Ministry of Finance of the Republic of Macedonia

Public Debt Management Department

PUBLIC DEBT MANAGAMENT STRATEGY OF THE REPUBLIC OF MACEDNIA FOR THE PERIOD 2009-2011

Skopje, June, 2009

Contents

Pursuant to Article 7 paragraph 2 of the Law on Public Debt ("Official Gazette of the Republic of Macedonia" no. 62/05 and 88/08), the Parliament of the Republic of Macedonia at its session held on 17 June 2009 adopted the following:

Public Debt Management Strategy of the Republic of Macedonia for the period 2009-2011

I. INTRODUCTION

Basic principles taken into account when managing the public debt portfolio and thus during the drafting and implementation of the Public Debt Management Strategy are the following:

- establishing the optimum structure of debt portfolio and its harmonization with the national macroeconomic policy;
- harmonizing the debt portfolio costs 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.

According to the adoption of the Public Debt Management Strategy, the Parliament of the Republic of Macedonia provides a framework for the Government of the Republic of Macedonia, and above all, the Ministry of Finance, to act focusing on prudent public debt management on medium term, i.e. in the next three years.

Data presented in the Public Debt Management Strategy are based on actual 2008 data, while projections for the period to come are subject to changes depending on the priorities for financing and development of the government securities market.

The public debt portfolio management in this Public Debt Management Strategy, as in the previous strategies will be aimed at creating favourable debt structure, meaning increase in the Euro currency at the external debt and increase in the percentage share of the domestic denar-denominated debt in relation to the total debt. In addition, to the end of reducing the sensitivity of the public debt portfolio to certain market risks, the coming period will be focused on maintenance or possible increase in the debt with fixed interest rate.

However, unlike the previous strategies, the framework of the government debt trend, under this Strategy, is narrowed by 5 percentage points in relation to the Gross Domestic Product. However, despite the reduction of the public debt limit, the public debt remains at the set limits from the previous Strategies. This implies wider space for borrowing at the public enterprises, for which, the state would issue sovereign guarantees.

Despite the small differences from the previously adopted strategies, the 2009-2001 Public Debt Management Strategy fully correlates with the Fiscal and Macroeconomic Strategy because of which the new borrowing will not jeopardize the fiscal and macroeconomic maintenance of the state.

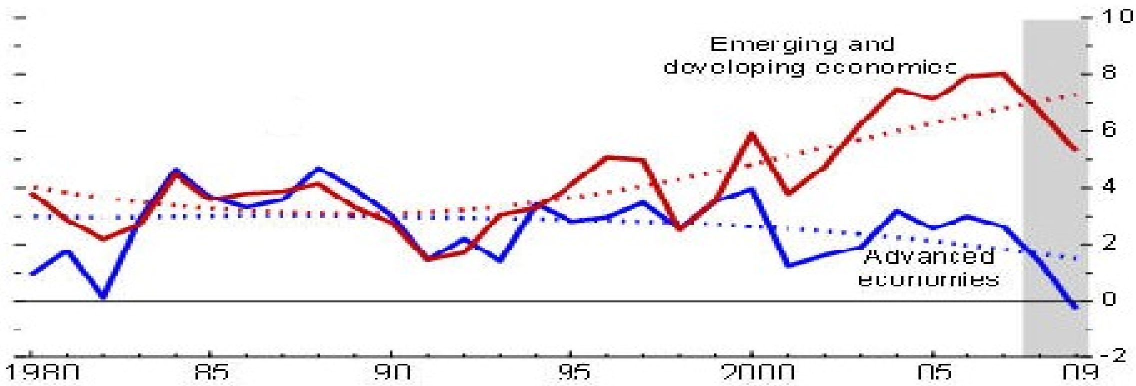
II. INTERNATIONAL ENVIRONMENT

Main feature of 2008 was the financial crisis affecting the world. Shock on the financial markets begun in the middle of 2007 in USA, turning into crisis on a global scale in 2008. Huge liquid injections were made by the central banks and Governments so as to prevent or minimize the crisis. Thus, in 2008, US$ 700 billion were provided in USA and US$ 469 billion in Europe, and numerous countries addressed IMF for help.

According to the International Monetary Fund (World Economic Outlook 2009) the global growth decreased from 5% in 2007 to 3,75% in 2008, while global growth by 2.2% is envisaged for 2009. This growth of the global economy would be due, above all, to the projected growth of the emerging markets, which is planned to achieve 5%. With regard to these emerging markets, such as China, India and Brazil, decrease of the growth rate is projected in 2009, but they will still be in the positive growth zone. In China, the development rate will decrease from 9.7% in 2008 to 8.5% in 2009. In India, it will decrease from 7.8% in 2009 to 6.3% in 2009 while it will decrease from 5.2% to only 3% in 2009 in Brazil.

Stagnation and even decrease of the economic activity by 0.25% on annual level is envisaged in the developed countries. Decline of the global growth was mainly due to the projected negative growth rates of the developed countries by 0.7% of the Euro-zone and 0.3% of the USA. Support of the growth by the net-import will be reduced in Japan.

Chart 1: Real GDP growth



Source: IMF

According to RGE Monitor (World Economic Outlook 2009), the recession the world currently faces, is expected to be difficult as the Global Depression of the thirties and negative global increase by 0.5% is also expected.

In 2008, it is envisaged for the dollar to depreciate in relation to the Japanese Yen and the Swiss franc and to appreciate in relation to the Euro and the British pound (Table 1).

Table 1 Projection of exchange rate in relation to US$

	Current Exchange rate	3 months	6 months	9 months	12 months
EUR	1,30	1,25	1,20	1,10	1,15
JPY	88	86	87	95	109
GBP	1,38	1,30	1,20	1,16	1,29
CHF	1,16	1,19	1,20	1,33	1,29

In 2009, from the point of view of the trends in interest rates, according to the International Monetary Fund, it is projected for the interest rates to decrease by 1 percentage point in USA and the Euro-zone and by 0.25 percentage points in Japan. In addition, dollar deposits are expected to have interest rate of only 2%, while the interest rate on Euro deposits is expected to be 3%. In 2009, interest rates of the Central Banks will also decline. Interest Rate of the European Central Bank was adjusted at the beginning of 2009, when it reduced by 0,5 percentage points and it is expected to decrease again by 0.25 percentage points and to amount to 1.75% in March. In the end o2 2008, Federal Reserves of USA reduced the interest rate, applying zero interest rate policy (from 0 to 0.25%) and no change is envisaged thereon by 2010. In January 2009, Bank of Britain reduced the interest rate by 0.5 percentage points and such decrease is also planned in February, by which, the interest rate will be 1%. In December 2008, Bank of Japan made last change of the interest rate, amounting to 0.3%. Trend in the interest rate of Central Banks is shown in Table 2.

Table 2 Projection of Interest Rates of Central Banks

Central Bank	ECB			FED			BoE		
	date	change	interest rate	date	change	ineterst rate	date	change	interst rate
Last changes	15.01.2009	-50 bp	2,00%	16.12. 2008	-75 bp	0-0.25%	08.01. 2009	-50 bp	1.50%
Expected changes	05.03.2009	-25 bp	1.75%	2010			05.02. 2009	-50 bp	1.00%

Source Reuters, 22.01.2009
**bp – basic points*

Other feature of the global economy in 2008 is the weakening of the global demand, depreciating the prices of the products. During the first half of 2008, prices largely increased, decreasing sharply in the second half. Pressure influencing their decrease is also expected in 2009.

Perspectives of global economy in 2009 are related to a great extent to the oil price. Although the oil reached record price of US$ 147.27 per barrel in July 2008, it still reduced about 70% by the end of the year, ranging around US$ 40 per barrel, mainly due to the reduced consumption of the energy sources initiated by the global crisis. There are different projections for the oil price amount for 2009, ranging between US$ 25 per barrel, according to the prognosis of certain banks, US$ 45 according to the International Energy Agency – IEA, US$ 68 according to IMF ranging between US$ 60 and 70 according to the Organization of the Petroleum Exporting Countries – OPEC.

According to the World Bank, general decrease of the energy price by 25% is expected, including oil, natural gas and coal. According to the same prognosis, prices of non-energy products will reduce by 23.2% in average in 2009.

In addition, the prices of metals and food also reduced, resulting in inflation stabilization. Inflations is expected to be below 1.5% in the developed markets by the end of 2009.

Global recession and reduction of the global trade will largely affect the balance of payments current accounts of many countries. According to the World Bank, surplus of Japan and Eurozone will increase regardless of the reduced trading volume. Account deficit of USA is expected to increase from 5.4% to 5.8% in relation to GDP in 2009.

Events on the international markets also affect the public debt of the Republic of Macedonia. In fact, the reduction of interest rates occurring at the end of 2009 will contribute to relative decrease of the interest cost regarding the variable interest rates from the public debt portfolio of the Republic of Macedonia.

From the point of view of exchange rates, the expected appreciation of US$ compared to the Euro would increase the interest cost of the US dollar- denominated debt with variable interest rate. However, taking into account that it does not have significant share in the total public debt, it will not cause noticeable negative exchange rate differences.

Slowdown of the global economy growth, and thus of the key trade partners of the Republic of Macedonia too, taking into account that Macedonia is small and open economy. Macedonia would influence the reduction of the GDP growth rate.

III. MACROECONOMIC TRENDS, FISCAL INDICATORS AND PUBLIC DEBT IN THE REPUBLIC OF MACEDONIA

III.1 Current macroeconomic climate and expected medium-term macroeconomic trends

In 2008, Macedonian economy continued to show significant economic achievements, despite the slowdown of the global economic activity, including the countries in the region. Positive trends were recorded in almost all sectors of the economy. Accelerated growth was realized in conditions of higher coordination between fiscal and monetary policy, supported by disciplined and responsible fiscal policy and consistent and more restrictive monetary policy.

