

NATIONAL BANK OF THE REPUBLIC OF MACEDONIA

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# **C O N T E N T S**

Address of the Governor

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Honorable,

*Facing with an extremely tough year, in 2001 the Republic of Macedonia experienced jeopardized security and resulting consequences. Armed conflicts leave permanent mark in the history of each nation, destroying human lives, creating family tragedies. Of course, the economy was not spared, as well. Namely, the worldwide experience has so far proved that armed conflicts destroy the economy, draw back and slow down the positive economic trends and waste the financial resources for unproductive purposes. Furthermore, they undermine the confidence of the domestic entities, foreign investors and partners in the potentials of the country and perspectives for future development, something that requires a lot of time and effort to be created and maintained. Thus, in the Republic of Macedonia, after five years of continuous upward trend, in 2001 a real GDP decline of 4.1% was registered, which reflects the extremely deteriorated working conditions.*

*In such a difficult year, observing from an economic viewpoint in spite of all unfavorable influences, deterioration and turbulent conditions, few very important positive achievements and activities marked the year 2001:*

- despite given circumstances, in 2001 the price stability in the economy was maintained, which is a significant macroeconomic precondition for sustainable economic growth. Simultaneously, this enabled the achievement of the ultimate goal of the monetary policy - the price stability, which is a result of the exceptional effort of the Central Bank, having in mind the circumstances under which it was realized;*
- although operating in uncertainty and under strong pressure of unfavorable psychological influences determined by the war tensions in the country, the banking system did not face serious liquidity problems, i.e. systemic shocks were successfully avoided. The measures and the supervisory controls conducted by the Central Bank, as well as the strengthened banks' management and appropriate banks' policies had their contribution to this;*
- in 2001, in a relatively short period, the payment system reform was completed, and the payment system was successfully overtaken by the banks and implemented in their scope of activities. It was an exceptionally complex reform - a base of the everyday functioning of the economy with large number of direct participants, and in this sense, its realization reflects the reform-oriented course of the economy;*
- the Euro-conversion of the in-currencies was successfully realized through the banking system, with adequate support and organization by the NBRM, thus enabling significant assets inflow in the banking sector, and high increase in their deposit potential. Namely, the world economy in general faced this activity, but it deserves attention due to the comprehensive necessary preparations that were undertaken.*

*With respect to the National Bank of the Republic of Macedonia viewpoint and monetary policy conduction, the conditions for monetary regulation were extremely difficult in 2001. Namely, in an exceptionally stressed and tensed situation in the country, when the budget registered high expenditures for security needs, the Central Bank had to bear the heaviest burden in maintaining macroeconomic stability. All this had to be done in terms of high level of currency in circulation determined by the psychological factors due to the war crisis, withdrawal of households' deposits from the banks, increased demand for foreign currency and pressure for depreciation of the Denar exchange rate against the Deutsche Mark. This situation imposed the need for everyday wakeful monitoring of the movements in the economy, and for optimal combination and flexibility of the monetary instruments.*

*During the crisis period, the National Bank of the Republic of Macedonia intervened on both sides: on the supply side on the foreign exchange market by selling foreign currency, and on the demand side by withdrawing the Denar liquidity, primarily through auctions of Central Bank bills, which interest rates were doubled in order to increase their attractiveness.*

*Together with all other accompanying measures (regarding the reserve requirement, Lombard credits, foreign exchange activities), the Central Bank succeeded in maintaining the stable exchange rate of the Denar against the Deutsche Mark, i.e. the price stability. Thus, the realized average inflation rate of 5.5% in 2001 is almost at the same level as in the previous year (5.8%). Having in mind the circumstances, the maintained price stability represents an exceptionally significant achievement of the macroeconomic policy.*

*The easing of the war tensions enabled gradual normalization of the economic flows. Thus, starting from September, the NBRM had a role of net-purchaser of foreign currency on the foreign exchange market. Furthermore, as the tensions diminished, deposits of the economic entities returned in the banking system, and in the last months of 2001 the foreign currency deposits registered a significantly high increase (due to the need for conversion of the currencies of the 12 member states of the EMU into the EURO). In line with the overall improvements in the economy, the National Bank of the Republic of Macedonia from October 2001 to February 2002 gradually, in three stages, reduced the interest rates of the CB bills (interest rates on CB bills with 28-day maturity were reduced from 20% in June to 13% at the end of February). With this, the Central Bank gives a signal for an appropriate decrease in banks' interest rates, which contributes to the revitalization of the economic activity and development of the economy.*

*2001 was an exceptional example of a successful coordination of the monetary and the foreign exchange policy with the fiscal policy, aimed at maintaining macroeconomic stability. Namely, in a period when it was necessary to increase budget expenditures for security needs, as a factor that acts towards liquidity increase in the economy, the monetary policy was necessarily directed towards reserve money withdrawal, in order to neutralize the effects from the increased budget spending. This contributed to a reduction of the potential destabilizing factors that affect the exchange rate, as well as the inflationary impulses from the high liquidity in the economy, which in the end resulted in maintained price stability. Thus, in 2001 the fundamental factors in the Macedonian economy were stable, as a necessary precondition for regaining the trend of achieving positive growth rates of the economy after the crisis. The improvement of the situation and the achievement of the previous level of development take a lot of time and, in this context, the events in 2001 were a strong shock for the fragile Macedonian economy.*

*In 2001, the banking sector passed an important test for conducting relatively normal operations during time of crisis, without losing the confidence of the clients during the deposits withdrawal at the beginning of the crisis. Opposite to the previous years, this year the banks showed better interest rate responsiveness to the monetary policy signals. Namely, in the first half of the year, the banks' lending interest rates maintained the level around 18%, annually. In July 2001 they started to increase, and the maximum level of 21.2% was registered in September. Afterwards, they began to decline, and in December 2001 they equalled 19.1%. These movements of the banks' interest rates correspond, to a high extent, with the changes of the interest rates of CB bills. The average weighted deposit interest rates of the banks were relatively stable in 2001 and equalled around 10%, annually.*

*Monetary aggregates in 2001 were affected by the overall situation in the economy and the psychological factors due to the war crisis, as well as by certain extraordinary factors, like the conversion of the 12 European currencies into Euro and the payment system reform. Thus, the money supply M1 increased by 14.5% in 2001 relative to the previous year, while the broader monetary aggregates realized exceptionally high growth rates, which is due to the effect from deposited foreign currencies in the banks prior to the introduction of the Euro. Thus, the money supply M2 increased by 70%, while the broadest monetary aggregate M4 by 66.1%. Especially important effect for the Macedonian economy (and, in general, for all countries in transition) from the introduction of the Euro is the historical opportunity for pulling out the savings of the households kept "under the mattresses" and depositing them in*

*the banks, which was done in order to avoid the commission. This provided a more precise information about the amount of the non-mobilized households savings (in the last quarter of 2001 around US Dollar 360 million were deposited in the banks), and it was a unique opportunity for the banks to increase their deposit potential through conducting an active policy of attracting assets, and what is even more important, through retaining the deposits in the banks after the conversion.*

*Total banks' placements to the non-Government sector increased by Denar 3,033 million, or by 7.7% in 2001. In addition, the Denar placements increased by 8.7%, and the foreign currency placements by 0.6%. Although with a certain time lag, the banks decreased their credit activity during the crisis (during the June – November 2001 period, a continuous decline of domestic currency credits was registered). During the period of the crisis, more significant deterioration of the quality of the banks' credit portfolio was not registered, which points out the increased cautiousness of the banks and conduction of prudential policies.*

*Deteriorated security in the country in 2001 had a negative impact on the foreign trade, mainly because of the cancelled contracts with the foreign partners and indirectly, because of the lowered domestic output. Thus, in 2001 the foreign trade of the Republic of Macedonia decreased by 16.5%, with a decline in the exports and the imports by 12.4% and 19%, respectively. The current account deficit in the balance of payments in 2001 increased by more than three times, mainly due to the increased deficit in services and transfers. In 2001 the highest amount of foreign investments of US Dollar 442 million was registered, as a result of the privatisation of the Macedonian Telecom in January 2001. Gross foreign exchange reserves of the NBRM increased by US Dollar 62 million in 2001 (mainly as a result of increased Government foreign currency deposits) and as of December 31, 2001 reached US Dollar 775 million. Having in mind the decline in the imports, it resulted in an increased average import coverage, equaling 5.5 months. Despite the difficult situation in 2001, the Republic of Macedonia continued with the regular repayment of the foreign liabilities, retaining the position of a less indebted country. Because the amount of repaid obligations exceeded the withdrawn assets, the foreign debt of the Republic of Macedonia decreased by 3.2% compared to the previous year and in the end of 2001 it equaled US Dollar 1,440 million.*

*The strategic goal of the Republic of Macedonia is its entrance in the European Union. Hence, in 2001 the Stabilization and Association Agreement with the European Union was signed, and its positive effects are expected in the coming years. The firm reform determination was present in 2001, when, despite the situation in the economy, the payment system reform was successfully completed (the Central Bank was one of the main pillars), as a base for modern infrastructure. Herewith, from the beginning of 2002 the payment system is transferred in the banks, while the settlement among the banks is conducted through the NBRM. The pension system reform, the activities related to the money laundering prevention and many other reforms for further development of the financial system are in process. Simultaneously, several new laws related to the economic issues were prepared, and most of them will become effective in 2002. In this context, especially important is the new Law on the National Bank of the Republic of Macedonia (effective since January 2002), as a modern law, compatible with the EU standards, which should mainly provide higher independence of the Central Bank.*

*Since independence until present day, the Macedonian economy has for many times faced the need for overcoming the consequences from disturbances and shocks of different character. This need was maybe most evident in 2001, having in mind the nature of the crisis and the size of the estimated (and non-estimated) damages. Therefore, the success with the donors' conference for the Republic of Macedonia (held in March 2002) and financial inflows from abroad are very important. The assets from this conference represent an impulse for revitalization of the economy after the war crisis and reflect the international support of the*

*Republic of Macedonia, as a country with peaceful external policy, sound and consistent macroeconomic framework and persistence in the reforms during the transition process.*

*The overcoming of the consequences from the crisis in the real sector of the economy by revitalization of the domestic production and consumption, as well as by renewal of the trade relations with abroad, is expected to come along with further strengthening of the financial system. The positive trends that have already begun in the banking sector, manifested as a process of consolidation of the banks through mergers and acquisitions, and the flexibility of the business policies, are expected to enable qualitative improvement of the competition in the banking sector. This, in line with the positive effects from the realized payment system reform and increased deposit potential, will result in a reduction of the interest rates, reacher credit supply and faster revitalization of the economy. Development of the financial system and increased level of financial intermediation represent a base of the modern market economies and their long-term growth. Hence, the activities of the National Bank of the Republic of Macedonia are directed towards building sound banking and financial system, as a strong support of the real sector, but, at the same time, the Macedonian economy has a need for stable and peaceful environment as the most important precondition for normal realization of the economic activity and economic growth.*

*Ljube Trpeski, Ph.D.*

*May 2002, Skopje*

*Governor and President of the  
NBRM Council*

## I. World Economic Developments

In the world economy, 2001 is marked as a year of unfavourable economic developments. The world economy registered a deceleration of the economic growth, which equalled 2.6%<sup>1</sup> and comparing to the previous year this is lower by 2.1 percentage points. These developments are typical for all regions – developed countries, developing countries and transition countries. The most unfavourable developments of the economic growth are registered in USA (economic growth rate reduced to 1.3% in 2001 after a four-year trend of above 4% economic growth), while Japan entered the zone of negative growth rates (from 1.5% growth rate in 2000 to -0.5% in 2001).

This deceleration of the economic growth was followed by a decrease of the world trade growth, associated with a decrease of prices in world markets, decreased consumers confidence and increased uncertainty of producers. Thus, in 2001, world trade registered a modest growth of 2.7%, which represents the lowest rate in the last decade. In addition, in 2001 a decrease of the price of oil (by 5.0%), primary products (by 2.6%) and industrial products (by 3.1%) was registered, thus giving contribution to maintaining the inflation on a relatively low level: 2.4% in developed countries, 5.9% in developing countries and 16.4% in transition countries.

Table 1  
Selected indicators of the world economy

	1997	1998	1999	2000	2001
			(in %)		
Real GDP growth rate	4.2	2.8	3.6	4.7	2.6
Growth in the world trade	10.3	4.1	5.3	12.4	2.7
Inflation rate					
Developed countries	2.1	1.5	1.4	2.3	2.4
Developing countries	9.9	10.5	6.8	6.0	5.9
Transition countries	27.3	21.8	43.9	20.0	16.4
Prices					
Oil	-5.4	-32.1	37.5	56.9	-5.0
Primary products	-3.2	-14.7	-7.0	2.6	-2.6
Industrial products	-8.0	-1.9	-1.8	-5.1	-3.1
			(% of GDP)		
Saving rate	23.9	23.0	23.1	23.7	22.8
Investment	24.2	23.3	23.1	23.5	23.1

Source: IMF World Economic Outlook, October 2001

### 1.1. Developed countries

In 2001, developed countries experienced a real GDP growth rate of 1.3%, which is 2.5 percentage points lower compared to that of 2000 and represents the lowest growth rate in the last decade. These developments are mostly due to the decelerated trend of the increase of domestic consumption by 2.4 percentage points, thus reducing to 1.3% in 2001. The average rate of inflation in developed countries in 2001 was maintained at the same level of 2.4%. This is as a result of the decline in the world prices of oil, primary products and industrial products (5.0%, 2.6% and 3.1%, respectively), with a simultaneous increase in the unit labour

<sup>1</sup> Estimation, WEO, October 2001



costs by 2.9% in developed countries (which is by 4.3 percentage points higher than in the previous year), and a moderate increase of labour productivity of 1.5% (which is by 4.4 percentage points lower than in the previous year). These developments of GDP growth rate, labour productivity and unit labour costs resulted in a moderate increase of unemployment by 0.2 percentage points compared to the previous year, reaching the level of 6.0% in 2001. In addition, as a result of the decreased domestic demand, the deficit in the current account of the balance of payment of developed countries reduced to US Dollar 223.1 billion.

Table 2  
Selected economic indicators for the developed countries

	GDP (real growth rate in %)			Inflation (retail prices increase in %)			Unemployment (in %)			Current account of the Balance of Payments (in US Dollar billion)		
	1999	2000	2001	1999	2000	2001	1999	2000	2001	1999	2000	2001
Developed countries	3.4	3.8	1.3	1.4	2.3	2.4	6.4	5.8	6.0	-121.1	-248.4	-223.1
European Union	2.7	3.4	1.8	1.4	2.3	2.6	9.1	8.1	7.7	23.9	-22.5	0.3
Germany	1.8	3.0	0.8	0.7	2.1	2.5	8.2	7.5	7.5	-17.9	-19.4	-14.4
France	3.0	3.4	2.0	0.6	1.8	1.8	11.2	9.5	8.7	37.2	23.8	32.0
Italy	1.6	2.9	1.8	1.7	2.6	2.6	11.4	10.6	9.5	6.3	-5.7	-0.9
USA	4.1	4.1	1.3	2.2	3.4	3.2	6.1	5.7	5.9	-324.4	-444.7	-407.1
Japan	0.8	1.5	-0.5	-0.3	-0.6	-0.7	4.2	4.0	4.7	106.8	116.9	88.8

Source: IMF World Economic Outlook, October 2001

In 2001, the European Union (EU), as the main trade partner of the Republic of Macedonia realised a moderate real GDP growth of 1.8%. This is by 1.6 percentage points lower compared to 2000, mostly due to the decelerated growth trend of domestic demand, which increased by 1.5% in 2001, contrary to the 3.1% registered in the previous year. In addition, inflation in the European Union equalled 2.6% in 2001, which is within the expectations of the European Central Bank. At the same time, the downward trend of the unemployment rate continued and it was reduced to 7.7% in 2001, under conditions of increased labour productivity by 2.4% (which is by 2.6 percentage points lower than in the previous year) and increased unit labour costs by 1.1% (which is by 2.5 percentage points higher than in the previous year).

Analysing by countries, in 2001 unfavourable developments reflected through decelerated economic growth were registered in all member-countries of EU. Real GDP growth in Germany, as one of traditionally most important markets for export of Macedonian goods, considerably dropped and it was reduced to 0.8%. This is mostly due to a low level of domestic demand, as well as the decelerated increase of export (from 11.5% in 2000 to 1.7% in 2001). In addition, inflation in Germany registered a moderate increase and reached 2.5% in 2001, while the rate of unemployment remained at the same level as in the previous year, i.e. 7.5%.

The several-year acceleration of economic growth in USA was stopped in 2001. Namely, the rate of real GDP growth in the American economy was reduced to 1.3% in 2001, which is lower by 2.8 percentage points compared to the last year. So, the effects of “the information technology revolution”, considered to be the major driving force for the expansion of the US economy in the last decade, were dampened in 2001. The considerable decline in the domestic demand, which in 2001 registered a moderate increase of 1.3% contrary to 4.8% in the previous year, also had an impact on economic growth. The terrorist attack in USA on September 11, 2001, which mainly affected the financial markets through a decline of the prices of stocks, bonds and other financial derivatives due to the increased

country risk, gave an additional negative impulse to this economic constellation. Increased uncertainty of consumers and producers resulted in a decline of consumption and investments. These unfavourable developments in USA, as a country with highest influence in the world economy, were spread in other countries, as well. Inflation rate in USA remained 3.2% in 2001, while unemployment registered a moderate increase of 0.2 percentage points, reaching the level of 5.9%. In 2001, labour productivity in the American economy increased by 1.6% (contrary to 6.7% in the previous year) and unit labour costs increased by 5.3%. The deficit in the current account of the balance of payments of USA decreased by US Dollar 37.6 billion compared to 2000, thus reducing to US Dollar 407.1 billion in 2001, mostly due to the larger decrease of import than export of goods and services and the movements in the Dollar exchange rate.

## 1.2. Developing Countries

Influenced by the unfavourable movements in the developed countries and the world economy in general, developing countries in 2001 registered lower economic growth comparing to the previous year (by 1.5 percentage points) and it equalled 4.3%. Analysing by regions (groups of countries), in 2001 the highest rate of economic growth was registered in Asia (5.8%), followed by Africa (3.8%), Middle East (2.3%) and West Hemisphere<sup>2</sup> (1.7%).

Table 3  
Selected economic indicators of developing countries

Annual changes	1997	1998	1999	2000	2001
	(in %)				
Real GDP	5.8	3.5	3.9	5.8	4.3
Exports	13.1	5.1	4.6	15.1	5.0
Imports	10.1	-1.6	2.1	16.6	6.4
	(US Dollar billion)				
Current account of the Balance of Payments	-59.1	-86.8	-10.5	60.2	22.4

In 2001, the unfavourable economic movements in the developing countries are determined by the foreign trade with developed countries (where these countries export mainly primary products), taking into consideration that prices of primary products and oil declined in the international commodity markets. Imports and exports of goods and services in this region registered moderate increase in 2001, i.e. 5.0% and 6.4%, respectively. In addition, higher increase of imports than that of exports of these countries resulted in a decrease in the surplus in the current account of the balance of payments, which in 2001 equalled US Dollar 22.4 billion.

## 1.3. Transition Countries<sup>3</sup>

Globalisation and integration processes in the world affected mostly the transition countries, which for more than one decade have been in the process of transformation toward market economy and establishment of macroeconomic and institutional framework of the market economy. Numerous structural reforms have been accomplished, as well as liberalisation of prices, liberalisation of foreign trade and capital movement. Foreign trade of the transition countries from Central Eastern and South Eastern Europe, during the transition period was redirected toward the European Union, which is consistent with their efforts for integration in EU. This increases the dependence of these countries on EU, and as a

<sup>2</sup> Countries from Latin America

<sup>3</sup> Central & Eastern Europe and Baltic Countries, South & Eastern Europe and the Community of Independent States

consequence developments in EU and other developed countries are reflected in transition countries.

Table 4  
Selected economic indicators for transition countries

	GDP (real growth rate in %)			Inflation (in %)			Current account of the Balance of Payments (% of GDP)			Foreign direct investment (in US Dollar million)		
	1999	2000	2001	1999	2000	2001	1999	2000	2001	1999	2000	2001
Countries in transition*	3.6	6.3	4.0	43.9	20.0	16.4	-6.8	-4.6	-6.2	24,051	23,831	25,382
Central and Eastern Europe	2.6	4.0	2.9	5.2	6.5	5.7	-6.3	-4.7	-5.4	17,622	19,035	17,269
Czech Republic	-0.8	3.1	3.5	2.1	3.9	4.9	-3.0	-4.6	-6.8	6,234	4,477	5,000
Estonia	-0.7	6.9	4.5	3.3	4.0	6.1	-4.8	-6.3	-7.5	222	324	350
Croatia	-0.4	3.7	3.8	4.2	6.2	5.7	-4.3	-3.3	-3.1	1,445	827	470
Latvia	1.1	6.6	6.5	2.4	2.8	2.4	-9.8	-6.9	-7.4	331	398	300
Lithuania	-3.9	3.9	4.0	0.8	1.0	1.5	-11.2	-6.0	-6.6	478	375	450
Poland	4.1	4.1	4.0	7.3	10.1	5.6	7.5	-6.2	-5.0	6,348	9,299	7,000
Slovak Republic	1.9	2.2	3.0	10.6	12.0	7.4	-5.5	-3.7	-6.4	701	2,058	2,000
Slovenia	5.2	4.9	2.2	6.1	8.9	8.6	-3.9	-3.4	-1.8	144	110	385
Hungary	4.5	5.2	4.5	10.0	9.8	9.1	-6.9	-2.1	-4.1	1,720	1,167	1,314
South and Eastern Europe	-3.2	3.6	4.0	16.5	25.1	29.1	-8.2	-9.1	-10.5	2,141	2,494	2,321
Albania	7.3	7.8	7.0	0.4	0.1	3.5	-7.2	-6.9	-7.5	51	141	207
Bosnia and Herzegovina	10.0	5.0	5.0				-21.4	-21.2	-20.4	836	1,000	500
Bulgaria	2.4	5.8	4.0	0.7	9.9	8.0	-5.3	-5.8	-5.8	90	150	164
SR Yugoslavia	-15.7	5.0	5.0	37.1	60.4	93.6	-7.5	-8.3	-9.6	112	25	200
Macedonia <sup>1</sup>	4.3	4.3	-4.6	-1.1	5.8	5.5	-3.0	-3.1	-9.4	32	176	439
Romania	-3.2	1.6	4.0	45.8	45.7	34.2	-3.8	-3.8	-5.8	1,025	1,009	900
Community of Independent States	4.5	7.9	5.8	48.0	29.0	17.0	-5.9	0.0	-2.6	4,288	2,302	5,792

Source: Transition Report, EBRD, 2001

\* WEO, IMF, October, 2001

1/ The official institutions are the source of data on the Republic of Macedonia

In 2001 transition countries registered 4.0% economic growth, which is by 2.3 percentage points lower comparing to the previous year. Decelerated economic growth was mostly expressed in the Community of Independent States (CIS), where the real GDP growth rate of 7.9% in 2000 was reduced to 5.8% in 2001, mostly due to decreased prices of primary products and oil in the world market. Central and Eastern Europe and Baltic countries (CEB) registered a decrease of the economic growth by 1.1 percentage point equalling 2.9%. This is a reflection of the decelerated economic dynamics in EU, taking into consideration that these countries are closely related and geographically closer to EU. In 2001, South-East European (SEE) countries registered different economic developments, while as a region they realised economic growth rate of 4.0%. Higher rates of economic growth in CIS and SEE comparing to CEB are determined from the structural and institutional reforms in the past years. In addition, in 2001 only CEB countries overshoot the official real GDP level of 1989 by 10.1%, while countries from SEE and CIS still have lower level of real GDP by 24.1% and 35.5%, respectively.

During the whole period of transition, transition countries are characterised with higher inflation comparing to developed countries and developing countries. However, there was a downward trend of inflation, being reduced to 16.4% in 2001 (by 3.6 percentage points lower comparing to the previous year). This is mostly due to the low level of domestic demand and labour productivity growth. Analysing by regions, inflation is reduced in the Central and Eastern Europe and Baltic countries (by 0.8 percentage points) and in the Community of Independent States (by 8.0 percentage points), thus the inflation rate in 2001

equalled 5.7% and 17.0%, respectively. Unfavourable developments are registered in South Eastern Europe, where inflation increased by 4.0 percentage points and reached the level of 29.1%, mostly due to the higher inflation in FR Yugoslavia.

In 2001 transition countries registered unfavourable developments in foreign trade, while the deficit in the current account of the balance of payments increased by 1.6 percentage points, reaching 6.2% of GDP. This is mostly due to the decreased external demand from EU and other developed countries, which determined reduction of exports in these countries, while imports remained unchanged. In addition, the deficit of CEB and SEE countries, in 2001, reached the level of 5.4% and 10.5% of GDP, respectively. On the other hand, CIS countries registered lower deficit in the current account (2.6% of GDP) which is partly due to the increased trade within the region, thus reducing the effects of the world economy depression.

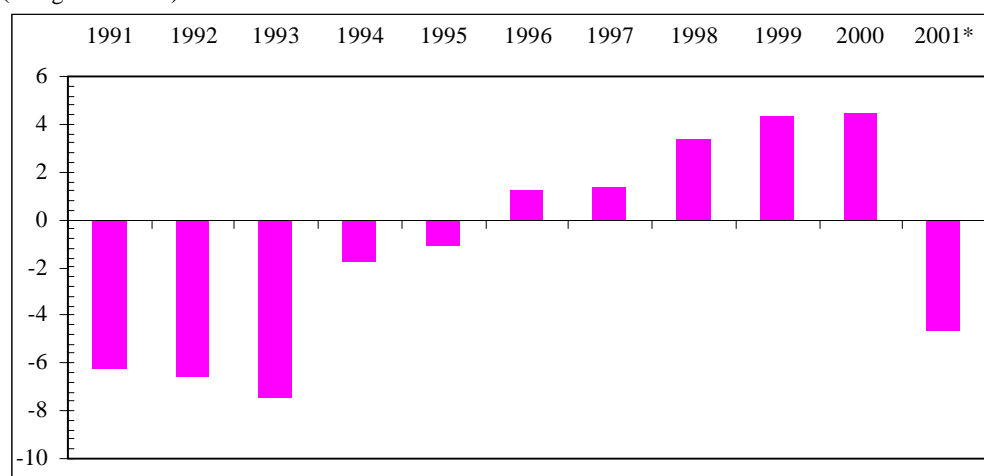
Midterm objective of transition countries is import of foreign accumulation through attracting foreign direct investments, aimed at increasing the competitiveness and export, and consequently reducing the deficit in the current account of the balance of payments. The total amount of foreign direct investments in transition countries in 2001 equalled US Dollar 25.4 billion, which represents an increase of 6.5% comparing to the previous year, completely determined by the increased foreign direct investments in CIS (by 2.5 times). In addition, the highest amount of foreign direct investments is registered in CEB (US Dollar 17.3 billion), followed by CIS (US Dollar 5.8 billion) and SEE (US Dollar 2.3 billion).

## II. Economic developments in the Republic of Macedonia

### 2.1. Gross domestic product

The continuous trend of economic growth in the Republic of Macedonia since 1996 onwards, which in 2000 reached the highest real growth of the gross domestic product of 4.5%, was terminated in 2001. Namely, the deteriorated security in the country and worsened working conditions caused a decline of the total economic activity and weak macroeconomic performances. This led to a significant economic decline, expressed by the real decrease of the gross domestic product by 4.1%<sup>4</sup> in 2001, relative to 2000.

Chart 1  
Gross domestic product  
(real growth rates)



\* Preliminary data.

With respect to dynamics, in all quarters of the year a decline in the economic growth was registered<sup>5</sup>. In addition, the decline in the first and in the second quarter equaled 5.7% and 3.4%, respectively. The highest decrease of the real GDP was registered in the third quarter of 2001 (by 6.0%), which corresponds with the depletion of the economy caused by the escalation of the war crisis and increased uncertainty in the resolution of the political and security events. However, in accordance with the expectations, the decline of the gross domestic product in the fourth quarter of the year was significantly lower compared to the previous quarters and equaled 1.2%, having in mind the stabilized situation and revival of the economic activity.

Looking at the GDP expenditure aggregates, in 2001 compared to the previous year, the Government consumption registered nominal growth rate of 33.9%. The high increase of the Government consumption is due to the increased spending of the Central Government budget for security needs (supply of military equipment and cash payments to the regular and reserve members of the police and the army). However, the increased Government consumption did not create a positive impulse for the domestic economy, having in mind the fact that most of the expenses are related to the supply of equipment from abroad. The investments in machinery and equipment decreased nominally by 16.9%, due to the restraint of the economic entities from new investments having in mind the uncertainty caused by the deteriorated security in the country. Simultaneously, declined foreign trade of the country,

<sup>4</sup> Preliminary data.

<sup>5</sup> In 2000, the State Statistical Office started the calculation of GDP on a quarterly basis. The quarterly GDP is at constant prices, and the data series are from 1997.

determined high and identical nominal decrease of import and export of goods and services by 11.4%.

From the supply side, the registered fall of the gross domestic product in 2001 is mainly due to the high decline in the value added in the industrial sector by 3%, which represents 24.6% of the total GDP in the Republic of Macedonia, and due to the decline in the trade sector by 11.2%, with its share of 10%. Significant decrease by 14.3% is registered in the agricultural sector, which comprises 9.1% of the total GDP.<sup>6</sup>

## **2.2. Domestic output**

The unfavorable development of the political and security events in the Republic of Macedonia in 2001 had a negative impact on all sectors in the economy. One of the affected sectors is the industrial output. Namely, in 2001 the industrial output registered an average rate of decrease of 10.1%.<sup>7</sup>

The major determinants of the high decrease in the industrial output were the military actions in the North - West part of the country during the February - August 2001 period, which deteriorated the working conditions and caused a contraction of production activity. Namely, due to deteriorated security, the enterprises in the country faced the problem related to difficult supply of raw and reproduction materials and canceled contracts with foreign partners. Due to the uncertainty and the risk from the instability in the region, the economic agents restrained from new investments, while the decreased export demand for Macedonian products determined a decline in the foreign trade. Despite the above-mentioned factors, the high rate of decline of the industrial output in 2001 is partly due to the high comparison base from the previous year, which is considered as one of the more successful years of the Macedonian economy.

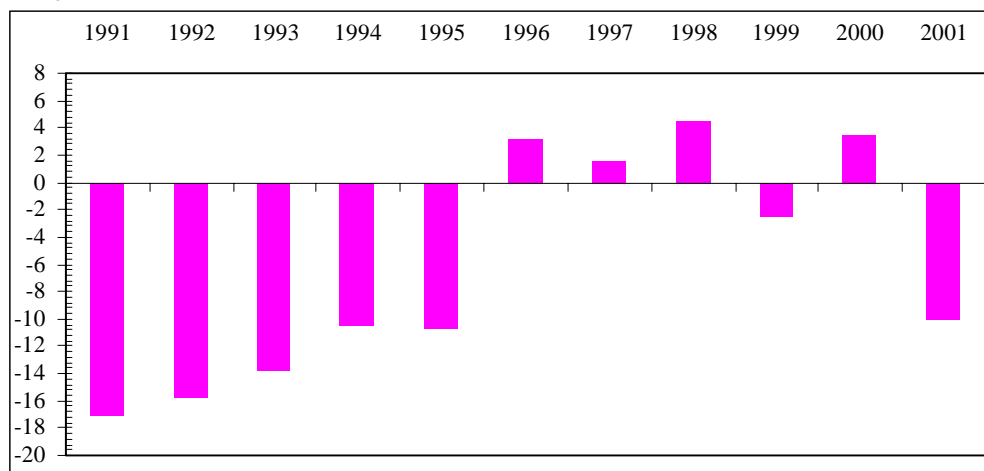
Despite the relatively stabilized security after the signing of the Framework Agreement (August 13, 2001), the negative effects from the crisis on the economy were still present. In addition, the period after the signing of the Agreement was too short for more significant revitalization of the domestic output in 2001.

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<sup>6</sup> According to the National Classification of Activities.

<sup>7</sup> Since January 2002, the State Statistical Office of the Republic of Macedonia has been calculating the industrial output indexes according to the National Classification by Activity (NCA) and by applying the National Nomenclature of Industrial Products (NNIP), on the basis of the recommendations of EUROSTAT. Thus, the industrial output index for the year 2001 was revised, in compliance with the new weighting system, with the average decrease in the volume of the industrial output in 2001 equaling 3.1%.

Chart 2  
Industrial output  
(changes in %)

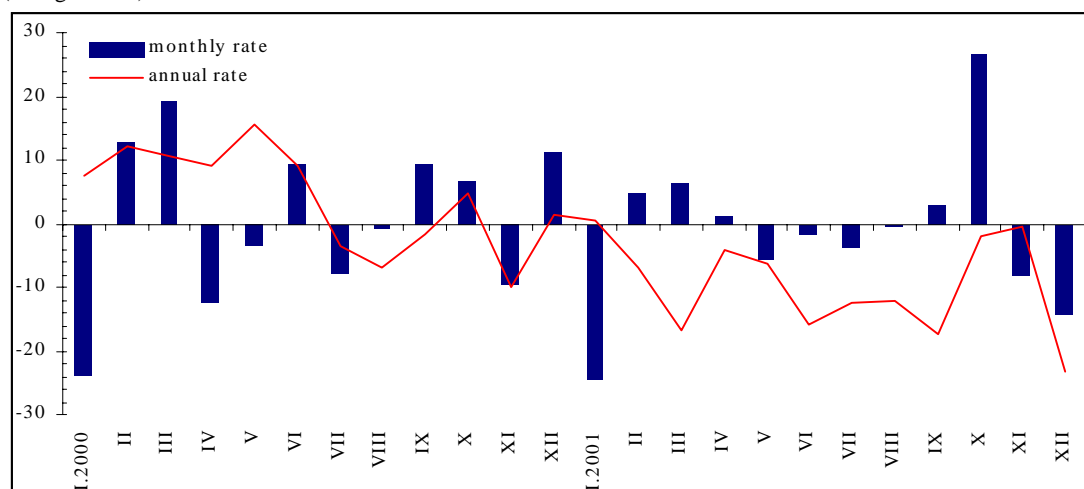


With respect to the structure, the decrease of the industrial output in 2001 is due to the reduced production of reproduction material and consumption goods (by 13.5% and by 8.8%, respectively). Production of means of production realized high increase by 23.2% in the observed period, but this increase was not sufficient to compensate for the decline in the other two components.

