National Bank of the Republic of Macedonia

Quarterly Report

October, 2013

Contents:

Introduction

Changes in the monetary policy during the third quarter of 2013 resulted again in monetary loosening. Monetary conditions were relaxed through the key interest rate, as well as through the changes in the reserve requirement. The regular assessment of economic and financial conditions showed that there is room for monetary accommodation. The inflationary pressures gradually decreased, which was consistent with the projected movements of the inflation. In the second quarter, part of the needs for financing the balance of payments transactions were covered by foreign reserves, but with an intensity that was fully in line with the projection. Foreign reserves were constantly held at the adequate level. Real sector indicators pointed to a stronger than expected recovery, and the lending activity on the credit market was conducted in accordance with expectations, however amid more pronounced downward risks by the end of the year. **Lowering of the interest rate followed the previously made changes in the reserve requirement.** In the beginning of July a decision was made to increase the rate of allocating reserve requirement on foreign currency liabilities and to lower the rate of allocating reserve requirement on liabilities in Denars. Also, long-term foreign currency liabilities to non-residents were excluded from the base for calculating the reserve requirement. Such changes led to releasing liquidity into the system, which can be used as financial support to the private sector, simultaneously cushioning part of the previously identified risks to the position of the balance of payments. Notably, with these changes a contribution was made to additionally increase the attractiveness of saving in Denars, while simultaneously reducing the cost of attracting long-term capital from abroad. In such conditions, given the favorable performances from the point of view of the monetary policy and reduced risks, in mid-July monetary policy was loosened by lowering the key interest rate by 0.25 percentage points. Thus, the interest rate on CB bills was brought down to historically lowest level of 3.25%. **Also, in October, an amendment was made to the Decision on banks' liquidity risk management, by which the obligation of banks to hold liquid assets is reduced, which also has a loosening effect.**

In between the two projections, the developments in the global and in the domestic economy pointed to some changes in the initial conditions and in the input assumptions in the projections for individual segments. Global setting has not changed significantly, compared with the April projections. According to the assessments for 2013, external demand will limit growth (in conditions of additional annual reduction), while its gradual recovery is expected during 2014. Despite the still slow recovery of external demand in the first half of the year, the sensitivity of the domestic economy to changes in the global environment is still not very pronounced. The reason for this are the changes in the domestic production structure due to the entry of new foreign investment, leading to export growth and diversification, but also the strong fiscal impulse in the segment of investments, which has a positive impact on growth. At the same time, foreign direct investments in the first half of the year registered solid nominal annual growth of 36%. Thus, in the first half of the year a solid growth in GDP of 3.4% was achieved, making the economic performances significantly better than anticipated. Such better performances were supported by the stronger than expected recovery of private consumption, amid favorable developments in the labor market and enhanced credit support from banks for this particular market segment. In the first half of the year, the export sector had a greater contribution to growth than expected, due to the activity of the new facilities with foreign capital. At the same time, developments in 2013 pointed to lower than expected import demand, primarily for energy, which also contributed to better economic performance. **Against the background of such initial conditions, and given the retained assumptions for further support of growth through foreign and public investment, coupled with**

the recovery of private consumption for the entire 2013, current assessments point to GDP growth of 3.3% (2.2% in the April projections). Similarly to the April projections, also in this projection cycle, in 2014, it is expected that the economy will continue to grow at an accelerated pace, with an expected GDP growth rate of 3.7% (3% in the previous projections). It is still expected that the main generator of the growth will be the export sector, as a combined effect of the increasingly greater capacity utilization of foreign investors, but also the recovery of other exporters amid more stimulating external environment. It is expected that the investment cycle will further strengthen in 2014, mainly supported by the strong fiscal impulse and foreign private capital. In 2014, continuation of existing public investments and start of new infrastructure projects are expected. It is estimated that these developments in the export sector and the strengthened investment activity will create positive spillover effects on the labor market and expectations, which will translate into further increase in household consumption. **In 2015, it is expected that the economic growth rate will reach 4.4%,** and the sources of growth would be similar to those in 2014. **It is expected that credit flows in the domestic economy will be one of the sources of financing growth.** In 2013, lending support to the economy is a little weaker than expected, given the still present restraint of banks from lending, amid assessments for high risks present in the corporate sector and conservative strategies of major banking groups present in the Macedonian banking system. Current estimates point to annual credit growth rate in 2013 of about 5% and expectations for its increase to about 6% and 8% in 2014 and 2015, respectively. Estimates for a rapid credit growth in the next two years are based on assumptions for solid growth in the main source of funding (deposits), in conditions of recovery of the position of the real sector and increased foreign exchange inflows. Furthermore, it is expected that the economic recovery will improve the quality of credit demand and banks' risk perceptions, which will contribute to a gradual reduction of their limiting impact on credit growth.

In terms of inflation, its dynamics so far is in line with the expectations, and it is expected that the average inflation for 2013 will stay around 2.8%. New assumptions for import prices, excluding foreign inflation were minimally revised to somewhat sharper decline (faster growth) of prices than previously expected. **It is expected that the estimated economic growth for the next period will close the negative output gap in mid-2014.** However, it is not expected that these changes will be so strong to cause major changes in current assumptions about the effect of domestic demand on inflation. **Given the similar starting assumptions and in the absence of major changes in the assumptions for import prices and domestic demand, for 2014, an average annual inflation of 2.3% is still expected, and growth in prices of about 2% is expected also for 2015.**

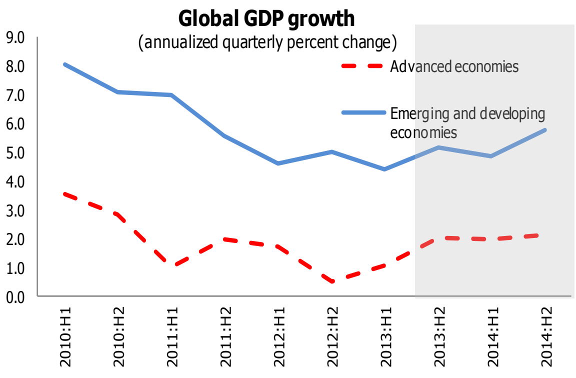
Recent assessments of the position of the balance of payments in 2013 and 2014 indicate possibility of a smaller current account deficit than previously expected. Thus, in these two years, deficit of 3% and 4.6% of GDP is expected (4.2% and 6% in the previous projections), with the changes between the two projections being a combined effect of the lower than expected import pressures and better export achievements, especially of new foreign facilities. Considering the dynamics, the new projections for 2013 imply stagnation of the current account deficit, compared with 2012, amid a smaller trade deficit, and simultaneous reduction of private transfers. **For 2014,** as in the April projections, **it is expected that the assessed widening of the current account deficit** will be partly caused by the larger import pressures created through the growth of import-dependent exports and investments, which will further be strengthened by the expected growth of private consumption. Additional widening of the current account deficit to 5.7% is expected also in 2015, mainly due to the reduction of private transfers, whose dynamics is difficult to predict. No major changes are expected in the trade deficit, in conditions when the rising import pressures are largely estimated to be offset by the growth in the exports of foreign companies. The present path of the current account deficit and its structure do not suggest major imbalances in the economy, i.e. they indicate absence of major import pressures from unproductive consumption. Hence, in the **new scenario about the balance of payments it is expected that capital inflows will fully finance the deficit from current transactions and will lead to further accumulation of foreign reserves.** It is expected that capital inflows will continue to be a combination of debt and non-debt flows. The projected path of foreign reserves for 2014-2015 is upward, and the indicators of adequacy of reserves at an appropriate level are retained.

Generally, the new projections of the NBRM suggest keeping a similar macroeconomic picture as in April, and a balance of payments position which provides growth and further maintenance of foreign reserves at an adequate level. The risks around achieving this macroeconomic scenario continue to be mainly of external nature, and are associated with possible changes in the dynamics of recovery of the global economic growth and movements in the prices of primary products in world markets. NBRM will continue to closely monitor the developments in the next period and, if necessary, it will make appropriate changes in the monetary policy in order to successfully achieve the monetary goals.

I. Macroeconomic developments

1.1. International economic environment[1]

In the first half of 2013, global economic activity continued to grow, but slower than expected, achieving an annual growth rate of 2.5%, versus the expected 3.1%. Moreover, there were significant changes in the dynamics of growth among the emerging and developed economies. Namely, the economic activity in the emerging and developing countries slowed down significantly, while the economic activity in developed countries gradually strengthens, and it is estimated that such movement will continue in the forthcoming period. Signs of recovery were noted also in the Euro area, which in the second quarter of 2013 emerged from recession, in circumstances of improved outturn of the core countries and stabilization of the situation in the peripheral economies. In the second quarter of 2013, the economic growth rate in the USA accelerated, and a more significant impetus for the global growth from the US economy is expected also in the forthcoming period, amid lesser fiscal consolidation and favorable monetary conditions. According to the October projections of the IMF, the global economy is expected to grow moderately at rates of 2.9% in 2013 and 3.6% in 2014, and downside risks are still largely prevailing2. In terms of inflation, in the first two months of the third quarter it mildly accelerated, reaching the level of 3.4%, and is expected to stabilize in the forthcoming period.

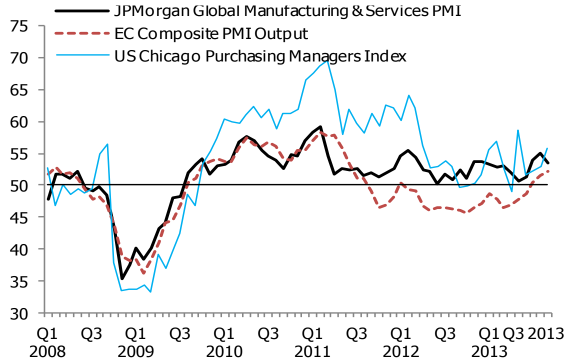


Source: IMF.

In the first half of 2013, the global economy grew by 2.5% on an annual basis. Analyzed by groups of countries, after a long period of economic growth supported by stimulating macroeconomic policies, amid favorable movements in the primary commodities markets and relatively favorable financing conditions, the growth rates of emerging countries gradually stabilize. Their GDP growth is expected to be limited by factors of cyclical and structural character[3], which is reflected also in the downward revision of the annual growth rates for 2013 and 2014, equaling 4.5% and 5.1% respectively[4] (downward adjustment of 0.5 and 0.4 percentage points compared to the July projection). With respect to the developed countries, in the second quarter of 2013, the quarterly growth of the economy of the Euro area contributed to mitigating the decline on an annual basis, so that now the annual rate of decline for the entire year is expected to be -0.4%. It is anticipated that the trend of economic recovery in the Euro area will continue during 2014, when the economy will

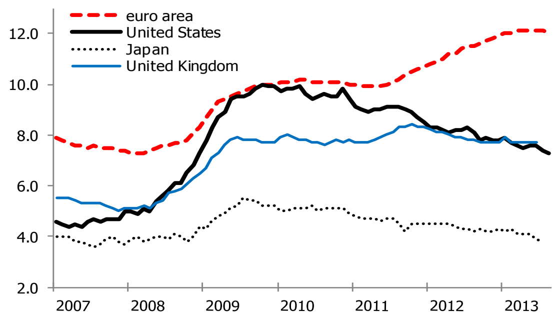
[1] The analysis is based on the ECB's monthly bulletin, July, August and September, 2013; press releases of "Markit Economics"; the "World Economic Outlook" of the IMF, October 2013; monthly reports of Deutsche Bank, and the IMF monthly press releases on the primary commodities market.
[2] "World Economic Outlook", IMF October 2013.
[3] Structural problems of emerging countries are in the field of infrastructure, labor market and investments.
[4] "World Economic Outlook", IMF October 2013.

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.

Unemployment in advanced economies
(in percent; seasonally adjusted monthly data)

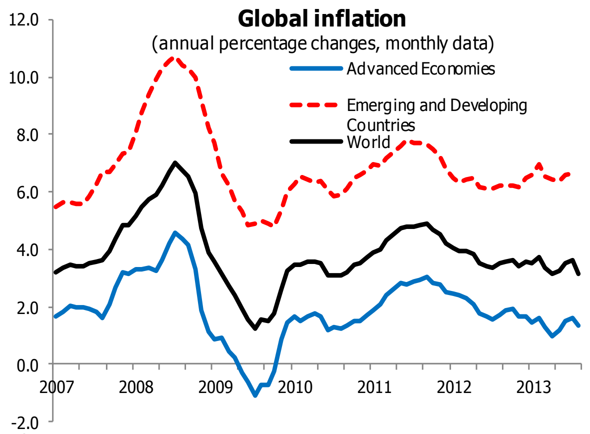


Source: Eurostat.

return to the positive zone of annual growth, projected at the level of 1%[5]. In the United States, in the second quarter of 2013, the quarterly economic growth rate accelerated to 0.6% (versus 0.3% in the previous quarter), whereby the GDP growth reached 1.6% on an annual basis[6]. This outturn was primarily driven by the growth in private consumption and investments, and the contribution of net exports is moderately negative, in circumstances of growth in both the exports and the imports. The decline in public consumption, although relatively lower compared to the previous two quarters, still acts in a downward direction. At the same time, the unemployment rate continued to decline, and in August it equaled 7.3%. However, the situation on the labor market remains unfavorable, as in the absence of growth in the number of new jobs created, these results are solely a reflection of the decline in the activity rate. In terms of expectations, the IMF anticipates that the annual growth rate for 2013 will remain at 1.6% and will increase to 2.6% in 2014, amid slowing fiscal consolidation, where growth will be encouraged by the stimulating monetary policy, improving household balance sheets and recovery of the real estate market. Leading indicators of economic activity - PMI[7] point to accelerated growth of the world economy in the short run. Thus, in the third quarter, the global composite PMI reached an average value of 54.2%, which is the highest level achieved since the first quarter of 2011. These movements are due to the improved outturn of the manufacturing industry and the services sector. Positive trends in the indicators of trust are recorded in both the USA and the Euro area, which is consistent with the recovered optimism among market participants. **In terms of projections for the global economy, in its October report, the IMF anticipates global growth of 2.9% for 2013 and 3.6% for 2014, which compared with the July forecast represents a downward revision of 0.3 i.e. 0.2 percentage points.** Downside risks are still largely prevailing. One of the short-term threats to the global economy is the uncertainty regarding the pace of resolving the fiscal problems of the United States related to the timely adoption of the budget for the upcoming fiscal year and the

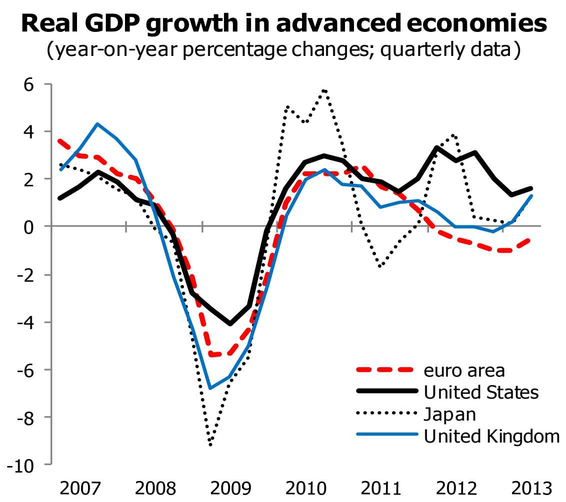
[5] "World Economic Outlook", IMF October 2013.
[6] According to the latest revised data.
[7] PMI (Purchasing Managers Index - PMI) are based on surveys of a representative sample of companies from the manufacturing and service sectors, and are often used as high frequency indicators of current and future economic activity.

increase of the public debt ceiling[8]. In the medium term, the risks pertain to the dangers of low and stagnant growth of the Euro area amid still present financial fragmentation; fiscal problems in the USA and Japan; as well as the capital outflow and lower potential growth in key emerging economies.



Source: IMF.

In the third quarter, global inflation recorded a slight acceleration on a quarterly basis. The average annual inflation rate[9] in the first two months of the third quarter equaled 3.4%, which is by 0.1 percentage point higher than the one registered in the previous quarter[10]. In circumstances of divergent growth of developed and emerging countries in the next period, the IMF envisages that inflation will be low on a global level also in the future. The inflation rate in developed economies for 2013, is expected to equal 1.4% (downward revision of 0.1 percentage point), in circumstances where economic activity will remain below potential. For 2013, the increase in the general price level in emerging countries is expected to be 6.2% (upward revision of 0.2%), which is due to the upward pressures expected from the depreciation of the exchange rates and the higher domestic demand in some of the emerging countries, as opposed to the fall in the prices of primary products and slower economic growth.



Source: Eurostat.

In the second quarter of 2013, the economy of the Euro area emerged from recession. Quarterly GDP growth of 0.3% was registered, which is the first positive growth rate in the last six quarters. On an annual basis, economic activity is still in the zone of negative change, and the fall of 0.5% is still slower compared to the previous quarter. The major economies of the Euro area, Germany and France, registered a significant quarterly GDP growth of 0.7% and 0.5%, respectively, giving a positive contribution to the increase in the overall economic activity of the Monetary Union. Thus, after the stagnation in the first quarter of 2013, the German economy grew again, due to the recovery of private consumption, investment and exports. At the same time, growth in private consumption and exports was the main

---

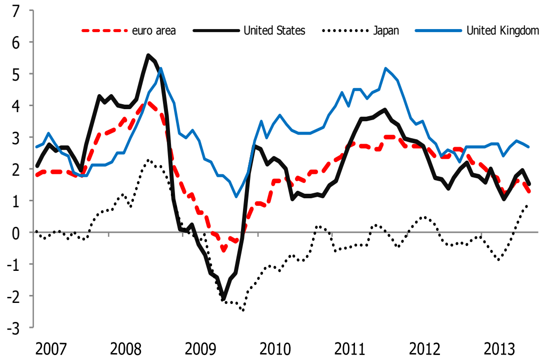
[8] For more than two weeks, as the deadline for reaching an agreement regarding the budget for the fiscal year which began on October 1, 2013 was exceeded, the work of U.S. government agencies with non-core services was halted, and 800 thousand federal workers were sent on forced leave. The resolution reached in the middle of the month, raised the debt ceiling, whereby a greater negative impact on global financial stability was avoided.

[9] Source of data is the database "International Financial Statistics" of the IMF.

[10] According to the latest revised data.

factor in overcoming the recession also in France. After a longer period of decline in the economic activity, favorable results were observed also in one of the countries affected by the debt crisis, Portugal, whose GDP registered a quarterly growth rate of 1.1%, which is the highest achievement at the level of the Euro area. The quarterly growth of Portugal is due to the increase in the exports and the smaller fall of investments. In the other peripheral economies, such as Spain and Italy, economic activity remains in the zone of negative quarterly changes, although with somewhat slower decline of their GDP (to -0.1% in the second quarter compared to -0.4% in the first quarter for Spain, and to -0.2% from -0.6% for Italy). In view of the structure of the GDP of the Euro area, the growth in domestic demand and net exports positively contributed to the quarterly increase. The quarterly growth of private consumption and investments corresponds with the gradual return of optimism among market participants, reflected by the more favorable performances of the confidence indicators. Given the recovery of the export and import component, net exports again registered positive quarterly growth rates. These changes are largely due to the strengthening of foreign demand. The unemployment rate on the labor market in the Euro area in August equaled 12%, and was unchanged compared to July (12.1%[11] in the April-June period). **The annual inflation in the Euro area remains below 2%.** The months of the third quarter were characterized by a trend of slowing annual inflation, which averaged to the level of 1.3%. Considering the components of the consumer price index, this is mainly due to the decline in the prices of the energy component in the last two months of the quarter, amid simultaneous slowdown in the growth of food prices. Available data indicate stable movements also in the core inflation[12], which averaged 1.1%.

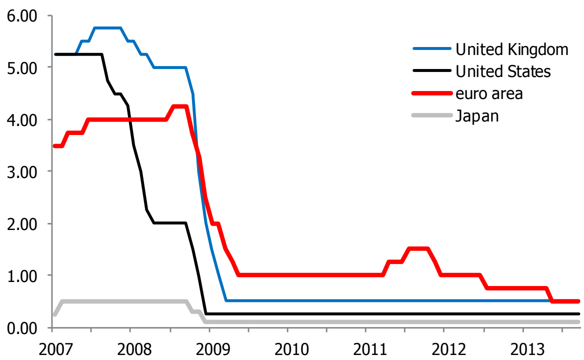
Inflation in advanced economies
(annual percentage changes; monthly data)



Source: Eurostat and national statistical offices.

The policy rates of the FED, ECB and the Bank of England remained unchanged in the third quarter of 2013, i.e. they are at levels near zero (0.25%, 0.5% and 0.5%, respectively). Amid almost reached lower threshold of the interest rate, in this quarter, ECB together with the Bank of England launched a new way of reporting on the future path of the policy rate (forward guidance). ECB started this manner of reporting with the statement for holding interest rates at current or lower level in the forthcoming period, at a time when inflation expectations are stable, and economic performance is weak. The

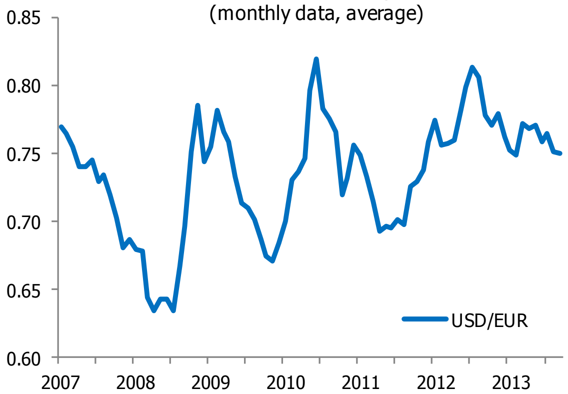
Policy rates in advanced economies
(in %)



Source: Central banks.

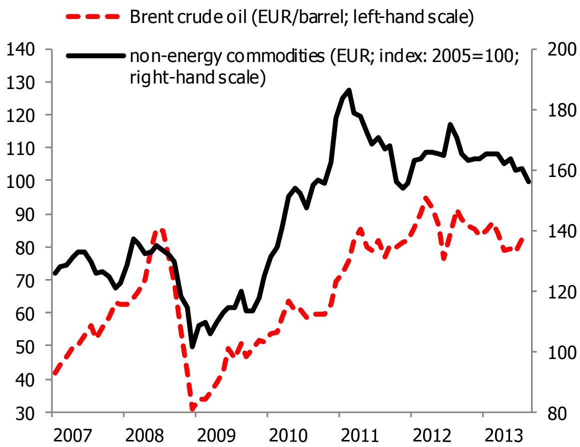
[11] According to the latest revised data.
[12] Overall index of consumer prices excluding the prices of energy, food, alcohol and tobacco.

USD/EUR Exchange rate
(monthly data, average)



Source: Eurostat.

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



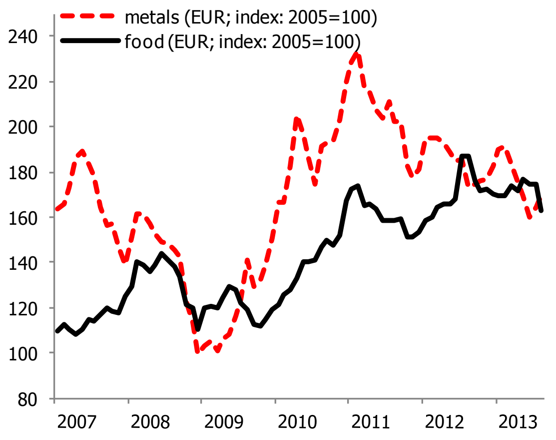
Source: IMF monthly database.

forward guidance is primarily aimed at reducing the volatility of interest rates and stabilizing the expectations about the key interest rate around the level that is necessary to maintain price stability. Unlike the ECB, which did not link the forward guidance to specific targets, the Bank of England announced that until the unemployment rate is above the threshold of 7%, it will not increase the key interest rate of 0.5%. Moreover, they announced willingness to further purchase assets if it is determined that such additional monetary stimulus is needed to reduce the unemployment rate. However, the measures would stop if the Monetary Policy Committee finds that it is likely that over the next 18 to 24 months inflation will exceed the target level of 2% by more than 0.5 percentage points, if the mid-term expectations for inflation destabilize or if it is assessed that the monetary policy which is conducted could threaten financial stability. As for the FED, at the meeting of the Federal Open Market Committee (FOMC) held on 09.17.2013 it was decided to postpone the start of the exit strategy from the quantitative easing until the US economy is not strong enough, or until targets for inflation and unemployment are reached.

In the third quarter of 2013, the nominal exchange rate of the Euro against the US Dollar was volatile, but on average, on quarterly and annual basis moderate appreciation was observed. Thus, in July 2013, the Euro depreciated by 0.8% on a monthly basis, while in August and September 2013, it appreciated by 1.8% and 0.2%, respectively. Such movements are primarily due to the improved economic confidence within the Euro area. On the other hand, announcements of the ECB for keeping interest rates low for an extended period of time may create pressures for depreciation of the Euro. In September 2013, one Euro was exchanged for 1.33 US Dollars, which is an appreciation of 3.8% compared to September 2012.

In the third quarter of 2013, oil prices increased compared to the previous quarter. Crude oil "Brent" in this period averaged Euro 83.12 per barrel, which is by 5.4% more compared with the previous quarter. The rise in oil prices is mainly due to the uncertainty and the growing tensions in the Middle East. Regarding the supply, recent developments in Egypt and Syria increased the risk of possible cuts in the supply of oil, which could not be supplemented by increasing the supply by Saudi Arabia, and which on average would reduce the total supply by OPEC countries.

Prices of food and metals
(monthly data)

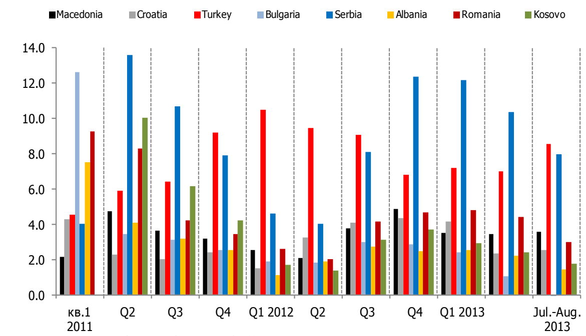


Source: IMF monthly database.

On the demand side, upward pressures on oil prices were stemming from the increased demand for refined oils, mainly by non-OPEC countries. **On the other hand, the price index of non-energy primary products**[13] **recorded quarterly fall in the third quarter,** with an average decline in metal prices of 1.1% and average decline in food prices of 3.4%. The decline in metal prices is primarily due to the lower global demand, despite the increased imports of metals by China. On the other hand, the fall in the prices of food is mostly associated with the positive expectations for the proceeds from this year's harvest. The announcement of the FED for gradual tapering of the third tranche of the quantitative easing starting from the end of 2013, also contributed to the fall in the prices of non-energy primary products.

In the second quarter of 2013, economic activity in most of the countries of the region grew moderately, although growth was different in individual countries. Specifically, Turkey recorded fast growth, while Serbia and Romania experienced slower growth in economic activity. On the other hand, decelerated economic activity in Croatia, which began six quarters ago, continued in the second quarter of 2013, while in the same quarter, Bulgaria registered a small decline in economic activity, for the first time since the first quarter of 2010.

Inflation in countries from the region
(annual percentage changes)



Source: Eurostat and national statistical offices.

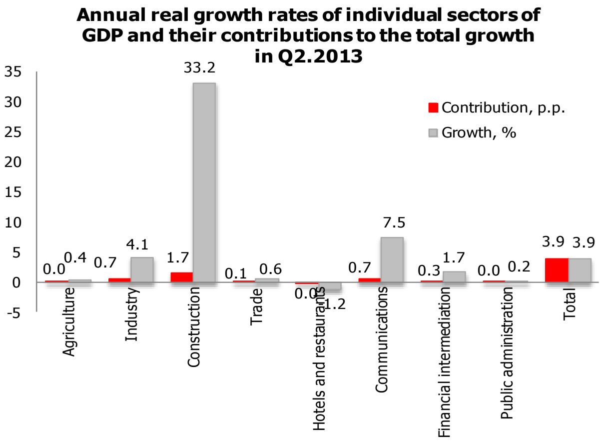
In the period July-August 2013, in most of the countries, a moderate reduction in the rate of inflation was registered, while Bulgaria experienced deflation. This movement in nearly all countries is a consequence of the moderate decline in the prices of food and beverages. In the case of Bulgaria, deflationary pressures primarily result from the fall in the prices of electricity, due to the reduction of administrative fees by the state regulatory commission, which was followed by a reduction in fuel and heating prices, and in housing costs.

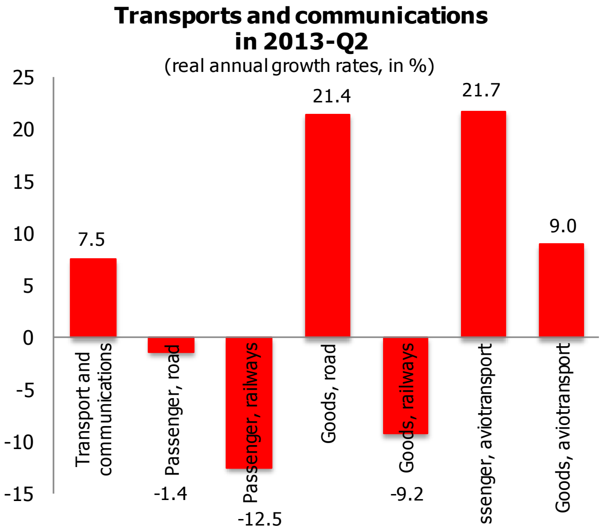
1.2. Domestic supply

The recovery of the domestic economy continued in the second quarter of 2013. Economic activity grew annually by 3.9%, which is the highest growth after that observed in the first quarter of 2011. On a quarterly basis, GDP continued to grow with a similar intensity as in the previous quarter, with the economy still being in the zone of positive quarterly changes, for the fifth consecutive quarter. In terms of individual sectors, in the second quarter the economic growth was dispersed. With the exception of catering, all other sectors

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

experienced positive economic outturn. Construction continues to have the highest individual contribution to the growth. Such an outturn is probably a combined effect of construction activities funded by private domestic and foreign investors and of the fiscal stimulus in the form of public infrastructural projects. In the second quarter, positive developments were observed also in the industry, with strengthening of the annual rate of growth, driven by the growth in the energy sector, and partly by the activity of the new foreign facilities. The degree of utilization of the industrial capacities grew in the second quarter and exceeded the long term average. According to the business tendency surveys, economic entities assessed the current economic situation as more favorable, but still they sent signals for less optimistic expectations in terms of the volume of production for the next quarter.





