

NATIONAL BANK OF THE REPUBLIC OF MACEDONIA
MONETARY POLICY AND RESEARCH DEPARTMENT



**Recent Macroeconomic Indicators
Review of the Current Situation**

October 2014

Recent Macroeconomic Indicators

Review of the Current Situation - Implications for the Monetary Policy

The review of the current situation aims to give an overview of the recent macroeconomic data (July- September 2014) and to make a comparison with the latest macroeconomic projections (April 2014). This will determine the extent to which the current situation in the economy corresponds to the expected movements of the variables in the previous cycle of projections. The review focuses on the changes in external assumptions and performances of domestic variables and the effect of these changes on the environment for monetary policy conduct.

The global economic environment has not undergone major changes compared to the period of the last assessments. After the stagnation of the economy in the second quarter, the high frequency economic indicators for the euro area do not give encouraging signals for resuming economic recovery in the third quarter. Following the downward revision of growth projections for 2014 and 2015 over the previous month, at its last meeting in October the ECB again highlighted the downward risks to growth, related to the possible reduction of confidence because of the geopolitical risks and the possible lack of progress in the implementation of structural reforms. Further slowdown in the inflation growth, amid annual increase in consumer prices of 0.3% in September increases the risk of a prolonged period of low inflation. After the relaxation of the monetary policy in September, in October the ECB did not change the interest rates, highlighting that it will closely follow the trends in inflation and the transmission effects of the monetary measures undertaken so far. However, after the meeting details were published about the announced program for repurchase of securities, relating to the duration, the segments in which the ECB will intervene, eligibility criteria and other operational aspects. **Observed from a viewpoint of the individual quantitative external environment indicators for the Macedonian economy, the assessments for the foreign effective demand for the period 2014-2015 registered minor changes relative to the April projection.** The new assessments indicate somewhat less intensive recovery of external demand, largely due to the weaker economic outlook in the region after the floods that hit it over the past period. **Changes in the expectations about the prices of primary products are in a different direction and are more favorable in terms of expected in the April projection.** Latest developments and assessments for the **world oil prices** further indicate lower price levels of this fuel in relation to the April expectations, and thus less pressure on inflation and terms of trade. The latest assessments for the **metal prices** point to more favorable developments in the terms of trade for this export sector than projected in April. This movement is especially pronounced in the nickel prices, and is mainly associated with the factors on the supply side. Regarding the **food prices**, recent data on the prices of cereals show their significant decline, indicating notably lower import pressures through this channel on domestic inflation and terms of trade, compared with the April projections. However, one should bear in mind that the presence of the geopolitical tensions in the world creates great uncertainty about future movements in the prices of primary products.

The comparison of the latest macroeconomic indicators with their projected dynamics within the April cycle of projections indicates certain deviations in some segments. In terms of individual indicators relevant for the monetary policy, inflation data for September pointed to retention of the continuity of downward deviations compared with the projection. In September, inflation stagnated on a monthly basis, while the annual and average change in prices remained negative and mainly driven by the fall in the prices in the food component. The downward deviation in inflation in September, compared with the projection, is a combined effect of all three components of inflation (energy component, core inflation and food). In September, for the first time in a long period core inflation was negative on an annual basis. Lower baseline conditions and estimates for the lower pressures from import prices than previously expected, pointed to downward risks to the inflation projection for 2014. On the other hand, there are still upward risks

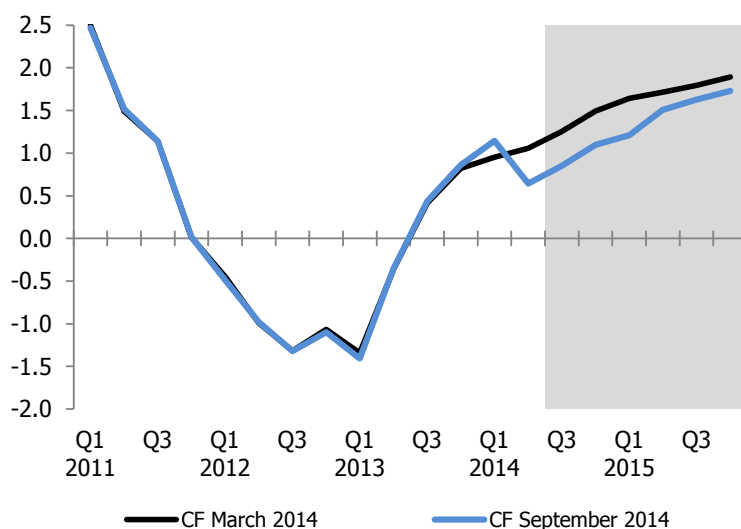
regarding the prices of energy and food (related to the geopolitical tensions in Iraq, the Russian-Ukrainian conflict, and the possible effects of the flooding in the region), whose possible materialization could create price pressures in the forthcoming period. However, **we further assess that downward risks are dominant in the balance of risks around the projected movement of prices.**

According to the latest available data for the third quarter of 2014, foreign reserves (adjusted for the price and exchange rate differences and price changes of securities) increased at a faster pace than projected in April. Most of this increase is due to the government borrowing on the international market, which was not included as an assumption in the projections for 2014. Excluding the effect of the government borrowing, foreign reserves still registered a moderate growth, amid favorable movements in the foreign exchange market and interventions with purchase of foreign currency. The number of available external sector indicators for the third quarter is still limited, making it impossible to identify accurately the factors of changes in foreign reserves. From the external sector indicators, available are the data on the net purchase from currency exchange operations as of September, which now point to net inflows from private transfers in line with the expectations. Data on foreign trade for the period from July to August indicate somewhat smaller trade deficit for the third quarter than expected. The analysis of foreign reserves adequacy indicators shows that they continue to move in a safe zone.

Signals that the new high frequency indicators for the economic activity send for the third quarter are favorable and consistent with current assessments. They suggest keeping the positive trends from the previous quarter, when a real GDP growth of 4.3% was registered. However, as indicated for some of the key sectors, moderate slowdown of growth is possible in the third quarter. Such dynamics is indicated by the slower growth of the activity in industry and trade, as well as maintaining the value of construction work performed in July in the zone of negative annual change. **With regard to the monetary developments, preliminary data on the credit market for September** point to acceleration of the monthly credit flows, and thus the annual rate of credit growth, which reached 9.6%. The level of loans in September exceeded the projection for the end of the third quarter. In terms of the deposit potential, during September deposits continued to grow at a solid pace, leading to depletion of the negative gap relative to the projection. The monetary growth at the end of September, is in line with the projection. The latest assessments of **EURIBOR indicate its lower level for 2014 relative to that projected in April, with significant downward revision of the expectations for 2015.**

The latest macroeconomic indicators and estimates do not indicate major changes in the environment and risks perceptions compared to the assumptions provided in the April projections. Foreign reserves rose (without the government leveraging effect) and followed the projected path for the third quarter. Analyzing the indicators of foreign reserves adequacy, they continue to move in a safe zone. The risks from the external environment remain unfavorable and are further highlighted by the weaker than expected economic performance of the eurozone and the persistent geopolitical tensions. Inflation in September again deviates from the projected path and suggests price pressures lower than expected. The risks around the inflation projection are still assessed as predominantly downward. However, upward risks were identified, associated with external factors, which could cause instability and major price shocks that could influence the future inflation. Divergence in inflation is further explained by the variance in the factors on the supply side, amid assessments for movement in the demand within the expected range. Economic activity indicators suggest that the economy will continue to grow also during the third quarter of 2014, as expected. New credit flows are solid, making the total loans exceed projections. Thus the downward risks to the projection are less pronounced, although amid uncertain economic environment, they are still present.

Foreign effective demand
(annual rates of change in %)



Source: Consensus Forecast and NBRM calculations.

Under the new assessments, the growth of foreign effective demand in 2014 is revised downward compared with the April projection ...

... and it is expected to be 0.9% instead of 1.2% ...

... which is mostly due to the expectations for a decline in the economic activity in Serbia and Italy, despite the April projections for their economic growth. Lower expected growth of the German economy also has downward impact on the growth of foreign demand in 2014.

Downward revision is made also to the projection of foreign demand in 2015, which now forecasts growth of 1.5%, versus 1.8% in April.

In 2014 it is expected that foreign effective inflation will be low and will amount to 0.3% ...

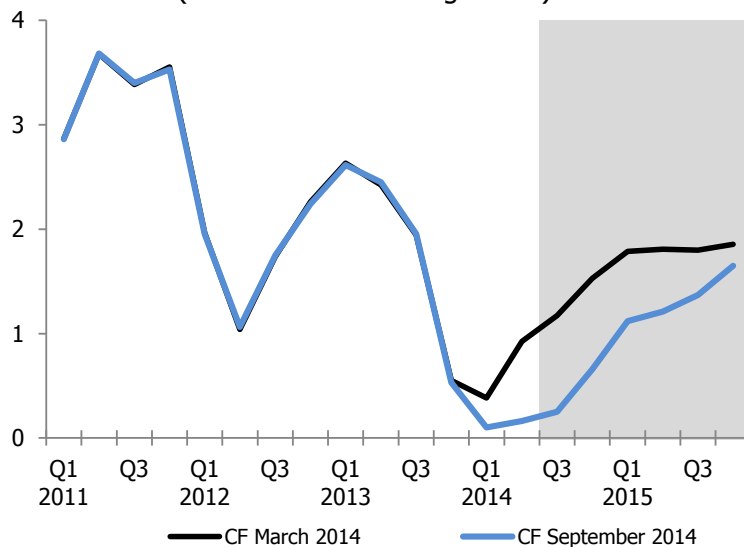
... which is a significant downward deviation in relation to the April projection of 1%.

The correction is due to the assessment for lower inflation in all our import partners ...

... among which Bulgaria and Serbia (countries with projected deflation), as well as Germany, have the greatest contribution.

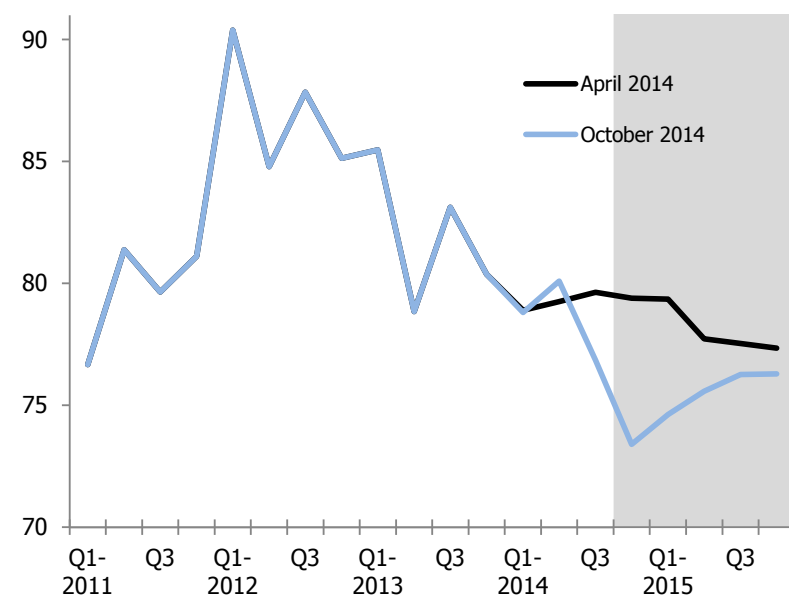
Assessment of foreign inflation is revised downward also for 2015 and it is now expected to equal 1.3%, versus the projection of 1.8% in April.

Foreign effective inflation
(annual rates of change in %)



Source: Consensus Forecast and NBRM calculations.

Brent oil
(quarterly average, EUR/Barrel)



Source: IMF and NBRM calculations.

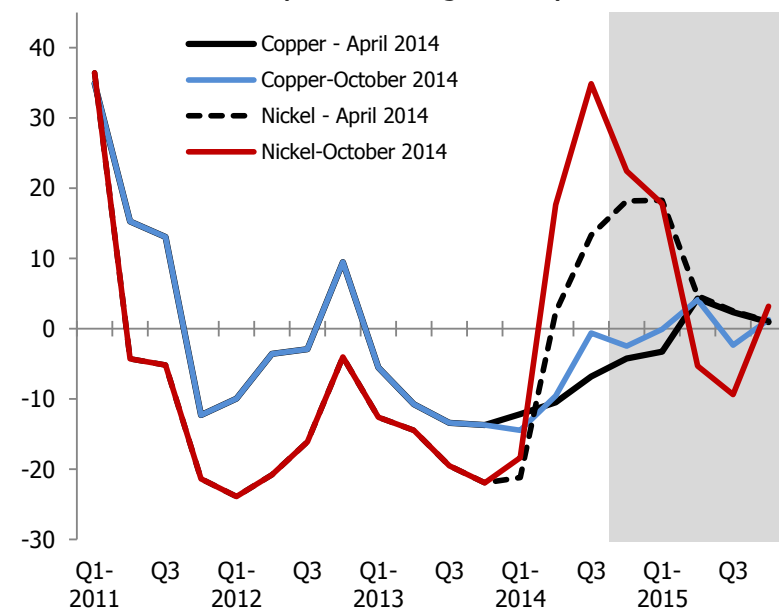
Despite the numerous global geopolitical risks, in the third quarter of 2014 the price of oil registered a sharper decline than envisaged in the April projection ...

