REPUBLIC OF MACEDONIA

MINISTRY OF FINANCE

PUBLIC DEBT MANAGEMENT STRATEGY FOR THE PERIOD 2006 - 2008

Skopje, December 2005

I. Introduction

One of the more significant reforms that the Ministry of Finance of the Republic of Macedonia began implementing in 2005 was the reform in public debt management area. To this end, legal and institutional changes were made, thus creating basis for smooth running of this function.

To the end of upgrading the legal framework covering public debt management and fulfilling all preconditions for continuous development of public debt management, the Ministry of Finance drafted three-year public debt management strategy, covering the period 2006 – 2008, setting the fundamental public debt management policy objectives and measures, as well as the borrowing policy of the public sector.

Pursuant to the Law on Public Debt (Official Gazette of the RM no. 62/2005), the public debt management strategy sets the level of public debt and sovereign guarantees, the maximum amount of new borrowing and the newly issued guarantees during the current year, the balance of the public debt and the sovereign guarantees at the end of the year, the structure (maturity, interest and currency) of public debt and the sovereign guarantees, as well as the manners of public debt management and servicing.

Taking into account the aspirations of the Republic of Macedonia for membership into the European Union, the Ministry of Finance, i.e. the Government of the Republic of Macedonia committed to make the public debt sustainable in the long run, as well as to harmonize it with the Maastricht criteria according to which debt-to-GDP ratio must not exceed 60%.

Basic **principles** taken into account when setting the public debt portfolio are the following:

- establishing the optimum structure of debt portfolio and its harmonization with the national macroeconomic policy;
- harmonizing the debt portfolio costs with the ones set in the government budget for each year individually and on medium term; and
- restricting and eliminating the effect of the financial risks on public debt sustainability in the medium and long run.

Basic **objectives** of public debt management, in accordance with the Law on Public Debt are the following:

- undertaking measures and activities by the Ministry of Finance to the end of ensuring financing of the needs of the state with the lowest possible cost, in the medium and long run, and with sustainable level of risk; and
- undertaking measures and activities by the Ministry of Finance to the end of developing and maintaining efficient domestic financial market.

II. Macroeconomic developments and public debt

II.1. Macroeconomic developments in 2005 and 2006

According to the preliminary projections based on the results achieved in the first half of 2005 the industrial growth in the third quarter, as well as the expected developments by the end of the year, the Republic of Macedonia at end-2005 will have 3,8% GDP growth and 0,7% average inflation rate (measured via costs of living).

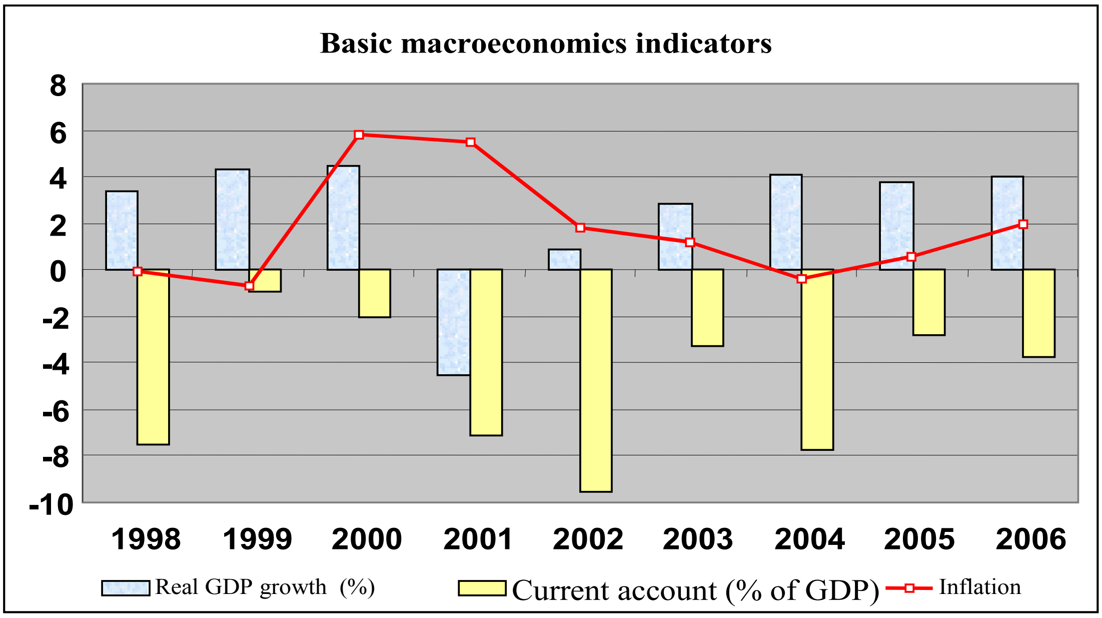
The significant import growth, high level of transfers, disciplined fiscal policy, as well as good coordination between the fiscal and the monetary policy contributed to significant growth of the gross foreign exchange reserves in 2005. At end-October, gross foreign exchange reserves reached a level of US$ 1.096 million, which, compared to end-2004 is US$ 110 million. Net international reserves (IMF agreed target) at end-September were higher in relation to the projected by EUR 68 million.

Positive developments are expected to continue in 2006, as well as 4% real GDP growth, which would enable the Macedonian economy to achieve 15,5% real growth in four-year period (2003-2006). Taking into account the announcements for higher investments, the growth dynamics is expected to intensify in the second half of the year (4.2%). With regard to inflation, no major changes are expected in 2006, meaning that the policy of maintaining the price stability in the economy by achieving low and predictable inflation level would continue. According to the projections, the average inflation rate 2006 will not exceed the 2% level.

At the same time, the coordination between the fiscal and the monetary policy would contribute to the maintenance of price stability, whereby no major changes are expected in the budget policy, meaning that the policy of balanced budget expenditure would continue, expressed as general government budget deficit of 0.6% of GDP in 2006.

To the end of achieving the projected average inflation rate, it would be of special importance to continue the strategy of pegging the denar exchange rate in relation to the euro, but also to maintain the average US$ exchange rate in 2006 at a level approximately equal to the one in the previous year. In addition, and in accordance with the projections by many relevant international financial institutions (IMF, ECB and The Economist) the inflation in 2006 in the eurozone (as the biggest trade partner of the Republic of Macedonia), would remain at the level of around 1.7% to 2%.

Chart no.1



Source: Ministry of Finance

Within the current account, after an exceptionally low level in the previous year, slight increase of the current account deficit is expected in 2006 and its stabilization at around 4% of GDP, mainly as a result of the expected stagnation of the trade deficit, slight rise of the deficit in services, which will be partly offset by the growth of inflows on the basis of private transfers.

II.2. Macroeconomic indicators and future trends in public debt management for the period 2006-2008

The macroeconomic indicators that underpin the government's fiscal projections and the preparation of the public debt management strategy are presented in Table no.1:

Table no. 1: Summary of macroeconomic variables 2006-2008

	2006	2007	2008
GDP at current price (Denar million)	294.122	313.504	334.164
Balance of the public debt (Denar million) in accordance with the Law on Public Debt	114.527	119.370	117.960
Budget revenues (Denar million)	103.167	106.208	109.836
Budget expenditures (Denar million)	104.874	108.065	111.812
Budget deficit (Denar million)	1.707	1.857	1.976
Real GDP growth	4,0	4,5	4,5
Budget deficit (% of GDP)	0,6	0,6	0,6
Inflation, CPI	2.0	2,0	2,0
Servicing of the public debt (% of GDP)	2,7	2,6	2,6
Servicing of the public debt (% of revenues)	7,4	7,6	7,6
Servicing of the public debt (% of expenditure)	7,3	7,5	7,5
Balance of the public debt (% of GDP)	39,0	38,1	35,3

Source: Ministry of Finance

Basic steps of the policy of the Ministry of Finance related to public debt management will be focused on the following:

- *Diversification of the portfolio of government securities, whereby the short-term government securities (treasury bills) will gradually decline and the long-term securities (government bonds) would increase;*
- *Consideration of the possibilities to apply operations that would enable replacement of non-marketable debt with debt marketable on domestic and international capital markets;*
- *Consideration of the opportunities for shifting from US$-denominated and other non-euro denominated debt into euro-denominated debt;*
- *Giving priority to borrowing under fixed interest rate against variable interest rate due to minimization of the risk of interest rate rise on the international market in the future; and*

Undertaking of operations for increase of the average maturity structure of the internal public debt.

III. Characteristics of the public debt portfolio

Immediately after gaining independence, the Government of the Republic of Macedonia began clearing the liabilities towards international creditors, inherited from the former SFRY, as well as restructuring part of the external debt that the Republic of Macedonia inherited from the former SFRY. In 1994 the inherited debt towards the World Bank was cleared, and in 1996, the liabilities towards the European Investment Fund (EIB), EUROFIMA and the Council of Europe Resettlement Fund (CERF).

Within this context, the debt towards the Paris Club of Creditors was rescheduled twice in **1995** and in **2000.**

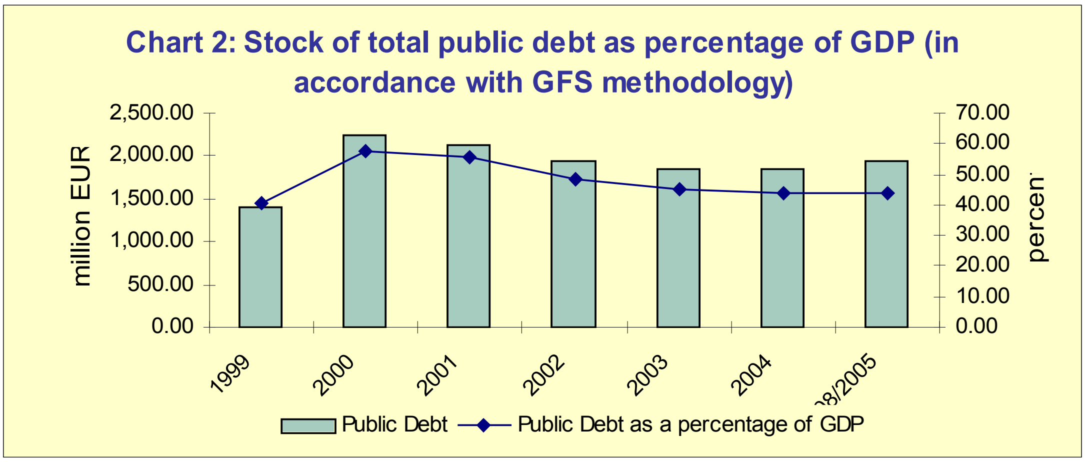
The debt towards the London Club of Creditors was refinanced within the **1998** New Financial Agreement that enabled the Republic of Macedonia to acquire the right to redeem the bonds at any time under the conditions on the securities market, provided it has no outstanding liabilities upon principal and interest.

At the same time, to the end of resolving certain structural issues that occurred after Macedonia gained independence, the Government issued so-called structural bonds that significantly influenced the increase of public debt. Especially significant was the effect of the bond for old foreign exchange saving that the Government issued in 2000 in the amount of EUR 546.5 million to the end of repaying the foreign currency deposits to the citizens that were frozen in the banks in the Republic of Macedonia, after the dissolution of the former Yugoslav federation. As a result of this bond, the stock of public debt formally rose in 2000, to EUR 2.219 million, although the liability assumed by the government on the basis of the frozen foreign currency deposits dates de facto from the very independence.

Public debt[1] as a percentage of GDP reached its peak in 2000, which was 57.2% of GDP. Since then, the rate gradually declines each year and under the 2005 projections, it is 44.1% of the GDP projected under the GFS methodology, i.e. 40.9% of the GDP projected under the Law on Public Debt.

The inherited debt problems, as well as the current restructuring of the banking sector affected the creation of unfavorable debt portfolio dominated by non-tradable instruments.

The total public debt comprises public sector liabilities on the basis of external and internal borrowing. At the end of 2004, total public debt was EUR 1.841,00 million, 64% of which was external debt and 36% domestic debt. The share of total public debt in GDP in 2004 was 43,8%, i.e. 1.3 percentage points less in relation to the previous year. The movement of the overall public sector debt and the indicator public debt in relation to GDP in the period 1999 - 2005 (projections) are shown in chart no. 2.



Source: Ministry of Finance and NBRM

Detailed data on the last movements of the condition of the overall debt of the public sector are shown in Table no. 2 and chart no. 3.

Table no. 2: Public debt

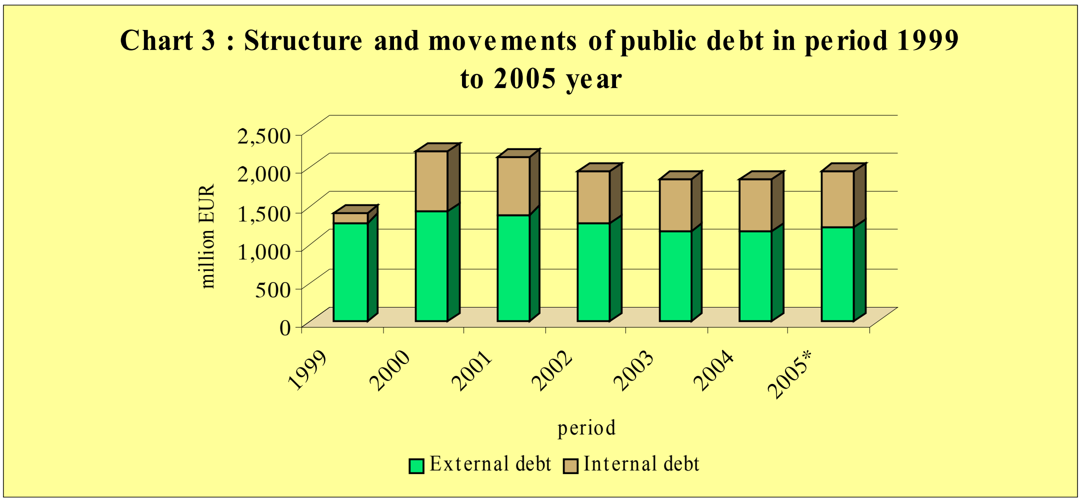
EUR million

basis	Year

[1] The stock of public debt in the tables in this Strategy is calculated according to the GFS methodology (set by the IMF) to the end of international comparability. However, the Public Debt Law of the NBRM is not included in the public debt definition. According to this law, the definition of public debt covers the debt of the Republic of Macedonia, municipal debt and the debt of public enterprises.

	1999	2000	2001	2002	2003	2004	2005*
External public debt	1,290	1,428	1,395	1,268	1,179	1,178	1,228
Domestic Public Debt	114	791	733	676	665	663	718
Total public debt (GFS)	1,403	2,219	2,128	1,944	1,844	1,841	1,946
GDP	3,448	3,877	3,838	3,991	4,095	4,207	4,411
Total public debt (GFS)/GDP	40.7	57.2	55.5	48.7	45.0	43.8	44.1
Total public debt (Public Debt Law)	**1268.2**	**2035.7**	**1996.2**	**1829.9**	**1717.8**	**1721.7**	**1803.1**
Total public debt/GDP	**36.8**	**52.5**	**52.0**	**45.8**	**41.9**	**40.9**	**40.9**

Source: *Ministry of Finance and NBRM*
**31.12.2005 Projection*



Source: Ministry of Finance and NBRM

The data in the table no.3 show the relation of the total public debt expressed in domestic currency in relation to the debt expressed in foreign currency. It also includes projections for public debt movements for the period from 2005 to 2008.

Table no.3: Stock and projections of public debt for period from 1999 to 2008 (by currency)

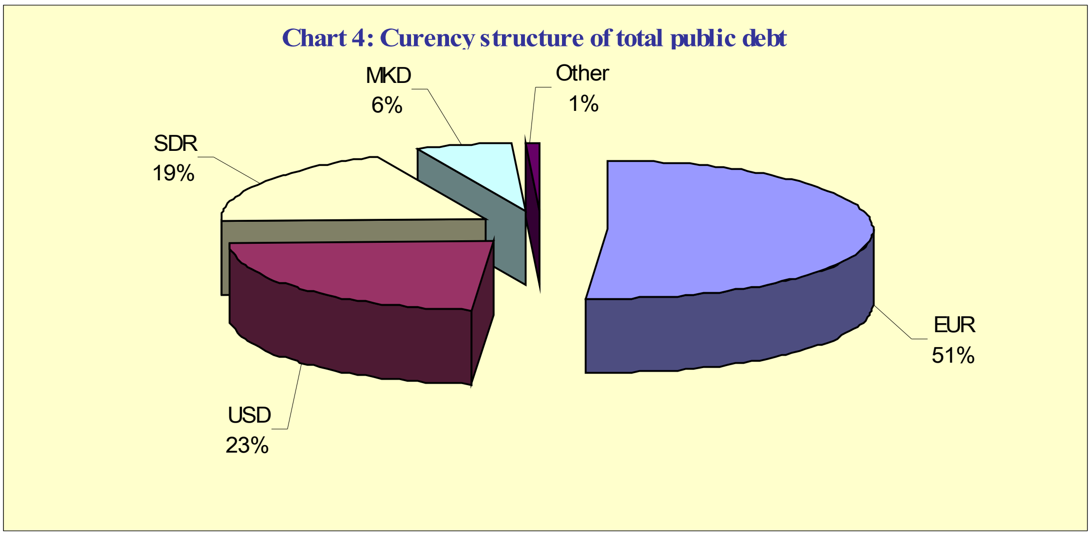
EUR million

	realization						projection				
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total public debt	**1,268**	**2,036**	**1,996**	**1,830**	**1,718**	**1,722**	**1,804**	**1,868**	**1,947**	**1,924**	**1,884**
In foreign currency	1,290	1,963	1,931	1,770	1,663	1,641	1,687	1,708	1,736	1,653	1,545
- External debt	1,189	1,324	1,315	1,203	1,124	1,132	1,191	1,224	1,270	1,271	1,247
- Domestic debt	0	639	616	567	539	509	496	484	466	382	298
In domestic currency	80	73	65	60	55	81	117	160	212	271	340

Source: *Ministry of Finance and NBRM (Public Debt Law)*

Most part, i.e. 94% of the public debt until September 30, 2005 inclusive is denominated in foreign currency, while 6% is denominated in domestic currency. From the aspect of the currency structure, 51% of the total debt is denominated in euros, while 23% is denominated in US$ (chart no.4). Euro-denominated debt comprises major part of structural bonds (old foreign exchange saving bond, Stopanska banka privatization bond, denationalization bonds), credits from the European Commission (EC), the European investment bank (EIB), European Bank for Reconstruction and Development (EBRD) and part of the credits from the Paris Club of Creditors. US$-denominated debt comprises mostly the following: debt towards the London Club of Creditors and part of the debt towards the Paris Club of Creditors, as well as credits from the International Bank for Reconstruction and Development (IBRD). The debt towards the International Monetary Fund (IMF), the

International Development Association (IDA) and the International Fund for Agricultural Development (IFAD) is denominated in Special Drawing Rights (SDR). Continuous government securities, the structural bonds issued for rehabilitation of the banking sector and the selective credit bond are denominated in domestic currency.



