International Monetary Fund

Former Yugoslav Republic of Macedonia and the IMF

Press Release:
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September 1, 2005

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Former Yugoslav Republic of Macedonia: Letter of Intent, Memorandum of Economic and Financial Policies and Technical Memorandum of Understanding

August 16, 2005

The following item is a Letter of Intent of the government of Former Yugoslav Republic of Macedonia, which describes the policies that Former Yugoslav Republic of Macedonia intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Former Yugoslav Republic of Macedonia, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Skopje, August 16, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, DC 20431
U.S.A.

Dear Mr. de Rato,

The attached Memorandum of Economic and Financial Policies for 2005–08 (MEFP) describes a 3-year economic program that aims to increase growth and employment, reduce external imbalances, and secure macroeconomic stability. The associated Technical Memorandum of Understanding (TMU) describes the methods to be used in assessing program performance.

In support of the program we request a 36-month Stand-By Arrangement in an amount of SDR 51.675 million, equivalent to 75 percent of quota. The prior actions for the approval of the arrangement listed in Table 2 of the MEFP have been implemented.

We intend to make the first purchase that would become available upon the approval of the new arrangement. However, should macroeconomic conditions and balance of payments financing turn out to be in line with the program's baseline assumptions, or be more favorable, we will forgo further purchases and treat the remaining access as precautionary.

To smooth our debt service profile, we also request that the repurchase expectations falling due before end-September 2006 be extended to an obligations basis.

We believe that the policies set forth in the attached MEFP are adequate to achieve the objectives of our program but we will take any further measures that may become appropriate for this purpose. We will consult with the Fund on the adoption of such measures and in advance of any revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultations.

Sincerely,

/s/
Vlado Bučkovski
Prime Minister

/s/
Nikola Popovski
Minister of Finance

/s/
Petar Gošev
Governor
National Bank of the Republic of Macedonia

Attachments (2)

FYR Macedonia
Memorandum on Economic and Financial Policies

I. Introduction

1. **This memorandum describes the 2005-08 economic program which we are asking the International Monetary Fund (IMF) to support under a three-year Stand-By Arrangement (SBA).**

2. **A number of accomplishments during the last few years set the stage for a new arrangement.** On the macroeconomic front, the main objective of the previous SBA—a return to a sustainable fiscal position after the security crisis in 2001—has been attained. Macroeconomic stability is now firmly entrenched; inflationary pressures remain subdued, and growth, while still below potential, has begun to pick up. There has also been progress on the political agenda. Key components of the Framework Agreement—territorial reorganization and fiscal decentralization—are moving ahead and the representation of non-majority communities in state organs has increased. Furthermore, Macedonia has applied for candidacy to the European Union. For 2006, we expect an invitation for membership in NATO. These developments have contributed to positive reviews (BB+/B local currency, BB/B foreign currency) by a major international credit rating agency (Standard and Poor's).

3. **At the same time, relatively slow growth and a persistently wide current account deficit underline the need for structural reforms to complement our already prudent macroeconomic posture.** As noted in the IMF's ex-post assessment (EPA), Macedonia's growth and employment have been weaker than in other transition economies—including countries that also experienced conflict-related turbulence. And the current account deficit is still at a level that raises concerns regarding competitiveness. Business climate surveys consistently indicate that deficiencies in the public sector, limited results in the fight against corruption, an inefficient and non-transparent judicial system, and limited policy predictability have impeded private sector development. Moreover, outside a few large privatizations, foreign direct investment has been slow to materialize. Against this background, a main objective of our program is to improve the business climate by increasing the flexibility of the labor market, raising the efficiency of the judicial system, and improving public sector governance and efficiency. These measures will be supported by continued prudent fiscal and monetary policies.

4. **We anticipate that structural reforms and macroeconomic stability will enhance external competitiveness and accelerate growth**. We expect that the growth rate of real GDP will rise to about 4.5 percent per year on average during 2005-08, with inflation rising from its current exceptionally low level to about 2 percent. The external current account deficit (excluding official grants), which one-time factors raised to an exceptional 9.4 percent of GDP in 2004, is expected to fall by 1½ percentage points in 2005 as these temporary factors unwind, and further to about 6 percent of GDP as structural reforms strengthen competitiveness.

