

Former Yugoslav Republic of Macedonia: First Review Under the Stand-By Arrangement and Request for Waiver of Applicability of Performance Criteria—Staff Report; Staff Statement; Press Release on the Executive Board Discussion

In the context of the first review under the Stand-By Arrangement and request for waiver of applicability of performance criteria, the following documents have been released and are included in this package:

- the staff report for the first review under the Stand-By Arrangement and request for waiver of applicability of performance criteria, prepared by a staff team of the IMF, following discussions that ended on **August 8, 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 September 29, 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 **October 17, 2003** updating information on recent developments.
- Press Release summarizing the **views of the Executive Board as expressed during its October 17, 2003 discussion** of the staff report that completed the review.

The documents 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*
Supplementary Memorandum of Economic and Financial Policies by the authorities of the
Former Yugoslav Republic of Macedonia*
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.

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INTERNATIONAL MONETARY FUND
FORMER YUGOSLAV REPUBLIC OF MACEDONIA
**First Review Under the Stand-By Arrangement
and Request for Waiver of Applicability of Performance Criteria**

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

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September 29, 2003

Contents	Page
Executive Summary	4
I. Introduction.....	5
II. Background.....	6
III. Policy Discussion.....	9
A. Financial Policies in 2003 and 2004	10
B. Structural Reforms	12
C. Program Design and Monitoring	16
IV. Staff Appraisal	16
Text Tables	
1. Real Sector Developments in 2003.....	6
2. Current Account Developments in 2003.....	7
3. Central Government Operations, Revised Fiscal Program, 2003	8
Text Chart	
1. Central Government Balance, 2001-2003.....	10
Text Boxes	
1. Main Recommendations of the Financial Sector Assessment Program	14
2. FRY Macedonia, Public Expenditure Management Reform	15

Figures

1.	Selected Economic Indicators, 1996-2003	19
2.	Real Sector Developments, 1998-2003.....	20
3.	Monetary and Financial Indicators, 1998-2003	21
4.	External Sector Developments and Competitiveness	22

Tables

1.	Selected Economic Indicators, 1998-2204	23
2.	Central Government Operations, 2000-2004.....	24
3.	General Government Operations, 2000-2004	25
4.	National Bank Accounts, 2001-2004.....	26
5.	Monetary Survey, 2002-2004	27
6.	Balance of Payments, 2001-2004	28
7.	Macroeconomic Framework, 1998-2004.....	29
8.	Indicators of Financial and External Vulnerability, 1999-2003	30

Appendices

I.	Fund Relations	31
II	IMF-World Bank Relations	34
III	Statistical Issues	45
IV	Letter of Intent and Supplementary Memorandum on Economic and Financial Policies	48
	Table 1. Quantitative Performance Criteria and Indicative Targets for 2003 and Q1 2004	56
	Table 2. Structural Performance Criteria and Structural Benchmarks Under the Stand-By Arrangement	57
	Table 3. Schedule of Purchases Under the Stand-By Arrangement	59
V.	Technical Memorandum of Understanding	60
	Table 1. Net International Reserves of the NBRM.....	70
	Table 2. Balance of Payments Financing Assumptions For end-December 2002-end-March 2004.....	71
VI.	Social Indicators.....	72

ABBREVIATIONS AND ACRONYMS

AML/CFT	Anti-Money Laundering/Combating of Financing Terrorism
EBF	Extrabudgetary Funds
FAD	Fiscal Affairs Department
FSAP	Financial Sector Assessment Program
FYRM	Former Yugoslav Republic of Macedonia
GDP	Gross Domestic Product
GFS	Government Financial Statistics
HIF	Health Insurance Fund
IMF	International Monetary Fund
MIPS	Macedonia Interbank Payments Systems
MOF	Ministry of Finance
NBRM	National Bank of the Republic of Macedonia
NIR	Net International Reserves
SBA	Stand-By Arrangement
SDR	Special Drawing Rights
SMEFP	Supplementary Memorandum of Economic and Financial Policies
TSA	Treasury Single Account
VAT	Value-Added Tax

EXECUTIVE SUMMARY

FYR Macedonia's program has been implemented against the background of an incipient and still fragile recovery of growth and lower-than-anticipated inflation. The annual growth projection has been shaved from 3 percent to 2¾ percent, to reflect risks stemming from the fact that growth in the first half of the year was concentrated in a small number of exporting firms. The inflation outlook for the year was revised from 3 percent to 1¾ percent after the appreciation of the euro (to which the denar is pegged) and a dip in food prices brought inflation close to zero in the first half of the year. Finally, the external current account deficit for the year, while still large at 8½ percent of GDP, is now expected to be slightly smaller than originally projected since a strong export performance is likely to offset the temporary import surge in the first half of the year.

All performance criteria under the program were met, while one indicative target and one structural benchmark (both in the health sector) were not.

Given significant structural delays in spending in the first half of the year, fiscal discussions focused on whether to raise spending in the second half of the year and reach the original annual deficit targets, or to save the underspending from the first half and lower the annual deficit. The authorities preferred to adhere to the original program targets while the mission argued that the abrupt whipsawing of demand—and possibly also interest rates—could be destabilizing. The outcome of the discussions was a revised budget in which all of the underspending on capital goods but only half of the underspending on recurrent items will be made up in the second half. This will deliver a strong fiscal impulse in the second half of the year. Also, the large injection of liquidity from the use of central bank credit could put significant pressure on external reserves and require a hike in interest rates in order to reach program targets. The NBRM took the view that the liquidity injection could be absorbed without an increase in interest rates but committed to increasing the interest rate if necessary.

Discussions on structural reforms under the program focused on: the implementation of FSAP recommendations (strengthening bank supervision in the context of increasing euroization and improving the regulatory framework); measures to bring cost cutting measures in the health sector back on track; and the need to ensure that fiscal decentralization moves ahead in a phased and orderly way, in line with FAD advice and consistent with the development of administrative capacity in the new municipalities. In addition, staff urged the authorities to strengthen collection of the VAT and pension contributions and to continue reforms of the treasury and budget management.

Looking ahead to 2004, while the first quarter external imbalance (covered by the program) is financed, the remainder of the year is not. The authorities will thus need to secure additional balance of payments financing in order to keep gross international reserves close to four months of imports. In addition, since the government's deposits at the central bank (privatization receipts from earlier years) are being run down, it will be important to move ahead with plans to develop a government securities market as an alternative source of domestic finance.

I. INTRODUCTION

1. **A staff team visited Skopje during July 23-August 8, 2003 to hold discussions for the first review under the Stand-By Arrangement (SBA).**¹ On April 30, 2003 the Executive Board approved the 14-month SBA for SDR 20 million or 29 percent of quota (25 percent of quota on an annual basis), to be made available in five equal tranches—a first purchase upon Board approval of the program and the remainder subject to performance and two program reviews, (IMF Country Report/03/131). The mission assessed performance under the program to date and reached understandings, ad referendum, on a Supplementary Memorandum on Economic and Financial Policies (SMEFP, Appendix IV). The authorities have expressed interest in a follow-up program.

2. **All quantitative performance criteria and most indicative targets under the program to date have been met (SMEFP Tables 1 and 2).** The fiscal and monetary targets for end-June were met by large margins, mainly due to low fiscal spending in the first half of the year—about 1¼ percent of GDP below the programmed level—and to a return of confidence in the denar. One indicative quantitative target, the non-accumulation of arrears by the Health Insurance Fund (HIF) was not met. In the structural area, the one performance criterion (a July 1 increase in the electricity price) was met, as were the benchmarks on expenditure control, including wages, labor market flexibility and the NBRM audit, but the audit of the HIF was initiated behind schedule.

3. **Two years after the signing of the General Framework Agreement for Peace (Ohrid Agreement), ethnic and political tensions persist and significant challenges lie ahead.** On the security front, a recent flurry of violent incidents—while largely criminal in nature—is undermining the business climate and testing the capacity of the authorities to maintain order. High—and rising—measured unemployment is also raising the political temperature at a time when overstaffing—in public agencies and enterprises—calls for labor shedding. On a more positive note, consultations between the political parties within the government have become more timely and regular, helping to defuse potentially explosive issues; there are also regular meetings between the Prime Minister and the leader of the main opposition party. A critical test of the political dialogue will be negotiations on municipal boundaries, which are needed in order to move ahead, in 2004, with a politically sensitive program of administrative and fiscal decentralization.

¹ The staff team was composed of Mr. Rozwadowski (head), Ms. Ribakova, Ms. Dieterich, Ms. Tuladhar (all EU1), Mr. Wiczorek (PDR) and Mr. Quintyn (MFD). The IMF's resident representative in Skopje, Mr. Ross participated in the discussions. The mission met the Prime Minister, the Ministers of Finance, Interior and Education, and the Governor of the NBRM. The mission also met with labor leaders, the leaders of some political parties and representatives of the international community.

II. BACKGROUND

Text Table 1. Real Sector Developments in 2003

(Percentage change; period average)

	H1		Annual	
	Prog.	Prel.	Prog.	Proj.
Growth	2.5	2.7	3.0	2.8
Inflation	2.3	0.3	3.0	1.8

Source: Macedonian authorities and IMF staff estimates.

4. **Growth in 2003 to date was broadly in line with program projections (Text Table 1), but was mainly driven by positive developments in a few sectors.** GDP is estimated to have grown by 2.7 percent (year-on-year) in the first half of the year, reflecting one off factors like the strong performance of a small number of

exporting companies (for example, the reopening of a closed metals exporter), as well as some positive developments in the trade and transportation sector. A broad-based resumption of growth is still elusive, however, as evidenced by declines in 17 out of 23 sectors in the end-June industrial production index (Figures 1 and 2). The fragility of the economic turnaround was related in part to the abrupt withdrawal of fiscal stimulus in the first two quarters of the year, which offset the lagged effects of the strong fiscal impulse in late 2002. Job creation is also weak as shown by a nearly 5 percent increase in the official unemployment figure which reached almost 37 percent in 2003. The increase reflects job losses in the agricultural and mining sectors, and a large number of entrants into the labor force.

5. **Given that growth in the first half of the year was narrowly-based and dependent on one-time factors, the staff and the authorities agreed to trim the annual growth projection for 2003 from 3 percent in the original program to 2¾ percent.** While the increased fiscal impulse in the second half of the year will provide some stimulus, it comes too late to boost 2003 growth significantly, and may spill over into 2004. Nevertheless, growth in the second half of 2003 is expected to be more broad-based than in the first half, spreading to food processing, construction and textiles. A solid performance in the second half of 2003, signaling a decisive turnaround, would be necessary to maintain the program growth projection for 2004 of 4 percent. However, the mission based revised projections for 2004 on a more conservative 3 percent growth assumption, to be reviewed in the context of the 2004 budget discussions (Table 1).

Text Table 2. Current Account Developments in 2003

(In percent of annual GDP)

	H1		Annual	
	Prog.	Prel.	Prog.	Proj.
Current Account Balance	-3.6	-4.2	-6.9	-6.3
o.w. Telecom imports	0.0	-0.4		
Trade Balance	-8.0	-8.9	-16.7	-16.6
Services	-0.4	-0.3	-0.4	-0.4
Income	-0.8	-0.2	-1.2	-0.6
Transfers	5.6	5.2	11.5	11.3

Source: NBRM data and IMF staff estimates.

6. The external current account deficit was larger than programmed in the first half of 2003, reflecting a one-off import surge, but a turnaround is expected in the second half as export growth continues (Text Table 2, Table 6). The import surge in the first half of the year, comprised mainly two one-off items: equipment for a newly-opened mobile phone company and

exceptional purchases of fuel by government agencies. For the year as a whole, however, the take-off of the steel sector, which is already underway, and a revival of textiles exports are expected to bring the trade deficit back to the programmed level.² The current account deficit was covered largely by donor financing. Foreign direct investment (Figure 4) declined from already low levels, reflecting high political risk and an unfriendly business climate. Competitiveness indicators remain broadly unchanged (¶2).³

7. Inflation was close to zero (year-on-year) in early 2003, and the annual projection has therefore been revised down (Text Table 1). The main reasons for the lower than expected inflation in the first half of the year were the appreciation of the euro (to which the denar is pegged) and a dip in food prices due to a good harvest and increased food imports. Even though some developments that will push up prices are expected in the second half of the year, for example, an increase in electricity prices in June following the April VAT increase, the projection for 2003 has been reduced to 1¾ percent from 3 percent in the original program. Inflation is projected to rise to 2½ percent in 2004, or higher if administered prices are increased.

8. Delays in expenditures produced a much larger than planned fiscal contraction in the first half of 2003 (Text Table 3). Expenditures were delayed by the late (March) budget approval, a government review of capital projects, and teething problems with new, stricter, procurement procedures. Consequently, the general government deficit during January-June was below the program projection by the equivalent of 1.6 percent of GDP, with 1/3 of the shortfall in capital expenditure and 2/3 in recurrent expenditure (Tables 2 and 3), (¶3)).

² Exports are expected to be 10 percent higher in the second half of 2003 than in the first half; imports are projected to grow by only 0.8 percent as the effects of a projected fiscal stimulus will be offset by the nonoccurrence of one-off items.

³ Paragraph numbers refer to the SMEFP.

Text Table 3. Central Government Operations, Revised Fiscal Program, 2003
(In percent of annual GDP)

	H1 2003			2003		
	Program (EBS/03/51)	Actual	Difference	Adjusted Program 1/ (EBS/03/51)	Revised Program	Difference
Total revenue and grants	10.3	10.5	0.2	22.2	22.1	-0.1
Tax revenue	9.5	9.7	0.2	20.6	20.2	-0.4
Non-tax revenue	0.8	0.9	0.1	1.5	1.9	0.4
Total expenditures	11.6	10.3	-1.3	23.8	23.5	-0.3
Current expenditure	10.6	9.8	-0.9	21.4	21.1	-0.3
Capital expenditure	0.9	0.5	-0.4	2.4	2.4	0.0
Balance	-1.2	0.2	1.5	-1.6	-1.4	0.3

Sources: Data provided by the FYR Macedonian authorities; and IMF staff projections.
Notes: 1/ Figures are those presented in (EBS/03/51) except for an increase of Denar 320 million in both revenues and expenditures to present on a gross basis operations that had previously been presented on a net basis.

9. **Overall tax collection was in line with projections, but the structure of collections raises concerns about the tax effort.** In particular, VAT collection was broadly on target in spite of the import surge and the accumulation of VAT refund arrears, both of which should have raised VAT revenues above the target level. At the same time, VAT collection arrears increased in spite of a program commitment to strengthen the collection of arrears (¶13, 15). In other areas, higher-than-expected corporate profits taxes partly offset weak excise revenues, and pension contributions were well below projections.

10. **The restoration of confidence in monetary and exchange rate policies, combined with the liquidity effects of the fiscal tightening, eased pressures on international reserves and enabled the NBRM to lower the interest rate significantly.** The clarification of policies following the adoption of the Fund-supported program restored confidence in the denar after a period when poor fiscal management had undermined confidence in monetary and exchange rate policies. At the same time, large liquidity injections in late 2002—resulting from the drawdown of government deposits at the central bank—came to an end in early 2003 when the fiscal position tightened. Consequently, a large and prolonged outflow of foreign exchange reserves slowed to a halt and the NBRM lowered the rates on central bank bills, in stages, from around 15 percent during December-February to 7 percent in April (Table 4). In spite of the lower interest rate, the reserve flow turned positive in July and August, when the central bank made significant net purchases on the foreign exchange market.

11. **Commercial banks responded to the cut in the central bank rate by lowering deposit and loan rates (Figure 3) in the context of a significant re-intermediation, particularly in the euroized segment of the balance sheet.** Commercial bank rates declined

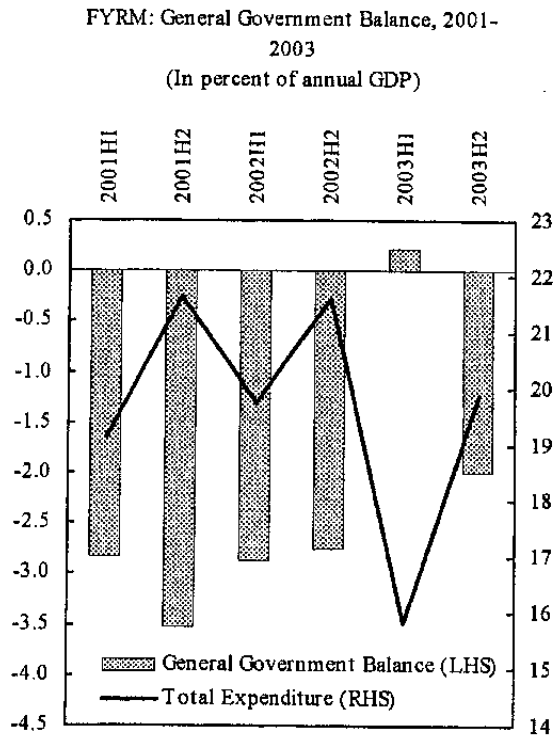
by less than the central bank rate, but nonetheless reached post-transition lows (¶4) and the low rates may have provided some monetary offset to the withdrawal of fiscal stimulus. In spite of the reduced interest rates, denar deposits rose strongly in the first half of the year partly because the elimination of the financial transactions tax reduced the incentive to hold cash. Foreign currency deposits increased by even more, reflecting increased confidence in banks, a narrowing of interest rate differentials which favor denar deposits as well as legislative changes that permitted exporters to retain earnings in foreign currency: overall, foreign currency liabilities rose to more than 40 percent of M3 in June. Foreign currency credit to the private sector rose significantly from a low base, mainly representing on-lending based on credit lines provided by IFI's and bilateral donors to commercial banks.

III. POLICY DISCUSSIONS

12. **With growth broadly in line with expectations and inflation low, the main targets of the program—reducing the general government deficit to 2½ percent of GDP by 2004 and keeping gross international reserves at about 4 months of imports—remain appropriate and provided the framework for the program review.** Macroeconomic policy discussions focused on whether to preserve the fiscal savings resulting from the under-spending in the first half of 2003 or to accelerate spending in the second half in order to reach the annual spending and deficit levels in the original program. Other issues discussed included:

- A calendar for bringing delayed health sector reforms back on track;
- Measures to build or strengthen institutions in the areas of domestic debt management, public expenditure management, and fiscal decentralization.
- Measures—to be incorporated in program conditionality—to increase the stability of the financial sector in light of the findings of the FSAP mission.

