National Bank of the Republic of Macedonia

Quarterly Report

October 2014

Contents

Introduction

During the third quarter of the year, the monetary policy remained unchanged. The National Bank maintained the policy rate at 3.25%, assessing it as appropriate for the economic and financial conditions in this period, as well as for the estimated risks. Monitoring of the key indicators has shown that they move along the expected path, although in certain segments deviations compared with the April expectations were registered. However, it was assessed that these deviations do not significantly change the environment for conducting the monetary policy and thus do not require monetary changes. Also in the third quarter, data on **inflation** indicated further downward adjustment of the general price level. These changes correspond to the downward adjustments of import prices, amid simultaneous absence of price pressures through demand. Changes in prices are continuously smaller than expected, and these deviations are associated with factors on the supply side. On the other hand, the dynamics of **economic growth** is solid, given the more dynamic activity of the real sector in the first half of the year than anticipated in the April projections. These performances are supported by the information from the **credit market**, which point to growth in both the demand and supply of loans, with the loans intended to support the private sector having exceeded expectations. The conducted surveys indicate that the intensive credit activity is a result of banks' more stable perceptions of the risk and the increased propensity of the private sector to borrow. These factors have strengthened the role of banks in supporting growth, compared with the previous period. In the third quarter, **foreign reserves** recorded significant growth, largely supported by government external borrowing. The favorable conditions in the international financial markets were used to mobilize additional capital for funding future budget needs. However, even without the effect of government borrowing on the international financial markets, foreign reserves registered moderate growth and moved along the expected path, amid favorable movements in the foreign exchange market and net purchase of foreign currency by the NBRM. Foreign reserves adequacy indicators remained favorable, with assessments for a level of foreign reserves sufficient to absorb potential unforeseen shocks. The data from the external sector give indications of lower current account deficit than expected, but also smaller financial flows (without the effect of the Eurobond). **Regarding the risks about future trends, key risks are still those arising from the external environment, but throughout this period they further strengthened.** This is especially true of the Euro zone, where the economic recovery is going at a slower pace and suggests prolonging of the recovery period. In circumstances of solid growth of the domestic economy and loans, but with increased risks for the external sector, the current monetary relaxation was assessed as sufficient. Also, it was assessed that the exit from the zone of accommodative monetary policy will be determined by the trends in the external sector.

Besides the changes in the initial conditions for some indicators of the domestic economy, in the period between the two projections certain changes occurred also in the assessments of the indicators that define the external environment. This assertion refers to the **import prices** pointing to more favorable terms of trade and lower pressures from import prices on inflation. **Changes were made also in the assumptions for the foreign effective demand,** where further recovery is expected in the period 2014-2016, but at a slower pace than previously expected. However, as in previous assessments, it is expected that the external environment will be more stimulating in the medium run, with expected twice faster growth in external demand in 2016, compared to the current pace.

Despite the moderate downward movements in foreign demand, the estimated growth of the domestic economy continues to point to solid performance. The pace of the economy in the first half of the year and the assumptions about the factors of growth by the end of the year point to GDP growth in 2014 of 3.7%, the same as in April projections. Amid unchanged initial conditions and retained assumptions for further support of growth through foreign and public investment, the assessments for accelerated growth in 2015 are retained, which along with the expectations for improved global environment would lead to its further acceleration in 2016. **However, given the slower recovery of foreign demand relative to the April projections, the assessments for the growth in 2015 indicate slightly slower growth of 4.1% (4.4% in the April projections) and its acceleration to 4.5% in 2016.** Such assessments show that the process of "decoupling" of the speed and intensity of the recovery of the Macedonian economy and the foreign effective demand continues in the next period, driven by specific factors that reduce the vulnerability of the domestic economy. The presence of new companies - foreign investments, which continuously increase the capacity utilization, as well as the fiscal stimulus on investments in infrastructure, are the main factors stimulating the growth of the domestic economy. Their positive second-round effects are expected to continue to be felt in the labor market by increasing the demand and price of labor. Under such assumptions, it is expected that the domestic demand will continue to be the generator of economic growth, while net exports would have a negative contribution, which is in line with previous expectations. By the end of the time horizon of the projections, there are assessments for gradual balancing of the growth structure, with a gradual reduction of the negative contribution of net exports.

Consumer and investment decisions of the entities are expected to continue to be encouraged by financial support from domestic banks. Improved performances in the credit market as of September and the assumptions about the movement of the sources of funding for banks indicate higher credit growth in 2014, which is assessed at 8.7%, and its acceleration to 9% in 2015 (from about 7% and 8% respectively in the previous projection) and 10% in 2016. These projections continue to be contingent on meeting the assumptions for the recovery of the economy as the main prerequisite for the growth of the deposit potential, for forming positive expectations of banks and for greater propensity of the private sector to borrow.

In terms of inflation, it is expected that the level of domestic prices in 2014, on average, will be similar to that in 2013, i.e. the average inflation for 2014 will be around zero (1% in the previous projection). Revised assessments for the inflation are based on the lower registered inflation, as well as the latest external assumptions showing lower pressures through the world prices of oil and food, relative to the previously expected for the entire time horizon of the projections. Major changes in current assumptions about the effect of the domestic demand on inflation in 2014 have not been made. Namely, recent assessments indicate closing of the negative output gap in the fourth quarter of 2014 (third quarter in the April projection). The gradual opening of a positive output gap, amid faster growth of the domestic economy is expected to lead to a gradual increase in inflation, which according to recent projections would be around 1% in 2015 (2% in the previous projection) and around 2% in 2016. Identified risks to inflation are mainly related to changes in the exogenous assumptions, driven by the uncertainty about the effects of the climate factors and geopolitical relations - the crisis in the Middle East and the Ukrainian crisis.

The latest assessments about the position of the balance of payments indicate the possibility of a smaller current account deficit than previously expected for 2014, i.e., a deficit of 2.7% of GDP, compared to 4% of GDP in the April projection. Changes between the two projections reflect the effect of the balance of goods and services as a result of the weaker import demand and smaller outflows in the services, relative to the expectations. Considering the dynamics, projections for 2014 still imply deepening of the current account deficit, compared with 2013, amid reduced relative share of the secondary income (mainly private transfers). In this direction is also the larger deficit in the balance of goods and services, given the growing import pressures created by the export dependent on the import of raw materials and the new investments, and also on the growth of private consumption. **The decline in the relative share of secondary income in GDP, coupled with the small shifts in the balance of goods is the reason for the further deepening of the current account deficit in 2015 and 2016, which is expected to reach 3.9% of GDP (contrary to 5.8% of GDP in the April projection) and 4.6% of GDP, respectively.** The current path of the current account deficit and its structure do not suggest major imbalances in the economy. As in the previous projection, current assessments suggest that the structure of capital inflows will be a combination of debt and non-debt flows. In terms of the dynamics, in 2014 transactions in the balance of payments are expected to result in an accumulation of foreign reserves, while in 2015 foreign reserves are expected to decline. Such dynamics of foreign reserves is largely determined by the Government, i.e. the already made Government borrowing on the international capital market in 2014 and the high amounts of repayment of external debt of this sector, which mature in 2015. The assessments for 2016 point to a room for new accumulation of foreign reserves, based on the assumptions of a gradual increase in foreign investment and borrowings of the private sector, but also based on further debt inflows for the country (in accordance with the structure of financing of the budget needs, presented in the recent fiscal strategy 2015-2017). The projected path of foreign reserves for 2014-2016, still indicates retention of the foreign reserves adequacy indicators in a safe zone.

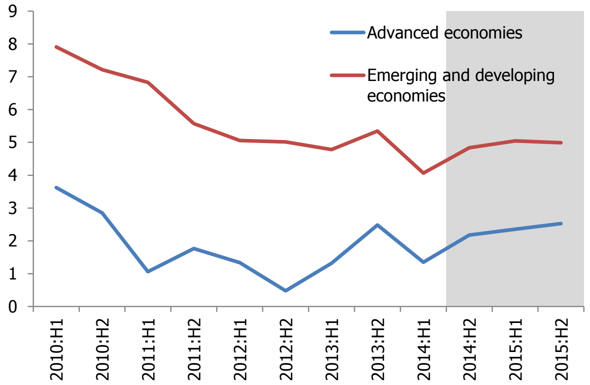
In general, recent performances point to maintaining of an economic image similar to that in the April projections, with estimates for solid economic and credit growth, absence of price pressures and balance of payments position which provides growth and further maintenance of the foreign reserves at an adequate level. The risks around the achievement of this macroeconomic scenario remain to be mainly of an external nature, and are related to the possible changes in the pace of recovery of the global economic growth, particularly that in the European Union, as well as to the movements in the prices of primary products in world markets. The NBRM will continue to closely monitor the developments in the period ahead, and if necessary it will make appropriate adjustments to the monetary policy aimed at successful achievement of the monetary policy objectives.

I. Macroeconomic Developments

1.1. International Economic Surrounding[1]

In the first half of 2014, the global economy continued to recover, but growth slowed down and was lower than expected. In the second half of the year global growth is still expected to accelerate compared to last year, with equal contribution from both developed and developing countries. However, due to the lower than expected growth in the first half of the year, the IMF made a minimal downward revision of the projections for 2014 from 3.4% to 3.3%. The global recovery is still expected to be heterogeneous among countries. The growth of developing countries is expected to be largely driven by the United States amid further monetary stimulus, minor adverse effects of fiscal consolidation and improving condition on the labor market, while the recovery of the Euro area will continue to be slow and uneven. On the other hand, growth in developing countries will be supported by the recovery of domestic demand, economic policies and strengthening of foreign demand. In 2015, the IMF expects that global growth will accelerate moderately and will reach 3.8%, which is still below the expectations compared with the July projection. Short-term risks around the projections are downward and even more pronounced, and cover the increased geopolitical risks, the risk of correction of the developments on the financial markets, and the risk of achieving low inflation or its shift into deflation in the developed countries. Globally, no significant inflationary pressures are expected. Moreover, in the developed countries, inflation is expected to be low, but gradually approach the target set by the central banks (1.8% in 2015), while in the developing countries it is expected to decrease in 2014 and basically remain unchanged in 2015 (5.5%).

Global GDP growth
(annualized semiannual rates)



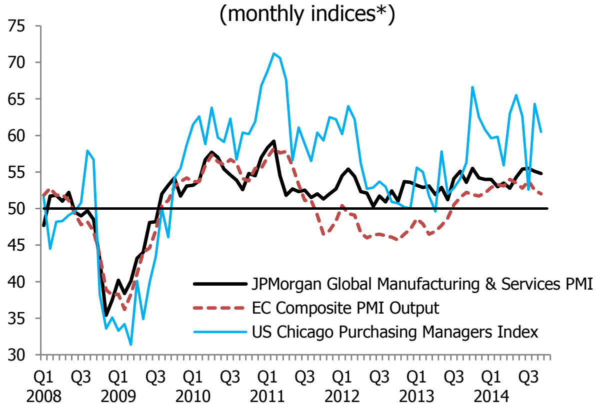
Source: IMF.

The latest performances point to slower global economic activity in the first half of the year. The slower global growth reflects the temporary decline in the US economy in the first quarter, the weak performances of the economies of the Euro area, and the slower activity in Russia, China, Japan and Latin America. However, in the second half of the year the economic growth in developed and in developing countries is expected to accelerate. This is also illustrated by the **global composite PMI index[2]**, which in the third quarter of 2014 increased (by 1 percentage point) compared to the previous quarter and reached 55.1 index points. Growth in developed countries will be supported by the

[1] The analysis is based on the ECB's Monthly Bulletins, the IMF's World Economic Outlook, October 2014; reports of Capital Economics, releases of Markit Economics, weekly reports of the Bank of Greece and the IMF's monthly releases on the primary commodities market.

[2] PMI (Purchasing Managers 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.

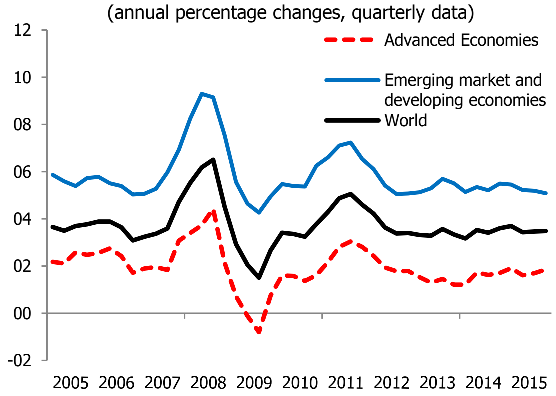
Global economic activity indicators
(monthly indices*)



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

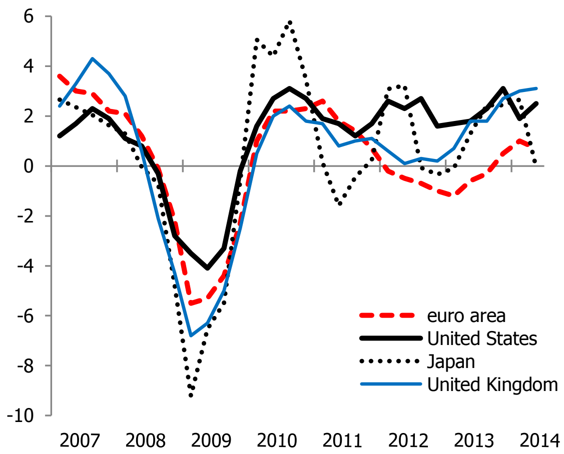
decelerated fiscal consolidation and the stimulating monetary and financial conditions, while in developing countries, the main drivers will be the strengthening of domestic and foreign demand. **On annual level, the October projections of the IMF forecast global growth of 3.3% for 2014 and 3.8% for 2015, which is minimal downward revision of 0.1 i.e. 0.2 percentage points compared to the July projections.** The prospects for growth in developed and in developing economies are considerably heterogeneous. From the perspective of developed countries, the strongest economic recovery is expected in the USA, amid further monetary stimulus, smaller adverse effects of the fiscal consolidation and improved household balance sheets. On the other hand, the Euro area is expected to register slower and uneven recovery, with growth of 0.8% in 2014 and 1.3% in 2015, supported by the accommodative monetary policy and improved lending conditions. Regarding the developing economies, Asian economies are still expected to grow fast, with moderate slowdown in China and acceleration in India, as opposed to the projections for slow growth of the Brazilian and Russian economies. Regarding the risk balance, downward risks have increased, which could adversely affect global growth in both the short and the long run. The main reason for this are the increased geopolitical risks in relation to the situation in the Middle East and Ukraine, and their potential adverse impact on the markets of primary products and on the real activity in global terms. The risk of the normalization of Fed's monetary policy, which is primarily related to the timing and pace of increase of the policy rate, is still present. Hence, despite the optimism present in the financial markets, downward risks have increased, concerning their reaction in case of a faster than expected increase in the interest rates in the USA. At the same time, it is assessed that there is a possibility for a sudden growth of risk premiums and financial volatility in the event of adverse global economic and geopolitical developments. In some developed countries, inflation continued to decline, and there is a risk that the long period of very low inflation or the emergence of deflation would have negative effects on the economic activity and public debt sustainability. The probability of lower growth of the Chinese economy in the short run, as a result of significant adjustments to the real estate market also poses a risk to global growth. In the medium run, the risks to the global economy arise from the possibility of lower potential growth of developed economies and developing countries, as well as the possibility of prolonged economic stagnation of the

Global Inflation
(annual percentage changes, quarterly data)



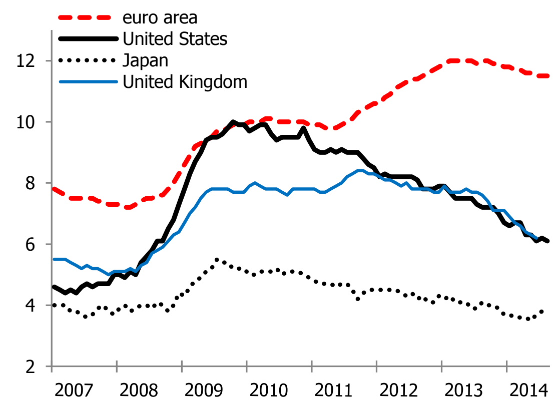
Source: IMF.

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



Source: Eurostat.

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



Source: Eurostat.

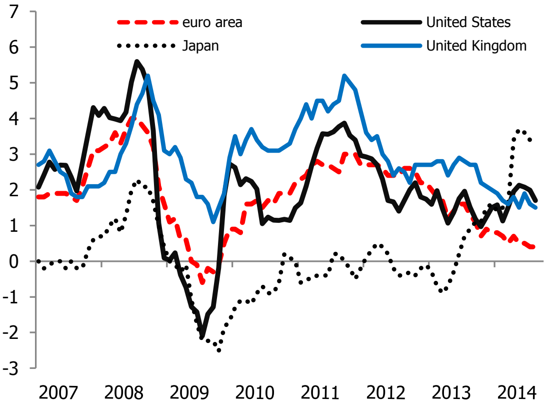
developed countries (the so-called secular stagnation).

In the first two months of the third quarter of 2014, global inflation was minimally lower compared with the second quarter. The global inflation rate in this period equaled 3.4%, versus 3.5% in the second quarter of the year. The lower global inflation is solely due to the moderate slowing of the inflation in the developed countries, amid inflation in the emerging and developing economies, which has remained unchanged for the third quarter in a row and is being maintained at one of the lowest levels after 2009. The latest IMF projections forecast that inflation will be low in the developed countries, but that it will gradually increase to a level of 1.6% in 2014 and 1.8% in 2015. On the other hand, in the developing countries, the inflation is expected to decelerate to 5.5% in 2014, and to remain at approximately the same level next year.

After four consecutive quarters of growth, in the second quarter of 2014 economic activity in the Euro area remained at the level registered in the previous quarter. However, it is estimated that the halt in the recovery of the European economy is probably temporary and results from the more intensive spending of the inventories, while the movements in domestic demand and net exports are favorable. More unfavorable movements compared to the first quarter are registered in most European economies. Thus, in Germany and in Italy a quarterly decline in GDP of 0.2% was registered, while the GDP of France remained at the level of the previous quarter. Among the major European economies growth was registered only in Spain (0.6%) and in the Netherlands (0.5%)[3]. The quarterly stagnation also caused a slowdown in the annual growth of the economy of the Euro area to 0.7% (compared to 1% annual growth in the first quarter). Despite the stagnation of the economic activity, the labor market in the Euro area continued to register favorable movements. The unemployment rate in the period from July to August reduced by additional 0.1 percentage points compared to the second quarter, and equaled 11.5%. **Inflation in the Euro area remains low and is well below the targeted inflation rate of 2%.** In the third quarter, the average annual inflation rate was 0.4%, a level that was last recorded in 2009. Low inflation is

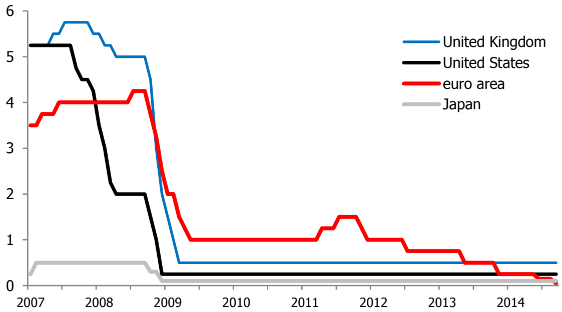
[3] http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-14082014-AP/EN/2-14082014-AP-EN.PDF

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



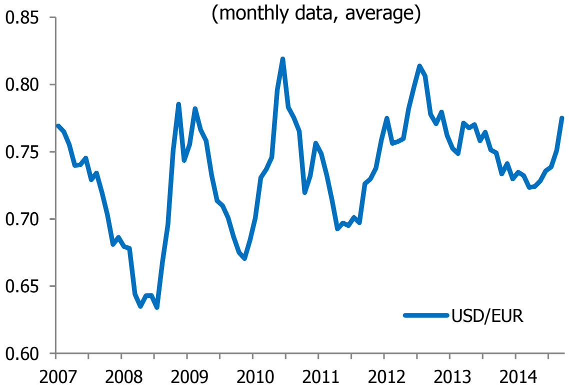
Source: Eurostat and national statistical offices.

Policy rates in advanced economies
(in %)



Source: Central banks.

USD/EUR Exchange rate
(monthly data, average)



Source: Eurostat.

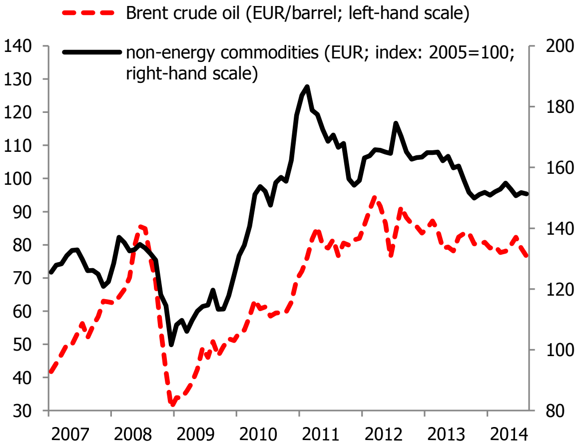
mainly explained by the lower prices of energy and food, amid unchanged core inflation.

The conduct of an accommodative monetary policy in the developed economies continued in the third quarter of 2014. Fed and the Bank of England kept the key interest rates at a record low (0-0.25% and 0.5%, respectively). On the other hand, amid a slow recovery of the economy of the Euro area, in September, the Governing Council of the ECB decided to further cut its key interest rate by 0.1 percentage points[4], whereby it reached a record low of 0.05 %. The reduction in the key interest rate was followed by a reduction in the interest rate on marginal lending facility to 0.3%, and the interest rate on deposit facility to -0.2%. In addition, the ECB announced that in the second half of October it will start a third covered bond purchase program (CBPP3[5]), and that it will launch a new asset-backed securities purchase program (ABSPP[6]) during the fourth quarter. The two programs are expected to be implemented over a period of at least two years. Meanwhile, in September one of the planned auctions within the measure for targeted long-term refinancing operations was conducted, the purpose of which is the direct support of lending to the private sector. Regarding the Fed, at its September meeting, the Federal Open Market Operations Committee (FOMC) decided to further reduce the purchase of mortgage bonds to US Dollars 5 billion (from the previous US Dollars10 billion), and the purchase of longer-term government bonds to US Dollars 10 billion (from the previous US Dollars 15 billion) starting from October. This decision was taken in accordance with the perceptions for the continued growth of the economic activity, further improvement of labor market conditions and growth of household consumption.

During the third quarter of 2014, the trend of depreciation of the Euro against the US Dollar on a monthly basis, continued. Namely, after the mild depreciation of the Euro in July 2014, in August and especially in September, a significant depreciation of the Euro was registered by 1.6% and 3.1%, respectively. Such trends reflect the expectations regarding the future activities of the monetary policy, and the adjustments of market expectations for the

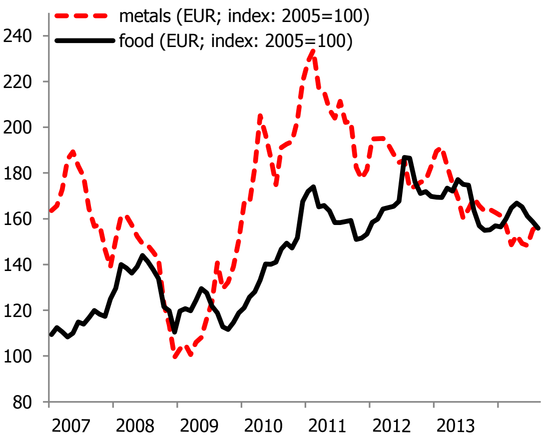
[4]http://www.ecb.europa.eu/press/pressconf/2014/html/is140904.en.html
[5] Covered Bond Purchase Programme 3
[6] Asset-Backed Securities Purchase Programme

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



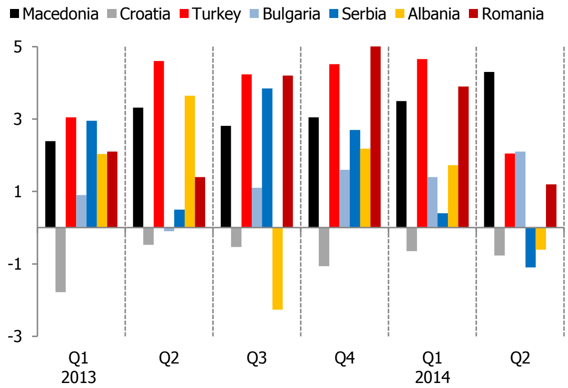
Source: IMF monthly database.

Prices of food and metals
(monthly data)



Source: IMF monthly database.

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



Source: Eurostat and national statistical offices.

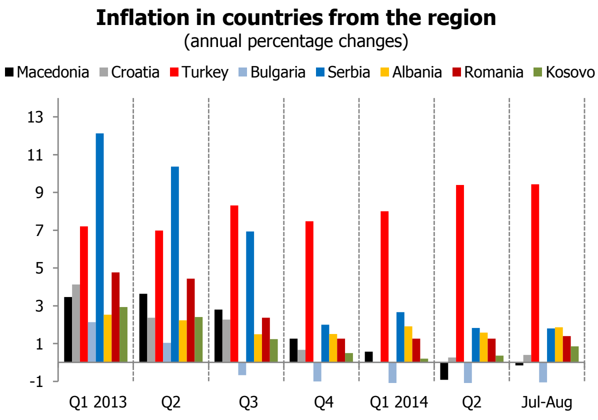
economic developments in the Euro area compared to other major economies. In September 2014, one Euro was exchanged for 1.29 US Dollars, which compared to September 2013 is a depreciation of 3.3%.

In the first two months of the third quarter of 2014 there was a decline in oil prices, expressed in Euros, despite the expectations for upward pressures on the price due to the geopolitical tensions in Ukraine and Iraq and the problems associated with the oil production in Libya. Thus, the price of crude oil "Brent" in this period averaged Euro 77.8 per barrel, which is a drop in the price of 2.9% compared with the previous quarter. This shift is mainly associated with the growth of the supply of oil, amid weaker demand for oil and petroleum products. Further downward impact on oil prices resulted from the appreciation of the US Dollar in this period. **On the other hand, prices of non-energy primary products[7] in the first two months of the third quarter decreased by 1% compared to the previous quarter.** The decline is entirely explained by the lower food prices (-4.7%), amid a significant increase in the supply and stocks of cereals worldwide. Despite such trends in food, metal prices registered quarterly growth of 4.1%, with growth registered in the prices of almost all metals entering the calculation of the total index, which is mainly associated with the lower supply of metals in the world due to various factors[8].

In the second quarter of 2014, economic activity slowed down in almost all countries in the region, but most of them remained in the zone of positive growth. Thus, positive growth rates were registered in Turkey and Romania, but due to the weaker private consumption they were lower compared with the previous quarter. From among the countries with positive growth only in Bulgaria it intensified, largely as a result of the positive contribution of net exports. On the other hand, the economic activity in Croatia continued to decline, and the catastrophic floods caused a decline also in the economy of Serbia, for the first time since 2012.

[7] http://www.imf.org/external/np/res/commod/pdf/cqr/cqr0914.pdf

[8] Ban on exports of nickel by Indonesia, reduced supply and stocks of aluminum in the world, as well as closure of several large zinc mines.

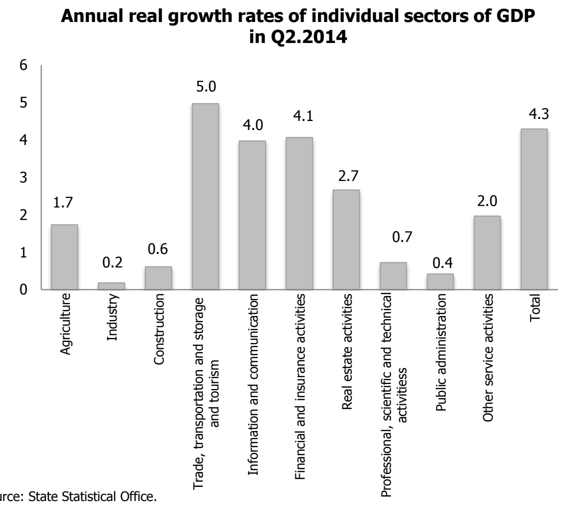


Source: Eurostat and national statistical offices.

In the July - August 2014 period, countries of the region witnessed divergent movement of inflation rates. The inflation rate rose in Croatia, Albania, Romania and Kosovo, while in Serbia and Turkey it remained at the level registered in the previous quarter. In Bulgaria, the deflationary movements continued also in the first two months of the third quarter, which, as in the first part of the year were driven by the low prices of energy and food.

1.2. Domestic Supply

The growth of domestic production continued in the second quarter of 2014, when an annual GDP growth of 4.3% was registered. Improved economic performances in the second quarter of 2014 were distributed among all sectors of activity, with the highest growth being registered in the activities in trade, transport and catering. Solid achievements were recorded also in industry amid accelerated growth of the volume of industrial production, which is largely associated with the activity of the capacities in the technological and industrial development zones. On the other hand, the data associated with the activity in the construction sector, which in recent quarters has been one of the engines of economic growth, point to weaker performance in this sector. However, these adverse developments are probably of a temporary character, which is signaled by the results of the surveys in this area.

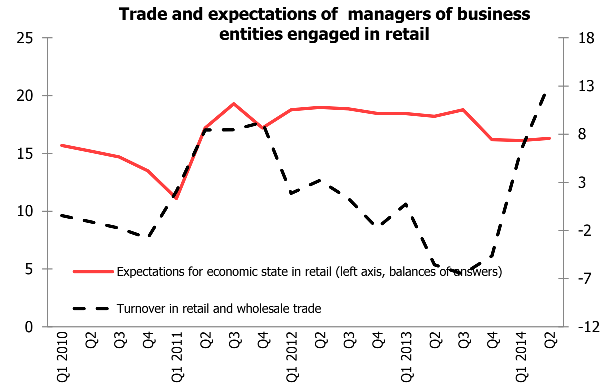


Source: State Statistical Office.

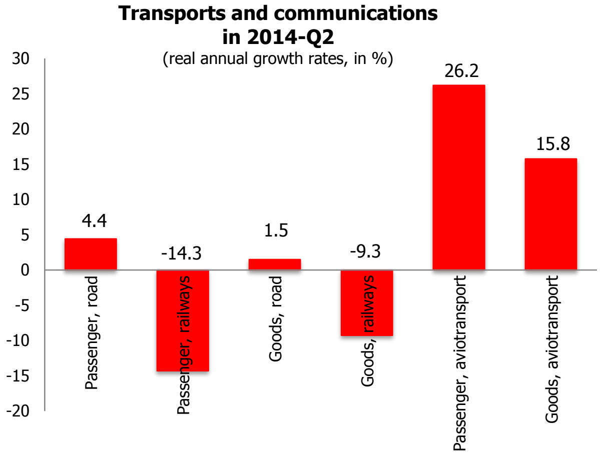
In the second quarter of 2014, the annual growth of domestic production was 4.3%[9]. Higher value added was registered in all sectors of the economy, with the highest growth being registered in trade, transport and catering[10]. Solid achievements were recorded in the activities "financial intermediation", "information and communications", "activities related to real estate", as well as in agriculture.

[9] The data on the movement of GDP and its components in the second quarter of 2014 that the SSO announced in September 2014 include a revision of the method of calculation of certain categories in order to achieve greater scope and application of the ESA 2010 methodology. Additionally, the data by sector and compilation of data by sector of economic activity are presented according to the NACE Rev.2 classification. In the absence of a longer, consistent historical data series (which is scheduled to be published by the end of the year) the analysis of the domestic supply in the second quarter is done mainly by using the indicative categories for the movement of the value added in the economic sectors.

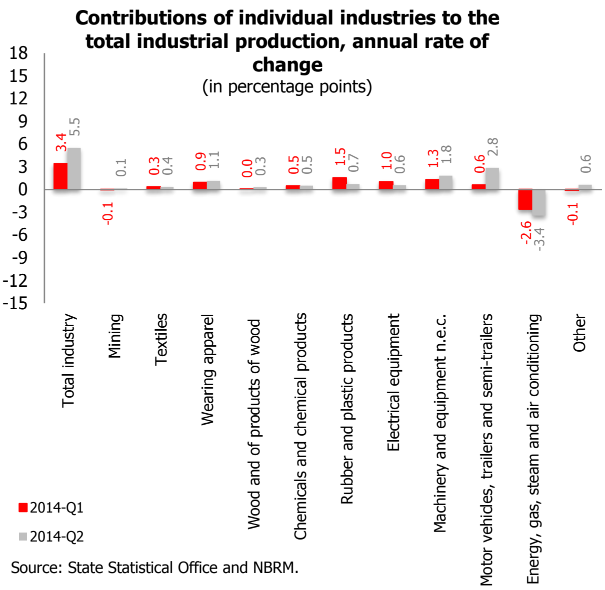
[10] Within the published data on GDP, in the second quarter the three activities: "trade", "transport and communications" and "catering" are published collectively, i.e. it is impossible to isolate the individual growth of each of them.



Source: State Statistical Office and NBRM.



Source: State Statistical Office and NBRM.



Source: State Statistical Office and NBRM.

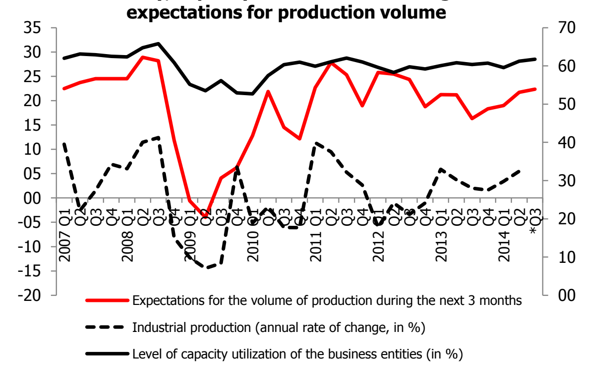
Favorable movements in trade continued during the second quarter of 2014[11]. Moreover, as in the previous quarter, the growth is fully explained by the increased turnover in wholesales. The turnover in retail trade still declines on an annual basis, but at a significantly slower pace. The results of the **Survey of the managers in retail trade**[12] also indicate improvement in the situation in this sector given the more positive assessments of the managers regarding the current situation and more optimistic expectations regarding the business conditions, employment and selling prices compared to the previous quarter. However, managers further emphasize the existence of certain limiting factors whose adverse impact is stronger than in the first quarter of the year, such as lower demand by customers, rising costs, and more difficult access to bank loans.