II. Economic and Financial Policies

A. Medium Term Issues

5. **Our financial program (see Table 1) aims to manage the passage from dependence on official balance of payments support to reliance on market financing while maintaining the fixed exchange rate that has anchored inflation in the past.** This task is made more difficult by a number of factors. First, in view of our dependence on a narrow and volatile export base and the prospect of increased exposure to capital markets, a key program objective is to increase gross international reserves from three months to four months of import cover. Second, budget financing is made more difficult by declining balance of payments support at a time when our capacity to raise domestic finance is still not well developed. And, third, we need to amortize large volumes of foreign exchange indexed debt to residents—debt that compensates for expropriations that took place prior to independence.

6. **Our financial strategy has three main elements.** First, to keep the financing need manageable, we will keep the fiscal deficit at levels (0.8 percent of GDP in 2005 and 0.6 percent thereafter—approval of a 2006 budget in line with this ceiling is a performance criterion under the program) that are well below the threshold of debt sustainability. Second, to make it possible to increase international reserves, we will accelerate our sales of state assets, including through major privatizations. And, third, we are developing our capacity to borrow on commercial terms both domestically and abroad. The IMF arrangement that we are seeking will provide an additional cushion. However, if privatization inflows are in line with our (conservative) projections, we will not need to draw on the IMF after the initial purchase.

7. **In the fiscal area, our medium term strategy includes strengthening tax collection, and improving public resource management.** In the tax area we intend to broaden the tax base and we will harmonize the bases and unify the collection of the personal income tax and social contributions (¶ 36). In the expenditure area, we plan to keep wages and hiring under strict control in order to ensure that the share of salaries in tax revenues does not rise above the level in the 2005 supplementary budget.[1] Additional hiring needs, including those arising from reforms and from our policy of ensuring equitable representation of ethnic communities, will be accommodated through natural attrition and improved allocation of existing human resources in line with the medium term strategy of human resource management defined below (¶ 41).

8. **Our privatization program is ambitious, extending to the electricity sector, telecommunications, banks and rental property among others.** On electricity, the details

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[1] Once fiscal decentralization moves to its second phase, transfers earmarked for municipal salaries will be included in this ratio.

of a partial privatization of Electricity power company of Macedonia (ESM) are still being finalized with support from the EBRD, which is participating in the pre-privatization process, and the World Bank, which is providing an assessment of the regulatory implications. We intend to sell the distribution in the first quarter of 2006 (structural performance criterion) and part or all of our generating capacity in 2007, following further study of the regulatory implications of privatizing hydroelectric capacity. We will sell our residual shares in the telecommunication sector by mid-2006 (structural performance criterion). In addition, we will start tendering our equity in commercial banks by end-2005 (except Postal Bank and the Macedonian Bank for Development Promotion)(structural benchmark) and will sell the public company holding the state's rental property in 2007.

9. **In developing our capacity to borrow commercially we will focus on the medium-term task of strengthening the infant treasury market while relying on external borrowing.** The positive reviews of credit rating agencies have put Macedonia on the map for institutional investors. With the issuance of our first Eurobond we will generate resources to lengthen the maturity of our foreign debt and cushion the decline in official financing. At the same time, we will press ahead with the development of the domestic treasury market in order to limit our dependence on international capital markets. (¶ 23).

B. Fiscal and Monetary Policies for 2005

10. **The 2005 supplementary budget tightens our fiscal stance in order to contain a large fiscal impulse and limit the need for central bank finance.** The government has adopted a supplementary budget (prior action) with a central government deficit of 0.8 percent of GDP including transfers to recapitalize the NBRM and 0.4 percent excluding these transfers, which create no fiscal impulse. This represents an adjustment of 0.8 percent of GDP compared with the original 2005 budget. Stronger than anticipated tax and non-tax revenues account for around 2/3 of the adjustment; the rest will be achieved by net expenditure savings and cuts. At the same time, some spending pressures (notably the need to bring the wages of appointed and elected officials in line with those of senior civil servants) will be accommodated through reallocations of expenditures.

