

**National Bank of the Republic of Macedonia**



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## *Governor's foreword,*

Global economy in 2007 faced two major challenges: intensive increase in food prices and further acceleration in the increase in the price of energy sources, as well as big turbulences at the financial market in the USA that spilled over into the other economies. It caused global uncertainty and pessimistic prognoses related to the financing and further growth of economies.

The process of trade and financial integration, through which the Macedonian economy passes, certainly brings about advantages, both in view of risk sharing and their diversification and in view of support of the consumption and investments, as a necessary condition for the economic growth. However, this process entails risks, too, especially by increasing the sensitiveness of the domestic economy to the negative external shocks and to the changes in the position of the foreign investors. Precisely this year, a part of those risks had a negative influence on the Macedonian economy. Those were, primarily, the world prices of food and energy that exerted strong inflationary pressures in the last quarter of the year, with a parallel deterioration in the conditions of exchange, thus exacerbating the external position of our economy. The “heated up” inflationary expectations and uncertainty, combined with some other factors, contributed to slowing down of private transfer inflows and portfolio investments, which, on the other hand, created pressures on the foreign exchange market.

The Central Bank continued to implement the strategy of foreign exchange rate targeting in 2007 as well, in order to maintain price stability as an ultimate monetary objective. The average inflation in 2007 was 2.3%, being within the perceptions of a low and stable inflation. However, the annual inflation of 6.1% in December was a clear indicator of the price increase trend in the last months of the year that derived mostly from the increase in the prices of food and energy. Such changes were mainly a result of the factors from the side of the domestic supply-dry period and increased exports, in conditions of intensified domestic demand, along with the pressures exerted by the imported inflation on the domestic one. However, the moderate rise in the basic inflation during the year, which was 0.7% on average in 2007, was an indicator of the partial influence of the demand on the inflation. Future trend of the world prices of food and energy, as well as potential pressures on the prices caused by the real convergence are short-term and mid-term risks that NBRM clearly perceives. Furthermore, in accordance with its mandate, NBRM stands firm on its intention to continue to maintain monetary policy that will prevent the occurrence of secondary effects from the increase in the prices of food and energy and will stabilize mid-term and long-term inflationary expectations. In this context, the exchange rate remains a nominal anchor, the stability of which has positive effects on “curbing” inflation and inflationary expectations.

The economic growth in 2007 was within the expectations. From this viewpoint, last year was especially successful because the real GDP growth of 5.1% has been the highest performance of the Macedonian economy so far. Such growth rate, undoubtedly contributes to a faster real convergence to the EU, and the combination of successful structural reforms and macroeconomic stability is a key to the increase in the productivity of the economy and, consequently, increase in the potential growth. The service sector, that is, trade and telecommunications, accounted for the largest portion of the growth in 2007. Thus, the Macedonian economy started to pursue the same development stages as the other emerging economies. Nevertheless, the key challenge in the mid-run is the allocation of the investments in the sector of exchangeable goods and increase in its productivity that will provide to Macedonia, as a small and open economy, greater competitiveness at the foreign markets, decrease in the trade deficit and lower sensitivity of the external sector. The greater contribution of the total investments to the economic growth in the last two years is of course, an encouraging signal that leads to a possibility of a medium-term increase in the potential of the economy. However, the dominant role of the personal consumption, as well as the negative contribution of the net export entail a need of a more balanced growth, that is, a need for bringing closer the contribution of the domestic and external demand to the total growth of the economy.

With such shifts in the growth structure, accelerated mid-term growth in the productivity of the economy may be expected, which, along with the strengthening of the institutional infrastructure, making markets more flexible and developed, especially the labor market, as well as the further financial integration, will facilitate the process of real convergence to the EU.

The sustainable external developments are a key pillar of the macroeconomic stability for a small and open economy such as the Macedonian. The high trade deficit, which has averaged around 19% of GDP in the last seven years, clearly indicates the need of structural shifts that will result in a change of the export structure and stimulation of the productivity in the sector of exchangeable goods. Namely, the pace of the trade deficit is under a great influence of external factors, such as energy prices, and lately, food prices, as well as the developments at the metal market, in conditions when metal industry is the dominant export sector. In 2007, the maintenance of a favorable conjuncture at the world metal market, especially in the first half of the year, contributed to further increase in the positive balance of this category that neutralized to a great extent the negative shifts in the other segments, including energy exchange. Therefore, despite the increase in the world prices of energy sources, food prices, as well as the growth in the import of consumption goods, and especially import of food, in a part due to the price increase, supported by the rapid growth in crediting, trade deficit in 2007 deepened by one percentage point and reached 21% of GDP. However, the expansion of the current account deficit was more emphasized, going up from 0.9% to 3.1% of GDP, reflecting the effect of the decelerated growth in the private transfers, mainly conditioned by the negative growth dynamics in the last quarter of the year. Although the size of the trade deficit *per se* does not raise any particular concerns<sup>1</sup>, still, the high sensitivity of the export to the fluctuations of the prices at the world stock markets and the maintenance of a low current deficit through the private transfer inflows thus far, (the susceptibility of which to swift upheavals in the trend, in conditions of increased uncertainty, was confirmed at the end of 2007), is a clear indication of the risks in the external sector. What is typical of last year is an increased inflow of direct investments, 4.5% of GDP, which, together with portfolio investments, contributed to an increase in the foreign exchange reserves, that reached Euro 1,524 million, or coverage of 3.8 months of the import of goods and services planned for the following year. The allocation of these investments to the sector of exchangeable goods is important for the improvement of the foreign trade exchange and for a positive trend in the current transactions with abroad, in the medium run.

From the aspect of the monetary policy, the challenges in 2007 were mainly concentrated in the second half of the year. Namely, the first half of the year was a continuation of the developments in the previous period: low inflation, high foreign exchange inflows and low budget expenditures, as the main features of the environment in which the monetary policy was conducted. The second half of the year was marked by higher pressures on the domestic inflation caused, mainly, by the increase in the import prices of food, drastic reduction in the inflows based on portfolio investments, commencement of the trend of annual reduction in private transfers, increase in the budget expenditures in the last quarter of the year. It led to a complete turn of the circumstances in which monetary policy was conducted. In conditions of a strategy of a fixed exchange rate, the fall in the foreign exchange inflows and growth in the inflation and inflationary expectations, had, primarily, a reflection on the foreign exchange market, where, after a longer period of high amounts of net-purchase of foreign exchange, the purchase of foreign exchange by the Central Bank was almost stopped in the last two months. In 2007, despite the increase in the domestic inflation, having in parallel, a stable nominal exchange rate, the real effective exchange rate competitiveness had not referred to any problems in this domain yet.

Notwithstanding the variation in the trend in the last months, taking into consideration that in the major part of 2007, the foreign exchange inflows on the basis of private transfers, portfolio investments and foreign investments were continuously growing, NBRM purchased foreign

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<sup>1</sup> For example, IMF Model of Regional Convergence provides for Macedonia a central projection of sustainable current account deficit of 7% of GDP. Source: IMF, World Economic and Financial Surveys, Regional Economic Outlook: Europe, April 2008.

exchange at the foreign exchange market in the amount of 6.4% of GDP, as opposed to 4.8% of GDP in the previous year. So, the interventions at the foreign exchange market neutralized the effect on the foreign exchange reserves from the large early repayments of the public debt to the Paris Club of Creditors, World Bank, IMF and EIB. Although during the first three quarters, a significant part of the need for sterilization of the liquidity effects was supported through the accumulation of funds at the government account with NBRM, still, the concentration of the major part of the fiscal expenditures in the last quarter imposed in this period a complete assumption of the burden for sterilization by means of monetary instruments. In 2007, excess liquidity of 3.4% of GDP was withdrawn through the Central Bank bills, as opposed to 1.7% of GDP in the previous year.

The need for sterilization of foreign exchange inflows usually leads also to an increase in the interest rates in order to raise the interest in investment of the excess liquidity with the central bank. In the particular case, in 2007 as well, the higher demand for NBRM securities compared to the supply led to a trend of reduction in interest rate on the Central Bank bills, being reduced to 4.77% in 2007, as opposed to 5.74% in December 2006. This speaks of a relatively poor range of investment opportunities and high attractiveness of the Central Bank bills, in spite of the decreased yield. Such changes in the reference interest rate spilled over into the inter-bank money market, as well, where the average interest rate registered an annual decrease of 1.8 percentage points thus amounting to 3.1% in December. It might be concluded that the interest rate developments in the banking system were under the dominant influence of the pressures exerted by the competition. The policy of the banks to increase their market share in the overall credits and deposits led to a trend of reduction in the interests on debit balances that amounted to 10.2% on average, which was an annual drop of 1 percentage point and an increase in the interests on credit balances, that were 4.9% on average, which was an annual increase of 0.2 percentage points.

The financial system plays a key role in the process of convergence and integration of the Macedonian economy with the EU economy. In 2007, the financial intermediation in Macedonia continued at an intensive pace. However, as in the other emerging economies, such fast pace of financial deepening, in addition to the advantages, carries many risks, too, both for the financial and macroeconomic stability. The very fast credit growth entails risks from potential deterioration in the credit portfolio in the medium term, as well as a support of the aggregate demand beyond the threshold that enables price stability and external balance. The potential risks are certainly a sufficient reason for the dynamics of the financial deepening to be carefully monitored, with a simultaneous creation of a system of instruments that would correct least painfully the possible de-balances caused by the credit growth. The actual credit growth of 39.1% in 2007 has been the highest so far. Such growth rates are not unusual for the economies that are in a, what is known as, expansion stage with high capital inflows, increased deficit in the current account, growth in the consumption of non exchangeable goods. Still, the fact that this growth was above seven percentage points annual increase of the credit share in GDP, by which they reached almost 37% of GDP, and around half of it was created by extending loans to the population, is an indicator of the fact that the maintenance of a similar dynamics and structure of the credit growth may cause potential problems. On the other hand, taking into consideration the low starting point, such activity of the banks signifies a great support to the investments and consumption. At the same time, as opposed to some other economies in transition, credit growth in Macedonia is mostly financed by the higher monetization-an annual rise in the deposits of almost 30% in 2007, their share in GDP of 38%, and it is much less financed through external borrowing of the banks, that indicates that such growth in the credits does not impose a direct threat on the external sustainability of the economy.

The maintenance of the macroeconomic stability, and primarily the price stability, has been one of the main features of the Macedonian economy for a longer period of time and, undoubtedly, a very important precondition for normal functioning of the economy. In 2007, we faced a challenge encountered by the majority of the economies in the world, which is acceleration in the inflation caused by the global increase in the prices of food and energy. The uncertainty as far as

the duration of the shift in these prices is concerned, or whether it will have secondary effects, what influence it will have on the wages and whether perhaps it will mean a fast wage increase relative to the productiveness, are dilemmas that the majority of the central banks in the world face at the moment. For all of them, as it is for us, too, it is clear that the monetary authority must undertake everything which is within its competences to retain the inflation at an acceptable level. As opposed to some other economies, (the second challenge of which at the moment is the slowing down of the growth, due to the problems at the financial markets), the second main area for us is the external sector. Although the current account deficit is still low, and the gross external debt is at a level of around 49% of GDP and does not indicate any problems, the sensitivity of the foreign trade to the external price shocks, uncertainty regarding the dynamics of private transfers, as well as the possible abrupt changes in the investors' positions, are definitely indicators of the potential risks in the external position. Therefore, the conclusions regarding the direction we should follow do not differ much from the conclusions so far, nor are they much different than those that refer to the other emerging economies, especially the ones that are already EU member states, or are on the way to the EU integration. First, the structural reforms towards a more favorable environment are, undoubtedly key to the increase in the potential growth and for its environment. Second, the macroeconomic management, that is, monetary and fiscal policy, should answer appropriately to the risks that threaten macroeconomic stability and especially to those that cause external de-balances. Third, the growth in the productiveness is a key factor that can enable sound and sustainable growth of the economy, and its dynamics should be faster than the one of the wages, thus preventing creation of high price pressures and lowering the competitiveness of our economy. Fourth, further development and implementation of an appropriate regulation and well-thought framework is an important condition for a sound and resistant financial system that could, without any greater problems, endure potential shocks.

The list of directions and recommendation can be, of course, much more detailed and longer, but this general framework is a sufficient indicator of the direction we should follow so that we can continue smoothly with the gradual approximation to the EU, having at the same time a capacity to face the potential risks without any greater turbulences. The Central Bank, in the segments that are within its domain, is constantly making efforts to give its contribution to the sooner European integration. It means that we will continue to maintain secure monetary policy that will be conducive to the maintenance of a low and stable inflation as the most favorable ambiance for achieving a sustainable economic development. We will continue with the increase in the efficiency of the banking sector supervision and improvement of payment systems, along with the accelerated harmonization of the overall regulation and practice with the one of the European Union. We are convinced that the National Bank of the Republic of Macedonia will be a full member of the European System of Central Banks, being equally capable of performing its responsible tasks.

Governor  
and President of  
the NBRM Council

Skopje, May 2008

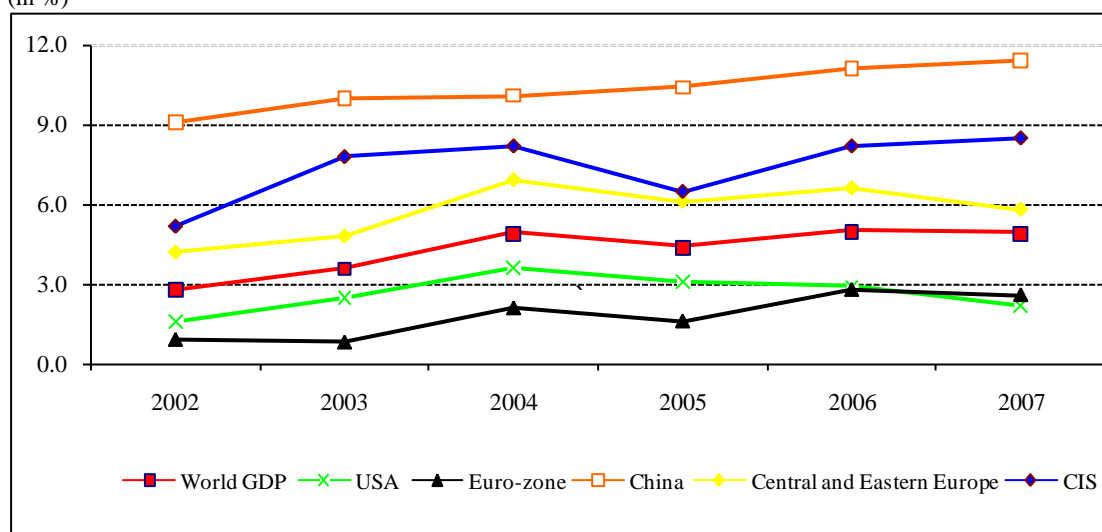
Petar Goshev, MSc

## I. Economic developments in the world

Global economic expansion, characteristic of the last four years, continued during 2007 as well.<sup>2</sup> Thus, the growth rate of the global GDP was 4.9%, which, compared with the previous year, was a minimal deceleration in the growth dynamics of 0.1 percentage points. Main contributors to the economic growth in 2007 were a part of the fast-growing economies- China, India and Russia, that contributed to almost one half of the global GDP growth. Their growth was due mainly to the strong domestic demand, maintenance of a disciplined macroeconomic policy, as well as increase in prices of certain export raw materials (oil, metals and food) which especially applied to Russia. Thus, the growth of these economies neutralized to a certain degree the slower growth in the USA during 2007, caused mainly by the financial crisis at the market of sub-prime mortgage credits, that caused spillover effects on all segments of the financial markets not only in the USA, but also in the West European countries and led to slowing down of their growth in the second half of the year.

Analyzed from the aspect of the quarterly dynamics, the most intensive growth in the world GDP was realized in the first quarter of 2007, whereas in the following quarters the growth rate slowed down partially due to the intensive growth in the prices of crude oil, food, metals, but also due to the influence of the financial crisis in the USA.

Figure 1  
Real GDP growth by groups of countries and individual countries  
(in %)



Source: IMF, World Economic Outlook, April 2008.

Observed from the viewpoint of the individual economies in the world, China had the greatest contribution to the world GDP for the first time with an annual real growth rate of 11.4%. In addition, India and Russia had also a high contribution with growth rates of 9.2% and 8.1%, respectively. High annual increase was also registered in some of the South American countries (Brazil and Argentina with growth rates of 5.4% and 8.7%, respectively), as well as the Near East countries. Namely, the increase in the crude oil prices at the world stock markets enabled high inflows of funds to the countries-exporters of oil that stimulated domestic demand by increasing public and private consumption. The USA had relatively lower contribution to the growth in the global GDP compared with the previous year with a growth rate of 2.2%, as well as Euro-zone and Japan (growth of 2.6% and 2.1%, respectively).

<sup>2</sup> The analysis is mainly based on the IMF World Economic Outlook (WEO), October 2007, January and April 2008; ECB Monthly Report, December 2007 and January 2008.

Table 1  
Indicators for the world economy

	2002	2003	2004	2005	2006	2007
	(in %)					
<i>Growth rates of the real gross domestic product</i>	2.8	3.6	4.9	4.4	5.0	4.9
Developed economies	1.6	1.9	3.2	2.6	3.0	2.7
USA	1.6	2.5	3.6	3.1	2.9	2.2
Euro-zone	0.9	0.8	2.1	1.6	2.8	2.6
China	9.1	10.0	10.1	10.4	11.1	11.4
India	4.6	6.9	7.9	9.1	9.7	9.2
Central and Eastern Europe	4.2	4.8	6.9	6.1	6.6	5.8
CIS*	5.2	7.8	8.2	6.5	8.2	8.5
Russia	4.7	7.3	7.2	6.4	7.4	8.1
<i>Growth of the world trade</i>	3.5	5.4	10.7	7.6	9.2	6.8
<i>Rate of inflation</i>						
Developed economies	1.5	1.8	2.0	2.3	2.4	2.2
USA	1.6	2.3	2.7	3.4	3.2	2.9
Euro-zone	2.3	2.1	2.1	2.2	2.2	2.1
China	-0.8	1.2	3.9	1.8	1.5	4.8
India	4.3	3.8	3.8	4.2	6.2	6.4
Central and Eastern Europe	16.4	10.1	6.3	5.1	5.4	5.6
CIS*	14.0	12.3	10.4	12.1	9.5	9.7
Russia	15.8	13.7	10.9	12.7	9.7	9.0
<i>Annual change of prices</i>						
Crude oil	2.5	15.8	30.7	41.3	20.5	10.7
Primary commodities	1.9	5.9	15.2	6.1	23.2	14.0
	(% of GDP)					
<i>Rate of savings</i>	20.5	20.8	21.9	22.5	23.3	23.7
<i>Investment</i>	20.8	21.1	21.9	22.4	23.0	23.3
<i>Nominal exchange rate (US dollar/ EUR)</i>	0.946	1.131	1.244	1.244	1.256	1.371

\*Mongolia is included, even it is not a member of the CIS (commonwealth of independent states).

Source: IMF World Economic Outlook, april 2008 and Eurostat, january 2008.

From the aspect of the monetary policy, the central banks of the developed countries (except for the USA) in the course of 2007 turned towards a more restrictive monetary policy by increasing key interest rates. Thus, a there followed a wave of increasing the key interest rates by the central banks of Canada, New Zeland, Australia, Japan, England and the European Central Bank (ECB). ECB increased the basic interest rate two times, in March and June, by 0,25 percentage points, respectively, so that at the end of 2007, it amounted to 4%. The reasons for the increase in the reference interest rate were the increased inflationary pressures caused by the increase in the prices of food, oil, VAT increase in Germany at the beginning of the year, but also the strong increase in the domestic demand supported by the increase in the employment and wages. During 2007, the Bank of England increased the key interest rate by 0.5 percentage points and at the end of the year it amounted to 5.5%. In the same direction, the Bank of Japan, too, increased the key interest rate in February by 0.35% percentage points and it amounted to 0.75% at the end of 2007. On the other hand, the US Federal Reserve System, due to the significant deceleration in the economic growth, reduced the key interest rate during 2007 by 1 percentage point, so that at the end of the year it amounted to 4.25%.

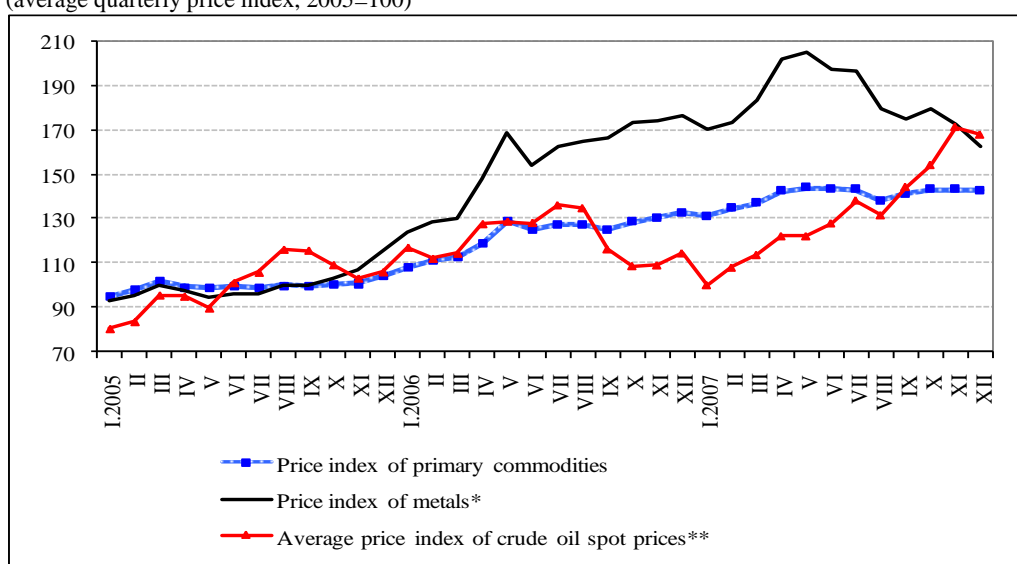
Nominal prices of primary products that have a significantly higher share in the world trade relative to the oil, realized an annaul growth of 14%, which was mostly caused by the increase in the prices of metals and food at the world stock markets. Thus, the index of the food prices was



increased by 15% at an annual basis, mainly due to the increase in the prices of soybeans, corn, meat and wheat. The increase in the prices of soybeans and corn was mostly conditioned by the increased production of biofuels in the world, whereas the increase in the prices of the other food products was due to the increased demand from China, but also the reduced production of food, that was a result of the unfavorable weather conditions in some parts of the world. Nominal prices of metals also achieved relatively high annual increase of 17.4%. Analyzed from a dynamic aspect, metal prices realized an intensive growth during the first half of the year, reaching the historically highest level in May 2007, whereas in the second half of the year, they registered a gradual reduction. The highest annual increase by approximately two times was registered in the case of the uranium, as a result of the increased demand for nuclear energy production in the world, as well as in the case of the lead. There was also a high increase in the prices of sheet metal and nickel of 65,6% and 53,9%, respectively.

Figure 2

Movement of the index of world prices of primary products and crude oil  
(average quarterly price index, 2005=100)



\* Price index of the metals is a weighted average of the spot-prices of: copper, aluminium, iron ore, sheet metal, nickel, zinc, lead and uranium.

\*\* Spot price of the crude oil is an average of the following types of oil: Dated Brent, West Texas Intermediate and Dubai Fateh.

Source: IMF, database of the World Economic Outlook, January 2008.

During 2007, the nominal average price of the crude oil at the world stock exchanges was increased by 10.7%, at an annual basis, reaching the historically highest level in November. The reasons for the annual increase lie in factors both from the supply and demand side, but also in factors of speculative nature. Closing of certain oil capacities in Nigeria and reduced oil production by Mexico, due to the start of the hurricane season in the Gulf of Mexico had an influence on the supply. Additional factors that had influence on the supply side of oil were the reduced reserves in the OECD member states in the first half of the year and the strict production discipline in OPEC, which led to a reduction in the oil reserves in the USA in the second half of the year. The oil demand side was effected by the increased needs, especially by the fast-growing economies of China and India. The increase in the oil prices was further stimulated by speculative factors caused by the geopolitical tensions in the Near East, as well as the weak US Dollar/Euro exchange rate during the year. In the course of 2008, it is expected that oil prices will continue to rise due to the continuation of the pace of increase in demand for oil by China and India, slowed down pace of increase in supply of oil due to the strict production policy by OPEC, as well as limited oil fields of Norway and United Kingdom. The relatively high increase in the prices of crude oil, food and metals during 2007 is assessed as the prime factor in the world that has had an adverse effect on the global economic development because of the increased inflationary pressures.

## 1.1. Developed countries in 2007

The dynamics of GDP growth in 2007 was 2.7% in the developed economies, which, compared with the previous year, was a deceleration of 0.3 percentage points, caused mainly by the financial crisis in the USA at the subprime mortgages markets having several-fold consequences on the US economy and indirectly on the European Union. As a response to such events, in order to stabilize short-term interest rates on the overnight credits and to alleviate liquidity problems in the financial sector, the central banks of the USA, England and the European Central Bank intervened in August by injecting liquidity at the money market through open market operations. Additional factor that influenced the deceleration in the growth dynamics was the increase in the prices of oil, food and metals.

Table 2  
Economic indicators for the developed countries

	GDP (real growth rates in %)			Inflation (in %)			Unemployment rate (in %)			General government fiscal balances (% of GDP)			Current account balance of balance of payments (% of GDP)		
	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007
Developed economies	2.6	3.0	2.7	2.3	2.4	2.2	6.0	5.6	/	-3.5	-2.6	-2.2	-1.3	-1.5	-1.2
Euro-zone	1.6	2.8	2.6	2.2	2.2	2.1	8.8	8.2	7.4*	-2.6	-1.4	-0.6	0.2	-0.1	-0.2
Germany	0.8	2.9	2.5	1.9	1.8	2.3	10.6	9.8	8.4	-3.4	-1.6	-0.2	4.6	5.0	5.6
France	1.7	2.0	1.9	1.9	1.9	1.6	9.3	9.2	8.3	-3.0	-2.5	-2.4	-0.9	-1.3	-1.3
Italy	0.6	1.8	1.5	2.2	2.2	2.0	7.7	6.8	6.0	-4.2	-3.4	-1.9	-1.6	-2.6	-2.2
Greece	3.8	4.2	4.0	3.5	3.3	3.0	9.9	8.9	8.3	-5.1	-2.5	-2.7**	-7.4	-11.0	-13.9
USA	3.1	2.9	2.2	3.4	3.2	2.9	5.1	4.6	4.6	-3.6	-2.6	-2.5	-6.1	-6.2	-5.3
Japan	1.9	2.4	2.1	-0.3	0.3	0.1*	4.4	4.1	3.9	-5.0	-3.8	-3.4	3.6	3.9	4.9

\*Source: ECB, Monthly report, March 2008.

\*\* Estimate.

Source: IMF World Economic Outlook, april 2008.

From the viewpoint of the individual economies, the USA experienced the greatest deceleration in the economic growth of 0.7 percentage points compared to the previous year, as a consequence of the financial crisis at the subprime mortgages markets that resulted directly in a drop in the prices of real estate and led to a decrease in the private consumption and buying real estate by the retail sector. As a reaction, the US central bank reduced the key interest rate in order to stimulate economic growth. Still, despite the reduction in the GDP growth rate, the unemployment rate and budget deficit remained at an unchanged level compared with the previous year. Positive changes were registered at the current account deficit that amounted to 5.3% of GDP and compared with the previous year it was decreased by 0.9 percentage points as a result of the further depreciation of the US Dollar and increased net export. In conditions of slowing down of the domestic demand, the inflation in the USA remained at an unchanged level relative to the previous year notwithstanding the increased inflationary pressures due to the increase in the prices of primary products and oil, as well as reduction in the key interest rate of FED.

The trend of depreciation of the US Dollar relative to the Euro continued in 2007. Thus, the average annual nominal exchange rate Dollar/Euro<sup>3</sup> equaled 1.37, which compared with the preceding year was a depreciation of the US Dollar of 9.1%. Main factors of depreciation of the US Dollar were the turbulences at the US financial markets, improved macroeconomic results in the Euro-zone compared with the USA and higher inflation in the USA.

Similar to the US economy, after the relatively high GDP growth during the first quarter of the year, the economic activities in Japan registered a significant deceleration. Namely, the rate of GDP growth in 2007 was 2.1% and, compared with the previous year, it was lower by 0.3

<sup>3</sup> Source: EUROSTAT.

percentage points which was due to the reduced investments and decelerated growth in the domestic consumption. However, despite the weaker economic performances, the unemployment rate in the second and third quarter registered reduction. During the first three quarters of the year, the Japanese economy entered again in the zone of deflation (0.1%), but as a result of the increase in the price of the land and of oil and primary products in the world, the inflation reached 0.5% in the fourth quarter, thus the annual inflation reached 0.1% as opposed to 0.3% in 2006.

Economic growth within EU and Euro-zone for 2007<sup>4</sup> was estimated at 2.9 and 2.6% respectively. Analyzed from a dynamic aspect, the growth within Euro-zone was relatively high during the first half of the year, whereas in the second half it registered a significant deceleration mainly due to the spillover effects caused by the financial crisis in the USA, so the growth rate was reduced by 0.2 percentage points on an annual basis. The growth in the Euro-zone was stimulated by the domestic demand (private consumption and investment) and the increase in the exports. The unemployment rate in the Euro-zone continued to decrease in the course of 2007 and reached the historically lowest level (7.4% and compared with 2006 it was reduced by 0.8 percentage points<sup>5</sup>).

The average annual inflation rate within the Euro-zone equaled 2.1% in 2007, and was kept within the target of the European Central Bank. During the first three quarters of the year, the annual inflation rate equaled 1.9%, whereas the inflationary pressures were mostly emphasized in the fourth quarter when the inflation rate reached 2.9%. The main factors that affected the increase in the price level, especially in the last quarter of the year were increase in the energy prices (household oil and gas) and food prices. The basic inflation rate at an annual level was increased by 0.5 percentage points and in 2007 it amounted to 2%. The reasons for its annual augmentation were the increase in VAT in Germany since the beginning of the year, in the processed food prices as well as in a part of prices of services.

Within the countries from the Euro-zone which are the main trade partners to the Republic of Macedonia, it was Greece and Germany that accomplished the highest annual GDP growth rate in 2007 of 4% and 2.5%, respectively. The growth in Germany was caused mainly by the increase in the investment in fixed assets, construction activities and exports. On the other hand, a decelerated growth dynamics in 2007 was registered in Italy, mainly due to the reduction in the industrial production and domestic consumption. The inflation rates in these countries were within the average of the Euro-zone, whereby a significantly higher rate of 3% was registered in Greece. In the course of 2007, a decreasing trend in the unemployment rates was registered in these countries, the highest drop in the unemployment rate of 1.4 percentage points being registered in Germany. The surplus in the BOP current account deficit in Germany in 2007 was increased by 0.6 percentage points, whereas in Greece there was a deepening of the deficit and it equaled 13.9% of GDP.

## **Annex 1**

### **How did the large Central Banks react to the crisis at the financial markets?**

Turbulent developments at the global financial market in the second half of 2007 contributed to a creation of significant challenges for the large central banks, mainly, European Central Bank (ECB), Federal Reserve System (FED) and Bank of England (BA). Namely, under normal circumstances, the central banks are focused on provision of an appropriate level of liquidity in the financial system in order to neutralize pressures on reference interest rate and maintain it at an appropriate level. For a successful realization of monetary objectives, fulfillment of two basic pre-conditions is necessary: a) the banks that enter in direct transactions with the central bank (through open market operations) should perform an efficient distribution of the liquidity among the market participants; and b) existence of a stable link between the reference

<sup>4</sup> Source: European Commission, previous projections, February 2008.

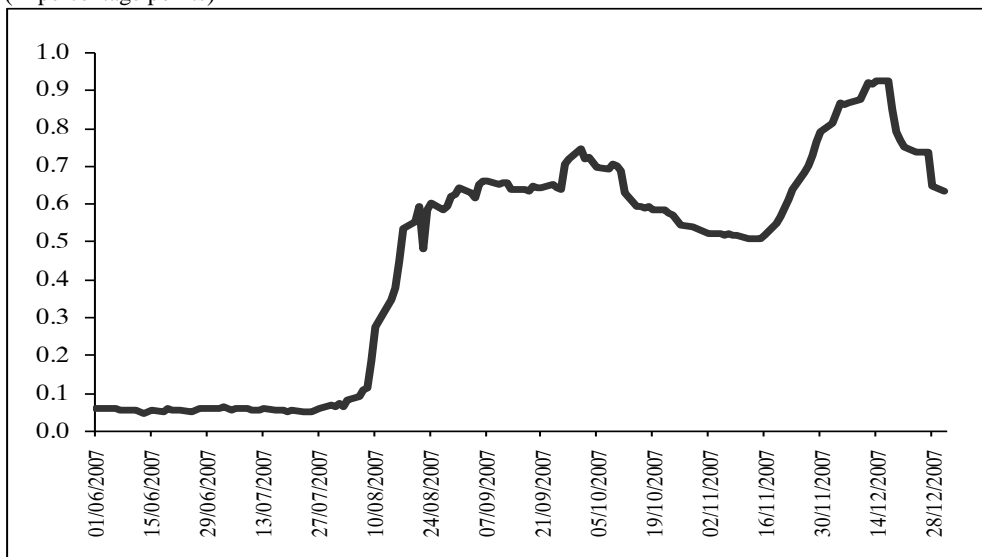
<sup>5</sup> Source: ECB Monthly Report, January 2008. The unemployment rate is adjusted to the seasonal influences.

interest rate of the central bank on one hand, and interest rates on the instruments with a longer maturity, as factor that influences aggregate demand, on the other hand.

The crisis with the subprime mortgages markets in the USA disturbed the functioning of the financial markets, leading to an interruption in the previously established stable links, widening of the gap between the interest rates of the secured and non-secured financial instruments and almost complete exhausting of the forward financing market in the longer run. The yield curve became more stable, making uncertain the effect of the change in the reference interest rate on the economy. The best indicator of the scope of the present financial differences is the dynamics of the interest margin between LIBOR and the overnight indexed swap-OIS<sup>6</sup> interest rate with the same maturity, which was significantly expanded in the period August-December 2007.

Figure 3

Interest margin between EURO LIBOR (3 months) and EONIA indexed swap (3 months)  
(in percentage points)

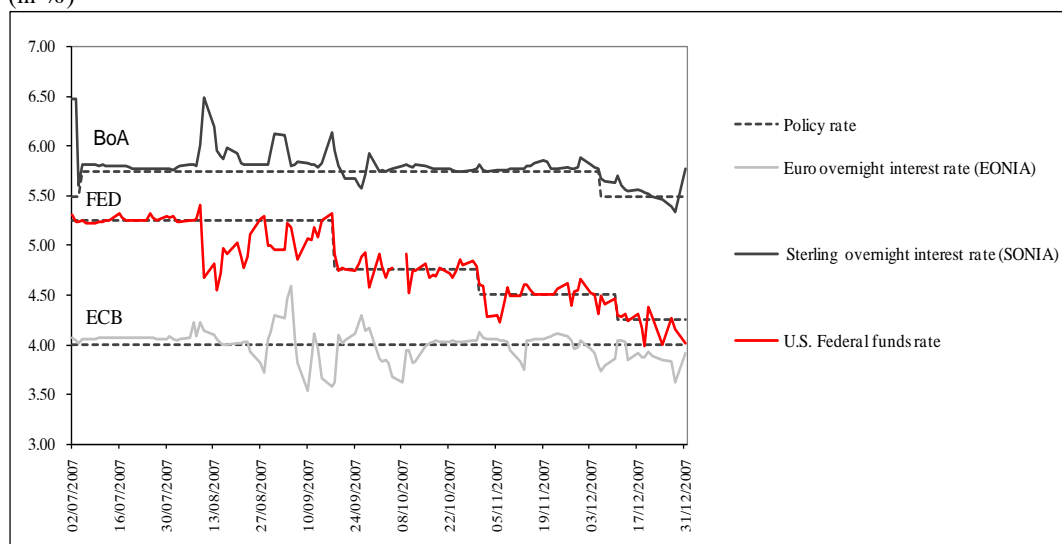


Source: [www.bba.org.uk](http://www.bba.org.uk), [www.eoniaswap.org](http://www.eoniaswap.org).

In such conditions, the large central banks were forced to react in order to calm down the financial markets. Their reactions were to a large degree conditioned by the specific macroeconomic features of the country of their activity. Thus, in accordance with the present indicators of slowing down of the economic growth in the US economy, FED began with a re-definition of the monetary policy in order to alleviate the effects of the stricter conditions of extending loans imposed by the banks. Consequently, FED reduced the reference interest rate in several occasions. On the other hand, ECB and BA turned towards maintaining a more restrictive monetary policy in order to retain the price stability, in conditions of a growing trend of the prices of food and crude oil. Thus, in the period January-July 2007, ECB and BA increased the reference interest rates (ECB in two occasions, and BA in three occasions). In the second half of the year, despite the further existence of inflationary risks, ECB and BA did not intervene with a change in the interest rates in order to clam down financial markets and overcome more easily banks' liquidity problems. In December 2007, BA reduced reference interest rate, as a preventive measure against the increased downward risks on the economic activity.

<sup>6</sup> OIS is a swap contract, based on the swap of a flexible interest rate (EONIA) for a fixed interest rate that is defined with the swap contract. The fixed interest rate is called swap interest and it reflects the investors' expectations for the dynamics of the overnight interest rate up to the maturity of the swap.

Figure 4  
Reference and effective interest rates  
(in %)



Source: Web sites of the central banks.

The occurrence of the first financial de-balances raised uncertainty among deposit institutions from a potential deterioration in their balances. Consequently, there was a significant increase in the demand of short-term liquid assets, at which ECB and FED reacted by providing additional liquidity through open market operations. Thus, these central banks contributed to a stabilization of the money market, avoiding more significant fluctuations of the short-term interest rates. On the other hand, BA has initially decided not to undertake additional measures and intervene through the standing facilities, which led to higher interest rates.

During the fourth quarter, when the potential financial losses were being assessed, the liquidity management remained in the focus of the commercial banks. ECB, FED and BA continued with the active management of the supply in accordance with the changes in the demand for liquid assets that was still maintained at a relatively high level. Changes in the operational frameworks were also introduced towards expansion of the range of financial instruments that had a function of collateral, as well as a possibility for borrowing for a longer period (of three and more months) mainly through the open market operations. FED also introduced Term Auction Facility (TAF) as a form of collateralized loans with a longer maturity.

The decision to introduce the new monetary instrument (TAF) was announced on 12 December 2007 in a joint action with four others central banks (the Bank of Canada, Bank of England, ECB, and Bank of Switzerland), which, by giving announcements, presented a group of measures for normalizing financial flows. Thus, FED announced that it plans to issue US\$ 40 billion in the financial system by the end of the year through the TAF program. Simultaneously, additional US\$ 24 billion were made available to the European banks through foreign exchange swap lines, agreed with ECB and the Bank of Switzerland. BA emphasized that it would continue to provide short-term and long-term repurchase loans, accepting almost all offered financial instruments as collateral, whereas the Bank of Canada, notwithstanding the planned increase in the frequency of the repurchase auctions, stated that it was ready to accept mortgage backed securities as collateral. It was an indicator that the above-mentioned central banks created a flexible approach to the liquidity problem and that they jointly followed the developments at the financial markets.

Source: *Gray S. and Stella P.*, (2008) "IMF Assesses Central Banks' Reaction" IMF Survey Magazine: Policy, International Monetary Fund; *Mishkin F.*, "The Federal Reserve's Tools for Responding to Financial Disruptions", Speech at the Tuck Global Markets Conference, Tuck School of Business, Dartmouth College, Hanover, New Hampshire, January 15, 2008; *web sites*: [www.ecb.int](http://www.ecb.int), [www.bankofengland.co.uk](http://www.bankofengland.co.uk), [www.federalreserve.gov](http://www.federalreserve.gov), [www.bba.org.uk](http://www.bba.org.uk), [www.eoniaswap.org](http://www.eoniaswap.org).

## 1.2. Countries in transition in 2007

It is estimated that the real GDP growth rate in the countries in transition<sup>7</sup> will reach 7% in 2007, which is at the same time the highest growth rate since the beginning of the transition period. Such intensive growth, typical of the last several years indicates a process of real convergence towards the developed countries and especially towards the countries in the Euro-zone. The main factors of the economic growth in the transition economies are the strong domestic demand, relatively high inflow of foreign direct investment and private transfers, all that substantiated by the increased crediting by the banking sector. An additional stimulating growth factor is the increase in the exports, which applies especially to the countries rich in natural resources.

Table 3  
Economic indicators for the countries in transition

	GDP			Inflation		
	(real growth rates in %)			(annual change in %)		
	2005	2006*	2007**	2005	2006*	2007**
<b>Transition economies</b>	<b>5.8</b>	<b>6.9</b>	<b>7.0</b>	<b>6.5</b>	<b>6.5</b>	<b>7.0</b>
<i>Central and Eastern Europe</i>	4.9	6.2	6.0	3.2	3.6	4.6
<i>South Eastern Europe</i>	4.8	6.4	6.1	5.6	5.7	4.4
<i>Commonwealth of independent states</i>	6.7	7.5	7.8	9.2	8.7	9.3

\* Estimate.

\*\* Projection.

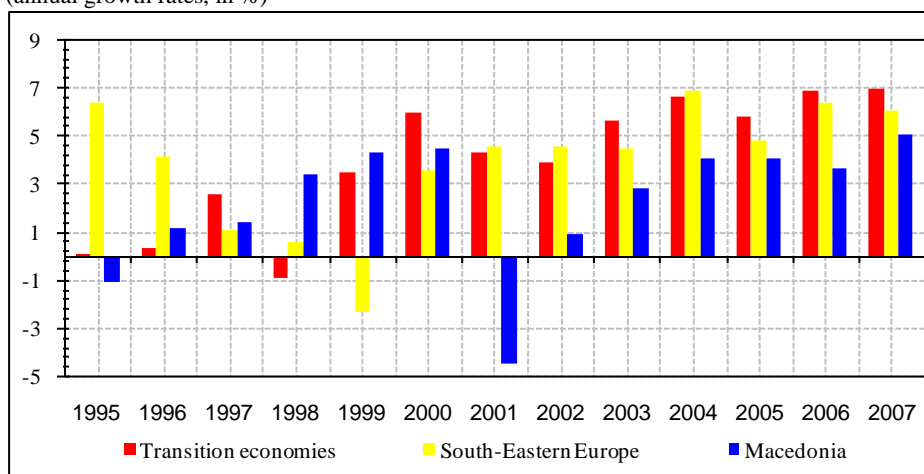
Source: EBRD Transition Report 2007.

Analyzed from the aspect of the individual groups of countries within the transition economies, it is expected that in 2007 as well, the highest rate of real GDP growth of 7.8% will be achieved by the countries of the Commonwealth of Independent States (CIS). The economic growth of a part of the CIS countries rich in natural resources is caused mainly by the increased foreign exchange inflow on the basis of the exports of natural resources (oil, gas and metals), that result directly in strengthening of the domestic demand and construction, whereas in the countries that are not rich in natural resources, economic growth is stimulated by foreign exchange inflows as a result of private transfers from abroad. The growth rate in the group of countries of Central-Eastern Europe and Baltic Countries (CEB) in 2007 is assessed to reach 6%, which is a reduction in the growth intensity of 0.2 percentage points compared to 2006. The main growth factors in this group of countries are domestic demand stimulated through the increase in the investment in new production capacities, private consumption supported by the increase in wages, employment and credit expansion of the banking sector, as well as increase in the exports. Similar to the CEB countries, the growth rate in the group of countries from South-eastern Europe (SEE) is estimated to reach 6.1% which is a reduction of 0.3% relative to the previous year. The growth in this group of countries results mainly from the domestic demand, private transfers from abroad, but also the inflow of foreign direct investment, which reflects the increased political stability in the region due to the membership of Bulgaria and Romania in the EU, as well as the increased efforts for the approximation of the other SEE countries to the EU. From the aspect of the separate SEE countries, relatively high growth rates were achieved by Romania and Bulgaria of 6.5% and 6%, respectively. Still, the growth rate in Romania was reduced by 1.2 percentage points compared with 2006 due to the maintenance of a more restrictive fiscal policy. Among the group of Western Balkan countries,

<sup>7</sup> It refers to the Central-Eastern European and Baltic countries (CEB), South-eastern Europe (SEE) and the Commonwealth of Independent States including Mongolia (CIS). The analysis is mainly based on EBRD Transition Report 2007.

it is expected that the highest growth of 7% will be achieved by Montenegro, which results from the high profits generated from the tourism and increase in the exports. It is expected that Albania and Serbia will realize relatively high growth rates of 6%, whereas the assessed growth in the Republic of Macedonia is 5.1%.

Figure 5  
Gross domestic product  
(annual growth rates, in %)



Source: EBRD Transition Report 2007.

Taking into consideration the high inflation at the beginning of the transition period and accordingly, maintenance of macroeconomic policies directed towards its reduction, in the last several years a trend of inflation reduction to a one-digit level was registered in the SEE countries. Thus, the inflation in the SEE countries in 2007 was reduced by 1.3 percentage points compared with 2006 and it reached 4.4%, whereby in the Western Balkan countries, the most conspicuous reduction in the inflation rate was registered in Serbia and Bosnia and Herzegovina, while the Republic of Macedonia had been for years among the most successful countries in view of the maintenance of price stability. However, the analysis of the whole group of countries in transition indicated certain strengthening of the inflation in 2007. As a result of the increased consumption in the transition economies in the last several years and their economic expansion, but also due to the increase in the prices of the primary products and oil at the world stock markets in 2007, the inflation rate was increased and it reached 7%. It should be taken into consideration that the price effect of the food prices in the countries in transition was basically stronger compared with the effect in the developed countries, because of the greater contribution of the food to the price index in transition economies following the structure of their consumer basket which is mainly a reflection of the standard of living. Simultaneously, it should be taken into consideration that the price increase in the countries in transition involved the effects of price convergence towards the developed countries, and the dynamics of this process might be different in various countries.

In the course of 2007, the countries in transition continued with the structural and institutional reforms, however, at a slower pace compared to the previous years. Thus, in 2007, the highest progress was achieved in the SEE and CIS countries, whereas reforms with a lower intensity were implemented in the CEB countries. The reasons behind the slower pace of reforms in 2007 lie in the fact that the initial stage of reforms<sup>8</sup> in the CEB countries, but also in the major part of SEE countries has already been completed, except for Albania, Bosnia and Herzegovina, Serbia and Montenegro, that still lag behind the other SEE<sup>9</sup> countries in certain segments of the reforms. In general, the greatest progress in the SEE countries was achieved regarding the strengthening of

<sup>8</sup> The initial stage of reforms pertains to liberalization, stabilization and privatization of small and medium enterprises, while the second, advanced stage pertains to improvement of the competition, restructuring of enterprises, development of financial institutions and infrastructural reforms.

<sup>9</sup> In accordance with the EBRD Transition Report, 2007.

the competitiveness and creation of autonomous agencies, the infrastructure and banking sector. In the Western Balkan countries, the biggest reforms were implemented in Bosnia and Herzegovina, in the area of privatization of large companies by selling Telecom and Oil Refinery, as well as in the competition policy by strengthening anti-monopoly agencies. Reforms with a similar intensity were implemented in Montenegro as well in the areas of trade and foreign exchange system by signing Stabilization and Association Agreement with the EU, the progress achieved with the membership in the World Trade Organization and accession to CEFTA. Further reforms were also carried out in the area of competition policy with the approximation of the legislation to the European one. In the Republic of Macedonia, bearing in mind that the initial stage of the reforms had been completed, reforms in 2007 were focused on the area of competition policy with the amendments and modifications to the Law on Competition.

Table 4  
Transition indicators for 2006

	Enterprises			Markets and trade			Financial institutions		Infrastructure
	Large-scale privatisation	Small-scale privatisation	Corporate & enterprise restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banks' reforms and liberalisation of the interest rates	Markets of Securities & and non-banking financial institutions	Infrastructural reforms
Albania	3	4	2+	4+	4+	2	3-	2-	2+
Bosnia and Herzegovina	3	3	2	4	4-	2	3-	2-	2+
Macedonia	3+	4	3-	4+	4+	2	3-	2+	2+
Serbia	3-	4-	2+	4	3+	2	3-	2	2
Croatia	3+	4+	3	4	4+	3-	4	3	3
Montenegro	3+	4-	2	4	4	2-	3-	2-	2

Source: EBRD Transition Report, September 2007.



## II. Economic developments in the Republic of Macedonia

### 2.1. Economic activity<sup>10</sup>

Economic growth of the Republic of Macedonia in 2007 registered intensification and reached 5.1% (as opposed to 4% in 2006). The achieved economic growth rate was in accordance with the expectations and was higher than the achievements of the previous years.<sup>11</sup>

GDP growth was supported by the intensification of the personal consumption, in conditions of reduced cost and facilitated access to credits, as well as increase in the wages in the economy. At the same time, the increased public and investment consumption also led towards stimulation of the domestic demand. The contribution of the fiscal policy was also reflected through the measures for stimulation of the supply, mainly by the undertaken tax reforms for reduction in the rates of profit tax and personal income tax, in order to stimulate a more efficient allocation of resources, that is, increase in employment and increase in investment. The intensified pace of the entry of foreign direct investment was also one of the factors that were conducive to the acceleration of the economic growth, although their overall effects could be seen in the longer run.

The external factors had divergent effects on the Macedonian economy in 2007. The negative shock from the increase in the oil price at the world stock markets as well as from the increase in the electric energy price was transferred to the domestic economy, whereas the increase in the price of metals at the world stock markets had a positive influence on the Macedonian export. Still, notwithstanding the significant increase in the foreign demand for domestic products, being under pressure of the import-dependence of the production and increased demand, the import of goods registered a significant increase, that deepened trade deficit and had a negative influence on the GDP growth (especially from the second half of the year).