In view of the developments in the sector "transport and storage" most indicators point to a continuation of the favorable developments from the first quarter. Fast growth was registered in air transport, while road transport recorded a moderate increase. On the other hand, data on realized railway transport remained negative in the second quarter.

Value added in industry recorded a small annual growth, while the volume of industrial production increased by 5.5%, which is an acceleration of the annual growth compared with the previous quarter. Improved performances are largely associated with the activity of the capacities in the technological and industrial development zones, and the improved external environment also has a positive impact on the activity in this sector, which can be seen through the annual growth of foreign demand. The largest contribution to the annual growth in the second quarter continued to be that of the manufacturing industry, with positive trends being registered in most of the activities, among which the most important is the contribution of the growth in the production of machinery and

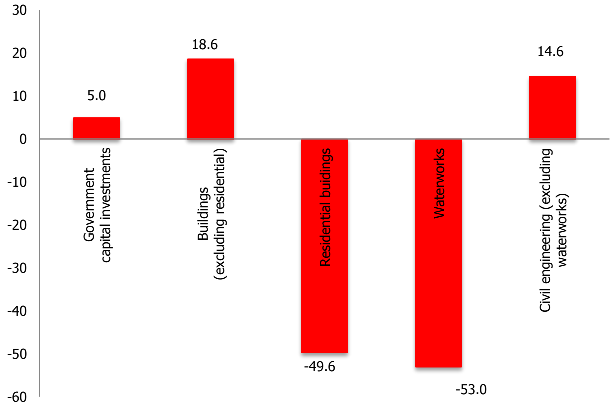
[11] The analysis of the movements in trade is based on data for the trade turnover.
[12] SSO's Business Tendency Survey in retail trade for the second quarter of 2014. The balance of responses is the difference between weighted positive and negative responses of the managers of business entities. The 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 the managers of the business entities.

Industry, capacity utilization and managers' expectations for production volume



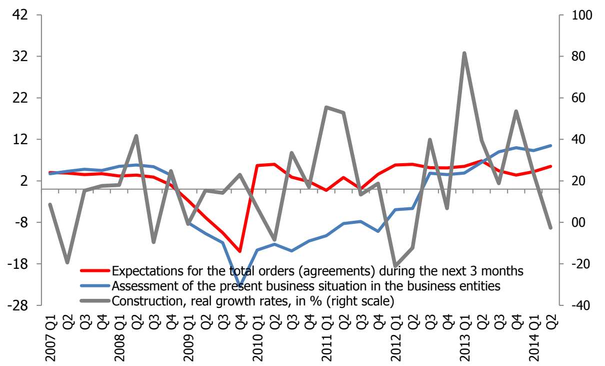
Source: State Statistical Office.
* average of expectations for 7 and 8 month of 2014

Contruction in 2014-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.

equipment, motor vehicles and clothing. Besides the manufacturing industry, in the second quarter of the year growth of activity was registered in mining, while the activity in the "supply of electricity, gas, steam and air conditioning" again gave a negative contribution to the growth of industrial production. The improved performance in the industry is confirmed also by the **Business Tendency Survey in manufacturing industry**[13]. According to the Survey, in the second quarter, there was a continuous improvement of the perceptions of company managers for the current economic situation. As for the limiting factors, company managers emphasize the lack of resources, insufficient demand (domestic and foreign) and the lack of skilled labor as factors with more prominent negative impact in the second versus the first quarter. **The results of the surveys conducted in the first two months of the third quarter point to a continuation of the favorable developments in the industry** amid continuous improvement of the assessments for the current economic situation of enterprises and increase in the average capacity utilization.

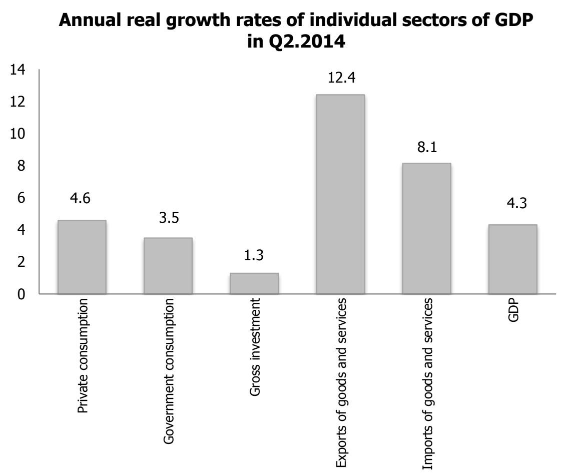
Despite the strong growth in construction activity in the past two years, since the beginning of this year the pace of growth has slowed significantly. Thus, in the second quarter of 2014, the slowdown in the annual growth of value added in construction continued, while the value of completed construction works dropped. In terms of the types of buildings, the weaker construction activity can be explained by the lower construction of residential buildings, as well as the reduced activities in the field of hydro construction. Other activities in the field of high-rise construction and civil engineering registered moderate annual growth. However, these developments, according to the results of the **Business Tendency Survey in construction,** are probably temporary. The managers of construction companies assess the current situation in this sector as more satisfactory compared to the previous quarter, which contributed to the more optimistic expectations for the third quarter in terms of the sales prices and employment in this sector, while expectations for future orders remained stable. Regarding the factors that limit the growth of the construction activity, managers point to the higher costs for materials and labor, collateral for the loans and lack of trained personnel, as factors whose

[13] It refers to the surveys conducted in the second quarter of 2014.

negative influence was stronger in the second than in the first quarter.

1.3. Aggregate Demand

In terms of demand, the annual growth of gross domestic product of 4.3% in the second quarter of 2014 is explained by the concurrent growth of domestic demand and export activity. All components of domestic demand grew, with the highest growth (of 4.6%) being registered in household consumption supported by the increase in households' available funds and retail lending. Investment demand in the second quarter recorded a modest increase (of 1.3%) amid deteriorated performances of the construction sector, assessed to be of a temporary nature. The favorable developments in the export sector (annual growth of 12.4%) were mostly due to the activity of the new production facilities in technological and industrial development zones, and the gradual strengthening of foreign demand gave an additional stimulus. Increased domestic and export demand, amid high dependence of domestic production on imports, increased the imports by 8.1%.

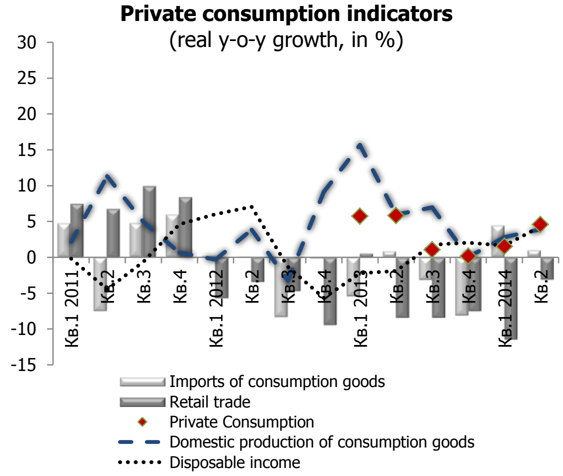


Source: State Statistical Office.

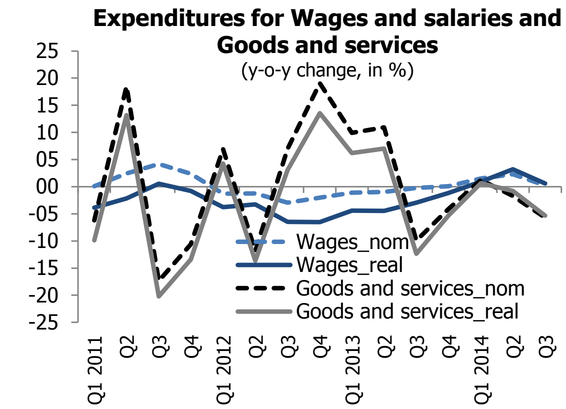
Analyzing GDP in relation to demand, indicates that the relatively high annual growth in the second quarter of 2014 is due to the increased domestic and foreign demand, partially offset by the increase in imports. In terms of individual components, the highest growth, as in the first quarter, was registered in the export of goods and services. Favorable movements in the export sector were largely a result of the activity of the new production facilities in technological and industrial development zones, as well as the gradual strengthening of external demand. In the second quarter of the year growth was registered in all domestic components of demand. Namely, the positive developments in the labor market, partly as a second-round effect of the activity of new export facilities, and real wage growth accelerated the growth of household consumption. The increase in public spending, which started in the previous quarter, continued in the second quarter of the year. Gross investment remained in the area of positive movements, but their growth slowed significantly reflecting the less favorable movements in the construction sector. Increased domestic and export demand led to growth of imports, but with less intensity compared to the growth of exports.

1.3.1. Private Consumption

In the second quarter of 2014, the annual growth of private consumption accelerated to 4.6% in line with the increase in available funds.



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



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

Real growth in average wages paid (despite the decline registered in the first quarter), coupled with higher employment, accelerated the growth of the wage bill in the economy. In the second quarter, the growth of pensions continued as well, although at a slower pace compared to the previous quarter. Higher inflows based on private transfers from abroad (despite their decline in the first quarter of the year) had an additional positive contribution to the growth of the household income. Beside the growth of the main components of households' disposable income, higher consumption in the first quarter was supported by the increased lending to households, mainly in the form of consumer loans. The movement of short-term indicators of private consumption, largely corresponds to the growth registered in the second quarter. Thus, annual growth was observed in the domestic production and import of goods for private consumption, as well as in the net income from VAT. On the other hand, turnover in retail trade continued to decline in the second quarter, but at a significantly slower pace.

Growth in the private consumption is expected to continue in the third quarter of the year according to the latest available data[14]. Namely, the increase in real wages, pensions and transfers in the first two months of the third quarter points to an assessment for further growth of the total households' disposable income. According to the data on lending in the period from July to August, consumer loans to households grew with similar intensity as in the previous quarter, which is also in favor of the expectations for growth of private consumption in the third quarter. Credit growth is in line with the banks' expectations for easing of the credit conditions and increased demand in the third quarter of 2014[15]. From among the short-term indicators of private consumption, accelerated annual growth was recorded in domestic production and in the imports of consumer goods.

1.3.2. Public Consumption

In the second quarter of 2014, public consumption registered an annual growth of 3.5%. Real annual growth stems from the increase in the expenditures for wages and in the transfers for health care[16]. The available data for

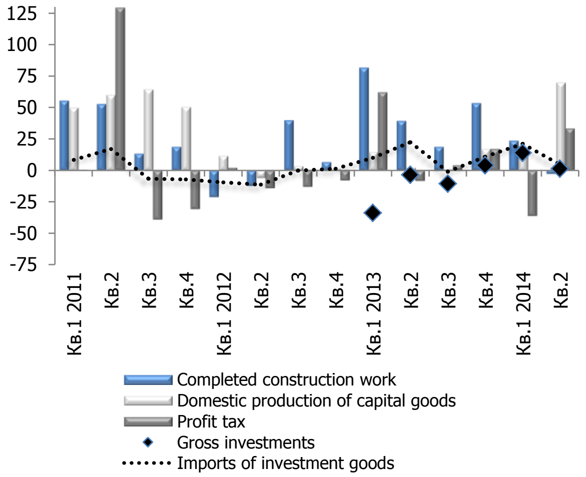
[14] Wage data are as of July, while other data are as of August.
[15] NBRM's Lending Survey conducted in July 2014.
[16] Most of these assets relate to expenditures for goods and services.

July-August 2014 indicate a reduction of public consumption **in the third quarter of 2014,** given the reduced costs for goods and services and lower transfers for health care.

1.3.3. Investment Consumption

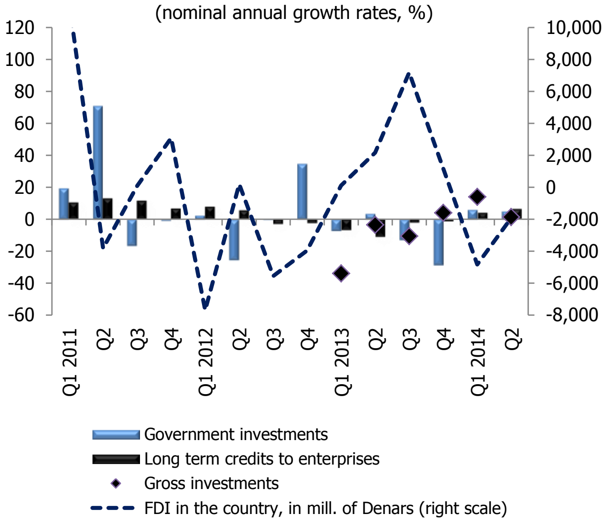
Gross investments in the second quarter of 2014 registered a modest annual growth of 1.3%. According to the data on the short-term indicators of investment activity, this movement probably reflects the lower growth of investments in fixed assets, i.e. lower investments in construction and machinery and equipment. Namely, after the intensive growth in the past few quarters, in the second quarter of the year, there was a decline in the value of completed construction works, which points to unfavorable movements in the investments in construction. The import of investment products, which is an indicator of investments in machinery and equipment continued to grow in the second quarter, but the growth is significantly lower than in the first quarter. Most of the other investment indicators support the growth of investments in the second quarter. Thus, in the second quarter, growth was registered in the domestic production of investment goods, government expenditures for capital investments, as well as corporate loans. Moreover, according to the results of the Lending Survey[17], also in this quarter a significant part of the credit demand from the corporate sector was aimed at investments in inventories and working capital. Additionally, banks emphasize that the growth of loans to the corporate sector is due to the net easing of credit conditions in this sector, given the improved banks' perceptions of the corporate sector, in terms of risk.

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



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

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



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

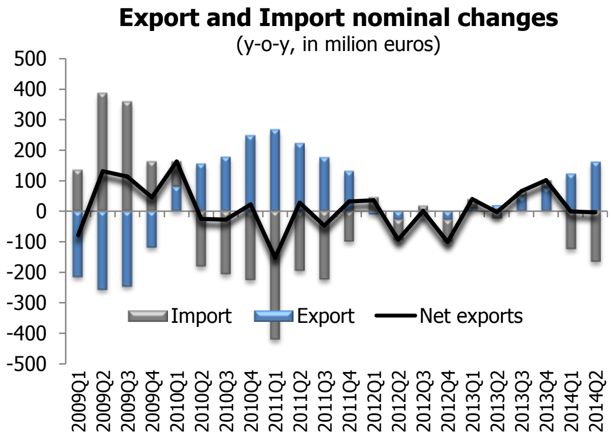
The latest available indicators of investment activity point to further slowdown in investment activity in the third quarter of 2014.[18] Namely, the value of completed construction works in July registered a relatively sharp real annual decline. On the other hand, the expected value of construction permits in July increased significantly on an annual basis, particularly in civil engineering, which is related to the previously announced major infrastructure projects. Also, expectations of managers in the construction sector in the second quarter are generally more favorable compared to the previous

[17] NBRM's Lending Survey conducted in July 2014.
[18] Data on completed construction works and foreign direct investments are as of July, while other data are as of August.

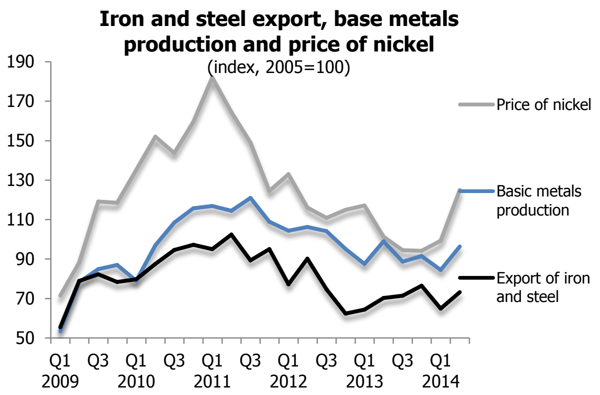
quarter[19]. Hence, it is estimated that the current unfavorable movements in construction are probably temporary. Besides the lower investments in construction activity, the slower investment demand is also confirmed by the movement of other short-term indicators at the beginning of the third quarter. Thus, slowing growth was registered in the domestic production of capital goods, while government capital expenditures decreased on an annual basis. Long-term bank lending to companies continues to grow, but at a slower pace compared with the second quarter.

1.3.4. Net External Demand

The situation in the external sector in the second quarter of the year is estimated as more favorable compared to the previous quarter. Namely, in the second quarter of the year, there was a significantly faster growth of exports of goods and services versus the imports which indicates narrowing of the deficit in foreign trade. Thus, real exports of goods and services registered an annual growth of 12.4%, representing a component with the highest growth in the GDP. This growth, as in the previous quarter, was mainly due to the increased exports of the new production facilities in the country. Solid achievements were registered in part of the other exports, i.e. the export of textile and clothing, which is in line with the gradual recovery of external demand. Analyzed by product categories the export of machinery and equipment was the highest also in the second quarter. On the other hand, the still weak global demand for metals has an adverse effect on the domestic metal industry, despite the moderate increase in metal prices on the world market. Imports of goods and services in the second quarter of 2014 increased by 8.1% on an annual basis, which given the dependence of the domestic production on imports is explained by higher imports of intermediate products.



Source: National Bank of the Republic of Macedonia



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

The data for the third quarter point to a continuation of favorable developments on the export side. Amid higher capacity utilization in the manufacturing industry, in July and August 2014, export of goods, especially machinery and electrical equipment, generated a nominal annual growth, whose increase was significantly supported by the capacities operating in the technological industrial development zones. These

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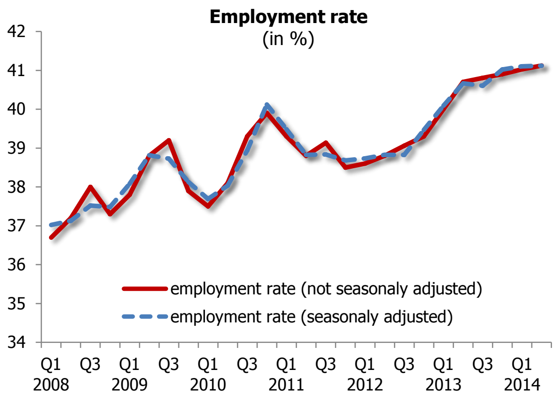
[19] SSO's Business Tendency Survey in construction conducted in the second quarter of 2014.

developments are in line also with the estimates for the foreign effective demand, indicating gradual acceleration of the growth. **In the first two months of the third quarter, nominal annual growth was recorded also in the imports,** primarily due to increased import of raw materials by a major export capacity, along with the growth of import of equipment and machinery. Regarding the movement of net export demand in the third quarter, it is estimated that its contribution to growth would be negative amid higher growth of imports relative to exports.

1.4. Employment and Wages

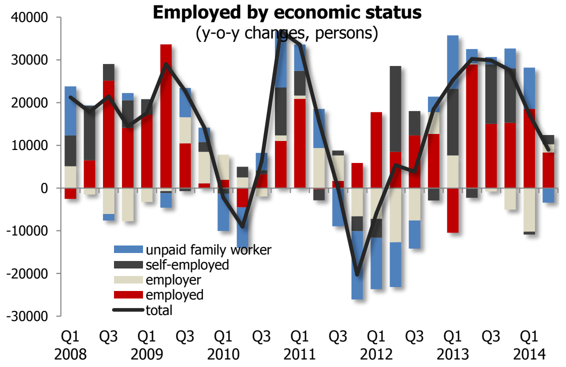
In the second quarter of 2014, the number of employees continued to grow on an annual basis (1.3% growth), whereby this indicator has remained in the zone of positive annual changes for nine consecutive quarters. However, given the dynamic growth in the number of employees in the past, since the beginning of 2014, the pace of growth in this number slows down. Favorable developments in the labor market are in line with the performances of the real sector, which point to a retained trend of growth in the economic activity. The improvement of some of the key labor market indicators over several years in a row is continuously attributable to the growth of domestic production, largely driven by the operation of the new facilities in the technological industrial development zones, as well as active employment policies. According to the aggregated signals from surveys on business tendencies, the favorable developments in the labor market are expected to continue in the third quarter of the year.

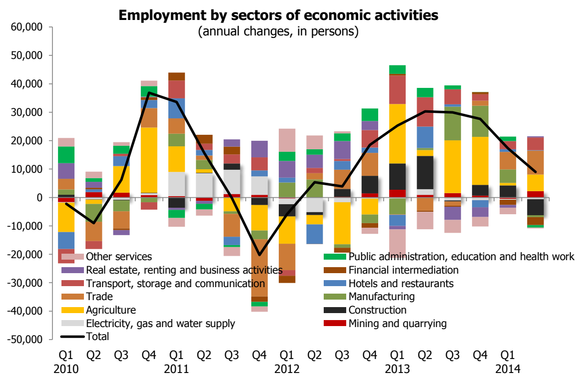


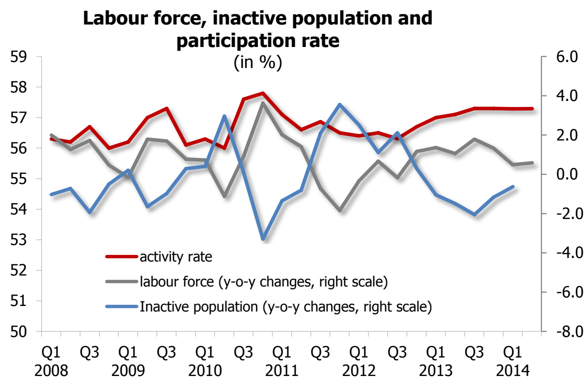
Source: State Statistical Office, Labour Force Survey.

In the second quarter, the favorable developments in the labor market continued, amid registered annual growth of the number of employees by 1.3%, while on a quarterly basis the number of employees remained at the level of the previous quarter[20]. Most of the annual growth in the number of employees is distributed among the sectors of agriculture, mining, trade and transportation, while in terms of the economic

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







Source: State Statistical Office, Labor Force Survey.

status[21], the growth of total employment in the second quarter was mainly due to the growth in the number of employees. Employment in the categories of employers and own-account workers increased moderately, while the number of unpaid family workers decreased in the second quarter. The results of the Vacancy Survey[22] are in favor of the growth in the number of employees. Namely, the number of vacancies, which is another indicator of the movement of labor demand, increased by 23% in the second quarter, compared to the same period last year, while the rate of vacancies rose by 0.2 percentage points and equaled 1.4%.

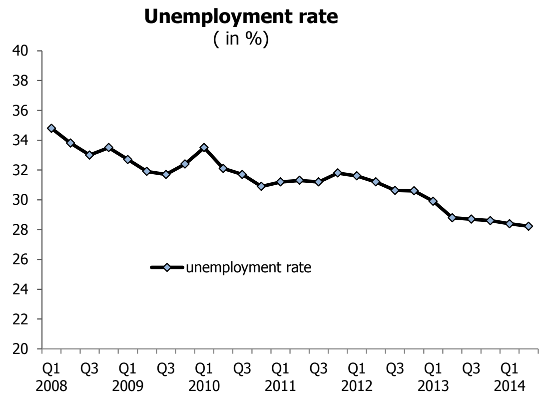
However, analyzing the dynamics, data for the second quarter point to a significant slowdown in growth compared with the previous quarter, but also compared with the developments in the previous year when employment, on average, increased by about 4%. The slowdown in growth is mostly explained by the fall of employment in construction, reflecting the high base effect from the previous year when the number of employees increased by almost 30%. High employment growth in this sector in the first half of 2013 corresponds to the intense construction activity, which is largely associated with the publicly funded construction work and foreign investment in real estate in this period. The fall in the employment in the manufacturing industry gave an additional contribution to the slower employment growth in the second quarter of 2014, despite the intensive employment growth in this sector in the previous quarter. These changes resulted in a slowdown in the annual employment growth rate which in the second quarter registered a more moderate growth of 0.4 percentage points and reached 41.1% (compared to the growth of 1 percentage points in the previous quarter).

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

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

The prospects in terms of the movements on the labor market by the end of the year remain favorable. Namely, according to the aggregate signals from the surveys on business tendencies[23], moderately increased optimism compared to the previous quarter was registered. This tendency corresponds to the positive developments in the domestic and the gradual recovery of the global economy.

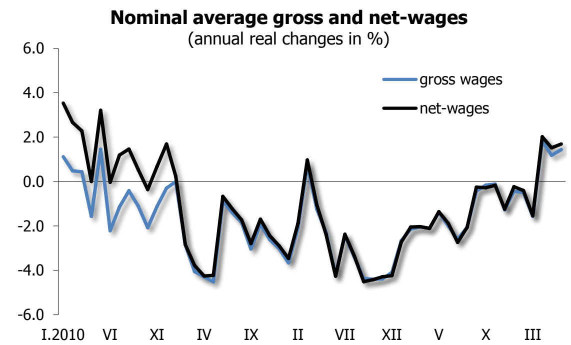
Demand growth in the second quarter was followed by growth in the labor supply. Compared to the same period last year, the total active population increased by moderate 0.6%, which amid simultaneous decline in the inactive population, caused an annual growth of the activity rate, which in the second quarter was positioned at the level of 57.3%.



Source: State Statistical Office, Labor Force Survey.

In the second quarter, the reduction of unemployment continued, amid further more intensive growth of labor demand versus the growth of labor supply. However, the reduction is slower compared to the previous quarter. Thus, the number of unemployed persons in the second quarter was lower by 1.3% on an annual basis, compared to 4.5% as was the drop in the first quarter. In such circumstances, the unemployment rate fell by 0.6 percentage points on an annual basis (compared to the decrease of 1.5 percentage points in the first quarter) and in the second quarter it was reduced to 28.2%, which is the historically lowest level. The

Box 6 Box presents an analysis of the changes in the overall unemployment rate, starting from 2000, with a focus on youth unemployment as an age group with large contribution to the change in the overall unemployment rate.

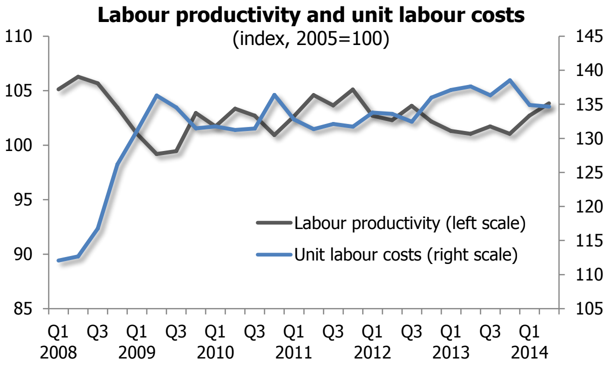


Source: State Statistical Office.

After the fall in the first quarter of the year, average wages paid in the second quarter grew. Thus, the nominal net and gross wages in the second quarter increased by 0.8% and 0.6%, respectively, on an annual basis. In terms of the sectors of activity, wage growth was registered in almost all sectors, with the greatest increase being achieved in construction and activities related to real estate. Wage growth was registered also on a quarterly basis, i.e. nominal net and gross wages increased by 1% and 0.9%, respectively, amid wage growth in most of the activities. **Given the negative annual change**

[23] Source: State Statistical Office, business tendency surveys in manufacturing industry (April 2014), construction (first quarter of 2014) and trade (first quarter of 2014).

in the general price level in the second quarter of the year, real wages grew for the first time in two years (1.7% in net wages and 1.5% in gross wages). Amid a small quarterly decline in the consumer prices, the real wage growth on a quarterly basis is close to the nominal change, i.e. it equals about 1%.

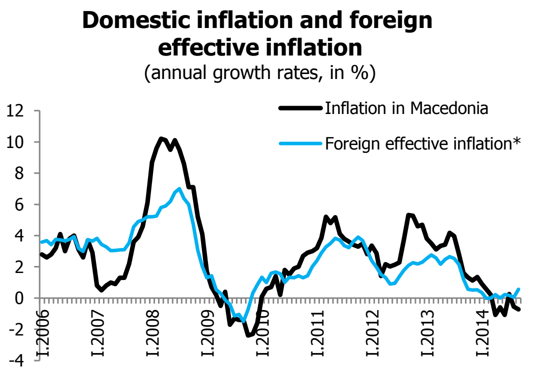


Source: State Statistical Office and NBRM calculations.

Labor productivity registered an annual growth of 2.8% in the second quarter, which is an acceleration of the positive trend that started in the previous quarter. As before, the productivity growth stems from the more intensive annual growth of economic activity compared to the growth in the number of employees. Productivity grew also on a quarterly basis, amid quarterly growth of the economic activity and unchanged number of employees. **The decline in unit labor costs continued in the second quarter when they fell by 2.2%** amid significant annual productivity growth and slow growth of gross wages. Minimal downward adjustment of labor costs of 0.2% was also registered on a quarterly basis.

1.5. Inflation

In the third quarter of 2014, domestic prices continued with the decline that started in the second quarter this year (by 0.3%) amid lower prices of the food component of inflation. This in part reflects the base effect of the last year, when due to the unfavorable weather conditions, there was a high increase in the prices of vegetables and fruits. On the other hand, prices of energy and long-term component grew. Decline in the consumer prices with similar to the annual intensity was registered also on a quarterly basis, mainly reflecting the seasonal decline in the prices of part of the food products. Producer price indices, have registered an annual decline for a fourth consecutive quarter, while on a quarterly basis they remained at the level of the previous quarter.

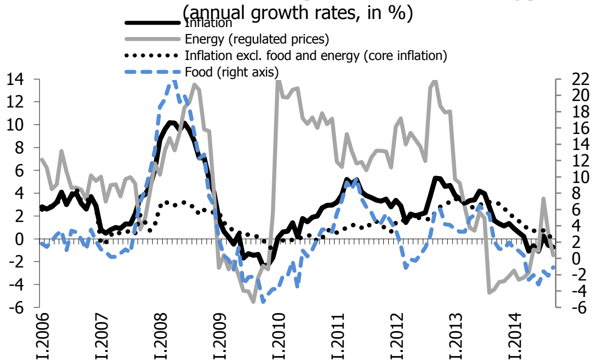


* Foreign effective inflation is calculated as weighted sum of inflations in countries that are major trade partners with Macedonia.
Source: State statistical office, Eurostat and NBRM calculations.

The reduction in domestic consumer prices, which started in the second quarter, continued in the third quarter of 2014. Thus, compared to the same period last year, prices are lower by 0.3%, which is entirely a result of the decline in food prices, primarily the lower prices of oil and fat, but also of the lower prices of fresh meat, fruit and bread and baked goods. Such movements to some extent reflect the base effect from the last year, but they are also influenced by the reduced world food prices and the inputs in production. Despite the lower food prices, the long-term component of inflation remained in the positive zone as a result of the rise in the prices of

Inflation and volatility of food and energy

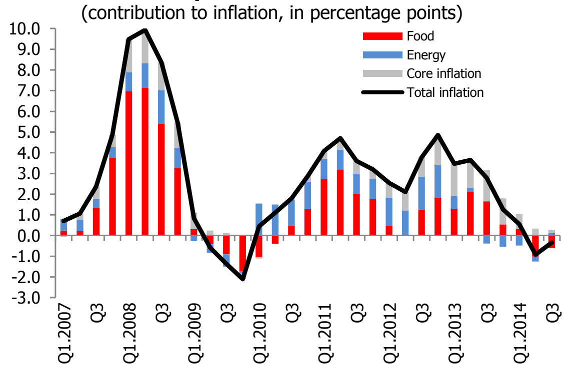
(annual growth rates, in %)



Source: State statistical office and NBRM calculations.

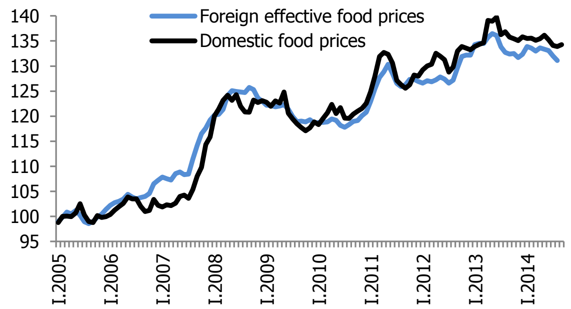
Volatile (food and energy) and long-term component of inflation

(contribution to inflation, in percentage points)



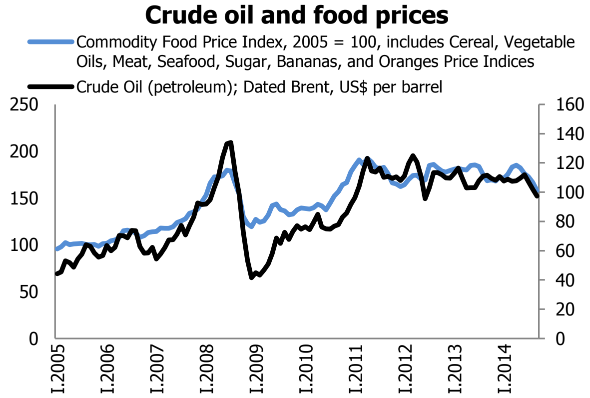
Source: State statistical office and NBRM calculations.

Foreign effective food prices* and domestic food prices



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

Crude oil and food prices



Source: IMF Primary Commodity Prices.

pharmaceutical products and tobacco[24]. Annual growth in the third quarter was registered also in the energy prices, contrary to the decline in the previous four quarters, which is explained by the upward adjustments[25] in the price of electricity.

However, compared with the previous quarter, when prices fell by 0.9%, in the third quarter there was a significant slowdown in the annual decline in prices due to the slower decline in food prices and the rise in the price of energy. **On the other hand, the long-term component of the inflation maintained the trend of slowing annual growth,** i.e. the annual rate of core inflation (price component excluding food and energy) of 0.7% in the second quarter, was reduced to 0.3% in the third quarter. In terms of individual categories, the slowdown in the pace of core inflation in this quarter was mainly due to the exhaustion of the effect of the rise in excise duties on alcohol last year (annual decline in the price of beer, contrary to the double-digit growth in the previous four quarters), as well as the slower growth in the prices of pharmaceutical products. The increase in excise taxes on tobacco products, and the slower decline in the prices of accommodation services acted in reverse direction.

On a quarterly basis, consumer prices dropped by 0.2%, which is explained by the movement of the food component of inflation, which in the third quarter of the year fell by 1.1% mainly reflecting the seasonal decline in the prices of fresh vegetables. Downward adjustment was registered in most of the prices of other food products, which corresponds with the fall in the prices of some of the internationally traded primary food products, as well as foreign effective food prices[26]. Contrary to this movement in the food component, the energy[27] and the long-term component of inflation recorded an increase of 1.0% and 0.2%, respectively. **On the other hand, seasonally adjusted data indicate quarterly growth in consumer prices of 1.1%,** amid simultaneous increase in the prices of

[24] From 1 July 2014, the excise duty on cigarettes increased (Denar 0.15 per cigarette). According to the Law on Excise, this is part of the ten-year calendar for the gradual increase of excise duties, with planned increase in the excise duty each year, while starting from 1 July 2016 (until 1 July 2023), excise duty will increase by Denar 0.20 each year.
[25] In June 2014, the ERC decided to increase the price of electricity by 3.6%, effective from 1 July.
[26] Data on foreign effective food prices refer to the first two months of the quarter.
[27] The growth of the energy component is due to the higher cost of electricity, whose effect was partly offset by the lower prices of firewood.

