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Former Yugoslav Republic of Macedonia: Second Review Under the Stand-By Arrangement and Request for Waiver of Performance Criteria and Rephasing of the Program—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the former Yugoslav Republic of Macedonia

In the context of the second review under the Stand-By Arrangement with the former Yugoslav Republic of Macedonia and its request for a waiver of performance criteria and rephasing of the program, the following documents have been released and are included in this package:

- The staff report for the Second Review Under the Stand-By Arrangement and Request for Waiver of Performance Criteria and Rephasing of the Program, prepared by a staff team of the IMF, following discussions that ended on February 5, 2007, with the officials of the former Yugoslav Republic of Macedonia on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on April 10, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement of April 27, 2007 updating information on recent developments.
- A Press Release (PR) summarizing the views of the Executive Board as expressed during its April 27, 2007 discussion of the staff report that concluded the review.
- A statement by the Executive Director for the former Yugoslav Republic of Macedonia.

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*
Technical Memorandum of Understanding*
*Also included in Staff Report

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

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

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INTERNATIONAL MONETARY FUND

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Second Review Under the Stand-By Arrangement and Request for Waiver of Performance Criteria and Rephasing of the Program

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

Approved by Juha Kähkönen and Scott Brown

April 10, 2007

Executive Summary

Economic performance is improving. Growth is around 4 percent, reserves are strengthening, fiscal targets met, and interest rates have fallen.

Delays in completing the review reflect extensive discussions, as staff sought to incorporate the new government's economic initiatives—raising growth through tax reform and investment incentives—in a manner consistent with the Fund-supported program.

The 2007 fiscal deficit target increases modestly to 1 percent of GDP. Taxes are cut and budget quality improves, but there are also fiscal risks, in particular in delivering the planned reduction in transfers and subsidies. Over the medium term, the government aims to keep the fiscal deficit below 1½ percent of GDP, cutting overall government spending by 2 percent of GDP while raising public investment.

Structural reforms aim at raising growth. The draft banking law will strengthen banking supervision, while social security base harmonization will simplify tax administration.

All quantitative performance criteria and most structural conditionality have been met, though the latter with some delay due to the elections (LOI Tables 1 and 2). The authorities request waivers for non-observance of two structural performance criteria relating to creation of a large contributor office and sale of the government's remaining shares in the telecom monopoly (Table 1). In light of the delay, they also request a rephasing of remaining purchases (LOI Table 5). Given the authorities' commitments to new measures to meet the goals of these performance criteria, and strong performance under the program, **the staff recommends completion of the Second Review**.

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I. INTRODUCTION

1. **Following completion of the First Review last April, a new center-right government took office in August 2006, with a manifesto commitment to economic reform.** The new government's program aims to raise investment and growth while maintaining macroeconomic stability, through incentives and accelerated structural reform.

2. **Discussions focused on aligning these initiatives with the Fund-supported program**. The resulting program for 2007 aims at preserving fiscal discipline, stimulating foreign direct investment, revising the banking law to enhance supervision and encourage foreign bank participation, putting the previous structural agenda back on track (or revising it consistent with the program's goals), and integrating the new government's plans for further structural reform.

II. RECENT DEVELOPMENTS

3. **Economic activity continues to improve (Figure 1; Tables 2-3)**. Growth is around 4 percent, with higher world prices stimulating metal production and exports. Though statistics office estimates show growth slowed to 3 percent in 2006, activity indicators suggest the true growth rate was higher (Annex I).

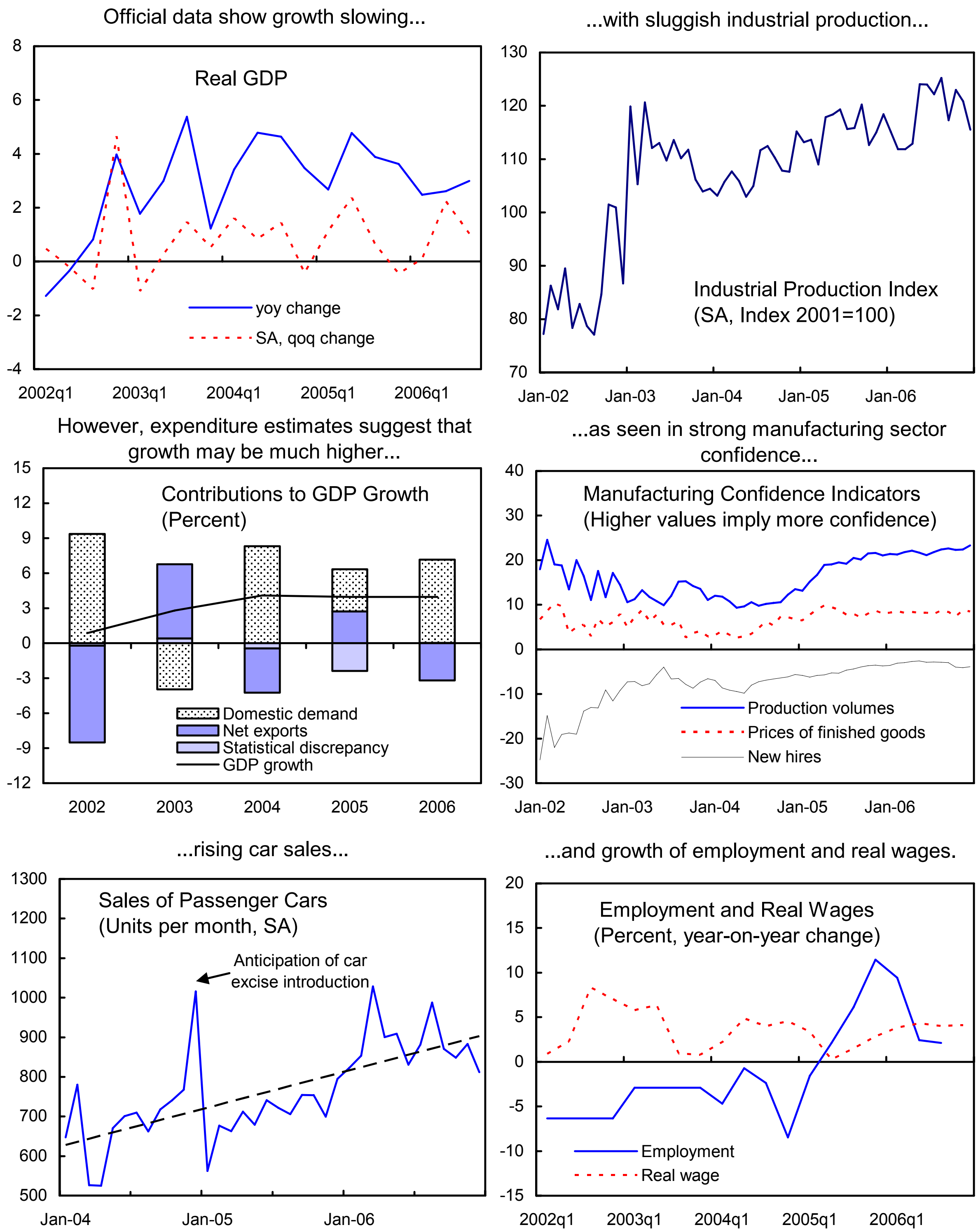
Growth and Domestic Demand, 2003-06
(percent change, year-on-year)

	2003	2004	2005	2006
Real GDP	2.8	4.1	3.8	3.1 1/
Consumption demand				
Import of consumption goods	-4.6	6.7	1.1	6.6
Sales of passenger cars	...	...	0.4	24.9
Real wages	3.6	4.4	2.0	4.1
Investment demand (nominal terms)				
Import of investment and intermediate goods	-4.1	29.6	-3.6	16.9
Gross fixed capital formation	...	4.9	4.9	19.7
Credit to private sector	19.0	25.0	20.5	30.5
Consumer prices (period average)	1.2	-0.4	0.5	3.2

Sources: NBRM; MOF; and SSO.

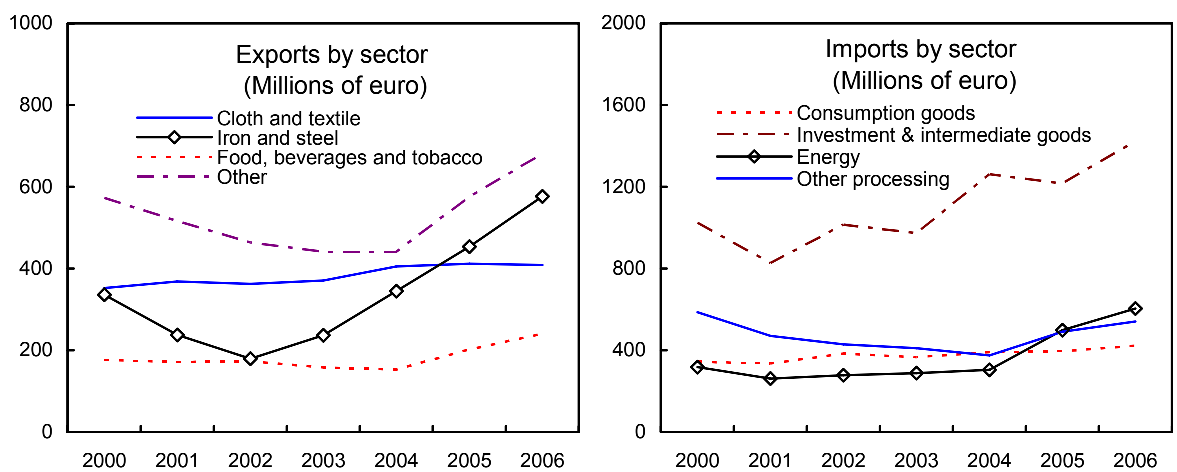
1/ Preliminary SSO estimate. Staff estimate uses 4.0 percent, though demand side indicators in this table suggest true figure may have been higher.

Figure 1. FYR Macedonia: Real Sector Indicators, 2002-06



Sources: State Statistical Office; NBRM; and IMF staff estimates.

4. **The balance of payments is strengthening (Figures 2-3; Table 4)**. Since 2004, international reserves have doubled to €1.4 billion (4½ months of imports), allowing the authorities to reach agreement in January to prepay €78 million in Paris Club debt, and to make repurchases to the Fund (¶6).[1] While competitiveness still appears adequate, the trade deficit widened to 20 percent of GDP in 2006, due to higher oil prices and domestic demand-led import growth (intermediate and investment goods). However, increasing foreign currency sales to exchange bureaus (recorded as private transfers) and delayed payment of the telecom dividend to foreign shareholders narrowed the current account deficit. Though the government could not sell its 40 percent stake in the fixed-line telephone monopoly, last March's €225 million electricity distribution privatization exceeded expectations. Portfolio investment and loans to the private sector are recovering, but greenfield foreign direct investment (1.2 percent of GDP) is low.



Sources: SSO; NBRM and IMF staff estimates.

5. **Fiscal policy remains disciplined (Table 5)**. Last November's supplementary budget increased spending on (overdue) tobacco subsidy payments, court settlements, and transfers to MEPSO (electricity transmission), and reduced VAT for agricultural inputs—financed by an anticipated telecom dividend of 0.8 percent of GDP. Though the dividend payment did not materialize, underexecution of capital expenditure (a fairly normal event) allowed the authorities to meet the deficit target.

6. **Money and credit growth are picking up (Tables 6-8; Figures 4-6)**. With global liquidity conditions favorable, fiscal discipline and increased reserves have reduced risk

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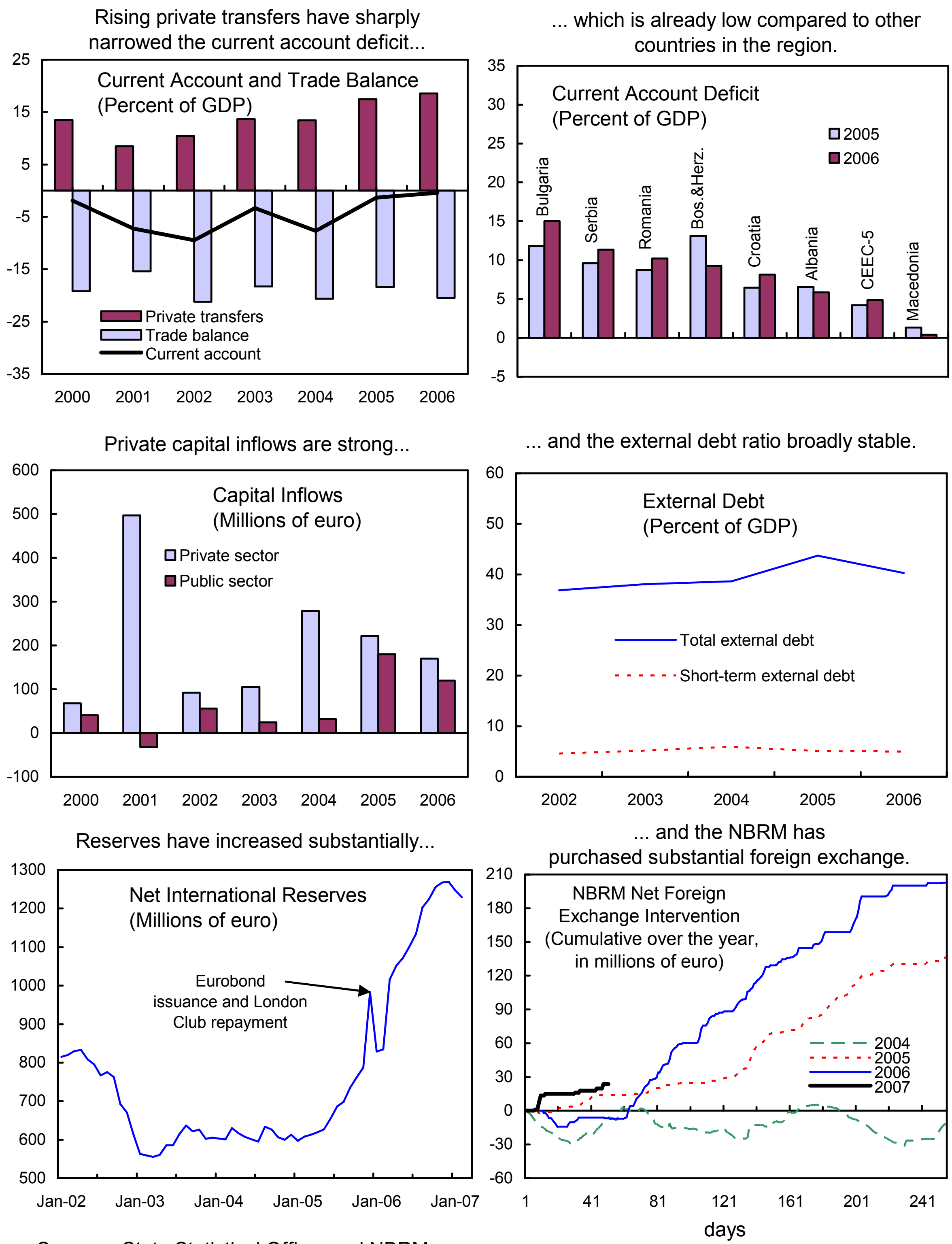
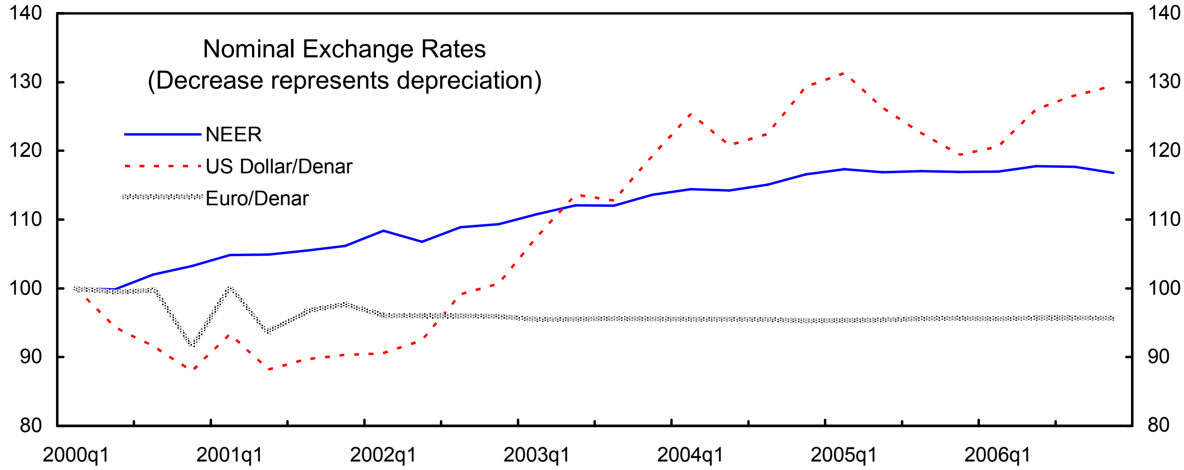
[1] Numbers refer to LOI paragraphs.

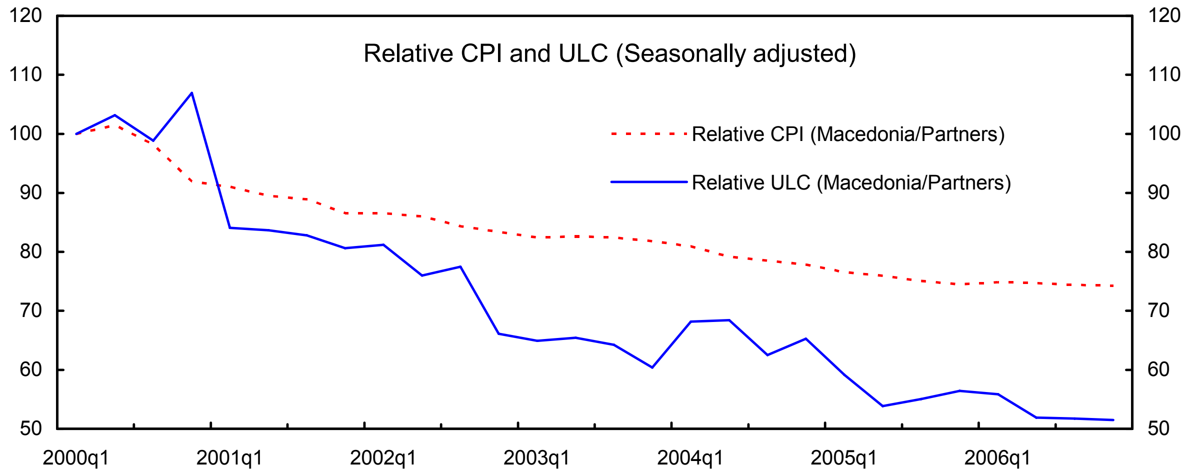
Figure 2. FYR Macedonia: External Sector Indicators, 2000-06

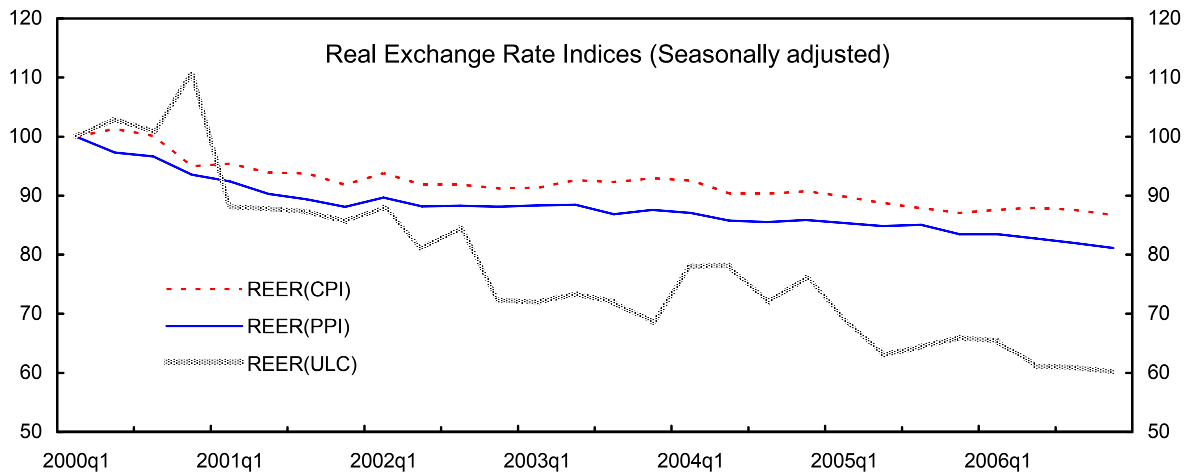


Sources: State Statistical Office; and NBRM.

Figure 3. FYR Macedonia: Exchange Rate Indicators, 2000-06
(2000q1=100) 1/

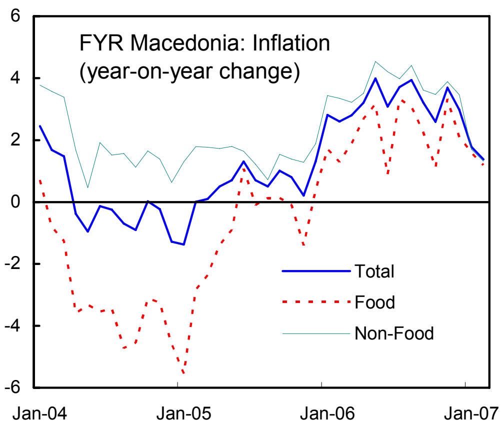


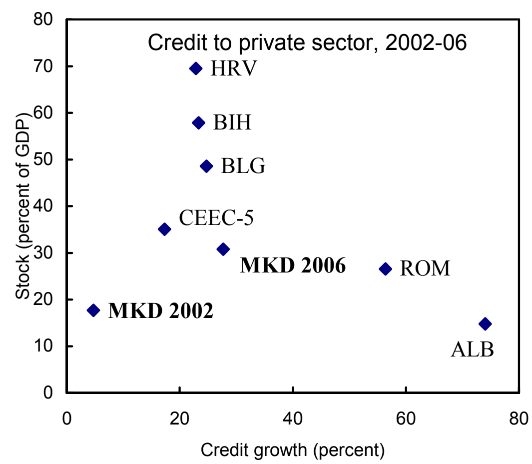




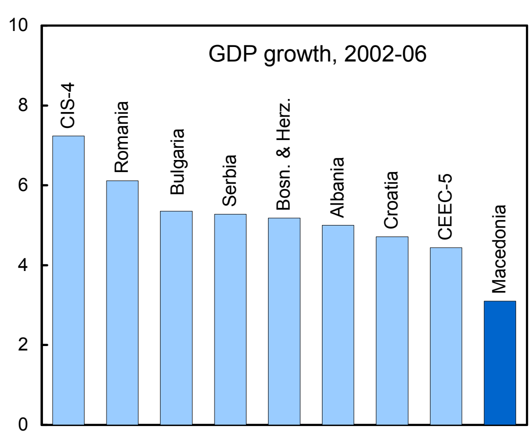
Sources: Eurostat; IFS; and IMF staff calculations.
1/ Trade weights based on 1999-2001 data for exports of goods. Partner countries comprise: Austria, Bulgaria, Croatia, France, Germany, Greece, Italy, Netherlands, Russia, Serbia, Slovenia, Switzerland, Turkey, United Kingdom, and United States.

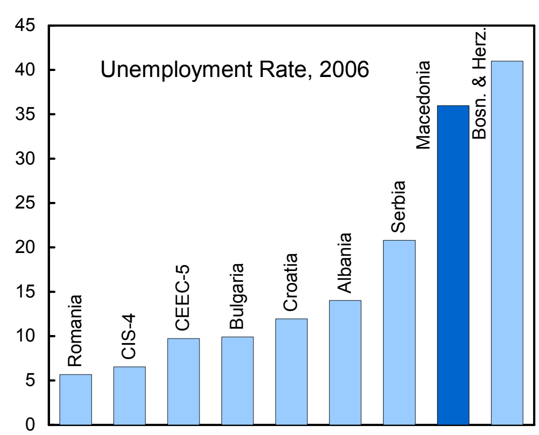
premia and interest rates, stimulating credit growth. Deposits grew by almost 25 percent in 2006. By taking new syndicated loans and drawing down assets held abroad, banks have financed credit growth of around 30 percent (though from a low base). Despite the credit expansion, inflation remains low (anchored by the exchange rate peg) and the financial sector stable. Although attempts to sell the largest private bank failed, foreign interest in the banking system is increasing.





