

National Bank of the Republic of Macedonia

***ANNUAL
REPORT***

1995

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I. World economic movements in 1995

The worldwide economic activity in 1995 was going in the upward direction. According to the first nine months performance, the 1995 output is expected to increase by 3.7%. The economic growth, in 1995, was much more equally distributed between developed and developing countries, and for the first time the countries in transition from Central and Eastern Europe, as a group, have reached a positive growth rates of the social product. The increase of economic activity in 1995 was due to the improvement of general economic conditions: low inflation rates, increased savings and investment, productivity increase, and etc.

Based on the data for the first three quarters of 1995, the developed countries economic growth rate is expected to be about 2.6%. The basic condition that enabled their economic activity trend of growth to continue in 1995, was maintenance of low inflation rate, which determine savings and investment to increase, as well as more optimal resource allocation. Simultaneously, maintenance of low inflation rates for long period of time was one of the factors that influenced the decline of nominal and real interest rates in 1995, which acted towards more dynamic economic growth. However, due to the structural problems that highly developed countries are facing with, the unemployment rate remained relatively high, and some tendencies for acceleration of the inflationary pressures still persist. For overcoming the abovementioned problems, structural reforms of the labor market, social welfare, private sector restructuring, financial consolidation, etc. are necessary.

Table 1

International economic indicators

	GSP real increase in %			Inflation (retail price increase in %)			Unemployment in %			Balance of payments in billion USD		
	1993	1994	1995	1993	1994	1995	1993	1994	1995	1993	1994	1995
Industrial countries	1.1	3.1	2.6	2.9	2.3	2.4	-	8.1	7.7	-29	-6	-19
European Union	-	2.8	2.6	-	2.9	3.0	-	11.6	11.2	-	-	-
USA	3.1	4.1	2.9	3.0	2.6	2.8	-	7.2	6.9	-100	-151	-176
Germany	-1.2	2.9	2.6	4.5	2.7	1.8	-	9.6	9.4	-16	-21	-17
Japan	-0.2	0.5	0.5	1.3	0.7	-0.1	-	2.9	3.2	131	129	116
Countries in transition	-9.1	-8.9	-1.6	675	301	148	-	-	-	-3.3	-1.8	-7.6
Central and East. Europe	-	-3.0	1.1	-	150	75	-	-	-	-	-	-
Developing countries	6.1	6.4	6.0	43	48	20	-	-	-	-99	-68	-64

Source: IMF, World Economic Outlook (October 1995), previous data

According to the previous data, in 1995, the increase of *developing countries* social product was between 6.0% and 6.5%. This was mainly due to the successful stabilization and reform efforts, as well as to the abundant foreign capital inflow into these countries. However, continuation of high growth rates unsustainable in the long run for those economies, could cause inflationary pressures, especially in some of the Asian countries where the 1995 economic growth level was more than 8.0%.

The basic generator of the economic growth in the developing countries in 1995, was the foreign capital inflow from private creditors and foreign governments. Thus, the total capital inflow into developing countries in 1995, amounted to USD 180 billion, of which the most intensive inflow has been recorded in Asian developing countries (USD 95 billion). The foreign capital inflow in Europe (including the Middle East) was much more moderate and amounted to USD 13 billion. Most of the capital inflow in 1995 was in a form of a direct investment (39.5% of total investments) and portfolio investments (19.7% of total investments).

As for the *countries in transition*, where the process of structural reforms has the most intensive dynamics, the output started to increase in 1993 (Slovenia, Poland), and in 1994 (Czech Republic, Hungary, Slovakia). In the other countries in transition, the process of the economic revitalization begun in 1995. Thus, in the countries in transition from the Central and Eastern Europe, the long-lasting declining trend of the economic activity was finely decelerated, so that the social product in these countries increased significantly by 1.1%, or by 4.7% (excluding Russia, Belarus and Ukraine). If, the scope of observation is extended to the countries in transition from Africa and Asia, the output in the countries in

transition in 1995 remained in a zone of negative values of around 1.6%, being 5.6 times lower decrease compared to the previous year.

The performance of the European countries in transition differed, depending on the degree of the undertaken restructuring, privatization and stabilization processes. Thus, at the top of the most successful countries in transition are the Czech Republic, Poland, Slovenia, Hungary, Estonia and Slovakia, which, due to the successfully implemented reforms, foreign capital inflow, the impressive export growth and revitalization of productive investments, in 1995 achieved an average increase of social product of 5.2%. On the other side, the former Soviet Union countries and few other countries are still in a stage of desinflation, with an average 1995 output decline of 4.4%. Nevertheless, significant results with respect to the bringing down the inflation to two digits were achieved in these countries, which together with the acceleration of the economic and banking system reforms, as well as the cease of the military operations in these countries, or in their region, will result in the economic activity revival and positive growth rates in 1996.

The average price increase in *developed countries* during 1995 remained 2.4%, same as in previous year. In the European Union countries, the 1995 inflation rate was 3.0% per annum. At the same time, developing countries and countries in transition achieved extraordinary stabilization results, bringing down the inflation rate by one half compared to the previous year. Thus, in developing countries, price increase in 1995 was brought down to 19.7% per annum, which is by 2.4 times lower than the increase in 1994. In countries in transition, desinflation processes resulted in a lower average price increase from 301.0% in 1994 to 148.0% per annum, in 1995. In the European countries in transition, the average annual 1995 inflation rate was 75.0%, which is two times lower than the rate in 1994. Excluding Belarus and Ukraine, the price increase in countries in transition in Central and Eastern Europe in 1995, was 25.0% per annum.

The volume of the world trade continued the intensity of a high growth in 1995 increasing of about 9.0% compared to the previous year. Thus, the import increased by 8.0% (in industrial countries), or 11.4% (in developing countries). The export in developed countries in 1995 increased by 7.5%, while the export increase in developing countries was 12.4%.

Balance of payments data in 1995, indicate a deterioration and an increase of the deficit compared to 1994. Therefore, in 1995, the most developed industrial countries balance of payments deficit, was in total USD 19 billion, which is three times more than in the previous year. In 1995, the total balance of payments deficit in countries in transition was USD 7.6 billion, which was four times more compared to 1994.

II. Economic movements in the Republic of Macedonia in 1995

The 1995 economic program in the Republic of Macedonia resulted with significant results in the area of financial stability: inflation rate was brought down to one digit; denar nominal value compared to the Deutsche Mark remained almost unchanged; country foreign exchange reserves increased significantly; and, in real terms, the investment activity increased as well.

Achieved price stability, as well as the exchange rate in 1995 were significant reasons for creating sound financial frameworks as a prerequisite for economic activity intensification. The financial stability should act towards more intensive mobilization of domestic savings, and in that sense revitalizing the investment cycle.

Realization of high degree of financial consolidation in 1995, was a result of coordinated stabilization efforts of both monetary and fiscal policy, as well as of further reduction of personal consumption through restrictively designed wage policy. The coordination of fiscal and monetary policy was made through Budget funds transfers to a special stabilization fund with the National Bank of the Republic of Macedonia in order to protect the denar exchange rate. The creation of such fund for Central Bank interventions on the foreign exchange market has not only enabled purchase of the excess foreign exchange without an initiation of undesired monetary effects, but also enabled monetary instruments to be completely focused on a short-term regulation of deposit money banks liquidity.

During 1995, the fiscal sector had the key role in achieving high degree of financial stability. The consolidation of the Budget expenditures enabled the fiscal adjustment in 1995, so that Budget revenues and expenditures were balanced. Such an adjustment was a continuation of the trend that have started in 1994, when the Budget deficit was lowered from 11.1% in 1993 to 2.6% of the social product, in 1994.

The results of the stabilization efforts in 1995 are even more significant, if the intensive implementation of the banking system rehabilitation and economic restructuring are taken in the account due to unavoidable engagement of considerable quantity of funds for such purposes. In order to sustain on the restrictive stance and under conditions of unexpected defaults in revenues, in the first half of 1995, the fiscal policy has respond with additional stabilization measures, which until the end of the year have resulted in high adjustment of Budget revenues and expenditures.

The reforms in the real sector in 1995 were concentrated on three main areas: a) banking system rehabilitation; b) privatization and restructuring of social enterprises, so that by the end of 1995, 604 enterprises were completely privatized, and c) restructuring the biggest twenty five loss making enterprises in the country according to the special program. The program assumed certain dynamics of the activities that were supposed to result in the enterprises recovery, or, otherwise, in their liquidation.

Within the activities regarding the banking system rehabilitation, in 1995, the liquidation process of one of the biggest banks has started, finalizing the first two stages of bank rehabilitation (spinning off 5 bank branches in order to minimize its monopoly position, and replacing the non-functional assets from the bank's balance sheet with Government bonds). The third stage of the rehabilitation process of this bank, comprising its complete privatization (during 1995, 58.0% of its total value was

privatized), additional capitalization and change of the shareholding structure should be completed in 1996.

In 1995, a significant progress in relations with the foreign creditors was achieved. In July 1995, a rescheduling credit agreement was signed with the Paris Club under favorable conditions: a) for loans extended before the pre-cut-off date (02.12.1982), with period of repayment of 15.5 years, grace period of 4 years; and b) for loans extended after the pre-cut-off date, with period of repayment of 6.5 years, grace period of 3 years. In both cases, the interest rates would be negotiated on bilateral basis with creditor-countries. In the last quarter of 1995, the realization of this agreement has started by concluding of bilateral agreements with the governments of some of the countries. In May 1995, the second tranche of the STF arrangement (the IMF loan) was purchased and, as a result of successfully finalized negotiations with this international institution, an agreement for using the funds under the Stand-by arrangement, was signed. During May, October and December 1995 withdrawals of funds under this agreement were made, which taking into account the rigorous criteria for purchasing this credit arrangement was a confirmation of the credibility and success of the economic policy. That facilitate a number of other significant credit arrangements with international financial institutions. Furthermore, at the end of June 1995, the FESAC loan was approved (credit on structural adjustment of financial sector and enterprises) with the International Development Association (IDA) within the World Bank. During the second half of 1995, the first tranche of the credit was purchased. At the same time, the International Development Agency granted a credit for support of the social reforms in the Republic of Macedonia.

The economic activities in 1995 continued to be realized under unfavorable external conditions, whereas the blockade on transfer of people, goods and financial assets over the southern and northern border were removed later, in the last quarter of 1995. Apart from deteriorated transport corridors, the efforts to conquer new foreign markets continued. The economic events in the aftermath of the reestablishment of transfers of goods and services over the northern border, imposed the need of a new export strategy for entering the markets considered as traditional in the past, towards which the Macedonian economy was inclined due to its structure.

Under such circumstances, the 1995 economic activity in the country was in the zone of negative values emphasizing slower dynamics of its decline than in the previous years. The social product movements would have been satisfactory, if there was a statistical possibility to include completely the value added of the newly established private sector, as well as the important activity existing within the so-called "informal sector".

Among other problems the Macedonian economy has been facing with and which would be policy makers primary tasks in the following period, are large financial losses and liquidity problems of the economic agents. Moreover, for maintenance of a sustainable financial stability for a longer period of time, it is necessary the process of structural reforms to continue, as well as, to establish complete financial market to enable mobilization of significant financial resources, more optimal distribution of capital, etc. Regarding the nature of abovementioned problems, their solution would take longer period of time, and more efficient and intensive implementation of the process of economic system transformation, as well.

2.1. Gross Social Product

In 1995, the social product of the Republic of Macedonia amounted to 140.851 million Denar and with respect to the previous year it increased by 13.6% in nominal terms. The real social product (at constant 1990 prices) in 1995 declined by 2.0%. Cumulatively, the real social product of the country, compared to 1989 declined by 42.1%.

Table 2

Gross social product							
(in million denar)							
	1989	1990	1991	1992	1993	1994	1995*
Current prices	126	551	1.136	16.015	60.411	123.989	140.851
Constant 1990 prices	608	551	492	426	374	360	352
Indices:							
Current prices	1.576,0	436,2	206,4	1.409,7	377,2	205,2	113,6
Constant 1990 prices	101,9	90,6	89,3	86,6	86,8	96,1	98,0

Source: Republic of Macedonia Bureau of Statistics

*Estimates

Relatively slow restructuring of the real sector implied a decline in a labor productivity in 1995 as well, resulting in a decline of the real gross social product. The negative influence of this factor was also strengthened by few objective factors having an inhibitory effects on the economic activity: the blockades on the southern and northern border and the low level of domestic savings and investment. Nevertheless, the speed of the social product decline in 1995 was two times slower than in 1994, resulting in a continuing deceleration of the economic activity decline which commenced in 1994. Thus, after the sharp drop of the social product in 1992 and 1993 (13.4% and 14.1% respectively), in 1994, the real gross social product declined by 4.0%, while in 1995 the real decline was 2.0%. Taking into account the termination of the external blockades, the long lasting stability of the internal and the external value of the denar and the gradual relaxation of monetary policy, it is likely in 1996 to expect a recovery from the depression that lasted for years, and a positive economic growth.

Apart from the reversal in the declining trend of the social product, there are also other encouraging signs pointing out that economic recovery can be well expected in 1996. Namely, some positive movements in the industrial production are noticeable in the last quarter of 1995, a recovery of the investment and construction activities is realized, as well export increase, etc.

Analyzing the data for the economic activity, the fact that the official statistical data for the social product have been partly underestimated, because the value added of the newly established private sector has not been entirely included, due to the continued changes of the economic system and the time needed for adjusting the computation methodology. Certainly, the official statistics does not register the activities of the so-called "gray economy", characteristic for almost all economies in transition, and which were quite significant in the Republic of Macedonia in the last period due to the regional crisis.

2.2. Domestic output

The industrial output in the period January-December 1995, compared to the same period of 1994, declined by 10.7% which is identical to the decline in the previous year. On a December-December basis, the output in 1995 compared to the end of 1994 decreased by 4.2%.

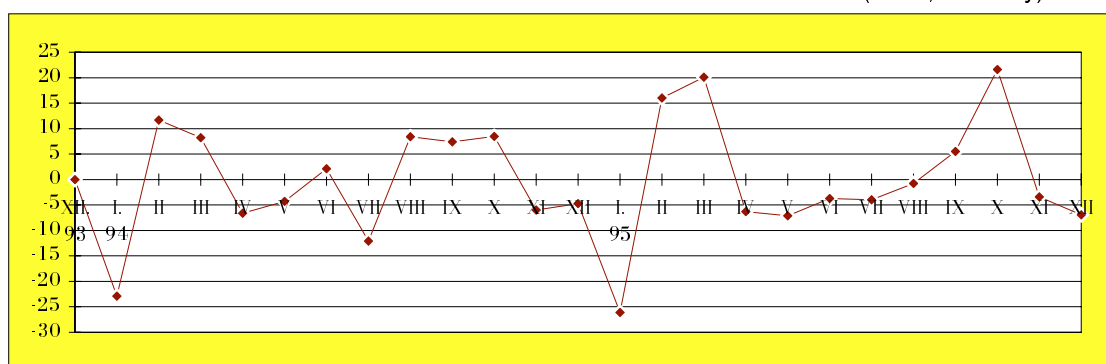
The decline of the industrial output in 1995 was a result of the following factors: a) this sector is the "most sensitive" one to the changes coming from the processes of ownership and structural reforms in the economy; b) extremely unfavorable impact of the external factor in the last three years, and, c) bad financial situation of the biggest social enterprises, which have determined significantly the industrial output performance in the Republic of Macedonia.

The smaller decline of the industrial output in 1995, on a December-December basis, compared to the same indicator derived from the annual averages, indicates initiation of certain positive movements during 1995. Thus, in four months in 1995, high positive rates of industrial output increase were registered, compared to the previous month, i.e.: in February and March a cumulative increase of 39.4% was realized, while in September and October together the industrial output increase by 28.3%. As for the rest of the months in 1995, the industrial output in the current month was lower than the output in the previous month. In general, due to the impact of the seasonal factors in certain months, the dynamics of the industrial output in 1995 were very much alike the ones in the previous year.

Chart 1

Total industrial output changes

(in %, monthly)



From a structural point of view, the biggest decline in 1995 of 18.0% occurred in the production of means of production, which is common for the economies undergoing economic system reforms. In the same period, the decrease of consumer goods production was 9.6% while the production of reproduction material had a lowest intensity of decrease in 1995 of 6.1%.

By industrial branches, in the period January-December 1995, only in six out of thirty-two industrial branches, positive rates of the production increase were realized. The biggest decline of the industrial output in 1995 was noticed in the engine industry (34.7%), metal industry (32.9%), wood processing industry (30.2%), textile industry (24.9%) and tobacco production and processing (22.6%).

The agricultural production increased in 1995 as well, alleviating the decline in the economic activity in the Republic of Macedonia. In the period January-December

1995, the agricultural output increased by 2.9%, which is by 5 percentage points lower increase compared to the excessive 1994. The actual rate of increase of the agricultural production in 1995 was equal to the long-term trend rate of increase of the production in this important economic activity in the Republic of Macedonia.

The inventories of the final products are an indicator for the phase of the cycle in which the economy of a certain country is. In the period January-December 1995, the final products inventories in the industry declined by 15.0% identically to the decline in the previous year. The decline resulted from the adverse movements of the inventories of particular kinds of industrial goods. Thus, unlike the decrease of the inventories of reproduction materials (by 18.1%) and of the inventories of consumption goods (by 14.6%), the inventories of the means for production in 1995 increased by 35.6%.

2.3. Labor market

Intensification of the process of structural and ownership transformation of the economic agents as well as productivity decline were the main factors which determined the labor market performance in 1995. Last year, both factors, enhanced by the drop of the economic activity influenced a further decrease in the number of employees and the rate of unemployment.

At the end of 1995, the number of employees in the Republic of Macedonia was brought down to 351,888, which is by 37,414 , or, 9.6% less than at the end of 1994. Taking into account the decline of the real wages in the same period by 8.0% and the industrial output decline by 10.7%, the decrease of the employment lowered the unit labor cost by 7.1%. It is a factor which influences the improvement of the international competitiveness of the Macedonian enterprises and partly alleviates their financial problems.

From the structural point of view, in the period January-December 1995, the number of employees in the economic activities declined by 12.0%, while the employment in the non-economic activities decreased by 1.0%.

Table 3

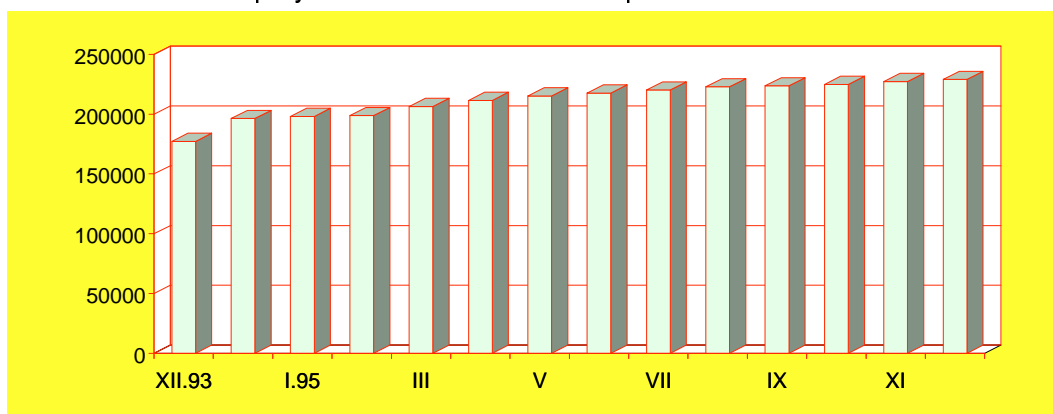
Total number of employees - indices with respect to December from the previous year -							
	1989	1990	1991	1992	1993	1994	1995
Total	100,8	96,0	94,2	94,3	93,4	95,3	90,4
-Economic activities	100,7	95,4	93,4	93,5	92,0	93,9	88,0
-Non-economic activities	101,1	99,1	97,8	97,8	99,3	100,8	99,0
Individuals seeking employment	101,2	103,8	104,7	103,9	102,2	110,8	116,6

Source: Republic of Macedonia Bureau of Statistics

At the end of 1995, the number of individuals looking for a work reached 228,952, which is 32,672 individuals (or 16.6%) more than in December from the previous year. Accordingly, the rate of unemployment at the end of 1995 was extremely high being 39.4%.

Chart 2

Unemployed individuals in the Republic of Macedonia



The high increase of the unemployment rate in the Republic of Macedonia is due to the lay-off of the excess labor as a part of the enterprises restructuring process, as well as to the many years declining economic activity. However, it has to be taken into account that the official statistics does not register the workers employed in the private sector not reported as employed by their employers. Changing of the regulation at the beginning of 1996 is expected to eliminate these failures and to provide more accurate picture of the situation on the labor market in the Republic of Macedonia.

2.4. Domestic Consumption

2.4.1. Public consumption

At the end of 1995, total revenues for financing of the public needs amounted to 63,277 million Denar, which, compared to the revenues collected in the period January-December 1994 dropped by 9.1% in real terms. The decline of the revenues for public consumption financing in 1995 is a consequence of the influence of a number of factors, of which the most significant are: a) decline of the real economic activity; b) bad financial results of the enterprises and real decline of wages as categories being a base for calculating part of the public revenues, and c) efforts to increase the disposable income of non-Government sector, and in that way increasing the amount of funds for savings and investment.

The intensity of decline of particular components in the total revenues for public consumption financing in 1995, was more pronounced in the revenues of the social funds, than in the Budget revenues. Thus, Budget revenues (customs duties, taxes and other revenues) being 63% of the total revenues, in the period January-December 1995 compared to the previous year nominally increased by 6.2%, meaning their real decline of 8.4%. In the same period, social funds revenues (taxes on profit, taxes on wages, etc.) nominally increased by 3.8%, or decreased by 10.4% in real terms.

2.4.2. Investment

Investments are a component of the total expenditures in the economy and a significant indicator for the future economic activity and for the potential aggregate supply in the national economy. At the same time, they are fundamental bearer of the

technical and technological progress resulting in productivity increase and economic growth of the country.

The 1995 data indicate significant recovering of the investment activity in the Republic of Macedonia. Total investments in the Republic of Macedonia in the period January-December 1995 were 24,359* million Denar, which compared to the previous year increased by 7.0% in real terms. During 1995, the investors in the Republic of Macedonia invested an average monthly amount of 2,030 million Denar, or 1.2 times more than in the previous year. The increase of the intensity of investments resulted in an increase of the participation of investments into the social product from 15.5% in 1994 to 17.3% in 1995. These investment developments in 1995 are encouraging, indicating an existence of a tendency of economic recovery in the Republic of Macedonia.