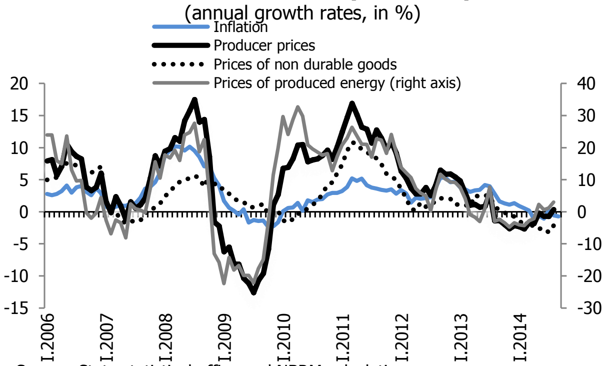
food, energy and long-term component of inflation.

Other price categories

	(annual growth rates, in %)								(contributions to annual growth rates, in p.p.)							
	2013				**2013**	**2014**			**2013**				**2013**	**2014**		
	Q1	**Q2**	**Q3**	**Q4**		**Q1**	**Q2**	**Q3**	**Q1**	**Q2**	**Q3**	**Q4**		**Q1**	**Q2**	**Q3**
Consumer price index - all items	**3.5**	**3.6**	**2.8**	**1.3**	**2.8**	**0.6**	**-0.9**	**-0.3**	**3.5**	**3.6**	**2.8**	**1.3**	**2.8**	**0.6**	**-0.9**	**-0.3**
Food	*3.4*	*5.6*	*4.4*	*1.4*	*3.7*	*0.8*	*-2.6*	*-1.6*	*1.3*	*2.1*	*1.7*	*0.5*	*1.4*	*0.3*	*-1.0*	*-0.6*
Energy	*4.3*	*1.3*	*-2.6*	*-3.6*	*-0.2*	*-3.3*	*-1.7*	*0.8*	*0.6*	*0.2*	*-0.4*	*-0.5*	*0.0*	*-0.5*	*-0.2*	*0.1*
Electricity	10.0	10.0	-1.0	-3.1	3.7	-3.1	-3.1	4.5	0.7	0.7	-0.1	-0.2	0.3	-0.2	-0.2	0.3
Heat energy	0.2	-10.3	-14.4	-16.3	-10.3	-12.3	-2.9	-8.2	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	-0.1
Fuels and lubricants	0.2	-6.7	-2.3	-4.2	-3.3	-4.3	-0.8	-2.2	0.0	-0.3	-0.1	-0.2	-0.1	-0.2	0.0	-0.1
Food and energy (volatile prices)	*3.6*	*4.4*	*2.4*	*0.0*	*2.6*	*-0.3*	*-2.4*	*-0.9*	*1.9*	*2.3*	*1.3*	*0.0*	*1.4*	*-0.2*	*-1.3*	*-0.5*
Core inflation (inflation excl. food and energy)	*3.3*	*2.8*	*3.2*	*2.7*	*3.0*	*1.5*	*0.7*	*0.3*	*1.6*	*1.3*	*1.5*	*1.3*	*1.4*	*0.7*	*0.3*	*0.2*

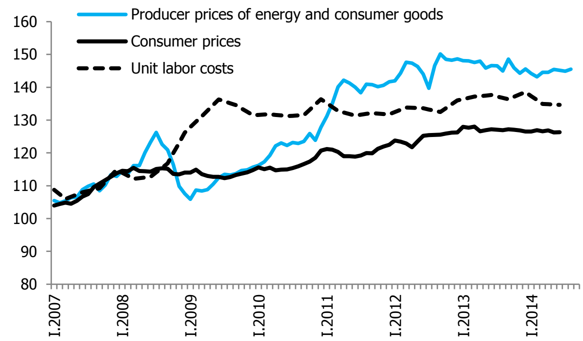
Source: State Statistical Office and NBRM calculations.

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



Source: State statistical office and NBRM calculations.

Factors affecting consumer prices
(indices, 2005=100)



Source: State statistical office and NBRM calculations.

In the third quarter of 2014, producer price indices remained in the negative zone, but their rate of decline slowed down to 0.5% (versus 0.9% in the previous quarter). Producer prices of food products, petroleum products and tobacco gave the largest contribution to the annual decline, while the higher production prices of coal and lignite, as well as electricity, acted in the opposite direction. **On a quarterly basis, production prices remained at the level of the previous quarter** (growth of 0.3% on a seasonally adjusted basis) which is mainly explained by the lower production costs of the processing industry (with a greater contribution of the prices of clothes), while the growth of electricity prices was in the opposite direction. **The movement of producer prices which affect domestic inflation component[28] indicates possible exhaustion of the downward pressures.** The annual decline in these prices slowed to 0.9% (compared to the fall of 1.1% in the previous quarter), amid simultaneously intensified quarterly growth from 0.5% to 1.1% (seasonally adjusted).

Lower labor costs, amid still negative output gap, suggest absence of pressure on the prices of final products through this channel. **Боџ 7** contains an econometric analysis of the sensitivity of the prices of individual products to changes in the movement of the production gap.

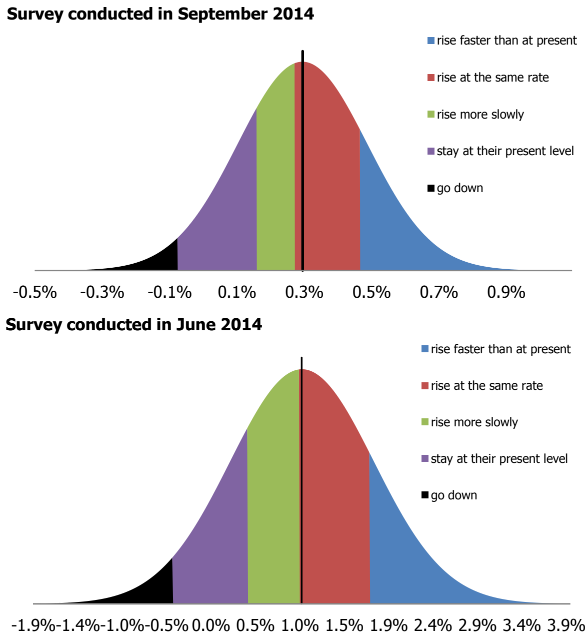
[28] Consumer goods (durable and non-durable) and energy.

Box 1: Inflation Expectations Survey[29]

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

The Inflation Expectations Survey includes three groups of respondents: economic analysts, companies and financial institutions. The qualitative questions regarding the expectations read as follows: "Compared with the past 12 months, how do you expect consumer prices to move in the next 12 months? a) they will grow faster; b) they will grow at the current pace; c) they will grow more slowly; d) they will remain almost unchanged; e) they will decline; f) it is difficult to determine", while the quantitative question reads: "What are your expectations/forecasts for the average inflation rate in 2014 and 2015?".

Chart 1. Normal distribution of answers of the respondents



Source: NBRM, Inflation Expectations Survey

The Inflation Expectations Survey was conducted in September 2014[30]. The survey results show the highest concentration of the respondents' answers in the segment of expectations for an unchanged inflation dynamics. So, a little more than a third (35.8%) of the respondents expect prices to rise at the current dynamics in the next 12 months. The distribution is equal (21% each) between the responses in terms of slower growth and unchanged prices, while 18.5% of the respondents expect faster price growth. Only 2.5% of the respondents expect price decline in the next 12 months. Amid average inflation of 0.3% in the previous 12-month period, the respondents expect the inflation rate to be maintained also in the next 12-month period, i.e. **they expected average inflation of 0.3%.** Analyzing individual surveyed groups, only surveyed ***economic analysts*** expect a slight slowdown (with expected inflation of 0.2%), while ***companies and financial institutions*** expect the same inflation rate (of 0.3%) to be maintained also in the next 12-month period.

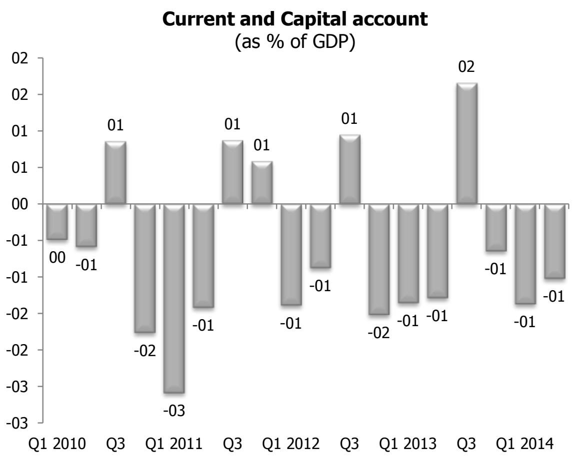
[29] In order to improve the survey measurement of inflation expectations, in 2013 the Monetary Policy and Research Department of the National Bank of the Republic of Macedonia started an in-depth analysis of the experiences of other central banks associated with conducting surveys. On that basis the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

[30] The percentage of responsiveness to the survey conducted in September was 42.9%, which compared to the previous quarter, represents an increase of responsiveness. Analyzed by groups of respondents, the financial institutions' responsiveness is 77.8%, followed by economic analysts with 48.5% and 33.0% of companies.

According to the respondents, the main factors that would affect the formation of prices by the end of 2014 are the following: the low inflation in the Euro area, the uncertainty about the movement of energy prices due to the conflicts in Ukraine and Syria, the implications from the economic sanctions on Russia, as well as the potential growth in the food prices caused by the unfavorable weather conditions in Macedonia and the region. **Respondents expect an average inflation rate in 2014 and 2015 of 1.7% and 2.3%, respectively.** Compared with the previous survey, these expectations are lower (2.2% and 2.6%, expected inflation in 2014 and 2015, respectively). Changes in the expectations are explained by the dynamics of consumer prices in the Euro area, as well as the decline in the prices in the domestic economy in the last two quarters of this year.

1.6. Balance of Payments[31]

In the second quarter of 2014, the deficit in the current and capital account of the balance of payments recorded a moderate quarterly narrowing (by 0.3 percentage points of GDP) and reduced to 1% of GDP[32]. The change is largely due to the higher net inflows of secondary income, but also the smaller trade deficit. On the other hand, deficit was registered in services, wherefore the total deficit of the trade in goods and services significantly widened relative to the previous quarter. Identical narrowing of the current and capital account deficit was reported also on an annual basis, with the annual factors of change being similar to those that explain the improvement of the balance on a quarterly basis. During the second quarter of the year, the financial account registered little net indebtedness to the rest of the world, created by the net borrowing on the basis of financial loans and realized growth of foreign direct investments on a net basis. However, the realized net borrowing in the financial account was not sufficient to fully fund the deficit in the current and capital transactions, wherefore part of them is financed through the foreign reserves.



Source: NBRM.

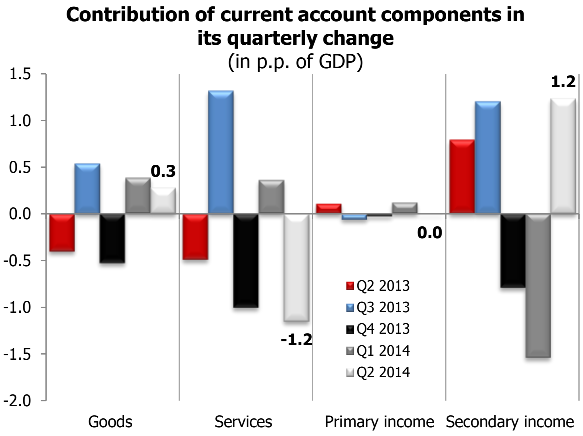
1.6.1. Current Account

In the second quarter of 2014, the deficit in the current and capital account of the balance of payments was Euro 86.5 million or 1% of GDP[33]. The current account deficit of Euro 88 million is the driving factor of the change, registering improvement on a quarterly basis by 0.3 percentage points of GDP. ***This narrowing is mostly due to the higher net inflows in the secondary income***

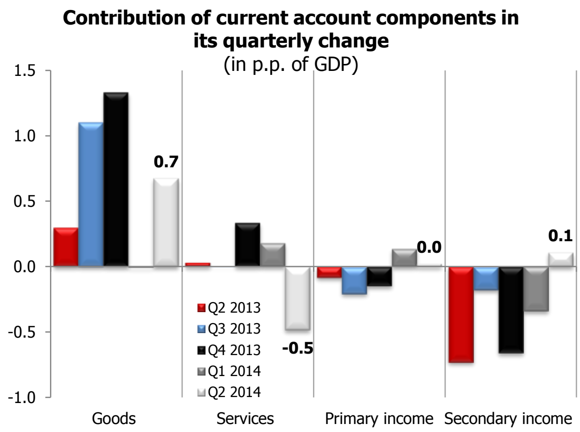
[31] Starting from this Quarterly Report, the analysis of the movements in the balance of payments will be based on data compiled in accordance with the Balance of Payments and International Investment Position Manual, sixth edition (IMF, 2009) (IMF, 1993). For more detailed information on the methodological changes, visit the NBRM website (http://nbrm.mk/WBStorage/Files/Statistika_Information_BPM6_30_06_eng.pdf).

[32] As part of this Quarterly Report all relative indicators are calculated by using historical data for the nominal amount of GDP by 2013, published by the SSO in June 2014, which were the basis for the projection of GDP for 2014.

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



Source: NBRM.



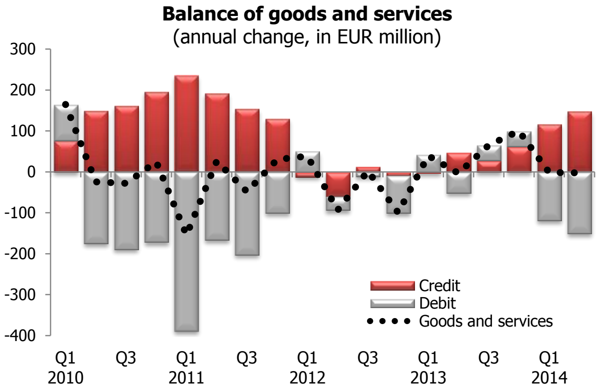
Source: NBRM.

(1.2 percentage points of GDP), driven by the growth in personal transfers through informal channels estimated on the basis of the net purchased cash on the currency exchange market and the transfers for the government sector[34]. The increased net inflows in the secondary income is a common seasonal variation, caused by usually higher net inflows in the private sector, in particular the seasonal increase in private transfers through an informal channel estimated through the net purchased cash foreign currency on the currency exchange market. *Narrowed deficit in the trade of goods (of 0.3 percentage points)* had an additional contribution to the positive quarterly change in the current account, accomplished amid significantly faster growth of exports compared with the growth of imports of goods. On the other hand, the intense growth in the import of services during the second quarter, particularly the import of construction services[35], caused a significant decrease in the surplus in this category (by 1.2 percentage points of GDP). The primary income registered no significant changes compared to the previous quarter.

The analysis on an annual basis, also indicates a slight narrowing of the current and capital account deficit of 0.3 percentage points of GDP, predominantly caused by the annual narrowing of the current account deficit (of 0.3 percentage points). The driving factor of positive annual change is the improved balance in the trade of goods, while the reduced surplus in services acted in the opposite direction. The narrowing of the *trade deficit* (by 0.7 percentage points of GDP) is entirely due to the positive changes in the non-energy trade balance, driven by the increasingly dynamic growth of the export component amid simultaneous moderate increase in imports. Intensification of exports is evident in the non-energy categories, particularly pronounced in the investment component and exports for private consumption. In the second quarter of the year, an *annual increase (of 0.1 percentage points) was registered also in the secondary income,* driven by the simultaneously

[34] During May, the secondary income of the government sector registered inflows on the basis of EU's IPA funds.

[35] The high outflow in services during the second quarter was due to the outflows in construction services registered in April, realized on the basis of advances for construction work on the projects for construction of highways. This transaction was simultaneously recorded in the financial account, as net-creation of liabilities on the basis of loans earmarked for financing road infrastructure, in the same amount as in the services, so that the net effect on the balance of payments in the respective period is neutral.



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

higher net inflows in the government sector and other sectors in the economy[36]. On the other hand, *the lower annual surplus in services (of 0.5 percentage points) gave a significant negative contribution to the current transactions*, which was a result of the significantly higher imports of construction services. The effect of the annual change in this service category is the pivotal factor for the deteriorated balance in services despite the higher surplus in the trade in services for further processing. In the *primary income there were no* significant changes on an annual basis either. **According to the latest data on the balance of payments, in July 2014 the current account recorded a small surplus of Euro 15.2 million.** On an annual basis, this is a smaller surplus from current transactions, due to the moderate deterioration of all individual components, with the largest contribution of the deteriorated balance of goods and services.

Box 2: Foreign trade of goods and movement of the Nominal and the Real Effective Exchange Rate (NEER and REER)[37]

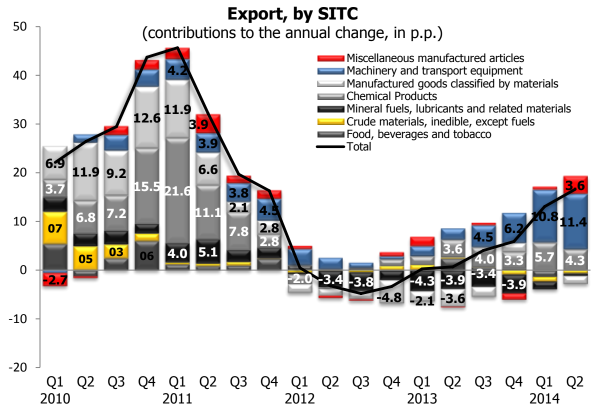
In the second quarter of 2014, the foreign trade of the Republic of Macedonia grew by 12.2% on a quarterly basis, reaching Euro 2,305.2 million, or 27.2% of GDP.
The increase of foreign trade was a result of the growth of both components, exports and imports. **The export of goods registered a quarterly growth of 15.2%** amid increased exports of food and tobacco, which is a common seasonal movement, as well as growth in the exports of machinery and transport equipment. On a quarterly basis, **an increase of 10.2% was also registered in the imports,** driven largely by the imports of raw materials for industry and investment imports of machinery and transport equipment. On the other hand, energy imports reduced, which is a common seasonal movement. **Such quarterly performance of exports and imports contributed to a slight widening of the trade deficit of 0.5%, compared to the previous quarter.** In terms of individual balances, narrowing of the negative energy balance largely offset the widening of the non-energy trade deficit.

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

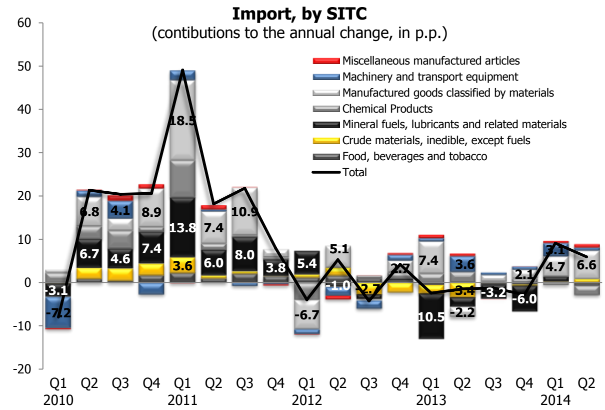
On an annual basis, exports continued to grow at a faster pace in the second quarter of the year, achieving positive growth rate for the sixth consecutive quarter. The

[36] Secondary income of other sectors of the economy includes the secondary income of financial companies, non-financial companies, households and non-profit institutions serving households classified as private transfers (current transfers between resident and non-resident households), net cash on the currency exchange market and other current transfers of the private sector.
[37] According to the Methodology on foreign trade, data on the export of goods are published on a f.o.b. basis, and on the import of goods, on a c.i.f. basis.

fast annual growth of 16.6% in the second quarter was higher than the average growth of the past five quarters (by 4.8%), reflecting the further intensification of the export activity of the new foreign facilities as the main driver of the positive annual change. A significant increase was registered also in the export of the textile industry and the export of furniture. On the other hand, performance in most of the traditional export products, such as iron and steel, and food and beverages, gave a negative contribution to the annual growth. Additionally, a small annual decrease was registered also in the export of energy. In general, export performances point to a continuation of the trend of gradual changing of the export structure by products through the growing share of the exports of automotive industry products, which are characterized by a higher degree of processing and higher added value. **After the intensive annual growth in the imports during the first quarter of the year (of 9.1%), the increase in the import demand in the second quarter continued with some slowdown and equaled 5.9%.** The import of raw materials for the new industrial facilities remains the main driver of the growth of total imports, which corresponds with their good export performances. Imports of raw materials for the textile industry and imports of ore also gave positive contribution, while the annual decline in the imports of iron and steel, and of food, acted in the opposite direction. Energy imports had a neutral effect on the annual change in the import component. **Intensified export activity, amid more moderate growth in imports caused a significant narrowing of the trade deficit of 11.9% on an annual basis.** Favorable developments in the trade balance are due to the narrowing of the negative non-energy balance, amid slight widening of the energy deficit. In this context, it is important to point to the constant improvement of the net export activity of the new industrial capacities, which reflects positively on the non-energy trade balance. Higher energy deficit is largely due to the deterioration in the negative balance of electricity.

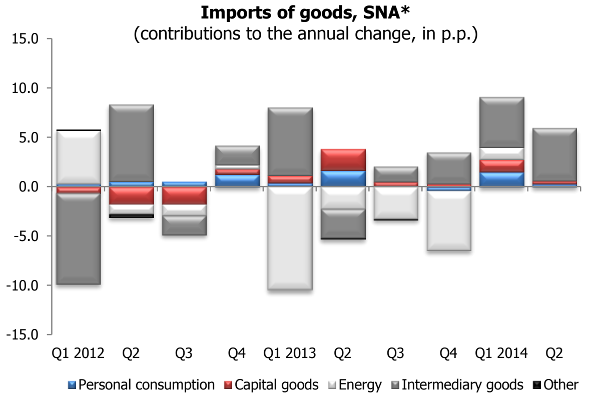


Source: SSO and NBRM.

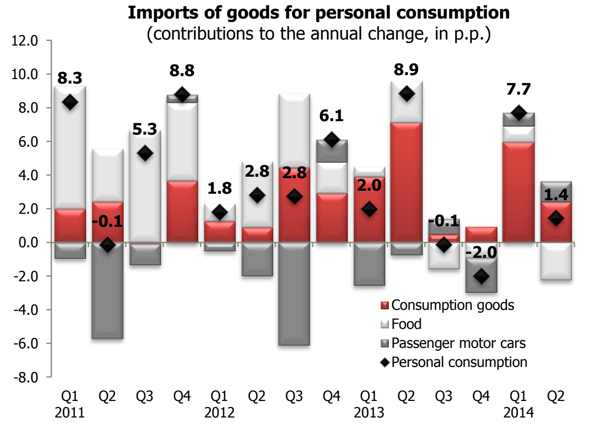


Source: SSO and NBRM.

The analysis of the import components, according to the classification under the System of National Accounts - SNA, shows that also in the second quarter intermediate products were the main driver of the annual growth of import demand. At the same time, although to a significantly lesser extent, the import growth was affected also by the import of goods for private consumption and capital goods, while the energy imports had a neutral contribution. Within the imports for private consumption, which is an important indicator for the conduct of monetary policy, consumer goods and passenger vehicles contributed to the annual growth, contrary to the negative contribution of the imports of food for private consumption. The growth of imports for private consumption remains moderate, indicating the absence of significant pressures on private consumption through this channel also in the past three-month period.

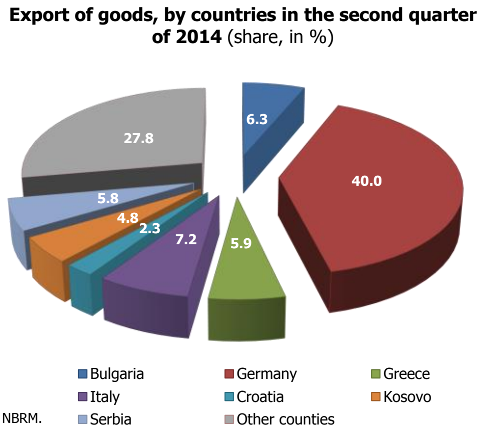


* Classification: System of national accounts (SNA).
Source: NBRM.

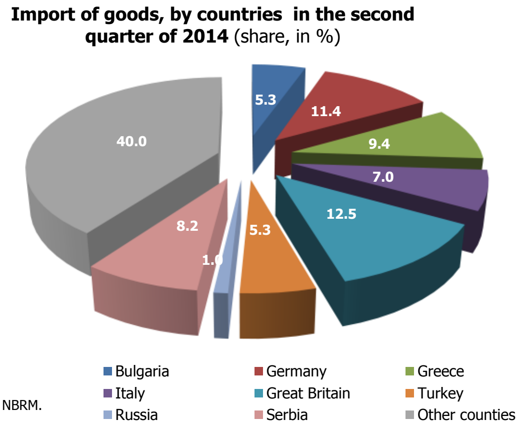


Source: NBRM.

In the second quarter, foreign trade analyzed by trading partners indicates further growth of the share of the European Union Member States in the total trade, which reached 70.1%. Such performances result from the simultaneous intensification of both the export and import activities with our most important trading partner. Also, a slight increase was registered in the share of the trade with the Western Balkans. According to the analysis of individual trading partners, the annual export growth is due primarily to the increase in the exports to Germany, reflecting the positive export performances of the new industrial facilities. Additionally, countries that contribute most to the export growth also include Belgium and Italy, while exports to Kosovo and to China continued to decline[38]. On the import side, the annual growth is due to the increased imports of platinum from Great Britain, as well as the imports from Germany and Romania, contrary to the reduction in the energy imports from Greece and Switzerland. Analyzing balances, domestic economy still registers the largest trade surplus with Germany, which in the second quarter recorded further annual growth. On the other hand, the negative balance in the trade with Great Britain further expanded and a significant deterioration is evident also in the trade with the Western Balkans[39], where deficit was registered for the second quarter in a row, as opposed to the history of positive trade balance with these countries.



Source: NBRM.



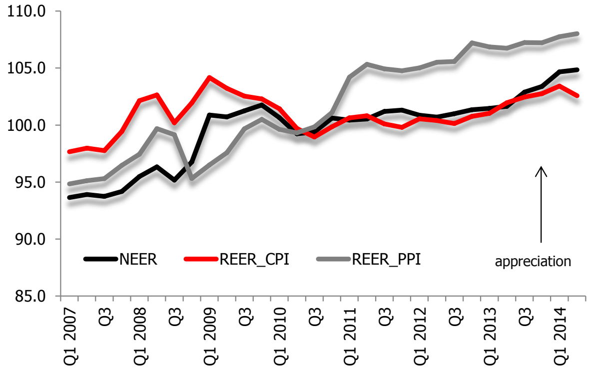
Source: NBRM.

During the second quarter, the price competitiveness indicators give divergent indications of the changes in the competitiveness of the national economy compared to the previous quarter. The REER deflated by consumer prices depreciated by 0.8%, while the REER

[38] The annual growth in the exports to Belgium is due to the higher exports of vehicles. Reduced exports to Kosovo result from the lower export of oil derivatives, while the decline in the export activity with China is a result of the lower export of iron and steel.
[39] The changes are mainly due to the higher imports of petroleum products and iron and steel from Serbia, as well as the further decline in the exports to Kosovo.

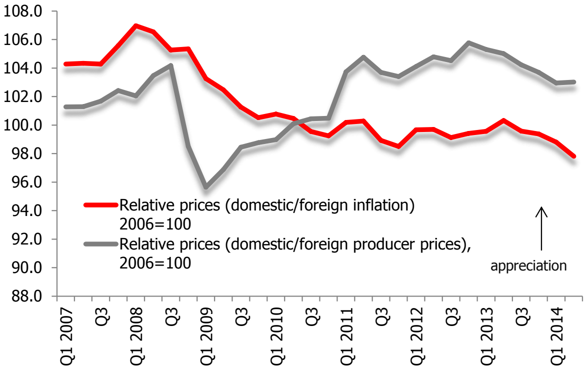
deflated by producer prices appreciated by 0.3%. Such divergent movements in both indices are a result of the changes in relative prices amid small quarterly appreciation of the nominal effective exchange rate (of 0.2%), driven by the appreciation of the denar against the Ukrainian hryvnia. The quarterly decline in domestic prices versus the rise in foreign prices resulted in a decline in relative prices by 1%, while the faster growth of domestic prices of industrial products compared to that of the foreign prices led to a small increase in the relative prices expressed by this price index.

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



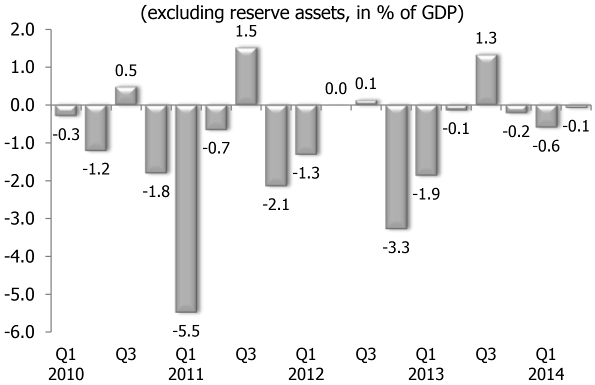
Source:NBRM.

Relative prices
(2006=100)



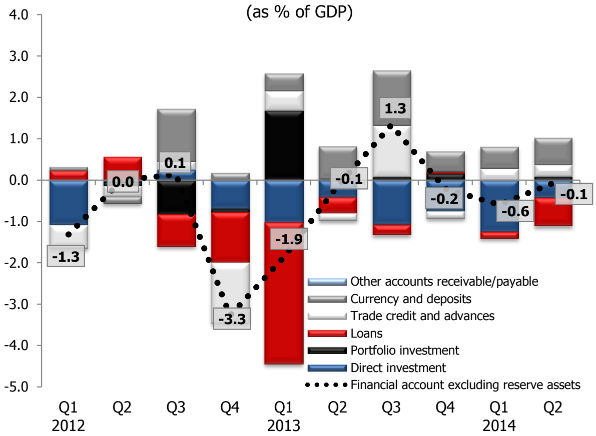
Source:NBRM.

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



Source: NBRM.

Financial account structure
(as % of GDP)

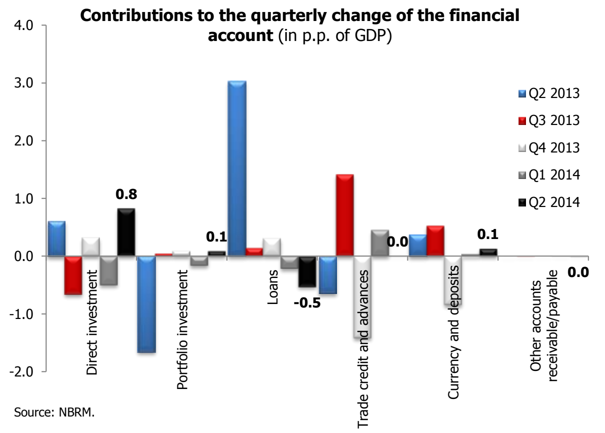


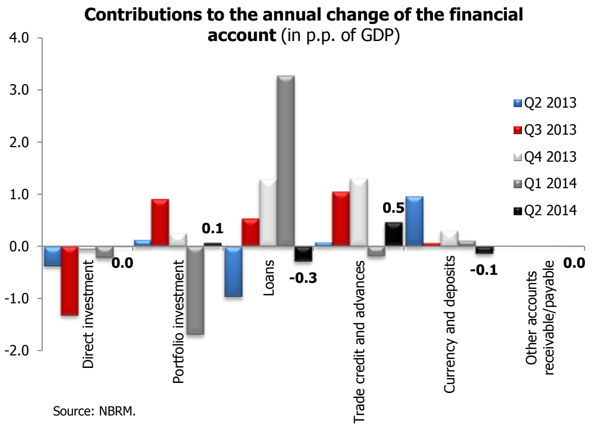
Source: NBRM.

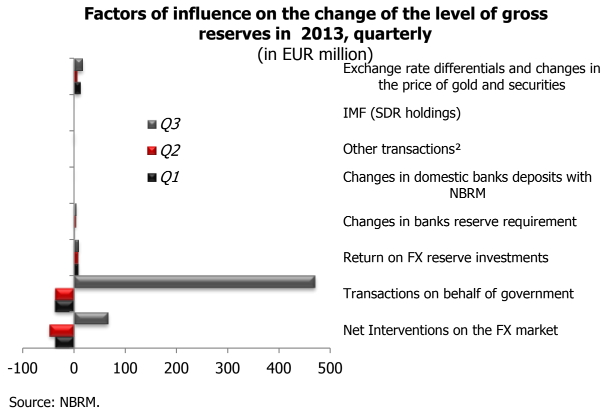
1.6.2. Capital and Financial Account

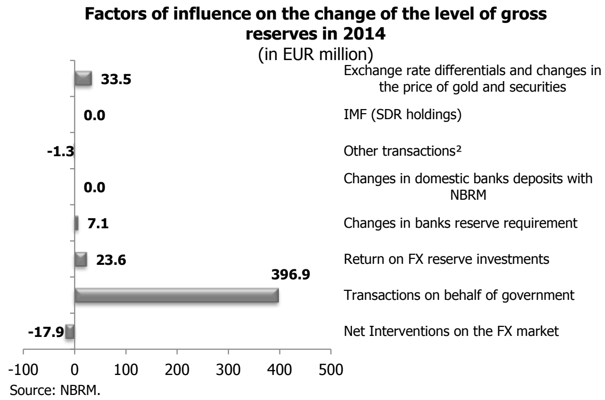
In the second quarter of 2014, slight external borrowing through the financial account of the balance of payments was registered, in the amount of Euro 6.3 million or 0.1% of GDP. *Loans and foreign direct investments were the key components of the financial account, which created net liabilities on the basis of financial loans[40] amid simultaneously reduced funds of direct investments.* The net effect of the movements in FDI is due to the direct investments in the form of loans from the parent companies, amid negative reinvested earnings as a result of higher payments based on dividends during the second quarter. Positive performances of these two components were to a significant extent offset by the increase in the net assets in the category "currency and deposits" due to the increased funds in the other sectors. *The quarterly analysis indicates lower net-flows on the financial account (by 0.5 percentage points of GDP) compared to the first quarter of the year.* The negative quarterly change is mainly due to the lower foreign direct investments on a net basis, as well as the increase in net assets from currency and deposits. The reduction in FDI reflects the fall in the net liabilities in non-debt form, i.e. the lower

[40]In the second quarter, PE State Roads borrowed a high amount of funds aimed at financing long-term infrastructure projects. Depository institutions also created net liabilities based on short-term loans.









reinvested earnings, as well as the lower debt flows, i.e. the reduced funding of companies with foreign capital through borrowing from their parent entities. These adverse movements in the financial account were mitigated by the higher net borrowing in the form of financial loans.

