May 2003
IMF Country Report No. 03/131

Former Yugoslav Republic of Macedonia: 2003 Article IV Consultation and Request for Stand-By Arrangement—Staff Report; Staff Statement; and Public Information Notice and Press Release on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2003 Article IV consultation with the former Yugoslav Republic of Macedonia and Request for Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the combined 2003 Article IV consultation and request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on **February 7, 2003**, with the officials of the former Yugoslav Republic of Macedonia on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 15, 2003**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of **April 30, 2003** updating information on recent economic developments.

- the Public Information Notice (PIN) and Press Release **summarizing the views of the Executive Board as expressed during its April 30, 2003, discussion** of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.

The document(s) listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of the former Yugoslav Republic of Macedonia*
Memorandum of Economic and Financial Policies by the authorities of the former Yugoslav Republic of Macedonia*
Selected Issues Paper and Statistical Appendix
Technical Memorandum of Understanding*

*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Staff Report for the 2003 Article IV Consultation and Request for Stand-By Arrangement

Prepared by European I Department
(In consultation with other departments)

Approved by Susan Schadler and G. Russell Kincaid

April 15, 2003

Contents | Page

Tables

Appendices

Executive Summary

Background: The FYRM economy is gradually recovering from the recession triggered by the 2001 security crisis. After six quarters of negative growth and declining exports, economic activity began to recover in the second half of 2002. Spending on security in 2001 and a pre-election spending spree in 2002 resulted in large fiscal and current account deficits, but the strong foreign reserve position, exceptional financial inflows, and prudent monetary policy allowed the central bank to maintain the peg to the euro and keep inflation in low single digits. In the area of structural reforms progress has been uneven. The payments system was reformed and treasury system reforms are well underway. But progress was slow in reforming enterprises and the labor market. Unemployment, already high, increased during the post-crisis slump. The main goals of the new government are to restart growth, reduce unemployment, overcome corruption and bring ethnic Albanians, including former rebels, into the political mainstream. The latter initiative faces opposition from many ethnic Macedonians.

Discussions and Program Content: The Article IV policy discussions focused on regaining a sustainable fiscal and external position, restarting economic growth and job creation and addressing vulnerabilities resulting from public sector indebtedness, banking sector fragility and the euroization of bank and government balance sheets. On the exchange rate it was agreed that the de facto peg and the level of the existing rate were appropriate under current circumstances. Drawing on the Article IV discussions, the authorities have formulated a program that aims to correct the fiscal and external imbalances and pave the way for growth and employment creation. The program includes a two-step fiscal adjustment to bring the fiscal deficit to a debt-stabilizing level by: ending crisis-related and other non-recurrent spending; bringing recurrent spending to a sustainable level; and rationalizing the VAT rate structure. Treasury and tax administration reforms will support the execution of the budget. Structural policies under the program include initiatives to promote small and medium enterprises, measures to increase the flexibility of the labor market, and active labor market policies. Banking sector issues will be the focus of the FSAP missions later this year, and the authorities will incorporate their recommendations into the program at a later stage.

Financing and risks to the program: FYRM has requested IMF support of the program under a stand-by arrangement in the amount SDR 20 million. The arrangement will catalyze balance of payments support from the EU and other official sources amounting to US$153 million over the program period, an amount the staff deems adequate to achieve the financial objectives of the program. The success of the program on the economic and financial side will depend on whether the revival of GDP and export growth continue. Program implementation will also depend on the effectiveness of the coalition government working under difficult economic and political circumstances.

I. Introduction

1. **A staff team[1] visited Skopje during January 22-February 7, 2003 to hold Article IV consultation discussions and reach understandings on policies for a Fund-supported program (Appendix I).** The authorities have requested a stand-by arrangement in the upper credit tranches in the amount SDR 20 million (29 percent of quota) during the period from Board approval through June 15, 2004 (Appendix II).

2. **The country is gradually stabilizing after the 2001 security crisis which ended with the August 2001 Ohrid peace framework agreement (PFA).** Ethnic violence has receded. The new government, a coalition including representatives of both major ethnic groups, marked its hundredth day in office during the mission. After some initial teething problems, the government is functioning more effectively although it continues to face challenges in bringing ethnic Albanians, including members of former armed groups, into the political mainstream in the face of opposition from many ethnic Macedonians. A high-profile anti-corruption campaign has strong public support, but is seen by the opposition as politically motivated.

3. **FYR Macedonia has accepted the obligations of Article VIII, Section 2, 3, and 4, with effect from June 19, 1998.** The country maintains an exchange restriction subject to Article VIII, Section 2(a) arising from the treatment of former frozen foreign currency savings deposits. **FYR Macedonia's relations with the Fund are summarized in Appendix III.** After the cancellation of FYR Macedonia's PRGF/EFF on November 22, 2001, the authorities requested staff monitoring of their policies for six months, starting January 1, 2002. In the event, fiscal execution departed significantly from the policies in the staff monitored program owing mainly to a large public sector salary increase and payments to investors in collapsed pyramid schemes.

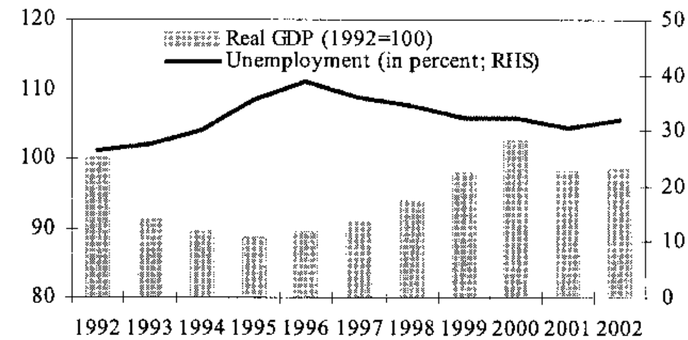
4. **The last Article IV consultation was concluded by the Executive Board on March 4, 2002** (SM/02/56). On that occasion Directors stressed the need to return to fiscal probity, accelerate structural reforms, and adequately fund implementation of the peace agreement.

---

[1] Messrs. Rozwadowski (head), Anayiotos, Moon, Zalduendo (all EU1), Wieczorek (PDR), and Ms. Reyes (assistant). Mr. Mikkelsen (Resident Representative) participated in the mission. Mr. T. Lane (PDR) joined the mission during January 25-31 to lead Article IV discussions. An advance team held technical meetings during January 22-24. The mission met with the President, Prime Minister, key economic ministers, the Governor of the National Bank of the Republic of Macedonia, and representatives of the trade unions and the private sector, and coordinated its work with World Bank staff.

II. Background

5. **In the three years before the 2001 security crisis economic activity grew by 4 percent a year on average and the unemployment rate came down significantly (text figure), while prices were stable.** This favorable performance reflected some progress with structural reforms in the context of sound macroeconomic policies. Restrained fiscal policy made room for private sector expansion while inflation was in low single digits, anchored by the de facto peg of the denar to the deutsche mark. Foreign exchange reserves increased as a result of a few large foreign direct investments and relatively moderate current account deficits.



6. **The security crisis, which erupted in the spring of 2001, halted growth and disrupted macroeconomic balance.** While the loss of life and destruction of property were limited, the crisis slowed structural reform and sapped business confidence. Real GDP declined by 4½ percent in 2001 and a further 1½ percent (year-on-year) in the first six months of 2002 (Table 1; Figures 1 and 2).

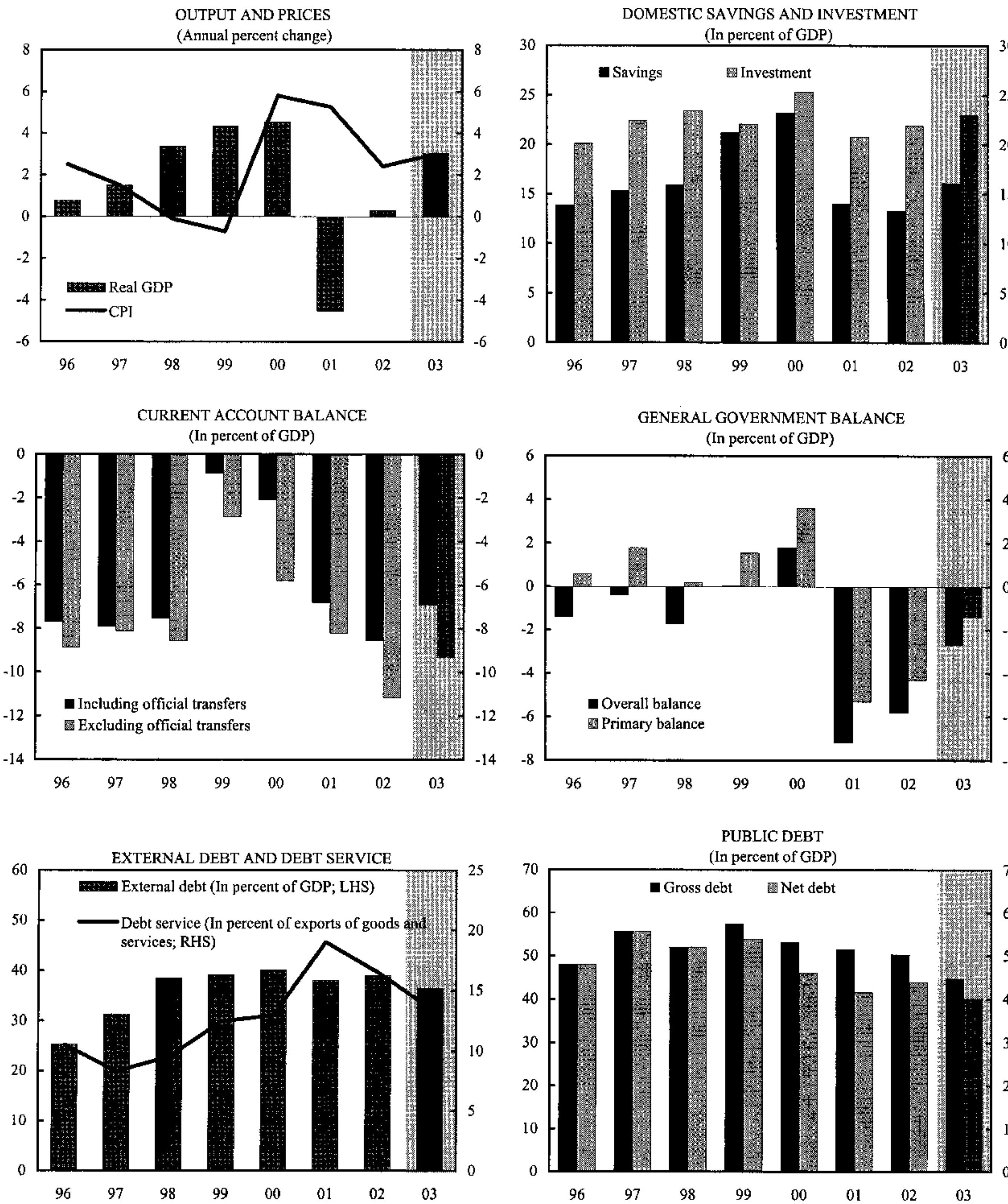
7. **Government spending ballooned during the crisis—and in the run-up to elections in 2002.** Security spending, though partly financed by an emergency financial transactions tax, nonetheless propelled the general government deficit to 7¼ percent of GDP in 2001 (compared with a surplus of 1¾ percent of GDP in 2000).[2] A fiscal consolidation planned for 2002 did not materialize owing to the postponement of security personnel demobilization and a pre-election spending surge (Tables 2 and 3). The impact of the deficits was cushioned by a large inflow of proceeds from telecoms privatization in 2001 and donor finance (to support the PFA) in early 2002.

8. **These privatization and donor receipts—together with monetary tightening—made it possible to maintain the exchange rate peg and keep inflation low against the backdrop of large fluctuations in monetary aggregates**. The uncertainties arising from the security crisis put significant pressure on gross official reserves. A surge in foreign exchange deposits in late 2001 related to the introduction of the euro was followed by a partial withdrawal (about a third of the original increase) during the first half of 2002 (Tables 4 and 5; and Figure 3) and electoral uncertainties further increased the pressures in the foreign

---

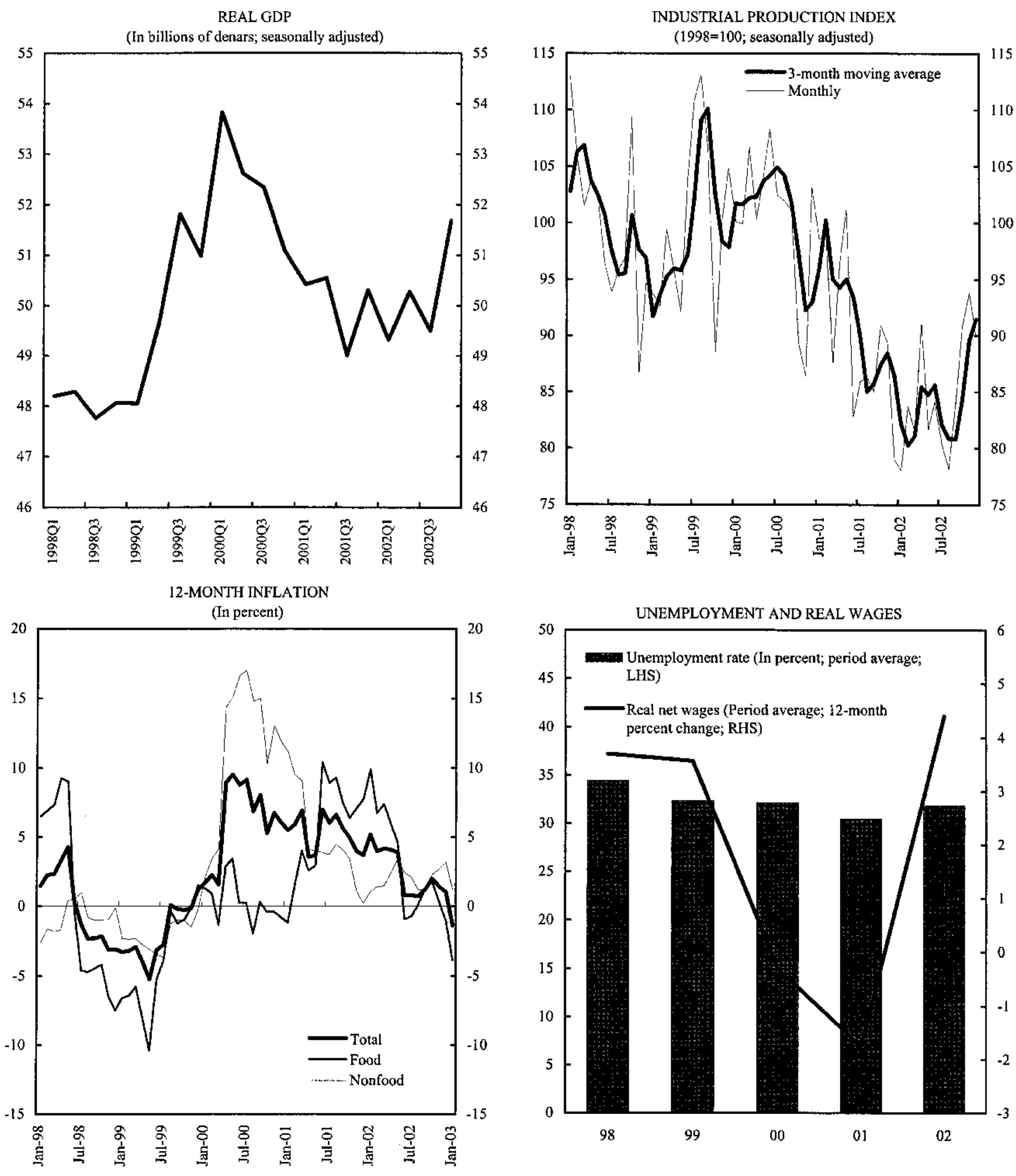
[2] The general government deficit is defined as the deficit of the central government and the Road Fund as reported by the authorities (and in past staff reports) plus donor financed investment projects, which were previously treated off budget.

Figure 1. FYRM: Selected Economic Indicators, 1996-2003 1/



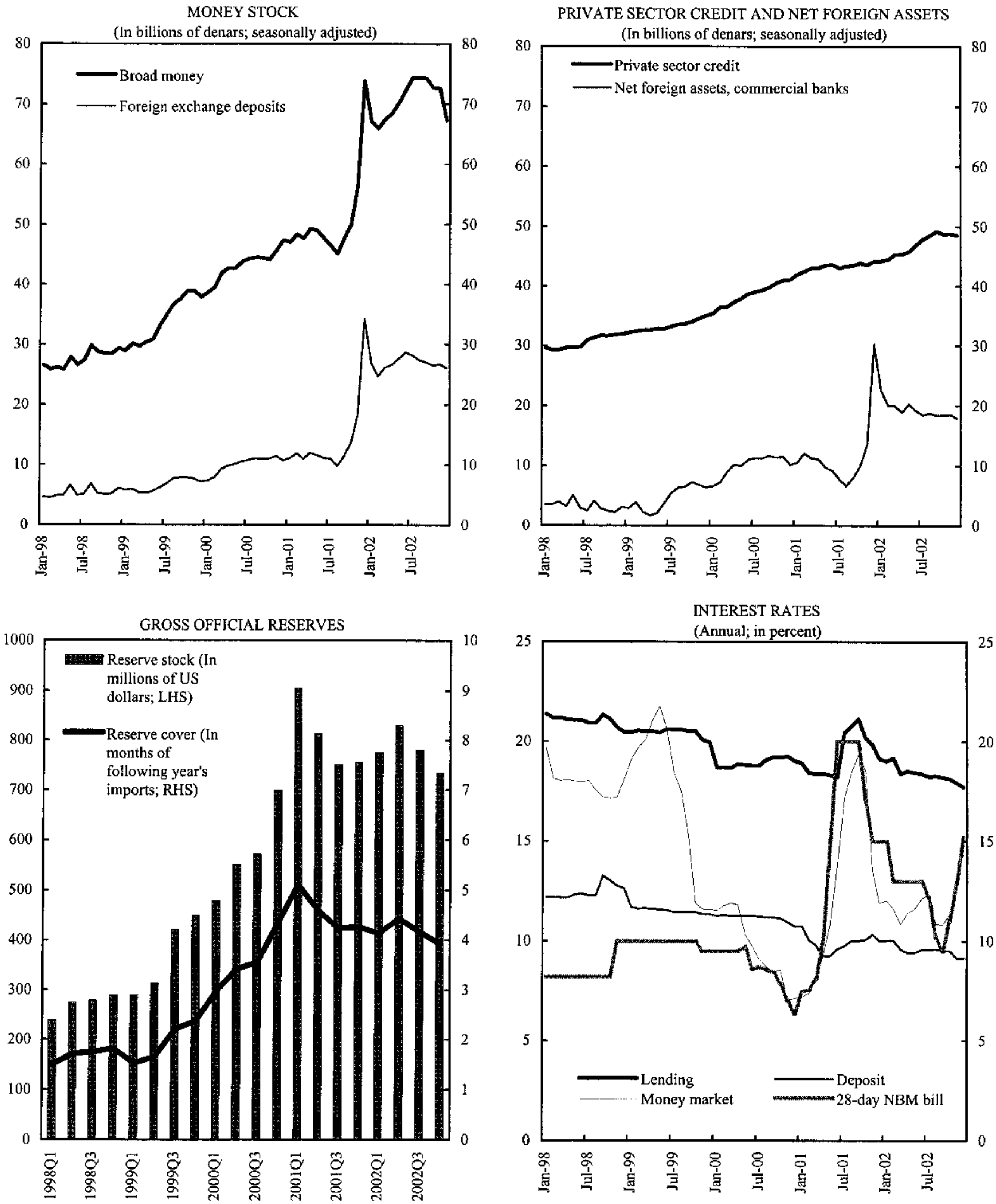
Sources: Macedonian authorities; and Fund staff estimates.
1/ Data for 2002 are estimates; and data for 2003 are projections.

Figure 2. FYRM: Real Sector Developments, 1998-2002



Sources: Macedonian authorities; and Fund staff estimates.

Figure 3. FYRM: Monetary and Financial Indicators, 1998-2002



Sources: Macedonian authorities; and Fund staff estimates.

exchange market in late 2002. But the availability of extraordinary sources of financing in 2001-02, and the NBRM's tight monetary policy stance, enabled FYR Macedonia to emerge from the crisis with foreign exchange reserves equivalent to 60 percent of broad money or 125 percent of the estimated gross financing requirements for 2003.

9. **The external current account deteriorated sharply during the crisis (Figure 4, Table 6).** Exports, always volatile due to a high concentration in steel and textiles, declined in 2001 and remained low in the first half of 2002, as a result of problems with market access and an overhang of uncertainty associated with the crisis and the September 2002 elections.[3] The current account deficit (excluding transfers) widened to 8 percent of GDP in 2001 and to over 10 percent of GDP in 2002, reflecting a surge in imports, a slow pickup in exports, and some one-time factors.

10. **Notwithstanding a few large pre-crisis investments, foreign investors have been lukewarm, and it seems unlikely that large FDI inflows can be relied upon to continue.** Political interference and corruption as well as regional instability have made FYR Macedonia an unattractive place to do business (Figure 5, EBRD transition score). Allegations of corruption associated with several privatizations in the late 1990s, and the ensuing litigation, sent a negative signal to prospective investors.

11. **While there were significant structural reforms in the financial sector and trade regime, FYR Macedonia's track record in enterprise reforms has been weak.** Most socially-owned enterprises were sold to insiders rather than to strategic investors with capital and know-how. Many old firms survive with substandard performance (see text table), and progress in winding up a few large loss-making enterprises has been slow. On the other hand, profitability has improved and the large number of firm closures and start-ups suggest a dynamic small- and medium-sized sector.

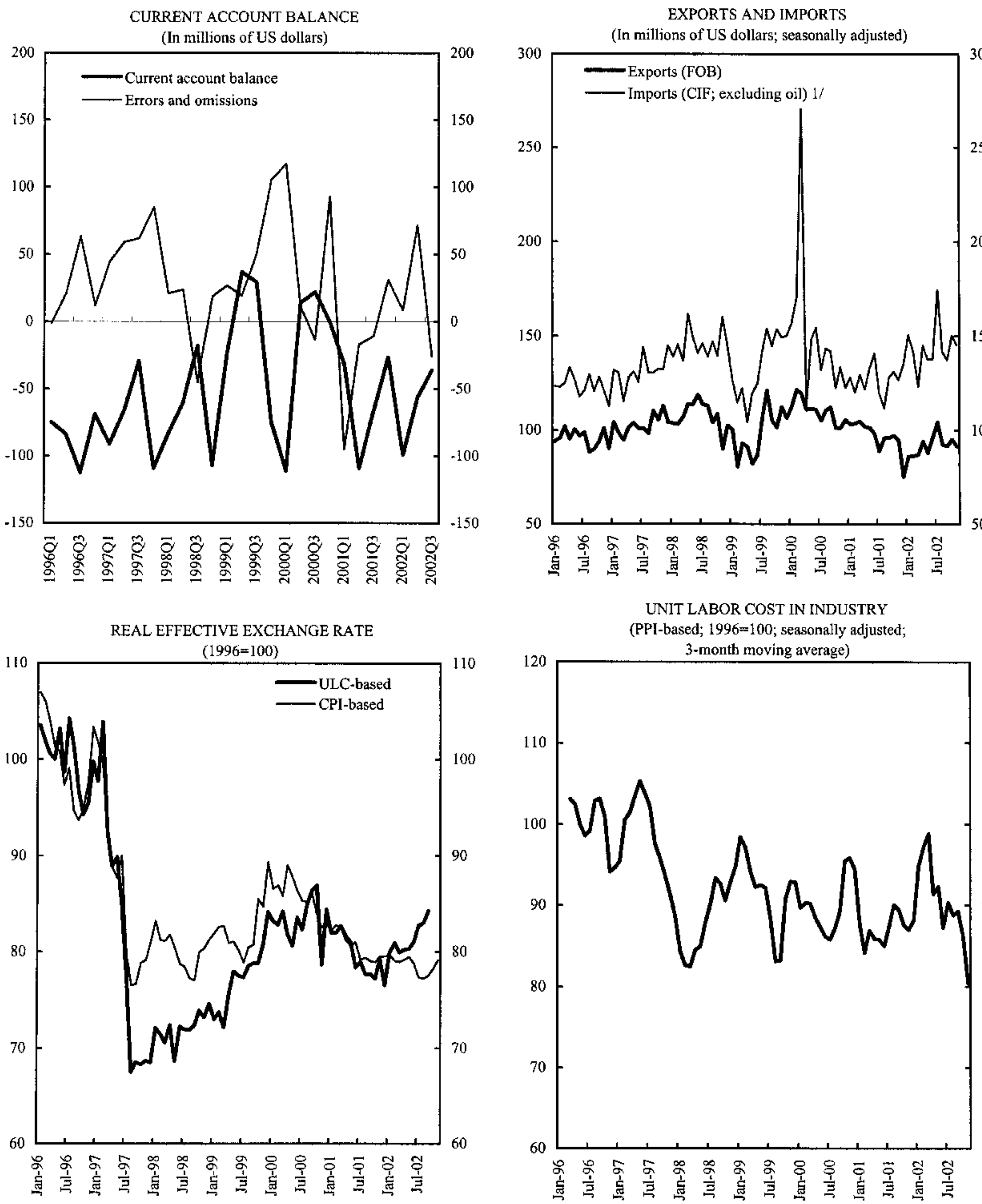
Indicators of Enterprise Performance 1/

	1994		1997			2000	
	Surviving firms	Dying firms	Surviving firms	Dying firms	New firms	Surviving firms	New firms
Number of firms	6710	10200	6710	4080	6961	6710	13725
Average employment	31.0	10.6	25.5	9.6	7.1	24.4	7.8
Total employment (in '000s)	207.7	107.7	171.4	39.2	49.6	163.5	107.6
Labor productivity (1994 denars, million)	0.22	0.12	0.20	0.16	0.14	0.23	0.23
Operational profits as share of value added	0.33	0.01	0.24	0.20	0.20	0.30	0.39
Profits/losses (in percent of GDP)	-6.1	-5.9	-1.1	-0.8	-1.0	-0.3	0.9

1/ Surviving firms are firms that existed throughout the period 1994-2000. Dying firms are defined as firms in existence in 1994 but that ceased to exist before 2000. New firms are firms that were created after 1994.

[3] Non-preferential treatment of steel exports to the US was lifted upon FYR Macedonia's accession to the WTO.