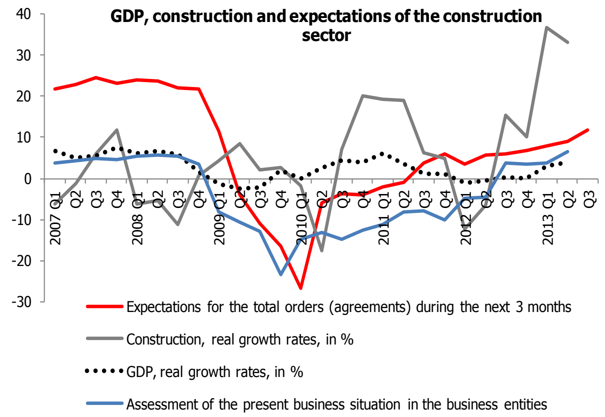
Source: State Statistical Office.

In the second quarter of 2013, gross domestic product[14] registered a quarterly growth of 1.3% (seasonally adjusted), whereby the economy is still in the zone of positive quarterly changes, for five consecutive quarters. On annual basis, the growth of domestic production accelerated and equaled 3.9%. Better quarterly outturn in the second quarter was mainly due to the growth of value added in "**industry**" with a somewhat lower contribution of "**trade**", "**construction**" and "**transport and communications**". On annual basis, the construction sector has been the largest driver of growth in the domestic economy for four consecutive quarters. At the same time, the outturn in the sectors "**transport and communications**" and "**industry**" gave positive and almost identical contribution to the growth, while somewhat smaller was the contribution of "financial intermediation" and "trade." In the second quarter, only the value added of "**catering**" declined on an annual basis, after the growth it experienced in the previous four quarters.

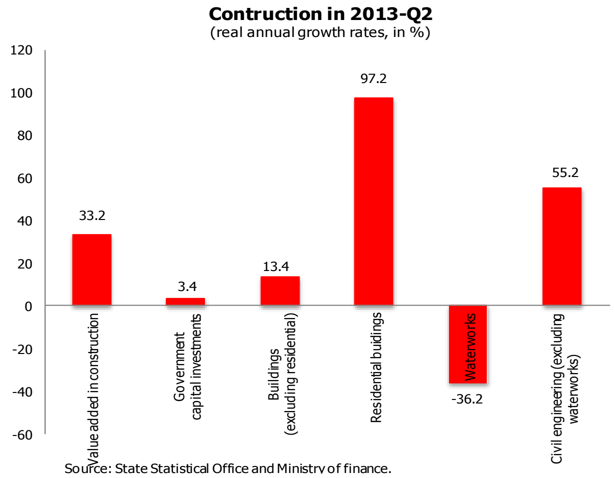
[14] Data on the annual change by quarter for 2013 are based on estimated data for 2012.

	annual growth rates, in %							contributions to GDP growth (in p.p.)						
	Q1 2012	Q2 2012	Q3 2012	Q4 2012	***2012.0***	Q1 2013	Q2 2013	Q1 2012	Q2 2012	Q3 2012	Q4 2012	***2012.0***	Q1 2013	Q2 2013
Agriculture	-1.5	1.7	0.4	2.4	***1.0***	1.0	0.4	-0.1	0.2	0.0	0.3	***0.1***	0.1	0.0
Industry	-11.8	-7.9	-7.3	-6.1	***-8.3***	0.7	4.1	-2.2	-1.3	-1.2	-0.9	***-1.4***	0.1	0.7
Construction	-12.4	-6.4	15.4	10.2	***3.9***	36.8	33.2	-0.5	-0.3	0.8	0.6	***0.2***	1.2	1.7
Trade	-0.1	-2.2	0.9	0.4	***-0.3***	2.3	0.6	0.0	-0.3	0.1	0.1	***0.0***	0.3	0.1
Hotels and restaurants	-0.6	3.5	3.8	2.9	***2.7***	1.6	-1.2	0.0	0.0	0.1	0.0	***0.0***	0.0	0.0
Communications	5.8	-1.2	2.5	-1.7	***1.2***	2.5	7.5	0.6	-0.1	0.2	-0.2	***0.1***	0.3	0.7
Financial intermediation	4.0	4.2	1.8	2.5	***3.1***	2.5	1.7	0.7	0.7	0.3	0.4	***0.5***	0.5	0.3
Public administration	1.4	1.5	1.7	2.7	***1.8***	0.5	0.2	0.2	0.2	0.2	0.3	***0.2***	0.1	0.0
Value Added	-1.9	-1.5	0.4	0.4	***-0.6***	3.0	4.1	-1.7	-1.3	0.3	0.3	***-0.5***	2.6	3.6
Net taxes on products	6.9	5.9	0.7	-0.9	***2.5***	2.7	2.5	0.8	0.8	0.1	-0.1	***0.4***	0.4	0.3
Gross Domestic Product	***-1.0***	***-0.6***	***0.4***	***0.1***	***-0.2***	***2.9***	***3.9***	***-1.0***	***-0.6***	***0.4***	***0.1***	***-0.2***	***2.9***	***3.9***

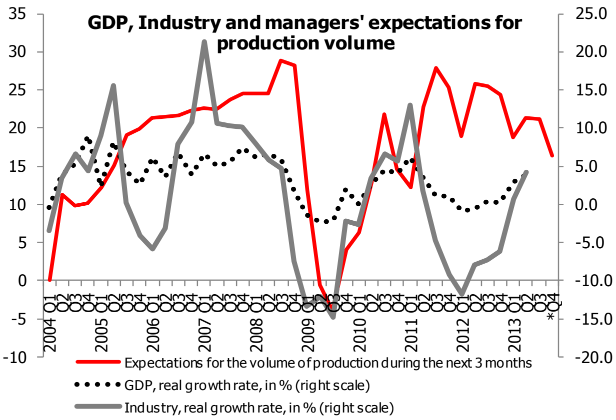
Source: State Statistical Office and NBRM calculations.



Source: State Statistical Office.



Source: State Statistical Office and Ministry of finance.

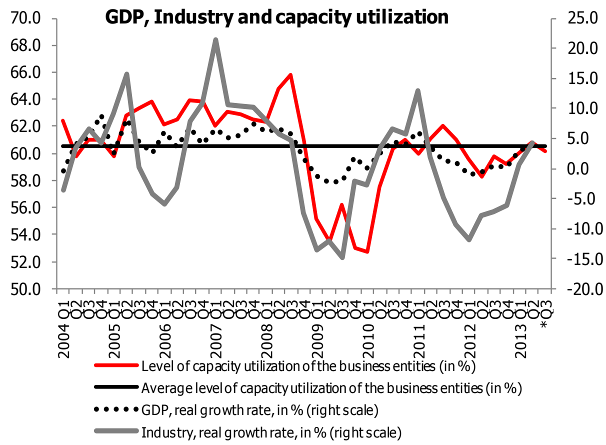


Source: State Statistical Office.
* average of expectations for 7 and 8 month of 2013.

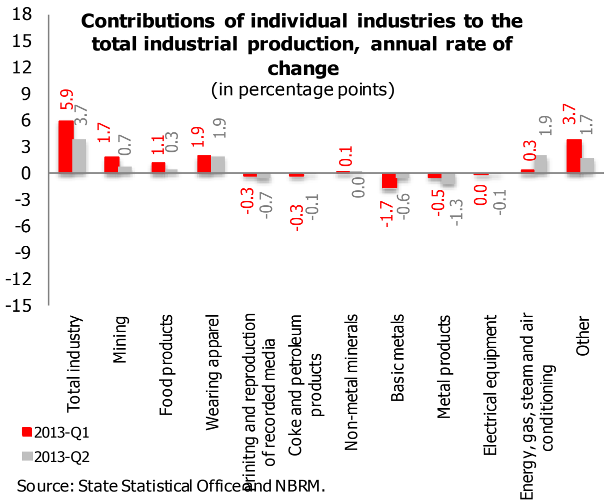
The steady growth in construction activity, on both quarterly[15] and annual basis, continued in the second quarter of this year. Although with slight slowdown in the quarterly and annual dynamics, construction was most conducive to economic growth for the past four quarters. The fast double-digit growth was largely due to the construction activity, i.e. public and private investments in the field of civil engineering and residential buildings. The significantly more favorable assessment of the managers regarding the economic condition of the business entities in the Business Tendency Survey in **construction**[16], confirms the positive climate in the construction sector. Positive perceptions of enterprises, according to the Survey, are a result of the reduced impact of certain limiting factors for improvement of the construction activity. There is an assessment for less restrictive impact of adverse weather conditions, rising costs for materials and labor, and less impact of the lack of trained staff and competition in the construction sector. Also, as of the first quarter of 2012, positive outnumber the negative perceptions regarding the financial condition of companies, while since the beginning of this year, companies give more positive assessment of the situation with delayed payments from customers. In terms of the expectations of the managers of construction companies for the next three months, there is an increased optimism compared to the previous quarter regarding the expectations for signing new contracts and regarding the number of employees, with prevailing expectations for growth in selling prices.

The quarterly increase in the industrial activity in the first quarter slowed down[17] in the second quarter. On annual basis, the growth of value added in the industry accelerated. Such a better outturn is associated with the improved hydrological conditions that contribute to the growth of

[15] Analyzed on a seasonally-adjusted basis.
[16] Refers to the second quarter of 2013.
[17] Analyzed on a seasonally-adjusted basis.



Source: State Statistical Office.
* average for 7 and 8 month of 2013.



Source: State Statistical Office and NBRM.

electricity production and the activity of the new export-oriented foreign facilities, which in circumstances of reduced foreign effective demand for Macedonian products contribute positively to the activity in the domestic industry. The largest contribution to the annual growth in the second quarter was that of the production of electricity, followed by the manufacturing industry, where the growth in the production of garments, textiles, beverages, and machinery and equipment contributed to the higher value added in industry. At the same time, mining gave a small positive contribution.

Better outturn in industry is confirmed by the Business Tendency Survey in the **manufacturing industry.** The average capacity utilization in the second quarter increased on both quarterly and annual basis. Thus, the average utilization has exceeded the historical average of the past eight years. Moreover, compared to the previous quarter, the companies have more positively evaluated the current economic situation, and the current production volume. In terms of the factors that limit the increase in production, the Survey points to a reduced impact of the uncertain economic environment and lack of raw materials, as well as of the insufficient foreign demand and shortage of skilled labor. The assessments in the Surveys for the first two months of the third quarter of 2013 indicate a slightly lower optimism of companies concerning the production volume, amid reduced average capacity utilization. Thus, despite the reduced limiting impact of the insufficient domestic and foreign demand, the limiting impact of the lack of skilled labor and the uncertain economic environment increased. Such assessments resulted in worsened expectations for the next three months, for both the volume of production, and for the purchasing prices of inputs and selling prices of finished goods.

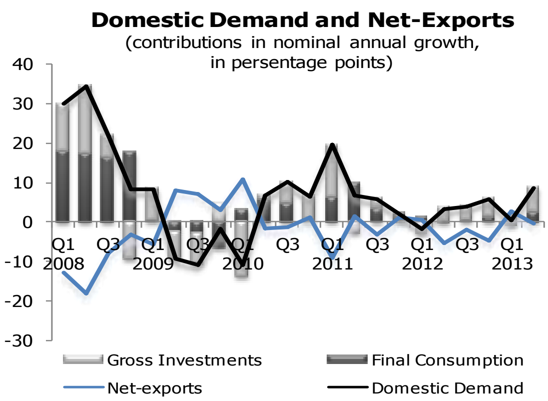
In the second quarter of 2013, there was a slight acceleration of the quarterly growth and a slowdown in the annual growth of value added in trade. Amid positive growth in private consumption, the increased trading resulted from the annual growth of trade in motor vehicles and wholesale trade, while retail trade declined. Unfavorable developments in retail trade were evident also from the Survey completed by the managers in **retail trade**[18] whose assessments indicate deterioration of the current financial

[18] Business Tendency Survey in retail, of the SSO for the second quarter of 2013.

condition of these companies, compared with the previous quarter. According to their findings, there is an increasingly limiting effect of the increased supply on the market, lack of trained staff and high financial costs. The expectations of company managers are slightly worse in terms of the business condition in the next six-month period, with reduced optimism regarding the growth of selling prices in the next three to four months.

1.3. Aggregate demand

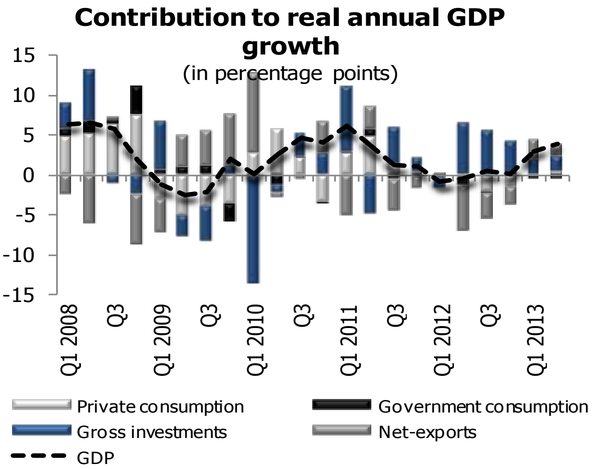
The strong annual economic growth in the second quarter of 2013 is due to the positive contribution of domestic demand and net exports. In the second quarter, exports of goods and services recorded a significant annual growth, making the largest individual contribution to the GDP growth. Amid still insufficiently recovered foreign demand and unfavorable terms of trade, export growth results from the increased exports of new facilities in the free economic zones. Investments remain one of the most important factors for growth, with further strong growth in construction activity given the increased foreign direct investments and government capital investments. Besides investments, within the domestic demand, the household consumption made a positive contribution to the growth, which increased after four quarters of decline, given the favorable trends in the labor market. In contrast, public spending in this quarter made a negative contribution to the growth. Import of goods and services returned to the zone of positive annual growth, but at a pace insufficient to offset the positive contribution of exports, so net exports made a positive contribution to the GDP growth.



Source: State Statistical Office and NBRM calculations.

Analyzing the demand, in the second quarter of 2013, same as the previous quarter, the annual GDP growth resulted from domestic factors and net exports, with both components making equal contribution. Observing the individual components, exports made the largest contribution. Against the background of still relatively unfavorable global economic environment, the resilience of exports results from the production facilities of foreign direct investors that are already operating in the free economic zones. Gross investments, which has been increasing five quarters in a row, again had a significant input to the growth, making this investment the main driver of the growth of domestic demand. The economic growth was accompanied by favorable developments in the labor market, where the number of employed persons recorded higher growth again. The above, coupled with the slower real fall of wages and rise of pensions, contributed to minor growth of private consumption after four quarters of decline. On the other hand, public consumption again declined.

Export growth, and particularly investment activity, increased the demand for imports, returning it to the zone of positive growth rates.

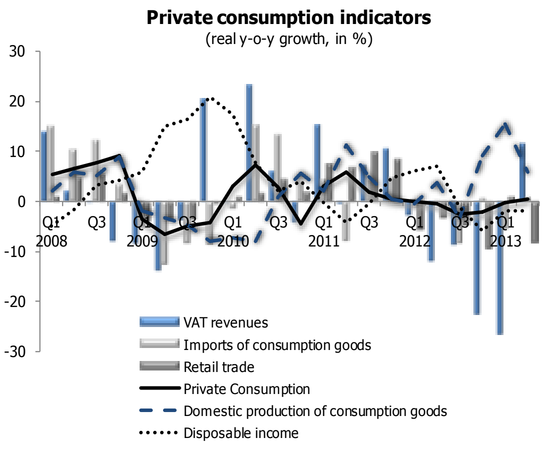


Source: State Statistical Office and NBRM calculations.

Real annual growth rates (%)

	2010-Q1	2010-Q2	2010-Q3	2010-Q4	2010	2011-Q1	2011-Q2	2011-Q3	2011-Q4	2011	2012-Q1	2012-Q2	2012-Q3	2012-Q4	2012	2013-Q1	2013-Q2
Private consumption	3.3	7.4	2.8	-4.3	2.1	3.2	6.1	1.9	0.5	2.9	0.1	-0.3	-2.5	-2.0	-1.2	-0.1	0.7
Government consumption	-0.6	-7.1	0.7	-0.8	-2.0	0.7	4.9	-2.7	-0.2	0.6	-1.8	-5.4	-1.4	0.1	-2.2	-1.5	-3.6
Gross investment	-47.6	-3.1	15.1	9.0	-6.7	55.4	-20.0	21.9	5.6	9.6	-5.8	34.7	22.9	13.1	16.0	9.4	7.0
Exports of goods and services	10.0	17.7	24.8	40.1	23.6	36.3	12.0	2.6	-0.4	10.5	0.2	0.7	-1.3	0.6	0.0	-0.3	6.8
Imports of goods and services	-10.2	12.8	18.8	16.0	9.5	33.3	3.6	8.6	2.2	10.4	-0.3	9.5	3.9	3.8	4.2	-3.7	2.3
Domestic demand	-8.3	3.0	4.5	-0.6	-0.3	9.2	0.7	4.8	1.8	3.9	-1.3	4.5	2.9	2.3	2.2	1.3	1.4
*Net exports**	*-35.1*	*3.6*	*2.9*	*-16.3*	*-13.8*	*27.1*	*-14.1*	*28.1*	*7.9*	*10.1*	*-1.2*	*33.8*	*17.4*	*10.5*	*14.2*	*-11.3*	*-7.0*
GDP	**0.0**	**2.5**	**4.5**	**4.0**	**2.9**	**6.1**	**3.6**	**1.2**	**1.0**	**2.8**	**-1.0**	**-0.6**	**0.4**	**0.1**	**-0.2**	**2.9**	**3.9**

**decrease represents lower deficit*
Source: SSO and NBRM calculations.



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

1.3.1. Private consumption

In the second quarter of 2013, the private consumption registered an annual growth after four quarters of steady decrease. The annual growth equaled 0.7%, and compared with the previous quarter, it grew by 1.3% (seasonally adjusted). The positive shift in consumer spending is partly due to the rapid annual growth of the wage bill, given the rapid annual growth in the number of employed persons, while real wages marked slowdown in their fall. At the same time, pensions recorded a rapid real growth, as well. Household lending continued to grow, at almost the same pace as in the previous quarter. The banks' assessments indicate increased credit demand given the eased lending terms, particularly in respect of interest rate[19]. Increased spending is also confirmed by the higher import of consumer goods, which recorded a solid real growth vis-à-vis the decline in the previous quarter, while the domestic production of these products also increased, though at a slower pace. VAT revenues also increased annually. On the other hand, the retail trade data are incompatible with these movements. After the

[19] NBRM's Lending Survey conducted in July 2013.

negligible growth in the previous quarter, retail trade was back in the zone of negative growth rates, with the greatest decline being recorded in the trade in food, beverages and tobacco. This is consistent with the estimates of the managers of retail trade businesses, which assess less favorable economic situation for the firms and increased stocks compared to the same quarter last year[20].

The latest available data[21] for the third quarter of 2013 are divergent and indicate no significant recovery in private consumption. Lending to households, primarily in the form of consumer loans, was strengthening despite the banks' expectations for mainly unchanged terms of lending and demand in the third quarter[22]. In addition, pensions continued to increase at nearly the same pace as in the previous quarter. Domestic production of consumer goods also accelerated but at a slower pace. In contrast, net wages, as the most important factor for financing the consumption, drop at a faster pace, amid slower growth of nominal wages and inflation. Both import of consumer goods and net VAT income registered a real decline, which is consistent with the faster decline in retail trade. However, the expectations of managers of retail businesses do not indicate deterioration, i.e. show almost unchanged expectations regarding the orders in the third quarter and the business environment in the next six months compared to the previous quarter, while regarding the number of employees, their expectations[23] are more favorable.

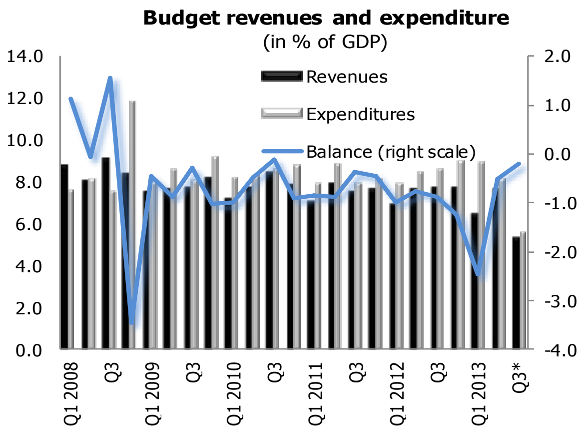
1.3.2. Public consumption

In the second quarter of 2013, public expenditure registered a quarterly decline of 3.3% (seasonally adjusted), causing an intensive annual decrease of 3.6% (down from 1.5% in the first quarter). However, the available data in August 2013 indicate a possible increase of **public spending in the third quarter**, amid slower decline of wages and rise of costs of health care and of goods and services.

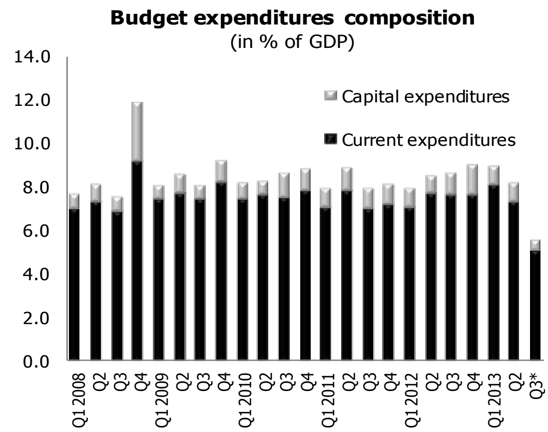
[20] SSO's Survey on Business Tendencies in retail trade conducted in the second quarter of 2013.
[21] Data on domestic production of consumer goods, pensions, VAT, import of consumer goods and household loans are as of August, while the data on wages and retail trade are as of July.
[22] NBRM's Lending Survey conducted in July 2013.
[23] SSO's Survey on Business Tendencies in retail trade conducted in the second quarter of 2013.

Box 1. Fiscal policy

During the second quarter of 2013, total revenues of 7.6% of GDP[24] were generated in the budget of the Republic of Macedonia (central budget and budgets of funds), which is almost at the level of budget revenues in the same period last year (7.7% of GDP). In nominal terms, in the second quarter, the amount of revenues increased by 2.9% annually. The structural analysis of total budget revenues shows higher tax revenues on an annual basis (7.7%), with the largest contribution being made by the improved VAT revenues, which were by 15.6% higher, on an annual basis. Growth was registered in both income tax and revenues from import duties (4.7% and 9.2%, respectively), while revenues from excise and income tax decreased on an annual basis by 5.6% and 5%, respectively. Total annual social security contributions were up 2.5%, contributing 0.7 percentage points to the growth of total revenues, whereas non-tax revenues of 29.7% decreased on an annual basis.



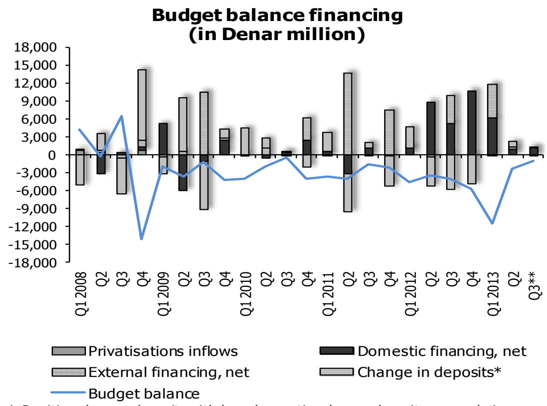
*Refers to July and August 2013
Source: Ministry of Finance.



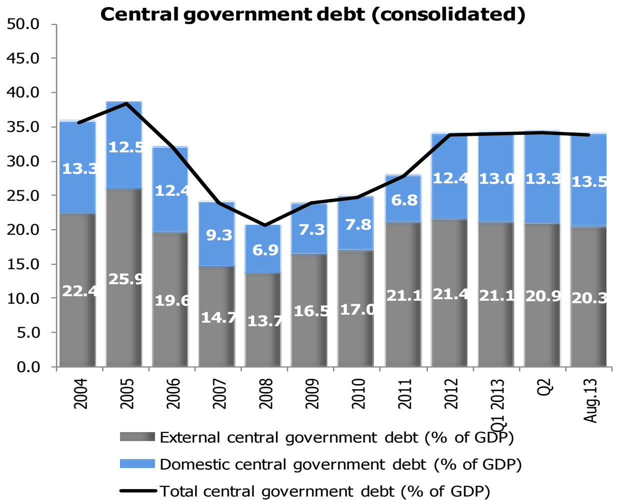
*Refers to July and August 2013.
Source: Ministry of Finance.

During the second quarter of 2013, the total budget expenditures amounted to 8.1% of GDP, compared to 8.5% of GDP in the same period last year. In nominal terms, in the second quarter, the total budget expenditures were lower by 0.3%, on an annual basis. The budget cut results solely from the lower levels of current expenditures (by 1.1% annually), primarily due to the lower level of expenditures on transfers. A decrease was also noted in the cost of wages and benefits, while expenditures on goods and services rose on an annual basis. In the second quarter, the capital expenditures were by 7.2% higher, on an annual basis, making a positive contribution to the change in total budget expenditures (of 0.7 percentage points).

[24] The analysis uses annualized GDP.



* Positive change- deposits withdrawal; negative change-deposits accumulation.
** Refers to July and August 2013.
Source: Ministry of finance of the Republic of Macedonia.



Source: Ministry of Finance of the Republic of Macedonia.

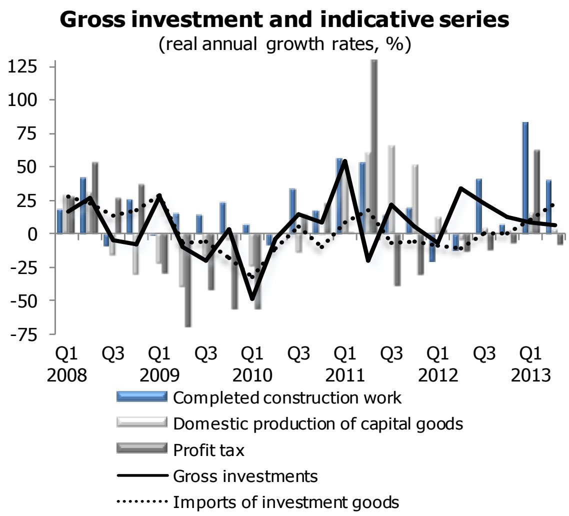
During the second quarter of 2013, the budget deficit amounted to Denar 2,370 million, or 0.5% of GDP. In this period, budget deficit was financed from a mix of domestic and external sources. Thus, the borrowing on the domestic market through new issues of government securities mobilized net inflows of Denar 653 million in total, while the net foreign debt totaled Denar 433 million. In this period, the budget deficit was also financed by using government deposits with the NBRM in the amount of Denar 859 million.

In the period July-August 2013, total revenues continued to grow increasingly, being by 6.2% higher relative to the same period last year. In this period, the increase of non-tax revenues (annual growth of 43.5%) made the greatest contribution to the acceleration of the growth of total revenues, while the growth of tax revenues slowed down to 1.2%, on an annual basis. **In this period, the total expenditures increased by 1.5% annually,** mostly arising from the higher level of capital costs (with an annual growth of 11.3%), which account for 1 percentage point of the growth of total budget expenditures. Current expenditures slightly increased annually by 0.6%. **During the period July-August, budget deficit totaled Denar 987 million,** primarily funded from domestic sources through government borrowing on the domestic securities market. According to the latest available data, the debt of the central government (consolidated) amounted to 33.8% of GDP, as at 31 August 2013.

Table 1
Budget of the Republic of Macedonia (Central budget and funds' budget)

	2013 Budget	Q1	Q3	Jul-Aug	January-August 2013	Y-o-Y changes , 2013 period over the same period of the previous year, in %			Contribution to annual change, 2013 period over the same period of the previous year, in p.p.		
	plan in Denar million	realized, in Denar million				Q1	Q2	Jul-Aug	Q1	Q2	Jul-Aug
TOTAL BUDGET REVENUES	**147,958**	**29,901**	**36,151**	**25,828**	**91,880**	**-6.0**	**2.9**	**6.2**	**-6.0**	**2.9**	**6.2**
Revenues base on taxes and contributi	125,555	26,476	30,665	21,542	78,683	-5.0	5.9	2.4	-4.4	4.8	2.1
Tax revenues	81,685	16,507	20,015	14,193	50,715	-9.4	7.7	1.2	-5.4	4.1	0.7
Contributions	42,842	9,720	10,436	7,204	27,360	2.9	2.5	5.0	0.9	0.7	1.4
Non-tax revenues	13,836	2,570	2,165	3,371	8,106	-7.6	-29.7	43.5	-0.7	-2.6	4.2
Capital revenues	4,432	299	2,461	235	2,995	-59.9	-8.8	-45.3	-1.4	-0.7	-0.8
Donations from abroad	3,535	456	752	636	1,844	62.9	154.1	68.7	0.6	1.3	1.1
Revenues of recovered loans	600	100	108	44	252	-15.3	11.3	-63.9	-0.1	0.0	-0.3
TOTAL BUDGET EXPENDITURES	**165,653**	**41,348**	**38,521**	**26,815**	**106,684**	**13.8**	**-0.3**	**1.5**	**13.8**	**-0.3**	**1.5**
Current expenditures	146,944	37,303	34,538	24,238	96,079	16.2	-1.1	0.6	14.3	-1.0	0.5
Capital expenditures	18,709	4,045	3,983	2,577	10,605	-4.0	7.2	11.3	-0.5	0.7	1.0
BUDGET DEFICIT / SURPLUS	**-17,695**	**-11,447**	**-2,370**	**-987**	**-14,804**	**152.7**	**-32.6**	**-53.0**			
Financing	17,695	11,447	2,370	987	14,804						
Inflow	**33,464**	**23,234**	**4,425**	**1,509**	**29,168**						
Revenues based on privatisation	0	30	240	0	270						
Foreign loans	17,758	16,726	1,025	393	18,740						
Deposits	12,022	299	859	-146	416						
Treasury bills	3,589	6,111	2,116	1,262	9,489						
Sale of shares	95	68	185	0	253						
Outflow	**15,769**	**11,787**	**2,055**	**522**	**14,364**						
Repayment of principal	15,769	11,787	2,055	522	14,364						
External debt	13,896	11,655	592	390	12,637						
Domestic debt	1,873	132	1,463	132	1,727						

Source: Ministry of Finance of the Republic of Macedonia.



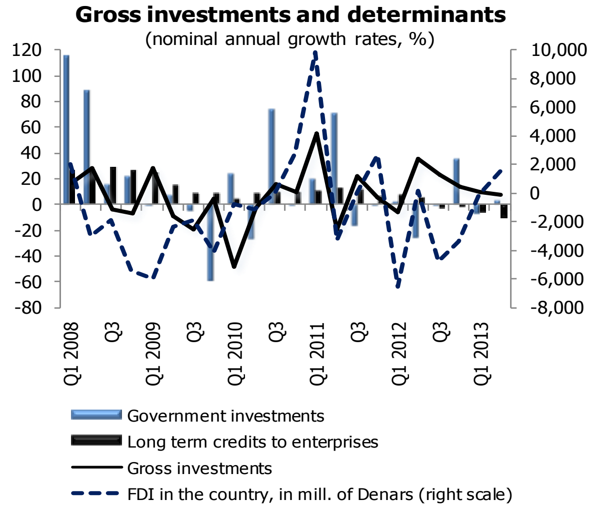
Source: State Statistical Office, Ministry of Finance and NBRM calculations.

