February 2011
IMF Country Report No. 11/42

Former Yugoslav Republic of Macedonia: 2010 Article IV Consultation and Request for an Arrangement Under the Precautionary Credit Line

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on **December 9, 2010**, 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 **January 4, 2011**. 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.

- Assessment of the Impact of the Proposed Precautionary Credit Line Arrangement on the Fund's Finances and Liquidity Position

- A staff statement

- A Press Release summarizing the views of the Executive Board as expressed during its **January 19, 2011** discussion of the staff report for the former Yugoslav Republic of Macedonia

- A statement by the Executive Director for the former Yugoslav Republic of Macedonia

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during **January 19, 2011** discussion of the staff report that concluded the Article IV Consultation

The document(s) listed below will be separately released

Selected Issues

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

Staff Report for the 2010 Article IV Consultation and Request for an Arrangement Under the Precautionary Credit Line

Prepared by the European Department
(in Consultation with other Departments)

Approved by Adam Bennett and Jan Kees Martijn

January 4, 2011

Discussion: Skopje, November 4–17 (for Article IV consultations and to discuss a possible PCL) and December 6–9, 2010 (to continue PCL discussions). The mission met with Prime Minister Gruevski, Finance Minister and Deputy Prime Minister Stavreski; Deputy Prime Minister Peshevski; Economy Minister Besimi; NBRM Governor Goshev; other officials; members of the political opposition; the private sector; press representatives, and others. At the conclusion of each visit a joint press conference was held with the finance minister and NBRM governor.

Team: November visit: Mr. McGrew (head, EUR), Mr. Arregui (EUR), Ms. Dobrescu (FAD), Ms. Bi (SPR), and Mr. Tieman (Resident Representative). December visit: Mr. Bennett (EUR), Mr. McGrew and Mr. Tieman.

Consultation focus: The focus was on policies to support the economic recovery while guarding against external risks, and the role a PCL could play in supporting the authorities' program.

PCL request: The authorities requested a two-year PCL arrangement, with access of 500 percent of quota (SDR 344.5 million) in the first year and an additional 100 percent of quota (SDR 68.9 million in the second year) to help protect the economy against external risks.

Political developments and EU accession: The ruling VMRO-DPMNE enjoys a majority in the unicameral parliament and does not face elections until mid-2012. It also holds the presidency and a majority of municipal governments. Together with its Albanian coalition partner DUI, it controls a super-majority of two-thirds of seats. The name dispute with Greece continues to block the initiation of EU accession negotiations and NATO membership.

Publication intentions: The authorities have agreed to publication of the staff report.

Exchange rate arrangement and Article VIII status: The *de jure* exchange rate regime is managed floating; the *de facto* regime is a stabilized arrangement against the euro. Macedonia has accepted the obligations of Article VIII, sections 2, 3, and 4.

Contents Page

Figures

Boxes

Attachments

EXECUTIVE SUMMARY

1. **Recovery from the modest recession in 2009 is underway, and growth is expected to accelerate to 3½ percent in 2011.** The resumption of growth is supported by the recent reductions on policy interest rates, which are expected to be transmitted with a lag to lower bank lending rates, the ongoing recovery in European trading partners, the cyclical bounce typical of recoveries, and the overall healthy condition of the banking sector. Core inflation has remained below 1 percent, although increasing food and energy prices have pushed headline inflation somewhat higher.

2. **External adjustment has been rapid and international reserves are broadly adequate.** The current account deficit fell from a peak of close to 13 percent of GDP in 2008 to a projected 3½ percent in 2010. The balance of payments appears sustainable over the medium term in light of the lack of significant overvaluation, healthy export prospects, and more subdued capital inflows and domestic credit growth than in the run-up to the crisis. International reserves are expected to be some 95 percent of short-term debt at end-2010 and to trend upwards in 2011 and over the medium term.

3. **The fiscal deficit is expected to be 2½ percent of GDP in 2010 and the 2011 budget also targets a deficit of 2½ percent.** The fiscal stance in 2010 was somewhat contractionary but will turn broadly neutral in 2011. In the view of staff, this strikes an appropriate balance between supporting economic recovery and preserving low public debt ratios and investor confidence. Over the medium-term, the authorities plan to reduce fiscal deficits to strengthen public finances further.

4. **The monetary authorities are near the end of an easing cycle that began in late 2009.** The National Bank of the Republic of Macedonia (NBRM) reduced its policy rate from 9 percent in November 2009 to 4 percent in December 2010. It based this easing on favorable trends in the balance of payments and international reserves, against a backdrop of contained inflation and below-potential output. In staff's view this easing has been consistent with protecting the exchange rate peg yet providing more room for growth, while the scope for further easing is limited due to the narrowing spread over ECB rates.

5. **The banking sector remains sound.** The crisis took its toll in the form of a significant increase in nonperforming loans and reduction in profitability over the past two years. However, the underlying soundness of the system remains intact, based on high capital adequacy ratios, ample liquidity, minimal reliance on foreign financing, conservative balance sheets, and careful supervision and regulation.

6. **The principal risks to this broadly favorable outlook come from the potential for financial turbulence in the Eurozone to spill over to Macedonia.** Turbulence in sovereign debt markets and financial systems and negative growth shocks in the Eurozone could affect Macedonia through the current and capital accounts. Lower demand for Macedonia's exports would damage growth prospects and could cause balance of payments pressures, while loss of

access to capital markets would deprive the authorities of financing for external debt service and the fiscal deficit. Upside risks include progress in the name dispute with Greece, which could unblock the path to EU accession and NATO membership, and further increases in prices of metal exports.

7. **In light of these risks, the authorities have requested a Precautionary Credit Line (PCL) arrangement.** They have requested a two-year arrangement, with access of 500 percent of quota (SDR 344.5 million) in the first year and an additional 100 percent of quota (SDR 68.9 million in the second year).

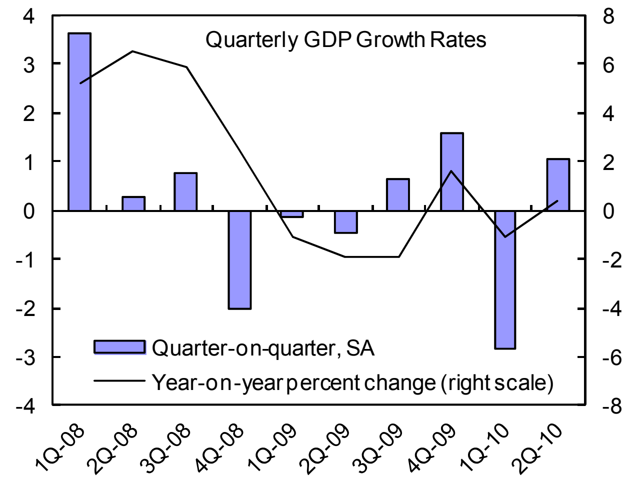
8. **Staff supports the authorities' request.** The resources available if needed under the proposed arrangement would help ensure that Macedonia could weather an adverse scenario. Moreover, having a PCL in place would send a positive signal that policies are sound and that the authorities have adequate resources to draw upon if needed, which should strengthen investor confidence and improve access to international capital markets. The authorities would not be expected to draw upon the PCL unless there is a significant deterioration in external conditions.

9. **The program will include indicative targets on the fiscal deficit and on net international reserves, as well as the standard continuous performance criteria.** These targets are described in the authorities' written communication requesting a PCL arrangement (Attachment 1). They are consistent with the authorities' 2011 budget and with their ongoing commitment to ensure a level of reserves sufficient to protect the exchange rate peg.

I. Overview: Gradual Recovery Two Years after Onset of Global Crisis

A. Growth and Inflation Developments

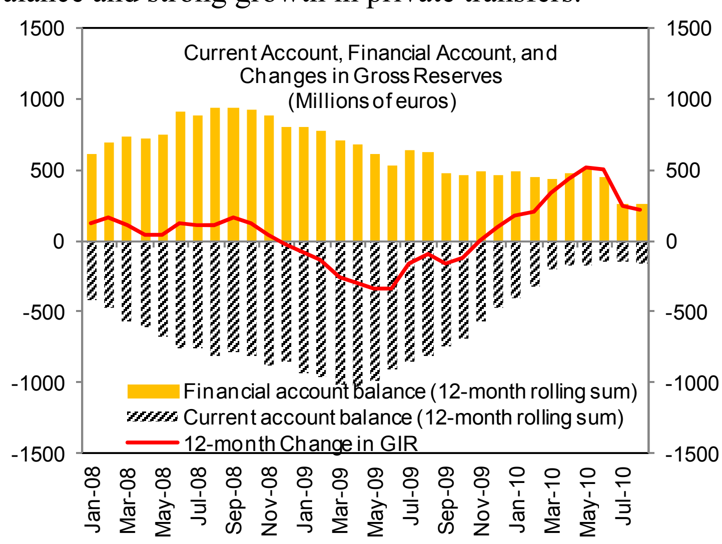
10. **Gradual recovery is underway.** Growth is projected at 1.2 percent in 2010, after a contraction of 0.9 percent in 2009. This moderate upturn has been driven primarily by recovery of exports, which have rebounded rapidly since mid-2009 and are now close to their pre-crisis peak. Recent indicators also point to a mild recovery of consumer and business spending, which are supported by resumed growth of bank credit, though at rates well below the years preceding the crisis. Inflation has picked up on the back of increases in food and energy prices, with a 2.9 percent annual increase in the headline CPI in November and core inflation of some 0.8 percent.



Sources: SSO; and IMF staff estimates.

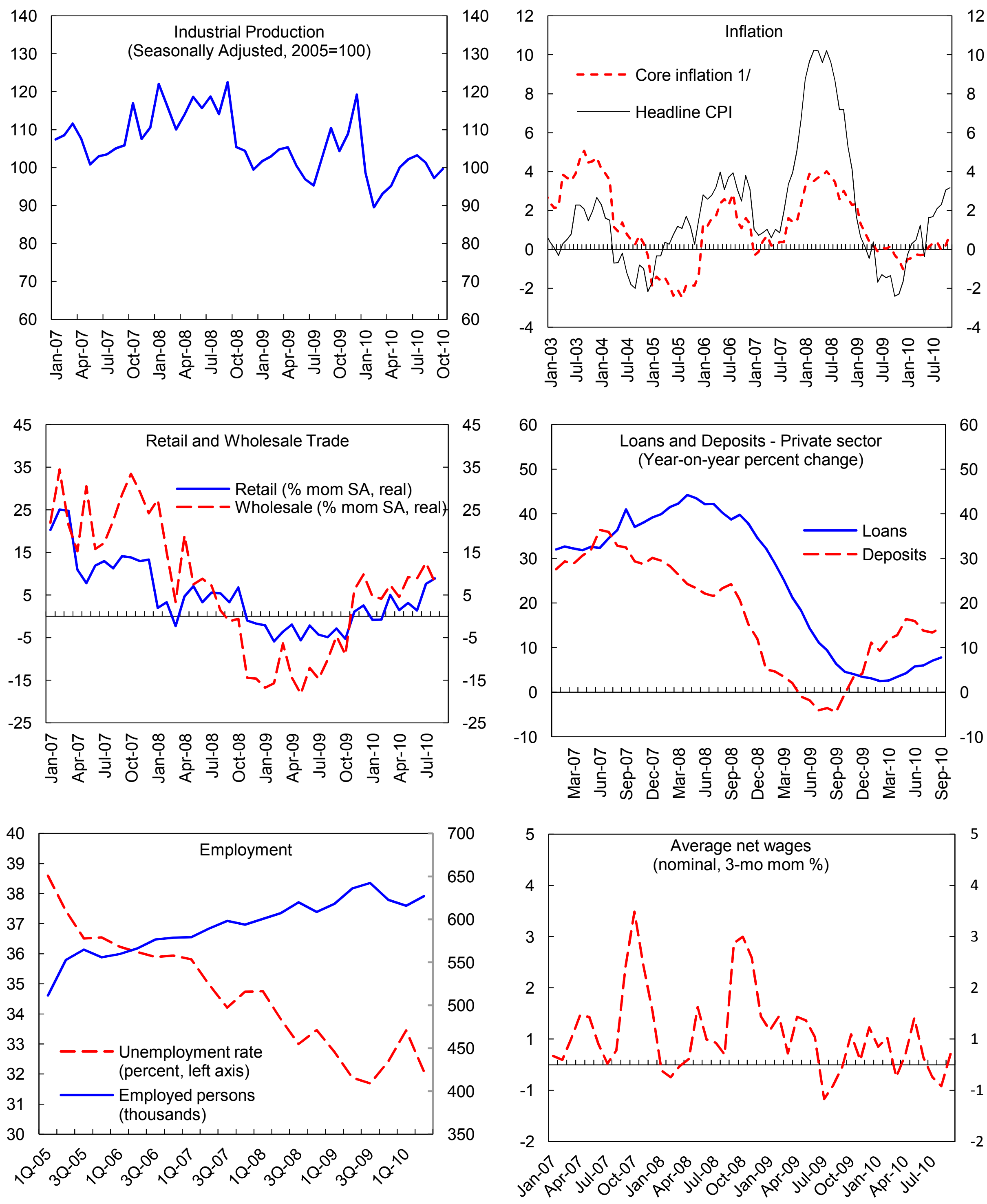
B. BOP and External Finances

11. **The current account deficit has adjusted sharply and is expected to register a deficit of some 3½ percent of GDP in 2010.** This adjustment from the deficit of 12.7 percent of GDP in 2008 reflects improvement in the trade balance and strong growth in private transfers. International reserves have climbed to €1.65 billion (95 percent of short-term debt at residual maturity) at end-December, some 40 percent above their low point in spring 2009. The spreads of Macedonia's 2015 Eurobond over German bunds widened after the collapse of Lehman Brothers and again during the Greek crisis, but have since narrowed (Figure 2). The impact of the Irish crisis and related turbulence in Eurozone sovereign debt markets on Macedonian spreads has been small thus far.



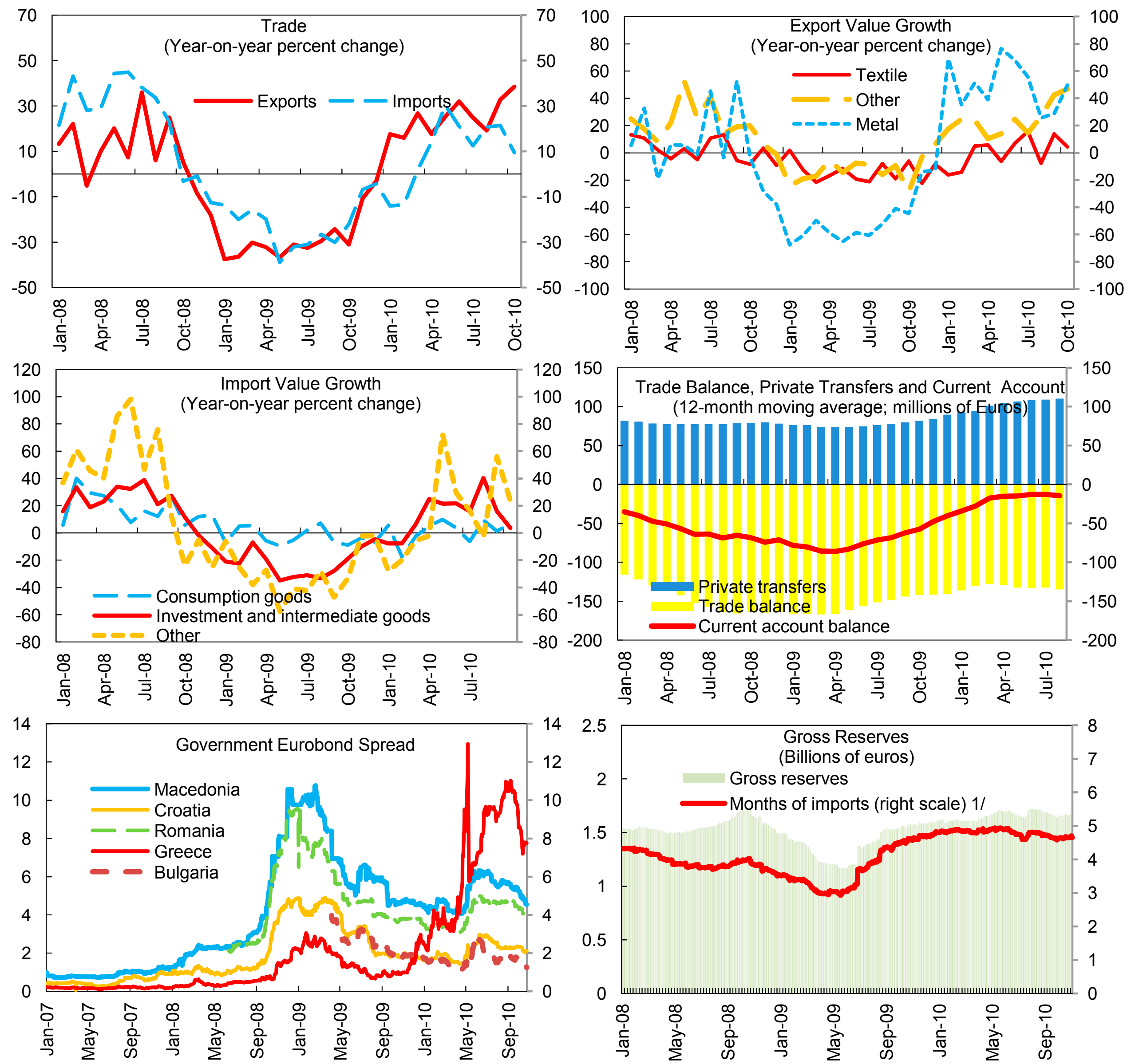
Sources: Authorities' data; and IMF staff estimates.

Figure 1. FYR Macedonia: Recent Economic Developments



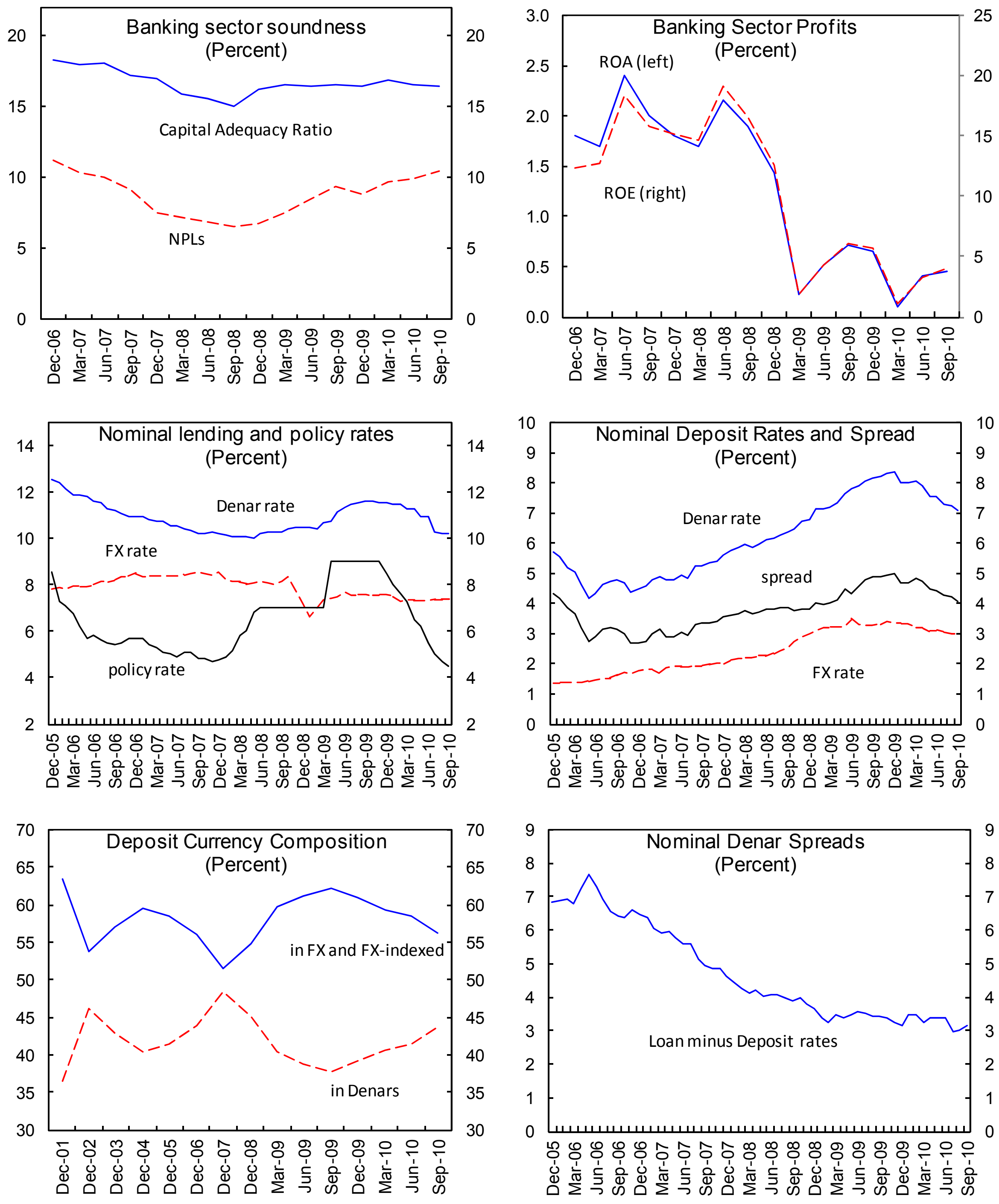
Sources: SSO; NBRM and IMF staff estimates.
1/ Excluding food, tobacco, fuels and heating.

Figure 2. FYR Macedonia: External Sector Developments



Sources: Bloomberg; Authorities' data; and IMF staff estimates.
1/ 12-month moving average of imports.

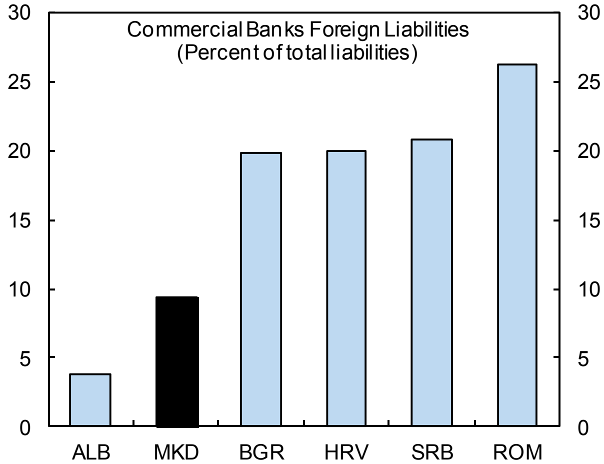
Figure 3. FYR Macedonia: Banking Sector Developments



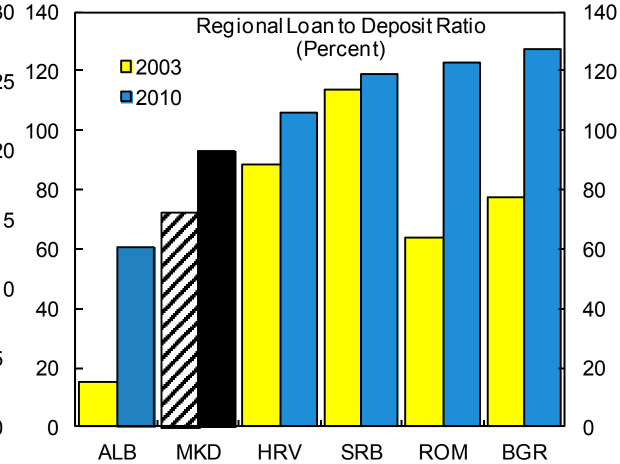
Sources: NBRM and IMF staff estimates.

C. Financial Sector

12. **The banking sector remains healthy and growth of bank credit and of deposits has started to recover.** The rapid growth of earlier years slowed to a crawl in 2009, but turned upwards in 2010. Meanwhile, bank balance sheets remain sound despite a rise in nonperforming loans, funding sources have been stable (primarily domestic deposits, with relatively little external borrowing) and the banking system is in a position to support economic recovery (Figure 3; Box 2).



Sources: Corresponding Central Banks; IFS; Haver Analytics and IMF staff estimates.