In addition, the industrial output registered an overall decline. Namely, out of the total number of 32 industrial branches, the production is reduced in 27 branches, representing 88.4% of the total industrial output. Among the leading industrial branches, highest decrease is registered in iron and steel industry (by 31.9%), basic chemical industry (by 25.7%), tobacco industry (by 23.8%) and construction materials industry (by 20.6%), mainly due to the lowered export demand for these products on the foreign markets. At the same time, significant decline was registered in food products industry (by 12.2%) and in generation, transmission and distribution of electricity (by 6.5%), which together comprise nearly one-third of the total industrial output. Namely, unfavorable hydrological conditions in the country, as well as the lowered use of electricity by the industrial enterprises (because of the reduced production activity), caused a decrease in the production of electricity in 2001. Furthermore, the canceled contracts by the foreign partners heavily stroked the textile industry (**tolling manufacturing**), hence the production of finished textile products was reduced by 10.4%. On the other hand, processing of the non-metal mineral products and production of electrical machinery and appliances increased by 28.8% and 19.5%, respectively.

Analyzing the dynamics, in the first six months of the year, most of the movements in the industrial output on monthly basis differ from the common movements, as a result of the deteriorated security in the country. On the contrary, since July, and especially August 2001, i.e. after the stabilization, the movements in the industrial output by months were common and mainly seasonally determined. The highest monthly decrease was registered in January (by 24.5%), due to the seasonal factors (fewer working days). More significant decline in the output was registered in December (by 14.4%) and in November (by 8.3%), which reflects the gradual normalization of the production activity after the movements in October. Namely, in October the highest monthly increase of the industrial output was registered (by 26.5%), due to the seasonal factors (increased production of wine and electricity, as well as intensified processing of fruits and vegetables in the tin industry).

Chart 3  
Dynamics of the industrial output  
(changes in %)



Total agricultural production in the Republic of Macedonia registered a significant decrease of 13.3%<sup>8</sup> in 2001 relative to the previous year. This was mainly due to the unfavorable weather conditions during 2001, because of the drought and the extremely low temperature in the last month of the year. From the structural point of view, the production in all agricultural branches was reduced. In addition, the highest decline registered the fruit growing (by 31.9%), while the lowest decrease of 7.2% was registered in the viticulture. Simultaneously, the field crops production and the cattle breeding were lowered by 13.1% and by 11.6%, respectively. The snow and the cold weather in December mostly affected the sheep livestock (decline by 25.1%).

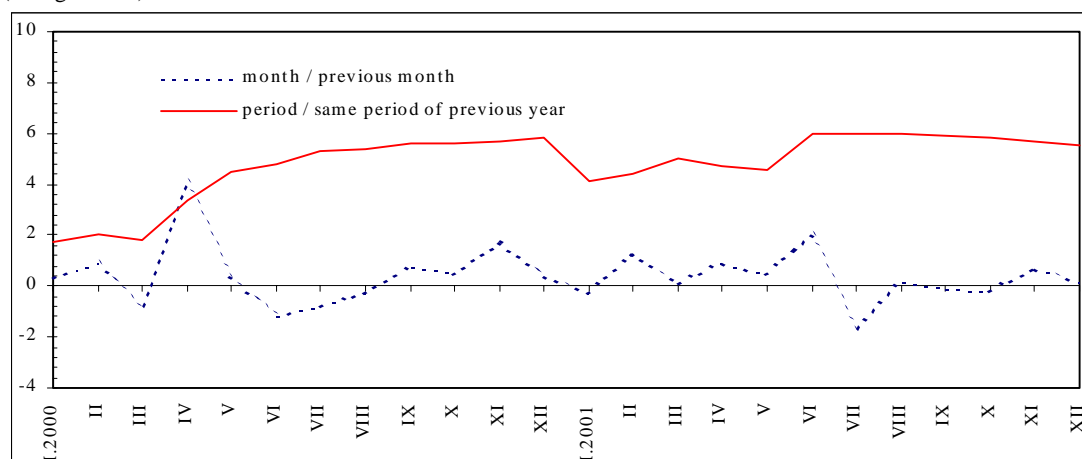
### 2.3. Inflation

Having in mind the complexity of the situation that the Macedonian economy faced in 2001, and especially having in mind the number of economic problems arising from the war crisis in the country, the price stability maintenance was a significant contribution of the monetary policy. Namely, in 2001 a single-digit average inflation rate of 5.5% was realized. In addition, the realized inflation was nearly identical with the projection for the same year (5.3%) and at the same time it was lower than the last-year inflation. On annual basis (December 2001 / December 2000), the inflation rate equaled 3.7%. In this context, the successful coordination of the monetary and the fiscal policy, and the firm determination for stable foreign exchange rate of the Denar against the Deutsche Mark, were aimed at and were of a great importance for alleviating the inflationary pressures during the crisis and for disabling the inflationary spiral exchange rate - prices.

<sup>8</sup> Preliminary data.



Chart 4  
Costs of living  
(changes in %)



The moderate growth of the inflation rate in 2001, measured through the costs of living, is mainly due to the influence of the non-monetary temporary factors:

- Liberalization of the prices of wheat flour and bread in February 2001. This resulted in a rise in the prices of bread, bakery products and cereals;
- Increased demand for foreign currency caused by the psychological factors during the war crisis. The pressure for depreciation of the Denar exchange rate at the exchange offices market during the crisis, led to an overall rise in the price level, having in mind the relatively fast impact of the fluctuations in the Denar exchange rate on the price level in the economy. These movements were most evident in June 2001, and were determined by the high uncertainty and escalation of the war activities in the North - West part of the country;
- Uncommon increase in the prices of agricultural products (vegetables and fruits) in June and November 2001. The drought and the reduced agricultural production in the regions affected with the war crisis, resulted in a decreased supply of these products at the domestic market;
- Increased prices of certain products that are controlled by the Government. Namely, in August 2001, a high increase of the prices of postal and telecommunication services was registered.

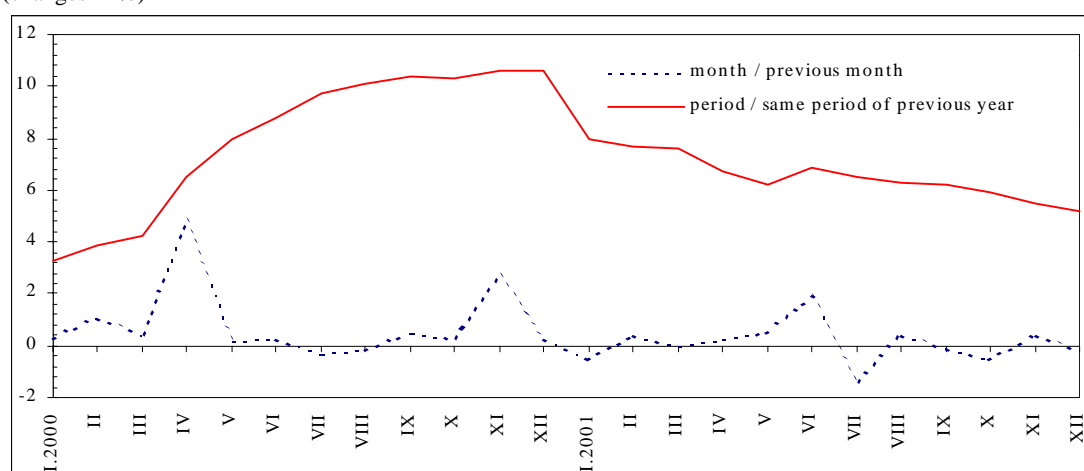
Structurally observed, in 2001 costs of services increased more intensively (by 10.9%), than the costs of goods (by 4.5%). Analyzed by different groups of consumption, the increment is registered in the costs of transport and communication services (by 9.5%), costs of food (by 6.9%) and costs of housing (by 5.5%), due to the higher prices of postal and telecommunication services, agricultural products and public utility services, respectively.

With respect to dynamics, in most of the months during 2001, i.e. in eight months, the costs of living registered an increase on monthly basis. In addition, in the February - June 2001 period they were continually increasing, and the highest monthly increment was realized in June (by 2.0%) and in February (by 1.3%). Increased costs of living in June are due to the uncommonly high increase in prices of agricultural products, and the fluctuations of the Denar exchange rate at the exchange offices market that relatively quickly affect the price level. The main determinant of the increase of the costs of living in February is the liberalization of the prices of wheat flour and bread, by the abolishment of their control by the Government. Costs of living decreased in four months during 2001. Thus, they decreased in July (by 1.7%) due to the seasonal decline in prices of vegetables, while the decline in January (by 0.3%), September (by 0.1%) and October (by 0.2%) is primarily determined by the decrease in the prices of oil derivatives.

The factors mentioned above also determined the increase of retail prices, in a way that they followed the movements of the costs of living. Thus, in 2001 retail prices on average were higher by 5.2% relative to 2000, while their annual growth rate equaled 1.2%.

With respect to the structure, the prices of services realized more intensive average increase of 9.0%, compared to the increase of the prices of goods of 3.2%, as it was the case with the costs of living. In addition, the highest increase was realized in the prices of agricultural and food products (by 11.2% and 7.1%, respectively). Analyzed by months, the most significant fluctuations of the retail prices were registered in June (increase by 1.9%) and in July (decrease by 1.4%), determined by the same factors that influenced the costs of living in the same months of the year.

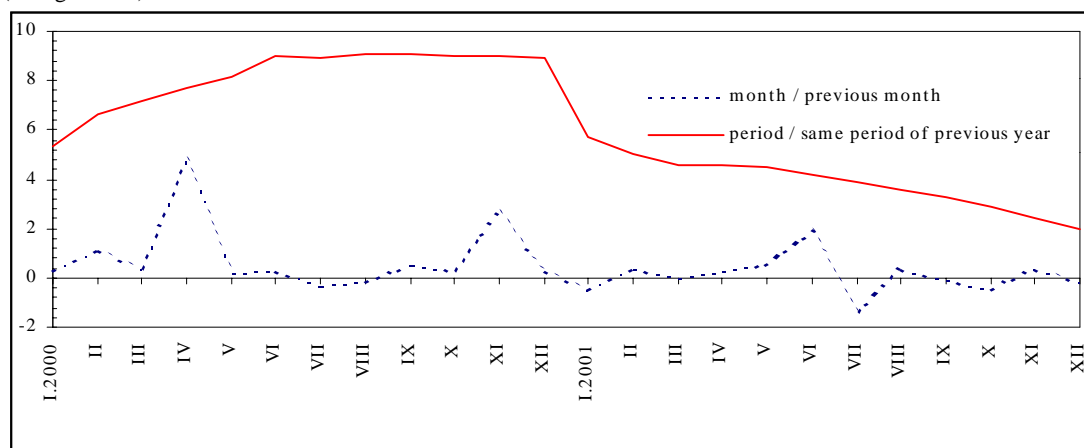
**Chart 5**  
**Retail prices**  
(changes in %)



In accordance with the moderate price growth, the average value of the consumer's basket for food and beverages<sup>9</sup> increased by 5.1% in 2001 relative to the average value in the previous year, and reached Denar 9.987. On annual basis (December 2001 / December 2000), the value of the consumer's basket is higher by 7.2%, due to the high increase of the value in the following categories: "raw and processed vegetables" (by 24.8%) and "cereal and cereal products" (by 17.1%). The increased value in these categories reflects the increased prices of vegetables on the domestic market and increased prices of wheat and bread after the Government abolished the regime for their direct control in February 2001.

<sup>9</sup> All products in "food and beverages" category, which compose the basket, are taken as average monthly needs of a four-member non-agricultural household, and that list of products is constant (same products - same quantities), during a one-year period.

Chart 6  
Prices of producers of industrial products  
(changes in %)



As in the previous year, in 2001 the fluctuations of the prices of producers of industrial products were, to a high extent, determined by the changes in the prices of producers of oil derivatives in the Republic of Macedonia (average decline by 5.2%) that depend on the movements of the crude oil prices on the world market and the value of the US Dollar. At the same time, in 2001 the prices of producers of industrial products were determined by the changes in the prices of producers of food products (average increase by 9.7%), which were determined by the rise in the prices of agricultural products, primarily cereals and vegetables as production inputs in the food industry. In accordance with these movements, the prices of producers of industrial products in 2001, relative to 2000, were higher by 2.0%, on average, which is significantly lower growth rate compared to that of the last year (8.9%). With respect to the structure, the prices of producers of consumption goods increased by 4.6%, while the prices of producers of reproduction material and means of production registered a decrease (by 0.3% and 0.2%, respectively). Dynamically observed, more significant increase was realized in February (by 1.9%) and June (by 0.9%), while the highest decline was registered in January (by 1.9%).

## 2.4. Labor market

Lowered economic activity in 2001, seen through the high decline in domestic output and gross domestic product, did not interrupt the downward trend of the unemployment rate in the Republic of Macedonia, lasting since 1998. However, regarding the long-term character of the problem of structural unemployment in the country, one can say that the changes on the labor market are only temporary, without any considerable effect in the long run.

Namely, according to the Labor Force Survey<sup>10</sup> for 2001, the active population reached 862,504 persons, which represents significant increase (by 50,947 persons, or by 6.3%) relative to the previous year, and is a result of the increased number of employees. According to the Survey, the number of employees in 2001 reached 599,308, which is an increase by 49,462 persons, compared to 2000. In addition, the employment rate, calculated as a share of the number of employees in the total population aged over 15, increased by 2.8 percentage points and reached 38.6%. These changes on the labor market are mainly a result of several factors arising from the deteriorated security in the country:

<sup>10</sup> The Survey was conducted between October 1 and 7, 2001 by the State Statistical Office of the Republic of Macedonia. The Survey was conducted on a sample of 7,200 households on the whole territory of the country, except for one town (Debar), and is in accordance with the methodological recommendations of the International Labor organization (ILO) and the recommendations of the European Statistical Bureau (EUROSTAT).

a) Involving a great portion of young unemployed population into the security forces of the Republic of Macedonia, as well as the activation of the unemployed within the police and military reserve forces. This determined the highest increase of the employment rate of the population aged between 25 and 29 and between 20 and 24 (by 5.1 and by 3.2 percentage points, respectively);

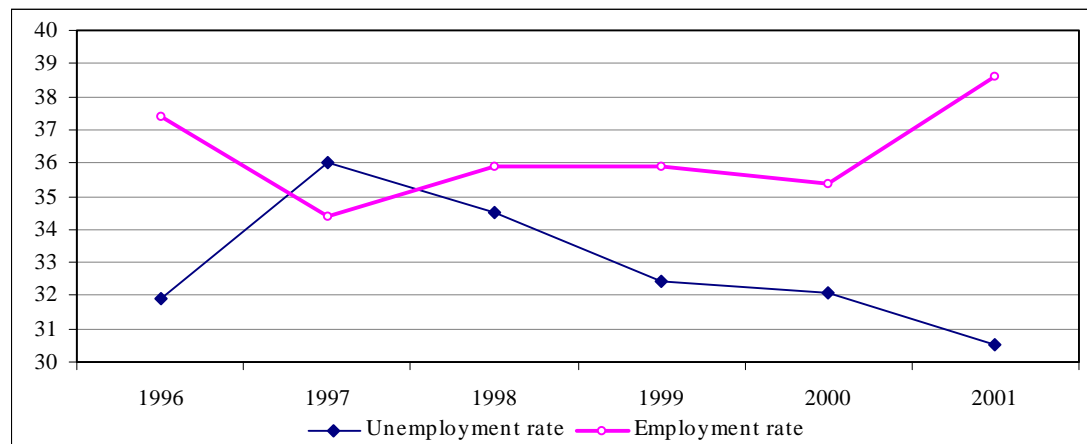
b) Instead in April, the Survey was postponed for October, because the military actions that took place in one part of the territory of the Republic of Macedonia disabled its conduction in the usual period of the year. This resulted in incorporation of the seasonal effect of the increased employment in the agricultural sector (increase by 12.5%);

c) Lowered living standard of the population, which forced retired people to accept an additional job, and in general there was a greater preference for accepting jobs on a shorter period of time.

All above-mentioned factors resulted in a high increase in the number of employees employed for a definite period of time (by 2.5 times).

Analyzed by gender, out of the total number of employed persons, 60% are men. In addition, significantly higher employment rate was registered in the male population (46.3%), compared to the female population (30.9%). With respect to the age, the highest employment rate was registered among the population aged between 40 and 44 (64.2%) and between 45 and 49 (62.8%).

Chart 7  
Employment and unemployment rates  
(in %)



According to the data from the Survey, the unemployment rate in the Republic of Macedonia, which represents the percentage share of the number of unemployed in the total labor force<sup>11</sup>, equals 30.5% in 2001. Compared to 2000, it is lower by 1.7 percentage points. However, in absolute values, the total number of unemployed persons is higher by 1.485 persons, reaching 263,196. Lowered unemployment rate in terms of increased number of unemployed persons is due to the significantly higher number of active population in 2001. Out of the total number of unemployed persons, 149,372 are male, while 113,825 are female. In addition, the unemployment rates of the male and female population equal 32.0% and 29.5%, respectively. Although decreased, these rates are still high; thus the unemployment still remains a prevailing problem in the Republic of Macedonia. Especially concerning is the

<sup>11</sup> Total labor force (the active population) includes the employed and unemployed persons aged between 15 and 80 years.

unemployment rate by age. As in the previous year, the highest unemployment rates this year were registered with the population aged between 15 and 19 (57.6%), between 20 and 24 (55.7%), and between 25 and 29 (44.1%), despite their lowered level compared to the last year (by 3.1, 3.9 and 5.6 percentage points, respectively).

## 2.5. Fiscal policy<sup>12</sup>

The military activities on part of the territory of the Republic of Macedonia in 2001, led to high expenditures of the Central Government budget for military and security needs, having in mind the considerably lower revenues in the budget, mainly due to the lowered economic activity in the country. Consequently, in 2001 the conduction of an expansive fiscal policy was inevitable, which determined a restrictiveness of the monetary policy, because this correlation is an essential precondition for maintaining macroeconomic stability. The need for obtaining additional revenues in the budget for covering the significantly increased expenditures for security needs, led to the introduction of a new “war” tax. Namely, as of July 01, 2001 the Law on Financial Transactions Tax was introduced, and was intended to be in force till the end of the year. However, significantly higher budget expenditures than the revenues in the budget in 2001, resulted in budget deficit (Central Government budget and Funds), which is estimated at around 5.7%<sup>13</sup> of the gross domestic product (contrary to the realized surplus in the previous year of 2.5% of the gross domestic product in 2000).

The main determinants for this situation in the fiscal sector in 2001 are: a/ high Government expenditures for acquiring military equipment (mainly from abroad) and for cash payments to the regular and reserve forces of the army and the police; b/ the planned tax revenues, as a crucial component in the budget revenue structure, were under-realized, due to the lowered economic activity and deteriorated working conditions because of the war crisis in the country; c/ high expenditures for repayment of the foreign debts (principal and interest); and d/ unrealised expected inflows from abroad. Namely, in 2001 the revenues in the budget based on foreign donations and foreign credits were considerably lower relative to the previous year, hence only 6%, i.e. 17% of the projections for 2001 were realized, respectively.

Total public revenues<sup>14</sup> in the Republic of Macedonia reached Denar 80,504 million in 2001. Total revenues of the central Government budget in the Republic of Macedonia equaled Denar 63,110<sup>15</sup> million in 2001, and were by 17% under the projection for the mentioned year.

### Chart 8

Structural share of the components of the total budget revenues

2001

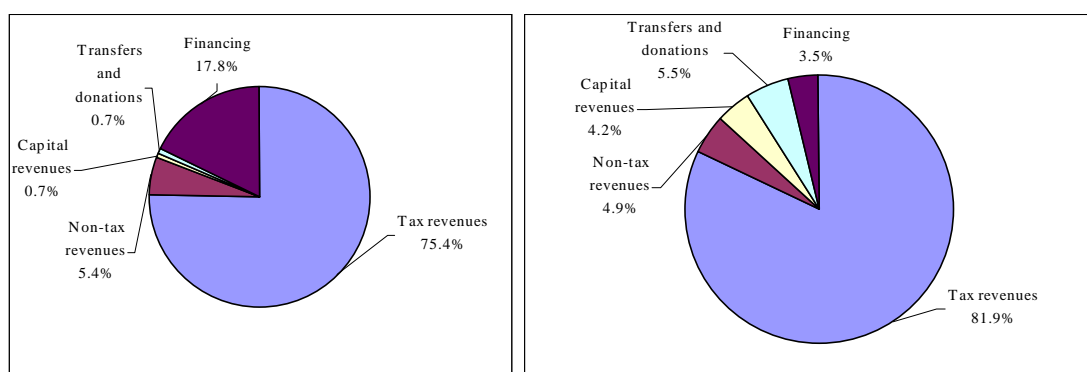
2000

<sup>12</sup> Data source: Ministry of Finance.

<sup>13</sup> Preliminary data. Source: Bulletin, Ministry of Finance.

<sup>14</sup> Public revenues of the Government refer to the revenues of the Central Government (excluding the revenues from budget financing) and the Funds.

<sup>15</sup> The total budget revenues encompass the revenues from financing.



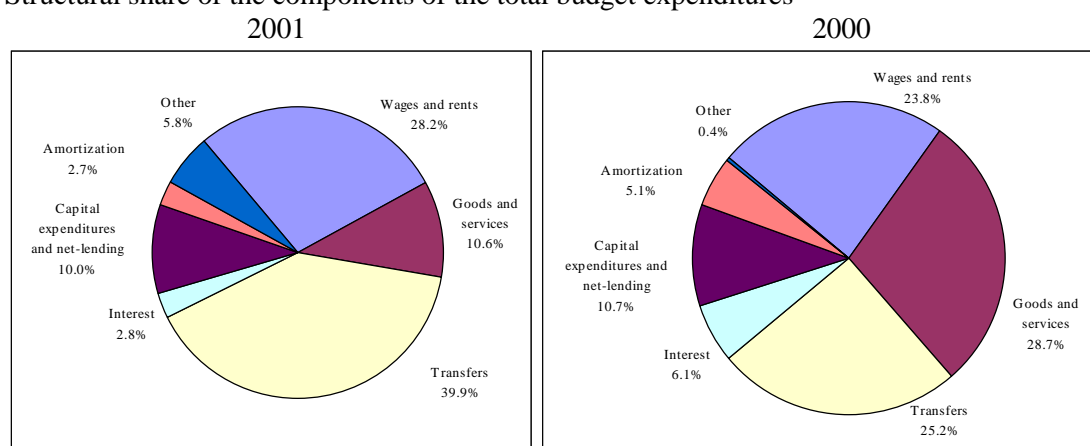
Primary budget revenues (tax and non-tax revenues) equalled Denar 50,967 million in 2001, and covered the largest part of the budget inflows (80.8% of the total budget revenues). Out of that, Denar 47,566 million refer to tax revenues. Relative to the projections for 2001, primary revenues were lower by 6.0%, due to the lower revenue collection than projected in both its components. Among the most significant tax revenues, the revenues from the customs, excises and value added tax did not reach the projected levels.

More significant inflows in the budget in 2001 were realized from the newly introduced tax on financial transactions and from the budget financing, which comprise 4.9%, and 17.9% of the total budget revenues, respectively.

Total public expenditures<sup>16</sup> of the Republic of Macedonia reached Denar 95,349 million in 2001. Total expenditures of the Central Government budget amounted to Denar 68,963<sup>17</sup> million and were by 9.0% lower than the projected level.

Chart 9

Structural share of the components of the total budget expenditures



The unfavorable structure of the budget expenditures was maintained in 2001, regarding the dominant share of the current expenditures (wages and salaries, goods and services, transfers and interest). Thus, in 2001 the current expenditures equaled Denar 57,867 million, or 83.9% of the total budget expenditures. The largest portion, or Denar 19,825 million refers to expenditures for goods and services, where the current expenditures of the Government for security needs are included. In addition, regarding the high expenditures for this purpose, their share in the total budget expenditures in 2001 is higher by 18.1 percentage points relative to the previous year, reaching 28.7%.

<sup>16</sup> Public expenditures of the Government refer to the expenditures of the central Government (excluding the expenditures for financing) and the Funds.

<sup>17</sup> The total budget expenditures also encompass the expenditures for budget financing.

Capital expenditures and net lending in 2001 equaled Denar 7,380 million, or 10.7% of the total budget expenditures. Out of that, the largest portion refers to the investments in fixed assets, where the supply of military equipment (mainly from abroad) is included. Regarding the unproductive character of the spendings, these investments did not have a positive impact on the level of economic activity in the country.

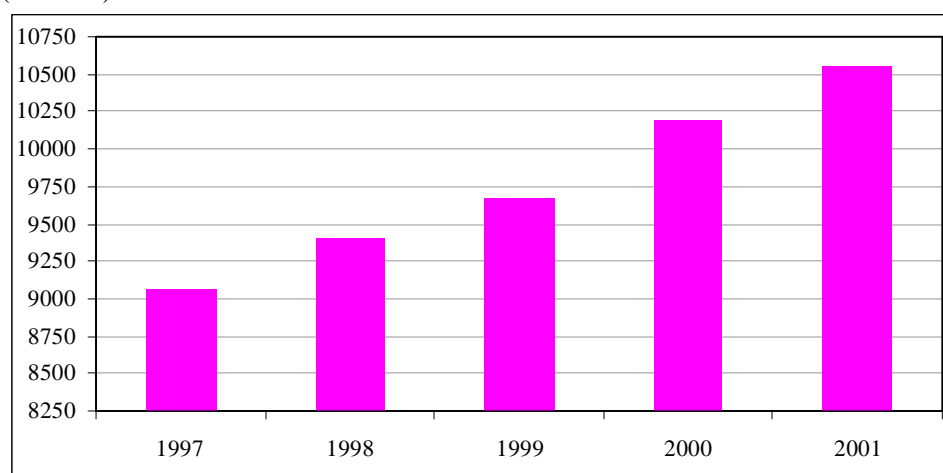
The overall situation in the country determined by the war crisis affected the extra-budgetary funds, resulting in unrealized projected revenues on one hand, and more restrictive spending on the other. Thus, total revenues of social funds (Pension and Disability Insurance Fund, Health Fund and Employment Fund) equaled Denar 41,411 million in 2001, and were by 5.1% lower than the projected revenues. Total expenditures of these funds equaled Denar 41,651 million and were also under the projected level by 4.6%. Total revenues and expenditures of the Road Fund were identical in 2001, and equaled Denar 4,012 million, which is significantly under the projection (by 29.8%).

## 2.6. Wage policy

In 2001, the wage policy was directed towards maintaining the macroeconomic stability in the country, through its coordination with the fiscal and monetary policy. In addition, in 2001 the Law on Wages was still in force, according to which, the increase of wages in the Government sector and in all legal entities with the level of privatization less than 70%, is limited. The aim of the limited wage increase is to prevent cost inflation by controlling the individual consumption. However, the effect of this Law in the last few years is diminishing, regarding the fact that in the Republic of Macedonia most of the legal entities are privatized and they pay the wages according to their financial abilities and labor productivity.<sup>18</sup>

Chart 10

Nominal average net-paid wage per worker  
(in Denars)



In 2001, the nominal average net-paid wage increased by 3.5% compared to 2000, thus reaching Denar 10,552. However, this increase was not as high as in the previous year, when an increase of 5.5% was registered. Structurally observed, the highest increase of wages was registered in the following branches: mining and quarrying (by 20.5%), financial

<sup>18</sup> During 2001, additional 62 enterprises were privatized. As of December 31, 2001, the total number of privatized enterprises reached 1.678 (around 95% of the legal entities), where a total number of 229,151 persons are employed. (Source: Agency of the Republic of Macedonia for Privatization).

intermediation (by 7.6%), activities related to real estate, renting and business activities (by 6.3%), and electricity, gas and water supply (by 5.4%).<sup>19</sup>

Table 5

Net-paid wage per worker in the Republic of Macedonia

	Amount in denars	Nominal growth 2001/2000	Real growth 2001/2000
	2001	(in %)	
Average monthly wage, Total	10,552	3.5	-1.9
<i>by sectors:</i>			
<i>Mining and quarrying</i>	8,885	20.5	15.0
<i>Financial intermediation</i>	21,564	7.6	2.1
<i>Real estate, renting and business activities</i>	13,538	6.3	0.8
<i>Electricity, gas and water supply</i>	14,192	5.4	-0.1
December wage, Total	10,529	0.6	-3.0

According to the real indicators, the average net-paid wage per worker in 2001 is lower by 1.9% relative to the previous year. This is due to the higher average inflation rate (5.5%) than the increase of the nominal average net wage.

On annual basis (December 2001 / December 2000), the average net wage per worker is nominally higher by 0.6%, while in real terms it was lower by 3.0%, due to the registered annual inflation rate of 3.7% in December 2001.

<sup>19</sup> Since May 2001, the State Statistical Office of the Republic of Macedonia has been implementing a new National classification of activities for calculating the index of the average net-paid wage, according to which the classification of the activities as economic and non-economic no longer exists.



### **III. Monetary Policy**

#### **3.1. Monetary Policy Goals**

As a consequence of the deteriorated security, 2001 was marked with an increased risk and uncertainty, deterioration in the working conditions and influence of psychological factors, due to the war crisis. In these circumstances, creating monetary policy was aggravated, imposing necessity for revision of the monetary policy projections.

The main monetary policy goal in 2001, within the global setting of the macroeconomic policy, was maintaining price stability, as the most adequate ambience for long-term sustainable growth. Thus, annual inflation rate of 1.2% was one of the basic assumptions of the initial monetary policy projection. The projected inflation rate was derived from the expectations for exhausting the influence of non-monetary factors, which in 2000 generated temporary inflationary movements, as well as from the assumption for stable prices of the oil derivatives and electricity supply.

The final monetary policy goal, price stability, in 2001 was anticipated to be achieved by keeping the stability of the nominal Denar exchange rate towards the Deutsche mark, as a monetary policy intermediary target. Hence, the Central Bank continued to implement the exchange rate targeting strategy, in line with the correlation between the exchange rate and price stability in a small and open economy, as well as with the successful results from the implementation of this strategy in the Macedonian economy. For maintaining low, stable and predictable inflation level, the consistency in conducting the macroeconomic policies is of high importance, with an intention monetary policy to be adequately supported by the fiscal and wage policies.

Another important assumption, when designing the monetary policy for 2001, was the initially projected real GDP growth of 6.0%, reflecting the expected upturn in the economic activity in the Republic of Macedonia. In addition, the economic growth was anticipated to derive from the surge in the activity, primarily in the industry, construction and “transport and communication services”, as well as by the reactivation of the loss making enterprises, sold to foreign strategic investors. As an additional impetus, the upswing in the investment activity was considered, in line with the increased banks’ deposit potential and consequently, credit support, as well as the expected decrease of the lending interest rates. Easier access to the European Union market, according to the Stabilization and Association Agreement, was anticipated to act toward increasing the economic activity, as well toward further labor productivity growth in the industry and decreased real unit labor costs.

In line with the initial monetary policy assumption, in the initial monetary policy projection for 2001 annual growth of the money supply M2 – Denar component of 12.0% was projected, with an identical increase being projected for the reserve money. Hence, monetary policy was designed to support the projected economic growth, avoiding simultaneous exposure of the price stability to risk. On the basis of the planned inflows from the capital transactions and in line with the implemented monetary strategy, the net purchase of foreign currency at the foreign exchange market by NBRM was projected for 2001.

The deteriorated security in the second half of February 2001 caused negative repercussions for the Macedonian economy, fundamentally changing the ambience for monetary policy implementation. Due to this, as well as to the impossibility to predict precisely the crisis length, the macroeconomic policies for the second half of 2001 were redesigned, with the main assumptions on which monetary policy projection is based being revised. Thus, lower real GDP growth rate was projected (2.5%), as well as higher inflation

rate (4.0%) on December basis, determined by the increased demand for goods influenced by psychological factors, with simultaneous decline in the domestic production. In addition, the projected economic growth primarily is based on the assumption for gradual relaxation of the war tensions in the country, as well as on the projects financed with the funds received from the privatization of the Macedonian Telecom, which were supposed to enable intensification of the economic activity in the second half of 2001.

In line with the revised projection, monetary policy in the second half of the year was intended to act towards excess liquidity withdrawal, caused by the increased Government spending for security purposes. This setting of the monetary policy, in combination with the interventions on the foreign exchange market through net sale of foreign currency was directed towards defending the targeted level of the exchange rate, in presence of pressures for depreciation. Having in mind the endogenous character of the money supply when targeting the exchange rate, in these circumstances the monetary policy stance is restrictive and monetary aggregates register a decline. Thus, with the revised projection for 2001, a nominal decline of the money supply M2 - Denar component of 10.0%, was projected. Within the efforts for liquidity sterilization, it was presumed monetary policy to be supported by the fiscal policy through the introduction of transient tax on financial transactions of the legal entities.

However, in order projected economic growth to be achieved, in 2001 total credits of the banks extended to the non-government sector were projected to increase by 6.8%, based on the expected decline in the net foreign assets of the monetary system. For disabling the pass through of the consequences from deterioration in the real sector of the economy to the banking sector, enhanced supervisory control of NBRM over the credit procedures was planned.

Within the monetary policy instruments, it was intended NBRM to continue with the implementation of indirect, market based instruments. In line with the overall situation, the CB bills auctions as the most utilized instrument, in the second half of the year were planned to act towards liquidity withdrawal, in order to sterilize the excess of liquidity. In addition, increased responsiveness of the banks to the Central Bank signals was expected, for achieving the monetary policy goals.