The analysis on an annual basis does not indicate significant changes in the financial account. Compared with the second quarter of 2013, net flows in the financial account deteriorated by only 0.1 percentage point of GDP. More significant changes are evident in debt flows - loans and trade credits. During the second quarter, trade credits and advances recorded flows of net lending to the rest of the world, as opposed to the registered net borrowing in the same period last year. On the other hand, higher annual net borrowing was on the basis of loans, driven by the growth of the long-term net external debt of other sectors, despite the reduction in the net liabilities with depository institutions and the government. Favorable movements compared with the same period last year were registered also in the category "currency and deposits", due to the positive changes in depository institutions, amid simultaneous reduction of the funds of depository institutions abroad and growth in the liabilities to non-residents compared to the second quarter of the previous year. **According to the latest data on the balance of payments, in July 2014, the financial account** was characterized by net creation of liabilities in the amount of Euro 488,3 million. Movements in the financial account are mainly a result of the government external borrowing by issuing the third Eurobond[41], as well as the reduced claims in foreign direct investments and the increased liabilities in trade credits. Contrary to the performances in these categories, currency and deposits registered higher capital inflows also in July.

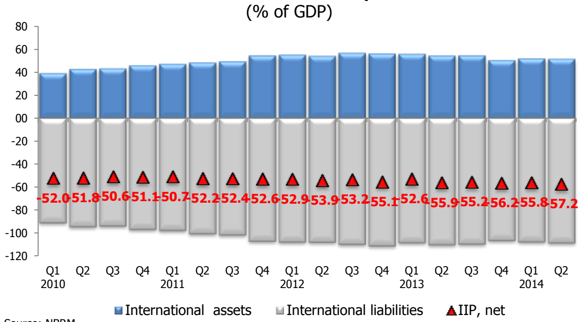
As of 30 June 2014, the gross foreign reserves amounted Euro 1,873 million, which is a quarterly decrease of Euro 68.2 million. The main factor behind the change is the net sale of foreign reserves on the foreign exchange market and the net outflows based on transactions on behalf of the government. On the other hand, the income from investment of foreign reserves, as well as price changes and exchange rate differences positively influenced the foreign reserves. *According to the latest available data, at*

[41] In July, the Government borrowed on the international financial markets by issuing a seven-year Eurobond in the amount of Euro 500 million.

the end of September, the foreign reserves amounted to Euro 2,435 million, which is by Euro 442 million more than at the end of 2013. The growth of foreign reserves is mostly due to the net inflows of funds based on transactions on behalf of the government[42], with additional positive contribution of price changes and exchange rate differences and income from investment of foreign reserves. On the other hand, the net sales by the NBRM in the foreign exchange market acted toward reducing the foreign reserves.

1.6.3. International Investment Position[43] and Gross External Debt

International investment position
(% of GDP)



Source: NBRM.

At the end of the second quarter of 2014, the **negative international investment position of the Republic of Macedonia amounted to Euro 4,836.1 million or 57.2% of GDP[44].** Compared to the previous quarter, net liabilities to the rest of the world increased by Euro 118.8 million, or 1.4 percentage points of GDP. The expansion of the negative investment position[45] of the country is due to the **increased international liabilities** (by 0.9%) and the **decline in international assets** (by 0.8%). *Analyzed by sector, all sectors, with the exception of the government sector, contribute to the quarterly expansion of the negative net liabilities in the international investment position.* The most

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[42] High inflows for the account of the government are mainly due to the issued Eurobond.

[43] The analysis in this section is entirely based on data on the international investment position compiled under a 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 detailed information on the methodological changes, visit the NBRM website (http://nbrm.mk/WBStorage/Files/Statistika_Information_BPM6_30_06_eng.pdf).

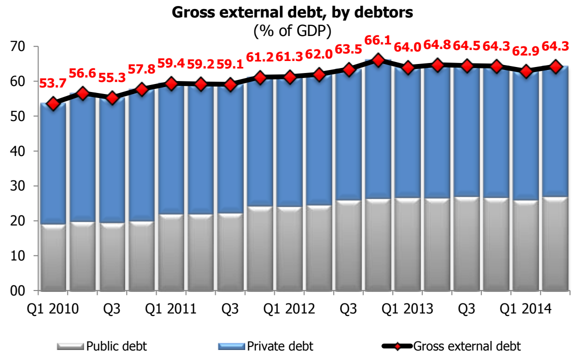
[44] The calculations use the projected amount for the nominal GDP.

[45] 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 for providing additional income. Conclusion of repo transactions creates liabilities. At the same time, the created claims from entering into reverse repo agreements 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 on net basis, 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. Transactions for borrowing of securities further expanded in 2012 and included the gold-backed swap transactions.

significant contribution to the negative quarterly change is that of the sector "central bank" as a result of the decline in the foreign exchange reserves, as well as "other sectors", where the quarterly change is mostly due to the more intensive increase in the liabilities on the basis of long-term loans[46]. On the other hand, the negative international investment position of the country improved on a quarterly basis, mainly as a result of the reduced liabilities based on financial loans[47].

	Q2 2013	Q1 2014	Q2 2014	*quarterly change*			*annual change*		
		in EUR million		*difference*	*contribution*	*in %*	*difference*	*contribution*	*in %*
IIP, net	**-4,532.6**	**-4,717.4**	**-4,836.1**	**-118.8**	**2.5**	**2.5**	**-303.6**	**6.7**	**6.7**
Government, net	-1,633.0	-1,577.9	-1,559.2	18.7	-0.4	-1.2	73.8	-1.6	-4.5
Central bank, net	1,975.2	1,868.1	1,799.1	-69.0	1.5	-3.7	-176.1	3.9	-8.9
Deposit-taking corporations, net	-628.5	-596.0	-602.0	-6.0	0.1	1.0	26.5	-0.6	-4.2
Other sectors, net	-4,246.3	-4,411.6	-4,474.1	-62.5	1.3	1.4	-227.8	5.0	5.4

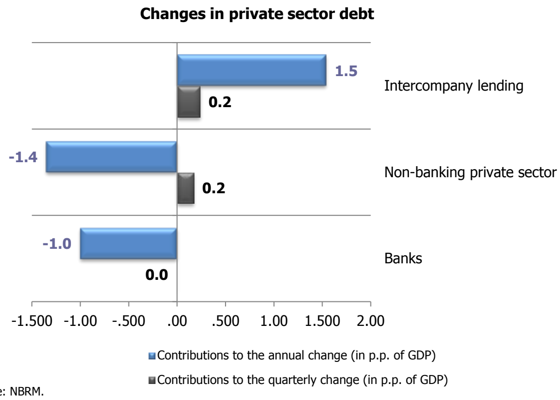
The annual increase of the net debt position of the economy which continued in the second quarter of 2014, was driven by the simultaneous reduction of international assets (by 1.3%) and the growth of international liabilities (of 2.8%). Compared to the same period last year, **the negative IIP increased by Euro 303.6 million, or by 1.3 percentage points of GDP.** *The analysis by individual sectors indicates that the expansion of the negative gap of MIP is due to the higher net liabilities of "other sectors" and the reduction of net assets of the central bank.* Moreover, *in the "other sectors", this change* is caused by the increased liabilities to foreign direct investors and liabilities based on long-term loans. With the central bank, the change in the position is a result of the decline in international assets in the form of foreign reserves, compared with the second quarter of the previous year. On the other hand, the sectors "government" and "depository institutions" registered a decrease in net liabilities to the rest of the world, mainly as a result of reduced liabilities on the basis of long-term loans in both sectors, with an additional contribution of the reduced liabilities by currency and deposits with depository institutions.



* Without repo-transactions.
Source: NBRM.

At the end of the second quarter of 2014, gross external debt totaled Euro 5,741.6 million[48]. Excluding repo transactions of the central bank, the gross external debt totals

[46] Higher liabilities on the basis of long-term foreign loans are mainly due to the borrowing of public enterprises for financing the construction of road infrastructure.
[47] During the second quarter the first part of the repayment of the Precautionary Credit Line (PCL) from the IMF was disbursed.
[48] Or 67.9% of GDP.



Source: NBRM.

Euro 5,437.5 million, or 64.3% of GDP[49].

The quarterly analysis indicates an increase in the gross external debt of the country by Euro 113.1 million, or 1.3 percentage points of GDP, as a result of the higher external debt of the public sector and the more moderate growth of the private sector debt. The quarterly increase in the public debt is entirely due to the intensified growth in the long-term debt of public enterprises on the basis of financial loans, amid simultaneous decline in the external debt of the central government. The moderate increase in the private debt is distributed between increased liabilities to foreign direct investors and higher debt of the non-financial private sector.

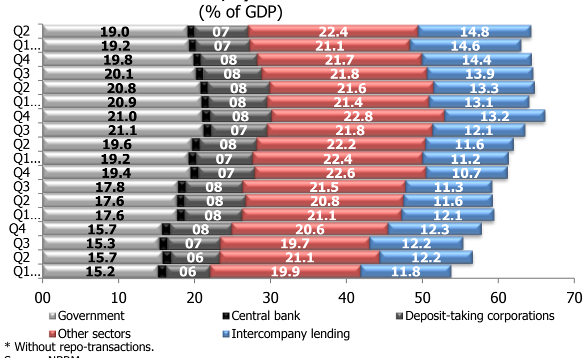
The gross external debt increased also on an annual basis. Compared with the second quarter of 2013, the debt rose by Euro 183.9 million. The increase in the gross external debt on an annual basis has mostly been driven by the growth of public debt as a result of the more intensive external borrowing by public enterprises in the form of long-term financial loans. More moderate increase was registered in the external debt of the private sector, driven by the increase in the liabilities to foreign direct investors, increase in the long-term liabilities with currency and deposits of depository institutions and liabilities based on trade credits with the rest of the private sector. ***Analyzed by its share in GDP, the gross external debt decreased by 0.5 percentage points of GDP due to the reduced private debt (by 0.8 percentage points of GDP) amid an increase in the public debt (by 0.3 percentage points of GDP) annually.***

The analysis of the dynamics of external debt[50] indicates deterioration in most solvency

[49] The overall further analysis relates to gross external debt without the liabilities of the central bank on the basis of repo transactions.

[50] The analysis of the external indebtedness indicators is prepared on the basis of balance of payments data in accordance with the 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 at the expense of the increase in the 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 - share

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



* Without repo-transactions.
Source: NBRM.

indicators on an annual basis, with the exception of the export of goods and services and other inflows to gross external debt ratio, and the gross external debt to GDP ratio. Despite the deterioration in certain indicators, indicators of external indebtedness of the domestic economy generally show that the gross external debt remains in the safe zone. The only indicator that classifies the economy in the group of highly indebted countries is the share of the external debt in GDP. Some of the liquidity indicators, i.e. indicators of coverage of short-term debt and short-term debt with residual maturity with foreign reserves, point to slight deterioration. However, the small deterioration in these indicators does not change the general conclusion that liquidity indicators still point to a favorable external position, with almost complete coverage of the liabilities based on short-term debt with residual maturity with funds from the foreign reserves.

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
31.03.2011	3.12	144.2	62.8	16.8	1.64	1.14	25.9
30.06.2011	3.12	143.6	62.6	16.8	1.59	1.09	25.8
30.09.2011	3.12	143.4	62.5	16.8	1.64	1.09	25.3
31.12.2011	3.12	148.4	64.6	16.8	1.78	1.18	25.2
31.03.2012	2.92	131.6	62.7	13.1	1.70	1.02	26.1
30.06.2012	2.92	133.1	63.4	13.1	1.63	1.01	26.4
30.09.2012	2.92	136.3	64.9	13.1	1.72	1.06	25.3
31.12.2012	2.92	141.9	67.6	13.1	1.64	1.03	26.7
31.03.2013	2.51	136.8	67.0	15.8	1.68	1.20	25.6
30.06.2013	2.51	138.5	67.8	15.8	1.48	1.05	26.2
30.09.2013	2.51	138.0	67.6	15.8	1.66	1.15	23.8
31.12.2013	2.51	137.6	67.4	15.8	1.64	1.08	23.3
31.03.2014	3.39	134.8	66.1	19.2	1.41	0.96	25.8
30.06.2014	3.39	137.6	67.5	19.2	1.34	0.91	25.7
Moderate indebtedness criterion	*12 - 20%*	*165 - 275%*	*30 - 50%*	*18 - 30%*		*1.00*	

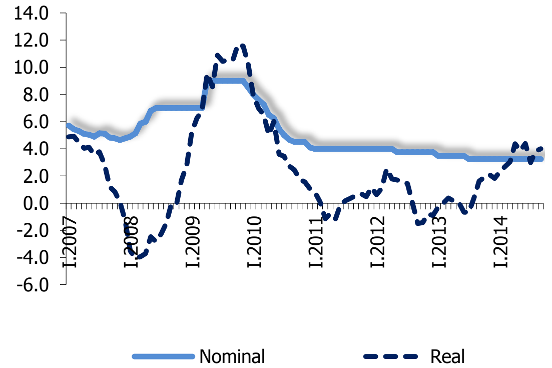
*The moderate indebtness criterion is accordng to the World bank's methodology of calculationg indebtness indicators, which implies 3-year moving averages of GDP and exports of goods and services in the calculation of the indicators.
In compliance with "External debt statistics: Guide for compilers and 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.
*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.

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.

II. Monetary Policy

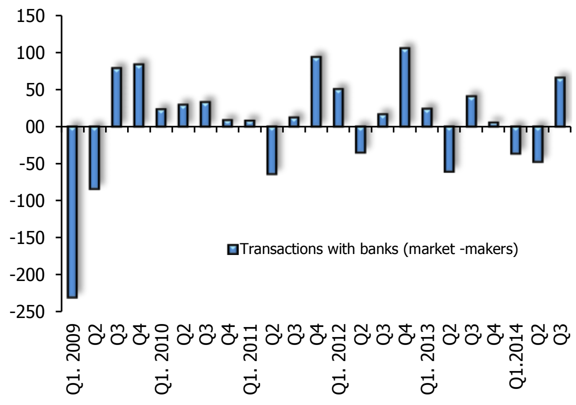
During the third quarter of 2014, the NBRM preserved the policy rate at 3.25%. This decision was based on the latest macroeconomic projections of the NBRM from April and the recent macroeconomic and financial indicators. The analyzes showed that the economy continues to grow at a solid pace, in part supported by bank lending, amid further maintenance of an adequate level of foreign reserves and absence of inflationary pressures. According to these developments it was assessed that there is an adequate environment for sustainable recovery of the private sector even without additional monetary stimulus. In the period ahead, the NBRM will continue to monitor closely the situation for the purpose of timely and appropriate adjustment of monetary policy.

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



Source: NBRM.

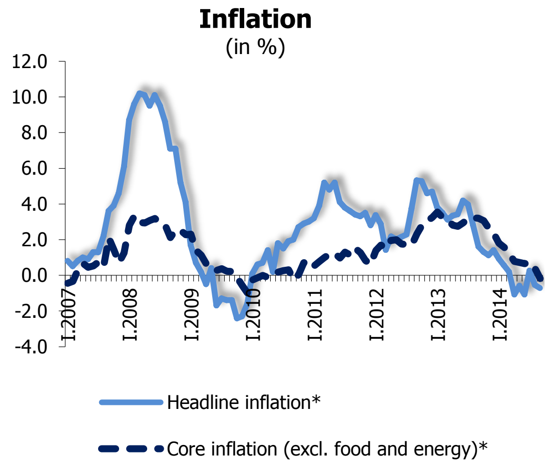
Interventions on the foreign exchange market by NBRM (in EUR million)



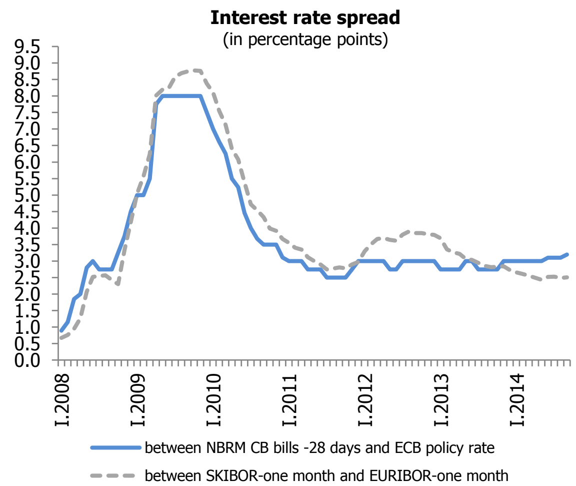
Source:NBRM

Based on the regular assessment of recent macroeconomic and financial developments, at the meetings held during the second quarter[51] of 2014, the NBRM's Committee on Operational Monetary Policy decided to preserve the interest rate on the CB bills at the level of 3.25%. The latest performances of the key macroeconomic indicators did not indicate any significant changes in the environment for conducting the monetary policy, compared to the previous estimates. In the third quarter, foreign reserves increased, mainly as an effect of the external government borrowing on the international capital market, and the disbursement of funds from the World Bank's Competitiveness Development Policy Loan. At the same time, and if the effect of the government borrowing is excluded, foreign reserves registered moderate growth as a result of the favorable developments in the foreign exchange market and the NBRM interventions with a net purchase of foreign assets (totaling Euro 65.9 million in the third quarter). Changes in foreign reserves were within the April projections, with the adequacy ratios remaining in a safe zone. Regarding the movement of domestic prices, in the third quarter there was a moderate decline in the general price level by 0.3%, mainly driven by lower food prices. Core inflation continued to slow down moderately, and in the period July - September it averaged 0.3%. Amid such movements and downward adjustments of the expectations for some import prices, the risks around the inflation projection were continuously assessed to be predominantly downward. On the other hand, upward risks were identified, associated with food and energy prices,

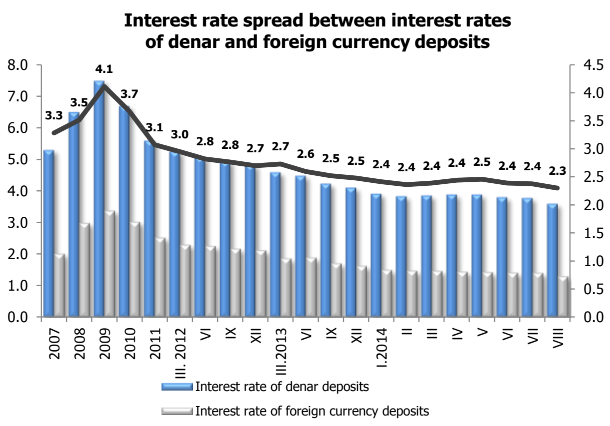
[51]During the quarter, the NBRM's Committee on Operational Monetary Policy held three sessions at which reassessment of the monetary policy setup was made, on 8 July 2014, 12 August 2014, and 9 September 2014.



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



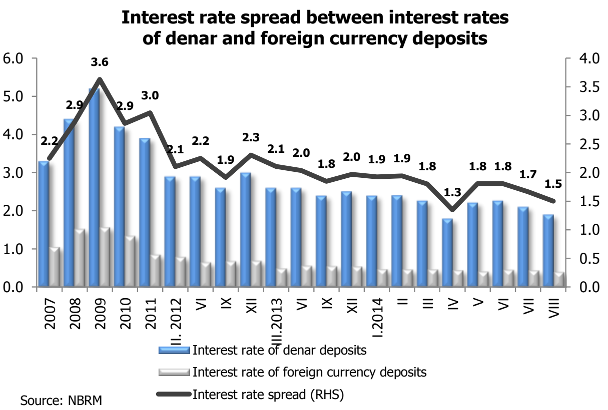
Source: NBRM, ECB (www.ecb.int) and De Nederlandsche Bank (www.statistics.dnb.nl).



Source: NBRM

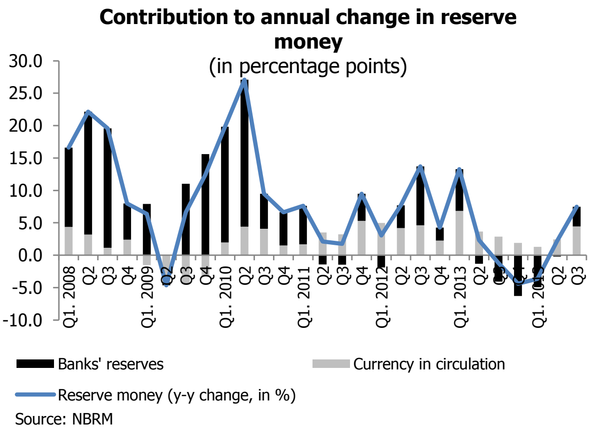
as a result of the geopolitical tensions in Iraq, conflict in Ukraine and floods in the region. The growth of economic activity continued in the second quarter, and the latest performances of the high-frequency economic indicators pointed to retention of the positive trends also in the third quarter. Banks continued to support the private sector through further growth in lending. Realized dynamics of bank lending as of September was in line with the projections, indicating more stable expectations and second-round effects of past monetary easing on credit activity. In order to further support lending, primarily in certain systemically important sectors of the economy, in September, the NBRM Council decided to extend the application of the non-standard measure for reducing the base for the reserve requirement of commercial banks for the amount of the new loans extended to net exporters and domestic producers of electricity by the end of 2015. Taking into account the previous positive effects of the decision to reduce the cost of financing of the enterprises from both sectors, the extension of its application is expected to provide further support not only for the private sector, but also for the overall economic growth. Against such a backdrop, **it was assessed that in the economy, conditions have been created for a sustained recovery of the private sector, i.e. there is no need of additional monetary stimulus. It was assessed that leaving the zone of accommodative monetary policy in the next period will depend on the changes in the external position of the economy and the effects on foreign reserves.**

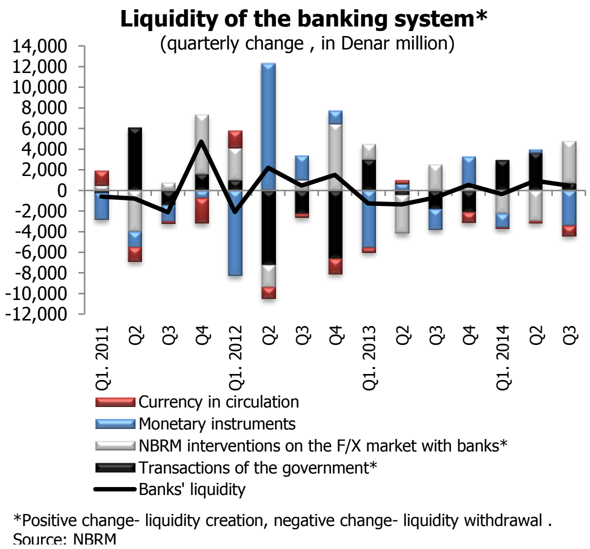
In September, the ECB made an additional easing of the monetary policy in response to the weaker economic activity than that expected for the second quarter and the further maintaining of low inflation in the Euro area. Thus, the policy rate was reduced from 0.15% to 0.05%. The interest rates on overnight lending facility and overnight deposit facility were also cut by 0.1 percentage point, whereby they were reduced to 0.3% and -0.2%, respectively. In addition, the ECB announced activation of the previously announced program for outright purchase of assets-backed securities, as well as a new program for purchase of secured bonds issued by financial institutions from the Euro area denominated in Euros, as of October 2014. The implementation of these two programs, according to the ECB is expected to improve the monetary policy transmission mechanism and encourage lending in the Euro area. Given the reduction of the policy rate of the



ECB and the retention of the policy rate of the NBRM at an unchanged level, the interest rate spread between the interest rate on CB bills and the policy rate of the ECB in September widened moderately and equaled 3.2 percentage points (versus 3.1 percentage points in June). Movements of short-term interest rates in the domestic and the European financial markets have been relatively stable, and in September the interest rate difference between the one-month SKIBOR[52] and one-month EURIBOR remained at the same level as in June, equaling 2.5 percentage points.

2.1 Banks' Liquidity and Interbank Money Market Developments





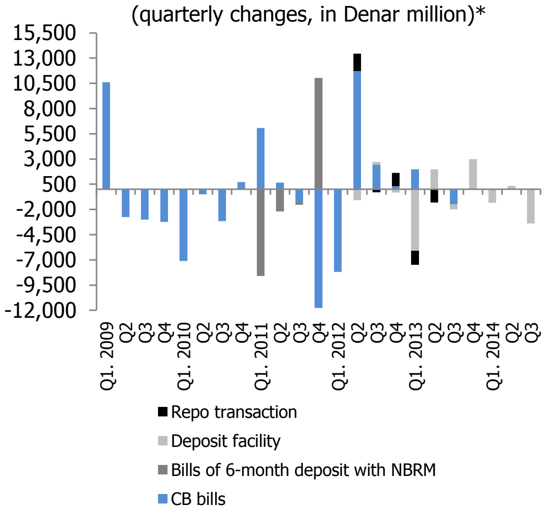
During the third quarter of 2014, bank liquidity increased by Denar 472 million, compared to the end of the second quarter. Thus, in September, the balances of banks' accounts with the NBRM[53] stood at Denar 16,846 million. In September, reserve money[54] increased by 7.5% annually, compared to June 2014, when they registered an annual growth of 2.2%.

During the third quarter[55] of 2014, the autonomous factors contributed to the creation of net liquidity of Denar 3,863 million. Within that framework, the NBRM's net purchase of foreign currency in the foreign exchange market with the market makers gave the largest contribution, where the NBRM's foreign exchange transactions in the third quarter contributed to the creation of liquid assets (in the total amount of Denar 4,047 million). Additional liquidity was created through the government (totaling Denar 733 million). Liquidity was withdrawn through currency in circulation in the amount of Denar 979 million.

In the third quarter, the NBRM's monetary instruments contributed to the withdrawal of net liquidity of Denar 3,391 million. Given the further stable level of CB bills, the change in the total monetary instruments in this period arises solely from changes in the NBRM's standing deposit facility. During the quarter, banks also used repo

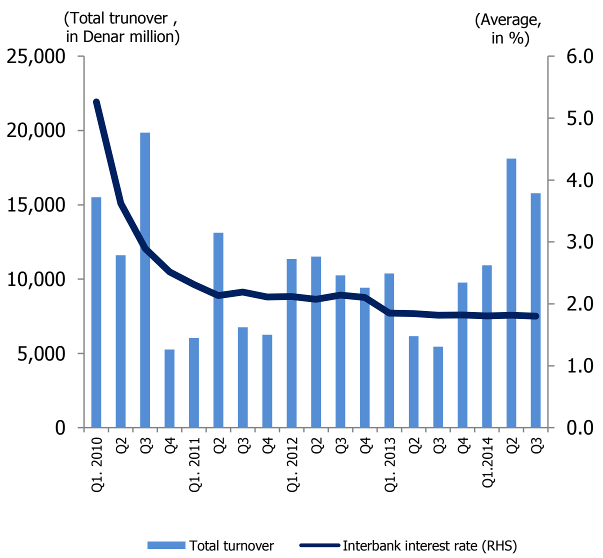
[52] Interbank interest rate calculated on the basis of quotations for selling unsecured Denar deposits of reference banks
[53] Refers to Denar accounts of banks that have an obligation to allocate reserve requirement.
[54] Includes reserve requirement in foreign currency.

Monetary policy instruments



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

Interbank deposit market



auctions for providing liquidity in order to overcome the short-term liquidity shortages. Due amounts were repaid in full, so this instrument had a neutral liquidity effect on a quarterly basis. In the third quarter, three auctions of CB bills with volume tender and fixed interest rate of 3.25% were held, where the NBRM determined the supply of CB bills in the due amount. Thus, CB bills had a neutral effect on the level of liquidity in the banking system. At the auctions held in the third quarter, demand was higher than the offered amount of CB bills. The demand was moderately higher also with respect to the potential, with certain banks being required to allocate funds in seven-day deposits with the NBRM[56]. Under these conditions and amid active use of this instrument for short-term liquidity management by banks, the seven-day deposit facility increased by Denar 3,630 million on a quarterly basis. At the same time, the amount of the overnight deposit facility was reduced by Denar 240 million on a quarterly basis. Consequently, in the third quarter, through the total deposit facility net liquidity was withdrawn from the banking sector in the total amount of Denar 3,390 million. In order to further channel banks' excess liquidity to the non-financial sector, in September the NBRM revised the mechanism for transfer of the demand for CB bills, which is above the banks' potential into another instrument, i.e. seven-day standing deposit facility. According to these changes, for the seven-day standing deposit facility that banks are obliged to allocate if on the CB bills auctions they demand an amount higher than the potential[57], an interest rate of 0% is determined. For the other assets that banks will voluntarily place into a seven-day standing deposit facility the regular interest rate will apply. During the period July-September 2014, banks allocated excess liquid assets over the reserve requirement of 0.6% on average (0.7% in the previous quarter).

In the third quarter of 2014, the interbank deposit market reported a total turnover of Denar 15,783 million, which compared to the second quarter of 2014, is a decline of 12.8%. Compared to the same period last year, in the third quarter of 2014, the activity

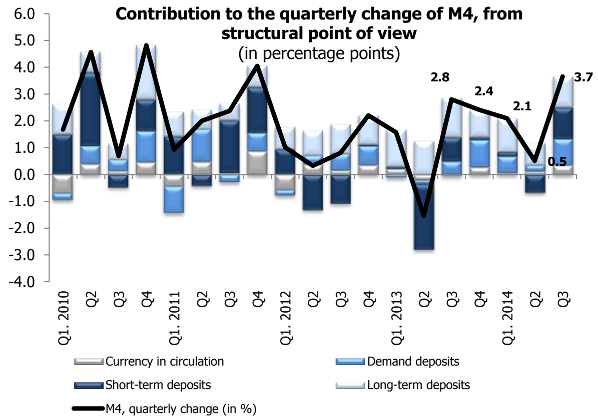
[56]The obligation of banks to allocate funds in seven-day deposits of the NBRM stems from the Methodology for determining the potential demand for CB bills, which the NBRM adopted in November 2013. For the method of determining the potential demand for CB bills see the Decision on CB bills, "Official Gazette of the Republic of Macedonia" no.166/13
[57]For the method of determining the potential demand for CB bills see the Decision on CB bills, "Official Gazette of the Republic of Macedonia" no.166/13

at the interbank money market rose by 2.9 times. Analyzed by maturity segments, intraday transactions had the highest share in the total turnover in the interbank money market in the third quarter, making up 79.1% of the total transactions, followed by transactions of up to seven days, with share of 19.5%. The interbank interest rate on overnight transactions (MKDONIA) equaled 1.8% on average in the third quarter (1.82% on average in the second quarter). The interbank interest rate (MBKS) equaled 1.9% on average, in the third quarter, same as in the previous quarter. **In the third quarter of 2014, repo transactions and transactions with treasury bills, totaling Denar 1,035.5 million, were executed on the secondary money market.**

2.2. Monetary and Credit Aggregates

In the third quarter of 2014, the quarterly growth rate of the broad money M4 significantly accelerated, which is a cumulative effect of the realized increase of all its components (according to maturity and currency structure). Analyzed by sector, faster quarterly growth was recorded in the corporate deposits (contrary to their decline in the previous quarter), amid further increase in the household savings. Regarding the balance, loans to the private sector still act toward increasing the money supply. Namely, the favorable trends of solid banks' support for the households and companies on the credit market continued, although at a slower pace compared with the previous quarter. On an annual basis, total loans grow at a faster pace, with a growth rate of 9.4% at the end of September compared to 8.5% in the previous quarter.

2.2.1. Monetary Aggregates



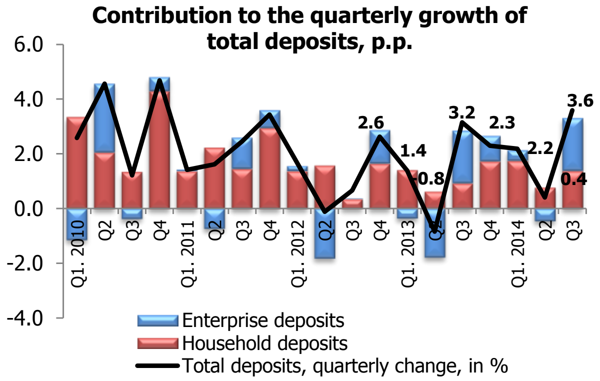
Source: NBRM.

In the third quarter of 2014, the quarterly growth rate of broad money M4 registered a significant acceleration, from 0.5% in the previous quarter to 3.7% at the end of September. This intensification of the rate of monetary growth is in part explained by the lower comparison base, taking into account that in the second quarter outflows from the banking sector were registered on the basis of corporate deposits due to the payment of dividends. However, even if this effect is excluded, in the third quarter there were relatively high inflows of new deposits in the banking sector, which corresponds to the further solid performance of the domestic economy. Seasonally higher inflows of foreign currency on the basis of private transfers may give an additional contribution to the growth of savings, primarily of households, which in part probably remain deposited on accounts in domestic banks. **Analyzing the structure,** in the

Total deposits

	2013				2014		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
q-o-q growth, %							
Total deposits	1.4	-0.8	3.2	2.3	2.2	0.4	3.6
contributions to quarterly growth, p.p.							
Deposit money	-0.2	0.5	0.6	1.1	0.7	0.3	1.1
Denar deposits	1.1	0.5	1.2	0.9	0.9	0.1	1.3
Foreign currency deposits	0.5	-1.9	1.3	0.3	0.6	0.0	1.3
Short-term deposits	-0.1	-2.6	1.0	0.1	0.3	-0.7	1.3
Long-term deposits	1.7	1.3	1.5	1.1	1.3	0.9	1.2

Source: NBRM



Source: NBRM.