Source: Ministry of Finance and NBRM

The interest rate structure is balanced, with 56% of the portfolio being linked to fixed rates and 44% floating rate (this percent includes the debt with a maturity of 12 months or less).

III.1: Internal public debt

The domestic public debt comprises the liabilities of the public sector on the basis of the structural bonds and the continuous government securities, municipal debt and the debt of the public enterprises.[2]

Structural bonds account for the largest proportion (nearly 95%) of domestic debt. The remaining internal public debt comprises continuous government securities issued for budget financing. (Chart no .5)

[2] Calculations according to the GFS methodology include the debt of the NBRM as well. Taking into account that the Ministry of Finance currently has no data on the municipal debt and the debt of public enterprises, they are not included in the calculation of internal debt.

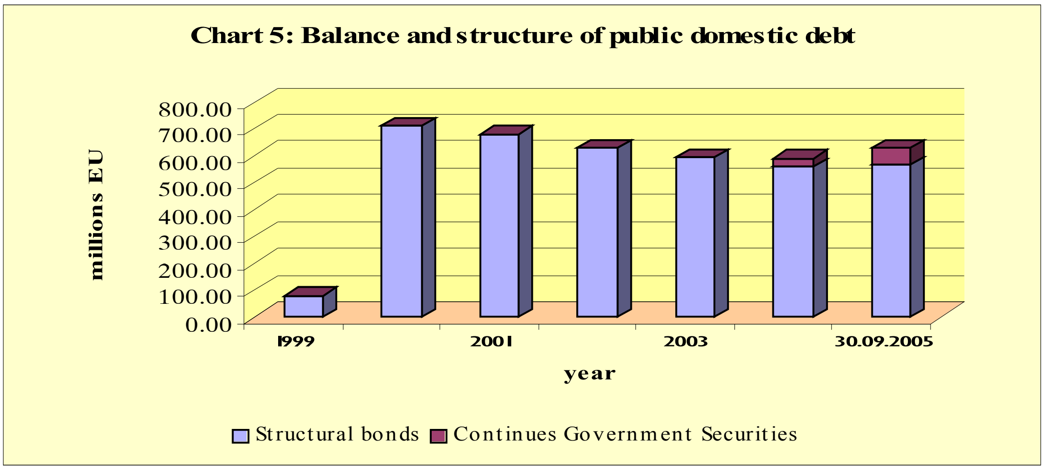


Chart 5: Balance and structure of public domestic debt

Source: Ministry of Finance

As of September 30, 2005, 83% of the total internal debt was denominated in foreign currency, i.e. in euros.[3]

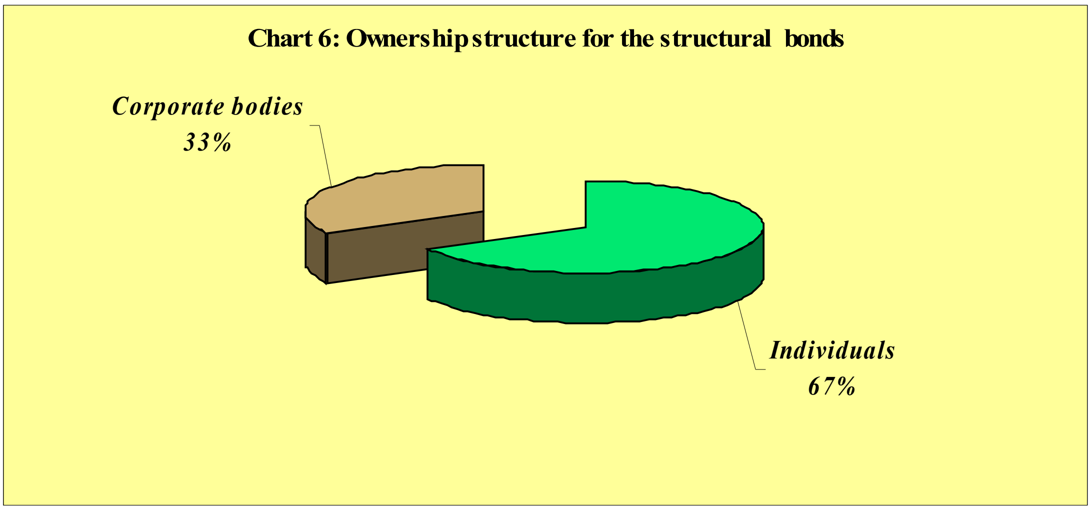
III.1.1. Structural bonds

Until September 30, 2005 the Republic of Macedonia issued a total of five structural bonds:

1. Bond for rehabilitation of Stopanska Banka AD Skopje - Asset Management Agency, on behalf and for the account of the Republic of Macedonia, issued bond for rehabilitation and reconstruction of Stopanska Banka in 1995;
2. Bond for selective credits – issued in the process of rehabilitation of the banking sector for compensation of the selective credits of NBRM offset with the amount of the non-collectible claims from NBRM.
3. Stopanska Banka privatization bond – issued in the process of privatization of Stopanska Banka AD Skopje. With this bond, the government assumes the non-collected claims of four Macedonian enterprises from the portfolio of Stopanska banka;
4. Old foreign exchange saving bond – issued as compensation to the persons that had frozen foreign currency savings in the banks in the Republic of Macedonia before its independence;
5. Denationalization bonds – issued as compensation for the property which was nationalized by the SFRY in the period 1945 - 1990. The Republic of Macedonia will make total of six issues of denationalization bonds, i.e. one each year. The first issue was made in 2002 and until 2005 inclusive, total of four issues were made, while in the next years, additional two denationalization bonds will be issued.

From the aspect of the ownership structure, as of September 2005, 67% of the structural bonds are owned by physical persons, while 33% are owned by legal entities (Chart no.6).

[33] Payments of the euro-denominated internal debt are made in denars.



Source: Ministry of Finance and CSD

Detailed characteristics of the structural bonds are summarized in Table no. 4.

Table no. 4 : Structural bonds – instruments and conditions

										EUR million	
Purposes for which the bonds are issued	Amount of the issue	Currency of the issue	Year of issue	Year of payment of the first installment	Year of payment of the last installment	Maturity period	Interest rate	Date of repayment of principal	Date of repayment of interest	Debt stock as of December 31, 2004*	Debt stock as of September 30, 2005*
Stopanska banka rehabilitation bond	Denar 6 billion	Denar	1996	1996	2010	15	discount rate (6.5%)	April 1	every month	31.87	26.59
Bond for selective credits	Denar 1,039 billion	Denar	1996	-	2020	25	no interest	-	-	16.95	16.97
Bonds for old foreign currency saving	EUR 546.5 million	EUR	2000	April 1, 2002.	October 1, 2011	10	2% annually	April 1, October 1	April 1, October 1	357.64	332.03
Stopanska banka privatization bond	EUR 120.15 million	EUR	2001	March 31, 2002	December 31, 2014	14	EURIBOR +1 percentage point.	March 31, June 31, September 30, December 31	March 31, June 31, September 30, December 31	85.82	81.53
Denationalization bond - I issue	EUR 2.5 million	EUR	2002	June 1, 2003	June 1, 2012	10	2% annually	June 1.	June 1	0.99	0.87
Denationalization bond – II issue	EUR 39.5 million	EUR	2003	June 1, 2004	June 1, 2013	10	2% annually	June 1	June 1	28.23	25
Denationalization bond - III issue	EUR 47 million	EUR	2004	June 1, 2005	June 1, 2014	10	2% annually	June 1	June 1	36.39	31.82
Denationalization bond - IV issue	EUR 58 million	EUR	2005	June 1, 2006	June 1, 2015	10	2% annually	June 1	June 1	0	53.68
Total										**557.89**	**568.49**

Source: Ministry of Finance

2004*- Amounts until 31.12.2004 inclusive are calculated under the exchange rate EUR = 61.3100 denars
2005*- Amounts until 30.09.2005 inclusive are calculated under the exchange rate EUR = 61.2264 denars

Part of the structural bonds (Old foreign exchange saving bond and Denationalization bonds) are listed on the Macedonian Stock Exchange and are tradable. However, with regard to the fact that these bonds were issued for settling certain liabilities of the state, the bonds are relatively illiquid and the trading is on a low and unsatisfactory level. The features of these bonds are specific due to the legal opportunity of the citizens to trade them and use them for other purposes set under the law.

Table no. 5 – Trading in structural bonds on the Macedonian Stock Exchange AD

EUR million

	December 2003	Q1-2004	Q2-2004	Q3-2004	Q4-2004	Q1-2005	Q2-2005	Q3-2005
Bonds for old foreign currency saving	1.19	1.69	1.43	1.20	1.61	7.84	1.10	1.14
Denationalization bond - I issue	0.03	0.06	0.06	0.02	0.02	0.22	0.01	0.01
Denationalization bond II issue	0.93	1.13	0.56	0.27	1.56	6.35	0.42	0.22
Denationalization bond - III issue	0.00	2.57	4.91	3.87	2.81	17.78	0.85	0.58
Denationalization bond IV issue	0.00	0.00	0.00	0.00	0.00	0.00	6.17	4.04

Source: Macedonian Securities Stock Exchange
**Q - quarter*

III.1.2. Continuous government securities

III.1.2.1. Primary market

Considering the need to develop the financial market, in 2003, the Government adopted a Strategy for development of government securities market. The adoption of this strategy was basis for initiation of an issue of continuous government securities. As a result of almost a year of preparation, the Ministry of Finance in January **2004** successfully lunched the first issue of continuous government securities (3-month treasury bills). Due to the satisfactory demand and the results from the auctions of 3-month T-Bills in 2004, in November of the same year, the Ministry of Finance decided to introduce 6-month treasury bills. In **2005,** the Ministry of Finance continued issuing treasury bills and introducing longer-term government securities. Thus, in June, as a result of the ongoing trend of growing demand for T-bills, 12-month treasury bills were introduced, and on November 24, 2005, the first issue of continuous government bonds with 2-year maturity period was made.

Continuous government securities are denominated in denars and are issued in dematerialized form. They are issued via auction according to previously announced calendar. The calendar, covering a 6-month period, is published in the newspapers, in the authorized direct participants (banks) and is publicly available on the Ministry of Finance website (www.finance.gov.mk).

The Ministry of Finance chose and organizes the auction mechanism of sale of government securities, as the most transparent one. The auctioning can be made via several types of tenders defined in the Rulebook on the manner and the procedure for issuance and payment of government securities (Official Gazette of the RM no.99/2005). In practice, the most frequently used type is the interest rate tender with multiple prices (American type). Under this type of auction, the successful auction participant pays the offered price.

Treasury bill is a debenture with a maturity period shorter than one calendar year from the day of issuance, issued by the Republic of Macedonia, to the end of raising funds. The stock of issued T-bills as of November 2005 inclusive is Denar 3.6 billion.

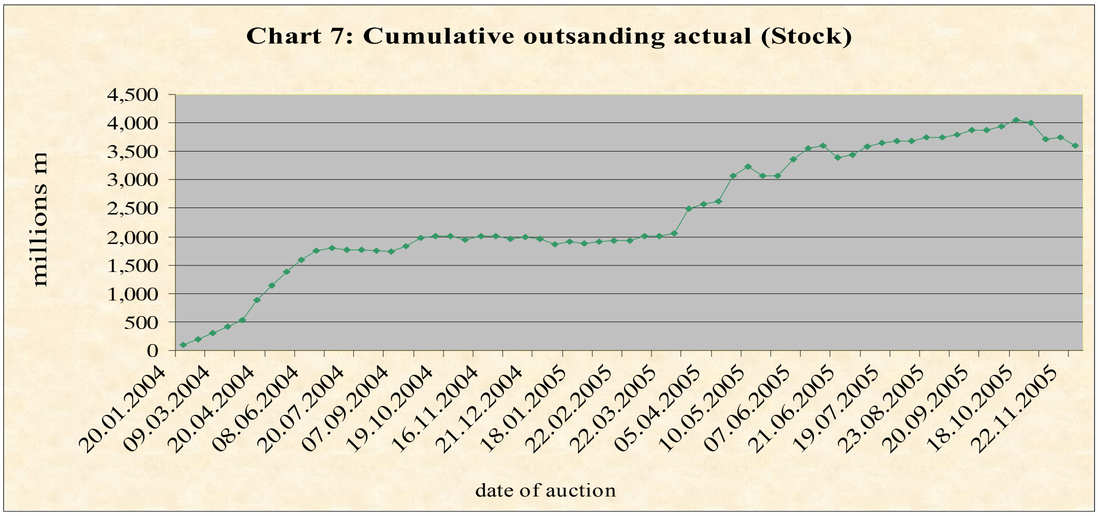


Chart 7: Cumulative outsanding actual (Stock)

Source: Ministry of Finance

In the period January - November 2005 a total amount of Denar 13 billion was offered, comprising 3-, 6- and 12-month treasury bills. The demand for this amount was higher, and it was Denar 16.5 billion while the realization was Denar 11.9 billion.

The charts below show the trends in the offer, the demand and the realization of 3-, 6- and 12-month treasury bills (D3) in 2005.

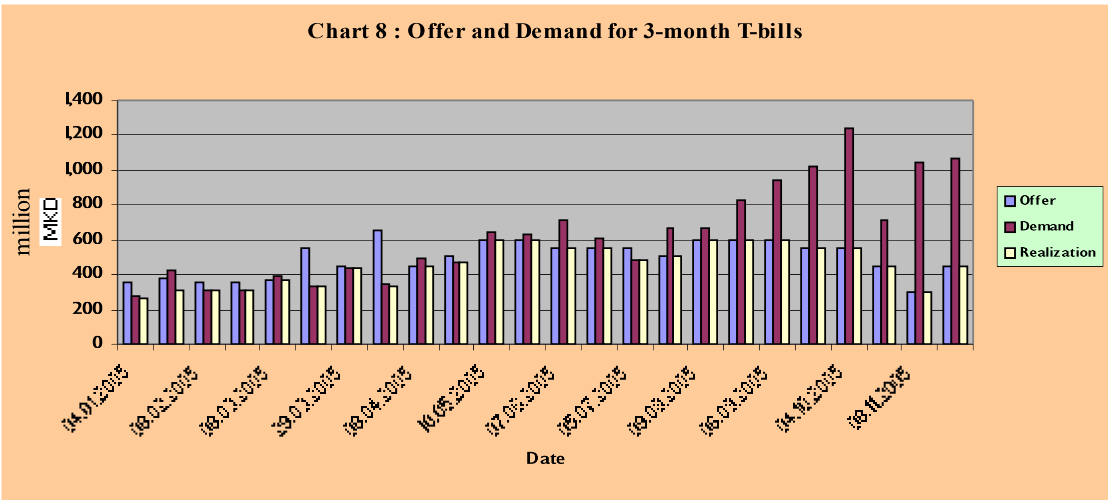


Chart 8 : Offer and Demand for 3-month T-bills

Source: Ministry of Finance

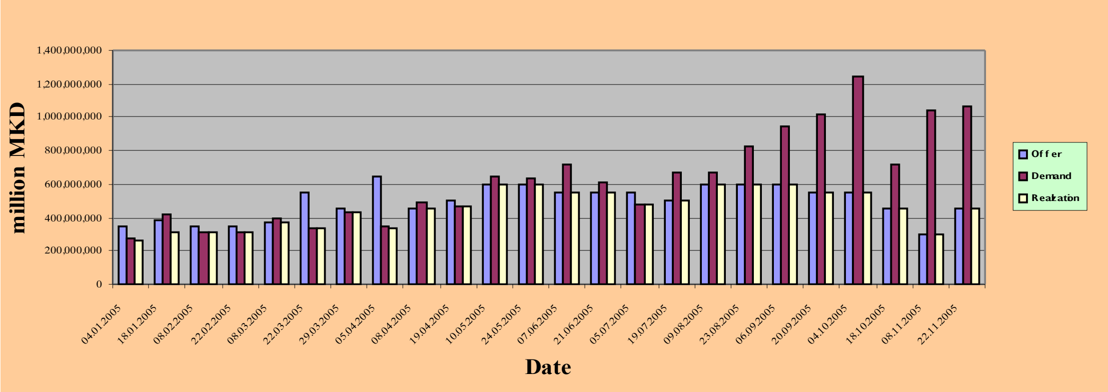


Chart 9. Offer and Demand for 6-month T-bills

Source: Ministry of Finance

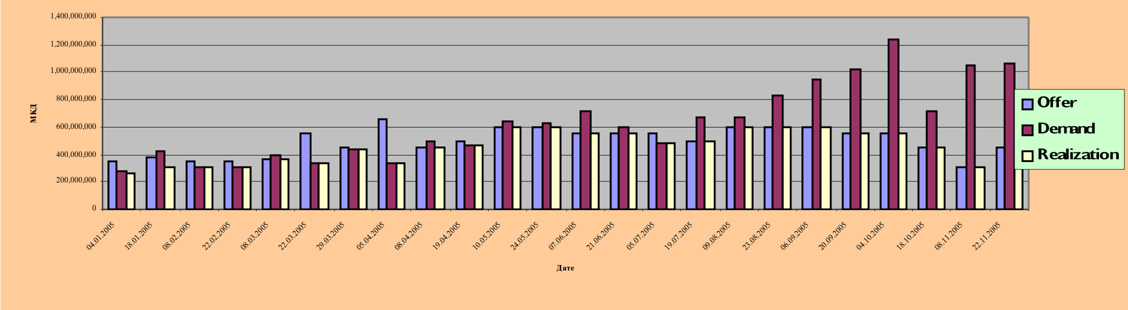


Chart 10. Offer and Demand for 12-month T-bills

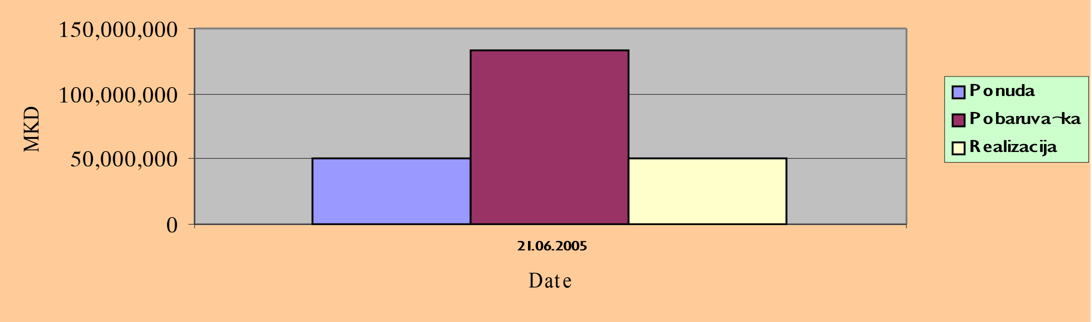


Chart 10: Offer and demand for 12 month t-bills

Source: Ministry of Finance

Government bond (GB) is a debenture with maturity period of one calendar year or longer, counted from the day of issuance, issued by the Republic of Macedonia, to the end of raising funds.

