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Former Yugoslav Republic of Macedonia: Third Review Under the Stand-By Arrangement and Request for Rephasing of Access—Staff Report; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Alternate Executive Director for the former Yugoslav Republic of Macedonia

In the context of the third review under the Stand-By Arrangement and request for rephasing of access, the following documents have been released and are included in this package:

- The staff report for the Third Review Under the Stand-By Arrangement and Request for Rephasing of Access, prepared by a staff team of the IMF, following discussions that ended on November 17, 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 February 11, 2008. 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 February 27, 2008 updating information on recent developments.

- A Press Release (PR) summarizing the views of the Executive Board as expressed during its February 27, 2008 discussion of the staff report that completed 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.

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INTERNATIONAL MONETARY FUND

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Third Review Under the Stand-By Arrangement and Request for Rephasing of Access

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

Approved by Juha Kähkönen and Scott Brown

February 11, 2008

Executive Summary

Economic recovery continues. Growth has increased to around 5 percent, reserves are growing, fiscal targets have been met due to strong revenue overperformance, and interest rates have fallen towards those in the Euro area.

Macroeconomic policies are supporting the recovery. The fiscal deficit target will increase from 1 percent of GDP in 2007 to 1½ percent of GDP in 2008. Changes include tax cuts and substantial increases in public investment, but also higher current spending on pensions and public wages. The new draft central bank law preserves the NRBM's independence, and should come closer to EU norms.

Structural reforms are aimed at attracting foreign direct investment and boosting growth. These include lower taxes, improved revenue administration, simpler business regulations, strengthening of property rights, and telecoms liberalization.

Program issues. All quantitative performance criteria through end-September were met, and most structural conditionality has been met too (LOI Tables 1 and 2). All end-December performance criteria also seem likely to have been met, though final data will only be available by the time of the Board discussion. The authorities continue to treat the arrangement as precautionary, but request a rephasing of remaining purchases in light of the delay completing this review (LOI Table 5).

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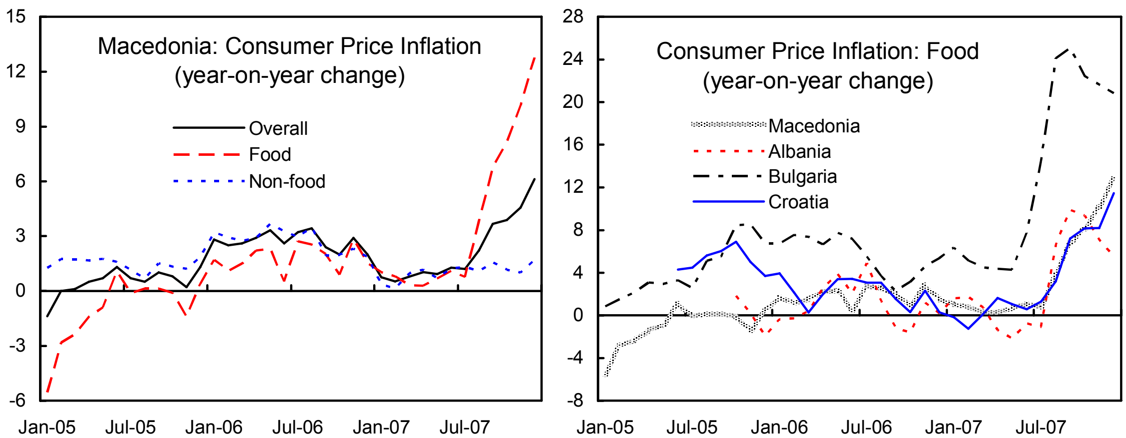
I. Recent Developments

1. **Economic recovery is in its sixth year (Figure 1, Tables 1-2, ¶3):**[1]

- **Output growth for 2006 has been revised upwards to almost 4 percent** (the true growth rate might have been even higher). For 2007, 5 percent growth is estimated, closer to the regional average. Exports are increasing strongly, led by iron and steel, and food products. Rapid credit growth is boosting domestic demand, employment and real wages, leading to higher imports. But the official unemployment rate (arguably overstated) remains high, at 35 percent.

- **Inflation has increased to 6 percent** (its highest in five years). So far, this is due to higher food prices (more than one-third of the basket), and so does not seem to represent a permanent upward shift in the inflation trend.



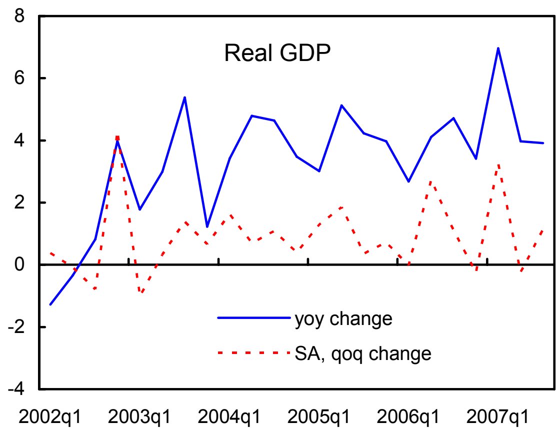
Sources: Eurostat; and national authorities.

2. **The external position has been comfortable (Figures 2-3, Table 3)**. Though the trade deficit has steadied at around 20 percent of GDP, this continues to be offset by foreign currency sales to exchange bureaus (recorded as private transfers), so that the current account deficit is only 2 percent of GDP. Increased portfolio and foreign direct investment have been used to repay external debt (€200 million to the Paris Club, World Bank, IMF and EIB) and to increase international reserves to €1.5 billion—higher than the program projection, but now slightly below 4 months of imports, given the rise in imports. With the real exchange rate depreciating slightly, competitiveness issues remain more structural than price-related (as described in the last Article IV (Country Report 06/344)).

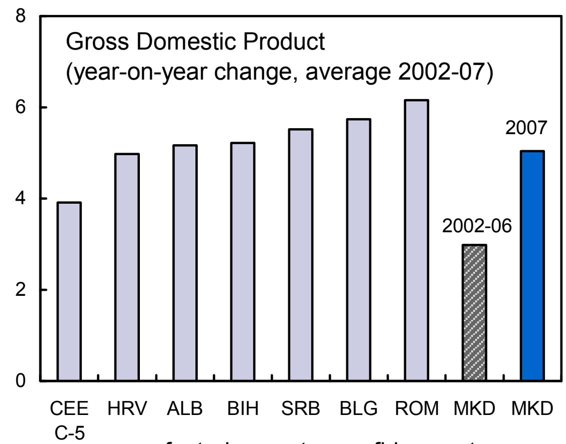
[1] Numbers refer to LOI paragraphs.

Figure 1. FYR Macedonia: Real Sector Indicators, 2002-07

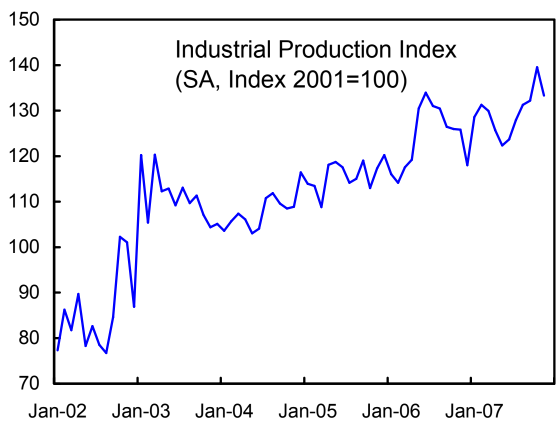
Official data show growth improving...



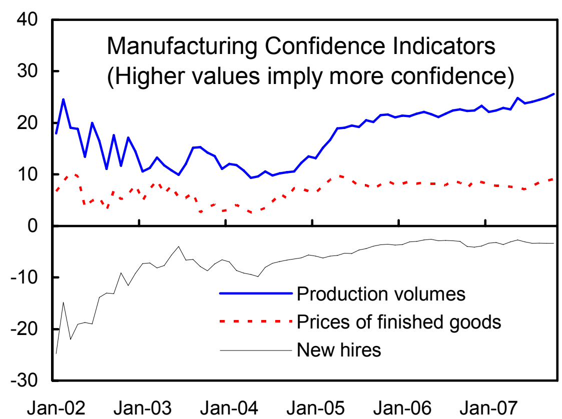
...closer to the regional average...



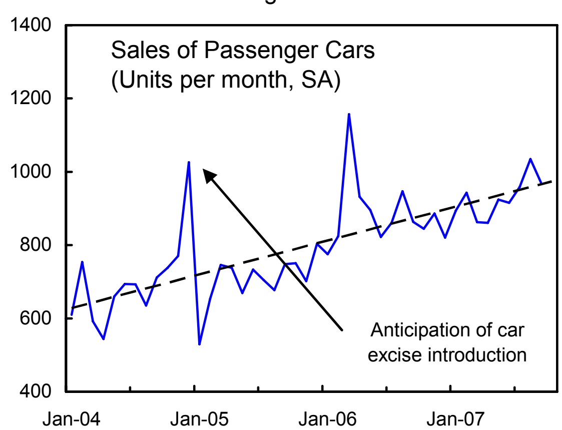
...with industrial production recovering...



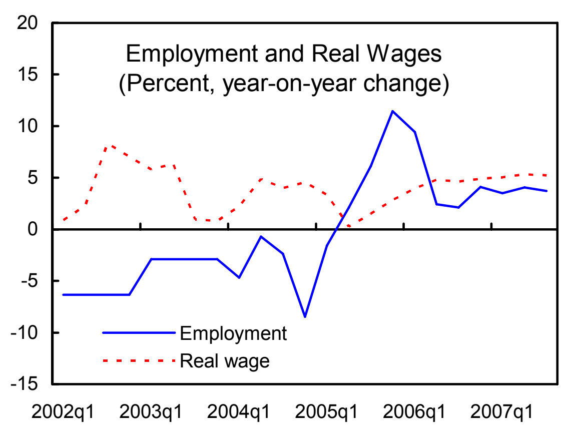
...manufacturing sector confidence strong...



...rising car sales...

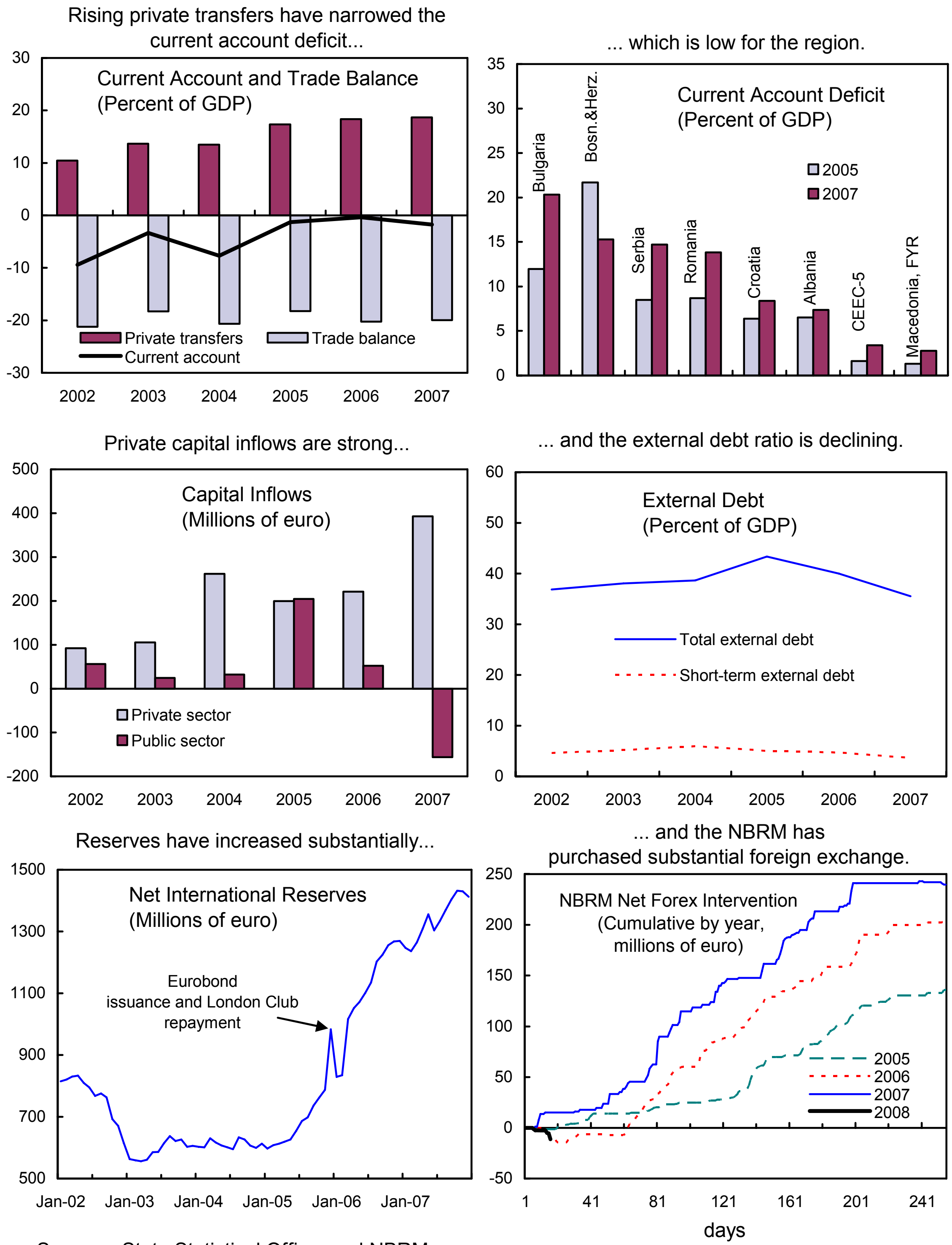


...and growth of employment and real wages.



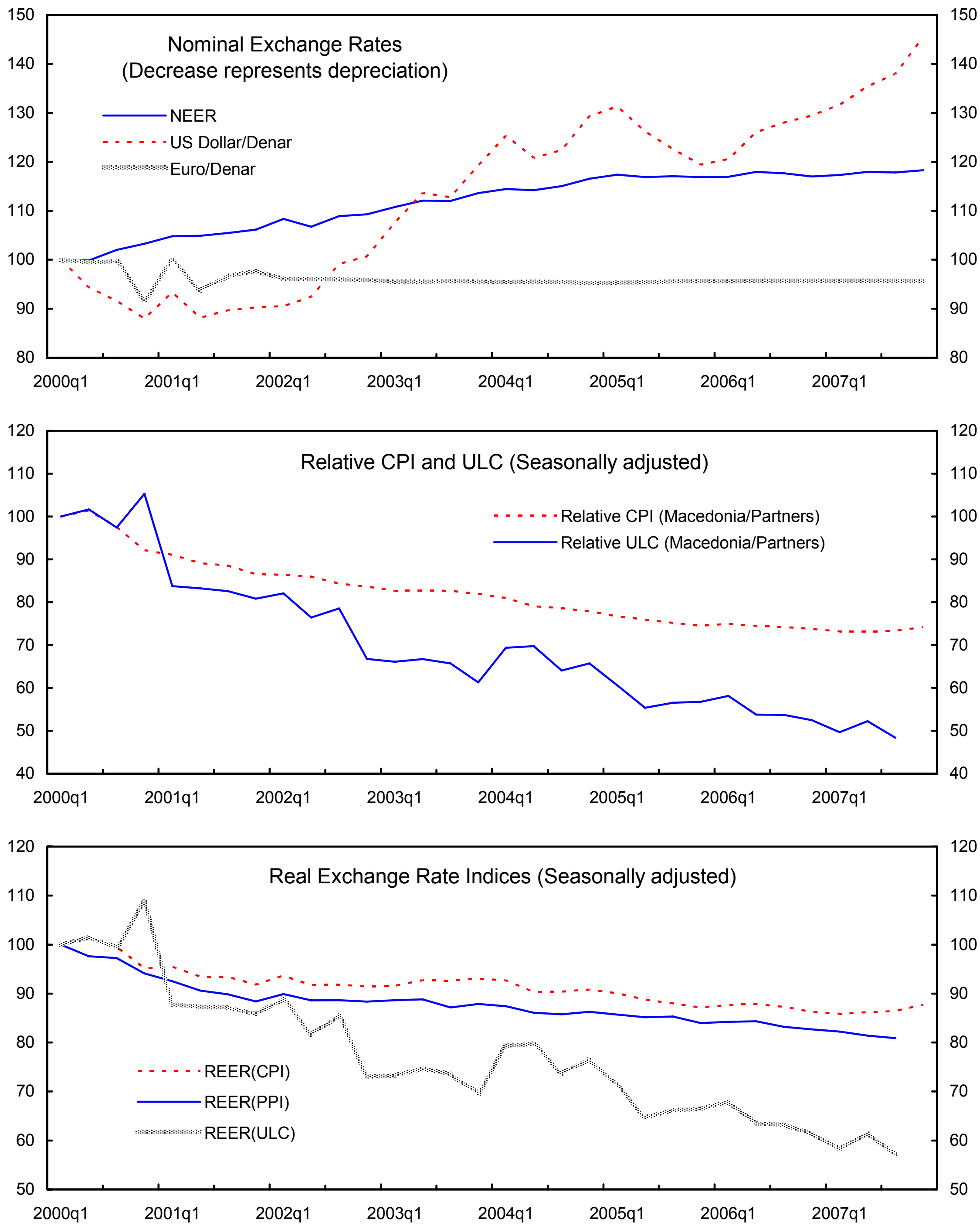
Sources: State Statistical Office; NBRM; and IMF staff estimates.