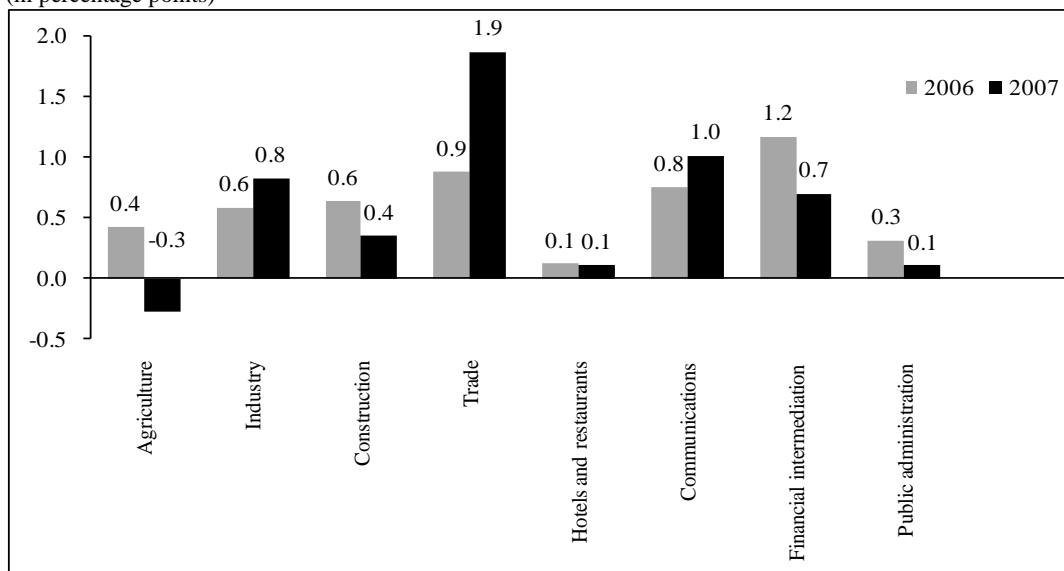
#### 2.1.1. Domestic supply

The dominance of the service sectors in the creation of GDP continued in 2007. Thus, in conditions of a stronger growth in the final consumption, three quarters of the GDP growth were created by the increased activity of the domestic trade, “transport and communications“ sector and financial intermediation sector. The increased foreign demand conditioned growth in the industrial activity in the Republic of Macedonia, that created around 16% of the GDP growth, whereas in spite of the strengthening of the investment activity, the construction sector had still a low contribution to the GDP growth (of 8%). The only exception from the positive trends was the activity of the agricultural sector that due to the unfavourable weather conditions registered a drop (especially from the second half of the year) and had a negative effect on the GDP growth.

<sup>10</sup> Source: State Statistical Office of the Republic of Macedonia. Quarterly calculations of GDP are expressed at constant prices, in Denars from 1997. The structure is in line with the National Classification of Activities (NCA).

<sup>11</sup> Trend-the rate is 2.3% and is calculated based on the regression of the real value of GDP of the trend, for the period from 1995 until 2007 and it represents the average rate of economic growth, isolated from the short-term fluctuations.

Figure 6  
Contributions to the GDP growth  
(in percentage points)

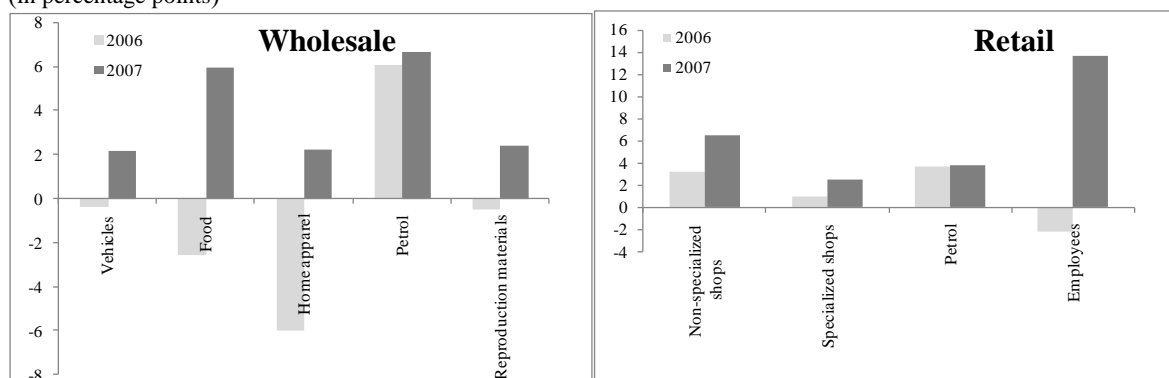


Source: State Statistical Office of the Republic of Macedonia and calculations of NBRM.

The improved business climate in the Republic of Macedonia in 2007 and the entry of significant foreign direct investment in the areas of telecommunications and manufacturing industry, as well as the re-starting of two mining capacities were a part of the growth factors in 2007.

In 2007, the major part of the GDP growth (37%) was a result of the increased volume in the *domestic trade*, where the value added registered a real annual increase of 14%. There was also an increased dynamics in the turnover of the wholesale trade (annual growth rate of 29.4%) and retail trade (growth rate of 17%). The increase in the turnover of the wholesales was to the greatest extent due to the increased turnover of food and fuels, but also household items, vehicles and reproduction materials. Similar trends were present regarding the retail trade, whereas significant increase in the turnover was registered in the non-specialized stores (for food etc.) and fuels, and to a lesser extent in the specialized stores (for clothes etc.). At the same time, the increased activity in this sector entailed a demand for labor force, which was reflected in the increase in the number of employees in the trade (by 13.6% on an annual basis).

Figure 7  
Contributions to the growth in the wholesales and retail trade  
(in percentage points)

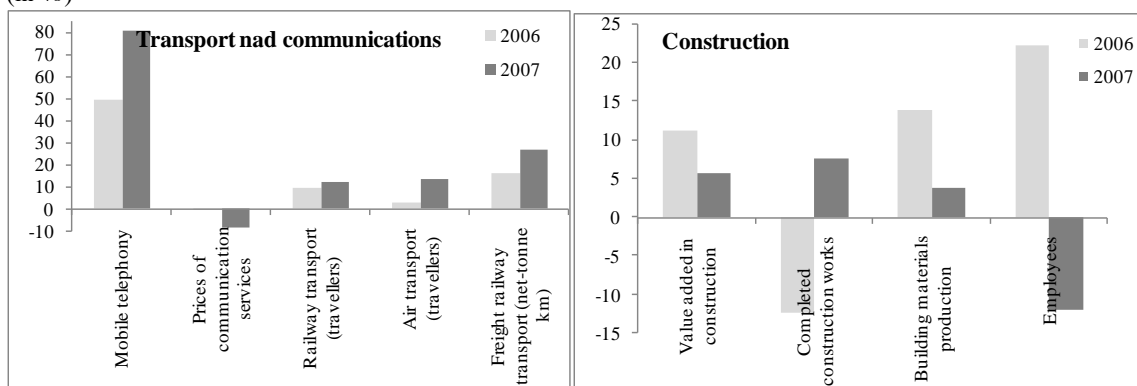


Source: State Statistical Office of the Republic of Macedonia.

The dynamic development in the telecommunications that continued in 2007 as well, along with the favorable achievements in the transport was reflected in a real annual growth of 12.5% of value added in the “transport and communications” sector. The further liberalization of the telecommunications market (the start of the operations of the third mobile operator) conditioned a reduction in the prices of these services thus stimulating the demand for them. In accordance with the increase in the activity, the number of employees in this sector registered an annual increase of 18.2% (with a greater intensity in the second half of the year, after the new company started to operate). Simultaneously, in the area of transport, the railway freight transport registered a significant annual increase (of 27%), as well as the airplane transport (of 14%) and railway passenger transport (of 12%).

The revival of the investment activity in the Republic of Macedonia in 2007 was reflected in the increase of the activity in the *construction*, where the value added registered a real annual increase of 5.8%. The positive tendencies in this sector conditioned an increase in the domestic production of construction materials (by 3.8% on an annual basis) and increased the import demand for them (by 11%). However, the number of employees in this sector registered an annual reduction (of 12%), which is surprising and refers to the high comparative basis from the previous year.

Figure 8  
Annual growth rates in communications and construction  
(in %)



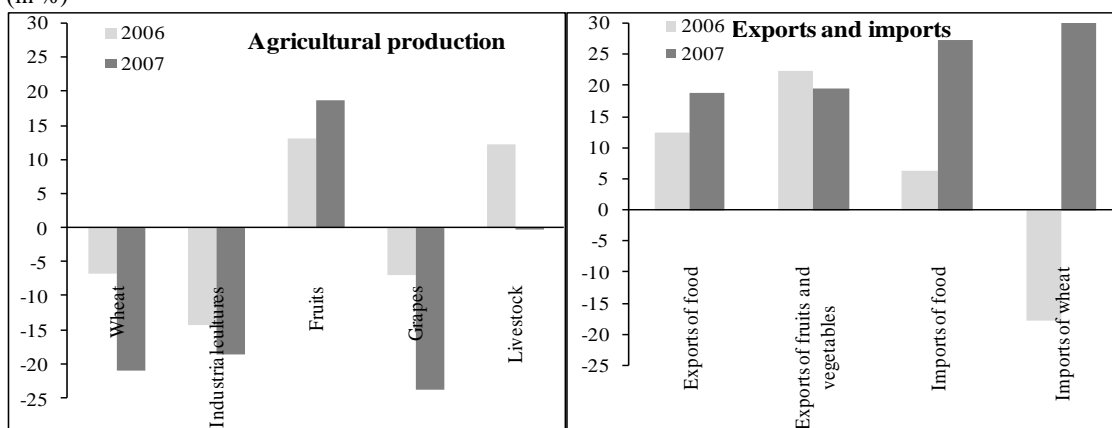
Source: State Statistical Office of the Republic of Macedonia.

The favorable economic developments in 2007 had also reflected on the activity in the *hotels and restaurants* sector, where the value added registered a real annual increase of 6.8%. The turnover in the catering sector registered an annual increase of 13.6%, and positive changes occurred in the tourism sector, too, where a higher inflow of foreign tourists was registered (of 13.7% on an annual basis) and increased number of overnights (by 17% on an annual basis). Due to the increased number of tourists, the foreign exchange inflow on the basis of tourism was higher by 32% in 2007 relative to 2006.

Positive performances in most of the economic sectors were partially offset by the unfavorable developments in the agriculture, where in conditions of high temperatures and insufficient quantity of rains, production was significantly reduced. The real annual drop in the value added of 2.9% in the “agriculture, forestry and fishery” sector was mostly a reflection of the fall in the agricultural production (a fall of 5.1% according to the initial data), that was mostly caused by the reduced production of industrial crops, cereals and grapes. On the other hand, the cattle raising production was at the same level as last year, whereas a high increase in the production was registered in the area of fruit-growing. The developments in the domestic agricultural production had a reflection on the developments of the foreign trade and at the same time on the domestic price level. Thus, the fall in the overall agricultural production conditioned a

high annual increase in the imported quantities of food products<sup>12</sup> (by 33%), in the frames of which the import of grain and grain products dominated (annual growth of 83%), that in conditions of a higher import price (by 13%, as a reflection of the global world trends), had also a reflection on the increase in the prices of flour and bread. On the other hand, the increased quantity of export of food (by 21% on an annual basis), in the frames of which the export of fruit and vegetable dominated<sup>13</sup>, (an annual increase of 23%), conditioned a reduced supply of these products at the domestic markets and thus, their higher prices.

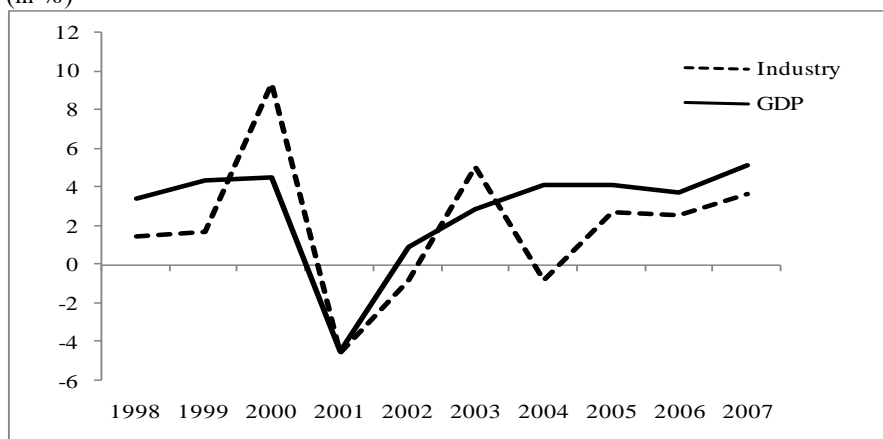
Figure 9  
Annual growth rates in the agriculture  
(in %)



Source: State Statistical Office of the Republic of Macedonia.

Notwithstanding the dynamic growth of the service sectors in the Republic of Macedonia, the overall economic results were mainly conditioned by the performances in the industry, as a dominant activity in creation of GDP. The results in this sector, in the course of 2007, might be described as favorable and encouraging, taking into consideration the fact that the growth in the value added of the industry of 3.7% was the highest in the last four years.

Figure 10  
Annual rates of real growth in the value added in the industry and GDP  
(in %)



Source: State Statistical Office of the Republic of Macedonia.

Driving force behind the overall trends in the industry was the manufacturing sector that had the greatest share in the total industrial production (of 84%). In 2007, the activity of the manufacturing sector registered a solid real growth of 5.2%, caused by the increased activity in

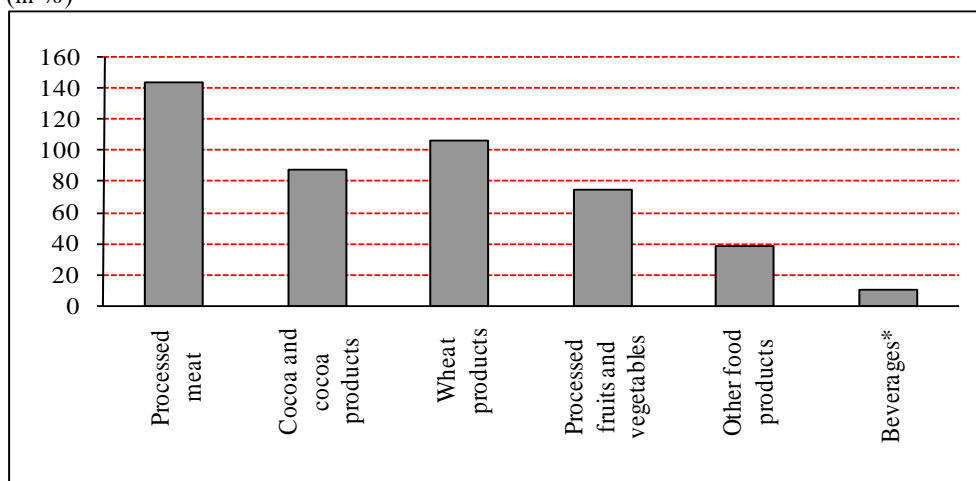
<sup>12</sup> Data according to classification SMTK.

<sup>13</sup> The increased export is realized in conditions of a moderate decrease in the production of garden crops.

twelve industrial branches (that constituted two thirds of the industrial production). Dominant within the manufacturing sector was the *production of basic* metals, which was increased by 34% in 2007 relative to 2006. Namely, the favorable conjuncture at the world market of metals was followed by an increase in the activity of several large domestic entities, producers of iron, ferronickel and steel. At the same time, the increased foreign demand for metal constructions resulted in a dynamic growth in the domestic production of metal products in the *metalworking stage* (by 46% on an annual basis).

The *food industry* in 2007 was characterized by a significant annual increase of 7.7%. Although a part of the activity in this industry resulted from the increased export of foodstuffs, in the frames of which the export of beverages, processed fruit and vegetable products, processed meat products and various ready products for nutrition dominated, food industry was still directed towards meeting the needs of the domestic market.

Figure 11  
Annual rates of real growth in the export of processed food products  
(in %)

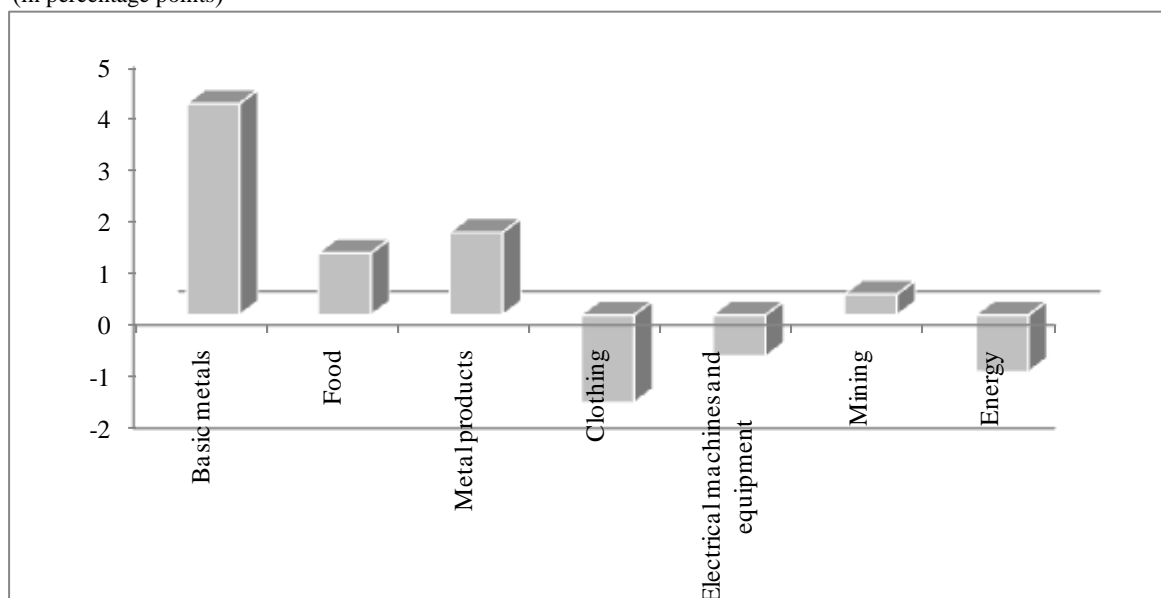


Source: National Bank of the Republic of Macedonia.

\* Source: State Statistical Office of the Republic of Macedonia.

As opposed to the positive developments in most of the industries within the manufacturing sector, annual reduction in the production was registered in the *clothing* industry (where the number of employees is the highest). The drop in the industrial output from 15.3% appeared in conditions of high increase in the export of clothes (of 13.2% on an annual basis) and increase in the employees in this industry (of 14.8% on an annual basis). Still, in spite of the increased export demand, high annual increase in the import of clothes was also registered in 2007 (of 14.4%, mainly from Greece and Turkey), which was, to a significant extent, a substitute for the domestic production. In addition to the decreased production of clothes, the production of *electrical machines and appliances* had a significantly negative effect on the overall industrial growth in 2007 (high real annual fall of 24.4%), due to the problems in the operations of the major entity in this industry.

Figure 12  
Contribution of the separate industrial branches to the increase in the industrial production  
(in percentage points)



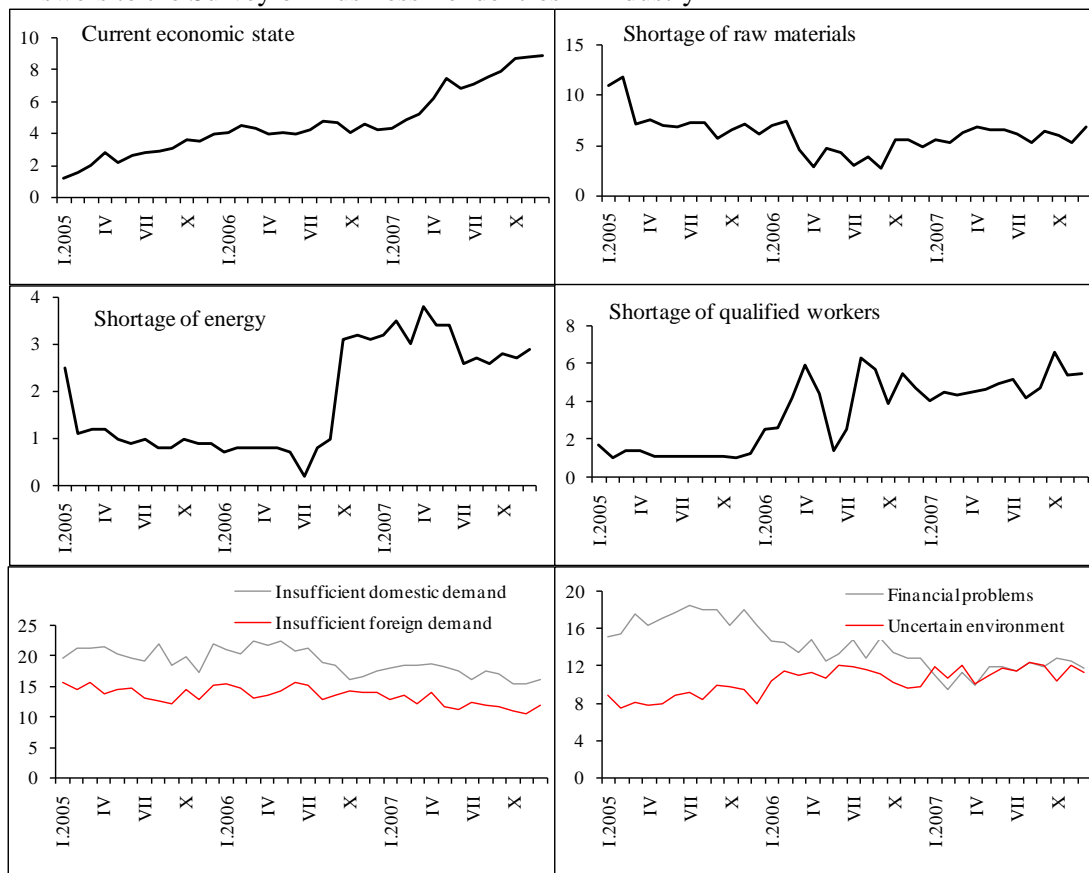
Source: State Statistical Office of the Republic of Macedonia and calculations of NBRM.

The restart of a significant mining capacity in the middle of 2006 and of two mines in 2007 led to an increase in the scope of the output in the mining sector (annual increase of 9.8%). The growth in this sector was caused by the excavation of ores of metals and coal, whereas the excavation of the non-metal ores registered annual reduction. With the intensification of the mining activity, the export of ores was improved, as well, and in 2007 it was significantly higher than in 2006 (by 1.2 times).

As opposed to the increased scope of output by manufacturing and extraction in 2007, a significant drop was registered in the production *in the energy* sector (of 9.5%). The reduction in the electric energy production was a result of the reduced scope of operations of the hydro electric power plants, caused by the low quantity of rains. In accordance with the revived economy, the increased consumption of electric energy, in conditions of reduced domestic supply, was satisfied with a significant export that was twice as high in 2007 relative to 2006.

According to the Business Tendency Survey in the Manufacturing Industry of the State Statistical Office, the managers' observations about the improved business situation in the industry coincide with the achieved results of the industrial sector. The changes with respect to the current events in the operations indicate structural improvements in the industry. Despite the opinion that the weak domestic and foreign demand is significant limiting factor of the operations, the significance of this factor has been constantly decreased. Financial limitations have the same tendency, and it is considered that they have ever smaller role in the operations, whereas the significance of the lack of raw materials, energy and qualified labor force, as limiting factors, is increased.

Figure 13  
Answers to the Survey on Business Tendencies in Industry



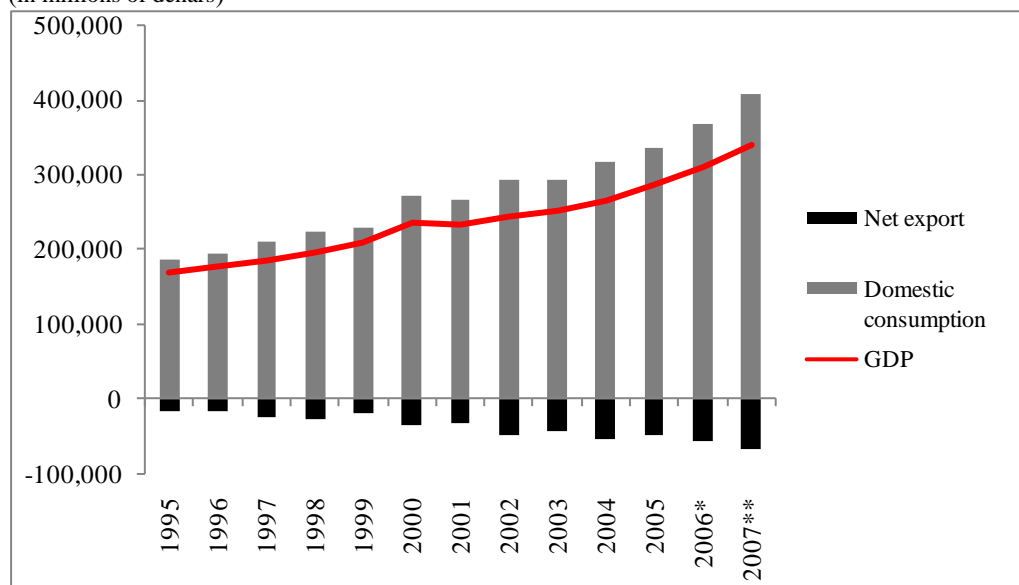
Source: State Statistical Office of the Republic of Macedonia.

### 2.1.2. Domestic demand

The increase in the aggregate demand<sup>14</sup> in 2007 resulted in a rise in the aggregate supply and caused additional inflationary pressures at the end of the year. The intensive increase in the personal consumption, followed by an augmentation in the public consumption and revival of the private and government investment consumption created pressures in the external sector that resulted in widening of the trade deficit.

<sup>14</sup> In March 2008, State Statistical Office published data on the main expenditure aggregates of GDP on quarterly basis. They refer to the final consumption, gross investment, export and import of goods and services for 2006 and 2007 and cover quarterly distribution and annual levels. The new data structure does not contain data on the sub-components of the final consumption (personal and public consumption) and gross investments (investments in fixed assets, reserves), due to which assessment of the sub-components was made on the basis of the movement of certain indicative variables.

Figure 14  
Domestic demand, deficit in the foreign trade and GDP  
(in millions of denars)



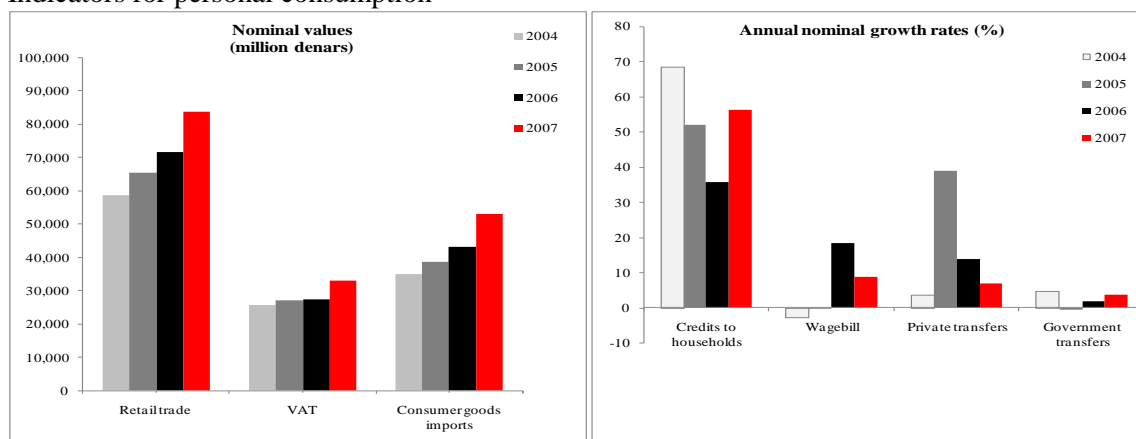
\*For 2006 previous data.

\*\* For 2006 estimated data.

Source: State Statistical Office of the Republic of Macedonia.

Domestic demand in 2007 registered a nominal growth of around 11% on an annual basis, which was a continuation of the achievements in 2006 (nominal annual increase of 10%). In addition to the intensified investment spending, two thirds of the growth in the domestic demand were caused by the final consumption that registered a nominal increase of 8%. The major part of the final consumption consisted of personal consumption that in the third and fourth quarter of the year particularly, registered high nominal growth rates. In the absence of complete statistical data, the assessment of the increase in the personal consumption was derived from the movement of certain indicative variables. Thus, the high annual increase in the scope of the retail trading (by 17%) and increased import of consumer goods (by 23% in conditions of a reduced domestic production of consumer goods), indicated an increase in personal consumption. In accordance with such developments, the level of revenues from VAT in the state budget in 2007 was higher by 21% compared with 2006.

Figure 15  
Indicators for personal consumption



Source: State Statistical Office of the Republic of Macedonia and Ministry of Finance of the Republic of Macedonia.



The trend of increase in the personal consumption corresponded with the increase in the components of the available household income<sup>15</sup>, with the increased optimism of the consumers and with the favorable conditions for crediting. Thus, from the beginning of 2007, the increased card operations and more relaxed crediting conditions led to a significant increase in the retail consumer loans<sup>16</sup> (of 56%), by which the banking system significantly supported personal consumption. Therefore, the increase in the wages in the economy (annual increase in the net wage bill by around 9%) and the announced gradual increase in the wages of the public administration (starting from October 2007 until 2009, 10% each year) and in the pensions (in January 2008, of 15% on average) contributed to positive expectations by the households regarding the movements of the future income. Thus, having in mind the presented expectations for the personal income and at the same time, if the trend of an intensive credit support is retained, it may be expected that the personal consumption will be further stimulated. Simultaneously, a significant component of the available household income are private transfers, that in 2007, apart from the slowed down pace of growth, were higher by around 7% compared with the previous year.

In conditions of a more emphasized increase in the inflows in the state budget, relaxation in the public consumption was registered starting from the second half of 2007.<sup>17</sup> The increase in the public consumption reflected to a great extent the increase in the wages in the public administration (by 10% in October 2007) and higher spending for goods and services in the last quarter of the year.

In the last two quarters of 2007, in parallel with the increase in the personal and public consumption, there was intensification in the investment consumption as well. Thus, gross investments were growing at rates of 24% and 52% in the third and fourth quarter of the year, whereas the annual increase was 21% (nominal growth). Such pace was in accordance with the pace of investments in machines and equipment that in the third quarter of the year (the last available data) registered an annual increase of 38%<sup>18</sup>. This had a favorable reflection on the domestic production of capital goods, too, that was increased by around 8% in 2007 relative to 2006, and at the same time an increase was registered in the “construction” sector (5.8%).

The increased investment consumption and, on that basis, the increased demand for capital, was supported by the banking system, that in 2007 increased the amount of approved long-term loans to enterprises by significant 44% (as opposed to the increase of 35% in 2006). In addition to the investments in the private sector, one part of the increased investment consumption reflected the government investments directed towards construction of capital facilities and procurement of fixed assets. Namely, the funds transferred from the government budget for construction of residential and sports facilities and procurement of buses in the last quarter of the year resulted in the government capital expenditures exceeding three times the level of the same quarter from the previous year, a signal of a more intensive investment activity in 2008. On an annual basis, the level of capital government expenditures was higher by 48%.

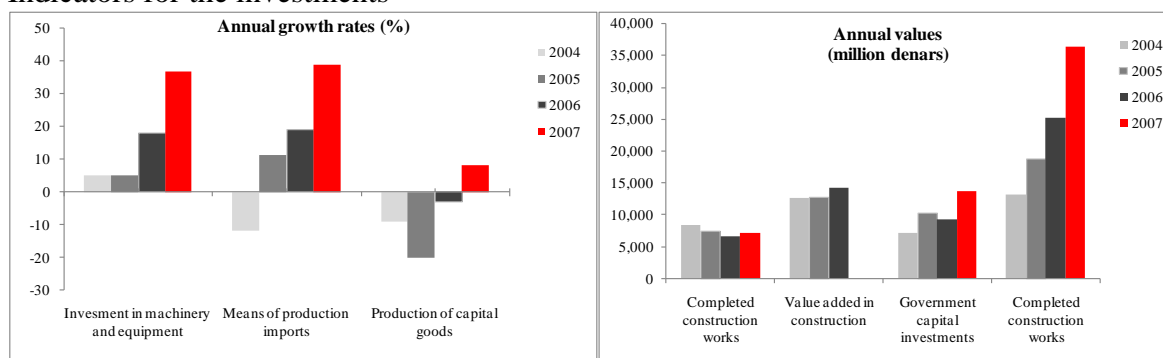
<sup>15</sup> In the absence of official data, NBRM carried out activities for calculation of the available household income. In the absence of the necessary official data, final calculations for 2006 and 2007 have not been made yet, and in the period 2000-2005 the available household income registered a constant trend of increase.

<sup>16</sup> Consumer loans comprise overall loans extended to the private persons excluding mortgage loans.

<sup>17</sup> On the basis of the published data on public consumption in the first three quarters and assessment for the last quarter, it is estimated that the annual increase in the public consumption in 2007 is around 10% (as opposed to 7% in 2006).

<sup>18</sup> On the basis of the published data on investment in machines and equipment in the first three quarters and assessment for the last quarter, it is assessed that the annual growth of this component in 2007 is around 39%.

Figure 16  
Indicators for the investments



Source: State Statistical Office of the Republic of Macedonia.

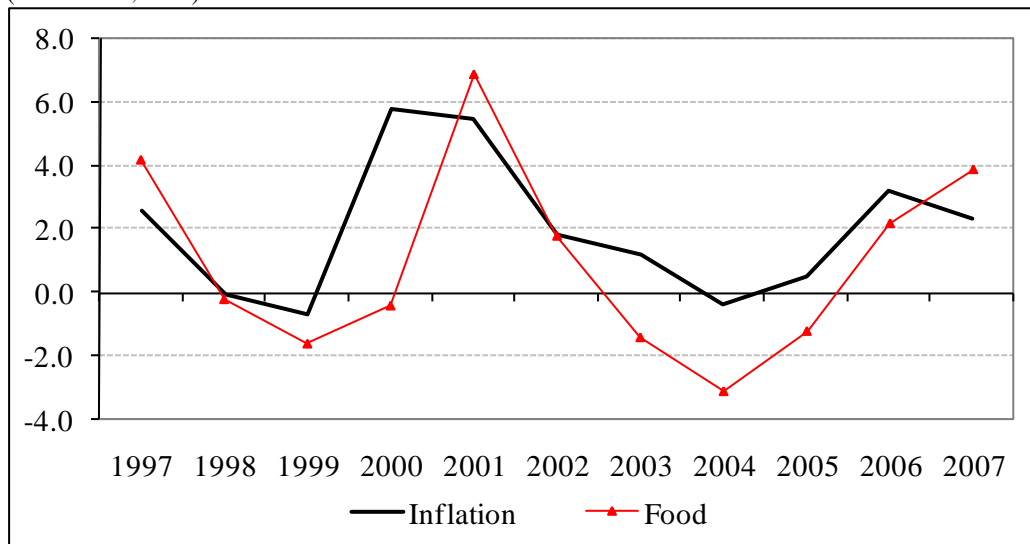
On the basis of the movements of certain expenditure components of GDP, it may be concluded that the intensification of the domestic consumption resulted both from the increased final consumption and from the intensified investment activity. In conditions of inability to meet its needs from the domestic production, the import was growing and trade deficit was deepening. Still, taking into consideration the significance of the investment consumption for the increase in the production capacity of the economy in the longer-run, we considered that the pressure on the import created through this channel was of a temporary character. On the other hand, careful following of the growth rate of the personal consumption is necessary, because further acceleration of the consumption growth may cause additional pressure in the price level in the economy.

## 2.2. Inflation

The inflation rate<sup>19</sup> in the Republic of Macedonia in 2007 was 2.3%, still remaining within the zone of a low and stable inflation rate conducive to a favorable macroeconomic environment. Unfavorable weather conditions that contributed directly to a reduction in the domestic supply of agricultural products, global increase in the food prices in the second half of the year, as well as change in the prices of electric and thermal energy were the main factors for the inflation developments in our country. If the influence of these factors on the official inflation is excluded, the inflation will be much lower, that indicates absence of factors of a monetary nature that affect inflation. Observed from a dynamic viewpoint, the intensification of the inflation started in August 2007, which is similar to the development of the inflation in the countries of the Euro-zone, indicating to a presence of factors of a global character. Notwithstanding the increase in the food prices by the end of the year, the average inflation rate in 2007 was lower by 0.9 percentage points compared with the previous year.

<sup>19</sup> A measure for the inflation is the consumer price index. Starting from January 2007, this index is calculated on the basis of the weights derived from the Survey on Household Consumption in 2005. At the same time, changes in the index structure were made in 2007 from the aspect of the main categories by adding two new items "restaurants and hotels" and "other services" that participate with 5.2% in the index. On the expense of that, more emphasized reduction of the participation was registered in the categories: "food", "tobacco and beverages", "clothes and footwear" and "means of transport and transport services". The calculations of the inflation rate on quarterly basis were made in NBRM, on the basis of data from the State Statistical Office.

Figure 17  
Development of the inflation and costs for food  
(annual rates, in %)

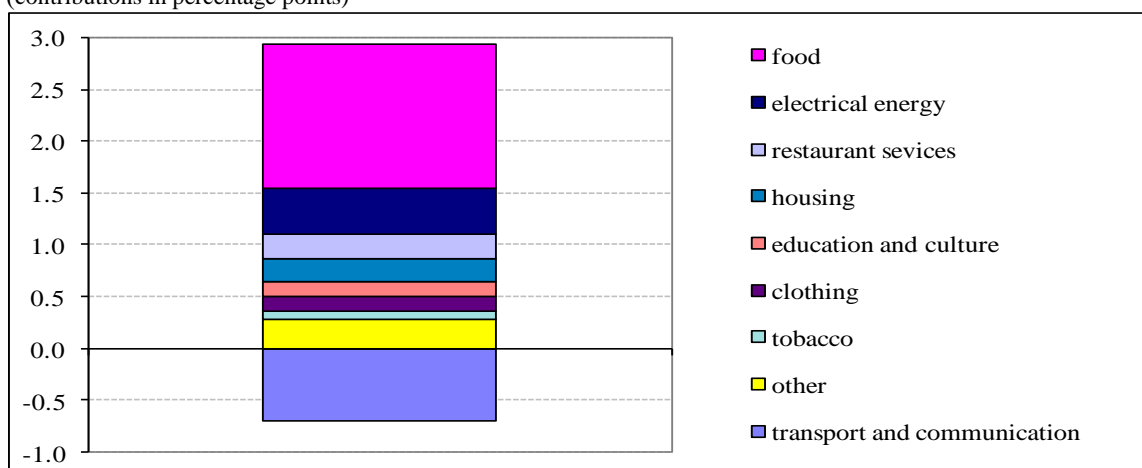


Source: State Statistical Office of the Republic of Macedonia.

The analysis of the structure of the inflation index indicates registered price increase in all main categories within the index, except for the prices of the telecommunication services that had a significant deflationary influence, due to the increased competition in this sector.

The higher food prices had the greatest contribution (1.4 percentage points) to the annual increase in the consumption prices, mainly caused by the unfavorable weather conditions (drought) in our country and beyond, but also by the increased export demand, that led to a reduced domestic supply of agricultural products. Likewise, a significant increase in the prices of certain agricultural inputs such as seed material, energy and fodder was registered in 2007. An additional factor for the increase in the domestic food prices was the global trend of increase in these goods, due to the increased global demand for certain agricultural crops used for production of biofuels that was transferred to our economy through the import of food products.

Figure 18  
Contribution of certain categories of inflation index to the average inflation rate in 2007  
(contributions in percentage points)



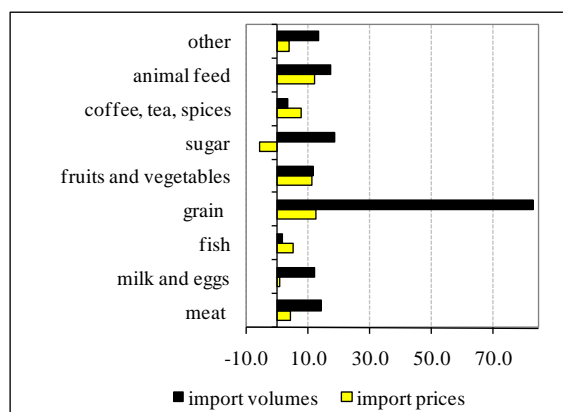
Source: State Statistical Office of the Republic of Macedonia.

The higher food prices resulted from the combined influence of the higher import prices and reduced domestic supply of foodstuffs, conditioned by the unfavorable weather conditions in

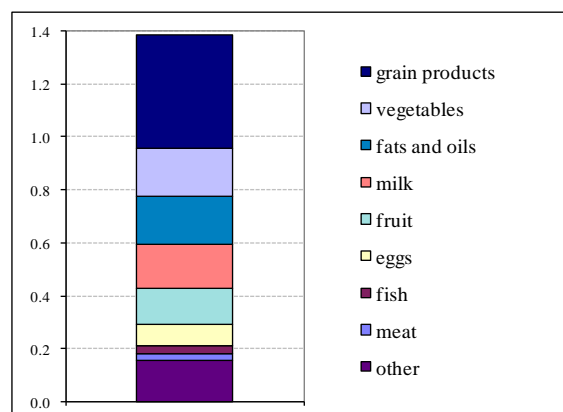
the country, but also by the increased export demand for certain categories of products (mainly vegetable and fruit). The unfavorable effect of the dry period, that led to a reduced domestic supply of certain agricultural products (mainly grain crops), as well as the need to supplement the insufficient domestic supply in conditions of increased export, led to an increase in the import of these products in 2007. The increased import, in conditions of a greater global demand and global increase in the food prices, led to an annual rise in the import prices of certain food products, most of all of grain, fruit and vegetable, meat and dairy products. The increased import of the above-mentioned products led to a high transferable effect on the domestic prices of the food products and caused the greatest inflationary pressures.

Figure 19

Annual change of the import prices and the imported quantity of the food products (in %)



Contribution of certain categories of food to the average inflation rate (contributions in percentage points)



Source: State Statistical Office of the Republic of Macedonia.

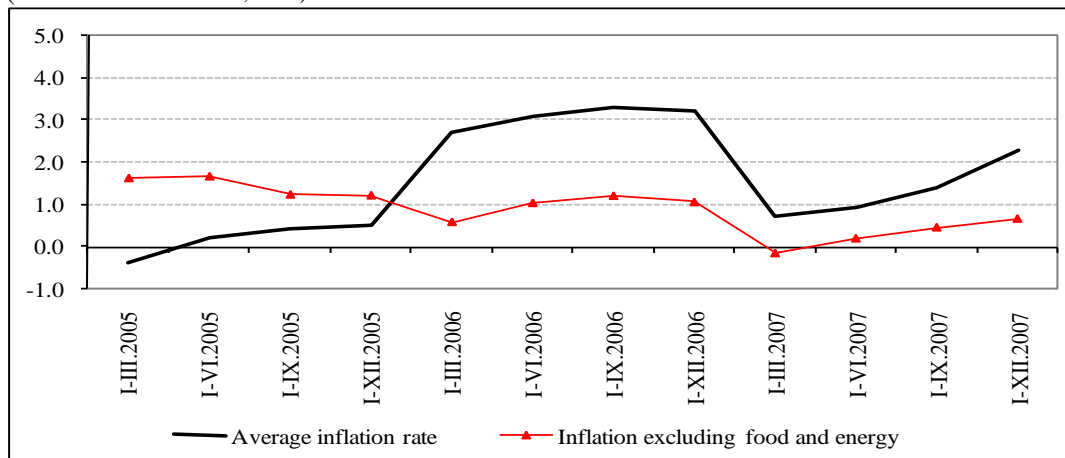
In accordance with such developments, the analysis of certain categories of food indicated increased costs in all sub-categories, the greatest contribution of which has the increase in the prices of the grain products (increase in the prices of the bread and pastry) and fresh vegetable. Likewise, within this category, a significant increase was registered in the prices of vegetable oils (increase in the price of the cooking oil), fresh and sour milk, as well as fresh fruit.

In addition by the increase in the food prices, the inflation in 2007 was significantly affected by the changes in the regulated prices of the electric and thermal energy that contributed with 0.5 percentage points. The increase in the price of the water supply of the households in the capital city, the higher prices of food and beverages in the restaurants and the effect of the increased excise rates for the tobacco<sup>20</sup>, connected with the implementation of the EU Directives in the tax area, constituted the remaining part that contributed to the increase in the inflation.

Considering the fact that the most significant determinant of the average inflation rate in 2007 were the prices of food and energy, the basic inflation rate (that does not take into consideration their influence) in 2007 was exceptionally low and amounted to 0.7%. Still, attention should be paid to the gradual upward movement of the basic inflation during the year, being 1.2 % annually in December, as opposed to 0.5% annually in June, which indicated a presence of other inflation factors as well.

<sup>20</sup> The excise was increased by 10% since the beginning of the year, but it had only partial and a little bit belated influence on the retail prices of the tobacco.

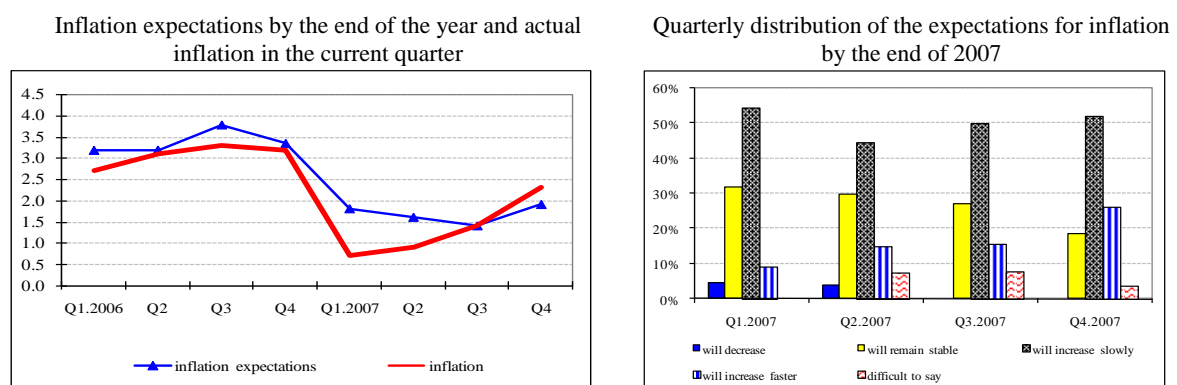
Figure 20  
Official and basic inflation rate  
(cumulative annual rates, in %)



Source: SSO and calculations of NBRM. In 2006 the effect of the increase of the excise on cigarettes is excluded.

The realized annual inflation rate of 2.3% in 2007 was within the frames of the initial projection of the inflation of 3%. The main reason for deviation from the initial projection of the inflation was the fact that the assumption regarding the effect of the increase in the excise rate of the tobacco was not realized. It was increased by 10% since the beginning of the year, but it affected the retail tobacco prices only partially and with a certain time lag (which is different compared with 2006, when this effect was much more pronounced). At the same time, there was a lower price effect than the expected within the initial projection also in the case of the prices of electric energy, central heating and fuels, which was significantly neutralized by the higher price effect of the food and water. The movement of the inflation in 2007 coincided approximately with the inflationary expectations of the economic entities in the country. Thus, the analysis of the expectations of the economic entities for the pace of the inflation in 2007 showed within the quarterly surveys, dominance of the percentage of entities that expected an increase in the inflation at a moderate and slower intensity. There was a lower percentage of surveyed entities that had stable inflationary expectations and their share had a downward trend, due to the intensification of the prices by the end of the year.<sup>21</sup>

Figure 21  
Results of the Survey on Inflation Expectations



Source: Survey on Inflation Expectations and calculations of NBRM.

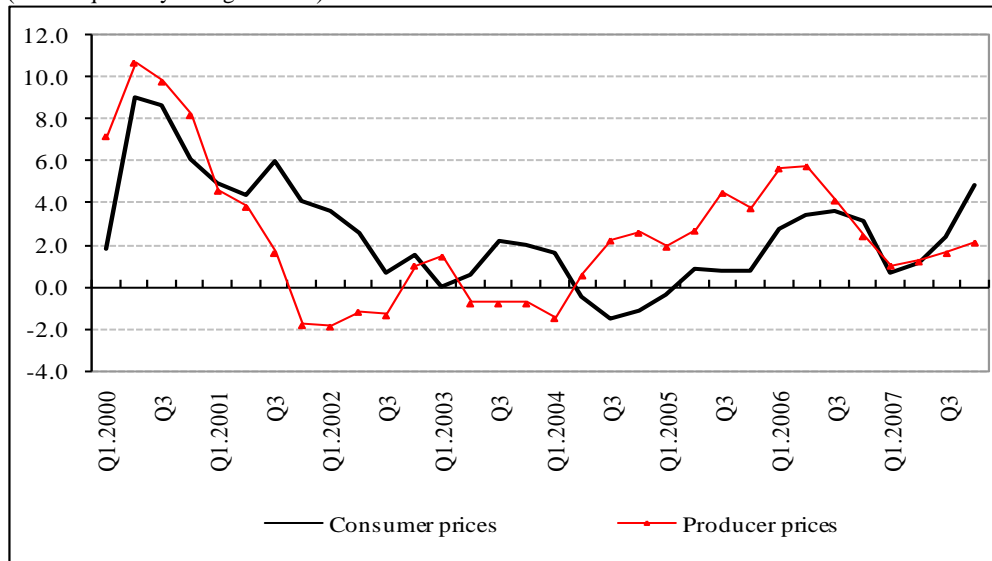
In parallel with the increase in the level of the prices of products and services for personal consumption, an increase in the prices of the producers of industrial products was also registered. Thus, after the average annual increase of 4.5% in 2006, production prices during 2007 were more

<sup>21</sup> The data on the inflation expectations are according to the results of the Survey on the Inflation Expectations of the Entities in Macedonia, conducted quarterly by NBRM.

stable and registered a moderate growth rate of 1.6% that derived from the increased prices in the produced electric energy and food products and beverages. The prices of oil derivate producers had the most significant deflationary influence.