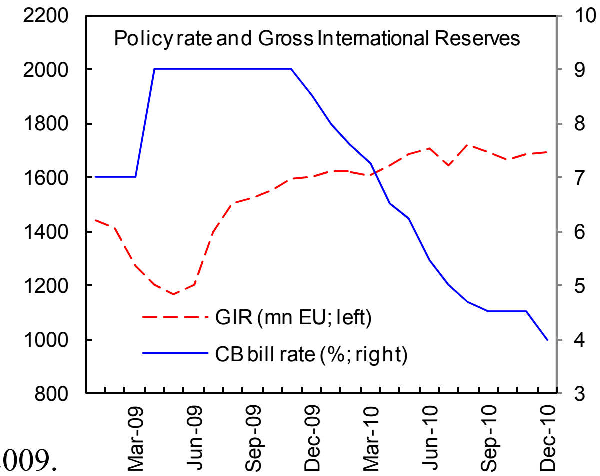
Sources: IFS; Haver Analytics; and IMF staff estimates.

D. Policy Stance

13. **The budget is on track to meet the 2010 fiscal deficit target of 2.5 percent of GDP.** Revenues are projected to fall some 1 percentage point of GDP short of amounts in the supplemental budget, due in part to lower than projected growth. The government has responded by restraining discretionary expenditure, including both current and capital spending, in order to meet the target. Earlier in the year, it also accumulated payment arrears on government invoices and VAT refund payments, which were cleared by October. These arrears resulted from cash flow pressures, related in part to the later than usual timing of the dividend on the government's stake in the telecom company and to difficult external debt market conditions in the wake of the Greek crisis.

14. **The SDR allocation, T-bill issuance, and use of deposits at the central bank were the main funding sources in 2010**. Gross financing needs, including the fiscal deficit and debt amortization, amounted to 4.5 percent of GDP. The authorities' original financing plan envisioned a Eurobond issuance of some €200 million, but this was shelved when market conditions worsened during the Greek crisis. The authorities instead drew upon their SDR allocation (1 percent of GDP) and used other official foreign financing, T-bills, and public deposits at the central bank (paragraph 23).

15. **The NBRM has cut interest rates significantly over the past year.** The easing cycle began in November 2009 when it reduced its policy rate (the 28-day CB-bill rate) from 9 to 8½ percent, while the most recent cut in December 2010 brought the rate to 4 percent. The NBRM motivated these moves by citing favorable trends in international reserves and the balance of payments, against a backdrop of low inflation and below-potential output. It has maintained the higher reserve requirements on foreign exchange denominated and indexed deposits, which were imposed as an anti-crisis measure in mid-2009.



Source: NBRM.

Box 1. Macedonia's Response to Past Policy Advice from the Fund

During the 2009 Article IV consultations (concluded in December 2009), Directors praised Macedonia's macroeconomic policies, while identifying the still large current account deficit (7.2 percent of GDP in 2009) as a vulnerability.

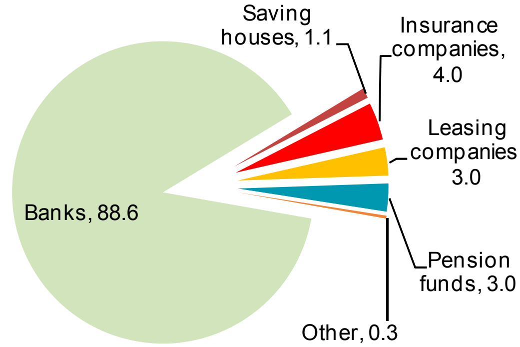
On fiscal policy Directors agreed that the 2010 fiscal deficit target of 2.5 percent of GDP was appropriate and that the authorities should strive to achieve this target even if revenues were to fall short of projections. Directors advised that debt sustainability considerations should guide fiscal targets over the medium term. On monetary policy Directors called for easing contingent on favorable trends in the balance of payments and international reserves.

The authorities' policies over the past year have been broadly consistent with the advice of Directors. The government is on track to meet its 2010 fiscal deficit targets, after reducing expenditures in response to underperformance of revenues. The NBRM has significantly lowered interest rates, in a context of rapid adjustment of the current account deficit and increasing international reserves, and has signaled that further interest rate reductions will be contingent on continued favorable trends in the external accounts.

Box 2. Financial Sector Soundness

The banking sector, which comprises 90 percent of the financial system by assets, remains in sound shape. Capital adequacy ratios have stayed above 16 percent since 2008, with tier one capital at almost 14 percent (Table 7). Domestic deposits are the main funding source, with a loan to deposit ratio of 91 percent. Reliance on foreign financing (excluding capital) is low, at 8.4 percent of assets. Nonperforming loans (NPLs) have risen from 6.8 percent of loans at end-2008 to 10.4 percent at end-September 2010 as a result of the economic downturn, but they are 93 percent covered by provisions. Banks hold ample liquidity, with highly liquid assets comprising 24 percent of total assets.

FYR Macedonia: Financial Sector Structure (end -2009)



Sources: NBRM and IMF Staff calculations

The two Greek-owned banks, representing 26 percent of system assets, are healthy overall. Stopanska Bank (owned by the National Bank of Greece) is the largest bank in Macedonia with 23 percent of system assets, and is systemically important. Its capital ratio is above the system average, it does not rely on its parent for funding, and has not experienced deposit outflows. The second Greek bank, Alpha Bank, holds 3 percent of system assets and has been hit harder by the downturn. Alpha expanded rapidly in 2007 and the first half of 2008, and was confronted with substantial NPL increases in 2009 and 2010. In response, Alpha has thoroughly reorganized its portfolio and lending practices, received a capital injection from its parent, and is now in a consolidation stage.

The quality of banking regulation and supervision has contributed to the stability of the banking sector. Supervision is conducted by the independent NBRM, which pays close attention to capital ratios, uses conservative practices and rules on NPL provisioning, and has set reserve and liquidity requirements at conservative levels. In addition, the NBRM conducts regular and thorough on-site examinations of asset quality and lending practices. It runs regular stress tests, which show that the system remains solvent under extreme adverse scenarios. In a scenario with a 20 percent depreciation combined with other shocks, the average capital adequacy ratio of the system remains above 12 percent but falls slightly below 8 percent for one large bank and becomes negative for one medium-sized bank.

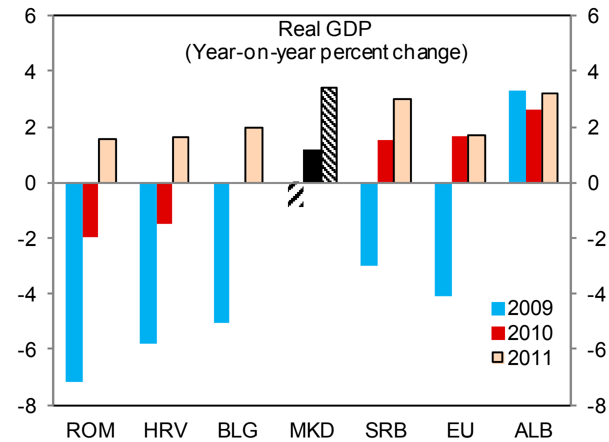
The banking system is highly euroized, with 56 percent of deposits and 58 percent of loans either in FX or linked to FX. Euroization increased with the onset of the global crisis in 2008, but has trended down (deposits) or been flat (loans) since mid-2009 (Figure 3). While the banking system has a net long open foreign exchange position, it is exposed to indirect credit risk from unhedged borrowers (according to NBRM surveys, 14 percent of loans to corporates are fully or partially hedged). Stability of the peg is thus important for the system's health.

The remaining 10 percent of the financial sector (insurance, leasing, and pension funds) do not pose systemic risk.

II. Macroeconomic Outlook

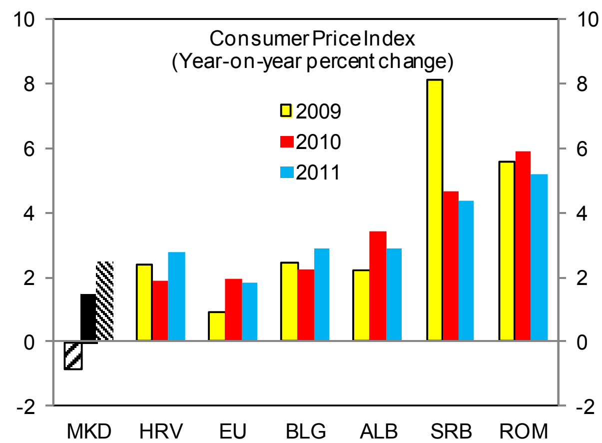
A. Real Economy and Inflation

16. **The recovery is expected to pick up pace in 2011, with growth at 3½ percent.** This favorable outlook is based on signs of momentum visible in leading indicators of consumption and investment and the upturn in bank credit. The resumption of growth will be supported by the recent reductions on policy interest rates, which are expected to be transmitted with a lag to lower bank lending rates; the ongoing recovery in European trading partners; the cyclical bounce typical of recoveries; and the overall healthy condition of the banking sector. The authorities broadly share this outlook.



Sources: WEO Oct. 2010; and IMF staff estimates.

17. **Headline inflation is expected to rise to 2½ percent in 2011 on the back of higher food and energy prices, although core inflation will be more contained**. Higher agriculture prices will add 0.8 percentage points to projected inflation, and liberalization of power prices will also contribute to higher headline inflation.



Sources: WEO Oct. 2010; and IMF staff estimates.

B. Balance of Payments

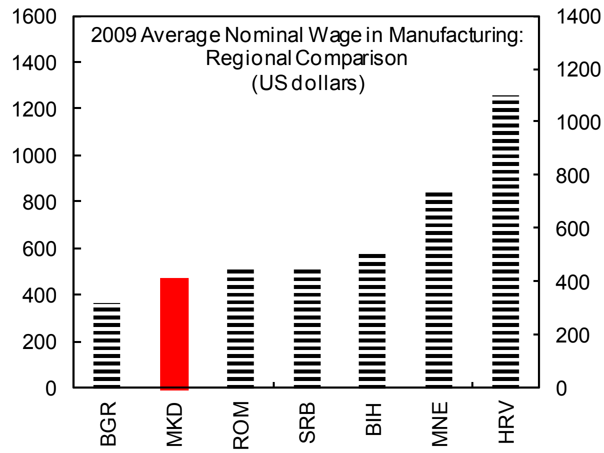
18. **The current account deficit is expected to remain at moderate levels that can be financed largely by FDI over the medium term.** As the recovery gains momentum and FDI recovers toward pre-crisis levels, the current account deficit is expected to widen to the 5½ percent range over the medium term. If growth surprises on the downside or FDI remains stagnant, the deficit would be more contained. International reserves are expected to rise gradually over the medium term, reaching 120 percent of short-term debt (residual maturity) in 2013–2015.

19. **The medium-term balance of payments is sustainable and the exchange rate peg remains viable and well supported.** This assessment is based on (1) the lack of real exchange rate overvaluation; (2) strong export prospects; (3) the strong link of the current

account to capital inflows (in particular FDI); and (4) slower domestic credit growth over the medium term than over 2004–08.

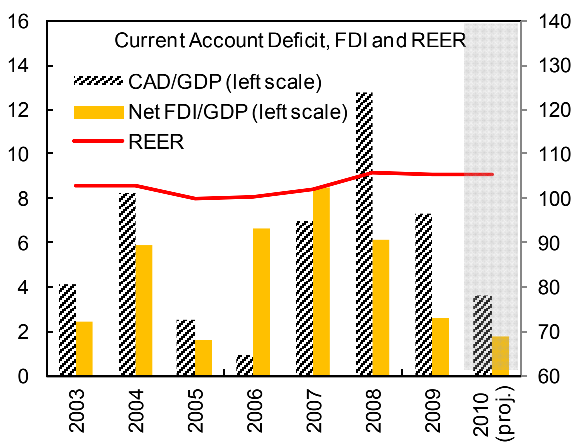
- The standard CGER methodology does not show any significant misalignment. The three CGER measures show a slight 3.3 percent to 6.3 percent overvaluation, which is not significantly different from zero (Box 4). This assessment of competitiveness is supported by the low wages and taxes (including 10 percent flat personal and corporate income tax rates) in Macedonia.

- Prospects for export growth are good over the medium-term. Exports in 2010 are projected to be 8 percent below 2008 levels, indicating excess capacity. Several large exporters have invested recently in capacity and have plans for sizable expansion, including the largest metals exporters and the auto part companies. Foreign investment in other export industries is in the pipeline.

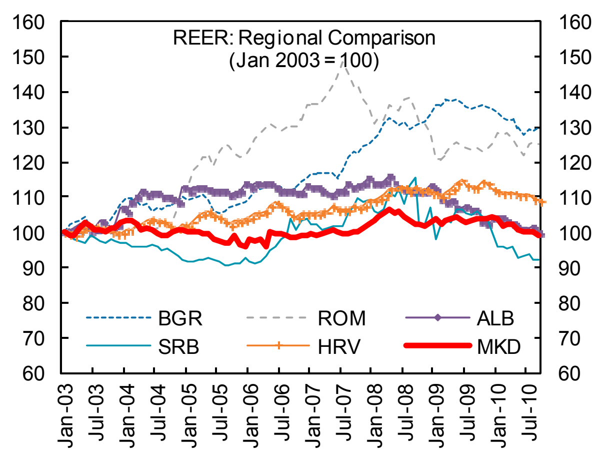


Sources: ILO data; and IMF staff calculation.

- Historically, the current account responds more to FDI and other capital inflows (with a lag) than to the exchange rate. Indeed, the real exchange rate has been very stable over the past decade, making its influence on the trade and current accounts difficult to isolate.



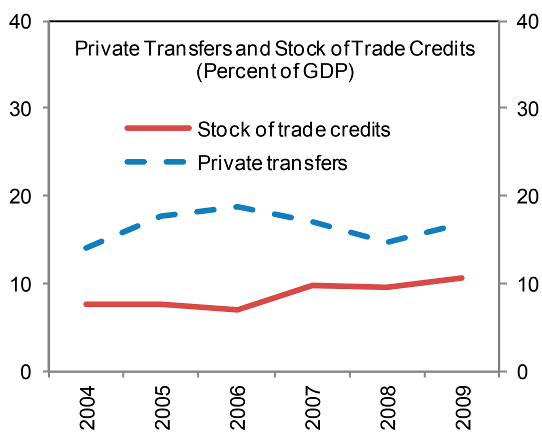
Sources: Authorities' data; and IMF staff estimates.



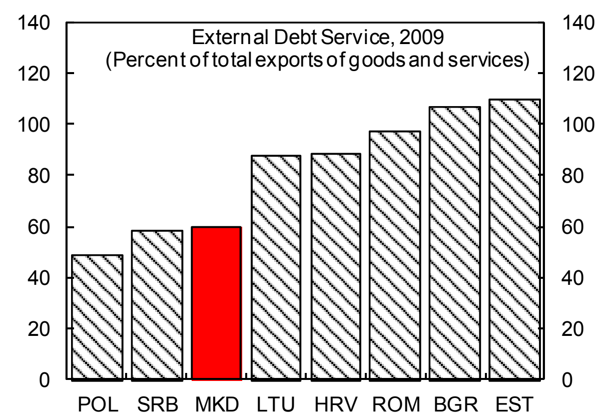
Source: INS data and IMF staff calculation.

- The strong growth of bank credit to the private sector of recent years (averaging 30 percent annually over 2004–08), which supported higher imports and a reduced savings rate, is not likely to recur in the foreseeable future, as bank funding will be more constrained and banks will likely retain their more cautious stance toward credit risk.

20. **Macedonia's external debt service ratio is moderate compared to other countries in the region.** External debt service was about 57 percent of exports of goods and services in 2009, slightly higher than in Poland and Serbia but lower than in other countries in the region. About 80 percent of external debt service consists of short-term debt, comprising mainly trade credits and intercompany loans. Both these types of short-term debt are less subject to rollover risk than many other liabilities such as bilateral bank loans, syndicated loans, and sovereign debt. In addition, trade credits are covered by imports that usually serve as collateral. The high level of trade credits in Macedonia can be partly explained by its high imports-to-GDP ratio. Another mitigating factor is strong private transfers, which have been stable over time. If these are included in the denominator, the debt service ratio falls to 40 percent.



Sources: Authorities' data; and IMF staff estimates.



Source: WEO

FYR Macedonia: External Debt Service Decomposition, 2009

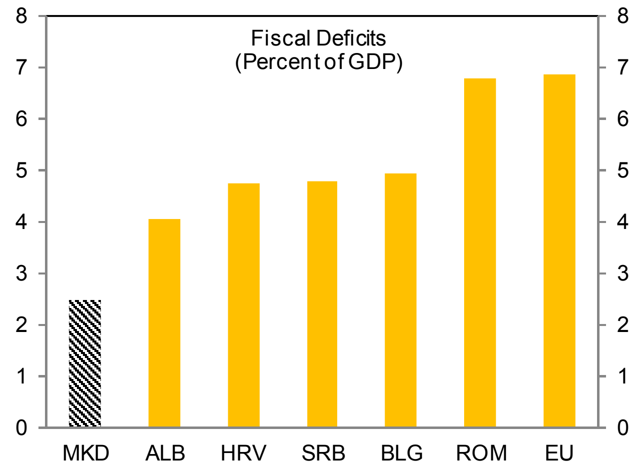
	Millions of euros	Percent of exports of G&S	Percent of exports of G&S and private transfers
Total external debt service	1,440	56.7	39.8
ST debt repayment	1,163	45.8	32.1
Private	1,163	45.8	32.1
Intercompany debt	253	10.0	7.0
Trade credits	622	24.5	17.2
Other	288	11.3	8.0
Amortization of MLT debt	193	7.6	5.3
Public	40	1.6	1.1
Private	153	6.0	4.2
Interest payment on MLT debt	85	3.3	2.3
Public	25	1.0	0.7
Private	60	2.4	1.7

Sources: NBRM; and IMF staff estimates.

III. Policy Discussions

A. Fiscal Policy

21. **The 2011 budget calls for a deficit of 2.5 percent of GDP, with gradual consolidation planned over the medium term.** The 2011 budget shifts expenditure toward capital spending, in part by freezing government wages and employment for a second straight year. It also postpones previously planned reductions in social contribution rates, which were intended to reduce the labor tax wedge, due to their revenue impact. The 2011 revenue projections appear realistic, and the authorities indicated their commitment to restrain spending in order to meet their deficit target in the event that revenues fall short of projections. Over the medium term the government plans to reduce the fiscal deficit to 1.5 percent of GDP, which will stabilize public debt near 25 percent of GDP.



Sources: WEO Oct. 2010; and IMF staff calculations.

22. **Staff views this fiscal stance as broadly appropriate on the basis of cyclical demand management and debt sustainability.** The 2010 stance is somewhat contractionary (a negative fiscal impulse of 1.3 percent of GDP), while the 2011 target is close to neutral. Although a more counter-cyclical stance might have been justified in 2010 (in light of slower than expected growth early in the year), financing was constrained externally by market volatility related to the crisis in Greece, and domestically by the limited size of the public debt market. This fiscal stance implies a rise in public debt from 24.6 percent of GDP at end-2010 to a projected peak of 27 percent of GDP in 2012, and then a gradual decline in outer years.

FYR Macedonia: Cyclically-adjusted Fiscal Balances

	2009	2010	2011	2012
Primary fiscal balance	-2.1	-1.8	-1.7	-1.3
Overall fiscal balance	-2.7	-2.5	-2.5	-2.2
Cyclically-adjusted primary balance	-2.5	-1.2	-1.3	-1.3
Cyclically-adjusted overall balace	-3.1	-2.0	-2.1	-2.2
Fiscal impulse (primary balance)	-0.2	-1.3	0.1	-0.1
Fiscal impulse (overall balance)	-0.3	-1.1	0.2	0.1

Source: IMF staff estimates.

Note:The fiscal impulse is the difference in the cyclically-adjusted balance between the previous and the current year (a negative fiscal impulse means a cyclically-adjusted contraction). Cyclical adjustment of fiscal balances is done with respect to both output and absorption gaps.

23. **The authorities plan to finance their 2011 budget deficit with a Eurobond issue in the first half of next year.** They view this as preferable to domestic financing, as it will help boost international reserves and may reduce crowding out of the private sector as economic activity picks up. Moreover, the domestic T-bill market is relatively small (below 4 percent of GDP) and over one percent of GDP will be required to repay maturing state bonds (which are largely a legacy of the break-up of the former Yugoslavia). Market conditions have improved since the onset of the Greek crisis, with secondary market yields on Macedonia's 2015 Eurobond under 6 percent (390 basis points over German Bunds) as of mid-December and little impact thus far from the crisis in Ireland. Staff agreed that Eurobond financing was appropriate for 2011 and that market conditions appeared to be adequately receptive at present. Staff advised that the authorities should turn towards domestic debt markets in the medium-term (Box 3). The authorities intend to avoid payment delays in the event of future financing pressures.

Central Government Financing

	2010		2011	
	Millions of euro	Percent of GDP	Millions of euro	Percent of GDP
Total financing requirement	307	4.5	320	4.3
Deficit	175	2.5	188	2.5
Gross amortizations	132	1.9	132	1.8
Domestic state bonds	90	1.3	82	1.1
External	42	0.6	50	0.7
Total financing sources	307	4.5	321	4.3
Central bank deposits	80	1.2	-36	-0.5
Domestic T-bill issuance (net)	85	1.2	87	1.2
External	142	2.1	269	3.6
Of which: SDR	66	1.0	-	-
Of which: private external	0	0.0	190	2.5

Sources: MoF; and IMF staff estimates.

Box 3. Medium-term Public Debt Strategy

The authorities' strategy of relying on Eurobond markets for deficit financing in 2011–2012 appears appropriate on balance. However, over the medium term Macedonia should seek to reduce its need to issue Eurobonds by developing domestic debt markets and reducing fiscal deficits.

Macedonia's public debt structure is in transition, from low interest rate non-market debt (multilateral and bilateral) to more costly private debt (domestic T-bills and external Eurobonds, Table 10). In 2011–2012 the government plans to finance budget shortfalls largely through Eurobonds, and over the medium-term to reduce deficits and develop the domestic debt market. As this process unfolds, debt management will become more important in light of the higher cost and greater volatility of market borrowing.

The higher cost of market debt means that the authorities must have higher primary surpluses to preserve stable debt ratios. For example, if Macedonia were to meet projected fiscal deficits through 2015 only with Eurobonds issued at the present secondary market yield, interest payments would rise by 0.3 percent of GDP, requiring an equal increase in the primary balance to stabilize public debt ratios.

As the authorities consider the relative weights of Eurobond and domestic T-bill issuance, there are several tradeoffs to take into account.

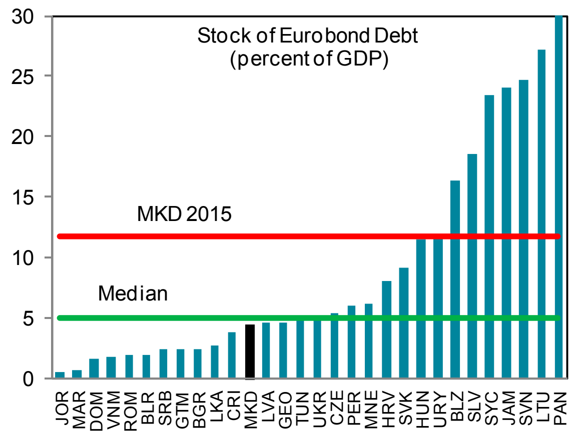
- Eurobond financing has several attractive features. First, it helps to build international reserves (provided it is at least partially sterilized by NBRM instruments). Second, it lengthens debt maturities (domestic market debt is virtually all short term), which reduces rollover risks. Third, there may be some reduction in crowding out, as external issuance boosts reserves and allows a more relaxed monetary stance (less than full sterilization by NBRM instruments). Finally, Eurobond financing helps establish a presence in international capital markets and broadens the investor base, with benefits for corporate access.

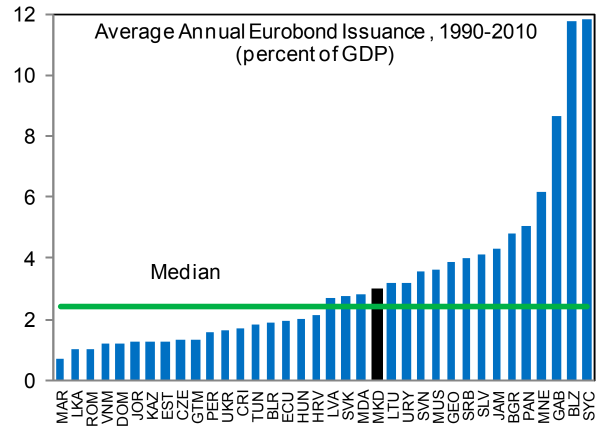
- Eurobond financing also carries risks. External markets are subject to volatility for external reasons, as seen in the spike in Eurobond yields during the Greek crisis, which did not have the same impact on domestic debt yields. A cross-country panel model of the determinants of spreads shows that domestic factors explain only a small portion of the recent movements in Macedonia's borrowing costs[1]. This external volatility creates the risk that markets will be closed or demand a high premium for issuance needed to finance deficits or roll over maturing debt. Moreover, external debt exposes the country to foreign exchange risk if the exchange rate comes under pressure.