With the gradual normalization of the economic and the security situation, following the signing of the Peace Agreement (August) and the reduced uncertainty, prerequisites for more realistic perceiving of the current and possible future movements were created. In addition, contrary to the optimistic prognosis for economic growth, it was clear that the negative consequences from the war crisis are significantly higher. Consequently, the macroeconomic policy was revised again (November), and also revision was made to the monetary policy projection. Thus, in line with the economic movements registered up to that moment, for 2001 real GDP decline of 4,6% was estimated, as well as average inflation rate of 5.3%. Within the monetary policy, nominal increase of the money supply M2-Denar component of 3.7% was projected. As a consequence from the deteriorated security and without being able to meet the quantitative targets agreed with the Mission of the International Monetary Fund, at the end of the year the arrangements with this financial institution (EFF and PRGF), concluded in the previous year, were canceled.

### **3.2. Report on the Monetary Developments in 2001**

Despite the unfavorable circumstances, the consistent implementation of the exchange rate targeting strategy enabled successful achievement of the monetary policy ultimate goal – maintaining price stability. The most considerably contribution, in this

direction was the consistent macroeconomic policy. Thus, the average inflation rate, measured through the costs of living, in 2001 equaled 5.5%, which is within the projected growth.

Monetary developments in the Republic of Macedonia in 2001 were determined by the general economic and security situation in the country. Namely, the war crisis from the north-west of the country (in the second half of February) determined high and irrational level of currency in circulation, as well as deposits withdrawal from the banking sector, influenced by psychological factors. The relatively high liquidity level in the economy resulted in an increased foreign currency demand, creating pressures for depreciation of the Denar exchange rate against the Deutsche mark. In order to defend the targeted exchange rate level from the psychological and speculative pressures for depreciation, NBRM interventions were two-sided: on the supply side (sale of foreign currency) and on the demand side (withdrawal of Denar liquidity, with attractive interest rates being offered at the CB bills auctions and increase of other NBRM interest rates). This monetary policy setting, together with certain changes in the foreign exchange policy stance, resulted in stabilization of the movements at the foreign exchange market and maintaining of the Denar exchange rate stability. At the same time, this monetary policy stance, as well as the restraint of the banks from placing funds at the money market in presence of uncertainty, caused increase of the market interest rates.

With the mitigation of the war tensions, as of September 2001 NBRM participated at the foreign exchange market as a net purchaser of foreign currency. Also, the deposits of the economic agents in the banking sector were revitalized, with foreign currency deposits registering extremely high increase in the last months of 2001 (due to the Euro conversion). Hence, for supporting positive economic trends NBRM decreased the interest rates on CB bills auctions, twice. At the same time, favorable movements were registered at the money market, with declining trend of money market interest rates.

#### **Chronology of Monetary Policy Measures**

During 2001 a number of monetary policy measures, reflecting its flexible setting and high consistency level with other segments of the macroeconomic policy, were undertaken. At the same time, through the chronology of the monetary policy measures, the high degree of monetary policy responsiveness to the current economic movements (for maintaining price and financial stability) can be delineated.

##### **May 21, 2001**

As a reaction to the permanent pressures for depreciation of the exchange rate at the foreign exchange market and for successful conduct of the exchange rate targeting strategy, in May the Council of NBRM decided to increase reserve requirement rate by 0.5 percentage point. Thus, the reserve requirement rate on short-term deposits (demand deposits, sight deposits and term deposits up to three months) was increased from 8% to 8.5%, whereas the rate on long-term deposits (term deposits over three months) was increased from 3.5% to 4%. The Decision was based on previous monitoring of the Denar and foreign currency liquidity of the banking system and it was aimed at withdrawing of the excess liquidity, which was pressuring the movements on the foreign exchange market. At the same time, the remuneration rate on the allocated reserve requirement, which follows the money market rate and is calculated as a percentage of the discount rate, was increased from 80% to 89% of the discount rate. For rational utilization of the Lombard credits, as a last resort facility, NBRM decided to increase the interest rate on Lombard credits from 17.5% to 19%, with reduced period allowed for utilization from 10 to 5 days, within the month.

**June 4, 2001**

CB bills were the main instrument of the Central Bank for managing the banking sector's liquidity. In addition, in line with the economic movements, NBRM was continuously striving to make this instrument more attractive. Thus, in June 2001 "volume tender" auction type was introduced, with possibility of investing in CB bills by all interested economic agents. The offered interest rates equaled 13%, 14%, 14% and 15%, for maturity of 3,7,14 and 28 days respectively.

At the same time, the reserve requirement rate was increased by 1.5 percentage points for short-term deposits (from 8.5% to 10%) and by 1 percentage point for long-term deposits (from 4% to 5%).

**June 15, 2001**

NBRM decided to increase the interest rate on CB' bills with maturity of 28 days (from 15% to 20%).

**June 28, 2001**

It was decided to increase the discount rate from 7.9% to 10.7%. Hence, the penalty rates, which are based on the discount rate (200% above the discount rate) were also increased.

**July 2, 2001**

The percentage of the face value of securities used as collateral for Lombard credits was increased (55% of the face value of the pledged securities).

**September 3, 2001**

NBRM abolished CB bills with 3-day maturity, as a result of the declined interest.

**October 15, 2001**

As a reaction of the Central Bank to the gradual normalization of economic movements and the stabilized foreign currency demand on the foreign exchange market, interest rates on CB bills were decreased. Thus, interest rates on bills with maturity of 7,14 and 28 days equaled 11%, 11% and 17%, respectively.

**November 19, 2001**

In line with the permanently declining pressures on the foreign exchange market, NBRM additionally decreased the interest rate on CB bills with 28-day maturity, thus reducing it to 15%.

**Foreign exchange policy** was set on a compatible basis with the monetary policy stance. In addition, the measures undertaken enabled increased foreign currency supply, thus contributing to the stabilization of the movements at the foreign exchange market. The main measures of the foreign exchange policy undertaken during 2001 were: 1) reduced period allowed for utilization of the foreign exchange swap as a last resort facility (5 days), accessible only to banks that according to the last report on foreign currency position are below or at the foreign currency minimum; 2) reduced period, in which legal entities are allowed to hold foreign currency on account, by legal entities from 180 to 30 days; 3) reduced maximum amount of foreign currency, allowed to be kept on accounts abroad, by banks with license for payment, credit and guarantee operations, abroad.

The money supply in 2001 was determined by the movements on the foreign exchange market, as well as by the movements of currency in circulation and deposits within the banks, driven by psychological factors. Thus, in presence of high currency in circulation increase (48.4%), the money supply M2-Denar component in 2001 increased on annual level by 13.6%. It is mostly due to the significant increase in the last month of 2001, determined by the extraordinary high increase of currency in circulation (primarily as a result of the payment

operations reform, high net-purchase of foreign currency from the exchange offices market and the common seasonal effect). In addition, this monetary aggregate registered double-digit annual rate of increase of 11.1%, due to the registered movements in the first half of the year. In the second half of 2001 the annual rate of the money supply declined, with one-digit growth rates being registered (excluding December).

In presence of slowed monetary multiplication, the money supply increase is a result of the significant reserve money increase. In addition, the growth rate and the reserve money dynamics are completely determined by the currency in circulation, as their dominant component. The reserve money in 2001 registered high average growth rate of 27.4%. On December basis, the reserve money growth was more intensive (35.8%) due to the excessive currency in circulation increase.

In presence of deteriorated economic performances and deteriorated movements in the real sector of the economy, determined by the war crisis, credit activity of the banking sector in 2001 registered increase of 7.7%. It is mostly due to the increased Denar credits of the banks (by 8.7%), with a moderate increase of foreign currency credits (by 0.6%). In addition, the main characteristic of the banks' credit activity was the lack of flexibility, reflected through the lagged response of the banking sector to the monetary policy measures and the general economic and security conditions. At the same time, divergent movements of Denar and foreign currency credits of the banks to the non-government sector were registered. Namely, contrary to the preferences for Denar credits in the first half of 2001, in the second half banks reoriented towards foreign currency placements, i.e. towards more intensive utilization of foreign credit lines. It is a reflection of the increased degree of banks' precaution, determined by the increased credit risk and the uncertainty regarding the movements of banks' liquidity.

## IV. Monetary developments in the Republic of Macedonia

### 4.1. Money Supply Creation and Withdrawal

In line with the monetary policy strategy, the Denar exchange rate against the Deutsche Mark was an intermediate target in 2001. NBRM kept its orientation towards price stability, as a main prerequisite for sustainable economic development. The dynamics of the money supply in 2001 was determined by the movements in the economy as a whole, and mostly by the psychological factors, considering the war crisis in the country.

Money supply M1 (currency in circulation and demand deposits) at the end of 2001, compared to December 31, 2000 registered a significant increase of Denar 3,214 million, or by 14.5%. Due to the slowed monetary multiplication process, determined by the high currency demand and the decrease of the demand deposits, the increase of the money supply M1 is completely due to the higher reserve money level. The M1 average annual rate of increase equaled 8.3% in 2001.

Table 6  
Money Supply M1 creation and withdrawal<sup>1</sup>  
(in Denar million)

	Balance as of 31.12.2000	Changes by quarters					Balance as of 31.12.2001
		I	II	III	IV	Total	
Money Supply M1	22,108	-601	-1,294	-314	5,423	3,214	25,322
Net foreign assets <sup>2</sup>	54,038	16,598	-8,022	-6,881	28,851	30,546	84,584
Net domestic assets	-4,432	-19,854	5,616	8,488	4,049	-1,701	-6,133
Domestic credits	33,650	-19,839	5,443	7,293	3,493	-3,610	30,040
out of which:							
Non-government sector credit <sup>3</sup>	34,314	649	-18	-112	39	558	34,872
- in Denars	30,256	1,222	-414	-867	583	524	30,780
- in foreign currency <sup>2</sup>	4,058	-573	396	755	-544	34	4,092
NBRM claims on Government, net	-12,067	-20,049	5,298	6,349	3,861	-4,541	-16,608
Other items, net	-38,082	-14	172	1,195	556	1,909	-36,173
Quasi- and non-monetary deposits <sup>4</sup>							
(non-government sector)	23,236	-414	-1,408	1,964	26,612	26,754	49,990
Government deposits <sup>4</sup>	4,262	-2,241	296	-44	867	-1,122	3,140
- demand deposits	2,883	-2,144	378	-155	115	-1,806	1,077
- quasi- and non-monetary deposits	1,379	-97	-82	111	752	684	2,063

1/ (+) Creation of Money Supply M1; (-) Withdrawal of Money Supply

2/ Stocks are valued at constant rate; flows are valued at current rate.

3/ Accounting balances of banks' credit to non government sector.

4/ Positive change reflects a withdrawal of money supply, negative change reflects creation of money supply.

With respect to the quarter to quarter dynamics, the analysis indicates decrease of the money supply M1 in the first three quarters (2.7%, 6.0% and 1.6%, respectively), whereas in the last quarter intensive increase of 27.3% was registered. The dynamics of the money supply M1 was determined by the fluctuations in the economic activity, changes in the expectations of the economic agents, having in mind the political instability, institutional changes, as well as by the introduction of the new European currency – Euro.

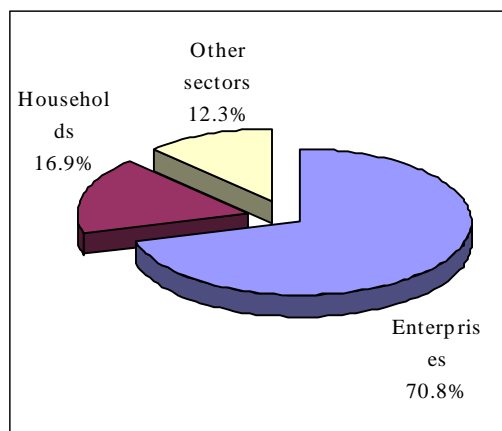
Regarding the structure, in 2001 divergent movements within the M1 components were registered. Thus, compared to the end of the previous year, the currency in circulation level was higher by 48.5%, whereas the total demand deposits registered a decrease of 11.1%. Consequently, the movements in the M1 structure were directed towards increased share of

currency in circulation. Thus, the average annual share of currency in circulation equaled 48.5% in 2001, being higher by 8.6 percentage points compared to the previous year.

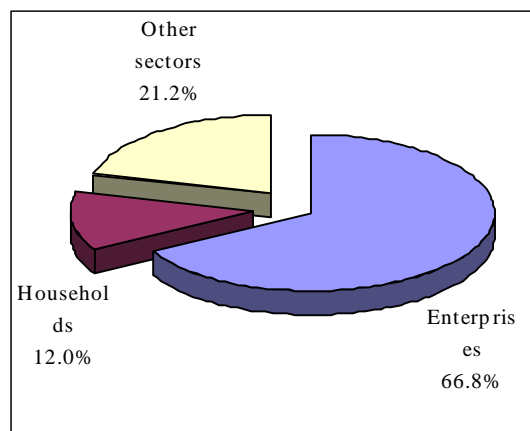
During 2001, the currency in circulation movement was deviating from its regular dynamics. Namely, at the beginning of 2001 the common stabilization of the currency demand, following the seasonal increase prior to the New Year and Christmas holidays, was not registered. Thus the analysis of the dynamics indicates permanent increase of the currency in circulation in the first quarter of the year (14.3%), influenced by several factors: a) the partial payment of the government bonds, based on old foreign currency savings; b) tobacco repurchase; c) public administration reforms (cash severance payments); d) preferences of the economic agents for cash holdings, resulting from the war crisis; e) cash payments for the security forces. In the second and the third quarter stabilization of the currency demand was registered (decrease by 7.2% and 9.4%, respectively), determined by the lessening of the psychological pressure, the gradual exhausting of the influence of the actors of increase from the previous period and the introduction of the tax on financial transactions (with higher taxation of the cash transactions). In the fourth quarter, intensive increase of currency in circulation by 54.5%, was registered. Besides the common seasonal factors (New Year and Christmas holidays), the currency level was influenced by the following factors: a) transient increase, as a result of the payment operations reform and the transformation of the Bureau for Payment Operations; b) the conversion of the Deutsche Mark into Euro, in the period prior to the Euro introduction, and due to the uncertain future parity among the leading international currencies.

Chart 11

Demand deposits by sectors  
December 31, 2001

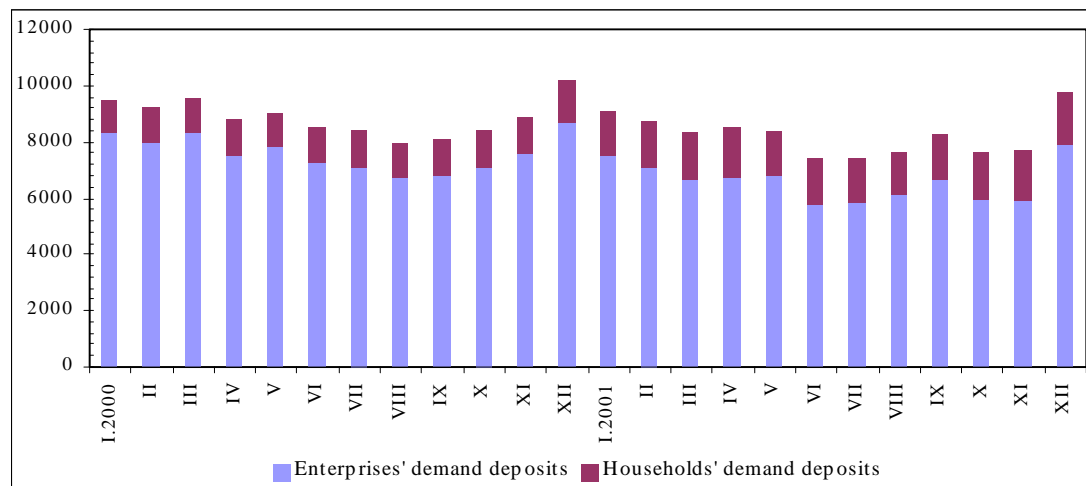


December 31, 2000



Regarding the sector structure, the demand deposits' decrease is completely determined by the decline in the enterprises' demand deposits, with simultaneous increase in the households' demand deposits. Thus, at the end of 2001 compared to the end of the previous year, the enterprises' demand deposits were lower by Denar 493 million, or by 5.9%. In addition, within the year their level was permanently fluctuating in line with the dynamics of the economic activity and the changes of the monetary and foreign exchange policy stance. Namely, the contraction of the economic activity, determined by the high political and war risk in the country resulted in an intensive decline of the enterprises' demand deposits in the first half of the year (31.6%). In the second half, the negative influences were moderate, as a result of the increased transactions in the economy and the changes in the foreign exchange policy stance (reduction in the period during which legal entities are allowed to hold foreign currency, from 180 to 30 days). Notwithstanding the negative trend of the enterprises' demand deposits, their share in the total demand deposits as of December 31, 2002 equaled 70.8%, which is by 4 percentage points higher, on annual level.

Chart 12  
Demand deposits of enterprises and households  
(in Denar million)



At the end of 2001, compared to the end of the previous year, the households' demand deposits were higher by Denar 383 million, or by significant 25.4%. In the first half of the year, transient outflows were registered, having in mind the deteriorated security in the country. Namely, the psychological pressures (as a result of the war crisis) determined redirection of part of the Denar liquidity in foreign currency. Consequently, the outflows from the transaction accounts of the households created additional demand for foreign currency, thus pressuring the exchange rate on the exchange offices market. In the second half of the year, not taking into account the seasonal decrease during the summer holidays, the households' demand deposits were at a relatively high level, indicating the gradual evaporating of the negative effects caused by the crisis. In line with this, the share of the households' demand deposits in the total demand deposits registered an annual increase of 4.9 percentage points and as of December 31, 2001 equaled 16.9%.

Table 7  
Monetary aggregates  
(in Denar million)

	Balance as of					Changes by quarters				
	31.12.2000	31.03.2001	30.06.2001	30.09.2001	31.12.2001	I	II	III	IV	Total
Currency in circulation	9,521	10,886	10,100	9,146	14,134	1,365	-786	-954	4,988	4,613
Demand deposits	12,587	10,621	10,113	10,753	11,188	-1,966	-508	640	435	-1,399
Money Supply M1	22,108	21,507	20,213	19,899	25,322	-601	-1,294	-314	5,423	3,214
Quasi-Denar deposits	8,429	8,210	7,546	8,644	9,368	-219	-664	1,098	724	939
Quasi-foreign currency deposits*	9,600	8,922	7,706	8,530	33,529	-678	-1,216	824	24,999	23,929
Money Supply M2	40,137	38,639	35,465	37,073	68,219	-1,498	-3,174	1,608	31,146	28,082
Non-monetary Denar deposits	3,316	3,971	3,875	3,798	3,828	655	-96	-77	30	512
Non-monetary foreign currency deposits*	1,891	1,719	2,287	2,406	3,265	-172	568	119	859	1,374
Money Supply M4	45,344	44,329	41,627	43,278	75,311	-1,015	-2,702	1,651	32,033	29,967

\*/ Stocks valued at constant rate; flows valued at current rate.

Monetary growth in 2001 was determined by the influence of multiple factors: a) deposits outflow in the first and the second quarter of 2001, as a consequence of the deteriorated security in the country; b) the negative impact of the war crisis on new savings; c) changes in the monetary and foreign exchange policy stance; d) the stopped investment cycle and contraction of the overall economic activity; e) the preparations for the physical introduction of the new European currency and the necessity for conversion of the Deutsche Mark and other "in-currencies" into Euro. The impact of the last factor determined intensive increase of the banks' deposit potential in the last quarter of 2001, which resulted in high



annual rates of increase of broader monetary aggregates. Thus, money supply M2 (includes money supply M1 and term deposits up to one year), at the end of 2001 compared to the end of the previous year was higher by Denar 28,082 million, or by 70.0%. Increase of Denar 4,153 million (13.6%) on annual basis was registered in the Denar component of M2, which compared to the projected level was higher by 7.4%. The broadest monetary aggregate M4 (which includes money supply M2, restricted and long term deposits), on December basis was higher by Denar 29,967 million, or by 66.1%.

#### 4.1.1. Total Deposits

The deposit base of the banking sector (sight deposits, term deposits up to and over one year), at the end of 2001 registered an exceptionally high annual rate of increase. Thus, the level of the total deposits of the non-Government sector with banks as of December 31, 2001, compared to the end of the previous year was higher by Denar 26,754 million, or by 115.1%. The significant widening of the deposit base, reflects mostly the Euro introduction effect and the inevitable conversion of the former national currencies into Euro. Namely, due to the high amount of savings denominated in Deutsche marks out of the official banking channels, the possibility for free of charge conversion (if deposited prior to the end of the year), determined high inflow of deposits into the banking system. With respect to the monetary effects, it determined significant increase of the monetary aggregates and consequently, enhanced monetary multiplication process.

Table 8  
Total Deposits  
(in Denar million)

	Balance as of					Changes by quarters				
	31.12.2000	31.03.2001	30.06.2001	30.09.2001	31.12.2001	I	II	III	IV	Total
Total deposits of the non-government sector	23,236	22,822	21,414	23,378	49,990	-414	-1,408	1,964	26,612	26,754
- Denar	11,745	12,181	11,421	12,442	13,196	436	-760	1,021	754	1,451
- foreign currency <sup>1</sup>	11,491	10,641	9,993	10,936	36,794	-850	-648	943	25,858	25,303
I. Short-term deposits <sup>2</sup>	18,029	17,132	15,252	17,174	42,897	-897	-1,880	1,922	25,723	24,868
- Denar	8,429	8,210	7,546	8,644	9,368	-219	-664	1,098	724	939
- foreign currency <sup>1</sup>	9,600	8,922	7,706	8,530	33,529	-678	-1,216	824	24,999	23,929
II. Long-term deposits <sup>3</sup>	5,207	5,690	6,162	6,204	7,093	483	472	42	889	1,886
- Denar	3,316	3,971	3,875	3,798	3,828	655	-96	-77	30	512
- foreign currency <sup>1</sup>	1,891	1,719	2,287	2,406	3,265	-172	568	119	859	1,374

1/ Stocks valued at constant rate; flows valued at current rate.

2/ Short-term deposits include sight deposits and time deposits up to one year.

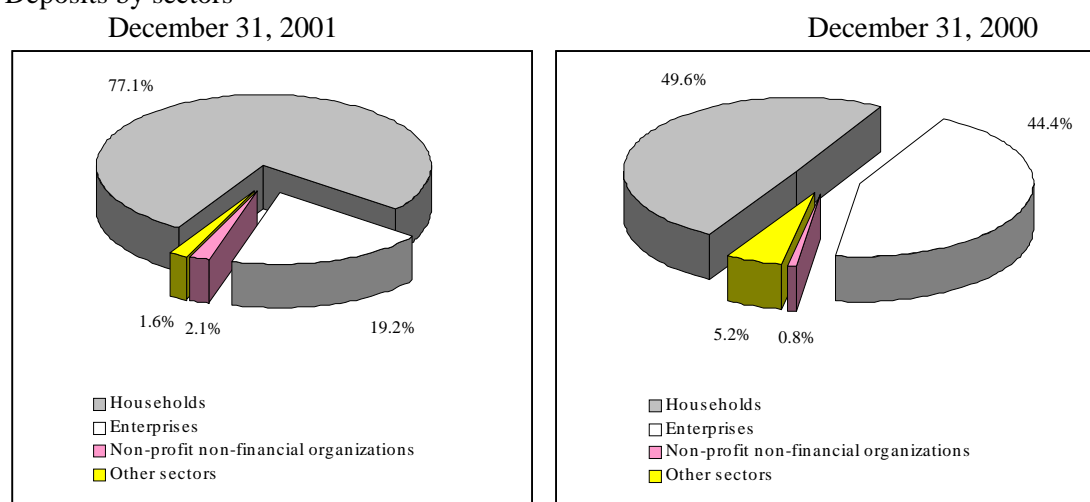
3/ Long-term deposits include time deposits over one year and restricted deposits.

Dynamically observed, in the first half of 2001, decline in the total deposits' level (decline by 1.8% and 6.2%, in the first and the second quarter, respectively) was registered. The decrease of the banks' deposit potential in the first half of the year is due to: a) psychological pressures determined by the war crisis in the country, which resulted in withdrawal of part of the deposits at the end of the first quarter of 2001; b) discouraged new savings, due to the high uncertainty and risk; c) contraction of the total economic activity and consequently, decline in the inflows on the accounts of the economic agents, within the banks. In the third quarter of the year gradual revitalization of savings (increase by 9.2%) was registered, resulting from: moderation of the recession tendencies in the economy, moderation of the negative effects of the war crisis on new savings, as well as absence of significant deposits outflow from the banking sector. The necessity for conversion of the savings denominated in Deutsche Marks and the active business policies of the banks, prior to the physical Euro introduction enabled mobilization of the non-mobilized households' savings and had the strongest effect on the total deposits' increase (significant increase of the total deposits in the fourth quarter by 113.8%).

With respect to the maturity, the total deposits' increase in 2001 is a result of the simultaneous increase of short-term and long-term deposits, with short-term deposits registering an exceptionally high increase. Thus, the short-term non-Government deposits at the end of 2001, compared to the end of the previous year were higher by 137.9%. In addition, their dynamics during the year was strongly influenced by the psychological pressures because of the war crisis, while in the last quarter significant positive effect was exacerbated by the Euro introduction. The increase of the long-term deposits in 2001 equaled 36.2%, with permanent fluctuations registered during the year. Namely, the dynamics of the long-term deposits was primarily determined by enterprises' deposits for payments based on instruments for payment operations, abroad, which fluctuate in line with the external trade movements. The more intensive dynamics of the short-term deposits' increase points out to the necessity for gradual modification of the deposits' maturity, as a support of the investment cycle and the economic activity.

Regarding the currency structure, more intensive increase was registered in the foreign currency deposits compared to the Denar deposits, which is mainly due to the Euro conversion and the orientation of the economic agents towards holding of foreign currency. Thus, the annual increase of total foreign currency deposits in 2001 equaled 220.2%, with increase of the short-term and long-term foreign currency deposits by 249.3% and 72.7%, respectively.

Chart 13  
Deposits by sectors



The sector by sector analysis<sup>20</sup>, indicates movements towards increased share of households' deposits and significant decline of enterprises deposits share. Thus, the share of households' deposits in the total deposits as of December 31, 2001 equaled 77.1% and compared to the end of the previous year it is higher by 27.5 percentage points, which mainly reflects the Euro conversion effect. On the other hand, the share of the enterprises' deposits at the end of the year equaled 19.2%, which represents decline by 25.2 percentage points, on annual basis.

At the end of 2001, compared to the end of 2000, households' deposits were higher by Denar 27,744 million, or by 226.3%. In addition, the withdrawal of households' deposits as a result of the psychological factors determined decline in the first half of the year (1.5%). In the second half of the year, the households' deposits registered high increase (231.2%), mainly because of the Euro conversion. On annual basis (December 2001 / December 2000),

<sup>20</sup> Within the sector by sector analysis, the deposits are valued at current exchange rate, whereas within the monetary aggregates stocks are valued at constant exchange rate and flows are valued at current exchange rate.

the total enterprises' deposits registered moderate decrease of Denar 1,028 million, or by 9.4%, having in mind the deteriorated investment cycle and recession tendencies in the economy, determined by the war crisis in the country.

#### 4.1.2. Banks' Placements<sup>21</sup>

Despite the deteriorated economic performances of the Macedonian economy as a consequence of the security crisis in the country, the total banks' credit activity registered an increase in 2001. Thus, the total banks' placements to the non-Government sector in 2001 increased by Denar 3,033 million, or by 7.7% and as of December 31, 2001 amounted to Denar 42,747 million. The increment was primarily due to the increase in the banks' Denar placements (by 8.7%), while the banks' foreign currency placements registered slight increase (of 0.6%). In addition, the divergent movements in the banks' Denar and foreign currency placements to the non-Government sector were the main characteristics of the banks' credit activity in 2001.

Table 9  
Deposit money banks' domestic credits  
(in Denar million)

	Balance as of					Changes by quarters				
	31.12.2000	31.03.2001	30.06.2001	30.09.2001	31.12.2001	I	II	III	IV	Total
Domestic credits <sup>1</sup>	45,717	45,927	46,072	47,016	46,676	210	145	944	-340	959
Domestic credits <sup>2</sup>	51,117	52,122	53,547	54,627	54,551	1,005	1,425	1,080	-76	3,434
1. Credits to the Government	7,090	7,193	7,439	7,627	7,606	103	246	188	-21	516
- Denar credits	352	360	699	802	859	8	339	103	57	507
- Foreign currency credits <sup>3</sup>	6,719	6,719	6,719	6,719	6,719	0	0	0	0	0
- Overdue interest	19	114	21	106	28	95	-93	85	-78	9
2. Social and private sector credit <sup>1</sup>	38,627	38,734	38,633	39,389	39,070	107	-101	756	-319	443
- Denar credits	30,256	31,478	31,064	30,197	30,780	1,222	-414	-867	583	524
- Foreign currency credits <sup>3</sup>	4,058	3,485	3,881	4,636	4,092	-573	396	755	-544	34
- Overdue interest	4,313	3,771	3,688	4,556	4,198	-542	-83	868	-358	-115
2a. Social and private sector credit <sup>2</sup>	39,714	41,158	42,420	42,444	42,747	1,444	1,262	24	303	3,033
- Denar credits	33,841	35,858	36,724	35,993	36,840	2,017	866	-731	847	2,999
- Foreign currency credits <sup>3</sup>	5,873	5,300	5,696	6,451	5,907	-573	396	755	-544	34

1/ Accounting balance.

2/ Actual balance.

3/ Stocks are valued at constant rate; flows are valued at current rate.

With respect to the dynamics of the banks' Denar and foreign currency placements to the non-Government sector during 2001, three periods can be identified: 1) January - May 2001; 2) June - November 2001 and 3) December 2001.

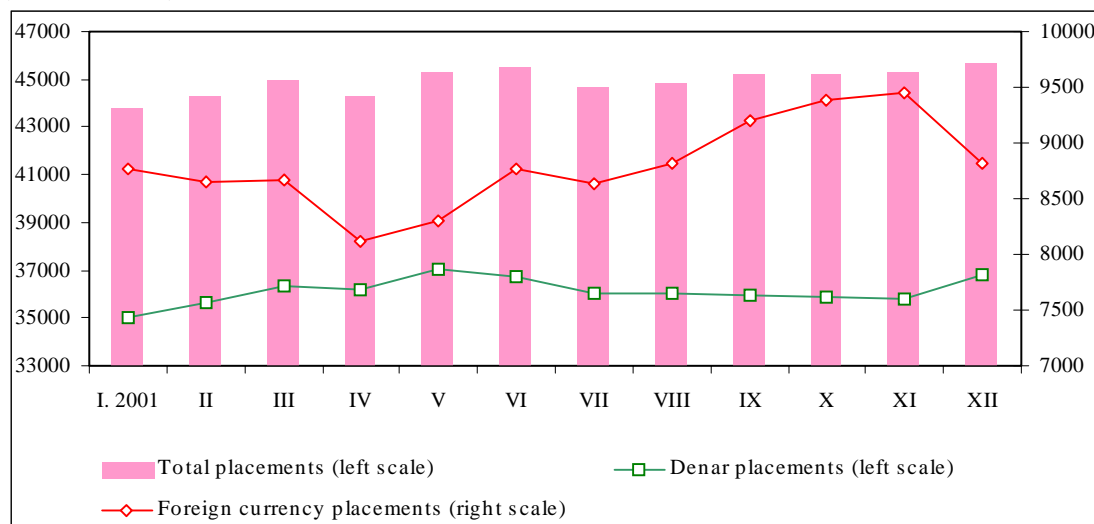
In January - May 2001 period, despite the slowed down dynamics of the activities in the real sector, the deterioration of the economic agents' liquidity and the permanent tightening in the banks' deposit potential, the banks' Denar placements increased by Denar 3,172 million, or by 9.4%. Because of that, in this period the banks' credit policy was characterized with high level of non-responsiveness to the general economic developments and increased risk, caused by the escalation of the security crisis in the country.

<sup>21</sup> Banks' placements are shown in accordance with their actual balance. The actual balance differs from the accounting balance because it includes the claim of one bank in 1997 in the amount of Denar 4,144 million, the claims of banks on the basis of overdue principal in the June 1998 – December 2001 period in the amount of Denar 6,500 million, as well as claims based on swap transaction of a bank with the Government in the amount of Denar 1,686 million in December 1999, while it excludes the increase in credits due to the consolidation of accounts in December 1998 in the amount of Denar 6,270 million. Foreign currency placements include the accounting re-recordings in December 1998 in the amount of Denar 774 million and claims based on the above-mentioned swap transaction and re-recordings with a bank in December 1999 in the amount of Denar 1,041 million.

Simultaneously, a downward tendency of decreasing was registered in the banks' foreign currency placements to the non-Government sector and the decrement equaled Denar 600 million, or 10.2%.

In the June - November 2001 period, opposite movement was registered and the banks' Denar placements decreased by Denar 1,180 million, or by 3.2%. The contraction in the banks' credit activity, although late, represents appropriate banks' response to the further deterioration in the real sector developments and the restrictive monetary policy. Simultaneously, it corresponds with the decreased demand for credits from the economic agents, which is in line with the developments in the Macedonian economy. On the other hand, the banks' foreign currency placements registered upward trend with an increment of Denar 1,299 million or 24.6% in this period. Having in mind the fluctuations in the banks' liquidity, increased credit risk and uncertainty, it represents a confirmation for the orientation of the banks towards using foreign credit lines and placing funds in foreign currency. Therefore, in the June - November 2001 period the banks' credit policy was characterized with higher cautiousness.

Chart 14  
Banks' placements  
(in Denar million)



The gradual normalization of the security and economic conditions in the country, as well as the monetary policy layout, create an environment for conducting more expansive banks' credit policy. Thus, in the last month of 2001 the six-month downward trend of the banks' Denar placements to the non-Government sector was interrupted and they registered a significant increase of Denar 1,007 million, or by 2.8%. Simultaneously, the banks' foreign currency placements, registered a decline of Denar 665 million, or by 10.1%, which reflects the banks' prudent credit policy.