1.3.3. Investment consumption

Gross capital formation has been increasing five quarters in a row, which is the longest series of consecutive growth since 2004. However, the annual growth has noticed a downward trend and reduced to 7% in the second quarter of 2013. Growth was also registered on a quarterly basis, of 9.6% (seasonally adjusted). The strong construction activity is a major factor in the annual growth of investment, which registered almost the same growth rate as in the first quarter. Managers confirm the positive climate in the construction sector, taking into account the significantly favorable assessment of the economic situation of businesses[25]. Construction also stimulates import of investment goods, which registered a rapid annual growth. The domestic production of capital goods also increased, though at a slower pace. Positive signals are received from financing factors, as well. Thus after several quarters of decline, foreign direct investment increased. The government also took stimulating measures, with its capital costs registering an annual growth

[25] SSO's Survey on Business Tendencies in construction sector conducted in the second quarter of 2013.

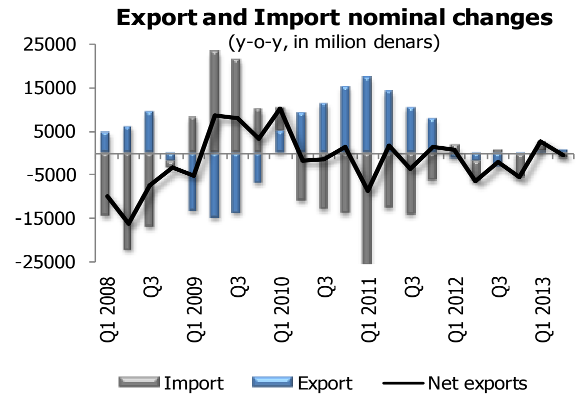
against the decline in the previous quarter. In contrast, long-term corporate lending still severely decreases, which is consistent with banks' assessments for further net tightening of the terms of lending to the corporate sector in the second quarter, with the risk perception still being the underlying reason behind the conservative credit policy[26]. **The latest available indicative data on the investment activity for the third quarter of 2013 mainly suggest maintaining of the annual growth rate[27].** The increased foreign direct investment and the increased annual growth of government capital expenditures reflect favorable trends. These developments are aligned with the domestic production of capital goods, which also registered a strong growth. Some favorable changes were observed in the corporate lending, with the long-term lending registering a significant slowdown of the fall. On the other hand, import of equipment and machinery registered a significant annual real decline versus the growth in the previous quarter. Data on completed construction works also shows a minimal real annual rate of decline, due to the high base effect. With the exhaustion of the base effect in the coming months, construction is expected to resurge, most probably at a slower pace, taking into account the annual decline of the value of construction licenses since May. These developments are partly compatible with the expectations of construction managers. The managers expect the period of securing new works to reduce, but on the other hand, they express more favorable expectations in terms of orders and the number of employees in the previous quarter[28].



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

1.3.4. Net export demand

In the second quarter of 2013, the impulses from foreign demand remained relatively weak and the conjuncture in the world metal markets worsened. Notwithstanding these developments, exports recorded a solid growth due to the increased exports of the new facilities operating in the free economic zones, which make them resilient to unfavorable external factors. While exports and domestic demand increased, imports of goods and service registered a real annual growth. Since the growth of exports exceeded that of the



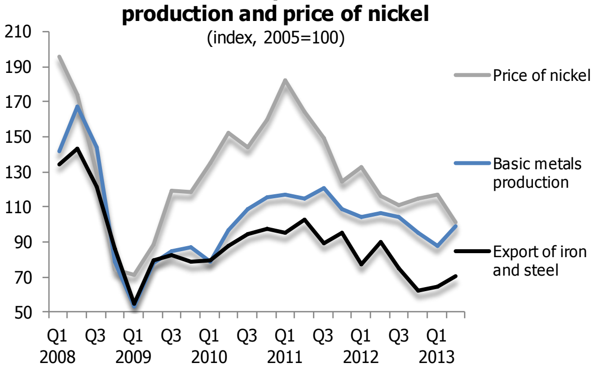
Source: State Statistical Office .

[26] NBRM's Lending Survey conducted in July 2013.
[27] Data on completed construction works and foreign direct investments are as of July, while other data are as of August.
[28] SSO's Survey on Business Tendencies in construction sector conducted in the second quarter of 2013.

imports, foreign trade deficit reduced, and therefore, in the second quarter of 2013, net exports again made a positive contribution to the GDP growth.

Exports has been recording a quarterly growth for three consecutive quarters, and in the second quarter of 2013, it registered a quarterly growth of 3.2% (seasonally adjusted). Hence, on an annual basis, after the minimum decline in the previous quarter, exports recorded a significant real growth of 6.8%, thus making the largest individual contribution to the overall GDP growth. Such solid developments result primarily from the new capacities operating in the free economic zones, which have a positive effect on exports and the overall economy. As for external factors, foreign effective demand, although still in the zone of negative growth rates, registered a substantial slowdown of its decline, which mainly comes from the trade partners from the European economy. On the other hand, metal prices show enhanced annual decline, still limiting the export supply of the metal industry. Besides the quarterly growth (seasonally adjusted) of 4.6%, the import of goods and services also registered a real annual growth of 2.3%, against the decline in the previous quarter. The long lasting growth of investment activity increased the imports of machinery and equipment, and created a need for construction services from abroad, as well as other business services.

Iron and steel export, base metals production and price of nickel
(index, 2005=100)



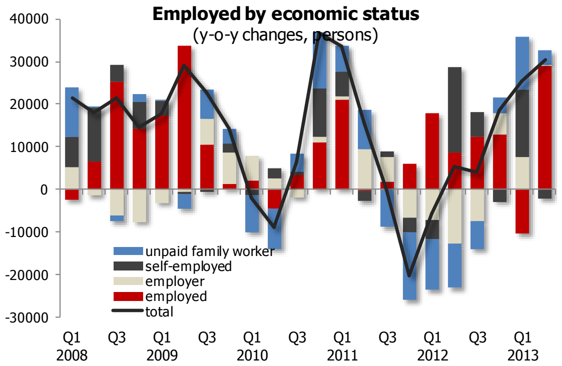
Source: State Statistical Office, IMF monthly database and NBRM calculations.

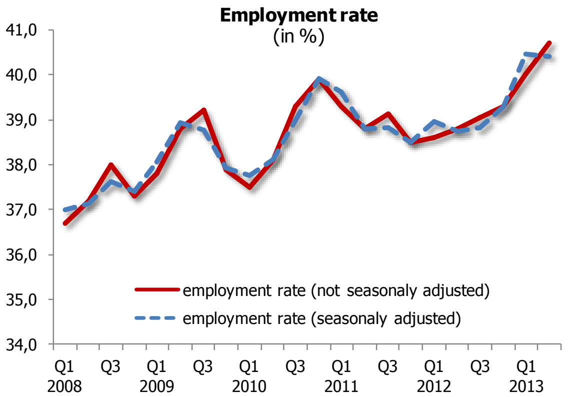
The latest data on the third quarter point to a slight narrowing of the foreign trade deficit. In the first two months of the third quarter of 2013, nominal exports of goods increased, mainly due to the growth of some of our most important export categories such as clothing and chemical products, as well as investment goods. These developments are in line with the growth of industrial output, against the backdrop of further deceleration of the decline of foreign demand, as well as the slower decline of metal prices. Despite the growth of exports, the trade balance further narrowed due to the reduced imports, which recorded a slowdown of its nominal decline.

1.4. Employment and wages

In the second quarter, some labor market indicators further improved. Thus, the number of employed persons increased both quarterly and annually, which is consistent with the improved economic performance. Greater resilience of the domestic economy and the labor market to the unfavorable global environment is partly associated with the new production capacities operating in

the free economic zones, as well as the foreign investments in the construction sector. Same effect was made by the fiscal stimulus in the form of publicly funded construction works, and the government programs and employment measures that have been undertaken for several consecutive years and have been yielding positive results for the domestic economy. In terms of labor cost, there is a moderate acceleration of the annual nominal wage growth and further slowdown of their real decline. The aggregated signals from the surveys on business tendencies regarding the future labor market developments show stronger optimism about the number of employees for the next three months. Besides the positive developments in the domestic economy, these trends are partly due to the gradual recovery of the global economy.

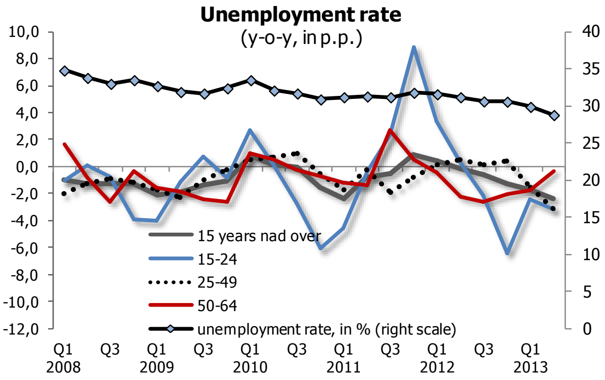




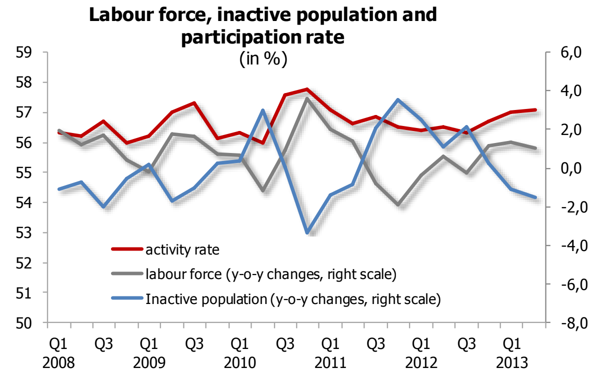
Source: State Statistical Office, Labour Force Survey.

In the second quarter, the number of employed persons increased quarterly by 1.4%, while seasonally adjusted, the employment records a minimum quarterly[29] fall (0.4%). Downward correction was made after the extremely high employment growth in the previous quarter. Analyzed in terms of economic status, there is a quarterly decline of the employment of employers and unpaid family workers. Analyzed by sector, the decline was mostly associated with the agriculture and comes after the record[30] high growth of employment in this sector in the previous quarter. In other sectors, the number of employees increased on a quarterly basis. The employment growth rate was up 0.7 percentage points, on a quarterly basis. **On an annual basis, the number of employed persons grew by 4.7%, which is an additional reinforcement of the positive movement.** This shift triggered an annual growth of the employment rate of 1.9 percentage points, to 40.7%, hitting record high. This movement indicates positive spillover effects of the recovery of economic activity, continuously present in the last four quarters. Analyzed by sector, the annual employment growth was mostly associated with construction, followed by transport, storage and communications. The role of these sectors as buffers against the negative effects on the labor market of the last recession is largely attributable to the publicly funded construction works and foreign investments in real estate. Employment growth in transport, storage and communications is perceived as positive externality of the operations of the new capacities with foreign capital, and the construction activities, since they complement each other. According to the Vacancy

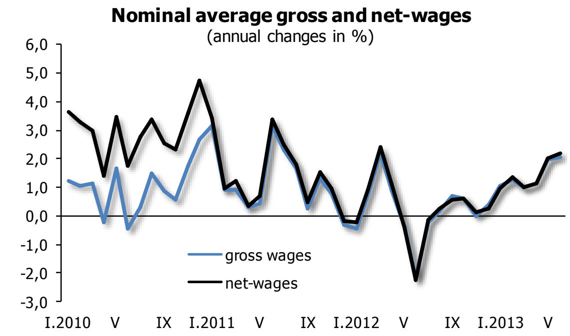
[29] The analysis of quarterly movements in the employment, unemployment and the total active population was made using seasonally adjusted data.
[30] The first quarter recorded an upward trend, which is the highest in seven years.



Source: State Statistical Office, Labor Force Survey.



Source: State Statistical Office, Labor Force Survey.



Source: State Statistical Office.

Survey[31], about 17% of new or vacant jobs in the second quarter relates to these sectors.

The aggregated signals from the surveys on business tendencies[32] indicate strengthening of optimism in terms of number of employees for the next three-month period. This trend corresponds to the positive developments in the domestic economy as well as the gradual recovery of the global economy that started in the euro area this quarter. Along with the expected positive shift in the economic activity in the euro area in the third quarter, there are increasingly stronger signals to improve the business environment in Germany (our major trading partner), which most probably have a significant impact on the optimism of domestic managers.

The insignificant quarterly decrease of demand (concentrated in agriculture) was followed by the quarterly decrease of labor supply. Thus the number of active population decreased by 1.2%. The slower reduction of labor, relative to the reduction of inactive population, determined a slight upward quarterly shift of the rate of activity to 57.1%. **On the other hand, the number of total active population went up by 1.1% relative to the same period last year**, which, given the decrease of the number of inactive population, increased the activity rate, whose pace remained unchanged compared with the previous quarter.

With the fall of labor supply exceeding the fall of labor demand, unemployment registered a quarterly downward trend. The quarterly fall of 3.1%, adds to the strengthening of the trend of downward adjustment of the number of unemployed persons. The annual reduction of the number of unemployed persons of 6.9% is attributed to the stronger labor demand growth compared to the growth of labor supply. The unemployment rate also decreased annually (by 2.4 percentage points) to the lowest historical level of 28.8%.

The average wages paid in the second quarter show a moderate

---

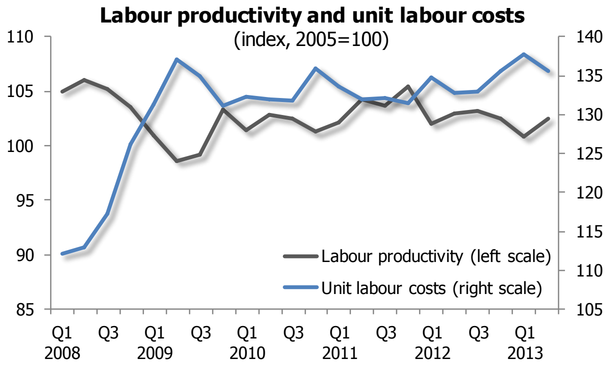
[31] In 2012, the State Statistical Office began to conduct a Vacancy Survey for the first time, as a part of the labor market research. The purpose of this survey is quarterly information on vacancies in the companies in the Republic of Macedonia as an important indicator of the macroeconomic developments and labor market policies.

[32] Source: State Statistical Office, Surveys on Business Tendencies in the manufacturing industry (August 2013), construction (second quarter of 2013) and trade (second quarter of 2013).

Annual changes in average paid net wage by sectors in Q2.2013
(in %)

	nominal changes	real changes
Total	1.8	-1.8
Agriculture, forestry and fishing	-2.0	-5.4
Mining and quarrying	5.8	2.1
Manufacturing	4.5	0.8
Electricity supply	2.0	-1.6
Water supply	-0.3	-3.8
Construction	5.3	1.6
Trade	1.8	-1.8
Transportation and storage	6.0	2.3
Accomodation and food service activities	0.8	-2.8
Information and communication	4.3	0.7
Financial and insurance activities	0.6	-3.0
Real estate activities	0.4	-3.1
Scientific activities	-0.5	-4.0
Administrative activities	0.1	-3.4
Public administration and defence	0.4	-3.2
Education	-0.1	-3.6
Health and social work	2.6	-1.1
Arts, entertainment and recreation	1.3	-2.3
Other service activities	-1.4	-4.9

Source: State Statistical Office.



Source: State Statistical Office and NBRM calculations.

strengthening of the annual growth. Thus, the nominal net and gross wages increased by 1.8% annually. The only exception to this tendency is the agriculture, where the average wage decreased. **The real annual wage decline continued in the second quarter, yet at a slower pace.** Amid insignificant strengthening of inflationary pressures, this shift reflects strengthening of the annual growth of nominal wages. Thus, the average real net wage is down 1.8% on an annual basis. **On a quarterly basis,** net and gross nominal wages remained almost unchanged. With a quarterly inflation of 1.4% and stagnant nominal performance, net wages declined by 1.4%, in real terms. This shift is caused by the downward adjustment of wages in the services sector and agriculture.

It is still considered that the slow increase of nominal wages amid employment growth suggests that employers cope with the uncertain economic environment through the wage channel rather than through the reduction of the number of employees.

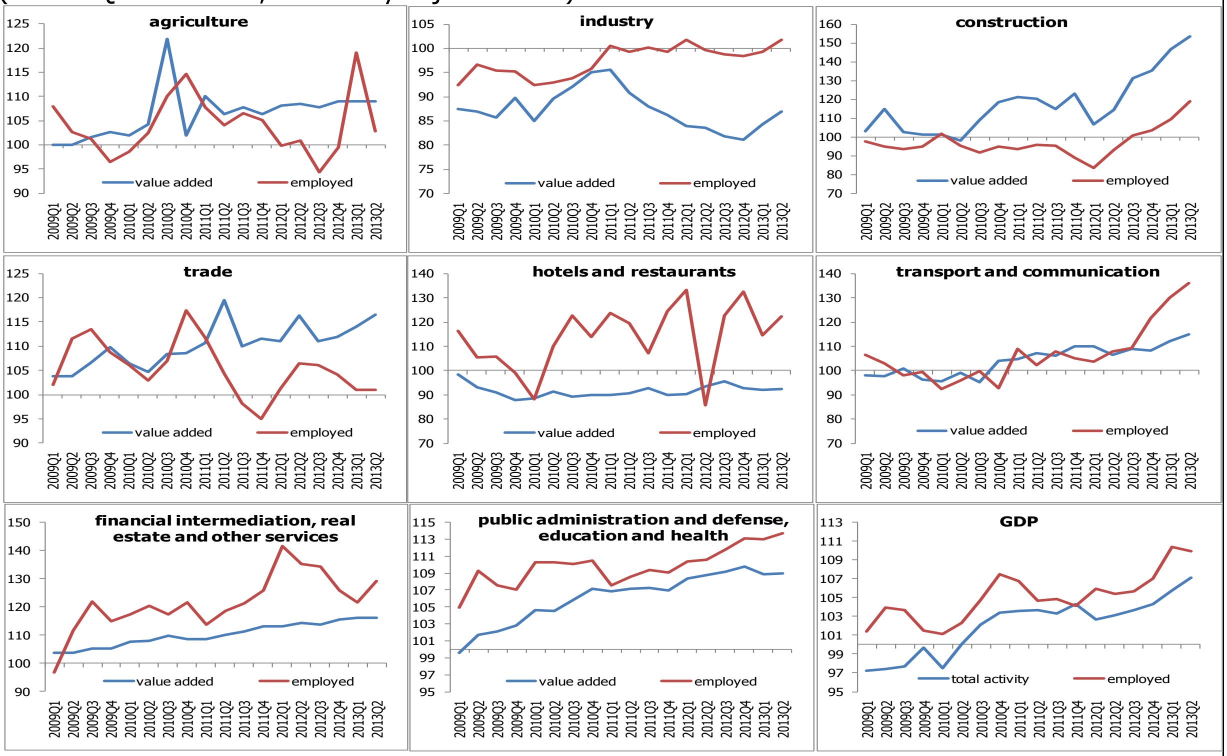
Labor productivity continued to decline, but at a slightly slower pace on an annual basis. The 0.4% decline in productivity in the second quarter reflects the stronger annual employment growth compared to the growth of economic activity. On the other hand, the quarterly increase of productivity is due to the output growth generated with a reduced number of employees. **The fall of labor productivity, while increasing gross wages, caused an annual rise of unit labor costs by 2.2%.** This is only a slight slowdown of the growth, compared with the previous quarter. However, competitiveness improved on a quarterly basis, i.e. downward adjustment of labor costs of 1.6%.

Box 2. Sectoral perspective of employment and economic activity

The article discusses the sectoral analysis of the level of synchronization of value added movements with the number of employees, without prejudice to the causes that determine the relationship between employment and growth in certain sectors. The analysis is done in light of the performances in the last period, compared to the third quarter of 2008, as a period before the onset of the effects of global crisis. This way we can get a picture of the economic performance of individual sectors in the post-crisis period and accordingly, their effects on employment.

The elasticity of employment with respect to economic growth is basically an indicator of the labor intensity of growth. A positive coefficient of elasticity indicates how many percent would the number of employees increase if economic activity increases by one percent and consequently, higher positive coefficient of elasticity indicates compatibility between labor, as a factor of production, and production itself. The sector-by-sector analysis of employment elasticity to growth of activity provides additional information about the sector perspective of employment, which is especially important for policy makers, economic growth and employment.

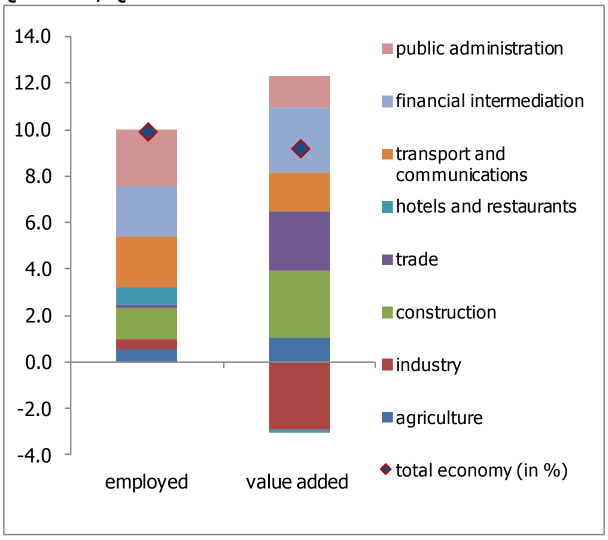
Figure 1
Added value and number of employees, by sector[33]
(indices Q3.2008=100, seasonally adjusted data)



Observing the overall economic activity, following the collapse in 2009 it has reported almost uninterrupted upward trend (except in 2012 when it registered a minor decline). Nowadays, the total economic activity has exceeded the pre-crisis level of 7.1%, largely resulting from the internal factors that mitigate the impact of the adverse external environment (inflow of foreign investments in the free economic zones and fiscal stimulus on investment). This upward trend of economic activity is appropriately followed by the trend of growth in employees, whose level in the second quarter of 2013 exceeds that of the third quarter of 2008 by almost 10%. Post-crisis GDP growth is attributable to all sectors, except industry and hotels and restaurants, while the number of employees increased in all sectors.

[33] For the purposes of cross analysis of economic activity with the number of employed persons by sector, the NBRM made approximate synthesizing of data on employees from the SSO's Labor Survey, i.e. their switch from NACE Rev. 2 to NACE Rev. 1 for the period since 2011. The purpose of this adjustment is to make a quarterly comparison with the statistics of national accounts, which still reports under NACE Rev. 1.

Figure 2
Contributions of sectors to the growth of added value and to the number of employees growth (in percentage points)
Q2 2013/Q3 2008



Construction is activity that reported the fastest increase in value added compared with the pre-crisis level (above 50%). Most of this growth (43%) was registered in the last five quarters, which is the strongest increase within the analyzed period. On the other hand, the number of employees during most of the analyzed period shows stagnation, remaining below the pre-crisis level. However, in the last period, the strong growth pace of construction activity is reflected in the increased demand for labor, with the number of employees exceeding pre-crisis level. Unlike construction, during the period under observation, **industrial activity** remained below the pre-crisis level. The trajectory of industrial activity exhibits two differentiated recession waves, with the latter being longer and more severe. During the first wave of the crisis, the number of employees was downwardly adjusted, showing some level of synchronization with the industrial activity. Nevertheless, in the first quarter of 2011, they reached the pre-crisis level and by the end of the analyzed period mainly gravitated around this level. This shows that during the second recession wave, the number of employees did not follow the downward momentum of industrial activity. The added value of **trade** was consistently preserved above the pre-crisis level, with almost constant upward trend. However, the number of employees does not fully follow this pace. Since the end of 2010, the number of employees decreased to the level below that before the crisis. However, this situation lasted for a relatively short time. In the recent period, the discrepancy between the activity and employment in trade again widened, and the number of employees only minimally exceeded that of the pre-crisis period. **Financial intermediation, real estate and other services** as well as **public administration**[34] registered simultaneous and ongoing uptrend in terms of both activity and employees. During most of the analyzed period, the activity and employment trends in **transport and communications** are synchronized. The last four quarters are exceptions, when the occupied labor force increased, partly explained to be as a positive externality of the construction expansion, taking into account that these activities complement each other.

A comparison of current performance with the pre-crisis performances shows that, except the industry, and hotels and restaurants, economic performances of all other sectors are accompanied by changes in the demand for labor. Of course, the intensity of change is not the same, probably due to factors specific to individual sectors. The low productivity in some sectors in the past may explain why, in favorable environment, there is no major reaction on the demand side of labor. The level of labor intensity is also a factor that influences the demand for labor

[34] The term public administration includes the following sectors: public administration and defense, compulsory social security, education, health and social work. This category should not be interpreted as a definition of the public sector since it includes the private segment of education and health.

(less labor intensive sectors may provide higher growth without large absorption of additional labor). In certain sectors, changes in conjuncture can be perceived as temporary, without causing changes in the number of employees, while certain sectors, especially in times of crisis, can be adjusted through the amount of wages, rather than through the number of employees. Certainly, a number of institutional factors in the labor market may affect these changes.

We will try to assess formally the findings of the employment elasticity to activity growth, derived from simply monitoring the dynamics of changes, by calculating elasticity coefficient. Calculation of elasticity applies Kapsos approach (2005), using a log-linear model specification where employment and economic activity enter the levels[35].

Employment elasticity is calculated as follows:

$$lnE_t = \alpha + \beta \ ln\, Y_t + u_t \qquad (1)$$

where E_t is the total number of employees, Y_t is the real GDP level (specifically, added value), while β is the coefficient of employment elasticity to economic activity. Higher positive elasticity coefficient implies economic growth that leads to a significant number of new jobs and vice versa. One of the drawbacks of the model is that it does not include other variables that influence the employment. However, elasticities presented in this analysis clearly show how employment and economic activity mutually vary during the historical period analyzed. Consequently, the results should be interpreted only as indication of existence of an interconnection, or in other words, they should not be interpreted as causality. All input variables use seasonally adjusted quarterly data for the period from 2005 to the end of the first half of 2013.

[35] According to Islam and Nazara (2000) and Islam (2004) (quotation from Kapsos (2005)), elasticities calculated by rates of change show greater volatility.

Figure 3
Employment elasticity[36]

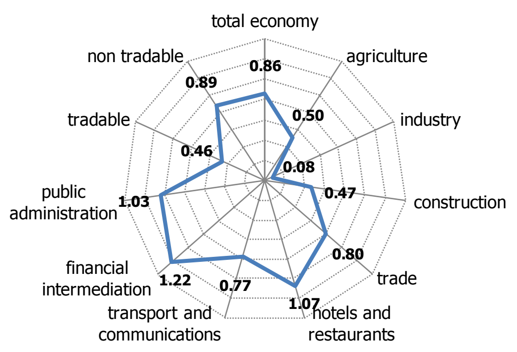


Figure 3 presents estimated elasticity coefficients. As can be noticed, all coefficients of employment elasticity to economic activity are positive and most of them range from 0.5 to 1. Also, notice that, in general, services have a higher coefficient of employment elasticity. Analyzed on a disaggregate basis, the employment in the financial intermediation, real estate and other services (1.2) shows the highest elasticity to economic activity, vis-à-vis the employment in industry that shows the lowest elasticity (0.1).

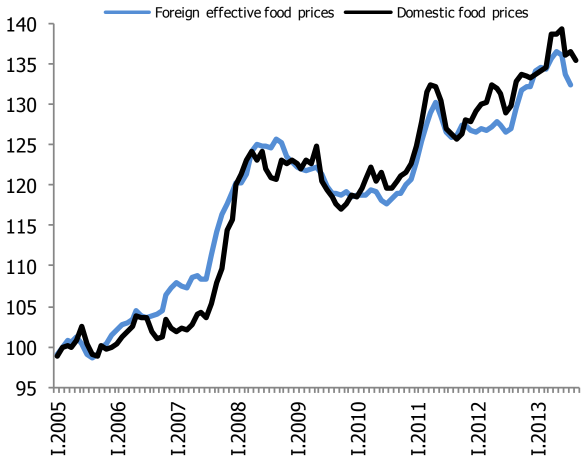
Kapsos (2005) points to the conclusion of Khan (2001), where the following stands out: ideally, the elasticity coefficients in developing countries should gravitate around 0.7, until they acquire status of countries with upper middle income. Kahn (2001) shows that as countries become more developed and face labor shortages, elasticities decline. Also, according to his study, countries with high labor supply and especially countries with high rates of poverty should achieve relatively higher labor intensity of growth, compared to countries that have less of a problem in that regard. The estimated elasticity coefficient of the overall economy is mainly in line with this argument. **In any case, this simple analysis suggests that the number of employees generally follow the dynamics of economic activity, as confirmed by the sectoral positive coefficients of elasticity.**

1.5. Inflation

In the third quarter of 2013, domestic inflation declined by 0.7% quarterly. The downward shift is due to the decrease of the price level of food and energy inflation component, despite the upward effect of the higher prices of long-term component of inflation. On an annual basis, inflation growth slowed down from 3.6% in second quarter to 2.8% in the third quarter, reflecting the high base effect. The annual growth still stems from the food and the long-term component of inflation. The core inflation growth accelerated both quarterly and annually, which, in addition to the spillover effect of rising prices of food and energy in the past, is partly explained by the one-off factors, amid absence of significant pressures from demand and import prices. International prices of primary food products and foreign effective food prices in the third quarter registered an annual slowdown.

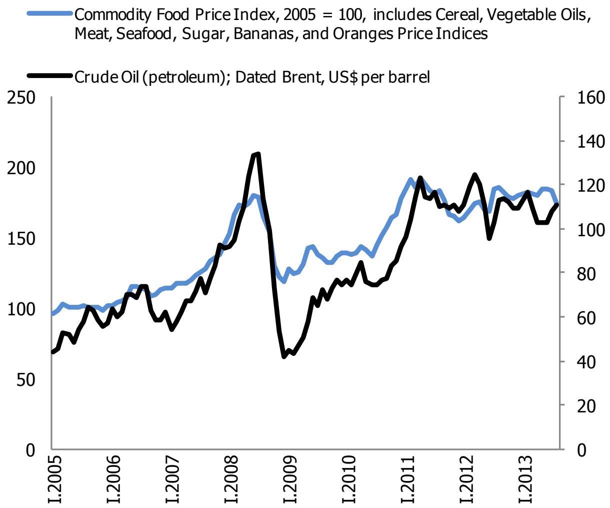
[36] Tradable sector includes agriculture and industry, while all other sectors are treated as untradeable.