11. **The NBRM will adopt a monetary stance that, combined with the tight supplementary budget and expected inflows from abroad, will allow for a modest increase in the underlying reserve cover in 2005.** Gross reserves are expected to reach 3.6 months of import cover (up from 3 months at end-2004) but most of the increase is made up of the proceeds of the Eurobond issue planned for late 2005, which will be used to restructure foreign debt in early 2006. (Excluding the debt restructuring, reserves will rise to only 3.1 months of import cover in 2005 but will reach 4 months in 2006, once the projected privatization proceeds have been received). Broad money is expected to grow in line with recent trends in velocity while the degree of euroization is expected to remain unchanged, reflecting the stabilization of currency preferences in 2004. Credit to the private sector is expected to increase by 23 percent, boosted by banks' lending some foreign currency deposits rather than investing them abroad. We project that these trends, combined with limits on credit to the government, should allow us to meet the reserve target without raising

the interest rate. However, if necessary, the NBRM stands ready to use all available monetary instruments, including a further increase in the interest rate.

III. BUSINESS ENVIRONMENT

12. **An important goal of our program is to strengthen the business environment, allowing Macedonian enterprises to compete more successfully in increasingly global markets.** The main weaknesses in the business climate are a rigid labor market, the judicial sector's limited expertise in commercial law, a limited ability to attract strategic investors for state-owned enterprises, and the failure of newly privatized firms to restructure or innovate. The measures outlined in this MEFP will be complemented by a new World Bank Business Environment Reform and Institutional Strengthening Project. They will stimulate economic growth based on increased domestic and foreign investment by strengthening the public sector capacity to improve selected areas of the business environment and increase competitiveness of the business sector.

A. Labor Market Reform

13. **The high rate of measured unemployment is a reflection of rigid labor market institutions and legislation.** High hiring and firing costs, restrictive work place regulations, generous mandated benefits, and ineffective mechanisms for settling disputes, have combined to limit opportunities for investment and job creation. At the same time, workers are frequently left unprotected in a system where labor contracts are not respected or enforced. This environment has eroded confidence in labor contracts and led to wage and contribution arrears, recurrent employment violations, and a large informal economy.

14. **Therefore, as a prior action under the program we have enacted new labor legislation which strikes a better balance between the protection of workers' rights and the needs of employers.** The new Law on Labor Relations, which was enacted in July this year, is a broad based and extensive overhaul of previous legislation and the system of collective agreements. In particular:

- Under the new law, collective agreements, including at the general and branch level, will be binding only for signatories and members of signatory associations and trade unions, and will be effective for a fixed term, set at 2 years;
- Barriers to fixed-term, temporary, and part-time contracts have been removed;
- The rules for overtime have been clarified and liberalized (under the new law, only a weekly overtime limit of 10 hours and an annual limit of 190 hours applies);
- Redundancy procedures have been streamlined and the scope for legal challenge reduced by eliminating the need to establish the existence of a "technological surplus" and by abolishing the requirement to revise the organizational chart of a company;

- Maximum severance payments have been reduced from 8 to 6 monthly salaries.
- The employers' obligation to pay a sick leave allowance has been reduced from 60 to 30 days. Additional costs arising from this measure for the HIF are covered by tightening conditions for the allowance and reducing its size which will be reflected in amendments in the Law on Health Insurance by September 2005.

In order to ensure that provisions of the new Law on Labor Relations become effective rapidly we will amend the Law on the Chamber of Commerce by end-2005 to allow employers to review their membership of the Chamber prior to the negotiation of new collective agreements (structural benchmark).

B. Judicial Reform

15. **Judicial reform will play a key role in facilitating investment and accelerating private sector-led growth.** In November 2004 the Government adopted a comprehensive strategy for legal and judicial reform and an action plan for its implementation. The goal of the strategy is to put in place an efficient justice system, based on European legal standards, that can support a market economy. While judicial reform will take several years to complete, we have begun to move forcefully: a number of key measures will be implemented within the next twelve months.

16. **An immediate objective is to reduce delays and strengthen the enforcement of court decisions.** Since delays are one of the main problems of Macedonian courts, we have recently (June 2005) adopted a new Law on Civil Procedures (or Law on Litigation) which should accelerate the resolution of cases by imposing stricter deadlines and sanctions for delays. And, to improve enforcement of court decisions, we have recently adopted a new Law on Enforcement that moves the enforcement of court decisions from the courts to independent specialized agents. We will use the 9-month transitional period before this law becomes effective to develop and adopt the necessary regulations and licensing procedures, train new enforcement agents, and educate the general public. We expect that the new enforcement system will start functioning in April 2006.