A. Financial Policies in 2003 and 2004



13. **The discussions centered on whether to maintain the fiscal targets for 2003 or preserve the unprogrammed savings in the first half, resulting in a lower-than-programmed deficit for the year.** While recognizing that the fiscal withdrawal in the first half had been larger than warranted, staff favored keeping budgetary spending in the second half of 2003, and therefore the second half deficit, close to the program targets in order to reduce the volatility of aggregate demand and interest rates and pressures on the current account deficit. In the staff's view, the alternative—maintaining the 2003 deficit target and allowing expenditure in the second half to substantially exceed the programmed amount for that period—would cause an undesirable whipsawing of expenditure and the deficit (Text Chart). Moreover, the sharp increase in government borrowing would inject liquidity, which the NBRM would

need to absorb in order to defend the external targets of the program.⁴ This could trigger possibly large interest rate hikes. Such volatility in the fiscal stance and in interest rates would introduce additional uncertainty into an already risky environment.

14. **While acknowledging staff's concerns, the authorities took the view that the revised 2003 budget should maintain spending ceilings at levels consistent with the original program.**⁵ They felt that high spending was needed in order to reverse the larger-than-planned negative fiscal impulse during the first half of the year. Moreover, budgetary "saving" in the first half of the year had mainly reflected start-up problems with stringent new procedures for approval of spending programs, not delays or cancellations. Finally, in

⁴ Pending the establishment of a government securities market, discussed below, domestic financing takes the form of drawing down government deposits in the central bank.

⁵ A revised budget would nonetheless be necessary in order to provide for transfers to the Health Insurance Fund which had been agreed under the program but not yet incorporated in the original 2003 budget.

view of the increase in the VAT earlier in the year, reductions in annual spending allocations, particularly on investment programs, would be difficult at this stage. When staff expressed doubt about the feasibility or desirability of increasing the pace of investment in the remaining months of the year to more than four times that in the first half, the authorities responded that a comprehensive review of investment projects, completed earlier in the year, had already prepared the ground. Administrative constraints would be addressed by focusing on a small number of large, urgently needed, infrastructure projects.

15. **On the monetary impact, the NBRM judged that it would be able to absorb the liquidity injected by the fiscal stimulus without raising interest rates paid on NBRM bills.** The demand for NBRM bills has been strong over the last months. Furthermore, the recent increase in NIR has created a buffer that could be used to help sterilize liquidity later in the year in case demand for NBRM bills weakens. Recalling the experience of late 2002, the mission emphasized that, should market conditions become less favorable, it would be difficult to absorb a large injection of liquidity without raising interest rates. In response, the NBRM assured staff that it stands ready to increase interest rates, if necessary, to keep foreign exchange reserves above the program floors.

16. **The concerns raised in the discussion were reflected in a compromise supplementary budget with a moderate expenditure reduction equivalent to 0.3 percent of GDP.** Under this budget, all of the January-June under-spending on capital, but only half of the under-spending on recurrent items will be made up during July-December. In other respects—notably freezes on wages and employment (with exceptions related to the hiring of minorities)—the policies underlying the original budget will be preserved (¶13). The lower current spending will reduce the projected central government deficit from 1.6 percent of GDP under the original budget to 1.4 percent of GDP (Text Table 3) after allowing for the use of some VAT revenues to clear VAT refund arrears. The adoption of a supplementary budget in line with these understandings is a prior action for completion of the review.

17. **In spite of the strong increase in fiscal stimulus in the second half of the year, aggregate demand and the external current account deficit in 2003 are expected to remain within program targets because of the backloading of the fiscal impulse.** However, there will be some spillover of demand into the first quarter of 2004 and the NBRM needs to be ready to take compensating action, if necessary.

18. **The financial program was extended to the first quarter of 2004 (the final quarter of the program) by working back from the agreed budget deficit for 2004 and a target stock of gross reserves equivalent to about four months of imports.** In view of the seasonality of reserve money (which is weak in the first quarter), a large London Club payment, and a modest volume of external assistance, the program envisages only a moderate increase in NIR during the first quarter, roughly a sixth of the annual accumulation. The authorities would have preferred a less ambitious NIR target for the first quarter, but staff noted that the proposed target should be achievable as a seasonally low first quarter fiscal deficit would reduce the need to absorb liquidity after the end-2003 injections. In addition, a

first issue of treasury securities, expected in the first quarter, will reduce the budget's reliance on central bank financing.

19. **While sufficient balance of payments financing is available up to March 2004, the end of the program period, the mission's projections for the rest of the year identify an external financing gap on the order of 50-60 million US dollars (Table 6).** The authorities are approaching the Fund, the Bank, and other bilateral donors to request balance of payments support in the context of a continued implementation of the Ohrid Agreement and a new or extended IMF program.

20. **While it is hoped that external support to fill the gap will be forthcoming in 2004, it is essential that FYR Macedonia moves quickly to strengthen its capacity to borrow domestically and to implement a proactive debt management strategy.** The need for domestic borrowing is made urgent by two developments: First, central bank financing will cease to be available once the government's deposits of privatization receipts have been drawn down.⁶ Second, balance of payments support can be expected to decline rapidly from the exceptional levels provided in support of the Ohrid Agreement. In addition, large volumes of maturing foreign debt and foreign currency-indexed domestic debt will need to be rolled over during the next six to ten years.⁷ In this context it may be necessary to issue foreign currency government securities as well as domestic currency securities in order to balance the benefit of reducing the exposure to foreign currency risk with the risk of creating pressures on the balance of payments.⁸ The authorities plan to issue the first treasury securities in late 2003 or early 2004 (¶20).

B. Structural Reforms

21. **Agreed structural measures focus on the stability of the banking system and on strengthening fiscal management, particularly by the health and pension funds.**

⁶ The main source of privatization receipts was the telecoms privatization in 2000.

⁷ Primarily London Club debt (principal payments equivalent to around 1 percent of GDP) and the Frozen Foreign Currency Bonds (principal payments in excess of 1 percent of GDP), which were issued to cover residents' foreign currency deposits frozen prior to the breakup of the former SFR Yugoslavia.

⁸ Balance of payments pressures would be created by rolling over foreign currency denominated debt into denars, thereby shifting the currency composition of domestically held government debt. At end-2002, most of the government debt was either indexed to the exchange rate or denominated in foreign currency. (Out of total gross government debts of 50.1 percent of GDP, only 1.3 percent of GDP was in denar.)

22. **While the FSAP found no immediate threats to the stability of the financial system, it flagged macro-financial risks arising from euroization and institutional weaknesses.** Vulnerabilities include weak governance in smaller banks, the high level of non-performing loans, and problems in enforcement due to an ineffective judiciary. Euroization adds to the banking sector's credit risk since borrowers in foreign currency are exposed to foreign exchange risk. In contrast, bank's own foreign currency liabilities are covered against depreciation risks.

23. **The authorities have already taken steps to implement some of the FSAP recommendations and plan to take additional measures in the context of the program.** Parliament has amended banking legislation to strengthen 'fit and proper' (§18) and licensing requirements, extend the range of prompt corrective actions available to supervisors, and introduce new criteria for changes in bank ownership and for bank investments (§24). Central bank accountability has been increased by obliging the governor to appear before Parliament, codifying the relationship with other supervisory agencies and increasing the exchange of information with the government. Measures to be taken under the program focus on banks' management of risks related to their foreign currency lending (structural performance criterion) (Box 1, and §23). In addition, the legal framework for international money wire services and anti-money laundering will be modified to establish greater supervisory authority in licensing, monitoring and imposing sanctions (§25).

24. **Measures have been agreed to bring the reform of the health sector back on track.** The still pending retrenchment of 1240 employees, which was to have been completed by July 2003, is a key short-term measure in the cost cutting program aimed at eliminating the central budget subsidy to the HIF starting from 2004 (in line with the practice prior to 2002). The retrenchment will be completed in two steps. A first group, 900 employees, will be laid off as a prior action for Board consideration of the review while the remaining 340 layoffs will be finalized by end-March 2004. In mid-September, the authorities decided that personnel to be laid off in the first round would be selected mainly through a voluntary separation program and not, as originally planned, by the health care institutions identifying certain positions as redundant in the context of restructuring plans.⁹ The staff was concerned that the new approach might lead to the departure of personnel with essential skills, adversely affecting the quality of health care. To avoid such an outcome, the authorities have agreed to carry out a health sector restructuring—prepared with World Bank advice—that will allow for the reduction in employment and for a redeployment of the remaining staff with a view to maintaining the level of health care (§19). In addition, though with some delay, the government has initiated, with World Bank support, a systems audit of the HIF. Finally, the authorities have committed to prepare, again with World Bank advice, a program of further cost saving measures (§7, 19). All these measures are essential to bring the cost dynamics of the HIF—with a total budget equivalent to 5 percent of GDP—under control.

⁹ The new approach, which has attracted mainly senior staff, will imply higher severance costs than the original plan. The increase will be covered by the reallocation of resources within the recurrent budget.

Box 1. Main Recommendations of the Financial Sector Assessment Program

The FSAP focused on bank regulation and supervision and on financial market development. Recommendations sought to enhance market stability and resilience, especially to risks arising from euroization and financial market liberalization.

To strengthen banking and financial market supervision, the FSAP recommended:

- Advancing to a more risk-based surveillance and monitoring system, and introducing accounting and disclosure standards for banks. In particular, the FSAP highlighted the importance of identifying and managing exchange rate risks arising from unhedged positions of borrowers. Banks are now required to submit to supervisors a report on their risk assessment methodology. In addition, the on-site supervision manual will be revised to require that supervisors check for borrowers' exchange rate risk assessment in credit files (structural performance criterion).
- Strengthening bank supervision in the areas of licensing, the quality of bank ownership, and governance. More specifically: strengthening the criteria for bank licensing, mergers and investments; imposing 'fit and proper' requirements on bank owners and board members (to replace requirements that were struck down by a Constitutional Court ruling); and empowering supervisors to investigate and seek criminal prosecution in cases where banking activity is undertaken without a license.
- Broadening supervisors' authority to enforce corrective actions, and expanding the powers of administrators overseeing weak banks.
- Strengthening the legal framework for the Anti-Money Laundering/Combating of Financing of Terrorism (AML/CFT) policies and providing legal authority to monitor compliance with the AML/CFT laws and impose sanctions.

To develop financial markets, the FSAP suggested introducing new instruments, improving infrastructure in payments and safety net systems, and increasing transparency and accountability. Recommendations included:

- Developing a government securities market to expand the range of market instruments.
- Improving liquidity management by introducing repos and increasing the range of instruments eligible as collateral for central bank lending.
- Establishing a framework for central bank emergency lending.
- Establishing a remote back-up facility for the Macedonian Interbank Payments Systems (MIPS).
- Clarifying the policy role for NBRM in the payment system and removing the obligation for NBRM to adjudicate and execute guarantees between third parties (without prior notice to the banks).

25. **While plans for a second pillar pension system remain on hold pending further study, weaknesses in the existing pension system need to be addressed immediately.** In particular, steps have been taken to strengthen collection of contributions. And, in order to strengthen the medium term viability of the pension fund, the indexation of pension payments to nominal wages will be replaced by a formula which indexes pension increases primarily to inflation (§17).

26. **Improvements in budget preparation and the continuation of the treasury reform are essential to reduce future whipsawing in fiscal policy and to improve the efficiency of spending.** Drawing on FAD technical assistance, the government has begun to address weaknesses in the budget preparation process starting with the 2004 budget (§16) and has taken further steps to improve treasury management and reporting, including the reconciliation of monetary and fiscal accounts (§27) which is a prior action under the program (Box 2).

Box 2. FYR Macedonia: Public Expenditure Management Reform

Substantial progress was achieved in treasury reform since 2000. The Treasury now includes virtually all central government revenues and expenditures in a Treasury Single Account (TSA), and produces timely reports on the execution of the central government budget. Further reforms are currently underway:

- *New financing instruments:* introduce a treasury securities market; strengthen cash management and link it with debt management; strengthen communication with NBRM on monetary and fiscal policy; establish regular communication with major market players;
- *Reporting and control:* develop analytical fiscal reporting in line with the GFS covering central government, local governments, extrabudgetary funds (EBF) and consolidated general government; reconcile fiscal and monetary data; introduce commitment recording and control;
- *Further consolidation of accounts:* establish a system to include foreign financed projects in fiscal reports; transfer EBF's accounts into the TSA as sub accounts with the idle balances to be used to fund any shortfalls in the budget.

While Treasury functions have been improved considerably, budget preparation techniques have lagged. It is necessary to restore balance, not least because the further development of the treasury system is likely to be constrained by the cumbersome budget that it is implementing. Progress is also needed in strengthening budget formulation techniques in order to be able to prioritize country expenditure policies. The following reforms are being initiated:

- *Ensure long term-sustainability:* establish a medium-term budgetary framework with forward looking fiscal policy; develop a debt management strategy;
- *Enhance flexibility:* increase room for discretionary expenditure and consolidate EBFs (about 40 percent of total expenditure is currently spend through EBFs);
- *Improve transparency:* streamline overly detailed economic line-item classification, improve the present functional classification; provide more description of underlying policy, programs, and activities; give time comparison of the estimates; develop internal audit function in the ministry of finance and budget users.

27. **While decentralization is a cornerstone of the Ohrid Agreement, an attempt to move ahead without adequate preparation would lead to a loss in fiscal control and a deterioration in the provision of services.** The mission urged the authorities to adopt the approach proposed by FAD in 2002 in which resources are devolved gradually as the municipalities develop administrative capacity. To date, prerequisite steps have been delayed (e.g., defining the number and boundaries of the municipalities; strengthening the collection of revenues already administered by local governments). An FAD mission is currently

assisting the authorities to draft a law on local government financing that sets out a framework for a phased decentralization and defines administrative preconditions for each phase (§21).

C. Program Design and Monitoring

28. **The original program design remains in place.** The mission agreed on revised quantitative performance criteria for September and December 2003 and on targets for March 2004. The NIR target as well as the underlying assumptions for the balance of payment are unchanged (SMEFP Table 1), while the fiscal adjustment (over two years) will be slightly more front-loaded than in the original program. For 2004, the deficit target remains unchanged. As agreed in the original program, the review incorporates new measures recommended by the FSAP mission; other structural benchmarks focus on correcting slippages in the first half of 2003 (SMEFP Table 2). Beside the measures in the health sector, described above, these include structural benchmarks to address weaknesses in tax administration and a liberalization of the tobacco market, in which local monopolies have had access to non-transparent government-financed—and NBRM-financed—guarantee schemes (§22). Finally, to address concerns raised by the safeguards assessment, the end-2002 submission of the NBRM to the IMF at current exchange rates has been reconciled with the audited financial accounts and a framework has been developed to monitor the program at constant exchange rates (§29).

IV. STAFF APPRAISAL

29. **It is disappointing that, two years after the signing of the Ohrid Agreement, the economic recovery remains fragile.** The macroeconomic stabilization underway should help strengthen the business climate, but it will need to be accompanied with measures to address political risks, accelerate structural reforms and create a business-friendly legal environment. Otherwise, it will be difficult to replace donor support in the medium-term with private capital flows, including foreign direct investment. The sharp decline in foreign direct investment in 2003 is particularly worrying and may reflect concerns arising from extensive litigation surrounding earlier privatizations.

30. **The fiscal stabilization at the center of the program is on track and puts FYR Macedonia well on the way to restoring fiscal sustainability after the 2001 security crisis.** At the same time, the NBRM's continued steady management of the de facto peg of the denar—including during the crisis—has enhanced the credibility of the central bank and kept inflation low. The reduction in interest rates and the lifting of pressures on the foreign exchange market are testimony of renewed market confidence in the currency and in financial management.

31. **Programming fiscal policy in the aftermath of the sharper-than-planned fiscal adjustment in the first half of 2003 has required a difficult choice between saving the over-adjustment and preserving full year spending plans.** The compromise reached—preserving annual capital spending plans while reducing current spending plans and the

programmed deficit—seems appropriate. It should prevent an undue change in spending plans for the year as a whole while containing the fiscal stimulus in the second half, which will need to be reversed in 2004. In this regard, the staff notes that, should the authorities be unable to achieve their very ambitious investment targets for the second half of 2003, a welcome consequence would be that the large fiscal stimulus, and the need for offsetting measures, will be reduced. The authorities' plans to strengthen budget preparation and execution procedures should reduce unplanned volatility in the future and are welcome. In the same vein, the management of public sector investments in a multi-year framework should be strengthened.

32. **With most of the fiscal deficit now concentrated in the second half of the year, the NBRM's ability to neutralize a large liquidity injection will be tested.** The NBRM's view that the liquidity can be absorbed without raising the interest rate on central bank bills is plausible in light of the continued strengthening of the external reserves position. Nevertheless, risks remain: a weakening in the demand for central bank bills would lead to a larger than anticipated increase in the interest rate; and staff welcomes the NBRM's assurance that it will stand ready to raise the interest rate, if needed, to defend the program's external targets.