The unfavorable movements in the maturity structure<sup>22</sup> of the banks' Denar placements to the non-Government sector continued in 2001. Namely, the share of the short-term placements registered an increase of 6.0 percentage points and as of December 31, 2001 reached 75.4% %. It represents the highest share in the last three years. The preference of the short-term placements reflects the reaction of the banks to the depressed economic movements and necessity of conducting the prudent credit policy. In addition, the unfavorable developments in the maturity structure in 2001 are due to the increase of the banks' short-

<sup>22</sup> In the maturity and sector analysis, banks' Denar placements are presented according to their accounting balance.

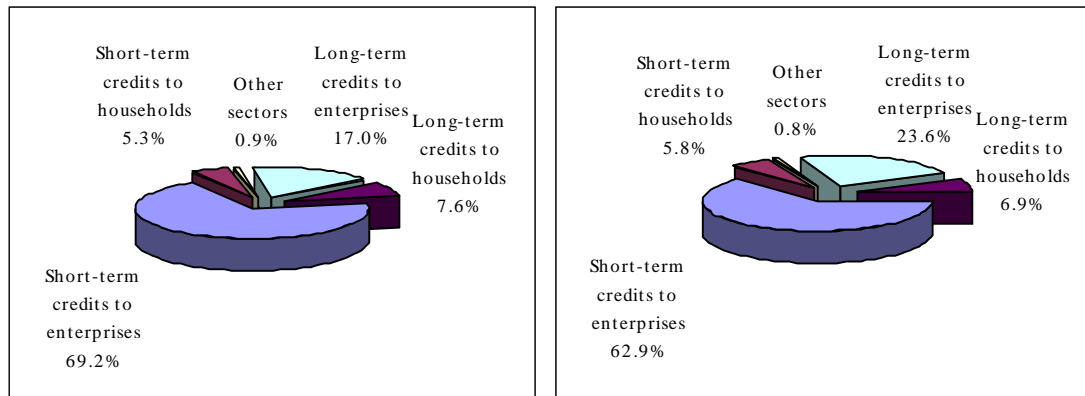
term placements (by 10.6%), with a simultaneous decrease in the long-term placements (by 18.3%).

Chart 15

Sector and maturity structure of the banks' Denar placements

31.12.2001

31.12.2000



In 2001, no significant changes in the sector structure of the banks' Denar placements took place, which was due to the slight increase in the credits extended to enterprises (by 1.3%) and the credits to the households (by 3.9%). As a result, at the end of 2001 the share of the placements to the enterprises (86.1%, fall of 0.4 percentage points) remained dominant, while the share of the placements to the households in the total banks' Denar placements to the non-Government sector equaled 12.9% (increase of 0.3 percentage points). Taking into account the developments registered in the maturity and sector structure of the banks' Denar placements, in 2001 the main characteristic of the banks' credit policy was the banks' orientation towards short-term credits extended to enterprises at the expense of long-term credits. Nevertheless, a slight increase in the share of the long-term credits extended to households was registered (increase of 0.7 percentage points), indicating the increased credit support to this sector.

Conducting a prudent credit policy, in a period of decreased economic activity and increased credit risk, caused unfavorable developments in the maturity structure of banks' foreign currency placements<sup>23</sup> to the non-Government sector. Namely, in 2001 the share of the long-term placements in the total foreign currency placements registered a significant decline of 8.8 percentage points and as of December 31, 2001 it was reduced to 42.2%. It is due to the banks' orientation towards short-term foreign currency credits (increase of 22.7%), while the long-term foreign currency credits declined by 13.8%, which is in line with the economic and military-political developments in the country.

Analyzed by sectors, at the end of 2001 the largest portion (98.3%) of the total banks' foreign currency placements was extended to the enterprises sector. Compared to the end of the previous year, the share of the foreign currency placements to enterprises was higher by 1.7 percentage points. Having in mind the insignificant increase in the foreign currency credits to households, it was due to the increment in the banks' foreign currency placements extended to enterprises (by 5.9%).

#### 4.1.3. Net Foreign Assets of the Monetary System

At the end of 2001, compared to the end of the previous year, net foreign assets of the monetary system (which includes transactions with non-residents), registered an increase of

<sup>23</sup> In the maturity and sector analysis, banks' foreign currency placements are presented according to their accounting balance and at current exchange rate.

Denar 30,546 million, or by 56.5%. In addition, an increase was registered in both of its components (net foreign assets of NBRM and net foreign assets of deposit money banks).

Table 10

Net foreign assets of the monetary system\*  
(in Denar million)

	Balance as of 31.12.2000	Changes by quarters					Balance as of 31.12.2001
		I	II	III	IV	Total	
Net foreign assets of the monetary system	54,038	16,598	-8,022	-6,881	28,851	30,546	84,584
Net foreign assets of NBRM	42,245	17,749	-5,526	-6,666	2,542	8,099	50,344
Foreign assets	47,094	16,112	-5,757	-6,434	2,133	6,054	53,148
Foreign liabilities	4,849	-1,637	-231	232	-409	-2,045	2,804
Net foreign assets of the deposit money banks	11,793	-1,151	-2,496	-215	26,309	22,447	34,240
Foreign assets	22,732	-4,227	-4,468	-77	29,327	20,555	43,287
Foreign liabilities	10,939	-3,075	-1,973	138	3,018	-1,892	9,047

\*/ Stocks valued at constant rate; flows valued at current rate.

In 2001, net foreign assets of NBRM, in 2001 increased by Denar 8,099 million, or by 19.2% as a result of the increase in the foreign assets and registered decline in the foreign liabilities.

The main factor contributing to the increase of the NBRM's foreign assets (12.9%) during 2001 was the inflow from the privatization of the Macedonian Telecom (US Dollar 322.7 million). At the same time, at the end of 2001, inflow of foreign assets based on received interest was registered (US Dollar 33.0 million), which additionally acted towards increase of NBRM's foreign assets. The external account of the Government acted towards decrease of the NBRM's foreign assets in the amount of US Dollar 41.2 million. Namely, despite the inflows based on the succession from the former SFRY (shares, gold and foreign currency in the amount of US Dollar 23.2 million), the payment of the foreign liabilities determined net outflow of funds from the external account. Permanent pressures for depreciation at the foreign exchange market were registered, in the first eight months of 2001 taking into account the deteriorated security in the country. In line with the exchange rate targeting strategy, NBRM intervened with net sale of foreign currency. Hence, the foreign exchange transactions of the Central Bank acted towards decline in the foreign assets. The foreign liabilities of NBRM decreased by 42.2%, due to the payment of the Bank for International Settlements (BIS) credit in February 2001 in the amount of US Dollar 14.1 million, as well as to the regular repayments of the liabilities towards the International Monetary Fund (IMF). With respect to the dynamics, the inflow based on the Telecom privatization determined a significant increase in the NBRM's net foreign assets in the first quarter of 2001. The escalation of the war crisis in the second quarter and permanent pressures for depreciation of the domestic currency, imposed the need for intervention of NBRM on the foreign exchange market with net sale of foreign currency. Consequently, in the second quarter of 2001 a decline in the net foreign assets of NBRM was registered. Also, decline was registered in the third quarter, despite the gradual moderation of the negative effects caused by the crisis (at the end of the third quarter pressures for depreciation were not registered). In the fourth quarter NBRM's net foreign assets increased, having in mind the interventions of the Central Bank on the foreign exchange market with net purchase of foreign currency.

Net foreign assets of deposit money banks at the end of 2001 registered an increase of Denar 22,447 million, or by 190.3% with an increased level of foreign assets (90.4%) and simultaneous decrease of foreign liabilities (17.3%). Namely, the introduction of the single European currency and the conversion of the former national currencies into Euro, determined high inflow of foreign currency deposits into the banking system in the last quarter of 2001. Consequently, the significant widening of the banks' foreign currency deposit base determined increase in their foreign assets. The withdrawal of part of the non-residents' deposits, having in mind the high country risk, acted towards decrease of banks' foreign

liabilities. At the same time the prudent credit policy of the banks (taking into account deteriorated security in the country) determined a decline in the used foreign credit lines, which additionally acted towards decline in their foreign liabilities. The analysis of the dynamics indicates decline in the net foreign assets of deposit money banks in the first two quarters, resulting from the registered withdrawal of foreign currency deposits. Despite the moderate increase of foreign currency deposits in the third quarter, net foreign assets of the deposit money banks declined again. Intensive increase was registered in the fourth quarter of 2001, with significantly higher level of foreign currency deposits in the banking system (because of the Euro conversion).

## 4.2. Reserve money

Despite the high comparison basis from the end of the previous year, the reserve money level at the end of 2001 registered significant annual increase of Denar 4,330 million, or by 35.8%. In addition, the reserve money dynamics during the year reflected the Central Bank's interventions on the foreign exchange market, budget spending, as well as payment operations reforms and the transformation of the Bureau for Payment Operations. Thus, the pressures for depreciation of the exchange rate imposed reserve money withdrawal through net sale of foreign currency at the foreign exchange market by the Central Bank. On the other hand, reserve money creation was realized through the increased public expenditures for security purposes. The permanently high level of currency in circulation (due to the psychological pressures, having in mind the war crisis, payment operations reforms and the Euro conversion), additionally acted toward an increase of the reserve money level.

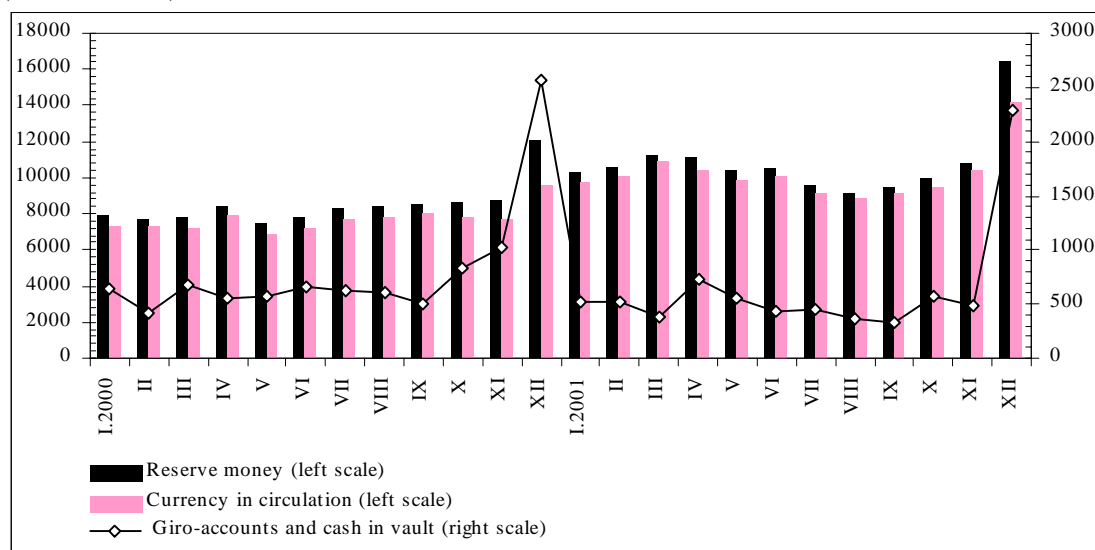
Table 11

Reserve money by the narrowest definition  
(in Denar million)

	Balance as of 31.12.2000	Changes by quarters					Balance as of 31.12.2001
		I	II	III	IV	Total	
Reserve money (narrowest definition)	12,089	-827	-732	-1,058	6,947	4,330	16,419
- currency in circulation	9,521	1,365	-786	-954	4,988	4,613	14,134
- giro-accounts and cash in vaults	2,568	-2,192	54	-104	1,959	-283	2,285

With respect to the quarter on quarter dynamics, in the first quarter despite the intensive and uncommon increase of currency in circulation, the reserve money level registered decline of 6.8%. It was due to the high comparison basis from the end of the previous year, as well as to the net sale of foreign currency at the foreign exchange market. In the second quarter of 2001, further decrease of the reserve money was registered (6.5%). Taking into account the increased dynamics of government deposits decline, the lower reserve money level was mainly determined by the moderate stabilization of the currency demand and net sale of foreign currency on the foreign exchange market. In the third quarter the reserve money level was lower by 10.0%, with further decline in the currency in circulation. The extremely high increase of the reserve money in the fourth quarter of the year (73.3%), is mostly due to the payment operations reforms and the transformation of the Bureau for Payment Operations. Namely, the reforms determined transient increase of the currency in circulation (caused by the uncertainty regarding the new payment system), as well as the increased amount of cash in vaults (determined by the transfer of the payment system within the banks and the necessity for higher cash holdings by the banks). Additional factor, which acted towards reserve money increase was the cash conversion of Deutsche Mark in Denars, prior to the Euro introduction. At the same time, currency in circulation increased because of the common seasonal effect (New Year and Christmas holidays).

Chart 16

Reserve money and their components  
(in Denar million)

Regarding the reserve money components, currency in circulation share at the end of 2001 equaled 86.1% and compared to the end of the previous year it was higher by 7.3 percentage points. At the end of the year, the share of the giro accounts and cash in vaults of the banks and savings houses equaled 13.9%, (decrease by 7.3 percentage points). The decline is due to the high comparison basis from the previous year, caused by the payment of the Government bonds, based on the old frozen foreign currency savings.

Table 12

Flows of reserve money creation and withdrawal<sup>1</sup>  
(in Denar million)

	Balance as of 31.12.2000	Changes by quarters					Balance as of 31.12.2001
		I	II	III	IV	Total	
Reserve money	12,089	-827	-732	-1,058	6,947	4,330	16,419
Net foreign assets <sup>2</sup>	42,245	17,749	-5,526	-6,666	2,524	8,099	50,344
Net domestic assets	-30,156	-18,576	4,794	5,608	4,405	-3,769	-33,925
- Domestic credits	-11,605	-20,068	5,558	6,089	3,652	-4,769	-16,374
- Other items, net	-11,811	-2,074	-1,260	2,518	39	-777	-12,588
- Instruments	-6,740	3,566	496	-2,999	714	1,777	-4,963

1/ (+) reserve money creation; (-) reserve money withdrawal

2/ \*/ Stocks valued at constant rate; flows valued at current rate.

With respect to the Central Bank's balance sheet, the reserve money increase in 2001 is completely due to the increase of the NBRM's net foreign assets, mainly caused by the receipts from the privatization of the Macedonian Telecom. Net domestic assets of NBRM, acted towards reserve money withdrawal, mostly due to the high level of Government deposits with NBRM in the first quarter of the year (albeit in the last three quarters they represented reserve money withdrawal flow, caused by the increased budget expenditures for security purposes).



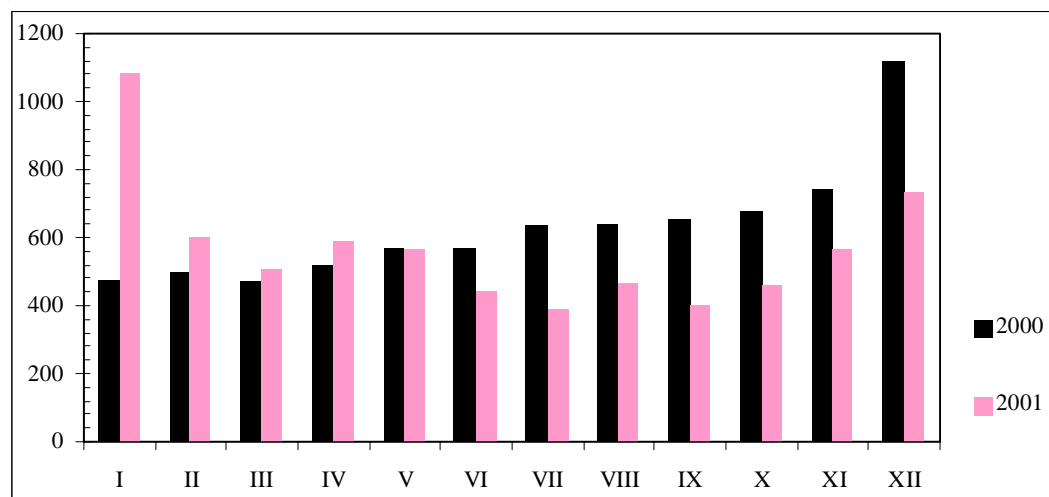
#### 4.2.1. Liquidity of Banks

*The liquidity of the banking system was maintained at a satisfactory level during 2001, although with permanent fluctuations in line with the autonomous movements of the currency in circulation, Government deposits with NBRM, the foreign exchange transactions of the Central Bank and the transfer of the payment operations within the banking sector.*

In 2001, the average daily liquidity of the banking system (giro accounts and cash in vault) equaled Denar 566.6 million and it was above the average level from the previous year by Denar 64.6 million, or by 10.2%. Analyzing the dynamics, in the first quarter of the year high level of average daily liquidity was registered (Denar 730.1 million), determined by the Budget expenditures for payment of part of the Government bonds based on old foreign currency savings in the first month of the year. However, during the first and the second quarter, the average daily liquidity of banks was permanently declining, which was mostly due to the withdrawal of households' deposits, caused by the war crisis in the country, the high level of currency in circulation, as well as Central Bank's interventions through net sale of foreign currency on the foreign exchange market (with preferences for higher foreign currency liquidity). The average daily liquidity of the banking sector in the third quarter was characterized by permanent fluctuations. However, as of September 2001 an upward trend was registered. The main factors contributing to the permanent increasing of the average daily liquidity in the September – December 2001 period were: a) the net sale of foreign currency at the foreign exchange market, by the Central Bank; b) transfer of the payment operations from the Bureau for Payment Operations within the banking sector, which imposed maintenance of high level of liquidity (especially cash in vault) in order to enable banks to provide smooth servicing of clients' requirements.

Chart 17

Average daily level of banks' liquidity  
(in Denar million)



The averaging provisions for reserve requirement (with banks allowed to use funds from the reserve requirements account up to 60% of the requirement, during the calculation period), enabled higher efficiency and flexibility in the liquidity management. Thus, during 2001 in line with the fluctuations of the liquidity level, banks were able to adjust their liquidity position by using part of the reserve requirements or by creating excess reserves. In addition, in 2001 banks held on average 7.4% excess reserves above the requirement. Compared to the previous year it is a decrease of 2.9 percentage points. Hence, the liquidity level of the banking sector, despite the war crisis in the country was satisfactory, which indicates prudent policy of the banks.

The transient unfavorable movements in the liquidity position of the banks during 2001, were neutralized by the last resort facilities- Lombard credits and foreign exchange swaps. Thus, during the year, 44 Lombard credits were extended, with 7 banks as beneficiaries. In addition, frequent using of Lombard credits was registered in the middle of the month, when the banks are short of liquidity, due to the clients' outflows for tax payments. The largest part of the credits was extended in May (8 extended Lombard credits). In 2001 the average monthly amount of Lombard credits equaled Denar 197 million. Regarding the foreign exchange swaps as a last resort facility, contrary to the trend from the last year, in 2001 the average monthly amount of foreign exchange swaps used was at a relatively low level and equaled Denar 43 million. It is partly due to the decline in the banks' foreign assets in the first three quarters of the year. Within the monetary policy instruments of NBRM, two types of foreign exchange swaps are used as "fine tuning" instruments of the Denar liquidity: auction foreign exchange swap (with standardized dynamics of the auction, announced maturity and market based interest rate) and bilateral foreign exchange swap (which can be arranged without previous announcement, maturity arranged on bank by bank basis, while the interest rate is in line with the interest rate on the auction type foreign exchange swaps, money market rate or the interest rate on the CB bills auctions). In 2001 bilateral foreign exchange swaps were used in the first seven months of the year, while the interventions through auction type swaps were conducted in January and February.

The fluctuations of the banks' liquidity level, during 200 had influence on the money market movements. Thus, the demand for liquidity (except in January and in November) was permanently above the supply of liquid funds. These movement partly reflect the alternative for investing the excess liquidity in CB bills, which in the second half of the year were securities with high yield. Namely, the CB bills auctions were the main instrument for liquidity management in 2001. Thus, the auctions were directed towards managing the excess liquidity of the economic agents (currency in circulation and demand deposits) for discouraging the preferences for conversion of the Denar into foreign currency liquidity and consequently, elimination of the pressure for depreciation of the exchange rate. With modifications in the setting of the auctions and with attractive interest rates, CB bills were appropriate investment alternative and enabled the Central Bank to be more efficient in managing the liquidity.

At the end of 2001 the last phase of the new payment system was implemented. Thus, with the transformation of the Bureau for Payment Operations, the administrating of accounts is within the banks. Hence, the banking sector and NBRM (through which "large value" payments are processed) and the clearing house (through which "small value" payments are processed), have the central position within the new payment system. The new setting of the payment system enables banks for permanent monitoring of their liquidity position and more efficient liquidity management.

#### *4.2.2. NBRM placements*

NBRM placements (credits extended to banks and Government net-position), at the end of 2001 equaled Denar 16,374 million (with negative sign) and compared to end of the previous year they were lower by Denar 4,769 million. The decline in the NBRM placements is due to the simultaneous decline in the credits extended to banks and the enhanced Government net-position with NBRM (the higher deposits level, compared to the claims on the Government).

Table 13  
NBRM placements  
(in Denar million)

	Balance as of 31.12.2000	Changes by quarters					Balance as of 31.12.2001
		I	II	III	IV	Total	
Domestic claims	-11,605	-20,068	5,558	6,089	3,652	-4,769	-16,374
I. Credits to banks	462	-19	260	-260	-209	-228	234
- lombard credits	0	0	257	-257	0	0	0
- other credits	462	-19	3	-3	-209	-228	234
II. Government, net	-12,067	-20,049	5,298	6,349	3,861	-4,541	-16,608
- Claims from the Government	4,383	-94	0	-82	0	-176	4,207
- Government deposits <sup>1</sup>	-16,700	-21,551	6,800	3,180	4,344	-7,227	-23,927
a) for monetary policy support	-8,560	0	0	0	0	0	-8,560
b) giro-account	-5,577	-2,322	3,161	1,536	-567	1,808	-3,769
c) other deposits	-2,563	-19,229	3,639	1,644	4,911	-9,035	-11,598
- External financing	250	1,596	-1,502	3,252	-484	2,862	3,112

1/ Since the accounts are part of the liabilities, but are shown on the assets side of the balance sheet, the balances as of 31.12.2000 and 31.12.2001 are presented with a negative sign. Within the quarter by quarter changes, a change with a negative sign represents increase of the deposits, while a change with a positive sign represents a decrease of the deposits.

At the end of 2001, the total Central Bank's credits extended to banks declined by 49.4%. Within the year their amount was maintained at a relatively stable level. In addition, Lombard credits, as a last resort facility, were used during the whole year (except in April and in September), for neutralizing the transient worsening of the liquidity position of certain banks. Lombard credits were extended with maturity of one day and except for June 2001, their level at the end of the month was reduced to zero. The decline of the total credits extended to banks, is completely due to the transfer of part of the claims in the "other credits" category in off balance sheet recording.

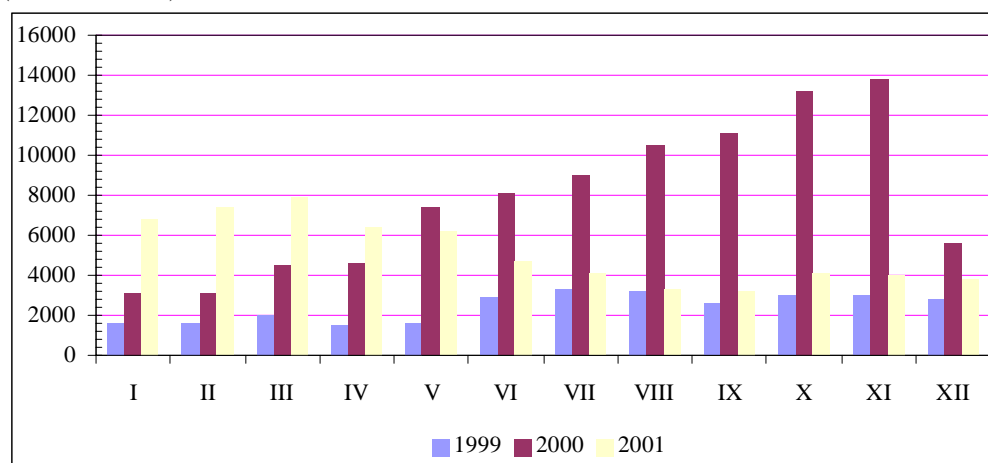
The Government net-position with NBRM (NBRM claims on the Government, Government deposits with NBRM and the external account, presented on net basis), at the end of 2001 reached Denar 16,608 million (with negative sign). The Government net-position with NBRM in 2001 declined by Denar 4,541 million. Hence, the enhancing of the Government net-position with NBRM continued and it acted towards reserve money withdrawal.

Regarding the components, the strengthening of the Government net-position with NBRM is determined by the decline of the NBRM claims on the Government and the increased Government deposits with NBRM, whereas the external account acted in opposite direction. Thus, at the end of 2001 a decline of the NBRM claims on the Government of 4.0% was registered, due to the regular servicing of the liabilities towards foreign creditors.

The Government deposits with NBRM, at the end of 2001 compared to the end of the previous year were higher by 43.3%. This is completely due to the increased foreign currency deposits (496.9%), determined by the foreign currency inflow from the Telecom privatization in January 2001. The initial inflow, based on the privatization determined permanently high level of the total Government deposits, despite the outflow of funds during the war crisis in the country. Thus, on annual basis (December 2001 / December 2000) the Denar Government deposits were lower by 16.3%, reflecting the permanent decline of the Government deposits (except in January and in February), in line with the increased public expenditures for security purposes.

Chart 18

Dynamics of the Government giro account funds  
(in Denar million)



The balance of the Government external account (refers to Government international transactions), at the end of 2001, compared to the end of the previous year was higher by 12.4 times. Hence, the amount of debt repayment was above the registered inflows at the external account in 2001.

#### 4.2.3. Main Instruments for Monetary Regulation

Within the monetary policy instruments, the main instruments which are defined as instruments for reserve money withdrawal are the CB bills auctions and compulsory reserves of banks and saving houses. Thus, the total amount of reserve money withdrawn through these instruments at the end of the year equaled Denar 4,963 million and compared to the end of the previous year it was lower by 26.4%, mainly due to the high comparison basis. Namely the excess liquidity created through the payment of the Government bonds based on old foreign currency savings, was mostly sterilized through the CB bills auctions.

Table 14

Instruments of Monetary Regulation<sup>1</sup>  
(in Denar million)

	Balance as of 31.12.2000	Changes by quarters					Balance as of 31.12.2001
		I	II	III	IV	Total	
Compulsory reserve	-1,918	604	77	-1,068	499	112	-1,806
Central Bank bills sold at auction	-4,822	2,962	419	-1,931	215	1,665	3,157
Total amount withdrawn	-6,740	3,566	496	-2,999	714	1,777	-4,963

1/ (-) Reserve money withdrawal; (+) Reserve Money creation.

On December basis the amount of bills sold at auction declined by Denar 1,665 million, or by 34.5%, mainly due to the high comparison basis, as well as to the higher liquidity demand by the banks, common for the last month of the year. With respect to the quarter by quarter dynamics, in the first quarter of the year high average amount of bills sold at auction (Denar 3,327 million) was registered, determined by the further sterilization of the excess liquidity, created through the payment of the Government bonds. In addition, the beginning of the war crisis in February 2001, determined liquidity outflows from the banking system and higher currency holdings or their allocation in hard foreign currencies. Hence, in February and March 2001, as well as during the second quarter declining interest in CB's bills was registered. In the second quarter, the average amount of bills sold was reduced to Denar 1,689 million. The necessity for sterilization of the excess liquidity in the economy (which created pressures for depreciation of the exchange rate), imposed certain monetary policy

measures. Thus, with respect to the CB bills auctions, in June 2001 interest rates were increased and modifications in the setting of the auctions (daily auctions, with possibility for all interested economic agents to invest in CB bills) were introduced. Consequently, in the third quarter of 2001 increased interest in CB bills was registered and the average amount of bills sold reached Denar 2,573 million. In the fourth quarter, the increase of the bills sold continued (except their common decline in the last month of the year). Hence, in the fourth quarter of the year the highest amount of bills sold was registered (Denar 3,744 million), despite the decrease of the interest rates, as a reaction of the Central Bank to the relatively stabilized economic movements.

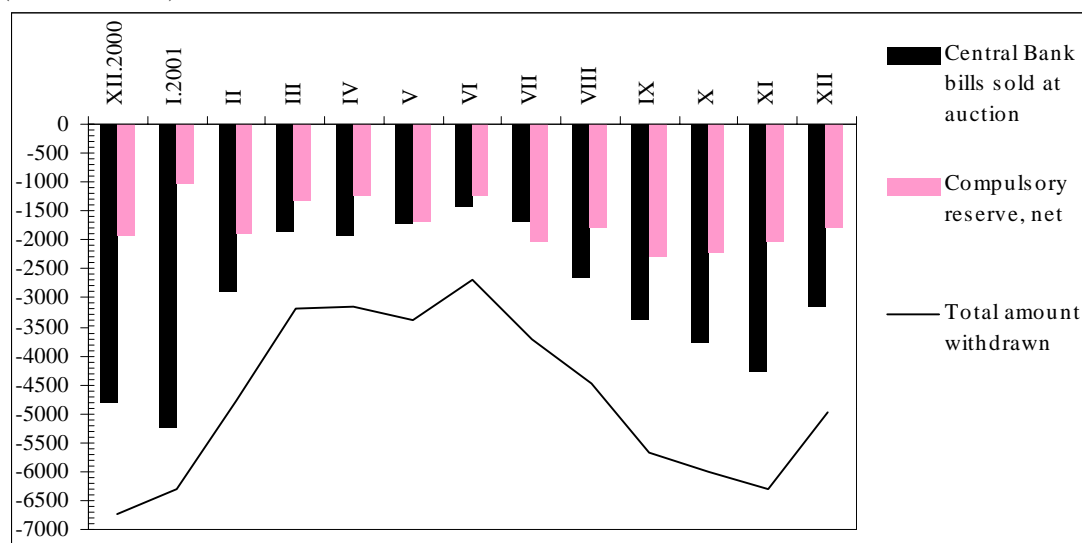
Table 15  
Review of the CB' bills auctions in 2001

	Average amount of CB bills (in Denar million)	Maturity of realized CB bills (in days)	Weighted interest rate
January	5,265	14;28	6.70
February	4,120	28	7.60
March	2,491	7;14;28	7.80
April	1,815	7;14;28	9.20
May	1,981	7;14;28	11.90
June	1,912	3;7;14;28	15.00
July	1,762	3;7;14;28	16.30
August	2,323	3;7;14;28	17.10
September	2,989	7;14;28	17.98
October	4,135	7;14;28	17.42
November	4,225	7;14;28	14.41
December	3,732	7;14;28	12.16

For the January- March 2001 period weighted interest rates at "interest rate tender" auctions are presented, for the April-June 2001 period weighted interest rate at both types of auctions is presented, while as of July 2001 weighted interest rates at "volume tender" auctions are presented.

In line with the movements in the economy, having in mind the war crisis, NBRM was oriented towards flexible implementation of the CB bills auctions, as a main instrument for liquidity management. Thus for more efficient withdrawal of the excess liquidity in the economy, which had negative impact on the foreign exchange market, as of May 2001 "volume tender" auction type was introduced, with attractive interest rates, different maturity and with possibilities all interested economic agents to invest in the CB bills. In addition, with respect to the terms of the auctions, the following changes are of great significance: a) in June interest rates were increased and set at 13%, 14%, 14% and 15% for maturity of 3,7,14 and 28 days, respectively. During the month the interest rate on CB bills with 28-day maturity was increased from 15% to 20%; b) due to the weak interest, in September 2001 the CB bills with 3 days maturity were abolished; c) the relatively stabilized economic movements and absence of pressures for depreciation on the foreign exchange market, determined decrease of the interest rate by 3 percentage points in October 2001 and additional 2 percentage points in November on the bills with maturity of 28 days. Also, in November the dynamics of the auctions was changed. Namely, instead of the daily auctioning, auctions were held three times during the week.

Chart 19  
Effects of the Instruments for Reserve Money Withdrawal  
(in Denar million)



At the end of 2001, the allocated compulsory reserve of banks and saving houses was lower by Denar 112 million, or by 5.8%, thus acting towards reserve money creation. In addition, the amount of allocated compulsory reserves, with averaging provision, reflect the liquidity management policy of banks. From the aspect of the dynamics, reserve money withdrawal through the compulsory reserves was registered in the third quarter of the year (Denar 1,068 million), while in the first, second and fourth quarter reserve money creation was registered (Denar 604 million, Denar 77 million and Denar 499 million, respectively). The high amount of withdrawn reserve money in the third quarter, partly reflects the increased reserve requirements rates. Namely, in May 2001 the reserve requirement rate on short-term and long-term deposits was increased by 0,5 percentage point and additional 1,5 and 1,0 percentage point, respectively (increase from 8% to 10% for short-term and from 3.5% to 5% for long-term deposits). These changes are in line with the changes in the monetary policy stance, as a reaction to the upheaval of the economic movements, due to the war crisis.

