National Bank of the Republic of Macedonia

Quarterly Report
July 2014

Contents

Introduction

During the second quarter of 2014, the interest rate at CB bill auctions remained 3.25%. This decision was based on the last reassessment of macroeconomic projections of the NBRM made in April and the latest developments in the key macroeconomic and financial indicators, which indicated no significant changes in the environment of implementing monetary policy compared to previous estimates. Thus, within the **global environment,** the euro area continued recovering at a moderate pace. The **domestic economy** kept on recovering at a stronger pace given the **low inflation** and **increased credit support** from the banking sector. The foreign exchange market developments were as expected, while the **foreign reserves** were further maintained at an adequate level to absorb possible unforeseen shocks. In this period, **risks surrounding future developments** were assessed to be largely external, associated with possible changes in the pace of recovery of global economic growth and the rise in international prices of food and energy**. In such conditions, and given the already taken measures by the NBRM in the previous period with an effect of loosening, in the second quarter, the monetary setup was assessed as adequate.**

Key macroeconomic parameters in the domestic economy were generally moving within the April cycle projections. Gross domestic product registered an annual growth of 3.9%, which is a higher rate of growth than expected in the first quarter. Export sector remains the main generator of growth, as an effect of increased activity of new production facilities in the technological industrial development zones and the gradual strengthening of external demand. Gross capital formation had a strong effect on growth, primarily as a result of increased private and public investments. Such export and investment developments ensured further maintenance of positive developments on the labor market and continuing growth of household consumption, with the public consumption making a positive contribution to the GDP growth. Increased domestic and export demand, amid import-dependent domestic production, have created pressure for increased imports. Under these circumstances, the contribution of net exports to the GDP growth in the first quarter was negative, which is the first such performance in four quarters. The performances in the first quarter and the available high frequency data for the second quarter of 2014 show that the economy remains within a solid growth area, and are in line with the projected path of GDP growth of 3.7% and 4.4% for 2014 and 2015, respectively. Export sector and investments are still expected to be the main driver of growth, which would generate positive second-round effects on the labor market and would further stimulate household consumption.

During the second quarter, domestic prices decreased on average by 0.9% annually. Such performances entailed significantly lower inflation pressures than expected, mainly due to factors on the supply side, i.e. the downward deviations in the dynamics of international prices of food and oil and their knock-on effects on domestic prices. Slowdown was registered in **core inflation**, which in the second quarter averaged 0.7%. Considering the actual movements and the latest revisions of external input assumptions, **risks around the inflation projection of 1% for 2014, are assessed as predominantly downward.** On the other hand, upward risks have also been identified, associated with domestic and external factors on the supply side that could cause price pressures, which would be reflected on future inflation.[1] For 2015, the expectations for roughly 2% inflation rate remain.

Within the external sector, in the first quarter of 2014, the current account showed a deficit of Euro 122.3 million or 1.5% of GDP, which is slightly higher than expected for the first quarter, given the higher trade deficit and slightly lower net inflows of private transfers. At the same time, the capital and financial account registered net inflows of Euro 51.2 million or 0.6% of GDP. The capital inflows generated in the first quarter were as projected and in line with the expectations for this period that portion of the current account deficit will be funded by foreign reserves. In the second quarter, **gross foreign reserves** dropped with slightly greater intensity than expected for this period, largely because of the time translation of a portion of foreign currency inflows projected for this period[2]. Available

[1] For more details on the risks surrounding inflation also see the Latest Macroeconomic Indicators - Review of the Current Situation, July 2014.
[2] Refers to inflows from the World Bank Development Policy Loan and the EIB inflows to finance lending through the MBDP.

indicators for certain external sector categories indicate that the decline in foreign reserves mostly reflects the weaker performance in the capital and financial account. Within the current account, high-frequency data indicate a likely better performance in the trade balance, while private transfers are as projected. Despite the decline in foreign reserves, foreign reserves adequacy indicators remain in a safe zone, i.e. indicate a sufficient level of foreign exchange reserves to cope with possible unforeseen shocks. Also, in the third quarter, a Eurobond was issued in the amount of about Euro 500 million for budget funding. These funds mean further strengthening of the foreign reserves. April projection for the period 2014-2015 expected accumulation of foreign reserves and further retention of foreign reserves adequacy indicators at an appropriate level. However, the downward risks in the external sector of the economy are still present and are associated with the present uncertainty in the global environment and changes in the prices of primary products.

In the second quarter, banks continued supporting the economic recovery by increasing the lending to the private sector. New lending in this period was largely directed to households, with further credit support for the corporate sector. Annual growth rate of total loans in June reached 8.5%, which is above the projection for the second quarter (7.3%), amid weaker deposit performance than expected in April (8.3% instead of 9.5 % as projected). Moreover, if we analyze the changes in the credit market as of the end of 2013, there is significant boost of lending activity, suggesting gradual materialization of the effects of the monetary easing and non-standard measures on the credit support for the private sector, as well as improved observations and expectations of banks for the risk of these loans. Such credit market performance suggest possibility of gradual weakening of downward risks associated with the dynamics of lending and achieving projected credit growth, which according to the April projection for the period 2014-2015, is expected to range between 7 and 8%.

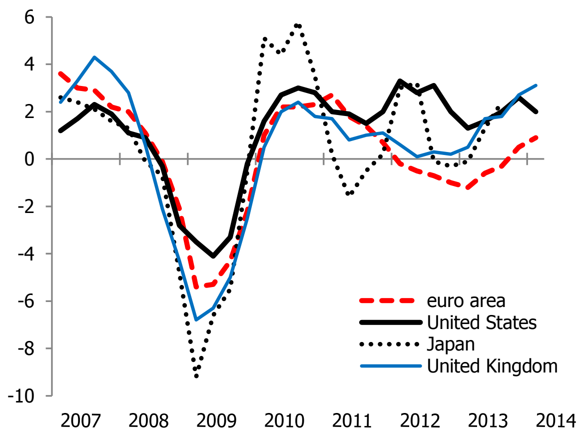
In summary, recent developments suggest further maintenance of an adequate level of foreign reserves, reduced inflationary pressures and enhanced credit support of the economic growth by the banking sector. In such conditions, it was assessed that the economy created conditions for sustained recovery of the private sector without any additional monetary stimulus, i.e. that the support of the local economy through monetary policy measures is sufficient. The exit from the zone of accommodative monetary policy in the next period will depend on changes in the external position of the economy and the effects on foreign reserves. The NBRM will continue to monitor the developments closely and if necessary, will make appropriate changes in the monetary policy for successful achieving of monetary objectives.

I. Macroeconomic Developments

1.1. International Economic Surrounding[3]

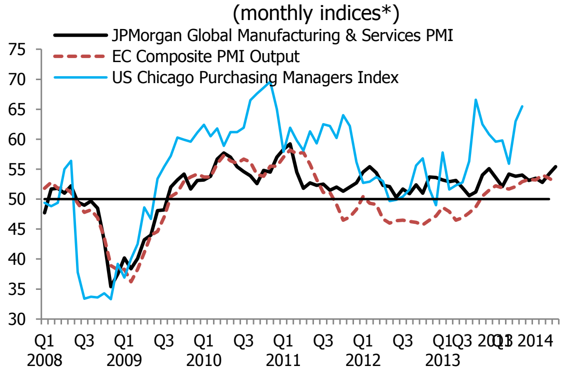
In the first quarter of 2014, global economic growth slowed down, causing downward adjustments to the projections for 2014, from 3.2% to 2.8%. Despite the weak performance, the growth is still expected to accelerate later this year. Developed economies are expected to be the major drivers given the reduced effects of fiscal consolidation, improved labor market performance and expected enhancement of demand. The global growth in 2015 and 2016 is expected to accelerate further by 3.4% and 3.5%, respectively. The risks around the global economy projections are mainly attributable to the conflict in Ukraine and its duration. Additional risks include low inflation in the euro area and the effects associated with the Fed's exit from accommodative monetary policy. In terms of inflationary trends, in the second quarter of the year, global inflation accelerated compared to the previous quarter, due to the rise in energy and food prices.

Real GDP growth in advanced economies
(year-on-year percentage changes; quarterly data)



Source: Eurostat.

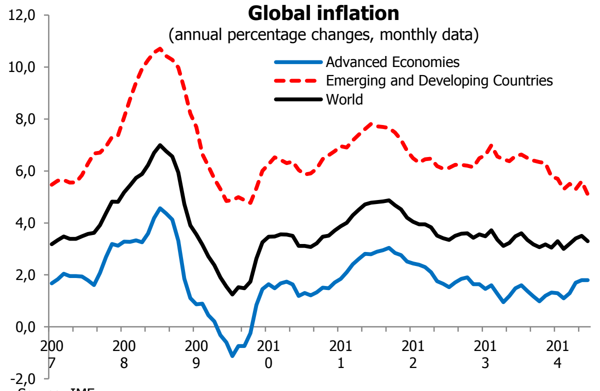
Global economic activity indicators
(monthly indices*)



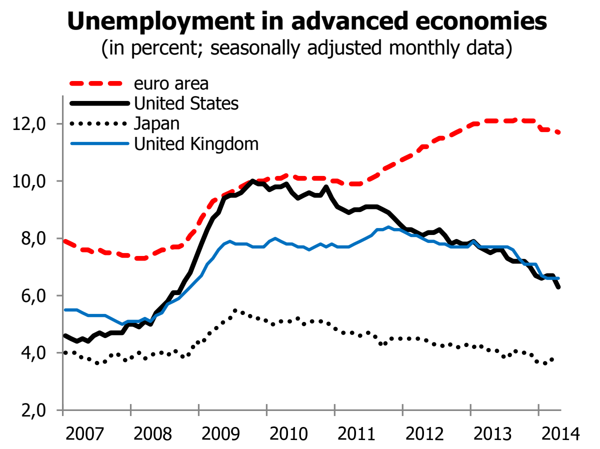
*The PMI index reflects the percentage of respondents that reported better bussiness conditions compared to the previous month and it can take values between 0 and 100. PMI=50 is considered as a reference value, indicating unchanged economic conditions. A PMI value over 50 is taken to indicate that the economy is expanding, while a PMI value below 50 suggests that the economy is contracting.
Source: Bloomberg.

Global economic activity continued to grow in the first quarter of 2014, but at a slower pace (annualized growth of 1% in the first quarter versus 3.5% in the fourth quarter of 2013). **These developments led to downward adjustment of the projected global growth for 2014 from 3.2% to 2.8%**[2]. The main factors for the slowdown in the global growth include weather conditions in the United States and the military conflict in Ukraine. The economic recovery in the euro area continued in the first three months of the year when the quarterly growth equaled 0.2%. However, the growth was lower than expected, causing a downward revision of the 2014 projection from 1.2% to 1%. On the other hand, the U.S. economy recorded a quarterly decline of 0.7% due to the extremely bad weather in the first quarter of the year. Estimates show that the negative effect of the weather is temporary and that the economic activity will improve in the second quarter. The accelerated growth of world economy is also illustrated by the global composite index - PMI[4], which increased in the second quarter of 2014 (by 0.6 percentage points) compared to the previous quarter, reaching 54.1 index points, given the improved

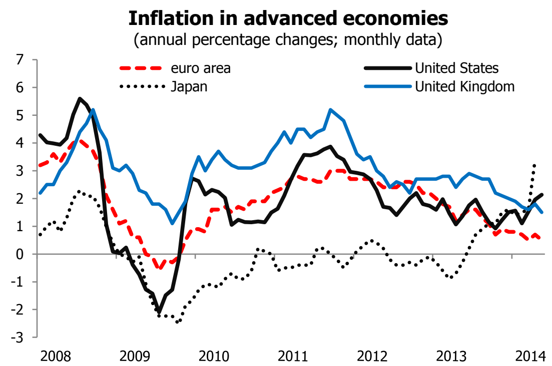
[3] The analysis is based on the ECB's Monthly Bulletins, April, May and June, 2013, the World Bank's Global Economic Prospectus, June 2014; the European Commission's European Economic Forecast, June 2014; reports from Capital Economics, releases from Markit Economics, weekly reports of the Bank of Greece and the IMF monthly releases on primary commodities market.
[4] PMI (Purchasing Managers Index) is based on surveys of a representative sample of companies from the manufacturing and service sectors, and are often used as high frequency indicators for the current and future economic activity.



Source: IMF.



Source: Eurostat.



Source: Eurostat and national statistical offices.

performances in the manufacturing industry and the service sector.

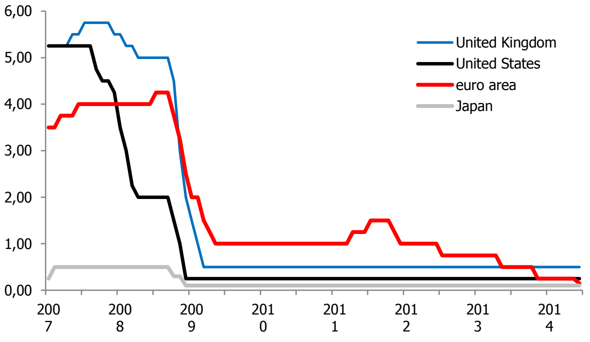
In the first month of the second quarter of 2014, global inflation slightly increased. The global inflation rate in April 2014 equaled 3.4%, versus 3.2% in the first quarter of the year. Minor slowdown in inflation was observed in emerging economies and developing economies, while in April it equaled 5.3% (lower performance of 0.2 percentage points compared with the previous quarter). The developed countries reported acceleration in the inflation in April-May 2014 to 1.7% from 1.2%, same as in the first three months of the year.

The economy of the euro area continued to rise in the first quarter of 2014, representing the fourth consecutive quarterly increase. Compared with the previous quarter, the economy of the euro area rose by 0.2%. The favorable quarterly movements in the previous four quarters accelerated the annual rate of growth, which in the first quarter of the year equaled 0.9%, versus 0.5% in the fourth quarter of 2013. Economic growth in the first quarter is mainly explained by the growth of domestic demand, given the higher private and public consumption and gross investments, whereas net exports had a negative impact given the higher import growth compared to the export growth. Analyzing individual economies, in the first quarter, the quarterly growth in the euro area is mainly explained by the positive developments in Germany and Spain, where GDP went up by 0.8% and 0.4%, respectively, while other major economies in the euro area reported unfavorable trends. The French economy remained at the level of the previous quarter, while the economic activity in Italy and the Netherlands decelerated. The improvement of economy had a positive effect on the labor market, although with a one-year time lag, when it finally reported certain improvements. The unemployment rate, though still high, in May 2014 decreased to 11.6% versus 11.8% at the first quarter of the year[5]. **Inflation in the euro area remains low and is well below the targeted inflation rate of 2%.** In the first two months of the second quarter, the average annual inflation rate equaled 0.6%. Considering the components of the consumer price index, the low inflation rate can be explained by the further slowdown of the increase in prices of services, food and non-energy industrial products.

[5]According to the latest revised data.

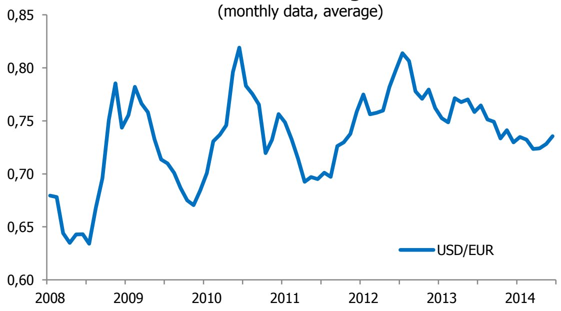
The implementation of accommodative monetary policy in developed economies continued in the second quarter of 2014. The policy rates of the Fed and the Bank of England remained at record low levels (0-0.25% and 0.5%, respectively), while the ECB decided to cut this interest rate from 0.25% to 0.15%. At its June meeting, the Federal Open Market Committee (FOMC) of the Fed decided from the beginning of July 2014 to further reduce the purchase of mortgage bonds to U.S. Dollar 15 billion (from U.S. Dollar 25 billion), as well as to reduce the amount of the monthly purchase of long-term government bonds to U.S. Dollar 20 billion (from U.S. Dollar 30 billion). This decision was taken in accordance with the observations for the continued growth of economic activity, further improving labor market conditions, the growth of household consumption and investments in the business sector. Also, the Fed stated that it will continue implementing accommodative monetary policy, and the future pace of purchase of securities will depend on the assessments of economic situation. If the labor market conditions continue improving as expected and the inflation approaches the target of 2%, it is possible to end the purchase of securities after the Fed's October meeting[6]. In the second quarter of the year, the Bank of England kept the interest rate on the main refinancing operations at the level of the previous quarter, and announced its increase in late 2014. The slow and uneven economic recovery in the euro area amid low inflation and weak credit activity were the main reasons behind the adoption of a new package of stimulating measures at the last ECB's Council meeting[7]. The package, in addition to reducing the policy rate, includes a reduction in the overnight loan rate by 35 basis points, to 0.4% and introduction of a negative deposit rate of 0.1%. Also, in order to stimulate the economy, enhance the functioning of transmission mechanism and stabilize money markets, the ECB introduced targeted long-term refinancing operations (TLTRO) with maturities through September 2018, and continued with refinancing operations that offer fixed-rate tenders with unlimited amount.

Policy rates in advanced economies
(in %)



Source: Central banks.

USD/EUR Exchange rate
(monthly data, average)



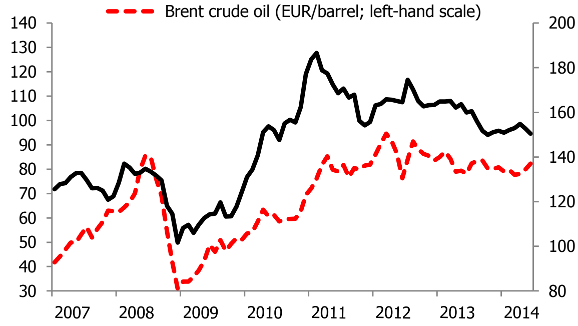
Source: Eurostat.

During the second quarter of 2014, the nominal exchange rate of the euro against the U.S. dollar followed the path of

[6] Testimony of Janet Yellen, as part of the Semiannual Monetary Policy Report to the Congress of 15 July 2014.

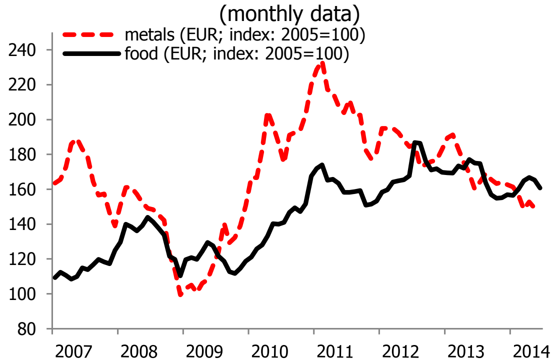
[7] http://www.ecb.europa.eu/press/pressconf/2014/html/is140605.en.html

Prices of crude oil and non-energy commodities
(monthly data)



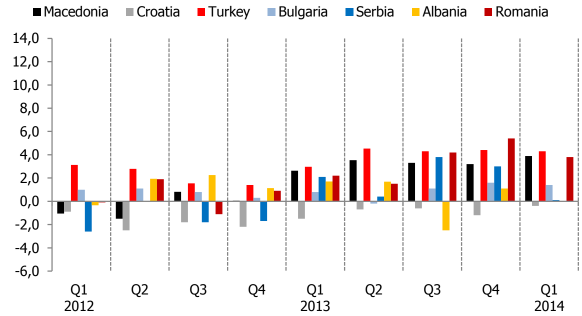
Source: IMF monthly database.

Prices of food and metals
(monthly data)



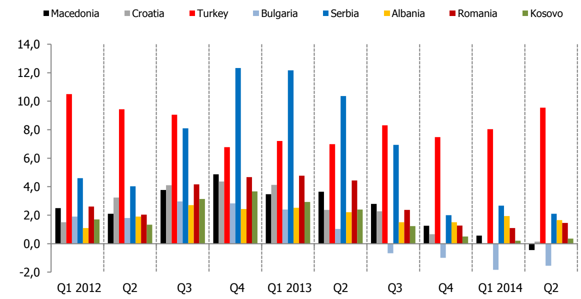
Source: IMF monthly database.

Real GDP growth in countries from the region
((annual percentage changes, quarterly data



Source: Eurostat and national statistical offices.

Inflation in countries from the region
(annual percentage changes)



Source: Eurostat and national statistical offices.

moderate depreciation. Namely, given the generally low volatility, during the three months of the second quarter, there was a moderate depreciation of the euro against the U.S. dollar. In June 2014, one euro was exchanged for 1.36 U.S. dollars, which is an appreciation of 3.1% compared to June 2013.

In the second quarter of 2014, there was a small rise in oil prices, expressed in euros. Thus, the price of crude oil "Brent" in this period averaged Euro 80.08 per barrel, which is an increase of 1.6% compared with the previous quarter. The price increase is mainly explained by the still present geopolitical tensions over Ukraine, reduced production by Libya due to the military conflict and the stirring up of the conflict in Iraq. **The rise in prices of non-energy commodities[8] continued in the second quarter of the year, when moderate quarterly growth of 0.5% was registered.** The growth is fully explained by higher food prices (2.4%), given the quarterly growth of all food index components. On the other hand, metal prices experienced a quarterly decline of 3.6%, given the lower prices of most metals included in the calculation of the overall index, which is mainly associated with the potential reduction in demand for metals from China. Nickel prices are an exception, which due to the export ban imposed by Indonesia experienced significant rise during the second quarter.

In the first quarter of 2014, the economic activity of most countries in the region increased, although with lower intensity than the previous quarter. Positive trends were observed in Turkey, Romania, Serbia, Albania and Bulgaria. Economic activity in Croatia remained in the negative zone. Yet, according to the latest data, there is a certain slowdown in the rate of annual GDP decline.

In April-May 2014, countries of the region witnessed divergent movement of inflation rates. A moderate rise in inflation was recorded in Croatia, Romania and Kosovo, while this rate in Serbia and Albania decreased. Turkey's inflation rate remained relatively high compared with other countries in the region, amid further intensification of the price increase. Low prices of energy and food continued the deflation

[8]The price index of non-energy primary commodities includes prices of food, beverages, agricultural raw materials and metals.

movements in Bulgaria in the first two months of the second quarter.

Box 1: Review of the Latest Set of Measures Adopted by the European Central Bank (ECB) in June 2014

At the meeting of the Governing Council, held on 5 June 2014, the European Central Bank (ECB) adopted a package of measures aimed at further easing of the monetary policy, enhancing the functionality of monetary transmission to the real economy and reducing the level of financial fragmentation in the euro area. The set of measures includes further reduction in the ECB interest rates, introduction of targeted long-term refinancing operations to support lending, intensification of preparations for activating the measure of outright purchases of assets-backed securities and further maintenance of the current design of the tender of conducting basic refinancing operations (fixed interest rate and unlimited amount). In addition, the ECB decided to abolish weekly fine tuning operations aimed at sterilizing the liquidity effects of the Program for Outright Purchase of Securities.

Analyzing the interest rate policy, the ECB cut the interest rate on the main refinancing operations by 0.1 percentage point, bringing it down to 0.15%. Additionally, the interest rate on overnight loan and the deposit facility were also cut (by 0.35 percentage points and by 0.1 percentage points, respectively) to 0.40% and to -0.10%, respectively. Negative interest rates were introduced to the banks' excess liquidity above the minimum reserve requirement, and to other deposit facilities within the Eurosystem[9]. According to the ECB, in conditions of downward revision of the three main ECB interest rates, the introduction of negative interest rates aims to ensure smooth functioning of the money market by maintaining an appropriate interest rate corridor.

Besides the change in interest rate policy, **the ECB also adopted additional non-standard measures by introducing targeted long-term refinancing operations (TLTRO) to support lending to the private sector.** With this measure, the ECB opens an opportunity for banks to borrow long-term funds on favorable terms, which is expected to improve the monetary transmission and to enhance credit support to the private sector. TLTRO maturity is around 4 years and fixed interest rate for the entire period of use of assets set at the level of the interest rate on main refinancing operations at the time of approval of TLTRO, increased by 0.1 percentage points. The money supply for 2014 is initially set at around Euro 400 billion, at two auctions, in September and December 2014. The allocation of funds will be determined by the lending dynamics of banks. Thus, at the first two auctions in 2014, banks will have the right to claim funds of up to 7% of the loans they have granted to the private sector (excluding housing loans) as of 30 April 2014. During 2015-2016, six more auctions are planned to be held (at the end of each quarter, ending June 2016), where the maximum amount of borrowing by banks will be determined depending on the pace of lending to the private sector in the period before and after April 2014. Assets borrowed at auctions should be intended exclusively for lending to the private sector, whereby the banks will be required to meet certain targets for the level of credit activity. Banks that failed to meet the targets will be required to make early repayment of the borrowed amount.

The Governing Council of the **ECB adopted a decision to abolish weekly fine tuning**

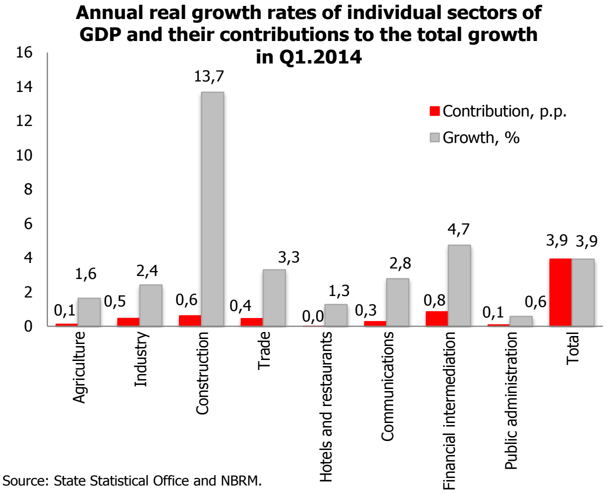
[9] 1) government deposits held within the Eurosystem at a level that is higher than the limits defined by the ECB; 2) accounts intended to manage reserve requirement held within the Eurosystem and which are free from paying fees; 3) accounts (overnight deposit facilities) held by central banks outside the Eurosystem within the TARGET 2; and 4) other accounts held by foreign institutions/individuals within the central banks of the Eurosystem, for which no fee is paid on an ongoing basis, or for which fee is paid in the amount of the interest rate on the ECB's deposit facilities.

operations aimed at sterilizing liquidity effects of the Program for Outright Purchase of Securities[10]. Also, **intensification of preparations to activate the program for outright purchase of asset-backed securities** was announced, which would improve the transmission mechanism of monetary policy and would act towards reducing the fragmentation of financial markets in the euro area. The ECB, in its communication, again emphasized its readiness to conduct accommodative monetary policy and to take additional measures if circumstances so require. In recognition of these efforts, **the ECB announced maintenance of the design of tender with unlimited amount and fixed interest rate during the regular refinancing operations at least until the end of 2016.**

The ECB expects the adopted set of measures to provide additional support for the process of economic recovery through increased credit support for the private sector, and will contribute to restoring the rate of inflation at close to 2%.

1.2. Domestic Supply

The Macedonian economy continued to grow in the first quarter of 2014, thus registering a quarterly growth of 1.7%. In times of positive quarterly developments, GDP registered an annual growth of 3.9%. Although the growth in the previous two quarters was concentrated in the construction sector, the improved economic performances in the first quarter of 2014 were dispersed in several sectors of the economy. The largest contribution to the increase was made by the financial intermediation, activities related to real estate, renting and business activities. In this quarter, the construction made large contribution to the annual growth due to the impulses of private investments in real estate and public infrastructure projects. The first quarter of this year is marked by the entry into the zone of positive annual changes in trading activity after its almost continuous decrease in the past two years. In this quarter, industry recorded a significant annual growth, driven by the activity of the export-oriented capacities with domestic and foreign capital, given the improved global macroeconomic outlook and recovery of foreign effective demand. The assessment for the economy and the level of utilization of industrial capacities also improved. The business tendency surveys from April and May generally indicate positive assessments by economic agents, both in terms of the current economic situation, and in terms of their expectations for the production volume.



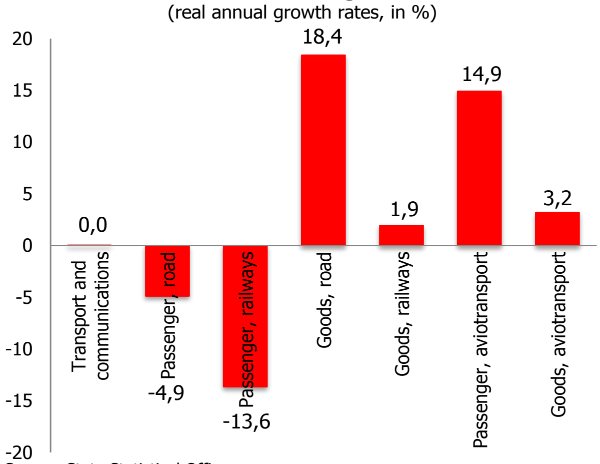
Source: State Statistical Office and NBRM.

In the first quarter of 2014, there was a significant acceleration in the quarterly growth of gross domestic product[11] **from 0.5% to 1.7% (seasonally adjusted), with the economy remaining in the positive zone of changes for seven consecutive quarters. The growth of**

[10] This program was introduced in May 2010 aimed at stabilizing the financial markets through outright purchase of securities based on public and private debt. Since the operation was meant to have a neutral effect on the liquidity level in the system, ECB sterilized the monetary effects of the outright purchase of securities through short-term instruments, conducting regular weekly auctions of interest-bearing deposit facilities in an amount equal to the amount of redeemed securities in the ECB's balance sheet.

