October 2006
IMF Country Report No. 06/344

Former Yugoslav Republic of Macedonia: 2006 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Former Yugoslav Republic of Macedonia

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with the Former Yugoslav Republic of Macedonia, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 5, 2006, 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 July 13, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 28, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Former Yugoslav Republic of Macedonia.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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

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Washington, D.C.

INTERNATIONAL MONETARY FUND

FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Consultation with the Former Yugoslav Republic of Macedonia

Approved by Juha Kähkönen and Scott Brown

July 13, 2006

- **Article IV discussions**. During May 24-June 5 the staff team met President Crvenkovski, Prime Minister Bučkovski, Deputy Prime Minister Šekerinska, Finance Minister Popovski, Minister of Economy Besimi, National Bank of the Republic of Macedonia Governor Gošev, Opposition Leader Gruevski, other senior officials, and representatives of the academic, banking, business, labor, political and international communities. Drafts of the Selected Issues papers were discussed in seminars. The mission's concluding statement is available at http://www.imf.org/external/np/ms/2006/060506.htm.

- **Staff**. The team comprised Mark Griffiths (head), Christine Dieterich, Chris Marsh, Alexander Pivovarsky (all EUR), Alessandro Giustiniani (MFD), Eva Gutierrez (PDR), and Kevin Ross (Resident Representative); Juha Kähkönen (EUR) joined to conclude the discussions. Vladimir Munteanu (OED) also participated in the meetings.

- **Exchange Restrictions**. The Executive Board granted FYR Macedonia an extension for restrictions under Article VIII Section 2 (a) until December 31, 2006. The one outstanding issue is passage of a regulation in relation to frozen foreign currency deposits; the authorities are committed to doing this by the end of the year.

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EXECUTIVE SUMMARY

Economic performance has started to improve. For more than a decade, economic growth was sluggish, in part the result of external shocks. Last year, growth likely exceeded 4 percent, driven by strong exports. Inflation this year has picked up to 4 percent, but the pegged exchange rate should hold this in check. The external position is better, with gross reserves now at around €1,200 million (more than 4 months of imports, or 25 percent of GDP). This increase in reserves has allowed the NBRM to cut rates significantly, from 10 percent to less than 6 percent since October, and which commercial banks have partly matched. Credit is expanding, to households especially, though from a low base and slowly compared to the region. Fiscal policy is also modestly expansionary, last year's ¼ percent of GDP surplus giving way to a projected 0.6 percent of GDP deficit. As a result, growth should remain at around 4 percent this year, with the current account deficit increasing only slightly.

However, the economy faces severe structural obstacles to the more rapid growth needed to raise living standards closer to European levels. Unemployment is exceptionally high, the financial system is still underdeveloped, and there are serious weaknesses in basic economic institutions.

Discussions focused on the main challenges facing the new government: sustaining and building on this recent improvement in macroeconomic performance, and reducing unemployment:

- **The authorities agreed that continued stable macroeconomic policy was a precondition for sustained growth**. This meant keeping to the 0.6 percent of GDP fiscal deficit target, while the fixed exchange rate would guide monetary policy. Pressures to spend privatization proceeds were increasing, and the authorities largely accepted the need to resist these; however, medium-term challenges to the fiscal target (loss of telecom dividend, pension reform, EU accession) will be considerable.
- **This needs to be accompanied by structural reforms to create a functioning market economy**. The mission highlighted the following priorities: (i) institutional reform (judicial reform, transparency in government decisions, telecoms liberalization) to promote factor productivity and growth; (ii) labor market reform (lower tax wedge, ending tax discrimination against part-time work) to reduce unemployment; and (iii) financial sector development (consolidating the banking system, revising the banking law, enhancing supervision). These themes are developed more fully in the accompanying Selected Issues papers, which the mission discussed in a seminar with the authorities.

With the current account improving, the level of the exchange rate for now is broadly appropriate.

I. INTRODUCTION

1. **With economic performance improving following a decade of low growth, and elections in July, the Article IV consultation took place at an opportune but sensitive time**. Despite recent improvements that owe much to generally sound policies (Box 1), FYR Macedonia still faces the considerable challenge of achieving sustained rapid growth, lowering unemployment, and reducing current account vulnerability. With financing constraints easing, pressure to relax macroeconomic policy is also increasing. Tax cuts and spending initiatives proposed during the election could jeopardize the hard-won record of stability. The discussions gave a chance to reassess the macroeconomic policy stance and to devise policies that will accelerate growth in a lasting way. By seeking the views of the current government, the opposition, unions and business leaders, this consultation should help shape the new government's economic program.

2. **While conditions are improving, understanding economic performance and assessing monetary and fiscal policy is complicated by data deficiencies.** National accounts data are available with considerable delay, and prone to revision, creating uncertainty over the forces determining growth. Trade performance and competitiveness are hard to gauge, with volume figures for 2005 indicating an exceptionally large contribution of net exports, difficult to reconcile with production-side GDP estimates. Increased conversions of foreign currency into denars at exchange bureaus are also hard to interpret. Are these current account transactions, such as increased remittances from abroad, tourism and informal exports? Or do they reflect capital inflows or the conversion of so-called mattress money? Aside from making this report's macroeconomic analysis more tentative, these statistical uncertainties caution against fine-tuning monetary and fiscal policy, increasing the premium on keeping macroeconomic policy stable and relatively simple.

II. BACKGROUND

A. The Medium-Term Problem: Stability But Low Growth

3. **Since independence in 1991, FYR Macedonia has faced severe challenges on top of the normal problems of transition**. Hyperinflation in the early 1990s, trade embargoes, regional conflict, and the 2001 internal security crisis have compounded the problems of restructuring and creating a market economy. The starting point also was weak: within Yugoslavia, Macedonia's economy was the poorest, specialized in very few, mainly traditional, sectors, with an unemployment rate of around 20 percent.

4. **Despite these challenges, conservative fiscal policy and the fixed exchange rate have controlled inflation**. After a 16 percent devaluation in 1997, the de facto peg to the DM and later the euro has remained intact. Since 2002, inflation averaged less than 1 percent. Save during crises, the fiscal deficit has been low, keeping gross public debt to 40 percent of GDP.

Box 1. Implementation of Past Fund Policy Advice

The Macedonian authorities have generally been responsive to the Fund's advice since the last Article IV consultation http://www.imf.org/external/np/sec/pn/2003/pn0363.htm and the ex-post assessment of the long-term use of Fund resources http://www.imf.org/external/np/sec/pn/2004/pn0497.htm.

Fiscal policy: Consistent with staff advice, the authorities pursued fiscal consolidation and reversed spending increases associated with the 2001 security crisis, to achieve sustainable medium-term fiscal and external positions. Revenue administration and public financial management have been strengthened, including by widening the coverage of the treasury single account, giving the Ministry of Finance power to control line ministries' spending, and improving procurement. While budget arrears are under control, progress containing health sector arrears has been mixed. Fiscal decentralization is on track, but local government financial management needs to improve.

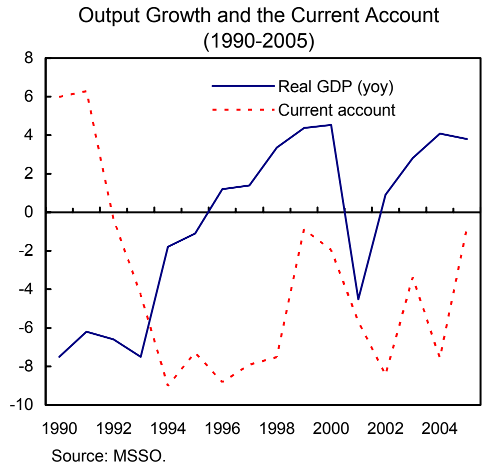
Exchange rate: Although agreeing in principle on the need for an exit strategy, either towards greater flexiblity or a harder peg, the authorities have continued with the "soft peg", which has worked well so far.

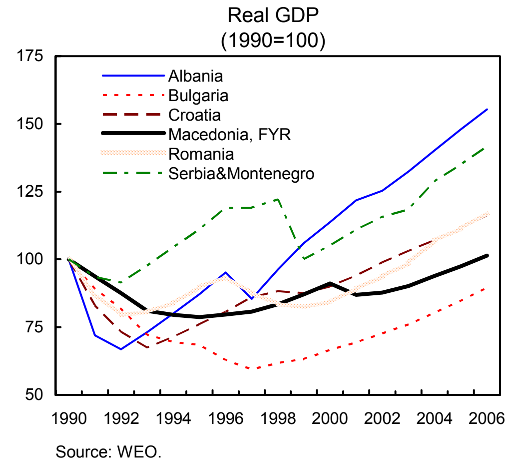
Structural reforms: Labor market flexibility and the business climate have improved. Privatization has continued and should improve corporate governance. Trade has been further liberalized. EU candidate status should catalyze the authorities' structural reform efforts, many long advocated by the Fund.

5. **However, macroeconomic stability has been slow to translate into rapid output or employment growth:**

- **Since 1995, growth has averaged only 2 percent**, well below other transition economies, so that GDP has only recently reached pre-transition levels. By the late 1990s, growth had picked up to around 4 percent, but this improvement was interrupted by the 2001 conflict. International reserve shortages have also increased growth rate volatility.

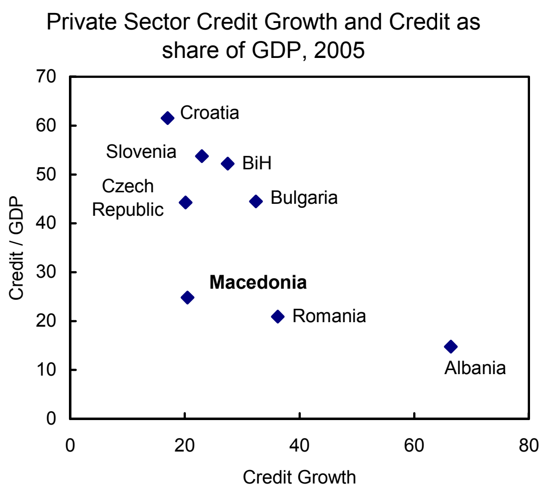
- **Recorded unemployment in 2005 reached 35 percent**. Employment has barely increased since 1995. Nevertheless, wages appear quite high for the region, suggesting that insiders are protected from competition. With two-thirds of the unemployed more than four years out of work, high youth unemployment, and low labor force participation, much of the unemployment is structural; reducing it will thus be difficult.

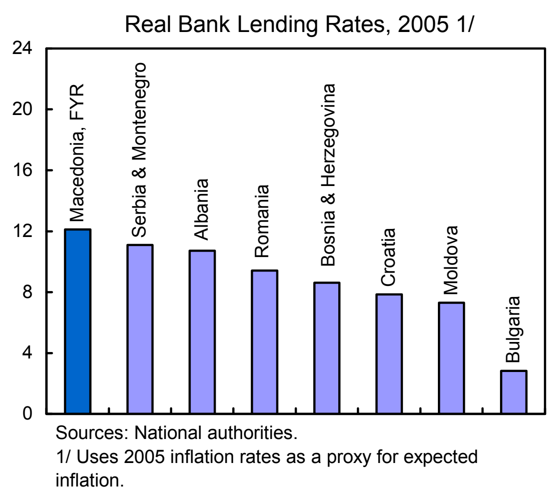




6. **Besides various shocks, high real interest rates and low foreign direct investment have slowed growth, suggesting underlying structural problems**:

- **Interest rates have been relatively high, despite low inflation**. High real interest rates have limited private credit growth, despite low financial intermediation. The fixed exchange rate has induced considerable volatility in NBRM rates; bank lending and deposit rates have largely ignored these, weakening monetary transmission.





- **The stock of foreign direct investment is very low**, less than US$600 per capita at end-2004. This is lower than the regional average, and substantially below that in Bulgaria, Croatia, and Romania. The gap between actual non-privatization and potential FDI (using regression estimates) is also substantial.

South Eastern Europe: Cumulative FDI

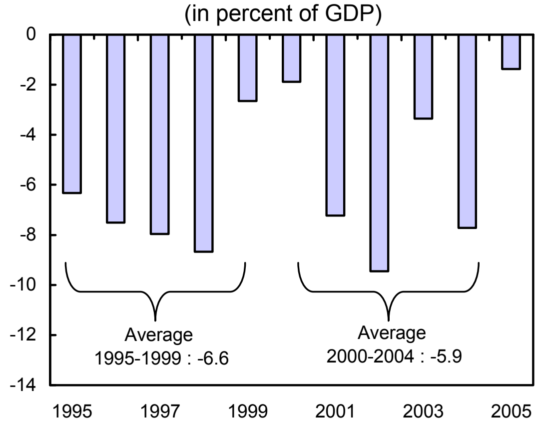
	Cumulative inward FDI (at end-2004)			FDI gap (in percent) 1/
	in millions US$	in per capita US$	in percent of GDP	
Macedonia	1,175	570	24.8	64
Albania	1,514	475	20.2	68
Bosnia and Herzegovina	1,660	433	20.1	82
Bulgaria	7,569	973	31.7	24
Croatia	12,989	2,882	39.1	66
Romania	18,009	824	25.2	38
Serbia and Montenegro	3,947	484	16.4	50
Average	6,695	949	25.4	56

Sources: UNCTAD, Demekas et al. (WP/05/110).

1/ FDI gap is defined as a difference between actual and potential non-privatization FDI stock based on the data for 2003, where potential FDI is derived using coefficients from a regression of gravity and institutional variables, with institutional variables at their best practice levels.

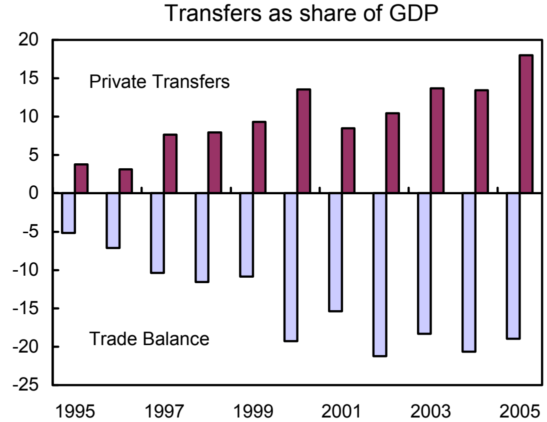
7. **In the past, persistent current account deficits created reserve shortages and rising external debt**. From 1995 to 2004, the current account deficit averaged more than 6 percent of GDP, any improvements typically proving short-lived. Reserve cover fell to less than 3 months of imports by 2004, and external debt rose above 40 percent of GDP. Higher private transfers from migrants (mostly foreign currency cash conversions) both boosted imports and financed the resulting trade deficit.

FYR Macedonia: Current Account Balance (in percent of GDP)



Source: NBRM.

FYR Macedonia: Trade Balance and Private Transfers as share of GDP



Source: NBRM.

Box 2. Macedonian Migration and Remittances

Though reported remittances are half the size of exports, information on their size and determinants is incomplete. Official figures for the number of Macedonians living abroad are outdated, dropped from the 2002 census as politically sensitive after the 2001 security crisis. ILO data only report those who obtained working visas from foreign embassies in Macedonia (112 in 2003). Data from recipient countries give an estimate of roughly ½ million, though the further back the generations the weaker the ties. If true, this would represent 20-25 percent of the population, even higher than in other migrant European countries like Moldova.

Lack of official data makes it difficult to assess whether emigration has accelerated. Unlike in other countries, increased migration has not increased wage pressure since unemployment remains high. Private transfers (which in Macedonia include remittances and cash exchanged in bureaus assumed sent by migrant workers) have doubled in the last five years, to almost 18 percent of GDP in 2005. Remittances seem stable and countercyclical, consistent with an altruism motivation. In contrast, cash exchanged is procyclical, and may reflect portfolio diversification.

Apart from Serbia, migrants are mostly located in Switzerland, Germany, Italy, Australia, USA, and Canada. Emigration to Australia and Canada predated independence, and low remittances in Australian and Canadian dollars suggest weakening ties. With the 10 most active foreign exchange bureaus located in municipalities with highest Human Development Indices, foreign migration is not exclusively a phenomenon of poor and rural areas, though roughly half cash exchanged is in ethnic Albanian areas.

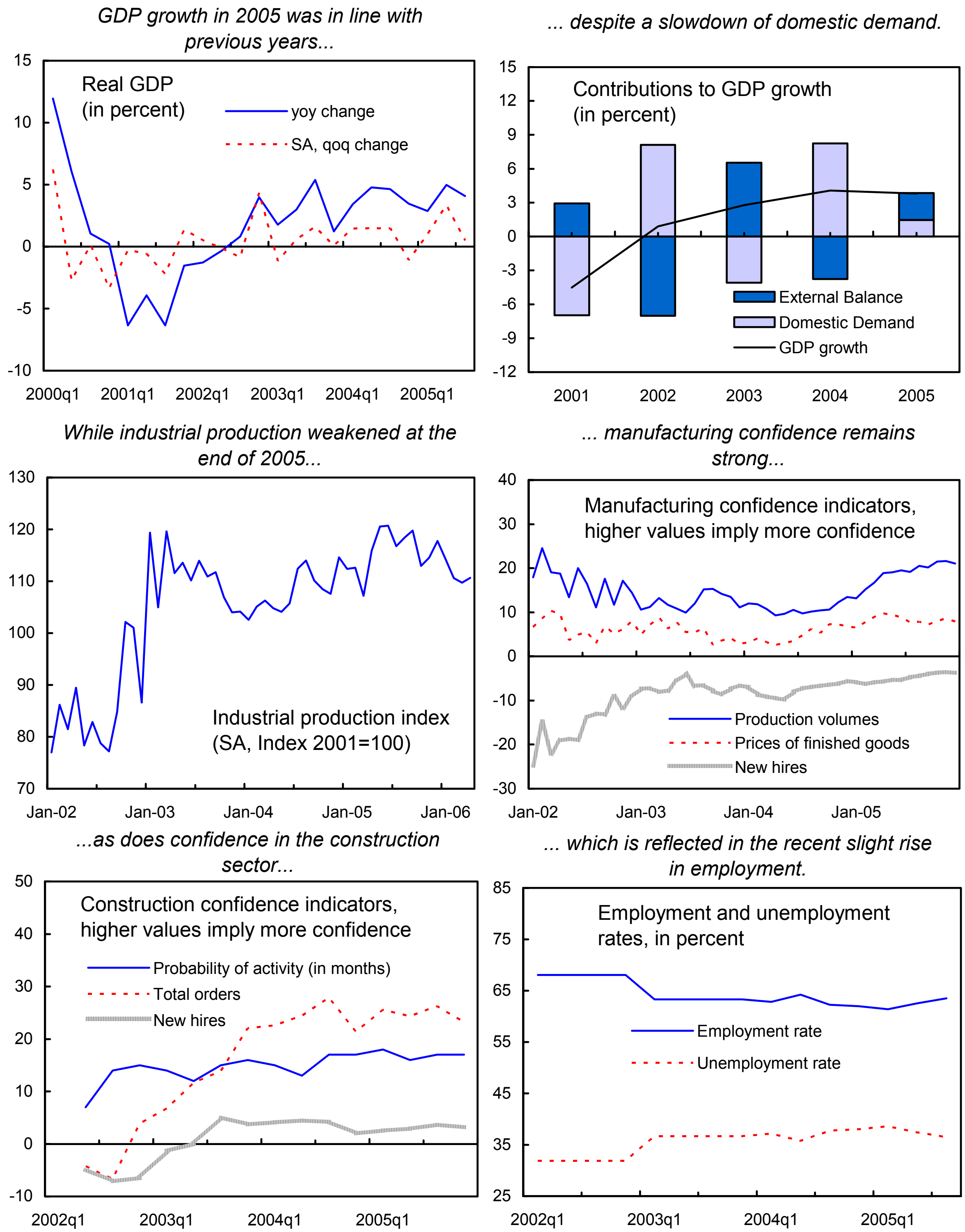
B. Recent Developments

8. **Despite these severe medium-term challenges, economic performance has improved recently (Figure 1, Table 1).** The authorities' preliminary estimates (based on industrial production) suggest growth reached 4 percent in 2005, driven by strong exports, with tight fiscal policy and high interest rates at end-2004 restraining domestic demand. However, corporate income tax receipts are much stronger than expected, likely reflecting higher profitability and value added, and the increase in consumption and investment (borne out by retail turnover, car sales, and investment data) due to higher private transfers and bank lending is unlikely to have been measured fully. The true growth rate could therefore be even higher, though unemployment has fallen only marginally. Despite higher oil prices, the stable exchange rate, lower tariffs, and food prices kept average inflation below 1 percent.