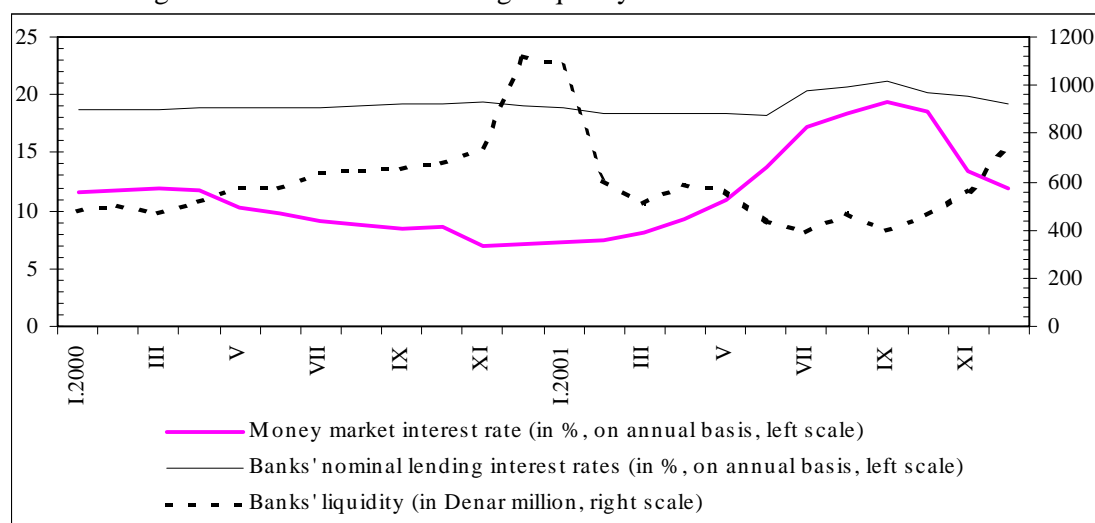
## V. Interest Rate Policy

In 2001 the banks' interest rates movements were determined by the changes in the liquidity level of the banking system, caused by the security and economic conditions in the country. During 2001 the NBRM interest rates policy played a key role in neutralizing the effects from the increased liquidity in the economy on the exchange rate and the prices. Namely, having in mind the increased government spending for security needs and the withdrawal of households' deposits from banks, the necessity for reserve money withdrawal arose. The main instrument for withdrawing the excess liquidity of the banks, which mainly reflects on the exchange offices market through the pressures for depreciation of the exchange rate of the Denar against the Deutsche Mark, were the CB bills auctions. In the crisis period the Central Bank offered attractive interest rates on CB bills auctions and after the stabilization of the situation in the country the CB started with their gradual reduction.

The setting of the interest rates on CB bills auctions depends of the type of the tender that is used and in 2001 two types of tenders were organized. Thus, in the January - April 2001 period NBRM applied "interest rate tender" on CB bills auctions. In this period, the average weighted CB bills interest rate equaled 7.8%, on annual basis. In order to increase the attractiveness of the CB bills, as a main instrument for sterilization of the excess Denar liquidity of the banks, starting from May it moved towards "volume tender", where NBRM permanently increased the CB bills interest rate. The intention was to withdraw the excess liquidity in the economy, which was causing pressure on the foreign exchange and exchange offices market, by offering an attractive interest rate on CB bills. In addition, starting from June 2001, NBRM was applying everyday CB bills auctions with different maturity of 3, 7, 14 and 28 days and different interest rates of 13%, 14%, 14% and 15%, respectively, that were subject to public tender and available to the legal entities and individuals (through the banks). In the second half of the month, the need for an additional increase of the attractiveness of the CB bills with longer maturity caused NBRM to increase the interest rate of the CB bills with maturity of 28 days from 15% to 20%, on annual basis.

The gradual normalization of the economic and security conditions in the country created preconditions for decreasing the interest rates on CB bills. Thus, in October 2001 NBRM reduced the interest rates on CB bills by three percentage points. Also, NBRM additionally decreased the CB bills interest rate with 28-day maturity by two percentage points in November, so, the new interest rates equaled 11% for 7 and 14 days and 15% for 28 days, p.a. (in September 2001 NBRM stopped offering CB bills with 3-day maturity due to the low interest). The reduction in the interest rates on CB bills was influenced by several factors: a) gradual normalization of the economic developments in the country; b) elimination of the pressures for depreciation of the Denar exchange rate against the Deutsche Mark; c) the downward tendency of the interest rates on the Money Market and d) increased households propensity to save. In November 2001, NBRM reduced the number of CB bills auctions, so that instead of everyday auctions, NBRM started organizing auctions three times a week.

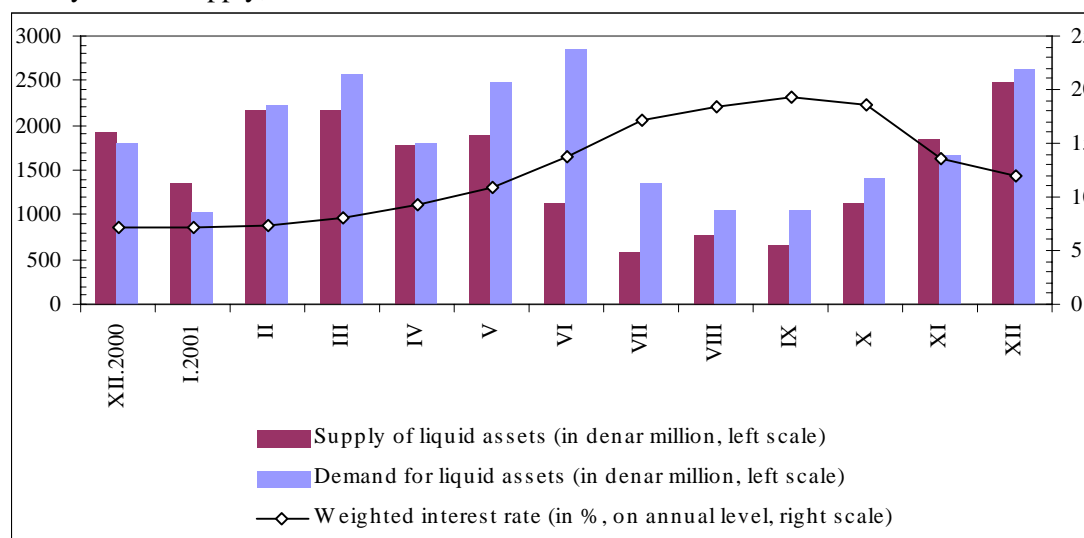
Chart 20  
Nominal weighted interest rates and average liquidity



One of the characteristics of the Money Market in the Republic of Macedonia is the high responsiveness to the CB interest rates and the fluctuations in the banks' liquidity. Thus, in the first two months of 2001, decreased demand for liquid assets was registered, causing the interest rates on the Money Market to remain on a relatively high level. The beginning and the escalation of the security crisis had unfavorable impact on the banks' liquidity, causing an increased demand for liquid assets. As a result, the interest rates on the Money Market were increasing permanently and the weighted money market interest rate reached the maximum level of 19.3% in September 2001 (increment of 12.2 percentage points relative to the end of 2000).

Stabilization of the security and economic conditions led to an improvement in the banks' liquidity, which caused gradual decline of the money market interest rates. In December 2001 the average weighted money market interest rate was reduced to 11.9%, on annual basis. Nevertheless, the average weighted money market interest rate was higher by 4.8 percentage points compared to December 2000.

Chart 21  
Money market supply, demand and interest rates





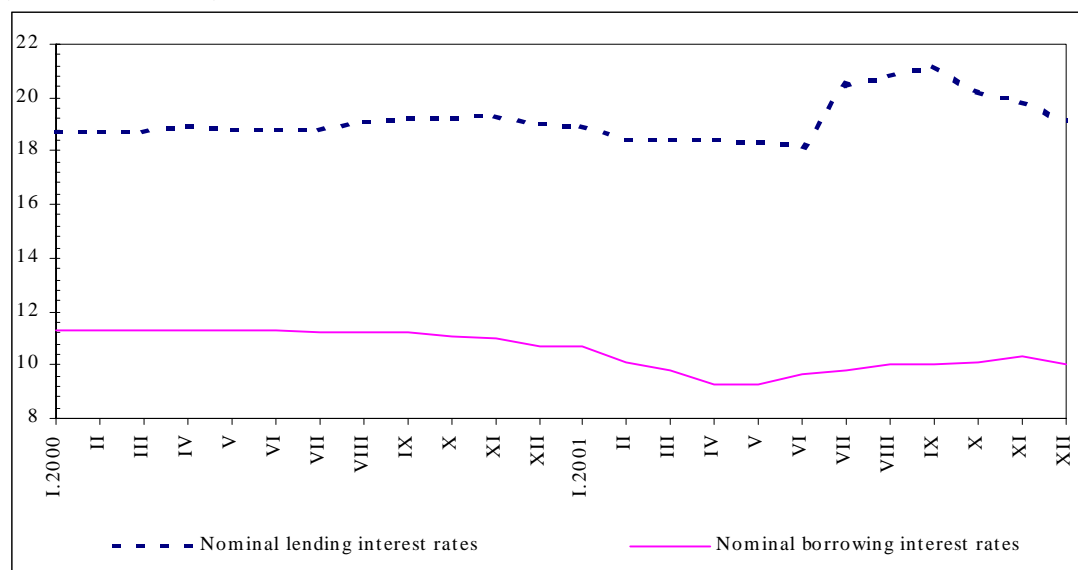
In accordance with the movements of the interest rates on the Money Market and CB bills auctions, in the first half of 2001 NBRM increased the others interest rates that it applies in the conduct of the monetary policy. Thus, the interest rate of Lombard credits was increased two times: in May from 17.5% to 19% and in June from 19% to 23%. In June 2001 the discount rate was increased from 7.9% to 10.7%. It represents a strong signal for the determination of the monetary policy to defend the exchange rate of the Denar in relation to the Deutsche Mark, as well as a signal for the banks to cover the lack of liquidity with other alternative sources of liquidity. The increment of the discount rate represents base for increasing the default interest rates in the banking system. During May 2001, in order to compensate for the banks' cost resulting from the allocation of compulsory reserve, NBRM increased the remuneration on the compulsory reserve from 80% to 89% out of the discount rate, i.e. from 6.3% to 7.0%. By the increment of the discount rate (from 7.9% to 10.7%) the remuneration on the compulsory reserve is increased to 9.5%.

The successful realization of the monetary policy needs appropriate banks' responsiveness to the monetary signals. From this point of view, during 2001 two periods can be identified. The January - June 2001 period with insufficient banks' flexibility regarding the combination and conversion of different kinds of liquidity, as well as the appropriate redesigning of the banks' credit and interest rate policies. Nevertheless, the banks' responsiveness to the monetary policy layout and liquidity condition took place in the July - December 2001 period. Therefore, contrary to the several years rigidity and non-responsiveness, the banks' credit policy showed some flexibility.

In the first half of 2001, despite the deteriorated working environment, increased credit risk caused by the deteriorated security in the country, increase of the money market interest rates and of the interest rates on CB bills, the banks' interest rates declined. Thus, in June 2001 the nominal weighted lending interest rates of the deposit money banks equaled 18.2% on annual basis, which is by 0.8 percentage points lower compared to the end of 2000. Simultaneously, the banks' nominal weighted deposit interest rates decreased by 1.1 percentage point and reduced to 9.6% on annual basis.

Chart 22

Nominal lending and deposit interest rates of the Deposit Money Banks  
(in %, on annual level)



The movements in the banks' interest rates in the second half of 2001 corresponds with the situation in the economy. Thus, in the third quarter of 2001 the nominal weighted

lending interest rates of the deposit money banks increased by 3.0 percentage points. Simultaneously, the banks' nominal weighted deposit interest rates registered a slight increase of 0.4 percentage points, determined by the need for prevention i.e. reduction the banks' funds outflow caused by the escalation of the crisis in the country. By extending the interest rate margins, the banks intend to depreciate the increased operating costs and to protect themselves from the possible placement risk according to the deteriorated economic and security situation in the country. Although late, it represents banks' response to the higher restriction of the monetary policy and the deteriorated working environment. In such conditions the banks' interest rate margins reached 11.1 percentage points in September, which is the highest level registered in the previous several years.

In the last quarter of 2001 the decrement of the interest rates on CB bills and the money market interest rates was followed with a decrease in the lending interest rates of the deposit money banks. Thus, in December the nominal weighted lending interest rates of the deposit money banks equaled 19.1%, which is by 2.0 percentage points lower relative to September. Simultaneously, the banks' nominal weighted deposit interest rates remained almost unchanged and equaled 10.0%, on annual level. These movements resulted in an adequate decrease in the banks' interest rate margins and on December 2001 they equaled 9.1 percentage points.

In general, in 2001 divergent movements in the average lending and deposit interest rates of the deposit money banks were registered. Thus, compared to 2000, the banks' average nominal weighted lending interest rates increased by 0.5 percentage points, thus reaching 19.4%, whereas the banks' average nominal weighted deposit interest rates decreased by 1.3 percentage points and equaled 9.9%. As a result, the banks' average interest rate margins registered an increase (of 1.8 percentage points) and in 2001 they reached the highest level in the last four years (9.5 percentage points).

In 2001 the banks' real lending and deposit interest rates registered a slight deviation from the nominal interest rate and on average they equaled 16.4% and 6.1%, respectively. It was due to the relatively low monthly changes in the inflation rate during 2001.

## VI. Financial Markets in the Republic of Macedonia

In 2001 the overall economic situation in the country, especially the fluctuation in the level of liquidity in the banking system strongly influenced the financial markets in the Republic of Macedonia. Namely, the beginning and the escalation of the security crisis in the country caused decreased economic activity, deteriorated banks' liquidity and, consequently, decreased supply and increased demand for liquid assets. It resulted in reduction in the turnover on the financial markets. Reduction of the tension concerning the security crisis led to opposite movements and the improved economic and liquidity conditions caused increased supply, decreased demand and increased turnover on the financial markets. The necessity of conversion of the EMU member-countries currencies prior to the Euro introduction acted in the same direction.

### 6.1. Macedonian Stock Exchange

The unfavorable political and security situation in the country had a negative impact on the terms and the environment in which the capital market and the Macedonian Stock Exchange were operating. In addition, the basic characteristic of the operations on the stock exchange in 2001 was the repurchase of large sets of shares and firms through the stock exchange, due to the continuation of the process of consolidation of the ownership in the Republic of Macedonia.

Table 16  
Transactions at the Macedonian Stock Exchange

period	Total turnover	Number of traded securities	Number of transactions	Number of transactions with Government bonds	Days of trading
1996	34,790,000	12,378	499	-	79
1997	1,101,000,000	8,030,323	6,525	-	101
1998	4,764,168,266	8,505,473	3,392	-	104
1999	1,552,771,065	4,289,880	2,480	-	103
2000	7,780,523,404	161,780,482	3,403	1,379	103
2001	28,800,112,104	17,397,290	3,527	6,715	136

In January 2001, the biggest transaction on the Macedonian Stock Exchange (the sale of "Macedonian Telecommunications" to a foreign investor) was executed. In addition, the registered turnover in January exceeded the total cumulative turnover on the stock exchange since its establishment. As a result of the exceptionally high turnover in January, in 2001 compared to 2000 the total and average daily turnover on the Macedonian Stock Exchange were significantly higher (by 3.7 times and 2.8 times, respectively). If the transaction related to the sale of "Macedonian Telecommunications" is excluded, the turnover in 2001 would be at the approximate level as in 2000. If the executed block transactions were excluded, the turnover on the stock exchange in 2001 compared to 2000 would be lower by 50%, reflecting the effects of the security crisis in the country. In 2001 compared to the previous year, a higher number of executed transactions and considerably lower number of traded securities was realized.

In 2001 the trading was conducted on all segments of the Stock Exchange, with the largest portion of the Stock Exchange turnover being carried out on the separated segment for trading in government-owned shares (77.1%). It was mostly due to the sale of the "Macedonian Telecommunications", executed on this segment of the Stock Exchange. The remaining portion of the turnover was carried out on the Third Unofficial Stock Exchange

Market (19.4%), while insignificant 3.5% of the total stock exchange turnover in 2001 were carried out on the official market (First and Second Market). In addition, the government bonds issued for the old “frozen” foreign currency savings, as well as the shares of “Toplifikacija” - Skopje were traded on the First Official Stock Exchange Market. Namely, in the middle of 2001, for the first time, the First Stock Exchange became operational, at which the shares of “Toplifikacija” - Skopje were offered. It was also the first quotation of a privatized company, which opens new perspectives in the development of the Macedonian Stock Exchange.

On November 1, 2001, the Macedonian Stock Exchange started to publish the stock exchange index (MBI), which is calculated on the basis of the average price of the five most liquid shares on the stock exchange. The initial value of the index is 1000 points, which is disclosed at the end of the trading day. It is an indicator for the general movements of the prices on the stock exchange, trend of movement on the overall capital market, with its growth and decline reflecting the overall economy. Thus, it is an indicator for the changes, stability and movements of the Macedonian economy.

At the end of December 2001, the value of the stock exchange index equaled 978 points, which compared to the initial value decreased by 22 points or by 2.2%. It is the lowest level since its introduction (November 2001). From the aspect of dynamics, in November the value of the stock exchange index declined by 1.8%, while in December there were no large oscillations in the value and the fall of 0.4% was registered in the last day of trading in December.

Table 17  
Transactions at the Macedonian Stock Exchange in 2001

	Realized turnover (in Denar million)	Number of traded securities	Number of transactions	Number of transactions with Government bonds	Days of trading
January	21,135.1	5,350,740	331	397	8
February	2,954.4	8,515,952	295	503	8
March	639.4	368,640	262	672	9
April	422.8	543,102	286	599	8
May	858.2	663,569	306	1,009	13
June	548.5	285,563	317	923	12
July	378.3	147,022	311	538	13
August	42.9	78,657	201	184	13
September	206.6	423,544	298	306	12
October	476.6	201,039	444	599	13
November	848.6	679,144	363	334	15
December	288.7	140,318	113	651	12
I-XII. 2001	28,800.1	17,397,290	3,527	6,715	136

At the end of April 2001, The Macedonian Stock Exchange introduced an electronic trading system, caused by the necessity of providing higher transparency and liquidity on the Stock Exchange. Also, it represents a new impulse in the operating of the stock exchange, which should create conditions for increased turnover, efficiency and liquidity on the stock exchange trading. In the middle of 2001, the transformation of the Macedonian Stock Exchange into a for-profit company with 18 shareholders (10 brokerage houses, 7 banks and 1 insurance company) was implemented. Thus, the Macedonian Stock Exchange became the first stock exchange in the region starting the process of transformation of the stock exchange from a for non-profit company to a for-profit joint-stock company.

During 2001, some changes in the tax regulations were made in order to intensify the development of the capital market in the Republic of Macedonia. Thus, there is no more capital gain for all securities transactions in the first five years and the corporate profit tax for listed companies is 50% lower for the first three years. Also, in order to complete the institutional infrastructure of the capital market, as well as to give more safety to the investors, the Central Securities Depository was founded and full dematerialization of securities was introduced. However, the effects from these changes did not take place in 2001, due to the political and security unsteadiness and decreased economic activity.

## 6.2. Money and Short-term Securities Market

In 2001 unfavorable movements, manifested through the substantially lower supply of liquid funds and decreased total money market turnover, were registered on the Money and Short-term Securities Market in the Republic of Macedonia. In addition, significant fluctuation in the level of the supply of liquid assets were registered during the year, which was in line with the liquidity condition in the banking system, caused by the political and the security situation in the country.

Thus, in 2001 relative to the previous year, the total supply of liquid assets decreased by 27.6%, while the decrement in the total demand for liquid assets was moderate and equaled 0.8%. These movements in the supply and demand for liquid assets resulted in a decrease in the total turnover on the Money Market by 17.2%. Significant portion (34.3%) of the total demand remained unsatisfied, because of the permanently higher demand relative to the supply of liquid assets registered on the Money Market during 2001 (except January and November). On the other hand, 8.7% of the total disposable assets were out of function, mainly because of limitations settled by banks-sellers whose objective is risk diversification. The average daily turnover on the Money Market in 2001 was Denar 66.8 million, which is by 16.0% lower compared to 2000 for lower number of days of trading.

Table 18

Transactions with Giro-money at Money and Short-term Securities Market in 2001

	<i>Supply</i>	<i>Demand</i>	<i>Realization</i>	<i>Weighted average interest rate (in %)</i>
I	1,345,400,000	1,031,400,000	1,011,800,000	7.22
II	2,165,950,000	2,227,500,000	1,942,800,000	7.39
III	2,167,700,000	2,577,300,000	2,072,700,000	8.08
IV	1,774,250,000	1,804,750,000	1,596,750,000	9.29
V	1,877,900,000	2,491,300,000	1,788,900,000	10.87
VI	1,137,400,000	2,852,300,000	1,109,900,000	13.82
VII	580,950,000	1,347,050,000	580,950,000	17.15
VIII	775,820,000	1,050,120,000	746,820,000	18.44
IX	662,170,000	1,053,670,000	654,170,000	19.34
X	1,140,900,000	1,408,700,000	1,067,400,000	18.55
XI	1,835,600,000	1,678,900,000	1,614,900,000	13.49
XII	2,477,400,000	2,644,400,000	2,323,400,000	11.92
<b>Total</b>	<b>17,941,440,000</b>	<b>22,167,390,000</b>	<b>16,510,490,000</b>	<b>13.00</b>

With respect to dynamics, the higher supply than demand for liquid assets in the second half of 2000, continued at the beginning of 2001. However, deterioration of the liquidity conditions in the banking system, caused by the escalation of the security crisis in the country, led to a rapidly increased demand and decreased supply of liquid assets, resulting in a reduced turnover on the Money Market. In June 2001 the Money Market registered historically the highest amount of demand for liquid assets (Denar 2,852 million) and in July

2001 the lowest amount of supply of liquid assets (Denar 581 million), since its establishment. Simultaneously, the largest discrepancy between the demand and supply of liquid assets was registered in June 2001 (the demand relative to the supply was higher by 2.5 times). In these conditions, the average weighted interest rate on the Money Market was increasing permanently and its maximum level was reached in September 2001 (19.3%).

The gradual normalization of the economic and security conditions led to improved banks' liquidity and consequently intensive activity on the Money and Short-term Securities Market. The supply of liquid assets started to increase and in November 2001 for the first time since the beginning of the security crisis the supply exceeded the demand for liquid funds. As a result, the average weighted interest rate on the Money Market started to decrease and in December 2001 its level was reduced to 11.9%, on annual basis.

### **6.3. Foreign Exchange and Exchange Offices Market**

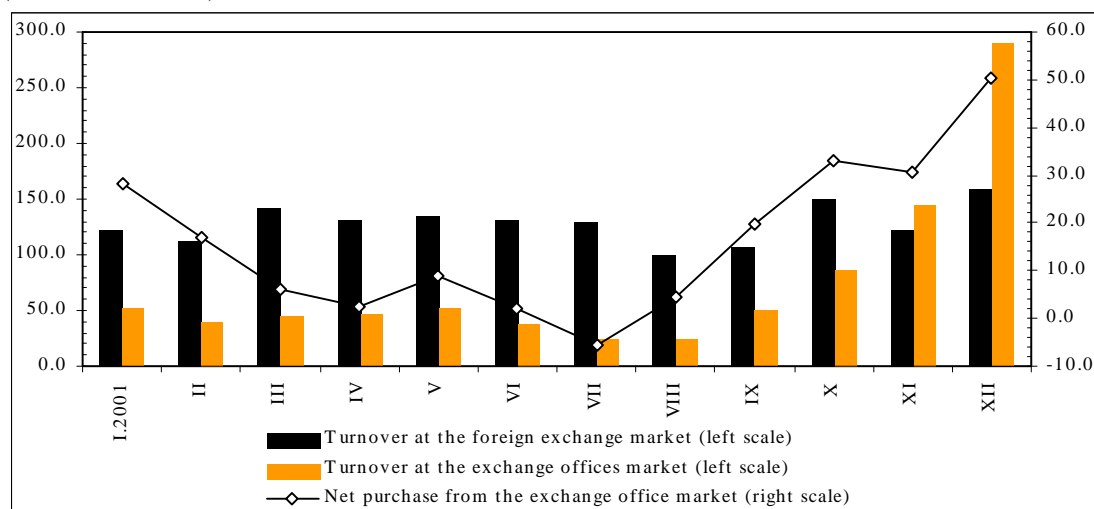
The reduction of the economic activity and consequently decreased foreign trade, caused by the security crisis, reflected on the foreign exchange market developments. In such conditions, the supply of foreign currency on the foreign exchange market considerably decreased, whereas the demand for foreign currency was preserved at a relatively high level, because of speculative and psychological factors. It resulted in a reduction in the total turnover on the foreign exchange market in 2001 relative to the previous year by USD 82.3 million, or by 5.1%, thus reducing to USD 1,540.9 million.

According to the legislation, the foreign exchange market in the Republic of Macedonia comprises of all purchases and sales of foreign currencies by authorized banks, domestic legal entities and the National Bank of the Republic of Macedonia. The reduction in the total turnover on the foreign exchange market in 2001 is mostly due to the decreased turnover resulting from the transactions between the banks and enterprises (by 17.0%), as a consequence of the considerably decreased supply of banks' foreign currency and decreased enterprises' demand for foreign currency. However, the largest portion, or 59.6% of the turnover on the foreign exchange market in 2001 was carried out through the transactions between the banks and the enterprises. A decline was also registered in the turnover from the transactions among the enterprises (by 4.5%), as well as the transactions among the banks (31.2%), and their shares in the total turnover on the foreign exchange market in 2001 equaled 15.4% and 2.2%, respectively. Only the turnover from the transactions between NBRM and the other participants on the foreign exchange market registered an increase (by 60%), hence, its share in the total turnover reached 22.8%.

In accordance with the adopted monetary strategy, the increased presence of the NBRM on the foreign exchange market in 2001 was due to the necessity of keeping the Denar exchange rate against the Deutsche Mark at the targeted level. In addition, the largest part of 2001 (January - August), NBRM was playing the role of a net-seller of foreign currency on the foreign exchange market. In conditions of escalation of the security crisis, it was due to the considerably higher demand than supply of foreign currency, caused by the increased psychological and speculative pressures for depreciation of the foreign exchange rate of the Denar with relation to Deutsche Mark. Stabilization of the tension concerning the security crisis, as well as the strong determination of the NBRM for defending the exchange rate of the Denar with relation to the Deutsche Mark, reduced the pressures. Hence, in the last four months of 2001 the NBRM was playing the role of a net-purchaser of foreign currency. Generally speaking, in 2001 the NBRM realized net-sale of foreign currency on the foreign exchange market in the amount of US Dollar 30 million.

Chart 23

**Total Turnover in Foreign Exchange and Exchange Offices Market**  
(in US Dollar million)



The total turnover on the exchange offices market in 2001 equaled USD 893.6 million, which is by USD 229.5 million, or by 34.6% higher than in 2000. In the transactions with individuals, foreign currency in the amount of USD 545.4 million was purchased, while the sale of foreign currency reached USD 348.2 million. It resulted in a net-purchase of foreign currency in the amount of USD 197.2 million, which is by USD 173.6 million or by 46.8% lower compared to 2000.

From the aspect of dynamics, the uncertainty concerning the security crisis influenced the transactions with individuals in the first nine months of 2001. The transactions with individuals were characterized with a decreased supply and increased demand for foreign currency. In July 2001, for the first time in the last several years, net-sale of foreign currency on the exchange offices market in the amount of US Dollar 5.7 million was registered. In such conditions, in the January - September 2001 period compared to the same period of 2000, the turnover on the foreign offices market decreased by 23.0%. On the other hand, in the last quarter of 2001 exceptionally high monthly turnover was registered, causing the increment in the total turnover on the foreign offices market in 2001. Namely, 58.3% of the total turnover on the foreign offices market in 2001 were carried out in the last quarter of 2001. It was a result of the considerably increased supply of foreign currency, caused by the preference of the economic agents for cash conversion of part of the foreign currency savings (in the currencies of the EMU member-countries) prior to the introduction of the new European currency - Euro.

## VII. External Sector

According to the Decision on Foreign Exchange Policy and the Balance of Payments Projection, in 2001 a further improvement of the performance of the foreign trade and foreign exchange sector was expected, expressed by an increase of the exports and obtaining the necessary level of imports, regular payment of the external debt, increase in foreign direct investments and increase of the foreign exchange reserves. However, the worsened security, which in the course of 2001 had a great impact on the Macedonian economy, caused only partial fulfillment of the projected goals of the foreign exchange policy. The very strong domestic shock reduced the economic activity, which was reflected in almost all segments of the balance of payments. Namely, due to the negative developments, in 2001 a high current account deficit was registered arising from the contraction of the foreign trade, the realized deficit in the balance of services and the balance of transfers, as well as halved current transfers. However, in 2001, mainly as a result of the developments in the first quarter of the year, positive movements were registered on the capital and financial account, reflected through the high increment in foreign direct investment, as well as the increase of the foreign exchange reserves, while maintaining the stability of the Denar exchange rate against the Deutsche Mark.

### 7.1. Balance of Payments<sup>24</sup>

In 2001, the deficit registered in the current account of the balance of payments increased markedly. It reached US Dollar 352 million and relative to 2000 it increased by US Dollar 245 million, or by more than three times. With this, the deficit in the current account reached 9.5% of GDP<sup>25</sup>, which compared to the previous year is an increase of 6.7 percentage points. The dynamic analysis indicates constant deficit throughout the year. The deficit registered in the first quarter of the year equaled US Dollar 55 million, whereas the highest deficit (US Dollar 127 million) was registered in the second quarter of the year entirely due to the unfavorable security situation in the country. The gradual stabilization of the Macedonian economy that occurred after the signed Peace Agreement was reflected through an increased activity of the economic agents and a rise in the foreign trade. Thus, the deficit in the third quarter equaled US Dollar 74 million, whereas in the fourth quarter the rise in imports and the decline in exports caused further increase of the deficit, which reached US Dollar 98 million.

However, the increased deficit in the current account of the balance of payments of the Republic of Macedonia<sup>26</sup> in 2001 is not a result of the deficit registered in the trade account. Namely, in 2001, the deficit in the trade account was brought down to US Dollar 428 million and relative to the previous year it was lowered by US Dollar 130 million, or by 23.3%. The decline was due to the contraction in the foreign trade that resulted from the dampened economic activity of the domestic economic agents. Namely, in 2001 compared to 2000, the export of goods was lowered by 12.4%, and imports by 19.0%, which caused a reduction in the foreign trade by 16.5%.

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<sup>24</sup> Preliminary data.

<sup>25</sup> The figure of GDP for 2001 is a projection of the Statistical Office.

<sup>26</sup> The deficit in the trade account of the balance of payments differs from the deficit in the foreign trade presented by the Statistical Office. The reason for this is that the imports in the balance of payments are presented on f.o.b. basis, while the official statistics presents imports on c.i.f. basis.



Table 19  
Balance of Payments of the Republic of Macedonia  
(In US Dollar million)

	2000 <sup>1</sup>					2001 <sup>1</sup>				
	Q1	Q2	Q3	Q4	2000	Q1	Q2	Q3	Q4	2001
1. Current account	-128	3	11	6	-108	-55	-127	-74	-98	-352
1.1. Goods, net	-215	-115	-79	-149	-558	-72	-121	-72	-163	-428
Exports, f.o.b.	330	317	344	327	1,317	291	285	295	282	1,153
Imports, f.o.b.	-545	-432	-422	-476	-1,875	-363	-406	-368	-445	-1,581
1.2. Services, net	-9	-13	-12	-21	-55	-24	-30	-22	-23	-99
1.3. Income, net	-21	-4	-21	0	-46	-16	-2	-19	-3	-41
1.4. Current transfers, net	118	135	123	175	551	58	26	40	91	214
Official	4	32	12	49	97	4	7	5	6	22
Other	114	103	111	126	454	54	19	35	84	192
2. Capital and financial account	100	5	-6	-60	40	105	142	25	107	379
2.1. Capital account, net	0	0	0	0	0	0	0	0	1	1
Official	0	0	0	0	0	0	0	0	4	4
Other	0	0	0	0	0	0	0	0	0	0
Acquisition/disposal of nonprod., nonfinan. assets	0	0	0	0	0	0	0	0	-2	-2
2.2. Financial account, net	100	5	-6	-60	39	105	142	25	106	378
Direct investments, net	37	62	41	37	176	372	13	18	40	442
Portfolio investments, net	0	0	0	0	0	0	0	0	0	0
Other investments, net	93	13	-29	23	99	-64	4	-46	79	-27
Trade credits, net	67	15	-34	39	88	-66	-33	-36	30	-106
Loans, net	29	14	-10	-19	14	-31	-10	-35	-32	-107
Foreign currency and f.c. deposits, net <sup>2</sup>	-7	-22	-11	-9	-50	26	44	17	76	164
o/w: Monetary authority, net						0	0	0	-77	-77
Commercial banks, net	-7	-22	-11	-9	-50	26	44	-3	-304	-237
Households, net <sup>3</sup>						0	0	21	457	478
Other, nets	4	6	26	12	48	7	3	8	5	22
Official reserve <sup>2</sup>	-29	-70	-18	-119	-236	-203	126	53	-13	-38
3. Errors and omissions	28	-8	-5	54	68	-50	-15	49	-9	-26

1/ Preliminary data.

2/ Increase in assets is denoted by a negative sign.

3/ Decline in the household's foreign assets out of the banking system and their placement in bank accounts due to the Euro conversion.