Figure 2. FYR Macedonia: External Sector Indicators, 2002-07

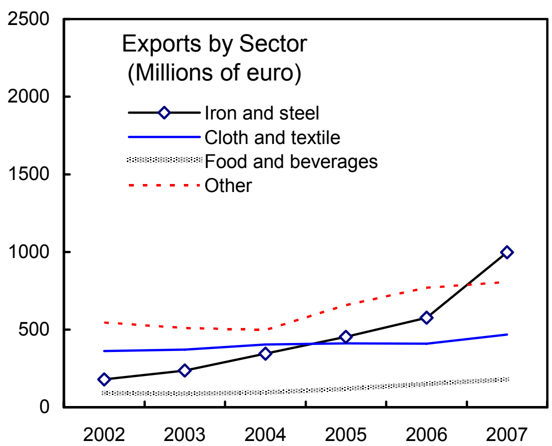


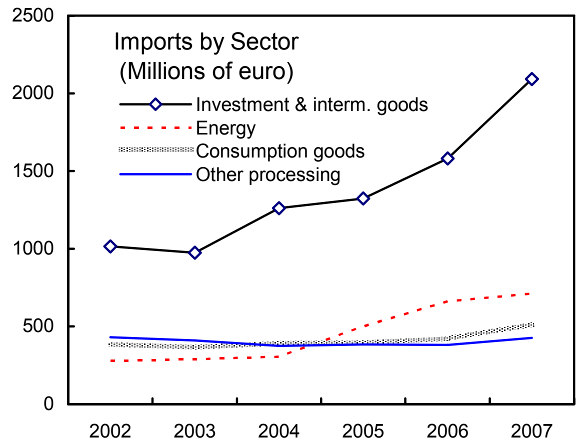
Sources: State Statistical Office; and NBRM.

Figure 3. FYR Macedonia: Exchange Rate Indicators, 2000-07
(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.

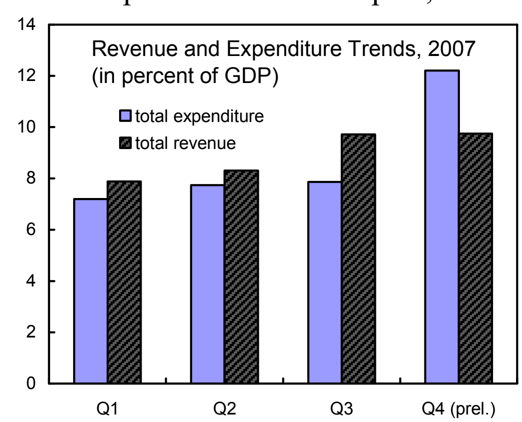




Sources: SSO; NBRM and IMF staff estimates.

3. **Monetary policy has facilitated the recovery (Figures 4-5, Tables 4-5)**. During 2007, the *de facto* exchange rate peg to the euro has not faced pressure. The central bank has lowered interest rates below 5 percent, low by historical standards, and only slightly above ECB rates. Interest rate spreads remain high (at around 5 percent), but have fallen due to increased competition. Broad money growth is 30 percent, with the denar deposit share increasing slightly. Credit growth is even higher (40 percent), but from a low base as private sector credit as a share of GDP is low for the region. Financial indicators remain sound, with the share of non-performing loans falling and bank profitability rising (Figure 6, Table 6). Stock market volatility has increased, but with little macroeconomic impact.

4. **The central government deficit target for 2007 was easily met (Table 7, ¶8)**. Preliminary data show that the central government ran a 0.6 percent of GDP surplus, well above the 1 percent deficit target for the year. Revenues ended the year 3 percent of GDP above program, driven by stronger VAT and CIT collections (due to improved tax administration, elimination of the double deduction for investment, and higher than expected profits in 2006). The impact on the deficit was partially offset by higher spending (especially in the fourth quarter), through the passage of two supplementary budgets.

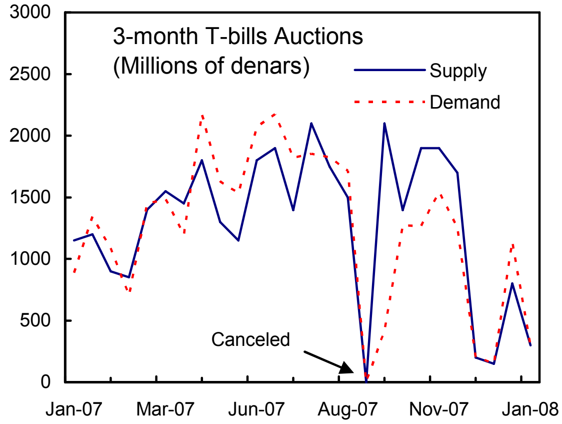


Source: Ministry of Finance.

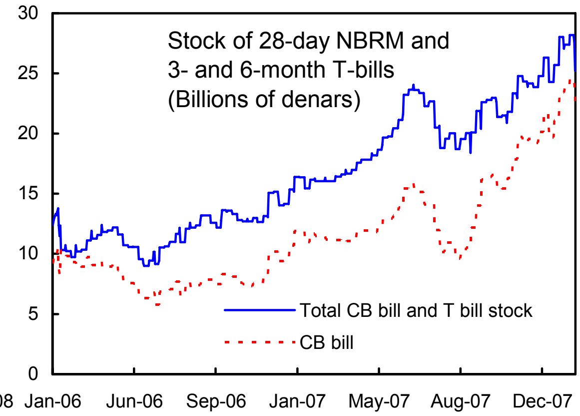
5. **Though improved international integration could boost business confidence, prospects here are finely balanced.** The European Commission's November 2007 progress report was generally positive on economic reform (except for unemployment), but stressed the need for a more inclusive and constructive political dialogue. No date for starting

Figure 4. FYR Macedonia: Financial Market Developments, 2006-07

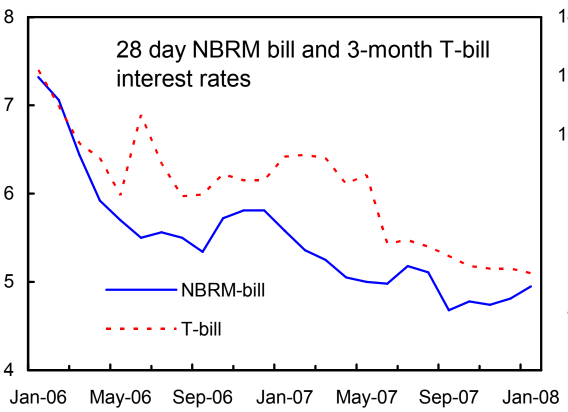
Demand for T-bills has fallen in line with the cap and participation limits...



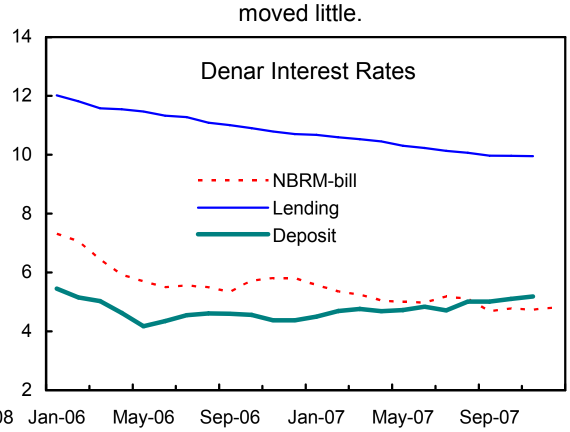
... forcing the NBRM to issue more CB-bills to maintain sterilization levels.



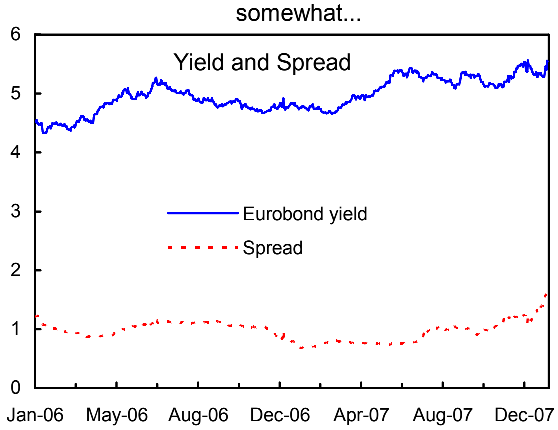
Official interest rates have fallen...



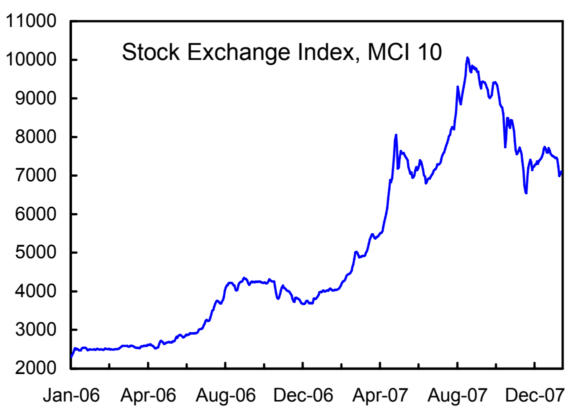
... but bank lending and deposit rates have moved little.



The eurobond spread has widened somewhat...

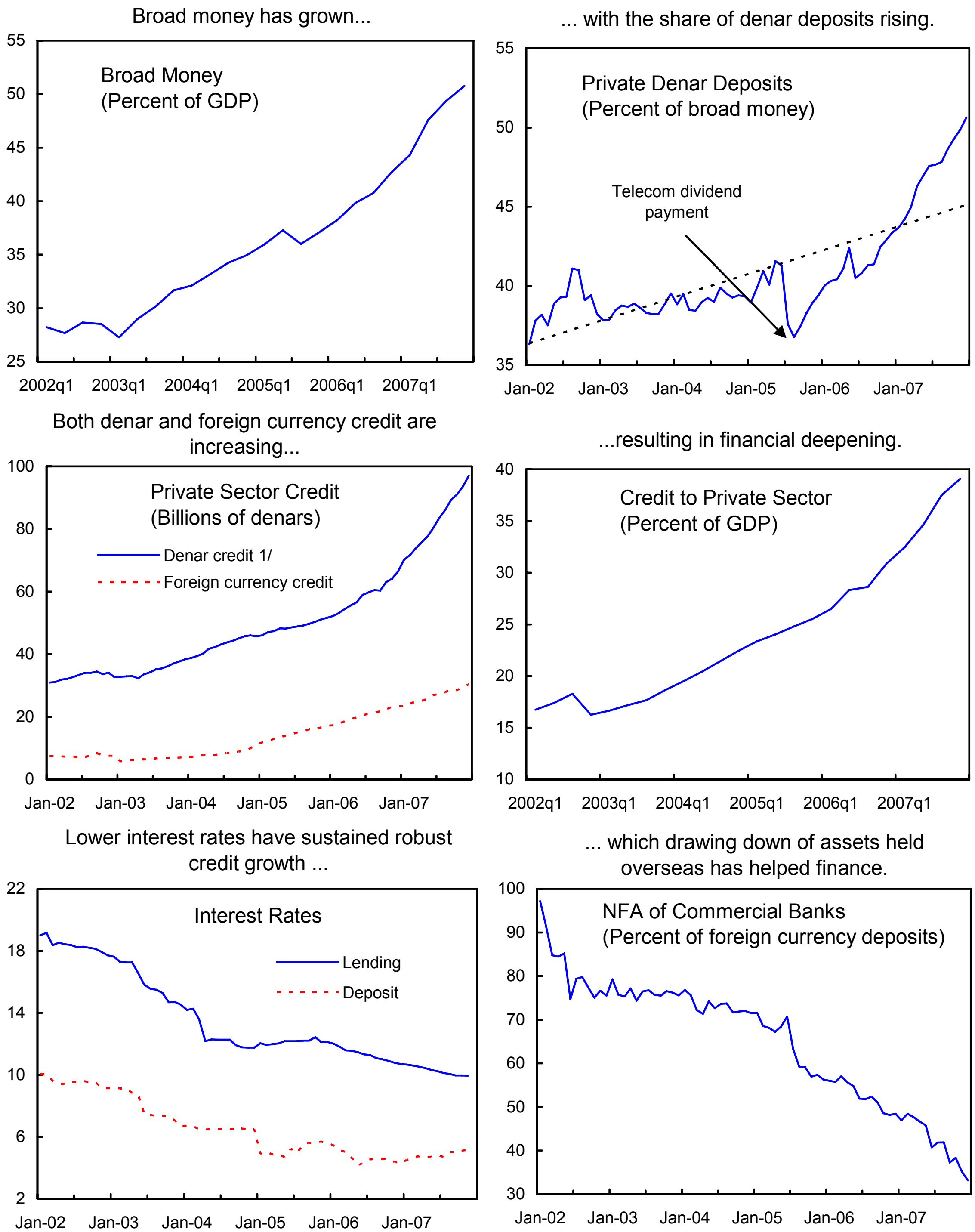


... and stock prices have been volatile.



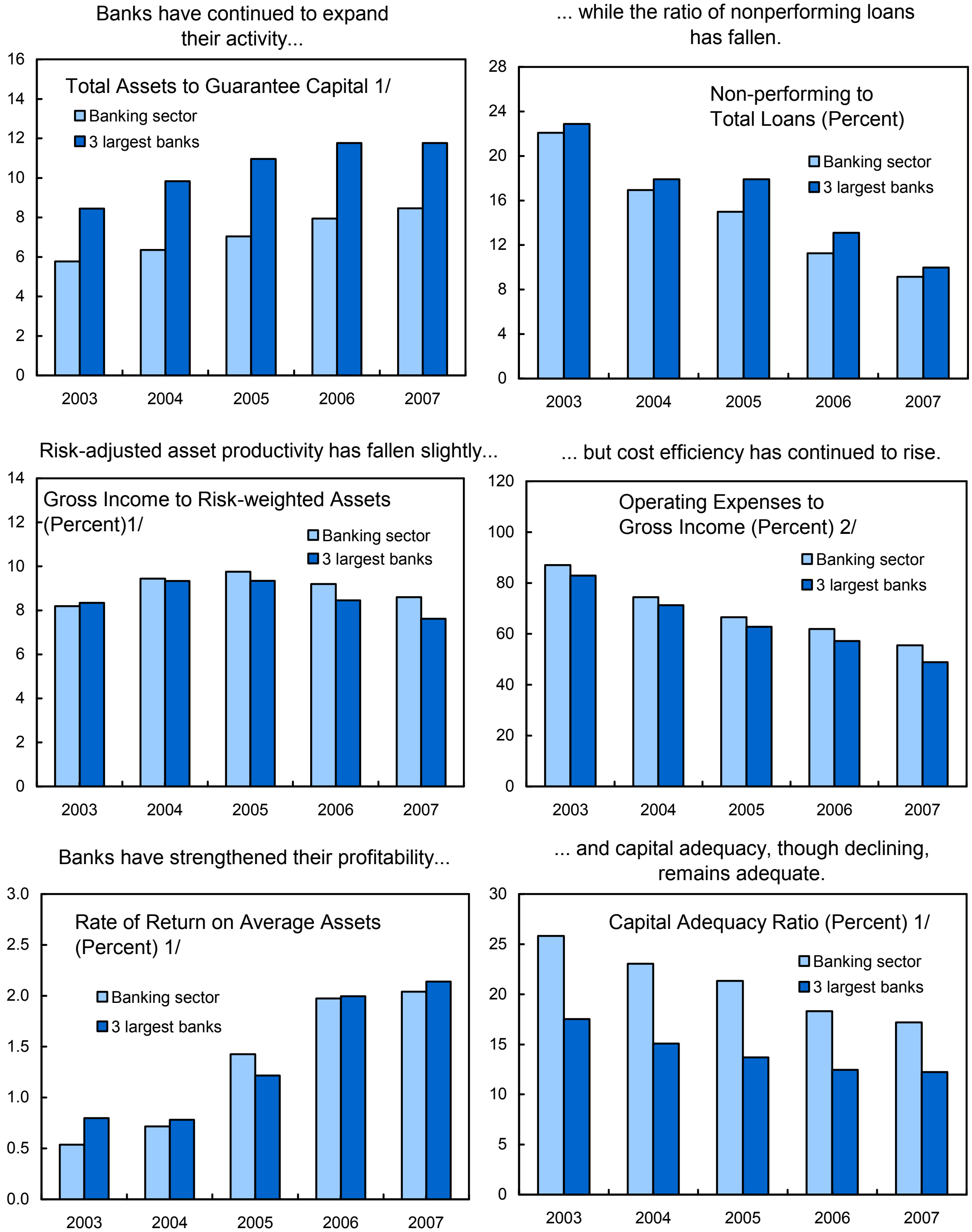
Sources: NBRM; and IMF staff estimates.

Figure 5. FYR Macedonia: Money and Credit Developments, 2002-07



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, 2003-07



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

accession negotiations was recommended. NATO membership, to be determined in April 2008, is the next challenge.

II. Medium-Term Outlook

6. **Recovery is expected to continue (¶6)**. Growth is projected to remain at around 5 percent in 2008, with credit growth and fiscal easing stimulating demand, and output responding given the considerable slack in the economy. The authorities believe that growth could be higher, but this will depend on intensified structural reforms, greater foreign direct investment, and improved business confidence (which progress in EU (and NATO) accession should encourage). Though the baseline projection has the exchange rate anchor pulling inflation back down to 2 percent by the end of the year, this hinges on the output gap dampening any second-round effects, and on an unwinding of recent food price increases.

Selected Foreign Direct Investment Projects in Macedonia (2007 and beyond)

Sector	Amount (Euro mns)
Food/Beverages	
Agrokor (food processing)	200
Swedmilk (dairy)	20
Soli (beverages)	15
Mlekara Bitola/Salford (dairy)	25
Real Estate Development	
Sun City (residential)	100-120
ERA (business/shopping)	Up to 95
Auto Parts	
Johnson Controls (parts)	20-25 (first phase)
Johnson Matthey (catalytic converters)	50 (first phase)
Banking/Insurance	
Vardar/Triglav (insurance)	40
Orhidska Banka/Société Générale (banking)	20
Other	
Metals	Up to 120
EVN (power distribution)	Up to 100
VIP Mobile/Mobilkom Austria (phone)	30-50

7. **The current account deficit is projected to widen, but increased capital inflows should allow continued international reserve accumulation**. Though export growth is expected to remain strong, more rapid import growth (reflecting increased government and private investment) and worsening terms of trade (higher oil import and lower metals export prices) increase the trade deficit to 25 percent of GDP. Repatriation of the telecom dividend and slower growth in private transfers should raise the current account deficit to close to 6 percent of GDP in 2008, before falling back to 4 percent of GDP later as new investment boosts export supply. However, the capital account improves by even more, as the large debt prepayments of 2006-07 come to an end while, consistent with recent developments,

international integration and the improved business environment raise foreign direct investment to 4½ percent of GDP. External debt (already relatively low at 35 percent of GDP) continues to fall over the medium term.

