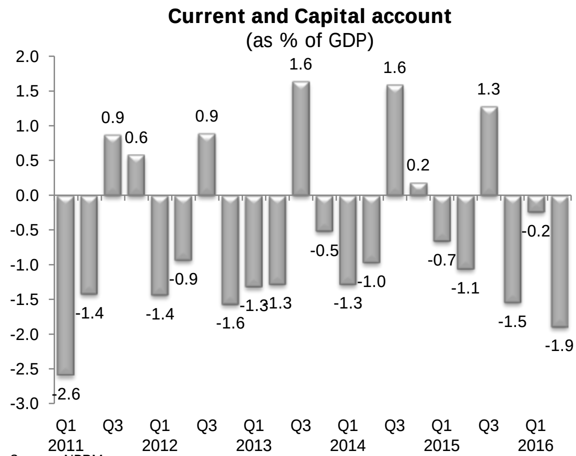
Source: NBRM.

1.6.1. Current account

In the second quarter of 2016, the balance of payments current account registered a deficit of Euro 184.4 million, or 1.9% of GDP. *Compared to the previous quarter, the current account balance has*

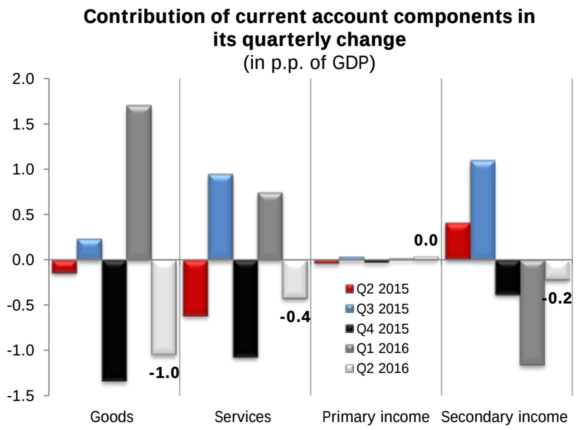
---

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



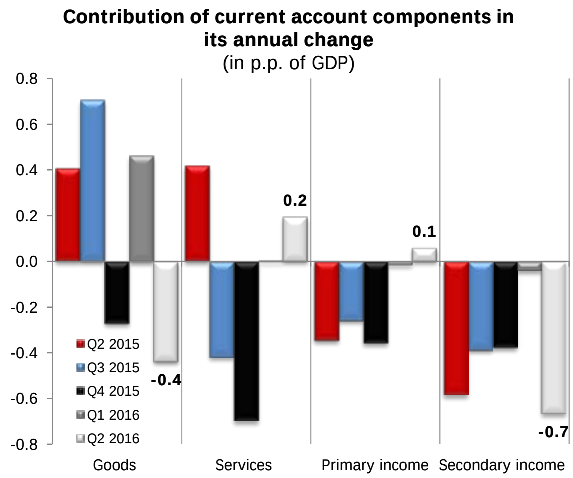
Source: NBRM.

worsened by 1.7 percentage points of GDP[37]. The quarterly change in the current account deficit stems from the widening of the balance of trade in goods and services, as well as the reduced net inflows of secondary income. Thus, as a result of the faster growth of import than export activity, the trade deficit widened by 1 percentage point of GDP on a quarterly basis, amid a simultaneous decrease in the positive balance of services (by 0.4 p.p.), due to weaker performances in production services for customization and construction. Also, the surplus in secondary income registered a quarterly decline of 0.2 percentage points, mainly due to the lower net inflows from official transfers. The primary income deficit did not record significant quarterly changes.



Извор:НБРМ

The annual analysis of the current account indicates a widening of the deficit by 0.8 percentage points of GDP, influenced by unfavorable developments in secondary income and the trade balance. In the second quarter, the surplus of secondary income significantly decreased (by 0.7 p.p.) as a result of the lower private transfers in cash, seen through the reduced purchase of foreign currency cash on the currency exchange market. Unfavorable developments on the domestic political scene increased the uncertainty in this period (especially in April and May), leading to a higher propensity of households to hold of foreign currency and consequently, reduced purchase on the currency exchange market. Also, the foreign trade deficit in goods deepened on an annual basis (by 0.4 p.p.), resulting from the widening of the non-energy deficit, amid significant narrowing of the energy component. The increased non-energy deficit largely reflects the weaker net exports of metal industry, primarily the significantly decreased export of iron and steel[38], due to the unfavorable conditions on the world metal market. On the other hand, there was an increase in the surplus of services, due to the improvement of the balance in other business services, then telecommunications services and transport services, which was partially offset by the annual decline in manufacturing services. There was no major annual change in primary income.

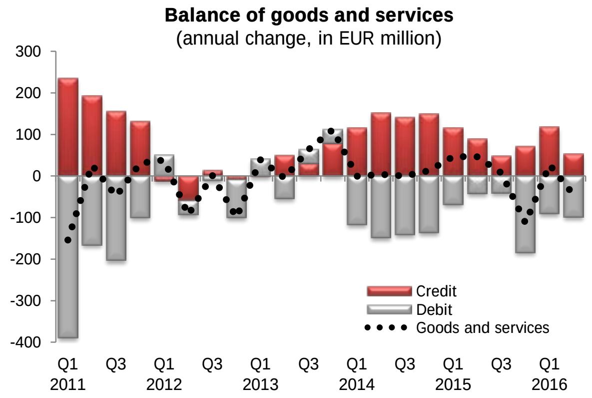


Source: NBRM.

According to the latest data on the balance

[37] The calculations use the projected amount for the nominal GDP.

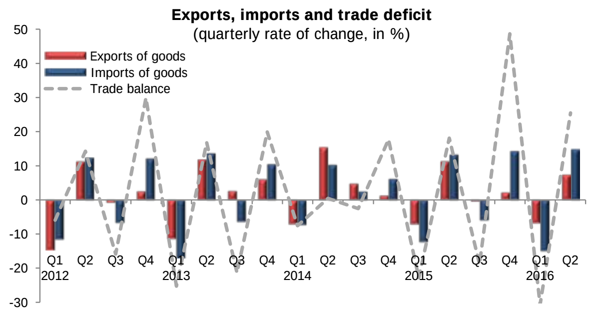
[38] Poor performances in the exports of the metal industry are in part due to the protest of the employees in the Thessaloniki port. The strike, active during May and June, caused a slowdown in the export activity in some of the companies that actively use this port for transport of their products.



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

of payments, in July 2016 the current account registered surplus of Euro 69.2 million, which is significantly higher compared to the same month last year. Favorable annual changes in the current transactions are fully driven by the improved balance in foreign trade of goods and services. On the other hand, secondary and primary income were almost unchanged on an annual basis.

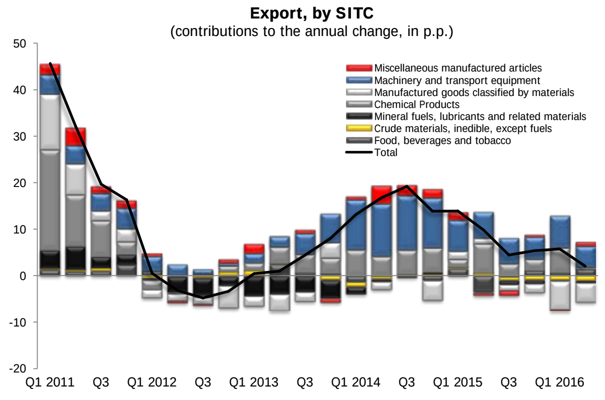
Box 2: Foreign trade of goods and movement of the Nominal and the Real Effective Exchange Rate (NEER and REER)[39]



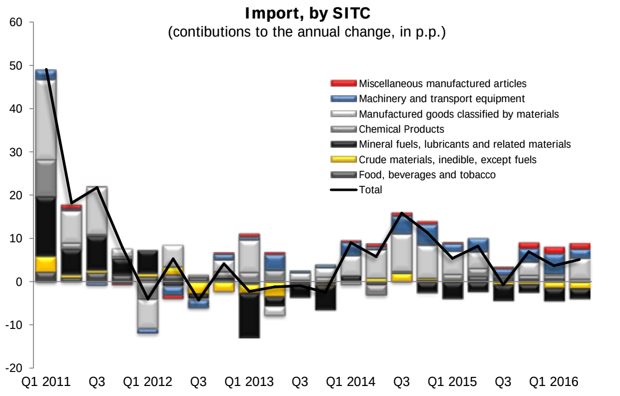
Source: SSO and NBRM.
** Negative change in the trade balance indicates contraction of the deficit.*

In the second quarter of 2016, foreign trade amounted to Euro 2,613.9 million, or 27.2% of GDP. Compared to the second quarter of the previous year, there was an increase of 3.9%, caused by the simultaneous growth of both components. Namely, **export of goods still registers an annual growth which amounted to 2% in this quarter,** which is a certain slowdown compared to the annual growth rate in the first quarter of the year (of 5.7%). The export of the new foreign owned export-oriented facilities remains driving factor of the enlarged export activity, coupled with the growth of food exports, tobacco and beverages. Contrary to the positive changes in these export sectors, the export of the metal processing and mining sectors still registers an annual decline. The fall in the export of iron and steel is fully price effect caused by the unfavorable conditions in the world metal markets[40], amid an increase in the export quantities compared to the same period last year. **In the second quarter, the growth of the import component continued,** which is higher by 5.1% on an annual basis, versus 3.7% in the previous quarter. Higher imports is mostly due to the raw materials component for the new export facilities, and to a lesser extent, the increased import of vehicles, iron and steel and medical and pharmaceutical products. Analyzed by categories, the categories of machines and transport equipment, non-ferrous metals and non-metallic manufactures made the largest contribution to the annual growth of imports. On the other hand, downward import pressures were registered in energy imports and to a lesser extent in imports of metal ore. Reduced energy imports is mainly price effect, amid significantly lower import prices in all energy components, while higher quantities are imported only in oil derivatives. Such price movements are due to the significant reduction in the price of crude oil on world markets, which adequately reflected with downward correction in other energy components. **The faster growth of imports of goods compared to export growth during the second quarter of 2016 led to a widening of the trade deficit by 12.3% on an annual basis.** The change in the trade balance stems from the widening of the non-energy deficit, amid significant narrowing of the energy component.

[39] According to the Foreign Trade Methodology, data on the export of goods are published on an f.o.b. basis, and on the import of goods, on a c.i.f. basis.
[40] In the second quarter of 2016, the stock exchange price of nickel expressed in US dollars registered an annual decline of 32.4%.

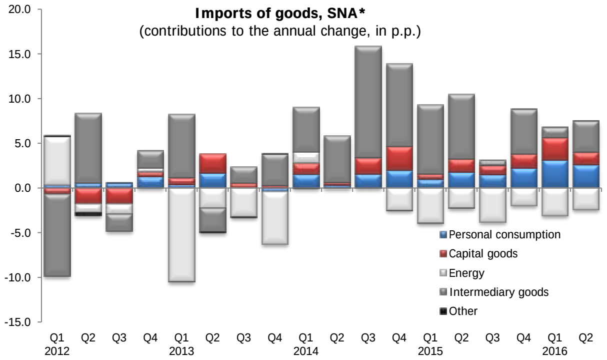


Source: SSO and NBRM.

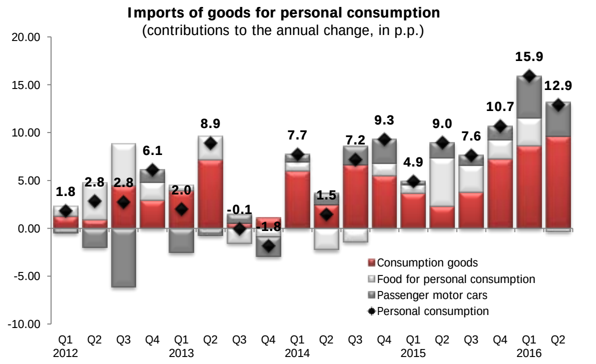


Source: SSO and NBRM.

The analysis of the import of goods under the System of National Accounts (SNA) indicates that in the second quarter of the year, the import of intermediate products made the dominant contribution to the annual growth of total imports. Also, the growth of imports is due to the higher import of *personal consumption goods and capital goods*, while the lower energy imports acted in the opposite direction. In terms of imports for private consumption, the annual growth of this component reflects the higher imports of consumer goods and to a lesser extent the imports of passenger vehicles, while the import of food registered no significant changes compared to the same period last year. Overall, the annual growth in imports for private consumption remains moderate, indicating presence of moderate pressures on imports by the private consumption.



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

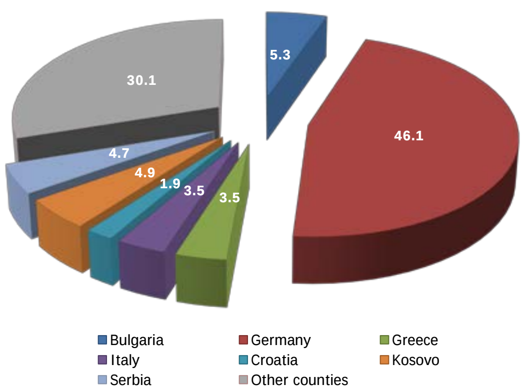


Source: NBRM.

The latest available data on foreign trade for July and August indicate fast growth of both components annually. More specifically, export of goods registered an annual growth of 13%, influenced by the improved export performance of the new production facilities and the tobacco industry. Annual growth was registered on the import side, from 9.2%, due to the higher imports of raw materials for the new companies, as well as the higher imports of iron and steel, amid further reduction of the energy imports.

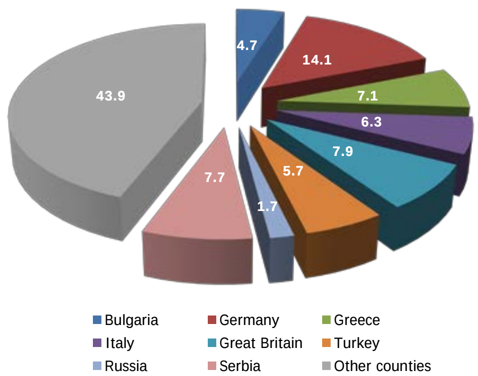
In the second quarter of 2016, the foreign trade, analyzed by trade partner, indicates the important role of the European Union as a trading partner of the domestic economy, accounting for 70.1% of total trade in goods. The export component indicates a significant increase in exports to Germany, but also increased exports to Belgium and Romania, markets in which the products of the new industrial facilities in the economy are placed. Contrary to the positive trends in the export activity to these markets, there was a decrease in exports to China, Taiwan and Bulgaria, whereby the lower export activity to Asian markets was mainly due to the lower exports of the metal industry. During this period, on the import side, the largest growth was recorded by the imports from the EU countries, particularly Great Britain, Hungary and to a lesser extent Poland, caused by the import of raw materials of the new foreign owned facilities. Among other trading partners, the import of goods from the US and Turkey has increased its share in total imports[41]. The lower imports from Ukraine (lower imports of iron and steel), Russia (imports of inorganic chemical products and energy), followed by the Netherlands and Greece acted in the opposite direction. According to the analysis of the balances by trade partner, the deepening of the trade deficit with China made the largest contribution to the widening of the trade deficit, due to the reduced export placement in this economy, coupled with the higher trade deficit with Great Britain, Turkey and the United States. The negative effect of the trade with these trading partners is mitigated by the further increase in the trade surplus with Germany, as well as the narrowing of the negative trade balance with Russia and Ukraine.

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



Source: SSO.

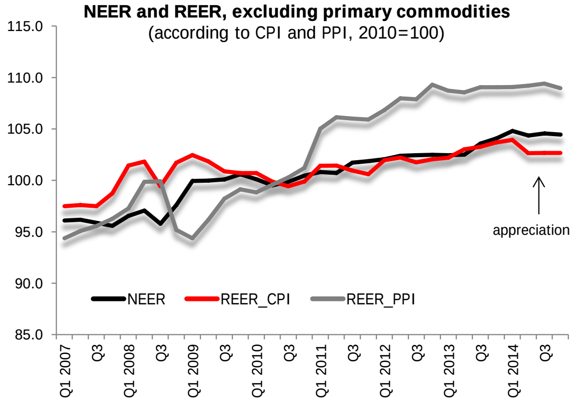
Import of goods, by countries in the second quarter of 2016 (share, in %)



Source: SSO.

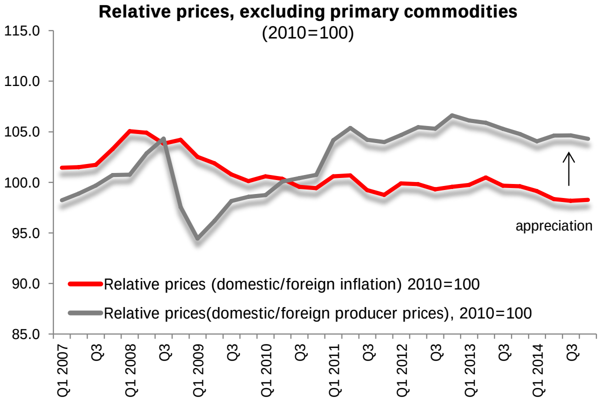
In the second quarter of 2016, indicators of price competitiveness of the Macedonian economy show moderate appreciation of the real effective exchange rate. REER deflated by consumer price index appreciated by 2.2% while REER deflated by the producer price index registered an annual appreciation of 6.4%. The upward pressures result from the nominal effective exchange rate, whose annual growth reached 3.6%, mostly as a result of the appreciation of the denar against the Russian ruble, the British pound, and the Turkish lira. As for the relative prices, the relative consumer prices registered an annual decline of 1.4%, while the relative producer prices increased by 2.7%.

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



Source:NBRM.

Relative prices, excluding primary commodities (2010=100)



Source:NBRM.

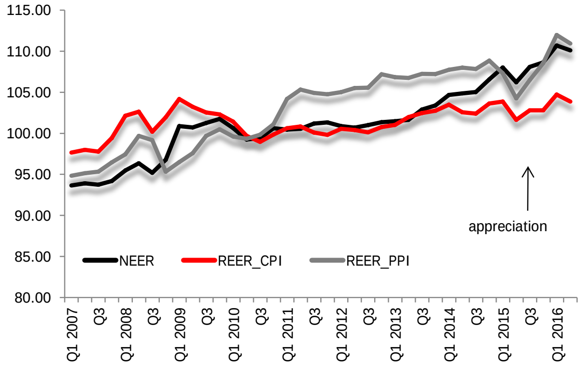
The analysis of REER indices as measured using weights based on the foreign trade without primary commodities[42] also indicate that they have appreciated moderately on an

[41] The increase in the imports from the United States is caused mostly by the higher imports of medical and pharmaceutical products, while the factors for the growth of the share of the imports from Turkey in the total imports are dispersed among several categories.

[42] Primary products not included in the calculation are: oil and oil derivatives, iron and steel, ores and imported raw materials for the new industrial facilities in the free economic zones. For more detailed information on the methodology for calculating the real effective exchange rate visit:

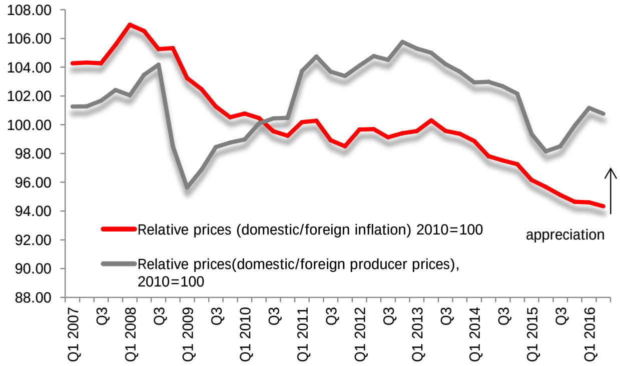
annual basis. Namely, REER deflated by consumer prices appreciated by 0.3%, while REER based on producer prices appreciated by 4.8% on an annual basis. The NEER index appreciated by 1.3%, while the relative prices registered divergent movements, i.e. an annual decline in the relative consumer prices and simultaneously an increase in the relative producer prices[43].

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



Source:NBRM.

Relative prices
(2006=100)

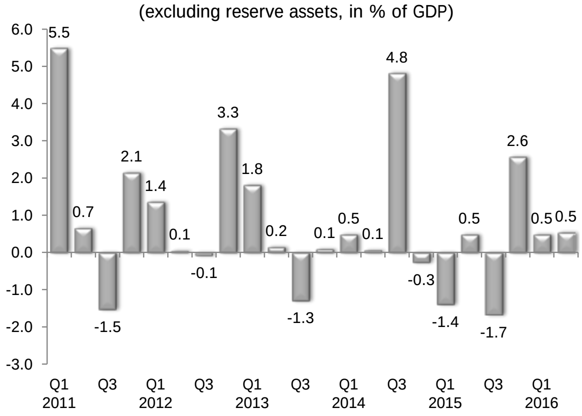


Source:NBRM.

The latest data on price competitiveness for the period July-August 2016 indicate a moderate annual appreciation of the REER, as measured using weights of the total trade of goods, as well as weights based on foreign trade without primary commodities. In both indices, annual changes mainly derive from the appreciation of the nominal effective exchange rate (of 2.9% and 1.4%, based on the weights on the overall trade and foreign trade-based weight excluding primary commodities, respectively). At the same time, both methods of calculation registered downward correction in the relative consumer prices and annual growth of the relative producer prices. As a result of such movements of individual components, with the REER based on the total foreign trade, the index deflated by consumer prices has appreciated by 1.4%, and the index based on producer prices has appreciated by 3.9%, while the movements of the REER with weights based on foreign trade without primary commodities indicate appreciation in both indices.

1.6.2. Financial account

Financial account
(excluding reserve assets, in % of GDP)



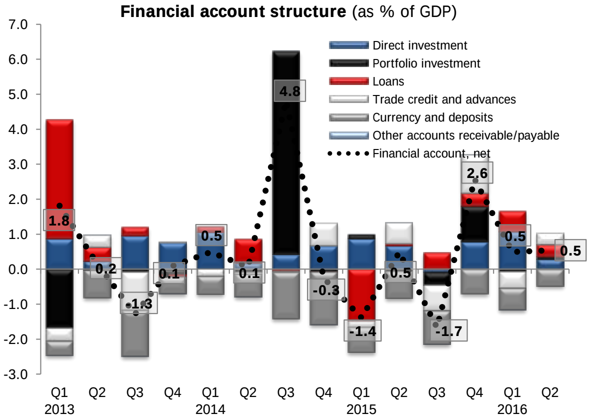
Source: NBRM.