Transition period in the Republic of Macedonia was characterized with relatively high macroeconomic stability, but low economic growth rates. During this period, Republic of Macedonia did not manage to join the other countries, which quickly restructured their economies and started realizing high growth rates. Such negative trend was interrupted in 2007, when the country, for the first time since its independence, realized GDP growth rate of 5.9%. After this turning point, the economy started both to recover quickly and use its potentials for high growth, the GDP growth rate was 5% in 2008, thus the commenced trend of realization of significant growth rates continued. What is important to mention is the diversification of this growth i.e. the fact that all production sectors participated in the growth. Most significant growth was registered in the processing industry (10.6%), the retail and wholesale trade (8.9%) and the sector hotel and restaurants (7%). High growth of value added at services led to further change and approximation of the production structure of GDP to the one in the developed countries.

Main objective of the Government of the Republic of Macedonia, in line with its economic program, remains to be keeping the high economic growth, whereby it is necessary to realize high growth rates several years in a row so as for the citizens to feel more significant increase of the available income and improvement of their living standard. In relation to the further success in attracting foreign direct investments as well as realizing the projected capital investments.

Regarding the expenditure side of GDP, driving force of the economic growth will be personal consumption and investments. Within the investments, foreign direct investments are expected to make a contribution, but the capital investments will be also significant. From the point of view of production method for calculation of GDP, services account the most in its creation, as the main drivers of growth. However, high growth is also expected at industrial production, as a result of continuation of restructuring of domestic capacities, as well as the entrance and commencement of production in realized and new FDIs.

Positive economic performance, being already noticeable and the confirmations thereon by renowned world institutions are significant stimulus for continuation of the reform policy of the Government of the Republic of Macedonia in all fields of the social and economic life. However, main precondition thereof is the readiness of all government institutions, the private sector and the citizens of the Republic of Macedonia to participate in the initiation and implementation of the reforms.

In addition, the financial crisis spreading very quickly in the world, already affecting the Republic of Macedonia is serious threat to the Republic of Macedonia. Macroeconomic projections included in the Public Debt Management Strategy were prepared by assuming that the crisis will be present within relatively short period. Thereby, risks that are possible to occur in the coming period, thus preventing the realization of the high economic growth projections, in addition to the global financial crisis are the following:

Possible drastic increase in oil prices and energy sources on the global markets in the analyzed period, which, taking into account the previous experience would cause higher inflation than the projected one, as well as increase in the production costs of enterprises.

Further reduction of prices of metals on the world stock exchanges, with subsequent decrease of the export and laying off workers. High risk being already present in the Republic of Macedonia was precondition for the Government of the Republic of Macedonia to propose set of ten measures aimed at overcoming the crisis.

Continuation of the process of thorough structural reforms is condition for realizing the expected economic trends by 2011. Taking into account that, in the short run, they may be restrictive for both the citizens and the economy, they may not be accepted by the public and the economic agents. *At the same time, the financial crisis may hinder their implementation;*

Fiscal reforms that were undertaken for the purpose of improving the investment climate and freeing greater amounts of cash resources for the private sector for investing, as well as the measures for increasing the living standard and encouraging the domestic demand, could cause inflationary pressure and according to the pessimistic scenario, the inflation could retain the relatively high level.

Other noticeable risk that should be emphasized is the high balance of payments trade deficit of the Republic of Macedonia, mainly financed from the inflows on the basis of private transfers i.e. from the funds who our citizens living and working abroad send to their relatives in this country. Inflows on the basis of private sectors have currently stable trend, but the risks from their reduction is high taking into account the economic recovery of the country and the improvement of the living standard, as well as due to the increased saving and the possible loss of job of our emigrants. Of course, the increased inflow on the basis of FDIs would neutralize such negative development.

III.2 Medium-term fiscal framework

Process of successful implementation of the fiscal consolidation, which started in the previous period, will also continue in the coming medium term, expressed through higher, but controlled fiscal deficit. However, fiscal consolidation, especially in 2009, when the consequences of the economic crisis will be the most evident, will certainly have to be realized in specific and risk conditions. In fact, measures undertaken, aimed at facilitating the Macedonian economy in the process of coping with the consequences of the crisis, will have fiscal effect on the revenues and expenditures in the coming medium-term period.

Revenues of the **consolidated government budget** (including the central government budget and the local government budget) in the next three-year period decline relatively as a share of GDP, from 40.7% of GDP in 2008 to 32.3% in 2011. Projected decrease is mainly result of the reduction of the tax burden on the basis of reduced taxes and social contributions, as well as the effect from the measures undertaken to help the Macedonian economy in coping with the global crisis, which will provide for reduction of the total costs of the Macedonian enterprises, as well as space for freeing available resources and their focusing on increased investments and job creation that will directly accelerate the development of the national economy.

Total expenditures in the period 2009-2011, in conditions of rational management of public finances at all government levels, according to the planned policies and low level of budget deficit, decline as a share of GDP from 42.2% in 2008 to 35.1% in 2011.

Table 4

Consolidated General Government Budget	**2008**	**2009**	**2010**	**2011**
(millions MKD)				
Consolidate Government Budget-Revenue	**155.127**	**162.194**	**165.463**	**169.774**
% of GDP	40,7	39,0	34,7	32,3
Consolidate Government Budget--Expenditure	**160.792**	**173.776**	**178.934**	**184.296**
% of GDP	42,2	41,7	37,5	35,1
Consolidate Government Budget- Deficit	**-5.665**	**-11.582**	**-13.471**	**-14.522**
% of GDP	-1,5	-2,8	-2,8	-2,8
Central Budget - revenues	**92.607**	**99.522**	**101.274**	**105.208**
% of GDP	24,3	23,9	21,2	20,0
Central Budget - expenditures	**94.956**	**109.604**	**112.555**	**118.457**

% of GDP	24,9	26,3	23,6	22,6
Central Budget - deficit	**-2.349**	**-10.082**	**-11.281**	**-13.249**
% of GDP	-0,6	-2,4	-2,4	-2,5
Extrabudgetary funds - revenues	**40.668**	**40.717**	**40.760**	**40.819**
% of GDP	10,7	9,8	8,5	7,8
Extrabudgetary funds - expenditures	**43.984**	**42.217**	**42.950**	**42.092**
% of GDP	11,5	10,1	9,0	8,0
Extrabudgetary funds - deficit	**-3.316**	**-1.500**	**-2.190**	**-1.273**
% of GDP	-0,9	-0,4	-0,5	-0,2
Local government budget - revenues	**21.852**	**21.955**	**23.429**	**23.747**
% of GDP	5,7	5,3	4,9	4,5
Local government budget - expenditures	**21.852**	**21.955**	**23.429**	**23.747**
% of GDP	5,7	5,3	4,9	4,5
Local government budget - deficit	**0**	**0**	**0**	**0**
% of GDP	0,0	0,0	0,0	0,0

Source: Ministry of Finance, 2009-2011 Fiscal Strategy

Such determined main postulates of the fiscal policy are actually controlled ***deficit level of 2.8%*** *of* the projected GDP.

Regarding the coming medium term, projected revenues and expenditures in the Budget of the Republic of Macedonia, including the central government budget and the budgets of the Funds, ensure controlled deficit level of 2.8% of the projected GDP. Attaining such deficit level, in conditions of full realization of capital investments, especially in the road and the railway infrastructure, will provide for an impetus to the economic growth, as solid basis in the integration processes.

Central budget deficit in the period 2009-2011 is projected at around 2% - 2.4% of the projected GDP. Financing of the projected deficit of the Budget of the Republic of Macedonia in the next medium-term period will mainly be provided from foreign sources for financing certain projects, and simultaneously from domestic sources, via continuous issues of government securities, inflows on the basis of possible privatizations as well as financing of certain project via renting property under concessions.

Table 5 *Denar million*

DEFICIT AND FINANCING SOURSING	2009	2010	2011
BUDGET BALANCE	**-11.582**	**-13.470**	**-14.522**
FINANCING OF DEFICIT	**11.582**	**13.470**	**14.522**
Inflow	**19.689**	**21.542**	**23.529**
Revenue from privatizations and concessions	2.500	1.100	1.100
Foreign credits	7.155	14.024	17.189
Domestic borrowings	6.050	6.010	7.005
Deposits/ Other sources	3.984	408	-1.765
Outflow	**8.107**	**8.072**	**9.007**
Principle payment of external public debt	2.271	2.504	2.860
Principle payment of domestic public debt	5.836	5.568	6.147

Source: Ministry of Finance, 2009-2011 Fiscal Strategy

Possible risks during the implementation of fiscal policy

Process of successful implementation of fiscal consolidation in the coming medium-term period will be conditioned directly by the negative effects from the global economic crisis, as well as the effects from the measures the Government of the Republic of Macedonia undertakes if necessary, aimed at facilitating the adverse consequences from the world crisis and recession.

In the light of this context, defined fiscal policy reflected through the 2009 Budget of the Republic of Macedonia will undergo certain changes in line with the effects from the set of measures the Government of the Republic of Macedonia adopted at the end of last year, to the end of facilitating the Macedonian economy in the process of coping with the crisis consequences. In fact, these measures have their own direct fiscal effect in the projection of revenues and expenditures for the coming medium-term period.

Apart from these direct effects, planned medium-term fiscal policy will generally depend on the successful realization of the following assumptions and challenges:

1. *Realization of the projected macroeconomic indicators in conditions of world economic recession, on which depends the realization of projected revenues and expenditures in the coming medium-term period;*

2. *Successful implementation of tax reforms through further harmonization of the national legislation with the Acquis, especially in the field of indirect taxes and application of low tax rates, as well as introduction of favorable conditions and incentives for foreign investments, especially investments in economic zones, which will give effects in stimulating the economic development;*

3. *Successful implementation of the policy of reduced social contribution rates by 10 percentage points in the next three years (from current 32% to 22%), which together with the integrated collection of all contributions and personal income tax will provide for further reduction of the total costs for the firms, improvement of their competitiveness, as well as reduction of unemployment and grey economy;*

4. *successful realization of planned policies in the coming period in conditions of reduced revenues and full realization of capital investments, in particular in road and railway infrastructure, which should provide for fiscal stimulation of the expected slowdown of the economic development and absorption of excess of labour force;*

5. *Efficient utilization of credit funds earmarked for the cadastre reforms, reforms in the judiciary, social protection, health and education, municipal development, irrigation rehabilitation and improvement of business environment, as well as the available resources from EU pre-accession funds will provide for job creation.*

III.3 Trends in the public debt of the Republic of Macedonia

In line with the national methodology, the public debt of the Republic of Macedonia comprises the government debt and the debt of both public enterprises and companies being fully or predominantly owned by the state, the municipalities, the municipalities in the City of Skopje and the City of Skopje as well as the debt of the National Bank of the Republic of Macedonia. However, the debt of the National Bank of the Republic of Macedonia, pursuant to the Law on Public Debt is only used for statistical purposes, not being subject-matter of the Public Debt Management Strategy.

