STANDARD & POOR'S

CREDIT RESEARCH REPORT

Credit Ratings

Local currency
BB+/Positive/B

Foreign currency
BB/Positive/B

[**Editor's note**: Since publication of this report the ratings have been changed on Aug. 23, 2005 to

Local currency
BBB-/Stable/A-3

Foreign currency
BB+/Stable/B]

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Macedonia (*Republic* of)

Major *Rating Factors*

Strengths:

- Strong support for the Ohrid Framework Agreement and EU membership anchor the rapid progress toward political stability, and are the main drivers for reforms.
- Prudent policies have maintained macroeconomic stability even through periods of severe stress.
- Moderate external indebtedness in all sectors keeps the need for external financing at bay, despite comparatively high current account deficits.

Weaknesses:

- Notwithstanding rapid political stabilization following the 2001 security crisis, interethnic relations will continue to play an important role.
- Structural problems in the economy and governance issues are a burden on economic and fiscal performance.
- An inflexible general government expenditure structure, as well as an inefficient and costly social security system, pose a risk for maintaining fiscal prudence.

Rationale

The ratings on Macedonia are constrained by the ongoing importance of interethnic relations, structural and governance issues in the economy, and a government expenditure structure that leaves little flexibility to rein in spending.

The ratings are supported by rapid progress toward political stability, driven by the 2001 Ohrid Framework Agreement and the prospect of EU membership. Moreover, the ratings are underpinned by macroeconomic stability and moderate levels of external indebtedness.

Political stability in Macedonia has improved greatly since the interethnic violence in 2001. The Ohrid Framework Agreement that ended the security crisis enjoys both broad political and public backing, and a repeat of those events looks highly unlikely. This is demonstrated by a number of recent stress tests such as the death of the president in a plane crash and renewed ethnic unrest in Kosovo (both in early 2004), which Macedonia navigated well. In addition, a referendum opposing the redrawing of municipal borders, which will give minorities greater rights in certain communities, failed to gain the necessary support on Nov. 7, 2004. Interethnic relations will still continue to play an important role in determining political stability in Macedonia, but the commitment of the international community to the maintenance of this stability remains strong, and would have a moderating influence should tensions increase again.

Prudent economic policies have managed to maintain macroeconomic stability, despite the multitude of shocks hitting the economy since independence. Inflation has remained in low single digits since the mid-1990s, and GDP growth is forecast to average 3.3% between 2004 and 2006. Serious structural imbalances in the economy—such as very high levels of unemployment—have yet to be addressed, however. In addition, poor governance both in the private and in the public sectors, corruption, and a weak judiciary depress domestic and foreign investment and hinder economic and employment growth.

Fiscal accounts are sound. Excluding the crisis years of 2001-2002, the general government budget has been in moderate-to-low deficit since the second half of the 1990s, and is expected to register slightly less than 1.5% of GDP in the medium term. If grants are included above-the-line, the budget will even be broadly balanced. Low net financing requirements will push the debt level down to 41.4% of GDP in 2006, from 46.6% in 2003. By contrast, structural rigidities on the expenditure side (where wages and transfers account for 87.0%), as well as an inefficient and costly social security system, pose risks to the maintenance of fiscal prudence.

Macedonia's trade deficit is very high, at 18.3% of GDP in 2003, but is readily financed by sizable private transfers, grants, and concessional lending. Consequently, levels of net external debt have remained moderate, at 30.7% of current account receipts (CARs) for the public sector and 6.3% of CARs for the nonfinancial private sector in 2003. The financial sector is a net external creditor, with net assets of 15.1% of CARs in 2003.

Outlook

The positive outlook on the ratings reflects Standard & Poor's expectation that, in addition to the ongoing implementation of the framework agreement, the prospect of EU membership at the turn of the decade will continue to play an essential role as a driver for further reforms and ongoing political stabilization. Macedonia applied for EU membership in March 2004 and might be awarded candidacy status as early as 2005. Support for EU membership is broad-based and a large share of new legislation is already geared toward EU requirements.

For most of the new EU members that joined the Union in May 2004, prospective EU membership served as a strong policy anchor, which in turn resulted in ratings upgrades. On the way toward EU membership, Macedonia will have to address many of its weaknesses, such as improving and sustaining political stability, correcting the structural imbalances in the economy, and tackling governance issues. An upgrade of the ratings on Macedonia is contingent on progress in these areas.

Table 1

Republic of Macedonia Selected Indicators

	2006f	2005f	2004e	2003	2002	2001	2000	'BB' Median 2004
GDP per capita ($)	3,146	2,903	2,680	2,296	1,874	1,689	1,766	1,957
Real GDP (% change)	3.9	3.9	2.0	3.2	0.9	(4.5)	4.5	4.2
Real GDP per capita (% change)	3.7	3.7	1.8	2.7	1.5	(4.7)	3.8	2.5
General government balance (% of GDP)	(1.2)	(1.3)	(1.5)	(1.6)	(5.6)	(7.2)	1.8	(3.5)
General government debt (% of GDP)	41.4	43.4	45.4	46.6	47.7	51.6	53.2	57.1
Net general government debt (% of GDP)	36.6	38.2	39.9	40.2	38.3	31.7	43.3	44.7
General government interest expenditures (% of revenues)	3.4	3.4	3.7	3.2	4.2	5.5	4.9	13.9
Domestic credit to private sector and NFPEs (% of GDP)	25.4	23.5	21.7	19.8	18.0	17.9	18.1	38.2
Consumer price index (average; % change)	2.5	1.5	0.5	1.2	1.8	5.2	5.8	5.2
Gross external financing requirement (% of usable foreign reserves*)	99.9	96.4	86.4	73.3	100.9	82.9	74.0	83.1
Net public sector external debt (% of CARs)	32.8	33.8	33.4	30.7	36.7	45.3	42.8	27.6
Net banking sector external debt (% of CARs)	(5.8)	(8.9)	(11.5)	(15.1)	(19.8)	(25.4)	(9.5)	2.1
Net nonbank private sector external debt (% of CARs)	9.6	8.9	7.7	6.3	5.9	5.7	3.2	2.4

*Excluding government and commercial bank foreign currency deposits with the National Bank of the Republic of Macedonia. NFPE—Nonfinancial public enterprise. CARs—Current account receipts. f—Forecast. e—Estimate.