In the second quarter of 2016, the financial account of the balance of payments registered moderate net inflows of Euro 52 million or 0.5% of GDP. The analysis of individual components suggests that financial loans, trade credits and advances and direct investments are the main sources of financial inflows. In terms of financial loans, net inflows were registered on the basis of short-term foreign borrowing by the banking sector, while long-term loans registered small negative flows. In this quarter, trade credits also registered growth, which is typical pattern for this time of year, according to the seasonal widening of the

http://nbrm.mk/WBStorage/Files/Statistika_REDK_Informacija_za_promenite_na_metodologijata_za_presmetuvanje_na_realniot_efektiven_devizen_kurs_na_denarot_mak.pdf

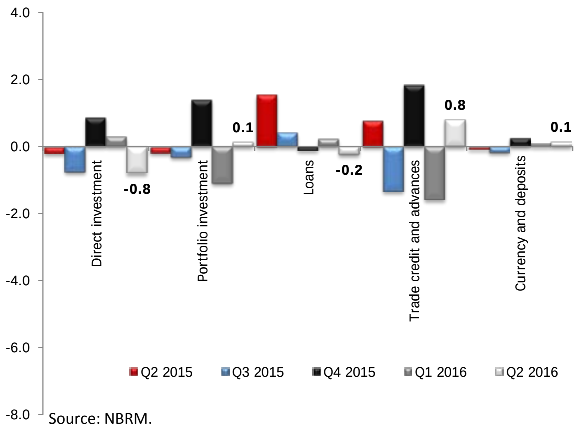
[43] The appreciation through relative prices of the producers of industrial products may be overestimated. Namely, unlike the foreign prices which dropped, the domestic prices during 2016 stagnate. However, it should be borne in mind that the weight structure of domestic index still does not include the latest changes in the structure of domestic production, and accordingly, the price changes via this index might not properly depict the actual changes.

Financial account structure (as % of GDP)



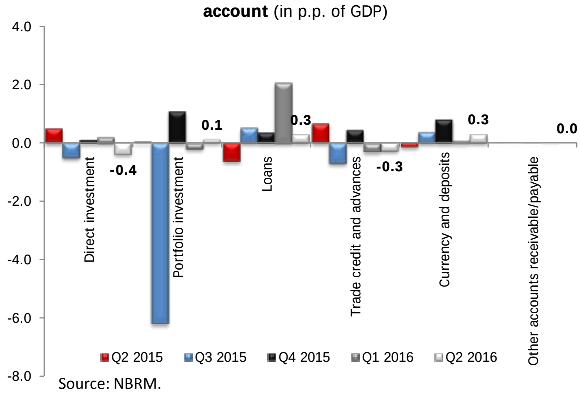
Source: NBRM.

Contributions to the quarterly change of the financial account (in p.p. of GDP)



Source: NBRM.

Contributions to the quarterly change of the financial account (in p.p. of GDP)



Source: NBRM.

trade deficit. Non-debt net flows prevail in the structure of foreign direct investments in the analyzed period, i.e. equity capital and reinvested earnings, as opposed to the debt component, which declined. On the other hand, the category of currency and deposits still registers net outflows in the second quarter of the year. High outflows were typical for other sectors in the economy, reflecting the withdrawal of foreign assets of the households from the banking sector, amid increased political uncertainty. However, these negative flows were largely mitigated by net inflows in depository institutions, arising from the withdrawal from the deposit accounts from abroad, which is associated with recent monetary measures of the NBRM to maintain and increase deposits in the domestic banking sector[44]. *Compared to the performances in the previous quarter, the financial account recorded a slight improvement.* This stems from the net inflows based on trade credits and portfolio investment (instead of net outflows in the previous quarter) and smaller outflows in currency and deposits. On the other hand, less favorable results were observed in direct investments and financial loans, amid lower net inflows on a quarterly basis.

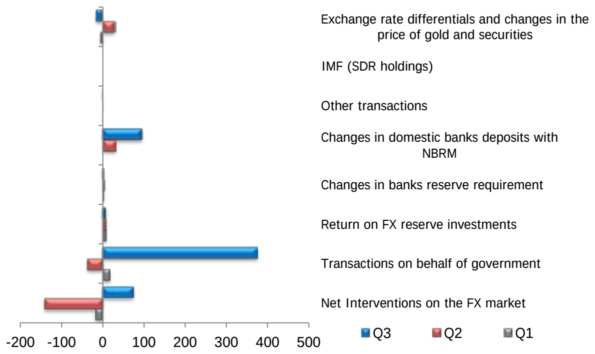
The annual analysis shows higher net inflows of the financial account compared to the second quarter of 2015. This change mainly stems from the higher net inflows of financial loans, coupled with the improvement in currency and deposits (lower outflows) and portfolio investment (realized inflows rather than outflows). The reduced net inflows in direct investment and trade credits acted in the opposite direction.

The latest balance of payments data as of July 2016 suggest net inflows of Euro 364.2 million in the financial account. Funding was mostly made through portfolio investment, which is a result of the government borrowing on the international financial markets by issuing the fifth Eurobond[45]. Direct investments are also an additional source of financial inflows, while other categories registered net outflows.

The gross foreign reserves at the end of the second quarter of 2016 amounted to Euro 2,158.8 million, which is a quarterly decrease of Euro 107.6 million. The reduction of foreign reserves results from interventions by

[44] Decision on foreign currency deposit with the National Bank of the Republic of Macedonia.
[45] On 26 July 2016, the government issued the fifth Eurobond in the amount of Euro 450 million, with maturity of seven years and interest rate of 5.625%.

Factors of change of the foreign reserves in 2016
(in EUR million)



Source: NBRM.

the NBRM in the foreign exchange market, as well as from transactions on behalf of the government. On the other hand, the foreign currency deposits of domestic banks with the NBRM[46], the positive currency changes, and changes in the price of gold, as well as the income from investing foreign reserves had a favorable impact.

According to the latest available data, at the end of September, the foreign reserves amounted to Euro 2,699.0 million, which is an increase of Euro 540.2 million relative to the end of the second quarter of 2016. The increase in foreign reserves was mostly due to transactions on behalf of the government, i.e. the issuance of the fifth Eurobond on the international financial markets[47]. Foreign currency deposits of domestic banks with the NBRM and the NBRM interventions on the foreign exchange market for net purchase of foreign currency are additional factors for growth of reserves. The decrease in the market value of foreign reserves acted in the opposite direction, as a result of the calculated negative currency and price differences.

1.6.3. International investment position[48] and gross external debt

At the end of the first half of 2016, the **negative international investment position[49] of the Republic of Macedonia amounted to Euro 5,436.9 million, or 56.6% of GDP.** The IIP quarterly analysis suggests deterioration by 2.6 p.p. of GDP, which stems from the sharper decline in the international assets than the decline in the international liabilities[50]. In terms of the division by sector, the quarterly shift was mostly

---

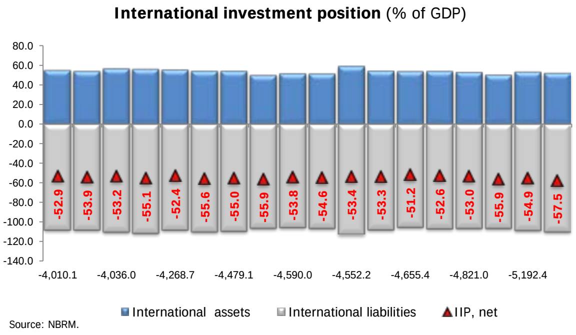
[46] The growth of foreign currency deposits of domestic banks with the NBRM stems from the Decision on foreign currency deposit with the National Bank of the Republic of Macedonia, adopted on 6 May 2016, which allows interest rates to be determined at a level higher than the level of interest rates which domestic banks receive in placing funds in euros abroad.

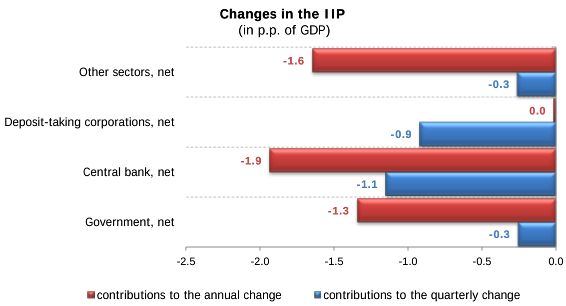
[47] On 26 July 2016, the government issued the fifth Eurobond in the amount of Euro 450 million, with maturity of seven years and interest rate of 5.625%.

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

[49] In the second quarter of 2011, the NBRM began concluding repo and reverse repo transactions. These transactions represent an investment opportunity to use portfolio securities to provide additional income. Conclusion of repo transactions incurs liabilities. At the same time, claims created from entering into reverse repo agreements tend to increase gross claims. The NBRM simultaneously carries out matched conclusion of repo and reverse repo agreements in nearly identical amounts. In general, as they are concluded concurrently, these transactions have a neutral net effect, i.e. they appear in almost identical amount on both liabilities and assets side, and therefore do not affect the total net IIP nor the total net external debt.

[50] In absolute terms, the increased IIP of the country is due to the decrease in the international assets, given the growth of the international liabilities on a quarterly basis.





due to the lower net assets with the central bank (reduced net assets on the basis of foreign reserves) and the higher net liabilities in depository institutions (decrease in net assets mainly due to the instrument currency and deposits), given the small increase in net liabilities of other sectors in the economy and the government.

The annual change in the net liabilities to the rest of the world indicates growth of 4.0 percentage points of GDP, as a result of the growth of the international liabilities (of 1.3 percentage points of GDP), coupled with the fall in the international assets (of 2.7 percentage points of GDP). The sector-by-sector analysis shows that this change results from the reduced net assets of the central bank (mainly as a result of the reduced foreign reserves), then the increased net government liabilities (increased net liabilities on portfolio investment in debt securities), as well as the higher net liabilities of other sectors in the economy (amid increased net liabilities to direct investors). At the same time, international net liabilities of depository institutions are almost unchanged.

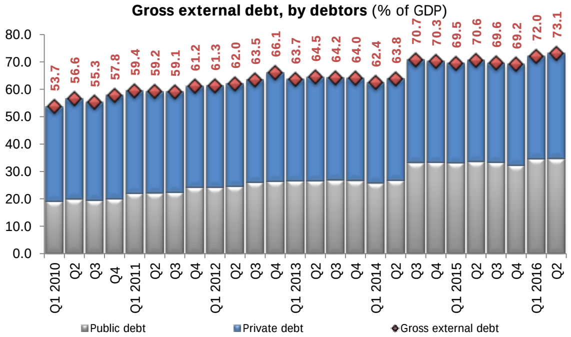
As of 30 June 2016, the gross external debt stood at Euro 6,914.6 million, or 72% of GDP, which is a quarterly increase of 1.1 percentage points of GDP. If we exclude the effect of repo transactions[51], the gross debt accounts for 69% of GDP, which is a quarterly increase of 1.3 percentage points of GDP[52]. This quarterly increase in the gross debt mainly stems from the growth of private debt, amid a slight upward movement in public debt. The growth of private debt is due to the higher intercompany debt, i.e. the increase in liabilities to direct investors, the increased debt of non-banking private sector, as well as the minimal increase in bank debt. The higher debt of the corporate sector is due to the increase in short-term liabilities based on trade credits and advances and loans, while bank debt increased moderately due to the growth of short-term liabilities based on loans and currency and deposits.

Compared to the end of the second quarter of 2015, gross external debt is

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

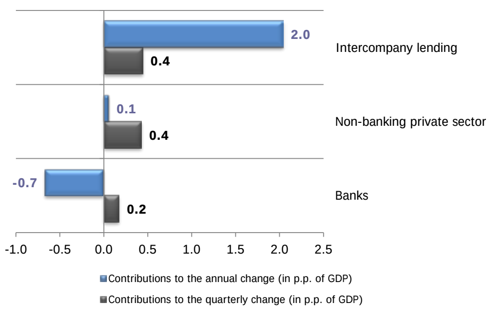
[52] The analysis in nominal terms indicates a slight increase in gross external debt of 0.8% compared to the end of 2015, due to the increased public sector debt, and less to the higher level of private sector debt.

Gross external debt, by debtors (% of GDP)



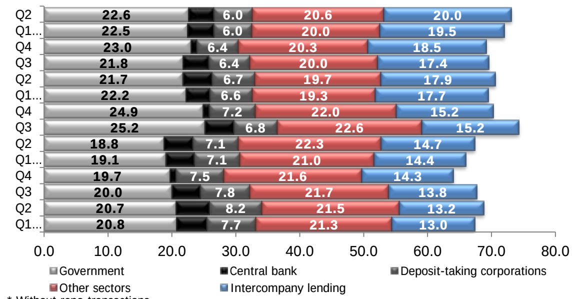
* Without repo-transactions.
Source: NBRM.

Changes in private sector debt



Source: NBRM.

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



* Without repo-transactions.
Source: NBRM.

higher by 2.0 percentage points of GDP, given the higher debt of the private and public sectors. The annual growth of private debt mainly stems from the increase in loans between related parties, i.e. there was a significant increase of intercompany debt. Moderate growth was registered in the debt of non-banking private sector, due to the increased short-term liabilities. Conversely, the level of debt of the banking sector reduced, primarily due to the reduction of long-term liabilities based on loans and currency, and deposits. The annual growth of public debt is mostly caused by the increase in government debt due to the issue of the fourth Eurobond in December 2015 and the further growth of the debt of public companies to support road infrastructure.

In general, the external indebtedness indicators of the national economy still show that the gross external debt is in the safe zone. The only indicator that classifies the economy in the group of highly indebted countries is the gross external debt to GDP ratio. The dynamic analysis of external indebtedness[53] indicates negative trends in three solvency indicators on an annual basis (the share of the repayment of interest in exports and the share of gross debt in GDP and the export of goods), while the indicator of the share of the repayment of gross debt in the export of goods and services registers an improvement. Moderate deterioration was also observed in the liquidity ratios, but there is further coverage of short term debt liabilities and short-term debt with residual maturity, with foreign reserves.

Net external debt, as an additional external debt indicator of the domestic economy, at the end of June 2016 amounted to Euro 2.586 million, or 26.9% of GDP, which indicates a quarterly increase of 2.6 percentage points of GDP. The increase in net debt is due to the increase in mainly public and then private net debt.

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

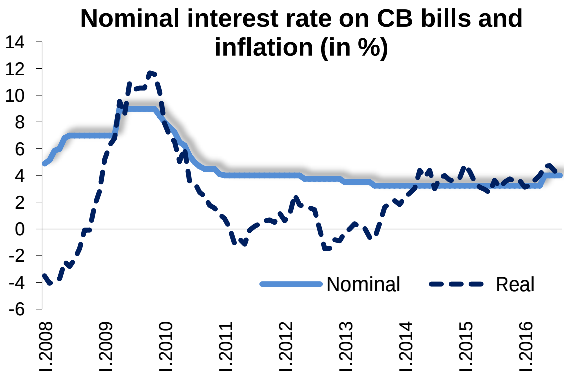
Indicators for external indebtness	Solvency				Liquidity		
	Interest payments/ Export of goods and services and other inflows	Gross debt/ Export of goods and services and other inflows	Gross debt/ GDP	Debt servicing/ Export of goods and services and other inflows	Foreign reserves/ Short-term debt	Foreign reserves/ Short-term debt, with residual maturity	Short-term debt/ Overall debt
	in %				ratio	ratio	in %
31.12.2004	2.41	129.3	47.3	12.4	1.14	0.89	30.3
31.12.2005	2.66	147.0	54.2	11.06	1.67	1.04	26.7
31.12.2006	3.44	131.3	49.8	21.7	1.95	1.34	29.0
31.12.2007	2.78	119.3	51.3	19.4	1.35	1.08	39.8
31.12.2008	2.66	116.9	54.1	10.2	1.29	0.95	35.2
31.12.2009	2.43	131.0	57.8	11.8	1.29	0.94	32.9
31.12.2010	3.22	140.4	59.7	13.9	1.49	0.99	27.9
31.12.2011	3.12	148.4	64.6	16.8	1.78	1.18	25.2
31.12.2012	2.92	141.9	67.6	13.1	1.64	1.03	26.7
31.12.2013	2.51	137.3	67.4	15.8	1.64	1.08	23.3
31.12.2014	3.02	149.4	74.1	17.3	1.82	1.13	22.3
31.03.2015	2.69	138.83	70.63	20.01	1.66	1.09	23.42
30.06.2015	2.69	139.28	70.86	20.01	1.56	1.03	23.80
30.09.2015	2.69	138.38	70.40	20.01	1.57	1.03	23.09
31.12.2015	2.69	143.93	73.23	20.01	1.69	1.13	21.32
31.03.2016	2.87	137.41	72.12	15.35	1.52	1.05	22.90
30.06.2016	2.87	139.91	73.43	15.35	1.39	0.97	23.45
Moderate indebtedness criterion	*12 - 20%*	*165 - 275%*	*30 - 50%*	*18 - 30%*		*1.00*	

*The moderate indebtness criterion is accordng to the World bank's methodology of calculationg indebtness indicators, which implies 3-year moving averages of GDP and exports of goods and services in the calculation of the indicators.
In compliance with "External debt statistics: Guide for compilers and users," published by the IMF.
*According to the "Greenspan-Guidotti rule", a country should maintain full coverage of short-term debt at remaining maturity with gross foreign reserves.
Source: NBRM.

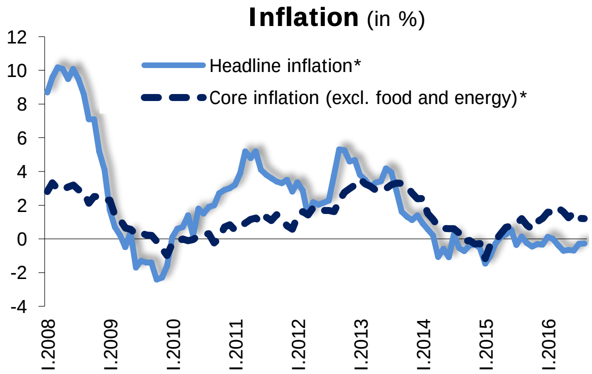
2. Monetary policy

After the tightening of the monetary policy at the beginning of May 2016, in response to the pressures caused by the political crisis, the NBRM during the third quarter did not change the monetary policy setup. Previously undertaken measures contributed to the stabilization of economic agents' expectations and normalization of foreign exchange market developments, and positive trends were present in the banks' deposit base. In conditions of improved foreign currency liquidity of banks, during the third quarter, the NBRM intervened by purchasing foreign currencies. Foreign exchange interventions and foreign currency deposits with the NBRM, together with the external government borrowing on the international financial markets, contributed to a significant increase in the level of foreign reserves. Developments in the third quarter provided evident signs of stabilization in the expectations and the behavior of the economic agents and thereby reducing the pressures on demand for foreign currency and banks' deposit base. However, there is still uncertainty related to the domestic political developments and global environment. In the period ahead, the NBRM will continue to monitor closely the situation for the timely and appropriate adjustment of monetary policy.

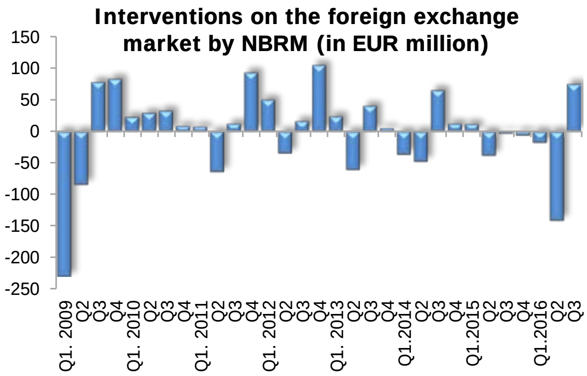
During the third quarter of 2016, no changes were made in the monetary policy setup. The NBRM reexamined the monetary setup



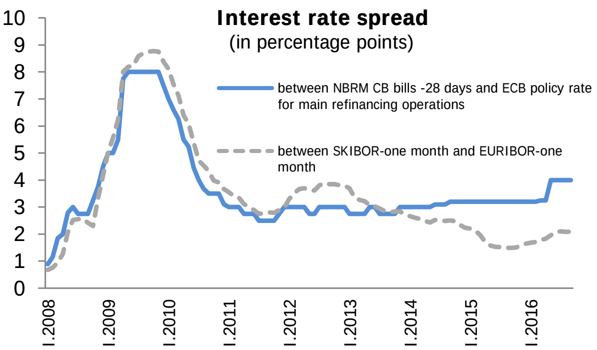
Source: NBRM.



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



Source:NBRM



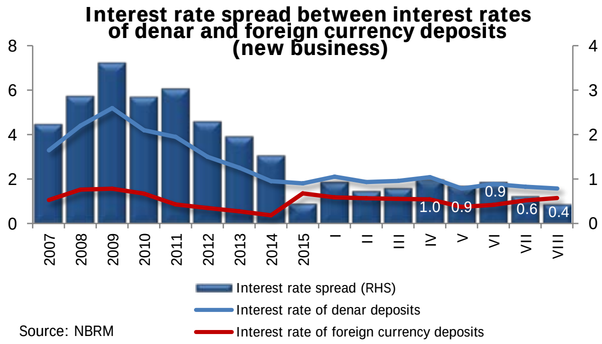
Source: NBRM, ECB (www.ecb.int) .

adequacy on a regular basis, whereby it was agreed that the economic fundamentals are kept sound. Measures undertaken by the NBRM in early May (increase in the policy rate from 3.25% to 4.00%), combined with changes in reserve requirements (higher rate for liabilities with foreign exchange clause) and the reactivation of the possibility for banks to place foreign currency deposits with the NBRM contributed to the stabilization of economic agents' expectations and normalization of foreign exchange market developments, and positive trends were observed in the banks' deposit base.

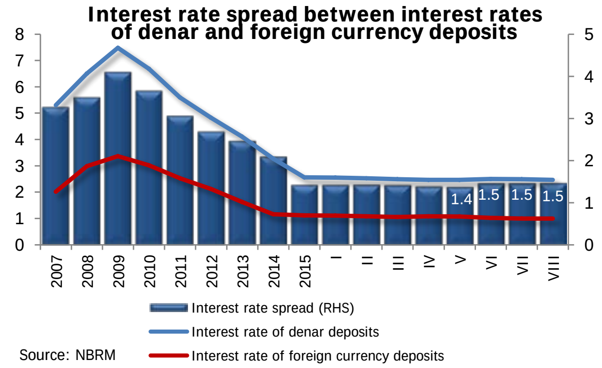
The performances of the main macroeconomic indicators give a different picture when compared to the April projections. The average annual inflation rate for the period July-August was negative (-0.3%), with lower food and energy prices, while core inflation remained in the zone of positive annual changes and averaged 1.2%. These performances are moderately lower than the expectations in the April projections. Data on economic activity in the second quarter of the year indicate a further annual growth of 2.2% of the domestic economy, which is lower than expected, amid lower performances of gross capital formation. High frequency data for the period July-August suggest further growth of the domestic economy, but they are not sufficient to provide a solid assessment of the future dynamics of economic growth. Foreign reserves in the third quarter of the year registered a fast growth, predominantly affected by government transactions, due to the issued Eurobond in the international financial markets54. The NBRM interventions with market makers (net purchase of foreign currency from market makers) and the amount of foreign currency deposits of domestic banks placed with the NBRM had an effect on the growth of foreign reserves. Foreign reserves adequacy analyses suggest that their level is appropriate and sufficient to deal with any future shocks. Despite through the foreign exchange market developments, stabilization in the expectations and the behavior of the economic agents was achieved by reducing the pressures on the banks' deposit base. In terms of developments on the credit market, lending registered a moderate slowdown in the third quarter (annual growth of 8.1% in August, versus 8.5% in

[54] In July 2016, Eurobond was issued in the nominal amount of Euro 450 million, a maturity of 7 years and an interest rate of 5.625%.

June55), but the annual growth remains in line with the April assessment for the third quarter of the year (annual growth of 7.9%). The uncertainty associated with the domestic political upheavals and the global surrounding still exists. In the period ahead, the NBRM will continue to monitor closely the situation for the timely and appropriate adjustment of monetary policy.