17. **Another overarching objective of judicial reform is to strengthen the independence and professionalism of the judiciary.** We plan to reform the selection, appointment and promotion of judges and prosecutors and make career development merit-based. By end-March 2006, we will amend key laws—notably the Law on Courts and the Law on the Judicial Council—to make the new system of judicial appointments operational. These legislative changes require Constitutional amendments, which will be completed by end-2005.

18. **We will also establish a training institution for judges and prosecutors.** Completion of a training course in the school will be a requirement for all new judicial appointments. We will adopt the law on the establishment of the school by end-November

2005 and will make the school operational in January 2006. The curriculum will include business economics and commercial law.

19. **The court reforms will also allow more efficient handling of administrative and misdemeanor cases (structural benchmark).** By end-July 2006 we will amend the Law on Misdemeanors to allow public institutions, such as the NBRM, the PRO, customs administration and others to impose sanctions for misdemeanors without prior court approval.

20. **Finally, as the reform moves ahead, we will improve the allocation of human and financial resources to the judicial sector.** In 2003, we increased the independence of the judiciary by passing the Law on Court Budget, which created a separate court budget and Court Budget Council to administer the budgetary process. By mid-2005, we will provide additional staff to the administrative body of the Council. With the help of USAID, we will prepare a preliminary report on the financial costs of the judicial reform and complete a human resource needs assessment for the court administration and police for the 2006 budget (structural benchmark). We will also, by end-2006, complete—with the help of the European Agency for Reconstruction (EAR)—the process of introducing a new IT system in the judicial system.

C. Other Measures to Improve the Business Climate

21. **We will take the following measures to reduce obstacles to investment and improve corporate governance:**

- In order to ease the *entry of new companies* we will lighten procedures by concentrating all aspects of company registration at the Central Registry. Company registration will be moved from courts to the Central Registry by September 2005 and documentation requirements will be streamlined. By end-2005, the Central Registry and the PRO will agree on a procedure for the issuance of registration numbers that meets the administrative requirements of the PRO but also integrates the issuance of registration numbers at the Central Registry (structural benchmark).

- We will *limit the number of licenses and streamline licensing procedures* (thus reducing delays and the scope for corruption) in line with the WB's FIAS project.

- We will press ahead with a project (supported by the World Bank and USAID) to set up a reliable *cadastre* which will be finalized no later than 2009.

- In order to *improve corporate governance* we will adopt by September 2005 a new Law on Audit that defines conditions for the audit of entities that perform activities in Macedonia. We have also made International Audit Standards binding and have published these standards in Macedonian. The establishment (by March-2006) of a self-governing institute for the qualification and certification of auditors will complete the public institution building process in this area.

- Finally, *exit procedures will be clarified and streamlined*. By end-2005, bankruptcy procedures will be improved and accelerated with a planned revision of the Bankruptcy Law that strengthens creditors' rights and clarifies the role and the required qualifications of bankruptcy trustees (structural benchmark).

We intend to use the findings of the June 2005 corporate ROSC as a basis for developing and implementing further measures to improve the business environment.

IV. Financial Sector Strengthening

A. Central Bank Independence

22. **The government will safeguard the independence of the NBRM by bolstering its capital base and establishing a framework that will allow it to maintain a sufficient financial cushion over the medium term.** The 2005 supplementary budget will restore the NBRM's capital to the level required by the central bank law through the issuance of marketable fixed income treasury securities paying interest on market-related terms. In addition, to make an up-front injection of reserve capital, the government will provide the NBRM with another 500 million denars of fixed income marketable government securities or cash. Later in 2005, in order to bolster the NBRM's ability to maintain a financial cushion, we will submit to parliament amendments to the central bank law to allow the NBRM to retain a large share of profits when general reserves are below a defined threshold and a smaller share when they are above the threshold. Passage of these amendments by parliament is a structural benchmark for the second review.