Household deposits

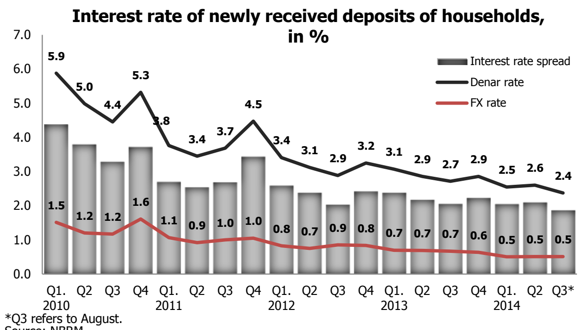
	2013				2014		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
quarterly change, in %							
Total household deposits	2.0	0.9	1.3	2.4	2.4	1.1	1.9
contribution to quarterly change of total deposits, in p.p.							
Deposit money	-0.1	0.2	-0.1	1.0	0.5	0.2	0.2
Denar deposits	1.2	0.8	0.8	1.1	1.2	0.7	0.9
FX deposits	0.8	-0.1	0.6	0.3	0.7	0.2	0.9
Short-term deposits	0.2	-0.4	-0.2	-0.2	0.2	-0.2	0.2
Long-term deposits	1.8	1.1	1.6	1.6	1.7	1.1	1.5

Source: NBRM.

third quarter, all components of the M4 gave a positive contribution, unlike the previous quarter when short-term deposits contributed to reducing the broadest monetary aggregate. So, at the end of September, short-term and long-term deposits have almost the same contribution to the accomplished monetary growth (explaining 32% and 31% of the quarterly increase, respectively), with registered more significant contribution of demand deposits (of 27% to total growth). The analysis regarding the currency of denomination shows faster growth of Denar deposits (with demand deposits)[58] compared with foreign currency deposits, with the share of the foreign currency deposits in M4 being stabilized at the level of the previous quarter (39%). **On an annual basis,** the growth of the broad money accelerated at the end of September, reaching 8.9% (8.0% in the second quarter), while total deposits increased by 8.8% (8.3% in the previous quarter).

During the third quarter of 2014, total deposits of the banking system recorded a significant acceleration of the quarterly growth rate which at the end of September amounted to 3.6% (0.4% at the end of June). The analysis of the structure of the quarterly growth of total deposits by sectors, indicates a more intensive growth of corporate deposits (versus the decline registered in the previous quarter), with simultaneous growth also of household deposits. In the third quarter, total household deposits increased by 1.9% compared to the growth of 1.1% registered in the previous quarter. The accelerated growth rate may partly be related to the favorable developments in the currency exchange operations, i.e. higher private transfers from abroad as an additional source of inflows for the households, especially in the summer, as well as to the continuously solid credit support from the banking system for this sector of the economy. According to the analysis of the structure of household deposits, long-term saving remains more attractive for the households, as a continuous feature of the second quarter of 2012, with a positive contribution also of short-term deposits (contrary to the decrease in the previous quarter). Analyzed by currency, the quarterly increase in household deposits is largely driven by Denar deposits. However, in this period there was

[58] The aggregate and sector-by-sector analysis of total deposits refers to total deposits, including demand deposits. Denar deposits are also analyzed with included demand deposits. Demand deposits refer to current accounts with banks and savings houses.

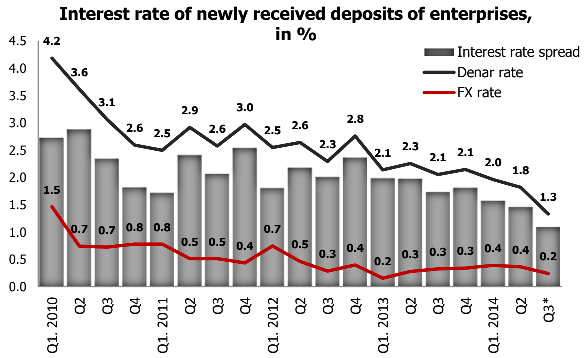


*Q3 refers to August.
Source: NBRM.

Enterprise deposits

	2013 Q1	Q2	Q3	Q4	2014 Q1	Q2	Q3
	quarterly change, in %						
Total household deposits	-1.5	-7.8	9.1	4.1	1.7	-2.0	8.8
	contribution to quarterly change of total deposits, in p.p.						
Deposit money	-1.4	1.3	2.9	1.9	1.1	0.2	3.3
Denar deposits	0.1	-1.3	2.6	1.6	0.2	-1.8	2.8
FX deposits	-0.3	-7.8	3.5	0.7	0.4	-0.4	2.7
Short-term deposits	-1.5	-9.4	5.0	2.1	0.3	-2.0	4.8
Long-term deposits	1.4	0.3	1.1	0.2	0.3	-0.2	0.6

Source: NBRM.



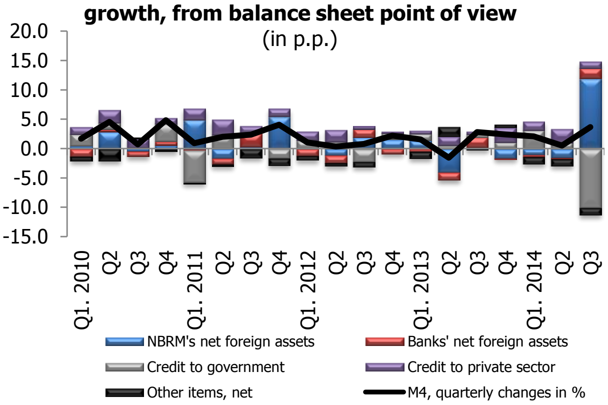
*Q3 refers to August. Source: NBRM.

a significant acceleration of the quarterly growth rate also of the foreign currency deposits, which at the end of September explain 46% of the total growth (about 18% in the previous quarter). Such shifts in households' preferences for saving in domestic or foreign currency are in part probably supported by the seasonally higher foreign exchange inflows from private transfers. In addition, proceeds from the new Denar savings in August decreased in comparison with June (by 0.2 percentage points), which given the unchanged interest rates on newly received foreign currency deposits point to a small narrowing of the interest rate spread between them. However, Denar savings remain more attractive for depositors, providing higher yield compared to foreign currency savings. **On an annual basis,** in the third quarter, total household deposits grew by 8.0% versus 7.4% in June.

At the end of September, **corporate deposits** registered relatively high quarterly growth rate of 8.8%, compared to the decrease recorded during the second quarter (by 2% on a quarterly basis). These positive trends in the third quarter are in part explained by the lower base effect from the second quarter, when there were outflows of corporate deposits due to the payment of dividends. However, this period is characterized by relatively higher flows of corporate deposits, supported by further positive economic trends in the real sector. Analyzing the structure, the growth of total corporate deposits is predominantly a result of the quarterly increase of short-term deposits (contrary to the decrease in the previous quarter) and demand deposits. Long-term deposits give moderate contribution in this direction. Within the currency structure, 69% of the total quarterly growth is due to the increase of Denar deposits amid more significant contribution also by foreign currency corporate deposits (contrary to their decline in the previous quarter). The analysis of the yields in August still points to lowering of the interest rate on new domestic and foreign currency corporate deposits by 0.5 percentage points and 0.2 percentage points, respectively, indicating further narrowing of the interest rate spread. **On an annual basis**, the growth rate of corporate deposits decelerated slightly, and at the end of September it was 12.9% versus 13.2% registered in June[59].

[59] In the second quarter of 2014, a higher annual growth rate of total corporate deposits was registered, mainly due to the almost twice lower outflow of funds (based on the payment of dividends by a larger domestic company) that took place in April 2014, relative to the outflow realized in April 2013.

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



Source: NBRM.

Analyzing the balance sheets, the quarterly increase of the money supply in the third quarter was mainly due to the intensive growth of the foreign assets of the NBRM[60]. Net foreign assets of banks and loans to the private sector also gave some positive contribution. On the other hand, net loans of the government had a significant contribution to the reduction of the broad money supply[61] contrary to the positive contribution recorded in the previous quarter.

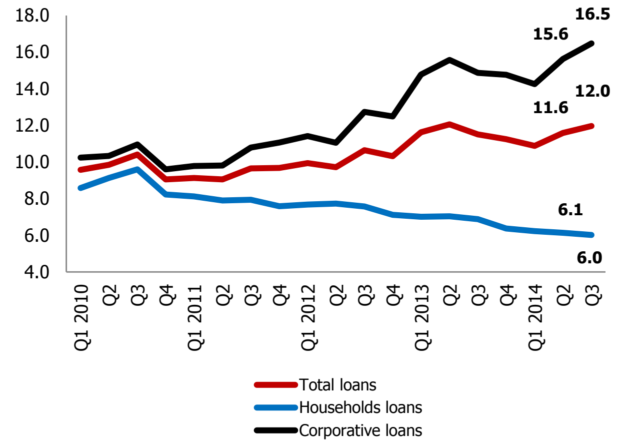
2.2.2. Lending Activity

Total credits of private sector

	2013				2014		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
quarterly change, in %							
Total credits of private sector	0.7	1.9	0.6	3.0	1.8	2.9	1.4
Contribution in quarterly change of total credits (in p.p)							
Denar credits	0.4	1.6	1.4	2.9	1.6	2.7	1.3
Foreign currency credits	0.3	0.3	-0.8	0.1	0.2	0.1	0.1
Short-term credits	-0.1	0.6	-0.4	0.7	0.7	0.4	0.0
Long-term credits	-0.6	0.6	1.6	2.3	1.2	1.3	0.9
Households	0.4	1.4	1.0	1.2	0.9	1.6	1.2
Corporations	0.3	0.5	-0.4	1.9	0.9	1.2	0.2

Source: NBRM.

Share of doubtful and contested claims in total loans



Source: NBRM.

In the third quarter of 2014, the credit market witnessed a solid pace of growth of total loans with the quarterly growth rate at the end of September being 1.4%. Compared to the previous quarter, these achievements point to a slower pace of growth of total loans (2.9% at the end of June) as a result of the simultaneous slowdown in lending to both companies and households. However, the weaker performances of total loans in this period largely arise from the corporate sector. The growth of corporate loans significantly slowed in the third quarter, which comes after the continued maintenance of a strong credit growth in the previous three quarters. This variability in the lending dynamics may point to still present perceptions of risk in the corporate sector by the banks, which given the further growth of the domestic economic activity could, in part, be linked to the dynamics of non-performing loans. Thus, doubtful and contested claims in the third quarter grew, which is still a result of the faster growth in the non-performing loans to the corporate sector. As of August, the share of doubtful and contested claims in total loans was 12% (11.6% in June).

According to the analysis of the maturity structure, realized quarterly growth of total loans is entirely a result of the increase in long-term loans

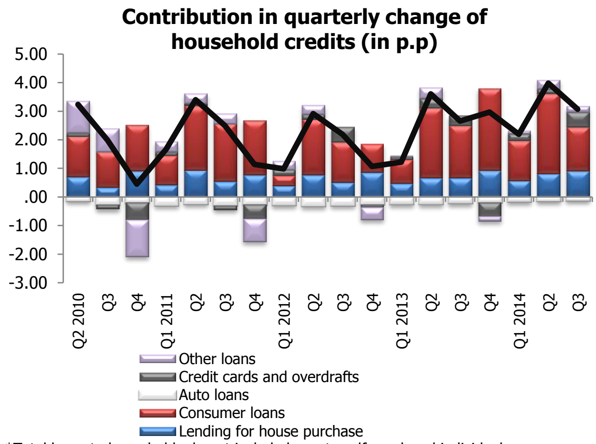
[60] Better performances in the net foreign assets of the NBRM registered in the third quarter of 2014 are predominantly a result of the issuance of the Eurobond. Namely, in July 2014 the Government issued the Eurobond in the amount of Euro 491.1 million, which had a significant effect on both the assets and the liabilities side of the balance sheet of the NBRM in the sense of increase in the net foreign assets of the NBRM and government deposits with the NBRM, respectively.

[61] The decline in net government loans is mostly explained by the inflows from the Eurobond, which enabled high accumulation of government deposits with the NBRM and consequently a negative contribution to the growth of the money supply.

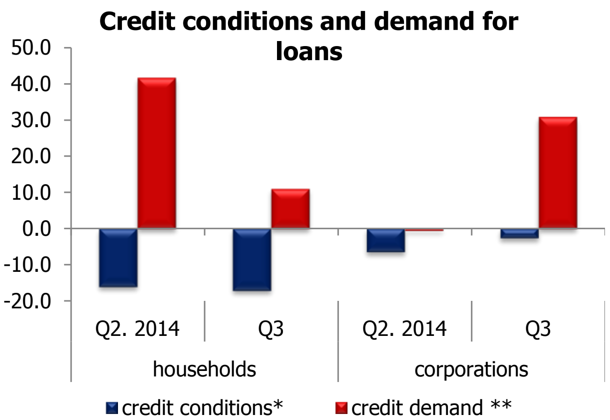
Total credits of households

	2013				2014		
	Q1	Q2	Q3	Q4	Q1		Q2
	quarterly change, in %						
Total credits of households	1.1	3.4	2.5	2.8	2.1	3.9	2.9
Contribution in quarterly change of household credits (in p.p)							
Denar credits	1.2	3.6	2.6	2.8	2.1	3.9	3.0
Foreign currency credits	-0.1	-0.1	-0.1	0.0	0.0	0.1	0.0
Short-term credits	0.1	0.4	0.3	-0.6	0.2	0.3	0.4
Long-term credits	0.9	2.7	2.1	3.8	1.8	3.5	2.5

Source: NBRM.



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



*negative net-percentage - easing of credit standards;
*positive net-percentage - tightening of credit standards;
**negative net-percentage - decrease in credit demand;
**positive net-percentage - increase in credit demand

amid a small decline in short-term loans. Analyzed by currency, the total quarterly increase is still a result of the growth of the Denar loans, which explain 94% of the registered growth in the third quarter. Realized quarterly credit growth is lower compared to the intense increase in the deposit base in the third quarter, indicating a reduction in the use of the deposit potential for lending to the private sector. At the end of September, the loans/deposits ratio was 89.6% versus 91.5% in the previous quarter. **On an annual basis,** there was a further acceleration of the credit growth which reached 9.4% from 8.5% in June.

Loans to the household sector continued to grow during the third quarter, but at a slower pace compared with the previous quarter. Thus, the quarterly growth rate of total loans to households as of September was 2.9% versus 3.9% in June. Such movements are mainly due to the slower growth of consumer loans and the further decline in car loans. Housing loans to households extended in the third quarter grew moderately. Such performances, according to the results of the Lending Survey[62], are mainly associated with factors on the side of demand for loans. Namely, in the third quarter, banks indicate significantly slower growth in the demand for all types of loans compared to the previous quarter. On the supply side, the changes are still in the direction of net easing of the conditions for granting loans to households. Regarding the maturity structure of the loans to households, there is a dominant contribution of long-term loans, but short-term loans also acted in this direction to a lesser extent. According to the analysis of the currency structure, the quarterly increase is entirely a result of Denar lending to households, in circumstances of a small decline in foreign currency loans. **On an annual basis,** total loans to households continued to grow at a moderately faster pace, with the annual growth rate at the end of September being 12.3% versus 11.8% in June.

The quarterly growth rate of total corporate loans in the third quarter of 2014 slowed to 0.3% from 2.0% in the second quarter. The increase was fully implemented in September while in the July-August period, total loans to enterprises declined by Denar 580 million. These two months were also characterized by weaker performances within the non-standard

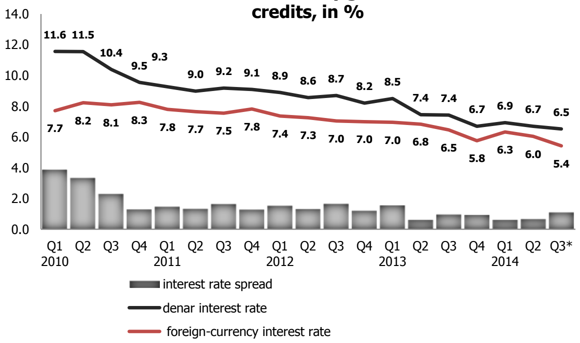
[62] For more information, see Lending Survey at http://www.nbrm.mk/?ItemID=F7AC78DEE498764FBAF39049F726CE3C

Total credits of corporations

	2013				2014		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
quarterly change, in %							
Total credits of corporations	0.5	0.9	-0.7	3.2	1.5	2.0	
Contribution in quarterly change of corporation credits (in p.p)							
Denar credits	-0.1	0.2	0.5	3.0	1.2	1.9	0.1
Foreign currency credits	0.5	0.7	-1.2	0.2	0.3	0.2	0.2
Short-term credits	-0.3	0.8	-1.0	1.6	1.0	0.6	-0.3
Long-term credits	-1.6	-0.8	1.1	1.3	0.7	-0.2	-0.2

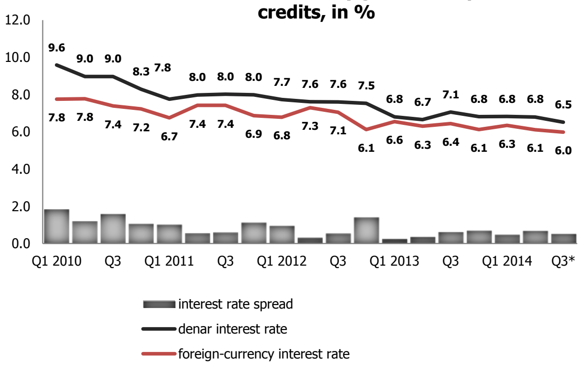
Source: NBRM.

Interest rate of total newly granted household credits, in %



*Q3 refers to the end of August
Source: NBRM.

Interest rate of total newly granted corporate credits, in %



*Q3 refers to the end of August
Source: NBRM.

measures of the NBRM[63] aimed at encouraging the lending activity for net exporters and producers of electricity[64]. On the other hand, through the EIB funds intended for lending to SMEs, the credit support provided to the corporate sector was in a similar amount as in the previous quarter (withdrawn first tranche of the EIB 4 credit line in the amount of Euro 10.9 million). These developments suggest more restrained lending policy of banks to the corporate sector, compared with the previous quarter, partially seen through the latest Lending Survey[65]. Thus, the survey indicates slightly weaker net easing of credit conditions by banks, at a time when credit demand grew fast on a quarterly basis, which could implicitly suggest that the slower activity of the credit segment of enterprises in the third quarter was largely driven by the credit supply. According to the analysis of the maturity structure, a decline in short-term and long-term loans was registered, amid growth of doubtful and contested claims. Within the currency structure, after four quarters of dominant contribution of the Denar loans, in the third quarter foreign currency loans explain over half of the total quarterly growth. **On an annual basis,** corporate loans rose by 7.2% in September (6.1% in June).

Regarding the cost of newly approved loans to households and companies, the latest data point to a further **reduction of the lending interest rates** for the two sectors of the economy. Thus, compared to June, there was a decrease in the interest rate on newly approved domestic and foreign currency loans to households by 0.2 percentage points and 0.6 percentage points, respectively, amid simultaneous reduction of the interest rate on newly approved denar and foreign currency corporate loans (decline of 0.3 percentage points and 0.1 percentage point, respectively). Regarding the total interest rate, data as of August indicate further minimal decline in the loans to households and companies, which equal 7.4% and 6.9%, respectively.

[63] Taking into account the previous positive effects of the application of this non-standard measure of the NBRM on the lending activity for net exporters and manufacturers of electricity, in September, the National Bank Council decided to extend its application until 31 December 2015.

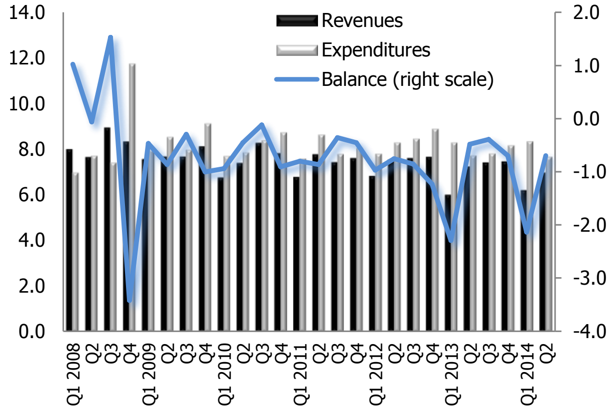
[64] Cumulatively, for the period July-August, newly-extended loans to net exporters and producers of electricity dropped by Denar 237 million. Cumulatively for the January-June 2014 period, banks marketed a total of Denar 1,973 million, as part of this measure.

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

III. Public Finances

During the second quarter of 2014, the growth in the total revenues in the Budget of the Republic of Macedonia (central budget and budgets of funds) slowed significantly on an annual basis compared to the previous quarter (0.4% versus 7.9%, respectively). In the period July-August 2014, generated budget revenues were lower compared with the same period last year. Such movements may in part be explained by the base effects. However, even if the base effects are excluded, in the period July to August there was lower tax collection, mainly driven by the poor realization of the revenues from VAT. Total expenditures continued to grow in the second quarter, although at a slower pace (3.5% versus 5% in the previous quarter), and from July to August realized expenditures were lower compared to the same period last year. Same as in the first quarter, during the second quarter, as well as in the period from July to August budget deficit was realized in the Budget. Since the beginning of the year until August, about 93% of the planned budget deficit for 2014 was realized. Against the backdrop of high realization of the budget deficit, in September, a Supplementary Budget for 2014 was adopted. With the Supplementary Budget a downward correction was made on both the revenue and the expenditure side, whereby a realization of somewhat higher budget deficit of 3.7% of GDP was envisaged (3.5% of GDP according to the initial plan).

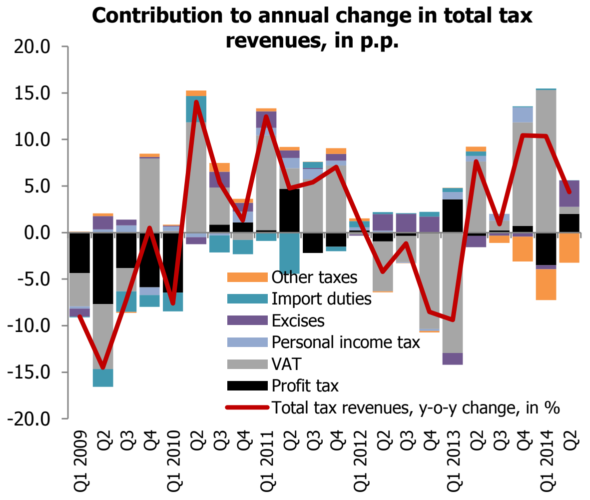
Budget revenues and expenditure
(in % of GDP)



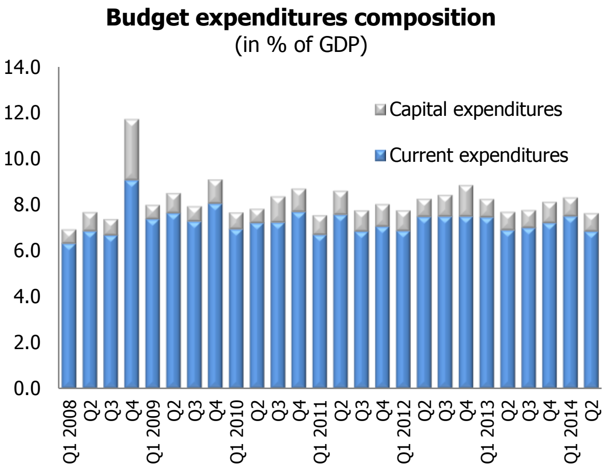
Source: Ministry of Finance

Total revenues in the Budget of the Republic of Macedonia[66] in the second quarter of 2014 were 7% of GDP[67], which is a somewhat weaker performance compared to the same quarter of the previous year (7.2% of GDP). Observed through the relative changes, total revenues in the second quarter went up by 0.4% on an annual basis, compared with the growth of 7.9% registered in the previous quarter. Such changes in the total income are largely explained by the slowing pace of growth in tax collection (down to 4.4% from 10.4% annual growth in the first quarter), primarily driven by the normalization of the growth of the inflows based on VAT to 1.5% annually in the second quarter. In the first quarter, revenues from VAT registered an extremely high annual growth (of 34%), which largely reflects the base effect, i.e. the lower comparison basis from the first quarter of 2013, when the Government made full payment of the arrears based on VAT returns. The analysis of the other tax categories shows faster growth in the

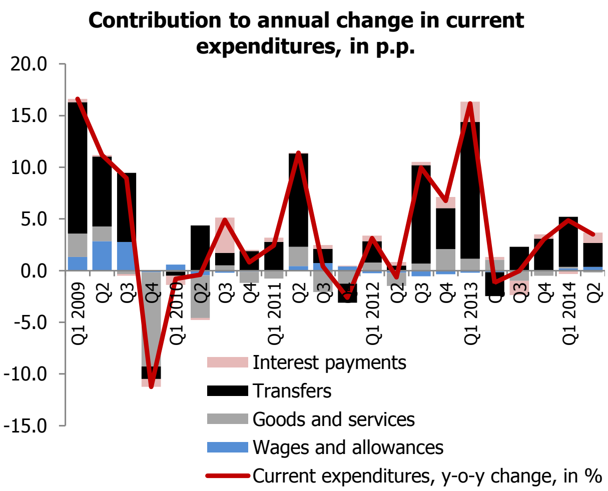
[66] Central budget and budgets of funds.
[67] The analysis uses GDP as projected by the NBRM.



Source: Ministry of Finance.



Source: Ministry of Finance

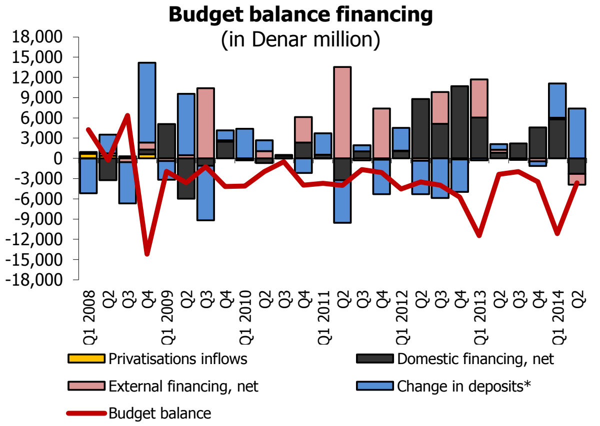


Source: Ministry of Finance.

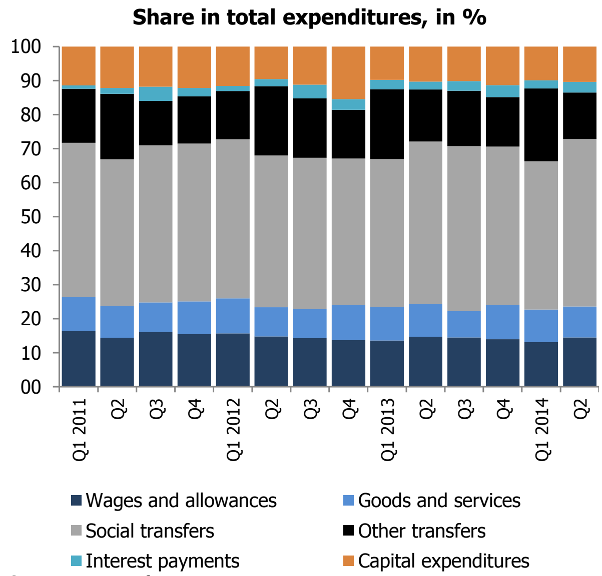
revenues from excise duties[68], which stand out as a tax category with the largest single contribution to the growth of total revenues in the second quarter. Acceleration of growth was noted also in the personal income tax, while the changes in the import duties were in the opposite direction. Thus, the contribution of these two categories to the growth of total revenues remained relatively stable compared to the previous quarter. After declining in the previous quarter, inflows from profit tax registered a relatively high annual growth in the second quarter, whereby they gave a significant contribution to the growth of total revenues. Total social contributions continued to grow at a moderately slower pace compared to the previous quarter (4.4% versus 5.1% in the first quarter), amid increased collection in all subcategories. Non-tax revenues also grew in the second quarter (after their decline in the previous two quarters), while the contribution of capital income remains negative, which is in part explained by the realization of lower inflows based on the dividend from the Macedonian Telecom, compared with the previous year.

In the second quarter of the year, total budget expenditures amounted to 7.7% of GDP, which is at the level of the budget expenditures realized in the same period last year. In nominal amounts, budget expenditures increased by 3.5% annually, compared with the growth of 5% as it was in the previous quarter. Observed through the individual expenditure categories, the annual growth of total expenditures in the second quarter was largely driven by the higher realization of current expenditures, whose growth continued, although at a slower pace compared to the previous quarter (3.5% versus 4.9% in the first quarter). In their framework, significant growth was observed in the expenditures for social transfers (mainly due to the increase in the transfers to the Pension Fund, amid registered acceleration of the growth also in the welfare transfers) and expenditures from interest. Slightly higher costs were realized also on the basis of payment of wages and allowances, while the cost of goods and services decreased on an annual basis. **Capital expenditures continued to grow also in the second quarter,** with their

[68] According to the Amendments to the Law on Excise from 2013 ("Official Gazette of the Republic of Macedonia" no.82 / 2013) from 1.07.2014, the rates of specific and minimum price of cigarettes increased by Denar 0.15 per piece, while the amount of the excise duty on tobacco for smoking as well as on finely chopped tobacco increased by Denar 50 per kilogram.



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



Source: Ministry of Finance.

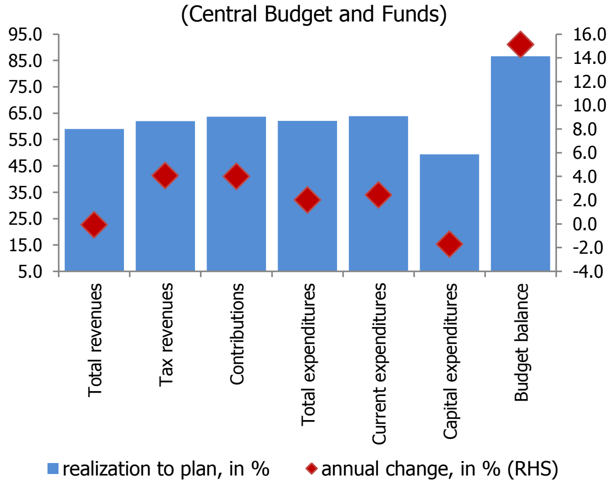
share in GDP (0.8%) and in total expenditures (10.4%) being in line with the performance in the same period last year.

In the second quarter of 2014, budget deficit of Denar 3,621 million was realized, representing 0.7% of GDP[69] (2.1% of GDP in the first quarter). To finance the deficit in the second quarter, the Government used part of the deposits in its account with the NBRM in the total amount of Denar 7,391 million. Regarding the borrowing on the domestic market, in the second quarter repayments based on the current debt were made. Repayments of foreign loans were higher than the new disbursements during the quarter. Consequently, based on borrowing in the domestic market and abroad, in the second quarter net outflows totaling Denar 2,305 million and Denar 1,595 million, respectively, were realized.

In the period July-August 2014, a decline in total revenues of 10% annually was registered. The largest contribution to the fall of the total revenues in this period was that of the intense reduction of non-tax revenues, which in significant part can be explained by the higher base from the same period last year when inflows were realized on the basis of concessions for offering services of the fourth generation of mobile telephony (4G). This period was also characterized by a distinctive and weaker performance of tax revenues, which are lower by 3.6% on an annual basis, mainly driven by lower inflows from VAT. Annual reduction was registered also in the import duties, while other taxes recorded higher realization compared to the same period of the previous year. Revenues from social contributions continued to increase on an annual basis, amid registered growth in all subcategories. **In the period from July to August weaker realization of budget expenditures compared with the same period last year (4.8% annually) was registered.** Such dynamics of total expenditures is largely driven by the reduction in current expenditures (primarily in the part of social transfers), amid registered decline also in the capital expenditures. **In the period**

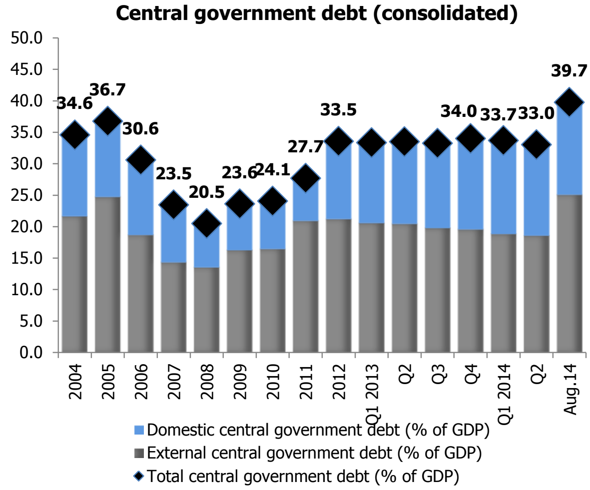
[69] If GDP as projected by the Ministry of Finance is used, in the second quarter the budget deficit was also 0.7% of GDP and 2.1% of GDP in the first quarter. The projection of GDP for 2014 is taken from the table of the Indicators and Projections of the Ministry of Finance and it includes a real GDP growth of 3.5% and a deflator of 1.6%. Differences in the relative indicators are small, with small differences between the projections for growth of the NBRM and of the Ministry of Finance.

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



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

Central government debt (consolidated)



Source: NBRM's calculations based on data from the Ministry of Finance.

from July to August, budget deficit of Denar 2,220 million (or 0.4% of GDP[70]) was realized. In terms of funding, in this period there were high inflows based on external borrowing, which on a net basis amounted to Denar 32,802 million. Most of the borrowing was made in July when the third Eurobond[71] was issued in the international capital market, based on which inflows of Euro 491 million were realized. Additional inflows were realized through withdrawal of funds from the Competitiveness Development Policy Loan funded by the World Bank in the amount of Euro 36.4 million. Based on borrowing in the domestic market, in the period from July to August net inflows in the amount of Denar 572 million were realized. Inflows in the Budget in this period were higher than the realized outflows which allowed accumulation of deposits on Government's account with the NBRM.