... mainly reflecting market fundamentals such as high supply and lower demand for oil during this period.

These factors are expected to continue to exert downward pressures on the oil price by the end of the year, and it is estimated that, on the annual level, the price drop will be sharper than in the April projection.

In 2015 a downward revision in the price of oil was also made, and now it is expected to decline somewhat more than in the April projection.

Nickel and copper prices in EUR
(annual changes in %)



Source: IMF and NBRM calculations.

In the third quarter of 2014, movements in metal prices are more favorable than projected in the April projection ...

... amid faster growth in the price of nickel because of the gap between demand and supply in this period¹...

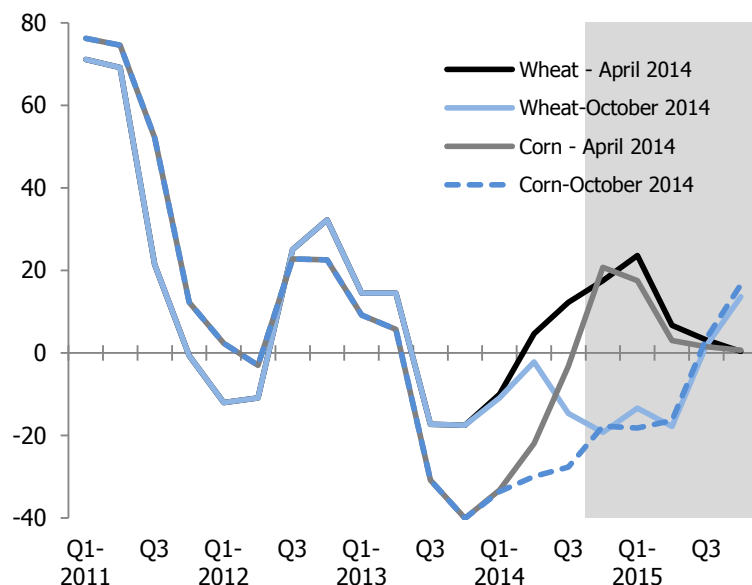
... and a smaller decline in the price of copper due to the positive indicators for the Chinese and the American economy.

These trends are expected to continue in the fourth quarter, so that at the level of 2014, a slightly lower decline in the copper prices and a significantly larger increase in the prices of nickel compared with April projections, is expected.

In 2015, the prices of nickel and copper will grow moderately, which is a downward revision compared to the April projection, especially in the case of nickel.

¹ The main reason for this is the ban on exports of nickel from Indonesia.

Wheat and corn prices in EUR
(annual changes in %)



Source: IMF and NBRM calculations.

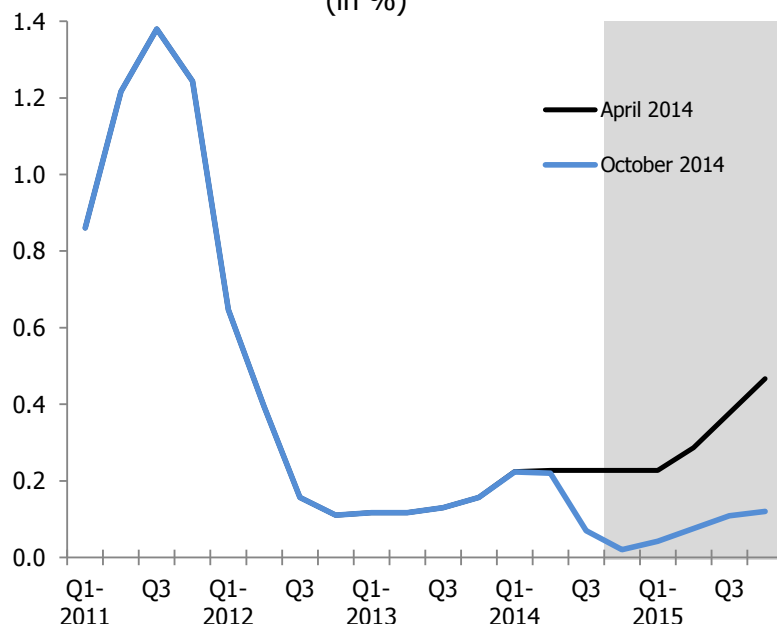
In the third quarter, the price of wheat decreased significantly, despite the April projection for growth, with a simultaneous significantly larger decline also in the price of corn.

Given that estimates for 2014 point to a solid supply of wheat and record yields of corn, especially in the United States as its biggest manufacturer, a substantial downward revision of the prices of primary foods for this year was made ...

... where compared to April, now it is expected to have twice larger annual decline in the price of corn and a significant decline, rather than increase, in the price of wheat.

In conditions of excessive production and high levels of accumulated stocks, the prices of wheat and corn are expected to decrease also in 2015, which is different from the April assessments for their growth.

1M Euribor
(in %)



Source: Consensus Forecast and NBRM calculations.

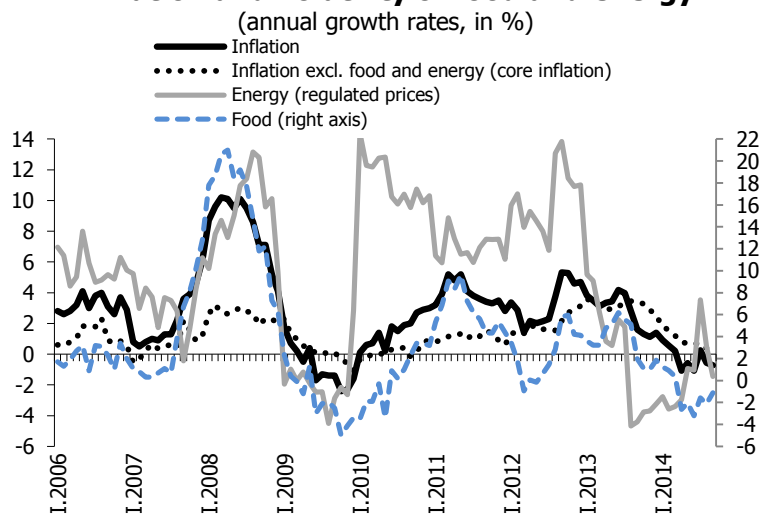
In the third quarter the foreign interest rate Euribor decreased significantly and reached a level that deviates downward from the April projection ...

... which is entirely a result of the new standard and non-standard measures of monetary easing undertaken by the ECB in this period.

Hence, for all of 2014, a downward revision to the projection for the 1-month Euribor is carried out, and now it is expected to amount to 0.13% instead of 0.23% in April.

Given that the accommodative monetary policy of the ECB will continue next year, estimates are that the 1-month Euribor in 2015 will reach historic lows of 0.09% compared to the April projection of 0.34%.

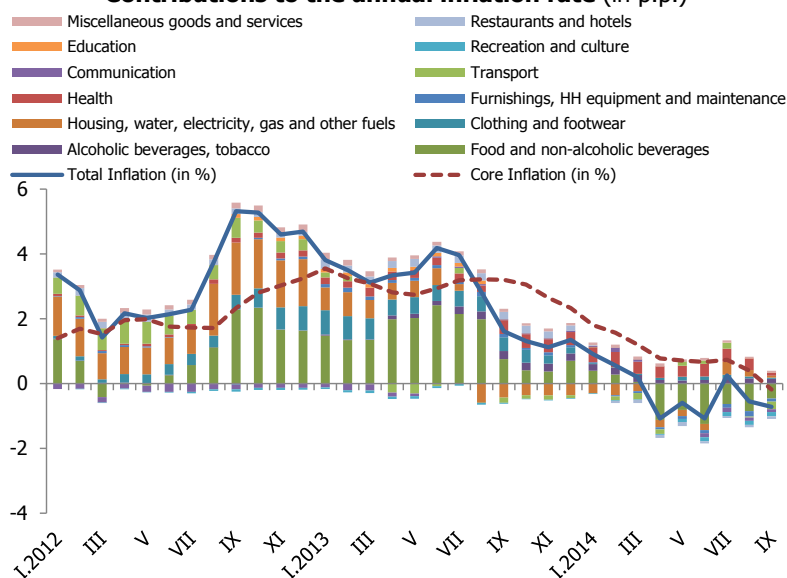
Inflation and volatility of food and energy



In July 2014, the consumer prices were unchanged on a monthly basis...

... amid price reductions in the energy component and a small increase in food prices².

Contributions to the annual inflation rate (in p.p.)



The annual decline in the general price level in September was 0.7%, and it is slightly sharper relative to the decline registered in the previous month ...

...which denotes a significantly lower inflation than expected in the April cycle of projections...

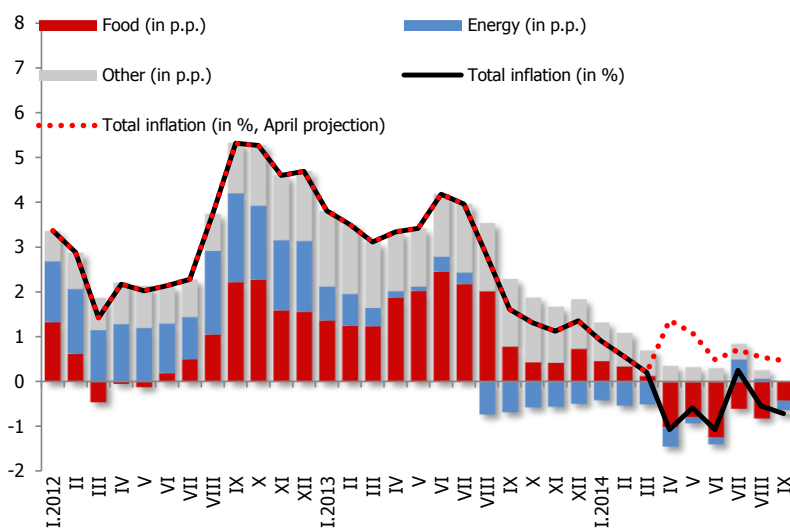
... amid larger downward deviation of realized from the projected inflation in the energy component and core inflation and smaller deviation in the food component.

In September, core inflation was unchanged on a monthly basis (compared to the drop in August)

... while annual core inflation continued to adjust downwardly, and in September it recorded an annual decline of 0.2% (for the first time after September 2010) versus the increase of 0.4% in August.

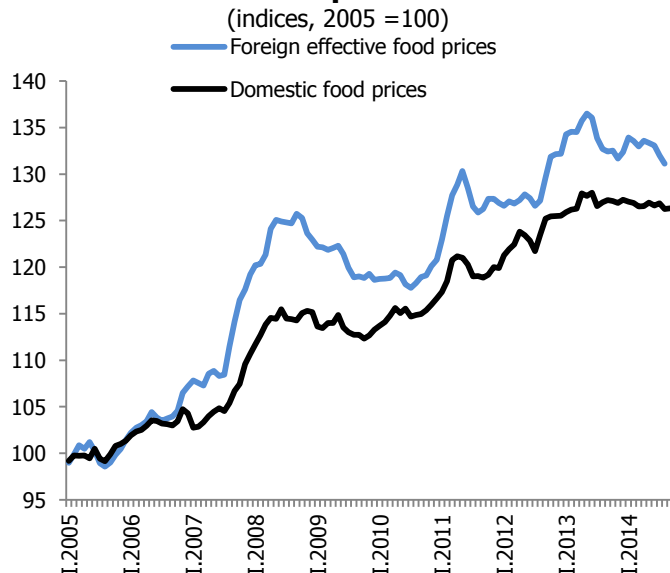
² Categories with the largest individual contribution to the September price level are the following: liquid fuels and lubricants (monthly decline in prices of 2.1%), oil and grease (monthly price increase of 3.5%) and milk, cheese and eggs (monthly price increase of 0.6%).

Inflation rate
(annual impacts to inflation, in p.p.)



Source: SSO and NBRM.