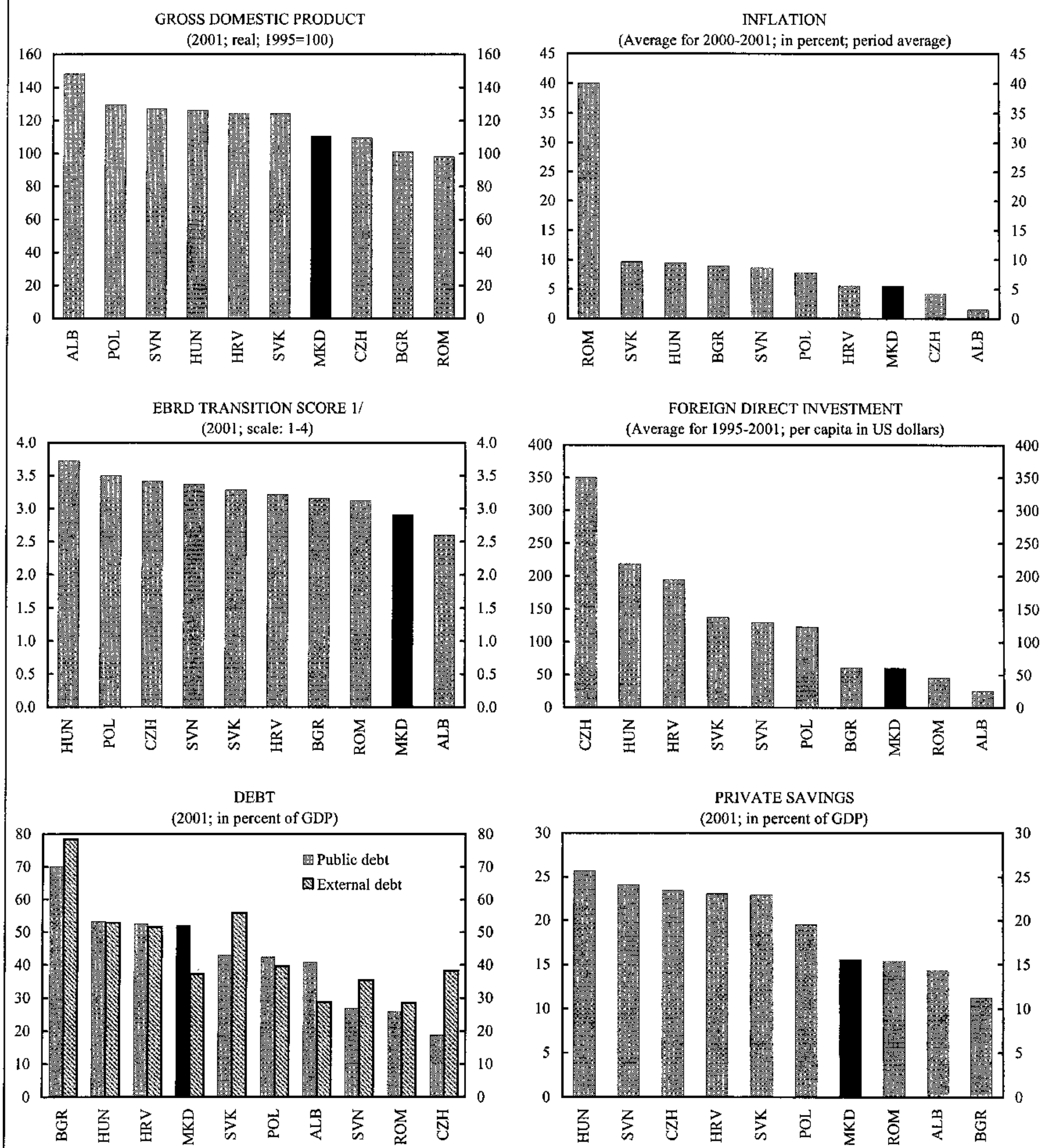
Figure 4. FYRM: External Sector Developments and Competitiveness, 1996-2002



Sources: Macedonian authorities; and Fund staff estimates.

1/ A sharp increase in imports took place prior to the introduction of the VAT in March 2000.

Figure 5. Cross-Country Comparison of Selected Economic Indicators



Sources: EBRD Transition Report 2002; and World Economic Outlook.

1/ Average of EBRD index scores across various measures of transition including liberalization, privatization, enterprise reform, infrastructure, financial institutions, and legal environment.

12. **The banking sector has strengthened but still has deep-rooted weaknesses.** All but one of FYR Macedonia's 21 banks (including the two largest) are now private and several banks (including the largest one) are foreign-owned. The banking sector remains concentrated: the two largest banks, taken together, account for nearly two thirds of deposits. Loan quality and profitability have recovered significantly from the low levels reached in 2001, but non-performing loans are still close to a third of the total and some small banks remain very weak. As in many Central and Eastern European countries, a high degree of euroization of banks' assets and liabilities—with some 40 percent of credit to the private sector denominated in or indexed to foreign currency—potentially exposes banks to greater credit risk associated with their clients' unhedged exposures, higher liquidity risks, and increased systemic risk.[4]

13. **Unemployment has been persistently high.** Official unemployment figures—above 30 percent for the past decade—are widely understood to overstate unemployment by as much as one-half: firms underreport their employment and unreported workers register as unemployed in order to receive benefits and health coverage. In part, the unemployment is structural, as suggested by exceptionally high rates of long term unemployment and unemployment among minorities and the young. An important underlying factor is that labor market practices—including generous severance packages and unemployment benefits—inhibit job creation by raising hiring costs and reducing the incentive to seek work. But unemployment also has a cyclical component and has tracked overall developments in the enterprise sector (text figure in paragraph 5).

14. **While Macedonia's incomplete reforms, high unemployment, and large current account deficit raise the issue of competitiveness, quantitative indices do not give a clear signal of a problem.** Labor costs in 2000-01 were lower than in most former Yugoslav countries, although higher than in some other transition economies (text table). Moreover, indicators of real effective exchange rates (REER) do not show an erosion of competitiveness relative to 1998-2000, the period when Macedonia's growth was strongest (see Figure 4).[5]

US Dollar Wages and Wage Bill Ratios (Average for 2000-2001)

	Economy wide gross wages (in US$)	Wage bill ratios to: GDP	Manufacturing value added
Former SR Yugoslavia			
Bosnia & Herzegovina	303	51	57
Croatia	684	64	68
Macedonia, FYR	**268**	**52**	**50**
Serbia and Montenegro	156	33	n/a
Slovenia	986	58	53
Other transition economies			
Bulgaria	144	35	41
Czech Republic	483	51	44
Hungary	445	42	41
Poland	554	58	49
Romania	187	50	n/a
Slovakia	336	42	39
Average	413	49	49

[4] For a detailed analysis of the risks to financial stability arising from dollarization see SM/03/112.

[5] The ULC-based REER depreciated by more than the 1997 exchange rate devaluation, owing to a concurrent decline in nominal wages. The REER appreciated somewhat in the first 1½ years after the devaluation, but stabilized from mid-1999 onward.

15. **Growth and exports recovered in the second half of 2002.** Industrial output picked up, particularly in the textile and steel industries, and confidence appears to be returning. Real GDP is estimated to have increased by 2 percent (year-on-year) in the second half of the year. Textile exports are back to pre-crisis levels and metals exports have increased. In the run-up to the mission, international reserves were declining, reflecting the weakening of fiscal discipline and, apparently, concerns that the new Fund-supported program would be accompanied by an exchange rate adjustment. The exchange market pressure eased in February and interest rates have come down.

III. Discussions with the Authorities

16. **Against this background, discussions focused on the main policy challenges: reducing the large current account and fiscal imbalances stemming from the security crisis and its aftermath (allowing for the need to support the PFA), addressing vulnerability to domestic and external shocks, and generating growth and employment.** Tackling these issues will require a combination of fiscal adjustment and structural reform, in the context of an appropriate regime for exchange rate and monetary policy.

17. **The authorities and the mission agreed on macroeconomic projections that assume a gradual return to pre-conflict growth rates, some 4 to 5 percent, over the medium term** (text table). This is supported by analytical work summarized in Box 1. The projections envisage a recovery of private investment to pre-conflict levels as confidence in political stability is gradually restored. Non-government saving, which declined with the economic slowdown in 2001-02 (presumably reflecting consumption smoothing) is assumed to rise gradually to about its pre-conflict rate as GDP growth returns to trend (Tables 7 and 8). With foreign savings expected to decline relative to GDP from their unusually high 2002 levels (as no more large privatizations are in prospect and external financing for the peace process is expected to taper off), the general government fiscal deficit (excluding grants)

Macroeconomic Framework; 1998-2007

	1998-2000 (average)	2002	2003	2004	2007
	(In percent of nominal GDP)				
Foreign savings (excluding official grants) 1/	3.5	8.6	6.9	6.6	4.7
Non-government national savings (including grants)	17.6	15.3	15.3	15.4	18.1
Non-government investment	21.1	18.1	19.4	19.6	20.2
Government savings (including grants)	2.5	-2.0	0.9	1.7	2.3
Government investment	2.5	3.8	3.6	4.1	4.9
General government debt (net)	50.6	43.9	40.2	39.5	39.3
	(Annual percent change)				
Real GDP	4.1	0.3	3.0	4.0	5.0

1/ External current account deficit, including official grants (+).

Box 1. FYR Macedonia's Medium-Term Growth Scenario

The economic literature on convergence suggests that a country's growth rate per capita is inversely related to its initial level of income, after taking into account differences in human capital, investment, economic policies, and demographic factors. FYR Macedonia's medium term growth prospects have been assessed by estimating a cross country growth equation based on work by Barbone and Zalduendo (1997). The equation is:

$$\text{growth in income per capita} = -0.005 - 0.018 \ln(\text{initial income per capita}) + 0.019 \ln(\text{investment/GDP}) + 0.007 \ln(\text{years of schooling}) + 0.020 \ln(\text{index of economic policies}) - 0.400 \ln(\text{fertility rates}) + \varepsilon$$

In the above equation all coefficients are statistically significant at the 95 percent level and the R squared equals 0.6. Economic policies are proxied by an index of economic policies constructed by Johnson and Sheehy (The Heritage Foundation), based on ten variables that indicate the quality of monetary policy, fiscal policy, openness, the rule of law, and price distortions.

Inserting FYR Macedonia information in the estimated equation gives rise to a predicted growth rate in the 4 to 5 percent range over the medium-term, assuming that the investment ratio is 24 percent. These estimates do not take into account a possible boost to growth through the absorption of the unemployed or the dampening effect of regional political instability.

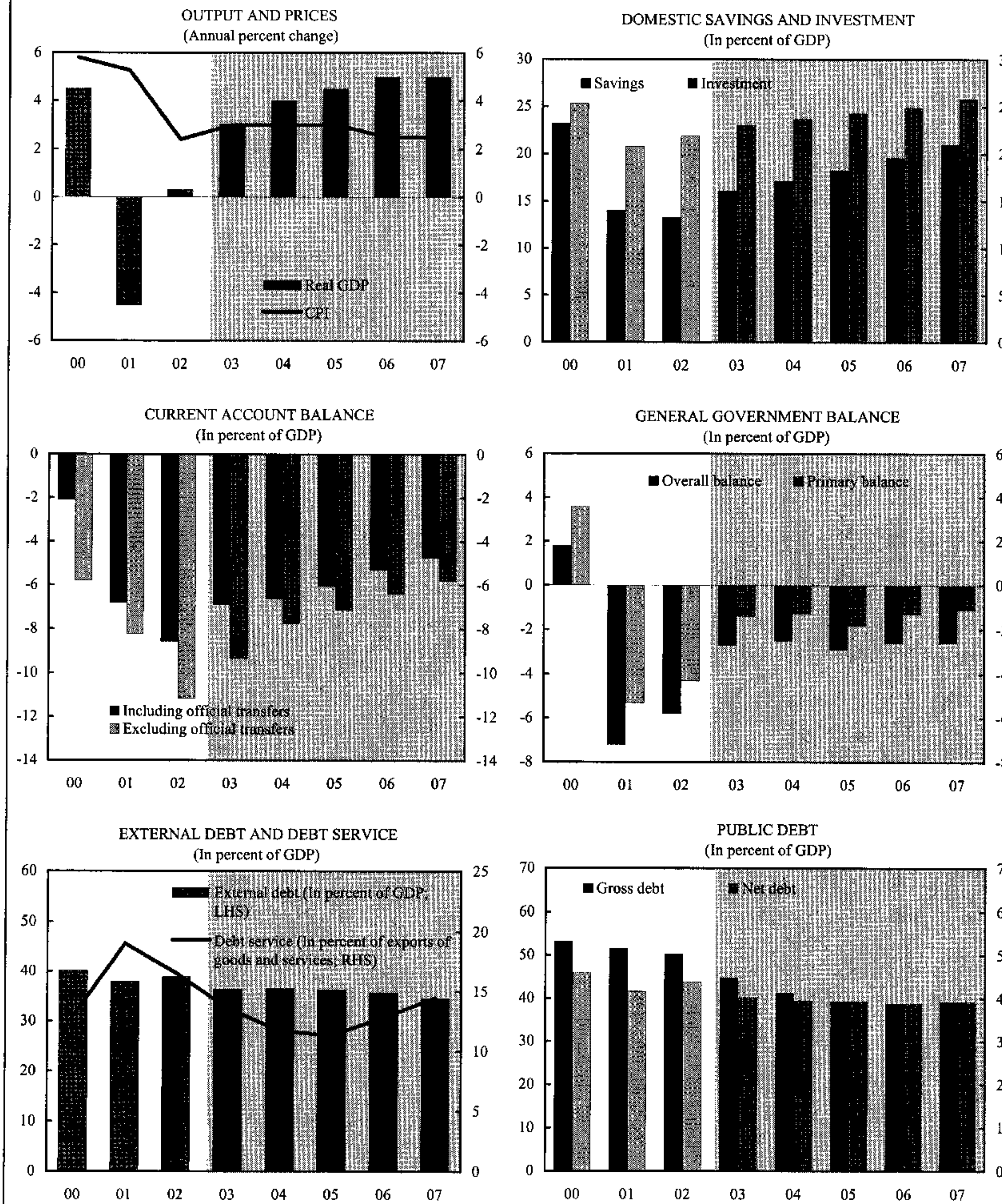
would need to decline by about 3 percentage points of GDP over the medium term to generate the public savings to finance the needed public investment levels. Official project lending, private external borrowing, and foreign direct investment are expected to increase gradually, and no exceptional foreign financing is expected beyond 2004 (Figure 6). Inflation is projected to stabilize in the range 2½-3 percent per year in the medium term.

18. **Drawing on the Article IV discussions, the mission and the authorities reached understandings on policies for 2003-04, which could be supported by a Fund arrangement.** The overall strategy is: to anchor inflation by maintaining the de facto fixed exchange rate, to reduce the fiscal deficit to sustainable levels; and to put in place structural reforms to strengthen the private sector and foster employment. Policies for 2003-04 are detailed in the attached Memorandum of Economic and Financial Policies (MEFP).

A. Exchange Rate and Monetary Policy

19. **During the Article IV consultation discussion, the authorities assessed the possible need for an exchange rate adjustment in the context of the present regime—a de facto peg to the euro—concluding that the present rate remains appropriate.** This conclusion reflected a balance of several considerations. Weak growth, the deterioration in the current account, and declining international reserves could suggest a need for devaluation but all three will improve if political stability helps restore growth to the 4 percent average achieved in the pre-crisis years (1998-2000) and fiscal consolidation takes place. Moreover competitiveness indicators did not point clearly to overvaluation. Another consideration was the heterogeneity of the enterprise sector: the relatively nimble new firms likely do not need a depreciation to be competitive, while the sluggish old firms would probably use a

Figure 6. FYRM: Recent Developments and Medium-Term Projections, 2000-2007 1/



Sources: Macedonian authorities; and Fund staff estimates.

1/ Data for 2002 are estimates; and data for 2003-2007 are projections.

depreciation only to delay needed restructuring[6]. A devaluation could also jeopardize banking system soundness, given the extensive foreign currency denominated and indexed lending, an unknown portion of which is to unhedged borrowers.

20. **The authorities also explored with the mission the appropriateness of the exchange rate regime over the medium term.** Although the de facto fixed exchange rate has helped deliver low inflation, the staff stressed that this regime—in the middle ground between hard peg and float—will become more difficult to maintain as the country becomes more open to capital flows. The appropriate exchange rate regime was discussed in light of experience of other countries in the region: change could be in the direction of greater flexibility accompanied by inflation targeting or a more formal peg. Staff noted that greater flexibility would facilitate adjustment to the persistent asymmetric shocks typically affecting transition economies and reduce the risk of crisis although exchange rate volatility could be high given the relative illiquidity of the foreign exchange market. The exchange rate risk associated with flexibility would be an incentive to reverse the extensive euroization of banks' and enterprises' balance sheets, although the vulnerabilities associated with euroization would need to be managed during the transition to greater flexibility. The alternative, a more formal peg, could help strengthen credibility, but would require a higher standard of fiscal prudence, banking system soundness, and labor market flexibility because it eliminates the ability of the exchange rate to absorb shocks and limits the scope for monetizing fiscal deficits or providing liquidity support to the banking system. The authorities did not reach a decision, but recognized that they need to start reviewing available options so as to lay down the foundations of a new monetary framework.

21. **Given the importance of central bank credibility—under any exchange rate regime—the authorities plan to strengthen the NBRM's independence.** In particular, the NBRM's authority over exchange rate policy will be made explicit; the central bank will end the practice of providing credit guarantees, which in the past were extended at the request of the government; and the initiative for nominating vice governors of the NBRM will be moved from the President of the Republic to the NBRM Governor. These measures are in line with prior Fund advice.

22. **During the mission, the authorities reorganized the foreign exchange market and rationalized their intervention procedures,** drawing on the Fund's previous technical assistance. The central bank's participation in the market had hitherto been episodic, and consequently spreads between the market exchange rate and the central bank rate were normally about 1-2 percent, spiking to as high as 6 percent at times of market pressure. The new arrangements establish a screen-based system on which all banks, including the NBRM, are required to post bids and asks. During the first few days after the reform, the interbank exchange rate converged quickly on the central bank's target rate in light trading. The

[6] A background paper examines the performance of the enterprise sector.

mission supported these reforms, which increase the efficiency of the market and signal the authorities' commitment to the exchange rate peg.

23. **The authorities sought the mission's views on modifying the foreign exchange law to allow lending in foreign currency.** The staff noted that the existing rules were illogical since they allow foreign currency lending only to importers—who do not have a natural hedge—and inconsistent since they do permit foreign currency indexed lending, which is already widespread. Staff stressed that both foreign currency and indexed lending call for sound risk management by banks and strengthened supervision of the banking system's exposure to credit risk associated with currency movements, and to foreign exchange liquidity pressures. The NBRM agreed, and has decided to require more detailed monthly information on banks' foreign exposures and liquidity, including breakdowns by maturity and, on the asset side, the purpose of the loan. Further steps will be needed to ensure that the associated credit risk is adequately controlled. In addition, the NBRM has decided to introduce a 7½ percent reserve requirements on foreign currency deposits (MEFP, ¶18). On the latter, staff noted that banks already maintain adequate liquidity in foreign exchange (Table 5) and keep their, generally long, foreign exchange positions within the prescribed prudential limits; the extension of reserve requirements to foreign currency deposits—at the same rate as for domestic currency deposits—levels the playing field.

24. **The discussions of the financial sector opened up several issues that will need to be addressed in the FSAP missions later this year.** The emergence of problem banks reflects difficulties in enforcing regulations (such as those governing large exposures and connected lending). In some cases bank ownership is also problematic: the authorities have decided to lower the threshold for central bank approval of bank share purchases from 10 to 5 percent of total equity, but there may be a need for further regulatory tightening. The strategy for dealing with weak banks also needs to be examined further: the authorities' approach has typically focused on keeping existing banks in business, rather than on activating an orderly winding-up. It is also expected that FSAP exercise will provide additional insights into the two-way linkages between financial sector vulnerabilities and macroeconomic performance, including potential fiscal consequences of a banking crisis and managing risks associated with dollarization.

25. **Reflecting the Article IV discussions, the authorities have adopted a monetary policy consistent with the fixed exchange rate.** Interest rates under the program will be managed through auctions of central bank bills, primarily through volume tenders, as a key instrument to maintain the exchange rate. The quantitative monetary program assumes that the velocities of broad money and denar money will continue to decline in 2003, but by less than in recent years.[7] The projected flow of central bank credit to the general government includes financing for the deficit plus 2 billion denars to amortize frozen foreign currency

[7] Currency in circulation is expected to decline in relation to nominal GDP reflecting a shift back to demand deposits following the end-December expiry of the financial transactions tax.

bonds (FFCB) held by households.[8] The program assumes, conservatively, that households will convert amortization (paid in denars) into foreign currency, resulting in a drain in official foreign exchange reserves. Private sector credit growth in 2003 is projected to be nearly 9½ percent—6 percent in real terms. The projected credit growth is modest, reflecting banks' demanding more collateral than many borrowers can provide.

B. Fiscal Policy

26. **The requirements for debt sustainability framed the Article IV discussions of fiscal policy.** The authorities agreed that fiscal policy should target public debt at about 40 percent of GDP. Staff cited international evidence that the risk of debt crisis rises significantly when the external debt-to-GDP ratio exceeds 40 percent.[9] They noted that the existing debt-to-GDP ratio was not high compared with EU countries, but recognized that FYR Macedonia's debt could not be judged by the same standard, given the currency composition of the debt and the shocks to which FYR Macedonia is subject. In this regard, staff referred to standard sustainability analysis indicating that either a depreciation of the currency or a slowdown in growth combined with disappointing FDI could push debt onto an unsustainable path. (Appendix IV and Tables 9 and 10).

27. **During the Article IV discussions, the authorities and staff initially disagreed on the appropriate path of adjustment toward a sustainable fiscal position.** The staff recommended a two-step fiscal adjustment to bring the *central government deficit* from 5½ percent of GDP in 2002 to 1½ percent in 2003 and 1 percent in 2004. This adjustment would bring the *general government deficit* down relative to GDP by about 3 percentage points to the debt-stabilizing level, 2¾ percent of GDP, in 2003 and maintain that level in the face of rising foreign-financed public investment. The authorities preferred a more gradual adjustment. Here, the staff noted, and the authorities agreed, that the apparent frontloading of the proposed adjustment path reflected mainly the non-recurrence in 2003 of exceptional spending in 2002. In addition, a larger deficit in 2003 would either starve the private sector of needed credit or result in an excessive drain of reserves.

28. **The composition of fiscal adjustment was another focus of the discussion.** Taken together, the winding down of crisis-related spending and revenues and the lapsing of other non-recurrent items would reduce the deficit relative to GDP by 2 percentage points; leaving

---

[8] These bonds were issued to households whose foreign currency deposits had been frozen prior to the breakup of Yugoslavia. Principal payments are in denars but indexed to the exchange rate.

[9] See SM/02/66, May 28, 2002.

a need for additional policy measures of about 1 percentage point of GDP (text table). During Article IV discussions, the staff recommended that these measures should preferably consist of restraint in recurrent spending. Any tax increases should be designed to eliminate distortions in the existing tax structure (as recommended by the Fund's technical assistance) rather than increasing rates.

Fiscal Adjustment in 2003
(In percent of GDP; general government)

Fiscal deficit in 2002	**5.8**
Additional deficit in 2003 from security crisis effects	**0.6**
Reduction in security-related spending	-2.1
Revenue loss from expiry of financial transaction tax	2.6
Savings in 2003 from non-recurrent 2002 spending	**-2.6**
Compensation to depositors in failed pyramid schemes	-1.6
Clearance of domestic arrears	-0.6
Investment projects	-0.2
Cost of elections and census	-0.2
Policy Measures in 2003	**-1.0**
VAT measures	-0.7
Reduction of spending (mainly reduction in goods and services)	-0.6
Subsidies for employment	0.2
Fiscal deficit in 2003	**2.7**

29. **In formulating policies for the Fund-supported program the authorities found it difficult to achieve the adjustment with spending cuts alone.** Instead, they proposed a mix of cuts in goods and services spending and an increase in VAT collection, to be achieved by reforming the rate structure. Staff was concerned that the cut-back in goods and services spending might be unsustainable, but the authorities noted that they would cut non-essential items, which had been identified in detail, returning the real level of spending per employee to the pre-crisis level. Finally, there would be no increase in the public sector wage scale and almost no net hiring in 2003: the wage bill increase was thus due to the full-year effect of wage increases granted in 2002.[10] The mission agreed that the measures were a sufficient basis for a program but noted that the significant overstaffing in the public sector was an obstacle to a future decompression of salaries and to the implementation of measures to rebalance the ethnic composition of public employment. Further details on the agreed budget for 2003 are reported in the MEFP (MEFP, ¶9 and ¶11).

30. **On the VAT, after examining several options, the authorities decided to move most non-food items from the preferential 5 percent rate to the standard rate and lower the standard rate from 19 to 18 percent.**[11] These changes are expected to increase collections while making the rate structure less distortionary. In order to cushion the social impact of the VAT increase, the authorities have decided that the electricity company (ESM) will pass only about half of the VAT increase through to the retail price of electricity, effective July 1. In order to prevent an erosion of the financial position of ESM, the price increase (by 7 percent) is a performance criterion under the program.[12]

[10] The exception is selected hires in the police force and army.

[11] The authorities decided to keep some non-food items at the preferential rate: newspapers, other printed material, and potable water.

[12] To compensate for the revenue shortfall, ESM will introduce cost-cutting measures, including a reduction of personnel expenses to pre-crisis levels.

31. **The authorities described their plans for structural fiscal reforms that will support the execution of the budget (MEFP, ¶10 and ¶13).** The treasury will initiate commitment control in some expenditure categories, while the budget execution law provides for strengthened parliamentary oversight of spending. In order to improve the financial management of the Health Fund the authorities will conduct an external audit of the Health Fund's financial statements and procurement procedures. The Health Fund is making preparations, with World Bank advice, to start purchasing medicines and equipment by international tender, eliminating the significant overpayments that have been the norm. The tenders are expected to be issued in early 2004. On tax administration, the Public Revenue Office will strengthen its focus on large taxpayers and work closely with the newly-created financial police. Finally, the VAT law has been amended to allow for the deregistration of inappropriately registered small taxpayers and to eliminate the need to file annual returns.

32. **The authorities proposed to strengthen their capacity for debt management by introducing government bonds in late 2003 or early 2004.** Government bonds could be used to reduce the share—now excessive—of foreign currency-denominated debt in total government debt and would provide an alternative instrument for central bank operations. As a related matter, government bonds could be used to finance the principal payments on FYR Macedonia's frozen foreign currency bonds (FFCBs). These payments are presently envisaged to be financed through domestic bank credit, putting pressure on international reserves.