Source: NBRM

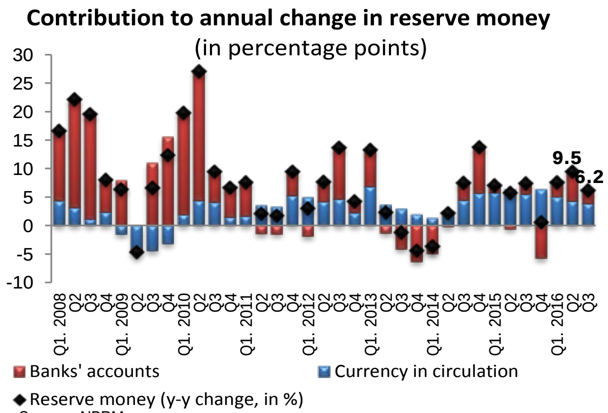


Source: NBRM

Interest rate spread of the policy rates (of the ECB and the NBRM) and short-term market interest rates remained relatively stable. The policy rates of the ECB and the NBRM in the third quarter remained unchanged. Meanwhile, the spread between short-term market interest rates in the domestic economy and on the financial markets in the euro area increased moderately (from 2.0 percentage points in the second quarter to 2.1 percentage point in the third quarter, on average).

With regard to interest rates on the banking sector in the domestic economy, analyzing the newly accepted deposits, in August, the interest rate on Denar deposits moderately decreased, which amid a simultaneous moderate increase in the interest rate on foreign currency deposits, narrowed the interest rate spread to 0.4 percentage points (from 0.9 percentage points in June)[56]. The spread between interest rates on total Denar and total foreign currency deposits remains stable (1.5 percentage points in August), remaining at the same level as at the end of the second quarter.

2.1. Banks' liquidity and interbank money market developments

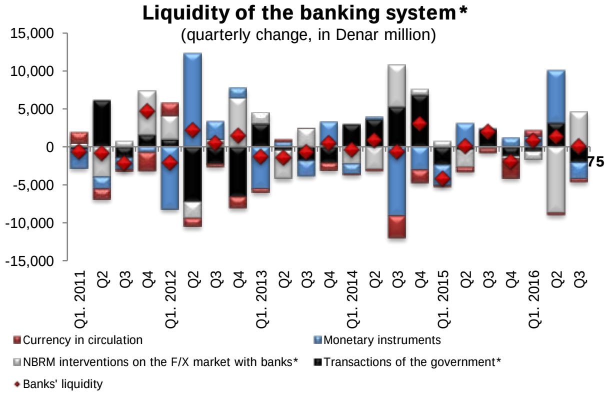


Source: NBRM

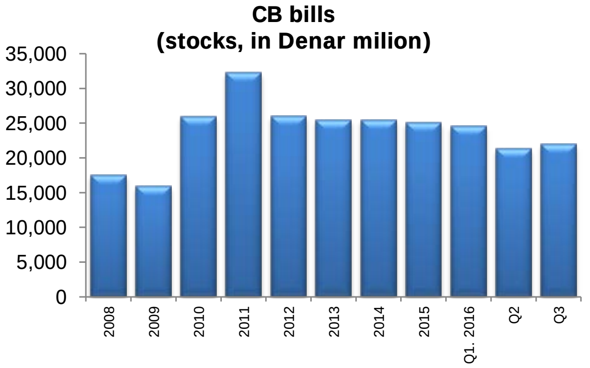
During the third quarter of 2016, bank liquidity, analyzed by banks' account balances with the NBRM, increased by Denar 75 million. The latest available data show that in September 2016, the reserve money[57] stood at 6.2% on an annual basis, down compared to the end of the second quarter of 2016, when it was 9.5%.

Autonomous factors contributed to the increase in bank net liquidity by Denar 2,278 million. By individual autonomous factors, the NBRM foreign exchange interventions (net

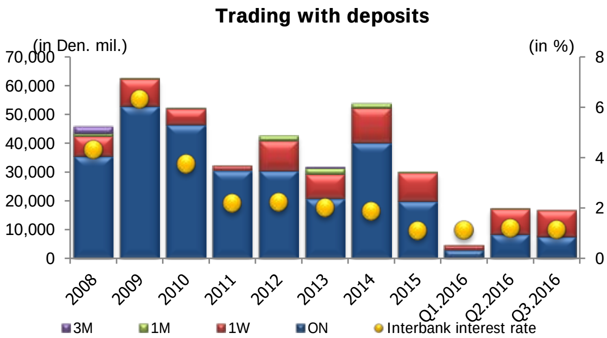
[55] The annual credit growth, including the effect of transferring doubtful and contested claims based on loans from the on-balance sheet to the off-balance sheet record, equals 2.9% in August, compared to 3.5% in June 2016.
[56] The interest rates on newly received deposits are volatile, which can result in frequent and temporary adjustments of the interest spread.
[57] Includes reserve requirement in foreign currency.

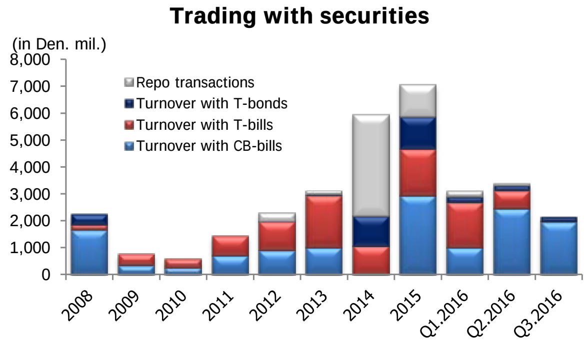


*Positive change- liquidity creation, negative change- liquidity withdrawal
Source: NBRM



Source: NBRM





purchase of foreign currency from market makers) have contributed to creating liquidity, while government transactions and currency in circulation caused a decrease in the banks' liquidity (of Denar 2.021 million and Denar 397 million, respectively).

Liquid assets in the total amount of Denar 2,203 million were withdrawn through the NBRM's monetary instruments. At the auctions of CB bills[58], the offer was set at a moderately higher level than the amount due[59]. The demand by banks was at the level of the offered amount, whereby liquid assets of Denar 670 million were withdrawn from the banking system. Thus, the stock of CB bills increased moderately, and at the end of September amounted to Denar 22,000 million. Also, banks had an interest in short-term deposits with the NBRM (overnight and 7-day deposits) and Denar 1,533 million were additionally withdrawn through these instruments in the third quarter. Hence, the liquidity created through autonomous factors was almost entirely withdrawn through monetary instruments, increasing the banks' liquid assets on the accounts with the NBRM by Denar 75 million in the third quarter. Analyzed in terms of reserve requirement, the banks' liquid assets with the NBRM in the third quarter was higher by 7%, on average (excess liquidity above the reserve requirement in the previous quarter averaged 6%).

During the third quarter, banks actively traded in unsecured deposits and securities. Transactions with 1-day to 7-day maturity, with a share of 45% and 55%, respectively, prevailed in the structure of trade in unsecured deposits. The interbank interest rate (MBKS) moderately decreased and averaged 1.1%. On the other hand, the interbank interest rate on overnight transactions (MKDONIA) has remained stable and averaged 1.0%. In the third quarter, banks also traded in securities, with lower trade of this segment on a quarterly basis. The structure of trade in securities, as in the previous quarter, was predominated by the definite CB bill transactions.

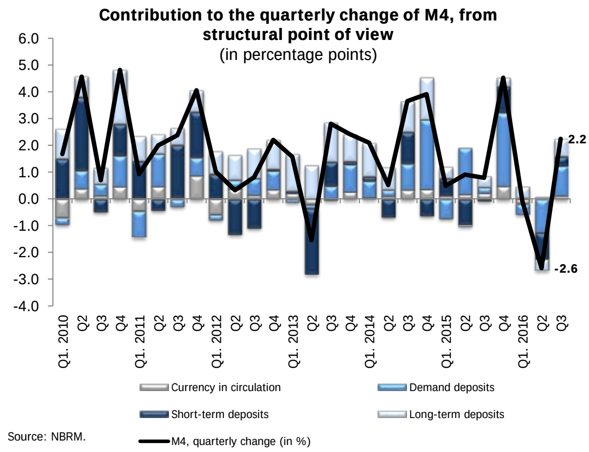
58 The auctions were conducted by applying volume tender (limited amount) and fixed interest rate (4.00%).
59 Decisions on the amount of CB bills at auctions are adopted in the monthly meetings of the Operational Monetary Policy Committee.

2.2. Monetary and credit aggregates

After the strong decline in the previous quarter, in the third quarter of 2016, the broad money M4 registers solid growth on a quarterly basis. Improved performance in the money supply in this period indicates a gradual stabilization of perceptions and confidence of economic agents, which were undermined by the domestic political instability in the second quarter. The money supply growth in the third quarter is due to the rise in all components, whereby the most liquid monetary aggregate M1 makes the largest individual contribution from maturity aspect, while Denar deposits with demand deposit make the largest contribution from currency aspect. The sector-by-sector analysis shows that the growth is explained by the increased household savings, and the positive contribution of corporate deposits. These changes only partially correspond to the developments on the credit market. Thus, in the third quarter, total loans to the private sector registered moderate growth on a quarterly basis, derived exclusively from household lending, while loans to the corporate sector registered a quarterly decline. The third quarter also registered gradual depletion of the effect of the amendments to the regulation of the NBRM to transfer part of the banks' doubtful and contested claims to the off-balance sheet record. On an annual basis, total loans in September increased by 2.5% (3.5% in June), but if we isolate the effect of regulatory changes, the annual growth in September was 7.7% compared to the growth of 8.5% in the previous quarter.

2.2.1. Monetary aggregates

In the third quarter of 2016, the broad money M4 registers solid growth of 2.2% on a quarterly basis, compared to the drop of 2.6% in the previous quarter. Namely, after the strong decline in the second quarter as a result of the uncertain domestic political environment, in this period there was a significant stabilization of perceptions of economic agents and their expectations. In such circumstances, there was growth of all money supply components as opposed to the reduction in almost all categories in the previous period (with the exception of currency in circulation which registered a small growth). Analyzed by individual components, the growth was mostly due to changes in the most liquid monetary aggregate M1 (which makes up 55.2% of total quarterly growth), despite the negative contribution in the second quarter. Term deposits acted in the same direction, whereby long-term deposits registered more favorable performances (accounting for 29.2% in the quarterly growth). Analyzing currency, growth was observed in both components. Thus, the Denar component of the money supply contributes to half of the growth in this period, compared to the significant decline registered in the last quarter due to the deteriorating perceptions of domestic economic agents and speculations about the devaluation of the Denar. On the other hand, foreign currency deposits registered accelerated quarterly growth rate indicating further propensity of entities to save in foreign currency. Amid simultaneous growth of Denar and foreign currency deposits, there are no significant changes in the degree of euroisation.



Source: NBRM.

Thus, the share of foreign currency deposits in M4 money supply at the end of September was 38.7%, compared to 38.6% at the end of June. The improved performance on a quarterly basis led to an acceleration in **the annual growth rate** of money supply, which is 4% at the end of September, compared to 2.5% at the end of the previous quarter.

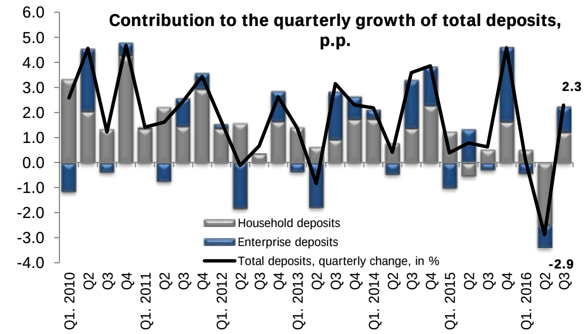
The total banks' deposit potential in the third quarter of 2016 increased by 2.3% on a quarterly basis, compared to the decline of 2.9% in the last quarter. The improved performances in this period are a clear signal for stabilization of the expectations and the behavior of the economic agents. This statement is also supported by the analysis of the currency and sectoral structure of the growth. Namely, after the significant decline in the second quarter, as a result of the political uncertainty and speculations about the devaluation of the domestic currency, denar deposits registered solid growth on a quarterly basis, amid a simultaneous increase in foreign currency deposits. Analyzing by sector, the growth mostly stems from household deposits (as opposed to the more significant withdrawal of deposits from the banking system in the previous quarter), amid a significant contribution by corporate deposits. Thus, **household deposits grew by 1.8% on a quarterly basis, compared to the decrease of 3.5% in the second quarter.** Analyzing the maturity structure, there was a positive contribution of long-term and short-term deposits to total deposit growth, despite their decrease in the previous quarter. Observing the currency, the quarterly increase is mostly due to the growth of foreign currency deposits, amid a simultaneous increase in deposits in local currency. **Annually,** at the end of September, total household deposits rose by 1.2%, compared to 0.2% in June.

The corporate deposits in the third quarter of the year registered a quarterly increase of 4.2%, despite the decline of 3.6% in the previous quarter. According to the analysis of the monthly flows of corporate deposits, the growth almost entirely stems from the higher performance in August, while in September, a decrease was registered. Such volatility of the monthly flows of corporate deposits mainly stems from changes in demand deposits, which in turn is explained by the need of companies for liquid assets to carry out their regular business activities. Also, the changes reflect the seasonal effect of the payment of dividends. Observing the maturity structure, the quarterly growth of corporate deposits is due to long-term deposits, amid

Total deposits

	2014	2015				2016		
	Q4	Q1	Q2	Q3	Q4	Кв.1	Кв.2	Кв.3
	q-o-q growth, %							
Total deposits	3.9	0.4	0.8	0.6	4.6	0.1	-2.9	2.3
	contributions to quarterly growth, p.p.							
Deposit money	2.8	-0.8	1.9	0.3	3.2	-0.4	-1.3	1.2
Denar deposits	1.5	0.0	-1.1	0.3	0.3	0.01	-1.6	0.0
Foreign currency deposits	-0.4	1.2	0.0	0.1	1.1	0.5	0.1	1.1
Short-term deposits	-0.7	0.7	-1.0	-0.1	1.1	0.03	-1.0	0.4
Long-term deposits	1.7	0.5	-0.1	0.4	0.3	0.5	-0.5	0.7

Source: NBRM.



Source: NBRM.

Household deposits

	2014	2015				2016		
	Q4	Q1	Q2	Q3	Q4	Кв.1	Кв.2	Кв.3
	quarterly change, in %							
Total household deposits	3.2	1.8	-0.7	0.7	2.3	0.8	-3.5	1.8
	contribution to quarterly change of total deposits, in p.p.							
Deposit money	1.9	0.1	-0.2	0.3	1.8	0.1	-0.9	0.6
Denar deposits	1.1	0.7	-0.4	-0.1	0.1	0.3	-2.6	0.0
FX deposits	0.2	1.0	-0.1	0.6	0.4	0.4	0.0	1.1
Short-term deposits	-0.2	1.1	-0.7	0.1	0.2	0.1	-1.8	0.6
Long-term deposits	1.4	0.6	0.1	0.4	0.3	0.6	-0.8	0.5

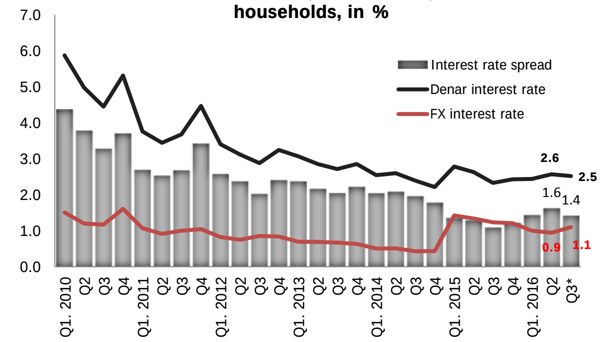
Source: NBRM.

Enterprise deposits

	2014	2015				2016		
	Q4	Q1	Q2	Q3	Q4	Кв.1	Кв.2	Кв.3
	квартални промени, во %							
Total household deposits	6.8	-4.2	5.9	-1.2	12.7	-1.7	-3.6	4.2
	contribution to quarterly change of total deposits, in p.p.							
Deposit money	7.6	-4.3	8.1	0.6	8.3	-2.3	-3.4	2.9
Denar deposits	1.3	-1.7	-2.6	-0.4	0.7	-0.1	0.0	-0.7
FX deposits	-2.1	1.8	0.5	-1.4	3.7	0.6	-0.3	1.9
Short-term deposits	-2.4	-1.1	-1.6	-1.2	4.3	-0.2	0.7	0.5
Long-term deposits	1.5	1.2	-0.6	-0.6	0.1	0.8	-0.9	0.8

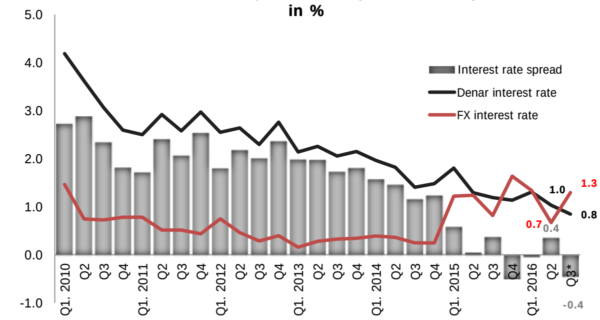
Source: NBRM.

Interest rate of newly received deposits of households, in %



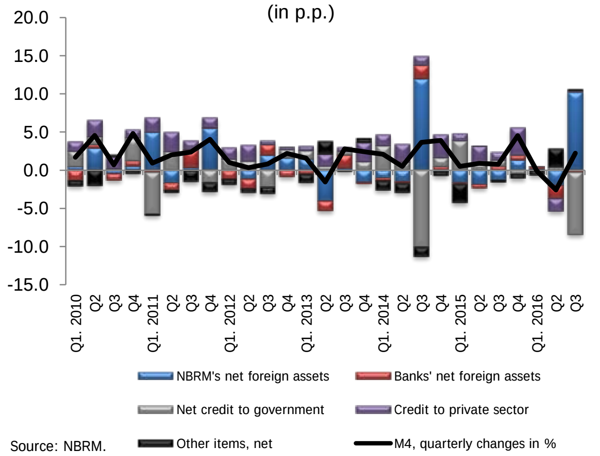
*refers to August 2016.
Source: NBRM.

Interest rate of newly received deposits of enterprises, in %



*refers to August 2016.
Source: NBRM.

Quarterly growth of M4 and contributions to growth, from balance sheet point of view
(in p.p.)



moderate growth of short-term deposits. In terms of currency structure, the quarterly increase stems from the simultaneous growth of Denar and foreign currency corporate deposits, as opposed to the previous quarter, when both components declined. **On an annual basis,** the growth of corporate deposits at the end of September is twice higher compared to the performance in the second quarter and amounted to 11.3% (5.6% at the end of June).

According to data on interest rates on new savings[60], the movements in newly accepted Denar and foreign currency deposits are divergent in both the households sector and the companies. Thus, in August, the Denar interest rates on newly accepted household and corporate deposits decreased by 0.1 p.p. and 0.2 p.p., respectively, while the foreign currency interest rates increased by 0.2 p.p. i.e. 0.6 p.p. compared to June. In such circumstances, the interest rate spread between the new Denar and foreign currency household savings was reduced to 1.4 percentage points, while in companies the interest rate spread passed in negative territory. In terms of total deposits, interest rates on Denar and foreign currency household deposits in August amounted to 2.5% and 1.1% respectively, while on Denar and foreign currency corporate deposits they equaled 2.2% and 1.3%, respectively.

According to the analysis of the money supply structure, from balance sheet aspect, the monetary growth in the third quarter mainly stems from the higher net foreign assets of the NBRM, and less from the loans to the private sector. On the other hand, net government loans contribute to significantly decreasing the broadest monetary aggregate.

2.2.2. Lending activity

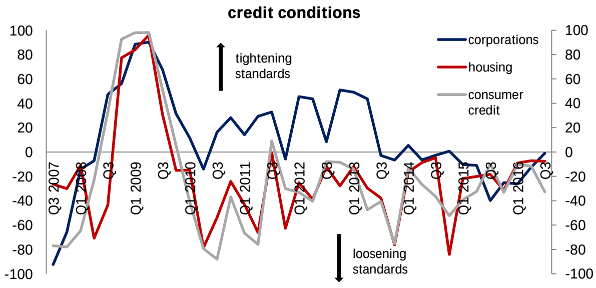
The lending of the banking sector grew by 0.2% in the third quarter, as opposed to the decrease of 2% in the preceding quarter. The third quarter registered depletion of the effect of the amendments to the regulation of the NBRM[61] to transfer part of the

[60] As of January 2015, data on interest rates of banks and savings houses have been collected under the new interest rate methodology. For more information see Quarterly Report, May 2015, p 53.
[61] On 17 December 2015, the National Bank Council adopted the Decision on amending the Decision on credit risk management that requires from banks by 30 June 2016 to write off (and to continue to write off) all claims that have been fully booked for more than two years, and where the bank has identified and fully covered the credit risk of default at least two years before.

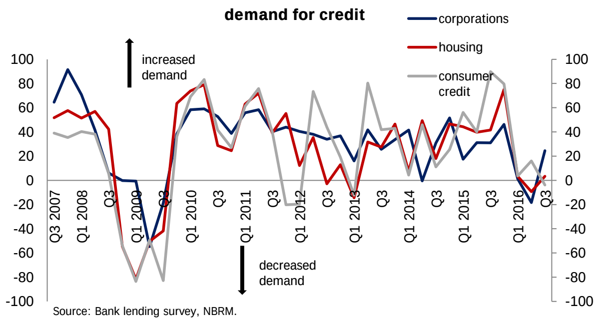
Total credits of private sector

	2014 Q1	Q2	Q3	Q4	2015 Q1	Q2	Q3	Q4	2016 Q1	Q2	Q3
quarterly change, in %											
Total credits of private sector	1.8	2.9	1.4	3.6	1.1	2.7	1.2	4.2	0.1	-2.0	0.2
Contribution in quarterly change of total credits (in p.p)											
Denar credits	1.6	2.7	1.3	3.1	0.7	3.2	1.6	3.7	0.6	-1.1	0.5
Foreign currency credits	0.2	0.1	0.1	0.5	0.4	-0.5	-0.3	0.5	-0.6	-0.9	-0.3
Short-term credits	0.7	0.4	0.0	1.7	-0.5	0.0	-0.4	1.8	-1.1	-0.3	-0.5
Long-term credits	1.2	1.3	0.9	2.4	1.2	2.5	0.3	2.9	1.0	2.2	0.9
Households	0.9	1.6	1.2	1.0	1.0	1.8	1.4	1.1	1.1	0.1	0.8
Corporations	0.9	1.2	0.2	2.6	0.1	0.9	-0.2	3.2	-1.0	-2.1	-0.6

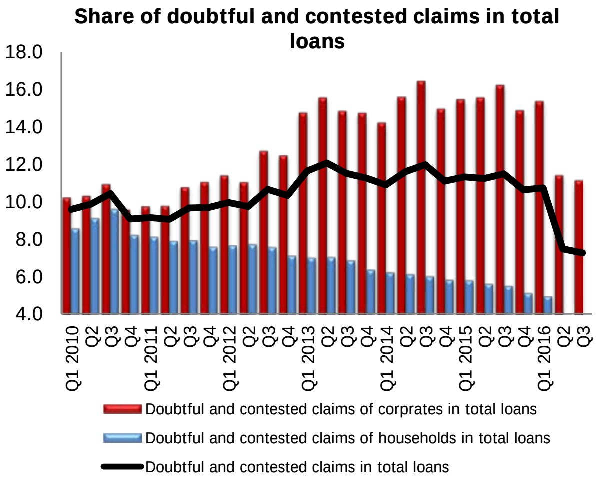
Source: NBRM.