There are no established benchmarks for the optimal or maximum stock of Eurobond debt. Looking at

[1] Empirical models indicate that Macedonia should be able to issue at a spread of some 250 basis points. This suggests that Macedonia can expect its current secondary market spreads of around 400 basis points to narrow as global financial conditions normalize.

other countries' experience, Macedonia's stock of external market debt is around 5 percent of GDP, which is relatively low and suggests there is room for additional issuance. However, if it were to finance its fiscal deficits solely by Eurobonds through 2015, its stock of Eurobond debt as a share of GDP would be high relative to comparable issuers. With respect to the size of individual bond issues, the 2½ percent of GDP range envisaged by the authorities for 2011 and 2012 is not out of line with the experience of other issuers.[2]

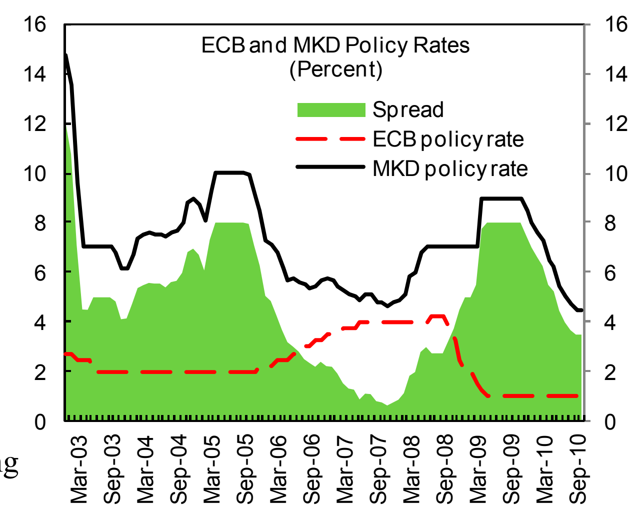




Sources: Dealogic; WEO; and IMF staff calculations.

B. Monetary and Exchange Rate Policy

24. **The NBRM is near the end of its easing cycle.** Its interest rate policies are driven foremost by the need to preserve confidence in the peg by holding adequate international reserves. It does not have an explicit target for reserves, but takes into account several factors including reserve adequacy measures (months of imports, coverage of short-term debt), underlying balance of payment trends that affect reserve movements, credit growth rates, trends in the ratio of euro-denominated to denar deposits, and Eurozone interest rates. Inflation is targeted indirectly by maintaining the peg to the Euro. Staff agreed with the authorities that this is an appropriate framework and that recent rate cuts were justified in light of conditions (trends in reserves, balance of payments, euroization, inflation and the output gap). Staff expressed the view that



Sources: NBRM; and Haver Analytics.

[2] See Selected Issues paper for further analysis on public debt strategy and Eurobond issuance

further easing should be cautious and dependent on continued favorable conditions, in light of the narrowing spread over Eurozone rates and the cost to credibility of easing excessively and then being required to reverse course. The authorities concurred, while noting that further modest easing is possible if conditions remain favorable in the coming months.

25. **The authorities are committed to maintaining the exchange rate peg, which they believe has provided a successful anchor for monetary policy and has deep public support.** Staff agreed that the peg has served Macedonia well, delivering low and stable inflation, a stable real exchange rate, and moderate volatility of output, and has not prevented current account adjustment. There was agreement that with supportive policies, the peg continued to provide a suitable anchor for the authorities' objectives of low inflation and stable growth.

C. Financial Sector and Structural Reform

26. **The authorities recently passed a new NBRM law and are taking several initiatives to improve further the resilience of the banking sector and to strengthen crisis response capabilities**. The new law on the NBRM will strengthen its independence and bring practices fully in line with EU directives and the European System of Central Banks Treaty, drawing upon advice from the EU, IMF, and World Bank. The authorities have prepared draft legislation to address the risk of court challenges to NBRM intervention of insolvent banks and close gaps in the ability to impose fit and proper requirements on bank owners and managers. They have also prepared proposals to widen the class of assets that banks may use to access liquidity support from the NBRM. The authorities recently created the Financial Stability Committee to coordinate crisis response activities and are in the process of making it operational.

27. **The authorities are undertaking structural reforms that are intended to improve Macedonia's long-term growth potential**. In the area of public infrastructure, they are making investments to raise the quality of key highway and railroad links with neighboring countries and have submitted a new energy law that will create a liberalized energy market and improve incentives for energy efficiency and investment. Full liberalization of the energy market will also have important macroeconomic benefits by helping to insulate the balance of payments from shocks to domestic electricity production and volatility in the price of electricity imports[3].The authorities are also continuing their efforts to improve the business environment and attract investment through initiatives such as cadastral reform, privatization of several loss-making state-owned enterprises, and moderate further reductions in social contribution rates in 2012 and 2013 to reduce the labor tax wedge and increase employment. The authorities plan to make these reductions in rates in a manner that is consistent with the

[3] See Selected Issues Paper on the electricity sector.

long-term financial sustainability of the public pension system.

28. **Economic and financial statistics are broadly adequate, though there are some shortcomings.** These include the lack of adequate quarterly real GDP statistics and incomplete fiscal data on public enterprises. The authorities recognize the need for improvement and are drawing on EU and IMF technical assistance, including an ongoing EU project whose goals include harmonizing national accounts and other statistics with the

Box 4. Exchange Rate Assessment

Staff analysis suggests that the real exchange rate is broadly in line with medium-term fundamentals. This is consistent with the conclusions of the last Article IV staff report. Standard CGER analysis based on three methodologies points to a slightly overvalued real exchange rate in the medium term (3 to 6 percent), which is not judged to be significant given the wide error bands:

- **Both the *macro-economic balance* (MB) approach and the *Equilibrium Real Effective Exchange Rate* (ERER) approach point to a slight overvaluation.** The MB approach suggests a current account norm of -4.0 percent of GDP, about 1½ percentage points lower than the underlying current account deficit. Depending on the assumptions used for elasticity of the current account with respect to the real effective exchange rate (REER), a real depreciation of 4 to 4½ percent would be needed to close the gap between the norm and the underlying current account in the medium run. Similarly, the ERER approach suggests an overvaluation of about 3½ percent.

Macedonia: Estimated REER Misalignment

Approach	Magnitude of Misalignment	
	Elasticity	
	Baseline (-0.35)	-0.3
Macroeconomic Balance	3.9	4.4
Equilibrium REER 1/	3.3	…
External Stability	5.6	6.3
Overall Assessment	No Significant Misalignment	

Source: IMF staff estimates.
1/ Equilibrium REER measure does not depend on elasticity.

- **The *External sustainability* (ES) approach indicates a somewhat larger overvaluation than the above two approaches.** In ES, the current account norm is estimated to be -3.4 percent of GDP, implying a REER adjustment of about 6 percent to stabilize net foreign assets.

This assessment relies on the projection that the current account deficit will widen only modestly before stabilizing at a level financeable by FDI. There are both upside and downside risks to this baseline scenario. On the upside, faster recovery in Eurozone and other neighboring countries could support a more vigorous rebound in exports, as could higher metals prices. Progress towards EU accession would improve prospects for foreign investment as well as competitiveness through accelerated structural reforms. On the downside, weaker than expected recovery in the Eurozone or terms of trade shocks (energy and metals prices) could increase the current account deficit. Moreover, if FDI rebounds over the medium term, the current account deficit is also likely to widen, as historically current account shortfalls tend to mirror FDI inflows (see text chart in paragraph 19).

Eurostat norms. They have taken the decision to subscribe to the IMF's Special Data

Dissemination Standard (SDDS), which will be an important step forward in ensuring best practices. An IMF STA mission visited Macedonia in December to help the authorities develop an action plan and timetable for subscribing to SDDS.

IV. Risks

29. **Vulnerabilities in Europe pose the main known risk for Macedonia.** Turbulence in sovereign debt markets and financial systems and negative growth shocks in the Eurozone could spill over to Macedonia through the current and capital accounts. Lower demand for Macedonia's exports would damage growth prospects and could also reduce international reserves and require a monetary policy response. Adverse developments in sovereign debt markets could make it difficult for the government to issue external debt to cover its external debt service and finance the fiscal deficit. On the upside, progress in the name dispute with Greece could unblock the path to EU accession and NATO membership, with positive effects on foreign investment and growth. Terms of trade shocks pose risks in both directions. Higher energy prices would increase the import bill, while further gains in metals prices would boost export revenues.

V. Precautionary Credit Line

A. Context: Sound Economic Fundamentals, Policies, and Policy Framework

30. **Macedonia has sound economic fundamentals and a track record of sound policies.** In the last five years, Macedonia has averaged an overall fiscal deficit of 1.2 percent of GDP, inflation of 2.7 percent and real growth of 3.7 percent. It has maintained the peg to the Deutsche Mark and euro since 1997. External debt, projected to be at 58 percent of GDP at end-2010, has a favorable composition and is manageable. The banking system is well capitalized, liquid, and funded predominantly by local deposits.

31. **The authorities' policy mix, consistent with recommendations in the 2009 Article IV consultation, has been supported by a sound institutional policy framework and good implementation capacity.** The central bank has tightened policy as needed to protect the exchange rate peg and operates independently of the government. Monetary policy was allowed to ease only as underlying balance of payments trends turned favorable and reserves rose to the recommended range, against a background of weak domestic demand. The finance ministry maintains low multiyear budget deficit targets and consistently meets them with regular budget rebalancing if revenues fall short during the course of the year.

32. **The authorities remain committed to sound policies in the future to reduce any remaining vulnerabilities.** The authorities are committed to a program of exchange rate stability, low fiscal deficits, structural reforms to improve the business climate and to strengthen further the resilience of the financial sector, and further improvements in the quality of economic and financial data.

33. **Macedonia's external accounts have improved, it does not have an actual balance of payments need at present, and it is not expected to have such a need in 2011–12.** The current account deficit is moderate and mostly financed by FDI. Foreign reserves have fully recovered their post-Lehman losses and are projected to reach 95 percent of short-term debt (residual maturity), 208 percent of base money, and 3.7 months of imports of prospective goods and services at end-2010.

B. Role of PCL, Access, and Conditionality

Role of PCL

34. **The PCL arrangement requested by the authorities would provide insurance against external risks.** Despite sound fundamentals and policies, external risks remain significant, including those emanating from financial markets in Europe. The resources available if needed under the proposed arrangement would help ensure that Macedonia could weather an adverse scenario. Moreover, having a PCL arrangement in place would send a positive signal that policies are sound and that the authorities have adequate resources to draw upon if needed, which could be expected to strengthen investor confidence.

Access

35. **The authorities have requested a two-year arrangement with 500 percent of quota (SDR 344.5 million) in the first year and an additional 100 percent of quota (SDR 68.9 million) in the second year.** They believed a two-year arrangement was appropriate in light of the persistence of external risks and the stronger signal that this would send relative to a one-year arrangement. They believed access of 500 percent of quota for the first year was justified by the risks of severe shocks relating to European sovereign debt markets, financial systems, and growth. For the second year, an additional 100 percent of quota would provide a buffer against a scenario of persistent shocks. The authorities also noted that they will need to pass legislation that will allow them to draw upon the PCL if needed, as required under the Public Debt Law (the government would submit legislation after Fund approval of the PCL, and passage would be expected by early March). Staff shares the authorities' confidence that parliamentary approval will be forthcoming.

36. **Staff agreed that a two-year arrangement would provide valuable insurance against the risk of a protracted external crisis and could also help to strengthen confidence ahead of the parliamentary elections due by mid-2012**. With respect to access level, staff agreed that a reasonable stress scenario could give rise to financing needs that would justify the access levels requested by the authorities (Box 5).

Macedonia, FYR: Proposed Access, 2010

			High-Access Cases 1/		
	Proposed Arrangement	Proposed Arrangement (Percentile)	20th Percentile	80th Percentile (Ratio)	Median
Access					
In millions of SDRs	413	6	1,449	13,424	6,662
Average annual access (percent of total)	300	56	168	561	261
Total access in percent of: 2/					
Actual quota	600	57	300	1,000	560
Gross domestic product	7	60	2.9	9.0	6
Gross international reserves	27	21	27	85	49
Exports of goods and nonfactor services	10	13	11.1	39.1	21.1
Imports of goods and nonfactor services	9	15	10.1	33.5	20
Total debt stock					
Of which: Public	27	72	9	33	12
External	11	44	7	20	12
Short-term 3/	29	40	20	83	33
M2	13	47	8	29	13

Sources: Executive Board documents, MONA database, and Fund staff estimates.

1/ High access cases include available data at approval and on augmentation for all the requests to the Board since 1997 which involved the use of the exceptional circumstances clause or SRF resources. Exceptional access augmentations are counted as separate observations. For the purpose of measuring access as a ratio of different metrics, access includes augmentations and previously approved and drawn amounts.

2/ The data used to calculate ratios is the actual value for the year prior to approval for public and short-term debt, and M2 (2009 data were used, as they are the latest available actual data), and the projection at the time of program approval for the year in which the program was approved for all other variables (projections for 2011 were used).

3/ Refers to residual maturity.

Box 5. Access Level

Staff prepared a stress case scenario based on negative shocks to EU growth and sovereign debt markets. The proposed access level of 500 percent of quota in the first year of the arrangement and 600 percent in the second year would broadly cover the financing needs arising in such a scenario (Table 4). The scenario assumes:

- GDP growth of 0.7 percent for the EU in 2011 (one percentage point lower than the Fall 2010 WEO baseline). Some persistence of this growth shock is assumed for 2012, when growth is assumed to rise only to 1.2 percent. Lower growth in the EU would widen Macedonia's trade deficit and reduce transfers and FDI.

- An outflow of 5 percent of bank deposits in 2011, with half the outflows returning in 2012. The assumed outflow reflects the possibility of the loss of depositor confidence in the event of negative developments in European banking systems.

- The loss of access to sovereign debt markets in 2011–12, which could occur in the event that shocks to external debt markets spill over to Macedonia.

- The financing gap is defined as that level of support needed to maintain gross international reserves at 85 percent of short-term debt. This is below the 100 percent benchmark that is often used for emerging markets, which is justified by the large share of relatively stable trade credits and intercompany loans in Macedonia's short-term debt. It is above the low point reached in spring 2009, when reserves dipped to 79 percent of end-year short-term debt.

Economic concept-based metrics for Macedonia's potential access of SDR413.4 million are in line with access under previous Fund arrangements.

Box 6. Exceptional Access Criteria

In view of the exceptional access under the authorities' request for a PCL arrangement (Attachment I), staff's evaluation is that Macedonia meets the four exceptional access criteria.

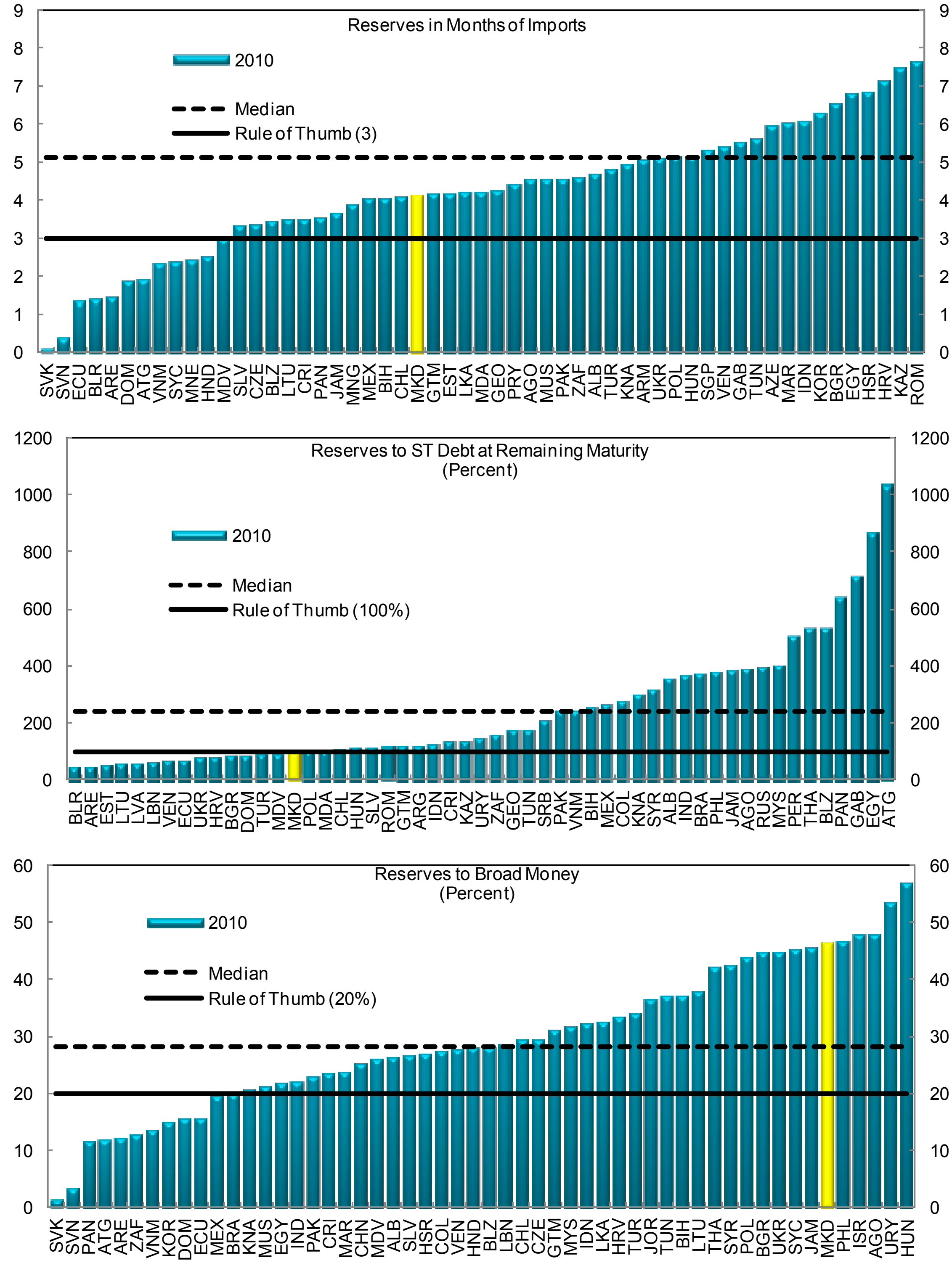
- **Criterion 1**: *The member is experiencing or has the potential to experience actual or potential exceptional balance of payments pressures on the current or capital account resulting in a need for Fund financing that cannot be met within the normal limits.* Macedonia does not face actual balance of payments pressures. However, it is exposed to risks of economic and financial disruptions in Europe. Staff is of the view that the realization of a stress scenario could give rise to financing needs beyond normal access limits.

- **Criterion 2**: *A rigorous and systematic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term.* Staff is of the view that there is a high probability that the debt will remain sustainable. Gross public debt is moderate at some 25 percent of GDP and would remain stable based on the authorities' medium-term fiscal strategy. Stress tests indicate that under the standard shocks, debt ratios would remain sustainable, below 35 percent of GDP.

- **Criterion 3**: *The member has* p*rospects of gaining or regaining access to capital markets within timeframe when Fund resources are outstanding.* Macedonia has two outstanding Eurobonds, maturing in 2013 and 2015. Secondary market yields on the 2015 issue spiked to 13 percent following the Lehman collapse and again (to a lesser extent) in the run-up to the support program for Greece, but have since eased back to around 6 percent. Staff is thus of the view that Macedonia could issue at present at rates near to those in its secondary market.

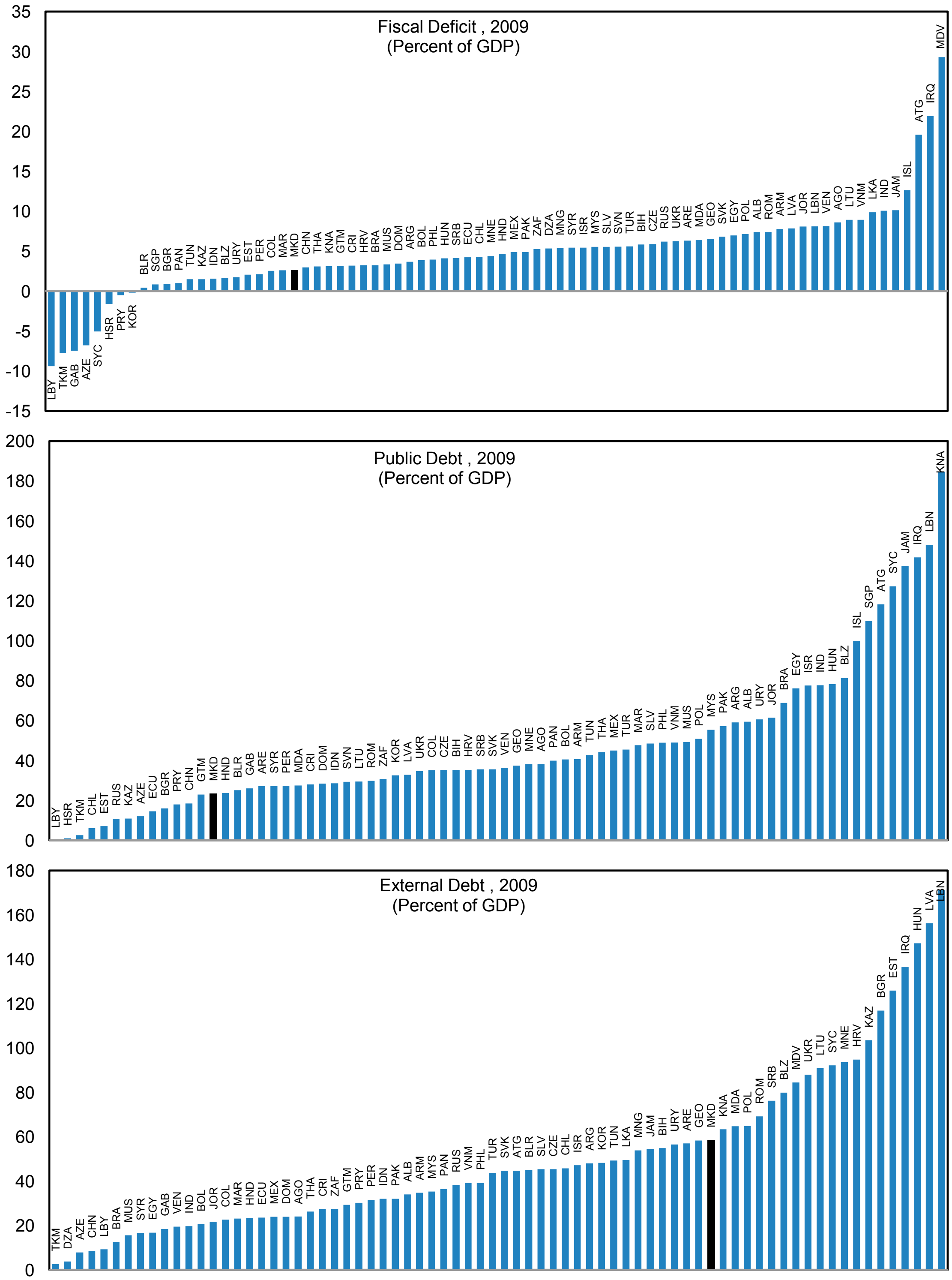
- **Criterion 4**: *The policy program and capacity to deliver the programmed adjustment provide a reasonably strong prospect of success.* Staff judges that the program has reasonably strong prospects of success, including both with regard to sound policy plans and also with respect to the institutional and political capacity to deliver on those policy plans. Macedonia's economic program, based on fiscal restraint and a central bank committed to policies consistent with the exchange rate peg, faces good prospects of success. The authorities' performance during the recent global crisis, the long track record of fiscal discipline, and the independence of the central bank give confidence in the prospect for continued sound policies in the future.