33. **The authorities indicated that decisions had now been taken on the timetable and modalities for the planned devolution of fiscal responsibilities to local governments.** The Law on Local Finance will be prepared in 2003, in consultation with the IMF. Fiscal decentralization will be phased so as to preserve accountability over funds transferred to local governments. New municipal boundaries would be decided in time for municipal elections in the fall of 2004; the new municipal governments will start work in early 2005 with expanded responsibilities and resources. Staff acknowledged that decentralization is an integral part of the PFA, but continued to stress that devolution should be supported by adequate accountability at the municipal level.

C. Macroeconomic and Financial Vulnerabilities

34. **The proposed program is subject to both macroeconomic and financial risks.** One risk is that the projected resumption of GDP and export growth does not occur. This risk is two sided: on one hand there are lingering political uncertainties and long-standing supply-side problems; on the other hand the program projections are conservative in that they assume only a gradual restoration of confidence and no vigorous rebound from the past two years' stagnation. FYR Macedonia's high degree of dollarization is a further source of potential vulnerability since if policies did not prove adequate to support the existing exchange rate the balance sheet effects of a depreciation could be severe. But some indicators—the healthy reserve position, the relatively low external debt service ratios, and the small share of debt maturing within one year—suggest that vulnerability to market pressures is in fact moderate (Table 15). For example, if the Middle East war were to depress

the growth of FYR Macedonia's export markets by 1.8 percentage points and raise the price of oil by US$15 per barrel, the resulting loss of reserves (about 1¾ percent of GDP) would still leave gross reserves at 3½ months of imports of goods and non-factor services.

D. Structural Reforms

35. **The Article IV discussion of structural policies focused on the requirements for sustainable growth.** The authorities' structural agenda reflects an active dialogue with the World Bank in the context of existing operations covering the enterprise and banking sectors, and proposed new operations in support of private sector development and improvements in public sector management (see Appendix V). The priorities for World Bank involvement will be reassessed in an updated Country Assistance Strategy this May.

36. **Despite the inaccuracy of official unemployment statistics, the authorities, trade unions, and employers viewed unemployment as a significant social problem which called for remedial policies.** The authorities agreed that it was important to address rigidities and improve incentives structures in the labor market. In this context the authorities acknowledged that Macedonia's generous severance packages and unemployment benefits raised the cost of hiring and lowered the incentive to seek work. Employers pointed out that, while the labor legislation allows them to terminate employment when justified, firing frequently results in costly litigation and pressure from employees.

37. **Given the exchange rate peg, increasing labor market flexibility is essential to foster competitiveness and economic growth.** The authorities have therefore decided to reduce the maximum duration of the unemployment benefits from 18 to 14 months and scale down the required severance payment by a third. Since these two measures represent an important step in a critical area they have been incorporated in program conditionality. The authorities will also tighten controls over eligibility for unemployment benefits and shift the focus of the employment bureau from paying benefits to job placement and vocational training. Finally—and with assistance from the World Bank—they intend to carry out a review of the Law on Labor Relations with a view to improving the framework for collective bargaining and streamlining conditions for termination of jobs.

38. **The authorities also intend to pursue active labor market policies, specifically by providing a subsidy for job-creation.** Fund staff—and also World Bank staff—advised against this policy: job subsidy schemes tend to be costly and ineffective; proper targeting will be difficult given administrative weaknesses; and the deadweight loss is expected to be large since the expected pickup in growth should increase employment even without the subsidy. The authorities recognized these concerns, but indicated that they needed to take visible steps to encourage employment. They saw the job subsidy as a less damaging alternative to a proposal, pressed by trade unions, to provide unemployment benefits until retirement to all employees with at least 25 years' service in loss-making companies; they undertook to eschew this early retirement proposal. Given this constraint, staff advised the authorities to minimize deadweight loss by targeting the subsidy on long-term unemployment, and to cap its cost (MEFP, ¶24).

39. **The authorities described their initiatives to promote small and medium enterprises (SMEs) by strengthening the institutional and financial infrastructure for entrepreneurship (MEFP, ¶22 and ¶30).** An Agency for the Promotion of Entrepreneurship will be created. The licensing and registration of new enterprises—now a lengthy and complex procedure—will be streamlined and simplified. In addition, since enterprises have difficulty raising the collateral banks required for lending, the authorities will create a loan guarantee fund to provide partial guarantees for loans to SMEs. Finally, plans are being developed to transform the one remaining state-owned bank into an agency providing or guaranteeing export credits. The mission welcomed the streamlining of enterprise start-up procedures but urged the authorities not to commit budgetary resources to the loan guarantee fund and to avoid the creation of budgetary contingent liabilities. The authorities agreed.

40. **While strengthening enterprises by tightening financial discipline is important to their long term health, the authorities' plans in this area are limited in scope.** The mission emphasized the importance of improving corporate governance in privatized enterprises by hardening budget constraints and streamlining exit procedures but the authorities were not ready to formulate policies in these areas, which are also not a priority under existing and proposed World Bank-supported programs. Instead, policies are mainly aimed at completing initiatives already in place—notably the World Bank-supported program to sell or close loss-making enterprises and a plan to auction off residual state-owned shares in privatized enterprises (and then close the privatization agency) (MEFP, ¶25).

41. **The authorities discussed their plans to tackle corruption, which is widely recognized as a major impediment to investment and economic activity.** In light of charges that recent corruption-related arrests have been politically motivated, they noted that the true test of effectiveness of measures to stem corruption will be whether officials in the governing party are equally subject to investigation. They also indicated that action was being taken to strengthen institutions, for instance by appointing an independent anti-corruption commissioner, and eliminating rent-seeking opportunities. For example, they had begun to allocate tariff free import quotas on a first-come, first served basis, reducing the scope for corruption.

42. **With regard to trade policy, the mission welcomed the recent ratification of the WTO accession treaty.** Overall, FYR Macedonia's trade regime is open, with a rating of 2 on the Fund's index of trade restrictiveness, which runs from 1 to 10; there are no quantitative restrictions (aside from WTO-compliant tariff-free import quotas) and the simple average import tariff rate is 14.6 percent. Further progress has been made recently in the liberalization of trade relations with regional partners. The bilateral agreement with EFTA came into effect in 2002, and a free trade agreement with Romania is being finalized. The authorities also intend to join CEFTA in the near future.

43. **The authorities also reported that they have reached bilateral agreements with two Paris Club creditors.** As regards the remaining agreements, still unsigned, the

authorities have decided to make a unilateral gesture of good faith by placing the outstanding amounts of principal and interest in an escrow account.

E. Other Issues

44. **The FYR Macedonia continues to maintain an exchange restriction resulting from the treatment of former frozen currency savings deposits.**The restriction continues to be subject to Fund approval under Article VIII, Section 2(a) despite the conversion of these deposits into government bonds. The authorities confirmed that they will adhere to an agreed schedule to eliminate this exchange restriction by April 2006.

45. **Statistical information is broadly adequate for surveillance and program monitoring, but statistical practice still has significant shortcomings** (Appendix VI). Specifically, the mission discussed with the authorities the reporting of inaccurate information on net foreign assets in connection with the 2000-01 EFF/PRGF arrangements. This inaccuracy did not fall under the Fund's misreporting policies, since no purchase was made based on the inaccurate information. The staff stressed that this episode was nonetheless serious, and pointed to the need for greater attention to the reporting of international reserves, including the treatment of encumbered foreign currency assets and foreign currency liabilities to residents; to this end, the authorities agreed to make use of the Fund's standard reserves template. More generally, the authorities intend to participate in the data ROSC module, with a view to assessing and improving their statistical information across a broad spectrum.

46. **The framework for anti-money laundering and combating the financing of terrorism (AML/CFT) has recently been upgraded**. Recent legislation defines elements of the AML/CFT system and complies with FATF 40 recommendations. The legislation imposes requirements on customer identification, reporting of suspicious transactions, and the maintenance of internal controls, in both financial and non-financial institutions. An agency on money laundering, the Money Laundering Prevention Directorate, was created in September 2001 and has exchanged information with agencies in other countries. The authorities have taken steps to implement UN Security Council Resolution 1373 on terrorist financing. The authorities have indicated that laws to criminalize terrorist financing and to ratify the 1999 Convention for the Suppression of the Financing of Terrorism are before parliament.

IV. Design of the Proposed Stand-By Arrangement

A. Proposed Access and Capacity to Repay the Fund

47. **The authorities have requested access of SDR 20 million through June 15, 2004.** This amounts to 29 percent of quota (about 25 percent on an annual basis) to be made available in five equal installments, one on approval and one after each program quarter (Table 11). In light of FYR Macedonia's comfortable external reserve position and gross

financing requirement, the proposed access is appropriate (Table 12).[13] Donors made an upper credit tranche arrangement with the Fund a condition for the release of the undisbursed portion (US$97 million) of their financial assistance. The option of a precautionary arrangement was considered but some donors resisted, seeking purchases under the proposed arrangement. The absence of the pledged funds would create a financing gap. FYR Macedonia is not expected to encounter problems in servicing its obligations to the Fund (Tables 13 and 14). Fund credit outstanding would decrease from 72 percent of quota at end-2002 to below 25 percent at in 2007. Debt service to the Fund would peak in 2003 at SDR 16.4 million (or 1.5 percent of exports of goods and services), decline in 2005 to SDR 7.4 million (0.6 percent of exports of goods and services), and peak again in 2007 at SDR 14.1 million (1.0 percent of exports of goods and services).

B. Safeguards Assessment

48. **A mission to undertake the Fund's safeguards assessment visited FYR Macedonia in February/March and its report is under preparation.** A summary of the preliminary findings of the mission will be issued prior to the Board discussion of this report. Further actions in the area of the safeguards framework will be added to program conditionality, as appropriate, at the time of the first program review (MEFP, ¶29).

C. Program Monitoring

49. **Implementation of the financial program will be monitored against quarterly quantitative performance criteria and indicative targets (MEFP, Table 1).** The targets include: (i) ceilings on net domestic assets of the NBRM; (ii) floors on net international reserves of the NBRM; (iii) ceilings on net credit to the general government from the banking system; (iv) floors on central and general government fiscal balances; (v) ceilings on contracting or guaranteeing non-concessional medium- and long-term external debt by the government or the NBRM; (vi) ceilings on the level of short-term external debt or guarantees by the government and the NBRM, except for normal import-related credits; (vii) ceilings on government domestic payment arrears and Health Fund arrears (indicative); (viii) ceilings on the central government wage bill (indicative); (ix) ceilings on the net domestic assets of the banking system (indicative); and (x) ceiling on personnel expenditures financed from special revenue accounts (indicative).

50. **Continuous performance criteria under the program cover:** (i) the non-accumulation of external payments arrears; and (ii) the imposition of restrictions on the making of payments and transfers for current international transactions, the introduction or

[13] FYR Macedonia is among the members to which the policies and practices set out in the Summing Up of the Conclusions of the Task Force on Prolonged Use of Fund Resources (BUFF/03/51; 4/8/03) would apply based on its having had two multi-year arrangements under the PRGF or ESAF facilities.

modification of multiple currency practices, the conclusion of bilateral payments agreements that are inconsistent with Article VIII of the IMF's Articles of Agreement, and the imposition or intensification of import restrictions for balance of payments reasons.

51. **The conditionality in the program includes two prior actions, one structural performance criterion, and five structural benchmarks (MEFP, Table 2).**

The *prior actions*, which have all been taken, are:

- Parliament to adopt key fiscal legislation: (i) a 2003 budget in line with the MEFP (MEFP, ¶7); (ii) abudget execution law for 2003 which contains provisions requiring parliamentary approval for the expenditure by first tier budget users of special revenues (except external project loans and grants) in excess of budget allocations and limiting the reallocation of fund by budget users (MEFP, ¶13); and (iii) a revised VAT law consistent with the MEFP (MEFP, ¶9 and ¶10). These measures underpin fiscal policy for 2003 and strengthen the revenue base in the medium term.

- The revocation of the NBRM Council decision that allowed for NBRM guarantees for borrowing by the private sector, public enterprises, or public funds (MEFP, ¶19). The practice of providing NBRM guarantees at the request of the government undermined central bank independence and put NBRM reserves at risk.

The *structural performance criterion* is to increase the retail price of electricity by 7 percent, effective July 1, 2003 (MEFP, ¶9). The increase will prevent an erosion of the financial position of the electricity company.

The *structural benchmarks* are:

- Amending the Law on Budgets and the Law on Public Procurement to allow commitment control and initiating commitment control for certain transactions (MEFP, ¶13). These measures represent a first step towards comprehensive ex ante commitment control by the treasury.

- Initiating an external audit of the financial position and procurement procedures of the Health Fund (MEFP, ¶14). The operations of the Health Fund, which is a major user of public funds, have been exceptionally nontransparent; moreover the Health Fund's procurement procedures have led to excessive costs and allegations of corruption.

- Publish the external audit of the NBRM's 2002 statements (MEFP, ¶29).

- Improving labor market flexibility by amending the Law on Employment and Unemployment Insurance and the Law on Labor Relations. These measures strengthen growth prospects and , given the fixed exchange rate, facilitate adjustment to real sector shocks (MEFP, ¶21).

- Adoption of a 2004 budget consistent with the commitments in the MEFP (MEFP, ¶7).

52. **Two reviews are scheduled under the arrangement.** The first will focus on banks and bank supervision, while the second will focus on the budget for 2004 (MEFP, ¶36).

V. Staff Appraisal

53. **Economic performance in 2002 was disappointing.** The recovery of business confidence was delayed by lingering doubts regarding the durability of the peace and by a tense pre-election atmosphere. The macroeconomic policy mix was unsustainable: the fiscal consolidation agreed under the staff monitored program did not take place owing to politically motivated expenditure overruns, and consequently, the central bank had to tighten the monetary stance, slowing the recovery of the private sector. Nonetheless there was some outflow of foreign exchange reserves. Progress in structural reforms was unconvincing: efforts to resolve loss-making enterprises were resumed but public sector hiring—mostly unwarranted—and a large across-the-board wage increase swelled the cost of fiscal operations and reversed earlier gains in rationalizing the public administration.

54. **The authorities' proposed policies for 2003 are consistent with their main objectives: to regain a sustainable medium-term fiscal and external position after the spending surges associated with the security crisis and the 2002 elections, and to restart economic growth after the crisis-related economic slowdown. But firm implementation is key and some important risks remain.**

55. **FYR Macedonia's exchange rate peg remains appropriate provided that sound fiscal and monetary policies are implemented and political stability maintained.** In the future, however, the liberalization of capital flows will make it increasingly difficult to maintain the existing de facto peg and the authorities will therefore need to review the options—either in the direction of greater flexibility or a more formal peg—and to devise appropriate supportive measures in consultation with the Fund staff.

56. **Turning to fiscal policy, the authorities' intention to stabilize the debt-to-GDP ratio at 40 percent is prudent.** FYR Macedonia's public debt ratio is on the high side and is almost entirely foreign currency-denominated. In addition there are large potential liabilities related to restitution rights; spending pressures, including on the PFA, are likely to emerge over the medium term; and growth prospects remain uncertain. In time the debt to GDP ratio should decline to below 40 percent of GDP.

57. **The fiscal adjustment envisaged in the Fund-supported program, will need to be implemented firmly.** Meaningful progress during the program period is needed to build credibility. Moreover, a slower adjustment would require financing that would drain international reserves or squeeze the credit needed to support private sector growth. Finally, since most of the fiscal adjustment will come from the non-recurrence of exceptional spending items in 2002, the effort involved is not excessive.

58. **The proposed composition of fiscal adjustment has several favorable aspects and a few shortcomings.** Eliminating crisis-related spending, and the distortionary financial transactions tax makes for a smaller government and the changes in the VAT will increase the efficiency of the tax system. At the same time, public sector over-staffing and the compressed wage structure remain to be addressed.

59. **The fiscal structural reforms underway are welcome.** The planned treasury reform, which will strengthen control over spending, is particularly important. It is also essential to improve tax administration and strengthen efforts to collect VAT arrears; such reforms promise to ensure a more equitable distribution of the tax burden. Fiscal decentralization, an important plank in the Peace Framework Agreement, should be implemented without compromising accountability for the resources transferred to municipalities.

60. **Macedonia's economic prospects ultimately depend on policies to achieve a higher sustainable rate of growth.** Accession to the WTO, and preparations for eventual EU accession, will bring in the brisk winds of competition. The challenge is to prepare for this competition by removing impediments to efficiency and growth.

61. **In this regard, the priority the authorities are giving to addressing the corruption that stifles economic activity and investment is welcome, as is their recognition that these efforts will need to be persistent, systematic, and even-handed.** The authorities' anti-corruption efforts enjoy strong popular support, but implementing them in the face of powerful vested interests will nonetheless require considerable perseverance.

62. **Labor market reforms are needed to address high unemployment.** The proposed measures to increase labor market flexibility, and the active policies to support job search and develop workplace skills should help, but labor market institutions need to come under a more comprehensive review. The government's commitment not to provide preferential unemployment benefits for workers in certain loss-making companies is welcome. The program to create fiscal incentives for hiring would not be recommended by staff, since it is likely to be ineffective in boosting overall employment; nonetheless the authorities' need to build support for the program must be recognized.

63. **The upcoming FSAP exercise will need to focus on key issues in financial supervision and regulation.**In particular, regulations on bank lending and ownership should be strictly enforced and in some cases strengthened, to ensure the integrity of operations and control risk. Supervision also needs to be better equipped to assess the credit risk and potential liquidity pressures associated with foreign currency denominated and indexed lending. The strategy for addressing problem banks should place greater emphasis on orderly exit, limiting the use of public funds to what is indispensable to reassure depositors.

64. **A prerequisite for robust growth is to strengthen the enterprise sector, following the strategy of "discipline and encourage" that has characterized successful transition economies—strengthening market discipline while creating an environment conducive**

to business and investment. Some key aspects of FYR Macedonia's policies can be seen in this light: fighting corruption, reforming tax administration to clamp down on arrears, liberalizing trade, and shutting down or privatizing the remaining loss-making enterprises. But following through with policies to strengthen corporate governance is a challenge that remains to be faced.

65. **In the staff's view, the program addresses FYR Macedonia's central problems, but involves important risks with respect to implementation.** Program implementation depends on the effectiveness of a coalition government working under difficult economic and political circumstances. Given the authorities' strong financial incentive to conclude an arrangement with the Fund, their ownership of the program is difficult to assess. The authorities appear to have taken ownership of the structural policies in the program, but had reservations regarding the path of fiscal adjustment; moreover, certain aspects of the changes in VAT rates are politically unpopular. The 2003 budget sets a fiscally prudent course, but perseverance will be required in the face of pressures for higher spending. A more general issue is the ultimate success of the PFA in maintaining lasting inter-ethnic peace: while the mission's sense is that good faith efforts are being made on both sides, deserving international support, the outcome is not guaranteed.

66. **In the staff's assessment the economic and financial risks of the program are acceptable.** While the success of the program requires a resumption of growth, the program projections are cautious. As regards exchange rate vulnerability, the remaining restrictions on capital mobility and FYR Macedonia's comfortable level of reserves suggest that the country will be able to ride out foreseeable balance of payments shocks.

67. **On this basis, the staff recommends approval of the proposed stand-by arrangement.**

68. **The staff recommends approval of the exchange restrictions arising from the treatment of former frozen currency savings deposits**. The restrictions were imposed for balance of payments reasons and are non-discriminatory. The authorities have agreed on a schedule for their elimination by April 2006.

69. **It is recommended that the next Article IV consultation be held in accordance with provisions of the decision on consultation cycles approved on July 15, 2002.**

Table 1. FYRM: Selected Economic Indicators, 1998–2004

	1998	1999	2000	2001	2002	2003	2004
						Projection	
Real economy				(Percent change)			
Real GDP	3.4	4.3	4.5	-4.5	0.3 *a,b*	3.0	4.0
Consumer prices							
period average	-0.1	-0.7	5.8	5.3	2.4 *a*	3.0	3.0
end of period	-3.1	2.6	6.1	3.7	1.0 *a*	2.7	3.0
Real wages, period average	3.7	3.6	-0.3	-1.7	4.4 *a,b*	2.1	2.0
Unemployment rate (average)	34.5	32.4	32.2	30.5	31.9 *b*	30.4	...
Government finances				(In percent of annual nominal GDP)			
General government balance (including grants)	-1.7	0.0	1.8	-7.2	-4.6	-1.6	-2.5
General government balance (excluding grants)	-1.7	0.0	1.8	-7.2	-5.8	-2.7	-2.5
Revenues	33.3	35.4	36.6	34.4	35.9	33.7	32.9
Total expenditures	35.0	35.4	34.9	41.6	41.7	36.4	35.3
Central government balance	-0.8	0.8	2.7	-5.8	-5.4	-1.6	-0.9
Government debt 1/							
Gross	52.0	57.4	53.2	51.6	50.3	44.8	41.3
Net	52.0	53.8	46.0	41.6	43.9	40.2	39.5
Money and credit				(Percent change, end of period)			
Broad money (M3) 2/	14.9	29.7	25.6	56.7	-8.6 *c*	6.8	...
Total credit to private sector	10.4	9.4	17.2	7.3	9.9 *c*	9.5	...
Short-term lending rate (percent)	20.5	20.0	19.0	19.2	17.7	...	...
Interbank money market rate (percent)	18.1	11.6	7.2	11.9	14.4	...	...
Balance of payments				(In millions of U.S. dollars)			
Exports	1,292	1,190	1,321	1,155	1,105 *b*	1,236	1,341
Imports	1,807	1,686	2,011	1,677	1,857 *b*	1,961	2,051
Trade balance	-515	-496	-690	-521	-752 *b*	-725	-710
Current account balance							
excluding grants	-307	-105	-208	-282	-414 *b*	-404	-361
(in percent of GDP)	-8.6	-2.9	-5.8	-8.2	-11.2 *b*	-9.3	-7.8
including grants	-269	-32	-75	-234	-318 *b*	-299	-308
(in percent of GDP)	-7.5	-0.9	-2.1	-6.8	-8.6 *b*	-6.9	-6.6
Overall balance	36	166	226	118	-123 *b*	25	47
Official gross reserves 3/	290	450	700	756	735	765	804
(in months of following year's imports							
of goods and services)	1.8	2.4	4.3	4.3	3.9 *b*	3.9	3.9
External debt service ratio 4/	9.5	12.4	13.0	19.0	16.5 *b*	13.6	11.7
External debt to GDP ratio (percent)	38.5	39.2	40.1	38.0	39.0 *b*	36.5	36.6
Exchange rates 5/				(Percent change, period average)			
Nominal effective exchange rate	0.9	12.4	12.4	3.3	0.7 *d*	...	...
Real effective exchange rate (CPI-based)	-7.0	2.9	4.0	-6.1	-2.4 *d*	...	...
Real effective exchange rate (ULC-based)	-11.4	7.3	7.7	-4.5	1.4 *e*	...	...

Sources: Data provided by the FYRM authorities; and IMF staff projections.

a Percentage change relative to the same period of the previous year.
b Estimate.
c Percentage change relative to December of previous year.
d January-November 2002.
e January-September 2002.

1/ Total debt of the general government; includes liabilities assumed by the government upon the sale or closure of loss-making enterprises and associated with the cleaning up of Stopanska Banka's balance sheet prior to its sale.
2/ Includes foreign currency deposits.
3/ Includes receipts from privatization of telecommunications company of US$323 million in January 2001.
4/ Debt service due, including IMF, as a percentage of exports of goods and services.
5/ An increase means appreciation of the denar. Partner countries include Federal Republic of Yugoslavia and Bulgaria.

Table 2. FYRM: Central Government Operations, 2000–2004 1/

	2000	2001	2002	2003 Budget	2004 Proj.	2000	2001	2002	2003 Budget	2004 Proj.
	(In millions of denars)					(In percent of GDP)				
Total revenues and grants	57,805	51,812	57,358	55,645	58,752	24.5	22.2	23.9	21.8	21.5
Tax revenues	51,115	47,564	54,387	51,738	54,910	21.6	20.3	22.6	20.3	20.1
Individual income tax	10,793	7,247	7,514	7,902	8,163	4.6	3.1	3.1	3.1	3.0
Profit tax	2,793	3,006	2,625	2,784	2,982	1.2	1.3	1.1	1.1	1.1
VAT	17,452	17,133	20,521	23,502	25,776	7.4	7.3	8.5	9.2	9.4
Excises	12,281	10,681	10,715	11,096	11,245	5.2	4.6	4.5	4.4	4.1
Import duties	7,733	6,111	6,335	6,151	6,428	3.3	2.6	2.6	2.4	2.4
Financial transaction tax	0	3,111	6,335	0	0	0.0	1.3	2.6	0.0	0.0
Other taxes	63	276	342	304	316	0.0	0.1	0.1	0.1	0.1
Non-tax and capital revenues	3,452	3,833	2,971	3,907	3,842	1.5	1.6	1.2	1.5	1.4
Grants	3,239	415	0	0	0	1.4	0.2	0.0	0.0	0.0
Total expenditures	51,520	65,363	70,378	59,720	61,249	21.8	28.0	29.3	23.4	22.4
Current expenditures	45,027	56,683	59,310	51,415	53,613	19.0	24.2	24.7	20.2	19.6
Goods and services	22,422	36,232	32,142	28,231	28,666	9.5	15.5	13.4	11.1	10.5
Wages and salaries	16,285	16,407	18,339	20,953	21,170	6.9	7.0	7.6	8.2	7.8
of which : new security-related	0	959	1,880	2,269	2,658	0.0	0.4	0.8	0.9	1.0
Goods and nonlabor services	6,137	19,825	13,803	7,278	7,496	2.6	8.5	5.7	2.9	2.7
of which : new security-related 2/	0	14,285	6,492	413	0	0.0	6.1	2.7	0.2	0.0
Refugee and special social expenses	1,482	582	389	446	446	0.6	0.2	0.2	0.2	0.2
Transfers	17,174	15,669	23,452	19,869	21,674	7.3	6.7	9.8	7.8	7.9
of which : to depositors in pyramid schemes	1,351	0	3,759	0	0	0.6	0.0	1.6	0.0	0.0
Interest	3,949	4,200	3,328	2,869	2,827	1.7	1.8	1.4	1.1	1.0
Domestic	1,183	1,066	1,177	1,026	1,210	0.5	0.5	0.5	0.4	0.4
Foreign	2,767	3,134	2,151	1,843	1,617	1.2	1.3	0.9	0.7	0.6
Capital expenditures 3/	5,751	7,380	8,221	6,089	6,828	2.4	3.2	3.4	2.4	2.5
of which : new security-related	0	434	0	0	0	0.0	0.2	0.0	0.0	0.0
of which : telecom projects	0	1,392	3,003	1,038	0	0.0	0.6	1.3	0.4	0.0
Gross costs of reforms	404	1,183	1,832	2,027	613	0.2	0.5	0.8	0.8	0.2
Other	338	117	1,014	190	195	0.1	0.0	0.4	0.1	0.1
Fiscal balance	6,285	-13,551	-13,019	-4,075	-2,497	2.7	-5.8	-5.4	-1.6	-0.9
Financing	-6,285	13,551	13,019	4,075	2,497	-2.7	5.8	5.4	1.6	0.9
Domestic	-11,780	-5,821	10,747	-330	3,314	-5.0	-2.5	4.5	-0.1	1.2
Bank	-10,233	-5,821	8,875	2,781	6,425	-4.3	-2.5	3.7	1.1	2.4
Non-bank	-1,547	0	1,872	-3,111	-3,111	-0.7	0.0	0.8	-1.2	-1.1
Foreign	2,872	-5,171	862	4,405	-817	1.2	-2.2	0.4	1.7	-0.3
Privatization receipts	2,622	24,543	1,411	0	0	1.1	10.5	0.6	0.0	0.0
Memorandum item:										
Security-related expenditures 4/	7,861	24,092	16,333	12,023	12,384	3.3	10.3	6.8	4.7	4.5
of which : new security-related	0	15,678	8,372	2,682	2,658	0.0	6.7	3.5	1.1	1.0
Nominal GDP	236,389	233,841	240,227	254,952	273,104					

Source: Data provided by the FYRM authorities; and IMF staff projections.