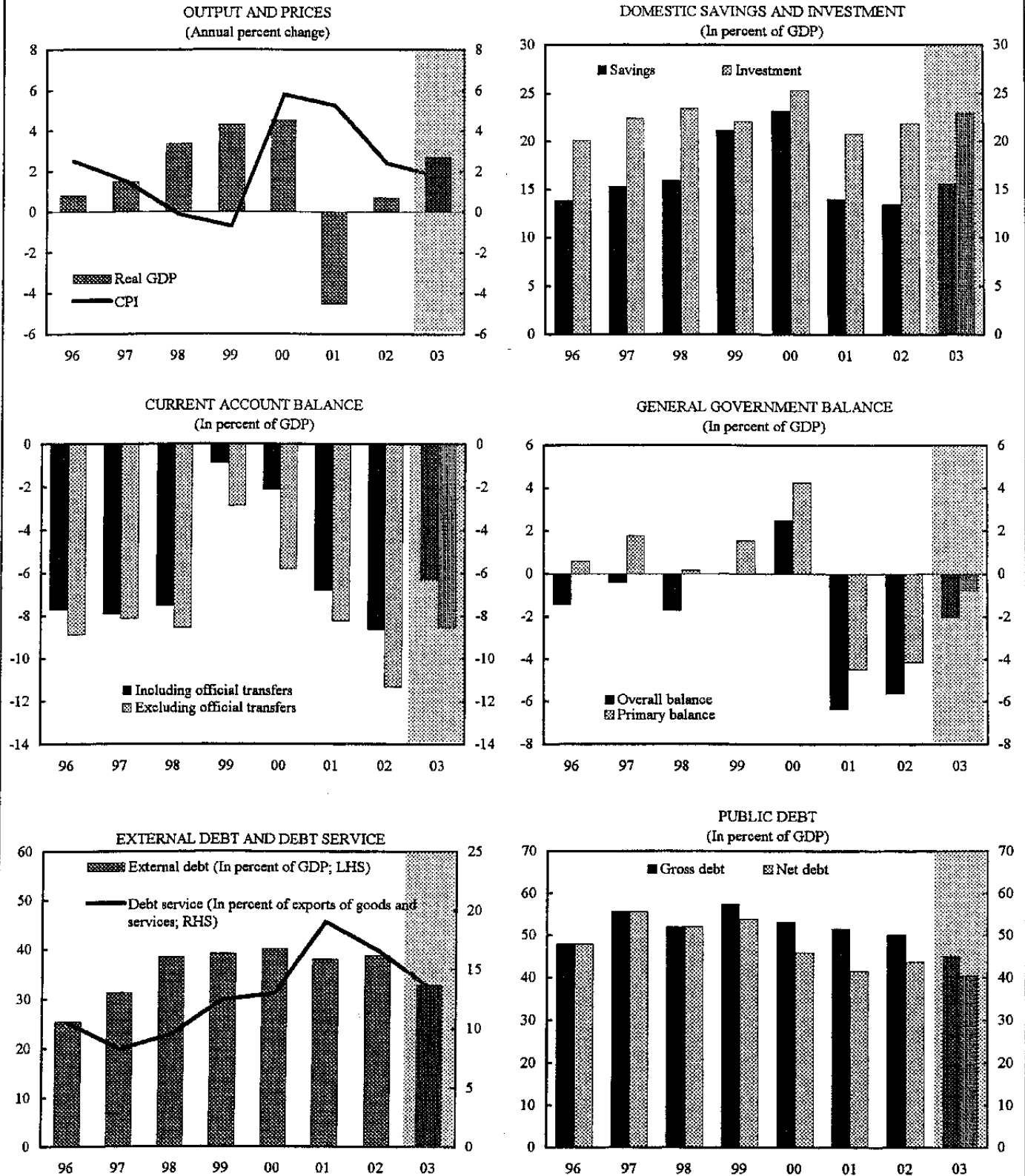
33. **The delays in the reform of the health sector are worrying, particularly since the major scandals over the past years have made this sector a prominent example of mismanagement and corruption.** The staff welcomes the commitment to eliminate the budgetary transfer to the Health Insurance Fund in 2004 and urges the authorities to work with World Bank staff on measures to achieve this objective while improving transparency and governance. As regards the retrenchment of redundant personnel, the reliance on voluntary departures creates some risk that the quality of health care could decline. To manage that risk, the authorities need to move quickly to restructure the sector—in line with World Bank advice—in order to ensure that the layoffs are permanent and that the quality of health care is maintained.

34. **The authorities have started implementing the recommendations of the FSAP mission and have prepared further measures to strengthen financial sector stability.** Strengthening prudential and supervisory procedures for the banking system is key to controlling the risks for the financial sector during the process of liberalizing capital movements in a highly euroized economy. The authorities have moved quickly to implement some recommendations; the additional measures agreed under the program lay a good basis for limiting the risks associated with financial euroization.

35. **It is essential both for macro stability and the quality of public services that the fiscal decentralization be implemented in an orderly way.** Staff is concerned that delays in the preparatory steps both on the central and local government levels and political pressures to accelerate the process could lead to a disorderly decentralization process that would deteriorate the provision of services and give room for corruption. Staff therefore urges the authorities to commit to a phased decentralization and to move quickly to put in place the required administrative reforms.

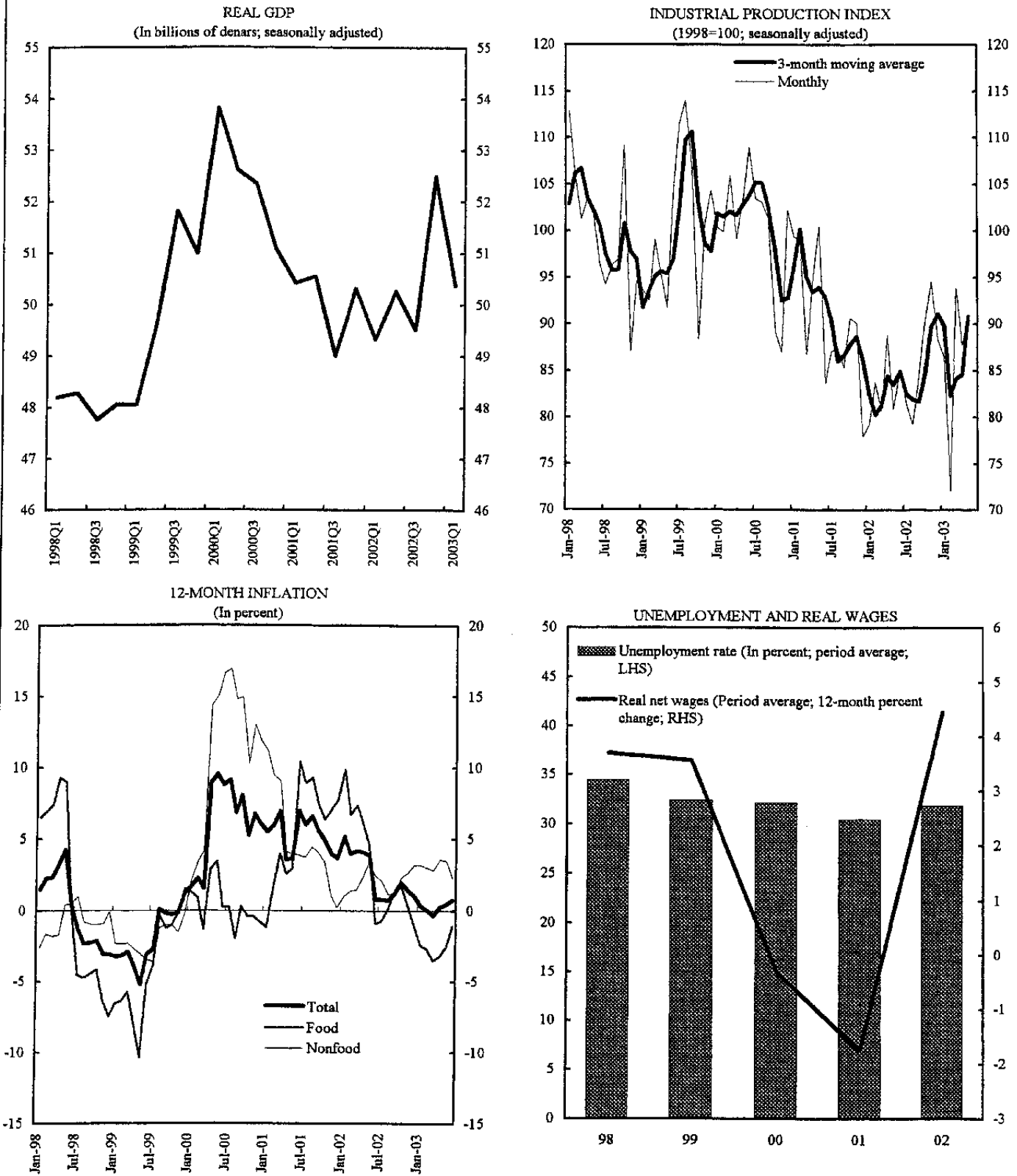
36. **Since the performance criteria under the program have all been met and in view of the policies described in the attached SMEFP, the staff recommends that waivers of applicability be granted for the end-September performance criteria, and that the first review under the Stand-By Arrangement be completed.**

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



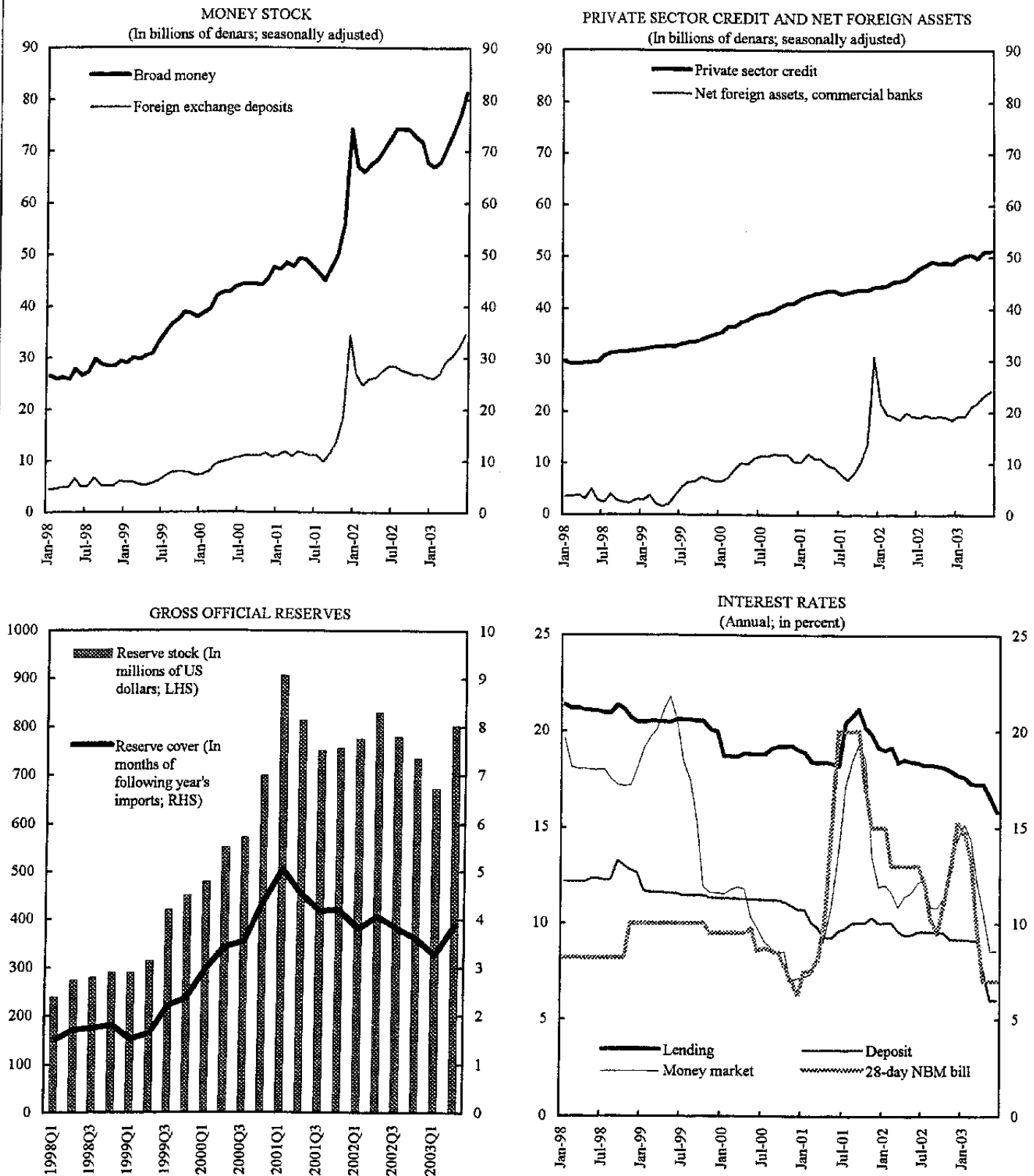
Sources: FYRM authorities; and Fund staff estimates.
1/ 2003: Projections.

Figure 2. FYRM: Real Sector Developments, 1998-2003



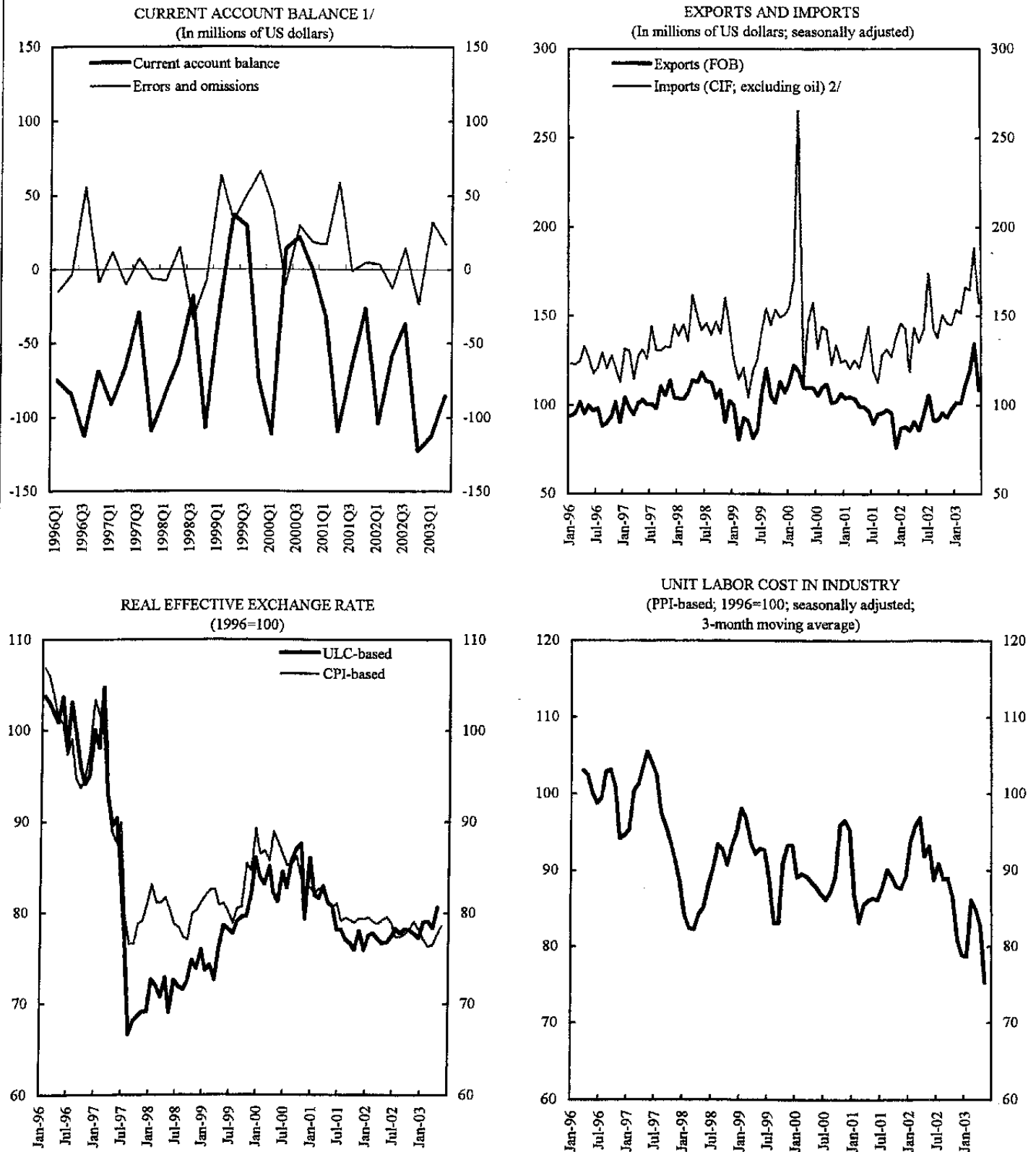
Sources: FYRM authorities; and Fund staff estimates.

Figure 3. FYRM: Monetary and Financial Indicators, 1998-2003



Sources: FYRM authorities; and Fund staff estimates.

Figure 4. FYRM: External Sector Developments and Competitiveness, 1996-2003



Sources: FYRM authorities; and Fund staff estimates.

1/ 2003 Q1-Q2: Preliminary.

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

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

	1998	1999	2000	2001	2002	2003			2004
						HI Prel.	Prog.	Proj.	Proj.
Real economy									
	(Percent change)								
Real GDP 1/	3.4	4.3	4.5	-4.5	0.7	2.7	3.0	2.8	3.0
Consumer prices									
period average	-0.1	-0.7	5.8	5.3	2.4	0.3	3.0	1.8	2.5
end of period	-3.1	2.6	6.1	3.7	1.0	0.7	2.7	2.2	2.5
Real wages, period average	3.7	3.6	-0.3	-1.7	4.5	...	2.1	...	2.0
Unemployment rate (average)	34.5	32.4	32.2	30.5	31.9	...	30.4	30.0	...
Government finances									
	(In percent of annual nominal GDP)								
General government balance	-1.7	0.0	1.8	-7.2	-5.7	-0.2	-2.7	-2.5	-2.5
Revenues	33.3	35.4	36.6	34.4	35.8	16.1	33.5	34.0	33.1
Total expenditures	35.0	35.4	34.9	41.6	41.5	16.3	36.3	36.5	35.6
Central government balance	-0.8	0.8	2.7	-5.8	-5.4	0.2	-1.6	-1.4	-0.9
Government debt 3/									
Gross	52.0	57.4	53.2	51.6	50.1	...	44.8	44.8	41.8
Net	52.0	53.8	46.0	41.6	43.7	...	40.2	40.1	37.9
Money and credit									
	(Percent change, end of period)								
Broad money (M3) 4/	14.9	29.7	25.6	56.7	-8.6	5.8	6.8	14.7	9.4
Total credit to private sector	10.4	9.4	17.2	7.3	9.9	7.1	9.5	9.5	7.2
Short-term lending rate (percent)	20.5	20.0	19.0	19.2	17.7	15.8	...	...	...
Interbank money market rate (percent)	18.1	11.6	7.2	11.9	14.4	8.6	...	...	...
Balance of payments									
	(In millions of U.S. dollars)								
Exports	1,292	1,190	1,321	1,155	1,113	645	1,236	1,354	1,443
Imports	1,807	1,686	2,011	1,677	1,877	1,058	1,961	2,123	2,202
Trade balance	-515	-496	-690	-521	-765	-413	-725	-769	-759
Current account balance									
excluding grants	-307	-105	-208	-282	-422	-248	-404	-395	-409
(in percent of GDP)	-8.6	-2.9	-5.8	-8.2	-11.3	-5.4	-9.3	-8.5	-8.2
including grants	-269	-32	-75	-234	-321	-198	-299	-292	-347
(in percent of GDP)	-7.5	-0.9	-2.1	-6.8	-8.6	-4.3	-6.9	-6.3	-7.0
Overall balance	36	166	226	118	-120	9	25	16	-23
Official gross reserves 5/	290	450	700	756	735	803	765	816	839
(in months of following year's imports of goods and services)	1.8	2.4	4.3	4.2	3.6	3.9	3.9	3.9	3.9
External debt service ratio 6/	9.5	12.4	13.0	19.0	16.6	...	13.6	13.5	13.3
External debt to GDP ratio (percent)	38.5	39.2	40.1	38.0	38.8	...	36.5	32.9	33.1
Exchange rates 7/									
	(Percent change, period average)								
Nominal effective exchange rate	0.9	12.4	12.4	3.3	0.7	2.6 <i>a</i>	...	...	...
Real effective exchange rate (CPI-based)	-7.0	2.9	4.0	-6.1	-2.5	-2.5 <i>a</i>	...	...	...
Real effective exchange rate (ULC-based)	-11.4	7.3	7.7	-4.5	-1.5	2.6 <i>b</i>	...	...	...