[11] GDP data for 2013 and 2014 are SSO's estimated data.

Transports and communications in 2014-Q1
(real annual growth rates, in %)



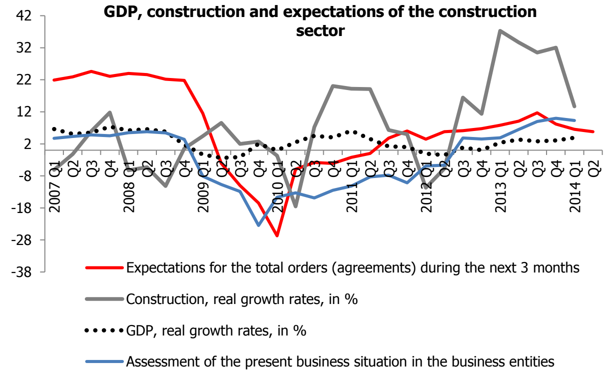
Source: State Statistical Office.

domestic production also accelerated annually and equaled 3.9%. Better quarterly performance in the first quarter is mainly due to the growth of added value of **trade and financial intermediation**, with slightly lower contribution of **industry, transport and agriculture**. On the other hand, the added value of **construction recorded a quarterly decline**. Analyzing the annual dynamics, all sectors contributed positively to the GDP growth in the first quarter. The largest contribution to the annual growth of domestic production was made by the growth in the **financial intermediation, activities related to real estate, renting and business activities** as well as the double-digit growth in **construction**. Solid positive impulse to the annual GDP growth was made by the **trade** and the **industry**.

	annual growth rates, in %											contributions to GDP growth (in p.p.)										
	Q1 2012	Q2 2012	Q3 2012	Q4 2012	***2012***	Q1 2013	Q2 2013	Q3 2013	Q4 2013	***2013***	Q1 2014	Q1 2012	Q2 2012	Q3 2012	Q4 2012	***2012***	Q1 2013	Q2 2013	Q3 2013	Q4 2013	***2013***	Q1 2014
Agriculture	-7.1	-7.0	0.0	-10.1	***-6.2***	-2.9	-0.3	1.6	1.9	***0.5***	1.6	-0.6	-0.6	0.0	-1.2	***-0.6***	-0.2	0.0	0.2	0.2	***0.0***	0.1
Industry	-5.0	0.0	5.6	7.8	***2.8***	8.9	6.9	1.6	2.6	***4.9***	2.4	-0.9	0.4	0.9	1.2	***0.5***	1.6	1.2	0.3	0.4	***0.8***	0.5
Construction	-11.7	2.6	16.5	11.3	***4.8***	37.3	33.7	30.5	32.1	***32.7***	13.7	-0.4	-0.3	0.9	0.7	***0.3***	1.2	1.7	1.9	2.2	***1.8***	0.6
Trade	-2.6	5.6	-4.2	-5.1	***-4.8***	-0.7	-1.1	2.8	-1.5	***-0.1***	3.3	-0.4	-1.1	-0.6	-0.7	***-0.7***	-0.1	-0.2	0.4	-0.2	***0.0***	0.4
Hotels and restaurants	-0.8	-5.7	3.4	2.4	***2.3***	4.2	2.3	-1.1	4.4	***2.1***	1.3	0.0	0.0	0.1	0.0	***0.0***	0.0	0.0	0.0	0.0	***0.0***	0.0
Communications	4.7	16.5	0.2	-4.2	***-0.8***	-1.7	4.4	-0.1	0.0	***0.6***	2.8	0.5	-0.3	0.0	-0.4	***-0.1***	-0.2	0.4	0.0	0.0	***0.1***	0.3
Financial intermediation	3.4	-6.7	0.6	0.7	***2.0***	1.4	0.9	1.9	1.2	***1.3***	4.7	0.6	0.5	0.1	0.1	***0.3***	0.2	0.2	0.3	0.2	***0.2***	0.8
Public administration	0.5	-4.2	0.2	1.0	***0.5***	-0.2	-0.2	-0.9	-0.2	***-0.4***	0.6	0.1	0.0	0.0	0.1	***0.1***	0.0	0.0	-0.1	0.0	***-0.1***	0.1
Value Added	-0.8	3.1	1.5	0.0	***0.0***	2.5	3.6	3.3	3.4	***3.2***	3.1	-0.7	-0.8	1.3	0.0	***0.0***	2.2	3.2	2.8	2.9	***2.8***	2.7
Net taxes on products	-2.0	3.4	-3.5	-1.0	***-2.8***	1.0	1.1	0.2	1.3	***0.9***	9.4	-0.2	-0.7	-0.5	-0.2	***-0.4***	0.1	0.1	0.0	0.2	***0.1***	1.1
Gross Domestic Product	***-1.1***	***-2.9***	***0.8***	***0.0***	***-0.4***	***2.4***	***3.3***	***2.8***	***3.1***	***2.9***	***3.9***	***-1.1***	***-1.5***	***0.8***	***0.0***	***-0.4***	***2.4***	***3.3***	***2.8***	***3.1***	***2.9***	***3.9***

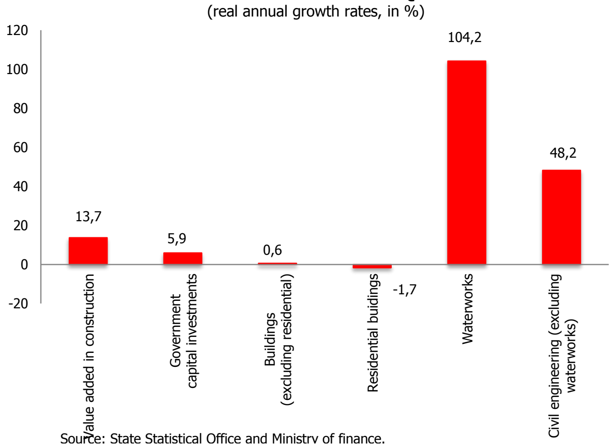
Source: State Statistical Office and NBRM calculations.

GDP, construction and expectations of the construction sector



Source: State Statistical Office.

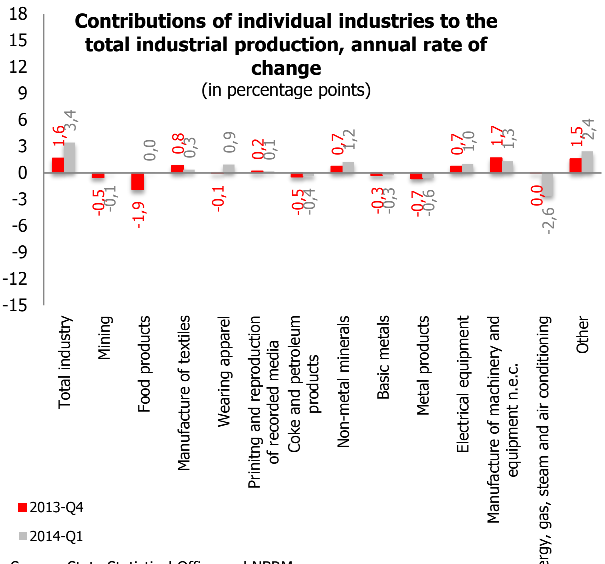
Contruction in 2014-Q1
(real annual growth rates, in %)



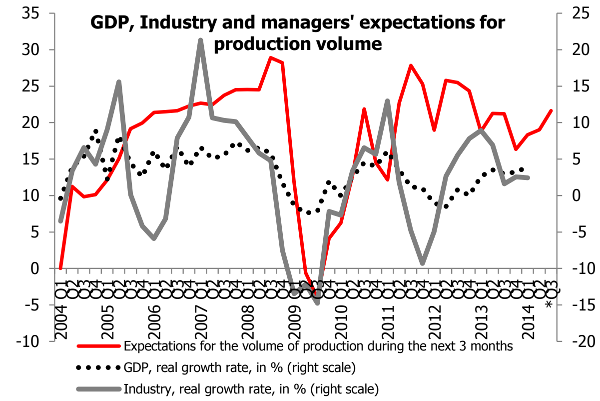
Source: State Statistical Office and Ministry of finance.

In the first quarter of the year, construction activity declined on a quarterly basis[12], thus slowing down the annual growth. Despite these changes, the activity in this quarter made the second largest contribution to the overall annual economic growth. Double-digit annual growth is largely due to public[13] and private investments in the hydro engineering and civil engineering, thus retaining the positive qualitative changes in the structure of construction growth[14]. Slowing construction activity in the first quarter is also confirmed by the slightly lower assessment for the economic activity as indicated in the Business Tendency Survey in construction. However, the assessments remain positive and indicate that optimism prevails among construction companies. Positive perceptions of enterprises, according to the survey, derive from the reduced impact of certain limiting factors for improving construction activity. The estimates indicated less limiting impact from the lack of trained personnel, the cost of labor and materials, and competition in the construction sector. Also, in the first quarter of

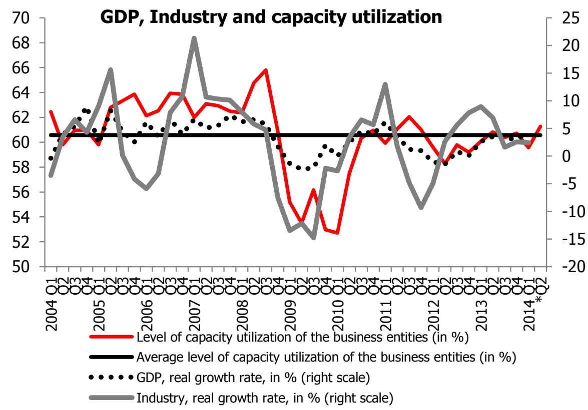
[12] Seasonally adjusted.
[13] Refers to government capital investments.
[14] Box 2 of the quarterly report, April 2014 contains more information about the effects of the changes in the structure of completed construction works on economic growth.



Source: State Statistical Office and NBRM.



Source: State Statistical Office.
* average of expectations for 4 and 5 month of 2014.



Source: State Statistical Office.
* average for 4 and 5 month of 2014.

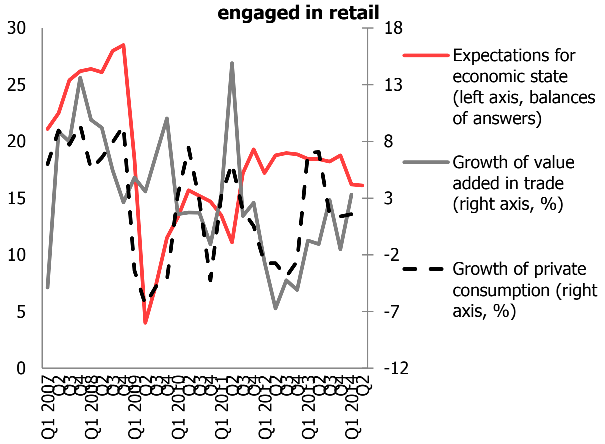
2014, positive perceptions regarding the financial situation of companies outnumbered the negative ones, and compared with the previous quarter, the companies assess the potential period for providing work more favorably. Observing the expectations of the managers of construction companies for the next three months, less optimistic compared to the previous quarter are the expectations for higher selling prices and signing new contracts.

The recovery of industrial activity continued in the first quarter of this year, and the activity in this sector slightly accelerated its quarterly growth[15], thus continuing its annual growth. The improved performance is associated with the improved global macroeconomic outlook, the annual growth of foreign effective demand in the first quarter of 2014, and the activity of the existing and the new facilities in the technological industrial development zones. The manufacturing industry made the largest contribution to the annual growth in the first quarter, where more than half of the activities made positive contribution, primarily the production of rubber and plastic products, manufacture of machinery and equipment, non-metallic minerals, electrical equipment, clothing and beverages. At the same time, mining and supply of electricity, gas, steam and air conditioning made a negative contribution to the growth in industrial production. The improved performance in the industry is partly confirmed by the Business Tendency Survey in **manufacturing industry[16]**. Notably, although the first quarter was predominated by positive perceptions of company managers for the current economic situation and the scale of production, estimates declined on a quarterly and annual basis. At the same time, the average capacity utilization in the first quarter declined on a quarterly and annual basis. Analyzing factors that limit the increase in production, the survey points to reducing impact of competitive imports, insufficient domestic and foreign demand, as well as uncertain economic environment. The assessments of survey conducted in the first two months of the second quarter of 2014 indicate an increase in the average capacity utilization over the historical average and improvement of perceptions regarding the economic situation of companies. Reduction was recorded in the limiting impact of the lack of equipment, the uncertain economic environment and financial problems. These findings have

[15] Seasonally adjusted.
[16] Refers to surveys conducted in the first quarter of 2014.

created more optimistic expectations of managers for the volume of production for the next three months, with lower expectations for growth in the procurement prices of inputs and selling prices of finished products.

Trade, household final consumption and expectations of managers of business entities engaged in retail



Source: State Statistical Office.

In the first quarter of 2014, the added value of trade registered a significant quarterly growth[17], thus contributing the most to the growth of domestic economy. This performance contributed to an annual growth of added value of trade (which in the last two years was almost continuously decreasing), which is explained by the increased volume of wholesale trade, amid reduction in retail trade. Unfavorable developments in retail trade are partly demonstrated in the survey of managers in **retail trade**[18], whose assessments, compared with the assessments from the previous quarter, indicate increasing limiting factors to the improvement of the current business situation of companies. In fact, compared with the last quarter of 2013, there is an increasing limiting impact of higher competition, lack of trained personnel, higher market supply, as well as higher labor costs. Expectations of company managers for the period ahead show reduced number of positive expectations about the business situation in the next six-month period, and increasing number of positive expectations for higher selling prices, orders and number of employees in the next three to four months.

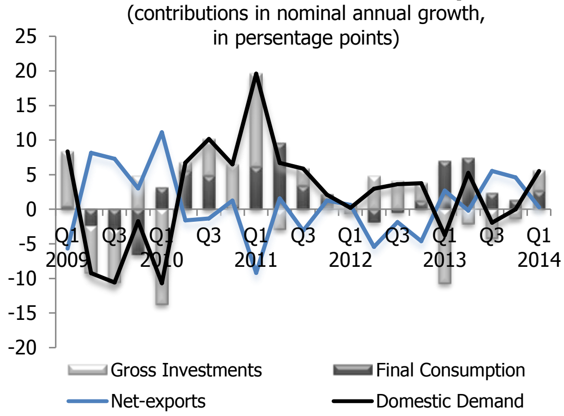
1.3. Aggregate Demand

Analyzing demand, the annual growth of gross domestic product in the first quarter of 2014 results from the positive contribution of domestic absorption, while net export demand has a negative impact on growth for the first time in four quarters. Analyzing by individual component, export and investment demand are the main drivers of annual growth in economic activity. Exports of new facilities operating in the technological industrial development zones, and the gradual strengthening of foreign demand had appropriate positive effect on the domestic industry and export sector. All components of domestic demand enhanced, with gross investments contributing the most mainly due to the increased private and public investment. Such trends in exports and investments contributed to further positive developments on the labor market and continued the growth of household consumption, with the public spending having a positive impact on the GDP growth, after decreasing in the previous four quarters. Increased domestic and export demand, amid high dependence of domestic production on imports, increased the imports.

[17] Seasonally-adjusted.
[18] SSO's Business Tendency Survey in retail trade for the first quarter of 2014.

Domestic Demand and Net-Exports

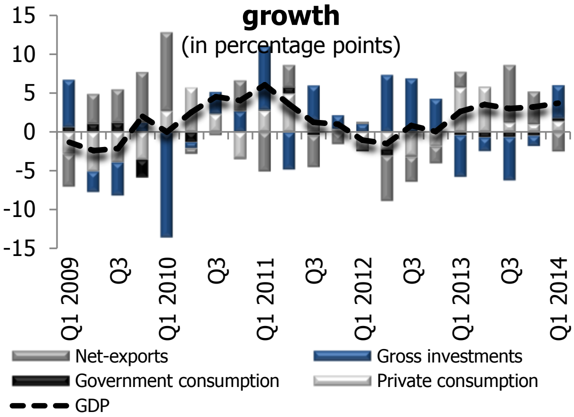
(contributions in nominal annual growth, in persentage points)



Source: State Statistical Office and NBRM calculations.

Contribution to real annual GDP growth

(in percentage points)



Source: State Statistical Office and NBRM calculations.

Analyzing GDP in relation to demand, the relatively high annual growth in the first quarter of 2014 is due to the increased domestic and foreign demand, partially offset by the increase in imports. Observing by individual component, export of goods and services is again the main generator of growth. Favorable export growth results from the increased export of production capacities operating in the technological industrial development zones, and the growth of other exports, along with the gradual strengthening of external demand. All domestic components of demand contributed positively to the growth of economic activity in the first quarter of 2014. Thus, the favorable trends in the export sector, given the increased capacities due to the new foreign investments and favorable outlook of foreign economic environment, increased private investments, along with the government investments. Amid further positive developments on the labor market, partly as a second-round effect of the new export capacities, household consumption which has had a steady annual growth (for five quarters in a row) also made a positive contribution to the growth. After a continued decline in the past year, public spending registered an annual growth and therefore, positively affected the GDP growth. Increased domestic and export demand led to a faster import growth, which caused widening of trade deficit and negative contribution of net exports.

Real annual growth rates (%)

	2011-Q1	2011-Q2	2011-Q3	2011-Q4	2011	2012-Q1	2012-Q2	2012-Q3	2012-Q4	2012	2013-Q1	2013-Q2	2013-Q3	2013-Q4	2013	2014-Q1
Private consumption	3.2	6.1	1.9	0.5	2.9	-2.7	-2.7	-3.9	-2.6	-3.0	7.0	7.1	1.6	1.4	4.2	1.6
Government consumption	0.7	4.9	-2.7	-0.2	0.6	-1.1	-4.7	-0.6	0.8	-1.4	-2.3	-4.3	-4.4	-3.2	-3.6	2.2
Gross investment	55.4	-20.0	21.9	5.6	9.6	4.8	39.1	28.0	12.7	20.0	-24.4	-7.3	-18.3	-4.1	-12.1	26.5
Exports of goods and services	36.3	12.0	2.6	-0.4	10.5	0.2	0.7	-1.3	0.6	0.0	-3.0	2.5	9.5	8.4	4.5	12.5
Imports of goods and services	33.3	3.6	8.6	2.2	10.4	-0.3	9.5	3.9	3.8	4.2	-4.9	1.6	-4.4	-0.8	-2.1	12.5
Domestic demand	9.2	0.7	4.8	1.8	3.9	-1.2	3.6	3.1	2.0	2.0	-0.3	2.5	-4.3	-0.8	-0.8	5.2
*Net exports**	*27.1*	*-14.1*	*28.1*	*7.9*	*10.1*	*-1.2*	*33.8*	*17.4*	*10.5*	*14.2*	*-9.2*	*-0.2*	*-34.5*	*-18.3*	*-15.8*	*12.6*
GDP	**6.1**	**3.6**	**1.2**	**1.0**	**2.8**	**-1.1**	**-1.5**	**0.8**	**0.0**	**-0.4**	**2.4**	**3.3**	**2.8**	**3.1**	**2.9**	**3.9**

**decrease represents lower deficit*

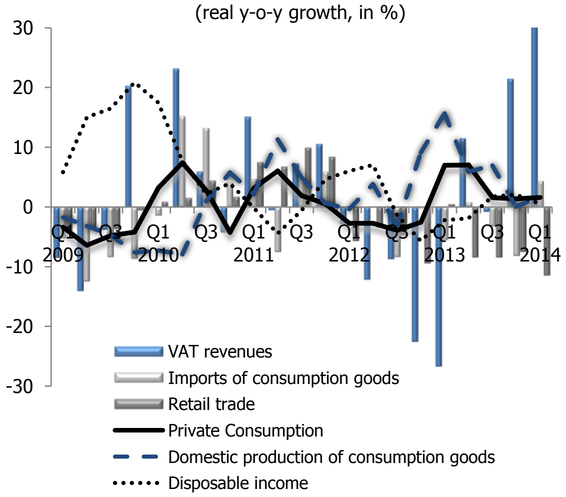
Source: SSO and NBRM calculations.

1.3.1. Private Consumption

In the first quarter of 2014, private consumption increased quarterly by 5.4% (seasonally adjusted), causing slight acceleration of the annual growth rate. Growth in private consumption corresponds to the further growth of the available funds, although they grow at a slower pace. Thus, the positive developments in the export sector, and the effect of active government employment measures

Private consumption indicators

(real y-o-y growth, in %)



Source: State Statistical Office , Ministry of Finance and NBRM calculations.

contributed for further favorable developments in the labor market. Employee number continued its solid growth, albeit at a slower pace compared with the growth over the past year. The annual real wage decline accelerated marginally, because of the nominal wage decline. Despite these changes in wages, the solid growth of employee number increased the wage bill, but at a moderate pace. Meanwhile, pension growth rate slightly slowed down, while private transfers have still been declining. Hence, the wage and pension bill are factors that kept the real annual growth rates of the estimated disposable income in a positive zone. The real growth of household lending, mainly in the form of consumer loans, as additional source of funding accelerated. These developments partly correspond to the movements of consumption indicators. Domestic production of personal consumption goods and imports of these goods registered an annual growth in the first quarter. On the other hand, retail trade registered an annual decline, which is consistent with the assessments of company managers in this sector for a higher amount of inventory in the regular season[19]. The movement of household deposits, whose annual growth accelerated in the first quarter of the year, slowed down the pace of consumer spending.

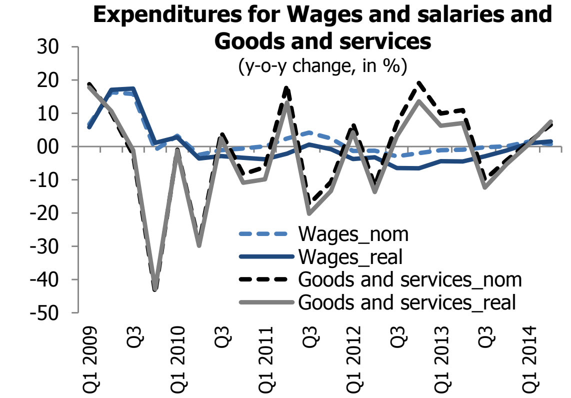
The latest available data[20] for the second quarter of 2014, largely point to growth in private consumption. In fact, real wages increased on an annual basis for the first time after two years of constant real annual decline. Continuing growth of pensions paid and net income from VAT, although at a slower pace, and intensive lending to households indicate increased household consumption. Loan growth is in line with the expectations of banks, which show greater optimism about the lending terms and the demand for consumer loans in the second quarter of 2014[21]. The domestic production of consumer goods registered an annual increase similar to the increase from the previous quarter. On the other hand, minority of consumer spending indicators register reverse trends. Namely, net private transfers and retail trade continued declining in the period April-May, but at a slower pace. However, the annual real decline in retail trade registered a significant slowdown, which is consistent with the managers' expectations for the second quarter of 2014 regarding the number of orders, selling

[19] SSO's Business Tendency Survey in retail trade conducted in the first quarter of 2014.

[20] Wage data are as of April, while other data are as of May.

[21] NBRM's Lending Survey conducted in April 2014.

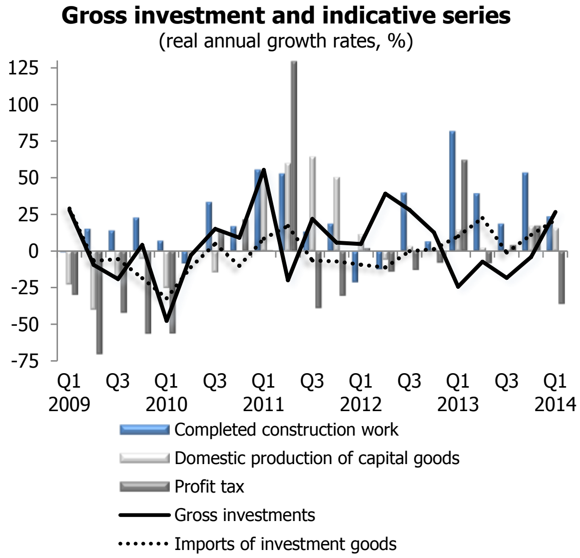
prices and the number of employees that are more favorable compared to the previous quarter, while the expectations for the business climate remain almost the same[22]. In April-May, the imports of consumer goods remained at the level of the previous year.



Source: Ministy of Finance and NBRM calculations.
The calculations include expenditures of Consolidated Budget of Central Government and Funds, deflated by CPI.

1.3.2. Public Consumption

In the first quarter of 2014, the public consumption recorded a quarterly growth of 2.5% (seasonally adjusted) and an annual growth of 2.2%, thus leaving the zone of negative real rates of growth recorded in the previous year. Real annual growth stems from the growth in expenditures on wages, and goods and services. Available data for April-May 2014 point to further **positive annual developments of public spending in the second quarter of 2014,** given the real growth in the cost of goods and services and transfers for health care[23].



Source: State Statistical Office, Ministry of Finance and NBRM calculations.

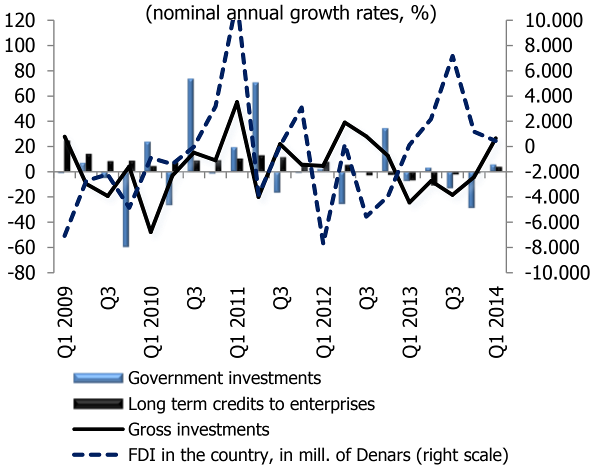
1.3.3. Investment Consumption

In the first quarter of 2014, gross investments show an annual and quarterly increase after decreasing annually four quarters in a row. The annual growth of investments equaled 26.5%, while the quarterly growth is slightly lower than the growth in the previous quarter and equaled 3.7% (seasonally adjusted). The annual growth of gross investments can be explained by the growth of investments in fixed assets as a result of the increased investments in construction and equipment and machinery. Thus, high annual growth rates in construction are also present in the first quarter of 2014 (23.7%) and are largely attributable to investments in transport infrastructure and hydro construction. However, this growth is slower compared to the previous quarter and in line with the assessments of managers in this sector[24], whose assessments of the current economic activity of companies are slightly less favorable, unlike the previous quarter. Among other investment indicators, in this quarter, domestic production and import of capital goods

[22] SSO's Business Tendency Survey in retail trade conducted in the first quarter of 2014.
[23] Most of these assets relate to expenditures on goods and services.
[24] SSO's Business Tendency Survey in construction conducted in the first quarter of 2014.

Gross investments and determinants

(nominal annual growth rates, %)



Source: State Statistical Office, Ministry of Finance and NBRM calculations.

registered a double-digit growth, the production registered similar growth rate as the previous quarter, while import growth rate significantly accelerated. Positive trends in investments in equipment and machinery are partly associated with foreign direct investments, which increased in the first quarter. Long-term corporate lending by banks increased annually in real terms for the first time after decreasing for six quarters, which is in line with the banks' lending assessments in the first quarter of 2014[25]. The banks reported higher demand for loans on a net basis, which is again driven by the increased demand for corporate loans earmarked for investments in fixed assets and inventories and working capital. On the other hand, banks reported a moderate net tightening of lending terms after two quarters of net easing. The growth of government expenditures on capital investments also indicates investment growth, after declining in the past two quarters.

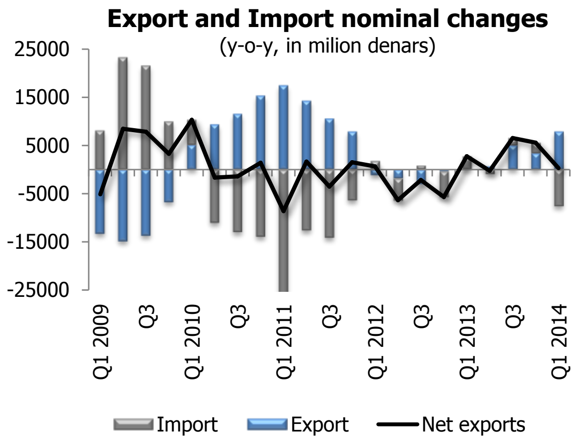
The latest available indicators for investment activity for the second quarter of 2014 show positive trends[26]. Thus, imports of investment goods and domestic production of capital goods recorded a real annual growth. The pace of import growth slowed down compared to the previous two quarters, while output growth accelerated significantly. Long-term corporate lending by banks continues to grow at a similar rate of real annual growth from the previous quarter. These developments are in line with the banks' expectations for the second quarter of 2014[27], indicating a moderate net easing of lending terms and increased demand for corporate loans on a net basis. In April, the construction recorded a small real annual growth, versus the two-digit growth rates in the previous seven quarters. However, more pronounced positive developments are expected for the next period, since the expected total value of construction licenses recorded a high annual growth, especially in civil engineering related to the previously announced major infrastructure projects. Analyzing expectations of managers in the construction sector, they express more favorable expectations for the second quarter compared with the previous one, in terms of the possible period of providing works and the number of employees, and less favorable expectations for the orders and pricing[28].