1/ Excludes most of the costs of implementing the Peace Framework Agreement. These costs are financed off-budget during 2002-04.
2/ The Ministry of Finance records wages and allowances of reservists during 2001-03 under goods and non-labor services.
3/ Excludes foreign-financed capital expenditure projects. These projects are included in the general government operations (Table 3).
4/ Expenditures by the Ministry of Defense and by the Ministry of Internal Affairs.

Table 3. FYRM: General Government Operations, 2000–2004 1/

	2000	2001	2002	2003 Budget	2004 Proj.	2000	2001	2002	2003 Budget	2004 Proj.
	(In millions of denars)					(In percent of GDP)				
Total revenue and grants	86,583	80,503	86,254	85,948	89,726	36.6	34.4	35.9	33.7	32.9
Tax revenues	78,059	74,694	81,619	80,161	83,879	33.0	31.9	34.0	31.4	30.7
Taxes on income and profits	13,586	10,253	10,140	10,686	11,145	5.7	4.4	4.2	4.2	4.1
Social insurance contributions	25,091	25,363	25,494	26,663	27,190	10.6	10.8	10.6	10.5	10.0
Local taxes	1,050	1,050	1,050	1,050	1,050	0.4	0.4	0.4	0.4	0.4
Domestic indirect taxes	30,537	28,529	31,923	35,307	37,750	12.9	12.2	13.3	13.8	13.8
Import duties	7,733	6,111	6,335	6,151	6,428	3.3	2.6	2.6	2.4	2.4
Financial transaction tax	0	3,111	6,335	0	0	0.0	1.3	2.6	0.0	0.0
Other taxes	63	276	342	304	316	0.0	0.1	0.1	0.1	0.1
Non-tax and capital revenues	5,284	5,307	4,600	5,787	5,846	2.2	2.3	1.9	2.3	2.1
Grants	3,239	502	35	0	0	1.4	0.2	0.0	0.0	0.0
Total expenditures	82,427	97,236	100,107	92,913	96,523	34.9	41.6	41.7	36.4	35.3
Current expenditure	73,748	85,848	88,776	81,869	84,487	31.2	36.7	37.0	32.1	30.9
Goods and services	24,053	37,741	34,370	30,115	30,651	10.2	16.1	14.3	11.8	11.2
Wages and salaries	16,863	16,946	19,012	21,609	21,848	7.1	7.2	7.9	8.5	8.0
of which : new security-related	0	959	1,880	2,269	2,658	0.0	0.4	0.8	0.9	1.0
Goods and nonlabor services	7,191	20,795	15,358	8,506	8,803	3.0	8.9	6.4	3.3	3.2
of which : new security-related 2/	0	14,285	6,492	413	0	0.0	6.1	2.7	0.2	0.0
Refugee and special social expenses	1,482	582	389	446	446	0.6	0.2	0.2	0.2	0.2
Transfers	44,051	43,167	50,438	48,119	50,221	18.6	18.5	21.0	18.9	18.4
Interest	4,161	4,359	3,579	3,189	3,170	1.8	1.9	1.5	1.3	1.2
Domestic	1,183	1,066	1,177	1,026	1,210	0.5	0.5	0.5	0.4	0.4
Foreign	2,978	3,293	2,402	2,163	1,959	1.3	1.4	1.0	0.8	0.7
Capital expenditures	8,076	10,012	9,137	9,168	11,328	3.4	4.3	3.8	3.6	4.1
of which : new security-related	0	434	0	0	0	0.0	0.2	0.0	0.0	0.0
of which : telecom projects	0	1,392	3,003	1,038	0	0.0	0.6	1.3	0.4	0.0
of which : foreign-financed projects	1,749	1,887	299	1,849	3,383	0.7	0.8	0.1	0.7	1.2
Net costs of reforms	233	899	1,600	1,687	513	0.1	0.4	0.7	0.7	0.2
Other	369	477	595	190	195	0.2	0.2	0.2	0.1	0.1
Fiscal balance	4,156	-16,733	-13,853	-6,966	-6,797	1.8	-7.2	-5.8	-2.7	-2.5
Financing	-4,156	16,733	13,853	6,966	6,797	-1.8	7.2	5.8	2.7	2.5
Domestic	-11,993	-5,546	10,245	-716	2,928	-5.1	-2.4	4.3	-0.3	1.1
Bank	-10,446	-5,546	8,373	2,765	6,409	-4.4	-2.4	3.5	1.1	2.3
Non-bank	-1,547	0	1,872	-3,481	-3,481	-0.7	0.0	0.8	-1.4	-1.3
Foreign	5,199	-2,430	2,026	7,616	3,803	2.2	-1.0	0.8	3.0	1.4
Privatization receipts	2,637	24,709	1,582	66	66	1.1	10.6	0.7	0.0	0.0
Memorandum item:										
Fiscal balance excluding foreign-financed projects	5,905	-14,846	-13,554	-5,117	-3,414	2.5	-6.3	-5.6	-2.0	-1.2
Security-related expenditures 3/	7,861	24,092	16,333	12,023	12,384	3.3	10.3	6.8	4.7	4.5
of which : new security-related	0	15,678	8,372	2,682	2,658	0.0	6.7	3.5	1.1	1.0
Nominal GDP	236,389	233,841	240,227	254,952	273,104					

Source: Data provided by the FYRM authorities; and IMF staff projections.

1/ Includes all donor funded investment projects carried out by government institutions except a large share of the costs of implementing the Peace Framework Agreement (PFA). Most of the PFA costs are financed off-budget during 2002-04.

2/ The Ministry of Finance records wages and allowances of reservists during 2001-03 under goods and non-labor services.

3/ Expenditures by the Ministry of Defense and by the Ministry of Internal Affairs.

Table 4. FYRM: The National Bank Accounts, 1998-2003

	1998	1999	2000	2001	2002	2003			
	Dec.	Dec.	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.
						Projection			
	(In millions of denars)								
Net foreign assets 1/	10,518	25,061	42,245	50,344	43,303	38,003	44,186	41,831	44,775
Net domestic assets	-1,737	-14,751	-28,238	-32,126	-25,128	-21,974	-25,195	-22,954	-24,376
Banks (net)	1,648	-1,063	-4,360	-2,923	-2,784	-3,139	-4,374	-4,892	-4,978
Credits	2,557	984	462	234	214	214	214	214	214
Instruments (NBRM bills)	-909	-2,047	-4,822	-3,157	-2,998	-3,353	-4,588	-5,106	-5,192
Government (net)	1,902	-2,597	-12,067	-17,875	-10,624	-5,973	-7,570	-4,811	-5,758
Credit	5,518	5,205	4,383	4,207	3,677	3,677	3,677	3,677	3,677
Deposits	-6,166	-9,684	-16,700	-25,040	-17,552	-12,901	-14,498	-11,739	-12,686
External account	2,550	1,882	250	2,958	3,251	3,251	3,251	3,251	3,251
Other items (net)	-5,287	-11,091	-11,811	-11,328	-11,720	-12,862	-13,251	-13,251	-13,640
Reserve money	8,781	10,310	14,007	18,218	18,175	16,029	18,991	18,877	20,400
Currency	7,137	8,169	9,521	14,134	14,136	11,894	12,369	12,096	13,502
Other	1,644	2,141	4,486	4,084	4,039	4,135	6,622	6,781	6,897
Cash in vaults	128	95	336	1,537	679	718	757	795	834
Total reserves 1/	1,516	2,046	4,150	2,547	3,360	3,418	5,865	5,986	6,063
Memorandum items	(Percent change from end of previous year)								
Reserve money (RM)	2.2	17.4	35.9	30.1	-0.2	-11.8	4.5	3.9	12.2
RM excluding required reserves on FX deposits	2.2	17.4	35.9	30.1	-0.2	-11.8	-9.7	-10.4	-2.1

1/ Includes reserve requirements on foreign exchange deposits; scheduled to be introduced in the second quarter of 2003.

Table 5. FYRM: Monetary Survey, 1998-2003

	1998	1999	2000	2001	2002	2003			
	Dec.	Dec.	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.
						Projection			
	(In millions of denars)								
Net foreign assets	14,105	32,482	53,851	84,395	63,374	57,485	61,684	58,739	61,685
National Bank of Macedonia (NBRM) 1/	10,518	25,061	42,245	50,344	43,303	38,003	44,186	41,831	44,775
Domestic money banks (DMB) 2/	3,587	7,421	11,606	34,051	20,071	19,482	17,497	16,909	16,910
Net domestic assets	17,103	8,000	-3,011	-4,727	9,456	13,838	13,018	16,856	16,085
Credit to the government	3,186	5,927	-4,977	-10,297	-2,729	1,791	-147	2,272	1,194
Banks	1,284	8,524	7,090	7,578	7,895	7,764	7,424	7,083	6,952
NBRM (net)	1,902	-2,597	-12,067	-17,875	-10,624	-5,973	-7,570	-4,811	-5,758
Credit to the private sector	30,547	30,267	35,749	36,286	39,437	40,441	41,948	43,367	44,063
In denars 3/	24,502	23,834	30,737	31,261	33,740	34,569	35,901	37,145	37,666
In foreign currency	6,045	6,433	5,012	5,025	5,697	5,872	6,047	6,222	6,397
Other items (net)	-16,630	-28,195	-33,783	-30,716	-27,252	-28,394	-28,783	-28,783	-29,172
Broad money (M3)	31,208	40,482	50,840	79,668	72,830	71,323	74,702	75,595	77,769
Currency in circulation	7,137	8,169	9,521	14,134	14,136	11,894	12,369	12,096	13,502
Deposits of public entities 4/	1,748	2,378	2,541	3,357	2,457	2,461	2,465	2,469	2,473
Private denar deposits	15,700	22,156	27,178	25,292	28,163	28,684	31,373	32,324	32,878
Private foreign currency deposits	6,623	7,779	11,600	36,885	28,074	28,285	28,495	28,706	28,916
Memorandum items:									
M1 private	19,245	19,694	24,326	25,602	26,687	25,601	27,597	28,025	29,262
M2 private denar	25,124	26,509	33,093	35,308	38,044	36,496	39,342	39,952	41,715
M3 private denar	28,499	30,325	36,699	39,426	42,299	40,578	43,742	44,420	46,380
(Percent change from end of previous year)	24.8	32.8	21.0	7.4	7.3	-4.1	3.4	5.0	9.6
M3 private	29,460	38,104	48,299	76,311	70,373	68,862	72,237	73,126	75,296
(Percent change from end of previous year)	14.3	29.3	26.8	58.0	-7.8	-2.1	2.6	3.9	7.0
Implicit velocity of M3 (private; end of period)	6.6	5.5	4.9	3.1	3.4	3.6	3.4	3.4	3.4
Implicit velocity of M3 (private denar; end of period)	8.5	6.9	6.4	5.9	5.7	6.0	5.7	5.7	5.5
Net credit to government	1,438	3,549	-7,518	-13,654	-5,186	-670	-2,612	-197	-1,279
Total private sector credit (adjusted) 5/	32,080	35,099	41,148	44,160	48,545	49,549	51,056	52,475	53,171
(Percent change from end of previous year)	10.4	9.4	17.2	7.3	9.9	2.1	5.2	8.1	9.5
Total private denar credit (adjusted) 5/	25,262	26,859	34,322	37,321	41,034	41,863	43,195	44,439	44,960
(Percent change from end of previous year)	5.9	6.3	27.8	8.7	9.9	2.0	5.3	8.3	9.6
NFA of DMBs in percent of private FX deposits 6/	54.2	95.4	100.1	92.3	71.5	68.9	70.4	67.9	67.5
FX assets of DMBs in percent of private FX deposits 7/	145.4	178.1	143.3	128.7	122.9	121.3	120.4	119.4	119.7
Ratio of private FX deposits to private denar deposits	0.42	0.35	0.43	1.46	1.00	0.99	0.91	0.89	0.88

Sources: The National Bank of Macedonia; and staff projections.

1/ A loss of foreign reserves equivalent to about Denar 2.1 billion is assumed following the repayment of frozen foreign currency bonds in 2003.

2/ The decline in the second quarter of 2003 reflects the introduction of reserve requirements on foreign exchange deposits with a corresponding increase in the NFA of the NBRM.

3/ Includes denar loans with foreign exchange indexing clause; i.e. about 25 percent of total private sector denar lending at end-2002.

4/ Includes deposits of extra-budgetary funds and public entities outside the central government.

5/ Adjusted for the removal of fully provisioned loans from banks' books.

6/ NFA of DMBs include required reserves on FX deposits.

7/ FX assets of DMBs include NFA, required reserves on FX deposits, loans in foreign currency and, from 2001, denar loans with FX indexing clause

Table 6. FYRM: Balance of Payments, 2000–2004
(In millions of U.S. dollars)

	2000	2001	2002	2003	2004
			Est.	Proj.	
Current account	-75	-234	-318	-299	-308
Excluding official transfers	-208	-282	-414	-404	-361
Trade balance (fob)	-690	-521	-752	-725	-710
Exports	1,321	1,155	1,105	1,236	1,341
Imports	2,011	1,677	1,857	1,961	2,051
Services (net)	47	-16	-17	-19	-6
Income (net; including net interest)	-45	-39	-48	-53	-44
Transfers (net)	614	343	500	498	453
Official	132	49	96	105	53
Private	481	294	403	393	400
Capital and financial account	223	273	246	292	304
Capital account (net)	0	1	7	0	0
Financial account	223	272	239	292	304
Disbursements	142	108	162	264	246
Amortization	120	182	162	131	121
Direct and portfolio investment (net)	176	443	101	105	120
Currency and deposits (net)	-122	27	75	54	60
Individuals (incl. euro-conversion effect)	-29	377	-140	0	0
Commercial banks	-93	-349	214	54	60
Trade credits (net) 1/	147	-125	62	0	0
Errors and omissions and short-term capital	79	79	-51	31	50
Overall balance	226	118	-123	25	47
Financing	-226	-118	123	-25	-47
Net foreign assets (flows)	-259	-133	120	-25	-47
Valuation effects on the stock of NFA (increase: -)	18	45	-108	0	0
Change in the stock of NFA (increase:-)	-241	-87	11	-25	-47
Change in gross foreign reserves (increase:-)	-250	-56	21	-30	-39
IMF (net)	-16	-8	-9	-5	-8
BIS (net)	14	-14	0	0	0
Other (net)	10	-10	-1	10	0
Change in arrears 2/	14	15	3	0	0
Rescheduling 3/	18	0	0	0	0
Financing gap	0	0	0	0	0 6/
Memorandum items:					
Current account (in percent of GDP)	-2.1	-6.8	-8.6	-6.9	-6.6
Excluding official transfers	-5.8	-8.2	-11.2	-9.3	-7.8
Including errors and omissions	0.1	-4.5	-9.9	-6.2	-5.6
Export growth rate (percent)	11.0	-12.5	-4.4	11.9	8.5
Import growth rate (percent)	19.3	-16.6	10.7	5.6	4.6
Gross reserves	700	756	735	765	804
(in months of next year's imports of goods and services)	4.3	4.3	3.9	3.9	3.9
External debt service ratio (in percent) 4/	13.0	19.0	16.5	13.6	11.7
External debt to GDP ratio (in percent) 5/	40.1	38.0	39.0	36.5	36.6
Nominal GDP (in millions of U.S. dollars)	3,582	3,437	3,711	4,329	4,637

Sources: Data provided by the FYRM authorities; and IMF staff estimates and projections.

1/ Projected trade credits are included in the projected errors and omissions and short-term capital.
2/ Private sector arrears. Clearance of technical arrears to Paris Club (US$4.3 million at end-2002) is included in debt service due for 2003.
3/ Refers to the deferral of debt service to Paris Club creditors from April 1999 through March 2000.
4/ Debt service due including IMF as percent of exports of goods and services.
5/ Medium-term and long-term debt including IMF.
6/ Assumes disbursement of US$180 million in BOP support in 2003–04 (grants: US$53 million; loans: US$100 million; IMF: $27 million).

Table 7. FYRM: Macroeconomic Framework, 1998–2007

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
	Official				Staff estimate	Projections				
	(In percent of nominal GDP)									
Foreign saving 1/	7.5	0.9	2.1	6.8	8.6	6.9	6.6	6.1	5.3	4.7
including official grants	8.6	2.9	5.8	8.2	11.2	9.3	7.8	7.1	6.4	5.8
National saving 2/	15.9	21.2	23.2	14.0	13.3	16.1	17.1	18.2	19.3	20.4
Government	0.1	2.3	5.2	-2.9	-2.0	0.9	1.7	2.0	2.1	2.3
Non-government	15.8	18.9	18.0	16.9	15.3	15.2	15.4	16.3	17.2	18.1
Gross domestic investment	23.4	22.1	25.3	20.8	21.9	23.0	23.7	24.3	24.6	25.1
Government	1.8	2.3	3.4	4.3	3.8	3.6	4.1	4.9	4.8	4.9
Non-government	21.7	19.8	21.9	16.5	18.1	19.4	19.5	19.4	19.9	20.2
Fixed investment	17.4	16.6	16.2	14.8	15.0	16.1	16.8	17.4	17.7	18.2
Change in stocks	6.0	5.5	9.1	5.9	6.9	6.9	6.9	6.9	6.9	6.9
Non-government national saving minus investment	-5.8	-0.9	-3.9	0.4	-2.8	-4.2	-4.1	-3.1	-2.7	-2.1
Fiscal indicators										
General government balance (including grants)	-1.7	0.0	1.8	-7.2	-4.6	-1.6	-2.5	-2.9	-2.6	-2.6
General government balance (excluding grants)	-1.7	0.0	1.8	-7.2	-5.8	-2.7	-2.5	-2.9	-2.6	-2.6
Revenues	33.3	35.4	36.6	34.4	35.9	33.7	32.9	32.4	31.9	31.1
Total expenditures	35.0	35.4	34.9	41.6	41.7	36.4	35.3	35.3	34.5	33.7
of which:										
Non-interest current expenditure 3/	31.4	31.7	29.4	34.8	35.5	30.9	29.8	29.1	28.3	27.1
Interest expenditure	1.9	1.5	1.8	1.9	1.5	1.3	1.2	1.1	1.3	1.5
Central government balance	-0.8	0.8	2.7	-5.8	-5.4	-1.6	-0.9	-0.8	-0.8	-0.8
Government debt 4/										
Gross	52.0	57.4	53.2	51.6	50.3	44.8	41.3	39.3	38.8	39.3
Net 5/	52.0	53.8	46.0	41.6	43.9	40.2	39.5	39.3	38.8	39.3
Memorandum items:	(Percent change in real terms)									
Consumption expenditure	3.4	3.8	8.1	-3.1	4.3	-1.8	1.4	2.2	3.0	3.3
of which: Non-government	3.3	3.6	11.1	-11.4	8.8	0.5	1.9	2.7	4.0	4.4
Gross capital formation	5.3	-2.2	14.7	-18.6	8.4	18.7	8.8	8.8	7.8	8.3
Fixed investment	-2.6	-1.4	-3.2	-4.5	1.1	11.4	9.0	9.6	7.3	8.2
Non-interest government current expenditure	0.5	3.9	2.3	12.7	1.6	-10.0	0.8	2.7	1.9	0.5
Domestic demand	3.8	2.7	9.2	-6.0	4.9	1.6	2.8	3.5	4.1	4.4
GDP	3.4	4.4	4.5	-4.5	0.3	3.0	4.0	4.5	5.0	5.0
Foreign saving including errors and omissions (in percent of nominal GDP)	8.5	-4.9	-0.1	4.5	9.9	6.2	5.6	5.0	4.4	3.9
Nominal GDP (billions of denars)	195.0	209.0	236.4	233.8	240.2	255.0	273.1	294.0	316.4	340.5

Sources: Data provided by the FYRM authorities; and IMF staff projections.

1/ External current account deficit, including official grants (+).

2/ Equal to gross domestic investment minus foreign saving.

3/ In 2001-02, includes security related expenditures and compensation to the depositors from failed pyramid schemes.

4/ Includes domestic debt of central government and external debt of the public sector. Figures include bonds issued in 2001 for the frozen foreign currency deposits, as well as liabilities assumed by the government as of end-March 2000 on account of bank and enterprise restructuring, but exclude obligations for retroactive payments to pensioners.

5/ Gross debt net of general government deposits in the banking system.

Table 8. FYRM: Medium-Term Balance of Payments, 1998–2007

(In millions of U.S. dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
					Est.			Projection		
Current account	-269	-32	-75	-234	-318	-299	-308	-302	-286	-274
Excluding official transfers	-307	-105	-208	-282	-414	-404	-361	-356	-344	-336
Trade balance (fob)	-515	-496	-690	-521	-752	-725	-710	-710	-712	-727
Exports	1292	1190	1321	1155	1,105	1,236	1,341	1,436	1,530	1,617
Imports	1807	1686	2011	1677	1,857	1,961	2,051	2,145	2,243	2,344
Services (net)	-60	42	47	-16	-17	-19	-6	14	32	46
Income (net; including net interest)	-45	-42	-45	-39	-48	-53	-44	-62	-76	-78
Transfers (net)	350	464	614	343	500	498	453	456	470	484
Official	37	73	132	49	96	105	53	54	58	62
Private	313	391	481	294	403	393	400	402	412	422
Capital and financial account	339	-14	223	273	246	292	304	291	292	282
Capital account (net)	-2	0	0	1	7	0	0	0	0	0
Financial account	341	-14	223	272	239	292	304	291	292	282
Disbursements	286	167	142	108	162	264	246	262	273	290
Amortization	75	106	120	182	162	131	121	131	161	189
Direct and portfolio investment (net)	126	32	176	443	101	105	120	130	150	160
of which : Direct investment	118	32	176	442	101	105	120	130	150	160
Portfolio investment	8	0	0	0	1	0	0	0	0	0
Currency and deposits (net)	-41	-114	-122	27	75	54	60	30	30	20
Individuals (incl. euro-conversion effect)	-12	-63	-29	377	-140	0	0	0	0	0
Commercial banks	-29	-51	-93	-349	214	54	60	30	30	20
Trade credits 1/	45	7	147	-125	62	0	0	0	0	0
Errors and omissions and short-term capital	-33	213	79	79	-51	31	50	50	50	50
Overall balance	36	166	226	118	-123	25	47	39	57	58
Financing	-36	-166	-226	-118	123	-25	-47	-39	-57	-58
Net foreign assets (flows)	-35	-184	-259	-133	120	-25	-47	-39	-57	-58
Valuation effects on the stock of NFA (increase: -)	-6	18	18	45	-108	0	0	0	0	0
Change in the stock of NFA (increase:-)	-41	-166	-241	-87	11	-25	-47	-39	-57	-58
Change in gross foreign reserves (increase:-)	-38	-160	-250	-56	21	-30	-39	-29	-47	-40
IMF (net)	10	2	-16	-8	-9	-5	-8	-9	-10	-18
BIS (net)	0	0	14	-14	0	0	0	0	0	0
Other (net)	-13	-8	10	-10	-1	10	0	-1	0	0
Change in arrears 2/	-2	-7	14	15	3	0	0	0	0	0
Rescheduling 3/	0	25	18	0	0	0	0	0	0	0
Financing gap	0	0	0	0	0	0	0	0	0	0
Memorandum items:										
Current account (in percent of GDP)	-7.5	-0.9	-2.1	-6.8	-8.6	-6.9	-6.6	-6.1	-5.3	-4.7
Excluding official transfers	-8.6	-2.9	-5.8	-8.2	-11.2	-9.3	-7.8	-7.1	-6.4	-5.8
Export growth rate (percent)	4.4	-7.9	11.0	-12.5	-4.4	11.9	8.5	7.0	6.6	5.7
Import growth rate (percent)	11.3	-6.7	19.3	-16.6	10.7	5.6	4.6	4.6	4.5	4.5
Gross reserves	290	450	700	756	735	765	804	833	880	919
(in months of following year's imports of goods and services)	1.8	2.4	4.3	4.3	3.9	3.9	3.9	3.9	4.0	4.0
External debt service ratio (in percent) 4/	9.5	12.4	13.0	19.0	16.5	13.6	11.7	11.3	12.8	14.5
External debt to GDP ratio (in percent) 5/	38.5	39.2	40.1	38.0	39.0	36.5	36.6	36.4	35.7	34.6
Nominal GDP (in millions of U.S. dollars)	3,580	3,675	3,582	3,437	3,711	4,329	4,637	4,992	5,372	5,782

Sources: Data provided by the FYRM authorities; and IMF staff estimates and projections.

1/ Projected trade credits are included in the projected errors and omissions and short-term capital.
2/ Private sector arrears. Clearance of technical arrears to Paris Club (US$4.3 million at end-2002) is included in debt service due for 2003.
3/ Refers to deferral of debt service to Paris Club creditors from April 1999 through March 2000.
4/ Debt service due including IMF as percent of exports of goods and services.
5/ Medium-term and long-term debt including IMF.