Box 1. Implications of Recent International Financial Tensions

The staff has remained in close contact with the Macedonian authorities and financial sector representatives regarding potential spillovers from global developments.

The direct impact is likely to remain limited:

- Macedonian banks do not seem exposed to sub-prime lending overseas.
- The domestic mortgage market is underdeveloped (less than 3 percent of GDP).
- Foreign bank presence is low compared to the region.
- Banks rely mainly on domestic deposits rather than international credit lines to fund lending.

However, the indirect impact could grow. Lower world growth could worsen the trade deficit, either through export demand (60 percent goes to the EU), falling terms of trade (metals are 40 percent of exports), or weaker remittances. While increasing recently, foreign direct investment could be sensitive to tighter international credit markets.

On balance, the staff believes that while there are greater downside risks (which the coming Fourth Review mission will discuss), the macroeconomic framework remains appropriate.

8. **Aside from the impact of recent international financial developments (Box 1)**, the main risks to this relatively favorable outlook remain the threat of political instability in the region, and obstacles on the path to EU accession and NATO membership. Main domestic economic challenges include: (i) reducing unemployment and raising both the actual and potential growth rate; and (ii) ensuring that despite the fiscal stimulus at the end of last year and prospective rapid credit growth, the recent uptick in (food price) inflation is contained.

III. PROGRAM DISCUSSIONS

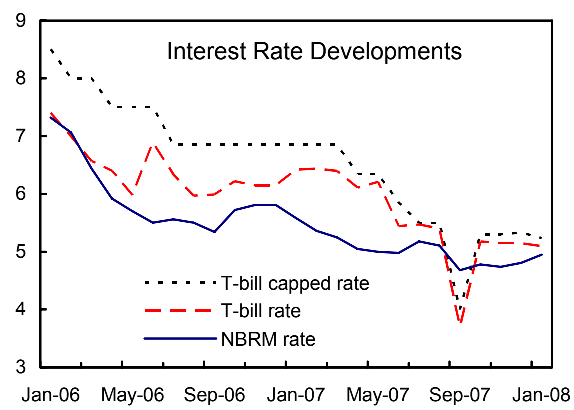
9. **Discussions focused on implementing the program strategy**: the monetary and fiscal policies underpinning the macroeconomic framework, and the structural reforms (base harmonization and banking supervision in the program, but many other micro-reforms too) that will boost growth and reduce unemployment. Extensive discussions on the central bank law, the NBRM’s use of treasury bills for sterilization, and on how to reconcile the authorities’ ambitious initiatives with next year’s deficit target resulted in a slight delay in completing this review, to ensure these issues were resolved satisfactorily.

A. Monetary Policy

10. **The monetary program assumes continued rapid credit growth, and increases in international reserves (¶20)**. Corrected for the expected large telecom dividend payment, denar deposits are projected to grow faster than euro deposits. Responding to increased competition, banks are optimistic about credit growth. They plan to finance this with deposit growth, drawing down foreign assets held abroad, and retained earnings. The NBRM will continue sterilizing excess liquidity, and the government's large deposits at the central bank will share some of the sterilization costs.

11. **The authorities have drafted a new central bank law (with MCM and LEG technical assistance), as part of the Government's EU harmonization strategy (¶21)**. The new law maintains the NBRM's independence, keeps price stability as its main goal, and strengthens governance by more clearly defining the powers of the Governor and the NBRM Council. Responsibility for determining the exchange rate regime was discussed extensively: previously the NBRM's responsibility, this will now be shared with the MOF. The ECB and the European Commission are reviewing the law; submission to Parliament by March is a new structural performance criterion.

12. **The authorities' decision to end the use of treasury bills for monetary policy purposes should reestablish the NBRM's operational independence**. During the summer, the MOF reduced the maximum interest rate it would accept on these papers, undermining the NBRM's ability to sterilize increases in the money supply. To restore its control of short-term interest rates, it was agreed that the NBRM would now issue its own papers: longer-term bills to sterilize "structural liquidity" and shorter-term bills for day-to-day smoothing of liquidity. The government will issue its own paper (mainly three-month maturity) for fiscal purposes, without setting a maximum interest rate.



Sources: NBRM; and Ministry of Finance.

B. Fiscal Policy

2008 Budget

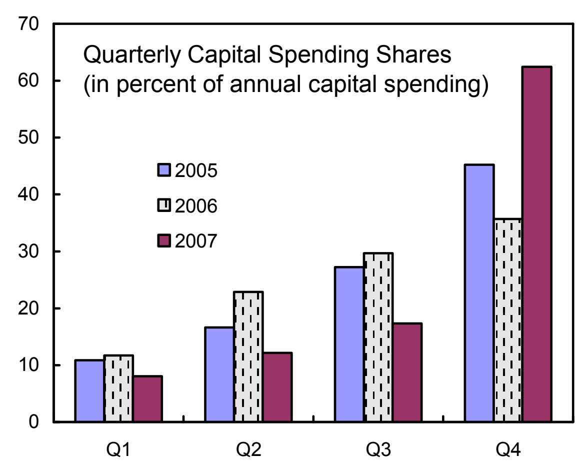
13. **The central government deficit target is increased to 1½ percent of GDP (from 1 percent in 2007), consistent with program commitments to safeguard macroeconomic stability and debt sustainability (¶9)**. The authorities argued for an even larger deficit to provide more fiscal space for infrastructure investment (especially roads), while still being consistent with debt sustainability. However, the staff noted that this year's experience

pointed less to insufficient "fiscal space" than to problems in project selection and implementation. Macroeconomic considerations—the recent rise in inflation and the fiscal impulse at the end of 2007—also called for caution.

Box 2. 2008 Budget—Main Elements

- Personal and corporate income tax rates reduced from 12 to 10 percent.
- 10 percent public sector wage increase.
- New teachers for compulsory secondary education.
- Increased agricultural subsidies.
- VAT rate for computers, medicines, and public transportation cut from 18 to 5 percent.
- Full year effect of minimum health contributions based on average wage of the economy, instead of average wage of the sector.
- Transition costs of the second pillar pension system.
- Pension indexation changed from inflation to average of inflation and wage growth. Further pension increase announced soon *after* Parliament adopted the budget.
- Simplified corporate income tax for small businesses.
- Decentralization to municipalities of education, child and elder care, and culture (¶17).
- Substantial increase in public investment (roads, health equipment, computers, and embassies).

14. **Discussions focused on the authorities' plans for significant increases in government wages and investment (¶10-11)**. In August the government announced a 34 percent increase in public sector wages, 10 percent for each of the next three years, arguing this was needed to retain top performers. The staff expressed concern that a pre-announced increase over three years would increase budget rigidity, and argued for greater use of wage decompression. However, in the end the staff accepted the increase, given the authorities' pledge to fit it within the 1½ percent of GDP deficit target. Concerning investment, it will be important to ensure that the substantial increase planned is of high quality and that, unlike in previous years (and especially so in 2007), capital spending is less heavily concentrated in the fourth quarter.



Source: Ministry of Finance.

15. **After Parliament passed the budget, the government announced that pensions would be increased by an average of 15 percent, not the 6 percent implicit in the budget**. The new indexation formula (half wages, half consumer price inflation) would be followed thereafter. The authorities argued that the increase was needed to keep up with past wage growth, and that stronger than anticipated contributions would finance the ½ percent of

GDP fiscal cost, safeguarding the 2008 deficit target. While accepting this latter point, the staff expressed concern at the lack of consultation in making this policy decision, the need to analyze the implications for pension system solvency, and the deterioration in budget quality that this permanent increase in current spending would cause.

Tax administration

16. **The authorities' tax administration reforms (with financing from the Netherlands, and FAD assistance) are increasing revenues (¶12-13)**:

- **The Public Revenue Office** is registering additional taxpayers, improving taxpayer services, recovering tax arrears, and improving audits.

- **The authorities have developed a strategy harmonizing personal income tax and social security contributions** (meeting, with delay, an end-September 2007 benchmark). From April 2008, health contributions for part-time workers will be calculated according to actual earnings, rather than assuming full-time work (structural performance criterion). This sharp reduction in the labor tax wedge should promote formal sector activity and reduce unemployment, as will the commitment to phase out minimum bases for social contributions (currently these are 65 percent of the average wage, again discriminating against low wage earners), although this will only be introduced over three years, starting from 2009. The staff encouraged the authorities to incorporate food and transport allowances into the bases for both personal income taxes and social contributions, to make the tax system simpler and fairer, and to help finance the reduction in minimum contributions or to lower rates.

- **Next steps are to integrate collections** from the three social funds into one (structural performance criterion for April 2008), and ultimately into the PRO.

C. Structural Reform

Financial Sector

17. **The new banking law, adopted in May 2007, has strengthened the NBRM's supervisory authority**, and the transition from compliance- to risk-based banking supervision is proceeding well (¶22-23). The recent withdrawal of the license of a small bank underlines the importance the NBRM attaches to upholding fit and proper standards, though the governor now faces a motion in Parliament censuring him for his conduct. While financial soundness indicators are improving (Table 6), the coming FSAP update mission will make a fuller assessment of financial sector vulnerabilities and recent improvements in banking supervision.

Business Climate

18. **The authorities are focused on improving the business climate to attract foreign direct investment, and boost growth and employment (Figure 7, ¶24-28)**. The World Bank's Doing Business 2008 Report identified Macedonia as one of the top five reformers, reflecting its elimination of the minimum capital requirement for starting a business, a faster process for obtaining construction permits, cuts in corporate income tax rates, and simplified tax payment procedures. However, other measures of reform are mixed. And the government's decision to cancel the sale of the Negotino power plant, despite electricity shortages in the region, has meant forgoing a substantial increase in foreign direct investment.

Electricity

19. **The government has prepared a plan to improve electricity sector finances, and eliminate budget subsidies, drawing in part on consultations with the World Bank and other donors (¶27)**:

- Starting January 2008, large users will pay import prices for electricity, not the much lower regulated price. This saves the budget ½ percent of GDP, but is discriminatory.

- The electricity distribution company (privatized under the program by the previous government, to the Austrian company EVN) will also have to pay import prices (not the regulated price) for losses above that allowed by the regulator. EVN will not be allowed to increase prices, but will be expected to offset the cost increase through improved payment discipline. This could result in a protracted dispute with one of the main foreign investors.

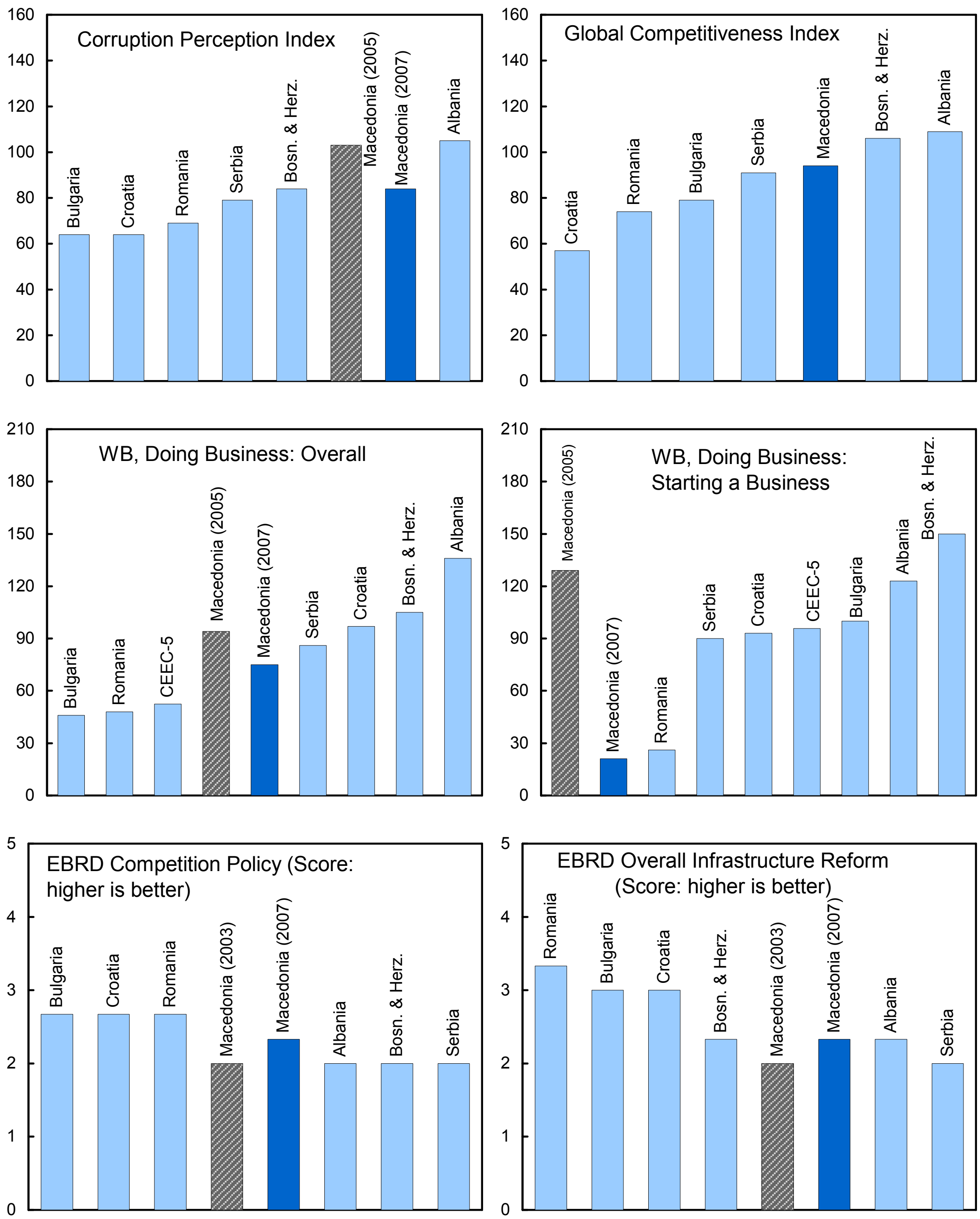
- There are provisional plans to liberalize prices for enterprises over the next 2-4 years, but household liberalization is only scheduled for 2015. Phasing in a gradual price increase could avoid a sharp shock, and help reduce electricity demand.

Though the plan makes significant budget savings, in light of these potential shortcomings, the authorities continue to discuss possible improvements with the World Bank and EU.

IV. Staff Appraisal

20. **Macroeconomic conditions continue to improve**. Through September, all of the program's quantitative performance criteria were met; this is expected to have continued through December (final data should be available before the Board meeting). The fiscal position continues to strengthen, international reserves are increasing, and central bank interest rates remain low. While inflation is projected to come down, risks from higher food prices together with higher public sector wages and increased domestic demand need to be

Figure 7. Indicators of Institutional Quality and Reform, 2007 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 181 countries. The global competitiveness index covers 125 countries. The World Bank indices cover 178 countries. The EBRD indices' maximum score is 4.33.

monitored. Given the exchange rate anchor, this may necessitate increased sterilization and continued prudent fiscal policy. Potential instabilities from recent international financial tensions and from regional political developments should continue to be monitored.

21. **Fiscal performance in 2007 was strong**. The authorities should be commended on their reforms of revenue administration, which have increased collections substantially. With domestic demand buoyant, the resulting fiscal overperformance is welcome, as it has helped contain inflation and current account pressures. However, the authorities need to address problems with the volatile execution of spending, particularly for public investment.

22. **This year's budget should maintain macroeconomic stability**. Strong performance in 2007 together with measures to reduce transfers to the energy sector has made possible ambitious cuts in personal and corporate income taxes, and increases in pensions, public investment, and government wages, while remaining within the 1.5 percent of GDP deficit target. However, unless there is a repeat of last year's overperformance of the budget target, this would represent a significant fiscal impulse. Should inflation or the current account deficit widen beyond projection, the authorities should stand ready to adjust their plans.

23. **However, changes in budget quality have been mixed**. Pre-announced increases in pensions and public sector wages have increased current spending and reduced budget flexibility. The announcement of an additional pension increase after the budget was passed also raises questions over the integrity of the budget process. Increasing agricultural subsidies at a time when higher food prices are boosting farm incomes could also be questioned. These measures are also hard to reconcile with the government's manifesto commitment to cut government spending by 2 percent of GDP. On the positive side, increased public investment should improve the quality of the budget, provided that projects are selected wisely, and implementation problems overcome.

24. **The decision to link health contributions for part-time workers to hours actually worked, from April 2008, will reduce the labor tax wedge**. However, the recent increase in social contribution revenues could have been used to bring forward the planned reduction (or even abolition) of minimum bases for social contributions, a substantial impediment to job creation in the formal sector, particularly for low wage earners. Given Macedonia's high unemployment rate, it is unfortunate that this opportunity was missed.

25. **The authorities are to be commended for taking time to improve the quality of their revised central bank law**, and for sending it to the ECB and to the European Commission for review, to improve consistency with the EU *acquis*. Ending the use of treasury bills for monetary policy purposes should reduce disagreements over the setting of short-term interest rates. Given the recent pickup in inflation, this is especially important for ensuring that the central bank can fulfill its price stability objective. The new central bank law (and the new banking law) include provisions that enhance the accountability of the NBRM. Such provisions need to be followed to protect the central bank from political interference, and to ensure its independence as banking supervisor and regulator.

26. **The electricity sector's fiscal problems are being addressed**, through the elimination of subsidies for large users. However, the resulting selective price increases distort incentives and may appear somewhat arbitrary, while cancelled privatization has resulted in substantial foregone private investment. Closer cooperation with the World Bank can help these and other reforms, such as improving payment discipline and strengthening the social safety net.

27. **Progress on broader structural and institutional reforms will help the authorities meet their economic objectives**. Business regulations have been simplified and progress made in property registration, as recognized in the World Bank's Doing Business report. To sustain recent revenue gains, the authorities should keep to the April 2008 timetable for integrating social fund collections, and then to merge these with the PRO. Success in strengthening international anchors—especially progress towards EU accession—and in promoting domestic political stability can magnify these reforms' impact.