9. **The external position has strengthened, with gross reserves rising from €700 million at end-2004 to around €1,200 million (more than 4 months of imports, 25 percent of GDP) by May 2006 (Figure 2, Table 2):**

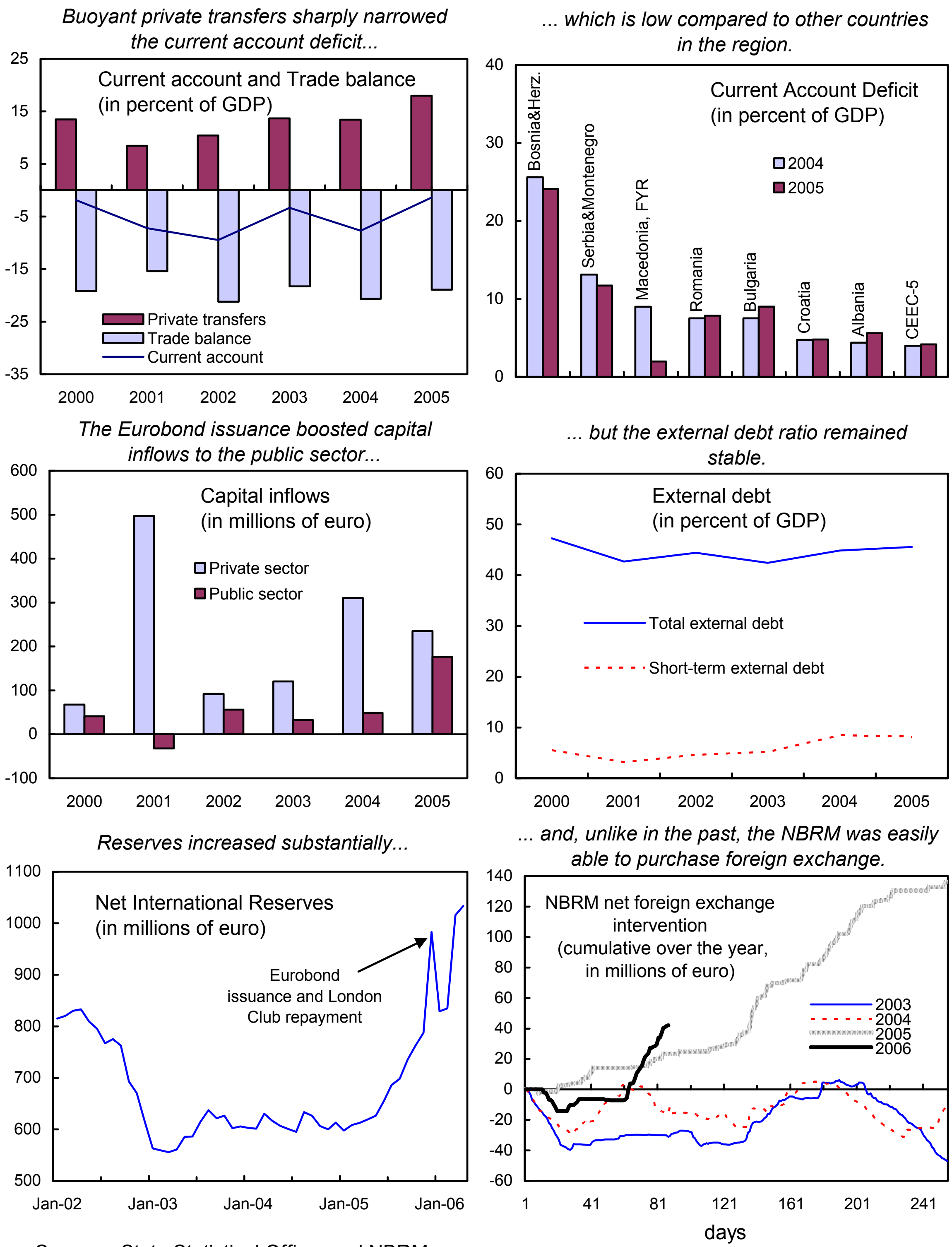
- **The reported current account deficit fell sharply to 1.3 percent of GDP in 2005**. The main factor was increased private transfers, which probably include capital

Figure 1. FYR Macedonia: Real Sector Indicators, 2000-06



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

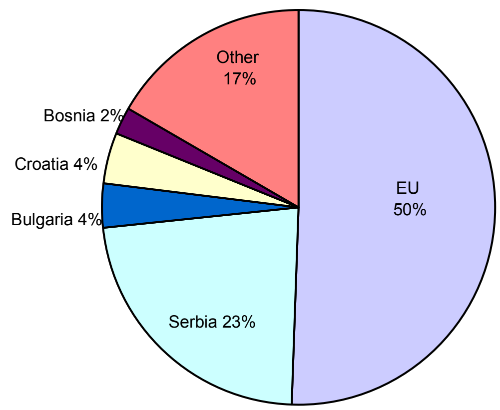
Figure 2. FYR Macedonia: External Sector Indicators, 2000-06



Sources: State Statistical Office; and NBRM.

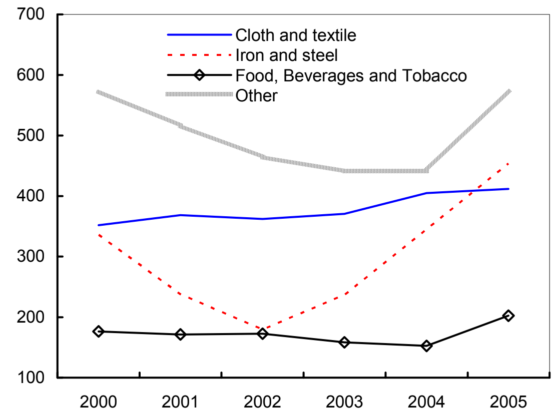
account transactions (a planned STA mission will examine this further); more conservative staff estimates would put the true deficit closer to 4.5 percent of GDP. Although higher oil prices raised imports by 3.3 percent of GDP, the overall trade deficit fell by 2 percent of GDP, but is still close to 20 percent of GDP. Export growth accelerated in all sectors except for textiles, and especially in steel (which grew 30 percent) with the reopening of the largest steel factory. Higher energy imports were offset by lower imports of goods for processing, while consumption goods imports were flat.

FYR Macedonia: Destination of Exports, 2000-05



Sources: MSSO; and IMF staff calculations.

FYR Macedonia: Exports by sector, 2000-05
(in millions of Euro)

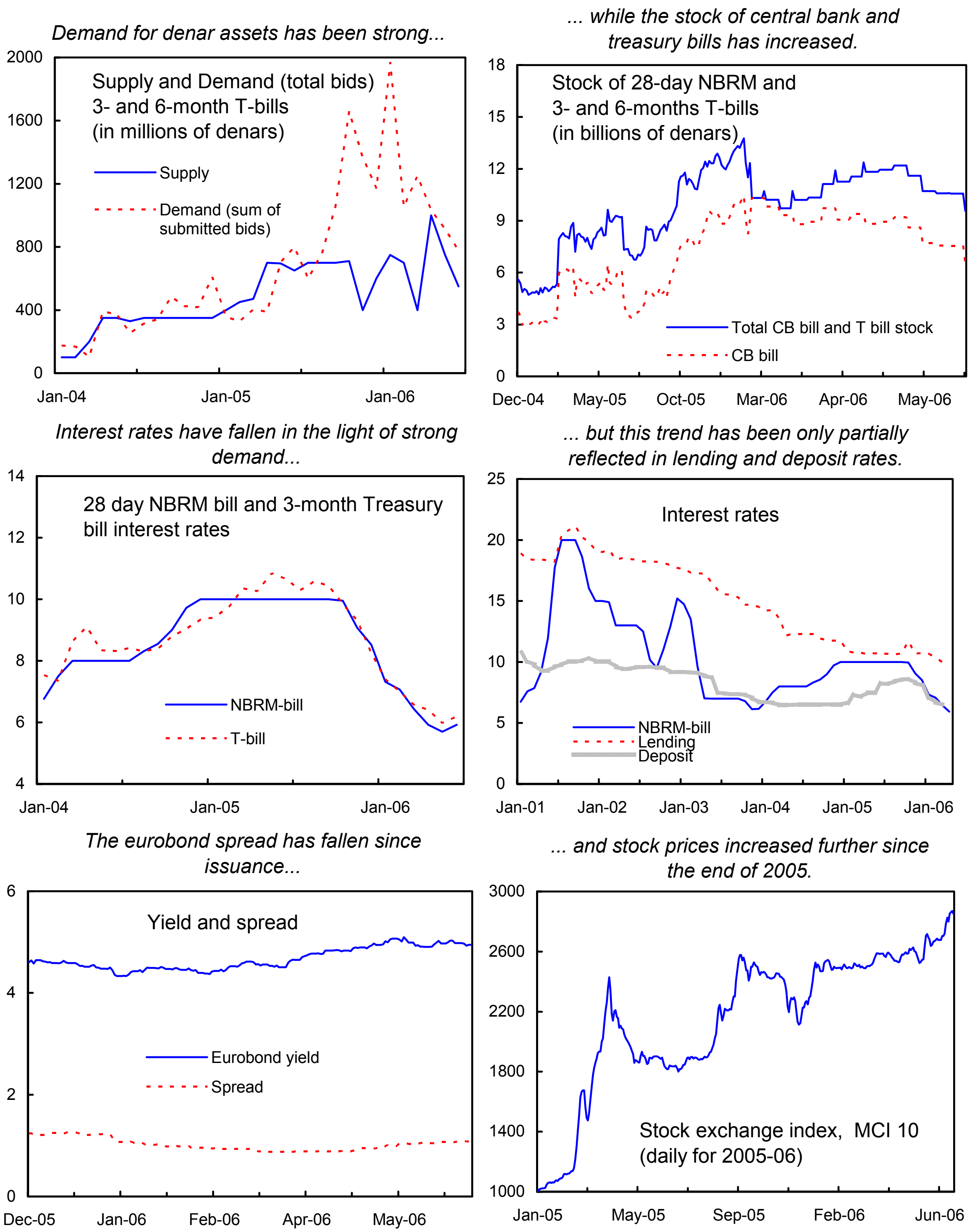


Sources: MSSO; and IMF staff calculations.

- **Capital account developments are difficult to gauge.** Abstracting from one-off items such as last year's €150 million Eurobond and this year's electricity privatization (€225 million, almost 5 percent of GDP), improvements are hard to discern. Long-term private borrowing and portfolio flows have increased, banks have drawn down deposits abroad to lend domestically, and EU candidacy has improved financial market confidence (Figure 3). In June, Fitch upgraded its rating to BB+ (one notch below investment grade). However greenfield FDI remains low, and mainly in nontradable sectors such as banking, telecoms, retail trade, and energy.

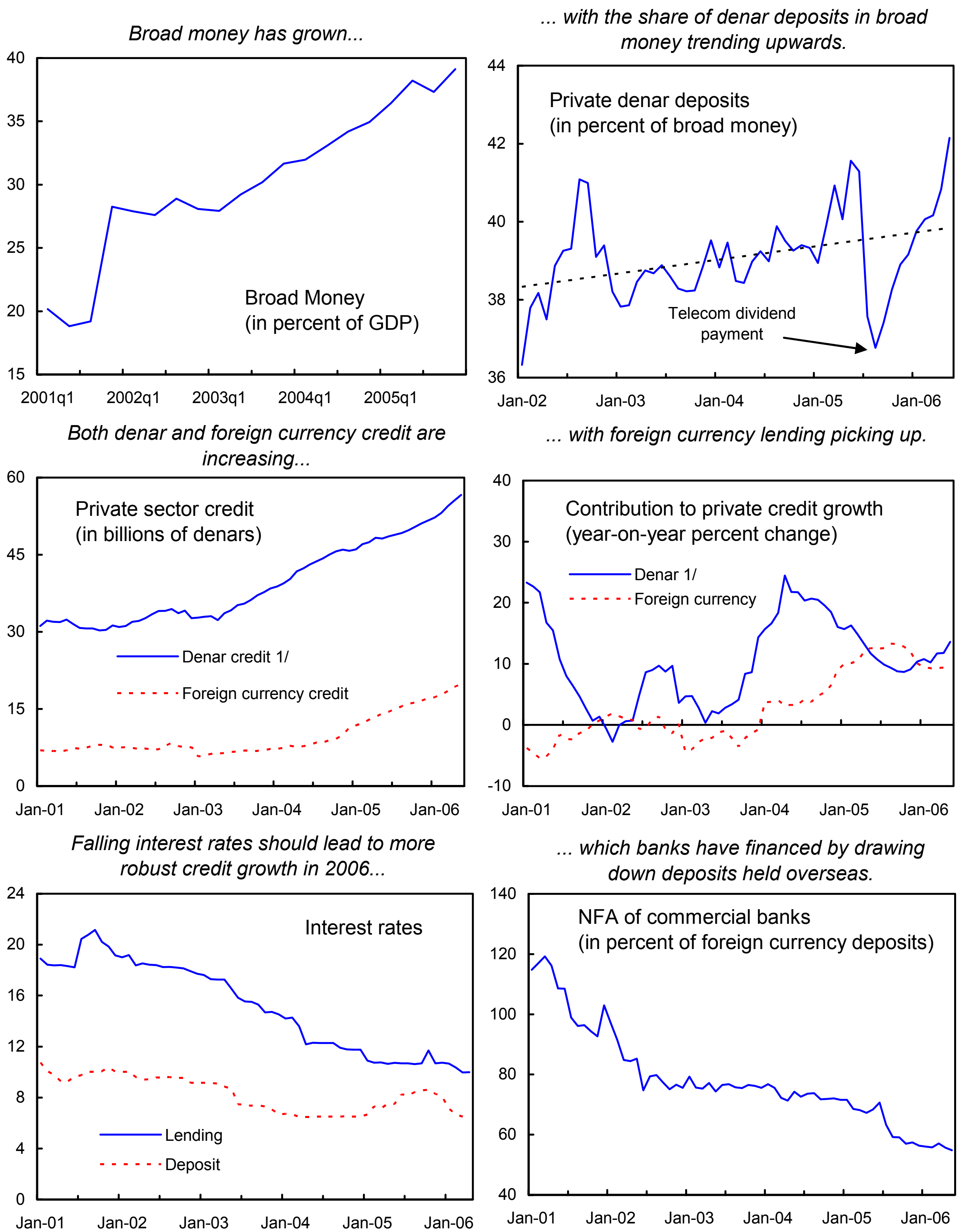
10. **The increase in reserves allowed the NBRM to cut interest rates from 10 percent in October to below 6 percent in May**. Though prompted partly by increased sterilization costs (which reached €10 million (0.2 percent of GDP) in 2005 and were set to rise significantly in 2006 with continued foreign currency purchases), the differential with euro-area rates had been high, perhaps because of residual uncertainties over the exchange rate. Banks have only partly matched the NBRM's rate cuts, in part because they did not entirely match earlier rate increases. Credit has expanded, especially to households and in foreign currency, though from a low base and less rapidly than the region (Figure 4, Tables 3-4).

Figure 3. FYR Macedonia: Financial Market Developments, 2004-06



Sources: NBRM; and IMF staff estimates.

Figure 4. FYR Macedonia: Money and Credit Developments, 2001-06



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

11. **Fiscal policy has been kept tight, though with some easing this year (Table 5)**. Last year's 0.3 percent of GDP central government budget surplus exceeded the program by more than 1 percent of GDP. Special Revenue Account underperformance continued, and the authorities also curbed public employment and delayed procurement. The unusually high telecom monopoly dividend (1 percent of GDP), and advancing VAT payments by importers also contributed. The 0.6 percent of GDP deficit in the 2006 budget represents a modest fiscal easing.

12. **Though present, traditional vulnerabilities are relatively low (Table 6)**. External debt exceeds 40 percent of GDP, though almost all is long term and around half owed to multilaterals. Private short-term external debt is very low (only 8 percent of GDP) and consists almost entirely of trade credits. Government debt is around 35 percent of GDP, almost entirely foreign currency denominated, but with maturity averaging more than 10 years (Table 7). Parts of the banking system appear weak and a large share of intermediation is in foreign currency (with a 50 percent share of deposits). However, the level of monetization is also low, with broad money only 40 percent of GDP, well covered by gross international reserves of 25 percent of GDP. In addition, though net foreign assets are declining as banks borrow from their overseas parents, their net foreign exchange position remains positive. Debt sustainability analyses likewise suggest only limited vulnerabilities, save for the scenario based on historical averages (which includes the security crisis years) (Tables 8-9). This underlines a main theme of this Article IV: the need to break with historical growth and current account trends.

13. **However, political risks (both domestic and regional) are quite significant, as are the risks of election-related policy slippage**. EU accession prospects may wane, with the government still to complete the five key priorities identified last year by the Commission, and the EU divided on enlargement. While all major parties are committed to reform, implementation will likely depend on how strong a coalition emerges after the election.

III. PROSPECTS FOR 2006

14. **Immediate prospects remain favorable, with somewhat easier monetary and fiscal policy sustaining growth, and inflation under control:**

- **Growth should meet the authorities' 4 percent projection.** Though exports and recorded industrial production show signs of slowing, the authorities noted that demand side indicators were favorable: net wages are rising 4 percent year on year in real terms, new car registrations are up more than 30 percent year on year, and retail sales are strong.

- **Average inflation should rise to around 3 percent, due to one-off factors.** Consumer price inflation rose to 4.1 percent year on year in May, driven by supply factors: increased tobacco taxes and oil prices, and higher than expected food prices.

With the exchange rate fixed, the mission agreed with the authorities that this price increase should be a blip (core inflation is only 1 percent), any domestic demand resurgence first showing up in the current account.

15. **The balance of payments should continue to strengthen in 2006, provided the sale of the remaining telecom shares is completed**:

- **The current account deficit should widen modestly to 3 percent of GDP**. Higher oil prices should increase the trade deficit by 2 percent of GDP; growing steel exports should be broadly offset by higher consumption and investment goods imports, stimulated by the recent interest rate decline. Though growing less rapidly (perhaps because lower interest rates are discouraging inflows), recorded private transfers should increase by 2 percent of GDP. Discussions suggested that the risks were finely balanced: oil prices could rise further, the reopened steel factory might take time to reach capacity, and Chinese competition could threaten textile exports. Against this, the private transfers projection was conservative, and the elimination of Serbia's quota on refined oil imports could boost exports.

- **Successful privatization of the government's remaining telecom shares could boost capital inflows by €300 million**, raising gross reserves to €1.6 billion (5½ months of imports of goods and services). However, the mission cautioned that excluding one-off effects from Eurobond issuance and privatization receipts, net capital inflows only increase modestly by about 5 percent. Greenfield foreign direct investment especially was projected to remain weak.