Foreign effective food prices* and domestic food prices
(indices, 2005 = 100)



* Foreign effective food prices are calculated as weighted sum of food prices in countries that are major trade partners with Macedonia.

Source: State statistical office, Eurostat and NBRM calculations.

Such dynamics is due to the significantly slower price growth of pharmaceutical products, and the significant annual decline in the prices of IT equipment and air traffic.

External input assumptions for 2014, which are included in the inflation projection, are revised downward.

Thus, the latest estimates for the prices of internationally traded primary food products indicate downward correction of prices of cereals in 2014, compared with the signals obtained during the April cycle of projections, and reflect the increase in yields and inventories from the previous year.

Also, expectations for the foreign effective inflation and the estimates of the movement in the oil price, by the end of next year show a downward correction, in circumstances of global inventories that are higher than the demand ...

... despite the upward risks associated with the instability in the Middle East and prolongation of the Russian-Ukrainian conflict.

In view of the projected movement of prices, downward risks remain to be most common in the balance of risks.

Lower initial conditions and downward revisions of external assumptions point to possible downward pressures on the inflation projection for 2014.

On the other hand, risk factors that could create upward pressures remain ...

... such as the risks associated with the intensification of tensions in Ukraine and the Middle East and the possible effects of the floods in the region.

These risks, in future, could lead to upward price pressures.

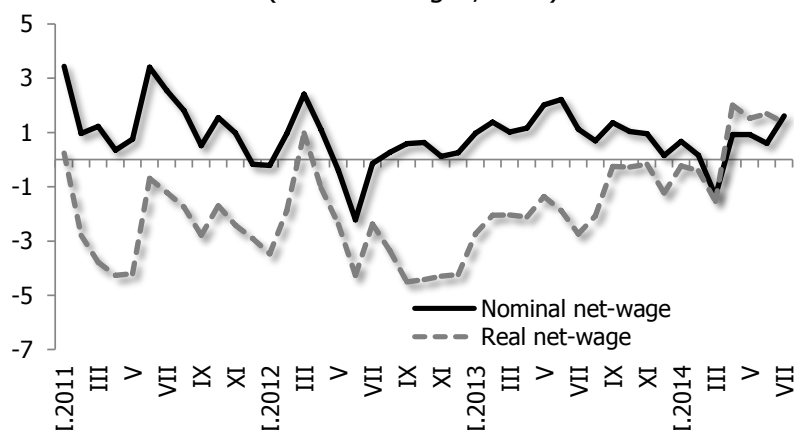
The average nominal **net wage** in July 2014, has significantly accelerated the pace of growth, achieving an annual growth of 1.6% (0.6% in June) ...

... amid growth of paid wages in all sectors of the economy.

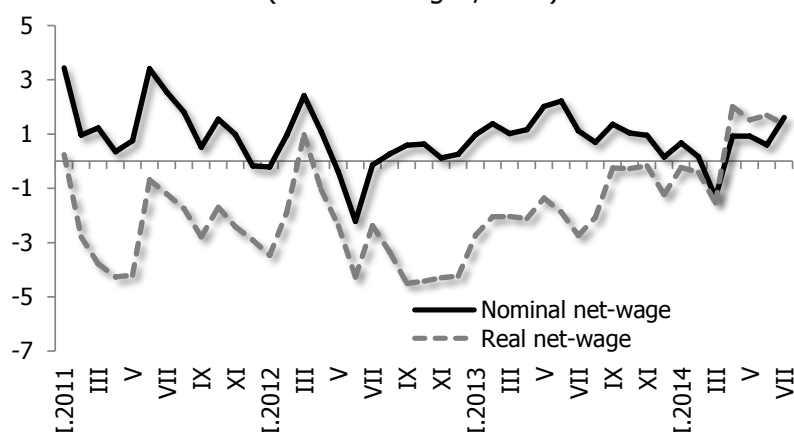
The largest growth was observed in the wages in construction and service industries, i.e. "professional, scientific and technical activities" and in "administrative and auxiliary service activities" ...

... and a significant increase in wages was observed also in mining.

Average net-wage
(annual changes, in %)

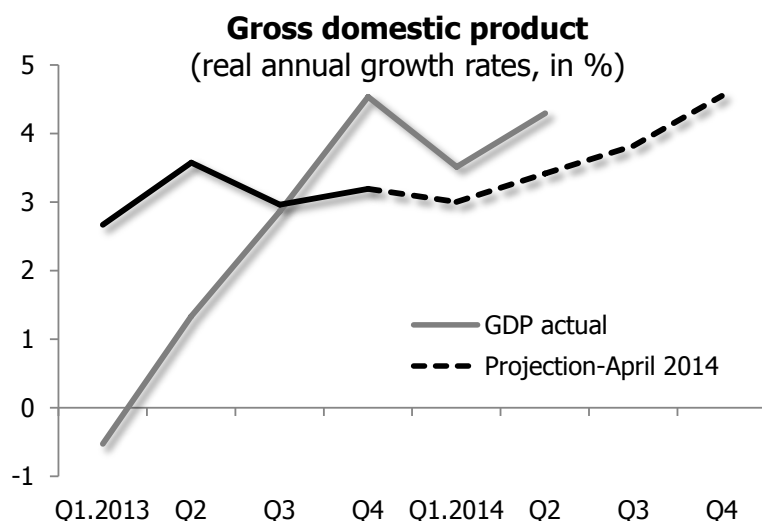


Average net-wage
(annual changes, in %)



This movement in the nominal wage is slightly more favorable than anticipated in the April projection (expected growth of 1.1% in the third quarter).

On the other hand, **real wages** in July 2014 registered a slowdown in the annual growth of 1.4% (1.7% in June), due to the rise in consumer prices. However, despite the slowdown this growth is faster than that projected in the April projection.



Source: SSO and NBRM projections.

In the second quarter of 2014, the real annual economic growth was 4.3%, and it is higher than expected according to the April projection (3.4%)³.

On the production side, the highest annual real growth was observed in the group of activities "Wholesale and retail trade; repair of motor vehicles and motorcycles; Transport and storage; Accommodation and food service activities", as well as the activities "Information and communications" and "Financial and insurance activities"...

... while in terms of demand, all components increased ...

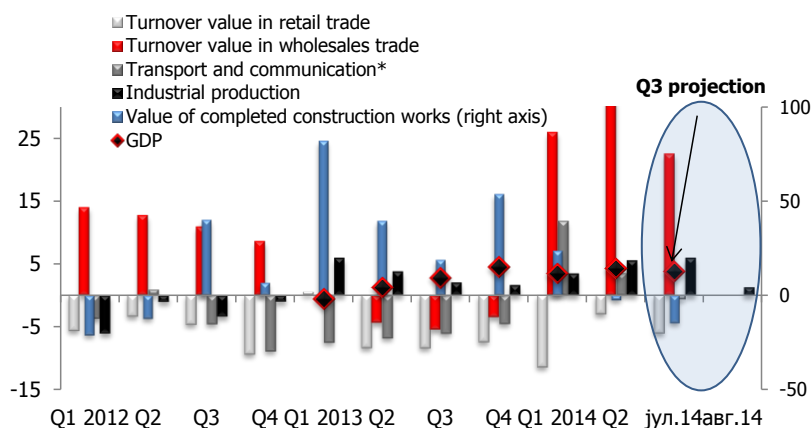
... with the export of goods and services registering the highest annual real growth, and a significant growth was noted also in the consumption of households and the public sector ...

... leading to pressures to increase imports.

The available data for the third quarter of 2014 point to continued growth of the domestic economy, but at a slower pace compared to the previous quarter, amid weaker performances of most of the important economic sectors.

³ Published quarterly GDP data include data revision due to methodological improvements and implementation of the new methodology ESA 2010 (for more information see: http://www.stat.gov.mk/Dokumenti/ESA2010_en.pdf) and hence they are not directly comparable with the data used in the April projection.

Economic activities (real annual changes, in %)



*Simple average of annual growth rates of the different types of transport and the telecommunications.
Source: SSO and NBRM calculations.

In the period July-August 2014, industrial production registered an average growth of 3.7% ...

... with the largest contribution to the growth being that of the production capacities in the technological industrial development zones (primarily the production of motor vehicles), as well as the production of food and metal industries...

... while a significant decline was recorded in the energy production and mining.

The growth in industry slowed down compared with the second quarter (5.5%). In July, slower pace of annual growth compared with the previous quarter was recorded also in the trade...

... amid slower real growth in the wholesale and faster pace of decline in retail trade.

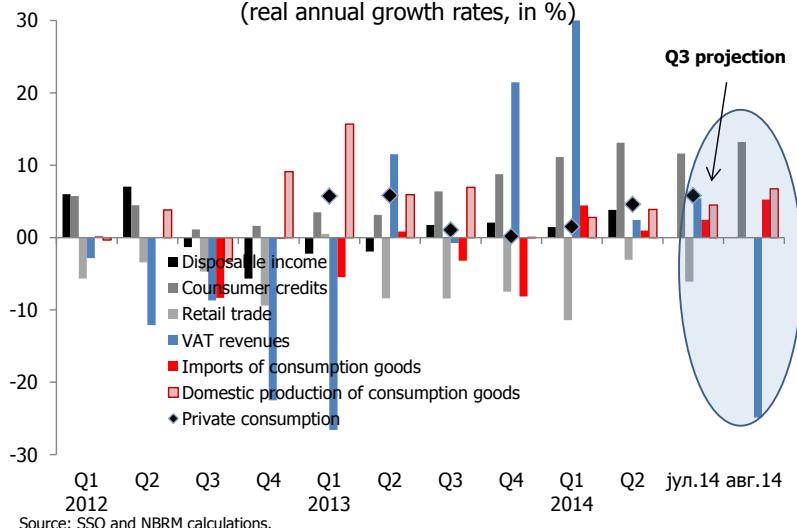
The positive economic growth is confirmed by the data on the turnover in catering whose growth intensified in July.

On the other hand, adverse changes were registered in **construction and transport** ...

... where the dynamics of decline in the value of performed construction work increased in July 2014 compared with the fall in the second quarter ...

... while data on the railway transport for July generally indicate an annual decline, but with smaller intensity relative to the second quarter.

Indicative variables for private consumption
(real annual growth rates, in %)



Available indicators of aggregate demand also point to further economic growth in the third quarter of 2014, which is consistent with the expectations in the April projection.

Available indicators of **private consumption** indicate growth in the third quarter and are somewhat more favorable compared to the previous quarter ...

... amid continuing steady pace of growth in lending to households ...

... accelerated annual growth in real net wages and real growth of the same intensity in pensions paid ...

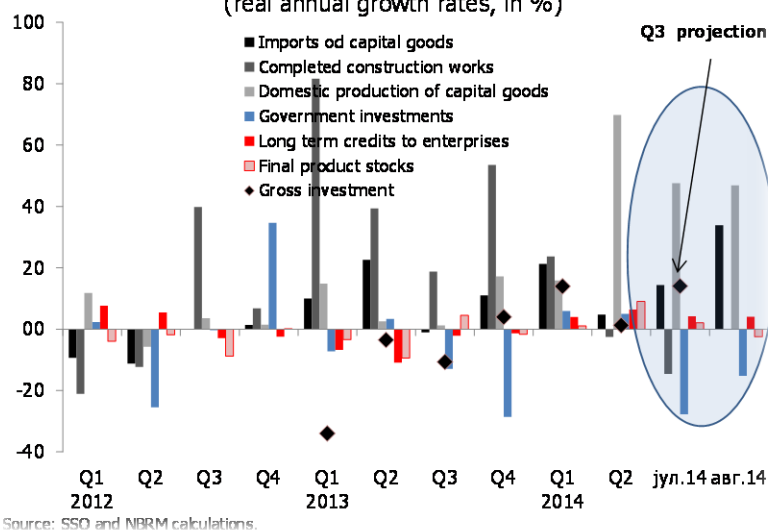
... as well as real growth of private transfers, but at a slower pace.

Accelerated growth was registered also in the domestic production and imports of consumer goods ...

... while retail trade remains in the negative zone, marking a rapid annual decline in real terms ...

... and the net revenues from VAT registered an annual decline, contrary to the growth in the previous quarter.

Indicative variables for gross investments
(real annual growth rates, in %)



The latest indicators of **investment activity** send different signals, but generally they point to a possible investment growth in the third quarter, however with lower intensity compared to the previous quarter.

Significant enhancement of growth is observed in the imports of investment products, while domestic production still registers high annual growth, but at a slower pace ...

...and slower growth was registered also in lending to the corporate sector.