Source: Bank lending survey, NBRM.



Source: Bank lending survey, NBRM.



Source: NBRM.

banks' doubtful and contested claims to the off-balance sheet record. The effects of these amendments were the strongest in the second quarter, especially in June 2016, while in July and August the effects were insignificant. By excluding the effect of regulatory changes, the total loans in the third quarter registered deceleration in the quarterly growth and from 2.8% they reduced to 0.5%. Performances in lending activity correspond to the results of the latest Bank Lending Survey[62], according to which, in the third quarter, net easing of the lending terms in both sectors is evident, amid net increase in the demand for housing loans, i.e. net decrease in consumer loans.

From a structural point of view, the increase in lending to the private sector in the third quarter was affected by the growth of loans to households, amid further reduction of corporate loans. In terms of currency structure, the increase in lending activity in this period completely stems from the growth of Denar loans, despite their fall in the previous quarter. Foreign currency loans continued to decline on a quarterly basis, but at a slower pace. The analysis of the maturity structure on a quarterly basis indicates decline in short-term loans, for the third consecutive quarter. Long-term loans continue to grow on a quarterly basis, but at a significantly slower pace compared to the previous quarter. In terms of doubtful and contested claims, at the end of September, there was a quarterly decrease in companies and small growth in households. The share of doubtful and contested loans in total loans was 7.3% and decreased by 0.2 percentage points compared to June.

On an annual basis, total loans in September grew by 2.5%, which is lower compared to the annual increase in June (3.5%). Excluding the effect of regulatory changes, the total loans in September registered annual increase of about 7.7% compared to the growth of 8.5% in the previous quarter. The credit-to-deposit ratio indicator[63] equaled 90.8% at the end of September (95.5% excluding the effects of regulatory changes), which shows smaller use of the deposit potential for lending to the private sector compared to the previous quarter.

Despite the write-off of these claims, i.e. their transfer to the off-balance sheet record, banks reserve the right for their collection.

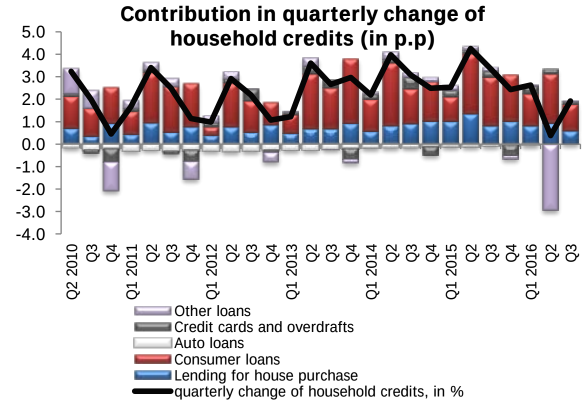
[62] For more information, also see Lending Survey at http://nbrm.mk/?ItemID=F7AC78DEE498764FBAF39049F726CE3C.

[63] According to monetary statistics data.

Total credits of households

	2014				2015				2016		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
quarterly change, in %											
Total credits of households	2.1	3.9	2.9	2.4	2.4	4.2	3.3	2.5	2.5	0.2	1.9
Contribution in quarterly change of household credits (in p.p)											
Denar credits	2.1	3.9	3.0	2.3	2.3	3.9	3.2	2.4	2.5	0.1	1.7
Foreign currency credits	0.0	0.1	0.0	0.1	0.1	0.2	0.1	0.1	0.1	0.2	0.1
Short-term credits	0.2	0.3	0.4	-0.4	0.2	0.2	0.2	-0.3	0.2	0.2	0.1
Long-term credits	1.8	3.5	2.5	2.8	2.0	3.9	3.0	3.0	2.4	3.1	1.8

Source: NBRM.

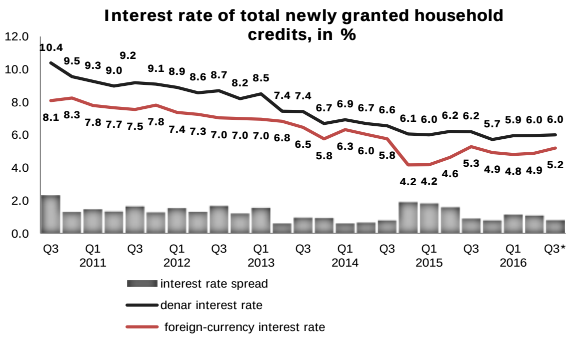


*Total loans to households do not include loans to self-employed individuals.
Source: NBRM.

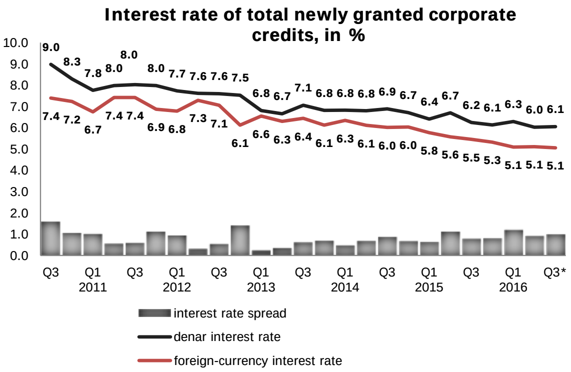
Total credits of corporations

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

Source: NBRM.



*Q3 2016 refers to the end of august.
Source: NBRM.



*Q3 2016 refers to the end of august.
Source: NBRM.

In the third quarter of 2016, the lending to the households sector registered an increase of 1.9%, versus 0.2% in the previous period. Excluding the effects of regulatory changes, total loans to households register deceleration in the quarterly growth from 3.7% to 2%. The results of the Bank Lending Survey indicate a net decrease in the demand for consumer loans, amid a small net increase in the demand for housing loans. The lending terms are still moderately relaxed, but at a faster pace in consumer loans compared to the previous quarter. The structural analysis shows that the main generators of the increase in the loans to households are the Denar loans, given small rise in the loans in foreign currency. As for individual types of loans to households, the growth continues to be predominantly driven by the rising consumer loans, but with a smaller contribution compared to the previous quarter. **Annually**, at the end of September, total loans to households increased by 7.3% (8.8% at the end of June). However, if we isolate the effect of the Decision, the total loans register annual increase of about 11%.

The loans of the corporate sector registered quarterly decrease of 1.1%, which was lower compared to the previous quarter (decrease of 3.8%). Without the effect of regulatory changes, the lending to the corporate sector in the third quarter decreases by 0.6%, compared to the growth of 2.1% in the previous period. According to the Bank Lending Survey, in the third quarter the demand for corporate loans registers a net increase, contrary to the net decrease in the previous quarter, amid a slight net easing of the lending terms. From the viewpoint of currency, the changes in the total loans are mainly a result of the reduction of foreign currency loans and moderate decline in Denar loans. **On annual basis,** at the end of September the corporate loans went down by 1.2%, but excluding the effect of the decision, the total corporate loans register an increase of about 5.3%.

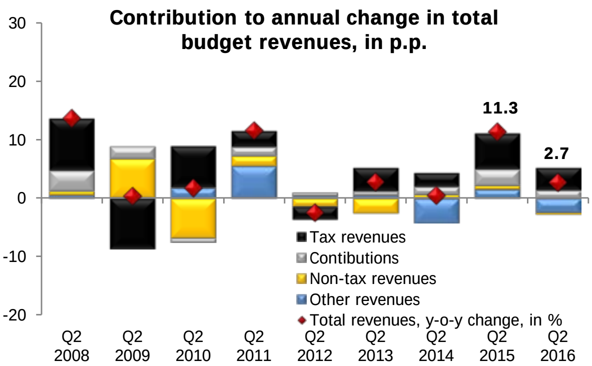
According to the data on the interest rates on the newly approved loans as of August[64], the interest rates on denar and foreign currency loans to households and enterprises are

[64] As of January 2015, data on interest rates of banks and savings houses have been collected under the new interest rate methodology. For more information see Quarterly Report, May 2015, p 53.

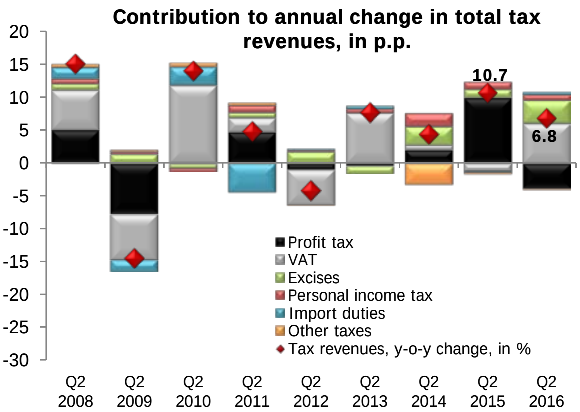
mainly at the same level as in the previous quarter. The interest rate on foreign currency loans to households is exception, since they registered moderate quarterly increase.

3. Public finances

In the second quarter of 2016, total revenues in the Budget of the Republic of Macedonia (central budget and budgets of funds) were higher by 2.7% on an annual basis, while total expenditures decreased by 1.9%. Increase in budget revenues is mostly a reflection of the VAT revenues, with the excise revenues also having a positive contribution in the annual growth. The decrease in budget revenues in the second quarter is due to the lower performances in current and capital expenditures. The budget deficit registered in the second quarter of the year equaled 0.2% of GDP, which is lower than the previous year (0.6% of GDP). The deficit in the second quarter of the year was financed through funds withdrawal from the government deposit account with the National Bank.



*Other revenues includes capital revenues, foreign donations and revenues from due loans.
Sources: Ministry of finance and NBRM`s calcualtions.

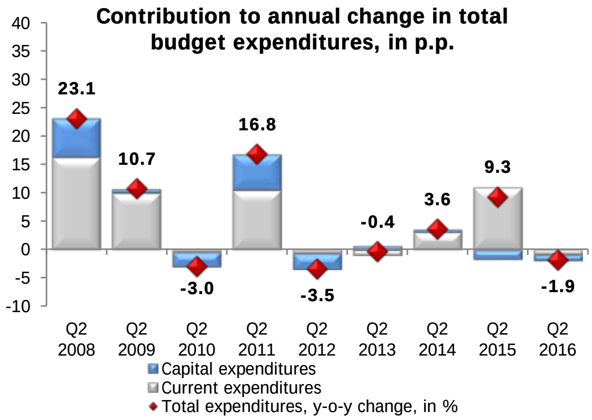


Source: Ministry of finance and NBRM`s calculations

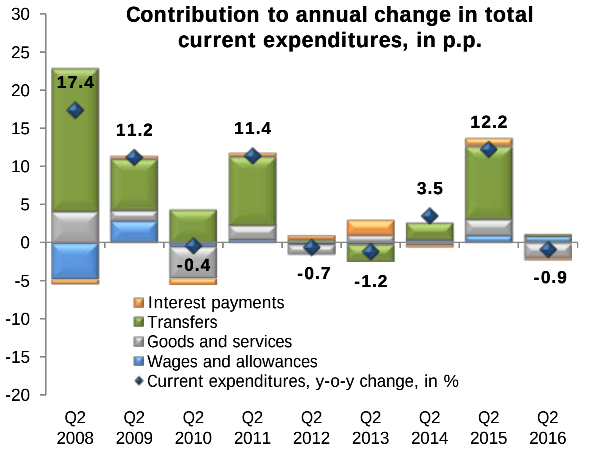
During the second quarter of 2016, the annual growth of total revenues in the Budget of the Republic of Macedonia[65] was 2.7%. Increase in budget revenues was mostly a reflection of higher tax revenues, mainly based on VAT (with a contribution to the annual increase of 3.1 p.p.), while revenues based on contributions register a relatively lower positive contribution to the increase (of 1.4 p.p). On the other hand, the contribution of other budget revenues[66] and non-tax incomes in the second quarter is negative. Compared to the performances in the same period of the previous year, the annual increase in the total budget revenues in the second quarter is lower and mostly due to the pace of tax revenues, mainly in the profit tax, lower capital expenditures and lower performances in revenues based on contributions.

In the second quarter, the total tax revenues in the Budget of RM registered an annual increase of 6.8%. The tax income growth generator are the VAT-based revenues, which are by 13.4% higher on an annual basis, and also the excise revenues have a positive contribution to the annual increase which

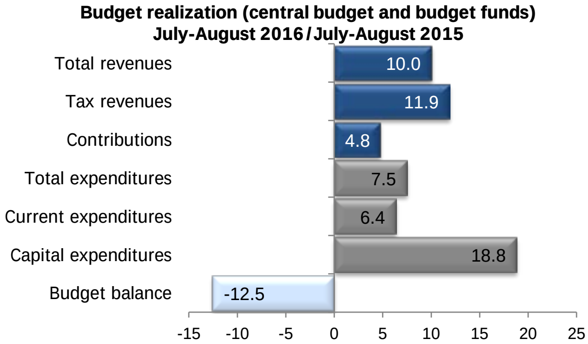
[65] Central budget and budgets of funds.
[66] In the second quarter of 2016, lower capital revenues were registered compared with the same period last year.



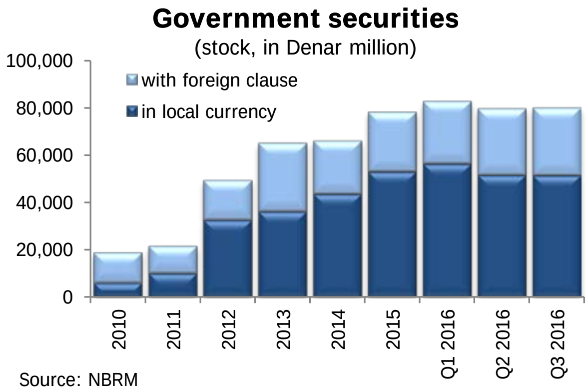
Sources: Ministry of finance.



Source: Ministry of finance and NBRM`s calcualtions.



Source: Ministry of finance and NBRM`s calcualtions.



Source: NBRM

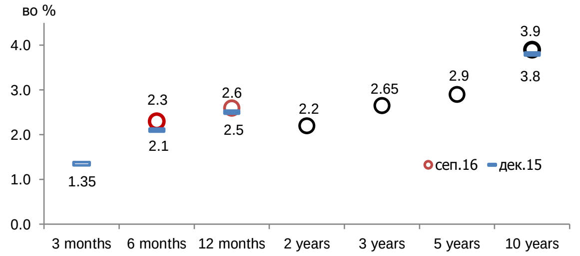
registered an annual growth of 17.4%. On the other hand, revenues based on profit tax, as in the previous quarter registered a negative annual change.

Total budget expenditures are lower by 1.9% on an annual basis. The lower budget revenues in the second quarter of the year are due to the lower performances in both main categories of budget expenditures (current and capital), with almost equally negative contribution to the annual change. In the second quarter, within current expenditures, a decrease of current expenditures for goods and services (with a negative contribution to the annual change of 1.9 p.p.) is registered. “Wages and compensations” category has a low positive contribution to the annual change.

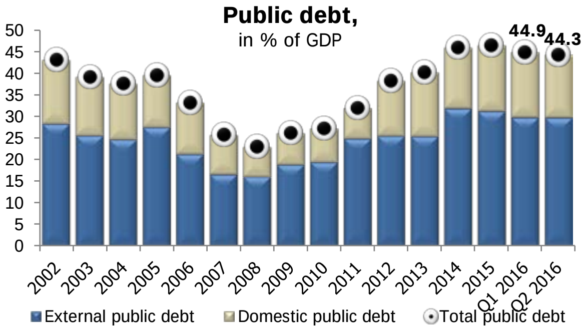
In the second quarter of 2016, the Budget of the Republic of Macedonia registered a deficit of Denar 1,311 million, or 0.2% of GDP, which is lower compared to the same period last year (0.6% of GDP). The deficit in the second quarter of the year was financed through funds withdrawal from the government deposit account with the National Bank.

In the period July-August 2016, total budget revenues are higher by 10% on annual basis. The tax revenues are higher by 11.9%, with the increase being dominantly driven by the VAT and excise inflows. Annual increase (of 4.8%) has also been registered in contributions, while the realization in capital revenues is lower. **On the other hand, budget expenditures in the same period decreased by 7.5% annually.** Higher budget expenditures in the period July-August are mostly due to the higher current expenditures (by 6.4%) annually, with a contribution of 5.8 p.p. in the annual increase. In terms of current expenditures, the higher increase is due to the higher expenditures for wages and compensations, whereas expenditures for goods and services register a moderate negative contribution. Capital expenditures are higher by 18.8% on annual basis, whereby their contribution to the annual increase is moderately positive (1.7 p.p.). With

Interest rates on government securities*

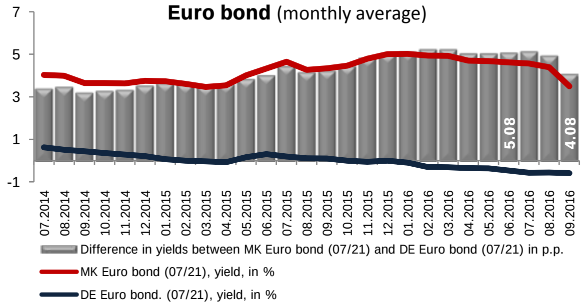


* Interest rates on 2-y, 3-y, 5-y и 10-y government bonds are from last auctions held (in May 2015, Sept.2015, Nov.2014 and Aug.2016, consequently).
Source: Ministry of finance.



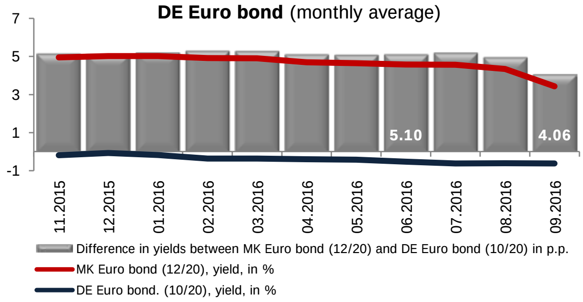
Source: MoF and NBRM calculations.

Difference in yields between MK Euro bond and DE Euro bond (monthly average)



Source: NBRM.

Difference in yields between MK Euro bond and DE Euro bond (monthly average)



Source: NBRM.

the performances **in July-August 2016, the budget deficit for eight month totaled Denar 9,816 million, which is 42% of the planned deficit in accordance with the second Budget Revision for 2016.** Most of the budget deficit in the beginning of the year is financed from government borrowing in the international financial markets.

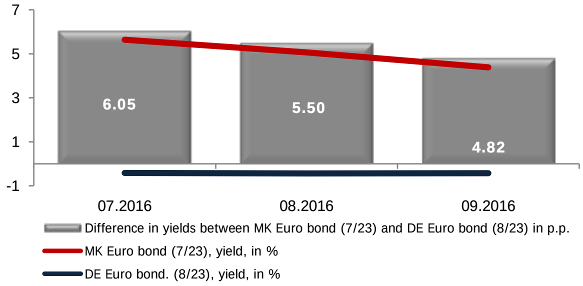
Since the beginning of 2016, the stock of government securities is higher by Denar 1,792 million, which is mainly due to the emission of new government securities in the first quarter of the year. In the second quarter, the total amount of government securities decreased, whereas in the third quarter, the stock of government securities registered a moderate increase and by the end of September equaled to Denar 80,126 million.

At the end of the third quarter, interest rates on government securities are moderately higher compared to the end of 2015.

On 30 June 2016, total public debt[67] is lower by 0.6 p.p. of GDP, compared to the previous quarter and amounts to 44.3% of GDP[68]. The analysis of its components indicates that the decline is entirely due to the decrease in the internal debt (by 0.6 p.p. of GDP). Thus, at the end of June 2016, the share of public and internal debt in GDP amounts to 29.8% and 14.5%, respectively. At the end of the second quarter, total government debt[69] is 36.2% of the GDP (36.8% of GDP at the end of the first quarter of 2016), whereas public enterprise debt[70] increased moderately from 8.1% of GDP in the first quarter to 8.2% of GDP in the second quarter.

[67] The public debt is defined under the Law on Public Debt (Official Gazette of the Republic of Macedonia No. 165/14), according to which it is the sum of the government debt and the debt of public enterprises established by the state or municipalities, municipalities within the City of Skopje and the City of Skopje, and companies that are entirely or predominantly owned by the state or by the municipalities, the municipalities within the City of Skopje and the City of Skopje, for which the Government has issued a state guarantee.
[68] Public debt calculation is conducted in relation to the projected GDP from the NBRM with the October projections.
[69] Government debt is defined as a sum of debts of the central and the local government.
[70] Refers to guaranteed debt of public enterprises and joint stock companies owned by the state, according to the public debt definition under the Law on Public Debt (Official Gazette of the Republic of Macedonia No. 165/14).

Difference in yields between MK Euro bond and DE Euro bond (monthly average)*



*the data for July are average from the last week of the month
Source: NBRM.

The spread between the yields of issued Macedonian[71] and German Eurobonds at the end of the third quarter equaled 4.08 p.p., 4.06 p.p. and 4.82 p.p., on average, respectively and was lower compared to the previous quarter.

The decrease of the spreads is due to the decrease of the yield of Macedonian Eurobonds, whereas the yields of the German Eurobonds, on average was maintained at a relatively stable level.