IV. Policy Discussions

A. Medium-Term Outlook

16. **Discussions focused on how best to sustain and build upon the recent improvement in economic performance, essential for reducing unemployment and raising living standards toward European levels**. This needed a two-handed approach. As a pre-condition, FYR Macedonia should maintain its hard-won macroeconomic stability. But for growth and jobs to be created, more ambitious structural reforms were required: enhancing financial intermediation with sound banking supervision, improving the business climate, and labor market reform to reduce unemployment. The Selected Issues papers describe these potential reforms in more detail. Underlying all these reforms was the need to improve the quality of institutions.

17. **The authorities agreed with this message, particularly the importance of structural reform.** Prime Minister Bučkovski noted that the achievement of macroeconomic stability, EU candidate status, and the implementation of labor, judicial, and bankruptcy

reforms, had improved confidence. Targeting 5-6 percent growth was therefore reasonable. Discussions with the main political parties, and the academic and business communities showed a broad commitment to reforms, and the formation of the new government offers an excellent chance to accelerate these. However, these discussions also revealed considerable pressures to spend recent privatization proceeds.

18. **The mission presented two medium-term macroeconomic scenarios to frame the policy discussions, compared to the program baseline** (updated for this report to include recent events, and which underlies Table 2 and the debt sustainability analysis)**:**

- **In the optimistic scenario, macroeconomic stability is maintained but structural reforms are accelerated compared to the program, amid intensified EU accession efforts (Figure 5, Table 10)**. Capital inflows and FDI boost investment, and structural reforms raise total factor productivity so that growth rises to 6 percent; Balassa-Samuelson effects raise inflation slightly. With imports 1½ times exports, the resulting modest increase in import growth rates widens the current account, though this is largely FDI-financed. The fiscal deficit target prevents overheating and contains the current account deficit; by anchoring policies, it also maintains confidence in the exchange rate peg.

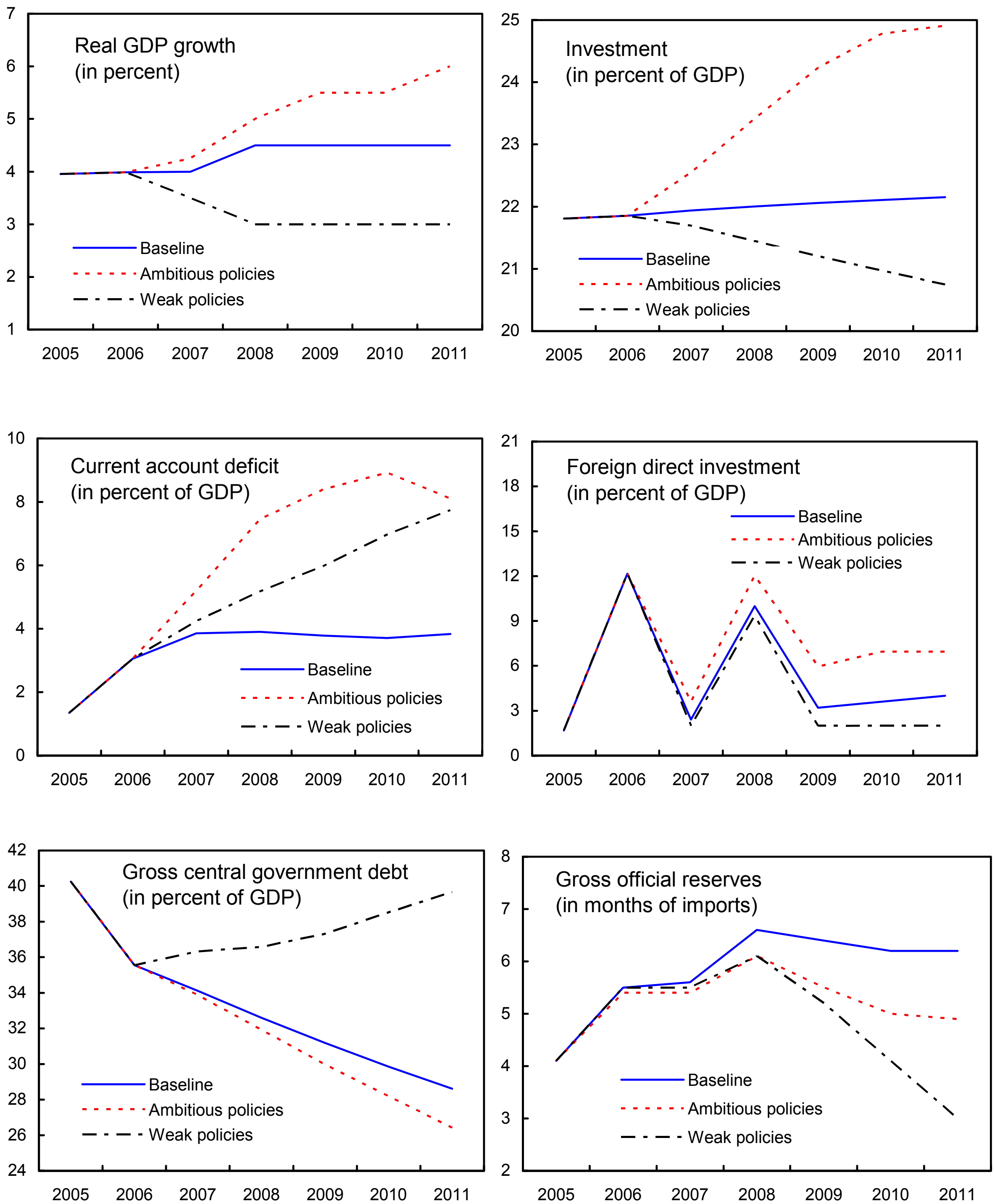
- **Conversely, delayed structural reforms slow growth to 3 percent, closer to historical averages (Table 11)**. Spending and tax cut pressures increase the fiscal deficit. Government debt ratios rise, while lower domestic saving raises the current account deficit. Financial market confidence and capital inflows worsen, reserves fall, and external vulnerability could again become an issue. A more restrictive fiscal stance would be needed to contain the current account deterioration, though at the cost of slower growth in domestic demand.

19. **The authorities agreed with the main message of these scenarios, and on the benefits of a medium-term fiscal anchor.** They looked forward to refining and using them in their Pre-Accession Economic Program.

B. Fiscal Policy

20. **The authorities are confident of meeting the 0.6 percent of GDP deficit target this year**. Though last year's advance payments from importers have weakened VAT collections, stronger direct taxes have compensated, especially corporate income tax due to unexpectedly high profits in 2005. The mission expressed concern at pre-election spending initiatives (tobacco farmer subsidy, health sector wages) which worsened budget composition, and tobacco tax increases which encouraged smuggling and lost revenue.

Figure 5. FYR Macedonia: Medium-Term Scenarios, 2005-11



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

However, the authorities noted that agricultural subsidies were low; doctors' salaries had not been increased in four years, and cost savings and increased contribution collections would finance this. Though the telecom dividend would likely be 0.6 percent of GDP higher than budgeted, the mission cautioned against using this to accommodate new spending pressures, since telephone charges are exceptionally high and this revenue will disappear once privatization is complete. The mission also stressed that pre-election tax and spending promises (from both the government and the opposition) needed to respect the deficit target.

Box 3. Medium-Term Fiscal Challenges

Macedonia faces considerable medium-term fiscal challenges:

- **EU Accession.** This year's national strategy for adoption of the acquis envisages the introduction of 300 new laws by 2010, and the need for 2,600 new staff (a quarter of the civil service). From 2007 funds will be drawn from the newly-established Instrument for Pre-accession Assistance, of around 1 percent of GDP. Disbursements will require around 25 percent co-financing. Transportation and environmental investment may need to rise by 1-2 percent of GDP. For comparison, fiscal costs of accession for other transition economies are estimated to have been around 1-2 percent of GDP.

- The new **second pillar pension system** reduces social security revenues by 0.5 percent of GDP this year, 0.9 percent of GDP by 2009.

- **Trade liberalization** will reduce tariff revenues by 0.5 percent of GDP by 2010.

- **Loss of the telecom dividend after privatization** reduces revenues by ½-1 percent of GDP.

21. **The mission stressed the importance of meeting medium-term fiscal challenges within the 0.6 percent of GDP fiscal deficit target (Box 3)**. The authorities acknowledged these pressures, but lacked detailed plans to address them. Staff suggested focusing on the following areas:

- **Broadening the corporate income tax base** (and possibly increasing VAT, depending on the findings of September's FAD tax policy mission).

- Completion of the **tax administration reform** project supported by the Fund and the Netherlands.

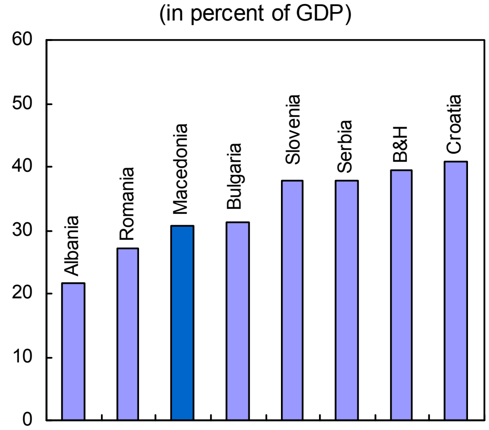
- **Reducing the share of non-discretionary government spending** (almost 80 percent) to create flexibility for EU-spending and public investment (currently only 3 percent of GDP).

- **Rationalizing public employment** (which had increased considerably before 2004). The World Bank's forthcoming public expenditure review might help here.

- **Containing health expenditures**, again with the World Bank.

22. **These challenges and the low revenue ratio compared to the region limit the scope for tax cuts**. Opposition proposals to introduce a flat tax would require offsetting measures, including withdrawing exemptions. The mission argued for reducing the labor tax wedge while raising other taxes: this could reduce unemployment and increase taxes on the grey economy. Taxing business property should also be considered, though the authorities noted this would primarily help municipalities.

Tax revenue (including social contributions)
(in percent of GDP)



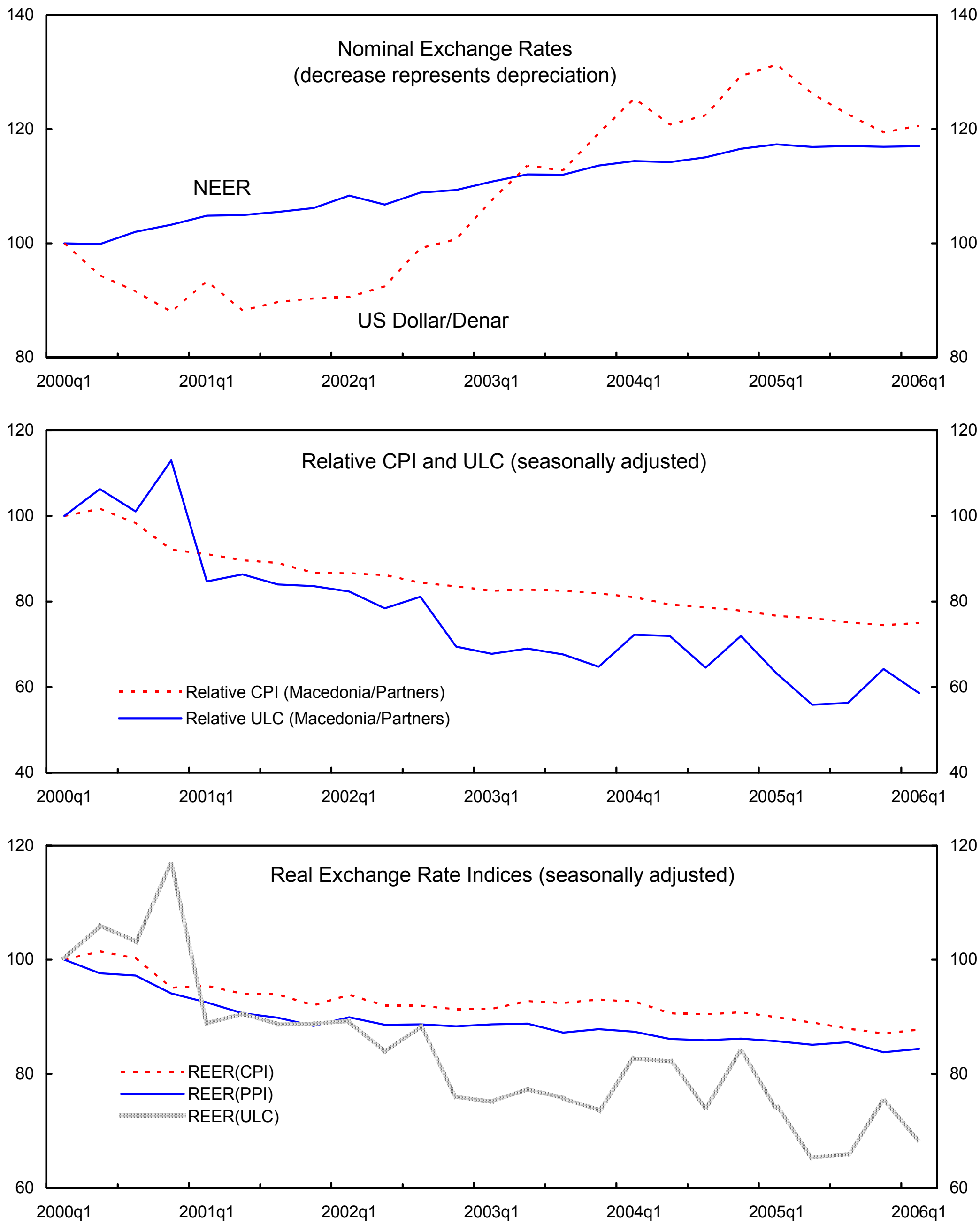
Sources: National authorities.

C. Monetary and Exchange Rate Policy

23. **The mission supported the NBRM's gradual interest rate reductions under the fixed exchange rate, made possible by the accumulation of foreign reserves**. However, the NBRM noted that the scope for further rate cuts seemed limited given uncertainty over the current account deficit, lags in transmission to bank lending and deposit rates and to credit growth, and because euro-area rates were rising and the differential was quite small compared to historical averages.

24. **Despite Macedonia's history of current account deficits, analysis in the Selected Issues suggests that while there are structural competitiveness problems, the level of the exchange rate is broadly appropriate.** The price level is low compared to countries with similar incomes, and the real exchange rate has depreciated steadily despite the peg (Figure 6). Though sensitive to output gap and equilibrium current account estimates, the macroeconomic balance approach suggests the exchange rate is in line with fundamentals, as do econometric estimates of the equilibrium real exchange rate. Against this, wage level comparisons may suggest a competitiveness problems, but data quality is weaker. The NBRM agreed with this assessment, being in line with its own research. It noted that wage growth had moderated recently, which should improve competitiveness. However, specialization in export sectors with low value added and declining world trade shares point to a structural competitiveness problem. Overcoming this will depend less on the exchange rate than reallocation to dynamic sectors, which depends on structural reform and FDI.

Figure 6. FYR Macedonia: Exchange Rate Indicators, 2000-06
(2000q1=100) 1/



Sources: Eurostat; IFS; and IMF staff calculations.

1/ Deviations from past REER(ULC) indicators can be explained by revisions of trade weights (based on 1999-2001 data for exports and imports of goods; partner countries comprise Austria, Bulgaria, Croatia, France, Germany, Greece, Italy, Netherlands, Russia, Serbia and Montenegro, Slovenia, Switzerland, Turkey, United Kingdom, and United States), new data that allowed staff to base the ULC analysis on the manufacturing sector for all partner countries, and changes in the methodology that make the REER(ULC) fully consistent with that used for the REER(CPI) and REER(PPI).

Box 4. Is the Fixed Exchange Rate Appropriate?

Using the framework developed by Husain (IMF WP/06/54), characteristics identified as key determinants of the choice of the exchange rate regime were quantified for FYR Macedonia. These include trade orientation, financial integration, economic diversification, macroeconomic stabilization, credibility and "fear of floating" effects. These characteristics were then compared to other countries, to assess the most suitable regime for Macedonia.

The results do not point to any compelling reason for changing the fixed rate regime. Macedonia is a small open economy, trade is heavily concentrated towards countries using the Euro, and the cycle is not out of line with the Euro area. Weak financial integration, the predominance of monetary over real shocks, and euroization also support fixed rates. Against this, capital flows' large relative size and export concentration (iron and steel, textiles) would point to greater flexibility. The track record of low inflation suggests less need for an exchange rate anchor for inflationary expectations.

However, economic transformation could revise the analysis. Amortization of euro-denominated bonds should reduce the share of foreign currency denominated debt from 95 percent to 60 percent by 2011, easing fear-of-floating concerns. Increasing financial integration and large capital inflows, if EU accession prospects firm, would call for greater flexibility.

Criteria	Score *
Economic integration	**2**
Trade orientation	2
Trade pattern concentration	2
Cyclical synchronicity with trade partner	3
Financial integration	**2**
Inclusion in major indices	1
Stock market turnover	3
Financial development	2
Economic diversification	**3**
Terms of trade volatility	2
Commodities dependence-GDP	4
Commodities dependence-activity	3
Macroeconomic stabilization	**2**
Capital versus trade flows	4
Monetary volatility	1
Real versus nominal shocks	1
Credibility	**4**
Inflation history—8 percent	3
Inflation history—10 percent	5
Fear-of-floating type effects	**2**
Dollarization	1
Balance sheet effects	3
Exchange rate pass through	3

Legend
1= strong case for peg
2= case for peg
3 =neutral
4= case against peg
5=strong case against peg

* Scores for the criteria are derived according to the percentile in the distribution of the value of the criteria for a sample of 51 countries.

25. **With reasons for change not compelling and the authorities committed to the peg, the fixed exchange rate regime seems appropriate for now (Box 4)**. The system has worked well in disinflation and, with capital inflows so far modest and price competitiveness a less pressing concern, there is no urgent case to switch. However, the mission cautioned that if reserve accumulation were to persist—for example if EU accession prospects firm—then the costs of sterilization, loss of interest rate control, and increased susceptibility to speculative attack would call for a reconsideration, as would a large terms of trade shock.

The NBRM is working on building capacity in order to be able to respond if the prevailing conditions change. Besides technical preparations, these should include ensuring the financial system's resilience to exchange rate volatility, development of money and foreign exchange markets, and data improvements.

D. Structural Reforms for Medium-Term Growth

Improving Growth Performance and the Business Environment

26. **Though macroeconomic stability is essential for sustained growth of 5-6 percent, structural reform and improving institutional quality are needed too.** Cross-country regressions in the Selected Issues suggest that increasing investment from 22 to 25 percent of GDP, closer to the regional average, will only raise the growth rate by around ⅔ of a percentage point. The high unemployment rate offers scope for boosting output through raising employment. However, more rapid growth cannot be sustained without a major improvement in total factor productivity, which has grown much more slowly than in the region. The Selected Issues stresses the need for institutional reform to achieve this.

FYR Macedonia: Average Output Growth and Sources (1996-2005)

GDP growth	2.5
Contribution of:	
Employment	0.1
Physical Capital	0.4
TFP	2.0

Source: IMF staff estimates.

South Eastern Europe: Indicators of Institutional Quality and Reform

	TI 2005 Corruption Perceptions Index		2005 WEF quality of the national business environment ranking 3/	Selected EBRD Transition Indicators 4/		
	Score 1/	Rank 2/		Competition policy	Enterprise restructuring	Overall infrastructure
Macedonia	2.7	103	83	2.00	2.33	2.00
Albania	2.4	126	113	2.00	2.00	2.00
Bulgaria	4.0	55	71	2.33	2.67	3.00
Croatia	3.4	70	61	2.33	3.00	3.00
Bosnia and Herzegovina	2.9	88	91	1.00	2.00	2.33
Romania	3.0	85	67	2.00	2.00	3.33
Serbia and Montenegro	2.8	97	86	1.00	2.00	2.00
Average	3.0	89	82	1.81	2.29	2.52

Sources: Transparency International (TI), World Economic Forum (WEF), European Bank for Reconstruction and Development (EBRD).