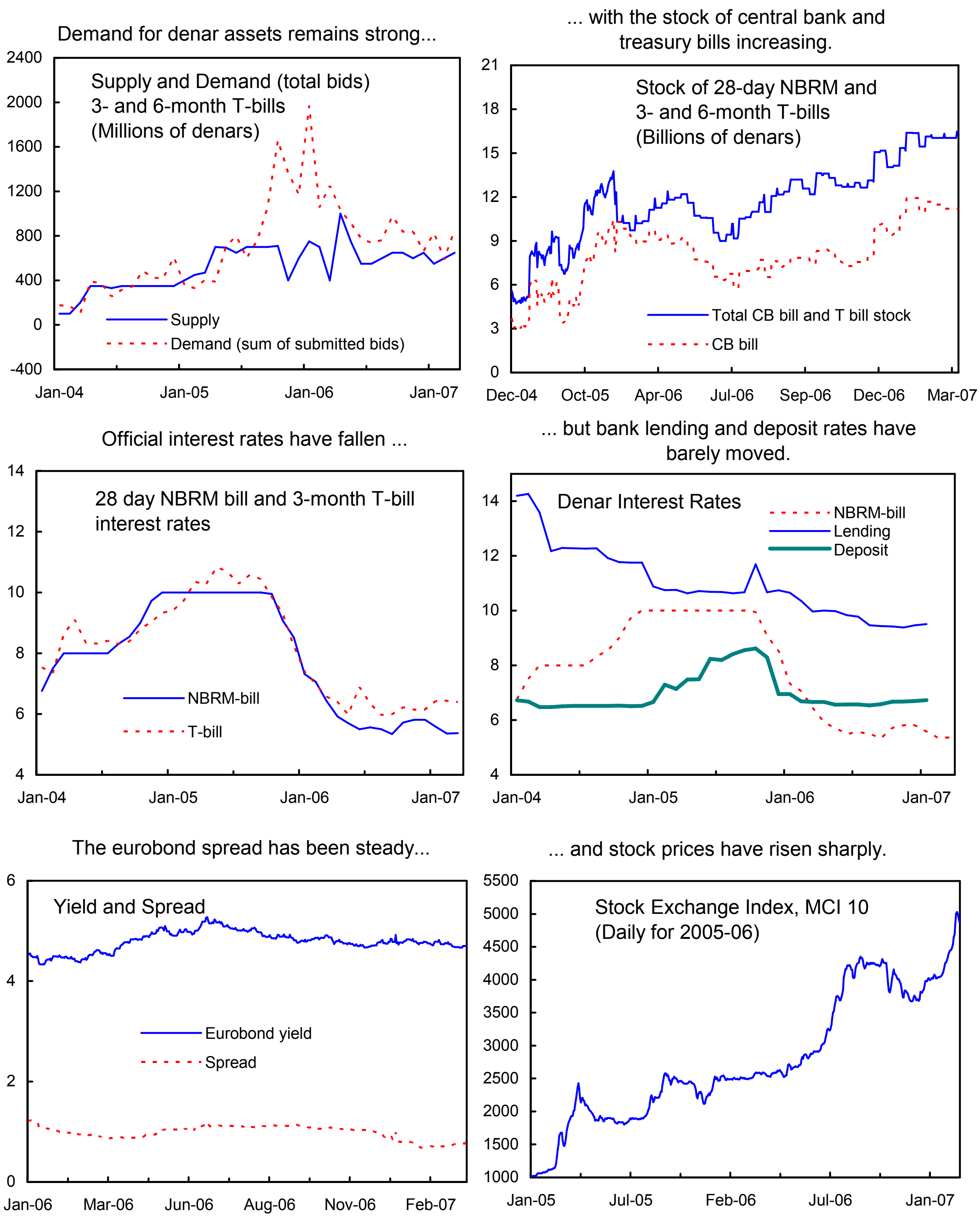
7. **Despite these successes, significant action is needed to improve growth prospects**. A major challenge is structural and institutional reform to improve the investment climate and redirect activity from the informal sector.





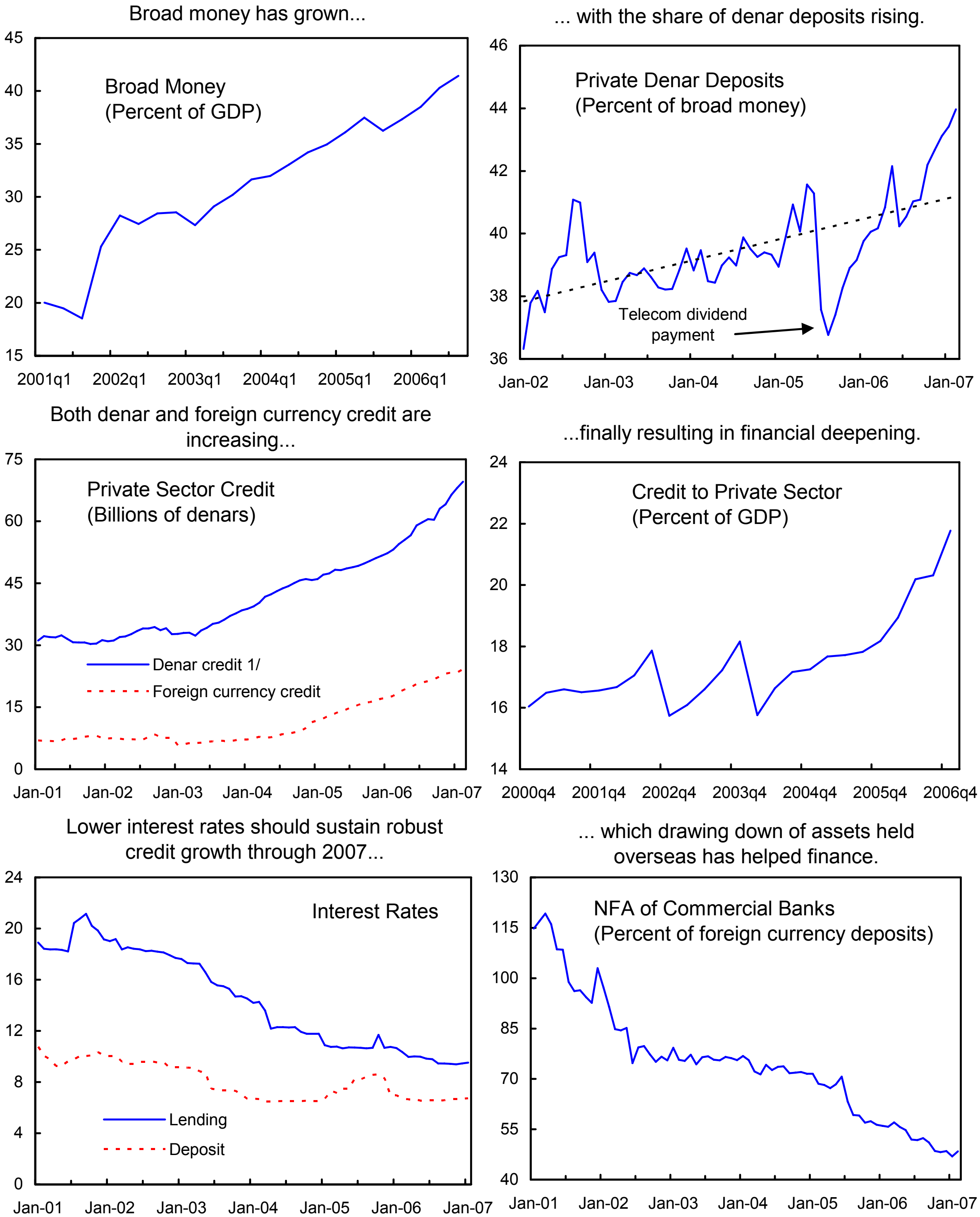
Sources: IMF, *World Economic Outlook* .
CEEC-5: Czech Republic, Hungary, Poland, Slovak Republic, Slovenia.
CIS-4: Belarus, Moldova, Russia, Ukraine.

Figure 4. FYR Macedonia: Financial Market Developments, 2004-06



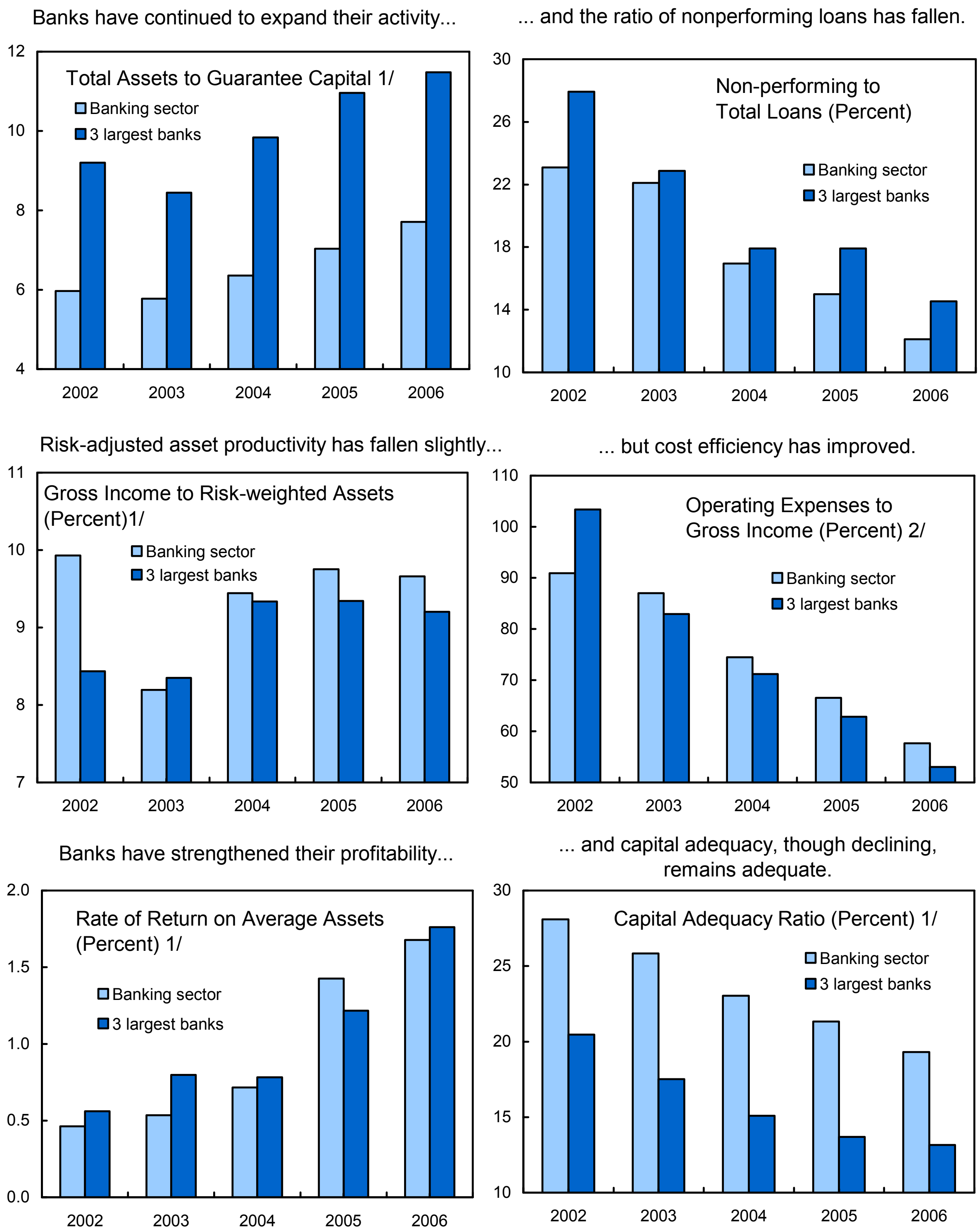
Sources: NBRM; and IMF staff estimates.

Figure 5. FYR Macedonia: Money and Credit Developments, 2001-06



Sources: NBRM; and IMF staff estimates.
1/ Includes foreign currency indexed lending (approximately one third of total denar credit).

Figure 6. FYR Macedonia: Banking Sector Developments, 2002-06



Sources: NBRM; and Fund staff estimates.
1/ Total assets include off-balance sheet items.
2/ Adjusted for unallocated provisions for potential losses.

8. **Improved international integration could underpin this transformation**. Early EU accession negotiations could improve the business climate and promote foreign investment. However, though the governing coalition is popular, there have been initial political tensions, both within the coalition and in reaching constructive dialogue with the opposition which led to some legislative delays that may complicate prospects for NATO membership and EU accession. Regional political stability can also be a concern for investors.

III. PROGRAM DISCUSSIONS

9. **The new government's economic program aims to raise incomes and employment through disciplined macroeconomic policies, investment incentives and accelerated structural reform:**[2]

- **The authorities seek to boost growth to 6-8 percent**. The Fund program is more cautious, basing revenue projections on 4½ percent growth. However, there is upside potential if structural reforms take hold quickly.

- **The government's macroeconomic framework** allows a modest increase in the fiscal deficit to 1 percent of GDP in 2007 and 1½ percent of GDP over the medium term, while preserving fiscal discipline and debt sustainability. The composition of public spending improves, with public investment projected to increase by 2 percent of GDP by 2010, overall spending falling by an equal amount. Central bank independence to achieve the goals of price stability and effective banking supervision is respected.

- **Structural reforms aim at**: (i) increasing competitiveness through investments in computer technology, knowledge, and training; (ii) encouraging investment through low taxes, simplified regulations, and improved infrastructure; (iii) improving government institutional capacity through enhancing transparency and fighting corruption.

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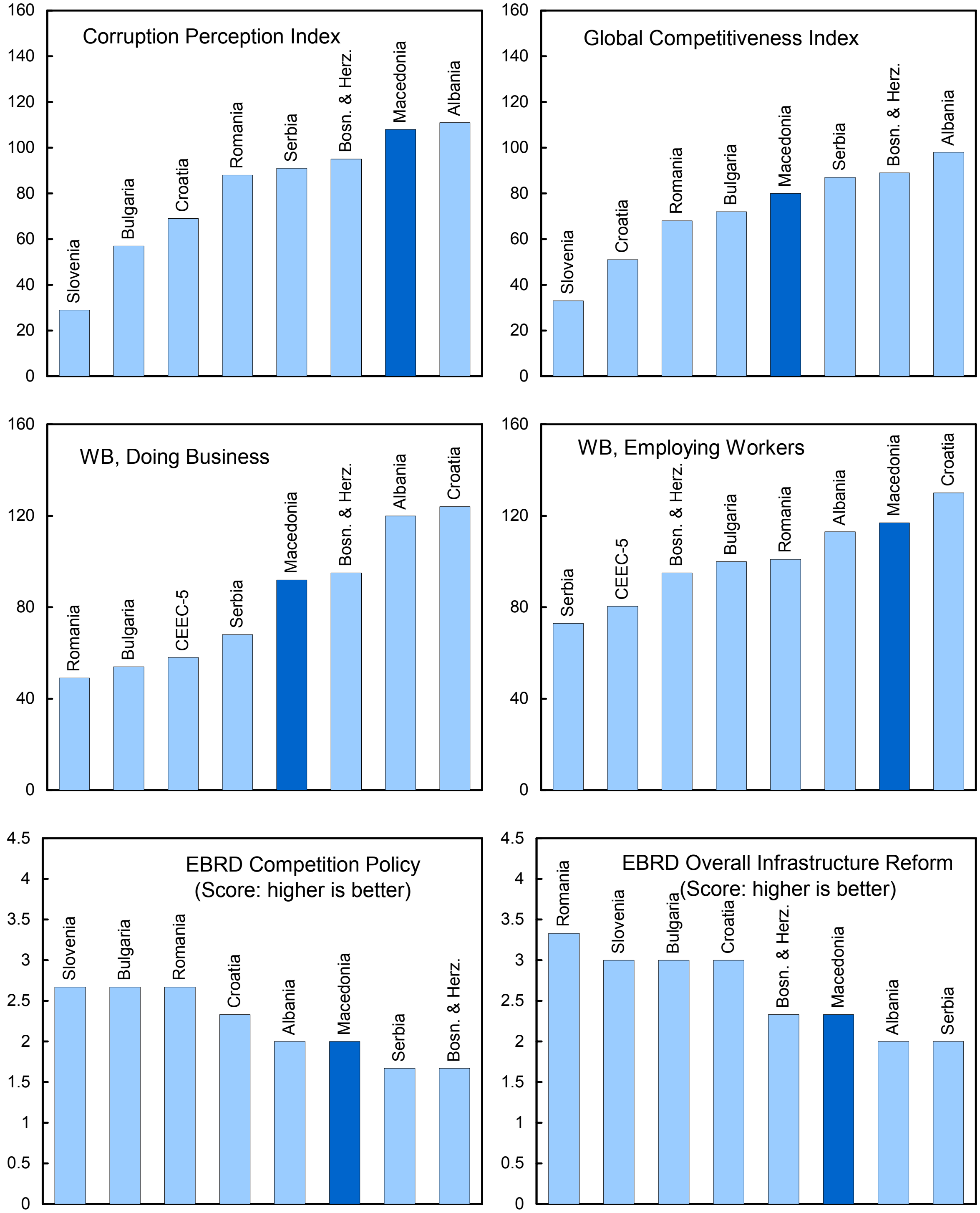
[2] The program is available at http://www.vlada.mk/english/index_en.htm

Figure 7. Indicators of Institutional Quality and Reform, 2006 1/
(Country Rank, lower is better, unless otherwise specified)



Sources: Transparency International; World Bank, Doing Business Database; World Economic Forum.
1/ The corruption perception index relates to the degree of corruption as seen by business people and country analysts; it covers 163 countries. The global competitiveness index covers 125 countries. The World Bank indices cover 175 countries. The EBRD indices' maximum score is 4.33.

A. Macroeconomic Outlook

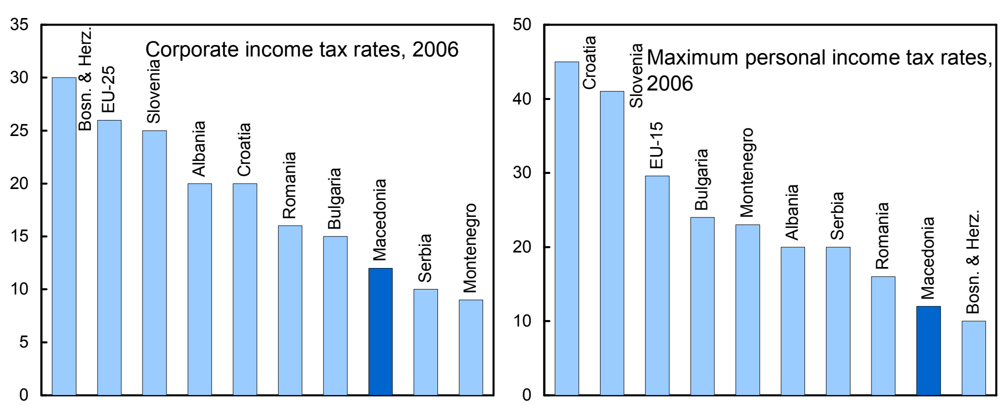
10. **Prospects for 2007 are favorable** (¶8). Growth should pick up to 4½ percent, with credit growth and modest fiscal easing stimulating demand. Lower oil prices should help reduce inflation to 2½ percent. The current account deficit widens to 3 percent of GDP due to larger foreign dividend payments and stabilization of private transfers. Debt sustainability prospects are good, and gross international reserves should increase as long as international financial conditions remain favorable and privatization continues. The staff is confident that obligations to the Fund will be met (Tables 9-12).

11. **The monetary program envisages continued moderate credit growth while maintaining adequate reserve coverage (**¶18**)**. Corrected for the large expected telecom dividend payment, denar deposits are projected to grow faster than euro deposits. Banks are optimistic about credit growth, which they again plan to finance through growing deposits, new foreign credit lines, and retained earnings. However, to maintain the *de facto* exchange rate peg the government may have to continue retaining large deposits at the central bank (NBRM) to share sterilization costs. Improved coordination in determining volumes and terms of treasury bill auctions may also be needed, as the NBRM increasingly uses these bills for open market operations.

B. Fiscal Policy

2007 Budget

12. **The 2007 budget targets a 1 percent of GDP deficit, with new 12 percent corporate and personal income flat taxes the centerpiece**. Together with the new zero corporate income tax for reinvested profits (though this deduction is capped at 50 percent in the first year), these will lower revenue by 1 percent of GDP. While revenue projections are optimistic (assuming 6 percent GDP growth and little use of the reinvested profits deduction), the telecom dividend is probably understated, making the 1 percent deficit target achievable.



Sources: IBFD, The Taxation of Companies in Europe; Deloitte Tax Guides.

13. **Budget quality improves somewhat**. As well as lower tax rates, the new budget includes costs of harmonizing social security bases, higher investment, transition to the second pillar pension, and lower tariffs. Though the staff urged the authorities to broaden the income tax base (to reduce distortions and compensate for lower rates), the government focused instead on implementing its zero reinvested profits tax (an election commitment).

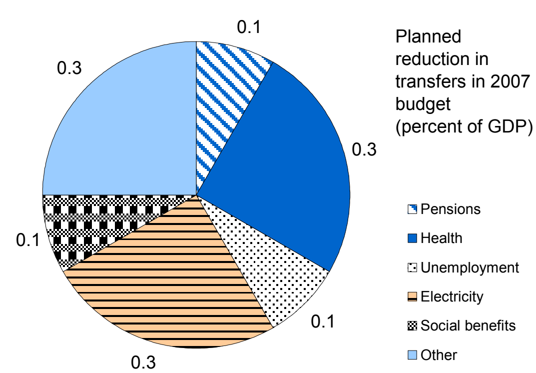
Fiscal Policy: Main Policy Changes
(Percent of GDP)

	2006	2007	
	Prel.	Budget	Staff Proj.
Total revenue and grants	33.5	32.7	32.7
of which tax revenue	29.3	27.8	27.6
of which income taxes	4.3	3.4	3.1
PIT	2.8	2.3	2.3
CIT	1.5	1.1	0.8
of which capital revenue	0.6	0.9	1.3
of which dividend	0.0	0.4	0.8
Total expenditures	34.1	33.7	33.7
of which capital expenditure	3.2	3.7	3.7
Fiscal balance	-0.6	-1.0	-1.0

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

14. **The proposed easing in the deficit is consistent with the program's medium-term objectives** (¶9). The staff stressed the advantages of the earlier 0.6 percent of GDP deficit target in restoring credibility, protecting the fixed exchange rate, and allowing interest rate reductions. However, the authorities noted that with international reserves far higher and government debt much lower than initially programmed, the proposed easing was still consistent with these objectives. As safeguards, the authorities developed a conservative fiscal program (with surpluses through September) and committed to corrective measures should the current account deficit appear threatened.

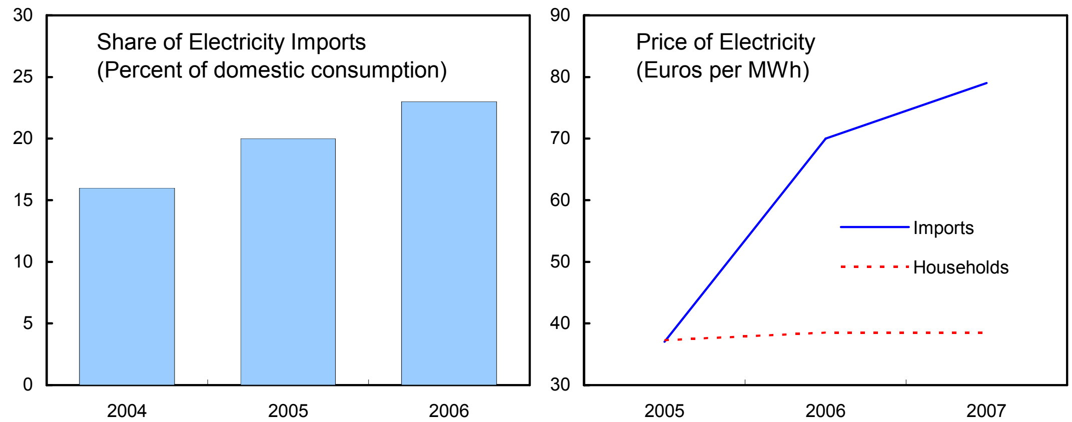
15. **However, the staff noted a number of fiscal risks, in particular in delivering the planned reduction in transfers**. The decline in spending assumes that the authorities address electricity sector problems so that last year's emergency transfer (0.3 percent of GDP) is not repeated (Box 1). Lower health spending will depend on finding cost-saving measures. For 2008, the further reduction in the flat tax to 10 percent together with removal of the cap for deducting reinvested profits could cause another 1 percent of GDP in revenue losses, threatening the deficit target.



Source: Ministry of Finance.

Box 1. Fiscal Risks in the Electricity Sector

The electricity sector is in poor financial condition. In 2006 an emergency 0.3 percent of GDP budget transfer was required to safeguard winter supply. Financial problems are caused in part by poor payment discipline but, fundamentally, by the rapidly growing cost of electricity not reflected in price adjustments.



Source: IMF staff estimates.

Electricity consumption has grown steadily. With domestic production stable, imports have risen. Import prices increased sharply in 2006 as regional market conditions tightened, due to rising demand and the loss of generating units in Bulgaria.

Without policy changes, electricity sector losses could reach 2 percent of GDP in 2007. However, the authorities are working with the World Bank on an action plan to resolve the problem. It could include price adjustments, cost savings, provisions for large users to import electricity, improved payment discipline, and social safeguards.

16. **The authorities are addressing these risks** by developing an electricity sector action plan (¶28) and health sector cost-savings (¶12) with the World Bank. The authorities have also committed to tightening should the fiscal target face risks or the current account deteriorate significantly beyond projection (¶9). Consistent with their commitment to fiscal discipline, the authorities have resisted demands of workers made redundant from bankrupt firms for early pensions (costing ½-1 percent of GDP). They will also cap the telecom dividend treated as revenue in 2007 at 0.8 percent of GDP to avoid spending two years' dividends in one year, though they wish to explore using any excess to finance one-off capital spending (such as embassy purchases). To help meet its deficit and medium-term spending targets, the government is seeking FAD technical assistance on expenditure rationalization.