BUDGET OF REPUBLIC OF MACEDONIA (Central budget and budgets of funds)

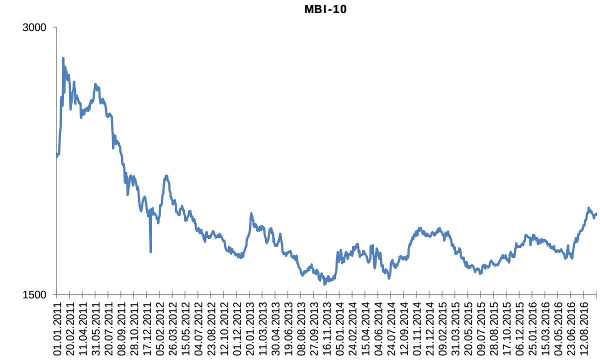
	Budget for 2016	Revised Budget (I)	Revised Budget (I)	Q1 2016	Q2 2016	July-Aug. 2016	Annual changes, perod in 2016 over the same period in the previous year, in %			Contributions in annual changes, perod in 2016 over the same period in the previous year, in %		
	Plan, in mil. denars	Plan, in mil. denars	Plan, in mil. denars	Realization, in mil. denars			Q1 2016	Q2 2016	July-Aug. 2016	Q1 2016	Q2 2016	July-Aug. 2016
TOTAL REVENUES	**177,292**	**174,291**	**174,291**	**40,590**	**41,425**	**28,606**	**7.4**	**2.7**	**10.0**	**7.4**	**2.7**	**10.0**
Tax revenues and contributions	150,718	149,597	149,597	35,650	37,546	25,743	7.0	6.1	9.5	6.2	5.4	8.6
Taxes	99,543	97,364	97,364	23,714	24,685	17,002	8.1	6.8	11.9	4.7	3.9	7.0
Contributions	49,187	50,145	50,145	11,585	12,457	8,492	6.0	4.7	4.8	1.7	1.4	1.5
Non-tax revenues	18,387	16,576	16,576	3,426	2,558	2,187	5.7	-4.3	22.2	0.5	-0.3	1.5
Capital revenues	3,155	2,329	2,329	614	275	195	75.4	-78.6	-25.3	0.7	-2.5	-0.3
Foreign donations	4,232	5,369	5,369	815	925	459	4.0	9.3	15.3	0.1	0.2	0.2
Revenues from repayments of loans	800	420	420	85	121	22	7.6	-28.8	-35.3	0.0	-0.1	0.0
TOTAL EXPENDITURES	**196,276**	**195,472**	**197,410**	**46,225**	**42,736**	**31,477**	**4.9**	**-1.9**	**7.5**	**4.9**	**-1.9**	**7.5**
Current expenditures	170,929	172,922	175,079	43,083	39,737	28,316	7.9	-0.9	6.4	7.1	-0.8	5.8
Capital expenditures	25,578	22,550	22,331	3,142	2,999	3,161	-24.2	-13.5	18.8	-2.3	-1.1	1.7
BUDGET DEFICIT/SURPLUS	**-18,984**	**-21,181**	**-23,119**	**-5,635**	**-1,311**	**-2,871**						
Financing	18,984	21,181	23,119	5,635	1,311	2,871						
Inflow	**40,546**	**42,635**	**44,573**	**7,545**	**4,325**	**3,361**						
Privatisation receipts	0	54	54	46	13	1						
Foreign loans	22,861	44,387	31,657	2,122	137	27,483						
Deposits	-1,209	-10,245	4,423	-113	6,000	-23,435						
Treasury bills	18,860	8,405	8,405	5,490	-1,836	-688						
Sale of shares	34	34	34	0	11	0						
Outflow	**21,562**	**21,454**	**21,454**	**1,910**	**3,014**	**490**						
Repayment of principal	21,562	21,454	21,454	1,910	3,014	490						
External debt	12,381	12,273	12,273	811	1,020	490						
Domestic debt	9,181	9,181	9,181	1,099	1,994	0						

Source: Ministry of Finance and NBRM ca

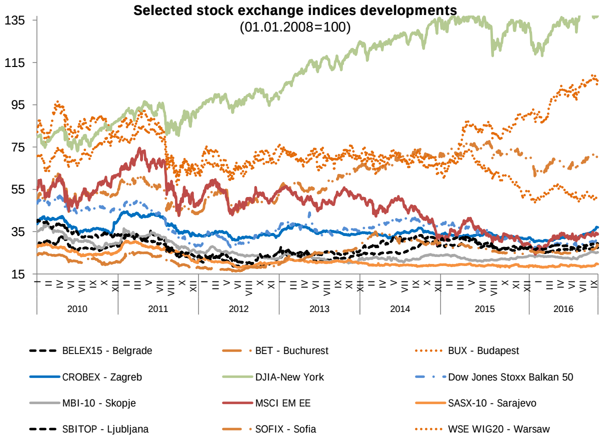
4. Stock exchange indices and real estate prices

In the third quarter of 2016, the Macedonian MBI-10 registered quarterly growth, and an increase was also registered in the value of bonds index (OMB). The trends in most regional markets are also upward, mostly associated with country-specific factors of the countries. In the third quarter, real estate prices in the domestic market for the second consecutive quarter registered moderate decrease, which is in the absence of significant changes in supply and demand for real estate.

[71] Refers to the Macedonian Eurobonds issued in July 2014, in December 2015 and in July 2016. Eurobonds were issued in a nominal amount of Euro 500 million, Euro 270 million and Euro 450 million, respectively, with a maturity date of 7,5 and 7 years, respectively and annual interest rates of 3.975%, 4.875% and 5.625%.

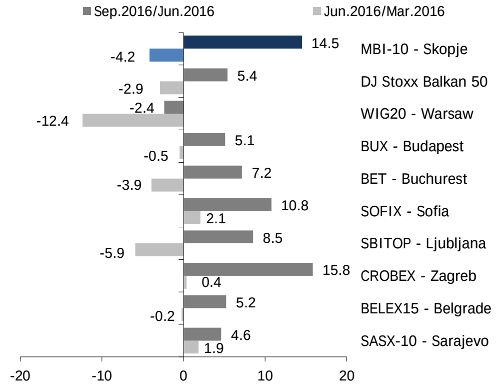


Source: Macedonian Stock Exchange Skopje



Source: National stock exchanges.

Changes of the regional stock exchange indices, eop September 2016/ eop June 2016 and eop June 2016/ eop March 2016 (во %)



Source: national stock exchanges.

During the third quarter of 2016, the value of the Macedonian MBI-10, registered quarterly growth of 14.5%, whereby the index reached the value of 1954.4 at the end of the quarter (compared to 1706.97 as it was at the beginning of the quarter). The upward index path is connected to the increased interest for the auctions of two companies that make up the MBI-10.

On the other hand, the total stock exchange turnover in the third quarter is lower by 22.3% compared to the previous quarter, and a similar pace of changes is also registered in block transactions trading. Such trends are most probably a reflection of the reduced interest of domestic investors, as well as the increased risk aversion, bearing in mind the current uncertain political situation in the country. A growth, but weaker than the MBI-10 is also registered in the bonds index (OMB)[72], which at the end of September increased by 0.4% compared to the end of June 2016 (compared to the decrease of 1.5% in the previous quarter).

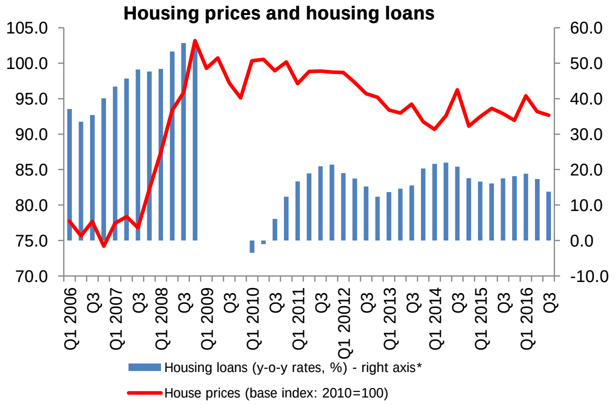
At the end of the third quarter of 2016, most of the regional stock indices increased, except the stock index in Warsaw. Such trends are mostly a reflection to the specific local factors in the economies of the region. The changes in global environment, are primarily connected to the June referendum in the United Kingdom for leaving the European Union had an unfavorable impact on the regional stock markets, which was evident through the higher investors restraint, but the influence was relatively restricted and short[73].

In the third quarter of the year, housing prices[74] registered a small decline,

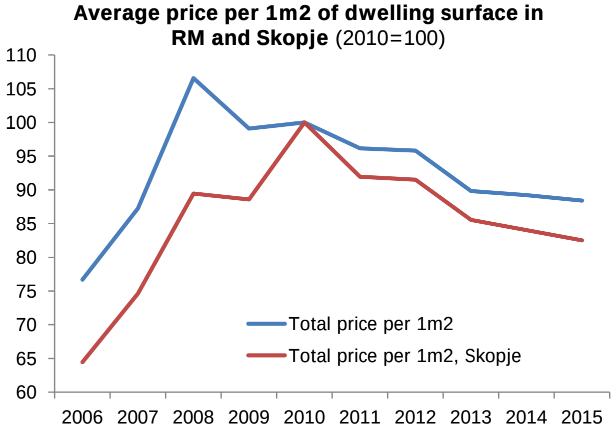
[72] On 7 July 2016, due to the largest share of trade in the market with bonds for denationalization of the fifteenth issue of the Republic of Macedonia, The Stock Exchange Index Committee conducted an extraordinary revision of the OMB, including it in the index. Thus, the Stock Exchange Index Committee determined that the following bonds will become elements of the OMB: (RMDEN07), (RMDEN08), (RMDEN09), (RMDEN10), (RMDEN11), (RMDEN12), (RMDEN13), (RMDEN14) и (RMDEN15).

[73] SEE Macroeconomic Outlook, Addiko Bank, July 2016.

[74] Hedonic index of housing prices, prepared by the NBRM on the basis of the notices of sale in the capital city, and published by the agencies dealing with trade in real estate. The price of the apartment is a function arising from the size of the



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



Source: State Statistical Office of RM and NBRM calculations.

similar as in the previous quarter. Thus, the price index on an annual basis is lower by 0.2% (decrease from 0.5% in the previous quarter). Such trend is in accordance with the downward adjustment of the housing prices (total and newly constructed) both in the capital and around the country in the last several years. In terms of the stock of supply and demand of real estate, indicators do not point to significant changes. Namely, the construction of residential properties continues registering double-digit growth rate (average annual growth rate of construction of residential properties in first half of 2016 of 25.3%), and a high double-digit rate also show the data of approvals for construction of residential properties. Analyzing the demand for apartments, the permanent solid growth of housing loans also continued in the third[75] quarter of 2016 which suggest further increase in the demand.

5. Macroeconomic forecasts and risks

In the first half of 2016, the domestic economy continued to grow but at a slower pace than expected, likely reflecting the effects of the domestic political uncertainty on the propensity to invest. Given such developments and the uncertain environment for making consumption and investment decisions, this forecast cycle estimates that domestic economy will not grow at the pace forecast in April. Hence, the latest assessment of economic growth for 2016 was 2.3%, while for 2017 the growth is again expected to accelerate to 3.5% (forecast of 3.5% and 4% respectively, in the April baseline scenario[76]). Economic growth in 2018 is expected to accelerate moderately to 3.7%. It is still expected that growth will be driven by export and investment demand (except for 2016), which corresponds to the assessments for exhaustion of the effects of the political crisis, further growth of foreign demand, positive effects of export-oriented facilities and positive impetus from private and public investment. Also, solid positive contribution to

apartment, the neighborhood in which it is located, the floor, whether the apartment has central heating and whether the apartment is new.

[75] Available data for the first two months of the quarter.

[76] In April, two forecast scenarios were prepared, baseline and alternative. The baseline scenario assumed a rapid stabilization of the political situation and absence of significant effects of the political crisis on the economy. The alternative scenario assumed a continuation of the crisis period and its effects on the economic trends, primarily through increased propensity to hold foreign currency, increased restraint of households from spending, and increased restraint of domestic and foreign investors.

growth is expected from household consumption, amid favorable developments in the labor market and credit support from banks. After the relatively short and limited effects of the political crisis on the economic entities' savings in the second quarter of 2016, recent forecasts assume solid deposit growth as the main source for financing banks' credit activity. Analyzing domestic prices, the previous movements and downward corrections in the assumptions on import prices resulted in a downward revision of inflation during the forecast horizon. **Thus, recent assessments point to inflation of 0% in 2016 and 1.3% in 2017 (0.5% and 1.6% respectively in the April forecast), while for 2018, inflation is expected to be positioned at the historical average of around 2%.** According to the latest estimates, the current account deficit has undergone an upward correction, mainly reflecting the estimates for higher primary income deficit. **As a result, now the deficit is expected to be 2.1% and 2.3% of GDP for 2016 and 2017 (in April, the deficits was forecast at 1.2% and 1.4% of GDP, respectively), while the deficit in 2018 will be 2.6%.** Foreign direct investment and borrowing are still expected to be the main sources of financing the deficit.

5.1. Assumptions in the external environment forecast[77]

In the first half of 2016, the growth of the global economy[78] slowed down, and downward revision was made for the whole year (from 3.2% in April to 3.1%). The reduced forecast reflects the worsened outlook for economic activity in the developed countries after the Brexit as well as the weaker US economic growth than expected in April. The rising economic, political and institutional limbo after the British referendum and the expected reduction of trade and financial flows between the UK and the rest of the EU are expected to have adverse macroeconomic effects on the developed economies in the medium run. Global growth is expected to accelerate in 2017, almost entirely due to the favorable trends in the emerging economies and developing countries. However, the recovery will be more modest than previously expected (3.4% vs. 3.5% in April). Given the downward revisions, and more pronounced downward risks, the global economic environment is assessed as less favorable compared to the April cycle.

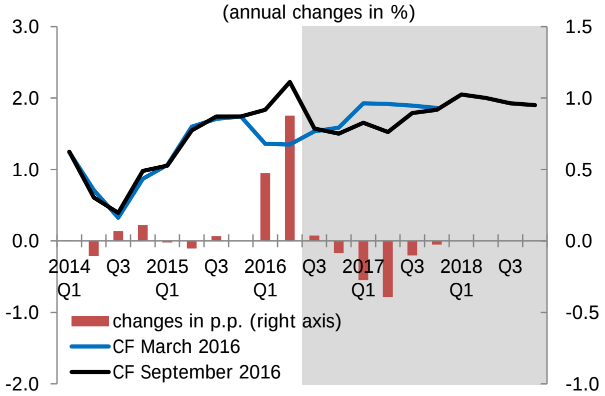
The latest estimates of the effective foreign demand[79] for 2016 and

[77] The historical data on the foreign demand, foreign inflation, exchange rate of the US Dollar/Euro and EURIBOR are sourced from Eurostat, while the IMF statistics is a source of the data on prices of oil, food and metals. The forecasts of the foreign demand, foreign inflation, foreign exchange rate of the US Dollar and EURIBOR are based on the Consensus Forecast, while the forecasts of the prices of oil, food and metals are based on the forecasts of market analysts. The analysis uses various reports of the IMF, the World Bank, ECB, FAO, OPEC and specialized economic portals.

[78] World Economic Outlook, IMF, October 2016.

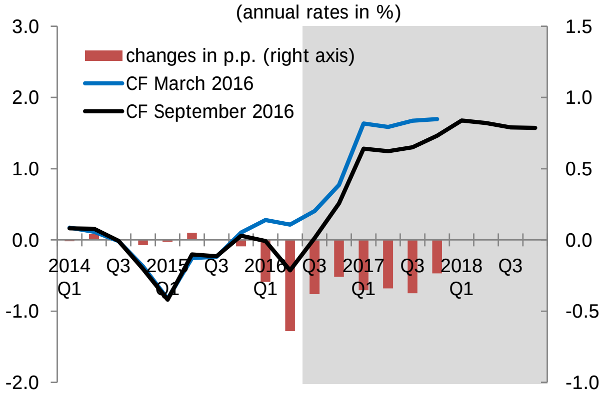
[79] Foreign effective demand is calculated as the weighted sum of GDP indices of the major trading partners of the Republic of Macedonia. The calculation of this index includes Germany, Greece, Italy, the Netherlands, Belgium, Spain, Serbia, Croatia, Slovenia and Bulgaria.

Foreign effective demand
(annual changes in %)



2017 have been revised downward compared with the April forecasts. Thus, now foreign demand is expected to grow by 1.8% in 2016, unlike the April forecasts for growth of 1.5%. The main reason for the upward correction is the higher growth of the German economy in the second quarter, as well as the improved economic forecast for Serbia, Croatia and Greece. On the other hand, certain adverse economic effects of the Brexit are embedded in the forecast for 2017, when the growth of the external demand is expected to be slower and equal 1.7% (1.9% from the April forecast, with the largest downward contribution resulting from reduced estimates for economic growth in Germany and Italy. It is expected that the economic activity of our trading partners will strengthen in 2018, when the growth of foreign demand is expected to reach 2%.

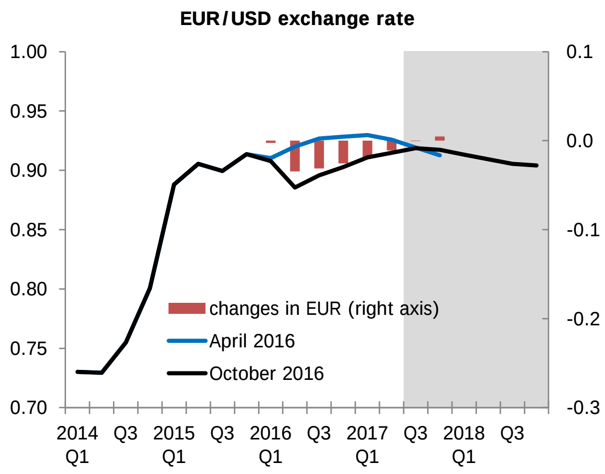
Foreign effective inflation
(annual rates in %)

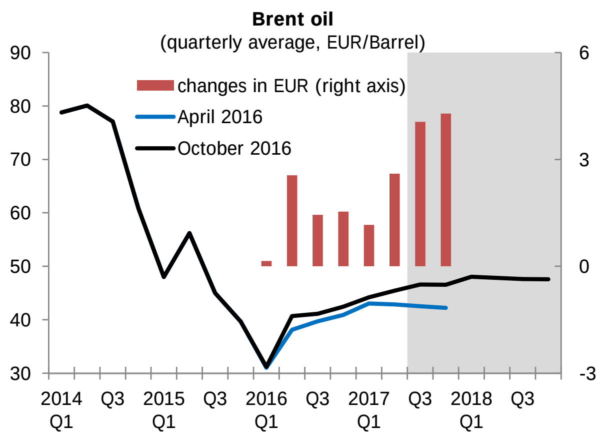


Compared to April, the foreign effective inflation[80] was revised downwards for the entire forecast horizon. Thus, now, the expected rate of foreign inflation is 0% for 2016, versus the expectations for growth of 0.4% in April. The downward revision is mainly due to the negative contribution of Serbia[81] and Bulgaria, amid expectations for decline rather than growth of prices in these countries. Similarly, lower growth of foreign prices is forecast for next year. Thus, the foreign inflation in 2017 is expected to be 1.3% versus 1.7% as forecast in April, again mostly resulting from lower expected inflation in Serbia. The trend of gradual acceleration of the growth in the prices of our major trading partners is expected to continue in 2018, and therefore, the foreign inflation is forecast at 1.6%.

In 2016, the **US dollar** is expected to **depreciate** against the euro by 0.4%, compared to the April forecast for growth of 2.3%, while for 2017, it is forecast to appreciate by 1.9% (rather than to depreciate by 0.1%), given the expectations of gradual tightening of the US monetary policy, unlike the euro area where there are expectation for continued policy of low/ negative interest rates and quantitative easing. On the other hand, it is

[80] The foreign effective inflation is calculated as the weighted sum of consumer price indices of the countries that are major partners of the Republic of Macedonia in the field of import of consumer goods. The calculation of this indicator includes Bulgaria, Germany, Greece, France, Italy, Austria, Slovenia, Croatia and Serbia.
[81] Inflation in Serbia has been adjusted for the changes in the exchange rate.



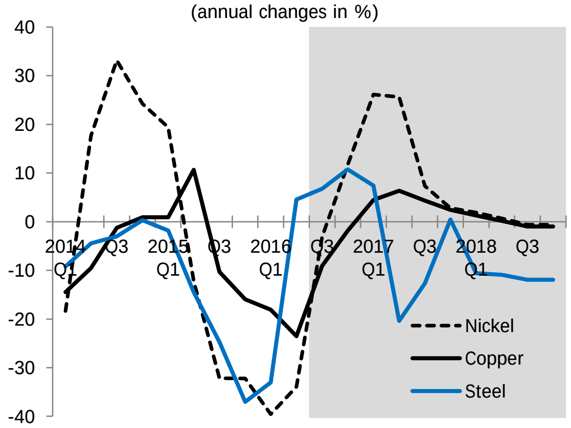


estimated that in 2018, the US dollar against the euro will depreciate by 0.8% on an annual basis.

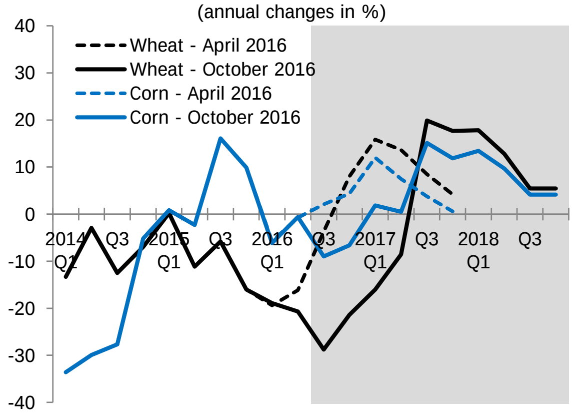
The third quarter of 2016 registered a smaller annual decline in the oil price than forecast in April. Expectations are that the multiyear decline will be terminated in the fourth quarter, when oil price will start to rise on an annual basis and at a stronger pace than forecast in April. Such changes in the forecasts are mostly associated with the present signals for gradual balancing of supply of and demand for oil in the second half of the year, especially with the potential implications of the agreement of the OPEC countries to cut production, and the possibility for some non-OPEC countries to join this agreement. As a result, slightly lower annual decline in oil prices is expected in 2016 compared with the April forecast, although it will continue to be substantial. Conversely, for 2017 there are expectations for more rapid cut in global oil inventories and possibly sooner exhaustion of excess supply in the market as a result of the OPEC agreement, which would result in slightly higher growth in oil prices that forecast in April. Oil price will continue to grow in 2018, but at a more moderate pace compared to 2017. In nominal terms, oil prices are expected to average Euro 38.9/barrel in 2016, Euro 45.7/barrel in 2017 and Euro 47.6/ barrel in 2018.

The revisions in the forecasts of metal prices are in different directions. Thus, the assessment is that the copper price in 2016 will decline at a slightly faster pace than forecast in April, given the continuous decline in imports in China and increase in inventories, unlike the nickel price which is expected to decline at a slower rate than in the April forecast, mainly due to the cessation of some mines by the authorities in the Philippines to verify their compliance with the environment protection standards. Due to decreased production and the uncertainty in this country, there is a risk of significant reduction of the global supply of nickel, particularly in 2017, which is the reason behind the substantial upward revision of growth in the metal price for the next year. Also, the expected growth in the copper price for 2017 was revised slightly upward. On the other hand, the trends in steel prices are divergent. Namely, next year, this metal price in expected to register more negative developments than forecast in April,

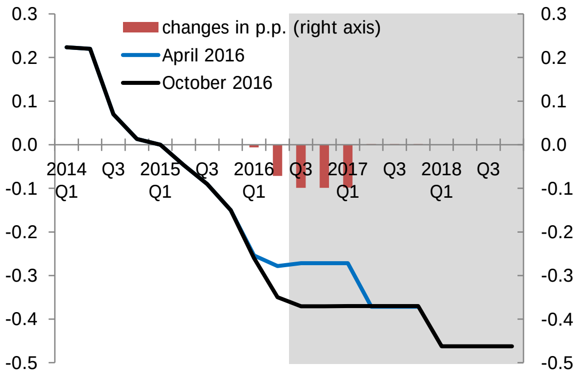
Metal prices in EUR
(annual changes in %)



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



1-month Euribor
(quarterly average, in %)



with more expected price decrease in 2016 and a decline instead of growth in 2017, taking into account the estimates of excess supply in the market and lower demand in China. Furthermore, stable nickel and copper prices are expected for 2018, as opposed to steel price, which will continue to register negative growth.