1/ The score relates to perceptions of the degree of corruption as seen by business people and country analysts and ranges between 10 (highly clean) and 0 (highly corrupt). Iceland, the top performer in 2005, scored 9.7.

2/ Total number of countries covered is 159.

3/ Total number of countries covered is 117.

4/ Maximum possible score is 4.33 for each category.

27. **Though the mission and the authorities agreed on the importance of improving productivity and attracting investment, how best to achieve this was debated**. The authorities and the opposition stressed the importance of attracting sizeable "brand-name" foreign direct investment, which would encourage other foreign firms to follow. Concessions

(free economic zones, selling land below market prices, or direct subsidies) were needed to meet neighboring country competition. Despite this stated commitment to foreign direct investment, the mission noted the lack of major foreign presence in such sectors as banking, hotels or airlines belied this and suggested forces of resistance, perhaps from domestic competitors. The mission also cautioned against granting concessions to individual firms. Aside from governance concerns, these result in opportunistic investments that typically create little value added, erode the tax base, and encourage others to seek similar treatment. They discriminate against firms which had earlier invested based on fundamentals.

28. **The mission instead stressed the benefits of creating an environment that attracts investment projects on merit**. Measures of the business environment, like the World Bank's governance indicators—covering areas such as the costs of opening and closing a business, hiring and laying off workers, and contract enforcement—rank FYR Macedonia poorly against its neighbors. These indicators have changed little in ten years, suggesting reform is difficult, but also that there is considerable scope for improvement.

29. **The authorities agreed on the need to improve the business environment, and discussions focused on the most important actions needed to enhance governance and lower business costs**:

- **Continuing judicial reform**. The government has amended the constitution and passed new laws to introduce comprehensive judicial reform, one of the five key priorities identified last year by the European Commission. A strategy to implement these changes is now needed, to reduce the backlog of court cases (a major utility claimed to be involved in 190,000 court cases in Skopje alone, one third of its customer base) and to improve governance in the judiciary. A key test will be whether agencies such as the Public Revenue Office or NBRM are finally able to impose fines for non-payment of taxes or non-compliance with regulations.

- **Enhance transparency of government action**. Electricity discounts should be offered to firms not through individual negotiation but by clear rules, based on rational and objective criteria, open to all. While there are rules on procurement, abolishing discretionary power to sell state-owned land through direct negotiations (and outlawing intimidation at auctions) would also strengthen governance. The authorities agreed that rapid completion of the cadastre was also essential for clarifying property rights. The new Law on Free Access to Information should promote greater transparency and better governance.

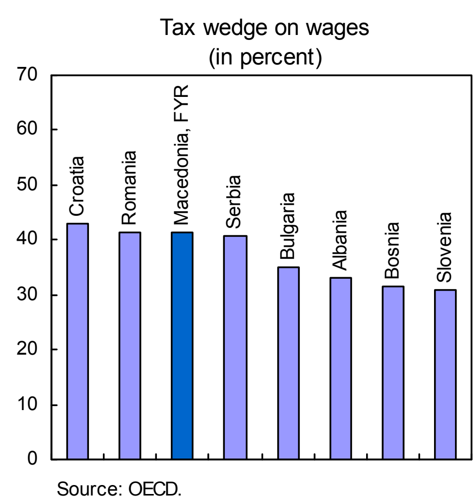
- **Liberalize the telecoms sector**. Aside from being an EU requirement, liberalization should reduce business costs. Publication of information on the internet and greater use of e-government can improve governance and efficiency, but only if there is widespread internet access. The mission urged the authorities to ensure consistency between the telephone monopoly's concession agreement and the new telecoms law, to promote competition. The authorities noted that facilitating interconnection for new operators might require tariff rebalancing: raising local call charges, and lowering those for international and long-distance.

Labor Market Reform

30. **The authorities agreed that high unemployment was the most pressing economic problem for the new government.** Last year's labor law had improved flexibility, but unemployment was still very high. The following reforms were discussed (described in more detail in the Selected Issues):

- **Improve the measurement of unemployment, to better target its reduction**. De-linking health benefits from unemployment registration and using sanctions made possible by judicial reform to shrink the informal sector should produce more accurate unemployment data. Even so, the underlying unemployment rate still likely exceeds 25 percent. Much of the unemployment fund was spent on passive measures, and the authorities intended to make greater use of UN-sponsored active labor market policies. These could rebuild the unemployed's skills, and screen out those who register as unemployed but work in the informal sector.

- **Though more rapid growth is the most effective way to reduce unemployment, the mission argued that the following reforms could also help**: (i) reducing the labor tax wedge by funding healthcare through general taxes instead of social contributions on payroll; (ii) promoting part-time employment by phasing out minimum social contributions (which assume full-time work at minimum wage for the whole month); (iii) building on the recently introduced "one-stop shop" by eliminating licensing requirements, to encourage small enterprises; (iv) education reform to improve human capital. The authorities agreed to consider these reforms, noting that some were already planned.



Trade Policy

31. **The mission commended the authorities' trade liberalization efforts.** Since 2000, the authorities had concluded 10 free trade agreements and joined the WTO. EU access

remains problematic in some sectors due to quality certification requirements. Textile producers expect to weather the elimination of Chinese export quotas, since they are specialized in small orders with quick turnaround.

Enhancing Financial Intermediation

32. **Improved financial market development should support growth**. Total financial sector assets are only half of GDP, almost all in the banking sector. Stock market capitalization has increased, but is still less than 20 percent of GDP. Though the banking sector, for the most part, is adequately capitalized and liquid, high levels of non-earning assets and operating costs lower bank profitability and raise spreads (Table 12). The number of banks and savings houses is high, suggesting considerable room for consolidation (Figure 7). Foreign bank penetration is moderate, mostly from neighboring countries, providing services for their nationals' businesses: no major foreign bank has entered the market.

33. **The mission urged the authorities to take steps to encourage financial intermediation.** Considerable progress has been made (Box 5). However, as discussed in the Selected Issues, weaknesses implementing the legal framework for insolvency, poor credit culture, and high operating costs had stifled intermediation.

34. **While accepting these concerns, the NBRM noted the transmission mechanism was improving.** Rather than lending, banks still had excess reserves, but these were falling and concentrated in smaller banks. There were signs that credit had recovered strongly in March and April. The mission noted that banks' uncertainty over the NBRM's willingness to supply liquidity in times of shortage, for example payment of the telecom dividend, might also be a problem. Greater clarity here (such as the NBRM's willingness to lend via repos) and money market development, might reduce banks' excess reserves and strengthen the transmission mechanism.

35. **Anticipating faster credit growth, banking supervision was being enhanced**. The NBRM argued that its corrective actions toward four small banks demonstrated its commitment to improving bank governance. Interest among strategic foreign investors was increasing, which could help foster competition, efficiency, and some market consolidation. The recently approved Supervisory Development Plan, agreed with the World Bank, provides a comprehensive strategy to migrate toward a more risk-based supervision and regulation, assisted by an MFD-sponsored resident advisor. The revision of the Banking Law, with MFD and LEG assistance, aims to bring the legal and regulatory framework more in line with international best practice and EU standards, facilitating the financial system's sound expansion.

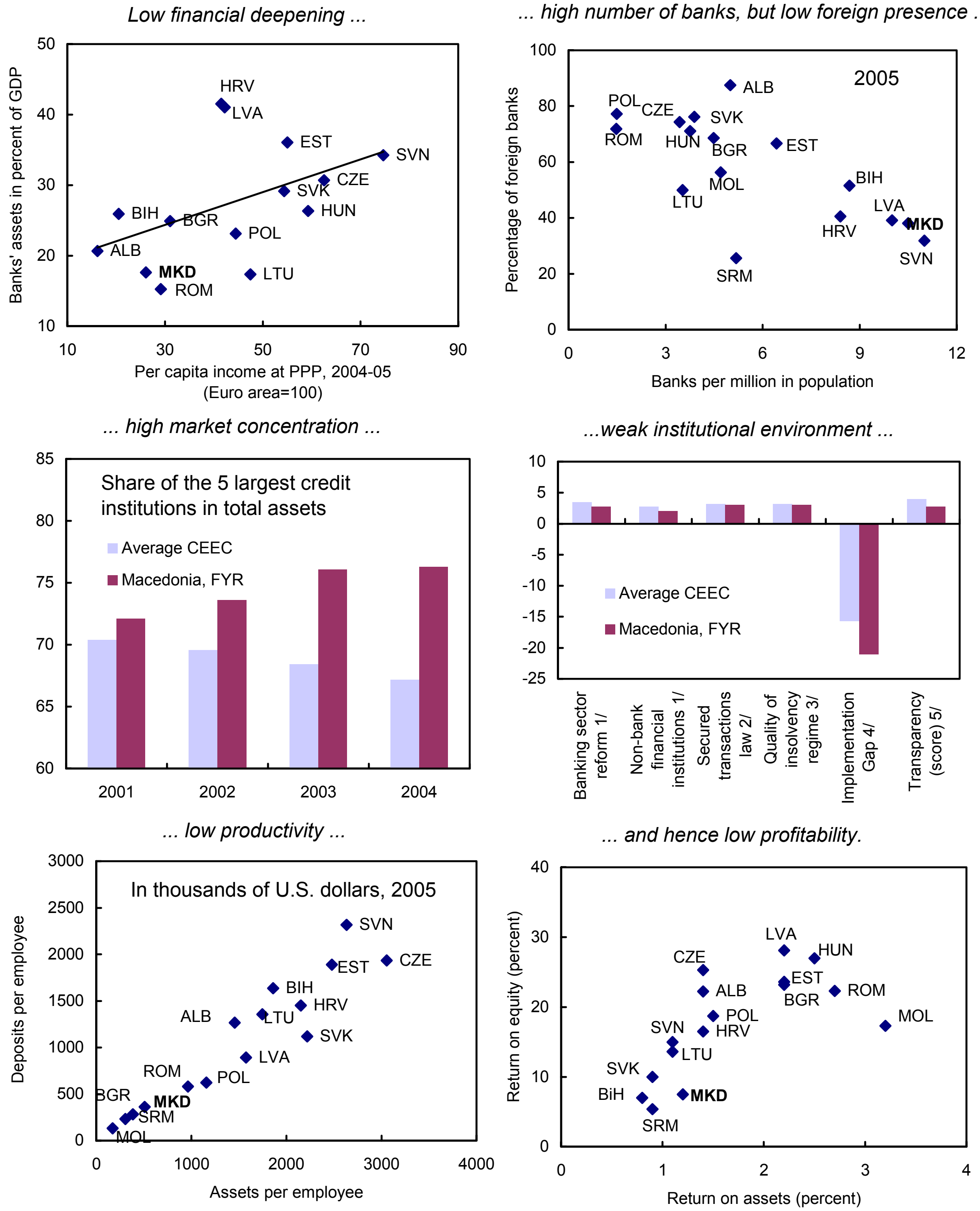
Box 5. Financial Sector Reform: Where Do We Stand?

While acknowledging improvements in the soundness of the banking system despite weak institutions and governance, the 2003 FSAP identified several financial sector weaknesses. In particular, the FSAP recommended to: (a) strengthen the legal and judicial framework (which would also help combat money laundering); (b) improve the quality of bank ownership; (c) enhance banking regulation and supervision by adopting a more risk-based approach; (d) develop the government securities market; (e) give the NBRM a clear oversight and policy role over the payments system; (f) establish a framework for NBRM emergency lending; and (g) develop supervisory capacity for the insurance and planned pension fund markets.

Implementation has been uneven, although improving. The legal framework has been improved but the implementation gap is still considerable. The new Law on Misdemeanors gives regulators legal authority to impose sanctions, but implementing regulations and the appeals process still need to be defined. Opaque bank ownership structures and governance weaknesses need to be addressed, although the NBRM has recently taken corrective measures. While prudential regulations on exchange rate risk have been strengthened, supervisory norms concerning all market risks in banks' trading portfolios and foreign exchange lending are expected in 2006. The NBRM has established an emergency lending facility and revised supervisory circulars and manuals to give supervisors a more active role in AML/CFT implementation and enforcement. Insurance supervision remains weak but a World Bank project to develop supervisory capacity has started this year.

Market infrastructure developments have been more positive. The domestic securities market has grown and the government has lengthened the maturity of new bond issues (to 2 years). New private pension funds, following the introduction of the two-pillar pension system in January 2006, should stimulate capital market development. Although the NBRM established an electronic over-the-counter market, the secondary market remains thin. Payments system operation, which is on a real-time gross settlement basis, has been enhanced and remote back-up facilities improved. However, weaknesses in the legal framework persist, including the need to better define the NBRM's role in developing a payment infrastructure and grandfathering of the NBRM's obligation to execute guarantees between third parties. Recent changes in some laws, such as giving municipalities the power to freeze (or directly withdraw funds from) the bank accounts of noncompliant customers without a court order, may affect the orderly functioning of the payment system.

Figure 7. FYR Macedonia: Banking Sector Developments, 2001-05



Sources: NBRM; Bankscope; and Fund staff estimates.

1/ Score range from a high of 4 (movement toward BIS standards), to a low of 1 (little progress beyond establishment of a two-tier system).

2/ Based on EBRD's 10 core principles of secured transactions. Scores are advanced (4), some defects (3), inefficient (2), malfunctioning (1).

3/ Scores range from very high (4), high, medium (3), low (2), to very low (1).

4/ Difference between insolvency legislation effectiveness and extensiveness scores. A larger negative value indicates capacity to implement has lagged behind quality of legislation.

5/ Score relates to perceptions of the degree of corruption as seen by business people and country analysts and ranges between 10 (highly clean) and 0 (highly corrupt). The survey encompasses 159 countries.

V. Staff Appraisal

36. **Macedonian economic performance is improving**. For more than a decade, economic growth has been sluggish, in part because of external shocks. However, in the last couple of years, growth has reached 4 percent, inflation has remained under control, the current account deficit has narrowed, international reserves have increased, and structural reforms have been initiated. Though adequate for surveillance, data uncertainties complicate economic policymaking.

37. **To raise living standards more decisively toward European levels, the authorities now need to sustain and accelerate these achievements**. As a pre-condition, this will require maintaining the country's hard-won macroeconomic stability. But for growth to accelerate and jobs to be created, more ambitious structural reforms are also needed: enhancing financial intermediation with sound banking supervision, improving the business climate and, underlying all these, improving institutional quality and reducing corruption.

38. **Though tempting, shifting to more expansionary monetary and fiscal policies will not deliver sustained growth**. In small open economies like FYR Macedonia, the result would only be higher imports and loss of international reserves, depreciation, and inflation. Likewise, pressure to spend the recent increase in international reserves should be resisted. Since this in large part reflects one-off privatizations, the proceeds are best saved (for example by repaying external debt) rather than spent. Keeping the reserves is already producing substantial economic benefits, by improving confidence in the fixed exchange rate and causing interest rates to fall.

39. **The 0.6 percent of GDP fiscal deficit target serves as an anchor for macroeconomic stability**. First, uncertainty over the current account deficit's true size, as well as its history of volatility, caution against fiscal expansion. Second, though there are spending needs, institutional capacity in line ministries to spend additional funds efficiently is lacking. Third, rationalization of the public sector is far from complete, and should be completed before spending increases are entertained. This should be championed at the highest levels of government. Finally, a clear fiscal anchor can create substantial credibility and expectational benefits, essential support to the fixed exchange rate regime.

40. **Although the level of the exchange rate is broadly appropriate, the NBRM should continue to build capacity in order to be able to respond if the prevailing conditions change**. Though structural deficiencies are considerable, price competitiveness and the level of the exchange rate seem broadly appropriate. The fixed rate regime also matches Macedonia's characteristics of a small open economy, with limited international financial market integration. However, the authorities should be ready for flexibility in case conditions alter (such as a pickup in capital inflows if EU accession prospects strengthen, or

a terms of trade shock). Recent interest rate cuts are welcome, but with euro-area rates higher and the need to see the effects on credit and the real economy, a pause is now needed.

41. **As well as ensuring macroeconomic stability is maintained, the authorities need to accelerate structural reform**. The agenda is vast, ranging from judicial reform to improving public governance to liberalizing markets, including telecommunications. Underlying all this is the need to improve the quality of institutions and to develop a functioning market economy. Labor market reform to reduce the very high unemployment rate is also needed: active labor market policies, reducing the tax wedge, and ending minimum social contributions should all be considered. The authorities should also continue to foster financial market development, by lowering intermediation costs, improving credit culture, and enhancing banking supervision. A more pro-active approach to banking consolidation may also be warranted.

42. **The tasks ahead are immense, but so are the potential rewards**. By committing to macroeconomic stability, but then addressing each of these structural impediments, the potential for higher growth and living standards should be considerable.

43. **It is recommended that the next Article IV consultation with FYR Macedonia take place within 24 months, subject to the provisions of the decision on consultation cycles in program countries.**

Table 1. FYR Macedonia: Selected Economic Indicators, 2003-07

	2003	2004	2005 Prel.	2006 Proj.	2007 Proj.
Real economy			(Percent change)		
Real GDP	2.8	4.1	4.0	4.0	4.0
Consumer prices					
period average	1.2	-0.3	0.5	2.9	2.0
end of period	2.6	-2.0	1.8	...	...
Real wages, period average	3.6	4.4	...	...	...
Unemployment rate (average)	36.7	37.2	37.3	...	...
Government finances	(In percent of GDP, unless otherwise indicated)				
Central government balance 1/	-0.1	0.4	0.3	-0.6	-0.6
Revenues (including grants)	38.4	36.5	35.8	33.8	34.5
Expenditures	38.5	36.1	35.6	34.4	35.1
Central Government debt 2/					
Gross	39.0	36.6	40.2	35.6	35.3
Net	34.9	32.5	32.5	20.9	21.7
Money and credit					
Broad money (M3, percent)	18.0	16.1	14.9	20.1	23.0
Short-term lending rate (percent)	14.5	11.8	11.7	...	...
Interbank money market rate (percent)	6.8	8.3	9.2	...	...
Balance of payments	(In millions of Euro, unless otherwise indicated)				
Exports	1,203	1,343	1,642	1,833	1,912
Imports	1,953	2,237	2,496	2,847	3,001
Trade balance	-750	-894	-853	-1,015	-1,089
Current account balance					
excluding grants	-227	-389	-114	-209	-290
(in percent of GDP)	-5.5	-9.0	-2.5	-4.2	-5.6
including grants	-137	-334	-62	-151	-201
(in percent of GDP)	-3.4	-7.7	-1.3	-3.1	-3.9
Overall balance	14	-19	340	478	120
Official gross reserves	710	717	1,123	1,602	1,699
(in months of following year's imports					
of goods and services)	3.3	2.9	4.1	5.5	5.6
External debt service ratio 3/	24.2	14.7	13.0	25.8	20.3
External debt to GDP ratio (percent) 4/	37.7	40.2	47.1	45.7	46.3
Exchange rate					
Real effective exchange rate (CPI-based)	-0.1	-1.6	-3.3	...	...

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

1/ In 2005, central government spent an additional 0.4 percent of GDP on the NBRM recapitalization.

2/ In 2005 and 2006 the change in stock reflects a major debt management operation.
Net debt is defined as gross debt minus government's deposits with the NBRM.

3/ Debt service due, including IMF, as a percent of exports. For 2006, includes a major debt management operation. Excludes rollover of trade credits.

4/ Total external debt, including trade credit. For 2005, includes a Euro 150 million Eurobond issue.