Government debt includes all financial obligations created via borrowing by the Republic of Macedonia, including the debt of the municipalities, the municipalities in the City of Skopje and the City of Skopje, not including the debt of public enterprises and companies being fully or predominantly owned by the state, the municipalities, the municipalities in the City of Skopje and the City of Skopje and of the National Bank of the Republic of Macedonia.

In the period 31st December 2007- 31st December 2008, **the government debt** reduced by EUR 43.3 million i.e. from 24.7% to 20.9% in relation to GDP. In addition, in this period, the **total public debt** reduced by EUR 59.8 million i.e. from 33.3% to 28.2% in relation to GDP.

The reduction of the stock of the government debt and the total public debt is result of both the regular servicing of the existing public debt and the smaller volume of new borrowing in the past period. However, the downward trend of the total debt is mainly determined from the drop of the domestic debt mainly due to the termination of the issue of treasury bills for monetary purposes, reduction of the debt of the National Bank of the Republic of Macedonia on the basis of the central bank bills, and as a result of the regular maturity of the structural bonds.

As a result of the low level of public debt the Republic of Macedonia achieved, reasonable space for new borrowing, by which the fiscal and macroeconomic maintenance in the country would not be jeopardized, was created. Therefore, in the period 2009-2011, increase in the investment activity in the Republic of Macedonia is projected, whereby, significant part of them will be realized via borrowing, which will have its own implications over the increase in the stock of the total public debt as a last resort.

Therefore, in the period 2009-2011, increase in the government debt by 3.1 percentage points i.e. from 22.6% to 25.7% in relation to GDP is projected. Such increase in the government debt was result of the new investments in the field of the road and the railway infrastructure, water supply and sewerage, sports facilities, construction of social flats as well as investments in the field of education that will be implemented by the state administration bodies.

In addition, projections for the total public debt for the same period show increase by 12 percentage points i.e. from 27.4% to 39.4% in relation to GDP. This increase is result of the above-mentioned investments and the additional investments that will be realized via borrowing by public enterprises in the filed of energy sector and railway infrastructure, and the state will issue government guarantee thereof.

Issuance of government guarantee also affects the increase in the contingent liabilities i.e. increase in the guaranteed public debt of the Republic of Macedonia.

Active public debt management of the Republic of Macedonia also continues in the coming period, the primary objective of which is aimed at reducing the sensitivity of the debt portfolio to the negative trends on the international financial markets.

Table 6 **Projection for trends in public debt and key parameters**[1]

	2009 projection	2010 projection	2011 projection
Total public debt (million EUR)*	1981,54	2734,15	3417,81
Total public debt as % of GDP	27,4%	34,7%	39,45%
Target for total public debt as % od GDP	**40,0%**	**40,0%**	**40,0%**
General government debt (million EUR)	1636,54	1939,25	2229,76
General government debt as % of GDP	22,6%	24,6%	25,7%
Target for general government debt as % of GDP	**30,0%**	**30,0%**	**30,0%**
External public debt (million EUR)	1460,64	2165,07	2715,1
External public debt as % of total public debt	**73,71%**	**79,19%**	**79,44%**
Target for external public debt	**70% - 80%**	**70% - 80%**	**70% - 80%**
Guaranteed public debt	312,87	768,6	861,6
Guaranteed public debt as % of GDP	4,3%	9,8%	9,9%
Target for guarenteed public debt	**10,0%**	**10,0%**	**10,0%**

Source: Ministry of Finance

** Total public debt includes the government debt, the guaranteed debt of public enterprises as well as the debt of public enterprises, for which, government guarantee was not issued.*

[1]Presentation of the projections for different categories of public debt is based on the following:

- data on concluded partnerships, framework agreements and agreements on future cooperation between the the Republic of Macedonia and the international financial institutions envisaging framework for new borrowings;
- dynamics of disbursing resources related to signed credits;
- projected issuance of government securities and
- projected future issues of denationalization bonds

IV. TARGETS FOR TRENDS IN TOTAL PUBLIC DEBT PORTFOLIO

To the end of providing sources for financing the needs of the state with lowest cost in the medium and long run with simultaneously sustainable level of risk, pursuant to the Law on Public Debt, several medium-targets as well as the targets referring only to the next year were defined.

Due to the world economic crisis, there is certain possibility for transferring the negative effects from the crisis in the national economy as well, being previously described in this strategy. This would contribute to under performance of the projections of certain economic indicators as well as lack of financial resources for stabilization of the negative effects as a last resort. Therefore, if there is need for additional borrowing aimed at achieving macroeconomic stability of the state is such extreme situation, the Ministry of Finance, pursuant to the competences of the Law on Public Debt, is authorized to exceed the set targets, and afterwards, by auditing the strategy, it will inform the public and the Parliament of the Republic of Macedonia on the reasons and effect thereon.

IV.1 Medium-term targets

Medium-term targets are used for building framework for public debt trends for the period 2009-2011. The medium-term targets define the maximum sustainable level of the total public debt in relation to GDP, the level of the government public debt in relation to GDP and the level of guaranteed public debt in relation to GDP. In addition, to the end of reducing the risk factors affecting the total public debt portfolio, the currency debt structure i.e. the share of Euro-denominated debt and the debt in domestic currency in the total public debt is also determined.

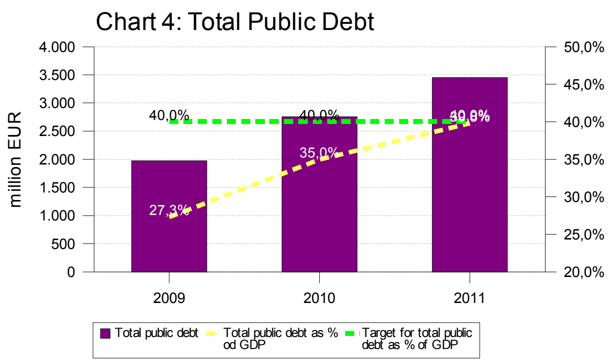
IV.1.1 Public debt to GDP ratio

Public debt level is considered sustainable if it enables timely servicing and refinancing for a longer period. Sustainable level of public debt in relation to GDP depends on many factors, such as the economic development rate, inflation rate, development of the domestic financial market, etc.

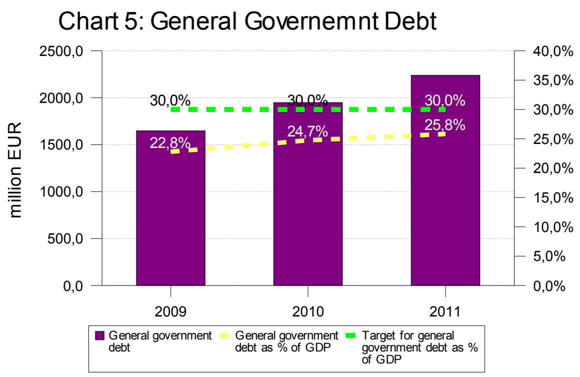
In order to retain the level of public debt under macroeconomic and fiscal sustainability, the following targets are defined:

–Level of government debt does not exceed 30% of GDP in the coming three years.

–Level of total public debt does not exceed 40% of GDP in the coming three years.



Source: Ministry of Finance



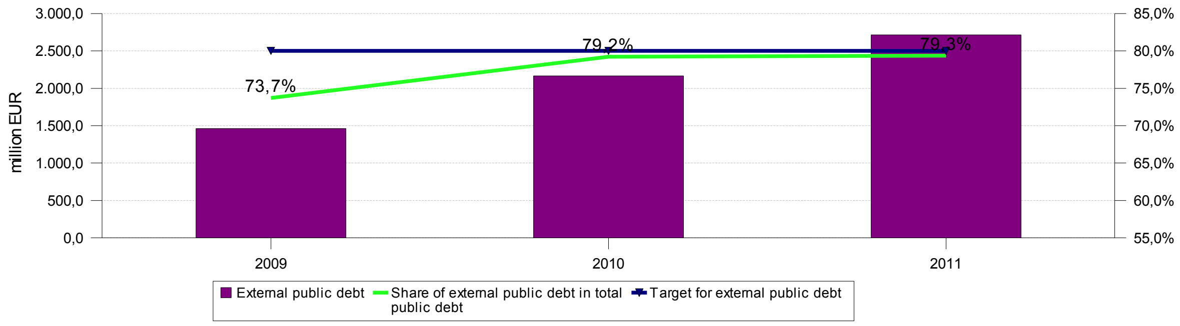
Source: Ministry of Finance

IV.1.2 External public debt in relation to total public debt

Taking into account the importance of the public debt management function in the financing of the needs of the public debt holders, the proper setup of the public debt portfolio from the point of view of the debt structure is of huge importance. For the purpose of contributing to the maintenance of internal and external balance of the economy from the point of view of avoiding the effect of crowding out the private sector, and thereby maintaining prudent level of the exchange rate risk, as well as the potential dangers from occurrence of “sudden stop” of the capital flows in the economy and for the purpose of supporting the balance of payments, the target for share of the external public debt in the total public debt was set.

- Share of external public debt in the total public debt for the coming three years to range between 70%-80%.