According to the execution of the Budget, as of August 58% of budget revenues and 61.6% of budget expenditures provided by the Budget of the Republic of Macedonia were realized. The budget deficit for the period January - August was 3.3% of GDP[72] on cumulative basis, whereby about 93% of the projected budget deficit for 2014 pursuant to the adopted Budget of the Republic of Macedonia were realized. Against such a backdrop, and in order to harmonize the dynamics of expenditures, especially in the part of infrastructure projects, with the dynamics of revenues, in September a Supplementary Budget for 2014 was adopted[73]. **Regarding the Supplementary Budget for 2014, the realization of the total budget revenues and expenditures as of August amounted to 59% and 62.1%, respectively, while the budget deficit was realized with 86.6%.** Considering that in July the Government borrowed a significant amount on the international capital market, as of 31 August 2014, the central government debt (consolidated)[74] increased in comparison with the end of the second quarter and amounted to 39.7%

[70] Also 0.4% according to the Ministry of Finance.
[71] The value of the Eurobond issued is Euro 500 million, with maturity of 7 years and rate of return of 4.25%, i.e. an interest rate of 3.975% per year.
[72] 3.2% of GDP if the projection of GDP by the Ministry of Finance is used.
[73] For details on the Supplementary Budget for 2014 see Box 4.
[74] Refers to the debt of the central government including public funds, excluding municipalities.

of GDP[75]. In order to increase the credibility of the medium-term fiscal plans and ensure fiscal discipline, in June, the Government suggested inclusion of fiscal rules in the framework of the Constitution of the Republic of Macedonia. The announced changes in the fiscal area, as well as a brief overview of the concept and application of fiscal rules is given in **Бoц 8.**

Budget of the Republic of Macedonia (central budget and budgets of funds)

	Budget for 2014	Supplementary Budget for 2014	Q1	Q2	Jul-Aug	Y-o-Y changes , 2014 period over the same period of the previous year, in %			Contribution to annual change, 2014 period over the same period of the previous year, in p.p.		
	planned, in Denar million	planned, in Denar million	realized, in Denar million			Q1	Q2	Jul-Aug	Q1	Q2	Jul-Aug
TOTAL BUDGET REVENUES	**158,243**	**155,554**	**32,291**	**36,259**	**23,274**	**7.9**	**0.4**	**-10.0**	**7.9**	**0.4**	**-10.0**
Revenues base on taxes and con	133,859	131,376	28,704	32,081	21,235	8.4	4.6	-1.4	7.4	3.9	-1.2
Tax revenues	87,222	85,189	18,216	20,887	13,675	10.4	4.4	-3.6	5.7	2.4	-2.0
Contributions	45,153	44,703	10,211	10,891	7,350	5.1	4.4	2.0	1.6	1.3	0.6
Non-tax revenues	14,973	14,697	2,591	2,433	1,520	-0.3	14.0	-55.0	0.0	0.8	-7.2
Capital revenues	5,290	4,177	181	1,046	207	-39.5	-57.5	-11.9	-0.4	-3.9	-0.1
Donations from abroad	3,521	4,504	612	534	268	34.2	-29.0	-57.9	0.5	-0.6	-1.4
Revenues of recovered loans	600	800	203	165	44	103.0	52.8	-25.4	0.3	0.2	-0.1
TOTAL BUDGET EXPENDITURES	**176,514**	**175,157**	**43,428**	**39,880**	**25,494**	**5.0**	**3.5**	**-4.8**	**5.0**	**3.5**	**-4.8**
Current expenditures	154,137	154,073	39,120	35,741	23,521	4.9	3.5	-2.9	4.4	3.1	-2.6
Capital expenditures	22,377	21,084	4,308	4,139	1,973	6.5	4.0	-23.4	0.6	0.4	-2.3
BUDGET DEFICIT / SURPLUS	**-18,271**	**-19,603**	**-11,137**	**-3,621**	**-2,220**	**-2.5**	**51.4**	**136.4**			
Financing	18,271	19,603	11,137	3,621	2,220						
Inflow	**29,131**	**30,463**	**12,006**	**7,444**	**2,835**						
Revenues based on privatisation	0	440	310	130	0						
Foreign loans	5,276	36,449	994	908	33,285						
Deposits	13,915	-12,676	4,791	7,391	-31,154						
Treasury bills	9,840	6,150	5,642	-985	704						
Sale of shares	100	100	269	0	0						
Outflow	**10,860**	**10,860**	**869**	**3,823**	**615**						
Repayment of principal	10,860	10,860	869	3,823	615						
External debt	9,133	9,133	737	2,503	483						
Domestic debt	1,727	1,727	132	1,320	132						

Source: Ministry of Finance.

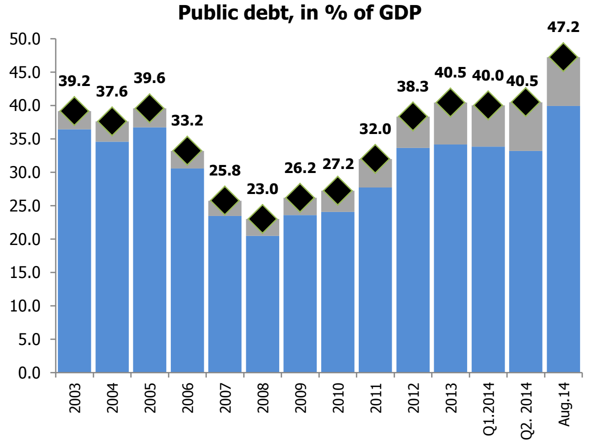
Box 3: Change in the scope of the public debt with the amendments to the Law on Public Debt

In September 2014, the Parliament of the Republic of Macedonia adopted the Law on Amendments to the Law on Public Debt, which changes the scope of the public debt, i.e. public debt is defined as 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 wholly or predominantly owned by the state or by the municipalities within the city of Skopje and the city of Skopje, for which the Government has issued a state guarantee. **Accordingly, when borrowing without a state guarantee, public enterprises and companies being fully or predominantly owned by the state are excluded from the procedure for borrowing under this Law, because their debt does not create direct fiscal implications and potential liabilities in the Budget of the Republic of Macedonia.** Public enterprises and companies being fully or predominantly owned by the municipalities, municipalities within the city of Skopje and the city of Skopje undergo the borrowing procedure because pursuant to the Law on financing local government units, their debt is guaranteed by the municipality that

[75] If we use the GDP projected by the Ministry of Finance, in August, the debt of the central government accounted for 39.4% of GDP.

established them and they are its potential liability.

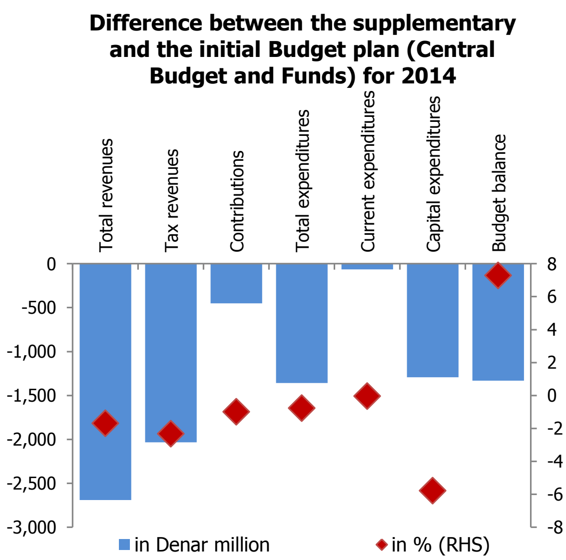
With the amendments to the Law, the NBRM's debt is excluded from the scope of the public debt since the NBRM as a Central Bank creates debt intended for conducting the monetary policy, which is conducted independently of the fiscal policy, and therefore does not create direct fiscal implications in the Budget of the Republic of Macedonia. Also, **under this Law, the short-term borrowing of MBPR AD for liquidity needs is excluded from the borrowing procedure.** An obligation is established for the Ministry of Finance to publish data on the public debt of the Republic of Macedonia on its website. According to the latest data released by the Ministry of Finance, at the end of August 2014, **the total public debt of the Republic of Macedonia, calculated according to the new methodology amounted to Euro 3,997.3 million or 47.2% of GDP[76].**



Source: NBRM's calculations based on data from the Ministry of Finance.

Box 4: Supplementary Budget of the Republic of Macedonia for 2014

In September 2014, Amendments to the Budget for 2014 were adopted, which envisage a reduction of total budget revenues and expenditures compared to the initial plan and realization of a higher budget deficit of 3.7% of GDP (3.5% of GDP in the initial Budget). Thus, in circumstances of weaker realization of budget revenues since the beginning of the year (as of August about 58% of the revenues projected with the initial plan were realized), **budget revenues projected with the Supplementary Budget decreased by 1.7% compared to the initial plan.** The Supplementary Budget envisages changes in the amount and the structure of total expenditures aimed at redistribution of funds between budget users and harmonization of the dynamics of capital expenditures in accordance with the dynamics of the realization of the planned projects. In this context, **now budget expenditures lower by 0.8% compared to the initial plan is envisaged, amid a significant reduction in capital expenditures (by 5.8%).** The changes on the expenditures side include: reduction of certain positions for budget users where a slower pace of accomplishment or achievement of certain savings was recorded; provision of additional funds for construction of the section Demir Kapija-



*Negative change in Denar million referes to higher budget deficit in the Supplementary Budget.
Source: Ministry of Finance.

[76]The calculation uses the projection of the NBRM for the nominal GDP for 2014. According to the projections of the Ministry of Finance, the public debt was 46.8% of GDP at the end of August 2014.

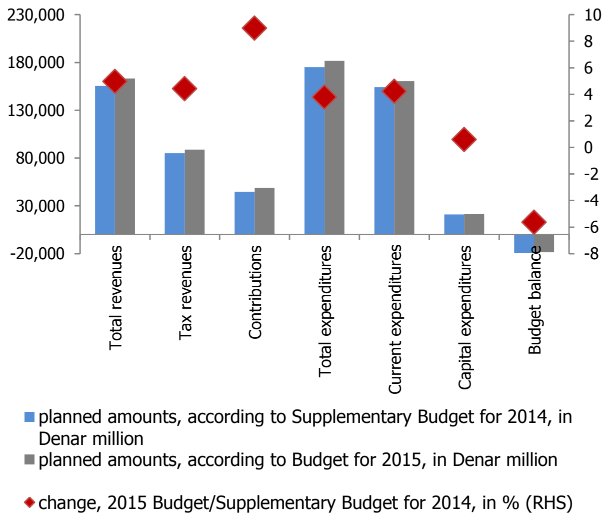
Smokvica from Corridor 10, according to the intensified construction; reallocation of funds among budget users within the wage bill; provision of additional funds to the Pension and Disability Insurance Fund for an uninterrupted payment of pensions; provision of additional funds for social rights, according to the latest trends of exercising the right to parental allowance for the third child; and provision of additional funds for overcoming the consequences of natural disasters in the municipalities.

According to the Ministry of Finance, these amendments to the Budget keep the commitment to a low tax burden, without changes in the tax policy and a slight increase in the budget deficit as a result of larger withdrawals of the credit for the accelerated construction of Corridor 10. The Supplementary Budget aims to ensure harmonization of the dynamics of expenditures, especially in the part of infrastructure projects with the dynamics of budget revenues.

Box 5: Budget of the Republic of Macedonia for 2015

In October 2014, the Parliament adopted the Budget of the Republic of Macedonia for 2015. In its frame, **the total revenues of the consolidated budget (central budget and budgets of funds) for 2015 were planned at the level of Denar 163,280 million,** which is an expectation to generate 5% higher revenues compared with 2014, according to the Supplementary Budget. Total realized budget expenditures in 2015 are expected to be in the amount of Denar 181,777 million, representing growth of 3.8% compared with the projection of the budget expenditures for 2014, according to the Supplementary Budget. Given such planned dynamics of total budget revenues and expenditures **for 2015, realized budget deficit is expected to be in the amount of Denar 18,497 million.**

Budget for 2015 and Supplementary Budget for 2014



Source: Ministry of Finance.

Within the structure of budget revenues, income tax remains to be the dominant item in which growth is expected, driven by the expected growth of the domestic economic activity and improved fiscal discipline, amid further retention of the policy of low tax rates. The structure of the total budget expenditures aims to provide regular and timely fulfillment of all legal obligations and continuation of the ongoing infrastructure projects. The allocation of expenditures between current and capital expenditures is similar to the Supplementary Budget for 2014 (and the initial plan of the Budget for 2014), while retaining the share of current in the total budget expenditures at the level of about 88%. Moreover, **in 2015 a higher realization of current expenditures compared with the Supplementary Budget for 2014 is envisaged, whereby, beside the performance of regular obligations, the implementation of certain government measures and policies would be allowed,** such as: single increase in the wages of public administration by 4%; increase in pensions by 5% on average, starting from the September pension paid in October 2015; increase in social benefits by 5%, starting from June, with payment in July 2015; provision of further support to agriculture through subsidies, transfers, etc. **Capital expenditures, which represent the development component of fiscal policy in 2015, are envisaged to be realized in the amount of Denar 21,208 million.** In this framework, funds are envisaged for investments in the construction of the Corridor 10 highway and the railway infrastructure, energy and utility infrastructure, as well as capital investments aimed at improving the conditions in the health, educational and social system, agriculture, culture, sport, environment protection and justice.

The financing of the budget deficit in 2015 for the most part is expected to be made through the use of funds from the Eurobond, which was issued in July 2014. The rest will be provided by foreign sources in the form of soft loans from international financial institutions and credit lines earmarked for financing certain projects. Regarding the borrowing on the domestic market, the budget for 2015 envisages refinancing of securities that mature in 2015, without creating new debt on this basis. In managing domestic debt, the Ministry of Finance will be oriented toward increasing the maturity of issued debt securities by issuing government bonds with a maturity of two, three, five and ten years in order to optimize payments and reduce the risk of refinancing.

As stated in the Budget, **such a design of the projection of the public finances for 2015 is based on a commitment for their gradual consolidation,** in line with the expectations for improvement of the macroeconomic indicators in the forthcoming period **and aims at maintaining the macroeconomic stability and promoting economic growth,** as basic conditions for increasing employment and improving the standard of living.

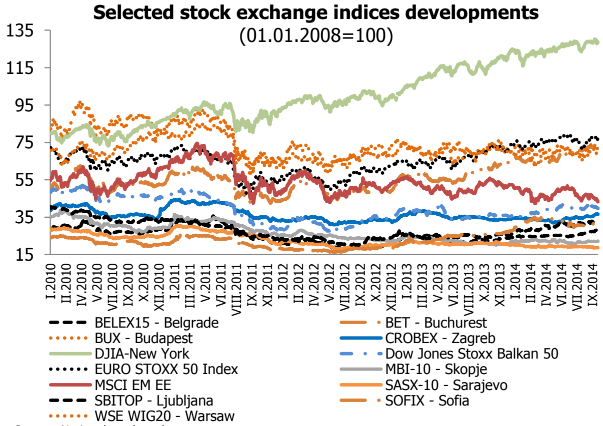
IV. Stock Exchange Indices and Real Estate Prices

In the third quarter of 2014, Macedonian Stock Exchange Index MBI-10 increased by 4.9%, after the negative changes in the previous two quarters, which corresponds with the improved economic performances and expectations for further positive developments in the domestic economy. On the other hand, the bond index value (OMB) is still following a downward trajectory. During the third quarter of 2014, there was an increased trading on the stock exchanges in the region, which has led to growth of most regional stock indices. Real estate prices in the domestic market began to follow an ascending trajectory (annual growth of 2%), but taking into account the movement of the fundamental factors, it is difficult to assess whether growth will continue, or it is a temporary move.

Source: Macedonian Stock echange Skopje

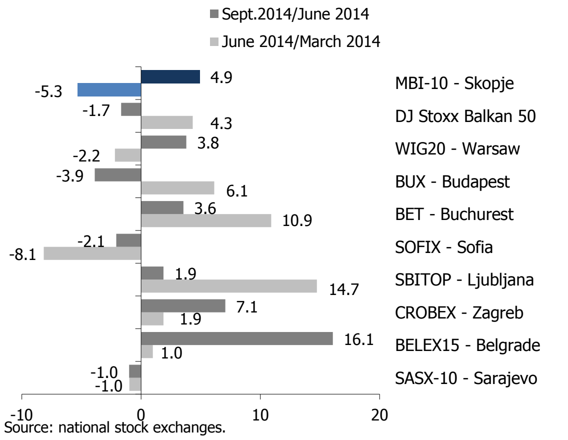
During the third quarter of 2014, the value of the Macedonian Stock Exchange Index MBI-10 increased by 4.9% (relative to the level registered at the end of the previous quarter), contrary to its decline in the first half of the year. With respect to the dynamics of the movement, in the third quarter, the stock exchange index generally followed an upward path and at the end of September it positioned at the level of 1713.4. Favorable movements in the stock exchange are in line with the improved economic performance and the expectations for continuation of the positive developments in the domestic economy. However, taking into account the historical data that indicate the sensitivity of the index, given the low interest of domestic investors and absence of foreign institutional investors, it is still difficult to determine whether this movement of the stock exchange index will continue or it is a temporary move. The total stock exchange turnover decreased by 43% compared to the previous quarter, which is a result of the smaller

Selected stock exchange indices developments
(01.01.2008=100)



Source: National stock exchanges.

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



Source: national stock exchanges.

number of block transactions, while the turnover generated from traditional trading increased by 1.3% on a quarterly basis, given the increased turnover of bonds. Contrary to the MBI-10, the bond index[77] (OMB) registered a minimal reduction of its value of 0.1% at the end of September 2014, compared to the end of June 2014.

During the third quarter of 2014 there was an increased trading on the stock exchanges in the region, which led to an increase in most regional stock indices. Thus, higher value of stock indices was registered on the stock exchanges in Belgrade, Zagreb, Warsaw, Bucharest and Ljubljana. Positive shifts in these indices were partly a reflection of the specific local factors (increased presence of foreign institutional investors, entry of new foreign companies). It is estimated that the new stimulating measures of the ECB also had a positive influence and on that basis also did the expectations for stabilization and acceleration of the global economic activity. Decline in the value of the stock exchange indices was recorded on the stock exchanges in Sofia[78], Budapest and Sarajevo largely influenced by local factors. An additional factor that may have had a certain impact is the situation in Ukraine, as well as the tightening of the trade relations between Russia and the European Union[79].

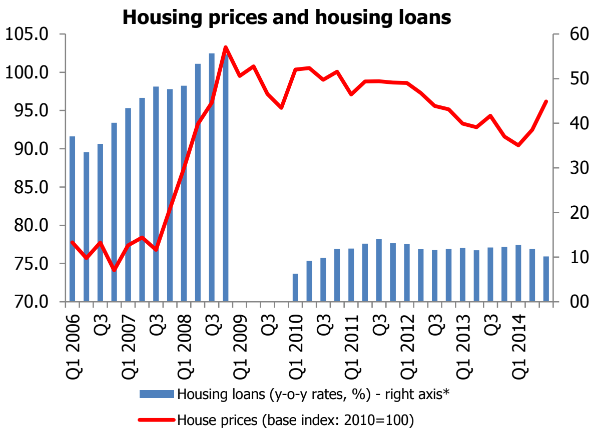
The growth of real estate prices which began in the second quarter, accelerated in the third quarter of 2014. Thus, the house price index [80] has registered accelerated growth of 4% on a quarterly basis (as opposed to the quarterly growth of 2.2% in the previous quarter), and growth of 2% on an annual basis (compared to the annual decline of 0.4% in the second quarter). According to the movement of the relevant indicators of the rise in the house prices corresponds with the continued strong growth of housing loans indicating further

[77] On 22 September 2014, the Stock Exchange Index Commission made an extraordinary revision of the index www.mse.mk/mk/news/22/9/2014/extraordinary-revision-of-mse-index-of-bonds-omb1

[78] The fall of the stock exchange index in Sofia at the end of the quarter was influenced by the growing reticence of investors for trading before the announced parliamentary elections in early October.

[79] Weekly reports of Raiffeisen Research (Raiffeisenbank Austria dd Zagreb) and weekly reports of individual stock exchanges.

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



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

strengthening of the demand for apartments. In view of the supply of apartments, the data point to its accelerated growth in recent years. Namely, the cumulative value of residential buildings constructed in the period 2011-2014[81] was by 61% higher than the value in the period 2007-2010. Data for approvals for construction of high rise buildings show similar dynamics. In summary, the indicators point to a continuous increase in the supply of real estate in recent years. Taking into account the movements between real estate prices and their determinants it is difficult to determine whether the prices will continue to rise in the third quarter of the year, or this is a temporary move. The correlation between the state of the economy, i.e. the changes in the economic cycle and the changes in house prices is analyzed in detail in **Боџ 10.**

V. Macroeconomic forecasts and risks

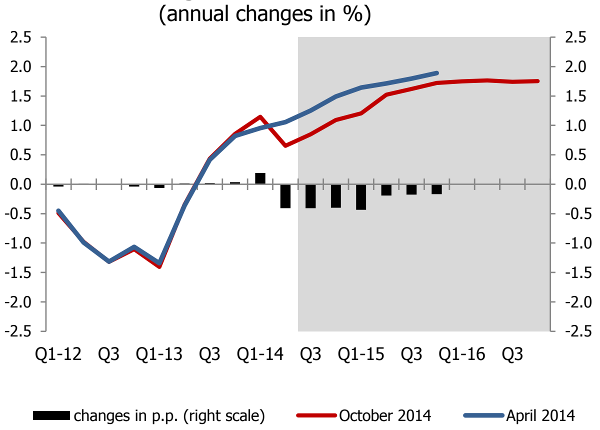
The achieved economic growth in the first half of the year was somewhat more dynamic compared with the April projection, which combined with the assessments for the future movement of the key factors of growth still indicates ***retention of the previous assessment for GDP growth of 3.7% in 2014. In 2015 and 2016, economic growth is expected to accelerate further to 4.1% and 4.5%, respectively. The growth for 2015 is slightly slower than previously expected (4.4%), as a consequence of the new projection for slower recovery of external demand.*** *Within this cycle of projections there are no major changes in the assessments for the major factors that will support the solid growth rates of the domestic economy. Greater capacity utilization of existing foreign investors, the entry of new investors and the fiscal impetus, which, according to the mid-term fiscal plan is expected to be present also in the next period, will further stimulate exports and investment. These factors are reflected positively on both the labor market and the expectations of consumers, whereby private consumption is expected to continue to grow and have a solid positive contribution to growth also in the coming two years. The gradual recovery of foreign demand will be an additional positive impetus for growth. In 2014, the current account deficit is estimated at 2.7% of GDP, which is less compared to the April projections (4% of GDP).* ***Despite the improved exports, it is expected that the growing import demand and declining share of secondary income in GDP will increase the current account deficit to 3.9% and 4.6% in 2015 and 2016, respectively.*** *In the financial account, debt and non-debt flows are still expected,* ***with the foreign reserves being maintained at an adequate level.*** *In circumstances of lower inflation and assessments for smaller pressures on import prices than expected earlier,* ***the latest estimates for inflation indicate an average change in the prices of about 0% and 1% in 2014 and 2015, respectively (about 1% and 2% in the previous projection).*** *Moderate acceleration of inflation will continue also in 2016, when it is expected to be around 2%, given the stabilization of import prices and increased price pressures from demand.*

[81] Data are as of the second quarter of 2014.

5.1. Assumptions in the external environment forecast[82]

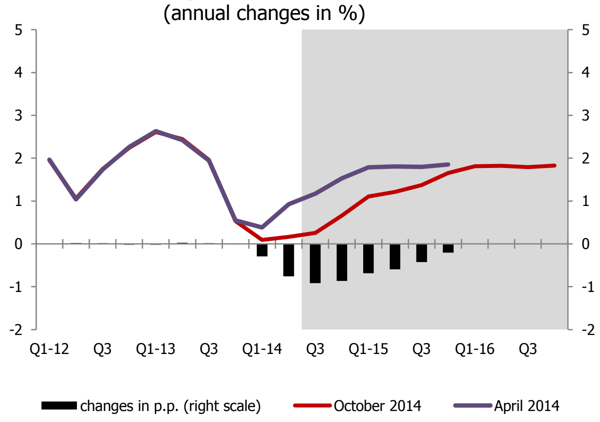
For 2014, a somewhat weaker global economic activity is projected, and certain downward revisions were made also for 2015[83]. The global recovery will continue at a different pace and it is largely expected to be driven by the US economy and emerging economies. On the other hand, less favorable are the expectations for the economy of the euro area, whose recovery is expected to be slow and with different dynamics among countries. Such global economic environment can be assessed as less favorable compared with the April cycle projections.

Foreign effective demand
(annual changes in %)



October estimates of the effective foreign demand for 2014 and 2015 deviate downward when compared with the April projections. So, now it is estimated that foreign GDP growth will be 0.9% in 2014 and 1.5% in 2015, unlike the April growth forecast of 1.2% and 1.8%, respectively. The reasons for these corrections are mostly associated with the downward revisions of the movements of the Serbian, Italian, German and Bulgarian economies in 2014 and 2015. It is expected that the economic activity of our trading partners will continue to gradually recover in 2016, when the growth of foreign demand is expected to reach 1.8%.

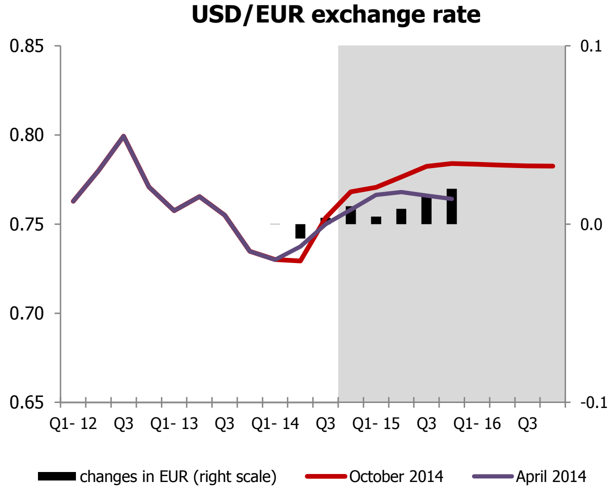
Foreign effective inflation
(annual changes in %)

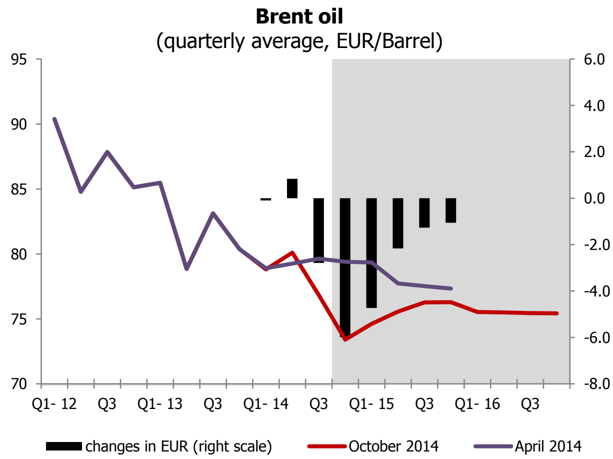


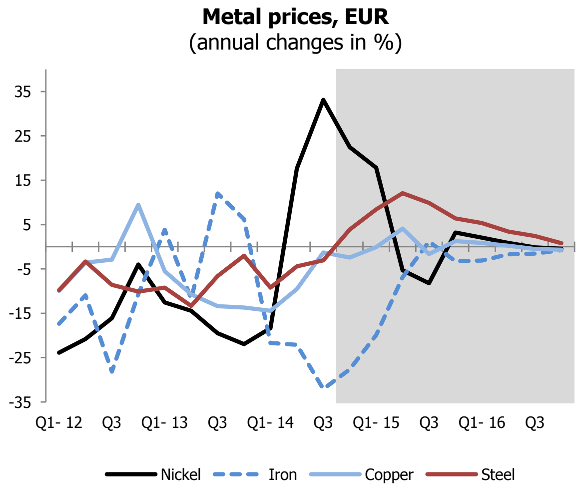
Foreign effective inflation has also been revised downwards compared with the April projections. Thus, as a result of the lower projected inflation with all our import partners, it is now expected that foreign inflation in 2014 will be low and equal 0.3% instead of 1% as expected in April. In 2015, foreign inflation is expected to reach 1.3%, which is also a downward deviation from the April projection of 1.8%. Downward revisions of foreign effective inflation in the next two years are mainly due to the latest expectations about price movements in Bulgaria, Serbia and Germany. Foreign inflation is expected to increase moderately in 2016 and reach 1.8%.

[82] Source of historical data on foreign demand, foreign inflation and exchange rate of the US dollar against the euro includes Eurostat and national statistical offices of the countries, while IMF statistics is a source of these data on the prices of oil, food and metals. Estimates of foreign demand, foreign inflation and foreign exchange rate of the US dollar are based on the Consensus Forecast, while the projections of the prices of oil, food and metals are based on the projections of market analysts.

[83] World Economic Outlook, IMF, October 2014.





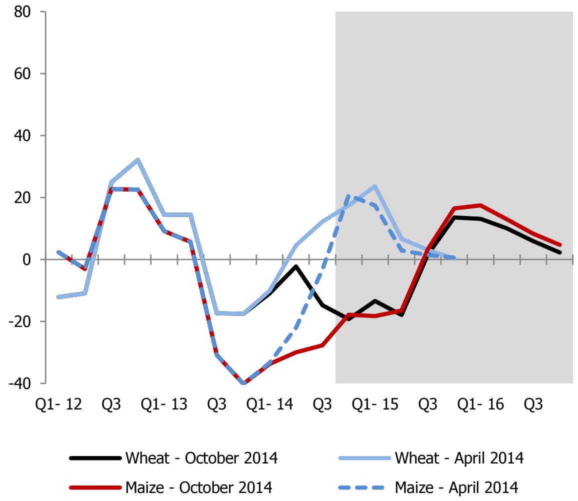


October assessment does not indicate a major change in the expectations for the movement in the US dollar/euro exchange rate in 2014, i.e. it is still expected that the dollar will depreciate moderately by 1% on an annual basis (1.2% in the April projection). Depreciation of the dollar is a result of the performances in the first three quarters, while in the last quarter it is expected to appreciate. Unlike the current year, in 2015 growth of the US currency is expected, which will be higher than the April projection (4.4% versus 3%). This correction is in accordance with the different policies that the Fed and the ECB are expected to continue to implement in 2015, and which mean normalization of the monetary policy in the USA amid still present monetary stimulus in the euro area. The trend of strengthening the value of the US dollar is expected to continue in 2016, when it is expected to appreciate by 0.6%.

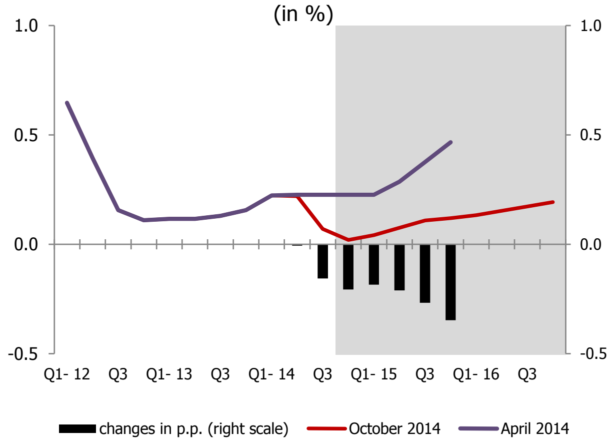
In the third quarter of 2014, a sharper decline in oil prices relative to the April projection was registered, and a significant decline is forecasted also for the fourth quarter, despite the present geopolitical risks in Iraq, Syria and Ukraine. The main factors that will put downward pressure on the price of oil by the end of the year are the high supply, weaker demand and the strong exchange rate of the US dollar. Due to the lower oil prices in the second part of the year, it is estimated that also for the entire 2014 the price decline will be higher than in the April projection. Imbalances between market fundamentals are expected to continue next year amid weaker growth in global oil demand and faster growth in supply, especially in non-OPEC countries. As a result of that, in 2015, a downward revision in the oil price was made, and now it is expected to decline somewhat more than in the April projection. The downward trend in the oil price is expected to be largely exhausted in 2016. In nominal amounts, oil prices are forecasted at Euro 77.3 per barrel in 2014, Euro 75.7 in 2015 and are expected to stabilize near that level in 2016. The risks for oil prices are mostly upward, with the main uncertainty arising from the possible escalation of the tensions in Iraq and the crisis in Ukraine.

As a reflection of the conditions and prospects on the supply side, in the third quarter of 2014, most of the metals registered a price drop, which is still lower than the April projection. The favorable movements in the prices of most metals, which are expected in the fourth quarter, led to upward

Food prices, EUR
(annual changes in %)



1M Euribor
(in %)



revision for the entire year. Less favorable are only the expectations for the price of iron, which will register sharper than anticipated decline. Compared to other metals, now faster growth in the price of nickel is projected, given the stronger effects of the ban on exports introduced by Indonesia earlier this year, and lower drop in the price of copper, given the certain reduction in inventories. On the other hand, the price of steel would register a decline that is essentially at the level of the April projection. In 2015, a downward revision in the price of nickel and copper was made and they are now expected to achieve lower growth than projected in April, while the prices of iron and steel are revised upward given the faster price growth of steel and lower drop in the price of iron. The positive trend in the global metals market is expected to continue in 2016, when moderate increase in the prices of most metals is expected. Risks regarding metal prices are assessed as balanced, given the current surplus on the supply side and the adequate stocks.

Compared with the April projection, in the third quarter of 2014, the prices of wheat registered a significant decline versus the projected growth, while corn prices fell more than expected. Given that the reduction of prices in the global market of primary food products is expected to last until 2015, the current projection for this and the next year significantly deviates from the April expectations. Thus now, for 2014, growth rather than decline in the price of wheat is expected, as well as twice sharper decline in the price of corn and a decline rather than increase in the prices of these products is projected for 2015. This correction is made in circumstances of higher yields of wheat and corn from the current harvest, increased inventories and improved prospects for future production. On the other hand, prices of wheat and corn are expected to follow an upward path during 2016.

After the increase at the end of the last and the beginning of this year, in the third quarter, **foreign interest rate Euribor**[84] decreased significantly, which was entirely due to the assumed new standard and non-standard measures for monetary easing undertaken by the ECB in this period. As a result, for 2014 it is estimated that the short-term interest rate will be lower than that expected in April. Given that the

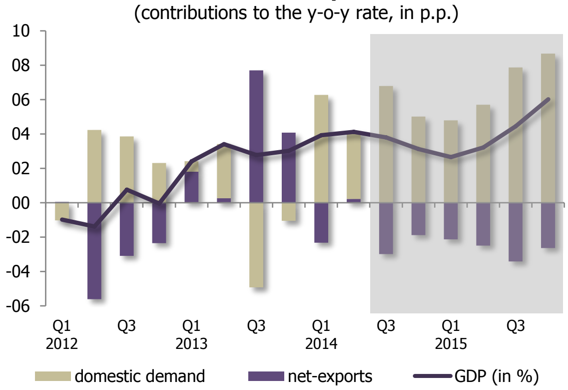
[84] Historical data were taken from Eurostat. Source for the projections is Consensus Forecast.

accommodative monetary policy of the ECB will continue in 2015, when it should produce the largest effects, estimates are that next year the 1-month Euribor will reach historic lows which will significantly deviate from the April projection. It is estimated that the foreign interest rate will be low also in 2016, with a tendency of gradual normalization.