[25] NBRM's Lending Survey conducted in April 2014.
[26] Data on completed construction works and foreign direct investments are as of April, while other data are as of May.
[27] NBRM's Lending Survey conducted in April 2014.
[28] SSO's Business Tendency Survey in construction conducted in the first quarter of 2014.

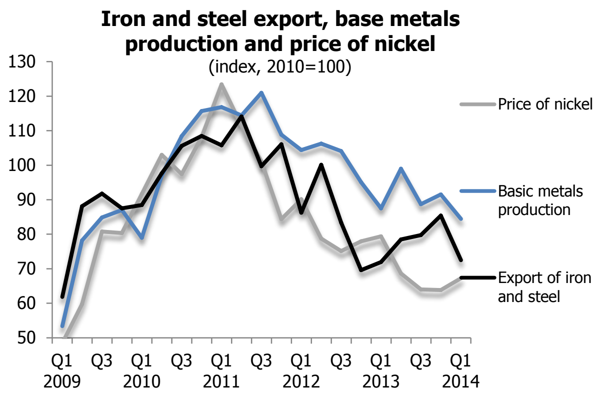
The growth of government capital expenditures accelerated, with favorable shifts being recorded in the inflows of foreign direct investments that increased annually.

1.3.4. Net External Demand

After the positive contribution in the previous four quarters, in the first quarter of 2014, net exports made negative contribution to the GDP growth. Amid same real annual growth rates of both imports and exports in goods and services (12.5%), the negative contribution arises from the stronger real growth in the absolute amount of imports than the export of goods and services. Amid still unfavorable dynamics of metal prices, favorable export growth is due to the activity of the new capacities in the technological industrial development zones and the gradual strengthening of the foreign effective demand. Increased domestic production intended for export and higher domestic demand, mainly investment demand, boosted the imports of raw materials, machinery and equipment, contributing to stronger growth of import of goods and services and negative impact on the growth of overall economic activity.



Source: State Statistical Office .



Source: State Statistical Office, IMF monthly database and NBRM calculations.

The permanent positive growth rates of export of goods and services in the second quarter of 2013 continued in the first quarter of 2014. Thus, real export of goods and services recorded a quarterly growth of 2.8% (seasonally adjusted), registering a relatively high annual growth of 12.5%, making it a component with the largest positive contribution to GDP growth. This growth was mainly due to the increased exports of production facilities in the technological industrial development zones, given the gradual strengthening of foreign effective demand. The favorable environment contributed to slightly higher utilization of manufacturing facilities[29] and increase in domestic industry and exports, with higher export of machinery and electrical equipment. Export of iron and steel recorded a marginal annual real growth, given the significantly slower pace of annual growth compared to the previous quarter. As in the previous quarter, this growth is likely due to the low base effect of the last year and reduced inventory, given the adverse

[29] SSO's Business Tendency Survey in manufacturing industry conducted in April 2014.

movements in the international metal prices and the still weak global demand for metals. Given the dependence of domestic production on imports and growth of investment demand, the first quarter of 2014 registered higher imports of raw materials, equipment and machinery. Thus, import of goods and services in the first quarter of 2014 increased in real terms by 12.5%, annually, while on a quarterly basis it also surged by 9.8% (seasonally adjusted).

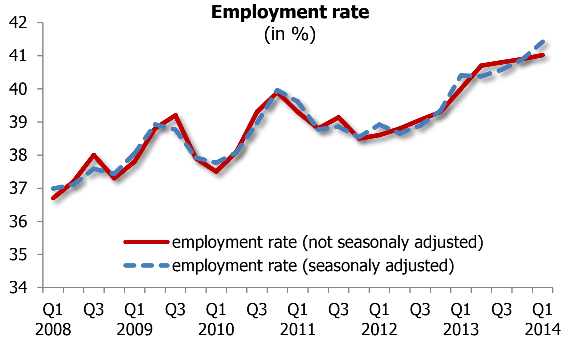
Unlike the first quarter, recent data for the second quarter point to return of 2013 trends of positive contribution of net exports on GDP. Amid higher capacity utilization in the manufacturing industry, in April and May 2014, export of goods, especially machinery and electrical equipment, generated a nominal annual growth, whose increase was significantly supported by the capacities operating in the technological industrial development zones. Consequently, the increased export of investment goods is the main driver of growth in the nominal exports in April and May 2014. These developments are in line with the estimates for the foreign effective demand, indicating a gradual strengthening of the growth. This is also demonstrated by the growth of industrial production in April and May, whereby the manufacturing facilities' managers express more favorable expectations compared to the previous quarter with respect to prices and production volume[30]. The imports also recorded a nominal annual growth in the first two months of the second quarter, primarily due to increased import of raw materials by a major export capacity, along with the growth of import of equipment and machinery.

1.4. Employment and Wages

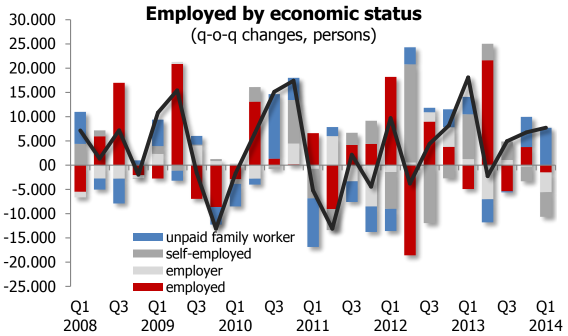
In the first quarter of 2014, the number of employees increased on an annual basis, but its pace of growth slowed down compared to the previous year. Also, this indicator has been dwelling in the zone of positive changes for eight quarters in a row. These developments are in line with the real sector performances, which are also favorable. The new wave of structural reforms in the form of publicly funded road, railway and energy infrastructure projects, and agricultural subsidy policies are underlying the fiscal stimulus, which provides a positive momentum in the labor market. The improvement of some key labor market indicators over several years is continuously attributable to the active

[30] SSO's Business Tendency Survey in manufacturing industry conducted in April 2014.

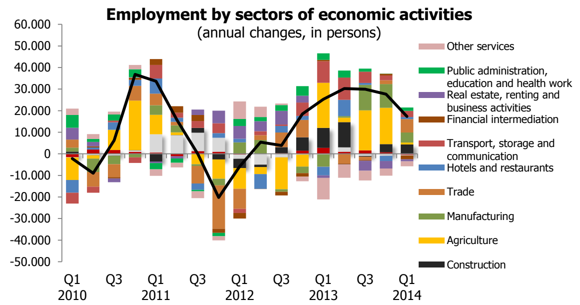
employment measures and the operation of new facilities in the technological industrial development zones. In the first quarter, competitiveness indicators also registered an annual improvement, for the first time after two years of continuous maintenance in the negative zone. Thus, labor productivity increased, with simultaneous downward adjustment of labor costs.



Source: State Statistical Office, Labour Force Survey.



Source: State Statistical Office, Labor Force Survey.



In the first quarter, the number of employees, seasonally adjusted, recorded a quarterly[31] growth of 1.1%. In terms of economic status[32], the quarterly increase in employment was solely attributable to unpaid family workers who are traditionally concentrated in agriculture. Analyzed by sectors, the quarterly employment growth stems entirely from services and agriculture. **The number of employees registered an annual growth of 2.6%, which is slowdown of the positive dynamics in the previous quarter, when employment grew by 4.2% on an annual basis.** This shift determined an annual growth of 1 percentage point of the employment rate, which reached 41%, hitting new record high. The annual employment growth is distributed among all sectors, among which trade, manufacturing industry and construction being the largest individual contributors to growth. In the area of construction, as one of the sectors that are in the focus of fiscal stimulus, the highest employment growth was registered in specialized construction activities[33], as well as in civil engineering, which is largely attributable to the beginning of the construction of some of the preannounced road and railway infrastructure projects.

According to the Vacancy Survey[34], about 35% of newly created or vacant jobs in the first

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[31] Analysis of quarterly dynamics of employment, unemployment and total active population is made by using seasonally adjusted data.

[32] Classification by economic status applies to the following groups: **employers** - persons who operate their own business entity or engages independently in their own shop, or farm owners who hire other employees; **employees** - persons who work in government institutions, business entities in public, mixed, cooperative and undefined ownership or for private employer; **own-account workers** - persons who operate their own business entity, company, engage independently in their own business and work on a farm in order to generate income, while not hiring other employees; **unpaid family workers** - persons who work without pay in a business entity, shop or farm (owned by a family member).

[33] According to the State Statistical Office's Nomenclature of type of Construction and Construction Works, specialized construction activities include site preparation and demolition, electrical and plumbing works, final construction works mainly plastering, laying of floor and wall coverings, painting works, and other specialized construction works.

[34] For the first time in 2012, the State Statistical Office began to conduct Vacancy Survey as part of the labor market research.

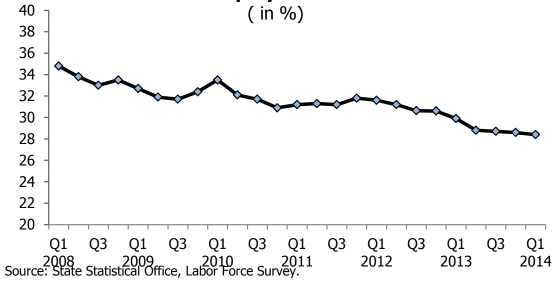
quarter are in the manufacturing industry. At the same time, the aggregated alerts from the business tendency surveys[35] show increasing optimism compared to the same period last year, in terms of the number of employees for the next three months. This tendency corresponds to the positive developments in the domestic and the gradual recovery of the global economy.

Demand growth triggered a quarterly increase of labor supply. In fact, the growth of 0.5% **in the first quarter of 2014** represents the third quarter of continuous upward trend of the total active population. The upward adjustment compared to the same period last year, along with the simultaneous decrease of inactive population, resulted in an annual activity growth rate, which in the first quarter settled at 57.3%.

The labor demand growth exceeding the labor supply growth led to quarterly downward shift of unemployment. The quarterly decline of 1.1% is only a marginal acceleration compared to the decline registered in the previous quarter. Annually, the 4.5% fall in the number of unemployed persons is associated with more intensive growth in labor demand compared to the growth in labor supply. The unemployment rate also decreased annually (by 1.5 percentage points), and hit the historic low of 28.4%.

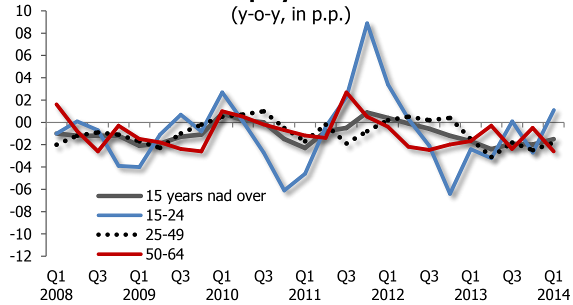
The average paid wages declined on an annual basis for the first time in six quarters. Thus, in the first quarter, the nominal net and gross wages registered an annual decrease of 0.2% and 0.3%, respectively, where the downward adjustment entirely attributes to the agriculture and the service sector. Nominal wage fall, despite the weakened inflationary pressures resulted in **real wage decline, whose annual dynamics is only marginally stronger compared to the previous quarter.** Thus, the average real net wage is lower by 0.7% on an annual basis. **On a quarterly basis**, net and gross nominal wages are lower by 0.8% and 1%, respectively, representing a downward correction sufficient to offset the rise from the previous quarter. Sector-by-sector analysis shows that this shift fully reflects the downward adjustment of wages in agriculture. However, due to the

Unemployment rate
(in %)



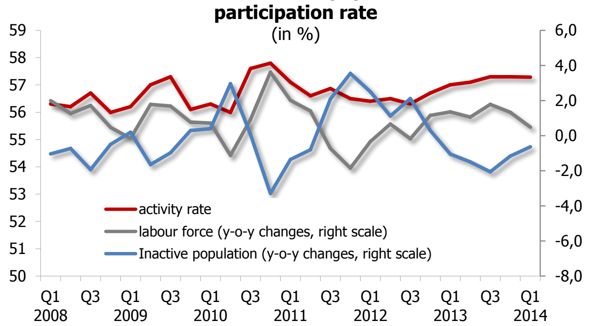
Source: State Statistical Office, Labor Force Survey.

Unemployment rate
(y-o-y, in p.p.)



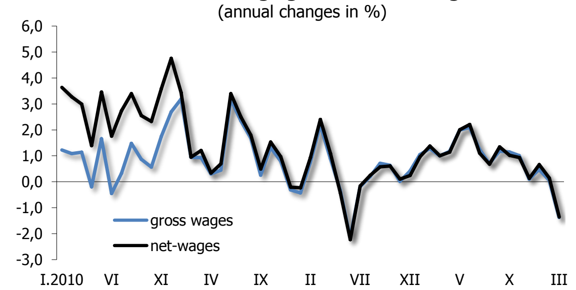
Source: State Statistical Office, Labor Force Survey.

Labour force, inactive population and participation rate
(in %)



Source: State Statistical Office, Labor Force Survey.

Nominal average gross and net-wages
(annual changes in %)



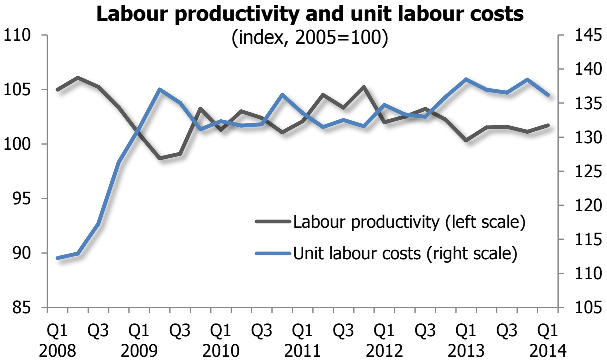
Source: State Statistical Office.

The purpose of this survey is quarterly information on vacancies in companies in the Republic of Macedonia, as an important indicator for macroeconomic developments and policies in the labor market.

[35] Source: State Statistical Office, business tendency surveys in manufacturing industry (April 2014), construction (first quarter of 2014) and trade (first quarter of 2014).

quarterly decline in the consumer price index, net wages registered a slightly milder reduction in real terms (down 0.6%).

Labour productivity and unit labour costs
(index, 2005=100)



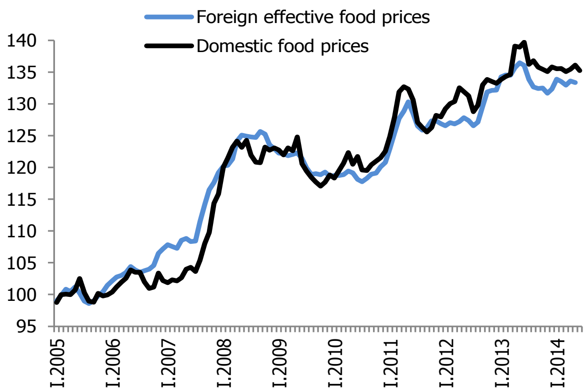
Source: State Statistical Office and NBRM calculations.

In the first quarter, the labor productivity registered an annual growth of 1.4% for the first time after two years of continuous dwelling in the negative zone. Productivity growth reflects the more intensive annual growth of economic activity compared to the employment growth. Furthermore, the determinants of annual growth also explain the quarterly productivity growth. **Productivity growth amid reduction of gross wages determined an annual decline of unit labor costs by 1.6%.** This performance was registered after eight quarters of continuous maintenance of this indicator in the positive zone. Downward adjustment of labor costs of 1.6% was also registered on a quarterly basis.

1.5. Inflation

Domestic prices kept on declining in the second quarter of 2014, and compared with the previous quarter, they were by 0.1% lower. The quarterly downward shift is mainly due to the decrease of price level of the long-term inflation component (core inflation), amid upward effect of higher prices of the food component of inflation. Consumer prices registered an annual decline. The prices decreased by 0.9% as a result of the food and energy inflation component. On the other hand, the annual change in long-term component, i.e. core inflation continued decelerating, but remained in the zone of positive annual changes. Producer price indices registered a small quarterly increase, while on an annual basis they registered negative changes for the third consecutive quarter.

Foreign effective food prices* and domestic food prices

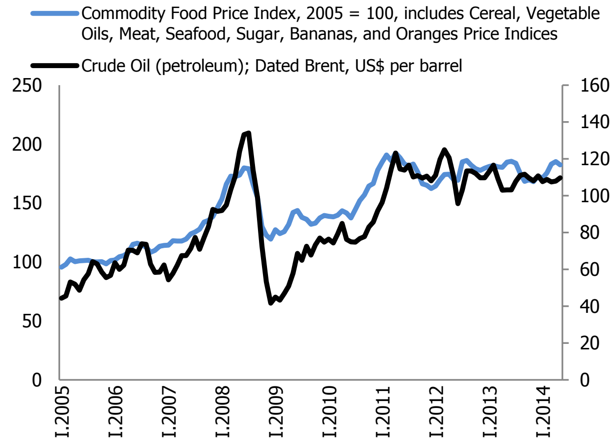


* Foreign effective food prices are calculated as weighted sum of food prices in countries that are major trade partners with Macedonia.
Source: State statistical office, Eurostat and NBRM calculations.

The reduction in domestic consumer prices, which started at the beginning of the year, continued in the second quarter of 2014. The consumer prices registered a quarterly decrease of 0.1%, which is a minimal slowdown of the decline compared to the previous quarter (0.2%). These movements are mainly explained by the long-term component of inflation which declined by 0.3% in the second quarter of the year. The energy component also reduced, but with a very small contribution (quarterly decline of 0.2%)[36]. On the other hand, food inflation registered a minor upward movement. This performance is attributable to the growth of unprocessed food (fruit and vegetables), which

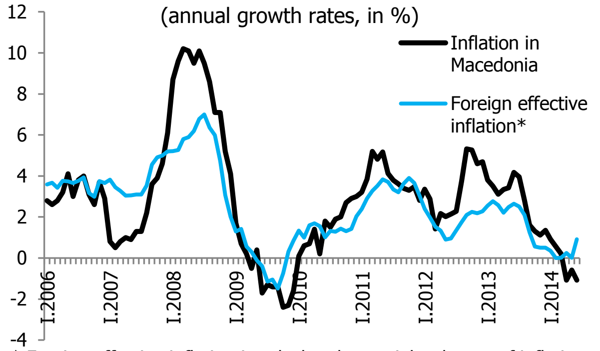
[36] The analysis of movements during the quarter shows a gradual monthly increase of domestic prices of oil derivatives (and therefore, of the total energy component) as a result of the increase in world oil prices due to the unrest in Iraq and Libya.

Crude oil and food prices



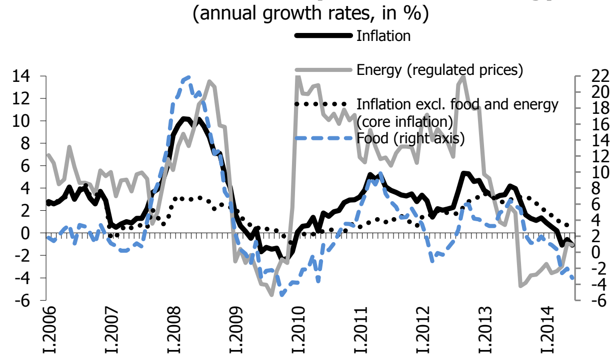
Source: IMF Primary Commodity Prices.

Domestic inflation and foreign effective inflation



* Foreign effective inflation is calculated as weighted sum of inflations in countries that are major trade partners with Macedonia.
Source: State statistical office. Eurostat and NBRM calculations.

Inflation and volatility of food and energy



Source: State statistical office and NBRM calculations.

was partially offset by the quarterly decline in unprocessed meat and oil and fats. The movement of domestic food prices corresponds to the dynamics of prices of some internationally traded primary food products.

Seasonally adjusted data indicate a slightly stronger reduction in the price level (quarterly decline of 0.7%). The quarterly decrease in prices, excluding the seasonal effects, is conditioned upon the food and the long-term component of consumer prices, while energy component made marginal positive contribution.

The annual rate of inflation continued to decelerate for fourth consecutive quarter and entered the zone of negative changes. Namely, in the second quarter of 2014, there was a negative annual inflation rate of 0.9%, which is the lowest rate since early 2010. Amid small quarterly changes, the annual rate of inflation is mainly explained by the annual decline in food inflation component. The decline in food prices is due to the lower international food prices and the base effect, i.e. lower prices of oil and fat and of unprocessed fruits and vegetables compared to the same period last year when they recorded an extremely high growth (due to the flooding in the eastern parts of Macedonia). Smaller contribution to the annual decline in prices was also made by the energy component of inflation that continued declining in the second quarter, although at a slower pace. The downward trajectory of this component is due to the downward adjustment of the price of electricity (in the third quarter of 2013), as well as the lower fuel prices. Despite the lower prices of food and energy, the long-term component of inflation remained in the positive zone, but continued slowing down. The positive performance of this component is due to the higher prices of pharmaceutical products, alcoholic beverages and catering services. Unlike domestic consumer prices, foreign effective inflation[37] accelerated annually, and equaled 0.4% (0.1% in the previous quarter).

[37] The calculation of foreign effective inflation takes into account the weighted sum of consumer price indices of countries that are major exporters of consumer goods in the Republic of Macedonia. The weight structure is based on the normalized shares of nominal imports from each country in the total nominal imports in the period 2010-2012. The calculation of this indicator includes Bulgaria, Germany, Greece, France, Italy, Austria, Slovenia, Croatia and Serbia.

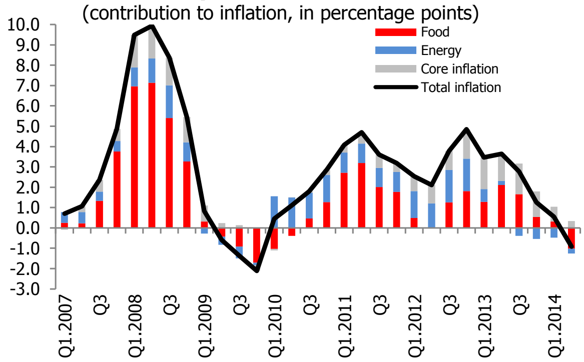
Other price categories

	(annual growth rates, in %)							(contributions to annual growth rates, in p.p.)						
	2013				2013	2014		2013				2013	2014	
	Q1	Q2	Q3	Q4		Q1	Q2	Q1	Q2	Q3	Q4		Q1	Q2
Consumer price index - all items	**3.5**	**3.6**	**2.8**	**1.3**	**2.8**	**0.6**	**-0.9**	**3.5**	**3.6**	**2.8**	**1.3**	**2.8**	**0.6**	**-0.9**
Food	*3.4*	*5.6*	*4.4*	*1.4*	*3.7*	*0.8*	*-2.6*	*1.3*	*2.1*	*1.7*	*0.5*	*1.4*	*0.3*	*-1.0*
Energy	*4.3*	*1.3*	*-2.6*	*-3.6*	*-0.2*	*-3.3*	*-1.7*	*0.6*	*0.2*	*-0.4*	*-0.5*	*0.0*	*-0.5*	*-0.2*
Electricity	10.0	10.0	-1.0	-3.1	3.7	-3.1	-3.1	0.7	0.7	-0.1	-0.2	0.3	-0.2	-0.2
Heat energy	0.2	-10.3	-14.4	-16.3	-10.3	-12.3	-2.9	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	0.0
Fuels and lubricants	0.2	-6.7	-2.3	-4.2	-3.3	-4.3	-0.8	0.0	-0.3	-0.1	-0.2	-0.1	-0.2	0.0
Food and energy (volatile prices)	*3.6*	*4.4*	*2.4*	*0.0*	*2.6*	*-0.3*	*-2.4*	*1.9*	*2.3*	*1.3*	*0.0*	*1.4*	*-0.2*	*-1.3*
Core inflation (inflation excl. food and energy)	*3.3*	*2.8*	*3.2*	*2.7*	*3.0*	*1.5*	*0.7*	*1.6*	*1.3*	*1.5*	*1.3*	*1.4*	*0.7*	*0.3*

Source: State Statistical Office and NBRM calculations.

Volatile (food and energy) and long-term component of inflation

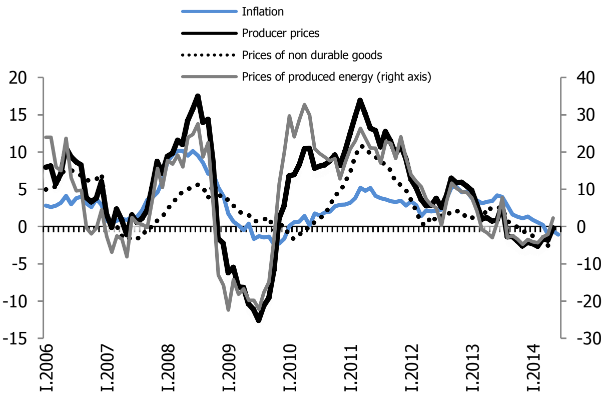
(contribution to inflation, in percentage points)



Source: State statistical office and NBRM calculations.

Inflation and industrial producer prices

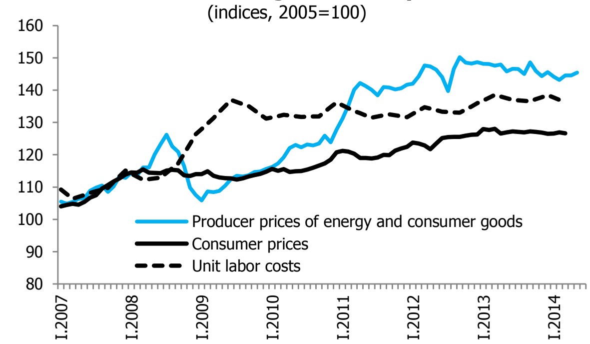
(annual growth rates, in %)



Source: State statistical office and NBRM calculations.

Factors affecting consumer prices

(indices, 2005=100)



Source: State statistical office and NBRM calculations.

The long-term component of inflation continued to decelerate in the second quarter of the year. Thus, the annual rate of core inflation (price component excluding food and energy) slowed down from 1.5% in the first quarter to 0.7% in the second quarter. Observing individual categories, the slowing pace of core inflation in this quarter is mainly explained by the changes in prices of household furniture (textile and household appliances) and the stronger annual decline in prices of accommodation services, while the contribution of changes in prices of pharmaceutical products was mostly in the opposite direction.

Producer price indices slightly increased in the second quarter of 2014[38]. The quarterly growth of producer prices equaled 0.6% (down from 0.1%, seasonally adjusted), mainly explained by the increase in producer prices of energy, clothing and beverages. On the other hand, more significant decrease was registered in producer prices of oil products and food products. Annually, there is a slowing rate of decline in producer prices, which in the second quarter of the year reduced to 1% (compared to 2.5% as it was in the previous quarter). The largest contribution to the annual decline was made by producer prices of food products, tobacco and electricity. **Producer prices affecting the domestic component of inflation[39]** fell by 0.5% on a quarterly basis (seasonally adjusted), while on an annual basis they dropped by 1.3%. Keeping these prices in the negative zone indicates lower inflationary pressures in the future.

In the first quarter of 2014**, labor unit costs decreased** (by 1.6%, both quarterly and annually), **for the first time after two years of continuous maintenance in the positive zone,** given the higher productivity and lower real wages. Lower labor costs, amid still negative

[38] The data refers to the producer prices in the domestic market in the first two months of the analyzed quarter.
[39] Consumer goods (durable and non-durable) and energy.

output gap[40], suggest absence of pressure on the prices of final products through this channel.

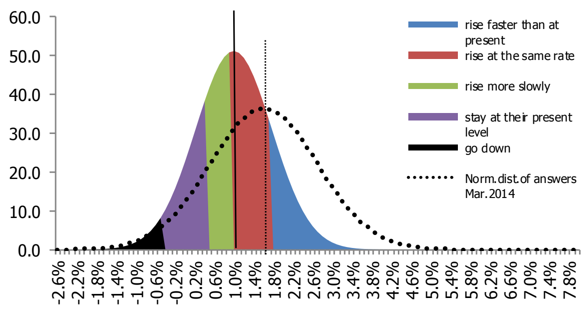
Box 2: Inflation Expectations Survey

In order to improve the survey measure of inflation expectations, in 2013 the National Bank of the Republic of Macedonia started an in-depth analysis of the experiences of other central banks associated with conducting surveys. On this basis, the existing survey was redesigned, due to its greater approximation to the European practice.

The new format of the questionnaire contains two questions, one qualitative and one quantitative in nature. The first question of inflation expectations is qualitative, i.e. the respondents do not provide a quantitative answer, but indicate the direction and extent of prices changes compared with the change in the previous 12 months. The procedure for measuring the qualitative answer is by using the probability approach of Carlson and Parkin (1975), which assumes that at a sufficiently large number of respondents, the expected change in prices is normally distributed among the population. The quantitative question requires from the respondent to determine accurately the expected average rate of change of prices in 2014 and 2015.

As before, the Inflation Expectations Survey includes three groups of respondents: economic analysts, companies and financial institutions. The qualitative questions of expectations read as follows: "Compared with the past 12 months, what change do you expect in consumer prices in the next 12 months? a) will have a faster growth; b) will grow at the current pace; c) will grow more slowly; d) will remain almost the same; d) will decrease; f) it is difficult to determine", while the quantitative question reads: "What are your expectations/forecasts for the average inflation rate in 2014 and 2015?".