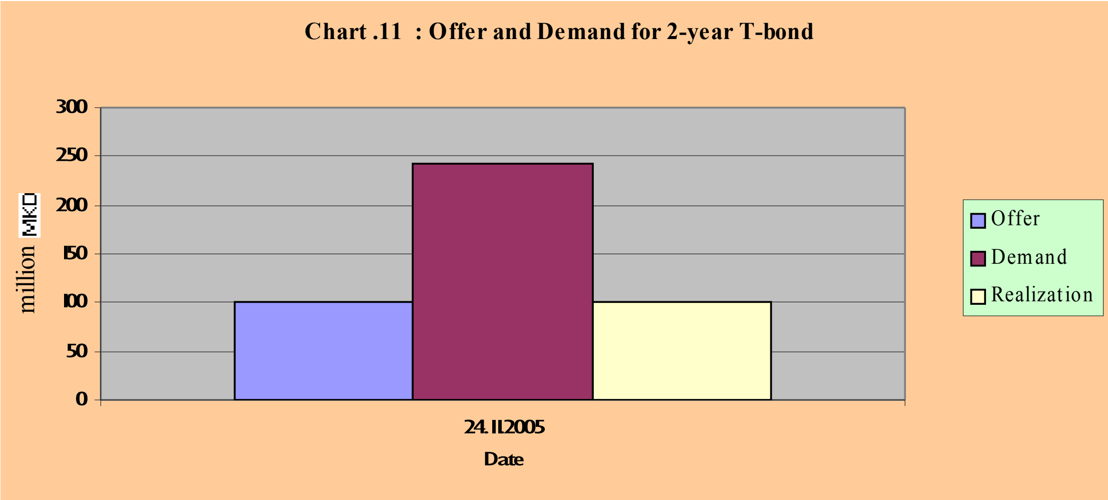


Chart .11 : Offer and Demand for 2-year T-bond

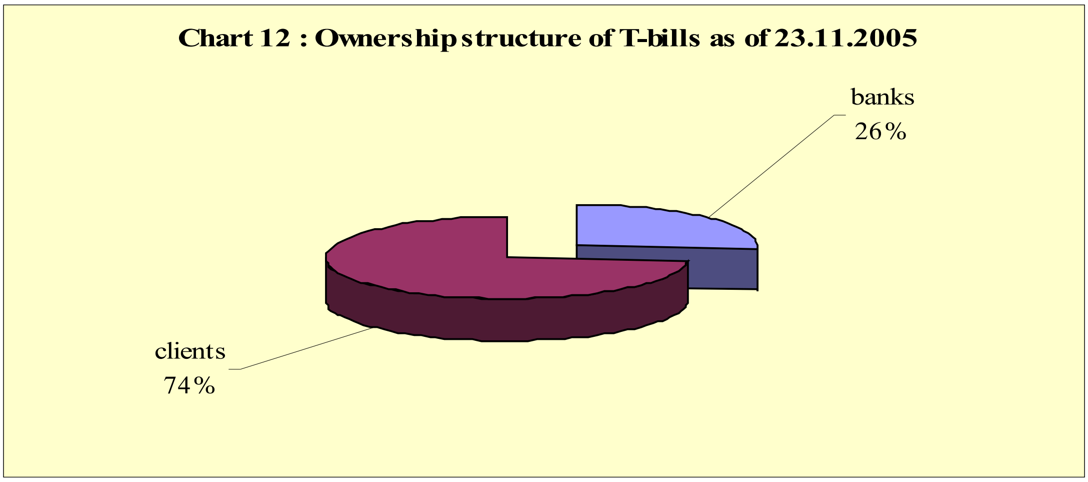
Source: Ministry of Finance

The first issued government bond has 2-year maturity period, it was a coupon bond, with annual payment of coupon interest in a nominal amount of Denar 100 million. The auction sale of the government bond was realized by applying volume tender with 10% coupon interest rate set in advance.

The government bond as a new standard debt instrument caused enormous interest on the primary market, which can be observed in the results of the first issue, showing that the demand is almost two and a half times the offer.

The structure of the treasury bills by ownership has significantly fluctuated between banks and clients from one auction to the next. At the beginning, on the first several auctions in 2004, banks predominated, which was expected in the initial phase of the development of the government securities market. Despite the promotional campaign for the new financial instrument, especially as risk-free instrument the payment of which is guaranteed by the government, still, the broader public was obviously insufficiently informed, thus resulting in significantly higher participation of the banks in the first several auctions – even by 50% greater than the one by the clients.

However, in the second half of 2004[5] and during 2005, the clients (legal entities and individuals) shifted towards the government securities market and as a result, the share of clients in the ownership structure of treasury bills significantly grew, and the share of the banks significantly declined. The ownership structure, observed cumulatively, in November 2005 is as follows - the share of banks in the demand for 3-month, 6-month and 12 month treasury bills is 26%, while the clients participate with 74%. (Presented in the chart no. 12).

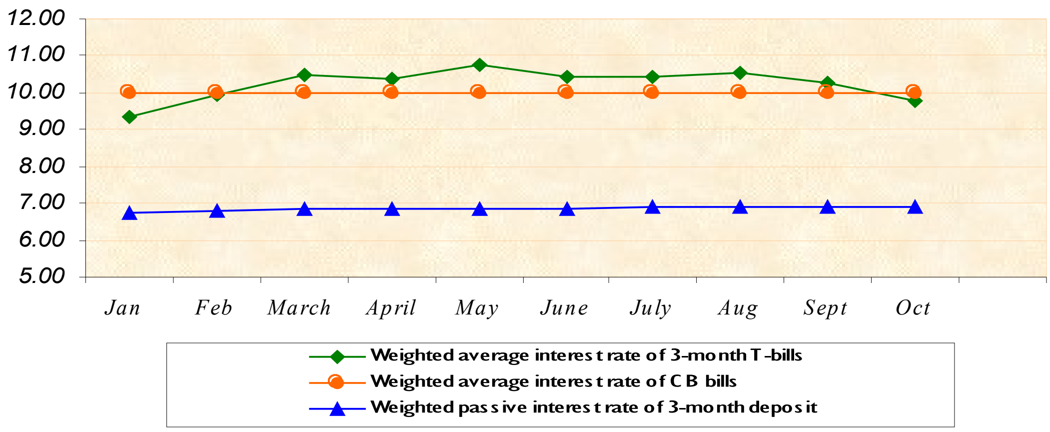


Source: Ministry of Finance

The share of banks in the ownership structure of the 2-year bond issued on November 24, 2005 is 72%, while the share of clients is 28%.

Chart no. 13 shows the trend of interest rates of 3-month treasury bills, central bank bills and banking deposits in 2005. The chart shows clearly greater attractiveness (higher interest rates) for saving in denars in the form of government securities, rather than for saving in denars as deposits in the banks in Macedonia.

Chart 13: Average interest rates

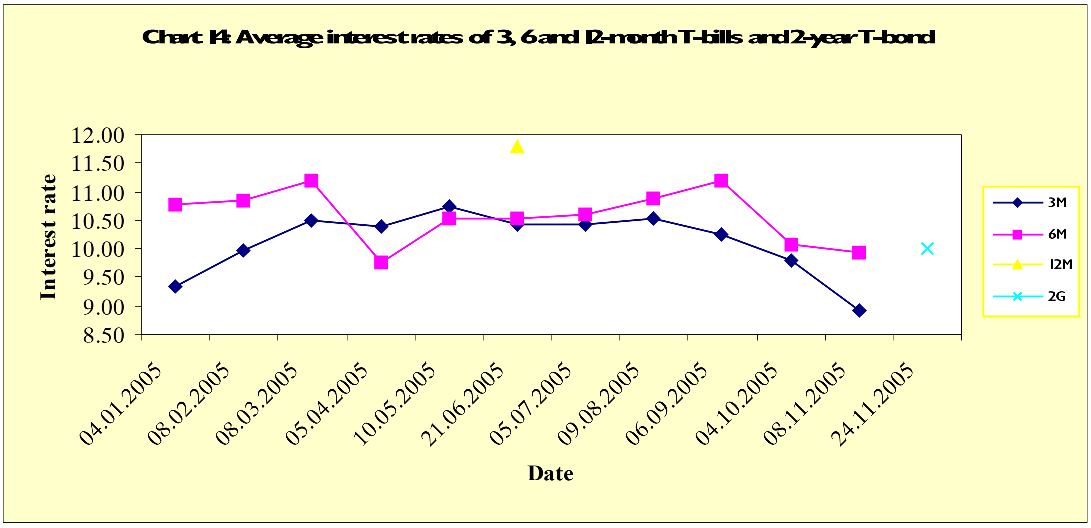


Source: Ministry of Finance and NBRM

Interest rates on treasury bills are market-set since the very beginning, i.e. determined by the auction offer and the demand. Unlike the T-bills, the level of interest rates of the central bank bills in 2004 and 2005 was fixed by the NBRM. Under the new decision dated October 26, 2005, the NBRM replaced the so-far volume tender with interest rate tender. Such change means that the interest rate for this debt instrument as well is market-based.

The movement of interest rates of treasury bills during 2005 notes continuous decline, above all, due to greater market demand. On the auction for 3-month treasury bills, the lowest interest rate was 8%, while the highest interest rate as of November 2005 was 11%. The average interest rate of the 3-month treasury bills notes continuous decline from 10.44% in September to 9.84% in October and 8.54% in November. Also, the interest rates of 6-month T-bills continuously declined, whereby the average interest rate on the last auction in November was 9.92%. This continuous decline of interest rates is a result of the continuing rise of the demand for government securities, the change of the tender for central bank bills, as well as the greater liquidity in the banking sector.

The movement of the average interest rates of the 3-, 6- and 12-month T-bills as of November 2005 is shown in the next chart.



Source: Ministry of Finance

From the aspect of the regulation of the issuance of continuous government securities, the Ministry of Finance, in November 2005, adopted new Rulebook on the Manner and Procedure for Issuance and Payment of Government Securities (Official Gazette of the Republic of Macedonia, no. 99/05) covering both treasury bills and government bonds.

III.1.2.1. Secondary trading

The existing regulations on secondary trading in the Republic of Macedonia enable trading in long-term and short-term securities on the Macedonian Stock Exchange, as well as trading in short-term securities on the money market and over the counter market.

No transaction was made so far on the money market. Trading in government securities on the Macedonian Stock Exchange is largely limited since the brokers and the stock market fees for the carried out transactions are relatively high. Thereby, a need occurred to promote a new manner of secondary trading in government securities by introducing over-the-counter market.

To this end, in April 2005, NBRM, in cooperation with the Ministry of Finance adopted Rulebook on the Manner and the Procedure for Trading and Settling Transactions in Securities on Over-the-Counter Market (Official Gazette of the RM no. 24/2005). By adopting this Rulebook, the over the counter market (OTC) started functioning officially, where currently treasury bills are traded, and it is planned to be supplemented with trading in continuous government bonds. Thus, the expectations of the Ministry of Finance are that the development of the secondary trading would lead to continuous decline of interest rates on government securities.

No transaction costs are currently charged for trading on the OTC market since neither NBRM nor the Central Securities Depositary charge fee for their services. The banks that participate in the transactions earn only profit from the spread between purchase and sale price. Additional advantage of this market is that the settlement of the transactions is in real time, i.e. immediately after the transaction is executed.

The results from the activities of the banks on the OTC market in the past several months have been satisfactory. Since the OTC market started functioning, 17 transactions have been realized so far, shown in Table 6. Even greater development of the secondary trading is expected in the next period, as a result of the future raising of net issues of government securities and the extension of their maturity.

Table 6 Transactions in treasury bills on the OTC markets

Date	Total amount	Weighted price (weighted yield to maturity %)
18.11.2005	2,000,000	99,8558 (10,40)
09.11.2005	3,000,000	99,1984 (10,38)
31.10.2005	1,000,000	99,3273 (10,60)
12.09.2005	10,000,000	98,8821 (10,99)
07.09.2005	2,320,000	98,3929 (14,00)
29.08.2005	93,370,000	98,7910 (10,80)
25.08.2005	1,540,000	97,3710 (10,80)
11.08.2005	660,000	97,3330 (10,96)
13.07.2005	60,000,000	99,7866 (11,00)
06.07.2005	10,000,000	98,1282 (10,90)
05.07.2005	8,780,000	98,5222 (10,80)
30.06.2005	10,000	98,4952 (10,00)
23.06.2005	250,000	97,3186 (11,02)
13.06.2005	50,000	98,8739 (11,08)
09.06.2005	50,000	98,8739 (10,00)
06.06.2005	1,020,000	98,6734 (11,00)
18.05.2005	1,150,000	98,6320 (10,19)

Source: NBRM

To the end of supporting the development of the treasury bills market by enhancing the liquidity of the treasury bills as well as strengthening the legal framework for collateralized borrowing among market participants, above all, banks, the NBRM in June 2005 drafted *General Repo Agreement*, being a legal basis for conclusion of repo transactions. When drafting the General Repo Agreement, experiences were used from several developed countries and countries in transition, above all the General Repo Agreement of the International Securities Market Association (ISMA). Furthermore, taking into account the favorable conditions in the application of repo transactions from the aspect of the central bank (flexible instrument enabling efficient liquidity management, monitoring market expectations for interest rates and overcoming the weaknesses of collateralized credits), the NBRM introduced repo transactions in monetary operations, whereby in September 2005 modifications were adopted to the bylaws enabling utilization of repo transactions in intraday and overnight credits.

The repo covers two transactions – sale of securities and simultaneous repurchase agreement for all or equivalent securities under pre-set price at some later date. Purchase of securities and simultaneous sales agreement is known as reverse repo. One of the preconditions for concluding repo transactions is the existence of developed and liquid market of government securities used as collateral when concluding repo transactions.

The advantages of repo transactions are the great flexibility of this instrument, enabling fast and safe conversion of money into securities, and vice versa. Due to this, repo transactions are attractive for many market participants lead by various motives for trading on the repo market: the NBRM and the banks (as liquidity management instrument), dealers (for covering their positions), companies (for investment) etc. By including many market participants in these transactions and by using government securities with different maturity as collateral, the repo market establishes positive feedback with the other segments of the financial market and enhances their liquidity.

III.2. External public debt

The external public debt of the Republic of Macedonia comprises liabilities of general government (central government, funds and municipalities), the public enterprises and the central bank towards multilateral, bilateral and private creditors abroad.

- **Multilateral** liabilities include the credits from IBRD**,** IDA, EIB, CEB, IFAD, EU, EUROFIMA and EBRD;
- The Paris Club of Creditors account for most of the **bilateral debt**; and.
- Debt to **private creditors** comprises the debt towards the London Club of Creditors in the form of C-Bond (Brady Bond).

Table 7 – Stock of external public debt

EUR million

	2000	2001	2002	2003	2004	2005*
External public debt	1,427.74	1,393.98	1,267.56	1,178.91	1,178.10	1,228.02
General government	1153.87	1191.9	1088.95	1005.54	992.69	1043.72
Multilateral creditors	543.32	585.84	596.92	617.93	659.55	731.31
IBRD	128.69	134.28	125	122.7	137.8	173.88
CEDB	7.49	6.42	13.91	13.91	16.91	19.98
EIB	70.09	82.23	95.71	91.22	103.84	112.12
IFAD	3.3	4.6	4.99	5.41	7.9	10.86
IDA	268.6	289.64	283.83	286.41	285.26	290.63
EBRD	11.08	8.94	6.38	8.28	17.84	33.84
EUROFIMA	14.07	9.73	5.1	0	0	0
EU	40	50	62	90	90	90
Bilateral creditors	338.98	308.68	248.2	192.71	161.89	148.95
Paris Club – reschedule 1995	255.31	217.79	175.12	135.03	111.77	94.58
Non-allocated debt	11.42	10.08	8.74	7.59	6.63	6.63
Paris Club – reschedule 2000	20.7	35.84	27.5	14.41	7	0
Newly concluded agreements	51.55	44.97	36.84	35.68	36.49	47.74
Private creditors	271.57	297.38	243.83	194.9	171.25	163.46
London Club	271.57	296.85	243.49	194.71	171.16	163.46
Other private creditors	0	0.53	0.34	0.19	0.09	0
NBRM debt	87.66	80.33	64.66	54.7	45.97	36.86
IMF	87.66	80.33	64.66	54.7	45.97	36.86

Debt of public enterprises	186.21	121.75	113.95	118.67	139.44	147.44
Multilateral creditors	108.7	44.96	32.77	37.81	44.91	55.05
IBRD	3.33	6.69	14.56	22.05	26.57	26.37
EUROFIMA	3.85	6.18	6.37	6.12	6.13	6.13
EIB	4.09	3.12	2.28	1.45	4.97	10.53
EBRD	49.07	28.97	9.56	8.19	7.24	12.02
IFC	48.36	0	0	0	0	0
Bilateral creditors	8.6	5.82	14.77	14.03	18.81	16.72
Other private creditors	68.91	70.97	66.41	66.83	75.72	75.67
Debt guaranteed by the Government	128.75	119.12	124.54	126.18	134.64	166

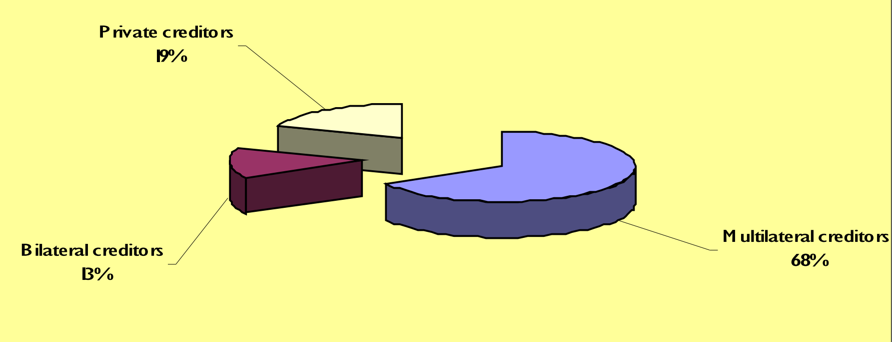
Source: NBRM
** 31.12.2005 Projection*

To the end of more efficient management of external borrowing, the Ministry of Finance, on behalf of the Government, issued the **first Eurobond** on the international capital market, in the amount of EUR 150 million and with 10-year maturity period. The idea for such issue arose as a result of the need to replace the existing risky variable interest rate debt towards the London Club of Creditors with fixed interest rate debt (in a period when the interest rates on the international capital market were record high).