Chart 6: External Public Debt



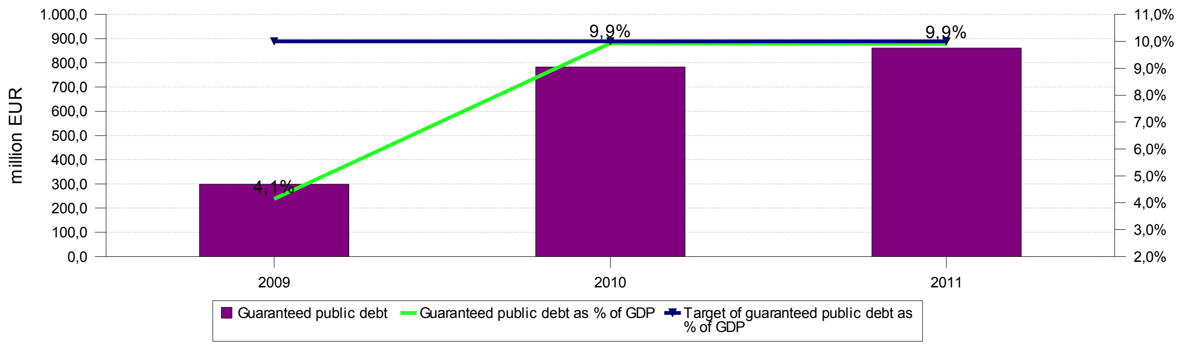
Source: Ministry of Finance

IV.1.3 Guaranteed public debt to GDP ratio

Issuance of sovereign guarantees is a contingent liability for the Budget of the Republic of Macedonia to call the guarantees up. Therefore, financing of public projects by issuing guarantees entails additional risks, thus entailing additional costs to the Budget of the Republic of Macedonia. According to analyses on the guaranteed public debt in the period 2009 – 20111, it is expected for the guaranteed debt to gradually increase, whereby what is of huge importance is the determination of sustainable level of issued guarantees during the next three tears so as to prevent greater negative consequences over the Budget of the Republic of Macedonia in case the guarantees are called-up.

–Level of guaranteed public debt not to exceed 10% of GDP in the coming three years.

Chart 7: Guaranteed Public Debt



Source: Ministry of Finance

According to Chart 7, showing the projections on the trend of guaranteed debt, its gradual increase is evident. However, maximum limit of the guaranteed debt is 10%. This means that according to this Strategy, additional issuance of sovereign guarantees is allowed for the level for which the risk of the contingent liabilities would increase. Therefore, prior to any new issuance of sovereign guarantee, *detailed credit analysis of the credit applicant would be made, under which the Ministry of Finance would deliver a positive opinion only for those credit applicants that could service their own liabilities.*

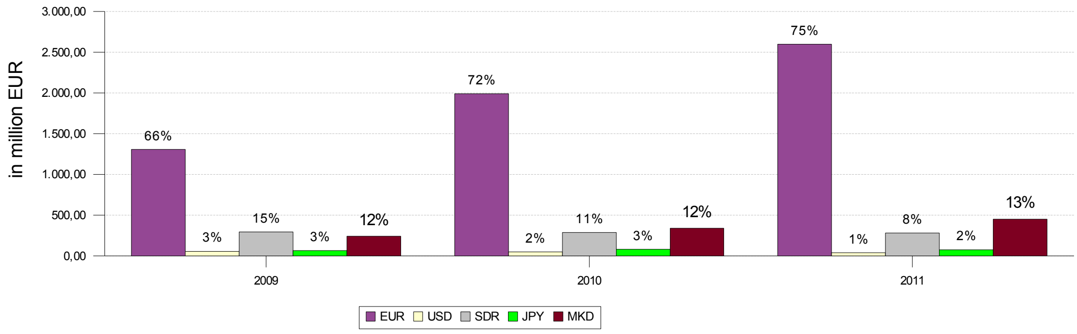
IV.1.4 Currency structure of the total public debt

In order to reduce the exchange rate risk and thus the interest rate risk, it is necessary to determine the optimum currency structure of the total public debt portfolio that will also contribute to the reduction of the costs for its servicing. Therefore, the Euro- denominated debt should have dominant share in the public debt structure due to the strategy for targeting the Denar exchange rate towards the Euro as well as the debt denominated in domestic currency. However, taking into account the world economic crisis, as well as the permanent lack of liquid financial resources during the preparation of this Strategy, greater flexibility from the point of view of possibility for new borrowing in other currencies is included therein in the coming medium-term period. With regard to the total public debt portfolio, in line with the projections and analyses for the future trends in the currency structure of the public debt, the focus will be put on the gradual increase in the share of the Euro-denominated and the domestic currency -denominated debt for the account of the other currencies in the public debt portfolio.

- **Share of Euro-denominated debt in the total public debt to amount to 70% (with maximum allowed deviation of +/- 5 percentage points)**

- **Share of Denar-denominated debt in the total public debt to amount to 13% (with maximum allowed deviation of +/- 3 percentage points)**

Chart 8:
Projection of currency structure of total public debt



Source: Ministry of Finance

IV.1.5 Interest structure of the total public debt

In order to protect the public debt portfolio against possible future market shocks and adverse changes of interest rates that directly lead to increase of the costs to the Budget of the Republic of Macedonia, gradual increase of the part of debt with fixed interest rate is one of the objectives at which public debt managers should aim. However, in the next three-year period, the Republic of Macedonia will strive for **maintenance of the current interest structure**, due to the following reasons:

1. regarding the external public debt, new borrowing with the international financial institutions are most often concluded with variable interest rate;

2. Existence of insufficiently developed domestic government securities market, lacking sufficient potential for issuance of long-term instruments.

IV.2 Targets pertaining only to 2009

In line with the medium-term targets for determining the optimum level and public debt portfolio structure, the targets pertaining only to 2009 are also defined. These targets determine the maximum amount of net borrowing I 2009 as well as the maximum amount of net borrowing on the basis of issued guarantees in the course of the same year.

IV.2.1 Net borrowing in 2009

In the course of 2009, the net borrowing includes the planned disbursement of funds on the basis of the total public debt reduced for the planned repayments on the basis thereof.

–In 2009, net borrowing is planned to amount to EUR 370 million.

IV.2.2 Net borrowing on the basis of guaranteed debt in 2009

In order to reduce the risk from the contingent liabilities in the public debt portfolio, the annual amount of net borrowing on the basis of guaranteed debt of the public enterprises is defined.

–In the course of 2009, the maximum amount of net borrowing on the basis of guaranteed debt must not exceed EU 150 million

V. MEASURES TO IMPLEMENT PUBLIC DEBT MANAGEMENT STRATEGY

V.1 Development of government securities market

Ministry of Finance also continues to regularly issue government securities (GS) in the coming period. The intention is to maintain regular presence of treasury bills (TB) with the constant maturity of 3, 6 and 12 months as well as increased presence of issuance of government bonds (GB) with 2 and 3-year maturity. In addition, issuance of 5-year GB with a possibility to introduce longer maturities depending on the impulse of the market (Annex 2 Calendar of Issue of Government Securities) is planned.

In fact, the so-far experience in issuing GS pointed out to the conclusion that frequency of issuing securities corresponds to the market needs and the Ministry of Finance (MoF) will continue with the same dynamics. Net issuance of GS will be also increased in line with the plan and projections for government securities issuance in the coming years. Thus, projected net issue will amount to Denar 6 billion in 2009.

Ministry of Finance continues to monitor the participating banks on the auctions, which started in May 2006. Ministry of Finance will adopt decision on possible establishment of primary dealers system, i.e. it will select a limited number of banks to have exclusive right to purchase at the auctions on the government securities primary market, at the same time setting rigorous obligations for placement of GS, listing on the secondary market, etc. It is expected for the primary dealers to contribute to the increase of the competitiveness among the banks, and to provide for more efficient implementation of the primary issue of government securities.

Decision for introduction of primary dealers in 2008 was postponed for the coming period since Ministry of Finance came to a conclusion that due to the turbulent movements in the past period GS market did not reach the necessary level of development.

Following the introduction of non-competitive offers in 2007, enabling the investors to participate in the government securities auctions only with amounts, being awarded the average weighted interest rate achieved at the auction, at the beginning of 2009, it is envisaged for the existing base of investors, being provided access to non-competitive offers so far, to be expanded, i.e. instead of the existing access only to natural persons, in the coming period, access will be provided to the legal (non-banking) entities as well. Non-competitive offers provide for huge advantage, especially for the smaller investors, as well as for increasing the popularity of government securities, being of great importance for the development stage of the government securities market in the Republic of Macedonia.

In addition to the promotion of this novelty, the Ministry of Finance will also continue with promotional activities for extending the base of investors in GS by carrying out marketing campaign in front of different target groups of investors and by maintaining regular dialogue with all participants in the government securities market.

In line with the carried out amendments to the Rules on the Manner and the Procedure for Trading and Settling Transactions in Securities on Over-the-Counter Market, obligation was set for the participating banks owning continuous government securities to list them regularly on daily basis. This obligation is binding for the amount of Denar 1,000,000.00, although not all the participating banks, owning GS, respect it on regular basis. Therefore, the Ministry of Finance, together with NBRM commit to enhanced monitoring, in the interest of better discipline, to the end of adhering to the legal regulations on one hand, and increasing transparency on the other. As e result of the common interest in developing this segment, at the meeting of the Market Committee held on 23rd December 2008, the banks agreed for signing Memorandum that is expected to contribute to the real functioning of the secondary market. Memorandum envisages binding between the banks to mandatory listing, mandatory execution of transactions as well as listing only upon previously determined spreads of purchase and selling prices.

According to the introduction of the public debt management software planned for 2009, all activities related to the issue of GS will obtain one new dimension to the end of more efficient monitoring of both the auctions and the results arising thereof and their appropriate analysis. Introduction of the software will enable holding of GS auctions that will follow the world trends. All this will lead to more efficient primary market and revival of the secondary market in the Republic of Macedonia.

V.2 Development of the cash management function

In the course of 2009, the Ministry of Finance will undertake more activities for developing the cash management, for the purpose of better management of the unique treasury account.