5.2. Forecast and effects on monetary policy

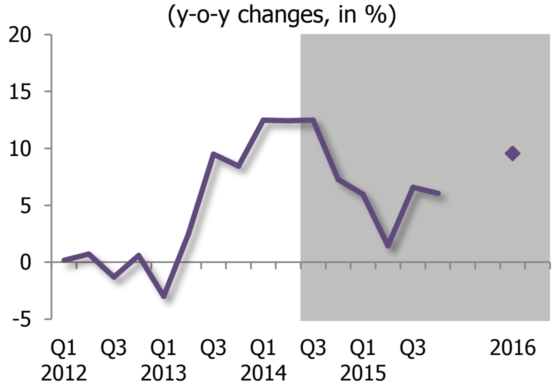
The latest projections indicate absence of major changes in the monetary policy setup. The new estimates for the external sector also show room for growth of foreign reserves in the next period and their maintenance at an appropriate level. Although it is expected that in the forthcoming period the stronger demand in the economy will create import pressures, they are not expected to cause major external imbalances. Also, it is estimated that the increasing utilization of the potential of new facilities with foreign capital will, to some extent, mitigate the effects on imports caused by the growth of exports and by the growing investment and private consumption. For the next two-year period, borrowings and direct investment are expected to be the key sources of funding the needs for external financing, in a volume sufficient for further maintaining of foreign reserves at an adequate level. **In light of the foreign interest, as an important factor for the domestic monetary policy, there are no major changes in this projection either.** Amid continues low inflation in the euro area and retained accommodative monetary policy by the ECB, it is expected that the interest rate EURIBOR will remain well below the historical average, with minimal growth in the future, which is similar to the April assessments. **The risks to the baseline macroeconomic scenario are moderately negative.** Amid still present uncertainty about the global recovery and continued downward revisions of foreign effective demand, there are risks to the external position of the economy. Moreover, it is estimated that the consequences of their potential materialization can spill over the domestic economy through several channels. These risks point to the need for continuous monitoring of possible changes in the external and domestic economic conditions in the future and taking prompt and appropriate measures.

Growth decomposition
(contributions to the y-o-y rate, in p.p.)



In the first half of 2014, the trend of accelerating economic activity, which started during 2013, continued. The main determinants of these movements in the first half of 2014 were the accelerated growth in exports and private consumption, as well as the positive trends in the investment activity. Based on available data, it is estimated that solid GDP growth rates will continue in the second half of 2014. Therefore, **it is estimated that the economic growth will equal 3.7% in 2014, and will further accelerate in the next two years, to 4.1% in 2015 and 4.5% in 2016.**

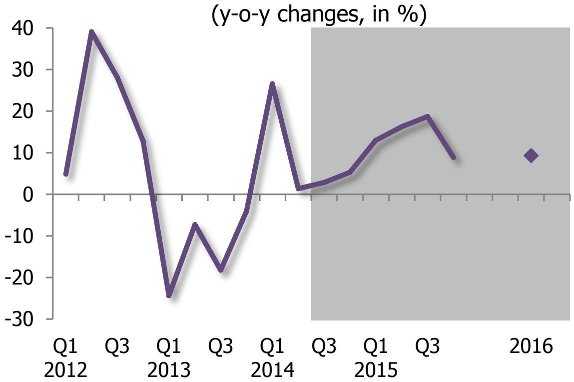
Exports of goods and services
(y-o-y changes, in %)



During 2014 relatively high rates of growth of real exports of goods and services were registered. Amid slow recovery of foreign demand, export growth largely reflects the structural changes in the export sector and the increased utilization of production capacities in technological and industrial development zones. The continuation of these trends, combined with the planned start-up of new production facilities, as well as the expected moderate recovery of foreign demand, will contribute to **further growth of real exports in 2015 and especially in 2016, which will make it an important individual factor of overall economic growth in these two years.**

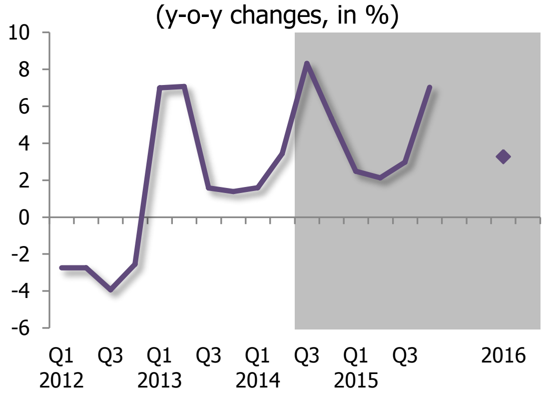
Economic growth in 2014 is a reflection of the positive changes in all components of domestic demand, contrary to the negative contribution of net exports. It is expected that in the second half of the year, **further acceleration of the growth of private consumption** on an annual basis will be registered. Despite the relatively low comparison base, the growth of household consumption in 2014 is explained by the continued favorable developments in all income components, and the continued bank lending to the household sector. Furthermore, **gross investments also have a positive influence** on the economic growth in 2014. However, after the fast growth in the first quarter, investment activity registered relatively low growth rates in the rest of the year, primarily reflecting the less favorable movements in construction activity, which are assessed to be temporary.

Gross capital formation
(y-o-y changes, in %)

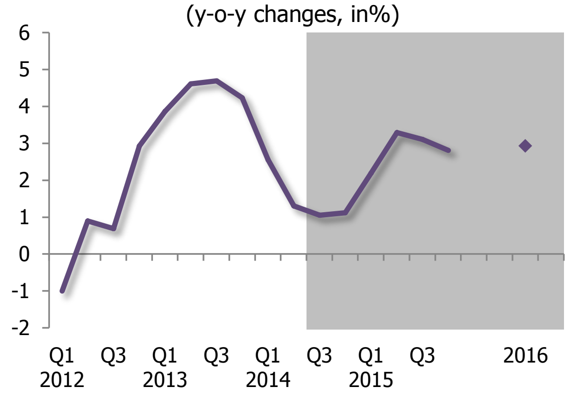


In 2015, positive contribution of domestic demand in the economic growth is expected, with significantly more intensive investment activity and further growth of private consumption. In conditions of high utilization of production capacities in technological and industrial development zones, steady inflow of foreign capital and relatively favorable expectations among enterprises, intensification of private investments in the coming year is

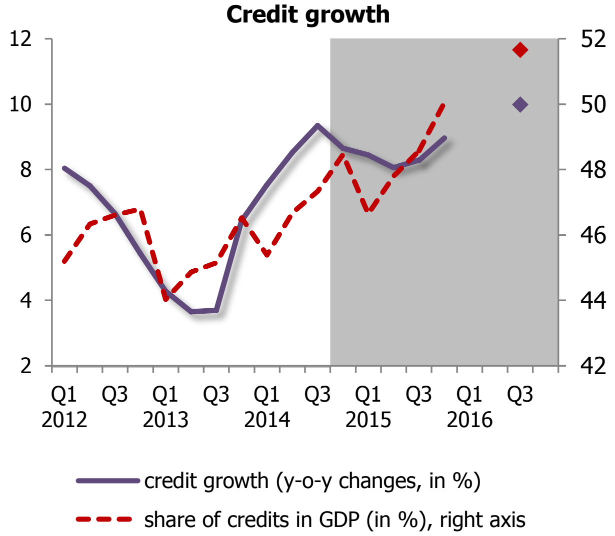
Private consumption
(y-o-y changes, in %)



Employed persons
(y-o-y changes, in%)



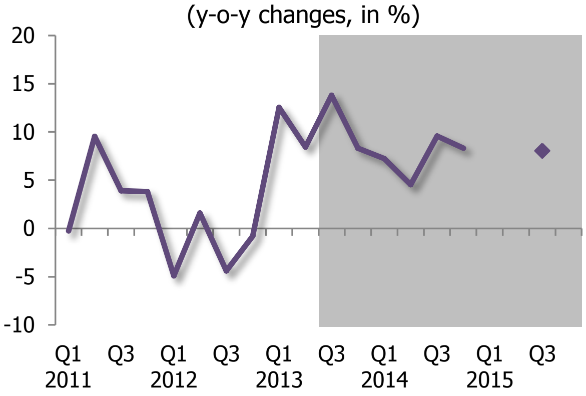
Credit growth



expected. In addition, a significant contribution to the growth of investment, and thus the overall economic growth in 2015 is expected from the announced government capital investment, particularly from the intensification of investment in road infrastructure. Therefore, investment activity will reflected primarily the factors related to the domestic economy, contrary to the anemic recovery in global demand. Furthermore, despite the moderately lower growth rates compared to 2014, **further positive contribution of private consumption on economic growth in 2015 is expected.** Growth in household consumption will primarily reflect the growth of the wage bill. Namely, growth of the employment in the private sector is expected as a result of the more intensive economic activity. An additional effect is expected from the relatively low, but steady growth in real wages, in circumstances of announced growth in public sector wages and expected wage growth in the private sector as a result of the more intensive economic activity. Besides the movements in the labor market, positive contribution to the growth of household consumption is also expected from the growth of pensions. Also, the growth of private consumption will continue to be supported by lending by banks, which are expected to continue to allocate a portion of their loans to the household sector. **The growth of domestic demand will continue during 2016,** amid moderately lower rates of growth in private consumption and gross investment, compared with 2015. The higher investment activity is expected to reflect the investment in new production facilities with foreign capital, government capital investments in road infrastructure, as well as the accelerated growth in export demand. These factors will also result in increased employment and wages, which will affect the further increase in household consumption. It is also expected that during 2015 and 2016 growth rates of public consumption will accelerate moderately, whereby it will have a positive but relatively small contribution to the GDP growth.

Continuously positive rates of economic growth and stabilization of perceptions of risk are expected to contribute to the continuation of a solid credit growth in the forthcoming period. Namely, it is estimated that credit growth in 2014 will be 8.7%, and over the next two years further acceleration of the credit dynamics is expected (about 9% and 10%, respectively). The expected credit growth reflects the positive signals on both the supply and the demand side. Namely, the realized and expected growth of the components of domestic demand will contribute to a stable demand for loans, amid growth in household consumption and investment activity. On the supply side, the continued growth of the deposit base, as well as the banks' stable risk perceptions are expected to give a positive contribution. In addition, standard and non-standard measures undertaken by the NBRM so far are still expected to produce favorable effects on the credit activity. As for the deposit potential, **it is estimated that by the end of 2014, the growth of deposits in the banking system will continue, and at the end of the year it will be 8.8%.** The expected acceleration of economic growth is estimated to lead to further growth of the deposit base at relatively high rates of around 9% and 10% in the next two years.

Imports of goods and services
(y-o-y changes, in %)



Real imports of goods and services registered a significant growth during 2014, primarily as a result of the export demand, as well as the components of domestic demand. Also in the next two years relatively high rates of growth of real imports are expected, amid steady growth in exports and private consumption, as well as accelerated growth of investment activity. As a result of these developments, **the contribution of net exports on growth will be negative over the whole period, but relatively lower in 2016.**

Balance of Payment Forecast (% of GDP)

	2011	2012	2013	2014	2015	2016
Current account	**-2.5**	**-2.9**	**-1.8**	**-2.7**	**-3.9**	**-4.6**
Balance of goods & services	-20.5	-22.4	-18.5	-18.8	-18.6	-18.4
Goods, net	-25.2	-26.5	-22.9	-23.2	-23.5	-24.0
Services, net	4.8	4.1	4.4	4.3	4.9	5.6
Primary income, net	-1.7	-1.9	-2.6	-2.5	-2.9	-3.1
Secondary income, net	19.7	21.4	19.3	18.6	17.5	16.8
Private sector, net	18.7	20.6	18.3	17.7	16.9	16.1
Capital account	**0.0**	**0.1**	**0.2**	**0.0**	**0.0**	**0.0**
Financial account	**-6.8**	**-4.5**	**-0.9**	**-6.9**	**-2.1**	**-6.2**
FDI, net	-4.6	-1.5	-3.3	-3.6	-3.8	-4.0
Portfolio Investment, net	1.0	-1.0	2.0	-5.6	1.6	-0.1
Other Investment, net	-3.2	-1.9	0.4	2.3	0.1	-2.1

According to recent assessments, in 2014, the current account deficit is expected to be 2.7% of GDP, which represents an annual increase of 0.9 percentage points of GDP. Widening of the deficit in the current transactions stems from the reduced surplus in the secondary income and widening of the deficit in the foreign trade in goods and services. Namely, despite higher expected export activity, especially of the new industrial capacities, the more intensive import of raw materials for export contributed to the expansion of the estimated deficit in the balance of goods and services to 18.8% of GDP, compared to 18.5% of GDP in 2013. **In 2015, the** trade deficit in goods and services is expected to stabilize and equal 18.6% of GDP. An important part of this deficit will continue to be funded by the secondary income, which is still expected to remain at a relatively high level. Regarding the dynamics, it is expected to gradually reduce its share in GDP, which will further contribute to the deterioration of the current account deficit. **Such shifts in 2015 are expected to result in a current account deficit of 3.9% of GDP. The current account deficit is expected to be further expanded in 2016 and reach 4.6% of**

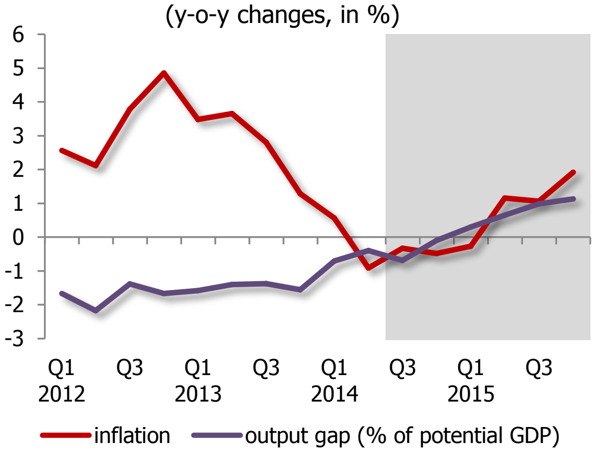
GDP. The higher negative gap, amid a relatively stable deficit in the trade in goods and services is due to the continued reduction of the surplus in the secondary income. In the medium term, narrowing of the current account deficit is expected, as a positive effect of the rising value added of foreign investments.

In the period 2014-2016, current account is expected to be mostly funded by the long term external borrowing of the public sector[85] **and by foreign direct investment.** Direct investments are expected to grow gradually, from 3.6% of GDP in 2014 to 3.8% of GDP in 2015 and to reach a level of 4% of GDP in 2016. In forthcoming period **main risks** to the external position of the economy come from the pace of the global recovery; thus the domestic economic growth and its impact on the perceptions of investors.

In the period 2014-2016, it is expected that the financial flows higher than the current account deficit will lead to accumulation of foreign reserves. During the entire period of projections foreign reserves adequacy indicators are maintained in a safe zone.

Inflation

(y-o-y changes, in %)



In 2014, the inflation rate is expected to be around 0%. The unchanged average price level compared to the previous year reflects the negative changes in the prices of energy and food, amid a relatively small increase in core inflation. **In 2015, gradual increment in the price level and inflation of around 1% is expected.** The growth of prices in the next year will primarily reflect the price changes of food products and to a lesser extent the effects of the further growth of domestic demand. On the other hand, it is expected that in 2015 energy prices will have an adverse impact on the overall rate of inflation[86], assuming the absence of a possible rise in the regulated price of electricity. The risks to the projected path of inflation in 2015 are related to the uncertainty about the global economy and the movements in the global prices of primary products. **It is expected that the gradual acceleration of the rate of inflation will continue during 2016, when it is expected to be about 2%.**

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[85] In 2014, the Government issued the third Eurobond in the amount of Euro 500 million and borrowed from the World Bank through the Programmatic Competitiveness Development Policy Loan (DPL) in the amount of Euro 36.7 million.

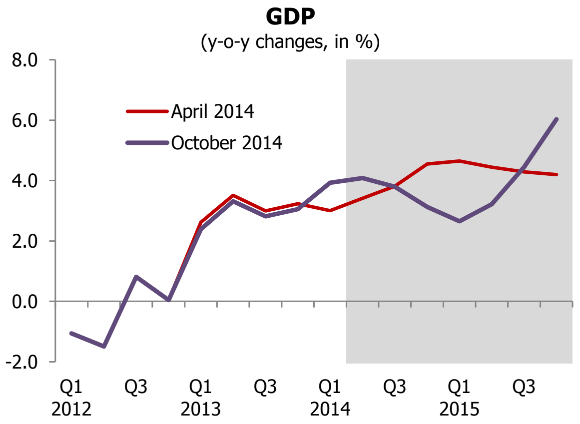
[86] The estimated effect on the average annual inflation of the possible increase in the price of electricity of 10% in mid-2015, would be 0.4 percentage points.

5.3. Comparison with the previous forecast

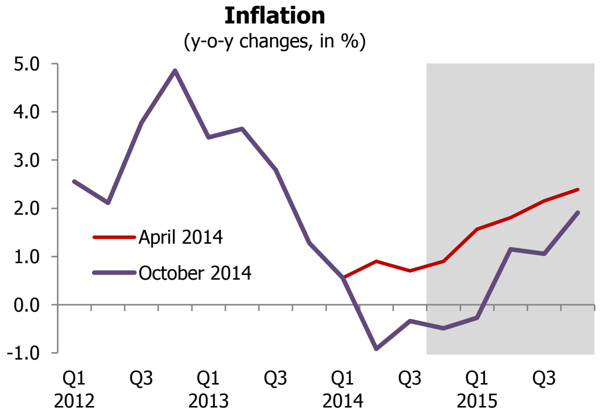
Forecast of selected macroeconomic variables

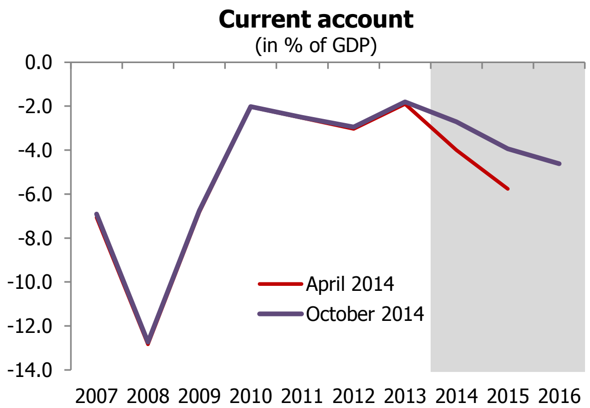
annual rates of change (in %)	2014 forecast		2015 forecast		2016 for.
	Apr.	**Oct.**	**Apr.**	**Oct.**	**Oct.**
GDP	**3.7**	**3.7**	**4.4**	**4.1**	**4.5**
Private consumption	2.6	4.5	4.0	3.6	3.3
Gross capital formation	14.6	7.6	9.7	14.2	9.3
Public consumption	0.5	0.5	1.0	1.2	1.4
Exports of goods and services	13.1	11.1	8.2	5.0	9.6
Imports of goods and services	12.6	10.6	8.1	7.4	8.0
Inflation	**1.0**	**0.0**	**2.0**	**1.0**	**2.1**
Current account deficit (% of GDP)	**-4.0**	**-2.7**	**-5.8**	**-3.9**	**-4.6**

The forecast for the growth of the domestic economy in 2014 is unchanged, while the projection for 2015 was moderately revised downward compared with the April assessments. Regarding the movement of prices, the latest assessments suggest a lower rates of inflation in 2014 and 2015. In this series of projections, assessments point to smaller current account deficit in 2014 and 2015. Also, the assessments for growth of capital inflows over the next two years are still valid. Their aggregate share in GDP in the period of projections (2014-2015) is somewhat lower compared with the April assessments, and with change in time allocation.



Despite the less favorable external environment, **the estimated GDP growth of 3.7% in 2014 is unchanged in comparison with the April projection,** due to the better performance in the first part of the year and the expectations about the influence of the domestic economic factors by the end of the year. Regarding the expenditure approach to GDP, there were no changes in the components that will drive growth. Thus, domestic demand is still expected to be the main driver of economic activity, but its positive contribution will be slightly lower than expected in April. This is primarily due to the lower contribution of gross investments, whose growth rate is expected to be significantly lower than the April projection. In contrast, a more significant upward revision was made in the projection of growth of private consumption, largely reflecting the performances in the first half of 2014. On the other hand, no changes were made in the growth in public consumption. Net exports are still expected to have a negative contribution to growth, but they will be slightly lower than estimated in April. **Expectations for less stimulating external environment will affect the economic growth in 2015, which led to its downward revision from 4.4% to 4.1%.** The slower growth in external demand is generally expected to be reflected in lower export growth, which consequently would result in more negative contribution of net exports to GDP growth. On the contrary, the domestic demand is expected to remain resistant and make a higher positive contribution to growth. This expectation is based primarily on the positive changes in gross investment, which, unlike the estimates in April, will be the main generator of growth of domestic demand. On the other hand, private consumption will grow at a moderately slower pace than





previously projected. Minimal upward revision is made also to the growth of public consumption.

In the three quarters of 2014, inflation was significantly lower than projected in April, amid downward variations in all three components. Lower performances so far, in circumstances of greater downward pressures from the stock exchange prices of primary products and foreign inflation resulted in **downward revisions of inflation in the domestic economy in the period 2014-2015, compared to the April projections.** Thus, it is now forecasted that in 2014, consumer prices will be at the level of 2013 (inflation of about 0%), unlike the April assessment for the inflation of 1%, while in 2015, inflation is expected to be around 1%, versus the 2% expected in April.

According to recent estimates, the current account deficit is expected to improve relative to the April cycle of projections. **By the end of 2014, it is expected that the deficit will be 2.7% of GDP, instead of the previously expected 4% of GDP.** Downward adjustments in the balance of current transactions arises from the smaller deficit in goods and services, amid lower import pressures than expected. On the other hand, the smaller surplus in secondary income and the higher negative gap in primary income act in the opposite direction. **In 2015, the current account deficit is expected to reach 3.9% of GDP, compared with 5.8% of GDP according to the April projection.** The smaller deficit in current transactions is again a consequence of the lower deficit in goods and services, in circumstances of lower surplus in secondary income and unchanged position of the primary income deficit. As for the secondary income for the two years, despite the nominally higher surplus, the relative share of this category in GDP is lower than previous expectations.

Regarding the financial flows, cumulatively in 2014 and 2015, lower inflows compared to the April projection are expected. Despite expectations for higher net external government borrowing, the downward revision of the financial account for the two years is based on the smaller borrowing of the private sector, direct investment and less favorable movements in short-term capital flows (currency and deposits), which given their volatility and uncertainty, are difficult to assess. Despite the less favorable expectations for the financial account, the assessment for the improvement in the current account indicates expected faster growth of foreign reserves in the period 2014-2015, in comparison with the accumulation expected with the April projections.

Comparison of GDP and inflation forecasts for Macedonia from various organisations

Organisation	Month of publication	Real GDP growth, %			Inflation (average rate, %)		
		2014	2015	2016	2014	2015	2016
IMF	October 2014	3.4	3.6	3.9	1.0	1.5	2.3
World Bank	June 2014	3.0	3.5	3.7	-	-	-
European Commission	November 2014	3.3	3.4	3.6	0.7	1.2	1.7
EBRD	September 2014	3.0	3.0	-	1.5	-	-
Consensus Forecast	October 2014	3.1	3.6	-	1.0	2.3	-
National Bank of Greece	October 2014	3.4	3.6	-	-	-	-
Ministry of Finance of the Rep. of Macedonia	October 2014	3.5	4.0	4.2	1.0	2.0	2.2
National Bank of the Republic of Macedonia	October 2014	3.7	4.1	4.5	0.0	1.0	2.1

Source: IMF World Economic Outlook, October 2014; World Bank Global Economic Prospects, June 2014; European Commission European economic forecast - autumn 2014; EBRD Regional Economic Prospects, September 2014; Consensus Forecast, October 2014; NBG Southeastern Europe and Mediterranean Emerging Market Economies, October 2014; Ministry of Finance of the Republic of Macedonia, Indicators and Projections and Fiscal Strategy 2015-2017, October 2014; and the National Bank of the Republic of Macedonia.

VI. Analytical appendices

Box 6: Analysis of the changes in the unemployment rate with special reference to unemployment among young people

In recent years, certain positive shifts have been registered on the Macedonian labor market. Since 2006, when it was 36%, the overall unemployment rate has been falling steadily, and reached 28.2% in the second quarter of 2014. This trend coincides with the general improvement of the macroeconomic environment, the growth of economic activity and production (excluding 2009 and 2012). New capacities in the technological-industrial development zones, whose production has intensified in recent years, also had a positive effect in terms of increasing the number of jobs and stimulating the demand for labor in the country. The downward trend in unemployment was further supported by the active employment measures and programs of the Government.

Despite these favorable developments, however, the labor market is further characterized by high unemployment, low participation rate[87], low employment rate and unfavorable structural features. Thus, most of the unemployment in Macedonia is mostly of a long-term character, i.e. over 80% of the unemployed in Macedonia are looking for a job for over a year (Chart 1). This structural feature of the Macedonian labor market is partly explained by the early transition period, when a number of manufacturing facilities were closed and there were massive layoffs[88]. On the other hand, the share of long-term unemployment remains high also in 2013, more than two decades since the start of the transition process. This feature indicates a strong hysteresis effect[89] of the Macedonian labor market. In terms of the age structure, unemployment is the highest among young population where unemployment rates were above 40% (Chart 2). Youth unemployment, as well as overall unemployment in the country, is mostly long-term - for the period 2000-2013, an average of 77% of the unemployed young people aged 15-29 were looking for a job for more than a year, of which nearly 60% have been unemployed for four years or more.

Chart 1 Unemployment structure (in%)

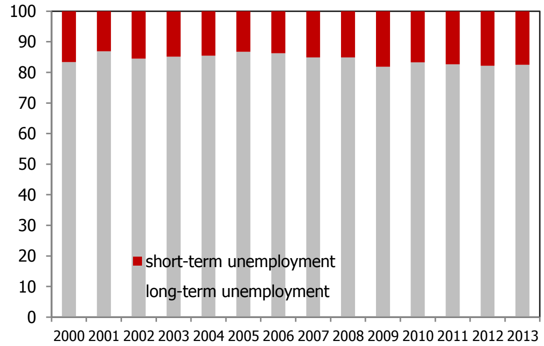
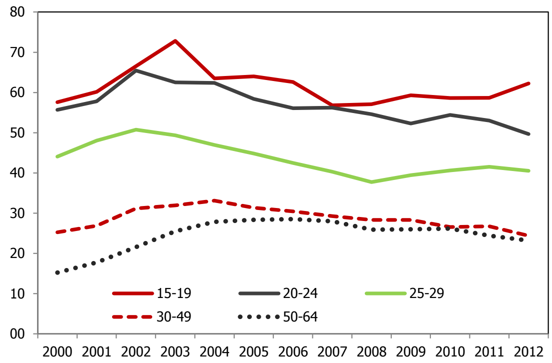


Chart 2 Unemployment rate by age group (in%)



Source: State Statistical Office.

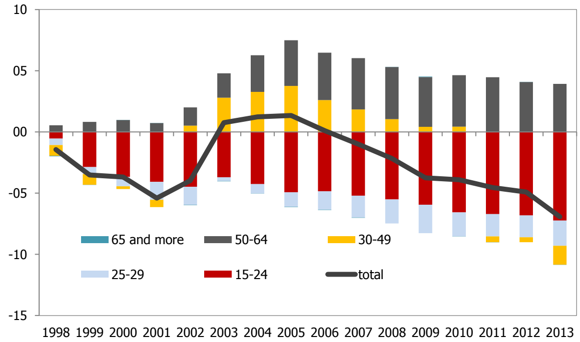
[87] According to Eurostat, in 2013, the participation rate of the population aged 15-64 in Macedonia was 64.9%, while in the European Union the rate was 72% for the same period.

[88] Quarterly Report of the NBRM, December 2006, Annex 4 "Long-term component of unemployment in the Republic of Macedonia".

[89] The notion of hysteresis in the economic science refers to a situation when a particular historical event has a lasting impact on the movement of economic variables. When it comes to the labor market, the effect of hysteresis usually refers to a permanent increase in the "natural rate of unemployment" as a result of a specific event, which further results in long periods of high unemployment.

This Box includes an analysis of the movement of the overall unemployment rate in terms of the shifts that have occurred in different age groups in order to determine the contributions of each group to the changes in the aggregate level. Special attention is paid to the movements in the young population[90], a group that, as can be seen from Chart 3, has a dominant contribution to the decline in the overall rate of unemployment versus 1997. The significant contribution of this age group is a result of two factors - the decline in the share of young people in the total workforce and reduced rate of youth unemployment[91]. The share of persons aged 15-29 in the total workforce in the Republic of Macedonia was reduced from 30.9% in 1997 to 23.7% in 2013, i.e. by 7 percentage points. The unemployment rate among this population in the same period fell by almost 20 percentage points, i.e. from 65.1% in 1997 it reached 45.5% in 2013.

Chart 3 Unemployment rate
(cumulative change compared to 1997 in % and contributions in p.p.)



Source: SSO and NBRM calculations.

Some of the positive changes in the young population which are due to the lower share of this age group can be explained by the change in the preferences of this category of people, in terms of continuing education at the expense of inclusion in the labor force. Namely, the probability of finding a better paid job is in direct correlation with the level of person's education. In recent years, in Macedonia , simultaneously with the decline in the share of young people in the workforce, there is a trend of increase in the share of this age group in the education system. Thus, in the period 2006-2013, the share in the formal and informal education system has increased by 22 percentage points with the group of 15 to 19 years of age, by 12.2 percentage points with the group of 20-24 years of age and by 5.3 percentage points with the group of 25-29 years of age[92]. Some of the structural government measures like the introduction of compulsory secondary education, dispersed studies, the reduction of financial expenses for higher education and so on, have probably had certain effect in terms of encouraging greater inclusion in the educational system.

Beside the decline in the share of young population in the labor market, at the same time there is a decline in unemployment and growth in employment with this age

[90] The term young population in this Appendix denotes the population aged between 15 and 29. This is consistent with the definition used within the report "Research on the transition from school to work" (Sarah Elder, Blagica Novkovska and Violeta Kristeva, "Research on the transition from school to work", International Labour Office, Geneva, July 2013).

[91] The total unemployment rate (U_t) is equal to the weighted sum of the unemployment rates (u_t) in different age groups (i), with weights equal to the shares of each age group in the total labor force (w_t).

$$U_t = \sum_i w_t(i) * u_t(i)$$

Hence, changes in the overall rate of unemployment result from the changes in the shares and/or changes in unemployment rates of different age groups.

[92] Source: Eurostat.

group. Part of the decrease in the rate of unemployment among young people could be related to the improved general situation on the labor market in recent years. **However, youth unemployment in the Republic of Macedonia still remains at a relatively high level.** In 2013, the unemployment rate among the population aged 15-24 in Macedonia was 52%, while in the European Union during the same period it was more than twice lower, equalling 24%[93]. An additional problem is its long-term character, which has negative economic and social consequences for the young people.

High youth unemployment entails high economic and social costs. From an economic perspective, youth unemployment is associated with slower growth in the economic activity in the future, growth of employment in the informal sector, higher costs for state contributions for unemployment, lower tax revenues, etc. In addition, youth unemployment, particularly if it is long-term as is the case in Macedonia, can lead to loss of self-esteem among young people, discouragement regarding further active participation in the labor market, and ultimately to an increase in crime and social unrest in the country. This implies the need for an active approach of the policy makers to solve this problem. In this regard, in 2012 the **National Action Plan on youth employment[94]** was adopted, which is fully compatible with the National Employment Strategy[95]. The Action Plan is focused on improving the opportunities for finding better jobs and social inclusion of young people, and within the Plan, four specific objectives have been defined: strengthening the labor market management (for young people), improvement of the employment opportunities for young people, promotion of youth employment through private sector development and ensuring inclusion of disadvantaged youth in the labor market through targeted measures for the labor market. Also, some of the active measures and policies of the Government in the form of programs for self-employment support, subsidized employment, organizing training and internship programs[96] are aimed at reducing unemployment among young people.

The problem associated with high youth unemployment, as outlined at the annual conference of the International Labour Organization (ILO) from 2012, is spread globally. According to ILO, the problem became even more pronounced after the global economic crisis - it is estimated that worldwide, four out of every ten young people are unemployed. Solving this problem requires an active approach of the macroeconomic policies in order to increase aggregate demand and facilitate the access to finance, coupled with specifically designed policies of education and training that will ease the transition from school to work and policies aimed at employment of disadvantaged young people, stimulation of entrepreneurship and self-employment and protection of workers' rights in accordance with international standards[97]. Activities of a similar character are implemented also in Macedonia, but it will take some time to assess the effectiveness of the measures taken. Taking into account the long-term negative effects that high youth unemployment can have on the overall economic environment in the country, the efficient solving of this structural problem is an important prerequisite for ensuring stable economic growth of good quality.

[93] The comparison is made only for the population under the age of 24 because of the availability of data.
[94] "Action Plan for youth employment 2015", Government of the Republic of Macedonia and the Ministry of Labor and Social Policy, Skopje 2012.
[95] "National Employment Strategy of the Republic of Macedonia 2015", Government of the Republic of Macedonia and the Ministry of Labor and Social Policy, Skopje, August 2011.
[96] Breakdown of active measures and employment policies can be found within the Annex "Review of active employment programs and measures in the Republic of Macedonia", Quarterly Report of the NBRM, January 2014.
[97] International Labour Office (ILO), 2012, "The youth employment crisis:Time for action", Report of the Director-General, International Labour Conference, 101st Session (Geneva).

Box 7: Sensitivity of the prices of certain products to changes in economic activity

According to the New Keynesian model, monetary policy affects inflation indirectly, or through its impact on economic activity. In particular, the interest rate of the central bank influences the output gap, through the IS curve, and then the output gap affects inflation through the Phillips curve[98]. Hence, identifying the link between economic activity and inflation is of great importance for the monetary authorities.

However, one should bear in mind that the effect of the changes in the economic activity on inflation may be different for different groups of products. In other words, the elasticity of the individual components of inflation to changes in demand may vary, and thus the effects of monetary policy changes on individual prices will be different. Thus, availability of more information on these links is useful for the monetary policy makers. They would help to adjust the monetary responses, according to the sources/causes for the changes in inflation. Precisely for this reason, in this Box an initial and simple attempt was made for assessment of the Phillips curve for individual components of inflation, at the level of disaggregation of 1 digit of the COICOP classification. Specifically, the equation that we evaluate is a new Keynesian Phillips curve, of the following type:

$$\pi_{ti} = \alpha_1 + \alpha_2 * E\pi_{ti+1} + \alpha_3 * y_{t-1} + \alpha_4 * \pi_t^{EU} + \alpha_5 * oil_{t-1} + u_t \quad (1)$$

where π indicates inflation, $E\pi$ expected inflation, y denotes the output gap, π^{EU} the inflation in the EU, *oil* - oil price, indices *t, t-1, t+1*, denote the time period (current, previous and future quarter), *i* refers to the individual product groups within the consumer price index, α are coefficients and u is the error (i.e., all other factors affecting inflation).