Table 2. FYR Macedonia: Medium-Term Balance of Payments, 2003-11
(In millions of Euro)

	2003	2004	2005	2006		2007	2008	2009	2010	2011
			Prel.	Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account	-137	-334	-62	-179	-151	-201	-217	-224	-234	-257
Excluding official transfers	-227	-389	-114	-237	-209	-290	-299	-293	-310	-339
Trade balance (fob)	-750	-894	-853	-1,002	-1,015	-1,089	-1,111	-1,134	-1,154	-1,198
Exports	1,203	1,343	1,642	1,805	1,833	1,912	2,001	2,100	2,205	2,315
Imports	-1,953	-2,237	-2,496	-2,807	-2,847	-3,001	-3,112	-3,234	-3,359	-3,514
Services (net)	-9	-43	-27	-24	-22	-38	-35	-31	-26	-26
Income (net; including net interest)	-28	-33	-44	-31	-53	-78	-85	-78	-97	-102
Transfers (net)	650	637	863	878	939	1,004	1,013	1,019	1,044	1,069
Official	89	55	52	58	58	90	82	69	76	82
Private	561	582	811	820	881	914	931	949	968	987
Capital and financial account	191	310	401	354	642	321	631	243	300	398
Capital account (net)	-6	-4	-2	-4	-4	-4	-4	-4	-4	-4
Financial account	197	314	403	358	645	325	635	247	303	402
Disbursements	215	198	256	273	324	352	323	346	380	428
Amortization	-148	-153	-143	-301	-342	-238	-304	-361	-383	-406
Direct and portfolio investment (net)	84	138	275	412	637	177	616	257	301	364
Direct investment	81	126	77	354	583	125	556	189	227	269
Portfolio investment	3	11	198	58	54	52	61	68	73	95
Currency and deposits (net)	-10	-25	-21	-60	-26	-34	-33	-33	-32	-31
Individuals	35	59	-43	-41	-47	-48	-48	-49	-49	-50
Commercial banks	-45	-84	22	-19	21	14	15	16	17	19
Short-term loans (net)	-13	20	14	0	0	0	0	0	0	0
Trade credits (net)	69	136	21	34	52	67	34	37	38	47
Errors and omissions	-40	5	-1	0	-13	0	0	0	0	0
Overall balance	14	-19	340	176	478	120	414	19	66	141
Financing	-14	19	-340	-176	-478	-120	-414	-19	-66	-141
Net foreign assets (flows)	-16	-4	-355	-176	-478	-120	-414	-19	-66	-141
Valuation effects on the stock of NFA (increase: -)	0	3	-47	0	-8	0	0	0	0	0
Change in the stock of NFA (increase:-)	-16	-1	-401	-176	-487	-120	-414	-19	-66	-141
Change in gross foreign reserves (increase:-)	-23	-7	-406	-169	-479	-97	-403	-14	-66	-141
IMF (net)	-5	-7	4	-8	-8	-23	-11	-5	0	0
Other (net)	15	19	1	0	0	0	0	0	0	0
Change in arrears 1/	-2	16	15	0	0	0	0	0	0	0
Memorandum items:										
Current account (in percent of GDP)	-3.4	-7.7	-1.3	-3.7	-3.1	-3.9	-3.9	-3.8	-3.7	-3.8
Excluding official transfers	-5.5	-9.0	-2.5	-5.0	-4.2	-5.6	-5.4	-5.0	-4.9	-5.0
Trade balance (in percent of GDP)	-18.3	-20.7	-18.6	-21.0	-20.6	-20.9	-20.0	-19.1	-18.3	-17.8
Non-oil trade balance (in percent of GDP)	-13.2	-15.4	-11.0	-12.0	-11.5	-11.7	-11.5	-11.2	-10.9	-10.9
Export growth rate (volumes)	-6.4	12.4	16.1	8.8	8.8	4.3	4.7	4.9	5.0	5.0
Import growth rate (volumes)	-18.0	14.9	2.6	11.2	11.2	4.1	4.1	4.0	4.0	3.9
Export price increase (in percent)	8.9	-0.8	13.4	1.1	2.5	-1.2	-2.7	-2.0	-2.1	-0.5
Import price increase (in percent)	14.6	-0.4	11.0	1.3	6.9	1.2	-0.4	-0.1	-0.1	0.7
Gross reserves	710	717	1,123	1,291	1,602	1,699	2,102	2,116	2,182	2,323
(in months of following year's imports of goods and services)	3.3	2.9	4.1	4.3	5.5	5.6	6.7	6.5	6.4	6.5
External debt service ratio (in percent) 2/	24.2	14.7	13.0	23.2	25.8	20.3	20.8	23.0	24.0	24.0
External debt to GDP ratio (in percent) 3/	33.6	32.7	39.0	34.5	37.1	37.2	35.8	33.7	32.2	32.2
Short-term external debt to GDP ratio (in percent) 4/	4.1	7.5	8.1	7.8	8.6	9.1	9.2	9.5	9.5	9.5
Net private transfers (in percent of GDP)	13.7	13.4	17.7	17.2	17.9	17.5	16.8	16.0	15.3	14.7
Nominal GDP (in millions of Euro)	4,095	4,325	4,593	4,780	4,913	5,212	5,556	5,922	6,312	6,728

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

1/ Private sector arrears.

2/ Debt service due including IMF as percent of exports of goods and services. Excluding rollover of trade credit.

3/ Medium and long-term debt including IMF.

4/ Including trade credit.

Table 3. FYR Macedonia: Central Bank Accounts, 2004-07
(In billions of denars)

	2004	2005				2006				2007
	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Dec.
	Actual	Actual	Actual	Actual	Actual	Actual	Proj.	Proj.	Proj.	Proj.
	(at current exchange rates)									
Net foreign assets	41.8	43.1	45.8	51.1	66.3	71.9	73.2	82.9	96.5	103.8
Net domestic assets	-20.7	-21.4	-22.9	-28.4	-40.5	-47.2	-48.3	-57.1	-69.0	-74.3
Banks (net)	-4.5	-6.0	-6.0	-6.4	-8.9	-10.0	-9.8	-10.8	-14.4	-20.3
o/w instruments (NBRM bills)	-4.6	-6.0	-6.1	-6.5	-8.9	-10.3	-10.1	-11.1	-14.7	-20.6
Central government (net)	-8.1	-6.8	-7.0	-10.9	-18.3	-23.6	-24.7	-32.5	-40.7	-40.1
Credit	2.9	2.9	2.6	2.6	3.3	3.3	3.3	3.3	3.3	3.3
Deposits	-11.0	-9.6	-9.5	-13.5	-21.6	-26.9	-28.0	-35.7	-44.0	-43.4
Municipalities (net)	...	...	-0.2	-0.6	-0.7	-0.8	-0.8	-0.8	-0.8	-0.8
Other items (net)	-8.1	-8.6	-9.7	-10.4	-12.7	-12.9	-13.0	-13.0	-13.1	-13.1
Reserve money	21.1	21.8	23.0	22.7	25.8	24.7	24.9	25.9	27.5	29.5
Currency	14.2	13.2	13.4	13.5	14.4	13.7	13.7	13.9	14.9	15.3
Other	6.9	8.6	9.6	9.2	11.3	11.0	11.2	11.9	12.6	14.2
Cash in vaults	0.9	0.8	0.9	0.9	1.4	1.0	1.0	1.0	1.0	1.0
Total reserves	6.0	7.8	8.7	8.3	9.9	10.0	10.2	10.9	11.6	13.2
on denar deposits	2.7	3.1	3.8	3.1	4.6	4.5	4.5	4.9	5.4	5.5
on FX deposits	3.4	4.7	4.9	5.2	5.3	5.5	5.7	6.1	6.2	7.7
	(year-on-year growth rates)									
Net foreign assets	-1.6	1.5	12.2	19.7	58.5	66.7	59.7	62.5	45.6	7.6
Net domestic assets	-3.6	-11.6	6.8	22.1	95.6	121.0	111.3	101.3	70.3	7.7
Reserve money	0.4	17.2	24.6	7.5	22.0	13.4	8.4	13.9	6.6	7.5
Currency	-0.1	0.7	1.7	-4.7	2.0	3.7	2.2	3.3	3.1	3.0
	(at constant exchange rates)									
Net foreign assets	41.8	42.6	44.2	49.2	63.7	68.9	70.2	80.0	93.5	...
Net domestic assets	-20.7	-20.8	-21.3	-26.5	-37.9	-44.2	-45.3	-54.1	-66.0	...
o/w credit to the government (net)	-8.1	-6.7	-6.8	-10.9	-18.3	-24.7	-25.8	-33.6	-41.8	...
Reserve money	21.1	21.8	23.0	22.7	25.8	24.7	24.9	25.9	27.5	...
Memorandum items:										
Program exchange rate (denars per Euro)	61.3	61.3	61.3	61.3	61.3	61.3	61.3	61.3	61.3	61.3

Sources: NBRM, and IMF staff projections.

Table 4. FYR Macedonia: Monetary Survey, 2004-07
(In billions of denars)

	2004	2005				2006				2007
	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Dec.
	Actual	Actual	Actual	Actual	Actual	Actual	Proj.	Proj.	Proj.	Proj.
					(at current exchange rates)					
Net foreign assets	68.9	68.4	74.4	75.3	89.7	96.6	97.0	108.4	120.2	127.0
NBRM	41.8	43.1	45.8	51.1	66.3	71.9	73.2	82.9	96.5	103.8
Domestic money banks	27.0	25.3	28.6	24.3	23.5	24.7	23.8	25.5	23.7	23.2
Net domestic assets	25.9	29.8	30.2	27.0	19.2	16.1	18.6	14.9	10.6	33.9
Credit to the government	-1.2	0.8	0.3	-4.4	-12.2	-16.2	-17.1	-24.7	-32.7	-29.5
Banks	6.9	7.5	7.5	7.1	6.8	8.2	8.4	8.6	8.9	11.4
NBRM (net)	-8.1	-6.8	-7.2	-11.5	-19.0	-24.4	-25.5	-33.3	-41.5	-40.9
o/w municipalities	...	...	-0.2	-0.6	-0.7	-0.8	-0.8	-0.8	-0.8	-0.8
Credit to the private sector	57.1	60.3	63.0	65.8	68.8	73.0	76.6	80.4	84.3	104.4
In denars 1/	45.8	47.4	48.6	49.8	51.7	54.5	57.0	59.4	62.0	76.8
In foreign currency	11.3	12.9	14.4	16.1	17.1	18.5	19.5	21.0	22.2	27.6
Other items (net)	-30.0	-31.3	-33.1	-34.4	-37.4	-40.7	-40.8	-40.8	-40.9	-40.9
Broad money (M3)	94.8	98.2	104.6	102.3	108.9	112.7	115.7	123.4	130.8	160.9
Currency in circulation	14.2	13.2	13.4	13.5	14.4	13.7	13.7	13.9	14.9	15.3
Private denar deposits 2/	38.1	40.9	43.9	38.9	43.4	46.1	44.8	48.8	53.6	68.3
Private foreign currency deposits	42.5	44.0	47.3	49.9	51.1	52.9	57.2	60.6	62.3	77.3
					(year-on-year growth rates)					
NFA domestic money banks	16.1	8.7	15.4	-6.0	-13.3	-2.3	-16.5	5.0	1.1	-2.2
Credit to the private sector	25.0	25.3	23.2	22.0	20.5	21.0	21.5	22.2	22.5	23.9
Denar credit	19.0	17.7	12.7	10.5	12.9	14.9	17.4	19.3	20.0	23.8
Foreign currency credit	56.6	63.9	79.2	80.1	50.7	43.6	35.3	31.1	30.0	24.0
Broad Money	16.1	20.9	21.1	13.4	14.9	14.8	10.6	20.6	20.1	23.0
Private denar deposits	15.5	27.8	26.5	6.8	13.8	12.5	1.9	25.4	23.6	27.4
Private foreign currency deposits	23.3	21.6	23.3	23.3	20.2	20.2	21.0	21.5	22.0	24.0
					(at constant exchange rates)					
Net foreign assets	68.9	67.7	72.4	73.2	86.8	93.4	93.8	105.2	116.9	...
Net domestic assets	25.9	30.2	31.4	28.3	21.3	18.7	21.2	17.5	13.2	...
o/w credit to the government	-1.2	0.7	0.6	-3.8	-11.5	-15.1	-16.0	-23.6	-31.6	...
Broad money (M3)	94.8	97.8	103.8	101.5	108.1	112.0	115.0	122.7	130.1	...
Memorandum items:										
Velocity of M3	0.36	0.37	0.38	0.37	0.39	0.39	0.40	0.42	0.43	0.50
Private credit (percent change from end of previous year)	25.0	5.6	10.4	15.3	20.5	6.2	11.3	17.0	22.5	23.9
NFA of DMBs in percent of private FX deposits 3/	71.5	68.2	70.7	59.1	56.3	57.1	51.7	52.0	48.0	30.0
Share of FX deposits in total deposits	0.53	0.52	0.52	0.56	0.54	0.53	0.56	0.55	0.54	0.53
Private credit (percent of GDP)	21.5	22.5	23.1	23.7	24.4	25.5	26.3	27.2	28.0	32.7
Nominal GDP (in billions of denar) 4/	265.3	267.8	272.9	277.3	281.6	285.9	291.1	295.6	301.2	319.5

Sources: NBRM, and IMF staff projections.

1/ Includes estimates of foreign currency indexed loans, estimated to be approximately one third of the total at end-September 2005.
2/ Includes municipal and public enterprise accounts.
3/ Includes required reserves (RR) on FX deposits.
4/ Measured on a rolling basis as a sum of nominal GDP of four preceeding quarters including the last full quarter of each period.

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

	2004	2005	2006		2007
			Prog.	Proj.	Proj.
	(in billion denars)				
Total revenue and grants	96.8	100.9	102.9	101.7	110.1
Tax revenue	81.6	84.6	87.0	86.5	93.7
Taxes on income and profits	10.1	10.9	11.2	12.5	13.2
Social insurance contributions 1/	28.1	28.6	28.6	29.1	30.5
Domestic taxes on goods & services	36.8	38.8	41.5	39.0	43.5
VAT 2/	25.8	27.1	28.3	27.1	30.0
Excises	11.0	11.7	13.1	11.9	13.5
Import duties	5.8	5.3	4.8	4.8	4.9
Other taxes 3/	0.8	1.0	0.8	1.1	1.5
Non-tax revenue	13.0	10.6	11.9	11.2	12.8
Capital revenue 4/	0.6	4.3	2.0	2.1	0.9
Grants	1.7	1.5	2.0	2.0	2.7
Total expenditures	95.8	100.2	104.8	103.6	112.0
Total expenditures, w/o errors & omissions	95.1	99.6	104.8	103.6	112.1
Current expenditure	86.7	89.5	93.2	92.9	98.8
Wages and salaries	22.0	22.8	24.0	24.0	25.3
Goods and services	12.2	13.0	12.5	12.6	13.8
Goods and nonlabor services	12.1	12.8	12.4	12.4	13.6
Reserves	0.1	0.2	0.2	0.2	0.2
Transfers 1/	50.2	51.0	53.4	52.9	56.1
Interest	2.3	2.6	3.3	3.3	3.6
Domestic	0.9	1.1	1.2	1.2	1.3
Foreign	1.4	1.5	2.1	2.1	2.2
Capital expenditure	8.4	10.2	11.5	10.8	13.3
Lending minus repayments	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy/Measures	0.7	0.5	0.0	0.0	-0.1
Consolidated Central Govt Fiscal Balance	1.1	0.7	-1.9	-1.9	-1.9
Balance excluding NBRM recapitalization	...	2.0	...	...	...
Financing	-1.1	-0.7	1.9	1.9	1.9
Domestic	-2.3	-12.2	6.7	8.4	-0.6
Bank financing	-0.7	-10.3	-6.7	-20.4	3.2
Central bank	-1.0	-10.2	-7.6	-22.4	0.7
Commercial banking system	0.4	0.0	1.0	2.0	2.5
o/w T-bills issue (starting 2004)	0.6	0.4	1.5	2.5	2.5
Other domestic financing	-2.2	-2.5	-2.3	-3.6	-3.9
Privatization receipts	0.5	0.5	15.7	32.4	0.1
Foreign	1.3	11.5	-4.9	-6.6	2.5
Memorandum item:					
Nominal GDP (in billion denars)	265.3	281.6	301.2	301.2	319.5

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

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

2/ The 2006 projected decline is largely due to reintroduction of the deferral mechanism for qualified importers, temporarily supended at end-2005, and exceptionally high refunds in early 2006.

3/ From 2006 onwards includes special taxes on tobacco products.

4/ From 2005 onwards capital revenue includes dividends, interest and other property income previously reported under non-tax revenue.

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

	2004	2005	2006		2007
			Prog.	Proj.	Proj.
	(in percent of GDP)				
Total revenue and grants	36.5	35.8	34.2	33.8	34.5
Tax revenue	30.7	30.0	28.9	28.7	29.3
Taxes on income and profits	3.8	3.9	3.7	4.1	4.1
Social insurance contributions 1/	10.6	10.2	9.5	9.7	9.6
Domestic taxes on goods & services	13.9	13.8	13.8	12.9	13.6
VAT 2/	9.7	9.6	9.4	9.0	9.4
Excises	4.1	4.2	4.4	4.0	4.2
Import duties	2.2	1.9	1.6	1.6	1.5
Other taxes 3/	0.3	0.3	0.3	0.4	0.5
Non-tax revenue	4.9	3.8	4.0	3.7	4.0
Capital revenue 4/	0.2	1.5	0.7	0.7	0.3
Grants	0.6	0.5	0.7	0.7	0.8
Total expenditures	36.1	35.6	34.8	34.4	35.1
Total expenditures, w/o errors & omissions	35.8	35.4	34.8	34.4	35.1
Current expenditure	32.7	31.8	31.0	30.8	30.9
Wages and salaries	8.3	8.1	8.0	8.0	7.9
Goods and services	4.6	4.6	4.2	4.2	4.3
Goods and nonlabor services	4.5	4.5	4.1	4.1	4.3
Reserves	0.1	0.1	0.1	0.1	0.1
Transfers 1/	18.9	18.1	17.7	17.6	17.6
Interest	0.9	0.9	1.1	1.1	1.1
Domestic	0.4	0.4	0.4	0.4	0.4
Foreign	0.5	0.5	0.7	0.7	0.7
Capital expenditure	3.2	3.6	3.8	3.6	4.2
Lending minus repayments	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy/Measures	0.3	0.2	0.0	0.0	0.0
Consolidated Central Govt Fiscal Balance	0.4	0.3	-0.6	-0.6	-0.6
Balance excluding NBRM recapitalization	...	0.7	...	...	...
Financing	-0.4	-0.3	0.6	0.6	0.6
Domestic	-0.9	-4.3	2.2	2.8	-0.2
Bank financing	-0.2	-3.6	-2.2	-6.8	1.0
Central bank	-0.4	-3.6	-2.5	-7.4	0.2
Commercial banking system	0.1	0.0	0.3	0.7	0.8
o/w T-bills issue (starting 2004)	0.2	0.1	0.5	0.8	0.8
Other domestic financing	-0.8	-0.9	-0.8	-1.2	-1.2
Privatization receipts	0.2	0.2	5.2	10.7	0.0
Foreign	0.5	4.1	-1.6	-2.2	0.8
Memorandum item:					
Nominal GDP (in billion denars)	265.3	281.6	301.2	301.2	319.5

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

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

2/ The 2006 projected decline is largely due to reintroduction of the deferral mechanism for qualified importers, temporarily suspended at end-2005, and exceptionally high refunds in early 2006.

3/ From 2006 onwards includes special taxes on tobacco products.

4/ From 2005 onwards capital revenue includes dividends, interest and other property previously reported under non-tax revenue.