Table 4

Investments in the Republic of Macedonia

	In million denar			Indices		
	1993	1994	1995	1993/92	1994/93	1995/94
Total:	10.876	19.637	24.359	411,8	180,5	124,0
Social sector	4.546	10.683	13.242	402,9	235,0	123,9
Private sector	6.330	8.954	11.117	418,4	141,4	124,2
Economic activities	5.562	12.476	15.923	434,7	224,3	127,6
Non-economic activities	5.314	7.161	8.436	390,3	134,7	117,8

Source: Republic of Macedonia Bureau of Statistics

In the period January-December 1995 compared to 1994, investments in the social sector increased by 6.9% in real terms, while the investments in the private sector, in the same period, increased by was 7.2%. Participation of the investments in the economic activities, in the social product, amounted to 11.3% at the end of 1995, being 1.5 percentage points higher than in the previous year. The biggest real increase occurred in the transport and communication sector (29.4%) as well as in the industry and mining (12.2%). During 1995, the investments in the non-economic activities increased by 1.6% in real terms, compared to the previous year. Thus, their participation in the social product reached 6.0%, which is 0.4 percentage points higher than their participation in 1994.

2.5. Wage policy

The efficient wage control was a significant component of the anti-inflationary program in 1995 as well. Namely, due to the still weak financial discipline of the economic agents, the operation of the Law for Wage and Pension Control introduced at the end of 1993, continued in the last year as well. Nevertheless, due to the intensified process of ownership structure transformation in 1995, the labor market segment where the law was being implemented was shrinking. At the same time, the relevance of the Law for Wage and Pensions Control in 1995 and in the future as well is expected to decrease as a result of the increased credibility of the non-accommodative monetary policy.

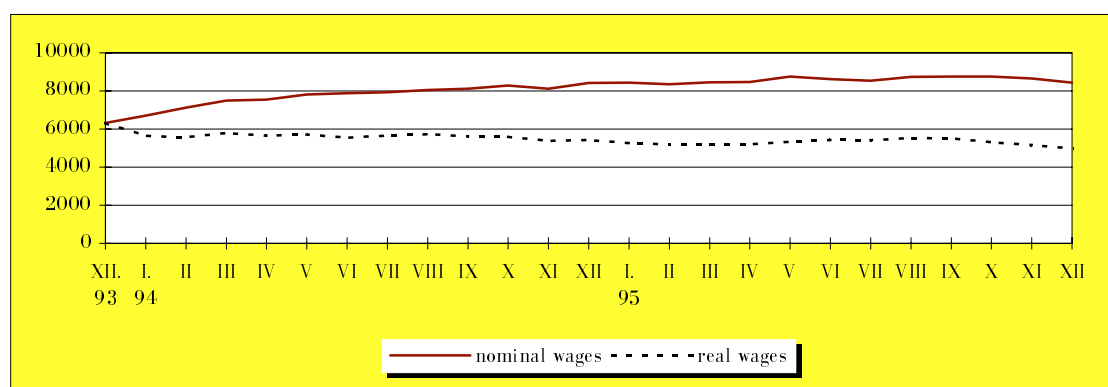
* Previous data

Wages and pensions payment control in 1995 resulted in a real wage decrease compared to the previous year. Thus, the average net paid wage per worker in the period January-December 1995 was 8,581 Denar, which compared to the average for the period January-December 1994 nominally increased by 10.7%. In real terms, compared to the average from the previous year, the average net wage in 1995 decreased by 4.5%.

By sectors, the decrease of the average wages in the period January-December 1995 was higher in the non-economic activities, where the real decrease amounted to 10.2%. At the same time, the average real wage in the economic activities in 1995 was lower by 3.1% compared to the previous year. Accordingly, during 1995, there were convergent movements in the average net wages in the economic and non-economic activities, and a discrepancy of 21.9% in 1994 (in favor of the non-economic sector), was brought down to 12.9% in 1995.

Chart 3

Average paid net wage per worker



If net wages paid in December 1995 are compared to the wages paid in December 1994, the average net wage per worker at the end of 1995 is nominally higher by 0.1%, which in real terms is an decrease of 8.0%. Due to the significant nominal and real decrease of the wages in the economic activities in December 1995, tendencies for reducing the discrepancy between the wages in the economic and non-economic activities were not neutralized, and the discrepancy actually increased. Thus, the net paid wages per worker in the economic activities, in December 1995, were lower in real terms compared to the wages paid in December 1994 by 9.3%, while the real decrease of the wages in the non-economic activities in the same period was 5.7%.

2.6. Price movements

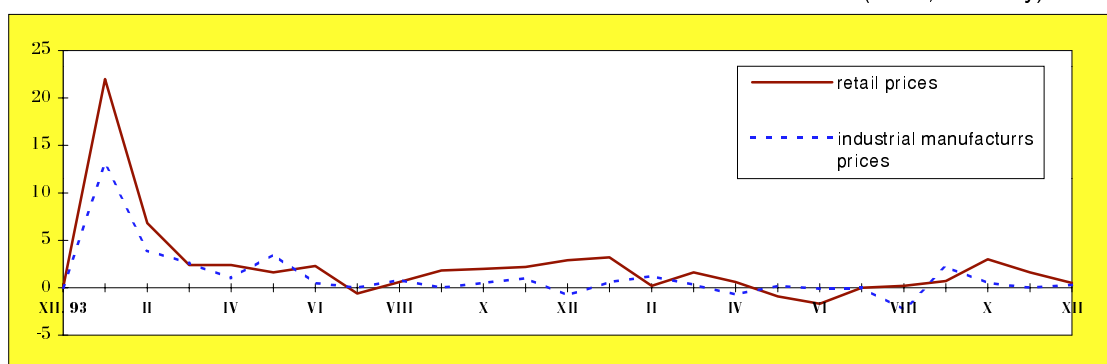
Financial stability is the most significant result of the 1995 economic program. The inflation rate measured by the annual increase of the retail prices (December 1995/December 1994) was brought down to one digit of 9.2%, on annual level or 0.7% per month. If the seasonal factor influence is eliminated, the trend inflation rate for 1995 was brought down to an average of 0.5% per month, or, 6.2% per annum. Thus, the average increase of the prices in the period January-December 1995, compared to the average of the retail prices in 1994, was 15.9%.

The actual inflation rate in the Republic of Macedonia in 1995 was eight times lower than the inflation rate in other countries in transition from Central and Eastern Europe. Compared to the inflation rates in the six most developed countries in transition, as well as in the developing countries, price increase in the Republic of Macedonia was by 2.1 times lower than in the previous year. However, compared to the most developed countries, the inflation rate in the Republic of Macedonia in 1995 was higher by 6 percentage points on annual level.

High price stability in 1995 was a result of the coordinated anti-inflationary measures of monetary and fiscal policy, supported by the foreign exchange rate policy. For bringing down the inflation and maintaining price stability in 1995, the personal consumption was restricted by the control of the wage increase.

Chart 4

Retail prices and industrial manufacturers prices changes
(in %, monthly)



Regarding the dynamics, with exemption of January and October, when, due to the seasonal factor and the correction of the prices under control (electricity), the monthly rate of inflation was 3.2%, and 3.0% respectively, and in May and June, when the seasonal factor influence was reversed (deflation of 0.9%, and 1.7% per month, respectively), in the rest of the months in 1995, low and stable rates of inflation were realized.

Table 5

Current price increase
- indices December to December of the previous year -

	1989	1990	1991	1992	1993	1994	1995
Retail prices	2.863,4	220,5	329,7	2.025,2	329,6	155,4	109,2
Industrial products							
Retail prices	2.832,5	202,4	357,9	2.055,7	310,7	138,8	106,5
Manufacturers' prices	2.957,8	141,8	381,5	2.248,6	276,1	128,6	102,2
Agricultural products	2.379,1	260,4	261,9	2.546,4	263,0	187,4	87,1
Prices of services	3.225,5	306,8	244,6	1.746,1	434,6	196,0	120,9
Cost of living	2.945,1	215,6	313,4	1.880,3	348,2	155,4	108,8

Source: Republic of Macedonia Bureau of Statistics

From a structural point of view, the movements of the retail prices of agricultural and industrial products were divergent. Thus, the prices of agricultural products in the period January-December 1995, decreased by 12.9% supporting the downward tendency of the inflation rate and its maintenance on a low level. The drop of the agricultural products prices was due to the increased supply, resulting from the

impossibility for finding complete replacement for the traditional markets where the products were exported. Retail prices of industrial products in 1995, moderately increased by 6.5%, while the industrial producers increased their prices by only 2.2%.

Costs of living at the end of December 1995, compared to December 1994 increased by 8.8%. The highest increase of the costs of living occurred in January and October, when, due to the seasonal factor and the increase of expenses for electricity and heating, the costs increased by 3.3% and 3.5% per month, respectively. On the other side, in June and July, the seasonal factor influence on the costs of living reversed reducing them by 2.9% and 0.6%, respectively. In the rest of the months in 1995, the increase of the costs of living was maintained stable. Compared to the average living costs in 1994, the consumer basket in 1995 was in average more expensive by 15.7%.

III. Monetary policy

3.1. Monetary policy objectives and tasks

Creation of stable financial conditions by further inflation rate reduction and, based on that, animation of the economic activity, were the basic objectives of the economic program in 1995. Monetary policy, together with the fiscal and wage policy, were integral components of a comprehensive stabilization program followed by appropriate structural reforms. During the definition of the monetary strategy for 1995, the monetary authorities have followed the standard concept: final objective - intermediary targets - indicators - operative instruments.

Primary ultimate objective of the monetary policy in 1995 was strengthening the domestic currency stability, i.e. further reduction of the inflation rate. This assumed creation of restrictive monetary frames, where it should be taken into account that money supply is to be maintained to the level sufficient for normal performance of the economic transactions.

As during the previous year, in 1995, basic intermediary objectives of the monetary policy were reserve money and money supply M1 in its narrowest sense. The money supply M1 projection was based on evaluated real money demand and projected inflation rate. Due to deteriorated functioning of transmission mechanism, as well as the impossibility for precise money supply governance, a strategy for reserve money governance was adopted. Reserve money is a monetary aggregate upon which, the National Bank of the Republic of Macedonia by adjusting its monetary mechanism can have the most direct and highest impact. The projected reserve money increase in 1995 was determined on basis of the estimated need for the money supply and of the monetary multiplier.

Due to the fact that managing reserve money is necessary, though not sufficient condition for realization of the assumed money supply increase, in 1995 implementation of direct monetary control instrument, i.e. ceilings on banks denar credits has been projected. The use of the credit ceilings in monetary practice in the Republic of Macedonia enabled a high degree of money supply control and governance, regarding direct and relatively precise relation between this monetary aggregate and the ultimate monetary policy objectives. Thus, due to the insufficient financial sector development, as well as the lack of sophisticated financial markets, the banking sector (not the capital market) has a dominant role in the intermediation between savings and investment. Hence, limitation of the credit multiplication process, implicitly means money supply regulation in the national economy.

Realization of monetary policy during 1995 was projected under conditions of flexible exchange rate regime. Thus, exchange rate movement was projected to be the basic indicator for the money supply and money demand imbalance, i.e. of the optimum stance of the monetary policy. Therefore, the eventual depreciation of denar exchange rate, which is not a result of fundamental balance of payments deterioration, was to be an indicator for loose monetary frameworks. That would implicitly mean a need for more restrictive monetary policy stance. In a case of permanent real money demand increase, it would be manifested at the foreign exchange market through an increase in foreign exchange supply and a decrease in foreign exchange demand, resulting into strengthening the external value of the domestic currency.

In addition, at the beginning of 1995, as a consequence of rigid monetary policy, high nominal and real interest rates, and partially due to the crisis in the region, it was projected that there would be excess of foreign exchange supply, characteristic for 1994 as well. Monetary policy projection for 1995 assumed an intervention of the National Bank of the Republic of Macedonia at the foreign exchange market by purchasing the excess foreign exchange. Accordingly, although the exchange rate was set forth as endogenously determined monetary policy variable (i.e. determination of exchange rate based on market relations between the supply and demand), an endeavor for avoiding nominal denar appreciation and further loss of competitiveness of Macedonian economy has been made.

The efforts to maintain stable nominal exchange rate, without endangering the monetary targets realization, it was projected the National Bank of the Republic of Macedonia to adjust the implementation of its operative instruments to the current situation of the foreign exchange market. Regarding the fact that the evaluated volume of necessary foreign exchange market interventions was beyond the monetary instruments capacity, it was projected that the monetary frameworks for such intervention would be provided through Budget funds deposited into a special fund with the National Bank of the Republic of Macedonia. Besides, it was assumed the Central Bank to undertake the role of the Government agent by transferring Government deposits from deposit money banks to the National Bank of the Republic of Macedonia.

In accordance with those global provisions, the fundamental monetary policy objective for 1995 was defined as curbing the inflation rate to 17.8% per annum, with an assumed mild increase of the real social product of 0.8%.

As a result of more intensive decrease of the inflation rate compared to the expectations, and, based on that, enhanced real money demand, in September 1995 basic assumptions of the monetary policy projection were revised. Thus, the revised target of retail prices increase was set forth on annual level of 8.0%, while a real drop of 4.0% was assumed for the social product. Based on the revised assumptions for the real variables, the targeted increase of the basic monetary aggregates through which monetary policy influence the realization of ultimate economic objectives was also revised:

Table 6

Projection of basic real and monetary variables for 1995

(in percentage)

	first projection	revised projection
1. Inflation	17,8	8,0
2. Social product	0,8	-4,0
3. Exchange rate	flexible	flexible
4. Reserve money	10,5	14,5
6. Denar credits	10,1	12,3
7. Money supply M1	18,9	23,0
8. Denar exchange rate support fund (in million denar on 31.12.1996)	2.437	2.237
9. Net foreign exchange assets (increase in million denar)	2.805	1.757

According to the revised projection, the nominal money supply M1 increase for 1995 was projected to be 23.0%. Based on assumed monetary multiplier, it was

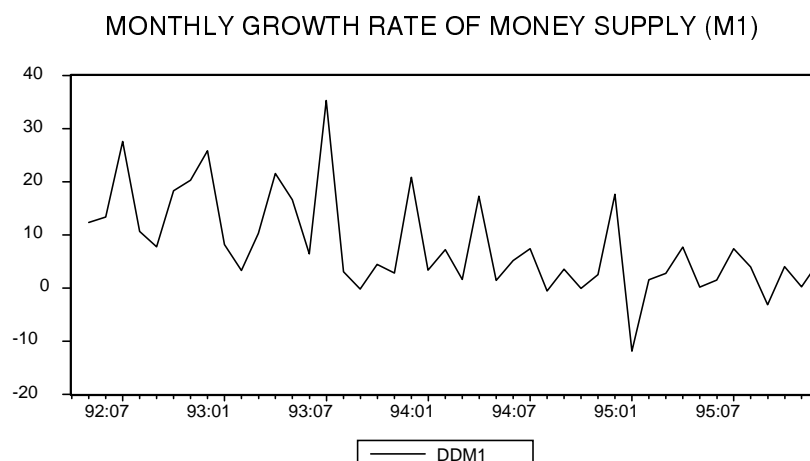
defined that for the realization of this target it is necessary reserve money to increase by 14.5% at the end of 1995, compared to December from the previous year. Revised target of banks denar credits assumed an increase of 12.3% (December 1995/December 1994). Government deposits for support of the monetary policy and denar exchange rate, were projected to be 2,237 million Denar at the end of 1995, enabling sterilizing interventions of the National Bank of the Republic of Macedonia on the foreign exchange market, meaning, purchase of projected surplus of USD 52.5 million.

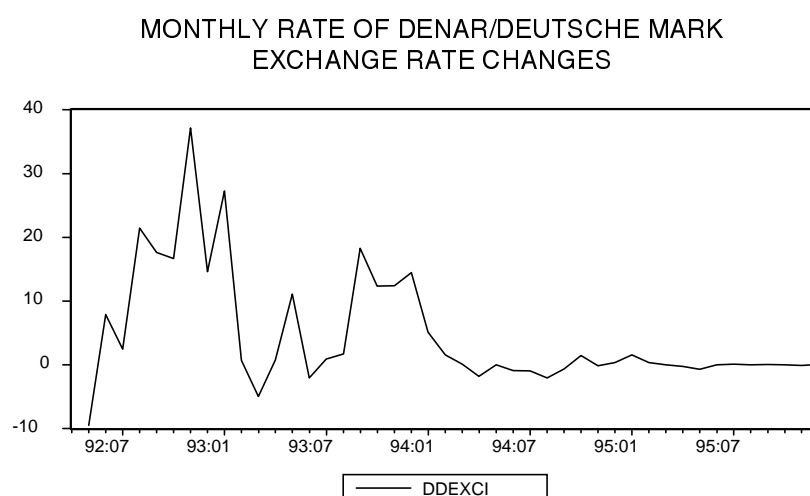
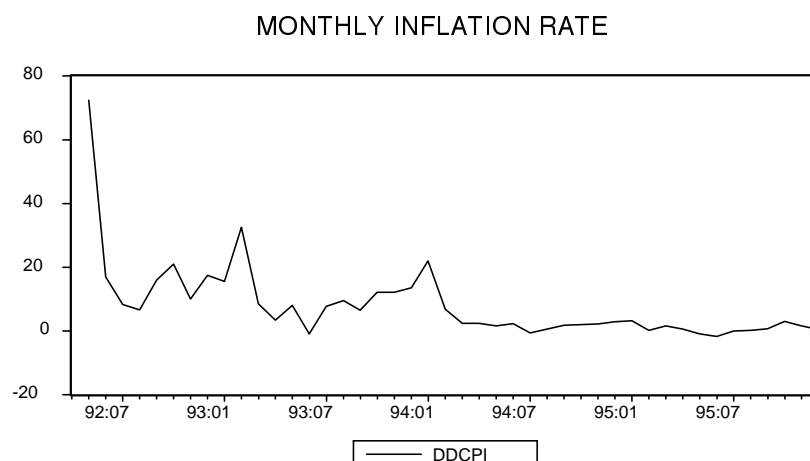
The discount rate of the National Bank of the Republic of Macedonia in 1995 was projected to follow the trend inflation rate, increased by 5 percentage points per annum, as real part. Thus, the intention was "stop-and-go" interest policy to be avoided. This implies that the high interest rates will be the basic instrument for defending denar exchange rate. However, after the inflation rate would be brought down and the inflationary expectations suppressed, the discount rate and consequently, the interest rates of deposit money banks would start to decrease gradually.

3.2. Financial movements in 1995

Basic feature of the economic movements in the Republic of Macedonia in 1995, was the realization of extremely high financial stability. Thus, due to the open economy approach as a prerequisite for development under conditions of territorial and market constraints, denar exchange rate is significant factor that determines the external trade volume. Simultaneously, it is basic nominal anchor upon which all other nominal variables in the economy depend. The analysis of the mutual relationship among the inflation rate, monetary aggregates and denar exchange rate in the Republic of Macedonia indicates that the correlation between the exchange rate and inflation is stronger compared to the correlation between the inflation rate and monetary aggregates.

Chart 5





According to the expectations, for the imbalance between foreign exchange supply and demand on the foreign exchange market to continue during 1995 (before that, for two years in a row there was enormous surplus of foreign exchange compared to the demand), monetary policy has been oriented to prevent the appreciation of the domestic currency in wider dimensions, without jeopardizing the realization of basic monetary targets. Such an objective of the monetary authorities in 1995 was completely realized. Namely, nominal effective denar exchange rate as a weighted average of the Deutsche mark and the American dollar in 1995, appreciated by 3.0%. Thus, compared to the Deutsche mark, in 1995, the denar depreciated by 1.2%, while compared to the American dollar in the same period, the denar appreciated by 7.3%.

The strengthening of the real effective denar exchange rate in 1995 was a result of the impact of the following factors: a) enhanced real denar demand, which caused increased foreign exchange supply on the foreign exchange market; b) significant foreign exchange inflow due to the credits and aid from abroad; c) high interest rates on denar financial instruments, and d) foreign exchange inflow due to the regional crisis. The impact of the abovementioned factors determined higher foreign exchange inflow on the foreign exchange market compared to the foreign exchange outflow caused by the trade balance deficit, whose overall effect resulted in constantly higher foreign exchange supply on the foreign exchange market in relation to the demand. In addition, the atrophied economic and banking system did not succeed to turn that foreign exchange into real demand and to direct them into productive investments. Under such circumstances, the purchase of the excess foreign exchange by the

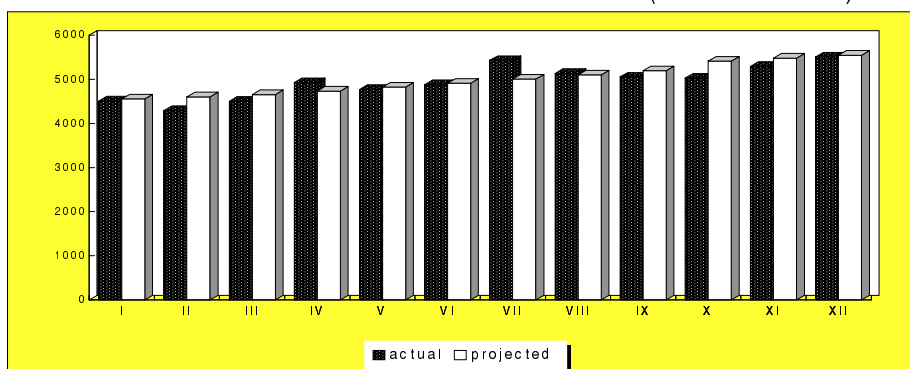
National Bank of the Republic of Macedonia, enabled accumulation of significant amount of foreign exchange reserves.

The purchase of foreign exchange surplus on the foreign exchange market by the National Bank of the Republic of Macedonia in 1995, was enabled through a transfer of Government deposits to a special fund with the Central Bank, aimed to support the monetary policy and denar exchange rate. By end-November 1995, the Budget met its obligation transferring deposits to the National Bank of the Republic of Macedonia in amount of 2,237 million Denar. Thus, it enabled an increase of net foreign exchange reserves of the National Bank of the Republic of Macedonia by USD 64.0 million, of which USD 60.5 million through purchasing foreign exchange on the foreign exchange market, and USD 3.5 million through net inflow of foreign exchange on the Government external account. Thus, at the end of 1995 foreign exchange reserves of the National Bank of the Republic of Macedonia amounted to USD 210.6 million, which is equal to two-month export value. Besides the creation of monetary frameworks for a sterilized intervention on the foreign exchange market by transferring Government funds to the National Bank of the Republic of Macedonia, at the same time, there was complete direction and utilization of monetary instruments for balancing short-term oscillations of the deposit money banks liquidity potential.

Reserve money, in its narrowest sense, as basic intermediary objective of the monetary policy in 1995, was under complete control of the National Bank of the Republic of Macedonia. The increase of the seasonally adjusted aggregate in 1995 amounted to 661 million Denar, or 13.6%. Thus, at the end-December 1995, reserve money amounted 5,510 million Denar, being by 40 million Denar, or, by 0.7% below the target determined in the monetary policy projection. This implied, that even under difficult circumstances (due to narrower frameworks for new primary issue, suboptimal dispersion of liquid assets among banks and too ample foreign exchange inflow), primary intermediary target of the monetary policy in 1995 was completely within the projected frameworks. In addition, this also met one of the indicative criteria for the accomplishment of the Stand-by arrangement with the International Monetary Fund.