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

Notes:

a As of end-May 2003.

b As of end-april 2003.

1/ In the forthcoming SMEFF, 2004 GDP is projected in a range of 3 to 4 percent. For program purposes, a conservative estimate of 3 percent is used.

2/ The decrease in revenue and expenditures is due to lack of reliable data on municipalities. The series are taken out and therefore both revenues and expenditure are lower by 0.4 percent of GDP compared to the last staff report (EBS/03/51, 4/16/03).

3/ 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.

4/ Includes foreign currency deposits; strong growth of foreign currency deposits in HI 2003 explains the revision of the end-2003 figure.

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

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

7/ An increase means appreciation of the denar. Partner countries include among others Serbia and Montenegro, and Bulgaria.

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

	2000	2001	2002	H1 2003	2003		2004 Proj.	2000	2001	2002	H1 2003	2003		2004 Proj.
					Prog.	Rev. Prog.						Prog.	Rev. Prog.	
	(In millions of denars)							(In percent of GDP)						
Total revenues and grants	57,805	51,812	57,358	26,594	55,645	55,785	56,856	24.5	22.2	23.8	10.4	21.8	22.1	21.3
Tax revenues	51,115	47,564	54,387	24,357	51,738	50,932	52,536	21.6	20.3	22.5	9.6	20.3	20.2	19.7
Individual income tax	10,793	7,247	7,514	3,559	7,902	7,713	8,083	4.6	3.1	3.1	1.4	3.1	3.1	3.0
Profit tax	2,793	3,006	2,625	1,825	2,784	3,184	2,899	1.2	1.3	1.1	0.7	1.1	1.3	1.1
VAT	17,452	17,133	20,521	10,415	23,502	22,792	24,820	7.4	7.3	8.5	4.1	9.2	9.0	9.3
Excises	12,281	10,681	10,715	4,918	11,096	10,297	10,861	5.2	4.6	4.4	1.9	4.4	4.1	4.1
Import duties	7,733	6,111	6,335	3,339	6,151	6,596	5,551	3.3	2.6	2.6	1.3	2.4	2.6	2.1
Financial transaction tax	0	3,111	6,335	28	0	0	0	0.0	1.3	2.6	0.0	0.0	0.0	0.0
Other taxes	63	276	342	273	304	350	321	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Non-tax and capital revenues	3,452	3,833	2,971	2,237	3,907	4,853	4,321	1.5	1.6	1.2	0.9	1.5	1.9	1.6
Grants	3,239	415	0	0	0	0	0	1.4	0.2	0.0	0.0	0.0	0.0	0.0
Total expenditures	51,520	65,363	70,378	25,975	59,720	59,197	59,270	21.8	28.0	29.2	10.2	23.4	23.5	22.2
Current expenditures	45,027	56,683	59,310	23,874	51,415	50,900	51,802	19.0	24.2	24.6	9.4	20.2	20.2	19.4
Goods and services	22,422	36,232	32,142	13,357	28,231	28,361	28,709	9.5	15.5	13.3	5.2	11.1	11.2	10.8
Wages and salaries	16,285	16,407	18,339	10,011	20,953	20,785	21,169	6.9	7.0	7.6	3.9	8.2	8.2	7.9
of which : new security-related	0	959	1,880	...	2,269	2,269	0	0.0	0.4	0.8	...	0.9	0.9	0.0
Goods and nonlabor services	6,137	19,825	13,803	3,346	7,278	7,576	7,540	2.6	8.5	5.7	1.3	2.9	3.0	2.8
of which : new security-related 2/	0	14,285	6,492	...	413	413	0	0.0	6.1	2.7	...	0.2	0.2	0.0
Refugee and special social expenses	1,482	582	389	152	446	416	346	0.6	0.2	0.2	0.1	0.2	0.2	0.1
Transfers	17,174	15,669	23,452	8,991	19,869	19,359	19,920	7.3	6.7	9.7	3.5	7.8	7.7	7.5
Interest	3,949	4,200	3,328	1,374	2,869	2,764	2,827	1.7	1.8	1.4	0.5	1.1	1.1	1.1
Domestic	1,183	1,066	1,177	512	1,026	971	1,210	0.5	0.5	0.5	0.2	0.4	0.4	0.5
Foreign	2,767	3,134	2,151	862	1,843	1,793	1,617	1.2	1.3	0.9	0.3	0.7	0.7	0.6
Capital expenditures 3/	5,751	7,380	8,221	1,372	6,089	6,081	6,660	2.4	3.2	3.4	0.5	2.4	2.4	2.5
of which : new security-related	0	434	0	...	0	0	0	0.0	0.2	0.0	...	0.0	0.0	0.0
Gross costs of reforms	404	1,183	1,832	902	2,027	2,026	613	0.2	0.5	0.8	0.4	0.8	0.8	0.2
Other	338	117	1,014	-172	190	190	195	0.1	0.0	0.4	-0.1	0.1	0.1	0.1
Fiscal balance 4/	6,285	-13,551	-13,019	619	-4,075	-3,412	-2,413	2.7	-5.8	-5.4	0.2	-1.6	-1.4	-0.9
Financing	-6,285	13,551	13,019	-619	4,075	3,412	2,413	-2.7	5.8	5.4	-0.2	1.6	1.4	0.9
Domestic	-11,780	-5,821	10,747	-2,921	-328	-872	298	-5.0	-2.5	4.5	-1.1	-0.1	-0.3	0.1
Bank	-10,233	-5,821	8,875	-1,365	2,783	2,240	3,318	-4.3	-2.5	3.7	-0.5	1.1	0.9	1.2
Non-bank	-1,547	0	1,872	-1,556	-3,111	-3,111	-3,020	-0.7	0.0	0.8	-0.6	-1.2	-1.2	-1.1
Foreign	2,872	-5,171	862	2,235	4,403	4,216	-476	1.2	-2.2	0.4	0.9	1.7	1.7	-0.2
Privatization receipts	2,622	24,543	1,411	68	0	68	0	1.1	10.5	0.6	0.0	0.0	0.0	0.0
Unidentified financing 5/	...	...	...	...	...	...	2,591	...	...	...	...	...	...	1.0
Memorandum item:														
Security-related expenditures 6/	7,861	24,092	16,333	...	12,023	12,023	12,324	3.3	10.3	6.8	...	4.7	4.8	4.6
of which : new security-related	0	15,678	8,372	...	2,682	2,682	0	0.0	6.7	3.5	...	1.1	1.1	0.0
Nominal GDP	236,389	233,841	241,243	252,242	254,952	252,242	266,393	...	...	...	...	...	...	...

Sources: Data provided by the 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/ For Q1 2004, the deficit targeted of Denar 433 million was set. Detailed quarterly revenue and expenditure projections are subject to further discussion during the follow-up 2004 budget negotiations mission.

5/ Deficit for Q1 2004 is fully financed, financing is needed for Q2-Q3 of 2004.

6/ 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	H1 2003	2003		2004	2000	2001	2002	H1 2003	2003		2004	
					Prog.	Proj.	Proj.					Prog.	Proj.	Proj.	
	(In millions of denars)							(In percent of GDP)							
Total revenue and grants	86,583	80,503	86,254	40,555	85,498	85,868	88,083	36.6	34.4	35.8	16.1	33.5	34.0	33.1	
Tax revenues	78,059	74,694	81,619	37,439	79,711	78,795	81,720	33.0	31.9	33.8	14.8	31.3	31.2	30.7	
Taxes on income and profits	13,586	10,253	10,140	5,384	10,686	10,897	10,982	5.7	4.4	4.2	2.1	4.2	4.3	4.1	
Social insurance contributions	25,091	25,363	25,494	12,770	27,263	27,224	28,514	10.6	10.8	10.6	5.1	10.7	10.8	10.7	
Domestic indirect taxes	30,537	28,529	31,923	15,645	35,307	33,728	36,352	12.9	12.2	13.2	6.2	13.8	13.4	13.6	
Import duties	7,733	6,111	6,335	3,339	6,151	6,596	5,551	3.3	2.6	2.6	1.3	2.4	2.6	2.1	
Financial transaction tax	0	3,111	6,335	28	0	0	0	0.0	1.3	2.6	0.0	0.0	0.0	0.0	
Other taxes	63	276	342	273	304	350	321	0.0	0.1	0.1	0.1	0.1	0.1	0.1	
Non-tax and capital revenues	5,284	5,307	4,600	3,115	5,787	7,072	6,362	2.2	2.3	1.9	1.2	2.3	2.8	2.4	
Grants	3,239	502	35	1	0	1	1	1.4	0.2	0.0	0.0	0.0	0.0	0.0	
Total expenditures	82,427	97,236	100,107	41,137	92,464	92,188	94,796	34.9	41.6	41.5	16.3	36.3	36.5	35.6	
Current expenditure	73,748	85,848	88,776	38,423	81,419	81,177	82,761	31.2	36.7	36.8	15.2	31.9	32.2	31.1	
Goods and services	24,053	37,741	34,370	14,238	30,115	30,570	30,674	10.2	16.1	14.2	5.6	11.8	12.1	11.5	
Wages and salaries	16,863	16,946	19,012	10,298	21,609	21,454	21,844	7.1	7.2	7.9	4.1	8.5	8.5	8.2	
of which: new security-related	0	959	1,880	...	2,269	2,269	0	0.0	0.4	0.8	...	0.9	0.9	0.0	
Goods and nonlabor services	7,191	20,795	15,358	3,940	8,506	9,116	8,830	3.0	8.9	6.4	1.6	3.3	3.6	3.3	
of which: new security-related 2/	0	14,285	6,492	...	413	413	0	0.0	6.1	2.7	...	0.2	0.2	0.0	
Refugee and special social expenses	1,482	582	389	152	446	416	346	0.6	0.2	0.2	0.1	0.2	0.2	0.1	
Transfers	44,051	43,167	50,438	22,510	47,669	47,107	48,576	18.6	18.5	20.9	8.9	18.7	18.7	18.2	
Interest	4,161	4,359	3,579	1,524	3,189	3,084	3,165	1.8	1.9	1.5	0.6	1.3	1.2	1.2	
Domestic	1,183	1,066	1,177	512	1,026	971	1,210	0.5	0.5	0.5	0.2	0.4	0.4	0.5	
Foreign	2,978	3,293	2,402	1,012	2,163	2,113	1,954	1.3	1.4	1.0	0.4	0.8	0.8	0.7	
Capital expenditures	8,076	10,012	9,137	2,557	9,168	9,163	11,159	3.4	4.3	3.8	1.0	3.6	3.6	4.2	
of which: foreign-financed projects	1,749	1,887	299	1,156	1,849	1,849	3,383	0.7	0.8	0.1	0.5	0.7	0.7	1.3	
Net costs of reforms	233	899	1,600	789	1,687	1,686	513	0.1	0.4	0.7	0.3	0.7	0.7	0.2	
Other	369	477	595	-632	190	162	363	0.2	0.2	0.2	-0.3	0.1	0.1	0.1	
Fiscal balance 3/	4,156	-16,733	-13,853	-583	-6,966	-6,320	-6,713	1.8	-7.2	-5.7	-0.2	-2.7	-2.5	-2.5	
Financing	-4,156	16,733	13,853	583	6,966	6,320	6,713	-1.8	7.2	5.7	0.2	2.7	2.5	2.5	
Domestic	-11,993	-5,546	10,245	-2,885	-714	-1,291	-138	-5.1	-2.4	4.2	-1.1	-0.3	-0.5	-0.1	
Bank	-10,446	-5,546	8,373	-1,283	2,767	2,241	3,252	-4.4	-2.4	3.5	-0.5	1.1	0.9	1.2	
Non-bank	-1,547	0	1,872	-1,602	-3,481	-3,531	-3,390	-0.7	0.0	0.8	-0.6	-1.4	-1.4	-1.3	
Foreign	5,199	-2,430	2,026	3,391	7,614	7,477	4,194	2.2	-1.0	0.8	1.3	3.0	3.0	1.6	
Privatization receipts	2,637	24,709	1,582	77	66	134	66	1.1	10.6	0.7	0.0	0.0	0.1	0.0	
Unidentified financing 4/	...	...	...	...	...	...	2,591	...	...	...	...	...	...	1.0
Memorandum item:															
Fiscal balance excluding foreign-financed proj.	5,905	-14,846	-13,554	574	-5,117	-4,471	-3,330	2.5	-6.3	-5.6	0.2	-2.0	-1.8	-1.3	
Security-related expenditures 5/	7,861	24,092	16,333	...	12,023	12,023	12,324	3.3	10.3	6.8	...	4.7	4.8	4.6	
of which: new security-related	0	15,678	8,372	...	2,682	2,682	0	0.0	6.7	3.5	...	1.1	1.1	0.0	
Nominal GDP	236,389	233,841	241,243	252,242	254,952	252,242	266,393	...	...	...	...	...	...	...

Sources: 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/ For Q1 2004, the deficit targeted of Denar 433 million was set. Detailed quarterly revenue and expenditure projections are subject to further discussions during the follow-up 2004 budget negotiations mission.

4/ Deficit for Q1 2004 is fully financed, financing needed for Q2-Q3 of 2004.

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

Table 4. FYRM: National Bank Accounts, 2001-2004

	2001 Dec.	2002 Dec.	2003 revised program				2004	
			Mar.	Jun.	Sep.	Dec.	Mar.	Dec.
			Actual	Actual	Prog.	Prog.	Prog.	Proj
Net foreign assets 1/	50,344	43,177	39,574	43,978	43,018	44,767	45,062	46,593
Net domestic assets	-32,126	-25,002	-24,543	-25,798	-24,904	-24,873	-25,676	-24,689
Banks (net)	-2,923	-2,784	-3,633	-3,980	-4,506	-6,032	-7,100	-6,458
Credits	234	214	96	99	99	99	99	99
Instruments (NBRM bills)	-3,157	-2,998	-3,729	-4,079	-4,605	-6,131	-7,199	-6,557
Government (net) 1/	-17,875	-10,606	-10,252	-11,486	-8,312	-6,281	-6,016	-4,893
Credit	4,207	3,677	3,591	3,284	3,284	3,284	3,284	3,284
Deposits	-25,040	-17,534	-19,271	-14,770	-11,596	-9,565	-9,300	-8,177
External account 2/	2,958	3,251	5,428	0	0	0	0	0
Other items (net)	-11,328	-11,612	-10,658	-10,332	-12,086	-12,560	-12,560	-13,338
Reserve money	18,218	18,175	15,031	18,180	18,114	19,894	19,386	21,904
Currency	14,134	14,136	11,861	12,726	12,445	13,892	13,834	15,259
Other	4,084	4,039	3,170	5,454	5,670	6,002	5,552	6,645
Cash in vaults	1,537	679	669	720	720	720	720	720
Total reserves 3/	2,547	3,360	2,501	4,734	4,950	5,282	4,832	5,925
o.w. On foreign exchange deposits 3/	0	0	0	2,474	2,393	2,507	2,477	2,659
Memorandum item								
Reserve money (RM)	30.1	-0.2	-17.3	0.0	-0.3	9.5	-2.6	10.1

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

1/ Compared to the credit to the government reported in the fiscal file, this number has been corrected for the unclaimed portion of payments foreign currency accounts in line with the definition in the Technical Memorandum of understanding.

2/ This account has been closed in June 2003 in line with the Technical Memorandum of Understanding.

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

Table 5. FYRM: Monetary Survey, 2002-2004

	2002	2003 revised program				2004	
	Dec. Actual	Mar. Actual	Jun. Actual	Sep. Prog.	Dec. Prog.	Mar. Prog.	Dec. Proj.
Net foreign assets	63,249	60,586	65,042	64,047	67,319	66,514	68,870
National Bank of Macedonia (NBRM) 1/	43,177	39,574	43,978	43,018	44,767	45,062	46,593
Domestic money banks (DMB)	20,072	21,012	21,064	21,029	22,552	21,452	22,278
Net domestic assets	9,585	10,443	11,989	14,246	16,186	16,934	22,473
Credit to the government	-2,711	-2,545	-4,193	-1,370	763	1,397	4,015
Banks	7,895	7,707	7,293	6,942	7,044	7,413	8,908
NBRM (net)	-10,606	-10,252	-11,486	-8,312	-6,281	-6,016	-4,893
Credit to the private sector	39,437	40,507	42,345	43,231	43,512	43,625	47,325
In denars 2/	33,740	34,126	35,284	35,890	35,892	35,655	38,555
In foreign currency	5,697	6,381	7,061	7,341	7,620	7,970	8,770
Other items (net)	-27,141	-27,519	-26,163	-27,615	-28,089	-28,089	-28,867
Broad money (M3)	72,834	71,029	77,031	78,293	83,506	83,447	91,343
Currency in circulation	14,136	11,861	12,726	12,445	13,892	13,834	15,259
Deposits of public entities 3/	2,461	2,328	2,552	2,552	2,552	2,552	2,552
Private denar deposits	28,163	27,609	30,015	31,394	33,635	34,035	38,081
Private foreign currency deposits	28,074	29,231	31,738	31,903	33,426	33,026	35,452
Memorandum items:							
M 3 (percent change from end of previous year)	-8.6	-2.5	5.8	7.5	14.7	-0.1	9.4
Implicit velocity of M3 (private; end of period)	3.4	3.6	3.3	3.3	3.1	3.1	3.0
Implicit velocity of M3 (private denar; end of period)	5.7	6.2	5.7	5.7	5.3	5.3	5.0
Net credit to government	-5,172	-4,873	-6,745	-3,922	-1,789	-1,155	1,463
Total private sector credit (adjusted) 4/	48,545	50,135	51,973	52,859	53,140	53,253	56,953
(Percent change from end of previous year)	9.9	3.3	7.1	8.9	9.5	0.2	7.2
NFA of DMBs in percent of private FX deposits	71.5	71.9	74.2	73.4	75.0	72.5	70.3
FX assets of DMBs in percent of private FX deposits 5/	122.9	121.8	114.8	115.4	115.5	114.5	113.2
Ratio of private FX deposits to private denar deposits	1.00	1.06	1.06	1.02	0.99	0.97	0.93

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. corresponding increase in the NFA of the NBRM.