Comparative Analysis

- In a similar fashion to most of its European peers, the prospect of EU membership provides a strong anchor for economic reform and contributes to political stability in Macedonia.
- Macedonia has maintained consistently low inflation rates and moderate general government deficits, both of which compare well to the sovereign's peers and the 'BB' median.
- Trade and current account deficits remain among the highest in the peer group, but external liquidity requirements are moderate and on a par with the 'BB' median.

EU has a substantial impact on policies.

One important characteristic of the policy environment in recent years that Macedonia shares with its peers, the Republic of Romania (foreign currency BB+/Stable/B; all references to ratings hereafter are to foreign currency sovereign credit ratings), The Russian Federation (BB+/Stable/B), the Republic of Bulgaria (BBB-/Stable/A-3), the Republic of Croatia (BBB-/Positive/A-3), and the Kingdom of Morocco (BB/Positive/B), is the pursuit of prudent and consistent macroeconomic policies and ongoing economic reforms. The European Union is an important driver of those reforms for most of the peer group. In March 2004, Macedonia submitted its application for membership of the EU and might receive candidacy status as early as 2005/2006. Already, much new legislation is geared toward EU requirements, and the prospect of EU membership helps to generate support for reforms.

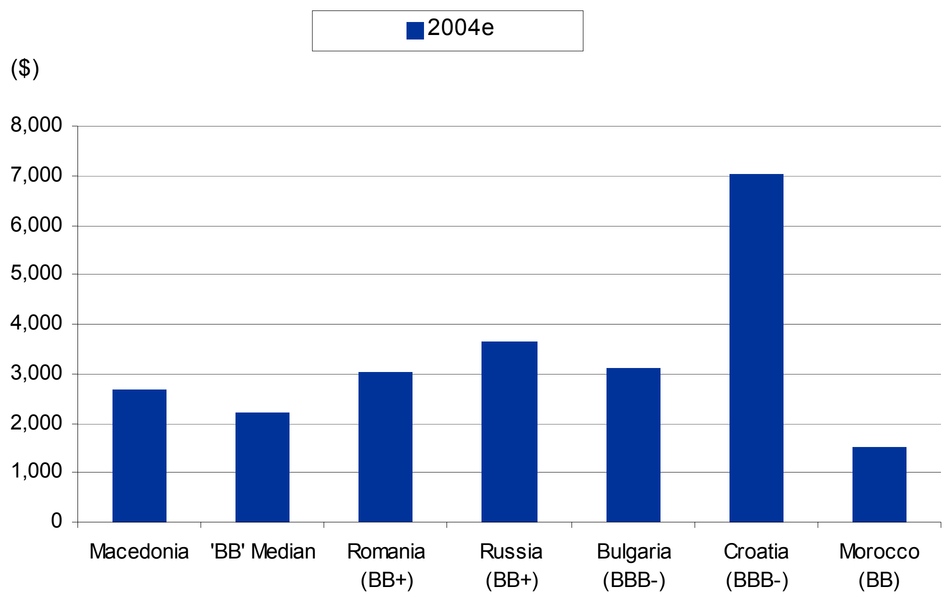
Romania, Bulgaria, and (since July 2004) Croatia are already EU candidates, and might become members as early as 2007, but will have to fulfill the respective preconditions by then, most importantly the "acquis communautaire". The experience of the 10 new EU members that joined in May 2004 demonstrates that the prospect of EU membership can serve as a very powerful anchor for economic reforms, prudent policies, and eventually rating improvements. Unlike the other peers mentioned, there is currently no prospect of Russia or Morocco becoming EU members, but Morocco has an Association Agreement with the EU, which leads to tighter integration between EU and Moroccan markets.

Income levels comparable with peers, but growth prospects lagging.
Income levels in Macedonia's peer group are broadly similar, with only Morocco recording GDP per capita of less than the 'BB' median of $2,200 in 2004. Macedonia's income levels, at $2,680 in 2004, are also only slightly below those in higher-rated Bulgaria (see Chart 1). The substantially higher income levels in Croatia (which, like Macedonia, was part of the former Yugoslavia), at $7,050, are largely due to a much more favorable economic structure inherited from the Yugoslav period. This structure gave Croatia a head start in the transformation process, whereas Macedonia had always been one of the poorest regions in the former Yugoslavia. Macedonia's growth prospects, averaging 3.0% in 2004-2006, lag those of its peers and the 'BB' median, which is forecast to register 4.2% (see Chart 2). For all peers, except Russia, growth prospects in 2004-2006 are forecast to be brighter than in the past. This is particularly true for Macedonia, where average 1999-2003 output suffered from the security crisis in 2001.

Chart 1

Macedonia Peer Group Comparison

GDP Per Capita

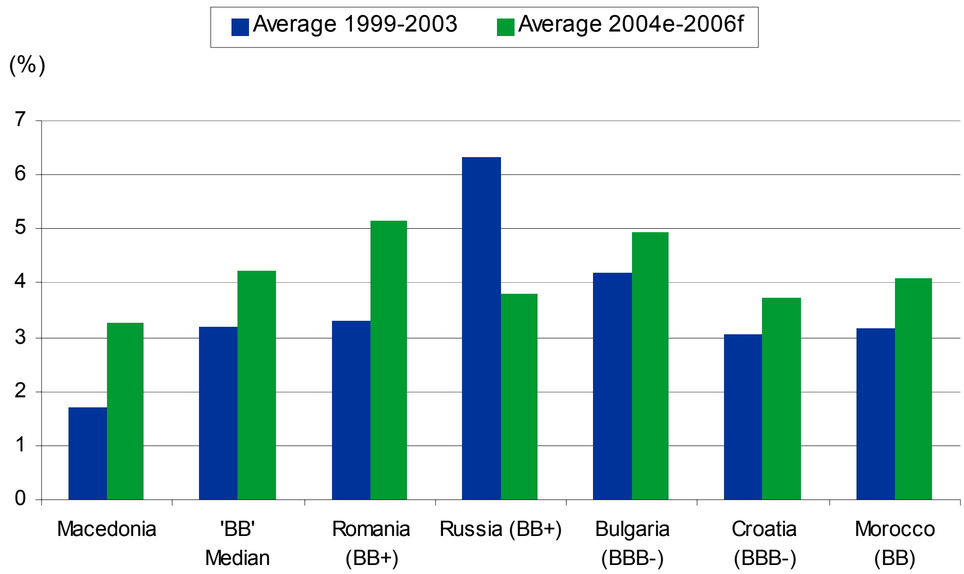


e--Estimate.