B. Developing Financial Markets

23. **In order to develop the market for treasury securities—which started operations in 2004—we are promoting secondary trading and the introduction of repurchase agreements.** As a startup measure, the central securities depository and the NBRM have provided settlement and clearing services free of charge since April 2005. And, to enhance competition and increase transparency, information on securities prices was integrated with an electronic trading platform available to commercial banks in July 2005. Looking ahead, the NBRM and the Ministry of Finance will set the criteria for choosing market makers and sign a market maker agreement with major participants by end March 2006. The Ministry of Finance has carried out an educational campaign for banks and large non-bank treasury market participants on primary issuance as well as secondary treasury bill trading. Finally, to support the switch to open market operations in treasury bills, the NBRM has finalized all legal and accounting requirements for introducing repurchase agreements for banks and will start using repos for monetary interventions by end-September 2005 (structural benchmark). To this end, we are looking forward to IMF technical assistance (in July) on issues concerning repo transactions.

24. **The range of instruments for implementing monetary policy will be widened.** We will take steps to reduce, and eventually end, the NBRM's reliance on central bank bills to absorb structural excess liquidity in the banking system. To that end, in the fall of 2005 the government and the NBRM will jointly present a plan to allow for the use of treasury bills for monetary policy purposes without creating an additional interest burden for the government budget (structural benchmark). Before that, and as a first step, the NBRM will start repo transactions with treasury securities obtained through the recapitalization operation. In addition, the NBRM will consider introducing a low-interest deposit facility, which will complete the interest rate corridor, thus providing a guide for market expectations of interest rates.

25. **The NBRM has also taken an active role in developing an inter-bank foreign exchange market.** The lack of real time information on transactions has limited the development of the market, resulting in large bid-ask spreads and an over-reliance on NBRM intervention. To address this problem, the NBRM has recently (June 2005) implemented an electronic system that provides electronic trading services and real time information on trades in foreign exchange. The NBRM has also signed a market maker agreement with the major participants in the foreign exchange market. The agreement sets limits on quote spreads and stipulates that the NBRM will deal only with these market makers.

26. **The NBRM will continue to improve the management of foreign exchange reserves.** Since most of the NBRM's assets are in foreign reserves, its profitability depends heavily on income from these assets. In December 2004, the NBRM adopted new rules and investment guidelines—including the creation of an investment committee—on foreign exchange reserve management. Drawing on recent IMF technical assistance, the NBRM plans to improve the guidelines on the currency composition of reserves, the management of the benchmark portfolio and its intended maturities. The revised guidelines will come into effect in October 2005.

C. Banking and Financial Sector Reforms

27. **The NBRM and the government will take steps to improve the soundness of the banking system.** By end-2005, the Banking Law will be amended to: (i) improve governance by empowering the NBRM to revoke its approvals of bank shareholders no longer fulfilling the fit and proper criteria; (ii) improve the efficiency of the receivership process and tighten the criteria for bankruptcy trustees; (iii) Increase the minimum capital requirement for establishing a bank from Euro 3.5 million to Euro 5 million; (iv) harmonize the Banking Law with the Law on Trade Companies; (v) improve the provisions on banks' governance in line with the upcoming World Bank Corporate Governance Report; and (vi) introduce provisions for consumer protection. In order to strengthen credibility and accountability of the NBRM's supervision activities, we will prepare by end-2005 a Supervisory Development Plan for risk-based supervision based on a World Bank diagnostic mission in July 2005. Since strengthening of the financial sector is a core element of the program, the amendment of the Banking Law is a prior action for the second review, the development of the Supervisory Development Plan a structural benchmark.

28. **The NBRM will strengthen its capacity to assess and supervise credit, particularly foreign currency credit, and will provide appropriate credit-related information to the public on a regular basis.** The supervision department has recently amended its manuals and regulations in order to ensure that banks' credit files contain the information needed to assess foreign exchange-induced credit risk. Prudential regulations will be revised and strengthened in order to limit exchange rate risk by end-2005. If necessary, follow up conditionality could become part of the second review. The revisions will draw on the recommendations of an upcoming IMF technical assistance mission on credit growth. In addition, from September 1, 2005 the NBRM will collect and publish more detailed interest rate and credit information in order to better follow credit developments. The publication will include an analysis of developments in loans indexed to or denominated in foreign exchange (in line with the publication in the 2004 annual report). Also by September 1, 2005, the NBRM will publish quarterly information on banks' soundness indicators.