The huge interest for the Republic of Macedonia and its financial instrument enabled creation of broad base of investors – owners of the Eurobond, from Europe, USA and Asia. Four times higher demand for the Eurobond in the amount of EUR 593 million contributed to reach relatively favorable coupon interest rate of 4.625%. The Eurobond issue will not lead to increase of public debt since the issue proceeds will be fully used for early redemption of the debt towards the London Club of Creditors.

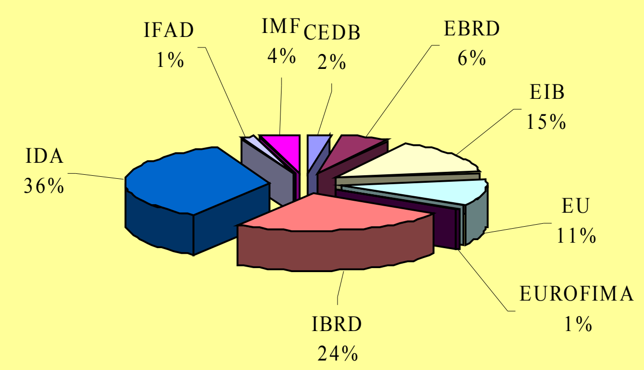
The structure of the external debt by creditors as of September 30, 2005 is summarized in Chart no. 15, and the breakdown between multilateral creditors is shown in chart no 16.

Chart 15: Structure of external debt by creditors



Source: Ministry of Finance and NBRM
** 31.12.2005 Projection*

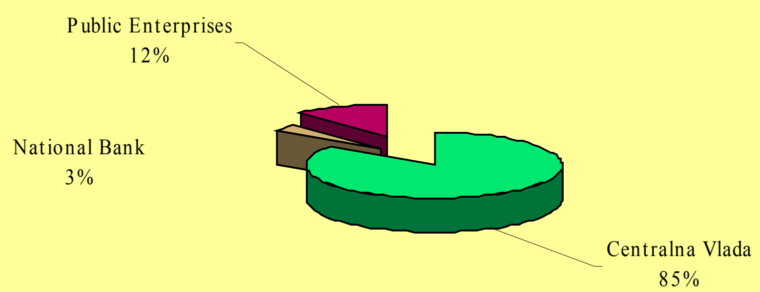
Chart 16: Structure of external public debt by multilateral creditors



Source: Ministry of Finance and NBRM
** 31.12.2005 Projection*

Chart no. 17 shows the distribution of liabilities on the basis of public sector external debt by debtor category as of September 30, 2005.

Chart 17 : Structure of external public debt by debtors



Source: Ministry of Finance and NBRM
** 31.12.2005 Projection*

The average period to maturity of total external debt is 17.4 years.

III.3. Guarantees

The procedure of issuance of guaranties to public enterprises and companies with a dominant state ownership is regulated in the new Public Debt Law (Official Gazette of Republic of Macedonia no. 62/2005), which was adopted in July 2005. This law regulates in more detail the procedure for issuance, servicing and cancellation of guarantees, as well as criteria, which should be meet by the projects the financing of which requires issuance of sovereign guarantee.

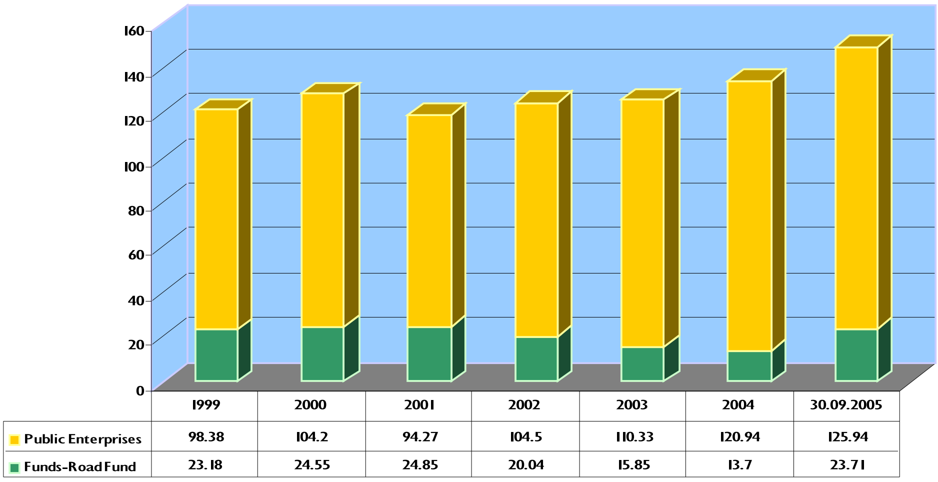
Do far, the Government has issued guarantees to public funds and public enterprises that used loans from foreign and domestic lenders.

Issued guarantees comprise 7.9% of the total public debt. The trend of continuous rise of the stock of guarantees in the previous period was alarming. However, despite that, the issued guarantees are usually for borrowers that are credible and that have so far regularly serviced their liabilities under already issued guarantees. Certain risk pose the potential guarantees that would be issued for newly established enterprises having insufficient source of revenues and poor capacity for positive financial operations, thus directly affecting the increase of the public debt on the basis of calling-up such guarantees.

The stock of guaranteed external public debt in the period 1999 to September 30, 2005 continues to rise. As of September 30, 2005, the stock of issued external guarantees amounted to EUR 149.7 million. In the total amount of external public debt guaranteed by the Government, during this period, the guarantees issued upon the foreign loans used by the public enterprises prevail – chart no. 18.

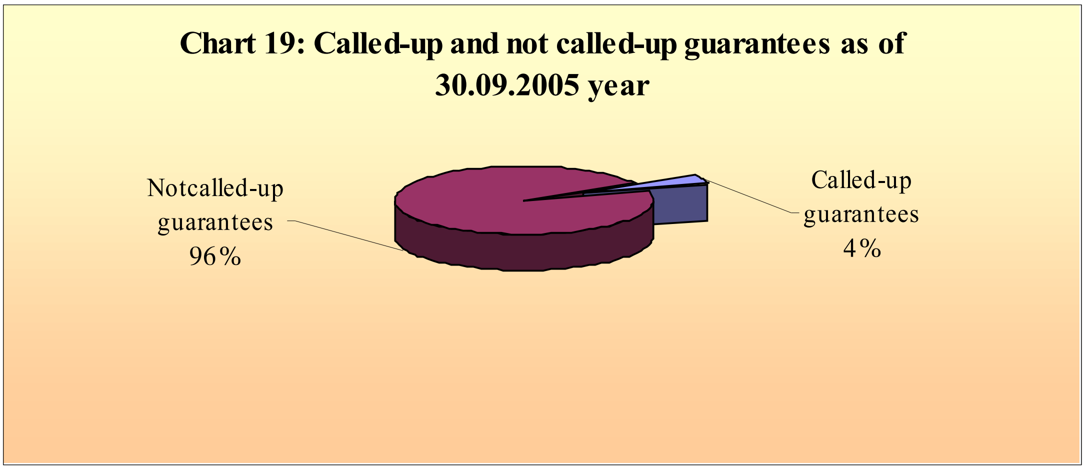
Chart no. 18: Stock of guarantees issued for external public debt

EUR million



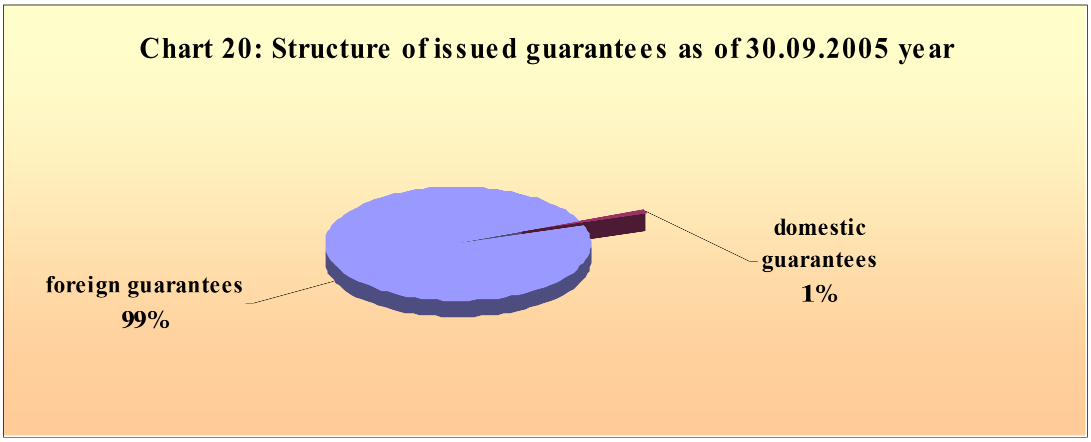
Source: Ministry of Finance and NBRM

In the so far practice, the main debtors, with certain exceptions, such as PE Standard – Debar and the PE Macedonian Railways, for which a guarantee has been called-up, to be covered by the budget, regularly service their liabilities under foreign loans. The stock of called-up guarantees for both enterprises is around EUR 6.4 million, i.e. 4.3% of the total issued guarantees.



Source: Ministry of Finance and NBRM

The government issued guarantees to legal entities that have used credits from domestic commercial banks. The potential debt of the government on the basis of guarantees, as of September 30, 2005, amounts to Denar 70 million (EUR 1.14 million). Accordingly, the share of the foreign guarantees - 99% - prevails in the structure of issued guarantees, while the share of the domestic guarantees is 1%.



Source: Ministry of Finance and NBRM

IV. Public Debt Management Risks

Liabilities on the basis of public sector debt are subject to uncertainty arising from their exposure to future movements of economic variables and the consequences of the future political decision. Due to this, public debt management is connected and inseparable from risk management.

The main objective of public debt management is to ensure that government financing needs and liabilities are covered with the lowest costs in the medium and long run with an acceptable risk level. These objectives should be achieved in the context of the public debt management strategy which, among other, defines the risks to which the debt portfolio is exposed, along with measures to be undertaken to cushion their effects. The implementation of the public debt management strategy means setting an optimum ration between costs and other objectives on one hand and exposure to risks on the other.

This chapter covers risks to which the public debt portfolio is most commonly exposed and the best manner of management.

IV.1. Risks connected to public debt stock

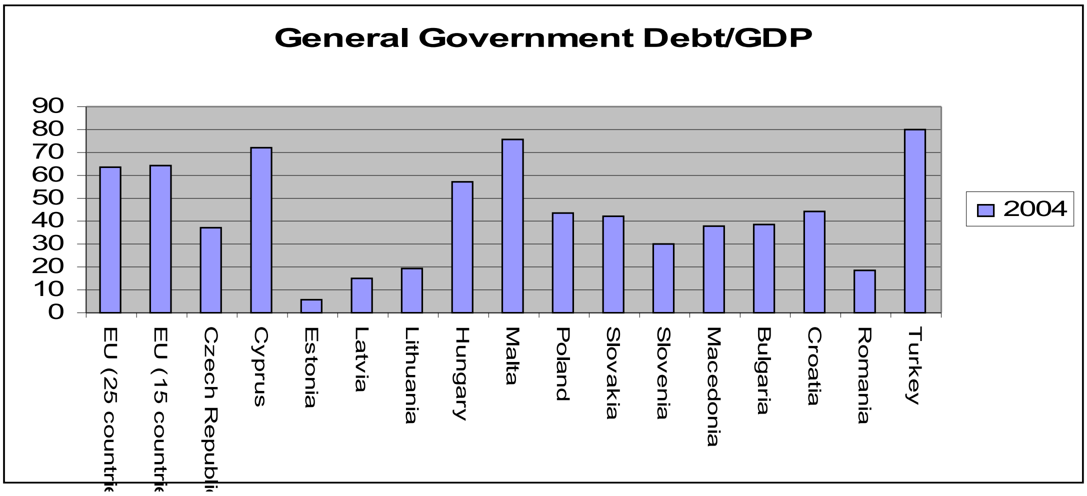
Public debt level is considered sustainable if it enables timely servicing and refinancing for a longer period. This level depends also on the size of the economy. Hence, a usually applied measure for the debt level is its level to GDP. Sustainable level of public debt in relation to GDP depends on many factors: level of economic development, economic growth rate, exposure to the international economic instability, domestic social and political stability, the quality of public institutions, inflation rate, interest rates, public debt portfolio structure (according to instruments and entities), development of the domestic financial market and the access to international financial markets. The lower the general development level of the country, the higher the risk of obstacles in the timely repayment of public debt and its refinancing. Therefore, the financial markets require the developing countries to have lower public debt-to-GDP ratio and higher capital return ration to financing public debt than the developed countries.

The Republic of Macedonia could be exposed to multiple risks due to its public debt level. These risks include:

- threat that the future borrowing needs of the country would exceed the capacity of the demand on the financial market, thus undermining the capability of the country to finance its needs with reasonable costs or to control the structure of the issue and the risk profile;
- the possibility for the Republic of Macedonia to exceed the EU convergence criteria (the so-called Maastricht criteria), having implications over the planned membership of the Republic of Macedonia in the EU and EMU;
- private sector crowding out effect with regard to the access to the domestic savings; and
- higher interest rates, adverse to the development of the domestic financial markets and the efficient operations of the monetary and the fiscal policy.

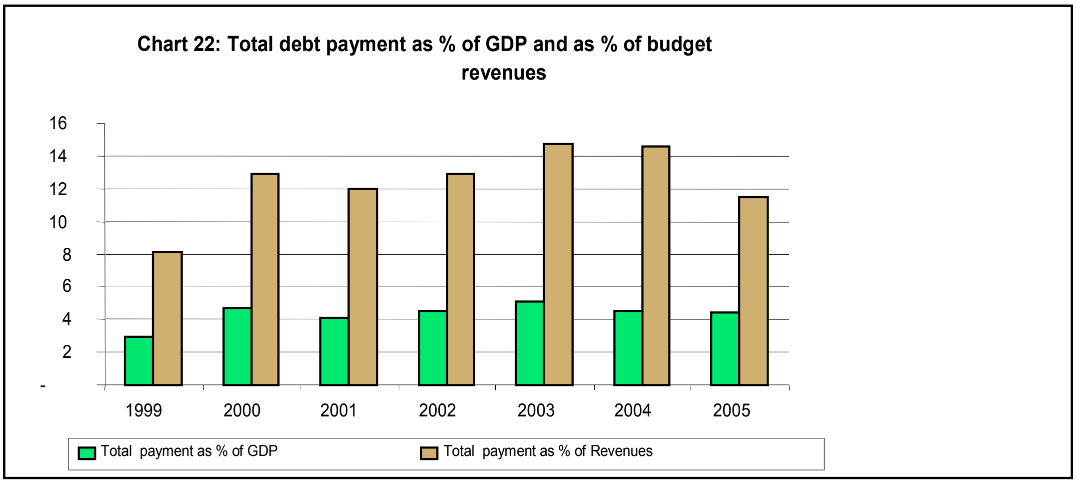
Public debt-to-GDP ratio in the Republic of Macedonia is lower compared to the EU, where in 2004 the public debt-to-GDP ratio for the 15 member states was 64.3%, and 63.4% for the enlarged EU. Still, the Republic of Macedonia is a country with lower creditworthiness and this should be taken into account when determining the safe public debt level. The overall public sector debt in the Republic of Macedonia is relatively modest compared to the levels in the other countries in the region (Chart no.21). In addition, the risk of the Republic of Macedonia losing its public debt servicing capability in certain period is very small, taking into account the projected reduction of public debt level during the years to come and the state prudent fiscal policy.

Chart 21



Source: Eurostat and Ministry of Finance

The fiscal policy should create guidelines for cost-efficient financing of the public sector debt, taking thereby into account the uncertain economic environment. Still, if we take into account the history of the Republic of Macedonia, burdening the GDP and the budget revenues with public debt repayments is relatively modest.



Source: Ministry of Finance

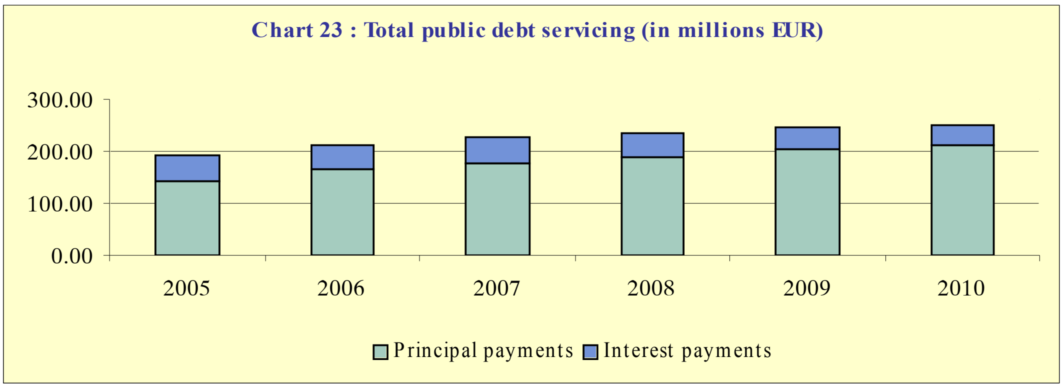
IV.2. Refinancing risk

Refinancing risk or risk of necessary financing on the basis of debt refers to risks related to the debt repayment period, the availability of financial resources for debt repayment and costs related to new borrowing. This risk is especially significant when the due debt should be refinanced by additional issuance of new debt, i.e. when there is a need to cover the repayments for the existing debt with new borrowing.