28. **The authorities' Fund-supported program is working.** The authorities' record of fiscal discipline, macroeconomic stability, and structural reform is producing results and deserves international approval. Accordingly, the staff supports the authorities' request for rephasing of the program, and recommends completion of the Third Review.

Table 1. FYR Macedonia: Selected Economic Indicators, 2004–08

	2004	2005	2006	2007		2008
			Est.	Prog.	Est.	Proj.
Real economy	(Percent change)					
Real GDP	4.1	4.1	3.7	4.5	5.0	5.0
Consumer prices						
period average	-0.4	0.5	3.2	2.5	2.2	4 to 5
end of period	-2.1	1.6	3.0	3.0	6.1	2.0
Real wages, period average	4.4	2.0	4.1	...	4.8	...
Unemployment rate (average)	37.2	37.3	36.0	...	35.4	33.0
Government finances	(In percent of GDP, unless otherwise indicated)					
Central government balance	0.7	0.3	-0.6	-1.0	0.6	-1.5
Revenues (including grants)	36.5	35.6	33.1	32.6	35.1	35.1
Expenditures	35.8	35.3	33.7	33.6	34.4	36.6
Central Government debt 1/						
Gross	36.6	39.5	34.3	31.8	27.3	25.7
Net	32.5	31.9	25.4	25.3	26.2	23.5
Money and credit						
Broad money (M3, percent change)	16.1	14.9	24.5	20.8	32.0	28.3
Short-term lending rate (percent)	11.8	10.8	9.5	...	8.6	...
NBRM short-term rate (28-day bill, end-period)	10.0	8.5	5.8	...	4.8	...
Balance of payments	(In millions of Euro, unless otherwise indicated)					
Exports	1,343	1,642	1,903	2,090	2,453	2,690
Imports	2,237	2,496	2,923	3,179	3,576	4,161
Trade balance	-894	-853	-1,021	-1,089	-1,123	-1,471
(in percent of GDP)	-20.7	-18.3	-20.2	-20.4	-20.5	-24.8
Current account balance	-334	-62	-19	-173	-128	-343
(in percent of GDP)	-7.7	-1.3	-0.4	-3.2	-2.3	-5.8
Overall balance	-19	341	296	89	114	251
Official gross reserves	717	1,123	1,417	1,482	1,523	1,774
(in months of imports)	3.0	4.1	4.1	4.4	3.8	4.1
External debt service ratio 2/	14.7	13.0	19.2	17.8	18.3	11.9
External debt to GDP ratio (percent)	38.7	43.7	40.0	40.3	35.7	37.2
Exchange rate						
Denars/Dollar (average)	48.6	49.3	48.8	...	44.7	...
Denars/Euro (average)	61.3	61.3	61.2	...	61.2	...
Real effective exchange rate (CPI-based, percent change)	-1.4	-2.9	-1.5	...	-0.8	...

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/ Debt service due including IMF as percent of exports of goods and services. Excludes rollover of trade credits.

Table 2. FYR Macedonia: Macroeconomic Framework, 2005-12

(percentage change, unless otherwise indicated)

	2005	2006	2007		2008	2009	2010	2011	2012
		Est.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Real GDP	4.1	3.7	4.5	5.0	5.0	5.5	5.8	6.0	6.0
Real domestic demand	3.0	5.1	6.4	6.7	6.6	5.5	5.2	4.5	4.0
Consumption	2.6	4.7	4.9	5.3	5.1	4.7	4.3	4.5	4.3
Private	2.5	5.1	5.7	5.7	5.8	5.4	5.0	5.1	4.8
Public	3.0	3.3	1.8	3.5	2.0	1.5	1.5	1.5	1.5
Fixed investment	5.1	7.4	15.1	15.0	14.3	9.7	8.9	4.5	3.0
Private	4.0	8.2	16.0	17.0	14.5	11.0	10.0	4.8	3.0
Public	10.0	3.9	11.0	6.0	13.0	3.0	3.0	3.0	3.0
Exports (volume)	14.4	9.3	8.7	20.1	15.8	13.8	13.1	10.8	10.4
Imports (volume)	7.0	10.3	11.5	19.5	15.9	11.8	10.4	7.6	6.8
Contributions to growth	4.1	3.7	4.5	5.0	5.0	5.5	5.8	6.0	6.0
Domestic demand	3.5	6.0	7.6	7.9	7.9	6.8	6.3	5.4	4.8
Net exports	1.6	-2.0	-3.1	-2.9	-2.9	-1.3	-0.5	0.6	1.2
Statistical discrepancy	-1.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Central government operations (percent of GDP)									
Revenues	35.6	33.1	32.6	35.1	35.1	34.7	34.8	34.9	35.0
Expenditures	35.3	33.7	33.6	34.4	36.6	36.2	36.3	36.4	36.5
of which capital	3.8	3.0	3.7	4.1	5.9	4.3	4.0	3.8	3.5
Balance	0.3	-0.6	-1.0	0.6	-1.5	-1.5	-1.5	-1.5	-1.5
Savings and investment (percent of GDP)									
Domestic saving	19.4	21.4	20.8	20.8	18.8	19.5	20.3	20.3	19.9
o/w public	3.4	2.6	2.5	3.2	2.0	1.8	1.7	1.6	1.5
private	16.0	18.8	18.4	17.6	16.9	17.7	18.6	18.7	18.4
Foreign saving 1/	1.3	0.4	3.2	2.3	5.8	5.5	4.9	4.5	4.3
Gross investment	20.7	21.8	24.1	23.1	24.6	25.0	25.2	24.9	24.3
Consumer prices									
Period average	0.5	3.2	2.5	2.2	4 to 5	2.5	2.5	2.5	2.5
End-period	1.6	3.0	3.0	6.1	2.0	2.5	2.5	2.5	2.5
Memorandum items									
Gross official reserves (in million Euro)	1,123	1,417	1,482	1,523	1,774	1,989	2,174	2,369	2,585
Gross official reserves (in months of imports)	4.1	4.1	4.4	3.8	4.1	4.2	4.3	4.3	...
Gross central government debt (in billion denars)	113.1	106.0	104.3	91.4	93.5	99.5	106.1	113.2	121.0
Central government gross debt (in percent of GDP)	39.5	34.3	31.8	27.3	25.7	24.9	24.1	23.7	23.4
Central government net debt (in percent of GDP) 2/	31.9	25.4	25.3	26.2	23.5	22.1	21.6	21.4	21.3
Foreign direct investment (percent of GDP)	1.6	5.7	2.7	3.9	4.7	5.0	4.4	4.4	4.5
Nominal GDP (in billion denars)	286.6	308.8	327.8	335.3	364.1	400.1	439.8	477.3	516.0
Nominal GDP (in million Euro)	4,676	5,046	5,334	5,469	5,938	6,525	7,174	7,785	8,416

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

1/ Current account deficit.

2/ Gross central government debt minus central government deposits at the NBRM.

Table 3. FYR Macedonia: Medium-Term Balance of Payments, 2006-12
(In millions of Euros)

	2006	2007		2008	2009	2010	2011	2012
		Prog.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account	-19	-173	-128	-343	-356	-351	-354	-366
(excluding official transfers)	-78	-243	-123	-410	-428	-431	-444	-456
Trade balance (fob)	-1,021	-1,089	-1,123	-1,471	-1,514	-1,570	-1,602	-1,630
Exports	1,903	2,090	2,453	2,690	2,997	3,313	3,653	4,033
Imports	-2,923	-3,179	-3,576	-4,161	-4,511	-4,883	-5,255	-5,662
Services (net)	20	-3	11	33	41	44	47	49
Income (net; including net interest) /1	-2	-90	-34	-20	-29	-6	-16	-28
of which Telecom Dividend	0	-100	0	-71	-62	-31	-31	-31
Transfers (net)	984	1,009	1,018	1,115	1,146	1,181	1,218	1,243
Official 2/	59	70	-4	67	72	80	91	91
Private	925	939	1,022	1,048	1,074	1,101	1,127	1,153
Capital and financial account	306	262	248	594	571	536	549	581
Capital account (net)	-1	5	2	-20	0	0	0	0
of which embassy purchases	0	0	-9	-20	0	0	0	0
Financial account	307	257	246	614	571	536	549	581
Net disbursements	-10	96	-36	205	118	91	76	71
Disbursements	292	370	348	451	442	450	460	470
Amortization	-302	-274	-383	-246	-324	-359	-384	-399
of which prepayments 3/	167	78	170	0	0	0	0	0
Direct and portfolio investment (net)	351	187	334	407	461	454	485	524
Direct investment	286	146	213	282	329	315	341	375
of which non-privatization related FDI	61	106	223	282	279	315	341	375
Portfolio investment	66	42	122	125	132	139	144	150
of which Eurobond	0	0	0	0	0	0	0	0
Other (currency, deposits, other credits)	-34	-27	-52	2	-8	-10	-12	-14
Currency and deposits (net)	-78	-62	-26	-48	-51	-54	-58	-61
Other credits (net)	44	35	-27	50	43	44	46	47
Errors and omissions	9	0	-6	0	0	0	0	0
Overall balance	296	89	114	251	216	184	196	216
Financing	-296	-89	-114	-251	-216	-184	-196	-216
Net foreign assets (flows)	-311	-89	-150	-251	-216	-184	-196	-216
Valuation effects on the stock of NFA (increase: -)	4	0	2	0	0	0	0	0
Change in the stock of NFA (increase:-)	-307	-89	-148	-251	-216	-184	-196	-216
Change in gross foreign reserves (increase:-)	-294	-65	-106	-251	-216	-184	-196	-216
IMF (net)	-8	-23	-42	0	0	0	0	0
Other (net)	-6	0	0	0	0	0	0	0
Change in arrears 4/	15	0	35	0	0	0	0	0

Table 3. FYR Macedonia: Medium-Term Balance of Payments, 2006-12 (continued)
(In millions of Euros)

	2006	2007		2008	2009	2010	2011	2012
		Prog.	Est..	Proj.	Proj.	Proj.	Proj.	Proj.
Memorandum items:								
Current account (% of GDP)	-0.4	-3.2	-2.3	-5.8	-5.5	-4.9	-4.5	-4.3
(excluding official transfers)	-1.5	-4.5	-2.3	-6.9	-6.6	-6.0	-5.7	-5.4
Trade balance (% of GDP)	-20.2	-20.4	-20.5	-24.8	-23.2	-21.9	-20.6	-19.4
Exports f.o.b. (% of GDP)	37.7	39.2	44.9	45.3	45.9	46.2	46.9	47.9
Imports, f.o.b. (% of GDP)	57.9	59.6	65.4	70.1	69.1	68.1	67.5	67.3
Export growth rate (volumes)	9.3	8.7	20.1	15.8	13.8	13.1	10.8	10.4
Import growth rate (volumes)	10.3	11.5	19.5	15.9	11.8	10.4	7.6	6.8
Export price increase	6.0	1.0	7.3	-5.3	-2.0	-2.2	-0.5	0.0
Import price increase	6.2	-0.5	2.4	0.4	-3.0	-2.0	0.0	0.9
Nickel prices (in thousands of Euros/metric tonne)	19.2	16.0	25.7	20.4	18.8	16.9	16.5	16.0
Oil prices (USD per barrel)	64	57	71	87	81	79	79	78
Net FDI (% of GDP)	5.7	2.7	3.9	4.7	5.0	4.4	4.4	4.5
of which non-privatization related FDI (% of GDP)	1.2	2.0	4.1	4.7	4.3	4.4	4.4	4.5
Net private transfers (% of GDP)	18.3	17.6	18.7	17.7	16.5	15.3	14.5	13.7
Gross reserves (in millions of Euros)	1,417	1,482	1,523	1,774	1,989	2,174	2,369	2,585
(in months of following year's imports of G&S)	4.1	4.4	3.8	4.1	4.2	4.3	4.3	...
External debt service ratio (in percent) 5/	19.2	17.8	18.3	11.9	13.5	13.6	13.3	12.8
External debt to GDP ratio (in percent) 6/	40.0	40.3	35.7	37.2	36.3	34.9	33.7	32.6
Short-term external debt (% of official reserves)	16.7	21.3	13.8	14.7	15.3	16.0	16.6	17.0
Nominal GDP (in millions of euros)	5,046	5,334	5,469	5,938	6,525	7,174	7,785	8,416

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

1/ For 2008 and beyond, the figures include accrued interest on reserves.

2/ 2007 includes payment of settlement of Okta dispute.

3/ Amortization payments include prepayment of London Club debt in 2006 and Paris Club debt in 2007.

4/ Private sector arrears.

5/ Debt service due including IMF as percent of exports of goods and services. Excludes rollover of trade credits.

6/ Including IMF.

Table 4. FYR Macedonia: Central Bank Accounts, 2005–08
(End-period; in billions of denars unless otherwise indicated)

	2005 Dec Actual	2006 Dec Actual	2007 Sept Prog.	2007 Sept Actual	2007 Dec Prog.	2007 Dec Proj.	2008 Dec Proj.
			(At current exchange rates)				
Net foreign assets (NFA)	66.3	85.1	89.9	94.2	90.6	94.3	109.6
Net domestic assets (NDA)	-40.5	-53.9	-57.7	-61.7	-56.1	-57.4	-66.2
Banks (net)	-8.9	-14.0	-18.7	-22.6	-22.0	-30.5	-42.3
Central government (net)	-18.3	-25.5	-24.6	-22.2	-19.7	-10.1	-6.8
o/w deposits	-21.6	-27.7	-26.5	-23.3	-21.6	-11.1	-7.9
Municipalities (net)	-0.7	-0.6	-0.6	-1.4	-0.6	-1.4	-1.4
Other items (net)	-12.7	-13.7	-13.7	-15.4	-13.7	-15.4	-15.7
Reserve money	25.8	31.3	32.2	32.5	34.5	36.8	43.4
Currency	14.4	16.2	16.4	16.7	17.8	18.2	19.5
Other	11.3	15.1	15.8	15.8	16.7	18.6	23.9
Cash in vaults	1.4	1.5	1.5	1.8	1.5	1.8	1.8
Total reserves	9.9	13.5	14.3	14.0	15.2	16.9	22.1
on denar deposits	4.6	7.2	7.2	6.8	7.7	10.1	14.5
on FX deposits	5.3	6.4	7.1	7.2	7.5	6.8	7.7
			(Year-on-year growth rates, percent)				
Net foreign assets	58.5	28.4	9.5	14.8	6.4	10.7	16.3
Reserve money	22.0	21.4	17.6	18.9	10.3	17.8	17.9
Currency	2.0	12.2	10.4	13.1	9.6	12.3	7.2
			(Contribution to year-on-year change in base money)				
Net foreign assets	115.9	73.1	28.5	44.4	17.4	29.2	41.8
Net domestic assets	-93.8	-51.8	-10.9	-25.5	-7.1	-11.4	-23.9
			(At program exchange rates)				
Net foreign assets	63.7	82.9	87.6	92.0	88.3	92.05	107.4
Net domestic assets	-37.9	-51.6	-55.4	-59.5	-53.8	-55.2	-64.0
o/w credit to central government (net)	-18.3	-25.5	-24.6	-22.2	-19.7	-10.1	-6.8
Reserve money	25.8	31.3	32.2	32.5	34.5	36.8	43.4
Memorandum items:							
Reserve money/GDP (in percent)	9.0	10.1	9.9	10.0	10.5	11.0	11.9
Program exchange rate (denars per euro)	61.3	61.3	61.3	61.3	61.3	61.3	61.3
GDP (yearly total) 1/	286.6	308.8	324.0	326.6	327.0	335.3	364.1

Sources: NBRM, and IMF staff projections.

1/ Measured on a rolling basis as a sum of nominal GDP of four preceding quarters including the last quarter of each period

Table 5. FYR Macedonia: Monetary Survey, 2005–08
(End-period; in billions of denars unless otherwise indicated)

	2005 Dec Actual	2006 Dec Actual	2007 Sept Prog.	2007 Sept Actual	2007 Dec Prog.	2007 Dec Proj.	2008 Dec Proj.
			(At current exchange rates)				
Net foreign assets (NFA)	89.7	108.0	109.8	111.6	110.4	110.1	121.0
NBRM	66.3	85.1	89.9	94.2	90.6	94.3	109.6
Domestic money banks (DMBs)	23.5	22.9	19.9	17.4	19.8	15.9	11.4
Net domestic assets (NDA)	19.2	27.6	43.7	49.8	53.4	68.9	108.6
Credit to the government	-12.2	-17.9	-15.8	-16.3	-10.5	-3.3	2.8
Banks	6.8	8.2	9.4	7.4	9.7	8.1	11.0
NBRM (net)	-19.0	-26.1	-25.2	-23.6	-20.3	-11.5	-8.2
Credit to the private sector	68.8	89.8	104.9	115.8	109.7	123.4	169.3
In denars 1/	51.7	66.4	77.4	86.9	80.7	93.7	133.9
In foreign currency	17.1	23.4	27.4	28.8	29.0	29.7	35.4
Other items (net)	-37.4	-44.3	-45.4	-49.7	-45.8	-51.2	-63.4
Broad money (M3)	108.9	135.6	153.5	161.4	163.8	179.0	229.7
Currency in circulation	14.4	16.2	16.4	16.7	17.8	18.2	19.5
Private denar deposits 1/ 2/	43.4	59.0	65.9	78.7	70.9	92.7	133.2
Private foreign currency deposits	51.1	60.4	71.2	66.0	75.2	68.1	76.9
			(Year-on-year growth rates, percent)				
NFA domestic money banks	-13.3	-2.3	-15.5	-26.3	-13.4	-30.8	-28.3
Credit to the private sector	20.5	30.5	27.7	41.0	22.2	37.5	37.1
Denar credit	12.9	28.5	28.3	44.0	21.5	41.1	42.9
Foreign currency credit	50.7	36.6	26.2	32.7	24.3	27.3	19.0
Broad Money	14.9	24.5	23.2	29.6	20.8	32.0	28.3
Private denar deposits	13.8	36.0	27.2	51.9	20.2	57.1	43.7
Private foreign currency deposits	20.2	18.3	23.0	13.9	24.4	12.7	12.9
			(Contribution to year-on-year change of credit to private sector)				
Denar credit (excluding foreign currency indexed)	5.2	7.3	12.5	12.8	10.1	13.6	15.0
Foreign currency (including foreign currency indexed)	15.3	23.2	15.3	28.3	12.1	23.9	22.1
			(At program exchange rates)				
Net foreign assets	86.8	105.8	107.5	109.5	108.1	108.0	118.9
Net domestic assets	21.3	29.8	45.9	52.3	55.6	71.4	111.1
Broad money	108.1	135.6	153.4	161.8	163.7	179.4	230.0
Memorandum items:							
M3/GDP (percent)	38.0	43.9	47.4	49.4	50.1	53.4	63.1
Forex and forex indexed deposits/total deposits (percent)	57.3	54.6	53.7	52.6	53.2	49.8	44.8
Forex and forex indexed loans/total loans (percent)	47.8	54.4	53.2	57.4	53.4	57.0	55.2
Forex linked assets/Forex linked liabilities 3/	113.9	119.8	112.6	119.7	110.6	116.2	119.5
Broad money multiplier (M3/reserve money)	4.2	4.3	4.8	5.0	4.7	4.9	5.3
NFA of DMBs/forex deposits (percent)	56.3	48.5	38.0	37.3	36.4	33.3	24.8
Private credit (percent of GDP)	24.0	29.1	32.4	35.4	33.5	36.8	46.5
Nominal GDP (yearly total) 4/	286.6	308.8	324.0	326.6	327.0	335.3	364.1

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 on a rolling basis as a sum of nominal GDP of four preceding quarters including the last quarter of each period.