Chart 6

Projected and actual level of reserve money
(in million denar)



Regarding the accepted monetary regulation concept, money supply considered as second intermediate target of monetary policy in 1995, was determined by reserve money increase and changes in real money demand. In the period January-December 1995, money supply M1 increased by 2,668 million Denar, or by 27.9%. Thus, at the end of 1995, money supply M1 was 12,229 million Denar, which is by 471 million Denar, or by 4.0% above the projected target.

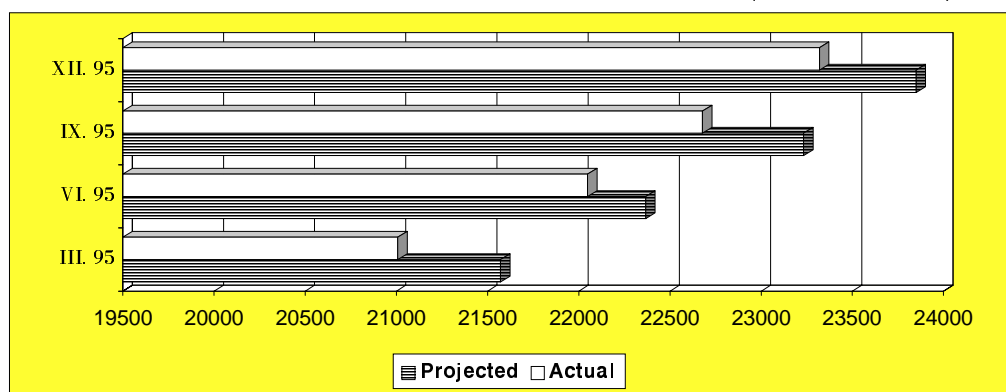
Increased money supply at the end of 1995, compared to the projected one, was a result of the following factors: a) larger amount of the currency in circulation compared to the projected one by 118 million Denar, or by 2.3%; b) transfer of savings deposits into demand deposit due to the inflation rate and nominal interest rates decrease, i.e. lower opportunity costs for holding the funds in a liquid, but low interest bearing forms. Thus, the amount of transaction deposits that economic subjects held at their deposit accounts within the monetary system at the end of 1995 was by 353 million Denar, or, by 5.4% higher than the projected; and, c) innovations in the deposit money banks operations. Namely, in mid-1995, to the clients that have not made payments within a given number of days, deposit money banks begun to calculate and to pay interest on their giro-accounts, the same as the interest for one month denar time deposits. This caused increase of the demand for demand deposit, and, consequently, of the demand for money supply M1.

The average monthly increase of money supply M1 in 1995 was 2.1% which was two and a half times lower than the increase in 1994. Under the conditions of realized average monthly price increase of 0.7% (being 0.5% on permanent basis), higher average money supply increase was not expansion of monetary policy, but, simply a reaction to the significant strengthening of the real money demand, which was a result of a drastic decrease of the inflation and suppressed inflationary expectations. Hence, a part of money supply was actually in a function of the commenced process of remonetarization of economy, meaning that it allowed productive filling of the financial channels exhausted in the previous period.

In 1995, the ceilings of the bank credits were also maintained as one of the monetary regulation instruments regarding the deteriorated impact of transmitting mechanism in the monetary area. At the same time, this monetary aggregate was one of the quantitative criteria for accomplishment of the Stand-by arrangement with the International Monetary Fund.

Chart 7

Projected and actual level of domestic denar credits
(in million denar)



Increase of the bank denar credits to the private and social sector, during 1995 was completely maintained within the projected frameworks. At the end of 1995, the new denar credits under ceilings, were 16,792 million Denar. Together with the non-performing claims on bank denar credits undertaken by the Government during the process of bank rehabilitation (in April, the principal of non-performing denar credits in amount of 4,905 million Denar was transferred, and, in November, the doubtful and contested claims on non-performing credits in amount of 1,238 million Denar were transferred as well), and selective credits used to write-off the non-performing credits (in amount of 384 million Denar), bank denar credits amounted to 23,320 million Denar

by the end-1995. Compared to end of 1994, the increase of banks new denar credits in 1995 amounted 2,089 million Denar, i.e. 9.8%. In comparison with the allowed ceilings, on 31 December 1995 bank denar credits were by 530 million Denar, or by 2.2%, lower, than the allowed limit by the monetary policy projection.

In addition, this has partly neutralized the money supply creation from larger foreign exchange purchase on the foreign exchange market compared to the projected figure, by US\$ 8.0 million. In case all available ceilings were used for denar credits increase, the increase of money supply would have been by 1,000 million Denar, or by 8.5% above the projected level (instead the actual exceeding of 470 million Denar, or 4.0%). That would have created monetary imbalance, enhancement of inflationary pressures and pressure on the exchange rate, endangering the realization of the criteria envisaged under the Stand-by arrangement.

IV. Monetary and credit movements

4.1. Money supply creation and withdrawal

National Bank of the Republic of Macedonia influence on the price stability is realized through two channels: a) on the one hand, through money supply control, it can influence lowering the demand for goods and services, which determines price stability and b) on the other hand, through the foreign exchange market and interest rates, where through denar supply equal to the volume of commodity-money transactions, it can maintain a stable foreign exchange demand. That is oriented towards maintenance of a stable exchange rate, with a retroactive impact on the prices stability. The money demand projection is based on the assumed price and social product movements, as well as on the assumption for the real money demand in the national economy. The maintenance of balanced money supply with money demand, is achieved through reserve money governance, and with the assumed monetary multiplier. Simultaneously, due to deteriorated function of the transmission mechanism and imperfect interest rate as a factor for balancing the supply of and demand for money, the implementation of credit ceilings continued in 1995, which was in a function of money supply governance.

The determination for further inflation rate reduction in 1995, implied money supply growth deceleration. Seasonally adjusted money supply M1 in the period of January-December 1995 has increased by 2,668 million Denar, or by 27.9%. In accordance with that, an average monthly increase of money supply M1 in 1995 amounted to 2.1%, being 2.5 times lower than in the previous year. Besides the deceleration of the monetary growth rate in 1995, the money supply enabled optimum real activity performance, being by 19.5 percentage points higher than the increase of commodity-money transactions in the economy. Nevertheless, it did not result into inflationary pressures increase, due to the fact that the higher money supply increase with respect to the volume of transactions enabled only a gradual remonetarization of the economy.

At the end of 1995, money supply M1 amounted to 12,229 million Denar, which is by 471 million Denar, or by 4.0% above the projected level for 1995. Higher actual money supply increase, compared to the projected one, was due to the strengthened real money M1 demand, which was by 16 percentage points higher than the projected. The increase of real money demand in 1995 was a result of the drastic inflation decrease, suppressed inflationary expectations of the economic entities, high exchange rate stability and reduced opportunity costs for holding interest-free liquid funds. This resulted in a transfer of the rest of non-monetary deposits into financial instruments comprising money supply M1 in its narrowest sense. Thus, at the end of 1995, demand deposits reached an amount of 6,948 million Denar, by 5.4% above the projected amount. Simultaneously, currency in circulation at the end of December 1995 amounted to 5,281 million Denar, which was by 29.6% higher than at the end of 1994, and, by 118 million Denar above the expected increase.

Regarding the dynamics, money supply increase was the most moderate in the first quarter of 1995 (by 106 million Denar, or by 1.1%). This was in accordance with the seasonal dynamics of real economic activity, which, measured through the physical volume of the industrial production in this period, had the most intensive decline (18.6%). It was reflected in a demand deposits decrease of 60 million Denar in the first

quarter of 1995, whereas currency in circulation was of a moderate increase of 166 million Denar. In the period of April-December 1995, money supply increase had more intensive dynamics. Therefore, in the last three quarters of 1995, there was a total increase of money supply M1 of 2,562 million Denar, or by 26.5%. On average, in each of these three quarters, money supply increased by 854 million Denar, or, by 8.2%. At the same time, the dynamics of currency in circulation increase was more intensive in the second and in the fourth quarter of the year, and, the demand deposits had their most intensive growth in the third and the fourth quarter of 1995.

As in the previous years, the basic sources for the money supply creation in 1995 were net foreign assets of the monetary system, and deposit money banks credits. In addition, quantifying the impact of abovementioned sources on the money supply creation was more difficult due to writing-off of the banks foreign exchange claims and liabilities regarding the credits from the Paris and Zurich Club, as a phase of the banking system rehabilitation process and replacement of non-performing denar credits of the biggest bank in the Republic of Macedonia with Government bonds, as part of its rehabilitation.

Table 7

Money supply (M1) creation and withdrawal ¹⁾

	Position 31.12.94	Quarterly changes (in million denar)					Position 31.12.95	Factors of growth in %			
		I	II	III	IV	Total		03.95 12.94	06.95 12.94	09.95 12.94	12.95 12.94
M1 (excluding Government sector)	9.561	106	921	870	771	2.668	12.229	1,1	10,7	19,8	27,9
Net foreign assets 2/	-9.652	-308	5.253	1.839	13.759	20.543	10.891	-3,2	51,7	71,0	214,9
Domestic credits	75.425	4.203	-3.955	2.772	-15.881	-12.861	62.564	44,0	2,6	31,6	-134,5
Deposit money banks credits	73.698	5.258	-3.610	3.329	-14.509	-9.532	64.166	55,0	17,2	52,1	-99,7
- in denar	54.375	3.752	-571	1.526	-6.881	-2.174	52.201	39,2	33,3	49,2	-22,7
-in for. exchange 2/	19.323	1.506	-3.039	1.803	-7.628	-7.358	11.965	15,8	-16,0	2,9	-77,0
NBRM, credits to Government, net	1.727	-1.055	-345	-557	-1.372	-3.329	-1.602	-11,0	-14,6	-20,5	-34,8
Other items, net	-44.777	-3.276	-1.164	-3.733	2.825	-5.348	-50.125	-34,3	-46,4	-85,5	-55,9
Non-monetary deposits	-11.435	-514	789	-8	68	335	-11.100	-5,4	2,9	2,8	3,5

1)(+) Money supply (M1) creation

(-) Money supply (M1) withdrawal

2/ Positions valued at constant exchange rate (end of December 1993 1USD=44.4558); flows valued at current exchange rate.

4.1.1. Net foreign assets

In 1995, net foreign assets of the monetary system increased by 20,543 million Denar, of which 16,458 million Denar was a result of writing-off the foreign exchange liabilities of deposit money banks to creditors from the Paris and Zurich Club, while, 4,085 million Denar was a real increase of net foreign assets with monetary effects. Out of which, 3,265 million Denar was an increase of the National Bank of the Republic of Macedonia net foreign assets, and, 820 million Denar was real increase of net foreign assets of deposit money banks. The autonomous growth of net foreign assets of 4,085 million Denar resulted in a money supply creation of 42.8%, of which, the increase of net foreign assets with the National Bank of the Republic of Macedonia (3,265 million Denar) determined money supply creation of 34.2%, while, net foreign assets of deposit money banks reflected money supply creation of 8.6%.

The dynamics of net foreign assets in 1995 was highly determined by the writing-off the banks foreign exchange liabilities to creditors from Paris and Zurich Club. Besides, the net foreign assets changes were significantly influenced by the changes (increase) of net foreign assets with the National Bank of the Republic of Macedonia in particular periods of the year. Thus, in the second and in the fourth quarter, when the writing-off foreign exchange liabilities to the Paris and Zurich Club creditors from the banks balance sheets was done, the net foreign assets of the monetary system have increased by 5,253 million Denar and 13,759 million Denar, respectively. Apart from writing-off, the high increase in the last quarter of 1995 was also influenced by the National Bank net foreign assets increase of 1,340 million Denar. In the third quarter of 1995, net foreign assets of the monetary system have increased by 1,839 million Denar, mainly due to the National Bank net foreign assets increase of 1,114 million Denar. In the first quarter of 1995 total net foreign assets have decreased by 308 million Denar, while the National Bank net foreign assets have increased by 458 million Denar, and the net foreign assets of deposit money banks decreased by 766 million Denar.

4.1.2. Bank credits

In 1995, monetary system credits, not taking into consideration the changes that resulted from writing-off (i.e., without foreign exchange claims decrease as an offsetting accounting entry for the foreign exchange liabilities writing-off towards the Paris and the Zurich Club creditors, as well as without the writing-off the non-performing denar credits of the biggest bank and their partial replacement with the Government bonds), were the source of money supply creation. Thus, in the period January-December, the total monetary system credits have increased by 4,437 million Denar 1995, whose monetary effect resulted in money supply creation of 46.4%. However, if writing-off is taken into account, total deposit money banks credits have decreased by 9,532 million Denar, in the period January-December, 1995.

Within total credits of deposit money banks, denar credits granted to the Government decreased by 10 million Denar on gross basis. If the partial replacement of non-performing credits of the biggest bank with Government bonds is taken into account, as well as the amount of Government deposits within the deposit money banks, in 1995, Government credits have increased by 4,865 million Denar on net basis.

Deposit money banks denar credits granted to the private and social sector in 1995, had a real increase of 4,447 million Denar, determining the money supply creation of 46.5%. If the autonomous movements are corrected for the accomplished accounting settlements, this category would show a decline of 7,039 million Denar in the observed period.

New denar credits granted to the non-Government sector are a monetary policy instrument through which directly money supply growth is controlled. At the same time, the increase of these credits is one of the criteria which should be met for realization of the Stand-by arrangement with the International Monetary Fund. In the period January-December 1995, banks new denar credits, as a result of autonomous movements, have increased by 2,089 million Denar, or 9.8%. The actual denar credits increase was completely within the monetary projection frameworks and according to the conditions of the Stand-by arrangement. Due to the precise and direct relation between the movements of this aggregate and the money supply, denar credits maintenance within the projected limits for 1995 was particularly significant for efficient realization of the monetary policy.

If changes of denar credits to the private and social sector which are result of writing-off non-performing credits of the biggest bank (in total amount of 6,528 million Denar) are shown, this category declined by 4,439 million Denar in 1995.

Table 8

Deposit money banks domestic credits

(in million denar)

	Position					Quarterly changes				
	31.12.94	31.03.95	30.06.95	30.09.95	31.12.95	I	II	III	IV	Total
Domestic credits	73.698	78.956	75.346	78.675	64.166	5.258	-3.610	3.329	-14.509	-9.532
<i>1. In denar</i>	54.375	58.127	57.556	59.082	52.201	3.752	-571	1.526	-6.881	-2.174
a) Government credits, net	-625	-456	3.574	3.307	4.240	-1.081	4.030	-267	933	4.865
- credits	78	68	4.899	4924	4.924	-10	4.831	25	0	4.846
- interest	786	885	84	53	34	99	-801	-31	-19	-752
- Government deposits	-1.489	-1.409	-1.409	-1.670	-718	80	0	-261	952	771
b) Priv. and social sector credits	55.000	58.583	53.982	55.775	47.961	3.583	-4.601	1.793	-7.814	-7.039
- credits	21.231	21.008	16.759	17.389	16.792	-223	-4.249	630	-597	-4.439
- interest	33.769	37.575	37.223	38.386	31.169	3.806	-352	1.163	-7.217	-2.600
<i>2. In foreign exchange */</i>	19.323	20.829	17.790	19.593	11.965	1.506	-3.039	1.803	-7.628	-7.358
- Government	9.417	9.872	8.489	9.240	5.578	455	-1.383	751	-3.662	-3.839
- Private and social sector	9.906	10.956	9.301	10.353	6.387	1.050	-1.655	1.052	-3.966	-3.519

*/ Positions valued at constant exchange rate end-December 1993 (1USD=44.4558); flows valued at current exchange rate.

Based on accounting data, banks foreign exchange credits decreased by 7,358 million Denar during 1995. This category decrease was due to the writing-off deposit money banks claims on the Government and non-Government sector, as an offsetting entry of the writing-off banks foreign exchange liabilities to Paris and Zurich Club from banks balance sheets. However, if the abovementioned writing-off is not taken into account, deposit money banks foreign exchange credits in 1995 have increased by 327 million Denar, or by 1.7%. The largest part of this increase was due to an increase of banks foreign exchange credits granted to the private and social sector (by 292 million Denar, or by 2.9%), while foreign exchange credits granted to the Government in 1995 have increased by 35 million Denar only, or by 0.4%.

4.1.3. Non-monetary deposits

Unlike previous years, total non-Government non-monetary deposits (comprising foreign exchange and denar sight deposits, time-deposits of and more than a year and restricted deposits) in 1995, have decreased in nominal and real terms. At the end of 1995, total non-monetary deposits were 11,100 million Denar, being by 335 million Denar, or, by 2.9% less than in December 1994. Deflated with the inflation rate (for denar categories) and with the exchange rate (for foreign exchange components), non-monetary deposits have declined in real terms by 5.9% compared to the previous year. Therefore, instead using the non-monetary deposits for money supply M1 withdrawal, in 1995, they were a source of money supply creation in its narrowest sense of 3.5%.

Table 9

Non-monetary deposits

(in million denar)

	Positions					Quarterly changes				
	31.12.94	31.03.95	30.06.95	30.09.95	31.12.95	I	II	III	IV	Total
Total non-monetary deposits	11.435	11.949	11.160	11.168	11.100	514	-789	8	-68	-335
in denar	6.298	6.431	6.474	6.301	6.192	133	43	-173	-109	-106
in foreign exchange	5.137	5.518	4.686	4.867	4.908	381	-832	181	41	-229
I. Quasi deposits	8.813	9.160	8.558	8.532	8.136	347	-602	-26	-396	-677
in denar	3.727	4.028	4.053	3.880	3.491	301	25	-173	-389	-236
in foreign exchange	5.086	5.132	4.505	4.652	4.645	46	-627	147	-7	-441
II. Other non-monetary deposits	2.622	2.789	2.602	2.636	2.964	167	-187	34	328	342
in denar	2.571	2.403	2.421	2.421	2.701	-168	18	0	280	130
in foreign exchange	51	386	181	215	263	335	-205	34	48	212

Non-monetary deposits decline in nominal and real terms in 1995, was due to the influence of the following factors: a) transfer of non-monetary into monetary deposits as a consequence of lower opportunity cost for holding funds in more liquid forms. Preference of holding more liquid but interest free funds by economic entities, is due to suppressing the inflationary expectations and based on that strengthened real money demand, and due to the interest rates decrease; b) ceasing the foreign exchange substitution process of assets (which households kept out of the financial system) into denar financial instruments, as a consequence of passive interest rates decrease; and, c) decline of the households total income and the economic agents income in real terms, as well as high income differentiation among classes. This resulted in lack of real financial potential and in low propensity for saving of lower income classes, while higher income classes under conditions of unsophisticated financial market and still unrecovered confidence in the banking institutions were more inclined to turn their holdings into real estate, rather than incorporating it in financial channels.

Regarding the dynamics, non-monetary deposits movements varied, and consequently, they had changeable impact on money supply M1 creation and withdrawal. Namely, in the first and the third quarter in 1995 they have acted towards money supply withdrawal, regarding the realized non-monetary growth in these intervals. On the other side, in the second and fourth quarter of the previous year, a transfer of non-monetary into monetary deposits has occurred, which was source of money supply M1 creation.

With respect to the non-monetary deposits currency denomination, denar non-monetary deposits were of a higher intensity of real decline compared to foreign exchange deposits. Thus, in the period January-December, 1995, total non-monetary denar deposits nominally decreased by 106 million Denar, or by 1.7%, which was a real decrease of 10.0%. Within the denar categories, highest decline was realized in short-term denar deposits (technically defined as quasi denar deposits), that in the observed period nominally decreased by 6.3%, or by 14.2% in real terms. In the same period, together long-term denar deposits and restricted denar deposits nominally increased by 5.1%, which was a real decline of 3.8%.

During January-December 1995, foreign exchange non-monetary deposits had a nominal decline of 4.5%, that deflated with the weighted denar exchange rate was a real decline of 1.0%. In addition, short-term foreign exchange deposits have declined in nominal and real terms by 8.7%, and 5.4%, respectively, while long-term foreign exchange non-monetary deposits and restricted foreign exchange deposits in 1995 increased by 15.5% in real terms.

The dynamics of denar and foreign exchange non-monetary deposits in 1995, was different. Namely, in the first half of the year, denar non-monetary deposits have increased, mainly as result of the high real interest rates. However, in the second half of the year, when the interest rates were significantly lowered and the non-accommodative monetary policy concept has achieved its highest results, the economic agents interest for saving their funds in long-term financial instruments has declined. The foreign exchange non-monetary deposits decline in 1995, was result of their decrease in the second quarter of the year, while in all other quarters they had a dynamics of moderate increase. The foreign exchange non-monetary deposits dynamics in 1995, was also stimulated with the foreign exchange policy measures, which have enabled foreign exchange purchase on the foreign exchange market by the enterprises for payment of the goods and services imported.

4.2. Relation between money supply and inflation

Monetary aggregates control and management are in a function of realization of the ultimate economic policy objectives, among which the inflation rate has a dominant place. The existence of a relation between the movements of particular monetary aggregates and the inflation rate, as well as the direction and the intensity of such correlation, are subject to constant monitoring and research by the monetary policy makers.

The average monthly increase of the inflation rate in 1995 was 0.7%. In the same period, money supply M1 - the narrowest defined monetary aggregate, was increasing in average by 2.1% on a monthly level. Accordingly, the relation between the basic intermediary monetary policy target and the inflation rate in 1995 was in average 3:1, showing lower degree of correlation between these two categories compared to 1994, when their ratio was 1.4:1.

