LAPSE OF TIME

SM/16/302
Correction 1

November 15, 2016

To: Members of the Executive Board

From: The Secretary

Subject: **Former Yugoslav Republic of Macedonia—Staff Report for the 2016 Article IV Consultation**

Board Action:	The attached corrections SM/16/302 (10/26/16) have been provided by the staff:
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 4, 8, 14, 15 (paras. 22, 23 (lines 1 and 4), text chart (left figure heading text)) 16, 26, 28, 29, 30, 31, 36, 39, 40, 43**
Typographical Errors	**Pages 15 (spelling of "Denar" in left text chart), 27**
Questions:	Ms. Rahman, EUR (ext. 36649) Mr. Omoev, EUR (ext. 36451) Ms. Jirasavetakul, EUR (ext. 39433)

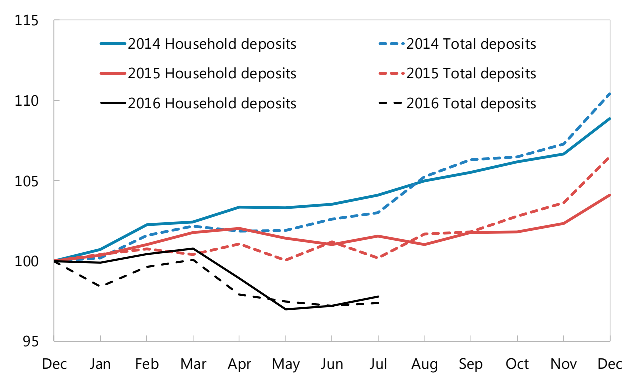
CONTEXT

1. **The economy has endured a deep and prolonged political crisis**. The crisis started in January 2015 with the main opposition party (SDSM-social democrat) releasing tape recordings implicating state officials of the ruling coalition (led by VMRO-DPMNE-nationalist) in vote rigging and large-scale government abuse of power. It subsequently led to the resignation of the Prime Minister and gave way to an interim technical government. Despite active mediation from the European Union (EU) and the U.S., parliamentary elections are yet to take place. On July 20, 2016, the four main political parties signed a new agreement on steps to promote the rule of law, ensure media freedom, and clean up the voter list with parliamentary elections set for December 11. While this agreement removes the long political impasse, there are lingering risks of further postponement of elections and post-election instability.

2. **The crisis has begun to affect confidence and prospects.** The banking sector has seen a drastic slowdown in deposit growth. FDI inflows have also moderated. Meanwhile, in November 2015, nine years after granting the candidate status, the EU decided to keep the recommendation conditional on progress on political and governance fronts. A failure to make meaningful progress in these areas is likely to negatively affect FYR Macedonia's EU accession aspirations and dent FDI inflows, much of which are sourced from EU countries.

FYR Macedonia: Monthly Deposits

(Stock of deposits, December data of previous year =100)

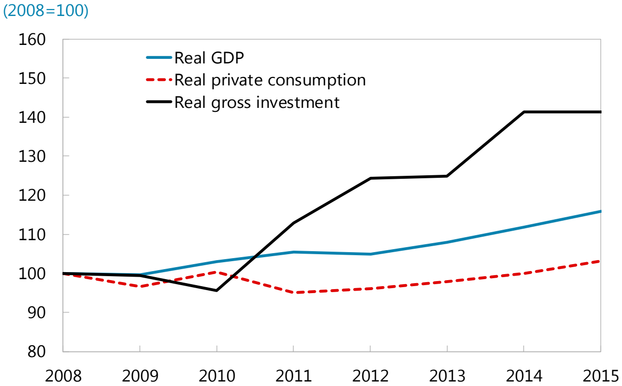


Sources: NBRM, IMF Staff Calculations.

3. **Recovery from the global financial crisis has been solid, but growth has slowed.** Real GDP growth averaged around 2½ percent during 2010–15 compared to 4 percent during 2003–0~~8~~9, mostly reflecting a slowdown in potential growth, an experience shared by other countries in the region (Box 1). Although contributions from capital have held up, benefitting from large infrastructure and foreign direct investment, lower contributions from labor and negative productivity growth are estimated to have nearly halved FYR Macedonia's potential output growth in post-crisis years. High structural unemployment, low labor force participation and an ageing population cast a lasting shadow on the longer-term economic outlook. As policy support and stimulus from infrastructure investment taper off, growth may lose steam unless reforms to improve productivity and labor's contribution are put in place.

FYR Macedonia: Real GDP and Components

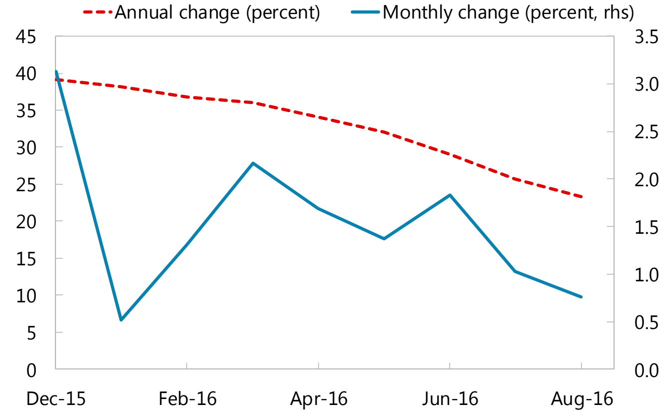
(2008=100)



Sources: Republic of Macedonia State Statistical Office (SSO); and IMF staff calculations.

7. Credit growth has been solid despite some slowdown in both household and corporate credit (Figure 4). Household credit growth has been buoyant with some slowdown in long-term consumer lending. This partly reflects policy measures taken in December 2015 that increased the risk weight on newly approved long-term consumer loans with maturity equal to or longer than eight years from 75 percent to up to 150 percent. Reflecting uncertainties, credit growth to non-financial corporates (NFCs) continued to slow despite declining lending rates.

Consumer Loans with Original Maturity Equal or Longer than 8 Years



Sources: NBRM and IMF staff calculations.

OUTLOOK AND RISKS

8. GDP growth is projected to soften in 2016 but pick up in the medium term. In 2016, GDP growth is projected to slow down to 2.2 percent mostly reflecting stalled investment and some moderation in credit growth. Assuming elections in December followed by stable government, growth is projected to increase to 3.2 percent in 2017 with some pick-up in outer years benefiting from infrastructure investment, continued improvement in labor market and some strengthening of credit growth (Table 1). Staff's analysis shows that the authorities' planned infrastructure investment during 2014-18 is likely to contribute to growth by ½ percentage points annually in the medium term including by improving productivity.[2] Headline inflation turned positive in September 2016 and is projected to gradually reach 2 percent by end-2018. Staff projects a widening of the current account deficit in the medium term to around 3 percent of GDP reflecting higher interest and dividend payments and lower transfers (Tables 1 and 3). A modest strengthening of FDI inflows is anticipated based on expectations of political stability. Despite strong growth, external debt-to-GDP ratio is projected to rise above 70 percent of GDP in the medium term reflecting large financing needs of the public sector.

9. This positive outlook is highly contingent on return of political stability. A derailment of the agreement among main political parties and further postponement of elections could significantly affect near-term growth with related negative impacts on the financial sector and the fiscal balance. In 2017, real GDP growth could drop to below 2 percent through further confidence loss and weaker credit growth that would impact private consumption and investment. The banking sector could see renewed pressures of deposit outflows and currency conversion with a decline in

[2] It is important to note that public infrastructure investment is mostly carried out by a non-financial public enterprise, and therefore, financed outside of the general government budget. See Selected Issues Paper "Public Infrastructure Investment and Economic Growth in FYR Macedonia" for details.

and growth. Choosing a prudent debt limit in the medium term will enhance its ability to accommodate longer-term spending pressures.