Chart 1. Normal distribution of answers of the respondents



The Inflation Expectations Survey was conducted in June 2014[41]. The survey results show the highest concentration of responses in the segment of expectations for unchanged inflation dynamics, i.e. one third (33.3%) of respondents expect prices to rise at the current pace in the next 12 months. Furthermore, 25% of respondents expect slowdown in inflation growth, 18.1% expect prices to remain unchanged, while 16.7% expect faster growth in prices. Only 2.8% of respondents expect price decline in the next 12 months. Amid average inflation of 1.3% in the previous 12-month period, the respondents expect the inflation to slow down by an average of 0.3 percentage points in the next 12-month period, i.e. **they expected average inflation of 1.0%.** Analyzing individual surveyed groups, the surveyed ***financial institutions*** expect the highest slowdown (expected inflation of 0.8%), followed by ***companies*** (expected inflation of 0.9%), while ***economic analysts*** expect the inflation to slow to 1.2%. For 2014 and 2015, the respondents expect lower average rate of inflation compared to the previous survey (currently, the inflation rate is expected to equal 2.2% for 2014 and 2.6% for 2015, versus 2.7% for 2014 and 2.9% for 2015 according to the April survey). According to the respondents, the main factors for their expectations include low domestic inflation performance, low inflation in the euro area, a possible increase in food prices due to the weather disasters that hit the region, as well as uncertainty regarding the movement of energy prices amid military crisis in Ukraine and Iraq.

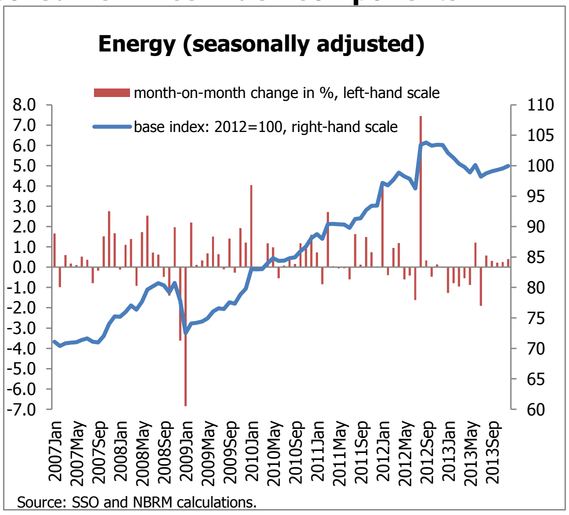
[40] The NBRM's estimates show that domestic output is still below the potential level (negative output gap).

[41] The percentage of responsiveness of the survey, conducted in June equaled 38.3%. Analyzing by groups of respondents, the financial institutions' responsiveness is 55.6%, followed by economic analysts with 44.8% and 31.1% of companies.

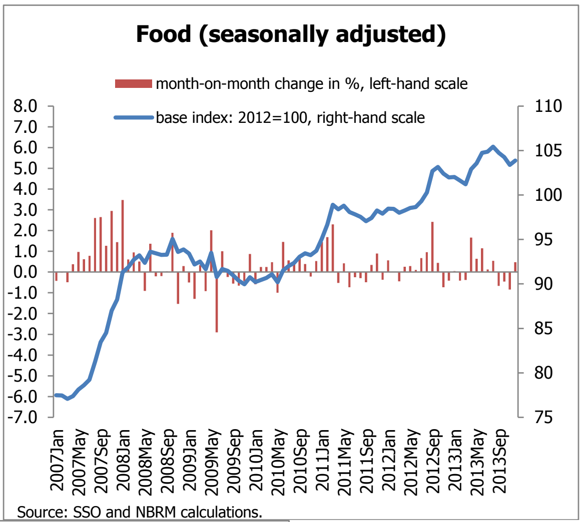
Box 3: The Role of Base Effects of Volatile Consumer Price Components on Future Inflation Movements

Energy and food prices are the most volatile components of the consumer price index. Namely, after the removal of the usual seasonality of data, volatility of monthly changes in the energy prices and food prices, as measured by standard deviation, is greater by 4.3 times and 2.7 times, respectively, compared with the core inflation (total CPI with food and energy excluded). This box analyzes how changes in energy and food prices in 2013 may affect the path of annual rate of inflation in 2014 through the so-called base effects.

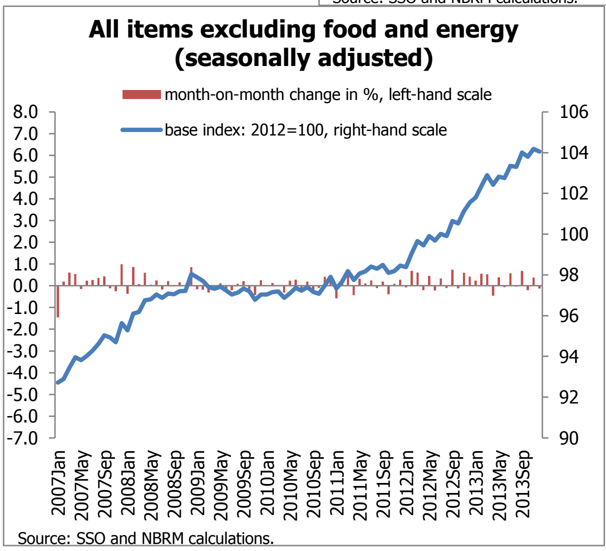
Chart A
Consumer Price Index Components



Source: SSO and NBRM calculations.



Source: SSO and NBRM calculations.



Source: SSO and NBRM calculations.

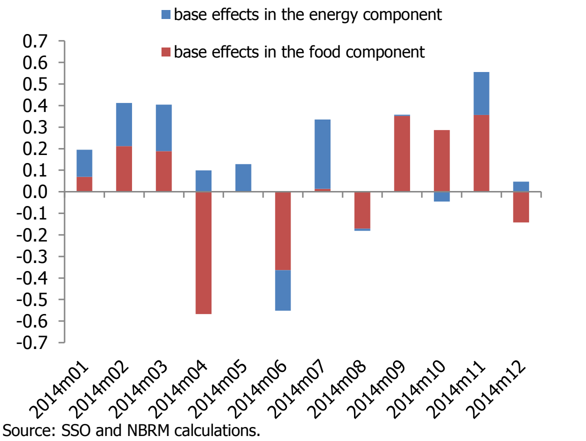
When considering the changes in the annual inflation rate, it is crucial to identify the extent to which these changes are explained by movements in the prices of the current year (i.e. current "news" from one month to another), and the extent to which they are due to the so-called base effects. Base effects relate to variations in the annual growth rate of an economic indicator, in this case the consumer price index, which is the result of some atypical movement 12 months earlier. Since there is no generally accepted method of calculating the base effect, in this box, the base effects of inflation in the Macedonian economy are calculated according to the approach used by the ECB[42]. Thus, the base effect

[42] For more details also see the box of the ECB: "Accounting for Recent and Prospective Movements in HICP Inflation: The Role of Base Effects", *Monthly Bulletin*, ECB, December 2008.

is defined as the contribution to the change in the annual rate of inflation in a given month, which arises from the deviation of the monthly rate of change in the base month (i.e. the same month of the previous year) from their usual or normal change. The usual changes in the consumer price index are calculated as an average of the monthly changes in each year since January 1997, taking into account seasonal fluctuations. Furthermore, the comparison of changes in the consumer price index in 2013 with the usual changes, identified the months that registered unusual movements and that could have an effect on the rate of inflation during 2014. The estimated base effects for 2014 of food and energy components are presented in charts B and C.

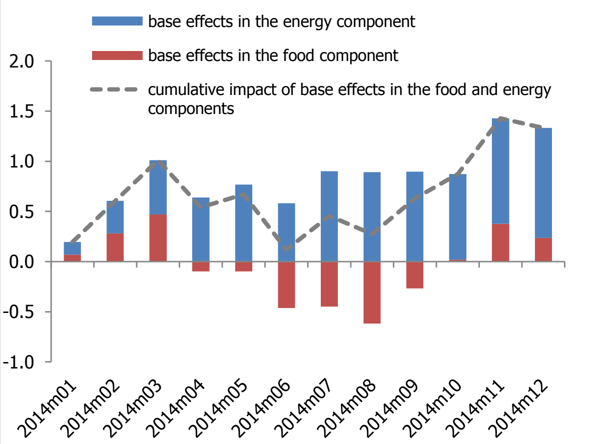
Chart B shows the estimated contributions of base effects of energy and food component of the consumer price index to the change of the annual rate of inflation for the period of January to December 2014. The contribution of base effects from energy prices is perceived as positive in most of the year. The positive base effect will be strongest in July 2014, reflecting the reduction in the electricity price in the same month of 2013. An exception to the positive base effects of the energy are June, August and October, when negative contributions were calculated. Base effects arising from food prices are perceived as positive at the beginning and at the end of the year, while the mid-year base effects are negative. High negative base effects of this component are due to the extraordinary increase in the prices of unprocessed vegetables in April 2013 due to the bad weather in one of the most important agricultural regions in the country. However, for 2014 the impact of the base effects on the overall index of consumer prices was calculated to be below the average compared with 2013, and with the average, calculated since 1998.

Chart B: Contribution of base effects in the food and energy components to the monthly change in annual inflation in 2014 (in p.p.)



Source: SSO and NBRM calculations.

Chart C: Cumulative impact of base effects in the food and energy components in 2014 (in p.p.)



Source: SSO and NBRM calculations.

Chart C shows cumulative contributions of the base effects to changes in the annual rates of the consumer price index. Estimates show that the cumulative contribution of these base effects to the overall inflation during the period from January to December 2014 will be positive and will equal 1.3 percentage points. The contribution of the base effects of energy prices will dominate, while the effect of food prices will be lower.

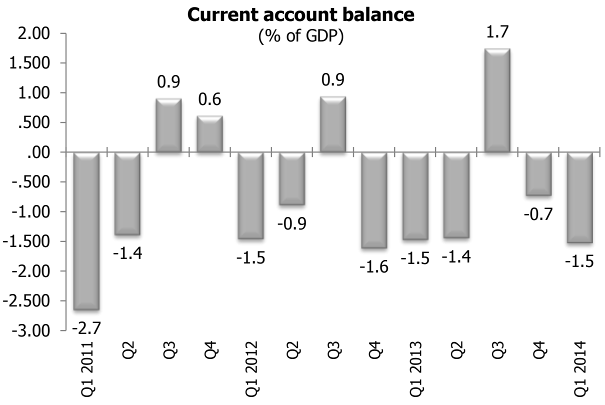
Base effects stemming from past changes in energy and food prices are among factors that determine the path of inflation in the coming months and as such, they represent additional information when projecting the inflation. However, the future inflation movements also depend on other factors, such as consumer demand, as well as factors on the supply side (changes in the cost of production factors, import prices, etc.). In the case of Macedonian economy, given the absence of pressures from the demand, the current year may expect that inflation will be influenced by the expected base effects, and the future trends in import prices of primary commodities.

1.6. Balance of Payments[43]

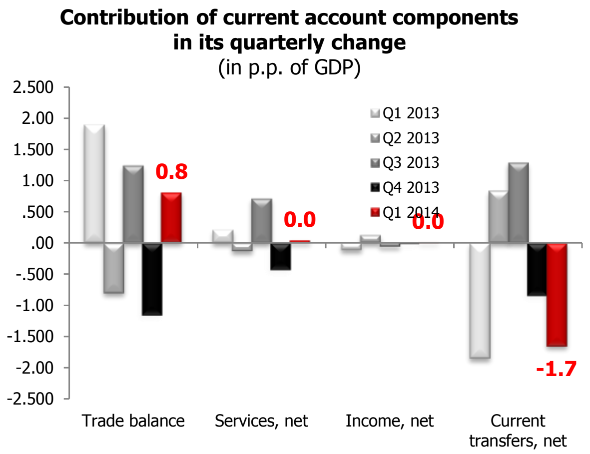
In the first quarter of 2014, the current account deficit recorded a quarterly expansion, almost entirely explained by the seasonal decline in current transfers. The trade deficit dropped sharply, typical for this period. The trade balance was adjusted because of the faster decline in imports than in exports of goods. The current account deficit also increased annually, reflecting lower net inflows of current transfers, after their extremely high growth in the recent period. The capital and financial account recorded moderate net inflows as a result of the improved performance of foreign direct investments in the first quarter of the year. However, the net capital inflows were not sufficient to fund fully the current account deficit, thus part of the current account deficit was covered by foreign reserves.

1.6.1. Current Account

In the first quarter of 2014, the current account deficit totaled Euro 122.3 million or 1.5% of GDP[44], which is expansion of 0.8 percentage points compared to the previous quarter. **The quarterly deterioration of deficit** almost entirely derives from the decline of current transfers, amid positive trends in the trade in goods and services and neutral contribution of income deficit. ***Changes in the two major current account components, trade balance and current transfers, are mostly due to the seasonal dynamics typical for the first quarter of the year.*** *The decrease in current transfers* (1.7 percentage points of GDP), which usually register the lowest performance in the first three months of the year, is due to the lower private transfers in cash or reduced inflows of foreign assets purchased in the currency exchange market. On the other hand, given the stronger decline in imports compared to the fall in exports, *the trade deficit narrowed quarterly (0.8 percentage points of GDP) solely due to the narrowing of non-energy deficit*[45]. Additional favorable trends are registered in services, i.e. the surplus in services trade increased (0.04 percentage points of GDP), mainly due to the lower outflows in other business services. The income registered no significant changes compared to the previous quarter.



Source: NBRM.

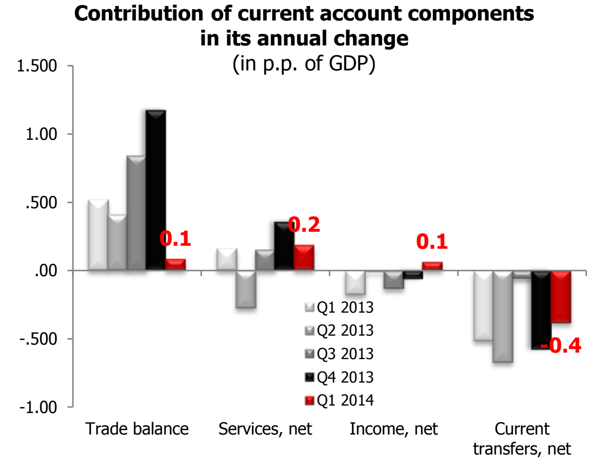


Source: NBRM.

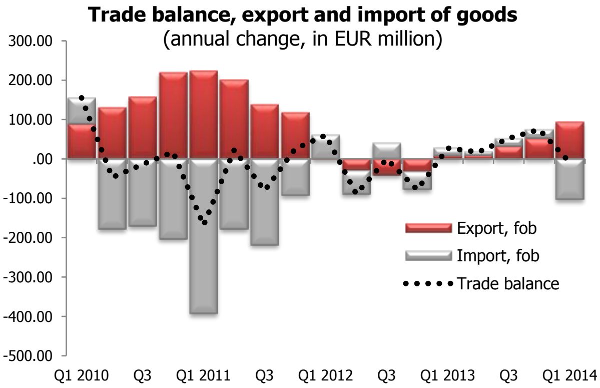
[43] The analysis of balance of payments movements in this Quarterly Report is made according to the *Balance of Payments Manual, BPM5 (IMF, 1993),* while the analysis of the international investment position and gross debt, is made according to the *Balance of Payments and International Investment Position Manual, sixth edition (IMF, 2009).*

[44] Calculations use the projected amount for nominal GDP.

[45] For more details also see the foreign trade section.



Source: NBRM.



* Positive change in import means decrease of import of goods.
Source: NBRM.

The annual analysis also indicates minimal expansion of the current account deficit of 0.1 percentage points of GDP. The main factor for the annual expansion of the current account deficit is the decline in net inflows of current transfers, while all other components registered positive shifts. In the first quarter, *current transfers recorded an annual decrease of 0.4 percentage points*, largely due to the lower private transfers in cash. *The foreign trade deficit in goods slightly improved by 0.1 percentage points of GDP, annually.* In absolute amounts, more dynamic annual growth in imports of goods (mainly higher import of raw materials and investments) compared to the increase in exports of goods *slightly worsened the trade deficit. Positive contribution to the current account was made by the higher annual surplus in services (0.2 percentage points),* whose prime generator is the surging inflows from other business services, specifically intermediation and various business, professional and technical services. Slight annual narrowing of *income* deficit is caused by the lower net outflows in other investment (particularly the government, due to the higher base effect[46]), and direct investments, which were largely offset by lower net inflows of compensation for employees. **The recent balance of payments data show that in April 2014, the current account recorded a deficit of Euro 126.8 million.** Annually, the higher current account deficit is largely due to the high outflow in services[47].

Box 4: Foreign Trade of Goods and Movement of the Nominal and the Real Effective Exchange Rate (NEER and REER)

In the first quarter of 2014, the foreign trade of the Republic of Macedonia registered a quarterly decline of 6.4%. Thus it reduced to **Euro 2054.7 million, or 25.6% of GDP**. The decrease in foreign trade was a result of the fall of the two trade components, exports and imports, which is a common seasonal pattern for this time of the year. **In the first three months, the exports of goods registered a quarterly decline of 5.5%,** which mainly reflects the reduced export of some traditional export products, primarily iron and steel, and to a lesser extent, export of food and tobacco. These negative developments were partially offset by increased export activity of new capacities in the economy, i.e. through increased exports of equipment and machinery. **On a**

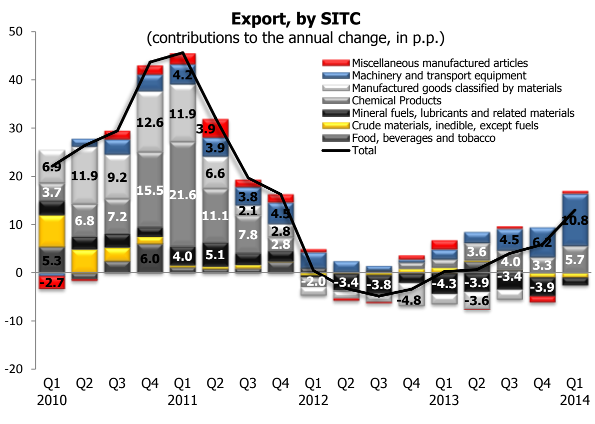
[46] In the first quarter of 2013, the last interest payment for the second Eurobond was made (which was completely repaid in January 2013).

[47] The services balance deficit in April is due to the high outflows in construction services based on advances for construction works related to highway construction projects. Meanwhile, in April, the capital and financial account registered inflows of foreign borrowing to finance road infrastructure, in the amount same as the amount of outflows through services, with the net effect on the balance of payments in the given month being neutral.

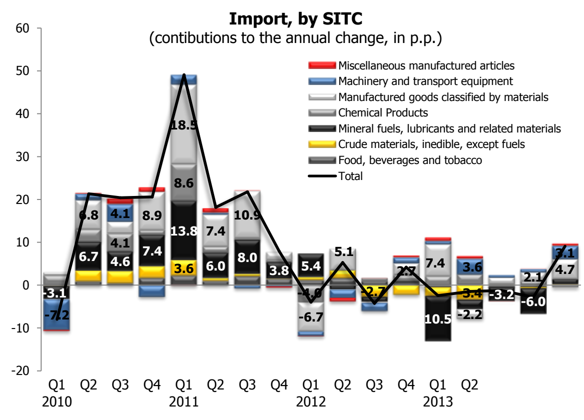
quarterly basis, imports went down by 6.9% as a result of the reduction of almost all components, with the exception of energy imports (higher imported quantities). Textile raw materials, food and machinery, and transport equipment have the dominant contribution to the quarterly decline in imports. **The stronger decline in imports of goods compared to the exports of goods narrowed the trade deficit by 9.6%.** Observing individual balances, lower non-energy balance contribute to the quarterly improvement in the trade deficit, while the energy deficit mildly expanded.

On annual basis, the export growth considerably enhanced. In the first quarter of 2014, exports registered a double-digit growth rate of 13%, versus 5.9% in the previous quarter. This growth rate is the highest in the past two-year period and reflects the growing use of the capacities of the new export-oriented companies in the automotive industry. Additionally, earlier this year, some traditional export sectors, such as export of clothing and food registered favorable export performances. On the other hand, significant negative contribution to the change in exports in the first quarter was made by the decline in export of tobacco and oil derivatives (due to changes in the operations of the domestic refinery[48]). **After the continuing reduction of import demand in 2013, in the first quarter this year, imports of goods grew by 9.1%.** These developments are in line with the intensification of export and investment activity in the country. In this regard, import of raw materials for the new industrial capacities and textile industry, as well as the import of machinery and transport equipment made the largest positive contribution to the annual growth. Additionally, annual growth was also registered by the energy component, arising from the growth of import of electricity and petroleum products (imported higher amounts). In contrast, further reduction was registered by the import of iron and steel, which is consistent with the still unfavorable export performances. **The faster growth of imports compared to the growth of exports of goods slightly widened the trade deficit on an annual basis, which equals 2.3%.** Observing balances, the deterioration in the trade deficit results from the higher energy balance deficit, while the non-energy balance acted in the opposite direction.

Source: SSO and NBRM.
** Negative change in the trade balance represents contraction of the deficit.*



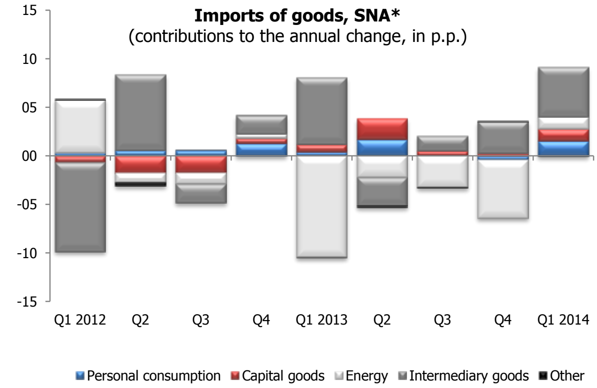
Source: SSO and NBRM.



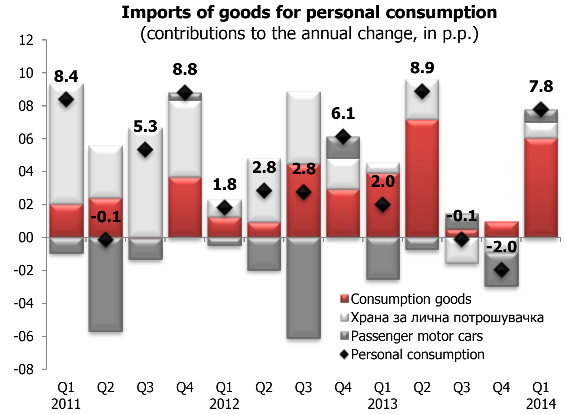
Source: SSO and NBRM.

[48] Changes in domestic refinery operations relate to significant reduction of its production activity, resulting in a continuing trend of declining export quantity of oil derivatives of the last two years. Accordingly, on the import side, such changes are reflected by full replacement of imports of crude oil with oil derivatives.

The analysis of import components according to the division under the System of National Accounts - SNA[49], shows that the main driver of the annual growth of imports in the first quarter of 2014 is the imports of the intermediate goods, raw materials mainly intended for new and existing industrial facilities. These performances confirm the conclusion for the great import-dependence of the Macedonian export, and suggest that in the next period, we could expect positive developments on the export side. Other import components, such as the import of goods for personal consumption[50], energy and capital goods that generate nearly identical contributions act in the same direction, but with lower intensity. The growth of imports of personal consumption goods, as an important indicator in terms of the conduct of monetary policy is mainly due to the increased imports of consumer goods. Performances in import for personal consumption is moderate, the contribution to the total imports is positive, but small, currently indicating an absence of significant import pressure by consumer spending.



* Classification: System of national accounts (SNA).
Source: NBRM.

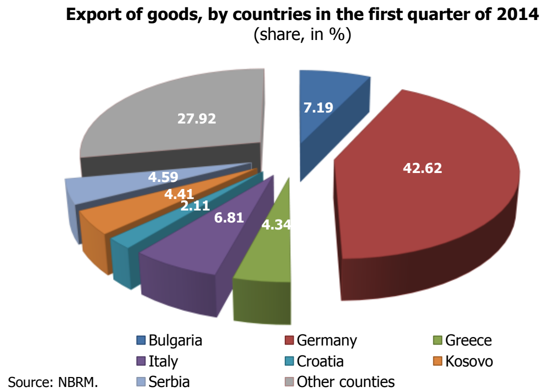


Source: NBRM.

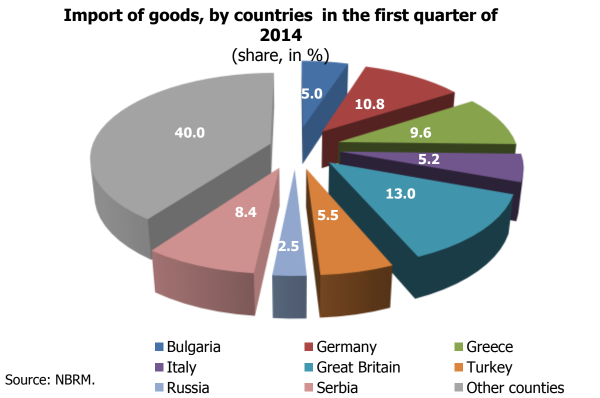
The latest available data on foreign trade indicate continuation of trends in the trade components during April and May. Exports of goods continued rising (13.3%) on an annual basis as a result of higher exports of the new industrial capacities and growth in exports of clothing. Imports of goods registered an annual growth (3.8%), mainly due to the higher import of raw materials for the new capacities, driven by the export activity of the aforementioned facilities.

The analysis of **foreign trade by trading partners** shows further growth of the trade of the Macedonian economy with the most important trade partner - the European Union (EU). In the first quarter of 2014, the share of trade with the EU reached 69.9%, hitting a new historic high in the trade. Also, an annual growth in total trade is also registered with the Western Balkans, a group of countries which is the second most important trading partner for the Macedonian economy, but which gradually reduces its share in the overall trade. Analyzing individual countries on the export side, the exports to Germany and Belgium made the largest positive contribution to the annual growth. The exports to Germany retained the growing trend (steady growth of the share in total exports, which reached 42.6%), which is consistent with the intensified export activity of the new industrial capacities. The annual decline in exports to Kosovo acted in the opposite direction, which is mainly due to the reduced export of oil derivatives. Thus, the Kosovo's share in total exports reduced to 4.4% in the first quarter of 2014, which is the lowest share of the trade with this country (this share equaled 9.8% and 6.5% in 2012 and 2013, respectively). Observing individual countries on the import side, the imports from Greece, Great Britain, Germany and Serbia registered an annual growth, amid steady decline in imports of oil from Russia. Analyzing balances, domestic economy further registers the largest trade surplus with Germany, while the increased negative balance with Serbia and the reduced surplus with Kosovo constructed the first trade deficit with the Western Balkans.

[49] NBRM calculations based on linking of items from the System of National Accounts (SNA 2008) with foreign trade items.
[50] Imports of personal consumption goods consist of consumer goods, personal consumption food and passenger vehicles.

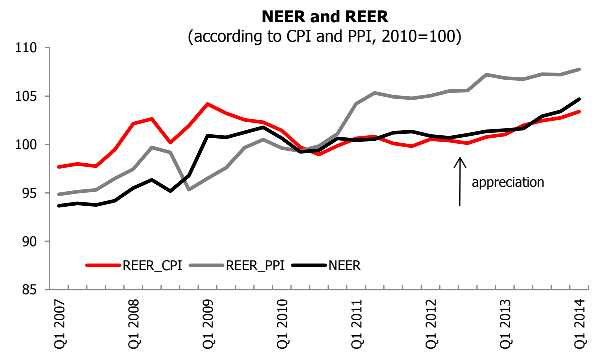


Source: NBRM.

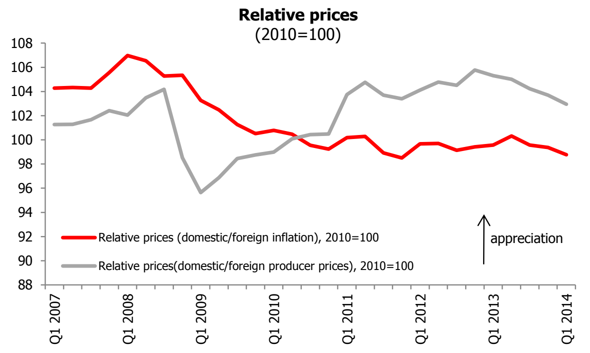


Source: NBRM.

Indicators of price competitiveness of the domestic economy in the first quarter indicate a slight deterioration of price competitiveness of the Macedonian products on foreign markets, on a quarterly basis. Compared with the previous quarter, both price indices appreciated. The REER deflated by consumer prices appreciated by 0.6%, while the REER deflated by producer prices appreciated by 0.5%[51]. Such movements are entirely due to the appreciation of the NEER by 1.2% as a result of the depreciation of the Russian ruble, Turkish lira, and to a lesser extent the Ukrainian hryvnia and Serbian dinar against the denar. Favorable shifts in the relative prices offset a part of the NEER appreciation. The quarterly decline in domestic prices versus the rise in foreign prices (consumer and producer prices) resulted in a decline in relative prices by 0.6% and 0.7%, respectively. *The latest data on price competitiveness indicators* in the period April-May, indicate depreciation of REER deflated by consumer prices (0.9%) compared to the second quarter of the year due to the decline in relative prices, whereby NEER made a neutral contribution. On the other hand, given the small increase of domestic prices relative to foreign prices, REER deflated by producer prices recorded a minor appreciation of 0.1% compared to the second quarter.