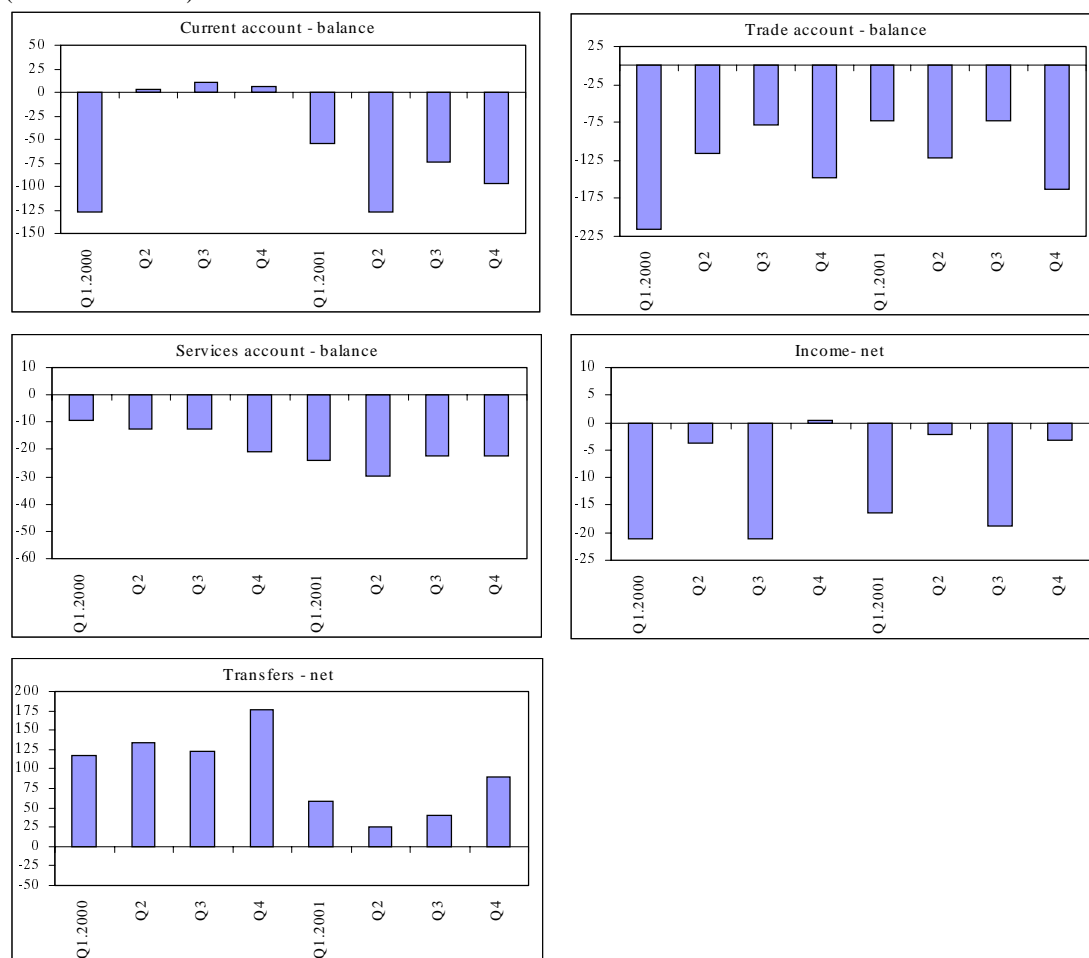
In 2001, the increase in the deficit in the current account of the balance of payments of the Republic of Macedonia is mainly due to the increased deficit in the services, and markedly reduced current transfers. Namely, in 2001, the deficit in the category "services, net" reached US Dollar 99 million and in comparison to 2000 it increased by US Dollar 44 million. The worsened balance of services is a result of the decline in the inflow of funds based on all services provided to nonresidents (tourism, transport, and other services), which in comparison to 2000 declined by US Dollar 69 million. In 2001, the outflow on behalf of services received declined by US Dollar 25 million, basically due to the decline in the transport services received by nonresidents (US Dollar 32 million less than in 2000).

In 2001, the realized net-inflow of transfers in the current account of the balance of payments of Republic of Macedonia was reduced to US Dollar 214 million, or by US Dollar 337 million, or two times less than the level from the previous year. The significant decline in current transfers is due to the decline in official, as well as in private transfers. In addition, a more substantial decline was registered in the private transfers, which relative to 2000 decreased by US Dollar 262 million.

The deficit in the category "income, net" decreased by US Dollar 5 million and was brought down to US Dollar 41 million. The decline in the deficit results from the increased inflow of funds on the basis of received interest payments (US Dollar 6 million). In 2001, there were no significant movements in the amount of funds repatriated abroad on the basis of created profits by foreign investors.

Chart 24

Components of the Current Account of the Balance of Payments  
(US Dollar million)



As well as in the previous years, in 2001, the deficit in the current account of the balance of payments of the Republic of Macedonia was financed by financial transactions. In 2001, a significant foreign exchange inflow in the amount of US Dollar 379 million was registered on the capital and financial account, relative to the US Dollar 40 million registered in 2000. The increase was generally induced by the high amount of foreign direct investments in the Republic of Macedonia.

The foreign direct investments in the Republic of Macedonia in 2001 amounted to US Dollar 442 million, which is the highest amount registered since the independence of the Republic of Macedonia. It results from the continuous process of privatization of the state-owned capital by finding strategic investors. In this line, in the course of 2001, the privatization of one of the biggest public enterprises - the Macedonian Telecom was executed. During 2001, some other big enterprises were also privatized among which: Skopje Fair, Zito Luks, mine Bucim, as well as the inflow of foreign funds based on foreign investments in new legal entities (Euroswiss Bank and MTS - the new mobile operator). Consequently, relative to the previous year, the foreign direct investments in the Republic of Macedonia increased by US Dollar 266 million.

Contrary to the realized inflow in 2000, the category "other investments, net" in 2001 registered an outflow of foreign exchange funds in the amount of US Dollar 27 million. The outflow is due to the drastic decline in the trade credits used for import of goods, which led to a significant annual fall (by US Dollar 193 million) in the category trade credits, net. At the

same time, the low amount of used credits, taking into account the intensified payment of the liabilities towards foreign creditors, determined net-outflow of funds in the category "loans, net", which relative to 2000 decreased by US Dollar 121 million.

In 2001, a significant inflow of US Dollar 164 million was registered in the category "currency and deposits, net", which is by US Dollar 213 million higher than in 2000. In addition, the inflow expresses the effect of the Euro conversion that caused high inflow of foreign exchange of the households, which prior to the introduction of the Euro registered a significant increase and in the fourth quarter of 2001 reached US Dollar 457 million.

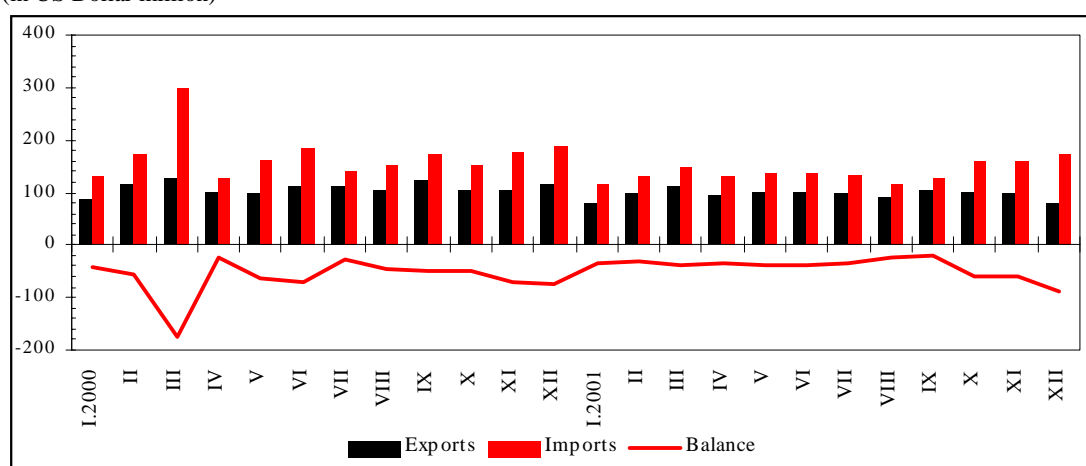
In 2001, the gross foreign reserves<sup>27</sup> increased by US Dollar 38 million, and the category "errors and omissions" had negative sign and equaled US Dollar 26 million, which reflects the inability for entire identification of the transactions of the nonresidents.

## 7.2. Foreign Trade

The negative shock caused by the worsened security in the country in 2001, had a negative impact on the foreign trade. Thus, the foreign trade in 2001 relative to 2000 decreased by US Dollar 561 million, or by 16.5% and was reduced to US Dollar 2,842 million. The decline in the foreign trade is a direct consequence of the security crisis that led to an overall contraction of the economic activity in the country. Namely, the high uncertainty and the high political risk in the course of 2001 caused precaution of the economic agents who refrain from significant investments and production of domestic products for export at the same time facing difficulties in obtaining raw materials and products for reproduction. In this context, the increased costs on the basis of insurance and guaranties, as well as the canceled contracts with the foreign partners resulted in a lower utilization of the production capacity. In addition, the high decline in the foreign trade of the Republic of Macedonia in 2001 was determined by the simultaneous decline of import and export of goods, because the shock was reflected on the supply of the domestic goods as well as on the domestic demand for foreign goods.

Chart 25

Foreign Trade of the Republic of Macedonia  
(in US Dollar million)



<sup>27</sup> The data on gross foreign reserves shown in the balance of payments differs from the data for gross foreign reserves according to the official statistics, because the balance of payments statistics excludes the inflow of foreign currency from the succession, which does not represent a balance of payments transaction.

In 2001, the total export of Macedonian products on the foreign markets equaled US Dollar 1,155 million, which relative to the previous year is a decline of US Dollar 164 million, or by 12.4%. Besides the security situation that was one of the main reasons for this decline, the fall in exports was determined by the decreased export demand for Macedonian products on the Kosovo market, where significant part of Macedonian products are exported (half of the export realized in the trade with FR Yugoslavia). Thus, in 2001 relative to 2000, the export of the traditionally most exported goods on this market - tobacco and oil, decreased by 42.9% and 32.1%, respectively. This decline was also determined by the worsened performance of the iron and steel industry, expressed by the considerable decrease of export of iron and steel (by 35.1%).

The imports of the Republic of Macedonia in 2001 registered more intensive decline than the exports. Thus, on annual level, the total import of goods decreased by US Dollar 397 million, or by 19.0%, and was brought down to US Dollar 1,688 million. The highest decay in imports was registered in the first quarter of the year (by 34.0% relative to the same period of the previous year) that is due to the relatively higher comparative basis from 2000, when prior to the introduction of VAT the import of goods significantly increased. Generally, in the course of 2001 compared to 2000, lower amounts of imports were registered, mainly due to the reduced economic activity of the domestic economic agents determined by the worsened security situation in the country, as well as the difficulties in the process of obtaining the necessary raw materials because of the increased transportation and transaction costs. The only exception was December, when due to seasonal factors, an increase in imports was registered (procurement of strategic reserves and the New Year and Christmas holidays).

The movements of exports and imports in 2001 resulted in a deficit in the foreign trade of the Republic of Macedonia in the amount of US Dollar 533 million. Because of the relatively higher fall of imports relative to exports, the realized deficit in 2001 compared to 2000 decreased by US Dollar 233 million, or by 30.5%. Consequently, the import-export coverage ratio increased by 5.1 percentage points and reached 68.4%.

The analysis with respect to the economic use of goods shows that the deterioration in the foreign trade of the Republic of Macedonia results from the decline of exports and imports of all products. On the export side, in 2001, the exports of reproduction materials dominate with 49.5% share of total export. Compared to 2000, favorable movements were registered in the structure of exports reflected as a decline of the share of this group of products in the total exports by 4.9 percentage points. At the same time, positive movements were registered in the exports of consumption goods the share of which in the total export in 2001 relative to 2000 increased by 5.1 percentage points and reached 47.9%. In 2001, the export of means of production accounts for 2.5% of the total exports, and the item "undistributed" accounts for minimal 0.1%.

Table 20

Foreign Trade of Republic of Macedonia by Economic Use of Goods  
(in US Dollar million)

Type of goods	Exports				Imports			
	2000	2001	index 2001/2000	structure	2000	2001	index 2001/2000	structure
Republic of Macedonia (total)	1,319	1,155	87.6	100.0	2,085	1,688	81.0	100.0
1. Reproduction materials	718	572	79.7	49.5	1,411	1,121	79.4	66.4
2. Means of production	33	29	87.9	2.5	261	209	80.1	12.4
3. Consumption goods	564	553	98.0	47.9	406	350	86.2	20.7
4. Undistributed	4	1	25.0	0.1	6	8	133.3	0.5

The analysis of the imports shows adverse movements in the structure of foreign trade. Namely, in 2001, the reproduction materials were the most imported goods, which still

have a dominant share in total imports of 66.4%. Compared to 2000, their share decreased by 1.3 percentage points, mainly due to the reduced economic activity in 2001. Opposite movements were registered in the share of the imports of consumption goods, which increased by 1.2 percentage points relative to 2000 and reached 20.7% in the total imports of the Republic of Macedonia. An insignificant fall in the share of the import of means of production (by 0.2 percentage points) was registered, thus reducing to 12.4% of the total imports.

The structure of the foreign trade of Republic of Macedonia with respect to the economic group of countries clearly confirms the orientation towards the European Union. Namely, in 2001, the European Union increased its share in the total exports of the Republic of Macedonia by 6.1 percentage points and still remains to be a dominant group of countries on the exports side (the share is 48.7%). On the other hand, in the course of 2001, lower export demand for Macedonian goods with some more important groups of countries was registered, especially with the Countries of the Former SFRY whose share in the total exports of the Republic of Macedonia decreased by 1.3 percentage points, thus lowering to 31.4%.

Table 21

Foreign Trade of Republic of Macedonia by Economic Groups of Countries  
(in US Dollar million)

	Exports	Structure	Imports	Structure	Foreign trade	Structure
<i>Economic groups of countries</i>	I - XII 2001					
Republic of Macedonia (total)	1,155	100.0	1,688	100.0	2,843	100.0
1. Developed countries	719	62.3	876	51.9	1,596	56.1
out of which:						
EU	563	48.7	716	42.4	1,279	45.0
EFTA	41	3.5	26	1.5	66	2.3
Other developed countries	116	10.1	134	8.0	250	8.8
2. Countries of Central and Eastern Europe and former USSR	56	4.9	393	23.3	449	15.8
3. Undeveloped countries	3	0.3	2	0.1	4	0.2
4. Developing countries	14	1.2	91	5.4	104	3.7
5. Republics of the former SFRY	362	31.4	327	19.4	689	24.2
6. Other countries	1	0.0	0	0.0	1	0.0

The analysis of imports with respect to the economic group of countries shows relative increase in the shares of almost all groups of countries. In addition, the highest increase of the share is registered in the import from the countries of the European Union (by 4.3 percentage points), which reached 42.4% of total imports. The only exception is the group of countries from the Countries of Central and Eastern Europe. Namely, the decline in the economic activity and the relatively lower utilization of the production capacity in the iron and steel industry, and in the non-ferrous industry, industries that traditionally import materials for reprocessing, caused lower share of this group in the Macedonian imports by 4.7 percentage points. With this, the share of the Countries of Central and Eastern Europe in the total import of Republic of Macedonia was reduced to 23.3%.

In 2001, with respect to individual countries, the most important trading partner of the Republic of Macedonia is Germany, with exchanged goods in the amount of US Dollar 451 million. With this, this country has a share in the total foreign trade of 15.9%, and relative to 2000 it increased its share by 1 percentage point. The increased share of Germany is due to the higher share in exports and imports, by 1.2 percentage points and 0.5 percentage points,

respectively. The events in the northwest part of the Republic of Macedonia were negatively reflected on the exchange of goods with the second most important trade partner - FR Yugoslavia. In 2001, goods in the amount of US Dollar 424 million were exchanged with FR Yugoslavia, which relative to 2000 is a decline of 23.3%. Thus, the share of this country in the total foreign trade of the Republic of Macedonia was reduced to 14.9% (0.5 percentage points less than in 2000). The fall registered is due to the decreased share in exports (by 2.2 percentage points) with simultaneous unchanged share in the total imports of the Republic of Macedonia. Greece follows with exchanged goods in the amount of US Dollar 286 million in 2001. In addition, the share of Greece in the total trade reached 10.1%, which represents an increase of 1.8 percentage points relative to 2000. This increase is due to the relatively higher increase of the share in the total exports (by 2.4 percentage points) relative to the increase of the share in imports (by 1 percentage point). In 2001, the worsened performances registered in the exchange of the traditionally most exported products - iron and steel, caused a decline in the export of Macedonian products in the USA (by 37.8%) which was determined by the drastic decline of imports of reproduction materials from Ukraine (by 60.7%). These movements led to a lower share of USA on the export side (by 4 percentage points) and lower share of Ukraine on the import side (by 4.8 percentage points).

Table 22

Ten Largest Trading Partners of Republic of Macedonia

	Foreign trade (in US Dollar million)	Share	Exports (in US Dollar million)	Share	Imports (in US Dollar million)	Share	Import - export coverage ratio
I-XII 2001							
<b>Republic of Macedonia</b>	<b>2,843</b>	<b>100.0</b>	<b>1,155</b>	<b>100</b>	<b>1,688</b>	<b>100.0</b>	<b>68.4</b>
<i>out of which:</i>							
Germany	451	15.9	237	20.6	213	12.6	111.3
FR Yugoslavia	424	14.9	267	23.1	157	9.3	169.7
Greece	286	10.1	101	8.8	184	10.9	55.0
Italy	196	6.9	89	7.7	108	6.4	82.4
Russia	153	5.4	14	1.2	139	8.3	10.0
USA	151	5.3	100	8.6	52	3.1	193.5
Slovenia	140	4.9	21	1.8	119	7.0	17.6
Bulgaria	124	4.4	21	1.8	103	6.1	20.0
Croatia	105	3.7	58	5.1	46	2.7	125.9
Netherlands	91	3.2	45	3.9	46	2.7	99.0
Total (10 largest trading partners)	2,121	74.6	908	82.5	1,168	69.2	77.7

In 2001, in the foreign trade with the ten most important trading partners, the Republic of Macedonia registered positive balance in the trade with four countries: USA, FR Yugoslavia, Germany and Croatia. In addition, in the exchange with USA, a surplus of US Dollar 48 million was realized, or an import-export coverage ratio of 193.5%. In the exchange with FR Yugoslavia and Germany export was higher than import by US Dollar 110 million, or by US Dollar 24 million, thus representing an import-export coverage ratio of 169.7% and 111.3%, respectively. In 2001, the positive developments in the exchange of goods with Croatia are of big importance. Namely, for the first time since 1995, Republic of Macedonia has a positive balance in the trade in the amount of US Dollar 12 million, or a positive import-export coverage ratio of 125.9%.

On the other hand, the highest deficit registered among the ten most important trading partners is in the exchange with Russia in the amount of US Dollar 125 million. With this, the import-export coverage ratio reduced to 10.0%, mainly due to the high import of mineral fuel. In 2001, as well as in the previous years, the Free Trade Agreement with Slovenia did not have a positive influence on the trade balance of the Republic of Macedonia. In 2001, the

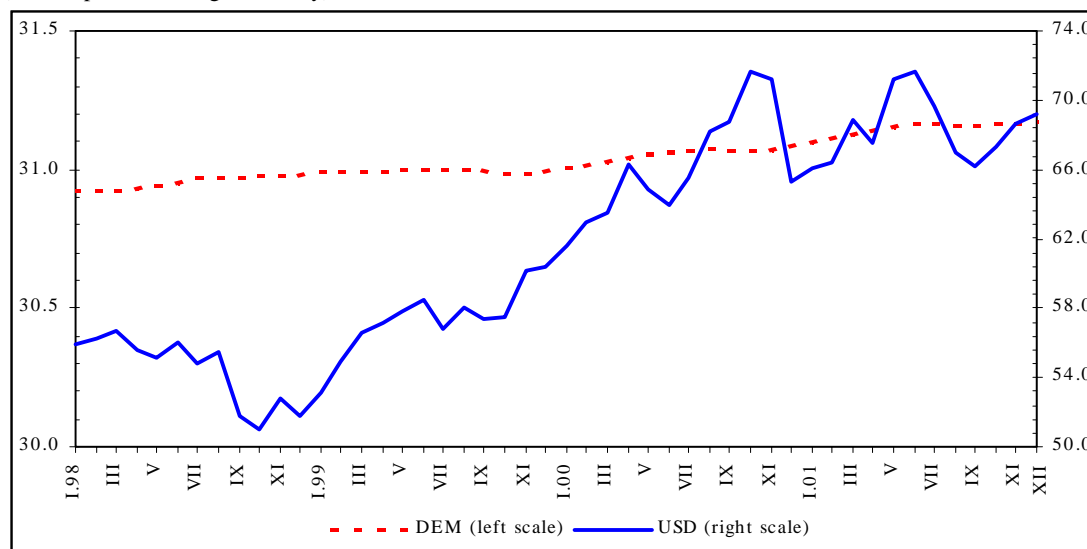
Republic of Macedonia in the exchange with Slovenia realized deficit in the amount of US Dollar 98 million, thus realizing low import-export coverage ratio of 17.6%.

### 7.3. Denar Exchange Rate

The worsened security situation in Republic of Macedonia determined a more complex conduct of the monetary and foreign exchange policies. Namely, the relatively high level of liquidity in the economy caused increased demand for foreign currency on the foreign exchange market and consequently pressure for depreciation of the Denar exchange rate against the Deutsche Mark. In these terms, according to the strategy of exchange rate targeting, the Central Bank intervened on the foreign exchange market by selling foreign currency, and simultaneously withdrawing the excess Denar liquidity through the monetary instruments. Thus, on December 31, 2001, 31.17 Denars were exchanged per Deutsche Mark on the foreign exchange market.

Chart 26

Nominal Exchange Rate of the Denar against the Deutsche Mark and the US Dollar on the Foreign Exchange Market  
(Denars per unit foreign currency)

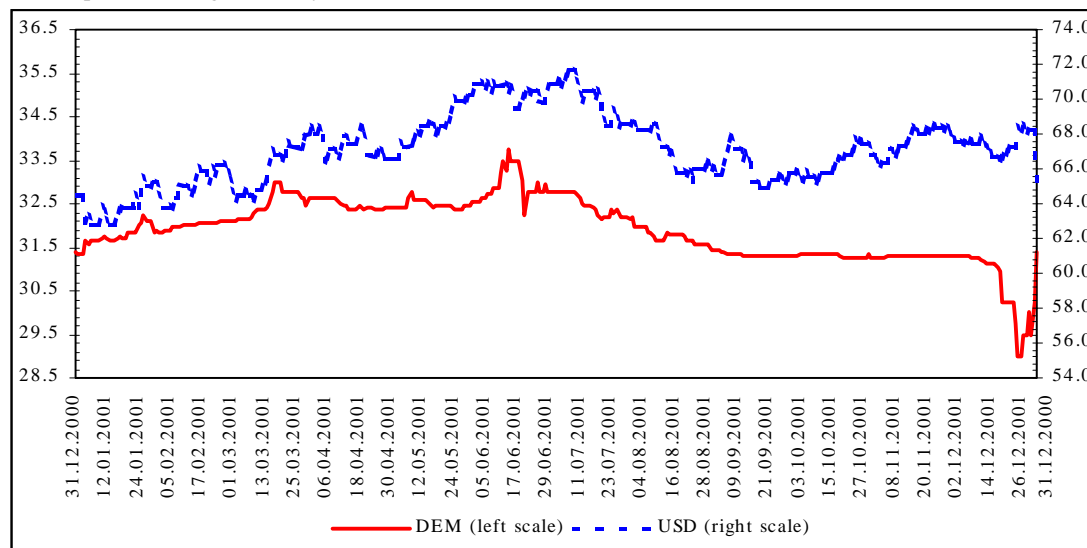


The pressures on the Denar exchange rate in the course of 2001 were more reflected on the exchange offices market, as a consequence of the lower supply of foreign currency relative to the continuously high demand for foreign currency. The main determinant of the high demand for foreign currency were the psychological factors, or the efforts of the households to have cash foreign currency in the period of crisis. Consequently, the Denar exchange rate against the Deutsche Mark in the period of the crisis continuously increased and in the second decade of June 2001 reached the highest level throughout the year of 33.75 Denars per Deutsche Mark. However, the more aggressive manner of acting of the Central Bank, as well as the use of combined monetary instruments, in terms of gradual stabilization of the situation in the country, led to normalization on the foreign exchange offices market and consequently to a decline in the level of the Denar exchange rate. The decline was intensified in the last quarter of 2001, or in the period prior to the introduction of the Euro as a single currency for the member countries of the European Monetary Union. Namely, the exchange of Deutsche Marks into Denars and into other foreign currencies caused pressures for appreciation of the Denar exchange rate on the exchange offices market. Thus, in the third decade of December, the Denar exchange rate against the Deutsche Mark reduced to 29.0 Denars per Deutsche mark, which was the lowest registered level of the Denar exchange rate

since the beginning of the year. These movements reflected the economic agents' preferences for cash conversion of part of their savings. However, as of December 31, 2001, the level of the Denar exchange rate against the Deutsche Mark stabilized and equaled 30.3 Denars, and relative to the end of 2001 appreciated by 3.7%.

Chart 27

Nominal Exchange Rate of the Denar against the Deutsche Mark and the US Dollar on the Exchange Offices Market  
(Denars per unit foreign currency)



Prior to the introduction of the Euro, fixed rates of conversion between the Euro and the national currencies of the member countries of the European Monetary Union were established. Accordingly, in terms of unchanged Denar exchange rate against the Deutsche Mark, the nominal Denar exchange rate against the Euro remained unchanged, and at the end of December 2001 equaled 61.0 Denar per Euro.

The Denar exchange rate against the other foreign currencies is determined by the exchange rates of the Deutsche Mark and these foreign currencies on the Frankfurt Stock Exchange. Thus, the nominal Denar exchange rate against the US Dollar on December 31, 2001 equaled 69.17 Denars per US Dollar, which relative to the end of 2000 is a 5.7% depreciation of the Denar against the US Dollar. Simultaneously, on the foreign exchange offices market, the value of the Denar depreciated by 5.9% and at the end of the December, 2001, 68.2 Denars per US Dollar were exchanged.

The real effective exchange rate is a global measure of the prices of goods and services in the domestic country relative to the prices of goods and services abroad, or it is an indicator of the price competitiveness of the national economy. In 2001<sup>28</sup>, relative to the end of 2000, the real effective exchange rate of the Denar<sup>29</sup> calculated according to the index of prices of industrial products, appreciated by 1.5%, while calculated according to the index of retail prices, it appreciated by 0.3%. The appreciation is due to the more intensive decline of the relative prices in comparison to the decline in the nominal effective exchange rate of the Denar.

<sup>28</sup> Preliminary data are used for December 2001.

<sup>29</sup> Calculations of the NBRM.



## 7.4. Foreign Exchange Reserves of the Republic of Macedonia

At the end of December 2001, the total foreign exchange potential of the Republic of Macedonia, which consists of the total foreign assets of NBRM and the foreign exchange reserves of the banks licensed to conduct international operations reached US Dollar 1,486 million. With respect to December 31, 2000, it increased by US Dollar 348 million, or by 30.6%. The increase is due to the increment in its two components, and especially to the increase in the foreign exchange reserves of the banks licensed to conduct international operations.

At the end of 2001, the total foreign assets of the NBRM equaled US Dollar 797 million, which relative to the end of 2000 is an increase of US Dollar 62 million. The increase is due to the significant rise in the cash in treasury by US Dollar 105 million, as well as the increase of the monetary gold by US Dollar 23 million. Simultaneously, the deposits with foreign banks decreased by US Dollar 42 million, and the invested assets in securities by US Dollar 24 million.

The gross foreign reserves of the NBRM<sup>30</sup>, in 2001 continued to increase thus reaching US Dollar 775 million, which compared to the level from the end of 2000 is an increase of US Dollar 62 million, or 8.5%. The increment of the gross foreign reserves of the NBRM, taking into account the decreased imports due to the worsened security situation, resulted in a higher coverage of imports with foreign reserves. Namely, in 2001 they reached 5.5 monthly import of goods that relative to 2000 is an increase of the coverage by 1.4 percentage points.

Table 23

Inflows and Outflows in the Gross Foreign Exchange Reserves of the NBRM  
(in US Dollar million, end of period)

	31.12.2000	IQ	IIQ	IIIQ	IVQ	01.01.01- 31.12.01
Foreign exchange reserves	714	917	823	762	775	
Change in foreign exchange reserves, net		203	-94	-61	13	62
Realized change in foreign exchange reserves, on net basis						
Purchase and sale		-35	-63	-15	82	-30
External account		-24	21	-47	9	-41
Interest received on foreign currency deposits		8	8	9	5	31
IMF credits		-2	-2	0	-1	-6
BIS credits		-14	0	0	0	-14
Government deposits		314	-35	-48	-63	169
Exchange rate differentials		-47	-20	41	-21	-47

In 2001, the net inflow of government foreign deposits of US Dollar 169 million acted towards an increase of the gross foreign reserves of the NBRM. In addition, the highest increase of the government deposits was registered in the first quarter of 2001, as a result of the inflow of foreign funds due to the privatization of the Macedonian Telecom. The gross foreign reserves increased also due to the interest received on foreign currency deposits in foreign banks in the amount of US Dollar 31 million, on net basis.

On the other hand, the net outflow of the foreign assets on the basis of foreign exchange differentials in the amount of US Dollar 47 million acted towards a decline in the gross foreign reserves of the NBRM. The reduced amount of credits used and simultaneous regular payment of the liabilities towards foreign creditors, in 2001 caused net outflow from

<sup>30</sup> The gross foreign reserves of the NBRM are calculated as a difference between the total foreign assets of the NBRM and the collateral.

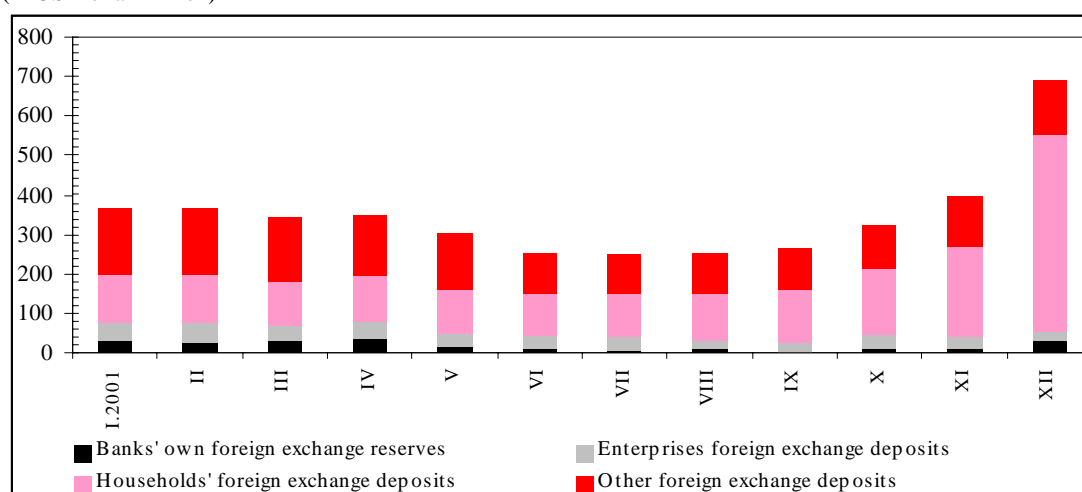
the external account in the amount of US Dollar 41 million. The payment of liabilities towards the Bank for International Settlements (BIS) and the International Monetary Fund (IMF) in the amount of US Dollar 14 million and US Dollar 6 million, respectively, also acted in this direction. In line with the interventions of the NBRM on the foreign exchange market in the period of crisis, in 2001 for satiation of the higher demand for foreign currency (caused by the worsened security situation), net - sale of foreign currency in the amount of US Dollar 30 million was realized, which also declined the foreign reserves.

The net foreign reserves of the NBRM are calculated as a difference between the gross foreign reserves and the liabilities towards IMF and other liabilities.<sup>31</sup> On December, 31, 2001 they reached US Dollar 704 million, and were higher by US Dollar 87 million compared to the previous year. The increase of the net foreign reserves is due to the increase of the gross foreign reserves of the NBRM as well as the decline in the liabilities towards the International Monetary Fund and Bank for International Settlement by US Dollar 12 million, and US Dollar 14 million, respectively. Consequently, on December 31, 2001, the total liabilities of the Republic of Macedonia towards the International Monetary Fund were brought down to US Dollar 71 million.

Chart 28

#### Structure of the Foreign Exchange Funds of the Deposit Money Banks

(in US Dollar million)



At the end of 2001, the total foreign assets of the banks licensed to conduct international operations reached US Dollar 689 million, which relative to the previous year is an increase of US Dollar 287 million, or by 71.2%. The high increment is mainly due to the increase in the foreign currency deposits of the economic agents with the banks caused by the increase of the households' foreign currency deposits generated in the second half of 2001. Namely, analyzing the dynamics, it is evident that the first half of the year was characterized by continuous decline of the households' deposits, due to the preferences of the economic agents for holding cash in the period of crisis. This condition was preserved until July 2001, when an upward trend of the households' deposits was registered, especially intensified in the last quarter of 2001. Namely, prior to the introduction of the new currency of the member countries of EMU - the Euro currency, households deposited part of their savings in Deutsche Mark in the banking sector, thus obtaining costless conversion. Consequently, at the end of December 2001, households' foreign currency deposits reached US Dollar 496 million and relative to December 31, 2001 they increased by US Dollar 381 million, or by four times. On

<sup>31</sup> Since August 2000, the category other liabilities includes the liabilities towards the Bank for International Settlements (BIS).

the other hand, banks' own foreign assets<sup>32</sup> decreased by US Dollar 12 million relative to the end of 2000, and as of December 31, 2001 were brought down to US Dollar 28 million.

## **7.5. External Debt of the Republic of Macedonia<sup>33</sup>**

The external debt of the Republic of Macedonia consists of liabilities of the Government as well as the liabilities of domestic legal entities towards foreign multilateral, bilateral and private creditors on the basis of used short-term, medium-term, and long-term loans and credits.

The unfavorable developments in the country in the course of 2001 caused by the security crises created lower economic activity and were also reflected in the external indebtedness of the country. On December 31, 2001, the total external debt of Republic of Macedonia on the basis of used short-term, medium-term, and long-term loans and credits equaled US Dollar 1,440 million, and relative to the previous year decreased by US Dollar 48 million, or by 3.2%. The decline in the external debt is due to the higher payment of the credits borrowed and the lower amount of credits withdrawn. This situation shows the strong endeavor of the Republic of Macedonia for regular and timely servicing of the debt even in very difficult economic conditions, like the ones that prevailed in the course of 2001.

From a structural aspect, liabilities based on principle account for US Dollar 1,417 million, or 98.4% of the total external debt, and the rest are liabilities based on interest. With respect to maturity, US Dollar 1,378 million, or 95.7% are liabilities on the basis of used medium-term and long-term credits, the remaining US Dollar 62 million, or 4.3% are short-term liabilities.

The analysis of the external indebtedness of the Republic of Macedonia in 2001, according to the 4 standard criteria shows that the Macedonian economy is listed among the less indebted countries. Namely, according to three indicators: the ratio between the total external debt and the average export of goods and services in the last three years (97.0%), the ratio between the debt servicing and the average export of goods and services in the last three years (13.7%), and the interest payments relative to the average export of goods and services in the three last years (4.1%), the Republic of Macedonia is among the less indebted countries with medium income. Only with respect to the index of total external debt relative to the average GDP in the last three years, which equals 40.5%, the Republic of Macedonia is listed in the group of moderately indebted countries.