18. Reforms to rein in the sizable pension deficit are warranted. Staff highlighted several options: (i) raise statutory retirement age given the sizable gap of 3 years for men and 5 years for women with the EU average; (ii) consider revising indexation (currently indexed as 50/50 to CPI/wage) to mostly CPI in line with many countries in the EU; (iii) implement reforms to increase labor force participation, particularly that of women (one of the lowest in Europe), and (iv) consider increasing contribution rates if sustainability is not secured through other measures.

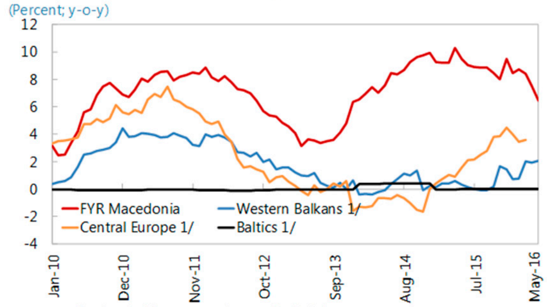
19. The authorities agreed with staff on the need to rebuild fiscal policy space. They drew attention to the importance of fiscal policy in supporting the economy during the global financial crisis. Going forward, they envisaged the role of the government as largely that of an enabler to maximize private sector's contributions to the economy. They acknowledged the rapid rise in public debt, and reiterated the commitment to consolidate their fiscal positions to contain risks and rebuild buffers. The authorities see fiscal consolidation rely on (i) a broadening of the tax base from stronger growth and enhanced revenue mobilization through modernization of the tax system, and (ii) higher expenditure efficiency, including through strengthening the link between expenditure planning and execution. On revenue measures, the authorities appreciated FAD's advice and technical assistance and noted that they are in the process of reviewing action plans following the recent TADAT assessment.

20. Preparations for the introduction of the fiscal rule, originally planned for January 2017, are on hold. The authorities explained that this will need to wait until after a stable government. Institutional readiness needs improvement given limited linkages between the medium-term budget framework and the annual budget process, persistent over-projection of revenues and the periodic build-up of public sector payment arrears. The legal framework for the fiscal rule should include independent monitoring and oversight, as well as other enforcement mechanisms, such as corrective measures to restore deviations over a certain period of time.

B. Monetary and Financial Policies: Maintaining Stability

Background

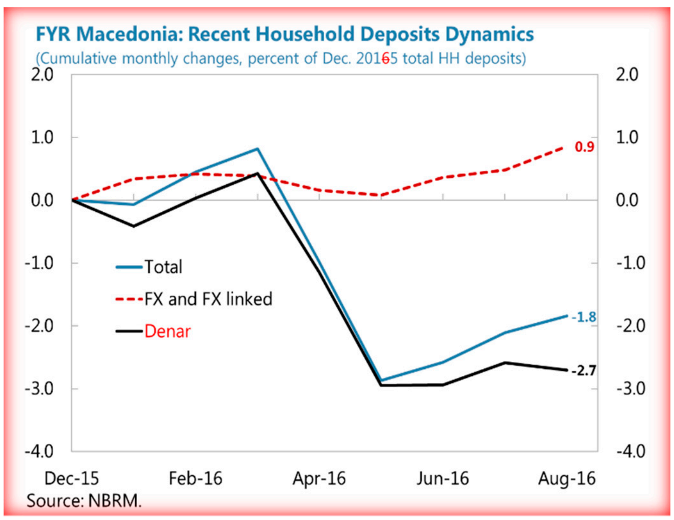
Private Sector Credit Growth, 2010–16
(Percent; y-o-y)

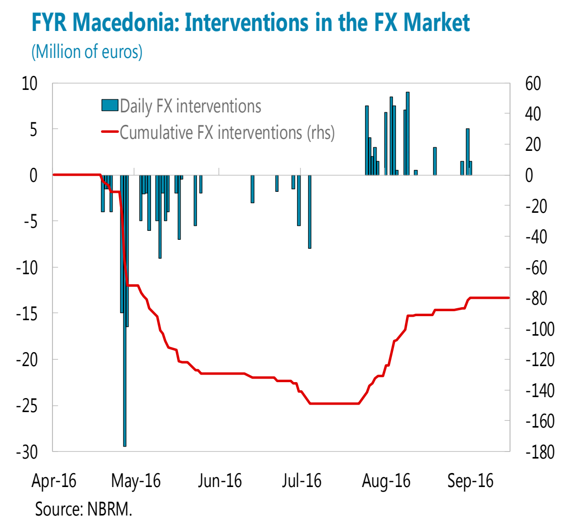


Sources: National Authorities; EBRD; and IMF staff calculations.
Note: 1/ Simple average. Baltics: Estonia, Latvia, and Lithuania. Central Europe includes Czech Republic, Poland, Slovakia, and Slovenia. Western Balkans: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, and Serbia.

21. Robust household credit growth has sustained financial deepening. Given that pre-crisis credit boom was mostly financed by domestic deposits, post-crisis resumption of credit growth has been more resilient compared to many others in emerging Europe facing prolonged deleveraging by parent institutions. Risks from household credit growth appear low based on overall debt stock (21 percent of GDP) and debt service relative to income (~~9~~8 percent). Most mortgage holders are also first-time house buyers.

22. Banking sector is healthy and profitable. Banks are well-capitalized, with the capital adequacy level twice the regulatory requirement of 8 percent. The NPL ratio fell to 7 percent in July reflecting the recent measures to write off NPLs that are fully provisioned for more than two years (Figure 4). Banks' profitability continued to improve in light of strong growth in net interest income. Structural liquidity in the banking system is ample and, according to NBRM's latest stress tests, provides strong buffers to withstand severe deposit outflow shocks. Liquid assets count for one third of total assets in the banking system covering around ~~60~~ 70 percent of household deposits and over 90 percent of liabilities with residual contractual maturity of up to 30 days.

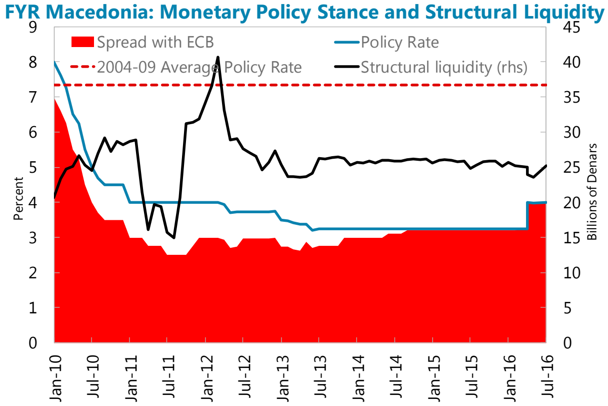




23. However, the banking sector remains susceptible to deposit outflows. In ~~May~~April, an intensification of the political crisis led to deposit outflow and currency conversion pressures prompting the NBRM to increase the policy rate by 75 bps to 4 percent. The NBRM also sold a total of ~~149~~141 million euros (about ~~7~~6 percent of its end-March stock of reserves of 2.26 billion) during April-June and took the following macro-prudential measures (i) increased reserve requirement on FX-linked deposits to 50 percent from 20 percent, and (ii) resumed FX deposit auctions offering banks an interest rate higher than the current euro negative rate. These measures successfully stabilized the exchange rate although lost household deposits have not fully returned to the system. This was the second deposit run in the last eighteen months following an earlier episode in summer 2015 at the height of the financial crisis in Greece. A repeat of such episodes cannot be ruled out as long as political uncertainties persist.

Discussion

FYR Macedonia: Monetary Policy Stance and Structural Liquidity



Source: NBRM.