On the other hand, in July the construction registered a decline, which is deeper than that in the previous quarter ...

... as well as the budget capital

expenditures, which decreased contrary to the increase in the previous quarter ...
... while annual reduction was registered also in foreign investment and inventories of finished products.

Available data on **foreign trade** as of August show widening of the trade deficit ...

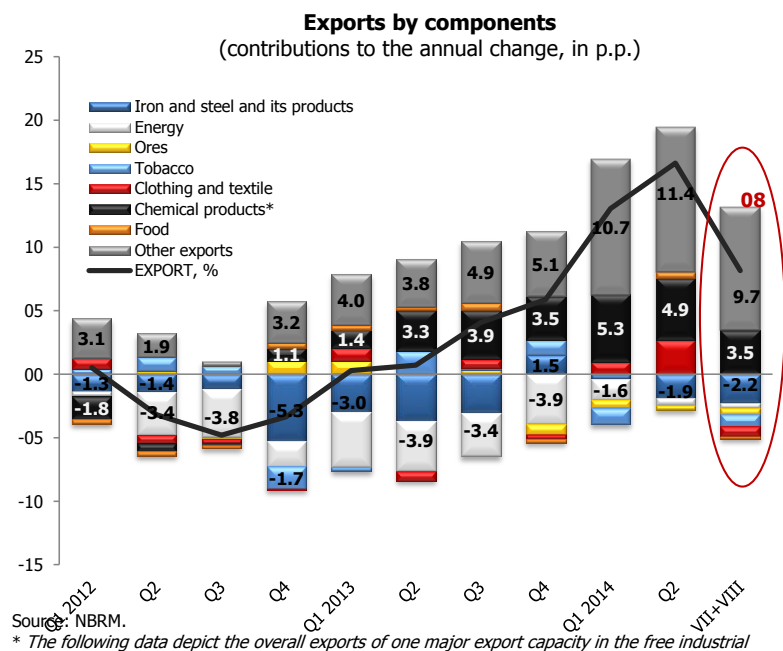
... amid faster annual growth in the import than in the export of goods ...

... which is in line with the expectations from the April projection.

Budget performances in the first two months of the third quarter indicate a decline in **public consumption**, contrary to the expectations for growth in the April projection ...

... with a significant annual reduction of the transfers for health care⁴ and the costs for goods and services.

⁴ Most of these assets relate to expenditures for goods and services.



In the period from July to August, the foreign trade deficit expanded by 22.4% on an annual basis, conditional on the faster annual growth of import relative to the growth of export activity ...

...contrary to the assessments in the April projection, which envisage more moderate expansion of the trade deficit in the third quarter.

Exports during July and August recorded an annual growth of 8.2%, and the increased use of new facilities remains a major factor of the positive changes in exports ...

... while all other categories acted in the opposite direction, with the largest decline being registered in the export of iron and steel.

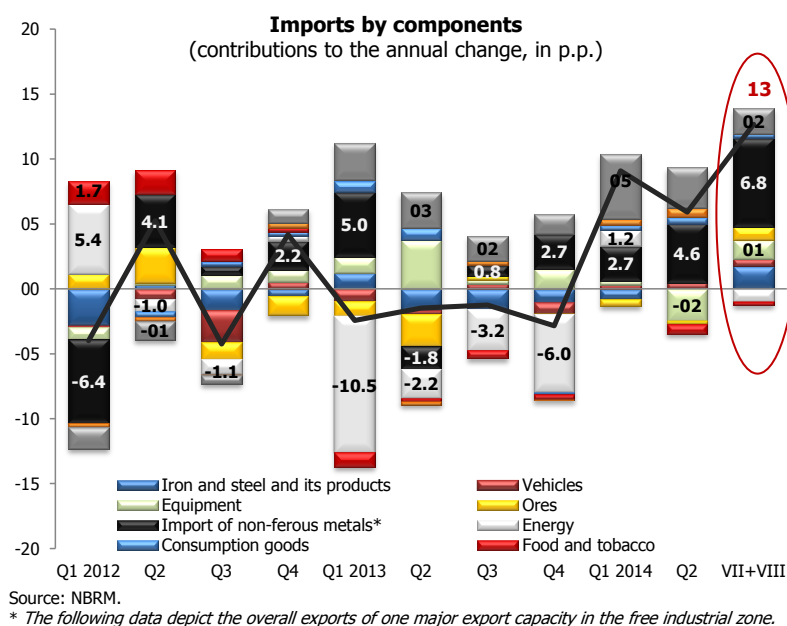
Movement of exports in July and August was somewhat less intensive than expected for the third quarter, according to the April projections.

Larger downward deviations occurred in part of the traditional export products, i.e. exports of iron and steel, ores and tobacco, which is largely offset with the export activity of the new facilities.

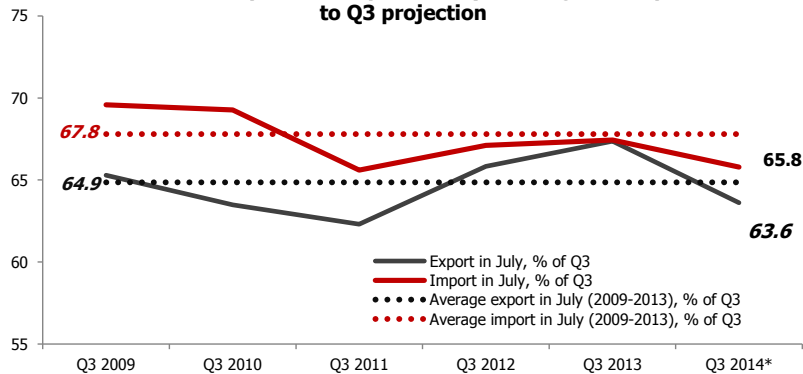
The imports in July and August reached an annual growth rate of 12.7%, largely driven by the rising import of raw materials for the new export oriented facilities and metal industry ...

... versus the moderate annual decline observed in the energy imports.

The import in July and August was lower than anticipated for the third quarter. The import of food, other import products, equipment and machinery, and iron and steel is lower than expected, while upward deviation was registered in ores and imports of raw materials for one important facility from the technological and industrial development zone.



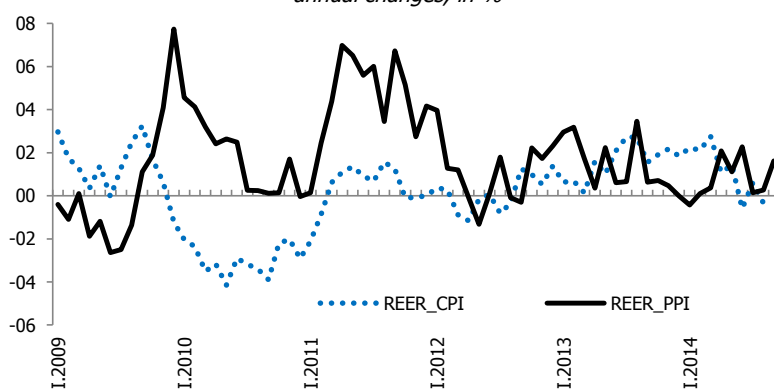
Share of the export and import in July and August compared to Q3 projection



Source: NBRM.

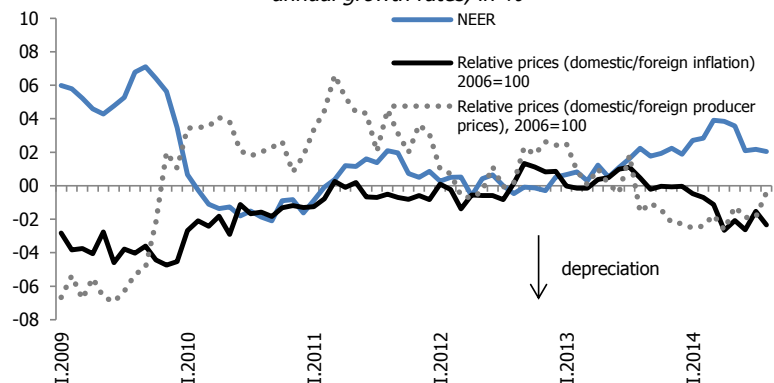
* Share of the export/import in July and August in the projected export/import for Q3 2014, projection April 2014.

REER
annual changes, in %



Source: NBRM.

NEER and relative prices
annual growth rates, in %



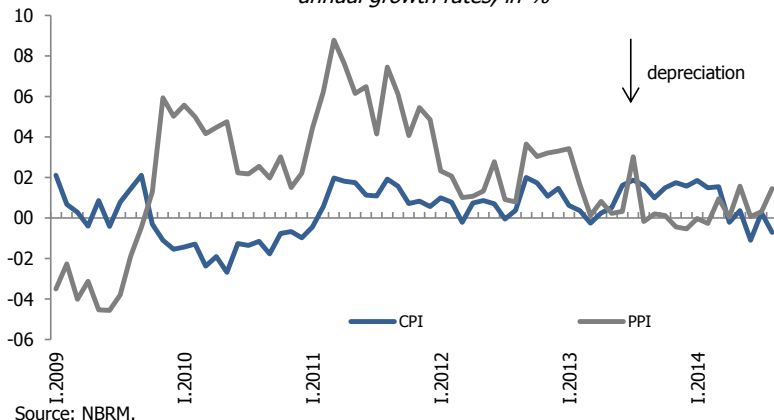
Source: NBRM.

Despite the weaker performances in the export of goods, the absence of major import pressures in the period July-August point to the possibility of achieving somewhat lower trade deficit than projected for the third quarter of the year.

In August 2014, price competitiveness indicators of the domestic economy registered divergent movements on an annual level. Compared with the same month of the previous year, the REER deflated by consumer prices depreciated by 0.3%, while the REER deflated by producer prices appreciated by 1.6% on an annual basis.

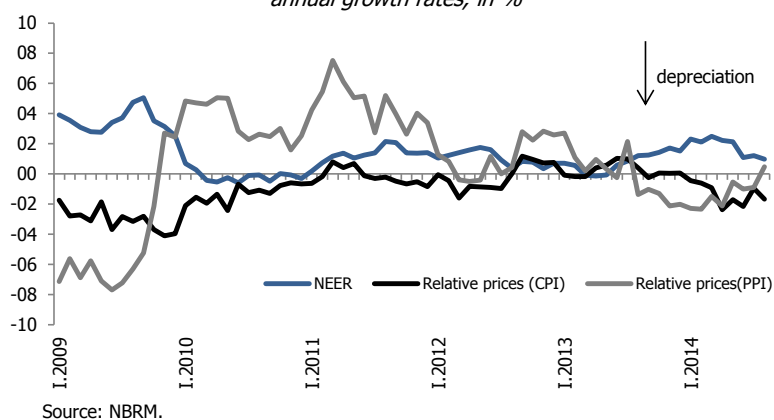
The further appreciation of the nominal effective exchange rate (by 2%) on an annual basis, as a result of the depreciation of the Ukrainian hryvnia, Russian ruble and Turkish lira against the denar, caused upward pressures on both REER indices. On the other hand, the growth of foreign consumer prices, as opposed to the moderate annual decline in domestic prices, as well as faster growth in foreign versus domestic prices of industrial products, led to a decline in relative prices by 2.3% and 0.4% respectively.

REER, excluding primary commodities
annual growth rates, in %



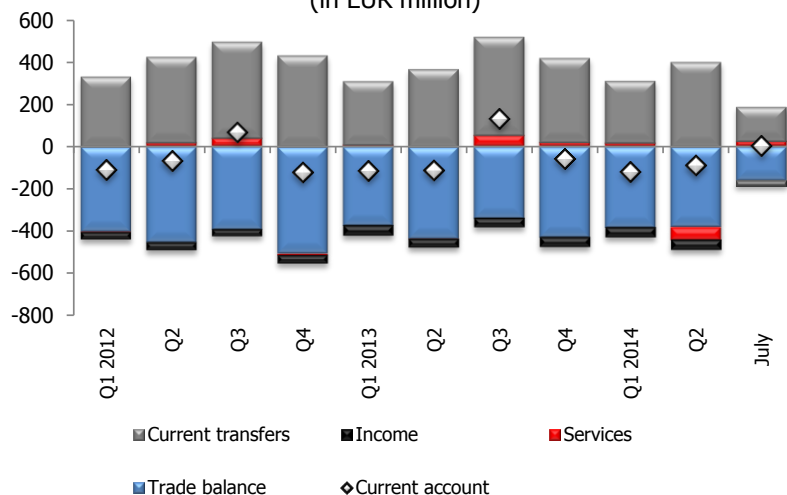
The analysis of the movement of the REER indices calculated with weights based on the foreign trade without primary commodities⁵, indicates similar movements in the domestic price competitiveness. The REER deflated by consumer prices depreciated by 0.7% on an annual basis, while the REER deflated by producer prices appreciated by 1.5%.