Tax Administration and Base Harmonization

17. **The authorities are implementing substantial tax administration reforms to boost revenues and help finance planned tax cuts** (¶13):

- **The Public Revenue Office (PRO) has followed its successful establishment of a large taxpayer office (structural performance criterion)** with a new strategic plan to guide its reform program (with financing from the Netherlands, and FAD assistance). However, the government's new small business tax regime may be hard to administer: limits are not aligned with VAT thresholds, and firms may misreport income to benefit from the low lump sum taxes.

- **The program strategy for improving social fund collections has been revised, given the missed end-July performance criterion**. While the authorities eventually established a large contributor office (LCO), it has only a monitoring function, as a broader operational role was precluded by legal problems of ensuring equal treatment among all contributors. Instead, the authorities are intensifying efforts to integrate collections for the three social funds. This should be completed by April 2008, with all social fund contributions moved to the PRO by end-2009.

18. **Base harmonization will simplify tax administration and, potentially, reduce the labor tax wedge and increase revenues** (¶13):

- **In March, Parliament passed legislation harmonizing social contribution bases**, aligning minimum health fund contributions with the employment and pension funds. However, for a one-year transition, minimum health contributions will be 50 percent of the average wage (below the employment and pension funds' 65 percent) to protect low wage sectors.

- **Harmonization of social security and personal income tax bases will follow**. This has several socially sensitive dimensions (common definitions of employment income, abolishing minimum contributions, including allowances). The authorities will prepare a strategy paper by September, for which they are seeking FAD technical assistance, with the first steps included in next year's budget.

C. Structural Reform

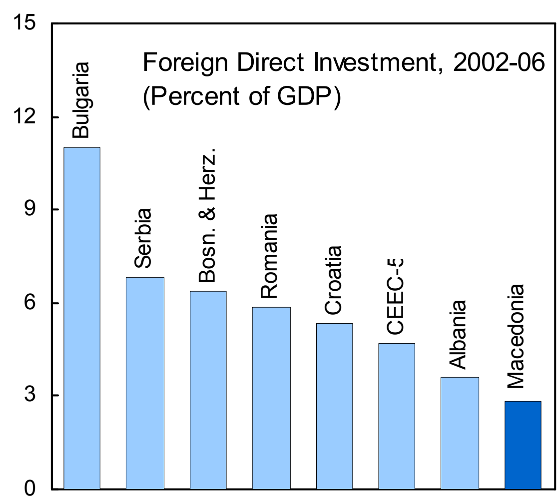
19. **While the program embraces many structural reforms (LOI Table 4),** discussions emphasized three: financial sector reform (¶19-23), encouraging foreign direct investment (¶24-26), and telecommunications liberalization (¶29).

Financial Sector

20. **The proposed new banking law strengthens banking supervision** (¶20) by protecting the governor's decision in the areas of bank licensing, receivership and bankruptcy from reversal by the courts and establishing clear frameworks for consolidated supervision and corrective action against weak banks. It also eases restrictions on foreign bank branching (a priority of the new government) which should encourage urgently-needed competition and banking consolidation; after staff discussions, supervisory safeguards have also been included. Submission of the new law to Parliament is a prior action.

Stimulating Foreign Direct Investment

21. **The authorities are trying to increase the very low level of foreign direct investment**. The government recognizes the importance of institutional reform, bringing forward completion of the land registry and planning to eliminate unnecessary regulations. To secure an immediate response, it also aims to set the lowest personal and corporate income tax rates in Europe, mindful of regional competition. In addition, the government is increasing FDI incentives, despite staff concerns over their efficiency and transparency. Though the export requirement was raised, the new free economic zone law halves personal income tax rates and includes new infrastructure subsidies to stimulate foreign direct investment, on top of the existing corporate income tax holiday. In response to suggestions to publish details of individual firm subsidies, the authorities noted that the law defines the incentives transparently.



Telecommunications Liberalization

22. **Instead of selling its remaining minority stake in the fixed-line monopoly (end-December 2006 performance criterion), the new government emphasizes liberalization**. The previous government's attempt to sell these shares failed last June: only a 10 percent stake was sold, which the company itself bought back. Accounting irregularities and the majority owner's right of first refusal complicate sale. With sufficient international reserves, the new government is concentrating on more fundamental goals: promoting competition to reduce prices (some of the highest in the region) and expanding internet access through market liberalization.

IV. Staff Appraisal

23. **Macroeconomic stability has been maintained**. Inflation is low and international reserves are increasing, consistent with the decision to treat the arrangement as precautionary. The slightly increased fiscal deficit will finance tax and tariff reductions, as well as higher public investment. Together with moderate credit growth and continued structural reform, this should sustain the recovery and improve growth potential.

24. **Fiscal discipline underpins macroeconomic stability**. The authorities' efforts to reduce financial losses in the electricity sector and to resist spending pressures are welcome. Commitments to take offsetting measures should the budget targets appear threatened, or if the current account deteriorates significantly, provide additional safeguards. For 2008, further cuts in the flax tax to 10 percent, full tax-deductibility of reinvested profits, and spending pressures such as the cost of compulsory secondary education, pose considerable challenges. To maintain fiscal discipline, the authorities should develop plans for expenditure rationalization and broadening the tax base.

25. **Strengthened tax administration can also help contain the fiscal deficit**. Delays in creating the large contributor office are regrettable, as is its more limited monitoring role. The authorities should deliver on their revised strategy of integrating the social funds first, now that the LCO can no longer be used as a pilot. Failure could jeopardize planned tax cuts.

26. **Budget quality has been improved, but further reforms are needed**. While the flat tax has political appeal, rates were already low. Lower social contributions would have done more to reduce the labor tax wedge. While lower corporate income tax rates should stimulate investment and growth, the base should have been broadened, not narrowed by expanding incentives and exemptions.

27. **The new banking law should strengthen NBRM supervision**. As long as the appropriate prudential safeguards are in place, easier conditions for foreign branching should promote competition, improve services and reduce spreads, and foster needed consolidation in this sector. However, entry may also expose weaknesses in domestic banks, which strengthened NBRM supervision should anticipate.

28. **While the authorities' focus on attracting foreign direct investment is well-placed, the emphasis on incentives and exemptions is not**. Aside from raising concerns of governance, unequal treatment, and WTO-compatibility, these complicate administration and threaten the tax base. Their possible incompatibility with EU state aid rules could even make them counterproductive. Instead, the authorities should concentrate on maintaining macroeconomic stability, and accelerating structural reforms to enhance the business environment.

29. **Progress on broader structural and institutional reforms, outside the Fund's mandate, will be crucial for meeting the authorities' economic objectives**. Domestic

political stability and establishing international anchors—especially progress towards EU accession—are important for improving the business environment and accelerating growth. The authorities' efforts in judicial reform, law enforcement, strengthening property rights, and fighting corruption are also essential for investment and growth, though these will take time and specific results will be hard to pinpoint. In addition, regional political stability will be needed for these reforms to have full effect.

30. **Implementation of the program offers the prospect of a sustained improvement in economic performance.** The authorities' strong commitments to fiscal discipline, macroeconomic stability, and structural reform, have generated results and deserve the support of the international community. Accordingly, the staff supports the authorities' request for waivers of non-observance of performance criteria and rephasing of the program, and recommends completion of the Second Review

.

Table 1. Performance Criteria and Prior Actions in the Program

Measures (target date)	Status/Comments
Quantitative Performance Criteria (end 2006)	All met
Structural Performance Criteria in 2006	
Sale of the first tranche (at least 10 percent of the company) of government's residual shares in Makedonski Telekomunikacii AD (June 2006).	Met
Establish a Large Taxpayer Office at PRO and a Large Contributor Office at PDF (July 2006).	Waiver requested. LTO established on schedule in July 2006. A LCO has been established with delay, but due to unanticipated legal obstacles, it is currently limited to a monitoring and coordination role. Revised strategy is to integrate all social fund collections by April 2008 (new structural performance criterion).
Sale of all of the government's residual shares in Makedonski Telekomunikacii AD (except for a minority shareholding of up to 7 percent) (December 2006).	Waiver requested. Put up for sale in June 2006 but attracted insufficient bids. Revised strategy focuses on liberalization (new structural benchmark), with emphasis on competition.
Proposed Structural Performance Criteria and Prior Actions for 2007 and 2008 1/	
Submit to parliament a new Banking Law that has been agreed with IMF staff (Prior Action).	Submission originally intended for December 2006.
Implement the March 2007 legislation harmonizing social security bases (abolishing complexity factors and sectoral minimum wages in calculation of health fund premia) (July 2007).	This measure was originally intended by the authorities for completion by December 2006, but was not formally established as a PC.
Initiate phased implementation of the strategy for the harmonization of the base of the personal income tax and social security contributions (January 2008).	To be set at Third Review.
Integration of Social Fund collections. Pension and Disability Fund and its network of field offices will design and execute collection programs for all social insurance contributions and their contributors (April 2008).	

1/ See LOI for proposed quantitative performance criteria and indicative targets, and structural benchmarks.

Table 2. FYR Macedonia: Selected Economic Indicators, 2003-07

	2003	2004	2005 Prel.	2006 Est.	2007 Proj.
Real economy			(Percent change)		
Real GDP	2.8	4.1	3.8	4.0	4.5
Consumer prices					
period average	1.2	-0.4	0.5	3.2	2.5
end of period	2.6	-1.9	1.2	2.9	3.0
Real wages, period average	3.6	4.4	2.0	4.1	...
Unemployment rate (average)	36.7	37.2	37.3	36.1	...
Government finances	(Percent of GDP, unless otherwise indicated)				
Central government balance	0.3	0.7	0.3	-0.6	-1.0
Revenues (including grants)	38.4	36.5	35.5	33.5	32.7
Expenditures	38.1	35.8	35.3	34.1	33.7
Central Government debt 1/					
Gross	39.0	36.6	39.9	34.7	31.9
Net	34.9	32.6	32.3	25.6	25.4
Money and credit					
Broad money (M3, percent change)	18.0	16.1	14.9	24.5	20.8
Short-term lending rate (percent) 2/	14.5	11.8	10.8	9.5	9.5
Interbank money market rate (percent) 2/	6.5	7.9	8.7	4.9	4.8
Balance of payments	(Millions of Euro, unless otherwise indicated)				
Exports	1,203	1,343	1,642	1,903	2,090
Imports	1,953	2,237	2,496	2,923	3,179
Trade balance	-750	-894	-853	-1,021	-1,089
Current account balance					
including official transfers	-137	-334	-62	-19	-173
(in percent of GDP)	-3.3	-7.7	-1.3	-0.4	-3.2
excluding official transfers	-227	-389	-114	-78	-243
(in percent of GDP)	-5.5	-9.0	-2.5	-1.6	-4.5
Overall balance	14	-19	340	299	89
Official gross reserves	710	717	1,123	1,417	1,482
(in months of following year's imports of goods and services)	3.3	3.0	4.1	4.6	4.4
External debt service ratio 3/	24.2	14.7	13.0	19.2	17.8
External debt to GDP ratio (percent)	38.1	38.7	43.7	40.9	40.3
Exchange rate					
Denars/Dollar (average)	50.0	48.6	49.3	48.8	...
Denars/Euro (average)	61.3	61.3	61.3	61.2	...
Real effective exchange rate (CPI-based, percent change)	0.1	-1.4	-2.9	-1.0	...

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

1/ Movements in 2005 and 2006 reflect the issuance of a Euro 150 million Eurobond and repayment of the London club debt. Net debt is defined as gross debt minus NBRM deposits of the central government.
2/ Weighted averages for December of each year.
3/ Debt service due including IMF as percent of exports of goods and services. Excludes rollover of trade credits.

Table 3. FYR Macedonia: Macroeconomic Framework, 2003-2012
(Percentage change, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
			Prel.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real GDP	2.8	4.1	3.8	4.0	4.5	4.5	4.5	4.5	4.5	4.5
Real domestic demand	-3.2	7.1	3.1	5.1	6.4	4.7	4.6	4.2	4.0	3.7
Consumption	-3.3	6.2	2.6	4.7	4.9	4.5	4.3	4.0	3.7	3.7
Private	-1.5	6.8	2.5	5.1	5.7	5.0	4.7	4.3	3.9	3.8
Public	4.5	3.9	3.1	3.3	1.8	2.5	2.5	3.0	3.0	3.0
Fixed investment	1.1	10.9	5.4	7.4	15.1	5.0	5.9	5.2	5.3	4.0
Private	-2.3	20.8	4.0	8.2	16.0	6.0	6.0	5.4	5.5	4.0
Public	13.3	-20.0	11.7	3.9	11.0	5.0	5.5	4.5	4.5	4.5
Change in stocks	-16.8	13.4	4.0	4.0	4.5	4.5	4.5	4.5	4.5	4.5
Exports (volume)	-5.7	13.0	14.3	9.2	8.7	6.7	7.5	8.5	9.0	9.5
Imports (volume)	-15.2	16.7	7.0	10.2	11.5	6.7	7.0	7.0	7.0	7.0
Contributions to growth	2.8	4.1	3.8	4.0	4.5	4.5	4.5	4.5	4.5	4.5
Domestic demand	-3.9	8.1	3.6	6.0	7.6	5.7	5.6	5.1	4.9	4.5
Net exports	6.9	-3.7	1.6	-1.9	-3.1	-1.2	-1.1	-0.6	-0.3	0.0
Statistical discrepancy	-0.2	-0.4	-1.4	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Central government operations (percent of GDP)										
Revenues	38.4	36.5	35.6	33.5	32.7	31.1	30.7	30.5	30.5	30.5
Expenditures	38.1	35.8	35.3	34.1	33.7	32.3	32.2	32.0	32.0	32.0
of which capital	4.1	3.2	3.8	3.2	3.7	3.7	4.0	4.0	4.0	4.0
Balance	0.3	0.7	0.3	-0.6	-1.0	-1.2	-1.5	-1.5	-1.5	-1.5
Savings and investment (percent of GDP)										
Domestic saving	16.6	13.7	20.6	21.9	20.8	21.2	21.0	20.4	21.0	21.6
o/w public	4.3	3.9	3.6	2.7	2.5	2.3	2.0	2.0	2.0	1.9
private	12.3	9.8	17.0	19.2	18.4	18.9	19.1	18.4	19.0	19.6
Foreign saving 1/	3.3	7.7	1.3	0.4	3.2	3.5	4.0	4.9	4.6	4.0
Gross investment	20.0	21.4	21.9	22.3	24.1	24.6	25.0	25.3	25.6	25.6
Fixed investment	16.7	17.8	18.4	18.8	20.6	21.2	21.6	21.8	22.1	22.1
Change in stocks	3.2	3.6	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
Consumer prices										
Period average	1.2	-0.4	0.5	3.2	2.5	2.5	2.0	2.0	2.0	2.0
End-period	2.6	-1.9	1.2	2.9	3.0	2.0	2.0	2.0	2.0	2.0
Memorandum items										
Central government balance (percent of GDP)	-0.1	0.4	0.3	-0.4	-1.0	-1.2	-1.5	-1.5	-1.5	-1.5
Gross official reserves (in million Euro)	710	717	1,123	1,417	1,482	1,745	1,800	1,858	2,001	2,217
Gross official reserves (in months of imports)	3.3	2.9	4.1	4.6	4.4	4.9	4.8	4.6	4.6	...
Foreign direct investment (percent of GDP)	2.0	2.9	1.7	5.7	2.7	6.0	3.2	4.0	4.5	4.5
Nominal GDP (in billion denars)	251.5	265.3	284.2	305.1	327.0	350.3	373.4	398.0	424.2	452.2
Nominal GDP (in million Euro)	4,105	4,325	4,637	4,986	5,334	5,714	6,090	6,492	6,919	7,375

Sources: NBRM, SSO, MOF, and IMF staff projections.

1/ Current account deficit.

Table 4. FYR Macedonia: Medium-Term Balance of Payments, 2005-12
(Millions of Euro)

	2005	2006		2007	2008	2009	2010	2011	2012
	Prel.	Prog.	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account	-62	-177	-19	-173	-197	-242	-317	-315	-293
Excluding official transfers	-114	-235	-78	-243	-292	-328	-403	-397	-383
Trade balance (fob)	-853	-1,002	-1,021	-1,089	-1,217	-1,322	-1,404	-1,450	-1,494
Exports	1,642	1,805	1,903	2,090	2,256	2,364	2,509	2,751	3,026
Imports	-2,496	-2,807	-2,923	-3,179	-3,473	-3,686	-3,913	-4,201	-4,521
Services (net)	-27	-29	20	-3	3	19	20	36	56
Income (net; including net interest)	-44	-31	-2	-90	-54	-40	-74	-80	-85
Transfers (net)	863	878	984	1,009	1,071	1,101	1,141	1,179	1,230
Official	52	58	59	70	94	86	86	82	90
Private	811	820	925	939	976	1,015	1,055	1,097	1,140
of which cash-exchanged	555	570	649	655	681	708	736	765	795
Capital and financial account	401	354	307	262	474	303	375	459	509
Capital account (net)	-2	-4	-1	5	0	0	0	0	0
Financial account	403	358	307	257	474	303	375	459	509
Disbursements	256	273	292	370	341	369	384	425	471
of which private sector	139	147	208	243	203	249	284	325	372
Amortization 1/	-143	-301	-302	-274	-252	-331	-361	-385	-411
Direct and portfolio investment (net)	275	412	351	187	393	257	329	394	422
Direct investment	77	354	286	146	343	195	260	311	332
of which non-privatization related FDI	77	109	61	106	143	195	260	311	332
Portfolio investment 2/	198	58	66	42	50	62	70	83	91
Currency and deposits (net)	-21	-60	-78	-62	-55	-58	-62	-65	-68
Individuals	-43	-41	-67	-73	-75	-78	-82	-85	-88
Commercial banks	22	-19	-10	11	20	20	20	20	20
Other credits (net)	36	34	44	35	48	67	83	89	96
Errors and omissions	1	0	12	0	0	0	0	0	0
Overall balance	340	177	299	89	277	60	58	143	216
Financing	-340	-177	-299	-89	-277	-60	-58	-143	-216
Net foreign assets (flows)	-355	-177	-314	-89	-277	-60	-58	-143	-216
Valuation effects on the stock of NFA (increase: -)	-47	0	7	0	0	0	0	0	0
Change in the stock of NFA (increase:-)	-401	-177	-307	-89	-277	-60	-58	-143	-216
Change in gross foreign reserves (increase:-)	-406	-169	-294	-65	-263	-55	-57	-143	-216
IMF (net)	4	-8	-8	-23	-14	-5	-1	0	0
Other (net)	1	0	-6	0	0	0	0	0	0
Change in arrears 3/	15	0	15	0	0	0	0	0	0
Memorandum items:									
Current account (in percent of GDP)	-1.3	-3.7	-0.4	-3.2	-3.5	-4.0	-4.9	-4.6	-4.0
Excluding official transfers	-2.5	-4.9	-1.6	-4.5	-5.1	-5.4	-6.2	-5.7	-5.2
Trade balance (in percent of GDP)	-18.4	-21.0	-20.5	-20.4	-21.3	-21.7	-21.6	-21.0	-20.3
Non-energy trade balance (in percent of GDP)	-10.9	-12.0	-12.4	-12.0	-13.3	-14.4	-14.9	-14.8	-14.5
Export growth rate (volumes) 4/	14.3	9.8	9.2	8.7	6.7	7.5	8.5	9.0	9.5
Import growth rate (volumes) 4/	7.0	12.5	10.2	11.5	6.7	7.0	7.0	7.0	7.0
Export price increase	6.9	1.1	6.1	1.0	1.2	-2.5	-2.2	0.6	0.5
Import price increase	4.3	1.3	4.2	-0.5	2.9	-0.6	-0.4	0.7	0.6
Gross reserves	1,123	1,291	1,417	1,482	1,745	1,800	1,858	2,001	2,217
(in months of following year's imports of goods and services)	4.1	4.3	4.6	4.4	4.9	4.8	4.6	4.6	...
(in percent of denar broad money)	119.1	115.3	115.3	102.5	...	...	...	...	...
External debt service ratio (in percent) 5/	13.0	23.2	19.2	17.8	15.9	18.2	19.0	18.7	18.4
External debt to GDP ratio (in percent) 6/	43.7	42.3	40.9	40.3	39.8	39.0	38.3	37.8	37.5
of which medium and long term 6/	38.6	34.5	35.3	34.4	33.5	31.9	30.3	29.0	28.0
short-term 7/	5.1	7.8	5.6	5.9	6.4	7.1	7.9	8.7	9.5
Short-term external debt in percent of gross official reserves	21.1	28.8	19.8	21.3	20.8	23.8	27.5	30.0	31.3
Net private transfers (in percent of GDP)	17.5	17.2	18.6	17.6	17.1	16.7	16.3	15.8	15.5
Nominal GDP (in millions of euros)	4,637	4,771	4,986	5,334	5,714	6,090	6,492	6,919	7,375

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

1/ Amortization payments include prepayment of London club debt in 2006 and Paris Club debt in 2007.
2/ Portfolio investment includes Eurobond issuance in 2005.
3/ Private sector arrears.
4/ Higher projected investment is expected to increase imports and lead to higher exports over the medium term.
5/ Debt service due including IMF as percent of exports of goods and services. Excludes rollover of trade credits.
6/ Including IMF.
7/ Including trade credits.

Table 5. FYR Macedonia: Central Government Operations, 2004–07

	2004	2005	2006			2007	
			Prog.	Revised Budget	Prel.	Budget	Proj.
	(Billions of denars)						
Total revenue and grants	96.8	100.9	102.9	107.3	102.3	106.8	106.8
Tax revenue	81.6	84.6	87.0	88.2	89.3	91.0	90.1
Taxes on income and profits	10.1	10.9	11.2	12.7	13.1	11.2	10.1
Social insurance contributions 1/	28.1	28.6	28.6	29.3	29.5	29.3	29.3
Domestic taxes on goods & services	36.8	38.8	41.5	39.0	39.4	43.0	42.8
VAT	25.8	27.1	28.3	27.4	27.2	30.4	30.3
Excises	11.0	11.7	13.1	11.7	12.2	12.6	12.5
Import duties	5.8	5.3	4.8	5.5	5.4	5.5	5.5
Other taxes	0.8	1.0	0.8	1.7	1.8	2.0	2.4
Non-tax revenue	13.0	10.5	11.9	12.9	9.9	11.4	11.1
Capital revenue 2/	0.6	4.3	2.0	3.8	1.8	2.9	4.1
Grants	1.7	1.5	2.0	2.4	1.4	1.5	1.5
Total expenditures	95.1	100.2	104.8	109.8	104.0	110.2	110.2
Current expenditure	86.7	90.0	93.2	97.9	94.8	98.0	98.0
Wages and salaries	22.0	22.8	24.0	23.9	23.4	24.9	24.9
Goods and services	12.2	13.0	12.5	14.4	12.9	14.7	14.7
Transfers 1/	50.2	51.6	53.4	56.2	55.4	55.5	55.5
Interest	2.3	2.6	3.3	3.4	3.1	3.0	3.0
Capital expenditure	8.4	10.2	11.5	12.3	9.6	12.2	12.2
Lending minus repayments	0.0	0.0	0.0	-0.4	-0.4	0.0	0.0
Fiscal Balance	1.8	0.7	-1.9	-2.4	-1.7	-3.4	-3.4
Fiscal Balance below the line	1.1	0.8	-1.9	-2.4	-1.1	-3.4	-3.4
Discrepancy	0.7	-0.1	0.0	0.0	-0.6	0.0	0.0
Financing	-1.1	-0.8	1.9	2.4	1.1	3.4	3.4
Domestic	-2.9	-12.9	-9.0	-8.9	-9.8	5.6	5.0
Central bank	-1.0	-10.2	-7.6	-7.5	-7.2	6.7	6.1
Other domestic financing	-1.8	-2.6	-1.4	-1.4	-2.7	-1.1	-1.1
Privatization receipts	0.5	0.6	15.7	20.3	20.3	0.8	2.6
Foreign	1.3	11.5	-4.9	-8.9	-9.4	-3.0	-4.2
Memorandum item:							
Telecom dividend	...	2.8	0.6	2.5	0.0	1.2	2.5
Fiscal Balance General Government 3/	...	...	...	...	-1.2	-3.4	-3.4
Nominal GDP	265.3	284.2	305.1	305.1	305.1	327.0	327.0

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

1/ Excluding contributions and transfers related to the second pillar pension scheme that commenced in 2006.

2/ Including Telecom dividend.

3/ Central government and municipalities.

