

QUARTERLY ECONOMIC REPORT

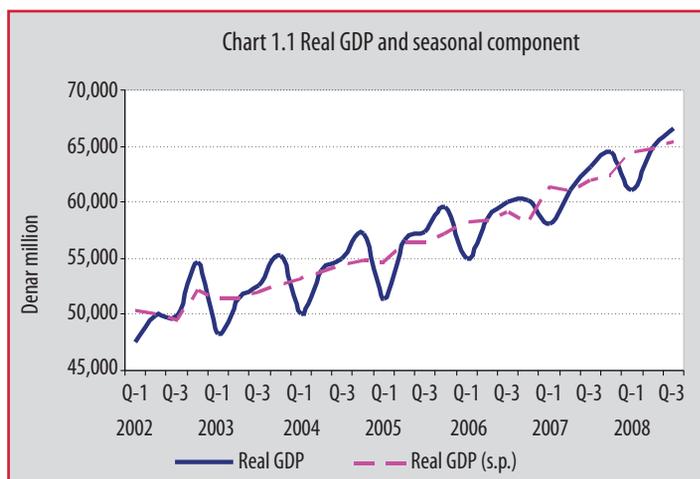
Q-3-2008

SUMMARY

- **Real GDP growth** in Q3 2008 was 5.5%, being by 0.5 p.p. higher than the growth realized in Q3 2007. **Industrial production** significantly grew by 13%.
- **Employment growth** accounted for 3.6% compared to Q3 2007, while **unemployment rate** dropped by 1.2 p.p. in relation to Q3 2007.
- **Inflation rate** was 8.4% (Q/Q-4), compared to 9.9% in the previous quarter.
- **Net salary** grew by 10.7% in nominal terms, and by 2.3% in real terms.
- **Budget surplus** at the end of Q3 was 2.7% of the projected GDP in 2008. **Fiscal burden** in Q3, measured as participation of the budget revenues in relation to nominal GDP, was 29.5%, dropping by 0.8 p.p. **Total public debt** at the end of Q3 was 28.5% of GDP, which was an increase by 0.4 p.p.
- **Credits to the private sector** grew by 38.4% in relation to Q3 2007, being a slight decline of the credit growth. Credit growth in relation to nominal GDP was 42.4% and it was lower by 0.6 p.p. compared to the previous quarter.
- **Macedonian stock exchange index** MSEI-10 experienced further drop by 52% on quarterly basis.
- **Export of goods** grew by 16.8%, while **import of goods** surged by 28.5%.
- **Trade balance** (-26.5% of GDP) improved compared to Q2, as well as **current account deficit** (7.6% of GDP), however it is still the main source of economic risk.
- Index of **real Denar effective exchange rate** continued the downward trend from Q2, pointing out to certain improvement of the export competitiveness of the Macedonian economy.

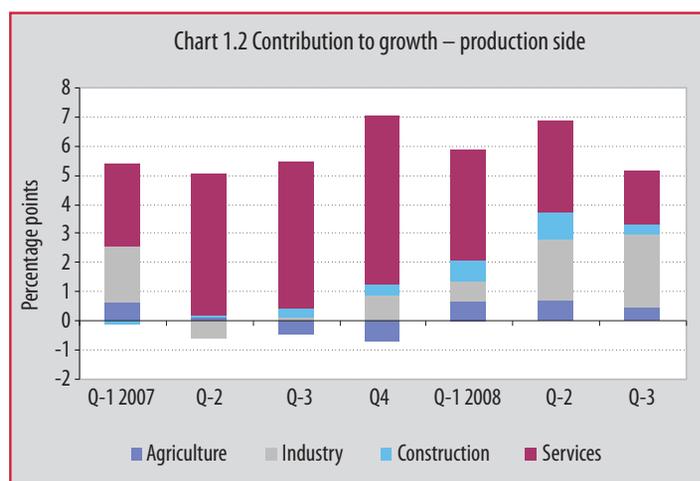
1. MACROECONOMIC TRENDS AND REAL SECTOR

In Q3, GDP in current prices was Denar 104,772 million. In terms of per capita, it is Denar 51,230 and, compared to the same quarter in 2007, there was a nominal increase by around Denar 5,500. In Q3 2008, **real GDP growth** was 5.5% with regard to the same quarter in 2007 and it slightly increased compared to the growth in Q1 2008 (5.3%), while in relation to the previous quarter (6.2%) it dropped, mainly due to the effects of the global economic crisis (Chart 1.1). Seasonally adjusted, GDP grew by