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.

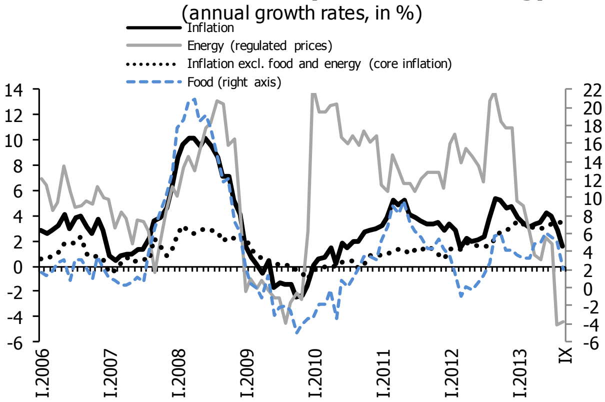
Crude oil and food prices



Source: IMF Primary Commodity Prices.

Inflation and volatility of food and energy

(annual growth rates, in %)



Source: State statistical office and NBRM calculations.

In the third quarter of 2013, domestic consumer prices recorded a quarterly decline of 0.7% (increase of 1.4% in the previous quarter). The fall of prices results from the lower prices of food component, mainly due to the decrease of prices of unprocessed vegetables. Prices of vegetables dropped following their significant growth in the previous quarter, as a result of damages from the February floods on the yield of early vegetable production in the Strumica region and floods in Europe. At the same time, the energy component reduced the inflation for the third consecutive quarter, given the cut of prices by 1.4% in the third quarter due to the decrease of regulated prices[37] of electricity and central heating.

On the other hand, the seasonally adjusted data indicate a quarterly growth of consumer prices of 0.7%, due to the rise of prices of food component and to a lesser extent, to the long-term component of inflation.

In the third quarter, the annual rate of inflation equaled 2.8%, which is a significant slowdown (3.6% in the previous quarter). Hence, in the first nine months of 2013, the average inflation rate reduced to 3.3%. The slowdown of annual inflation rate reflects the effect of lower prices of energy component (electricity and central heating) and the slower rise of food prices (a slower increase of prices of fresh vegetables and a fall of prices of vegetable oil), given the high base effect. These trends are consistent with the movements of international prices of primary food products, as well as the effective international food prices[38], which in the third quarter registered an annual slowdown. The annual growth of foreign effective inflation[39] also slowed down (2.8% versus 3.3% in the previous quarter), in conditions of a minor rush of the quarterly growth (0.5%).

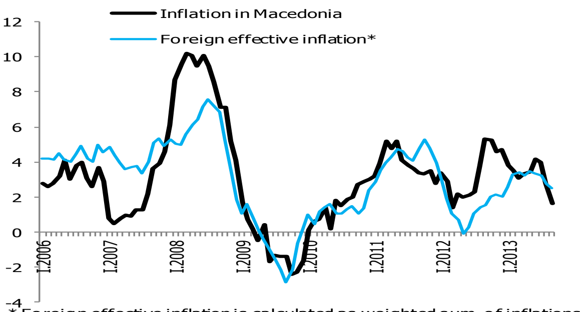
---

[37] The ERC made a decision to cut the price of central heating for households by 2.9%, which came into force on 1 August 2013. In June 2013, the ERC decided to reduce the price of electricity by 4.5%, which took effect from July 1. In July, the ERC accepted the appeal of EVN, thus increasing the electricity price by 1.5% in August. Thus, the effective reduction of the price of electricity totaled 3.1%.

[38] Data on foreign effective food prices are as of the first two months of the quarter.

[39] The calculation of foreign effective inflation is derived from the weighted sum of the 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 2005-2010. The calculation of this indicator includes Bulgaria, Germany, Greece, France, Italy, Austria, Slovenia, Croatia, the United States and Serbia.

Domestic inflation and foreign effective inflation
(annual growth rates, in %)



* 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.

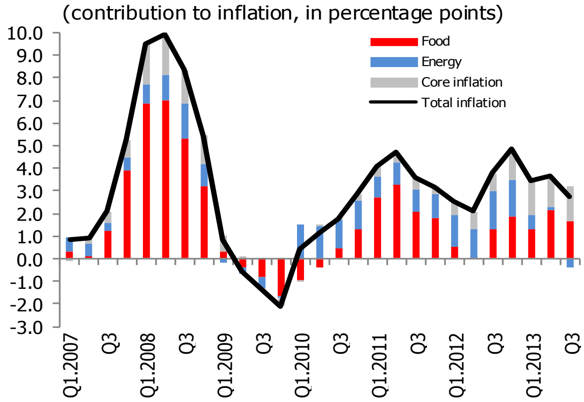
After the slowdown of the annual growth of long-term component of inflation in the second quarter, in the third quarter it resurged. Namely, given the quarterly growth of 0.8% (seasonally adjusted), the annual rate of core inflation reached 3.4% in the third quarter (3% in the previous quarter). The acceleration of core inflation is largely due to the price increase of transport and postal and telecommunication services[40] and the price increase of alcoholic beverages (due to higher excise duties on alcohol[41]). These are one-time factors that affect core inflation in absence of pressure from domestic demand[42]. Same as the previous quarter, higher prices of clothing and footwear and hygiene and health contributed the most to the annual rate of core inflation, reflecting mainly the spillover effect of the rising prices of food and energy in the past.

Price categories

	(annual growth rates, in %)															
	2012				2012	2013			2012				2012	2013		
	Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q1	Q2	Q3	Q4		Q1	Q2	Q3
Consumer price index - all items	*2.5*	*2.1*	*3.8*	*4.9*	*3.3*	*3.5*	*3.6*	*2.8*	*2.5*	*2.1*	*3.8*	*4.9*	*3.3*	*3.5*	*3.6*	2.8
Food	*1.4*	*0.2*	*3.4*	*4.7*	*2.4*	*3.3*	*5.4*	*4.2*	*0.6*	*0.1*	*1.3*	*1.9*	*1.0*	*1.3*	*2.1*	*1.6*
Fresh food	0.7	-0.4	6.2	7.4	3.5	*4.8*	*9.4*	*8.6*	0.1	-0.1	1.1	1.3	0.6	0.9	1.7	*1.5*
Processed food	2.0	0.6	1.1	2.6	1.6	*2.1*	*1.8*	*0.5*	0.4	0.1	0.2	0.6	0.3	0.4	0.4	0.1
Energy	*9.4*	*8.7*	*11.2*	*11.1*	*10.1*	*4.2*	*1.2*	*-2.5*	*1.4*	*1.2*	*1.6*	*1.6*	*1.5*	*0.6*	*0.2*	-0.4
Fuels and lubricants	7.9	10.5	8.0	5.1	7.9	0.2	-6.7	-2.2	0.4	0.5	0.4	0.2	0.4	0.0	-0.3	-0.1
Electrical power	11.5	7.7	14.9	18.4	13.1	9.9	9.9	-1.0	0.8	0.5	1.0	1.3	0.9	0.7	0.7	-0.1
Heating power	7.6	7.7	7.7	4.0	6.7	-2.8	-6.3	-6.5	0.2	0.2	0.2	0.1	0.2	-0.1	-0.2	-0.2
Food and energy (volatile prices)	3.5	2.4	5.5	6.5	4.5	3.6	4.2	2.3	1.9	1.3	3.0	3.5	2.4	2.0	2.3	1.2
Core inflation (inflation excl. food and energy)	*1.4*	*1.8*	*1.8*	*2.9*	*2.0*	*3.3*	*3.0*	*3.4*	*0.6*	*0.8*	*0.8*	*1.3*	*0.9*	*1.5*	*1.3*	*1.5*

Source: State Statistical Office and NBRM calculations.

Volatile (food and energy) and long-term component of inflation
(contribution to inflation, in percentage points)

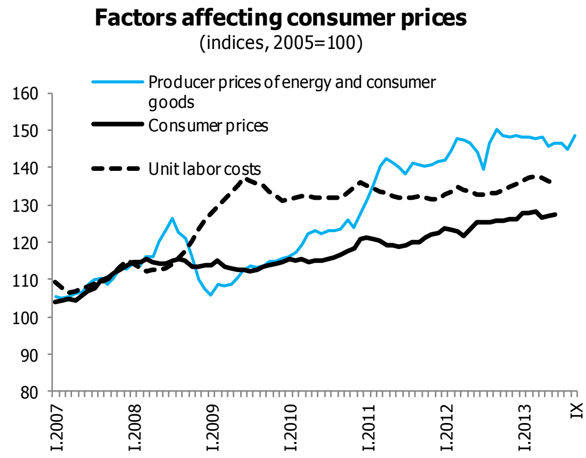


Source: State statistical office and NBRM calculations.

Producer prices decreased during the third quarter. The quarterly decline of these prices equaled 0.3% (a rise of 0.4%, seasonally adjusted), which is due to the fall of producer prices of electricity, clothing and food, amid upward effect of higher prices of refined oil derivatives. On an annual basis, in the third quarter the price level of the overall index remained unchanged due to the effect of lower prices in the processing industry, which were offset by the further, though slower, growth of producer prices of electricity. **The trend of producer prices that affect the domestic component[43] of inflation suggests, probably, slightly higher inflationary pressures in the period ahead.** Namely, with a quarterly growth of 1.2% (seasonally adjusted), the annual rise of these prices accelerated marginally from 0.6% in the previous quarter to 0.8% in the third quarter.

In the second quarter, the reduction of **unit labor costs** on quarterly basis contributed to

[40] Increase in flight ticket prices.
[41] On 13 July, 2013, the Law on Amendments to the Law on Excise came into effect.
[42] The NBRM's estimates show that domestic output is still below the potential (negative output gap).
[43] Consumer goods (durable and non-durable) and energy.



Source: State statistical office and NBRM calculations.

further slowdown of the annual growth to 2.2%. Given the further maintenance of the negative output gap, no inflationary pressures are expected through the channel of labor costs.

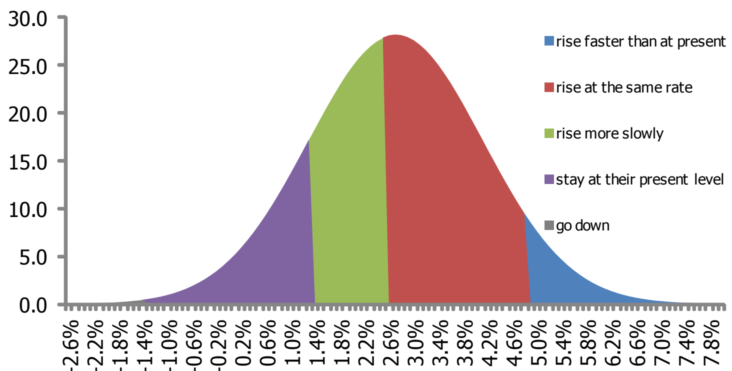
Box 3. Survey on Inflation Expectations

In order to improve the survey measure of inflation expectations, in 2013, the NBRM Monetary Policy and Research Department carried out an in-depth analysis of the central banks' experience in conducting surveys. On this basis, they redesigned the existing survey so as to bring it closer to the European practice.

The newly designed questionnaire contains two questions: qualitative and quantitative. The first question of inflation expectations is designed in a qualitative way, i.e. the respondents do not provide a quantitative answer, but indicate the direction and extent of price changes compared with the change in the previous twelve months. The procedure for measuring qualitative responses uses the probability approach of Carlson and Parkin (1975), which assumes that when there is sufficiently large number of participants, the expected price change is normally distributed. The quantitative question requires the respondent to determine accurately the expected average rate of change of prices in 2014 and 2015.

As before, the Survey on Inflation Expectations covers three groups of respondents: economic analysts, companies and financial institutions. The qualitative question about the expectations is: Compared with the last twelve months, what are your expectations about the consumer prices in the next twelve months? a) they will increase more rapidly, b) they will increase at the current rate, c) they will increase at a slower rate d) they will stay about the current level e) they will fall f) difficult to determine. The quantitative question states: What are your expectations/forecasts for the average inflation in 2014 and 2015?

Chart 1. Normal distribution of answers of the respondents



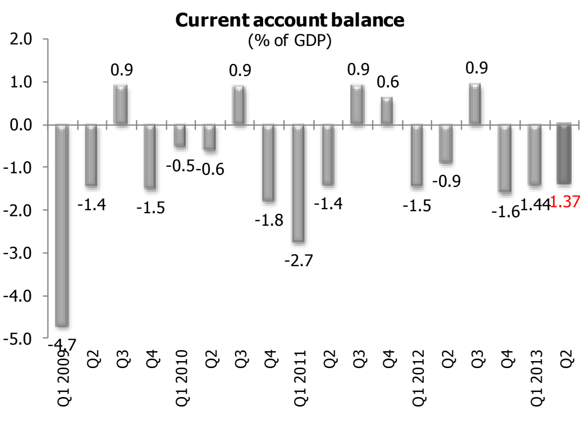
Source: NBRM, Survey on Inflation Expectations.

The survey conducted in October 2013 shows that 48.4% of respondents expect prices to rise at the current pace in the next 12 months, 28.0% expect a slowdown of inflation, 16.1% expect prices to remain unchanged, while only 6.5% expect higher inflation. Against the backdrop of higher average inflation in the previous twelve-month period (3.7%), respondents indicate a slowdown of inflation by 1 percentage point, on average, in the next twelve-month period, or average inflation of 2.7%. Observing by group, the strongest deceleration is expected by ***companies*** (2.4%), followed by ***economic analysts*** (2.7%), while ***financial institutions*** expect that inflation will slow down to 3.0%. Respondents explain these expectations are based on the expectations for slower growth of international food and energy prices, in the absence of pressure from the demand side. Respondents expect the average inflation of 3.3% and 3.4%, respectively, in 2014 and 2015.

1.6. Balance of payments

In the second quarter of the year, the current account deficit improved on a quarterly basis, which is consistent with the common seasonal dynamics. The higher inflows of current transfers, as well as the narrowed income deficit are main drivers of this change. On the other hand, the trade deficit increased on a quarterly basis. The trade balance worsened due to increased non-energy deficit, i.e. the increased investment imports, reflecting strong investment activity since the beginning of the year, and increased import of textiles, in accordance with the usual seasonal dynamics. Annually, the current account deficit increased given the lower transfers and higher services deficit. In the second quarter, the capital and financial account of the balance of payments registered modest net inflows, and therefore, the current account deficit was primarily financed by foreign reserves, which despite such movements remained at adequate level during the second quarter.

1.6.1. Current account

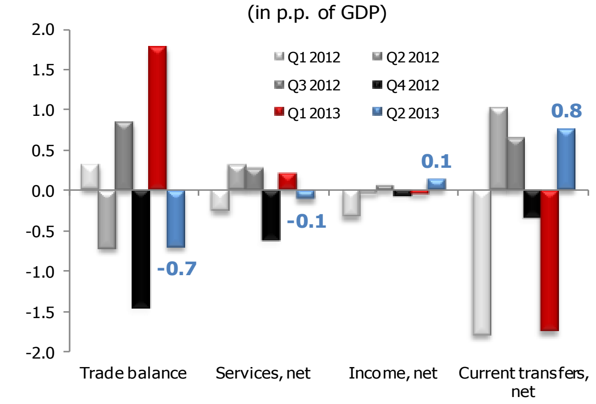


Source: NBRM.

In the second quarter of the year, the current account deficit amounted to Euro 105.5 million, or 1.4% of GDP. In line with the usual seasonal dynamics, the current account deficit registered a quarterly contraction (2.6% or 0.1 percentage points of GDP). *The quarterly analysis* of subcomponents points to the net inflows of current transfers as a major factor for this change, followed by the lower income outflows. Higher current transfers mainly reflect the increase of cash remittances, in line with the usual seasonal increase of net inflows due to the foreign assets purchased on the exchange market. Positive contribution was also made by the reduced income deficit or lower net interest payments, which is primarily a reflection of the high base effect from the previous quarter when higher interests were paid by the government[44]. The performances of these two components were sufficient to cover the trade deficit. The increase of trade deficit (0.7 percentage points of GDP) is solely due to the higher imports (increased

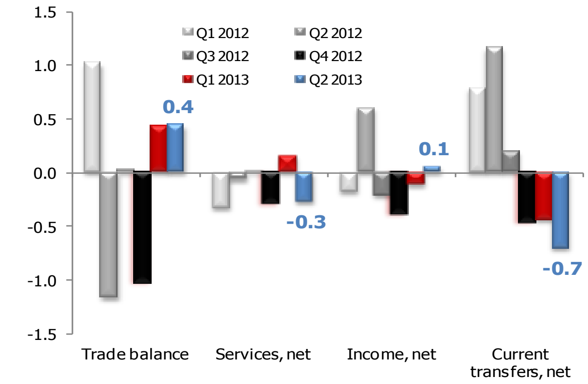
[44] The higher amount of net interest payments by the government refers to the last interest paid on the second Eurobond in January 2013.

Contribution of current account components in its quarterly change
(in p.p. of GDP)



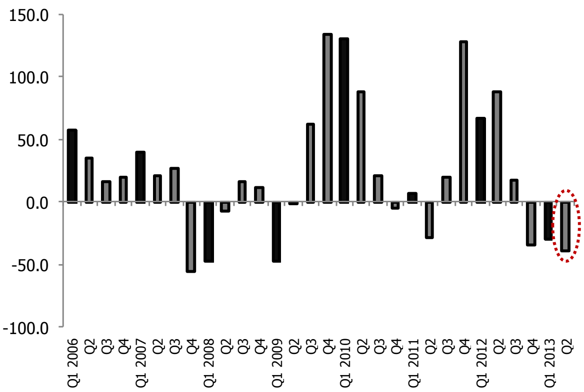
Source: NBRM.

Contribution of current account components in its annual change
(in p.p. of GDP)



Source: NBRM.

Current transfers
(annual change, million of Euros)



Source: NBRM.

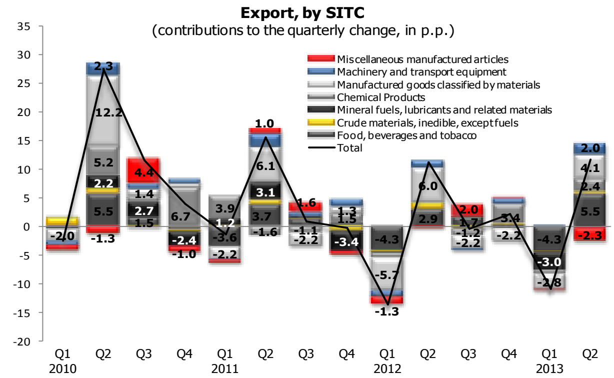
investment imports and imports of textiles[45]) in spite of the export growth. Contrary to the usual seasonal dynamics, the services increased the current account deficit. This mainly reflects the increased deficit in transport services (all types of transport, except the road transport) and the extraordinary deficits registered in other services (more precisely, other business services and patents and licenses).

The annual change in the current account shows an increase in the current account deficit by 0.5 percentage points of GDP. The lower net inflows of current transfers and increased services deficit are the main drivers of the annual widening of current account deficit. Conversely to the positive quarterly change, current transfers decreased by 0.7 percentage points of GDP compared to the second quarter last year. This is the third consecutive annual decline of transfers, with the lower private cash transfers being the prime generator (decrease of net cash exchange of 11.8%). This is expected and due to the high base effect of the previous year when the increased uncertainty in the euro area triggered the conversion of foreign currencies into Denars and caused a significant increase of the supply of foreign currency. As uncertainty reduced, these effects gradually exhausted, and the currency exchange market developments stabilized. The higher services deficit (by 0.3 percentage points of GDP) arise from other services deficit, mostly due to the increased deficit in other business services (larger outflows for accounting, auditing and consulting services and architectural services) and patents and licenses. On the other hand, the trade deficit fell by 0.4 percentage points of GDP as a result of the growth of exports and fall of imports of goods. The income deficit narrowed due to the higher net inflows of portfolio investments[46]. **According to recent data, in July 2013, the current account of the balance of payments reported a surplus of Euro 46.3 million, which is a common seasonal dynamics.** On annual basis, this surplus declined as a result of the increased deficit in services and reduced net inflows of current transfers. The trade balance improved and income deficit remained almost unchanged.

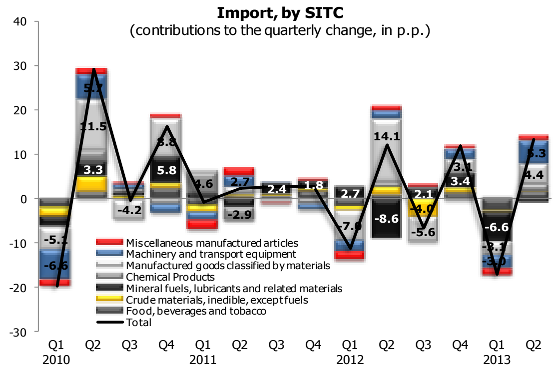
[45] For more details, see the section on foreign trade.
[46] Increased net inflows of income from portfolio investments is due to the lower outflows of interest paid on government securities and higher interest income based on the investment of foreign reserves in securities.

Box 4. Foreign trade and nominal and real effective exchange rate (NEER and REER)

In the second quarter, the foreign trade increased on a quarterly basis as a result of the higher exports and imports. In line with the usual seasonal dynamics, the faster growth of imports (of 13.5%) compared to the quarterly growth of exports of goods (of 11.7%) **enhanced the trade deficit by 16.6%**, solely due to the deterioration of **non-energy trade balance**. In environment of significant investment activity in the country, changes in non-energy balance mainly resulted from higher imports of equipment and machinery, coupled with the higher import of raw materials for the textile industry[47] and the lower surplus in the category of miscellaneous manufactured articles (lower export of clothing). Other traditional export industries such as tobacco, metal manufacturing and food industry followed the usual seasonal dynamics, and therefore, the export of tobacco, iron and steel and unprocessed fruits and vegetables registered a significant quarterly growth. **The negative energy balance** decrease negligibly, amid divergent movements in the individual energy categories. Having stagnation in the export side, the reduction of energy imports is due to the lower imports of oil gases, an effect of favorable price changes given the higher imported quantities and lower import of electricity. On the other hand, imports of oil and oil derivatives recorded positive growth rates, mostly due to the higher quantity of imported oil derivatives[48], in times when, due to the decreased activity of the domestic refinery, there was no import of crude oil.



Source: SSO and NBRM.



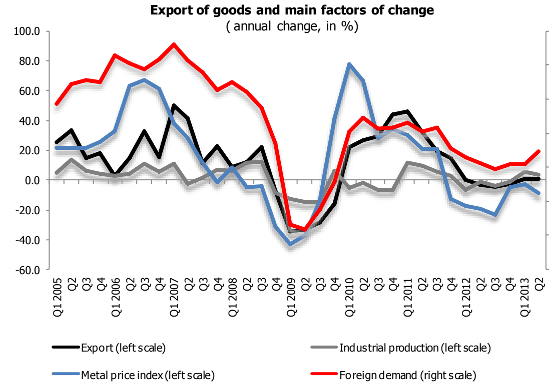
Source: SSO and NBRM.

The annual analysis shows reduced foreign trade, which is entirely due to the reduction of imports, given the slow growth of exports. Despite the still weak impulses from the external environment, according to the dynamics, **the exports has been recovering since the first quarter, reporting a growth rate of 1%.** In conditions of reduced foreign demand and extended decline of world metal prices, export growth is mainly due to the export activity of the new foreign facilities in the economy (an annual growth of export of chemical products and investment export of equipment and machinery of 22.2% and 24.9%, respectively), with additional positive contribution of the tobacco industry (an annual growth of export of tobacco of 55.8%). The trend of annual decline of exports of oil derivatives and iron and steel is still present in this quarter, which is sixth in a row. Pursuant to the significantly contracted economic activity of the domestic refinery during the second quarter, the exports of oil derivatives registered a significant decline of 59.3%. The reduced global demand and prolonged decline of metal prices, especially the price of nickel, which in the second quarter of the year hit the record low in four years[49], remains a key factor for the constant weak

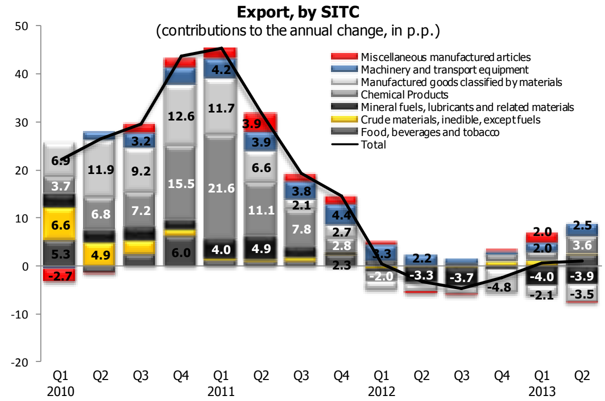
[47] In the second quarter of the year, the imports of textile yarns and dyeing and tanning extracts increased.
[48] Although the increasing amount of imported quantities was driver of the higher import of oil derivatives, the increase of imported prices made an additional effect, which does not correspond with the movements in the prices of crude oil on world markets.
[49] The slowdown of the growth of Chinese economy, which is the largest importer of nickel with nearly 45% of the world production, contributed to the significant reduction of stock prices of nickel.

export performance of the metal manufacturing industry. In addition to the reduced export of oil derivatives and iron and steel, this quarter experienced a decline in export activity of the textile industry.

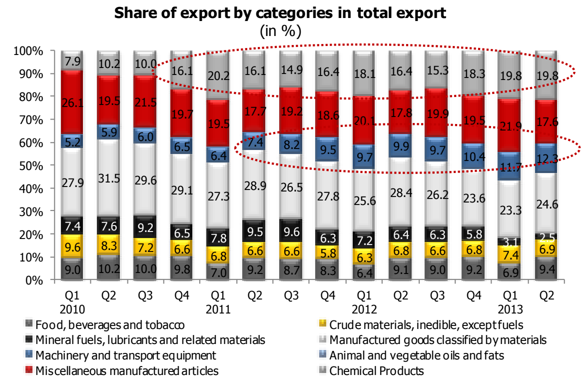
The analysis of export structure by product shows continuation of the trend of diversification, constantly present over the last three years. Since the second quarter of 2010, the share of traditional export products[50] in total exports has decreased gradually, whereas the share of new export products of the automotive industry increased. The growing diversification of export structure is noticeable through the increased share of chemical products and machinery and equipment in total exports from 11.3% in the second quarter of 2010 to 27% in the second quarter of the current year. Simultaneously, the share of traditional export products significantly decreased (from 46.5% to 37.4%) for the same period. The higher level of processing of new non-traditional export products reduced the export sensitivity to price shocks, particularly to the negative changes in metal prices.



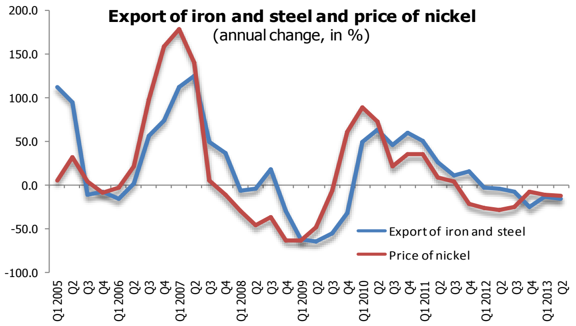
Source: SSO and NBRM.



Source: SSO and NBRM.



Source: SSO and NBRM.



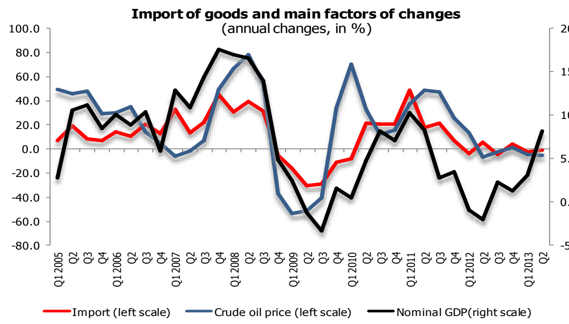
Source: SSO and NBRM.

In the second quarter, imports again declined on an annual basis, though at a slower pace compared to the first quarter of the year (down 1.2% versus 2.4%, respectively). The reduced import demand is primarily due to the lower import of raw materials for industry and energy, which offset the higher import of investment goods. Observed by category, the decline of imports of raw materials is due to the lower world import prices (nickel and platinum), and the high base effect in the second quarter of 2012, when there was high import of ore and non-ferrous metals, which are the basic raw materials in the production of two major export capacities of the metal manufacturing industry and the automotive industry[51]. Import of iron and steel also reduced, probably due to the synchronization between imports and exports in this category. Import of

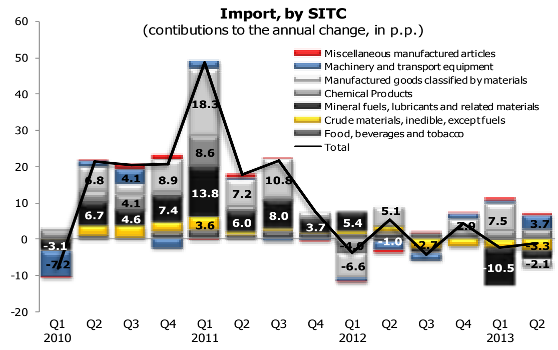
[50] Traditional export products include iron and steel, ores, tobacco and textiles.

[51] During April 2012, a major export capacity imported high amounts of platinum. The second quarter of the previous year reported a significantly higher nickel imports from Indonesia, dedicated to the production process of a major capacity of the metal industry.

raw materials for the textile industry is the only category that increased (higher import of dyeing and tanning extracts and textile yarns), indicating expectations for improved export performance of this traditional product in the next period. The fall of prices of crude oil and Russian gas on the world markets affected the domestic imports, causing a nominal decline of energy imports of 13.3% on an annual basis. Apart from the favorable price trends, which decreased the value of import of natural gas (30.1%), and oil and oil derivatives (5.3%), an additional factor that contributed to the decline of imports was the increasing domestic production of electricity. The favorable weather conditions increased the hydro potential, leading to an annual decrease of the import of electricity of 36.8%[52]. Given the enhanced investment activity, investment imports recorded a significant increase, especially imports of equipment and machinery. **Such movements of foreign trade components caused annual narrowing of the trade deficit in the second quarter by 4.8%.** The analysis of individual balances shows that the improvement of trade balance is fully due to non-energy balance, while the energy balance had a neutral effect. Changes in non-energy balance are due to the improved trade balances in non-ferrous metals and inorganic chemical products, as well as the high surplus in mining and tobacco, with simultaneous worsening of the trade balance in machinery and equipment and decrease of the trade surplus in iron and steel.



Source: SSO and NBRM.



Source: SSO and NBRM.