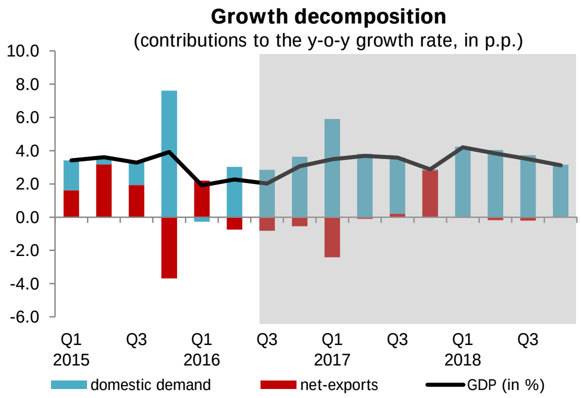
Prospects for global cereal production for 2016 have significantly improved with the April forecast, taking into account the particularly favorable weather conditions in the major producing countries. As a result, there are expectations for record high yields of wheat, resulting in a significant downward revision of its price on the world market compared to April. The situation with the corn is similar, i.e. its price is also expected to decline faster compared to the April forecast, as a result of assessments for record high supply and high inventories, especially in the United States. On the other hand, the revision of prices of primary food commodities for 2017 are in a different direction, with expectations for significantly slower growth of wheat price and a slightly faster rise in the corn price compared to April forecasts. Market prices of wheat and corn are expected to continue increasing in 2018.

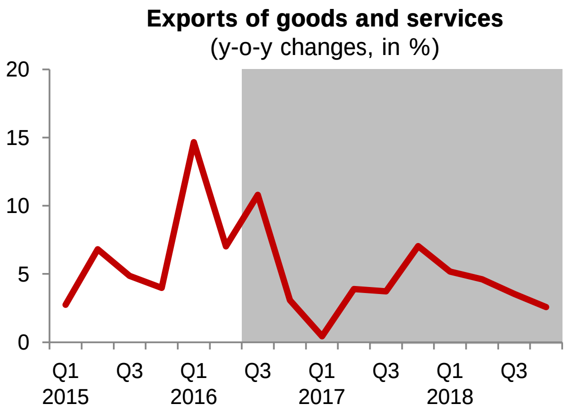
Amid conduct of the ECB's Quantitative Easing Program as planned, maintenance of interest rates at low or negative level, and emphasizing the bank readiness to ensure additional monetary stimulus if required, there are no major changes in the future trend of **one-month Euribor** compared to the April forecasts. Hence, foreign interest rate is still expected to be negative for the period and to average -0.34% and -0.37% in 2016 and 2017, respectively, which is similar to the rates of -0.27 % and -0.35%, as forecast in April. For 2018, Euribor is estimated to further decrease to -0.46%.

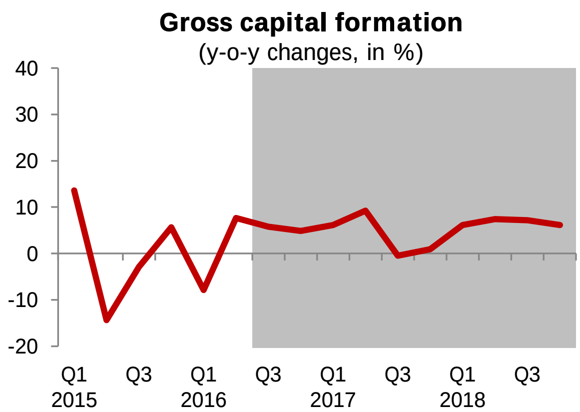
5.2. Forecast and effects on monetary policy

The basic macroeconomic scenario indicates a stable external position of the economy and foreign reserves, which in the next period will be maintained at an appropriate level. Although the growth of domestic economy is expected to create certain import pressures, primarily triggered by the investment demand, yet it is estimated that they will not disrupt the external equilibrium. For the next years, current account deficit is expected to be financed by direct investments and borrowing, which will increase foreign reserves and maintain them at an appropriate level. **Analyzing the foreign interest rate as an important factor for the domestic monetary policy, there are no major changes in this forecast either.** Thus the one-month Euribor is still expected to be in the negative zone throughout the entire forecast horizon, taking into account the ECB's measures from March 2016 for further monetary easing. **Risks to the baseline macroeconomic scenario are similar to those of the April forecast cycle.** The period between the two forecasts witnessed materialization of the **domestic risk** associated with political crisis, but the effects were relatively short-lived. However, despite the steps taken towards resolving the political crisis, it is estimated that some uncertainty remains, and accordingly, unfavorable risks for the domestic economy. **The external risks** are still perceived as negative, considering the uncertainty about the global recovery related to the uncertain consequences of the Brexit, the possible rise in protectionism globally, as well as the great volatility in global financial markets.

In the first half of 2016, the domestic economy continued to grow but at a moderate pace, partly due to the deteriorating political environment in this period. Exports and private consumption continued to be the main drivers of economic growth, showing some resilience to the political crisis. Also, public spending made a small positive contribution to the growth. On the other hand, despite the strong growth of infrastructure investments and inflow of foreign investment, the total investment demand in the first half of the year made negative contribution to overall growth. This performance shows that the turbulent domestic environment most likely had an adverse effect on this demand component. Current estimates and high frequency indicators for the





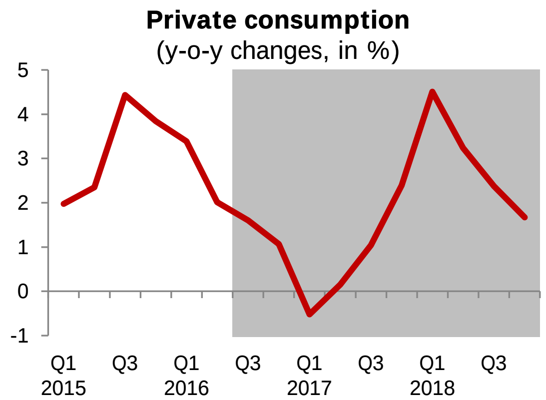


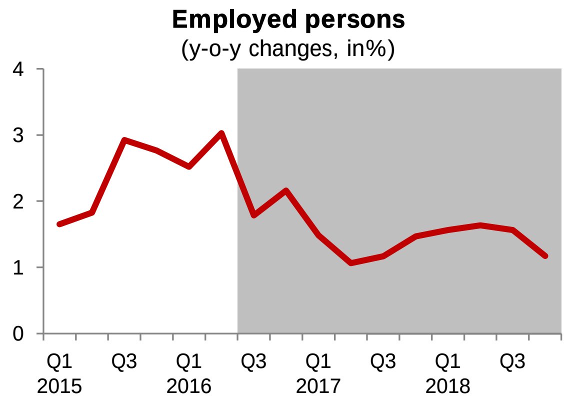
second half of the year indicate a slightly stronger GDP growth, given the recovery in investment activity and further solid growth in exports. Significant positive stimulus of public spending is expected for this period. **However speaking for the whole year, the adverse shock from the political crisis has slowed down domestic economy in 2016 to 2.3% (3.8% in 2015). In the next two years, the growth is expected to gradually accelerate to 3.5% and 3.7% in 2017 and 2018, respectively.**

The real export of goods and services is expected to be the major driver of growth in 2016, with strong contribution of the activity of new export capacities. In the next two years, real exports are expected to further support the growth of the economy. Assessments show that this export growth will continue to be supported by the new export-oriented companies, which amid assessment for gradual stabilization of their production capacity would still make relatively smaller contribution. The recovery of some traditional sectors and foreign demand will provide additional impetus to the export sector. Hence, although its contribution to total GDP growth is expected to diminish after the relatively high level in 2016, exports will remain the most important generator of the overall economic growth in the medium run.

It is estimated that domestic demand in 2016 will continue to make positive contribution to GDP growth, given the positive trends in all components. Of these, the largest positive contribution will be made by **private consumption**, given the growth in households' disposable income and bank's lending. However, dynamically speaking, the growth of private consumption will be lower than last year, partly due to the estimates for restraint of households from higher consumption in times of political crisis. All components of disposable income, excluding private transfers, are expected to register solid growth, similar to previous year. After the negative performance in the first half of the year, **gross capital formation** is expected to recover by the end of the year and make positive contribution to growth for the entire 2016. Such estimates rely upon expectations for solid completion of construction works initiated by private and public sector, growth of investment necessary to support export activity, and enhanced credit support to the domestic corporate sector by the banks. **Public spending** is also expected to contribute positively to GDP growth.

The growth of domestic demand in 2017

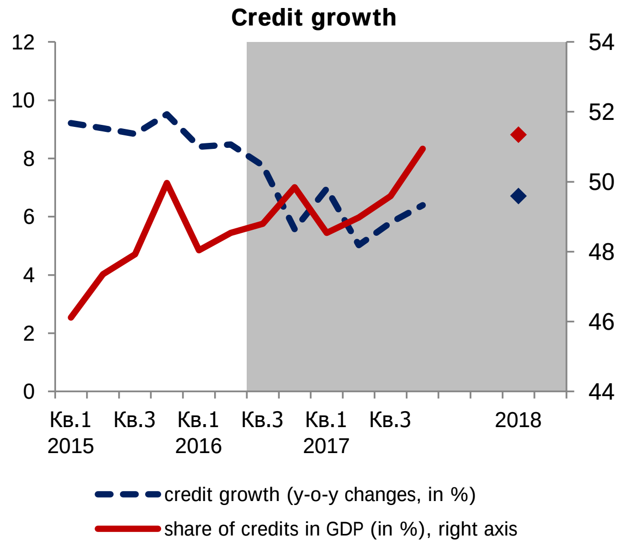




is expected to be determined by investment and private consumption, and its positive contribution to GDP growth to increase relative to the previous year. The stabilization on the political scene would lead to less restraint from investments, which would lead to forecasts for acceleration of **investment activity,** and accordingly, of the contribution to the overall growth. The increase in gross capital formation is expected to take place amid growth of construction works in road infrastructure, foreign investments in new facilities, and forecasts for increased export activity. **Private consumption** will also have significant positive contribution to GDP growth in 2017, although the growth rate will be lower than in 2016. The positive trends in the labor market are expected to continue, reflecting further growth in employment and real wages, but at somewhat slower pace. Namely, in 2017, nominal wages are expected to be higher than in 2016, the growth in real wages will be lower due to the higher expected inflation. Next year, the household disposable income will be further supported by higher pensions, which also includes the effect of the coming nominal increase of 5%, which will start to be paid in December 2016, but also by the significant increase in private transfers after the fall in 2016. The growth of domestic economy will, to some extent, be supported by **public spending**, under the budget expenditures planned for 2017.

Domestic demand will continue to grow in 2018, amid stronger growth of private and investment consumption. However, in 2018, investment with largest positive input to economic growth will have dominant contribution, amid continuing investment cycle of the government and growth of foreign direct investment. Moreover, apart from domestic factors, the strengthened foreign demand expected for 2018 will also have favorable effects on investment activity. In addition, the solid performance of investments and exports, and continued growth in disposable income and credit support will significantly accelerate the growth in private consumption. On the other hand, after the budgetary stimulus in previous years, for 2018, it is expected that public spending will have a neutral impact on the economic activity.

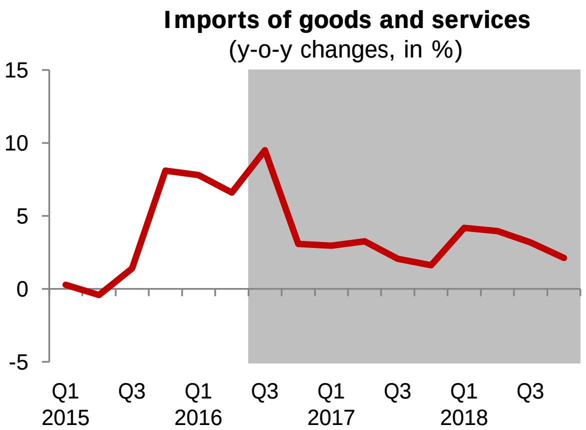
The credit market assessments for 2016 indicate a solid credit support to the private



sector by banks[82]. The forecast, not including write-offs, indicates credit growth of 5.6% in 2016, which will further strengthen in 2017 and 2018, and reach 6.4% and 6.7%[83]. Credit activity is expected to strengthen amid positive developments on the demand and the supply side. On the one hand, creditworthiness of economic agents is expected to improve in line with the intensification of economic activity in the next two years. Amid higher private and investment consumption, there will be greater need and readiness to finance the private sector through loans. On the other hand, there is also ground for growth of the loan supply by banks, taking into account expectations for solid growth in the deposit base in the next two years and rising competitive pressures within the banking sector, amid assessments for absence of greater risks in the economy relevant for the banking sector. **Looking at the deposit potential** as a major source of credit funding, there are estimates for significant slowdown in the growth of deposits in 2016 to 2.6% (from 6.3% in 2015), mainly reflecting the larger withdrawal of deposits from the banking system amid speculation for devaluation of the denar in the first half of the year and faltering confidence of economic agents due to the uncertain domestic political environment. However, given the stabilization of the situation, it is expected that the withdrawn deposits will be gradually returned to the system in the coming period. This, together with the favorable expected trends in the domestic economy will enable faster accumulation of deposits in the banking system that are expected to grow at a solid rate of 7.5% in the next two years.

In 2016, there are expectations for strong growth of real import of goods and services, which is in line with estimates of increased export and investment demand. Import growth is expected to continue in 2017, but at a slower pace, amid relatively slower growth in exports and private consumption. Moreover, given the simultaneous higher growth in real exports than imports, the contribution of net exports to the overall growth is expected to be neutral in the current year and minimally positive, next year. On the other hand, investment demand, exports and personal consumption are expected to create greater import pressures in 2018, and as a result, the net exports to have a minimum negative contribution to GDP growth.

[82] Not taking into account the effect of regulatory change that excluded fully provisioned doubtful and contested claims on loans for more than two years from on-balance sheet records and their transfer to off-balance sheet records.
[83] If we include the effect of write-offs, the credit growth rates would be 0.5% for 2016, 6.7% for 2017 and 7% for 2018.



Balance of Payment Forecast (% of GDP)

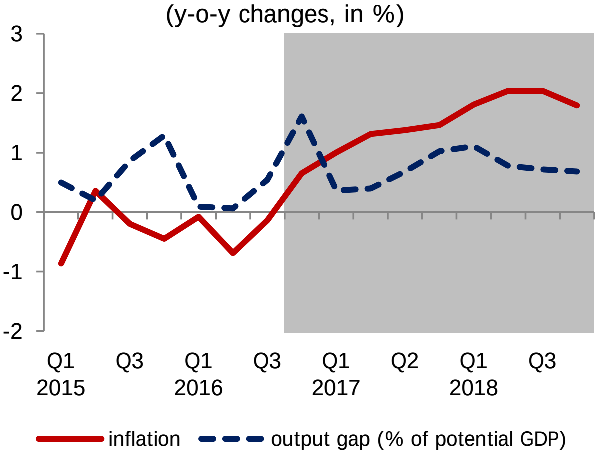
	2013	2014	2015	2016	2017	2018
Current account	**-1.6**	**-0.5**	**-2.1**	**-2.1**	**-2.3**	**-2.6**
Balance of goods & services	-18.3	-17.3	-16.3	-15.3	-15.3	-15.1
Goods, net	-22.9	-21.8	-20.1	-19.7	-20.1	-20.0
Services, net	4.6	4.5	3.8	4.5	4.9	4.9
Primary income, net	-2.4	-1.9	-3.1	-3.2	-3.8	-3.9
Secondary income, net	19.0	18.6	17.4	16.3	16.7	16.4
Private sector, net	18.1	17.3	16.8	15.6	15.9	15.7
Capital account	**0.2**	**0.0**	**0.1**	**0.1**	**0.0**	**0.0**
Financial account	**-0.8**	**-5.1**	**0.0**	**-3.8**	**-1.4**	**-3.3**
FDI, net	-2.8	-2.3	-2.2	-2.6	-2.8	-3.0
Portfolio Investment, net	2.0	-5.7	-0.7	-4.3	0.1	0.1
Other Investment, net	0.1	2.9	3.0	3.0	1.3	-0.4

Under recent estimates, the current account deficit for 2016 is expected to be 2.1% of GDP, i.e. to remain unchanged compared to 2015. Within the current transactions, favorable developments have been registered in the balance of foreign trade of goods and services, given the permanent narrowing of energy deficit, amid lower energy prices on world markets. Further positive effects are expected from the new export facilities as well, while the estimated performances in part of the traditional export sector are less favorable on an annual basis. Contrary, the secondary income expects lower yet solid net inflows from current transfers of 16.3% of GDP. **In 2017, the current account deficit is expected to increase marginally by 0.2 percentage points of GDP and to equal 2.3% of GDP.** This annual change is mainly expected to come from the increasing primary income deficit. The balance of goods and services is expected to remain the same at 15.3% of GDP, amid forecast increase in the energy deficit, but improved performances in the surplus in services. On the other hand, after the negative shock in 2016 because of the political crisis, in 2017, the secondary income is expected to increase the surplus. The current account deficit in 2018 is expected to increase slightly to 2.6% of GDP, reflecting estimates for marginal growth of the primary income deficit, and reduction in the relative share of net inflows of the secondary income in GDP. **Next three years, the current account is expected to be financed through foreign direct investments, and long-term public and private external borrowing.**

In the period 2016-2018, the current account deficit is expected to be fully covered by financial flows, which will ensure additional increase in the foreign reserves. During the entire forecast horizon, foreign reserves adequacy indicators have ranged within the safe zone.

For 2016, the inflation rate is expected to be 0%. This year, the main factors that led to shifts in inflation are associated with the spillover effects of adverse changes in world prices of primary commodities, which also decrease the food and energy component of domestic prices. **For 2017, prices are expected to moderately increase, whereby the inflation will be 1.3% annually.** The growth of domestic prices is expected to be largely driven by the growth of food inflation, and lesser by the increase in energy inflation, which is consistent with the forecasts for growth of world prices of food and energy next

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



year. Certain effects on inflation are expected from the increase in core inflation, which is associated with the further increase in domestic demand, and with the spillover effects of rising energy and food prices. Risks associated with the forecast of inflation are mainly related to the risk of possibly faster growth in oil prices than expected. **The assessments for 2018 indicate that inflation will be positioned at around 2%, amid strengthening domestic economic growth and demand, intensified foreign inflation and further rise in food and energy prices on the world market.**

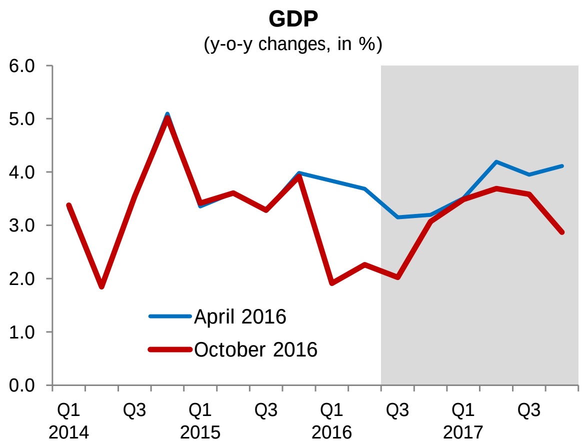
5.3. Comparison with the previous forecast

The forecasts for growth of the domestic economy in 2016 and 2017 was revised downwards compared to the April forecasts, given the materialization of some effects of the domestic developments caused by non-economic factors. Analyzing the prices, small downward revision was made for 2016, given the lower inflation and lower import prices, and for 2017, the forecast is slightly lower than in April. In this forecast cycle, estimates indicate a higher current account deficit for 2016 and 2017, driven by estimates of higher deficit in primary income, compared to previous expectations. Financial flows expect lower cumulative inflows for the period 2016 - 2017, compared to April forecasts. These assessments of financial flows rely upon the higher external government borrowing and higher inflows of direct investment, which showed relative resilience to the domestic risks. The deposit growth in 2016 is slower than expected, reflecting the negative impact of political crisis on the economic agents' propensity to save in the banking system. On the other hand, the loan dynamics (not including write-offs) is close to the April forecast. For 2017, there are expectations for normalization of flows, and hence there are no major adjustments to the forecasts for growth of deposits and loans compared to April.

Forecast of selected macroeconomic variables

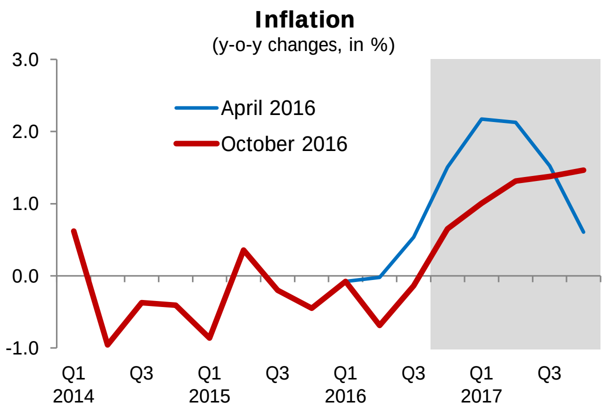
	2016 forecast			2017 forecast			2018 for.
	Oct.	Apr.	Apr. alt.	Oct.	Apr.	Apr. alt.	Oct.
GDP, %	**2.3**	**3.5**	**1.6**	**3.5**	**4.0**	**3.9**	**3.7**
Private consumption	2.0	2.7	-0.1	0.8	2.7	3.2	3.0
Gross capital formation	2.3	7.9	4.7	3.9	8.8	6.0	7.0
Public consumption	2.9	3.4	3.6	2.0	1.4	1.4	-0.2
Exports of goods and services	8.8	5.9	5.7	3.9	4.3	4.6	4.0
Imports of goods and services	6.7	6.2	4.5	2.5	4.1	3.9	3.4
Loans to private sector, % (w/o write-offs)	**5.6**	**6.8**	**3.0**	**6.4**	**7.0**	**5.0**	**6.7**
Deposits, %	**2.6**	**6.0**	**2.3**	**7.5**	**7.2**	**4.0**	**7.5**
Current account deficit, % of GDP	**-2.1**	**-1.2**	**-2.0**	**-2.3**	**-1.4**	**-2.8**	**-2.6**
Secondary income, private sector, net	**15.6**	**16.4**	**16.1**	**15.9**	**15.9**	**16.3**	**15.7**
FDI, net	**2.6**	**2.1**	**1.6**	**2.8**	**2.3**	**1.8**	**3.0**

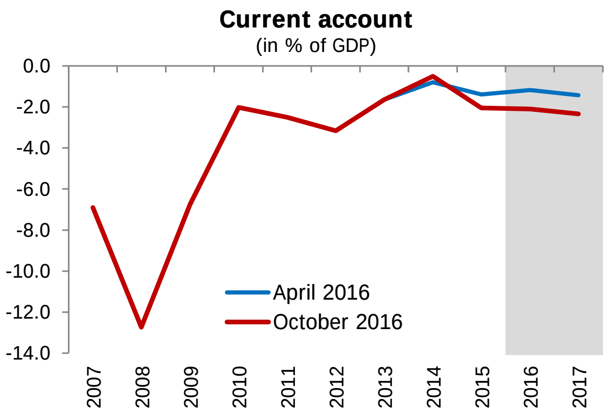
The expectations for economic growth for 2016 and 2017 are adjusted downward compared to the baseline scenario of the April forecast, but maintaining the dynamics of gradual acceleration of growth in 2017. **Now, GDP growth is expected to be 2.3% and 3.5% in 2016 and 2017, respectively (3.5% and 4% in 2016 and**



2017, respectively, in the baseline scenario in April). Observing the structure of growth, exports remain to be the main engine of economic growth for 2016, but with a stronger contribution than expected in April, given the higher performance in the first half of the year, with more favorable effects of the existing industrial facilities in the free economic zones and improved economic outlook for our major trading partners this year. Positive contribution is expected to the private consumption and investment, but with lower effect than previously expected. This change probably reflects the adverse effects of the increased uncertainty of the domestic political crisis on the propensity of economic agents for investment and consumption. There are changes in the domestic demand. Namely, investments that were previously expected to have a stronger contribution than the household consumption, according to the the current forecast, have considerably smaller contribution due to the weaker performance in the first half of 2016. Deviations in the private consumption determinants are generally downwards. Thus, now there are forecasts for slightly lower growth in employment and real wages than expected in April. Additionally, it is expected that the real private transfers will decline in 2016, despite the April assessments of growth, as an effect of the political crisis. On the other hand, only pensions are expected to register somewhat higher real growth compared to April. Growth factors of 2017 do not change much compared with the April forecasts. Thus, exports and investment are again components that contribute the most to growth, although now the investments' contribution is expected to be lower, and the exports are expected to make somewhat stronger contribution. Assumptions for the fundamental factors that drive the investment and export demand - public investment and investment of foreign facilities - remain the same as in the April forecast. However, the growth rates of both GDP components are revised downwards compared to April. The growth of private consumption is also expected to be lower, along with its contribution to the overall GDP growth, given the slightly weaker employment growth than forecast in April. On the other hand, public consumption in 2016 and 2017 on average will make higher positive contribution compared to April, according to the forecasts of the 2016 budget revision, and the 2017 budget.