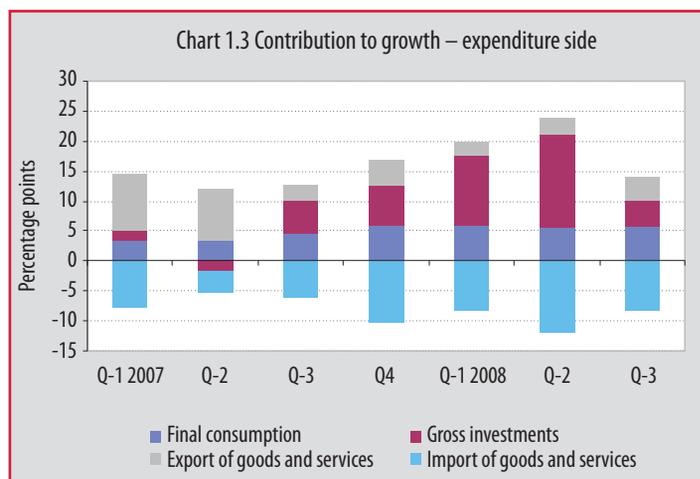


5.5% in real terms in Q3 2008 compared to Q3 2007 and by 1% compared to Q2 2008. Growth in Q3 was broad, whereby all sectors in the economy, except for the traffic and communications and financial mediation, experienced growth. Growth driving force in Q3 2008 was the processing industry (10.6%) and retail and whole sale (8.9%). As a whole, services experienced growth slowdown compared to the previous quarters (3.6% in Q3) (Chart 1.2).

Industrial production significantly grew on annual basis by 13% in Q3 2008, higher than the previous quarters (12.4% in Q2 2008 and 6.5% in Q1 2008).



Observing GDP from the expenditure side, in Q3 2008, final consumption grew in nominal terms by 15.4%, gross investments grew by 38%, export grew by 17.9%, and import by 27.2%. Nominal share of final consumption in growth was 5.6%, like in the previous quarter; share of gross investments was 4.6%, significantly declining compared to the previous quarters (11.6% in Q1 and 15.6% in Q2), while share of trade balance was negative, -5.1%, however significantly improved in relation to Q2, when it was -15.9%. Although values were in nominal terms and were higher due to the high inflation in Q3, still, growth components experienced intensive real growth (deflated with the costs of living index) compared to the previous quarters. Such growth had direct effects on the increase of the demand of import goods as inputs in the production process, and on the increase of trade deficit which, in nominal terms, increased by 109.5% in Q3 of 2008 in relation to the same



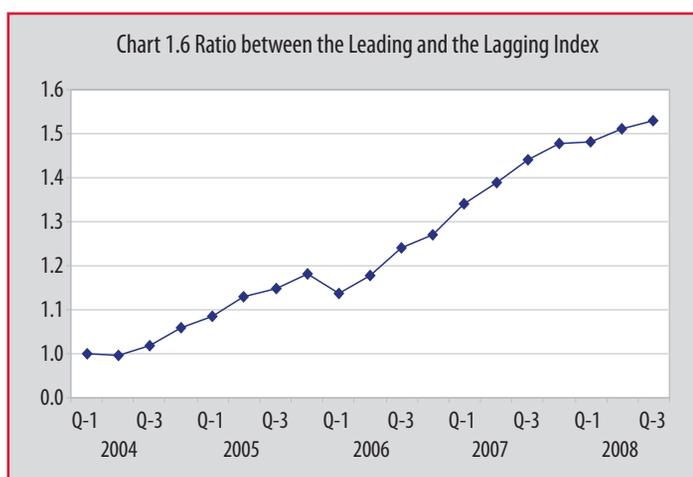
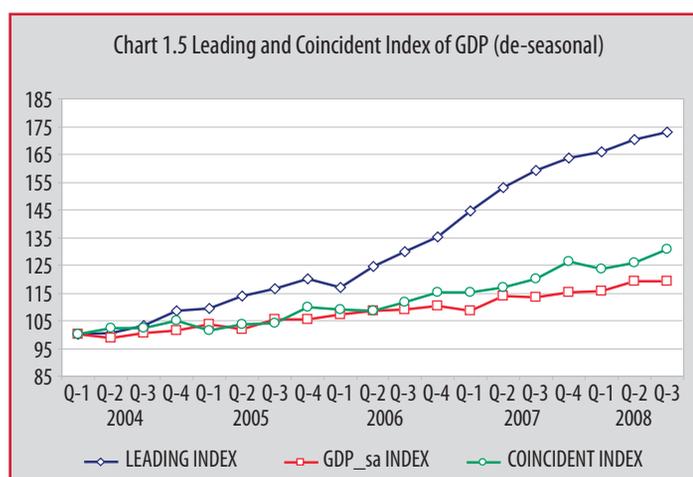
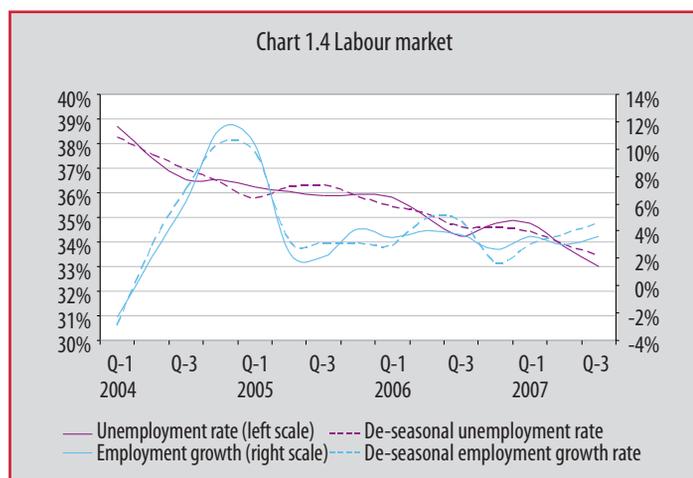
quarter previous year.