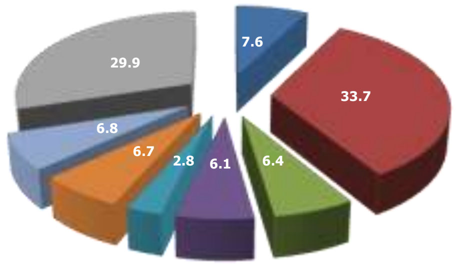
*The latest available foreign trade data indicate a continuation of the favorable trends in **July and August**.* The negative foreign trade balance continued to shrink annually during this period, registering an annual reduction of 13.1%, given the annual growth of exports and mild decrease on the import side. The growth of exports (of 5.9%) is still due to the higher exports of chemical materials and products and export of equipment and machinery, with additional positive contribution made by the higher exports of textiles compared to the same period last year. The downtrend of imports during the previous two quarters continued in the period July-August, but at a slower pace. The lower imports (1%) is still due to the reduced energy imports and the import of raw materials for the metal manufacturing industry, with additional contribution made by imports of machinery and equipment.

In the second quarter of the year, the **foreign trade analysis by trading partner** suggests further increase of the share of the EU Member States (to 66.9%) in this quarter, which is enhanced by the entry of Croatia into the EU[53], thus the foreign trade with this country is now included in the foreign trade with the EU. Accordingly, this change led to a simultaneous decrease in the share of foreign trade with the Western Balkan countries in the total foreign trade. The annual narrowing of trade deficit is due to the more substantial reduction of the trade deficit with the EU, as well as the reduction of trade deficit with the Association of Southeast Asia (due to the lower imports of ore from Indonesia) and with Russia. The steady growth of exports to Germany is a driver of the improvement of trade balance with the EU. The improved export performances of the new capacities in the economy have further strengthened the trade relations with our traditionally important partner.

[52] Data from the monthly reports of MEPSO shows that the second quarter of the year recorded an annual decline of 18.9% of the imported quantity of electricity and 77.1% increase of the production of hydropower plants.
[53] On 1 July 1, 2013, Croatia became the 28th Member State of the European Union.

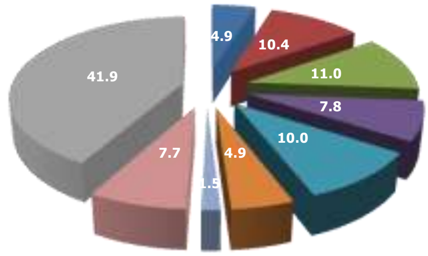
Moreover, the downward trend in imports of crude oil and oil derivatives from Bulgaria and Greece during the second quarter narrowed the trade deficit with the EU. On the other hand, the trade balance with the Western Balkan countries deteriorated relative to the second quarter of the previous year, due to the further decrease of trade surplus with Kosovo, given the further reduction of exports of mineral fuels.

Export of goods, by countries in the second quarter of 2013 (share, in %)



Source: NBRM.

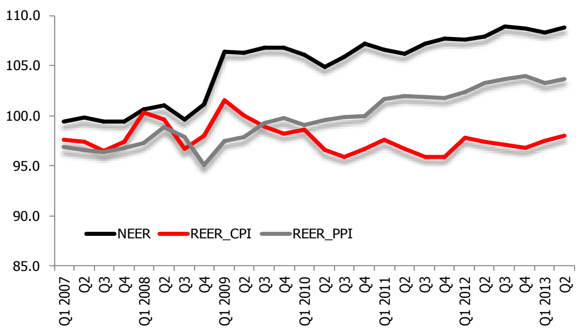
Import of goods, by countries in the second quarter of 2013 (share, in %)



Source: NBRM.

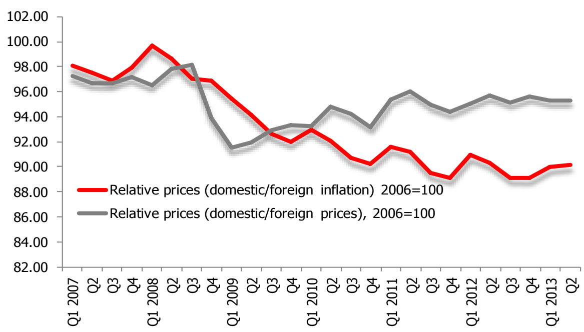
The movement of price competitiveness indicators in the second quarter indicates a mild reduction of competitiveness of the domestic economy compared to the previous quarter. REER deflated by the consumer prices appreciated by 0.6% on a quarterly basis, while REER deflated by the producers prices appreciated by 0.4% on a quarterly basis after the depreciation in the first quarter of the year. Both indices changed due to the appreciation of the nominal effective exchange rate and the faster increase of domestic prices compared to foreign prices. The NEER appreciation of 0.4% compared to the previous quarter is mainly due to the appreciation of the Denar against the Russian ruble. The appreciation was underpinned by changes in domestic prices relative to foreign prices (the growth of the domestic CPI exceeded that of the foreign CPI by 0.2%), while the change in domestic producer prices relative to foreign ones had a neutral effect. The latest data on the movement of price competitiveness of the Macedonian economy for July and August indicate further appreciation of REER deflated by the consumer prices (0.4%), caused by the appreciation of the NEER (1.4%[54]) compared to the second quarter of the year. On the other hand, the REER deflated by the producers prices registered divergent trends compared to the second quarter and depreciated by 0.2% under the influence of the fall in domestic producer prices relative to foreign ones.

NEER and REER
(according to CPI and PPI,2006=100)



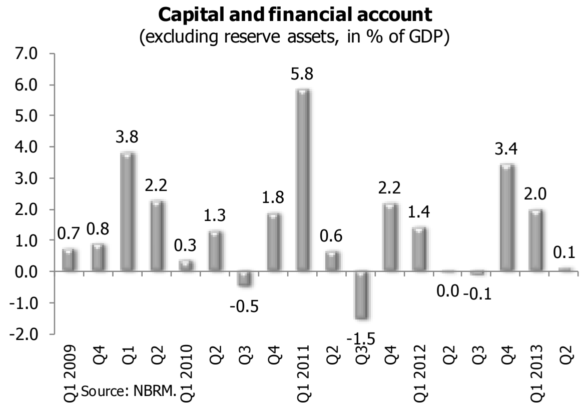
Source:NBRM.

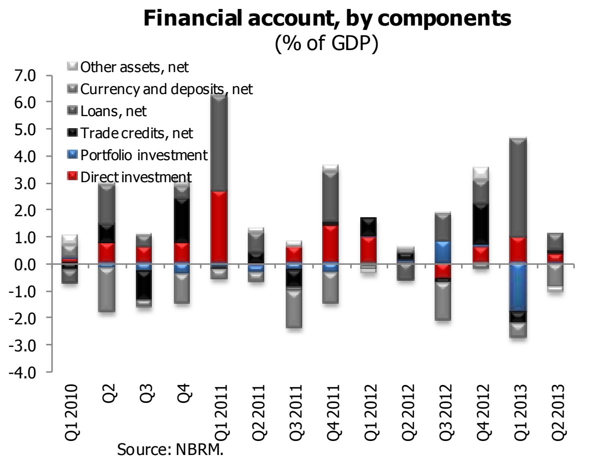
Relative prices
(2006=100)

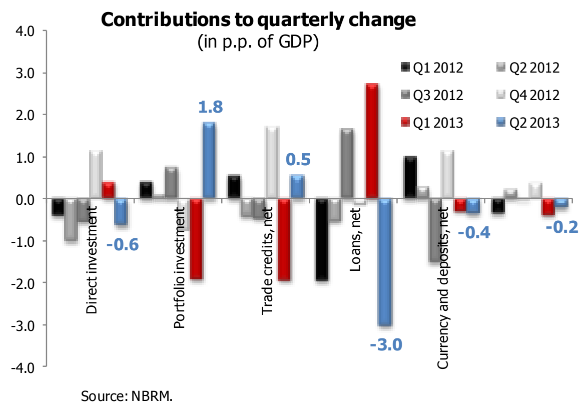


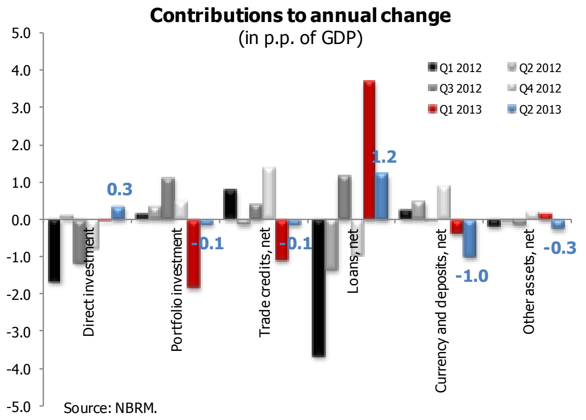
Source:NBRM.

[54] NEER appreciation in this period is due to the appreciation of Denar against the traditionally volatile currencies, namely the Russian ruble, Turkish lira and the Serbian dinar.







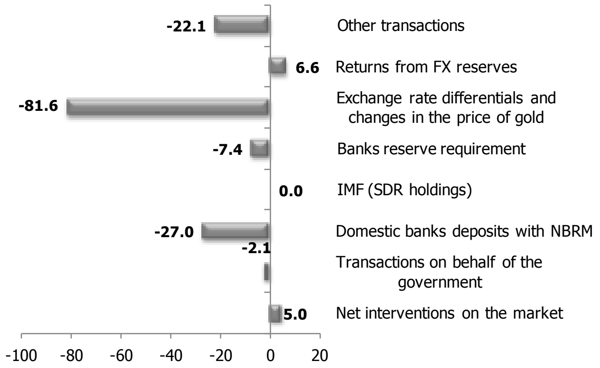


1.6.2. Capital and financial account

In the second quarter of 2013, the capital and financial account of the balance of payments generated net inflows of Euro 7 million, or 0.1% of GDP. Analyzing the financial account components, *net inflows were generated on the basis of net borrowing abroad in a short and long run, and on the basis of direct investments and trade credits.* Net borrowing of the banking sector, mainly in a short run, significantly contributed to the performances of the loans category, while intercompany lending and inflows from equities were fundamental inflows from foreign direct investment. Net capital inflows were largely offset by *net outflows generated in the category of currency and deposits,* due to the net outflows of currency and deposits of other sectors.

The quarterly analysis shows significantly lower net capital inflows (by 95.3% or 1.9 percentage points of GDP). The decline is explained by the high base effect from the first quarter that witnessed three large capital flows, i.e. government funds withdrawal from the Deutsche Bank loan using a World Bank guarantee, and from the World Bank loan for developmental policies and encouraging competitiveness, partially offset by the repayment of the Eurobond issued in 2009 (1.9% of GDP on a net basis). If we exclude the above mentioned one-time effects, in the second quarter, the net capital inflows exceed those in the first three months of the year by 3.3 times, or 0.1 percentage points of GDP. Loans and trade credits are core drivers of the quarterly change and fully offset the quarterly decline of direct investments and higher net outflows of currency and deposits, which are almost entirely attributable to the net outflows in other sectors. *The annual analysis of the capital and financial account indicates slightly higher net inflows (due to small net outflows last year), by 0.1 percentage points of GDP.* Most significant contribution to the annual growth of net capital inflows is made by net inflows from external borrowing. The second significant changing factor is the direct investments, mainly reflecting the growth of intercompany debt. On the other hand, the category of currency and deposits had a dominant negative contribution mainly reflecting the lower net foreign assets of banks. **According to the latest data on the balance of payments, in July 2013, the capital and financial account recorded net outflows of Euro 41.1 million.** The net capital outflows mainly relate to the net outflows in currency and

Factors of influence on the change of the level of gross reserves in the trhird quarter of 2013
(in EUR million)



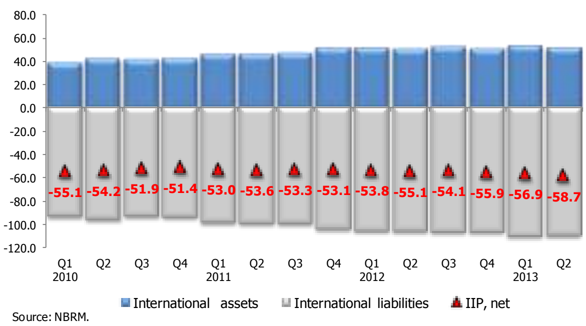
Source: NBRM.

deposits (almost equally distributed between banks and households) and trade credits. On the other hand, significant inflows came from direct investments, mostly due to intercompany lending.

At the end of the second quarter, the gross foreign reserves amounted to Euro 2,039.2 million, which is a quarterly drop of Euro 191.2 million. The most important factors for the change are the negative currency and exchange rate differentials[55], the NBRM's net sales on the foreign exchange market, which is a common seasonal change, and the transactions for government account. *According to the latest available data, as of 30 September, 2013, the foreign reserves total Euro 2,064.8 million*, which is an increase of Euro 25.6 million compared to the end of June. The positive foreign reserves trends primarily results from the NBRM's net purchase of foreign currency on the foreign exchange market, other transactions, followed by the positive currency and exchange rate differentials.

1.6.3. International investment position [56] and gross external debt

International investment position (% of GDP)



Source: NBRM.

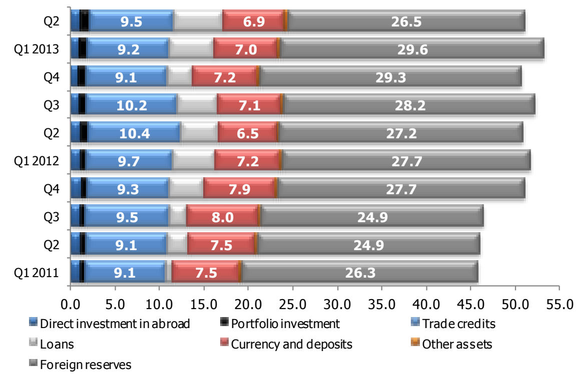
In the second quarter of 2013, **the investment position of the Republic of Macedonia** to the rest of the world deepened again and on June 30,2013 it **equaled Euro 4,513.7 million, or 58.7% of GDP[57].** *In comparison with the previous quarter,* the net foreign liabilities increased by Euro 227.8 million,

[55] During the second quarter, gold prices declined by about 25% (from 1,602 U.S. dollar/ounce at the end of March to U.S. dollar 1,203/ounce), causing adverse price changes in the gold portfolio within the foreign reserves. Moreover, the value of U.S. dollar against the euro was down about 2%, which contributed to a decrease of the value of foreign reserves due to accrued negative exchange rate differences.

[56] In September 2012, the NBRM started disclosing data on the international investment position (IIP) of the Republic of Macedonia, by quarter. IIP data are available at the NBRM website: (www.nbrm.mk/statistika/eksterni statistiki).

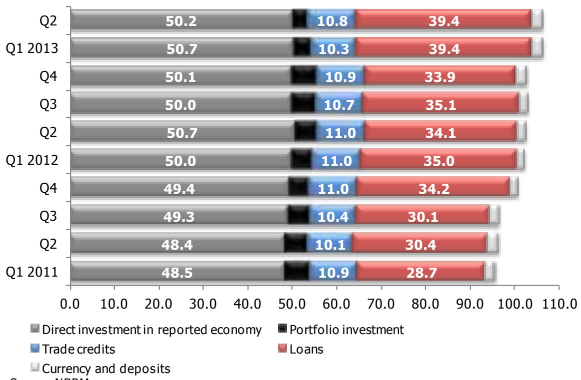
[57] In the second quarter of 2011, the NBRM started concluding repo and reverse repo transactions. These transactions are investment possibility for using the securities portfolio for generating additional revenues. The conclusion of repo transactions produces liabilities. Simultaneously, the conclusion of reverse repo transactions creates claims that contribute to the increase in gross claims. The NBRM simultaneously conducts matched conclusion of repo and reverse repo agreements, in almost identical amount. Overall, since they are concluded concurrently, these transactions have neutral net-effect, i.e. they appear in almost identical amount on the side of both liabilities and claims, thus having no effect on the total net IIP and the net external debt. The transactions for borrowing securities additionally widened in 2012 and encompassed swap transactions with gold as collateral.

International assets, by instruments (% of GDP)



Source:NBRM.

International liabilities, by instruments (% od GDP)



Source: NBRM.

or analyzed by the share in GDP[58], the net liabilities augmented by 1.8 p.p..

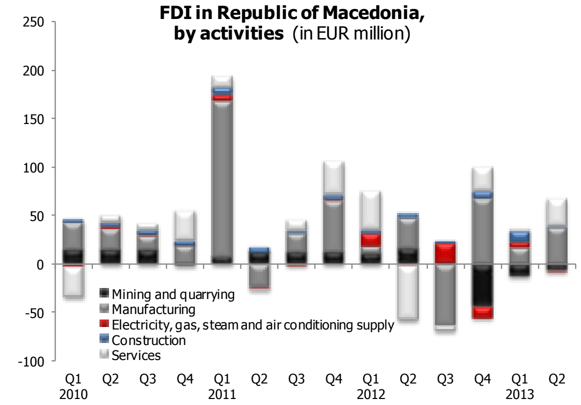
The increase in the negative investment position of the country to the rest of the world is due to the simultaneous **increase in the international liabilities** of 1.6% and to the **decrease in the international assets** of 2.3%. Most of the ***quarterly decrease in the assets*** stems from the changes with the gross foreign reserves in form of securities and monetary gold, as well as the decrease of the bank claims based on the short-term foreign loans. The changes with the monetary gold are caused exclusively by the developments on the stock exchange gold prices, given unchanged quantity. On the other hand, in the second quarter, increase in the claims based on trade loans and claims of the monetary authority based on loans (repo transactions) was registered. **On liabilities side,** most of the quarterly rise is due to the increased liabilities based on trade credits, as well as loan-based liabilities in form of short-term loans of the monetary authority (repo transactions) and banks. The increased liabilities to the direct investors (non-residents) in form of intercompany loans had additional impact.

Analyzed by sectors, the largest input to the quarterly deepening of the negative net liabilities in the international investment position is given by the monetary authority and the banks, as a result of the simultaneous decrease in the assets and increase in the liabilities with both sectors. On the other hand, the "government" sector registered decrease in the net liabilities to the rest of the world.

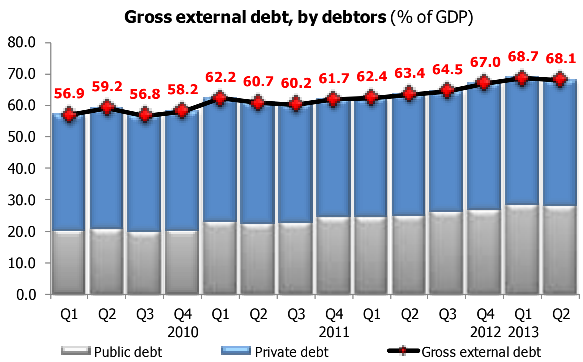
The constant annual deepening of the net debt position of the country continued also in the second quarter of 2013. The faster increase in the international liabilities relative to the international assets (of 7.4% and 4.1%, respectively) caused rise in the **negative MIP of Euro 426.2 million, or 3.6 p.p. of GDP, in comparison with the second quarter of the preceding quarter**.

	Q2 2012	Q1 2013	Q2 2013	*quarterly change*			*annual change*		
		in EUR million		*difference*	*contribution*	*in %*	*difference*	*contribution*	*in %*
IIP, net	**-4,087.5**	**-4,286.0**	**-4,513.8**	**-227.8**	**5.3**	**5.3**	**-426.2**	**10.4**	**10.4**
Government, net	-1,438.2	-1,641.0	-1,632.8	8.2	-0.2	-0.5	-194.7	4.8	13.5
Monetary authorities, net	1,940.6	2,154.4	1,975.2	-179.1	4.2	-8.3	34.6	-0.8	1.8
Banks, net	-556.5	-555.6	-605.9	-50.2	1.2	9.0	-49.4	1.2	8.9
Other sectors, net	-4,033.5	-4,243.7	-4,250.3	-6.6	0.2	0.2	-216.8	5.3	5.4

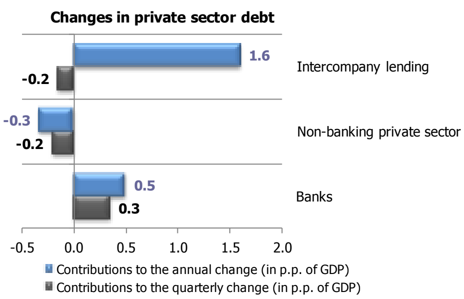
[58] The calculation uses annualized GDP, which is sum of the registered nominal GDP in the last four quarters.



Source: NBRM.



* Without repo-transactions.
Source: NBRM.



Source: NBRM.

The main reason for **the annual assets growth** is the higher demand of the monetary authorities based on short-term loans (higher repo transactions), the higher deposits of the banking sector abroad, as well as the higher gross foreign reserves. Most of the annual increase in the **international liabilities** is due to the increase in loan-based liabilities with all sectors, but almost half of the increase arises from the "government" sector. The increase in the total international liabilities is also due to the larger liabilities based on direct investments in the country, as well as the higher banks' liabilities based on non-residents' deposits.

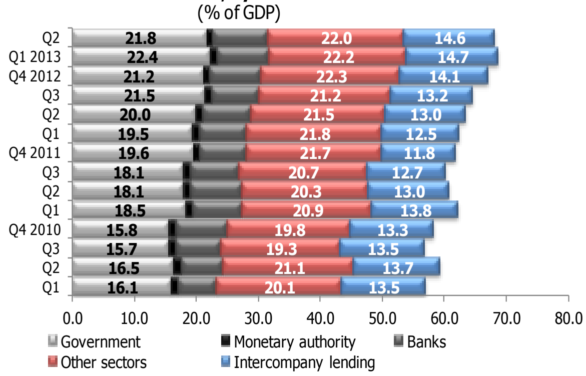
The annual sector analysis indicates the higher net liabilities with all institutional sectors, except monetary authority, as the main reason for the widening of the negative gap of MPI of the Republic of Macedonia. However, from the aspect of the international liabilities structure, it remains favorable. Namely, the share of the foreign direct investments in the total international liabilities remains close to 50%. The analysis of the flows with the foreign direct investments shows that the largest portion of the inflows originates from the foreign direct investments in activities that produce tradable goods, with an especially high contribution of the FDI in the manufacturing activity.

At the end of the second quarter of 2013, the gross external debt of the country equaled Euro 5,584.1 million, or 72.6% of GDP. If exclude the repo transactions of the monetary authority, the gross external debt equals Euro 5,232.4 million, or 68.1% of GDP[59].

In comparison with the previous quarter, the amount of the gross external debt incremented by Euro 57.9 million, mostly due to the risen external borrowing of the private sector. The quarterly increase in the private debt is caused by the higher short-term and long-term borrowing of the banking sector and the increase in the debt of the private sector based on trade credits. On the other hand, the public debt did not register substantial quarterly changes, after the high increase registered in the first quarter of

[59] The entire further analysis refers to the gross external debt without the liabilities of the monetary authority based on repo transactions.

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



* Without repo-transactions.
Source: NBRM.

the year, when significant net external borrowing of the Government was registered[60].

The debt increased on annual basis as well. In comparison with the same quarter of the previous year, the amount of the gross debt is higher by Euro 531.3 million, or 4.7 p.p. of GDP. The annual change is caused by the simultaneous increase in both the public and the private external debt. The largest reason for the increased public debt is the larger amount of government liabilities based on long-term external borrowings, while the annual increase in the private debt was triggered by the increased liabilities to direct investors in form of intercompany debt and higher short-term borrowing of the banking sector.

The analysis of the movement of the external indebtedness of the country, by using **the solvency indicators**, showed that all indicators worsened on annual basis, except the indicator for the share of the interest payment in the export of goods and services, which again improved by 0.1 p.p.. The remaining three indicators, such as the gross debt-export of goods and services, gross debt and GDP, and debt repayment and export of goods and services ratio did not improve either in the second quarter. Despite the worsening with individual indicators, the Republic of Macedonia is still within the group of low debt countries according to the indebtedness criteria established by the World Bank. Only the indicator for the share of the external debt in GDP includes the economy in the group of highly indebted countries. **The liquidity indicators** mainly show relatively favorable external position, i.e. almost full coverage of the liabilities based on short-term debt with residual maturity with the foreign reserves assets, although this indicators deteriorated slightly by 0.1 p.p. on annual basis.

[60] In January, the Government borrowed from the World Bank in order to foster competitiveness, and additionally from the Deutsche Bank by using a guarantee from the World Bank. The total amount of the withdrawn loans equaled Euro 280 million, which despite the high payment of the Eurobond in January resulted in net increase in the gross external debt of the Government.

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	2.24	120.1	49.3	11.5	1.14	0.89	30.3
31.12.2005	2.33	128.5	56.3	9.66	1.67	1.04	26.7
31.12.2006	2.88	109.8	51.8	18.2	1.95	1.34	29.0
31.12.2007	2.38	102.3	53.2	16.6	1.35	1.08	39.8
31.12.2008	2.30	101.1	55.3	8.8	1.29	0.95	35.2
31.12.2009	2.10	113.3	58.5	10.2	1.29	0.94	32.9
31.12.2010	2.78	121.1	60.1	11.9	1.31	0.90	32.0
31.03.2011	2.70	124.7	63.3	14.5	1.46	1.05	29.1
30.06.2011	2.70	124.3	63.1	14.5	1.40	1.00	29.3
30.09.2011	2.70	124.1	63.0	14.5	1.42	0.99	29.1
31.12.2011	2.70	128.4	65.2	14.5	1.53	1.06	29.4
31.03.2012	2.53	114.3	63.4	11.3	1.49	0.94	29.9
30.06.2012	2.53	115.6	64.1	11.3	1.40	0.92	30.6
30.09.2012	2.53	118.3	65.6	11.3	1.49	0.96	29.4
31.12.2012	2.53	123.2	68.3	11.3	1.39	0.93	31.4
31.03.2013	2.46	118.7	69.0	16.8	1.36	1.02	31.7
30.06.2013	2.46	120.0	69.3	16.8	1.20	0.90	32.4
Moderate indebtness 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. Data for 2013 are according to BoP projection April 2013.
*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.

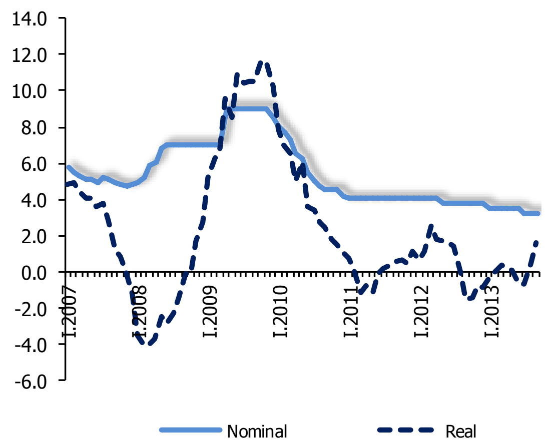
Source: NBRM.

II. Monetary policy

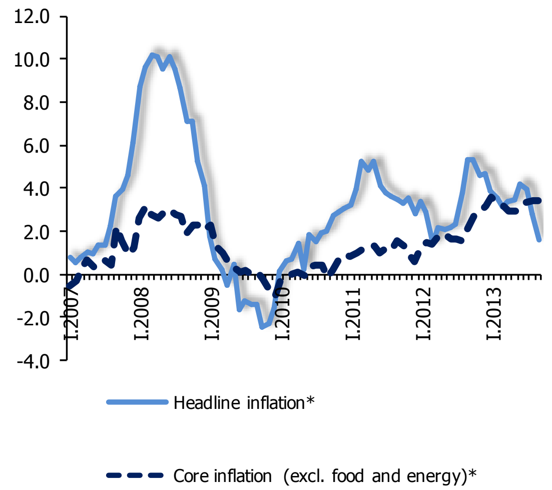
At the beginning of the third quarter of 2013, the NBRM lowered its policy rate by 0.25 percentage points, and accordingly, it reduced to 3.25%. The loosening of the monetary policy through interest rate followed the previously adopted changes in the setup of the reserve requirement instrument. These changes are aimed at giving further growth support to the domestic currency savings, and contribute towards larger long-term foreign capital inflows into the domestic economy. These measures are expected to contribute to the mitigation of some of the risks identified in the external sector, which still largely result from the vague external environment. In such circumstances and when the foreign exchange reserves and inflation range within the expected limits, it was assessed that there is a room to lower the interest rate, as an additional support to the process of economic recovery. During the third quarter, the inflation continues to move within the projections and the foreign reserves maintained at a level that is appropriate for dealing with possible unforeseen shocks. In such conditions of stable movements in the domestic economy, but still present risks, and considering the measures that the NBRM have taken prior to the end of the third quarter, no changes in the monetary policy were made. The NBRM will continue to closely monitor the situation also in the following period, in order to ensure timely and adequate adjustment of monetary policy.

On the basis of regular analysis of the latest economic and financial developments, on July 7, 2013 the Operational Monetary Policy Committee, at its session, passed a decision on reducing the interest rate on the CB bills by 0.25 percentage points, thus

Nominal interest rate on CB bills and inflation (in %)

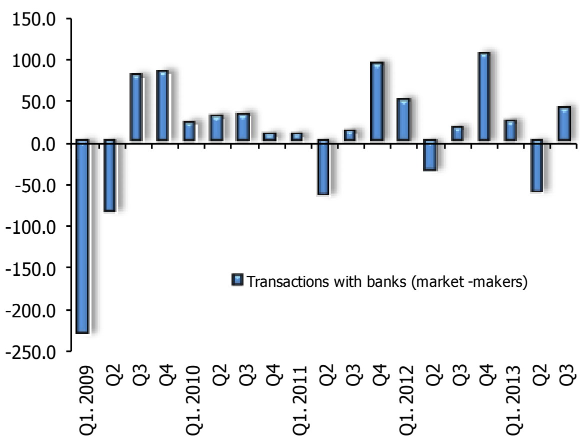


Inflation (in %)



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

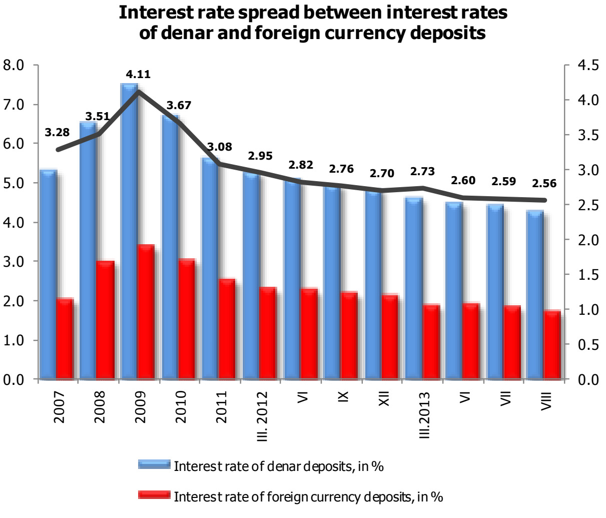
Interventions on the foreign exchange market by NBRM (in EUR million)



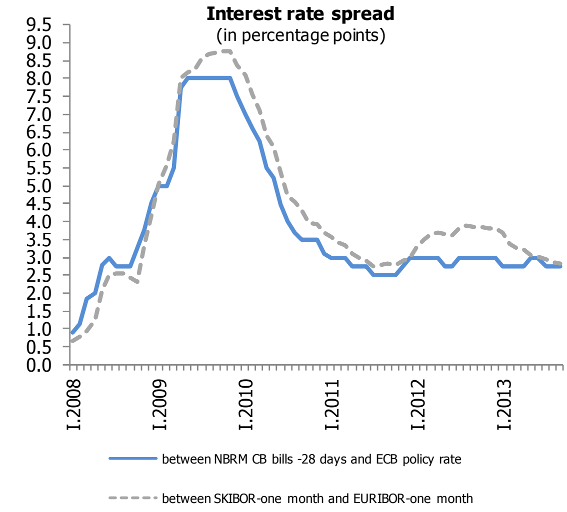
reducing the policy rate of NBRM to its historical minimum of 3.25%. However, the CB bills auctions were held on restricted offer and fixed interest rate principle, unlike the auctions held until then, where the banks auctioned with interest rate. The decision on loosening the monetary policy was preceded by changes in the setup of the reserve requirement instrument. Thus, on the session held on July 4 2013, the NBRM Council adopted the Decision on amending the Decision on reserve requirement[61], stipulating higher FX reserve requirement allocation rate, but lower reserve requirement allocation rate in Denars. In addition, the long-term liabilities to abroad are also excluded from the reserve requirement. The changes were made in order to ensure further support to the increase in the domestic currency savings and to contribute to higher inflows of long-term foreign capital in the domestic economy[62]. It is expected that these measures will help mitigating some of the identified risks for the following period, especially the risks in the external sector, which still mainly relate to the uncertain global environment. It is expected that the new measures will create enough space for the banks to stimulate the lending activity. In such conditions and movements in the foreign reserves and inflation within expectations, the NBRM decided to reduce the policy rate, as an additional support to the economic recovery process.