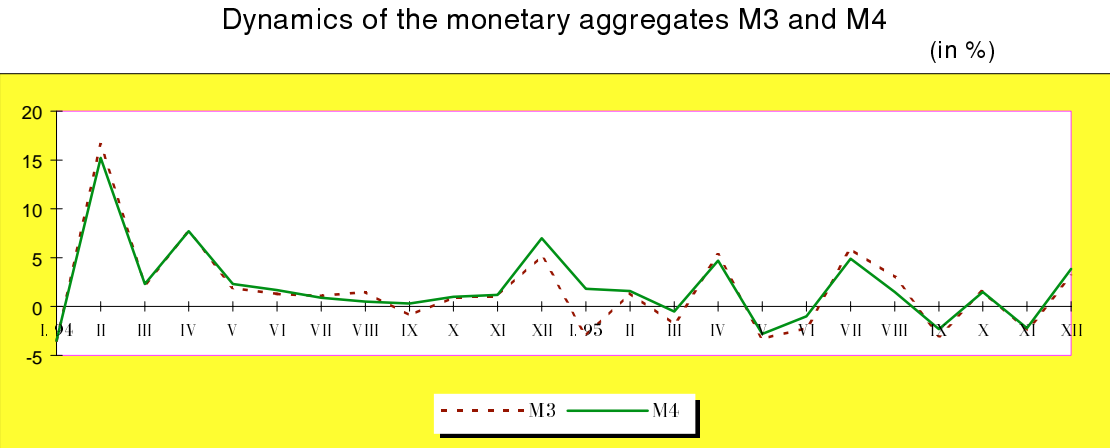
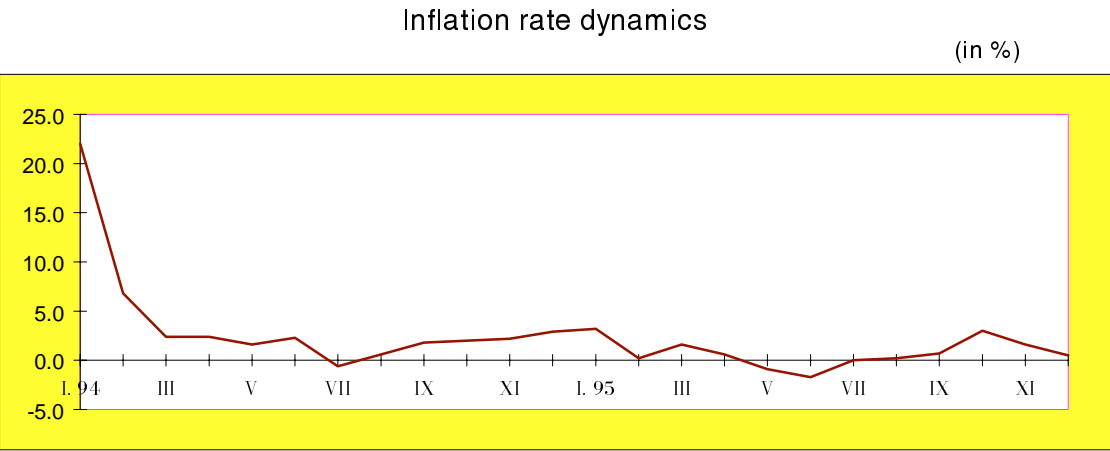
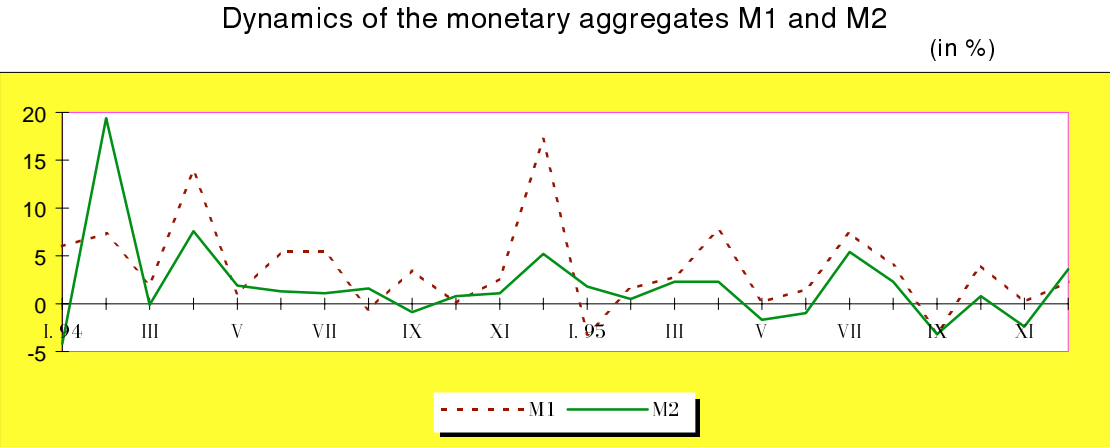
The analysis pointed out to a high stability of money supply M2 movement during 1995. The average monthly increase of money supply M2 (that besides the currency in circulation and demand deposits, i.e. money supply M1, comprises denar and foreign exchange quasi deposits, as well) in 1995 was 0.8%. Accordingly, the coefficient of the relation between money supply M2 and the inflation rate for 1995 was 1.1:1, showing high degree of coordination between inflation rate and this aggregate movements, in the Republic of Macedonia. This statement would be supported, if the monitoring horizon is extended to the previous year as well, when the correlation coefficient between the monetary aggregate M2 and the inflation rate was 0.7:1.

High stability degree of money supply M2 and the inflation rate movements in 1994 and 1995 pointed out the possibility to use money supply M2 as the indicator for the monetary policy stance, besides the denar exchange rate. Namely, the exchange rate was accepted as the most appropriate indicator for the monetary policy stance, because of the advantage to be followed on daily basis, which gives an possibility for prompt and clear monetary policy signals to be given to the economic entities. Nevertheless, the exchange rate was more acceptable as an indicator and as the basic nominal anchor in the economy under the conditions of insufficient credibility of the monetary and economic policy in general, which has been a case of the Republic of Macedonia shortly after gaining its monetary independence. However, with the achieved high degree of financial stability and strengthening the economic policy credibility, the analysis of the correlation between the money supply M2 and the

inflation showed a possibility to use this monetary aggregate in the future as a basic nominal anchor and as an indicator for the monetary policy stance.

The average monthly growth of the monetary aggregate M3 in 1995 was 0.8%, meaning that the relation of this aggregate to the inflation rate was similar to the one of the monetary aggregate M2. This results from the small amount of restricted deposits, by which these two monetary aggregates differ.

Chart 8



Monetary aggregate M4, as the broadest money supply definition in the Republic of Macedonia comprises the monetary aggregate M3 plus long-term time deposits. An average monthly growth of this monetary aggregate in 1995 was 0.9%. Accordingly, the coefficient of the ratio between the increase of the money supply M4 and the inflation rate in 1995 was 1.3:1, presenting somewhat smaller correlation of this monetary aggregate and the inflation rate compared to 1994, when the coefficient was 0.9:1.

V. Reserve money creation and withdrawal

5.1. Reserve money

The monetary strategy of the National Bank of the Republic of Macedonia in 1995, was based on a management of the reserve money in its narrowest sense (currency in circulation and giro-accounts as well as cash in vaults of the banks), as a monetary aggregate upon which the most direct and strongest impact is made through the monetary policy measures. Seasonally adjusted reserve money supply in the period January - December 1995 increased by 661 million Denar in nominal terms, or, by 13.6%, which deflated by the retail price index, presented a real increase of 4.0%. The average monthly nominal reserve money increase in the previous year was 1.1%, being four times lower than the one in 1994. At the same time, the average monthly reserve money increase in 1995 was two times lower than the average monthly increase of the money supply. The main reason for that was the high increase of the money multiplier, due to the decrease of the banking system liquidity.

Table 10

Reserve money, the narrowest definition ^{1/}

(in million denar)

	Position 31.12.94	Quarterly changes					Position 31.12.95	Factors of growth in %			
		I	II	III	IV	Total		03.95 12.94	06.95 12.94	09.95 12.94	12.95 12.94
Reserve money (narrowest definition)	4.849	-343	374	174	456	661	5.510	-7,1	0,6	4,2	13,6
- currency in circulation	4.075	166	472	143	425	1.206	5.281	3,4	13,2	16,1	24,9
- giro-accounts and cash in vaults	774	-509	-98	31	31	-545	229	-10,5	-12,5	-11,9	-11,2

1/ + reserve money creation

- reserve money withdrawal

From the point of view of its dynamics, in the first quarter of 1995, reserve money decreased compared to end of 1994, due to the reduction of too high denar bank liquidity at the beginning of the year. After reaching the optimum liquidity level, in the rest of 1995, the supply of the reserve money was continually increasing with the higher intensity in the second and the forth quarter of the year.

The reserve money management, in the first half of the 1995, was realized under difficult conditions, due to the following factors: a) the high level of the bank liquidity when banks entered 1995, and when the need for reducing the liquid assets surplus narrowed the framework of a new primary issue; b) extremely high imbalance between the supply of and demand for foreign exchange on the foreign exchange market, forcing the National Bank to intervene in order to prevent nominal appreciation of the exchange rate. Although with some difficulties, with a combination of monetary and fiscal policy measures the whole foreign exchange surplus on the foreign exchange market was purchased, without losing the control over reserve money and, c) suboptimal dispersion of liquidity among banks under conditions of non-existence of a developed interbank market for balancing short-term liquidity oscillations, has deteriorated monetary policy instruments efficiency. Under such conditions, the National Bank of the Republic of Macedonia, as a lender of last resort, was forced to intervene in short intervals to supplement the liquidity potential of illiquid banks, although the global liquidity level was within satisfactory framework, not imposing a

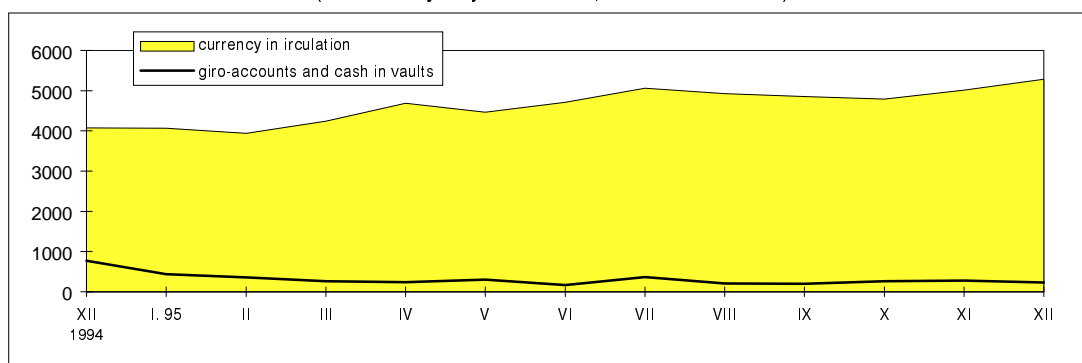
need for intervention. However, the National Bank of the Republic of Macedonia succeeded through an optimal coordination of the monetary policy instruments to sterilize the monetary effects of these operations.

In the second half of 1995, especially in the period September-December, more favorable conditions have been created for control and management of the reserve money, due to the following factors: a) revised monetary target under agreement with the International Monetary Fund in August and September 1995, enabled certain monetary policy relaxation in the last quarter of the year; b) in the last quarter of 1995 the Budget eliminated the delays, characteristic for the previous period of 1995, with respect to the dynamics and the intensity of transferring the funds to the National Bank of the Republic of Macedonia projected for foreign exchange market interventions. Thus, at the end of November, Government funds with the National Bank of the Republic of Macedonia for denar exchange rate support, amounted to 2,237 million Denar, meaning realization of the amount projected in the monetary policy projection. At the same time, the total quantum of public sector deposits with the National Bank of the Republic of Macedonia was increased with the transfer of the funds of the ministries and other users of Budget funds, from deposit money banks to the Central Bank in amount of 1,809 million Denar and c) implementation of the banking system rehabilitation process, which, comprised, among other, measures for liquidity improvement and projection of the liquidity movements of the biggest bank in the Republic of Macedonia.

Reserve money components in 1995 had divergent movements. Seasonally adjusted currency in circulation in the period January-December 1995 increased from 1,206 million Denar, or by 29.6%. In the same period, banks liquid assets decreased by 545 million Denar.

Chart 9

Currency in circulation and bank liquid assets
(seasonally adjusted data, in million Denar)



High currency in circulation increase in 1995 was a result of the influence of number of factors: a) decrease of denar savings interest rate, meaning a decrease of the opportunity cost for holding a part of the property in liquid, interest free form; b) real money demand strengthening due to the drastic decline of inflation and suppression of the inflation expectations; c) wages and pension payments in the Republic of Macedonia, where a significant percentage out of total payments is still made in cash; d) lack of developed system of credit cards, automatic teller machines and other sophisticated non-cash payment instruments in the banking practice; and, e) large portion of the so-called "gray economy" in total payments, where for many reasons the use of cash is the most appropriate form for settlement of such transactions. Besides, currency in circulation movements were determined by the influence of the seasonal factor as well. Oscillations of the currency in circulation

demand, being of a seasonal character, in the course of 1995 have been successfully anticipated and neutralized with the operational instruments of the monetary policy.

5.1.1. Bank liquidity

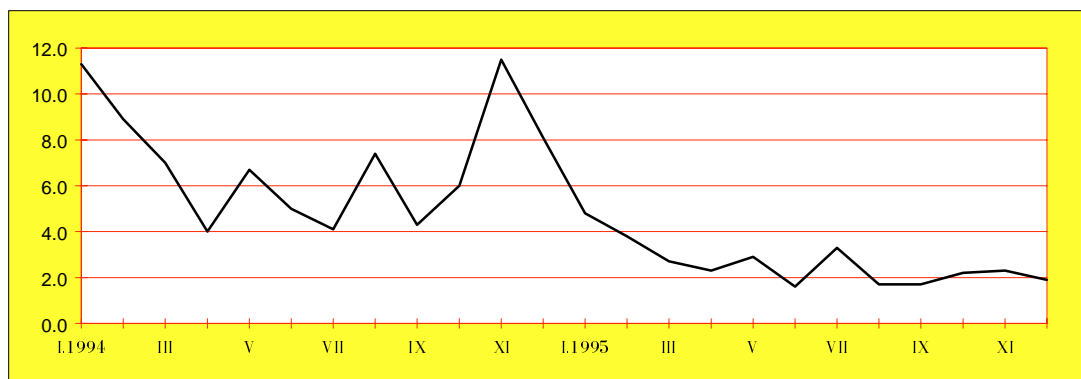
Total bank liquidity is usually measured by the position of bank giro-accounts and their cash in vaults, by monitoring the use of secondary sources of liquidity (interbank credits, compulsory reserve) and the use of liquidity credits, as well as credits for payment of savings deposits.

Banks in the Republic of Macedonia entered 1995 with extremely high level of primary liquidity (giro-accounts and cash in vaults). In accordance with the restrictive concept of the monetary policy, the National Bank of the Republic of Macedonia intention was to reduce gradually the primary liquidity rate, without deteriorating the realization of the projected increase of the monetary aggregates for 1995. Although as a whole, this objective of the monetary authorities has been realized, the high oscillations of the banks liquidity in certain periods of the year, as well as the extremely imbalance dispersion of the bank liquidity, have significantly jeopardized the daily operationalization of the monetary policy.

Based on the projection of the needed liquidity level, in the first half of 1995, gradual decrease of the liquid assets of the banking system commenced. Thus, banks giro-accounts and cash in vaults in this period decreased by 607 million Denar, or by 78.4%. In the second half of 1995, a satisfactory global level of liquidity was achieved, and the liquid assets of the banks in the Republic, excluding the impact of the seasonal factor, have moderately increased by 62 million Denar, or by 37.1%. In this way, banks giro-accounts and cash in vaults at the end of 1995 reached an amount of 229 million Denar, or 1.9% of the money supply M1. In 1995, the average monthly participation of the banks giro-accounts and cash in vaults in the money supply M1 was 2.6%, being 2.7 times below the adequate participation in 1994. From the dynamic point of view, after the adjustment of the banks liquidity in the first quarter of 1995, in the period April-December, a relatively high stability of the banks liquidity rate with respect to the money supply M1 (excluding the seasonal oscillations in May and July) was achieved, with an average participation of the liquid funds in the money supply M1 of 2.2%.

Chart 10

Share of the bank liquidity in money supply M1
(seasonally adjusted data, in percent)



Similar to 1994, the dispersion of the liquid assets among banks in the Republic of Macedonia, was extremely imbalance in 1995 as well. It created contradictory

situations in a sense of achieving satisfactory level of global bank liquidity on one hand, and a need for intervention by the National Bank of the Republic of Macedonia, on the other hand, to provide additional funds to the liquidity potential of banks under rehabilitation process (resulting from its institutional function as a lender of last resort). Nevertheless, with an efficient combination and dosage of the instruments for reserve money issue and withdrawal, these short-term conflict situations during 1995 were successfully solved.

Simultaneously, profiling of the bank liquidity in 1995 was complicated also because of the transfer of the public sector deposits from deposit money banks to the National Bank of the Republic of Macedonia. Taking into account the high concentration of the Government deposits with only few banks, public sector deposits withdrawal had to be made carefully, in order for this operation not to create negative effects for the liquidity of the particular banks. Therefore, public sector deposits withdrawal that was made in several steps (in March, June, September, October and November 1995), was compensated with parallel injection of funds through the auctions of deposits. Thus, the effects from the Government deposits withdrawal on the bank liquidity were successfully neutralized.

5.1.2. Net foreign assets of the National Bank of the Republic of Macedonia

The analysis of the assets side of the balance sheet of the National Bank of the Republic of Macedonia shows that in 1995, reserve money creation has been realized mainly through the foreign exchange transactions.

In the period January-December 1995, net foreign assets of the National Bank of the Republic of Macedonia, as a difference between the foreign assets and foreign liabilities increased by 3,265 million Denar, or by 51.7%. It resulted in reserve money creation in the period under observation, of 67.4%. The net foreign assets increase was a result of the purchase of the foreign exchange surplus on the foreign exchange market, resulting in increase of the National Bank of the Republic of Macedonia foreign exchange reserves by US\$ 60.5 million, as well as of the net foreign exchange inflows on the external account of the Government (meaning higher inflow of funds from donations and foreign aid with respect to the payments for servicing the external debt of the country) in amount of US\$ 3.5 million.

Table 11

Reserve money creation and withdrawal ^{1/}

(in million denar)

	Position 31.12.94	Quarterly changes					Position 31.12.95	Factors of growth in %			
		I	II	III	IV	Total		III.95 XII.94	VI.95 XII.94	IX.95 XII.94	XII.95 XII.94
Reserve money	4.849	-343	374	174	456	661	5.510	-7,1	0,6	4,2	13,6
Net foreign assets ^{2/}	6.316	458	354	1.114	1.340	3.265	8.532	9,4	16,7	39,7	67,4
-Foreign assets	7.248	450	1.225	1.114	1.604	4.393	10.591	9,3	34,5	57,5	90,6
- Foreign liabilities	932	8	-870	0	-265	-1.127	2.059	0,1	-17,8	-17,8	-23,2
Domestic credit	3.142	-9	-739	-898	186	-1.460	1.682	-0,2	-15,4	-33,9	-30,1
Other items net	-3.743	-84	964	83	-612	351	-3.392	-1,7	18,1	19,9	7,2
Instruments	-758	-721	-218	-113	455	-597	-1.355	-14,9	-19,4	-21,7	-12,3
Other deposits	-108	13	13	-12	-912	-898	-1.006	0,3	0,6	0,3	-18,5

1/ + reserve money creation
- reserve money withdrawal

2/ Positions valued at constant exchange rate (end December 1993 1USD = 44.4558); flows valued at current exchange rate.

Regarding the dynamics, net foreign assets of the National Bank of the Republic of Macedonia in 1995, had a trend of a continual increase, with more pronounced

intensity of the increase in the second half of the year. Thus, in the first half of 1995, net foreign assets increase amounted to 812 million Denar, or 12.9%, determining reserve money creation of 16.7%. In the period July-December, net foreign assets increased by 2,454 million Denar (or 34.4%), resulting in a reserve money creation of 43.4%.

5.1.3. National Bank of Republic of Macedonia credits

Denar credits to deposit money banks in the period January-December 1995, increased by 1,869 million Denar, or by 132.2%. Accordingly, as in the previous year, they influenced reserve money creation of 38.5%. In the same period, net credits to the Government decreased by 3,329 million Denar, due to the transfer of Government deposits to the National Bank of the Republic of Macedonia and the creation of a fund for monetary support of the exchange rate. As a result of that, total credits of the National Bank of the Republic of Macedonia in 1995, decreased by 1,460 million Denar, influencing the reserve money withdrawal of 30.1%.

The dynamics of the denar credits to deposit money banks, was predominantly determined by the amount of reserve money issued through foreign exchange transactions. In the periods when the reserve money creation through the foreign exchange transactions was high, denar credits increase stagnated, and vice versa, during periods of lower reserve money creation through foreign exchange transactions, the increase of the denar credits to deposit money banks was more intensive.

Table 12

Domestic credit of the National Bank of the Republic of Macedonia^{1/}

(in million denar)

	Position 31.12.94	Quarterly changes					Position 31.12.95	Factors of growth in %			
		I	II	III	IV	Total		III.95 XII.94	VI.95 XII.94	IX.95 XII.94	XII.95 XII.94
Domestic credit	3.142	-9	-739	-898	186	-1.460	1.682	-0,2	-15,4	-33,9	-30,1
I./ Credits to banks	1.415	-1046	-394	-341	1.558	1.869	3.284	21,6	13,4	6,4	38,5
- Selective credits	659	0	-628	0	-8	-636	23	0,0	-13,0	-13,0	-13,1
- Deposits sold on auctions	0	1.074	542	-418	1.568	2.766	2.766	22,1	33,3	24,7	57,0
- Liquidity credits	180	-2	16	70	24	108	288	0,0	0,3	1,7	2,2
- Other credits	576	-26	-324	9	-26	-369	207	-0,5	-7,2	-7,0	-7,6
II./ Credit to Government, net	1.727	-1.055	-345	-557	-1.372	-3.329	-1.602	-21,8	-28,9	-40,4	-68,7
- Credits to Government	1.790	-67	-54	-5	-841	-969	821	-1,4	-2,5	-2,6	-20,0
- Government deposits	-63	-1.009	-802	-55	-154	-2.020	-2.083	-20,8	-37,3	-38,5	16,5
a) for monetary support	-63	-544	-561	-590	337	-1.348	-1.421	-11,2	-22,8	-35,0	-27,8
6) giro-account	0	-465	-241	535	-491	-662	-662	-9,6	-14,6	-3,5	-13,7
III./ External financing	0	21	511	-497	-375	-340	-340	0,4	11,0	0,7	-7,0

1/ + reserve money creation
- reserve money withdrawal

Within the credits to the banks in 1995, the most intensive reserve money creation was realized through the deposits sold on auctions. The reserve money creation through this monetary policy instrument in the period January-December amounted to 2, 766 million Denar. The amount of reserve money issued in particular periods of the year, was determined by the seasonal fluctuations of reserve money demand, by the effects from the foreign exchange transactions of the National Bank of the Republic of Macedonia, as well as by the efforts to neutralize eventual negative liquidity effects of the Government deposits transfer from banks to the National Bank of the Republic of Macedonia. Therefore, it was logical the most intensive reserve money increase to be realized in the periods when the transfer of Government deposits had a strongest intensity.

The deposits sold on auctions in 1995 were with a maturity from 1 to 7 days. Mainly, deposits were sold to the banks for 1 day, unlike the previous year, when the deposits were sold predominantly with maturity from 5 to 7 days. The interest rate on deposits sold on auctions in 1995, have been changed a number of times, as a result of the continual decrease of the discount rate, and the inflation rate. Thus, starting from 28.3% per annum, as the weighted interest rates for the deposits sold to the banks on auctions were at the beginning of 1995, they decreased to 16.0-18.0% per annum (depending on the periods) at the end of the year.

Reserve money in 1995 were also created as a result of the use of the National Bank of the Republic of Macedonia guarantee for denar savings of the citizens with the banks. In the period January-December 1995, the amount of reserve money created on this basis increased by 108 million Denar.

Selective credits and other credits in 1995, declined by 636 million Denar, and 369 million Denar, respectively. Selective credits decline was a result of their utilization in the rehabilitation process of the biggest deposit money bank, where the claim resulting from these credits has been transformed into the Bank Rehabilitation Agency bond. In the same context, as well, is the reduction of the long-term credits of the National bank of the Republic of Macedonia (as a part of the other credits), which was made in April, last year. As for the total amount of the credits used in the rehabilitation process of the abovementioned bank (1,039 million Denar), the Bank Rehabilitation Agency issued interest free bond to the National Bank of the Republic of Macedonia.