Source: NBRM.



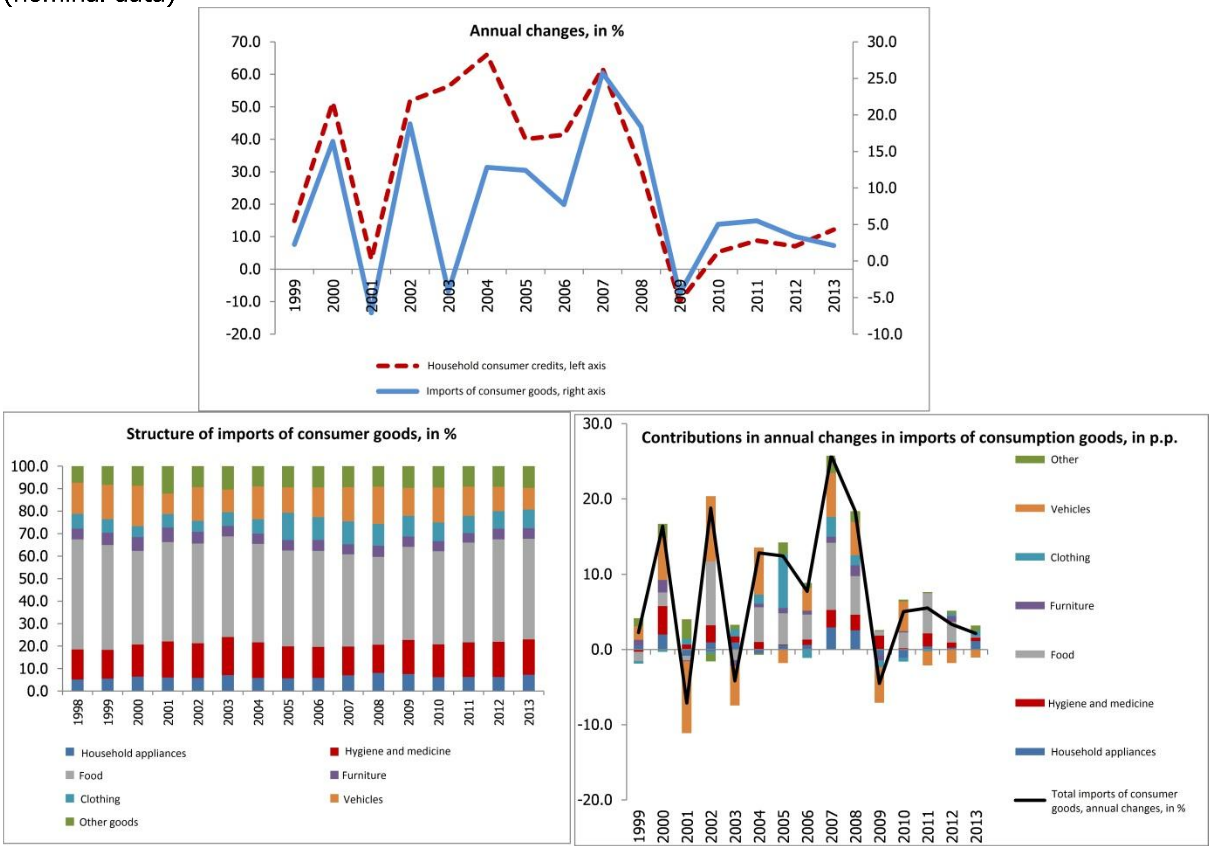
Source: NBRM.

51 The data on REER index deflated by the two indices (consumer price index and producer price index) are calculated under the new methodology for calculating the REER. For more detailed information about the changes in the current methodology for calculating the REER, visit: http://www.nbrm.mk/WBStorage/Files/Statistika_REDK_Informacija_za_promenite_na_metodologijata_za_presmetuvanje_na_realniot_efek tiven_devizen_kurs_na_denarot_mak.pdf

Box 5: Analysis of the Sensitivity of Imports of Consumer Goods to Changes in Consumer Loans to Households

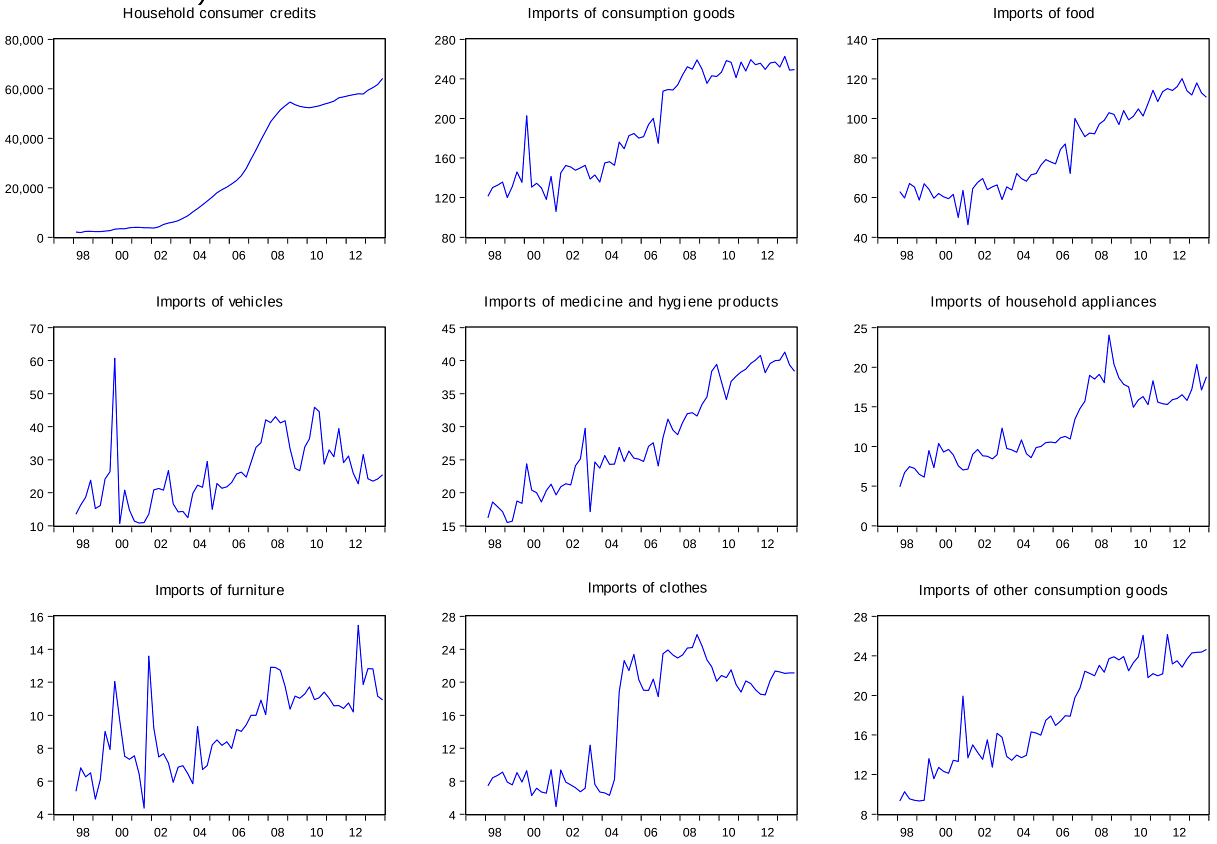
This brief analysis examines the relationship between changes in imports of consumer goods and changes in household consumer loans. Namely, given the limited domestic supply of consumer goods in the Macedonian economy, it is expected that an increase in the consumption of households will result in increased imports of consumer goods (primarily in durable goods). At the same time, the capacity for household consumption, despite by the current income, is also determined by the extent of credit support from the banking sector, suggesting potential impact of household loans to the dynamics of imports of consumer goods. Hence, the purpose of this analysis is to investigate how changes in the credit support of banks to the household sector are reflected in the imports of consumer goods, which would provide indications of the effects of changes in credit activity on the external position of the economy.

Chart 1
Imports of consumer goods and consumer loans to households
(nominal data)



A descriptive historical analysis of the data suggests that there is a relationship between changes in bank lending to the household sector and imports of consumer goods. Periods of growth of imports are accompanied by growth of loans to households. The most intensive growth in imports of consumer goods was noticed in the period before the global crisis (2006-2008), when consumer spending of households also experienced high growth. The same period was marked by an active credit support from the banking sector, with growth rates of loans to households of over 50% annually. Food, as the dominant component of the import of consumer goods (with an average share in total imports of 43.6% for the period 1998-2013) stands out as the category with the highest contribution to the growth of import of consumer goods in the pre-crisis period, followed by import of vehicles and household appliances, as categories with the highest nominal growth during this period. In addition to these categories, the growth of import of furniture, medicine and hygiene, as well as the category "other goods" also intensified in the pre-crisis period. With the emergence of the global economic crisis and the subsequent adjustment of consumer spending, the import of consumer goods also slowed down, with the categories with the highest growth before the crisis registering the largest correction in the period after 2008. This period was also marked by a significant adjustment in the annual growth rates of loans to households, which reduced to a single-digit level. Therefore, this descriptive analysis suggests a potential link between consumer loans to households and imports of consumer goods, and the next step in the analysis is to formally investigate this relationship.

Chart 2
Imports of consumer goods and consumer loans to households
(Seasonally adjusted data, in real terms (2012 prices). Credits are in millions of denars, imports are in millions of euros).



The analysis is made using simple equations, estimated by ordinary least squares, such as:[52]

Imports = f (income, loans)

Two specifications are used. The first uses one variable for the disposable income of households represented as the sum of the wage bill, pensions and remittances from abroad[53]. In the second, the three components of disposable income are included separately.

The results presented include only current values of the variables. Specifications with lagged values provide similar results as the presented, with the current value of variables being more significant than the lagged values, almost always. For clarity, these specifications are not displayed.

The analysis covered the period 1998-2013 and used quarterly data. All data are seasonally

[52] The results of the Johansen technique provide less stable results, probably because of the short period of analysis and the large variability of the data.
[53] Private transfers include remittances and net inflows of currency exchange operations, in a total amount.

adjusted and presented in real amounts, deflated by consumer price index. The series for consumer loans refers to total loans to households[54] decreased for housing loans and doubtful and contested claims[55]. Import of consumer goods[56] is disaggregated on the following components: 1) food; 2) vehicles; 3) medicine and hygiene (excluding cosmetics); 4) household appliances; 5) furniture; 6) clothing and 7) other goods. Variables included in the equation are in logarithms, which means that the resulting coefficients show the elasticities.

Elasticities of import of consumer goods, at the aggregate level and at the level of individual categories, to consumer loans, are shown in Table 1. The results of both equations are shown. The interpretation of coefficients is, for example: *"increase in consumer loans by 1%, is associated with an increase n import of clothing by 0.4 to 0.5%, on average, ceteris paribus".*

Table 1 - Elasticities of individual consumer goods

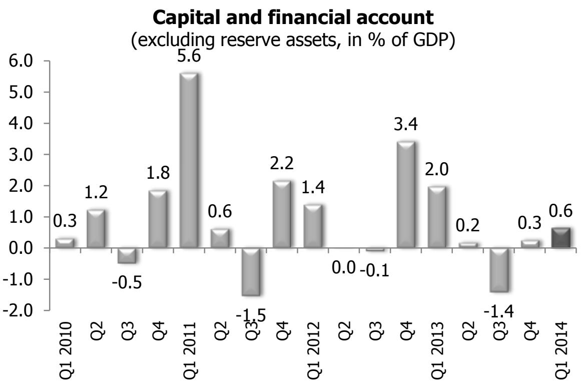
Import of consumer goods, total	food	vehicles	medicine and hygiene	household appliances	furniture	clothing	other
0.09-0.11	0	0.20-0.21	0.07-0.10	0.16-0.18	0	0.40-0.51*	0.18-0.19

**due to the sharp jump in import of clothing in 2004 Q4, as a robustness check, these equations are also estimated just for the period after the jump. The elasticity in this case equaled about 0.3, according to the both specifications, indicating the stability of the results for import of clothing.*

Import of food, as expected, appears to be insensitive to credits. Clothes prove to be the most sensitive, followed by vehicles, other products and household appliances. Perhaps unexpectedly, the import of medicines and hygiene proves to be sensitive to credit, while furniture proves to be insensitive.

In summary, the analysis suggests the existence of a relationship between changes in consumer loans to households and import of consumer goods. The estimated elasticities are relatively small, though. Still, obtaining values different from zero for most of the categories indicates that changes in the volume of consumer loans granted by banks affect the capacity for household consumption, which ultimately affects the import of consumer goods. As a final remark, given the simplicity of the analysis and the techniques applied, the results should be interpreted with a degree of caution.

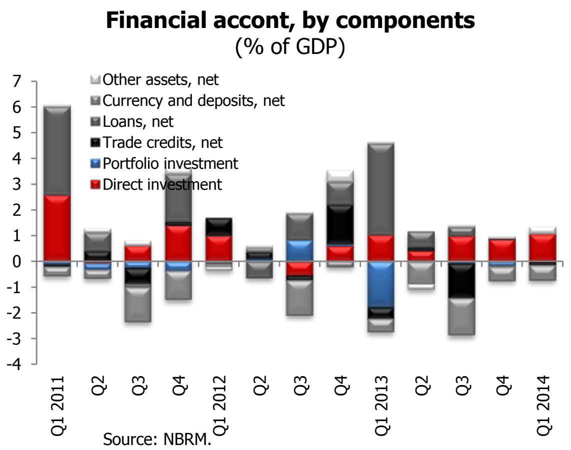
1.6.2. Capital and Financial Account

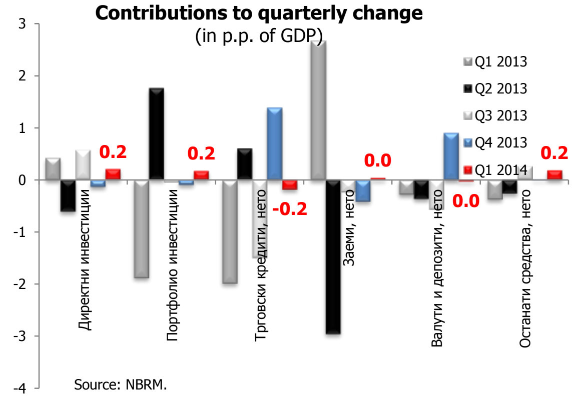


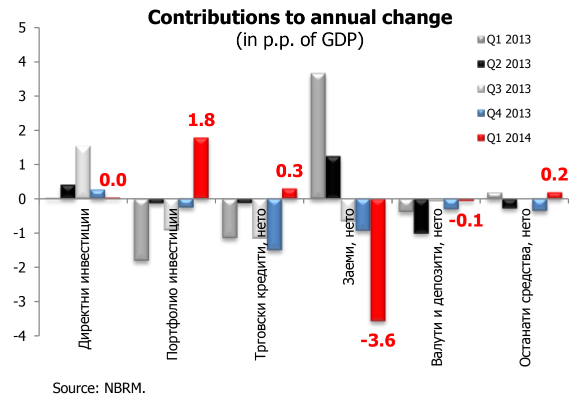
Source: NBRM.

In the first quarter of 2014, the capital and financial account of the balance of payments registered net inflows of Euro 51.2 million or 0.6% of GDP. *Foreign direct investments were the main component of the financial account, which created net inflows in the form of reinvested earnings and intercompany*

[54] For the period before 2009, data were used according to the old methodology.
[55] The results are almost identical if we include doubtful and contested claims (for the period after 2009). Since there are no data for doubtful and contested claims in loans to households before 2009, the series used excludes these components.
[56] Data on import of consumer goods are taken from the internal calculations of the Monetary Policy and Research Department, which correspond to the system of national accounts.





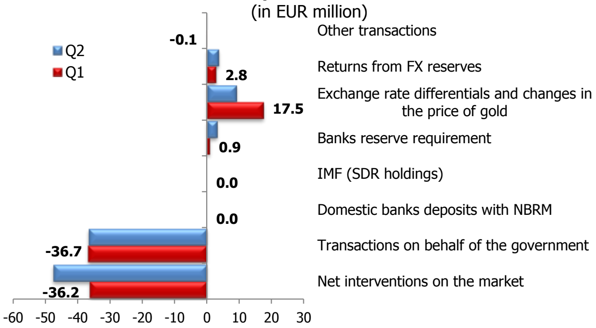


loans. A significant part of capital inflows of FDIs was offset by net outflows in the category of currency and deposits, mainly due to net outflows in other sectors and net repayments of trade credits. *The quarterly analysis indicates higher net capital inflows (by 0.4 percentage points of GDP).* The positive quarterly change is mostly due to the increased inflows of direct investments, higher short-term inflows of other investments in other sectors of the economy, and reduced net outflows in the portfolio investments. Rising inflows based on direct investments mainly reflect the financing of already existing foreign companies by borrowing from their parent entities. Despite the positive contribution of these two categories, higher negative quarterly change was registered in the trade loans that in the first three months registered net outflows, compared with the small net inflows the previous quarter. The remaining components of the capital and financial account show no significant changes on a quarterly basis.

Annually, the capital and financial account registered significantly lower net inflows (by 1.3 percentage points of GDP). Major shifts in the annual change in the capital flows result from the one-off effects in net loans and portfolio investments in the first quarter of 2013. Hence, the dominant generator of the annual decline is the change in net external borrowing, or the registered small net repayments versus the high net disbursements in the same period last year, mainly from the government sector[57]. A small negative contribution to the annual change was also made by the higher net outflows in currency and deposits, i.e. in other sectors of the economy. On the other hand, portfolio investments registered exceptionally lower net outflows, which is due to the high base effect[58]. They made the largest positive contribution to the annual change and partly offset the changes in net loans. More favorable movements compared to the same period last year were also registered by trade credits, larger inflows of other investments and increased direct investments. **According to the latest balance of payments data in April 2014, in the capital and financial account registered** net inflows of Euro 83.1 million. For the most part, capital inflows were registered in

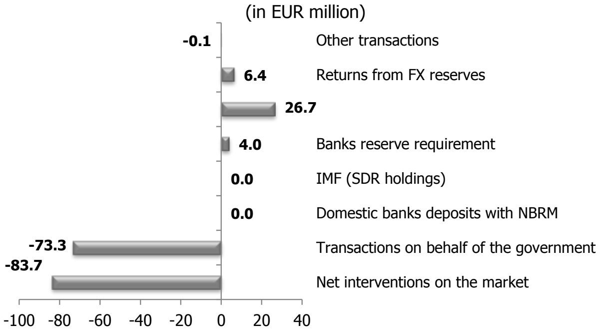
[57] In January 2013, the government borrowed from foreign lenders, mostly by withdrawing funds from the Deutsche Bank loan, using a guarantee from the World Bank, and from the World Bank's Competitiveness Development Policy Loan.
[58] The second Eurobond issued in 2009 by the government was repaid in January 2013.

Factors of change of the foreign reserves in the first two quarters of 2014
(in EUR million)



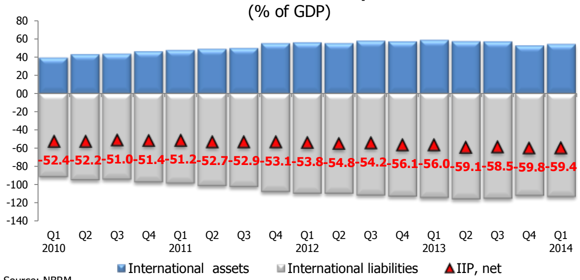
Source: NBRM.

Factors of change of the foreign reserves in the first half of 2014
(in EUR million)



Source: NBRM.

International investment position
(% of GDP)



Source: NBRM.

the net external borrowing[59], followed by trade credits. On the other hand, the category of currency and deposits registered higher capital outflows.

As of 31 March 2014, the gross foreign reserves amounted Euro 1941.2 million, which is a quarterly decrease of Euro 51.8 million. The net outflows of transactions on behalf of the government and the NBRM net sale of foreign currency on the foreign exchange market are main factors for the change. On the other hand, the exchange rate differentials and changes in the price of gold, as well as returns from foreign reserves had a positive impact on the foreign reserves. *According to the latest available data, at the end of June, the foreign reserves amounted to Euro 1,873 million*, which is by Euro 120 million less than at the end of 2013. The decline in foreign reserves is mostly due to net sales by the NBRM in the foreign exchange market and the net outflows of transactions on behalf of the government[60]. On the other hand, the exchange rate differentials and changes in the price of gold acted towards accumulation of foreign reserves.

1.6.3. International Investment Position[61] and Gross External Debt

At the end of the first quarter of 2014, the **negative international investment position of the Republic of Macedonia amounted to Euro 4,758.9 million or 59.4% of GDP[62].** *Compared with the previous quarter, net liabilities to the rest of the world rose to Euro 164.5 million, while expressed as a share of GDP, net liabilities reduced by 0.4 percentage points.* The expansion of negative investment position[63] of the country is

[59] Significant portion of the inflows are due to borrowing from abroad to finance road infrastructure.
[60] Much is due to the repayment of liabilities based on the PCL to the IMF.
[61] The analysis in this section is entirely based on newly disseminated data compiled under a new methodology. Namely, since July 2014, the NBRM started disseminating data on the international investment position (IIP) and gross external debt of the Republic of Macedonia, according to the new international statistical standards defined by the Balance of Payments and International Investment Position Manual (BPM6) and External Debt Statistics (2013). For more detailed information on the methodological changes, visit the NBRM website (http://nbrm.mk/WBStorage/Files/Statistika_Informacija_za_promenite_vo_platniot_bilans_megunarodnata_investiciska_pozicija_i_nadvoresniot_dolg_koisto_proizleguvaat_od_primenata_na_novite_megunarodni_statisticki_standardi.pdf).
[62] The calculations use the projected amount for nominal GDP.
[63] In the second quarter of 2011, the NBRM began concluding repo and reverse repo transactions. These transactions

solely due to the **increased international liabilities** (by 7.4%), with a simultaneous **increase in the international assets** (by 5.4%), with the highest increase compared to the previous quarter being registered by net liabilities to foreign direct investors.

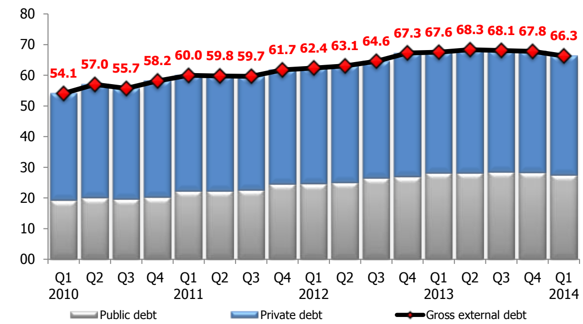
Analyzed by sector, all sectors made *contribution to the quarterly increase of net liabilities in the international investment position*, with the largest contribution being made by other sectors as a result of the more intensive increase in liabilities based on foreign direct investments. Additionally, the central bank also made significant contribution to the quarterly increase of the negative international investment position, which reported moderate growth of assets relative to the growth of international liabilities. The change in deposit institutions compared to the previous quarter is due to the reduction of international assets in the form of currency and deposits.

	Q1 2013	Q4 2013	Q1 2014	*quarterly change*			*annual change*		
		in EUR million		*difference*	*contribution*	*in %*	*difference*	*contribution*	*in %*
IIP, net	**-4,305.1**	**-4,594.3**	**-4,758.9**	**-164.5**	**3.6**	**3.6**	**-453.8**	**10.5**	**10.5**
Government, net	-1,645.2	-1,565.0	-1,581.9	-16.9	0.4	1.1	63.3	-1.5	-3.8
Monetary authorities, net	2,154.4	1,920.4	1,868.1	-52.3	1.1	-2.7	-286.3	6.7	-13.3
Banks, net	-559.7	-541.7	-557.5	-15.9	0.3	2.9	2.1	0.0	-0.4
Other sectors, net	-4,254.6	-4,408.1	-4,487.5	-79.4	1.7	1.8	-232.9	5.4	5.5

The annual increase of net debt position of the economy continued in the first quarter of 2014, driven by the simultaneous reduction of international assets (of 3.7%) and the growth of international liabilities (of 3.2%). Compared to the same period last year, **the negative IIP increased by Euro 453.8 million, or by 3.3 percentage points of GDP.** *The sector-by-sector analysis on an annual basis shows that the expansion of the negative IIP gap of the Republic of Macedonia is due to the higher net liabilities of the central bank and other sectors, caused by the reduction of international assets in the form of foreign reserves and the increase of foreign liabilities to direct investors compared to the first quarter of the previous year. On the other hand,*

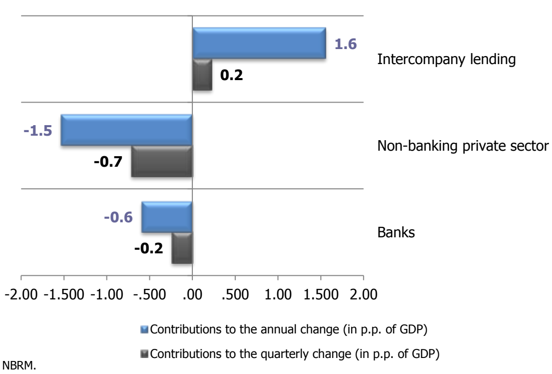
represent an investment opportunity to use portfolio securities to provide additional income. Conclusion of repo transactions creates liabilities. At the same time, when concluding reverse repo agreements, the created receivables increase the gross receivables. The NBRM simultaneously carries out matched conclusion of repo and reverse repo agreements, in almost identical amounts. In general, as they are concluded concurrently, these transactions have a neutral net effect, i.e. they appear in almost identical amount on both liabilities and assets side, thus having no effect on the side of liabilities and on the side of receivables, and therefore, do not affect the total net IIP and the total net external debt.

Gross external debt, by debtors (% of GDP)



* Without repo-transactions.
Source: NBRM.

Changes in private sector debt



Source: NBRM.

the government sector's net liabilities to the rest of the world decreased as a result of the lower long-term loan liabilities.

At the end of the first quarter of 2014, gross external debt totaled Euro 5,616.7 million[64]. Excluding repo transactions of the central bank, the gross external debt totals Euro 5,312.4 million, or 66.3% of GDP[65].

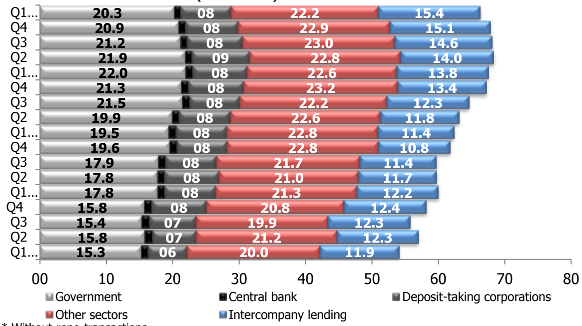
The quarterly analysis indicates an increase in the gross external debt of the country by Euro 102.3 million, while the analysis of the share of gross external debt to GDP indicates a quarterly decline of 1.5 percentage points of GDP, as a result of the lower external debt, both public and private. The quarterly reduction of public external debt is solely due to the lower long-term loan liabilities of the government. On the other hand, the decline of private debt compared to the previous quarter is due to the reduction in liabilities based on currency and deposits of the banking sector and liabilities in the form trade credits and financial loans in other sectors, with further increase in liabilities to direct investors.

The gross external debt increased on an annual basis, but at a significantly reduced pace. Compared with the first quarter of 2013, the debt rose by Euro 123.6 million. The annual increase in gross external debt is mostly driven by the growth of private debt, as a result of the further increase in liabilities to direct investors and the growth of long-term liabilities based on currency and deposits of the banking sector, amid simultaneous reduction of short-term liabilities in this category. Slight increase in public debt is due to the higher external borrowing of public companies in the form of long-term financial loans. ***Analyzing the share in GDP, gross external debt decreased by 1.2 percentage points of GDP.*** The gross debt to GDP ratio decreased due to the reduction of public debt (by 0.7 percentage points of GDP) amid simultaneous reduction of the private debt (by 0.6 percentage points of GDP) annually.

The analysis of the dynamics of external debt[66] indicates deterioration in most solvency

[64] Or 70.1% of GDP.
[65] The overall analysis below relates to gross external debt without the central bank liabilities based on repo transactions.
[66] The analysis of the external indebtedness indicators is prepared on the basis of balance of payments data in accordance with Balance of Payments and International Investment Position Manual (BPM6) and data on gross external

Gross external debt, by institutional sectors
(% of GDP)



* Without repo-transactions.
Source: NBRM.

indicators on an annual basis, with the exception of the export and other inflows to gross external debt ratio. Despite the deterioration in some indicators, external debt indicators for the domestic economy generally show that gross external debt is in the safe zone and confirm that Macedonia remains in the group of low indebted countries according to the World Bank's indebtedness criteria. Only the external debt to GDP ratio still classifies the economy in the group of highly indebted countries. Liquidity ratios indicate a favorable external position, with virtually full coverage of short-term debt liabilities with residual maturity with foreign reserves, despite the slight deterioration in this indicator on an annual basis.