Efforts of the Ministry of Finance will be mainly focused on determining the optimum level of the unique treasury account and the spread around the optimum level on daily basis, taking into account all types of risks during the projections. Determination of the optimum level of the treasury account may be done after certain period of monitoring its cash flows.

When the optimum level is a determined, appropriate instruments for cash managements should be developed i.e. placement of the excess of cash resources in different market instruments, which would generate additional flows of cash resources, as well as usage of instruments for collecting cash resources so as to cover the lack of cash.

At the same time, it is necessary to prepare appropriate legislation regarding the cash management, as well as to improve the communication with the budget users, so as for them to get acquainted with the importance of the performance of projections.

In addition, it is planned for market determination of the interest rates on Denar and foreign exchange deposits to be provided under the cash management. To the end of efficient cash management, it is also necessary to provide appropriate training of the staff that will be included in this process.

V.3 Active application of financial derivatives

The request for possibilities to protect the sensitivity of public debt portfolio to the domestic and international circumstances and the uncertainties remains to be one of the most significant priorities of the managers in the efficient public debt portfolio management.

In order to achieve this objective, what is of great importance is the application of financial derivatives as instrument for reduction of the costs of the public debt portfolio as well as the risk diversification. Taking into account the most recent events on the international financial market as well as the fact that the reduction of the development rate in many countries even the facing with negative growth rates is envisaged in 2009, the coordinated policy for reducing the interest rates of the largest central banks was one of the measures for preventing or alleviating the recession threatening to the most developed countries in the world. Usage of the possibility from the current low interest rates through the operations with derivative financial instruments i.e. by examining the possibility for usage of currency and interest swap operations of the existing public debt portfolio remains to be one of the measures that will enable efficient and effective control of costs and risks.

Therefore, during the next period, the Republic of Macedonia will focus on signing ISDA Agreement as one of the preconditions for starting the application of financial derivatives.

V.4 Measures for implementing the Strategy regarding the software implementation

Public debt portfolio including the internal and external debt of the public sector is the largest financial portfolio in a country, being usually exposed to numerous risks that may cause financial crisis and instability. In addition, the size of obligations arising from the servicing of the public debt is also often uncertain since they are determined and dependent on the future trends of the macroeconomic indicators.

One of the key factors for successful defining of the optimum debt structure, and hence of the objectives and measures of the Public Debt Management Strategy is also having appropriate software solution that facilitated all processes related to the public debt management.

One of the bigger obstacles hindering the intensive development of the public debt management function in the Republic of Macedonia so far, is the lack of public debt management IT system.

In fact, even though the public debt management functions in the Republic of Macedonia have been centralized in the Ministry of Finances - Public Debt Management Department so far, the data on the debt were dispersed in different departments in the National Bank of the Republic of Macedonia (NBRM) and in the Public Debt Management Department. Lack of integrated public debt database hindered to a great extent the debt portfolio analysis process and hence the process of defining the objectives and priorities under the Public Debt Management Strategy.

In 2008, in order to overcome this situation, the Ministry of Finance started to realize the Project" Implementation of Public Debt Management IT System", having for its purpose the following:

•supporting and controlling the operations and the flow of information within the debt management function, taking into account its organizational model including Front Office, Middle Office and Back Office;

•providing integrated review of the debt portfolio by centralizing the debt data;

•proving support in the decision making process (for example, by using stimulation techniques);

•strengthening the risk analysis;

•improving the quality and speed of carrying out the work activities related to the debt management, including the settlement of transactions related to the debt management and liquidity, and reducing the operational risk;

•upgrading the public debt management function in line with the determined standards in the EU Member States; and

•improving the cooperation with the creditors.

From the point of view of the Public Debt Management Strategy, the IT system intends to facilitate the process of preparation of the Public Debt Management Strategy by providing wide spectrum of instruments for analytical management and risk management. Thus, the system will include analytical risk measures, such as:

•sensitivity to the interest rate trends, shown in parallel changes in the yield curve inclination;

•sensitivity to the trends in the exchange rate;

•credit risk (risk by the other contracting party);

•Duration;

•Average time to maturity;

•Average time to re-fixing;

•Net Current Value.

On the other hand, regarding the field of defining the optimum debt structure, the system will also provide possibility for testing the portfolio within different scenarios and projections for the public debt trends, for the purpose of assessing which segment of the debt portfolio is the most sensitive to the changes of the general conditions (shocks) in the economy (domestic or international).

Finally, from the point of view of implementation of the strategy, the system will also provide possibility for introducing, maintaining and monitoring limits defined under the Public Debt Management Strategy. Thus, the Middle Office will be able to monitor the influence of the separate transactions on theses limits with possibility for preventing and/or freeing (certain types) of transactions on one hand and measuring the performance of the actual portfolios in relation to the defined portfolios determined as benchmarks (i.e. portfolios, the contents of which may be changed in time according to previously defined parameter or decision) or in relation to preferred strategic portfolios on the other.

IT system is expected to be fully implemented and active from the middle of 2009.

VI. PUBLIC DEBT MANAGEMENT RISKS

Uncertainty arising from the future trend of the macroeconomic variables of the international and the domestic market has significant influence when reaching decisions for efficient debt portfolio management of the country. In conditions of big turbulences of the economic variables, it is necessary to actively manage the risks to which the public debt portfolio of the Republic of Macedonia is exposed.

Main risks, identified during the management of this portfolio are the following:

- Refinancing risk:
- Market risk including the following risks:
    1. Interest rate risk
    2. Exchange rate risk
- Liquidity risk
- Risk associated with the contingent liabilities and
- Operational risk

VI.1 Refinancing risk

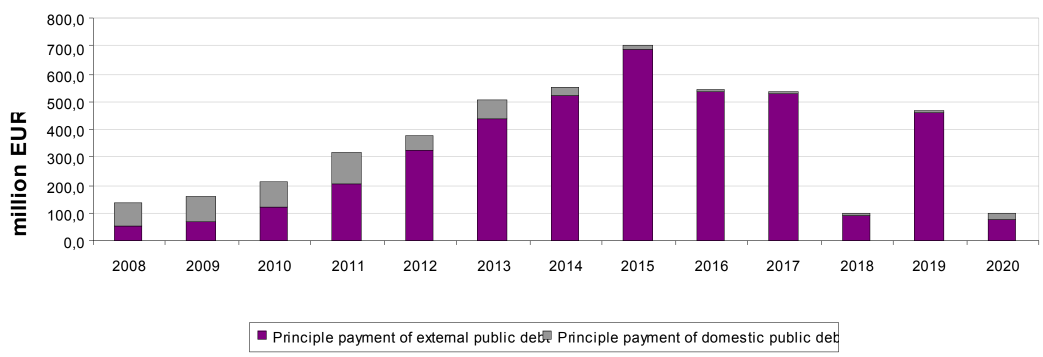
The need for monitoring the refinancing risk arises in the countries having high level of debt, instable macroeconomic conditions and underdeveloped (shallow) financial markets, whereas the refinancing risk in the developed countries is of marginal significance.

The refinancing risk is managed by preventing major part of the financial liabilities to fall due at once at any time and providing evenly distributed maturity of the liabilities on the basis of the debt. The exposure of public debt portfolio to refinancing risk is measured by profile of the debt repayment and the indicator showing the average time to maturity of the debt.

Taking into consideration the projections for the repayment profile in the coming years, one can conclude that there the liabilities for repayment of the external debt increase, while with regard to the domestic debt they decline. Accordingly, increase of the liabilities for repayment of the external debt in the coming period also increases the re-financing risk of the debt. Special challenge for efficient refinancing risk managements is expected in 2015, when the Eurobond issued in 2005 will regularly fell due in the amount of EUR 150 million, but reason for increasing the volume of repayments in the coming period are also the repayments on the basis of the projected capital investments in the field of the energy sector and the infrastructure.

From the point of view of repayment of the domestic public debt, certain stable profile of the principal repayment is also noticed. As a result of the maturity of the last installment of the bonds for the old foreign exchange saving in 2011, certain relaxation of the repayments in the coming years is obvious.

Chart 9: Total public debt servicin



Source: Ministry of Finance

IV.1.1 Average time to maturity - ATM

The greater the value of this indicator, the lower the uncertainty, i.e. the refinancing risk.

Table 7 **Average time to maturity of the public debt**

	ATM (in years)			
	2008	2009	2010	2011
Structural bonds	3,0	2,9	3,1	3,4
Continuos government securities	0,5	0,7	0,9	1,1
External debt with fixed interest rate	10,1	9,5	8,9	8,4
External debt with floating interest rate	5,1	6,2	6,2	5,6
Total public debt	**6,4**	**6,2**	**5,8**	**5,3**

Source: Ministry of Finance

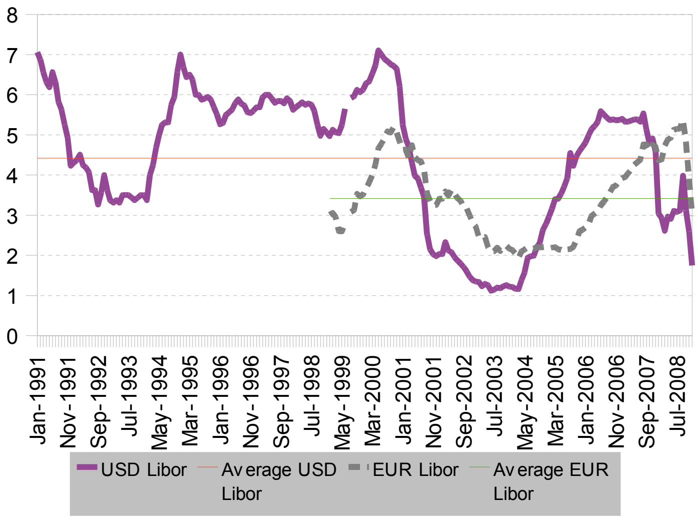
Continuous decrease of the average time to maturity of the total public debt is expected in the period 2009-2011, thus the projection of 6,4 years at the end of 2008 will be reduced to 5.3 years in 2011. Such decrease may be serious indicator that, in future, during time discrepancy of the budget inflows and outflows or widening of the budget deficit due to the slowdown of the economy, there is danger from refinancing part pf the liabilities in unfavourable conditions, with high interest rates as well as occurrence of overdue liabilities on short run. Relative share of the individual components in the total debt is changing, whereby the share of the components having shorter average time to maturity will gradually increase for the account of the components with longer average time to maturity by 2011. The reasons for such situation lie in the fact that the Republic of Macedonia is no longer classified in the category of countries eligible to borrow under concessional terms with low interest rates and long maturity deadlines, such as the credits from the International Development Agency (IDA affiliate of World Bank).