Figure 4. Macedonia, FYR: Cross country comparisons



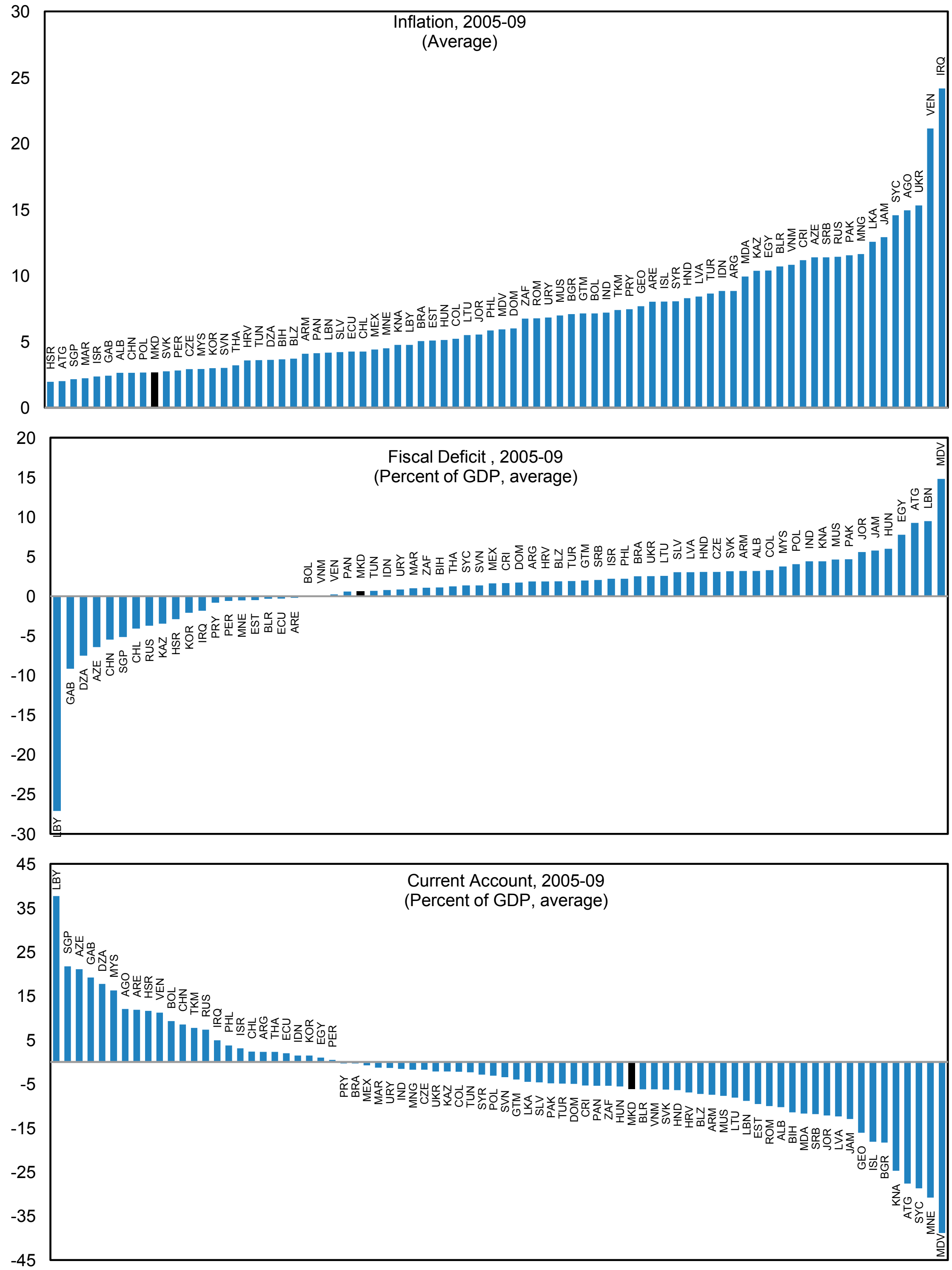
Source: WEO; IFS; IMF staff calculations.

Figure 4. Macedonia, FYR: Cross-Country Comparisons (continued)



Sources: WEO; IMF staff calculations.

Figure 4. Macedonia, FYR: Cross-country Comparisons (continued)



Sources: WEO; IMF staff calculations.

Conditionality

37. **The proposed arrangement would include indicative targets on the fiscal deficit and on net international reserves, as well as the standard continuous performance criteria.** These are described in the authorities' written communication requesting a PCL arrangement (Attachment 1). The authorities' program also includes improvements in data quality (they have committed to subscribe to the IMF Special Data Dissemination Standard), financial sector measures, and other structural reform measures (paragraphs 26–28 and Attachment 1). Information on indicative targets, review dates, and access is summarized in Table 12.

Fiscal target

38. **The fiscal targets for 2011 would be set at levels that correspond to an annual deficit of 2.5 percent of projected GDP, which is consistent with the budget passed by parliament**. The target for the first review, which would take place in July 2011, would be a cumulative deficit of denar 6.4 billion (1.4 percent of GDP) through end-May. This is based on the authorities' intention to phase the deficit evenly over the year while allowing some margin for lumpiness of revenues and expenditures. In the event that revenues fall short of projections, the government is committed to reduce expenditures to meet the target.

39. **This target avoids a negative fiscal impact on growth as the recovery gains momentum, and is consistent with stable public debt ratios at sustainable levels**. The authorities have a strong record of moderate fiscal deficits and of taking measures necessary to meet their deficit targets. This includes both 2009 and 2010, when revenues fell short of projections due in large part to slower than anticipated growth and the government met its targets by restraining expenditure. The proposed indicative target will help to strengthen confidence in the government's continued commitment to sound fiscal policies. In light of the strong credibility of the government's commitment to its deficit targets, staff supports the authorities' view that an indicative target rather than performance criterion is appropriate.

Net international reserves

40. **The proposed indicative targets (floors) on net international reserves (NIR) would be set at €1.15 billion for the end-May test date and €1.35 billion for the end-November test date.** These NIR floors correspond to gross international reserves (GIR) of €1.4 billion and €1.6 billion, respectively. The proposed floors are based on staff projections that GIR will finish 2011 at €1.85 billion (104 percent of short-term debt at residual maturity) if the government issues a Eurobond and €1.65 billion (93 percent of short-term debt) otherwise. They provide a margin for events that may affect reserves without signaling persistent pressures and hence do not call for a policy response. If reserves were to fall below the proposed floors, this could indicate the emergence of external

pressures and should trigger an examination of whether a monetary (and possibly also fiscal) policy response would be appropriate to protect reserves.

C. Qualification Criteria

41. **Macedonia performs strongly in three of the PCL qualification areas, notably fiscal policy, monetary policy, and financial sector soundness and supervision**. There is moderate underperformance against the remaining two areas, external position and data adequacy.

Fiscal policy

42. **Macedonia performs strongly in the fiscal policy area, with moderate fiscal deficits and public debt levels, and its track record indicates strong commitment to the announced fiscal deficit targets (Figure 4)**. Some 50 percent of public debt is from official lenders at low interest rates, and a further 15 percent is non-market, low interest rate domestic compensation bonds, leading to an average interest rate on public debt of 3 percent.

43. **Macedonia has a medium-term fiscal strategy in place and is undertaking efforts to fine-tune its medium-term budgeting framework**. A three-year fiscal strategy is prepared annually and includes allocation of budget ceilings to specific budget users and provisions for multiyear capital projects. Macedonia is receiving technical assistance from the IMF and the EU to put in place further improvements, including simplification of budget codes, more coordinated monitoring of spending units, and more streamlined production of strategic planning documents.

44. **The fiscal transparency ROSC from 2006 gave a generally positive assessment and further progress has taken place since**. In particular, the medium-term budgeting capacity has been improved, including a focus on the economic development program.

Monetary policy

45. **Macedonia performs strongly in the monetary policy area (Figure 4)**. The exchange rate peg has contributed to low inflation for over a decade. The central bank has a strong record of acting to defend the peg during periods of market pressure, most recently in 2009 when it raised the interest rate decisively in response to significant reserve losses. As pressures receded and reserves recovered, and against a background of weak growth and low inflation, it embarked on an easing cycle.

Financial sector soundness and supervision

46. **The financial sector is sound and supervision is adequate, fully satisfying Macedonia's performance requirements in this area (Box 2)**. The 2008 FSAP provided a

broadly favorable assessment of banking supervision. It found that a sound legal and regulatory framework and supervisory independence had been established, and that supervisory practices broadly conformed to Basel Core Principles.

External position and market access

47. **Macedonia scores well in the external sector area, but does have some remaining vulnerabilities**. External debt service is moderate, rollover pressures are limited and foreign reserve levels are broadly adequate (Section II.B). The real exchange rate appears to be fairly valued, and low wage rates and prices relative to trading partners are supportive of export growth over the medium term.

- External debt is largely made up of intercompany loans (22 percent of the total at end-2009), official sector loans to the government (21 percent), and trade credits (18 percent) (Table 11). Foreign investors do not hold local currency public debt. The standard debt sustainability tests show modest impact from interest rate, growth, or current account shocks, although a significant depreciation could create a large spike in the debt ratio (Figure 6).

- The financial account is dominated by private capital flows. Over the past five years, the public sector has on net repaid debt from official lenders.

- Macedonia first accessed international sovereign debt markets in 2005 with a 10-year €150 million Eurobond issue (at an original yield of 4.7 percent), followed by a second 3½ year €175 million bond in July 2009 (issued at 9⅞ percent). Secondary market yields on these bonds have declined as pressures from the global crisis eased, with yields of around 6 percent in mid-December 2010. The government plans to issue another Eurobond in 2011 for purposes of budget financing (including some €100 million in external debt service) and to build foreign exchange reserves, although market access remains vulnerable to adverse developments in EU sovereign debt markets.

- Reserves are relatively comfortable at €1.65 billion currently, meeting the standard thresholds for reserve adequacy and falling within the €1.5–2 billion target range recommended in the 2009 Article IV consultation. Projected balance of payments flows support moderate continued reserve accumulation over the medium term.

Data adequacy and integrity

48. **Data quality is adequate for surveillance and program monitoring, though there are shortcomings in national income accounts and government finance statistics**. Monetary and balance of payments statistics are generally of good quality (as discussed in the monetary and financial policy transparency ROSC). Fiscal data in key areas are adequate and are comprehensive for the central government (fiscal transparency ROSC). However,

data on state-owned enterprises remains inadequate. Macedonia does not currently subscribe to SDDS but the authorities have committed to do so and are working with the IMF STA department on an action plan for subscribing. They also aim to bring national account statistics up to European standards (ESA95) for production and dissemination of data, and are actively working on this with extensive multiyear EU technical assistance.

Approval criteria

49. **Macedonia does not face any of the circumstances under which the Fund may not approve a PCL:** (i) sustained inability to access international capital markets; (ii) the need to undertake a large macroeconomic or structural policy adjustment; (iii) a public debt position that is not sustainable in the medium term with a high probability; or (iv) widespread bank insolvencies.

VI. Impact on Fund Finances, Risks and Safeguards

50. **Access under the proposed PCL of 600 percent of quota (SDR 413.4 million) is small relative to the Fund's liquidity.** The Fund's liquidity is expected to remain adequate after approval of a PCL arrangement for Macedonia, as discussed further in the supplement assessing the impact on the Fund's finances and liquidity position.

51. **Risks to the Fund are expected to be low.** The authorities are not expected to draw upon the PCL, which is intended to be used only in the event of adverse shocks. In the event that Macedonia were to draw the entire amount available, its low public debt ratios and strong fiscal position would leave it well-positioned to repay the Fund.

52. **Macedonia has agreed to undergo a safeguards assessment, as required under the PCL framework.** The assessment has already been initiated. The most recent previous safeguards assessment update was completed in 2006.

VII. Staff Appraisal

53. **Macedonia's track record of sound economic policies held it in good stead during the recent economic crisis.** A history of low deficits and low public debt created room for modest increases in fiscal deficits in 2009 and 2010, reducing the need to match weak revenues with pro-cyclical expenditure cuts. The exchange rate regime has helped bring about low inflation and stable output for the past decade, and in staff's view there is no significant exchange rate misalignment. The NBRM responded firmly to pressures in early 2009, and as pressures abated it began an easing cycle at end-2009. A well-regulated banking system with limited integration into international markets helped shield it from the impact of the crisis.

54. **Staff welcomes the authorities' continued commitment to sound policies.** Their intention to reduce fiscal deficits over the medium term will keep debt ratios low and ensure

there is adequate fiscal space to respond to future shocks. The NBRM's policy of conditioning interest rate cuts on adequate levels and favorable trends in international reserves is a cornerstone of ensuring the continued stability of the exchange rate regime. Structural reforms to attract investment and support productivity growth will help ensure medium-term sustainability in the balance of payments. Based on this sound policy framework and contained vulnerabilities, prospects for a return to stable growth in 2011 and beyond look promising.

55. **Notwithstanding this positive outlook, Macedonia faces external risks that could translate into balance of payments or fiscal financing needs should an adverse scenario materialize.** These vulnerabilities are more a reflection of Macedonia's exposure to external shocks than weakness in economic fundamentals or policies. Nonetheless, they call for an extra degree of caution in macroeconomic and financial policies.

56. **The proposed PCL arrangement would offer Macedonia valuable insurance against external shocks.** While the authorities would not be expected to draw upon the PCL unless there is a significant deterioration in external conditions, it would provide a significant additional buffer that could help preserve stability and reduce the need for contractionary adjustments in the event of temporary shocks. Moreover, the PCL arrangement should strengthen investor confidence and facilitate better access to international capital markets. The level of access requested by the authorities is commensurate with a reasonable stress scenario.

57. **The conditionality under the proposed arrangement is appropriate for Macedonia's circumstances.** The two indicative targets reflect the existing policies of the authorities. The target on the fiscal deficit signals the government's commitment to stable public finances and to taking compensating measures in case revenues fall short of projections. The target on net international reserves signals the authorities' policy of maintaining adequate reserve buffers and taking measures to safeguard reserves in the event they are threatened by adverse external developments. In light of the authorities' strong commitment to policies consistent with these targets and their strong track record, staff supports the authorities' request for indicative targets rather than performance criteria in these areas.

58. **It is expected that the next Article IV consultation will be held on the standard 12-month cycle.**

Table 1. FYR Macedonia: Macroeconomic Framework, 2007−15

(Percentage change, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
						Proj.			
Real GDP	6.1	5.0	-0.9	1.2	3.5	4.5	4.2	4.0	4.0
Real domestic demand	9.2	6.7	-2.6	0.2	4.2	3.9	3.3	3.5	3.4
Consumption	6.5	8.0	-4.4	0.2	3.5	3.9	3.4	3.6	3.5
Private	8.1	7.4	-3.9	0.1	3.6	4.2	3.9	3.9	3.8
Public	-0.3	10.6	-6.4	0.4	2.8	1.9	0.9	2.2	2.3
Gross investment	22.2	5.4	0.9	0.2	7.3	4.0	3.0	3.0	3.0
Exports (volume)	11.8	-6.3	-10.7	11.9	16.6	14.2	11.2	9.6	9.5
Imports (volume)	16.1	0.8	-11.1	5.8	13.9	10.1	7.6	7.3	7.1
Contributions to growth	6.1	5.0	-0.9	1.2	3.5	4.5	4.2	4.0	4.0
Domestic demand	10.8	8.1	-3.1	0.2	5.1	4.7	4.0	4.2	4.0
Net exports	-4.6	-3.1	2.2	1.0	-1.6	-0.2	0.2	-0.2	0.0
Central government operations (percent of GDP)									
Revenues	32.2	32.5	30.6	30.9	31.5	31.7	31.8	32.1	32.1
Expenditures	31.6	33.4	33.3	33.5	34.0	33.9	33.6	33.6	33.6
Of which: capital	3.8	4.9	3.3	3.6	5.0	5.0	5.0	5.0	5.0
Balance	0.6	-0.9	-2.7	-2.5	-2.5	-2.2	-1.8	-1.5	-1.5
Savings and investment (percent of GDP)									
Domestic saving	17.7	14.1	18.9	21.9	21.7	21.3	21.3	21.3	21.5
Public	4.4	3.9	0.6	1.1	2.5	2.8	3.2	3.5	3.5
Private	13.3	10.2	18.3	20.8	19.2	18.5	18.2	17.8	18.0
Foreign saving	7.0	12.7	7.2	3.5	4.6	5.4	5.4	5.4	5.4
Gross investment	24.6	26.8	26.2	25.4	26.4	26.7	26.7	26.7	26.8
Consumer prices									
Period average	2.3	8.3	-0.8	1.5	2.5	2.0	1.9	1.8	1.9
End-period	6.1	4.1	-1.6	2.8	1.8	2.0	1.9	1.8	1.9
Memorandum items:									
Current account balance (percent of GDP)	-7.0	-12.7	-7.2	-3.5	-4.6	-5.4	-5.4	-5.4	-5.4
Gross official reserves (millions of euros)	1524	1495	1598	1648	1846	2141	2330	2484	2660
in percent of ST debt	118	110	109	95	104	103	123	118	118
in months of imports	3.6	4.4	4.2	3.7	3.7	3.9	4.0	4.0	4.0
Gross Central Government Debt (percent of GDP)	24.0	20.7	23.9	24.6	25.7	26.9	26.7	26.1	26.0
Foreign direct investment (percent of GDP)	8.5	6.1	2.6	1.8	3.5	4.5	5.0	5.0	5.0
External debt (percent of GDP)	47.6	49.2	57.5	58.5	57.8	58.7	57.7	56.2	55.1
Nominal GDP (billions of denars)	365	412	409	424	458	490	525	563	601
Nominal GDP (millions of euros)	5,965	6,720	6,677	6,917	7,483	8,005	8,573	9,193	9,816

Sources: NBRM; SSO; MOF; IMF staff estimates and projections.

Table 2. FYR Macedonia: Central Government Operations, 2006−11

	2006	2007	2008	2009	2010		2011
					Budget	Proj.	Budget
	(In billion denars)						
Total revenue	102.3	117.5	133.7	125.4	135.5	131.1	144.5
Tax revenue	89.2	101.3	112.7	107.0	111.2	108.7	119.2
Personal Income Tax	8.4	8.9	8.7	8.7	9.3	8.7	10.0
Corporate Income Tax	4.7	5.9	8.6	4.4	3.1	3.1	3.6
VAT	27.2	33.0	36.2	35.2	37.7	37.7	41.1
Excises	12.2	13.3	14.3	14.5	14.8	15.1	15.9
Custom Duties	5.4	6.2	6.3	5.2	5.7	5.0	5.7
Other taxes	1.8	2.5	2.9	2.9	3.0	3.6	3.0
Social contributions (total)	29.4	31.6	35.8	35.9	37.2	35.5	39.4
Pension contributions	18.6	20.1	23.1	23.4	23.9	23.1	25.7
Unemployment contributions	1.4	1.5	1.8	1.8	1.7	1.7	1.8
Health contributions	9.4	10.0	10.9	10.7	11.6	10.7	11.9
Non Tax revenue	9.9	10.4	12.8	12.6	15.1	13.8	14.4
Capital Revenue	1.8	4.9	6.9	5.0	6.2	5.6	7.1
Of which: Telecom dividend	0.0	2.9	3.8	2.4	2.5	2.5	2.6
Grants	1.4	0.9	1.3	0.8	3.1	3.1	3.8
Total expenditure	104.0	115.4	137.6	136.3	146.1	141.9	156.1
Current expenditure	94.8	101.8	117.7	123.1	128.6	126.8	133.6
Wages and salaries	23.4	23.6	20.8	22.7	23.0	22.6	23.5
Goods and services	12.9	14.8	18.7	16.2	16.1	15.6	17.2
Transfers	55.3	60.5	75.5	81.7	86.3	85.4	89.7
Pensions	25.4	26.3	30.9	33.6	34.6	34.6	36.2
Health	15.8	16.1	19.1	18.7	19.9	19.9	21.3
Local governments	2.1	3.7	10.5	12.8	13.3	13.3	14.2
Other	12.0	14.4	15.0	16.7	18.5	17.5	18.1
Interest	3.1	2.9	2.6	2.4	3.2	3.2	3.3
Capital expenditure	9.3	13.7	20.1	13.4	17.7	15.3	22.9
Lending minus repayment	0.0	-0.2	-0.2	-0.2	-0.2	-0.2	-0.4
Fiscal Balance	-1.7	2.2	-3.9	-10.9	-10.6	-10.8	-11.6
Financing	1.1	-3.7	2.4	10.8	10.5	10.7	11.6
Domestic	-9.8	7.5	-0.1	0.1	-5.5	4.2	-2.2
Central Bank	-7.2	12.7	3.2	-0.2	-4.0	4.5	-2.5
Other domestic financing	-2.6	-5.2	-3.3	0.3	-1.5	-0.3	0.3
Privatization receipts	20.3	-0.7	1.7	0.0	0.4	0.4	0.3
Foreign	-9.4	-10.5	0.8	10.7	16.1	6.2	13.5
Official	…	…	…	0.0	3.1	6.2	1.8
Private	…	…	…	10.7	8.6	0.0	11.6
Memo items:							
Contributions to second pillar pensions	1.3	1.9	2.5	2.9	2.9	2.9	2.9
Gross debt (as share of GDP)	33.0	24.0	20.7	23.9	24.6	24.6	25.7
Nominal GDP (bill. Denars)	320.1	365.0	411.7	409.1	423.1	423.8	458.5

Sources: IMF Staff and MoF estimates.

Note: Central government refers to the core government, plus consolidated extra-budgetary funds.

Table 2. FYR Macedonia: Central Government Operations, 2006−11 (continued)

	2006	2007	2008	2009	2010		2011
					Budget	Proj.	Budget
	(as share of GDP)						
Total revenue	32.0	32.2	32.5	30.6	32.0	30.9	31.5
Tax revenue	27.9	27.8	27.4	26.1	26.3	25.7	26.0
Personal Income Tax	2.6	2.4	2.1	2.1	2.2	2.1	2.2
Corporate Income Tax	1.5	1.6	2.1	1.1	0.7	0.7	0.8
VAT	8.5	9.0	8.8	8.6	8.9	8.9	9.0
Excises	3.8	3.6	3.5	3.6	3.5	3.6	3.5
Custom Duties	1.7	1.7	1.5	1.3	1.3	1.2	1.2
Other taxes	0.6	0.7	0.7	0.7	0.7	0.8	0.7
Social contributions (total)	9.2	8.7	8.7	8.8	8.8	8.4	8.6
Pension contributions	5.8	5.5	5.6	5.7	5.6	5.5	5.6
Unemployment contributions	0.4	0.4	0.4	0.5	0.4	0.4	0.4
Health contributions	3.0	2.7	2.6	2.6	2.7	2.5	2.6
Non Tax revenue	3.1	2.8	3.1	3.1	3.6	3.2	3.1
Capital Revenue	0.6	1.4	1.7	1.2	1.5	1.3	1.5
Of which: Telecom dividend	0.0	0.8	0.9	0.6	0.6	0.6	0.6
Grants	0.4	0.2	0.3	0.2	0.7	0.7	0.8
Total expenditure	32.5	31.6	33.4	33.3	34.5	33.5	34.0
Current expenditure	29.6	27.9	28.6	30.1	30.4	29.9	29.1
Wages and salaries	7.3	6.5	5.1	5.5	5.4	5.3	5.1
Goods and services	4.0	4.1	4.6	4.0	3.8	3.7	3.7
Transfers	17.3	16.6	18.3	20.0	20.4	20.1	19.6
Pensions	7.9	7.2	7.5	8.2	8.2	8.2	7.9
Health	4.9	4.4	4.6	4.6	4.7	4.7	4.6
Local governments	0.7	1.0	2.5	3.1	3.1	3.1	3.1
Other	3.7	4.0	3.7	4.1	4.4	4.1	3.9
Interest	1.0	0.8	0.6	0.6	0.8	0.8	0.7
Capital expenditure	2.9	3.8	4.9	3.3	4.2	3.6	5.0
Lending minus repayment	0.0	-0.1	0.0	0.0	0.0	0.0	-0.1
Fiscal Balance	-0.5	0.6	-0.9	-2.7	-2.5	-2.5	-2.5
Financing	0.4	-1.0	0.6	2.6	2.5	2.5	2.5
Domestic	-3.1	2.1	0.0	0.0	-1.3	1.0	-0.5
Central Bank	-2.2	3.5	0.8	0.0	-0.9	1.1	-0.5
Other domestic financing	-0.8	-1.4	-0.8	0.1	-0.4	-0.1	0.1
Privatization receipts	6.3	-0.2	0.4	0.0	0.1	0.1	0.1
Foreign	-2.9	-2.9	0.2	2.6	3.8	1.5	2.9
Official	…	…	…	0.0	0.7	1.5	0.4
Private	…	…	…	2.6	2.0	0.0	2.5
Memo items:							
Contributions to second pillar pensions	0.4	0.5	0.6	0.7	0.7	0.7	0.6
Gross debt (as share of GDP)	33.0	24.0	20.7	23.9	24.6	24.6	25.7
Nominal GDP (bill. Denars)	320	365	412	409	423	424	458

Sources: IMF Staff and MoF estimates.

Note: Central government refers to the core government, plus consolidated extra-budgetary funds.