Table 9. FYRM: Public Sector Debt Sustainability Framework, 1998-2007
(In percent of GDP, unless otherwise indicated)

	Actual				Est.	Projections				
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
					I. Baseline Medium-Term Projections					
Public sector debt 1/	52.0	57.4	53.2	51.6	**50.3**	**44.8**	41.3	39.3	38.8	39.3
o/w foreign-currency denominated	47.5	53.2	51.3	50.2	48.9	43.6	40.3	38.4	37.0	35.2
Change in public sector debt	-3.7	5.3	-4.2	-1.6	-1.2	-5.5	-3.5	-2.0	-0.5	0.5
Identified debt-creating flows (4+7+12)	3.4	-1.7	-2.2	-3.1	1.3	-5.1	-1.4	-1.4	-1.4	-1.4
Primary deficit	-0.2	-1.5	-4.3	4.5	4.2	0.8	0.1	0.1	0.0	-0.2
Revenue and grants	33.3	35.4	36.6	34.4	35.9	33.5	32.7	32.2	31.7	30.9
Primary (noninterest) expenditure	33.1	33.9	32.4	38.9	40.1	34.3	32.8	32.4	31.7	30.7
Automatic debt dynamics 2/	4.4	-0.1	3.2	3.0	-2.2	-6.0	-1.6	-1.6	-1.5	-1.3
Contribution from interest rate/growth differential 3/	-0.7	-1.9	-4.9	1.3	0.2	-1.7	-1.6	-1.6	-1.5	-1.3
Of which contribution from real interest rate	1.1	0.1	-2.6	-1.1	0.3	-0.3	0.1	0.1	0.3	0.5
Of which contribution from real GDP growth	-1.8	-2.1	-2.3	2.4	-0.2	-1.4	-1.7	-1.7	-1.8	-1.8
Contribution from exchange rate depreciation 4/	5.1	1.9	8.1	1.7	-2.4	-4.3	0.0	0.0	0.0	0.0
Other identified debt-creating flows	-0.9	-0.1	-1.1	-10.6	-0.7	0.1	0.1	0.1	0.1	0.1
Privatization receipts (negative)	-0.9	-0.1	-1.1	-10.6	-0.7	0.1	0.1	0.1	0.1	0.1
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	-7.0	7.0	-2.0	1.5	-2.5	-0.4	-2.2	-0.7	0.9	1.9
Public sector debt-to-revenue ratio 1/	156.2	162.0	145.2	149.8	140.2	133.7	126.3	121.8	122.4	127.1
Gross financing need 5/	1.7	0.0	-2.5	8.3	7.5	4.2	3.1	2.9	3.1	3.0
in billions of U.S. dollars	0.1	0.0	-0.1	0.3	0.3	0.2	0.1	0.1	0.2	0.2
Key Macroeconomic and Fiscal Assumptions										
Real GDP growth (in percent)	3.4	4.3	4.6	-4.5	0.3	3.0	4.0	4.5	5.0	5.0
Average nominal interest rate on public debt (in percent) 6/	3.6	3.1	3.5	3.5	3.0	2.6	2.8	2.9	3.4	4.1
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.2	0.4	-4.7	-2.4	0.7	-0.5	0.4	0.5	1.0	1.6
Nominal appreciation (increase in US dollar value of local currency, in percent)	-9.2	-3.9	-13.8	-3.2	5.0	10.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	1.4	2.7	8.2	5.8	2.3	3.1	2.4	2.4	2.5	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	3.8	6.7	-0.1	12.3	3.4	-12.0	0.1	3.8	2.8	1.6
					II. Stress Tests for Public Debt Ratio					
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007					**50.3**	**43.5**	**39.6**	**37.2**	**36.5**	**36.7**
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004					**50.4**	**47.2**	**45.6**	**43.4**	**42.8**	**43.1**
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004					**50.4**	**49.5**	**51.4**	**49.1**	**48.2**	**48.4**
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004					**50.4**	**49.9**	**51.9**	**49.4**	**48.6**	**48.7**
5. Combination of 2-4 using one standard deviation shocks					**50.4**	**50.2**	**52.9**	**46.0**	**40.9**	**37.1**
6. One time 30 percent real depreciation in 2003 7/					**50.4**	**72.5**	**68.0**	**65.0**	**63.5**	**63.2**
7. 10 percent of GDP increase in other debt-creating flows in 2003					**50.4**	**54.8**	**50.9**	**48.5**	**47.7**	**47.9**

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2002-07
Primary deficit	-0.7	3.2	0.8
Real GDP growth (in percent)	1.9	4.3	3.6
Nominal interest rate (in percent) 6/	3.7	0.6	3.1
Real interest rate (in percent)	-1.1	3.0	0.6
Inflation rate (GDP deflator, in percent)	4.5	3.1	2.5
Revenue to GDP ratio	34.9	1.2	32.8

Sources: Data provided by the FYRM authorities; and IMF staff projections.

1/ General government; gross debt.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 10. FYRM: External Debt Sustainability Framework, 1997–2007
(In percent of GDP, unless otherwise indicated)

	Actual					Est.	Projections				
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
						I. Baseline Medium-Term Projections					
External debt	31.3	38.5	39.2	40.1	38.0	**39.0**	**36.5**	**36.6**	**36.4**	**35.7**	**34.6**
Change in external debt	6.0	7.2	0.7	0.9	-2.1	1.0	-2.5	0.1	-0.2	-0.7	-1.1
Identified external debt-creating flows (4+8+11)	12.1	5.4	-1.0	-1.8	-4.4	3.0	-1.1	1.6	0.9	-0.1	-0.6
Current account deficit, excluding interest payments	6.0	5.6	-0.9	-0.1	4.5	7.0	5.5	5.4	4.8	3.9	3.3
Deficit in balance of goods and services	14.3	16.1	12.4	18.0	15.6	20.7	17.2	15.4	13.9	12.7	11.8
Exports	36.6	40.3	39.8	45.7	40.6	36.6	34.7	35.1	35.0	34.7	34.1
Imports	50.8	56.3	52.2	63.6	56.3	57.4	51.9	50.5	48.9	47.4	45.9
Net non-debt creating capital inflows (negative)	-0.5	-3.5	-0.9	-4.9	-12.9	-2.7	-2.4	-2.6	-2.6	-2.8	-2.8
Net foreign direct investment, equity	0.4	3.3	0.9	4.9	12.9	2.7	2.4	2.6	2.6	2.8	2.8
Net portfolio investment,equity	0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Automatic debt dynamics 1/	6.6	3.2	0.8	3.3	4.0	-1.3	-4.2	-1.2	-1.3	-1.2	-1.1
Contribution from nominal interest rate	1.9	1.9	1.8	2.2	2.3	1.5	1.4	1.2	1.3	1.4	1.5
Contribution from real GDP growth	-0.6	-1.1	-1.6	-1.8	1.9	-0.1	-1.0	-1.4	-1.5	-1.7	-1.7
Contribution from price and exchange rate changes 2/	5.3	2.5	0.6	2.8	-0.2	-2.7	-4.5	-1.1	-1.1	-0.9	-0.9
Residual, incl. change in gross foreign assets (2-3)	-6.1	1.8	1.6	2.7	2.3	-2.1	-1.4	-1.5	-1.0	-0.6	-0.5
External debt-to-exports ratio (in percent)	85.7	95.7	98.4	87.8	93.5	106.3	105.0	104.2	104.0	102.9	101.6
Gross external financing need (in billions of US dollars) 3/	343.4	346.5	223.9	268.0	474.0	550.9	511.1	509.9	506.4	523.0	549.5
in percent of GDP	9.2	9.7	6.1	7.5	13.8	14.8	11.8	11.0	10.1	9.7	9.5
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	2.0	3.4	4.3	4.5	-4.5	0.3	3.0	4.0	4.5	5.0	5.0
Exchange rate appreciation (US dollar value of local currency, change in percent)	-19.8	-8.5	-4.2	-13.8	-3.0	5.1	9.9	0.0	0.0	0.0	0.0
GDP deflator in US dollars (change in percent)	-17.1	-7.3	-1.6	-6.8	0.5	7.6	13.2	3.0	3.0	2.5	2.5
Nominal external interest rate (in percent)	6.4	5.8	4.7	5.6	5.6	4.4	4.1	3.6	3.8	4.1	4.4
Growth of exports (US dollar terms, in percent)	4.9	5.6	1.5	11.8	-14.6	-2.7	10.6	8.2	7.4	6.8	5.7
Growth of imports (US dollar terms, in percent)	7.1	6.2	-4.9	18.9	-15.1	10.1	5.6	4.3	4.2	4.2	4.2
						II. Stress Tests for External Debt Ratio					
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in :						39.0	39.6	40.1	41.1	42.6	44.2
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004						39.0	37.9	39.6	39.4	38.6	37.4
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						39.0	39.6	43.4	43.0	42.1	40.8
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004						39.0	58.3	84.8	83.0	80.8	78.3
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004						39.0	40.8	45.1	44.7	43.7	42.4
6. Combination of 2-5 using one standard deviation shocks						39.0	52.6	69.8	68.4	66.7	64.7
7. One time 30 percent nominal depreciation in 2003						39.0	56.3	55.7	54.9	53.6	52.0

Historical Statistics for Key Variables (1994–2001)	Historical Average	Standard Deviation	Average 2002–07
Current account deficit, excluding interest payments	4.1	2.9	5.0
Net non-debt creating capital inflows	3.0	4.4	2.7
Nominal external interest rate (in percent)	6.1	0.8	4.1
Real GDP growth (in percent)	1.0	3.2	3.6
GDP deflator in US dollars (change in percent)	2.6	16.5	5.3

Sources: Data provided by the FYRM authorities; and IMF staff projections

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Table 11. FYRM: Schedule of Purchases Under the Proposed Stand-By Arrangement 1/

Date	Amount of Purchase 2/ In millions of SDRs	Amount of Purchase 2/ In percent of quota	Conditions
April 15, 2003	4.0	5.806	Board approval of stand-by arrangement.
August 15, 2003	4.0	5.806	Observance of end-June 2003 performance criteria and completion of first review.
November 15, 2003	4.0	5.806	Observance of end-September 2003 performance criteria.
February 15, 2004	4.0	5.806	Observance of end-December 2003 performance criteria and completion of second review
May 15, 2004	4.0	5.806	Observance of end-March 2004 performance criteria.
Total	**20.0**	**29.03**	

1/ The schedule assumes that the SBA begins on April 15, 2003 for 14 months.
2/ Assuming maximum proposed access. Annual access would equal 24.88 percent of the quota.

Table 12. FYRM: External Financing Requirements and Sources, 2001–05
(In millions of U.S. dollars)

	Act.	Est.	IMF Staff Projection		
	2001	2002	2003	2004	2005
1. Gross Financing Requirement	553	590	586	539	525
External current account deficit (excluding official transfers)	282	414	404	361	356
Debt amortization	182	162	131	121	131
Multilateral 1/	57	74	30	28	31
Bilateral	43	34	39	36	37
Commercial Creditors	81	54	62	56	63
Repayment of arrears	11	26	0	0	0
Gross reserves accumulation	56	-21	30	39	29
IMF/BIS repurchases and repayments	22	9	21	18	9
2. Identified Financing	553	590	586	539	525
Official creditors	119	181	280	199	207
Official transfers and grants	49	96	105	53	54
European Union	8	9	19	0	0
Other	41	87	86	53	54
Debt financing	70	85	174	146	153
Multilateral	62	75	156	103	107
World Bank	23	34	69	13	13
FESAL	0	0	41	0	0
Other	23	34	28	13	13
European Union	10	10	29	0	0
Other	30	31	58	90	94
Bilateral	8	10	19	43	45
Commercial creditors 2/	38	78	90	100	109
IMF/BIS purchases and disbursements 3/	0	0	16	11	0
Foreign direct investment (net)	443	101	105	120	130
Other flows 4/	-73	200	95	110	79
Accumulation of arrears 5/	26	30	0	0	0
3. Financing Gap (1 - 2)	0	0	0	0	0

Sources: Data provided by the FYRM authorities; and IMF staff estimates and projections.

1/ Excluding the IMF.
2/ Includes the capitalization of moratorium interest according to the London Club agreement of 1997.
3/ The proposed SBA.
4/ Includes all other net financial flows and errors and omissions.
5/ Private sector and public enterprise arrears.

Table 13. FYRM: Indicators of Capacity to Repay the Fund, 2002–2010 1/

(Under Obligation)

	2002	2003	2004	2005	2006	2007	2008	2009	2010
	Est.	Projections							
Fund repurchases and charges 2/									
In millions of SDRs	7.7	16.4	14.5	7.4	8.1	14.1	10.2	2.1	0.6
In millions of U.S. dollars	10.0	21.8	19.3	9.9	10.8	18.8	13.6	2.8	0.8
In percent of exports of goods and services	0.7	1.5	1.2	0.6	0.6	1.0	0.7	0.1	0.0
In percent of debt service	4.4	10.7	10.2	5.0	4.5	6.6	...	...	...
In percent of quota	11.2	23.8	21.0	10.7	11.8	20.5	14.8	3.0	0.9
In percent of gross official reserves	1.4	2.9	2.4	1.2	1.2	2.0	1.4	0.3	0.1
In percent of underlying gross official reserves 3/	1.7	3.2	2.6	1.3	1.3	2.2	...	...	...
Fund credit outstanding (e.o.p.) 2/									
In millions of SDRs	49.6	46.0	40.3	33.6	26.1	12.5	2.6	0.5	0.0
In millions of U.S. dollars	64.2	61.0	53.6	44.8	34.8	16.7	3.4	0.7	0.0
In percent of quota	71.9	66.8	58.4	48.7	37.9	18.2	3.7	0.8	0.0
In percent of GDP	0.0	0.0	0.0	0.0	0.0	0.0	...	...	...
In percent of gross official reserves	8.7	8.0	6.7	5.4	4.0	1.8	0.4	0.1	0.0
In percent of underlying gross official reserves 3/	10.8	8.9	7.2	5.8	4.2	1.9	...	...	...
Memorandum items:									
Exports of goods and services (millions of US dollars)	1,360	1,503	1,627	1,747	1,866	1,972	2,081	2,164	2,251
Debt service (millions of U.S. dollars) 2/	224	204	190	198	239	285	...	...	...
Quota (millions of SDRs)	69	69	69	69	69	69	69	69	69
Quota (millions of U.S. dollars)	89	91	92	92	92	92	92	92	92
Gross official reserves (millions of U.S. dollars) 2/	735	765	804	833	880	919	959	998	1,038
Underlying gross official reserves (millions of U.S. dollars) 2/	594	684	742	773	821	863	...	...	...
GDP (millions of U.S. dollars)	240,227	254,952	273,104	293,956	316,370	340,493	...	...	...
U.S. dollars per SDR 4/	1.295	1.327	1.332	1.334	1.334	1.334	1.334	1.334	1.334

Sources: Data provided by the FYRM authorities; and IMF staff estimates and projections.

1/ As of December 31, 2002.
2/ Including the purchases under the proposed stand-by arrangement.
3/ Underlying gross official reserves equal gross official resererves less net saving from privatization receipts.
4/ WEO assumptions of December 2002.

Table 14. FYRM: Projected Payments to the Fund as of December 31, 2002 Under Obligated Repurchase Schedule
(in millions of SDRs)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total
Obligations from existing drawings										
Principal										
GRA Repurchases	11.0	8.3	1.2	0.2	0.2	0.2	0.2	0.2	0.0	21.5
PRGF Repayments	4.5	5.5	5.5	5.8	4.9	1.3	0.4	0.3	0.0	28.1
Charges and Interest 1/										
Periodic Charges	0.4	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.7
PRGF Interest	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.4
SDR Net Charges	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.8
Total obligations	16.3	14.1	6.9	6.2	5.2	1.5	0.6	0.6	0.1	51.5
(percent of quota)	23.6	20.5	10.0	9.0	7.5	2.2	0.9	0.9	0.1	74.7
Obligations from prospective drawings										
Principal										
GRA Repurchases	0.0	0.0	0.0	1.5	8.5	8.5	1.5	0.0	0.0	20.0
Charges and Interest 1/										
Periodic Charges	0.1	0.5	0.5	0.5	0.4	0.2	0.0	0.0	0.0	2.2
Total obligations	0.1	0.5	0.5	2.0	8.9	8.7	1.5	0.0	0.0	22.2
(percent of quota)	0.1	0.7	0.7	2.9	12.9	12.6	2.2	0.0	0.0	32.2
Cumulative (existing and prospective)										
Principal										
GRA Repurchases	11.0	8.3	1.2	1.7	8.7	8.7	1.7	0.2	0.0	41.5
PRGF Repayments	4.5	5.5	5.5	5.8	4.9	1.3	0.4	0.3	0.0	28.1
Charges and Interest 1/										
Periodic Charges	0.5	0.7	0.5	0.5	0.4	0.2	0.0	0.0	0.0	2.9
PRGF Interest	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.4
SDR Net Charges	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.8
Total obligations	16.4	14.5	7.4	8.1	14.1	10.2	2.1	0.6	0.1	73.7
(percent of quota)	23.8	21.0	10.7	11.8	20.5	14.8	3.0	0.9	0.1	107.0

1/ The GRA basic rate of charge 2.44% is computed by applying a factor of 1.2800 to the SDR interest rate 1.91%. It is then increased by 0.02% for burden sharing and furthermore by 0.07% for the SCA for a total rate of 2.53%.

Prepared by Treasurer's Department.

Table 15. FYRM. Indicators of Financial and External Vulnerability, 1999-2002

	1999	2000	2001	2002
Financial indicators				
Broad money (end of period; percent change from end of previous year)	29.7	25.6	56.7	-8.6
Private sector credit (end of period; percent change from end of previous year)	9.4	17.2	7.3	9.9
Share of non-performing loans in total bank exposures (end of period, in percent) 1/	41.3	34.8	33.7	30.9 *a*
Foreign currency deposits (end of period, in percent of broad money)	19.2	22.8	46.3	38.5
Indexed loans to private sector				
(end of period, in percent of denar credit to private sector)	...	...	26.9	25.9
Foreign currency credit to private sector				
(end of period, in percent of total credit to private sector)	21.3	14.0	13.8	14.4
Indexed loans and foreign currency credit to private sector				
(end of period, in percent of total credit to private sector)	...	...	37.0	40.3
Central bank short-term foreign liabilities (in millions of US dollars)	102	14	0	0
Short term foreign assets of commercial banks (in millions of US dollars)	400	434	642	508 *a*
Short term foreign liabilities of commercial banks (in millions of US dollars)	265	217	162	195 *a*
Money market rate (end of period; in percent)	11.6	7.2	11.9	14.4
External Indicators				
Exports (percent change, in terms of US$)	-7.9	11.0	-12.5	-4.4 *b*
Imports (percent change, in terms of US$)	-6.7	19.3	-16.6	10.7 *b*
Current account balance (in percent of GDP)				
(Including official grants)	-0.9	-2.1	-6.8	-8.6 *b*
(Excluding official grants)	-2.9	-5.8	-8.2	-11.2 *b*
Foreign direct investment (in percent of GDP)	0.9	4.9	12.9	2.7 *b*
Gross official reserves (in US$)	450	700	756	735
(In months of next year's imports of goods and services)	2.4	4.3	4.3	3.9
(In percent of broad money)	67.1	89.9	65.6	59.1
Total external debt (in percent of GDP)	39.2	40.1	38.0	39.0
of which: public sector (in percent of GDP)	34.1	35.7	33.7	33.9
Short-term debt (by remaining maturity)				
(In percent of GDP)	4.8	5.3	7.3	6.2
(In percent of official reserves)	39.2	27.2	33.3	31.5
External debt service payments (in percent of exports of goods and services)	12.4	13.0	19.0	16.5 *b*
Exchange rate (denar per U.S. dollar, period average)	56.9	66.0	68.0	64.7
REER (average percent change; (-) depreciation)				
CPI-based	2.9	4.0	-6.1	-2.4 *c*
ULC-based	7.6	8.8	-2.2	1.4 *a*

Source: Staff calculations and estimates based on the data provided by the NBM.

1/ Excludes fully provisioned loans that have been moved to off-balance sheet.

a Data as of end-September 2002.
b Estimates based on actual data through November 2002.
c Data as of end-November 2002.

April 15, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, DC 20431
U.S.A.

Dear Mr. Köhler,

The attached Memorandum of Economic and Financial Policies for 2003–04 (MEFP) describes the program that the Government of the Republic of Macedonia will implement during the remainder of 2003 and the first quarter of 2004, with the intention of reversing financial imbalances related to the 2001 insurgency crisis and setting the stage for a resumption of economic growth after the severe recession in 2001-02.

In support of the program we request a 14-month Stand-by Arrangement in an amount of SDR 20 million, equivalent to 29 percent of quota. The prior actions for the approval of the arrangement listed in Table 2 have been implemented.

Our arrangements under the IMF's Poverty Reduction and Growth Facility and the Extended Fund Facility, which were approved by the Executive Board in late 2000, went off track in the wake of the 2001 insurgency crisis. In spite of adverse circumstances, much of the agenda covered by those arrangements was completed, including in the areas of enterprise reform and privatization, tax reforms and reforms of the treasury and the payments system. We have also made progress in liberalizing trade and foreign exchange operations and have recently completed our accession to the WTO. We remain committed to further structural reforms, for which we are also seeking support from the World Bank and other international financial institutions, as well as the EU and bilateral donors.

We believe that the policies set forth in the attached MEFP are adequate to achieve the objectives of our program but we will take any further measures that may become appropriate for this purpose. We will consult with the Fund on the adoption of these measures, in accordance with the Fund's policies on such consultations, and we will consult with the Managing Director in advance of any revisions of the policies covered in this MEFP.

Sincerely,

/s/
Branko Crvenkovski
Prime Minister

/s/
Petar Gošev
Minister of Finance

/s/
Ljube Trpeski
Governor
National Bank of the Republic of Macedonia

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES 2003-04

I. Introduction

1. This memorandum outlines the Government's economic program for the period January 2003-March 2004, for which support is being requested from the International Monetary Fund (IMF) under a new 14-month Stand-By Arrangement (SBA).

2. After a generally favorable economic outturn in 2000, economic activity slowed markedly in 2001, as the March-August security crisis disrupted production and sapped consumer and business confidence. Real GDP declined by 4½ percent in 2001 and grew by only 0.3 percent in 2002. The contraction affected all sectors in the economy except government, where activity was boosted by security-related spending. Thanks to the successful management of the de facto fixed exchange rate, inflation averaged about 5¼ percent in 2001 (in spite of the security crisis) and declined to 2.4 percent in 2002.

3. The fiscal deficit of the general government widened to 6¼ percent of GDP in 2001 because of the slowdown in economic activity and new expenditures related to security operations. A fiscal consolidation was planned in 2002 but did not materialize owing to the postponed demobilization of reservists and to expenditure overruns in the run-up to the parliamentary elections.

4. Despite high levels of foreign exchange outflows throughout 2001 and 2002, the National Bank of the Republic of Macedonia (NBRM) managed to retain a relatively comfortable level of official reserves—equivalent to about 4 months of next year's imports of goods and services at end-January 2003. The outflow of reserves, which reflected mainly the impact of security-related imports, sluggish exports, and a crisis-induced erosion of market confidence in the denar, was mitigated by receipts from the telecom privatization in 2001, the inflow of donor finance in 2002, and tight monetary policy implemented by the NBRM.

5. On the structural front, there was progress in several areas. Five *loss-making state-owned enterprises* were sold or liquidated; the largest of these, which was sold, has now resumed production. The regulatory framework for *bank supervision* has been strengthened and the health of the major banks is improving, though a few smaller banks have experienced problems. The Government successfully implemented a new and modern *payments system* in mid-2001. Starting in early 2002, important *treasury reforms* were implemented: the treasury single account approach was implemented and the treasury took over payment functions for budget users. Finally, a new Foreign Exchange Law, which came into effect in October 2002, further liberalized the foreign exchange regime by permitting certain credit and portfolio operations.

II. Objectives and Policies for 2003-04

A. Strategy and Macroeconomic Framework

6. The political normalization and the implementation of the Peace Framework Agreement (PFA) have set the stage for a resumption of economic growth. We now intend to implement a program that creates the economic basis for sustained growth and increased employment. The main elements of the program are: a fiscal adjustment to reverse the crisis-related imbalances and restore fiscal sustainability; maintaining the fixed exchange rate anchor, with comfortable reserve cover; and implementing pro-market structural reforms in the labor market. In this climate real GDP is projected to grow by 3 percent in 2003 and 4 percent in 2004. Average inflation is projected to remain at about 3 percent per annum.

B. Fiscal Policy and Budget Reforms

7. Given the large fiscal deficits over the last two years, fiscal adjustment is a key objective of the program. Adjustment is needed both in order to stabilize Macedonia's net public debt ratio at about 40 percent of GDP, and in order to lower interest rates and create room for more private sector credit. Consistent with these objectives the Government intends to reduce the general government deficit to 2 percent of GDP in 2003 and to the debt-stabilizing level, about 1¼ percent of GDP, in 2004. Taking into account expected externally financed expenditures by the Road Fund, this would imply a central government budget deficit of 1.6 percent of GDP in 2003 and 0.9 percent of GDP in 2004. The 2003 budget, which was enacted in March 2003, was prepared within this framework.

8. The budget allocates resources to PFA-related expenditures that are not funded by donors, including the costs of hiring members of under-represented minority groups into the police force–500 of the 600 police to be hired in 2003. Other PFA-related costs, such as those related to equipment and technical assistance, are expected to be covered by grants committed at the March 2002 donor meeting. The Government has also sought technical assistance from the European Union for an updated assessment of the budgetary costs of implementing the PFA.

9. General government revenues are expected to decline to 33.7 percent of GDP in 2003 from 35.9 percent of GDP in 2002. The decline in revenue reflects mainly the elimination of the distortionary financial transaction tax, which was introduced during the crisis. In addition, recent free trade agreements with countries in the region and with the EU, and the elimination of the 1 percent fee for processing customs documentation, have reduced reliance on customs revenues. In order to close the fiscal gap and strengthen the revenue base for the medium term, the VAT has been restructured by moving most non-food items from the preferential 5 percent rate to the standard rate, which in turn has been reduced from 19 percent to 18 percent. Food, potable water, and some printed materials (including newspapers, magazines and educational books) continue to be taxed at 5 percent. The measure is expected to increase revenue from the VAT by about 1.8 billion denars (0.7 percent of GDP) in 2003. In order to cushion the social impact of the VAT increase, the

price of electricity per kilowatt-hour in each category of household electricity consumption will be increased by 7 percent (effective July 1, 2003; structural performance criterion) instead of the 12½ percent required for a full passthrough of the change in VAT rates—electricity rates to enterprises already reflect the full passthrough. To compensate for the own revenue shortfall the electricity company (ESM) will suffer as a result of the less-than-full passthrough, ESM will introduce cost-cutting measures, including laying-off regular employees (in April 2003, which provide savings of about 200 million denars during this year). However, the government is committed not to weaken the financial position of ESM. To this end, if these measures prove insufficient, the need for additional increases in electricity prices will be assessed prior to completing the first program review.