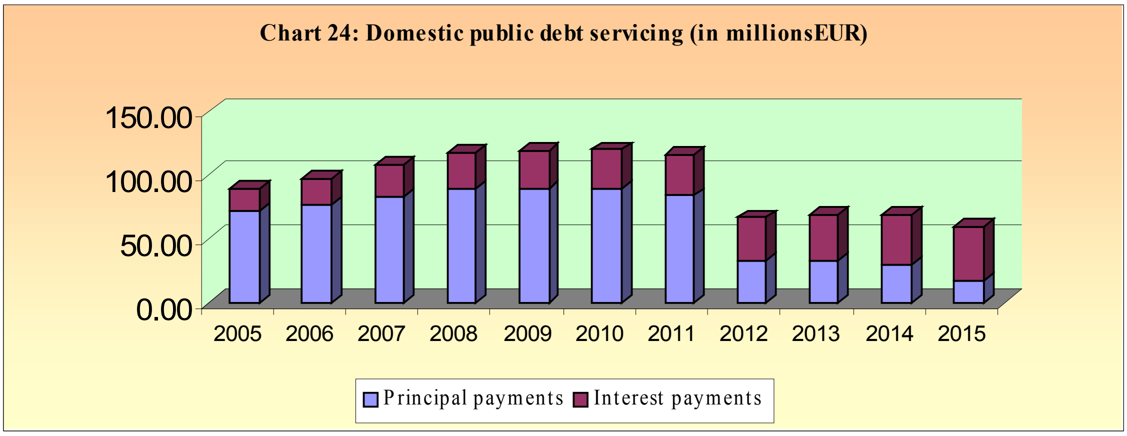
Refinancing risks is affected by the need to refinance the debt as well as the potential variability of interest rates. The degree of risk is a function of the time distribution of debt and the volume of debt repayment and it is higher when bigger liabilities on the basis of debt fall due in the same period. Refinancing risk is managed by providing appropriate profile of the maturity of liabilities and preventing major part of the liabilities to fall due at once at any time.

Debt servicing costs should be evenly distributed over time, both to reduce refinancing costs and to avoid and risk that their volatility might have a destabilizing effect on the budget. Public debt is relatively well distributed and there is no major concentration of repayments in any year on medium term (Charts no. 23 and 24). In the past, the loans from official creditors were the basic source of refinancing external debt. Since 2004 the issuance of securities on the domestic market ensured additional source of funds. With regard to the significant improvement of the economic conditions in the past few years, **the policy of future borrowings will be oriented more towards capital markets and private creditors**, **i.e. greater part of the public debt in the form of securities (being market and liquid instruments enabling reduction of refinancing risk).**

To this end, it is necessary to pay more attention to the financial requirements by the investors and thus **build safe and diversified base of institutional and private investors in the debt portfolio.** Having in mind the increasingly dominant share of market instruments in the debt portfolio, the Republic of Macedonia will have an opportunity to actively manage the distribution of public debt servicing costs, for example, by using switch auctions and/or early redemption of the issued bonds.



Source: Ministry of Finance and NBRM



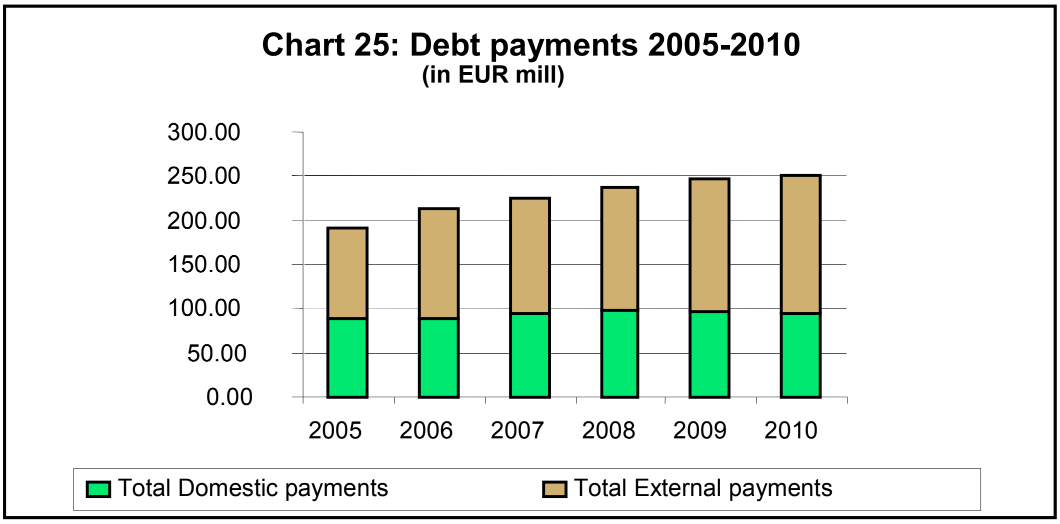
Source: Ministry of Finance

IV.2.1. Refinancing risk related to internal public debt

During the past few years the risk of refinancing the internal public debt gains importance. The average maturity period of the public debt in domestic securities, excluding treasury bills, was 4.3 at end-2004 and 3.4 years in September 2005. The declining trend of this indicator is largely due to the financing of structural bonds by issuance of government securities.

Short-term government securities have relatively small share in the overall domestic public debt (treasury bills account for around 10% of the domestic public debt). Still, due to the absence of developed market for longer-term securities, these data point that the short-term public debt grows fast. The increase of the short-term public debt means growth of the refinancing risk since all domestic financing needs are currently covered by issuance of continuous treasury bills. A positive trend is the first issuance of two-year government bond made in November 2005.

Refinancing risk will be reduced by issuance of instruments with longer maturity periods, although this usually involves higher public debt servicing costs due to the risk premium for the longer-term investments. The development of the government securities market is a long-term process that began in 2004. By increasing the confidence in the issuer and the enhanced demand by the investors, the domestic government securities market will gradually expand. Each new market segment at the beginning will be shallow, with low absorption power, but it will gain importance over time. Market deepening will be supported by the expansion of the investor base and the participation of the newly established pension funds will be of great significance. This process will contribute to declining of the yield of the long-term bonds, as well as to a lower price volatility and greater liquidity, thus enabling lower refinancing risks.



Source: Ministry of Finance and NBRM

IV.2.2. Refinancing risk on the basis of external public debt

Average maturity period of the external public debt and the public debt repayment volume falling due per annum are measures of refinancing risk. The average external public debt maturity period is high, reaching 17.4 years in September 2005. This period will continue declining since the Republic of Macedonia, due to its greater economic growth and increase of GDP per capita is not eligible to use resources from non-concessional official sources of financing meaning longer repayment periods (IDA conditions). The average level of repayment of principal in a given budget year within the time framework covered in the Strategy is below EUR 94 million.

IV.3. Market risk

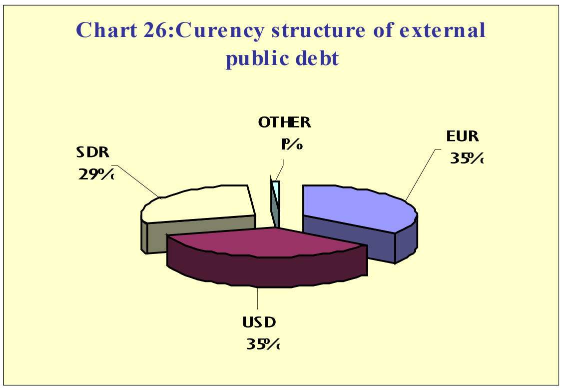
Market risk arises from the exposure of debt-related liabilities to changes in economic variables, especially the variation of interest rates on the domestic and the international capital market and the movement of foreign exchange rates. The risk is especially high where major part of the debt is denominated in foreign currency and with variable interest rates. The variation of interest rates on the domestic and international markets affects the debt-related costs on the day when the fixed interest rate debt is refinanced or on the day when the interest is re-set for variable interest rate debt. Hence, short-term variable interest rate debt usually bears higher risk compared to long-term fixed interest rate debt.

Public debt management policy could reduce these risks by reducing the part of debt denominated in foreign currency via transactions for early repayment of part of such debt, by refinancing part of the external debt due with domestic debt and by extending the maturity period of the issued debt.

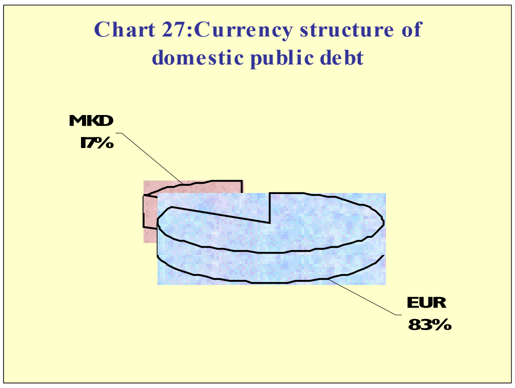
IV.3.1. Risk of exchange rate variation

The risk of variation of the exchange rate is connected with the public debt instruments denominated and settled or indexed in foreign currency. External debt (or foreign currency denominated domestic debt) is the crucial risk in the developing countries and it should be actively managed. Significant changes in the exchange rate could largely enhance the costs envisaged for repayment upon public debt, expressed in denars.

Significant portion of the present public debt portfolio is denominated in foreign currency, a fact immediately identifying the crucial risk.

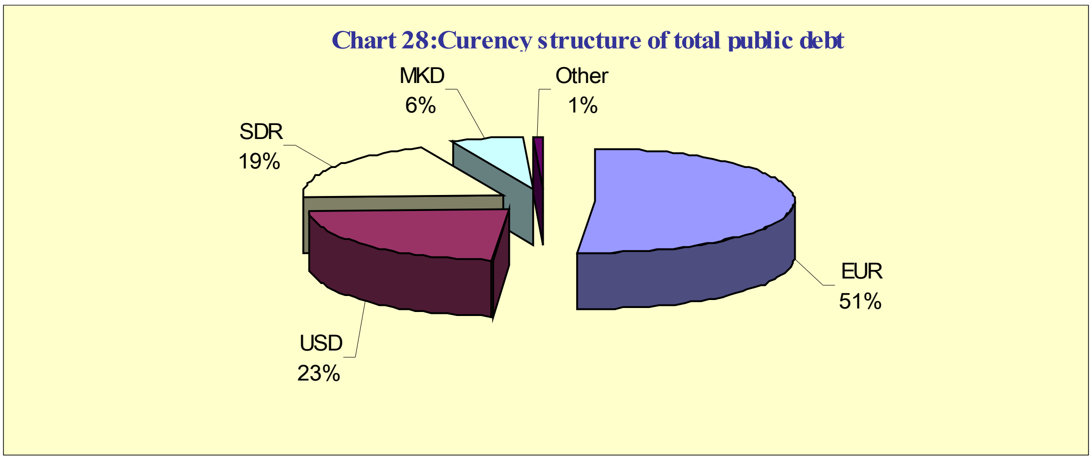


Source: Ministry of finance and NBRM



Source: Ministry of Finance

Not only is the overall external public debt denominated in foreign currency, but also around 80% of the domestic public debt is indexed to the euro. As a result, 94% of the overall public debt portfolio, as of September 2005 is exposed to the risk of exchange rate variation.



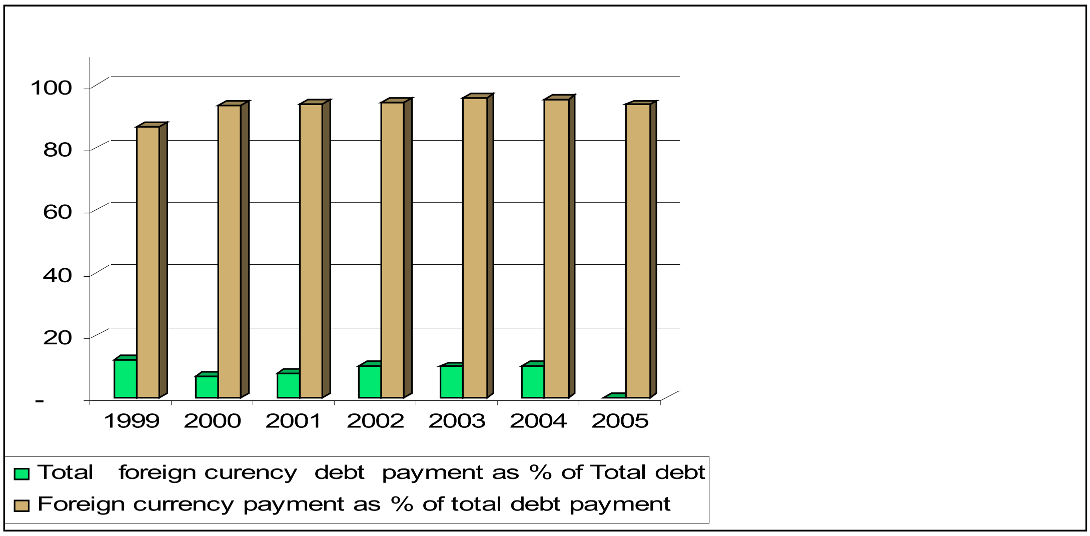
Source: Ministry of Finance and NBRM

It should be underlined that in near future, the risk of exchange rate variation could not be eliminated since this would expose the portfolio to much higher debt servicing costs and other risks.

The present exchange rate risk level is related to the foreign exchange regime. Since 1995, the Republic of Macedonia applies de facto fixed exchange rate of the denar in relation to the German Mark, and since 2002 onwards, in relation to the euro. Dominant currency on which the public debt portfolio depends is the euro, with 51% share in the overall public debt structure. In addition to the euro, other currencies have also significant percentage in the public debt structure (US$ - 23% and SDR - 19%).

The risk of variation of the exchange rate from the aspect of the debt denominated in foreign currency can be analyzed with regard to the public debt servicing costs, as well as with regard to the public debt level. Still, the level of payments for servicing the external debt is also significant in relation to the debt level (around 10%) and in relation to public debt servicing costs (94%) as of September 2005.

Chart 29: Servicing of public debt



Source: Ministry of Finance and NBRM

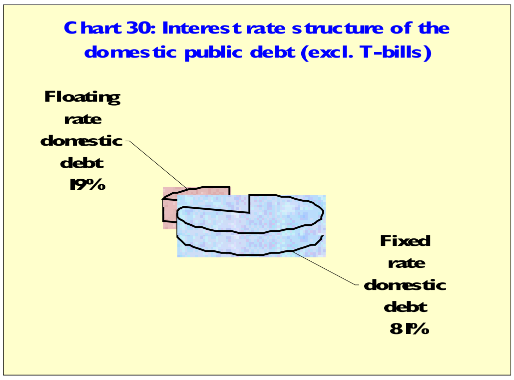
The public debt currency structure underlines the need to development of the market for Denar-denominated instruments. In parallel, the derivatives could be used for replacing the external non-euro debt denominated in euros, reflecting the dominant position of the euro in the external financial transactions. Having in mind the geographical location of the Republic of Macedonia in Europe, the connection of the denar to the euro and of the major part of the trade with Europe, the exposure of currencies other than the euro poses significant risk for the debt portfolio.

IV.3.2 Interest Rate Ris*ks*

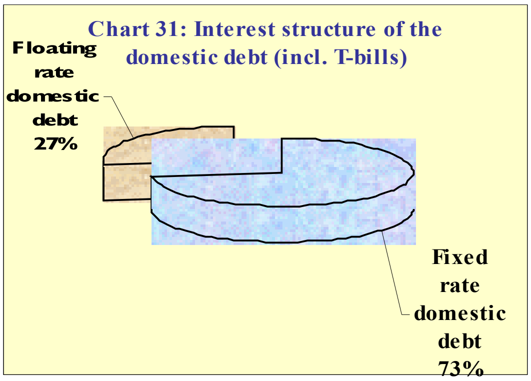
Interest rate risk results from the impact of the interest rate changes on the public debt portfolio. It is closely connected to refinancing risk, insofar as the debt falls due in a future period, where interest rates are unknown. An appropriate combination between fixed and variable interest rates enables diversification of interest risk, as well as reduction of debt-related costs.

This risk can be especially relevant for debt portfolios dominated by securities, especially bonds, since the interest rate directly affects the bond value. If the interest rate on the financial markets rises, the bond value declines and vice versa. Interest rate rises imply a greater opportunity cost for keeping the bond, giving investors an incentive to look for higher rate investments. Management of this risk is especially important for the markets in the developing countries. Similarly, if interest rates fall, then the market value of the debt increases, but future debt servicing will benefit from the lower costs of refinanced debt.

The following charts present the interest structure of domestic public debt, showing that domestic debt is not exposed to serious interest rate risk, as only 20% of the portfolio is exposed to interest rate changes (floating rate debt also includes the debt with a residual maturity of less than one year or debt on which the interest rate is reset with a frequency of less than one year).

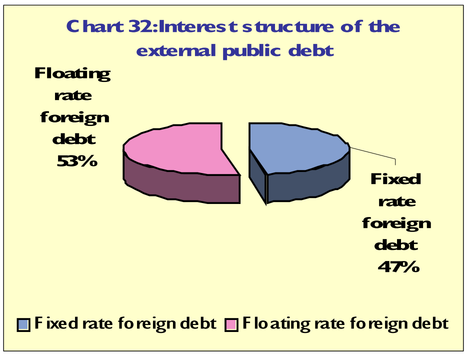


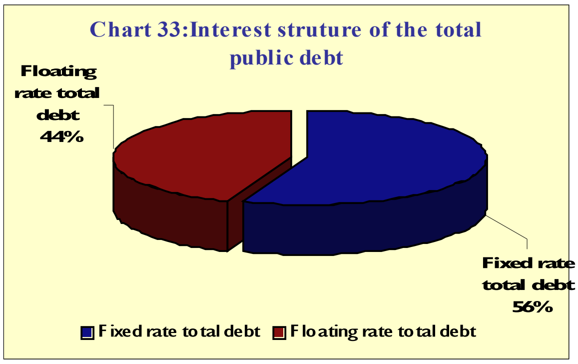
Source: Ministry of finance



Source: Ministry of Finance

However, the situation for external debt, and consequently the total debt portfolio, is different. The next charts illustrate the high proportion of floating interest rate debt within total foreign debt and the total debt portfolio.





Source: NBRM

Source: Ministry of Finance and NBRM

By building market capacity, and thereby extending the maturity of issued securities, through the issuance of long-term fixed-rate bonds, both refinancing and interest rate risk are reduced. There remains an open issue on the relation between the acceptable interest rate risk and the level of debt servicing costs. Long-term debt is usually associated with a higher anticipated cost, associated with the risk premium expected by investors lending assets for longer periods on fixed terms, as reflected in the typically upwards sloping yield curve.

Interest rate risk in the Republic of Macedonia becomes ever more serious risk due to the fact that public debt with longer period of maturity is refinanced with short-term debt and, therefore, is subject to interest rate fluctuations. In future, interest rate risk will be reduced by the new longer-term borrowing, mostly with fixed interest rate. In due course, the use of derivatives will complement the options for managing interest rate risk.

IV.4. Liquidity Risk

Liquidity risk is related to the opportunity to synchronize short-term liabilities with the resources necessary to finance them. There are two types of liquidity risk. One refers to the cost or penalty that investors calculate due to the small number of transactions or because of the lack of depth of a particular market. The other form of liquidity risk for a borrower refers to a situation where the volume of liquid assets can diminish quickly in the face of unanticipated cash flow obligations and/or a possible difficulty in raising cash through borrowing in a short period of time. The objective of portfolio liquidity risk management is to own liquid assets in sufficient volume so as to be able to repay liabilities falling due.