Figure 22

Consumer price index and prices of the producers of industrial products  
(annual quarterly changes in %)

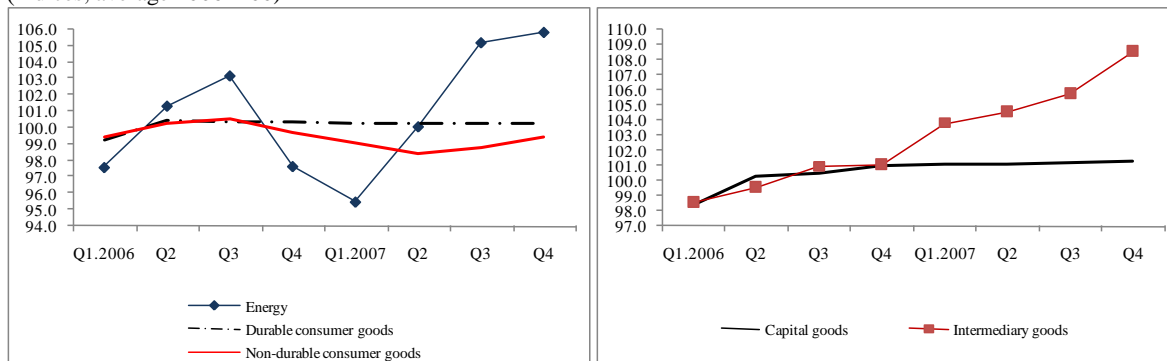


Source: State Statistical Office of the Republic of Macedonia.

Observed from the viewpoint of their influence on the domestic component of the consumer prices, a significant increase in the prices of energy and intermediary products was present, whereas the prices of the consumer goods were at a lower level relative to the previous year. Consequently, the energy prices had inflationary influences, being an integral part of the household consumption that referred at the same time, to possible inflationary pressures on the inflation on the basis of the transferred (indirect) effect from the change in the production prices of the energy.

Figure 23

Movement of the domestic producers' prices  
(indices, average 2006=100)



Source: State Statistical Office of the Republic of Macedonia and calculations of NBRM.

In 2007, the actual inflation rate in our country was the second lowest compared with the countries from South-eastern Europe. A lower inflation rate was registered only in Bosnia and Herzegovina (1.5%). The highest inflation rate was registered in Bulgaria, being continuously at a relatively higher level since 2004, while in 2007 the inflation in Bulgaria involved the strong effect from the increase in the food prices. The trend of a significant reduction in the inflation in Romania

continued in 2007, when it was reduced to 4.9% (lower by 1.7 percentage points with respect to the actual inflation in 2006). Similar trend was followed by Serbia as well, that managed to reach a one-digit inflation in 2007. A stable and low inflation rate was constantly registered in the Euro-zone countries that amounted to 2.1% in 2007, whereas the average inflation rate in the South-east European countries was twice as high and amounted to 4.2%. The inflation in the South-east European countries was reduced by 1.3 percentage points compared with 2006, as a result of the maintenance of an appropriate monetary and fiscal policy.

Table 5  
Inflation in the Euro-zone and in the countries of South-eastern Europe  
(in %)

	Inflation (average annual changes)					
	2002	2003	2004	2005	2006	2007
<i>Eurozone</i>	2.3	2.1	2.1	2.2	2.2	2.1
<i>South East Europe</i>	8.8	5.2	4.4	5.4	5.5	4.2
Albania	1.7	3.3	2.2	2.0	2.5	3.1
Bosnia and Herzegovina	1.0	0.6	0.4	3.8	6.1	1.5
Bulgaria	5.8	2.3	6.1	6.0	7.4	7.6
Montenegro	16.4	6.8	2.2	2.4	2.9	4.2
Croatia	1.7	1.8	2.1	3.3	3.2	2.9
Macedonia	1.8	1.2	-0.4	0.5	3.2	2.3
Romania	22.5	15.3	11.9	9.0	6.6	4.9
Serbia	19.5	10.0	11.0	16.1	11.8	6.8

Source: EUROSTAT and national statistical offices.

## Annex 2

### Price Convergence process and its effect on the inflation

Survey on the prices of food, beverages and tobacco was conducted by EUROSTAT in 2006, within the European Comparison Program, covering 37 countries: 27 EU member states, 3 EFTA member states (Island, Norway and Switzerland) and 3 EU candidate countries (Macedonia, Croatia and Turkey), as well as Albania, Bosnia and Herzegovina, Montenegro and Serbia. The Survey covered around 500 products, grouped in four groups-food, non-alcoholic beverages, alcohol and tobacco.

According to the results of the above-mentioned Survey, the greatest variations in the 37 countries were registered concerning the prices of cigarettes and alcohol which was due to the notable differences in the national regulations on these products, excises and other taxes, while there were smaller variations in the prices of food and non-alcoholic beverages. In the 27 EU members states a reduction in the prices of all four groups of products was registered, relative to 2003, which was an indicator of the convergence of the prices within EU. The convergence was mostly emphasized as far as food prices were concerned and least emphasized in the case of the prices of tobacco products.

Table 6  
Ratios of variations in the price indices

	Coefficient of variation, all countries		Coefficient of variation, EU27, 2003	Coefficient of variation, EU27, 2006	Percentage change, 2006/2003
Total	32.2				
Food	29.9	Food	29.2	24.3	-16.80%
Non-alcoholic beverages	25.9	Non-alcoholic beverages	25.3	22.7	-10.20%
Alcoholic beverages	37.8	Alcoholic beverages	32.6	28.1	-13.50%
Tobacco	61.1	Tobacco	54.1	50.4	-6.80%

Source: EUROSTAT.

Out of all 37 European countries, Macedonia had the lowest total index for the mentioned prices (of food, beverages and tobacco), resulting from the lowest level of prices in three out of the four groups—food, non-alcoholic beverages and alcoholic beverages. Thus, the level of food prices in Macedonia was around a half from the EU average (EU-27), the prices of the beverages were around one third of the EU level, while the level of prices of tobacco products was even lower.

Although the prices in the other countries from the region—Serbia, Bosnia and Herzegovina, Montenegro and Albania were also among the lowest in Europe, they were, however, significantly higher than the ones in Macedonia. Thus, as a comparison, the food prices in these countries were higher by one fifth to one third. The only group of products that were not the cheapest in Macedonia were the cigarettes and their price was almost the same as in Albania and Bosnia and Herzegovina, and more expensive compared with Montenegro and Serbia. Bulgaria had insignificantly higher prices than Macedonia, except for the tobacco products that were more expensive in Bulgaria by more than a half. The prices in the other two candidate countries for EU membership, Croatia and Turkey were much closer to the ones in the EU with an average level of the overall prices that was by only 10% under the average of the EU, and as much as 60% above the average level in Macedonia. The non-alcoholic and alcoholic beverages in Croatia and Turkey were even more expensive than the EU average.

Table 7  
Comparative indices of the price levels, 2006

	EU	MKD	BUL	SER	ALB	BIH	MNE	CRO	TUR
Total	100	53	56	62	68	65	67	87	85
Food	100	55	55	67	70	70	74	87	82
Non-alcoholic beverages	100	67	73	72	98	89	77	107	101
Alcoholic beverages	100	65	69	73	96	78	76	113	176
Tobacco	100	31	51	26	33	32	24	65	56

Source: EUROSTAT.

The occurrence of the more intensified inflationary pressures since the beginning of the last quarter of 2007 imposed the question of whether the Republic of Macedonia should intensify the process of price convergence towards the European Union. The analyses made by NBRM for 2007 were based on calculation of the Purchasing Power Parity (PPP) of the domestic currency regarding the prices of all categories of products in the inflation index, but only relative to three EU member states—its significant trade partners: Germany, Italy and Slovenia. According to the results, despite the notable price convergence in certain categories of products and services, national price level was still lower than the price level in the three mentioned countries, in an interval from 29% to



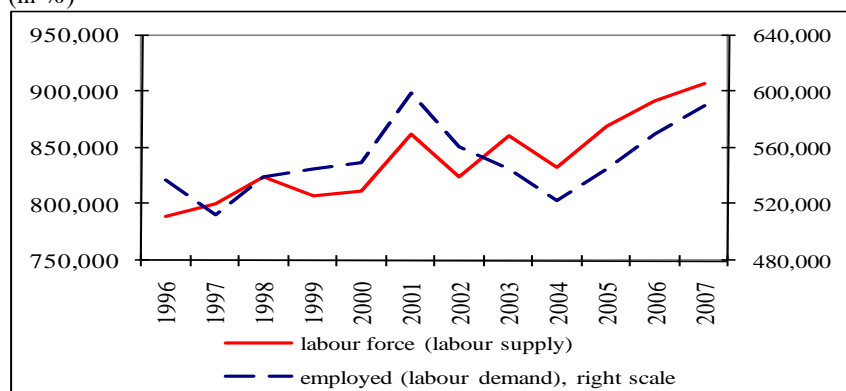
40% compared with individual countries. When making a comparison of the pace of the price convergence, it may be concluded that the national price level approximated the price level in Slovenia, Italy and Germany from 2 to 6 percentage points in 2006, whereas in 2007 from 2 to 4 percentage points relative to the above-mentioned countries. In this context, it should be emphasized that the process of price convergence in 2007 was not intensified, explained by the fact that the inflation in the Republic of Macedonia was intensified in the last months of 2007, at the same time when intensification of the inflation was registered in the foreign countries with which the comparison was made. At the same time, in the domestic inflation index during the year, reduction in the prices of some categories of products and services was registered, thus mitigating the convergence towards the foreign prices.

Within the frames of individual categories of products and services, a more significant convergence of the prices of oil and fats was registered (with respect to the prices in Italy), vegetable (towards the three countries), fruit (towards the prices in Germany and Italy), heating and lightning (towards the prices in Germany and Italy) and car spare parts (towards the three countries). Still, in spite of the reduced price difference in case of the most products, the prices of the products and services in the Republic of Macedonia were still lower than the prices in the analyzed countries from the EU. For instance, in spite of the increased vegetable prices, the average price in the Republic of Macedonia was by 42% lower than the average price of vegetable in Germany and Italy and by 29% lower relative to Slovenia. According to the analysis, the Republic of Macedonia had almost the same price of the milk, dairy products and eggs, alcoholic beverages, household appliances and to a certain extent, cars, as the afore mentioned countries.. On the other hand, the prices of the IT equipment and telecommunication services in 2007 were lower in the Republic of Macedonia compared with the other countries.

### 2.3. Labor market and wages

The accelerated economic growth in 2007 led to an improvement of the situation of the labor market, that is, increase in the demand for labor force and increase in the number of employees. The increased number of employments led to unemployment reduction and, in conditions of minimum increase in the total working age population, to a lower unemployment rate. Still, such developments did not cause changes in the structure of the unemployment in which the long-term unemployment remained to be dominant.

Figure 24  
Labor market  
(in %)



Source: State Statistical Office of the Republic of Macedonia, Labor Force Survey, according to the definition of the International Labor Organization of the labor force (or economically active population).

In 2007, the demand for the labor force was mainly directed to the service sector, above all, to the activities that had the highest contribution to the creation of the value added in 2007. Thus,

the registered increase in the employment was 13.6% in the trade, 18.2% in communications and 27.7% in the financial intermediation. The increased number of persons employed in these industries was partially a reflection of the foreign direct investment in these industries and consequently, opening of new jobs. Simultaneously, the restarting of several mining capacities in the course of 2007 caused an intensive increase in the employment in the mining sector (32%). The employment in the manufacturing industry, as an industry with the most significant share in the total employment, registered a moderate increase of 2.5%, whereas a reduced number of employees in 2007 was registered in agriculture and construction sector.

Figure 25  
Employment by sector  
(number of employees)

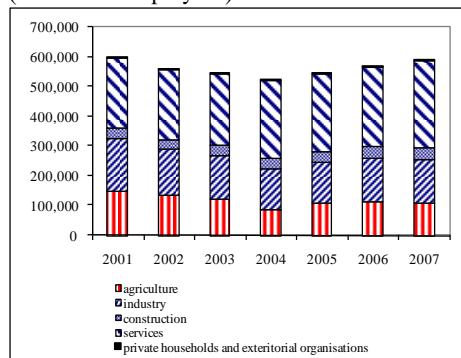
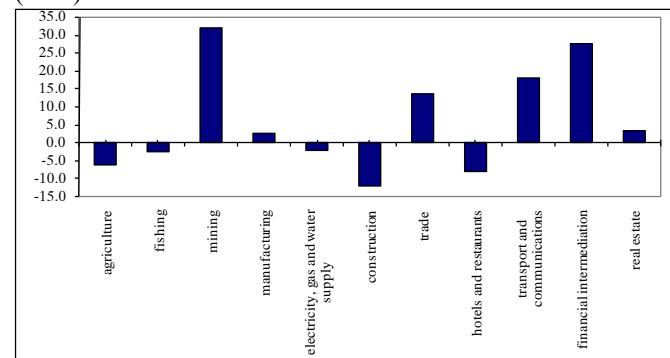


Figure 26  
Rates of increase of the employees by sector  
(in %)



Source: State Statistical Office of the Republic of Macedonia, Labor Force Survey.

Notwithstanding the positive short-term shifts on the labor market, changes could not be registered in the structure of the unemployment from the aspect of its duration. The major part of the unemployment was still of a long-term character, that is, the major part of the persons were unemployed for more than a year (around 85% in the period from 2000 to 2006). The short-term unemployment (persons unemployed up to a year) participated only with around 15% in the overall number of unemployed. In 2007, the number of persons unemployed up to a year was reduced by 14%, whereas the unemployment in the group over a year only by 2.8%<sup>22</sup>.

Figure 27  
Structure of unemployment from the aspect of duration  
(in %)

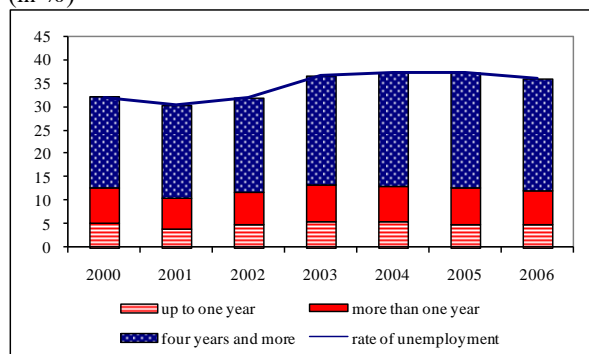
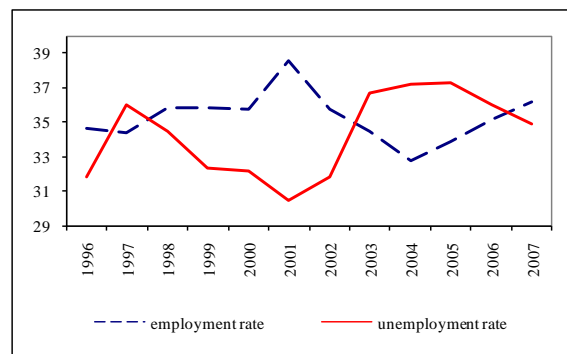


Figure 28  
Employment rate and unemployment rate  
(in %)



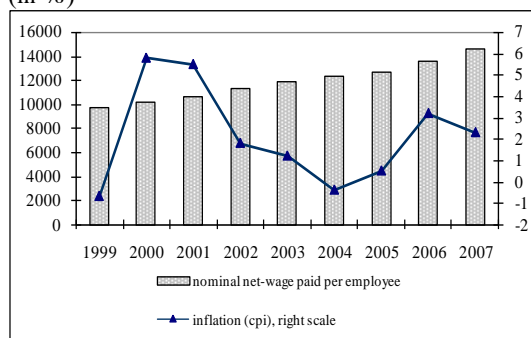
Source: State Statistical Office of the Republic of Macedonia, Labor Force Survey.

Taking into consideration such structure of unemployment, the unemployment rate in 2007 was at a relatively high level (34.9%) in 2007 as well, although compared with the previous year, it was lower by 1.1 percentage points. There was an identical increase in the employment rates as well (36.2%) in conditions of a simultaneous increase in the demand and supply of labor force. For the first time in the last four years, in 2007, employment rates exceeded unemployment rate.

<sup>22</sup> Employment Agency of the Republic of Macedonia.

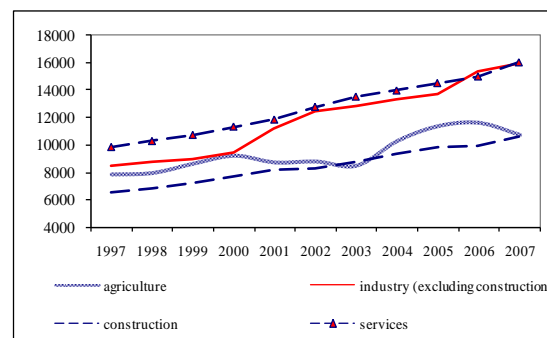
The trend of increase in the wages, as one of the main consumption factors, continued in 2007 as well. Thus, the average gross<sup>23</sup> and net wages per employee registered a nominal annual increase of 4.8% and 7.9%, respectively. Realistically, in conditions of annual inflation rate of 2.3%, the average gross and net wages were increased by 2.4% and 5.5%, respectively. Such movement of the average wages in the economy resulted mainly from the increased wages both in the private and public sector. The higher wages in the public sector reflected the process of wage decompression for the wages of the civil servants that ended in March 2007 and increase in the wages in the public administration of 10% in October 2007. Appropriately, a significant increase in the net wages was registered in the public administration and defense (7.1%), education (12.2%) and health and social work (6.4%). On the other hand, wage increase was also registered in the private sector, most intensive being in the manufacturing industry (by 9.7%), construction (6.6%), financial intermediation (6.9%) and “activities with real estate” sector (by 8.8%). During 2007, the highest increase in the wages, of almost 12%, was registered in the last quarter, when higher wages were recorded in all areas of the economy, except for the fishery.

Figure 29  
Annual nominal changes of the gross and net wages and inflation rate  
(in %)



Source: State Statistical Office of the Republic of Macedonia.

Figure 30  
Average net wage per employee, per sectors  
(in Denars)

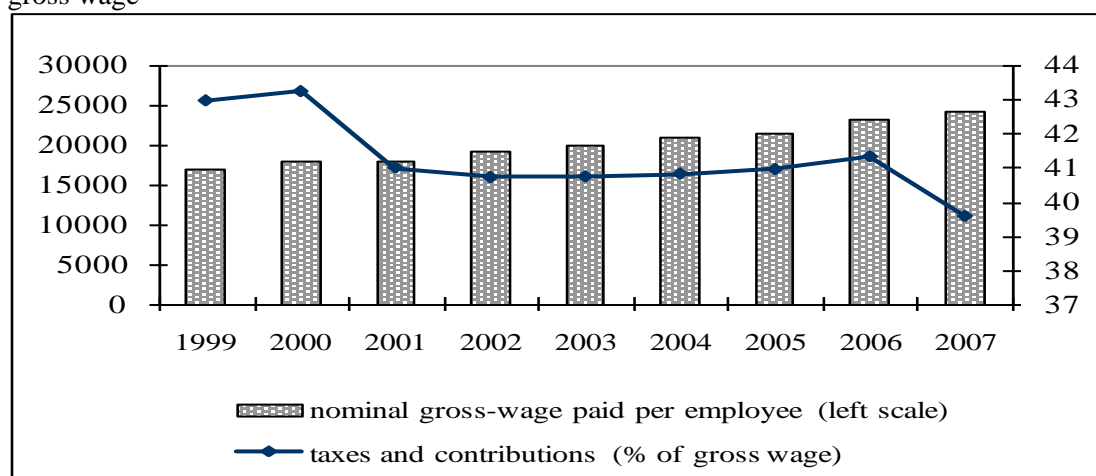


The slower nominal increase in the gross wages in 2007 relative to the increase in the net wages, was due to the changes in the tax area. At the beginning of the year, the personal income tax rate was reduced<sup>24</sup>, which led to a reduction in the share of the payroll taxes in the gross wages and narrowing of the gap between the net and gross wages by 1.7 percentage points.

<sup>23</sup> Source: State Statistical Office. Total paid gross wages include: paid net wages for the reporting month, paid personal income tax, and paid contributions (for pension and disability insurance, for health insurance, for employment, for professional illness and for water supply).

<sup>24</sup> By the end of 2006, measures were undertaken to reduce the costs for salaries in the Republic of Macedonia, so the previous personal income tax rates of 24%, 18% and 15% were equalled at 12% at the beginning of 2007, while in 2008, this rate is 10%.

Figure 31  
Nominal gross wages and share of the taxes (in percentage) in the gross wage



Source: State Statistical Office of the Republic of Macedonia.

The wages in Macedonia, in spite of the significant increase, were still among the lowest in the region. The highest net wages in 2007 were paid out in Slovenia and Croatia, whereas lower wages than the ones in Macedonia were paid out only in Bulgaria. In addition, in comparison with the other countries, a moderate increase relative to the previous year as well as still the highest taxes and contributions as a percentage of the gross salary was registered in Macedonia. Taking into consideration the significance of the taxes and fees as a cost for the employers, and consequently, as one of the basic determinant of the investments, the high charges were a potential limiting factor for the economic growth.

Table 8  
Wages per countries

		2007				
		2006	2007	annual growth rate in nominal terms, in %	annual inflation, in %*	personal tax and contributions, % of the average gross wage
<b>Macedonia</b>	average gross wage	376	395	4.9	2.3	39.6
	average net wage	221	238	7.9		
<b>Slovenia</b>	average gross wage	1213	1285	5.9	3.8	35.0
	average net wage	773	835	8.0		
<b>Croatia</b>	average gross wage	906	961	6.0	2.9	31.3
	average net wage	628	660	5.1		
<b>Bulgaria</b>	average wage	178	213	19.6	7.6	
<b>Bosnia and Herzegovina</b>	average gross wage	453	524	15.6	1.5	35.4
	average net wage	308	339	9.9		
<b>Serbia</b>	average gross wage	380	484	27.3	6.8	28.4
	average net wage	260	347	33.3		
<b>Montenegro</b>	average gross wage	433	497	14.8	4.2	32.0
	average net wage	282	338	19.9		
<b>Romania</b>	average gross wage	309	407	31.6	4.9	25.3
	average net wage	232	303	30.8		

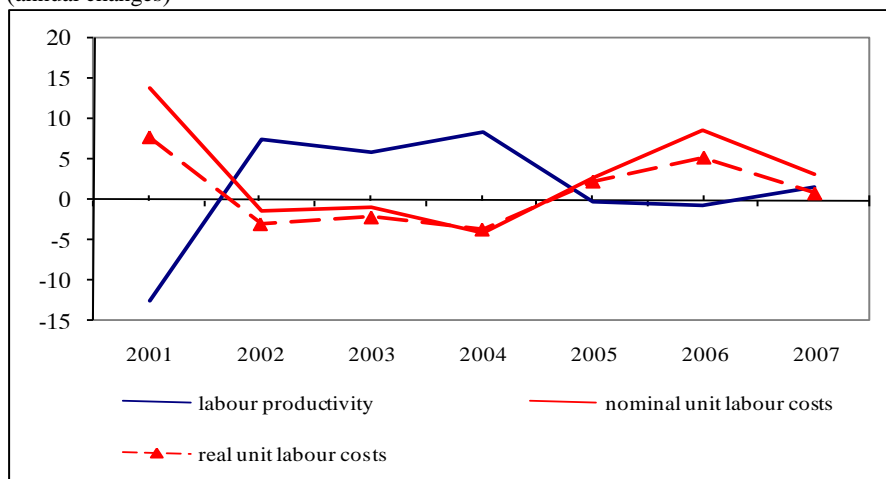
\* The official inflation in Serbia is measured according to the consumer price index.

Source: EBRD Report on the Transition in 2007, Eastern Europe Consensus Forecasts, Central Banks and Statistical Offices of the appropriate countries.

Labor productivity in 2007 was higher by 1.6%, as opposed to the two previous years when it registered a drop as a reflection of the higher increase in the employees relative to the production.

The nominal costs per labor unit, taking into consideration the increase in the average gross salaries of almost 5%, were higher by 3.2% compared to the previous year. With the effect of the inflation being isolated, the costs per labor unit registered a moderate increase of 0.9%<sup>25</sup>.

Figure 32  
Productivity and costs per labor unit  
(annual changes)



Source: State Statistical Office of the Republic of Macedonia and calculations of NBRM.

## 2.4. External sector

### 2.4.1. Balance of payments

In 2007, deficit on the current account was registered in the balance of payments which amounted to 3.1% of GDP. The realized level of deficit reflected the deepening in the negative trade balance and the lower dynamics of growth in the private transfers, as dominant factors. The development in the other components was divergent. In the income, in accordance with the higher foreign investments, higher net outflows were registered, with positive developments in the sub-balance of services. In 2007, in the capital and financial account of the balance of payments net inflows of capital were registered, mainly as a result of non-debit financing (foreign direct and portfolio investments), despite the realized net outflows based on early repayments of a considerable share of the external public debt.

<sup>25</sup> The productivity and the unit labor costs for the whole economy are calculated on the basis of data on GDP, for the total number of employees according to the Labor Force Survey of the State Statistical Office and according to the data on the average gross wages.

Table 9  
Balance of payments of the Republic of Macedonia /1  
(in millions of euros)

	2003	2004	2005	2006	2007
<b>Current Account</b>	<b>-168.2</b>	<b>-362.7</b>	<b>-121.3</b>	<b>-44.9</b>	<b>-170.9</b>
<b>Goods, net</b>	<b>-753.0</b>	<b>-914.3</b>	<b>-858.5</b>	<b>-1,020.4</b>	<b>-1,172.8</b>
Exports, f.o.b.	1,203.2	1,345.0	1,642.9	1,902.6	2,441.5
Imports, f.o.b. /2	-1,956.2	-2,259.3	-2,501.4	-2,923.1	-3,614.3
<b>Services, net</b>	<b>-6.0</b>	<b>-43.4</b>	<b>-24.7</b>	<b>22.2</b>	<b>25.5</b>
<b>Income, net</b>	<b>-55.3</b>	<b>-33.2</b>	<b>-91.5</b>	<b>-28.4</b>	<b>-33.4</b>
o/w: interest, net	-27.7	-20.8	-20.7	-19.4	-17.9
<b>Current transfers, net</b>	<b>646.1</b>	<b>628.2</b>	<b>853.3</b>	<b>981.8</b>	<b>1,009.8</b>
Official	89.4	55.5	53.4	58.7	23.9
Private	556.7	572.7	799.9	923.1	985.8
<b>Capital and Financial Account</b>	<b>193.9</b>	<b>347.1</b>	<b>127.7</b>	<b>38.0</b>	<b>194.3</b>
<b>Capital and Financial Account without official reserves</b>	<b>232.5</b>	<b>363.0</b>	<b>475.6</b>	<b>335.6</b>	<b>296.0</b>
<b>Capital account, net</b>	<b>-5.8</b>	<b>-3.8</b>	<b>-1.7</b>	<b>-0.8</b>	<b>1.3</b>
Capital transfers, net	-5.8	-3.8	-1.7	-0.8	-1.1
Official	0.0	0.0	0.0	0.0	0.0
Other	-5.8	-3.8	-1.7	-0.8	-1.1
Acquisition/disposal of non-produced, non-financial assets	-0.1	0.0	0.0	0.0	2.4
<b>Financial account, net</b>	<b>199.7</b>	<b>350.9</b>	<b>129.4</b>	<b>38.8</b>	<b>192.9</b>
Direct investment, net	100.1	259.7	74.9	344.6	240.1
Portfolio investment, net	4.9	9.5	200.2	73.1	110.8
Other investment, net	133.3	97.6	202.2	-81.4	-56.3
Trade credits, net	67.4	71.0	105.9	2.9	-33.5
Loans, net	50.3	6.1	100.2	-22.3	-107.7
Currency and deposits, net	5.9	-2.3	-20.3	-83.7	5.9
o/w: Monetary Authorities, net	15.5	23.2	0.0	-5.7	-0.2
o/w: Commercial Banks, net	-44.7	-84.4	22.4	-10.4	68.4
o/w: Individuals, net	35.1	58.9	-42.7	-67.6	-62.3
Other, net	9.8	22.8	16.5	21.7	78.9
<b>Gross official reserves (- = increase)</b>	<b>-38.6</b>	<b>-15.9</b>	<b>-347.9</b>	<b>-297.6</b>	<b>-101.8</b>
<b>III. Errors and Omissions</b>	<b>-25.7</b>	<b>15.6</b>	<b>-6.4</b>	<b>6.9</b>	<b>-23.4</b>

1/ Preliminary data.

2/ Import is presented on f.o.b. parity in accordance with the fifth edition of the IMF's Balance of Payments Manual; the factor c.i.f. - f.o.b. equals 4.06%; for 2006 adjustment in the period of recording was made for the import of electricity.

3/ In 2005 with the inflows from the Eurobonds.

4/ Overdue liabilities.

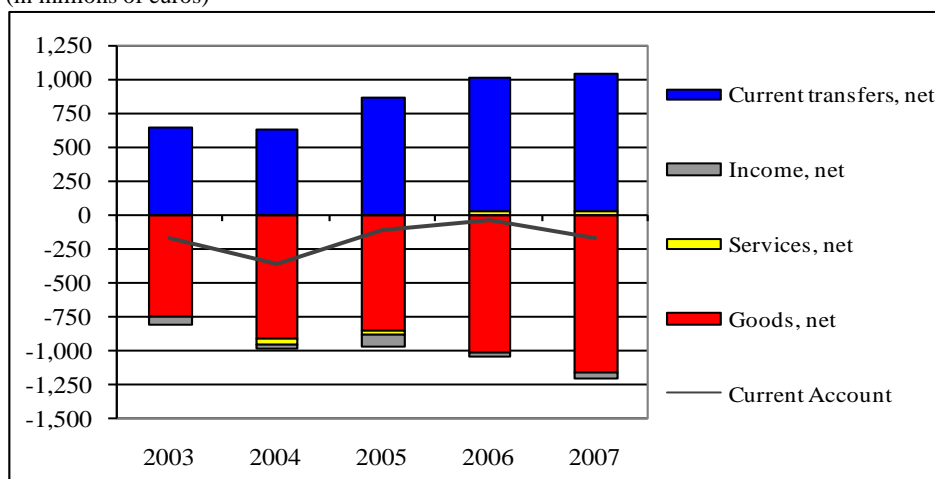
5/ Excluding monetary gold and foreign exchange differentials.

Source: National Bank of the Republic of Macedonia.

In 2007, on the *current account* of the balance of payments, deficit in amount of Euro 170.9 million was realized, or 3.1% of GDP, which compared to 2006 represented worsening by 2.2 percentage points. The analysis of the components of the current account showed that the higher trade deficit and the lower annual growth in the private transfers were the basic factors for the registered developments. The worsening in the terms of trade<sup>26</sup> in the second half of 2007, in conditions of high import and energy dependence of the Macedonian economy, negatively influenced the balance in the foreign trade, whereas the lower upward trend in the transfers, to certain extent, reflected the uncertainty of the current political developments in the region.

<sup>26</sup> Terms of trade represent correlation between the export and import prices.

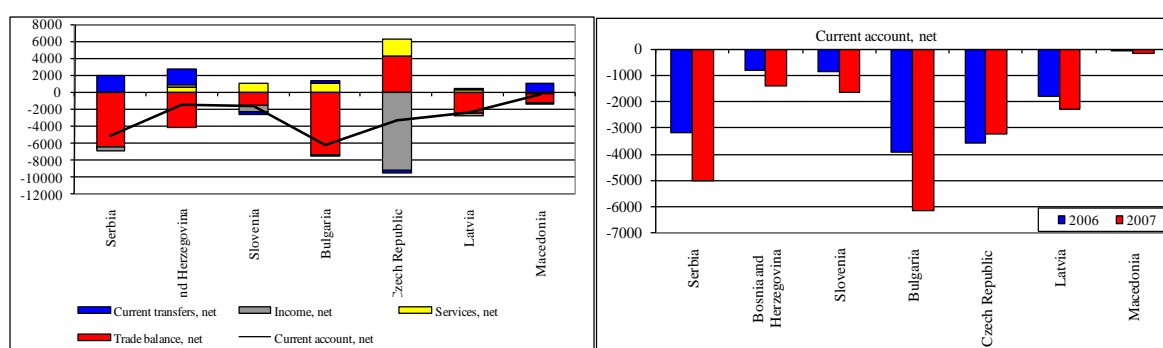
Figure 33  
Dynamics of the balance and components of the current account of the balance of payments of the Republic of Macedonia  
(in millions of euros)



Source: National Bank of the Republic of Macedonia.

The comparison analysis of the current accounts of the balances of payments by individual countries in transition showed deepening in the negative balances in all countries on annual basis, except for the Czech Republic. Macedonia realized lowest deficit on the current account (3.1% of GDP) among the analyzed countries in 2007, whereas Bulgaria registered highest deficit which reached up to 21.6% of GDP. Concerning the integral components, all countries (excluding the Czech Republic) registered dominant negative trade balance, from which mainly resulted the deficit in the trade balance. Financing of the trade deficit in the less developed countries (Macedonia, Serbia and Bosnia and Herzegovina) was performed mainly with the high inflows from private transfers, whereas in the more developed economies, with the high inflows from services. In the Czech Republic the registered deficit was mainly due to the high net outflows of income, mainly based on direct and portfolio investments.

Figure 34  
Dynamics of the balance and components of the current account of individual countries in 2007  
(in millions of euros)



Source: Web sites of central banks of individual countries.

#### 2.4.1.1. Foreign trade

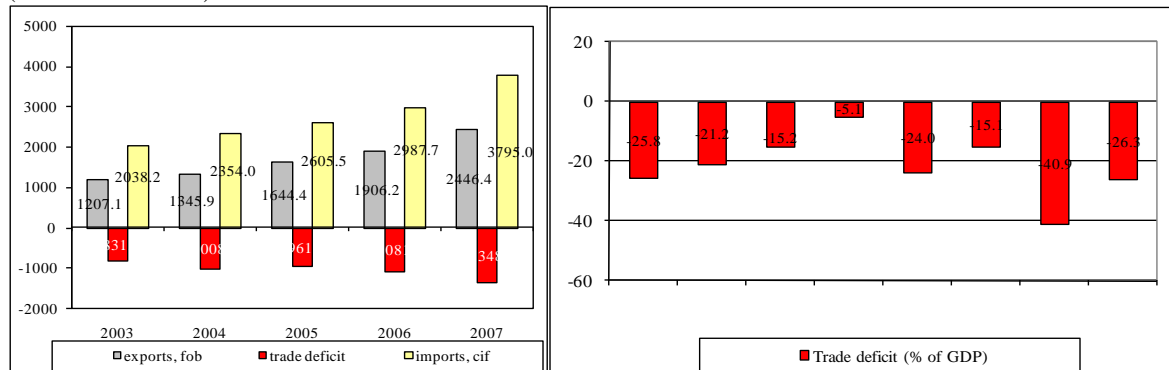
In 2007, the overall foreign trade<sup>27</sup> in the Republic of Macedonia registered increase of 27.5%, in conditions of growth in the supply of goods for export (of 28.3%) and simultaneously,

<sup>27</sup> Source: Preliminary data of the State Statistical Office. The export of goods is presented on f.o.b. basis, while the import of goods on c.i.f. basis. Export and import are different from the amounts in the balance of payments due to methodological reasons (the adjustment

growth in the domestic demand for import goods (of 27%), part of which represented basic raw materials for further production and export activity. Thus, the export and import jointly exceeded the GDP by 12.6%, relative to the previous year, when they created 96.3% of GDP, which represented considerable increase in the level of openness of the domestic economy.

Figure 35

Export, import, and trade deficit of the Republic of Macedonia and trade deficit by countries  
(in millions of euros)



Source: NBRM and NBRM calculations based on the data from the web sites of the central banks of individual countries (Bulgaria, Slovenia, Serbia, Lithuania, Bosnia and Herzegovina and Latvia); IMF, International Financial Statistics, March 2008 (Romania), on the export and import of goods; EBRD transition report for 2007 for GDP (projection).

In 2007, the more intensive growth in the import than in the export of goods, in absolute amount, resulted in historical lowest level of the deficit in the foreign trade in the Republic of Macedonia, which registered increase by 24.7% relative to the previous year, when the higher deficit in the trade of machines and transport devices and mineral fuels and lubricants<sup>28</sup> gave the largest contribution (in 2007 the participation of the deficit in the trade of this groups of products in GDP equaled 11.5% and 10.6%, respectively, relative to the participations of 9% and 8.4% in 2006). Simultaneously, the export-import coverage ratio of 64.5% was higher by 0.7 percentage points, relative to 2006. The comparison analysis of the balance of payments of individual transition economies based on the participations of the trade deficit in the gross domestic product (GDP) of the respective countries showed that Macedonia registered higher participation than Slovenia, Lithuania and Romania, and lower than Serbia, Bulgaria, Latvia and Bosnia and Herzegovina<sup>29</sup> in 2007.

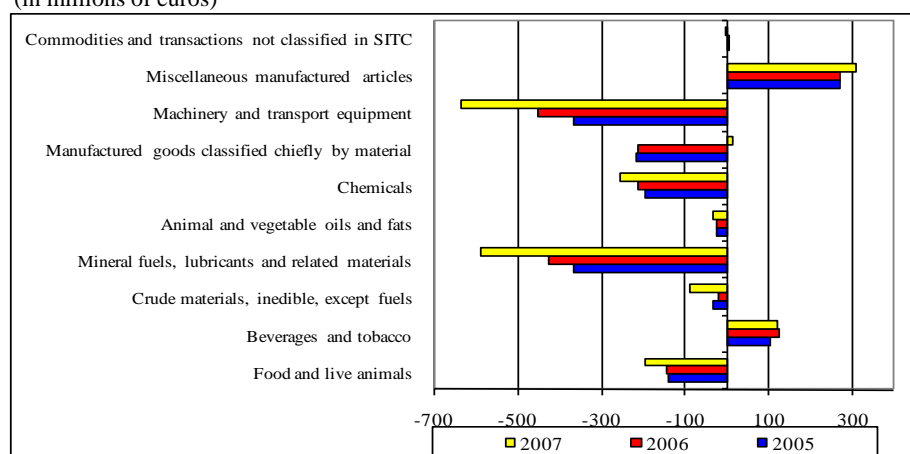
in the period of recording of the import of electricity in 2007 was included in the balance of payments statistics, unlike the data on the imports of the SSO, which have not been adjusted on that basis).

<sup>28</sup> Classified according to the sectors of the SITC.

<sup>29</sup> The export and import of goods are presented on f.o.b. basis.



Figure 36  
Trade balance by groups of products /1  
(in millions of euros)



1/ According to the Standard International Trade Classification (SITC).  
Source: State Statistical Office of the Republic of Macedonia.

Analyzed by categories of products, the higher export of iron and steel, of wearing apparel and textile, metal ore and metal waste and of fruit and vegetables most significantly contributed to the annual growth in the value of the export of goods. The higher export of iron and steel created 72.4% of the growth in the total export and it was mainly determined by the intensive production and export activity of the metal manufacturing capacities, in conditions of positive conjuncture in the international metal stock exchanges (steel sheet, nickel, iron and copper<sup>30</sup>). The value of the export of iron and steel registered annual growth of 73.8% (growth in the average actual price and the exported quantities of 38% and 25.9%, respectively), so the export of ferro-nickel to the markets of Spain, Italy and Belgium dominantly participated. The restarting of some mining capacities resulted in growth in the export of metal ore and metal waste, contributing with 6% to the growth in the total export in 2007.

Table 10  
Contribution to the total increase in the export of goods by group of products /1

groups of products	2006	2007	2007-2006	2007/2006	2006	2007	2007/2006
	in millions of Euros		changes in absolute amount (in millions of Euros)	changes in (%)	structure (in%)		contribution to the growth of exports (in %)
<b>EXPORT OF GOODS</b>	<b>1,906.2</b>	<b>2,446.4</b>	<b>540.2</b>	<b>28.3</b>	<b>100.0</b>	<b>100.0</b>	
<i>Food and live animals</i>	151.8	180.5	28.6	18.9	8.0	7.4	5.3
of which: cereals and cereal preparations	16.1	21.8	5.7	35.5	0.8	0.9	1.1
fruits and vegetables	86.5	103.5	17.0	19.7	4.5	4.2	3.1
<i>Beverages and tobacco</i>	152.7	151.0	-1.7	-1.1	8.0	6.2	-0.3
of which: beverages	63.8	74.0	10.2	16.0	3.3	3.0	1.9
tobacco and tobacco manufactures	88.9	77.0	-11.9	-13.3	4.7	3.1	-2.2
<i>Crude materials, inedible, except fuels</i>	88.6	123.9	35.3	39.8	4.6	5.1	6.5
of which: metalliferous ores and metal scrap	59.9	92.2	32.3	53.9	3.1	3.8	6.0
<i>Mineral fuels, lubricants and related materials</i>	178.4	120.0	-58.4	-32.7	9.4	4.9	-10.8
of which: petroleum and petroleum products	161.5	114.9	-46.7	-28.9	8.5	4.7	-8.6
<i>Manufactured goods classified chiefly by material</i>	676.0	1,097.0	421.1	62.3	35.5	44.8	77.9
of which: iron and steel	530.0	921.2	391.3	73.8	27.8	37.7	72.4
<i>Others</i>	658.7	774.0	115.2	17.5	34.6	31.6	21.3
of which: clothes	440.8	499.0	58.2	13.2	23.1	20.4	10.8

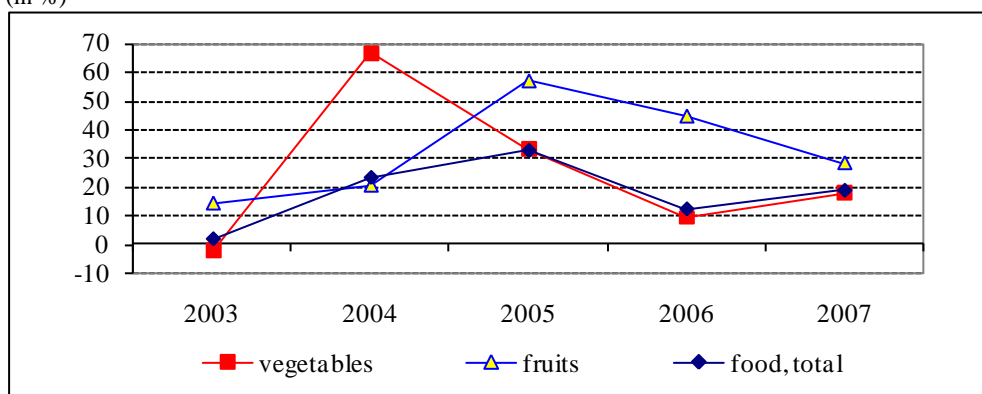
1/ According to SITC.  
Source: State Statistical Office of the Republic of Macedonia.

In 2007, the global climate conditions caused decrease in the production of food and increase in the demand in global terms, which resulted in higher export of the Macedonian food

<sup>30</sup> Source: www.worldbank.org; commodity price index; the calculations were made in the NBRM. The average prices of steel sheet and nickel in 2007 registered a significant annual increase of 65.6% and 53.5%, respectively, and at the same time the increase in the average prices of iron ore and copper equaled 9.5% and 5.9%, respectively.

products. With respect to the certain products, the export of vegetables, fruit and products thereof and bakery products and confectionery products registered highest realized export, and simultaneously highest contribution to the growth in the export of food, with total contribution of 78.6%. The export of vegetables registered intensified growth in accordance with the higher demand for export, whereas the export of fruits registered lower dynamics continuing the trend of 2006.

Figure 37  
Dynamics of the export of food and certain products /1  
(in %)



1/ According to tariff numbers.

Source: State Statistical Office of the Republic of Macedonia.

The developments in the export of certain group of export products resulted in structural movements in the total export acting towards higher participation of the iron and steel and of the metal ore (by 9.9 and 0.6 percentage points, respectively) and lower participation of the oil derivatives, wearing apparel and textile and of tobacco (by 3.8, 2.7 and 1.5 percentage points, respectively). Generally, the participation of wearing apparel and textile in the export registered downward trend since 2005. The concentration of the export of goods from the Republic of Macedonia, quantified by the Herfindahl-Hirschman index in 2007 showed higher concentration of the export (0.316 in 2007, relative to 0.244 and 0.251 in 2006 and 2005, respectively).

In conditions of high level of import dependence of the Macedonian economy, lower custom duties in the beginning of the year, in accordance with the SAA and WTO<sup>31</sup>, as well as significant inflows based on investments and the launching of new facilities, the *import of goods* registered increase by 27% in 2007, relative to the previous year. Analyzed by products, the growth was mainly due to the higher import of iron and steel and of energy, which represented a basis for further production and export activity. Namely, the value of the import of iron and steel was higher by 34.9% on annual basis, as a result of the growth in the prices by 9.9% and of the imported quantities by 22.8%.

<sup>31</sup> In accordance with the admission of the Republic of Macedonia to the WTO and with the Stabilization and Association Agreement with the European Union, customs duties on individual products decreased since January 01, 2007, with the average non-weighted customs rate being reduced from 9.78% in 2006 to 9.29% in 2007. The average customs rate on agricultural and industrial products decreased from 17.28% and 7.45%, respectively, in 2006 to 16.50% and 7.02%, respectively, in 2007.

Table 11  
Contribution to the total increase in the import of goods by group of products /1

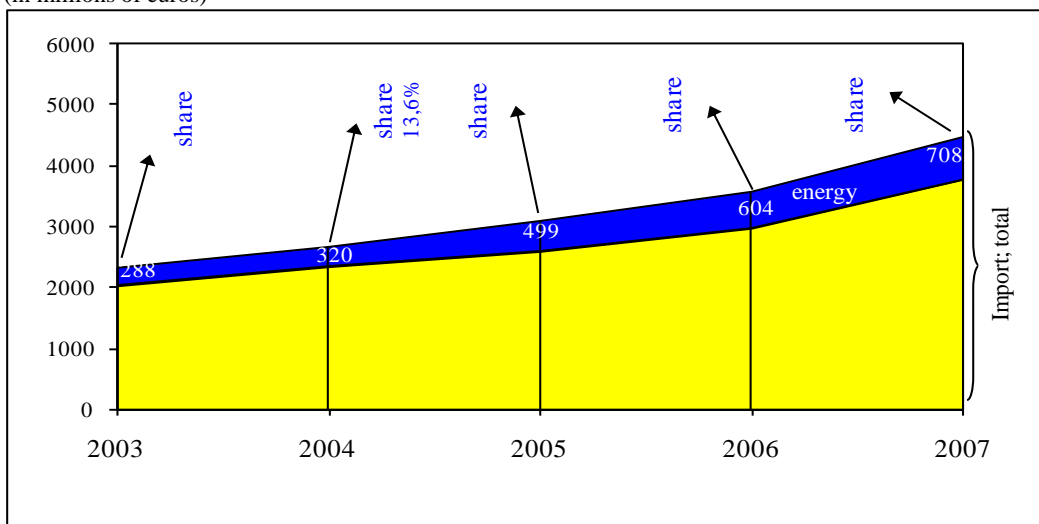
groups of products	2006	2007	2007-2006	2007/2006	2006	2007	2007/2006
	in millions of Euros		absolute amount (in millions of	changes in (%)	structure (in%)		contribution to the growth of exports (in %)
<b>IMPORTS OF GOODS</b>	<b>2,987.7</b>	<b>3,795.0</b>	<b>807.3</b>	<b>27.0</b>	<b>100.0</b>	<b>100.0</b>	
<i>Mineral fuels, lubricants and related materials</i>	<i>603.8</i>	<i>708.3</i>	<i>104.6</i>	<i>17.3</i>	<i>20.2</i>	<i>18.7</i>	<i>13.0</i>
of which: petroleum and petroleum products	497.4	459.0	-38.5	-7.7	16.6	12.1	-4.8
- crude oil	426.2	413.9	-12.2	-2.9	14.3	10.9	-1.5
volumes in tons	1,078,737.6	1,063,614.4	-15,123.2	-1.4			
price in euro for 1 kg	0.40	0.39	-0.01	-1.5			
electric energy	50.0	180.8	130.8	261.9	1.7	4.8	16.2
<i>Crude materials, inedible, except fuels</i>	<i>106.4</i>	<i>212.6</i>	<i>106.2</i>	<i>99.8</i>	<i>3.6</i>	<i>5.6</i>	<i>13.2</i>
of which: metalliferous ores and metal scrap	57.6	155.2	97.5	169.2	1.9	4.1	12.1
<i>Manufactured goods classified chiefly by material</i>	<i>886.7</i>	<i>1,080.1</i>	<i>193.4</i>	<i>21.8</i>	<i>29.7</i>	<i>28.5</i>	<i>24.0</i>
of which: iron and steel	293.8	396.4	102.6	34.9	9.8	10.4	12.7
manufactures of metals, n.e.s.	66.6	82.7	16.1	24.2	2.2	2.2	2.0
<i>Machinery and transport equipment</i>	<i>547.4</i>	<i>746.4</i>	<i>199.0</i>	<i>36.4</i>	<i>18.3</i>	<i>19.7</i>	<i>24.7</i>
of which: telecommunication equipment	65.1	112.7	47.6	73.2	2.2	3.0	5.9
road vehicles	161.6	232.1	70.5	43.6	5.4	6.1	8.7
<i>Others</i>	<i>843.5</i>	<i>1,047.5</i>	<i>204.1</i>	<i>24.2</i>	<i>28.2</i>	<i>27.6</i>	<i>25.3</i>

1/ According to SITC.

Source: State Statistical Office of the Republic of Macedonia.

The growth in the import of energy in 2007 (of 17.3%) came as a result of the energy import dependence of the Macedonian economy in conditions of further growth in the prices of the energy sources in the international stock exchanges. Within the certain types of energy sources, the import of electricity registered growth in conditions of higher demand, which was due to the intensified production activity and insufficient domestic production of this energy source, on one side, and growth in the import price on the other (higher average actual price by 63.1% relative to the previous year). Simultaneously, the value of the import of oil and oil derivatives decreased by 7.7% on annual level, within which the import of crude oil registered fall of 2.9% on annual basis, which represented combined effect of decreased prices and quantities (annual fall of 1.5% and 1.4%, respectively). Thus, the lower participation of the import of energy in the total import of goods (which amounted to 18.7% in 2007, relative to 20.2% in the previous year) was determined by the fall in the import of oil and oil derivatives. Namely, the temporary effects from introducing the ecology standards by Kosovo and from the overhaul of the domestic oil refinery acted towards lower import of crude oil in May and June by 50.6% and 45.6%, respectively, on annual basis, which simultaneously resulted in lower export of oil derivatives by 28.9% (in May and June 2007 significantly lower export of oil derivatives by 98.9% and 99.2%, respectively, was registered relative to the same months of the previous year). In the other categories, the higher import of metal ore and metal waste as a raw material for domestic production, as well as the import of new vehicles significantly contributed to the growth in the import. By the Herfindahl-Hirschman index, in 2007, on the side of the import of goods, lower level of concentration was registered (0.097 in 2007, relative to 0.120 in 2006).