In Q3 2008, **employment growth** accounted for 3.6% compared to Q3 2007, increasing by 0.6 p.p. in relation to the growth realized in the previous quarter. Taking into account that growth of active population was significant, unemployment dropped by 1.3%, while **unemployment rate** accounted for 33%, and compared to D3 2007, it fell by 1.3 p.p.

If seasonal effects are excluded, unemployment rate registered no significant changes, i.e. it was more of a structural than fractional character. General downward trend of unemployment that started in 2006 is expected to continue in the coming period, however with a slower pace than the initial expectations.

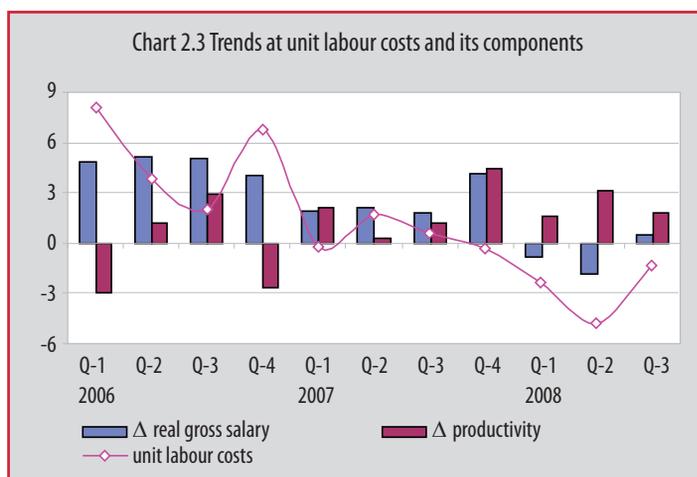
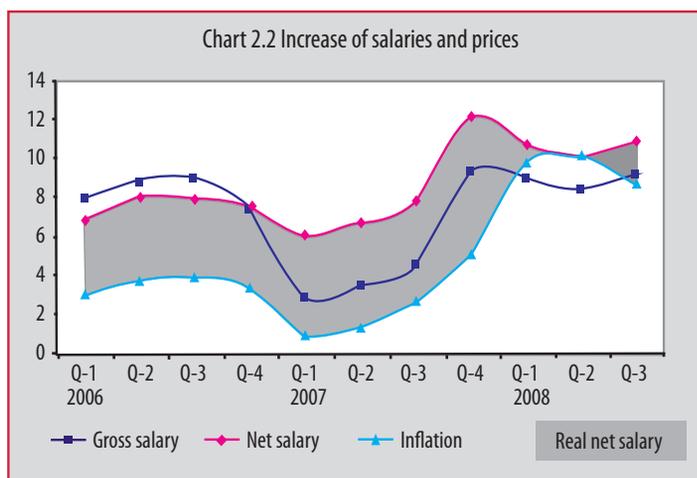
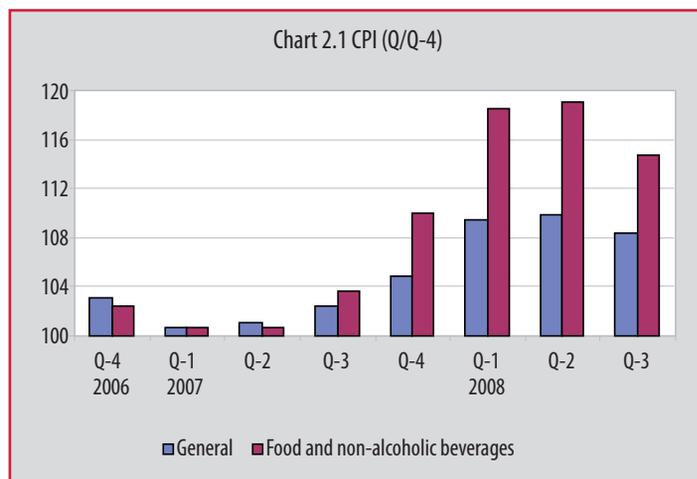
Leading composite index, MakLead, increased by 2.5 index points in Q3 2008 in relation to the previous quarter, and by 13.7 index points in relation to the same quarter in 2007. MakLead slowed down after the high increase in the previous quarter (4.5 index points). In Q3 2008, leading diffusion index registered positive trends at 69% of the components of the composite index, unlike in the same quarter in 2007, when it was 100.

