EBS/14/2
Correction 2

February 5, 2014

To: Members of the Executive Board

From: The Secretary

Subject: **Former Yugoslav Republic of Macedonia—Second Post-Program Monitoring Discussions**

The attached correction to EBS/14/2 (1/14/14) has been provided by the staff:

Factual Error Not Affecting the Presentation of Staff's Analysis or Views

Page 5, paragraph 5, line 5: "simultaneously" removed
paragraph 5, line 6: "and FX-indexed loans" removed

Questions may be referred to Ms. Vladkova Hollar (ext. 39695) and Mr. Gerard (ext. 39576) in EUR.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

- GDP, the current account deficit is projected to widen by about 0.4 percentage points, to 3.4 percent of GDP[3].

- ***After remaining muted in the first semester, net foreign direct investment has picked up recently and is expected to reach 3.3 percent of GDP***. These flows are now expected to be some 1.2 percentage points below the forecast at the time of the 2013 Article IV discussions. Nonetheless, they reflect a strengthening of net FDI relative to 2012, particularly as the scale of capital outflows in the form of profit repatriation and intercompany loans observed in 2012 has diminished.

- ***Foreign exchange reserves have declined.*** While robust net borrowing by the public sector has generated a sustained inflow of foreign exchange, sizable negative valuation effects affecting gold and foreign securities have resulted in an erosion of the stock of official reserve assets by about €185 million as of early December, since end-2012.

4. The banking sector remains healthy, although profitability has been declining. As of the third quarter, capital ratios are high, with an average CAR of 17.3 percent (Tier 1 of 14.7 percent). Liquidity is, too, with a liquidity ratio above 32 percent of total assets. NPLs fell to 11.8 percent of total loans from 12.3 percent in June, reversing the previous trend increase. Moreover, recent stress tests conducted by the NBRM, partially based on macroeconomic scenarios, indicate that the banking sector is resilient to significant deposit withdrawals or to a sharp deterioration in the quality of loans. Yet profitability has been declining, with ROE down to about 1.8 percent on average, due to the practice of fully provisioning non-performing loans and impaired assets, in a context of uncertainty surrounding the situation of euro area parent banks.

5. Further monetary easing has been unable to revive credit growth. In the face of a deceleration in credit growth to about 3.1 percent in the first half of the year, in July the authorities reduced the central bank bill rate (the main policy instrument) and the 7-day deposit facility rate by 25 basis points, to 3.25 percent and 1.50 percent, respectively. At the same time, they lowered reserve requirements on liabilities in domestic currency, ~~simultaneously~~ tightening them on short-term FX deposits ~~and FX-indexed loans~~, with the dual objectives of stimulating deposit growth in local currency and encouraging long-term foreign capital funding of domestic banks. Yet credit growth has remained subdued so far, especially to the corporate sector—partly due to risk aversion, partly to portfolio cleaning.

6. Budget execution through October suggests that the new 2013 deficit target will likely be met. The higher cash deficit target established by the supplementary budget and approved by Parliament in November accomodates a MKD 1 billion increase in pensions as well as MKD 0.4 billion to clear arrears with foreign suppliers. Despite revenue underperformance of

[3] This represents a substantial upward revision of the current account balance projection relative to the 2013 Article IV Consultation, due to sizeable base effects. Statistical revisions related to activities in the free-trade zone have led to revisions of the official historical data on current account deficits to 2.5 percent of GDP in 2011 (from 3 percent) and 3 percent of GDP in 2012 (from 3.9 percent).

about 1.3 percent of GDP on a full year basis, expenditure compression in goods and services and capital expenditures—some of it automatic— suggest that the overall fiscal deficit target of 3.9 percent of GDP for 2013 is attainable.

OUTLOOK AND RISKS

7. **Growth is expected to strengthen to 4 percent in medium term**. Domestic demand will continue to be the main driver of growth. While unlikely to return to pre-crisis growth rates of about 6 percent, consumption is expected to recover to about 3–3 ½ percent growth. The contribution of net exports would strengthen only gradually, as imports increase in line with the rebound in both private consumption and foreign direct investment. Nevertheless, there are risks to this outlook, particularly from weak credit growth, which could impede the rebound in private consumption and investment (see ¶8), as well as broader risks to institutions and investment from continued uncertainty regarding the start of EU accession talks.[4] With no substantive policy distortions in the labor market (see SM/13/137) and generally good policies, stronger convergence growth seems to have been hampered primarily by slower accumulation of capital (text figure). The authorities' growth agenda is thus appropriately focused on building capital—where both public infrastructure and foreign investment flows play a key role.

8. **Credit conditions are expected to improve in 2014, but risks are tilted to the downside**. Credit expansion will likely accelerate, as some banks reach out to under-served market segments through refined monitoring and credit scoring methodologies that allow them to lend against cash flows, in contrast with the predominant strategy to only lend against collateral[5]. A supply-side analysis of potential space for expanding credit to the private sector—taking into account government financing needs—suggests scope for credit growth of around 4.5 percent in 2014. Risks to the credit outlook pertain to potential restructuring in Slovenian and Greek parent banks, whose local subsidiaries, with an almost 40 percent share of assets, are systemically important to the Macedonian banking system. The authorities underscored that a lengthy process of divestment of these Macedonian subsidiaries—should it become part of the restructuring process of their parent banks—risks a shift in strategy away from credit intermediation toward portfolio beautification, negatively affecting domestic demand.

9. **The current account is expected to deteriorate in 2014, mainly due to a further decline in private transfers**. Import volume growth is projected to accelerate in line with both the setting up of new production capacities and the intensification of trade in the free-trade zones. Yet, export volume growth would outpace import growth, broadly stabilizing the trade

[4] The European Commission's latest communication on enlargement is available here: http://europa.eu/rapid/press-release_SPEECH-13-816_en.htm

[5] (SM/13/137).