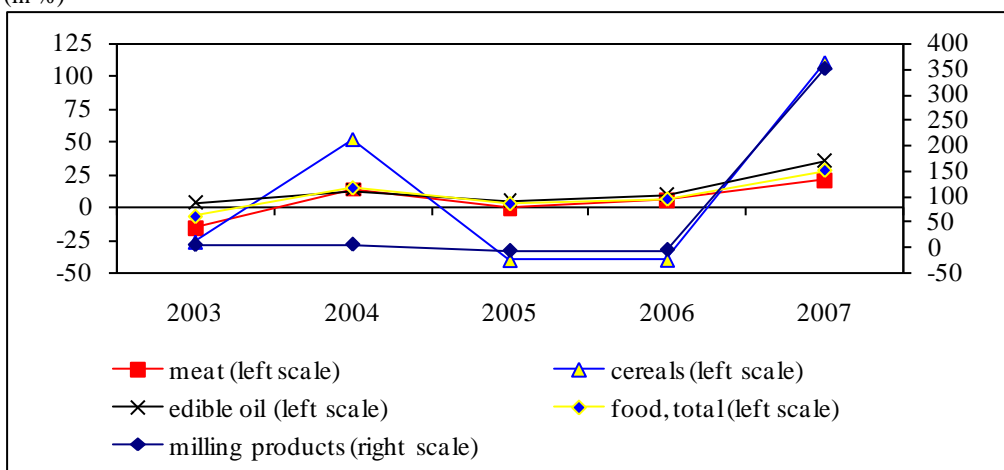
Figure 38  
Dynamics of the import of energy  
(in millions of euros)



Source: State Statistical Office of the Republic of Macedonia.

Within the other products, the food products registered significant movement, the growth rate of which registered larger intensification (27.5%), and the contribution to the total growth of the import amounted to about 11%, opposite of the lower rate and contribution in the previous years. The analysis of certain food products showed largest change in the import of cereals and mill products (contribution of 36.2%), in accordance with the higher import demand for these products, which was due to the lower domestic production due to the draught period. Also, the higher domestic demand determined higher import of meat and cooking oils with contribution of 13.8% and 11.6%, respectively. It should be taken in consideration that there was a strong price effect in these categories which was due to the intensified growth in their prices in the international markets.

Figure 39  
Dynamics of the import of food and certain products /1  
(in %)



1/ According to tariff numbers.

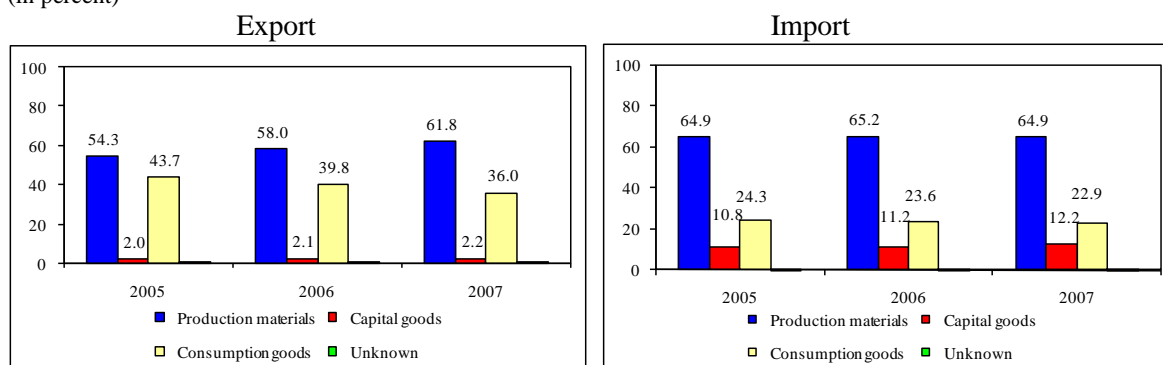
Source: State Statistical Office of the Republic of Macedonia.

The analysis by the economic use of products which were subject of foreign trade in 2007 indicated dominant participation of reproduction materials in the structure of export and import (61.8% and 64.9%, respectively). Analyzed by dynamics, on the side of the export, these products registered higher participation by 3.8 percentage points on annual basis, relative to the consumer goods. On the side of the import, higher participation of means for operating was registered, as a

reflection of the intensification of the economic activity and decrease in the participation of the consumer goods and reproduction materials.

Figure 40

Trade in goods of the Republic of Macedonia by economic use of the products  
(in percent)



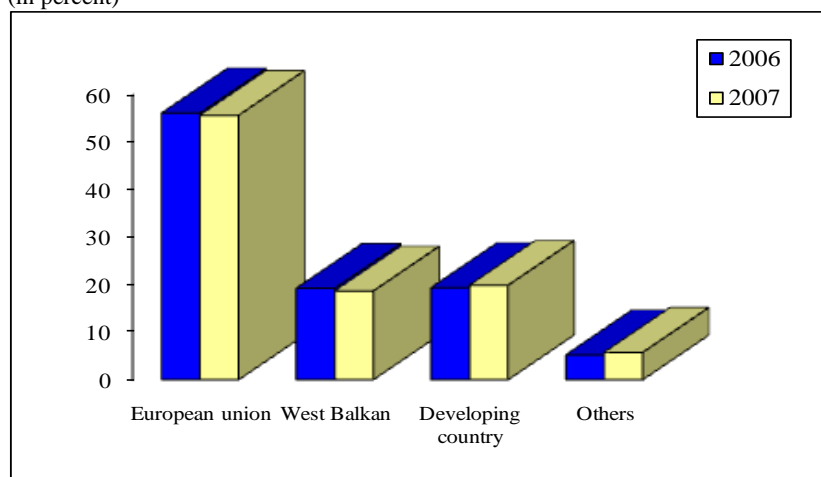
Source: State Statistical Office of the Republic of Macedonia.

The analysis of the foreign trade by the currency structure in 2007 showed dominant participation of the Euro on the side of both the export and the import of goods (of 70.7% and 70.1%, respectively), whereas the participation of the USA Dollar in the export and import of goods equaled 28.6% and 28.8%, respectively, in 2007.

In 2007, the analysis of the geographic distribution of the foreign trade indicated high orientation of the domestic economy towards the European Union. Thus, EU participated in the export of goods with 65.2%, which represented growth of 6.5 percentage points on annual basis, while on the side of the import the participation of EU decreased by 6.4 percentage points relative to the previous year and it equaled 49.6%. On the other hand, in 2007, the participation of the countries from West Balkans in the total trade registered annual fall of 0.6 percentage points equaling 18.7%, relative to the increase in the participation of the developing countries (19.9%) by 0.5 percentage points (including China).

Figure 41

Geographic distribution of the foreign trade of the Republic of Macedonia  
(in percent)



Source: State Statistical Office of the Republic of Macedonia.

In 2007, Serbia, Germany and Greece remained the most significant trade partners of the Republic of Macedonia (with participation of 34.2%). Republic of Macedonia realized highest positive balance in the trade with Serbia and it equaled Euro 140.8 million, while the highest deficit was realized with Russia (Euro 449.6 million), as a result of the high import of crude oil and gas.

### Annex 3

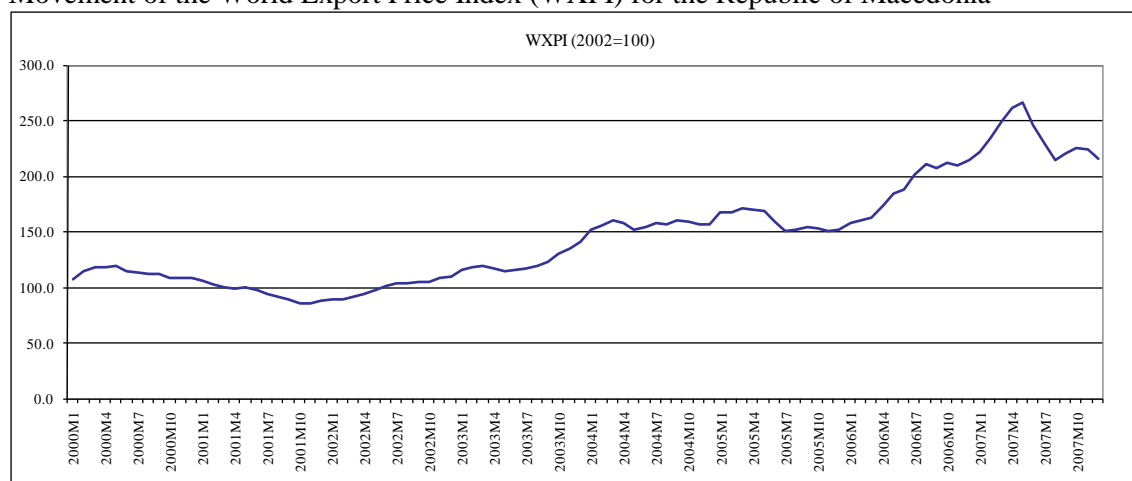
#### World Export Price Index for the Republic of Macedonia

As a small and opened economy, the Republic of Macedonia inevitably characterizes with high level of orientation to abroad concerning the trade in goods and services. In this context, the development in the World Export Price Index - WXPI was especially significant and it represents weighted price index in the structure of which the international stock exchange prices of certain group of raw materials (significant for a country on the side of the export) are included, so the normalized weight structure is calculated from the value of the export of selected raw materials and products which have these primary products as their ingredients. WXPI, for the Republic of Macedonia, represents weighted price index in the structure of which the international stock exchange prices of the following raw materials are included: cotton, tobacco, lamb, iron ore, nickel, steel products and zinc.<sup>32</sup>

In 2007, the prices of all primary products which are included in the World Export Price Index for the Republic of Macedonia registered upward developments, relative to 2006. In 2007, the index level, on average, registered growth of 22.1%, relative to 2006. It indicated the positive price conjuncture in the international markets for the most significant export products for the Republic of Macedonia, as well as for the products which have these primary products as their ingredients. This was especially characteristic for the first half of the year, considering that somewhere in the middle of the year the index registered fall maintaining lower levels till the end of the year. It is significant to be stated that the level of this index, calculated by the actual realized export prices (weighted with the quantities) of the same raw materials and the products which have these primary products as their ingredients, showed higher growth in 2007, relative to 2006 (43.7%), which indicated realized positive effects from the positive conjuncture in the international markets, relative to both the prices and the adjustment of the supplied quantities, in accordance with the demand.

Figure 42

Movement of the World Export Price Index (WXPI) for the Republic of Macedonia



Source: NBRM calculations based on data from IMF, IFS, March 2008 and from the State Statistical Office of the Republic of Macedonia.

<sup>32</sup> The value of the normalized weight structure is calculated from the value of the Macedonian export of these raw materials and products which have these primary products as their ingredients in 2005. The data on the prices of the raw materials included in the index are primarily from the database of IFS (Commodity prices), and they pertain to the following categories: cotton: Liverpool; tobacco: USA; lamb: New Zealand; iron ore: Brazil; nickel: Canada and zinc: Great Britain, which means that the transaction prices on the markets in the countries which represent largest world producers of these raw materials and which in the same time dictate the world price also, are taken as referential. The prices of steel products are included through CRUspi Global (CRU steel price index Global), which is a weighted price index whose value is calculated from the transaction prices of five types of steel products realized at the three largest consumer markets: North America, Europe and Asia.

Within the basic metals which are included in the index, i.e. the nickel and the zinc, the average price in 2007 went up by 53.1% and 2.2%, respectively, relative to 2006. Namely, 2007 remains to be remembered as an year when large number of stock exchange raw materials reached a historical price maximum, especially those in the group of basic metals<sup>33</sup>. The high stock exchange prices did not slowed down the global demand for these products, partly because the prices of substitutes grew equally fast, restricting the possibilities for effects of substitution. The higher Chinese huge demand for raw materials was considered as lot more significant determinant of the price growth. Yet, in 2007, the risk of downward market correction of prices was higher than in the previous year, which was due to the fact that the prices of basic metals were already high, high deficits were not felt in the markets for basic metals, generally, and as a result of that very low growth in the reserves of some of the metals resulted in sharp falls in the market prices. That was the case with the nickel the market price of which had especially high downward correction in the second half of 2007. Although in 2007, the zinc registered higher price, on average, than the average price registered in 2006, yet in 2007 the development in its market price constantly registered downward trend, with relatively short periods of stagnation and price recovery. Although the nickel price decreased, it remained high in 2007 because in the global market of zinc there was still a deficit of this metal.

In January 2007, the iron ore had one-time upward correction in the market price of 8.8%, relative to the average price level in 2006, maintaining the higher level till the end of 2007. The global demand for cotton in 2007 exceeded the supply and as a result of that the prices of this raw material registered upward corrections, so in 2007 the price went up by 8.5%, on average, relative to 2006. Also in 2007, the stock exchange price of the tobacco, on average, registered growth (by 11.1%), relative to 2006. The price of the lamb in 2007, on average, was higher than the price in 2006 by 5.3%. In 2007 the prices of steel products also grew (growth of 9.9%).

The perspectives on the global economic growth were very relevant indicator for the development of WXPI. Namely, the forecasts for the global economy perspectives for 2008 indicated recession in USA, which can influence also the Continental Europe, through the trade mechanisms, but also due to the developments which are directly concerning the financial markets. That, potentially, may result in fall in the demand for certain primary products, which may also mean a fall in their transaction prices, especially in the products the price of which is positively correlated with the industrial activity of highly industrialized economies (their stock exchange prices are sensitive to higher demand in the global markets), for example, the prices of nickel and iron ore. But, weather it is really going to happened a decrease in the global demand for these products it will depend on the developments in the developing countries, i.e., on weather these countries will experience economic slowing down, considering that their growth now is standing on more firm base than it was before 10 years (these countries have already made space for positive developments with much wider range of terms). These economies have much stronger domestic demand, as a growth generator, which made them more robust on that aspect, but yet it can not be said that they are economically separated from the situation in the highly industrialized countries. By that, some of the developing countries are also expected to register slowing down, for some of them more intensively, but yet by the general judgment, the negative economic situation in the developed countries will be partly neutralized by the healthy growth in the most of the developing countries, and especially by the healthy and continuous growth of India and China, which is expected to grow with two-numbered rate in 2008.

The prices of some of the stock exchange raw materials which are an integral part of the index were in high positive correlation with the development of the industrial activity in the high developed economies<sup>34</sup> (for example, the price of the nickel and of iron ore). The positive correlation indicated that the growth in the world prices, especially of the nickel and of iron ore, in

<sup>33</sup> Source: Economist Intelligence Unit - EUI.

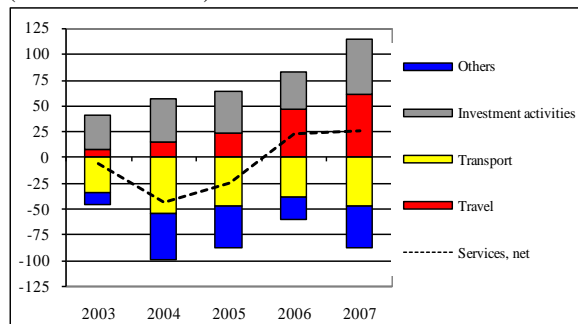
<sup>34</sup> Correlation coefficients are calculated based on monthly data on the stock exchange prices of certain raw materials and the index of industrial output in the developed economies (USA, Canada, Australia, Japan and New Zealand).

accordance with the more dynamic industrial activity of the highly industrialized economies, potentially, causes positive externalities for a significant part of the Macedonian export sector, which was mainly due to the fact that their stock exchange prices were sensitive to the higher global demand for these primary products. On the other hand, the prices of those export raw materials which continued to grow on a global level and in conditions of recession in the industrialized economies (for example, the price of cotton), as well as those raw materials the prices of which were not so sensitive to factors on the side of demand (for example, the world prices of tobacco, lamb, steel products and zinc), would potentially have positive effect on the adequate segment of the Macedonian export sector and in episodes of recession in the highly developed countries (supposing that the negative influence of the factors which are influencing the side of the supply is excluded, i.e. that the quality domestic production and its successful placement to abroad will be maintained). With respect to the trade balance, this would mean a possibility for neutralization of one part of the potential negative effect over the Macedonian primary export, which may emerge due to a recession in the markets of nickel and iron ore (caused by a lower global demand of these raw materials), the price of which is sensitive to the demand.

#### 2.4.1.2. Other components of the current account

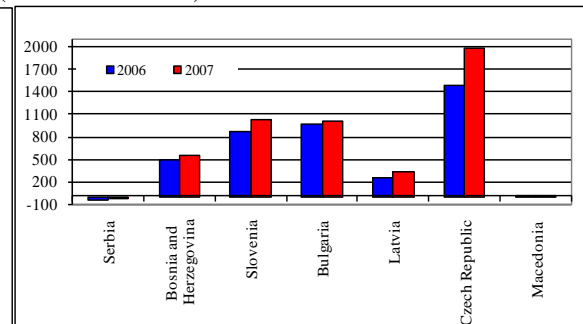
In 2007, the foreign trade of services registered positive balance of Euro 25.5 million, influencing positively on the balance of the current account. On annual basis, the surplus in the trade of services registered growth of 15.3%, mainly determined by the higher amount of net inflows from the performed investment activities to abroad (by 47.7%), i.e. the realized activities of the Macedonian construction companies mostly in Ukraine, Croatia, Russia and Serbia<sup>35</sup>. The higher inflows based on tourism/traveling significantly contributed to the realized surplus (by 31.8%), i.e. the higher inflows of the games of chance and of the turnover form the payment cards of non-residents, which can be confirmed by the higher number of tourists and overnights on annual basis (7% and 5.3%, respectively)<sup>36</sup>. It is important to be noted that the volume of the trade of services significantly grew realizing annual growth rate of 24.7%.

Figure 43  
Dynamics of the services balance  
by individual category on net basis in RM  
(in millions of euros)



Source: NBRM and web sites of central banks of individual countries.

Figure 44  
Dynamics of the services balance  
on net basis by individual countries  
(in millions of euros)



In 2007, the analyzed countries in transition (including Macedonia) realized higher net inflows from services, compared to 2006, excluding Serbia. In the more developed economies in transition (Slovenia, Czech Republic, Bulgaria), some common characteristics of the components of the balance of services can be noted. Namely, the net inflows based on traveling and the net inflows based on transport dominantly participated in the trade of services, while the other services registered net outflows. Macedonia joined this trend through the category "traveling", where it also registered net inflows, but in the area of transport services still registered net outflows.

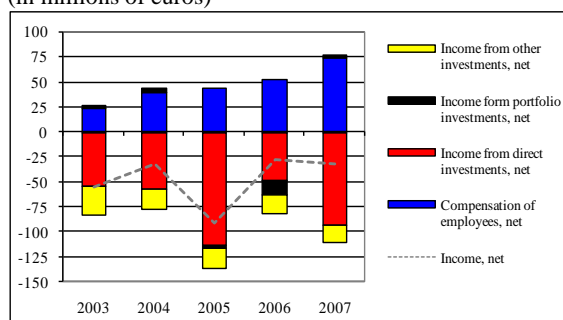
<sup>35</sup> According to SSO data.

<sup>36</sup> According to SSO data.



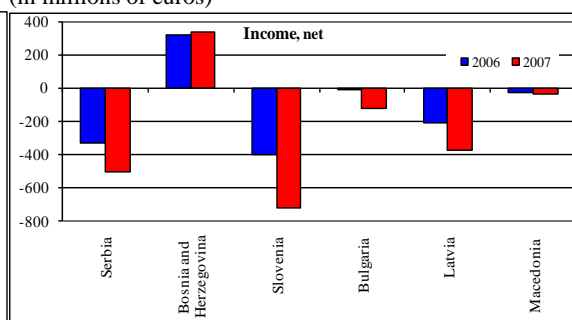
In 2007, in the sub-balance of income, net outflows of Euro 33.4 million were registered, which compared to 2006 rose by 17.4%. The deepening in the deficit in this category was a result of the higher net outflow of funds based on income from direct investments, which was partially neutralized by the higher net inflows based on compensations for employees - resident persons (by Euro 22 million) and by the net inflows of income (by Euro 7.2 million) from the placement of foreign reserves. Thus, the paid dividends to abroad in 2007 registered growth of 5.1 times on annual basis besides the delay of the payment of dividend to one larger foreign investor. Such dynamics of increase in the deficits in the category "income", especially in the part of the income from investments was trend characteristic for more developed economies in transition as Slovenian, Latvian and Czech<sup>37</sup> and it corresponded with the higher inflow of foreign direct investments and portfolio investments in these countries.

Figure 45  
Dynamics of the income balance  
by individual components on net basis in RM  
(in millions of euros)



Source: NBRM and web sites of central banks of individual countries.

Figure 46  
Dynamics of the income balance  
on net basis by individual countries  
(in millions of euros)

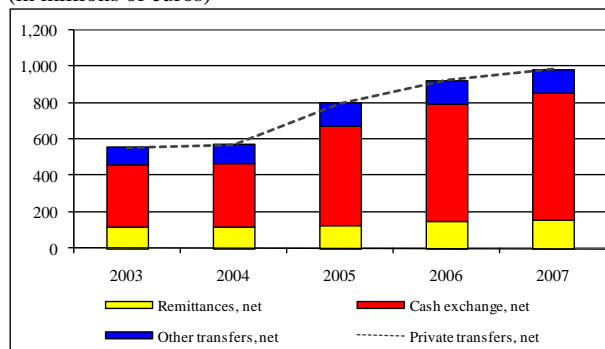


The current transfers, net, still remained the basic source of financing the trade deficit within the current account of the Macedonian economy. Thus, in 2007, the current transfers equaled Euro 1,009.8 million (annual growth of 2.8%), within which the private transfers dominantly participated (with 97.6%), while the rest of them were official transfers. In 2007 the private transfers amounted to 17.8% of GDP thus enabling coverage of the trade deficit of 84.1%. Analyzed with respect to the integral components, the net assets from the foreign exchange operations<sup>38</sup> most significantly participated (with 70.5%) and it was canalized in the banking sector, and its development imposed the dynamics of the total private transfers. The annual growth rate of the net assets amounted to 7.1% (opposite of the annual growth rates of 18.7% and 58%, in 2006 and 2005, respectively). Such slowing down mainly reflected the developments in the fourth quarter of 2007 when for the first time since 2004, negative annual rates were registered, probably as a result of the higher level of uncertainty determined by the political situation in the region. The other components of the private transfers, remittances and other transfers (leases, pensions, disablement allowances), the joint structure participation of which equaled 29.5%, on annual level, realized growth rates of 9.3% and 2.6%, respectively.

<sup>37</sup> The Czech Republic is not presented in the Figure due to the high amounts in this category.

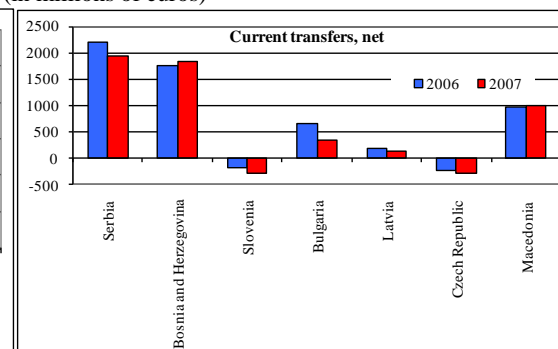
<sup>38</sup> The net assets on the foreign exchange market which are canalized in the banking sector is supposed to be in the largest part it pertains to inflows based on private transfers in cash, so as a result of that during the preparation of the balance of payments of RM it is included in the category of private transfers. For the purpose of better comprehending and registering the inflows from the foreign exchange operations, in the summer of 2007, a survey of the emigrants was conducted, organized by NBRM.

Figure 47  
Dynamics and structure of the private transfers by components in RM  
(in millions of euros)



Source: NBRM and web sites of central banks of individual countries.

Figure 48  
Dynamics of the current transfers on net basis by individual countries  
(in millions of euros)

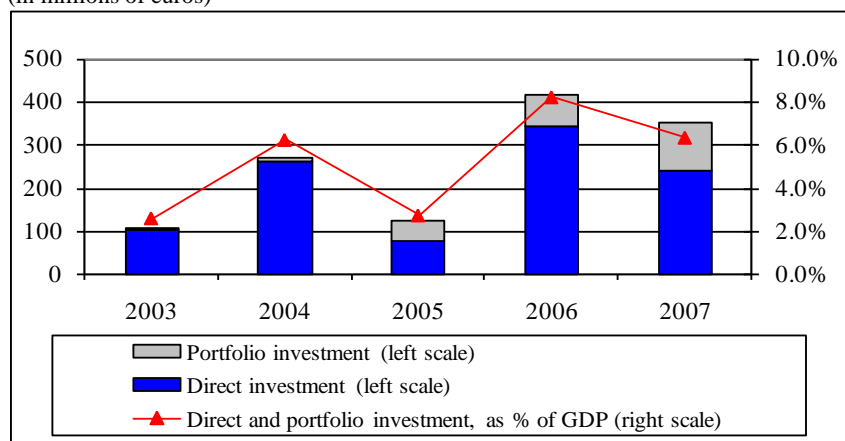


The comparison analysis of the balance in the current transfers of the analyzed countries showed that the less developed economies in transition, where our country was also included, still registered net inflows, while more developed economies (Czech Republic and Slovenia), realized net outflows on the same basis (more intensive net outflows than in 2006).

#### 2.4.1.3. Capital and financial account

In 2007 in the *capital and financial account* lower net inflows of capital were registered by Euro 39.7 million, relative to the previous year, as a result of the high comparison basis. Namely, if the effect from the privatization of "ESM - Distribution" is excluded (March 2006), the net inflows of capital are higher by Euro 190 million, relative to the previous year, despite the realized net outflows in the category "borrowings" (in amount of Euro 107.7 million), which emerged based on early repayment of a significant share of the foreign public debt (full repayment of debt to the World Bank - IBRD, the repayments of a share of the debt to the Paris Club of Creditors, full repayment of a debt to the International Monetary Fund and EIB). Within the financial account, the inflows realized based on foreign direct investments reached up to Euro 240.1 million and rose by 108.8% (if the effect of the privatization of ESM is excluded), reaching up to 4.3% of GDP. The analysis of the foreign investments showed that in 2007 the largest investors in the country were Austria, Slovenia, Serbia and France (participating with 19%, 18.9%, 13.7% and 11.7%, respectively), while with respect to the activities, the financial intermediation was most attractive for investments (participation of 37.8%), as well as the telecommunications and food industry (19.1% and 16.6%, respectively). The inflows based on portfolio investments reached up to Euro 110.8 million (with participation of 2% in GDP) and they were higher by 51.5%, on annual basis, in conditions of higher interest of the foreign investors for buying domestic equity securities (excluding February and December, when net outflows in this category were registered). Simultaneously, in the capital account, inflow in amount of Euro 1.3 million was registered.

Figure 49  
Dynamics of direct and portfolio investments /<sup>1</sup>  
(in millions of euros)



1/ In 2005 excluding the inflows from Eurobonds.

Source: National Bank of the Republic of Macedonia.

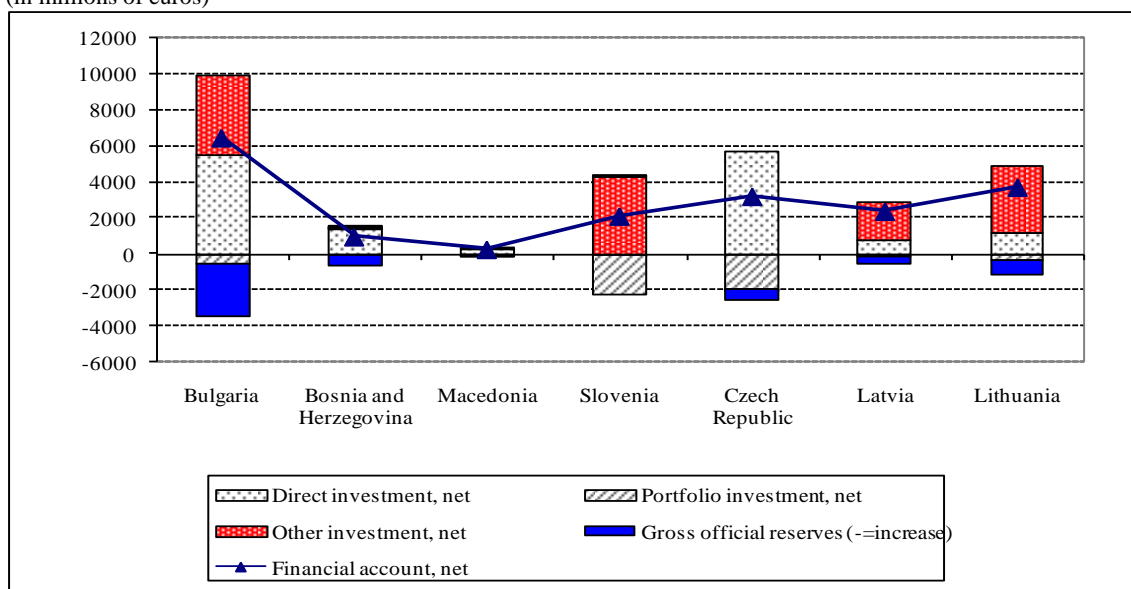
On the other hand, the currencies and the deposits, on net basis, registered fall in amount of Euro 5.9 million, as a result of the decrease in the foreign exchange assets of banks of Euro 68.4 million (growth in the foreign exchange liabilities of banks to the non-residents by Euro 67.1 million), while the household funds outside the banking sector rose by Euro 62.2 million, which was mainly due to the received private transfers through fast money transfer (Euro 66 million).

In 2007, in conditions of such dynamics of the individual transactions from the balance of payments, the gross official reserves registered further increase (by Euro 101.8 million on annual basis)<sup>39</sup>.

The comparison analysis of the capital and financial account of the balances of payments in individual countries in transition, in 2007, showed net inflows of financial assets with all analyzed countries, registering Bulgaria as a country with highest net inflows (36.7% of GDP), and Macedonia with the lowest net inflows (5.3% of GDP). Analyzed by the capital flows based on foreign direct investments, Czech Republic, Bulgaria, and Bosnia and Herzegovina were considered as more attractive countries for this type of investments, while Lithuania, Latvia and Macedonia registered lower inflows in 2007. On the other hand, although with lower volume, Slovenia was the only country which in 2007 registered net outflows of direct investments, as well as fall in the gross foreign reserves which was significantly lower compared to the previous year. Simultaneously, in the more developed financial markets (Slovenia and Czech Republic), higher net outflows in form of portfolio investments were registered, which was in accordance with the more developed phase of liberalization in the capital account. From the analyzed countries, Bulgaria, Slovenia, Lithuania, Latvia and Bosnia and Herzegovina registered net inflows of capital through the foreign indebtedness, while net outflows of capital on the same basis were registered in Czech Republic and Macedonia.

<sup>39</sup> The data on the gross official reserves showed in the balance of payments is different from the data on the gross foreign reserves, as in the balance of payments statistics the cross-currency differences and the monetary gold are excluded.

Figure 50  
Balance and components of the financial account of individual countries in 2007 /1  
(in millions of euros)



1/ Category "other investments, net" is a group review of borrowings (long-term and short-term), currencies and deposits and financial derivatives.

Source: Web sites of central banks of individual countries.

#### 2.4.2. Foreign debt

At the end of 2007, the gross foreign debt<sup>40</sup> equaled Euro 2,711.5 million, which on annual basis represented increase of 8.7%. On institutional aspect, such development of the foreign debt was determined by the continuous growth in the foreign debt, primarily in the category "other sectors" (non-banking financial intermediates, non-financial trade associations, households and non-profitable institutions), than by the banking sector and the debt among enterprises, which fully neutralized the decrease in the gross foreign debt of the Government sector and the monetary Government. The decrease in the foreign public debt was performed through the early repayment to individual foreign creditors, as follows: Paris Club of Creditors, International Bank for Reconstruction and Development (IBRD), International Monetary Fund (IMF) and the European Investment Bank (EIB).

On December 31, 2007, the foreign indebtedness of the Republic of Macedonia, on net basis, equaled Euro 30.5 million, which was a result of the higher amount of gross external debt compared to the amount of the gross foreign claims and it includes the country in the group of the countries which are net debtors relative to the rest of the world. On annual basis, the net foreign debt of the country decreased by 55%, which was due to the increase of 10.5% of the gross foreign claims, in conditions of simultaneous annual growth in the external debt on gross basis.

<sup>40</sup> In 2007, NBRM started preparing and issuing data on the gross foreign debt. The data pertains to the period 2004-2007.

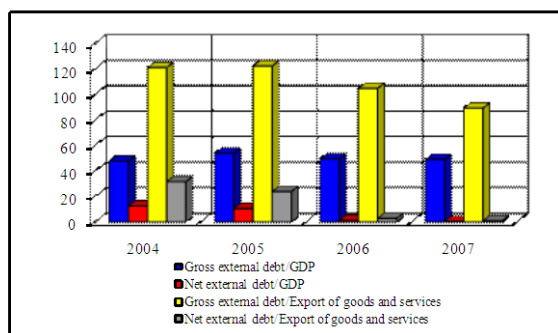
Table 12  
Dynamics of the external debt

	2005	2006	2007	2005	2006	2007	2005	2006	2007
	in EUR millions			annual changes					
				absolute amount			in %		
<b>Gross external debt</b>	<b>2,518.1</b>	<b>2,495.2</b>	<b>2,711.5</b>	<b>447.5</b>	<b>-22.9</b>	<b>216.4</b>	<b>21.6</b>	<b>-0.9</b>	<b>8.7</b>
General Government	1,282.8	1,066.9	910.4	266.4	-215.9	-156.5	26.2	-16.8	-14.7
Monetary Authorities	52.7	42.4	0.0	6.7	-10.3	-42.4	14.5	-19.5	-100.0
Banks	192.0	269.9	387.9	68.8	77.9	118.0	55.8	40.6	43.7
Other Sectors	721.0	786.7	973.4	120.6	65.7	186.7	20.1	9.1	23.7
Direct investment: Intercompany lending	269.6	329.3	439.8	-14.9	59.7	110.5	-5.3	22.2	33.6
<b>Gross external claims</b>	<b>2,026.2</b>	<b>2,427.4</b>	<b>2,681.1</b>	<b>496.2</b>	<b>401.2</b>	<b>253.7</b>	<b>32.4</b>	<b>19.8</b>	<b>10.5</b>
General Government	0.0	0.0	0.0	0.0	0.0	0.0			
Monetary Authorities	1,040.5	1,327.0	1,445.5	375.8	286.5	118.5	56.5	27.5	8.9
Banks	635.9	668.3	648.1	16.3	32.4	-20.2	2.6	5.1	-3.0
Other Sectors	253.9	336.5	460.7	56.2	82.6	124.1	28.4	32.5	36.9
Direct investment: Intercompany lending	95.9	95.6	126.9	47.9	-0.3	31.3	99.8	-0.3	32.7
<b>Net external debt</b>	<b>491.9</b>	<b>67.8</b>	<b>30.5</b>	<b>-48.7</b>	<b>-424.1</b>	<b>-37.3</b>	<b>-9.0</b>	<b>-86.2</b>	<b>-55.0</b>

Source: National Bank of the Republic of Macedonia.

The registered annual growth in the gross foreign claims was mainly due to the increase in the foreign demand of the “other sectors” and the monetary sector. With respect to the “other sectors”, the increased short-term trade credits were dominant factor, while the increased foreign claims of the monetary sector represented a result of the inflows based on foreign reserves.

Figure 51  
Indicators for external indebtedness  
(in %)

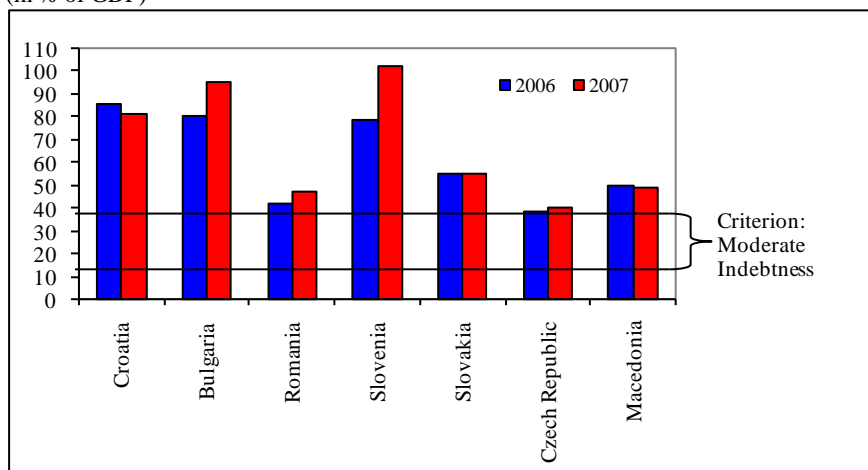


Source: National Bank of the Republic of Macedonia.

The indicators of the relative foreign indebtedness of the country indicated improvement, relative to 2006. Namely, from the indicators on gross basis, the foreign debt relative to GDP (48.9%), showed small decrease, which was mainly due to the more intensive growth rate of GDP relative to the foreign debt which includes our country in the group of moderate indebted countries. The indicator of the gross foreign debt, relative to the export of goods and services (89.3%), showed significant improvement of 15.5

percentage points, which was due to the higher export of goods and services on annual level so according to it, the Republic of Macedonia is in the group of less indebted countries. In the indicators of the foreign indebtedness on net basis, the foreign debt relative to GDP, i.e. relative to the export of goods and services, improved by 0.8 percentage points, i.e. 1.8 percentage points, respectively.

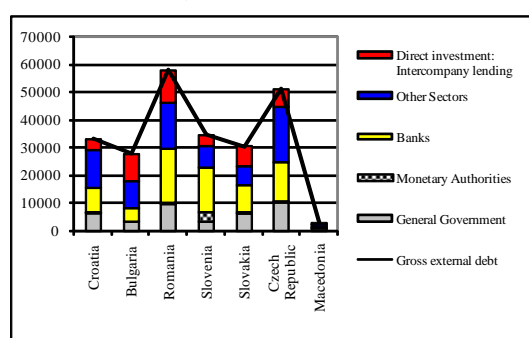
Figure 52  
Comparison analysis of the gross external debt  
(in % of GDP)



The criterion on indebtedness was by the Methodology of the World Bank. The calculations are based on the data for the adequate years. Source: National Bank of the Republic of Macedonia.

Compared with some more developed countries in transition, based on the participation of the gross foreign debt in GDP, the Republic of Macedonia, together with Czech Republic and Romania, were in the area of moderate indebtedness, different from the other analyzed countries, which had a large percent of foreign indebtedness on gross basis. All countries registered increase in the participation of the gross foreign debt in GDP, relative to 2006, excluding Croatia and Macedonia, where this percent was lower.

Figure 53  
Comparison analysis of the dynamics of the gross external debt and its components  
(in millions of euros)



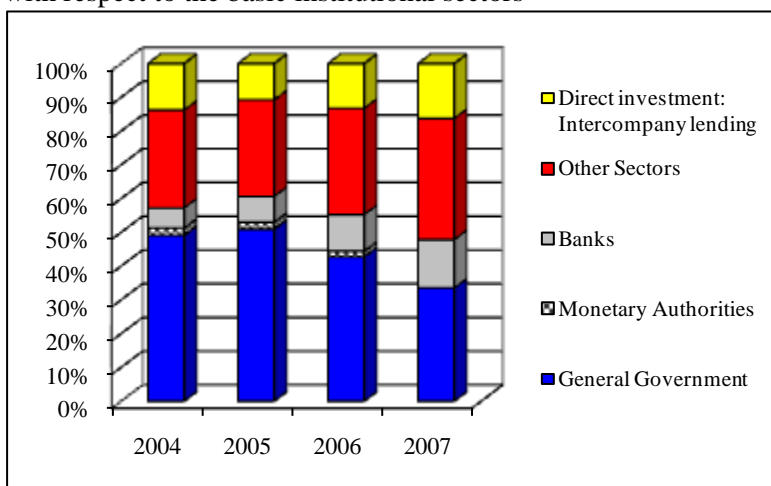
Source: National Bank of the Republic of Macedonia.

excluding Slovenia, where this percent equaled 10.4%.

Observed with respect to the integral components of the gross external debt by countries, it can be noted that in Macedonia, Croatia, Bulgaria and Czech Republic, the largest share of the debt concerns the other economy sectors, i.e. the private non-banking sector, while in the rest of the countries (Romania, Slovenia and Slovakia), it is the debt of the banking sector. Concerning the debt of the monetary Government, in all the analyzed countries, it was with very small or zero structural participation,

Within the gross external debt, *the other economy sectors* had dominant structural participation of 35.9% (compared with 2006, increase by 4.4 percentage points), which mostly concerns the non-financial trade associations. It can be noted that, the largest share were short term credits, in form of trade credits, relative to the long-term debt of the rest of the sectors, where the basic instrument of indebtedness were the borrowings. Simultaneously, on annual basis, the debt of the *banking sector* registered growth in the structural participation by 3.5 percentage points. The banks, mostly, had long term indebtedness, and almost fully (95.3%) they were withdrawals based on borrowings, whereas the short-term debts were mostly liabilities based on deposits of non-residents. The *borrowings among the connected entities*, which mainly represent liabilities to the direct investors, represented 16.2% of the total gross debt and on annual level, they rose by 3 percentage points. Such dynamics corresponds also with the annual growth in the foreign direct investments which also include these borrowings.

Figure 54  
Structure of the gross external debt  
with respect to the basic institutional sectors

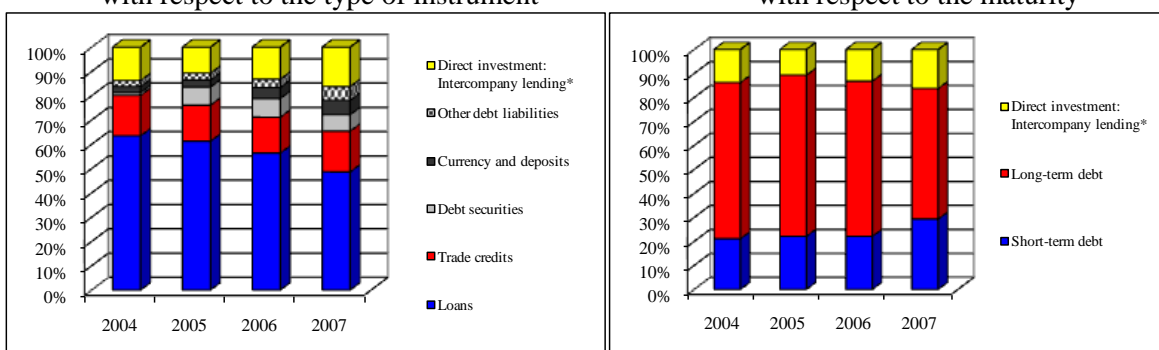


Source: National Bank of the Republic of Macedonia.

On the other hand, the foreign indebtedness of the Government sector, which basically includes the liabilities based on used long-term foreign loans and for the issued Euro-bonds, in the overall structure of the gross external debt decreased by 9.2 percentage points in 2007, as a result of the early repayment to some of the foreign creditors. With the full repayment of the debt to IMF, by NBRM, the foreign indebtedness of the monetary Government fully extinguished.

Analyzed by certain instruments, the loans were dominant instrument of indebtedness, the participation of which (48.7%) decreased on annual basis, mainly for the account of the trade credits and borrowings of the connected entities (16.8% and 16.2%, respectively). The analysis with respect to the maturity showed that the long-term debts dominated (54.4%), but in conditions of upward trend of indebtedness on short term.

Figure 55  
Structure of the gross external debt  
with respect to the type of instrument



\* Category FDI: Borrowings among connected entities is a composite category, which includes liabilities for different instruments (borrowings, trade credits, securities).

Source: National Bank of the Republic of Macedonia.

## 2.5. Public finances

In 2007, the fiscal policy acted towards creating possibilities for higher economic growth, through initiating the aggregate supply and demand. The reforms in the tax system in December 2006, which acted towards creating efficient and transparent tax system, had the purpose to initiate the aggregate supply in the Republic of Macedonia, through increase in the employment and

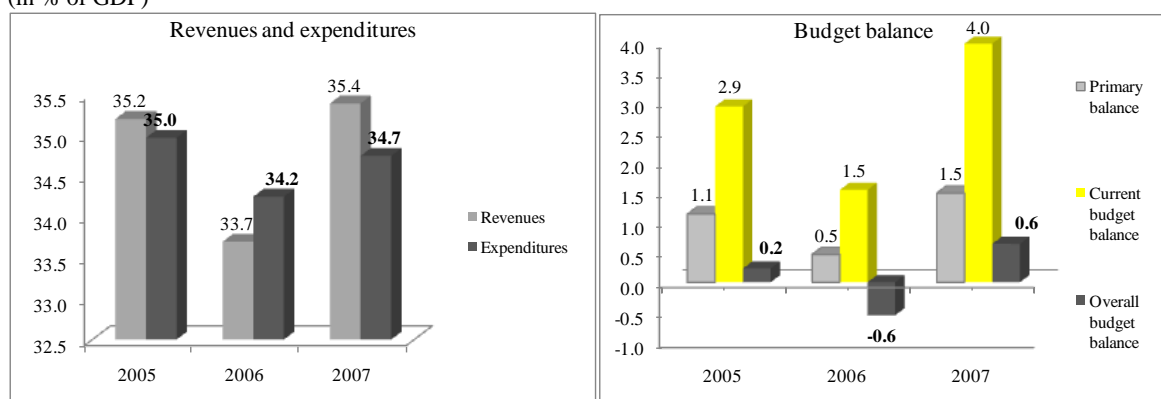
investments to the private sector. The amendments to the law on the personal income tax which introduced the flat tax, i.e. the replacement of the current rates of 15%, 18% and 24%, with single tax rate of 12% in 2007 (and 10% since 2008) acted towards decrease in the costs of the employers for engaging working force, initiating employment and decreasing the grey economy. Simultaneously, the changes in the law concerning the gain tax, by which the tax rate of 15% decreased to 12% in 2007 (and to 10% since 2008) and which introduced the tax release equaling the amount of the reinvested gain, resulted in high collection of this tax from the enterprises and, consequently, in considerable cumulating of assets in the Government budget. The stated tax changes reflected the decision of the fiscal governments to decrease the tax burdening in the costs of the producing factors (working force and capital). Yet, in the area of consumption taxation also, in the value added tax (VAT) changes were performed (September 2007), which concerns the introduction of preferential tax rate of 5% for the medications and medical appliances, the computers and software for them, for the thermal solar systems and components and for the public transportation, in aim to facilitate or to support their consumption.

In accordance with the growth in the wages in the public administration (measure adopted in October 2007) and the increased current expenditure of the Government for goods and services (especially in the last quarter), in the second quarter of 2007, the public consumption registered intensification. Also, the investment consumption in RM was significantly supported by the Government in 2007, which gave significant result in the construction. On that manner, the fiscal policy actively influenced as a policy for initiating the aggregate demand.

In conditions of positive economic developments, the reforms in the tax policy and the sharpened tax control in the first half of 2007 contributed to realization of high income, which significantly exceeded the initial projected level. Consequently, in the second half of the year (in August and October) two rebalances of the budget were performed for the purpose of more rational usage and distribution of the accumulated assets. Yet, despite the intensive current and capital expenditure of the Government (especially in the last quarter), the continuous strong income performances in the second half of the year resulted in positive budget balance in 2007. Thus, budget surplus of 0.6% of the realized GDP was registered in the Government budget<sup>41</sup> in 2007, which was significantly differing from the annual projection for surplus of 1% of GDP. The current<sup>42</sup> and the primary<sup>43</sup> budget balance represented confirmation for the success of the fiscal reforms and the good management of the discretionary Government expenditure, which reached up to 4% and 1.5% of the realized GDP.

Figure 56

Budget income and expenditures, primary, current and total budget balance  
(in % of GDP)



Source: Ministry of Finance of the Republic of Macedonia.

<sup>41</sup> Analysis is based on the consolidated Government budget which includes the central Government budget and the funds.

<sup>42</sup> The current budget balance represent a differential between the current income and current expenditures.

<sup>43</sup> The primary budget balance is the total budget balance corrected with the interest repayments.



In the Republic of Macedonia, for a longer period, a prudent policy with low budget deficits (or surpluses) which are lower than the Maastricht criterion for the budget deficit (by 3% of GDP) was conducted. Compared to the countries in Central-East Europe, the policy in RM significantly differs from the expansive fiscal policy in the Czech Republic, Hungary, Poland and Slovakia, and relative to the countries in South-East Europe, from the policy in Croatia and Albania. By the latest analysis, the countries which have strategy of targeting the inflation, insist to introduce fiscal discipline, i.e. to reduce the level of public debt on long term, while for the countries which have fixed foreign exchange rate was recommended to decrease the public consumption prior to the intensive capital inflows.