Ratio between the leading and the lagging index is constantly increasing during the whole observation period. More intensive increase at this indicator is evident starting in 2006, which can be taken as approximate turning point in the economy, taking into account that the average value of the indicator in the period before was around one. In Q3 2008, this ratio increased further compared to the previous quarter, following the slight stagnation in Q1, and it reached 1.53, which suggests that the leading index was by around 53% higher compared to the lagging index.



2. PRICES, COSTS AND PRODUCTIVITY

In Q3 2008, inflation rate, measures according to the CPI, was 8.4% (Q/Q-4) compared to 9.9% in the previous quarter. Food costs increased by 14.7% compared to Q3 2007, participating with 5.6 p.p. in the total increase of the consumer prices, taking into account that average Macedonian household sets aside 38.2% from the personal consumption for food. High increase of prices on annual basis was also registered in the following categories: hotels and restaurants (13.1%), housing (6.3%) and transport (5.1%), i.e. in the sectors where increase of prices of food and energy had direct influence. However, increase of prices has a downward trend, especially in the sectors where measures of the Government to reduce the oil shock had effects. Thus, prices in the transport sector declined by 1.4% on monthly basis. Housing sector experienced increase by 1.4% as a result of the higher heating prices. Core inflation, which includes the effect of food and energy, was 2.4%, compared to 2.6% in the previous quarter. Downward trend of consumer prices is expected to continue in the coming period, taking into account the trends on the world stock markets and maintenance of core inflation at stable level.



increase of prices has a downward trend, especially in the sectors where measures of the Government to reduce the oil shock had effects. Thus, prices in the transport sector declined by 1.4% on monthly basis. Housing sector experienced increase by 1.4% as a result of the higher heating prices. Core inflation, which includes the effect of food and energy, was 2.4%, compared to 2.6% in the previous quarter. Downward trend of consumer prices is expected to continue in the coming period, taking into account the trends on the world stock markets and maintenance of core inflation at stable level.

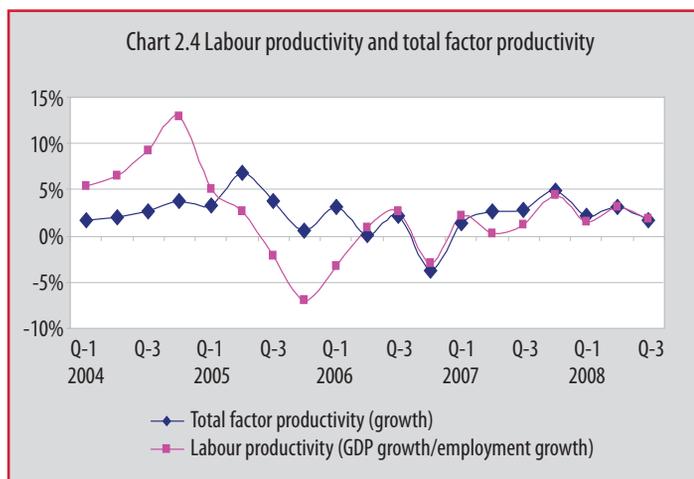
Retail prices in Q3 2008 were higher by 7.3% compared to the same quarter in 2007, whereby growth was the highest at the industrial-alimentary products (15.9%) and food products (14.9%). Thus, prices in agriculture experienced significant decline by 5.1% on monthly basis. Value of the consumer basket of food and beverages for a four-member household, calculated on the basis of retail prices, increased by 14.5% compared to Q3 2007, accounting for 74% of the average net salary.