29. **While credit growth has picked up, financial intermediation is still inefficient.** The disincentives to bank lending include the high level of non-performing loans, weak contract enforcement, poor accounting, and limited information on credit performance. To strengthen bank intermediation, the NBRM and the government will: (i) enhance the information content of the NBRM's credit register, make financial and other data accessible for banks, and link the register with the central registry (by end-2006); (ii) issue accounting guidelines, a chart of accounts and formats for financial statements of banks in line with IAS based on the findings of the World Bank's REPARIS program and the work of the national steering committee on accounting and auditing by mid-2006; (iii) implement the law on data in Electronic Form, and E-Signature by end-2005.

30. **Also, by end-2005, the Law on Payment Operations and the law on the NBRM will be amended in order to remove anomalies and clarify the NBRM's competencies.** In line with the recommendations of the FSAP mission and IMF Technical Assistance mission, the Law on Payment Operations will be amended to: (i) remove provisions that allow holders of guarantees and bills of exchange to issue payment orders against the issuer's bank account; (ii) move procedural and operational issues from the law to manuals. In addition, by end-2005 we will submit to Parliament amendments to the Law on the NBRM to define more precisely its competences and actions, streamline the process for resolving appeals against the decisions and corrective measures that the NBRM imposes on banks.

V. Public Sector Reforms

A. Budget Procedures and Transparency

31. **We have made important strides in strengthening the transparency of the budget process.** Our recent introduction of program budgeting has clarified expenditure plans and laid the basis for better informed parliamentary debate. For the 2005 budget cycle, a number of reforms were enacted: (i) appropriations were incorporated according to budget

programs, (ii) the content of the government's fiscal strategy paper was improved, (iii) line ministries were required to identify budget managers at each ministry, and (iv) expenditure limits were set early in the budgetary process. A side effect of the new budgetary process has been an increased emphasis on training.

32. **We now plan to take additional steps to improve budget planning and execution, as well as fiscal transparency.** We will implement the following key measures:

- In July 2005 we will pass a new Budget Law that clarifies the procedures for preparation, adoption and execution of the budget. The new law will increase transparency by requiring the Ministry of Finance to prepare a mid-year budget report on both an economic and functional basis—with updated forecasts for the rest of the year. This report will be published on the Ministry of Finance's website.

- Starting with the 2006 budget, budget documents presented to Parliament will include a medium term fiscal framework (strategy) which will be used to assess medium-term policies, including public sector wages, employment, taxation, and spending priorities.

- During the 2006 budget process, budget management will be strengthened in key ministries—e.g., Agriculture, Education, Health, Justice and Transportation—through added training of the ministry staffs.

- The Ministry of Finance will continue to move toward GFS-consistent definitions in fiscal planning and reporting. Starting with the 2006 budget, the Ministry of Finance will use new GFS-consistent definitions, including local government budgets. Once the reporting framework for local governments has been established, the program will set fiscal targets at the general government level. In order to enhance transparency in the government's on-lending activities, the Ministry of Finance, with support from the NBRM's APEX unit database, will prepare, by June-2006, a report on on-lending by the central government to other government units and to the private sector (structural benchmark). Based on the findings of this report, steps will be taken to incorporate on-lending in the budget.

33. **Public debt management and reporting will be strengthened**. A fully staffed Public Debt Management Department has been created within the Ministry of Finance and has begun preparing a medium-term debt management strategy. Debt management software that meets specifications recommended by EAR and the IMF, will be selected by mid-2006. A public debt law was passed in July 2005 and a medium-term debt strategy will be submitted to parliament with the 2006 budget, including information on public debt sustainability, fiscal risks and the government's contingent liabilities. Fiscal transparency will be further enhanced through regular publication and analysis of statistics on public debt that will commence before end-2006. In line with program conditionality, we will limit non-concessional debt to the limits spelled out in Table 1 and will not accumulate any public external arrears.

B. Tax Policy and Administration

34. **In order to offset revenue losses caused by the ongoing trade liberalization required by the WTO agreement, we plan to broaden the revenue base, including by cutting back tax incentive schemes.** The loss of revenues caused by corporate tax incentives is estimated at around 1 billion denar per annum. The current revision of the corporate income tax law aims at eliminating incentives accounting for at least half of these losses by end-2005, but due to grandfathering rules revenues will only react starting in 2007. In addition, no new free economic zone privileges will be granted and the existing ones will not be renewed. We will also broaden the personal income tax base by further measures to be defined in more detail at the time of the first review. A new tax will be levied in order to protect the environment, but with little impact on revenues.