Table 5. FYR Macedonia: Central Government Operations, 2004–07 (continued)

	2004	2005	2006			2007	
			Prog.	Revised Budget	Prel.	Budget	Proj.
	(Percent of GDP)						
Total revenue and grants	36.5	35.5	33.7	35.2	33.5	32.7	32.7
Tax revenue	30.7	29.8	28.5	28.9	29.3	27.8	27.6
Taxes on income and profits	3.8	3.8	3.7	4.2	4.3	3.4	3.1
Social insurance contributions 1/	10.6	10.1	9.4	9.6	9.7	9.0	9.0
Domestic taxes on goods & services	13.9	13.7	13.6	12.8	12.9	13.2	13.1
VAT	9.7	9.5	9.3	9.0	8.9	9.3	9.3
Excises	4.1	4.1	4.3	3.8	4.0	3.9	3.8
Import duties	2.2	1.9	1.6	1.8	1.8	1.7	1.7
Other taxes	0.3	0.3	0.3	0.6	0.6	0.6	0.7
Non-tax revenue	4.9	3.7	3.9	4.2	3.2	3.5	3.4
Capital revenue 2/	0.2	1.5	0.7	1.2	0.6	0.9	1.3
Grants	0.6	0.5	0.6	0.8	0.5	0.5	0.5
Total expenditures	35.8	35.3	34.3	36.0	34.1	33.7	33.7
Current expenditure	32.7	31.7	30.6	32.1	31.1	30.0	30.0
Wages and salaries	8.3	8.0	7.9	7.8	7.7	7.6	7.6
Goods and services	4.6	4.6	4.1	4.7	4.2	4.5	4.5
Transfers 1/	18.9	18.2	17.5	18.4	18.1	17.0	17.0
Interest	0.9	0.9	1.1	1.1	1.0	0.9	0.9
Capital expenditure	3.2	3.6	3.8	4.0	3.2	3.7	3.7
Lending minus repayments	0.0	0.0	0.0	-0.1	-0.1	0.0	0.0
Fiscal Balance	0.7	0.2	-0.6	-0.8	-0.6	-1.0	-1.0
Fiscal Balance below the line	0.4	0.3	-0.6	-0.8	-0.4	-1.0	-1.0
Discrepancy	0.3	0.0	0.0	0.0	-0.2	0.0	0.0
Financing	-0.4	-0.3	0.6	0.8	0.4	1.0	1.0
Domestic	-1.1	-4.5	-3.0	-2.9	-3.2	1.7	1.5
Central bank	-0.4	-3.6	-2.5	-2.5	-2.4	2.1	1.9
Other domestic financing	-0.7	-0.9	-0.4	-0.5	-0.9	-0.3	-0.3
Privatization receipts	0.2	0.2	5.2	6.6	6.7	0.2	0.8
Foreign	0.5	4.0	-1.6	-2.9	-3.1	-0.9	-1.3
Memorandum item:							
Telecom dividend	...	1.0	0.2	0.8	0.0	0.4	0.8
Fiscal Balance General Government 3/	...	...	...	...	-0.4	-1.0	-1.0

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

1/ Excluding contributions and transfers related to the second pillar pension scheme that commenced in 2006.
2/ Including Telecom dividend.
3/ Central government and municipalities.

Table 6. FYR Macedonia: Central Bank Accounts, 2004-07
(End-period; in billions of denars unless otherwise indicated)

	2004 Dec Actual	2005 Dec Actual	2006 Dec Actual	2007 Mar Proj.	June Proj.	Sept Proj.	Dec Proj.
	(At current exchange rates)						
Net foreign assets (NFA)	41.8	66.3	85.1	80.8	85.5	89.9	90.6
Net domestic assets (NDA)	-20.7	-40.5	-53.9	-51.3	-54.3	-57.7	-56.1
Banks (net)	-4.5	-8.9	-14.0	-12.2	-16.3	-18.7	-22.0
Central government (net)	-8.1	-18.3	-25.5	-24.7	-23.6	-24.6	-19.7
o/w deposits	-11.0	-21.6	-27.7	-27.0	-25.6	-26.5	-21.6
Municipalities (net)	0.0	-0.7	-0.6	-0.6	-0.6	-0.6	-0.6
Other items (net)	-8.1	-12.7	-13.7	-13.7	-13.7	-13.7	-13.7
Reserve money	21.1	25.8	31.3	29.6	31.2	32.2	34.5
Currency	14.2	14.4	16.2	15.3	16.1	16.4	17.8
Other	6.9	11.3	15.1	14.3	15.2	15.8	16.7
Cash in vaults	0.9	1.4	1.5	1.5	1.5	1.5	1.5
Total reserves	6.0	9.9	13.5	12.8	13.7	14.3	15.2
on denar deposits	2.7	4.6	7.2	6.4	6.9	7.2	7.7
on FX deposits	3.4	5.3	6.4	6.4	6.7	7.1	7.5
	(Year-on-year growth rates, percent)						
Net foreign assets	...	58.5	28.4	12.4	10.7	9.5	6.4
Reserve money	...	22.0	21.4	19.7	16.0	17.6	10.3
Currency	...	2.0	12.2	11.4	10.1	10.4	9.6
	(Contribution to year-on-year change in base money)						
Net foreign assets	...	115.9	73.1	36.1	30.6	28.5	17.4
Net domestic assets	...	-93.8	-51.8	-16.4	-14.6	-10.9	-7.1
	(At program exchange rates)						
Net foreign assets	41.8	63.7	82.9	78.6	83.3	87.6	88.3
Net domestic assets	-20.7	-37.9	-51.6	-49.0	-52.0	-55.4	-53.8
o/w credit to central government (net)	-8.1	-18.3	-25.5	-24.7	-23.6	-24.6	-19.7
Reserve money	21.1	25.8	31.3	29.6	31.3	32.2	34.5
Memorandum items:							
Reserve money/GDP (in percent)	8.0	9.1	10.2	9.5	9.8	9.9	10.5
Program exchange rate (denars per euro)	61.3	61.3	61.3	61.3	61.3	61.3	61.3
GDP (yearly total) 1/	265.3	284.2	305.1	312.2	318.2	324.0	327.0

Sources: NBRM, and IMF staff projections.

1/ Measured as a four quarter rolling sum.

Table 7. FYR Macedonia: Monetary Survey, 2004-07
(End-period; billions of denars unless otherwise indicated)

	2004 Dec Actual	2005 Dec Actual	2006 Dec Actual	2007 Mar Proj.	June Proj.	Sept Proj.	Dec Proj.
	(At current exchange rates)						
Net foreign assets (NFA)	68.9	89.7	108.0	103.8	106.4	109.8	110.4
NBRM	41.8	66.3	85.1	80.8	85.5	89.9	90.6
Domestic money banks (DMBs)	27.0	23.5	22.9	23.0	20.9	19.9	19.8
Net domestic assets (NDA)	25.9	19.2	27.6	33.4	40.2	43.7	53.4
Credit to the government	-1.2	-12.2	-18.0	-16.8	-15.3	-15.8	-10.5
Banks	6.9	6.8	8.1	8.5	8.9	9.4	9.7
NBRM (net)	-8.1	-19.0	-26.1	-25.4	-24.2	-25.2	-20.3
Credit to the private sector	57.1	68.8	89.8	94.8	100.4	104.9	109.7
In denars 1/	45.8	51.7	66.4	70.6	74.1	77.4	80.7
In foreign currency	11.3	17.1	23.4	24.2	26.4	27.4	29.0
Other items (net)	-30.0	-37.4	-44.2	-44.6	-45.0	-45.4	-45.8
Broad money (M3)	94.8	108.9	135.6	137.2	146.6	153.5	163.8
Currency in circulation	14.2	14.4	16.2	15.3	16.1	16.4	17.8
Private denar deposits 1/ 2/	38.1	43.4	59.0	58.0	63.1	65.9	70.9
Private foreign currency deposits	42.5	51.1	60.4	63.9	67.5	71.2	75.2
	(Year-on-year growth rates, percent)						
NFA domestic money banks	...	-13.3	-2.3	-6.8	-9.2	-15.5	-13.4
Credit to the private sector	...	20.5	30.5	29.8	26.3	27.7	22.2
Denar credit	...	12.9	28.5	29.6	25.5	28.3	21.5
Foreign currency credit	...	50.7	36.6	30.3	28.3	26.2	24.3
Broad Money	...	14.9	24.5	21.7	24.2	23.2	20.8
Private denar deposits	...	13.8	36.0	25.9	30.8	27.2	20.2
Private foreign currency deposits	...	20.2	18.3	20.8	22.1	23.0	24.4
	(Contribution to year-on-year change of credit to private sector)						
Denar credit (excluding foreign currency indexed)	...	5.2	9.0	10.7	9.5	12.5	10.1
Foreign currency (including foreign currency indexed)	...	15.3	21.6	19.1	16.8	15.3	12.1
	(At program exchange rates)						
Net foreign assets	68.9	86.8	105.8	101.6	104.2	107.5	108.1
Net domestic assets	25.9	21.3	29.8	35.5	42.4	45.9	55.6
Broad money	94.8	108.1	135.5	137.1	146.5	153.4	163.7
Memorandum items:							
M3/GDP (percent)	35.7	38.3	44.5	43.9	46.1	47.4	50.1
Private denar deposits excl. Telecom (percent growth)	...	16.0	27.3	32.1	37.9	23.7	30.3
Forex and forex indexed deposits/total deposits (percent)	62.4	57.3	52.4	54.1	53.4	53.7	53.2
Forex and forex indexed loans/total loans (percent)	42.3	47.8	53.2	52.8	53.3	53.2	53.4
Forex linked assets/Forex linked liabilities 3/	108.6	113.9	123.1	120.4	116.5	112.6	110.6
Broad money multiplier (M3/reserve money)	4.5	4.2	4.3	4.6	4.7	4.8	4.7
NFA of DMBs/forex deposits (percent)	71.5	56.3	48.5	46.0	41.0	38.0	36.4
Private credit (percent of GDP)	21.5	24.2	29.4	30.3	31.6	32.4	33.5
Nominal GDP (yearly total) 4/	265.3	284.2	305.1	312.2	318.2	324.0	327.0

Sources: NBRM, and IMF staff projections.

1/ Includes foreign currency indexed.
2/ Includes municipal and public enterprise accounts.
3/ Forex linked assets include banks' NFA, forex loans (including forex indexed), and forex reserves at the NBRM. Forex linked liabilities include forex denominated and forex indexed deposits.
4/ Measured as a four quarter rolling sum.

Table 8. FYR Macedonia: Financial Soundness Indicators, 2001–06

	2001	2002	2003	2004	2005	2006 8/
	(Percent, unless indicated otherwise)					
Capital adequacy						
Regulatory capital/risk weighted assets	34.3	28.1	25.8	23.0	21.3	19.3
Tier I capital/risk weighted assets	35.1	28.3	26.2	23.9	21.6	19.5
Asset composition and quality						
Sectoral loans to nonfinancial enterprises/total loans 1/						
Enterprises	42.1	37.3	44.4	43.5	43.8	45.0
Households	5.9	7.9	11.8	16.3	20.3	23.1
Foreign currency lending						
Foreign currency lending/total credit to private sector	13.8	22.2	16.2	20.0	25.4	26.8
Foreign currency indexed lending/total credit to private sector 2/	...	16.8	22.2	20.6	22.2	24.3
NPLs/gross loans 3/	24.5	23.1	22.1	17.0	15.0	12.1
NPLs net of provision /capital 3/	9.3	11.8	10.6	2.2	2.0	0.3
Large exposures/capital	93.0	220.0	193.0	219.0	190.0	199.6
Gross official reserves/Denar broad money						
Connected lending						
Banking system exposure to shareholders/capital	...	11.8	7.0	7.4	4.3	5.6
Banking system equity participation/capital	6.7	7.3	6.3	5.6	6.2	5.8
Earning and profitability						
ROAA 4/	-0.7	0.4	0.5	0.6	1.2	1.7
ROAE 4/	-3.2	2.0	2.3	3.1	7.5	11.1
Interest margin/gross income	34.3	44.0	46.2	49.6	53.8	55.6
Noninterest expenses/gross income	86.8	91.5	87.7	75.6	68.1	59.3
Personnel expenses/noninterest expenses	38.7	38.9	42.5	41.7	42.1	40.4
Interest rate spreads (in percentage points)						
Local currency	9.5	8.8	7.8	5.5	6.9	6.4
Foreign currency	3.3	5.4	...	5.6	6.5	6.6
Interbank market	13.1	5.9	9.8	6.9	8.5	4.7
Liquidity						
Highly liquid assets/total assets 5/	46.2	40.1	38.7	37.8	37.1	31.9
Highly liquid assets/total short-term liabilities 6/	67.3	62.2	57.4	55.0	53.8	45.0
Short-term foreign assets of commercial banks (million euros)	876	609	624	714	767	851
Short-term foreign liabilities of commercial banks (million euros)	771	555	627	743	899	1,078
Customer deposits/total (noninterbank) loans	163.0	130.2	140.5	143.4	142.3	138.0
Foreign currency deposits/total deposits (from the balance sheet-excluding deposits of banks)	62.4	52.3	52.7	54.4	55.7	54.2
Central bank credit to banks/bank liabilities 7/	0.4	0.4	0.4	0.9	0.7	1.4
Central bank short-term foreign liabilities (million euros)	0.0	2.0	0.0	0.7	0.0	0.9
Sensitivity to market risk						
Net foreign exchange position /capital	60.5	56.2	56.3	52.1	49.6	43.9

Sources: NBRM.

1/ Total loans include deposits with banks.
2/ The ratio differs from that used in the monetary survey due to different definitions.
3/ Includes only loans to nonfinancial sector.
4/ Adjusted for unallocated provisions for potential loan losses.
5/ Highly liquid assets are defined as cash and balance with the NBRM, NBRM bills, and accounts with foreign banks.
6/ Short-term liabilities are defined as deposits and other liabilities with a maturity of one year or less.
7/ The increase in 2006 is due to loans channeled through NBRM, not NBRM credit to banks.
8/ For short-term assets and liabilities of commercial banks and short term liabilities of the NBRM as of end-December; for other variables as of end-September.

Table 9. FYR Macedonia: Fiscal Debt Sustainability Framework, 2002-12
(Percent of GDP, unless otherwise indicated)

		Actual							Projections					
	2002	2003	2004	2005	2006			2007	2008	2009	2010	2011	2012
								I. Baseline Projections					
1 **Public sector debt 1/**	43.0	39.0	36.6	39.9	34.7			**31.9**	**31.0**	**30.5**	**30.2**	**29.8**	**29.5**
o/w foreign-currency denominated	41.5	37.7	34.7	37.4	29.6			28.1	25.6	22.7	19.6	16.6	15.6
2 Change in public sector debt	-5.9	-4.0	-2.4	3.3	-5.1			-2.9	-0.9	-0.4	-0.4	-0.4	-0.3
3 Identified debt-creating flows (4+7+12)	3.0	-0.5	-1.5	-1.3	-8.1			-1.0	-4.4	-0.4	-0.4	-0.4	-0.3
4 Primary deficit	4.1	-1.0	-1.3	-1.2	-0.5			0.1	0.3	0.6	0.6	0.6	0.6
5 Revenue and grants	34.9	38.4	36.5	35.5	33.6			32.7	31.1	30.7	30.5	30.5	30.5
6 Primary (noninterest) expenditure	39.0	37.4	35.2	34.3	33.1			32.8	31.4	31.3	31.1	31.1	31.1
7 Automatic debt dynamics 2/	-0.5	0.0	-1.1	-1.6	-1.7			-1.4	-1.2	-1.0	-1.0	-1.0	-0.9
8 Contribution from interest rate/growth differential 3/	-0.6	-0.2	-1.1	-1.5	-1.7			-1.4	-1.2	-1.0	-1.0	-1.0	-0.9
9 Of which contribution from real interest rate	-0.2	1.0	0.4	-0.2	-0.2			0.0	0.1	0.3	0.3	0.3	0.3
10 Of which contribution from real GDP growth	-0.4	-1.2	-1.5	-1.3	-1.5			-1.5	-1.3	-1.3	-1.3	-1.3	-1.3
11 Contribution from exchange rate depreciation 4/	0.1	0.1	0.0	-0.1	0.0			0.0	0.0	0.0	0.0	0.0	0.0
12 Other identified debt-creating flows	-0.6	0.6	0.9	1.5	-5.9			0.3	-3.5	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	-0.6	-0.3	-0.2	-0.2	-6.6			-0.8	-3.5	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.9	1.1	1.2	0.7			1.1	0.0	0.0	0.0	0.0	0.0
15 Other (incl. NBRM recapitalization and debt prepayment)	0.0	0.0	0.0	0.4	0.0			0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	-8.9	-3.5	-0.9	4.5	3.0			-1.9	3.5	0.0	0.0	0.0	0.0
of which change in NBRM deposits	-3.2	-1.3	0.2	3.8	2.0			-1.9	3.5	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	123.0	101.5	100.2	112.3	103.4			97.5	99.6	99.5	98.9	97.7	96.6
Gross financing need 5/	8.0	3.2	2.4	3.1	8.5			7.4	7.4	8.3	9.1	9.5	10.0
in million Euros	320.6	131.8	103.9	145.7	424.2			393.4	420.5	505.2	591.1	654.0	736.0
Key Macroeconomic and Fiscal Assumptions						7-Year Historical Average	7-Year Standard Deviation						
Real GDP growth (in percent)	0.9	2.8	4.1	3.8	4.0	2.2	3.2	4.5	4.5	4.5	4.5	4.5	4.5
Average nominal interest rate on public debt (in percent) 6/	3.1	2.6	2.5	2.7	2.7	3.4	1.3	2.8	3.0	3.1	3.1	3.2	3.2
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-0.3	2.4	1.1	-0.5	-0.5	0.1	1.4	0.2	0.5	1.1	1.1	1.2	1.2
Nominal appreciation (increase in Euro of local currency, in percent)	-0.2	-0.4	0.0	0.2	0.0	-0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	3.4	0.3	1.3	3.2	3.2	3.3	2.5	2.6	2.5	2.0	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	2.3	-1.5	-2.0	1.2	0.3	2.2	5.8	3.6	0.0	4.2	3.8	4.5	4.5
Primary deficit	4.1	-1.0	-1.3	-1.2	-0.5	0.0	3.1	0.1	0.3	0.6	0.6	0.6	0.6
								II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2006-10 7/								**32.5**	**31.8**	**31.2**	**30.6**	**30.0**	**29.4**
A2. No policy change (constant primary balance) in 2006-10								**31.3**	**29.6**	**28.1**	**26.7**	**25.3**	**24.0**
B. Bound Tests													
B1. Real interest rate is at baseline plus one standard deviations								**32.1**	**31.4**	**31.2**	**30.9**	**30.8**	**30.6**
B2. Real GDP growth is at baseline minus one-half standard deviation								**32.9**	**33.4**	**34.9**	**36.9**	**39.4**	**42.4**
B3. Primary balance is at baseline minus one-half standard deviation								**33.5**	**34.0**	**35.1**	**36.1**	**37.2**	**38.2**
B4. Combination of B1-B3 using one-quarter standard deviation shocks								**33.0**	**33.2**	**33.9**	**34.5**	**35.2**	**35.8**
B5. One time 30 percent real depreciation in 2006 8/								**45.7**	**44.2**	**43.4**	**42.6**	**41.8**	**41.1**
B6. 10 percent of GDP increase in other debt-creating flows in 2006								**41.9**	**40.6**	**39.9**	**39.2**	**38.5**	**37.9**

1/ Consolidated central government gross debt.
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of Euro).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in Euro value of local currency) minus domestic inflation (based on GDP deflator).
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 10. FYR Macedonia: External Debt Sustainability Framework, 2002-12
(Percent of GDP, unless otherwise indicated)

		Actual							Projections						
		2002	2003	2004	2005	2006			2007	2008	2009	2010	2011	2012	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	36.9	38.1	38.7	43.7	40.9			**40.3**	**39.8**	**39.0**	**38.3**	**37.8**	**37.5**	**-6.5**
2	Change in external debt	-5.0	1.2	0.6	5.0	-2.8			-0.5	-0.5	-0.8	-0.8	-0.5	-0.2	
3	Identified external debt-creating flows (4+8+9)	5.7	0.4	2.6	-3.9	-9.7			-2.0	-5.1	-1.9	-1.8	-2.7	-3.3	
4	Current account deficit, excluding interest payments	8.0	2.2	6.8	0.3	-1.0			1.9	2.1	2.6	3.3	3.0	2.5	
5	Deficit in balance of goods and services	21.8	18.5	21.7	19.0	20.1			20.5	21.3	21.4	21.3	20.4	19.5	
6	Exports	36.0	36.3	38.6	43.6	47.7			48.8	49.4	48.9	48.7	50.1	51.7	
7	Imports	57.8	54.8	60.3	62.6	67.8			69.2	70.6	70.3	70.0	70.5	71.2	
8	Net non-debt creating capital inflows (negative)	-2.0	-2.0	-3.2	-2.6	-7.0			-3.5	-6.9	-4.2	-5.1	-5.7	-5.7	
9	Automatic debt dynamics 1/	-0.3	0.2	-1.0	-1.6	-1.7			-0.3	-0.3	-0.3	-0.1	-0.1	-0.1	
10	Contribution from nominal interest rate	1.4	1.2	0.9	1.0	1.4			1.4	1.4	1.4	1.5	1.5	1.5	
11	Contribution from real GDP growth	-0.3	-1.0	-1.5	-1.4	-1.6			-1.7	-1.7	-1.7	-1.6	-1.6	-1.6	
12	Contribution from price and exchange rate changes 2/	-1.4	0.1	-0.5	-1.2	-1.4			...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	-10.7	0.8	-2.0	8.9	6.9			1.4	4.6	1.1	1.1	2.3	3.1	
	External debt-to-exports ratio (in percent)	102.4	104.8	100.1	100.2	85.6			82.7	80.7	79.8	78.5	75.4	72.6	
	Gross external financing need (in million Euro) 4/	694.9	419.7	694.5	484.8	565.6			751.1	778.6	942.4	1108.4	1214.5	1308.0	
	in percent of GDP	17.4	10.2	16.1	10.5	11.3	10-Year	10-Year	14.1	13.6	15.5	17.1	17.6	17.7	
	Scenario with key variables at their historical averages 5/								**40.3**	**45.8**	**47.5**	**49.2**	**52.3**	**56.4**	**-3.8**
	Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
	Real GDP growth (in percent)	0.9	2.8	4.1	3.8	4.0	3.2	3.3	4.5	4.5	4.5	4.5	4.5	4.5	
	GDP deflator in Euro (change in percent)	3.3	-0.2	1.2	3.3	3.4	0.7	5.9	2.4	2.5	2.0	2.0	2.0	2.0	
	Nominal external interest rate (in percent)	3.5	3.2	2.5	2.7	3.4	4.1	1.4	3.6	3.6	3.7	4.2	4.3	4.3	
	Growth of exports (Euro terms, in percent)	-7.9	3.5	12.0	21.1	17.7	9.5	13.1	9.3	8.4	5.6	6.1	9.6	10.0	
	Growth of imports (Euro terms, in percent)	6.3	-2.7	15.9	11.3	16.4	10.0	13.7	9.2	9.3	6.1	6.2	7.4	7.6	
	Current account balance, excluding interest payments	-8.0	-2.2	-6.8	-0.3	1.0	-3.5	3.3	-1.9	-2.1	-2.6	-3.3	-3.0	-2.5	
	Net non-debt creating capital inflows	2.0	2.0	3.2	2.6	7.0	3.9	3.6	3.5	6.9	4.2	5.1	5.7	5.7	

1/ Derived as [r - g - ρ(1+g) + $\varepsilon\alpha$(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in Euro terms, ε = nominal appreciation (increase in Euro value of domestic currency), α = share of domestic-currency denominated debt in total external debt, and g = real GDP growth rate.

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + $\varepsilon\alpha$(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; Euro deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, Euro deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 11. FYR Macedonia: Indicators of Capacity to Repay the Fund, 2005-12 1/
(Under Expectation Schedule)

	2005	2006	2007	2008	2009	2010	2011	2012
	Actual	Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Fund repurchases and charges								
In millions of SDRs	8.2	8.0	10.9	21.2	5.0	0.9	0.4	0.4
In millions of Euros	9.9	9.1	12.5	24.1	5.7	1.0	0.4	0.4
In percent of exports of goods and services	0.5	0.4	0.5	0.9	0.2	0.0	0.0	0.0
In percent of debt service	3.8	2.0	2.7	5.4	1.0	0.2	0.1	0.1
In percent of quota	11.9	11.6	15.9	30.7	7.2	1.3	0.5	0.5
In percent of gross official reserves	0.9	0.6	0.8	1.4	0.3	0.1	0.0	0.0
Fund credit outstanding (e.o.p.)								
In millions of SDRs	43.5	37.0	24.9	5.0	0.5	0.0	0.0	0.0
In millions of Euros	52.7	42.3	28.4	5.7	0.6	0.0	0.0	0.0
In percent of quota	52.1	47.0	31.7	6.4	0.7	0.0	0.0	0.0
In percent of GDP	1.1	0.8	0.5	0.1	0.0	0.0	0.0	0.0
In percent of gross official reserves	4.7	3.0	1.9	0.3	0.0	0.0	0.0	0.0
Memorandum items:								
Exports of goods and services (millions of Euros)	2,023	2,380	2,601	2,820	2,978	3,161	3,466	3,813
Debt service (millions of Euros)	263	458	463	449	542	601	649	700
Quota (millions of SDRs)	69	69	69	69	69	69	69	69
Quota (millions of Euros)	83	79	79	79	79	79	79	79
Gross official reserves (millions of Euros)	1,123	1,417	1,482	1,745	1,800	1,858	2,001	2,217
GDP (millions of Euros)	4,637	4,986	5,334	5,714	6,090	6,492	6,919	7,375
Euros per SDR (end-period)	1.21	1.14	1.14	1.14	1.14	1.14	1.14	1.14

Sources: Data provided by the NBRM and IMF staff estimates and projections.