24. Staff and the authorities agreed that the current monetary policy stance is appropriate. Limited capital mobility allows FYR Macedonia to have some control over monetary policy despite a fixed exchange rate regime (officially classified as *stabilized arrangement*). The weaker growth in 2016 does not call for policy relaxation given that broader economic indicators are robust (Figure 1). At the same time, with no major misalignment in the exchange rate (Annex 1), continued deflation and still-negative output gap, staff does not see reasons to increase the policy rate. However, in case of pressures on the exchange rate or risk of deposit outflows, staff and the authorities agreed that the monetary policy stance may need to be tightened by raising the policy rate along with stricter macro-prudential policies, such as raising the reserve requirement on FX- or FX-linked deposits and offering higher interest rate on FX deposit auctions.

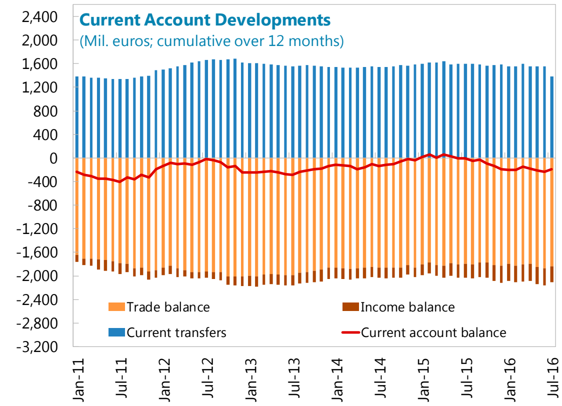
25. The authorities viewed the current pace of credit growth as satisfactory but expressed concerns regarding slow deposit growth. Overall, a high single-digit growth rate for private sector credit augurs well for financial deepening. There are risks of weakening of credit growth if household deposits continue to stagnate. The authorities viewed current NFC credit growth to be solid given political uncertainties and the very low post-crisis NFC credit growth in the rest of region reflecting weak balance sheets and high credit standards. Staff highlighted structural impediments that may also be weighing down NFC credit demand. A predominantly collateral-based lending system together with very high collateral requirements (on average 180 percent of the loan value) deters access to finance for the domestic private sector together with other regulatory hurdles (see paragraph 30).

26. The authorities expressed their intention to maintain the prudential measures that were put in place to monitor the Greek-owned subsidiaries. In May 2016, the smaller Greek-owned subsidiary Alpha Bank was sold to ~~Luxembourg~~Switzerland-based Silk Road Investment Fund. The remaining Greek-owned subsidiary Stopanska Bank is systemic (holds about a fifth of the system's assets), profitable, and fully domestic deposit-funded. Although contagion pressures are no longer present, staff agreed with authorities' decision to maintain current prudential measures for enhanced surveillance (e.g., limits on intra-group exposure, daily deposit monitoring, ex-post notification for parent-sub transaction, see SM/15/214 for details) given uncertainties in Greece. The temporary and targeted capital flow measures adopted in June 2015 to prevent possible outflows to Greece expired in December as planned.

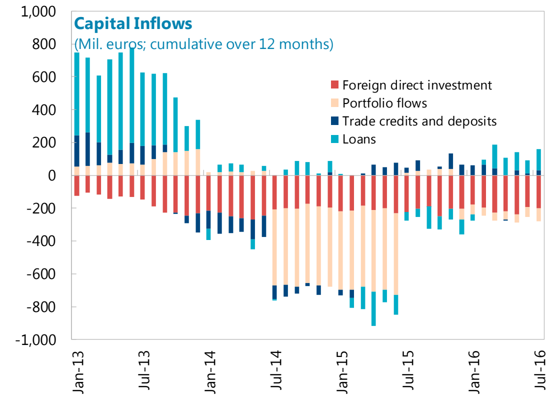
27. Cooperation between the NBRM and the European Single Supervisory Mechanism (SSM) is satisfactory. In October 2015, FYR Macedonia, together with four other southeastern European non-EU countries, signed a memorandum of understanding with the European Banking

Figure 3. FYR Macedonia: External Sector Developments

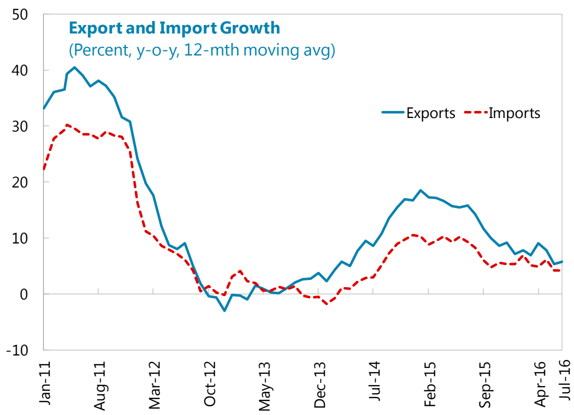
The current account deficit increased in 2015....



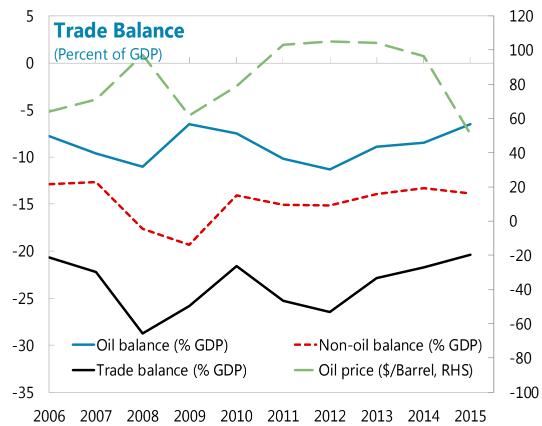
.. but remained fully financed by FDI.



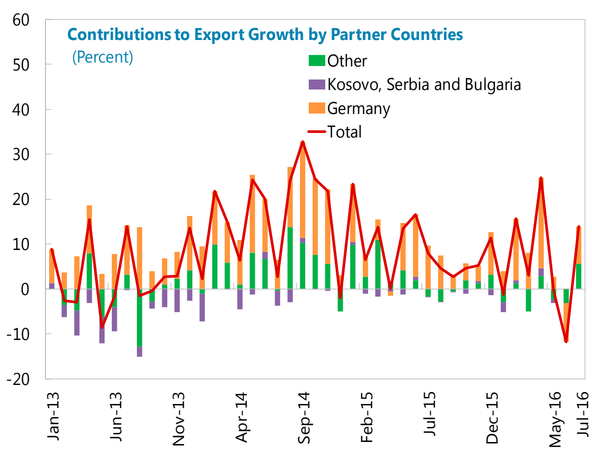
Exports growth has slowed in recent months...



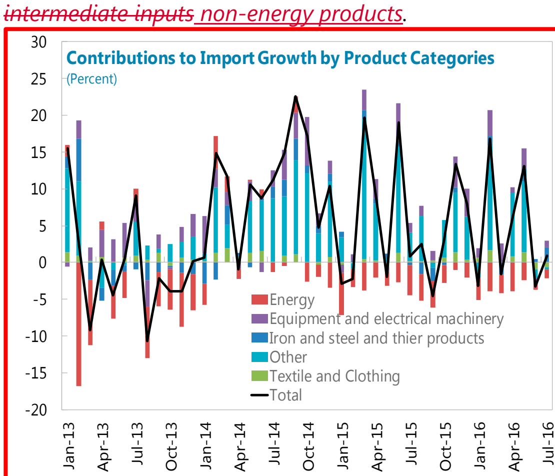
..but trade deficit improved due to oil trade deficit.



Exports benefit from strong demand from Germany...