NEER and relative prices, excluding primary commodities
annual growth rates, in %



Relative CPI registered an annual decline of 1.7%, driven by the decline in domestic prices, contrary to the annual growth of foreign prices. On the other hand, the relative prices of industrial products recorded a growth of 0.5%, driven by higher domestic prices, versus the decline registered in the foreign prices of industrial products. NEER appreciation continued in August, annual change driven by the depreciation of the Turkish lira and the Serbian dinar against the denar.

Main components of the current account
(in EUR million)



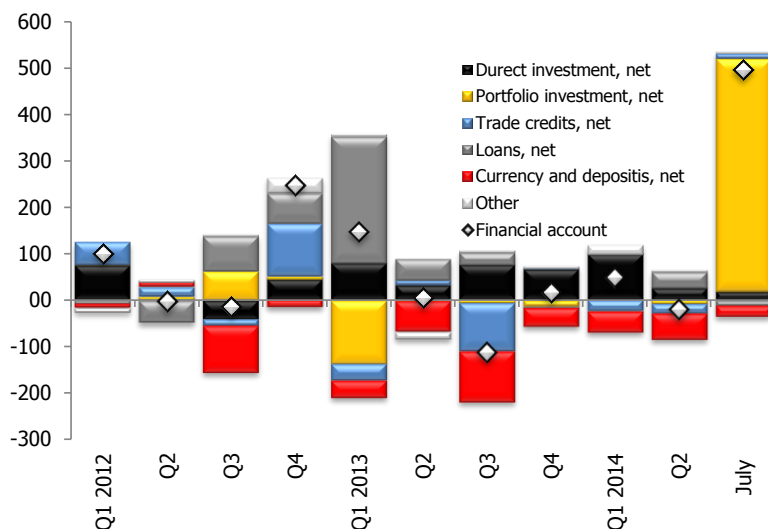
In July 2014, the balance of payments current account registered a surplus of Euro 5.7 million (or 0.1% of GDP). The achieved positive balance was lower than the expected surplus for the third quarter of the year, according to the April projection.

In terms of individual components, negative deviations from the projection were registered in the trade deficit and the deficit in the income category ..

... while the performances of current transfers and the positive balance in the trade in services are higher than anticipated.

⁵ Primary products excluded from the calculation include: oil and oil derivatives, iron and steel, ores and imported raw materials for the new industrial capacities in the free economic zones.

Financial account components
(in EUR million)



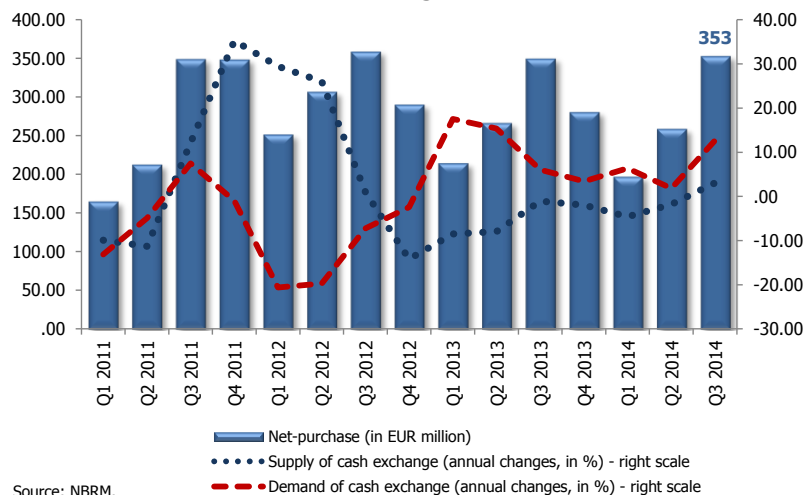
Source: NBRM.

During July, the capital and financial account registered high net inflows of Euro 496.1 million (or 6.2% of GDP), which are significantly higher than projected for the third quarter of the year.

Deviations with respect to the April projection are largely due to the actual inflows of portfolio investments as a result of the government's external borrowing by issuing the third Eurobond⁶. *If we exclude the impact of the Eurobond, the capital and financial account registered small net outflows of nearly Euro 4 million, lower than the expected net outflows for the third quarter of the year.*

Deviations in other categories were largely due to the realized net inflows based on trade credits instead of the expected net outflows, as well as the lower net outflows in the short-term loans. On the other hand, higher net outflows were registered in currency and deposits, coupled with lower inflows observed in direct investments.

Cash exchange market



Source: NBRM.

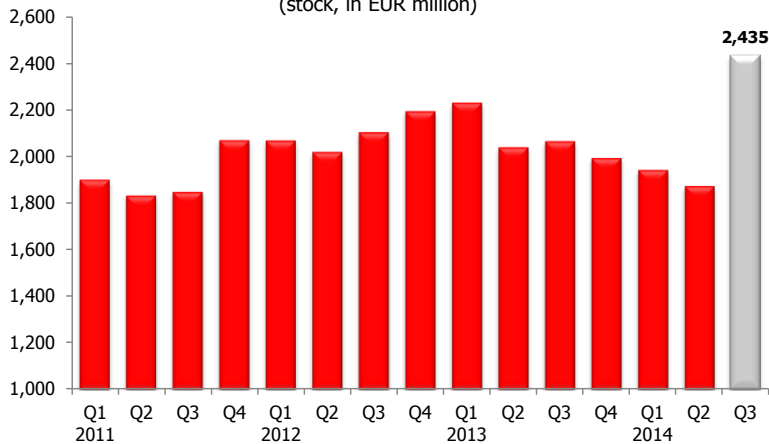
Recent data on currency exchange operations as of September 2014 suggest continuous growth in the supply of foreign currency, registered also in the previous month, amid further annual growth also in the demand for foreign currency.

Realized net purchase on the currency exchange market in the third quarter of the year was Euro 352.3 million, representing a small increase (of 1%) compared to the previous year.

According to the latest data available from the currency exchange market, net inflows of private transfers in the third quarter of 2014 are in line with the planned according to the April projection.

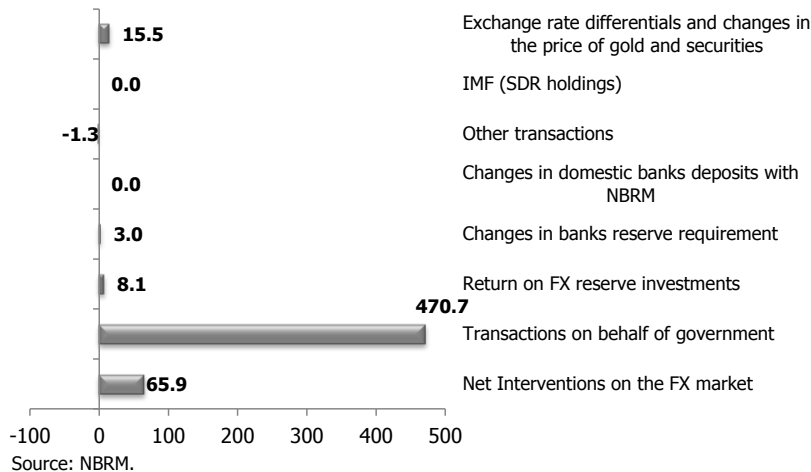
⁶ In July, the Government borrowed from the international financial markets by issuing a seven-year Eurobond in the amount of Euro 500 million.

Foreign exchange reserves
(stock, in EUR million)

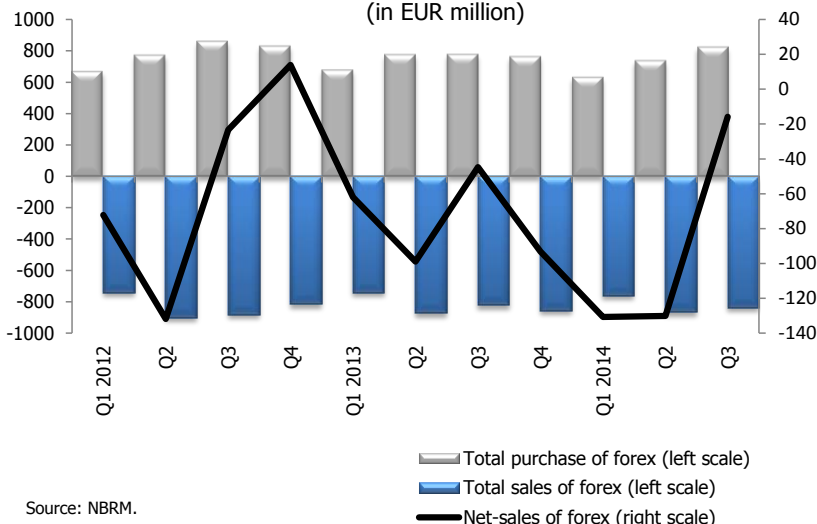


As of 30 September 2014, gross foreign reserves were in the amount of Euro 2.435 million, which is an increase of Euro 562 million compared to the end of the second quarter of 2014. The fast growth in foreign reserves is mostly due to transactions for the account of the government, i.e. foreign exchange inflows from the Eurobond, and the Development Policy Loan⁷ with additional positive effect of the net purchase of foreign currency by the NBRM in the foreign exchange market, and currency changes and changes in the price of gold.

Factors of change of the foreign reserves in the third quarter (in EUR million)



Forex market
(in EUR million)

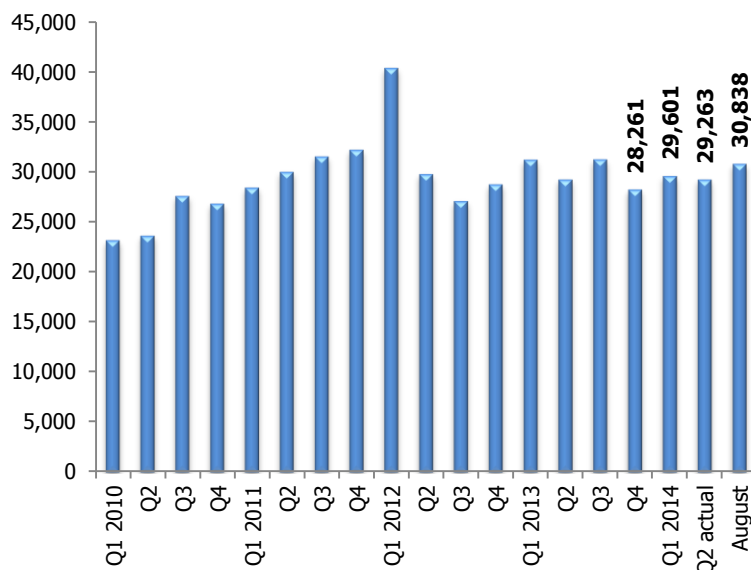


In the third quarter of 2014, the **foreign exchange market** with the banks registered a net sale of Euro 15.8 million, which is lower than the net sale of Euro 44.7 million realized in the same period last year. This annual change is a result of the faster annual growth in the supply relative to the demand for foreign currency (of 5.8% and 2%, respectively).

The sector-by-sector analysis shows better annual performances in all the individual components on an annual basis, with the exception of exchange offices, where the net purchase registered a slight decline on an annual basis.

⁷ In July, the Government borrowed from the international financial markets by issuing a seven-year Eurobond in the amount of Euro 500 million, and in August there was an inflow of funds from the Development Policy Loan in the amount of Euro 36.7 million.

Monetary policy instruments, in MKD million



Source: NBRM.

Data as of June showed liquidity withdrawal through monetary instruments relative to the end of the second quarter, but in a significantly smaller volume compared with the April projection...

..which can largely be explained by the more intensive growth of reserve money than projected ...

... at a time when net foreign assets of the NBRM⁸ grew, as of the end of August, which is within the projection for the third quarter ...