1/ Assumes no advance repurchases and no new purchases.

Table 12. FYR Macedonia: External Financing Requirements and Sources, 2004–10
(Millions of Euro)

	2004	2005	2006		2007	2008	2009	2010
	Act.	Prel.	Prog.	Prel.	Proj.	Proj.	Proj.	Proj.
1. Gross Financing Requirement	565	672	714	681	606	821	719	822
External current account deficit (excl. official transfers)	389	114	235	78	243	292	328	403
Debt amortization 1/	153	143	301	302	274	252	331	361
Gross reserves accumulation	7	406	169	294	65	263	55	57
IMF/BIS repurchases and repayments 2/	16	9	8	8	23	14	5	1
2. Identified Financing	565	672	714	682	606	821	719	822
Official creditors	167	169	184	143	197	232	206	186
Official transfers and grants	55	52	58	59	70	94	86	86
Debt financing	111	117	126	84	128	138	120	100
IMF/BIS purchases and disbursements	10	13	0	0	0	0	0	0
Foreign direct investment (net)	126	77	354	286	146	343	195	260
Other flows 3/	246	398	176	238	263	246	319	376
Accumulation of arrears 4/	16	15	0	15	0	0	0	0
3. Financing Gap (1 - 2)	0	0	0	0	0	0	0	0

Sources: NBRM, and IMF staff estimates and projections.

1/ Excluding the IMF.
2/ Consistent with authorities' planned repurchases (see LOI, para. 6).
3/ Includes all other net financial flows and errors and omissions.
4/ Private sector and public enterprise arrears.

Annex I—FYR Macedonia: Statistical Issues

1. The authorities, with technical assistance from the Fund and other bilateral and multilateral agencies, have made significant progress in upgrading the country's statistical system in recent years. Continued efforts are being made to further improve data quality and availability. While data provision for surveillance purposes is now adequate, staff's analysis continues to be hampered by shortcomings in all major datasets.

2. The authorities mostly report data to the Fund on a timely basis and an IFS page is available. The authorities began participating in the General Data Dissemination System (GDDS) in February 2004. A data ROSC was prepared and published in 2004.

National Accounts

3. Quarterly GDP volume estimates are produced on a regular basis and their quality has benefited from improvements in the compilation of industrial production indicators which are used as a basis for the quarterly GDP estimates. The State Statistics Office (SSO), with support from STA, is currently improving compilation of the quarterly GDP by production and preparing for regular publication of quarterly GDP by expenditure. However, implementation of STA's recommendations has been slow mainly due to a heavy work load, lack of appropriate data and the need for further guidelines. Employment data from a company survey continue to be unreliable, but the timeliness of unemployment and labor force data has been improved as the labor force survey is now conducted on a quarterly basis (compared to annual surveys in the past). Wage data suffer from the volatility of wage arrears payments.

4. Data shortcomings have been reflected recently in large discrepancies between the official quarterly and annual GDP estimates, and between these and the behavior of a variety of indirect economic indicators. For example, official estimates suggest that in 2006 GDP growth decelerated to around 3 percent (breakdown by sector is included in Table 1). However, other indicators suggest that the growth rate was significantly higher. Employment increased faster than in 2005 (Table 2), even in sectors where GDP estimates by production show declines (construction, hotels and restaurants). Export volumes have increased rapidly, fruit and vegetables rising by almost 20 percent.

5. Further improvements in production and expenditure GDP estimates are urgently needed to better inform policy makers and markets about economic developments. A forthcoming STA expert visit is expected to help verify the methodology used by the State Statistics Office and provide recommendations on how to improve it.

Balance of Payments

6. The compilation and coverage of **balance of payments data** have improved in recent years. The October 2002 STA technical assistance mission recommended further

improvements to the estimation of short-term trade credits and investigated the large errors and omissions. Recommendations were made relating to the valuation of imports of goods and to the estimation of transportation services. Most recommendations were implemented by the authorities, but gaps remain because data from surveys and reports on transportation services, direct investment, and transactions settled through resident accounts with non-resident banks were not incorporated into the statistics. The 2004 data ROSC mission confirmed these shortcomings. In February 2005, an STA technical assistance mission focused on the validation and inclusion of surveys and reports in the compilation of balance of payments and international investment position. A follow-up STA mission on balance of payments statistics took place in late 2006.

7. A severe weakness in the BOP statistics stemmed from assuming that most of the foreign currency exchanged into denars in the foreign exchange bureaus reflects private transfers by migrants. The 2006 STA mission utilized a 2002 survey of migrants to estimate transfers. The survey provided information on the ratio of transfers made in cash to those sent through the banking system and on their use by households. Based on this information, the TA mission estimated the total amounts of private transfers and allocated them to the current and capital accounts (Table 4). The mission recommended that a similar survey be conducted every five years to ensure that the main assumptions remained valid. The Macedonian authorities accepted most of the mission's recommendations and requested funding from the Soros foundation to replicate the 2002 survey in the second half of 2007. A revision of the BOP statistics is expected to be issued by mid-2008 with findings of the 2002 survey to be used to revise figures on private transfers for 2003-2005 and the 2007 survey to be used to revise the figures for 2006-2007.

Government Finance

8. Progress has been made in **government finance statistics**. Data for the consolidated central government are now available following the expansion of coverage to extra-budgetary funds and special revenue accounts (SRAs), including their foreign-financed projects. However, reliability of extra-budgetary fund and SRA data could still be improved. The financing data for the central government is increasingly presented in line with GFSM 1986, and are now reconciled with BOP and monetary data following staff's recommendations. Data on central government domestic arrears has improved following the introduction of commitment accounting in autumn 2003. However, data on fund and hospital arrears are not fully reliable. As part of the ongoing process of fiscal decentralization, the authorities plan to start soon collecting data on municipalities that will allow monitoring of general government finances. The authorities also plan to begin implementation of GFSM 2001 in line with the recommendations of the 2004 data ROSC as a first step to bringing the fiscal reporting in line with the European Union's ESA95 methodology. In 2005, the authorities started systematic compilation of public debt data and are planning to start publishing statistics on public debt on a regular basis. Government statistics are not reported to the Fund for inclusion in the Government Finance Statistics Yearbook or IFS.

Money and Banking

9. **Money and banking data** are reported to the Fund on a regular basis, although in the past they have been subject to concerns regarding inconsistencies, accuracy and reliability. To address these issues, STA provided technical assistance in April 2005 based on the findings of the data ROSC in 2004. The mission and the authorities agreed on an action plan aimed at improving current data collection and compilation practices. Specific recommended actions include: (i) improved institutional coverage of monetary statistics through the inclusion of savings houses in the reporting of other depository corporations; (ii) the collection of more disaggregated data in both the National Bank of Republic of Macedonia (NBRM) and commercial banks' balance sheets for the improved classification of accounts by economic sector; (iii) improved data consistency through reconciliation of loan data among various sectors; (iv) the publication of improved interest rate data in IFS; and (v) the establishment of a well-defined policy on data revisions in line with best international practice. The NBRM has since begun to implement these improvements. Notably, the regular publication of lending and deposit interest rates of various maturities and currency-type has been an important step forward. However, these rates have not been reported to STA for publication in *International Financial Statistics* for about one year. Notwithstanding these advances, further TA might be necessary in the future as the financial sector develops.

Table 1. FYR Macedonia: GDP Growth (Production Method)
(in percent)

	Weights 1/	2004	2005	2006Q1-3
Agriculture	9.3	6.2	0.2	0.7
Manufacturing and mining	23.5	-0.8	4.4	2.2
Construction	5.4	7.4	-4.2	0.7
Wholesale and retail trade	12.7	15.7	2.0	5.4
Tourism	1.6	-11.3	-0.4	-0.5
Transport and communications	7.5	-4.8	6.6	6.8
Financial intermediation	12.7	11.7	-1.0	1.7
Public administration	14.0	-0.6	4.8	1.9
Net taxes on production	16.2	4.4	16.7	2.7
Gross domestic product	100.0	4.1	3.8	2.7

Source: SSO.

1/ Based on 2005 actuals. Sum of components is different from 100 percent due to residual and imputed banking services.

Table 2. FYR Macedonia: Employment
(percent change, year-on-year, unless otherwise indicated)

	Weights 1/	2004	2005	2006Q1-3
Manufacturing	22.0	-11.4	3.1	2.5
Agriculture, hunting and forestry	19.5	-27.0	21.2	5.6
Wholesale and retail, and repair	13.7	18.7	0.6	-3.0
Public administration, defense, and social security	7.0	14.3	-3.5	4.0
Construction	6.5	1.7	-3.2	28.1
Transport, storage, and communications	6.0	0.5	6.3	-12.0
Education	5.8	5.0	-5.9	7.5
Health and social work	5.7	-1.1	4.7	5.3
Other services	3.3	10.7	-7.5	-9.5
Electricity, gas and water supply	3.1	4.0	7.9	2.4
Real estate, renting and business activities	2.7	25.1	9.4	-2.7
Hotels and restaurants	2.5	-0.7	7.0	54.4
Financial intermediation	1.2	8.6	-18.2	5.1
Total	100.0	-4.1	4.3	4.5

Source: SSO.

1/ Based on 2005 actuals.

Table 3. FYR Macedonia: Domestic Demand Indicators, 2003-06
(percent change, year-on-year)

	2003	2004	2005	2006
Consumption demand				
Import of consumption goods (euros)	-4.6	6.7	1.1	6.6
Sales of passenger cars (units)	...	...	0.4	24.9
Real wages	3.6	4.4	2.0	4.1
Investment demand				
Import of investment and intermediate goods (euros)	-4.1	29.6	-3.6	16.9
Gross fixed capital formation (denars)	...	4.9	4.9	19.7
Credit to private sector (denars)	19.0	25.0	20.5	30.5

Sources: NBRM; MOF; and SSO.

Table 4. FYR Macedonia: Measuring Private Transfers
(In millions of euros)

	2003	2004	2005	2006
Total estimated private transfers 1/	821	827	870	987
o/w estimated remittances	620	624	657	745
estimated capital transfers	201	203	213	242
Total remittances reported in the balance of payments	504	514	731	843
Underestimated (+)/overestimated (-) remittances	116	110	-75	-98
Reported current account deficit (% of GDP)	-3.4	-7.7	-1.3	-0.4
Adjusted current account deficit (% of GDP) 2/	-0.5	-5.2	-3.0	-2.4

1/ Based on a 2002 survey, which estimated that total private transfers are approximately 6.4 times those sent through the banking system, of which approximately 75 percent are defined as remittances (e.g., for immediate consumption, housing maintenance, savings, and other purposes) and 25 percent are defined as capital transfers (e.g., unspecified investment and purchase or construction of homes).
2/ Utilizes transfers estimates in the 2002 survey.

FYR Macedonia: Table of Common Indicators Required for Surveillance

(as April 2, 2007)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	3/20/07	3/27//07	D and M	W and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	2/28/07	3/14/07	M	M	M		
Reserve/Base Money	2/28//07	3/21//07	D and M	W and M	M		
Broad Money	2/28//07	3/21/07	M	M	M	O, LO, LO, O	O, LO, O, O, O
Central Bank Balance Sheet	2/28//07	3/21/07	M	M	M		
Consolidated Balance Sheet of the Banking System	2/28//07	3/21/07	M	M	M		
Interest Rates[2]	2/28//07	4/1//07	M	M	M		
Consumer Price Index	Feb 2007	3/2/07	M	M	M	O, O, O, LO	LO, O, LNO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	NA	NA	NA	NA	NA		
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	12/31/06	1/28/07	M	M	M	LO, LNO, LO, O	LO, LO, LO, LO, LNO
Stocks of Central Government and Central Government-Guaranteed Debt[5]	9/30/06	10/15/06	M	M	I		
External Current Account Balance	Dec 2006	3/16/07	M	I	Q		
Exports and Imports of Goods and Services	Dec 2006	3/16/07	M	I	Q	O, LO, O, LO	LO, O, LO, O, LO
GDP/GNP	Sept 2006	12/15/06	Q	Q	Q	O, LO, O, LO	LO, O, LNO, O, O
Gross External Debt	9/30/06	10/15/06	M	M	M		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions. [2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds. [3] Foreign, domestic bank, and domestic nonbank financing. [4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments. [5] Currency and maturity composition is reported only on request. [6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA). [7] Reflects the assessment provided in the data ROSC or the Substantive Update (published on September 29, 2004, and based on the findings of the mission that took place during February 18 – March 3, 2004) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO). [8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Annex II—FYR Macedonia: Fund Relations
(as of February 28, 2007)

Mission. Skopje, October 24-November 6, 2006 and January 25-February 5 2007. Concluding statements are available at:

- http://www.imf.org/external/np/sec/pr/2006/pr06244.htm
- and http://www.imf.org/external/np/ms/2007/020507.htm

Staff team. Mark Griffiths (head), Pablo Lopez Murphy and Alexander Pivovarsky (all EUR), Alessandro Giustiniani (MFD), Peter Dohlman and Eva Gutierrez (PDR) and Bert van Selm (Resident Representative).

Discussions. The staff team met Prime Minister Gruevski, Deputy Prime Minister Stavreski, Finance Minister Slaveski, Minister of Economy Rafajlovska, Minister of Health Selmani, Labor Minister Meskov, National Bank of the Republic of Macedonia Governor Gošev, other senior officials, and representatives of the banking, business, political and international communities.

Stand-By Arrangement. The Fund supports FYR Macedonia's economic program with a three-year SDR 51.68 million Stand-By Arrangement (75 percent of quota), of which SDR 10.5 million has been purchased so far. An additional SDR 3.4 million becomes available on completion of this review. However, the authorities do not plan to make any more purchases under the arrangement, beyond the initial purchase. Remaining purchases are being rephased at this review.

Publication. The Macedonian authorities have consent on the publication of this staff report.

I.	**Membership Status**:	Joined 12/14/92; Article VIII	
II.	**General Resources Account**:	SDR Million	Percent of Quota
	Quota	68.90	100.00
	Fund holdings of currency	96.57	140.16
	Reserve Position	0.00	0.00
III.	**SDR Department**:	SDR Million	Percent of Allocation
	Net cumulative allocation	8.38	100.00
	Holdings	0.20	2.40
IV.	**Outstanding Purchases and**	SDR Million	Percent of Quota

Loans:		
Extended Arrangements	0.67	0.97
PRGF Arrangements	6.83	9.92
Stand-By Arrangements	27.00	39.19

V. **Latest Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	08/31/2005	08/30/2008	51.68	10.50
Stand-By	04/30/2003	08/15/2004	20.00	20.00
EFF	11/29/2000	11/22/2001	24.12	1.15

VI. **Projected Payments to the Fund (Expectations Basis)**[3]
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2007	2008	2009	2010	2011
Principal	9.58	19.91	4.47	0.54	
Charges/Interest	1.36	1.26	0.51	0.36	0.35
Total	10.94	21.18	4.99	0.89	0.35

Projected Payments to the Fund (Obligations Basis)[4]
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2007	2008	2009	2010	2011
Principal	9.58	11.66	8.79	4.47	
Charges/Interest	1.36	1.44	0.88	0.49	0.35
Total	10.94	13.10	9.67	4.96	0.35

VII. **Safeguards Assessments:**

[3] 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.

[4] 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 would be extended to their respective obligation dates by the IMF Executive Board upon request of the debtor country.

An update was completed on February 28, 2006 with respect to the current Stand-By Arrangement. The previous assessment was completed in April 2003. The update found that the NBRM had taken steps to strengthen its safeguards framework and recommendations from the earlier assessment had been implemented. Notwithstanding this progress, the report made recommendations in the reporting and audit areas, including: (i) review by the NBRM internal audit function of processes for compiling monetary data reported to the Fund under the program; and (ii) completion of annual external audits on a timely basis as prescribed by the central bank law. The NBRM has started to conduct internal audit reviews on the processes for compiling monetary data reported to the Fund.

VIII. **Exchange Arrangement**:

The currency of the FYR Macedonia is the denar. The FYR Macedonia 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 10 percent.

At end-February 2007, the official exchange rate was 46.24 denars per U.S. dollar and 61.18 denars per euro. The FYR Macedonia has accepted the obligations of Article VIII, Sections 2, 3, and 4 with effect from June 19, 1998.

The FYR Macedonia 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. The retention of this restriction was approved by the Board on December 21, 2006 until December 31, 2007. During the Article IV consultations, the authorities confirmed their commitment to eliminate all restrictions by then.

IX. **Article IV Consultations**:

The first consultation with the FYR Macedonia was concluded in August 1993. The last consultation was concluded on July 28, 2006. The FYR Macedonia is on the standard consultation cycle.

X. **Technical Assistance (since 2005)**:

Purpose	Department	Date
Tax Administration	FAD	October 2006
Balance of Payments Statistics	STA	October 2006
Tax Policy	FAD	September 2006
Government Finance Statistics	STA	June 2006
Banking Law	LEG, MFD	June 2006
Banking Reform	MFD	November 2005
Credit Growth	MFD	October 2005
National Accounts	STA	July 2005
BOP Statistics	STA	July 2005
Tax Administration	FAD	May 2005
Reserve Management	MFD	May 2005
Monetary Statistics	STA	April 2005
Resident Experts		
Banking Supervision	MFD	May 2006-present
Monetary Policies	MFD	October 2004-April 2005

XI. FSAP Participation and ROSCs (since 2003)

Purpose	Department	Date
Fiscal ROSC	FAD	February 2005
Data ROSC	STA	February 2004
FSAP	MFD/WB	May 2003 and June 2003

XII. Resident Representative

The Fund has had a resident representative in Skopje since 1995. Mr. Bert van Selm has held this position since August 2006.

Annex III—FYR Macedonia: World Bank Relations[5]

A. Partnership in FYR Macedonia's Development Strategy

1. FYR Macedonia has made considerable progress since independence in 1991, with support from the international community. The government of FYR Macedonia has focused on strengthening growth and employment opportunities in the past few years. This follows the resolution of regional conflicts that took place through much of the 1990s, especially the cessation of hostilities in neighboring Kosovo, which particularly affected FYR Macedonia. Implementation of the Ohrid Framework Agreement has brought a reasonable measure of stability to the country, despite continuing political tensions. FYR Macedonia's progress is reflected perhaps most prominently in its candidacy for membership in the European Union.

2. Macro-economic stability has been largely maintained since the mid-1990s, and has been further strengthened since 2002. Fiscal discipline and the peg to the Euro have helped to maintain inflation at low levels for a decade. Government spending as a proportion of GDP has fallen to a level significantly lower than most of the other former Yugoslav republics.

3. Nevertheless, despite the recovery of annual growth rates of about 4 percent unemployment remains high and of serious concern. Growth has been constrained by structural impediments. While reforms have picked up in the past few years the country has failed to attract the investment needed to underpin more rapid growth and job creation.

B. World Bank Supported Reform

4. Since FYR Macedonia joined the World Bank in 1993, 39 loans have been approved with a total value of approximately US$810 million. Less than half of all lending has been on concessional IDA terms. FYR Macedonia graduated fully from IDA in 2003 reflecting improved economic performance and credit-worthiness. All new lending since 2003 has been on IBRD terms.

5. The World Bank's current program of assistance to FYR Macedonia is outlined in a Country Partnership Strategy discussed by the Board on March 27, 2007. Reflecting Government priorities, the CPS aims to accelerate FYR Macedonia's perspective to join the European Union. Proposed activities envisaged under this CPS are focused on two pillars: (i) fostering job-creating economic growth, and increasing living standards for all, and (ii) improving governance and transparency in public sector delivery to support a market economy. The CPS will employ a selected mix of investment and policy lending, along with a robust program of Analytical and Advisory Activities (AAA) work to support the CPS

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[5] Prepared by World Bank staff.

goals. The CPS also provides for total financing in a high case lending scenario of up to US$280 million over four years.

6. World Bank operations in 2002-2004 focused on supporting Macedonian Government efforts to strengthen public sector management and governance. A US$15 million *Public Sector Management Adjustment Credit (PSMAC)* was approved in 2002, and a US$30 million *Public Sector Management Adjustment Loan II (PSMAL II)* was approved in 2004.

7. While maintaining involvement in key elements of the governance agenda, particularly health sector financing reform, the Bank's policy lending shifted to structural reforms to improve the investment climate and promote growth and employment. Bank support for Macedonian Government reform efforts is centered on a series of *Programmatic Development Policy Loans (PDPLs)*, the first of which was approved by the Board in October 2005, shortly after IMF Board approval of the current Stand-By Arrangement (SBA). The second PDPL was approved by the Board on March 27, 2007. The PDPLs support Government efforts to undertake judicial reform, labor market reform, financial sector reform, and business regulatory reform. Efforts to further strengthen public sector governance include an emphasis on further reform to improve the transparency of the critical health sector, building the capacity of the civil service to permit more effective strategic prioritization, and support for the decentralization program being conducted under the umbrella of the Ohrid Framework Agreement.

8. Development policy lending has been, and will continue to be, supported by a series of specific investments to build capacity to implement priority reforms. On the governance and public administration side, a *Health Sector Management Improvement project* provides technical assistance and investment support to the broader health sector reform program; a *Social Protection* project supports reform in this area; and an *Education project* assists Government efforts to improve access and introduce stronger performance and equity measures in primary and secondary education financing. On the investment climate side, a *Business Environment Reform and Institutional Strengthening (BERIS) project* approved in June 2005 concentrates on building capacity to improve business entry, operations, and exit; as well as enhancing the competitiveness of the enterprise sector; and a *Real Estate Cadastre and Registration project* approved in early 2005 strengthens land markets and the use of real property as collateral for business investment by providing more secure title. A *Legal and Judicial Reform project* approved in mid May 2006 supports critical reforms in this area. Adjustment and investment lending has also been backed up by a comprehensive program of analytical work.

C. IMF–World Bank Collaboration in Specific Areas

9. World Bank and IMF engagement in FYR Macedonia in recent years has been marked by a spirit of collaboration and close cooperation between the two institutions, and with the Government. Synergies between the proposed Bank and IMF programs during the implementation of reforms supported by the PDPL series and the SBA reflect a strong degree of consensus between both institutions and the Government in regard to reform priorities. This close coordination has ensured that the SBA and the Bank program are mutually reinforcing.

Improving the Investment Climate

10. **Judicial reform** is central to improving the business environment in FYR Macedonia. The government's December 2004 *Strategy on the Reform of the Judicial Sector*, noted that comprehensive judicial reform would be especially urgent to firmly establish efficient, effective and fair enforcement of creditor, contract and property rights. The Bank's *Doing Business* report has also highlighted the time and cost of enforcing contracts and conducting bankruptcy procedures as particular constraints in FYR Macedonia. IMF SBA benchmarks to analyze and budget for the fiscal effects of judicial reform, enact amendments to the *Bankruptcy Law*, and amend the *Law on Misdemeanors* to allow administrative bodies to impose sanctions without prior court involvement complement Bank supported reform efforts. Under the PDPL program and the Legal and Judicial Reform project, the Bank is focusing on: reducing backlog and delays in court proceedings; improving the enforcement of court judgments; improving the regulatory and implementation framework for bankruptcy cases including the development of a profession of bankruptcy trustees; and increasing the speed, transparency and fairness of administrative decisions. Ultimately, institution building to support the legislative reform agenda will be crucial, and is likely to take several years.

11. Support for **labor market reform** will also require close coordination. A very rigid legislative framework governing labor relations contributed to a stagnant formal labor market, unemployment rates among the highest among transition economies, limited opportunities for new entrants to the labor market, and a large informal sector. The new *Law on Labor Relations* adopted in July 2005 eliminates the most burdensome features of the old law and, over time, should encourage growth, investment, and a gradual shift in employment from the informal sector to the formal sector, with a concomitant strengthening of workers' rights.

12. Judicial and labor market reforms are being complemented by a range of other measures to strengthen the framework for business activity. The enactment and implementation of a new *Business Registration Law* and associated regulations has significantly reduced the costs and time of business entry. This has led to a 50 percent increase in new business registration in 2006. The Government is also focusing on reforms to reduce the burden of unnecessary regulations on businesses. This reform will streamline

business licensing, permits and inspections. These continuing reforms are supported by the Bank's PDPL program as well as the BERIS project. Further actions to implement corporate governance and accounting and auditing reports on standards and codes (ROSCs) have been undertaken, including amendments to the *Company La*w and *Securities Law*, and the passage of a new *Audit Law*. The Bank and IMF have cooperated closely in supporting the capacity of the National Bank (NBRM) to supervise and regulate the banking sector, and to strengthen compliance with anti-money laundering and counter-terrorist financing requirements. .