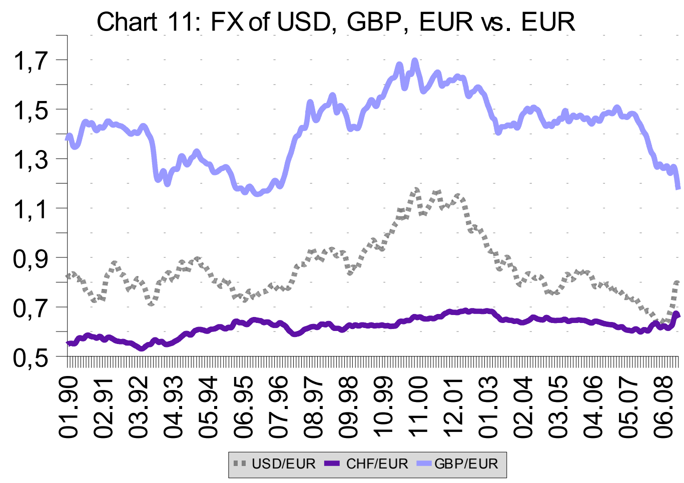
VI.2 Market risk

Market risk is determined by the exposure of the public debt portfolio to economic variables, especially the variation of interest rates on the domestic and the international capital markets and the trends in foreign exchange rates. Market risk may be divided into two components, i.e. the interest rate risk and the exchange rate risk. Identifying and managing market risks in the Republic of Macedonia is crucial for the public debt portfolio, since this risk is determined mainly by external factors, i.e. variations in interest rates on the international financial markets, where, due to their constant turbulences, the medium and long -term trend is very difficult to project.

The change of the interest rates on the domestic and international markets affects the debt-related costs, particularly

Chart 10: Interest rate movements on the international financial market

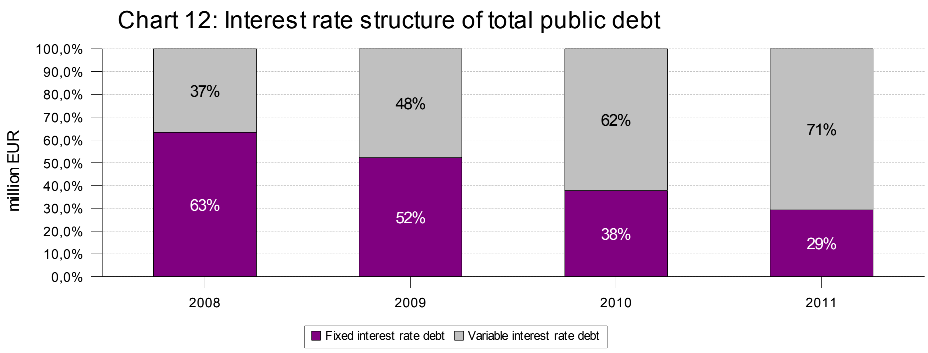




when the fixed interest rate debt should be refinanced or on the day when the interest is re-set with regard to the variable interest rate debt. Measuring and managing interest rate risk is especially important in the countries where domestic financial markets are underdeveloped and the need to borrow is covered from external sources under non-concessional terms, where exposure to the interest rate risk is greater.

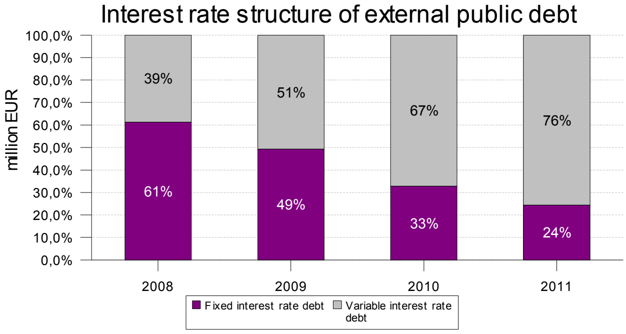
VI.2.1 Interest rate risk

The variation of interest rates on the domestic and international markets affects the debt-related costs, especially when the fixed interest rate debt should be refinanced on the day when the interest is re-set for the variable interest rate debt. Hence, the close connection between the interest rate risk and the debt re-financing risk is evident. Taking into account the projection for composing the total public debt portfolio from the point of view of the relation of the fixed interest rate debt with the variable interest rate debt, one may conclude that the sensitivity of the portfolio to the variation of interest rates increases as e result of the increase of the share of the variable interest rate debt. Sensitivity to the variation of interest rates is especially expressed at the external public debt due t the more expressed share of the variable interest rate debt, while with regard to the domestic public debt, the increasing trend of the variable interest rate debt is lower.



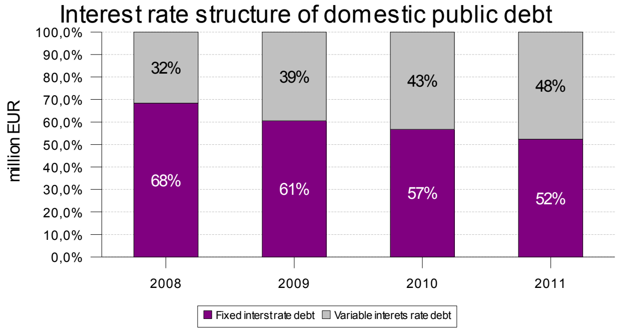
Source: Ministry of Finance

Chart 13:
Interest rate structure of external public debt



Source: Ministry of Finance

Chart 14:
Interest rate structure of domestic public debt



Source: Ministry of Finance

VI.2.2 Average time to re-fixing - ATR

ATR indicator measures the average time to re-fixing. The bigger value of this indicator shows that larger portion of the debt portfolio will not be subject to interest rate re-fixing and such portfolio is a lower risk one.

Table 9 Average time to refixing (ATR)

	2008	2009	2010	2011
Structural bonds	**2,6**	**2,6**	**2,7**	**3,2**
Continuos government securities	**0,5**	**0,7**	**0,9**	**1,1**
External debt with fixed interest rate	**10,1**	**9,5**	**8,9**	**8,4**
External debt with floating interest rate	**0,3**	**0,3**	**0,4**	**0,6**
Total public debt	**5,3**	**4,8**	**4,2**	**3,6**

Source: Ministry of Finance

In line with the projections of the public debt structure in the period 2009 – 2011, the average time to re-fixing to decrease sharply from 5.3 years at the end of 2008 to 3.6 years in 2011, thus the public debt portfolio of the Republic of Macedonia will be significantly more subject to re-fixing which, in conditions when the interest rates will increase, may lead to expansion of the interest-related costs and he budget deficit. Decrease of the average time to re-fixing was mainly due to the decrease of the fixed interest rate debt as well as the average depreciation of the structural bonds.

VI.2.3 Duration

This indicator shows how the interest rate variations would affect the debt-related cost, i.e. what is the change in the value of securities resulting from 1% variation in interest rates. Higher value of this indicator means that the interest rate has not changed during a longer period for the major portion of the debt. This indicator takes into account the net current value of money flows, meaning its calculation includes the interest-related cost when repaying the debt.

Table 10 **Duration (years)**

	2005	2006	2007	2008	2009	2010	2011
Structural bonds	2,8	2,9	2,2	2,1	2,1	2,2	2,6
Continuos government securities	0,9	0,6	0,6	0,5	0,7	0,9	1,1
Total domestic debt	2,6	2,5	2,0	1,7	1,5	1,5	1,5

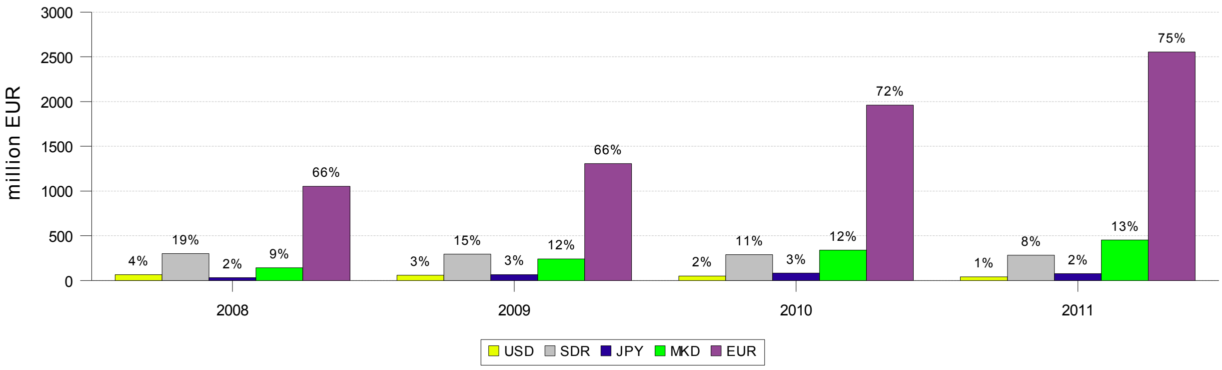
Source: Ministry of Finance

Calculations for this indicator and its monitoring refer only to the domestic public debt, since it is market debt and it is traded on secondary market, while the foreign public debt is predominated by the credits being non-market debt. Data on this indicator show that even though continuous downward trend of its value was observed starting 2005 to 2008, stabilization of this indicator is expected from 2009 to 2011 but at a level lower than the level in 2008. Unfavourable trend of this indicator is a result of the falling due of the structural bonds, which is not accompanied by the increase of the maturity of continuous securities, whose volume will be gradually increased in line with the financing needs of the Budget of the Republic of Macedonia and the need to develop the domestic market.