Amid growth of domestic demand and exports, there are expectations for higher imports and thus negative contribution to the economic growth. For 2016, this contribution will be nearly the same as in the April forecasts, while for 2017 it





is expected to decrease. Therefore, these revisions indicate weaker positive effect of *domestic demand* on the cumulative growth. On the other hand, *net exports* will have more favorable effect on the economic growth, compared with the April forecast, due to the more pronounced changes in real exports than in real imports, compared to the previous forecast. Thus, the faster growth of exports than imports in 2016 will have neutral effect of the growth on *net exports*, which will turn into small positive contribution in 2017, as opposed to the expected negative contribution in the previous forecast cycle for the both years.

The latest estimates for the movement of **prices for 2016 have been revised downwards and indicate unchanged price level**, as opposed to the expected inflation rate of 0.5% in the April forecasts. This downward correction stems largely from the weaker performance in the second and the third quarter than expected, as well as the downward revisions in the expectations for the future movement of food prices and foreign effective inflation. **The assessment of the inflation for 2017 is similar to the April forecasts - growth of 1.3% (1.6% in April).**

The comparison of October forecasts with the April alternative scenario shows a slightly faster growth of total GDP (1.6% in the alternative scenario), given that the duration of the main effect of the political crisis was shorter compared with the assumptions incorporated in April. The shock transmission channels are not fully as expected. Namely, in April, the political developments were expected to have the largest effect on the consumption of households that were expected to shy away from spending, but the performance showed solid consumption growth. Investment is the component that was hit the most by the crisis in the first half of the year, contrary to the April expectations. Crisis was not expected to have major effects on exports, so higher exports in the current forecasts mainly reflect the strong performance in 2016. Given the resilience of private consumption and stronger export growth, imports of goods and services are higher, compared to the alternative scenario. However, on a net basis, net exports in 2016 is assessed to be more moderately favorable than in the April alternative scenario.

According to the latest estimates, the current account deficit is higher than in the April baseline scenario. **By the end of 2016, the deficit is**

expected to be 2.1% of GDP, i.e. higher by 0.9 percentage points of GDP than the forecast. The upward correction in the current account deficit mainly arises from the higher deficit in primary income and lower surplus in secondary income - effect of non-economic factors related to the domestic political crisis. On the other hand, lower deficit is expected in the foreign trade in goods and services abroad, mainly due to the improvement in the balance of services. **The current account deficit for 2017 was revised upward to 2.3% of GDP, compared to 1.4% of GDP as forecast in April.** Such change in the current account deficit was almost entirely due to the higher deficit in the primary income, as opposed to somewhat higher expected net inflows of current transfers and forecasted favorable developments in the area of foreign trade in goods and services. **Observing the financial flows, higher cumulative inflows are expected for 2016 and 2017 compared to the April forecast.** The upward revision of the financial account for both years is mainly due to the higher net government borrowing abroad in 2016, and the higher financial flows in direct investment.

Observing the external position of the country, the comparison of the October forecast with the April alternative scenario indicates a slight upward correction (of 0.1 percentage points of GDP) in the current account deficit from the expected 2% of GDP, in line with the alternative scenario. Analyzing the transmission channels, shocks are not fully as expected. Namely, in April, political developments were expected to increase the household propensity to hold foreign currency, and thus the alternative scenario assumed reduction of inflows through the channel of private transfers[84]. Moreover, this assumption has materialized, and in the second quarter, the net purchase of cash on the currency exchange market has reduced, but the effect was short-lived and lesser than the alternative forecast. Also, larger effects were expected through the financial channel, in the form of smaller inflows of direct investments and hampered access of the government and the private sector to new external borrowing. However, recent developments in the financial account indicate opposite movements, amid significantly higher external government borrowing and improved flows of foreign direct investments than expected with the alternative scenario from the April forecast cycle.

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

Comparison of GDP and inflation forecasts for Macedonia from various organisations

Organisation	Month of publication	Real GDP growth, %			Inflation (average rate, %)		
		2016	2017	2018	2016	2017	2018
IMF	October 2016	2.2	3.5	3.5	0.1	0.8	1.5
World Bank	September 2016	2.0	3.3	3.7	-0.1	0.6	1.4
European Commission	November 2016	2.1	3.2	3.3	0.1	0.9	2.4
EBRD	November 2016	2.1	3.0	-	-	-	-
Consensus Forecast	October 2016	2.6	3.4	-	0.1	1.5	-
National Bank of Greece	October 2016	2.4	3.6	-	-	-	-
Ministry of Finance of the Rep. of Macedonia	July/October 2016	2.3	3.0	3.5	0.6	1.0	1.5
National Bank of the Republic of Macedonia	October 2016	2.3	3.5	3.7	0.0	1.3	2.0

Source: IMF World Economic Outlook, October 2016; World Bank SEE Regular Economic Report No.10, October 2016; European Commission European Economic Forecast, November 2016; EBRD Regional Economic Prospects, November 2016; Consensus Forecast, October 2016; NBG Southeastern Europe and Mediterranean Emerging Market Economies, October 2016; Ministry of Finance of the Republic of Macedonia, 2016 Budget revision, 2017 Budget and Fiscal strategy 2017-2019, July/October, 2016; and the National Bank of the Republic of Macedonia.

6. Analytical appendices

Box 1: Effects from the exit of Great Britain from the European Union – Brexit[85]

On 23 June 2016, a referendum was held in Great Britain on which the citizens voted for the exit of Great Britain from the European Union. In the last period many attempts for assessing the long-term economic effect from the potential exit of Britain from the EU were done, as well as for assessment of the possible transmission channels. Mainly, it is estimated that the uncertainty is high and still very early to come up with more concrete estimations of the effects from this event on the British economy and on the global economy in general. However, there are some points where the referendum results had fast effects, but it is difficult to assess their duration. Within this appendix, we are giving a short overview of these short-term effects, of the potential influence of this decision of the Great Britain on the European economy and possible indirect and direct effects on the Macedonian economy.

The first point where the referendum effects were fast is the value of the British pound. The reaction of financial markets to the referendum results brought about a fast and sharp decrease in the value of the British pound, which in the period from 23 June to 1 July decreased by 11%, and the short-term variability of the pound against the American dollar increased significantly. Although, during July, the pound returned a small part of the lost value, it is still uncertain what the views of the investors for the soundness of the British economy are going to be and if this trend of strengthening of the pound will continue.

Expectations for future changes in the key interest rate of the Central Bank of England are the second point where the Decision for exit of Britain had an effect. Unlike the May expectations of the markets for a moderate decrease of the interest rate in the short-term and its more pronounced increase in the following period, the latest expectations suggest a lot deeper and longer decrease of the interest rate and its more moderate increase in the following period. Such expectations show the current views of the investors for weaker recovery of the British economy from what was expected until now.

Similar changes are also registered in the ten-year government bonds yields. Immediately after the referendum, British ten-year bonds yields registered a decline, and even though it is not expected that the global effects from the Brexit are going to be high, however in this period a parallel decrease is registered in ten-year bonds yields in USA and Germany. Further developments of these yields, will mostly depend on the expectations of the investors for the future economic developments, effect of the exit from the EU on the long-term productivity and capacity for growth in Britain, its global effects and reactions of the central banks in these economies.

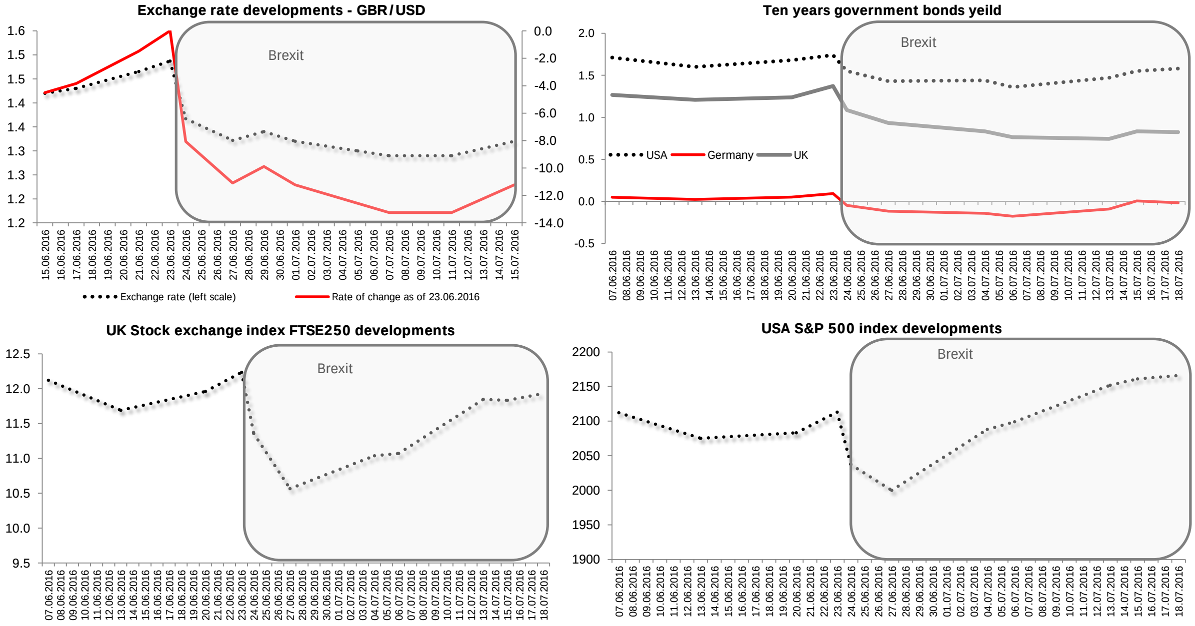
In stock markets, analyzed by individual composition indices, the initial reaction to the decision of Britain to exit the EU was different. Indices, which are based on companies' whose performances do not depend on the British economy, registered a certain growth. Such is SIP500, which under the influence of growth in the value of the US dollar registered a growth during July. On the other hand, the index having a large number of companies' whose profitability depends on the performances of the British economy (such is FTSE250), in July, was around 2.5% under the value prior to the referendum. The downward corrections of the stock prices of the British banks during the period from the referendum to 1 July were more evident, with a decrease of around 20%. However, any of these trends happen in a very short period, part of them are very pronounced and for now it is very difficult to assess if such trends will continue and to what extent will they reflect the expectation for changes in the economic fundamentals.

[85] Most frequently used abbreviation for the exit of Great Britain from the European Union. The appendix mostly includes conclusions of: Bank of England "Speech – Brexit and monetary policy", Financial stability report (July 2016), Bank of England, Capital economics, Rubini Global economics, Dhingra S. at all (2016) "The consequences of Brexit for UK trade and living standards, "Global Counsel (2016) Brexit, the impact on UK and EU".

A very important segment, for which available data also exist and which show reaction to the referendum, are the expectations and confidence of the economic entities, that certainly has effect on the demand in the economy, on the propensity for investing, and with that on the productivity and long-term growth potential. Latest data for costumer confidence in Britain points to its decrease. Also, the expectations in accordance with the surveys for corporate investment and employment plans have deteriorated. These researches suggest significantly pessimistic plans in this regard, after the publication of the referendum results. Although, these changes in expectation are the first and excessive reaction, still they point to an increased uncertainty and certain deterioration of the expectations.

Obviously, the first referendum effects in Great Britain were felt in the financial markets, where the increased uncertainty and the decreased confidence caused a decrease in the value of the British pound, decrease of the government securities yields and decrease in the stock prices of the British banks and companies.

Chart 1 Movements of individual indicators prior and after the Referendum in Great Britain



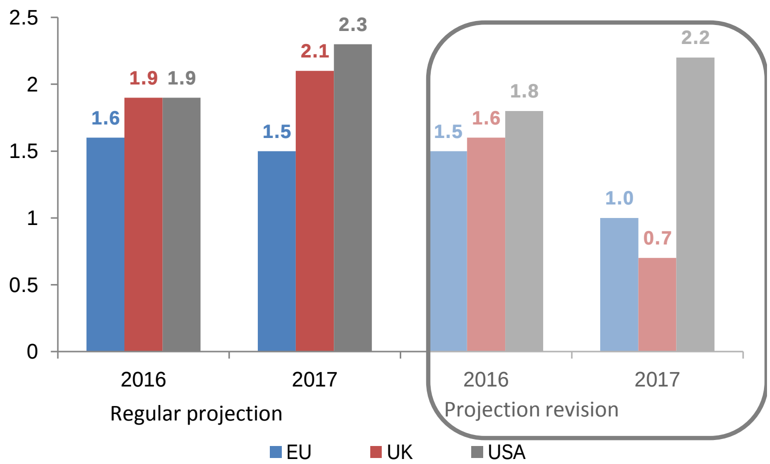
Source: Bloomberg

It is still early to assess the effect of Brexit on the global macroeconomic environment and on the EU economy more precisely. Given the short time period from the referendum, the economic research focused on the assessment of the potential effects are mostly focused on the transmission channels and give quantitative estimations, that are accompanied with great dose of uncertainty. Generally, it is expected that the global effect will be very restricted, with the exception of the EU countries where the negative influences will be felt the most. That is also stated in the last report of the IMF (World Economy Outlook, Update July 2016) [86] where, besides better performances in the beginning of 2016, a downward revision of the world economic growth by 0.1 p.p. in relation to the April projection[87] in 2016 and 2017 was conducted, mainly as a result to the outcome from the referendum in great Britain. In terms of the effect on the Euro area, IMF highlights that it is negative and is mainly due to the increased economic, political and institutional uncertainty and consequently, from the unfavorable effects on the confidence of the customers and the business sector. However, given the better performances in the beginning of the year, according to IMF the expectations for growth in the Euro area in 2016 are revised upwards compared to the April projections by 0.1 p.p., amid more negative

[86] World Economic Outlook, Update July 2016.
[87] Primary scenario does not include the exit of Great Britain from the EU.

expectations for the growth in 2017 by 0.2 p.p. Also, according to “Consensus forecast”, the economic analysts are expecting that the Brexit effect on the Euro area growth will be negative during the current and next year by 0.1 p.p. and 0.5 p.p. of GDP, respectively. Given the importance that EU has for the Macedonian economy, especially as the most important trade partner, with a share of 77.2% of the export in 2015, further focus on the Brexit effects on the European economy growth is simultaneously a focus on the indirect transmission channels of the potential negative influences on the economic performances of the domestic economy.

Chart 2 Brexit effects on the Euro area growth, Great Britain and USA



Source: “Consensus forecast”.

It is expected that the Brexit impact on the EU will be transmitted through several channels, mainly divided in two categories, political and economic. Although the importance of the political factors is great, through the increase of the Euroscepticism in other countries, the immigration problems and the treatment of EU countries citizens in the Great Britain, and conversely, rebalancing the voting power of the countries within the EU institutions, as well as other effects, still in focus of following analysis are the economic transmission channels. The key vulnerabilities of the EU economy from the decision for exit of Great Britain are: **1) trade association; 2) foreign direct investments; 3) financial sector; and 4) increased uncertainty**. Thus, there is a great difference between the EU member countries in terms of their economic exposure to Great Britain – from countries such as Netherlands, Ireland and Cyprus, where vulnerability is more expressed due to strong trade, investment and financial connections, to part of the CESEE countries and Italy[88], where the direct connection with the British economy is very small.

The trade transmission channel is very important for the EU countries, because the exit of Great Britain from EU could mean abolition of the free exchange of goods between both economies[89]. **Analyzed in terms of the European Union, the export to Great Britain is 7.1% of total EU export in 2015 or expressed as a share in GDP – 2.2%.** The largest part of this export is associated with the products with a high degree of processing, such as machinery and transportation equipment and chemical products. Observed by individual EU member countries, differences in the level of trade association are registered. Namely, given the historical and geographical connection, the Republic of Ireland stands as a country with the strongest trade connections with Great Britain, which performs nearly 14%[90] of the export with the British economy. Also, high share in the total

[88] In accordance with „Global Counsel“ analysis (BREXIT: the impact on the UK and the EU), since July 2015, Croatia, Slovenia, Romania and Bulgaria, together with Italy are least exposed to the risks that could arise from Brexit.
[89] Amid Britain’s exit from the EU, the free exchange of goods with other countries from the EU would ceases to be valid. However, during the negotiations for Britain’s exit from the EU the model for future trade and economic cooperation with the EU will be negotiated, which does not exclude further free movement of the goods between both economies.
[90] The data for foreign trade exchange are for 2015.

export to Great Britain have Holland (9.3%), Belgium (8.9%), Germany (7.5%) and Cyprus (7.3%). The great importance of the British market in these countries is also viewed through the relative indicators (share of export of Britain in GDP). Despite them, higher exposure is also registered in the Central Eastern Europe member countries, i.e. Slovakia, Czech Republic and Hungary, where in 2015 the share of export to Great Britain in GDP reached 4.8%, 4.5% and 3.3%, respectively.

Chart 3 Export to Great Britain, share in total export

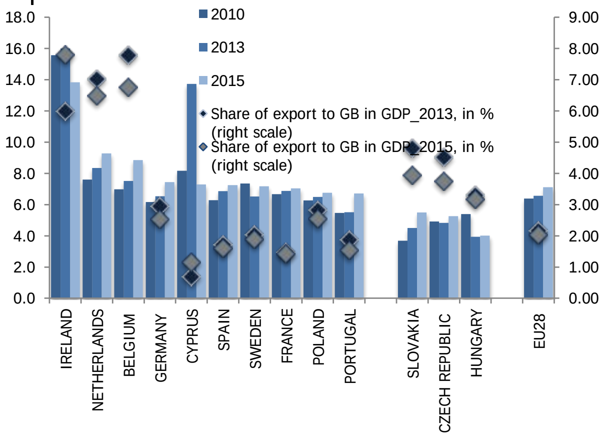
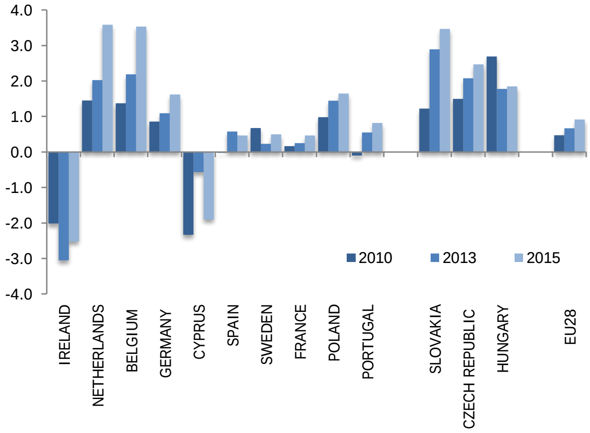


Chart 4 Trade stock in exchange with Great Britain, as % of GDP



Source: Eurostat.

In terms of foreign trade exchange between Great Britain and the European Union, Great Britain registered trade deficit with 23 EU member countries in 2015. The decrease of access in this market will potentially mean lower net export for most EU member countries, which is especially expressed in Netherlands, Belgium, Germany and CEE countries, where in 2015 a more evident trade surplus is registered in the exchange with Great Britain. Additional risk on the basis of the trade channel might arise in case of more significant depreciation of the British pound against the euro, which will lower the competition of the European products against the British and more significant decrease of the competition in the service sector, due to which the tourist destinations in the Southeast European countries are more vulnerable.

The second channel through which the risks on the EU economy could be transferred are the foreign direct investments. Namely, **a significant number of the large European corporation have investments in Great Britain, due to which are sensitive from the exit of this country from EU**. Primarily, these companies could suffer significant decrease of value, as a result to the change in the exchange rate euro/pound, and additional risks are the results from the legislative changes, changes in taxation and increased insecurity. At the same time, it is expected that Great Britain will focus on increasing its competition for attracting FDI, through change in the system of taxation and social regulative, as well as general librazation of the economy, becoming more competitive in comparison to the stricter EU members. The most exposed economies on the basis of this channel are Netherlands (50.7% of GDP), Ireland (22.45 of GDP) and Cyprus (18.5% of GDP), whereas in EU the stock of foreign direct investments in Great Britain amounts to 6.3% of GDP. However, despite the risks, this channel also has certain potential long-term advantages for EU economy. The exit of the Great Britain from a single European market can change the investment Decisions of the corporations (in and out of EU) and redirect their investments projects from Great Britain to the EU economies.