Table 6. FYR Macedonia: Financial Soundness Indicators, 2002–07

	2002	2003	2004	2005	2006	2007Q3
	(Percent, unless indicated otherwise)					
Capital adequacy						
Regulatory capital/risk weighted assets	28.1	25.8	23.0	21.3	18.3	17.2
Tier I capital/risk weighted assets	28.3	26.2	23.9	21.6	18.9	17.3
Asset composition and quality						
Sectoral loans to nonfinancial enterprises/total loans 1/						
Enterprises	37.3	44.4	43.5	43.8	59.0	56.7
Households	7.9	11.8	16.3	20.3	33.4	36.4
Foreign currency lending						
Foreign currency lending/total credit to private sector	22.2	16.2	20.0	25.4	26.3	25.2
Foreign currency indexed lending/total credit to private sector 2/	16.8	22.2	20.6	22.2	26.4	29.6
NPLs /gross loans 3/	23.1	22.1	17.0	15.0	11.2	9.1
NPLs net of provision /capital 3/	11.8	10.6	2.2	2.0	0.7	-1.8
Large exposures/capital	220.0	193.0	219.0	190.0	194.7	185.0
Connected lending						
Banking system exposure to shareholders/capital	11.8	7.0	7.4	4.3	5.2	2.8
Banking system equity participation/capital	7.3	6.3	5.6	6.2	5.5	4.2
Earning and profitability						
ROAA 4/	0.4	0.5	0.6	1.2	1.8	2.0
ROAE 4/	2.0	2.3	3.1	7.5	12.3	15.8
Interest margin/gross income	44.0	46.2	49.6	53.8	57.1	57.0
Noninterest expenses/gross income	91.5	87.7	75.6	68.1	63.6	57.4
Personnel expenses/noninterest expenses	38.9	42.5	41.7	42.1	41.1	38.4
Interest rate spreads (in percentage points)						
Local currency	8.8	7.8	5.5	6.9	6.3	5.0
Foreign currency	5.4	...	5.6	6.5	6.7	6.6
Interbank market	5.9	9.8	6.9	8.5	4.9	3.2
Liquidity						
Highly liquid assets/total assets 5/	40.1	38.7	37.8	37.1	17.7	18.5
Highly liquid assets/total short-term liabilities 6/	62.2	57.4	55.0	53.8	25.6	26.4
Customer deposits/total (noninterbank) loans	130.2	140.5	143.4	142.3	139.5	129.7
Foreign currency denominated and indexed deposits/total deposits (from the balance sheet, excluding deposits of banks)	53.8	57.1	59.6	58.5	56.8	53.5
Central bank credit to banks/bank liabilities 7/	0.4	0.4	0.9	0.7	1.3	1.0
Sensitivity to market risk						
Net foreign exchange position /capital	56.2	56.3	52.1	49.6	44.3	44.1

Sources: NBRM's Banking Regulations Department; and Fund staff estimates.

1/ Until 2005, total loans include deposits with banks. From end-2006 onwards, total loans include interbank loans.
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 balances with the NBRM, NBRM bills, and accounts with foreign banks. Large drop in 2006 compared to 2005 is due to change in methodology.
6/ Short-term liabilities are defined as deposits and other liabilities with a maturity of one year or less. Large drop in 2006 compared to 2005 is due to change in methodology.
7/ The increase in 2006 is due to loans channeled through NBRM, not NBRM credit to banks.

Table 7. FYR Macedonia: Central Government Operations, 2006-08

	2006	2007			2008
		prog.	budget 3/	prel.	proj.
	(In billion denars)				
Total revenue	102.3	106.8	114.2	117.6	127.9
Tax revenue	89.2	90.0	96.4	101.3	106.4
Personal income tax	8.4	7.3	8.3	8.9	8.9
Corporate income tax	4.7	2.8	5.7	5.9	5.3
VAT	27.2	30.2	31.8	33.0	35.7
Excises	12.2	12.5	13.2	13.3	14.2
Custom duties	5.4	5.5	5.7	6.2	7.4
Other taxes	1.8	2.4	2.2	2.5	2.6
Pension contributions	18.6	18.9	19.0	20.1	21.7
Unemployment contributions	1.4	1.4	1.4	1.5	1.5
Health contributions	9.4	9.0	9.1	10.0	9.2
Nontax revenue	9.9	11.1	11.8	10.4	15.3
Capital revenue	1.8	4.2	4.3	4.9	4.1
o/w Telecom dividend	0.0	2.5	2.9	2.9	2.6
Grants	1.4	1.5	1.8	0.9	2.0
Total expenditure	104.0	110.2	117.7	115.4	133.4
Current expenditure	94.8	98.0	103.4	101.8	112.1
Wages and salaries	23.4	24.9	24.3	23.6	24.4
Goods and services	12.9	14.7	17.2	14.8	18.7
Transfers	55.3	55.5	59.2	60.5	66.7
Pensions	...	...	26.7	...	29.9
Health	...	...	16.0	...	16.3
Wages local governments	...	...	1.3	...	5.5
MEPSO subsidies	...	...	0.7	...	0.0
Agriculture subsidies	...	...	1.9	...	3.0
Macedonia TV	...	...	0.2	...	0.0
Other	...	...	12.4	...	12.0
Interest	3.1	3.0	2.8	2.9	2.3
Capital expenditure	9.3	12.0	14.3	13.7	21.3
Lending minus repayment	0.0	0.2	0.0	-0.1	0.0
Fiscal balance	-1.7	-3.4	-3.5	2.2	-5.5
Fiscal balance below the line	-1.1	-3.4	...	...	-5.5
Financing	1.1	3.4	...	...	5.5
Domestic	-9.8	5.0	...	...	2.1
Central bank	-7.2	6.1	...	...	3.3
Other domestic financing	-2.6	-1.1	...	...	-1.2
Privatization receipts	20.3	2.6	...	...	0.2
Foreign	-9.4	-4.2	...	...	3.2
Memo items:					
Contributions to second pillar pensions	1.3	1.8	1.9	1.9	2.3
Total wage bill	23.4	24.9	25.6	...	29.9
Fiscal balance municipalities 1/	...	...	...	0.7	...
Fiscal balance public enterprises 2/	...	...	...	-1.9	...
GDP (billion denars)	308.8	327.8	335.3	335.3	364.1

Source: MOF and IMF Staff estimates.
1/ Outturn of the first 9 months of 2007.
2/ Outturn of the first 9 months of 2007 of the four largest public enterprises.
3/ Supplementary budget approved in September 2007.

Table 7. FYR Macedonia: Central Government Operations, 2006-08 (continued)

	2006	2007			2008
		prog.	budget 3/	prel.	proj.
	(In percent of GDP)				
Total revenue	33.1	32.6	34.1	35.1	35.1
Tax revenue	28.9	27.5	28.7	30.2	29.2
Personal income tax	2.7	2.2	2.5	2.7	2.5
Corporate income tax	1.5	0.9	1.7	1.8	1.4
VAT	8.8	9.2	9.5	9.8	9.8
Excises	3.9	3.8	3.9	4.0	3.9
Custom duties	1.8	1.7	1.7	1.8	2.0
Other taxes	0.6	0.7	0.7	0.8	0.7
Pension contributions	6.0	5.8	5.7	6.0	6.0
Unemployment contributions	0.4	0.4	0.4	0.5	0.4
Health contributions	3.1	2.8	2.7	3.0	2.5
Nontax revenue	3.2	3.4	3.5	3.1	4.2
Capital revenue	0.6	1.3	1.3	1.5	1.1
o/w Telecom dividend	0.0	0.8	0.9	0.9	0.7
Grants	0.5	0.5	0.5	0.3	0.5
Total expenditure	33.7	33.6	35.1	34.4	36.6
Current expenditure	30.7	29.9	30.8	30.4	30.8
Wages and salaries	7.6	7.6	7.3	7.0	6.7
Goods and services	4.2	4.5	5.1	4.4	5.1
Transfers	17.9	16.9	17.6	18.1	18.3
Pensions	...	...	7.9	...	8.2
Health	...	...	4.8	...	4.5
Wages local governments	...	...	0.4	...	1.5
MEPSO subsidies	...	...	0.2	...	0.0
Agriculture subsidies	...	...	0.6	...	0.8
Macedonia TV	...	...	0.1	...	0.0
Other	...		3.7	...	3.3
Interest	1.0	0.9	0.8	0.9	0.6
Capital expenditure	3.0	3.7	4.3	4.1	5.9
Lending minus repayment	0.0	0.1	0.0	0.0	0.0
Fiscal balance	-0.6	-1.0	-1.0	0.6	-1.5
Fiscal balance below the line	-0.4	-1.0	...	...	-1.5
Financing	0.4	1.0	...	...	1.5
Domestic	-3.2	1.5	...	...	0.6
Central bank	-2.3	1.9	...	...	0.9
Other domestic financing	-0.9	-0.3	...	...	-0.3
Privatization receipts	6.6	0.8	...	...	0.1
Foreign	-3.0	-1.3	...	...	0.9
Memo items:					
Contributions to second pillar pensions	0.4	0.6	0.6	0.6	0.6
Total wage bill	7.6	7.6	7.6	...	8.2
Fiscal balance municipalities 1/	...	...	...	0.2	...
Fiscal balance public enterprises 2/	...	...	...	-0.6	...
GDP (billion denars)	308.8	327.8	335.3	335.3	364.1

Source: MOF and IMF Staff estimates.
1/ Outturn of the first 9 months of 2007.
2/ Outturn of the first 9 months of 2007 of the four largest public enterprises.
3/ Supplementary budget approved in September 2007.

Table 8. FYR Macedonia: External Financing Requirements and Sources, 2005–12
(In millions of Euro)

	2005	2006	2007	2008	2009	2010	2011	2012
			Est.	Proj.	Proj.	Proj.	Proj.	Proj.
1. Gross Financing Requirement	672	681	654	907	967	974	1023	1070
External current account deficit (excl. official transfers)	114	78	123	410	428	431	444	456
Debt amortization 1/	143	302	383	246	324	359	384	399
Gross reserves accumulation	406	294	106	251	216	184	196	216
IMF/BIS repurchases and repayments (net)	9	8	42	0	0	0	0	0
2. Identified Financing	672	682	655	906	967	974	1023	1070
Official creditors	169	143	117	202	182	190	201	201
Official transfers and grants	52	59	-4	67	72	80	91	91
Debt financing	117	84	121	135	110	110	110	110
IMF/BIS purchases and disbursements	13	0	0	0	0	0	0	0
Foreign direct investment (net)	77	286	213	282	329	315	341	375
Other flows 2/	398	238	290	422	456	469	482	495
Accumulation of arrears 3/	15	15	35	0	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/ Includes all other net financial flows and errors and omissions.
3/ Private sector and public enterprise arrears.

ATTACHMENT

Skopje, Macedonia

February 6, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. Strauss-Kahn,

1. **After one and a half years in office, our ambitious economic reforms have created a better and more prosperous Macedonia.** The tax cuts we introduced have been designed to stimulate new investment and to boost employment. Our commercial banking law is attracting major foreign banks and will strengthen banking supervision. Our policies of market liberalization, most notably in telecommunications, transportation and other service sectors, are improving growth and competitiveness. In recognition of our achievements, the World Bank recently ranked us at the fourth place among economic reformers. These reforms will promote Macedonia's integration in the global economy, and create an environment that fosters internationally competitive enterprises.

2. **Looking ahead, we aim to maintain macroeconomic stability and further improve the business environment, so as to raise economic growth, attract foreign direct investment, and reduce unemployment**. Prudent fiscal policies will continue to underpin macroeconomic stability. Taxes and social security contributions will be further streamlined and reduced, including by cutting personal and corporate income tax rates (to 10 percent as of January 2008) and reducing payroll taxes. Government spending will be redirected to more productive uses, and spending on education and on infrastructure will be increased. Greater fiscal transparency, fiscal decentralization, and improved capital budget execution will further improve the quality of fiscal policy. The business environment will be further improved by completing the 'regulatory guillotine' process and the real estate cadastre, and by reforms in the central registry, and in bankruptcy procedures. We are also taking key steps to ensure stable energy supply and improve the electricity sector's finances. These reforms are expected to result in higher economic growth and a better standard of living.

Recent Economic Developments

3. **Economic performance continues to improve:**

- **In the first three quarters of 2007, real GDP increased by 5 percent compared to the previous year**. Industrial production (in particular of iron and steel, processed food and construction materials), trade, transportation and telecommunications made significant contributions to growth. Private consumption was stimulated by higher private sector wages, employment growth and increased access to consumer credit. Investment also picked up benefiting from lower taxes and more friendly investment climate.

- **Average inflation has fallen** from 3.2 percent in 2006 to 2.3 percent in 2007, but year-on-year the rate increased to 6.1 percent, mainly due to increases in food prices.

- **The current account balance during the first three quarters of 2007 has been stronger than expected**, reflecting a lower trade deficit and higher private transfers. Increases in exports of metals, together with high iron and nickel prices, have boosted export receipts. Imports have also risen, both consumption goods (reflecting strong economic activity and improved prospects), but particularly intermediate and investment goods, which will boost the economy's productive potential. Despite making more than €200 million in repayments to international creditors, at around €1.5 billion (or 4 months of imports of goods and services), international reserves remain ample. We have repaid all of our outstanding obligations to the Fund. As a result of the early repayments, external debt declined to 35 percent of GDP.

4. **In the first three quarters of the year, we met all of the program's fiscal and monetary program targets (Table 1)**. The fiscal balance has been much stronger than expected, with more rapid growth and improvements in tax administration boosting tax and social contribution revenues. Central bank interest rates have gradually declined to around 5 percent, while the spread between lending and deposit rates in commercial banks has continued to decline and is now around 5 percentage points.

5. **We have also successfully implemented a number of structural reforms,** in the areas of tax policy and administration, fiscal transparency, key economic sectors (including health, energy, finance, and telecommunication), and the overall business climate (Table 2). This Letter of Intent highlights key achievements in these areas in our first year in office, and lays out a reform agenda that builds on these.

Economic policies for 2008 and the medium term

6. **Economic growth is set to increase, while inflation will remain low.** In light of the strong results in 2007, we have raised the growth assumptions underlying our Fund-supported program to 5 percent in both 2007 and 2008, well above historical performance. Despite the increased risks in the international economy, we believe that these assumptions are prudent: as our reforms take hold, we believe that the actual growth outturn may be considerably higher: as much as 6 percent in 2007, 6½ percent over the medium-term. Over the medium-term inflation is expected to remain at around 2 percent, in line with partner countries. As growth picks up, the current account deficit is expected to increase to around 6 percent of GDP. We will keep gross international reserves at around 4 months of imports.

7. **With growth picking up, unemployment has started to fall**. Registered unemployment remains high, although this partly reflects registration of informal workers as unemployed, to claim health benefits. Our policies aimed at increased growth and foreign direct investment should significantly increase employment. But we are also taking direct measures to reduce unemployment, in particular by reducing the tax wedge for part-time and low-wage workers. Starting from April 2008, we will encourage part-time work, by no longer requiring part-time workers to pay full-time health contributions. We will also reduce social contributions for low paid workers, by gradually reducing minimum social contributions. Together with our policies aimed at improving education, our reforms will stimulate job creation and gradually reduce the unemployment rate.

Fiscal policy and public sector reforms

8. **In 2007, the central government ran a small budget surplus, outperforming the program's 1 percent of GDP deficit target.** In light of this strong revenue overperformance and likely expenditure savings, in 2007 we passed two supplementary budgets with increased spending (of around 2 percent of GDP) on education, infrastructure to attract foreign direct investment, civil service employment needed for EU accession, wage increases, and energy (additional allocations to allow budgetary organizations to clear their arrears with EVN-ESM). Starting in October 2007, VAT rates for computer hardware and software, public transport, thermal solar systems and medicines were reduced from 18 to 5 percent.

9. **For 2008 we will keep to our prudent fiscal policy, while continuing to reduce tax rates and to redirect government spending to more productive uses**. To maintain macroeconomic stability, we will keep the deficit target to 1½ percent of GDP. Starting in January, we lowered personal and corporate income tax rates from 12 to 10 percent. We also introduced a small business tax that replaces the profit tax for enterprises with turnover below MKD 3 million, and introduced a flat-rate tax based on turnover. Our budget also includes adequate funding for decentralization to allow an effective transition to formula-driven allocations to municipalities, as well as for the introduction of compulsory secondary education and implementation of the new Law on Higher Education.