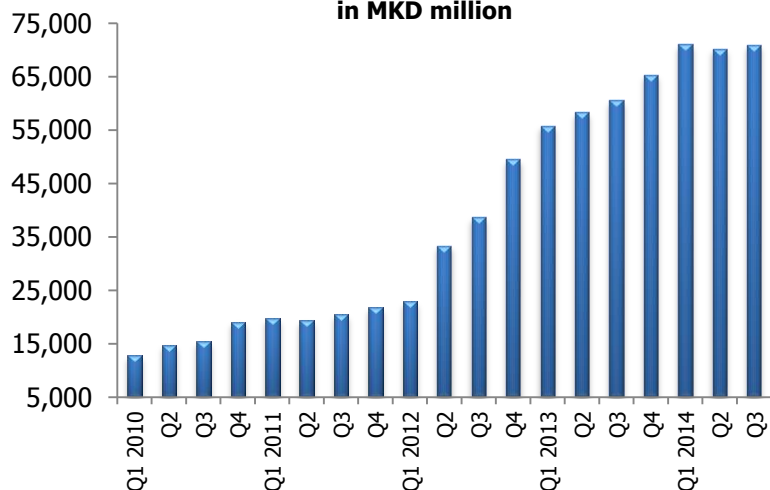
... and a stock of total government deposits with the NBRM, which is close to the projected one for the third quarter.

According to the latest available data, in the July - August period, in the Budget of the Republic of Macedonia a deficit of Denar 2,220 million was registered. On a cumulative basis, for the period January to August, the budget deficit amounted to Denar 16,978 million (or 3.4% of GDP), representing 86.6% of the projected budget deficit for 2014 in accordance with the supplementary budget. In terms of its financing, within the period from July to August higher net inflows from external borrowing were realized (issuance of the third Eurobond in the international capital market and withdrawal of funds based on the Development Policy Loan funded by the World Bank), which enabled significant accumulation of deposits on the government account with the NBRM. Thus, funds were provided mainly for financing of the budget deficit for 2015 and repayment of the Eurobond issued in 2005. Additional inflows in the budget were realized through borrowing on the domestic market through net issuance of government securities, but in a significantly smaller volume compared to

⁸ The analysis of the main categories of the balance sheet of the NBRM and their dynamics in relation to the April projection is made by excluding the effect of the Eurobond, which the Government issued in July 2014. The Eurobond had a significant effect on the assets and liabilities side of the balance sheet of the NBRM in respect of the increase in the net foreign assets of the NBRM and the government deposits with the NBRM, respectively, which was not provided with the April projection. Hence, due to clearer understanding of the performances in terms of their projected dynamics, we conduct the analysis by excluding this effect.

the first quarter (in the second quarter the Government made net payments based on government securities).

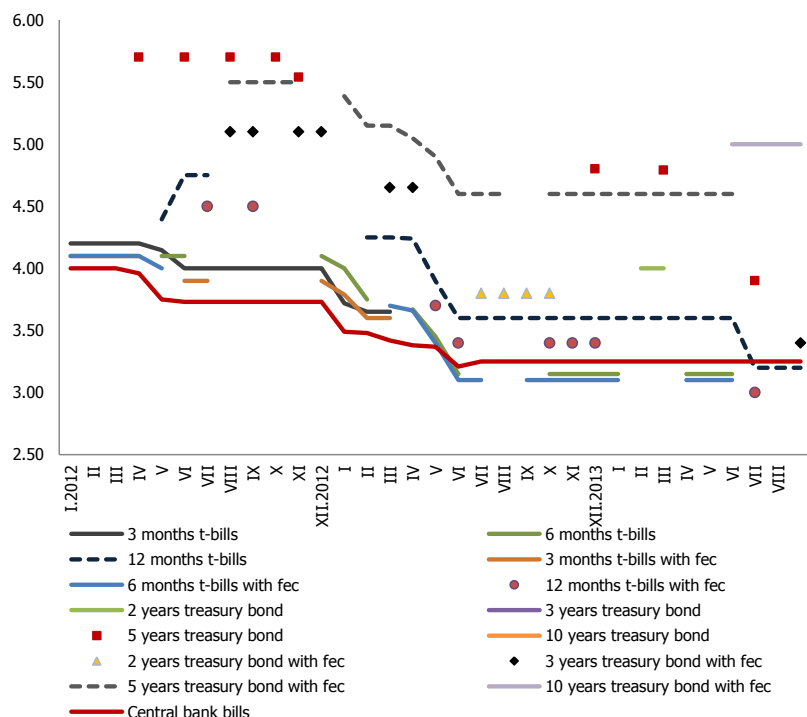
Outstanding amount of Government securities, in MKD million



Source: NBRM.

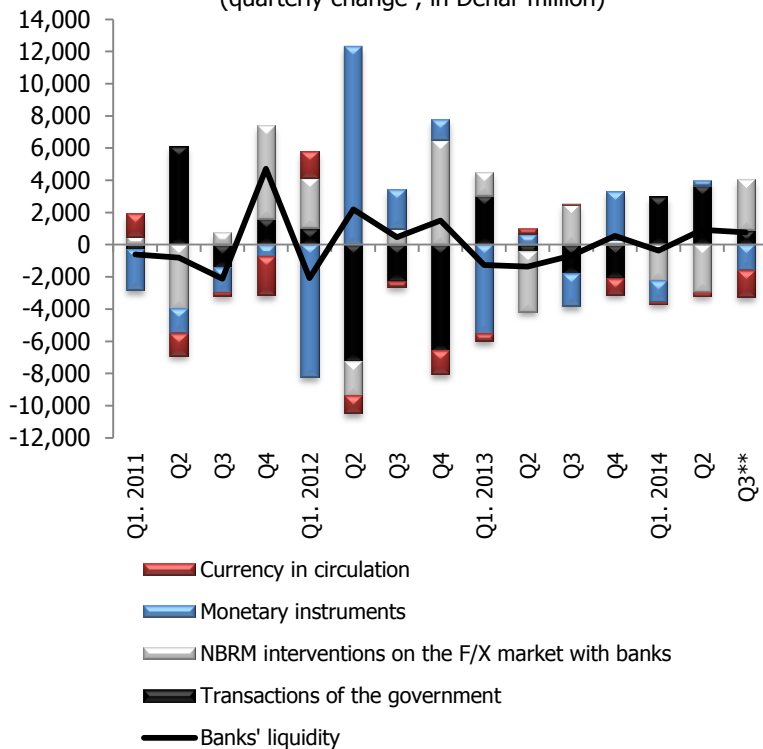
The stock of government securities on the domestic market at the end of September amounted to Denar 70,915 million, and compared to June 2014 it is higher by Denar 701 million.

Interest rates of treasury bills, treasury bonds and central bank bills, in %



Interest rates on government securities on the auctions held in September ranged from 3.2% for the 12-month treasury bills up to 5% for the 10-year government bonds with a currency clause. During the month auctions were held of 3-year government bonds (with and without foreign currency clause), 5-year and 10-year bonds, on the basis of which the Government borrowed at lower interest rates compared to the previous issues of these securities.

Liquidity of the banking system*
(quarterly change, in Denar million)



*Positive change- liquidity creation, negative change- liquidity withdrawal .

** including August

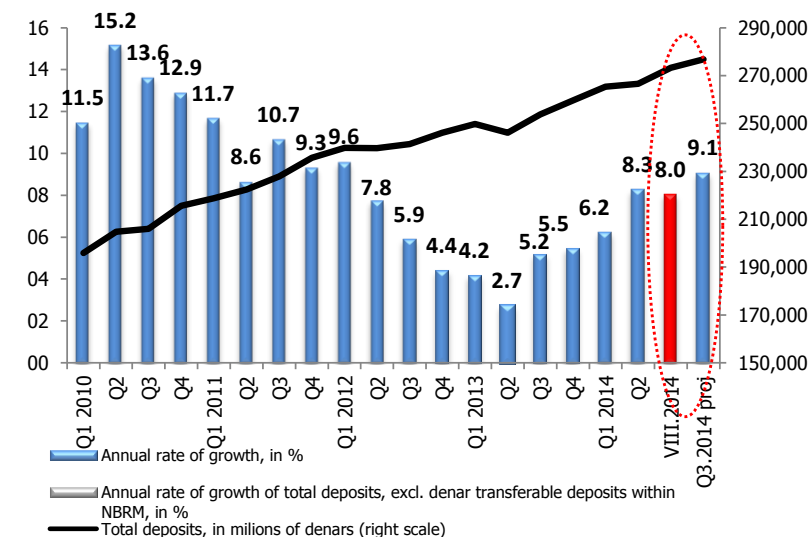
Source: NBRM.

In late August, the level of reserve money was significantly higher than the one projected for the third quarter...

... amid registered intensive growth of currency in circulation, despite the projected decrease in the April projection and slightly faster growth of total liquid assets of banks relative to the one projected for the third quarter.

The analysis of the flows of withdrawal and creation of liquidity for the period July-August shows the impact of total autonomous factors on the liquidity creation (in the amount of Denar 2,347 million), which is mostly due to the contribution of the foreign exchange transactions of the NBRM (according to the realized net purchase of foreign currency on the foreign exchange market) and to a lower extent to the government transactions. Currency in circulation during this period acted towards withdrawal of liquidity on a net basis. Withdrawal of liquidity was made also through the monetary instruments of the NBRM (amounting to Denar 1,575 million), i.e. through the standing deposit facility of the NBRM, amid unchanged amount of CB bills. During this period the banks used repo auctions to ensure liquidity from the NBRM, which was fully recovered by the end of the period. Thus, this instrument had a neutral effect on the liquidity of the banking sector in the analyzed period.

Total deposits

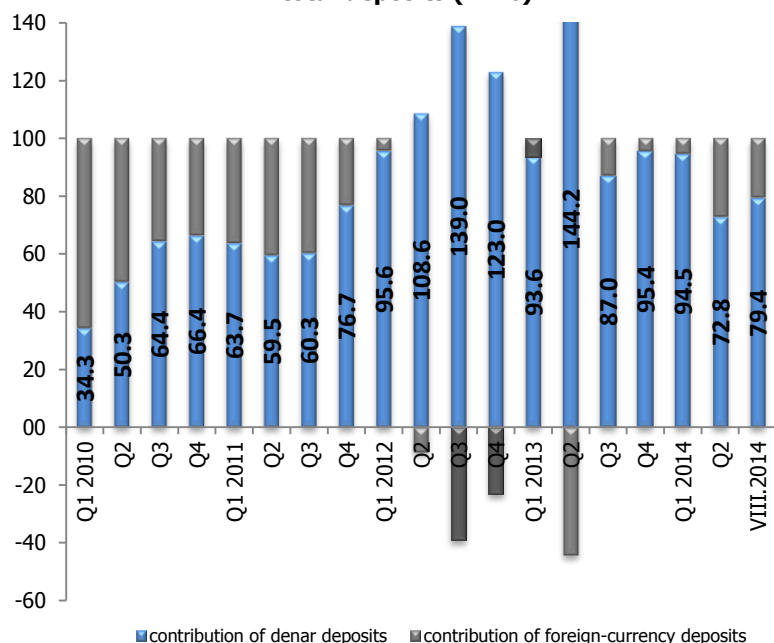


*Includes demand money

Source: NBRM.

Total deposits continued to grow in August with significantly higher intensity compared to the previous months⁹, with the new savings being almost six times higher than the flows recorded in July. Approximately 68% of the monthly increase results from the growth in corporate deposits (versus the small decline registered last month) while household deposits contribute with 29% to total growth. **According to data as of August, the annual growth rate of total deposits amounted to 8.0% and is below the projection for the third quarter of 2014 (projected annual growth of 9.1%).** On a quarterly basis, total deposits increased by Denar 6,776 million representing 93% of the projected quarterly increase for the third quarter, according to the April projection.

Contribution of denar and foreign currency deposits to the growth in total deposits (in %)



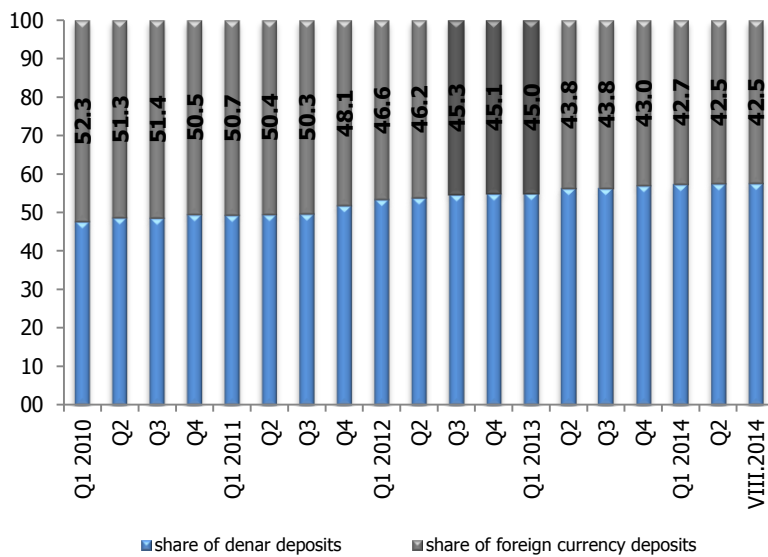
Source: NBRM.