The main instrument of liquidity management is the government's holding of liquid financial assets on accounts with the NBRM. The level of these deposits guarantees safe financing of the government's needs and protects the budget from financial crises which would prevent the raising of funds by borrowing on the financial market.

Liquidity risk management consists of two types of actions:

- keeping a safety reserve at optimal level – this is helped by improving the process of planning and monitoring government budget liquidity, building adequate infrastructure and organizational solutions, including improved cash flow forecasting and account monitoring; and
- managing liquid assets, which should generate budget revenue in order to counterbalance the costs of maintaining a specified, safe level of liquidity. For example, the interest rate on deposits with the NBRM is being calculated and transferred to the government budget.

Debt servicing costs in Macedonia are predictable within the government's cash flow needs. Additionally, pursuant to the Budget Law and the Law on Public Debt, liabilities towards the creditors are a priority obligation in execution of the budget. In addition, NBRM calculates and pays interest on government deposits according to the agreement between NBRM and the Ministry of Finance.

IV.5. Credit Risk

Credit risk is the risk of non-performance by borrowers of the obligations. This risk is particularly relevant in cases where public debt management includes the management of liquid assets. It may also be relevant in the acceptance of bids in auctions of government securities, when issuing guarantees and in derivative contracts.

Public debt portfolio has a limited exposure to credit risk in the management of debt liabilities. Ministry of Finance does not actively manage public debt portfolio in the secondary markets (through using derivatives). In future, Ministry of Finance will manage public debt by ensuring that, in the cash or derivative markets, it will cooperate exclusively with high quality entities – partners in transactions. Agreements between the Ministry of finance and the entities will be secured with quality guarantees. It will also be essential to provide organizational and technological facilities for monitoring the market value of transactions and to enable swift reactions to changeable market conditions.

IV.6. Operational Risks

Operational risks are those pertaining to people, organizational schemes and systematization, software and electronic system, working processes and external events. These risks include: errors in the various stages of executing and recording transactions, data and payments; inadequacies or failures in internal controls; legal risks; natural disasters and other external events that affect business activity and continuity. It also includes poor management, lack of supervision, and weak accountability and control.

Primarily, the main operational risk in the operations is the human resources. In fact, Ministry of Finance can achieve optimal effects in the public debt management with the personnel adequate to the set organizational structure. However, long procedures for recruitment of personnel, and the short ones for dismissal, often create a time gap of inadequate filling in of working posts, which can be considered as one of the most significant operational risks.

The set organizational structure doe not completely follow the world practice in public debt management. In fact, Public Debt Management Department has two Units at the moment: *Unit for Borrowing and Investment (Front Office) and Unit for Records, Monitoring and Servicing Public Debt Liabilities (Back Office).* Thereby, the absence of a *Unit in charge of development of policies and portfolio strategy, risk policy management, processing and control (Middle Office)*, being of essential importance for most of the control and operational activities in the public debt management. Division of the competencies of the *Middle Office* between the existing Units is at the detriment of the final quality of the performed work and leads to increase of the operational risk.

Issues of software and electronic system are of special relevance. These issues are of essential importance for the further development of the function of public debt management. That is why it is necessary to consider this from two aspects.

On one hand, the need for functional electronic system is a necessity for the Public Debt Management Department when performing its regular activities, such as auctions of government securities. At the moment, this issue is resolved by having the NBRM as an agent in the process of issuance of government securities, while the development and maintenance of electronic system are within the scope of the agent, in cooperation with the Ministry of Finance (issuer), thus achieving successful control over the operational risk in transactions in the process of issuance of government securities, their recording and payment. However, there is still much work to be done to develop the operational risk management framework to bring it to good international standards.

On the other hand, existence of modern software is even of greater relevance for the Public Debt Management Department. In fact, pursuant to the Law on Public Debt, a need arises for comprehensive records on overall domestic and external debt in the Ministry of Finance. Public debt can be successfully managed only by having comprehensive records and simple and fast access to data. This explicitly shows the need for modern software to support the operations of the Department in line with the contemporary time, without any possibility for mistakes and by saving time and human resources. Regarding this issue, it can be concluded that the software is a necessity for the development of the public debt management.

At the end, in the series of operational risks, we would like to also mention the absence of internal control. Introduction of a regular internal control will improve the business practice and its existence will lead to reduction of the general operational risk.

IV.7 Settlement Risk

Settlement risk refers to the potential loss that the government could suffer as a result of failure to settle the transaction, for whatever reason.

Settlement risk is very low in the Republic of Macedonia. In the domestic market, clearing and settlement occurs through the Central Securities Depository (CSD), which maintains records in dematerialized form. CSD is modern, efficient, and follows best international practices. It is linked to the real time gross settlement system, which together provides the basis for government securities settlement on a delivery versus payment basis. Ministry of Finance does not release the results of an auction until matching with the CSD and the NBRM is confirmed.

Transaction on the secondary market are executed without any problems. In overseas markets, any hedging transaction, for example, associated with an external public debt issue, would always be undertaken with highly-rated and experienced counterparties so as to minimize the settlement risk.

IV.8. Risks associated with contingent liabilities

Risks associated with contingent liabilities (mainly guarantees) are of dual nature:

1. Increase in the total volume of guarantees or probability of their execution adds to the effective volume of public debt,
2. 2. Executed guarantees constitute increase in the debt servicing costs.

Guarantees extended to date by the Government do not pose threats to public finances. At the moment, the government guaranteed debt amounts to about 8 % of the total public debt. However, Republic of Macedonia is facing a trend of continuous increment of the issued sovereign guarantees in the last couple of years. So far, the main debtors (with two exceptions) are settling theirs liabilities upon the loans on a regular basis.

Difficulties in accessing capital markets and low profitability on projects carried out in the public sector put an increasing pressure on the issuance of sovereign guarantees. This process should be strictly regulated, subordinated to certain criteria, and tied to the risk assessment when making budget projections.

At the moment, the Government is determined not to issue guarantees on using domestic credits, which was not the case in the past when sovereign guarantees were issued for tobacco purchase to the tobacco companies.

V. Analysis of Public Debt Management Strategy (debt portfolio composition)

Medium-term level and composition of public debt are determined through analysis of public debt sustainability and public debt management strategy. Main difference between the analysis of debt sustainability and public debt strategy is that the former is aimed at determining the sustainable level of public debt in relation to GDP that would be realized on medium term under the assumption of differently set macroeconomic scenarios, while the latter is aimed at determining the most favorable composition of debt portfolio from the point of view of its maturity, interest and currency structure, taking into account the budget expenditures for debt servicing and the existing risks. Main objective of Public Debt Management Strategy is to ensure, on medium term, minimizing of public debt servicing costs, and simultaneous optimizing of the risks. The strategy is the main framework within which all future borrowings and other operations will be carried out, aimed at optimizing the debt portfolio.

The general objective of debt management must be to develop a public debt strategy that reflects the optimal relationship between cost and risk. The chapter will outline some of the work done by the within the Ministry of Finance to explore the relations between the costs and risks related to public debt composition.

Ministry of Finance has prepared a model for analysis of asset liability management framework (ALM), that allows the risk of government's liabilities to be measured against the risk of its assets, in particular its power to tax and manage assets. In particular, it means determining the possible variations of the future debt service costs and the primary deficit under the assumption that different macro-economic scenarios in national and world economy will occur and different alternative debt portfolios (issuance strategies).

The approach is different from debt sustainability analysis. In fact, ALM analysis addresses the trade-off between cost and risk in the design of the debt strategy, and the need for hedging to reduce risk.

Some countries are able to determine their debt structure from exploring past correlations of financial variables with the economic cycle. The intention is to offset not add to the volatility of fiscal variables. For example:

- If interest rates in a certain period move with the economic cycle then variable interest debt is acceptable; but, on the other hand, if the correlation is negligible, longer maturity debt helps to avoid the impact of short-term interest rate changes.
- If exchange rates move cyclically (i.e. appreciate with the economic upturn, but depreciate with the downturn), the foreign currency linked debt is a great risk to the increase of debt-related costs.

This kind of analysis is of limited benefit to the needs of the Republic of Macedonia. This is due to the reason that: Denar exchange rate is de facto pegged to the Euro and is administered by the monetary authorities; financial markets are shallow and not well developed yet; and there is a limited experience of a sufficiently stable economic environment to rely on such comparisons when making decisions on borrowing policies.

Taking into account the aforementioned, and in order to evaluate different strategies for public debt management, Ministry of Finance has prepared analysis (model) covering projections on future servicing flows of different structures of debt portfolio (borrowing strategies) and evaluated the costs and risks arising from those structures under four different macroeconomic scenarios for future market rates, such as interest and exchange rates.[4] In such analysis, the cost of debt is measured as share of the annual debt servicing cost in GDP for that period (to which the Government's tax revenue, as its main asset, is closely related).

[4] Ideally an integrated and internally consistent macro-model should be used within which, by running large number of simulations, many different scenarios will be created, out of which, depending on the policy of the Government (whether included more to risk or wanting to avoid risk), the most favourable will be chosen. However, Ministry of Finance has currently neither trained personnel nor software support to prepare such model at the moment.

On the other hand, risk is measured as the potential variation in these costs under adverse (macroeconomic) risk scenarios.

This analysis is particularly useful in considering the effects from severe economic shocks. The economy's resilience in the face of these shocks is arguably more important than fine tuning decisions on the assumption of a stable fiscal environment. For emerging market economies, such as Republic of Macedonia, that have yet to establish a long record of successful economic management, it is important to take into account not only the interest cost in terms of debt-servicing of the various strategies, but also the cost in terms of macroeconomic disruption (for example, loss in output) that could result from a severe shock in the economy. Due to these reasons, a strategy that performs well under adverse conditions may be more preferred to one that is optimal in normal conditions. In practice, the preferred strategy will have to be assessed against market feasibility; and the main policy implication will be to focus effort in the direction of changes and measures needed to secure these changes, such as development of the domestic government securities market.

V.1. Results of Analysis

As discussed in Chapter IV, the key risks that can have adverse influence on the volume, structure and flows of the public debt in the Republic of Macedonia are the market risk (in particular, MKD/EUR exchange rate risk) and refinancing risk. The debt sustainability analysis also emphasizes the need to maintain overall economic performance and avoid a substantial deterioration in GDP growth.[5]

The issuance strategy that have been explored previously have included seven different scenarios with a different structure of the following elements:

- External (currency denominated) and internal (MKD denominated) debt[6];
- Fixed and floating rate borrowing, both internal and external; and
- long-term and short-term debt.[7]

To facilitate the analysis preparation and make the results clearer, only "steady-state" strategies were considered. In fact, this enables applying the projections on the movement of the debt servicing costs in conditions of four different macroeconomic scenarios. Thereby, application and influence of macroeconomic scenarios on various issuance strategies assumes a period of several years. Each alternative steady-state portfolio (issuance strategies) was split across 4 categories (proportions) as follows:

- domestic debt - medium-term (3-year, with fixed rate) and short-term debt (3-month, with variable interest rate); and
- external euro denominated debt - long-term (10-year, with fixed rate) and long-term debt (10-year, with variable interest rate).

These proportions were continuously maintained in the modeling. Table 8 shows the alternative portfolios (issuance strategies) used in the modeling.

Table 8

%		Portfolios						
		1	2	3	4	5	6	7
External public debt	10-year with fixed interest rate	25	30	30	0	0	0	50
	10-year with variable interest rate	25	0	0	25	25	30	20

[5] Although many of the change on the macro environment are exogenous, some are at least partly endogenous (GDP growth and the MKD/EUR exchange rate are possible examples). This has to be taken into account in addressing the resilience of strategies.

[6] The strategies assume that there would be no euro-denominated domestic issuance of government securities (although in practice it is the euro-denominated structural bonds).

[7] In this context, for external debt "long-term" is 10 years, and for domestic debt 3 years.

	3-month with variable interest rate	25	50	20	50	25	40	15
Domestic public debt	**3-year with fixed interest rate**	25	20	50	25	50	30	15
		100	100	100	100	100	100	100

Source: Ministry of Finance

Under some scenarios, maintaining these proportions requires buy-backs of debt. In practice that might not be possible on the scale suggested or unadvisable for other reasons, however, constraining the model would not change the general results, i.e. conclusions from the model analysis.

In the model, debt service cost flows, under the first macroeconomic scenario, were projected for a medium term under assumptions that the fiscal deficit and future market rates will be according to Table 1, Chapter II (hereinafter: baseline scenario).

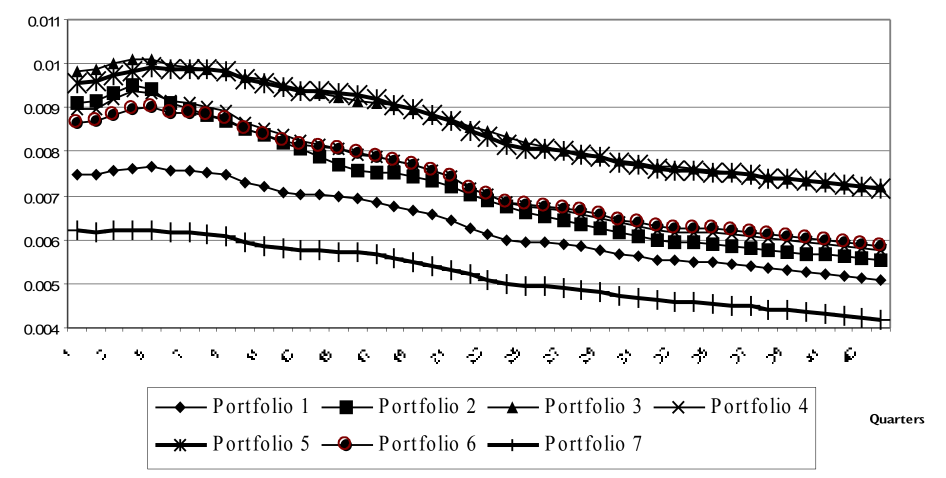
Other projections were made under the assumption of three different macroeconomic scenarios. This process was then repeated for all seven alternative issuance strategies, and the results related to the costs and the risks were additionally compared. The remaining three macroeconomic scenarios incorporated one-off shocks and consequences on the borrowing related interest rates, as follows: the second scenario envisages changes in the Denar exchange rate (20% devaluation) and effects on the interest related costs of the issuance strategies; the third scenario envisages changes in the domestic demand in Macedonia and the fourth scenario envisages external shock related to increasing the prices and the interest rates on the international markets.

Box: More detailed information from the analysis of the Public Debt Strategy

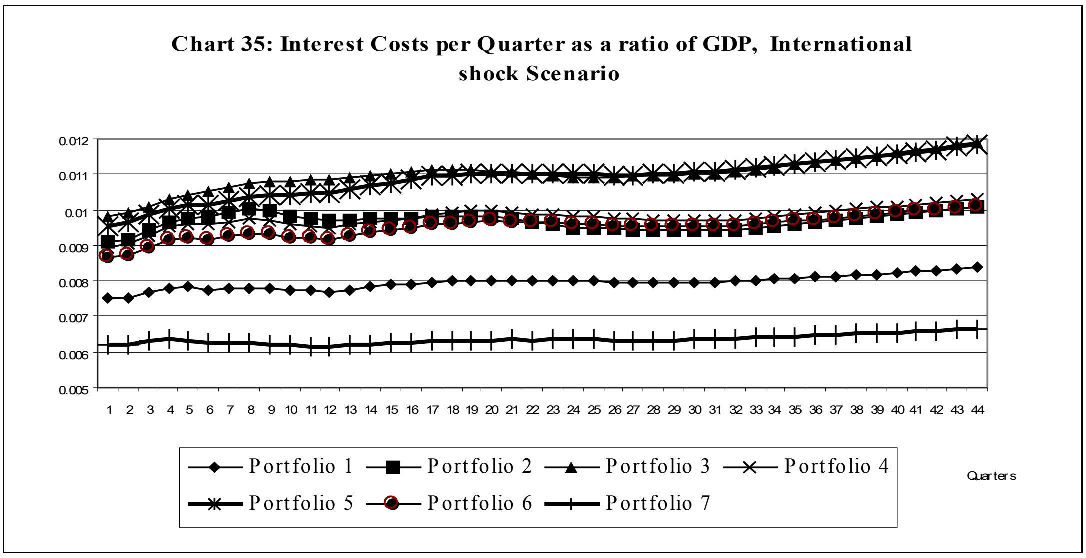
The text above describes some of the analytical work related to the evaluation of the seven alternative issuance strategies and the determination of the most favorable public debt management strategy. This box shows in more details some examples of the output of that work.

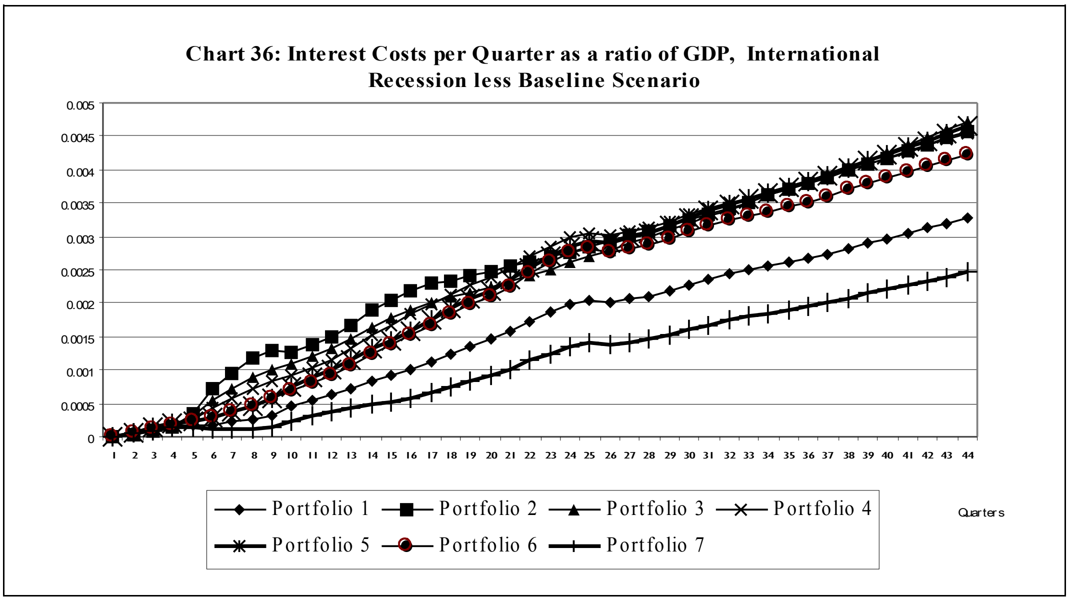
The first chart below shows the variability (flow) of the quarterly debt interest costs as a proportion of GDP for each of 7 alternative issuance strategies under the assumption that the economic variables are determined as in the baseline macroeconomic scenario. As in the debt sustainability analysis, debt interest costs are declining on longer run. Borrowing scenario, within the public debt structure, with lower costs in relation to GDP, generally have a higher proportion of lower-interest external debt.