10. VAT administration will be strengthened in line with advice from the IMF's Fiscal Affairs Department (FAD). The Public Revenue Office (PRO) will continue to devote a significant part of its effort to comprehensive audits of the 100 largest tax payers. The VAT law has been amended to eliminate the need to file annual returns. The PRO will develop an action plan—including an intensification of forced collections—to reduce VAT arrears. The plan will be implemented starting end-June at the latest. The PRO will define criteria and procedures for unilateral deregistration of small taxpayers. In addition, steps have been taken to create and staff a financial police unit with the mandate to investigate financial crimes, including tax fraud and money laundering. The financial police will cooperate closely with the PRO.

11. The Government intends to reduce general government expenditures to 35.7 percent of GDP in 2003 from 41.5 percent of GDP in 2002. The key elements of expenditure policy are:

- Security-related expenditures are being reduced from the crisis levels. The demobilization of reservists will be completed in March for the police and by December for the army. In spite of these cuts, security-related spending remains 1.4 percentage points of GDP higher than before the crisis.

- The salary scale will not be raised during the program period. The decompression of the civil service salary structure has been postponed to 2004.

- Public sector employment will be frozen on a net basis, except for net hiring of professional soldiers, 600 police (in line with the PFA), and special police units (which will be partly integrated into regular police units).

- Legislation mandating large increases in child allowances has been repealed. (The increases, which were never implemented, failed to target the sectors of the population in need of assistance).

- The transfers from the central government budget to the Health Fund in 2003 will be limited to 500 million denars. The fund is introducing a number of cost-cutting measures (providing savings of about 800 million denars, or 0.3 percent of GDP, in

2003) that will not affect the coverage and quality of healthcare: the number of employees will be reduced in April 2003 to save about 220 million denars during this year, the list of subsidized drugs used by pharmacies and hospitals will be changed to exclude high priced drugs that have lower priced substitutes, and competitive tenders with a 12-month commitment period will be launched for the procurement of medicines.[1]

- Agricultural subsidies will be limited to 685 million denars, about 400 million less than in 2002.[2] There will be no further earmarking of tax revenues for the Agricultural Fund. Instead, the budget will transfer 160 million denars to the Fund, while the central government budget will settle the Agricultural Fund's outstanding debt (440 million denars).

- All non-strategic commodity reserves will be sold and there will be no further net purchases in strategic reserves.

- Expenditures on other goods and services will be brought back to the pre-crisis levels in real terms.

- With the completion of projects funded by privatization receipts, general government capital expenditure will be reduced to pre-crisis levels, about 3 percent of GDP (excluding the foreign-financed portion of public sector investment projects).

12. In addition, we are developing plans for 30 budget-using agencies, which are performing non-core activities. The government will decide which agencies will be rationalized, downgraded, divested or closed, starting in 2003.

13. Further efforts will be made to improve expenditure management. The budget authorization and payments functions of the treasury system in the Ministry of Finance will be expanded to include monitoring and control of certain types of expenditure commitment and payments arrears effective September 2003. The relevant amendments to the Law on Budgets and the Law on Public Procurement will constitute a structural benchmark under the program. In addition, the 2003 budget execution law introduces provisions requiring parliamentary approval for the expenditure by first tier budget users of special revenues (other than external project loans and grants) in excess of budget allocations. Furthermore,

---

[1] In the meantime, and in line with World Bank recommendations, the Government will make preparations for re-tendering pharmaceutical supplies with international competitive bidding in 2004.

[2] Of this, 160 million denars will be transferred from the budget, another 211 million will be transferred from the Ministry of Agriculture budget, and up to 315 million will be the proceeds of sales of stocks of wheat and tobacco.

procedures will be strengthened to ensure that the budgetary impact of legislation submitted to parliament by the government continue to be first assessed by the Ministry of Finance.

14. In order to improve liquidity management, the government's stabilization fund, external account and privatization account, (all at the NBRM) will be consolidated, In time, the budgets of public funds will be monitored and executed through the treasury system and their accounts will be consolidated with the treasury single account. The Government will initiate, before end-June 2003, an external audit of the financial position and procurement procedures of the Health Fund (which accounts for 15 percent of general government expenditure), with terms of reference that will be specified in consultation with Fund and World Bank staff. The audit will constitute a structural benchmark under the program.

15. The implementation of decentralized government, which is at the core of the PFA, is also a step towards a more modern and democratic society. Based on the framework set out in the Law for Local Self-Government, the Government intends to speed up preparations for fiscal decentralization, including by: adopting remaining laws, completing detailed sector plans for transferring responsibilities to the local level, and building up administrative capacity at the local level. The Government also intends to implement as soon as possible recommendations prepared by the FAD technical assistance mission on local government financing, in particular with regard to the regulations regarding the collection and distribution of local fees and taxes. Special emphasis will be given to the development of sector policies, which in turn will have to be phased so as to ensure that decentralization can be accomplished in a way that preserves accountability for the resources transferred to municipalities. The Law of Local Finance and other supporting legislation will be prepared in consultation with the IMF and other donors.

C. Monetary and Exchange Rate Policies

16. The National Bank of the Republic of Macedonia (NBRM) will continue to orient monetary policy toward maintaining the de facto fixed exchange rate. Real exchange rate indicators suggest that external competitiveness is adequate. In 2003, the improved fiscal position and donor support will ease the pressure on monetary policy and should create scope for a gradual lowering of interest rates on NBRM bills. The NBRM will continue to monitor foreign exchange flows and, in the event of pressure on the foreign exchange market, will take appropriate measures, including exchange market interventions, operations with NBRM bills and adjustments of interest rates. As recommended by the MAE, the NBRM has recently strengthened the interbank exchange market by introducing new operating procedures that have increased the market's efficiency and transparency including by requiring all banks to quote bid and offer rates. An effect of the change was to bring the market rate into alignment with the central bank rate.

17. The NBRM has developed a monetary program that is consistent with maintaining the de facto fixed exchange rate and increasing gross foreign exchange reserves to the equivalent of 4 months of imports. The demand for money (excluding government deposits in banks) is projected to increase by almost 7 percent in 2003, roughly in line with the expected increase

in nominal GDP growth. The stock of foreign currency deposits is also projected to increase in line with economic activity. Net credit from the banking system to the general government is projected to increase by only about denar 3 billion, consistent with a 9½ percent growth in bank credit to the private sector. [3]

18. The auction of 28-days bills is the primary monetary policy instrument of the NBRM. The bill auctions will mainly be by volume tender in order better to signal the central bank's views on the interest rate. Also, the NBRM will make the Lombard facility more flexible, in line with the recommendations of the IMF's Monetary and Exchange Affairs Department (MAE) recent technical assistance mission: the facility will be available each working day (instead of 5 calendar days a month); the requirement for collateral in the form of central bank bills will be reduced from 182 percent of the loan to 105 percent; and the interest rate will be administered more flexibly.[4] The NBRM will unify the required reserve ratio on denar demand and time deposits at 7½ percent compared with, respectively, 10 percent and 5 percent at present. In addition, the NBRM will introduce a 7½ percent reserve requirement on foreign currency deposits, with reserves to be held in foreign exchange and remunerated at market-related interest rates. The introduction of the reserve requirement on foreign currency deposits will create a level playing field, help address prudential concerns arising from the expansion of foreign currency denominated and indexed lending, and will also absorb the liquidity created by the repayment of frozen foreign currency bonds maturing in 2003. As for future years, the Ministry of Finance will prepare a debt management strategy to address the recurrent financing needs resulting from the amortization of these bonds. To this end the government will put in place during 2003 the legislative and institutional framework necessary for issuing treasury bills and longer-term securities.

19. The NBRM recently abolished the practice of guaranteeing or pledging assets in support of activities performed by the private sector, public enterprises, or public funds. Existing guarantees will be allowed to expire. No further guarantees will be provided.

D. Structural Policies

20. In support of the macroeconomic stabilization policies laid out above, the Government intends to launch a structural reform program with strong pro-employment components. The key elements of this program include: measures to increase the flexibility of the labor market; a range of active labor market policies; the completion of the privatization process; the resolution of the remaining loss-making enterprises; a program to

---

[3] The figure excludes the effect of moving certain government deposits to other items net. The deposits in question correspond to interest and principal on frozen foreign currency bonds which matured before January 1, 2003 but have not yet been claimed.

[4] The requirement for collateral in the form of government bonds will not be reduced because government bonds are relatively illiquid and trade at large discounts.

support small and medium-sized enterprises (SME's); and the deepening of banking sector reforms. Moreover, the Government is committed to improving public sector governance and transparency, which will be essential to reactivate the business sector and attract foreign direct investments over the medium-term.

21. The high unemployment rate is partly a reflection of labor market rigidities that reduce the incentives for job creation. The Government therefore intends to make the labor market more flexible by scaling back over-generous unemployment benefits and severance packages. In particular, the Law on Employment and Unemployment Insurance will be amended by end-May 2003 to limit the duration of unemployment benefits to a scale rising to a maximum of 14 months for the unemployed with more than 15 years of service. In addition, the Law on Labor Relations will be amended by end-May 2003 to reduce the legally required severance pay from the present level, one month for every two years of service, to one month for every three years. These two measures will constitute structural benchmarks under the program. In addition, in order to reduce the scope for court challenges of lay-offs, we will review the rules and procedures for terminating employment, and seek ways to make them simpler and clearer. In addition, the Government, with World Bank assistance, will carry out a comprehensive review of the labor code and associated legislation with the goal of identifying additional areas for reform that would serve to increase labor market flexibility.

22. The structural reforms of the labor market will be accompanied by low-cost active labor market policies. These include refocusing the efforts of the Employment Fund on job placement services, vocational training, and the establishment of a job database. Also, the Government will implement a strategy supporting the development of SME's, including the creation, with technical assistance from SEED (the IFC-managed SME facility in the Balkans), of a fund for providing partial loan guarantees to SMEs. The loan guarantee fund will be fully-financed by donor grants.

23. Consistent with the policy of increasing the flexibility of the labor market, the Government will oppose amendments to the Law on Employment and Unemployment Insurance that would allow some or all workers with more than 25 years of service to obtain unemployment benefits until retirement.

24. In order to stimulate employment, and in the context of the program to restructure loss-making enterprises, we will put in place a subsidy program for enterprises that increase their employment above a pre-specified baseline number. The subsidy will be paid over a fixed period of 24 months, starting on the day when the program is put in place. In order to target the incentive on low-income groups the subsidy will be of a fixed size: the level of social contributions payable on a net salary of 8,000 denars. In order to target the incentive on the long-term unemployed, the newly hired employee must have been unemployed for at least 12 months. Finally, in order to limit the budgetary impact of the operation, its overall cost will be limited to 1.7 billion denars during 2003-05.

25. Preparations are underway to sell or close the remaining loss-making enterprises covered by the World Bank FESAL by end-2003. By end-2003, the Government also intends to sell by auction all remaining shares in state-owned enterprises held by the Privatization Agency and to close the Privatization Agency. Though this will bring the privatization process to an end, there will continue to be an urgent need to strengthen governance in already privatized enterprises. To this end, we intend to force restructuring or ownership change by: ending access to subsidies; enforcing debt collection, including wages, loans, and taxes; and by rapid and efficient enforcement of bankruptcy procedures. Moreover, strong measures will be taken against corruption, including through the judicial prosecution of proven offenders and zero tolerance for corruption in the government ranks, and government interference in private business activity will be reduced.

26. The ability of banks to channel domestic savings into productive activities in the private sector will be essential for achieving high and sustainable economic growth. On this basis, the ongoing efforts to improve the performance of the banking system will be sustained through strict enforcement of supervisory and prudential regulations. In particular, the NBRM will strengthen its monthly monitoring of the foreign exchange exposure of banks by requiring information on the composition of assets and liabilities (including breakdowns by the maturity and purpose of borrowing), will encourage banks to exercise prudence when lending to clients without foreign currency denominated income, and will stand ready to take corrective measures as necessary. Moreover, with the purpose of defining an exit strategy for the six banks currently under enhanced monitoring, the NBRM will enforce the implementation of corrective actions imposed in the course of on-site examinations. Failure to implement corrective actions by end-June 2003 will result in sanctions, such as suspension of all or particular banking operations for a certain period of time or revoking the operating license of the bank.

27. Further measures to strengthen the banking sector and bank supervision will be defined in the light of the findings of the forthcoming Financial Sector Assessment Program (FSAP) missions and will be incorporated into program conditionality at the first review under the program.

28. The Government will seek parliamentary approval of amendments to the Central Bank Law, which will make the NBRM solely responsible for the conduct of exchange rate policy and strengthen the governor's role in proposing the vice governors of the NBRM. Also, the Government intends to seek parliamentary approval of an amendment to the Banking Law, that lowers the threshold for central bank approval of changes in shareholding structure from 10 percent to 5 percent. The Foreign Exchange Law will be amended to allow banks to extend credits denominated in foreign currency to increase their ability to compete with foreign banks. The draft laws will be prepared in consultation with the IMF and will be enacted by end-April, 2003.

29. The audit of the final statements of the NBRM for 2002 by an independent external auditor based on international auditing standards will be completed and published by July 31, 2003 according to the recommendations of the IMF's Stage One safeguards assessment

of the NBRM (structural benchmark). Further actions in this area reflecting the recommendations of the February/March 2003 IMF safeguards assessment mission will be incorporated into program conditionality at the time of the first review of the program.

30. A program to restructure the one remaining state owned bank, the Macedonian Bank for Development Promotion, will be developed and adopted by the government before end-2003. Its primary role will become to promote Macedonian exports and provide assistance to exporters in the form of export guarantees and insurance on market terms.

31. In the area of trade policy: tariff free quotas, which are allocated on first-come first-served basis, will be allocated quarterly instead of semi-annually to limit the scope for market dominance by few trading companies.

III. External Financing Requirements

32. The balance of payments position deteriorated in 2001-02 because of the security crisis, but an improvement is projected for 2003. Exports are expected to recover, reflecting new contracts in the textile industry and the reopening under new ownership of a large formerly loss-making enterprise. Imports are projected to increase moderately as imports of used cars (which peaked in 2002 owing to a relaxation of import restrictions) return to a normal level. Private transfers, which had declined during the security crisis, increased in 2002 and are expected to remain at the higher level. On this basis, the external current account deficit, excluding grants, is projected to decline from 11.2 percent of GDP in 2002 to about 9.3 percent of GDP in 2003. Further improvements in the external position are expected in 2004, as increasing export demand continues to fuel the economic recovery. The external reserves targets specified in paragraph 17 of this memorandum are expected to be met with the help of balance of payments support of US$180 million from the IMF, World Bank, EU, and the governments of the U.S. and the Netherlands.

33. The external debt burden is moderate. At end-2002, the stock of medium- and long-term external debt (of the government and the non-government sector) is estimated to amount to the equivalent of 39 percent of GDP while debt service payments are estimated at about 16.5 percent of exports of goods and services. The Government will continue to limit the amount of new external debt that it contracts or guarantees on non-concessional terms under the program. As of end-January 2003 there were no outstanding external payments arrears as defined in the Technical Memorandum of Understanding. The Government will not accumulate new arrears in the future.

34. Since bilateral negotiations with Paris Club creditors have been protracted, and in order to demonstrate goodwill on Macedonia's part, we have taken the initiative of depositing amounts corresponding to Macedonia's technical arrears to Japan and Kuwait in an interest-bearing escrow account at a bank chosen in consultation with the Paris Club Secretariat. At the same time we will continue to press for a quick resolution of outstanding issues.

IV. PROGRAM MONITORING

35. Performance under the program will be monitored through quantitative performance criteria and indicative targets for end-March 2003, end-June 2003, end-September 2003, and end-December 2003, as well as one structural performance criterion and five structural benchmarks (Tables 1 and 2). Targets for end-March 2004 will be defined at the time of the first review. The quarterly quantitative targets include: (i) ceilings on net domestic assets of the NBRM; (ii) floors on net international reserves of the NBRM; (iii) ceilings on net credit to the general government from the banking system; (iv) floors on minimum central and general government fiscal balances; (v) ceilings on contracting or guaranteeing new non-concessional medium- and long-term external debt by the government or the NBRM; (vi) ceilings on the level of short-term external debt or guarantees by the government and the NBRM, except for normal import-related credits; (vii) ceilings on government domestic payments arrears and Health Fund arrears (indicative); (viii) ceilings on central government wage bill (indicative); (ix) ceilings on the net domestic assets of the banking system (indicative); and (x) ceilings on personnel expenditures financed from special revenue accounts (indicative). During the program period, the Government will not accumulate external payments arrears, impose restrictions on the making of payments and transfers for current international transactions, introduce or modify multiple currency practices, conclude bilateral agreements inconsistent with Article VIII of the IMF's Articles of Agreement, or impose or intensify import restrictions for balance of payments reasons. Details of the monitoring of the quantitative targets, including definition of adjusters, are provided in the Technical Memorandum of Understanding (Attachment II).

36. The program will be subject to two reviews by the IMF scheduled for early September 2003 and mid-February 2004. The first review will cover end-June 2003 performance under the program as well as the strategy to resolve problems of the 6 banks under enhanced supervision and its implementation. Based on the findings of the upcoming FSAP missions, the first review will, if appropriate, propose additional structural measures in the financial sector area. The second review will cover end-December 2003 performance, the budget for 2004 and medium term policies relating to the implementation at the PFA. The completion of the second review will be conditioned on the Parliamentary approval of the 2004 budget in line with program understandings (the general government deficit of 1¼ percent of GDP).

Table 1. Quantitative Performance Criteria and Indicative Targets for 2003 under the Proposed Stand-By Arrangement 1/

	2002	2003			
	Actual	End-Mar. Indicative	End-Jun.	End-Sep.	End-Dec.
		(Cumulative changes since end-December 2002)			
		(in millions of U.S. dollars)			
	End-year stocks				
Floor for net international reserves of the NBRM	654	-80	-16	-52	1
Ceiling on new nonconcessional medium- and long-term external debt contracted or guaranteed by the general government or the NBRM with original maturities of more than 1 year	...	0	25	210	250
Of which : with maturities of 1–5 years	...	0	0	30	30
Ceiling on short-term external debt of the general government or the NBRM with maturities of up to 1 year (stock); including guarantees for such debt	0	0	0	0	0
Accumulation of external payments arrears on a continuous basis	0	0	0	0	0
		(in millions of denars)			
Ceiling on net domestic assets of the NBRM	-25,128	3,154	-67	2,174	752
Ceiling on net domestic assets of the banking system (indicative)	9,456	4,382	3,562	7,400	6,629
Ceiling on net domestic credit to the general government from the banking system	-5,186	4,516	2,575	4,989	3,907
Ceilings on central government domestic arrears (indicative)					
Excluding those to suppliers	0	0	0	0	0
To suppliers	597	0	0	0	0
Ceilings on health fund arrears (indicative)	1,711	0	0	0	0
	Annual flows				
Ceiling on the central government wage bill (indicative)	18,339	5,143	10,429	15,527	20,953
Ceiling on personnel expenditures financed from special revenue accounts (indicative)	640	188	375	563	750
Floor for central government fiscal balance	-13,019	-1,685	-3,132	-4,021	-4,075
Floor for general government fiscal balance	-13,554	-1,630	-3,513	-4,627	-5,117

Sources: The FYRM authorities; and IMF staff.

1/ Adjustments to quantitative targets under the program are described in the Technical Memorandum of Understanding.

Table 2. Prior Actions, Structural Performance Criterion, and Structural Benchmarks

A. Prior Actions

1. (i) Parliament has adopted a 2003 budget consistent with the policies defined in the Memorandum of Economic and Financial Policies (MEFP ¶7).

   (ii) Parliament has adopted the 2003 budget execution law with provisions requiring parliamentary approval for the expenditure by first tier budget users of special revenues (except external project loans and grants) in excess of budget allocations (MEFP ¶13).

   (iii) Parliament has adopted a revised VAT law consistent with the MEFP (MEFP ¶9, ¶10).

2. The NBRM Council has reversed the decision that authorized the NBRM's guaranteeing or pledging of assets in support of activities performed by the private sector, public enterprises, or public funds (MEFP ¶19).

B. Structural Performance Criterion

1.	Raise electricity prices per kilowatt-hour by 7 percent in each category of household electricity consumption (MEFP ¶9).	July 1, 2003

C. Structural Benchmarks

1.	Amend the Law on Budgets and the Law on Public Procurement to expand budget authorization and payment functions of the treasury system in the Ministry of Finance to ensure proper monitoring and control over line ministries' expenditure commitments and payments arrears effective September 2003 (MEFP ¶13).	By end-May, 2003
2.	Improve labor market flexibility (MEFP ¶21) by: (i) amending the Law on Employment and Unemployment Insurance to limit the duration of unemployment benefits to a scale rising to a maximum of 14 months for the unemployed with more than 15 years of service, and (ii) amending the Law on Labor Relations to reduce the legally required severance pay to one month for every three years of service, from one month for every two years.	By end-May, 2003
3.	Initiate an external audit of the financial position and procurement procedures of the Health Fund, with terms of reference approved by the World Bank (MEFP ¶14).	By end-June, 2003
4.	Publish the external audit of the NBRM's 2002 statements (MEFP ¶29).	By end-July, 2003
5.	Enact a 2004 budget consistent with the general government deficit (fiscal balance excluding foreign-financed projects) of 1¼ percent of GDP (MEFP ¶7).	By end-December, 2003

TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum defines the variables subject to the quantitative targets (performance criteria and indicative benchmarks), established in the Memorandum of Economic and Financial Policies (MEFP) and describes the methods to be used in assessing the program performance with respect to these targets.

A. Definition of the General Government

1. For the purpose of this TMU, the term "general government" covers: central government (including Agency for Stock Reserves and courts), Agricultural Fund, Employment Fund, Health Insurance Fund, Pension Insurance Fund, Road Fund, Bank Restructuring Agency (BRA), Privatization Agency and other funds, agencies and institutions that are currently treated by the Ministry of Finance as part of government and which correspond to the classification followed by the National Bank of the Republic of Macedonia (NBRM) in their monthly submissions to the Fund of balance sheets of the central bank and the consolidated accounts of the commercial banks. The authorities will inform the Fund staff of any new funds, or other special budgetary and extrabudgetary programs that may be created during the program period to carry out operations of a fiscal nature as defined in the IMF's *Manual on Government Financial Statistics*, and will ensure that these will be incorporated within the definition of consolidated general government.

B. Net International Reserves of the NBRM

2. **Net international reserves** (NIR) of the NBRM are defined as the difference between NBRM's reserve assets and its reserve liabilities.

3. **Reserve assets** are defined as liquid and usable foreign convertible currency claims on nonresidents plus monetary gold. Alongside monetary gold, reserve assets of NBRM include SDRs, foreign currency cash, securities, deposits abroad, and the reserve position at the Fund. Excluded from reserve assets are any assets that are frozen, pledged, used as collateral, or otherwise encumbered, claims in foreign exchange arising from transactions in derivative assets (futures, forwards, swaps, and options), and precious metals other than gold.

4. **Reserve liabilities** are defined as all foreign exchange liabilities of the NBRM to nonresidents and residents, including all credit outstanding from the Fund, arrears on principal or interest payments to commercial banks, suppliers, or official export credit agencies, and future and contingent commitments to sell foreign exchange arising from transactions in derivative assets (futures, forwards, swaps, and options). General government's foreign exchange deposits at the NBRM are excluded from reserve liabilities.

5. At end-December 2002, reserve assets so defined stood at US$734.6 million; reserve liabilities so defined stood at US$80.8 million (including US$11.3 million in foreign exchange liabilities to residents); and NIR so defined stood at US$653.9 million. General government's foreign exchange deposits at the NBRM stood at US$134 million (Table 1).

6. Quarterly floors (NIR floors) have been established for the cumulative changes in the NIR of the NBRM from the level at end-December 2002 (see Table 1 of the MEFP). The changes in the NIR will be measured in U.S. dollars excluding valuation effects calculated according to the methodology described in Section J.

Adjustors

7. The NIR floors are set based on the assumption that the **balance of payments financing** will amount on a cumulative basis, from end-December 2002 to:

End-March 2003	US$ -6.4 million
End-June 2003	US$ 79.5 million
End-September 2003	US$ 77.4 million
End-December 2003	US$124.8 million.

The **balance of payments financing** is defined as gross disbursement of foreign loans or grants to the general government or the NBRM for balance of payments support minus payments, to the creditors with whom bilateral agreements are yet to be signed, of debt service due and technical arrears on the deferred April 1999–March 2000 maturities. Excluded from this definition are the project loans and grants, and purchases from the IMF (Table 2).

8. If balance of payments financing exceeds (falls short of) the baseline assumed in ¶7, the NIR floors of the NBRM will be adjusted upward (downward) to the same extent, with the proviso that the downward adjustment to the target will not exceed the equivalent of US$40 million on a cumulative basis.

9. The NIR floors will be adjusted downward by the amount of any prepayment of external debt and will be adjusted upward for any privatization proceeds or lump-sum proceeds from concession fees in foreign currency, and restitution of foreign assets of the former SFRY as a result of succession proceedings.

10. The NIR floors will be adjusted upward and to the same extent, if general government's foreign exchange deposits at the NBRM exceed their end-2002 level for reasons other than the balance of payments disbursements (see ¶7). In addition, the NIR floors will be adjusted upward and to the same extent, if the cumulative decline in frozen, encumbered and pledged assets of the NBRM exceeds the following baseline:

End-March 2003	US$ 2.0 million
End-June 2003	US$ 4.0 million
End-September 2003	US$ 9.0 million
End-December 2003	US$12.0 million.

C. Net Domestic Assets of the NBRM

11. **Net domestic assets** (NDA) of the NBRM are defined as reserve money minus the net foreign assets (NFA) of the NBRM.

12. **Reserve money** is defined as currency in circulation (outside banks), vault cash of banks, and required and excess reserve deposits of banks held at the NBRM.

13. **Net foreign assets** (NFA) of the NBRM are defined as reserve assets plus those foreign assets of the NBRM that are excluded from reserve assets under the definition in ¶3 of this TMU, minus foreign exchange liabilities of the NBRM to nonresidents.

14. At end-December 2002, reserve money so defined stood at denar 18,175 million; NFA so defined stood at US$714.4 million or denar 43,303 million (converted using the stock-flow valuation methodology described in Section J); and NDA so defined stood at denar -25,128 million.

15. Quarterly ceilings (ceilings for NDA) have been established for the cumulative changes in the NDA of the NBRM from the level at end-December 2002 (see Table 1 of the MEFP).