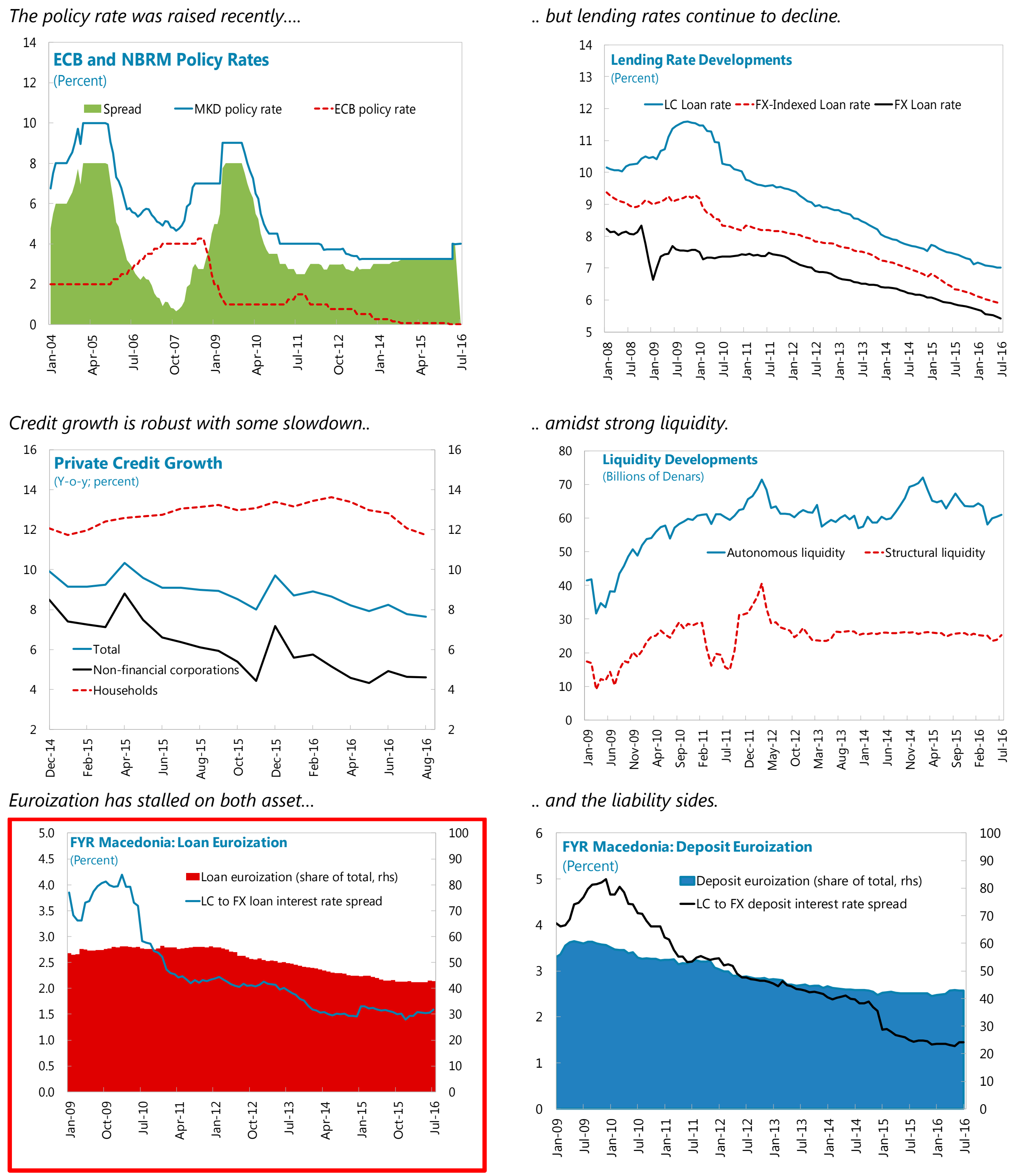


..while imports growth is largely driven by ~~investment and intermediate inputs~~ non-energy products.



Sources: National authorities; and IMF staff calculations.

Figure 4. FYR Macedonia: Monetary Sector Development

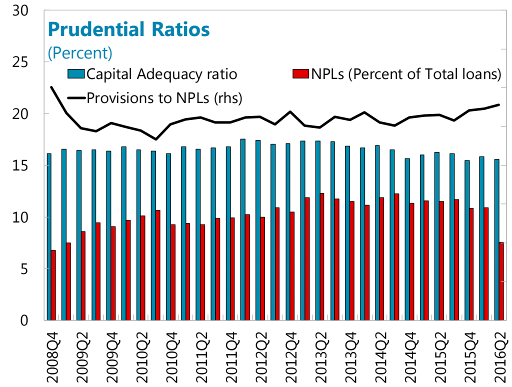


Sources: NBRM; and IMF staff calculations.

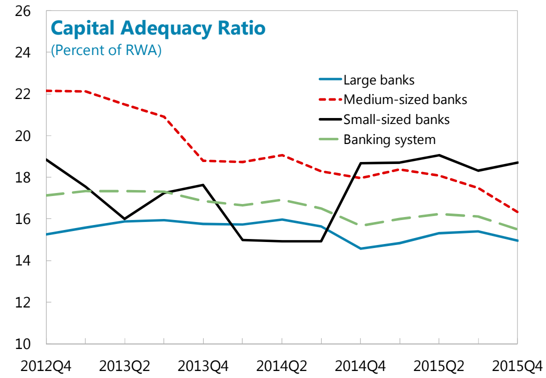
Note: Autonomous liquidity is computed as the sum of net foreign assets, net public sector assets, net bank assets,other items net, minus currency in circulation. Structural liquidity is calculated as autonomous liquidity minus reserves held by banks at the central bank.

Figure 5. FYR Macedonia: Banking Sector Development

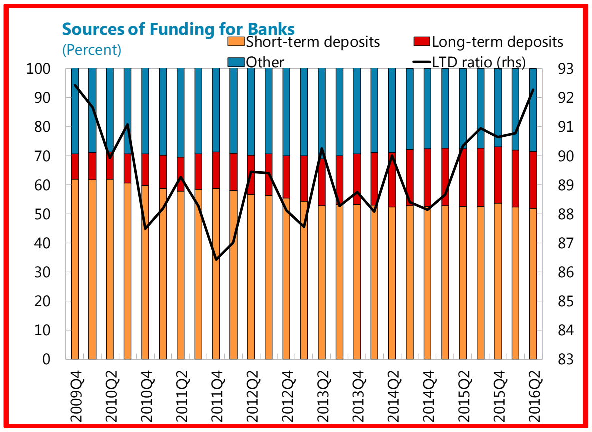
Banking sector continues to be resilient...



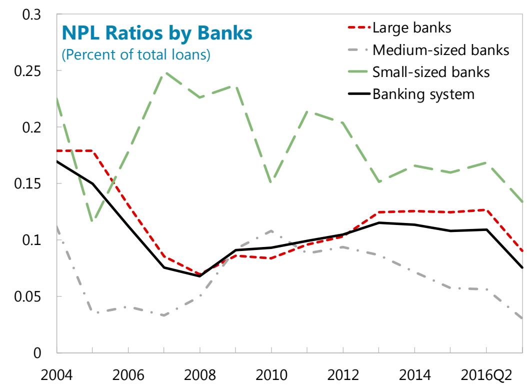
...with high capitalization



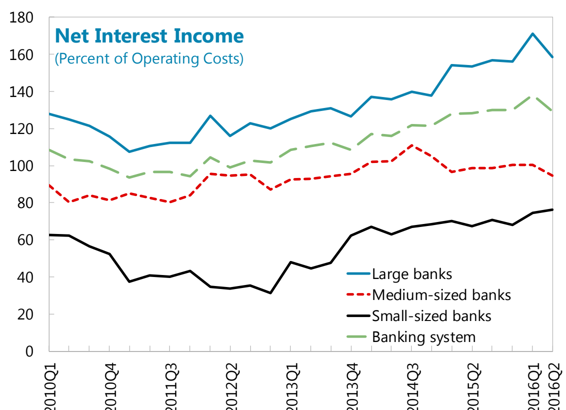
..and a funding structure reliant on ~~long term~~ deposits.