Public Sector Transparency and Governance

13. Reform of **health sector financing** is a key element of both the Bank and IMF programs. Health sector spending makes up 15 percent of Government expenditure and has historically been an area with significant public financial management risks associated with both pharmaceutical procurement and the less than fully transparent operation of the Health Insurance Fund (HIF). Implementation of health sector reform is a litmus test for the authorities' commitment to fight corruption. Prior actions and performance criteria in the SBA which required submission to Parliament of relevant legislation to tighten the selection of the HIF Board, implement more transparent budget procedures, and introduce binding budget ceilings for the largest public health institutions have reinforced the Bank's programs, which support efforts to further prioritize spending, improve the cost-effectiveness of health interventions, and further strengthen mechanisms for pharmaceutical procurement.

15. Bank support for **civil service reform**, including strengthening institutional arrangements for strategic prioritization, complement IMF efforts to improve fiscal and budget management. Extending the principles underpinning civil service reform to the majority of Government employees who are not civil servants will further strengthen meritocratic principles and the professionalism of the public sector. Nevertheless, any potential wage decompression in this group would require close coordination with the Fund to ensure that fiscal targets, including ceilings on the wage bill, are adhered to. This would also need to occur within the framework of the Ohrid Framework Agreement, and the associated provisions for the representation of minorities. Similarly, IMF benchmarks regarding the completion and implementation of a functional analysis of line Ministries have been set in close coordination with the Bank, as well as other bilateral and multilateral donors active in public sector reform.

16. The Government has made substantial progress in enacting the legislative framework for **decentralization**, including passage of the controversial *Law on Territorial Reorganization*, and adopting a formula for the distribution of VAT revenues between the national Government and the various municipalities. Considerable capacity strengthening at the municipal level will also be required if the second phase of decentralization, including the provision of block grants to municipalities to fund schools, is to be implemented successfully and for service standards to be maintained. This will clearly require close coordination between the Government, the IMF, the bank and other relevant donors.

D. Summary

17. FYR Macedonia has made considerable progress in macro-economic management and improving the transparency and operations of the public sector. Although continuing governance and macroeconomic challenges remain, there is broad consensus that a strong focus on structural reform must be sustained to overcome key impediments to growth and employment. This is reflected in both the IMF and Bank programs. The strong similarities between aspects of the IMF SBA and the Bank's proposed adjustment and investment lending program have considerable potential to generate synergies and complementarities. This will, however, require continuing strong collaboration between the Macedonian Government, the Bank and the IMF.

ATTACHMENT I

Skopje, Macedonia
April 10, 2007

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. de Rato,

1. **Our new government is committed to create an economically strong and socially just country, which will accomplish full integration into the European community of peoples**. We will work to realize an ambitious, but also realistic and attainable program, which should bring about a better and more prosperous Macedonia. We will seek to achieve sustained, high economic growth and a high degree of employment, with the aim of doubling per capita income in 10-12 years. The key for achieving higher growth and prosperity lies in maintaining macroeconomic stability, while implementing structural reforms to improve the business climate. We will facilitate Macedonia's integration in the global economy, and create an environment that fosters internationally competitive enterprises. The functioning of important markets—including financial markets and the labor market, but also product markets that hold the key to Macedonia's integration in the world economy, such as the telecommunications market—needs to be improved.

2. **Economic performance under the Stand-By Arrangement (SBA) remains strong.** According to preliminary production data, real GDP grew by around 3 percent in 2006, but indirect indicators of economic growth suggest that real economic growth may have been higher. Although average inflation increased to 3.2 percent in 2006, this was largely due to one-off factors, including the increase in tobacco excises and related duties introduced in January 2006 and the increase in household electricity prices in September 2006. The external position continued to improve, owing partly to continued buoyant private transfers and higher-than-anticipated proceeds from the sale of the electricity distribution company (ESM). The trade deficit was slightly higher than projected, with higher exports in virtually all sectors offset by higher imports of investment goods. Gross reserves amounted to €1.4 billion, or 4½ months of imports of goods and services, as of end-December 2006.

3. **We have met all fiscal and monetary program targets under the SBA in 2006** (Table 1). For most of the year, the fiscal balance was in surplus. Though taxes and contributions overperformed, there was a shortfall of non-tax revenues (because of the unpaid 2005 telecom dividend). This was offset by lower than programmed expenditures,

mainly investment. In November, parliament approved a supplementary budget authorizing additional spending of about 2 percent of GDP, to finance increased spending on agriculture, under budgeting of utility bills, mandatory government payments related to accelerated court rulings on a range of contingent liabilities, higher-than-budgeted take-up of the second pillar pension system, and arrears settlement by the health fund. These additional expenditures were met within the 0.6 percent of GDP deficit target. Sound macroeconomic policies have kept central bank interest rates stable at around 5½ percent, down from around 10 percent in October 2005, but commercial banks have only partially matched these cuts.

4. **However, progress in structural reforms slowed in the summer of 2006** (Table 2), owing to the July elections and the subsequent formation of our new government. The new government that took office on August 28, 2006 has taken key steps to overcome these delays:

- We have established a **Large Taxpayer Office** (LTO) on July 1, 2006 within the Public Revenue Office, which has been fully operational since October. In October 2006, we have also established a **Large Contributor Office** (LCO) in the Pension and Disability Fund (PDF) and staffed it with employees from the three funds that collect social security contributions—the PDF, the Health Insurance Fund (HIF) and the Employment Fund (EF). Creation of the LTO and the LCO is an important first step in the harmonization of the bases for social security contributions and the personal income tax, discussed in greater detail below. With these offices now established, we would like to request a waiver for noncompliance with the end-July 2006 performance criterion on the establishment of a Large Taxpayer Office and Large Contributor Office.

- **In line with our existing program commitments, we will implement the harmonization of social security bases.** The First Review envisaged that at the time of the Second Review, this action would be set as a performance criterion for end-December 2006. Given the revised timetable for this Board meeting, this reform is being set as a performance criterion for end-July 2007, starting with salaries for June 2007.

- **As a prior action for completing the Second Review, we will submit to parliament a new banking law that is consistent with technical assistance provided by Fund staff.**

- **We have not been able to sell the government's residual shares in Makedonski Telekomunikacii AD due to weak public interest and the company's failure to complete its 2005 accounts.** We now aim to first implement further measures to liberalize the telecommunications sector—which are already having an effect—and then reconsider our strategy to divest these shares after these measures have taken their full effect (see paragraph 29). In light of this revised strategy, we request a waiver of non-observance of the end-December 2006 structural performance criterion.

5. **Against this favorable backdrop, we request the completion of the Second Review.** We believe that the policies described in this letter (with program conditionality summarized in Tables 3 and 4) will achieve the goals of our economic program: sustained, high economic growth, high employment, and better integration in the world economy. Nevertheless, we stand ready to take any further measures to keep our program on track. We will remain in close consultation with the Fund, in accordance with the Fund's policies on such consultations. We will provide the Fund with such information as it requests on policy implementation and achievement of program objectives. The forthcoming Third Review, scheduled for the second half of 2007, will assess progress in program implementation, reach understandings on any measures that may be needed to reach the program's objectives, and set performance criteria for 2008.

6. **We reaffirm our intention not to make this and future purchases under the SBA that will become available upon observance of performance criteria and completion of reviews**. Going forward, in repaying our obligations to the Fund, we will make advance repayments that mirror a shift from an obligations to an expectations basis, in light of our strong international reserves position. In light of the delayed completion of this review, we would like to rephase purchases under the Arrangement, such that there will be five reviews rather than six reviews. Subsequent reviews will occur on or after August 15, 2007, February 15, 2008 and August 15, 2008 (Table 5).

Economic policies for 2007 and for the medium term

7. **Accelerating economic growth and job creation while maintaining macroeconomic stability is the main goal of our economic program.** The July 2006 election result has provided us with a strong mandate for implementing our ambitious economic reform program. Key elements of this program—discussed in greater detail below—are to:

- **Simplify tax policy and administration,** including by introducing flat and lower personal and corporate income tax rates, while broadening the bases of these taxes to contain revenue losses. In particular, we have eliminated the double deduction for investment in fixed assets from the corporate income tax law;

- **Reduce public expenditure** by 2 percent of GDP by 2010, while increasing the share of investment, education and health expenditures; increase the efficiency of spending on health and education;

- **Develop infrastructure** by expanding road, electricity and irrigation networks, and reducing telecommunication costs;

- **Improve market institutions,** including by simplifying registration and licensing requirements, completing the land cadastre, and improving the functioning of financial markets;

- **Improve governance**, including by strengthening the transparency of public procurement and by establishing an agency to fight organized crime;

- **Promote foreign direct investment**, by improving the business climate and deregulating the economy;

- **Develop agriculture and rural regions**, by implementing structural reforms (improving the functioning of the agricultural land market), undertaking infrastructure investments to improve competitiveness, and harmonizing policies and institutions with the EU's Common Agricultural Policy.

8. **The economic outlook for 2007 and for the medium term is favorable.** To ensure our budget has firm foundations, our macroeconomic framework is prudent: growth is assumed to reach 4½ percent in 2007. However, once our reforms are implemented, our objective is for growth to be considerably higher: as much as 6 percent in 2007, 6½ percent over the medium-term. Growth in 2007 is expected to be fueled by private consumption and investment. Inflation is expected to decrease to around 3 percent in 2007 and 2 to 2.5 percent over the medium term, in line with partner countries. The current account deficit in 2007 is expected to be around 3 percent of GDP, reflecting the payment of both the 2005 and 2006 telecom dividend. Increases in bank credit and greenfield FDI will stimulate consumer and investment goods imports, but exports, especially in iron and steel, are also expected to grow sharply. Increasing private and public capital inflows will continue to improve the capital account. As a result, gross international reserves are expected to further increase to around €1.5 billion by end-2007.

Fiscal policy and public sector reforms

9. **To secure macroeconomic stability, we will keep the 2007 fiscal deficit target at 1 percent of GDP (performance criterion), while improving the composition of the budget:**

- **We are reducing taxes and redirecting government spending to more productive uses**. The introduction of flat and lower personal and corporate income tax rates coupled with zero taxation of reinvested profits in January 2007 will likely cost around 1 percent of GDP in 2007. The possible loss of revenue stemming from the introduction of zero taxation of reinvested profits will be limited in 2007 by capping this deduction to a maximum of 50 percent of the CIT tax base. This cap will be reviewed towards the end of 2007, in light of the experience gained during the year with the new tax laws. Important reforms aimed at streamlining revenue administration, including the introduction of harmonized bases for social security contributions and the elimination of customs declaration fees, will result in a small revenue loss (0.2 percent of GDP). On the expenditure side, a planned decompression of wages in the education sector is estimated to cost 0.3 percent of GDP, while we intend to increase investment and EU-related spending by 0.5 and 0.1 percent of GDP.

- **We are taking steps to finance these reforms**. We have broadened the tax base by abolishing some existing exemptions from the corporate income tax (projected to raise 0.1 percent of GDP). We have also increased fees on gambling establishments and taxes on games of chance: these are projected to raise 0.1 percent of GDP in revenues. Wage expenditures are expected to decline by 0.1 percent of GDP due to lower personal income taxes and social insurance contributions, while spending cuts on furniture and cars and better targeting of social spending (through reduction of subsidies) are expected to generate savings of 0.2 percentage points of GDP.

- **In January 2007, Paris Club creditors accepted our proposal to immediately pay off our debt in the amount of US$104 million.** We expect to complete these prepayments by end-April 2007. As a result, interest payments on our foreign debt will decline and Macedonia's medium-term debt sustainability and public debt structure will improve.

- **Consistent with our commitment to fiscal discipline, we will keep non-HIF central government arrears close to their end-2004 level.** We are also taking steps (see below) to address problems in health and energy sector finances, to make sure these will not require additional transfers from the budget later in the year.

- **Fiscal policy underpins our commitment to macroeconomic stability and debt sustainability**. We stand ready to tighten the budget in the second half of 2007 if risks to meeting our fiscal target emerge or (unless clearly the result of increased FDI) the current account deteriorates by more than 1 percent of GDP compared to the program projections. To prevent spending one-off revenues, we will also cap the contribution of the telecom dividend at 2.5 billion denars in 2007 (when measuring the fiscal deficit under the program). Pending the sale of our remaining shares in Maktel, we will cap the contribution of the dividend at 2.0 billion denars in 2008, and for this to progressively decline. This is consistent with our plan to liberalize telecommunications, and for monopoly profits in this sector to gradually disappear.

10. **Over the medium term, we will maintain a prudent fiscal policy stance.** By keeping the central government deficit to 1-1½ percent of GDP in 2008-10, we will safeguard macroeconomic stability and debt sustainability. Within this framework, we aim to further reduce personal and corporate income tax rates. Government spending will be cut by 2 percent of GDP by 2010. Within this lower limit, we will create room to increase investment and education spending. Gross debt of the general government (including central government, funds and municipalities) will remain below 38 percent of GDP, excluding Treasury bills for monetary policy purposes. We have strengthened the debt management function at the Ministry of Finance, including by establishing a middle office in the public debt management department in December 2006 responsible for formulating policy and strategy for public debt management, tracking implementation of the portfolio targets, risk management and reporting.

11. **We will further develop the domestic public debt market**. Measures will include (i) extending the maturity of the central government's domestic securities, (ii) introducing non-competitive bids by end-March 2007, and (iii) establishing a primary dealer system by end-September 2007. Also, we will review our auction mechanisms and the instruments used to sterilize capital inflows in light of IMF technical assistance.

12. **Our health care reforms will increase accountability for delivering quality within agreed budget limits**:

- **To achieve this goal, we have replaced the entire Board of the Health Insurance Fund (HIF), as we were not satisfied with its performance.** We have secured appropriate representation from the Ministry of Finance and the Ministry of Health among the new Board members, and on September 28, 2006, appointed a budget officer from the Ministry of Finance in the HIF (structural benchmark for September 2006) .

- **Placement of budget officers in health care institutions (HCIs) has been delayed by the need to provide appropriate training**. The initial training has been completed and the officials put in place, with their terms of reference ready (structural benchmark for June 2006). After preparing appropriate legislation, by June 2007 we will appoint economic directors in all HCIs. They will be responsible for sound financial management, while the medical directors will be responsible for clinical aspects of HCI operations. Managers of HCIs that show negative operating results in two consecutive quarters will be replaced.

- **We are taking steps to reduce costs of healthcare provision.** Following a careful costing exercise (undertaken in cooperation with the World Bank), we are revising the standard medical benefits package available to all citizens and introducing a new list of medicines that it will cover. Our new international tendering for drug procurement will be concluded in June (structural benchmark). These reforms are expected to generate financial savings of 0.2 percent of GDP. We also aim to contain the wage bill in the health sector at the end-2006 level.

- **As of end-June 2006, HIF arrears measured using the program definition (obligations that are due but not paid by more than sixty days) were paid in full.** They have remained very low since then. Going forward, we aim not to accumulate any new arrears (the attached Technical Memorandum of Understanding sets a revised and much lower ceiling for HIF arrears) and also to reduce the stock of arrears of HCIs, which we will report under the program.

- **With finances now stabilized, we plan to embark on more fundamental health sector reforms**. We have changed the HIF's de facto role of financing health sector infrastructure to that of financing provision of health services. This should improve efficiency in the health care system and significantly reduce patients' informal out-of-pocket expenditures that currently contribute to poverty and inequality in access to health care services.

13. **We are streamlining tax administration to create a better business climate and to boost revenues:**

- **With technical support from the Netherlands and the Fund's Fiscal Affairs Department, we have embarked on a 3-year program to strengthen the effectiveness and efficiency of revenue administration to increase revenues, support essential government expenditures, and reduce the administrative burden on businesses.** This program includes measures for harmonizing the bases for and integrating the collection of social insurance contributions (for pensions, health, and employment) and personal income tax in a carefully phased, step-by-step manner.

- **Consistent with this strategy, in March 2007 Parliament passed legislation harmonizing the bases for social contributions.** This initiative is based on our recently completed strategy paper for harmonizing the bases for social security contributions that identifies key parameters for harmonization of social contribution bases, including a simple minimum contribution base based on the average wage, use of gross wages in rate calculations, common definitions of employer and employee, common lists of beneficiaries and a common definition of employment income. In line with the commitment made at the First Review, we will implement this new legislation, starting in July 2007 with salaries for June 2007 (structural performance criterion).

- **We plan to fully harmonize PIT and social contributions.** To this end, we will prepare a strategy (structural benchmark) by September 2007 for harmonizing the two sets of bases; phased implementation by the start of 2008 will be set at a subsequent review as a structural performance criterion. The strategy will consider, inter alia, (i) shifting from net to gross wages in calculating personal income tax and social contributions; (ii) phasing out the minimum base for social contributions; and (iii) calculating health care contributions on a per-hour basis. A final decision on the implementation of these reforms will be guided by future Fund technical assistance.

- **As an intermediate step towards integrating the collection of social contributions and taxes, the Pension and Disability Insurance Fund (PDF) will start collecting all social insurance contributions.** By April 2008, the PDF and its network of field offices will design and execute the collection programs for social insurance contributions and their contributors (structural performance criterion). These programs will include registering the contributors, processing declarations and payments, maintaining records of amounts paid and owed, auditing declarations, and recovering late payments and declarations. We have already established a Steering Committee to oversee this initiative, and in March 2007 the Steering Committee appointed a project team—with representatives from the PDF, the HIF, and the EF—to plan, design, and implement the integrated collection of social insurance contributions. By September 2007 draft legislation that vests the PDF with the legal authority for collecting health and employment contributions will be submitted to Parliament (structural benchmark). In addition, by September 2007 the Ministry of Health and Ministry of Labor will sign an inter-agency agreement that sets out the terms and conditions under which the Pension Fund will collect health and employment contributions on behalf of the Health and Employment Funds.

- **In the meantime, the Public Revenue Office (PRO) will be strengthened in preparation for fully integrating the collection of taxes and social insurance contributions.** In February 2007, the PRO finalized a strategic plan to guide its continuing modernization over the period 2007-09. As part of this process, the PRO will each year set operational targets and formulate new initiatives for registering additional taxpayers, improving taxpayer services, recovering tax arrears and delinquent tax returns, and auditing taxpayers. By May 2007, the PRO will identify performance measures for each of these functions, and set target levels of performance to be achieved by end-2007 (structural benchmark). We will further enhance the PRO's operational capacity by conducting an organizational and workforce review, preparing a comprehensive human resource management strategy, designing a new information technology system that is fully compatible with the PDF system, and preparing a comprehensive human resource management strategy under which all PRO staff would be subject to the same human resource policies set out in the Law on the Public Revenue Office. While continuing to improve the large taxpayer office, the PRO will also design a strategy for improving the administration of small- and medium-sized taxpayers (structural benchmark for end-June 2007). The integrated collection of taxes and social contributions will be carefully piloted in 2009. We aim for the PRO to collect all taxes and contributions from all employers by end-2009.

14. **Fiscal decentralization is a key element of our public sector reform program.**

- **On the basis of the Law on Local Self Government, municipalities will assume greater responsibility for various important state functions following the start of the second phase of the decentralization process**. As a result, the share of local government expenditures in general government expenditures is projected to increase from around 8 percent at present to around 16-18 percent after the completion of the decentralization process and the consolidation of the new local government system.

- **We will strengthen the revenue base of municipalities to finance these expenditures**. Municipalities have now assumed responsibility for the administration of the property tax. This tax has a clear potential for greater revenue as existing valuations are often out of date, and tax rates are low by international standards. By end-2007 the base of the property tax will be broadened by including business premises.

- **We will strengthen the control and monitoring of local government finances.** The Law on Local Financing shall be amended and modified so as to tighten the procedure for domestic and external borrowing and issuance of guarantees by municipalities. These amendments and modifications were submitted to the Parliament in February 2007. From January 2007 we started to prepare quarterly reports on the revenues, expenditures and fiscal balances of local governments; these will be treated as a memorandum item under the program.

15. **In accordance with pre-accession fiscal surveillance required for EU membership, we will start participating in the fiscal notification exercise in 2007**. On 30 November, 2006 we submitted our first pre-accession economic program to the EU. We will work towards the introduction of European System of Accounts 1995 (*ESA 95*) over the medium term, to ensure that statistics are in accordance with EU requirements. As a first step towards *ESA 95*, we will recast cash statistics into the analytical framework of the *Government Financial Statistics Manual 2001* by end-2007.

16. **We will continue to monitor and control finances in public enterprises.** By mid-2007, we will enact legislation requiring public enterprises to submit quarterly reports on their financial position to the government. The first reports will cover the second quarter of 2007 and will be submitted by October 2007 (structural benchmark). On the basis of these reports, we will begin to report the financial position of public enterprises on a quarterly basis, starting with the four largest (ELEM, MEPSO, Macedonian Railways and the State Company for Management of Resident and Business Premises); these will be included as a memorandum item under the program. We have also prepared our first annual report on the government's economic activities (meeting a structural benchmark for December 2006). The report includes a list of the state's equity holdings, and plans for privatization.

17. **We will intensify our efforts to improve the management of major public enterprises, and we are committed to selling remaining government equity stakes in enterprises.** Rationalization of the management of public enterprises and sale of remaining government equity shares will make a crucial contribution to improving both public finances and the business climate. In the past, inadequate management of the State Company for Management of Resident and Business Premises has contributed to poorly defined property rights and inefficient use of real estate. Following an international tender procedure, a consultant will prepare the privatization of this company in 2007. We have also prepared an action plan for the reorganization of Macedonian Railways, in cooperation with the World Bank. Rail infrastructure will remain in state hands, while rail transport will be privatized in 2008. In addition, tender procedures for selling government equity stakes in two major enterprises are now underway. For remaining state equity holdings, tenders will be announced during 2007.

Monetary and financial sector reform policies

18. **The NBRM will continue to support our economic program by maintaining a de facto pegged exchange rate regime backed by adequate international reserves.** The NBRM's monetary program for 2007 is consistent with broad money growth of about 20 percent, in line with a gradual increase in money demand. We expect that sizable inflows of capital experienced in 2006 will continue in 2007, reflecting confidence in our macroeconomic policies. To ensure the continued success of the de facto pegged exchange rate, we stand ready to continue our policy of sterilizing inflows through the issuance of central bank bills and treasury bills for monetary policy purposes. Increased monetization, supplemented with a moderate increase in external financing and a drawdown of banks' funds abroad, will further increase private sector credit and financial intermediation.

19. **The government remains committed to strengthening the financial soundness of the Central Bank and safeguarding its independence.** In December, Parliament passed amendments to the NBRM law to: (i) let the NBRM retain 70 percent of its profits when general reserves are below the statutory limit, and then 15 percent after that, and (ii) limit the right of appeal to the NBRM Council to internal NBRM decisions, while letting appeals of external decisions go directly to the courts (structural benchmark for end-June).

20. **We have prepared a comprehensive revision of the legal framework to improve the soundness of the banking system.** After consultations between the Ministry of Finance and the NBRM, we produced a draft new Banking Law. In line with international best practice, the new law enhances licensing requirements, strengthens banks' governance, increase minimum capital requirements, tightens provisions on connected lending, and establishes a clear framework for consolidated supervision as well as for corrective actions and resolution of weak or insolvent banks. It also includes measures to allow foreign bank branching. The draft Banking Law also contains provisions to protect the governor's decisions in the areas of bank licensing, receivership and bankruptcy from reversal by the courts, though successful appeals still might seek financial compensation. Submission of the new banking law to Parliament is a prior action for completing this review. In 2007, we expect to review the Law on Deposit Insurance to ensure its consistency with the new Banking Law, including setting an appropriate target for Deposit Insurance Fund reserves and ensuring more timely payment of insured deposits.

21. **We have strengthened several aspects of banking supervision.** In spite of improving indicators of creditworthiness, for prudential reasons the NBRM has tightened prudential guidelines for banks' lending denominated in or indexed to foreign currency. The NBRM has also introduced a mandatory specific provision of 1 percent on A-type loans, while keeping the voluntary specific provision of 2 percent, and enacted rules requiring a gradual write-off of foreclosed assets. Moreover, as of end-October 2006, we have increased the resources of the supervision and banking regulations department by 10 new staff (structural benchmark); we stand ready to add more resources as needed. We have improved

the tax treatment of banks' loan loss provisions by making specific provisions fully tax-deductible.

22. **The NBRM's Supervisory Development Plan, which aims to migrate to a more risk based, anticipatory approach to banking supervision, is now being implemented.** In accordance with this plan, by end-September 2007, the NBRM will prepare a framework for assessing banks' risk profile and test the performance of the prepared procedures on at least two banks (new structural benchmark). The NBRM will then finalize by end-December 2007 a detailed guidance manual which will be used for conducting on-site supervision (new structural benchmark).

23. **While our commitment to enhance banking intermediation, strengthen credit culture and market discipline is undiminished, the timing of a few measures envisaged in the previous Letter of Intent was delayed for technical reasons:**

- Owing to the belated finalization of the memorandum of understanding between a donor and the NBRM, the **selection of the consulting company that will help the NBRM to carry out the transition to IFRS** in the banking system was undertaken only in September, and its contract finalized in November. Therefore, the NBRM now aims to issue accounting guidelines, a new chart of accounts and formats for banks' financial statements in line with IFRS by end-September 2007 (rephased structural benchmark). The new Banking Law will allow the NBRM to set additional accounting guidelines and request further information and disclosures from financial institutions that are needed for prudential purposes.