Adjustors

16. If balance of payments financing exceeds (falls short of) the programmed levels shown above (in ¶7), the ceilings for NDA of the NBRM will be adjusted downward (upward) to the same extent, with the proviso that the upward adjustment will not exceed the denar equivalent of US$40 million on a cumulative basis.

17. The ceilings for NDA of the NBRM will be adjusted upward by the amount of any prepayment of external debt and will be adjusted downward for any privatization proceeds or lump sum proceeds from concession fees in domestic and foreign currency, and restitution of foreign assets of the former SFRY as a result of succession proceedings, and exceptional (i.e., exceeding denar 700 million in January–December 2003) dividend receipts from Macedonian Telecom. Proceeds from the sale of government flats will be excluded from this adjustment.

D. Net Domestic Assets of the Banking System

18. **Net domestic assets** (NDA) of the banking system, which includes the NBRM and the deposit money banks, are defined as broad money (M3) minus the net foreign assets (NFA) of the banking system.

19. **Broad money** (M3) includes currency in circulation, demand deposits, quasi-deposits, and non-monetary deposits (time deposits over 12 months and restricted deposits) of the non-government, and government deposits held at domestic money banks. Quasi and non-monetary deposits include deposits denominated in denar and in foreign currency.

20. **NFA of the banking system** are defined as the banking system's foreign assets minus foreign liabilities.

21. At end-December 2002, broad money so defined stood at denar 72,830 million; NFA of the banking system so defined stood at denar 63,374 million; and NDA of the banking system so defined stood at denar 9,456 million.

22. Quarterly indicative ceilings have been established for the cumulative changes in the NDA of the banking system from the level at end-December 2002 (see Table 1 of the MEFP).

Adjustors

23. The ceilings on the NDA of the banking system will be subject to the same adjustors as the ceilings on the NDA of the NBRM.

E. Net Domestic Credit to the General Government

24. **Net domestic credit to the general government** is defined as credit in denar and foreign currency to general government from the NBRM and deposit money banks minus total general government deposits in denar and foreign currency with the NBRM and deposit money banks. For the purpose of this program, accounts of the general government include all accounts recorded as government accounts in the monetary statistics reported by the NBRM in accordance with the definition of general government in ¶1 excluding the unclaimed portion of the payment of principal and interest on frozen foreign currency deposits.

25. At end-December 2002, the amount of outstanding credit from the NBRM to the general government in denar and foreign currency stood at denar 6,928 million; the amount of outstanding credit from deposit money banks in denar and foreign currency stood at denar 7,895 million; the amount of general government deposits held at the NBRM was equal to denar 17,552 million (including denar 1,142 million corresponding to the unclaimed portion of the payment of principal and interest on frozen foreign currency deposits); and the amount of general government deposits held at deposit money banks was equal to denar 2,457 million.

26. At end-December 2002, net domestic credit to the general government so defined stood at denar -5,186 million (including denar -1,142 million corresponding to the unclaimed portion of the payment of principal and interest on frozen foreign currency deposits). Of this net credit from deposit money banks was equal to denar 5,438 million; and net credit from the NBRM stood at denar -10,624 million.

27. Quarterly ceilings have been established for the cumulative changes in net domestic credit to the general government from the level at end-December 2002 (See Table 1 of the MEFP).

Adjustors

28. The ceilings on net domestic credit to the general government will be subject to the same adjustors as the ceilings on the NDA of the NBRM.

F. Central and General Government Fiscal Balances

29. Quarterly floors for the cumulative changes in central and general government fiscal balances will be determined and monitored from the financing side beginning end-December 2002 (see Table 1 of the MEFP). The financing flows will be measured as a sum of domestic financing, foreign financing, and privatization proceeds.

30. **Domestic financing** for the central government includes net credit from the domestic banking system (excluding the unclaimed portion of the repayment of frozen foreign currency deposits), net placement of securities outside the domestic banking system and other net credit from the domestic non-banking sector, and net variation in domestic arrears. **Foreign financing** for the central government includes disbursements of external loans and non-budgetary support grants received by the central government (i.e., balance of payments support as defined in ¶7) minus amortization due or pre-paid, and rescheduled debt service payments programmed to be paid out. **Privatization proceeds** for the central government include proceeds in denar and foreign currency. It is assumed that privatization proceeds for the central government will be equal zero during 2003. The central government balance in January–December 2002 was denar -13,019 million.

31. The **general government fiscal balance** includes, in addition to the central government fiscal balance, the financing position of the institutions included in the definition of general government in ¶1. Monitoring will also be done from the financing side and include, in particular, foreign financing resources linked to the road construction program. The general government balance in January–December 2002 was denar -13,554 million.

Adjustors

32. The floors on general government fiscal balance will be adjusted upward by any shortfalls of gross external financing to the Road Fund with respect to the following baseline:

End-March 2003	US$ 0.0 million
End-June 2003	US$ 8.3 million
End-September 2003	US$15.6 million
End-December 2003	US$24.0 million.

G. Ceilings on the Wage Bill of the Central Government

33. Quarterly indicative ceilings have been established for the cumulative wage bill from the central government budget from the level at end-December 2002 (see Table 1 of the MEFP). The wage bill ceiling includes all components of chapter 40 of the Macedonian budget classification (this component includes wages and salaries; social contributions;

travel, food and vacation allowances; and other related categories in existence in the budget law of the year 2002), and any other personnel related expenses including overtime payments, bonuses, and vacation allowances. No wage bill or personnel related expenditures should be assigned to other budget categories. The wages and personnel expenses paid out of the central government budget chapter 40 during the period January-December 2002 were denar 18,339 million. A separate ceiling is also established on wages and other personnel expenses being paid out of special revenue and expenditures accounts, or the so-called 631, 785, 786, 787, and 788 accounts. Wages and personnel expenses paid out of these accounts in January–December 2002 amounted to denar 640 million.

H. External Debt

34. The limit on medium and long-term debt (see Table 1 of the MEFP) applies to the contracting or guaranteeing by any branch of general government or the NBRM of new nonconcessional external debt with an original maturity of more than one year, with sublimits on external debt with an original maturity of more than one year and up to and including five years. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000 by the Executive Board of the IMF (EBS/00/128)[1], but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are changes in indebtedness resulting from refinancing credits and rescheduling operations (including the deferral of interest on commercial debt), credits extended by the IMF and the BIS, and credits on concessional terms, defined as those with a grant element of 35 percent or more calculated using the OECD Commercial Interest Reference Rates (CIRRs) applicable for the program period. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

35. The limit on short-term debt (see Table 1 of the MEFP) applies to the outstanding stock of short-term government and government-guaranteed external debt of general government and the NBRM with an original maturity of up to and including one year. The term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000 by the Executive Board of the IMF. Excluded from this performance criterion are changes in indebtedness resulting from rescheduling operations (including the deferral of interest on commercial debt), and normal import-related credits. Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective. There was no official short-term debt or guarantees on outstanding short-term debt as of end-December 2002.

---

[1] Under the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000 by the Executive Board of the IMF The definition of "debt" has been broadened with respect to the conventional definition to include, among other things, such instruments as financial leases.

I. External and Domestic Payments Arrears

36. External payments arrears consist of the total past-due amounts of debt service obligations (interest and principal) on government, government-guaranteed, and the NBRM external debt, excluding arrears on external debt service obligations pending the conclusion of debt rescheduling agreements. Under the program, the nonaccumulation of external payments arrears is a continuous performance criterion. As of March 14, 2003, there were no outstanding external payment arrears as defined above.

37. Central government domestic arrears, excluding those to suppliers, are defined to include all payment delays to: (i) banks for bond payments (including for the repayment of frozen foreign currency deposits); (ii) individuals for Social Assistance Program payments; (iii) central government employees including for wages and salaries, and food and travel allowances; (iv) the Employment Fund and the Pension Fund; and (v) benefit recipients of the Child Care Program. The definition excludes the customary lag in paying wages, social assistance and child allowance payments, and transfers to the extra-budgetary funds (in the following month after they accrue). According to the definition here, and as reported to IMF staff, central government domestic arrears, excluding those to suppliers, were denar 0 million as of end-December 2002. Under the program, the outstanding stock of domestic arrears, as defined above, will not exceed at any time the amount outstanding as of end-December 2002, except in cases where payments depend on the adoption of programs to be prepared by budget users and adopted by the government, as stipulated in the 2003 Budget Execution Law.

38. Central government domestic arrears to suppliers are defined as obligations by government entities and institutions, including but not restricted to the Agency for Under-Developed Regions, the Service for Common Government Functions, and the Ministries of Agriculture, Culture, Education, Finance, Defense, Health, and Interior to suppliers which are overdue by more than 60 days and are non-disputed. As defined here, and as reported to Fund staff, the stock of arrears to suppliers stood at denar 597 million as of end-December 2002. Under the program, the outstanding stock of domestic arrears, as defined above, will not exceed the amount outstanding as of end-December 2002.

39. Health fund arrears are defined as unpaid obligations to suppliers and health-related personnel. As defined here, and as reported to Fund staff, the aggregate stock of these arrears stood at denar 1,711 million as of end-December 2002. Under the program the outstanding stock of arrears will not exceed the amount outstanding as of end-2002.

J. Valuation

40. The stocks of assets and liabilities denominated in foreign currencies in the monetary survey will continue to be valued according to the stock/flow methodology. The stocks of assets and liabilities denominated in foreign currencies outstanding at September 30, 1996, are valued at the current exchange rate on that day. On a monthly basis, any subsequent changes in the assets and liabilities in foreign currencies to residents and non-residents will be valued at the average exchange rate prevailing in the month of the transaction. In

particular, changes in the NIR of the NBRM (in denar) will be calculated by applying the average monthly denar per U.S. dollar exchange rate to the monthly dollar value of transactions (equal to the change in NIR excluding valuation effects as calculated by the Foreign Reserves Department of the NBRM). Changes in the telecom privatization account held at the NBRM (in denar) will be calculated by applying the average monthly denar per Euro exchange rate to the monthly Euro value of transactions. Gold is valued at the price fixed in the London market and was valued at US$342.75 per ounce at end-December 2002. The programmed foreign exchange flow projections assume an exchange rate of denar 58.8909 per U.S. dollar, denar 61.3761 per Euro, and cross exchange rates at the level prevailing at end-December 2002.

41. The Foreign Reserves Department of the NBRM estimates the valuation effects on the NIR of the NBRM as follows. On a daily basis all foreign currency denominated balances are converted into U.S. dollars using the middle rates from the NBRM official exchange rate list for the same day. These balances are compared to the balances in U.S. dollars at the end of the previous day calculated in the same way (i.e., using the middle rates from the NBRM official exchange rate list for that day). The change in the daily U.S. dollar denominated balances, so calculated, is compared to the recorded daily transaction flows converted in U.S. dollars using the same methodology. Any difference between the two values is attributed to valuation effects.

42. The exchange rate effects on the foreign currency denominated assets and liabilities of the commercial banks will be estimated on the basis of their currency composition, as provided by the NBRM.

K. Monitoring and Reporting Requirements

43. Performance under the program will be monitored from information provided to the IMF by the NBRM and the Ministry of Finance. All data will be monthly, unless otherwise specified, and should be submitted by the authorities to the IMF staff within 30 days of the end of each month, unless otherwise specified. In addition, data on performance at the program test dates will be submitted with a cover letter signed by an authorized official.

44. The following information will be supplied to the IMF by the Ministry of Finance: (i) fiscal table for the central government and extra-budgetary funds; (ii) monthly information on privatization receipts (including detailed description of cash payments in local and foreign currency and payments with government bonds); (iii) data on enterprises including action taken and workers registered as unemployed; (iv) information on special revenue accounts of line ministries and separately on personnel expenditures financed from these accounts; (v) information on guarantees given on new debt, and on new debt contracted by the government, government agencies, and public enterprises; (vi) information on domestic arrears, including to suppliers and distinguishing between court disputed and non-disputed arrears; (vii) data on spending on projects and repayment to pensioners (agreed under the program as uses of privatization receipts from the sale of the Telecom company), and outlays on structural reforms; (viii) data on the claimed and unclaimed portion of the repayment of

frozen foreign currency deposits; and (ix) information on number of workers registered under the employment subsidy scheme.

45. The NBRM will supply: (i) balance sheets of the NBRM and the consolidated accounts of the commercial banks—both should include details of the credit and deposits position of funds and other government entities as listed in ¶1; (ii) the monetary survey; (iii) data on components of NIR of the NBRM as defined in section A, valued in U.S. dollars adjusted for valuation changes; (iv) statement from the Road Fund indicating its balances (in denar and foreign currency) at the NBRM and at the commercial banks separately; (v) the foreign exchange cashflow of the NBRM, including the level of official reserves; (vi) record of transactions in the privatization account identified by their use and valued in U.S. dollars and Euros; (vii) daily and monthly closing and average exchange rates; (viii) detailed data on exports and imports; (ix) information on all overdue payments on short-term external debt and on medium- and long-term external debt; (x) data on foreign borrowing including gross disbursements, amortization, and interest payments; (xi) information on lending by domestic money banks according to credit ratings of borrowers; (xii) data on off-balance sheet activity of domestic money banks; and (xiii) data on each domestic money banks' compliance with prudential regulations will be provided in a quarterly basis till end-2001 and in a monthly basis thereafter within 30 days of the end of the quarter/month. Monthly data on all components of balance of payments will be submitted within 2½ months of the end of each month. Data on stock of external debt will be provided on a quarterly basis, within 30 days of the end of the quarter.

April 15, 2003

Table 1. Net International Reserves of the NBRM
(In millions of U.S. dollars)

	End-Dec. 2002
Net international reserves [1 - 2]	653.9
1. Reserve assets [1.1 - 1.2]	734.6
1.1. Foreign assets	783.8
Gold	67.9
Demand deposits in foreign banks	202.6
Time deposits in foreign banks	497.2
Foreign currency at the NBM	8.2
Foreign securities	8.0
Letters of credits	0.0
Guarantees	0.0
Checks	0.0
1.2. Frozen, encumbered, pledged assets	49.2
Subordinated loan (AY Bank)	5.0
Booked funds (formerly AY Bank)	15.5
Other pledged assets	28.7
2. Reserve liabilities [2.1 + 2.2]	80.8
2.1. To nonresidents	69.5
IMF	67.4
BIS	0.0
Other	2.1
2.2. To residents 1/	11.3
Foreign currency deposists of banks	11.3
Required reserves	0.0
Other	0.0
Memorandum items:	
Net foreign assets	714.4
Foreign currency deposits of general government	134.0

Source: NBRM

1/ Foreign currency deposits of general government are excluded from reserve liabilities.

Table 2. Balance of Payments Financing Assumptions for 2003
(in millions of U.S. dollars)

	Mar-03	Jun-03	Sep-03	Dec-03
Grants	0.0	40.1	0.0	8.3
EU	0.0	10.4	0.0	8.3
The Netherlands	0.0	17.7	0.0	0.0
United States	0.0	12.0	0.0	0.0
Other	0.0	0.0	0.0	0.0
Loans	0.0	45.7	0.0	39.1
IBRD/IDA	0.0	35.3	0.0	20.3
EU	0.0	10.4	0.0	18.8
Other	0.0	0.0	0.0	0.0
Payments 1/	-6.4	0.0	-2.0	0.0
Total				
BOP financing assumptions for TMU (quarterly flows)	-6.4	85.9	-2.0	47.4
BOP financing assumptions for TMU (cumulative from end-December 2002)	-6.4	79.5	77.4	124.8

Source: NBRM and MOF projections

1/ NBRM assumption for debt service payments to France, Japan, Kuwait, and USA (deferral of April 1999–March 2000 maturities), with whom bilateral agreements are yet to be signed. Includes the repayment of technical arrears (US$4.3 million) in Q1.

FYR Macedonia—Fund Relations
(As of February 28, 2003)

I. **Membership Status**: Joined 12/14/92; Article VIII

		SDR Million	Percent of Quota
II.	**General Resources Account**:	SDR Million	Percent of Quota
	Quota	68.90	100.00
	Fund holdings of currency	87.62	127.17
III.	**SDR Department**:	SDR Million	Percent of Allocation
	Net cumulative allocation	8.38	100.00
	Holdings	1.58	18.89
IV.	**Outstanding Purchases and Loans**:	SDR Million	Percent of Quota
	Extended Arrangements	1.15	1.67
	Contingency and Compensatory	10.34	15.00
	Systemic Transformation Facility	7.23	10.50
	PRGF Arrangements	28.09	40.78

V. **Latest Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	12/18/2000	11/22/2001	10.34	1.72
EFF	11/29/2000	11/22/2001	24.12	1.15
ESAF/PRGF	04/11/1997	04/10/2000	54.56	27.28

VI. **Projected Obligations to the Fund**
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	12.8	13.7	6.7	6.0	5.1
Charges/Interest	0.5	0.4	0.2	0.2	0.2
Total	13.3	14.1	6.9	6.2	5.3

VII. **Safeguards Assessments:**

Under the Fund's safeguards assessment policy, National Bank of the Republic of Macedonia (NBRM) is subject to a full safeguards assessment with respect to the anticipated arrangement. An off-site assessment of the NBRM was completed on September 14, 2000. The assessment concluded that high risks existed in the external audit mechanism, the financial reporting framework, the internal audit mechanism, and in the system of internal controls, and recommended an on-site assessment. An on-site assessment was undertaken in February/March 2003 and the draft report is currently being finalized.

VIII. **Exchange Arrangement**:

The currency of the FYRM is the denar. The FYRM maintains a managed floating exchange rate system with a de facto peg to the Euro, where enterprises and households deal in separate markets. Whereas households can transact only through commercial banks or through foreign exchange bureaus that act as agents of banks, enterprises can sell foreign exchange to each other in addition to transacting through the banking system. Enterprises must use or sell export proceeds within 30 days. Bureaus can hold overnight foreign exchange positions equivalent to 50 percent of the preceding day's purchases. The effective reserve requirements on resident foreign currency deposits range from 0 to 75 percent, depending on the type and maturity of the deposit. At end-February 2003, the official exchange rate was denar 57.1 per U.S. dollar. The FYRM has accepted the obligations of Article VIII, Sections 2, 3, and 4 with effect from June 19, 1998. The FYRM maintains an exchange restriction subject to the Fund's approval under Article VIII, Section 2(a) arising from restrictions imposed on the transferability of proceeds from current international transactions contained in former frozen foreign currency saving deposits.

IX. **Article IV Consultations**:

The first consultation with the FYRM was concluded in August 1993. The last consultation was concluded on March 4, 2002 (SM/02/56). The FYRM is on the standard consultation cycle.

X. **Technical Assistance (since 1999)**:

Purpose	Department	Date
Balance of Payments Statistics	STA	June-August, 2000 October 2002
Value-Added Tax	FAD	February 1999 October 1999 October 2000
Development of a Treasury System	FAD	October 2000 November 2001
Tax Policy	FAD	December 2001

Purpose	Department	Date
Fiscal Decentralization	FAD/ World Bank	March 2002
Monetary Policy and Banking Supervision	MAE/ World Bank	October 1999
	MAE	December 1999 May 2000
Monetary Operations and Payment System	MAE	November-December 2002
Article VIII	MAE/LEG	September 2000
Resident Experts		
Value-Added Tax	FAD	October 1999-April 2001
Development of a Treasury System	FAD	January 2000-July 2001

XI. Resident Representative

The Fund has had a resident representative in Skopje since 1995. Mr. Jan Mikkelsen assumed the post on May 15, 2000.

FYR Macedonia—Debt Sustainability Analysis

Fiscal and external sustainability assessments were conducted over the medium-term. To test robustness of the projections, standardized sensitivity tests (in accordance to SM/02/166, endorsed by the Board in June 2002) were applied to the staff's baseline scenario.

Fiscal Sustainability

Under the staff's baseline scenario, the public debt to GDP ratio (including both contracted and guaranteed debt) is projected to decline by 11 percentage points between 2002 and 2007 to about 39 percent (Table 9). When the historical average values of real GDP growth, real interest rate and primary balance are used throughout the projection period, the public debt ratio declines further to about 37 percent, about 2 percentage points lower than the baseline scenario. This is mainly the result of lower historical average primary deficit and average real GDP growth. Further stress tests on the public debt ratio for the period 2002-2007 based on historical averages for isolated shocks result to: (i) a smooth decline of the ratio in the case of the historical average real interest rate; and (ii) a slight increase in 2004 and then a gradual decline by 2007 in the cases of the historical averages of real GDP growth, and of primary balance. A one time 30 percent real depreciation in 2003 increases the public debt ratio by about 22 percentage points in 2003. The debt ratio starts declining once the depreciation shock disappears to about 63 percent by 2007.

External Sustainability

The baseline scenario portrays a sustainable path with the debt to GDP ratio declining from 39 percent of GDP in 2002 to 34.6 percent in 2007 (Table 10). This comfortable outlook mainly hinges on the assumption of the GDP in US$ terms growing throughout this period at 7 percent per annum; of which 4.5 percentage points on average are attributable to the real GDP growth and 2.5–3 percentage points to the projected changes in the GDP deflator in US$ terms (implicitly allowing for the Balassa-Samuelson effect of equal magnitude). The baseline scenario also assumes that more than a half of the current account deficit (some 4 percent of GDP on average in 2003–07) will be covered with non debt creating inflows (FDI and unrecorded items that are shown as projected errors and omissions). Stress testing shows that this baseline scenario is subject to significant risks, which could render the external debt unsustainable in the imminent future. In the extreme case (when the US$ deflator in 2003 and 2004 is subject to negative shocks equal its two standard deviations), the debt to GDP ratio rises to 58.3 percent of GDP in 2003 and 84.8 percent of GDP in 2004. While this scenario is mainly driven by the changes in the US$ GDP deflator in 1994–95 (21.8 and 33 percent respectively), which reflected the episode of a steep real appreciation of the denar during the early disinflation period, other—more plausible—scenarios reveal important vulnerabilities of Macedonia's external position to shocks. Most notably, a combination of low (historic average) growth and rapidly widening current account deficit could raise the debt-to-GDP ratio to an unsustainable level if the resultant financing needs are to be covered with debt creating flows. Similarly, a *ceteris paribus* 30 percent depreciation of the denar would instantly elevate the debt-to-GDP ratio to 56.3 percent of GDP.

FYR Macedonia: IMF-World Bank Relations

1. This Annex briefly describes the Bank's current involvement in policy areas and structural reforms, pending the preparation of a new Country Assistance Strategy. The Bank has been operating under a Transitional Support Strategy (September 2001) which laid out a program of post-conflict support for FY02, extended to cover FY03. The upcoming CAS (to be ready by mid-2003) will be accompanied by an updated fuller version of this Annex, reflecting the Bank's full set of strategic priorities for FY04-06.

2. The key areas of Bank-Fund collaboration have been public expenditure management and budgeting and financial sector reform. In some other areas, the Bank's analysis and policy recommendations have contributed to the Fund's advice on fiscal policy and, in some cases, conditionality under the Fund program. These areas include the resolution of loss-making state enterprises, civil service reform, liberalization of labor market policies, better targeting and financial controls for social protection programs, and greater financial discipline in the health sector.

3. **Public expenditure management**. The Bank has supported the government's reform agenda to improve budget management and civil service management through a Public Expenditure and Institutional Review and a series of Public Sector Management Adjustment operations, the first of which was approved by the Bank's Board in April 2002. Within this agenda, the Bank has coordinated closely with the Fund on strengthening management of the public sector wage bill, controlling government guarantees, improving financial accountability through development of a Treasury, and improving the audit function.

4. **Financial sector reform**. A Financial and Enterprise Sector Adjustment Credit/Loan has provided support for financial sector reform, in particular, to improve the legal framework for banking activity, to strengthen bank regulation and supervision, to resolve problem banks, and to develop financial infrastructure such as a modern payments system. A Financial Sector Assessment Program will be undertaken jointly by Bank and Fund staff in mid-2003.

Questions may be referred to Ms. Jorgensen (473-5343), Mr. Funck (473-0874), and Mr. Gilbo (458-2449).

FYR Macedonia—Statistical Issues

The authorities, with technical assistance from the Fund, and other bilateral and multilateral agencies, have made significant progress in upgrading the country's statistical system in recent years. Continued efforts are being undertaken to further improve the quality and data availability of the country's statistical system. Data reporting to the Fund remains timely and an IFS page is available.

Real sector data have improved, but remaining deficiencies need to be addressed. Efforts to improve surveys and techniques are ongoing to harmonize GDP data from the production and expenditure approaches in line with international practices. Quarterly GDP estimates, based on a set of production indicators, are being produced on a regular basis. These estimates are being revised later to be consistent with the final annual GDP figures. Quarterly GDP data using the expenditure approach are not available. Calculations of deflators should be reviewed, as historical deflators appear to be out of line with price developments elsewhere in the economy. Consumer, retail, and producer price statistics are compiled on a timely basis. However, the procedures for determining the weights and adjusting for seasonality should be reviewed. Employment statistics continue to be unreliable. The annual labor force survey has been conducted every April since 1996, except 2001 when it was postponed until October 2001 following the outbreak of the security crisis.

The compilation and coverage of balance of payments data, in particular on external debt, have improved in recent years. However, a large portion of private transfers and short-term capital flows is unrecorded, which manifests itself in significant and fluctuating errors and omissions. Kosovo-related non-resident purchases are recorded as a separate item under exports of goods and services in the national income accounts but are not fully captured in the exports of goods and services under the balance of payments statistics. The technical assistance mission from the Fund in June-August 2000 identified the following areas where improvement was needed: (i) recording of external assets and liabilities of the monetary authorities in accordance with the BPM5 methodolology, and (ii) correcting the overstatement of private transfers due to transactions involving foreign currency accounts. Furthermore, the recent (October 2002) STA technical assistance mission recommended further improvements to the estimation of short-term trade credits, reviewed the work that had been carried out to adjust for the "Euro-conversion effect", and reviewed the work that had been carried out to improve the valuation of transactions in goods. Further recommendations were made relating to the valuation of imports of goods and to the estimation of transportation services.

No government finance statistics (GFS) have been reported to STA since the annual data for 1996 were provided by the Ministry of Finance and published in IFS. However, satisfactory sources exist for central government fiscal data from which GFS can be compiled. The data for extra-budgetary funds are less reliable. Off-budget operations and special revenue and expenditures of line ministries have been compiled with a lag since February 2001. Data on domestic arrears are not fully reliable.

Money and banking data are reported to the Fund on a regular basis. Since mid-2000, the National Bank of Macedonia (NBM) has broadened its coverage of foreign reserve assets recorded in its balance sheet to include the counterpart of government foreign currency deposits held at the NBM. The institutional coverage of monetary statistics could be improved by including all other depository corporations, such as savings houses. Improvement of the analytical usefulness of interest rates could be made by compiling weighted average lending and deposit rates. Other improvements could also be made in the data reported by the commercial banks to the NBM for specific analytical and supervisory purposes, such as reporting of data on credit by economic activity, and monthly data on full financial statements of the banks.