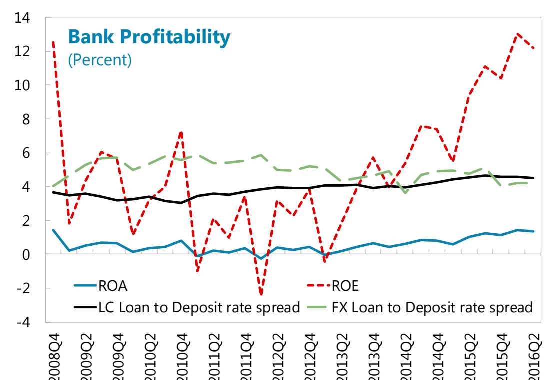
NPLs continue to decline.



Rising net interest incomes and fees...



..., have contributed to strong profitability in recent years.



Sources: NBRM; and IMF staff calculations.

Table 1. FYR Macedonia: Macroeconomic Framework, 2012–2021

(Year-on-year percentage change, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
				Est.			Proj.			
Real GDP	-0.5	2.9	3.6	3.8	2.2	3.2	3.4	3.6	3.8	3.8
Real domestic demand	3.5	1.3	4.7	2.1	1.6	2.6	2.7	2.9	3.2	3.1
Consumption	1.4	1.6	1.9	3.5	1.6	2.3	2.4	2.6	3.0	2.7
Private consumption	1.2	1.9	2.1	3.2	2.4	2.5	2.6	2.8	3.0	3.0
Gross investment	10.2	0.5	13.1	0.1	0.0	3.2	3.5	3.7	3.7	4.3
Exports (volume)	2.0	6.1	18.2	4.6	6.1	6.3	7.0	7.5	7.9	8.0
Imports (volume)	8.2	2.2	16.0	2.4	4.0	4.5	5.1	5.6	6.1	6.2
Contributions to growth 1/										
Domestic demand	4.0	1.6	5.5	2.5	1.8	3.0	3.1	3.3	3.6	3.5
Net exports	-3.9	1.3	-1.7	0.7	0.4	0.2	0.3	0.3	0.2	0.3
Output gap (percent of potential GDP)	-1.9	-1.3	-0.5	-0.4	-0.6	-0.4	-0.3	-0.2	-0.1	0.0
General government operations (percent of GDP)										
Revenues	29.4	27.8	27.5	28.8	28.9	29.5	29.5	29.5	29.5	29.5
Expenditures	33.3	31.7	31.7	32.3	32.9	33.0	33.1	33.1	33.1	33.1
Of which: capital	4.0	3.3	3.3	3.3	2.8	3.5	3.5	3.5	3.5	3.5
Balance	-3.8	-3.8	-4.2	-3.5	-4.0	-3.5	-3.5	-3.6	-3.6	-3.6
Savings and investment (percent of GDP)										
Domestic saving	25.8	27.2	29.8	29.0	31.8	33.3	33.8	34.1	34.5	35.1
Public	0.2	-0.5	-0.9	-0.1	-1.2	0.0	0.0	-0.1	-0.1	-0.1
Private	25.6	27.7	30.6	29.2	33.1	33.4	33.9	34.2	34.6	35.2
Foreign saving	3.2	1.6	0.5	2.1	1.9	1.6	1.8	2.1	2.4	2.8
Gross investment	28.9	28.8	30.3	31.1	33.7	34.9	35.6	36.2	36.9	38.0
Consumer prices										
Period average	3.3	2.8	-0.1	-0.2	0.0	0.8	1.6	2.0	2.0	2.0
End-period	4.7	1.5	-0.5	-0.3	0.4	1.1	2.0	2.0	2.0	2.0
Private sector credit growth	5.2	6.3	9.8	9.5	4.5	6.9	6.6	6.7	7.2	7.3
Memorandum items:										
Current account balance (percent of GDP)	-3.2	-1.6	-0.5	-2.1	-1.9	-1.6	-1.8	-2.1	-2.4	-2.8
Gross official reserves (millions of euros)	2,193	1,993	2,437	2,262	2,347	2,422	2,577	2,856	3,094	3,285
in percent of ST debt	92.1	96.1	105.2	101.2	104.9	106.2	119.1	131.2	143.2	153.0
in months of prospective imports	5.2	4.3	5.0	4.4	4.1	3.9	3.8	3.8	3.8	3.8
Gross general government debt (percent of GDP)	~~33.9~~ 33.7	34.0	38.0	38.2	40.3	40.7	42.2	43.6	44.7	45.8
Public and publicly guaranteed debt (percent of GDP)	~~36.6~~ 36.4	38.0	43.4	44.2	47.9	49.9	52.5	53.7	54.2	54.7
Foreign direct investment (percent of GDP)	1.7	2.8	2.3	2.2	1.7	2.0	2.4	2.6	2.8	2.7
External debt (percent of GDP)	68.2	64.0	70.0	69.4	71.2	71.5	71.4	72.2	72.3	72.1
Nominal GDP (billions of denars)	467	502	528	558	579	605	636	671	712	755
Nominal GDP (millions of euros)	7,585	8,150	8,562	9,061	9,394	9,821	10,317	10,892	11,554	12,257
GDP per capita (PPP, constant USD 2005)	9,323	...	...	...	...	...	...	...	...	...
Gini coefficient	...	...	...	...	...	...	...	...	...	...

Sources: NBRM; SSO; MOF; World Bank; and IMF staff estimates and projections. National Accounts are revised by SSO, using ESA 2010 Methodology.

Note: 1/ The inconsistency between Real GDP growth and contributions to growth results from discrepancies in the official data on GDP and its components.

Note: 2/ Including general government and public sector non-financial enterprises.

Table 2a. FYR Macedonia: General Government Operations, 2012–2021
(Billions of denars)