- **The current credit registry is in the process of being upgraded in several respects** where several new supervisory tools have been added, including a transition matrix on borrowers' risk classification. Starting in January 2007, additional information will be obtained by the credit registry from the Central Registry, thus making financial and other data accessible to supervisors. Further enhancements of the quantity and timeliness of data accessible to banks (such as reducing the loan threshold, switching to monthly reporting, and shortening the data processing period) require more advanced hardware and software. The NBRM has, therefore, decided to launch a project aimed at creating a totally new credit registry that is expected to be fully operational by December 2007 (rephased structural benchmark).

Attracting foreign investment and improving the business climate

24. **Implementation of regulatory reforms and improvement of the quality of regulations are among our top priorities**. In close consultation with the business community, and drawing on the expertise of the World Bank, we will simplify the regulatory regime and improve the quality of regulations affecting business activity. In November 2006 we made a government decision introducing the "regulatory guillotine", with clear steps and deadlines for its implementation. Government working groups have submitted a list of laws

and by-laws that regulate the economy. We are now reviewing these, in consultation with the business community. As a result of this process, we will publish a list of all licenses administered by line ministries and government agencies, together with their justification, by end-June 2007 (rephased structural benchmark); those that are not needed will be abolished by end-September 2007 (rephased structural benchmark).

25. **We will strengthen our legal system, property rights, and contract enforcement**. At present, about 50 percent of the territory in Macedonia is covered by the Real Estate Registry, while the remaining 50 percent is still covered by the Land Cadastre. In order to resolve this problem, we will expand the coverage of the Unique Real Estate Registry (Cadastre) to 68 percent by end-2007, and aim to complete it by end-2008. This will provide legal security to investors and will allow for use of land as loan collateral, which will help expand credit. We will also improve contract enforcement by reducing the backlog of court cases. Effective implementation of a group of new laws, including the Law on Enforcement, the Law on Courts and the Law on Misdemeanors, will increase the independence and the efficiency of our judiciary. The Judicial Budget Council's analysis of the fiscal implications of judicial reform has been used to determine our court budget request for the 2007 budget (structural benchmark).

26. **Attracting greenfield foreign direct investment by leading international companies is a key objective of our economic program.** In 2007, we will formulate a national program to stimulate investments, which will identify priority measures and activities necessary to attract high quality FDI for the period of 2007-2010. The efforts to promote Macedonia as a favorable destination for foreign investment were intensified with the appointment of two ministers responsible exclusively for foreign investment promotion, organization of a high-level Investor Forum in 2007, reorganization of the Agency for Foreign Investment and a range of other activities. The Investor Forum will track improvements in the business climate and learn of foreign investors' concerns. In January 2007 Parliament replaced the old free economic zone law with a new Law on Technological Industrial Development Zones. These zones will encourage the development of companies in the information technology, innovation and research sectors and companies producing according to new technologies and high ecological standards. To qualify for the preferred tax regime offered by this new law, firms must export at least 80 percent of their production. We will ensure that our initiatives to encourage FDI will neither compromise our fiscal deficit target, nor the quality of the budget.

27. **We will further liberalize the labor market by reducing the labor wedge and promoting part-time work.** Our reforms of personal income tax and social security contributions discussed have already reduced labor costs, promoting employment. Phased implementation of our strategy to harmonize the bases of PIT and social contributions (discussed in paragraph 13) should contribute to a further reduction in the labor wedge. Phasing out minimum social contributions (which at present are based on 65 percent of the average wage) and calculating health contributions on a per hour basis instead of the current

practice of calculating them on a full time basis regardless of hours worked could make important contributions to reduce the labor wedge and promote part-time work.

28. **We will improve the financial condition of the energy sector, and ensure stable energy supply.** The government has unbundled the sector's generation, distribution and transmission assets, and the distribution arm (ESM) was sold to a strategic investor (EVN) in March 2006. We are now privatizing the Negotino thermal power plant, the second largest in the country. In addition, we have initiated private participation in the development of more than 60 small and medium-sized hydro-electric facilities, and the sale of the Skopje gas company. We will develop an action plan, working with the World Bank, to improve finances in this sector, by end-May 2007 (new structural benchmark). This plan will contain the following elements:

- **First, we will provide strong support to the transmission and the distribution companies** in their efforts to cut off non-paying customers—whether they are budget organizations, large industrial users, or households.

- **Second, the supplementary 2006 budget contained sufficient allocations to pay off outstanding arrears of budget users**, and we have ensured that 2007 budget allocations are sufficient to meet the electricity needs of these organizations. We will support EVN-ESM in their efforts to (i) identify any remaining arrears, and reach agreement with budget users on the amounts due; (ii) design mutually agreed payment plans to gradually reduce these arrears; and (iii) ensure that budget users will make timely payments for their current electricity needs.

- **Third, in March 2007 we amended the energy law to limit the quantity of electricity that large industrial users will be allowed to purchase** from MEPSO at a regulated price and provide these users with an option to buy electricity directly from suppliers other than MEPSO.

- **Fourth, we will continue to support the independence of the Energy Regulatory Commission**. We will encourage both ELEM and MEPSO to review their current cost structure and determine whether their prices are adequate to cover both operational and capital costs. If they find that prices do not cover costs, we will not object to these companies submitting a request for a price increase to the Regulatory Commission immediately. ELEM and MEPSO will also make greater efforts to reduce their costs.

- **Fifth, we will consider the options for developing a proper social protection mechanism** to provide an affordable minimum electricity supply to poor households.

If this action plan does not fully address all financial losses incurred in the sector, we will take offsetting measures to protect the fiscal deficit target that do not worsen budget quality.

29. **We are strongly committed to telecommunications liberalization.** This will significantly reduce the cost of doing business, and is critical to increasing the globalization of Macedonia's economy. We have already made significant progress towards reducing telecommunications costs and expanding Internet access:

Progress In Telecom Liberalization

	2005q1	2005q2	2005q3	2005q4	2006q1	2006q2	2006q3	2006q4	2007q1
Number of VOIP providers 1/	...	...	...	20	...	...	...	46	...
Number of internet providers 1/	...	...	...	12	...	...	...	87	...
Fix telephone providers 1/	...	...	...	1	...	...	...	1	2
Internet penetration 2/	...	...	...	...	...	...	...	27	...
Interconnection fees (local call origination) 3/	...	...	...	...	...	1.43	...	...	0.54
Fixed telephone tariff to US 4/	18.0	...	...	...	...	12.90	...	...	8.39
Fixed telephone tariff to Germany 4/	27.0	...	...	...	...	16.90	...	...	8.39

1/ Number of notified providers at the end of the year.
2/ Number of internet users as a fraction of total population, based on 2006 survey.
3/ Denars per minute (MakTel).
4/ Denars per minute (MakTel); drop in price from 2006q2 reflects entry of three new providers.

- **In January 2007, the Agency for Electronic Communication reduced interconnection rates by 300 percent**. This has facilitated competition in landline telecommunications, with a second provider now entering this market.

- **In addition, in February 2007, parliament adopted amendments to the law on telecommunications that will in effect terminate the existing concession agreements** between the Ministry of Transport and Makedonski Telekomunikacii AD (Maktel), Mobimak and Cosmofon by end-March 2007, thereby resolving the conflict between the 2005 telecommunications law and these concession agreements.

- **We also completed the sale of a license for a third mobile operator in March 2007**.

- **We plan to allow telephone number portability by July 2007**.

Since these steps to liberalize the telecommunications market will take time to have their full effect, the government is reconsidering its strategy to divest its remaining shares in Maktel. The continuing audit of Maktel's 2005 accounts also needs to be completed before the government can make an informed decision on the appropriate privatization strategy. If we decide to sell the remaining shares, we will hire a consultant to prepare options for the ownership of our remaining shares in Maktel. Consistent with the objectives of the government, and as established at the First Review, the program will continue to monitor quantitative measures of liberalization in this sector every six months (structural benchmark).

30. **To facilitate Macedonia's integration in the global economy, the air transportation system needs significant improvements.** We will liberalize the market for air transport, consistent with our commitment to meeting the EU *acquis*, and with the aim of

easing the conditions for low-cost airlines to establish operations. Macedonian Airlines (MAT) will be stripped of its industry regulatory functions. Ratification by Parliament of the European Common Aviation Area (ECAA) agreement, which took place in February 2007, is a key step towards liberalization of the air transportation market.

Sincerely,

/s/
Nikola Gruevski
Prime Minister

/s/
Zoran Stavreski
Deputy Prime Minister

/s/
Trajko Slaveski
Minister of Finance

/s/
Petar Gošev
Governor
National Bank of the Republic of Macedonia

Table 1. FYR Macedonia: Quantitative Performance Criteria and Indicative Targets for 2006
(Targets and Actual Outcomes)

	Mar-06	Jun-06	Sep-06	Dec-06
	(In million euro)			
	End of Period Stocks for Program Evaluation			
Floor for net international reserves of the NBRM	909	968	1,027	1,058
Adjustor	-66	-20	30	-55
Revised target	844	948	1,057	1,003
Actual	965	1,049	1,176	1,230
	Cumulative Changes for Program Evaluation			
Ceiling on new non-concessional medium- and long-term external debt contracted or guaranteed by the general government or the NBRM with original maturities of more than 1 year	231	239	246	286
Actual	209	280	280	280
Ceiling on short-term external debt of the central government or the NBRM with maturities of up to 1 year (stock); including guarantees for such debt	0	0	0	0
Actual	0	0	0	0
Accumulation of external payments arrears	0	0	0	0
Actual	0	0	0	0
	(In million denars)			
	Quarterly Stocks for Program Evaluation			
Ceiling on net domestic assets of the NBRM	-37,980	-40,830	-44,303	-44,824
Adjustor	4,020	1,211	-1,855	3,372
Revised target	-33,960	-39,619	-46,158	-41,452
Actual	-44,207	-47,682	-52,149	-51,586
Ceiling on net domestic assets of the banking system (indicative)	24,022	26,797	31,416	30,129
Adjustor	4,020	1,211	-1,855	3,372
Revised target	28,042	28,008	29,561	33,501
Actual	18,666	20,091	21,164	29,780
Ceiling on net domestic credit to the central government from the NBRM	-26,301	-20,808	-19,996	-25,942
Adjustor	4,020	1,211	-1,855	3,372
Revised target	-22,281	-19,597	-21,851	-22,570
Actual	-23,303	-27,247	-28,502	-25,486
Ceiling on central government domestic arrears excluding suppliers (indicative)	0	0	0	0
Actual	0	0	0	0
Ceilings on central government domestic arrears to suppliers (indicative)	979	979	979	979
o/w non HIF domestic central government arrears	309	309	309	309
Actual	1,236	333	482	254
o/w non HIF domestic central government arrears	375	330	458	254
Ceiling on arrears of the Health Insurance Fund (indicative)	670	670	670	670
Actual	861	3	24	0
	Cumulative Flows within the Year			
Ceiling on central government wages (indicative)	...	...	...	24,666
Actual	...	...	...	23,421
Floor for central government fiscal balance	-253	-1,364	-2,570	-1,851
Adjustor	552	530	781	579
Revised target	299	-834	-1789	-1272
Actual	113	437	1778	9
Memo item: Program exchange rate (Denars per Euro)	61.31	61.31	61.31	61.31

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

Table 2. FYR Macedonia: Performance of Structural Conditionality in 2006

Measure	Type 1/	Status
June 2006		
Sale of the first tranche (at least 10 percent of the company) of government's residual shares in Makedonski Telekomunikacii AD.	PC	Met.
LTO to pilot test a new computer system which is compatible with systems being developed by the social funds.	BM	Met.
Start publishing comprehensive data on the realization of the government's on-lending agreements and government projections for future on-lending.	BM	Met.
Anti-corruption commission to audit the financial disclosure reports of randomly chosen senior elected and appointed officials and civil servants.	BM	Met.
HIF to report on its spending by economic classification, on a cash and commitment basis, including a breakdown of HCI spending, based on the Q1 2006 outcome.	BM	Met. Published on the HIF website.
Pass amendments to the NBRM law and other legislation that revise provisions on the retention/distribution of NBRM profits and to strengthen governor's decision-making powers (new commitment).	BM	Partially achieved. Amendments to the NBRM law were passed with delay in December 2006.
Place budget control officers in the 15 largest HCIs.	BM	Achieved with delay (in place November 2006, fully operational January 2007).
Government to prepare a strategy paper for base harmonization among social contributions.	BM	Achieved with delay (January 2007).
Liberalize the telecommunication sector (to be measured, inter alia, by the number of new VOIP and other service providers, new fixed line competition, and additional mobile telephone licenses).	BM	Met.
Introduce prudential regulations on a gradual write-off of foreclosed assets and a mandatory 1 percent general provision on A-type loans.	BM	Met.
July 2006		
Establish a Large Taxpayer Office at PRO and a Large Contributor Office at PDF.	PC	Not observed. LTO established on schedule in July 2006. LCO has been established, but legal problems mean it only has a monitoring role. Revised strategy is to integrate all social fund collections (not just large contributors) by April 2008.
Amend Law on Misdemeanors to allow administrative bodies (such as NBRM, PRO, Customs) to impose sanctions on misdemeanor cases without prior court involvement.	BM	Met.

1/ PC=structural performance criterion; BM=structural benchmark

Table 2. FYR Macedonia: Performance of Structural Conditionality in 2006 (continued)

Measure	Type 1/	Status
September 2006		
Submit to Parliament legislation on a harmonized base for social insurance contributions.	BM	Achieved with delay (January 2007). Implementation will start July 2007.
Establish MOF budget officer in the HIF.	BM	Met.
Complete draft Banking Law agreed with the staff (focused on, inter alia, bank governance, consolidated supervision, the framework for corrective actions and resolution of weak or insolvent banks, connected lending, and harmonization with EU legislation).	BM	Achieved with delay.
Judicial Budget Council to prepare a detailed analysis of the fiscal implications of judicial reform.	BM	Achieved with delay.
Publish a list of all licenses administered by line ministries and government agencies, together with their justification.	BM	Not met. The new government has a more comprehensive approach to regulatory reform. Reset to June 2007.
December 2006		
Sale of all of the government's residual shares in Makedonski Telekomunikacii AD (except for a minority shareholding of up to 7 percent).	PC	Not met. Put up for sale in June 2006 but attracted insufficient bids. New government to decide on completing sale later. Revised strategy focuses on liberalization.
Issue accounting guidelines, chart of accounts and formats for banks' financial statements in line with IFRS.	BM	Not met. Technical assistance was delayed. Preparations commenced. Reset for end-September 2007.
Liberalize the telecommunication sector (to be measured, inter alia, by the number of new VOIP and other service providers, new fixed line competition, and additional mobile telephone licenses).	BM	Met.
Prepare a report on the government's economic activities.	BM	Met.
Add 10 staff to the NBRM's Supervision and Regulation Department.	BM	Met.
Revise the systematization of selected line ministries and reflect the new systematization in the 2007 budget.	BM	Met.

1/ PC=structural performance criterion; BM=structural benchmark

Table 3. FYR Macedonia: Quantitative Performance Criteria and Indicative Targets for 2007

	Mar-07 1/	Jun-07	Sep-07	Dec-07
	(In million euro)			
	End of Period Stocks for Program Evaluation			
Floor for net international reserves of the NBRM	1,130	1,186	1,247	1,259
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
	Cumulative Changes for Program Evaluation			
Ceiling on new non-concessional medium- and long-term external debt contracted or guaranteed by the general government or the NBRM with original maturities of more than 1 year	38	64	89	103
Actual	...	...	...	...
Ceiling on new non-concessional medium and long-term external debt contracted by the public enterprises with original maturities of more than 1 year (indicative)	25	33	52	60
Actual	...	...	...	...
Ceiling on short-term external debt of the central government or the NBRM with maturities of up to 1 year (stock); including guarantees for such debt	0	0	0	0
Actual	...	...	...	...
Accumulation of external payments arrears	0	0	0	0
Actual	...	...	...	...
	(In billion denars)			
	Quarterly Stocks for Program Evaluation			
Ceiling on net domestic assets of the NBRM	-47.2	-48.9	-51.8	-50.1
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
Ceiling on net domestic assets of the banking system (indicative)	35.5	42.4	45.9	55.6
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
Ceiling on net domestic credit to the central government from the NBRM	-24.7	-23.6	-24.6	-19.7
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
Ceiling on central government domestic arrears excluding suppliers (indicative)	0	0	0	0
Actual	...	...	...	...
Ceilings on central government domestic arrears to suppliers (indicative)	0.6	0.6	0.6	0.6
o/w non HIF domestic central government arrears	0.4	0.4	0.4	0.4
Actual	...	...	...	...
o/w non HIF domestic central government arrears	...	...	...	...
Ceiling on arrears of the Health Insurance Fund (indicative)	0.2	0.2	0.2	0.2
Actual	...	...	...	...
	Cumulative Flows within the Year			
Ceiling on central government wages (indicative)	...	...	...	26.0
Actual	...	...	...	...
Floor for central government fiscal balance	0.3	0.5	0.8	-3.4
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
Memo item: Program exchange rate (Denars per Euro)	61.31	61.31	61.31	61.31

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

1/ All targets for March 2007 are indicative since before the Board meeting.

Table 4. FYR Macedonia: Structural Conditionality 2007-08

Measure	Type 1/	Date
Tax policy and administration		
Public Revenue Office to identify performance measures for (i) registering additional taxpayers; (ii) improving taxpayer services; (iii) recovering tax arrears and delinquent tax returns; and (iv) auditing taxpayers; and set target levels of performance to be achieved by end-2007.	BM	May 2007
Public Revenue Office to design a strategy for improving the administration of small- and medium-sized enterprises.	BM	June 2007
Implement the March 2007 legislation harmonizing social security bases (abolishing complexity factors and sectoral minimum wages in calculation of health fund premia).	PC	July 2007 (originally intended for December 2006, but not formally established)
Prepare a strategy for the harmonization of the base of the personal income tax and social security contributions.	BM	September 2007
Submit legislation to parliament that vests the Pension and Disability Fund with the legal authority for collecting health and employment contributions.	BM	September 2007
Initiate phased implementation of the strategy for the harmonization of the base of the personal income tax and social security contributions (details to be specified at Third Review).	PC to be set at Third Review	January 2008
Integration of Social Fund collections. Pension and Disability Fund and its network of field offices will design and execute collection programs for all social insurance contributions and their contributors.	PC	April 2008
Fiscal transparency		
Implement legislation requiring state enterprises to submit quarterly reports on their financial position to the government, starting with data for second quarter of 2007.	BM	October 2007
Health sector		
Conclude international tendering for drug procurement.	BM	June 2007
Financial sector		
Submit to parliament a new Banking Law that has been agreed with IMF staff.	PA	
Prepare a comprehensive framework for assessing banks' risk profile and test the performance of the prepared procedures on at least two banks.	BM	September 2007
Issue accounting guidelines, a new chart of accounts, and formats for bank's financial statements in line with IFRS.	BM	September 2007 (reset from December 2006)
Finalize detailed guidance manual for conducting on-site supervision.	BM	December 2007
Create a new credit registry and make it fully operational.	BM	December 2007 (reset from June 2007)
Business climate		
Publish a list of all licenses administered by line ministries and social agencies, together with their justification.	BM	June 2007 (reset from September 2006)
Abolish licenses that are no longer needed.	BM	September 2007 (reset from March 2007)
Energy sector		
Develop an action plan, working with the World Bank, to improve energy sector finances.	BM	May 2007
Telecoms liberalization		
Liberalize the telecommunications sector (to be measured, inter alia, by the number of new service providers, new fixed line competition, and additional mobile telephone licenses).	BM	Monitored June and December 2007.

1/ PC=structural performance criterion; BM=structural benchmark; PA=prior action.

Table 5. FYR Macedonia: Revised Schedule of Performance Criteria and Purchases, 2007–08 1/

	Original Schedule				Revised Schedule			
	Performance Criteria	Purchase (SDR millions)	In percent of quota	Scheduled Purchase 2/	Performance Criteria	Purchase (SDR millions)	In percent of quota	Scheduled Purchase 2/
Approved purchases		17.36250	25.20			17.36250	25.20	
Actual		10.50000	15.24			10.50000	15.24	
Treated as precautionary 3/		6.86250	9.96			6.86250	9.96	
Reviews								
	March 31, 2006	3.43125	4.98	May 15, 2006	…	…		…
2nd Review	June 30, 2006	3.43125	4.98	August 15, 2006	December 31, 2006	10.29375 3/	9.96	Approval of 2nd Review
	September 30, 2006	3.43125	4.98	November 15, 2006	…	…		…
3rd Review	December 31,2006	3.43125	4.98	February 15, 2007	June 30, 2007	4.80375 4/	6.97	August 15, 2007
	March 31, 2007	3.43125	4.98	May 15, 2007	September 30, 2007	4.80375 4/	6.97	November 15, 2007
4th Review	June 30, 2007	3.43125	4.98	August 15, 2007	December 31, 2007	4.80375 4/	6.97	February 15, 2008
	September 30, 2007	3.43125	4.98	November 15, 2007	March 31, 2008	4.80375 4/	6.97	May 15, 2008
5th Review	December 31, 2007	3.43125	4.98	February 15, 2008	June 30, 2008	4.80375 4/	6.97	August 15, 2008
	March 31, 2008	3.43125	4.98	May 15, 2008	…	…		…
6th Review	June 30, 2008	3.43125	4.98	August 15, 2008	…	…		…
Total purchases		51.67500	75.00			51.67500	75.00	

1/ The authorities have made one purchase under this program totaling 15.24 percent of quota, and are treating remaining available purchases in a precautionary manner.

2/ Earliest possible date at which a purchase could be made available.

3/ Including purchases originally tied to the end-March, June, and September 2006 test dates.

4/ Includes rephased amounts that were originally tied to the end-December 2006 test date and completion of the third review, and the end-March 2007 test date.

ATTACHMENT II

TECHNICAL MEMORANDUM OF UNDERSTANDING

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

A. DEFINITIONS

1. For the purpose of this TMU, the term "central government" covers: central government as defined in the Annual Budget Document, including Special Revenue Accounts, Employment Fund, Health Insurance Fund, Pension Insurance Fund, Road Fund, and 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 its 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 extra-budgetary 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 Finance Statistics 2001*, and will ensure that these will be incorporated within the definition of central government.

2. The term "general government" covers the central government as defined above and the municipalities which are classified as part of general government according to the budget documents and which are included by the NBRM in its monthly submissions to the Fund of balance sheets of the central bank and the consolidated accounts of the commercial banks.

3. The term "public enterprises" refers to institutional units that are established and controlled by the Government and the Parliament of the Republic of Macedonia and that perform market activities.

B. NET INTERNATIONAL RESERVES OF THE NBRM

	Floor on level of NIR (in million euros)
March 31, 2007 (indicative target)	1130
June 30, 2007 (performance criterion)	1186
September 30, 2007 (performance criterion)	1247
December 31, 2007 (performance criterion)	1259

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

5. **Reserve assets** are defined as liquid and usable foreign convertible currency claims on nonresidents plus monetary gold. Reserve assets of the NBRM thus include monetary gold, 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. On December 31, 2006, reserve assets thus defined amounted to 1,377 million euro.

6. **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). Central government's foreign exchange deposits at the NBRM are excluded from reserve liabilities. On December 31, 2006, reserve liabilities thus defined amounted to 147 million euro.

Assumptions

7. On a cumulative basis from end-December 2006, privatization proceeds (including lump sum proceeds from concession fees) in foreign currency are assumed to be:

End-March 2007	EUR 0 million
End-June 2007	EUR 45 million
End-September 2007	EUR 45 million;
End-December 2007	EUR 45 million.

8. On a cumulative basis from end-December 2006, repayments of Paris club debt are assumed to be:

End-March 2007	EUR 8 million
End-June 2007	EUR 78 million
End-September 2007	EUR 78 million;
End-December 2007	EUR 78 million.

Adjustors

9. The NIR floors of the NBRM will be adjusted:

- upward (downward) for any privatization proceeds in foreign currency exceeding (falling short of) the baseline;

- downward (upward) for any repayments of Paris club debt exceeding (falling short of) the baseline;

- downward for any government payments to the new owners of the recently privatized electricity distribution company resulting from revisions to the value of the assets of the company as contemplated in the sale contract;

- downward for any prepayment of external debt.

C. Net Domestic Assets of the NBRM

	Ceiling on level of NDA (in billion denars)
March 31, 2007 (indicative target)	-47.2
June 30, 2007 (performance criterion)	-48.9
September 30, 2007 (performance criterion)	-51.8
December 31, 2007 (performance criterion)	-50.1

10. **Net domestic assets** (NDA) of the NBRM are defined as reserve money minus the net foreign assets (NFA) of the NBRM. On December 31, 2006 NDA of the NBRM was minus 51.6 billion denars.

11. **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. On December 31, 2006 reserve money was 31.3 billion denars.

12. **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 defined in this TMU, minus foreign exchange liabilities of the NBRM to nonresidents. On December 31, 2006 NFA of the NBRM was 82.9 billion denars.