The second component of domestic credit is the Government net position with the Central Bank. In 1995, the Government net credit with the National bank of the Republic of Macedonia declined (actually turned into net liability of the National Bank to the Government) by 3,329 million Denar. It determined reserve money withdrawal of 68.7%. Thus, the total Government credit decreased by 969 million Denar, and was mainly due to the repayment of short-term credit of 826 million Denar, used by the Government in 1995.

Due to the need for coordinated action of both fiscal and monetary policy, in 1995, Government deposits were transferred from deposit money banks to the National Bank of the Republic of Macedonia. Government deposits transferred to the National Bank of the Republic of Macedonia comprise Government deposits for foreign exchange market interventions and exchange rate support, as well as the demand deposits (giro-accounts) of the Budget, ministries and other users of Budget funds.

In order to enable sterilizing interventions of the National Bank of the Republic of Macedonia on the foreign exchange market in 1995, Government funds in amount of 2,237 million Denar were transferred into a special fund. At the end of 1995, 826 million Denar of the funds deposited in that Fund were used by the Government for repayment of the short-term credit to the National Bank of the Republic of Macedonia. In the first nine months of 1995, Government funds transfer for monetary policy support was not accomplished in accordance with the projected dynamics, mainly due to the shortage of Budget revenues in that period. Nevertheless, in the last quarter of 1995, the Budget had completely eliminated the delay, so that the amount of Government deposits for foreign exchange market interventions met the projected target.

Beginning March 1995, the giro-account of the Budget was also transferred to the National Bank of the Republic of Macedonia, so that in average, in the period March-December, the Budget had an amount of 246 million Denar available on its giro account. In November, in accordance with the decision of the Government of the

Republic of Macedonia the demand deposits of the ministries, government institutions and agencies, social funds and of other users of Budget funds were transferred to the Central Bank as well.

At the end of 1995, on the external account (comprising payments in favor of the Government from foreign donations and foreign aid, etc., excluding the inflow of credit funds from the International Monetary Fund and the payments for servicing the external debt of the Republic of Macedonia), the Government had a claim from the National Bank of the Republic of Macedonia in amount of 340 million Denar. In the first half of 1995, the net position of the Government external account showed a liability of the Government to the National Bank of the Republic of Macedonia (less inflows than outflows in the relations with abroad), while in the second half of the year the movements reversed, meaning that the Government funds inflows were higher than the outflows.

5.1.4. Other deposits

Other deposits with National Bank of the Republic Macedonia comprise the deposits of economic agents not having agreements for depositing funds with any of the deposit money banks, and beginning November, the deposits of agencies, social funds, public sector institutions (schools, hospitals, etc.) and other institutions users of Budget funds. With the transfer of the deposits of these entities to the National Bank of the Republic of Macedonia, other deposits in the period January-December 1995, increased by 898 million Denar, causing a reserve money withdrawal of 18.5%. Actually, this effect was realized in the last quarter of 1995 (in November), when the deposits of the abovementioned entities were transferred to the National Bank of the Republic of Macedonia.

5.1.5. Instruments for reserve money withdrawal

The combination of particular instruments for reserve money withdrawal in 1995 was determined by the dynamics and the scope of the National Bank of the Republic of Macedonia interventions on the foreign exchange market, and, the interventions for maintaining liquidity of particular banks. Deposits purchased on auctions and National Bank bills were main instruments the National Bank of the Republic of Macedonia was using for sterilization of the monetary effects from the abovementioned interventions in 1995. Besides the auctions, as an "open market operations", for reserve money withdrawal, the traditional instrument - compulsory reserve was used as well. At the end of 1995, through the instruments for reserve money withdrawal, total amount of 1,355 million Denar was withdrawn, which is by 597 million Denar more than in December 1994. In that way, the reserve money decreased by 12.3%.

Table 13

Instruments for reserve money withdrawal ^{1/}

(in million denar)

	Position 31.12.94	Quarterly changes					Position 31.12.95	Factors of growth in %			
		I	II	III	IV	Total		III.95 XII.94	VI.95 XII.94	IX.95 XII.94	XII.95 XII.94
Instruments	-758	-721	-218	-113	455	-597	-1,355	-14.9	-19.4	-21.7	-12.3
- compulsory reserve	-758	192	168	-205	238	393	-316	4.0	7.4	3.2	8.1
- deposits bought on auction	0	-343	83	-122	-97	-480	-480	-7.1	-5.4	-7.9	-9.9
- auctions on Central bank bills	0	-569	-469	214	314	-510	-510	-11.7	-21.4	-17.0	-10.5

1/ + reserve money creation
- reserve money withdrawal

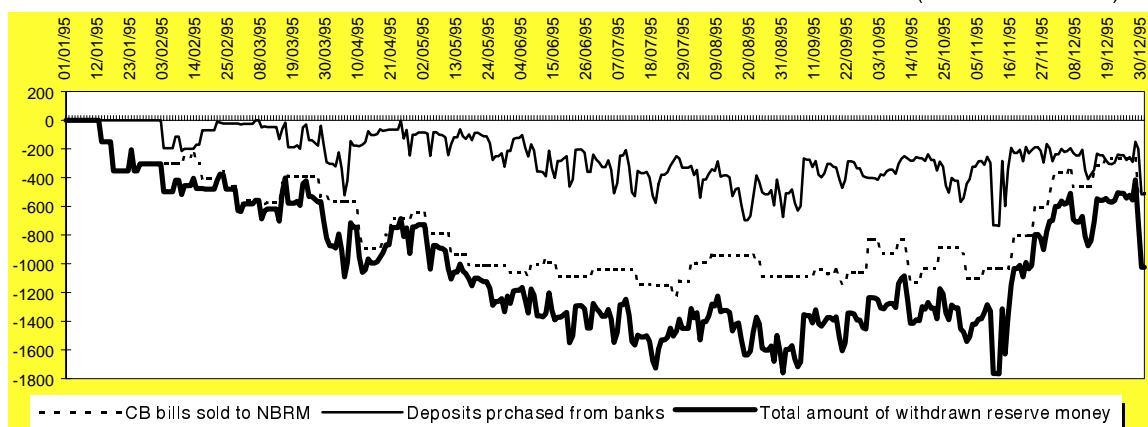
Through the deposits purchased on auctions and auctions on National Bank bills, in the period January-December 1995, in average amount of 1,044 million Denar has been withdrawn. At the end of 1995, reserve money in amount of 990 million Denar were withdrawn with these two instruments.

Through the auctions of the National Bank bills 510 million Denar were withdrawn, at the end of 1995. In 1995 with the sold National Bank bills, in average on a monthly basis, an amount of 748 million Denar was withdrawn, which is 15.1% of the average reserve money. The use of the auctions of the National Bank bills had a different dynamics and trend during last year. Thus, in average on a monthly basis 704 million Denar were withdrawn with this instrument in the first half of the year, so that at the end of June the amount of the National Bank bills subscribed reached 1,038 million Denar. In the second half of 1995, the amount of withdrawn reserve money with this instrument gradually decreased.

During 1995, as a result of the reduction of the discount rate, the interest rate for the National Bank bills sold on auction was gradually decreased. Thus, from 23.0% on an annual level, at the beginning of 1995, the interest rate of the National Bank bills was brought down to 12.0% per annum at the end of 1995. Thus, in the first half of 1995, National bank bills were mainly sold with maturity of 10-20 days, while, in the period July-December 1995 National bank bills were sold with a longer maturity from 32-45 days (in July and August) up to 60 days (in October, November and December).

Chart 11

Effects of the instruments for reserve money withdrawal
(in million denar)



With the deposits purchased on auctions, 480 million Denar were withdrawn from circulation at the end of 1995. In average, during 1995, 296 million Denar or 6.0% of the average reserve money were withdrawn with this instrument.

As in 1994 deposits bought from the banks were mainly with a maturity of 1 to 3 days. The weighted interest rates for the deposits bought on auction were from 22.1% per annum, at the beginning of 1995, to 3.1%-8.8% per annum, at the end of the last year.

In accordance with the ongoing process of bank rehabilitation, at the beginning of April, 1995, the selective credits of the National Bank of the Republic of Macedonia were transformed into long-term bonds of the Bank Rehabilitation Agency. It was the first formal and the only open market operation with Government securities in the Republic of Macedonia as there were no other Government securities available. However, in the future, these and other long-term securities issued for rehabilitation of

the banks will be basis for developing operations for purchase and repurchase of Government bonds.

Apart from the open market operations, in 1995 the traditional instrument of compulsory reserve was also used for withdrawal of liquid funds from the banks and for creation of demand for reserve money. At the end of December 1995, an amount of 818 million Denar of reserve money were withdrawn with this instrument, which is by 35 million Denar more than at the end of 1994. However, due to the liquidity problems that some of the banks in the Republic were facing, the allocated funds as compulsory reserve were continually used as additional source of liquidity. Thus, on December 31 1995, the compulsory reserve used by the banks as additional liquid potential, amounted to 453 million Denar, or 55.4% of the total amount of the allocated funds. Continuous use of the compulsory reserve is an unplanned reserve money creation, causing serious problems for reserve money management.

For neutralizing the high liquidity of the banks in the first quarter of 1995, the National Bank of the Republic of Macedonia, in the first ten days of March, introduced an instrument compulsory reserve calculated at marginal rates. The use of this measure for regulation of the banking system liquidity potential was conditioned by the insufficient response of the banks to the indirect monetary policy instruments. Marginal compulsory reserve was calculated at a rate of 75% of the basis being the difference between the amount of liquid funds of the bank and the optimum amount of liquid funds calculated by multiplying the amount of demand deposits with certain coefficients. Thus, at the beginning of March, the amount of demand deposits was multiplied by 3%, beginning the last ten days of March by 4.7%, and in the last ten days of April by 6.1%. The, banks holding liquid funds up to 2.0 million Denar were not obliged to calculate and allocate compulsory reserve at marginal rates.

The marginal compulsory reserve had a prompt impact towards absorbing the excess of liquid funds in the banking system, so that the initial monetary effect was a reserve money withdrawal in amount of 125 million Denar. In the following two months, April and May, through allocation of compulsory reserve at marginal rates, in average on a monthly basis, 26.0, and 29.6 million Denar, respectively were withdrawn. The use of this instrument for monetary regulation had both direct and indirect effects. Thus, the high rate of marginal compulsory reserve increased the banks incentives to participate more actively in the auctions of deposits and at the same time to use them as instruments for short-term regulation of their liquidity. Beginning the first ten days of June 1995, this measure for monetary regulation was abolished.

VI. Interest rate policy

In developed market economies, monetary targeting has been more and more replaced with strategy of interest rates management within the strategy for realization low and stable inflation rate compatible with the natural rate of unemployment and potential economic growth. Due to the insufficient development of the financial market and financial instruments, basic interest rate management in the Republic of Macedonia can not be the main regulator and factor for money supply and money demand balancing. That function of the interest rate policy was still unable because of the insufficient financial discipline and deteriorated mechanism for transferring monetary signals to the real sphere.

During 1995, the movements of the National Bank discount rate were determined by real, monetary and foreign exchange movements in the Republic of Macedonia. Thus, achievement of a high financial stability had a direct impact on the reduction of the National Bank discount rate, and indirectly on the level of deposit money banks lending and borrowing interest rates. Besides, in mid-1995, the National Bank of the Republic of Macedonia started to present the interest rates on an annual level, being a confirmation of its intention for further reduction of inflation rate, and at the same time was a significant psychological factor for the effort to suppress the inflationary expectations completely.

However, regarding the insufficiently developed mechanism for reserve money issue through open market operations, the discount rate in the Republic of Macedonia in 1995, as well as in the previous years, was more a reflection of the realized inflation rate for the previous period, rather than of the actual relation between the supply of and demand for the primary issue funds. Therefore, in 1995, the discount rate used to be determined according to the formula: actual average inflation rate for the previous two months increased by 5 percentage points per annum, as a real part.

Table 14

Discount rate
(annual level in %)

1995	Inflation rate*	Discount rate	
		nominal	real
January	45,9	33,0	-12,9
February	2,4	31,0	28,6
March	21,0	28,0	7,0
April	7,4	28,0	20,5
May	-11,4	23,0	34,3
June	-22,4	18,0	40,4
July	0,0	18,0	18,0
August	2,4	18,0	15,6
September	8,7	18,0	9,3
October	42,6	15,0	-27,6
November	21,0	15,0	-6,0
December	6,2	15,0	8,8
1995 average	10,4	21,7	11,3

*inflation rate in the current month, on annual level

As a result of the inflation rate reduction on permanent basis, during 1995, the National Bank of the Republic of Macedonia has reduced the discount rate several times, so that from 33.0% on annual level in January, the discount rate was brought

down to 15.0% per annum in December, 1995. In the observed period an average discount rate was 21.7% per annum, that corrected by the inflation rate increase in the same period has been a realization of an average real positive discount rate of 11.3% on annual level.

Accordingly to the discount rate decrease, the National Bank lending and borrowing interest rates, which are calculated in certain relation to the discount rate, have declined. Namely, between the central bank lending and borrowing interest rates and the discount rate certain relations exist, so that the discount rate change was implicitly a change of other lending and borrowing interest rates of the National Bank of the Republic of Macedonia.

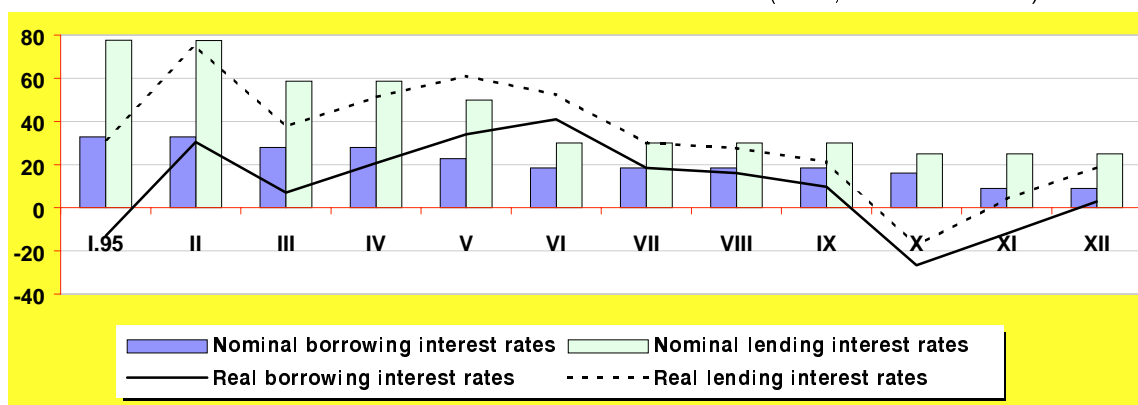
The discount and inflation rate changes affected partly and with certain delays the lending and borrowing interest rates of the deposit money banks in 1995.

In the first half of 1995, the deposit money banks interest rate policy did not reflect the general situation of the Macedonian economy, first of all the achieved financial stability, productivity decrease, the decline of the general economic activity and the global liquidity, etc. Although, the interest rates decreased in 1995 compared to the previous year, they were not still in a function of economic activity reanimation, i.e., in real terms they were still much higher than the profitability that the enterprises could realized under deteriorated economic conditions. Simultaneously, like in the previous years, in 1995, the margins between lending and borrowing interest rates were on a relatively high level, thus, in average the lending interest rates were twice as much than the borrowing interest rates.

Chart 12

Nominal and real interest rates

(in %, on annual level)



Under conditions of high price stability (average inflation rate about 6.1% per annum), lending and borrowing interest rates in the period January-June 1995, were maintained on high nominal and real level. In the first half of 1995, banks borrowing interest rates amounted 31%, in real terms, while the real annual interest rate of bank credits reached extremely high annual level of 75%.

By the end of June 1995, within the Banking Association in the Republic of Macedonia Chamber of Commerce, certain criteria and measures for determining the interest rates of deposit money banks were stipulated. In that way, interest rates movements were more coordinated by banks, as well as between the National Bank and deposit money banks. Following up the principles in determining the interest rates, in the second half of 1995 (especially in the last quarter), resulted in bringing down the

nominal and real interest rates of banks to a moderate level, having a tendency for further decrease. Hence, at the end of 1995, real interest rate of denar time-deposits over three months was brought down to 3.0% per annum. From the point of creating financial conditions for revitalization of the economic activity, even more significant was bringing down the real interest rates of bank credits, so that at the end of 1995 they were brought down to 19.0% per annum. With the banking system revitalization, improvement of the financial discipline and the level of collection of banks claims on enterprises, a further reduction of the bank lending interest rates, as well as narrowing the interest rate margins between lending and borrowing interest rates is expected in the future.

VII. Balance of Payments

7.1. Methodological changes in the balance of payments statistics

Analyzing the balance of payments of the Republic of Macedonia, it is necessary to take into consideration methodological changes made with IMF assistance, as well as current conditions in the capital and financial account.

Thus, in 1995, in order to adjust the balance of payments statistics according to the subscribed standards of the IMF, the data of the external trade statistics on realized imports, is brought from parity c.i.f. to the parity of f.o.b. For the value of the calculated transport costs and insurance costs on imported goods, there was an increase of certain items under services. For the comparison of data in time series, the equal revision for 1994 following the same methodology, was made.

On the capital and financial account of the balance of payments, concerning the old credit liabilities, only the transactions on credits originally used by the enterprises with residency on the territory of the Republic of Macedonia, or, the so-called allocated debt, as well as on credits undertaken by the Government of the Republic of Macedonia, were included. Such undertaken liabilities are comprised of the World Bank and the Paris Club Creditors credits taken over by the Federation of former Yugoslavia according to the Law on undertaking obligations by the Federation on particular foreign loans and indebtedness of the National Bank of Yugoslavia abroad on the behalf of the Federation ("Official Gazette of SFRY" no.83/89), as well as the part of the unallocated debt towards the Paris Club Creditors, that regarding the IMF criteria refers to Macedonia.

7.2. Balance of payments in 1995

In 1995, in the balance of payments of the Republic of Macedonia, was a deficit in the current account of USD 216 million and surplus in the capital and financial account of USD 156 million, with increase of net official foreign exchange reserves of USD 64 million (Table 15). Such balances in the current account and capital and financial account, were burdened by interest and principle arrears matured in the current period.

Table 15

Balance of payments of the Republic of Macedonia

(in USD million)

	1994	1994				1995				1995	indices
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
	1=2+3+4+5	2	3	4	5	6	7	8	9	10=6+7+8+9	11=10/1
Current account - balance	-158	9	-87	-10	-69	-9	-13	-66	-128	-216	136.60
Trade balance	-185	-8	-80	-30	-67	7	-22	-72	-131	-217	117.59
Reported trade	-101	17	-57	-13	-48	16	-1	-63	-121	-168	166.50
Aid and other trade	-84	-25	-23	-17	-19	-10	-21	-9	-10	-49	58.82
Exports	1,086	235	273	275	304	313	327	273	292	1,205	110.91
Imports f.o.b.	1,271	243	352	305	372	307	349	344	423	1,422	111.88
Reported imports f.o.b.	1,187	218	329	288	353	297	328	336	413	1,373	115.63
Aid and other trade	84	25	23	17	19	10	21	9	10	49	58.82
Services, net	-155	-32	-44	-33	-46	-51	-43	-48	-58	-200	129.12
Income, net /1	-47	-14	-12	-10	-10	-9	-10	-7	-6	-31	66.14
Current transfers, net	229	62	48	63	54	44	61	61	67	233	101.81
Other, net	185	47	35	56	45	39	46	58	62	206	111.42
Official, net /2	44	15	13	7	9	5	15	3	5	27	61.45
Capital & financial account - balance	77	18	80	-40	18	-32	-7	70	125	156	203.45
Capital transfers, net	30	20	0	5	5	2	0	0	0	2	5.67
Direct investment, net	24	5	5	9	5	1	5	1	1	9	36.63
Portfolio investment, net	0	0	0	0	0	1	2	0	0	2	-
Other investment, net	23	-7	75	-54	8	-35	-14	68	124	144	627.90
Trade credits, net	98	-12	71	-3	42	-38	-3	65	118	142	144.54
Loans, net /1/3	-5	25	20	-26	-24	-15	-31	23	2	-21	392.14
Currency and deposits, net	-70	-20	-16	-24	-9	18	20	-19	4	23	-
Errors & omissions	102	12	35	27	28	26	-16	9	-12	7	7.10
Overall balance	21	38	28	-23	-22	-15	-36	13	-14	-52	-
Change in official reserves, net /4	-25	36	-52	-7	-1	-6	-7	-32	-20	-64	255.22
Gross official reserves /5	-41	18	-51	-7	0	-5	-30	-32	-34	-101	248.23
IMF	16	17	-1	0	-1	0	23	0	14	37	237.13
Changes in total arrears	4	-74	24	30	24	20	43	-228	22	-144	-
New arrears	111	32	25	30	24	20	43	17	22	102	-
Repayment of arrears	-107	-106	-1	0	0	0	0	-245	0	-246	229.39
- paid	-107	-106	-1	0	0	0	0	0	0	0	-
- rescheduled (Paris Club)	0	0	0	0	0	0	0	-245	0	-245	-
Rescheduling - Paris Club	0	0	0	0	0	0	0	247	12	259	-

1) Interest and amortization owing on debts that are taken over and guaranteed by Government of the Republic of Macedonia.

2) Data for official transfers in 1994 are provided by Ministry of Development

3) Excluding IMF

4) End-of-period; increase in assets denoted by a minus sign; includes IMF.

5) Excluding valuation changes.

Gross official foreign exchange reserves, excluding valuation changes, increased by USD 101 million, of which USD 38 million were purchase under the arrangements with the International Monetary Fund with at a same time decrease in liabilities to this institution of USD 1 million. The net increase of official foreign exchange reserves of USD 64 million, was USD 39 million higher than in the previous year.

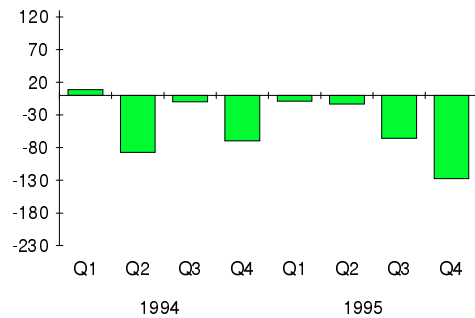
The accumulation of new interest and principle arrears in the current year was USD 102 million. However, by the concluded rescheduling agreements with the Paris Club Creditors, there was decrease in net changes in arrears of USD 144 million. Until the end of the year, to these creditors, was rescheduled liabilities in total amount of USD 259 million, of which USD 245 million were rescheduled arrears as of end-June, whereas the rest of USD 14 million were rescheduled current liabilities, due in the third and the fourth quarter of the year.