Table 3. FYR Macedonia: Balance of Payments, 2008−15
(Millions of Euros unless specified otherwise)

	2008	2009	2010	2011	2012	2013	2014	2015
					Projection			
Current Account	-853	-483	-244	-348	-432	-462	-499	-527
Trade Balance	-1751	-1551	-1507	-1668	-1831	-1910	-2003	-2116
Exports	2684	1921	2390	2874	3307	3645	3950	4219
Imports	-4435	-3472	-3897	-4543	-5138	-5555	-5953	-6335
Services (net)	4	28	56	30	32	34	37	39
Income (net)	-91	-92	-121	-130	-139	-149	-159	-170
Transfers (net)	984	1131	1328	1420	1507	1562	1626	1720
Official	48	54	49	50	51	50	50	50
Private	936	1078	1279	1370	1456	1513	1576	1669
Of which: Cash Exchange	695	631	1103	1189	1269	1320	1387	1474
Capital and Financial Account	784	473	216	546	727	650	653	703
Capital Account (net)	-12	20	10	0	0	0	0	0
Financial Account	796	453	207	546	727	650	653	703
Direct Investment (net)	409	172	123	265	360	429	460	491
Portfolio Investment (net)	-51	104	-67	157	186	56	31	51
Of which: Eurobond (net)	-16	152	0	190	155	25	0	20
Other Investment	437	176	150	124	181	166	163	161
Trade Credits (net)	-16	167	-5	57	98	69	65	63
MLT Loans (net)	281	31	105	84	101	117	118	120
Of which:								
Public Sector	36	7	55	29	43	55	51	50
Disbursements	69	47	101	79	101	119	135	118
Amortizations	-32	-40	-46	-50	-58	-64	-83	-68
Banks (net)	-1	15	19	13	14	15	15	16
Non-Banks (net)	246	9	31	41	45	48	51	55
ST Loans (net)	-44	15	57	7	8	9	9	10
Currency and Deposits (net)	207	-62	-34	-55	-59	-63	-66	-71
Of which: Commercial Banks	251	-60	39	-13	-14	-15	-15	-16
Other (net)	8	27	28	30	32	34	37	39
Errors and Omissions	2	17	5	0	0	0	0	0
Overall Balance	-68	7	-23	198	295	188	154	176
				(in percent of GDP)				
Current Account	-12.7	-7.2	-3.5	-4.6	-5.4	-5.4	-5.4	-5.4
Of which: Trade Balance	-26.1	-23.2	-21.8	-22.3	-22.9	-22.3	-21.8	-21.6
Of which: Private Transfers	13.9	16.1	18.5	18.3	18.2	17.6	17.1	17.0
FDI (net)	6.1	2.6	1.8	3.5	4.5	5.0	5.0	5.0
				(percent change yoy)				
Exports of G&S (Value)	11.0	-24.7	22.1	19.6	15.0	10.2	8.4	6.8
Volume	-7.0	-8.6	11.9	16.6	14.2	11.2	9.6	9.5
Price	19.4	-17.6	9.1	2.6	0.8	-0.9	-1.1	-2.4
Imports of G&S (Value)	22.3	-20.6	12.0	17.5	13.4	8.5	7.4	6.5
Volume	0.0	-9.1	5.8	13.9	10.1	7.6	7.3	7.1
Price	22.3	-12.7	5.9	3.2	3.1	0.8	0.1	-0.6
Memorandum Items:								
Nominal GDP (Euro Millions)	6714	6678	6918	7485	8006	8573	9193	9816
ST Debt at residual maturity (year-end)	1355	1468	1736	1772	2072	1890	2111	2248
Gross Foreign Exchange Reserves (Euro Millions)	1495	1598	1648	1846	2141	2330	2484	2660
in mo of imports of G&S	4.4	4.2	3.7	3.7	3.9	4.0	4.0	4.0
in % of short term debt (residual maturity)	110.3	108.9	94.9	104.2	103.4	123.3	117.7	118.3
External Debt (% of GDP)	49.2	57.5	58.5	57.8	58.7	57.7	56.2	55.1
Medium and Long Term	31.9	38.0	38.5	38.0	38.6	37.6	36.2	35.2
Short Term	17.3	19.5	20.0	19.7	20.2	20.1	20.0	19.9
External Debt Service (Euro Millions)	1377	1440	1582	1881	1945	2260	2085	2313
in % of exports of G&S	40.9	56.7	51.0	50.7	45.6	48.1	40.9	42.5
in % of exports of G&S and private transfers	32.0	39.8	36.1	37.1	34.0	36.4	31.2	32.5

Source: NBRM, IMF Staff Estimates

Table 4. FYR Macedonia: External Financing Requirements

(Millions of Euros unless specified otherwise)

	2010	2011		2012	
	Baseline	Baseline	Adverse Scenario 1/	Baseline	Adverse Scenario 1/
Gross financing requirements	1633	1939	2163	2087	2167
Current account deficit	244	348	572	432	512
Trade deficit	1507	1668	1796	1831	1879
Transfers and other deficit	-1263	-1320	-1223	-1400	-1368
ST debt amortization (original maturity)	1303	1383	1383	1478	1478
MLT debt amortization 2/	85	208	208	177	177
Financing sources	1610	2137	1675	2382	2290
FDI (net)	123	265	168	360	336
Portfolio investment	-67	157	-33	186	31
o/w Eurobond issuance	0	190	0	155	0
ST debt disbursements	1383	1478	1478	1616	1616
Currency and deposits	-34	-55	-229	-59	29
MLT debt disbursements	190	292	292	278	278
Other 3/	14	0	0	0	0
Overall balance	-23	198	-488	295	123
Total size of shock in adverse scenario			686		172
Gross international reserves (GIR)	1648	1846	1160	2141	1283
Short-term debt (residual maturity)	1736	1772	1772	2072	2072
GIR as % of ST debt	94.9	104.2	65.4	103.4	61.9
Excess (+: buffer) / Shortfall (-: financing gap) of GIR relative to 85 percent of ST debt coverage	172	340	-347	380	-478
Financing gap in % of quota	N/A	N/A	435	N/A	597

Source: NBRM; and IMF Staff Estimates.

1/ The adverse scenario assumes: (1) a 0.7% growth for the EU in 2011 and a 1.2% growth for the EU in 2012. Lower growth in the EU would affect the trade balance, transfers, and FDI; (2) an outflow of 5 percent of bank deposits in 2011 and half of the outflow returns in 2012; and (3) loss of access to sovereign debt markets in both 2011 and 2012.

2/ Excludes amortization of MLT intercompany loans, which is included in FDI (net).

3/ Includes capital account balance and net errors and omissions.

Table 5. FYR Macedonia - Central Bank Survey 2007-2010
(End-period; in billions of denars unless specified otherwise)

	2007	2008	2009				2010			
			1Q-09	2Q-09	3Q-09	4Q-09	1Q-10	2Q-10	3Q-10	4Q-10
										Proj.
NFA	94.4	91.0	77.2	73.2	89.0	93.2	94.2	100.3	99.3	96.6
Assets	95.0	91.9	78.2	73.9	93.5	97.8	98.9	105.2	104.2	101.4
Liabilities	-0.6	-1.0	-0.9	-0.7	-4.5	-4.6	-4.7	-4.9	-4.8	-4.8
NDA	-56.6	-50.1	-40.5	-35.8	-47.2	-47.3	-50.2	-52.9	-53.6	-48.0
Banks (net)	-21.0	-19.0	-7.7	-12.8	-15.5	-16.8	-23.2	-23.6	-27.6	-24.8
of which:										
NBRM Bills	-21.0	-17.5	-6.9	-9.7	-12.6	-15.9	-23.0	-23.5	-26.6	-24.7
Central Government (net)	-19.6	-11.0	-13.6	-4.1	-12.2	-11.4	-6.9	-5.4	-5.0	-2.4
of which:										
Deposits at Central Bank	-20.8	-12.3	-14.9	-5.4	-13.5	-12.7	-8.2	-6.8	-10.4	-7.8
Denar	-15.3	-9.2	-12.4	-3.5	-1.5	-2.8	-4.2	-2.2	-3.5	-2.8
FX	-5.5	-3.1	-2.5	-2.0	-12.0	-9.9	-4.0	-4.6	-6.9	-5.0
State and Local Governments (net)	-1.6	-2.8	-2.7	-3.2	-3.5	-2.4	-2.6	-3.2	-3.4	-3.5
Other items (net)	-14.4	-17.2	-16.6	-15.7	-16.0	-16.7	-17.5	-20.7	-17.6	-17.3
Reserve Money	37.9	40.9	36.7	37.3	41.8	46.0	44.0	47.5	45.7	48.6
Currency in Circulation	17.9	17.6	14.6	14.2	14.5	16.3	14.8	15.7	15.9	16.2
Other	20.0	23.3	22.1	23.1	27.3	29.7	29.2	31.8	29.8	32.3
Cash in Vaults	2.0	3.2	2.6	2.6	2.7	3.2	3.2	2.8	2.9	2.9
Total Reserves	18.0	20.1	19.4	20.5	24.6	26.5	26.0	29.0	26.8	29.4
on Denar Deposits	10.7	10.3	8.8	9.3	12.6	14.2	13.8	16.3	13.8	16.1
on FX Deposits	7.3	9.8	10.6	11.2	12.0	12.2	12.2	12.7	13.0	13.3
			Growth Rates (by contribution to annual growth in reserve money)							
NFA	30.4	-9.2	-45.6	-53.0	-34.3	5.6	46.2	72.8	24.8	7.2
NDA	-10.2	17.2	51.9	48.3	40.9	6.8	-26.4	-45.7	-15.3	-1.5
Reserve Money	20.2	8.0	6.4	-4.7	6.6	12.4	19.8	27.1	9.5	5.7
Memorandum Items										
NBRM Bills (percent of GDP)	5.8	4.2	1.7	2.4	3.1	3.9	5.4	5.5	6.3	5.9
Govt Deposits at Central Bank (Percent of GD	5.7	3.0	3.6	1.3	3.3	3.1	1.9	1.6	2.5	1.8

Sources: NBRM, Staff Estimates

Table 6. FYR Macedonia - Monetary Survey 2007-2010
(End-period; in billions of denars unless specified otherwise)

	2007	2008	2009				2010			
			1Q-09	2Q-09	3Q-09	4Q-09	1Q-10	2Q-10	3Q-10	4Q-10
										Proj.
NFA	109.1	91.0	80.9	77.5	92.2	94.8	92.9	100.0	97.1	96.4
Central Bank	94.4	91.0	77.2	73.2	89.0	93.2	94.2	100.3	99.3	96.6
Commercial Banks	14.6	0.0	3.7	4.3	3.2	1.5	-1.3	-0.4	-2.2	-0.1
NDA	66.7	104.5	109.4	114.5	103.6	112.5	117.8	120.4	124.8	133.6
Credit to Government (net)	-10.5	-8.4	-6.7	-2.2	-10.8	-4.8	-0.4	1.9	2.3	8.0
From Banks (net)	10.6	5.5	9.5	5.2	4.9	9.0	9.0	10.4	10.8	13.9
of which: Credit (Tbills)	13.0	9.4	13.5	9.2	9.7	13.1	13.1	14.3	13.6	16.7
From Central Bank (net)	-21.2	-13.9	-16.2	-7.4	-15.7	-13.7	-9.5	-8.6	-8.5	-5.9
of which: Deposits	-20.8	-12.3	-14.9	-5.4	-13.5	-12.7	-8.2	-6.8	-10.4	-7.8
Credit to Private Sector (Gross)	130.4	174.8	177.8	176.9	176.9	180.2	182.8	187.6	191.2	194.7
From Banks	129.0	173.3	176.3	175.4	175.4	178.7	181.4	186.2	189.7	193.2
Denars	97.9	134.5	137.4	137.5	137.7	139.8	141.1	143.0	145.8	148.3
FX	31.0	38.8	38.9	37.9	37.7	38.9	40.3	43.2	44.0	44.9
From Central Bank	1.4	1.5	1.5	1.5	1.5	1.5	1.5	1.4	1.5	1.5
Other Items (net)	-53.1	-61.9	-61.6	-60.2	-62.6	-62.9	-64.6	-69.1	-68.7	-69.0
Broad Money (M3)	175.8	195.5	190.4	191.9	195.7	207.3	210.7	220.4	221.9	230.1
Currency in Circulation	17.9	17.6	14.6	14.2	14.5	16.3	14.8	15.7	15.9	16.2
Total Deposits	157.9	177.9	175.7	177.7	181.3	191.0	195.9	204.7	205.9	213.8
Denars	89.6	94.1	86.4	86.1	84.2	90.5	93.4	99.7	100.0	104.7
FX	68.3	83.8	89.3	91.6	97.1	100.5	102.5	105.0	105.9	109.1
Growth Rates (yoy)										
Private Sector Credit	39.0	34.1	24.3	13.6	5.9	3.1	2.8	6.1	8.1	8.0
Broad Money	29.3	11.2	6.6	1.2	-1.1	6.0	10.7	14.8	13.4	11.0
Private Sector Deposits	31.9	12.7	7.9	2.4	-0.1	7.3	11.5	15.2	13.6	12.0
Growth Rates (by contribution to annual growth in broad money)										
NFA	1.1	-10.3	-13.3	-14.1	-9.5	1.9	6.3	11.7	2.5	0.8
NDA	28.2	21.5	20.0	15.2	8.4	4.1	4.4	3.1	10.8	10.2
Broad Money	29.3	11.2	6.6	1.2	-1.1	6.0	10.7	14.8	13.4	11.0
(in percent of GDP)										
Private Sector Credit	35.7	42.5	43.5	43.2	43.2	44.0	43.2	44.3	45.2	46.0
Broad Money	48.2	47.5	46.5	46.9	47.8	50.7	49.8	52.1	52.4	54.3
Private Sector Deposits	43.3	43.2	43.0	43.4	44.3	46.7	46.3	48.4	48.7	50.5
Memorandum Items:										
Money Multiplier	4.6	4.8	5.2	5.1	4.7	4.5	4.8	4.6	4.9	4.7
Reserve Requirement Ratio (% of deposits)										
Denars	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
FX Indexed	10.0	10.0	10.0	10.0	20.0	20.0	20.0	20.0	20.0	20.0
FX	10.0	10.0	10.0	10.0	13.0	13.0	13.0	13.0	13.0	13.0
Velocity	2.1	2.1				2.0				1.8

Sources: NBRM, Staff Estimates

Table 7. FYR Macedonia: Financial Soundness Indicators of the Macedonian Banking System, 2005-2010

	2005	2006	2007	2008	2009	2010Q1	2010Q2	2010Q3
Capital adequacy								
Regulatory capital/risk weighted assets	21.3	18.3	17.0	16.2	16.4	16.8	16.5	16.4
Tier I capital/risk weighted assets 1/	24.3	18.9	15.7	14.0	13.8	14.3	13.9	13.7
Equity and reserves to Assets	15.9	13.3	11.4	11.5	11.4	11.6	11.3	11.1
Asset composition and quality								
Structure of loans								
Enterprises (loans to enterprises/total loans)	61.7	59.0	54.9	54.2	58.7	59.1	58.9	58.9
Households (loans to households/total loans)	30.6	33.4	37.7	38.5	37.9	37.4	37.5	37.4
Foreign currency lending to private sector	49.2	52.7	54.7	57.0	58.5	58.9	58.6	58.0
Foreign currency lending/total credit to private sector	25.4	26.3	24.6	22.9	22.6	23.0	23.9	23.8
Foreign currency indexed lending/total credit to private sector	23.8	26.4	30.1	34.1	35.9	35.9	34.7	34.2
NPLs								
NPLs / gross loans 2/	15.0	11.2	7.5	6.8	8.9	9.7	9.9	10.4
NPLs net of provision / capital	2.9	0.7	-5.0	-6.2	-0.6	1.1	1.2	3.7
Provisions to Non-Performing Loans	95.8	100.8	117.0	120.3	101.4	97.7	97.6	93.0
Large exposures/capital	189.7	194.7	181.4	118.0	213.3	175.4	180.3	190.3
Connected lending								
Banking system exposure to shareholders / own funds	4.3	5.2	5.6	3.1	11.4	10.1	9.8	10.1
Banking system equity investments/own funds	7.0	6.3	4.9	3.9	1.5	1.5	1.4	1.3
Earning and profitability								
ROAA 3/	1.2	1.8	1.8	1.4	0.6	0.1	0.4	0.5
ROAE 3/	7.5	12.3	15.0	12.5	5.6	1.1	3.2	4.0
Interest margin/gross income 4/	53.8	57.1	57.0	58.9	62.6	64.5	63.9	63.5
Noninterest expenses/gross income 5/	68.1	63.6	60.3	64.0	64.5	64.3	66.9	67.3
Personnel expenses/noninterest expenses	42.1	41.1	38.4	36.5	36.9	37.1	36.2	36.3
Interest Rates 6/								
Local currency spreads	6.5	6.3	4.5	3.2	2.8	2.3	2.6	2.4
Foreign currency spreads	6.5	6.7	6.5	4.2	4.2	4.1	4.2	4.4
Interbank market interest rate	8.7	4.9	3.1	5.3	6.2	4.4	3.3	2.6
Liquidity								
Highly liquid assets/total assets 7/	14.9	17.7	20.6	16.6	20.6	22.0	23.7	23.8
Highly liquid assets/total short-term liabilities 8/	22.0	25.6	28.7	24.4	30.1	32.9	35.6	35.7
Customer deposits/total (noninterbank) loans	142.3	137.1	128.3	107.7	108.2	109.1	111.2	109.8
Foreign currency deposits/total deposits	55.7	51.8	44.5	48.1	56.2	55.9	54.8	54.5
Including foreign exchange-indexed 9/	58.5	56.1	51.5	54.8	60.9	59.3	58.5	56.2
Central bank credit to banks/bank liabilities 10/	0.2	0.2	0.1	0.1	0.0	0.0	0.0	0.0
Sensitivity to market risk								
Net open foreign exchange position / own funds	51.6	47.0	38.2	25.1	13.0	13.4	12.8	19.7

Sources: NBRM's Financial Stability, Banking Regulations and Methodology Department.

1/ Until 2007Q3 Tier I Capital includes common shares, non-cumulative preference shares, general reserves and undistributed profits, net of uncovered loss from previous years, current loss and goodwill. Starting from 2007Q4, Tier I Capital includes nominal value of common and non-cumulative preference shares, premiums from common and noncumulative preference shares, general reserves and distributed profits, positions as a result of consolidation, net of uncovered loss from previous years, current loss and intangible goods, owned common and non-cumulative preference shares and the difference between the amount of necessary and the amount of allocated reserves for potential losses.

2/ Includes loans to financial and nonfinancial sector.

3/ Adjusted for unallocated provisions for potential loan losses. Since 31.03.2009 these items have been adjusted for unrecognized impairment.

4/ Interest margin is interest income less interest expense. Gross income includes net interest income, fees and commissions income (gross, not net), dividends, net income regarding securities, net capital income, net FX income and other income excluding extraordinary income.

5/ Noninterest expenses include fees and commissions expenses, operating expenses and other expenses excluding extraordinary expenses.

6/ The data has been revised as of 2010Q1.

7/ Highly liquid assets are defined as cash and balance with the NBRM, treasury bills, NBRM bills, and correspondent accounts with foreign banks.

8/ Short-term liabilities are defined as deposits and other liabilities with a maturity of one year or less (without deposits and borrowings from domestic banks). The data has been revised as of 2010Q1.

9/ FX indexed deposits include deposits and other FX indexed liabilities. However FX indexed deposits comprise the majority of these items. Since 31.03.2009 the figure refers only to FX indexed deposits.

10/ The increase in 2006 is due to loans channeled through NBRM, not NBRM credit to banks.

Table 8. FYR Macedonia: Fiscal Debt Sustainability Framework, 2005-15

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2005	2006	2007	2008	2009			2010	2011	2012	2013	2014	2015	Debt-stabilizing primary balance 9/
Public sector debt 1/	38.4	32.1	24.0	20.7	23.9			24.6	25.7	27.0	26.6	26.0	25.9	-0.6
Of which: foreign-currency denominated	25.9	19.6	14.7	13.7	16.6			17.2	18.8	20.0	19.6	18.9	18.4	
Change in public sector debt	1.8	-6.4	-8.0	-3.4	3.3			0.7	1.1	1.2	-0.3	-0.6	-0.2	
Identified debt-creating flows	-1.7	-8.1	-3.3	-1.8	2.8			1.7	0.7	0.5	0.0	-0.3	-0.2	
Primary deficit	-1.2	-0.4	-1.4	0.3	2.0			1.8	1.7	1.3	0.8	0.5	0.5	
Revenue and grants	35.2	32.0	32.2	32.5	30.6			30.9	31.5	31.7	31.8	32.1	32.1	
Primary (noninterest) expenditure	34.1	31.5	30.8	32.8	32.7			32.7	33.2	32.9	32.6	32.6	32.6	
Automatic debt dynamics 2/	-2.0	-2.0	-3.1	-2.1	0.8			-0.1	-1.0	-0.7	-0.8	-0.8	-0.6	
Contribution from interest rate/growth differential 3/	-1.9	-2.0	-3.1	-2.1	0.8			-0.1	-1.0	-0.7	-0.8	-0.8	-0.6	
Of which contribution from real interest rate	-0.4	-0.3	-1.4	-1.0	0.6			0.2	-0.2	0.3	0.3	0.2	0.3	
Of which contribution from real GDP growth	-1.5	-1.8	-1.7	-1.1	0.2			-0.3	-0.8	-1.1	-1.1	-1.0	-1.0	
Contribution from exchange rate depreciation 4/	-0.1	0.1	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Other identified debt-creating flows	1.4	-5.7	1.2	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-0.2	-6.3	0.2	-0.4	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	1.2	0.6	1.0	0.4	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual	3.6	1.7	-4.7	-1.6	0.5			-1.1	0.5	0.7	-0.4	-0.3	0.0	
Public sector debt-to-revenue ratio 1/	109.0	100.3	74.6	63.6	78.1			79.5	81.6	85.1	83.7	81.1	80.5	
Gross financing need 5/	1.9	6.7	6.7	4.1	6.5			7.5	8.1	7.6	9.8	8.0	9.9	
in million Euros	89.6	351.8	401.8	272.0	432.8			519.7	605.1	610.3	837.0	738.5	967.6	
Key Macroeconomic and Fiscal Assumptions						7-Year Historical Average	7-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	4.4	5.0	6.1	5.0	-0.9	4.0	1.7	1.2	3.5	4.5	4.2	4.0	4.0	3.6
Average nominal interest rate on public debt (in percent) 6/	2.7	2.8	2.8	3.0	3.0	2.8	0.2	3.3	3.6	3.9	4.1	4.1	4.1	3.9
Average nominal interest rate on forex debt (in percent) 6/	2.8	3.3	3.7	4.2	2.7	2.9	0.8	3.2	3.7	4.0	4.2	4.2	4.1	3.9
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.1	-0.6	-4.6	-4.5	2.8	-1.1	2.6	0.9	-0.9	1.5	1.3	1.0	1.5	1.0
Nominal appreciation (increase in euro value of local currency, in percent)	0.2	-0.2	0.0	0.0	0.0	-0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	3.8	3.3	7.4	7.5	0.3	3.9	2.8	2.3	4.5	2.4	2.8	3.1	2.6	2.9
Growth of real primary spending (deflated by GDP deflator, in percent)	1.5	-2.9	3.8	11.7	-1.2	1.8	5.0	1.3	5.1	3.5	3.2	4.0	4.0	3.6
Primary deficit	-1.2	-0.4	-1.4	0.3	2.0	-0.1	2.0	1.8	1.7	1.3	0.8	0.5	0.5	1.0
A. Alternative Scenarios						II. Stress Tests for Public Debt Ratio								Debt-stabilizing primary balance 9/
A1. Key variables are at their historical averages in 2009-14 7/								24.2	25.9	27.9	28.8	29.6	30.8	-0.6
A2. No policy change (constant primary balance) in 2008-13								24.6	25.8	27.6	28.2	28.9	29.9	-0.8
B. Bound Tests														
B1. Real interest rate is at baseline plus one standard deviations								24.6	26.1	27.7	27.7	27.5	27.6	-0.3
B2. Real GDP growth is at baseline minus one-half standard deviation								24.6	26.3	28.3	29.0	29.7	31.1	-0.5
B3. Primary balance is at baseline minus one-half standard deviation								24.6	26.7	28.9	29.5	29.8	30.5	-0.8
B4. Combination of B1-B3 using one-quarter standard deviation shocks								24.6	26.5	28.5	28.9	29.0	29.5	-0.4
B5. One time 30 percent real depreciation in 2006 8/								24.6	33.6	34.7	34.1	33.4	33.0	-0.8
B6. 10 percent of GDP increase in other debt-creating flows in 2006								24.6	35.7	36.7	36.1	35.2	34.8	-0.8

Sources: MoF and IMF Staff estimates.

1/ Consolidated central government gross debt.