Indicators for external indebtness	***Solvency***				***Liquidity***		
	Interest payments/ Export of goods and services and other inflows	Gross debt/ Export of goods and services and other inflows	Gross debt/ GDP	Debt servicing/ Export of goods and services and other inflows	Foreign reserves/ Short-term debt	Foreign reserves/ Short-term debt, with residual maturity	Short-term debt/ Overall debt
	in %				ratio	ratio	in %
31.12.2004	2.41	129.3	49.3	12.4	1.14	0.89	30.3
31.12.2005	2.66	147.0	56.3	11.06	1.67	1.04	26.7
31.12.2006	3.44	131.3	51.8	21.7	1.95	1.34	29.0
31.12.2007	2.78	119.3	53.2	19.4	1.35	1.08	39.8
31.12.2008	2.66	116.9	55.3	10.2	1.29	0.95	35.2
31.12.2009	2.43	131.0	58.5	11.8	1.29	0.94	32.9
31.12.2010	3.22	140.4	60.1	13.9	1.49	0.99	27.9
31.03.2011	3.12	144.2	63.3	16.8	1.64	1.14	25.9
30.06.2011	3.12	143.6	63.1	16.8	1.59	1.09	25.8
30.09.2011	3.12	143.4	63.0	16.8	1.64	1.09	25.3
31.12.2011	3.12	148.4	65.2	16.8	1.78	1.18	25.2
31.03.2012	2.92	131.6	63.4	13.1	1.70	1.02	26.1
30.06.2012	2.92	133.1	64.2	13.1	1.63	1.01	26.4
30.09.2012	2.92	136.3	65.7	13.1	1.72	1.06	25.3
31.12.2012	2.92	141.9	68.4	13.1	1.64	1.03	26.7
31.03.2013	2.41	136.6	68.9	15.7	1.68	1.19	25.6
30.06.2013	2.41	138.2	69.7	15.7	1.48	1.04	26.3
30.09.2013	2.41	137.7	69.4	15.7	1.65	1.12	23.9
31.12.2013	2.41	137.2	69.1	15.7	1.64	1.08	23.3
31.03.2014	3.21	134.3	68.9	18.7	1.42	0.96	25.8
Moderate indebtedness criterion	*12 - 20%*	*165 - 275%*	*30 - 50%*	*18 - 30%*		*1.00*	

*The moderate indebtness criterion is accordng to the World bank's methodology of calculationg indebtness indicators, which implies 3-year moving averages of GDP and exports of goods and services in the calculation of the indicators.
In compliance with "External debt statistics: Guide for compilers and users," published by the IMF.
*According to the "Greenspan-Guidotti rule", a country should maintain full coverage of short-term debt at remaining maturity with gross foreign reserves.
*According to the "Greenspan-Guidotti rule", a country should maintain full coverage of short-term debt at remaining maturity with gross foreign reserves.
Source: NBRM.

debt according to the External Debt Statistics (2013). The methodological changes caused no changes in the overall level of external debt, but only affected the maturity and sector structure of the debt. Accordingly, under the new methodology, the level of short-term debt is lower on account of the increase in long-term debt component, which caused changes in the liquidity indicators, i.e. their improvement relative to the analyses based on data from the previous methodological framework. On the other hand, the methodological changes in the scope of export of goods and services and other inflows caused reductions in this category that caused deterioration of the indicators - share of export of goods and services and other inflows in the gross external debt and debt service in relation to export of goods and services and other inflows, compared with the indicators relevant prior to the methodological changes.

Box 6: Information on Changes in External Statistics arising from the Application of New International Statistical Standards

Starting from July 2014, the National Bank of the Republic of Macedonia began disseminating data from the external sector statistics (balance of payments, international investment position and gross external debt) compiled under the **new international statistical standards of the International Monetary Fund, as defined in the Balance of Payments and International Investment Position Manual, sixth edition (BPM6)**[67]. As a standard framework, the new manual aims to provide greater consistency with other national statistics, and better international comparability of data and to reduce the mismatch in the global macroeconomic aggregates and greater transparency, thoroughness and increased data quality. Due to the methodological changes, the NBRM prepared new standard reports and reviewed data from 2003 to 2013, published on the website of the National Bank, coupled with detailed information on the methodological changes and the effects thereof[68].

The foremost presentational changes are as follows:

- **a change in the convention on the use of signs** - use of a positive sign in both the current and the capital account in *credit* and *debit* items[69]. Additionally, the financial account will no longer use negative sign to show growth of assets and a positive sign for asset reduction, i.e. in BPM6, positive sign in both assets and liabilities implies their increase, and negative sign, their decrease. In IIP, there is no change in the use of signs.
- **terminology changes** - in the financial account, *credit* and *debit* items are renamed into net acquisition of assets and net incurrence of liabilities. Other terminology changes are presented in Table 1.
- change in the *directional principle* of **foreign direct investments**, which, in BPM6 are presented on a gross basis as *assets* and *liabilities*.

[67] For more details on the sixth edition of the Balance of Payments and International Investment Position Manual, 6th Edition, IMF, 2009), visit http://www.imf.org/external/pubs/ft/bop/2007/bopman6.htm.
[68] For more detailed explanation of the methodological changes, also see Information on Changes in the Balance of Payments, International Investment Position and External Debt Arising from the Application of New International Statistical Standards, available on the NBRM website (http://nbrm.mk/WBStorage/Files/Statistika_Informacija_BPM6_30_06_mak.pdf).
[69] Credit refers to the inflow/exports, while debit refers to outflow/imports.

Table 1 The Sign Convention and Changes in Terminology

	BPM6	BPM5
Current and Capital Account		
credit	+	+
debit	+	-
net	**credit - debit**	credit + debit
Financial Account		
Assets		
increase	+	-
decrease	-	+
net	increase + decrease	increase + decrease
Liabilities		
increase	+	+
decrease	-	-
net	increase + decrease	increase + decrease

BPM5	BPM6
Current and Capital Account	
Services, Royalties and license fees	Services, Charges for the use of intellectual property n.i.e.
Income	**Primary income**
Current transfers	**Secondary income**
Worker's remittances	Personal transfers
Financial Account	
Bonds and notes	Long-term debt securities
Money-market instruments	Short-term debt securities
Financial derivatives	Financial derivatives (other than reserves) and employee stock options
Trade credits	Trade credit and advances
Reinvested earning	Reinvestment of earning

The new Manual, besides the presentational changes, also introduced some **methodological changes**, which include introduction of the principle of *economic ownership*, new types of financial assets and liabilities and distinguishing of financial flows of transactions and other changes.

These presentational and methodological changes triggered appropriate adjustments to the individual categories of the balance of payments. The most important methodological changes in the **current, capital and financial account** are:

- **reclassification of goods for processing** from the goods component (recording on a gross basis) to the services category - manufacturing services on physical inputs owned by others (recording of the service value). This change reduced the import and export of goods on a gross basis, with a simultaneous increase in export and import of services, with negligible net effect on the current account.
- **reclassification of merchanting and other trade-related services** from the services component as a net inflow, to the goods category in the form of net export of goods.
- application of more sophisticated methodology for collecting, calculating and presenting **insurance and pension services**, which causes changes in several current account items.
- renaming of the income component into **primary income**, as well as introducing the concept of *superdividends*, recording of the dividend at the time of acquisition of the right to a dividend (*ex-dividend date*) and presenting the income from investments in investment fund shares as the sum of dividends and reinvested earnings. These changes have not caused significant changes in the amount of the overall category.
- renaming of the current transfer component into **secondary income**, as well as introducing the term *personal transfers*, which besides the previous *workers' remittances,* also includes all other transfers in cash or in kind between resident and non-resident households, regardless of the source of income or relationship between households.
- exclusion of *migrants' transfers* from the **capital account**.
- presentation of gross **FDIs** in the **financial account**, thus changing the amounts of assets and liabilities, but without any effect on the net FDI. Furthermore, intercompany debt between related **financial companies**[70] is excluded from FDIs, with this intercompany debt

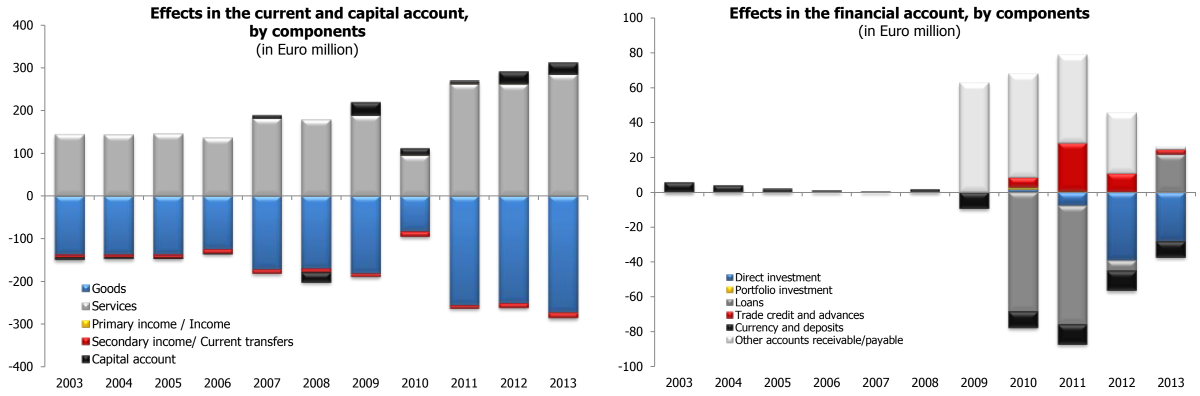
[70] In BM5, this classification applied only to banks, while BPM6 expands the scope to other financial institutions (excluding pension funds and insurance companies).

being shown in the relevant financial instrument (typically in the category of loans). BPM6 separately presents capital transactions between fellow enterprises[71], and transactions of reverse investment[72].

- change in **arrears**, which in the BPM6 are presented within the original instrument, vis-à-vis the previous presentation as short-term liabilities under the category of *other liabilities*.

The effects of methodological changes on individual categories of the balance of payments for the entire series available from 2003 to 2013 are shown in **Chart 1**.

Chart 1 Differences in the Components of BPM6 versus BPM5, in millions of euros



The introduction of new standards also caused methodological changes in the statistics on international investment position (IIP). Although the net IIP registers no significant changes, certain amounts have been reallocated between aggregates *assets* and *liabilities*. More precisely, the changes are due to:

• change in **claims on direct investors**, which are included in the *debt instruments* item within the direct investment assets. In BPM5, this category was part of *other capital* in direct investments in the country. Accordingly, **liabilities to companies owned by domestic investors abroad** are recorded as liabilities based on debt instruments within the direct investments.

• redistribution of intercompany debt and claims on other financial institutions (OFI)[73] within *loans* (respectively on the assets or liabilities side) from the *other capital* item within *direct investments*.

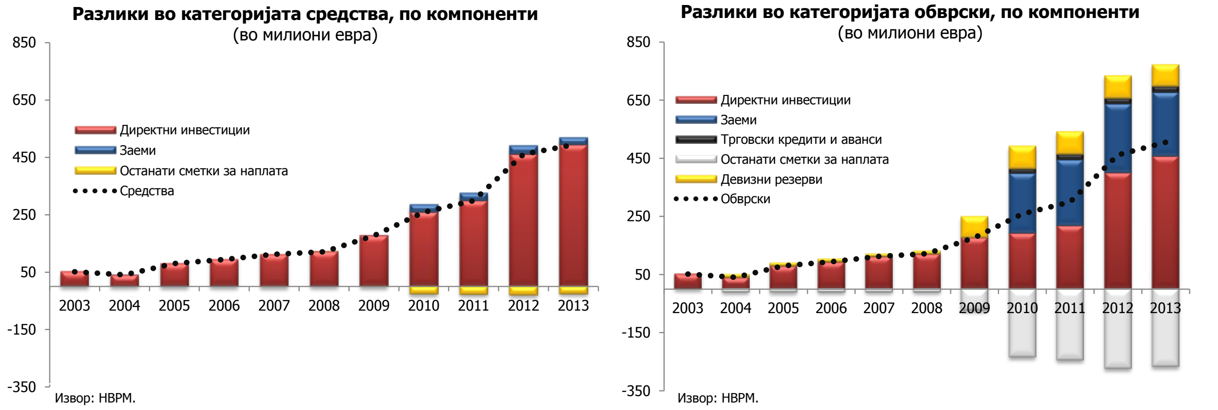
• redistribution of **arrears** based on loans and long-term trade credits within the appropriate instrument, i.e. within the instruments of loans and trade credits, on the side of both assets and liabilities.

• disclosure of **liabilities based on SDR allocation** as a new instrument on the liabilities side and their proper exclusion from the *other liabilities* item.

The effects of methodological changes on the balance of payments categories for a complete series available from 2003 to 2013 are shown in **chart 2.**

[71] Fellow enterprises are non-residents controlled or established by the same direct or indirect investor in the chain of links, but with whom there is no capital relationship of above 10%.
[72] Investing in direct investor's capital with a share of below 10%.
[73] Excluding pension funds and insurance companies.

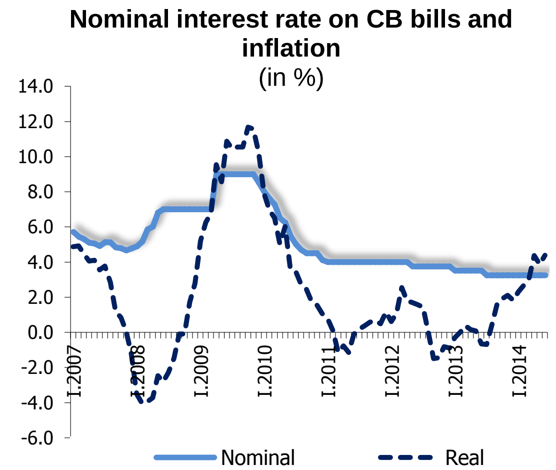
Figure 2 Differences in the IIP components according to BPM6 versus BPM5, in millions of euros



The introduction of new statistical standards caused no changes in the gross external debt, but redistributions between financial instruments and institutional sectors, appropriately to the changes in the IIP.

II. Monetary Policy

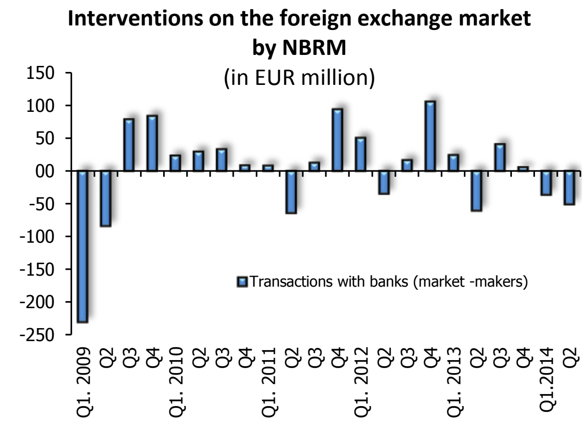
During the second quarter of 2014, the NBRM preserved the policy rate at 3.25%. This decision was based on the latest macroeconomic projections of April and the recent performances of key macroeconomic and financial indicators. The analyses showed that amid movement of foreign reserves in line with expectations and their further retention at adequate levels, denarization of economy, reduced inflationary pressures and enhanced credit support of the banking sector, there are already preconditions for a sustained recovery of the private sector without additional monetary stimulus. In the period ahead, the NBRM will continue to monitor closely the situation for the timely and appropriate adjustment of monetary policy.



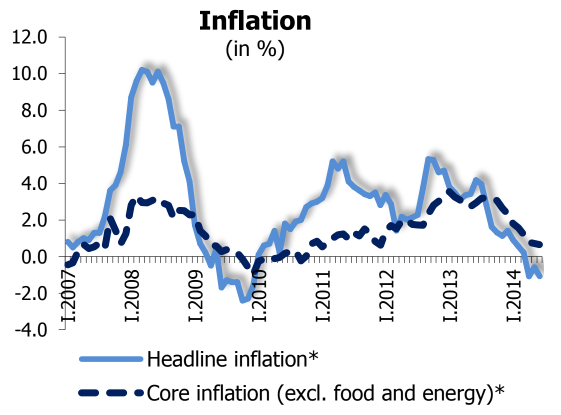
Source: NBRM.

Based on the regular assessment of recent macroeconomic and financial developments, at the meetings held during the second quarter[74] of 2014, the NBRM's Committee on Operational Monetary Policy decided to preserve the CB bill interest rate at the level of 3.25%. The latest reassessment of the NBRM's macroeconomic projections in April indicated no significant changes in the environment for conducting monetary policy compared to the previous estimates. As for the performance, during the second quarter, globally, the euro area kept on recovering at a moderate pace, although the risks around the sustainability of the recovery are still present. In the domestic economy, movements in key macroeconomic indicators do not deviate much from the expected dynamics. Thus, in the second quarter, the NBRM

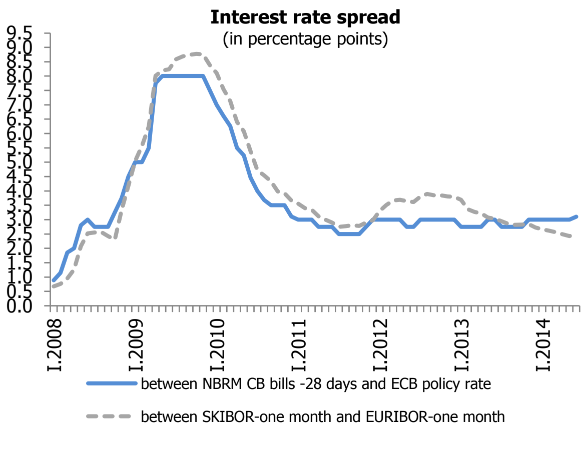
[74] During the quarter, the NBRM's Committee on Operational Monetary Policy held three sessions devoted to the monetary policy setup, on 8 April 2014, 13 May 2014, and 10 June 2014.



Source:NBRM



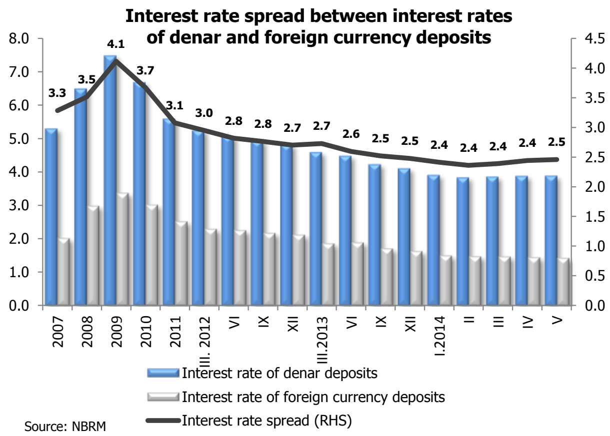
*Current month/same month of the previous year.
Source: SSO

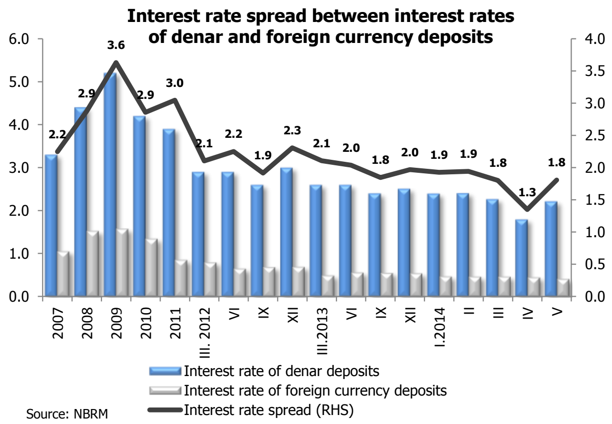


Source: NBRM, ECB (www.ecb.int) and De Nederlandsche Bank (www.statistics.dnb.nl).

sold net amount of foreign currency in the foreign exchange market (of Euro 50.7 million). The decline in foreign reserves was in line with expectations for this period that portion of the current account deficit will be financed through foreign reserves. However, despite the decline, foreign reserves are maintained at an appropriate level sufficient to deal with any unforeseen shocks. The rise of domestic prices slowed down in the second quarter, as well, when inflation registered an annual decrease of 0.9% on average. The alleviation of inflationary pressures was also apparent through the dynamics of core inflation, whose annual growth continued to slow down, and in the period from April to June averaged 0.7%. Amid such movements and downward adjustments of some import prices, the risks around the inflation projection to the end of the year were assessed to be predominantly downward. On the other hand, upward risks were identified, associated with food and energy prices, as a result of the conflicts in Ukraine and floods in the region. Growth in economic activity continued in the first quarter, amid growth diversification in several sectors. Banks continued supporting the private sector through further growth in lending. Thus, the dynamics of banks' lending activity as of June is above the April projection for the second quarter. The new lending in this period was largely directed to households, with further credit support to the corporate sector. Since the end of the last year, the lending continued registering solid annual growth rates, which may indicate gradual materialization of the effects of the monetary easing and the reduced risk aversion of the domestic banks on the credit growth. In such conditions, **it was assessed that in the economy, conditions have been created for a sustained recovery of the private sector, i.e. there is no need of additional monetary stimulus. In other words, it was assessed that the support of the monetary policy measures for the domestic economy is sufficient. Leaving the zone of accommodative monetary policy in the next period will depend on changes in the external position of the economy and the effects on foreign reserves.**

In June, the ECB adopted a set of measures aimed at easing of monetary policy to revive lending and further support for the real sector, as well as return of the inflation rate at a level close to 2%. The set



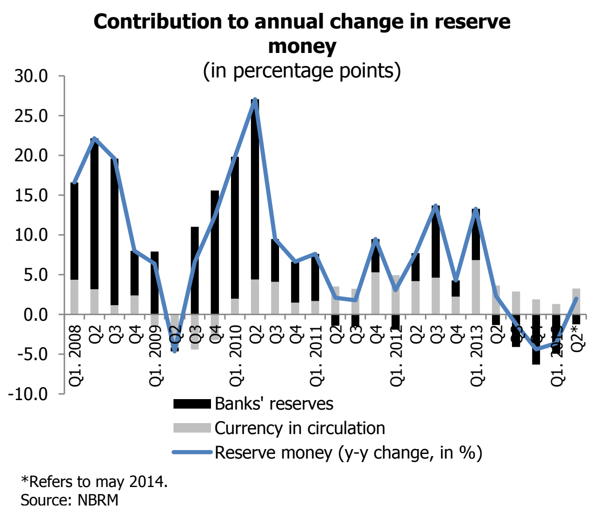


of measures[75] include further reduction in the ECB's interest rates and introduction of targeted long-term refinancing operations to support lending. In addition, a possibility was announced to activate the measure of outright purchase of asset-backed securities. **The policy rate was cut to 0.15%, and a negative interest rate on deposit facility was introduced for the first time.** The ECB's decision to cut the interest rate mitigates some of the potential risks to the external position of the domestic economy. Changes in the interest rate of the anchor central bank increase the spread between the interest rate of the domestic currency and the euro, thus increasing the attractiveness and credibility of the domestic currency.

The interest rate spread between the interest rate on CB bills and the ECB's policy rate expanded in June and equaled 3.1 percentage points (versus the previous 3 percentage points). The movements of short-term interest rates in the domestic and European financial markets were relatively stable, and in this period, the interest rate difference between the one-month SKIBOR[76] and one-month EURIBOR moderately narrowed to 2.5 percentage points in June (versus 2.6 percentage points in March).

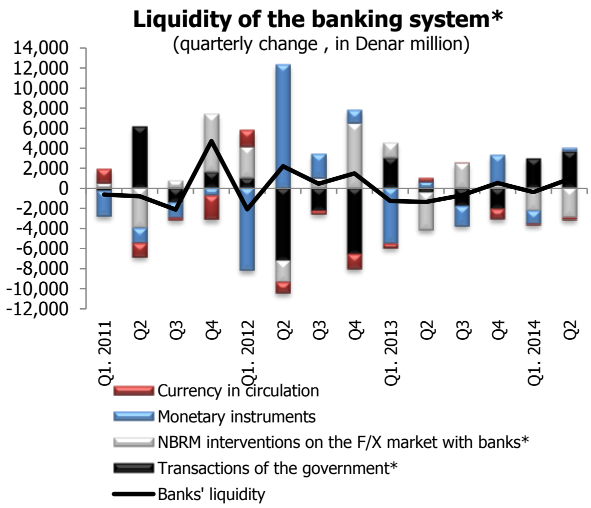
2.1 Banks' Liquidity[77] and Interbank Money Market Developments

During the second quarter of 2014, bank liquidity increased by Denar 926 million, compared to the end of March 2014. Thus, in June, the balances of banks' accounts with the NBRM stood at Denar 16,374 million. In May, reserve money[78] increased by 2% annually, compared to March 2014, when they registered an annual fall of 3.6%.

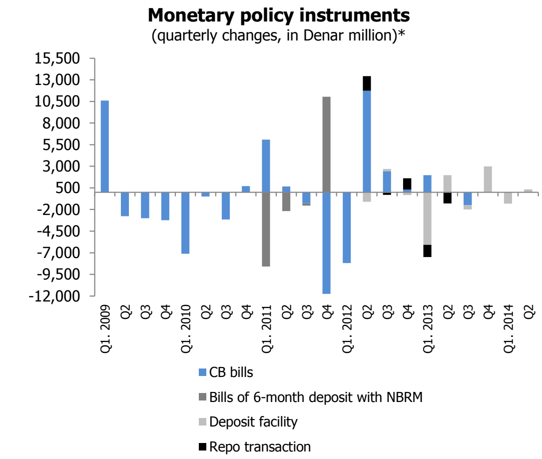


During the second quarter of 2014, the autonomous factors contributed to creation of net liquidity of Denar 588 million. Among them, government transactions made the largest contribution to the increase in liquidity (in a total amount of Denar 3,670 million), which is entirely due to the withdrawal of funds from the government denar account with the NBRM to

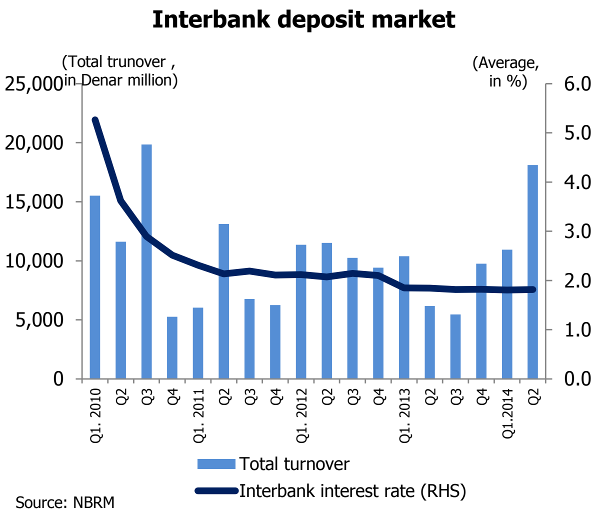
[75]For more details on the new set of measures the ECB also see Box 1.
[76] Interbank interest rate on denar deposits, calculated using the quotations of reference banks.
[77]Liquidity refers to the banks' denar accounts with the NBRM.
[78] Includes reserve requirement in foreign currency.



*Positive change- liquidity creation, negative change- liquidity withdrawal .
Source: NBRM



*Positive change - liquidity creation, negative change-liquidity withdrawal.
Source: NBRM



Source: NBRM

finance budgetary needs. With the NBRM's net sale of foreign currency in the foreign currency market with the market makers, the NBRM's foreign exchange transactions in the second quarter contributed to withdrawal of liquid assets (in the total amount of Denar 2.933 million). Liquidity was withdrawn through currency in circulation in the amount of Denar 215 million.

In the second quarter, the NBRM's monetary instruments contributed to creation of net liquidity of Denar 338 million. Given the further stable level of CB bills, the change in the total monetary instruments in this period arises solely from changes in the NBRM's deposit facility. Namely, in the second quarter, three auctions of CB bills with amounts and fixed interest rate of 3.25% were held, where the NBRM determined the supply of CB bills at the due amount. Thus, CB bills had a neutral effect on the level of liquidity in the banking system. At the auctions held in the second quarter, the demand was higher than the bid amount of CB bills and remained relatively stable relative to the auctions held at the beginning of the application of the Methodology for calculating the potential demand. The demand was moderately higher than the potential. Consequently, in the second quarter, some banks were required to allocate funds in seven-day deposits with the NBRM. Under these conditions and active use of this instrument by banks, for short-term liquidity management, the seven-day deposit facility created liquidity of Denar 683 million on a quarterly basis. On the other hand, liquidity of Denar 345 million was withdrawn from the system through overnight deposit facility, on a quarterly basis. Consequently, in second quarter, the total deposits facilities created net liquidity in the banking sector in the amount of Denar 338 million. During the second quarter of 2014, banks allocated excess liquid assets over the reserve requirement of 0.7% on average. In the first quarter, the banks allocated a relatively higher excess liquidity (4.7% on average), which is due to temporary factors related to liquidity management by certain banks.