Chart 13

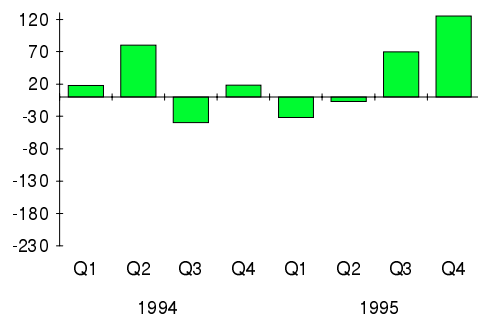
Balance of payments influence on the official foreign exchange reserves

(in million USD)

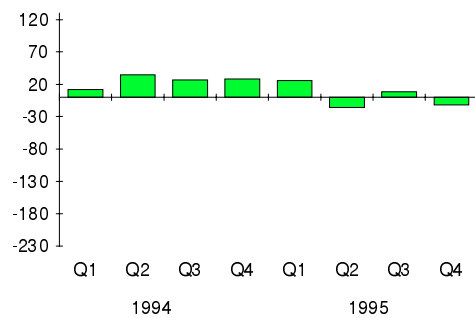
Current account - balance



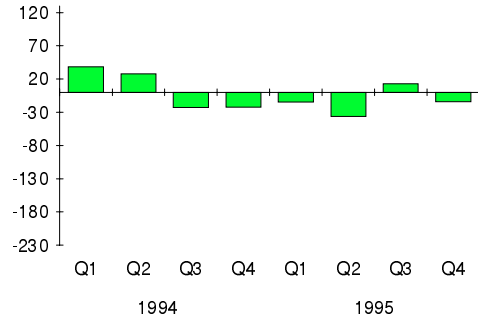
Capital & financial account - balance



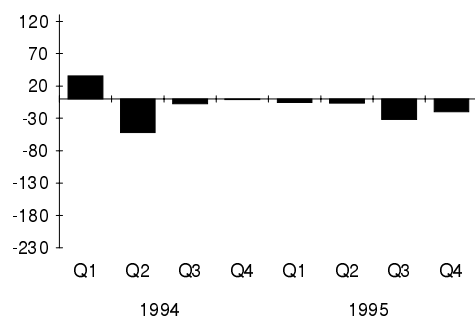
Errors and omissions



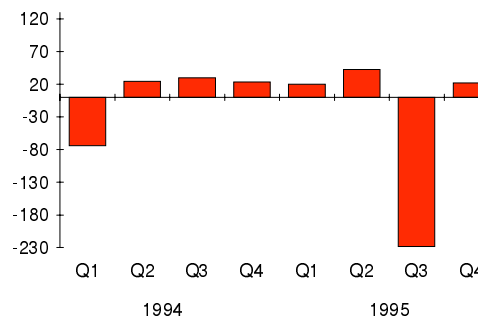
Overall balance



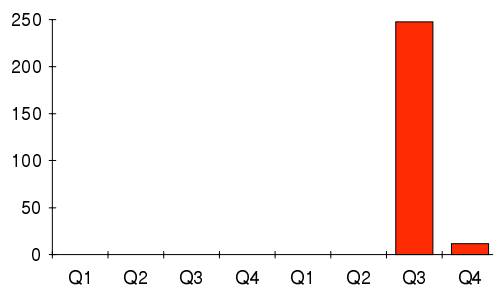
Changes in official foreign exchange reserves



Changes in total arrears



Rescheduling - Paris Club



As a result of new rescheduling arrangements with the Paris Club Creditors, changes in total arrears and net increase of net official foreign exchange reserves, the overall balance amounted USD -52 million, showing the overburden of the overall balance with newly accumulated arrears throughout the current period as well as with new liabilities after the rescheduling.

The deficit in the current account, as well as the increase of net official foreign exchange reserves were financed from the surplus in the capital and financial account of USD 156 million, net effects of the new rescheduling arrangements and changes in total arrears of USD 115 million, and the unidentified inflow under errors and omissions of USD 7 million.

7.2.1. Current account

The deficit in the current account of USD 216 million, was due mainly to the high deficit in the trade balance of USD 217 million and to the deficit in the balance of services of USD 200 million.

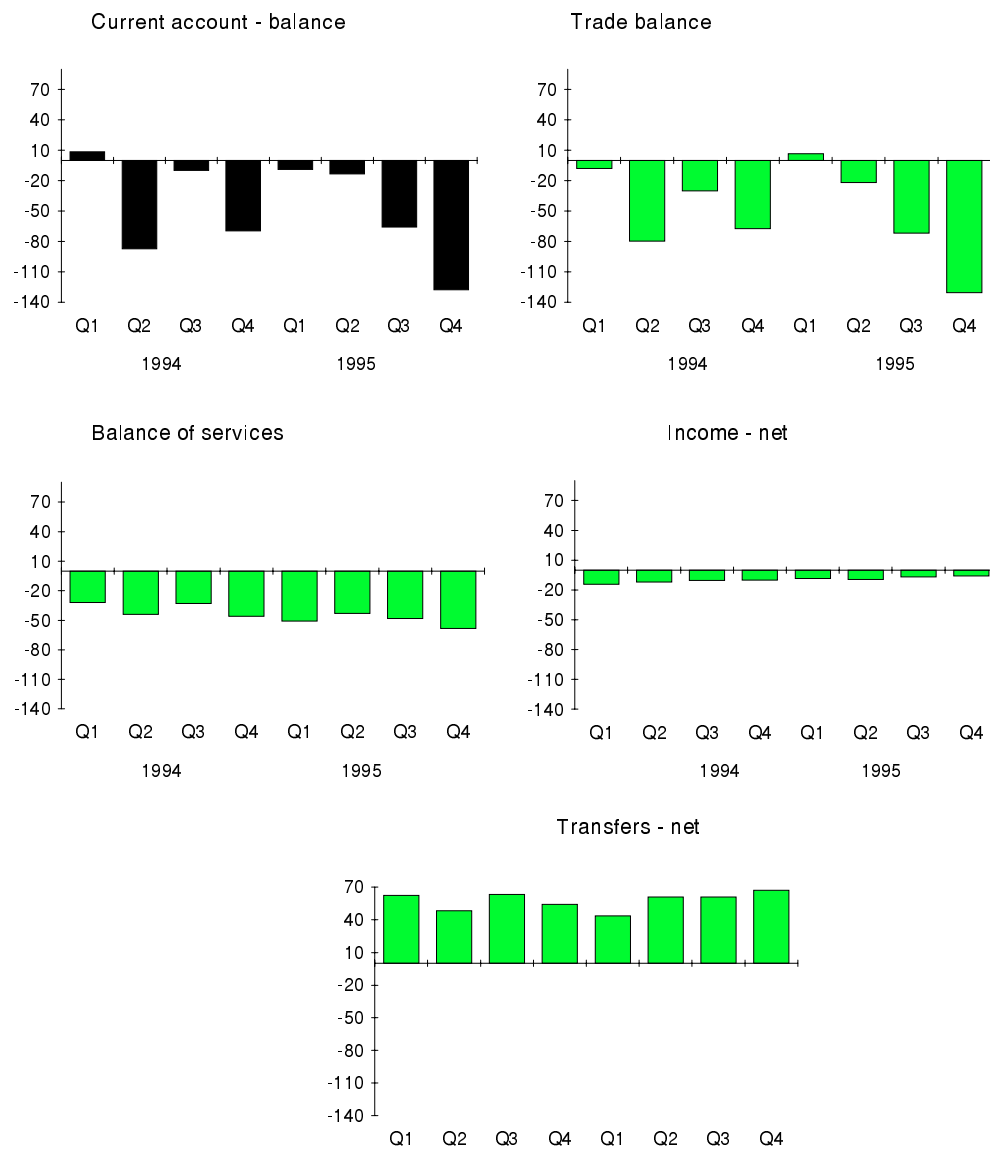
Compared to the previous year, the deficit in the current account was by USD 31 million, or by 36.6% higher as a result of the increase of the deficit in the trade balance and balance of services as well. Such deficit, was 5.8% of the gross social product in 1995, whereas in the previous year was 5.5%.

Total external trade increased by 13.42% compared to the previous year, with higher increase in imports than exports of goods, especially emphasized in the third and the fourth quarter of the year. Higher external trade, by itself, caused an increase in transport costs as well as in business services costs, so that the deficit in the balance of services in 1995 was by 29.12% higher than the previous year.

Based on the interest, there was net expenditure of USD 33 million. The interest income on official and commercial banks foreign exchange was USD 21 million, whereas the interest expenditure was USD 54 million, of which: USD 37 million interest arrears, and USD 17 million regular interest payments to the World Bank and to the International Monetary Fund, as well as on short-term credits.

Chart 14

The impact of current flows on the current account balance
(in million USD)



In the current transfers of the balance of payments in 1995, was surplus of USD 233 million, which was by 1.81% higher compared to the previous year. On the private transfers item, there was an increase of 11.42%, mainly due to the increased inflow of remittances from abroad as well as from the purchased cash foreign exchange. The decrease of 38.55% in the official transfers compared to the 1994, was a result of lower inflow into other transfers than PHARE program which receipts in 1995 amounted USD 23 million, and USD 8 million in 1994.

7.2.2. Capital and financial account

In 1995, in the capital and financial account, there was a surplus of USD 156 million, the surplus in the previous year was USD 77 million.

Higher surplus on the capital and financial account was due to the higher financial support to the balance of payments from the trade credits. Namely, there was net inflow on trade credits of USD 142 million as a result of higher unpaid imported goods (credits received for imports) than unreceived inflow on exported goods (credits extended on exports). Net inflow of trade credits throughout the previous year was USD 98 million.

During the year, were disbursed USD 42 million as financial support to the balance of payments and USD 41 million under medium and long-term project credits, from the World Bank. At the same time, as amortization were repaid USD 28 million, the principle arrears burdening the financial account amounted USD 65 million, and USD 11 million were rescheduled current liabilities towards the Paris Club Creditors. As a result of such transactions, there was a deficit in the balance of loans item of USD 21 million.

Currencies and deposits of the Commercial Banks were decreased by USD 23 million, whereas during the previous year the banks increased their foreign exchange reserves for USD 70 million.

The inflow in the capital transfers was decreased, having in mind that in 1994 was high inflow as donor's aid for clearing the arrears to the World Bank. There was decrease in the direct investments item, too.

VIII. Foreign exchange reserves of the Republic of Macedonia

Foreign exchange reserves of the Republic of Macedonia, comprising official foreign exchange reserves and commercial banks foreign exchange reserves amounted USD 354.02 million at end - December 1995, presenting an increase of USD 100.14 million or 39.45% compared to the level at end - December 1994.

Gross official foreign exchange reserves were USD 274.87, which, compared to the level at the end of the previous year was an increase of 66.19%, as a result of net inflow of USD 109.47 million. Thus, in order to maintain minimum external liquidity of the country, by the Decision on foreign exchange policy and balance of payments projection of the Republic of Macedonia for 1995, the core foreign exchange reserves (as a component of official foreign exchange reserves) were determined on the level of USD 110 million. The rest of USD 164.87 million were current or operative foreign exchange reserves.

Total inflow in the official foreign exchange reserves in 1995, amounted USD 234.73 million. The largest part of inflow or 53.0% resulted from internal sources, i.e., from the purchase of foreign exchange excess on the foreign exchange and exchange offices market (48.9%) and from the sale of social flats (4.1%); than 35.4% based on disbursements under new foreign credits and loans (the IMF arrangements as a support of the Government stabilization program and FESAC credit from the World Bank for structural adjustment of the financial and enterprises sector as support to the balance of payments); 1.1% based on donors aid to the domestic Government from abroad; and the rest was an interest inflow ,valuation changes effects, etc.

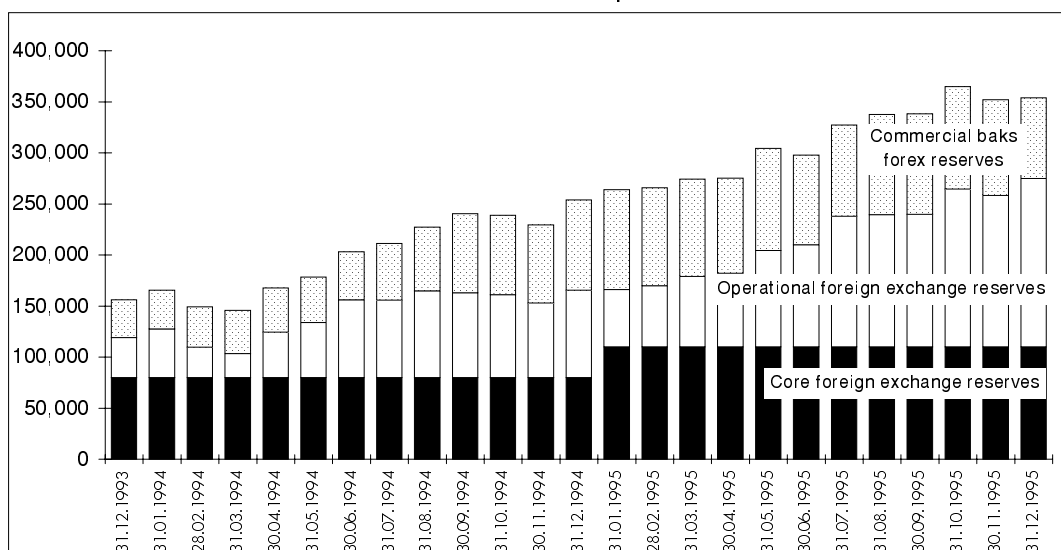
Simultaneously, from the official foreign exchange reserves there was an outflow of USD 125.26 million. These foreign exchange were mostly (48.3%) used for interventions on the foreign exchange market; than (31.2%) for repayment of liabilities guaranteed by the Republic of Macedonia towards foreign creditors; and the rest for payments according to the decisions of the Government, etc.

As a result of high inflow from the purchase of excess surplus on the foreign exchange and exchange offices market, net official foreign exchange reserves (gross official foreign exchange reserves minus liabilities to the IMF and excluding valuation changes) reached USD 210.64 million or equivalent of about two months of imports at end - December 1995. The level of net foreign exchange reserves at the end of the previous year, was 1.3 in terms of imports. Compared to the projected net foreign exchange reserves (assumed to be USD 205 million at the end - December 1995), they were higher by USD 5.64 million.

The dynamics of the official foreign exchange reserves changes in 1995, was closely related to the dynamics of the liabilities repayments of guaranteed old credits, inflows from exchange offices, as well as the interventions on the foreign exchange market due to the supply of and demand for foreign exchange (Chart 15).

Chart 15

Foreign exchange reserves of the Republic of Macedonia at the end of the period



Commercial banks foreign exchange reserves stood at USD 79.15 million at the end - December 1995, and decreased by USD 9.33 million from the end December 1994 level. However, during the year, foreign exchange reserves of banks were higher than the level at the end of December. By prescribing the maximum for maintaining foreign exchange assets with a Decision of the Council of the National Bank, and, following the given possibility for quarterly settlements of banks where an overdraft beyond the allowed maximum appeared, the banks foreign exchange reserves showed a tendency of decrease. The decrease of foreign exchange reserves was, *inter alia*, due to the large demand than supply on the foreign exchange market. Nevertheless, total banks foreign exchange reserves at the end - December 1995, were higher than the prescribed minimum for USD 17.07 million.

At the end of the year, the exporters had USD 53.53 million of foreign exchange deposits with banks, while the foreign exchange deposits of other depositors were USD 103.04 million. Taking into account these foreign exchange assets, which are at the same time foreign exchange liabilities of the banks, total foreign exchange potential of the Republic of Macedonia at the end of the year amounted USD 510.58 million.

IX. Exchange rate movements

The exchange rate of the Denar in 1995 was determined as flexible exchange rate depending on the supply of and demand for foreign exchange on the foreign exchange market. Thus, the exchange rate policy, having an aim to reach the final objective of the stabilization program of the Government (further reduction in inflation), in a situation of non existing market oriented monetary policy instruments, continued to be complementary with the monetary policy in maintaining a stable domestic currency, i.e., 27 Denar per one Deutsche Mark. Namely, the denar depreciation, not arising from the balance of payments deterioration, was a main indicator for a disproportion between the money supply and money demand and for a further reduction of the reserve money below the programmed target.

On the other hand, the policy of the National Bank interventions on the exchange market, in order to prevent the currency appreciation, and, subsequently, to prevent the export competitiveness, was directed towards absorption of the excess of foreign exchange on the foreign exchange market. In this respect, monetary policy and exchange rate policy were supported by the fiscal policy, with funds in a form of stabilization fund deposited with the National bank. Thus, the injection of new liquid funds on the money market was prevented.

In a case of a tendency for noticeable denar appreciation that could have not been prevented with the National Bank interventions, or, in a case of a significant denar depreciation as a result of the balance of payments deterioration, revision of the defined targets with a consultation with the International Monetary Fund was necessary, which at the end would result into straightening, or, weakening of the domestic currency.

Under such exchange rate policy, in 1995, the domestic currency appreciated in nominal terms on average by 3.03%, followed by different monthly dynamics of decrease or increase of the exchange rate depending on the supply and demand on the foreign exchange market (Chart 16). Thus, the average nominal exchange rate of the Denar with respect to the Deutsche Mark increased (denar depreciation) by 1.24%, while with respect to the American Dollar decreased (denar appreciation) by 7.29%, mainly due to the weakening of the dollar on the world foreign exchange markets, especially in the first half of the year.

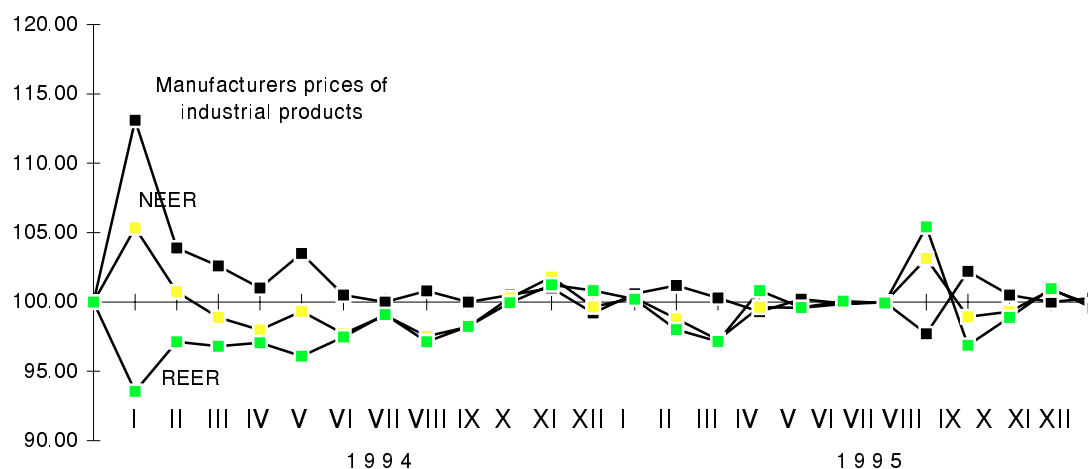
In January, as a result of the excess demand for foreign exchange on the foreign exchange market due to the higher liquidity in the banking system inherited from 1994, the nominal effective exchange rate increased by 0.3%. The National Bank intervened with selling foreign exchange on the foreign exchange market, in order to withdraw the reserve money within the projected monetary targets. However, in the following months the pressure of an excess supply of foreign exchange persisted, a situation that was present on the foreign exchange market in the previous year as well due to the situation in the region, which decreased (appreciation) the nominal value of the denar in February and March. The Central Bank interventions by purchase of the excess of the foreign exchange, successfully normalized and stabilized the exchange rate by the end of July. Such interventions were in accordance with the defined policy of the Central Bank interventions with the funds from the stabilization fund, staying within the projected target of the monetary policy for the reserve money increase.

At the end of July, and beginning of August, the situation on the foreign exchange market reversed. Namely, in this period, the pressure of the demand for foreign exchange on the foreign exchange market became significant. At the same time, the movements on the foreign exchange offices market was of a contrary kind, i.e., there was an excess supply of foreign exchange at the almost unchanged demand for foreign exchange. The possibility to purchase the excess of the foreign exchange on this market as one of the main sources for building up the official foreign exchange reserves, was mostly realized through the purchases by the exchange offices operating on the behalf of the National bank. In order to neutralize the effects to depreciation of the exchange rate because of the excess demand on the foreign exchange market, a portion of the foreign exchange purchased on the exchange offices was used by the National Bank for interventions to meet the demand on the foreign exchange market. These interventions stabilized the exchange rate by the end of the year within the framework of the macroeconomic program of the Government. Taking into account, that the shortage of foreign exchange on this market was not a result from the balance of payments deterioration, the National bank interventions to prevent the depreciation and to maintain a stable exchange rate were justifiable.

The instability of the value of the dollar in 1995 on the world foreign exchange market, had also certain influence on the nominal exchange rate. Thus, the decline of the value of the dollar in the first half of the year influenced the higher denar appreciation in this period and vice versa., the sudden increase of the value of the dollar in August influenced domestic currency depreciation.

Chart 16

Monthly index of nominal and real effective exchange rate and manufacturers prices of industrial products



Market determination of the exchange rate and the excess supply of foreign exchange on the foreign exchange market in the first half of the year, caused further pressures for the real denar exchange rate appreciation. As a result of this, the price competitiveness of the Macedonian exports, measured with the internationally acknowledged indicator (table 16), in June 1995, was by 4.10% lower than in December 1994. But, the reversed situation on the foreign exchange market in the second half of the year, although not due to the real foreign exchange shortage, but due to redirection of the supply of foreign exchange from the foreign exchange to the foreign exchange offices market, increased the nominal exchange rate and improved the exports competitiveness in this period, so that by the end of the year it was by 3.29% lower compared to the beginning of the year.

Compared to the beginning of the foreign exchange market operation, the export competitiveness was lower for 12.87%, mainly due to the present domination of supply over demand on the foreign exchange market, in the current as well as in the previous year (chart 17).

Table 16

Export competitiveness determined by the index of real effective exchange rate

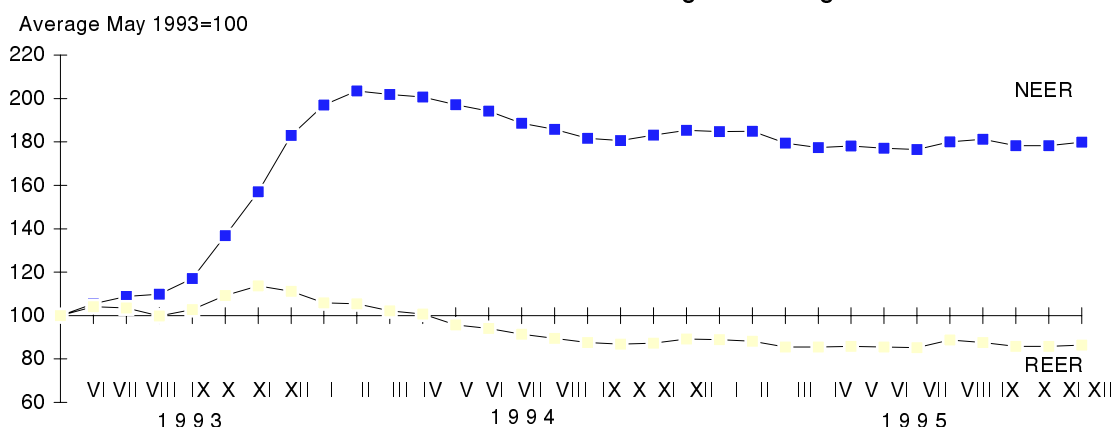
INDEX	31.12.1993	31.12.1994	31.12.1995	31.12.1995
	31.05.1993	31.12.1993	31.12.1994	31.05.1993
1. Nominal effective exchange rate /1	183,01	101,34	96,97	179,84
2. Index of domestic prices of industrial producers	165,44	128,60	102,16	217,35
3. Index of foreign prices of industrial producers	100,30	103,04	101,89	105,30
4. Relative prices (2:3*100)	164,95	124,80	100,27	206,41
5. Real effective exchange rate (1:4*100) /2	110,95	81,20	96,71	87,13

1) Nominal effective exchange rate calculated as a weighted average of the monthly average exchange rate with respect to the Deutsche Mark and the Dollar.