2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of euro).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

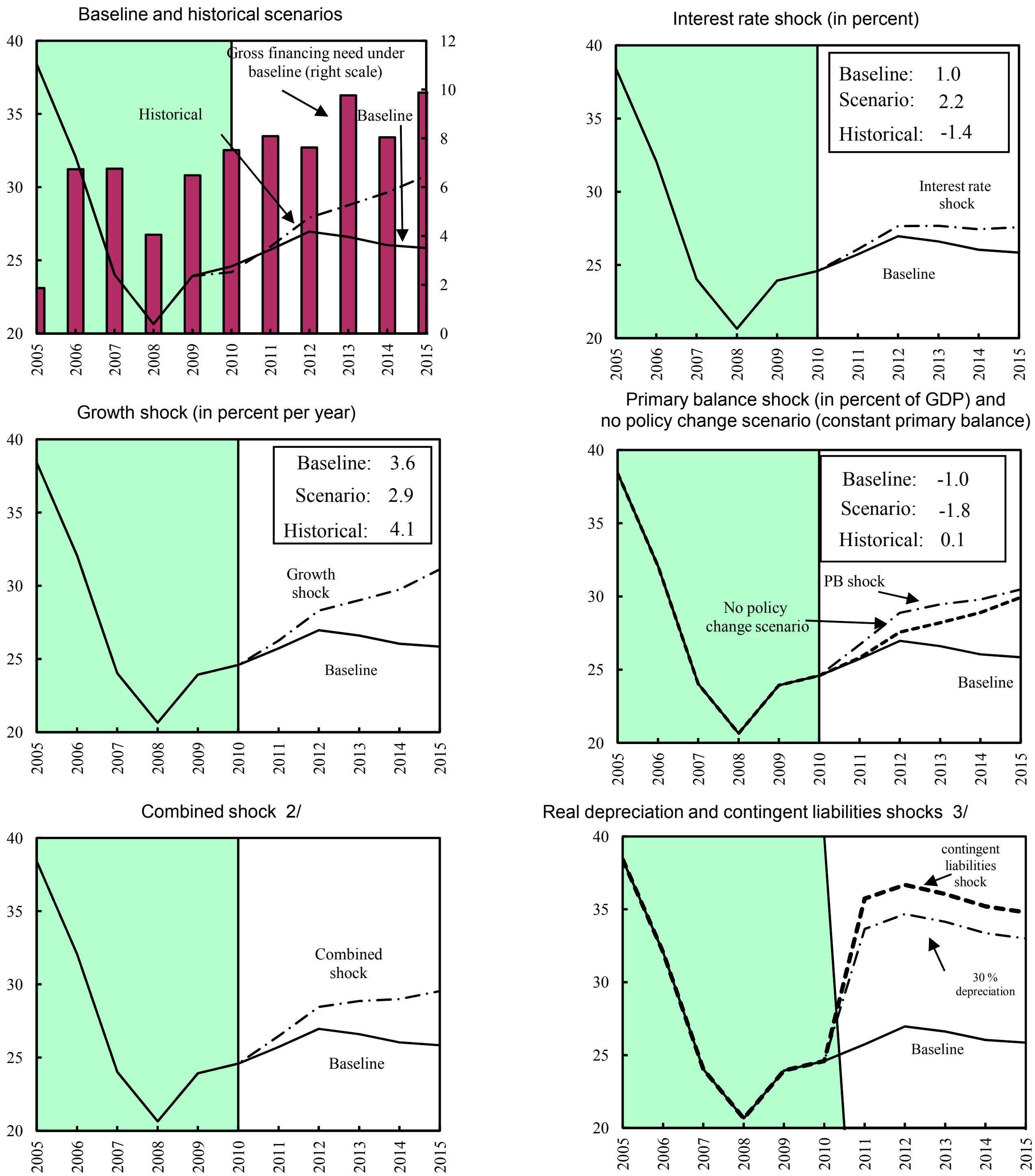
6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ The implied change in other key variables under this scenario is discussed in the text.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 5. FYR Macedonia: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent or a 10 percent of GDP shock to contingent liabilities occur in 2009. Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 9. FYR Macedonia: External Debt Sustainability Framework, 2005-2015
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2005	2006	2007	2008	2009			2010	2011	2012	2013	2014	2015	Debt-stabilizing non-interest current account 6/
Baseline: External debt	52.5	47.9	47.6	49.2	57.5			**58.5**	**57.8**	**58.7**	**57.7**	**56.2**	**55.1**	**-5.8**
Change in external debt	5.7	-4.7	-0.2	1.6	8.3			1.0	-0.7	1.0	-1.0	-1.5	-1.1	
Identified external debt-creating flows (4+8+9)	-4.5	-10.4	-7.2	4.4	7.2			2.4	0.4	-1.0	-1.3	-1.1	-1.1	
Current account deficit, excluding interest payments	1.4	-0.6	5.4	11.4	6.4			1.9	2.7	3.2	3.2	3.3	3.3	
Deficit in balance of goods and services	18.3	19.1	19.3	26.0	22.8			20.9	21.9	22.5	21.9	21.4	21.2	
Exports	42.8	45.5	50.9	50.2	38.0			44.8	49.5	53.3	54.8	55.4	55.5	
Imports	61.1	64.6	70.1	76.2	60.8			65.8	71.4	75.8	76.7	76.8	76.6	
Net non-debt creating capital inflows (negative)	-3.4	-7.1	-8.3	-3.0	-0.8			-0.5	-2.4	-4.0	-4.4	-4.3	-4.3	
Automatic debt dynamics 1/	-2.5	-2.7	-4.3	-4.0	1.5			1.0	0.0	-0.3	-0.1	0.0	-0.1	
Contribution from nominal interest rate	1.1	1.5	1.5	1.3	1.3			1.7	1.9	2.2	2.2	2.1	2.1	
Contribution from real GDP growth	-1.9	-2.4	-2.6	-2.1	0.4			-0.7	-1.9	-2.4	-2.3	-2.2	-2.1	
Contribution from price and exchange rate changes 2/	-1.7	-1.8	-3.3	-3.2	-0.2			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	10.2	5.8	7.0	-2.9	1.1			-1.4	-1.0	2.0	0.2	-0.4	-0.1	
External debt-to-exports ratio (in percent)	122.8	105.2	93.6	98.0	151.2			130.4	116.6	110.3	105.2	101.4	99.3	
Gross external financing need (in billions of US dollars) 4/	0.9	1.0	1.5	2.1	1.9			1.7	2.1	2.2	2.5	2.4	2.6	
in percent of GDP	18.2	19.0	25.3	31.9	28.0	10-Year	10-Year	24.7	27.8	27.5	29.6	26.0	26.9	
Scenario with key variables at their historical averages 5/								**58.5**	**57.9**	**59.3**	**59.1**	**58.4**	**57.7**	**-6.7**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	4.4	5.0	6.1	5.0	-0.9	2.8	3.3	1.2	3.5	4.5	4.2	4.0	4.0	
GDP deflator in US dollars (change in percent)	3.8	3.5	7.4	7.2	0.4	4.0	2.8	2.3	4.5	2.4	2.8	3.1	2.6	
Nominal external interest rate (in percent)	2.5	3.0	3.7	3.1	2.6	3.4	0.9	3.0	3.6	4.0	4.0	3.9	3.9	
Growth of exports (US dollar terms, in percent)	20.5	15.6	27.6	11.0	-24.7	7.9	17.8	22.1	19.6	15.0	10.2	8.4	6.8	
Growth of imports (US dollar terms, in percent)	10.3	14.8	23.9	22.3	-20.6	9.8	17.3	12.0	17.5	13.4	8.5	7.4	6.5	
Current account balance, excluding interest payments	-1.4	0.6	-5.4	-11.4	-6.4	-4.7	3.8	-1.9	-2.7	-3.2	-3.2	-3.3	-3.3	
Net non-debt creating capital inflows	3.4	7.1	8.3	3.0	0.8	4.8	3.5	0.5	2.4	4.0	4.4	4.3	4.3	

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

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

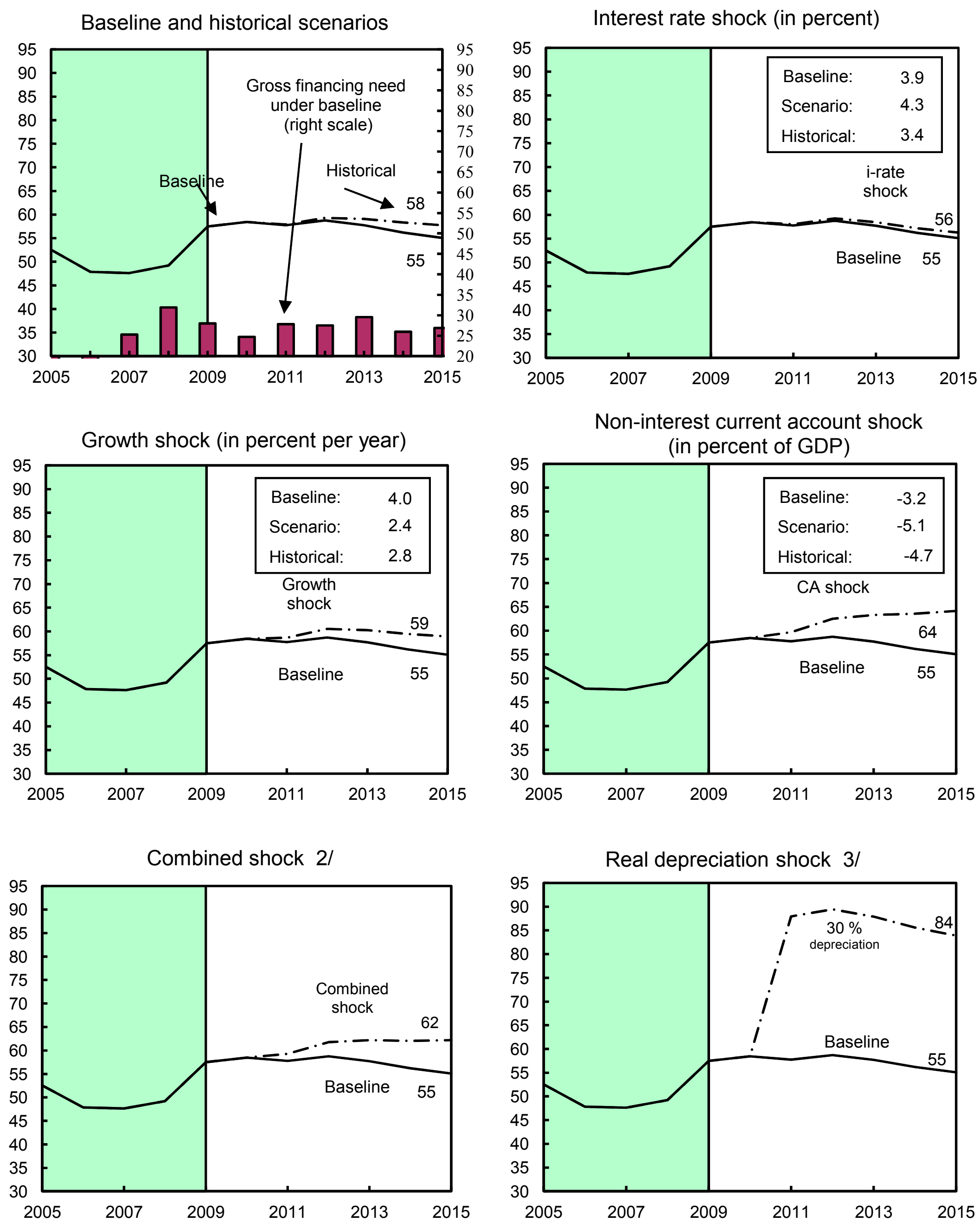
3/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

Figure 6 FYR Macedonia: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2010.

Table 10. FYR Macedonia: Composition of Central Government Debt

	2009		2010	
	(Share of GDP)	(Share of debt)	(Share of GDP)	(Share of debt)
External	16.6	69.2	17.2	69.8
Official	11.7	48.9	12.5	50.7
Private	4.9	20.4	4.7	19.1
Domestic	7.4	30.8	7.4	30.2
Structural Bonds	4.2	17.7	3.3	13.5
Government Securities	3.1	13.1	4.1	16.7
Gross Debt	23.9	100.0	24.6	100.0
NBRM Deposits	3.0		1.8	
Net Debt	20.9		22.8	
Memo Items:				
Foreign currency debt	21.6	90.5	22.7	92.4
Short-term debt	3.1	13.1	3.8	15.3

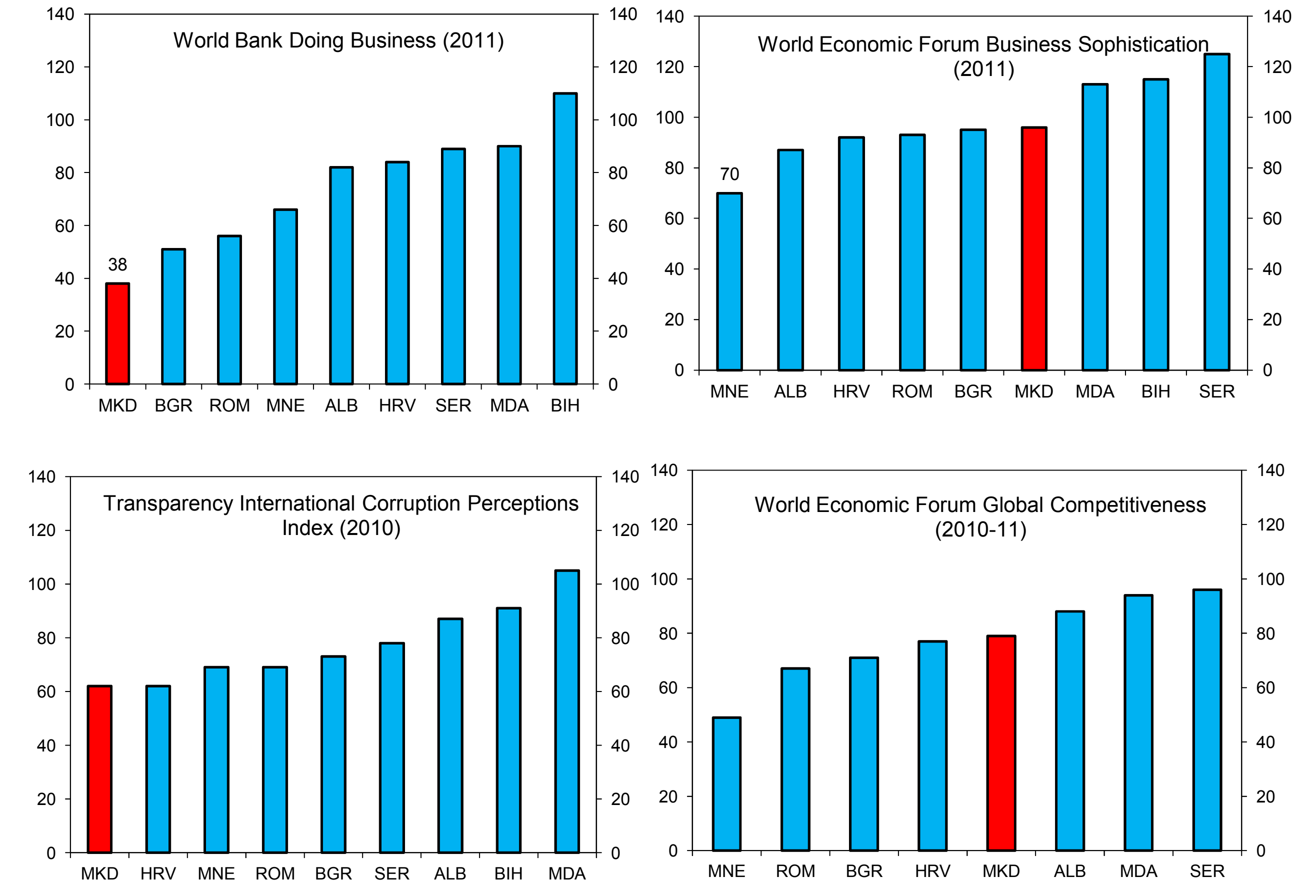
Sources: MoF and Staff estimates.

Table 11. FYR Macedonia: External Debt Decomposition, end-2009

	Millions of euros	Percent of GDP
Total External Debt	3,839	57.5
Total External MLT Debt	2,536	38.0
Private	1,409	21.1
Intecompany Loans	564	8.4
Loans	802	12.0
Other	43	0.6
Public 1/	1,127	16.9
Official Creditors	802	12.0
Private Creditors	325	4.9
Total External ST Debt	1,303	19.5
Private	1,303	19.5
Intercompany Debt	263	3.9
Trade Credits	695	10.4
Arrears	128	1.9
Other	218	3.3

Sources: NBRM and IMF Staff Estimates
1/ Public includes general government and monetary authorities.

Figure 7. Regional Rankings for Competitiveness and Business Environment 2009–10



Source: World Bank; World Economic Forum; and Transparency International.

Table 12. FYR Macedonia: Schedule and Terms Under the Precautionary Credit Line Arrangement

		Indicative targets		Credit available 3/			
Review date	Conditions for access	Central government overall fiscal deficit, ceiling (billions of denar) 1/	Net international reserves (billions of Euro) 2/	Million SDR	Million Euros 4/	Percent of Quota	Percent of Total Access
January 19,2010 5/	Board approval of the PCL	N/A	N/A	344.5	399.38	500	83.33
July 18, 2011	First review, based on May 31, 2011 indicative targets	6.4	1.15	344.5	399.38	500	83.33
January 18, 2012	Second review, based on November 30, 2011 indicative targets	11.6	1.35	413.4 6/	479.26	600	100
July 18, 2012	Third review, based on May 31, 2012 indicative targets	To be set in the second review	To be set in the second review	413.4	479.26	600	100
Total				413.4	479.26	600	100

Source: Fund staff estimates.

1/ For the first review, the target is calculated as (i) 5/12 of the annual deficit target of denar 11.59 billion; plus (ii) 5/12 of the telecom dividend (anticipated to be denar 2.6 billion), which is expected to be received after May 31, plus (iii) a 10 percent margin to account for unanticipated lumpiness of revenues and expenditures.

2/ For the second review, the target is set at a level that assumes the government will issue a Eurobond in the amount of €190 million during the course of 2011. In the event that it does not issue a Eurobond, or issues in an amount smaller than €190 million, the NIR target for November 30 will be adjusted downward by the shortfall of actual issuance relative to the amount of €190 million, with the downward adjustment limited to a maximum of €100 million.

3/ Credit available assuming no purchase.

4/ SDR/Euro exchange rate of 0.86258 as of December 16, 2010.

5/ Corresponds to the date of approval of the PCL arrangement.

6/ SDR 68.9 million will be available on January 19, 2012.

ATTACHMENT: REQUEST FOR A PRECAUTIONARY CREDIT LINE ARRANGEMENT

Skopje, Macedonia
December 30, 2010

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

Dear Mr. Strauss-Kahn,

We welcome the recent approval by the International Monetary Fund of the Precautionary Credit Line (PCL) as a new financial instrument designed for countries with sound fundamentals and policies, but moderate vulnerabilities.

Macedonia has sound economic fundamentals and a track record of sound policies, and does not have a balance of payments need. Yet we continue to face risks arising from uncertainties in the global economy. We therefore believe that the PCL would be an appropriate instrument to support our continued commitment to sound policies and to provide insurance against downside risks that could generate unanticipated financing needs. On this basis, we would like to request the IMF to approve a PCL arrangement covering 24 months in the amount of SDR 413.4 million (600 percent of quota), with a maximum of SDR 344.5 million (500 percent of quota) available during the first twelve months of the arrangement.

As elsewhere, Macedonia was affected by the recent global economic crisis. However, it suffered only a mild recession and balance of payments pressures in 2009 were contained. The situation has improved in 2010. Growth has gradually resumed, exports have rebounded, the external current account has adjusted rapidly, and international reserves have recovered fully. Meanwhile, our financial sector has avoided any significant pressures. This favorable performance during a period of external stress is due to our strong economic fundamentals and our commitment to take the policy measures needed to preserve stability. This included budget restraint sufficient to meet our 2009 fiscal deficit target of 2.8 percent of GDP despite a significant shortfall of revenues, an increase in central bank policy rates to safeguard international reserves, and higher bank reserve requirements to ensure adequate buffers. We also benefited from having a sound banking system with a conservative balance sheet and minimal reliance on external financing, which helped to shield it from the turbulence in the global financial system.

We are well-positioned to strengthen our economic and financial position and reduce external vulnerabilities further during the coming years. We remain committed to following strong policies and to responding appropriately to any adverse events that may arise. However, external risks persist due to the potential for adverse developments in Macedonia's trading partners and in international capital markets. These risks could potentially spill over to Macedonia through loss of access to international capital markets and widening of the trade deficit, which could lead to pressures on the balance of payments. A PCL arrangement would complement our economic policy strategy by bolstering investor confidence, which should help to mitigate the impact of any new external shocks.

Our 2011 budget targets a fiscal deficit of 2.5 percent of GDP, which we expect to be phased evenly over the year. The budget calls for both expenditures and revenues to increase in line with nominal growth. It provides for an increase in capital spending to strengthen public infrastructure and help lay the foundations for future growth. Non-capital spending will be restrained, with no nominal increase in government sector wage and salary levels and a freeze in public employment levels (with limited exceptions in areas related to the Ohrid Framework Agreement and EU accession). The budget will also be supported by measures to rationalize the delivery of health services, which we are undertaking with the support of the World Bank and the EU. We intend to meet our public financing requirements in 2011 with a combination of domestic and external financing, including the issuance of external debt to the private markets.

This prudent fiscal stance is consistent with our medium-term strategy to preserve our moderate public debt ratios and is in line with available financing, while also safeguarding essential government expenditure and supporting the resumption of economic growth. In the event that revenues fall short of budget projections, we will reduce expenditure in order to achieve our fiscal deficit target. For 2012, we foresee a reduction in the fiscal deficit to near 2 percent of GDP. The 2012 budget will aim for a continued emphasis on capital expenditure, with a particular focus on our development program in the areas of transportation, school construction, and hospital equipment.

Monetary policy will continue to be guided by the principle of consistency with the exchange rate regime, which seeks to maintain low inflation through a fixed rate relative to the euro. This policy has served Macedonia well for over a decade, delivering low and stable inflation and a stable real exchange rate that have allowed us to preserve competitiveness. In the first half of 2009, during the period of intense global financial turbulence, we increased our policy interest rate from 7 to 9 percent and increased bank reserve requirements in response to an outflow of international reserves. That policy response, together with prudential banking measures and fiscal restraint, helped to stabilize the situation. By midyear the balance of payments had strengthened and we began to rebuild international reserves. In light of favorable trends in the balance of payments and reserves, and against the background of weak growth and very low inflation, we initiated a series of reductions in interest rates that brought the policy rate to the present level of 4 percent.

Our monetary policy will continue to be governed by the need to support our exchange rate regime and maintain an adequate level of international reserves. In judging what is an appropriate level of reserves and how to respond to changes in reserve levels, we take into account a range of factors. Reserve levels in relation to months of imports and to short-term debt are important guideposts for assessing the desired reserve level. We also take into account underlying balance of payments trends, including seasonal factors in trade and remittances, and one-off events such as the timing of the government's external debt issuances and commercial bank substitution between foreign assets and domestic public debt that is denominated in or linked to foreign currency. The ultimate objective is to have a comfortable buffer to support our exchange rate in the event of adverse developments. If the level of reserves and underlying trends threaten this objective, we will respond with an appropriate mix of monetary and fiscal policies to help safeguard reserves and preserve confidence.

Our external position is solid, with a moderate current account deficit (projected to be below 4 percent of GDP in 2010), an adequate level of reserves, and favorable underlying balance of payments trends. We expect to see a further accumulation of reserves over the course of 2011. We successfully accessed external capital markets in 2009, although at a high price that reflected the prevailing unsettled market conditions. Secondary market yields on our outstanding Eurobonds have since fallen to below 6 percent as of November 2010, indicating that we enjoy improved market access. This reduction in yields reflects investor confidence in our public finances and external sustainability, and increased market differentiation between Macedonia and other countries.

Our financial sector and banking regulatory framework are both sound. Capital adequacy ratios have been stable at above 16 percent throughout the crisis. Nonperforming loans (NPLs) as a share of total loans have risen from 6.8 percent at the end of 2008 to 10.4 percent in the third quarter of 2010 as a consequence of the economic downturn. However, these NPLs are 93 percent provisioned, on a conservative basis that excludes collateral. Funding is stable, with a loan-to-deposit ratio of 91 percent and low reliance on external funding. Profits have fallen, largely due to the need to provision nonperforming loans, but have remained positive. Liquidity is strong, with highly liquid assets totaling 23.8 percent of all assets.