The authorities have expressed their intention to participate in the General Data Dissemination System (GDDS). They designated a GDDS coordinator in March 2001 and submitted draft metadata to STA in October 2002. STA is currently reviewing the metadata and will communicate its comments to the authorities in the coming weeks.

FYR Macedonia—Core Statistical Indicators
(as of March 27, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Debt/ Debt Service
Date of Latest Observation	Mar 26	Mar 10	Jan 31	Mar 17	Jan 31	Feb 28	February	January	November	Jan 31	September	Dec 31
Date Received	Mar 26	Mar 13	Feb 25	Mar 18	Feb 25	Mar 3	Mar 6	Mar 24	Jan 24	Feb 28	Dec 27	Jan 24
Frequency of Data	Daily	Daily	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly
Frequency of Reporting	Weekly	Weekly	Monthly	Weekly	Monthly	Monthly	Monthly	Variable	Variable	Monthly	Quarterly	Variable
Source of Update	NBM	NBM	NBM	NBM	NBM	NBM	SOM	NBM	NBM	MOF	SOM	MOF/NBM
Mode of Reporting	Fax	Fax	Fax/E-mail	Fax	Fax/E-mail	Fax	Fax/E-mail	E-mail	E-mail	E-mail	Mission/ Fax	Mission/ E-mail
Confidentiality	UR	UR[1]	UR[1]	UR[1]	UR	UR	UR	UR	UR[1]	UR[1]	UR	SB
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly	Quarterly	Monthly

List of abbreviations:

NBM: National Bank of Macedonia
MOF: Ministry of Finance
UR: Unrestricted use
SB: For use by staff and the Executive Board
SOM: Statistics Office

[1] Preliminary data received by Fund staff before it has been published by the authorities should be treated as confidential.

FYRM: Selected Social and Demographic Indicators

	FYRM	Albania	Bulgaria	Romania	Greece
Area characteristics					
Total land area (sq km)	25,430	27,400	110,550	230,340	128,900
Of which: arable land (1999, in percent)	23.1	21.1	38.9	40.5	21.4
Population density (2000, people per sq km)	79.9	124.5	73.9	97.4	81.9
Population					
Total population (2000, in thousands)	2,031	3,411	8,167	22,435	10,560
Average annual population growth (2000, in percent)	0.7	0.8	-0.5	-0.1	0.2
Life expectancy at birth (2000, in years)	72.8	73.9	71.5	69.9	77.9
Male	70.6	71.7	68.1	66.1	75.3
Female	75.1	76.4	75.2	73.8	70.7
Under 5-years mortality rate (2000, per 1,000 live births) 1/	16.9	30.6	15.8	23.0	8.2
Crude birth rate (2000, per 1,000 persons)	13.5	17.2	9.0	10.4	11.7
Crude death rate (2000, per 1,000 persons)	8.4	5.5	14.1	11.4	10.5
Income and poverty					
GDP per capita (2000, in U.S. dollars)	1,759	1,100	1,469	1,637	10,667
Poverty rate (2000, in percent) 2/	22.3	29.6	11.7	21.5	...
Urban	18.8	17.2	...	20.4	...
Rural	27.2	36.8	...	27.9	...
Health					
Physicians (1997, per 1,000 persons)	2.3	1.4	3.3	1.8	4.1
Hospital beds (1997, per 1,000 persons) 3/	5.2	3.2	8.6	7.6	5.0
Education					
Net enrollment ratios (1998, in percent)					
Primary 4/	95.5	101.7	93.4	94.5	94.6
Secondary 5/	79.3	38.2	80.8	75.5	86.4

Sources: World Development Indicators, 2002, World Bank; FYRM: Statistics Office; Bulgaria: Poverty Assessment Update, 2001, World Bank; World Development Report 2002, World Bank; and Albania: National Strategy for Socio-Economic Development, Medium-term Program of the Albanian Government "Growth and Poverty Reduction Strategy", November 2001.

1/ Data for Albania is for 1996.
2/ Percentage of population below the national poverty line. For FYRM, the poverty rate or the incidence of poverty is the proportion of individuals with an income (consumption) below 70 percent of median monthly 2000 consumption. Data for Romania refer to 1994. For Bulgaria, data refers to 2001 and the poverty rate is the proportion of individuals with consumption below two-thirds of median consumption in 1997. Data for urban Albania refer to 1998.
3/ Data for Albania is for 1995, and for Romania is for 1996.
4/ Data for Albania is for 1995.
5/ Figure for Albania is gross enrollment ratio for 1996.

Press Release No. 03/63
FOR IMMEDIATE RELEASE
April 30, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Approves US$28 Million Stand-By Credit for the Former Yugoslav Republic of Macedonia

The Executive Board of the International Monetary Fund (IMF) today approved a Stand-By Arrangement for SDR 20 million (about US$28 million) for the former Yugoslav Republic of Macedonia in support of the country's economic program for the period April 30, 2003-June 15, 2004. The decision will enable FRY Macedonia to draw SDR 4 million (about US$5.5 million) from the IMF immediately.

The Stand-By Arrangement follows a staff-monitored program with the IMF during the first half of 2002, which the authorities had requested after the cancellation of the arrangements under the Poverty Reduction and Growth Facility (PRGF) and the Extended Fund Facility (EFF) in November 2001.

Following the Executive Board discussion, Shigemitsu Sugisaki, Deputy Managing Director and Acting Chair, said:

"The former Yugoslav Republic of Macedonia authorities have adopted an economic program to promote fiscal and external sustainability. The program restores the fiscal deficit to a sustainable level after the spending surges following the 2001 security crisis, and builds on the successful record of monetary policy. The elimination of the distortionary financial transaction tax and the implementation of measures aimed at increasing labor market flexibility, promoting exports and improving the business climate will pave the way for a resumption of economic growth, a reduction in unemployment, and improvements in living standards. The successful implementation of the program will require resolve on the part of the authorities and consolidation of inter-ethnic peace.

"The authorities' economic strategy is realistic and prudent. The fiscal adjustment aims at reducing the budget deficit in 2003 to a level consistent with stabilizing the net public debt at 40 percent of GDP. This is to be achieved by elimination of some non-recurrent expenditures, bringing recurrent spending back to the pre-crisis level, and rationalizing the VAT rate structure. The authorities intend to keep the fiscal deficit at a sustainable level in 2004 and beyond, while accommodating public investment needed for improvements in infrastructure.

"The authorities' program is consistent with the Peace Framework Agreement and makes provisions for expenditure related to the devolution of certain responsibilities to local government institutions. The authorities are prepared to move with caution in this area in order to ensure that the fiscal decentralization does not undermine the efficiency and accountability of fiscal operations.

"The de facto peg of the denar to the euro has served the former Yugoslav Republic of Macedonia well in the past, sustaining its impressive record of low inflation during turbulent times. The level of the exchange rate remains consistent with the objective of maintaining competitiveness, economic growth, and low inflation. The authorities have supported the peg by enhancing the transparency of the interbank foreign exchange market," Mr. Sugisaki said.

ANNEX

Recent Economic Developments

When the security crisis erupted in the spring of 2001, growth came to a halt and macroeconomic balance was disrupted. While the loss of life and destruction of property were limited, the crisis slowed structural reform and sapped business confidence. Real GDP declined by 4.5 percent in 2001 and a further 1.5 percent year-on-year in the first six months of 2002. Government spending ballooned during the crisis and in the run-up to elections in 2002. Security spending, though partly covered by an emergency financial transactions tax, nonetheless propelled the general government deficit to 7.2 percent of GDP in 2001 (including foreign-financed projects), compared with a surplus of 1.8 percent of GDP in 2000. Fiscal consolidation planned for 2002 did not materialize owing to the postponement of security personnel demobilization and pre-election spending surge.

The impact of the deficits, however, was cushioned by a large inflow of proceeds from telecoms privatization in 2001 and donor finance in early 2002. These privatization and donor receipts—together with monetary tightening—made it possible to maintain the exchange rate peg and keep inflation low against the backdrop of large fluctuations in monetary aggregates.

In the second half of 2002, growth and exports recovered. Industrial output picked up, particularly in the textile and steel industries, and business confidence appeared to be returning. Real GDP is estimated to have increased by 2 percent year-on-year in the second half of the year. Textile exports are back to pre-crisis levels and metals exports have increased. In late 2002 and January 2003, international reserves declined, reflecting the weakening of fiscal discipline, but the exchange market pressure eased in February 2003 and interest rates have come down.

Program Summary

Political normalization and the implementation of the Peace Framework Agreement (PFA) have set the stage for a resumption of economic growth. The authorities' program is aimed at creating the economic basis for sustained growth and increased employment. The main elements of the program are fiscal adjustment to reduce the crisis-related imbalances and restore fiscal sustainability; maintaining the fixed exchange rate anchor, with comfortable reserve cover; and implementing pro-market structural reforms in the labor market. In this climate, real GDP is projected to grow by 3 percent in 2003 and 4 percent in 2004. Average inflation is projected to remain at about 3 percent per annum.

FYR Macedonia's balance of payments position is projected to improve in 2003. Exports are expected to sustain the recovery that began in the second half of 2002, reflecting new contracts in the textile industry and the reopening under new private ownership of a large formerly loss-making enterprise. Imports are expected to increase moderately as imports of used cars, which peaked in 2002 owing to a relaxation of import restrictions, return to normal levels. The external debt burden is moderate. At end-2002, the stock of medium- and long-term external debt is estimated to amount to the equivalent of 39 percent of GDP while debt service payments are estimated at about 16.5 percent of exports of goods and services.

Given the large fiscal deficits over the last two years, fiscal adjustment is a key objective of the program. Adjustment is needed both in order to stabilize FYR Macedonia's public debt ratio at about 40 percent of GDP, and in order to lower interest rates and create more room for private sector credit. Through a mix of cuts in goods and services spending and an increase in VAT collection by reforming the VAT-rate structure, the government intends to reduce the general government deficit (including foreign-financed projects) to 2.7 percent of GDP in 2003 and to about 2.5 percent in 2004–the debt stabilizing level. Excluding foreign-financed projects, these general government deficits correspond to 2 percent of GDP in 2003 and 1.3 percent in 2004. The authorities further intend to implement structural fiscal reforms to support the execution of the budget.

On exchange rate and monetary policy, the National Bank of the Republic of Macedonia (NBRM) has developed a monetary program consistent with maintaining the de facto fixed exchange rate and increasing gross foreign exchange reserves to the equivalent of four months of imports. Real exchange rate indicators suggest that external competitiveness is adequate. In 2003, the improved fiscal position and donor support is expected to ease the pressure on monetary policy and should create scope for lower interest rates on NBRM bills in 2003 compared with 2002. The NBRM will continue to monitor foreign exchange flows and, in the event of pressure on the foreign exchange market, will take appropriate measures, including exchange market interventions, operations with NBRM bills, and adjustments of interest rates.

On structural reforms, the government intends to implement measures to address rigidities and improve incentives structures in the labor market. The key elements include measures to increase the flexibility of the labor market by scaling back overly generous unemployment benefits and severance packages and implementing a range of active labor market policies; the completion of the privatization process; the resolution of the remaining loss-making enterprises; a program to support small and medium-sized enterprises (SMEs); and the deepening of banking sector reforms. Further, the government plans to improve public sector governance and transparency, which will be essential to reactivate the business sector and attract foreign direct investments over the medium-term.

Although preparations are underway to bring the privatization process to an end, there will continue to be an urgent need to strengthen governance in already privatized enterprises. The ability of banks to channel domestic savings into productive activities in the private sector will be essential for achieving high and sustainable economic growth. Thus, the improvement of strict enforcement of bank supervisory and prudential regulations will continue. Further measures to strengthen the banking sector and bank supervision will be defined in light of the findings of the forthcoming Financial Sector Assessment Program (FSAP) mission and will be incorporated into the program conditionality at the first review under the program.

On trade policy, the authorities will allocate tariff free import quotas on a quarterly instead of a semi-annual first-come first-serve basis in an effort to limit the scope for market dominance by a few trading companies.

FRY Macedonia joined the IMF as a member on December 14, 1992. Its quota[1] is SDR 68.9 million (about US$95 million), and its outstanding use of IMF credits totals SDR 45.9 million (about US$63 million).

[1] A member's quota in the IMF determines, in particular, the amount of its subscription, its voting weight, its access to IMF financing, and its allocation of SDRs.

FYRM: Selected Economic Indicators, 1998-2004								
	1998	1999	2000	2001	2002		2003	2004
							Projection	
Real economy	(Percent change)							
Real GDP	3.4	4.3	4.5	-4.5	0.3	*a, b*	3.0	4.0
Consumer prices								
period average	-0.1	-0.7	5.8	5.3	2.4	*a*	3.0	3.0
end of period	-3.1	2.6	6.1	3.7	1.0	*a*	2.7	3.0
Real wages, period average	3.7	3.6	-0.3	-1.7	4.4	*a, b*	2.1	2.0
Unemployment rate (average)	34.5	32.4	32.2	30.5	31.9	*b*	30.4	...
Government finances	(In percent of annual nominal GDP)							
General government balance (excluding foreign-financed projects)	-1.7	0.0	2.5	-6.3	-5.6		-2.0	-1.2
General government balance (including foreign-financed projects)	-1.7	0.0	1.8	-7.2	-5.8		-2.7	-2.5
Revenues	33.3	35.4	36.6	34.4	35.9		33.7	32.9
Total expenditures	35.0	35.4	34.9	41.6	41.7		36.4	35.3
Central government balance	-0.8	0.8	2.7	-5.8	-5.4		-1.6	-0.9
Government debt 1/								
Gross	52.0	57.4	53.2	51.6	50.3		44.8	41.3
Net	52.0	53.8	46.0	41.6	43.9		40.2	39.5
Money and credit	(Percent change, end of period)							
Broad money (M3) 2/	14.9	29.7	25.6	56.7	-8.6	*c*	6.8	...
Total credit to private sector	10.4	9.4	17.2	7.3	9.9	*c*	9.5	...
Short-term lending rate (percent)	20.5	20.0	19.0	19.2	17.7		...	...
Interbank money market rate (percent)	18.1	11.6	7.2	11.9	14.4		...	...
Balance of payments	(In millions of U.S. dollars)							
Exports	1,292	1,190	1,321	1,155	1,105	*b*	1,236	1,341
Imports	1,807	1,686	2,011	1,677	1,857	*b*	1,961	2,051
Trade balance	-515	-496	-690	-521	-752	*b*	-725	-710
Current account balance								
excluding grants	-307	-105	-208	-282	-414	*b*	-404	-361
(in percent of GDP)	-8.6	-2.9	-5.8	-8.2	-11.2	*b*	-9.3	-7.8
including grants	-269	-32	-75	-234	-318	*b*	-299	-308
(in percent of GDP)	-7.5	-0.9	-2.1	-6.8	-8.6	*b*	-6.9	-6.6
Overall balance	36	166	226	118	-123	*b*	25	47
Official gross reserves 3/	290	450	700	756	735		765	804
(in months of following year's imports								
of goods and services)	1.8	2.4	4.3	4.3	3.9	*b*	3.9	3.9
External debt service ratio 4/	9.5	12.4	13.0	19.0	16.5	*b*	13.6	11.7
External debt to GDP ratio (percent)	38.5	39.2	40.1	38.0	39.0	*b*	36.5	36.6
Exchange rates 5/	(Percent change, period average)							
Nominal effective exchange rate	0.9	12.4	12.4	3.3	0.7	*d*	...	...
Real effective exchange rate (CPI-based)	-7.0	2.9	4.0	-6.1	-2.4	*d*	...	...

Real effective exchange rate (ULC-based)	-11.4	7.3	7.7	-4.5	1.4	*e*	...	...

Sources: Data provided by the FYRM authorities; and IMF staff projection.

a. Percentage change relative to the same period of the previous year.

b. Estimate.

c. Percentage change relative to December of previous year.

d. January-November 2002.

e. January-September 2002.

1/ Total debt of the general government; includes liabilities assumed by the government upon the sale or closure of loss-making enterprises and associated with the cleaning up of Stopanska Banka's balance sheet prior to its sale.

2/ Includes foreign currency deposits.

3/ Includes receipts from privatization of telecommunications company of US$323 million in January 2001.

4/ Debt service due, including IMF, as a percentage of exports of goods and services.

5/ An increase means appreciation of the denar. Partner countries include Federal Republic of Yugoslavia and Bulgaria.

Statement by the IMF Staff Representative
April 30, 2003

1. This statement reports on the safeguards assessment of the National Bank of the Republic of Macedonia, which was finalized after the issuance of the Staff Report for the 2003 Article IV Consultation and Request for Stand-By Arrangement. This statement does not alter the thrust of the staff appraisal.

2. The safeguards assessment of the National Bank of the Republic of Macedonia, referred to in paragraph 48 of the Staff Report for the 2003 Article IV Consultation and Request for Stand-By Arrangement, has now been finalized. The staff's assessment is that there are no systemic vulnerabilities in the safeguards of the NBRM, but that a few weaknesses could be addressed through measures to further strengthen the NBRM's operations and reduce the possibility of misreporting and misuse of Fund resources. The priority recommendations are for the NBRM (i) to establish a formal process of reconciling the economic data that are prepared for the IMF program with the corresponding accounting records, and (ii) to publish the complete version of its 2002 audited financial statements. The authorities have agreed with the staff findings and recommendations and the relevant measures will be monitored by staff under the Stand-By Arrangement

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 03/63
FOR IMMEDIATE RELEASE
May 20, 2003

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2003 Article IV Consultation with the former Yugoslav Republic of Macedonia

On April 30, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the former Yugoslav Republic of Macedonia.[1]

Background

The negative effects of the 2001 security crisis on growth persisted in the early months of 2002, but a turnaround in performance took place in the second half of the year. Real GDP declined by 2 percent, year-on-year, in the first six months of 2002, but a recovery in key sectors is estimated to have increased growth for the year as a whole to 0.5 percent. Industrial output picked up, particularly in the textile and steel industries. Peaceful elections and a decline in ethnically-based violence raise hopes that investor confidence is returning.

The fiscal consolidation planned in the original 2002 budget did not materialize mainly because expenditures departed significantly from the budget. The fiscal deficit in 2002 reached 5.8 percent of GDP, only 0.5 percentage point of GDP below the 2001 level.

The external current account worsened. Exports remained low in the first half of 2002 reflecting problems with market access and lagged effects of the crisis, but they recovered some of the lost ground in late 2002. Notwithstanding the gradual but steady improvement in exports, the current account deficit (excluding transfers) widened to 11.3 percent owing to a surge in imports and a number of one-time factors. As a result the loss of foreign exchange was heavy, but the impact on reserves was cushioned by exceptional financing: privatization receipts in early 2001 and donor support following the 2002 donor conference.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

FYR Macedonia succeeded in maintaining the de facto exchange rate peg against the backdrop of large fluctuations in monetary aggregates. Electoral uncertainties and a weakening of fiscal discipline in the second half of 2002 increased the pressures in the foreign exchange market, but the availability of exceptional financing sources and the National Bank of the Republic of Macedonia's (NBRM) tight monetary policy stance enabled FYR Macedonia to maintain a comfortable level of foreign exchange reserves—4 months of imports and 100 percent of private denar broad money at end-2002—and reinforce the credibility in the exchange rate peg. Annual inflation rates, anchored by the peg, remained in single digits.

FYR Macedonia's track record in structural reforms remains mixed. The banking sector has strengthened but still has deep-rooted weaknesses. Non-performing loans are close to a third of the total and small banks remain weak, but profitability indicators are improving. However, the high degree of euroization of banks' assets and liabilities makes the assessment of banks' vulnerabilities particularly complex. The trade regime is fairly open. Free trade agreements have been signed with neighboring countries and with the European Union, and Parliament has recently ratified the WTO accession treaty. Efforts to downsize the public sector through divesting non-core activities and reducing employment in the public sector administration have been put on hold by the commitment of the signatories of the peace framework agreement (PFA) to increase the representation of minorities. Corporate governance in the enterprise sector remains weak. On one hand, many old firms survive with substandard performance, and progress in winding up a few large loss-making enterprises has been slow. On the other hand, profitability has improved among small and medium-size new firms.

The main policy challenges ahead are to reduce macroeconomic imbalances while implementing the PFA, address fiscal and external vulnerabilities, and generate the conditions for growth. Tackling these issues will require a combination of fiscal adjustment and structural reforms. The strategy of the new government envisages maintaining the de facto exchange rate peg, reducing the fiscal deficit over a two-year period (partly through clawing back in 2003 the non-recurrent aspects of the 2002 outlays), and putting in place reforms to strengthen private sector growth. To support implementation of such a program the authorities have requested a Stand-by arrangement covering the period from April 30, 2003 to June 15, 2004.

Executive Board Assessment

Executive Directors shared the authorities' view that the main priority in the former Yugoslav Republic of Macedonia is to boost economic growth and reduce unemployment following the sharp recession caused by the 2001 security crisis. In this regard, they welcomed the authorities' intention to focus on achieving a stable macroeconomic environment and strengthening the business climate in order to stimulate private investment; and they endorsed the strategy for achieving these objectives, which involves reining in the fiscal deficit, maintaining the de facto fixed exchange rate, addressing corruption, restarting structural reforms, and pressing ahead with the implementation of the Ohrid Peace Framework Agreement.

Directors stressed that fiscal consolidation is necessary to ease pressures on the external current account, allow more rapid growth of credit to the private sector, and stabilize the public debt at 40 percent of GDP or less. They cautioned that the high share of foreign currency-denominated debt and the government's large potential liabilities increased the former Yugoslav Republic of Macedonia's medium-term fiscal and external vulnerability. Most Directors considered the stance of fiscal policy for the period 2003-04 to be adequate for achieving fiscal and external sustainability. Directors considered the envisaged rapid pace of fiscal adjustment to be important for reinforcing the credibility of the government.

Directors generally agreed that the immediate fiscal adjustment should occur mostly through a winding-down of crisis-related spending, the expiration of other non-recurrent expenditures, and cuts in recurrent spending. For the medium term, they stressed the need to reduce public sector employment and to reform treasury operations in order to strengthen expenditure control. While success in carrying out the Peace Framework Agreement will be essential to restoring business confidence, accompanying pressures on public sector employment should be resisted. Furthermore, fiscal decentralization, an important element of the Peace Framework Agreement, will have to be implemented cautiously so as not to compromise fiscal soundness and accountability. Directors welcomed the expiration of the distortionary financial transaction tax and the rationalization of the value added tax, and called for improvements in tax administration to further strengthen the reliability and fairness of the value added tax structure.

Directors observed that the de facto pegged exchange rate regime has served the former Yugoslav Republic of Macedonia well as the monetary anchor, keeping inflation low even during the security crisis. They welcomed the recent reforms to increase the transparency of the interbank foreign exchange market. Directors agreed that, for the time being, and given the current limited capital mobility, the de facto peg remains appropriate in anchoring inflation if supported by prudent fiscal policy, greater labor market flexibility, and banking sector reforms. However, Directors suggested that the appropriateness of the exchange rate regime be reviewed in light of the gradual liberalization of capital flows, and that an adequate strategy be prepared in advance for a possible exit from the de facto peg. A number of Directors felt that a more flexible exchange rate system would help mitigate external shocks and reduce the risk of financial crisis. Directors supported the authorities' cautious and gradualist approach toward capital account liberalization, and the strengthening of monetary control through auctions of central bank bills. They also called for steps to increase central bank independence.

Directors expressed concern over the extent of euroization of the banking system. They urged the central bank to maintain a proactive supervisory stance, to monitor banks' foreign exposure and liquidity closely and to maintain adequate international reserve coverage. They welcomed the intention to introduce a reserve requirement on foreign currency deposits. Directors urged the central bank to address problem banks in a decisive manner, including by closure if appropriate. They stressed the importance of strengthening market discipline and protecting depositors. They welcomed the decision to participate in a Financial Sector Assessment Program.

Directors urged the authorities to press ahead with structural reforms to increase economic growth and employment opportunities and to reduce the external current account deficit. They emphasized that enterprises should be subject to market discipline, hard budget constraints, and strengthened bankruptcy procedures. While they encouraged further privatization, they stressed the need to follow transparent procedures and to avoid insider privatization. At the same time, the business environment needs to be improved to encourage investment, through, inter alia, steps to fight corruption, increase the flexibility of the labor market, and institute transparent bankruptcy procedures. In this regard, Directors praised the authorities' decision to step up the fight against corruption and urged them to be persistent and even-handed in these efforts. They stressed the importance of broad-based progress in public sector and corporate governance. Directors also welcomed the recent steps toward greater labor market flexibility and urged the authorities to bring labor market institutions under a more comprehensive review. However, they were skeptical of the authorities' program to provide fiscal incentives for hiring:

subsidies might have only a limited impact on employment and could distort firms' investment and hiring decisions.

Directors stressed the need to diversify the export base to reduce the dependence on the volatile steel and textile exports. They welcomed the former Yugoslav Republic of Macedonia's accession to the World Trade Organization. They noted that further trade liberalization will increase competition, and urged the authorities to confront this challenge by removing impediments to efficiency.

Directors welcomed the recent upgrading of the framework for combating money laundering and the financing of terrorism. They urged the authorities to take additional steps to freeze terrorist assets without delay and to fully implement the UN Security Council Resolution and Conventions on terrorism financing.

Directors welcomed the authorities' efforts toward increased transparency and compliance with best statistical practice, and their intention to participate in the GDDS and in a data ROSC module.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with the former Yugoslav Republic of Macedonia is also available.

FYR Macedonia: Selected Economic Indicators

	1998	1999	2000	2001	2002 (prel.)
Real GDP growth	3.4	4.3	4.5	-4.5	0.3
CPI (eop)	-3.1	2.6	6.1	3.7	1.0
Unemployment rate (average)	34.5	32.4	32.2	30.5	31.9
General government balance (excluding grants)	-1.7	0.9	1.8	-7.2	-5.8
Central government balance	-0.8	0.8	2.7	-5.8	-5.4
Government debt to GDP ratio (net)	52.0	53.8	46.0	41.6	43.9
Broad money (M3)	14.9	29.7	25.6	56.7	-8.6
Total credit to private sector	10.4	9.4	17.2	7.3	9.9
Trade Balance	-14.4	-13.5	-19.3	-15.2	-20.4
Current account balance (excluding grants)	-8.6	-2.9	-5.8	-8.2	-11.2
External debt to GDP ratio	38.5	39.2	40.1	38.0	39.0
Official reserves (months of prospective imports)	1.8	2.4	4.3	4.3	3.9

Sources: FYR Macedonia authorities and IMF staff estimates.