Chart 2

Macedonia Peer Group Comparison

GDP Growth



f--Forecast. e--Estimate.

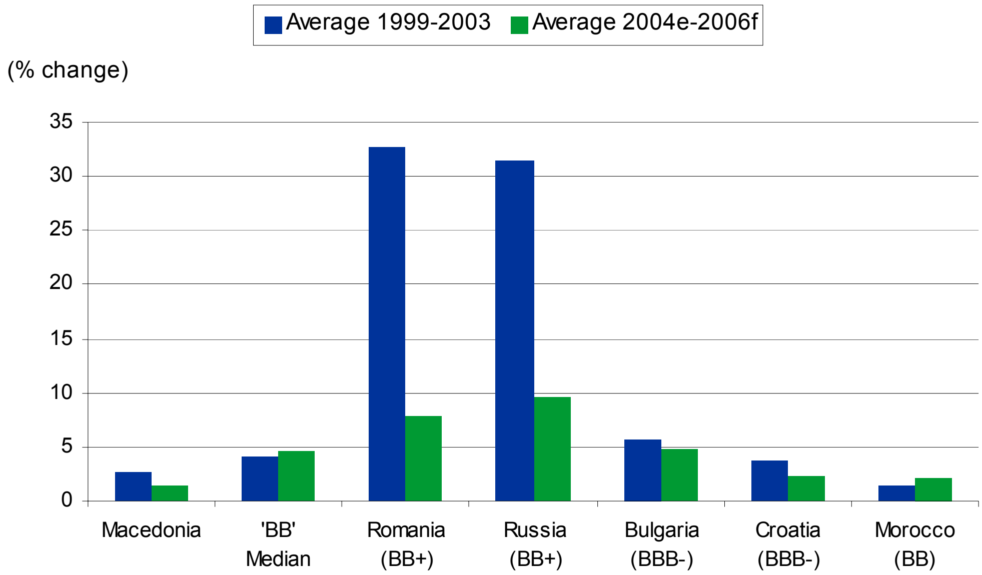
Stability culture means low inflation and small fiscal deficits.

Despite internal political unrest just three years ago, Macedonia has developed a culture of macroeconomic stability, which started with the introduction of a fixed exchange rate in the mid-1990s. Inflation rates have been, and remain, well below the 'BB' median and levels in most peers, including Bulgaria—which adopted a currency board, an even more rigid fixed exchange rate arrangement, in 1997 (see Chart 3). By contrast, post-transformation inflation in Romania and Russia has been much more persistent. The rate of inflation was still as high as 46% and 86% for Romania and Russia, respectively, in 1999, and will only gradually fall below 10%.

Chart 3

Macedonia Peer Group Comparison

Consumer Price Index



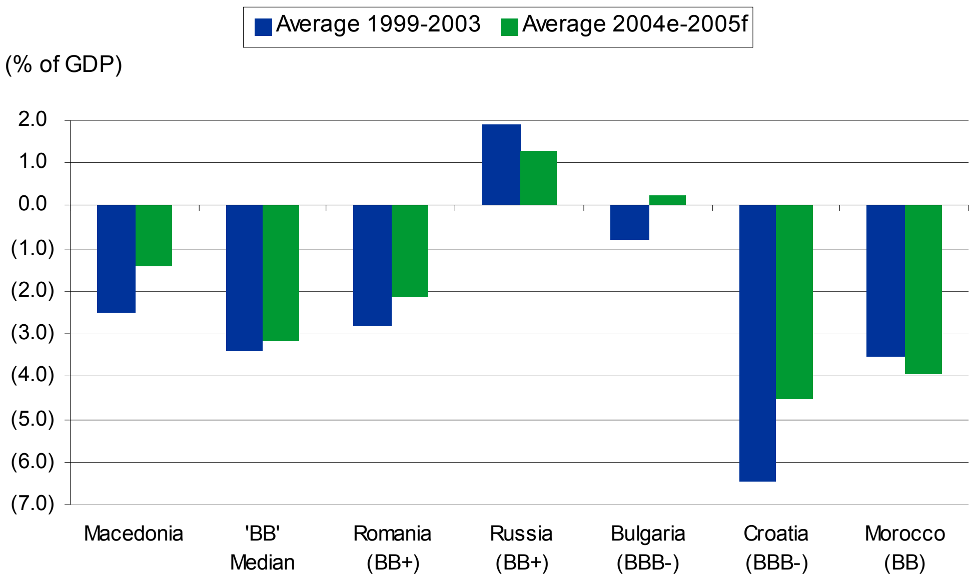
f--Forecast. e--Estimate.

The Macedonian authorities have also managed to maintain prudent policies in fiscal matters, as evident from a history of relatively low fiscal deficits (see Chart 4). In 1999-2003, the average deficit amounted to 2.5% of GDP in Macedonia, despite an average deficit of more than 6.0% of GDP for the years 2001-2002 as a result of security-related spending. In comparison, deficits have been lower only in Bulgaria, which embarked on an ambitious stabilization course after its 1997 economic crisis, and in Russia, where the budget benefits from sizable oil revenues. The picture is not expected to change much in the medium term; deficits in Macedonia will continue to be about 1.5% of GDP in 2004-2005, considerably less than the 'BB' median of 3.2%.