### *7.5.1. External Debt Structure*

The short-run debt consists of all the credits used by the residents from non-residents with maturity up to one year.

On December 31, 2001, the short-term debt of the Republic of Macedonia equaled US Dollar 62 million. The largest part of the short-term debt, or 99.3% are liabilities based on principle. Regarding the type of credits used, financial credits have a dominant share of 90.4% in the total short-term liabilities of the Republic of Macedonia at the end of 2001. The short-term credit lines follow with 6.7% share and the commercial credits with 2.9% share. Compared to the stock of external debt of Republic of Macedonia as of December 31, 2000, the share of the financial credits significantly increased, or by 33.8 percentage points.

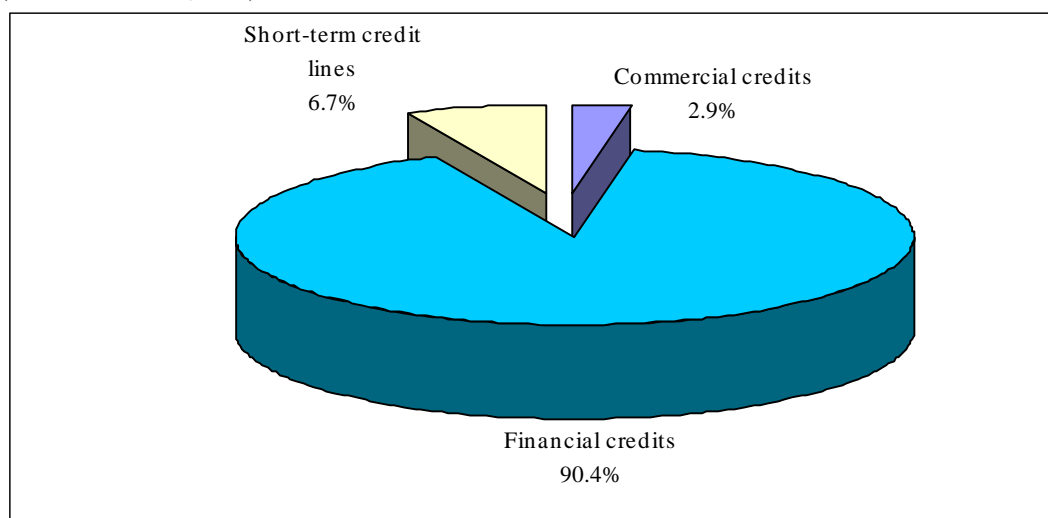
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<sup>32</sup> The difference between the foreign exchange assets and foreign exchange liabilities of the banks, excluding the medium-term and long-term liabilities of the deposit money banks based on foreign credits.

<sup>33</sup> Preliminary NBRM data.

Chart 29

Structure of the Debt by Types of Foreign Credits  
(as of December 31, 2001)



The medium-term and long-term external debt refers to liabilities towards non-residents with maturity longer than one year.

In 2001, relative to the same period of the previous year, the analysis of the structure of the medium-term and long-term debt does not show any significant changes. Namely, the largest part or US Dollar 1,355 million (98.3%) are liabilities on behalf on principle. The interest due equals US Dollar 18 million, or 1.3%, and the estimated overdue interest equals US Dollar 5 million, or 0.4% from the medium-term and long-term debt of Republic of Macedonia.

Table 24

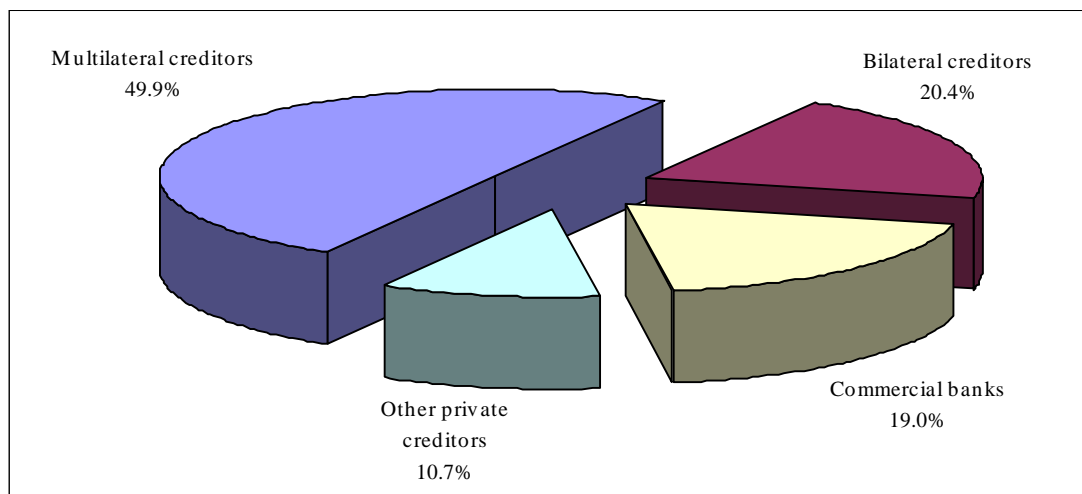
Movements in the External Debt of Republic of Macedonia in 2001

	Balance as of 31.12.2001		Structure (in %)	Changes relative to 31.12.2000	
	(in USD million)	(in %)		(in USD million)	(in %)
<b>Medium-term and long-term</b>					
<b>loans and credits</b>	<b>1,378</b>	<b>100.0</b>	95.7	-59	-4.1
Principal	1,355	98.3			
Interest	23	1.7			
<b>Short-term credits</b>	<b>62</b>	<b>100.0</b>	4.3	11	21.0
Principal	62	99.3			
Interest	0	0.7			
<b>Total debt</b>	<b>1,440</b>		100.0	-48	-3.2

In 2001, the structure of the medium and long-term external debt of the Republic of Macedonia by types of foreign creditors, did not register any significant changes. The official creditors (multilateral and bilateral) dominate with US Dollar 969 million, or with 70.3% (71.9% in 2000). Out of this, the multilateral creditors account for US Dollar 688 million, or 71.0% (69.3% in 2000), and the bilateral account for US Dollar 281 million, or 30.1% (30.7% in 2000).

Chart 30

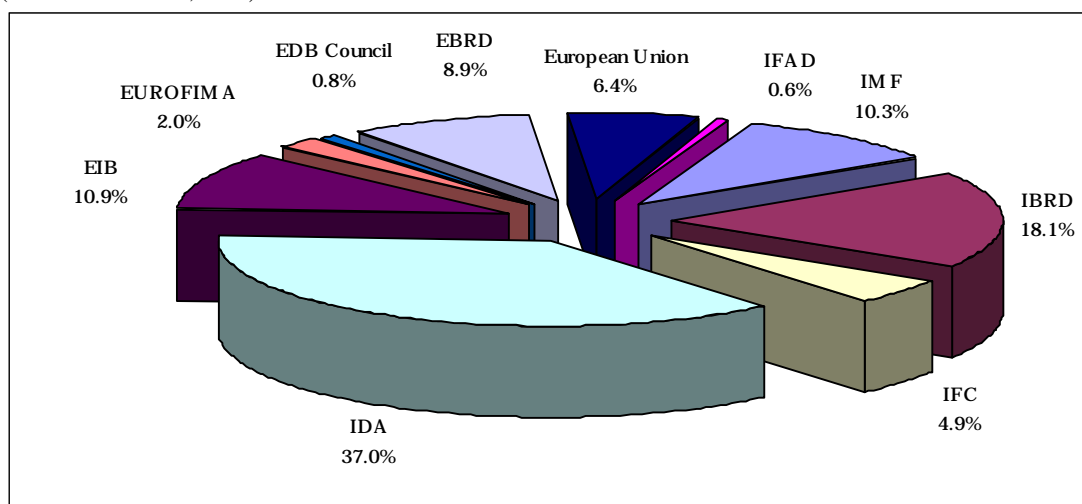
Structure of the Medium and Long-Term Debt by Types of Foreign Credits  
(as of December 31, 2001)



In 2001, the largest creditor of Republic of Macedonia in the group of multilateral creditors is the International Development Agency (IDA) with a share of 37.0% in the total foreign debt of the Republic of Macedonia towards this group of creditors (the share increased by 2.1 percentage point relative to December 31, 2000). Next is the International Bank for Reconstruction and Development (IBRD) with share of 18.1% and the European Investment Bank (EIB) with 10.9%, which among this group of creditors increased their share by 0.9 and 1.5 percentage point, respectively.

Chart 31

Structure of the Foreign Debt towards Multilateral Creditors  
(as of December 31, 2001)



In the structure of the indebtedness of the Republic of Macedonia towards bilateral creditors, the rescheduled debt towards the Paris Club of Creditors has the dominant share of US Dollar 232 million, or 82.5%. Simultaneously, the indebtedness on the basis of newly signed credits on bilateral basis equaled US Dollar 49 million, hence its share in the total liabilities towards bilateral creditors reached 17.5%.

At the end of 2001, the total external debt of the Republic of Macedonia towards private creditors reached US Dollar 409 million. With this, its share relative to the share as of December 31, 2000 increased by 1.7 percentage points and reached 29.7% of the total

external debt based on medium and long-term credits. In addition, the debt towards the London Club of Creditors has a dominant share in this group of creditors (64.1%).

At the end of 2001, the external debt towards other private creditors equaled US Dollar 147 million, or 35.9% of the total external debt towards private creditors. Out of this, US Dollar 116 million, or 78.9% refer to the banks and financial institutions, and US Dollar 31 million, or 21.1% refer to the external debt towards foreign enterprises.

#### *7.5.2. External Debt Developments in 2001*

The external debt of the Republic of Macedonia as of December 31, 2001 compared to the end of 2000, registered a decrease of US Dollar 48 million, or by 3.2%. Medium-term and long-term external debt of the Republic of Macedonia, which are the biggest part of the total external debt, decreased by US Dollar 59 million, or by 4.1%. The external debt on the basis of short-term credits increased by US Dollar 11 million, or by 21.1%.

In 2001, the total amount of withdrawn funds on the basis of the approved short-term, medium-term and long-term credits reached US Dollar 140 million, which represents a decrease of US Dollar 52 million compared to the end of 2000. The significantly smaller amount of withdrawn funds in the course of 2001 is a consequence of the increased risk resulting from the deteriorated security in the state, which made foreign creditors precautionous when extending new credits.

Regarding the maturity, in 2001, US Dollar 59 million were withdrawn on the basis of short-term credits, which is by US Dollar 22 million more than in the previous year. The increase of short-term indebtedness shows that despite the crisis, domestic subjects overpassed the insufficiency of funds insuring short-term credits from foreign sources of financing. The biggest part of the new indebtedness to foreign countries is a result of extended financial credits, that at the end of 2001 reached US Dollar 58 million, or 98.6% of the total amount of withdrawn short-term credits. Analyzing the dynamics, it is obvious that the biggest amount of withdrawn funds is registered in June 2001 (US Dollar 14 million), when actually the biggest part of the financial credits was withdrawn.

In 2001, a total amount of US Dollar 81 million was withdrawn from the extended medium-term and long-term credits, which is by US Dollar 65 million less compared to 2000. In addition, US Dollar 62 million were withdrawn from the multilateral creditors, which is by US Dollar 32 million less compared to the previous year. Simultaneously, US Dollar 1 million and US Dollar 18 million were withdrawn from the bilateral creditors and from the private creditors. Compared to 2000, the amounts of withdrawn funds from bilateral and private creditors in 2001 decreased by US Dollar 15 million and US Dollar 18 million, respectively.

From the aspect of separate creditors, among the multilateral creditors, the largest part of the funds, i.e. US Dollar 15 million were withdrawn from the International Development Agency (IDA) for the Health Sector Transition Project (US Dollar 7 million), Social Support Project (US Dollar 2 million) and Emergency Economic Recovery Credit (US Dollar 2 million). The remainder of withdrawn funds is related to Irrigation Rehabilitation and Restructuring Project, Private Farmer Support Project and other projects. On the basis of the roads building project, US Dollar 14 million were withdrawn from the European Investment Bank (EIB) in 2001.

On the basis of the new arrangement for structural adjustment (December 2000), during 2001 funds in the amount of US Dollar 10 million were withdrawn from the European Union (EU). At the same time, funds in the amount of US Dollar 9 million were withdrawn from the European Bank of Reconstruction and Development (EBRD). Largest part of these funds was withdrawn from the steel factory "Makstil-Skopje" A.D. (US Dollar 8 million) for

equipment purchasing and modernization of production, and the rest of the funds refer to the Communes and the Environment Promotion Project.

During 2001, US Dollar 8 million were withdrawn from the International Bank for Reconstruction and Development (IBRD). The withdrawn funds refer to three projects: the Transport Sector Project (US Dollar 3 million), the Power System Improvement Project (US Dollar 3 million) and the Private Sector Development Project (US Dollar 2 million).

In 2001, the largest part of the withdrawn funds from the bilateral creditors (US Dollar 0,7 million) is related to the last withdrawal of funds from the American EXIM Bank on the basis of the credit for purchasing vehicles and equipment for the Ministry for Internal Affairs. The rest of the funds were withdrawn credit lines from Norway, (Project for Transformation of the Payments Operations Bureau) and from Italy (credit line for import of equipment).

Regarding the private creditors, in 2001, funds in the amount of US Dollar 5 million were withdrawn from the banks and other international private financial institutions, and US Dollar 4 million were withdrawn from the foreign enterprises. Thus, on December 31, 2001, the total amount of withdrawn funds from other private creditors reached US Dollar 9 million. At the end of 2001, in accordance with the terms of "The New Financial Agreement", i.e. the agreement for rescheduling of the liabilities of the Republic of Macedonia made with the London Club of Creditors in 1997, the capitalized interest reached US Dollar 9 million.

Table 25

Withdrawn funds and paid liabilities refers to the creditors in 2001

(in million US Dollars)

	Withdrawn assets	Paid liabilities
<b>MEDIUM-TERM AND LONG-TERM LOANS AND CREDITS</b>	<b>81</b>	<b>201</b>
MULTILATERAL CREDITORS	62	93
International Monetary Fund	-	10
World Bank	8	12
International Financial Corporation	3	31
International Deveopment Agency	15	2
European Investment Bank	14	6
European Railway Funding Company	2	5
European Development Bank Council	-	1
European Bank for Reconstruction and Development	9	25
European Union	10	2
International Fund for Agriculture Development	1	0
BILATERAL CREDITORS	1	61
Paris club (total)		44
New credits		17
PRIVATE CREDITORS	18	48
London club	9	10
Other private creditors	9	38
Banks and private financial institutions	5	28
Foreign enterprises	4	10
<b>SHORT-TERM CREDITS</b>	<b>59</b>	<b>40</b>
Commercial credits	1	1
Financial credits	58	25
Short-term credit lines		-
Liquidity credit in the international payments	-	14
<b>TOTAL</b>	<b>140</b>	<b>241</b>

The total amount of the paid credits of the Republic of Macedonia to foreign creditors at the end of 2001 reached US Dollar 241 million, which is by US Dollar 44 million more compared to 2000. Out of this amount, US Dollar 180 million refer to the payments on the basis of principal, and the rest of US Dollar 61 million refer to the payments on the basis of interest.

In the course of 2001, the total amount of paid liabilities based on short-term credits reached US Dollar 40 million, i.e. US Dollar 8 million more compared to the previous year. The largest part of the paid short-term liabilities refers to the payments of financial credits (US Dollar 25 million). From the total amount of repaid short-term liabilities, repayments on the basis of principal amount to US Dollar 39 million, and US Dollar 1 million refers to the repaid interest.

At the end of 2001, the total amount of repaid liabilities to foreign creditors which arise from used medium and long term credits reached US Dollar 201 million, which compared to the end of 2000, represents an increase of US Dollar 36 million. In addition, US Dollar 141 million refer to repayment of the principal, and US Dollar 60 million refer to paid interest. The analysis from the aspect of separate creditors shows that the biggest part of the funds, or US Dollar 153 million, were repaid toward official creditors, or US Dollars 93



million against multilateral creditors and US Dollar 60 million against bilateral creditors. Within the multilateral creditors, the largest part is repaid to the International Financial Corporation (IFC) (US Dollar 31 million) and to the European Bank of Reconstruction and Development (EBRD) (US Dollar 25 million). Simultaneously, in the bilateral creditors group, the largest part of the funds was repaid toward the Paris Club of Creditors in the total amount of US Dollar 61 million.

During 2001, liabilities in the amount of US Dollar 48 million (US Dollar 33 million principal and US Dollar 15 million interest) were repaid toward private creditors, i.e. US Dollar 18 million less compared to previous year. The largest part of this amount, or US Dollar 28 million, refers to repaid liabilities against banks and private financial institutions. At the same time, an equal amount of US Dollar 10 million is repaid to the London Club of Creditors and to the foreign enterprises, respectively.

## **7.6. Relations with the International Financial Institutions**

### *7.6.1. Multilateral Creditors*

The deteriorated macroeconomic performances of the Macedonian economy in 2001, caused by the security crisis, were reflected in the sphere of the external credit indebtedness. Namely, in the course of 2001 no new arrangements were concluded with the International Monetary Fund (IMF), and as a consequence of the crisis and the receded ability to complete the quantitative performance criteria, the arrangements concluded in 2000 - Poverty Reduction and Growth Facility (PRGF) and Extended Fund Facility (EFF) were temporarily interrupted.

By December 31, 2001, the Republic of Macedonia has concluded several arrangements with the International Bank for Reconstruction and Development (IBRD). In the 1994-2001 period 9 arrangements were concluded in the total amount of US Dollar 199 million. In the course of 2001, because of the developments in the country no new arrangements were concluded with the International Bank for Reconstruction and Development (IBRD).

In 2001, two new arrangements were concluded with the International Development Association: Emergency Economic Recovery Credit in the amount of SDR 12 million (US Dollar 15 million) and Project for Trade and Transport Facilitation in South-East Europe in the amount of 7 million SDR (US Dollar 9 million). With these two new arrangements, in the 1994-2001 period, the Republic of Macedonia concluded 15 arrangements with the International Development Association in the total amount of 238 million SDR (US Dollar 299 million).

In 2001, the International Financial Corporation financed a project within the private sector in the amount of US Dollar 3 million. Hereby, in the 1997-2001 period, the total funds that this financial institution designated for private sector projects in the Republic of Macedonia equaled US Dollar 71 million.

The main objectives of the European Bank for Reconstruction and Development (EBRD) strategy in the Republic of Macedonia pertain to the development of the private and the financial sectors, as well as the realization of key and specific infrastructural projects that facilitate the development of the private sector and regional integration of the country. For realization of these goals, EBRD in Republic of Macedonia period acclaimed funds in the total amount of US Dollar 159 million.

In 2001, Republic of Macedonia is charged toward the European Union with loan in amount of EURO 10 million (US Dollar 9 million) on the basis of acclaimed Structural Accommodation Loan. In the 1997-2001 period, the total amount of the funds that this financial institution intended for private sector projects in the Republic of Macedonia reached EURO 91 million (US Dollar 80 million).

On the basis of the Project for Global Investment in small and medium-size enterprises and infrastructure projects of the local government, Republic of Macedonia, in 2001, concluded an arrangement with the European Investment Bank (EIB) in the amount of EURO 20 million (US Dollar 18 million). Cumulatively analyzed, in the 1998-2001 period, EIB provided funds to the Republic of Macedonia in the total amount of EURO 150 million (US Dollar 132 million).

In the 1996-2001 period, European Community for Financing of Railway Equipment to the Republic of Macedonia provided funds in the total amount of US Dollar 7 million designated for supply of equipment and spare parts for the "Macedonian railways" public enterprise. In 2001, a financial credit was extended to this public enterprise in the amount of EURO 2 million (US Dollar 2 million).

The total amount of funds that the European Development Bank Council extended to the Republic of Macedonia in the 1999-2001 period, reached EURO 20 million (US Dollar 18 million). In the 1997-2001 period, the International Fund for Agriculture Development extended credits for development of the agricultural sector of the Republic of Macedonia in the total amount of 12 million SDR (US Dollar 15 million).

#### *7.6.2. Bilateral Creditors*

In 2001, the Republic of Macedonia continued with the regular servicing of its liabilities toward the Paris Club of Creditors, and concluded new bilateral arrangements of which:

- Loan from the Government of the Republic of Portugal in the amount of EURO 13 million (US Dollar 11 million) on the basis of the Municipal and Environmental Action Program;
- Loan from Norway for transformation of the Payments Operations Bureau in the amount of US Dollar 1 million.

#### *7.6.3. Private Creditors - London Club of Creditors*

The total undertaken debt toward the London Club of Creditors reached US Dollar 229 million. In 2001, liabilities based on interest in the amount of US Dollar 10 million were repaid toward this group of creditors. The outstanding debt to the London Club of Creditors equals US Dollar 262 million, including the capitalized interest.

## **VIII. Supervision of Banks and Saving Houses**

### **8.1. Supervision of banks during 2001**

#### *8.1.1. Revision and improvement of the regulatory framework*

In 2001, NBRM activities in the area of regulatory framework of the banking supervision were focused on finishing the process that came after the enforcement of the Banking Law (Official Gazette of the Republic of Macedonia no.63/2000), directed mainly towards:

- Clarification of particular provisions of the Banking Law through enforcement of adequate by-laws, as well as adjustment of the existing supervisory standards with the by-laws contained in this Law; and
- Further adjustment of the domestic supervisory regulation and supervisory practice with international supervisory standards and the so-called 25 Core Principles for Effective Banking Supervision.

Therefore, during the first semester of 2001 the package of new supervisory decisions that replaced the existing decisions enforced in 1995 and 1996 was finalised. The new supervisory decisions incorporate the modern Basle principles and practices for prudent operation of banks and they are regulating the basic supervisory standards, such as: calculation of the capital adequacy of banks, estimation of the credit risk through prescription of methodology for classification of the riskiness of the banks assets, identification, measurement and monitoring of the country risk; identification, measurement and monitoring of the limitations of credit concentration, etc.

With regard to the complexity of these supervisory standards, the implementation of which requires appropriate changes also in the internal systems and software solutions of banks, as well as the effects expected on the financial position of banks, the banks are given a period to adjust to the new by-laws until March 31, 2002, when the banks will be obliged to apply these standards.

At the same time, for the purpose of full completion of the legal regulatory framework, the National Bank of the Republic of Macedonia prepared Instructions for uniform application of the provisions incorporated in the laws and by-laws.

Also, during 2001, NBRM continued with the practice of preparing supervisory circulars, which represent an appropriate instrument for giving directions about more effective realisation of legal obligations, banking activities and their compliance with international supervisory standards and practices. Thus, in 2001 the following supervisory circulars were adopted:

- Supervisory circular no.3 – Repurchase of own stocks. The aim of this circular is to give certain explanations about the legal decisions relating to repurchase of own stocks, i.e. addresses the problem of repurchase of own stocks and the adequate accounting when purchasing and the repurchase and latter again selling their own stocks;
- Supervisory circular no.4 – Systems of corporate governance with banks. This circular gives the main directions for obtaining effective system of corporate governance, with special accent on definition of rights and responsibilities of

bodies included in the corporate governance: Board of Directors, Risk Management Board, Auditing Board and Executive Body.

In 2001 the Anti-Money Laundering Law (Official Gazette of the Republic of Macedonia no.70/2001) was enforced, which defines the measures and actions for detecting and preventing money laundering, as well as the subjects that undertake these measures and actions. Through provisions of this Law, the National Bank of the Republic of Macedonia is involved in the process of anti-money laundering process, first of all through the control of the systems of anti-money laundering that banks and saving houses have to establish. The control means to analyse the whole process of management with this specific (operating) risk that banks are exposed to: establishment and implementation of appropriate policies and procedures, adequacy of the system of identification of clients and adequacy of the management information system and internal control of banks.

#### *8.1.2. Licensing function*

Within the framework of licensing activities, in 2001, the NBRM issued licence for founding and operating of the Euroswiss Bank a.d. Skopje and three licences for changes of status: for acquisition of Zemjodelska Banka a.d. Skopje by Sileks Banka a.d. Skopje, for acquisition of Pelagoniska Banka a.d. Prilep by Komercijalna Banka a.d. Skopje and for merging of Teteks Banka a.d. Skopje with Kreditna Banka a.d. Bitola. After registration in the trade register, Zemjodelska Banka a.d. Skopje and Pelagoniska Banka a.d. Prilep stopped existing as separate legal entities, while Teteks Banka a.d. Skopje and Kreditna banka a.d. Bitola are functioning as a new legal entity, with the name Teteks Kreditna Banka a.d. Skopje.

In the same period a licence for reorganisation of the Postal Office Savings House a.d. Skopje in Postenska Banka a.d. Skopje is issued, while the licence for founding and operating Zegin Victoria savings house Ltd. Skopje is revoked.

#### *8.1.3. On site examination and off-site surveillance of the operations at banks and savings houses*

In the frame of the activities for on-site examination, in 2001, the NBRM carried out a total number of 47 examinations, 19 of which were full-scope and 28 were limited examinations.

Full-scope on-site examination was carried out in 9 banks and 10 savings houses. Also, 28 limited examinations of 12 banks and 5 savings houses were carried out. The limited examinations were aimed at checking the responsiveness, i.e. the manner of accomplishing certain corrective measures recommended by NBRM, checking particular operating segments, such as credit portfolio, shareholders structure, operation with deposit accounts, checking particular developments and situations detected by the off-site surveillance of banks, etc. Limited examination was carried out in one of the savings houses on the base of the submitted application for closing its activities. In addition to checking the responsiveness of the institutions to the measures defined by NBRM, limited on-site examinations were also aimed at verifying the findings they got from the off-site surveillance, checking the shareholders structure and checking the accomplishment of the recommendations of the auditing house Arthur & Andersen, given after the diagnostic studies performed in 2000. Also, in 2001, 10 limited examinations were carried out in order to check the compliance of the savings houses with the item 4 of the Decision on determining of the size and the way of operating of savings houses.

On-site supervisory examination and permanent off-site surveillance of banks and savings houses conducted during 2001, confirmed the already identified problematic

segments of their operations. Credit risk still represents a dominant risk in the operations of banks and savings houses. Inappropriate credit procedures of institutions, followed by the impact of certain external factors, such as the worsened political and security situation, worsened economic situation, non-effective juridical procedures, etc., caused problems with collection of accounts receivable of banks and the high percentage of bad placements in their balances. Also, the liquidity problem of some banks is added as a consequence of the political security crisis in the Republic of Macedonia because of large withdrawal of deposits from banks, which was typical for the first semester of 2001. Despite this, the performed on-site examination identified inappropriate accounting procedures and weaknesses in the recording in part of the banking institutions, as well weaknesses in the functioning of the systems of internal control and the internal audit, which results in certain deviations from the regulations.

In parallel with the supervision of banks and savings houses, the NBRM carries out inspection control for the application of regulations in the area of foreign exchange operations. Thus, in 2001, a total number of 111 controls was realised, out of which, 13 controls covered the entire foreign exchange operations of banks, 26 controls covered separate segments of banks' foreign exchange operations, 60 controls referred to the operations of exchange offices and 12 controls to the operations of savings houses.

## **8.2. Banking system in the Republic of Macedonia in 2001**

### *8.2.1. Structure of the banking system in the Republic of Macedonia*

At the end of 2001, the banking system of the Republic of Macedonia consisted of 21 banks and 17 saving houses. Out of the total number of banks, 18 banks had the so-called full licence for conducting international payments, credit and guarantee operations, while the other 3 banks had only a licence for conducting domestic operation.

Comparing to December 31, 2000, the number of banks that consist the dominant segment of the banking system of the Republic of Macedonia, has been reduced. Also, the general downward trend of the number of savings houses, present in the last years, continues.

Main reason for the decrease of the number of banks is the process of concentration and consolidation of the banking system of the Republic of Macedonia, which started in 2001. This trend is due to the increased competition in the banking system which is a result of the entrance of foreign direct investments in part of larger banks in the Republic of Macedonia in 2000, as well as the reforms in the payment system and its transfer to commercial banks.

The analysis of the structural relations among banks and savings houses at the end of 2001, as two main segments of the baking system of the Republic of Macedonia, once again confirms the structural dominance of banks.

The main structural characteristics of the banking system in the Republic of Macedonia are analysed than several aspects:

1. Size of the banking institutions,
2. Ownership structure and
3. Regional structure.

The analysis of the structure of the banking system of the Republic of Macedonia, following the above listed criteria, shows the dominance of the two largest banks. Thus, as of December 31, 2001 the two largest banks of the banking system in the Republic of Macedonia account for 55.8% of the total net assets. Comparing to December 31, 2000, concentration according to this criterion is reduced by only 0.8 percentage points.

The analysis regarding to the market share, i.e. total amount of balance and off-balance banking activities, shows that as of December 31, 2001 the two largest banks had a share of 55.5%, which represents a reduction of 2.6 percentage points compared to the same period in the previous year.

Taking into consideration the banking capital, as of December 31, 2001 the share of 29.6% of the total banking system belonged to the two largest banks, which represents lower level of concentration comparing to the previous two criteria.

However, considerable concentration of the financial potential in the two largest banks, remains the basic structural characteristic of the banking system of the Republic of Macedonia in 2001, despite the identified moderate downward trend of the concentration.

The ownership structure of banks in the Republic of Macedonia is analysed from the aspect of the level of privatisation of banks and from the aspect of the share of foreign capital. The level of privatisation of the banking capital in the Republic of Macedonia as of December 31, 2001 equals 84.3%, i.e. 88.6% if the analysis excludes the banking institution which is entirely in state ownership (Macedonian Bank for Development Promotion a.d. Skopje). Analysing banks separately, the level of privatisation ranges from 61.5% to 100% in 8 banks. The level of privatisation of banks is increased by 0.7 percentage points compared to December 31, 2000, mostly due to establishment of Euroswiss Banka a.d. Skopje in the second semester of 2001, which is founded with 100% private capital.

As of December 12, 2001 the percentage share of foreign capital in the total equity capital of banks in the Republic of Macedonia equals 40.1%, which is almost unchanged compared to the end of December 2000. The analysis of banks separately shows that foreign capital exists in 17 banks, and its share is between 0.3% and 100%.

From a regional aspect, the structure of the banking system in the Republic of Macedonia confirms the already identified asymmetry and concentration of the supply of financial services in the capital city of the Republic of Macedonia. Namely, as of December 31, 2001 only 4 out of the total number of banks were located out of Skopje, out of which 3 have the licence for conducting international payment credit and guarantee operations. The financial potential of these 4 institutions participates with 9.5% in the total financial potential of the banking system of the Republic of Macedonia. The existing regional structure is corrected with a relatively wide net of branches, subsidiaries, counters, operational units and representative offices.

#### *8.2.2. Performance of the banking system in the Republic of Macedonia*

##### *8.2.2.1. Capital Adequacy / Insolvency Risk*

As of December 31, 2001 the total capital of banks in the Republic of Macedonia amounted to Denar 19,159 million, which is equal to Euro 314.3 million. During 2001 the level of the capital of all banks remained unchanged, i.e. registered insignificant increase of Denar 57 million, or 0.3% compared to December 31, 2000.

The higher increase of the net assets in 2001 comparing to 2000, reflected mainly through the increase of the liquid assets of banks, determines the decline of the level of capitalisation expressed through the coverage ratio of balance activities with banks own assets. On annual basis, own assets of banks registered an increase of 0.3%, while the total assets registered an increase of 28.8%. As a result, the capitalisation ratio on December 31, 2001 amounted to 18.1%, which represents a decline of 5.1 percentage points compared to the end of December 2000.

The average capital adequacy ratio of banks in the Republic of Macedonia, as a relation between guarantee capital and total risk-weighted assets, amounted to 34.3% in 2001 and registered a decline by 2.4 percentage points, compared to the previous year. In addition, the capital adequacy ratio of the first two largest banks sector amounted 20.9%, which compared to the average capital adequacy ratio of the banking is lower by 13.4 percentage points. Remaining banks have the average capital adequacy rate of 46.6%, which is by 12.3 percentage points higher compared to the average capital adequacy ratio of the banking sector.

All banks in the Republic of Macedonia fulfil the required minimum capital adequacy ratio of 8%. Analysing separately by banks, the lowest level of capital adequacy amounts to 19.8%, and the highest is 342.8%.

#### *8.2.2.2. Credit Risk*

The credit risk has the most important role in the definition of risk profile of banks in the Republic of Macedonia due to the domination of the classical banking intermediary functions and the low level of development of financial markets and instruments.

In 2001 the credit risk of banks increased as a consequence of the political-security crises in the Republic of Macedonia. Hence, the positive trend of improving the asset quality registered in 2000, which represented the recovery of banks from the consequences from the strong external shock caused by the Kosovo crisis in 1999, was stopped.

Namely, the basic indicators for the quality of the credit portfolio calculated in December 2001 show a trend of deterioration during 2001. To be in line with the trend of the changes in the quality of the credit portfolio in 2001, it is necessary to take into consideration the total amount of claims classified in the risk category E more than two quarters, which are re-recorded in off-balance evidence during the year. Thus, together with this amount that in 2000 reached Denar 3,835 million, the total credit exposure of banks as of December 31, 2001 equalled Denar 21,727 million. So, the credit exposure classified in the risk categories C, D and E participates with 38.2% in the total credit portfolio of banks as of December 31, 2001, which compared to December 2000 represents an increase of 3.4 percentage points. If the guarantee capital is taken as a comparison basis, the indicator of total credit exposure in C, D and E / guarantee capital equals to 116.2%. The deterioration of the indicator by 22 percentage points compared to 2000 is determined by the absolute increase of placements in C, D and E by Denar 4,113 million, contrary to the unchanged amount the guarantee capital. The reason for stagnation of the guarantee capital despite the entrance of foreign capital and foundation of two banks is due to the aggregate loss of Denar 620.3 million in the banking system in 2001, reflected in the own assets and in the guarantee capital, consequently.