Chart 5 Most important foreign investors of EU in Great Britain

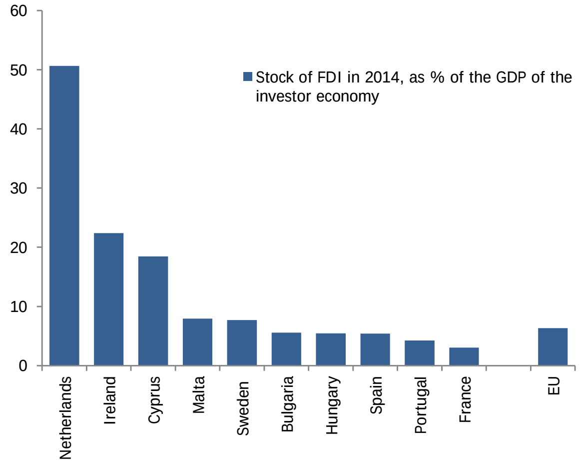
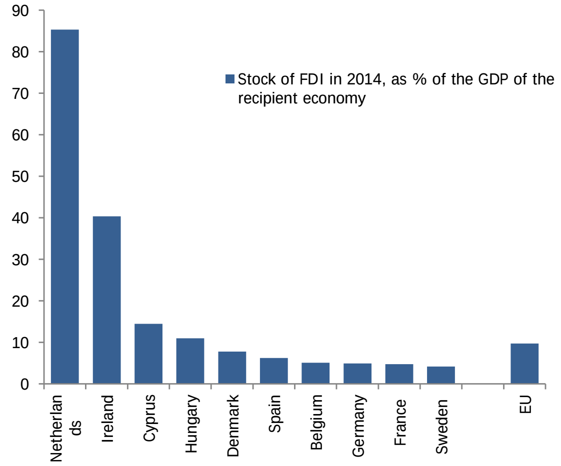


Chart 6 Most important EU recipients of foreign direct investments from Great Britain



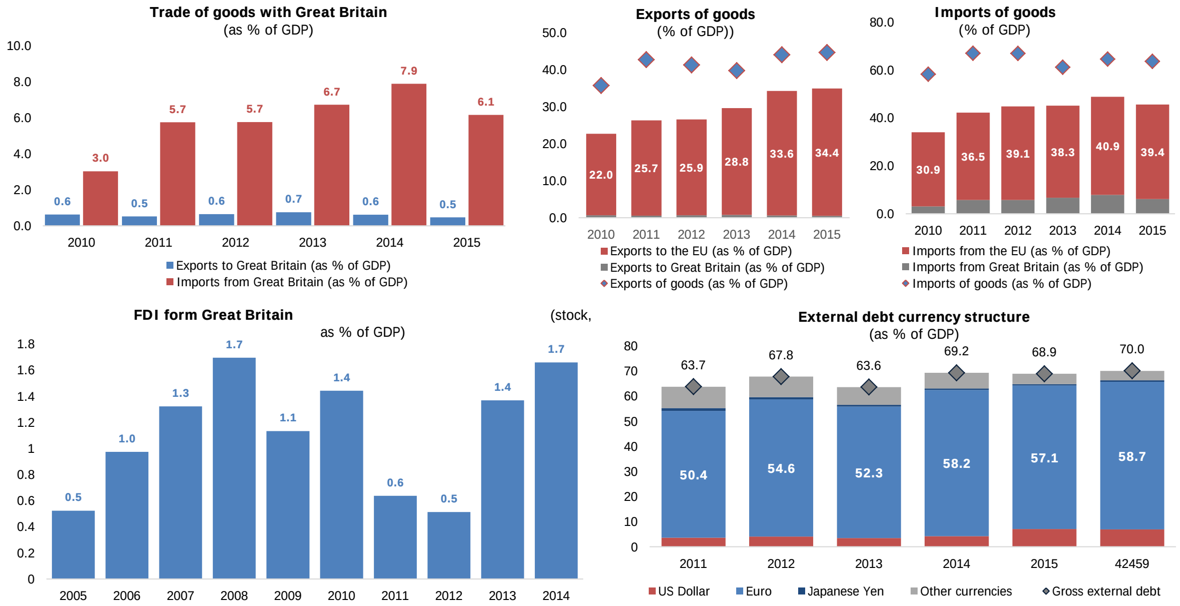
Source: Eurostat.

The risks arising from the financial sector are associated with the EU banks' exposure to Great Britain and the importance that this economy has in providing financial services. Total exposure of the EU27 banks to British households, as well as to the corporate and government sector, is around 5% from the banking systems assets in these countries[91]. Although, the European banking system aggregate risk is not notably high, analyzed by countries, significant differences were registered. In the case of Spain, the exposure to Britain was nearly 16% of the total banking assets, and over the European average are Ireland (8%) and Germany (6%). In terms of the second aspect, financial services, the risk from this channel could be affected by the decrease of liquidity and increase of the price of financial services in Europe, bearing in mind that London is a financial center in Europe, with the greatest role in providing a great number of the financial products.

At the end**, the risk from the increased uncertainty as a result to the prolonged exit of Great Britain from the EU**, may appear as the most harmful to the EU, and for the Macedonian economy respectively. The uncertainty about Brexit could decrease the confidence and increase of investment restraint both in domestic and foreign investors in the EU. The negative economic conditions could be spilled over on the Macedonian economy, through the usual trade and financial channels.

[91] How would EU countries be affected by Brexit? - Welles Fargo Securities, April 2016.

Chart 7 Exposure of the Macedonian economy to Great Britain



Source: NBRM.

Indirect risks from the exit of Great Britain from the European Union on the Macedonian economy evidently will depend from the effect on the European Union, as our most important trade partner. The potential direct effect, given the small association of the domestic economy with the British are estimated as low. There are several direct channels through which the domestic economic activity could be potentially sensitive from the developments in the British economy after the Brexit. **The trade channel is the most important for a small and open economy, i.e. exchange of goods with the British companies.** The share of Great Britain in the total foreign trade is relatively low and for the period 2010-2015 totaled 6.5%, on average, of GDP, and is almost entirely due from the import component, in condition of insignificant export of goods. The average share of the imports of goods from Great Britain in the total imports for the period 2010-2015 totaled 9.2%, while the average share of GDP for the same period was 5.9%. The analysis of the imported goods from the British economy points to high concentration of import of platinum and other metals from the platinum group (structured share of around 90% of the analyzed import in 2015). **The direct exposure from developments in the British economy can be viewed through direct investments and the change in exchange rate.** The stock of direct investments of investors from Great Britain in the domestic economy in 2014 equaled 1.7% of GDP, i.e. represents a very small part of the stock of total direct investments of 47.2% of GDP. The impact from the change in the value of the pound is also estimated as small, given its small share in key economic categories. Thus, for example, the currency structure of gross external debt of Macedonia suggests to the largest share (around 81.8% in total debt, in the last five years) of debt dominated in euro, followed by debt borrowed in American dollars and Japanese yen (6.7% and 1.2%, respectively), while in other currencies where the British pound is included 10.3% of gross external debt in the last five-year period are expressed. Thus, the debt in British pounds is very small or negligible, suggesting negligible risk from the latest developments in the British pound. However, the share of the British pound in the currency structure of deposits and loans in the balance and domestic banking systems is insignificant, whereby the risk from larger changes in the value of this currency is minimal. *The risk of transferring the deteriorated economic condition of Britain through financial channels,* mostly through banking sector, is also estimated as insignificant due to the weak financial connection of both economies.

Overall, the outcome from the referendum in the Great Britain for the country's exit from the European Union had fast effects on the developments of financial markets in the last month. The decrease of the value of the British pound and increased volatility of stock markets in Europe are the initial effects and their duration is uncertain. It is still early to give a comprehensive estimation of the impacts on the EU and on the Macedonian economy. It is estimated that the direct Brexit effects on the Macedonian economy would be small, while potential risk is the indirect transmission of effects through the EU, as our major trading partner.

Box 2: Size and concentration of the banking system

Maintaining sound, stable and efficient banking sector is an indispensable precondition for accelerated economy growth of one country. On the other hand, part of the research suggests possible unfavorable effects on the economy if the banking system is large or excessively concentrated. Namely, research in the last several years suggests there is a certain threshold over which the size of the bank activity is associated with a lower and volatile economic growth, with possible additional impacts on the financial stability and fiscal sustainability. Such possible consequences from excessive growth of the banking system are associated with the abrupt growth of the size of individual banks, higher concentration of entire system and higher leverage in the largest banks. Also, the large banking system points to undertaking excessive risks from the banks, which increases the possibility for financial crisis.

This descriptive analysis touches the issue whether the Macedonian banking system is too large for the needs of our real economy, whereby it is motivated by the analysis of the European Systemic Risk Board for the banking system of Europe[92]. The difficulty and challenge of such analysis is in the quantitative definition of the world "too large". Namely, in the economic literature there is no single indicator for which we can definitely conclude whether the size of the banking system is within the "normal" or already represents risk for the economic growth and further perspective of the domestic economy. However, there are many indicators that give certain indications for the possible excessive increase of the banking activity, such is the size of the banks' assets and total credit exposure as a share of GDP, the registered growth in assets and loans in the last several years, concentration of the banking sector, leverage, model of operation and banks' activities etc. In order to draw a conclusion for the adequacy of the size of the Macedonian banking system, we analyze part of the listed indicators individually, and additionally compare them with the indicators of other comparing countries in the region[93]. The comparative analysis with the countries in the region provides a clearer picture for the current condition of the banking system and it is feasible given the similarities in terms of structure, development and function of their banking systems. Namely, starting from the 1990s, these banking systems were subject to a mass clearing of the balance sheets of the banks, deep reforms within regulations and supervision, significant consolidation, recapitalization and privatization from larger foreign investors. As a result to such processes, from the beginning to the middle of 2000s, the countries of the region succeeded in establishing a sound and efficient banking sector.

Within the analysis, the relevant indicators are grouped in two different groups. In the first part of the analysis, we focus on the indicators which are related to the size of the banking sector, expressed through the share in total assets of the banking sector and the credit activity as a share of GDP and their annual growth rates. The second group is composed of the indicators associated to the concentration of the banking system, such as the number of banks in the banking system, share of assets of the largest banks in the total assets of the banking sector, Herfindahl index and the profitability of the largest banks. In the Macedonian banking system, at the end of 2015, the share of total assets of banks and total loans in GDP equaled to 75.6% and 50%, respectively, which represents significant lagging behind the developed economies in the Euro area, but is also lower than most of the countries in the region. Total assets of the banking system in other countries of the region at the end of 2015 range from 59% in Kosovo (which is the only country with a lower share of assets of banks in GDP compared to the Macedonian banking system) to 118% of GDP in Croatia, whereas the share in credit activity in these countries ranges from 35% to 67% in Kosovo and Croatia, respectively. From the analysis of this simple criterion and its comparison to other countries in the region, we could conclude that the size of the banking system does not deviate much from the average in the region, and even falls behind compared to the majority of the countries.

[92] European Systemic Risk Board, Reports of the Advisory Scientific Committee, "Is Europe overbanked?", No. 4=12014

[93] In the analysis are included: Albania, Bosnia and Hercegovina, Croatia, Serbia, Montenegro and Kosovo.

Chart 1 Financial sector assets to GDP

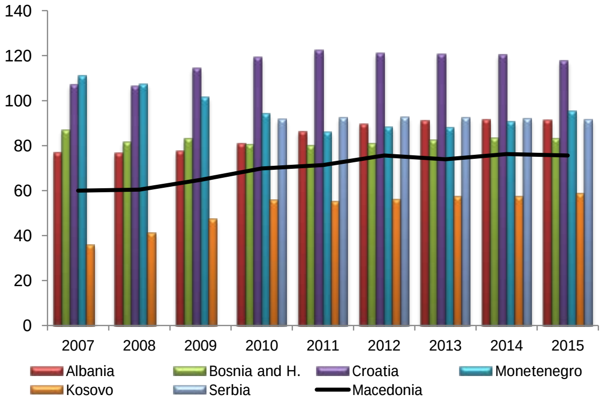
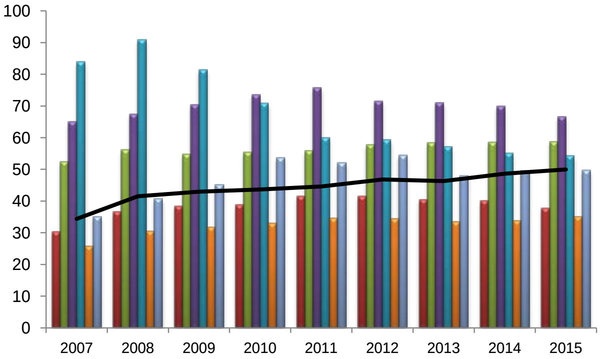


Chart 2 Banks' total loans to GDP



If analyzed cumulatively, the assets of domestic banks and their credit activity register increase of around 30 p.p. of GDP and 27 p.p. of GDP, respectively, in the period 2005-2015, which is a significant increase of their share in the domestic economy. Such strong growth of these indicators could signal for accelerated and excessive increase of the banking sector in Macedonia, thus the need for more detailed analysis appears. So, if analyzed dynamically, it is registered that within the analyzed period the banks functioned in two different phases of the economic cycle the "boom" phase prior the start of the global financial crisis and the phase immediately after the financial crisis or the "bust" phase. Thus, in the first phase, the Macedonian banking system was characterized with strengthened growth of total assets and credit activity, whereby the cumulative growth for the period 2005-2008 equaled around 15 p.p. of GDP and 19 p.p. of GDP, respectively, or annual growth of 5 p.p. of GDP and 6.2 p.p. of GDP, on average, respectively. On the other hand, in the second phase, the annual growth of these indicators in the period 2009-2015 is significantly more moderate and equals 2.2 p.p. of GDP and 1.2 p.p. of GDP, on average, respectively. Compared to other countries in the region, the situation is relatively similar, but it shows that Macedonia is one of the rare countries of the region in which in the post crisis period the share of loans in GDP further increases. Such pace is a reflection of the sound economic fundaments and sound and stable banking system, whereby the resilience to the crisis was also great. In the region, during the analyzed period, total assets of banks and credit activity register a significant increase, which is still stronger in the period prior the start of the crisis. In the second period, apart from deceleration of the growth, in certain countries a decrease of the share of these indicators in GDP is registered. So, the share of total assets of banks in Montenegro is lower by 12 p.p. compared to the level in 2008, whereas the share of loans in GDP registers downward adjustment in Montenegro (by 36.6 p.p. of GDP) and Croatia (by 0.8 p.p. of GDP). According to the pace of the movement of the assets of banks and their credit activity within the analyzed period and especially in the last several years, it can be concluded that the size of the Macedonian banking system is within the frames of some kind of "normal".

Chart 3 Average annual growth in total assets of the banking sector, (in percentage points of GDP).

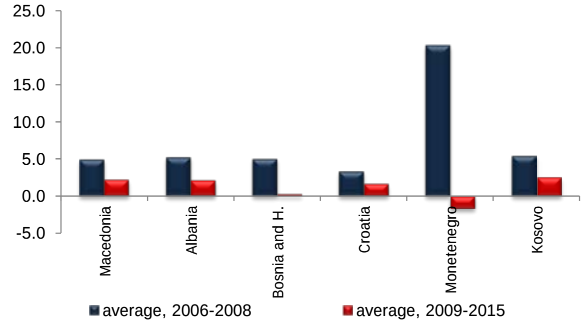
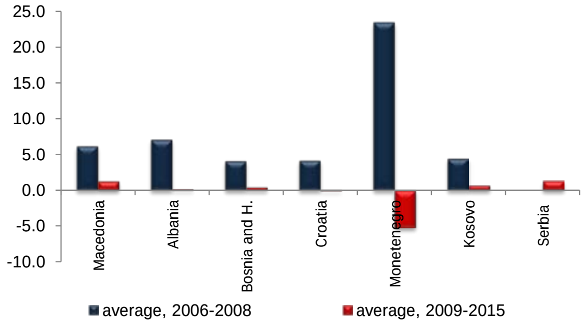


Chart 4 Average annual growth of total loans in the banking sector, (in percentage points of GDP).



In terms of the second group indicators associated with competition, the experience of economically more developed countries of the European Union suggests that the growth in the banking system in the European Union and the growth of assets of its largest banks are two closely related phenomena. Namely, as the size of the banking system grows, it simultaneously becomes more and more concentrated. In the case of Macedonia, in accordance with the analysis of part of the relevant indicators for concentration of the banking sector, the Macedonian banking system falls in the group of countries with relatively high concentration. So, the share of the assets of the banks which constitute the group “large banks “[94] in the total assets of the banking sector is relatively high and at the end of 2015 equals 67.1% (share of assets of the three and five largest banks in the system is almost 60% and 75%, respectively). On the other hand, the Herfindahl index gradually and continuously decreases, whereby Macedonia with the index value of 1390 at the end of 2015 falls in the group of countries with an acceptable concentration of the banking sector. If indicators are analyzed in terms of the total number of banks in the domestic banking system (total of 15 banks), the high fragmentation of our banking system is expressed, i.e. a relatively large number of the banks which have relatively low share in the total assets of the banking sector are registered, and as such occupy only a small part of the overall banking sector. In the case of Macedonia, the total assets of “small banks”, at the end of 2015, represent only 3.7% of the total assets of the banking system and from 2005 it continuously decreases (with exception of 2011 and 2013). The analysis of banks profitability by groups of banks[95] points to similar conclusions. Namely, at the end of 2015, the performed financial result of the large banks participates with 79.2% in the total performed profitability of the banking sector, whereas small banks since 2008 constantly create losses. Such indicators suggest that in the past several years these banks still do not create sufficiently high and stable income which would provide constant positive financial result and long-term prospects for survival. Hence, it is obvious that part of the banks from this group need to change the business model, undertake changes in the operation strategy or merge with another bank.

[94] On 31.12.2015, the limits between bank groups are Denar 32.100 million between middle and large banks and Denar 8.000 million between small and middle banks (the amount is referred to the assets of the banks.)

[95] Four banks are included in the large banks group, whereas in the middle banks group there are seven. Three banks are included in the small banks group.

Chart 5 Share in total assets of domestic banking sector

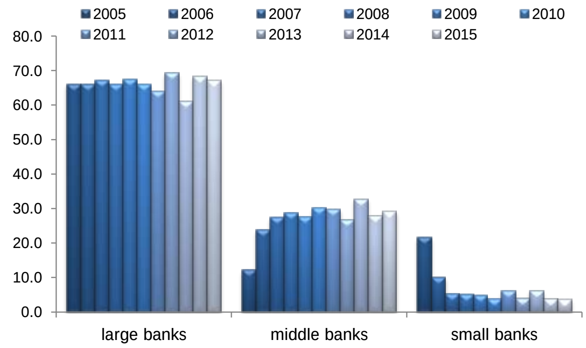
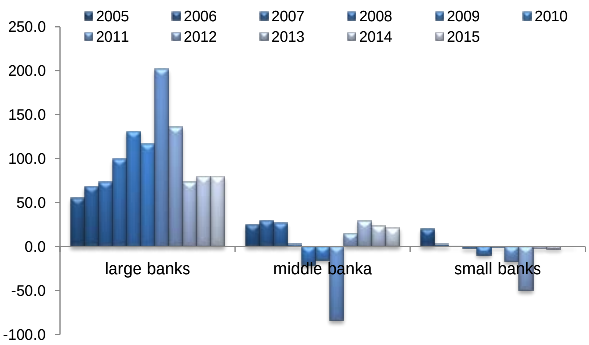
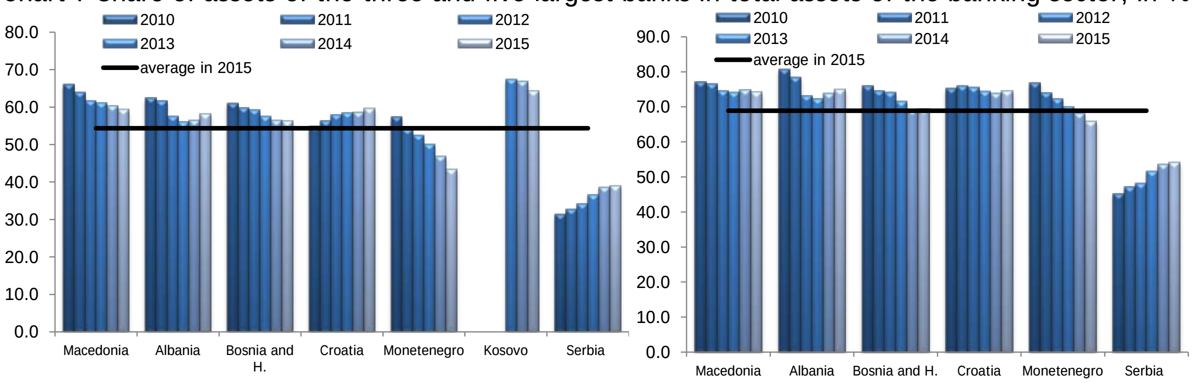


Chart 6 Share in realized financial result of the domestic banking sector



The situation in terms of concentration of the banking system is similar in the other countries of the region. Namely, the share of the first three and the first five banks in the total assets in the analyzed countries in 2015 is around 54%, respectively around 69%, on average, which points to a relatively high concentration of their banking system. In accordance with the analysis of the Herfindahl index at the end of 2015, the concentration of the banking system in all the analyzed countries is within the acceptable limits (under the threshold of 1800) and moves around 1300, on average. In terms of profitability, the total performed financial result continues to be concentrated in few large and systemically important banks, which suggests that the rest of the banking sector, especially smaller banks actually function on or under the level of efficiency threshold[96]. According to the analysis of the total number of banks which function within their financial systems, although this indicator in and of itself doesn't mean that the banking sector is very large or very small for the needs of the economy of one country, recently published ECB[97] material estimate that the number of banks in most of the analyzed countries is actually high relative to their economy, pointing to the need of further consolidation.

Chart 7 Share of assets of the three and five largest banks in total assets of the banking sector, in %



[96] According to reports for financial stability from the relevant central banks.
[97] ECB, Occasional Paper No 164, "Financial Stability Challenges in EU candidate and potential countries candidate countries", August 2015.

Chart 8 Herfindahl index for total assets of the banking sector

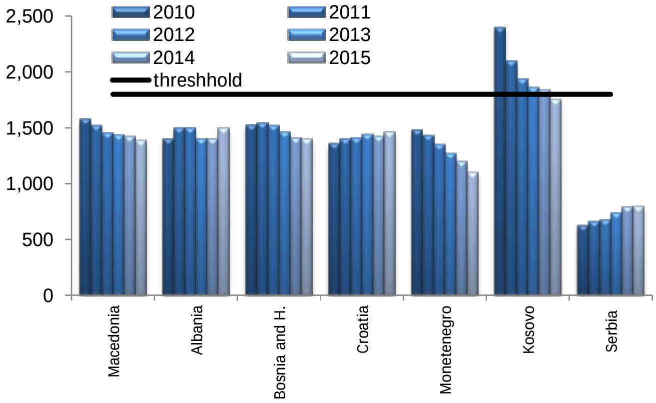
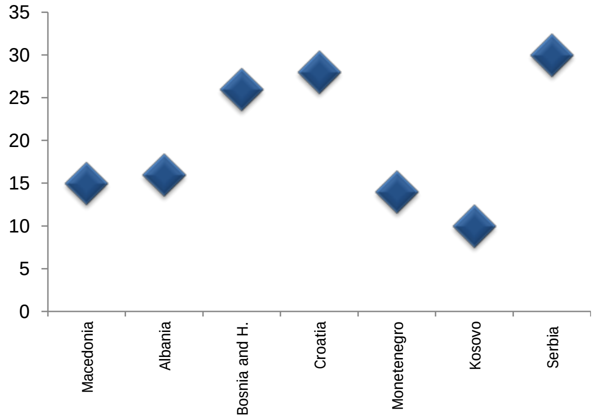


Chart 9 Total number of banks at the end of 2015



Given the important role of the concentration level of the banking system for the financial stability of one country, and consequently the overall economic development, the current state in Macedonia, and in the other countries of the region, points to further need for consolidation of the banking system. Thus, observed in terms of medium-term and long-term perspective, such need for consolidation is not negligible, and what is possibly the most important, in accordance with the latest developments and pressures in terms of retaining banks profitability, such need will increasingly come to the fore in the future.

Generally, the estimation of adequacy of size and concentration of the banking system cannot be based on a single indicator, nor there is a specific threshold which will clearly show the potential vulnerability of this aspect. Many additional structural characteristics of the economy and banking system are also extremely important while drawing conclusions in this domain. However, our analysis of few important indicators associated with the size of total assets and loans of the banks gives a certain indication that the “size” of the Macedonian banking system is appropriate for the real needs of the domestic economy. In accordance with the second group indicators associated with the concentration of the banking system, in the structure of the Macedonian banking system there is room for its further consolidation, which will further contribute for a sound, stable and efficient financial system and consequently, stable and sustainable economic growth.