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

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

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

5/ FX assets of DMBs include NFA, RR on FX deposits, loans in foreign currency and, from 2001, denar loans with foreign exchange indexing clause.

Table 6. FYRM: Balance of Payments, 2001-2004
(In millions of U.S. dollars)

	2001	2002	2003 Orig. proj.	2003		2003	2004 Proj.
				Q1	Q2		
				Act.	Est.		
Current account	-234	-321	-299	-112	-85	-292	-347
Excluding official transfers	-282	-422	-404	-136	-112	-395	-409
Trade balance (fob)	-521	-765	-725	-212	-201	-769	-759
Exports	1,155	1,113	1,236	295	350	1,354	1,443
Imports	1,677	1,877	1,961	507	551	2,123	2,202
Services (net)	-16	-25	-19	-8	-6	-17	-3
Income (net; including net interest)	-39	-30	-53	-8	-3	-29	-78
Transfers (net)	343	498	498	117	124	523	494
Official	49	100	105	24	27	102	62
Private	294	398	393	93	97	421	431
Capital and financial account	273	220	292	12	146	228	226
Capital account (net)	1	8	0	0	17	17	0
Financial account	272	212	292	12	128	211	226
Disbursements	108	162	264	17	55	233	269
Amortization	182	164	131	49	22	150	154
Direct and portfolio investment (net)	443	78	105	5	10	45	88
Currency and deposits (net)	27	69	54	-16	28	-13	5
Individuals (incl. euro-conversion effect)	377	-136	0	2	10	12	0
Commercial banks	-349	206	54	-18	18	-25	5
Short-term loans (net)	0	0	0	0	0	-18	18
Trade credits (net) 1/	-125	66	0	57	58	114	0
Errors and omissions, and short-term capital	79	-18	31	32	17	80	97
Overall balance	118	-120	25	-68	77	16	-23
Financing	-118	120	-25	68	-77	-16	-31
Net foreign assets (flows)	-133	120	-25	63	-83	-27	-31
Valuation effects on the stock of NFA (increase: -)	45	-108	0	-12	-28	-41	0
Change in the stock of NFA (increase: -)	-87	11	-25	50	-111	-68	-31
Change in gross foreign reserves (increase: -)	-56	21	-30	62	-131	-82	-23
IMF (net)	-8	-9	-5	-4	-1	-5	-8
BIS (net)	-14	0	0	0	0	0	0
Other (net)	-10	-1	10	-8	20	19	0
Change in arrears 2/	15	0	0	6	6	11	0
Rescheduling 3/	0	0	0	0	0	0	0
Financing gap	0	0	0	0	0	0	54 6/
Memorandum items:							
Current account (in percent of GDP)	-6.8	-8.6	-6.9	-2.4	-1.8	-6.3	-7.0
Excluding official transfers	-8.2	-11.3	-9.3	-2.9	-2.4	-8.5	-8.2
Export growth rate (percent)	-12.5	-3.7	11.9	21.0	32.6	21.7	6.6
Import growth rate (percent)	-16.6	12.0	5.6	19.5	25.3	13.1	3.7
Gross reserves	756	735	765	672	803	816	839
(in months of following period's imports of goods and services)	4.2	3.6	3.9	3.3	3.9	3.9	3.9
External debt service ratio (in percent) 4/	19.0	16.6	13.6	...	...	13.5	13.3
External debt to GDP ratio (in percent) 5/	38.0	38.8	36.5	...	...	32.9	33.1
Nominal annual GDP (in millions of U.S. dollars)	3,437	3,727	4,329	...	...	4,627	4,982
Denar/US\$ exchange rate (average)	68.0	64.7	58.9	57.1	54.2		

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 is included in debt service due.

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.

6/ Includes the potential need for additional Fund financing.

Table 7. FYRM: Macroeconomic Framework, 1998–2004

	1998	1999	2000	2001	2002	2003	2003	2004
	Official data				Staff est.	Prog.	Projections	
	(In percent of nominal GDP)							
Foreign saving 1/ including official grants	7.5	0.9	2.1	6.8	8.6	6.9	6.3	7.0
	8.6	2.9	5.8	8.2	11.3	9.3	8.5	8.2
National saving 2/ Government	15.9	21.2	23.2	14.0	13.3	16.1	16.1	15.8
Non-government	0.1	2.3	5.2	-2.9	-2.0	0.9	1.1	1.7
	15.8	18.9	18.0	16.9	15.2	15.2	15.0	14.1
Gross domestic investment Government	23.4	22.1	25.3	20.8	21.9	23.0	22.4	22.8
Non-government	1.8	2.3	3.4	4.3	3.8	3.6	3.6	4.2
	21.7	19.8	21.9	16.5	18.1	19.4	18.8	18.6
Fixed investment	17.4	16.6	16.2	14.8	15.0	16.1	16.5	17.3
Change in stocks	6.0	5.5	9.1	5.9	6.9	6.9	5.9	5.4
Non-government national saving minus investment	-5.8	-0.9	-3.9	0.4	-2.9	-4.2	-3.8	-4.4
Fiscal indicators								
General government balance	-1.7	0.0	1.8	-7.2	-5.7	-2.7	-2.5	-2.5
Revenues	33.3	35.4	36.6	34.4	35.8	33.5	34.0	33.1
Total expenditures	35.0	35.4	34.9	41.6	41.5	36.3	36.5	35.6
of which:								
Non-interest current expenditure 3/ Interest expenditure	31.4	31.7	29.4	34.8	35.3	30.9	31.0	29.9
	1.9	1.5	1.8	1.9	1.5	1.3	1.2	1.2
Central government balance	-0.8	0.8	2.7	-5.8	-5.4	-1.6	-1.4	-0.9
Government debt 4/ Gross	52.0	57.4	53.2	51.6	50.1	44.8	44.8	41.8
Net 5/	52.0	53.8	46.0	41.6	43.7	40.2	40.1	37.9
Memorandum items:								
	(Percent change in real terms)							
GDP	3.4	4.4	4.5	-4.5	0.7	3.0	2.8	3.0
Foreign saving including errors and omissions (in percent of nominal GDP)	8.5	-4.9	-0.1	4.5	9.1	6.2	4.6	5.0
Nominal GDP (billions of denars)	195.0	209.0	236.4	233.8	241.2	255.0	252.2	266.4

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: Indicators of Financial and External Vulnerability, 1999-2003

	1999	2000	2001	2002	2003 end-June
Financial indicators					
Broad money (end of period; percent change from end of previous year)	29.7	25.6	56.7	-8.6	5.8
Private sector credit (end of period; percent change from end of previous year)	9.4	17.2	7.3	9.9	7.1
Share of non-performing loans in total bank exposures (end of period, in percent) 1/	41.3	34.8	33.7	30.9	...
Foreign currency deposits (end of period, in percent of broad money)	19.2	22.8	46.3	38.5	38.1
Indexed loans to private sector (end of period, in percent of denar credit to private sector)	...	...	26.9	25.9	23.5
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	16.7
Indexed loans and foreign currency credit to private sector (end of period, in percent of total credit to private sector)	...	...	37.0	36.6	36.3
Central bank short-term foreign liabilities (in millions of US dollars)	102	14	0	0	0
Short term foreign assets of commercial banks (in millions of US dollars)	400	434	642	508	...
Short term foreign liabilities of commercial banks (in millions of US dollars)	265	217	162	195	...
Money market rate (end of period; in percent)	11.6	7.2	11.9	14.4	8.6
External Indicators					
Exports (percent change, in terms of US\$)	-7.9	11.0	-12.5	-3.7	27.0
Imports (percent change, in terms of US\$)	-6.7	19.3	-16.6	12.0	15.8
Current account balance (in percent of GDP) (Including official grants)	-0.9	-2.1	-6.8	-8.6	-4.3
(Excluding official grants)	-2.9	-5.8	-8.2	-11.3	-5.4
Foreign direct investment (in percent of GDP)	0.9	4.9	12.9	2.1	1.0
Gross official reserves (in US\$) (In months of next year's imports of goods and services)	450	700	756	735	803
(In percent of broad money)	2.4	4.3	4.3	3.6	3.7
Total external debt (in percent of GDP)	67.1	89.9	65.6	59.1	56.7
of which: public sector (in percent of GDP)	39.2	40.1	38.0	38.8	32.9 <i>a</i>
Short-term debt (by remaining maturity) (In percent of GDP)	34.1	35.7	33.7	33.8	28.5 <i>a</i>
(In percent of official reserves)	4.8	5.3	7.3	6.3	5.0 <i>a</i>
External debt service payments (in percent of exports of goods and services)	39.2	27.2	33.3	31.8	28.6 <i>a</i>
Exchange rate (denar per U.S. dollar, period average)	12.4	13.0	19.0	16.6	12.8
REER (average percent change; (-) depreciation)	56.9	66.0	68.0	64.7	54.2
CPI-based	2.9	4.0	-6.1	-2.5	-2.5 <i>b</i>
ULC-based	7.6	8.8	-2.2	-1.5	2.6 <i>c</i>

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 End-2003 projections

b Data as of end-May 2003.

c Data as of end-April 2003.

FYR Macedonia—Fund Relations
(As of August 31, 2003)

I.	Membership Status:	Joined 12/14/92; Article VIII					
II.	General Resources Account:	<u>SDR Million</u>	<u>Percent of Quota</u>				
	Quota	68.90	100.00				
	Fund holdings of currency	86.11	124.97				
III.	SDR Department:	<u>SDR Million</u>	<u>Percent of Allocation</u>				
	Net cumulative allocation	8.38	100.00				
	Holdings	0.38	4.53				
IV.	Outstanding Purchases and Loans:	<u>SDR Million</u>	<u>Percent of Quota</u>				
	Contingency and Compensatory	6.89	10.00				
	Extended Arrangements	1.15	1.67				
	ESAF/PRGF Arrangements	26.28	38.14				
	Stand-By	4.00	5.81				
	Systemic Transformation Facility	5.17	7.50				
V.	Latest Financial Arrangements:						
	<u>Type</u>	<u>Approval Date</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>		
	Stand-By	04/30/2003	06/15/2004	20.00	4.00		
	EFF	11/29/2000	11/22/2001	24.12	1.15		
	PRGF	12/18/2000	11/22/2001	10.34	1.72		
VI.	Projected Payments to the Fund (Expectations Basis) ¹						
	(SDR million; based on existing use of resources and present holdings of SDRs):						
			<u>Forthcoming</u>				
			2003	2004	2005	2006	2007
	Principal		5.48	13.72	7.87	8.18	6.27
	Charges/Interest		<u>0.19</u>	<u>0.46</u>	<u>0.32</u>	<u>0.24</u>	<u>0.16</u>
	Total		5.67	14.18	8.19	8.42	6.44

¹ This schedule presents all currently scheduled payments to the IMF, including repayment expectations and repayment obligations. The IMF Executive Board can extend repayment expectations (within predetermined limits) upon request by the debtor country if its external payments position is not strong enough to meet the expectations without undue hardship or risk, repayment schedules and IMF lending for details).

Projected Payments to the Fund (Obligations Basis) ²

(SDR million; based on existing use of resources and present holdings of SDRs):

	<u>Forthcoming</u>				
	2003	2004	2005	2006	2007
Principal	5.48	13.72	6.68	6.99	7.08
Charges/Interest	<u>0.16</u>	<u>0.40</u>	<u>0.31</u>	<u>0.28</u>	<u>0.21</u>
Total	5.64	14.12	6.99	7.27	7.29

VII. Safeguards Assessments:

Under the Fund's safeguards assessment policy, the National Bank of the Republic of Macedonia (NBRM) is subject to an assessment with respect to the arrangement, which was approved on April 30, 2003 and is scheduled to expire on June 15, 2004. A safeguards assessment of the NBRM was completed on April 24, 2003. The assessment concluded that substantial risks may exist in the area of internal audit and control. Staff findings, proposed recommendations under program conditionality and other recommendations are reported in EBS/03/51, 4/30/03. Implementation of the measures by the NBRM is being monitored by staff.

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. Households can transact only through commercial banks or through foreign exchange bureaus that act as agents of banks; enterprises can transact through the banking system. The reserve requirement on all foreign currency deposits is set at 7.5 percent.

At end-April 2003, the official exchange rate was denar 55.8 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.

² This schedule is not the currently applicable schedule of payments to the IMF. Rather, the schedule presents all payments to the IMF under the illustrative assumption that repayment expectations—except for SRF repayment expectations—would be extended to their respective obligation dates by the IMF Executive Board upon request of the debtor country (see [repayment schedules](#) and [IMF lending](#) for details). SRF repayments are shown on their current expectation dates, unless already converted to an obligation date by the IMF Executive Board.

IX. Article IV Consultations:

The first consultation with the FYRM was concluded in August 1993. The last consultation was concluded on April 30, 2003 (EBS/03/51). The FYRM is on the standard consultation cycle.

X. Technical Assistance (since 1999):

Purpose	Department	Date
Fiscal Decentralization	FAD	September 2003
FSAP	MFD/WB	May 2003 and June 2003
Public Expenditure Management	FAD	May 2003
Monetary Operations and Payment System	MFD	November-December 2002
Balance of Payments Statistics	STA	June-August, 2000 October 2002
Fiscal Decentralization	FAD/WB	March 2002
Tax Policy	FAD	December 2001
Development of a Treasury System	FAD	October 2000 November 2001
Value-Added Tax	FAD	February 1999 October 1999 October 2000
Article VIII	MFD/LEG	September 2000
Monetary Policy and Banking Supervision	MFD/ WB MFD	October 1999 December 1999, May 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. Kevin Ross has held this position since May 2003.

FYR Macedonia: IMF–World Bank Relations

Partnership in FYR Macedonia's Development Strategy

1. The former Yugoslav Republic of Macedonia (FYR Macedonia) has been a member of the World Bank since 1993. Since FYR Macedonia joined the Bank, 25 loans have been approved with a total value of \$630.7 million. Of this, \$252 million has been extended under IBRD and \$378.7 million under IDA. All new lending to FYR Macedonia is envisaged to be on IBRD terms.

Table 1: Summary of World Bank Operations
(As of September 2003)
(In US\$ Millions)

<u>FY</u>	<u>Name of Operation</u>	<u>IDA Amount</u>	<u>IBRD Amount</u>	<u>STATUS</u>	<u>Undis- bursed ¹</u>
1994	Economic Recovery Credit	40	40	Closed	
1995	Transit Facilitation Project		24	Closed	
1995	Social Reform & Technical Assistance	14		Closed	
1995	Financial & Enterprise Sector Adjustment	85		Closed	
1996	Private Sector Development		12	Closed	
1996	Private Farmer Support	7.9		Closed	
1996	Health Sector Transition	16.9		Closed	
1997	Structural Adjustment Credit	30	30	Closed	
1998	Education Rehabilitation	5		Closed	
1998	Private Sector Development II		25	Closed	
1998	Irrigation Rehabilitation	5	7.5	Active	6.9
1998	Power System Improvement		35	Active	10.5
1999	Pension Reform TA	1		Closed	
1999	Social Sector Adjustment	29		Closed	
1999	Transport Sector Project		32		
1999	Emergency Recovery Credit	50		Closed	
1999	Social Support Credit	10		Closed	
2001	Trade & Transport Facilitation (SE Europe)	9.3		Active	5.9
2001	Financial & Enterprise Sector Adjustment II	20	30.3	Active	20.0
2001	Community Development and Culture	5		Active	4.5
2001	Children and Youth Development	2.5		Active	1.8
2001	Water Utilities	13.1	16.2	Dropped	
2002	Emergency Economic Recovery Credit	15		Closed	
2002	Public Sector Management Adjustment	15		Closed	
2002	Community Development Project	5		Active	4.8
TOTAL		378.7	252.0		54.4

¹ Undisbursed amounts based on USD/EUR and USD/SDR exchanges rates at time of commitment.

2. The World Bank's Board endorsed a new Country Assistance Strategy (CAS) for FYR Macedonia on September 9, 2003. This CAS presents an IBRD program of support which seeks to build on the improved macro-economic management and progress in structural reform that has occurred since the formation of the new Government following elections in September 2002. While considerable risks remain, the new CAS reflects the window of opportunity for improved growth presented by the relatively calm internal and external environment, following regional conflict during much of the 1990s and the internal conflict in FYR Macedonia that was concluded with the Ohrid Peace Agreement of August 2001. The Stabilization and Association Agreement (SAA) signed between the Macedonian Government and the European Union in 2001 also provides a longer-term framework for the development agenda in FYR Macedonia.

I. BANK GROUP STRATEGY

3. The new CAS focuses on supporting the Macedonian Government's efforts to promote the effective management of public resources, tackle corruption, create the conditions for private sector led growth, and ensuring that effective and sustainable social programs are in place for the most vulnerable Macedonians. The CAS envisages a selective base-case program of IBRD investment lending of \$90 million. Additional lending of up to \$75 million, mostly as adjustment loans, is also available should the Government meet triggers for a high case lending program. Lending will be supported by a substantial body of diagnostic and fiduciary work. This is outlined in Table 2 below.

Table 2. The Planned IBRD Assistance Program FY04-06						
	<i>Low Case</i>	<i>US\$m</i>	<i>Base Case</i>	<i>US\$m</i>	<i>High Case</i>	<i>US\$m</i>
FY04 Lending	Education Access Improvement Project	5 ^a	Education Access Improvement Project Health and Social Protection Administration	5 ^a 15	Education Access Improvement Health and Social Protection Administration PSMAL II Transport Restructuring CEM Follow Up Notes FSAP Energy Sector Poverty Assessment Urban Slums Analysis	5 ^a 15 30 15
ESW/AAA	<i>CEM Follow Up Notes FSAP Energy Sector Poverty Assessment</i>		<i>CEM Follow Up Notes FSAP Energy Sector Strategy Poverty Assessment</i>			
FY05 Lending	Land Registration	15	Land Registration Financial Sector Development Water Resources Management (GEF) ^b	15 15	PSAL I Land Registration Financial Sector Development Water Resources(GEF) ^b Poverty Assessment Legal/Judicial Diagnostic Social Services Delivery	15 15 15
ESW/AAA	<i>Poverty Assessment Legal/Judicial Social Services Delivery</i>		<i>Poverty Assessment Legal/Judicial Diagnostic Social Services Delivery</i>			
FY06 Lending			Reg/ Judicial Reform Electric Power Dev	15 25	PSAL II Reg/Judicial Reform Electric Power Dev Poverty Assessment (TA) PEIR Update CPAR Update Social Development Update	15 15 25
ESW/AAA	<i>Poverty Assessment (TA) PEIR Update CPAR Update Social Development Update</i>		<i>Poverty Assessment (TA) PEIR Update CPAR Update Social Development Update</i>			
Total		20		90		165

- a. Expected to be co-financed by a US\$10 m grant from the Government of the Netherlands.
- b. An application for GEF financing will be presented in FY05.