By the end of the third quarter, the NBRM did not make any changes in the monetary policy setup. During the quarter, there were also factors indicating both possibility for monetary relaxation and need of more prudent monetary policy. Thus, the inflation and the foreign reserves remained stable also in the third quarter. In the third quarter, average annual inflation rate of 2.8% was registered, which is a slowdown in the price growth in comparison with the previous quarter. Thus, the inflation continues to move within the projections, with balanced risks regarding the projected average inflation of 2.8% for 2013 being assessed. In line with the usual seasonal trends, the foreign exchange market registered increased supply of foreign currency, so the NBRM intervened with a net purchase of foreign assets in the amount of Euro 40.8 million in the third quarter. These developments have contributed to the further maintenance of adequate foreign

[61] "Official Gazette of RM" no. 98/2013.
[62] More details for the changes in the reserve requirement instrument see in Quarterly Report, July, 2013, Box 6: Changes in the reserve requirement in July 2013.



Source: NBRM



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

reserves level for dealing with possible unforeseen shocks in the following period. At the same time, the banks continued to conduct restrained credit policy, especially to the corporate sector, amid uncertainty about the sustainability of the recovery of the domestic economy and more conservative strategies of the parent banks. The initial assessments of the SSO showed growth of the domestic economy in the second quarter by 3.9%. However, the uncertain global economic recovery pace indicated that there are still risks to the sustainability of the economic recovery in domestic terms. These developments open possibility for further monetary policy relaxation in order to encourage credit growth. On the other hand, having in mind the still uncertain global environment, there are still risks to the external position of the economy, indicating a need for prudent conduct of monetary policy. The maintenance of high core inflation for a relatively long period was also a factor for greater restraint. In addition, in September the changes in the reserve requirement instrument came into force, which resulted in the certain liquidity release in the banking sector. In such conditions, and expecting materialization of the effects of the measures taken before the end of the third quarter, the NBRM maintained the policy rate unchanged.

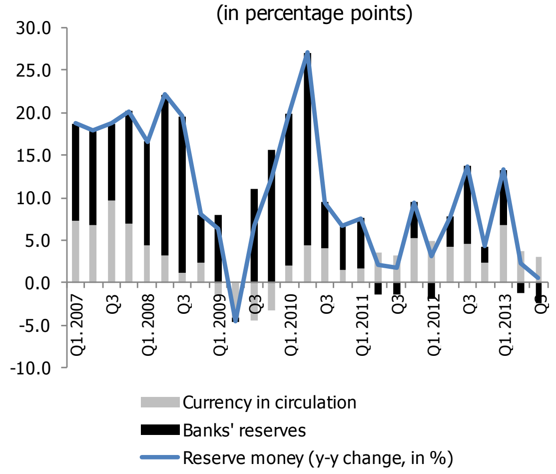
As a result of the reduction of the policy rate of NBRM in July, in conditions when the ECB has maintained its policy rate at a level of 0.5%, the interest rate spread between the interest rate on the CB bills and the policy rate of the ECB registered moderate narrowing and in September it equaled 2.8 percentage points (3 percentage points in June). On the domestic financial market SKIBOR[63] monitored the changes in the policy rate, and reducing during the third quarter by 0.20 percentage points. During the same period on the European financial market EURIBOR maintained stable close to the level registered in the second quarter. In such conditions, the interest rate spread between the on-month SKIBOR and the one-month EURIBOR was relatively stable and in September, it equaled 2.8 percentage points (3 percentage points in June).

2.1 Bank liquidity and developments on the interbank money market

At the end of September 2013 the bank liquidity reduced by Denar 690 million, compared to the end of the second quarter.

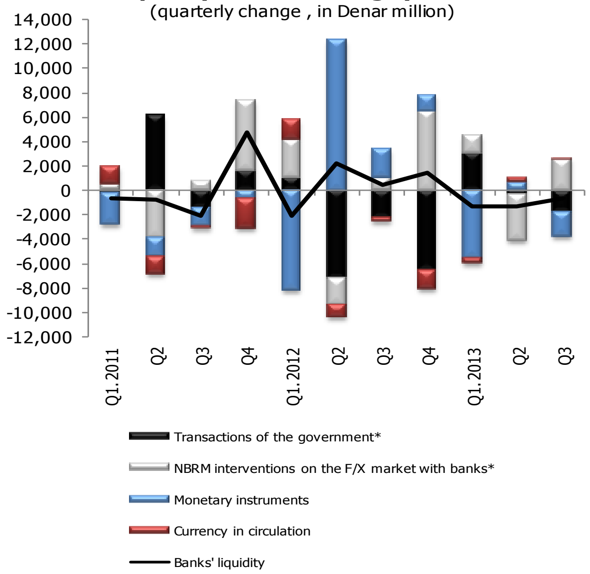
[63] Interbank interest rate on Denar loans, calculated using quotations of referent banks.

Contribution to annual change in reserve money
(in percentage points)



*end of August, 2013
Source: NBRM.

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



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

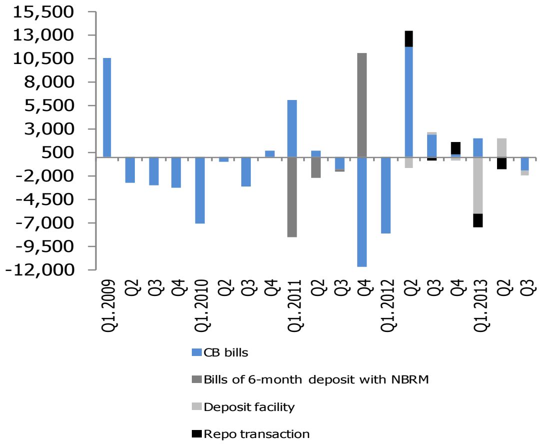
Thus, the balance on the bank accounts with the NBRM[64] equaled Denar 15,276 million at the end of September. In August, the annual growth rate of the reserve money[65] equaled 0.6%, compared to 2.3%, as it equaled at the end of the second quarter.

Within the third quarter of 2013, the autonomous factors, on a net basis, contributed in liquidity creation in the total amount of Denar 1,299 million. The foreign exchange transactions of NBRM with the market makers contributed towards creation of liquid assets, according to the registered net purchase of foreign exchange on the foreign exchange market (in denomination of the Denar 2,503 million). On the other hand, the government transactions contributed for withdrawal of liquid assets (in the total amount of Denar 1,785 million), under the influence of the realized increase in the deposits on the government Denar account with the NBRM. The currency in circulation contributed less to the liquid assets creation (in the amount of Denar 38 million).

The monetary instruments of NBRM in the third quarter, net, contributed towards liquid assets withdrawal in the amount of Denar 1,989 million. Within those frames, liquid assets in the total amount of Denar 1,480 million through CB bills were withdrawn. During this period, three auctions of CB bills, with restricted bid amount and fixed interest rate of 3.25% were held[66]. Liquidity withdrawal was made on the auction held in July, when the NBRM offered higher amount of CB bills than the due amount. On the auctions held in August and September, the offer of CB bills was set at the level of the due amount. Higher demand by the banks relative to the bid amount was registered during the all three auctions. The balance of the disposable deposits with NBRM (overnight and seven-day deposits) in the third quarter increased by Denar 509 million, which contributed for additional liquid assets withdrawal from the banking system. In the third quarter, in the repo transactions, no change on net basis was registered, and as a result the instrument had neutral influence on the liquidity of the banking sector. Also in the third quarter, the banks

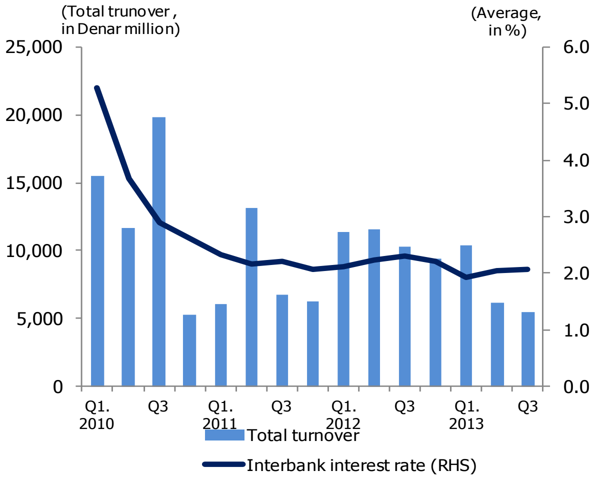
[64] Refers to Denar accounts of banks, obliged to allocate reserve requirement.
[65] It also includes the reserve requirement in foreign exchange.
[66]Starting from the July auction of Treasury bills, the NBRM switched from a tender with a restricted amount of supply and set maximum interest rate (the banks bid amounts and interest rates) to the tender with restricted bid amount and fixed interest rate (the banks only bid amounts).

Monetary policy instruments
(quarterly changes, in Denar million)*



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

Interbank deposit market



*
Source: NBRM.

continued to maintain relatively lower level of excess liquid assets over the reserve requirement. Thus in July - August 2013 period, the average allocated liquid assets over the reserve requirement equaled 0.4% (about 0.8%, on average, in the second quarter).

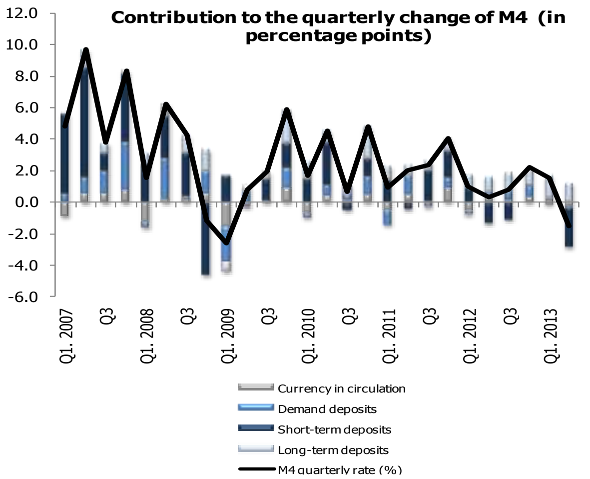
In the third quarter of 2013, the total turnover of Denar 5,452 million on the interbank market was registered, which was a decrease of 11.5% compared to the second quarter. In conditions of solid liquidity level, the activity on the interbank market in the third quarter of 2013 is lower by 46.8% annually. Analyzed by maturity segments, the largest share in the total realized turnover on the interbank money market in the third quarter had the transaction to one and to seven days, which equaled 43% and 45%, respectively, of the total realized transactions. The interest rates of the realized transactions followed, to smaller extent, the changes with the key interest rate, which is explained with their maturity structure. In the third quarter of 2013, the interbank interest rate (MBKS)[67] equaled 2.06% on average (2.03% in the second quarter). The interbank interest rate for concluded overnight transactions (MKDONIA), in the third quarter was stable and it equaled 1.82%, on average, which is almost at the level registered in the preceding quarter (1.84%). In the third quarter, total turnover in the amount of Denar 613 million **on the secondary money market** was registered, which mostly come from the concluded Treasury bills transactions. In July, for the first time since 2009, a transaction with government bonds was concluded, and one repo transaction was also registered.

2.2. Monetary and credit aggregates

In the second quarter of 2013, the broad money M4 reduced on a quarterly basis, which is its first quarterly decrease after four years of steady growth. The decrease in the money supply is due to the fall in the total deposits and the simultaneous reduction in the most liquid assets (cash in circulation and demand deposits). Most affected were the corporate deposits, owing to the large dividend paid to a company with foreign capital, which is common for this period. However, the changes in the deposit accounts of the rest of the corporate sector and households in the second quarter of 2013 were not enough to neutralize the effect of the payment of dividend. On the credit market, in the second quarter of 2013, slight acceleration of the credit growth was registered. The moderate quarterly increase in the lending activity corresponds to the gradual recovery of the domestic real sector. Also the banks' perceptions of risk in the economy in the second quarter were relatively stable. However, the credit growth remains concentrated with households, while the lending support to the corporate sector

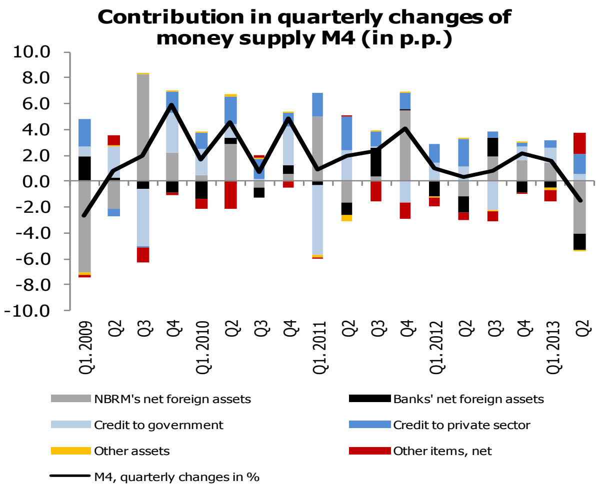
[67] Average interest rate on the interbank money market.

is weaker. These trends point to a different degree of credit risk in both sectors, as can be seen also through the growth generators of the non-performing loans. Thus, also in the second quarter, the non-performing loans increased, which still originates from the corporate sector. Despite the slight acceleration of the credit growth in the second quarter, over the third quarter[68] the lending activity decelerated again, indicating that the credit flows are variable, and for their sustainable recovery, a sustainable recuperation of several segments of the real sector will be needed, as well. Also, on annual basis, the annual credit growth generally slows down, and in September 2013, it equaled 3.8%.



Source: NBRM.

In the second quarter, the broad money M4 registered a quarterly decrease of 1.5%, compared to the growth in the previous quarter of 1.6%. In the second quarter, a dividend to a foreign company and to the Government was paid, which caused high single outflow of deposits with the domestic banks, which was not compensated with the impact of other factors. Observed *by structure*, the fall in the money supply is mainly a result of the quarterly decrease in both the short-term deposits, and the most liquid assets (demand deposits and currency in circulation). On the other hand, the long-term savings continued to grow in the second quarter of 2013, as well. Such developments are opposite to the performance in the preceding quarter, when almost all components contributed to the increase in the money supply, except the demand deposits which decreased.



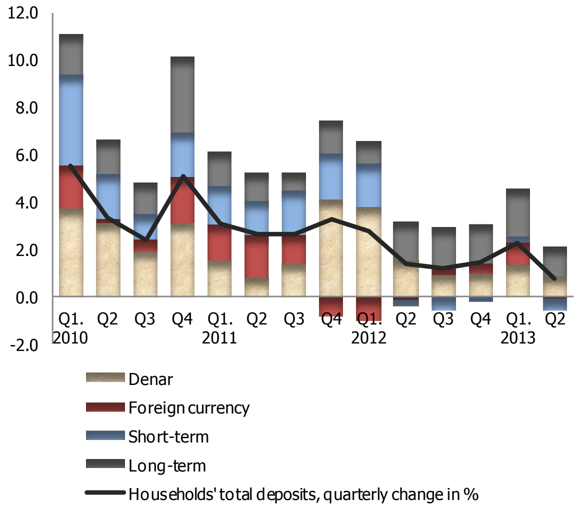
Source: NBRM.

From the aspect of the *balance sheet,* the greatest role for to the quarterly decline of M4 in the second quarter had net foreign assets of the NBRM (as a result of a decrease in the foreign reserves during this period), the reduction of which was partially compensated by the growth in the lending to the private sector and government loans. The monetization rate[69] dropped annually from 58.3% to 56.3%, as a result of the impeded increase in the money supply compared to the increase in the nominal GDP. **In fact, on an annual basis, the growth of the broad money M4 slowed down and from 5.0% in March, it reduced to 3.0% in June, amid slower annual growth of all components (currency in circulation, demand deposits and total deposits).** .

[68] Preliminary data on September.

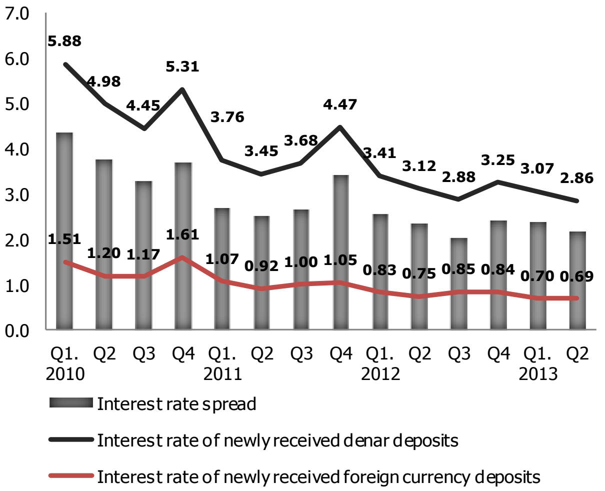
[69] Measured by the share of money supply in GDP (annualized nominal GDP, calculated as the moving sum of the past four quarters).

Contribution in quarterly growth of total deposits of households* (p.p)



*deposit money are not included
Source: NBRM.

Interest rate of newly received deposits of households, in %



Source: NBRM.

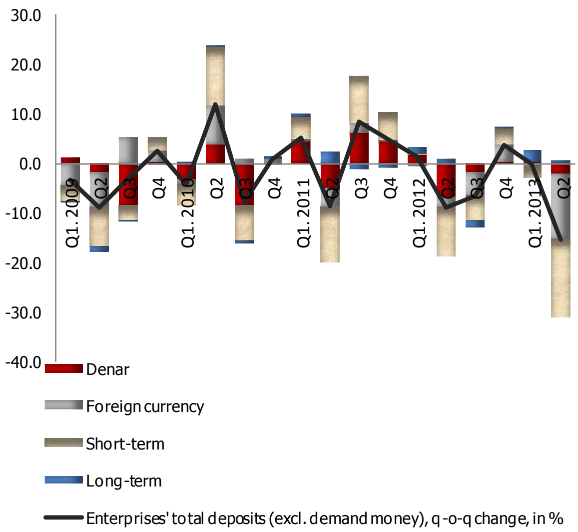
In the second quarter of 2013, the total deposits[70] registered a decrease of 1.6%, contrary to the rise of 2% in the previous period. Observed by currency structure, the fall in the total deposits is fully due to the quarterly decrease in the foreign currency deposits, while the Denar deposits continued to mount (in the previous quarter, both components contributed to increase in the total deposits). As a result of such developments, the trend of decrease of the euroization rate[71], present in the past two years, endured. From maturity aspect, the short-term deposits registered a decrease for the second consecutive quarter, while the long-term savings still contribute to larger total deposit potential in the banking system. Analyzed on annual basis, the total deposits (with demand deposits included) registered an increase of 6.4% in September 2013, compared to 3.9% in June.

Analyzed by the sector structure, the total household deposits (without demand deposits)[72] registered a quarterly increase of 0.7% compared to 2.3% in the preceding quarter. Although the increase in this quarter is decelerated, it is steady, however, and in line with the constant nominal wage growth, as well with the constant credit support to the household sector. From currency aspect, the household's foreign currency deposits decreased, given quarterly, but decelerated rise in the Denar deposits. By maturity components, the short-term deposits registered a quarterly decrease, whilst the long-term ones, a slower growth. These developments are adverse to the flows in the previous quarter, when all components of the household deposits (currency and maturity) registered intensified quarterly growth, in comparison with the previous period. However, despite such developments, the share of the Denar and the long-term deposits in the total household deposits keeps mounting, which indicates constant rise in the household propensity for a long-term Denar saving. These developments are proof for the rising confidence in the domestic currency and the banking system. From the aspect of the interest income on the new household deposits, the yield on the Denar deposits reduced compared to the preceding quarter, while the yield on foreign

---

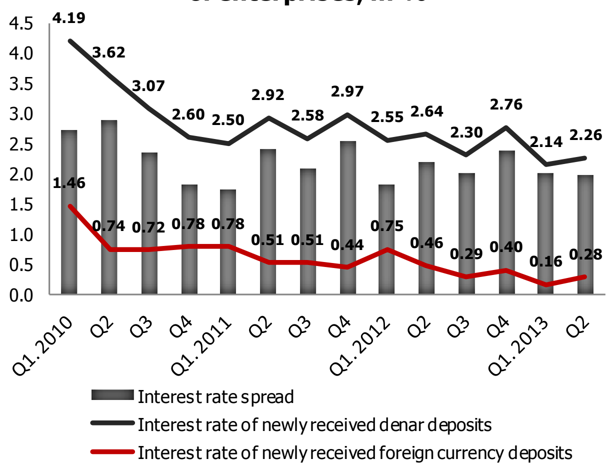
[70] Refers to the total deposits excluding demand deposits. If demand deposits are included, the quarterly growth of total deposits in the first quarter of 2013 amounts to 0.8%, versus 1.4% in the previous quarter.
[71] Presented through the share of foreign currency deposits in broad money M4.
[72] With demand deposits included, the quarterly growth rate of the total household deposits in the second quarter of 2013 equals 0.9%, compared to 2% in the previous quarter.

Contribution in quarterly change of total corporate deposits* (p.p)



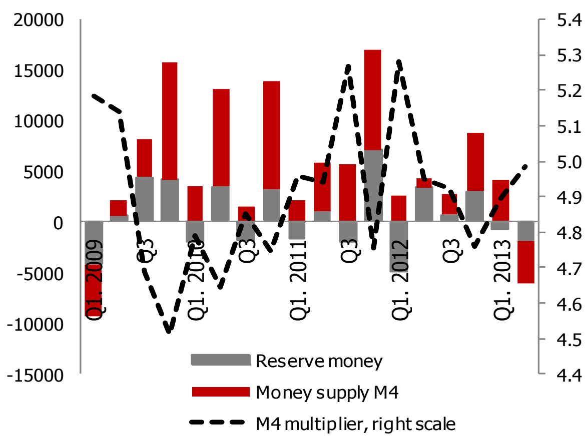
*deposit money are not included
Source: NBRM.

Interest rate of newly received deposits of enterprises, in %



Source: NBRM.

Components of monetary multiplier M4
(q-o-q changes, in Denar million)



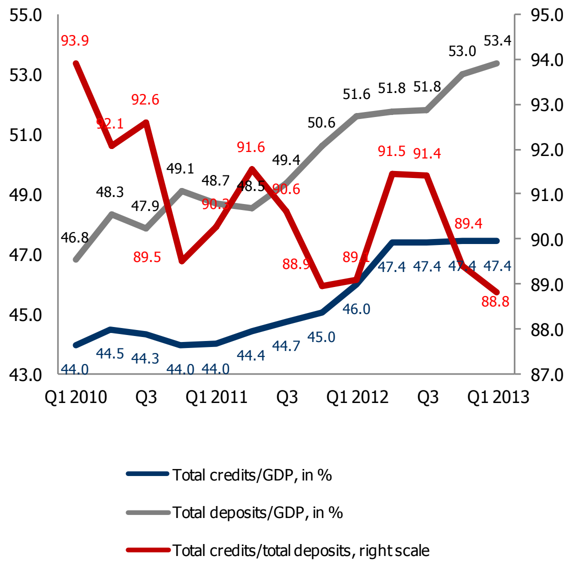
Source: NBRM.

currency deposits remained unchanged. As a result of such developments, the interest rate spread between the Denar and the foreign exchange deposit interest rate for households narrowed by 0.2 percentage points on a quarterly basis. From the aspect of the maturity structure[73], more substantial downward change was registered with the interest rate on the new Denar long-term deposits. On the other hand, the interest rates on the short-term Denar and long-term foreign currency deposits increased minimally. On annual basis, the increase in the total household deposits (with included demand deposits) accelerated, and in September the growth rate equals 6.6% (compared to 5.8% in June).

The corporate deposits[74] register quarterly fall also in this quarter, although much more intensively (from 0.2% to 15.3%). Amid intensified economic activity, such movements of the corporate deposits can partially be explained with single effects. In the previous quarter, the decrease in the corporate deposits mainly came from the high comparison base (in the last quarter of 2012, part of the due government liabilities to the private sector was paid). In the second quarter, larger amount was withdrawn from the corporate accounts in order to pay the dividend to a foreign investor and Government. This single effect, registered in April, caused certain movements in the components of the corporate deposits. Thus from the aspect of the currency and the maturity structure, all components registered a quarterly decrease, except the long-term deposits, which increased in comparison with the previous period. Foreign currency and short-term corporate deposits contribute most to the decrease in the corporate loans. From the aspect of the interest yield on new corporate deposits, increase in the income from Denar and foreign currency deposits compared to the preceding quarter was registered. As a result of the intensified increase in the Denar interest rate, the interest rate spread between the corporate deposit interest rates widened. From the aspect of the maturity structure, substantial downward revision with the interest rates on the new Denar and foreign currency long-term deposits was registered. On the other hand, the interest rate on the new short-term Denar deposits registered minimal increase. In the third quarter,

[73] The analysis of the interest rates with households and companies by maturity structure does not take into consideration the interest rates on the sight deposits.
[74] With demand deposits included, the quarterly rate of decline of the total corporate deposits in the second quarter of 2013 equals 7.8%, as opposed to the decrease of 1.5% in the previous quarter.

Total credit and deposit potential of the private sector and the economic activities



Source: NBRM.

the balance with the corporate deposits improved. Namely, after the longer period of negative annual changes (from the mid-2012), in the third quarter, the total corporate deposits increased in September by 4.3% annually, (compared to the decrease of 4.3% in June).

In the second quarter, the monetary multiplier of the broad money M4 equaled 4.9%, on average, compared to 5% in the first quarter of the year. The deceleration of the multiplication process is due to the decrease in the money supply, amid the accelerated decrease in the reserve money.

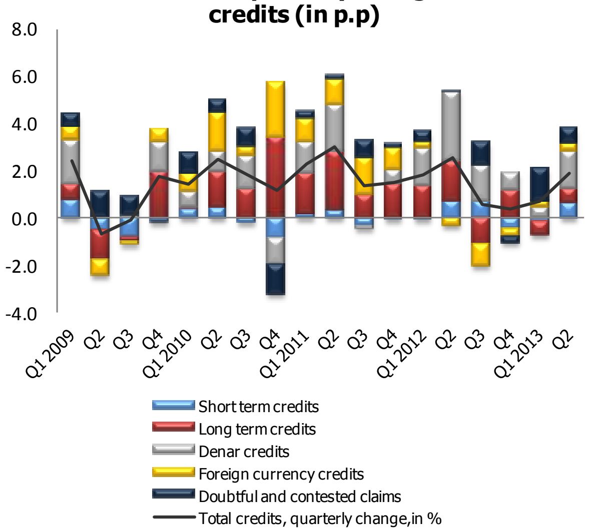
The latest monetary data for the January - September 2013 period indicate increase in the broadest money supply M4 of 2.8% in September, compared to the end of the second quarter, in conditions of accelerated increase in the total deposits in the banking sector, which indicates gradual exhaustion of the single effect of the asset outflow for payment of dividend. As a result of such developments, the broadest money supply registered annual acceleration of 5.1% in September (compared to 3% in June).

	Q2	Q3	Q4	Q1. 2013	Q2
Total credits (in million denars)	216,246	217,537	218,368	219,952	224,152
quarterly change, in %	**2.5**	**0.6**	**0.4**	**0.7**	**1.9**
Doubtful and contested claims (in million denars)	21,040	23,178	22,551	25,584	27,034
quarterly change, in %	**0.3**	**10.2**	**-2.7**	**13.4**	**5.7**
Short term credits (in million denars)	54,240	55,791	54,787	54,504	55,857
quarterly change, in %	**3.0**	**2.9**	**-1.8**	**-0.5**	**2.5**
Long term credits (in million denars)	138,513	136,068	138,614	137,371	138,738
quarterly change, in %	**2.6**	**-1.8**	**1.9**	**-0.9**	**1.0**
Denar credits (in million denars)	159,123	162,423	164,001	164,972	168,408
quarterly change, in %	**4.0**	**2.1**	**1.0**	**0.6**	**2.1**
Foreign currency credits (in million denars)	57,123	55,114	54,367	54,980	55,745
quarterly change, in %	**-1.3**	**-3.5**	**-1.4**	**1.1**	**1.4**
Households credits (in million denars)	84,544	86,172	86,916	87,840	90,855
quarterly change, in %	**2.7**	**1.9**	**0.9**	**1.1**	**3.4**
Enterprises credits (in million denars)	131,069	130,634	130,697	131,304	132,427
quarterly change, in %	**2.3**	**-0.3**	**0.0**	**0.5**	**0.9**

2.2.2. Lending activity

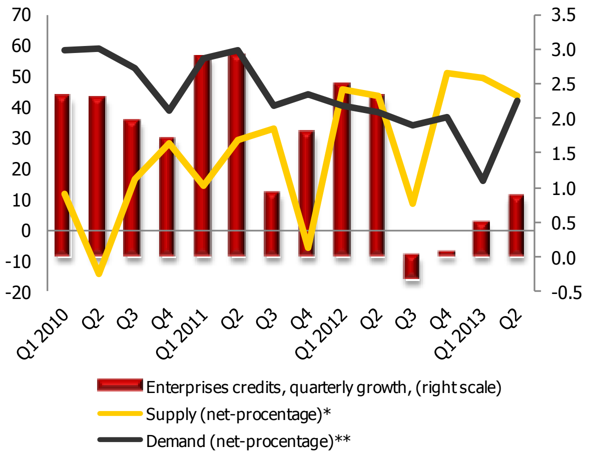
In the second quarter of 2013, the quarterly growth of the bank loans extended to the private sector registered slight acceleration. The quarterly growth rate equaled 1.9%, compared to 0.7% in the previous quarter, with the credit flows in the second quarter being higher by 2.7 times compared to the flows in the first quarter. These developments on the credit

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



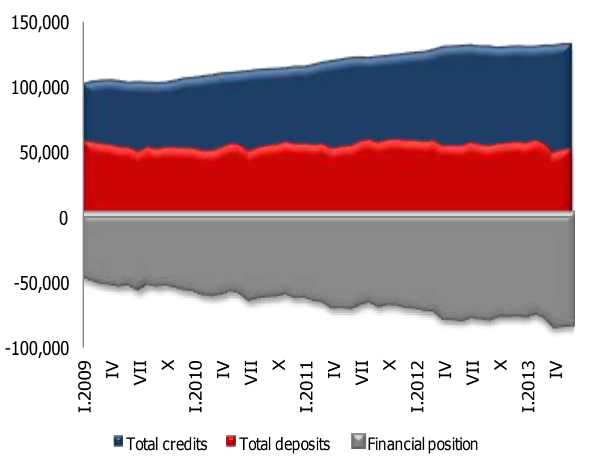
Source: NBRM.