*Includes demand deposits.

Achieved annual increase in total deposits is still mostly a result of the growth of denar deposits amid moderate positive contribution of foreign currency deposits. In August there was a faster growth of foreign currency deposits, which explain 45% of the total monthly growth (11% in the previous month).

⁹ Monthly growth of total deposits in August is the highest monthly increase since December 2007. Such positive trends in total deposits in August have been characteristic for several years in a row. The households may have a seasonal effect partly explained by the performances in the currency exchange market.

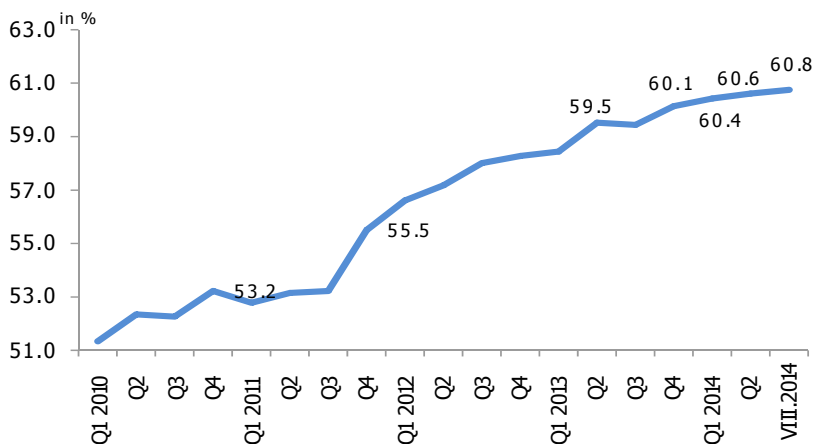
Share of denar and foreign currency deposits in the total deposits (in %)



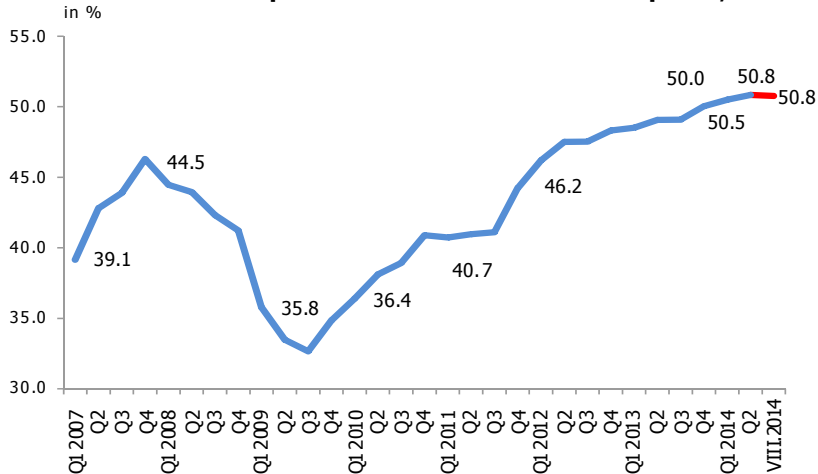
August data show stabilization in the share of denar and foreign currency deposits in the deposit base, with the deposits in domestic currency still having larger share in total deposits.

Source: NBRM.
*Includes demand deposits.

Share of M4 in denars in total M4 (in%)



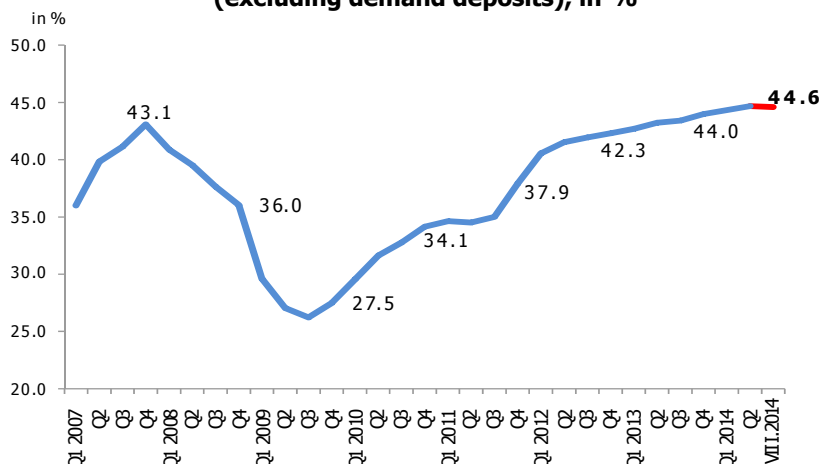
Share of denar deposits in the total household deposits, in %



*Includes demand deposits.

During August there was a further increase in total household deposits, with the increase of foreign currency deposits being slightly higher than the monthly increase of household denar deposits. However, such movements do not contribute to the change in the share of denar deposits in total deposits, which has stabilized at a level of 50.8% ...

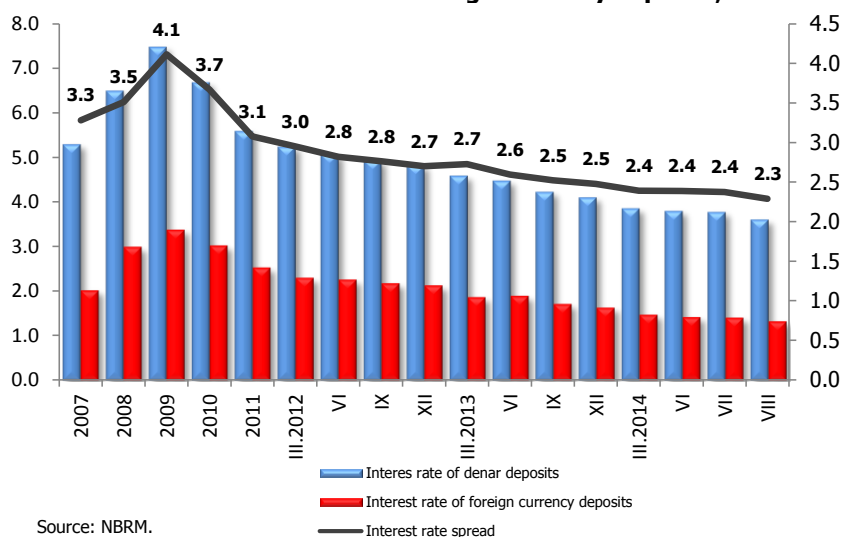
**Share of denar deposits in the total household deposits
(excluding demand deposits), in %**



* Denar deposits and total deposits without demand deposits.

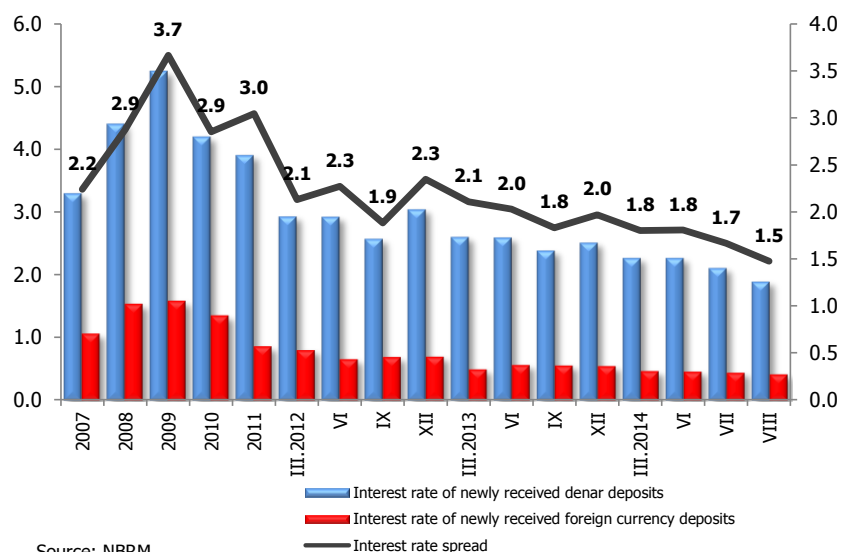
... while the share remains unchanged even in the analysis of household deposits excluding demand deposits.

Interest rates on denar and foreign currency deposits, in %



Source: NBRM.

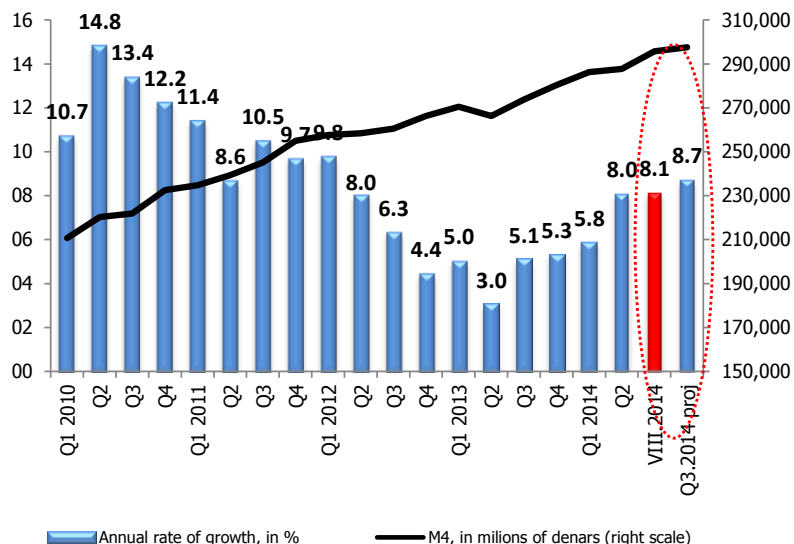
Interest rate of newly received denar and foreign currency deposits, in %



Source: NBRM.

Interest rates on denar and foreign currency deposits during August registered a monthly decline of 0.2 and 0.1 percentage points, respectively, leading to minimal narrowing of the interest rate spread. On the other hand, the interest rate spread between the new denar and foreign currency savings registered narrowing of 0.2 p.p. due to the further reduction of the proceeds from the new denar deposit.

Broad money, M4

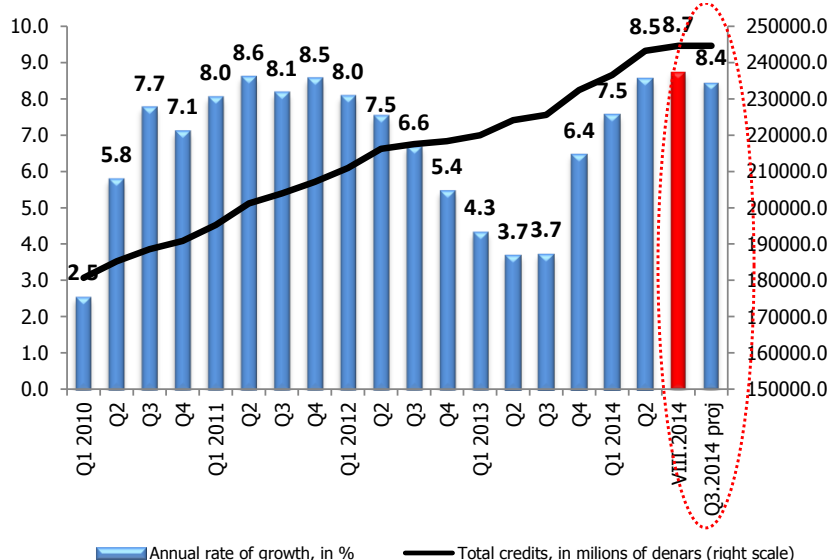


Source: NBRM.

During August there was a slower monetary growth relative to the projected ...

... which is still mainly due to the weaker performances in total deposits, amid more favorable performances of the currency in circulation, compared with the April projection. However, the data as of August point to a narrowing of the negative gap between the actual and projected monetary growth.