Chart 4

Macedonia Peer Group Comparison

General Government Fiscal Balance



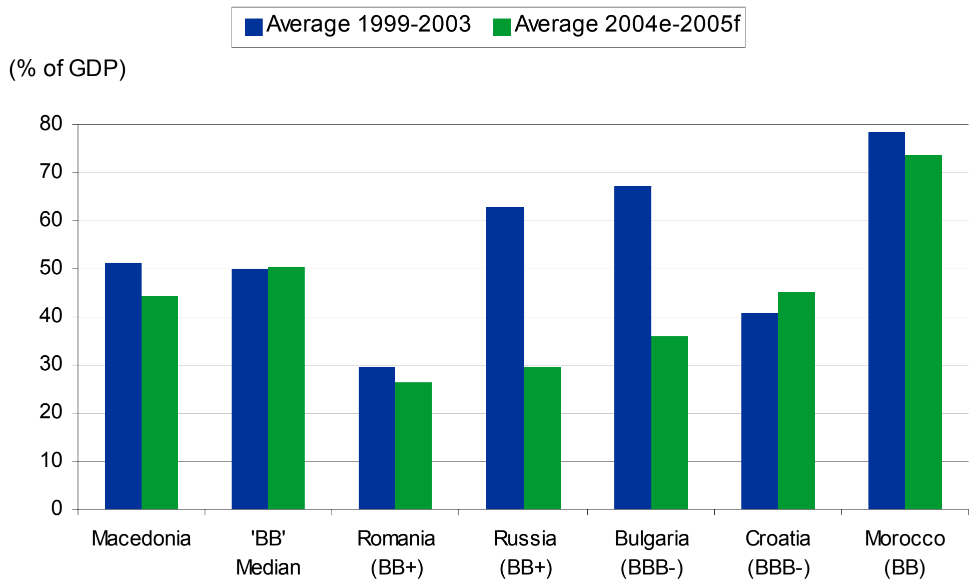
f--Forecast. e--Estimate.

As a result of relatively low budget deficits, which are also partly financed through external grants, general government gross debt levels in Macedonia are moderate, in line with the 2003 'BB' median of slightly more than 50% of GDP (see Chart 5). Debt levels will continue to decline, in line with all peers bar Croatia, to reach 43.4% in 2005. This decline will be less pronounced than in Bulgaria and Russia, however, which have much more favorable fiscal positions.

Chart 5

Macedonia Peer Group Comparison

General Government Debt



f--Forecast. e--Estimate.

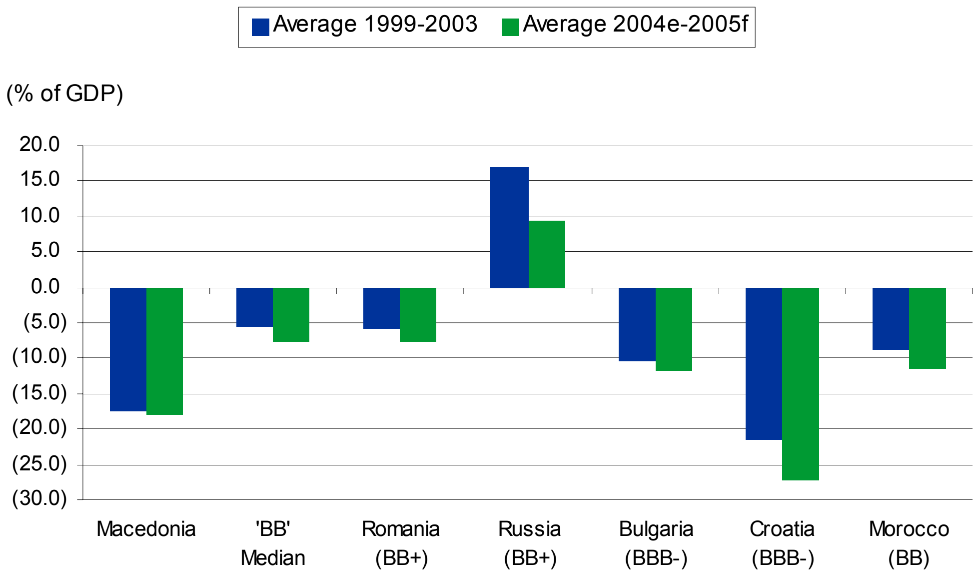
External liquidity requirements moderate.

Like most (post-)transition countries that are catching up in economic development and economic structure, Macedonia has a sizable trade balance deficit—averaging 17.5% of GDP 1999-2003. This phenomenon is analogous with its peers, particularly Croatia, where the average deficit in the same period was 21.6% (see Chart 6). These deficits are forecast to grow, if they change at all. By contrast, Russia, which is a large economy compared with all peers, benefits from its rich endowment of primary commodities, particularly fossil fuels, which contribute greatly to its sizable trade surplus, averaging 17.0% of GDP in 1999-2003.

Chart 6

Macedonia Peer Group Comparison

Trade Balance



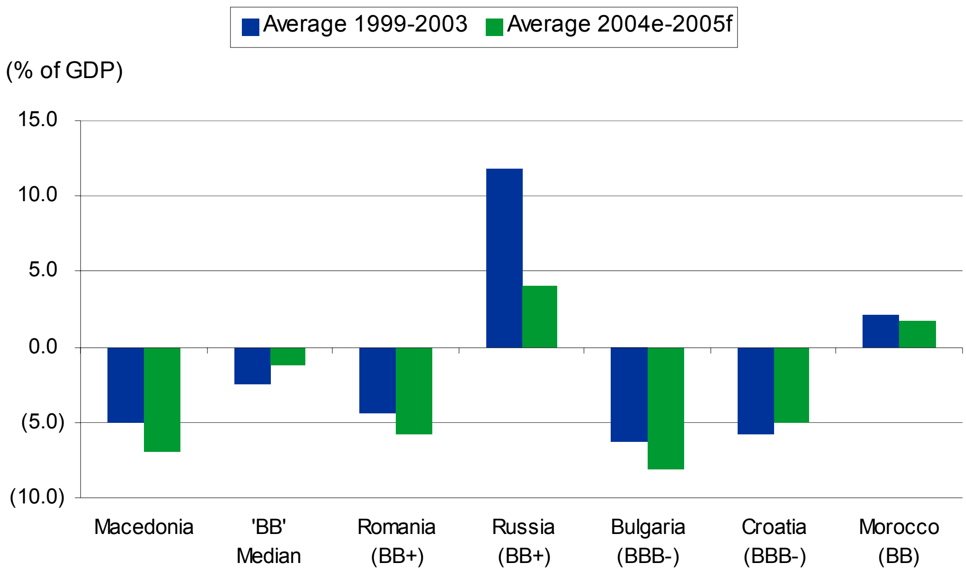
f--Forecast. e--Estimate.