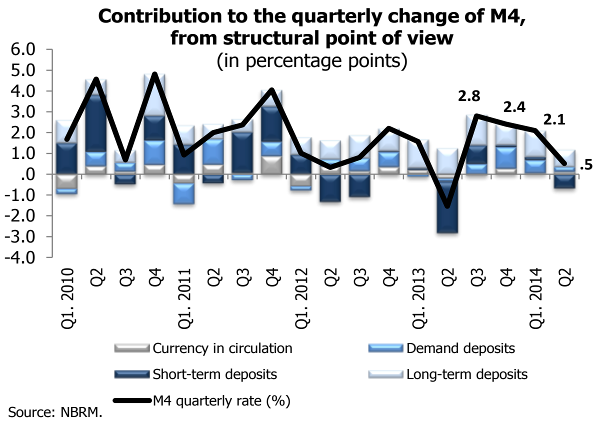
In the second quarter of 2014, the interbank deposit market reported a total turnover of Denar 18,102 million, which compared to the first quarter of 2014, increased by 65.6%. Compared to the same period last year, in the second quarter of 2014, the activity at the interbank money market rose by 2.9 times. Analyzed by maturity segments, intraday transactions had the highest share in the total turnover in the interbank money market in the second quarter, making up 74.1% of the total transactions, followed by transactions of up to seven days, with share of 22.4%. The interbank interest rate on overnight transactions (MKDONIA) equaled 1.82% on average in the second quarter (1.81% on average in the first quarter). The interbank interest rate (MBKS) equaled 1.9% on average, in the second quarter (2% on average, in the previous quarter). In the second quarter of 2014, two repo transactions and one outright transaction totaling Denar 1228.1 million were executed on the **secondary money market**.

2.2. Monetary and Credit Aggregates

Broad money M4 continued to grow during the second quarter of 2014, but at a slower pace compared to the previous quarter. Analysis of the structure of money supply shows further growth of long-term deposits and deposits in domestic currency. The total corporate deposits decreased on a quarterly basis, while the growth of household savings continued, although at a slower pace compared to the previous quarter. Analyzing balance sheets, the largest contribution to the growth of money supply in the second quarter was made by loans to the private sector. Namely, given the further solid performances of economic activity and improved risk perceptions of domestic banks, the credit market witnessed significant acceleration of lending activity. Credit flows in the second quarter suggest further support for the domestic economy by lending to corporations and households, with May and June experiencing significant growth of corporate loans. Annually, the growth rate of total loans accelerated to 8.5% at the end of June.

2.2.1. Monetary Aggregates

In the second quarter of 2014, the growth of broad money M4 slowed down to 0.5% on a quarterly basis, compared to 2.1% in the previous quarter. The slowdown in the monetary growth in the second quarter can partly be explained by the payment of a dividend by a larger company to the government and the foreign investors, resulting in larger outflows from the bank accounts of the companies in April. The reduced budget spending probably had certain influence towards this direction, which also meant less support for the deposit growth through this channel. **From the structural point of view**, long-term deposits remain the leading item of the monetary growth, given the growth in the demand for the most liquid assets (currency in circulation and demand deposits), while short-term deposits decreased on a quarterly basis. These developments were followed by the maintenance of relatively stable currency structure of the broadest monetary aggregate, by keeping the share of foreign currency deposits to around 39%.

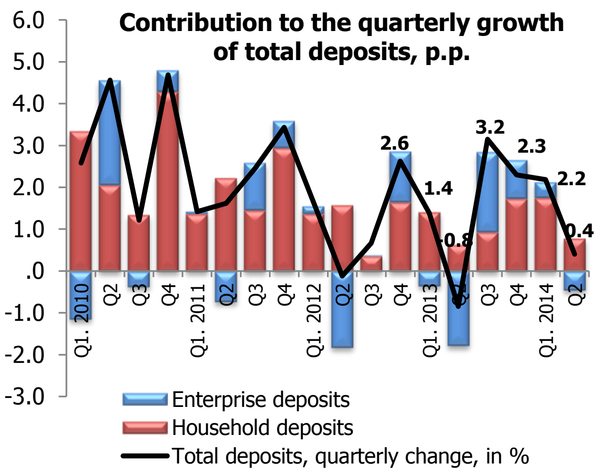


Source: NBRM.

Total deposits

	2013				2014	
	Q1	Q2	Q3	Q4	Q1	Q2
q-o-q growth, %						
Total deposits	1.4	-0.8	3.2	2.3	2.2	0.4
contributions to quarterly growth, p.p.						
Deposit money	-0.2	0.5	0.6	1.1	0.7	0.3
Denar deposits	1.1	0.5	1.2	0.9	0.9	0.1
Foreign currency deposits	0.5	-1.9	1.3	0.3	0.6	0.0
Short-term deposits	-0.1	-2.6	1.0	0.1	0.3	-0.7
Long-term deposits	1.7	1.3	1.5	1.1	1.3	0.9

Source: NBRM

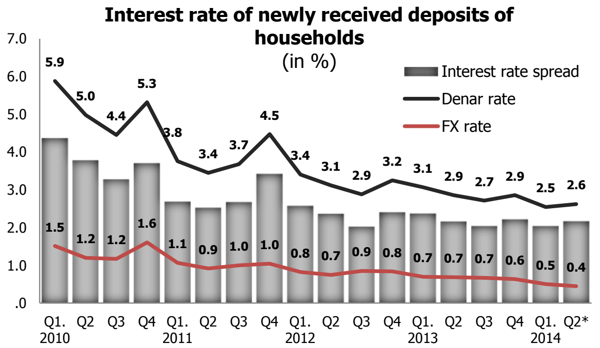


Source: NBRM.

Household deposits

	2013				2014	
	Q1	Q2	Q3	Q4	Q1	Q2
	quarterly change, in %					
Total household deposits	2.0	0.9	1.3	2.4	2.4	1.1
	contribution to quarterly change of total deposits, in p.p.					
Deposit money	-0.1	0.2	-0.1	1.0	0.5	0.2
Denar deposits	1.2	0.8	0.8	1.1	1.2	0.7
FX deposits	0.8	-0.1	0.6	0.3	0.7	0.2
Short-term deposits	0.2	-0.4	-0.2	-0.2	0.2	-0.2
Long-term deposits	1.8	1.1	1.6	1.6	1.7	1.1

Source: NBRM.



*Q2 refers to May. Source: NBRM

Enterprise deposits

	2013				2014	
	Q1	Q2	Q3	Q4	Q1	Q2
	квартални промени, во %					
Total household deposits	-1.5	-7.8	9.1	4.1	1.7	-2.0
	contribution to quarterly change of total deposits, in p.p.					
Deposit money	-1.4	1.3	2.9	1.9	1.1	0.2
Denar deposits	0.1	-1.3	2.6	1.6	0.2	-1.8
FX deposits	-0.3	-7.8	3.5	0.7	0.4	-0.4
Short-term deposits	-1.5	-9.4	5.0	2.1	0.3	-2.0
Long-term deposits	1.4	0.3	1.1	0.2	0.3	-0.2

Source: NBRM.

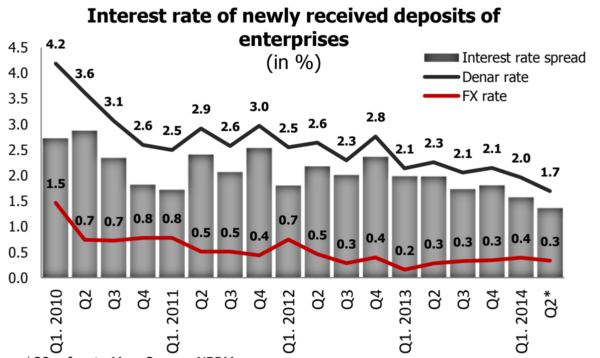
Analyzed on an **annual basis**, in June, the broad money increased by 8% (5.8% in the previous quarter), given the growth in total deposits[79] of 8.3% (6.9% in the previous quarter).

On a quarterly basis, total bank deposits in the second quarter increased by 0.4% (2.2% in the previous quarter). The sector-by-sector analysis shows further growth in household deposits, although at a slower pace compared to the previous quarter and a decline in corporate deposits, mainly as an effect of the dividend payment.

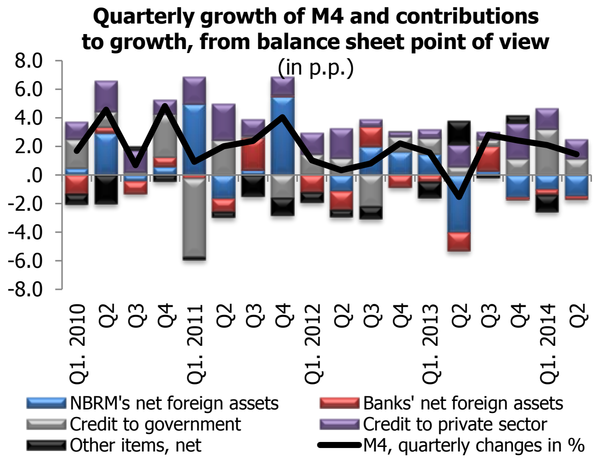
Total household deposits rose by 1.1% on a quarterly basis, versus 2.4% in the previous quarter, when the increased budget spending had an additional impact to encourage deposit growth[80]. Structurally observed, the growth of total household deposits was again primarily driven by long-term deposits, given the growth of demand deposits, while short-term deposits decreased on a quarterly basis. The analysis of currency structure shows more intense growth of denar deposits, which is typical for household deposits since the end of 2011. The growth of total deposit potential of households i.e. its denar component, in the second quarter, was supported by the maintenance of higher yields on denar savings compared with the foreign currency savings. Thus, interest rates on newly received denar and foreign currency deposits in the second quarter remained relatively stable, which enabled relatively stable interest rate spread in favor of the denar savings instruments. **Annually**, June recorded growth of total household deposits of 7.4%, versus 7.2% in March.

Total corporate deposits in the second quarter decreased by 2% on a quarterly basis, despite the growth of 1.7% in the first quarter. Given the maintenance of favorable developments in the real sector, such a change in corporate deposits can largely be explained by the withdrawal of funds by a larger company from its bank account to pay dividends to the government and the foreign investor in April. Analyzing maturity, the decline of total corporate deposits is driven by the lower level of short-term deposits, as well as the slight decline in long-term deposits.

[79] The aggregate and sector-by-sector analysis of total deposits refers to total deposits, including demand deposit. The previous quarterly reports discussed deposits without demand deposit.
[80] The first quarter registered higher transfer payments from the budget, primarily in the form of subsidies to farmers, which contributed to the growth of household deposits in the banking sector.



*Q2 refers to May. Source: NBRM.



Source: NBRM

Total credits of private sector

	2013				2014	
	Q1	Q2	Q3	Q4	Q1	Q2
quarterly change, in %						
Total credits of private sector	0.7	1.9	0.6	3.0	1.8	2.9
Contribution in quarterly change of total credits (in p.p)						
Denar credits	0.4	1.6	1.4	2.9	1.6	2.7
Foreign currency credits	0.3	0.3	-0.8	0.1	0.2	0.1
Short-term credits	-0.1	0.6	-0.4	0.7	0.7	0.4
Long-term credits	-0.6	0.6	1.6	2.3	1.2	1.3
Households	0.4	1.4	1.0	1.2	0.9	1.6
Corporations	0.3	0.5	-0.4	1.9	0.9	1.2

Source: NBRM.

Observing the currency structure, both denar and foreign currency deposits decreased. The analysis of yields shows significant reduction in the interest rate of newly received corporate denar deposits, which given the stable level of foreign currency interest rates, moderately narrowed the interest rate spread. Analyzed **annually**, total corporate deposits increased by 13.2%, in June, versus the 6.5% growth at the end of the first quarter[81].

Analyzing balance sheets, the growth of broad money in the second quarter was largely driven by the increased lending to the private sector. Government loans also made a positive contribution, although in significantly smaller volume compared to the previous quarter. Net foreign assets of the monetary system, primarily the NBRM and to a lesser extent the banking sector, acted in the opposite direction.

2.2.2. Lending Activity

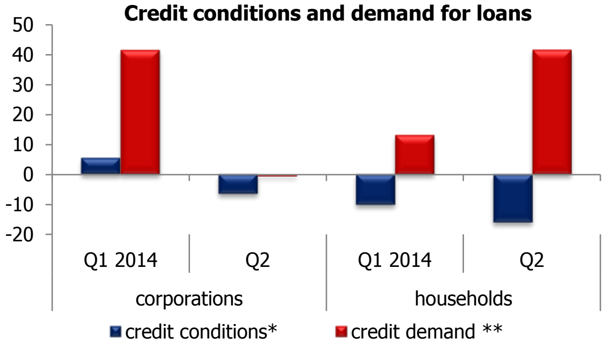
In the second quarter of 2014, the credit market witnessed acceleration of bank lending to the private sector, and the quarterly growth rate of total loans equaled 2.9%, at the end of June (1.8% in the previous quarter). The analysis of credit flows in this period indicates a solid support of the banking system for both household and corporate sectors. However, after the initial stir-up at the end of 2013, May and June again registered a significant movement of the activity of the corporate segment, which contributes 57% to the total credit growth in these two months. Such performances are reinforced by the solid economic growth in the first three months of 2014 and by the retention of favorable trends in the economic activity during the second quarter. In addition, such developments could partly be attributable to the disbursement of funds from the EIB intended for corporate lending[82]. Banks also invested funds within the non-standard monetary policy measures to encourage lending to certain segments of the corporate sector[83], although to a lesser extent

[81]The acceleration of the annual growth rate of total corporate deposits partly reflects the base effect, given that the outflow of funds for the payment of dividend in April 2013 was almost double, compared to the outflow in April 2014 (higher paid dividend for 2013 compared to 2014).

[82]In the second quarter of 2014, two tranches from the third EIB credit line were disbursed through the Macedonian Bank for Development Promotion, in total amount of Euro 10.8 million.

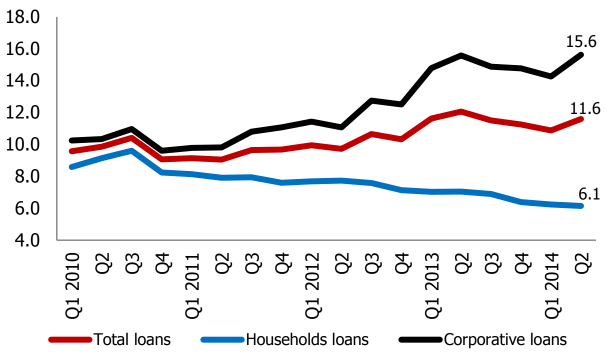
[83] As a part of the non-standard measures of the NBRM aimed at encouraging lending to net exporters and producers of electricity, in the second quarter of 2014, banks market new

Credit conditions and demand for loans



*negative net-percentage - easing of credit standards;
*positive net-percentage - tightening of credit standards;
**negative net-percentage - decrease in credit demand;
**positive net-percentage - increase in credit demand
Source: Bank lending survey, NBRM.

Share of doubtful and contested claims in total



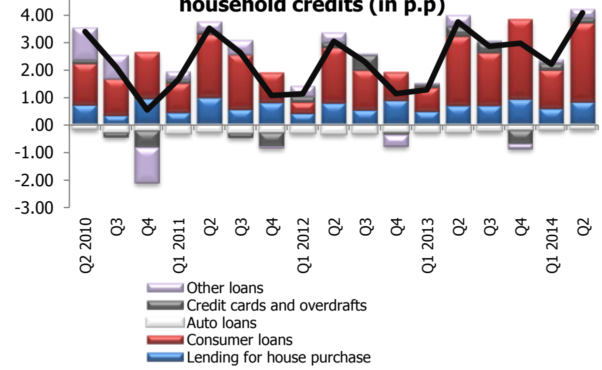
Source: NBRM.

Total credits of households

	2013 Q1	Q2	Q3	Q4	2014 Q1	Q2
	quarterly change, in %					
Total credits of households	1.1	3.4	2.5	2.8	2.1	3.9
Contribution in quarterly change of household credits (in p.p)						
Denar credits	1.2	3.6	2.6	2.8	2.1	3.9
Foreign currency credits	-0.1	-0.1	-0.1	0.0	0.0	0.1
Short-term credits	0.1	0.4	0.3	-0.6	0.2	0.3
Long-term credits	0.9	2.7	2.1	3.8	1.8	3.5

Source: NBRM.

Contribution in quarterly change of household credits (in p.p)



*Total loans to households do not include loans to self-employed individuals
Source: NBRM.

compared with the previous quarter. Positive trends in lending are also confirmed by the results of the Lending Survey[84] conducted in late June, which indicates an improvement of the banks' perceptions for the supply of and demand for corporate loans and household loans. On the other hand, after the reduction and stabilization of doubtful and contested claims[85] in the previous three quarters, in the second quarter they increased, driven by the performance of the corporate sector. The doubtful and contested claims to total loans ratio in June equaled 11.6%, which is approximately at the level of December 2013 (10.9% in March). Despite this insignificant increase, it is estimated that these movements are temporary. Namely, given the present economic recovery and accelerated credit activity, the downward trend in doubtful and contested claims is expected to continue in the coming period.

Analyzing by currency, the quarterly increase in total loans is predominantly driven by the growth of denar loans, which account for 96% of the quarterly growth. Observing the maturity structure, long-term loans again prevail, whose growth is three times higher than the growth of short-term loans. **On an annual basis**, the growth rate of total loans accelerated in June to 8.5% (7.5% in March). Given the intensive quarterly increase in total loans and moderate growth in the deposit base, there is an increasing utilization of deposits as the main source of funding, and the loans/deposits ratio at the end of June equaled 91.5% (89.3% in the previous quarter).

The quarterly growth rate of loans to the household sector accelerated from 2.1% to 3.9% in the second quarter of 2014, which is the most intensive quarterly growth since the outbreak of the crisis. The quarterly increase is mainly explained by the growth in consumer loans, with the housing loans acting in the same direction. These movements correspond with the results from the Lending Survey. The positive stir-up in the household sector is a combined effect of favorable developments on the demand side and the supply side of loans to the household sector. Thus, according to the responses of banks, in the second quarter of 2014,

Denar 175 million. Cumulatively, for the period January-June 2014, banks marketed a total of Denar 2,210 million.

[84] For more information, also see Lending Survey at http://www.nbrm.mk/?ItemID=F7AC78DEE498764FBAF39049F726CE3C

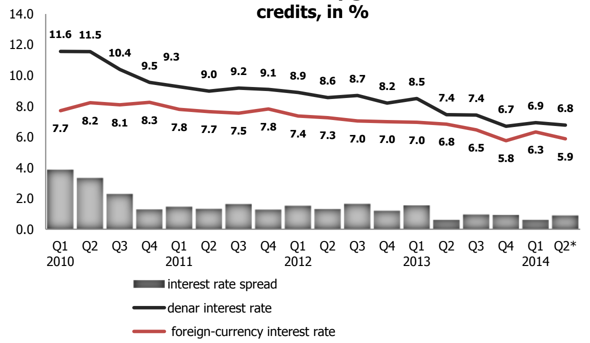
[85] The data are consistent with the monetary statistics

Total credits of corporations

	2013				2014	
	Q1	Q2	Q3	Q4	Q1	Q2
	quarterly change, in %					
Total credits of corporations	0.5	0.9	-0.7	3.2	1.5	2.0
Contribution in quarterly change of corporation credits (in p.p)						
Denar credits	-0.1	0.2	0.5	3.0	1.2	1.9
Foreign currency credits	0.5	0.7	-1.2	0.2	0.3	0.2
Short-term credits	-0.3	0.8	-1.0	1.6	1.0	0.6
Long-term credits	-1.6	-0.8	1.1	1.3	0.7	-0.2

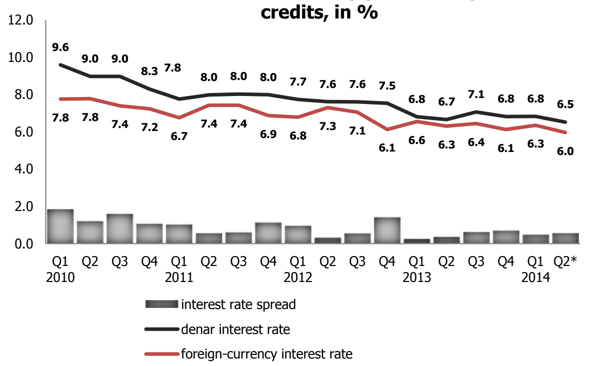
Source: NBRM.

Interest rate of total newly granted household credits, in %



*Q2 refers to the end of May
Source: NBRM.

Interest rate of total newly granted corporate credits, in %



*Q2 refers to the end of May
Source: NBRM.

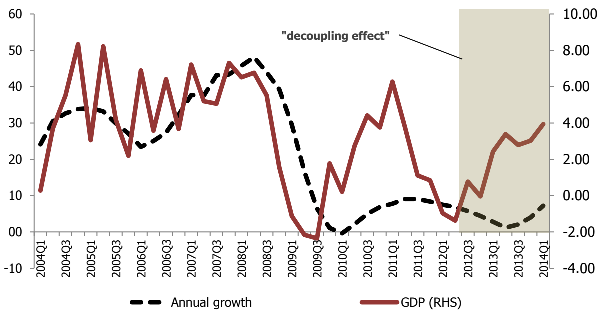
there was a higher net easing of lending terms for the households, which is more pronounced in consumer loans, given the increased demand for consumer and household loans. According to the analysis of the currency structure of the quarterly growth of loans to households, almost all quarterly increase was due to the growth of denar loans, with minor contribution of foreign currency loans to the total growth. From the maturity aspect, there is more intensive lending to households in the long run, and moderate growth in short-term loans. **Annually,** loans to households increased by 11.8% in June (11.3% in March).

Similar trends are present in the corporate sector. Namely, there is acceleration of the quarterly growth rate from 1.5% to 2% in the second quarter of 2014. These positive trends are consistent with the moderate net easing of the terms for granting corporate loans stated under the Lending Survey (versus the net tightening in the previous quarter), amid an increase in the demand for loans to SMEs and long-term loans. Within the currency structure, 92% of the quarterly growth is due to the rising denar corporate credits, which is an increase in their contribution to the total growth compared to the previous quarter (80% share in the quarterly growth in the first three months of 2014). According to the maturity structure, the long-term loans decreased, whereas the short-term loans increased. Doubtful and contested claims also made contribution to the overall quarterly growth of corporate loans in the second quarter. **On annual basis,** the growth of corporate loans at the end of June accelerated, reaching 6.1% (4.9% in the previous quarter).

Observing the terms of lending, recent data suggest relaxing of the **interest rates** applicable to household and corporate loans. Moreover, the denar and foreign currency interest rates on new loans to the households decreased by 0.1 and 0.4 percentage points respectively. Similar trends are observed in the interest rates on newly granted corporate loans, where the newly approved denar and foreign currency loans recorded simultaneous decrease of 0.3 percentage points. Minor fall of 0.1 percentage points compared to the end of March is registered in the overall interest rate, which in May equaled 7.6% and 7.0%, for the household and corporate loans, respectively.

Box 7: Alternative Indicators for Monitoring the Relationship between Lending and Economic Activity

The economic literature recognizes the fact that there is interdependence between loans to the private sector and the developments of economic activity. Therefore, various indicators of lending activity of the banking system are used to explain and design developments of the economic activity as measured by the growth rate of gross domestic product. Prior to the outbreak of the global financial crisis, the most common indicators used for this purpose were the total loans to GDP ratio, and the growth rate of loans to the private sector, vis-à-vis to the growth of the domestic economy (quarterly or annual). Thus, the empirical analyses show that during the expansion, loans marketed to the private sector and economic activity in general follow a parallel uptrend. The same happens in times of recession when growth rates of total loans slow down along with the economic activity. However, **it appears that in the post-crisis recovery periods, the synchronization between credit and economic growth disrupts**, known in the literature as creditless recovery. As stated by Calvo (2006), this term describes the phenomenon as seen in the first years after the economic and/or financial crisis, where the economic growth of a country is not accompanied by a simultaneous credit growth. Perhaps the most famous example of this phenomenon in the literature is the case of the U.S. economy after the Great Depression (when the real annual GDP growth equaled 11% and 9% in 1934 and 1935, respectively, while credit growth remained in the negative zone). Classens et al. (2008) identified the same phenomenon in 21 OECD member countries. The Macedonian economy, the period after the acute phase of the crisis was marked by a significant slowdown of credit activity of banks as compared with the pre-crisis period. On the other hand, the pace of recovery of the economic growth in general was solid, with occasional oscillations under the influence of external shocks. Such developments indicate weakening of the link between credit and economic growth under the impact of the crisis and potentially undermined credit growth as high frequency or leading indicator of changes in economic activity. The analysis of correlation coefficients between these two indicators confirms the above. Namely, during the post-crisis recovery, there is a negative correlation between annual rates of growth of total loans and the growth of economic activity (with a value of -0.25), despite the positive correlation that exists for the entire period under observation and the period before the onset of the crisis (with a value of the coefficient of 0.55 and 0.45, respectively).



Taking into account this distortion of the relationship between economic and credit growth, economic analysts encounter a space for identifying and using new and different indicators to explain the GDP movements in the changed environment. Thus, using data from developed economies and developing economies, Bigss (2009) came to the conclusion that after the financial crisis, economic recovery shows a closer connection with credit flows and changes in credit flows, rather than with the stock of total loans. The same relationship of these two indicators called "new debt" and "credit impulse" with the variability of GDP is confirmed by the analysis conducted by the Central Bank of Turkey for the Turkish economy (Ermisouglu, Akcelik, Oduncu 2013).

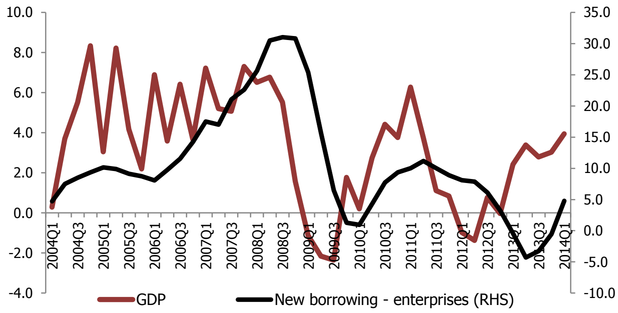
Following the above examples, in this box we are trying to conduct an analysis of the relationship of these two indicators for lending activity with the movements of the gross domestic product of the Macedonian economy. New debt and credit impulse is defined as follows:

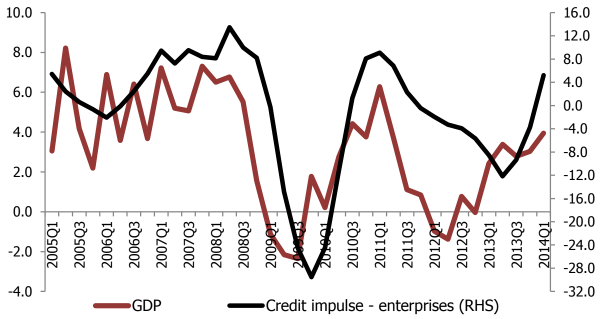
$$\textit{new debt}_t = (\textit{total loans}_t - \textit{total loans}_{t-4}) / \textit{GDP}_{t-4}$$
$$\textit{credit impulse}_t = \textit{new debt}_t - \textit{new debt}_{t-4}$$

which means that the new debt is calculated as share of the annual changes in total credit to GDP prior to their approval, while credit impulse is an annual change in the respective new debt.

Furthermore, the comparison of the dynamics of these indicators for lending activity with the annual changes in GDP[86] shows whether and to what extent changes in GDP have been followed by the lending activity. The analysis covers the period from the first quarter of 2003 to the first quarter of 2014, focusing on two subperiods, so as to draw some indications about the relationship of these indicators with the economic activity in different phases of the domestic economy (phase of expansive and phase of restrained economic growth). Thus, the first subperiod extends from the first quarter of 2003 through the third quarter of 2008, while the second subperiod covers the period from the last quarter of 2008 through the first quarter of 2014. The quarterly values of GDP at constant prices (base 2005, seasonally adjusted) are used as indicator of economic activity. As for the banks' lending activity, quarterly data are used on total loans[87] to the corporate sector and the household sector in nominal terms[88], including credit cards. Total loans are disaggregated by sector in order to extract more information about the relationship of different types of loans with the economic activity.

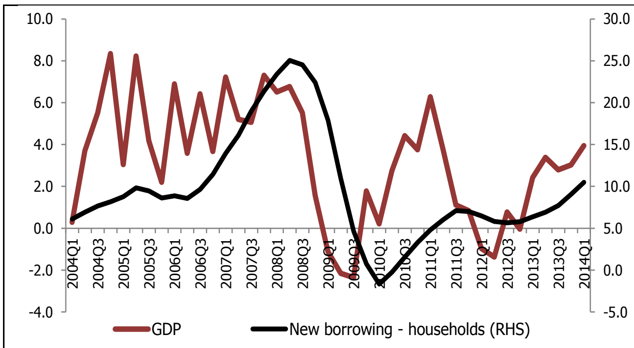
The main purpose of the analysis is to investigate the relationship of these two indicators with the movements in the domestic economy. Also, we tried to provide an answer on the issue which indicator is better for the Macedonian economy in general, which indicator is better for certain types of loans (corporate or intended for the household sector) and for what stages of the business cycle.