Table 6. FYR Macedonia: Indicators of Financial and External Vulnerability, 2001-05

	2001	2002	2003	2004	2005
Financial indicators					
Broad money (end of period; percent change from end of previous year)	62.6	-10.0	18.0	16.1	14.9
Private sector credit (end of period; percent change from end of previous year) 1/	2.1	-0.9	19.0	25.0	20.5
Share of non-performing loans in total bank exposure (end of period, in percent)	33.7	15.9	15.1	13.2	10.9
NPLs of nonfinancial private sector/gross loans to nonfinancial private sector (percent)	24.5	23.7	21.1	16.3	15.0
Foreign currency deposits (end of period, in percent of broad money)	45.8	40.3	42.2	44.8	46.9
Indexed and foreign currency credit to private sector					
(end of period, in percent of total credit to private sector)	...	...	37.6	41.2	46.2
Central bank short-term foreign liabilities (in millions of Euro)	0.0	2.0	0.0	0.7	0.0
Short term foreign assets of commercial banks (in millions of Euro)	876	609	624	714	767
Short term foreign liabilities of commercial banks (in millions of Euro)	771	555	627	743	899
Money market rate (end of period; in percent)	11.9	14.4	6.8	8.3	9.2
External Indicators					
Exports (percent change, in terms of Euro)	-10.0	-9.0	2.5	11.6	22.3
Imports (percent change, in terms of Euro)	-13.8	7.5	-3.4	14.5	11.6
Current account balance (in percent of GDP)					
(Including official grants)	-7.2	-9.5	-3.4	-7.7	-1.3
(Excluding official grants)	-8.7	-12.2	-5.5	-9.0	-2.5
Foreign direct investment (in percent of GDP)	12.4	2.0	2.0	2.9	1.7
Gross official reserves					
(In millions of Euro)	845	688	710	717	1,123
(In months of next year's imports of goods and services)	4.4	3.7	3.3	2.9	4.1
(In percent of private denar broad money)	131.3	103.9	93.8	85.4	120.6
(In percent of broad money)	67.4	61.0	53.3	46.4	63.2
Ratio of NFA of the monetary system to broad money (in percent)	112.5	90.9	80.6	72.7	82.4
Total external debt (in percent of GDP)	41.9	39.4	37.7	40.2	47.1
of which: public sector (in percent of GDP)	0	0	0	0	0
Short-term external debt (by remaining maturity, including trade credit)					
(In percent of GDP)	1.4	3.2	4.1	7.5	8.1
(In percent of official reserves)	6.6	18.5	23.8	45.3	33.1
External debt service payments (in percent of exports of goods and services) 2/	21.1	27.3	24.2	14.7	13.0
Exchange rate (denar per U.S. dollar, period average)	68.0	64.7	54.3	49.4	49.3
REER (average percent change; (-) depreciation)					
CPI-based	-7.6	-2.5	-0.1	-1.6	-3.3
ULC-based	-18.2	-6.6	-11.0	7.4	...

Sources: Staff calculations and estimates based on the data provided by the NBRM.

1/ 2001-02 credit growth affected by loan loss provisions.
2/ Excluding trade credit.

Table 7. FYR Macedonia: Composition of Central Government Debt, 2005-2006

	2005		2006 1/	
	Percent of GDP	Percent of gross debt	Percent of GDP	Percent of gross debt
Gross debt	40.2	100.0	33.8	100.0
External debt	27.1	67.4	20.6	61.1
Multilateral	16.4	40.7	14.8	43.7
Bilateral	3.4	8.3	2.8	8.3
Private 2/	7.4	18.4	3.1	9.1
Domestic debt	13.1	32.6	13.1	38.9
Structural bonds 3/	11.6	28.9	11.5	34.0
Treasury bills and bonds 4/	1.5	3.8	1.7	4.9
NBRM deposits	7.7	19.1	8.9	26.4
Net debt	32.5	80.9	24.9	73.6
Memorandum items:				
Fx-denominated debt	37.8	93.9	31.2	92.4
of which domestic	10.7	26.5	10.6	31.3
Short-term domestic debt	1.3	3.3	1.4	4.1

Source: Ministry of Finance, and NBRM.

1/ End-March 2006 preliminary outturn.

2/ Change in stock between 2005 and 2006 reflects a major debt management operation.

3/ Medium-term bonds issued to cover central government's contingent commitments.

4/ Excluding Treasury bills issued for monetary policy purposes introduced in March 2006.

Table 8. FYR Macedonia: Fiscal Debt Sustainability Framework, 2001-11
(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	2001	2002	2003	2004	2005			2006	2007	2008	2009	2010	2011
								I. Baseline Projections					
Public sector debt 1/	48.8	43.0	39.0	36.6	40.2			**35.6**	**35.3**	**33.7**	**32.2**	**30.8**	**29.5**
o/w foreign-currency denominated	47.1	41.5	37.7	34.7	37.7			30.8	29.5	26.2	23.2	20.3	17.6
Change in public sector debt	0.9	-5.9	-4.0	-2.4	3.6			-4.6	-0.3	-1.6	-1.5	-1.4	-1.3
Identified debt-creating flows (4+7+12)	-3.6	3.0	-0.5	-1.5	-0.4			-12.2	-0.3	-8.8	-1.5	-1.4	-1.3
Primary deficit	4.5	4.1	-1.0	-1.3	-1.2			-0.5	-0.4	-0.5	-0.4	-0.4	-0.3
Revenue and grants	34.0	34.9	38.4	36.5	35.8			33.8	34.5	34.8	34.8	34.7	34.7
Primary (noninterest) expenditure	38.5	39.0	37.4	35.2	34.7			33.3	34.0	34.3	34.3	34.4	34.4
Automatic debt dynamics 2/	2.5	-0.5	0.0	-1.1	-0.7			-1.6	-1.0	-1.1	-1.1	-1.0	-1.0
Contribution from interest rate/growth differential 3/	2.4	-0.6	-0.2	-1.1	-0.6			-1.6	-1.0	-1.1	-1.1	-1.0	-1.0
Of which contribution from real interest rate	0.2	-0.2	1.0	0.4	0.8			-0.2	0.3	0.4	0.3	0.3	0.3
Of which contribution from real GDP growth	2.2	-0.4	-1.2	-1.5	-1.4			-1.5	-1.3	-1.5	-1.4	-1.4	-1.3
Contribution from exchange rate depreciation 4/	0.1	0.1	0.1	0.0	-0.1			0.0	0.0	0.0	0.0	0.0	0.0
Other identified debt-creating flows	-10.6	-0.6	0.6	0.9	1.5			-10.1	1.1	-7.2	0.0	0.0	0.0
Privatization receipts (negative)	-10.6	-0.6	-0.3	-0.2	-0.2			-10.7	0.0	-7.2	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.9	1.1	1.3			0.7	1.1	0.0	0.0	0.0	0.0
NBRM recapitalization	0.0	0.0	0.0	0.0	0.4			0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	4.4	-8.9	-3.5	-0.9	3.9			7.6	0.0	7.2	0.0	0.0	0.0
of which change in NBRM deposits	2.3	-3.2	-1.3	0.2	3.8			6.4	0.0	7.2	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	143.7	123.0	101.5	100.2	112.1			105.3	102.4	96.9	92.7	88.7	85.0
Gross financing need 5/	8.1	8.0	3.2	2.4	3.2			6.3	5.3	6.3	7.8	9.1	9.8
in million Euros	0.3	0.3	0.1	0.1	0.1	7-Year Historical Average 10/	7-Year Standard Deviation 10/	311.4	274.0	349.6	462.2	571.7	660.3
Key Macroeconomic and Fiscal Assumptions													
Real GDP growth (in percent)	-4.5	0.9	2.8	4.1	4.0	2.3	3.3	4.0	4.0	4.5	4.5	4.5	4.5
Average nominal interest rate on public debt (in percent) 6/	3.8	3.1	2.6	2.4	2.7	3.5	1.4	2.9	3.1	3.2	3.2	3.1	3.1
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	0.2	-0.3	2.4	1.0	2.2	0.6	1.6	-0.3	1.1	1.2	1.2	1.1	1.1
Nominal appreciation (increase in US dollar value of local currency, in percent)	-0.3	-0.2	-0.4	0.0	0.2	0.0	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Inflation rate (GDP deflator, in percent)	3.6	3.4	0.3	1.3	0.5	2.9	2.7	3.2	2.0	2.0	2.0	2.0	2.0
Growth of real primary spending (deflated by GDP deflator, in percent)	15.0	2.3	-1.5	-1.9	3.9	3.5	5.9	-0.5	6.3	5.4	4.7	4.6	4.6
Primary deficit	4.5	4.1	-1.0	-1.3	-1.2	-0.1	3.2	-0.5	-0.4	-0.5	-0.4	-0.4	-0.3
								II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2006-10 7/								**35.6**	**36.0**	**35.3**	**34.6**	**33.9**	**33.3**
A2. No policy change (constant primary balance) in 2006-10								**35.6**	**35.2**	**33.6**	**32.1**	**30.5**	**29.0**
B. Bound Tests													
B1. Real interest rate is at baseline plus one standard deviations								**35.4**	**35.3**	**33.9**	**32.5**	**31.2**	**30.0**
B2. Real GDP growth is at baseline minus one-half standard deviation								**35.4**	**36.1**	**36.1**	**36.6**	**37.7**	**39.5**
B3. Primary balance is at baseline minus one-half standard deviation								**35.4**	**36.8**	**36.7**	**36.7**	**36.8**	**36.9**
B4. Combination of B1-B3 using one-quarter standard deviation shocks								**35.4**	**36.4**	**36.0**	**35.6**	**35.3**	**35.1**
B5. One time 30 percent real depreciation in 2006 8/								**35.4**	**49.1**	**46.9**	**44.9**	**43.0**	**41.1**
B6. 10 percent of GDP increase in other debt-creating flows in 2006								**35.4**	**45.2**	**43.3**	**41.5**	**39.8**	**38.2**

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 U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.
10/ 6-year average for the average real interest rate.

Table 9. FYR Macedonia: External Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2001	2002	2003	2004	2005			2006	2007	2008	2009	2010	2011	
								I. Baseline Projections						**Debt-stabilizing non-interest current account 6/**
External debt	41.9	39.4	37.7	40.2	47.1			**45.7**	**46.3**	**45.0**	**43.3**	**41.6**	**40.6**	**-6.4**
Change in external debt	3.3	-2.5	-1.7	2.5	6.9			-1.4	46.3	45.0	43.3	41.6	40.6	
Identified external debt-creating flows (4+8+9)	-5.1	5.8	0.3	2.5	-3.6			-11.1	-1.3	-8.6	-1.9	-2.7	-3.2	
Current account deficit, excluding interest payments	5.4	8.0	2.2	6.8	0.3			1.7	2.5	2.5	2.4	2.1	2.2	
Deficit in balance of goods and services	16.0	21.8	18.5	21.7	19.2			21.1	21.6	20.6	19.7	18.7	18.2	
Exports	40.8	36.1	36.4	38.6	44.0			46.4	45.6	44.8	44.1	43.4	42.8	
Imports	56.7	57.9	55.0	60.3	63.2			67.4	67.2	65.4	63.8	62.1	61.0	
Net non-debt creating capital inflows (negative)	-12.5	-2.0	-2.0	-3.2	-2.6			-12.5	-3.4	-11.1	-4.3	-4.8	-5.4	
Automatic debt dynamics 1/	1.9	-0.2	0.2	-1.1	-1.4			-0.3	-0.4	0.0	0.0	0.0	0.0	
Contribution from nominal interest rate	1.5	1.4	1.2	0.9	1.0			1.2	1.4	0.0	0.0	0.0	0.0	
Contribution from real GDP growth	1.8	-0.3	-1.1	-1.5	-1.5			-1.5	-1.8	0.0	0.0	0.0	0.0	
Contribution from price and exchange rate changes 2/	-1.4	-1.3	0.1	-0.5	-0.9			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	8.4	-8.3	-2.1	0.0	10.5			9.7	1.9	7.3	0.2	1.0	2.1	
External debt-to-exports ratio (in percent)	102.8	109.1	103.5	104.0	106.9			98.6	101.5	100.4	98.1	95.8	94.8	
Gross external financing need (in millions of Euros) 4/	635.9	694.9	517.3	675.6	551.2			961.5	955.9	1069.2	1187.1	1272.4	1352.6	
in percent of GDP	16.6	17.4	12.6	15.6	12.0	10-Year Historical Average	10-Year Standard Deviation	19.6	18.3	19.2	20.0	20.2	20.1	Projected Average
Key Macroeconomic Assumptions														
Real GDP growth (in percent)	-4.5	0.9	2.8	4.1	4.0	2.9	3.3	4.0	4.0	4.5	4.5	4.5	4.5	4.3
GDP deflator in Euros (change in percent)	3.7	3.1	-0.2	1.5	2.2	0.7	5.9	2.9	2.0	2.0	2.0	2.0	2.0	2.1
Nominal external interest rate (in percent)	4.0	3.5	3.0	2.5	2.6	4.5	1.7	3.2	3.2	3.2	3.3	3.9	4.0	3.5
Growth of exports (Euro terms, in percent)	-12.0	-7.9	3.5	12.0	21.1	7.4	13.3	12.6	4.4	4.7	4.9	5.0	5.0	6.1
Growth of imports (Euro terms, in percent)	-12.0	6.3	-2.7	15.9	11.3	8.4	13.8	14.1	5.7	3.7	3.9	3.9	4.6	6.0
Current account balance, excluding interest payments	-5.4	-8.0	-2.2	-6.8	-0.3	-4.1	2.9	-1.7	-2.5	-2.5	-2.4	-2.1	-2.2	-2.2
Net non-debt creating capital inflows	12.5	2.0	2.0	3.2	2.6	3.2	3.5	12.5	3.4	11.1	4.3	4.8	5.4	6.9
								II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 6/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2006-10 5/								**45.4**	**49.5**	**58.0**	**59.6**	**62.0**	**65.5**	**-2.7**
A2. Country-specific shock, real GDP growth is at 6-year historical average minus one standard deviation in 2006 and 2007								**48.2**	**51.6**	**46.3**	**44.6**	**42.9**	**41.8**	**-6.6**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2006 and 2007								**45.4**	**48.1**	**47.3**	**44.1**	**41.3**	**39.2**	**-6.4**
B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 2007								**45.4**	**49.7**	**50.9**	**47.6**	**44.8**	**42.7**	**-6.4**
B3. Change in Euro GDP deflator is at historical average minus two standard deviations in 2006 and 2007								**45.4**	**52.6**	**57.2**	**53.7**	**50.7**	**48.4**	**-6.6**
B4. Non-interest current account is at historical average minus two standard deviations in 2006 and 2007								**45.4**	**53.4**	**57.7**	**54.2**	**51.2**	**48.9**	**-6.6**
B5. Combination of B1-B4 using one standard deviation shocks								**45.4**	**57.5**	**67.8**	**64.0**	**60.8**	**58.2**	**-6.8**
B6. One time 30 percent nominal depreciation in 2006								**45.4**	**65.0**	**61.7**	**58.0**	**55.0**	**52.6**	**-6.7**

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 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.

Table 10. FYR Macedonia: Medium-Term Macroeconomic Framework (Ambitious Policies)
(Percentage change, unless otherwise indicated)

	1999-2002 Average	2003	2004	2005 Est.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.
Real GDP	1.3	2.8	4.1	4.0	4.0	4.2	5.0	5.5	5.5	6.0
Real domestic demand	3.2	-3.3	7.3	3.1	5.6	4.9	5.4	5.1	4.7	4.3
Consumption	3.7	-3.3	6.2	2.6	5.5	4.2	4.4	4.0	3.7	3.5
Private	3.9	-1.5	6.8	2.5	5.8	4.5	4.6	4.1	3.7	3.5
Public	5.1	-9.9	3.9	3.1	4.4	3.0	3.5	3.5	3.5	3.5
Fixed investment	1.6	1.1	10.9	5.4	6.4	8.9	10.8	10.8	9.2	7.5
Private	-1.5	-2.3	20.8	4.0	7.0	10.0	12.0	12.0	10.0	8.0
Public	22.6	13.3	-20.0	11.7	4.0	4.2	5.0	5.0	5.0	5.0
Change in stocks	5.2	-19.5	20.1	4.0	4.0	4.3	5.0	5.5	5.5	6.0
Exports of GNFS (volume)	2.0	-5.7	13.0	7.9	8.8	4.3	4.6	6.7	8.0	9.0
Imports of GNFS (volume)	5.9	-14.4	16.8	0.5	11.2	5.8	5.8	5.8	5.8	4.9
Contributions to growth	1.3	2.8	4.1	4.0	4.0	4.2	5.0	5.5	5.5	6.0
Domestic demand	3.5	-4.0	8.3	3.6	6.6	5.8	6.4	6.2	5.6	5.1
Net exports	-2.1	6.4	-3.8	2.7	-2.6	-1.6	-1.5	-0.7	-0.1	0.9
Statistical discrepancy	-0.2	0.4	-0.4	-2.4	0.0	0.0	0.0	0.0	0.0	0.0
Savings and investment (percent of GDP)										
Domestic saving	16.7	16.6	13.9	20.5	18.8	17.3	16.0	15.8	15.9	16.8
o/w public	0.9	4.0	3.6	3.7	2.7	2.7	2.7	2.6	2.6	2.5
private	15.8	12.6	10.3	16.8	16.1	14.6	13.3	13.2	13.3	14.3
Foreign saving 1/	5.3	3.4	7.7	1.3	3.1	5.2	7.5	8.4	8.9	8.1
Gross investment	22.0	20.0	21.6	21.8	21.9	22.5	23.4	24.2	24.8	24.9
Fixed investment	16.1	16.7	17.8	18.1	18.2	18.9	19.7	20.6	21.1	21.2
Change in stocks	5.9	3.2	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Consumer prices										
Period average	2.5	1.2	-0.3	0.5	2.9	2.5	3.0	3.0	3.0	3.0
End-period	2.7	2.6	-2.0	1.8	3.2	2.5	3.0	3.0	3.0	3.0
Memorandum items:										
Central government balance (percent of GDP)	-2.2	-0.1	0.4	0.3	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Gross official reserves (in million Euro)	742	710	717	1,123	1,602	1,683	2,010	1,912	1,858	1,903
Gross official reserves (in months of imports)	3.9	3.3	2.9	4.1	5.4	5.4	6.1	5.5	5.0	4.9
Central government gross debt (percent of GDP)	...	39.0	36.6	40.2	35.6	33.9	31.9	30.0	28.2	26.4
Central government net debt (percent of GDP) 2/	...	34.9	32.5	32.6	20.9	20.2	12.2	11.9	11.5	11.1
Foreign direct investment (percent of GDP)	5.0	2.0	2.9	1.7	12.2	3.6	12.0	6.0	7.0	7.0
Nominal GDP (in billion denars)	231	251	265	282	301	322	348	378	411	449
Nominal GDP (in million Euro)	3,788	4,095	4,325	4,593	4,913	5,250	5,677	6,169	6,704	7,319

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

1/ Current account deficit.