4. **Promoting the efficient management of public resources and tackling corruption.** Although public expenditure management has improved, much remains to be done, especially in strengthening fiduciary controls over public finances. A critical weakness which remains, and which has been a major source of corruption and misuse of public resources in the past, is the operation of five extra-budgetary funds, which are outside the control of the central government budget and are subject to weak oversight. These together comprise approximately 40 percent of central government spending. The civil service and broader public sector employment structures require considerable reform. Significant function decentralization, as envisaged in the Law on Local-Self Government will also pose significant challenges.

5. The Bank has undertaken analytic work to support improved public expenditure management through a Public Expenditure and Institutional Review (PEIR) conducted in 2000, a Country procurement Assessment Report (CPAR) in 2002 and a Country Financial Accountability Assessment (CFAA) in 2002. A PEIR update and a further CPAR are anticipated in FY06 to review progress.

6. Financial support has been provided through the Public Sector Management Adjustment Credit (PSMAC), which was approved in FY02, but not signed until the macro-economic framework improved following the formation of the new Government. Should FYR Macedonia meet triggers for a high case lending program, support of the public sector management reform program will be continued with a Public Sector Management Adjustment Loan II (PSMAL II) in FY04 which will support reform of the Health Insurance Fund and the Pension and Disability Insurance Fund, as well as further measures to consolidate improvements in budgetary planning and execution such as the implementation of control over commitments by budget entities. Reform of the existing instruments of social protection to improve targeting, eliminate adverse incentives affecting the labor market, and reduce the fiscal drain on government finances will also be supported. Technical assistance to implement these reforms, along with required information technology improvements, will be provided through a complementary Health and Social Protection Administration project, also planned for FY04. As progressively deeper reform of public administration is currently anticipated through the CAS period, the Bank will also look, as part of a high case lending program, to commence a Programmatic Structural Adjustment Loan (PSAL I) in FY05, to be followed by a second operation (PSAL II) in FY06. The PSAL operations are planned to support both the improvement of public sector management and reforms to improve the investment climate.

7. **Promoting the creation of jobs through sustainable private sector driven growth.** A rebound in private sector activity and growth will be critical to reduce poverty in FYR Macedonia, especially given persistently high unemployment. Extensive work will be completed through FY04 and FY05 to define a multi-year program of reforms aimed to stimulate the private sector, which is likely to include measures to improve the business environment, further strengthen the broader financial sector, and to complete the process of resolution of state owned enterprises.

8. Despite relatively good progress with privatizations under the current Financial and Enterprise Sector Adjustment Loan (FESAL), with more than 100 SOEs to be sold or closed by December 2003, the enterprise sector remains inefficient and uncompetitive. Improving this situation will require addressing the poor business/regulatory environment and operational inefficiencies of the banking sector. Recent work by the Bank and the IMF also indicates that the observance of auditing and accounting standards in FYR Macedonia is poor, and contributes to the overall climate of poor fiduciary control. As with the public sector reform program, the Bank's support to this objective will be anchored in programmatic lending, specifically through the PSAL I and PSAL II operations described above, should high case lending triggers be met. While the health of the banking system has been improved through the strengthening of regulatory and supervisory framework and the resolution of a number of problem banks, the sector remains under-developed and significant weaknesses persist. A joint IMF and World Bank Financial Sector Assessment Program completed in September 2003 will inform the design of a Financial Sector Development project proposed in FY05. The project will aim to strengthen the regulatory and supervisory framework for the financial sector, including the insurance and pension systems. In addition, the project could help implement policies to improve intermediation to the SME sector and the economy in general, and may also seek to address development of regulatory capacity in other sectors.

9. Adjustment lending would be supported by a series of complementary and linked investment operations. Reflecting the constraints to growth posed by a lack of secure land titles, a Land Registration project is planned for FY05 to support the completion of a real estate cadastre and the building of capacity to support land title transfer and land use monitoring. This will also seek to improve the security of land use rights and titles for the residents of urban slums. A Legal and Judicial Diagnostic study will expand on other studies which have identified significant weaknesses in the judicial system that adversely affect creditor and property rights, as well as generally undermining the rule of law. On the basis of this analysis, a Regulatory and Judicial Reform project is planned for FY06 and may include assistance to improve access to justice, raise judicial competence and discipline, strengthen the authority of the courts, de-politicize the office of the public prosecutor, and promote transparency.

10. In order to provide an enabling environment for private sector led growth, interventions in the transport and energy sectors are intended to increase private participation, improve services, and explore opportunities for greater sub-regional cooperation. Given FYR Macedonia's land-locked position, improvements in the transport sector are essential for regional integration and to promote growth. A primary objective of a Transport Sector Restructuring project planned for FY04 is to restructure the two principal SOEs that dominate the sector – Macedonian Railways and Makedonijapat (Roads)–to facilitate the opening of the transport sector to private sector investment and to reduce the burden on public finances from mounting losses. Bank engagement build on the existing Transport Sector Project, and complement efforts to harmonize customs and improve trade links through the regional Trade and Transport in South East Europe (TTFSE) initiative and anticipated transport sector investments by the EBRD and the private sector. An Energy Sector Strategy will seek to analyze options for alternative fuel sources for FYR Macedonia giving dwindling lignite supplies as well as exploring possibilities to diversify electricity

supply and integrate more closely into regional energy markets. This work will inform the design of an Electric Power Development project in FY06. Through this project the Bank will seek to catalyze partnerships with other institutions and the private sector, as well as reducing electricity losses in distribution. This operation will take advantage of the Bank's position to overcome obstacles to private sector involvement in infrastructure provision.

11. **Promoting social cohesion, building human capital and protecting the most vulnerable.** The Kosovo crisis and the civil conflict of 2001 eroded social cohesion. There are substantial social and economic differences between FYR Macedonia's ethnic communities, rural and urban populations and, more generally, between sub-regions of the country. While the implementation of some provisions of the Ohrid agreement has begun to promote reconciliation and reintegration of communities, there remains a substantial unfinished agenda.

12. The Government's primary vehicle for improving social cohesion is the Ohrid Agreement. Given significant donor assistance pledged to support the implementation of the agreement, and especially to support technical capacity building at the municipal level, the Bank will not focus its resources in this area. The Bank will, however, be looking to support specific elements of the decentralization process and seek to mitigate against critical risks, such as a breakdown in the delivery of key services. Support will focus especially on education. A planned Education Access Improvement project will focus on improving the quality of primary and secondary education in FYR Macedonia while piloting new financing arrangements. The project will seek to improve the access of girls to primary education and support access of minority groups to education, including support especially for Roma children who remain particularly disadvantaged. Through the adjustment lending program - the PSMAL II and the subsequent PSAL I and II - and the Health and Social Protection Administration project the Bank will also assist the government with a redesign of the existing social protection system to improve targeting of the safety net and provide better coverage of the poorest. The improvements in the transparency and accountability of health service delivery expected under the project will also be important to improving access to and quality of health care for the most vulnerable. The Bank will be working closely with the government to implement pension reform to improve the long term financial sustainability of the pension system, while mitigating the significant risks that exist. As discussed previously, a key component of these activities will be improved fiduciary control over the Health Insurance Fund and the Pension Fund. The Bank will also continue to support the broader reconciliation agenda through its existing portfolio, in particular through the Children and Youth Development and the Community Development projects under implementation.

13. Lending operations will be supported by a range of technical assistance and analytic activities. A Programmatic Poverty Assessment is intended to provide a comprehensive analysis of poverty data, as well as building the capacity of national institutions to collect and analyze data. Results of the November 2002 census will allow for the formulation of a new sampling frame and renewed analysis of poverty data from previous years. Although data deficiencies mean this is unlikely to be sufficient to deliver a robust poverty assessment, it will provide a much more accurate poverty profile than currently available and form the basis for more regular poverty monitoring reports. A Social Services Delivery Study is also

planned in FY05 to review the causes of inequity and gaps in access to social services, in the context of the changes taking place as a consequence of the Ohrid Agreement, and in light of the Poverty Assessment.

II. BANK-FUND COLLABORATION IN SPECIFIC AREAS

14. The Bank's assistance for structural reform in FYR Macedonia has supported the IMF's lead role on support for macro-economic policies aimed at facilitating sustainable growth. In areas of direct interest to the IMF, the Bank is engaging in policy dialogue and providing financial and technical assistance to support (i) improved public expenditure management; (ii) public sector reform; (iii) pension, health and social assistance reform; (iv) financial sector reform and development; and (v) an improved business environment. This is set out in Table 3.

15. **Public expenditure management.** The Bank has complemented IMF policy conditionality and technical assistance to improve budget management with a multi-pronged assistance program including lending operations and fiduciary and diagnostic work. A range of weaknesses in public resource management identified in a Public Expenditure and Institutional Review (PIER) conducted in 2000 have since been addressed in a revised Law on Budget and Financial Management and other enabling legislation. The implementation of an effective treasury system, and a further systems upgrade being undertaken in September 2003, have been important steps forward in improving budget execution and strengthening expenditure control systems, although further improvements are needed especially in budget preparation and the establishment of a medium-term budgetary framework. The Law on Budget and Financial Management and the 1999 Law on State Audits have also provided a solid legislative basis for the operations of the State Audit Office and the establishment of internal audit functions, although this function will require further strengthening. The Country Procurement Assessment Report (CPAR) and the Country Financial Accountability Assessment (CFAA) undertaken in 2002 will help to define further public expenditure management components and conditionality to be included in a second Public Sector Management Adjustment Loan (PSMAL II) that is anticipated should the Macedonian Government continue with further reform to meet high case lending triggers. The PSMAL is also anticipated to complemented IMF support for a phased approach to decentralization which, while a cornerstone of the Ohrid agreement, poses considerable fiduciary challenges in implementation. Through the education modernization project, the Bank will also be supporting efforts to decentralize education services and resources. Bank involvement has been informed by a decentralization status report undertaken in 2003.

Table 3: IMF–World Bank Collaboration in FYR Macedonia			
Area	Specialized Advice from the IMF	Specialized Advice from the Bank	Key Instruments
Public Expenditure Management	Appropriate fiscal policy envelope; management of decentralization; Treasury development.	Reform in central budget formulation and execution, procurement practices and auditing functions; sectoral aspects of decentralization.	<i>IMF</i> : SBA performance criteria; technical assistance <i>Bank</i> : <i>Analysis</i> : PEIR (2000); CPAR (2002); CFAA (2002); Decentralization status (2003). <i>Lending</i> : PSMAL II (FY04), Education Modernization (FY04)
Public Sector Reform		Civil service reform; decompression of salaries.	<i>Bank</i> : <i>Analysis</i> : CEM, PEIR <i>Lending</i> : PSMAC (2000); PSMAL II (FY04)
Pension, Health and Social Assistance Reform	Reform of unemployment benefit entitlements; incorporating Extra-budget funds into Single Treasury Account; Remove subsidies to Health Insurance Fund; Implement health sector redundancy program.	Management reform of Health Insurance Fund (HIF), based on audit; reform of pharmaceutical procurement; strengthening sustainability of pension system and Pension Fund.	<i>IMF</i> : SBA performance criteria <i>Bank</i> : <i>Analysis</i> : <i>Lending</i> : HSPP (FY04); PSMAC (FY04)
Financial Sector Reform and Development	Strengthening NBRM; Amending AML/CTF Law.	Improving regulatory and supervisory framework for the financial sector, strengthen AML/CTF policies and compliance; assist development of financial markets.	<i>IMF</i> : SBA performance criteria <i>Bank</i> : FESAL II (FY01); Financial Sector Development (FY05) <i>Joint</i> : FSAP
Improved Business Environment	Monetary policy, exchange rate, balance of payments, economic statistics; electricity pricing reform; Tobacco Law reform.	Economic growth; investment environment for private sector activities, especially in regulatory framework and land markets; judicial and regulatory reform; infrastructure development for growth.	<i>IMF</i> : SBA performance criteria <i>Bank</i> : <i>Analysis</i> : CEM (2003); Energy sector strategy (2003); Legal/Judicial diagnostic (2004). <i>Lending</i> : PSAL I (FY05); PSAL II (FY06); Judicial and regulatory reform (FY06); Land registration (FY05); Trade and transport facilitation for Southeastern Europe (2001); Transport restructuring (FY04) [in conjunction with EBRD]; Power systems improvement (1998); Electric power development (FY06).

16. **Public sector reform.** The civil service and broader public sector employment structures require significant reform. Uncontrolled growth of the wage bill is a major risk to fiscal sustainability. The civil service salary structure is also highly compressed and remains an obstacle to attracting and retaining skilled staff. The government's human resource management reform agenda encompasses both the civil service as well as pay and employment reform throughout the rest of the public administration (including employment with sub-national governments, public enterprises, extra-budgetary funds), which comprise a significant proportion of the total public sector wage bill. Progress has been made on civil service reform, including the passage of and subsequent revision of a new Law on Civil Servants and recent enforcement efforts. However, the proposed decompression of civil service salaries has been repeatedly postponed due to fiscal constraints. Initial support for public sector reform is anticipated through the PSMAL II, which will build on the PSMAC operation that was finally signed in 2002 once macro-economic stability improved. The Health and Social Protection Program (HSPP) and the Education Modernization operation anticipated in FY04 will also support the decompression of salaries in these sectors, which suffer from an overly large number of poorly paid teachers and health specialists. As progressively deeper reform of public administration is currently anticipated through the CAS period, the Bank will also look, as part of a high case lending program, to commence a Programmatic Structural Adjustment Loan (PSAL I) in FY05, to be followed by a second operation (PSAL II) in FY06.

17. **Pension, health and social assistance reform.** The Bank and the IMF are cooperating closely to assist the Government improve management of the Health Insurance Fund and the Pension Fund, which are the largest of the extra-budgetary funds operating outside the central government budget. Continuing reform will be critical to reduce liabilities on the central government budget from these sources and to reduce opportunities for corruption and mis-management, for which such funds have in the past proved a source. The Bank is providing advice and assistance to support the Government to meet its commitments to the IMF to consolidate the extra-budgetary funds within the Treasury Single Account.

18. **Inefficiency and corruption in the state Health Insurance Fund (HIF) and state-owned healthcare institutions is a major source of poor performance in the health system.** Efforts at reform have been tentative, though progress has occurred in some areas. For example, the HIF now contracts with private as well as public primary care providers. The Bank will also support the Government in its commitment to audit the Health Insurance Fund and to implement cost saving measures to ensure that further transfers to the HIF are not required from 2004. This will include new tenders for pharmaceuticals and other efficiency gains. Completing the audit of the HIF and implementing an action program to improve control and procurement systems will be a key performance trigger if a high case lending program is to be provided. Should progress be made, the PSMAL II will provide financial support for these reforms with technical assistance and funding for information technology improvements provided under the Health and Social Protection Project (HSPP), which will build on the 1996 Health Sector Transition Project.

19. Further reform of the pension system is also urgent. In 2002, the Pension and Disability Insurance Fund (PDIF) required considerable transfers from general revenue to meet expenditures. The structural deficit in the PDIF is expected to grow into the future. Reform will need to include parametric changes, along with efforts to improve administration through strengthened accounting and improved internal controls. The Bank has been active in supporting pension reform efforts in the past through a series of operations and technical assistance. The Bank will be providing further support, focused especially on strengthening the financial sustainability of the current defined benefit "first pillar" pension scheme, through the Health and Social Protection Project (HSPP) scheduled for Board consideration in FY04. Should triggers for a high case program be met, additional support for pension reform is anticipated through a Public Sector Management Adjustment Loan (PSMAL).

20. **Financial sector reform and development.** As noted previously, the health of the banking system has been improved through the strengthening of regulatory and supervisory framework and the resolution of a number of problem banks, but the sector remains underdeveloped and significant weaknesses persist. More effective banking and financial market supervision will especially be important to improve financial stability and integrity and to ensure that capital is allocated efficiently to promote private sector led growth. The Government has already taken steps to implement the recommendations of the joint IMF and World Bank FSAP completed in September, including moves to improve central bank accountability and strengthen banking and financial market supervision. The FSAP will influence the design of a Financial Sector Development project operation proposed for FY05. The project will aim to assist further improvements in the regulatory and supervisory framework for the financial sector, including the insurance and pension systems, strengthen the legal framework for Anti-Money Laundering, Counter-Terrorist Financing (AML/CTF) policies and provide legal authority to monitor compliance. The operation will also support efforts to promote financial market development, including increasing market breadth by the introduction of new instruments and increase transparency and accountability.

21. **Improving the business environment.** Improving the business environment will be crucial to overcome very high levels of unemployment and to attract investment flows, which, to date, have been disappointing. Complementing IMF dialogue with the Government to maintain a stable macro-economic environment conducive to increased private investment, the Bank will be providing technical and lending support to assist the Macedonian Government engage in structural reform and to finance important investments. Extensive work will be completed through FY04 and FY05 to define a multi-year program of reforms aimed to stimulate the private sector, which is likely to include measures to improve the business environment, further strengthen the broader financial sector, and to complete the process of resolution of state owned enterprises. Key instruments in Bank assistance to improve the overall regulatory environment will include proposed adjustment operations, as well as an anticipated legal and regulatory diagnostic study in FY04 leading to a possible lending operation in FY06. The Bank has taken the lead role in working with the Government to strengthen the power sector and encourage greater regional integration through the 1998 power sector development project, which is anticipated to be followed by an electric power development loan in FY06. The Bank has also been encouraging greater regional transport integration through the 2001 trade and transport facilitation program for

South Eastern Europe, and this could be followed by a transport sector restructuring program in FY04. While the Bank is likely to take the lead on railway restructuring, dialogue on road maintenance and investments will be conducted in close coordination with the EBRD.

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 made 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 reassessed. 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 methodology, and (ii) correcting the overstatement of private transfers due to transactions involving foreign currency accounts. Furthermore, the 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 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 financing data for the central government from the BOP and the monetary survey cannot be fully reconciled with the data provided by the Ministry of Finance. Recommendations for the reconciliation of accounts have been developed in the recent (June 2003) FAD technical assistance mission.