In Q3 2008, **gross salary** increased by 8.9% in relation to Q3 2007, which was 0.8 p.p. higher growth compared the one realized in the previous quarter. At the same time, **net salary** increased by 10.7%, being 0.8 p.p. higher growth compared to the previous quarter. Slower growth of gross salaries in relation to net salaries was due to the reduction of the personal income tax

from 12% to 10% at the beginning of 2008. Downward trend of inflation caused for real net salary to be higher by 2.3% (see shaded field in Chart 2.2).

In Q3 2008, **labour productivity and total factor productivity** increased by 1.8% and 1.7% respectively, compared to Q3 2007. Like labour productivity, growth of total factor productivity declined by 3.1% compared to the growth in the previous quarter.

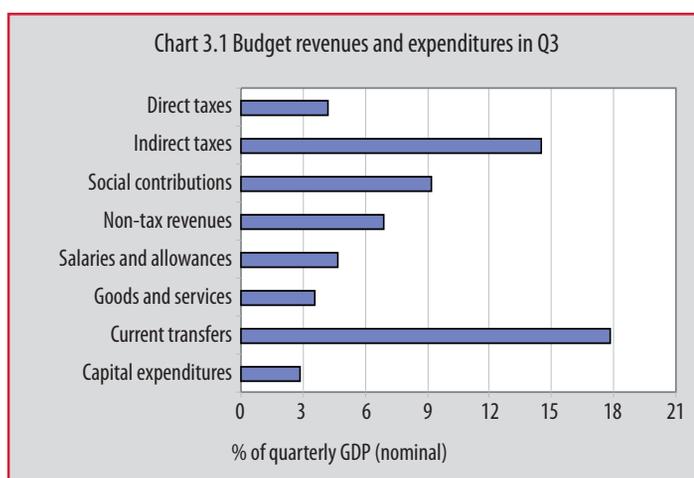
Unit labour costs (ULC), measures as ratio between real gross salary and productivity, continued the positive trend in Q3 2008, dropping by 1.4% on quarterly basis. Such phenomenon was a result of the fact that productivity growth was followed by lower growth of real gross salary (by 0.5%). ULC experienced highest decline of 16.3% in the primary sector, mainly as a result of the high decline of real gross salary (by 12.7%). Productivity in the primary sector, like in the industry, was 4.4%. Thereby, ULC were higher by 6% in the industry. Regarding the service sector, taking into account that real gross salary declined by the same percentage as productivity, ULC did not change.

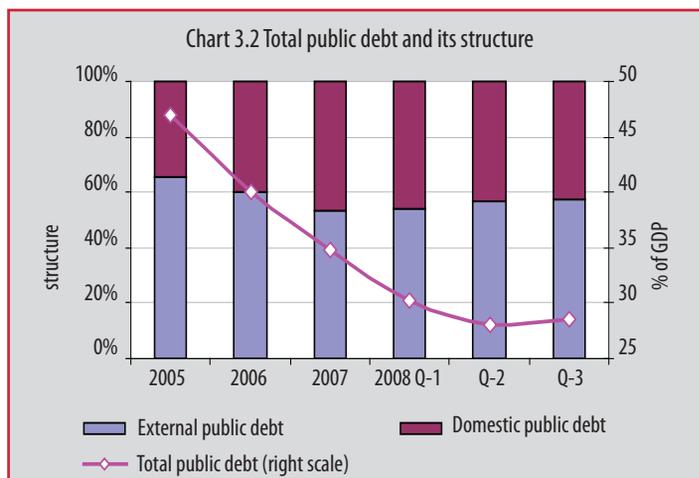


3. FISCAL SECTOR

Fiscal developments in Q3 2008 led to **budget surplus** in the amount of Denar 6.4 billion. This led to increase of the budget surplus of 2.7% of GDP in the first three quarters in 2008. Taking into account that large portion of projected capital investments is expected to be realized in the fourth quarter, it might be expected for fiscal position of the country to turn into deficit, however far lower than the projected 1.5% of GDP, as a result of the good revenue performance.