If the reserves for credit exposure classified in risk categories C, D and E are included in the analysis, it is identified that the uncovered part of this segment of the risk exposure of banks amounts Denar 9,789 million, which represents 17.2% of the total credit portfolio, namely 52.4% of the total guarantee capital of the entire banking system in the Republic of Macedonia as of December 31, 2001. This shows that the high credit risk is compensated with the high level of capitalisation of banks in the Republic of Macedonia.

The risk ratio of credit portfolio of Macedonian banks, which shows the relation between calculated potential losses and the total credit exposure, as of December 31, 2001 amounts 23.6%, which corresponds to the risk category C (25%). For comparison, this indicator in December 2000 equaled 21.4%, while at the end of December 1999, it was 22.6%.

Taking into consideration the average risk rate of 23.6% of the total credit portfolio of banks, it is identified that 5 banks are above the average level, while the other banks have the rate of risk of the credit portfolio which is lower than the calculated average of the whole banking system.

### *8.2.2.3. Liquidity Risk*

During 2001, banks in the Republic of Macedonia faced with serious challenges with regard to the liquidity risk management. As a result of the crisis in the country, which caused unfavourable external factors, during the first three quarters, the trend of strengthening the deposit potential of banks registered during 2000 was stopped. Under the influence of economic and psychological factors, total deposits of banks in the first two quarters of 2001 showed significant decrease that creates serious problems both for the banks and for the National Bank of the Republic of Macedonia in maintaining the liquidity of the banking system. In September the continuing downward trend of the deposit base of Macedonian banks was stopped, as a result of the gradual normalisation of the economic situation in the country. During the last quarter, especially in December, the process of conversion of the currencies of the EMU-member countries into Euro, caused to intensification of the dynamics of total deposits increase.

The share of liquid assets<sup>34</sup> in total assets of banks at the end of 2001 equaled 54.6% and compared to the end of the previous year it is higher by 7.3 percentage points. During the year, the share of liquid assets in total assets of banks oscillated, due to the war crisis and the withdrawal of the deposit base. Thus, during the first eight months of the year, liquid assets of banks decreased continuously and in August reached the highest level of Denar 22,069 million or 30.9% of the total assets of banks. During the last four months of the year, the process of conversion of foreign currency savings (in the currencies of EMU – member countries) to Euro brought to a significant increase of foreign currency sight deposits, which in the assets side was reflected with an increase of foreign currency cash and foreign currency demand deposits of banks at the National Bank of the Republic of Macedonia, through which most of the banks realised the physical transformation of EMU currencies.

Oscillations of the deposit base during the year imposed the need for banks' continuous use of short-run external sources of funds in their liquidity management. In 2001, the share of external sources of funds in the total liabilities of banks was 20.4% monthly, on average. As a result of the large increase of the deposit base of banks at the end of 2001, external sources of funds reduced their structural share in total liabilities to 14.6%, namely by 5.7 percentage points compared to the end of the previous year.

In May 2001 the National Bank of the Republic of Macedonia started with "volume tender" auctions of Central Bank bills, where the interest rate was about several percentage points higher than the interest rate realised in the Money market. Despite this measure, in order to increase the attractiveness of the Central Bank bills, at the beginning of 2001 the National Bank of Republic of Macedonia started to organise everyday auctions of Central Bank bills with different maturity and interest rates, opened for participation of other economic entities with intermediation of commercial bank.

At the same time, National Bank of the Republic of Macedonia increased the transparency through publication of the offers in the public media, allowing non-financial legal persons and natural persons to write CB bills of National Bank of the Republic of Macedonia through commercial banks. The main objective of the changes in this instrument

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<sup>34</sup> Liquid assets comprise the funds and balances with the National Bank of the Republic of Macedonia, securities with the National Bank of the Republic of Macedonia, short-run debt securities, short-run loans and balances at the accounts with domestic and foreign banks.



was to withdraw the excess of liquid assets, which was making pressure on the foreign exchange market, under the conditions when banks did not react to the increased interest rates as a measure of the monetary policy.

Money market is of a special importance for the liquidity management of banks, where banks invest part of their free funds. Under the conditions of the reduced liquidity of the banking system during the first three quarters of 2001, the demand for money in the Money market was higher than the supply, which implies continuous increase of interest rates of these assets. That was due to the lack of financial funds offered in the Money market, determined by the banks' retraining from investing funds in this market because of unfeasibility of precise planning of liquidity under conditions of high level of volatility of the deposit base. In September, the average weighted interest rate realised in the Money market reached the highest level within the year, namely it equalled 19.34%, or 9.65 percentage points higher than the level registered in December previous year.

The worsened liquidity position of banks implied more frequent use of the instruments for providing liquidity at the last resort, i.e. instruments for financing the liquidity deficits of banks. In the direction of approximation of the aims and tasks of the redesigned monetary policy, the National Bank of the Republic of Macedonia modified the Lombard credits and the foreign currency swaps.

The last stage of the reform in the payment system in the Republic of Macedonia, namely the introduction of RTGS system and the process of migration of accounts of legal entities from the Payment Bureau to commercial banks started at the beginning of August 2001. The reform of the payment system was finished at the end of 2001. With the introduction of the new payment system, the National Bank of the Republic of Macedonia introduced a new opportunity, i.e. the allowed overdraft (intra-day credit – secured with state bonds and CB bills of NBRM with the same percentage as for Lombard credits) in order to facilitate payments of banks. Changes in the payment system and monitoring of the part of the deposits of the public sector in commercial banks brought to redesigning of the instrument of compulsory reserves, practised during the first quarter of 2002. With implementation of the new payment system, banks increased their opportunity for better monitoring of their clients' funds, which should act forward of improving the planning and the management of liquidity.

#### *8.2.2.4. Analysis of the Profitability of the Banks in the Republic of Macedonia and Evaluation of their Efficiency*

At the end of 2001, banks in the Republic of Macedonia showed negative financial result in the amount of Denar 620.3 million on aggregate level. Out of the total number of 21 banks in the Republic of Macedonia, as of December 31, 2001, 17 banks showed positive financial result, while 4 banks showed negative financial result. In addition, if the showed negative result in one bank is excluded, banks in the Republic of Macedonia would show positive financial result of approximately the same level as in the previous year, on aggregate level.

Analysis of structural components in the consolidated income statement of banks in the Republic of Macedonia as of December 31, 2001 shows negative net interest revenue from provisions in the amount of Denar 684 million. If we take into consideration also, the undistributed reserves for potential losses (including the additionally established unfunctional interest) of Denar 97.5 million, identified by the on-site supervisory examinations, which are not showed in the income statement, then the net income from interest will register a negative amount of Denar 781.5 million.

Negative financial result of banks realised from their basic function (intermediation between the economic agents that register financial surplus and those registering financial

deficit) with calculated expenditures based on potential losses for credit risk, is an indicator of significantly low efficiency with regard to the allocation of the scarce resources. This is mostly due to the worsened security and political situation in the country in 2001 and its negative effects on all economic sectors. Finally, the negative net interest revenue from provisions is the main reason for the showed negative financial result from banking operations on aggregate base in the analysed period.

The negative financial result, showed aggregately by banks in the Republic of Macedonia on December 31, 2001, resulted in negative indicators for the rate of return on asset (ROAA) and the rate of return on equity (ROAE). The indicator ROAA showed that during 2001, 100 units assets of banks in the Republic of Macedonia generate 0.66 units loss, while the indicator ROAE shows that 100 units capital of banks in the Republic of Macedonia generate 3.24 units loss. If during the calculation of the above two indicators the showed negative financial result in one bank is excluded, banks in the Republic of Macedonia would show positive financial result on aggregate level, which determines positive values of the indicators for the rate of return on assets (ROAA: 1.13%) and the rate of return on equity (ROAE: 4.40%).

## **IX. Other Activities of NBRM**

### **9.1. Internal Audit**

#### *9.1.1. Introduction*

Internal audit explores the system of internal controls performed by the employees as a part of the regular working assignments, and also assesses the efficiency, detects weaknesses of operations and suggests measures for elimination of the anomalies. At the beginning, the internal audit paradigm was counting and observation, later conducting of controls, while the latest paradigm is based on exploration of business processes, in which the risk is central point of interest. According to the latest definition and internal audit standards, it represents an independent and objective activity of assurance (confirmation) and consulting, created for increasing the value and improving the performances of enterprises. Through systematic approach and approach which provides discipline, internal audit supports the valuation and improvement of the efficiency in the risk management, and the control of the management process.

As a result of the understanding of contemporary requirements, in reference to the internal audit function, in 2001 in the National Bank of the Republic of Macedonia, Policy on Internal Audit and Audit Plan were adopted, as well as an Internal Manual for internal audit practice. Accordingly, the total activities of Internal Audit were performed on the basis of these documents, using at the same time world-wide experiences. The audit activity performed in 2001 met the requirements, posed to the Internal Audit. The intended activities within the Audit Plan were realised, with support and cooperation with experts from the Dutch Central Bank and audit reports being prepared. Simultaneously, in the course of 2001 internal Audit was involved in realisation of certain development projects, even in their preparatory phase.

#### *9.1.2. Audit activities*

According to the Audit Plan for 2001, adopted by the NBRM Council in April 2001, Internal Audit examined 14 processes in the NBRM's operations. According to the Plan, objects of the audit were 16 processes, but the audit was made in 14, while two processes were not examined, due to objective reasons. Thus, for the process of payment of credits received at auction, as a monetary policy instrument an audit was not carried out, because currently the instrument is not used. The process of money withdrawal and supply of the institution which performs the payment operations, was not examined and an audit was not performed, because of the significant changes in this process, imposed by the new Law on Payment Operations.

#### *9.1.3. Main findings from the performed audits*

The on-site examination of the processes gave an assurance that satisfactory control procedures exist, as well as the compliance with NBRM's laws and legislation in the domains which were subjected to an audit.

With reference to market risks, it was concluded that awareness of the need for understanding, analysis and risk control, immanent for the open market operations, especially the credit and exchange rate risk do exist. The establishment of separate Division for risk management in the foreign reserve and foreign exchange market operations Department should be mentioned with a remark that there is a necessity this Division to become operative in the near future.

With respect to the effectiveness of the current internal control system, it is concluded that despite the significantly increased quantum of work, more significant weaknesses in the realisation of the internal control goals were not registered. In the transactions and data examined, considerable errors which can influence the accuracy, integrity and timeliness of the executed transactions and generated data were not found.

The Internal Audit with its audit reports gave recommendations that can be grouped in several groups:

- Written internal procedures for realisation of the processes, in which the responsibilities of each employee should be clearly stated;
- Adequate organisational setting of the tasks and separation of the functions within the departments, as a characteristic of modern control systems;
- The increased quantum of work in certain processes asks for adequate organisation and human resources policy;
- The applicative software which would be used by the departments to decrease the information risk from exchange of data, in order to provide accurate and timely presentation of certain transaction. This enables control of goals, regarding the accuracy and the timeliness of data.
- Active and regular formation of working groups in which employees from different departments will participate with relation to new projects, processes and software introduction.

In performing the audit activities, there was a good co-operation among the Internal Audit Department and departments where audit was executed.

## **9.2. Banknote Printing and Coin Minting**

Banknotes in denominations of Denars 10,50,100,500,1000 and 5000 are currently in circulation in the Republic of Macedonia. In 2001, 16.4 million banknotes in denomination of Denar 10, 16.4 million banknotes in denomination of Denar 50 and 6.7 million banknotes in denomination of Denar 100 were printed.

The banknote printing was at high quality level with extremely low deviations, damages expressed in promilles, which is far below the usual level in the rest of the world.

In the same year, coins in denominations of Denar 1,2 and 5 in total quantity of 23.1 million coins were minted.

It is significant to mention the successful minting of a golden jubilee coin, issued to mark the decade of independence, with 2000 minted coins.

Alongside with the mentioned regular treasury activities, in the course of 2001, preparations for implementation of the Payment Operation Law were conducted. In addition, the Central Bank as of January 01,2002, opened 10 dispersed treasuries on the territory of the Republic of Macedonia.

## **9.3. The Payment System in the Republic of Macedonia**

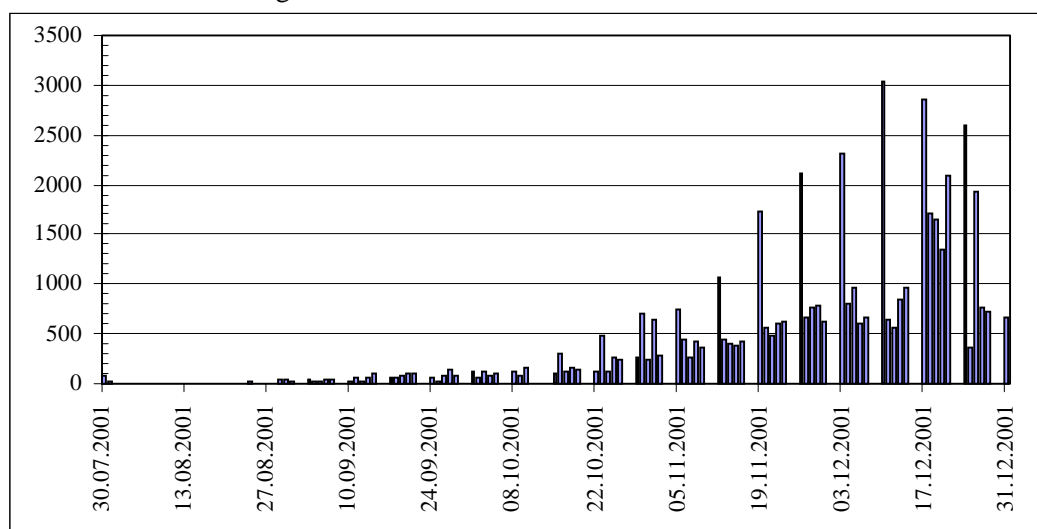
During 2001 the payment system reform in the Republic of Macedonia was finished, with the payment operations in the country being processed by the commercial banks, instead of the specialised institution - Payment Operations Bureau. In addition, the settlement among the banks is executed in the settlement system of the National Bank of the Republic of Macedonia.

Payment Operations Bureau was closed with part of its functions being overtaken by: banks, National Bank of the Republic of Macedonia, the Public Revenues Office, Treasury System of the Ministry of Finance, Central Securities Depository, Central Register, Clearing House and the Statistical Office.

The closing of the Payment Operations Bureau took place from July 30, 2001 to December 31, 2001, with accounts gradually being transferred to the banks. As of December 31, 2001, 48.460 accounts were transferred in the banks or new accounts were opened. In addition, the largest part of the accounts was transferred in the banks in the second half of November and the first half of December 2001. Those accounts which were not transferred in the banks (because they were blocked or there was no initiative from the owners), were transferred to the Agency for Blocked Accounts.

Chart 32

Number of accounts migrated in the banks



The expected results from the reformed payment system are:

- Increase of the competition among payment operation institutions, which will provide lower prices on the payment transactions, service improvement, application of the new technologies in the payment operations and reduction of the systemic risk;

- Prompt settlement, which is expected to lower the liquidity and credit risk, and hence the systemic risk;

- Direct contacts among the banks and their clients, which will result in improvement of the clients monitoring, and more realistic clients selection when choosing a bank;

- Improved liquidity management by the banks, since all the payments are processed within the banks and

- Harmonisation of the Payment system with the European Union payment system, in line with the orientation of the Republic of Macedonia toward EU integration.

The reform started with the adoption of the new Law on Payment Operations and the Law on Transformation of the Payment Operations Bureau, in April 2001. According to the Law on Payment Operations, the tasks of the National Bank of the Republic of Macedonia are:

- To organise a settlement system among the payment operations institutions ;
- To administrate banks' accounts, the treasury system, funds, brokerage houses deposit accounts and other accounts which are administrated by the National Bank of the Republic of Macedonia;
- To administrate the accounts of clearing institutions;
- To administrate a register of accounts in the system and to inform the single register of the accounts' owners.
- To prescribe a standard for construction of the accounts of the participants in the payment operations.
- To give a leading number to the payment operations institutions.
- To determine the amount of the small value inter-bank payment.
- To determine the banks' treasury maximum.
- To prescribe a criteria for issuance and termination of a licence for payment operations.
- To issue and terminate the licences for payment operations.
- To monitor banks and clearing institutions.

These tasks can be separated in three groups, as follows: operative, regulative and supervisory function.

In order to realise the **operative function** in the payment operations, National Bank of the Republic of Macedonia, with partial financial aid from the European Union through the PHARE program, implemented a real time gross settlement system (RTGS) which operates on gross basis. The system was prepared in April 2001. In June and July 2001 a simulation of the entire operation was performed (the system was working simultaneously with the Payment Operations Bureau). Since June, 2001 it has been the single system responsible for the inter-bank payment transactions.

The Real Time Gross Settlement System in the National Bank of the Republic of Macedonia is named Macedonian Interbank Payment System (MIPS). It enables transaction execution in real time, which means, the funds are disposable to the receiver immediately after the submission of the payment order. This is enabled by implementation of the electronic document signed with electronic signature, based on a written contract between the participant and the National Bank of the Republic of Macedonia. MIPS is the first system in the Republic of Macedonia that uses electronic documents, with electronic signature.

The participants in the MIPS system are:

- banks,
- National Bank of the Republic of Macedonia,
- Central Securities Depository,
- Clearing House - KIBS and
- Treasury System of the Ministry of Finance

The Payment Operations Bureau was also participant in the system, until it was closed down on December 31, 2001.

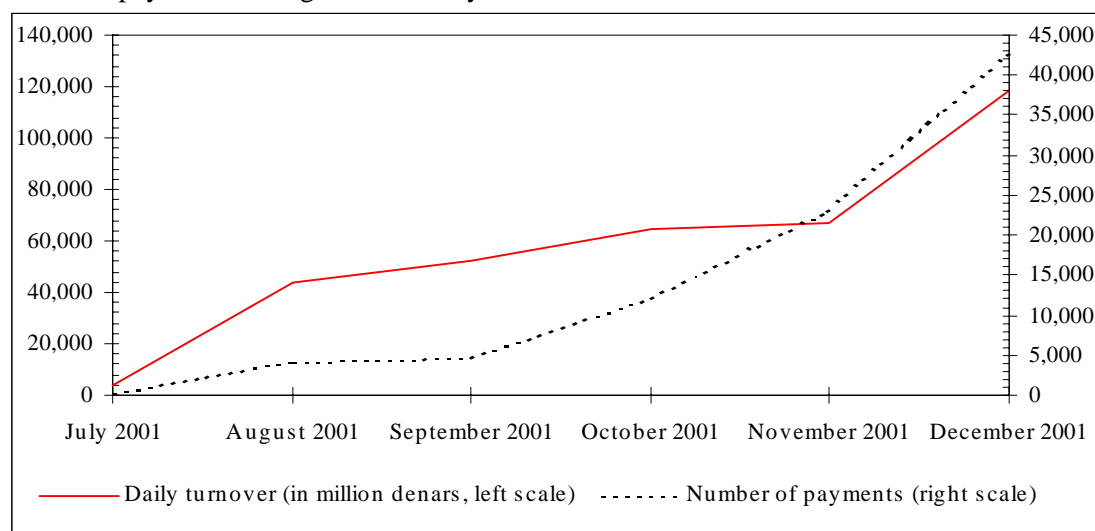
There are three ways for the system participants to take part in the MIPS: through international bank network SWIFT, through a private network, utilising the Macedonian telecommunications lines and through a private network with direct connection. Hence, flexible system was enabled, with system's participant being able to choose the best alternative.

For communications among the participants, standardised inter - bank messages are used in accordance with the international SWIFT standards. The system provides payments of the participants, operating with order of waiting, gridlocks, overdrafts allowed, minimal limits on account and participant, searching, etc.

The system operates in line with a rigid timetable from 07.00 a.m. until 06.00 p.m.

The primary purpose of the MIPS system is inter-bank settlement and support of the banks in the process of liquidity monitoring. In order this to be accomplished, all the payments higher than Denar 3 million are processed through this system and they are directly settled. Regarding the speed of the system, it is used for processing urgent payments. In 2001 (from July 30, 2001 to December 31, 2001) 87.030 payments were executed through the MIPS in total amount of Denar 350.694,4 million.

Chart 33  
Executed payments through the MIPS system



In co-operation with the Central Securities Depository, securities are settled through MIPS on DVP basis (securities delivery, together with the payment). Delivery is based on the net/gross method, i.e. securities are delivered on gross basis, while the money is delivered on net basis. The settlement is running between 10.00 a.m. and 11.00 a.m.

At the same time, in the MIPS system the Clearing House for small value payments-KIBS is settled. The Clearing House operates on net basis, with the settlement running once per day - between 03.00 a.m. and 04.00 a.m. Through the Clearing House most of the payments (around 91% of all payments in the country) are processed, but in small amounts (around 14% of the amount of all processed payments).

Within the **regulatory function** in the payment system, the National Bank of the Republic of Macedonia took many Decisions that regulate the basis of the payment operations. Beside the National Bank of the Republic of Macedonia, in accordance with the Law on Payment Operations, Ministry of Finance adopted one part of the legislation.

According to the legislation, the paper payment instruments were subject to changes, and currently they have a new design.

In 2001, as part of the **payment system monitoring function**, the National Bank of the Republic of Macedonia conducted an analysis on the banks' and Clearing House's systems, inspected their procedures, systems and human resources, and issued a license for domestic payment operations to 20 banks.

#### **9.4. Human Resources Policy**

In 2001, Central Bank's efforts for adequate recruiting and further professional upgrading of the human resources potential, through new employment, participation in seminars and courses, as well as the technical support projects and co-operation with certain institutions, continued.

Thus, in the course of 2001, the National Bank of the Republic of Macedonia recruited 38 new employees, of which 8 persons are with university degree (4 economists, 2 lawyers, 1 architect, and 1 electrical engineer), 1 with advanced school of economy and 29 persons with high school degree.

During 2001, the NBRM personnel participated in numerous seminars and courses organised by the following Institutes and Central Banks: seminars in the IMF Institute held in Washington, USA; seminars in the Joint Vienna Institute organised by IMF, World Bank, EBRD, IBRD, OECD and WTO in Vienna, Austria; seminars in the Swiss Central Bank organised by the Study Centre in Gerzensee, Switzerland; Seminars in the Dutch Central Bank held in Amsterdam; seminars in the Central Bank of Germany held in Frankfurt; seminars in the Central Bank of France organised by the International Institute for Banking and Finance held in Paris; seminars in the Central Bank of England organised by the Centre for Central Banking Studies held in London, etc.

As of June 30, 2002 the Dutch Central Bank's technical support project for the National Bank of the Republic of Macedonia, within the European Union's PHARE Project, with 18 months duration, was completed successfully.

The project was realised through six subprojects or modules. The gains from this co-operation can be sublimated as follows:

1. The National Bank of the Republic of Macedonia is the first institution in the Republic of Macedonia that has built a macroeconomic model, called MAKMODEL, on the basis of the technical expertise that the Research Department in NBRM was given by the Research Department in the Dutch Central Bank. By its further upgrading, monetary and economic policy designers in the Republic of Macedonia obtain a modern instrument for making proper and timely decisions;
2. A basis of a modern Internal Control Department, which started to apply the latest international internal audit standards, was set;
3. The Accounting Department acquired a useful knowledge regarding the international accounting standards and their practical implementation. This is of high importance since, according to the new Law on the National Bank of the Republic of Macedonia, the NBRM is obliged to engage an external auditor for audit of its financial reports.



4. Large part of the recommendations, related to the foreign exchange market operations are implemented in the new Foreign Exchange Law, which is adopted but it is to become effective with a delay, in 2002;
5. The recommendations related to the operations of the Department for Central Banking Operations: credits collateralization, introduction of foreign exchange swap, development of open market operations, further specialisation on liquidity planning and co-ordination of planning of the liquid flows between the government and NBRM, are very useful and have been implemented or are to be implemented;
6. The benefits of the Supervision Department, regarding the technical support are the following: support in the establishment of the off-site surveillance, especially in areas of defining operative procedures and procedures for banks' mergers and acquisitions, as well as support in equipment and materials.

## **9.5. Changes in legislation**

During 2001, several laws in the sphere of finance, banking and monetary and foreign exchange operations were implemented.

With the Payment Operations Law (Official Gazette of RM No.32/2001) the payment operations reform, reflected in the transfer of the payment operations of legal entities from the Payment Operations Bureau to the banks and transfer of the payment operations of the banks to the National Bank of the Republic of Macedonia, was implemented. The reform, which was prepared for a long period of time, was completed on December 31, 2001, when the Payment Operations Bureau, as a payment operations institution was closed, and all payment operations are processed through the banking system. Within this Law and the Law on the National Bank of the Republic of Macedonia the National Bank's function is defined as co-ordination of the payments and settlements of the accounts among the banks and monitoring of the payment system's legal aspects.

With respect to the payment operations, Law on Registering Cash-Payments (Official Gazette of RM No.31/2001), Law on Data in Electronic Form and Electronic Signature (Official Gazette of RM No.34/2001) and Law on Transformation of the Payment Operations Bureau (Official Gazette of RM No.32/2001), were adopted.

Foreign Exchange Law (Official Gazette of RM No.34/2001) although adopted in the course of 2001, is to be implemented, with delay on August 1, 2002. The delay is due to the high degree of liberalisation, which was not opportune due to the events during 2001. Hence, the old Foreign Exchange Law (Official Gazette of RM No.30/93) is effective. Namely, the new Foreign Exchange Law liberalises the capital-financial transactions between residents and non-residents, the direct investments in the Republic of Macedonia from abroad and from the Republic of Macedonia to abroad. At the same time, credit transactions' liberalisation is anticipated, permitting free flow of goods and services, except short-term financial credits, as well as gradual liberalisation of the financial transactions portfolio.

The Anti-Money Laundering Law (Official Gazette of RM No.70/2001) was adopted in 2001 with delayed implementation scheduled for March 01, 2002. This Law establishes an obligation for all the financial institutions, commercial companies, other enterprises and individuals who give services to report to the Anti-Money Laundering Agency (Ministry of Finance organ) the suspicious transactions and all the transactions for transferring amounts higher than EURO 10,000.

The Law on the National Bank of the Republic of Macedonia (Official Gazette of RM No.3/2002) was prepared and submitted to the Parliament of the Republic of Macedonia in the first half of 2001, but the events during 2001 slowed down its implementation. It was finally adopted in January 2002. This Law is in line with the laws on central banks in the European Union. Hence, the Central Bank's independence from the Government (functional, institutional, personal and financial independence) is emphasised. According to the new Law, price stability is the main goal of the NBRM. Thereby, the NBRM is independent in setting monetary policy goals, as well as monetary policy instruments. The Law imposes restrictive clauses in reference to the financing of the Government, with possibility of extending credit with one-day maturity, without possibilities for renewal and extension. The Central Bank's reports are submitted to the Parliament of the Republic of Macedonia, after previously being approved by the NBRM Council.

## **9.6. National Bank of the Republic of Macedonia Council**

NBRM Council is the highest decision-making body of the Central Bank. It consists of 9 members, including the Governor and two Vice Governors. The other members of the NBRM Council are external persons, professionally active in the NBRM Council (in accordance with the new NBRM Act). The Government member does not participate in the NBRM Council. According to the NBRM Act (Article 64), the Council decides on the most important issues regarding the Central Bank operation: adopts the decision on monetary policy objectives and monetary policy projection; adopts the report on the NBRM operations and the report on handling foreign exchange reserves; adopts the supervisory report and undertaken measures; defines the monetary policy measures and objectives and follows their realisation; defines the exchange rate policy, upon prior approval granted by the Government of the Republic of Macedonia; defines the rules and standards of the supervisory control; adopts the Financial Plan and the Annual Financial Statement of the NBRM; prescribes the interest policy of the NBRM; decides upon issuing new banknotes and coins; decides on establishing a numismatic collection of original and rare coins found on the territory of the Republic of Macedonia; decides upon appeals against decisions taken by the Governor. During the second instance procedure, i.e. in the cases when NBRM Council has to decide upon an appeal against a decision taken by the Governor, the decision is made in the absence of the Governor and the Vice Governors.

## **X. Report of Independent Auditors**

**Ernst & Young (Skopje) Ltd**

M. Tito, 19  
1000 Skopje  
Macedonia

***To the Council of  
National Bank of the Republic of Macedonia:***

*We have audited the accompanying balance sheet of National Bank of the Republic of Macedonia (the Bank) as of December 31, 2001, and the related statements of profit and loss, changes in capital and reserve accounts and cash flows for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.*

*We conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.*

*The National Bank of the Republic of Macedonia maintains its accounting records and prepares its annual statutory financial statements in accordance with the National Bank of the Republic of Macedonia Act, the Law on Accounting, and the generally accepted accounting principles in the Republic of Macedonia. These financial statements are not subject to this audit report. In addition, the National Bank of the Republic of Macedonia prepared these financial statements in accordance with International Accounting Standards, as promulgated by the International Accounting Standards Committee except for the matter disclosed in Note 3a). The Bank, in accordance with the National Bank of the Republic of Macedonia Act, and in common with other Central Banks, transfers net unrealized foreign exchange differences at year end directly to a revaluation reserve to the extent that this reserve has a positive balance after the transfer. This is not fully in compliance with International Accounting Standard 21 - The Effects of Changes in Foreign Exchange Rates (IAS 21), which requires that both realized and unrealized foreign exchange differences are written off to the Statement of Profit and Loss.*

*In our opinion, except for non-compliance with IAS 21 in respect of unrealized foreign exchange differences, based on our audit, the financial statements referred to above present fairly, in all material respects, the financial position of National Bank of the Republic of Macedonia as at December 31, 2001 and the results of its operations, changes in capital*

*and reserve accounts and its cash flows for the year then ended in accordance with International Accounting Standards.*

*Skopje  
Republic of Macedonia*

*July 6, 2002*

*National Bank of the Republic of Macedonia*  
**BALANCE SHEET**  
*as at 31 December 2001*  
*(All amounts in MKD'000)*

**ASSETS**

	2001	2000
<i>Sight deposits</i>	38,826,740	20,264,822
<i>Term deposits</i>	13,051,572	21,433,756
<i>Gold</i>	3,707,346	2,003,087
<i>Foreign currency and cheques in vault</i>	2,227,196	326,190
<i>SDR holdings, net</i>	154,018	42,796
<i>Foreign securities</i>	1,906,146	3,405,092
<b><i>Foreign assets</i></b>	<b>59,873,018</b>	<b>47,475,743</b>
<i>Loans</i>	19,177	26,209
<i>Relations with IMF</i>	1,177,498	1,331,724
<i>Securities</i>	3,355,192	3,337,216
<i>External account transactions</i>	3,798,357	898,119
<b><i>Claims on public sector</i></b>	<b>8,350,224</b>	<b>5,593,268</b>
<i>Loans</i>	62,802	62,802
<i>Other claims</i>	118,419	14,894
<i>Overdue claims</i>	153,775	176,775
<b><i>Claims on banks</i></b>	<b>334,996</b>	<b>254,471</b>
<i>Fixed assets</i>	879,258	775,473
<i>Inventories</i>	66,777	55,189
<i>Receivables</i>	32,997	26,875
<i>Other assets</i>	958,581	869,933
<b><i>Other assets</i></b>	<b>1,937,613</b>	<b>1,727,470</b>
<b>TOTAL ASSETS</b>	<b>70,495,851</b>	<b>55,050,952</b>

*National Bank of the Republic of Macedonia*  
**BALANCE SHEET**  
*as at 31 December 2001*  
*(all amounts in MKD'000)*

**LIABILITIES**

	2001	2000
<i>Narrow definition of reserve money</i>	16,420,127	12,065,863
<i>Bank compulsory reserves</i>	1,806,342	1,918,482
<i>NBRM bills</i>	3,157,338	4,822,338
<i>Demand deposits</i>	-	367,743
<b><i>Reserve money</i></b>	<b>21,383,807</b>	<b>19,174,426</b>
<b><i>Restricted deposits</i></b>	<b>587,247</b>	<b>135,832</b>
<i>Borrowings from IMF</i>	4,896,924	5,328,876
<i>Other foreign liabilities</i>	-	928,838
<b><i>Foreign liabilities</i></b>	<b>4,896,924</b>	<b>6,257,714</b>
<i>Denar deposits of the public sector</i>	3,812,404	6,805,448
<i>Foreign exchange deposits of public sector</i>	12,847,881	2,494,816
<i>Stabilization Fund of the Government</i>	8,559,998	8,559,998
<b><i>Deposits of the public sector</i></b>	<b>25,220,283</b>	<b>17,860,262</b>
<i>Payables</i>	558,394	435,088
<i>Other liabilities</i>	6,322,732	1,037,443
<i>Counter-entries in NBRM accounts</i>	414,741	572,238
<b><i>Other liabilities</i></b>	<b>7,295,867</b>	<b>2,044,769</b>
<b><i>SDR allocation liability</i></b>	<b>728,360</b>	<b>713,166</b>
<i>Reserves</i>	716,888	616,500
<i>Funds</i>	1,433,816	1,257,801
<i>Revaluation reserves</i>	8,610,732	7,423,149
<i>IAS adjustments</i>	(378,073)	(432,667)
<b><i>Capital accounts</i></b>	<b>10,383,363</b>	<b>8,864,783</b>
<b><i>TOTAL LIABILITIES</i></b>	<b>70,495,851</b>	<b>55,050,952</b>

*National Bank of the Republic of Macedonia*  
**PROFIT AND LOSS STATEMENT**  
*for the year ended 31 December 2001*  
*(all amounts in MKD'000)*

	2001	2000
<i>Interest income</i>	2,483,425	1,946,177
<i>Interest expense</i>	(1,592,833)	(934,729)
<b><i>Net interest income</i></b>	<b>890,592</b>	<b>1,011,448</b>
<i>Fee income</i>	148,529	105,248
<i>Fee expenses</i>	(89,780)	(81,666)
<i>Other income</i>	310,973	106,918
<i>Other expenses</i>	(508,129)	(337,873)
<i>Loan loss provisions, net</i>	-	(256,277)
<b>NET INCOME BEFORE TAXES</b>	<b>752,185</b>	<b>547,798</b>
<i>Income tax</i>	(131,997)	(84,108)
<b>NET INCOME AFTER TAXES</b>	<b>620,188</b>	<b>463,690</b>