Supply and demand of enterprises credits



*positive net-procentage-tightening of credit conditions, negative net-procentage, easing of credit conditions
**positive net-procentage-increase of credit demand, negative net-procentage-decrease of credit demand
Source: Bank credit survey, NBRM.

Financial position of enterprises (in million denars)



Source:NBRM.

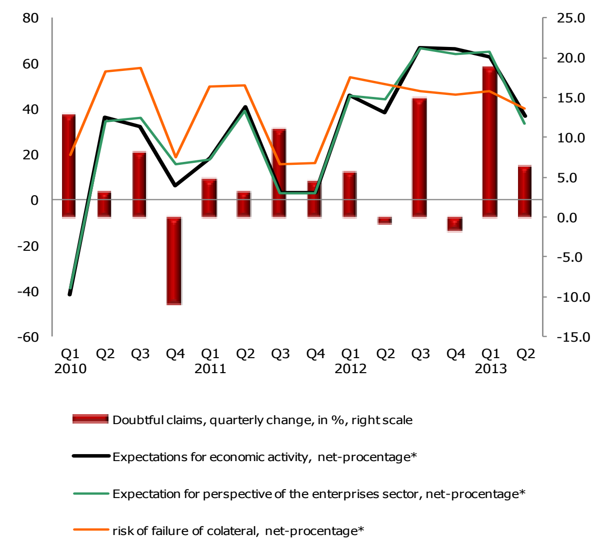
market correspond to the favorable movements in the real sector, given the relatively high growth in economic activity registered in the first half of 2013. Besides the recovery of the real sector and the banks' expectations for more stable environment, the activity of the credit market in the second quarter can partly be explained as an effect of the monetary policy relaxation by the NBRM at the beginning of the first quarter. **By individual sectors, in the second quarter, the banks directed most of their lending to the household sector.** This is a characteristic of the credit market for the fourth consecutive quarter, indicating banks' perceptions for lower risk in this sector. On the other hand, the contribution of the corporate lending in the total lending is constantly decreasing, indicating worsening of the risk profile of this sector. This conclusion is underpinned by the movement of the non-performing loans, which have been growing continuously since the beginning of the year, primarily due to the growth of the corporate non-performing loans.

The decrease in the deposit base, as a major source of funding for banks in the second quarter, in conditions of enhancing the lending activity, has led to **increased utilization of deposits for private sector crediting**. Thus, in the second quarter the loan/deposit ratio was 91.3%, compared to 88.8% in the previous quarter.

Analyzing the maturity structure of total loans, in the second quarter of 2013, both the short-term and the long-term loans had almost equal positive contribution to the total quarterly growth. **From the aspect of the currency structure**, the carrier of the credit growth in this quarter is the Denar lending, which contributed quite significantly to the growth of the total loans compared to the previous quarter, given the minimal increase in the share of the foreign currency lending. These movements correspond to the trend of "denarization" of the banks' deposit base.

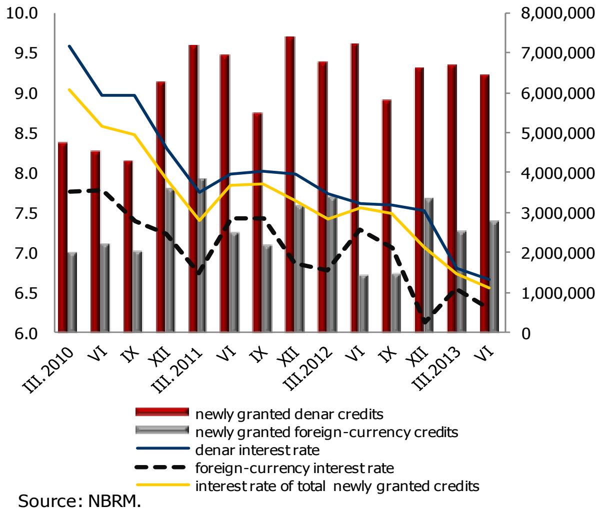
In the second quarter of 2013, the quarterly growth of the corporate loans accelerated moderately. The increase in the loans in this segment was almost twice bigger than in the previous quarter and it equaled 0.9%. Such movements can be partially explained by the use of funds from the EIB intended for corporate lending. The increased bank lending to net exporters and producers of electricity sector probably had additional effect. According to the January changes to reserve

Doubtful claims and risk perceptions of banks



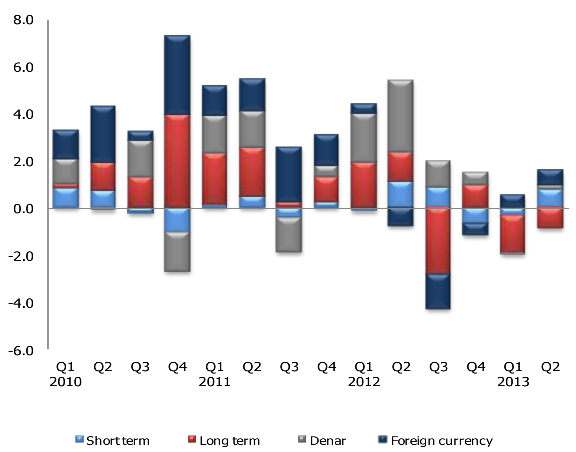
*Negative net-procentage, factors which contribute to relaxing of credit conditions, positive net-procentage, factors which contribute to tigtening of credit conditions
Source: NBRM.

Newly granted credits of enterprises and their interest rates (in thousand of denars and in %)



Source: NBRM.

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



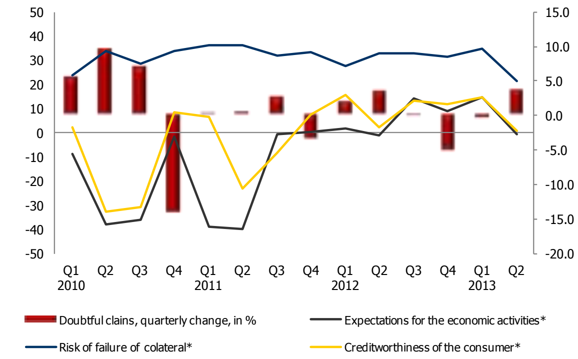
requirement, the basis for allocating the reserve requirement is reduced by the amount of these loans thus releasing liquidity, creating a room, in a way, for further increase in the credit support to the private sector. Namely, from the initial implementation of the non-standard measure in the reserve requirement, as of September, the amount of new loans to net exporters and manufacturers of electricity equals Denar 5819 million. **The increase in the new corporate borrowings, combined with the larger decrease in the corporate deposits contributed to the higher negative financial position[75] of the corporate sector in the second quarter.**

The Lending Survey for banks for the second quarter of 2013 indicates no major changes in terms of the direction and pace of change in the credit ***supply***, compared to the previous quarter. Namely, the lending conditions for all categories of corporate loans continue to register net tightening with the same intensity as in the previous quarter. The factors from the risks perception group are considered the main reason for this policy. However, it should be noted that in this quarter the influence of these factors on the tightening of lending conditions was less intensive. From the aspect of the ***demand,*** the Survey points to intensified demand for corporate loans. In terms of specific factors, no major movements in the banks' perception in comparison with the previous Survey were registered. Hence, more than a half of the banks still indicate the investments in inventory and working capital and the debt restructuring as factors that contribute to increased credit demand. According to one third of the banks, loans from other banks have the same impact, as well. On the other hand, as in the previous Survey, most of the banks indicated that the investment in fixed assets factor has neutral effect on the demand for corporate loans. From the aspect of ***the price of the new corporate loans,*** in the second quarter of 2013, new quarterly decrease in the interest rate of 0.2 percentage points was registered, and it reduced to 6.6%.

The increase in the lending activity of the household sector in the second quarter intensified from 1.1% in the preceding to quarter 3.4%. In conditions of

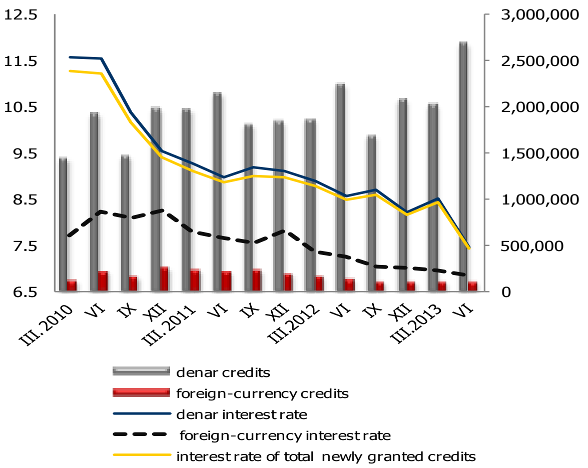
[75] It is defined only from the aspect of the deposit and the credit position of the companies, without taking into account other components of their portfolios. The financial position is difference between the total corporate deposits and the total corporate loans. If the difference is negative, the corporate sector is debtor to the system, while if positive, it is a creditor in the system.

Doubtful claims and risk perceptions of the banks



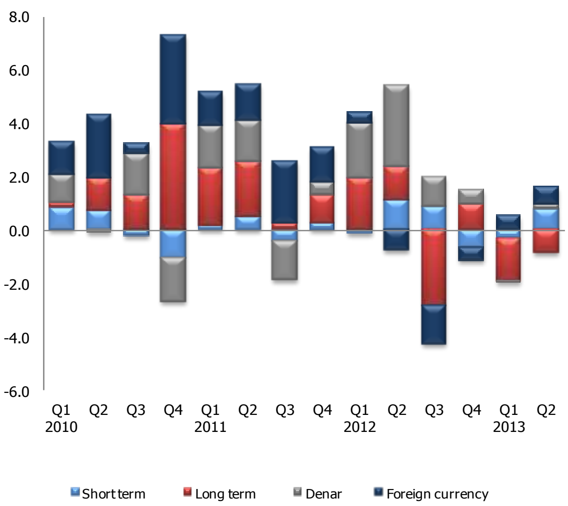
*Negative net-procentage-the nfluence of the factors is in direction of realxing the credit conditions, positive net-procentage-the influence of the factors is in direction of tightening of the credit conditions
Source: NBRM

Newly granted household credits and their interest rate (in thousand of denars and in %)



Source: NBRM.

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



solid increase in the indebtedness and moderate growth in the household deposits, deterioration in the household financial position was registered[76]. Regarding the ***credit supply,*** according to the Lending Survey, further net relaxation in the crediting terms for households, in comparison with the previous quarter, was registered, although most of the banks still indicate unchanged lending conditions. The consumer loans registered more significant change, where 47% of the banks pointed to partial relaxation of the crediting terms for this type of loans. Having in mind the individual factors, according to this Survey, there is slight decrease in the percentage of banks that indicate the risk perceptions as factors that contribute to tightening of the crediting terms. In terms of ***demand***, the banks indicate increase in the net demand, contrary to the net decrease in the previous quarter. Regarding the loans for house purchase, the confidence of the consumers, as well as the perspectives of the buildings construction, are estimated as factors that have stimulating effect. In terms of demand for consumer loans, the factors related to the group of consumer confidence, consumption of durable goods, savings and credits from other banks have much higher stimulating influence. Regarding the ***price of the new household loans,*** in the second quarter, the interest rate fell by 1 percentage point, contrary to the increase in the preceding quarter, which is the largest such decrease in the interest rate since the third quarter of 2010.

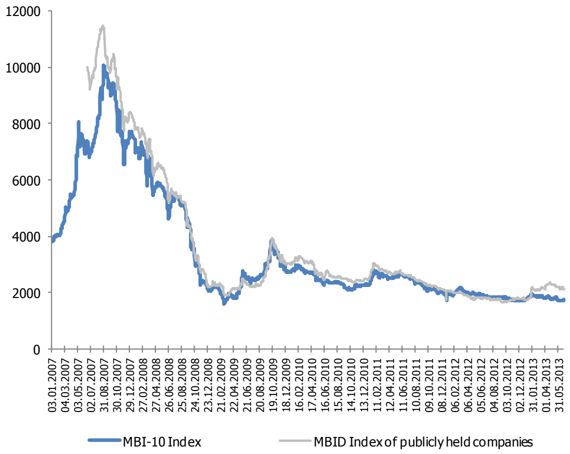
Analyzed on annual basis, the increase in the total loans in June 2013 decelerated again and it reduced to 3.7%. The share of the total loans in GDP[77] fails to register any bigger changes for five quarters. **According to the latest monetary data on July - September period, the annual growth rate of the total credits registered slight acceleration, and in September it equals 3.8%.** In September, the indicator for the coverage of the loans with deposits shows small utilization of the deposit potential of 2 percentage points and it equals 89%. The recent data indicate further acceleration in the annual credit growth of the households segment, given the annual decrease in the annual growth rate of the corporate loans.

[76] Difference between the total household deposits and the total household loans. If the difference is negative, the households is debtor to the system, while if positive, it is a creditor in the system.
[77] Annualized nominal GDP, calculated as a moving sum of the respective four quarters.

III. Stock exchange indices and real estate prices

The Macedonian stock exchange index MBI-10 remained in the zone of negative changes also in the third quarter of 2013. However, in the second half of the quarter there were signals of gradual recovery, which was related to the exit of the euro area from the recession and the faster increase in the domestic economy than expected. On the other hand, the value of the MBID index, after the short stagnation and minimal decline, began to increase, while the value of the OMB index still moves upwards. Unlike the domestic capital market, the regional stock exchange indices registered positive movement trend, following the signals of the leading markets and relevant economic data in advanced economies. The constant downward trend of the real estate prices on the domestic market in the last seven quarters ceased in the third quarter of 2013. The movements on the real estate market are result of the factors on supply and demand side.

Movements of MBI-10 and MBID Macedonian Stock Exchange Indices



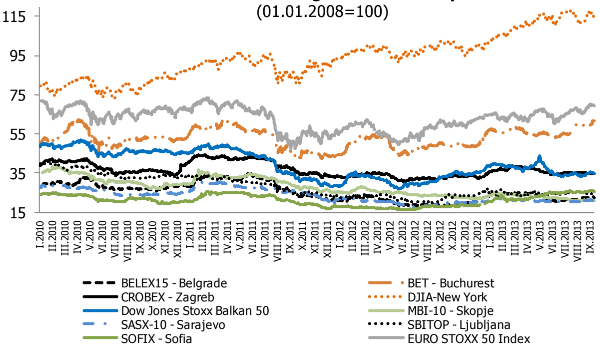
Source: Macedonian Stock Exchange.

In the third quarter of 2013, the MBI-10 remained in the zone of negative changes for the second consecutive quarter. The value of the Macedonian stock exchange index MBI-10 registered a quarterly decrease of 6.4%. However, from the aspect of the dynamics, the third quarter seems to be divided into two sub-periods. Namely, the index moved downwards until the mid-August, since when as of end of September it was moderately increasing. The publication of the more favorable economic developments in the euro area (the exit of euro area economy from recession that lasted six quarters) and domestic economy (stronger growth than previously expected) contributed for favorable trend in the second half of the quarter. However, despite these short-term positive movements, the long-term trend of MBI-10 is still downwards, reflecting the absence of foreign institutional investors on the stock exchange, as well as the still uncertain global environment. On the other hand, the mandatory listing[78] of the companies fails to have any effect on the stock exchange developments so far. Namely, the total stock exchange turnover fell by 16.8% compared to the previous quarter, while the turnover realized based on classical trading registered a quarterly decrease of 36%, as a result of the reduced turnover of both bonds and shares. Contrary to

[78] In accordance with the amendments to the Law on Securities of January 2013, new rules for listing on the stock exchange came into force in March this year, introducing a new market sub segment on the official market of the Stock Exchange - Mandatory Listing, where the aforementioned amendments require listing of securities not currently listed on the official market and whose issuers meet the prescribed criteria. As of September 25, 2013, shares of 87 companies were listed on the sub-segment of Mandatory Listing.

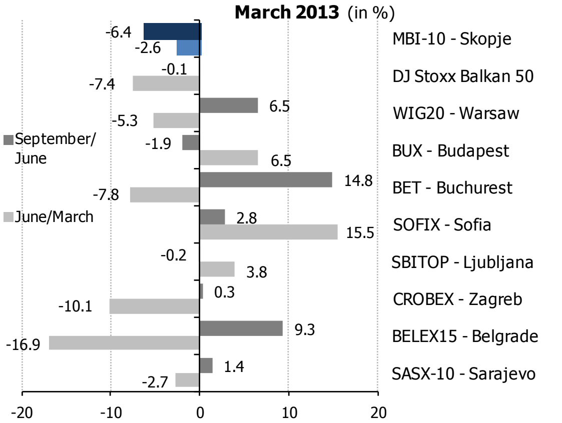
MBI-10[79], the index of the publicly owned companies (MBID) after the short stagnation and minimal fall, began increasing, and on September 13, 2013[80] this index is higher by 6.4% compared to end of June 2013. The bonds index (OMB) continued to move upwards, and its value registered an increase of 2.8% at the end of September 2013 compared to the end of June 2013.

Selected stock exchange indices developments
(01.01.2008=100)



Source: National stock exchanges.

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

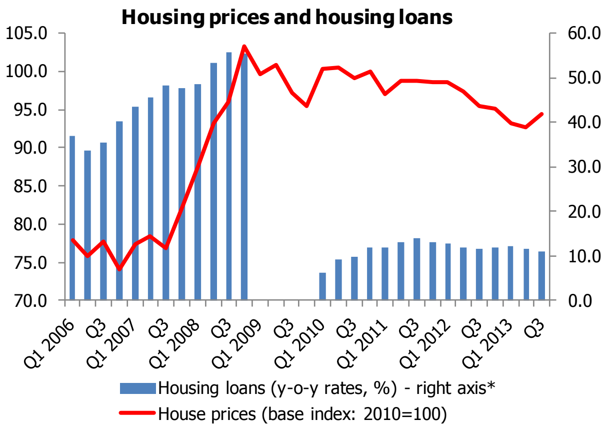


Source: national stock exchanges.

The value of the regional indices during the third quarter of 2013 had a positive trend, following the signals from the leading markets and relevant economic data in advanced economies. Almost all countries in the region registered higher stock exchange indexes, except for Budapest and Ljubljana indices. The positive developments with most of the regional indices reflect the economic growth in the euro area and its exit from recession. Also, the positive sentiment on the regional markets was supported by further growth of the U.S. economy, the positive data on the U.S. employment, and the FED's decision on postponing the initiation of the stimulating measures reduction, i.e. delay of the monetary policy tightening. In such conditions, the Bucharest, Belgrade and Warsaw stock exchange indices registered the fastest growth. The short periods of downward trends in the regional stock exchange indices recorded during the quarter are associated to the negative sentiment caused by the crisis in Egypt, the signals of a slowing economy in China, and the war in Syria.

The constant downward trend of the real estate prices in the last seven quarters ceased in the third quarter of 2013. Namely, the apartment price index[81] registered a quarterly rise of 1.8%. Such quarterly movements contributed towards solid deceleration of the

[79] In September, implementation of the new methodology for calculating MBI-10 began, according to which instead of five criteria, the index is based on three criteria (free float market capitalization, average daily turnover and number of trading days), with extraordinary revision of MBI-10 index also being made, which instead of the "Makstil" share, the calculation of the index included the share of "Makedonski Telekom".
[80] The Board of Directors of Macedonian Stock Exchange adopted a Decision for termination for calculating MBID, from September 16,2013. According to the Stock Exchange, with the procedure of mandatory listing on the Market of companies with special reporting obligations, shares of only 18 publicly held companies with extremely low liquidity are traded, and thus there is no longer relevant need to monitor the price movements of this sub-segment by calculating separate index.
[81] Hedonic Apartment Price Index prepared by the NBRM on the basis of notices of sales in the capital city, published by agencies dealing with trade in real estate. The price of apartment is a function of its size, neighborhood, floor, whether the apartment has central heating and year of construction.



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.

annual decrease (fall of 1.3%, after the decrease of 4.7% in the second quarter of 2013). In terms of constant high supply on the real estate market since the second half of 2010, additionally stimulated by foreign and public investments, the reversal of the trend of the apartment prices can be explained by the gradual increase in construction costs (construction cost index[82]). The indicators on the demand side also show rise in the price of apartments, given that the growth of loans for house purchase continues also in the first two months of the third quarter. Despite such quarterly increase, the level of apartment prices is below the pre-crisis period (2008), when the apartment price reached its maximum, which was mainly caused by the high growth of real income and the reduction of the real interest rate on loans[83].

IV. Macroeconomic projections and risks

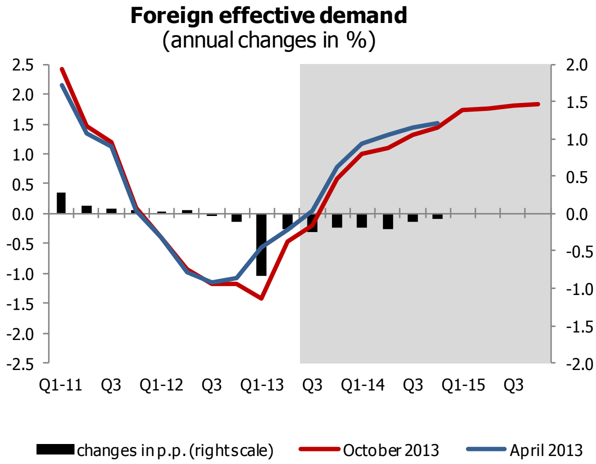
Economic performances in the first half of the year were better compared to the April projections, in circumstances of stronger export activity and faster recovery of private consumption, but also lower than expected import pressures. Amid such performances, ***the latest estimates for the economic growth in 2013 are revised upwards from 2.2% in the April projection to 3.3%,*** *retaining the expectations for the growth of domestic demand and exports.* ***During 2014 and 2015, an increase in the economic growth rate to 3.7% (3% in the previous projection) and 4.4%, respectively, is expected.*** *The positive effects of the new foreign investments and the recovery of the global environment are expected to have a stimulating effect on exports as the main driver of growth in 2014 and 2015. A high positive contribution is also expected from investments, largely supported by public investments, but also by the increased activity of private investors, which should be supported by the revival of banks' lending activity. In circumstances of increased disposable income and improved expectations, it is estimated that private consumption and investments will have an equal contribution towards GDP growth. Flows in the external sector indicate lower than expected import pressures* ***and therefore a lower current account deficit in 2013 is expected (3% versus 4.2% in the previous projections). In 2014, exports from new foreign investors are expected to increase, whereby the current account would register a deficit of 4.6%, compared to the previously expected deficit of 6%.*** *From the aspect of dynamics, current projections indicate continuous expansion of the current account deficit to 5.7% of GDP in 2015, as a reflection of rising imports, in line with the economic growth, as well as the reduction of the relative share of private transfers in GDP. Further debt and non-debt flows are expected in the capital and financial account, which will be* ***sufficient for the accumulation of foreign reserves and their maintenance at an adequate level.*** *Given that the price movements in the first three quarters were in line with previous projections, and in absence of significant changes in the key assumptions,* ***the expectations for the rate of inflation of about 2.8% in 2013 have been retained. The expected inflation for 2014 and 2015 equals 2.3% and 2%, respectively,***

[82] Source: Construction cost index for new residential buildings, SSO.
[83] See Box: "Analysis of the real estate prices in the Republic of Macedonia", Quarterly Report of NBRM, April 2009.

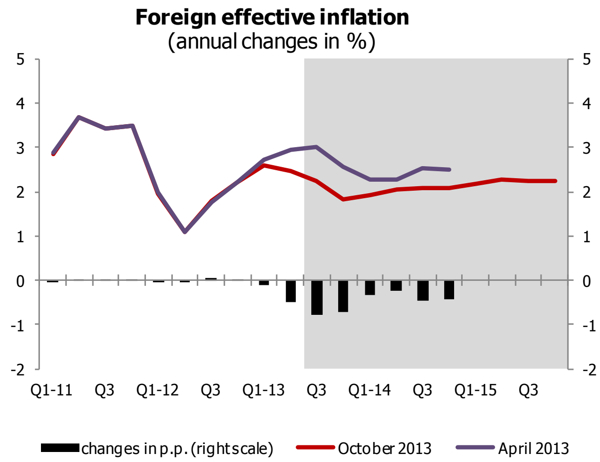
without taking into account the effect of the regulated prices. *Basically, the projections for inflation have not changed compared to April.*

4.1. Assumptions in the external environment projection[84]

Global economic activity in the first half of 2013 was weaker than expected, which called for a small downward revision[85] for the entire year. The economic trends by groups of countries are still divergent, but the latest revisions indicated a gradual strengthening of the economies of the advanced countries and slowing growth of emerging and developing countries. However, globally, it is further expected that the economic recovery will continue in 2014, with positive global growth, and the main impetus is expected to come from developed countries. The latest indicators for the third quarter of 2013 for part of the developed countries, suggest that the process of economic recovery is already underway.



Foreign effective demand for Macedonian products has been revised downwards compared to the April projections, but no changes were made in the expected trajectory[86]. Thus, on an annual basis, in 2013, foreign demand is expected to decline slightly faster, by -0.4%, versus the April forecast for its stagnation, due to some slowing of the economic activity with most of our trading partners this year. Analyzed through the contributions of individual countries, the downward adjustment comes primarily from the reduced positive contribution of Germany and the larger negative contribution that is expected from the Italian and Bulgarian economies. The current projection for the foreign demand in 2014, same as the April projection, indicates its return in the positive zone, with the growth being expected to equal 1.2%, which is slightly below the previous assessment of 1.4%. It is expected that the economic activity of our trading partners will be



---

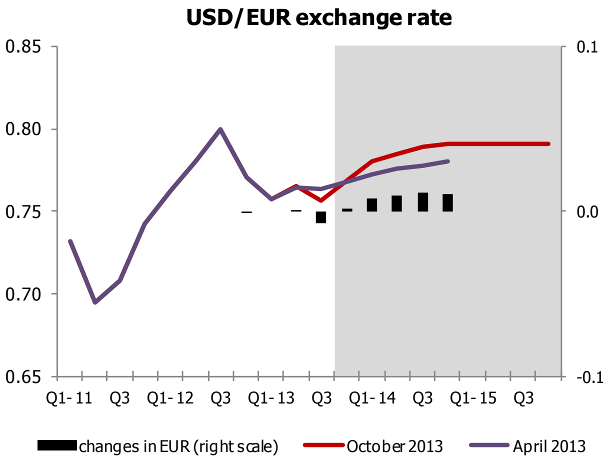
[84] Source of historical data on foreign demand, foreign inflation and USD/Euro exchange rate are EUROSTAT and national statistical offices of the countries and source of data on the prices of oil, food and metals is the IMF statistics. Projections for foreign demand, foreign inflation and USD/Euro exchange rate is based on " Consensus Forecast", while projections for the prices of oil, food and metals are based on forecasts of market analysts, obtained from the "Bloomberg" information service.

[85] World Economic Outlook, IMF, October 2013.

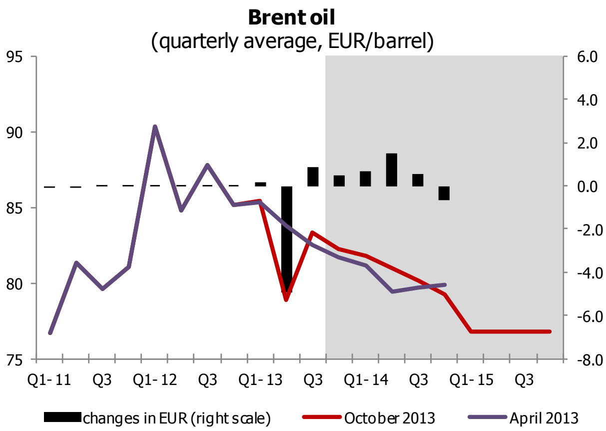
[86] Starting from this projections cycle, changes were made in the weights of the countries used in the calculation of foreign demand in accordance with their participation in the Macedonian exports between 2010-2012, and the group of countries additionally includes Slovenia. Therefore, for consistency, the comparison in the text is made with the April projections with altered weights and range of countries.

further strengthened in 2015, when the growth of foreign demand is expected to reach 1.8%.

Significant downward revisions were made to the projection for the foreign effective inflation. Regarding the projections for the current year, now lower growth is expected in the level of foreign prices, of 2.3%, compared to the April assessment of 2.8%[87]. Overall, the revisions in the projections for inflation in all countries contributed to lower annual foreign inflation. Observed by countries, Serbia has most significantly affected the revision, mainly due to the expectations for lower headline inflation and depreciation of the currency versus the previous expectations for appreciation. The expectations of lower inflation in Italy, Germany and Bulgaria and the deflationary movements in Greece had a similar effect. In 2014, foreign inflation is expected to drop to 2%, representing a downward deviation of 0.4 percentage points compared with the April projection. In 2015, similar trends in inflation are expected, and foreign inflation during the year will be stable and will equal 2.2% on average.



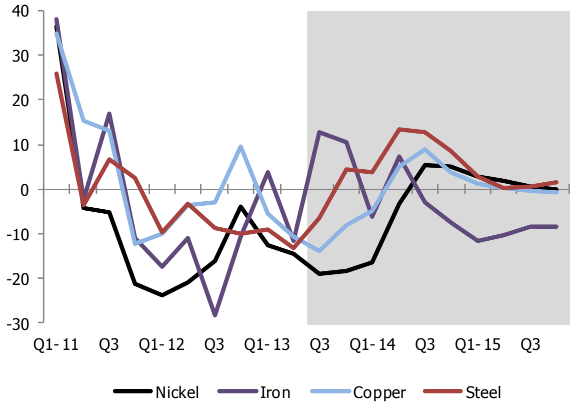
In 2013, the **US Dollar is expected to register a minimally greater depreciation against the Euro,** compared with the previous projection (2.1% instead of 1.9%), while in 2014 it is expected to appreciate more than in the April projection (3.1% instead of 1.7%), given the expectations for a gradual reduction of the quantitative easing by the FED (with the beginning of the exit strategy being delayed for 2014) and the faster economic growth of the USA. These factors would contribute to a further strengthening of the US Dollar in 2015, with the rate of appreciation equaling 0.6%.