The data for extra-budgetary funds are less reliable than the central government data. 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 (NBRM) 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 NBRM. 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 for different maturities. Other improvements need to be made in the data reported by the commercial banks to the NBRM for specific analytical and supervisory purposes, such as reporting of data on credit by economic activity, currency (including indexed lending) and maturity, 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.

FYR Macedonia—Core Statistical Indicators
(as of September 3, 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	Sept 3	August 22	July 31	August 28	July 31	August 28	August	May	May	June 30	March	Dec 31
Date Received	Sept 3	August 28	August 26	August 29	August 26	August 29	Sept. 2	July	July	July 24	July 1	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.

September 29, 2003

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

Dear Mr. Köhler:

On April 30, 2003, the Executive Board approved a Stand-by Arrangement (SBA) (EBS/03/51, 4/16/03) for the Republic of Macedonia. The attached Supplementary Memorandum of Economic and Financial Policies (SMEFP) describes our performance to date under the program with the Fund and the policies that the Government of the Republic of Macedonia will implement during the remainder of 2003 and in the first quarter of 2004. We believe that the policies set forth in our MEFP and the attached SMEFP are adequate to achieve the objectives of its 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, and in advance of revisions to the policies contained in our MEFP and SMEFP, in accordance with Fund policies on such consultation.

The program remains on track. All the end-June 2003 performance criteria (PCs) and most of the indicative targets were observed, the one exception being the indicative target on Health Insurance Fund (HIF) payments arrears. The single structural performance criterion and three of the four structural benchmarks were observed; the exception was the structural benchmark on audit of procurement procedures at the HIF, which was initiated with a one month delay.

Since our program is on track and in light of the policies described in the SMEFP, we request completion of the first review under the SBA and waivers of applicability with respect to those September 30, 2003 quantitative performance criteria for which data will not be available by the time of the Executive Board meeting scheduled for October 17, 2003. We are confident that all September 30, 2003 quantitative performance criteria will be met.

Sincerely,

/s/

Branko Crvenkovski
Prime Minister

/s/

Petar Gošev
Minister of Finance

/s/

Ljube Trpeski
Governor

National Bank of the Republic of Macedonia

Supplementary Memorandum of Economic and Financial Policies

I. INTRODUCTION

1. **This Supplementary Memorandum of Economic and Financial Policies (SMEFP) describes the government's economic program from July 2003 to March 2004, under the Stand-By Arrangement (SBA) that was approved by the Executive Board of the International Monetary Fund on April 30, 2003.** It supplements the original MEFP of April 15, 2003, particularly in the areas of banking sector governance and supervision, drawing on the recommendations of the FSAP mission. It also reflects understandings on the revised budget for the remainder of 2003 and incorporates new commitments to improve public sector management.
2. **Macroeconomic developments remain generally favorable, but there is little evidence of a decisive turnaround in economic performance or of a diffusion of growth across all sectors of the economy.**
 - Real GDP growth for the last quarter of 2002 (4.3 percent y-o-y) and the first quarter of 2003 (2.2 percent y-o-y) are consistent with a year-end turnaround. Increased activity for the rest of the year is likely to be supported by a strong growth in the metals sector, a continuing political stabilization and a pickup in government spending. However, a positive trend in industrial production in the first half of 2003 was concentrated in few sectors of the economy and dependent on the performance of a small number of companies.
 - The CPI inflation rate has slowed in the first half of the year and reached 0.7 percent (y-o-y) in June 2003. The low inflation reflects a dip in food prices, the strong euro and the expiry of the financial transactions tax.
 - In the external sector, the weak US dollar reduced the competitiveness of the textile sector, but total exports grew strongly nonetheless, owing to a brisk growth in steel and other metals exports. Despite this, the trade balance deteriorated somewhat in the first half of the year. This reflected some increase in imports for processing, but mainly one-time factors. On aggregate, competitiveness indicators have not changed significantly. Consequently, an improvement in the trade balance is expected in the second half of the year.
3. **The fiscal stance, which had been highly expansionary in the second half of 2002, turned markedly tighter in the first half of 2003.** First half central government spending was lower than projected—by about 1.3 percent of annual GDP—reflecting a late approval of the 2003 budget, the implementation of new procedures for strengthening fiscal discipline and public expenditure transparency, and a slow startup of capital spending after a review of projects pared their number. Taking into account larger

than expected non-tax revenues, the central government deficit in the first half was about 1.5 percent of annual GDP lower than projected.

4. **Easing monetary conditions provided an offsetting shift in the policy mix while the overall fiscal tightening reduced the pressure on the foreign exchange market.** As a result, net international reserves remained above program floors. The fiscal tightening, and a return of confidence in the denar, also contributed to a welcome decline in the interest rate on central bank bills from 15 percent to 7 percent during February-April. Commercial banks' deposit and lending rates declined by less (only two percentage points) and with some lag, reflecting weak competition and persistent structural problems in the bank lending market.
5. **Broad money grew approximately in line with the program assumptions, but the shift toward foreign currency deposits continued.** In spite of the tight fiscal policy, demand for money remained strong, due in part to the abolition of the financial transactions tax. The demand for denar deposits did not strengthen as much as anticipated, however, because changes in the denar-euro interest rate spread spurred an increase in the demand for foreign currency deposits. An additional factor may be the new foreign exchange law, which allows exporters to retain their foreign exchange proceeds indefinitely. The strengthening of money demand resulted in somewhat higher than anticipated credit to the private sector.
6. **We have undertaken a number of reforms to improve the financial position of the state electricity company (ESM).** The price of electricity per kilowatt-hour in each category of electricity consumption was raised by 7 percent on July 1, 2003 thus passing through about half of the increase in the VAT charged on electricity. In addition, we initiated a reduction of some 1050 non-essential personnel, which should generate savings of approximately 60 million denars in 2003. We are ready to take further measures, if necessary, to ensure the financial health of ESM on the eve of its privatization.
7. **We have begun to address the poor fiscal performance at the Health Insurance Fund.** The positive list for medicines was rationalized, and we have allowed participation of international pharmaceutical suppliers within a transparent procurement process. The financial system audit report by the State Audit Office (SAO) will be presented to Parliament by January 2004. The terms of reference for the international auditor was agreed with the World Bank, which should allow the completion of the full systems audit of the Health Fund by end-2003 in cooperation with the SAO.
8. **Parliament has enacted a package of amendments to the banking laws, improving the banking environment and bank supervision.** Several of the modifications were in response to FSAP mission recommendations. The amendments to the foreign exchange law substantially liberalized foreign currency lending, which should alleviate credit constraints in the economy. The new central bank law, inter alia, affirmed the NBRM's mandate to set exchange rate policy, allowed the Governor of the central bank to propose vice governors of the NBRM, and strengthened accountability. Three new vice governors have been appointed, ending a long standing impasse. In addition, with a goal of improving

banking supervision, the threshold for central bank approval of changes to shareholding structure was lowered, “fit and proper” provisions were strengthened, information sharing between supervisory agencies was improved and the range of corrective measures expanded and made more consistent.

9. **We have concluded bilateral agreements with all Paris Club creditors and Kuwait, cleared all technical arrears, and included the resulting current obligations in our debt service schedule.**

II. POLICIES FOR THE REMAINDER OF 2003 AND 2004

A. Macroeconomic Policy Framework

10. **Although the absence of broad-based growth highlights a risk to our macroeconomic projections, we see our program objectives as achievable.** Slightly slower than expected growth in the first half of the year has led us to refine our growth forecast for 2003 from about 3 percent to 2¾ percent. Moreover, pending further analysis, we now anticipate GDP growth in the range of 3 to 4 percent in 2004. The inflation forecast for 2003 has been reduced by 1¼ percentage point to 1¾ percent, while 2004 inflation is likely to be within a range of 2½ to 3 percent. The external current account deficit (excluding official grants) is expected to improve to about 8.5 percent of GDP in 2003 from 11.3 percent in 2002 and to improve further to 8.2 percent in 2004. If, however, growth fails to materialize or the external position deteriorates, we stand ready to modify our policies accordingly.

11. **In line with the revised macroeconomic outlook and reflecting our proposed supplementary budget for 2003 (described below), we have updated our financial program (Table 1) and the technical memorandum of understanding (Appendix V).** The program continues to be anchored by the need to bring the fiscal position to a sustainable level and by our intention to keep the stock of gross official foreign exchange reserves at about four months of imports.

12. **Our fiscal overperformance during the first half of the year (equivalent to about 1½ percent of GDP) has led to a revision of fiscal and monetary policies during the second half.** We recognize that an effort to reach the original annual expenditure ceilings after the underspending in the first half of the year would generate sharp reversals in the fiscal impulse—an upswing in the second half of 2003 followed by a downswing in 2004. We have therefore decided to hold central government recurrent spending for the year to a level that is ¼ of a percent of GDP lower than stipulated in the original budget. At the same time, in light of a significant backlog of important public investment projects, we will make an effort to keep capital spending for the year at the originally budgeted level. This will entail a significant acceleration—capital spending in the second half of the year will be four times the amount in the first half—but we note that spending in the first half was slowed by a late adoption of the budget and by our undertaking a review aimed at eliminating low-priority projects.

13. **For the year as a whole, aggregate revenue collection is expected to be broadly in line with projections except for higher than anticipated receipts of dividends from the telecommunications company.** This apparently healthy revenue position does not lead to complacency, however. The composition of revenues and weaknesses in the areas of VAT collection and excises are cause for concern. In addition, a large stock of VAT refund arrears (around 1 billion denars, the equivalent of about two months of refunds) is placing a burden on exporters and risks undermining compliance. We have therefore undertaken to reduce rapidly the stock of VAT refund arrears claims from denar 966 million at end-June 2003 to denar 866 million at end-September 2003 and denar 366 million at end-December 2003, by end-March 2004 all VAT refund arrears will be cleared. Consequently, tax revenues in 2003 will be slightly lower than had been programmed.

14. **The revision of our revenue and expenditure policies will lead to a central government deficit slightly smaller than had been programmed: 1.4 percent of GDP instead of 1.6 percent.** Given that the position in the first half of the year was nearly balanced, and that the main source of budget finance is the treasury deposit at the central bank, this will result in a large swing in central bank credit to the government. This expansion in the NBRM's net domestic assets could compromise compliance with the foreign exchange reserves targets under the program. The NBRM and the government recognize that, in order to ensure that these targets are met, it may be necessary for the NBRM to raise interest rates in the second half of the year. The size of any required increase is difficult to assess at this point. Nevertheless the NBRM is committed to using all available instruments, including raising of interest rates as much as necessary to ensure that program commitments will be met.

B. Public Sector Reforms

15. **We will take measures to improve VAT collection.** The stocks of VAT payment arrears increased in 2003 creating uncertainty about VAT collection. We will define a collectable stock of VAT payment arrears, and take necessary steps to begin the collection process. In addition, the financial police unit will investigate financial crimes, including tax fraud (in cooperation with PRO) and money laundering. The internal control department of the PRO will be strengthened by the addition of qualified staff and a program of system audits will be defined and implemented by end December 2003 (structural benchmark).

16. **We will continue to take measures to improve public expenditure management and further develop treasury operations.** In accordance with IMF recommendations in this area, we will make efforts to rebalance reform efforts between treasury operations, which have improved considerably, and budget preparation, which remains cumbersome. The Agricultural and Water Funds will be closed and their revenues and expenditures will be integrated into the central government budget, starting with the 2004 fiscal year. The 2004 budget presentation will be improved by eliminating excess detail and including a summary of central and general government budgets. Furthermore, we will seek ways to improve cash management including financial planning, debt management

(treasury bills and other debt management issues), commitment controls, and consolidation of extra budgetary funds (EBF) accounts within the treasury single account (TSA).

17. **We will take steps to improve the fiscal position of the social funds.** In this regard, we will strengthen the collection of contributions to the Pension, Health and Employment Funds through more vigorous administration. In particular, we will enhance the exchange of information between the funds and the PRO. We will also carry out joint audits by the funds and the PRO starting end-September 2003. On the cost side, we will impose strict adherence to rules governing spending by the funds. In order to strengthen the control of pension and benefit costs and improve our ability to forecast benefit entitlements, we will implement the September 2001 amendment to the Pension and Disability Law which provides for indexation on the CPI (80 percent weight) and wages (20 percent weight).

18. **To address the long-standing problem of social contribution arrears, we have put in place a framework for clearing arrears on an installment plan.** Legislation will be changed by end-2003 to provide for the application of a market rate of interest on arrears in social contributions to reduce moral hazard as is the case with late payments of tax liabilities. Structural and legal measures to strengthen collection will be taken by the end of the year.

19. **Reform in the health sector has lagged behind expectations and we are committed to bring reforms back on track.** By end-2003, in line with program commitments, arrears to suppliers will be reduced to the end-2002 level. In addition, as a prior action of the program, notification letters of redundancy will be sent out to 900 employees of the health sector. Most of these have been identified through a voluntary separation program. As a structural benchmark, notification letters will also be sent to another 340 employees by end-March 2004. In order to lock in the reduction (by at least 1,240) in the number of positions while maintaining the quality of health care, we will accelerate the restructuring of the health sector in line with the World Bank's technical assistance in the framework of the Health and Social Protection Project. In particular, we will prepare—by end-March 2004—revised organizational charts which allow for the reduction in the number of positions in health institutions and any needed reallocations of personnel (structural benchmark). We will complete all local tenders for all positive list drugs by end-November, 2003 and have the pharmaceuticals advisor in place at the HIF by end-October, 2003 to assist in preparing international tenders which will be announced by end-2003. Based on the results of the ongoing audits, we will improve the financial procedures in the HIF. Further efficiency gains will come from better management of medical supplies. Taken together, all these measures should enable the HIF to cover its current costs without government transfers starting in 2004. Over the medium-term, we see major cost cutting potential by privatizing state owned providers of medical services. As a first step, the law will be amended to prepare for the privatization of pharmacies and dentistry by end-2003. In addition, we are discussing with the World Bank a comprehensive project which includes a reform of HIF management and a contracting system for hospitals.

20. **With the assistance of the IMF, we are continuing to work on the development of government securities market and ways to strengthen our public debt**

management. A fully functioning Treasuries market will need to be in place by early-2004, in order to allow the MoF and NBRM to manage public debt and liquidity and develop the capacity to issue domestic and foreign currency securities. The law on the budget has been amended to allow the government to borrow on the bond market and the law on securities may need to be amended to allow the stock exchange to list short term government paper. Regulatory changes will also be undertaken to introduce OTC trading. We have requested technical assistance from the IMF—a short term resident adviser—to strengthen the Debt Management Unit within the MoF. We intend to make a first bill issue by January 2004.

21. **We remain firmly committed to the principles of fiscal decentralization as envisaged in the Ohrid Peace Framework Agreement.** While the process of devolving fiscal responsibilities and powers to the municipal level is difficult and complex, we intend to accelerate preparations—along the lines of previous IMF advice on phased implementation—before the next municipal elections in 2004. To speed the process, we have sought additional IMF technical assistance on the drafting of the Law on Local Government Financing (LLGF) which will be submitted to Parliament in time to be passed before the end of 2003, on the phasing of decentralization, and on measures which could be implemented at an early stage to help develop administrative capacity at the local level.

22. **We remain committed to eliminating all non-strategic commodities from the strategic reserves and to the full liberalization of the tobacco market.** Currently, the strategic commodity reserve fund contains 166 types of commodities. A new law on strategic reserves will be submitted to Parliament by end-2003. The new law will define the strategic reserves on the basis of four or five WTO-compliant commodities. Meanwhile, we continue to sell non-essential stocks and will complete the program of sales in line with the new law by end-March 2004. In the tobacco market, a complex system of loan guarantees and monopoly purchasing arrangements has distorted market incentives and hindered market performance. To address these problems, we will draft a new Tobacco Law that, among other things, allows any company, domestic or foreign to purchase and market tobacco in Macedonia. The law will be enacted by end-November 2003 in time for the next tobacco purchasing season (structural benchmark). Public resources will no longer be used to provide collateral or loan guarantees for tobacco marketing or related operations.

C. Monetary Framework and Banking Sector

23. **In the face of progressive euroization of deposit money banks' balance sheets, we will continue to strengthen banking supervision.** In this context, the bank supervision department of the NBRM will require more detailed reporting on banks' assets and liabilities, including breakdowns by currency, currency indexation, maturity and sector. The first report, covering end-December 2003, will be completed by end-March 2004 and system-wide data will be provided to the Fund on a regular basis from that date. By end-September, 2003, the department will also require each commercial bank to submit a description of its procedures to assess customers' exchange rate risks. The on-site supervision manual will be revised to include the exchange rate risk exposure of bank borrowers in the banks' credit risk

assessment by end-December 2003 (performance criterion). Supervisors will receive training to assess these risks.

24. **Furthermore, we will introduce legislation to improve governance and strengthen supervision of financial institutions.** A structural benchmark will be the submission to Parliament by end-December 2003 of legislation giving the NBRM the authority to license and supervise money transfer houses. A new legislative framework shall also be drafted to license and supervise savings houses.

25. **Amendments to the anti-money laundering law will be proposed (or a new law will be drafted) in line with the FSAP mission recommendations and implementation of the law will be expedited.** The amendments will criminalize terrorist financing. Supervisory authorities will be given a substantive role in implementing the law and imposing sanctions. These amendments will be submitted to Parliament by end-September 2003.

26. **Appropriate legislative and administrative measures will be taken to ensure that NBRM is not put in the position of appearing to adjudicate disputes relating to payment guarantees among banks and their clients.** By end-December 2003, the Ministries of Finance and Justice and NBRM will make a joint proposal on a mechanism to facilitate quick resolution of the disputes by the courts.

D. Program Monitoring and Data Reconciliation Issues

27. **We have set up a joint MoF-NBRM working group, with detailed terms of reference to reconcile fiscal and monetary data on a monthly basis.** As a prior action for completion of the review, the working group will prepare and submit to the Fund a report on the reconciliation of July 2003 data, that includes an analysis of any discrepancy and recommendations on measures to reduce the discrepancy in the future.

28. **We will continue to work on improving our national income statistics and data analysis.** The lack of good quality data on quarterly national income accounts continues to hamper our ability to analyze and project economic behavior in Macedonia. In order to rectify this situation, we will request IMF technical assistance to the Statistical Office of Macedonia that will focus on improving quarterly national income accounting methodology and expenditures approach to GDP calculation. In addition, the NBRM will prepare an inflation forecast on a regular basis.

29. **In line with the recommendations made in the Safeguards Assessment, we have taken the requisite measures to strengthen the NBRM's reporting system.** We now monitor monetary aggregates using a constant exchange rate methodology instead of the previously used stock-flow methodology. The end-2002 NBRM accounts used for the reporting to the IMF have been reconciled with the NBRM's financial accounts that were certified by the external auditor. We have also published the 2002 NBRM annual report.