General government budget revenues in Q3 2008 were higher compared to the previous quarter, while compared to the same quarter last year, they increased by 13.9%. Larger portion of the revenues were **tax revenues**, accounting for 53% in the total budget revenues, and they increased by 7.5% compared to Q3 2007. High increase of final consumption in Q3 influenced the increase of revenues from indirect taxes, causing for the revenues from import duties to increase the most intensively by 18.7%. VAT revenues, accounting for the most in tax revenues, surged by 8.1%, while excise revenues increased by 2%. With respect to direct taxes, revenues from profit tax increased significantly (36.8%), taking into account that profitability growth of the firms exceeded 70% last year. Collection of personal income tax revenues dropped by 10.4% in Q3 2008, which was not in line with the economic parameters.





In addition, revenues on the basis of social contributions were higher by 16.7%, and their share in total budget revenues increased by 26%. **Non-tax revenues** accounted for 19.4%, and they grew by 30.6% as a result of the higher dividend from Macedonian Telecom paid in 2008 (in August), as well as the higher revenues from the special revenue account.

General government budget revenues in Q3 2008, although lower by 2.5% compared to the previous quarter, increased by 16.2% in relation

to Q3 2007. Current expenditures surged by 15.3%, accounting for 90.3% in the total expenditures. Within **current expenditures**, transfers increased by 28.7% as a result of the increased transfers to local government (2.4 times higher), i.e. the shift to the second stage of decentralization. This caused for salary and allowance-related expenditures in the general government budget to drop by 17.9%, taking into account that most of the salaries and allowances in education and culture are paid from the municipal budgets. Expenditures for goods and services increased by 18.9%, while interest payments were lower by 4.4%. **Capital expenditures** in Q3 2008 were by 25% higher in relation to Q2 2007, accounting for 35.1% of the projected ones in 2008. Capital investments, projected at 6.3% of GDP, were expected to increase and intensify in the next quarter.

Fiscal burden, measured as participation of the budget revenues¹ in relation to nominal GDP, was 29.5% in Q3 2008, dropping by 0.8 p.p. in relation to Q3 2007. Total budget expenditures accounted for 29.3% of GDP, which was by 0.5 p.p. lower compared to Q3 2007.

Total public debt² at the end of Q3 2008 was 28.5% of GDP, which was an increase by 0.4 p.p. in relation to the end of the previous quarter. Such growth was due to the increase of the external public debt, while domestic public debt continued to drop as a result of the positive fiscal position of the country in this period. Thereby, 42.8% of the total public debt was domestic, while the remaining portion was external public debt (Chart 3.2).

General government debt, which includes the debt of NBRM and the public enterprises, slightly increased to 20.8% at the end of Q3 2008, i.e. it increased by 0.7 p.p. in relation to June 2008. This speaks in favour of the sound fiscal policy, which is one of the Maastricht criteria (60% limit of general government debt).

4. MONETARY-FINANCIAL TRENDS

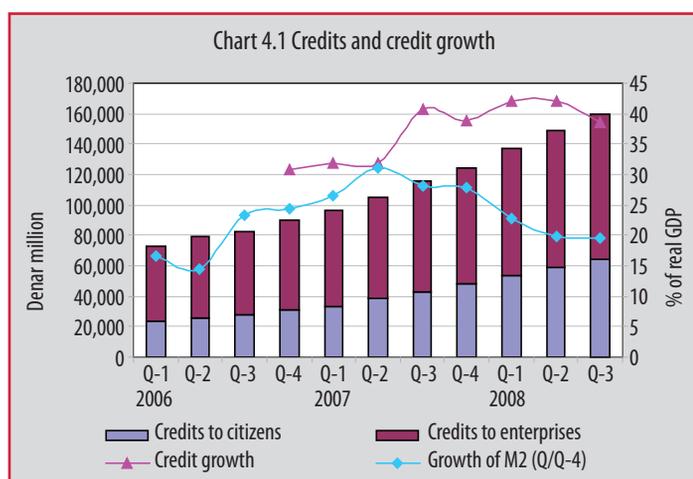
At the end of Q3 2008, **primary money** increased by 3.7% in relation to the previous quarter, and they increased by 23.9% on annual level, above all as a result of the increased liquidity of the commercial banks. In Q3 2008, **M1 monetary aggregate** increased by 0.3% compared to Q2 2008, while on annual basis, the increase was 20.5%, mainly as a result of the high increase of deposit money by 36%. In Q3, broader monetary aggregates **M2 and M4** grew in relation to the previous quarter (2.9%

1. Includes tax revenues, social contributions and part of non-tax revenues

2. According to GFS methodology

and 3.8% respectively) with an intensity corresponding to the deposit growth in the same quarter, although growth of M2 (Q/Q-4) registered certain slowdown (19.5% in Q3 2008 and 19.8% in Q2 2008).