By the end of the year, the price of crude oil is expected to reach a slightly higher level than in April, reflecting the still present geopolitical risks in the Middle East, which were particularly prominent in the third quarter, as well as due to the not completely resolved problems on the supply side in some of the oil producing countries. However, on an annual basis, in 2013, oil price is expected to decline slightly sharper than in the April projection (-5.2% versus -4.3%), solely as a result of the sharp price decline

[87] Just like in foreign demand, starting from this projection cycle changes are made in the weights of the countries used in the calculation of foreign inflation according to their participation in the Macedonian import of goods for personal consumption between 2010-2012, and the group of countries does not include USA. For consistency, the comparison in the text is made with the April projections with altered weights and range of countries.

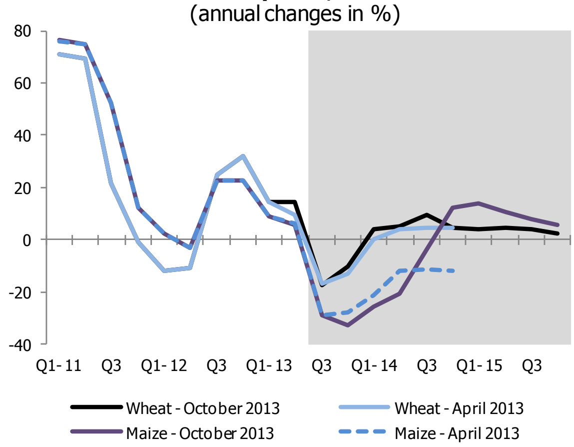
Metal prices, EUR
(annual changes in %)



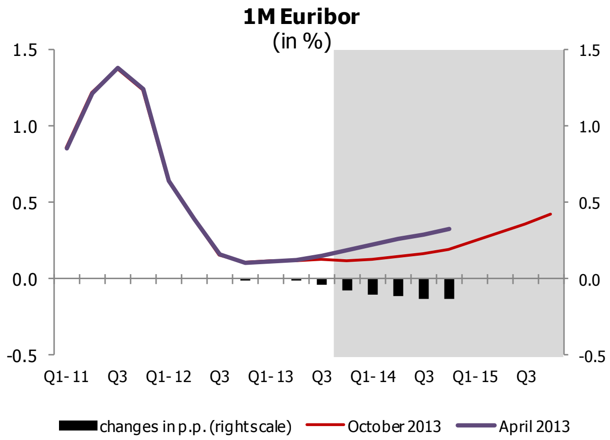
in the second quarter. On the other hand, in 2014, oil prices will register a lower decline than previously expected (2.3% instead of 4%), largely due to the lower base effect. In 2015, the reduction in prices is expected to continue and be stronger than in 2014. In terms of dynamics, the price of a barrel of oil will continuously follow a downward path in the projection period, and, on average, in 2013 it will amount to Euro 82.5, in 2014 Euro 80.5 and in 2015, it will drop down to the level of Euro 76.8.

The October projection for 2013 assumes a downward revision of the metal prices compared to the previous assessment. These expectations are based primarily on the present greater supply on the metal markets, high inventories compared with the historical average and weaker global demand. With respect to certain types of metals, the largest deviation between the two projections is evident in nickel prices, whose decline is now estimated to be nearly three times deeper than in the April projection. Significant decline is expected also in the prices of copper and steel, while growth is expected only in the price of iron, although it will be twice lower than previously expected. Compared with April, in 2014 upward revision was made in the prices of most metals, with faster price growth of copper and steel, and lower price decline of iron. Only in the price of nickel further unfavorable movements are expected. The situation in the metal market is expected to stabilize in 2015, when prices of most metals will register positive growth rates. However, price risks are downward and mainly depend on the growth of the Chinese economy, as the world's major consumer of metals.

Food prices, EUR
(annual changes in %)



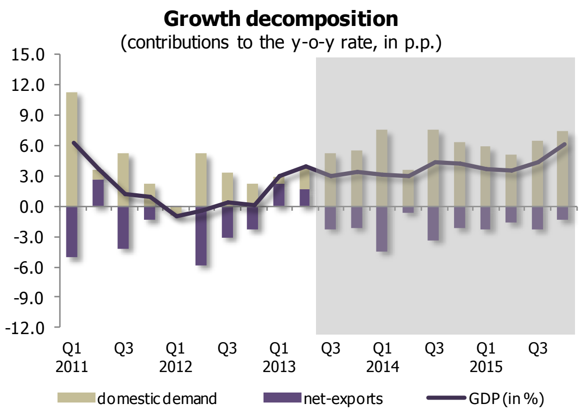
Compared with the April projection, in 2013 **wheat prices** are expected to achieve lower rates of decline, while **maize prices** will decline slightly faster than expected. The decline in food prices is expected, given that the April forecast for record high grain crop this season had materialized. Similar are the assessments of the conditions on the supply side also for 2014, which include the latest global estimates for faster growth in the price of wheat and slightly lower decline in the price of maize. Given the expectations for increased production of grains, the differences in the direction of annual price changes are due to the estimates for positive changes in the inventories of maize and negative changes in the inventories of wheat. On the other hand, the current projection indicates a general rise in the food commodity prices in 2015. The main risk to the achievement of these projections

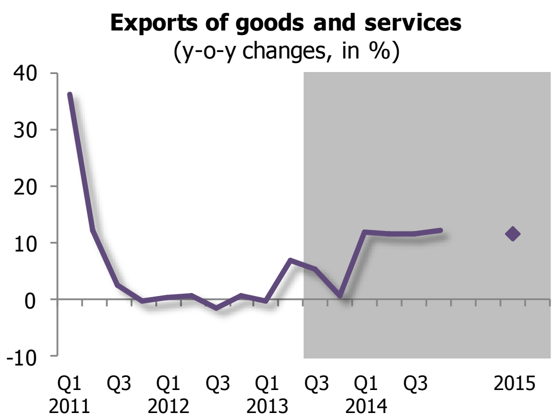


remains associated with the uncertainty about the weather conditions in the forthcoming period.

In the three-year projection period it is expected that the **one-month EURIBOR**[88] will remain significantly lower than the historical average. Moreover, in 2013 and 2014 this rate is expected to be lower than estimated in April. The downward revision is mainly associated with setting the forward guidance by the ECB about the future path of the key interest rate, i.e. ECB's commitment to keep the interest rate at current or lower level for a longer period of time. As a result, current expectations are related to more moderate increase in the foreign interest rate, compared to the April projection.

4.2. Projection and effects on the monetary policy





The latest projections indicate absence of significant changes in the environment for conducting the monetary policy. The new assessments for the external sector point to a room for accumulation of foreign reserves in the next period and their maintenance at an adequate level. Although in the period ahead it is expected that the stronger demand in the economy will create import pressures, they are not expected to cause major external imbalances. Also, it is estimated that the increasing utilization of the potential of new facilities with foreign capital will, to a certain extent, mitigate the effects on imports, caused by the growth of exports and the increasingly higher investment and private consumption. Also in the next two-year period, it is expected that borrowing and direct investments will be the sources for covering the needs for external financing, in a volume sufficient for further accumulation of foreign reserves. Therefore, it is expected that capital inflows will enable the maintenance of an adequate level of foreign reserves. **Regarding the foreign interest rate, as a factor that may affect certain flows in the balance of payments, this projection remains almost unchanged.** Against the background of the expected slow recovery of the euro area and announced continuation of the extremely relaxed policy of the ECB, the expected movement of the EURIBOR is similar to the April projection and remains well below the historical average. In such circumstances no outflows on this basis are expected. **Risks to the baseline**

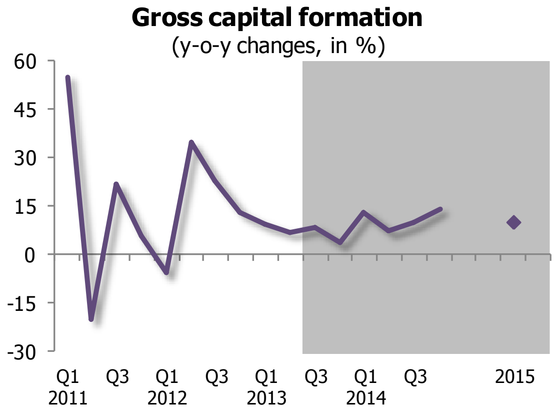
88 Historical data are taken from EUROSTAT. Source for the projection for 2013 and 2014 is "Consensus Forecast" and source for the projection for 2015 is "Bloomberg".

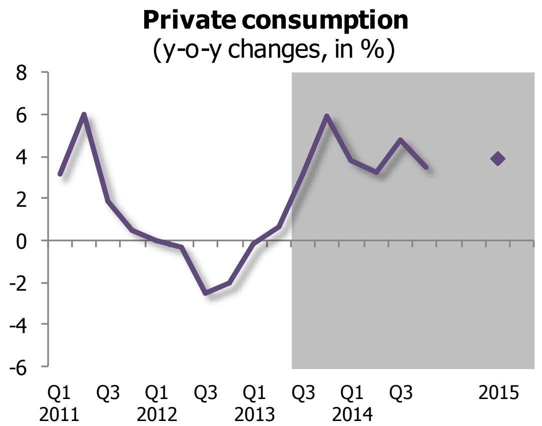
macroeconomic scenario are similar to those from the April projections cycle. Amid still present uncertainty about the global recovery, there are risks to the external position of the economy, which could be spilled over through multiple channels. These risks point to the need for continuous monitoring of the possible changes in the external and domestic economic conditions in the forthcoming period and taking timely measures.

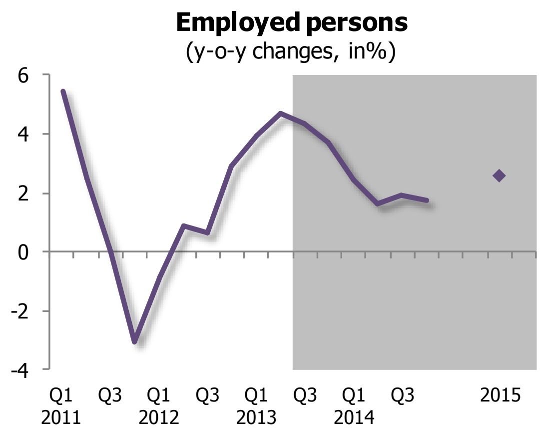
In the first half of 2013, a significant acceleration of economic activity was registered, primarily due to the growth in investments and exports. Based on the high frequency indicators, it is estimated that similar, relatively high rates of GDP growth on an annual basis will remain also in the second half of 2013. Therefore, it is expected that **the economic growth for the entire 2013 will equal 3.3%. Positive trends in domestic and export demand will contribute towards a further acceleration the growth rate to 3.7% in 2014 and 4.4% in 2015.**

After the anemic movements last year and early this year, **accelerated real exports** were registered in the second and third quarters, largely as a result of the expansion of the production capacities of some of the export-oriented companies in the country. Furthermore, it is estimated that continued investments in export-oriented production, and gradual recovery of external demand, will result in **faster rates of growth of real exports in 2014 and 2015, making it the most important single factor of growth.**

The components of domestic demand will also have a high positive contribution to growth in 2013. Moreover, it is expected that by the end of the year the trend of growth of investment activity will continue, although at moderately lower pace than in the first half of the year. It is expected that the growth of investments will largely be supported by public and foreign investments. Also, after the moderate growth in the first half of the year, **it is estimated that by the end of 2013, household consumption will considerably accelerate.** Increased propensity to consume is explained mainly by the increase in employment (in the first half of the year the growth in the number of employees resulted from the employment in construction, in transport, storage and communication and in agriculture). In addition, household consumption will be further supported by banks' lending activity.

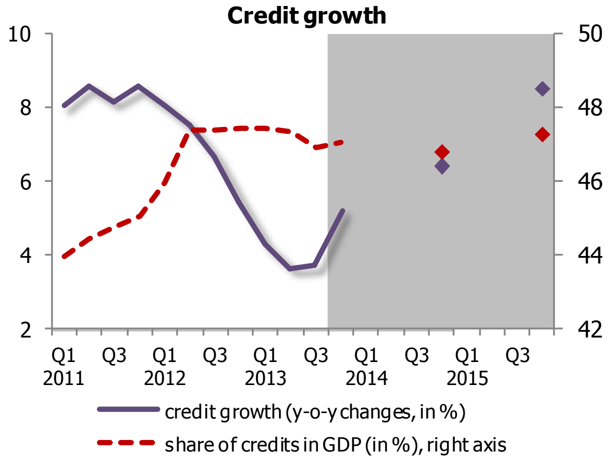


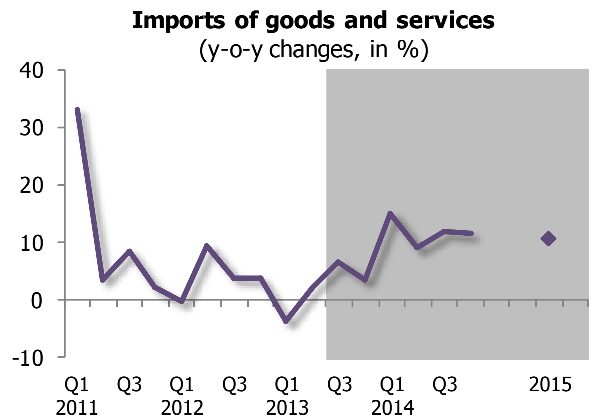




In the course of 2014, the growth of domestic demand will further accelerate, allowing for equal relatively high contribution of private consumption and investment in economic growth. It is expected that the gradual improvement in the global economic environment, amid increased export demand and higher inflows of foreign capital in the forthcoming period, will contribute to the increase in corporate investments. However, the announced government capital investments, especially investments in infrastructural projects, are expected to provide the greatest impetus to the growth of investments. Also, **significantly accelerated growth of private consumption is expected in 2014.** Employment will continue to be a major growth factor, reflecting not only the current positive trends, but also the expectations for the next period. The accelerated economic activity will contribute to a further increase in employment in the private sector, while the announced employments in the public sector are expected to have an additional effect. Also, it is expected that consumption growth will be supported by the growth in real wages over the next year, again as a result of the accelerated economic activity and the announced wage growth in the public sector. Beside the positive developments on the labor market, the continuation of the banks' policy for distribution of most of the loans in the household sector will also contribute to the increased household consumption, while the announced rise in pensions and the continuous inflows of private transfers will provide an additional positive contribution to growth. **It is expected that favorable movements in domestic demand will continue in 2015, amid similar growth rates of private consumption and gross investments as in 2014.** The stable high export demand and further government capital investments will be the main factors of growth of the investment activity. This will contribute to further improvements of the movements in the labor market, whereby the positive growth rates of household consumption will be maintained. After the moderate negative contribution to growth in 2013, **it is expected that public consumption will grow moderately in the next two years, i.e. it is expected that it will give positive contribution to GDP growth.**

It is expected that the accelerated economic activity and stabilized risk perceptions will contribute to the increased lending in the forthcoming period. Thus, it is





Balance of Payment Forecast (% of GDP)

	2010	2011	2012	2013	2014	2015
Current account	**-2.0**	**-2.5**	**-3.0**	**-3.0**	**-4.6**	**-5.7**
Balance of goods & services	-20.0	-20.8	-22.9	-20.5	-21.5	-21.2
Goods, net	-20.5	-22.1	-23.5	-20.8	-21.5	-21.6
Services, net	0.5	1.3	0.6	0.4	0.0	0.4
Income, net	-1.4	-1.8	-2.0	-2.1	-2.2	-2.5
Current transfers, net	19.4	20.0	21.8	19.5	19.1	18.0
Private transfers, net	18.9	19.0	21.0	18.9	18.5	17.4
Capital account	**0.2**	**0.1**	**0.3**	**0.1**	**0.0**	**0.0**
Financial account	**1.9**	**6.0**	**3.9**	**1.8**	**4.8**	**7.0**
FDI, net	2.2	4.5	1.0	2.7	4.0	4.5
Portfolio Investment, net	-0.8	-1.0	1.0	-1.8	-0.1	-1.6
Other Investment, net	0.4	2.6	1.9	1.0	0.9	4.1

estimated that the expected **annual credit growth of 5.2% in 2013 will speed up to 6.4% in 2014 and to 8.5% in 2015.** These movements will reflect the gradual exhaustion of the negative effects of banks' credit risk perceptions and of the conservative strategies of the major banking groups. NBRM measures in respect of the interest rate and other measures taken by the NBRM would also have a stimulating effect in the future. Positive impetus is expected by the stabilization of global financial markets and the expected growth in domestic demand. The growth of private consumption and corporate investment will have an additional positive contribution by increasing the credit demand. However, the baseline projection for banks' lending is accompanied with downward risks related to possible further refraining from lending as part of the strategy of foreign banking groups, i.e. parent banks. **As for the growth of deposits, despite the weaker performances in the first half of the year, it is expected that the acceleration in the third quarter, coupled with the typically faster deposit growth in the last quarter, will contribute to an annual growth rate of 4.8% in 2013.** Furthermore, it is expected that the strengthening of domestic economic activity, influenced by the growth in employment, wages and investment, will contribute to a significant recovery of the **deposit base, which would increase at rates of 9.1% in 2014 and 9.3% in 2015**.

It is expected that the strengthening of domestic and export demand will contribute to the more rapid growth of **real imports in the second half of 2013**. Furthermore, in accordance with the expectations for further significant acceleration of the investment activity and household consumption, as well as of the export activity, it is expected that real imports will significantly increase over the next two years. **The contribution of net exports to growth will be minimally negative in 2013, while this factor is expected to have a stronger negative contribution in the next two years.**

Current outturn, expectations for increased production and for higher exports of the new industrial facilities, as well as the gradual economic recovery in global terms, suggest an opportunity for nominal growth in **the exports of goods and services** in the forthcoming period. In 2013, it is expected that the growth will be more moderate (1.3%), and in the following year it would be faster, and reach a double-digit growth rate (12.8%). On the side of **imports of goods and**

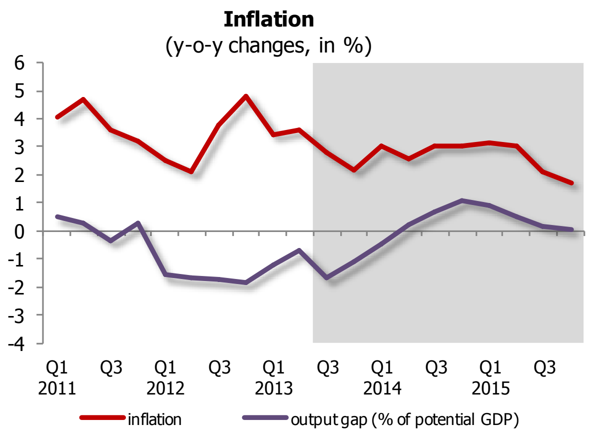
services, this year a slight decline is expected (of 0.6%), largely due to lower energy imports. Stronger import growth is expected in the next year (about 12.7%), affected by the growth of imports for export, but also of the imports caused by the increased investment and private consumption. Starting from the next year, it is expected that part of the envisaged investment projects, primarily infrastructural projects, would contribute to a greater increase in the import of services in the medium term. However, in 2013, in conditions of lower import pressures and growth in exports, **the deficit in the trade in goods and services is expected to narrow to 20.5% of GDP (from 22.9% of GDP in 2012).** The stronger movement of imports will lead to another **widening of the deficit in the trade in goods and services to 21.5% of GDP in 2014.** The possibly higher activity of the new export-oriented industries, compared to the current expectations, is a positive risk for the projection of the trade balance for 2014. A significant part of this deficit will continue to be financed by private transfers, which are expected to remain at a relatively high level this year, but would be lower compared to the previous year, given the gradual exhaustion of the effects associated with the weaker confidence in the Euro[89]. It is expected that the decline of the relative importance of transfers will continue next year, but more moderately. Hence, despite the narrowing of the deficit in the trade in goods and services, **in 2013, the current account deficit is expected to remain at 3% of GDP, while in 2014 it is expected to widen to 4.6% of GDP. This trend is expected to continue in 2015, when the negative current account balance would reach 5.7% of GDP,** which, will result from the more intense decline in the inflows of private transfers, amid assessments for a stable deficit in the trade in goods and services.

Capital inflows in this and in the next year will mainly reflect the expected foreign direct investment and planned foreign borrowing. Namely, it is expected that the growth of the domestic economy, improved global environment and the stabilization of global financial markets will contribute to more positive perceptions among investors. Consequently, foreign direct investment in this and in the next year will gradually increase and will reach 2.7% and 4% of GDP, respectively. The **main risks** to

[89] Within this category depositing and withdrawing cash foreign currency in and from the banking system are recorded. In the past, withdrawal of cash foreign currency was registered, which was converted to Denars, amid uncertainty over the future of the Euro.

the external position of the economy in this period are still coming from the pace of the global, and hence the domestic economic recovery and their impact on the perceptions of investors. Moreover, additional risks arise from possible larger outflows due to financing of the parent companies. However, the possible favorable access to external sources of funding by the government could be a positive risk for the external position of the economy. **It is expected that the growth of the inflows in the capital and financial account will accelerate in 2015,** amid further moderate growth of foreign direct investments that will reach 4.5% of GDP, as well as higher external borrowing, primarily by the government.

It is estimated that the projected developments in the capital and financial account will allow further accumulation of foreign reserves during 2014 and 2015 and their further maintenance at an adequate level.



The domestic inflation rate in 2013 is expected to be around 2.8%, driven by the food component and core inflation. **In 2014, it is expected that inflation rate will slow down and would average 2.3%.** Price increases in 2014 reflect the pass-through effect from the previous year, and the expected movements of some import prices and the recovery of domestic demand. This projection does not include the effects of a possible increase in the regulated price of electricity[90]. The risks to the projected path of inflation are perceived as balanced, with a risk of lower pass-through from future movements in the world market prices to domestic inflation and greater upward pressure from domestic demand. **It is expected that the slowdown in inflation would continue in 2015, when it would slowly approach the historical average and would be around 2%.**

4.3. Comparison with the previous projection

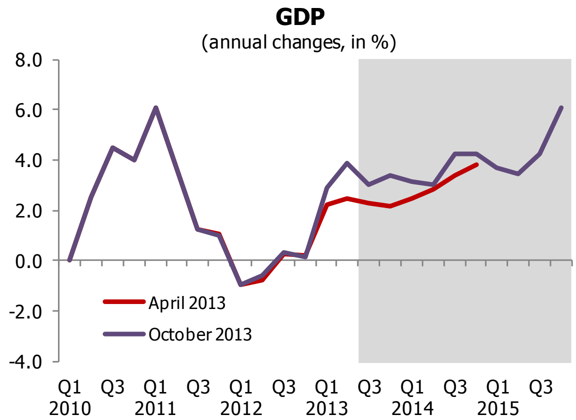
Forecast of selected macroeconomic variables

annual rates of change (in %)	2013 forecast		2014 forecast		2015 forecast
	Apr.	Oct.	Apr.	Oct.	Oct.
GDP	**2.2**	**3.3**	**3.0**	**3.7**	**4.4**
Personal consumption	1.5	2.2	3.6	3.9	3.9
Gross capital formation	6.4	6.6	8.3	11.0	9.9
Public consumption	1.3	-1.2	0.6	0.5	1.0
Exports of goods and services	4.0	3.0	9.5	11.8	11.7
Imports of goods and services	3.9	2.1	9.4	11.8	10.5
Inflation	**2.8**	**2.8**	**2.3**	**2.3**	**2.0**
Current account deficit (% of GDP)	**-4.2**	**-3.0**	**-6.0**	**-4.6**	**-5.7**

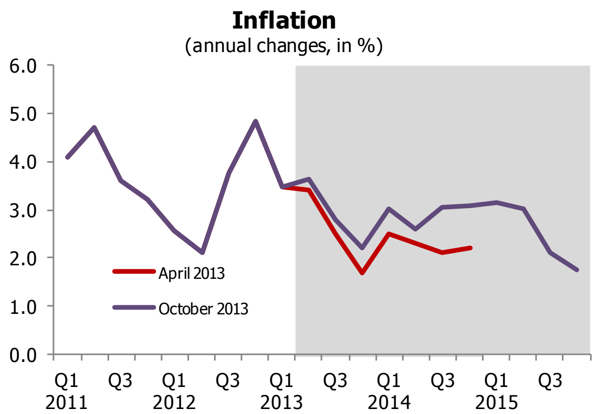
The outturn and new assessments indicate higher economic growth over this and the next year, compared to the April projections, and unchanged expectations for inflation. October assessments point to a lower current account deficit, and lower capital inflows for 2013 (mainly currency and deposits). In 2013, a slight fall of foreign reserves[91] is expected, while during 2014,

[90] The estimated effect on the average annual inflation from the increase in the price of electricity by 10% in mid-2014 is 0.4 percentage points.
[91] The fall of foreign reserves partly stems from the closing of the swap transaction of the NBRM and outflow of a foreign

further growth of foreign reserves is anticipated, in somewhat smaller volume than previously expected.



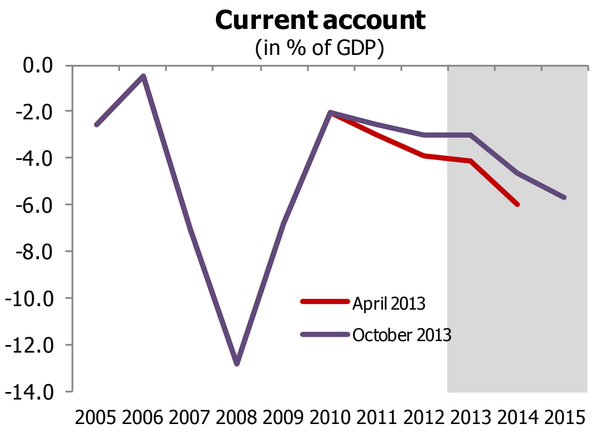
Upward revisions to GDP growth were made in circumstances of higher outturns in the real economy in the first half of 2013, upward revisions in some of the major drivers of growth of the GDP components and almost unchanged outlook for the global environment.**. Thus, in this and the next year, it is expected that the domestic economy will achieve positive growth rates of 3.3% and 3.7%, respectively** (2.2% and 3%, respectively, in the April projections). As in the April projection, domestic demand will be the main carrier of economic growth and investments will be its main driver this year, with approximately the same rate of growth. Domestic investment activity comes from government and foreign investments and export growth. Unlike the April projection, it is expected that investments will be the main carrier of the domestic demand also in the next year, in accordance with the new information on important infrastructural projects for the next few years. Moderate upward revisions are made to the private consumption. The outturn in the first half of 2013 showed a faster recovery of private consumption compared to the April expectations, amid significantly improved developments in the labor market. Consequently, for 2013 and 2014, the expectations for the pace of private consumption are similar as before, i.e. more moderate growth this year and more pronounced growth in next year, but faster than envisaged in the April projections. On the other hand, the contribution of net exports in 2013 will be less negative, amid more pronounced downward revision of imports compared to exports, relative to the April growth in these categories.



As of the third quarter of 2013, actual inflation was in line with projections. Therefore, in the absence of major changes in key assumptions, **expectations for inflation for this and the next year are basically unchanged compared to the April projection.**

Regarding the current account deficit, the latest assessments point to its improvement compared to the expectations in April. Namely, given the more favorable outturn, **the deficit for this year will be 3% of GDP, versus the previously expected 4.2%, while for the next year it is revised from 6% to 4.6% of**

currency bank deposit from the NBRM at the beginning of the year.



GDP. Such downward revisions are a result of the lower trade deficit, primarily in the part of the energy trade balance[92], and are additionally supported by the expected contraction of the non-energy trade deficit in the next year. For 2013, a downward revision of the export growth was made, while instead of moderate growth, current projections contain a decline[93] in the import of goods, given the weaker outturn. For 2014, accelerated growth in both categories is expected, which will be a little more pronounced in exports, compared with the April projections, which is in line with the favorable export expectations due to the new industrial facilities. Contrary to the improved expectations for the trade balance, in the part of services, expectations are more unfavorable compared to the April projections, which in 2013 is due to the weaker outturn, while next year they will be mainly reflecting the expectations for increased outflows associated with planned infrastructural projects. Downward revisions for both years are made in the item which covers most of the trade deficit - private transfers, in accordance with the lower outturn, but also their uncertain dynamics. Regarding the capital and financial account, current assessments indicate lower inflows compared to the April expectations. Downward revisions for 2013 primarily result from the outturn, and given the volatility of the components, it is still difficult to determine the reasons for these deviations. The likelihood of a more favorable performance by the end of the year is not excluded. Regarding 2014, the downward revision stems partly from the new information about the lower external government borrowing[94]. **Despite the improvement in the current account, the assessment for lower capital inflows points to a fall of foreign reserves in 2013, contrary to the expected accumulation in the April projections. For 2014, the level of foreign reserves is expected to increase further.**

---

92 While all categories within the energy balance contribute to the improvement, the changes are mainly derived from the trade in oil and oil derivatives.
93 The largest is the contribution of the lower energy imports.
94 In April, the assumptions for the budget deficit and its financing structure were taken from the Pre-Accession Economic Programme for 2013-2015, while for the October projection, the Fiscal Strategy 2014-2016, published in September 2013, was used. It also takes into account the announced foreign borrowing of the Agency for Roads associated with the realization of the infrastructural projects.

Comparison of GDP and inflation forecasts for Macedonia from various organisations

Organisation	Month of publication	Real GDP growth, %		Inflation (average rate, %)	
		2013	2014	2013	2014
IMF	October 2013	2.2	3.2	2.8	2.1
World Bank	June 2013	1.0	2.2	-	-
European Commission	May 2013	1.5	2.0	3.2	2.8
EBRD	May 2013	1.5	2.6	2.7	-
Consensus Forecast	October 2013	1.4	2.6	3.1	2.9
National Bank of Greece	October 2013	3.2	2.6	2.3	2.0
Ministry of Finance of the Rep. of Macedonia	September 2012	2.0	3.2	3.5	3.3
National Bank of the Republic of Macedonia	October 2013	3.3	3.7	2.8	2.3

Source: IMF World Economic Outlook, October 2013; World Bank Global Economic Prospects, June 2013; European Commission European economic forecast - spring 2013; EBRD Regional Economic Prospects, May 2013; Consensus Forecast, October 2013; NBG Southeastern Europe and Mediterranean Emerging Market Economies, October 2013; Ministry of Finance of the Republic of Macedonia, 2014 Draft Budget of the Republic of Macedonia, September 2013; and the National Bank of the Republic of Macedonia.