2) The real effective exchange rate index, as internationally accepted and generally used indicator is calculated as an averaged index of the movement of the domestic currency with respect to the currencies of the biggest trading partner countries, adjusted with the ratio of the domestic over foreign prices. For computing the average rate, the equal weights of the dollar and the Deutsche mark were used. The index of the real effective rate over 100 is an increase of price competitiveness, while the index below 100 is a decrease of price competitiveness.

Chart 17

Nominal and real effective exchange rates movements since the establishment of the foreign exchange market



X. Operation of the foreign exchange and exchange offices market

10.1. Foreign exchange market

The foreign exchange market as market within the framework of each bank authorized for payment operations abroad, in 1995, continued with progressive rhythm present since of its beginning.

Total foreign exchange turnover in 1995 of USD 983.8 million, was by 22.50% higher than the total foreign exchange turnover in 1994. The first quarter turnover was USD 217.03 million, with an daily average of USD 3.44 million, and the second quarter turnover was USD 251.70 million with an daily average of USD 4.00 million. The tendency to decrease was noticed in the third quarter when the turnover was USD 241.41 million with daily average of USD 3.83 million. However, compared to the turnover in the third quarter 1994, this was an increase of 8.56%. In the fourth quarter of 1995, there was further increase with turnover of USD 273.62 million and daily average turnover of USD 4.27 million.

Average monthly turnover on the foreign exchange market in 1995, was USD 81.98 million with daily average of USD 3.89 million, whereas in 1994, the average monthly turnover was USD 66.9 million, with an daily average daily of USD 3.2 million.

By months, the lowest turnover was recorded at the beginning of the year in January and February in amount of USD 67.00 million and USD 59.47 million, respectively, and the highest in the last month of the year i.e. December - USD 101.13 million. These movements were present in 1994 as well, due to the influence of the seasonal factor.

The trading among participants on the foreign exchange market, was mainly between enterprises and authorized banks or 62.61%, 34.97% between enterprises by direct selling, and only 2.42% was between banks showing a still low level of their participation on the foreign exchange market.

The National Bank of the Republic of Macedonia intervened on the foreign exchange market during the whole year. In the first quarter, it purchased foreign exchange surplus in amount of USD 14.7 million, and sold USD 18.8 million, meaning that in this period was shortage of foreign exchange on the market due to the higher demand than supply. The foreign exchange purchased by the National Bank in the second quarter was USD 7.3 million, and the sale was of USD 4.9 million, as a result of higher supply than the demand. In the third and fourth quarter of the year was shortage of foreign exchange on the market, thus, the National Bank purchased USD 4.1 million and USD 10.1 million, and sold USD 13.0 million and USD 23.9 million, respectively. The payments for oil imports after ceasing the embargo by the Republic of Greece in November 1995, had influence on increasing the demand for foreign exchange. During the whole 1995, the National Bank purchased USD 36.2 million, and sold USD 60.6 million on the foreign exchange market, i.e. net selling of USD 24.4 million. By such interventions, the National bank balanced time imbalances between supply and demand in order to maintain stable exchange rate in accordance with the stabilization program and monetary policy.

The tendency of declining the foreign exchange trade through banks with traditionally high trade, and increasing and permanent by other relatively new banks, was present throughout 1995 as well.

10.2. Exchange offices market

In 1995, on the exchange offices market was very high turnover of USD 309.50 million, of which USD 215.82 million were purchased foreign exchange and USD 93.68 million were sold foreign exchange. The higher purchase than sell of foreign exchange indicate on domination of supply over demand during the year on this market.

Larger part of the turnover was realized through exchange offices operating on their own behalf that purchased USD 138.28 million and sold USD 87.34 million. The exchange offices that operate on their own behalf and on behalf of the National Bank of the Republic of Macedonia, purchased USD 77.53 million, and, at the same time sold USD 6.35 million.

As a result of such transactions, there was net inflow of USD 122.13 million, of which USD 71.18 million from exchange offices operating on behalf of the National Bank, and the rest of USD 50.95 million from exchange offices operating on their own behalf.

The biggest part of such inflow of foreign exchange, in amount of USD 78.60 million, was transferred to the foreign exchange reserves of the National bank, while the rest of USD 43.52 million increased the foreign exchange assets of the commercial banks.

The dynamic of the turnover on the exchange offices market, had tendency to increase in 1995, especially emphasized on the purchase side. Thus, the purchase of foreign exchange was increased from USD 31.8 million, in the first quarter, to USD 50.5 million, in the second quarter, and to USD 70.5 million in the third quarter, whereas the purchase in the fourth quarter slightly decreased amounting USD 63.1 million. As for the sale, there was lower dynamic of increase, from USD 18.2 million in the first quarter to USD 24.8 million in the second quarter, while in the third and in the fourth quarter there was constant level of USD 25.1 million and USD 25.4 million, respectively.

The interest of the agents for doing foreign exchange operations was present in 1995, as well. Therefore, in 1995, were issued 299 new licenses, of which 173 for exchange offices operating for and on their own behalf, and 56 for their own behalf and on the behalf of the National Bank of the Republic of Macedonia. In this year, 20 exchange offices were closed, by their own request, due to the nonprofitability of their operation.

XI. External medium and long-term debt stock of the Republic of Macedonia on December 31 1995

The analyzed external debt stock of the Republic of Macedonia included: liabilities to all international financial institutions, total liabilities to the Paris Club Creditors (including taken over liabilities by the Federation of former Yugoslavia according to the Law on undertaking liabilities from the Federation in respect to particular foreign credits and the indebtedness of the National Bank of Yugoslavia abroad on the behalf of the Federation "Official Gazette of SFRY" no.83/89 and including 5.4% of the so - called unallocated debt of former SFRY to these creditors), as well as liabilities to the London Club Creditors for credits used by enterprises from the Republic of Macedonia, i.e., excluding the liabilities undertaken by the Federation of former SFRY and the part of the unallocated debt, to these creditors.

Such presented external debt stock at the end of December 1995, was USD 1,235.97 million. In addition, USD 1,074.00 million were principle liabilities, while USD 131.83 million and USD 30.14 million were capitalized interest arrears and late interest, respectively, which together comprised the total debt of the country.*

Of the total principle liabilities, USD 88.68 million were principle arrears which together with interest arrears of USD 131.83 million (excluding late interest on arrears), amounted USD 220.51 million total arrears of the country. By years, USD 40.16 million were due by 1992, USD 44.14 million in 1993, USD 63.60 million in 1994, and, USD 72.61 million in 1995. Of the liabilities due but not paid in 1995, USD 41.21 million refer to unrepaid principle and USD 31.40 million to matured interest. These arrears refer to creditors with which relations have not been normalized yet.

The external debt stock also included the inflow from new foreign credits/loans, i.e., disbursements under the granted foreign credits/loans, which in 1995 amounted USD 121.26 million.

Thus, from the International Monetary Fund were received USD 38.07 million, of which USD 19.52 million as purchase under the second tranche of the STF arrangement, and USD 18.55 million under the agreed Stand-by arrangement.

With the World Bank, an agreement for financial and enterprises sector structural adjustment credit - FESAC in amount of USD 85 million, as well as credit for social reforms and technical assistance SRTAP in amount of USD 14 million, were signed in 1995. It is important to notice that both credits were granted under IDA terms and conditions. In June, by the IBRD, was granted a loan for road construction in amount of USD 24 million. Within these credit agreements, in 1995, has been disbursed USD 61.72 million. In addition, from IDA were disbursed USD 41.74 million (FESAC - USD 40.62 million and SRTAP - USD 1.12 million), and from IBRD, under the project for road construction, USD 19.98 million.

From the European Bank for Reconstruction and Development under granted credits, in 1995 were disbursed USD 14.47 million, of which USD 5.92 million for the

* According to the Internationally accepted standard, external debt stock (net present value) is the amount of disbursed and outstanding liabilities to repay principal and the cumulative interest due but not paid including penalty - late interest on the amount of the total arrears i.e. capitalization of total cumulative arrears.

project for the electricity sector, USD 1.68 million for flight control system improvement and USD 6.87 million for post office.

By the official bilateral creditors, were disbursed USD 7.00 million under the commodity credit for corn, granted in 1995 by the Government of USA.

With respect to the unregulated relations with external creditors, the normalization of relations with the official bilateral creditors, i.e., Paris Club Creditors was essential to unlock the new financial support and acceleration of structural reforms process. For that purpose, by the Government of the Republic of Macedonia, in March, were initiated negotiations for the rescheduling of the debt with these creditors, while in July was a meeting where the Agreed Minute on the Consolidation of the Debt of the Republic of Macedonia toward these creditors, was signed. By the Agreed Minute on the Consolidation on the debt, from July 17, 1995, the following terms and conditions for rescheduling or refinancing the debt were stipulated:

- for credits and loans concluded before December 2, 1982 cut-off date, all arrears as at end June, 1995 (excluding late interest), and principle and interest falling due during the reorganization period from July 1, 1995 to June 30, 1996 above SDR 0.5 million by Creditor Countries, will be rescheduled or refinanced within a repayment period of 15.5 years and 4 years grace period, accounted from June 30, 1995. The above determined liabilities less than SDR 0.5 million by Creditor Countries should be made on the original due dates.

Late interest accrued as at June 30, 1995, will be rescheduled or refinanced with repayment period of 6.5 years and 3 years of grace period, accounted from June 30, 1995.

- for credits and loans concluded after December 2, 1982 cut-off date, all arrears as at end June, 1995 including late interest, will be rescheduled or refinanced within a repayment period of 6.5 years and 3 years grace period, accounted from June 30, 1995.

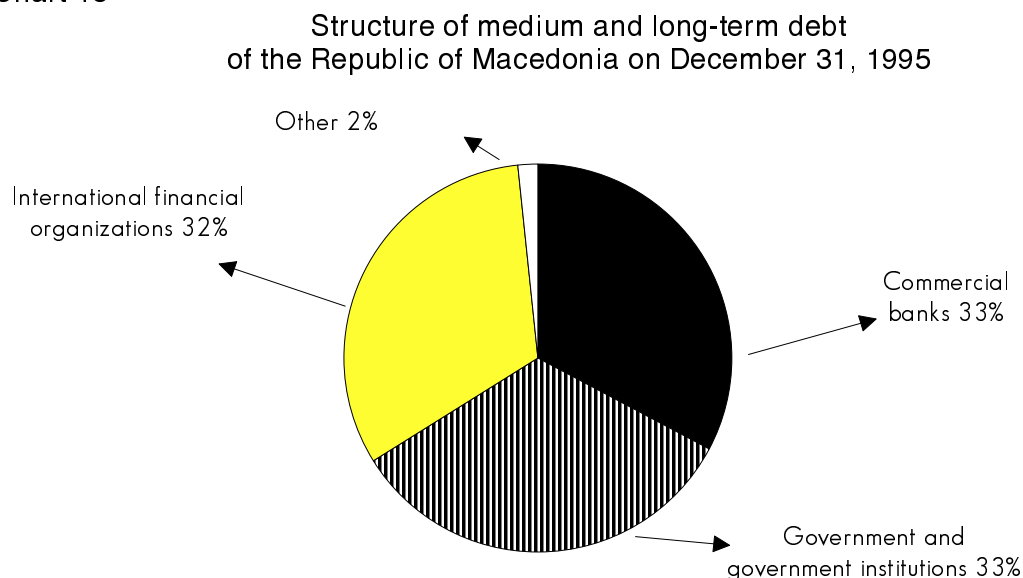
Liabilities out of the rescheduling or refinancing arrangement, i.e., maturing after June 30, 1996 on the pre-cut-off date debt, and after June 30, 1995 on the post cut-off date debt, should be paid on the original due dates, with interest rates as it is stipulated in concluded agreements.

The rates and the conditions of interest on the refinanced arrangements covered by the Agreed Minute will be determined bilaterally between the Government of the Republic of Macedonia and the Government of each Creditor Countries. Until the end of 1995, bilateral agreements were reached with governments of the Federal Republic of Germany, Austria and Switzerland, still expecting agreements with ten Creditor Countries.

11.1. External Debt structure by creditors

Foreign creditors, grouped according to their institutional founding, have got almost equal participation in the total debt of the Republic, at the end December, 1995. Thus, debt to the Paris Club Creditors amounted USD 411.91 million, to the Commercial Banks creditors USD 404.28 million, to the international financial institutions USD 397.59 million and the debt towards other private creditors amounted USD 22.19 million.

Chart 18



The debt to the Paris Club Creditors of USD 411.91 million significantly increased compared to the debt calculations made when the Agreed Minute took place, as the part of the unallocated debt and debt on the clearing credits from the former Democratic Republic of Germany were included by the bilateral agreement with the Government of the Social Republic of Germany, due to the advantages given for their regulations (discount of 25%, positive effects from cross-exchange rates etc.).

Of the total debt to the Paris Club Creditors, USD 333.80 million are rescheduled, USD 71.11 million are non-rescheduled, and, USD 7 million are liabilities under new credit for corn approved by the Government of the USA. The rescheduled debt are computed by USD 228.21 million principle, USD 54.45 million interest and USD 51.13 million related late interest. The non-rescheduled debt include payments with the maturity after June 30, 1996, on Pre-cut-off date debt, payments maturing after June 30, 1995, on Post-cut-off date debt, as well as payments on credits originally contracted with banks with residency on the territory of the other republics of former SFRY (the case with Belgium - former Associated Ljubljanska Banka, Ljubljana; and Germany - former Associated Yugobanka, Belgrade).

By particular countries, the USA has the largest participation of 31.29%, than Germany 29.54%, France 10.42%, Italy 6.34%, Switzerland 5.86%, or, these countries debt comprise about 85% of the total debt to the Paris Club Creditors.

At the end of 1995, the principle arrears and interest arrears to this group of creditors, on the accrual basis, amounted USD 6.58 million, and USD 0.80 million,

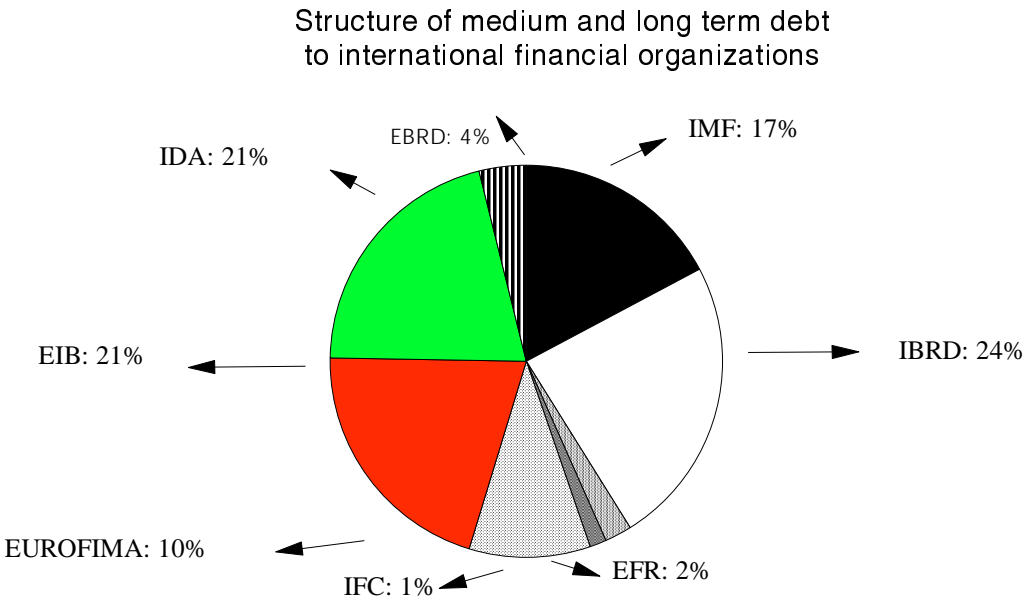
respectively. Such arrears refer to credits originally contracted by banks with their head offices in the territory of the other republics of former SFRY, as well as liabilities maturing in the second half of 1995 on Post-cut-off date debt. Computed penalty interest on these arrears amounted USD 1.12 million.

Debt stock to foreign commercial banks so - called London Club Creditors in amount of USD 404.28 million were not yet regulated, and there are on-going efforts to find possibilities for the regulation and normalization of relations. The accrual arrears to these creditors at December 31, 1995, amounted USD 44.13 million of non repaid principle and USD 103.11 million of matured interest, with computed evaluated late interest of USD 19.26 million.

As for the structure of the debt to the international financial organizations, the biggest part is towards the IBRD - USD 94.41 million, followed by the IDA - USD 83.57 million, EIB - USD 81.61 million, IMF - USD 69.07 million, EUROFIMA - USD 39.57 million, EBRD - USD 14.71 million, European Fund for reintegration - USD 9.52 million and IFC - USD 5.12 million. In 1995, were regularly paid the liabilities towards the following international financial institutions: IMF, affiliations of the World Bank (IBRD, IDA, IFC) and EBRD.

The arrears under this category of creditors in amount of USD 27.85 million of non repaid principle and USD 26.62 million of matured interest, with evaluated late interest of USD 8.89 million, relate towards EIB, EUROFIMA and the European Fund for Reintegration, i.e., the accrual arrears up the end third quarter for EIB and EUROFIMA and accrual arrears up December 31, 1995 for the European Fund for Reintegration. In accordance with the agreed Stand-by arrangement with the IMF, the Government of the Republic of Macedonia undertook obligations for regular debt service to these multilateral creditors. In addition, it was agreed regular debt service towards the EIB and EUROFIMA, to commence from the fourth quarter of the year. However, in 1995, an issue regarding the way of regulating the abovementioned arrears to these two institutions (USD 31.6 million to the EIB and USD 25.5 million to EUROFIMA), as well as to the European Fund for Reintegration (USD 6.3 million), was unsettled, therefore they were presented as a financial gap in the balance of payments projection for 1996. For the clearance of such arrears, it is necessary to find appropriate funds such as donations, new loans, refinancing or reprogramming of debts, etc.

Chart 19



XII. Banks and savings houses supervision

In 1995, banks and savings houses in the Republic of Macedonia were making efforts to compliance their operations with the supervision standards stipulated by the National Bank of the Republic of Macedonia, which were in accordance with the international prudential standards. This was, first of all, compliance with the provisions for the claims classification according to their risks, maximum available credit by borrowers, allocations of reservations for preventing potential losses, capital adequacy, open foreign exchange position, etc.

The banks compliance according to the supervisory standards has been regulated with the provisions from the Banks and Savings Houses Act. Namely, on May 28, 1995 the two years term for bank compliance to the provisions from the Banks and Savings Houses Act, aimed to improve the banking system stability and safety, has terminated.

Bank supervision has begun several months before the dead line for the final compliance to the Act regulations has ended. Banks were obliged to submit operative plans for their compliance to the Act provisions, especially emphasizing the origin of the founders' capital, which for the operations within the country amounted DEM 3.0 million (in denar countervalue), while for payment operations and credit activities abroad amounted DEM 9.0 million (in denar countervalue).

The analysis of submitted documentation showed that out of 19 banks operating on the Republic of Macedonia territory before May 28, 1995, 3 banks did not succeed in providing the needed minimum capital of DEM 3.0 million and their licenses for further activities were withdrawn. One of these banks met the conditions prescribed for savings houses and after obtaining the license from the National Bank of the Republic of Macedonia, it continued to operate as savings house. A liquidation procedure was undertaken for the other two banks.

The activities for compliance the banks operations in accordance with the Banks and Savings Houses Act have continued after May 28, 1995, as well, by further monitoring and verifications of those banks operative plans where some failures of a smaller range were found. This was accompanied by an intensification of regular direct and indirect controls of banks and savings houses operations. Indirect controls were based on supervisory reports on capital adequacy, the assets structure and quality, and monthly balance and income sheets. The characteristic of direct controls during 1995 was the adopted American (could be said also international model) "CAMEL" (capital, assets, management, earnings and liquidity) system of banks ranking. The usage of this system implicated appropriate structuring of controls in the sense of comprising the five areas - CAMEL rating components. For that purpose, direct controls were made under conditions of testing and practical implementation of the control procedures developed by the engaged foreign advisors, focused on coverage of all areas of bank operations where possible risks could appear.

On basis of banks regular statements submitted to the National Bank, and on the basis of on-site direct controls of the banks, some failures in the operations of certain banks were found: lack of compliance to the prescribed limits for maximum credit exposure towards certain clients (30%), especially regarding limits for credit exposure to the bank founders (10%), inadequate credit procedures, weaknesses in

classification of asset items and in calculating potential losses, especially allocation of reservations, etc.

After the undertaken measures by the Supervision department within the National Bank of the Republic of Macedonia, defined failures were mostly removed and the operations of banks and savings houses were adjusted to the legislation. Undertaken corrective measures were a kind of prevention, because the banks started to pay more attention to compliance of their operations to the legislation and prudential standards, which acted in direction of lowering the number and intensity of needed corrective measures in the banking sector. The intensification of controls on savings houses operations is expected to result into an increase of these institutions stability and safety, which is the ultimate objective of the supervision activities

In 1995, no new banks were established, except the spin-off five former branches of the biggest bank in the Republic into independent banks, as part of its rehabilitation process. Giving a license to these banks, the total number of banks operating on the territory of the Republic of Macedonia on December 31, 1995 was 21. In the period January-December, 1995, 5 licenses were issued to the new savings houses, so that their number at the end of 1995 increased to 28.

XIII. Bank rehabilitation

The banking system rehabilitation is a substantial question in the Republic of Macedonia due to the necessity to build up sound, efficient and competitive banking system, as basis for further structural changes in the state. Moreover, the banking system rehabilitation, as part of the commenced reforms, was one of conditions that were supposed to be fulfilled for purchasing the first tranche of FESAC credit from the World Bank.

The banking system in the Republic of Macedonia is characterized by the accumulated problems lasting for years already, that, under present conditions of competition among financial institutions are a large burden on bank operations, and at the same time a big threat and constraint for further reforms in the economy. Among the most significant problems banks have been facing with in the Republic of Macedonia in the period after the monetary independence and consequently during 1995, is the concentration of high amount of non-performing credits on the assets side, as well as the solution of the problem with the foreign exchange depositors.