The impact of the trade balance on the current account balance is dampened, however, by other mitigating factors both for Macedonia and for Croatia. Although their trade deficits are the largest of all peers, their current account deficits are less than that in Bulgaria and in line with that in Romania (see Chart 7). In the case of Macedonia, this is primarily due to a large surplus in the balance of transfers, stemming both from considerable official transfers and from even larger private transfers, mainly remittances and net cash exchange (effectively unrecorded exports). In the case of Croatia, by contrast, the trade deficit is partly compensated by a sizable balance of services surplus, mainly stemming from a thriving tourism sector.

Chart 7

Macedonia Peer Group Comparison

Current Account Balance



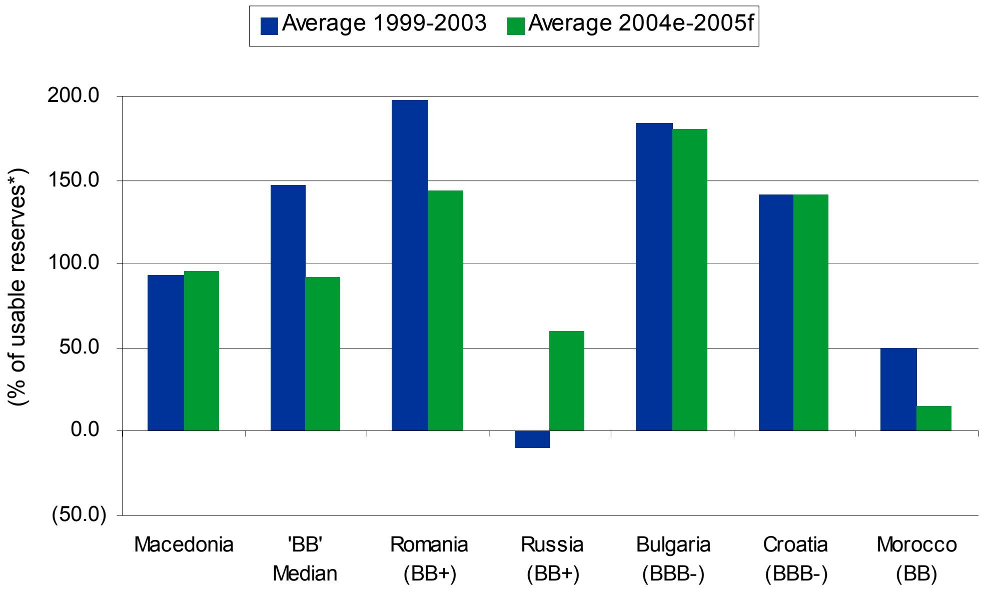
f--Forecast. e--Estimate.

Despite relatively high current account deficits, Macedonia's gross external financing requirement, at a forecast 95% of usable foreign exchange reserves in 2004-2005, is on a par with the 'BB' median, and considerably less than those of Romania, Bulgaria, and Croatia (all three broadly about 150%; see Chart 8). This difference is thanks to the current account deficit being partly financed through external grants, and to a favorable external debt structure.

Chart 8

Macedonia Peer Group Comparison

Gross External Financing Requirement



*Excluding government and commercial bank foreign currency deposits w ith the National Bank of the Republic of Macedonia. f--Forecast. e--Estimate.

Political Environment

- Political stability has increased since the peak of ethnic conflict in 2001, due to the ongoing implementation of the Ohrid Framework Agreement and much-improved relations with neighbors.
- The aim of EU membership is an important driving force behind much of the current reform efforts.
- Corruption, a weak judiciary, and an inefficient public administration remain the principal obstacles on the way to potential EU membership.

Since independence from Yugoslavia in 1992, Macedonia has been hit by many external and internal shocks that have repeatedly undermined political and economic stability. The Hellenic Republic (Greece; A/Stable/A) imposed a trade embargo in 1994, in a dispute over the name and the national flag of Macedonia. The Yugoslav wars in the 1990s and the Kosovo crisis in 1998 led to an influx of thousands of Albanian refugees. Internally, interethnic tensions between the Macedonian majority and the Albanian minority mounted in a brief armed insurgency of Albanian radicals against the government in 2001.

Three years on, the situation in Macedonia has stabilized significantly compared with the country's first decade of independence. The armed insurgency was ended by intervention of the international community and a NATO peacekeeping force, which eventually led to the signing of the Ohrid Framework Agreement (FA). The FA envisages a marked improvement in minority rights and powers, and increased representation of minorities in public administration. The last major part of the FA that still awaits implementation is the decentralization and devolution of power from central to local governments.

Standard & Poor's considers a renewed build-up of ethnic tensions that undermines political stability to be unlikely, but interethnic relations will continue to play an important role for Macedonia. The FA enjoys broad political as well as public backing, and there is a general perception that both conflict parties have ultimately benefited from it. Certain radical parts of the political spectrum do still promote secession along ethnic lines, but these ideas do not resonate with the broad public anymore.

The country's resilience to recent tests of political stability has been encouraging. Neither the withdrawal of the NATO policing force in November 2003, nor the death of popular president Boris Trajkovski (who had played an important role in the peace process) and renewed violence in Kosovo in early 2004 led to fresh tensions in Macedonia. Furthermore, the international community remains firmly committed to maintaining stability in Macedonia, which would be a moderating factor should tensions increase again. Plans to redraw municipal borders—narrowly passed by parliament as part of the process of power devolution—will give minorities greater rights in certain communities. They resulted in a brief episode of renewed controversy, as ethnic Macedonian opponents of the plan forced a referendum on the issue. The referendum failed to reach the necessary participation of 50% of voters, however, with just 26% casting their vote on Nov. 7, 2004.