Adjustors

13. The NDA ceilings will be adjusted:

- downward (upward) for any privatization proceeds in foreign currency exceeding (falling short of) the baseline defined above;

- upward (downward) for any repayments of Paris club debt exceeding (falling short of) the baseline;

- upward for any government payments to the new owners of the recently privatized electricity distribution company resulting from revisions to the value of the assets of the company as contemplated in the sale contract; upward by the amount of any prepayment of external debt.

D. Net Domestic Assets of the Banking System

	Ceiling on level of NDA (in billion denars)
March 31, 2007 (indicative target)	35.5
June 30, 2007 (indicative target)	42.4
September 30, 2007 (indicative target)	45.9
December 31, 2007 (indicative target)	55.6

14. **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. On December 31, 2006 NDA of the banking system was 29.8 billion denars.

15. **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-central government denominated in denars and in foreign currency. On December 31, 2006 broad money was 135.5 billion denars.

16. **NFA of the banking system** are defined as the banking system's foreign assets minus foreign liabilities. On December 31, 2006 NFA of the banking system was 105.8 billion denars.

Adjustors

17. 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 Credit to the Central Government from the NBRM

	Ceiling on level of net credit to central government from NBRM (in billion denars)
March 31, 2007 (indicative target)	-24.7
June 30, 2007 (performance criterion)	-23.6
September 30, 2007 (performance criterion)	-24.6
December 31, 2007 (performance criterion)	-19.7

18. **Net credit to the central government** from the NBRM is defined as claims in denars and foreign currency on the central government from the NBRM minus total central government deposits in denars and foreign currency with the NBRM. For the purpose of this program, accounts of the central government include all accounts recorded as central government accounts in the monetary statistics reported by the NBRM in accordance with the above definition of central government. Excluded from this definition are any T-bills issued for monetary policy purposes and corresponding government deposits at the NBRM. On December 31, 2006 net credit to central government from the NBRM was 25.5 billion denars.

Adjustors

19. The ceilings on net credit to the central government from the NBRM will be subject to the same adjustors as the ceilings for the NDA of the NBRM.

F. Government Fiscal Balances

	Floors on cumulative changes in central government fiscal balances (in billion denars)
March 31, 2007 (indicative target)	0.3
June 30, 2007 (performance criterion)	0.5
September 30, 2007 (performance criterion)	0.8
December 31, 2007 (performance criterion)	-3.4

20. Quarterly floors for the cumulative changes in central government fiscal balances will be determined and monitored from the financing side relative to end-December 2006. The financing flows will be measured as the sum of domestic financing, foreign financing, and privatization proceeds.

21. **Domestic financing** for the central government includes net credit to the central government from the NBRM as defined above, change of the central government accounts in the commercial banks, change in stock of domestic securities issued by the central government, and net variation in domestic arrears (as defined below).

22. **Foreign financing** for the central government includes disbursements of external loans received by the central government, including disbursements received for foreign financed projects of budget users and extra-budgetary funds, and restitution of foreign assets of the former SFRY as a result of succession proceedings minus amortization due or pre-paid, and rescheduled debt service payments programmed to be paid out.

23. **Privatization proceeds** for the central government include privatization proceeds and lump sum proceeds from concession fees in denars and foreign currency.

24. It is expected that quantitative targets on fiscal balances for the general government will be set for the fiscal year 2008, provided that sufficiently comprehensive and reliable data on municipalities' finances will have become available.

Adjustors

25. The floor on the central government fiscal balances will be adjusted upwards by any dividend receipts in 2007 from the Makedonski Telekomunikacii exceeding 2.5 billion denars.

G. Central Government Wage Bill

26. The ceiling on the **central government wage bill** includes central government wages and salaries, including allowances.

27. An annual ceiling of 26.0 billion denars (indicative target) has been established for the central government wage bill to be measured at end-December 2007.[1]

H. Medium and Long-Term Debt

	Ceiling on new non-concessional medium- and long-term external debt contracted or guaranteed by the general government or the NBRM (in million euros, cumulative from end-2006)
March 31, 2007 (indicative target)	38
June 30, 2007 (performance criterion)	64
September 30, 2007 (performance criterion)	89
December 31, 2007 (performance criterion)	103

28. The limit on **medium and long-term debt** applies to the contracting or guaranteeing by any branch of the general government and the NBRM of new non-concessional external debt with an original maturity of more than one year. The 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,[2] but also to commitments contracted or guaranteed for which value has not been received. Excluded from

[1] Under the program, the authorities are committed to holding the ration of the central government wage bill to tax revenues (excluding social security contributions) at the level of the 2005 supplementary budget.

[2] *Decision No. 6230-(79/140) August 3, 1979, as amended by Decision Nos. 11096-(95/100), October 25, 1995, and 12274-(00/85), August 24, 2000.* 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.

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. Specifically, the discount rates for debts with maturities less than 15 years will be based on the average CIRR of the previous 6 months, and for debts with maturities of 15 years and more the average CIRR of the previous 10 years. Debt falling within the limit shall be valued in euro at the exchange rate prevailing at the time the contract or guarantee becomes effective.

	Ceiling on new non-concessional medium- and long-term external debt contracted by the public enterprises (in million euros, cumulative from end-2006)
March 31, 2007 (indicative target)	25
June 30, 2007 (indicative target)	33
September 30, 2007 (indicative target)	52
December 31, 2007 (indicative target)	60

29. A separate limit is established on contracting by the public enterprises of new non-concessional external debt with an original maturity of more than one year. Thirty three public enterprises will be covered under this performance criterion, including: PE Sluzben Vesnik (official gazette), PE Makedonski Zheleznici (railways), Mlekara DOO (trading in dairy products), 11 Octomvri-Eurocompozit AD (production of electrical insulation and materials), PE Agro-Berza (agricultural commodity exchange), Soncogledi (production, trade and services), PE za Stopanisuvanje so Stanben i Deloven Prostor (public housing activities), Veles DOOEL (production of rail vehicles), Remont na Prugi i Niskogradba DOOEL (maintenance of rail tracks and civil engineering), PE Makedonska Radiodifusija (broadcasting), Makedonska Banka za Podrska na Razvojot (Macedonian Bank for Support of Development), PE za Stopanisuvanje so Pasista (pastures management), PE za Stopanisuvanje za Objekti za Sport (management of sport facilities), PE Zletovica (water supply activities), PE Studencica (water supply), PE Lisice (water supply activities), Makedonska Informativna Agencija (information agency), PE Dojransko Ezero (water management), PE Gevgelisko Valandovsko Pole (water supply), PE Jasen (management of pastures), Makedonska Posta (postal services), MEPSO (electricity transmission), PE Makedonski Sumi (forestry), PE Srezevo (irrigation), ELEM (electricity generation), TEC Negotino (electricity generation), Boris Trajkovski DOOEL (construction, management, and leasing of a concert/athletic hall), GA-MA (transportation and distribution of natural gas), Toplik 2001 DOOEL (multi-purpose hall), Arest DOOEL (production, trade and services), PE Makedonija Pat (road maintenance), Drzaven Studentski Centar Skopje (student housing), PE Makedonska Radio-Televizija (radio and television broadcasting). When there is a change of control of any of the listed enterprises due to privatization, the stock of debt

contracted or guaranteed by such enterprises as defined under this performance criterion will be limited to the level reached on the day the control is transferred.

I. Short-Term External Debt

30. The limit on **short-term external debt** applies to the outstanding stock of short-term debt contracted or guaranteed by central 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 euro at the program exchange rates. Under the program, non-accumulation of short-term debt as defined above is a continuous performance criterion. On December 31, 2006, short-term external debt as defined above was zero euros.

J. External Payments Arrears

31. **External payments arrears** consist of the total past-due amounts of debt service obligations (interest and principal) on government, government-guaranteed, and NBRM external debt, excluding arrears on external debt service obligations pending the conclusion of debt rescheduling agreements.[3] Under the program, the non accumulation of external payments arrears is a continuous performance criterion. On December 31, 2006, the stock of external payment arrears as defined above was zero euros.

K. Domestic Payments Arrears

32. **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) benefit recipients of the Child Care Program; and (v) local governments. The definition excludes the customary lag in paying wages, social assistance and child allowance payments, and transfers to the Funds (in the following month after they accrue). Under the program, non-accumulation of central government arrears, excluding those to suppliers, as defined above will be an indicative target. On December 31, 2006, central government domestic arrears as defined in this paragraph were zero denars.

33. Central government domestic arrears to suppliers are defined as obligations to suppliers which are due but not paid by more than 60 days and are non-disputed. Under the

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[3] Amounts are only considered past-due after the contractual grace period expires.

program, the outstanding stock of domestic arrears, as defined above, will not exceed 0.6 billion denars. On December 31, 2006 the amount of central government domestic arrears to suppliers as defined in this paragraph was 0.3 billion denars.

34. A separate sub-ceiling is set for Health Insurance Fund arrears to suppliers, defined as obligations to suppliers which are due but not paid by more than 60 days and are not disputed. Under the program the aggregate outstanding stock of arrears will not exceed 0.2 billion denars. On December 31, 2006, the Health Insurance Fund arrears as defined in this paragraph were zero denars.

L. Valuation

35. For program purposes, all foreign currency-related assets, liabilities, [and flows] will be evaluated at program exchange rates, with the exception of the government fiscal balances, which will be measured at current exchange rates. For 2007, the program exchange rates are those that prevailed on December 31, 2004. In particular, EUR1 = 61.3100 denars, US$1= 45.0676 denars; SDR1= 69.9903 denars, and EUR1=1.3604 U.S. dollars. Gold is valued at the price fixed in the London market at end-December 2004 (US$ 438.00 per ounce).

36. 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.

37. For program monitoring, 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 Euros using the middle rates from the NBRM official exchange rate list for the same day. These balances are compared to the balances in Euros 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 Euro denominated balances, so calculated, is compared to the recorded daily transaction flows converted in Euros using the same methodology. Any difference between the two values is attributed to valuation effects.

M. Monitoring and Reporting Requirements

38. Performance under the program will be monitored from data supplied to the Fund by the NBRM, the Ministry of Finance, and the SSO as outlined in Table 1. The authorities will transmit promptly to the Fund staff any data revisions. In addition, data on performance at the program test dates will be submitted with a cover letter signed by authorized officials.

Table 1. FYR Macedonia: Data to be Reported to the IMF

Item	Periodicity
To be provided by the MOF	
Consolidated central government operations	Monthly, within four weeks of the end of each month
Privatization receipts received by the budget (in denars and foreign exchange, and payments in governments bonds)	Monthly, within four weeks of the end of each month
Data on workers registered as unemployed with the employment fund.	Monthly, within three weeks of the end of each month
Information on new debt and guarantees given on new debt, contracted by the government agencies and public enterprises.	Quarterly, within four weeks of the end of each quarter
Data on central government arrears, including to suppliers	Monthly, within four weeks of the end of each month
Data on the Health Insurance Fund arrears	Monthly, within four weeks of the end of each month
Data on operations of all municipalities	Quarterly, within four weeks of the end of each quarter
Data on operations of four largest public enterprises	Quarterly, within eight weeks of the end of each quarter (to begin in November 2007)
To be provided by the NBRM	
Balance sheet of the NBRM	Weekly, within one week of the end of each week Monthly, within three weeks of the end of each month
Consolidated accounts of the commercial banks	Monthly, within three weeks of the end of each month
Monetary survey	Monthly, within three weeks of the end of each month
Data on components of the NIR of the NBRM	Weekly, within one week of the end of each week
Data on foreign exchange cash flow of the NBRM	Weekly, within one week of the end of each week
Foreign exchange market data (exchange rates, volume of trades, and interventions)	Weekly, within one week of the end of each week
Current and capita account data	Monthly, within eleven weeks of the end of each month
Commercial banks' balance sheets (bank-by-bank)	Monthly, within three weeks of the end of each month
Commercial banks' income statements (bank-by bank)	Monthly, within three weeks of the end of each month
Data on each bank's liquid position (bank-by bank) including breakdown by currency and maturity	Monthly, within three weeks of the end of each month

Table 1. FYR Macedonia: Data to be Reported to the IMF (continued)

Item	Periodicity
Data on lending by domestic money banks (new and rolled-over loans) according to credit rating of borrowers	Monthly, within four weeks of the end of each month
Data on off-balance sheet activity of domestic money banks	Monthly, within four weeks of the end of each month
Detailed data on each bank's assets and liabilities, including breakdown by currency (domestic, foreign, indexed) and maturity	Monthly, within three weeks of the end of each month
Data on commercial banks' deposit and lending rates and underlying stocks	Monthly, within four weeks of the end of each month
Financial soundness indicators	Quarterly, within 50 days of the end of the period ending in March and September, within 70 days of the end of the period ending in June and within 100 days for the period ending in December.
Commercial banks' balance sheets (bank-by-bank)	Same as above.
Commercial banks' income statements (bank-by bank)	Same as above.
Data on structure of each bank's loans by sector (corporate vs. households) and by currency (domestic, foreign, indexed)	Same as above.
Data on each bank's compliance with prudential regulations	Same as above.
To be provided by the SSO	
Overall consumer price index	Monthly, within two weeks of the end of each month
Overall producer price index	Monthly, within two weeks of the end of each month
Data on industrial production	Monthly, within two weeks of the end of each month
Data on wages	Monthly, within two weeks of the end of each month
National accounts by sector of production (nominal and real terms)	Quarterly, within eight weeks of the end of each month
To be provided jointly by the NBRM and MOF	
Data on domestic and foreign borrowing including gross and net debt stock, disbursements, amortization, interest payments by debtors and stock of external payment arrears (including central government, agencies and public enterprises)	Quarterly, within four weeks of the end of each quarter

Statement by the IMF Staff Representative
April 27, 2007

This statement provides information on developments since the issuance of the staff report for the Former Yugoslav Republic of Macedonia's Request for the Second Review Under the Stand-By Arrangement, and Request for Waiver of Performance Criteria and Rephasing of the Program. It does not change the thrust of the staff appraisal.

Last week, the authorities submitted to Parliament a new Banking Law consistent with the objectives set out in paragraph 20 of the Letter of Intent, and with technical assistance provided by Fund staff, meeting the prior action that had been established.

Economic and financial data remain broadly consistent with the program. Inflation has fallen below 1 percent, while industrial production has recovered strongly, increasing by almost 13 percent year on year in January and February. The sale of a domestic bank to a major foreign bank seems to have been successfully completed, auguring well for increased competition and efficiency in this sector.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

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FOR IMMEDIATE RELEASE
April 27, 2007

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Second Review Under Stand-By Arrangement with the Former Yugoslav Republic of Macedonia

The Executive Board of the International Monetary Fund (IMF) today completed the second review of the former Yugoslav Republic of Macedonia's economic performance under a Stand-By Arrangement.

In completing the review, the Board approved the authorities' requests for waivers of nonobservance of the structural performance criteria with respect to the establishment of a Large Taxpayer Office at the Public Revenue Office and a Large Contributor Office at the Pension and Disability Fund, as well as with respect to the sale of the remainder of the government's residual shares in Makedonski Telkomunikacii AD (except for a minority shareholding of no more than 7 percent).

The three-year Stand-By Arrangement for an amount equivalent to SDR 51.7 million (about US$ 78.9 million) was approved on August 31, 2005 (see Press Release No. 05/196). The authorities now treat the arrangement as precautionary.

Following the Executive Board discussion of Macedonia, Mr. Takatoshi Kato, Deputy Managing Director and Acting Chair, stated:

"Economic performance of the former Yugoslav Republic of Macedonia and implementation of its Fund-supported program remain encouraging. Growth has been stable, inflation is low, and international reserves are steadily increasing. The new banking law should encourage competition and reduce interest rate spreads, while strengthening banking supervision. The main challenge ahead will be to maintain macroeconomic stability, and to raise significantly the country's growth potential through accelerated structural reforms.

"Fiscal discipline has underpinned the country's continued strong performance. Although the budget deficit is expected to increase slightly in 2007, this will finance reductions in taxes and import tariffs, and allow an increase in public investment. A reduction of the financial losses in the electricity sector and continued resistance to spending pressures will be key to meeting this year's deficit target.

"For the medium term, rationalizing government spending, and harmonizing and broadening the tax base are needed to help ensure that the government's tax-cutting plans are consistent with fiscal discipline. The effective implementation of reforms in the Public Revenue Office, together with the planned integration of social fund collections, should also boost revenues and help finance these tax cuts.

"The authorities are giving appropriate priority to the goal of attracting foreign direct investment. In order to secure a lasting improvement, this is best achieved through a continued focus on macroeconomic stability and the acceleration of structural reforms to enhance the business environment, instead of using generous tax incentives," Mr. Kato said.

Statement by YuriyYakusha, Alternate Executive Director for Former Yugoslav Republic of Macedonia and Vladimir Monteanu, Senior Advisor to Executive Director April 27, 2007

On behalf of the Macedonian authorities we thank staff for the constructive policy dialogue since the new government took office last August, and for the valuable advice, which is helping them in the policy formation process.

Macedonia's economic performance under the program has remained strong, reflecting the authorities' commitment to build on the progress made and to advance the reform agenda to a level which will help accomplish full integration into the European community. Real GDP growth is estimated by staff to have reached 4 percent in 2006, with exports being the main engine of growth. More recently, increasing internal demand has also contributed to growth. The authorities' prudent economic policies helped safeguard the hard-won macroeconomic stability and boosted market confidence, while broad-based growth, in combination with labor market liberalization contributed to a modest but consistent increase in employment. Fiscal policy remained disciplined allowing Macedonia to meet the program deficit target of 0.6 percent of GDP, and to further improve its external debt sustainability. Although inflation is higher than in previous years, largely due to one-off factors, including an increase in excises and household electricity prices, it remains low, at 0.8 percent (y-o-y) at end-March 2007. The external position continued to improve, owing to stronger exports, buoyant private transfers, and higher-than-anticipated privatization proceeds. This also led to an increase in international reserves.

The economic outlook for 2007 and for the medium-term remains favorable. To ensure a firm foundation for continued fiscal sustainability, the authorities' macroeconomic framework is prudent in assuming 4½ percent real GDP growth. At the same time, the authorities believe that their ambitious structural reforms will take hold quickly and the real GDP growth may reach 6 percent in 2007. The government's macroeconomic framework allows a modest increase in the budget deficit, while preserving fiscal discipline and debt sustainability. Inflation is expected to decrease slightly in 2007 and will reach 2 to 2.5 percent over the medium term. The current account deficit will remain sustainable and the gross international reserves will continue to grow.

Although progress has been made since the new government took office, the main economic challenges facing the authorities are to turn around the weak business climate through structural reforms, to increase productivity growth, to foster entrepreneurial activity and to reduce rigidities in the labor market. The authorities share staff's view that a continuedstable macroeconomic policy is necessary to sustain growth, and remain committed to address the underlying structural weaknesses, by improving institutional capacity and enhancing financial market development.

Against this background, the authorities request the completion of the second review and waivers for non-observance on structural performance criteria, as well as rephasing of remaining purchases. Also, they reaffirm their intention not to make the purchase under the SBA.

Fiscal policy

The authorities continued their strong track record of prudent fiscal policy, comfortably meeting the program's deficit target despite a shortfall in non-tax revenues. Underexecution of capital expenditures, savings on goods and services and higher tax revenues offset this shortfall (unpaid telecom dividend of about 0.8 percent of GDP), and allowed to reduce arrears in healthcare. Simplifying the tax system, improving its efficiency, and reducing the tax burden is a key element in the authorities' economic reform agenda. Along with these principles, shortly after coming to office the new government launched an ambitious tax reform, which envisages the introduction of flat and lower personal and corporate income tax rates, while broadening the bases of these taxes to contain revenue losses. To this effect, the personal and corporate income tax rates were unified at a flat 12 percent in 2007, and will be reduced to 10 percent in 2008, with a zero tax on reinvested profit. In addition, important reforms aimed at streamlining revenue administration, including the introduction of harmonized bases for social security contributions and the elimination of customs declaration fees, will be implemented.

The authorities share staff's concerns regarding the revenue losses associated with these reforms and have introduced a number of compensatory measures. To this effect, the tax base was broadened by abolishing some existing exemptions from the corporate income tax. Also, the double deduction for investment in fixed assets from the corporate income tax law has been eliminated, and fees on gambling establishments and taxes on games of chance have been increased. On the expenditure side, steps were made to redirect government spending to more productive use, including reduction in spending on furniture and cars. In addition, wage expenditures are expected to decline by 0.2 percent of GDP, bringing the total effect of these compensatory measures to 0.6 percent of GDP. Furthermore, the authorities are pleased to report that tax revenues for the first quarter of 2007 have overperformed by 12 percent, compared to staff's more conservative expectations.

Consistent with their commitment to fiscal discipline, the authorities are taking steps to address problems in health and energy sector finances, to ensure that these will not require additional transfers from the budget later in the year. In this context, Health Insurance Fund (HIF) arrears were cleared in 2006, while non-HIF central government arrears will be kept close to their end-2004 level. In the same vein, the authorities put a lot of emphasis on short-term expenditure rationalization, which goes to the core of their fiscal program. For this the authorities seek IMF assistance.

In light of the strong budget position, in 2007 the authorities are repaying around EUR 180 million of Macedonia's external debt, by drawing down part of the Government's significant foreign currency deposits. This will improve the structure and level of the public debt and will create important interest savings in the budget.

Looking forward, fiscal policy will continue to be the main policy tool to ensure macroeconomic stability and debt sustainability. The authorities stand ready to tighten the budget in the second half of 2007 if risks to meeting the fiscal target emerge or the current account deteriorates. To prevent spending one-off revenues, they will cap the contribution of the telecom dividend, which is also consistent with their plan to liberalize telecommunications.

Exchange rate and financial sector

The National Bank of the Republic of Macedonia (NBRM) continues to support the economic program by maintaining a de facto pegged exchange rate regime backed by an adequate level of international reserves. The exchange rate serves well as a nominal anchor, and in combination with a prudent fiscal stance has helped contain inflation at low levels. Average inflation increased to 3.2 percent in 2006, largely due to one-off factors, including an increase in excises and in household electricity prices last September. Central bank interest rates remain stable at around 5½ percent. Deposits in local currency and credit to the private sector grew by 36 percent and 30 percent respectively. Macedonia's external position continued to improve, with stronger exports in virtually all sectors offsetting the higher import bill for investment goods. This, also supported by buoyant capital inflows, allowed the central bank to further increase its international reserves to €1.4 billion.

The authorities remain committed to safeguarding the NBRM's independence and strengthening its financial soundness. To this effect, the law on the NBRM was amended, allowing it to retain 70 percent of its profits when general reserves are below the statutory limit, and then 15 percent after that.

In order to promote financial market development and to improve its soundness, the authorities have prepared a comprehensive revision of the legal framework in line with international best practice. Along with enhanced licensing requirements, the new Banking law strengthens bank governance, increases minimum capital requirements, and tightens provisions on connected lending. It establishes a clear framework for consolidated supervision and for corrective action and/or resolution of weak or insolvent banks. The new law protects the central bank's decision-making powers in the areas of banking licensing, receivership and bankruptcy from reversal by the courts. It also allows foreign bank branching, which in the authorities' opinion will enhance competition and deepen financial intermediation.

In light of increasing credit growth, in particular lending denominated in or indexed to foreign currency, the NBRM took steps to strengthen banking supervision by tightening prudential guidelines for bank lending. They also improved the tax treatment of banks' loan loss provisions by making specific provisions fully tax-deductible. Furthermore, the NBRM has started the implementation of its Supervisory Development Plan, which aims to migrate to a more risk-based, anticipatory approach to banking supervision. Actions were taken to improve the NBRM's supervisory capacities. To this effect the NBRM has increased the resources of the supervision and banking regulation department, and stands ready to add more resources if needed.

Attracting FDI and improving the business climate

Macedonia has made substantial progress on the structural reform front, however the authorities recognize that it is time for the next generation of reforms. While the reform agenda remains broad and ambitious, regulatory reform, liberalization of telecommunications and improving the business environment are at the top of this agenda. Attracting greenfield foreign direct investment by leading international companies is a key objective of the authorities' economic program. In 2007, they will formulate a national program to stimulate investments, which will identify priority measures and activities necessary to attract high quality FDI for the period 2007-2010.

In close consultation with the business community, and drawing on the expertise of the World Bank, the authorities introduced the “regulatory guillotine” initiative, in November 2006. This initiative aims at simplifying the regulatory regime and improving the quality of regulations affecting business activity. Under this process, all laws and by-laws regulating economic activity are being currently reviewed and the unnecessary ones will be abolished by end-September 2007.

The authorities strongly believe that strengthening the legal system, property rights, and contract enforcement is key to achieving sustained private sector-led growth and improving the business climate. In this regard, they plan to complete full registration of real estate property and land by end-2008. This will provide legal security to investors and will allow for use of land as collateral, which will help to expand credit. In addition, they will improve contract enforcement by reducing the backlog of court cases.

One of the centerpieces of the reform program, which the authorities believe will have a major impact on the business environment, remains the ambitious judicial reform. Effective implementation of several new laws, including the Law on Enforcement, the Law on Courts, and the Law on Misdemeanors, will increase the independence and the efficiency of the country’s judiciary. Last but not least, the authorities remain committed to further liberalize the labor market by reducing the labor wedge and promoting part-time work.