Table 13  
Budget deficits by countries

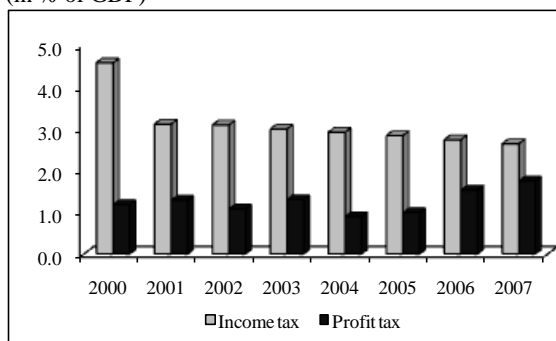
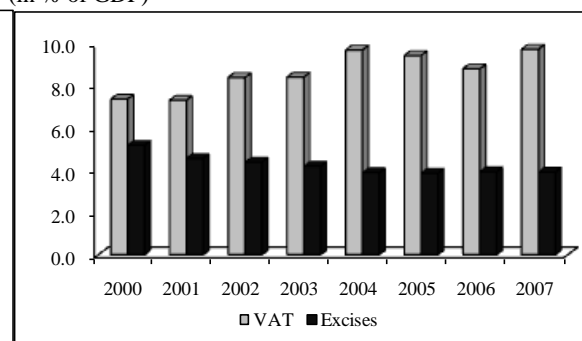
<i>in % of GDP</i>	2000	2001	2002	2003	2004	2005	2006	2007
<i>Central Eastern Europe and Baltic's Countries</i>								
Czech Republic	-3.8	-5.8	-6.8	-6.6	-2.9	-3.6	-3.5	-4.0
Estonia	-0.6	0.3	0.4	2.0	2.3	2.3	3.8	3.8
Hungary	-3.0	-3.5	-8.4	-7.2	-6.5	-7.8	-9.2	-6.8
Latvia	-2.8	-2.1	-2.3	-1.2	-0.9	0.2	-1.5	-1.3
Lithuania	-2.5	-2.0	-1.4	-1.2	-1.5	-0.5	-0.3	-0.5
Poland	-3.0	-5.1	-5.0	-6.3	-5.7	-4.3	-3.9	-3.4
Slovak Republic	-12.2	-6.5	-7.7	-2.7	-2.4	-2.8	-3.4	-2.9
Slovenia	-3.8	-4.1	-2.5	-2.8	-2.3	-1.5	-1.4	-1.5
<i>average</i>	<i>-4.0</i>	<i>-3.6</i>	<i>-4.2</i>	<i>-3.3</i>	<i>-2.5</i>	<i>-2.3</i>	<i>-2.4</i>	<i>-2.1</i>
<i>South Eastern Europe</i>								
Bulgaria	-0.5	1.9	0.1	-0.9	2.2	1.9	3.3	2.3
Croatia	-7.5	-6.8	-4.9	-6.2	-4.8	-4.0	-3.0	-2.8
Romania	-4.6	-3.3	-2.0	-1.5	-1.5	-1.4	-1.9	-2.5
Albania	-9.2	-8.5	-7.2	-4.3	-5.1	-3.6	-4.1	-4.0
Bosnia and Herzegovina	-8.3	-4.5	-3.3	-2.2	-0.6	0.8	-0.2	-1.1
Macedonia	1.8	-7.2	-5.7	-1.1	0.0	0.2	-0.6	0.6
Montenegro	-6.9	-4.0	-3.8	-4.9	-2.6	-1.7	-0.3	-0.5
Serbia	-1.0	-4.9	-8.3	-3.4	0.0	0.9	2.7	0.9
<i>average</i>	<i>-4.4</i>	<i>-4.6</i>	<i>-4.4</i>	<i>-2.9</i>	<i>-1.5</i>	<i>-0.9</i>	<i>-0.5</i>	<i>-1.2</i>

Source: EBRD transition report 2007.

In accordance with the high performances of the tax incomes and the collection of a dividend from one large company with participation of Government capital in 2007, 15% more than the income in 2006 were cumulated in the Government budget (3% over the projected level with the second rebalance of the budget). The improved tax collection generated almost more than a half or 64% of the growth in the total incomes, non-tax income and contributions generated 21% and 17%, respectively, while small percent was determined by the growth in the capital incomes. On the other hand, the inflows from the foreign donations and the incomes from the collected loans registered annual decrease of 3.3% and 1.9%, respectively.

In conditions of higher domestic consumption (annual growth in the volume of domestic trade and in the import of goods of 24% and 27%, respectively) and with more intensive tax control, the incomes of VAT created about 60% of the growth in the tax income. Yet, the high level of VAT income reflected the price growth, which was with intensified dynamics since the last quarter of 2007. The increased import of motor vehicles by 44% and of alcoholic beverages of 8% on annual basis (in conditions of annual fall in the import of oil and cigarettes by 7.7% and 6.4%, respectively and minimal annual fall in the domestic production of cigarettes) resulted in growth in the income from excises (by 9% on annual basis). Thus, in 2007, two thirds of the growth in the tax income was realized by the domestic taxes on goods and services (VAT and excises, which together formed 14% of GDP).

Figure 57

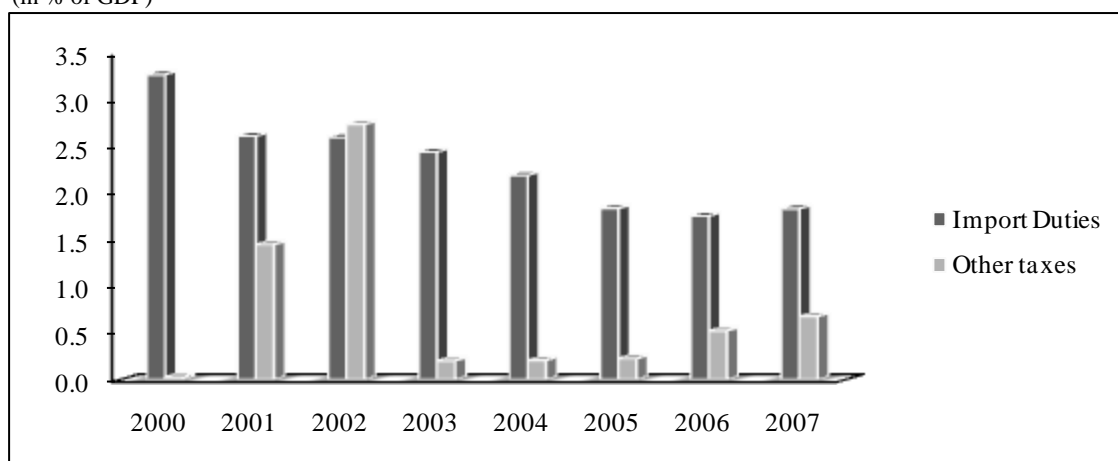
Income and profit tax  
(in % of GDP)Domestic taxes of goods and services  
(in % of GDP)

Source: Ministry of Finance of the Republic of Macedonia.

The trend of high realization of income from taxation of the corporative profit, which started in 2006, continued also in 2007, despite the lower tax rate. In 2007, the income from the gain tax registered annual growth of 25.3% contributing with 8% to the growth in the total income, which indicated stronger financial results of the enterprises and higher tax control. On the other hand, despite the growth in the amount of the gross wages (by about 9% on annual basis), the introduction of a flat tax with single, and simultaneously, lower tax rate determined insignificant growth in the income from the personal income tax. Yet, despite the performed second rebalance of the budget at the end of the year, the income from the personal income tax and the gain tax exceeded the projection by 7% and 3%, respectively.

Despite the gradual decrease in the customs burdening (in accordance with the agreement with STO<sup>44</sup>), in 2007, the stronger customs control in conditions of intensified import, contributed to the growth in the income from custom duties (of 14.4% on annual basis), exceeding the projected value by almost 10%. Within the taxes, significant inflow was realized from the other tax fees also, which registered high annual growth of 42%.

Figure 58

Share of customs revenues and other taxes in the tax revenue structure  
(in % of GDP)

Source: Ministry of Finance of the Republic of Macedonia.

The income from contributions, which had significant structural participation of about 28% in the income structure, in 2007 registered annual growth of 8.7% (with growth in the contributions with all funds being registered), while the growth in the non-tax income of 30.4% mainly reflected

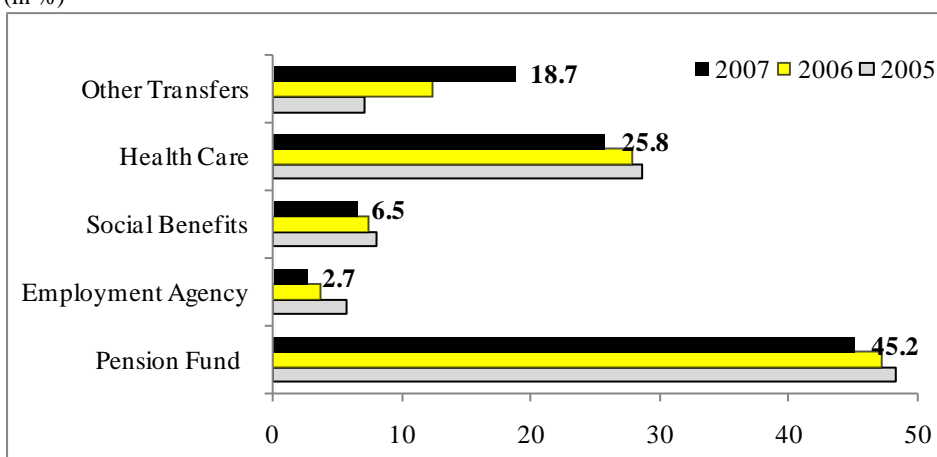
<sup>44</sup> The customs protection for agricultural products decreased from 17.3% to 16.5%. The average non-weighted customs rate for industrial products decreased from 7.5% to 5.3%, whereas the total non-weighted customs rate for the agricultural and industrial products decreased from 9.29% to 8.4%.

the transferred dividend from one large company with participation of Government capital (contribution of 18.4% to the total growth in the income).

In conditions of quality income performances, in 2007, the budget consumption registered annual growth of 11%, which represented realization which was lower by 1.8%, relative to the realization planned with the second rebalance. The largest part of the growth, or by 62%, was determined by the current expenditure, while the capital expenditure of the Government had more higher intensity in the last quarter of the year.

Within the current costs, half of the growth was a result of the higher transfers, especially to the local governments, which corresponded with the start of the second phase of the process of fiscal decentralization<sup>45</sup> (in the third quarter of 2007), with which the payment of the wages to the public administration was performed through the local Government. Thus, the transfers to the local governments registered significant annual growth (of 2.3 times), which adequately reflected the growth in the wages of the public administration (in accordance with the Government's decision in October 2007). On the other hand, the analysis of the costs for wages and compensations showed that they registered minimal annual increase of 0.8% and that they had minimal contribution to the annual growth in the expenditures. Within the other transfers, the agriculture subventions registered significant growth also, which corresponds with the Government's commitments to support directly the agricultural sector.

Figure 59  
Share of the social and other transfers in the total transfers  
(in %)

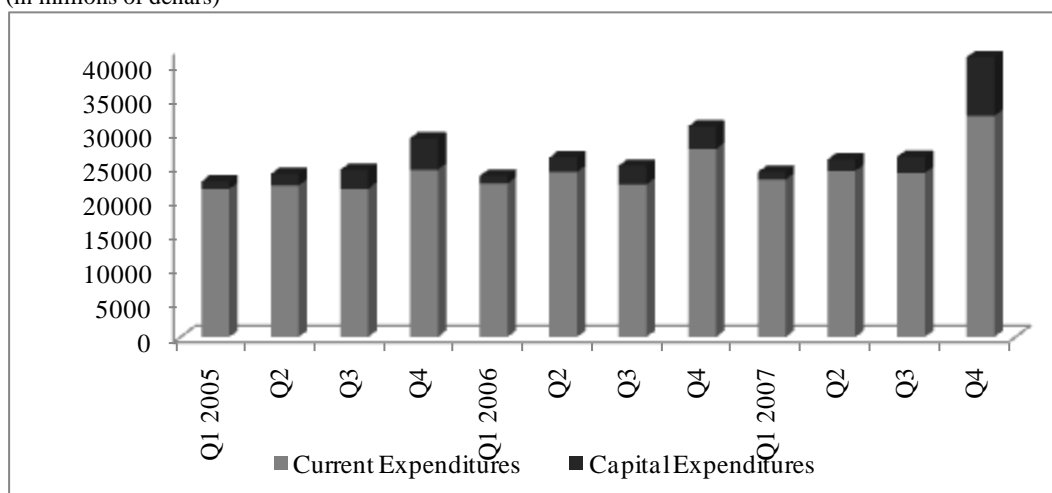


Source: Ministry of Finance of the Republic of Macedonia.

The costs for goods and services, which generated about 13% of the total expenditure structure, in 2007 went up by 14.6% on annual basis, while in conditions of early repayment of a principal of foreign debt and lower domestic indebtedness, the payments based on interest were lower by 8.4%, on annual level. On the other hand, the Government capital investments registered significant intensification in the last quarter of the year, so the capital expenditures determined 38% of the growth in the total expenditures till the end of the year. Such dynamics, i.e. the high concentration of the Government capital expenditures in the last quarter of the year was usual, but in 2007 it significantly exceeded the average from the previous years. Namely, large part of the capital transfers pertains to one-time payment for lawsuit, whereas the part for investments in basic assets pertains to assets transferred for construction of sport, education, business facilities and buildings, the realization of which started in 2007 or shall be performed in 2008.

<sup>45</sup> According to the Governments' decision adopted in July 2007, the costs for compensations and wages for the employees in four sectors of the local public administration (education, social policy and child protection, culture and health) are financed through block-donations in the municipalities which fulfilled the adequate criteria.

Figure 60  
Quarterly distribution of the current and capital expenditures  
(in millions of denars)



Source: Ministry of Finance of the Republic of Macedonia.

Table 14  
Consolidated budget (central Government and funds)

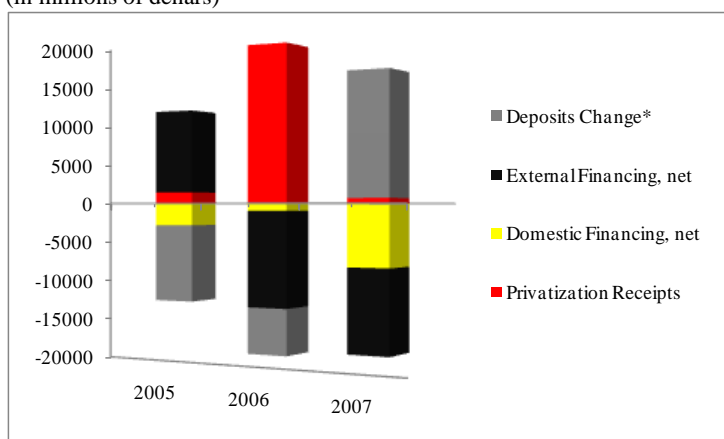
	2006	2007	Annual Change	Contributions	Plan fulfillment 2007
	(million denars)			in %	
<b>TOTAL REVENUES</b>	<b>104,044</b>	<b>119,609</b>	<b>15.0</b>	<b>100</b>	<b>103.0</b>
<b>Taxes and Contributions</b>	<b>90,540</b>	<b>103,219</b>	<b>14.0</b>	<b>81</b>	<b>105.0</b>
Tax Revenues (SRA)	199	247	24.1	0	117.1
Taxes	59,575	69,515	16.7	64	104.2
Personal Income Tax	8,414	8,893	5.7	3	106.9
Profit Tax	4,708	5,898	25.3	8	103.1
VAT	27,239	32,962	21.0	37	103.5
Excises	12,174	13,265	9.0	7	100.5
Import Duties	5,420	6,199	14.4	5	109.7
Other Taxes	1,620	2,298	41.9	4	114.9
Contributions	30,766	33,457	8.7	17	106.8
<b>Non Tax Revenues</b>	<b>10,706</b>	<b>13,962</b>	<b>30.4</b>	<b>21</b>	<b>90.4</b>
Non Tax Revenues (SRA)*	5,771	5,912	2.4	1	82.1
<b>Capital Revenues</b>	<b>948</b>	<b>1,397</b>	<b>47.4</b>	<b>3</b>	<b>2.5 (times)</b>
<b>Foreign Donations</b>	<b>1,423</b>	<b>906</b>	<b>-36.3</b>	<b>-3</b>	<b>49.8</b>
<b>Revenues from repayment of loans</b>	<b>427</b>	<b>125</b>	<b>-70.7</b>	<b>-2</b>	<b>6.3 (times)</b>
<b>TOTAL EXPENDITURES</b>	<b>105,744</b>	<b>117,441</b>	<b>11.1</b>	<b>100</b>	<b>98.2</b>
<b>Current Expenditures</b>	<b>96,478</b>	<b>103,700</b>	<b>7.5</b>	<b>62</b>	<b>98.5</b>
Wages and Allowances	23,421	23,607	0.8	2	97.0
Goods and Services	12,927	14,813	14.6	16	86.3
Transfers	56,607	62,406	10.2	50	102.2
Interest	3,137	2,874	-8.4	-2	104.4
Guaranties	387	0			
<b>Capital Expenditures</b>	<b>9,266</b>	<b>13,741</b>	<b>48.3</b>	<b>38</b>	<b>96.0</b>
<b>BUDGET BALANCE</b>	<b>-1,700</b>	<b>2,168</b>			
<b>FINANCING</b>	<b>1,700</b>	<b>-2,168</b>			
<b>Inflow</b>	<b>21,031</b>	<b>19,300</b>			
Privatisation Receipts	20,697	662			
Foreign Loans	1,732	3,643			
Deposits	-5,877	15,459			
Domestic borrowing	2,019	-526			
Sell of Shares	2,459	62			
<b>Outflow</b>	<b>19,331</b>	<b>21,468</b>			
Repayment of Principal	19,331	21,468			
Foreign	13,944	14,200			
Domestic	5,387	7,268			

\* Special Revenue Accounts

Source: Ministry of Finance of the Republic of Macedonia.

In conditions of significant inflow of income and realization of high budget surpluses (excluding the last quarter of 2007) and when high net position of the Government with NBRM being registered, the Ministry of Finance started decreasing the level of the public debt in 2007. The positive developments in the budget, supplemented by the concession inflows (Denar 609 million from issuing the founding and operating license to the third mobile operator), the foreign borrowings (Denar 3,643 million) and the assets of the Government with NBRM, created conditions for repayment of a principal of foreign debt (Denar 14,200 million) and domestic debt (Denar 7,268 million). In the first half of the year, early purchase was performed of a part of the debt to the Paris Club of Creditors (Euro 68.2 million), part of the debt to the International Bank for Reconstruction and Development (Euro 95.9 million), and from the domestic debt, the Rehabilitation Bond of "Stopanska Banka" AD Skopje was repaid (in amount of Euro 21.2 million) and repayment of the regular installments of the bonds for old foreign currency savings and denationalization (in April and June, respectively). In the second half of 2007, repayment of a debt to the European Investment Bank (in amount of Euro 6.8 million) and of the rest of the debt to the Paris Club of Creditors (in amount of Euro 8.35 million) was performed and after the performed revision, part of the funds from the privatization of ESM (Euro 22.5 million) were returned to the foreign investor. On the side of the domestic debt, repayment of the regular installment of the bond for old foreign currency saving was performed (in October).

Figure 61  
Financing the budget balance  
(in millions of denars)

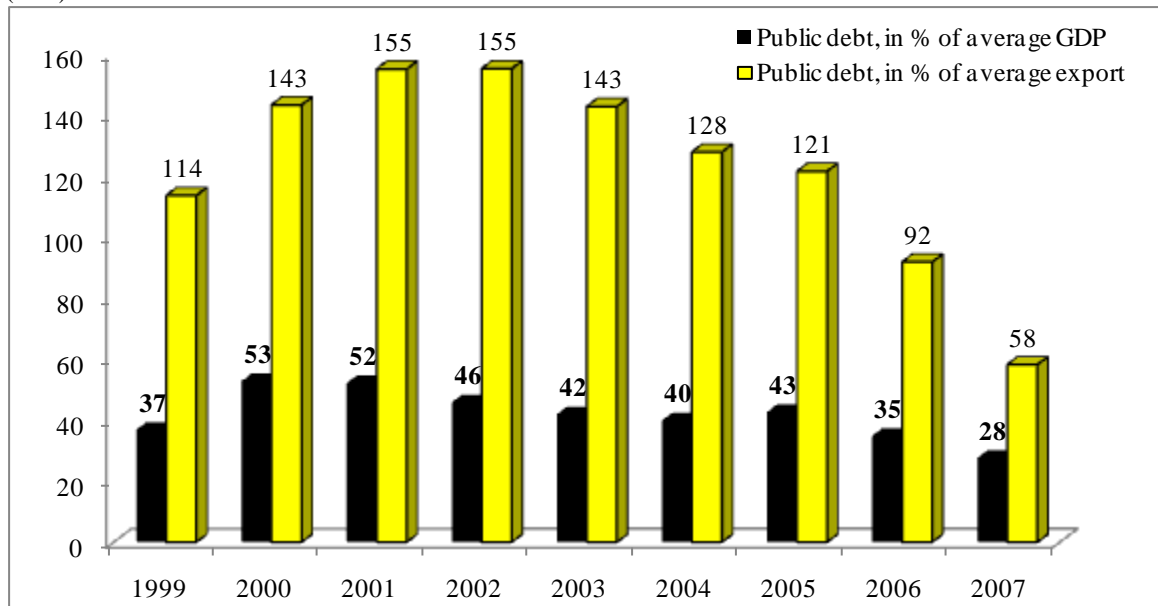


\* The positive development in the Government deposits represent withdrawal from the account with NBRM.  
Source: Ministry of Finance of the Republic of Macedonia.

In accordance with the early and regular repayments of a principal of external and domestic debt, and in conditions of a lower domestic indebtedness in the market of Government securities (with higher budget incomes being registered), in 2007, the overall public debt of the central Government (central Government, funds and public associations)<sup>46</sup> reduced by Euro 247 million. Thus, in 2007, the participation of the public debt in GDP reduced to 28%, which was significantly under the Maastricht criterion for the level of public debt (60% of GDP).

<sup>46</sup> The analysis of the public debt encompasses the debt of the central Government, funds and public enterprises (the debt of the municipalities is 0). Namely, such analysis corresponds with the national methodology for calculating the public debt (excluding the debt of NBRM), but it does not correspond with the statistics of the Government finances (of IMF) which includes the debt of NBRM. The domestic debt of the central Government covers the structural and continuous securities.

Figure 62  
Public debt  
(in %)



Source: Ministry of Finance of the Republic of Macedonia.

In accordance with the good fiscal position, in 2007, the needs of the Government both for foreign and domestic indebtedness decreased. Thus, with lower supply of Treasury bills and continuous fall in the maximal interest rate being registered, the demand registered fall. The overall supply exceeded the overall demand by 3.4%, so the average weighted interest rate for all Treasury bills with different maturity registered decrease (from 6.6% in 2006 to 5.7% in 2007). Analyzed with respect to the maturity, the three-month bills continued dominating in the total portfolio of Government securities, which in 2007 registered downward trend of demand, so the total supply exceeded the total demand by 4.7%, and the average weighted interest rate registered annual decrease of 0.8 percentage points (it reduced to 5.6%). On the other hand, opposite of the lower investments in three-month Treasury bills, the overall demand for six-month bills exceeded the overall supply by 23.6%, despite the registered fall in the interest rate. In the first half of the year three auctions of one year Treasury bills were held (January, March, June), whereas in the second half<sup>47</sup> on the auctions in September and December 20% and 4% of the supplied amount were realized, respectively. The downward trend of the demand for Government securities was registered also in the Government bonds. Namely, in the first half of the year two auctions of two-year bonds were held (in February and May, with lower interest for the second one which was due to the significantly lower maximal interest rate), and in the second half of the year<sup>48</sup>, in November, 87% of the supplied amount were realized. At the end of March the second three-year Government bond<sup>49</sup> was issued when about 86% of the supplied amount were realized.

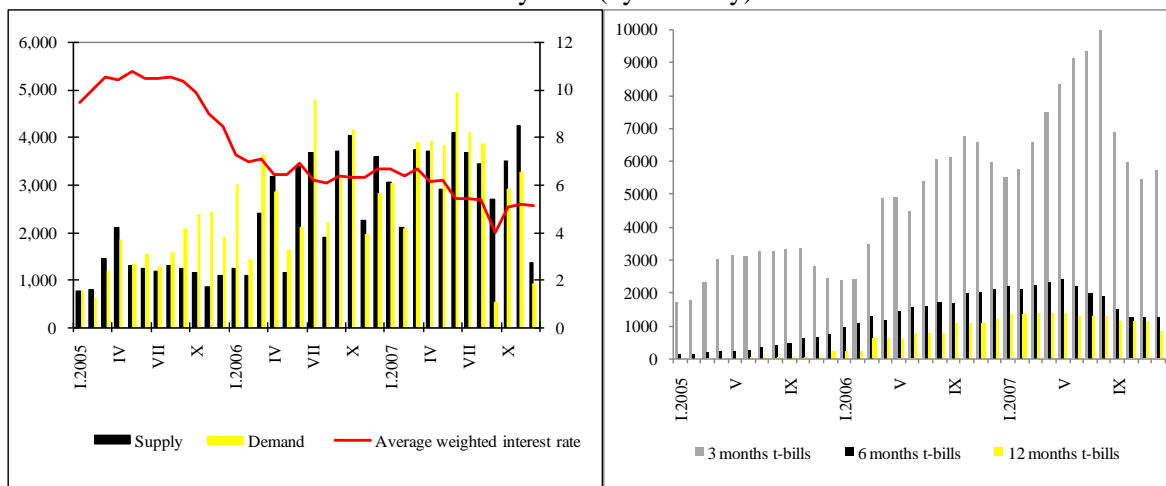
<sup>47</sup> Auction of one-year Treasury bills in July was revoked due to a lack of interest for investment.

<sup>48</sup> Auction of two-year bond in August which was revoked.

<sup>49</sup> Auction of three-year bond in June was revoked (in conditions of lower interest rate).

Figure 63

Total supply and demand of Treasury bills (in millions of denars) and average weighted interest rate and stock of the investments in Treasury bills (by maturity)

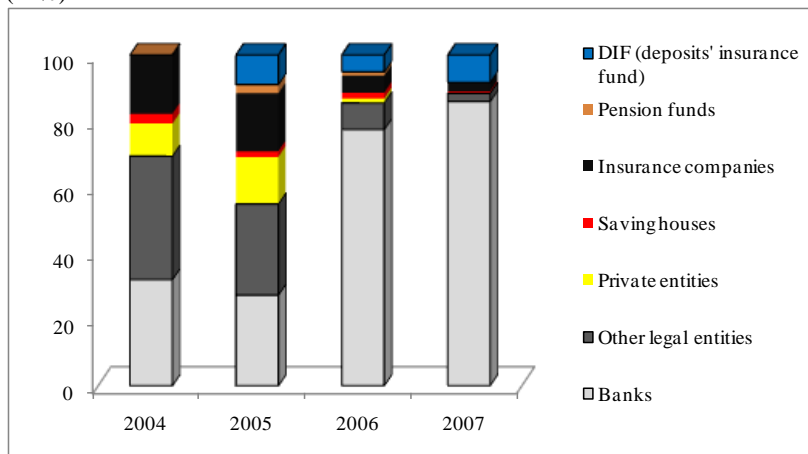


Source: NBRM and the Ministry of Finance of the Republic of Macedonia.

In the last two years, the banks represented dominant investor in the primary market of Government securities. Thus, at the end of 2007, their participation equaled 86%, the participation of the Deposit Insurance Fund (DIF) was 8%, whereas the investments of the corporate sector and of natural persons were insignificant.

Figure 64

Structure of investments in Treasury bills by investors\* (in %)



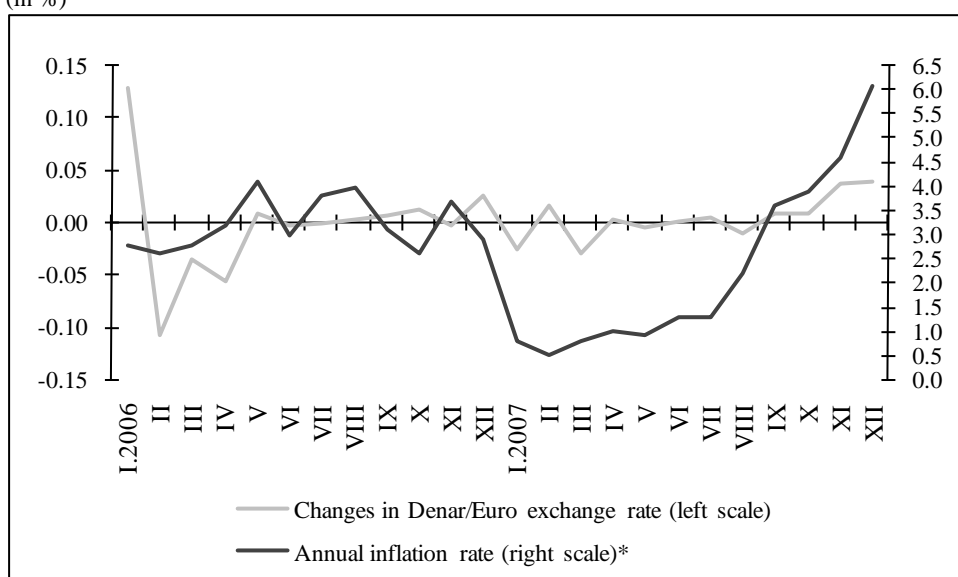
\* On March 7, 2006, NBRM in cooperation with the Ministry of Finance of the Republic of Macedonia started with emission of Treasury bills for monetary purposes, with maturity of three months.

Source: NBRM and Ministry of Finance of the Republic of Macedonia.

### III. Monetary developments in the Republic of Macedonia

The monetary policy in the 2007 was focused on maintaining the stability of the nominal foreign exchange rate of the Denar against the Euro and low and stable inflation. Thus, in 2007 relatively low average inflation rate of 2.3% was realized. Yet, in the second half of the year the inflation rate intensified, mainly under the influence of the intensified growth in the prices of food, which represented global trend. The basic inflation rate (excluding the food and energy) was lower and it equaled 0.7%. During the year, higher foreign currency inflows based on private transfers, portfolio and foreign direct investments were registered, which enabled high net purchase of foreign currencies by NBRM.

Figure 65  
Inflation and foreign exchange rate  
(in %)



\* Current month relative to the same month of the previous year.

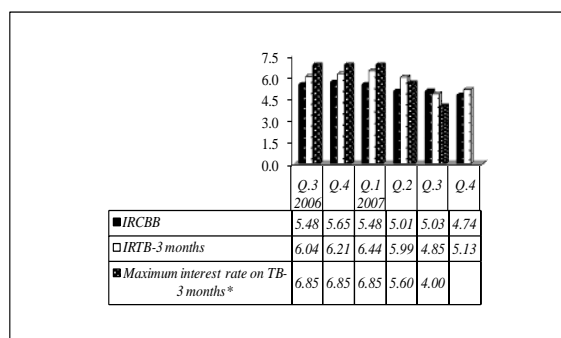
Source: National Bank of the Republic of Macedonia and State Statistical Office.

The monetary instruments of NBRM were in function of sterilization of the monetary effects from the foreign currency transactions of NBRM, which enabled efficient management with the liquidity in the banking system<sup>50</sup>. On the auctions of CB bills held during the year, the demand generally exceeded the supply, creating pressure for decrease in the interest rate, which in December 2007 reduced to the level of one-month EURIBOR equaling 4.77% (5.74% in December 2006). Such intensified approximation of the domestic interest rate to those in the Euro-zone was realized in conditions of restrictive monetary policy of ECB and upward trend of the EURIBOR, initiated by the instability in the money markets, as a result of the mortgage crises in USA. The interest rate of the three-month Treasury bills, on annual basis, decreased by 1.1 percentage points and it equaled 5.15% in December 2007.

<sup>50</sup> NBRM prepares separate report on the banking system - Report on the Banking System and Banking Supervision of the Republic of Macedonia.



Figure 66  
Interest rates\*  
(in %, on annual level)

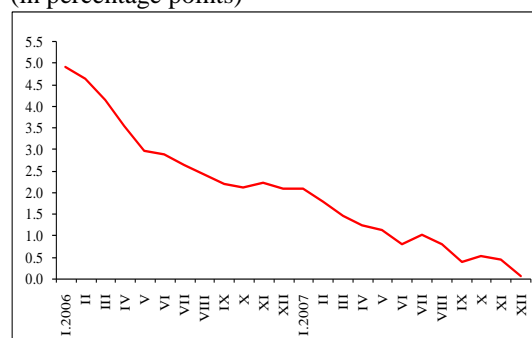


\* Average for the quarter of the average weighted interest rate, except for the maximal interest rate, which pertains to the interest on the last auction in the quarter. In October 2007, the Ministry of Finance revoked the maximal interest rates and introduced a speculative percentage point, which was determined at the level of 0.02 for the three-month Treasury bills. TBIR - Treasury bills interest rate.

TBIR -3-months - three-month Treasury bills interest rate.

Source: National Bank of the Republic of Macedonia, Ministry of Finance and Central Bank of Nederland (www.statistics.dnb.nl).

Figure 67  
Interest differential among the CB bills - 28 days and EURIBOR - one month  
(in percentage points)



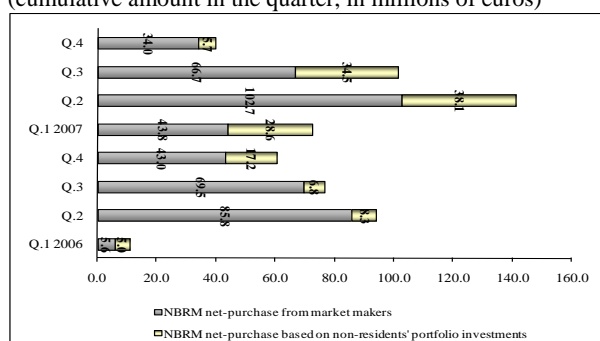
In 2007, the analysis of the autonomous factors which influenced the liquidity in the banking system showed dominant creating liquidity through the purchase of high inflows of foreign currencies in the foreign exchange market by NBRM. Thus, the net purchase of foreign currencies reached up to 6.4% of GDP<sup>51</sup>, relative to 4.8% of GDP in 2006. With respect to the dynamics, the high foreign currency inflows from abroad were characteristic for most of the year, excluding the last quarter, when in accordance with the worsened position of the balance of payments, pressures for depreciation of the domestic currency emerged in the foreign exchange market. Yet, despite such developments, in the fourth quarter of 2007, NBRM realized net purchase of foreign currency assets in the transactions with the supporting banks, whereas outflow of foreign currency assets was realized based on net sale of foreign currencies for using foreign currency rights for portfolio investments (in November and December)<sup>52</sup>. The lower preference of the foreign investors for investment in domestic securities corresponded with the higher political uncertainty in the area, as well as with the instability in the global financial market, as a factor which reduced the demand for financial assets in the countries which were not directly exposed to the mortgage crisis, and simultaneously influenced on the decrease in the liquidity in the countries which were facing a financial crises.

<sup>51</sup> Estimated GDP data.

<sup>52</sup> In the last quarter of 2007 net sale of foreign currencies was realized for Government needs.

Figure 68  
Interventions on the foreign exchange market by  
NBRM

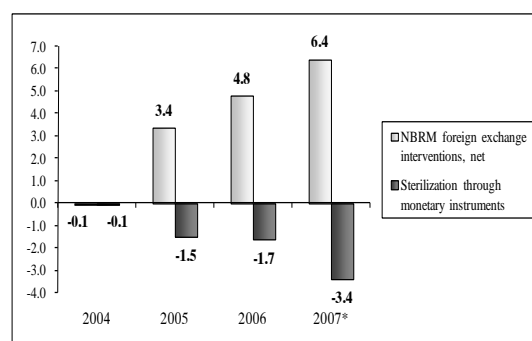
(cumulative amount in the quarter, in millions of euros)



\* Estimated value of GDP.

Source: National Bank of the Republic of Macedonia.

Figure 69  
Participation on GDP  
(in %)



The Denar deposits of the Government with NBRM, on annual basis acted towards creating liquidity, reflecting the high budget expenditure, concentrated in the last month of the year<sup>53</sup>. Yet, during the year, in conditions of improved realization of the tax income and the realized payment of dividend by one larger domestic company (in August 2007), the Denar deposits of the Government mainly grew, neutralizing a share of the created liquidity in the banking system. The currency in circulation followed the usual seasonal dynamics and on annual basis they acted towards liquidity withdrawal from the banking system. On net basis, the autonomous factors acted towards creating liquidity in the banking system, which was mainly sterilized through the monetary instruments (additionally sterilized liquidity in 2007 of 3.4% of GDP<sup>54</sup>, relative to 1.7% of GDP in 2006).

Table 15  
Flows of creating and withdrawing liquidity \*  
(in millions of denars)

	Balance as of 31.12.2006	Changes by quarters				Total	Balance as of 31.12.2007
		Q.1	Q.2	Q.3	Q.4		
<b>Banks' liquidity (banks' account with the NBRM)</b>	7,159	-901	1,197	-665	3,625	3,256	10,415
<b>Liquidity creation</b>						<b>9,227</b>	
1. Net foreign assets	85,116	-50	2,724	6,419	134	9,227	94,343
<b>Liquidity withdrawal</b>						<b>-5,971</b>	
1. Net domestic assets	-60,225	-2,081	-595	-6,004	4,871	-3,809	-64,034
of which:							
CB bills	-9,456	-1,847	-3,792	-1,244	-4,656	-11,539	-20,995
Treasury bills for monetary purposes	-4,573	-964	-2,545	1,770	1,752	13	-4,560
Government denar deposits with the NBRM <sup>1</sup>	-10,753	-3,816	844	-6,091	9,970	907	-9,846
Government foreign currency deposits with the NBRM	-17,631	5,501	6,401	889	-753	12,038	-5,593
Other items, net	-20,113	-950	-274	-1,328	-1,441	-3,993	-24,106
2. Currency in circulation	16,206	1172	-810	-902	-1181	-1,721	17,927
3. Banks' vault cash	1,526	58	-122	-178	-199	-441	1,967

<sup>1</sup> Excludes the Treasury bills for monetary purposes.

\* Positive change - creating liquidity; negative change - liquidity withdrawal.

Source: National Bank of the Republic of Macedonia.

At the end of 2007, the reserve money went up by 21.8%, relative to the end of the previous year, with growth in the both components being registered. More intensive annual change was registered in the total liquidity assets and the cash in the banks' vault which contributed with 68.2% to the growth in the reserve money.

<sup>53</sup> Higher realization of capital expenditures, higher transfer payments in the country and to abroad and realized return of funds to a foreign investor after performed revision.

<sup>54</sup> Estimated GDP data.

**Table 16**  
**NBRM Survey**  
(in millions of denars)

	Balance as of	Changes by quarters					Balance as of
	31.12.2006	Q.1	Q.2	Q.3	Q.4	Total	31.12.2007
Reserve money	24,891	-2,131	2,129	415	5,005	5,418	30,309
Currency in circulation	16,206	-1172	810	902	1181	1,721	17,927
Banks' account with the NBRM	7,159	-901	1,197	-665	3,625	3,256	10,415
Banks' vault cash	1,526	-58	122	178	199	441	1,967
Net foreign assets	85,116	-50	2,724	6,419	134	9,227	94,343
Foreign assets	87,761	-235	323	6,360	134	6,582	94,343
Foreign liabilities	2,645	-185	-2,401	-59	0	-2,645	0
Net domestic assets	-60,225	-2,081	-595	-6,004	4,871	-3,809	-64,034
1. Credit to banks, net	-13,995	-2,816	-6,338	526	-2,905	-11,533	-25,528
- credits	34	-5	-1	0	-1	-7	27
-instruments <sup>1</sup>	-14,029	-2,811	-6,337	526	-2,904	-11,526	-25,555
2. Net government position with the NBRM	-26,117	1,685	6,017	-5,202	9,217	11,717	-14,400
-Claims on Government	2,267	0	-1,228	0	0	-1,228	1,039
-Government deposits <sup>2</sup>	-28,384	1,685	7,245	-5,202	9,217	12,945	-15,439
3. Other items, net	-20,113	-950	-274	-1,328	-1,441	-3,993	-24,106

<sup>1</sup> Includes the CB bills and Treasury bills for monetary purposes.

<sup>2</sup> Excludes the Treasury bills for monetary purposes.

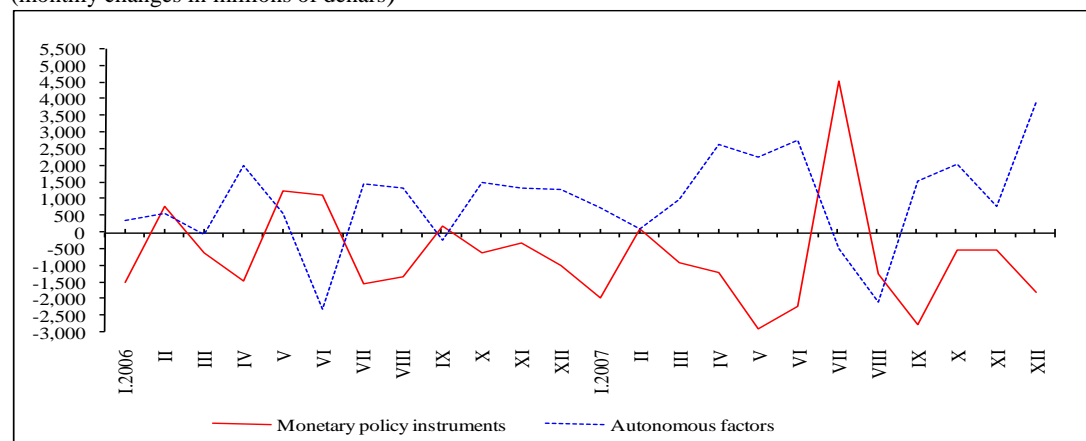
Source: National Bank of the Republic of Macedonia.

Analyzed with respect to the NBRM balance, in 2007 the net foreign currency assets of NBRM acted towards growth in the reserve money, based on the realized net purchase of foreign currencies in the foreign exchange market. The net domestic assets of NBRM, in 2007 represented a flow of withdrawal of reserve money, which was mostly realized through the monetary instruments.

### 3.1. Monetary instruments

In accordance with the applied monetary strategy of targeting the foreign exchange rate of the Denar, the changes in the monetary instruments represented reaction of the developments in the foreign exchange market and of the position of the fiscal policy in 2007 also. In 2007, in conditions of maintaining budget surplus in most of the year, mainly sterilization of the liquidity effects from the high foreign currency inflows was performed through the monetary instruments.

**Figure 70**  
Monetary policy instruments and autonomous factors of creating and withdrawing liquidity \*  
(monthly changes in millions of denars)



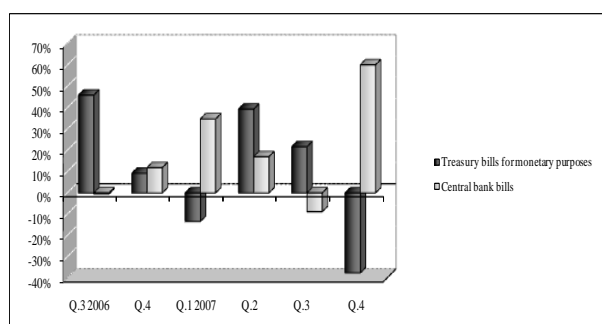
\* Positive change - creating liquidity; negative change - liquidity withdrawal.

Source: National Bank of the Republic of Macedonia.

In 2007, the CB bills represented dominant financial instrument for investment of the free liquidity assets of banks. During the year, NBRM did not made changes in the position of the

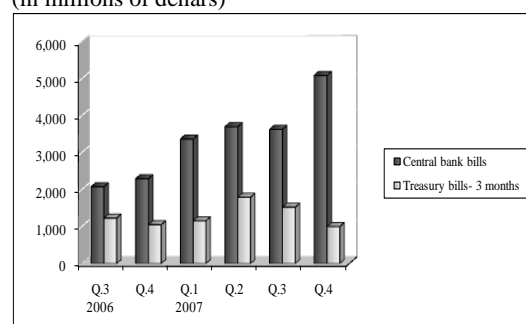
monetary instruments, i.e. it continued holding auctions based on the principle of "interest rate tender". On the auctions of CB bills, held during the year, the average demand exceeded the supply by 5.8%, which contributed for further decrease in the interest rate (4.77% in December 2007, relative to 5.74% in December 2006). Through the CB bills, total Denar 11,539 million were sterilized, whereas the Treasury bills for monetary purposes, on annual basis, acted towards liquidity emission in the banking system. Such dynamics of the Treasury bills for monetary purposes was solely due to the lower interest of the banks for investments in these securities in the second half of the year, as a result of the performed changes in the terms of the auctions of Treasury bills. Namely, the significant decrease in the maximal interest rate by the Ministry of Finance, as well as the introduction of the right for restricted participation<sup>55</sup>, resulted in decrease in the attractiveness of the Treasury bills and returning of the banks towards auctions of CB bills.

Figure 71  
Quarterly dynamics of the supply of CB bills and Treasury bills for monetary purposes



Source: National Bank of the Republic of Macedonia.

Figure 72  
Average demand on the auctions held in the quarter  
(in millions of denars)



In 2007 in the management with the liquidity by the banking sector, further decrease in the allocated liquidity excess over the reserve requirements was registered. Thus, in 2007, at the end of the accounting period, the banks allocated 8.3% on average over the reserve requirements (in denars)<sup>56</sup>, which was by 2.1 percentage point lower than the average of the previous year. Such developments indicated more efficient liquidity management by the banks, taking in consideration that the lower level of excess over the reserve requirement, as non-interest bearing assets, means also a lower opportunity cost. In conditions of continuous maintaining an adequate liquidity level in the banking system and structure excess, in 2007 no Lombard credits were used.

#### Annex 4

##### Chronology of the amendments to the legal framework pertaining to the monetary instruments and foreign exchange market in 2007

**May 23, 2007**

NBRM adopted a Decision on decreasing the interest rate on Lombard credit<sup>57</sup> from 9.5% to 7.5%.

<sup>55</sup> In October 2007, the Ministry of Finances revoked the maximal interest rate and introduced right to a limited participation and speculative percentage point, determined at the value of 0.02 for three-month Treasury bills.

<sup>56</sup> The period for maintaining (fulfilling) the banks' reserve requirement covers the period from the 11<sup>th</sup> in the current month to the 10<sup>th</sup> in the following month. The excess pertains to funds allocated to the banks' accounts with NBRM over the reserve requirement.

<sup>57</sup> Collateralized short-term credits for overcoming the temporary liquidity problems of the banks, entering the monetary instruments group - „standing facilities“.

**December 27, 2007**

NBRM adopted new Decision on reserve requirement of banks (entering into force on February 11, 2008), which prescribed the basis for calculating the reserve requirement by introducing new categories of accounts from the banks' balances, thus enabling further application of the basic principles of the instrument - equal treatment and wide scope of the liabilities from the banks' balances.

**December 27, 2007**

NBRM adopted a Decision on the cessation of the validity of the Decision on the manner of and the conditions for conducting non-residents' operations with securities of the Republic of Macedonia. By adopting this Decision, entering into force on January 01, 2008, full liberalization in the purchase of securities by non-residents is enabled, i.e. the foreign exchange rights and other requirements for the non-residents' portfolio investments in the Republic of Macedonia are revoked. The liberalization of the portfolio investments is directed towards further implementation of the undertaken requirements under the Stabilization and Association Agreement between the Republic of Macedonia and the European Union, which enables equal conditions for foreign portfolio investments as other countries in the region, as well as significantly reduced administrative procedures given the entry of portfolio investments.

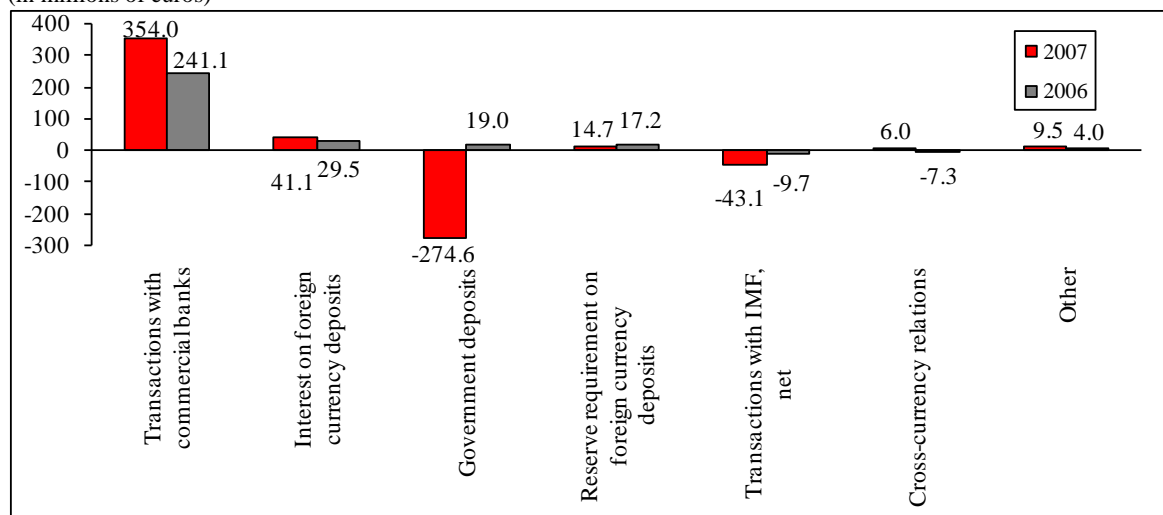
**3.2. Foreign reserves and foreign exchange rate**

The favorable movements on the foreign exchange market since 2005 had positive reflection on the foreign reserves. Namely, the gradual liberalization of the capital account, the admission to CEFTA, the acquiring of the status of candidate country for joining EU, the higher credit rating, as well as the aggressive policy of the Government for attracting foreign capital in the country (tax reduction, international promotion of the country), contributed to incremented inflow of foreign currency. The largest portion of the foreign currency inflow in 2007 originates from private transfers, which together with the intensified inflows from foreign investors in type of portfolio and direct investments, as well as the indebtedness of the private sector abroad enabled increase in the foreign reserves. On December 31, 2007, the gross foreign reserves reached Euro 1,524.4 million, and compared to the previous year they augmented by Euro 107.7 million.

Figure 73

Factors of change in the gross foreign reserves in 2006 and 2007

(in millions of euros)



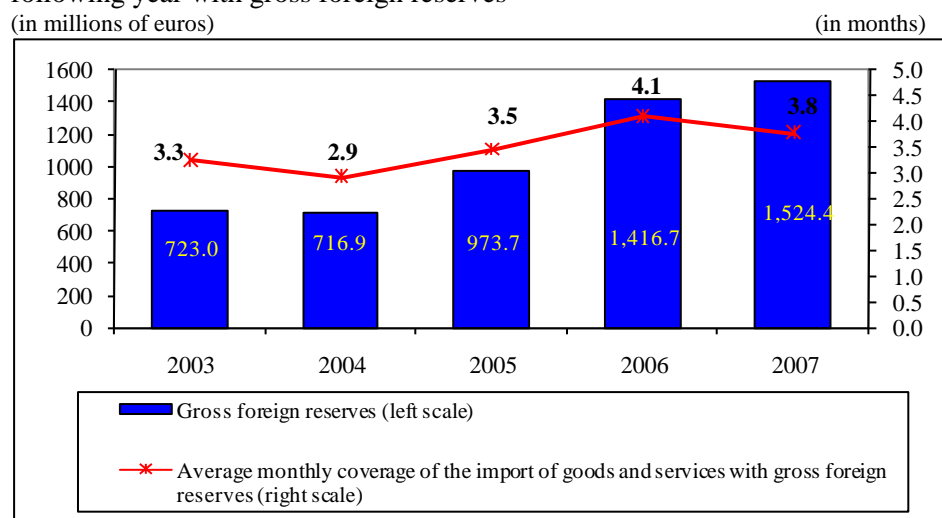
Source: National Bank of the Republic of Macedonia

In 2007, the NBRM, by applying its intervenient policy on the foreign exchange market, registered high net purchase of foreign exchange in the amount of Euro 354 million, with the NBRM foreign exchange transactions contributing with 83% within the factors with positive share in the change in the foreign reserves. Namely, the risen foreign exchange inflows from abroad resulted in excess foreign currency on the foreign exchange market, which in environment of implementation of the policy for the Denar foreign exchange rate targeting against the Euro, was absorbed through the NBRM transactions with the foreign exchange market supporting banks. In environment of favorable movements in the external sector and satisfactory level of foreign reserves, in 2007 besides the regular payments based on the previously used credits, early payments towards several international institutions were also made, the largest portion of which were realized in the first half of 2007 (Paris Club of Creditors, IMF, MBDP).