VI.2.2 Exchange rate risk

Exchange rate risk refers to the debt indexed or denominated in foreign currency. Major portion of the debt denominated in foreign currency in relation to the total public debt points out to higher exchange rate risk. This risk is crucial for the developing countries where external public debt is fully indexed, and major portion of the domestic public debt is denominated in foreign currency.

Chart 15: Currency structure of public debt



Source: Ministry of Finance

Share of the debt denominated in domestic currency of only 9% in the total public debt portfolio of the Republic of Macedonia in 2008. Macedonia is sufficient indicator for the exposure of the portfolio to the exchange rate risk. However, the commitments for further development of the domestic securities market with gradual increase of the borrowing by issuing continuous government securities influence the gradual increase in the percentage share of the debt denominated in domestic currency. Thus, the debt denominated in denars is expected to increase by around 4 percentage points by 2011.

Changes in the foreign exchange rate may largely affect, i.e. increase the envisaged costs for repayment of public debt -denominated in foreign currency. However, taking into account the fact that since 1995, the Republic of Macedonia applies de facto fixed exchange rate of the denar in relation to the Deutch Mark, and since 2002 onwards, in relation to the Euro, the exposure to such risk would be measured also as a share of the Euro in the total public debt portfolio, which is actually prevalent currency with 66% share in the total debt structure at the end of 2008. Share of the Euro-denominated debt is planned to be increased and to achieve 75% by the end of 2011, being mainly due to the new projected borrowing that will be denominated in Euro currency as well as the average maturity of the debt denominated in the other currencies (Special Drawing Rights, the American dollar and the Japanese Yen).

VI.3 Liquidity risk

Liquidity risk is a result of the inability of the country to service the due liabilities due with liquid assets, necessary for their financing. The objective of management of this risk is to ensure optimum amount of liquid assets so as to be able to pay the liabilities falling due. The country being the main instrument of liquidity management uses the balance of liquid financial assets on accounts with the National Bank of the Republic of Macedonia. Macedonia. The level of these deposits guarantees safe financing of the country's needs and it protects the budget from financial crises, which would prevent or decrease the raising of funds by borrowing on the financial market.

Table 11

million EUR	2009	2010	2011
Short-term debt maturing within period of one year	187	197	235
General Government revenues	2.645	2.699	2.769
Ratio of short-term debt compared to General Government revenues (in %)	7,06%	7,28%	8,48%

Source: Ministry of Finance

Liquidity risk management comprises keeping liquid assets at optimum level by improving the process of planning and monitoring the government budget execution, as well as by managing the surplus of liquid assets. From the point of view of the liabilities falling due within a year in relation to the budget revenues, upward trend of this share can be observed, thus this indicator accounts for 7.06% in 2009 and it will achieve 8.48% by 2011. This increase of the liabilities on the basis of the debt is a result of the projected growth of the level of the government debt due to the increase of the investment activity in the Republic of during the coming period.

VI.4 Risk associated with contingent liabilities

Guaranteed public debt, being contingent liability of the state despite the fact that it influences the increase in the volume of the government debt, it is also a serious threat to the increase of the servicing - related costs in case it is called-up and thus it may lead to facing with serious liquidity problems.

As a result of the projected investments being very important for the further development of the energy sector and the infrastructure, the increase of the level of the guaranteed public debt is projected in the coming period. Strategic priorities that will be implemented by the public enterprises will be financed by domestic and foreign creditors for the purpose of obtaining better conditions for their financing, the state plans to issue sovereign guarantee. Taking into account the risk the state may face in future in case the issued guarantees are called-up, analysis for the possible increase of the costs for servicing the due liabilities was made.

Table 12 **Guaranteed public debt servicing**

		2009	2010	2011
Scenario I	Guaranteed public debt payments (in EUR million)*	29,2	90,7	195,1
	Guaranteed public debt payment as % of total public debt payments	13,7%	30,4%	43,3%
Scenario II	Calling-up of 50% of guaranteed public debt liabilities (in EUR million)	14,6	45,4	97,5
	50% of guaranteed public debt payment as % of total public debt payment	6,8%	15,2%	21,6%
Scenario III	Calling-up of 25% of guaranteed public debt liabilities (in EUR million)	7,3	22,7	48,8
	25% of guaranteed public debt payment as % of total public debt payment	3,4%	7,6%	10,8%

*In case of inability of the final beneficiaries of the debt to service their liabilities on basis of credits, Ministry of finance executes the payment in their name, in order the guarantee not to be called, which would reflect in whole debt maturing

Source: Ministry of Finance

Liabilities on the basis of the guaranteed debt falling due in 2009 amount to EUR 29.2 million, being around 13.7% in relation to the liabilities on the basis of the total public debt. Under the assumption that the main debtors are not in a position to timely service 50% of the liabilities falling due in 2009 on the basis of the guaranteed debt, they still do not exceed more than EUR 14.6 million i.e. 6.8% compared to the total liabilities on the basis of the public debt. However certain increase of the liabilities falling due for servicing the guaranteed debt that affects the increase of the liquidity risk was observed in 2010 and 2011.

Therefore and in order for the Budget of the Republic of Macedonia not to be exposed to high risk of calling-up of guarantees, the process of issuance of new guarantees is strictly regulated and it is subject to certain criteria, the applicants of guarantees should fulfill and assessment of the risks to which they are subject.

VI.5 Operational risk

Operational risk includes the settlement risk and the error risk. Settlement risk appears if a number of non-automated activities is used during data processing, while the error risk often refers to the manner of segregation, division in executing the transactions and functions related to settlement across the units, within the institution in charge of the public debt management.

Public debt management in the Republic of Macedonia is carried out within the Ministry of Finance, by the Public Debt Management Department. The department consists of three units carrying out the activities related to the borrowing and investing (Front Office), creating public debt management policy and risk analysis (Middle Office) as well as public debt recording, servicing and monitoring (Back Office).

Taking into consideration the fact that the operational risk may be reduced by applying formal procedures, clearly précising the individual tasks and responsibilities of the persons involved in carrying out the debt management function, the Public Debt Management Department prepared and begun to apply procedures, determining in details the manner and procedure of carrying out the working tasks related the public debt. The procedures also determine précised specific tasks for each employee in the department, being directly responsible for their execution, and a deputy is appointed to carry out these activities in case of his absence. Thus, the possibility for occurrence of error due to the insufficiently precise procedure or responsibility when performing certain task or the absence of the responsible persons is largely decreased.

Significant progress in the department operations was attained by introducing the "six-eye principle", meaning that each document prepared within one unit is controlled by two persons in the unit (officer and superior), while the third control is carried out by the head of department.

From the technical assistance point of view, when carrying out the public debt management function, it is important to mention the fact that significant steps aimed at improving this function were made in 2007. Therefore, what is of special importance is to emphasize the upgrading of the platform for carrying out auctions of the government securities, thus enabling the preparation of reports, on the basis of which, the Department is able to easily monitor the trends on the government securities market, and a significant progress was also achieved in the procedure for submission of offers by the authorized direct participants during the auctions. The platform is projected to be further upgraded during 2009, thus leading to even more successful monitoring and carrying out of auctions.

In addition, it is very important to point out the activities, the department undertakes to the end of procuring public debt management IT system. In fact, pursuant to the Law on Public Debt Management, the department should create and maintain unique base of the public debt. On the other hand, the department can successfully manage the public debt, without room for errors as well as to save time and human resources, only with comprehensive recording and simple and fast access to the data. Having this as a starting point, the Public Debt Management Department undertook intensive activities for procurement of such IT system in 2007 and 2008, and is expected for the overall system implementation procedure to be completed in the middle of 2009.

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After the mentioned analysis of the risks to which the public debt portfolio is subject, and by assessing the value of the indicators for the relevant risks, one can make a general conclusion that the public debt portfolio is becoming more risky in the coming period compared to the previous one. This is due to several reasons, those being the following:

- Gradual debt repayment concluded under concessional terms, i.e. credits with long repayment period and low fixed interest rates and borrowing from the international financial institutions with variable interest rates and shorter loan repayment period;
- Repayment of structural bonds and reduction of their share in the domestic debt, and borrowing with continuous government securities, having shorter maturity than those of the structural bonds and due to the underdevelopment of this market, major portion of the government securities' portfolio comprises short-term instruments with variable interest rate.

At the moment, the risk management of the public debt portfolio in the Republic of Macedonia is modest. In fact, in conditions of certain shortage of liquid financial resources on the international capital market, the capital price also increases i.e. the interest rate increases. Furthermore, multilateral and bilateral creditors want to protect their portfolios from different risks and therefore they place their resources with variable interest rates i.e. the reference rates Libor and Euribor increased or decreased by certain margin. When borrowing under these conditions, the sensitivity of the public debt portfolio increases mainly from the point of view of the market risk and the refinancing risk.

In such conditions, main commitment under this medium-term strategy regarding the risk management will be focused on the commencement of the restructuring of the debt portfolio by both using the financial derivatives and fixing the interest rates on certain loans if the market conditions allow that as well as issues of bonds on the international markets having fixed interests after the possible market stabilization. Interest rate risk would decrease through such operations.

In addition, for the purpose of protecting the foreign exchange risk, the Ministry of Finance will focus on the percentage share of the denar-denominated debt by broadening the investment base on the government securities market.