	2012	2013	2014	2015	2016			2017		2018	2019	2020	2021
					Budget	Revised budget	Proj.	Budget	Proj.	Proj.	Proj.	Proj.	Proj.
Total Revenues	137.4	139.7	145.2	160.7	176.5	173.5	167.2	187.2	178.6	187.8	198.3	210.3	223.1
Tax Revenues and Contributions	117.4	121.0	129.3	140.8	150.7	149.6	147.8	160.7	155.4	163.5	172.6	183.1	194.2
PIT	9.6	10.3	12.3	12.9	14.0	14.0	13.9	15.3	14.7	15.5	16.4	17.3	18.4
CIT	3.7	4.4	5.1	12.0	11.0	10.0	10.0	11.6	10.4	10.9	11.6	12.3	13.0
VAT (net)	38.5	39.8	43.9	41.7	47.6	47.3	46.9	52.1	49.0	51.5	54.3	57.6	61.1
Excises	16.6	16.0	17.4	19.8	20.2	20.0	20.0	22.6	21.2	22.3	23.6	25.0	26.5
Custom Duties	4.1	4.3	4.2	4.3	5.1	4.9	4.8	5.0	5.3	5.7	6.1	6.4	6.8
Other Taxes	4.3	3.8	2.3	2.2	2.6	3.2	2.1	2.3	2.3	2.4	2.6	2.7	2.9
Social Contributions	40.8	42.5	44.2	47.9	49.2	50.1	50.1	51.9	52.4	55.1	58.1	61.7	65.4
Pensions	27.5	28.7	29.7	32.2	33.2	33.8	33.8	35.0	35.3	37.1	39.2	41.5	44.1
Unemployment	1.7	1.8	1.9	2.0	2.1	2.1	2.1	2.2	2.2	2.3	2.4	2.5	2.7
Health	11.5	12.0	12.6	13.6	13.9	14.3	14.3	14.8	15.0	15.7	16.6	17.6	18.7
Non-Tax Revenues	12.4	11.6	10.4	12.1	18.4	16.6	12.9	17.5	14.3	15.0	15.8	16.8	17.8
Capital Revenues	4.6	3.7	2.1	3.0	3.2	2.3	1.4	2.6	2.6	2.7	2.9	3.1	3.3
Grants	3.0	3.5	3.4	4.7	4.2	5.0	5.0	6.3	6.3	6.6	7.0	7.4	7.8
Expenditures	155.2	159.0	167.3	180.1	195.5	196.6	190.4	205.8	199.8	210.1	222.3	235.9	250.3
Current Expenditures	137.1	142.9	150.4	162.0	170.7	175.1	175.1	179.3	179.3	188.5	199.5	211.7	224.6
Wages and salaries	22.7	22.6	23.1	24.7	25.9	26.5	26.5	26.8	26.8	28.1	29.7	31.5	33.4
Goods and services	14.7	14.9	15.5	18.1	19.8	21.7	21.7	19.6	19.6	20.6	21.7	23.1	24.5
Transfers	95.5	100.8	106.8	112.7	119.2	119.9	119.9	124.6	124.7	131.0	138.3	146.7	155.6
Pensions	40.9	44.9	48.1	50.3	48.7	48.4	48.7	51.2	51.2	53.8	56.8	60.3	63.9
Health	20.9	21.4	22.1	23.6	25.0	25.6	25.0	26.4	26.4	27.7	29.3	31.0	32.9
Other	33.7	34.5	36.6	38.8	45.5	46.0	46.3	47.1	47.1	49.5	52.2	55.4	58.8
Interest	4.2	4.6	5.1	6.5	5.8	6.9	6.9	8.2	8.2	8.8	9.7	10.5	11.1
Capital Expenditures	18.8	16.6	17.6	18.7	25.6	22.3	16.1	27.0	21.0	22.1	23.3	24.7	26.2
Lending minus repayment 1/	-0.6	-0.6	-0.7	-0.5	-0.8	-0.8	-0.8	-0.5	-0.5	-0.5	-0.5	-0.5	-0.6
Overall fiscal balance	-17.8	-19.3	-22.1	-19.4	-19.0	-23.1	-23.2	-18.6	-21.3	-22.3	-24.0	-25.6	-27.2
Financing	17.7	19.3	22.1	19.5	19.0	23.1	23.2	18.6	21.3	22.3	24.0	25.6	27.2
Domestic	13.3	13.1	-6.1	21.7	8.5	3.7	3.7	10.2	12.9	14.8	12.6	28.2	43.5
Central Bank deposits	-12.3	-0.3	-5.4	10.3	-1.2	4.4	3.2	1.7	8.6	-0.1	0.2	-0.2	-0.2
Other domestic financing	25.6	13.4	-0.8	11.4	9.7	-0.7	0.5	8.5	4.2	15.0	12.5	28.5	43.7
Privatization receipts	0.1	0.6	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	4.3	5.6	27.8	-2.2	10.5	19.4	19.4	8.4	8.4	7.5	11.4	-2.7	-16.3
Memo items:													
Gross general government debt (in percent of GDP)	~~33.9~~ 33.7	34.0	38.1	38.2			40.4		40.7	42.3	43.6	44.7	45.8
Nominal GDP (billions of denars)	467	502	528	558			578.8		605.1	635.6	671.0	711.9	755.2
Stock of government deposits at the NBRM (EUR mln eop)	316.5	305.0	370.0	202.4			150.0		9.9	12.2	9.5	13.0	16.8
Public and publicly guaranteed debt (in percent of GDP) 2/	~~36.6~~ 36.4	38.0	43.4	44.2			47.9		49.9	52.5	53.7	54.2	54.7
Cyclically-adjusted primary balance 3/	-8.4	-9.5	-16.2	-14.3			-13.1		-12.3	-12.9	-13.8	-14.9	-16.1

Sources: IMF Staff and MoF estimates.

Notes:

1/ Resulting from excluding: (i) revenues from lending; and (ii) lending guarantees from current expenditures.

2/ Including general government and non-financial SOEs.

3/ Includes 0.4% of GDP one-off profit tax revenue in 2015.

Table 2b. FYR Macedonia: General Government Operations, 2012–2021
(Percent of GDP)

	2012	2013	2014	2015	2016			2017		2018	2019	2020	2021
					Budget	Revised budget	Proj.	Budget	Proj.	Proj.	Proj.	Proj.	Proj.
Total Revenues	29.4	27.8	27.5	28.8	30.5	29.8	28.9	30.7	29.5	29.5	29.5	29.5	29.5
Tax Revenues and Contributions	25.2	24.1	24.5	25.2	26.0	25.7	25.5	26.3	25.7	25.7	25.7	25.7	25.7
PIT	2.0	2.0	2.3	2.3	2.4	2.4	2.4	2.5	2.4	2.4	2.4	2.4	2.4
CIT	0.8	0.9	1.0	2.2	1.9	1.7	1.7	1.9	1.7	1.7	1.7	1.7	1.7
VAT (net)	8.2	7.9	8.3	7.5	8.2	8.1	8.1	8.5	8.1	8.1	8.1	8.1	8.1
Excises	3.6	3.2	3.3	3.5	3.5	3.4	3.5	3.7	3.5	3.5	3.5	3.5	3.5
Custom Duties	0.9	0.8	0.8	0.8	0.9	0.8	0.8	0.8	0.9	0.9	0.9	0.9	0.9
Other Taxes	0.9	0.8	0.4	0.4	0.4	0.6	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Social Contributions	8.7	8.5	8.4	8.6	8.5	8.6	8.7	8.5	8.7	8.7	8.7	8.7	8.7
Non-Tax Revenues	2.7	2.3	2.0	2.2	3.2	2.8	2.2	2.9	2.4	2.4	2.4	2.4	2.4
Capital Revenues	1.0	0.7	0.4	0.5	0.5	0.4	0.2	0.4	0.4	0.4	0.4	0.4	0.4
Grants	0.7	0.7	0.6	0.8	0.7	0.9	0.9	1.0	1.0	1.0	1.0	1.0	1.0
Expenditures	33.3	31.7	31.7	32.3	33.8	33.8	32.9	33.7	33.0	33.1	33.1	33.1	33.1
Current Expenditures	29.4	28.5	28.5	29.0	29.5	30.1	30.2	29.4	29.6	29.7	29.7	29.7	29.7
Wages and salaries	4.9	4.5	4.4	4.4	4.5	4.6	4.6	4.4	4.4	4.4	4.4	4.4	4.4
Goods and services	3.1	3.0	2.9	3.2	3.4	3.7	3.8	3.2	3.2	3.2	3.2	3.2	3.2
Transfers	20.5	20.1	20.2	20.2	20.6	20.6	20.7	20.4	20.6	20.6	20.6	20.6	20.6
Pensions	8.8	9.0	9.1	9.0	8.4	8.3	8.4	8.4	8.5	8.5	8.5	8.5	8.5
Health	4.5	4.3	4.2	4.2	4.3	4.4	4.3	4.3	4.4	4.4	4.4	4.4	4.4
Other	7.2	6.9	6.9	7.0	7.9	7.9	8.0	7.7	7.8	7.8	7.8	7.8	7.8
Interest	0.9	0.9	1.0	1.2	1.0	1.2	1.2	1.3	1.4	1.4	1.5	1.5	1.5
Capital Expenditures	4.0	3.3	3.3	3.3	4.4	3.8	2.8	4.4	3.5	3.5	3.5	3.5	3.5
Lending minus repayment 1/	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Overall fiscal balance	-3.8	-3.8	-4.2	-3.5	-3.3	-4.0	-4.0	-3.0	-3.5	-3.5	-3.6	-3.6	-3.6
Financing	3.8	3.8	4.2	3.5	3.3	4.0	4.0	3.0	3.5	3.5	3.6	3.6	3.6
Domestic	2.8	2.6	-1.2	3.9	1.5	0.6	0.6	1.7	2.1	2.3	1.9	4.0	5.8
Central Bank deposits	-2.6	-0.1	-1.0	1.8	-0.2	0.8	0.6	0.3	1.4	0.0	0.0	0.0	0.0
Other domestic financing	5.5	2.7	-0.1	2.0	1.7	-0.1	0.1	1.4	0.7	2.4	1.9	4.0	5.8
Privatization receipts	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Foreign	0.9	1.1	5.3	-0.4	1.8	3.3	3.4	1.4	1.4	1.2	1.7	-0.4	-2.2
Memo items:													
Gross general government debt (in percent of GDP)	~~33.9~~ 33.7	34.0	38.1	38.2			40.4		40.7	42.3	43.6	44.7	45.8
Nominal GDP (billions of denars)	466.7	501.9	527.6	558.2			578.8		605.1	635.6	671.0	711.9	755.2
Stock of government deposits at the NBRM (EUR mln eop)	316.5	305.0	370.0	202.4			150.0		9.9	12.2	9.5	13.0	16.8
Public and publicly guaranteed debt (in percent of GDP) 2/	~~36.6~~ 36.4	38.0	43.4	44.2			47.9		49.9	52.5	53.7	54.2	54.7
Cyclically-adjusted primary balance 3/	-1.8	-1.9	-3.1	-2.6			-2.3		-2.0	-2.0	-2.1	-2.1	-2.1