As a result of the movements in the balance of payments and the early payment of a significant part of the public debt, the level of the gross foreign reserves at the end 2007 enabled coverage of 3.8-month import of goods (f.o.b.) and services for the following year, on average<sup>58</sup>, compared to the import coverage of 4.1-month, on average, in 2006.

Figure 74

Gross foreign reserves and monthly coverage of the import of goods (f.o.b.) and services from the following year with gross foreign reserves\*



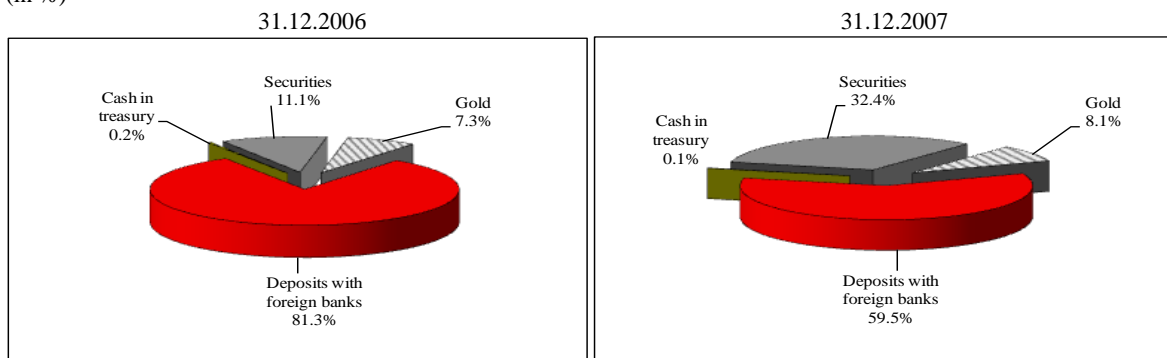
\* The data on the import of goods (f.o.b.) and services from the following year after the 2004 - 2007 period are given according to the realized amounts, while the import in 2008 is given according to the projection.  
Source: National Bank of the Republic of Macedonia.

The structural analysis of the total foreign assets<sup>59</sup> shows dominant, although significantly reduced structural share of the foreign currency deposits in foreign banks (by 21.9 percentage points), for the account of the positive structural movements with the securities (by 21.3 percentage points). This structural share is due to the application of active approach regarding the foreign reserves placement, which ensures balance of risks and yields, and it is also in conformity with the contemporary world flows in this area.

<sup>58</sup> According to the balance of payments projection prepared within the IMF Mission in November 2007.

<sup>59</sup> The total foreign assets differ from the gross foreign reserves by the amount of foreign assets given as collateral in foreign banks and funds allocated on special account, which are included in the total foreign assets, but not in the gross foreign reserves.

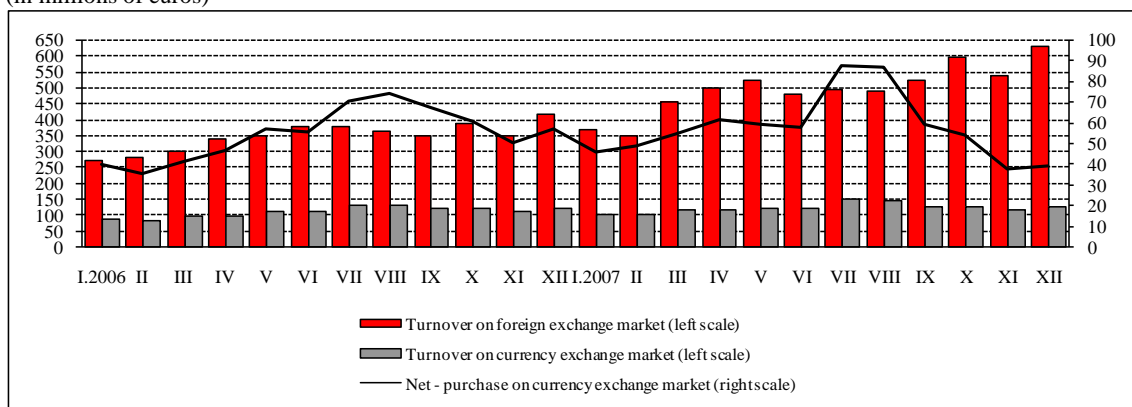
Figure 75  
Structure of the total foreign assets  
(in %)



Source: National Bank of the Republic of Macedonia.

In 2007, the foreign currency flows in the Macedonian economy reflected on both foreign exchange and currency exchange market. Thus the turnover on the currency exchange market equaled Euro 1,472.2 million and it went up by 11.5%, annually. However, the continuously higher supply than demand for foreign currency during the whole year enabled net purchase to reach Euro 687.5 million, with, commonly, the highest amounts being registered in July and August. The quarterly analysis indicates that in the first three quarters the net purchase registers an increase, compared to the previous year, although with slower pace, while in the fourth quarter, for the first time since 2004, a drop was registered (of 22.2%, annually). Consequently, the net purchase of the currency exchange operating evidenced lower annual increase of 5.6%, compared to 21.2% and 47% in 2006 and 2005, respectively. Also the foreign exchange market witnessed intensified turnover. Thus in 2007, the turnover on the foreign exchange market amounted to Euro 5,955.6 million, which is rise of 43.1% relative to the preceding year. The highest turnover was registered in the "banks-enterprises" segment, with the banks registering cumulative net sale of foreign exchange in the amount of Euro 383.5 million at the end of the year, which is an annual decline of 5.7%<sup>60</sup>. The turnover of the "banks-banks" segment went up by 60.7% annually, proving the importance of the supporting banks in the functioning of the foreign exchange market. The high foreign currency inflows in the economy led to incremented supply than demand of foreign currency during the whole year (except in November), thus causing pressure for appreciation of the domestic currency.

Figure 76  
Turnover on both foreign exchange and currency exchange market  
(in millions of euros)



Source: National Bank of the Republic of Macedonia.

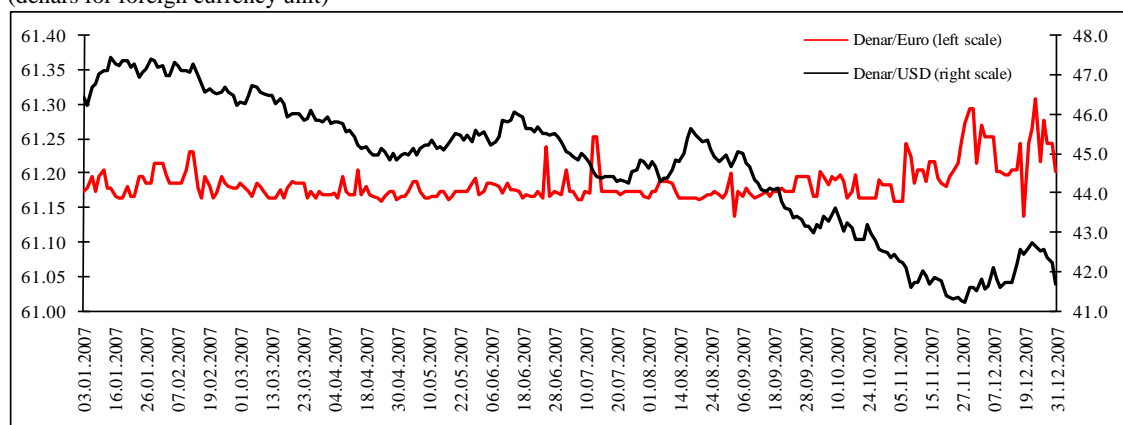
<sup>60</sup> The banks registered net purchase of foreign exchange only in April, as a result of the enhanced demand for Denars due to the undertaking of one bank by a foreign investor.

In order to maintain stable foreign exchange rate of the Denar relative to the Euro, the NBRM intervened on the foreign exchange market with a net purchase of foreign exchange (out of the total net purchase, the interventions intended for maintenance of the foreign exchange rate of the supporting banks equaled Euro 247.1 million in 2007, while the purchase based on the foreign exchange rights related to the securities from non-residents amounted to Euro 107 million). Consequently, in 2007, the average exchange rate of the Denar relative to the Euro on the foreign exchange market remained stable and it equaled Denar 61.18 per one Euro (Denar 61.19 per one Euro were traded in 2006), while the foreign exchange rate on the currency exchange market equaled Denar 61.41 per one Euro (unchanged relative to 2006).

Figure 77

Nominal foreign exchange rate of the Denar against the Euro and the US Dollar on the foreign exchange market

(denars for foreign currency unit)



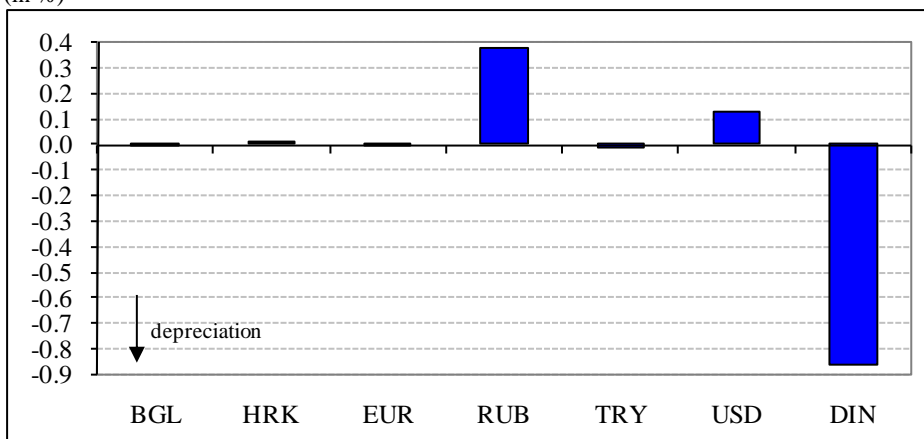
Source: National Bank of the Republic of Macedonia.

In 2007, the appreciation of the Euro compared to the US Dollar appropriately reflected on the Denar/US Dollar correlation. Namely, the Denar registered continuous strengthening of its value relative to the US Dollar, especially in the second half of 2007, with the highest value being evidenced at the end of November. Thus the average foreign exchange rate in 2007 equaled Denar 44.72 per one US Dollar, i.e. significant annual nominal appreciation of 8.3% was recorded. Change with same foreign exchange rate intensity was also recorded on the currency exchange market, where Denar 44.78 on average were traded per one US Dollar.

The real effective exchange rate (REER) index is macroeconomic indicator through which the economy competitiveness is monitored and it is presented as a correlation between the nominal effective exchange rate (NEER) index and the relative prices index. In 2007, the average NEER of the Denar depreciated by 0.4% in comparison with 2006, which results primarily from the intensified appreciation of the Serbian Dinar relative to the US Dollar, compared to that of the Macedonian Denar.



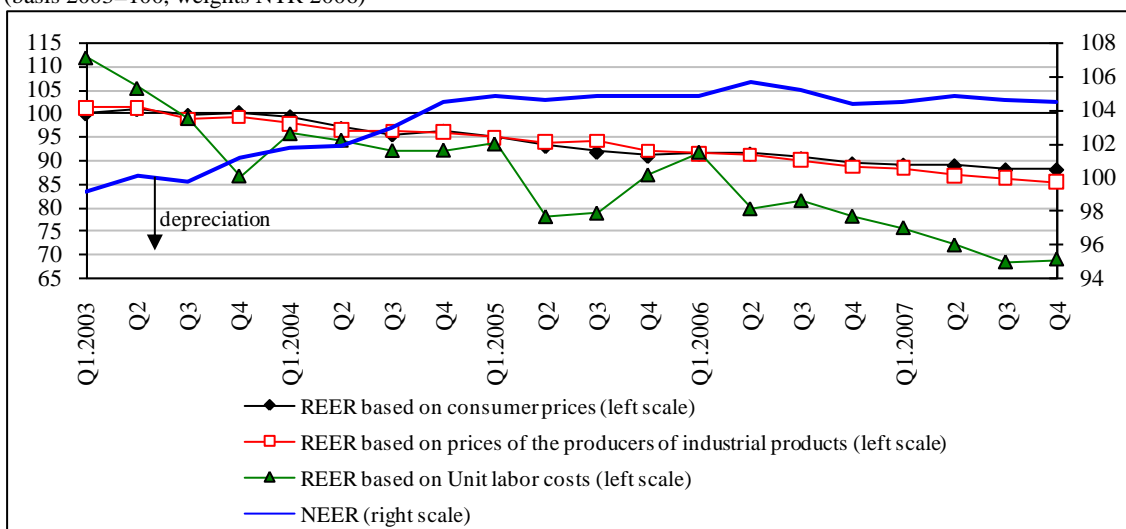
Figure 78  
Contribution to the change of NEER of the Denar \*  
(in %)



\* Aggregated weight out of the weights of the Euro zone countries is used for the Euro, included in the calculation of REER.  
Source: National Bank of the Republic of Macedonia.

The depreciation of the NEER of the Denar was supplemented with the increase in the relative prices, with the REER of the Denar also registering an annual depreciation. However, depreciation of the Denar of 2.3% was registered with the REER of the Denar deflated with the consumer price index, in environment of more intensive increase in the foreign and domestic prices (4.8% and 2.8%, respectively<sup>61</sup>). Similar movements were also recorded with REER, calculated according to the index of the prices of the producers of industrial products, i.e. annual depreciation of 4.0%, which is a result primarily from the significantly higher increase in the foreign prices compared to the domestic ones (5.5% and 1.7%, respectively<sup>62</sup>). REER of the Denar deflated with the index of the labour force costs per currency unit<sup>63</sup> registered annual depreciation of 13.9%, which is mostly a result of the change in the relative prices of 15.4% (increase in the foreign and decrease in the domestic costs of the labour force per currency unit).

Figure 79  
Index of REER and NEER of the Denar  
(basis 2003=100, weights NTR 2006)



Source: National Bank of the Republic of Macedonia.

<sup>61</sup> Changes in prices with base 2003=100.

<sup>62</sup> Changes in prices with base 2003=100.

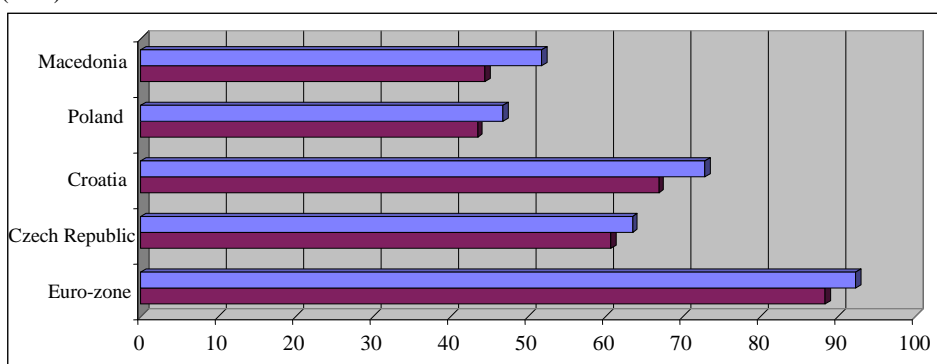
<sup>63</sup> The index of labour force costs per labour unit pertains to the industry.

### 3.3. Monetary aggregates

Keeping pace with the enhanced economic activity and improved economic achievements, the dynamic increase in the supply of money continued also in 2007. The strengthened confidence of the economic agents in the banking system, in terms of additionally created available income, given the growth in the domestic economy, stimulated enhanced saving in the banking system institutions and thus continuous increase in the monetary aggregates. Besides the common effect of the inflows originating from the payment of the regular installments from the Government bonds for old foreign exchange saving and increased balance of private transfers, the additional widening of the banks' deposit base in 2007 was influenced also by the enhanced interest of the economic agents for trading in securities and increased returns on this basis. Simultaneously, the supply of money was influenced by the effect of the payment of dividend by one large company to the Government, which acted towards the decrease in the monetary aggregates (in August).

Besides the continuous trend of monetary growth and faster advancing towards more developed countries in the last several years, however, the comparison of the participation of the money supply in the GDP indicates to the yet lower level of monetization of the domestic economy compared to more developed economies.

Figure 80  
Share of the broadest money supply M4 in GDP\*  
(in %)



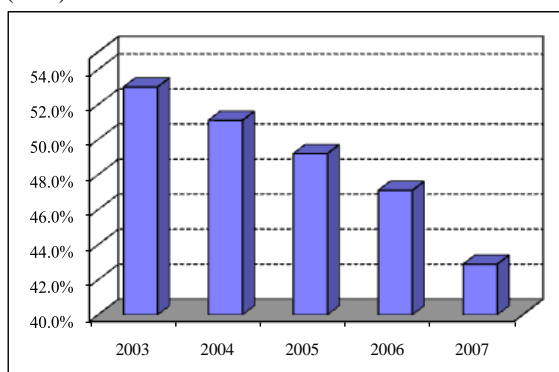
\*The data for Macedonia pertain to 2007 and 2006, while the data on the remaining countries pertain to 2006 and 2005. The data are presented on annual basis, at the end of the year.

Source: IMF, IFS, March 2007, NBRM.

In 2007, the money supply<sup>64</sup> M1 reached the historically highest increase, registering annual growth rate of 31.7%. Main factor influencing on the movement of the monetary aggregate M1 were the demand deposits, the growth of which in 2007 quickly reached 50.1%. Contemporaneously, the demand for cash went up by 10.6%, which is slower dynamics by 1.6 percentage points compared to the increase recorded last year. Such movements with the currency in circulation show further trend of decrease in their share in the monetary aggregate M1 structure, which is especially strong in 2007 (42.9%, on average in 2007, compared to 47.1 in 2006), which corresponds to the private sector's tendency to use cash, in terms of the banks' active policy directed towards constant development of new and competitive wire transfer instruments.

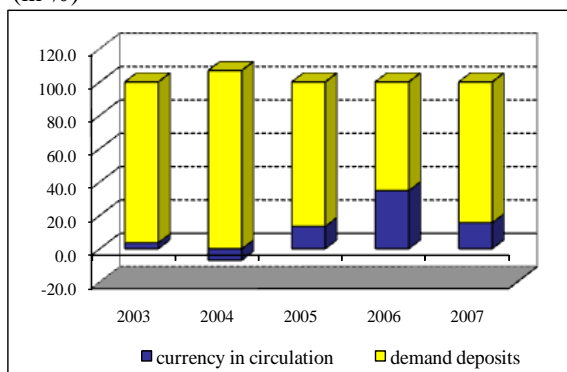
<sup>64</sup> Since October 2007, the data on the total deposits and credits of banks do not encompass "Makedonska Banka" AD Skopje, to which the NBRM revoked the founding and operating license on October 16, 2007.

Figure 81  
Average share of the currency in circulation  
in M1  
(in %)



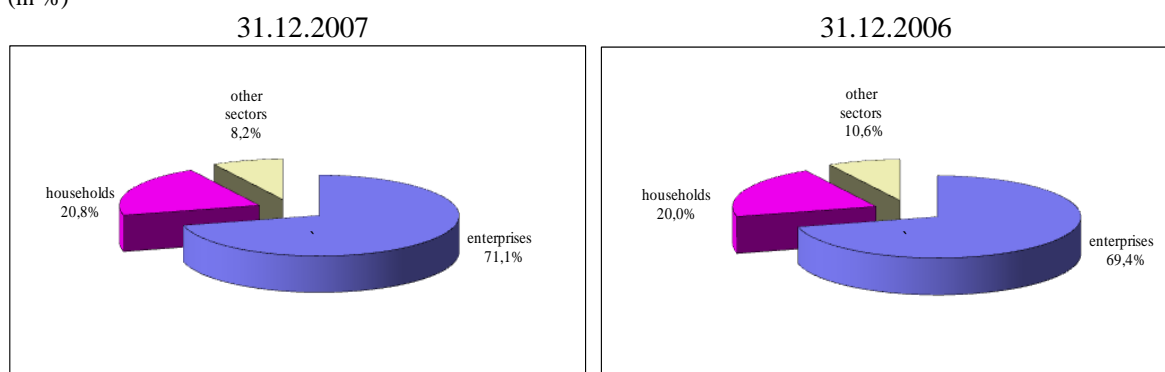
Source: National Bank of the Republic of Macedonia.

Figure 82  
Contribution to the annual increase in the money  
supply M1  
(in %)



The increase in the demand deposits, as main generator of the higher money supply M1, was influenced by larger transaction deposits of households (which registered higher growth rate by three times in 2007 compared to the preceding year, i.e. 56.3%), as well as to the higher rise in the funds cumulated on the enterprises' transaction deposits by twice (annual growth rate of 53.9%). The incremented transaction deposits, mainly as a result of the higher wages in the economy and yields resulting from the enhanced investments in securities, caused also appropriate effect on the increase in the personal consumption. From the aspect of the individual share in the demand deposit money, the enterprises increased their dominance (by 1.7 percentage points), while the structural share of the households remained almost unchanged.

Figure 83  
Demand deposit structure by sectors  
(in %)



Source: National Bank of the Republic of Macedonia.

Table 17  
Components of the monetary aggregates\*  
(in millions of denars)

	stock					quarterly changes				total
	31.12.2006	31.03.2007	30.06.2007	30.09.2007	31.12.2007	I	II	III	IV	
Currency in circulation	16206	15034	15844	16746	17927	-1172	810	902	1181	1721
Demand deposits	18527	19220	20475	22602	27832	693	1255	2127	5230	9305
M1	34733	34254	36319	39348	45759	-479	2065	3029	6411	11026
Quasi Denar deposits	36316	40511	48389	50045	55054	4195	7878	1656	5009	18738
Quasi foreign currency deposits	57430	59985	62001	62057	64047	2555	2016	56	1990	6617
M2	128479	134750	146709	151450	164860	6271	11959	4741	13410	36381
Non-monetary Denar deposits	3630	3749	4888	5498	5669	119	1139	610	171	2039
Non-monetary foreign currency deposits	3008	2974	3555	3913	4502	-34	581	358	589	1494
M4	135117	141473	155152	160861	175031	6356	13679	5709	14170	39914

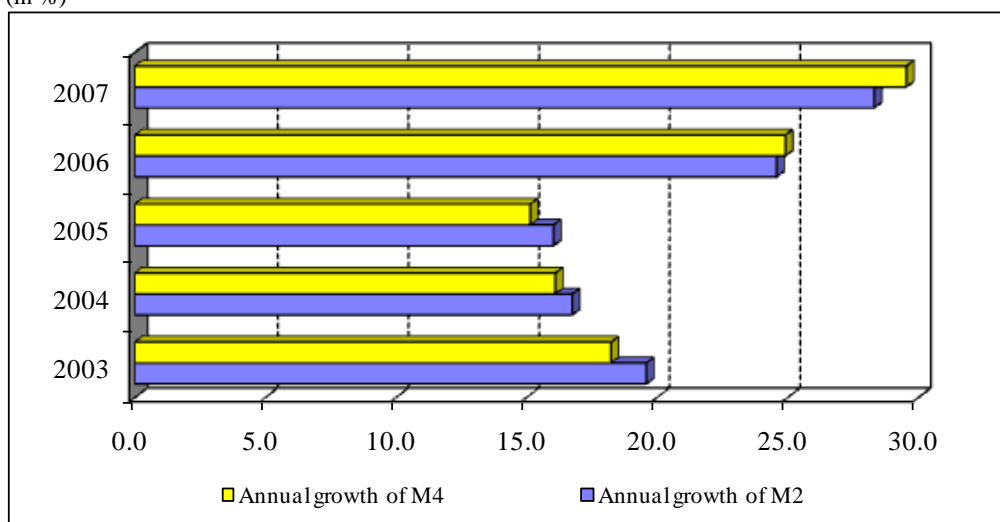
\*The foreign exchange categories are evaluated according to the current foreign exchange rate.

Source: National Bank of the Republic of Macedonia.

The positive perceptions of the economic developments in the country, as well as the stable macroeconomic environment, enabled further broadening of the banks' deposit base, and thus continuous increase in the broaden monetary aggregates. Thus in 2007, the money supply M2 registered annual growth rate of 28.3%, which is primarily reflection of the higher level of short-term Denar deposits (of 51.6%). Regarding the monetary aggregate M2 - Denar share - intensified increase of 41.9%, annually was recorded. However, having in mind the higher growth in the transaction deposits in 2007, the share of the short-term deposits in the additionally created money supply M2 went down by 10.2 percentage points and it equaled 69.8%. In 2007, the broadest money supply M4 incremented by 29.5%, annually.

Figure 84

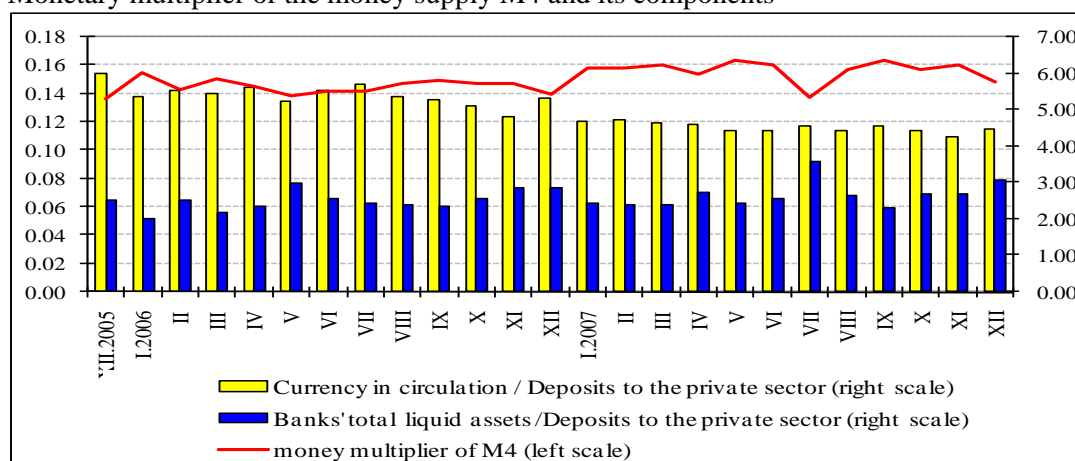
Average annual growth rates of the money supply M2 and M4  
(in %)



Source: National Bank of the Republic of Macedonia.

In 2007, the increase in the money supply M2 and M4 was registered in environment of strengthen monetary multiplication. Namely, the economic agents' propensity for keeping cash, evidenced through continuing trend of intensified decrease in the share of the cash in the money supply on the one hand and the stable correlation between the banks' propensity to save liquid funds with the NBRM and the increase in the deposit potential, on the other, contributed to a significant rise in the monetary multipliers of the money supply M2 and M4. Thus the monetary multipliers of the money supply M2 and M4 equaled, on average 5.75 and 6.08 (compared to 5.39 and 5.66, respectively in 2006), reflecting the higher multiplication effect of the banks in the monetary policy creation in 2007.

Figure 85  
Monetary multiplier of the money supply M4 and its components

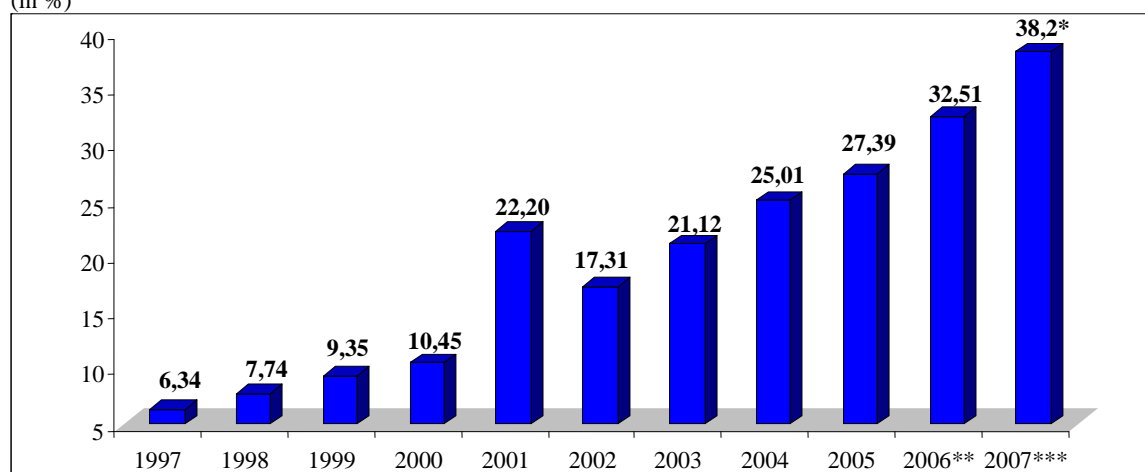


Source: National Bank of the Republic of Macedonia.

### 3.3.1. Total deposits

In terms of stable macroeconomic environment, the enhanced confidence in the banking system, as well as the higher potential of the domestic economy for creating supplementary available income, the saving of the economic agents continued the trend of constant rise also in 2007. The deviation from such direction was recorded only in August, when as a result of the deposit outflow for the payment of the dividend to the Government by one larger company the outstanding amount on the deposit accounts registered a drop. The continuous increase in the deposit potential<sup>65</sup> of the banks resulted in increment in their share in the GDP, and thus, further deepening of the financial intermediation. Thus in 2007, the share of the total deposits in the gross domestic product is higher by 5.7 percentage points and it equals 38.2%.

Figure 86  
Share of the private sector deposits with banks in the GDP  
(in %)



\*The data on the total deposits are presented as of the end of the year. If the share of the deposits is calculated as a geometric average of the total deposits in the GDP, the participation of the total deposits in the GDP equals 34.5%.

\*\*Preliminary data on the BDP.

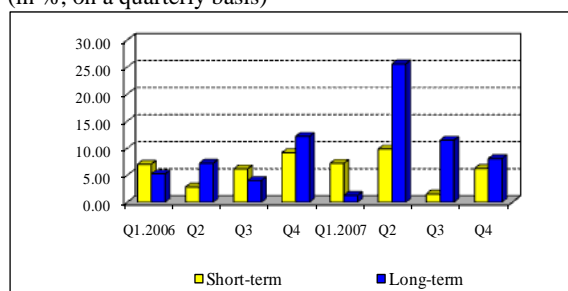
\*\*\*Estimated data on the GDP.

Source: National Bank of the Republic of Macedonia.

<sup>65</sup> Since October 2007, the data on the banks' total deposits do not contain data on "Makedonska Banka" AD Skopje (see footnote 65).

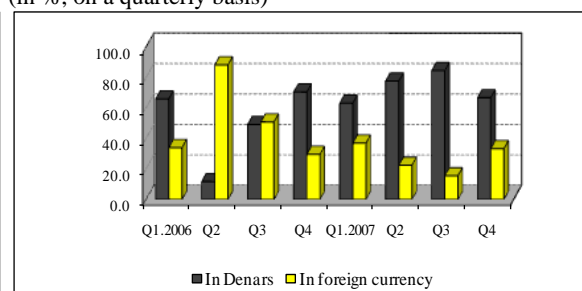
In 2007, the banks' deposit base went up by 28.8% compared to the previous year, reflecting the additional accumulation of funds on the deposit accounts by both households and enterprises. The short-term deposits are still the dominant component of the increase, from the aspect of the maturity structure (with a share in the annual increase of 87.8%), reflecting the depositors' predisposition to invest in shorter terms. However, the stronger confidence of the economic agents in the banking system, as well as the more attractive interest income the banks offer for the long-term saving, resulted in positive movement in the deposit potential maturity in 2007. Thus the intensified annual increase in the long-term deposits (of 53.2%), compared to the growth of the short-term time deposits (27%) enabled increase in the contribution of the long-term segment in the additionally created deposit base of the banks (12.2% in 2007, compared to 7.3% in the previous year).

Figure 87  
Changes with the components of the total deposits by maturity  
(in %, on a quarterly basis)



Source: National Bank of the Republic of Macedonia.

Figure 88  
Contribution of the individual components in the increase in the total deposits by currency  
(in %, on a quarterly basis)



From the currency aspect, strengthening of the Denar deposits position is evidenced, for the account of the continuous decline in the share of the foreign currency deposits. Namely, evident reorientation of the economic agents to save in domestic economy starting from the third quarter of 2006 and further in 2007, was registered, which points to the commenced trend of intensified "Denarization" of the domestic economy. Such movements reflect the stable inflation expectations of the economic agents, created in environment of prudent monetary policy, directed towards the maintenance of both price stability and stability of the foreign exchange rate. Simultaneously, additional factor that stimulates the Denar saving is the higher interest rates on the Denar time deposits. As a result of such movements, the Denar deposits went up by 52%, participating in the newly created deposit base by 71.9%, while the growth of the foreign currency deposits equaled 13.4%.

Table 18  
Total deposits of the banking system\*  
(in millions of Denars)

	2006				2007			
	stock as of 31.12.2006	annual change %	contribution to the growth of total deposits	share	stock as of 31.12.2007	annual change %	contribution to the growth of total deposits	share
Total deposits to the non- government sector	100384	27.9	100%	100%	129272	28.8	100%	100%
- in Denars	39946	45.7	57.3	39.8	60723	52.0	71.9	47.0
- in foreign currency	60438	18.3	42.7	60.2	68549	13.4	28.1	53.0
Short-term deposits	93746	27.6	92.7	93.4	119101	27.0	87.8	92.1
- in Denars	36316	49.1	54.6	36.2	55054	51.6	64.9	42.6
- in foreign currency	57430	16.9	38.1	57.2	64047	11.5	22.9	49.5
Long-term deposits	6638	31.7	7.3	6.6	10171	53.2	12.2	7.9
- in Denars	3630	18.7	2.6	3.6	5669	56.2	7.1	4.4
- in foreign currency	3008	51.7	4.7	3.0	4502	49.7	5.2	3.5

1/ The short-term deposits also include the sight deposits and time deposits with maturity of up to one year.

2/ The long-term deposits include the time deposits with maturity exceeding one year and the restricted deposits.

\*The foreign exchange categories are estimated according to the current foreign exchange rate.

Source: National Bank of the Republic of Macedonia

The sector "households", as the main entity registering surplus, showed high rate of saving also in 2007, forming 71.8% of the newly created deposit base of the banks. The registered annual increase in the total households' deposits (of 30.8%) reflects the increased inflows, channelized in the banking system mainly in form of short-term time deposits and in domestic currency. Namely, in 2007 the average nominal increase in the wages equals 7.9%, given the simultaneous increase in the wages of the employees in both public and private sector. Simultaneously, the households registered additional inflows based on payment of the regular installments from the old foreign exchange saving bond (in April and October) and on the basis of the private transfers from abroad, as well as the higher income based on increased income based on capital investments. From the aspect of the currency, dominant contribution in the increase in the households' deposits of 72.8% accounts for the Denar saving, which points to the constant strengthening of the Denar component position in the rise of the total deposits (in 2006 and 2005, the share of the Denar deposits equaled 57.8% and 30%, respectively). Although the foreign currency deposits take the largest share of the structure of the total households' deposits (of about 61.1%, on average), however, their share registers downward trend (in 2006 and 2005, their share equaled 69.6% and 73.3%, respectively), thus verifying the incremented significance of the households' saving in Denars. Annual increase of 67.3% was registered with the Denar deposits (compared to the increase in the foreign currency deposits of 12.6%), pointing to further strengthening of the credibility of the Macedonian Denar. From the aspect of the maturity, the dominant contribution of the short-term deposits declined (from 91.5% in 2006, to 87.6% in 2007), in terms of higher rational motive of the households for long-term saving and strengthened confidence in the banking system.

Table 19

## Total deposits of households and enterprises

(in millions of denars)

	Households				Enterprises			
	31.12.2007	annual change (in %)	contribution to the growth of total deposits	share in total deposits	31.12.2007	annual change (in %)	contribution to the growth of total deposits	share in total deposits
Total	88106	30.8	71.8	68.2	37438	29.1	39.1	29.0
- short-term	81641	28.7	62.9	63.2	35850	21.8	22.2	27.7
- long-term	6465	66.0	8.9	5.0	1588	18.9	0.9	1.2
- in Denars	37561	67.3	52.3	29.1	20005	28.9	15.5	15.5
- in foreign currency	50545	12.6	19.5	39.1	17433	14.2	7.5	13.5

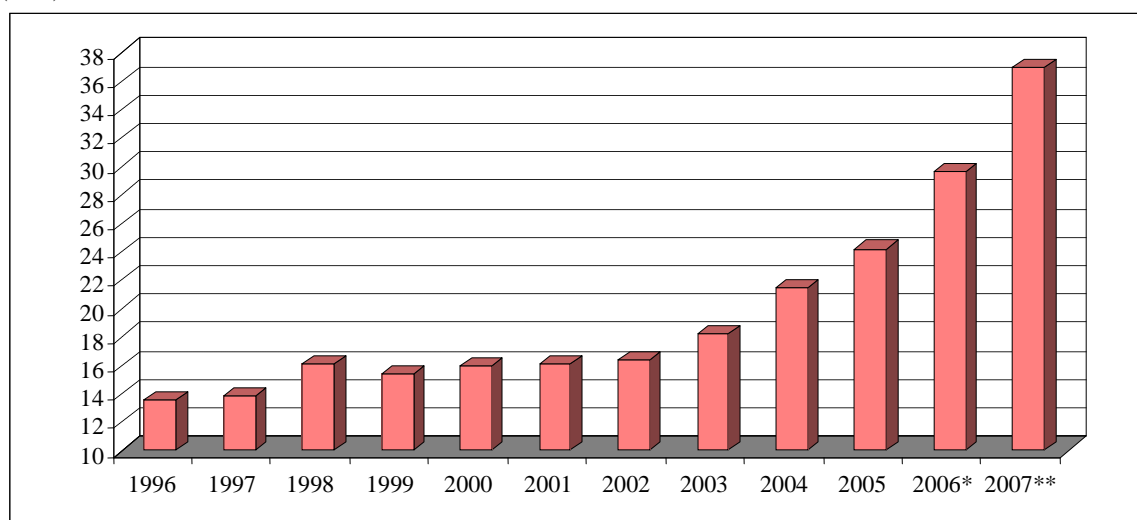
Source: National Bank of the Republic of Macedonia.

At the end of 2007, the total deposits of the corporate sector rose annually by 21.7%, thus pointing to the lower growth intensity in comparison with the preceding year (36.7%). The slower growth dynamics is partially due to the effect of the payment of a dividend to the Government by one large company, compared to 2006 when the planned payment of the dividend was not realized. However, the enterprises' deposits were increasing during the entire 2007, except in the third quarter, when as a result of the outflow based on the paid dividend, the enterprises' deposits dropped. The deposits movements, from the aspect of the currency, were influenced by the need of additional accumulation of Denar funds by the same company, as a preparation for payment of the planned dividend to both Government and foreign investor. In environment of non-realized payment of the dividend share intended for the foreign investor, the higher amounts on the Denar accounts retained in the banking system, registering annual growth rate of 28.9%. Thus they represent dominant part of the increase in the total enterprises' deposits, the contribution of which equals 67.4%. However, as a result of the intensified export activity of the domestic enterprises, an increase in the foreign currency deposits of 14.2% was also registered. From the aspect of the maturity structure, the largest contribution to the increase in the enterprises' deposits (of 96.2%) still accounts for the short-term deposits.

### 3.4. Bank placements

In the last several years, the financial crediting of the private sector in the transition economies registers continuous growth. The obvious growth in the private sector crediting by the banks, supplemented by the expansion of the non-banking financial institutions contribute to efficient allocation of resources, widening and improvement of the quality of the financial services portfolio and growth stimulation. However, the most significant effect for the economic development of one economy accounts for the level of the banks' financial support of the private sector, especially for the countries in transition, where besides the intensified growth of the non-bank financial institutions, the banks retain the primary position in financing the economic entities.

Figure 89  
Share of the credits in the GDP  
(in %)



The data on the total credits are taken as of the end of the year. If the share of the credits is calculated as a geometrical average in the total credits in the GDP, the share of the total credits in the GDP equals 31.5%.

\* Preliminary data on the value of the GDP.

\*\* Estimated value of the GDP.

Source: National Bank of the Republic of Macedonia.

The indicator measuring the financial intermediation of the banks in 2007 points to further financial deepening at national level. Namely, given annual credit growth<sup>66</sup> of 39.1%, the share of the bank placements to the private sector in the GDP<sup>67</sup> equals 36.9%, and compared to the previous year it is rise of 7.3 percentage points. The comparison base of this indicator according to the „stock-flow“ method shows that the Macedonian banking system is dragging behind the Euro zone countries and more developed transition countries. But, if „flow-flow“ approach, which uses the share of the change in the credits in the GDP as a starting point, is used as an indicator for estimating the financial intermediation gap, it can be perceived that the gap in the financial intermediation is significantly narrow compared to that obtained as a result of the first approach.

<sup>66</sup> Since October 2007, the data on the total placements exclude "Makedonska Banka" AD Skopje (see footnote 65.).

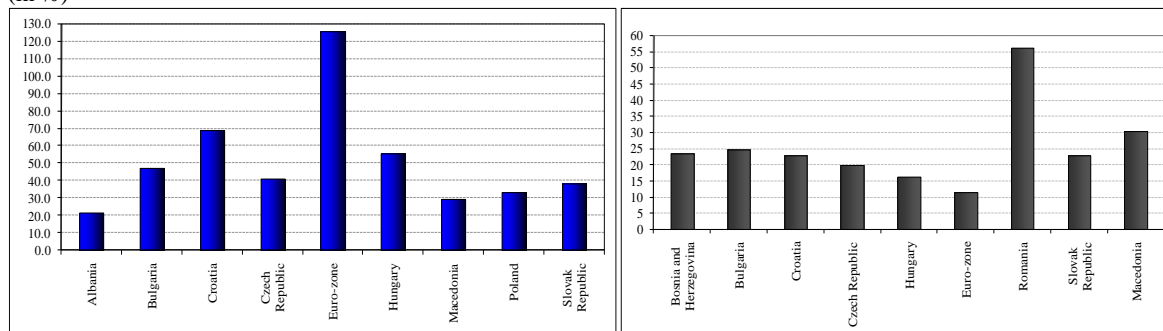
<sup>67</sup> The datum on the GDP fo 2007 is estimated, while the datum pertaining for 2007 is preliminary. Source: State Statistical Office.



Figure 90

Share of the total bank placements in GDP in 2006 and annual growth rate\* of credits in 2007 by countries

(in %)



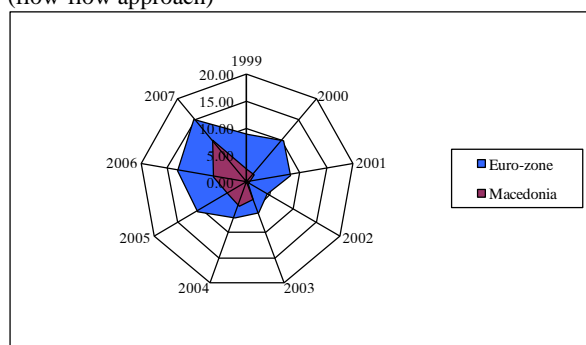
\* October 2007/ October 2006.

Source: IMF, IFS.

Namely, the flow-flow approach is an intermediation measure between the new saving and the new investments, not depending on the previous accumulation of loans. Consequently, this indicator is appropriate for comparing the economies having extremely different initial outstanding amounts of credits, with the convergence in the financial intermediation, through this indicator, may last significantly shorter, than the convergence measured through the share in the outstanding amount in the GDP. This approach reflects the short-term movements in the banking intermediation, or economic cycle, and represents better measure for the banks; capability to mobilize additional saving and to allocate capital in the productive economy's sectors. The advantage of this approach lies in its larger objectivity in the comparison of the degree of financial intermediation among different countries, especially when transition countries are in question, the credit activity of which started intensifying in the beginning of '90, contrary to the developed countries experiencing longer tradition in the banking operations.

Figure 91

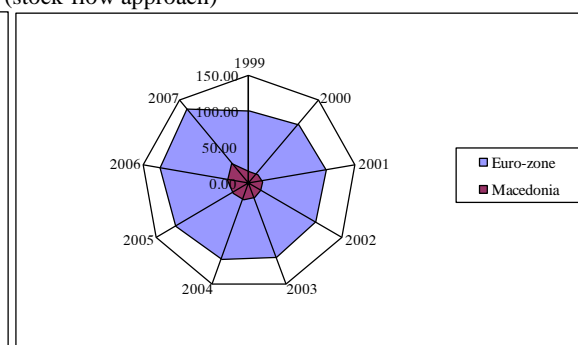
Share of credits in GDP  
(flow-flow approach)



Source: EUROSTAT, IMF, IFS, NBRM.

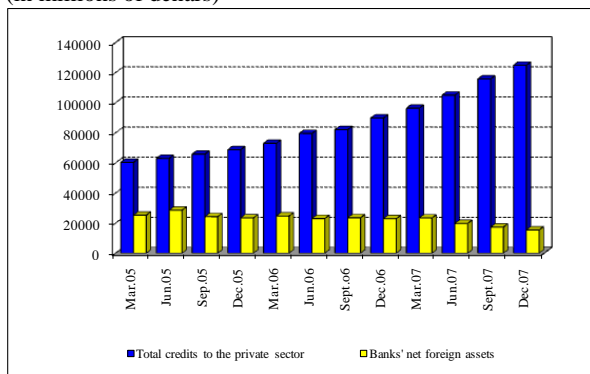
Figure 92

Share of credits in GDP  
(stock-flow approach)



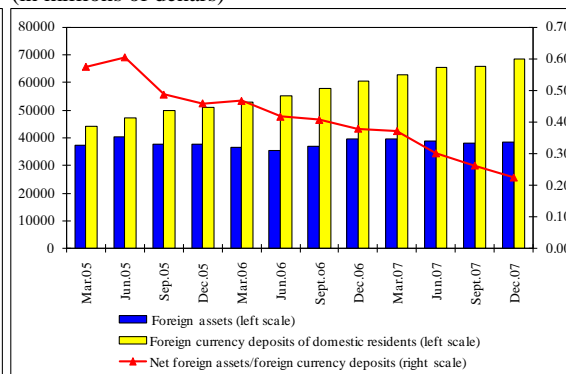
The increased demand for credits in the banking sector continued to be financed by the higher deposit base of the banks also in 2007. The channeling of larger portion of the banks' foreign currency deposit potential to credit placements to the domestic economy instead of increasing the balance on the accounts abroad represents an additional factor for the credit expansion. Consequently, the correlation between the net foreign assets and the total foreign currency deposits in the banking sector reduced from 0.38 in 2006 to 0.23 in 2007. However, the banks' net foreign assets registered an annual drop of 32.6%, as a result of the intensive increase in the foreign currency liabilities of 3.2%. Such movements indicate to the trend of the banks' higher foreign indebtedness, thus additionally enlarging their credit capacity.

Figure 93  
Total credits and banks' net foreign assets  
(in millions of denars)



Source: National Bank of the Republic of Macedonia.

Figure 94  
Foreign assets and foreign currency deposits  
of the residents in the banks  
(in millions of denars)



From the aspect of the maturity of the placed credits, in 2007 the banks continued their orientation to extend mainly long-term credits, which rose by 44.5% compared to 2006. The long-term loans took 60.5%, on average, of the total credit portfolio thus resulting in an annual increase in the total loans of 67.7%. However, in comparison with the preceding year, the contribution of the long-term crediting registered a decrease (from 73.6% in 2006 to 67.7% in 2007), which corresponds to the intensified increase in the short-term component of the total loans (31.9% in 2007, compared to 17.9% in 2006). The increased amount of extended short-term credits is also evident with the corporate sector, as well, where the extended loans are higher almost by twice compared to the previous year.

Table 20  
Domestic credits of deposit banks\*  
(in millions of denars)

	stock as of 31.12.2007	annual change		contribution to the growth of the total loans ( in % )	share
		in millions of Denars	in %		
Total placements of banks to the private sector	124,875	35,095	39.1	100%	100%
In Denars**	94,496	28,083	42.3	80.0	75.7
In Foreign currency	30,379	7,012	30.0	20.0	24.3
Short- term	47,810	11,351	31.1	32.3	38.3
Long - term	77,065	23,744	44.5	67.7	61.7
Enterprises	76,290	17,470	29.7	49.8	61.1
Households	48,272	17,417	56.4	49.6	38.7

\*The foreign exchange categories are estimated at current exchange rate.

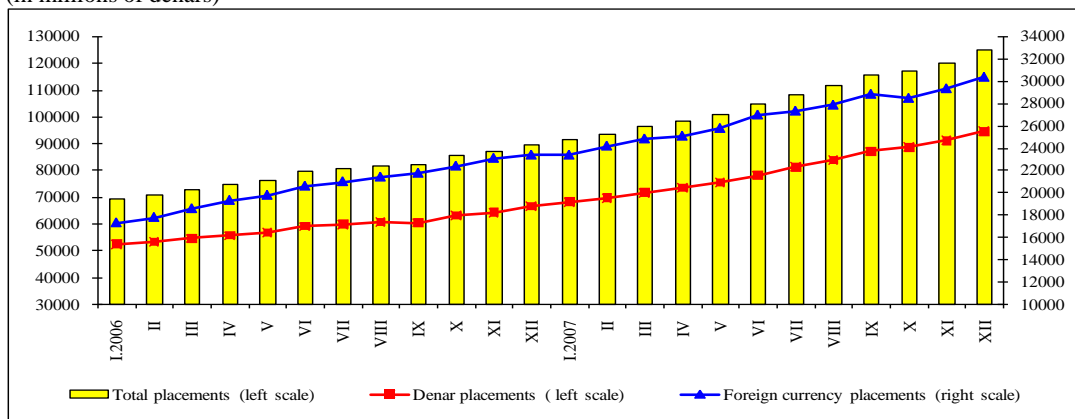
\*\* The denar credits include also the denar credits with FX clause.