Our agenda for structural reform seeks to further strengthen our financial sector regulatory framework, improve the quality of our economic and financial data, and improve our long-term growth potential.

In the area of financial sector regulation, we have submitted a new law on the NBRM that will strengthen its independence and bring practices fully in line with EU directives and the European System of Central Banks Treaty. This new law has benefited from advice from the ECB, European Commission, IMF, and World Bank. We have also prepared draft legislation that will address the risk of court challenges to NBRM intervention of insolvent banks and close gaps in our ability to impose fit and proper requirements on bank owners and managers; and we have prepared proposals to widen the class of assets that banks may use to access liquidity support from the NBRM. We recently created the Financial Stability

Committee to coordinate our crisis response activities and are in the process of making it operational.

We are committed to continuing the process of improving the quality and transparency of economic and financial data. In this effort we have benefited from EU and IMF technical assistance, including an ongoing EU project whose goals include further harmonizing national accounts and other statistics with the Eurostat norms. We have taken the decision to subscribe to the IMF's Special Data Dissemination Standard (SDDS), which will be an important step forward in ensuring we meet best practices in this area, and we look forward to the findings of an IMF technical assistance mission that we have invited to help us develop a roadmap and timetable for subscribing to SDDS.

We are taking actions on several fronts to improve our long-term growth potential. In the area of public infrastructure, we are undertaking investments to raise the quality of key highway and railroad links with our major trading partners, and we have submitted a new energy law that will create a liberalized energy market and improve incentives for energy efficiency and investment. We are also continuing our efforts to improve the business environment and attract investment through initiatives such as cadastral reform, privatization of several loss-making state-owned enterprises, and further reductions in social contributions in 2012 and 2013 to reduce the labor tax wedge and increase employment. Reductions in pension contribution rates will be made in a framework that ensures the long-term financial sustainability of the public pension system.

We will provide the Fund all needed information to monitor economic and policy developments under the requested PCL arrangement, and we invite a safeguards assessment in accordance with the IMF safeguards policy. We will also observe the standard commitments related to trade and exchange restrictions, discriminatory currency arrangements, multiple currency practices, and non-accumulation of external debt payments arrears, in accordance with requirements under the PCL.

In summary, our sound economic fundamentals and institutional policy framework, and our track record of sound policies and commitment to such policies in the future, provide confidence that we will respond appropriately to any future balance of payments difficulties that may arise. The strength of our policies was recognized by the positive assessment of the Executive Board of the IMF in the context of our most recent Article IV consultations.

/s/	/s/
Zoran Stavreski	Petar Gosev
Vice Prime Minister and	Governor of National Bank of
Minister of Finance	The Republic of Macedonia

ATTACHMENT: REVIEW DATES, INDICATIVE TARGETS, TEST DATES, AND DEFINITIONS

Review dates (assuming Board approval date of 1/19/2011):
The first review is scheduled to be completed by July 18, 2011.
The second review is scheduled to be completed by January 18, 2012.
The third review is scheduled to be completed by July 18, 2012.

Indicative targets:

(1) *Central government overall fiscal deficit*:
For the first review: a ceiling of denar 6.4 billion for the period January through May 2011[1]. The test date will be May 31, 2011. For the second review: a ceiling of denar 11.6 billion for the period January through November 2011. The test date will be November 30, 2011. A target and a test date for the third review will be set during the second review under the arrangement. The government will report to the IMF on the monthly and cumulative year-to-date fiscal deficits for each month before the end of the following month.

(2) *Net International reserves (NIR):*
The indicative targets for floors on NIR for the first and second reviews will be set at €1,150 million and €1,350 million, respectively. The test date for the first review will be May 31, 2011 and the test date for the second review will be November 30, 2011. A target and test date for the third review will be set during the second review under the arrangement. The NBRM will report to the IMF the level of NIR not later than two weeks after the end of each month.

Definitions and adjustors

For purposes of this arrangement, the deficit of the central government covers the central government as defined in the Annual Budget Document (including Special Revenue Accounts, Employment Fund, Health Insurance Fund, Pension Insurance Fund, and Road Fund), which are treated by the Ministry of Finance as part of the consolidated central government. It is the authorities' policy not to accumulate arrears on central government payments or delays in non-disputed VAT refund payments past the legal limit for paying such refunds. In the event that such arrears or VAT refund delays occur, they shall be

[1] The May 31 target is calculated as (i) 5/12 of the annual deficit target of denar 11.59 billion; plus (ii) 5/12 of the telecom dividend (anticipated to be denar 2.6 billion), which is expected to be received after May 31, plus (iii) a 10 percent margin to account for unanticipated lumpiness of revenues and expenditures.

included in the definition of the deficit for purposes of this arrangement.[2].

For purposes of this arrangement, NIR is defined as the difference between NBRM's reserve assets and its reserve liabilities,[3] where reserve assets and liabilities will be calculated at a gold price of US$ 1,391.50 per ounce, a US$/€ exchange rate of 1.29980, a SDR/€ exchange rate of 0.84957; exchange rates for other reserve assets held as of December 1, 2010 will be the market rates prevailing on December 1, 2010. The indicative target on NIR is set at a level that assumes the government will issue a Eurobond in the amount of €190 million during the course of 2011. In the event that it does not issue a Eurobond, or issues in an amount smaller than €190 million, the NIR target for November 30 will be adjusted downward by the shortfall of actual issuance relative to the amount of €190 million, with the downward adjustment limited to a maximum of €100 million.

For purposes of this arrangement, external payments arrears will be defined as total past-due debt service (principal and interest) on government, government-guaranteed, and NBRM external debt.

[2] 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; (v) local governments. The definition excludes the customary lag in paying wages, social assistance and child allowance
payments, and transfers to the extra-budgetary funds (in the following month after they accrue). 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.

[3] Reserve assets are defined as liquid and usable foreign convertible currency claims on nonresidents plus monetary gold. Reserve assets of the NBRM thus include monetary gold, SDRs, foreign currency cash, securities, deposits abroad, and the reserve position at the Fund. Reserve liabilities are defined as all foreign exchange liabilities of the NBRM to nonresidents and residents (excluding central and local government foreign exchange deposits at the NBRM), 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).

INTERNATIONAL MONETARY FUND

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Staff Report for the 2010 Article IV Consultation and Request for an Arrangement Under the Precautionary Credit Line

Informational Annex

Prepared by the European Department

January 4, 2011

Contents Page

ANNEX I— FUND RELATIONS
(As of November 30, 2010)

Missions. Article IV mission, Skopje, November 4-17, 2010. Concluding statement is available at: http://www.imf.org/external/np/ms/2010/111710.htm.

Staff team. Wes McGrew (head), Nicolas Arregui (EUR), Gabriela Dobrescu (FAD), Ran Bi (SPR), and Alexander Tieman (Resident Representative).

Discussions. The staff team met Deputy Prime Minister and Minister of Finance Stavreski, National Bank of the Republic of Macedonia Governor Gošev, Deputy Prime Minister Peshevski, other senior officials, and representatives of the banking, business, political and international communities.

Publication. The Macedonian authorities have indicated that they agree with 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	65.62	100.00
Holdings	0.81	1.23

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
ECF[1/]	12/18/2000	11/22/2001	10.34	1.72

1/ formerly PRGF

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

	Forthcoming			
	2011	2012	2013	2014
Principal				
Charges/Interest	0.24	0.24	0.24	0.24
Total	0.24	0.24	0.24	0.24

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 stabilized arrangement against the Euro. The exchange rate system is free of restrictions on the making of payments and transfers for current international transactions. Households can transact through commercial banks or through foreign exchange bureaus that act as agents of banks; enterprises can transact through the banking system. The reserve requirement on foreign currency deposits is set at 13 percent, while that on FX-indexed denar deposits are set at 20 percent.

At end-November 2010, the official exchange rate was 46.8 denars per U.S. dollar and 61.5 denars per euro. The FYR Macedonia has accepted the obligations of Article VIII, Sections 2, 3, and 4 with effect from June 19, 1998.

IX. **Article IV Consultations**:

The first consultation with the FYR Macedonia was concluded in August 1993. The last consultation was concluded on December 11, 2009 (SM/09/278). The FYR Macedonia is on the standard 12-month consultation cycle.

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

Purpose	**Department**	**Date**
Macroeconomic Modeling at NBRM	MCM	March, November 2009, September, November 2010
Public Financial Management	FAD	September 2009
Tax Administration	FAD	July 2009
National Accounts	STA	June 2009
Contingency Planning and Crisis Preparedness	MCM	February 2009

Government Finance Statistics	STA	October 2008
Balance of Payments Statistics	STA	October 2008
National Accounts Statistics	STA	April 2007, January, May, September, December 2008
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
National Accounts Statistics	STA	April 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

Tax Administration	FAD	October 2006-present
Banking Supervision	MCM	May 2006-May 2008
Monetary Policies	MCM	October 2004- April 2005

XI. **FSAP Participation and ROSCs (since 2003)**

Purpose	**Department**	**Date**
FSAP update	MCM/WB	March 2008
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. Alexander Tieman has held this position since August 2009.

ANNEX II—STATISTICAL ISSUES

As of December 1, 2010

I. Assessment of Data Adequacy for Surveillance
General: Data provision has some shortcomings, but is broadly adequate for surveillance and monitoring purposes. Areas that would benefit most from further improvement are national accounts and government finance statistics.
National accounts: Quarterly GDP data in constant prices are not compiled. Despite recent improvements, there continue to be discrepancies between the official quarterly and annual GDP estimates. Employment data from the company survey continue to be unreliable. **Price statistics:** The CPI series are rebased every year and this has caused small discrepancies in historical data.
Government finance statistics: The consolidated central government data are affected by lack of data on arrears, including hospital arrears. In addition, data coverage on government below-the-line financing from National Bank deposits is inadequate, as a result of different coverage of accounts between the Ministry of Finance and the National Bank – the Treasury Single Account and budgetary FX account balances are not regularly reported. Data on state enterprises are limited. Macedonia does not report government finance statistics to the Fund for publication in either the *Government Finance Statistics Yearbook* (GFSMY) or the *International Financial Statistics* (*IFS)*.
Monetary sector: EUR receives a monthly electronic report of monetary statistics, covering the balance sheet of the central bank, the commercial banks and other depository corporations.
External sector: Balance of payment data are compiled on monthly basis. The compilation and coverage have improved in recent years, and most of the recommendations from the 2004 ROSC mission and the late 2006 STA mission were implemented.

II. Data Standards and Quality	
FYR Macedonia participates in the General Data Dissemination System (GDDS), and is preparing for subscription to the Special Data Dissemination Standard (SDDS).	Data ROSC published on September 29, 2004
III. Reporting to STA (Optional)	
No data are being reported for publication in the *Government Finance Statistics Yearbook* or in the *IFS.*	

FYR MACEDONIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(as of December 1, 2010)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality – Accuracy and reliability[9]
Exchange Rates	Current	11/26/10	D	W	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	11/19/10	11/25/10	D	W	Q		
Reserve/Base Money	11/25/10	11/26/10	W	W	M		
Broad Money	Oct. 10	11/22/10	M	M	M	O, LO, LO, O	O, LO, O, O, O
Central Bank Balance Sheet	Oct. 10	11/22/10	M	M	M		
Consolidated Balance Sheet of the Banking System	Oct. 10	11/22/10	M	M	M		
Interest Rates[2]	Oct. 10	11/30/10	M	M	M		
Consumer Price Index	Oct. 10	11/01/10	M	M	M	O, O, O, LO	LO, O, LNO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Oct. 10	11/29/10	Q	Q	Q		
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Oct. 10	11/29/10	M	M	M	LO, LNO, LO, O	LO, LO, LO, LO, LNO
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Sept. 10	Nov 10	M	M	I		
External Current Account Balance	Aug. 10	11/16/10	M	M	M		
Exports and Imports of Goods and Services	Sept. 10	11/11/10	M	M	M	O, LO, O, LO	LO, O, LO, O, LO
GDP/GNP	Jun. 10	09/23/10	Q	Q	Q	O, LO, O, LO	LO, O, LNO, O, O
Gross External Debt	06/30/10	09/30/10	Q	Q	Q		
International Investment Position[6]	2009	Dec 10	A	A	A		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Weighted interest rates on loans and deposits in domestic banks. Separately, data is submitted on the rates on central bank bills (policy rate) and 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] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[8] 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).
[9] Same as footnote 8, except referring to international standards concerning source data, assessment and validation of source data,, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

ANNEX III—COORDINATION OF IMF AND WORLD BANK WORK PLANS

1. **IMF and World Bank country teams for FYR Macedonia agreed that FYR Macedonia has weathered the global crisis relatively well but continued to face challenges that include below-potential growth and high unemployment.** Low growth has resulted in weak tax revenues that have given rise to budget financing pressures. Further, while the banking sector remained broadly in good shape, it was exposed to risks of prolonged slow growth in Macedonia through a deterioration in the quality of its loan portfolio. Balance of payments pressures have eased significantly as the current account deficit has fallen and official foreign exchange reserves have recouped their losses. Nonetheless, the exchange rate peg to the Euro, while beneficial for stability, will continue to constrain economic policies. Against this background Macedonia's main macroeconomic challenges are to avoid procyclical fiscal policies and maintain fiscal sustainability while securing adequate budget financing; pursue monetary and fiscal policies that are supportive both of the exchange rate regime and of economic growth; and safeguard the stability of the financial system, including through continued sound supervision and regulation as well as contingency planning.

2. **Based on this shared assessment, the teams identified six areas of structural reform as macrocritical** in light of their importance for stimulating private sector activity, and ensuring fiscal and external sustainability and financial sector stability.

- **Public expenditure management and public finance.** Improving budget planning and the structure of public spending are key areas for improvement. Accurate revenue and expenditure forecasts are needed to ensure realistic budgets and avoid supplementary budgets that result from revenue underperformance or underestimation of spending. Moreover, further expanding the medium-term elements of the fiscal framework would help to anchor fiscal policy around the goal of public debt sustainability. The domestic public debt market needs to be developed over the medium term to provide a domestic source of fiscal financing and reduce reliance on external funding.

- **Tax administration.** Continued reforms in this area will help to improve compliance and reduce informality, contributing to a broader and more stable tax base that allows lower tax rates and adequate fiscal financing. Macedonia has already achieved major gains by unifying the collection of social contributions (pension, health and unemployment) and integrating them with personal income tax collection, resulting in significant improvement in compliance.

- **Social Sector spending.** *Pension reform.* Considerable reforms have been implemented to put the system on a sustainable financial basis. Still, with the recent reduction in contribution rates and changes to the pension indexation formula, the budgetary transfers made to the Pension and Disability Insurance Fund (PDIF) increased. *Social safety net.* The social safety net is complex, with a large number of overlapping programs that are not well-targeted and fail to reach some of most vulnerable elements in society. Efforts are needed to ensure pressures to cut spending do not weaken the social safety net while increasing share of transfer reach the poor. *Health Sector*. Spending pressures recently re-emerged in the health sector as contribution rate were lowered while higher wages increased costs.

- **Improving the business environments**. The business climate improved in Macedonia in recent years, though areas where further efforts can pay off include streamlining administrative procedures, improving contract enforcement, and facilitating foreign trade, particularly by reducing tariffs and simplifying procedures and costs. Advances are needed in safeguarding property rights and the rule of law, facilitating competition through improved market entry and exit, and improving access to financing. Though the burden of excessive regulations has been reduced it still impedes economic activity in certain areas and there is some evidence that policy uncertainty has increased.

- **Financial sector**. Stronger financial sector supervision and contingency planning will help to ensure the authorities are able to monitor the health of the system carefully and respond appropriately to problems that emerge. This includes powers of the banking regulator to impose fit and proper requirements on bank owners and to intervene in banks that are not viable. Implementation in practice of the recently concluded MoU on crisis coordination and cooperation between the NBRM, the Finance Ministry (MoF), and other agencies, is also important to improve supervision as well as identify and provide a quick response to threats.

- **Electricity sector.** It will be important over time to revise the tariff structure to better reflect the costs of service delivery and comply with the country's obligations under the Energy Community Treaty. This will help eliminate hidden and cross-subsidies that are poorly targeted, encourage inefficient patterns of consumption, damage incentives for investment, and impose fiscal or quasi-fiscal costs. New investment in generation capacity is also needed in light of inadequate domestic supplies. In view of financial and environmental considerations, end-use energy efficiency improvement, use of PPPs and renewable energy sources should be promoted. Reforms to create a more transparent regulatory framework will be helpful in this regard.

3. **The teams agreed on the following division of labor.**

- The Bank will begin the preparation of the new Country Economic Memorandum which should help identify challenges to improved competitiveness and poverty reduction, by integrating sustainability and green growth into the main objectives of stronger growth, job creation and attracting FDI and EU accession.

- The Fund will retain the lead in tax administration reform. It has a full-time resident advisor in place (funded by the Dutch government) as well as a full program of technical assistance missions. Priorities for the coming year include reviewing the progress in modernizing revenue administration, addressing compliance problems that have emerged with the economic slowdown, increasing training for Public Revenue Office staff, and coordinating technical assistance with other donors.

- The Bank will support the Government in undertaking an analysis of the recent changes to the pension system and their implications for its financial sustainability and will work with the authorities to make needed adjustments to preserve the system's sustainability and prevent a drain on general tax revenues.

- Social safety net. The Bank will continue to advise the government on measures to consolidate various programs and improve targeting through its Social Protection Implementation Loan (SPIL) and Conditional Cash Transfers (CCT) operations and the Programmatic Poverty Assessment analytical work. Future priorities include introduction of a registry of programs and beneficiaries, initiating a conditional cash transfer system to ensure compliance with requirements for mandatory secondary school enrollment, consolidation of benefits, etc. Once implemented, these activities should result in better administration and targeting of social programs.

- Both the Fund and the Bank will encourage the authorities to implement realistic, predictable, and transparent budget procedures. The Fund will also encourage the authorities to anchor fiscal policies in a credible medium-term fiscal framework and is prepared to offer technical assistance for that purpose. The Bank will provide support in improving the public procurement process.

- A considerable part of the World Bank's portfolio is providing support to improve the business environment. Infrastructure improvements are supported under the Regional and Local Roads Project, the Railways Project, Municipal Services Improvement Project and the Second Trade and Transport Facilitation Project. At the same time, the Business Environment Reform Project, the Real Estate Cadastre and Registration Project, the Legal and Judicial Implementation Project and the Agriculture Strengthening and Accession Project support development and reform of institutions to support growth. The ongoing Education Modernization Project and a planned Technical Assistance for Higher Education aim to assist the authorities in building skills. An innovative regional Disaster Management operation planned for 2011 will provide financial protection from losses caused by climate change and geo-hazards. Going further, the authorities have requested technical assistance from the Doing Business Reform Advisory on selected elements of the business environment (construction permits, trading across borders etc.).

- The Fund and Bank have both been involved in financial sector reform, including through the November 2008 joint FSAA update as well as the extensive dialogue during the preparation of the 2009 World Bank First Development Policy Loan (DPL1). The Fund has also provided technical assistance in the area of contingency planning and will provide further assistance in this area as well as in macro modeling and stress testing bank balance sheets. The Bank, through the DPL2 and the Balkan Financial Sector Technical Assistance Facility will: i) (with input from IMF staff) assist the authorities in reviewing the bank resolution framework and the operational capacity of the Deposit Insurance Fund and ii) provide advice on the operational rules for the Financial Stability Committee and the design of a solvency test in case of Lender of Last Resort request.

- The Bank has the lead on electricity sector reform. It will continue to encourage the adoption over time of realistic prices of electricity and elimination of subsidized rates. As part of the dialogue, the Bank provided comments on sections of the Energy Sector Strategy and is advising the government on promoting use of alternative ways of financing energy sector investments (PPPs) as well as diversifying energy sources (use of gas, renewables, wind etc.). The Bank is also providing assistance to strengthen the Energy Regulatory Commission. The Bank's Energy Community of South East Europe Adaptable Programmatic Loan 3 (ECSEE APL3), the follow-up financing of this project planned for 2011 and the hydro-power project planned for 2011, support improvements of interconnectivity and the transmission grid and reliability of production. Finally, the recently restructured Global Environment Facility project will promote energy efficiency in the public sector.

Appendix 1. Macedonia: Bank and Fund Planned Activities in Macrocritical Structural Reform Areas, June 2010-December 2011

Title	Products	Provisional Timing of Missions	Expected Delivery Date
1. Fund work program	Article IV consultation	November 2010	January 2011
	Technical assistance to NBRM on stress testing	Feb. 2011 (tentative)	TA report by spring 2011
	Technical assistance to MoF on medium term budgeting and debt sustainability	Mission: January 2011 (tentative) Short-term expert: March 2011 (tentative)	TA report by summer 2011
	Technical assistance to the Public Revenue Office on modernizing revenue administration	Ongoing	TA review report by Summer 2011
2. Bank work program)	Supervision of CCT and SPIL projects	Ongoing	
	Additional Financing for ECSEE APL 3 (Macedonia)		December 2011
	Supervision of energy sector activities	Ongoing	
	DPL2 preparation (fiscal framework; pensions; social safety net; health spending; financial sector stability and	September 2010	March 2011

	supervision)		
	Balkan Financial Sector Technical Assistance Facility (TA to NBRM and MoF on bank resolution; LoLR etc.)	September 2010	June 2011
	Technical assistance to MoTransport on issuance of construction permits	September / October 2010	December 2010
	Technical assistance to MoF and other agencies on improving the business environment	TBD	
	Country Economic Memorandum	TBD	

INTERNATIONAL MONETARY FUND

Former Yugoslav Republic of Macedonia—Assessment of the Impact of the Proposed Precautionary Credit Line Arrangement on the Fund's Finances and Liquidity Position

Prepared by the Finance and Strategy, Policy and Review Departments

(In consultation with other Departments)

Approved by David Andrews and Jan Kees Martijn

January 7, 2011

This note assesses the impact of the proposed Precautionary Credit Line (PCL) arrangement for Macedonia on the Fund's finances and liquidity position, in accordance with the policy on exceptional access.[1] The proposed arrangement would be the first under the PCL, and would cover a 24-month period, with access in an amount equivalent to SDR 413.4 million (600 percent of quota) available in one or more purchases.[2] Of this access, an amount equivalent to SDR 344.5 million (500 percent of quota) would be available in the first year of the arrangement and the remaining amount would be made available at the beginning of the second year, subject to the completion of the relevant six-monthly review. As required for a PCL arrangement, Macedonia does not have an actual balance of payments need; therefore, the authorities intend to treat the arrangement as precautionary.

I. Background

1. **Macedonia had several Fund arrangements in the 1990s and 2000s until it fully repaid its outstanding credit in 2007.** Since 1995 Macedonia has had three Stand-By arrangements (1995, 2003, and 2005), two PRGF arrangements (1997 and 2000), and one extended arrangement (2000). The first SBA—equivalent to SDR 22.3 million (45 percent of quota)—was fully drawn. In April 1997, a three-year PRGF arrangement was approved but was cancelled in the aftermath of the 1999 Kosovo crisis and replaced by an extended arrangement and a PRGF arrangement in late 2000. However, the latter were cancelled by the authorities because of a new military crisis and were succeeded by an SBA in April 2003, which was fully drawn. In August 2005, Macedonia requested an SBA equivalent to

[1] See paragraph 5 in: *The Fund's Mandate—The Future Financing Role: Revised Reform Proposals* (August 25, 2010), http://www.imf.org/external/np/pp/eng/2010/082510.pdf .

[2] After the first six months of the arrangement, any purchases are subject to completion of six-monthly reviews under the PCL arrangement.

SDR 51.7 million (75 percent of quota); after an initial drawing of SDR 10.5 million, the authorities indicated that they would treat the arrangement as precautionary. Macedonia fully repaid its outstanding credit in May 2007 (Table 1).