Sources: IMF Staff and MoF estimates.

Notes:

1/ Resulting from excluding: (i) revenues from lending; and (ii) lending guarantees from current expenditures.

2/ Including general government and non-financial SOEs.

3/ Includes 0.4% of GDP one-off profit tax revenue in 2015.

Table 6. FYR Macedonia: Financial Soundness Indicators, 2011–2015

Table 6. FYR Macedonia: Financial Soundness Indicators of the Macedonian Banking System, 2011-2016

(Percent)

	2011	2012	2013	2014	2015				2016			
					2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2		Aug.
Capital adequacy												
Regulatory capital/risk weighted assets	16.8	17.1	16.8	15.7	16.0	16.2	16.1	15.5	15.8	15.6		n.a.
Tier I capital/risk weighted assets 1/	14.1	14.5	14.4	13.7	13.9	14.6	14.5	13.9	14.3	14.1		n.a.
Equity and reserves to Assets	11.0	11.2	11.3	10.8	10.9	11.0	11.3	10.8	11.1	11.5		11.3
Asset composition												
Structure of loans												
Enterprises (loans to enterprises/total loans)	58.2	56.9	55.4	55.2	54.7	54.2	53.4	53.9	53.0	51.6		n.a.
Households (loans to households/total loans)	36.5	36.4	37.7	38.7	39.3	39.9	40.9	40.0	41.2	42.3		n.a.
Lending with foreign currency component to private sector	59.2	55.4	52.7	49.4	49.2	47.7	47.5	46.5	46.2	46.0		n.a.
Foreign currency lending/total credit to private sector	28.2	25.5	23.8	22.4	22.6	21.5	20.9	20.5	20.0	19.3		n.a.
Foreign currency indexed lending/total credit to private sector	31.0	29.8	28.9	27.0	26.6	26.3	26.6	25.9	26.3	26.7		n.a.
NPLs 2/												
NPLs/gross loans	9.5	10.1	10.9	10.8	11.1	11.0	11.2	10.3	10.4	7.2		n.a.
NPLs net of provision/own funds	-0.9	-3.7	-1.8	-3.0	-3.6	-3.8	-2.0	-5.3	-5.8	-4.8		n.a.
Provisions to Non-Performing Loans	101.9	107.1	103.1	104.6	105.5	106.0	103.1	108.4	109.2	111.3		111.0
Large exposures/own funds	189.6	205.1	188.5	233.1	211.6	202.9	193.5	212.4	201.1	175.5		n.a.
Connected lending												
Banking system exposure to subsidiaries and shareholders/own funds	4.6	3.5	4.2	4.3	5.0	4.5	3.4	3.4	3.4	4.1		n.a.
Banking system equity investments/own funds	1.6	1.8	1.7	2.6	3.4	2.6	2.6	2.6	2.6	2.6		n.a.
Earning and profitability												
ROAA 3/	0.4	0.4	0.6	0.8	0.6	1.0	1.2	1.1	1.4	1.4	~~1.4~~	1.5
ROAE 3/	3.4	3.8	5.7	7.4	5.5	9.4	11.1	10.4	13.0	12.2	~~12.2~~	13.5
Interest margin/gross income 4/	60.0	60.7	62.2	63.5	61.2	62.5	62.8	62.8	64.9	62.6		63.7
Noninterest expenses/gross income 5/	69.7	65.3	62.8	58.1	53.6	54.8	54.6	54.7	53.2	54.8	~~54.8~~	54.5
Personnel expenses/noninterest expenses	34.1	33.1	35.0	35.5	37.3	37.0	36.3	35.8	37.5	34.7		35.0
Interest Rates												
Local currency spreads	3.2	3.5	3.6	4.0	4.1	4.1	4.3	4.2	4.2	4.1		n.a.
Foreign currency spreads	4.8	4.6	4.8	4.9	4.5	4.5	4.6	4.6	4.5	4.4		n.a.
Interbank market interest rate	2.2	2.1	2.2	1.5	1.1	1.0	1.1	1.2	1.2	1.2		n.a.
Liquidity												
Highly liquid assets/total assets 6/	25.3	29.4	27.3	25.5	24.5	23.6	24.5	24.3	24.8	22.8		24.7
Highly liquid assets/total short-term liabilities 7/	39.6	48.2	47.6	45.5	44.0	42.2	43.9	42.4	43.7	40.5		n.a.
Liquid assets/total assets	31.2	32.4	31.2	29.8	29.2	27.9	28.3	28.2	28.7	26.0		27.4
Liquid assets/total short-term liabilities	48.9	53.0	54.5	53.2	52.4	49.9	50.8	49.2	50.5	46.3		48.7
Customer deposits/total (noninterbank) loans	115.7	113.5	112.7	113.4	112.8	110.7	110.0	110.3	110.2	108.4		111.6
Foreign currency deposits/total deposits	50.8	47.3	44.9	42.3	43.3	42.9	43.0	42.1	42.5	43.7		43.9
Including foreign exchange-indexed 8/	52.7	48.3	45.5	42.8	44.0	43.1	43.4	42.4	42.9	44.1		n.a.
Central bank credit to banks/bank liabilities	0.01	0.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.		n.a.
Sensitivity to market risk												
Net open foreign exchange position/own funds	21.3	11.4	15.6	17.5	10.3	8.5	7.7	11.1	10.3	10.1		n.a.

Sources: NBRM's Financial Stability Unit.

Notes:

1/ Until 2007Q3 Tier I Capital includes common shares, non-cumulative preference shares, general reserves and undistributed profits, net of uncovered loss from previous years, current loss and goodwill. Starting from 2007Q4, Tier I Capital includes nominal value of common and non-cumulative preference shares, premiums from common and noncumulative preference shares, general reserves and distributed profits, positions as a result of consolidation, net of uncovered loss from previous years, current loss and intangible goods, owned common and non-cumulative preference shares and the difference between the amount of necessary and the amount of allocated reserves for potential losses.