Credits to the private sector in Q3 2008 grew by 38.4% in relation to Q3 2007, however compared to Q2, credit growth dropped by 3.7 p.p. as a result of the restrictive measures of the monetary policy previously undertaken by NBRM. Growth slowdown, although slight, was registered at credits to enterprises by 1.7 p.p. (from 34.7% in Q2 to 33% in Q3), leading to the conclusion that banks started applying the policy enforced by NBRM aimed at calming down the inflationary trends, which reached the peak in the middle of the year. On the other hand, growth of household credits slowed down significantly by 6.9 p.p. (47.6% in Q3 in relation to 54.5% in Q2). Credits to the private sector, compared to the planned nominal GDP in 2008, was 39.5% in Q3 2008, being a 2.7 p.p. increase in relation to the previous quarter, while credit growth slightly slowed down.



Total deposit potential of the private sector registered an upward trend, and growth intensified (22.1% in Q3 2008 in relation to 18.7% in the previous quarter). In Q3 2008, deposits of citizens increased by 19.7% in relation to Q3 2007, and they were lower by 0.3 p.p. in relation to Q2 2008. Deposits of enterprises surged by 24.7% in relation to Q2 2007, whereby growth significantly accelerated in relation to Q2 2008 (growth increase of 11.2 p.p.).

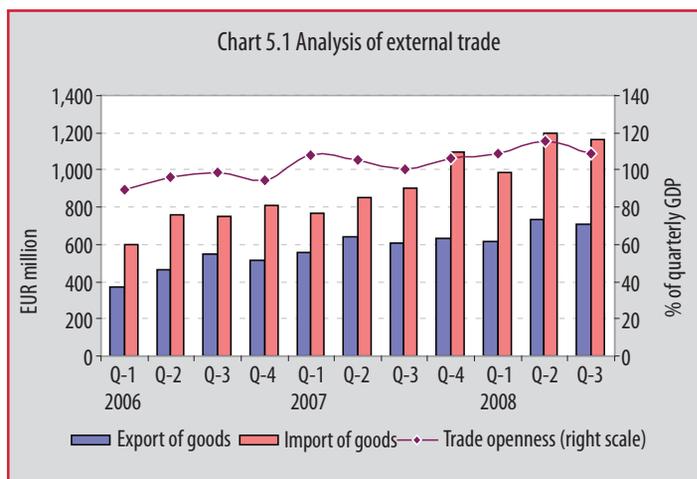
Interest on central bank bills was kept on the same level as in q2 2008, i.e. 7%. For comparison purposes, reference interest rate in the Euro zone dropped several times, cumulatively by 2.25 p.p. compared to July 2008, and starting 21 January 2009, it was 2%. Taking into account that the main reason for increase of interest on central bank bills – inflation increase was put under control by the middle of the year, no further increase of interest rate is expected, and as a reaction to the global financial crisis, it is advisable to start its reduction, a step already undertaken by the three leading central banks – ECB, FED and the Bank of England.

Average weighted interest rate on Denar credits amounted to 9,6% at the end of Q3 2008, registering a drop of 0.4 p.p. annually, and a drop of 0.1 p.p. compared to the previous quarter. Interest rates on deposits continuously grew, thus at the end of Q3 2008, interest on credit balance on Denar deposits increased by 1.1 p.p. in relation to Q3 2007 and amounted to 6.1%, which was by 0.3 p.p. higher compared to Q2 2008. No reduction of banking interest rates is expected in the coming period, mainly due to the current monetary policy of increased reference interest rate, as well as due to the financial crisis in the USA which has already spilled over to the European financial institutions that are business partners to the Macedonian banks.

In Q3 2008, **Macedonian stock exchange index MSEI-10**, as aggregate indicator of stock exchange trends, dropped by 9% in relation to Q2 2008, while the drop in relation to Q3 2007 was even more significant, amounting to 52%. Further decline of stock exchange activity in Q3 2008 was mainly due to the global economic developments and weakening of the capital market worldwide as a result of the global financial crisis.