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

Table 11. FYR Macedonia: Medium-Term Macroeconomic Framework (Weak Policies)
(Percentage change, unless otherwise indicated)

	1999-2002 Average	2003	2004	2005 Est.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.
Real GDP	1.3	2.8	4.1	4.0	4.0	3.5	3.0	3.0	3.0	3.0
Real domestic demand	3.2	-3.3	7.3	3.1	5.6	3.4	2.6	2.8	2.8	2.9
Consumption	3.7	-3.3	6.2	2.6	5.5	3.4	2.7	3.0	3.0	3.1
Private	3.9	-1.5	6.8	2.5	5.8	3.3	2.0	2.3	2.3	2.4
Public	5.1	-9.9	3.9	3.1	4.4	4.0	5.5	5.5	5.5	5.5
Fixed investment	1.6	1.1	10.9	5.4	6.4	3.0	2.0	2.0	2.0	2.0
Private	-1.5	-2.3	20.8	4.0	7.0	3.0	2.0	2.0	2.0	2.0
Public	22.6	13.3	-20.0	11.7	4.0	3.0	2.0	2.0	2.0	2.0
Change in stocks	5.2	-19.5	20.1	4.0	4.0	3.5	3.0	3.0	3.0	3.0
Exports of GNFS (volume)	2.0	-5.7	13.0	7.9	8.8	3.7	3.5	3.1	3.1	2.7
Imports of GNFS (volume)	5.9	-14.4	16.8	0.5	11.2	3.6	2.7	2.8	2.8	2.8
Contributions to growth	1.3	2.8	4.1	4.0	4.0	3.5	3.0	3.0	3.0	3.0
Domestic demand	3.5	-4.0	8.3	3.6	6.6	4.0	3.1	3.3	3.3	3.4
Net exports	-2.1	6.4	-3.8	2.7	-2.6	-0.5	-0.1	-0.3	-0.3	-0.5
Statistical discrepancy	-0.2	0.4	-0.4	-2.4	0.0	0.0	0.0	0.0	0.0	0.0
Savings and investment (percent of GDP)										
Domestic saving	16.7	16.6	13.9	20.5	18.8	17.5	16.3	15.2	14.0	13.0
o/w public	0.9	4.0	3.6	3.7	2.7	1.8	1.3	0.7	0.2	0.1
private	15.8	12.6	10.3	16.8	16.1	15.7	15.0	14.5	13.8	12.9
Foreign saving 1/	5.3	3.4	7.7	1.3	3.1	4.2	5.2	6.0	7.0	7.7
Gross investment	22.0	20.0	21.6	21.8	21.9	21.7	21.4	21.2	21.0	20.8
Fixed investment	16.1	16.7	17.8	18.1	18.2	18.0	17.8	17.5	17.3	17.1
Change in stocks	5.9	3.2	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Consumer prices										
Period average	2.5	1.2	-0.3	0.5	2.9	2.0	2.0	2.0	2.0	2.0
End-period	2.7	2.6	-2.0	1.8	3.2	2.0	2.0	2.0	2.0	2.0
Memorandum items:										
Central government balance (percent of GDP)	-2.2	-0.1	0.4	0.3	-0.6	-1.5	-2.0	-2.5	-3.0	-3.0
Gross official reserves (in million Euro)	742	710	717	1,123	1,602	1,629	1,863	1,619	1,323	1,000
Gross official reserves (in months of imports)	3.9	3.3	2.9	4.1	5.5	5.5	6.1	5.2	4.1	3.0
Central government gross debt (percent of GDP)	...	39.0	36.6	40.2	35.6	36.3	36.6	37.3	38.5	39.7
Central government net debt (percent of GDP) 2/	...	34.9	32.5	32.6	20.9	22.5	16.1	17.8	19.9	22.0
Foreign direct investment (percent of GDP)	5.0	2.0	2.9	1.7	12.2	2.0	9.3	2.0	2.0	2.0
Nominal GDP (in billion denars)	231	251	265	282	301	318	334	351	369	387
Nominal GDP (in million Euro)	3,788	4,095	4,325	4,593	4,913	5,186	5,449	5,725	6,014	6,319

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

1/ Current account deficit.

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

Table 12. FYR Macedonia: Financial Soundness Indicators, 2001–05

	2001	2002	2003	2004	2005
			(in percent)		
Capital adequacy					
Regulatory capital/risk weighted assets	34.3	28.1	25.8	23.0	21.3
Tier I capital/risk weighted assets 1/	35.1	28.3	26.2	23.9	21.6
Asset composition and quality					
Sectoral loans to nonfinancial enterprises/total loans 2/					
Enterprises	42.1	37.3	44.4	43.5	43.8
Households	5.9	7.9	11.8	16.3	20.3
Foreign currency lending					
Foreign currency lending/total credit to private sector	13.8	22.2	16.2	20.0	25.4
Foreign currency indexed lending/total credit to private sector	...	16.8	22.2	20.6	22.2
Gross nonperforming exposures/total credit exposure 3/	33.7	15.9	15.1	13.2	10.9
NPLs net of provision/capital	52.4	41.6	32.5	29.5	26.1
Large exposures/capital	93.0	220.0	193.0	219.0	190.0
Connected lending					
Banking system exposure to shareholders/capital	...	11.8	7.0	7.4	4.3
Banking system equity investments/capital	6.7	7.3	6.3	5.6	6.2
Earning and profitability					
Return on average assets (ROAA)	-0.7	0.4	0.5	1.1	1.3
Return on average equity (ROAE)	-3.2	2.1	2.3	6.2	8.1
Interest margin/gross income	22.2	27.9	33.0	41.3	45.1
Noninterest expenses/gross income	92.1	94.6	90.0	78.8	75.2
Personnel expenses/noninterest expenses	42.4	44.2	47.7	46.7	45.1
Interest rate spreads (in percentage points)					
Local currency	9.5	8.8	7.8	5.5	6.9
Foreign currency	3.3	5.4	...	5.6	6.5
Interbank market	13.1	5.9	9.8	6.9	8.5
Liquidity					
Liquid assets/total assets 4/	54.6	44.8	45.0	42.8	46.9
Liquid assets/total short-term liabilities 4/	79.4	69.4	62.7	62.2	68.0
Customer deposits/total (noninterbank) loans	163.0	130.2	140.5	143.4	142.3
Foreign currency deposits/total deposits	71.9	63.9	53.5	54.4	55.7
Central bank credit to banks/bank liabilities	0.2	0.2	0.4	0.9	0.7
Sensitivity to market risk					
Net FX position/capital	60.5	56.2	56.3	52.1	49.6

Sources: NBRM.

1/ Tier 1 capital includes common shares, general and revaluation reserves, and undistributed profits, net of specific provisions.

2/ Total loans include deposits with banks.

3/ Based on the new methodology in which interbank loans are included in total credit exposure.

4/ Liquid assets are defined as cash and balances with the NBRM, securities rediscounted by the NBRM, and short-term bank placements. Short-term liabilities are defined as deposits and other liablities with a maturity of one year or less.

Appendix I—FYR Macedonia: Fund Relations
(as of May 31, 2006)

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	99.67	144.66
Reserve Position	0.00	0.00

III. **SDR Department**:	SDR Million	Percent of Allocation
Net cumulative allocation	8.38	100.00
Holdings	0.82	9.78

IV. **Outstanding Purchases and Loans**:	SDR Million	Percent of Quota
Extended Arrangements	0.77	1.11
PRGF Arrangements	10.82	15.70
Stand-By Arrangements	30.00	43.54

V. **Latest Financial Arrangements**:

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

VI. **Projected Payments to the Fund (Expectations Basis)**[1]

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	4.58	12.08	19.91	4.47	0.54
Charges/Interest	0.95	1.68	1.09	0.42	0.28
Total	5.53	13.76	21.01	4.89	0.82

Projected Payments to the Fund (Obligations Basis)[2]

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	4.58	12.08	11.66	8.79	4.47
Charges/Interest	0.95	1.68	1.25	0.75	0.40
Total	5.53	13.76	12.91	9.53	4.87

VII. **Safeguards Assessments:**

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

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

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

prescribed by the central bank law. The NBRM has started to conduct internal audit reviews on the processes for compiling monetary data reported to the Fund.

VIII. **Exchange Arrangement**:

The currency of the FYR Macedonia is the denar. The FYR Macedonia maintains a managed floating exchange rate system with a de facto peg to the Euro. Households can transact only through commercial banks or through foreign exchange bureaus that act as agents of banks; enterprises can transact through the banking system. The reserve requirement on all foreign currency deposits is set at 10 percent.

At end-May 2006, the official exchange rate was 47.65 denars per U.S. dollar and 61.18 denars per euro. The FYR Macedonia has accepted the obligations of Article VIII, Sections 2, 3, and 4 with effect from June 19, 1998.

The FYR Macedonia maintains an exchange restriction subject to the Fund's approval under Article VIII, Section 2(a) arising from restrictions imposed on the transferability of proceeds from current international transactions contained in former frozen foreign currency saving deposits. The retention of this restriction was approved by the Board on April 26, 2006 until December 31, 2006. During the Article IV consolations, the authorities confirmed their commitment to eliminate all restrictions by then.

IX. **Article IV Consultations**:

The first consultation with the FYR Macedonia was concluded in August 1993. The last consultation was concluded on April 30, 2003. The FYR Macedonia is on the standard consultation cycle.

X. **Technical Assistance (since 2001)**:

Purpose	**Department**	**Date**
Banking Law	LEG, MFD	June 2006
Banking Reform	MFD	November 2005
Credit Growth	MFD	October 2005
National Accounts	STA	July 2005
BOP Statistics	STA	July 2005
Tax Administration	FAD	May 2005
Reserve Management	MFD	May 2005

Monetary Statistics	STA	April 2005
Monetary and Foreign Exchange Policy and Operations	MFD	November-December 2004
Debt Management	FAD	October 2004
National Accounts	STA	May 2004, October 2004
Debt Management	FAD	March 2004
Fiscal Decentralization	FAD	September 2003 March 2002
Public Expenditure Management	FAD	May 2003
Monetary Operations and Payment System	MFD	November-December 2002 April 2004
Balance of Payments Statistics	STA	October 2002
Tax Policy	FAD	December 2001
Development of a Treasury System	FAD	November 2001
Resident Experts		
Banking Supervision	MFD	May 2006-present
Money Markets and Operations	MFD	October 2004-April 2005
Value-Added Tax	FAD	October 1999-April 2001
Development of a Treasury System	FAD	January 2000-July 2001

XI. FSAP Participation and ROSCs (since 2003)

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

XII. Resident Representative

The Fund has had a resident representative in Skopje since 1995. Mr. Kevin Ross has held this position since May 2003.

Appendix II—FYR Macedonia: Statistical Issues

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

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

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

4. The compilation and coverage of **balance of payments data** have improved in recent years. The October 2002 STA technical assistance mission recommended further improvements to the estimation of short-term trade credits and investigated the large errors and omissions. Recommendations were made relating to the valuation of imports of goods and to the estimation of transportation services. Most recommendations were implemented by the authorities, but gaps remain because data from surveys and reports on transportation services, direct investment, and transactions settled through resident accounts with non-resident banks were not incorporated into the statistics. The 2004 data ROSC mission confirmed these shortcomings. The February 2005 STA technical assistance mission focused on the validation and inclusion of surveys and reports in the compilation of balance of payments and international investment position. A severe weakness in the BOP statistics evolved in 2005 when high inflows of foreign exchange cash inflated private transfers. A STA TA mission, which will deal with private transfers, other cash transactions, and other issues, will be conducted during 2006.

5. Progress has been made in **government finance statistics** since 2004. Data for the consolidated central government are now available following the expansion of coverage to extra-budgetary funds and special revenue accounts (SRAs), including their foreign-financed

projects. However, reliability of extra-budgetary funds and SRAs data could still be improved. The financing data for the central government is increasingly presented in line with GFSM 1986 and are now reconciled with BOP and monetary data following staff's recommendations. Data on central government domestic arrears has improved following introduction of commitment accounting in autumn 2003. However, data on fund arrears, especially of the Health Insurance Fund, remain unreliable. As part of the ongoing process of fiscal decentralization, the authorities plan to start collecting data on municipalities that will allow monitoring of general government finances in 2006. The authorities also plan to begin implementation of the *GFSM 2001* in line with the recommendations of the 2004 data ROSC as a first step to bringing the fiscal reporting in line with the European Union's ESA95 methodology. In 2005, the authorities started systematic compilation of public debt data and are planning to start publishing statistics on public debt on a regular basis in 2006. Government Finance Statistics are not reported to the Fund for inclusion in the *Government Finance Statistics Yearbook* or the *IFS.*

6. **Money and banking data** are reported to the Fund on a regular basis, although in the past they have been subject to concerns regarding inconsistencies, accuracy and reliability. To address these issues, STA provided technical assistance in April 2005 based on the findings of the data ROSC in 2004. The mission and the authorities agreed on an action plan aimed at improving current data collection and compilation practices. Specific recommended actions include: (i) improved institutional coverage of monetary statistics through the inclusion of savings houses in the reporting of other depository corporations; (ii) the collection of more disaggregated data in both the National Bank of Republic of Macedonia (NBRM) and commercial banks' balance sheets for the improved classification of accounts by economic sector; (iii) improved data consistency through reconciliation of loan data among various sectors; (iv) the publication of improved interest rate data in *IFS;* and (v) the establishment of a well-defined policy on data revisions in line with best international practice. The NBRM has since begun to implement these improvements. Notably, the regular publication of lending and deposit interest rates of various maturities and currency-type has been an important step forward. Notwithstanding these advances, further TA might be necessary in the future as the financial sector develops.

APPENDIX II—MACEDONIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(as April 28, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	5/31/06	6/7//06	D and M	W and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/23/06	6/28/06	M	M	M		
Reserve/Base Money	4/31//06	6/14//06	D and M	W and M	M	O, LO, LO, O	O, LO, O, O, O
Broad Money	4/31//06	6/14//06	M	M	M		
Central Bank Balance Sheet	4/31//06	6/14/06	M	M	M		
Consolidated Balance Sheet of the Banking System	4/31//06	6/14//06	M	M	M		
Interest Rates[2]	5/31//06	6/14//06	M	M	M		
Consumer Price Index	May 2006	6/21/06	M	M	M	O, O, O, LO	LO, O, LNO, O, LO
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	NA	NA	NA	NA	NA	LO, LNO, LO, O	LO, LO, LO, LO, LNO
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	4/30/06	6/9/06	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	3/31/06	5/15/06	M	M	I		
External Current Account Balance	Mar 2006	6/15/06	M	I	Q	O, LO, O, LO	LO, O, LO, O, LO
Exports and Imports of Goods and Services	Mar 2006	6/15/06	M	I	Q		
GDP/GNP	Dec 2005	4/7/06	Q	Q	Q	O, LO, O, LO	LO, O, LNO, O, O
Gross External Debt	3/31/06	5/15/06	M	M	M		

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

Appendix III—FYR Macedonia: World Bank Relations

A. Partnership in FYR Macedonia's Development Strategy

1. FYR Macedonia has made considerable progress since independence in 1991, with support from the international community. While risks still remain, the relatively calm external and internal environment presents FYR Macedonia with perhaps the first significant window of opportunity since independence to focus on strengthening growth and employment opportunities. This follows the resolution of regional conflicts that took place through much of the 1990s, especially the cessation of hostilities in neighboring Kosovo, which particularly affected FYR Macedonia. Similarly, the Ohrid Framework Agreement of late 2001 has brought a reasonable measure of stability to the country, despite continuing isolated incidents. FYR Macedonia's progress is reflected perhaps most prominently in the agreement with the European Union (EU) on a Stabilization and Association Agreement, as well as FYR Macedonia's recent application to begin negotiations on EU membership.

2. Macro-economic stability has been largely maintained since the mid-1990s, and been further strengthened since 2002. Fiscal discipline and the peg to the Euro have helped to bring inflation close to zero, and resulted in Government spending falling as a proportion of GDP to a level significantly lower than most of the other former Yugoslav republics.

3. Nevertheless, despite the recovery of annual growth rates of 4 percent unemployment remains high and of serious concern. Growth remains constrained by structural impediments. Further reform to improve competitiveness will be crucial to attract the investment needed to encourage stronger growth and to provide employment opportunities.

B. World Bank Supported Reform

4. Since FYR Macedonia joined the World Bank in 1993, 33 loans have been approved with a total value of approximately US$754 million. About half of all lending has been on concessional IDA terms. FYR Macedonia graduated fully from IDA in 2003 reflecting improved economic performance and credit-worthiness. All new lending since 2003 has been on IBRD terms.

5. The World Bank's current program of assistance to FYR Macedonia is outlined in a Country Assistance Strategy discussed by the Board in September 2003. Reflecting Government priorities, the CAS outlines three broad areas of support: (i) promoting the efficient management of public resources and tackling corruption; (ii) promoting the creation of jobs through sustainable private sector led growth; and (iii) promoting social cohesion, building human capital, and protecting the most vulnerable. The CAS envisages a series of multi-sector development policy loans, supported by specific investment operations to build

capacity to support priority reform areas. The CAS also provides for total financing in a high case lending scenario of up to US$165 million over three years. FYR Macedonia has qualified for such a high case lending scenario since the CAS was discussed by the Board.

6. World Bank operations in the past few years have focused primarily on supporting Macedonian Government efforts to strengthen public sector management and governance. A US$15 million *Public Sector Management Adjustment Credit (PSMAC)* approved in 2002, and a recently completed US$30 million *Public Sector Management Adjustment Loan II (PSMAL II)* have emphasized:

(i) improving governance of the health sector, particularly through reform of the Health Insurance Fund and international tendering for very significant pharmaceuticals contracts (which has resulted in savings to the Government of over US$10 million per annum);

(ii) strengthening overall budgetary management, especially though the consolidation of extra-budgetary funds within the Treasury Single Account; and

(iii) civil service reform, including the greater application of the merit principle in hiring and promotion decisions, and associated wage decompression to encourage retention of senior and experienced staff.

7. While maintaining involvement in key elements of the governance agenda, particularly health sector financing reform, the Bank's policy dialogue with the Government is increasingly shifting to structural economic reform to improve the business environment and promote growth and employment. Bank support for Macedonian Government reform efforts will be centered on a series of *Programmatic Development Policy Loans (PDPLs)*, the first of which was approved by the Board in October 2005, shortly after IMF Board approval of the proposed Stand-By Arrangement (SBA). In terms of strengthening the overall business and investment climate, the PDPLs support Government efforts to undertake judicial reform, labor market reform, and strengthened financial sector regulation and supervision. Efforts to further strengthen public sector governance include an emphasis on further reform to improve the transparency of the critical health sector, building the capacity of the civil service to permit more effective strategic prioritization, and support for the decentralization program being conducted under the umbrella of the Ohrid Framework Agreement.

8. Development policy lending has been, and will continue to be, supported by a series of specific investments to build capacity to implement priority reforms. On the governance and public administration side, a *Health Sector Management Improvement project* will continue to provide technical assistance and investment support to the broader health sector reform program; a *Social Protection* project will continue to support reform in this area,

including the proposed introduction of a second pillar pension system; and an *Education project* will continue to assist Government efforts to improve access and introduce stronger performance and equity measures in primary and secondary education financing. On the investment climate side, a *Business Environment Reform and Institutional Strengthening (BERIS) project* approved in June 2005 will concentrate on building capacity to improve business entry, operations, and exit; as well as enhancing the competitiveness of the enterprise sector; and a *Real Estate Cadastre and Registration project* approved in early 2005 is intended to strengthen land markets and the use of real property as collateral for business investment by providing more secure title. A *Legal and Judicial Reform project* currently under preparation is planned to be presented to the Board in early 2006 to support critical reforms in this area. Adjustment and investment lending has also been backed up by a comprehensive program of analytical work.

C. IMF – World Bank Collaboration in Specific Areas

9. World Bank and IMF engagement in FYR Macedonia in recent years has been marked by a spirit of collaboration and cooperation between the two institutions, and with the Government. Synergies between the proposed Bank and IMF programs over the next three years reflect a strong degree of consensus between both institutions and the Government in regard to reform priorities. Especially given the broad range of structural reform areas in which the Bank and the Fund will both be engaged, however, it will be critical that close coordination is maintained in order to ensure that the SBA and the Bank program are mutually reinforcing.