Annex I: Active credits* as of 31st December 2008
Table 13

	Original currency	Total amount according to the agreement	Disbursed amount as of December 31, 2008 (in EUR)	Undisbursed amount as of December 31, 2008 (in EUR)
Total		**330.531.264**	**111.735.573**	**218.795.691**
IBRD		**183.029.921**	**43.999.412**	**139.030.509**
SPIL	USD	7.203.759	4.446.599	2.757.160
Health Sector Management Project	USD	7.350.775	3.489.919	3.860.855
Judicial Reform/Court Administration	EUR	10.000.000	1.977.396	8.022.604
Macedonian Railways Restructuring	EUR	15.000.000	7.421.731	7.578.269
Real Estate Cadastre&Registration Project	EUR	10.300.000	6.771.372	3.528.628
BERIS	EUR	8.800.000	794.000	8.006.000
Project for AD MEPSO	EUR	20.700.000	10.279.704	10.420.296
Education Modernization Project	USD	3.675.387	1.376.577	2.298.811
TTFSE II - Customs Administration	EUR	1.400.000	0	1.400.000
TTFSE II - Roads Fund	EUR	11.000.000	1.700.000	9.300.000
TTFSE II - Macedonian Railways	EUR	2.600.000	0	2.600.000
Project for agriculture	EUR	15.000.000	5.567.115	9.432.885
Project for local and regional rouds	EUR	70.000.000	175.000	69.825.000
EBRD		**40.470.600**	**18.956.067**	**21.514.533**
Power Transmission (400 kV interconnection Macedonia-Bulgaria)	EUR	40.470.600	18.956.067	21.514.533
CEDB		**12.500.000**	**0**	**12.500.000**
Physical education facilities (“PEFs”)	EUR	12.500.000	0	12.500.000
Bilateral creditors		**94.530.742**	**48.780.093**	**45.750.649**
Irrigation Vardar Valley-Kfw	EUR	6.646.794	5.998.009	648.785
JBIC-Zletovica Project	JPY	68.701.663	30.517.172	38.184.491
Rationalization of management system and modernization of biomedical equipment in health sector	EUR	2.582.285	1.582.285	1.000.000
ELEM-Brod Gneotino (without sovereign guarantee)	EUR	16.600.000	10.682.627	5.917.373

Source: Ministry of Finance

* Active credits are those credits concluded in previous year, but the period of their utilization (i.e. disbursement of funds) is not completed yet.

Annex II: Calendar of issuance of government securities in 2008

Table 14

Quarter	Month	Auction code	Date of auction	Auction date	Payment date	Maturity in days/years
I	January	DZ2009/01-90	05.01.2009	08.01.2009	08.04.2009	90
		DZ2009/01-181	05.01.2009	08.01.2009	08.07.2009	181
		DZ2009/03-91	20.01.2009	21.01.2009	22.04.2009	91
		DZ2009/01-364	20.01.2009	21.01.2009	20.01.2010	364
	February	DZ2009/04-91	03.02.2009	04.02.2009	06.05.2009	91
		DZ2009/02-182	03.02.2009	04.02.2009	05.08.2009	182
		DZ2009/05-91	17.02.2009	18.02.2009	20.05.2009	91
		DO2009/01-0211	24.02.2009	26.02.2009	26.02.2011	02
	March	DZ2009/06-91	03.03.2009	04.03.2009	03.06.2009	91
		DZ2009/03-182	03.03.2009	04.03.2009	02.09.2009	182
		DZ2009/07-91	17.03.2009	18.03.2009	17.06.2009	91
		DZ2009/02-364	17.03.2009	18.03.2009	17.03.2010	364
		DO2009/02-0312	26.03.2009	30.03.2009	30.03.2012	03
II	April	DZ2009/08-91	07.04.2009	08.04.2009	08.07.2009	91
		DZ2009/04-182	07.04.2009	08.04.2009	07.10.2009	182
		DZ2009/09-91	21.04.2009	22.04.2009	22.07.2009	91
		DO2009/03-0411	28.04.2009	30.04.2009	30.04.2011	02
	May	DZ2009/10-91	05.05.2009	06.05.2009	05.08.2009	91
		DZ2009/05-182	05.05.2009	06.05.2009	04.11.2009	182
		DZ2009/11-91	19.05.2009	20.05.2009	19.08.2009	91
		DO2009/04-0512	26.05.2009	28.05.2009	28.05.2012	03
	June	DZ2009/12-91	02.06.2009	03.06.2009	02.09.2009	91
		DZ2009/06-182	02.06.2009	03.06.2009	02.12.2009	182
		DZ2009/13-91	16.06.2009	17.06.2009	16.09.2009	91
		DZ2009/03-364	16.06.2009	17.06.2009	16.06.2010	364
III	July	DZ2009/14-91	07.07.2009	08.07.2009	07.10.2009	91
		DZ2009/07-182	07.07.2009	08.07.2009	06.01.2010	182
		DZ2009/15-91	21.07.2009	22.07.2009	21.10.2009	91
		DZ2009/04-364	21.07.2009	22.07.2009	21.07.2010	364
	August	DZ2009/16-91	04.08.2009	05.08.2009	04.11.2009	91
		DZ2009/08-182	04.08.2009	05.08.2009	03.02.2010	182
		DZ2009/17-91	18.08.2009	19.08.2009	18.11.2009	91
		DO2009/05-0811	25.08.2009	27.08.2009	27.08.2011	02
	Septemebr	DZ2009/18-91	01.09.2009	02.09.2009	02.12.2009	91
		DZ2009/09-182	01.09.2009	02.09.2009	03.03.2010	182
		DZ2009/19-91	15.09.2009	16.09.2009	16.12.2009	91
		DZ2009/05-364	15.09.2009	16.09.2009	15.09.2010	364
		DO2009/06-0912	24.09.2009	28.09.2009	28.09.2012	03
IV	October	DZ2009/20-91	06.10.2009	07.10.2009	06.01.2010	91
		DZ2009/10-182	06.10.2009	07.10.2009	07.04.2010	182
		DZ2009/21-91	20.10.2009	21.10.2009	20.01.2010	91
		DO2009/07-1011	27.10.2009	29.10.2009	29.10.2011	02
	November	DZ2009/22-91	03.11.2009	04.11.2009	03.02.2010	91
		DZ2009/11-182	03.11.2009	04.11.2009	05.05.2010	182
		DZ2009/23-91	17.11.2009	18.11.2009	17.02.2010	91
		DO2009/08-1114	24.11.2009	26.11.2009	26.11.2014	05
	December	DZ2009/24-91	01.12.2009	02.12.2009	03.03.2010	91
		DZ2009/12-182	01.12.2009	02.12.2009	02.06.2010	182
		DZ2009/25-91	15.12.2009	16.12.2009	17.03.2010	91
		DZ2009/06-364	15.12.2009	16.12.2009	15.12.2010	364

The 2008 calendar is indicative and it can be subject to changes, taking into account the shifts that might occur due to the religious and national holidays.

Source: Ministry of Finance

Annex III: Analysis of the sensitivity of the servicing –related costs

The **issued sovereign guarantees** are **potential risk** that may generate additional costs to the budget. Issued guarantees are usually intended for borrowers implementing projects of general interest, being credit worthy, regularly servicing their liabilities upon already issued guarantees so far. In 2009, for the purpose of accelerated investments in the energy sector and the railway network, issuance of sovereign guarantees in the amount of around EUR 500 million is planned. These funds from the new borrowing will be used in the next several years and they will gradually increase the guaranteed debt, thus increasing the risk related to the calling up of the contingent liabilities in future.

In order to examine the exposure of the public debt portfolio of the Republic of Macedonia to the market risk i.e. the Interest rate risk and the foreign exchange rates, analysis for the influence of the variation of the inters rates and the foreign exchange rate over the general government external debt is prepared.

Sensitivity analysis of servicing costs of general government external debt as a result of changes in interst rate and foreign exchange rate

	2009	2010	2011
Base line*	**100,00**	**100,00**	**100,00**
Scenario I – decreasing the level of interets rate for 0,5% points	**97,46**	**97,41**	**97,47**
Scenario II – increasing the level of interets rate for 0,5% points	**102,54**	**102,59**	**102,53**
Scenario III – decreasing the level of interets rate for 1% points	**105,08**	**105,18**	**105,05**
Scenario IV – increasing the level of interets rate for 1% points	**94,92**	**94,82**	**94,95**
Scenario V-appreciation of EUR against other currencies for 10%.	**98,85**	**98,58**	**98,53**
Scenario VI-depreciation of EUR against other currencies for 10%.	**101,15**	**101,42**	**101,47**

Base line scenario data for FX and interest rate as at 10 December 2008

This sensitive analysis on the trends in the interest-related costs in the Budget of the Republic of Macedonia on the basis of external debt is based upon the following **assumptions**:

- According to the change of one variable, all other variables remain unchanged i.e. ceteris paribus.
- During possible trends in the other currencies in relation to the Euro, the Denar exchange rate in relation to the Euro retains the stable value.
- Non-existence of correlation between the interest trends and the trends in the foreign exchange rate.

Main conclusions that may arise from this analysis are some of the following:

1. Servicing –related costs on the basis of the general government external debt are highly sensitive to the trends in the interest rates. If the interest rates increase/decrease by only 1% point in 2009, it would cause increase/decrease of the servicing-related costs by 5.1%. This sensitivity may be explained as a result of the high exposure of the debt portfolio to the interest rate risk, being result of the relatively high share of the debt with variable interest rates.

2. Increasing or downward trend of the sensitivity of the servicing-related costs to the variations of the interest rates cannot be noticed from the results presented under the sensitive analysis. This is result of the retaining of the interest structure at the existing level.

3. Future **appreciation/depreciation of the Euro** in relation to the other currencies in the portfolio (the American dollar, the Japanese Yen and the Special Drawing Rights) by 10% will cause decrease/increase of the servicing-related costs due to the fixed exchange rate regime of the domestic currency, the denar in relation to the Euro. However, the possible unfavourable trends in the foreign exchange rates of the other currencies in relation to the Euro will **not be strongly felt over the servicing-related costs** due to the fact that the major portion of the general government external debt is denominated in Euro currency.

4. In the next three years, the servicing of the Euro- denominated debt in the total servicing decreases from 80.5% in 2009 to 73.9% i.e. 71% in 2010 and 2011. Therefore, the analysis of the servicing-related cost for these three years shows **increase of the sensitivity to changes in the foreign exchange rates** from 1.2% for 2009 to 1.4%, i.e. 1.4% for 2010 and 2011.

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Public Debt Management Strategy of the Republic of Macedonia for the period 2009-2011 enters into force on the day when it is published in the “Official Gazette of the Republic of Macedonia.