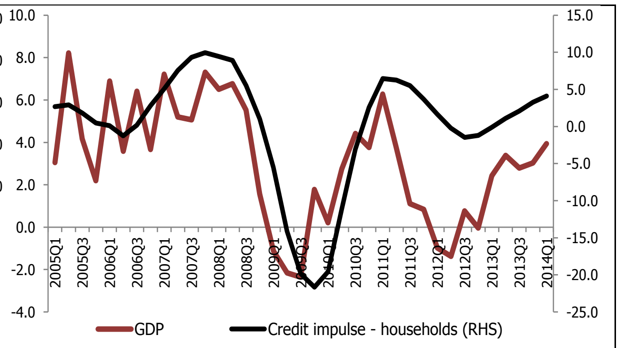




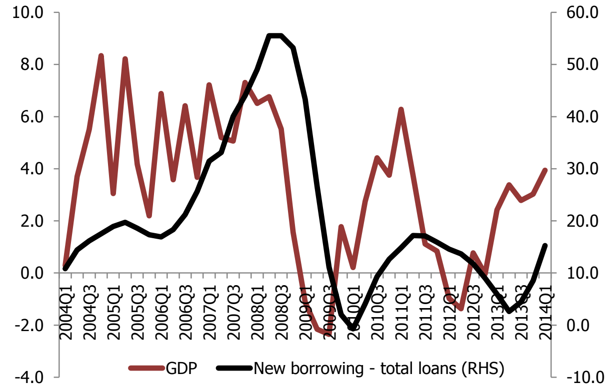
The graphic display of the new debt and credit impulse to the companies suggests certain connection between these indicators and the economic activity, which is more pronounced in the credit impulse indicator. The analysis of correlation coefficients confirms this conclusion through the resulting values of 0.61 for the credit impulse and 0.28 for the new debt.

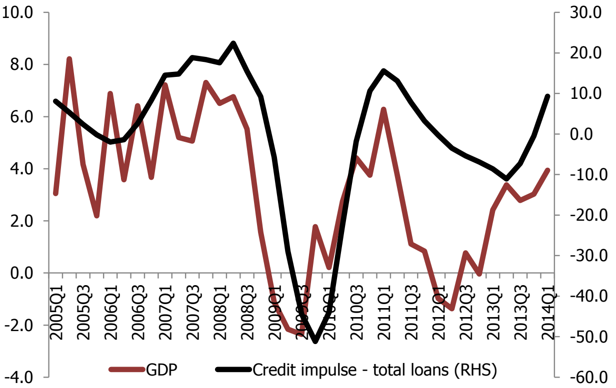
[86] The paper of the Central Bank of Turkey, which we use as a reference paper for our analysis, uses quarterly changes in GDP and the relevant indicators for lending activity. Our analysis of the data of the Macedonian economy showed better results with the annual changes of the relevant variables and are presented within this box.
[87] Quarterly amount of total loans is a simple average of the relevant monthly stocks. Total loans to the private sector do not include doubtful and claims on companies and households, and loans to the financial sector.
[88] Calculations that use realistic values of loans, deflated by the consumer price index, and seasonally adjusted data for nominal and real loans do not change the general conclusions.





Household sector chart also indicates high connection of credit impulse with the annual growth of GDP, which is also supported by the correlation coefficient, which equals 0.61. In the new household borrowing, the relationship with GDP is lower and equals 0.37.





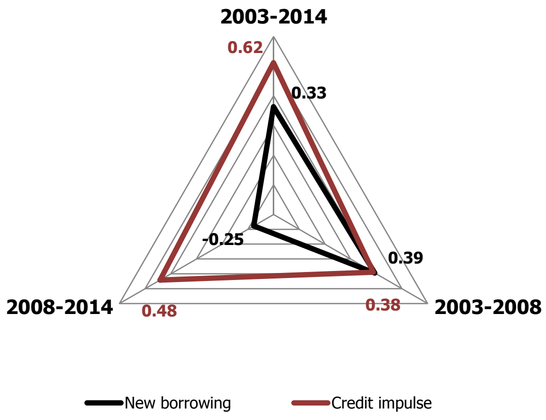
The movements of these indicators for total loans to the private sector also show a high connection with the annual changes in economic activity. Similar to the sector-by-sector analysis, this connection is higher for the indicator for credit impulse with correlation coefficient of 0.62, while the correlation of the new debt is almost twice as low and equals 0.33.

Analyzing by sector, credit impulse indicator shows the same level of connectivity of economic activity with the household sector and the corporate sector (with a correlation coefficient of 0.61). On the other hand, the new debt indicator shows a slightly higher association of economic activity with the household sector than with the corporate sector. So the new debt of households has a correlation coefficient with the annual GDP growth of 0.37 for the entire analyzed period (0.28 in corporate loans). These results, at first glance may seem counterintuitive and contrary to some of the findings of the theoretical and empirical literature that establishes a positive and significant relationship between corporate loans and the growth of GDP per capita and lack of connection with household loans[89]. These results could partly be explained by the conservative perceptions of Macedonian banks for riskiness of the corporate sector in the period in the wake of the global crisis, which caused a significant slowdown in the growth of corporate loans, and an increasing growth of loans to households. However, one should bear in mind that these results are interpreted merely as an indication of the existence of correlation, in other words, should not be interpreted as causality.

The analysis of both subperiods which is intended to receive indications of possible changes in the relationship of economic activity with new debt and credit impulse affected by the global crisis, shows a higher correlation of credit impulse in the post acute phase of the crisis compared with the first subperiod, while opposite conclusions could be drawn for the new debt. Namely, in the period before the onset of the global crisis, the relationship between the new debt in total loans and the economic activity is positive and in

[89] Beck, Buyukkarabacak, Rioja, Valev (2012), Who gets the credit? And does it matter? Household vs. firm lending across countries.

value similar to the credit impulse, while in the second period the correlation is negative. Negative correlation in the post-crisis period is obtained if the economic activity is analyzed in terms of annual growth rates of total loans. These findings, which are similar to the results of the analysis of Bigss (2009) and the Turkish Central Bank, indicate specific impact of the global crisis towards strengthening the synchronization of the credit impulse with the GDP growth.

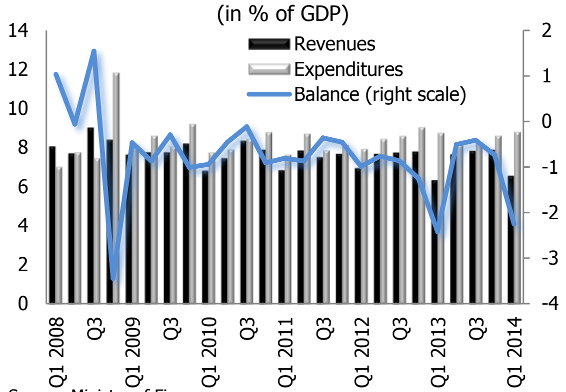


In summary, the analysis of the connection of new indicators of credit activity to economic activity suggests certain synchronization between the new debt and primarily the credit impulse in the household and corporate sector throughout the period under observation. According to our analysis, the connection between the economic growth and the credit impulse strengthens in the post-crisis recovery period (compared to the pre-crisis period), when there is some distortion of the relationship between the economic growth and the growth of total loans, analyzed through growth rates. This implies that in the case of the Macedonian economy, especially in the post-crisis recovery period, credit impulse might be an appropriate indicator for monitoring changes in economic activity. Given that credit activity is one of the factors used to project GDP, the next step would be to incorporate the credit impulse in models for short-term forecasting of GDP, which would formally investigate the informative value of the credit impulse versus credit growth rates and the total loans to GDP ratio, as standard indicators used for credit activity so far.

III. Public Finances

In the first quarter of 2014, the Budget of the Republic of Macedonia (central budget and budgets of funds) generated by 7.9% higher revenues, while the budget expenditures increased by 5% compared to the same period last year. In this period, the budget deficit accounted for 2.3% of GDP, mostly financed from domestic sources. In the period April-May, the growth of total revenues was insignificant (0.7%) compared to the same period last year, with the performance in the first five months equaling 36.4% of total projected revenues for the year. In the same period, budget expenditures increased by 5.2%, and cumulatively amount to 40.2% of total budgetary expenditures projected for 2014. In such circumstances, the budget deficit in the two months of the quarter constituted 0.4% of GDP, or 2.7% in the first five months of the year.

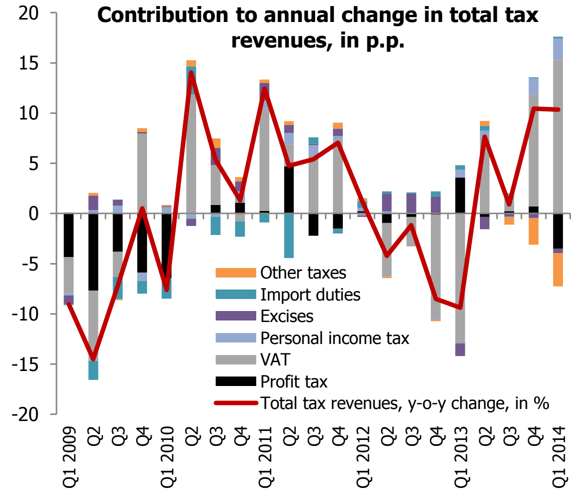
Budget revenues and expenditure
(in % of GDP)



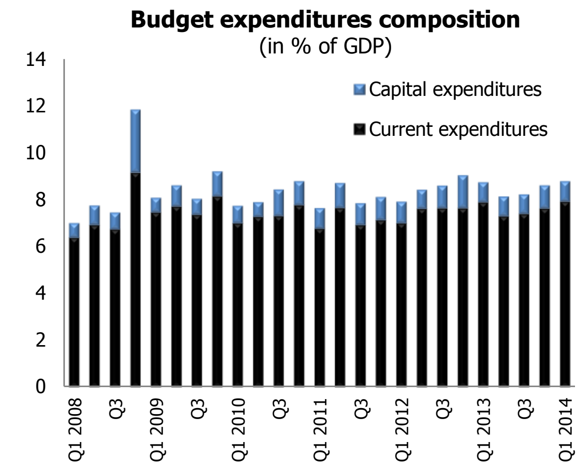
Source: Ministry of Finance

Total revenues in the Budget of the Republic of Macedonia[90] equaled 6.5% of GDP in the first quarter of 2014[91], which is slightly higher compared to the same quarter of the previous year (6.3% of GDP). Observing the relative growths, annually, the budget revenues increased by 7.9% in nominal terms. This significant growth is largely due to the positive contribution of tax revenues (of 5.7 percentage points), which continues to grow at double-digit rates (10.4% in the first quarter).

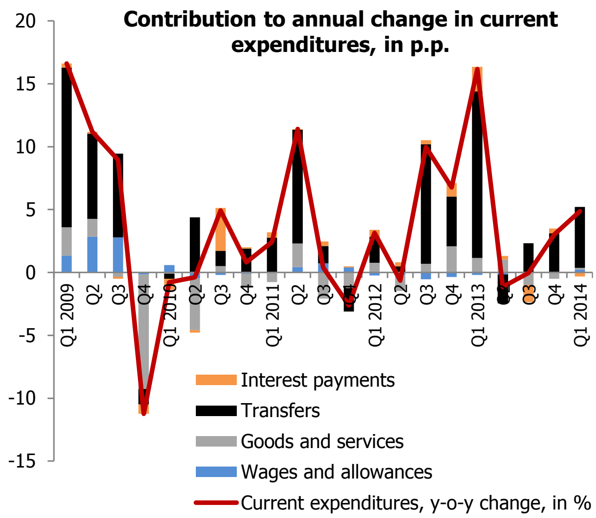
[90] Central budget and budgets of funds.
[91] The analysis uses GDP as projected by the NBRM.



Source: Ministry of Finance.



Source: Ministry of Finance

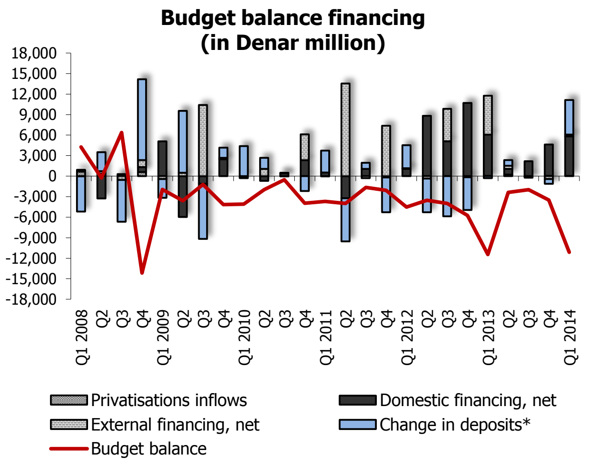


Source: Ministry of Finance.

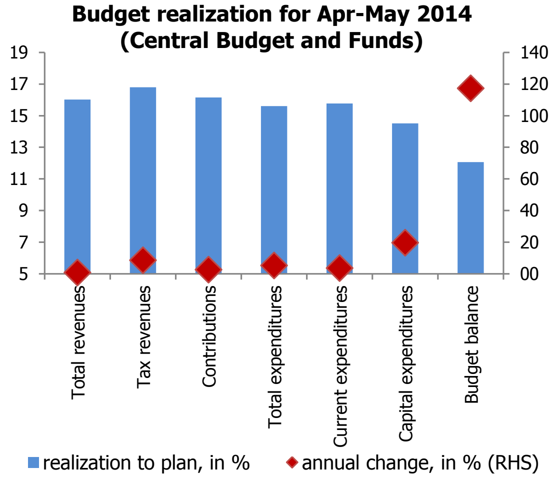
Regarding the structure of tax revenues, in the first quarter, the highest growth of 34% was registered in the revenue from VAT, thus making the greatest contribution to the growth of total tax revenues. However, one should bear in mind that the main reason for the sharp rise in the VAT is the low base effect in the first quarter compared to the previous year, when the government fully repaid the arrears based on VAT returns. Given the positive developments in the labor market at the beginning of the year and further growth in employment, revenues from personal income tax continued to grow stronger than before, and their growth of 14.4% was the second highest performance within the tax revenues. Compared to the same quarter of the previous year, the collection of import duties is higher by 2.7%. On the other hand, in the first quarter, profit tax and excise tax revenues decreased by 35.7% and 2.3%, respectively. Total social contributions increased by 5.1%, given the higher collection in all subcategories, making their contribution to total revenue growth of 1.6% higher compared to the same quarter of the previous year. Conversely, in this period, non-tax revenues went down by 0.3% on an annual basis.

In the first quarter of the year, the total budget expenditures made up 8.8% of GDP, which is slightly higher compared with the same quarter of the previous year. In nominal terms, budget expenditures increased by 5% annually. Viewed from the aspect of certain expenditure categories, the growth of total expenditures is primarily due to higher current costs, which registered enhanced growth of 4.9% annually. The main generators of the growth of current expenditures are transfers, whose growth in the first quarter equaled 6.8%. Analyzing transfers, a significant increase was observed in the category of other transfers (9.4%), probably due to the payment of subsidies in agriculture in this period. In addition, social transfers increased by 5.4% annually, which is mostly due to higher transfers of budgetary assets to the Pension and Disability Insurance Fund. During this period, growth was recorded in expenses for wages and benefits (1.5%) and the costs of goods and services (1.2%). Expenditures decreased only in interest payments (by 10.6%), due to the lower interest costs based on external borrowing[92]. **Since the beginning of the year, capital expenditures increased by 6.5% on an annual basis,** with their share in GDP (0.9%)

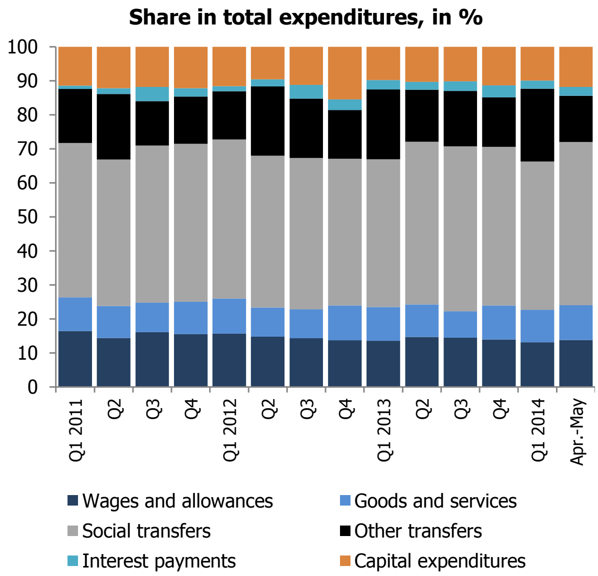
[92] High base effect from the last year, given the last interest payment for the second Eurobond.



* Positive change- deposits withdrawal; negative change-deposits accumulation.
Source: Ministry of finance of the Republic of Macedonia.



* With respect to Budget plan for 2014.
Source: Ministry of Finance.



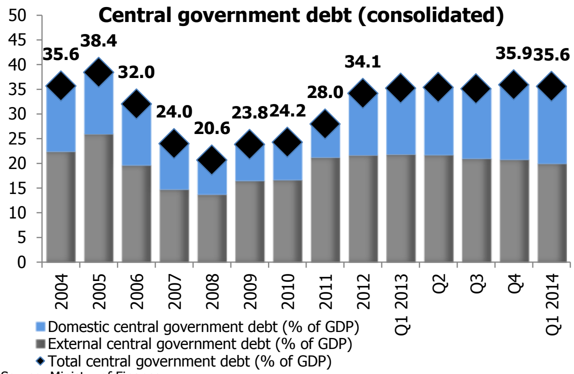
Source: Ministry of Finance.

and in total expenditures (9.9%) being at the level of the same period last year.

In the first three months of 2014, the budget deficit totaled Denar 11,137 million in nominal terms, constituting 2.3% of GDP[93] or 61% of the budget plan. In this period, domestic borrowing and government deposits, and to a lesser extent, foreign loans were sources of funding of the deficit. The majority of funding included borrowing from the domestic market, where net amount of Denar 5,510 million was provided through the issuance of government securities. Additional funds were mobilized through the withdrawal of government deposits from the account with the NBRM in the amount of Denar 5,060 million and through external borrowing in the net amount of Denar 257 million.

In April-May 2014, the annual growth of total budget revenues reduced to 0.7%, suggesting that in the current quarter, the pace of growth will be significantly slower compared to the first quarter of the year. In the analyzed period, tax revenues and contributions continued to grow annually (8.5% and 2.5%, respectively), thus contributing positively to the growth of total revenues. On the other hand, the largest downward effect on total revenues resulted from the negative contribution of capital income, which dropped by 57.9% compared to the same period last year, mainly due to the lower dividend of Macedonian Telekom. **Unlike the income, expenditures continued their increasing growth, with their growth in these two months slightly exceeding the growth of the first quarter, reaching 5.2% annually.** However, it is important to emphasize that a significant contribution to this performance was particularly made by the high level of capital expenditures in this period (an increase of 19.5% on an annual basis), compared to the growth of 3.5% of current costs, thus somewhat reducing the gap regarding the higher contribution to the growth of total expenditure made by the current costs. In terms of the plan for 2014, in April and May were realized 16% of the anticipated revenue and 15.6% of the projected expenditures for the year, with the cumulative basis, in January-May realization of revenues and expenditures reached 36.4 % and 40.2%, respectively. **The two months of the second quarter recorded a budget deficit of Denar 2.203 million (or**

[93] If we use the GDP projected by the Ministry of Finance, the budget deficit accounted for 2.2% of GDP in the first quarter.



Source: Ministry of Finance

0.4% of GDP[94]), thus cumulatively, in January-May, the deficit accounted for 2.7% of GDP, which is 73% of the deficit projected for 2014. In the period April-May, the budget deficit was fully financed from domestic sources through withdrawals of deposits from the government account with the NBRM. Since the repayments of domestic and foreign borrowing in May were higher than the inflows, as of 31 May 2014, the central government debt (consolidated) decreased to 35.2% of GDP compared to March[95].

	Budget for 2014	Q1	Apr-May	Y-o-y changes, 2014 period over the same period of the previous year, in %		Contribution to y-o-y change, 2014 period over the same period of the previous year, in p.p.	
	planned, in Denar million	realized, in Denar million		Q1	Apr-May	Q1	Apr-May
TOTAL BUDGET REVENUES	**158,243**	**32,291**	**25,350**	**7.9**	**0.7**	**7.9**	**0.7**
Revenues base on taxes and contributions	133,859	28,704	22,131	8.4	6.6	7.4	5.4
Tax revenues	87,222	18,216	14,649	10.4	8.5	5.7	4.6
Contributions	45,153	10,211	7,294	5.1	2.5	1.6	0.7
Non-tax revenues	14,973	2,591	1,654	-0.3	14.0	0.0	0.8
Capital revenues	5,290	181	1,002	-39.5	-57.9	-0.4	-5.5
Donations from abroad	3,521	612	445	34.2	-12.9	0.5	-0.3
Revenues of recovered loans	600	203	118	103.0	59.5	0.3	0.2
TOTAL BUDGET EXPENDITURES	**176,514**	**43,428**	**27,553**	**5.0**	**5.2**	**5.0**	**5.2**
Current expenditures	154,137	39,120	24,305	4.9	3.5	4.4	3.2
Capital expenditures	22,377	4,308	3,248	6.5	19.5	0.6	2.0
BUDGET DEFICIT / SURPLUS	**-18,271**	**-11,137**	**-2,203**	**-2.5**	**117.3**		
Financing	18,271	11,126	2,203				
Inflow	**29,131**	**11,995**	**2,897**				
Revenues based on privatisation	0	41	0				
Foreign loans	5,276	994	382				
Deposits	13,915	5,049	4,319				
Treasury bills	9,840	5,642	-1,804				
Sale of shares	100	269	0				
Outflow	**10,860**	**869**	**694**				
Repayment of principal	10,860	869	694				
External debt	9,133	737	562				
Domestic debt	1,727	132	132				

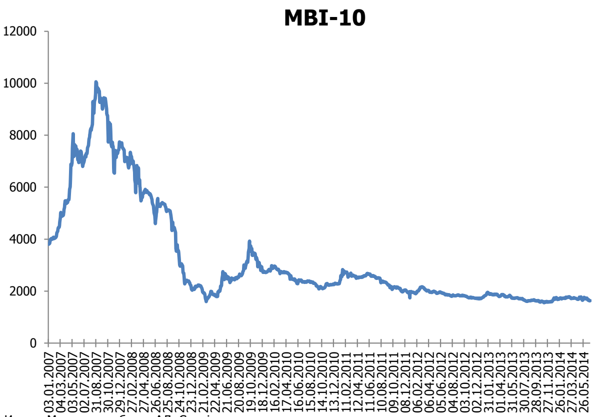
Source: Ministry of Finance.

IV. Stock Exchange Indices and Real Estate Prices

In the second quarter of 2014, MBI-10 continued to decline on a quarterly basis. However, during the quarter, the stock exchange index registered positive oscillations occasionally. Higher values were achieved in mid-May and mid-June, reflecting higher

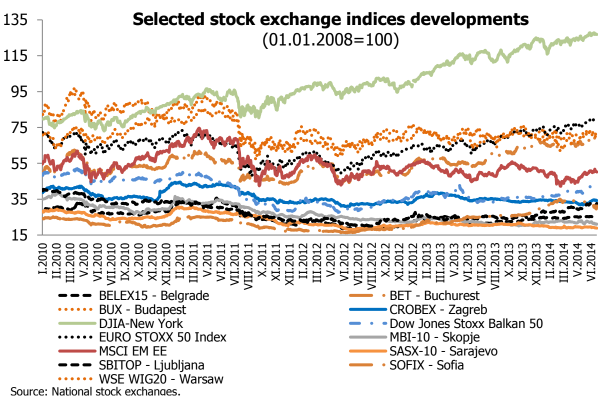
[94] Also 0.4% according to the Ministry of Finance.
[95] If we use the GDP projected by the Ministry of Finance, in May, the debt of the central government accounted for 34.9% of GDP.

than expected growth of domestic economy, continuing favorable economic performance in the economies in the euro area and the positive movements of most of the high frequency domestic economic indicators. After the positive shifts in the previous quarters, the OMB index began to move in a negative direction. The value of regional stock indices varied from one country to another. The main factors that influence in a positive direction included the favorable economic performances in the euro area, as the crisis in Ukraine, and turbulence in the banking system in Bulgaria, were the reason for the less favorable stock performances. Real estate prices in the domestic market increased after the negative shifts in the previous two quarters.



Извор: Македонска берза АД, Скопје.

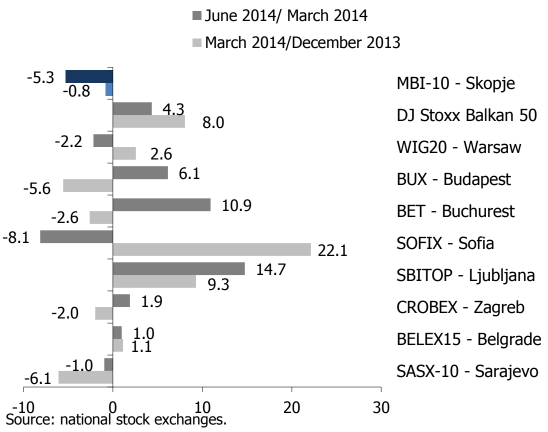
The value of the MBI-10 continued to decline in the second quarter of 2014. Thus, at the end of June 2014, MBI-10 index was lower by 5.3% compared to the end of March 2014. These negative changes in the stock exchange index remains largely explained by the absence of foreign institutional investors from the stock market, as well as lack of interest among domestic investors. However, analyzing the dynamics of the movement of the index, during the second quarter of 2014, it registered occasional positive oscillations in mid-May and mid-June. Factors that contributed to the short-term positive trends may include the higher than expected growth of the domestic economy, continuing favorable economic performances in the economies in the euro area (quarterly GDP growth second quarter in a row), as well as favorable to most of the high frequency domestic economic indicators. The total stock exchange turnover increased by 44.9% compared to the previous quarter, while turnover generated from traditional trading decreased by 16.9% on a quarterly basis, given the reduced turnover of bonds. In addition to MBI-10, a quarterly decrease was also noted in OMB, whose value decline moderately by 1% at the end of June 2014 compared to the end of March 2014.



Source: National stock exchanges.

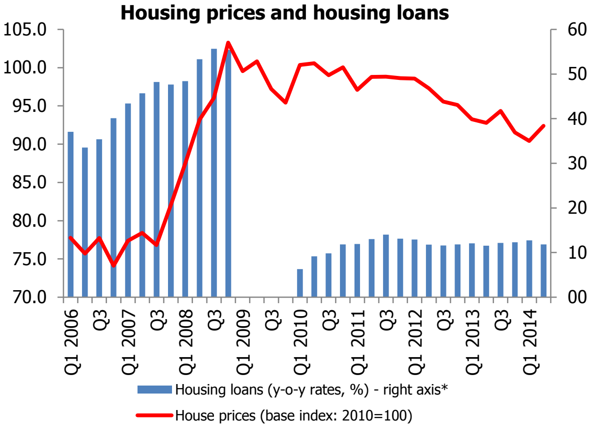
In the second quarter of 2014, the regional stock exchange indexes recorded different movements, and the performances were influenced by positive signals of leading markets, positive economic data in developed economies, and the crisis in Ukraine, as well as certain domestic factors (turbulence in the banking system of Bulgaria). Thus, growth in the value of stock indices was observed in the stock markets in Belgrade, Zagreb, Ljubljana, Bucharest and Budapest. Positive changes in these regional indices reflect the published data for further favorable economic performance in the economies in the euro area and improved economic performance in the United States along with the constant and significant reduction in the unemployment rate. Furthermore, the positive mood in these regional markets was supported by

Changes of the regional stock exchange indices, eop June/eop March 2014 and eop March 2014/eop December 2013 (in %)



Source: national stock exchanges.

Housing prices and housing loans



Source: NBRM. Index of housing prices is calculated by the employees of the NBRM based on the data from the daily newspapers.
*Annual changes for 2009 are not calculated due to changes in the methodology.

the solid macro-indicators published for the respective countries[96], as well as the positive signals of leading markets. On the other hand, a decline in the value of the stock exchange index was observed in the stock markets in Sofia, Warsaw and Sarajevo, under the influence of local factors and the overall regional impact of the crisis in Ukraine.[97] The announced future electronic connection of stock exchanges in Macedonia, Bulgaria and Croatia is expected to stir-up the stock markets in the region in the future.

After the reduction observed in the previous two quarters, property prices rose in the second quarter of 2014. The index of prices of apartments increased by 2.2% on a quarterly basis, thus slowing down the decline in prices on an annual basis (decline of 0.4%, after the fall of 3.1% in the first quarter of 2014). Such movements in real estate prices do not correspond to the movements of their determinants. Observing the factors on the supply side, the construction of residential buildings in the first quarter of the year registered a significant quarterly increase, which would be expected to have a downward effect on the price of real estate. Construction costs are expected to act in the same direction (according to the construction cost index[98]) which recorded a quarterly decline in the past few quarters. Analyzing the factors on the side of the demand for real estate, the second quarter registered a growth of housing loans, but at a slower pace. Taking into account the movements between real estate prices and their determinants it is difficult to determine whether the prices will continue to rise in the second quarter of the year, or this is a temporary shift.

[96] Weekly reports of Raiffeisen Research (Raiffeisenbank Austria dd Zagreb).
[97] The lower value of the stock exchange index in Bulgaria was caused by the fall of value of shares of two major Bulgarian banks, while the stock exchange index in Sarajevo recorded the highest decline in June due to the fall in value of the shares of six major companies in the country. The negative shift of the Warsaw stock exchange index is largely caused by the geopolitical tensions in Ukraine, the uncertain political situation in the country because of the upcoming political elections and the potential for deterioration in trade relations with Ukraine. (Source: http://cib.natixis.com/flushdoc.aspx?id=77447 and Monthly Reports of the Sarajevo Stock Exchange).
[98] Source: Index of construction costs for new residential buildings, SSO.