Relations with neighbors Greece, Bulgaria, the Union of Serbia and Montenegro, and Albania have improved markedly thanks to a pragmatic approach and increased dialogue and cooperation. The country has agreed on free-trade arrangements with all its non-EU neighbors, as well as with the EU. Although the name dispute with the Greek authorities has not been resolved, Greece has still become the main investor in Macedonia and a major trading partner.

An overarching anchor for ongoing reform efforts and much new legislation, besides the FA, is the aim of EU membership roughly at the turn of the current decade. Macedonia formally applied for EU membership in March 2004. If the application is successful, Macedonia might eventually become a candidate country, making it eligible for EU pre-accession funds as early as 2007. Furthermore, the Stabilization and Association Agreement (SAA) with the EU, signed in 2001, came into effect in April 2004, making Macedonia the first country in the western Balkans with a fully ratified SAA. The SAA gives Macedonia free-trade access to EU markets and aims to bring the country closer to EU standards. Macedonia is also aiming for NATO membership, which could happen as early as 2007.

Major obstacles to EU membership, besides the need for economic convergence, remain high levels of corruption, a weak and inefficient judiciary, and inefficient public administration. In Transparency International's 2004 index of corruption perceptions, Macedonia ranked 97 out of 146 countries, ahead of Albania (108), and on a par with Serbia and Montenegro, but trailing Romania (87), BosniA-Herzegovina (82), Croatia (67), Bulgaria (54), and Greece (49).

The governing coalition comprised of the Social Democratic Alliance of Macedonia (SDSM), the Liberal Democratic Party (LDP), and the Albanian Democratic Union for Integration (DUI) came to power on an anti-corruption platform in 2002. Progress in this area, however, has been slow. The coalition appears to be stable, but not free from tensions, as highlighted by the resignation of independent prime minister Hari Kostov in November 2004. President Branko Crvenkovski has appointed Vlado Buckovski, the new head of SDSM, to form a new government, which will involve the same parties as the previous administration. Standard & Poor's does not expect this reshuffle to lead to a different policy direction.

Economic Prospects

- Levels of wealth are broadly in line with the region, with GDP per capita of $2,680 in 2004, not including the extensive unrecorded economy.
- Prudent policies have maintained macroeconomic stability, but structural and microeconomic imbalances hamper investment, employment, and growth.
- Growth has slowly recovered from the 2001 crisis and is set to reach its potential rate of 4.0% in 2005.
- Improvements in growth potential hinge on enhancing the business climate and tackling corruption, a weak judiciary, and governance problems.

Table 2

Republic of Macedonia Economic and Financial Indicators

	2006f	2005f	2004e	2003	2002	2001	2000
Nominal GDP (bil. DEN)	299.0	281.3	264.6	253.5	244.0	233.8	236.4
GDP per capita ($)	3,146	2,903	2,680	2,296	1,874	1,689	1,766
Real GDP (% change)	3.9	3.9	2.0	3.2	0.9	(4.5)	4.5
Real GDP per capita (% change)	3.7	3.7	1.8	2.7	1.5	(4.7)	3.8
Real domestic demand (% change)	5.7	5.3	3.7	7.4	6.5	(5.3)	9.2
Real investment (% change)	7.0	8.0	5.0	5.0	6.0	(8.6)	(3.2)
Gross domestic investment (% of GDP)	22.5	22.1	21.6	21.0	20.7	19.1	22.3
Gross domestic savings (% of GDP)	14.8	14.6	15.1	15.0	11.1	12.0	20.2
Real exports (% change)	6.2	7.5	6.0	4.0	(2.5)	(15.7)	19.0
Unemployment rate (ILO definition)	31.5	33.0	34.0	36.7	31.9	30.5	32.2
Consumer price index (% change)	2.5	1.5	0.5	1.2	1.8	5.2	5.8
Domestic credit to private sector and NFPEs (% change)	14.9	14.9	14.5	14.2	4.8	(1.8)	(2.7)
(% of GDP)							
Domestic credit to private sector and NFPEs	25.4	23.5	21.7	19.8	18.0	17.9	18.1
Current account balance	(7.7)	(7.5)	(6.5)	(6.0)	(9.5)	(7.1)	(2.0)
Net foreign direct investment	2.5	2.5	2.3	2.0	2.0	12.8	4.9

DEN—Macedonian denar. ILO—International Labor Organization. NFPE—Nonfinancial public enterprise. f—Forecast. E—Estimate.

Economic structure.

Macedonia is a small, open economy. Its landlocked position means that it is dependent on good relations with its neighbors. This is particularly true because, aside from Germany, Macedonia's main trading partners are Greece and the Union of Serbia and Montenegro, between them accounting for one-third of exports and almost one-quarter of imports in 2003.

Levels of wealth in Macedonia are broadly in line with those in the region. At an estimated $2,680, GDP per capita in 2004 exceeds that of Albania and Serbia and Montenegro, but is below the levels in Bulgaria and Greece. Like much of the economic data on Macedonia, however, this figure has to be treated with caution. First, statistical data on the country remains unreliable, and second, an extensive shadow economy, estimated to account for up to one-third of GDP, also tends to undermine the accuracy of economic data.

Prudent macroeconomic policies, supported by successive programs with the IMF, have helped maintain relative macroeconomic stability, particularly when taking into account the number and extent of shocks hitting the economy. The current stand-by agreement with the Fund ran out in August, and a new agreement looks likely to be arranged early next year.

Levels of unemployment in Macedonia have historically been very high, at 36.7% in 2003. This figure most probably overstates the true extent of unemployment by as much as one-half, however, due to the shadow economy, to current incentives to register as unemployed in order to receive health insurance benefits, and to statistical problems. Unemployment has been increasing rapidly in recent years, rising by 6.2 percentage points between 2001 and 2003. The majority of this increase was due to the liquidation of the largest loss-making public enterprises, which was concluded in 2003. Since then, the rise in unemployment has eventually come to a halt, and unemployment is now forecast to start declining again, to reach about 31.5% in 2006.