Table 1. Macedonia: IMF Financial Arrangements, 1992-2007
(in millions of SDRs)

Year	Type of Arrangement	Date of Arrangement	Date of Expiration or Cancellation	Amount of New Arrangement	Arrangement as a Percent of Quota	Amount Drawn	Purchases	Repurchases	Fund GRA	Fund ECF (PRGF)	Fund Exposure Total 1/
1992							8.4	0.8	7.6	0.0	7.6
1993							0.0	4.8	2.8	0.0	2.8
1994							12.4	1.2	14.0	0.0	14.0
1995	SBA	5-May-95	4-Jun-96	22.3	45.0	22.3	24.8	0.7	38.1	0.0	38.1
1996							9.9	0.6	47.4	0.0	47.4
1997	ECF	11-Apr-97	10-Apr-00	54.6	110.0	27.3	18.2	0.3	47.1	18.2	65.3
1998							9.1	1.7	45.4	27.3	72.7
1999							13.8	12.4	46.8	27.3	74.1
2000	EFF	29-Nov-00	22-Nov-01	24.1	35.0	1.1	2.9	14.7	33.3	29.0	62.3
	ECF	18-Dec-00	22-Nov-01	10.3	15.0	1.7					
2001							0.0	6.0	27.3	29.0	56.3
2002							0.0	6.8	21.5	28.1	49.6
2003	SBA	30-Apr-03	15-Aug-04	20.0	29.0	20.0	12.0	15.6	22.4	23.5	46.0
2004							8.0	13.7	22.2	18.1	40.3
2005	SBA	31-Aug-05	30-Aug-08	51.7	75.0	10.5	10.5	7.3	30.9	12.6	43.5
2006							0.0	6.5	30.2	6.8	37.0
2007							0.0	37.0	0.0	0.0	0.0

Source: Finance Department.

1/ As of end-December.

2. **While Macedonia's total external debt is moderately high, its public debt is modest; both appear to be sustainable.** Under the baseline scenario, external debt, which has been in the range of 50–60 percent of GDP over the last few years, is projected to remain below 60 percent of GDP over the medium term. Short-term external debt (on a residual maturity basis) is projected at around 40 percent of total external debt and 80 percent of gross international reserves. Public debt, which is estimated at 25 percent of GDP by end-2010, is projected to decline as the public sector's primary surplus improves. Sustainability analyses show both external and public debt remaining manageable under a range of scenarios.

3. **If the full amounts available under the proposed PCL arrangement were to be purchased:**

- **Access would be the lowest among the current exceptional access arrangements.** Macedonia's outstanding use of GRA resources would reach SDR 344.5 million in the first year and SDR 413.4 million in the second year.[3]

- **Fund credit would represent a modest fraction of Macedonia's external debt.** Total external debt would rise to nearly 65 percent of GDP initially, and public external debt would rise to over 28 percent of GDP, with Fund credit being close to

[3] The largest GRA credit exposure thus far has been SDR 23.359 billion to Brazil in 2003.

about 6 percent of GDP (Table 2). At its peak, Macedonia's outstanding use of GRA resources would account for about 9 percent of total external debt, about 21 percent of public external debt, and about 22 percent of gross international reserves.

- **External debt service would increase moderately over the medium-term and would be manageable under staff's medium-term macroeconomic projections**. Macedonia's projected debt service to the Fund would peak in 2015 at SDR 201.9 million, or about 2.4 percent of GDP.[4] In terms of exports of goods and services, external debt service to the Fund would peak at about 4.4 percent by 2015, and would account for 45 percent of public external debt service in 2014, and 42 percent in 2015.

Table 2. Macedonia: Capacity to Repay Indicators 1/

	2010	2011	2012	2013	2014	2015	2016	2017
Exposure and Repayments (In SDR millions)								
GRA credit to Macedonia 2/	-	344.5	413.4	413.4	284.2	86.1	8.6	0.0
(In percent of quota)	-	500.0	600.0	600.0	412.5	125.0	12.5	0.0
Charges due on GRA credit 3/	-	7.9	9.9	10.1	10.1	3.8	0.8	0.3
Debt service due on GRA credit 4/	-	7.9	9.9	10.1	139.3	201.9	78.3	8.9
Debt and Debt Service Ratios 5/								
In percent of GDP								
Total external debt	58.5	63.1	64.8	63.4	59.8	56.1	54.0	52.0
External debt, public	19.9	26.7	28.4	27.5	24.6	21.4	19.1	17.1
Total public debt	24.6	31.0	32.9	32.3	29.7	27.0	26.0	25.9
GRA credit to Macedonia	-	5.3	6.0	5.6	3.6	1.0	0.1	0.0
Total external debt service 6/	22.9	25.3	24.4	26.5	24.5	26.0	24.2	23.1
Public external debt service 6/	1.6	1.8	2.0	4.1	4.0	5.8	3.9	2.8
Debt service due on GRA credit	-	0.1	0.1	0.1	1.8	2.4	0.9	0.1
In percent of Central Government Revenues								
Public external debt service 6/	5.2	5.7	6.4	12.9	12.3	18.0	12.3	8.8
Debt service due on GRA credit	-	0.4	0.5	0.4	5.5	7.6	2.8	0.3
In percent of Gross International Reserves								
Total external debt	245.4	211.2	234.4	234.3	237.1	227.5	206.9	200.6
External debt, public	83.7	89.3	103.0	101.8	97.5	86.6	73.3	66.0
GRA credit to Macedonia	-	17.8	21.7	20.8	14.4	4.2	0.4	0.0
Debt service due on GRA credit	-	0.4	0.5	0.5	7.0	9.8	3.4	0.4
In percent of Exports of Goods and Services								
Total external debt service 6/	51.0	51.0	45.9	48.3	44.1	46.9	44.0	42.2
Public external debt service 6/	3.6	3.7	3.8	7.5	7.1	10.4	7.2	5.1
Debt service due on GRA credit	-	0.2	0.3	0.3	3.2	4.4	1.6	0.2
In percent of Total External Debt								
GRA credit to Macedonia	-	8.4	9.3	8.9	6.1	1.8	0.2	0.0
In percent of Total External Debt Service								
Debt service due on GRA credit	-	0.5	0.6	0.5	7.3	9.3	3.6	0.4
In percent of Total Public External Debt								
GRA credit to Macedonia	-	19.9	21.1	20.5	14.8	4.8	0.5	0.0
In percent of Total Public External Debt Service								
Debt service due on GRA credit	-	6.7	7.1	3.3	44.9	42.0	22.4	3.4

Sources: Macedonian authorities, Finance Department, World Economic Outlook, and IMF staff estimates.
1/ Assumes full drawings.
2/ Repurchases are assumed to be made as scheduled.
3/ Includes GRA basic rate of charge, surcharges and service fees.
4/ Includes charges due on GRA credit and payments on principal.
5/ Staff projections for external debt, GDP, gross international reserves, and exports of goods and services, as used in the staff report that requests the proposed PCL.
6/ Interest on and amortization of medium and long-term debt.

[4] The figures on debt service used in this report are calculated assuming that full amount available under the arrangement is purchased upon approval of the arrangement, and that all repurchases are made as scheduled.

4. **The impact of the proposed arrangement on the Fund's liquidity and potential exposure would be small:**

- **The proposed arrangement would reduce the Fund's forward commitment capacity (FCC) marginally.**[5] Approval of the proposed arrangement would reduce the FCC by SDR 413.4 million, a 0.4 percent reduction (Table 3).

- **If the resources available under the PCL arrangement were fully drawn, GRA credit to Macedonia as a share of GRA credit outstanding would be 0.8 percent.** As a result, the concentration of Fund credit among the top five users of Fund resources would decline to 71.9 percent from 72.4 percent.

- **Potential GRA exposure to Macedonia would be less than 6 percent Fund's current precautionary balances.** While the scale of the Fund's potential exposure to Macedonia is relatively small, the recent increases in commitments to other members and the possibility of further credit expansion under already existing or new Fund arrangements—underscores the need to strengthen the Fund's precautionary balances.

Table 3. PCL Arrangement for Macedonia—Impact on GRA Finances
(In SDR millions, unless otherwise indicated)

	as of 12/21/2010
Liquidity measures	
One-year Forward Commitment Capacity (FCC) 1/	132,263
FCC including the proposed FCLs for Mexico and Poland	111,023
Impact on FCC on approval 2/	413
Prudential measures	
Fund GRA credit to Macedonia	
in percent of current precautionary balances	5.6
in percent of total GRA credit outstanding	0.8
Fund GRA credit outstanding to top five borrowers	
in percent of total GRA credit outstanding	72.4
in percent of total GRA credit outstanding, upon approval of the PCL	71.9
Memorandum items	
Fund's precautionary balances (FY2010) 3/	7,320
Total FCL commitments 4/	68,780
Total PCL commitments	413
Fund's Residual Burden Sharing Capacity 5/	28

Source: Macedonian authorities, Finance Department, World Economic Outlook, and IMF staff estimates.

1/ November-January 2011 FTP. The FCC is defined as the Fund's stock of usable resources less undrawn balances under existing arragements, plus projected repurchases during the coming 12 months, less repayments of borrowing due one year forward, less a prudential balance.
2/ A single country's negative impact on the FCC is defined as the country's sum of Fund credit and undrawn commitments minus repurchases one-year forward.
3/ Precautionary balances exclude amounts in Special Reserves attributable to profits on gold sales in FY2010.
4/ Includes the proposed FCLs commitments for Mexico and Poland.
5/ Burden-sharing capacity is calculated based on the floor for remuneration at 85 percent of the SDR interest rate. Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being utilized to offset deferred charges and takes into account the loss in capacity due to nonpayment of burden sharing adjustments by members in arrears.

[5] The FCC has been greatly bolstered by the supplementary resources available under the bilateral borrowing and note purchase agreements. The FCC reflects that most creditors have responded positively to the Managing Director's request to keep their bilateral lines open for the financing of pre-NAB activation commitments after the enlarged and amended NAB becomes effective, currently expected around end-March 2011.

II. Assessment

5. **The proposed PCL arrangement would have a limited impact on the Fund's liquidity.** The authorities intend to make purchases under the PCL only in the event of adverse shocks. If Macedonia were to draw the entire amount available, the impact of the proposed arrangement on the Fund's liquidity position would be limited, and Fund's liquidity would continue to be manageable. It should be noted, however, that if purchases under the proposed PCL occurred against the backdrop of very adverse global conditions, there could be substantial demand for Fund resources from other members.

6. **Risks to the Fund are expected to be low.** Macedonia faces external risks that could bring about balance of payments difficulties or fiscal financing needs should an adverse scenario materialize. Macedonia's vulnerabilities largely stem from its exposure to external shocks, which call for caution in macroeconomic and financial policies. Nonetheless, Macedonia's overall external debt and debt service ratios are expected to remain manageable even if the PCL is fully drawn; while short-term external debt is about 80 percent of its gross international reserves, the composition of this debt significantly lowers potential rollover risks. Macedonia's sustained track record of implementing strong policies and sound institutional policy framework provide assurances about the future course of policies such that Macedonia's capacity to repay is expected to remain strong.

Statement by the IMF Staff Representative on the Former Yugoslav Republic of Macedonia
Executive Board Meeting
January 19, 2010

This statement provides information that has become available since the issuance of the staff report (EBS/11/3). The new information does not alter the thrust of the staff appraisal.

1. **The cumulative fiscal outturn through November 2010 was 2.1 percent of projected annual GDP**. This suggests the budget was on-track to meet the 2010 deficit target of 2.5 percent of GDP.

2. **Average inflation in 2010 was 1.6 percent, while December year-end inflation was 3.0 percent**. These figures are close to the staff report projections of 1.5 percent (average) and 2.8 percent (end-year). The December uptick is mainly due to jumps in food and energy prices.

3. **GDP grew 1.3 percent year-on-year in the third quarter**. This is broadly consistent with the staff projection of annual growth in 2010 of 1.2 percent.

4. **Gross international reserves were €1.71 billion (99 percent of short-term debt by residual maturity) on December 31**. This is higher than the €1.65 billion projected in the staff report and suggests balance of payments trends were somewhat more favorable in December than expected by staff.

5. **Macedonian government Eurobond spreads have not been notably affected by sovereign debt market pressures in the Eurozone thus far**. The spread on Macedonia's five-year Eurobond was 414 basis points on January 5 (a yield of 5.93 percent), similar to levels of mid-October.

Press Release No. 11/14
FOR IMMEDIATE RELEASE
January 19, 2011

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves €475.6 million Arrangement for Macedonia Under the Precautionary Credit Line

The Executive Board of the International Monetary Fund (IMF) today approved a two-year arrangement for the Former Yugoslav Republic of Macedonia under the Precautionary Credit Line (PCL) in the amount equivalent to SDR 413.4 million (about €475.6 million, 600 percent of quota). The access under the arrangement in the first year will be equivalent to SDR 344.5 million (about €396.4 million, 500 percent of quota), rising in the second year to cumulatively SDR 413.4 million).

The arrangement for Macedonia is the first commitment under the PCL. The PCL was established in 2010 in the context of expanding and enhancing the IMF's lending tools to help provide effective crisis prevention.

Following the Executive Board's discussion on Macedonia, Mr. Naoyuki Shinohara, Deputy Managing Director and Acting Chair, made the following statement:

"Macedonia's track record of sound economic policies has contributed to a solid macroeconomic performance that includes low public debt and inflation, and a resilient banking system. Such strong fundamentals have cushioned the impact of the global crisis on the Macedonian economy.

"The authorities are committed to maintaining sound economic policies. One pillar of their policy framework is moderate fiscal deficits, which will help preserve a sustainable fiscal position and safeguard investor confidence. A second pillar is the ongoing commitment to support the exchange rate peg, including with a monetary stance that maintains an adequate level of international reserves. Based on these commitments, prospects for preserving macroeconomic stability and returning to more robust economic growth appear good.

"Despite the broadly favorable outlook for growth and macroeconomic stability, vulnerabilities to spillovers from economic and financial volatility in the region remain. The

PCL will mitigate the risk of contagion, including by signaling sound policies. In light of Macedonia's strong fundamentals, the absence of balance of payments pressures at present, and the generally positive economic prospects, Macedonia is not expected to draw upon the resources available under the PCL. Nevertheless, the availability of these resources, if needed, will provide important insurance against the possibility of adverse external developments".

The PCL is an instrument established last year that is available to Fund members with sound economic fundamentals and policies that do not have actual financing needs but face risks that could give rise to such needs (see Press Release No. 10/321). Thus, countries with PCL arrangements would be expected not to draw upon the available funds unless there is a deterioration in external conditions. The PCL arrangement provides countries with confidence that in the event of adverse developments they have a deep reservoir to draw upon to preserve stability. Moreover, having a PCL arrangement in place should help to strengthen confidence and facilitate better access to private capital markets.

Statement by Mr. Bakker and Mr. Tanasescu on Former Yugoslav Republic of Macedonia
January 19, 2011

Economic Developments

Macedonia has sound economic fundamentals. As elsewhere, the country was affected by the recent global economic crisis, but recovery from the 2009 recession is underway. Growth is projected at about 1 percent for 2010 and is expected to accelerate to 3.5 percent this year. The resumption of growth was initially led by exports, but revitalization of investment and consumption demand are expected to play a more important role this year. This economic recovery is supported by recent reductions in policy interest rates, which led to resumption of bank credit growth. Risks related to growth projections still exist however, especially in case export demand fails to continue recovering as expected or if metal prices weaken again. Vulnerabilities in euro zone countries could spill over to Macedonia through the current and capital accounts, and could hamper access to international capital markets. On the upside, progress towards EU accession would improve prospects for attracting foreign investment.

The inflation rate is expected to rise in the coming months and to reach 2.5 percent in 2011, due mainly to higher food and energy prices. At the same time, core inflation has remained below 1 percent, and is expected to remain low.

The external position is solid, and the most recent data show the current account deficit to be at below 3 percent of GDP in 2010, down from 13 percent of GDP in 2008. The balance of payments is sustainable over the medium term and the international reserves are relatively comfortable at 1.7 billion euros. The projected balance of payments flows support moderate continued reserve accumulation over the medium term. In 2009 Macedonia successfully accessed external capital markets, although at a high price, that reflected the prevailing unsettled market conditions. Since then secondary market yields on the outstanding Eurobonds have fallen to below 6 percent as of January 2011. This reduction in yields reflects investor confidence in the public finances and external sector, and creates good prospects for issuing a new Eurobond on the international capital markets in the first half of 2011.

Fiscal Policy

In recent years the authorities have successfully pursued fiscal consolidation. This provided room in the current economic crisis to implement some fiscal stimulus and to move ahead with improving infrastructure. The fiscal deficit is expected to have reached 2.5 percent of GDP in 2010 and the 2011 budget also targets a deficit of 2.5 percent of GDP. This prudent fiscal stance is in line with the authorities' medium-term strategy to preserve moderate public debt ratios. For 2012 the Macedonian authorities will continue the fiscal consolidation and they foresee a reduction in the fiscal deficit to near 2 percent of GDP. Over the medium term the authorities plan to reduce the fiscal deficit to 1.5 percent of GDP, which will stabilize public debt near 25 percent of GDP and help protect international reserves and the peg.

Monetary Policy and Financial Sector

The National Bank of the Republic of Macedonia (NBRM) continues to play a central role in ensuring the stability of the exchange rate peg, and in maintaining low inflation. In 2009 the NBRM responded firmly to the global financial turbulence, increasing its interest rate and bank reserve requirements in response to an outflow of international reserves. Since November 2009, after the situation stabilized, in light of favorable trends in the balance of payments and reserves, and against a background of weak growth and low inflation, the NBRM reduced gradually its interest rate that brought the policy rate to the present level of 4 percent. The National Bank takes a cautious stance, acknowledging that further easing should be dependent on continued favorable conditions. The authorities will remain vigilant to keep monetary policy the main anchor in keeping a stable exchange rate regime backed by an adequate level of international reserves.

The financial sector and bank regulatory framework are both sound, and the banks are well capitalized. At the end of September the capital adequacy ratio was above 16 percent, providing a significant buffer against shocks.. NPLs as a share of total loans increased, due to the economic downturn, but more than 93 percent of them are provisioned. Recently the authorities passed a new NBRM law which brings practices fully in line with EU directives and the European System of Central Banks Treaty. At the same time, the authorities have initiated changes in the legislation which would address the risk of court challenges to NBRM intervention in insolvent banks, and to widen the class of assets that banks may use to access liquidity support from the NBRM.

Structural Reforms

Macedonia has made significant progress on structural reforms, attracting greenfield foreign direct investment, privatizing and restructuring most of the economy, liberalizing telecommunications, and improving the business climate. In line with their medium-term strategy, the Macedonian authorities will continue structural reforms, including in the area of public infrastructure, and in the energy sector. The authorities have submitted a new energy law that will create a liberalized energy market and improve incentives for energy efficiency and investment. Going forward, implementation of these policies will contribute to reliable and safe energy supply at lower environmental costs, and reduce risks to the balance of payments and the budget.

Precautionary Credit Line (PCL)

My Macedonian authorities welcome the recent approval by the Fund of the PCL as a new financial instrument designed for countries with sound fundamentals and policies, and moderate remaining vulnerabilities. The policies implemented in the last years have well positioned Macedonia, and the authorities are committed to strengthening its economic and financial position and to further reducing external vulnerabilities during the coming years.

The authorities recognize that external risks persist due to the potential for adverse developments in Macedonia's trading partners and in international capital markets, which could lead to pressures on the balance of payments. The Macedonian authorities consider that a PCL arrangement would complement their economic policy strategy by bolstering investor confidence and mitigating the impact of any new external shocks. The authorities believe that the PCL would be an appropriate insurance against downside risks that could generate unanticipated financing needs. They will treat the PCL as precautionary, and they would not expect to draw upon the PCL unless there is a significant deterioration in external conditions. They plan to finance their 2011 budget with a Eurobond issue in the first half of 2011. Market conditions improved since last summer and have not been negatively affected so far by renewed turbulence in euro zone sovereign debt markets, and staff agreed that Eurobond financing is appropriate for this year. At the same time, the authorities agreed that they should turn towards domestic debt markets in the medium term.

Finally, we would like to express the authorities' commitment to continuing to implement sound policies, and they consider the PCL a significant additional buffer that could help preserve stability and reduce the need for contractionary adjustments in the event of temporary shocks.

Public Information Notice (PIN) No. 11/18
FOR IMMEDIATE RELEASE
February 4, 2011

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

IMF Executive Board Concludes 2010 Article IV Consultation with FYR Macedonia

On January 19, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the 2010 Article IV consultation with FYR Macedonia.[1]

Background

The pace of economic recovery is picking up, with growth expected to accelerate from somewhat over 1 percent in 2010 to 3½ percent in 2011. The recovery was driven initially by a rebound in exports, but the contribution from domestic consumption and investment has increased more recently. Inflation remains at low levels, despite some increases in food and energy prices. On the external side, the current account deficit has adjusted rapidly over the past two years, on the back of strong remittances and an improved trade balance. The current account deficit is expected to finish 2010 at some 3½ percent of GDP. Meanwhile, international reserves have fully recovered their earlier losses to reach their pre-crisis levels.

In the financial sector, non-performing loans (NPLs) rose and bank profitability declined as a result of the crisis. However, the system remained free of pressures on liquidity or solvency. NPLs were close to fully provisioned, capital ratios remained well above their

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

regulatory minimum, and bank liquidity was ample. Stable funding sources (primarily domestic deposits), minimal reliance on external funding, and conservative asset portfolios all helped to contain the effect of the crisis on the banking system. After dipping following the onset of the crisis, bank deposits and bank credit to the private sector have both resumed growing, although at a more moderate pace than before the crisis.

Macedonia appears to be on track to meet its 2010 fiscal deficit target of 2½ percent of GDP. This was achieved by reducing expenditure as revenues fell short of projections, in part due to weak economic growth. The 2011 budget passed by parliament also targets a deficit of 2.5 percent of GDP, which represents a neutral cyclical stance. On the monetary policy side, the National Bank of the Republic of Macedonia (NBRM) has reduced interest rates from a high of 9 percent in 2009 to the current level of 4 percent. The NBRM based this easing on the recovery of international reserves and favorable underlying trends in the balance of payments.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They commended the Macedonian authorities for their sound macroeconomic and financial policies, which helped to contain the impact of the global crisis, and welcomed prospects for a return to more robust growth in 2011 and beyond.

Directors noted that the fiscal outcome in 2010 and the 2011 budget strike the right balance between safeguarding investor confidence in continued fiscal prudence and the need to support the economic recovery. They concurred that, once a more robust recovery is underway, fiscal consolidation will help strengthen the public finances further and provide a policy buffer against future shocks. Directors considered that deepening the domestic public debt market over time could help reduce external financing vulnerabilities.

Directors noted that the significant reductions in policy interest rates over the preceding year were justified against a background of subdued inflation, output below potential, and favorable trends in international reserves. In their view, the scope for further interest rate cuts is limited by the narrowing spread over ECB rates, and additional easing should be contingent on continued favorable developments in the balance of payments and international reserves.

Directors were encouraged by the overall healthy condition of the financial system. They noted in particular the high capital and liquidity cushions at banks and the reliance on relatively stable domestic deposits for funding. Directors encouraged the authorities to move forward with the implementation of the new law on the central bank.

Directors emphasized the need to accelerate structural reforms and strengthen public infrastructure to raise productivity and help reduce high unemployment. Directors were also encouraged by the authorities' commitment to improve data quality, including by subscribing to the Fund's Special Data Dissemination Standard.

Despite the broadly favorable outlook for macroeconomic stability, Directors agreed that vulnerabilities to spillovers from economic and financial volatility in the region remain. Directors believed that Macedonia met the Precautionary Credit Line (PCL) qualification requirements and that such an arrangement would mitigate the risk of contagion, including by signaling sound policies. In light of Macedonia's strong fundamentals, the absence of balance of payments pressures at present, and the generally positive economic prospects, Directors expected that Macedonia would not need to draw upon the resources available under the PCL.

FYR Macedonia: Selected Economic Indicators

	2007	2008	2009	2010 Est.
	(Annual percentage change, unless otherwise specified)			
Real GDP	6.1	5.0	-0.9	1.2
Total domestic demand	9.2	6.7	-2.6	0.2
Consumption	6.5	8.0	-4.4	0.2
Investment	22.2	5.4	0.9	0.2
Net exports 1/	-4.6	-3.1	2.2	1.0
CPI (Average)	2.3	8.3	-0.8	1.5
Unemployment rate (annual average)	34.9	33.8	32.2	…
	(In percent of GDP)			
Current Account	-7.0	-12.7	-7.2	-3.5
Trade balance	-19.7	-26.1	-23.2	-21.8
Exports of goods	40.9	40.0	28.8	34.6
Imports of goods	-60.6	-66.1	-52.0	-56.3
Gross external debt	47.6	49.2	57.5	58.5
Gross Domestic Investment	24.6	26.8	26.2	25.4
National savings	17.7	14.1	18.9	21.9
Public	4.4	3.9	0.6	1.1
Private	13.3	10.2	18.3	20.8
Foreign savings	7.0	12.7	7.2	3.5
Central Government Gross Debt	24.0	20.7	23.9	24.6
Central Government Balance	0.6	-0.9	-2.7	-2.5
Memo:				
GDP (billions of denar, 2009)			409	
EUR (billions)			6.7	
Per capita (EUR)			3,253	

Sources: Ministry of Finance, National Bank of Republic of Macedonia; World Development Indicators 2008, and IMF staff estimates.
1/ Contribution to growth.