Source: The National Bank of the Republic of Macedonia.

The currency analysis indicates dominant participation of the Denar<sup>68</sup> credits in the total banks' credit structure. In conditions of significantly higher growth intensity (42.3%), the Denar credits raised their contribution to the increase in the total credits by 9.8 percentage points, compared to the previous year, justifying 80% of the registered annual change. The growth dynamics of the foreign currency credits was slower, with their annual growth rate being equal to 30%.

<sup>68</sup> It also includes the Denar credits with FX clause.

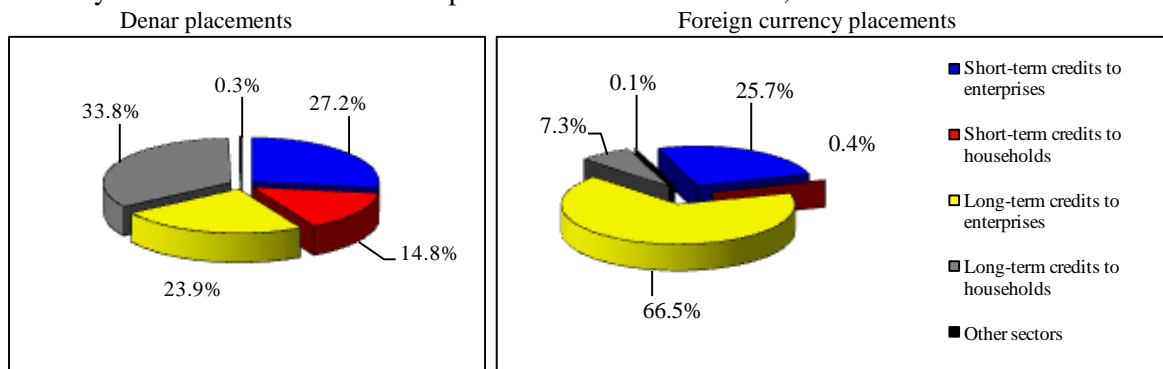
Figure 95  
Bank placements  
(in millions of denars)



Source: National Bank of the Republic of Macedonia.

The incremented intensity of the banks' credit activity directed towards the private sector significantly supported the country's economic growth. By developing the banking sector, the role of the banks in financing the enterprises' investment activities also strengthens, simultaneously contributing to the stimulation of the households' personal consumption. In that direction, the banks continued to credit households and enterprises also in 2007, registering high rates of credit expansion, especially in the sector "households".

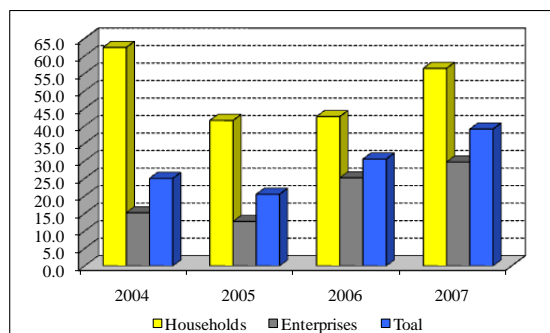
Figure 96  
Maturity and sector structure of bank placements on December 31, 2007



Source: National Bank of the Republic of Macedonia.

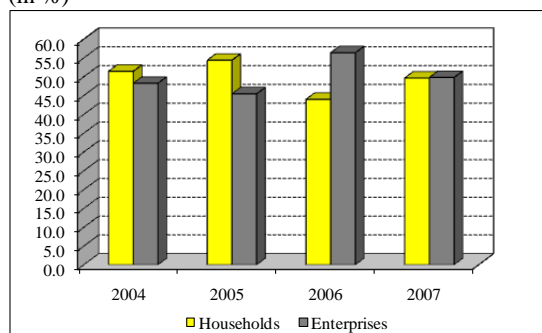
The trend of larger movements in the structure of the credit placements towards households crediting dominated during the entire year, with the bank placing 36.6%, on average, of their portfolio with this sector. Namely, besides the dominance of the corporate financing, the credits to households registered higher annual growth rates almost by twice (56.4%, compared to 29.7% on corporate credits), which resulted in equal share of these two sectors in the annual increase in the total credits (49.7%).

Figure 97  
Annual changes  
(in %)



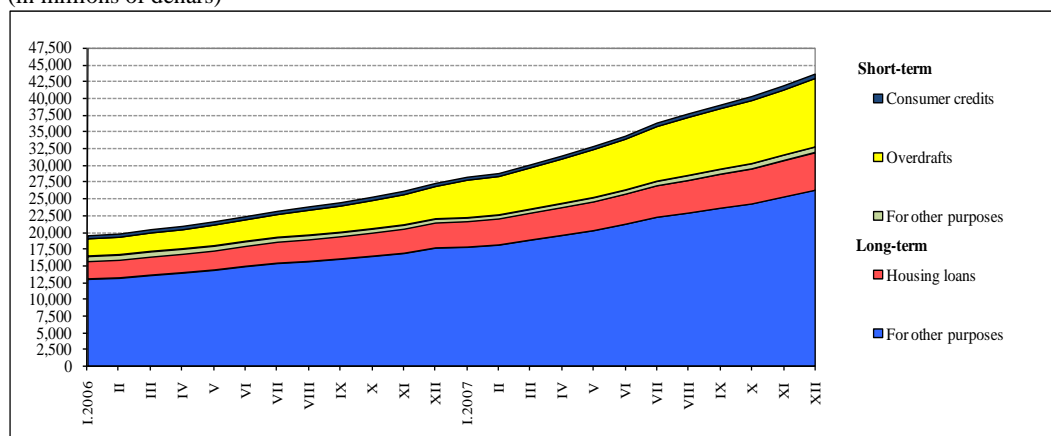
Source: National Bank of the Republic of Macedonia.

Figure 98  
Contribution in the annual increase in the  
total credits  
(in %)



From the aspect of the maturity structure of the credits to households, the long-term credits, which surged by 48%, dominated, with their share in the amount of credits additionally placed with the households equaling 63.6%. Within the long-term component, the largest portion still accounts for the long-term credits for other purposes<sup>69</sup> (the annual increase of which equals 49.2%). On the other hand, larger amount of placed credits by twice is registered with the short-term crediting of the households, within which the framework credits<sup>70</sup> still having dominant position (in comparison with the previous year, they went up by twice). Analyzed by currency, the main carriers for the increase in the total credits to households are the Denar credits (including also the Denar credits with FX clause), the contribution of which in the increase equaling 96.3%. Compared to the previous year, the Denar crediting went up with more intensive dynamics (from 39.6% in 2006 to 57.6% in 2007), whereas the reduced intensity of the growth of the foreign currency credits of 37.3% (compared to the realized increase in 2006 of 2.3 times).

Figure 99  
Distribution of denar credits to households by type of credits  
(in millions of denars)



Source: National Bank of the Republic of Macedonia.

The tendency of enhanced crediting of the households corresponds to the strengthened credit capability of the sector, as well as to the enlarged banks capacity for credit approval and motive for diversification of their credit portfolios. However, in 2007 the bank policy directed towards partial lessening of the credit conditions, supplemented with higher degree of clients' confidence, as well as the large consumption of durable consumer products<sup>71</sup>, contributed for continuous increase in the

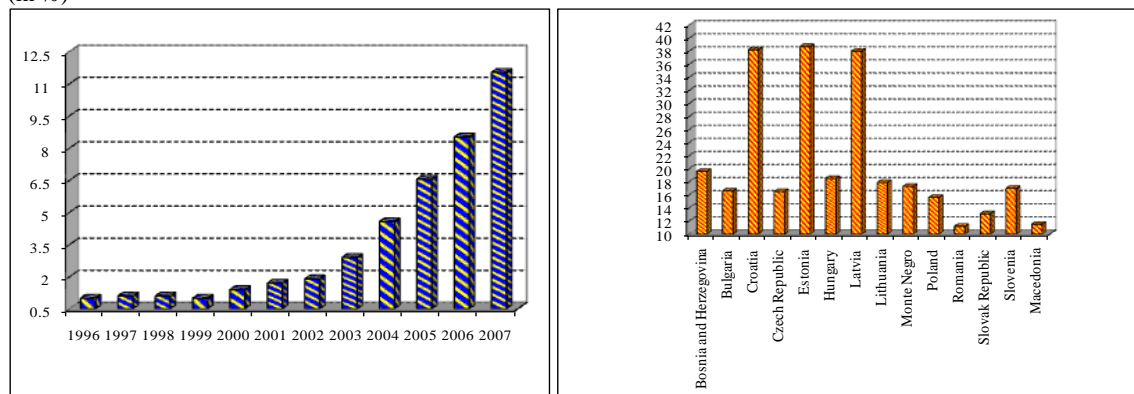
<sup>69</sup> Credits for other purposes include consumer credits, housing credits, automobile credits, education credits and credits for other purposes.

<sup>70</sup> Negative current account balances.

<sup>71</sup> In line with the results of the quarterly surveys for the banks' credit activity carried out in 2007.

credits to the households. However, besides the evident expansion of the bank placements to this sector, the level of financial support, the banks provide at the level of this sector, is relatively low compared to the remaining countries in transition and the Eurozone. Thus the average share of the credits to households in the GDP is yet below the average in CEB and SEE. Simultaneously, the incremented indebtedness of the households, compared to the increase in the total income in this sector, points to the conclusion that the households is capable to service its debt and that it can tolerate additional indebtedness in future.

Figure 100  
Share of credits to households in GDP\*  
(in %)



\*Calculated as a geometrical average of the households' credits in GDP, in Macedonia for the 2003 - 2007 period.

Source: NBRM, SSO, EBRD Report on the transition in 2007.

\* For individual countries, the data pertain to 2006, while the datum on Macedonia refers to 2007.

In 2007, the banks allocated funds in form of credits also with the corporate sector. The augmented corporate crediting was realized in conditions of intensified economic activity of the enterprises and enlargement of their capacity, which contributed to the increase in the demand for credits, as dominant external factor for enterprises finance. The increased demand for credits was supported also by the favourable crediting conditions, primarily the interest rate, as effect of the toughen competitiveness in the banking system. The financial support by the banks was directed not only towards satisfying the needs of fixed capital, but to the investments in working capital, as well<sup>72</sup>. From the aspect of the currency, the Denar credits registered almost identical increase as the foreign currency ones (29.9% and 29.4%, respectively), with the Denar credits (including also the Denar credits with FX clause) preserving the dominant role in the increase in the total credits (of 63.6%). The maturity structure of the corporate credits is dominated by the long-term credits with roughly 53%, on average, which indicates a trend of further gradual re-direction to long-term crediting of the enterprises, which corresponds to the enhanced investment activity in the country. The credit expansion of the banks directed towards enterprises is still in course of supporting the development potentials of the economy, representing stable source for financing the corporate operations.

The increased participation of the banks in the private sector finance, constant widening of the banking activities and the diversification of the financial services, envisages a possibility for elevating the level of undertaken risk by the banks. Besides the enhanced credit growth in 2007, the credit exposure quality<sup>73</sup> of the banks to the private sector registered no deterioration. Namely, the improved credit discipline, the better risk management, the corporate governance with banks and improving the cost efficiency, effected significantly on the banks success in coping with the increased risks during the operating. The constant improvement of the banking regulations and the

<sup>72</sup> In line with the results from the quarterly surveys on the credit activity of the banks carried out in 2007.

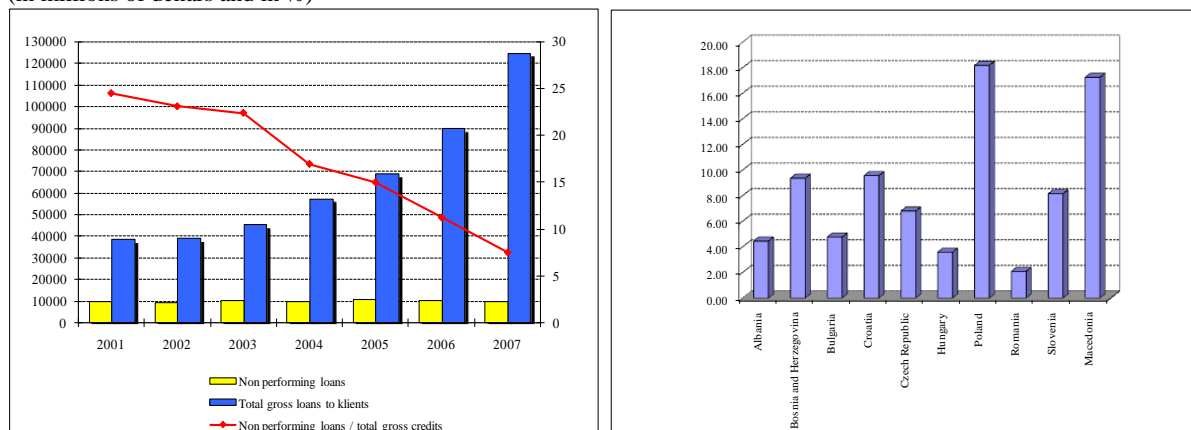
<sup>73</sup> The credit exposure of the bank towards individual entity encompasses the total balance sheet claims and off-balance sheet items. The off-balance sheet items include: issued uncovered guarantees, open uncovered letters of credits, backing guarantees, bank accept orders, uncovered performance guarantees and other forms of off-balance sheet items.

supervisory standards, strengthening of the institutional capacities and the stability of the banking system, enable quality environment of banks.

Figure 101

Share of the non-performing loans<sup>74</sup> in the total banks' credits in the Republic of Macedonia and by countries<sup>75</sup>

(in millions of denars and in %)



Source: NBRM (for the data pertaining to the Republic of Macedonia), IFS (for the data pertaining to other countries).

The global financial turbulences witnessed on the international markets starting from August 2007, are the possible factors for deterioration of the financial stability in global terms. The beginning of the market imbalances stirred by the problems on the American mortgage markets, went on the international capital markets and reflected on the international growth. Namely, the bank standards for approving credits of the American subprime mortgage markets were significantly relaxed, the private sector could debit in absence of quality credit history and information on the financial strength, leading to the significant increase in the risk the banks undertake during their operating. The credits collateralized with risky mortgages were the foundation for issuing mortgage-backed securities. The drop in the prices of real estate reflected on these securitized loans, caused decline in the bank liquidity, and thus to the holders of these securities, increase the uncertainty, panic with the economic agents, larger financial losses and deepening of the crises. Significant transitional effect may be felt in the transition countries, primarily the countries registering high external imbalances, i.e. emerging as large users of external financing. However, these developments in 2007 have no transitional effect in the Macedonian economy. Namely, the financial innovations characteristic for developed markets (securitization, credits sale etc.), have not been represented on the Macedonian market yet, while the financial system structure is in its initial stage of diversification, i.e. the share of the institutional investors in the financial system is still low. If the developments witnessed in the world spill over, the effect will be insignificant, mainly directed towards more restrictive approach concerning the assessment of the credit applications by the banks, i.e. the estimation of the risk the banks can undertake, as well as increase in the investors' risk resistance in future. However, the constant efforts for improvement of the regulatory environment, the supervisory standards and the institutional framework, have remarkable significance for further development of the banking system and overcoming of the possible financial crises.

### 3.5. Interest rates

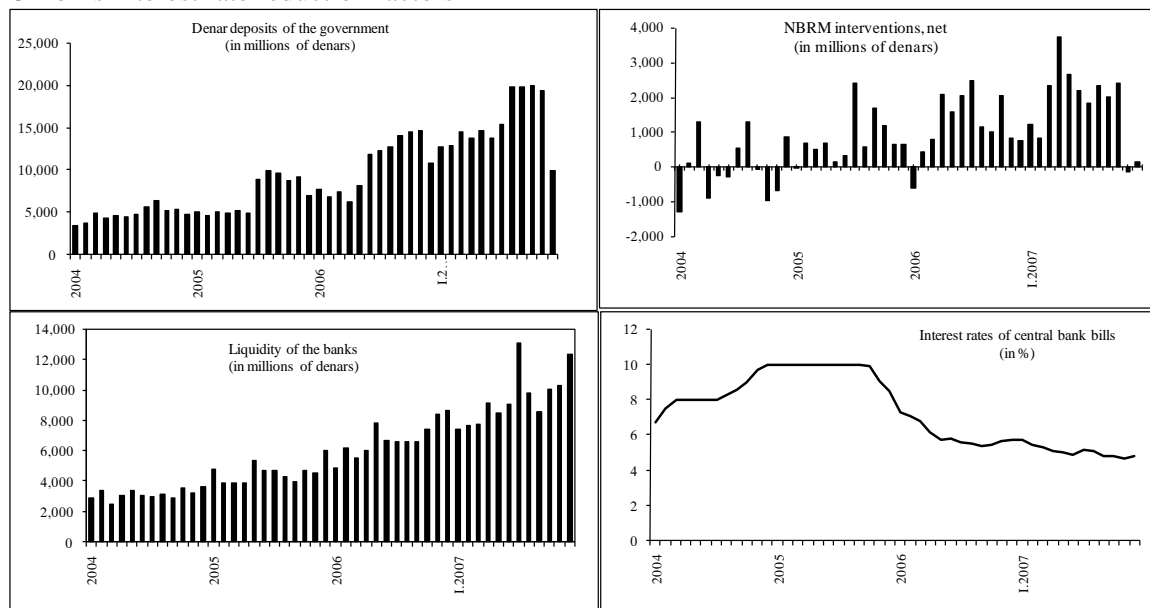
In 2007, the interest rate of NBRM was in the sign of monetary policy relaxation, in conditions of favourable movements on the foreign exchange market and constant increase in the liquidity on this basis, as well as prudent fiscal policy. Thus the reference interest rate of NBRM

<sup>74</sup> Non-performing credit denotes the claim based on principal, which is not collected longer than 90 days, calculated from the date of maturity.

<sup>75</sup> Calculated as average share of the non-performing loans in the total bank credits in individual countries within 2001 - 2006 period, while regarding the Republic of Macedonia, the period also includes 2007.

during the year was constantly decreasing, reflecting on the interest rates on the Money Market and the Treasury bills market. The decline was also registered with the banks' lending interest rate, with simultaneous increase in the deposit interest rate resulting in narrowing of the banks' interest rate spread. During the year, the NBRM reduced the interest rate on Lombard Credit, as well.

Figure 102  
CB bills interest rate reduction factors

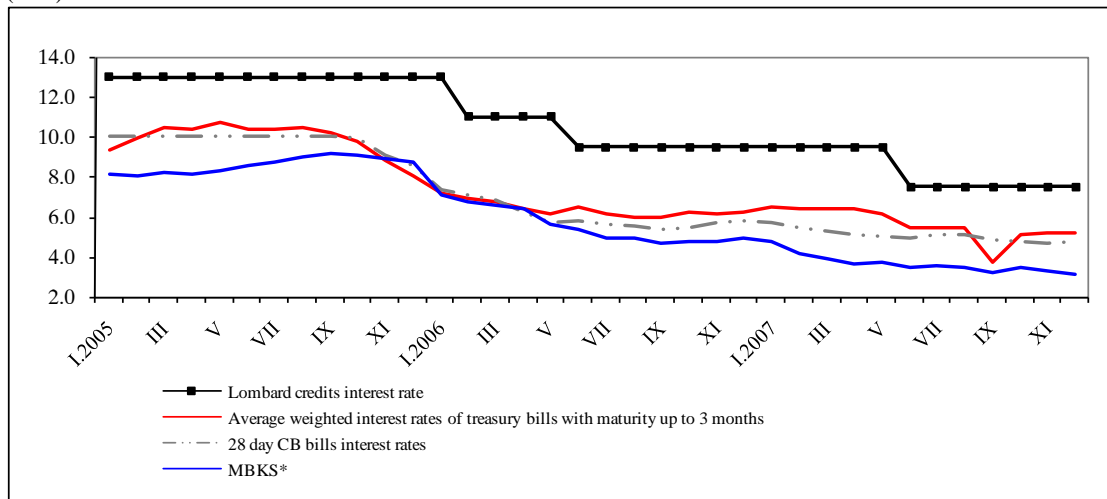


Source: National Bank of the Republic of Macedonia.

In 2007, the CB bills turnover enhanced, compared to the preceding year (increase in the level of 85%), which points to the banks persistence to invest in shorter-term instruments, and to their high liquidity, as well. However, in conditions of average demand than supply of CB bills (by Denar 931 million, or by 6%), the average interest rate on the CB bills plunged by 0.9 percentage points and it equaled 5.1% (compared to 6% in 2006). Besides the preserved reference interest rates of the European Central Bank in the second half of 2007 (as a precaution against the inflation growth) and the increase in the LIBOR interest rate, due to the lack of liquidity caused by the mortgage crisis in the USA, the largest decrease in the interest rates on the SCB bills in the Macedonian economy is registered only in that period, reducing to the lowest level of 4.66% (in November 2007), which points primarily to the conditionality of the domestic financial market factors, i.e. the low level of integration in the international financial flows. This trend of the movement of the reference interest rate points to the persistence for constant relaxation of the monetary policy.

Figure 103

NBRM short-term interest rates, interest rates on both Money and Government Securities Market (in %)



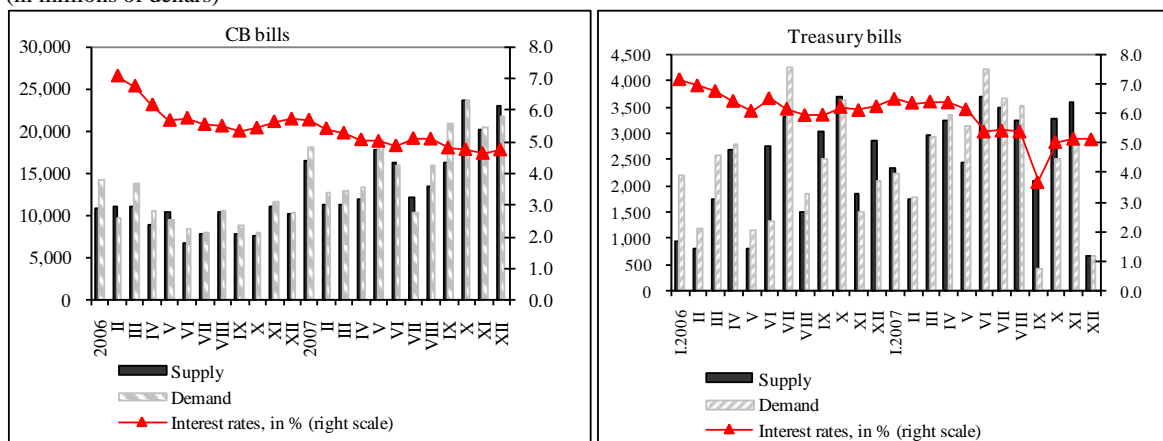
\*MBKS- interbank interest rate.

Source: NBRM, Money and Short-term Securities Market and Ministry of Finance.

The average interest rates on the three-month, six-month and twelve-month Treasury bills decreased and reduced to 5.6%, 6.1% and 6.7%, respectively in 2007, i.e. decline of 0.8, 0.9 and 2 percentage points, respectively, compared to the previous year. Besides the market conditions, the changes in the prices of the Treasury bills were influenced by the change in the conditions for trade with Government securities (a decrease in the maximum interest rate on the Treasury bills by the Ministry of Finance, with the interest rate on the three-month Treasury bills in September registering the lowest level of 3.7%). In 2007, the average supply of the three-month Treasury bills was higher by Denar 124 million (or by 5%) than the average demand.

Figure 104

28-day CB bills auctions, 3-month treasury bills auctions and interest rates development (in millions of denars)



Source: NBRM, and Money and Short-Term Securities Market.

In 2007, significant role in the banks' liquidity management was played also by the Money market, as an alternative mechanism for both placement of the excess and coverage of the temporary liquidity shortages, within which higher turnover by 2.1 times was registered compared to the previous year. From the aspect of the dynamics in 2007, the largest portion of the total turnover (63.5%) is registered in the second half of the year, with the highest concentration of the turnover being registered in the last quarter (44.6% of the total turnover in 2007). In the conditions



of high level of liquidity in 2007, the average interest rate on the interbank Money market - MBKS fell by 1.9 percentage points and equaled 3.7% (compared to 5.6% in 2006).

Table 21  
Turnover and interest rate on the Money Market

	total turnover (in millions of denars)	change (in %)	average weighted interest rate (in %)	share in total turnover by maturity (in %)		
				1 day	to 3 days	over 3 days to 1 month
Q.1 2006	1,574.0	-30.4	6.8	71.0	24.2	4.8
Q.2	3,250.0	2,1 times	5.8	76.3	3.8	19.9
Q.3	2,717.0	-16.4	4.9	64.4	16.4	19.2
Q.4	2,106.0	-22.5	4.8	76.6	11.3	12.1
2006	9,647.0	-43.8	5.6	72.2	12.3	15.5
Q.1 2007	4,184.8	2 times	4.3	82.6	9.6	7.9
Q.2	3,317.0	-20.7	3.6	84.8	8.9	6.3
Q.3	3,878.0	16.9	3.4	86.8	6.4	6.8
Q.4	9,169.5	2,4 times	3.3	94.0	4.3	1.3
2007	20,549	2,1 times	3.7	88.8	6.5	4.5

Source: National Bank of the Republic of Macedonia.

From the aspect of the transactions' maturity, in 2007 the transactions with one-day maturity dominated, accounting for 88.8% of the total realized transactions, 6.5% were transactions with three-day maturity, 3.4% accounted for those maturing up to five days, while the share of the transactions with maturity of up to seven days and one month was insignificant (0.9% and 0.1%, respectively).

In line with the downward trend of the reference interest rate, in May 2007 decrease in the interest rate on the Lombard Credit of 2 percentage points was registered, and it reduced to 7.5%. This enabled the interest rate on the Lombard Credit to get closer to the interest rate on the CB bills, with the interest rate on the Lombard Credit preserving the position of the highest interest rate in the group of interest group. By using the comparison analysis of the movement of the reference rates in certain group of countries, in 2007 their growth is registered, which is mainly a result of the instability of the international financial market and the increase in the inflation rate. The reference interest rates in Macedonia and Serbia, registering annual decline, are exemption, which signalizes the partial inertness of these economies to the international developments.

Table 22  
Average reference nominal interest rate of the central banks by countries (in %)

	2003	2004	2005	2006	2007
Bulgaria	2.6	2.6	2.0	2.7	3.9
Croatia	4.5	4.5	4.5	4.5	4.9
Czech Republic	2.3	2.3	1.9	2.2	2.9
Euro zone	3.3	3.0	3.0	3.9	4.9
Hungary	8.8	11.3	7.0	6.8	7.8
Poland	5.6	5.8	5.3	4.1	4.5
Slovakia	6.4	4.8	3.2	4.1	4.4
Serbia	10.8	14.4	15.9	19.1	10.5
Slovenia	8.8	5.6	5.0	4.6	/
Macedonia	8.2	8.3	9.8	6.0	5.1

Source: IMF, IFS, European Central Bank and the NBRM.

In 2007, the interest rate policy of the banks was directed towards stimulating both enterprises and households to use credits as one of the sources for financing. The movement of the lending and the deposit base corresponds to the constant increase in the credit potential, as well as the deposit supply, as well. Thus the average lending Denar interest rate declined by 1.1 percentage point and it equal 10.2% (compared to 11.3% in 2006). On the other hand, the average interest rate on the Denar deposits went up by 0.2 percentage points (as a result of the increase in the interest rates on the households' deposits), reaching the level of. 4.9%. The change in the deposit interest rate reflect the banks' efforts to mobilize the available cash funds in conditions of strengthening of the competitiveness, as well as the increase in the interest rates on the international markets. According to the Credit Activity Survey, the competitiveness from other banks, the expectations for the total economic activity, the banks access to market finance, are one of the factors that influence on the lessening of the crediting conditions, including the interest rate. The trend of movement of the lending and the deposit interest rate in 2007 contributed to narrow the interest rate spread by 1.3 percentage points compared to the previous year, and it reduced to 5.3 percentage points. The country-by-country analysis in 2007 shows that the interest rate spread narrowed in most of the cases (with exception to Bulgaria, the Czech Republic and Slovakia), showing the commitment for improving the efficiency of the banking systems. Thus almost all Western Balkan countries (except to the Bosnia and Herzegovina and Serbia) register increase in the deposit interest rate, given the further decrease in the lending interest rate.

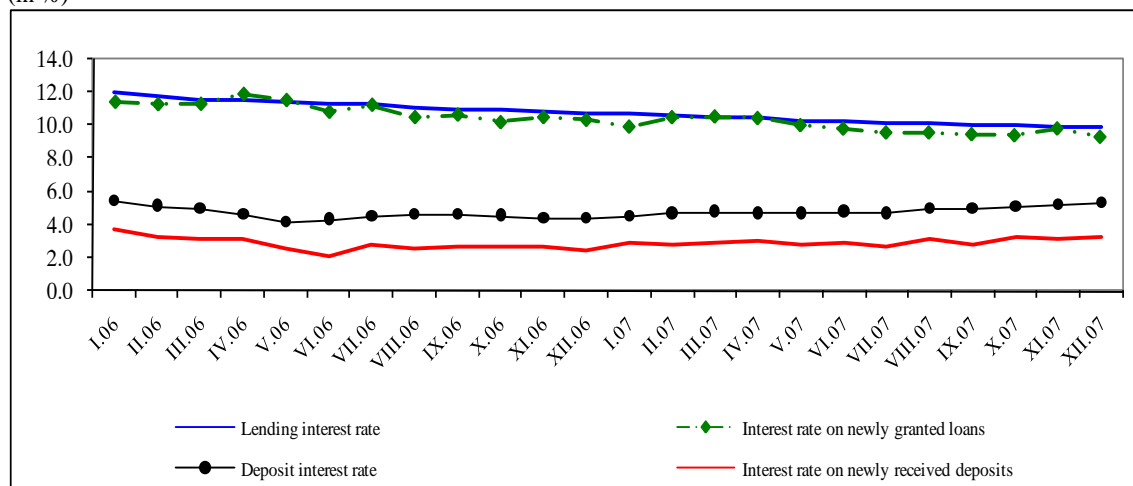
Table 23  
Average lending and deposit interest rates by countries  
(in %)

	2003		2004		2005		2006		2007	
	Lending	Deposit	Lending	Deposit	Lending	Deposit	Lending	Deposit	Lending	Deposit
Bulgaria	8.5	2.9	8.9	3.0	8.7	3.1	8.9	3.2	10.0	3.7
Croatia	11.6	1.5	11.7	1.9	11.2	1.7	9.9	1.7	9.3	2.3
Czech republic	5.9	1.3	6.0	1.3	5.8	1.2	5.6	1.2	5.8	1.3
Hungary	9.6	7.1	12.8	10.5	8.5	6.4	8.1	6.0	9.1	7.2
Poland	7.3	3.7	7.6	3.8	6.8	2.8	5.5	2.2	/	/
Slovakia	8.5	5.3	9.1	4.1	6.7	2.4	7.7	3.6	8.1	3.7
Bosnia and Herzegovina	10.9	4.0	10.3	3.7	9.6	3.6	8.0	3.7	7.2	3.6
Serbia	16.5	2.6	15.7	3.5	15.4	3.5	18.3	5.1	12.6	4.4
Slovenia	10.8	6.0	8.7	3.8	7.8	3.2	7.4	2.8	5.9	3.6
Macedonia	16.0	8.0	12.4	6.5	12.1	5.2	11.3	4.7	10.2	4.9

Source: IMF, IFS and NBRM.

In 2007, decrease in the average interest rate of the newly extended credits was registered, given the simultaneous increase in the average price of the newly accepted deposits. The comparison analysis on annual basis shows that the average price of the newly extended credits equals 9.8% and relative to the average interest rate on the total deposits it is lower by 0.4 percentage points. With regard to the deposit interest rates, significant deviation from the average interest rates on the total deposits and the newly accepted deposits is registered (4.9% compared to 2.9%, respectively).

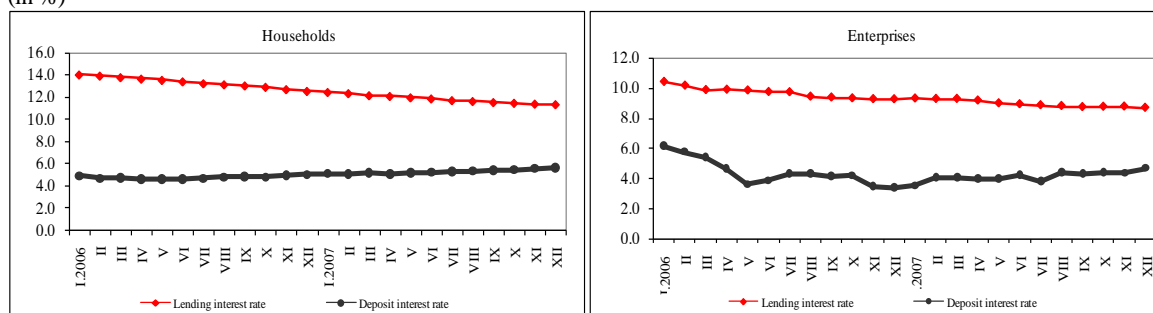
Figure 105  
Denar lending and deposit interest rates  
(in %)



Source: National Bank of the Republic of Macedonia.

Observed from the aspect of the sectors, in 2007 an annual decrease in the average interest rate on households' credits of 1.5 percentage points was registered, thus reaching the level of 11.8%, while the average interest rate on the deposits registered an increase of 0.5 percentage points and it equaled 5.3%. The detailed analysis shows reduction in the average prices of all credit categories intended for households, with the most apparent decrease being witnessed with the average interest rate on the credits without currency clause (with the short-term ones of 2 percent points, reaching the level of 15.7%, while the long-term credits, by 1.2 percentage points, and it equals 13.7%). Namely, the average interest rate on long-term credits with FX clause also dropped by 1.1 percentage point, and it equals 10.3%. Regarding the interest rate on the Denar deposits, larger changes are recorded with the average interest rate on the Denar deposit without FX clause, from 4.8% in 2006 to 5.3% in 2007.

Figure 106  
Weighted Denar lending and deposit interest rate on households and enterprises  
(in %)



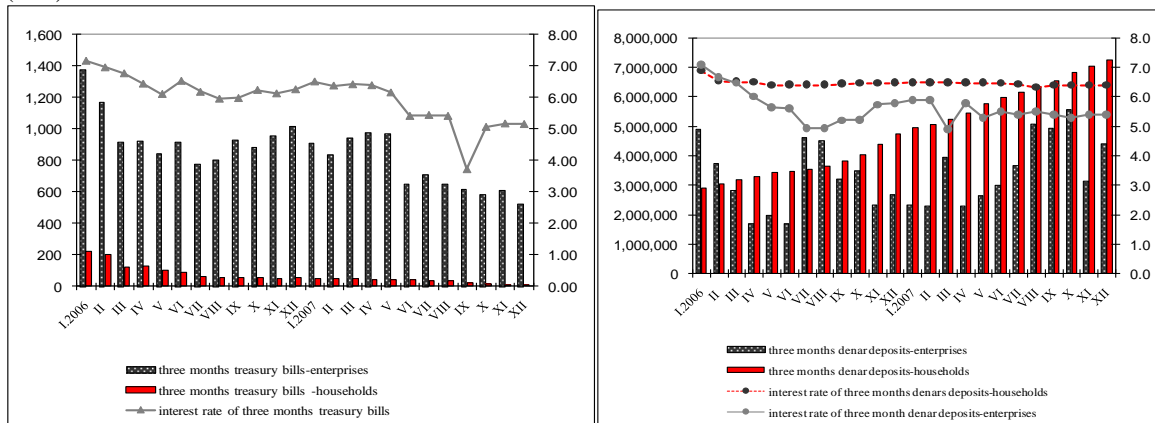
Source: National Bank of the Republic of Macedonia.

Regarding the corporate sector, in 2007 the banks cut down both lending and deposit interest rates. Thus in comparison with the previous year, the average interest rate on the Denar credits to enterprises went down by 0.7 percentage points and it equals 9%, while the average interest rate on the Denar deposits equals 4.2% (drop of 0.3 percentage points). The largest decrease is registered with the average interest rate on the short-term credits without FX clause and the long-term credits with FX clause of 0.8 and 0.9 percentage points, respectively, reducing to the level of 9.1% and 9.7%, respectively. The largest change was registered in the interest rate on the Denar deposits without FX clause, especially with the sight deposits (increase of 1.4 percentage points), and it equals 1.9%, as well as with the long-term time deposits of enterprises (drop of 1.8

percentage points), equaling 5%. An annual decline also on the average price of the long-term time deposits with FX clause of 1 percentage point was witnessed, and it equaled 4.1%.

Figure 107

Investments in three-month Treasury bills and Denar three-month time deposits and appropriate interest rates (in %)

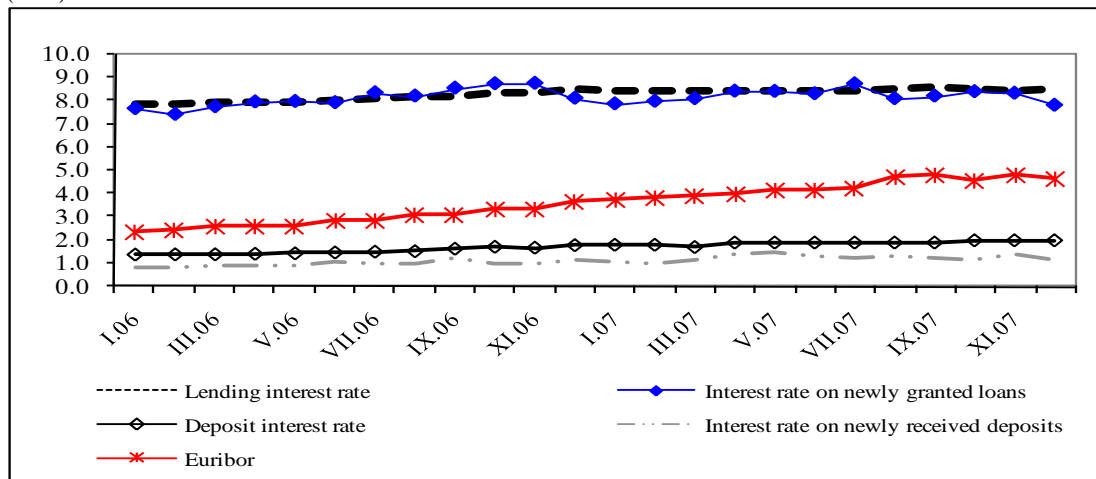


Source: National Bank of the Republic of Macedonia.

The comparison analysis of the investments in the three-month Treasury bills and three-month Denar time deposits in 2007 shows higher increase in the deposits, given simultaneous decrease in the investments in Treasury bills. Despite the annual increase in the average deposit interest rates, however, the fact that the three-month Denar deposits register interest rate reduction should also be taken into consideration. Thus in 2007, increment in the three-month Denar deposits with the households of 67% was registered (in the conditions of decrease in the average interest rate of 0.1 percentage point), given the simultaneous reduction in the households investments in three-month Treasury bills of roughly 69%. Annual rise of about 15% was registered with the three-month enterprises deposits (in environment of drop in the interest rate of 0.3 percentage points), given the decrease in their investments in three-month Treasury bills of about 22%. The fall of the average interest rate of the three-month Treasury bills in 2007 contributed to its approach to the average interest rate on the enterprises' Denar time deposits.

Figure 108

Foreign currency lending and deposit interest rates and three-month interest rate EURIBOR (in %)



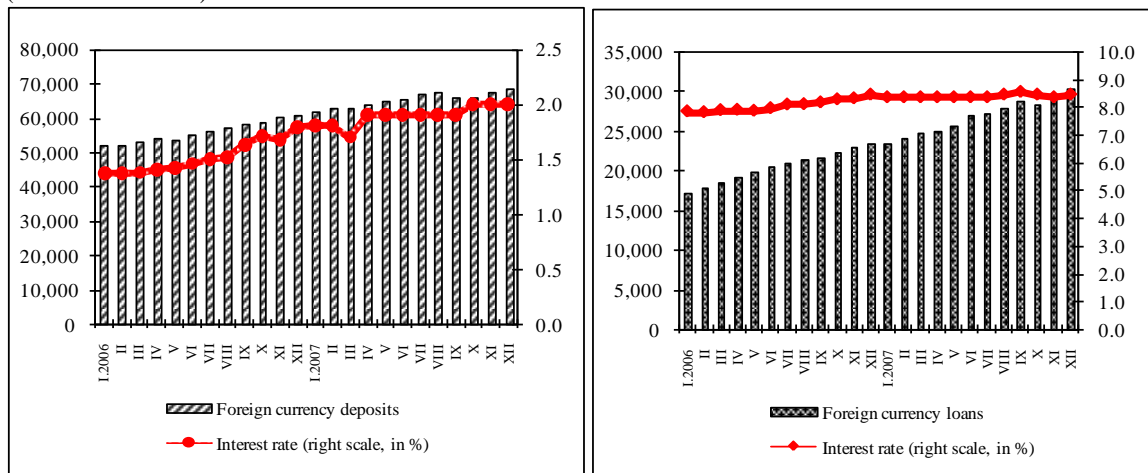
Source: National Bank of the Republic of Macedonia.

In 2007, the banks' interest rates on the foreign currency credits and deposits followed the movement of the interest rates on the international financial markets. Thus the lending and the

deposit foreign exchange interest rate, on average, equal 8.4% and 1.9%, respectively (compared to 8.1% and 1.5% in 2006). Also, the average interest rate on the newly extended foreign exchange credits is by 0.2 percentage points lower than the average price of the total foreign exchange credits. On the other hand, the difference between the average interest rates of the total foreign currency deposits and the newly accepted deposits is higher and it equals 0.7 percentage points, with the price of the new foreign currency deposits, on average equaling 1.2%.

Figure 109

Monthly dynamics of the foreign currency deposits and credits of the private sector and the deposit and the lending interest rate  
(in millions of denars)



Source: National Bank of the Republic of Macedonia.

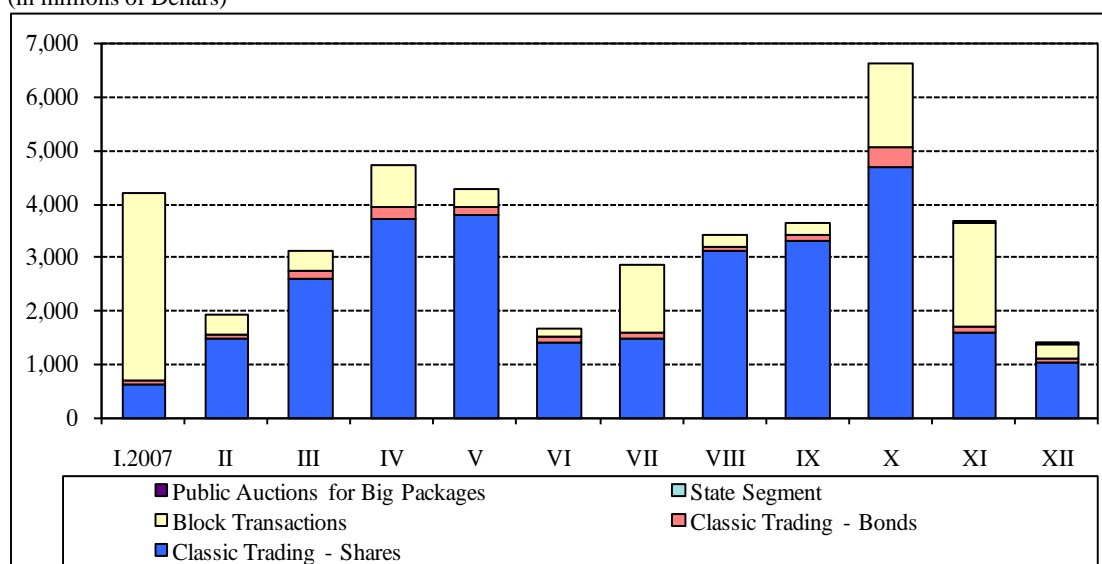
The detailed analysis of the interest rates on the foreign currency credits and deposits show that the sector "household" registers decrease in the average interest rate on both short-term and long-term credits (extended in Euros) of 1.5 and 0.8 percentage points, respectively. Also, in 2007 the annual growth of the average interest rate on the short-term and the long-term time deposits of 0.5 percentage points, respectively, was determined. Regarding the corporate sector, the most significant change was registered with the short-term credits (extended in US Dollars), the average interest rate of which decreased by 1 percentage point, as well as with the long-term credits (extended in Euros), the average interest rate of which went up by 0.5 percentage points. Relating the deposit interest rates, average increase in the price of the short-term time deposits (in Euros) from 2.4% in 2006 to 3.2% in 2007 was registered.

## IV. Capital market

In 2007, the stock exchange trade registered an expansion, with the turnover being the highest since the establishment of the Macedonian Stock Exchange of Long-term Securities. Such achievements are result of the increased interest of the foreign investors (especially the institutional ones) to invest on the stock exchange, as well as to the domestic natural persons, the interest of which for higher inclusion of the domestic securities in their portfolio increased. However, the most dominant share accounts for the trade in securities, thus reflecting the increased confidence in the domestic companies' perspectives and the expectations for higher income.

The total turnover on the Macedonian Stock Exchange of Long-term Securities in 2007 amounts to Denar 41.7 billion, which is an increase of 34.4% in comparison with the turnover in 2006<sup>76</sup>. The increase in the stock exchange turnover is completely a result of the annual increase in the classical stock trade of 3.4 times, compared to the annual decrease in the classical trade with bonds, the block transactions and the trade of the government segment. The stock exchange turnover in 2007 almost completely consists of classical stock trade and block transactions, comprising 69.2% and 26.9% of the total turnover, respectively. However, the largest share in the classical stock trade accounts for the stock trade of the companies from the banking sector, construction, pharmaceutical and petroleum industry.

Figure 110  
Stock Exchange structure  
(in millions of Denars)



Source: Macedonian Stock Exchange AD Skopje.

At the end of 2007, the value of the MBI-10 index<sup>77</sup> equals 7,740.8 index points, which is more than a double increase in comparison with the end of the preceding year, when it equaled 3,702 index points (growth of 2.1 times). The MBI-10 index is characterized with a rapid increase from January until the beginning of May, parallel to the intensification of the classical trade. After the gradual two-month decline, at the beginning of July the MBI-10 and the classical trade commenced to increase again, with this trend lasting until the end of August. On the last day of

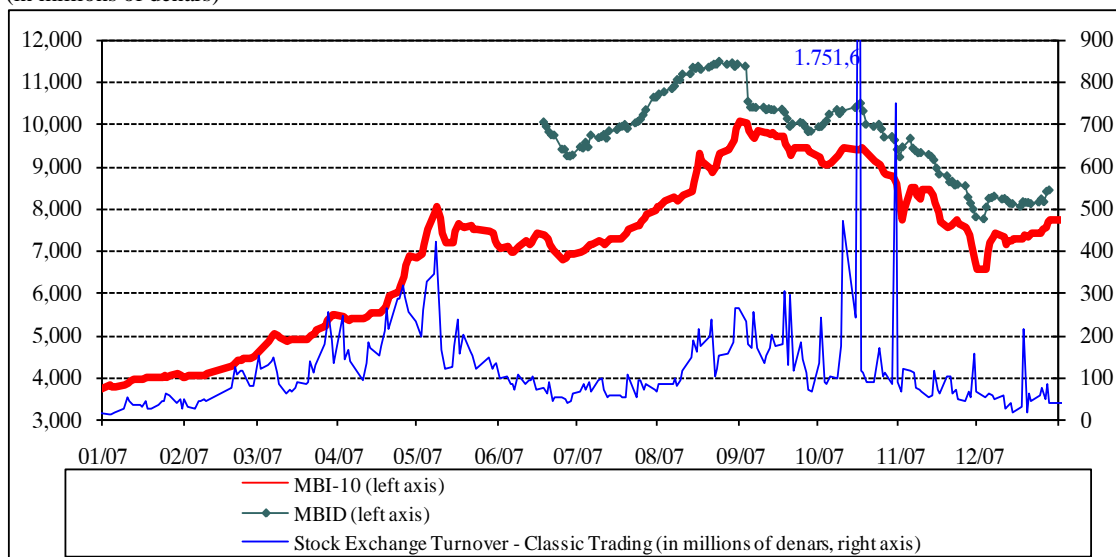
<sup>76</sup> If the block transactions with the shares of the electricity company ESM in March 2006 and January 2007 are excluded, the total stock exchange turnover in 2007 will be higher by 90.5%.

<sup>77</sup> Price index, weighted with the market capitalization, comprised of ten, at most, listed companies on the official market. During the regular index reviews (twice a year), the composite elements of the MBI-10 are set having in mind the market capitalization, the average daily turnover and the number of transactions in the previous six months, the number of trade days and the relative liquidity of the shares of the companies listed on the official market.

August, the MBI-10 registered the historical highest level of 10,057.8 index points, but then it started registering a downward trend, so at the end of the year it dropped to the level which is by 23% lower than that registered at the end of August. The classical trade on the stock-exchange also registered a downward trend from September till the end of the year, as well as larger instability compared to the previous part of the year.

At the end of 2007, the value of the index on the publicly owned companies - MBID<sup>78</sup> equals 8,413.6, which is a decline of 15.9% compared to June 15, 2007, when the calculation and the announcing of this index commenced. However, the movement of MBID completely follows the movement of MBI-10.

Figure 111  
MBI-10, MBID and stock exchange turnover through classical trade<sup>79</sup>  
(in millions of denars)



Source: Macedonian Stock Exchange AD Skopje.