Total loans

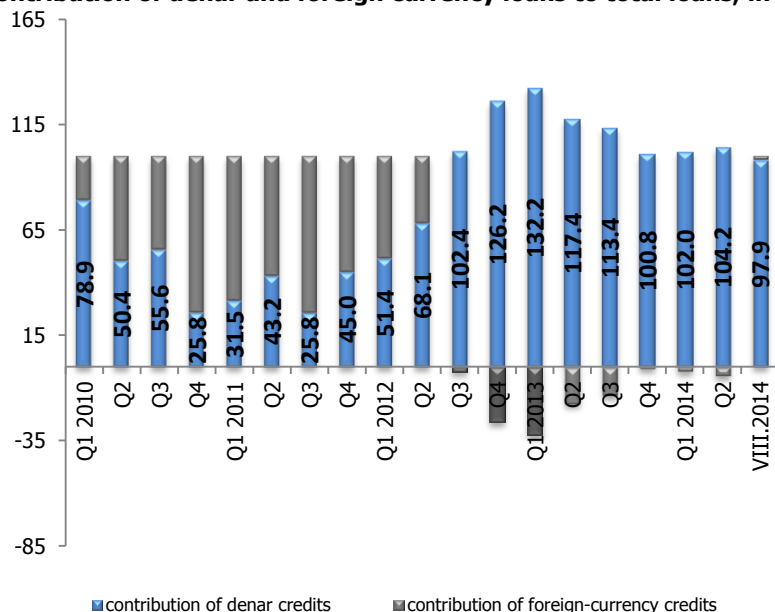


Source: NBRM.

Total loans continued to rise in August with similar dynamics as in the previous month. The monthly increase is still a result of the growth of household loans amid slower decline in corporate loans, compared to the previous month.

According to the data as of August, the annual growth rate of total loans equaled 8.7%, which is above the projected growth of 8.4% for the third quarter of 2014. However, on a quarterly basis, the growth of Denar 1,321 million represents about 32% of the projected increase in the third quarter, according to the April projection. These developments suggest weaker performances in total loans since the beginning of the third quarter, compared with the first half of the year.

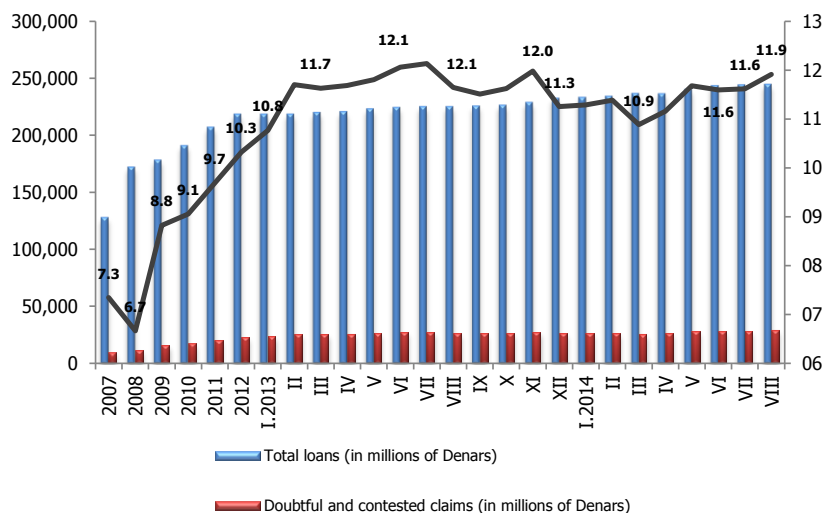
Contribution of denar and foreign currency loans to total loans, in %



Achieved annual growth of total loans predominantly stems from increased denar loans. However, for the first time since February, foreign currency loans have a small positive contribution to overall growth.

Source: NBRM.

Share of doubtful and contested claims in total loans, in %

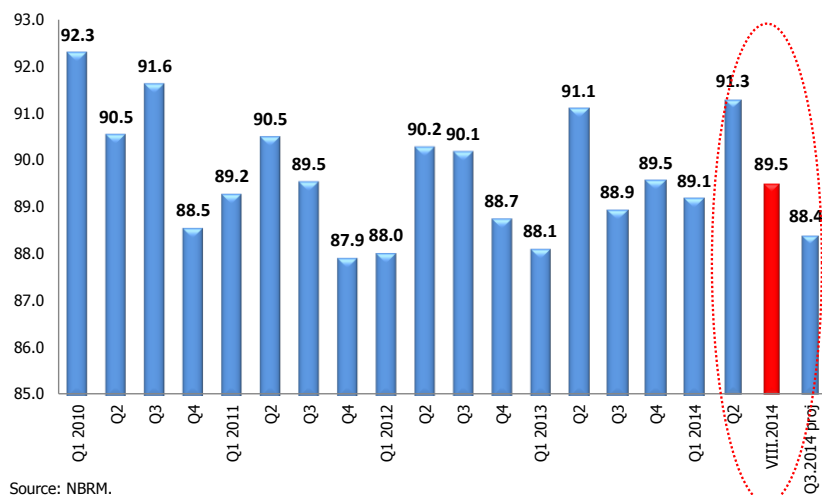


Source: NBRM.

In August, there was a slight increase in the share of doubtful and contested claims to total loans¹⁰ as a result of the intensified growth of non-performing loans to the corporate sector. On the other hand, doubtful and contested loans to households remained stable.

¹⁰ The indicator refers to the total loans to the financial and non-financial sector.

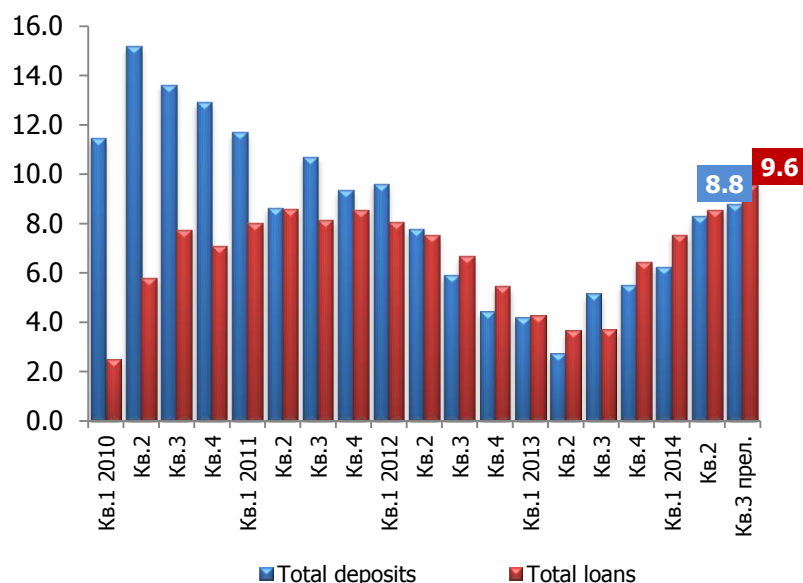
Ratio of total loans to deposits, in%



Source: NBRM.

As a result of the faster quarterly growth in the deposit base relative to the growth of total household loans, in August a decline in the use of the deposit potential for lending to the private sector was registered. However, the realized ratio is still higher compared to the projected level for the third quarter, according to the latest projection.

Total loans and deposits, annual changes, in %



Source: NBRM.

Pursuant to the preliminary data, also in September total deposits continued to grow at a solid pace on a monthly basis, which again was a result of the greater contribution of corporate deposits. The growth of household deposits also continued, albeit with lower intensity compared to the previous month, and was largely driven by increased savings in domestic currency. In total loans, preliminary data as of September show intensified credit activity compared with the previous two months, when slightly slower credit growth was registered. During September, most of the new loans were placed in the corporate sector, which also represents a significant change relative to the previous two months, when corporate loans declined on a monthly basis. On an annual basis, total deposits in September grew by 8.8%, while the annual growth of total loans was 9.6%.

Annex 1 Timeline of changes in the monetary instrument setup of the NBRM and selected supervisory decisions adopted in the period 2013-2014

January 2013

- A Decision amending the Decision on reserve requirement (adopted in November 2012) came into force, allowing reduction of the reserve requirement base of banks for the amount of new loans to net exporters and domestic producers of electricity, as well as for the investments in debt securities in domestic currency without a currency clause, issued by the aforementioned companies. This decision fully exempts the banks from allocating reserve requirement for liabilities based on debt securities issued in local currency with an original maturity of at least two years. The Decision will apply throughout 2014, after which, depending on the results, the need for further application will be reconsidered.
- A Decision on reducing CB bill interest rate was adopted to cut the policy rate from 3.75% to 3.5%. At the same time, the interest rate on seven-day deposit facility and on overnight deposit facility was cut from 2% to 1.75% and from 1.0% to 0.75%, respectively.

March 2013

- A Decision on credit risk management was adopted, which has been applied since 1 December 2013.

July 2013

- A Decision on reducing CB bill interest rate was adopted to cut the policy rate from 3.5% to 3.25%. At the same time, the interest rate on seven-day deposit facility was cut from 1.75% to 1.5%.
- A Decision amending the Decision on the reserve requirement was adopted, which reduces the reserve requirement rate for banks' liabilities in domestic currency from 10% to 8% and increases the reserve requirement rate for liabilities in foreign currency from 13% to 15%. In addition, the amendments stipulate a reserve requirement rate of 0% for banks' liabilities to nonresident financial companies with contractual maturity of over one year, as well as for all liabilities to nonresidents with contractual maturity of over two years. A rate of 13% still applies to short-term liabilities to nonresident financial companies in foreign currency with contractual maturity of up to one year. To maintain the reserve requirement in denars and in euros relatively stable, the amendments increase the reserve requirement in euros that is fulfilled in denars from 23% to 30%.

October 2013

- A Decision amending the Decision on banks' liquidity risk management was adopted. This decision reduces the proportion of time deposits assumed to flow out from banks, from 80% to 60%, and applies from 1 December 2013. This amendment makes more room for long-term bank lending to the real sector.

November 2013

- A Decision amending the Decision on the reserve requirement was adopted, which exempts the NBRM from paying reserve requirement remuneration (previously, this remuneration equaled 1% for denar reserve requirement and 0.1% for euro reserve requirement). The Decision is being applied since 1 January 2014.

- A Decision on CB bills was adopted, which introduces a methodology for determining the potential demand for CB bills. In accordance with the established mechanism, if there is a higher demand than the potential across the overall banking system, banks that bid higher amounts of their own liquidity potential will be required to place this difference in seven-day deposits.

February 2014

- A Decision on reducing the interest rate on seven-day deposit facility from 1.5% to 1.25% was adopted.

April 2014

- A Decision amending the Decision on the methodology for determining capital adequacy was adopted, introducing two amendments in the current decision that are expected to contribute positively to the credit support of the commercial banks to the corporate sector. Namely, with this Decision (and in accordance with the changes in the new EU Regulation no. 575/2013 on prudential requirements for credit institutions and investment companies), performance guarantees or warranties that guarantee some work done, stand out as items with low-intermediate risk, and therefore lower conversion factor (20%) is provided for them, instead of 50% as it has been so far. That would mean that in the calculation of capital adequacy, smaller part of these off-balance sheet items would be treated as a balance sheet items, which could affect the improvement of capital adequacy and encourage lending to the corporate sector. There is another innovation motivated by the international practice of establishing funds by low-risk subjects (central governments or multilateral development banks) whose main goal is funding development projects. These projects are mostly funded through one or more commercial banks, which also contribute funds by dividing the exposure into a defined ratio between the bank and the fund or by providing guarantees or other similar instruments used by the fund (warranty provider) to guarantee covering part of the credit risk in the event of default by the debtor. In order to cover these cases, this decision also introduces a more favorable regulatory treatment of the funds established by one or several central governments, multilateral development banks or public institutions. These funds will take 0% risk weight, and the requirement will be that the funding is executed by payment in stakes, i.e. on-balance sheet and off-balance sheet activities to be covered by the fund's equity.

September 2014

- In order to further channel banks' excess liquidity to the non-financial sector, in September the NBRM revised the mechanism for transfer of the demand for CB bills, which is above the banks' potential into another instrument, i.e. seven-day standing deposit facility. According to these changes, for the seven-day standing deposit facility that banks are obliged to allocate if on the CB bills auctions they demand an amount higher than the potential¹¹, an interest rate of 0% is determined. For the other assets that banks will voluntarily place into a seven-day standing deposit facility the regular interest rate will apply.

September 2014

¹¹For the method of determining the potential demand for CB bills see the Decision on CB bills, "Official Gazette of the Republic of Macedonia" no.166/13

- The National Bank of the Republic of Macedonia Council adopted the Decision amending the Decision on the reserve requirement, which extends the application of the non-standard measure for reduction of the base for the reserve requirement of commercial banks for the amount of new loans extended to net exporters and domestic producers of electricity. The main objective of the Decision is to provide further support to the two systemically important sectors of the economy. The current implementation of this measure has generated positive effects on the dynamics of lending and thus the overall economic growth, contributing to a reduction of the cost of funding of companies from both sectors. In such circumstances, and given the data that indicate some uncertainty about the pace of lending to the corporate sector in the next period, this Decision envisages continued application of this non-standard measure until December 31, 2015.