Table 1. Quantitative Performance Criteria and Indicative Targets for 2003 and Q1 2004 1/

	2002		2003											2004
	Actual	End-Mar.				End-Jun.				End-Sep.		End-Dec.		End-Mar. 1st Rev PC
		Indic. Target	Indicativ Adj. T.	Actual	Perf margin	Prog. PC	Adjusted PC	Actual	Perf. margin	SBA orig. PC	1st Rev revised	SBA orig. PC	1st Rev revised	
(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	-73	-63	10	-16	-26	-16	10	-52	-30	1	2	8
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	0	0	0	25	25	0	25	210	210	250	250	250
<i>Of which</i> : with maturities of 1-5 years	...	0	0	0	0	0	0	0	0	30	30	30	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	0	0	0	0	0	0	0	0	0
Accumulation of external payments arrears on a continuous basis	0	0	0	0	0	0	0	0	0	0	0	0	0	0
(in millions of denars)														
Ceiling on net domestic assets of the NBRM	-25,002	3,154	2,116	459	1,657	-67	569	-796	1,365	2,174	98	752	129	-674
Ceiling on net domestic assets of the banking system (indicative)	9,585	4,382	3,344	858	2,486	3,562	4,198	2,404	1,794	7,400	4,661	6,629	6,601	7,349
Ceiling on net domestic credit to the general government from the banking system 2/	-5,172	4,516	3,478	1,370	2,108	2,575	3,211	-141	3,352	4,989	1,250	3,907	3,383	4,017
Ceilings on central government domestic arrears (indicative)														
Excluding those to suppliers	0	0	0	0	0	0	0	0	0	0	0	0	0	0
To suppliers	597	0	0	-10	10	0	0	-153	153	0	0	0	0	0
Ceilings on health fund arrears (indicative)	1,711	0	0	238	-238	0	0	308	-308	0	0	0	0	0
(in millions of denars)														
	Annual flows													
Ceiling on the central government wage bill (indicative)	18,339	5,143	5,143	4953	190	10,429	10,429	10,011	418	15,527	15,109	20,953	20,785	25,981
Ceiling on personnel expenditures financed from special revenue accounts (indicative)	640	188	188	142	46	375	375	306	69	563	528	750	750	938
Floor for central government fiscal balance	-13,019	-1,685	-1,685	667	2,352	-3,132	-3,132	828	3,960	-4,021	-1,104	-4,075	-3,203	-3,636
Floor for general government fiscal balance	-13,554	-1,630	-1,630	346	1,976	-3,513	-3,024	429	3,453	-4,627	-1,664	-5,117	-4,616	-5,077
Ceiling on VAT refund arrears/outstanding VAT refund claims	...	...	...	...	...	...	...	966	...	...	866	...	366	0

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

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

2/ The actual is adjusted to exclude the programmed transfer of unclaimed FFCBs that was scheduled for Q1 2003 but has been effected in Q3 2003.

Table 2. Structural Performance Criteria and Structural Benchmarks Under the Stand-By Arrangement

I. Original Program		
A. 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	Completed in June
B. 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	Completed in April
2. Improve labor market flexibility (MEFP ¶21) by:	By end-May, 2003	Completed in April
(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.		
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	Financial audit initiated; audit of procurement procedures delayed
4. Publish the external audit of the NBRM's 2002 statements (MEFP ¶29).	By end-July, 2003	Completed in June
5. Enact a 2004 budget consistent with the general government deficit (fiscal balance excluding foreign-financed projects) of 1 1/4 percent of GDP (MEFP ¶7).	By end-December, 2003	

II. Revised Program

A. Prior Action

1. Send out notification letters of redundancy to 900 employees of the health sector.
2. Set up a working group with members from the MOF and the NBRM in charge of reconciling monetary and fiscal accounts. The working group will prepare a detailed report on the reason for the discrepancies and list recommendations for preventing such discrepancies in the future.
3. Send a supplementary budget to parliament in line with the agreement in the LOI.

B. Structural Performance Criterion

1. Revise the on-site banking supervision manual of the NBRM to include the indirect exchange rate risk exposure of borrowers in the credit risk assessment. By end-December, 2003

C. Structural Benchmark

1. Send out notification letters of redundancy to additional 340 health sector employees selected in line with a health sector reorganization plan to ensure that the layoffs are permanent and do not impair the quality of health care. By end-March, 2004
 3. Strengthen the internal control department of the Public Revenue Office by the addition of qualified staff and define and implement a program of system audits. By end-December, 2003
 4. Submit a new Tobacco Law to parliament that, among other things, allows any company, domestic or foreign to purchase and market tobacco in Macedonia. By end-November 2003
 5. Introduce legislation under which the NBRM will have the authority to license and supervise money transfer houses. By end-December 2003
-

Table 3. Schedule of Purchases Under the Stand-By Arrangement 1/

Date	Amount of Purchase 2/		Conditions
	In millions of SDRs	In percent of quota	
October 17, 2003	4.0	5.806	Observance of end-September 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	16.0	23.22	

1/ The first purchase of SDR 4 million was made in May 2003.

2/ Assuming maximum proposed access. Annual access would equal 24.88 percent of the quota.

TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum defines the variables subject to the quantitative targets (performance, criteria and indicative benchmarks), established in the Supplementary Memorandum of Economic and Financial Policies (SMEFP) 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 as defined in the Annual Budget Document (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 (Table 1 of the SMEFP). 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:

	Original	Revised at 1 st review
End-March 2003	US\$-6.4 million	...
End-June 2003	US\$79.5 million	...
End-September 2003	US\$77.4 million	US\$87.6 million
End-December 2003	US\$124.8 million	US\$114.7 million
End-March 2004	...	US\$135.0 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 which amounted to US\$17.8 million in April 2003.

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 gross disbursement of balance of payments financing (¶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
End-March 2004	US\$13.4 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 in denars and in foreign currency held at the NBRM or at the NBRM accounts abroad.

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\$714.2 million or denar 43,177 million (converted using the stock flow valuation methodology described in Section J); and NDA so defined stood at denar -25,002 million. At constant exchange rates (converted using the valuation methodology described in Section J), NFA so defined stood at denar 42,074 million and NDA at denar - 23,899 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 (Table 1 of the SMEFP).

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. 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 72,834 million; NFA of the banking system so defined stood at denar 63,249 million; and NDA of the banking system so defined stood at denar 9,585 million (converted using the stock flow valuation methodology described in Section J). At constant exchange rates (converted using the valuation methodology described in Section J), broad money stood at denar 72,072; and NDA of the banking system at denar 9,295 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 (Table 1 of the SMEFP).

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. The unclaimed amount reached denar 1,432 million by end-June 2003 and is programmed to be reported under other items net in the monetary survey, starting end-September 2003. To ensure the proper reporting of this amount, a separate account will be opened at the NBRM by end-September 2003. Transactions in transitory foreign exchange accounts related to payment operations (account code numbers 7191 and 7192) and foreign exchange accounts related to usage of world bank loan (so called PSDL with accounts code number 2921) are not considered part of government financing.

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 17,534 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 2,461 million.

26. At end-December 2002, net domestic credit to the general government so defined stood at denar -5,172 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 5,434 million; and net credit from the NBRM stood at denar -10,606 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 (Table 1 of the SMEFP).

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 (Table 1 of the SMEFP). The financing flows will be measured as a sum of domestic financing, foreign financing, and privatization proceeds.

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 (converted using the valuation methodology described in Section J) 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. Transactions in transitory foreign exchange accounts related to payment operations (account code numbers 7191 and 7192) and foreign exchange accounts related to usage of world bank loan (so called PSDL with accounts code number 2921) are not considered part of foreign financing.

30. **Privatization proceeds** for the central government include proceeds in denar and foreign currency. It is assumed that in January 2003–March 2004 privatization proceeds for the central government will be equal zero. 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

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
End-March 2004	US\$24.5 million.

The floor on the general fiscal balance will be adjusted upwards on a cumulative basis, by any shortfalls in reducing the stock of VAT refund arrears/ VAT refund claims with respect to the following baseline:

End-September 2003	100 million denar
End-December 2003	600 million denar
End-March 2004	766 billion denar

The stock of VAT refund arrears/VAT refund claims stood at denar 1,018 million by end-December 2002 and denar 966 million by end-June 2003.

G. Ceilings on the Wage Bill of the Central Government

32. 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

33. The limit on medium and long-term debt (Table 1 of the SMEFP) 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, 6/30/00)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.

34. The limit on short-term debt (Table 1 of the SMEFP) 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.

I. External and Domestic Payments Arrears

35. 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

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.

payments arrears is a continuous performance criterion. As of June 31, 2003 there were no outstanding external payment arrears as defined above.

36. 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.

37. 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 due but not paid 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.

38. 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

Valuation of the NBRM balance sheet and the monetary survey

39. For the programmed foreign exchange projections, the program exchange rates were applied.

40. Performance of monetary aggregates under the program has been monitored in stock flow methodology for January to June 2003. The stock-flow methodology has the following features: The stocks of assets and liabilities denominated in foreign currency outstanding at September 30, 1996, are valued at the current exchange rate on that day. On a monthly basis, any subsequent changes in assets and liabilities in foreign currencies to residents and non-residents have been valued at the average exchange rates prevailing in the month of the transaction. In particular, changes in the NIR of the NBRM (in denar) have been 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) have been 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 end-December 2002 at US\$342.75 per ounce.

41. For the remainder of the program, performance will be measured in constant exchange rates. For this methodology, assets and liabilities of the banking system will be valued as follows: The stocks of assets and liabilities denominated in foreign currencies outstanding at December 31, 2002 are valued at the program exchange rate (denar 58.8909 per U.S. dollar, denar 61.3761 per Euro, and cross exchange rates at the level prevailing at end-December 2002). Gold is valued at the price fixed in the London market at end-December 2002 (US\$342.75 per ounce). Changes in assets and liabilities will also be valued at these exchange rates. The exchange rate effects on the foreign currency denominated assets and liabilities of commercial banks will be estimated on the basis of their currency composition, as provided by the NBRM banking supervision department.

Valuation of NIR

42. For the programmed foreign exchange projections, the program exchange rates were applied.

43. For program monitoring, 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.

Valuation of the fiscal deficit

44. For the programmed foreign exchange projections, the program exchange rates were applied.

45. For fiscal deficit measuring purposes, the constant exchange rate methodology was used to convert the foreign currency component from January to June 2003. For measuring the fiscal deficit for the remainder of the program, the foreign currency component of deficit financing will also be converted at constant exchange rates.

K. Monitoring and Reporting Requirements

46. 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.

47. 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.

48. 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; (xiv) Detailed reporting on commercial banks assets and liabilities, including breakdowns by currency, currency indexation, maturity and sector, starting March 2004 on a quarterly basis; (xv) Quarterly information on commercial banks lending indexed to foreign currencies. 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.

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

	End-Dec. 2002	End-Mar. 2003	End-June 2003
Net international reserves [1 - 2]	653.9	603.0	679.3
1. Reserve assets [1.1 - 1.2]	734.6	672.5	803.1
1.1. Foreign assets	783.8	730.4	846.9
Gold	67.9	66.0	68.4
Demand deposits in foreign banks	202.6	204.6	229.0
Time deposits in foreign banks	497.2	382.4	394.9
Foreign currency at the NBM	8.2	8.3	6.4
Foreign securities	8.0	69.0	148.2
Letters of credits	0.0	0.0	0.0
Guarantees	0.0	0.0	0.0
Checks	0.0	0.0	0.0
1.2. Foreign assets excluded from reserve assets	49.2	57.9	43.8
Subordinated loan (AY Bank)	5.0	5.0	5.0
Booked funds (formerly AY Bank)	15.5	14.1	14.1
Other pledged assets	28.7	26.8	24.7
Other FA excluded from gross reserves 2/		12.0	
2. Reserve liabilities [2.1 + 2.2]	80.8	69.5	123.7
2.1. To nonresidents	69.5	66.5	71.7
IMF	67.4	64.3	64.8
BIS	0.0	0.0	0.0
Other	2.1	2.1	6.8
2.2. To residents 3/	11.3	3.0	52.1
Foreign currency deposits of banks	11.3	3.0	6.0
Required reserves	0.0	0.0	0.0
Other	0.0	0.0	46.1
Memorandum items:			
Net foreign assets [1.1 - 2.1]	714.4	663.9	775.2
Foreign currency deposits of general government 4/	134.0	140.7	158.3
Valuation changes to NIR (cumulative from end-2002)	-	12.1	41.6
NIR excluding valuation changes	653.9	590.9	637.8

Source: NBRM

1/ At current exchange rates unless otherwise stated.

2/ The end-March figure corresponds to the amount of US grant that was excluded from NIR pending SBA approval

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

4/ From NBRM accounts table at current exchange rates.

Table 2. Balance of Payments Financing Assumptions for end-December 2002–end-March 2004
(in millions of U.S. dollars, unless otherwise indicated)

	Mar-03	Jun-03	Sep-03	Dec-03	Mar-04
	Original program				
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 (original)	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	...
	Actual	Revised (1st review) baseline			
Grants	12.0	14.9	17.7	8.3	0.0
EU	0.0	10.4	0.0	8.3	0.0
The Netherlands	0.0	0.0	17.7	0.0	0.0
United States 2/	12.0	4.5	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Loans	0.0	25.4	20.3	18.8	20.3
IBRD/IDA	0.0	15.0	20.3	0.0	20.3
EU	0.0	10.4	0.0	18.8	0.0
Other	0.0	0.0	0.0	0.0	0.0
Payments 1/	-1.1	-1.6	...	...	...
Total					
Quarterly flows	10.9	38.7			
Cumulative from end-December 2002	10.9	49.6			
Adjustment to the NIR floors 3/	5.2	-29.9			
Adjustment to the NDA ceilings (in millions of denars)	-1,016	1,496			
Revised BOP financing assumptions for TMU (quarterly flows)			38.0	27.1	20.3
BOP financing assumptions (cumulative from end-December 2002) 3/			87.6	114.7	135.0
Program exchange rate is denars per U.S. dollar:	58.8909	58.8909	58.8909	58.8909	58.8909

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. Included the repayment of technical arrears (US\$4.3 million) in Q1.

No assumption regarding this item is needed for the revised program; all agreements have been implemented by end-September 2003 and payments are included in the revised BOP projection.

2/ The second tranche of the US assistance (US\$4.5 million) was originally expected in Q1 2004.

3/ There is no adjustment for US\$12 million from the U.S.: the funds were deposited in a blocked account pending SBA approval and as such were excluded from NIR at end-March; however, since it was part of NFA, it is included in the adjustment to NDA.

4/ New baseline = Actual in Q1 and Q2 2003 (at program exchange rates) + Revised Projections for Q3 2003–Q1 2004.

FYR of Macedonia: Selected Social and Demographic Indicators

	FYR of Macedonia	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; FYR of Macedonia: 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 FYR of Macedonia, 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.

**Statement by the IMF Staff Representative
October 17, 2003**

This statement provides information on developments since the issuance of the staff report for the first review under the Stand-By Arrangement with FYR Macedonia. This statement does not change the thrust of the staff appraisal.

The prior actions for the review have all been met

- The supplementary 2003 budget was passed on September 17, 2003.
- A report on the reconciliation of the fiscal and monetary accounts was transmitted to the staff on September 18, 2003.
- In the health sector, the staff has been informed that 910 health sector employees have been notified that they have been declared redundant, and will be laid off. (The World Bank staff have indicated that these redundancies—if accompanied by a redeployment of staff—will not result in deterioration in the delivery of health care.)

Budgetary spending continues to fall short of targeted levels

Preliminary third quarter data suggests that government spending, particularly investment spending, continues to be well below budgeted levels. The expenditure shortfall—if sustained during the remaining months of the year—could reduce the central government deficit to as much as one percentage point of GDP below the program figure. As indicated in the staff appraisal, this would alleviate concerns about a sharp fiscal impulse in the second half of 2003.



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FOR IMMEDIATE RELEASE
October 17, 2003

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes First Review Under Stand-By Arrangement for the Former Yugoslav Republic of Macedonia and Approves US\$5.7 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the first review of the former Yugoslav Republic of Macedonia's economic performance under the 14-month Stand-By Arrangement. The decision will enable FYR Macedonia to draw SDR 4 million (about US\$5.7 million) from the IMF immediately.

The Stand-By Arrangement amounting to SDR 20 million (about US\$28.6 million) was approved on April 30, 2003 (see [Press Release No. 03/63](#)). FYR Macedonia's initial drawing under the arrangement amounted to SDR 4 million (about US\$5.7 million).

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

"Macedonia's macroeconomic stabilization program for 2003 continues to rest on a basis of sound fiscal and monetary policies, and has restored the fiscal balance to a sustainable level after two years of high deficits. Continued sound monetary policy, anchored by the de facto peg of the denar, has kept inflation low and enhanced the credibility of the central bank while leaving competitiveness indicators broadly unchanged. The effects of these policies are already visible: interest rates have dropped significantly while foreign exchange reserves are accumulating. The authorities have also advanced on their structural agenda in a number of areas, including reforms to increase the flexibility of the labor market, though they are encouraged to accelerate the momentum of reforms.

"Fiscal management in 2003 was complicated by a slow start-up of government spending. While there are no indications yet of a significant increase of spending in the second half of the year in line with the supplementary budget approved in September, any increase could complicate monetary policy and put pressure on financial markets. The central bank, however, is committed to taking corrective measures to ensure that program targets are achieved. Looking forward, volatility in expenditures should be reduced. To help stabilize budget financing, the establishment of a government securities market is essential. Fiscal decentralization should continue at a pace consistent with the development of local administrative capacity.

“Further structural measures are important to address impediments to growth and to reduce unemployment. Reforms are necessary to strengthen the investment climate by creating a predictable business environment, implementing judicial reforms and addressing governance problems. In the same vein, the authorities should remove the bottlenecks in reform of the health sector. To achieve the authorities’ commitment to stop budgetary transfers to the health sector by 2004, it is essential to press ahead with World Bank-supported measures to strengthen governance.

“The Financial System Stability Assessment acknowledged the authorities’ efforts to improve the soundness of the banking system in recent years as well as to address remaining vulnerabilities. Reforms are particularly important to tackle corruption and money laundering. There has been considerable progress in laying the groundwork for financial sector supervision, especially banking supervision, though there remains a need to move towards risk-based assessments of banks in the highly euroized environment,” Mr. Sugisaki said.