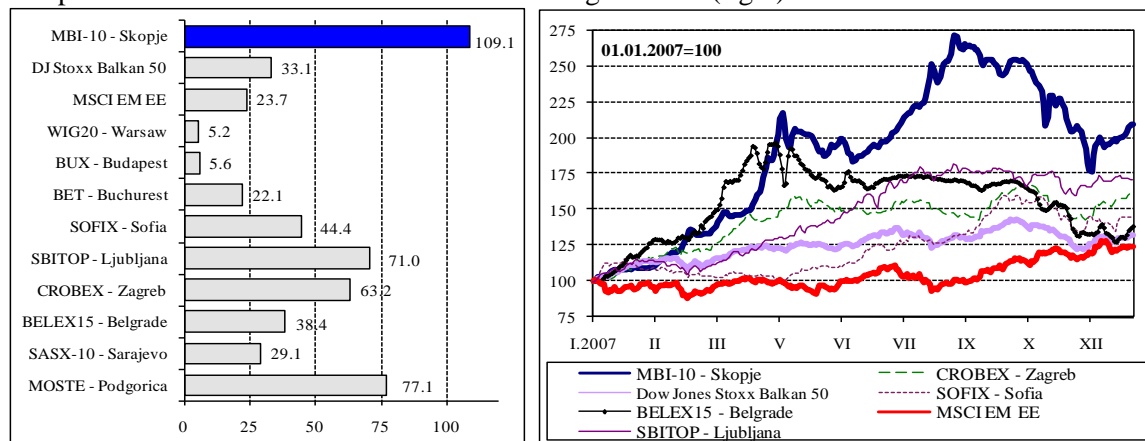
MBI-10 was the most rapidly growing index in the region in 2007, in conditions of annual increase in the indices of all other national stock exchanges, as well as to the composite regional indices. In the first half of the year, the MBI-10 moves in similar direction as other indices, thus reflecting the attractiveness of the stock exchanges in the region. Starting from June, the movement of MBI-10 diversifies from the other national and composite stock exchange indices in the region and firstly it grows, and then drops far more rapidly than they do. This indicates the still insufficient integration of the Macedonian capital market into the regional Balkan and European capital flows, as well as to the significant presence of the speculative behavior of the Macedonian capital market. However, besides the decrease in the last four months, the level of the MBI-10 at the end of 2007 is the highest relative to the national and the composite regional stock exchange indices.

<sup>78</sup> Price weighted index, which includes common shares listed on the Publicly Owned Companies Market. During the regular quarterly reviews of the index, the composite elements of the MBID are determined having in mind the registered turnover and the number of trade days in the previous quarter.

<sup>79</sup> The figure shows the daily stock exchange trade through classical trade, encompassing only the classical stock and bonds trade, while it excludes other transactions types. In order to provide better presentation of the data, the figure fails to show entirely the classical trade on 16.10, which equals Denar 1,751.6 million (which is due to the undertaking of one domestic company by a foreign investor).

Figure 112

Annual growth rates of the national and composite regional stock exchange indices<sup>80</sup> (left) and comparison of the movement of the stock exchange indices (right)



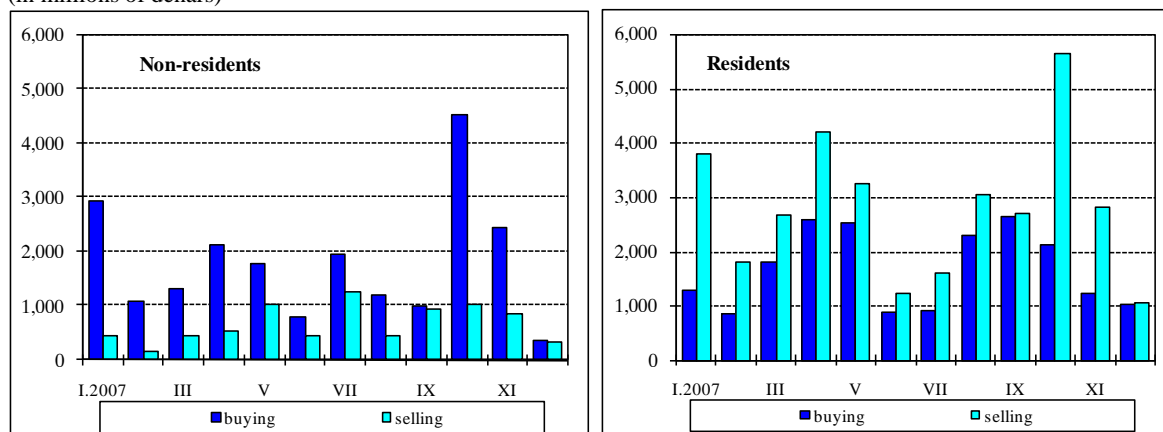
Source: Bloomberg, Dow Jones (Bloomberg, Dow Jones), Macedonian Stock Exchange AD Skopje, national stock exchanges.

In 2007, the trend of the non-residents' investments on the Macedonian Stock Exchange continued. Larger number of investments was witnessed on the side of the purchase, the share of which in the total purchase on the stock exchange equals 51.3%, while on the side of the sale, they participated with 18.6% in the total sale on the stock exchange. Regarding the non-residents, the institutional investors dominated, i.e. the legal entities comprised 47.3% of the total purchase and 15.2% of the total sale on the stock exchange in 2007. As a result of this movement, at the end of 2007 the share of the foreign investors in the total principal of the companies on the stock exchange' official market went up by 30.9% (compared to 23.1% at the end of 2006). On the other hand, the share of the foreign investors in the total face value of the bonds fell from 11.2% at the end of 2006 to 8.4% at the end of 2007. The enhanced interest of the non-residents for ownership securities, which are more risky, but simultaneously yield bearing, points to the increased confidence in the performances of the Macedonian companies. The high demand for shares, especially by the non-residents led to increase in their prices, thus reflecting with a rise in the stock exchange indices in Macedonia. However, in the last four months, the indices in Macedonia register a downward trend, which is primarily due to the combined effect of the privatization of large companies in other countries in the region (Croatian Telecommunications), which attracted the interest of the regional institutional investors, the problems on the global financial markets, as well as the political independence in the region.

<sup>80</sup> „Dow Jones Stoxx Balkan 50“ includes the shares of the 50 largest and most liquid companies from eight Balkan stock exchanges. „Morgan Stanley Capital International - Emerging Markets Eastern Europe“ (MSCI EM EE), is an index weighted according to the market capitalization and it includes shares from four Central and Eastern European stock exchanges.



Figure 113  
 Stock exchange turnover in 2007, by investors and transactions direction  
 (in millions of denars)



Source: Macedonian Stock Exchange AD Skopje and NBRM calculations.

The intensification of the portfolio investments of the non-residents reflects also on the increase in the purchase of foreign exchange by the NBRM. Thus in 2007, the total amount of purchased foreign assets by the NBRM on the basis of foreign currency rights exceeds the amount of sold foreign currency on the basis of withdrawal of the invested funds by the non-residents by Euro 107 million (i.e. by 2.5 times), compared to the net purchase of Euro 37.4 million in 2006.

At the end of 2007, in line with the obligations under the Stabilization and Association Agreement concluded between the Republic of Macedonia and the EU, the NBRM revoked the banks obligation to purchase foreign currency rights based on non-residents' portfolio investments. Besides the fulfillment of the obligation stipulated in the Agreement, this also means a significant reduction of the administrative burden given the portfolio investments' entry, which is expected to influence on the improvement in the foreign investors' perceptions for the attractiveness of Macedonia as a investment destination.

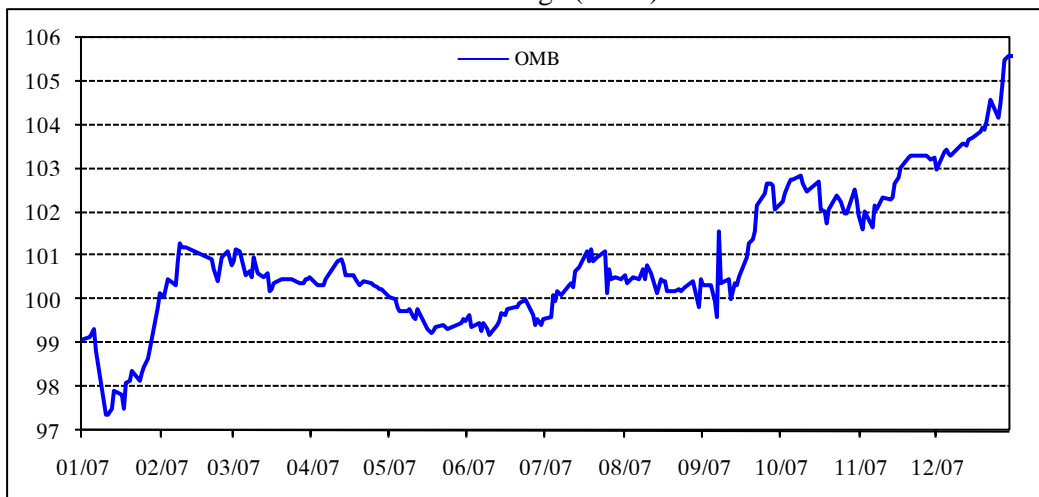
The domestic investors continue to participate mainly on the side of the sale of securities, i.e. their share equaled 81.4% of the total sale and 48.7% of the total purchase on the stock exchange. However, the trade of the domestic natural persons comprises 49.2% of the total sale and 31.8% of the total purchase on the stock exchange in 2007. The analysis of the investment structure of the domestic natural persons on the Stock Exchange<sup>81</sup> shows that as of the end of 2007, the largest portion, i.e. 92.9% of the invested funds of the domestic natural persons on the stock exchange are invested in shares, while the remaining share is invested in government securities. These data point to the domestic households' readiness to undertake higher risk as an effort to register higher yields. However, it can be assumed that the trade of the natural persons partially reflects a speculative behaviour, i.e. it is motivated from the possibility to register high capital gains in conditions of fast growing prices on the stock exchange, which can expose the sector "households" to serious consequences and property effects.

The registered bonds turnover on the official market on the Stock Exchange in 2007 amounts to Denar 1,559.8 million and it is lower by 30.1% compared to 2006. The denationalization bond of the 4th and the 6th issue were the most traded ones (27.6% and 26.2% of the total turnover, respectively). During the year, the prices of the government bonds moved in a relatively wide range - of 75% (the Denationalization bond of the 6th issue) up to 90% (the Old foreign exchange saving bond ) of the face value. The Bond Index of the Macedonian Stock

<sup>81</sup> Source: Central Depository of Securities.

Exchange<sup>82</sup> (OMB) registered a significant drop and then in January, it increased and maintained relatively stable until September, when the rapid increase in index commenced, which is probably partially due to the re-direction of the demand from shares to bonds, as a financial instrument providing higher safety. At the end of 2007, the value of OMB amounts a record 105.6 index points, which represents an increase of 6.6%, compared to the end of the preceding year.

Figure 114  
Bond Index of the Macedonian Stock Exchange (OMB)



Source: Macedonian Stock Exchange AD Skopje.

In 2007, the total turnover with long-term government securities on the Over the Counter Market amounts to Denar 696.3 million, almost half of which is registered in the first quarter. The turnover of government securities with residual maturity of three-years equals 59.2%, while the turnover of the government securities with residual maturity of up to two years represents 40.8% of the total turnover with long-term government bonds on this market.

<sup>82</sup> The OMB index is composed of bonds for old foreign exchange savings and denationalization bonds of the 1st, 2nd, 3rd, 4th, 5th and 6th issue. The OMB is a price index weighted by the turnover, with a restriction according to which the share of none of the bonds within the index structure is not allowed to exceed 30%.

## V. Other activities of the NBRM

### 5.1. Payment system in the Republic of Macedonia

In 2007, the payment system in the Republic of Macedonia continued successfully performing its function and development. The NBRM, as the owner and manager of the Macedonian Interbank Payment System (MIPS), through which real time gross settlement is performed, successfully implemented its operational function in the payment system. Also the remaining components of the payments system, such as: the Clearing House "KIBS" AD Skopje, "Kasis" AD Skopje and internal bank systems, through their functioning, contributed to stable, smooth and efficient functioning of the payments system in the Republic of Macedonia.

In 2007, the National Payment Systems Council of the Republic of Macedonia was focused on the preparation of the Payment System Development Strategy of the Republic of Macedonia 2007 - 2011, as well as to the proposals in the process of adoption of the Payment Operations Law and the bylaws, which is in direction of higher efficiency and smooth functioning of the payment system in the Republic of Macedonia. Full cooperation and coordination with the institutions directly or indirectly related with the payment system is enabled through the national payment Systems Council of the Republic of Macedonia.

#### 5.1.1. NBRM role in the payment operations

For ensuring efficient and safe payment system in the Republic of Macedonia, the NBRM acts its role in the payment operations through the following functions:

- a) operational function,
- b) regulatory function, and
- v) oversight function.

##### *a) Operational function*

In the performance of its operational function, the NBRM manages the settlement system - MIPS. In 2007, MIPS operated in a real time with accessibility of 99.79% of the envisaged working time during the entire year. Furthermore, the System was processing 11.416 orders a day, on average, and the maximum number of orders processed a day equaled 26.787.

Participants in MIPS are the banks (including the NBRM), the clearing institutions and the Ministry of Finance. At the end of 2007, the total number of participants in MIPS equaled 24.

Apart from the above, while performing its operational function, in 2007, the NBRM received and processed 3.604 execution orders and decisions on forced collection, 2.380 of which fully executed, with the remaining being partially or fully unexecuted due to lack of debtors' funds, postponement by the authority which adopted them, or since incomplete and returned to the courts or the enforcement agents for their further completion.

In 2007, out of 2.831.339 transactions settled in MIPS, 76.841 transactions were queuing, which is 2.71% of the total number of transactions settled in MIPS, or 309,8 transactions a day, on average. The average queuing time is 8.445 minutes, which is significant reduction in the average queuing time compared to 2006, when it equaled 13.28 minutes. The reasons are provided in details in the analysis of the queues in MIPS for 2007.

### *b) Regulatory function*

In 2007, pursuant to the new Payment Operations Law, within its regulatory function, the NBRM performed its regulatory function in the area of payment systems by adopting the following regulations:

1. Decision on setting a standard for constructing the accounts of the participants in the payment system and assigning a leading number of the carriers of the payments system;
2. Decision on specifying the amount of small interbank payment;
3. Decision on submitting data on the performed activities in the payment operations;
  - 3.1. Instructions on submitting data on the turnover in the internal and the external clearing;
  - 3.2. Instructions on submitting data on the performed activities in the payment operations;
4. Decision on the method of maintaining and the contents of the Single Registry of Transaction Accounts;
5. Decision on the method and the procedure for opening and closing transaction account;
6. Decision on the criteria and the standards for the payment systems operating;
7. Decision on the method and the methodology for the payment systems oversight; and
8. Instructions on the procedure for correction of an error made by the payment operations carrier.

The stated legal framework enables quality improvement on the sub-laws pertaining to the payment systems.

### *c) Oversight function*

As a part of its payment systems oversight function, in 2007, the NBRM conducted on-site oversight of the banks and the clearing house. The payment system was monitored through the IT system, developed on the basis of the Instructions for internal and external clearing, requiring day-to-day electronic submission of data on the banks' payment system. In addition, the blocked accounts are monitored indirectly, on a daily basis, by comparing the blocked accounts reports submitted by the bank and the blocked accounts reports across the banking system, generated from the data the NBRM receives from the clearing house.

In 2007, with the adoption of the Law on the Payment Operations and bylaws by the NBRM, such as: the Decision on the method and the methodology for payment systems oversight and the Decision on the criteria and the standards for the payment system operating, the oversight function of the NBRM was legally implemented in the payment system according to the example of the EU member states. Such an approach is a result of the technical cooperation with experts from the Central Bank of the Netherlands. This cooperation also continued in 2008, in order to completely finalize the oversight function of the NBRM regarding the payment systems.

Furthermore, in 2007, the NBRM continued gathering and distributing payment operations data on a monthly basis, as specified by the Decision on submission and distribution of payment operations data.

In 2007, the NBRM oversight function in the area of payment system was performed through the National Payment Systems Council. For that purpose, the work group established by the National Payment Systems Council of the Republic of Macedonia in 2005, continued operating in 2007. In the performance of its tasks conferred by the National Payment Systems Council, the work group established international cooperation with representatives of the developed central banks responsible for the oversight of the payment systems within the consultative process in the preparation of the Payment System Development Strategy of the Republic of Macedonia 2007 - 2011. The adoption of the Payment System Development Strategy, which sets forth the strategic

development directions until 2011, is actually a central event within the payment systems area in 2007.

In 2007, the NBRM had active participation in the coordination with the Enforcement Agents Chamber and the banks in more efficient implementation of the Law on Enforced Payment in the part concerning the payment systems.

### 5.1.2. Indicators for the operations of the payment systems in the Republic of Macedonia

#### a) Opened accounts

In 2007, 1,859,296 new accounts of natural persons and legal entities were reported to the Single Accountholders Registry with the carriers of the payment operations in the Republic of Macedonia (banks and the NBRM), and 12,725 were closed, with the total amount of accounts opened in the Single Accountholders Registry reaching 2,127,826 at the end of the year. Holders of these accounts are 1,024,461 different entities (natural persons and legal entities), 54.48% of them holding only one account, with the average number of opened accounts equaling approximately 2.07702 accounts per entity.

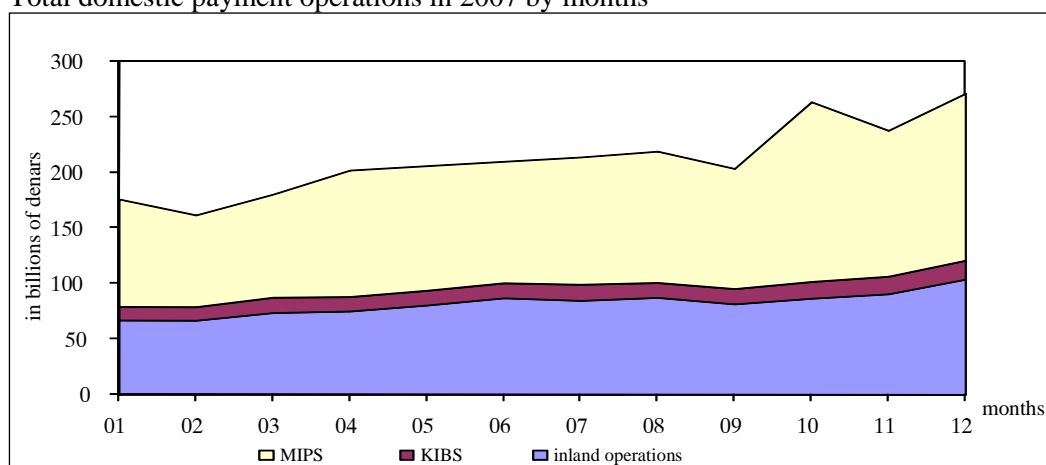
From the launching of the new payment system to the end of 2007, the total number of registered blocked accounts equaled 16,084. In 2007, 17,094 blockings were initiated, 9,398 of which were closed (unblocked), making up 58.43.1% of the total number of initiated blockings.

#### b) Total payment operations in the Republic of Macedonia

In 2007, the executed payment operations totaled Denar 2,545.18 billion. The total payment operations do not include transactions on settlement of the net net-balance of the clearing house KIBS. Thus, 38.7% are inland operations of the banks (between accounts in a same bank), 54.7% relate to interbank payment operations through MIPS and 6.6% are interbank operations through KIBS.

Figure 115

Total domestic payment operations in 2007 by months



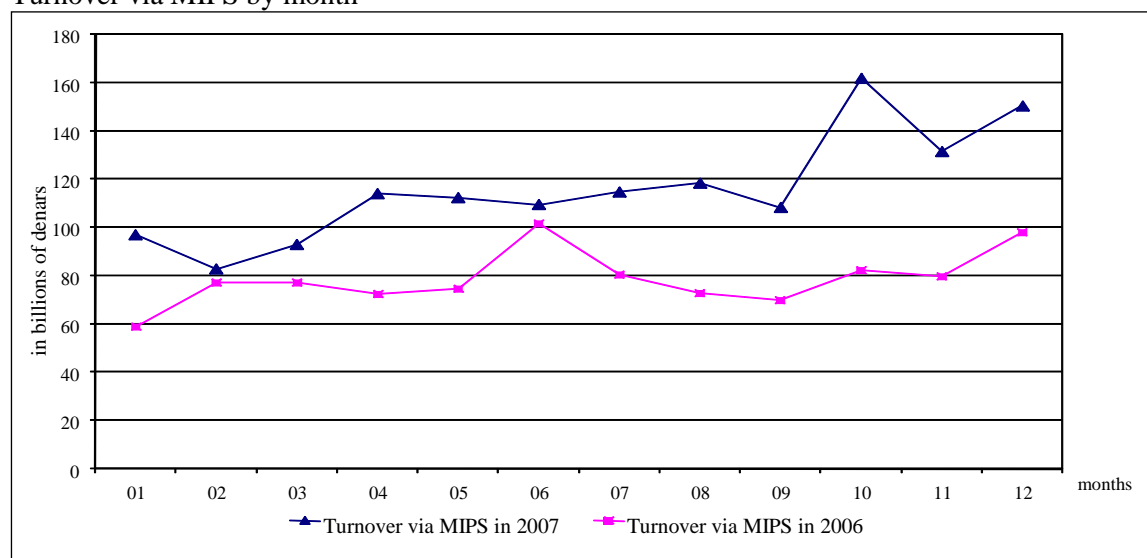
Source: National Bank of the Republic of Macedonia.

In 2007, the number of executed transactions in the domestic payment operations totaled 27,415,119, 10.3% of which via MIPS, 45.7% via KIBS, and 44% via the internal clearing.

*c) Turnover and number of transactions executed via MIPS in 2007*

In 2007, total turnover of Denar 1,452.75 billion was conducted via the NBRM's MIPS in a total number of 2.831.339 executed transactions, including also the transactions of the settlement of net balances of the clearing house KIBS. In 2007, the turnover made through MIPS went up by 42.5%, relative to the previous year. Of the total turnover conducted via MIPS, 52.6% is interbank turnover initiated by other payment operations carriers, and 47.4% is turnover initiated by government institutions (NBRM, Treasury system, etc.).

Figure 116  
Turnover via MIPS by month



Source: National Bank of the Republic of Macedonia.

In 2007, the number of executed transactions rose by 15.4% relative to the preceding year. Of the total number of transactions executed via MIPS, 64.1% are interbank transactions initiated by other payment operations carrier and 35.8% are transactions initiated by government institutions (NBRM, Treasury system, etc.).

*d) Internal banking payment operations in 2007*

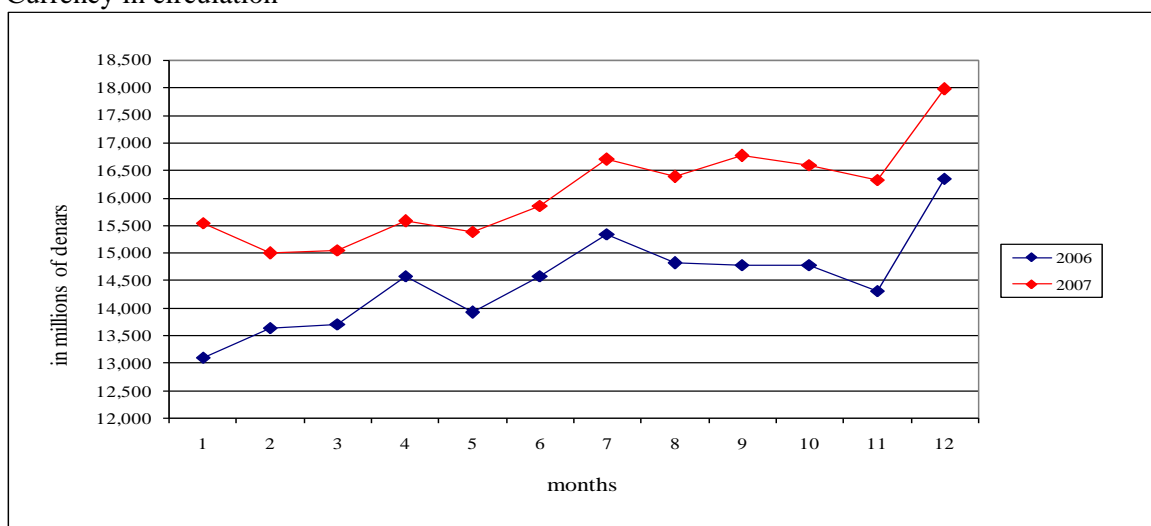
The analysis of the executed payment operations in 2007, between depositors' accounts opened in the system of a same payment operations carrier shows 31.8% higher value of internal bank payment operations relative to the preceding year. The registered turnover amounts to Denar 985.2 billion, in 12.058.263 executed transactions, which is by 18.0% more compared to the preceding year.

## 5.2. Cash management operations

### 5.2.1. Currency in circulation

The National Bank of the Republic of Macedonia has the single right to issue coins and banknotes, to determine the denomination and the basic feature marks of the banknotes and coins representing legal means of payment in the Republic of Macedonia. On December 31, 2007, the banknotes and the coins accounted for 98.6% and 1.4%, respectively of the outstanding amount of the banknotes and coins. The structure of the currency in circulation, shown through the number of pieces, indicates a participation of 31.1%, while the share of coins equals 68.7%. The value and the quantity structure of the currency in circulation remained relatively unchanged compared to 2006.

Figure 117  
Currency in circulation



Source: National Bank of the Republic of Macedonia.

At the end of 2007, the number of banknotes in circulation equaled 56.3 million, which is by 6.2% more relative to the end of 2006, and their value (Denar 17.7 billion) increased by 10.0%. The currency in circulation structure, by banknotes and coins is as follows:

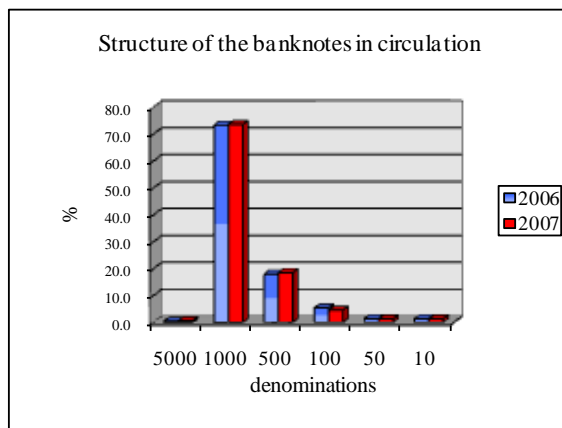
Table 24  
Dynamics of the currency in circulation

	Banknotes in circulation		Coins		Total cash in circulation in millions of Denars
	value in millions of Denars	quantity in millions	value in millions of Denars	quantity in millions	
1999	8.052	30,6	116,1	60,2	8.168
2000	9.424	36,0	135.2	68,7	9.559
2001	14.141	44,9	145.9	74,2	14.287
2002	13.945	44,4	160.9	80,9	14.106
2003	14.004	45,4	175.2	87,8	14.179
2004	14.049	46,9	192.6	96,2	14.241
2005	14.401	49,6	211.2	104,1	14.612
2006	16.109	53,0	233.0	113,4	16.341
2007	17.708	56,3	260.0	124,9	17.968

Source: National Bank of the Republic of Macedonia.

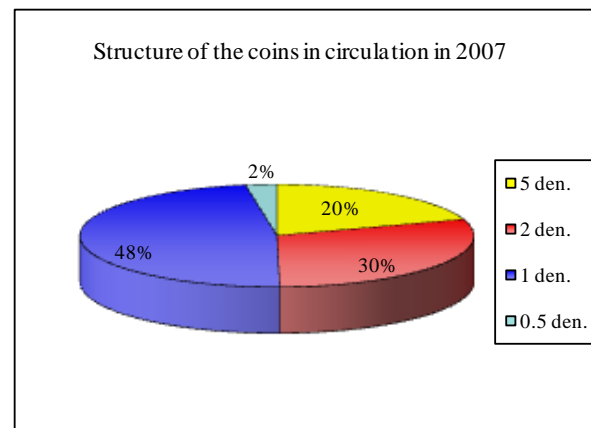
Analyzing the value, the denominations of Denar 1000 and Denar 500 were dominant category in the banknotes in circulation. The denomination of Denar 1000 made up 73.6% (73.3% at the end of 2006), and the denomination of Denar 500 constituted 18.5% of the value of the banknotes in circulation (18.0% at the end of 2006). The other denominations of banknotes, comprise only 7.9% of the total value of banknotes in circulation, which is by 0.7 percentage points less compared to the end of 2006. The structure of the coins by quantity in circulation, in 2007, by the denomination, is shown in figure no. 115. The largest share of the coins in circulation accounts for the denomination of Denar 1(48%).

Figure 118  
Banknotes in circulation



Source: National Bank of the Republic of Macedonia.

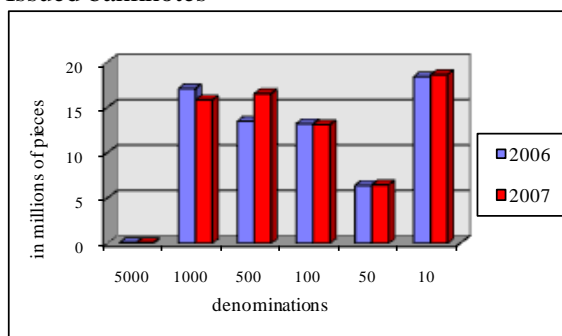
Figure 119  
Coins in circulation



### 5.2.2. Supplying banks with cash

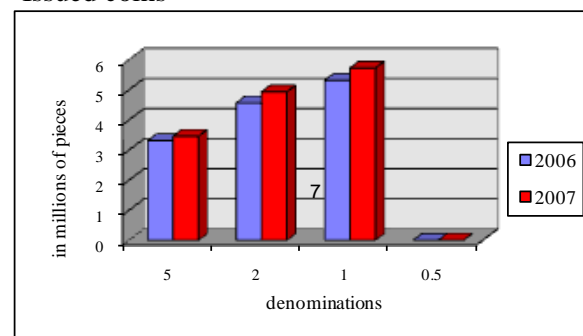
In 2007, the central vault of the NBRM and the two subunits for handling cash issued Denar 26.5 billion in cash to the banks, or 3,938 realized transactions (70.6 millions of banknotes and 14.1 millions of coins issued), which is by 1.5% more compared to 2006. Simultaneously, cash in the amount of Denar 24.3 billion was received from the banks through 4,835 transactions. Presented in banknotes, 65.1 millions of banknotes and 2.8 millions of coins were received, which is almost the same level compared to 2006.

Figure 120  
Issued banknotes



Source: National Bank of the Republic of Macedonia.

Figure 121  
Issued coins



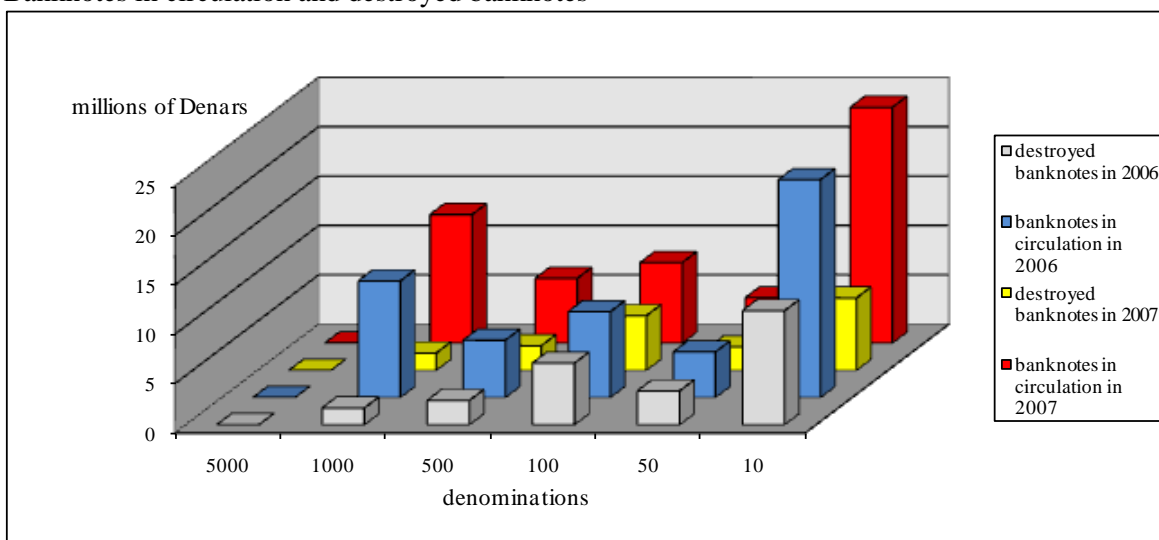
### 5.2.3. Banknote processing and destroying

In 2007, the banknote processing machine in the central vault processed total of 35.2 millions of banknotes (34.5 millions in 2006). The lowest share in the processing accounted for the banknotes in denomination of Denar 5000, as a result of their minor participation in the circulation.

In 2007, total of 35.2 millions out of the total processed banknotes were destroyed, 19.5 millions because they were worn out and damaged banknotes, and in comparison with 2006, when 25.4 millions were destroyed, 5.9 millions less are destroyed. The largest portion of the destroyed banknotes accounted for those in the denomination of Denar 10, 50 and 100, or in percentage 78.1%. Out of the total number of destroyed banknotes, 21.9% account for the banknotes with higher denomination structure (500, 1000 and 5000).



Figure 122  
Banknotes in circulation and destroyed banknotes

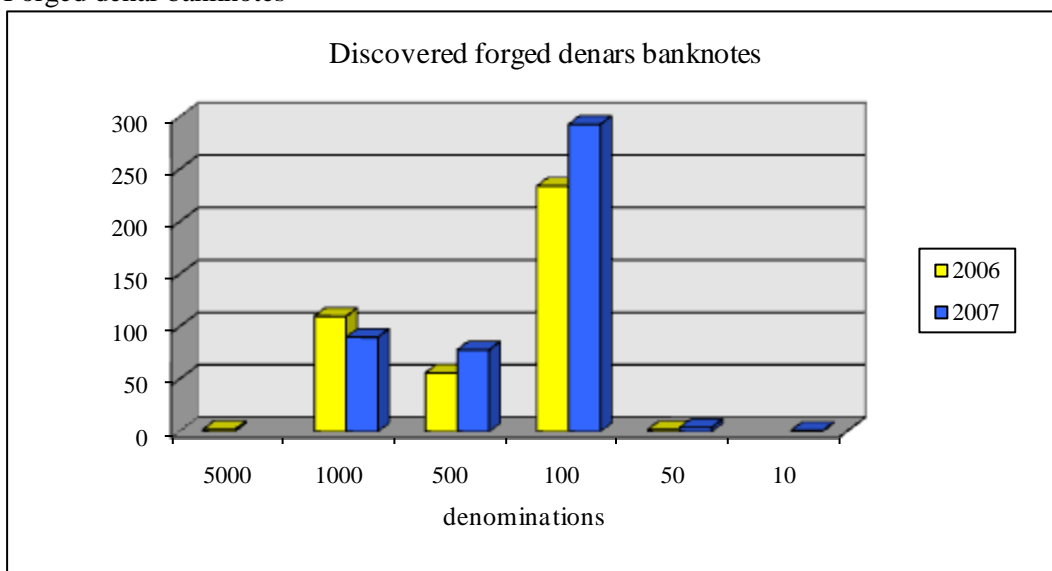


Source: National Bank of the Republic of Macedonia.

#### 5.2.4. Expertise on suspicious/forged banknotes

In 2007, the expertise showed total of 466 forged Denar banknotes discovered by the commercial banks and confiscated in the Republic of Macedonia by the Ministry of Interior, which is by 15.3% more compared to the forgeries in 2006 (404). The largest share out of the total number of discovered forged banknotes accounts for the banknote in the denomination of Denar 100 (total 293 pieces, or 62.8% of the total number of forgeries). The value of forged Denars (Denar 158,510) is marginal compared to the value of currency in circulation. The quality of all types of forgeries can not be assessed as good. The discovered forgeries were primarily made by computer (scanning and printing) or copies in color on a regular paper, without protection elements. In 2007, the National Bank sent ten banknotes of suspected forged Euros (50, 100 and 200) to the Ministry of Interior for an expertise, reported and submitted to the National Bank by individual entities.

Figure 123  
Forged denar banknotes



Source: National Bank of the Republic of Macedonia.

### 5.2.5. *Printing banknotes and other value papers*

In 2007, 20 millions of banknotes in denomination of Denar 100 were printed for the purposes of supplementing the reserves of banknotes. Total of 21.6 million pieces of coins in denomination of Denar 1, 2 and 5 were minted. A quantity of 9.976.000 pieces of administrative stamps, 5,000.000 pieces of court government stamps and 400,000 pieces of bills of exchange forms were printed for the account of Ministry of Finance.

### 5.2.6. *Other cash management operations*

In 2007, total amount of 12.7 million pieces of administrative and court government stamps (11.4 millions in 2006) and commercial papers in all denominations in the amount of 168,400 pieces (232,600 pieces in 2006) were sold for the account of the Ministry of Finance.

In 2007, alcohol and cigarettes banderoles were stored in and issued from the vault, for the account of the Ministry of Finance and the Public Revenues Office. There were total of 186 transactions of issuing cigarettes banderoles, which is by 8.8% more compared to 2006. Also, there were total of 506 transactions of issuing alcohol banderoles, which is by 8.1% more compared to 2006.

Total of 111 transactions on the basis of depositing foreign and Denar assets temporary confiscated by the competent bodies in the National Bank's vault were executed in 2007 (30 transactions in 2006). Contemporaneously, total of 22 payments of the temporarily confiscated foreign currency were executed on the basis of court decisions (12 in 2006). Also, sureties (Denars and foreign exchange) were deposited in the NBRM vault by the competent courts in the Republic of Macedonia, with six transactions for receipt and two for returning of the surety being carried out.

As a result of the regular foreign currency vault operation, there were 2,741 payments of cash foreign currency of government bodies from the vault (2,322 in 2006) and 456 receipts of cash foreign currency (250 in 2006).

With regard to the sold numismatics of sold golden and silver anniversary coins, total of 166 pieces were sold in 2007.

## 5.3. **Internal audit**

With the implementation of the Internal Audit Program in 2007, the internal audit fulfilled its ultimate task to identify risks the National Bank is exposed to in the performance of its functions, to establish and efficiently apply adequate internal control system. The work processes in the Bank should have achieved the following goals: credibility and integrity of the financial and other information, compliance of the operations with the laws and bylaws, the internal policies and the operating procedures, safeguarding of assets, and rational and efficient resource employment.

The regular audits of the NBRM operating processes provided an assessment on the adequacy of the internal control system in place, which is subject of regular reporting to the NBRM management. Recommendations were given for overcoming the identified weaknesses, if any, presented in the audit reports together with the accomplishment of the given recommendations. The audits were planned, not only with respect to the risk assessment, but also the importance of the performed functions, the time interval from the last audit and the changes made in the processes.

The internal audit also undertook some activities aimed at improving the operations through commenced activities for complete implementation of the international internal audit standards, and consequently, development of the Program for self-assessment of the quality of the internal audit operations, development of the Methodology for the preparation of the Annual

program for risk-oriented operations, as well as revision of the existing internal operating procedures. The implementation of these activities is performed in cooperation with the Central Bank of the Netherlands, which within the extended technical assistance made external assessment of the quality of the operations of the internal audit of the NBRM, in order to identify the possibilities, recommend improvements in the operations, as well as to promote the image and the credibility of the internal audit.

Fifteen regular and three extraordinary audits were conducted in 2007, with the implementation of the recommendations given in the audit reports, which were to be completed by 2007, being closely monitored on a regular quarterly basis. The monitoring mainly showed that the recommendations were observed and implemented within the given periods. The audits of 34 work processes in NBRM in 2007, resulted in 92 recommendations for improvement of the internal control system.

The internal control systems in the departments, whose individual operating processes were subjected to audit in 2007, were regarded as generally satisfactory, with a need of their further development and improvement.

#### **5.4. Strengthening of the NBRM institutional capacity**

- In 2007, the inflation projection model was actively worked on, which will have the central place in the area of the NBRM macroeconomic projections in the following years. The model encompasses the basic economy segments and it is placed such that it can perceive the possible movements of the most significant macroeconomic variables, and depending on that, estimate the future inflation direction, and accordingly, an adequate reaction by the monetary policy. With this model the NBRM follows the practice of the contemporary central banks regarding the inflation projection based on macroeconomic foundation and assessment of the influences of the international environment, as a basis for the monetary policy decision-making. It is a middle-term project, for which technical assistance from the Czech Central Bank, provided by the IMF, was used.

- In 2007, the activities for the implementation of the Supervision Development Plan, commenced in May 2006, continued, through the systematization of the tasks in ten critical areas. Identification of the risk the banks are exposed to was made, and the approach of the National Bank of the Republic of Macedonia regarding the assessment of these risks was defined. The foreign consultant engaged in 2006 continued to support the NBRM in the process of a transition to a risk focused supervision.

Starting from the current procedures and processes for performing supervision on banks by the National Bank of the Republic of Macedonia, draft of the new supervisory framework defining the approach and the processes applied in the supervision on banks was prepared. The approach defined in such a manner, together with the procedures for estimating the level of risk exposure and the quality of the risk management, starting from the fourth quarter of 2006, represents a subject of testing by the National Bank of the Republic of Macedonia. The results of these tests, which continued also in 2007, give the basis for determining the applicability of the risk oriented supervision.

In the second half of 2007, activities for providing consultant services in direction of strengthened application of the activities in the Division of Supervision, Banking Regulation and Financial Stability commenced. The main objective of these activities, that were carried out within the project with the World Bank, for improving the investment environment and strengthening the public sector management in the Republic of Macedonia supported by a donation of the Kingdom of the Netherlands, is more efficient realization of the Supervision Development Plan.

Simultaneously, organizational restructuring of the supervisory function in the National bank of the Republic of Macedonia was performed in the second half of 2007, as a part of the

Supervision Development Plan. The Division of Supervision, Banking Regulation and Financial Stability was established, consisting of three departments: Department of Off-Site Supervision and Licensing, Department of On-Site Supervision and Department of Financial Stability, Banking Regulations and Methodologies. A Supervisory Committee was created within the Division, which is responsible for reviewing and approving the findings and recommendations received through the activities of the three departments within the division. For its operations, the Supervisory Committee is held liable to the Governor of the National Bank, to whom, in written form, submits all proposals pertaining to the control activities and the supervision on individual institutions and proposals in the part of the financial stability, banking regulations and the methodology. The new organizational layout enables larger specialization of the human resources and optimization of the level of their utilization.

- The new Banking Law (adopted in June 2007) provides significant quality improvement of the banking regulations and supervision in the Republic of Macedonia. This Law is based on the provisions and the standards stipulated in the EU Directive 2006/48 for founding and operating of the credit institutions and the EU Directive 2006/49 for the capital adequacy of the investment companies and credit institutions. Pursuant to the Banking Law, the National Bank Council was obliged to adopt all bylaws within the period of nine months after its enforcement. On that basis, as of February 2008, the NBRM prepared and passed 23 bylaws, thus encircling the entire legal framework for the banking system and the banking supervision. The most significant changes and improvements in the Banking Law and the appropriate bylaws pertain to the following: tightening of the licensing criteria for shareholders having qualified holding in the bank; strengthening of the banks' risk management systems; improving the manner of conducting supervision and oversight, harmonization of the accounting standards and rules with the International Accounting Standards and the International Standards for Financial Reporting; strengthening of the corrective actions and improving the efficiency of the exit procedure (bankruptcy, liquidation) of the bank from the banking system; providing legal possibility for opening and operating of a foreign bank branch office.
- In order to improve the institutional operating of the National Bank of the Republic of Macedonia, in 2007 the National Bank of the Republic of Macedonia bodies passed bylaws from the following area :
  - with the reference of the Law on the Payment Operations, eleven (11) bylaws were adopted;
  - with the reference of the Law on the Foreign Exchange Operations, eighteen (18) bylaws were adopted;
  - with the reference of the Law on Fast Money transfer, two (2) bylaws were adopted;
  - with the reference of the Banking Law, twenty-three (23) bylaws were adopted;
  - with the reference of the Law on Securities, one (1) bylaw was adopted;
  - with the reference of the Law on the National Bank of the Republic of Macedonia, six (6) bylaws were adopted;
- In direction of improvement in the monitoring of the financial position of the National Bank and improvement of its financial reporting, in conformity with the International Standards for Financial Reporting and in line with the needs of the central banks, in 2007 Accounting Policies for Financial Reporting were adopted, encompassing the methodology, the form and the financial statements and deadlines for financial reporting.

In the second quarter, analysis of the data on the fixed assets was made, with the needs for change in the use value of the fixed assets being determined on the basis of the accounting value. The new accounting policies review the policy for calculating the depreciation, with the life of the fixed assets being reduced, for the purpose of more realistic cost appropriation during the period of assets utilization. In September 2007, new policy for calculating the amortization in a new module for recording fixed assets was implemented, which was prepared internally, within the National Bank, on the basis of the data integration principles. By applying

this module, single record of the fixed assets was achieved, providing tangible and value record, record by locations, as well as calculation of the amortization. The preliminary manner of recording same data in two separate applications in two different departments for different purposes was abandoned.

In order to automate the process of preparation of the Financial Plan and the Investments Plan and in order to monitor the realization of the plans, in 2007 the development of an application for the preparation of plans was made. In 2007, monitoring of the realization of the Financial Plan by organizational units was enabled. The monitoring of the realization of the Financial Plan is connected to the data in the General Ledger of the National Bank.

- In 2007, massive upgrade of the IT infrastructure of the National Bank was carried out by installing the Storage Area Network (SAN) which has possibilities for constant data replication, more than thirty new servers, new equipment for data file and new network equipment. Besides that, 20% of all PCs were replaced, and the procedure for the replacement of the remaining 80% that is expected to end in 2008, commenced. This opened the possibility for improvement of the functionality, availability and the safety of the information system of the National Bank of the Republic of Macedonia.
- In 2007, the cooperation of the National Bank of the Republic of Macedonia with the Dutch Central Bank in the area of technical assistance continued. The technical assistance project of the NBRM by the Dutch Central Bank, initiated in 2000, continued to be successfully carried out also in 2007. The project encompassed almost all main functions and activities of the National Bank of the Republic of Macedonia. Also, in 2007, the National Bank cooperated successfully in the area of the technical assistance also with the Austrian Central Bank and the International Monetary Fund.
- In 2007, increase in the number of the seminars attended by the NBRM employees was registered, given the simultaneous increase in the number of employees who attend seminars, which points to the constant efforts for upgrade and professional improvement of the personnel.

Number of seminars attended in 2006 and 2007

	2006	2007	annual change
In the country	8	20	
Abroad	87	99	
<b>Total</b>	<b>95</b>	<b>119</b>	<b>25%</b>

Number of employees attending seminars in 2006 and 2007

2006	2007	annual change
<b>66</b>	<b>89</b>	<b>35%</b>

From the aspect of the area the seminars cover, 23% of the attended seminars are from the monetary policy and central banking operations area, 15% pertain to the IT area, 13% Euro integration processes, 11% accounts for the supervision area, 8% from the statistics, 7% financial stability and financial markets, respectively, while the remaining 16% account for the seminars covering the cash management, internal audit, payment systems, accounting and translations.

It is significant to emphasize that the large number of the advanced training is realized on the basis of the annual training programs of the European central banks and other significant international institutions, the largest share of which, regarding the costs, is covered by the organizers themselves. Namely, from the aspect of the organizers, the largest portion of the attended seminars in 2007 (19%) was organized by the Joint Vienna Institute, followed by the

seminars organized by the German Central Bank(12%) and the Bank of England (7%), IMF and the Financial Stability Institute (by 5%, respectively). The remaining share refers to the seminars organized by other central banks, institutes and other organizations.

In 2007, the qualification structure of the NBRM registered improvement, which is presented as follows.

Qualification structure of the NBRM employees

Qualification structure	31.12.2006	31.12.2007	annual change
<b>Total number of employees:</b>	<b>417</b>	<b>418</b>	0.2%
(University degree, total, with MS.cA and PhD)	205	212	3.5%
1. MSc.	29	36	24%
2. PhD	1	3	three times
Higher education	20	19	-5%
Secondary education	173	168	-3%
Secondary education with fifth degree	15	15	/
Elementary school	4	4	/

- In 2007, in the NBRM premises the following trainings, seminars and workshops were held:

- In May 2007, the National Bank of the Republic of Macedonia, in cooperation with the State Statistical Office, organized one-day workshop on the topics *Problems in the inflation measurement*. The main objective of the workshop was to give review on the problems in the inflation measurement in the Republic of Macedonia and the future challenges in this domain, the country will face with on the road towards the European Union approach. Foreign experiences and perspectives about the open issues and dilemmas related with the inflation measurement were presented.

- In order to strengthen analytical capacity of the NBRM employees for the implementation of the statistic and econometric techniques in the application of the tasks, in February 2007, internal training for the econometrics was held in the NBRM. Later, in July 2007, one-week seminar for the econometrics with an eminent foreign professor was held, at which advanced econometrics techniques were presented. The seminar was organized in cooperation with the IMF and had regional character.

- In October, in cooperation with the Central Bank of the Netherlands and the Bank of England, in the NBRM one-week seminar on the topics of *Inflation and Monetary Policy Targeting* was held, attended also by the representatives of the regional central banks. The seminar offered quality review on the contemporary challenges of the monetary policy in the conditions of dynamic environment, with special attention being paid to the monetary strategies in the transition countries. A significant qualitative feature of the seminar was the elaboration of certain practical aspects regarding the application of analysis techniques and projection of the monetary policy needs;

- In the area of financial and accounting operations of the central banks, in 2007, in cooperation with the Central Bank of the Netherlands, international seminar on the topics of the accounting of the central banks was organized. Seventeen external representatives from 10 regional central banks took participation in the seminar.

- In 2007, the NBRM for the first time introduced the Annual Reward for the study from the macroeconomic area for a young researcher, in order to stimulate the scientific and researching

activity in the country, as well as the young personnel's potentials towards profound researches of the macroeconomic issues which concern the economy.

- Internal acts of higher importance adopted in 2007 are as follows:
  - Book of rules for personal data protection;
  - Book of rules for establishing a Misdemeanor Committee and Intermediation Committee;
  - Book of rules for organizing the sessions of the National Bank Council;
  - Book of rules for setting the working time in the National Bank;
  - Book of rules for data distribution from the Central Registry of the Republic of Macedonia;
  - Book of rules for utilization of Internet;
  - Book of rules for utilization of user accounts and passwords;
  - Book of rules for travel and other expenses;
  - Book of rules for conducting inventory;
  - Book of rules for organizing the operations of the National Bank;
  - Book of rules for of the operations and tasks systematization in the National Bank;
  - Decision on appraisal of working positions;
  - Basic policies for the accounting record and financial reporting;
  - Accounting rules for recording real estate, equipment and intangible assets;
  - Accounting rules for recording an investment in deposits certificates.