Chart 34 : Interest Costs per Quarter as a ratio of GDP, Baseline Scenario



If there was a shock to the economy, these portfolios would be affected differently. For example, if there was an international recession, having adverse implications on Macedonia's economic growth and on the level of interest rates on both external and domestic borrowing, the cost for each of the portfolios might be as shown in the Chart 35. Chart 36 shows the cost movements for each portfolio in relation to the baseline scenario.





In order to identify the optimal debt issuance strategy as a necessity, more sophisticated model would be needed, which, unfortunately, the Ministry of Finance does not have. Even then, it will be difficult to take account of all possible variations in the economic environment, and as noted above, it is the impact of the extreme shocks, the characteristics and effects of which can often be uncertain, that need particular study. The results from this analysis can, therefore, be only indicative, not quite precise. **Moreover, one should take into account that debt issuance strategies under "steady state" leave out of account the process of transition from the present structure of the public debt portfolio.**

This is a significant issue in the Republic of Macedonia, given the underdevelopment of the domestic financial market. In practice, therefore, the analysis results indicate a direction of change of the public debt structure, rather than a precise objective (target).

One clear-cut result from this analysis is the exposure of the debt portfolio to a change (deterioration) in the Denar exchange rate against other currencies in which debt is denominated.[8]

External debt will usually be cheaper than domestic debt, at least until the domestic capital market is underdeveloped. However, should there be a significant devaluation of the domestic currency, it would greatly increase interest and principal related costs on the basis of foreign debt expressed in Denar equivalent. Moreover, the impact on the budget would be immediate, increasing the needs to provided funds for the repayment of the foreign debt following the devaluation. Even if the extra payments were tolerable over a longer term, their immediate impact could complicate budget and liquidity management. Portion of the current portfolio of the public debt denominated in foreign currency is extremely high, at about 94%, which is somewhat higher than considered in any alternative debt issuance strategy. As discussed in more details in the following chapter, high priority objective should be to reduce significantly the proportion of foreign currency denominated debt, and for that account to increase the portion of the Denar denominated debt.

Other conclusions from the analysis are less straightforward in quantitative terms, and depend on the shape of the yield curve and expected interest rate volatility under the different scenarios.

High percentage of short maturity debt expose the Ministry of Finance to much higher financing costs at times of economic shocks and higher interest rates, regardless of whether it is a domestic of foreign debt.[9]

Although short-term or variable rate debt would typically be cheaper than longer-term fixed rate debt, this low cost has to be balanced against the much higher costs that can result at times of adverse economic shocks (high interest rate risk). Indeed, there is extensive international experience drawing attention to the potential damage inherent in short-term rate obligations at a time of deteriorating economic conditions. This refinancing risk is closely related to liquidity risk (the ability to meet or refinance obligations at acceptable interest rates), which may be highly dependent on market circumstances at the time. It points to the importance of the existence of a harmonized and adequate solution to the refinancing profile for the portfolio and active management of liquidity sources.

Current public debt portfolio has substantial percentage of floating rate debt, with longer maturity period. Due to this, liquidity risk is reduced, but there remains exposure of the portfolio to interest rate changes and the budgetary costs that can arise therefrom.

All these conclusions point to the importance of developing the domestic government securities market, so as:

- to reduce the dependence on external markets and the proportion of foreign currency denominated debt;

[8] Debt servicing costs are also exposed to changes in, for example, the dollar denominated debt in case of change of the exchange rate of US dollar against the euro. But their impact would probably be much less significant than a change in the denar/euro rate.

[9] Moreover, a fixed exchange rate regime, as in the Republic of Macedonia, would normally mean greater volatility of domestic interest rates compared to that under a floating rate regime, because under a fixed rate regime monetary policy is more oriented to the foreign exchange market using domestic interest rates as an instrument to control the pressures on the foreign exchange market.

- to provide a important source of liquidity (i.e. developed domestic securities market), particularly at a time when international markets might be effectively closed or unusually expensive to transition countries;
- to use the benefits from the development of the financial markets in the Republic of Macedonia also by other domestic borrowers, besides the state. In fact, issuing fixed rate debt by the state would promote the development of a yield curve, as a reference yield of the borrowing by other domestic entities, which is an essential building block for the development of domestic capital markets. A domestic yield curve would also allow banks to make the pricing on the basis of the risk born by the government securities. It would also allow corporations to have a benchmark when they decide whether to issue corporate bonds. It would as well help investors to value alternative investment options, and it would provide an important indicator to the NBRM and the Ministry of Finance of how monetary policy and fiscal policy are affecting the market's views on inflation and government credit risk.

VI. OBJECTIVES AND MEASURES OF THE PUBLIC DEBT MANAGEMENT STRATEGY
VI.1. Objectives

- **Reducing the volume of public debt to GDP**

Current stock of public debt is below the limit set in Maastricht criteria (45% vs. 60%). Notwithstanding, medium-term objective of the Ministry of Finance is to gradually decrease the volume of public debt to GDP. This intention is explained with tight fiscal policy and favorably debt dynamics, notably with significant real GDP growth rate. ***As of 2008 inclusive, public debt to GDP is recommendable to be reduced within 35%-38% of GDP.***

- **Gradual increase in debt with fixed interest rates**

Interest rate structure at the moment is relatively favourable. Approximately one half of the costs related to public debt are calculated with fixed interest rates. However, when determining the optimal level to which this proportion should be reduce, one should consider the advantages and disadvantages of the dependence of debt servicing on floating rates, such as LIBOR and EURIBOR. Thereby, determining the optimal interest structure of the public debt is often correlated with the volatility in international interest rates. Additionally, domestic shocks often are associated with vastly higher interest rates, which is an additional burden to the state budget. Exposure of debt portfolio to interest rate risk, in many cases, leads to incremental budget expenses, and therefore a balanced policy of including a reasonable amount of floating rate exposure is typically efficient. For these reasons, it is desirable to achieve continuous increase in debt with fixed interest rate, accompanied with decreasing of the floating rate debt.

In this regard, Ministry of Finance think over the possibility to partially achieve this objective by early refinancing of part of current floating rate debt, with fixed rate debt. Also, it is necessary for the Ministry of Finance, in every future borrowing, to give priority to fixed interest rates in conditions of low interest rates on the international and/or domestic market. ***In the period as of 2008 inclusive, it is recommendable for 70% to 80% of the debt to be with fixed interest rate.***

- **Increasing the proportion on debt denominated in Denars**

As we mention before, only 6% of total public debt is denominated in domestic currency. This proportion refers mostly on continuous short-term government securities, which are issued for financing the costs for servicing liabilities on the structural bonds, which are denominated in euro. This indicates large exposure of domestic debt portfolio on foreign exchange risk. Therefore, need arises to develop the domestic government securities market, meaning increased issue of government securities.

In the medium term, debt denominated in Denar is recommendable to be gradually increased, reaching 15%-20% in the total debt portfolio by the end of 2008.

- **Increasing the proportion of Euro denominated debt in the structure of the currency denominated debt**

Besides the overall level and maturity of external public debt, currency structure of the external debt is also of paramount importance for the public debt management. This is due to the fact that Macedonian currency (Denar) is linked to the Euro, and most trade is performed with trade partners within the Europe, part of public debt portfolio denominated in non-Euro currencies is exposed to additional risk, i.e. potential loss. Moreover, considering the structure of exports in the USA in the last three years, which has resulted in decline in dollar-denominated receipts on one hand, and increase of the receipts denominated in euros on the other, ***it is desirable for the share of dollar denominated debt and other non-Euro currencies (75% as of 30th September 2005) to decline permanently, with the prospect of being about 40% in 2008***. It is necessary for the state to harmonize the inflows from abroad with its liabilities from currency point of view. To that end, it is recommendable to consider the possibility for early buyback, i.e. restructuring of the existing debt that is not expressed in euro. Certainly, during the analyses and the activities, financial justification of the possible decisions has to be taken into account.

- **Increasing the proportion of domestic debt while decreasing external borrowing**

Overall external debt, as well foreign currency denominated debt, is a key risk in financing the borrowing by the Republic of Macedonia that should be managed to the maximum possible extent. In fact, 94% of the public debt is exposed to the risk of change of the exchange rate between the Denar and the other currencies. In conditions of stable exchange rate, as is the case in Macedonia, this risk is not significant. However, modern principles of debt management point out to its minimizing. In this view, share of domestic debt should be increased gradually, in line with the need of the budget, the market conditions, capacity and possibilities of the financial system in the Republic of Macedonia. Thus, sound development of the domestic securities market will be provided, which will be the main support to the state regarding the borrowing policy in the future. At the same time, dependence of the financing side of the budget on the foreign borrowing and the fluctuations on the international market will be decreased.

- **Increasing the share of market instruments, while gradually decreasing the loans from official creditors**

Major share of the external debt are loans taken from official creditors. Since these debt instruments are not liquid, and cannot be traded on the secondary market, they are not favourable for debt management purposes. Also, the improved economic situation in the country and the improvements of its credit rating, will require and make possible the gradual switch in financing to private sector as well. In the next few years, it will be necessary for the financing be brought into line with, and aimed at, ensuring greater access of the country to the corresponding type of investors (diversified by geographical location, type and similar). If larger proportion of the public debt is in the form of securities, it is provided for the refinancing risk to be reduced due to their liquidity.

- **Extending maturity of the public debt**

Maturity of the public debt is key parameter in assuring financial stability. Therefore, key objective for the Ministry of Finance is to assure that the extension of maturity of the public debt is gradual, with conservative debt policy and various sources of liquidity that will help the stabilization in the periods of potential economic stress. This policy should include consistent focus on maintaining all sources of financing. Maturity profile of domestic public debt is becoming less favorable as the domestic long-term structural bonds are amortized. This increases the financing needs and underscores the need for public debt management strategy to pays due regard to the liquidity risks. Policy objectives considering this objective include:

- gradual extension of the maturity of domestic public debt through the development of the domestic market over the next 5 year;
- buybacks and exchange offers for the existing debt in order to manage maturities of external debt when they have less than 5 years to maturity;
- using the market debt (bonds and loans) with maturities between 5 and 30 years;
- maximizing maturity when borrowing spread and/or underlying government interest rates are low;
- maturity for new issues should be 10-12 years, with shorter issuances in higher rate environments, i.e. longer maturities (30 year) on an opportunistic basis, when available; and
- overall debt maturity, including domestic and external debt, should not be shorter than 5-year weighted average life at any time, with domestic debt taking up the shorter end and external debt taking up the longer maturities.

- **Ensuring smooth profile of repayments**

Public debt servicing costs should be evenly distributed both during the year and by separate years, so as to reduce refinancing costs and to avoid the risk that their volatility might have a destabilizing effect on the budget. As outlined in Chapter **IV**, public debt servicing costs are relatively well distributed and there is no heavy concentration of payments in one year.

However, future borrowings, both domestic and external, should be considered so as to retain and/or improve such smooth repayment profile of public debt. In fact, by extending the average maturity of the domestic debt by issuing longer maturity securities, although costs for debt servicing will increase (due to the maturity premium), even distribution of the domestic public debt repayment profile will be ensured.

- **Taking advantage of the early repayment of public debt where cost effective to do so**

In order to attain preceding objectives related to creation of more favourable (maturity, interest and currency) structure, as well as to smooth the public debt repayment profile, Ministry of Finance will consider as an option the buyback operations and exchange offers for early repayment for part of the bilateral and commercial credits with market (private) and multilateral debt. There is an opportunity for the early repayment of external debt to official creditors, given the continuation of a low budget deficit and implementation of larger issuance of domestic debt at the expense of negative net external financing. Possibility can be considered for buyback of the debt with a short time remaining to maturity, especially in years with heavy payment loads, as well as the one with the higher price of service. These operations will be used only if situation on the market allows creating the most cost-effective structure of public debt portfolio.

- **Restrictive approach to financing public projects with generating government debt or issuing sovereign guarantees**

At the moment, total amount of guarantees accounts for about 8 % of the total public debt. Financing public projects and issuing guarantees are categories of public debt, which although not being direct obligation of the budget, entail risks and additional cost for the budget, in case when they are called-up. Thus, future government policy related to the guarantees and financing public projects will be intended for reducing them. This policy will be realized through minimizing the intermediation by the state and encouraging the private sector to increase their share in financing public projects (public-private partnership, road concession, etc.), whenever possible.

VI.2. Measures

- **Development of primary market of government securities**

a. For the purpose of further development of the primary market in the coming period, Ministry of Finance plan to eventually introduce system of primary dealers. At the moment, Ministry of Finance monitor the engagement and the participation of the authorized direct participants (all authorized banks) on the primary market and consider different criteria on the basis of which it will select the primary dealers through which participation in the auctions would be only possible.

b. In order to bring auctions closer to the small investors, Ministry of Finance will provide for introduction of a non-competitive offers in 2006. In fact, out of the total amount offered on each separate auction of Government securities, percentage will be determined for which non-competitive offers can be given. Regarding the non-competitive offers, interested participants will participate only with an amount, and they will pay the weighted interest rate to be determined at the regular auction.

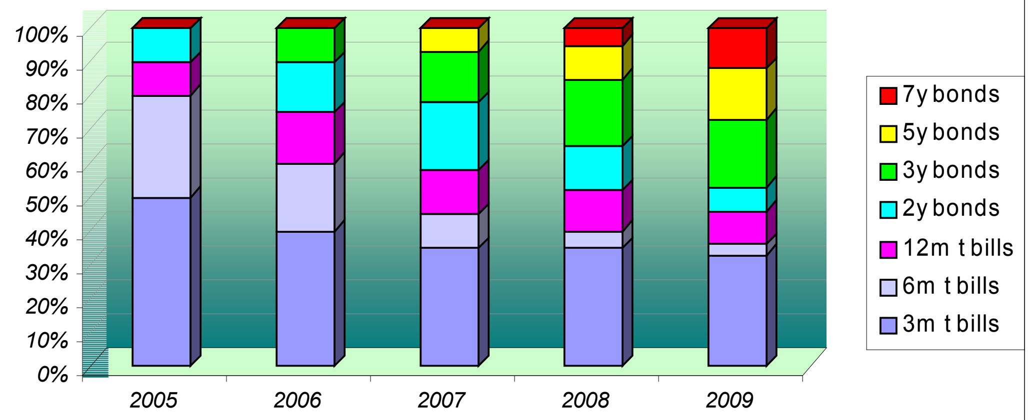
Ministry of Finance will introduce this measure to the end of keeping the attractiveness of the government securities so as for larger number of investors to participate in the government securities auctions. This measure is characteristic for the development stage of the primary market of government securities and it is stimulative.

c. Another novelty the Ministry of Finance introduces, in cooperation with the NBRM, is the issue of treasury bills for monetary purposes. The main reasons for such an activity are sought in the initiative to abolish market segregation between Central Bank bills and the treasury bills of the Ministry of Finance, as well as to create a homogenous government securities market, through which the NBRM will be able to better monitor the market signals of the participants and to strengthen its transmission mechanisms, increasing the banks' responsiveness to the activities undertaken by the monetary authorities.

Treasury bills for monetary purposes will be issued on the regular auctions of government securities, in a way that, at every auction, part of the issue amount to be used for monetary purposes and the part intended for fiscal policy purposes will be announced. They will have the same features as the regular treasury bills, the only difference being that the collected funds from these issues will be sterilized on a special account with the NBRM.

d. Introduction of longer-term instruments attractive to the institutional investors

Chart 37: Projection of the maturity structure for continuous government securities



Source: Ministry of Finance

If the market allows, Ministry of Finance can continue the maturity of the continuous government securities with faster dynamics than the envisaged one in Chart 37. Many indicator, of course, for the Ministry of Finance will be the demand of government securities and the structure of the investors and their preferences.

e. In addition, according to the trend of increased demand for government securities, it is determined that the given real time for submission of offers to participate in the auctions is not always enough. To that end, the Ministry of Finance and NBRM are developing the electronic system so that the authorized direct participants (the banks) can enter the offers in advance in order to be submitted in shorter period of time.

- **Development of secondary market of government securities**

Development of the secondary market will also help the achieving of the abovementioned objectives. More active trading will create greater demand by both the financial sector and the other investors. Policy of stable and liquid domestic securities market with transparent policy for issue of government securities, as well as the perspective for EU membership, should also increase the interest of the foreign investors in government securities.

To attain this objective, the following is envisaged:

- increase of the annual net issue of government securities;
- introduction of government securities for monetary purposes as well;
- using repo operations by the NBRM and the banks;
- enabling the usage of repo and OTC trading for the continuous long-term government securities as well;
- monitoring the activities of the banks on the government securities market and possible selection of market makers; and

- increase of the transparency of the results from the OTC trading.

- **Maintain an active dialogue with rating agencies**

Ministry of Finance, supported by all relevant state institutions, should continue realizing cooperation with the rating agencies. The Ministry of Finance should organize the collection and supply of timely and complete information on the developments in the country. Qualities such as transparency, regular data exchanges, improvements in the macroeconomic environment, public debt stock and similar are preconditions for further improvements in the credit rating.

- **Attracting investors and diversification of the investor structure**

A greater share of small non-institutional investors in government securities auction will ensure a stable and diversified investor base and will influence interest savings favorably. In addition, Ministry of Finance should more intensively communicate with the non-residents (potential and present investors in domestic securities).

At the same time, in case of possible issues of government securities on the international market, Ministry of Finance should ensure conditions for greater diversification of the investor structure, thereby not jeopardizing the financial effects arising from the borrowing.

- **Ensuring integrated records**

Ministry of Finance is engaged in a process of acquiring a software system for the purposes of public debt management. It is foreseen to integrate records on both domestic and external debt into one system, in order to create comprehensive public debt registry. This registry is an obligation pursuant to the Public debt Law, and should be publicly available, and it will enable active monitoring of the debt structure and analysis.