Such situations in the banking system of the Republic of Macedonia imposed the need for its rehabilitation and restructuring, as part of the economic reforms in the state. Thus, in 1995, the intensive activities for constitution of institutional framework for restructuring a number of banks in the Republic of Macedonia have started. In that sense, on March 16, 1995, the Parliament of the Republic of Macedonia has passed the Act on Rehabilitation and Restructuring of a number of banks in the Republic of Macedonia ("Official Gazette of the Republic of Macedonia", no.14/95).

The Act comprises three sets of measures that were supposed to result in banks rehabilitation, which were facing the liquidity and insolvency problems: a) writing-off the old foreign exchange deposits from the banks balance sheets; b) writing-off the claims and liabilities regarding foreign credits from the banks balance sheets, and c) restructuring the biggest bank in the Republic, i.e., Stopanska Banka, a.d. Skopje.

First two measures were implemented in linear order, because all banks that were operating in the previous system in their balance sheet had claims and liabilities regarding the "frozen" foreign exchange deposits and credits obtained from foreign creditors, so that:

- starting from January 1, 1995, in accordance with Article 4 from the Act on rehabilitation and restructuring of number of banks in the Republic of Macedonia, banks have been removed the households "frozen" foreign exchange deposits from the assets and liabilities sides of their balance sheets in amount of DEM 1,438 million (position on December 31, 1994). Banks were obliged to keep off-balance evidence on these deposits and to service them for and on the behalf of the Republic of Macedonia, that guaranteed for the payments up to the level of funds determined for such purposes by the Government of the Republic of Macedonia. However, on the banks balance sheets, there still remained the claims on the Government in amount of DEM 147 million, as a result of accomplished payments regarding the households "frozen" foreign exchange deposits. Out of that, DEM 103 million were claims based on payments following the legal regulations, while DEM 44 million were claims on payments made above the legal limits. Coverage of that amount by the Government is still a subject of further agreement between the banks and the Government.

- starting from January 1, 1995 there has been removal of liabilities to and claims on credits purchased from the Paris Club creditors from the banks balance sheets with a position on December 31, 1994. These liabilities and claims were specially recorded, so that the collection of claims from the domestic enterprises and payments towards foreign creditors were undertaken by the Republic of Macedonia. According to the evidence of the National Bank of the Republic of Macedonia the amount of credits (principle and interest) from the Paris Club creditors amounted USD 262 million on December 31, 1994.

- by October 31, 1995, banks were obliged to remove claims and liabilities from their balance sheets regarding credits granted from commercial banks (the so-called Zurich Club of creditors). Banks were obliged to continue the evidence of these credits on off-balance items. According to the evidence of the National Bank of the Republic of Macedonia, these credits (principle and interest) amounted USD 524 million.

The third measure that was supposed to be undertaken in the process of banking system rehabilitation was the restructuring of Stopanska Banka a.d., Skopje. The necessity to restructure Stopanska Banka a.d., Skopje was imposed due to its dominant role, size and position that this bank had in the banking system of the Republic of Macedonia, as well as because of non-performing credits on the assets side of this bank balance sheet. Therefore, measures for its rehabilitation, privatization and change of the bank management were undertaken, aimed to transform it into efficient, market oriented banking institution.

The process of restructuring Stopanska Banka a.d., Skopje comprised implementation of three-stage measures. The first stage covered the bank balance sheet rehabilitation of the non-performing credits with position on December 31, 1994, where was removed:

- bank claims on and liabilities to households upon deposited foreign exchange savings in amount of 18,815 million Denar, or, DEM 718 million;

- claims on and liabilities to Paris Club creditors upon credits amounting 8,420 million Denar;

- non-performing bank denar claims amounting 7,734 million Denar, or DEM 490 million (position on December 31, 1994), defined by the National Bank of the Republic of Macedonia in accordance with the international standards and classification rules of bank claims in respect to their risk level.

The amount of 7,734 million denar was lowered by the amount of the shareholders capital of the enterprises-borrowers (968 million Denar), selective credits granted to the bank on the behalf of the enterprises-borrowers (384 million Denar), and adequate part of bank reservations (1,477 million Denar). The remain of non-performing denar claims in amount of 4,905 million Denar, together with the amount of non-performing denar claims covered with selective credits (384 million Denar) - has been transferred to the Bank Rehabilitation Agency, so that the Agency issued to Stopanska Banka a.d., Skopje bonds with maturity of 15 years in equal annual installments starting from April 1, 1994.

Simultaneously, the Agency issued interest free bond in amount of 1,039 million Denar to the National Bank of the Republic of Macedonia in a single payment on April 1, 2020, that will be evident as the Bank Rehabilitation Agency claims on final users of the credit in amount of (384 million Denar) and on Stopanska Banka a.d., Skopje (655

million Denar), which would be claimed from the clients with classified non-performed credits.

In addition, at the end of 1995, from Stopanska Banka a.d., Skopje and from the newly established banks - former bank branches, contested and doubtful claims on principle and interest in amount of 6,409 million were transferred to the Bank Rehabilitation Agency.

The second stage of the rehabilitation process of Stopanska Banka a.d., Skopje comprised its reorganization, i.e., bank reduction of at least 10%, computed on the basis of the bank balance sheet after the clearance. At the appeal of the National Bank of the Republic of Macedonia, only 5 bank branches have submitted their requests and have obtained licenses for operating as independent banks, due to the fact that they have met the defined criteria.

The third and the last stage of the process of restructuring Stopanska Banka a.d., Skopje comprised its privatization, followed by additional capitalization and change of the bank management. Up to now, Stopanska Banka has been privatized spontaneously through the process of privatization of its founders. During 1995, efforts were made for engagement of some foreign banks capital in the sense of investing it in Stopanska Banka a.d. Skopje. In addition, there is also a possibility the European Bank for Reconstruction and Development to invest its capital in Stopanska Banka a.d. Skopje.

Annual Report 1995 Summary

Creation of stable financial conditions by further inflation rate reduction and, based on that, animation of the economic activity, were the basic objectives of the economic program in 1995. Monetary policy, together with the fiscal and wage policy, were integral components of a comprehensive stabilization program followed by appropriate structural reforms.

The fundamental monetary policy objective for 1995 was reducing the inflation rate to 17.8% per annum, with an assumed mild increase of the real social product of 0.8%. As a result of more intensive decrease of the inflation rate compared to the expectations, and, based on that, enhanced real money demand, in September 1995 basic assumptions of the monetary policy projection were revised. Thus, the revised target of retail prices increase was set forth on annual level of 8.0%, while a real drop of 4.0% was assumed for the social product.

Due to deteriorated functioning of transmission mechanism, as well as the impossibility for precise money supply governance, a strategy for reserve money governance was adopted. Due to the fact that managing reserve money is necessary, though not sufficient condition for realization of the assumed money supply increase, in 1995 implementation of direct monetary control instrument, i.e. ceilings on banks denar credits has been projected. With 1995 revised projection, the increase of this monetary aggregate was assumed to be 12.3%.

Basic intermediary objectives of the monetary policy in 1995 were reserve money and money supply M1 in its narrowest sense. According to the revised projection, the nominal money supply M1 increase for 1995 was projected to be 23.0%. Based on assumed monetary multiplier, it was defined that for the realization of this target it is necessary reserve money to increase by 14.5% at the end of 1995, compared to December from the previous year.

Realization of monetary policy during 1995 was projected under conditions of flexible exchange rate regime. Thus, exchange rate movement was projected to be the basic indicator for the money supply and money demand imbalance, i.e. of the optimum stance of the monetary policy.

The economic activities in 1995 continued to be realized under unfavorable external conditions, whereas the blockade on transfer of people, goods and financial assets over the southern and northern border were removed later, in the last quarter of 1995. Apart from deteriorated transport corridors, the efforts to conquer new foreign markets have continued during 1995.

The reforms in the real sector in 1995 were concentrated on three main areas: a) banking system rehabilitation; b) privatization and restructuring of social enterprises, so that by the end of 1995, 604 enterprises were completely privatized, and c) restructuring the biggest twenty five loss making enterprises in the country according to the special program. The program assumed certain dynamics of the activities that were supposed to result in the enterprises recovery, or, otherwise, in their liquidation.

The 1995 economic program in the Republic of Macedonia resulted with significant results in the area of financial stability: inflation rate was brought down to

one digit; denar nominal value compared to the Deutsche Mark remained almost unchanged; country foreign exchange reserves increased significantly; and, in real terms, the investment activity increased as well. In the real sector, the deceleration of the economic activity declining trend which has started in 1994 continued, where as a result of the unfavorable external conditions and the decreased labor productivity, the real social product in 1995 declined by 2.0%.

As a result of coordinated stabilization efforts of both monetary and fiscal policy, as well as the implementation of the appropriate wage policy and exchange rate policy, in the period January-December 1995 the inflation rate was reduced to 9.2% on annual level, i.e., on 0.7% on monthly level. If the influence of the seasonal factor is eliminated, the average monthly inflation rate in 1995 was 0.5%, or 6.2% on annual level.

The coordination of fiscal and monetary policy was made through Government funds transfers to a special stabilization fund with the National Bank of the Republic of Macedonia in order to protect the denar exchange rate. Besides, the significant contribution of the fiscal sector in the achieved financial stability in 1995 was the achieved balance of the Budget revenues and expenditures, which was succeeded in conditions of unavoidable Budget funds engagement for the economy reconstruction and banking system rehabilitation.

According to the expectations, for the imbalance between foreign exchange supply and demand on the foreign exchange market to continue during 1995, monetary policy has been oriented to prevent the appreciation of the domestic currency in wider dimensions, without jeopardizing the realization of basic monetary targets. Such an objective of the monetary authorities in 1995 was completely realized. Namely, nominal effective denar exchange rate as a weighted average of the Deutsche mark and the American dollar in 1995, appreciated by 3.0%. Denar exchange rate appreciation in 1995 was a result of the impact of the following factors: a) enhanced real denar demand, which caused increased foreign exchange supply on the foreign exchange market; b) significant foreign exchange inflow due to the credits and aid from abroad; c) high interest rates on denar financial instruments, and d) foreign exchange inflow due to the regional crisis.

Regarding the fact that the evaluated volume of necessary foreign exchange market interventions was beyond the monetary instruments capacity, the monetary frameworks for such intervention were provided through Budget funds deposited into a special fund with the National Bank of the Republic of Macedonia. By end-November 1995, the Budget has transferred deposits for this purpose to the National Bank of the Republic of Macedonia in amount of 2,237 million Denar. Thus, it enabled an increase of net foreign exchange reserves of the National Bank of the Republic of Macedonia by USD 64.0 million, of which USD 60.5 million through purchasing foreign exchange on the foreign exchange market, and USD 3.5 million through net inflow of foreign exchange on the Government external account. Thus, at the end of 1995 foreign exchange reserves of the National Bank of the Republic of Macedonia amounted to USD 210.6 million, which is equal to two-month export value. Besides, starting from March 1995 the Government deposits were transferred from the deposit money banks with the National Bank of the Republic of Macedonia, undertaking the role of the Government agent.

Money supply considered as second intermediate target of monetary policy in 1995, was determined by reserve money increase and changes in real money demand. In the period January-December 1995, money supply M1 increased by 2,668 million

Denar, or by 27.9%. Thus, at the end of 1995, money supply M1 was 12,229 million Denar, which is by 471 million Denar, or by 4.0% above the projected target.

Higher actual money supply increase, compared to the projected one, was due to the strengthened real money M1 demand, which was by 16 percentage points higher than the projected. The increase of real money demand in 1995 was a result of the drastic inflation decrease, suppressed inflationary expectations of the economic entities, high exchange rate stability and reduced opportunity costs for holding interest-free liquid funds. This resulted in a transfer of the rest of non-monetary deposits into financial instruments comprising money supply M1 in its narrowest sense.

In 1995, net foreign assets of the monetary system increased by 20,543 million Denar, of which 16,458 million Denar was a result of writing-off the foreign exchange liabilities of deposit money banks to creditors from the Paris and Zurich Club, while, 4,085 million Denar was a real increase of net foreign assets with monetary effects. Out of which, 3,265 million Denar was an increase of the National Bank of the Republic of Macedonia net foreign assets, and, 820 million Denar was real increase of net foreign assets of deposit money banks.

Banks new denar credits granted to private and social sector, as a monetary aggregate whose increase was under direct limitation in order to control the money supply, at the end of 1995 amounted to 23,320 million Denar. This amount includes uncollected claims from bank denar credits which in the bank rehabilitation process were undertaken by the Government, as well the selective credits used for writing-off the uncollected claims. With respect to the end of 1994, the bank new denar credits increase in 1995 amounted to 2,089 million Denar, or 9.8%. Compared to the allowed ceiling, denar credits on December 31, 1995 is for 530 million Denar, or for 2.2% lower than the allowed frames with the monetary policy projection. The lower denar credit increase with respect to the allowed ceilings enable partial neutralization of money supply created through larger foreign exchange purchase on the foreign exchange market than the projected one for USD 8.0 million. In total, the realized denar credit increase in 1995 is completely within the projected frameworks with the monetary projection and with the conditions of the Stand-by arrangement.

Reserve money, in its narrowest sense, as basic intermediary objective of the monetary policy in 1995, was under complete control of the National Bank of the Republic of Macedonia. The increase of the seasonally adjusted aggregate in 1995 amounted to 661 million Denar, or 13.6%. Thus, at the end-December 1995, reserve money amounted 5,510 million Denar, being by 40 million Denar, or, by 0.7% below the target determined in the monetary policy projection. This implied, that even under difficult circumstances (due to narrower frameworks for new primary issue, suboptimal dispersion of liquid assets among banks and too ample foreign exchange inflow), primary intermediary target of the monetary policy in 1995 was completely within the projected frameworks. In addition, this also met one of the indicative criteria for the accomplishment of the Stand-by arrangement with the International Monetary Fund.

Based on the projection of the needed liquidity level, during 1995, gradual decrease of the liquid assets of the banking system commenced. In 1995, the average monthly participation of the banks giro-accounts and cash in vaults in the money supply M1 was 2.6%, being 2.7 times below the adequate participation in 1994. From the dynamic point of view, after the adjustment of the banks liquidity in the first quarter of 1995, in the period April-December, a relatively high stability of the banks liquidity rate with respect to the money supply M1 (excluding the seasonal oscillations in May

and July) was achieved, with an average participation of the liquid funds in the money supply M1 of 2.2%.

In the period January-December 1995, net foreign assets of the National Bank of the Republic of Macedonia, as a difference between the foreign assets and foreign liabilities increased by 3,265 million Denar, or by 51.7%. The net foreign assets increase was a result of the purchase of the foreign exchange surplus on the foreign exchange market, resulting in increase of the National Bank of the Republic of Macedonia foreign exchange reserves by US\$ 60.5 million, as well as of the net foreign exchange inflows on the external account of the Government (meaning higher inflow of funds from donations and foreign aid with respect to the payments for servicing the external debt of the country) in amount of US\$ 3.5 million.

Denar credits to deposit money banks in the period January-December 1995, increased by 1,869 million Denar, or by 132.2%. In the same period, net credits to the Government decreased by 3,329 million Denar, due to the transfer of Government deposits to the National Bank of the Republic of Macedonia and the creation of a fund for monetary support of the exchange rate. As a result of that, total credits of the National Bank of the Republic of Macedonia in 1995, decreased by 1,460 million Denar.

Within the credits to the banks in 1995, the most intensive reserve money creation was realized through the deposits sold on auctions. The reserve money creation through this monetary policy instrument in the period January-December amounted to 2,766 million Denar. The amount of reserve money issued in particular periods of the year, was determined by the seasonal fluctuations of reserve money demand, by the effects from the foreign exchange transactions of the National Bank of the Republic of Macedonia, as well as by the efforts to neutralize eventual negative liquidity effects of the Government deposits transfer from banks to the National Bank of the Republic of Macedonia.

The deposits sold on auctions in 1995 were with a maturity from 1 to 7 days. Mainly, deposits were sold to the banks for 1 day. The interest rate on deposits sold on auctions in 1995, have been changed a number of times, as a result of the continual decrease of the discount rate. Thus, starting from 28.3% per annum, as the weighted interest rates for the deposits sold to the banks on auctions were at the beginning of 1995, they decreased to 16.0-18.0% per annum (depending on the periods) at the end of the year.

Deposits purchased on auctions and National Bank bills were main instruments the National Bank of the Republic of Macedonia has used in 1995 for reserve money withdrawal. Besides the auctions, as an "open market operations", for reserve money withdrawal, the traditional instrument - compulsory reserve was used as well. At the end of 1995, through the instruments for reserve money withdrawal, total amount of 1,355 million Denar was withdrawn, which is by 597 million Denar more than in December 1994. Thus, through the auctions on National Bank bills, at the end of 1995 510 million Denar were withdrawn, through deposits purchased on auctions 480 million Denar were withdrawn, while on basis of allocated net compulsory reserve were withdrawn from circulation 365 million Denar.

In accordance with the ongoing process of bank rehabilitation, at the beginning of April, 1995, the selective credits of the National Bank of the Republic of Macedonia were transformed into long-term bonds of the Bank Rehabilitation Agency. It was the first formal and the only open market operation with Government securities in the Republic of Macedonia as there were no other Government securities available.

The discount rate of the National Bank of the Republic of Macedonia in 1995 was projected to follow the trend inflation rate, increased by 5 percentage points per annum, as real part. The achieved high financial stability in the period January-December 1995 resulted in gradual reduction of the Central Bank discount rate, so that from 33.0% on annual level in January, the discount rate was brought down to 15.0% per annum in December, 1995. In the observed period an average discount rate was 21.7% per annum, that corrected by the inflation rate increase in the same period has been a realization of an average real positive discount rate of 11.3% on annual level.

The discount and inflation rate changes affected partly and with certain delays the lending and borrowing interest rates of the deposit money banks in 1995. In the first half of 1995, the deposit money banks interest rate policy did not reflect the achieved financial stability, productivity decrease, the decline of the general economic activity and the global liquidity, etc. From these reasons, by the end of June 1995, certain criteria and measures for determining the interest rates of deposit money banks were stipulated, with whose implementation the real lending interest rates at the end of 1995 were brought down to a moderate level of 19.0% per annum. Simultaneously, like in the previous years, in 1995, the margins between lending and borrowing interest rates were on a relatively high level, thus, in average the lending interest rates were twice as much than the borrowing interest rates.

In 1995, in the balance of payments of the Republic of Macedonia, was a deficit in the current account of USD 216 million and surplus in the capital and financial account of USD 156 million.

Foreign exchange reserves of the Republic of Macedonia, comprising official foreign exchange reserves and commercial banks foreign exchange reserves amounted USD 354 million at end - December 1995. Gross official foreign exchange reserves were USD 275 million. Thus, the core foreign exchange reserves (as a component of official foreign exchange reserves) were determined on the level of USD 110 million. The rest of USD 165 million were current or operative foreign exchange reserves.

Total foreign exchange turnover in 1995 of USD 984 million, was by 22.50% higher than the total foreign exchange turnover in 1994. In period January-December 1995, total realized turnover on the exchange offices market amounted to USD 310 million.

In 1995, a significant progress in relations with the foreign creditors was achieved. In July 1995, a rescheduling credit agreement was signed with the Paris Club under favorable conditions: a) for loans extended before the pre-cut-off date (02.12.1982), with period of repayment of 15.5 years, grace period of 4 years; and b) for loans extended after the pre-cut-off date, with period of repayment of 6.5 years, grace period of 3 years. In both cases, the interest rates would be negotiated on bilateral basis with creditor-countries. By the end of 1995, rescheduling or refinancing bilateral agreements with the German, Austrian and Swiss Government were achieved, while there are agreements with other ten countries which will be signed later.

In May 1995, an agreement with the International Monetary Fund is signed for utilization of funds under the Stand-by arrangement, so that during May, October and December 1995 withdrawals of funds under this agreement were made in amount of USD 18.5 million. Simultaneously, the second tranche from the STF arrangement in amount of USD 19.5 million was withdrawn.

Furthermore, during 1995, the FESAC loan with the World Bank, for structural adjustment of the enterprises and financial sector in the Republic of Macedonia in amount of USD 85 million, as well as a loan for social reforms and technical assistance in amount of USD 14 million was approved. At the same time, a loan for transportation infrastructure in amount of USD 24 million was approved with the World Bank. Within these loan agreements in 1995, a total of USD 61.7 million were withdrawn.

At the same time, from the loans approved from the European Bank for Reconstruction and Development, in 1995, total amount of USD 14.5 million was withdrawn, while from the official bilateral creditors a commodity credit of USD 7 million was approved by the US Government.

In 1995, banks and savings houses in the Republic of Macedonia were making efforts to compliance their operations with the supervision standards stipulated by the National Bank of the Republic of Macedonia, which were in accordance with the international prudential standards. The banks compliance according to the supervisory standards has been regulated with the provisions from the Banks and Savings Houses Act. Namely, on May 28, 1995 the two years term for bank compliance to the provisions from the Banks and Savings Houses Act, has terminated, especially emphasizing the origin of the founders' capital, which for the operations within the country amounted DEM 3.0 million (in denar countervalue), while for payment operations and credit activities abroad amounted DEM 9.0 million (in denar countervalue).

Out of 19 banks operating on the Republic of Macedonia territory before May 28, 1995, 3 banks did not succeed in providing the needed minimum capital of DEM 3.0 million and their licenses for further activities were withdrawn. In 1995, no new banks were established, except the spin-off five former branches of the biggest bank in the Republic into independent banks. Giving a license to these banks, the total number of banks operating on the territory of the Republic of Macedonia on December 31, 1995 was 21. In the period January-December, 1995, 5 licenses were issued to the new savings houses, so that their number at the end of 1995 increased to 28.

As result of the accumulated problems lasting for years already, among which the most significant are the concentration of high amount of non-performing credits, and the solution of the problem with the foreign exchange depositors, in 1995 rehabilitation and restructuring, as part of the overall economic reforms in the state were undertaken. Thus, the constitution of institutional framework for restructuring a number of banks in the Republic of Macedonia was imposed with adoption of the Act on Rehabilitation and Restructuring of a number of banks in the Republic of Macedonia.

The Act comprises three sets of measures that were supposed to result in banks rehabilitation: a) writing-off the old foreign exchange deposits from the banks balance sheets; b) writing-off the claims and liabilities regarding foreign credits from the banks balance sheets, and c) restructuring the biggest bank in the Republic, i.e., Stopanska Banka, a.d. Skopje.

First two measures were implemented in linear order, so that starting from January 1, 1995, banks have removed the households "frozen" foreign exchange deposits from the assets and liabilities side of their balance sheets, as well as liabilities and claims from the credits approved by the Paris Club creditors. By October 31, 1995, banks removed claims and liabilities from their balance sheets regarding credits granted from commercial banks (the so-called Zurich Club of creditors).

The third measure in the process of banking system rehabilitation was the restructuring of Stopanska Banka a.d., Skopje, which was realized by undertaking its non-performing claims by the Government, which were reduced by the capital of the net borrowers and by the bank downsizing with the spin-off five branches which fulfilled the prescribed conditions, into independent banks. The finalization of the reconstruction of Stopanska Banka a.d., Skopje comprising its privatization, additional

capitalization and change of the bank management is expected to be realized during 1996.