2/ Includes loans to financial and nonfinancial sector.

3/ Adjusted for unallocated provisions for potential loan losses. Since 2009Q1 these items have been adjusted for unrecognized impairment.

4/ Interest margin represents interest income less interest expense. Gross income includes net interest income, fees and commissions income (gross, not net) and other gross income excluding extraordinary income.

5/ Noninterest expenses include fees and commissions expenses, operating expenses and other expenses excluding extraordinary expenses.

6/ Highly liquid assets are defined as cash and balance with the NBRM, treasury bills, NBRM bills, and correspondent accounts with foreign banks. Assets in domestic banks are excluded from total assets.

7/ Short-term liabilities are defined as deposits and other liabilities with a maturity of one year or less (without deposits and borrowings from domestic banks).

8/ FX indexed deposits include deposits and other FX indexed liabilities. However FX indexed deposits comprise the majority of these items. Since 2009Q1, the figure refers only to FX indexed deposits.

Annex II. Sustainability of the Pension System

FYR Macedonia's public pension system currently suffers from significant financial imbalances. The pension system comprises three pillars: the first PAYG (pay- as-you-go) pillar, the second mandatory fully-funded pension pillar where new labor market entrants after ~~2006~~ 2003 are obliged to join and the third voluntary fully-funded pension pillar. The pension deficit, defined as pension revenues net of pension expenditure, has increased from nearly 3 percent of GDP in 2007 to 4½ percent of GDP in 2014 contributing significantly to the overall fiscal deficit. The deterioration reflects the following developments.

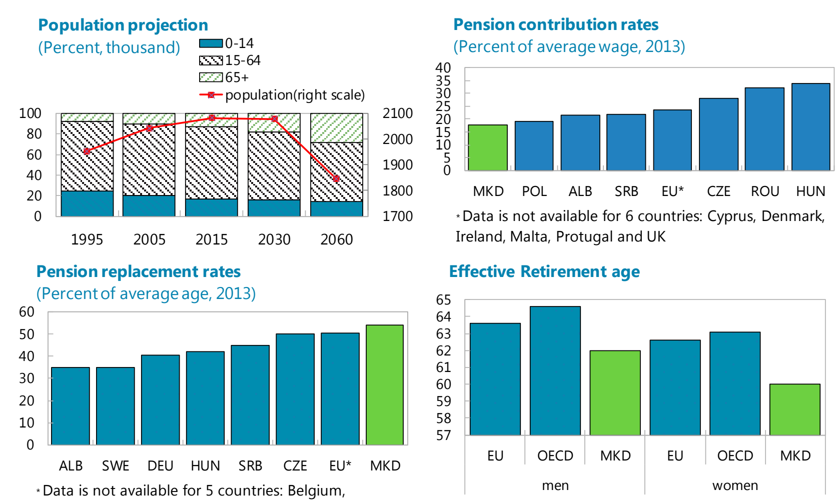
Rapid ageing of population: The share of population aged over 65 in the total population has increased to 12.7 percent in 2015 from 8 percent in 1995. This trend is projected to continue, with the share of population aged over 65 reaching 28.6 percent in 2060. At the same time, overall population is projected to decline drastically after 2030.

Low contribution rates: The authorities have lowered the contribution rate several times to improve labor cost competitiveness, putting FYR Macedonia among countries with the lowest pension contribution rates in Europe.

Relatively generous pension benefits: The pension replacement rate, which stood at 56 percent in 2014, was the most generous among transition economies, and even higher than in several high-income EU member states such as Germany, Sweden, Norway, and Finland.

Low effective retirement age: The authorities have increased the statutory retirement age (to 64 for men and 62 for women), abolished general early retirement and tightened eligibility criteria for disability pension. However, effective retirement age in FYR Macedonia around 61 years is lower than in most countries in the region.

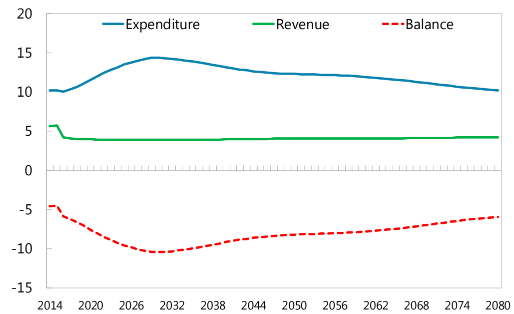
Background for Pension Imbalances



Sources: UN, World bank, OECD, Euro statistics, and PIOM.

Without further reforms, rising pension deficit is projected to pose significant pressures on the overall fiscal deficit. The number of pensioners, which had increased by 23 percent between 2000 and 2014, would exceed the number of contributors by ~~2017~~2037. According to the World Bank's calculations, PAYG pension deficit is projected to rise to 10.5 percent of GDP by 2030.[1] The PAYG deficit is projected to add to fiscal deficit by 3.7 percent of GDP in 2017 from the current 3 percent of GDP. In addition, the replacement rate is also projected to fall to below 40 percent by 2050 without further reforms due to the increase of second pillar pensioners with lower accrual rates.

Pension Projection
(Percent of GDP)



Sources: World bank and IMF staff calculations

1/ The analysis is based on the Public Expenditure Review of FYR Macedonia, The World Bank.

Annex IV. Public Debt Sustainability Analysis

General government and public debt is projected to increase, driven by primary deficits and external financing for public investments. High gross financing needs and potential shocks to growth constitute major risks. Stronger fiscal consolidation is therefore needed to stabilize debt and rebuild fiscal space. Improvement in public debt management is visible and should be continued.

1. **General government debt is expected to rise by 7¾ percent of GDP over the forecast horizon, to about 45¾ percent at end-2021.** An increase in the general government debt level in 2016 is driven by widening fiscal deficit—partially due to flood-related spending—which is expected to be mainly financed by domestic T-bills and Eurobond issuance (of €450 million at ~~5.265~~5.625% yield) in July 2016. Debt accumulation over the medium term is mainly driven by primary deficit and partially offset by favorable growth prospects.

2. **Public sector debt, including that of non-financial public sector, is expected to rise to nearly 55 percent of GDP by end-2021, up from 44 percent of GDP in 2015.** Publicly guaranteed debt of public non-financial enterprises, including that of the Public Enterprise for State Roads (PESR) – the main implementer of public transport infrastructure projects, is expected to grow by nearly 4 percent of GDP during the next few years, reflecting continued borrowing to finance public infrastructure investments. Publicly guaranteed debt of public non-financial enterprises is projected to gradually decline after 2018 due to scheduled debt repayments.

3. **Stronger fiscal consolidation is needed to stabilize debt and rebuild fiscal space.** While the level of public debt is not alarmingly high, the speed of debt accumulation since the global financial crisis raises caution. Baseline gross financing needs are above the benchmark, and adverse shocks, particularly in GDP growth could result in general government and public debt well above 50 and at 60 percent of GDP, respectively, by 2021. Space for fiscal policy, the main countercyclical stabilization policy tool in FYR Macedonia, is limited. The general government primary deficit is expected to be around 2.1 percent of GDP by 2021, 0.6 percentage points higher than the debt-stabilizing primary balance, revealing a pressing need for stronger fiscal consolidation.

4. **The improvement in public debt management is welcome and should be continued.** These improvements are most significant in the domestic government securities market. The average maturity of outstanding government securities has increased significantly from less than 12 months in 2011 to more than 4 years by 2015, reflecting increasing reliance on long-term borrowing. In the meantime, the share of foreign currency denominated domestic government securities has declined from 90 percent in 2009 to around 30 percent in 2015. Interest rates on all types of securities have decreased noticeably. However, overall a large share of public debt is still denominated in foreign currencies and improvements in public debt management should continue.