10. **We are taking steps to improve the quality of government spending.** In the **health** sector, we will emphasize cost-effective preventive and primary health care services, and reduce spending on relatively expensive inpatient and specialized interventions. We are also developing a plan for improving the efficiency of hospitals, and we are providing hospitals with incentives to reduce expenditures and improve the quality of services. The use of co-payments will be increased, to provide an effective incentive for cost-conscious choices by patients. In **education**, we will increase instructional time in schools, with teachers spending more time on teaching. Starting from the school year 2007/08, secondary education becomes compulsory. Computers and information technology will be integrated into education under the "computer for every child" project, and additional resources will be made available for school furniture and furnishings. We have introduced mandatory instruction in two foreign

languages in primary education, and classes on entrepreneurship and business administration in secondary education. We will increase spending on **infrastructure**, maintaining and investing in new roads, and improving transport links to our neighbouring countries, including by developing railway infrastructure along Corridor 10.

11. **Public wages will be increased by 10 percent in each of the next three years, starting in October 2007**. This will allow the public sector to attract quality staff. The increase in wages will also result in an increase in pensions. To keep pensions in line with improving living standards, we have changed the pension indexation formula to 50 percent wages and 50 percent consumer price inflation. However, after the budget was passed, in January 2008 we increased pensions by an average of 15 percent, a one-off measure to make up for low increases in previous years. We project that higher contribution collections will finance this. Further pension increases will follow the new 50 percent wages and 50 percent price inflation indexation formula. In making the public wage and pension increase, we remain committed to meeting the 1½ percent of GDP deficit target.

12. **Reforms in the Public Revenue Office (PRO) and the social funds, supported by IMF technical assistance, have boosted revenue collection**:

- The **PRO** has intensified arrears collection by applying the new Tax Administration Law, and improved services by accelerating refunds and making more information available to taxpayers. The PRO has also set itself performance targets to be achieved by end-2007 (May structural benchmark). The special tax office for administering large taxpayers, created in July 2006, has strengthened compliance and improved service to the country's largest businesses. The PRO has also designed a strategy for improving the administration of small- and medium-sized taxpayers (June structural benchmark). Amendments to the Law on the Public Revenue Office to allow the PRO more flexibility in paying salaries and rewarding performance through a professional performance management system were recently submitted to parliament.

- The **Pension and Disability Fund** (PDF)'s new IT system, introduced in 2006, has bolstered revenue collection. From April 2008 the PDF will start collecting all social insurance contributions (structural performance criterion). We have established an inter-fund working group to design and implement this initiative. As part of this process, in March 2007 Parliament passed legislation harmonizing the minimum bases for social contributions. This legislation was implemented in July 2007, starting with salaries paid in June (structural performance criterion). Legislation to harmonize the base for health care contributions (currently calculated on the basis of earned salary) with pension and employment contributions (which are based on contracted salary) is under preparation; this will be implemented by July 2008 (new structural performance criterion). In July 2007 we submitted draft legislation that gives the PDF legal authority for collecting health and employment contributions to Parliament (structural benchmark). Following this, the Ministry of Health and the Ministry of

Labor have signed an inter-agency agreement setting out the terms and conditions under which the Pension Fund will collect health and employment contributions on behalf of the Health and Employment Funds. Our aim remains for the PRO to collect all taxes and contributions by end-2009.

13. **We have designed and announced a strategy to fully harmonize PIT and social contributions** (structural benchmark), central to our strategy of cutting labour taxes, fighting the informal economy, enhancing the business environment and reducing unemployment. Harmonization will also greatly simplify the tax burden for businesses, again stimulating employment. This year we will start the phased implementation of this strategy. From April 2008 onwards, health care contributions for part-time workers will be calculated on a per-hour basis (structural performance criterion), harmonizing them with personal income tax and other contribution collections. This will reduce the labour tax wedge. From 2009, we will phase out minimum social contributions over a period of two to three years. We also aim to shift from net to gross wages in calculating personal income tax and social contributions as soon as is practicable.

14. **Our customs administration reforms have also helped boost revenues and improve the business climate**. New simplified procedures for import clearance and the elimination of most customs fees and administrative taxes have improved compliance. Going forward, we will introduce a new customs information system to facilitate enforcement and the exchange of information with our international partners. Amendments to the Customs Law, to align the law with the EU acquis, were adopted by parliament in January 2008.

15. **Health sector finances are much better.** We have now placed economic directors in all Health Care Institutions (HCIs), and have reduced the stock of HCI arrears from 1.8 billion denar (0.6 percent of GDP) at end-2006 to 1.2 billion denar (0.4 percent of GDP) by end-June 2007. The new international tender for drug procurement (structural benchmark for end-June 2007) was delayed because in the first phase of the tender, 16 out of 29 bidders had to be excluded (in accordance with public procurement procedures). However, after re-tendering, 27 bidders were authorized to participate in the second phase; we expect that this will result in lower prices. The tender is expected to be completed shortly (reset structural benchmark for end-April). We will also take steps to limit the unnecessary use of drugs and encourage rational drug prescription.

16. **We will exercise caution in the exploration of possibilities for using Public-Private Partnerships (PPPs) for infrastructure investment which will be aimed at achieving value-for-money.** We will carefully identify and select opportunities for PPPs after establishing a framework for managing the associated fiscal risks, including through

appropriate legislation, sound institutions, and establishing a system for reflecting PPPs in fiscal reporting and debt sustainability analysis.

17. **We have launched the second phase of fiscal decentralization**:

- **To date, 51 out of 84 municipalities have qualified for participation in the second phase of decentralization**. Municipalities qualify for participation in the second phase of decentralization if they (i) have met the conditions for the first phase of decentralization, (ii) possess adequate staff capacity for financial management, (iii) show 'good financial results' for at least 24 months and (iv) have no arrears to suppliers or creditors exceeding ordinary terms of payment. Those that have moved to the second phase have started to receive block grants from the central government for primary and secondary education, child care, social care for the elderly, and culture. We have adopted by-laws specifying the methodology for the allocation of the block grants, increasing the flexibility of municipalities to allocate non-salary revenues more efficiently and encourage savings. A student-based formula for the calculation of the block grant for primary and secondary education will be introduced for 2008. We have established working groups to monitor spending of the grants and report to the government every six months.

- **We have also taken several other actions to increase local government revenues**: (i) business premises are now included in the base of the property tax; (ii) charges for street lighting have been doubled; (iii) the central government tax on lease agreements and the sale of urban land will now be shared with local governments (40 percent for the central government and 60 percent for local governments); and (iv) the tax on the exploration of natural resources is shared on the same basis. While decentralization should improve the targeting of spending, by carefully devolving revenues with responsibilities, it will not have any impact on the government deficit.

18. **We will strengthen the monitoring and control of public enterprise finances.** In 2006, Parliament adopted legislation requiring public enterprises to submit quarterly reports on their financial position to the government. Enterprises have now amended their statutes to comply with this new legislation. The first reports, covering the second quarter of 2007, were submitted by October 2007 (structural benchmark). We have selected a consultant to prepare for the privatization of the State Company for Management of Resident and Business Premises. By end-April 2008, the consultant will prepare a report that assesses the value of the company's assets and advises on the modalities of the privatization. In July 2007 we split Macedonian Railways in two: rail infrastructure and rail transport. A World Bank funded consultant will submit a strategy paper that advises on, inter alia, possibilities for cost reduction and track access charges by end-March 2008. Regarding privatization, the consultant will advise by June 2008, at which time the government will decide on the best option for strengthening rail services and efficiency, and for addressing outstanding debt of the rail companies. We are preparing legislation to introduce competition in freight

transportation by rail. Consultants are also providing advice on the privatization or concessioning of Macedonia's two airports. We aim to select an investor in these airports by May 2008.

19. **We will continue developing the domestic public debt market**. Our revised debt management strategy, to be presented to Parliament in February 2008, will aim to reduce the cost of government borrowing and develop the public debt market. In October 2007, we removed the cap on interest rates in the three month treasury bill auctions to facilitate market development. To promote competition in the treasury bill market we will reject outlier bids and limit the size of individual participation in each auction. We have established monthly meetings between the government and the NBRM to discuss economic developments. The NBRM will continue to sterilize excess liquidity using various monetary policy instruments, including longer-term central bank bills.

Monetary and financial sector reform policies

20. **The NBRM will aim at low inflation by maintaining a de facto pegged exchange rate regime backed by adequate international reserves.** The NBRM's monetary program for 2008 is consistent with average growth of broad money of about 30 percent, in line with a gradual increase in money demand. We expect capital inflows to remain strong, reflecting confidence in our macroeconomic policies. Increased monetization, supplemented with a moderate increase in banks' external financing and a drawdown of their funds abroad, will finance increased private sector credit and financial intermediation. The Ministry of Finance and the NBRM will stand ready to prevent the strong balance of payments from leading to excessive liquidity in the financial system.

21. **We remain committed to strengthening the financial soundness of the Central Bank and safeguarding its independence**. As part of our strategy to implement EU-consistent legislation, we have prepared a new draft Central Bank Law, with the help of IMF technical assistance. In October 2007, we submitted our draft for review to the European Commission and to the ECB, and we aim to submit our draft to parliament by end-March 2008 (new structural performance criterion). The primary objective of the NBRM will remain to achieve and maintain domestic price stability, and the NBRM will retain full autonomy in reaching that goal. The draft law strengthens the NBRM's governance and accountability, including by providing a clearer division of responsibilities between the Governor and the NBRM Council. Under the draft law, all three vice governors of the NBRM will be members of the Council (which will continue to have nine members). The draft also proposes that the exchange rate regime shall be jointly agreed between the government and the NBRM, without prejudice to the NBRM's primary objective.

22. **We are continuing to reform the financial sector.** In May 2007, we passed a new banking law which, among other things, strengthens banks' governance, tightens provisions on connected lending, and establishes a framework for consolidated supervision, more closely in line with best international practice. The law eases restrictions on foreign bank

branching, and contains provisions to protect the governor's decisions in the areas of bank licensing, administration and bankruptcy from reversal by the courts. Credit is growing at more than 30 percent annually, the presence of foreign banks is increasing, and spreads between lending and deposit rates have continued to narrow.

23. **The NBRM is implementing a more risk-based, anticipatory approach to banking supervision, through its supervisory development plan.** A framework for assessing risk profiles has been developed and tested successfully on three banks (September structural benchmark). In December 2007, the NBRM finalized a detailed guidance manual which will be used for conducting on-site supervision (structural benchmark). We will publish documents on the supervisory framework and the risk assessment process by end-March 2008 (structural benchmark). The NBRM has also issued accounting guidelines, a new chart of accounts and formats for banks' financial statements in line with IFRS (September 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 NBRM's efforts to create a completely new credit registry are expected to be completed by August 2008 (reset structural benchmark), slightly later than earlier envisaged, owing delays in technical assistance. In the interim, the NBRM will approve the credit registry's detailed content specifications and protocols for submitting and retrieving data by end-March 2008 (structural benchmark).

Attracting foreign investment and improving the business climate

24. **We are simplifying business regulations.** In June we published a list of all licenses administered by line ministries and government agencies, together with their justification (June structural benchmark). We have subsequently reviewed these (about 2,000 laws and by-laws), in consultation with the business community and international experts. On the basis of this, the government adopted a set of measures in July and August, including reductions in fees (including at the State Cadastre, Central Registry, and Customs Authority), selected use of the "silence is consent" rule, and a reduction in documentation requirements. By end-February 2008, changes in by-laws will be completed, and required amendments in laws will be submitted to Parliament. Regulations that remain will be entered into a national electronic registry, easily accessible to all. When developing new laws and regulations, we will also introduce a regulatory impact assessment (RIA) system. Recent amendments to the Company Law and the Law establishing the "one-stop shop" reduced the time required to register a business from five days to four hours, and eliminated the requirement to deposit paid–in capital before registering a limited liability company. With the "one-stop shop system" in place, business registrations have increased dramatically, from about 7,000 in 2005 to 11,000 in 2006, and about 10,800 in the first 10 months of 2007.

25. **We are making good progress in strengthening property rights**. About 70 percent of Macedonian territory will be covered by the Real Estate Cadastre by end-2007, 75 percent by end-June 2008 (structural benchmark), 84 percent by end-2008, and the Cadastre will be

completed by end-2009. We submitted a new Law on the Real Estate Cadastre to parliament in early 2008. This law, which has been prepared in close consultation with the World Bank, should help improve the quality of services provided by the Cadastre office. These reforms should facilitate the use of land as loan collateral, which will help lower borrowing costs and expand credit.

26. **Foreign direct investment is increasing.** We have created new Technological Industrial Development Zones near Skopje (Skopje-2), Stip and Tetovo, bringing the total of these to four. The first zone, Skopje-1, is evolving into a cluster of automotive industrial activity. The 2007 supplementary budget included increased infrastructure spending to support these zones. We have also amended the law on Technological Industrial Development Zones to bring it closer to the EU *acquis*. To limit erosion of the tax base, the government will continue to use an 80 percent export requirement as one of the guiding principles for participation in these zones.

27. **We are implementing a number of key steps to ensure stable energy supply and improve the finances of the electricity sector, in close collaboration with the World Bank. These key steps are:**

- **Development of a new strategy**. With the cooperation of the World Bank, we have developed a strategy that will identify priority investments in the energy sector and lay out a plan for obtaining the necessary financial resources.

- **Increased private sector participation**. We are in the process of securing private participation in the development of more than 60 small and medium-sized hydro-electric facilities. The tender to privatize the Negotino thermal power plant, the second largest in the country, was cancelled, with a view to safeguarding Macedonia's security of electricity supply. However, tenders for the construction of a number of new hydro-power plants are proceeding well, and we have recently authorized the construction of the first combined heat and power plant.

- **Improved payment discipline**. We will continue to support EVN-ESM, the electricity distribution company, in its efforts to ensure that all users make timely payments for their current electricity use. We will ensure that budgetary organizations clear their arrears with EVN-ESM. To limit network losses, we will eliminate legal barriers related to meter ownership, access and connection. The transfer of meter ownership to EVN-ESM should help reduce electricity theft and meter manipulation.

- **Reform of the electricity market model**. In March 2007 we amended the energy law to reduce the quantity of electricity supplied to large users at subsidised prices. From May 2007, subsidised electricity was reduced to 45 percent of historical usage. This reduced fiscal losses in the electricity sector by around €50 million. Starting from January 2008, large users are required to purchase 100 percent of their electricity at market prices, which should remove the need for a budgetary transfer to

MEPSO in 2008. In addition to this, we envisage a phased transition from the present single-buyer model to a competitive model based on bilateral contracts. ELEM, the power generation company, will be provided with a license to supply power directly to EVN-ESM under regulated contracts, to be used to satisfy the electricity needs of medium-sized and small users; any power generated by ELEM that exceeds the needs of these users may be sold at the open market. A gradual liberalization of the electricity market for medium sized and small users (including households) is envisaged to be completed by 2015.

- **Transparent budget support for the sector**. The 2007 budget included a transparent subsidy to compensate MEPSO for its operating losses (largely due to the difference between import and domestic prices), estimated at €20 million. Under the new market model, MEPSO will transmit power for a transmission fee, and will no longer engage in wholesale trade of electricity.

- We will support **reform of electricity tariffs and tariff methodology** to facilitate the introduction of the new market model, aiming to gradually phase out cross-subsidies between consumer groups, and establish prices at full cost recovery levels. We will develop a new tariff scheme with a block structure, and gradually increase tariffs for all users. We will continue to support the independence of the energy regulatory commission, and strengthen its capacity.

- We are developing a **social protection mechanism** to target electricity subsidies to the most needy consumers. The new program is expected to provide subsidies to around 70,000 households.

- We are also working on an energy efficiency program, aiming to reduce the use of electricity for heating purposes.

28. **We continue to make significant progress in reducing telecommunications costs and expanding Internet access**.

Progress in Telecom Liberalization

	2005q1	2005q2	2005q3	2005q4	2006q1	2006q2	2006q3	2006q4	2007q1	2007q2	2007q3
Number of VOIP providers 1/	...	...	...	20	...	...	...	46	65	84	118
Number of internet providers 1/	...	...	...	12	...	...	...	87	87	97	97
Fixed telephone providers	...	...	...	1	...	...	...	1	2	5	5
Internet penetration 2/	...	...	...	...	...	...	...	27	27	28.5	29
Interconnection fees (local call origination) 3/	...	...	...	...	...	1.43	...	...	0.54	0.54	0.54
Fixed telephone tariff to US 4/	18.0	...	...	...	...	12.90	...	...	9.9	9.9	9.9
Fixed telephone tariff to Germany 4/	27.0	...	...	...	...	16.90	...	...	9.9	9.9	9.9

1/ Number of notified providers at the end of the year.
2/ Number of internet users as a fraction of the total population.
3/ Denars per minute (Maktel).
4/ Denars per minute (Maktel).

- **A third mobile operator started providing services in September.**
- **We recently launched a tender for the allocation of one frequency for 3G cell phone services**.
- **We have had to delay the introduction of telephone number portability** until June 2008 to allow more time to select a commercial provider to organize and maintain the central database of ported numbers.
- **We are in the process of harmonizing the concession agreements** with Maktel, T-mobile and Cosmofon with the Electronic Communications Law, in cooperation with the European Commission.
- **As a result of these efforts we have strengthened liberalization and competition**: the number of providers has increased, including fixed line and mobile providers, and prices for consumers have fallen (meeting the June structural benchmark).
- **The program will continue to monitor quantitative measures of liberalization** in this sector every six months (structural benchmark).

29. **On the basis of our strong policy implementation and economic track record, we request completion of the Third Review, and a rephasing of access under the Arrangement.** We believe that the policies described in this letter (with program conditionality for 2008 summarized in Tables 3 and 4) will achieve the goals of our economic program: macroeconomic stability; sustained, high economic growth; increased employment, and better integration into the world economy. Nevertheless, we stand ready to take any further measures to keep our program on track. In light of the delayed completion of the review, we would like to rephase purchases under the Arrangement, such that there will be four reviews rather than five reviews. The fourth review will be completed on or after May 15, 2008 (Table 5). Data for end-December quantitative performance criteria will be

available before the Board discussion, and we expect that all of these will be observed. We will remain in close consultation with the Fund, in accordance with the Fund's policies, and provide the Fund with such information as it requests on policy implementation and achievement of program objectives. 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.