VII. Quantitative Targets of the Strategy

- **Level (limit) of the public debt**
  Taking into account the restrictiveness of the determined fiscal policy which in the coming three-year period envisages realization of a very low budget deficit of below 0.6% of GDP (including the deficit of the general government budget, deficit caused of the foreign financed projects of the budget users and the deficit of the National and Regional Road Fund), as well as the projections covered with the macroeconomic policy for accelerated economic growth expressed through GDP growth by more than 4% each year, ***the level (limit) of public debt in relation to GDP in the period 2006 - 2008 will have a tendency to continuously decline and will range between 37% to 41%. Within the public debt, central government debt will also have a declining trend, ranging between 35% to 38% of GDP.***

- **Level (limit) of the sovereign guarantees**
  Unlike the limit of the public debt which is to be reduced, limits of the issued sovereign guarantees in the period 2006 - 2008 will insignificantly increase ***and will range between 3.8% and 4.1% of GDP***.

- **Maximum amount of new borrowing in the current year**

Total amount of the new borrowing in 2006 ***is expected to amount to EUR 180 million, EUR 49 million***[10]***out of which on the basis of issue of continuous government securities***, ***while the remaining EUR 131 million on the basis of borrowing abroad.*** Out of the amount envisaged for external borrowing, EUR 30 million will be on the basis of newly extended credits, and the rest will be on the basis of disbursed tranches under agreements concluded in the previous years. ***These calculations and limits do not include some potential future assuming of liabilities (debts), such as on the basis of succession and liabilities of Macedonian Railways public enterprise.*** More details on the projects the realization of which will be financed by foreign borrowing are presented in Annex 2.

- **Maximum amount of newly issued sovereign guarantees in the current year**
  Issued sovereign guarantees bear high level of risk arising from the possibility for they to be called up, causing additional costs when executing the Budget. Having this as a starting point, policies of the Government in relation to the issuance of new sovereign guarantees in the period 2006 - 2008 will be significantly restrictive. This especially refers to sovereign guarantees on the basis of domestic borrowing for which the Government will issue no guarantees in the coming three-year period. Contrary to this attitude, policy for issuance of sovereign guarantees for borrowing abroad will be less restrictive. Thus, in 2006, it is planned to issue one guarantee in the amount of EUR 20.7 million for the World Bank credits. More details on the projects the realization of which will be financed by foreign borrowing for which the state will issue sovereign guarantee are presented in Annex 3.

- **Public debt stock and structure at the end of 2006** Public debt stock in 2006 will be reduced by around EUR 30 million, reaching the level of EUR 1.9 billion. 66% out of this amount will account for external debt, while 34% for domestic debt. Contrary to this structure, ratio between the debt denominated in foreign currency and the debt denominated in domestic currency will be 92% and 8% respectively. Such trend of increase of the domestic currency denominated debt in relation to the foreign currency denominated debt will continue in the coming period as well.

- **Sovereign guarantee stock and structure at the end of 2006**
  In the period 2006 – 2008, guarantees the state plans to issue for borrowing abroad will influence the stock of the issued sovereign guarantees. As a result, the stock of guarantees in the reviewed period will continuously increase, **and in 2006 it will amount to around EUR 175 million.**

[10] Amount of government securities planned to be issued in 2006 will be Denar 3 billion.

ANNEX I

LEGAL REGULATION AND INSTITUTIONAL SETUP FOR PUBLIC DEBT MANAGEMENT

1. Legal Regulations

Legal regulations governing the basis of public debt management comprises the following:

1. Law on Public Debt (Official Gazette of the Republic of Macedonia, no. 62/05);
2. Budget Law (Official Gazette of the Republic of Macedonia, no. 64/05);
3. Securities Law (Official Gazette of the Republic of Macedonia, no. 95/05)
4. Law on National Bank of the Republic of Macedonia (Official Gazette of the Republic of Macedonia, no. 3/02, 51/03, 85/03, 40/04 and 61/05);
5. Law on Foreign Exchange Operations (Official Gazette of the Republic of Macedonia, no. 34/01; 49/01; 103/01; 54/02; 51/03);
6. Rulebook on the Manner and Procedure for Issuance and Payment of Government Securities (Official Gazette of the Republic of Macedonia, no. 99/05),
7. Rules on the Manner and the Procedure for Trading and Settlement of Treasury Bills Transactions on the Over-the-counter Markets (Official Gazette of the Republic of Macedonia, no. 24/05);

Law on Public Debt was adopted in July 2005, determining the main objectives of public debt management, the activities Ministry of Finance can implement in order to efficiently and effectively manage the debt of the public sector, the procedures and the manner of borrowing in the country and abroad by the public debt issuers, purposes of state debt, procedure for issuance, servicing and termination of sovereign guarantees, as well as public debt transparency.

Law on Public Debt covers several chapters, such as:

- First chapter “General Provisions” covers the issue of which the Law regulates, and it defines what is not considered as a public debt. In addition, it provides an explanation of certain terms defined by the Law, such as: state debt, public debt, debt servicing, re-financing, rescheduling, sovereign guarantee, agent, borrowing. There is also a clear digression in terms of NBRM debt, and it is not considered as public debt. Clear distinction is also made with respect to the private debt, comprising all financial liabilities assumed by resident of the Republic of Macedonia, but not being guaranteed by the state.
- The second chapter "Public Debt Management Strategy" of the Law envisages the preparation and the implementation of a medium-term public debt management strategy, covering a three-year period, and it will be adopted by the Parliament of the Republic of Macedonia, together with the Budget of the Republic of Macedonia for the next year. This chapter covers the contents of the strategy, public debt management, objectives of public debt management, competences of the Ministry of Finance in public debt management, contents and the manner of keeping records in the Public Debt Registry.

Public debt limits are determined in the Public Debt Management Strategy, and they are calculated as ratio between the public debt and GDP.

Main objectives of public debt management determined in the Law are the following:

- undertaking measures and activities for the purpose of ensuring the financing of the needs of the state with lowest cost possible, on medium and long term, and with sustainable risk level; and
- undertaking measures and activities to the end of development and maintenance of efficient domestic financial markets.

- Third chapter "State Debt" covers the purposes and treatment of the state debt, borrowing by concluding loan agreements, borrowing by issuance of government securities, issuance, servicing, collection right and termination of sovereign guarantees. This chapter defines the purposes for which debt is incurred and used and the procedure for incurring debt by concluding loan agreement and by issuing government securities. Borrowing by the public sector can be in a form of a loan from domestic or foreign creditors or in a form of government securities issued on domestic or foreign capital market. Regarding the borrowing, the Law envisages for the borrowing from foreign lenders to be carried out on the basis of a separate law for each new borrowing, while for the borrowing from domestic lenders to be carried out on the basis of adoption of a *Decision* by the Government of the Republic of Macedonia. In addition, each borrowing, i.e. Decision by the Government, mandatorily requires obtaining of a positive opinion by the Ministry of Finance, as well as mandatory participation of representatives from the Ministry of Finance and other authorized representatives of the Government in the negotiations for conclusion of a loan agreement. With respect to the issuance of government securities, Ministry of Finance issues them, upon prior adopted *Decision* by the Government of Macedonia.

Claims by the creditors on the basis of domestic debt is a priority liability of the Budget of the Republic of Macedonia for regular servicing.

The part on the procedure for issuance, servicing, collection right and cancellation of sovereign guarantee defines the criteria to be met by the projects, the financing of which requires issuance of sovereign guarantee.

These criteria are the following:

- justification of the purpose for which the funds are used;
- ensured co-financing resources to the end of smooth project implementation; and
- solvency of the issuer of public debt proposing the project for timely servicing of the public debt.

This part describes the procedure for issuance of sovereign guarantee, which included consent by the Government of the Republic of Macedonia and a positive opinion by the Ministry of Finance, and mandatory participation of representatives from the Ministry of Finance and other authorized representatives of the Government when concluding loan agreement for which sovereign guaranteed is needed. In addition, this Law stipulates where to make the payment upon called-up guarantee. Ministry of Finance has the right to collect the claim that includes the collection of principal, interest, default interest and other costs incurred, in case when the issuer of public debt for which guarantee is issued is not able to service the debt. Regarding public enterprises, companies being predominantly owned by the state, the municipalities or the City of Skopje, as issuers of public debt for which the guarantee is issued, Ministry of Finance has the right, in order to collect the called-up guarantee, to block the account of the issuer of public debt.

- Fourth chapter of the Law covers the debt of public enterprises and companies being fully or partially owned by the state. Thereby, each borrowing of the public enterprises and companies abroad has to be regulated by a law, while the borrowing from domestic lenders has to be regulated by a Decision by the Government, but it is mandatorily required to obtain a consent by the Government and a positive opinion by the Ministry of Finance for each borrowing.
- Fifth and sixth chapters cover the information on the public debt and transparency, and it is explained which information the issuers of public debt are obliged to submit to the Ministry of Finance and the deadline therefore. Transparency part more precisely presents to whom and in what form, and the deadlines, the Ministry of Finance is responsible to provide information on the public debt.

Financial resources acquired on the basis of borrowing can be used for the following: financing the budget deficit, financing projects and investments, promoting the development of the financial markets in the Republic of Macedonia, debt re-financing, BOP support, support to the foreign exchange reserves of the Republic of Macedonia, temporary financing of the liquidity related to cash flows, payments on the basis of sovereign guarantees and protection or elimination of effects caused by natural disasters or ecological disasters.

There is also a distinction made regarding the borrowing by the local government units in which case the borrowing is regulated pursuant to the **Law on Local Financing** and by the **Law on the City of Skopje**. Pursuant to the Law on Local Financing, municipalities cannot borrow by July 2007, except with an approval by the Government for credits from international financial institutions. Following July 2007, they can borrow both in the country and abroad (according to the limit prescribed in the Law), while the borrowing abroad is made only upon prior consent by the Government. Municipality cannot give its property, which serves for performing activity of public interest, under mortgage. Borrowing by the municipality can be a short-term one for the purpose of covering temporary shortage of cash funds, and long-term one for the purpose of financing capital assets and investments. Short-term borrowing during the fiscal year cannot exceed 20% of the realized revenues in the previous fiscal year, while the long-term borrowing cannot exceed 15% of the realized revenues in the previous fiscal year.

Annual costs for servicing the liabilities under the state debt are determined in the annual state budget. The new **Budget Law** includes a provision pursuant to which the Government is committed that it will regularly and timely settle the liabilities related to the debt on medium and long run, regardless of the balance on the state budget account.

2. Institutional Setup

By the beginning of 2005, public debt management was performed on a decentralized level, in more institutions in the state. There was a Public Debt Management Unit in the Ministry of Finance, which was part of the Treasury Department and the task of which was to timely service the liabilities on the basis of the state debt. Records on the domestic debt were kept by the Financial System Department, while the records on the external debt were kept by the International Finance Department in the Ministry of Finance and the NBRM. Registry on Ownership of Government Securities issued on the domestic capital market is kept within the Central Securities Depositary.

In order to ensure centralized approach, i.e. concentration of the competencies for public debt management in one institution, in March 2005, separate organization unit - **Public Debt Management Department** was established within the Ministry of Finance.

Regarding the organizational structure of the Public Debt Management Department, it comprises two Units:

- Unit for Borrowing and Investments (Front Office)
- Unit for Records, Monitoring and Servicing Public Debt Liabilities (Back Office).

Unit for Borrowing and Investments performs all the borrowing operations by the state on the domestic and the foreign capital market, organizing auctions of government securities on the domestic capital market, maintaining regular contacts with foreign and domestic investors, managing the excess of liquid cash assets and ensuring the financing of temporary shortage of liquid cash assets in the budget.

Unit for Records, Monitoring and Servicing Public Debt Liabilities is in charge of recording the liabilities on the basis of domestic debt, timely servicing of the liabilities on the basis of domestic and external state debt, monitoring the balance of the Denar and foreign currency accounts of the state, preparing reports, implementing the Public Debt Management Strategy and managing the financial risks.

According to the Action Plan, in 2006, the Department will establish one more Unit, that will perform the activities related to the analysis and research, preparation of debt reports and management of financial risks. It is also planned to create a software application in 2006, in which database on overall state debt will be created.

Institutions and Departments which the Public Debt Management Department cooperates with when performing its activities and tasks are the following:

1. within the Ministry of Finance:

- Budget Department – in fact, Public Debt Management Department provides data on the costs related to servicing both the domestic and the external state debt in the process of preparation of the budget for the next year, as well as of the Fiscal Strategy for the coming three years.
- International Finance Department – this Department participates directly in the negotiations on the borrowing at foreign multilateral and bilateral creditors. Public Debt Management Department obtains data on each new borrowing by the state and the dynamics of disbursements under the existing credit lines.
- Treasury Department – this Department is in charge of the records on the budget transactions, including the ones that refer to the repayments on the basis of state debt, being repaid from the budget account.
- Financial System Department, that is in charge of the regulations for the financial instruments and the financial markets.

2. outside the Ministry of Finance:

- National Bank of the Republic of Macedonia – relevance of this institution for the performance of the activities of the Public Debt Management Department comprises three aspects:
  - (a) NBRM keeps full records on the external borrowing by the state, and all data that refer to the external debt are provided from this institution;

(b) NBRM is an agent authorized by the Ministry of Finance, in charge of carrying out the auctions of government securities; and

(c) successful public debt management means regular and smooth correlation with the policy of the monetary authorities.

- Central Securities Depositary – this institution registers the ownership of all government long-term and short-term securities.
- Commercial banks – commercial banks are direct participants in the process of auction of government securities and they are a direct link between the Ministry of Finance, as issuer, and the other legal entities and physical persons than can participate indirectly in the auctions through the banks.

Market Committee was established in 2004 for the purpose of development of the domestic market of government securities. Market Committee comprises representatives from the Ministry of Finance, NBRM, the banks and other financial institutions. Main functions of the Market Committee are the following:

- promotion of government securities to the end of attracting individual investors;
- stimulating the demand on the domestic debt market by attracting foreign investors as well;
- development of repo market and secondary trading with government securities;
- introduction of longer-term government securities.

In 2005, Market Committee convened twice. There is a need in 2006 for this Committee to organize an initial meeting with the market participants, especially by organizing meetings of the Market Committee.

ANNEX II

List of projects to be financed on the basis of external borrowing and projection of the planned medium-term external financing

(EUR)

	Project	2006	2007	2008
	Public Sector	**131,751,158**	**117,162,897**	**88,972,849**
	Multilateral	**97,971,647**	**94,868,034**	**57,998,999**
	IBRD/IDA	**39,454,681**	**45,170,629**	**32,846,625**
C	Irrigation Rehabilitation and Restructuring Project	1,957,267	1,731,875	0
C	Children and Youth Development Project	652,422	0	
C	Community Development and Culture Project	1,304,845	0	0
C	Community Development Project	1,304,844	0	0
C	TTFSE	729,836	0	
C	SPIL	1,957,267	1,009,261	1,778,145
C	Health Sector Management Project	2,038,820	1,007,512	1,114,809
P	Legal and Judicial Implementation and Institutional Support Project	464,851	1,249,632	2,205,232
PS	Macedonia- Railways Reforms Project	2,200,000	3,600,000	4,500,000
C	Real estate Cadastre and Registration Project	1,631,056	1,600,000	3,200,000
C	BERIS	530,093	1,120,000	3,782,368
PS	Electric Power Development Project	1,000,000	7,000,000	8,000,000
C	PDPL 1	0	0	
P	PDPL 2	22,052,324	0	
P	PDPL 3	0	22,052,324	0
C	Education Modernization Project	1,631,056	514,554	514,554
P	TTFSE II	0	735,077	1,837,694
P	**Unidentified projects *(in the framework of WB CAS2007-09)***	0	3,550,393	5,913,823
	EBRD	**36,059,700**	**24,462,656**	**8,552,374**
C	(Regional) Road Project II	7,500,000	11,737,768	8,402,374
C	Macedonia-Bulgaria Transmission Project (400 kV transmission line)	23,000,000	10,910,000	150,000
C	MEAP	3,570,000	0	0
C	Civil Aviation Upgrading Project	1,989,700	1,814,888	
	EIB	**17,000,000**	**17,800,00**	**12,100,000**
C	Roads Project II (60 million EURO)	13,700,000	11,100,000	9,100,000
C	ESM Power Substations Project	3,300,000	4,700,000	0
P	Regional Solid Waste Management Project	0	2,000,000	3,000,000
	IFAD	**1,957,266**	**934,749**	**0**
C	Southern and Eastern Regions Rural Rehabilitation Project	**228,032**	**0**	
C	Agricultural Financial Services Project	1,729,234	934,749	

	CEB	**3,500,000**	**6,500,000**	**4,500,000**
C	Social Housing Project	0		
P	Health Sector Project	0	1,500,000	3,000,000
C	Job Creation Project II (MBDP)	3,500,000	5,000,000	1,500,000
	Bilateral	**33,780,123**	**22,294,762**	**30,973,850**
	Italy	**5,073,763**	**1,098,024**	**8,000,000**
C	Support to SMEs (small and medium enterprises)	3,589,502		
PS	Rationalization of the Management System and Modernization of Bio-medical Equipment in the Health Sector (Health Sector Management Project HSMP)	1,484,261	1,098,024	0
P	Support to SMEs (small and medium enterprises) II	0	0	8,000,000
	Germany	**11,583,533**	**5,157,261**	**5,440,000**
C	Irrigation Programme in the Southern Vardar Valley	3,914,533	2,657,261	0
P	Support to Micro, Small and Medium Enterprises 3	7,669,000	0	0
P	Water Supply Project	0	0	3,440,000
P	Solid Waste Management	0	2,500,000	2,000,000
	Spain			
C	Project Hydro Power Plant Lisice –Loan from ICO	4,321,887	0	0
C	Project HPP Lisice-Loan from BBVA-	2,018,657	0	0
C	Project HPP Lera- Loan from ICO	0	0	0
	Japan	**8,155,276**	**16,039,133**	**17,533,850**
	C Improvement of water utilization of water basin of the river Zletovica (Hydro project Zletovica)	8,155,276	16,039,133	17,533,850
C	**China** Construction of HPP Kozjak (Hydro project Kozjak)	2,630,839	0	0

c - concluded, signed loan agreement;
ps - prior signing a loan agreement;
p - planned project;

* The table shows medium-term review of the planned projects and the amount of external financing necessary therefore. Efforts will be made for the amounts to remain unchanged on annual level, by anticipating the possibility for changes of the amounts given for financing separate projects. However, any change in the external financing will be in line with the determined fiscal framework and the determined budget deficit.

ANNEX III

List of projects for which it is planned to issue a sovereign guarantee to the foreign creditors

Creditor	Project	Original currency	Amount	Repayment conditions			Projected disbursements in 2006				Final beneficiary
				Repayment period	**Grace period**	**Interest rate**	**Q1**	**Q2**	**Q3**	**Q4**	
IBRD	Electric Power Development Project	EURO	20,700,000	17	5	LIBOR on EURO +0,75%	**0**	**0**	**0**	**1,000,000**	MEP SO