High levels of unemployment reflect not only a high tax wedge on labor, inflexible labor markets, and the structural problems of the formal sector, but also an unfavorable business climate. Obstacles to investment include low domestic savings (at about 14% of GDP in 2003), corruption and weak governance, and administrative hurdles. Also detrimental to the investment climate was the privatization process, where the large majority of the approximately 1,700 public enterprises privatized since independence was sold to insiders through management and employees buyouts. This approach gave rise to poor governance and corruption, delayed the necessary restructuring of the enterprises, and kept foreign capital out.

Economic growth.

After a marked contraction in GDP following the security crisis in 2001, growth has slowly recovered and is forecast to reach its potential rate of about 4.0% in 2005. This growth is set to come partly from gradually increasing investment, as political risk continues to recede and the country's ties strengthen both with neighbors in the region and with the EU. To increase its growth potential to the levels enjoyed by peers in the 'BB' rating category, however, the important impediments to further investment and growth, as mentioned above, need to be addressed.

Fiscal Flexibility

- Deficits have recovered from the 2001/2002 peaks, and are forecast to remain at about 1.5% of GDP.
- General government debt continues to be on a declining trend, to reach 41.4% of GDP in 2006.
- Inflexibilities are high, particularly on the expenditure side of the budget, and although the government is committed to restructuring both the revenue and expenditure sides, progress is moderate at best.
- Social security systems, especially health care and pensions, are in need of restructuring, and reform efforts are being made in both areas.

Table 3

Republic of Macedonia Fiscal Indicators

(% of GDP)	2006f	2005f	2004e	2003	2002	2001	2000
General government debt	41.4	43.4	45.4	46.6	47.7	51.6	53.2
General government net debt	36.6	38.2	39.9	40.2	38.3	31.7	43.3
Central government debt	33.3	34.9	36.5	37.6	42.0	47.8	46.5
Central government net debt	28.5	29.8	31.1	31.2	32.6	27.9	36.6
General government revenues	31.3	32.1	33.0	33.2	34.9	34.0	36.2
Of which central government	19.5	20.0	20.8	21.3	23.5	22.2	24.5
General government expenditure	32.5	33.5	34.5	34.8	40.5	41.1	34.4
Of which central government	20.6	21.1	21.7	22.2	28.8	28.0	21.8
General government balance	(1.2)	(1.3)	(1.5)	(1.6)	(5.6)	(7.2)	1.8

Table 3

Republic of Macedonia Fiscal Indicators (cont.'d)							
(% of GDP)	**2006f**	**2005f**	**2004e**	**2003**	**2002**	**2001**	**2000**
Of which central government	(1.1)	(1.0)	(0.9)	(0.9)	(5.3)	(5.8)	2.7
Of which local authorities	0.0	0.0	0.0	0.1	0.1	0.8	0.0
General government primary balance	(0.1)	(0.2)	(0.3)	(0.5)	(4.2)	(5.3)	3.5
General government interest payments (% of revenues)	3.4	3.4	3.7	3.2	4.2	5.5	4.9

f—Forecast. e—Estimate.

Revenue, expenditure, and balance performance.

The general government deficit fell to 1.6% of GDP in 2003, from an average deficit exceeding 6.0% in 2001-2002, related to the security crisis in 2001 and the general election in 2002. Expenditures in 2003 fell by 10.7% of GDP compared with 2002, as spending normalized again and security-related outlays, which amounted to a maximum of 5.9% of GDP in 2001, petered out. The 2003 central government deficit, at 0.9% of GDP, was also slightly lower than projections, as well as the 1.4% target agreed with the IMF, mainly due to a 20.0% shortfall in capital spending. General government deficits are forecast to remain moderate, between 1.0% and 1.5% of GDP until 2006. If grants to the government are included as revenues, the budget will even be broadly balanced.

The government is committed to restructuring both the revenue and the expenditure sides of the budget, although progress is slow in certain areas. On the revenue side, the introduction of VAT in 2000, and the reduction of personal income tax in 2001, have led to a better structure of revenues. Flexibility on the expenditure side is limited, with wages and transfers accounting for 87% of all general government expenditures. The government has committed itself to cutting the wage bill by 4% in 2004, but a sustainable reduction in the wage bill will be difficult, as the government has also decided to decompress wages in the public sector, which had been frozen since 1997. Also, increased representation of minorities in the public administration in the coming years, as laid out in the Framework Agreement, will put additional pressure on the wage bill.

Recent constitutional reforms will also presage a devolution of responsibilities from central to local government, starting later in 2005, following the local elections in the first half of 2005. In the process, about 20% of the central government budget will eventually be transferred to the local government level, which is fiscally insignificant at present. This change will see both revenue and expenditure flexibility increase at the local government level.

Systems of social security are in need of reform, and the high contributions (at 32% of gross wages), which are entirely paid by employers, aggravate the large tax wedge on labor. Arrears in health insurance amounted to Macedonian denar (DEN) 1.7 billion ($35.6 million; 0.6% of GDP) at the end of July 2004, on a declining trend. The health insurance system is characterized by inefficiencies and governance problems. Health insurance contributions are not levied on individual wages, but instead on industry-wide average wages. Reform of the system has now been initiated, in cooperation with the International Bank for Reconstruction and Development (World Bank; AAA/Stable/A-1+).

The pension system is characterized by unsustainable levels of benefits, with the replacement rate relative to average wages earned reaching up to 80%, and the ratio of contributors to beneficiaries currently at 1.3x. Recent pension reform is set to reduce the replacement rate over the next 10 years to 72% and will also lift the retirement age for women to 62 years from 60.5 years. A privately managed, fully funded second pension pillar is to be introduced in mid-2005, which will receive one-third of pension contributions and will be mandatory for entrants to the labor market from January 2003 onward. The cost of the pension reform is estimated to reach DEN1.1 billion (0.3% of GDP) in 2007.

Government debt and interest burden.