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 2007
(Targets and Actual Outcomes)

	Mar-07	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	-43	-127	-135	...
Revised target	1,087	1,059	1,112	...
Actual	1,224	1,267	1,366	...
Ceiling on new nonconcessional medium- and long-term external debt contracted or guaranteed by the general government or the NBRM with original maturities of more than 1 year	38	64	89	103
Actual	0	0	53	...
Ceiling on new non-concessional medium and long-term external debt contracted	25	33	52	60
by the public enterprises with original maturities of more than 1 year (indicative)	0	0	0	...
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	0	0	0	...
Accumulation of external payments arrears	0	0	0	0
Actual	0	0	0	...
	(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	2.6	7.8	8.3	...
Revised target	-44.6	-41.1	-43.5	...
Actual	-53.3	-54.0	-59.5	...
Ceiling on net domestic assets of the banking system (indicative)	35.5	42.4	45.9	55.6
Adjustor	2.6	7.8	8.3	...
Revised target	38.1	50.2	54.2	...
Actual	35.8	50.2	52.3	...
Ceiling on net domestic credit to the central government from the NBRM	-24.7	-23.6	-24.6	-19.7
Adjustor	2.6	7.8	8.3	...
Revised target	-22.1	-15.8	-16.3	...
Actual	-23.5	-17.3	-22.2	...
Ceiling on central government domestic arrears excluding suppliers (indicative)	0	0	0	0
Actual	0	0	0	...
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	0.3	0.4	0.3	...
o/w non HIF domestic central government arrears	0.3	0.4	0.3	...
Ceiling on arrears of the Health Insurance Fund (indicative)	0.2	0.2	0.2	0.2
Actual	0	0	0	...
	Cumulative Flows within the Year for Program Evaluation			
Ceiling on central government wages (indicative)	...	...	...	26.0
Actual	...	...	...	...
Floor for central government fiscal balance	0.3	0.5	0.8	-3.4
Adjustor	0	0	0.4	...
Revised target	0.3	0.5	1.2	...
Actual	2.0	5.3	11.7	...
Memo item: Program exchange rate	61.3	61.3	61.3	61.3

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

Table 2. FYR Macedonia: Performance of Structural Conditionality in 2007

Measure	Type 1/	Status
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. (May 2007)	BM	Met.
Public Revenue Office to design a strategy for improving the administration of small- and medium-sized enterprises (June 2007).	BM	Met.
Implement the March 2007 legislation harmonizing social security bases (abolishing complexity factors and sectoral minimum wages in calculation of health fund premia) (July 2007).	PC	Met.
Prepare a strategy for the harmonization of the base of the personal income tax and social security contributions (September 2007).	BM	Met with delay, in January 2008 .
Submit legislation to parliament that vests the Pension and Disability Fund with the legal authority for collecting health and employment contributions (September 2007).	BM	Met.
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	Implementation will start in April 2008, with contributions for part-time workers based on actual earnings (PC), and in July 2008 with use of actual rather than contracted wages (PC).
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 (October 2007).	BM	Met.
Health sector		
Conclude international tendering for drug procurement (June 2007).	BM	Not met. Reset for April 2008.
Financial sector		
Prepare a comprehensive framework for assessing banks' risk profile and test the performance of the prepared procedures on at least two banks (September 2007).	BM	Met.
Issue accounting guidelines, a new chart of accounts, and formats for bank's financial statements in line with IFRS (September 2007).	BM	Met.
Finalize detailed guidance manual for conducting on-site supervision (December 2007).	BM	Met.
Create a new credit registry and make it fully operational (December 2007).	BM	Reset to August 2008 in light of TA delays.
Business climate		
Publish a list of all licenses administered by line ministries and social agencies, together with their justification (June 2007).	BM	Met.
Abolish licenses that are no longer needed (September 2007).	BM	Delayed. Changes in by-laws are expected to be completed by end-February 2008, and amendments in laws will be submitted to Parliament by end-February 2008.
Energy sector		
Develop an action plan, working with the World Bank, to improve energy sector finances (May 2007).	BM	Partially met with delay, in January 2008. The plan improves government finances, but at the expense of large users and the privatized distribution company.
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) (June and December 2007).	BM	Met.

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

Table 3. FYR Macedonia: Quantitative Performance Criteria and Indicative Targets for 2008

	Mar-08	Jun-08	Sep-08 Proj.	Dec-08 Proj.
	(In million euro)			
	End of Period Stocks for Program Evaluation			
Floor for net international reserves of the NBRM	1,359	1,439	1,527	1,567
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
	Cumulative Changes for Program Evaluation			
Ceiling on new nonconcessional medium- and long-term external debt contracted or guaranteed by the general government or the NBRM with original maturities of more than 1 year	108	168	214	290
Actual	...	...	...	...
Ceiling on new non-concessional medium and long-term external debt contracted	0	15	15	53
by the public enterprises with original maturities of more than 1 year (indicative)	...	...	...	...
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	-54.8	-57.5	-61.3	-60.9
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
Ceiling on net domestic assets of the banking system (indicative)	77.6	89.5	95.5	111.1
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
Ceiling on net domestic credit to the central government from the NBRM	-10.9	-9.0	-10.2	-6.8
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 for Program Evaluation			
Ceiling on central government wages (indicative)	...	15.8	...	31.6
Actual	...	...	...	...
Floor for central government fiscal balance	-0.7	-1.4	-2.8	-5.5
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
Memo item: Program exchange rate	61.3	61.3	61.3	61.3

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

Table 4. FYR Macedonia: 2008 Structural Conditionality

Measure	Type 1/	Date
Tax policy and administration		
Integration of Social Fund Collections. Pension and Disability Fund and its network of field offices will execute collection programs for all social insurance contributions and their contributors.	PC	April 2008
Health Fund contributions for part-time workers to be paid on actual hours worked, rather than assuming a full-time work week.	PC	April 2008
Pension and Disability Fund and Employment Fund contributions calculated on the basis of actual, rather than contracted, wages.	PC	July 2008
Health sector		
Conclude international tendering for drug procurement.	BM	April 2008
Financial sector		
Submit to parliament a new Central Bank law, as described in paragraph 21 of the Letter of Intent.	PC	March 2008
NBRM to publish documents on the supervisory framework and the risk assessment process under risk-based banking supervision.	BM	March 2008
NBRM to approve the new credit registry's detailed content specifications and protocols for submitting and retrieving data.	BM	March 2008
Business climate		
Extend the coverage of the Real Estate cadastre to 75 percent of Macedonian territory	BM	June 2008

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

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

	Schedule set at 2nd Review				Proposed 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	…	…	27.65625	40.14	…
Actual	…	10.50000	15.24	…	…	10.50000	15.24	…
Treated as precautionary 3/	…	6.86250	9.96	…	…	17.15625	24.90	…
Reviews								
2nd Review	December 31, 2006	10.29375	14.94	Approval of 2nd Review	…	…	…	…
3rd Review	June 30, 2007	4.80375	6.97	August 15, 2007	September 30, 2007	9.60750 3/	13.94	Approval of 3rd Review
---	September 30, 2007	4.80375	6.97	November 15, 2007				
4th Review	December 31, 2007	4.80375	6.97	February 15, 2008	March 31, 2008	7.20563 4/	10.46	May 15, 2008
---	March 31, 2008	4.80375	6.97	May 15, 2008	June 30, 2008	7.20563 4/	10.46	August 15, 2008
5th Review	June 30, 2008	4.80375	6.97	August 15, 2008	…	…	…	…
Total purchases	…	51.67500	75.00	…	…	51.67500	75.00	…

1/ The authorities have made one purchase under this arrangement 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 scheduled to be made available in August (end-June test date) and November (end-September test date) 2007.
4/ Includes rephased amounts that were originally scheduled to be made available in February 2008 (based on end-December 2007 test date and completion of the 4th Review).

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.

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.

NET INTERNATIONAL RESERVES OF THE NBRM

	Floor on level of NIR (in million euros)
March 31, 2008 (performance criterion)	1359
June 30, 2008 (performance criterion)	1439

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 (including accrued interest), 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 September 30, 2007, reserve assets thus defined amounted to 1,489 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 September 30, 2007, reserve liabilities thus defined amounted to 119 million euro.

Adjustors

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

- upward for any privatization proceeds in foreign currency;
- downward for any prepayment of external debt.

NET DOMESTIC ASSETS OF THE NBRM

	Ceiling on level of NDA (in billion denars)
March 31, 2008 (performance criterion)	-54.8
June 30, 2008 (performance criterion)	-57.5

8. **Net domestic assets** (NDA) of the NBRM are defined as reserve money minus the net foreign assets (NFA) of the NBRM. On September 30, 2007, NDA of the NBRM was minus 59.7 billion denars.

9. **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 September 30, 2007, reserve money was 32.5 billion denars.

10. **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 September 30, 2007, NFA of the NBRM was 92.3 billion denars.

Adjustors

11. The NDA ceilings will be adjusted:

- downward for any privatization proceeds in foreign currency;
- upward by the amount of any prepayment of external debt.

NET DOMESTIC ASSETS OF THE BANKING SYSTEM

	Ceiling on level of NDA (in billion denars)
March 31, 2008 (indicative target)	77.6
June 30, 2008 (indicative target)	89.5

12. **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 September 30, 2007, NDA of the banking system was 52.1 billion denars.

13. **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 September 30, 2007, broad money was 161.8 billion denars.

14. **NFA of the banking system** are defined as the banking system's foreign assets minus foreign liabilities. On September 30, 2007, NFA of the banking system was 109.7 billion denars.

Adjustors

15. 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.

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, 2008 (performance criterion)	-10.9
June 30, 2008 (performance criterion)	-9.0

16. **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 September 30, 2007, net credit to central government from the NBRM was 22.2 billion denars.

Adjustors

17. 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.

GOVERNMENT FISCAL BALANCES

	Floors on cumulative changes in central government fiscal balances (in billion denars)
March 31, 2008 (performance criterion)	-0.7
June 30, 2008 (performance criterion)	-1.4

18. Quarterly floors for the cumulative changes in central government fiscal balances will be determined and monitored from the financing side relative to end-December 2007. The financing flows will be measured as the sum of domestic financing, foreign financing, and privatization proceeds.

19. **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).

20. **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.

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

Adjustors

22. The floor on the central government fiscal balances will be adjusted upwards by any dividend receipts in 2008 from the Makedonski Telekomunikacii exceeding 2.6 billion denars.

CENTRAL GOVERNMENT WAGE BILL

23. The ceiling on the **central government wage bill** includes central government wages and salaries, including allowances, as well as transfers to local governments to cover wages in education, child care, and elderly care.

24. A semi annual ceiling of 15.8 billion denars (indicative target) has been established for the wage bill to be measured at end-June 2008.[1]

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-2007)
March 31, 2008 (performance criterion)	108
June 30, 2008 (performance criterion)	168

25. 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 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.

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[1] Under the program, the authorities are committed to holding the yearly ratio 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.

26. 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-2007)
March 31, 2008 (indicative target)	0
June 30, 2008 (indicative target)	15

27. 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.

SHORT-TERM EXTERNAL DEBT

28. 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 September 30, 2007, short-term external debt as defined above was zero euros.

EXTERNAL PAYMENTS ARREARS

29. **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 September 30, 2007, the stock of external payment arrears as defined above was zero euros.

DOMESTIC PAYMENTS ARREARS

30. **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 September 30, 2007, central government domestic arrears as defined in this paragraph were zero denars.

31. 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 program, the outstanding stock of domestic arrears, as defined above, will not exceed 0.6 billion denars. On September 30, 2007 the amount of central government domestic arrears to suppliers as defined in this paragraph was 0.3 billion denars.

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

32. 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 September 30, 2007, the Health Insurance Fund arrears as defined in this paragraph were zero denars.

Valuation

33. 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 2008, 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).

34. 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.

35. 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. Valuation effects on accrued interest will be calculated as of end-September 2007.

Monitoring and Reporting Requirements

36. 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 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

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, Employment and Wages

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 authorities are aware of the large discrepancies between the official quarterly and annual GDP estimates, and between these and the behavior of a variety of indirect economic indicators, as noted in the previous program review.

4. The State Statistics Office,(SSO) with support from STA, has been improving compilation of the quarterly GDP by production and is 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, capacity constraints, lack of appropriate data and the need for further guidelines.

5. Further improvements in production and expenditure GDP estimates are needed to better inform policy makers and markets about economic developments. STA plans several visits of its peripatetic advisor in 2008 to provide hands-on assistance to improve the methodology used by the SSO and to provide further recommendations.

6. Employment data from the 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.

Balance of Payments

7. 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 the balance of payments and the international investment position.

8. A follow-up STA mission on balance of payments statistics took place in late 2006, and the authorities accepted most of the mission's recommendations. Following this mission, the authorities extended the scope of the annual international investment position data, in particular by covering direct investment. Other improvements are underway, and a revision of the BOP statistics is expected to be formally issued by mid-2008. One important weakness in the BOP statistics that is currently being reviewed relates to private transfers. The weaknesses have stemmed from the assumption 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 private survey of migrants to estimate transfers to generate estimates of the total amounts of private transfers and allocated them to the current and capital accounts. The National Bank of the Republic of Macedonia (NBRM) is currently completing a more comprehensive follow-up survey, which will form the basis of adjustments (the mission recommended that such surveys be conducted every five years going forward, to ensure that the main assumptions remained valid). During the first half of 2008, technical assistance is expected to improve the preparation of import and export deflators, which will help strengthen forecasts.

Government Finance

9. 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 extra-budgetary funds and hospital arrears are not fully reliable. As part of the 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* (*GFSY)* nor in the *International Financial Statistics (IFS).* The October-November 2007 government finance statistics (GFS) pilot study mission to promote the methodology of the GFSM 2001 focused, among other things, on bridging the statistics reported to the European Department (EUR) to the analytical framework of the *GFSM 2001* and producing a balance sheet for the central government. The mission identified serious data gaps in the accounts of the government that could have implications for fiscal analysis. It is envisaged that further technical assistance in GFS will be provided by the GFS regional advisor assigned to the Center of Excellence in Finance in Slovenia.

Money and Banking

10. 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 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.

11. The NBRM has recently submitted test data reported on the Standardized Report Forms from January 2003, which are being reviewed in STA.

FYR MACEDONIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(as of December 31st, 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	12/27/07	12/28//07	D and M	W and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	11/30/07	12/28/07	M	M	M		
Reserve/Base Money	11/30//07	12/21//07	D and M	W and M	M		
Broad Money	11/30//07	12/21/07	M	M	M	O, LO, LO, O	O, LO, O, O, O
Central Bank Balance Sheet	11/30//07	12/21/07	M	M	M		
Consolidated Balance Sheet of the Banking System	11/30//07	12/21/07	M	M	M		
Interest Rates[2]	11/30//07	12/28/07	M	M	M		
Consumer Price Index	Nov 2007	12/2/07	M	M	M	O, O, O, LO	LO, O, LNO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	9/30/07	11/15/07	Q	Q	Q		
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	9/30/07	11/15/07	Q	Q	Q	LO, LNO, LO, O	LO, LO, LO, LO, LNO
Stocks of Central Government and Central Government-Guaranteed Debt[5]	6/30/07	7/30/07	M	M	I		
External Current Account Balance	Sept 2007	12/17/07	M	I	Q		
Exports and Imports of Goods and Services	Nov 2007	12/17/07	M	M	Q	O, LO, O, LO	LO, O, LO, O, LO
GDP/GNP	Jun 2007	10/30/07	Q	Q	Q	O, LO, O, LO	LO, O, LNO, O, O
Gross External Debt	6/30/07	7/30/07	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 December 31, 2007)

Missions. Skopje, September 11-23, 2007 and November 7-17, 2007. Concluding statements are available at:

- http://www.imf.org/external/np/sec/pr/2007/pr07203.htm
- and http://www.imf.org/external/np/sec/pr/2007/pr07269.htm

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

Discussions. The staff team met Deputy Prime Minister Stavreski, Finance Minister Slaveski, 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). SDR 10.5 million was purchased initially but this, and earlier outstanding amounts, have been repaid. An additional SDR 4.8 million becomes available on completion of this review, but the authorities do not plan to make any more purchases under the arrangement. Remaining purchases are being rephased at this review.

Publication. The Macedonian authorities have not yet decided 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	68.90	100.00
	Reserve Position	0.00	0.00

III.	**SDR Department**:	SDR Million	Percent of Allocation
	Net cumulative allocation	8.38	100.00
	Holdings	0.92	10.97

IV. **Outstanding Purchases and Loans:** None

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)**[1]
(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2008	2009	2010	2011	2012
Principal					
Charges/Interest	0.26	0.26	0.26	0.26	0.26
Total	0.26	0.26	0.26	0.26	0.26

VII. **Safeguards Assessments:**

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

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

banking system. The reserve requirement on all foreign currency deposits is set at 10 percent.
At end-December 2007, the official exchange rate was 41.66 denars per U.S. dollar and 61.20 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 had maintained 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. Retention of this restriction was approved by the Board on December 21, 2006 until December 31, 2007, but it has now been lifted.

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**
Export and Import Deflators	STA	December 2007
GFS 2001	STA	November 2007
Expenditure Rationalization	FAD	July 2007
Central Bank Law	MCM	July 2007
Tax Policy	FAD	June 2007
Liquidity, Cash and Debt Management	MCM	April 2007
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, MCM	June 2006
Banking Reform	MCM	November 2005
Credit Growth	MCM	October 2005

National Accounts	STA	July 2005
BOP Statistics	STA	July 2005
Tax Administration	FAD	May 2005
Reserve Management	MCM	May 2005
Monetary Statistics	STA	April 2005
Resident Experts		
Banking Supervision	MCM	May 2006-present
Tax Administration	FAD	October 2006-present
Monetary Policies	MCM	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	MCM/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[1]

A. Partnership in FYR Macedonia's Development Strategy

1. The country has made considerable progress since independence, amid a highly unfavorable regional outlook during most of the 1990's and a domestic conflict in 2001. The Ohrid Framework Agreement, which ended the 2001 insurgency, brought a reasonable measure of stability to the country, despite continuing political tensions. The strategic priorities of the Government have included EU and NATO accession, implementation of the Ohrid Agreement and promoting growth and reducing unemployment and poverty. FYR Macedonia's progress is reflected perhaps most prominently in its candidacy for membership in the European Union.