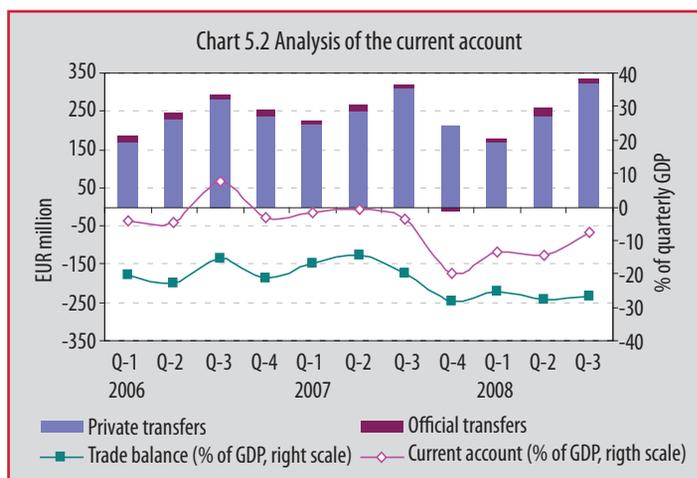
5. EXTERNAL SECTOR AND BALANCE OF PAYMENTS

In Q3 2008, **export of goods**, expressed in euros, increased by 16.8% in relation to the same quarter in 2007, growth rate higher than the one in Q2 (14.7%) and Q1 (9.4%). In Q3 2008, **import of goods**, expressed in euros, was higher by 28.5% compared to Q3 2007, and following the high increase in Q2 (40.8%), it dropped to Q1 level. Highest import growth, besides at the categories mineral fuels and lubricants (58.1%) and raw materials (43%), was also registered at the categories beverages and tobacco (32%), machines and transportation devices (30%), products classified according to the material (29.7%) and chemical products (23.2%).

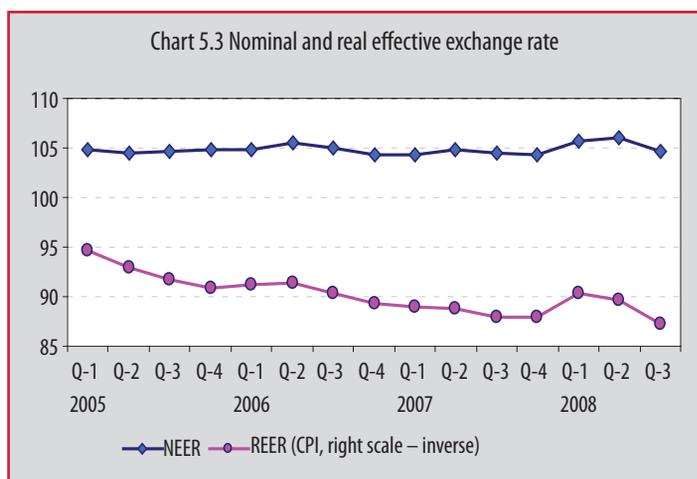


Import growth at these categories of goods, which are intermediary inputs in the production process, points out to strengthening of the production activity in the next quarters and is in line with the growth projections in the next quarters.

Trade openness of the Republic of Macedonia was 109.1% in Q3 2008, being at the Q1 2008 level, while the decline in relation to Q2 was 115.6%. Such decline was a result of the low export growth, as well as GDP growth in Q3 2008. In Q3 2008, **trading volume with EU** was 52.3% of the total trade of Macedonia in relation to Q2 and there were no significant changes. Second most significant trading partner to the Republic of Macedonia is Serbia, whereby the trading volume in Q3 2008 accounted for 12.9% of the total trade and it slightly dropped in relation to Q2.



As a result of lowering the inflation pressure, and the still expensive imported energy, in Q3 2008, **trade balance** reached 26.5% of GDP, which was a certain improvement in relation to Q2 (-27.6). In the same quarter, **net current transfers**, unlike the previous two quarters which registered a decline, surged for the first time quarterly (by 4.5%) in relation to Q3 2007, private transfers accounting for the most (96%). As a result of increase of current transfers and improvement of the trade balance in Q3, BOP **current account balance**, although still negative, significantly improved in relation to Q1 (13.3%) and Q2 2008 (14.3%), it amounted to 7.6% of GDP, however,



it remains to be the main source of economic risks in the coming period.

Nominal Denar/EUR exchange rate remains as intermediary target of the monetary policy. In Q3 2008, **nominal Denar effective exchange rate** depreciated compared to the previous two quarters. **Real Denar effective exchange rate** index, calculated on the basis of CPI index, declined further, after the appreciation in the first quarter in 2008. On the other hand, REER calculated on the basis of price index of producers of industrial products

registered slight depreciation, pointing out to certain improvement in the export competitiveness of the Macedonian economy. This could explain the improvement of the negative balances on the trade and the current account in Q3 (Chart 5.4).