The level of general government debt has remained moderate and on a declining trend. This trend was enabled by sizable privatization receipts of $318 million (8.7% of GDP)—mainly from the sale of Macedonian Telecommunications, which started in 1999—as well as by foreign grants that continue to help finance part of the budget deficit. Gross general government debt has declined to 46.6% of GDP in 2003, from 57.4% in 1999, and is forecast to decline further to 41.4% in 2006. Similarly, net general government debt has been declining and is to reach about 36.6% in 2006. General government interest is low, at 3.2% of revenues in 2003, mainly reflecting the relatively favorable structure and cost of government debt, which to a large extent is owed to bilateral and multilateral lenders.

With a view to shifting the structure of government debt more toward local currency debt, and to promote the development of domestic capital markets, the government has started issuing Treasury-bills in 2004. Maturities initially started at three months and are going to be extended gradually to 12 months by 2005.

Off-budget and contingent liabilities.

The stock of government guarantees is negligible, amounting to just $1.4 million in 2003, less than 0.1% of GDP. In March 2004, external debt of public enterprises amounted to $162.2 million, or 2.9% of GDP, to which should be added another 0.2% of GDP of domestic debt with deposit money banks. Lending by Macedonian Bank for Development Promotion (MBDP), the only remaining public sector financial institution, is negligible, at 0.5% of GDP.

Macedonia's banking system poses a moderate contingent liability to the government, due to the relatively low level of financial intermediation (domestic credit stood at 19.8% in 2003), as well as to the significantly improved structure of the system. The system is largely privatized, with 91.4% of all capital held privately (not including MBDP), and the share of foreign capital amounts to 47.2%. Levels of gross nonperforming loans (Macedonian risk categories C, D, and E) are moderate, at 15.1% of total loans in 2003, mainly representing a burden of the turbulent past. The profitability of the banking system is moderate, with return on average equity at 2.3% in 2003.

The banking system has been overhauled and banking regulation and supervision have been improving in recent years. The general approach to lending is conservative and interest spreads are high. Credit growth has picked up in 2003, to reach 14.2%, but domestic credit as a proportion of GDP is still below its 1999 level. Excess liquidity in the system is high and deposits (67.0% of assets in 2003) significantly exceed loans (35.4%), providing ample space for loan growth. At the end of 2003, average levels of capital adequacy stood at 25.8% for the banking system as a whole, and at 16.4% for the four largest banks.

Monetary Policy

- The fixed exchange rate vis-à-vis the euro serves as an effective nominal anchor. Ever since its introduction in 1995, inflation has been consistently low, reaching 1.2% in 2003.
- The use of the euro in the economy is high, at 53% of all deposits.

The fixed exchange rate of the Macedonian denar vis-à-vis the euro (previously the German mark) has been a successful nominal anchor since 1995, with one discrete devaluation in 1997. The

National Bank of the Republic of Macedonia (NBRM) operates a largely rule-based exchange rate regime, with a view to keeping foreign exchange reserves at a minimum of 4.0 months of import coverage. Reserves stood at 4.3 months import coverage at the end of 2003.

The exchange rate regime successfully ended hyperinflation after independence, and since 1995, inflation rates have been consistently in the low single-digit range, even in the crisis years. Inflation in 2003, at 1.2%, was lower than expected, mainly due to falls in the prices for foods, which carry a relatively large weight in the price index.

Euro usage is prevalent in the Macedonian economy, and 64% of all deposits were denominated in foreign currency—mostly euros—at the end of 2003. This follows the negative experience of many Macedonians with hyperinflation after independence, and with the collapse of extensive financial pyramid schemes in 1997.

External Finances

- Despite high current account deficits, external liquidity requirements will increase but remain moderate, at just below 100% of usable reserves until 2006.
- The financial sector is a net external creditor.
- The public and the private non-financial sectors are moderate external debtors.

Table 4

Republic of Macedonia External Indicators

(% of CARs)	2006f	2005f	2004e	2003	2002	2001	2000
Current account balance	(15.9)	(15.7)	(13.7)	(11.6)	(18.5)	(13.3)	(3.1)
Total external debt	89.7	87.8	83.7	76.0	82.6	82.3	64.2
Net external debt	27.5	24.4	20.0	11.8	13.2	3.5	25.5
Net public sector external debt	32.8	33.8	33.4	30.7	36.7	45.3	42.8
Net nonbank private sector external debt	9.6	8.9	7.7	6.3	5.9	5.7	3.2
Net banking sector external debt	(5.8)	(8.9)	(11.5)	(15.1)	(19.8)	(25.4)	(9.5)
Usable foreign reserves*/imports (months)	3.1	3.1	3.1	3.2	3.2	3.2	1.6
Gross external financing requirement (% of usable foreign reserves*)	99.9	96.4	86.4	73.3	100.9	82.9	74.0

*Excluding government and commercial bank foreign currency deposits with the National Bank of the Republic of Macedonia. CARs—Current account receipts. f—Forecast. e—Estimate.

In 2003, the current account deficit recorded 6.0% of GDP, against an average of 8.3% in 2001-2002. In the medium term, the current account deficit is forecast to return to levels of about 7.0% of GDP. Net foreign direct investment, which averaged 2.0% of GDP in 2002 and 2003, is unlikely to increase its share in the current account financing significantly. The privatization process has largely been concluded and investor attitudes toward the country are unlikely to change dramatically, despite the reduced political risk.

Transfers take significant pressure off the balance-of-payments. Although net official transfers have contributed an average of 2.4% of GDP to the balance-of-payments between 1999 and 2003, private transfers—consisting of remittances as well as cash exchange profits (effectively unrecorded exports)—amounted to an average 10.8% of GDP over the same period.

Despite relatively high current account deficits, the external liquidity requirement remains moderate, due to the only moderate level and the favorable structure of external debt. In the medium term, the gross external financing requirement as a percentage of usable foreign exchange reserves will broadly stay around the long-term 1998-2003 average of 87%.

Public and private sector external debt.

Levels of external debt are moderate in Macedonia. Public sector net external debt is to remain broadly at its current levels, slightly above 30% of CARs. The financial sector is a net external creditor, although on a slightly declining trend, to reach net external assets of 6% of CARs in 2006, down from 15% in 2003. The nonfinancial private sector is only a moderate debtor, with net external debt remaining below 10% of CARs in the forecast period.

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