2. Macroeconomic stability has been maintained since the mid-1990s. Fiscal discipline and the peg to the Euro helped maintain inflation at low levels for a decade. Government spending as a proportion of GDP has fallen to levels lower than most countries in the region. This, together with intensified structural reforms in recent years, has resulted in growth rates of around 4 percent since 2004. Stronger growth has been constrained by structural impediments and continuation of reforms is crucial if the country is to attract the investment needed to underpin more rapid growth and job creation.

3. The modest growth has been insufficient to trigger a more substantial reduction in the unemployment rate. In the second quarter of 2007, the unemployment rate was 35 percent, compared to 36.1 percent in the same period of 2006. At the same time, absolute poverty continues to affect around 20 percent of the population.

B. World Bank Supported Reform

4. Since FYR Macedonia joined the World Bank in 1993, 44 loans have been approved with a total value of approximately US$840 million, out of which around 44 percent on concessional IDA terms. FYR Macedonia graduated fully from IDA in 2003 reflecting improved economic performance and credit-worthiness. In June 2007 the authorities pre-paid slightly less than half of the disbursed IBRD portfolio.

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 by focusing on two pillars: (i) fostering job-creating economic growth, and increasing living standards for all, and (ii) improving public sector delivery and good

[1] Prepared by World Bank staff.

governance. The CPS will employ a selected mix of investment and policy lending (up to a total high case lending scenario of US$280 million over 4 years), along with a robust program of Analytical and Advisory Activities (AAA) work to support the CPS goals.

6. Over the last five years, World Bank support gradually shifted from support to the governance reforms agenda (*Public Sector Management Adjustment Credit* approved in 2002, and *Public Sector Management Adjustment Loan II* approved in 2004) towards reforms to improve the investment climate and promote growth and employment. Bank support for 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 and the third and final PDPL is planned for the first half of 2008. 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 transparency and efficiency in health sector spending, 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.

7. The Development policy lending is 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 pension and social assistance reforms; 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.

8. The Bank is also providing support to other sectors, including railways (*Railways Reform project*), energy sector (*Energy Community in Southeast Europe project* and *Sustainable Energy GEF*), agriculture (*Agriculture Strengthening and Accession project*) and trade facilitation (*Trade and Transport Facilitation in Southeast Europe 2*).

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 at all levels, as well as with the Government. Synergies between the Bank and IMF programs during the implementation of reforms 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.

10. **Judicial reform** is central to improving the business environment in FYR Macedonia and firmly establishing protection of creditor, contract and property rights. 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 complemented Bank supported reform efforts. Under the PDPL 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; and increasing the speed, transparency and fairness of administrative decisions.

11. Support for **labor market reform** also requires close coordination. A very rigid legislative framework governing labor relations as well as a high tax wedge contributed to a stagnant formal labor market, exceptionally high unemployment rate and a large informal sector. The Bank took the lead in supporting the new *Law on Labor Relations* adopted in July 2005 which eliminated the most burdensome features of the old law while the IMF has provided support in reducing the tax wedge and streamlining procedures.

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.

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 fiduciary risks associated with pharmaceutical procurement and less than fully transparent operation of the Health Insurance Fund (HIF) and Health Care Institutions (HCIs). Prior actions and performance criteria in the SBA have reinforced the Bank's programs, which support efforts to further prioritize spending, improve cost-effectiveness, and strengthen mechanisms for pharmaceutical procurement.

14. 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 will further strengthen meritocratic principles and the professionalism of the public sector. This would need to occur within the framework of the Ohrid Framework Agreement, and the associated provisions for the representation of minorities.

15. Substantial progress has been made in adopting the framework for **decentralization**, most recently with the graduation of more than half of the municipalities to the second phase as well as adoption of formulas for distribution of earmarked and block grants. While not directly involved in the design, the World Bank's and IMF's involvement ensured a fiscally sustainable progress in decentralization but further coordination will be required.

16. Most recently, the Bank and the Fund have cooperated closely on the energy sector dialogue. The Bank is assisting the counterparts in designing a plan that would ensure stable and affordable energy supply in the future, and the IMF SBA has supported this.

D. Summary

17. FYR Macedonia has made considerable progress in macroeconomic 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, however, requires continuing strong collaboration between the Macedonian Government, the Bank and the IMF.

Statement by the IMF Staff Representative
February 27, 2008

This statement provides information on developments since the issuance of the staff report. It does not change the thrust of the staff appraisal.

1. As anticipated in the staff report, all quantitative performance criteria for end-December were met (table). The indicative target on net domestic assets of the banking system was missed by a small margin, due to higher than expected private credit growth.

2. Twelve-month consumer price inflation increased from 6 percent in December to 9 percent in January, driven by an 18 percent year-on-year food price increase. There has also been a slight increase in non-food price inflation, but this remains low at around 3 percent year-on-year. However, year-average inflation for 2008 now appears likely to exceed the staff report's projection of 4 to 5 percent.

3. The National Bank of the Republic of Macedonia has responded by increasing its key policy interest rate to 5.25 percent, and has issued a statement indicating that it would further tighten monetary policy if necessary. The staff believes this response is appropriate. The exchange rate anchor and continued prudent fiscal policy should help to pull back inflation. However, the authorities should stand ready to adjust their plans (including by repeating last year's fiscal overperformance, or through further interest rate increases) should inflation increase or the current account deficit widen beyond the projected level.

4. Recent tensions in Kosovo have had no discernible impact on Macedonian financial markets.

Table. FYR Macedonia: Quantitative Performance Criteria and Indicative Targets for 2007
(Targets and Actual Outcomes)

	Mar-07	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	-43	-127	-135	-166
Revised target	1,087	1,059	1,112	1,093
Actual	1,224	1,267	1,366	1,360
Ceiling on new nonconcessional medium- and long-term external debt contracted or guaranteed by the general government or the NBRM with original maturities of more than 1 year	38	64	89	103
Actual	0	0	53	61
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
	0	0	0	0
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	0	0	0	0
Accumulation of external payments arrears	0	0	0	0
Actual	0	0	0	0
	(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	2.6	7.8	8.3	10.2
Revised target	-44.6	-41.1	-43.5	-39.9
Actual	-53.3	-54.0	-59.5	-54.2
Ceiling on net domestic assets of the banking system (indicative)	35.5	42.4	45.9	55.6
Adjustor	2.6	7.8	8.3	10.2
Revised target	38.1	50.2	54.2	65.8
Actual	35.8	50.2	52.3	68.7
Ceiling on net domestic credit to the central government from the NBRM	-24.7	-23.6	-24.6	-19.7
Adjustor	2.6	7.8	8.3	10.2
Revised target	-22.1	-15.8	-16.3	-9.5
Actual	-23.5	-17.3	-22.2	-12.8
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)	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	0.3	0.4	0.3	0.2
o/w non HIF domestic central government arrears	0.3	0.4	0.3	0.2
Ceiling on arrears of the Health Insurance Fund (indicative)	0.2	0.2	0.2	0.2
Actual	0	0	0	0
	Cumulative Flows within the Year for Program Evaluation			
Ceiling on central government wages (indicative)	...	...	...	26.0
Actual	...	...	...	24.9 1/
Floor for central government fiscal balance	0.3	0.5	0.8	-3.4
Adjustor	0	0	0.4	0.4
Revised target	0.3	0.5	1.2	-3.0
Actual	2.0	5.3	11.7	3.8
Memo item: Program exchange rate	61.3	61.3	61.3	61.3

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

1/ This total includes wage expenditures of 1.3 billion denars made by local governments to cover functions transferred to them in the context of decentralization in October 2007 and classified as transfers in the central government's fiscal accounts.

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February 27, 2008

International Monetary Fund
Washington, D.C. 20431 USA

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

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

The three-year Arrangement for an amount equivalent to SDR 51.7 million (about US$82.2 million) was approved on August 31, 2005 (see Press Release No. 05/196). The authorities are treating 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 under the Fund-supported program continues to improve. Economic growth has been robust, the fiscal position has strengthened, and foreign direct investment and international reserves have increased. The Government has also continued to make progress in reducing its external debt. Despite these successes, economic challenges remain, including containing the recent rise in inflation, achieving a sustained higher economic growth rate, and reducing unemployment.

"The authorities' record of fiscal discipline has underpinned Macedonia's strong macroeconomic performance. Substantial improvements in revenue administration and tax collections have made possible ambitious cuts in personal and corporate income tax rates, and increases in investment. At the same time, the Government expects to contain its fiscal deficit to 1.5 percent of GDP in 2008. However, substantial pension and public sector wage increases, the latter pre-announced for three years, will limit the flexibility of the budget.

"A key near term policy challenge will be to contain inflation. The central bank's interest rate increase is expected to help ensure that recent food and energy price pressures only have a temporary impact on inflation. The government should stand ready to tighten fiscal policy in case inflation pressures persist or the current account deficit widens beyond projection. By strengthening central bank governance and independence, the new central bank law should also help safeguard price stability.

"The recent increase in foreign direct investment is positive, but continued structural reform is needed to further improve the business environment and boost growth. The authorities' commitment to link health contributions to hours actually worked is commendable: this should increase part-time employment and reduce the unemployment rate. The next step should be to reduce quickly minimum social insurance contributions, as these remain a substantial impediment to job creation in the formal sector, particularly for low wage earners," Mr. Kato said.

Statement by Yuriy Yakusha, Alternate Executive Director for Former Yugoslav Republic of Macedonia and Mihai Tanasescu Senior Advisor to Executive Director
February 27, 2008

On behalf of the Macedonian authorities we thank staff for their contribution to the policy dialogue and their analysis and recommendations. The authorities value their close cooperation with the Fund, and are of the view that the consultation process has worked well and has focused on topics of importance to the Macedonian economy. This third review of the Stand-By Arrangement provides again a good opportunity to focus on the economic issues aimed at strengthening macroeconomic stability, and intensifying structural reforms.

Economic performance and outlook

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. From a longer-term perspective, the Macedonian economy continued to exhibit solid growth, averaging around 5 percent over the past years. For 2007 the growth rate is expected to reach between 5 and 5.5 percent, propelled by industrial production, in particular of iron and steel, trade and transportation. At the same time, private consumption and investment picked up, benefiting from lower taxes and a friendly business climate. The average inflation rate was 2.3 percent, although it started to pick up recently due to a relatively high increase in food prices, reflecting the global trend. Unemployment has continued to decline, but the official unemployment rate remains high at 34.2 percent in the third quarter of 2007. However, more than 50,000 jobs, or around 10 percent of the total 2007 employment, have been created in the last seven quarters, showing that implementing strong structural reforms will attract further foreign direct investment, and reduce unemployment. Savings have been healthy, aided by improved government savings, which, in turn, helped maintain a rising investment share in the economy. FDI and portfolio investments have correspondingly also been strong, and together with the higher private transfer inflows resulted in an increase of international reserves to 1.5 billion euro, higher than the program projection, besides the early repayment of the external debt, which has declined to around 35 percent of GDP. The current account deficit was only 2 percent of GDP. Looking forward, prospects for growth remain good. Over the medium term the real GDP growth is expected to reach around 6.5 percent, and inflation is projected at a relatively low level. Higher growth and investment, especially FDIs, is expected to temporarily widen the current account deficit. to around 6 percent of GDP in 2007, and employment is projected to increase by about 4 percent per year with a further decline in unemployment. Following a possible invitation for membership in NATO, and accelerated procedures for membership in EU, FDI could rise and the convergence process could accelerate even further, allowing for an additional pickup in potential growth.

Fiscal policy

The authorities have implemented a successful policy of fiscal consolidation over the past few years, in agreement also with staff and in the context of the successfully completed first two reviews of the Stand-By Arrangement. In 2007, the general budget ran a small budget surplus, of about 0.6 percent of GDP, well above the 1 percent deficit target. This fiscal consolidation was due to a strong revenue overperformance and expenditure savings. However, two supplementary budgets implemented in the last quarter of 2007 increased public spending, particularly in education, health and infrastructure, and allowed the reduction of arrears in these sectors. The 2007 fiscal consolidation was possible because the main element in the authorities' economic reform agenda is simplifying the tax system, improving its efficiency, and reducing the tax burden. In January 2008 the authorities further reduced personal and corporate income tax rates from 12 to 10 percent, and they introduced a simplified corporate income tax for small businesses, with a flat rate based on turnover. On the expenditure side, the authorities will improve the quality of spending and redirect public spending to more productive uses, such as health, education and infrastructure. For 2008 the authorities are committed to maintaining macroeconomic stability, and the fiscal deficit target of 1.5 percent of GDP is in line with the program.

The authorities acknowledge staff's concerns regarding the pension increase by on average 15 percent after the Parliament had passed the budget, but are committed to continue the fiscal consolidation and to fit these measures within the 1.5 percent of the GDP deficit target already approved. The 2008 budget and the medium-term fiscal strategy already incorporated a wage bill increase of 10 percent in each of the next three years, starting in October 2007. The tax reform implemented in the last two years led to improved revenue collection; tax revenue in 2007 exceeded the program target by 3 percent of GDP. In this respect, the authorities expect the increases in the wage bill to be funded in full from current tax revenues, and the latest data for January 2008 show an overperformance in total revenues, especially from VAT. The data for January 2008 also demonstrate that the collection of pension contributions overperformed, and the authorities expect that the pension contributions will continue to follow the rising trend from November last year. The authorities are consistent with their commitment to fiscal discipline, and they believe that overperformance in social contributions will finance the cost of the pension increase that was announced in January 2008 (0.5 percent of GDP), safeguarding the 2008 deficit target. Tax administration reform is currently well underway. The Public Revenue Office has intensified arrears collection, and improved tax collection from both large and small taxpayers. It has designed a clear strategy for improving tax administration and for making more information available to taxpayers. Furthermore, the new IT system introduced in the Pension Disability Fund has bolstered revenue collection, and preparation of legislation harmonizing the base for healthcare contributions with pension and employment contributions will strengthen the collection of social contributions and reduce the labor tax wedge. The customs administration reform and the implementation of the second phase of fiscal decentralization will strengthen the fiscal reform and will allow the local governments to increase their revenues. All these reforms in the tax administration will allow the authorities to keep fiscal policy as the main policy tool to ensure macroeconomic stability and debt sustainability.

Monetary policy and financial sector reform

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 together with a prudent fiscal policy has helped contain inflation at low levels. The inflation path in the Macedonian economy in 2007 does not resemble developments in the previous years, and does create a potential challenge for monetary policy. Inflation started to accelerate as of August 2007 and reached 6.1 percent on year-on-year basis in December. The largest part is explained by supplyside factors such as a pick-up in food and energy prices, with core inflation remaining low at 1.2 percent y-o-y. Inflation expectations are currently stable, but the risks, from wage increases, increased domestic demand, and acceleration of credit growth, are present and stress the need for strong vigilance from the NBRM. In this respect the Central Bank recently increased the interest rates on their own bills from 5.08 percent to 5.25 percent, to absorb liquidity from the domestic banks. It should be said at the outset that external vulnerability remains manageable, and the recent international financial turmoil did not directly affect the Macedonian banking system. Its indirect impact, on the other hand, could lower economic growth and worsen the trade deficit or weaken remittances. However, the external position remains strong , the current account deficit is lower compared with the program projection, and the international reserves have increased, representing around 4 months of imports.

The authorities remain committed to safeguarding the Central Bank's independence. The new draft NBRM law was sent to the EU Commission and ECB last October, and meanwhile the Ministry of Finance has made procedural consultations with the Secretariat for Legislature and the Ministry of Justice. Once the opinion from the EU institutions is received, the law will be ready for submission to the Government and subsequently to the Parliament for adoption. The primary objective of the Central Bank, under the new law, will remain to achieve and maintain domestic price stability, and it will retain full autonomy in reaching that goal.

In order to promote financial market development, the government is currently implementing a financial sector reform package, with the intention of making Macedonia more attractive for foreign banks. Some recent developments indicate significant steps forward in the process of strengthening banks' governance, tightening provisions on connected lending, and establishing a framework for consolidated supervision. At the same time, the NBRM is implementing a new framework to strengthen the banking supervision through its supervisory development plan, for assessing risk profiles of the commercial banks, and also to issue accounting guidelines in line with the new chart of accounts and formats for banks' financial statements.

Structural reforms, and improving the business climate

Macedonia has made significant progress on the structural reform side, and a number of these reforms were already mentioned when considering the government's fiscal plan. Other notable areas include plans for regulatory reform, liberalization of telecommunications, privatizations and railway restructuring. Attracting greenfield foreign direct investment is a main objective of the authorities' economic program, and the modifications of the law on Technological Industrial Development Zones will bring it closer to the EU *acquis*, and should attract leading international companies, creating new jobs and reducing unemployment.

In consultation with the business community, the authorities simplified business regulations, establishing the "one-stop-shop", and reduced the time required to register a business from five days to four hours. They have eliminated the requirement to deposit paid-in capital before registering a limited liability company. As a result business registration increased from about 7,000 in 2005 to more than 11,000 in 2007. The authorities are committed to strengthen the legal system of property rights, and they made good progress drafting, in consultation with the World Bank, a new law on the Real Estate Cadastre, improving the quality of services provided by the Cadastre office, and facilitating the use of land as loan collateral, which will help lower borrowing costs and expand credit.

One of the most important reform programs is in the electricity sector. The authorities strongly believe that improving the electricity sector's finances and eliminating budget subsidies will increase private sector participation and will improve financial discipline. In this regard, in collaboration with the World Bank, the authorities developed a strategy that will identify priority investments in the energy sector, and a plan for obtaining the necessary financial resources. The government will furthermore accelerate private-sector involvement in the energy sector, by privatizing small and medium-sized hydro-electric plants, and starting new tenders for the construction of a number of new hydro-power plants. The government decided that starting January 2008, large energy users have to pay import prices for electricity, eliminating subsidies. It also decided to start liberalizing prices for enterprises over the next 2-4 years. Last but not least, the authorities remain committed to further liberalizing household prices, but in a gradual manner, avoiding sharp shock.

Finally, we would like to express the authorities' commitment to continuing implementing the necessary reforms for improving the business environment and attracting foreign investment, reducing unemployment and strengthening the macroeconomic stability.