Inflation, according to equation (1) is explained by the movements in expected inflation (i.e. changes in the prices of individual components of the consumer price index in our case), the output gap, foreign inflation and oil price. Indicator of expected inflation is the inflation movement in the next quarter i.e. rational expectations are assumed[99]. The analysis was made by using quarterly data for the period 1997-2013. For evaluation of the equation two techniques were applied - the method of least squares (OLS) and generalized method of moments (GMM)[100]. Two lags were used as instruments for the endogenous variables (output gap and expected inflation) in the GMM estimation. As instruments for the exogenous variables (price of oil and inflation in the EU), the variables themselves were used, i.e. their past values. Some results of the econometric analysis are shown in Table 1[101].

[98] It should be emphasized that in reality this is not the only channel through which monetary policy can affect inflation.

[99] In the version with adaptive expectations, i.e. with past value of inflation, expected inflation was statistically insignificant at 10%.

[100] The advantage of the GMM method is that it corrects the problem of endogeneity (i.e. the possibility the inflation, too, to affect the output gap, as well as the possibility certain variables to be omitted from the analysis), due to which the results obtained with this method are more reliable. On the other hand, the use of the GMM method involves using a large sample (for example, more than 300 observations), while the sample used in the analysis is relatively small (50-60 observations).

[101] Considering the focus of the analysis - the impact of the production gap on inflation in Table 1, only these coefficients are presented.

Table 1 - Coefficients of the output gap of the regressions by individual components

Component of the consumer price index	Share of the components in the total index	Coefficient of the OLS estimation	Coefficient of the GMM estimation
1 food	0.39	**0.18****	**0.28*****
21 beverages	0.03	**0.08***	**0.19****
5 hygiene and health	0.09	0.08	**0.33****
8 restaurants and hotels	0.06	**0.17*****	**0.28*****
4 housing	0.16	**0.21*****	0.22
7 transportation means and services	0.13	**0.25***	-0.28
3 clothing and footwear	0.07	-0.01	-0.20
6 culture and entertainment	0.04	-0.00	-0.19
22 tobacco	0.03	0.31	-0.17
91 administrative services	0.00	**-0.18***	**-0.54****
Total inflation	1.00	**0.20*****	**0.23****

Bold text indicates the statistically significant variables.
*, ** and *** indicate significance at 10, 5 and 1%, respectively.
Regression for food includes wheat prices on world markets, as an independent variable, in order to cover the external shocks of that channel.
Administrative services have the opposite sign from that expected for the output gap (when the economy grows, prices fall), which can be explained by the fact that the government maybe reduces the tariffs when the economy grows because of higher budget revenues.

As can be seen from Table 1, coefficients of the GMM estimation are generally higher than the coefficients of the OLS estimation, which arises from the presence of the endogeneity, i.e., the probability the inflation to affect the output gap, too. Namely, higher inflation is likely to have a negative impact on economic activity, and hence the output gap. In this case OLS estimation will be lower than the GMM estimation (which is adjusted for the endogeneity problem) because the negative impact of inflation on the output gap will reduce the positive impact of the output gap on inflation.

The analysis leads to two important conclusions. **First**, overall inflation is sensitive to the output gap (last row in Table 1). Obtained coefficient is statistically significant and suggests that when the gap increases by 1 percentage point, as % of the potential GDP, inflation increases by about 0.2 percentage points on a quarterly basis (0.8 percentage points per year). This result leads to the conclusion that the central bank can affect the rate of inflation, assuming that the other elements of the transmission channel are operational, too.

Second, there is a significant heterogeneity between individual components of inflation in terms of sensitivity to the output gap. For example, the prices of food, beverages, personal care and health products, tourism and catering and administrative services show certain sensitivity to the economic activity, unlike the prices of housing, transport equipment and services, clothing, culture and tobacco. Our findings for Macedonia are similar to some findings for the euro area. For example, Fröhling and Lommatzsch (2011)[102], found that most sensitive in the euro area are food and beverages, and least sensitive are housing, transport equipment, culture and tobacco (p. 35-36). The five categories that respond to the changes in the output gap in Macedonia account for 75% of the

[102] Fröhling, Annette and Kirsten Lommatzsch (2011), "Output sensitivity of inflation in the euro area: indirect evidence from disaggregated consumer prices", Discussion Paper Series 1: Economic Studies No 25/2011, Deutsche Bundesbank.

consumer price index. These findings point to a different intensity with which monetary decisions would reflect on the prices of individual products.

The analysis presented in this Box is the first step in determining the response of the prices of various products to the changes in economic activity. These results represent the foundation for the expansion of the research aimed at including subcomponents of the main groups of products that were included in this analysis. This primarily refers to the category with the highest share in the index - food, a category that is not taken into account in the calculation of core inflation as price index that is most sensitive to monetary decisions, and which, according to the analysis shows a significant reaction. Based on the findings from the more detailed analysis, the previously used index of core inflation could be supplemented with additional product groups.

Box 8: Brief overview of the concept of fiscal rules

Fiscal problems that surfaced with the advent of the recent global crisis, contributed to the accelerated implementation of reforms aimed at strengthening the institutional fiscal framework, with a particularly strong focus on the introduction of numerical fiscal rules. This primarily refers to the reforms in the euro area and the EU, but also in many countries outside the EU, which started to implement or considered the implementation of fiscal rules or revision of the existing, in order to "provide medium-term anchors, support of the efforts for credible long-term fiscal adjustment and ensuring fiscal sustainability[103]". Macedonia is one of the countries outside the EU, which in order to increase the credibility of the medium-term fiscal plans and ensure fiscal discipline plans to enter the group of countries with fiscal rules. With the announced amendments to the Constitution of the Republic of Macedonia, fiscal policy is planned to be designed and conducted within specified fiscal rules. Given these announced changes in the fiscal area, within this Box we provide a brief overview of the concept and application of fiscal rules.

Fiscal rules are usually defined as permanent restrictions in conducting fiscal policy, by establishing numerical limits for certain budget indicators. Setting such limitations precludes frequent changes in fiscal policy. If the rules are well placed, and if one does not deviate, the capacity of fiscal policy for countercyclicity strengthens without jeopardizing fiscal sustainability. However, it does not mean that they have no deficiencies, and the most frequently mentioned are limiting the room for reaction to shocks, deviation of the priorities regarding budgetary spending, and even reducing transparency because of the so-called "creative accounting"[104].

There are different types of fiscal rules. By type of budget indicators that are limited, fiscal rules are divided into four groups: rules of public debt, budget balance rules, rules of public expenditures and rules of public revenues. The rules of public debt set explicit restrictions on the public debt, they are transparent and easy to communicate, but there are no short-term operational guidelines for them, they can be pro-cyclical and can be influenced by factors that are beyond the control of the fiscal authorities (interest rates, exchange rates). **Budget balance rules** provide a short-term operational direction, they are also simple and transparent, limit the indicator that has a direct effect on the public debt, and the possibility of control by the fiscal authorities is greater. The rules of the budget deficit can be specified as rules of total, cyclically

[103] Schaechter,A.,T. Kinda and N. Budina (2012). "Fiscal Rules in Response to the Crisis – Towards the "New Generation" Rules, A New Dataset, IMF Working Paper, WP/12/187, p.31. The main reference material for preparing the Appendix. Tables in the Appendix are taken from this reference material.

[104]The term "creative accounting" refers to the mechanisms through which the fiscal authorities are trying to circumvent the fiscal rule. One of them, for example, is the exclusion of certain fiscal operations from the budget, which is subject to limitation by the fiscal rule - the transfer of fiscal expenditures outside the budget.

adjusted or structural balance or the "over the cycle" balance.[105] While the first type of rules can not mitigate the phases of the economic cycle, the latter two can, but are less transparent or more complex for communication.[106] **The rules of public expenditures** set permanent limits on the total, primary or current expenditures and are not directly related to the sustainability of debt, because they do not restrict the revenue side. However, in combination with the rules of the debt or the budget deficit, they can provide an operational tool for achieving the necessary fiscal consolidation. **The rules of public revenues** set upper and lower limits of revenues in order to increase revenues and prevent excessive tax burden. These rules also are not directly related to the control of the public debt, because they do not contain restrictions on the expenditure side. **Fiscal rules vary also according to the territorial application** and can be classified into national, sub-national and supranational rules[107].

In order to mitigate the weaknesses of individual rules and provide greater connection with debt sustainability, part of the introduced fiscal rules represent a combination of two or more rules. Research shows that the rules which are combination of the rule of limiting the debt and limiting the budget balance are dominant.[108] **Fiscal rules have several important elements - the legal basis, the scope of the public sector, the escape clauses and the automatic correction mechanisms.** As regards the legal basis, statistics show that most of the rules are embedded in the legal norms (see Table 1 and Table 2). The rules that are embedded in a higher legal basis have lasting character because it is very difficult to cancel or modify them.

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[105]The cyclically- adjusted budget deficit excludes the changes that are effect of the economic cycle on the budget, as well as the additional one-off factors and other non-discretionary changes in the budget that are not related to the economic cycle. While these targets specify an annual target, the "over-the-cycle" rule requires maintenance of the nominal budget deficit at average levels over the economic cycle.

[106] There are other budget balance rules, such as the rule of the primary budget balance, which have weaker connection with debt sustainability, because the increase in interest payments does not entail budget adjustments, even in the case of potential impact on the budget deficit or public debt. The "golden rule", targeting the overall budget deficit reduced by the costs for capital investment, which is even less associated with the debt. The "pay-as-you-go" rule, which states that any measure in the form of additional costs or reduced income that increases the deficit should be compensated by another measure with a neutral effect on the deficit, is considered a procedural rule, i.e. it is not included in the so-called numerical fiscal rules, because it does not set limits on the values of budget indicators.

[107] According to current estimates, about 52% of the active fiscal rules are national, while the others are included in the four supranational agreements: the Pact for Stability and Growth in Europe, the West African Economic and Monetary Union, the Central African Economic and Monetary Community and the East -Caribbean Currency Union. In currency unions, the main goal of the supranational rules is to internalize the regional costs of fiscal indiscipline and form a framework for better coordination of the monetary-fiscal mix.

[108] Largely due to their dominance in supranational rules. In national rules, rules limiting expenditures are vastly present, but primarily in developed economies and in combination with the rule of the debt or deficit.

Table 1. Statutory Basis of Fiscal Rules 1/

	Type of Fiscal Rule			
	Expenditure	Revenue	Balance	Debt
Political Commitment	4	2	3	4
Coalition Agreement	4	1	3	4
Statutory	12	2	21	14
International Treaty 2/			41	47
Constitutional	0	1	2	1
Total	20	6	70	70

Source: IMF.

1/ Based on fiscal rules in effect by end-March 2012. The sum across columns can yield a higher number than the countries with rules as multiple rules are in place in many countries. All rules are national fiscal rules unless otherwise noted.

2/ These are all supranational fiscal rules.

Table 2. Countries with Constitutional Legal Basis

Country	Type of Rule	Year of Adoption
France	Revenue	2006
Germany	Budget Balance	1969, 2009
Poland	Debt	2004
Spain	Budget Balance, debt, expenditure	2011
Switzerland	Budget Balance	2003

Source: IMF.

Note: Includes only rules that took effect by end-March 2012. Other countries that have adopted fiscal rules in their constitution but operational details are still being determined or include a long transition path until implementation are Italy, Hungary and Spain.

Regarding the scope, experience shows that most of the supranational rules of debt and deficit cover the ratios of the general government, while the national rules, especially those that are a combination of a rule of expenditures and budget deficit mostly cover ratios of the central government. In terms of the number of national rules of revenues and debt, coverage of general and central government is almost balanced. **Current formal escape clauses from fiscal rules are an important dimension to quickly and effectively overcome some extraordinary, unpredictable situations, and they are particularly present in the rules that have been introduced recently and are one of the ways to increase their flexibility** (Table 3 provides a review of the application of the escape clauses). Basically these clauses should include: (1) a very limited number of factors that allow activation; (2) clear guidelines regarding the interpretation of the events; and (3) specification of the way back to restored application of the rule and the treatment of accumulated escape clauses. The main problem associated with these clauses is the vague definition of the events on the basis of which escape clauses are activated.[109]

Table 3. Fiscal Rules with Escape Clauses

Country and Date	Natural disaster	Economic recession	Banking system bailout, guarantee schemes	Change in Government	Change in budget coverage	Other events outside government control	Voting machanism defined	Transition path defined
Brazil (since 2000)	x	x	-	-	-	-	x	-
Colombia (since 2011)	-	x	-	-	-	x	-	-
Germany (since 2010)	x	x	-	-	-	x	x	x
Jamaica (since 2010)	x	x	-	-	-	x	-	-
Mauritius (since 2008)	x	x	-	-	-	x	-	-
Mexico (since 2006)	-	x	-	-	-	-	-	-
Panama (since 2008)	x	x	-	-	-	x	-	x
Peru (since 2000)	x	x	-	-	-	x	-	x
Romania (since 2010)	-	x	-	x	x	x	-	x
Slovakia (since 2012)	x	x	x	-	-	x	-	-
Spain (since 2002)	x	x	-	-	-	x	x	x
Switzerland (since 2003)	x	x	-	-	-	x	x	x
EU member states/ euro area (since 2005)	-	x	-	-	-	-	-	x
WAEMU (since 2000)		x	-	-	-	-	-	-

Source: IMF.

Given the wide range of fiscal rules and their special features that correspond to the specific characteristics of each country, it is difficult to identify the general effectiveness of fiscal rules.[110] However, numerous empirical studies have confirmed the positive effects of the introduction of national fiscal rules through improved fiscal performances of certain

[109]For example, until the constitutional change in 2009, the German rule permitted deviations in the case of "disorders of macroeconomic balance" that was commonly applied to justify exceeding the upper limit of the deficit. In India, the clauses allow the government to deviate from the target in exceptional circumstances "as the central government may determine". This ambiguity significantly reduces the transparency of fiscal rules and clauses.

[110] Wyplosz,C. 2012); "Fiscal Rules: theoretical issues and historical experiences", Working Paper 17884, NBER, March.

countries.[111] But, of course, what is important in order the fiscal rules to produce the desired results is their effective implementation. **The fiscal rule itself does not mean its guaranteed implementation. Hence, one of the key elements is the implementation of the rules.** One way to strengthen the assurance of the implementation of fiscal rules is the incorporation of the so-called **mechanisms for automatic correction of deviations from the rule.** Such examples are the rules of the structural budget deficit of Switzerland and Germany, which contain mechanisms for automatic correction ("debt brake"), which are activated in case of exceeding the upper limit of the deficit[112]. Also, the new agreement on fiscal sustainability "Fiscal Compact" (Box 9), which was signed by 25 EU Member States on 2 March 2012, includes specific guidelines by the European Commission for creating automated mechanisms for stabilization of the potential deviations from the rules[113].

The effective implementation of fiscal rules assumes a strong institutional capacity to implement fiscal rules. This refers to a number of elements, starting with the availability of appropriate data, adequate systems for forecasting, capacity for developing high-quality medium-term fiscal framework, support of fiscal rules with fiscal responsibility laws. **Recently, particularly large emphasis is placed on the introduction of fiscal councils as one of the modalities for ensuring effective implementation of fiscal rules. Fiscal councils** are independent institutions whose primary responsibility is to monitor the consistency of fiscal policy with the prescribed fiscal rules, as well as to asses the possible need of taking corrective action in order to strengthen fiscal discipline.[114] Many countries in the euro area have already established or are in process of establishing fiscal councils. Thus, 19 Member States have active fiscal councils, which is four times more than in 2007.[115] The number of these councils is expected to grow in the coming months. The effectiveness of these councils will greatly depend on whether they are independent of political influence and whether they have functional autonomy. It is very important that there is no political influence, the selection of members of these councils to be based on expertise, and certainly their function not to be advisory only, i.e. their guidance and recommendations to be of effective importance in the implementation of the fiscal policy.

As mentioned above, by adopting the proposed constitutional changes, the Republic of Macedonia will join the group of countries with fiscal rules, which will apply from 2017. The proposed rule assumes several elements: 1) limiting the budget deficit to no more than 3% of GDP; 2) limiting the amount of public debt[116] to up to 60% of GDP; 3) defining several escape clauses in extraordinary situations: natural disasters and external shocks that jeopardize national security, public health or in the event of a significant decline in GDP; 4) the occurrence of extraordinary situations is determined by the Parliament with a two-thirds majority; 5) the obligation of the government in case of occurrence of extraordinary situations to report to Parliament by stating the reasons for deviating from the rules, the measures that will be taken to re-establish the rules and the

[111] Carlo Cottarelli (2009). Fiscal Rules – Anchoring Expectations for Sustainable Public Finances, p.15.

[112] In both countries, this mechanism is activated when accumulated deviations exceed certain legally defined threshold. The adjustment in Switzerland must be made within three consecutive fiscal years, while in Germany it is made in a period of economic recovery in order to avoid pro-cyclical fiscal contraction, and can be done through both the revenue and expenditure side.

[113] If implemented effectively, the "Fiscal Compact" or the Treaty on Stability, Coordination and Governance in the EMU should be an effective tool for ensuring fiscal sustainability. This treaty introduces some new elements of the fiscal rules at the national level and strengthens the framework for fiscal management implied in the Stability and Growth Pact (SGP). Further explained in Box 9 within this Quarterly Report.

[114] Charles Wyplosz (2008). Fiscal Policy Councils: Unlovable or just unloved?, Swedish Economic Policy Review 15, p.15-18.

[115] Monthly Bulletin, ECB, June 2014,p.99-100.

[116] In September 2014, the Parliament of the Republic of Macedonia adopted the Law amending the Law on Public Debt, which among other things, changes the current scope of public debt - more detail in Box 3 of this Report.

time period in which fiscal policy will be re-implemented within the established fiscal rules.

The number of countries that have introduced fiscal rules is growing, and it shows that the authorities are increasingly perceiving them as important fiscal anchor and instrument of fiscal discipline and greater credibility. The practice shows that the new rules become more complex, with more operational elements that should be clearly defined, in order to provide clear guidance on the application and narrow the room for discretionary interpretation. Growing emphasis is placed on the effective implementation of the fiscal rules, given that only with strict adherence to the rules, and transparent communication in the case of possible deviation from these rules, the countries can achieve the purposes for which the rules have been introduced.

Box 9: Fiscal Compact and Six Pack - new chapters in reforming the fiscal governance of EU [117]

The Fiscal Compact (formally called the Treaty on Stability, Coordination and Governance of the Economic and Monetary Union) was signed on 02 March 2012 by 25 members of the European Council, and it should help in achieving fiscal sustainability. The Fiscal Compact introduced several new elements in the fiscal rules at the national level and strengthened the fiscal management framework within the Stability and Growth Pact. The framework was previously enhanced through package of six legal acts in the area of fiscal policy (Six Pack), composed of five EU regulations and one EU Directive which came into force in December 2011. Countries are expected to adopt the latest provisions by 2014. They include:

- **National rule for the structural budget balance.** The main novelty in the Fiscal Compact is the obligation to introduce national rules in the legal system, which limit the structural budget deficit to a maximum of 0.5% of GDP (i.e. 1% of GDP for the countries whose debt levels are lower than 60% and are considered low risk in terms of debt sustainability). The transitional period for implementation of the new limit of the deficit will be agreed with the European Commission. The Fiscal Compact may also include an upward revision of the so-called medium-term goals, which are already part of the Stability and Growth Pact.
- **More effective implementation of national rules.** To ensure more effective implementation, countries should introduce automatic correction mechanisms at the national level, which will be activated in the event of breach of the rules. European Court of Justice is responsible to verify that the rules for structural budget balance are translated into the domestic laws, but will not supervise their implementation.
- **New rule for debt at a supranational level.** The Fiscal Compact and the Six Pack prescribe an obligation to continuously reduce the share of public debt in GDP to the upper limit of 60%. On an annual basis, the debt should be reduced by at least 5% of the value of the deviation of the current level from the target, starting three years after the country comes out of the Excessive Deficit Procedure (EDP). This will ensure a gradual move toward the threshold of 60%.
- **New reference value for the expenditures at a supranational level.** The annual growth of primary expenditures, excluding the unemployment benefits and reduced by the amount of discretionary increases in income, should not exceed the nominal GDP growth rate in the long run. This reference value is only valid if the country is not included in the Excessive Deficit Procedure (i.e. its total deficit is less than 3% of GDP). Implementation instruments are limited.
- **More broadly defined criteria and more automated process of activating the Excessive Deficit Procedure.** Apart from the failure to comply with the rule on the size of the deficit, countries can be included in the Excessive Deficit Procedure also if they do not fulfil the rule for the debt, if it is decided by qualified majority in the Economic and

[117] As in Schaechter,A.,T. Kinda and N. Budina (2012). "Fiscal Rules in Response to the Crisis – Towards the "New Generation" Rules, A New Dataset, IMF Working Paper, WP/12/187, p.31.

Financial Affairs Council - ECOFIN. If the rule for the size of the deficit is not met, the Fiscal Compact should provide automatic activation of the Excessive Deficit Procedure, as would happen upon recommendation of the Commission, unless prevented by a qualified majority in the Council (so-called reverse qualified majority).

Budgetary procedures and independent fiscal councils. In order to implement these fiscal rules more effectively, the Six Pack provides a number of recommendations to make the medium-term budgetary framework more binding; preparation of the budget from higher to lower decision-making levels (top-down approach); more frequent, timely and more comprehensive reporting on fiscal trends and risks; and giving more importance to independent councils in the preparation of the assumptions in the budget and in assessing the fulfilment of the rules.

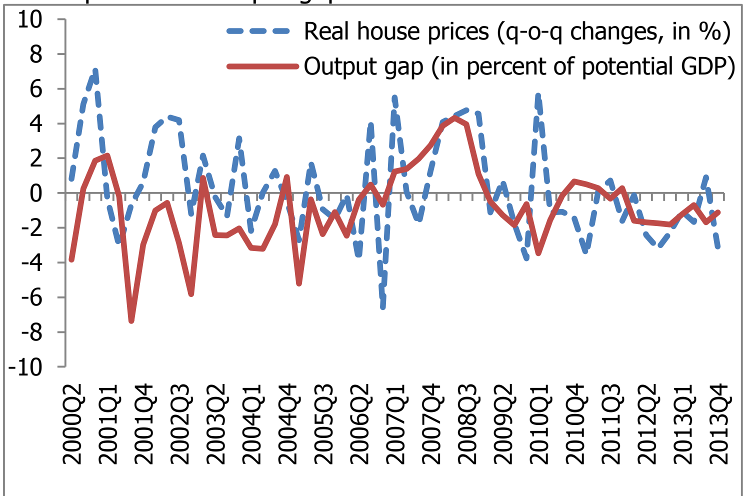
Box 10: The relation between real estate prices and the economic cycle

The movement of economic indicators is largely determined by the business cycle, i.e. the operational phase of the economy. When the economy is in a phase of expansion, the aggregate demand exceeds the supply, production, employment and wages are growing, the capacity and willingness for lending and borrowing increases, inflationary pressures are created and the general level of prices increases. Economic indicators move in the reverse direction if the economy is in a phase of recession.

The real estate market is also one of the segments which can show high sensitivity to changes in the economic cycle. Indeed, recent experiences during the global crisis showed that the **shifts in this market segment and their impact on the economic activity are important for the monetary policy, especially in some developed economies, in which it is one of the key channels of monetary transmission.** Hence the identification of the links between economic activity and the real estate market is an important prerequisite for better understanding of monetary transmission and more effective monetary policy. In other words, monetary policy-makers need to know whether property prices behave in a pro-cyclical, countercyclical or acyclical manner, and accordingly include this price component in the set of data on which monetary decisions are based. The importance of house prices for central banks in the context of monetary transmission is mostly emphasized in the developed economies in which they are an important determinant of the changes in the nominal disposable income of the households. Besides the impact on disposable income, they have a direct effect on the fair value of the collateral used when the entities borrow through the financial system and its changes can have big implications for financial stability. Therefore, house prices and their relation to the economic cycle are extremely important also for the central banks in those economies in which the real estate market is not an important direct link in the monetary transmission.

Within this Box we analyze the relation between the economic cycle and real estate prices in the Macedonian economy. The analysis is relatively simple and descriptive and aims: 1) to identify if there is a synchronized movement of the output gap, as an indicator of the phase of the economic cycle and real estate prices in Macedonia and 2) to track the behavior of individual economic parameters in the period before and after the identified major changes (increase/decrease) in the real estate prices. It should be emphasized that these episodes of strong increase/decrease are not selected on the basis of the assessment of overestimated/underestimated real estate prices[118], but they are based on monitoring of the dynamics of prices and isolating episodes of their sharp increase/decrease. This approach is motivated by the assessments of Ahearne at al. (2005)[119], that explore episodes of sharp increase/decrease in house prices in the example of eighteen major industrialized countries, while making an attempt to draw some conclusions relevant for the monetary policy.

Chart 1
House prices and output gap



Source: NBRM

The comparison of the path of movement of the output gap and house prices in the Macedonian economy suggests some synchronization. Chart 1 shows the real quarterly changes of the house price index[120] and the movement of the output gap[121]. The charts show certain similarities in terms of the movement of these two variables. Thus, in the period 2000-2006 when the economy generally functioned below the potential, house prices followed a downward trend, and in some periods even negative rates were registered. In the period of expansion (2007-2008) an increase in the price of apartments was registered, which corresponds to the growth of the economic activity and the opening of the positive output gap[122]. After 2008, there were periods of volatile movements of the output gap. However, overall the output gap moves in the negative zone that corresponds to the changes in the house prices, which are mostly in a downward direction.

[118] Previous research on this subject has shown that so far house prices in Macedonia have not deviated significantly from the level that their foundations have suggested. See: Davidovska-Stojanova, B., Jovanovic, B., Kadievska-Vojnovic, M., Ramadani, G., Petrovska, M., "Real estate prices in the Republic of Macedonia", Working paper of the NBRM, Skopje, August 2008 and Jovanovic, Branimir (2014), "Recent trends in house prices in Macedonia", in "Papers presented during the Narodowy Bank Polski Workshop: Recent trends in the real estate market and its analysis, 2013, Volume 2", NBP Working Paper No. 182, Economic Institute, National Bank of Poland, Warsaw, 2014

[119] Ahearne, Alan G., John Ammer, Brian M. Doyle, Linda S. Kole and Robert F. Martin (2005), "House Prices and Monetary Policy: A Cross-Country Study," Board of Governors of the Federal Reserve System, International Finance Discussion Papers No. 841.

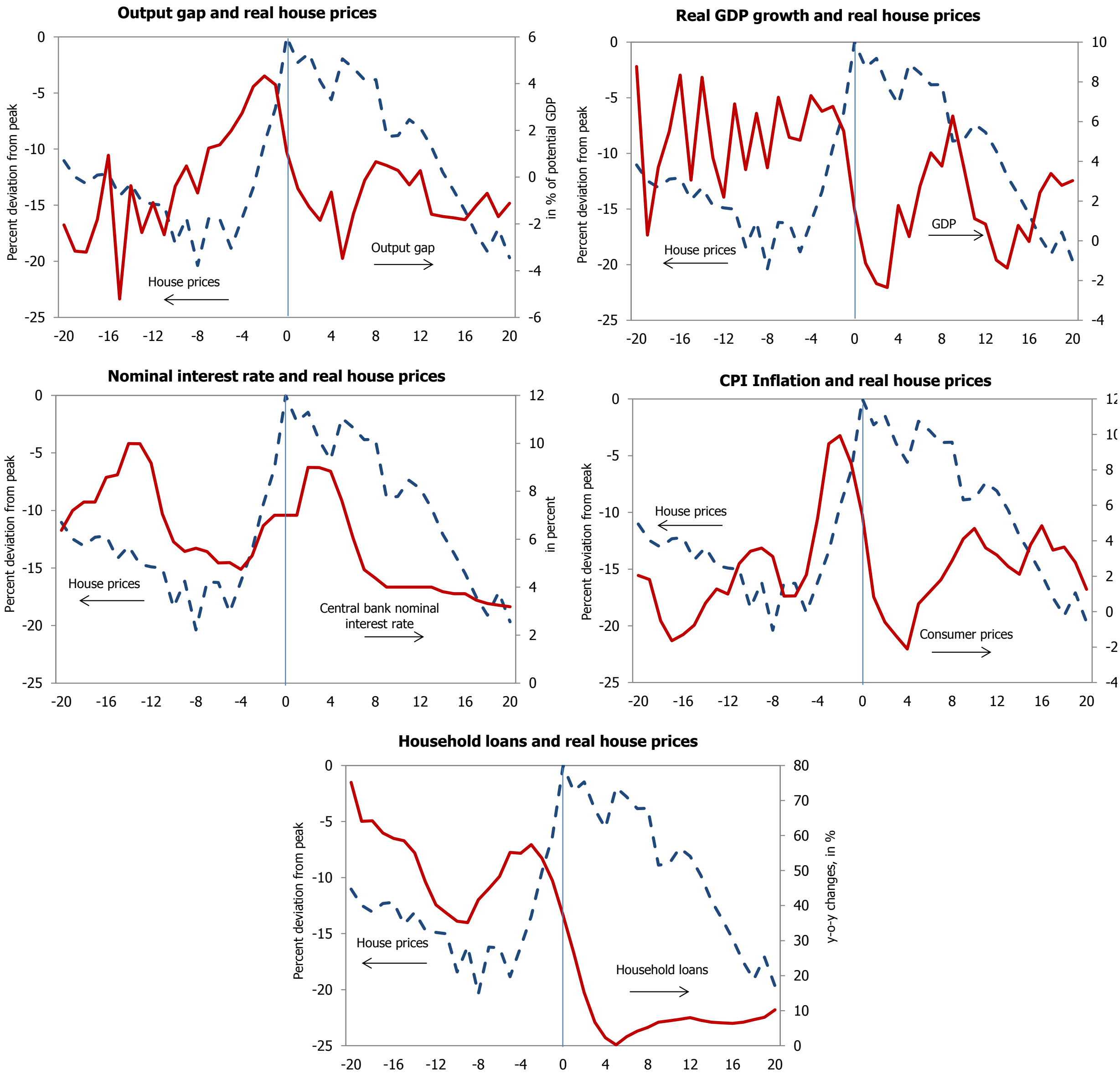
[120] Hedonic index of house prices, prepared by the NBRM on the basis of the notices of sale in the capital city, and published by the agencies dealing with trade in real estate. The price of the apartment is a function arising from the size of the apartment, the neighborhood in which it is located,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

[121] Output gap in this Appendix is not assessed by the univariate techniques but is derived from the general macroeconomic model used by the Monetary Policy and Research Department of the NBRM.

[122] In addition, the rise in the house prices in this period can be related also to the positive expectations for potential membership of Macedonia in NATO.

Considering the dynamic transition period through which the Macedonian economy passed, accompanied by a number of external and internal shocks, it is extremely difficult to isolate a complete economic cycle. For these reasons, the analysis for the pro-cyclical movement of the house prices is concentrated around the period of expansion of the economic activity in 2007-2008, during which the growth of house prices accelerated. The link between house prices and some of the key macroeconomic indicators is made through the so-called "event analysis", where the time of the event is defined as the period during which the peak in house prices was reached, in this case it is the fourth quarter of 2008. This period is marked as zero period, while other periods are the number of quarters before or after the occurrence of the "event". Chart 2 shows the movement of the output gap, real GDP, inflation, the nominal policy rate and the loans along with the movement of house prices. The choice of variables is determined on the basis of the theoretical assumption (as for other types of prices) that the sharp rise in house prices is preceded by a period of low interest rates, debt growth and economic expansion.

Chart 2
Comparison of the movement of real house prices (percent deviation from peak) with key macroeconomic indicators



Source: SSO and NBRM calculations.

The general conclusion from the results shown in Chart 2 is that the movements in the house prices are related with the movements of key macroeconomic indicators, where the movement in the house prices is of a pro-cyclical character. So, before the peak in house prices was reached, relatively higher rates of GDP growth of around 5% were registered. In the same period, real GDP grows faster than potential GDP (positive output gap), i.e. the level of real GDP is around 3% over the potential level. On the other hand, the decrease in house prices corresponds with slowing production and opening of a negative output gap of nearly 2%. Achieved maximum in the real house prices also corresponds to the movement of other key macroeconomic variables in this period. The inflation rate begins to accelerate several quarters before the registered maximum. However, compared with the house prices, consumer prices decreased relatively quickly in the period of expansion, reaching the initial level in a period of four quarters[123]. The period of accelerated growth in house prices was preceded by a period of intense growth in lending in accordance with the growing demand in the economy[124]. Credit growth begins to decelerate a few quarters before the house prices peak in parallel with the closing of the positive output gap in the economy. Another indicator in favor of the pro-cyclical movement of house prices is the movement of interest rates in the economy. Namely, the increase in the house prices starts in a period of relatively lower interest rates and more relaxed monetary policy. The reference interest rate of the Central Bank starts to rise four quarters before the house prices peak, while several quarters after the peak it begins to fall, dropping by more than 5 percentage points over the following 16 quarters. Presented "event analysis" provides useful information about the relationship between house prices and the economic cycle, but as any descriptive analysis it has certain drawbacks. To check the pro-cyclical movement of house prices with the output gap, an econometric estimation is made, by using two techniques - the method of least squares (OLS) and generalized method of moments (GMM). The results of the econometric estimation are consistent with the hypothesis of a pro-cyclical movement of house prices, i.e. they suggest a statistically significant and positive impact of the output gap on the house prices.

The presented analysis is relatively simple, but gives results that are indicative and depict the cyclicity of house prices. The "event analysis", although based on only one episode, same as more formal empirical tests, gives indications of pro-cyclicality of house prices. This means that house prices follow the cyclical movement of the economic activity. Getting out of the expansion phase for a short period, could mean downward correction of real estate prices, which is important information for the central bank, both in terms of the monetary policy and in terms of financial stability and design of the measures for its maintenance.

[123] The inflation rate used in the analysis is the core inflation rate from which changes in food, energy and tobacco are isolated.

[124] Exception to this movement is credit growth in 2003 that is not connected with the movement of house prices, i.e. can be explained by the low base effect, the liberalization of foreign exchange lending and methodological changes.