Improving the Investment Climate

10. There is broad consensus that **judicial reform** is central to improving the business environment in FYR Macedonia. As recognized in the Government's December 2004 *Strategy on the Reform of the Judicial Sector*, comprehensive judicial reform is especially urgent to firmly establish the efficient, effective and fair enforcement of creditor, contract and property rights. The Bank's *Doing Business* report has also highlighted the time and cost of enforcing contracts and conducting bankruptcy procedures as particular constraints in FYR Macedonia. IMF SBA benchmarks to analyze and budget for the fiscal effects of judicial reform, enact amendments to the *Bankruptcy Law*, and amend the *Law on Misdemeanors* to allow administrative bodies to impose sanctions without prior court involvement should complement Bank supported reform efforts. Under the PDPL and the proposed Legal and Judicial Reform project, the Bank will focus on: reducing backlog and delays in court proceedings by 25 percent; improve the enforcement of court judgments; improve the regulatory and implementation framework for bankruptcy cases including the development of a profession of bankruptcy trustees; and increase the speed, transparency and

fairness of administrative decisions. Ultimately, institution building to support the legislative reform agenda will be crucial, and is likely to take several years.

11. Support for **labor market reform** will also require close coordination. A very rigid legislative framework governing labor relations has contributed to a stagnant formal labor market, unemployment rates among the highest among transition economies, limited opportunities for new entrants to the labor market, and a large informal sector. The recently adopted *Law on Labor Relations* – a prior action for the Fund SBA—will eliminate the most burdensome features of the old law and, over time encourage growth, investment, and a gradual shift in employment from the informal sector to the formal sector, with a concomitant strengthening of workers' rights. Further efforts to strengthen labor market flexibility, including the implementation of the new legislative framework, the establishment of alternative dispute resolution mechanisms, and a renegotiation of collective agreements are expected to be supported the three PDPL operations.

12. Judicial and labor market reforms are being complemented by a range of other measures to strengthen the framework for business activity. The enactment and implementation of a new *Business Registration Law* and associated regulations will critical to reducing the relatively high costs and time of business entry – with the time required for registration currently exceeding the regional average. The Government is also establishing a permanent body to oversee regulatory reform, including the streamlining of business licensing, permits and inspections. These continuing reforms will be supported over the next few years by the Bank's PDPL operations as well as the BERIS project. Further actions to implement corporate governance and accounting and auditing reports on standards and codes (ROSCs) will also be required, including amendments to the *Company La*w and *Securities Law*, and the passage of a new *Audit Law*. Efforts by the Bank to support the capacity of the National Bank (NBRM) to supervise and regulate the banking sector, and to strengthen compliance with anti-money laundering and counter-terrorist financing requirements, will also need close coordination with the IMF, and the SBA also includes benchmarks on the strengthening of risk-based supervision by the NBRM.

Public Sector Transparency and Governance

13. Reform of **health sector financing** will be a key element of both the Bank and IMF programs. Health sector financing makes up 15 percent of Government expenditure and has historically been an area with significant public financial management risks associated with both pharmaceutical procurement and the less than fully transparent operation of the Health Insurance Fund (HIF). As noted in the SBA documentation, implementation of health sector reform will be a litmus test for the authorities' commitment to fight corruption. Prior actions and performance criteria in the SBA requiring submission to Parliament of relevant legislation to tighten the selection of the HIF Board, implement more transparent budget

procedures, and introduce binding budget ceilings for the largest public health institutions will be reinforced through existing and proposed Bank programs, which will also support efforts to further prioritize spending, improve the cost-effectiveness of health interventions, and further strengthen mechanisms for pharmaceutical procurement.

14. Continued collaboration between the Bank and the IMF will be necessary in regard to the consolidation and rationalization of **social insurance contributions** with the collection of personal income tax. The Bank supports Government efforts, with IMF assistance, to merge collection over time. At the implementation level, however, rationalization and consolidation of social insurance contributions will need to continue to be coordinated with Bank efforts to support Government reform of the social protection system, including the introduction of a second pillar pension scheme.

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

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

D. Summary

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

INTERNATIONAL MONETARY FUND
Public Information Notice
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Public Information Notice (PIN) No. 06/98
FOR IMMEDIATE RELEASE
August 11, 2006

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

IMF Concludes 2006 Article IV Consultation with the former Yugoslav Republic of Macedonia

On July 28, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the former Yugoslav Republic of Macedonia.[1]

Background

Economic performance has started to improve. After a decade of sluggish growth, in part the result of external shocks, growth has reached 4 percent for two years in a row. In 2005, growth was driven by strong exports. A broadly balanced fiscal position and the fixed exchange rate have kept inflation under control. The external position has strengthened, with gross reserves rising from €700 million at end-2004 to around €1,200 (more than 4 months of imports or 25 percent of GDP) by May 2006. The recorded current account deficit fell sharply to 1.3 percent of GDP in 2005 driven by increased private transfers, though these may also capture capital account transactions.

The increase in reserves has allowed the central bank to cut interest rates. Bank credit has expanded, especially to households and in foreign currency, though from a low base and less rapidly than in the region's other countries.

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[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.

The overall fiscal position showed a small surplus in 2005. Last year's 0.3 percent of GDP central government budget surplus was better than projected by 1 percent of GDP, reflecting continuing underperformance of ministries' Special Revenue Accounts, restraint in public employment, and procurement delays. One-off revenue developments, including the unusually high telecom monopoly dividend and advancing VAT payments by importers, also contributed.

In 2006, growth is projected to remain at 4 percent, with higher domestic demand offsetting some decline in net exports. Inflation is expected to increase to 3 percent, driven by supply factors, including higher tobacco taxes and oil prices. The official current account deficit is projected to widen to 3 percent of GDP due to higher oil prices, lower interest rates stimulating imports, and some slowing in last year's increase in private transfers.

Despite recent progress, structural weaknesses constrain the economy's ability to increase employment and achieve more rapid output growth. Recorded unemployment in 2005 reached 35 percent, one of the highest in the region, as employment has barely increased since 1995. Levels of financial intermediation and the stock of foreign direct investment remain low. Macedonia ranked poorly in international comparisons of the business environment due to high costs of opening and closing a business, hiring and laying off workers, and enforcing contracts. Property rights are poorly defined with the land cadastre incomplete, the tax wedge on labor remains high, and telecommunications services are expensive. The government has amended the constitution and passed new laws to introduce comprehensive judicial reform, yet implementation has just started.

Executive Board Assessment

Executive Directors commended the Macedonian authorities for their sound macroeconomic policies which, after a decade of sluggish growth, have now started to deliver economic recovery. Inflation has remained under control, the current account deficit has narrowed, international reserves have increased, and the fiscal position is sound.

Directors noted that, despite these successes, considerable challenges lie ahead. These include raising living standards closer to European levels, reducing unemployment, and keeping the current account deficit under control. Directors stressed that the best way to meet these challenges would be by maintaining the country's hard-won macroeconomic stability, and accelerating structural reforms.

Directors viewed the 0.6 percent of GDP fiscal deficit target as one of the anchors of macroeconomic stability. They cautioned that loosening the fiscal stance would be premature in view of uncertainties about the current account's true size, medium-term fiscal challenges, and the limited institutional capacity in line ministries to spend additional funds efficiently. Rationalization of the public sector should be undertaken before spending increases are envisaged. Going forward, Directors also encouraged efforts to strengthen the fiscal revenue base and reduce nondiscretionary spending.

Directors considered that the exchange rate peg is appropriate given the Macedonian economy's size and openness, and its limited international financial market integration. The peg has kept inflation low, and, although there are structural weaknesses in the economy, price competitiveness and the level of the exchange rate seem broadly satisfactory. Directors considered it important to continue to strengthen the central bank's policy instruments. They welcomed the central bank's recent interest rate cuts, but with euro-area rates higher and the need to see the effects of the cuts on credit and the real economy, a pause now seems appropriate.

Directors stressed the importance of structural reforms for accelerating growth. Institutional reforms, ranging from judicial reform and improving public governance to market liberalization and privatization, will be essential to developing a functioning market economy. Reducing the very high unemployment rate should be a priority, and can be achieved through active labor market policies, reducing the tax wedge, and eliminating barriers to part-time employment. Financial market development is also needed, notably to lower intermediation costs, improve the credit culture, and enhance banking supervision. Such reforms would boost investment and employment, strengthen total factor productivity, and increase Macedonia's attractiveness for foreign direct investment. Directors noted that although these tasks are immense, so too are the potential rewards, and they encouraged the authorities to implement these reforms expeditiously.

Macedonia's provision of data to the Fund is broadly adequate for surveillance purposes. Directors nevertheless underscored the need for continued efforts to improve the quality and coverage of statistics, including in the area of fiscal transparency.

Table 1. FYR Macedonia: Selected Economic Indicators, 2003-07

	2003	2004	2005 Prel.	2006 Proj.	2007 Proj.
			(Percentage change)		
Real economy					
Real GDP	2.8	4.1	4.0	4.0	4.0
Consumer prices					
period average	1.2	-0.3	0.5	2.9	2.0
end of period	2.6	-2.0	1.8	...	...
Real wages, period average	3.6	4.4	...	...	...
Unemployment rate (average)	36.7	37.2	37.3	...	...
Government finances	(In percent of GDP, unless otherwise indicated)				
Central government balance 1/	-0.1	0.4	0.3	-0.6	-0.6
Revenues (including grants)	38.4	36.5	35.8	33.8	34.5
Expenditures	38.5	36.1	35.6	34.4	35.1
Central Government debt 2/					
Gross	39.0	36.6	40.2	35.6	35.3
Net	34.9	32.5	32.5	20.9	21.7
Money and credit					
Broad money (M3, percent)	18.0	16.1	14.9	20.1	23.0
Short-term lending rate (percent)	14.5	11.8	11.7	...	...
Interbank money market rate (percent)	6.8	8.3	9.2	...	...
Balance of payments	(In millions of Euro, unless otherwise indicated)				
Exports	1,203	1,343	1,642	1,833	1,912
Imports	1,953	2,237	2,496	2,847	3,001
Trade balance	-750	-894	-853	-1,015	-1,089
Current account balance					
excluding grants	-227	-389	-114	-209	-290
(in percent of GDP)	-5.5	-9.0	-2.5	-4.2	-5.6
including grants	-137	-334	-62	-151	-201
(in percent of GDP)	-3.4	-7.7	-1.3	-3.1	-3.9
Overall balance	14	-19	340	478	120
Official gross reserves	710	717	1,123	1,602	1,699
(in months of following year's imports of goods and services)	3.3	2.9	4.1	5.5	5.6
External debt service ratio 3/	24.2	14.7	13.0	25.8	20.3
External debt to GDP ratio (percent) 4/	37.7	40.2	47.1	45.7	46.3
Exchange rate					
Real effective exchange rate (CPI-based)	-0.1	-1.6	-3.3	...	...

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

1/ In 2005, central government spent an additional 0.4 percent of GDP on the NBRM recapitalization.
2/ In 2005 and 2006 the change in stock reflects a major debt management operation. Net is defined as Gross debt minus government's deposits with the NBRM.
3/ Debt service due, including IMF, as a percent of exports. For 2006, includes a major debt management Operations. Excludes rollover of trade credits.
4/ Total external debt, including trade credit. For 2005, includes a Euro 150 million Eurobond issue.

Statement by Jeoren J. M. Kremers, Executive Director for Former Yugoslav Republic of Macedonia July 28, 2006

On behalf of the Macedonian authorities I thank staff for the constructive policy dialogue during the mission and the comprehensive set of papers, including the very useful selected issues analysis, which will help the new government in their policy formation process.

The main political event since our previous Board discussion on Macedonia about two months ago was the July 5th Parliamentary election, which has been regarded both by the international and local observers as transparent and fair. As a result, the main opposition party VMRO-DPMNE (headed by the former Minister of Finance Nikola Gruevski) secured 45 out of 120 seats in the parliament and is currently conducting negotiations with potential partners for a coalition government. This marks Macedonia's shift to sustained political and macroeconomic stability following the 2001 security crisis and confirms the progress in implementing the Ohrid Framework Agreement reflecting the county's broad consensus on the need to strengthen democratic process towards full convergence to EU principles. In the same vein, Macedonia's economic performance has remained strong, with exports being the main engine of economic growth for the second consecutive year, low inflation and a consistent increase in employment. Reflecting the policy stance and a considerable increase in transfers, Macedonia's external position has improved substantially and is projected to remain sustainable over the medium term.

These achievements were accomplished thanks to continued support from the Fund and other development partners, prudent and well-coordinated monetary and fiscal policies, and labor market liberalization. The authorities share staff's view that a continued stable macroeconomic policy is key to sustained growth, and remain committed to build on recent progress by addressing underlying long-term structural weaknesses, improving institutional capacity and enhancing financial market development. Their commitment enjoys broad support across society and is underpinned by the European Council's decision to grant Macedonia EU candidate status.

Continued economic stability has also resulted in an increase in financial market confidence and improvement in the capital account, as evidenced by growing capital inflows including the large oversubscription on Macedonia's first Eurobond issue at the end of last year. These developments were marked by a rating upgrade from Standard and Poor's in 2005 followed by one from Fitch in June, 2006.

The authorities' medium-term goals are consistent with the SBA, currently under implementation, and the main challenge is to accelerate real GDP growth to above 4.5 percent, while sustaining and building on recent macroeconomic performance.

Fiscal policy

Notably, the tight fiscal stance from 2003 onwards, supported by price stability, has contributed to the improved economic situation. A budget surplus was achieved for two consecutive years, the 2005 program target being exceeded by more than 1 percent of GDP. This is a significant improvement compared to a 5 percent of GDP deficit only three years earlier. The impressive fiscal consolidation reflects politically difficult measures undertaken by the authorities, who, among other measures, increased taxes, raised utility prices and cut expenditures. Given the improvement in the current account and lower public debt ratios, the modestly expansionary fiscal policy in 2006 is appropriate. This is also supported by Macedonia's low capital expenditure as a share of GDP and the absence of major mediumterm fiscal sustainability risks. In this context, the deficit target of 0.6 percent of GDP for 2006 appears to be reachable.

The fiscal framework was recently assessed by the IMF through the fiscal transparency ROSC, which concluded that Macedonia meets the requirements of the fiscal transparency code in several key areas. In particular, the ROSC emphasized the appropriate allocation of responsibilities among different levels of government, the central bank's operational independence, the availability of reliable information on public and publiclyguaranteed debt, the adequate legal framework for the management of public funds, and the transparency of the annual budget process. It also points out that the legislative basis for taxation is clear and comprehensive. At the same time, the assessment cites a number of areas were improvements are warranted including the provision in budget documents of public debt sustainability analysis and information on fiscal risks, strengthened reporting on state-owned enterprises, and the development of a system for tracking fiscal incentives and their expenditure implications, and further support to the recently-established internal audit units. Addressing these issues is a comprehensive part of the authorities' broader fiscal reform agenda which is being implemented with support from the Fund and the Bank.

Implementation of the broad-based reform of the tax administration with technical support from the Fund and the Netherlands remains an important element of the fiscal agenda. Considerable ground has already been covered in establishing a base for improved fiscal administration, including Parliamentary approval of the new Law on Tax Administration Procedures, expanding taxpayer protection and broadening the Public Revenue Office's (PRO) authority. Also, the authorities made progress toward improving arrears collection, tax payer registration, public procurement and performance measurement. Harmonization of personal income tax and social contribution is underway, and its first phase is expected to be completed by year-end.

Looking forward, the authorities are aware of the medium-term fiscal challenges including those related to the fiscal costs of EU accession, further trade liberalization, SOEs privatization and the development of the second pillar pension system. To this end, they continue efforts to improve the quality and efficiency of fiscal spending and control mechanisms. Particular attention is paid to containing arrears in the health sector within SBA parameters. Furthermore, the preliminary findings of the Public Expenditure review conducted with Bank support will help guide the 2007 budget process. The authorities look forward to starting the regular monitoring and reporting exercises and pre-accession fiscal surveillance required for EU membership.

The staff report indicates that debt dynamics are generally subdued, with the government debt at around 35 percent of GDP and an average maturity of more than 10 years. The private short-term external debt is also low and constitutes only 8 percent of GDP. Although debt sustainability analysis suggests limited vulnerabilities, the authorities have used the favorable environment to substantially upgrade debt management at the Ministry of Finance.

Monetary policy and exchange rate regime

The National Bank's (NBRM) monetary policy, in combination with a tight fiscal stance, is consistent with maintaining the de facto currency peg backed by an adequate level of international reserves. The authorities believe that the exchange rate regime has served Macedonia well as a clearly defined monetary anchor and will continue to do so. Additionally, staff estimates of the equilibrium real exchange rate using the macroeconomic balance approach suggest that the exchange rate is broadly appropriate. At the same time, as the sterilization costs are increasing, the authorities are open to consider ways to improve its sterilization cost projections to asses the regime's durability and to proceed with preparations for possible inflation targeting.

The improved external position and substantial privatization proceeds led to a greater than initially projected international reserves accumulation. Gross reserves are currently at around 1.2 billion EURO and represent about 4.5 months of import cover. This has allowed the NBRM to cut interest rates from 10 to 6 percent. The authorities are in agreement with staff that the scope for further rate cuts is limited given the uncertainty over the current account deficit, the lags in transmission to bank lending and the narrowing differential with the euro area rates.

With the increased confidence in the denar and growing capital inflows, the NBRM expects a fall in the level of euroization as the demand for local assets is increasing. To avoid inflationary pressures and ensure continued success of the exchange rate regime, the NBRM stands ready to sterilize capital inflows by issuing central bank and treasury bills.

Financial market development is key to sustained economic growth and the authorities remain committed to build on the progress made in encouraging financial intermediation. In this context, they will seek further support in improving the legal framework for insolvency and poor credit practices. In order to improve the soundness of the banking system, the authorities are preparing a comprehensive revision of the legal framework. They have produced a new draft of the Banking Law aimed at a number of important areas, including governance issues, clarification of the roles of the Audit Committee and Risk Management Committee, and increased capital and enhanced licensing requirements.

In anticipation of faster credit growth the NBRM has undertaken a number of steps to strengthen banking supervision. With World Bank assistance, a Supervisory Development Plan (SDP) has been developed to enable a more risk-based, anticipatory approach to banking supervision. To that effect, an MFD resident advisor has been in place since May. To give supervisors a more active role in AML/CFT implementation and enforcement, the central bank has established an emergency lending facility and revised supervisory circulars.

Structural reforms

The useful selected issues paper gives an excellent overview of the role of structural reform in improving productivity and attracting foreign investment that should ultimately result in achieving a GDP growth of 5-6 percent. The authorities are in broad agreement with staff that further structural reforms and improved institutional capacity are critical for a healthy business environment conducive to sustained economic growth.

Important components of an attractive business environment are enhanced governance and lower business costs. To this effect, the authorities have amended the constitution and passed new laws to introduce an ambitious and comprehensive judicial reform in line with the European Commission's recommendations. In order to enhance business activity, government introduction of a one-stop shop for business registration, a new Bankruptcy Law and the Law on Audit were approved, among other measures. Also, the authorities see scope for faster completion of the cadastre project in order to improve property rights. With regard to further liberalization in telecommunication, the authorities will pursue with vigor the implementation of the February 2005 Law on Electronic Communications.

Reducing unemployment is one the most pressing and difficult policy challenges facing the authorities. With a recorded unemployment rate of 35 percent, much of which is structural, and low labor participation, as the staff report correctly emphasizes, bringing the unemployment rate to the regional level will require further labor market liberalization, improved unemployment measurement, reducing the labor tax wedge, and promoting parttime employment. Next to that, a broader context of economic stability and growth will be key to achieving this objective.