35. **We plan to implement a comprehensive reform of tax administration in line with FAD recommendations.** A new Law on Tax Administration Procedures was approved by government in July 2005 and will be passed by Parliament by end-2005 to expand taxpayers' protections and broaden the PRO's authorities. This will allow the PRO to impose penalties and seize assets without requiring prior court action. Organizational changes, rights and responsibilities of the PRO will be reflected in changes in the law on the PRO which will be sent to parliament together with the law on tax administration procedures. The PRO will also further strengthen its headquarters capacity in the areas of program development, operational planning, and support services by designing a new organization chart and filling new positions by end-2005 (structural performance criterion). Comprehensive programs will be developed for identifying and registering taxpayers, securing tax returns, recovering arrears, and detecting unreported taxes. Performance will be monitored by a comprehensive set of indicators for each tax administration function, which will be in place by January 2006. We will also conduct a national survey on taxpayer satisfaction to measure progress in taxpayer services. In order to meet the needs of different types of taxpayers, the PRO will establish a large taxpayer office (LTO) by July 2006 and a pilot office for administering small and medium taxpayers by July 2007. The PRO will develop a new computer system that is to be piloted at the LTO and compatible with the systems being developed by the social insurance funds by June 2006 (structural benchmark).

36. **To improve the collection of social insurance contributions, we will gradually consolidate the collection activities of the pension, health, and unemployment funds and the PRO.** By July 2006, we will create a new Large Contributor Office (LCO) comprising separate units for the PDF and the HIF and collecting contributions from the 100 largest employers (structural benchmark). By mid-2006 the government will approve the harmonization of the base across personal income tax and social contributions (structural performance criterion). By July 2008, the LCO will be merged with the LTO under the PRO to collect taxes and social contributions. At the same time we will decide on a time frame for merging fully the collection of PIT and social contributions. Donors have indicated their support for this ambitious reform project; the government will ensure that adequate budgetary resources are provided. In order to ensure speedy implementation of the planned

reform which requires coordination of several government agencies and Extrabudgetary Funds, we have established an inter-ministerial steering committee to oversee and direct the reform (prior action).

C. Governance in the Health Sector

37. **We have taken steps to increase the efficiency, transparency, and fiscal soundness of the health care system**. The government has approved legislative amendments in the Law on Health Insurance, the Law on Health Care Law, and changes in by-laws (including the HIF statute) that will strengthen the HIF Board and require transparent budget preparation, reporting and auditing by the HIF and Public Health Institutions (PHIs) (prior action). The revised amendments have been submitted to Parliament and are expected to be enacted by end-September, 2005. Specific measures, which have been prepared with technical assistance from the World Bank include the following:

- The amendments to the HIF statute reduce the number of HIF Board members to 7 and tighten the qualifications for membership. The new qualifications rule out conflict of interest and ensure that Board members have sufficient financial or accounting training to analyze the financial operations of the HIF. The amended law stipulates that representatives of the Ministries of Finance and Health will hold alternating chairmanship and vice-chairmanship of the Board and have a veto over Board decisions.

- The approved amendments to the Laws on Health Insurance and Health Care (and associated by-laws) create a legal framework for transparent budget preparation (in line with the HIF's action plan) and for reporting by the HIF and PHIs in a format mandated by MOH and MOF. Specific features include binding spending ceilings for PHIs and the abolition of the HIF's compulsory reserve.

- Starting in May 2005, monthly HIF budget execution reports have been published on the HIF website. The reports provide details of HIF transfers to PHIs (by institution) and of PHIs' expenditures in *economic classification* (on both cash and commitment bases). They also include monthly financial reports in *functional classification* for the largest 7 PHIs (on both cash and a commitment bases). Starting with the 2006 budget, the HIF will report on budget execution, including transfers to PHI's, in functional classification, on a cash and commitment basis (structural benchmark). By mid-2006, reporting in economic classification will be added (structural benchmark). Reports on functional classification (on both cash and commitment bases) will be included for *all* PHIs starting in mid-2006.

- The 7 largest PHIs will prepare budgets for the 2006 fiscal year, for approval by the MOH in consultation with the HIF and the MOF. Once approved, the PHI budgets, which need to be in line with the HIF's transfers, will impose binding spending ceilings (structural performance criterion). For the 2007 fiscal year and thereafter budgets will be prepared for all PHIs.

- We will publish external audits (including reactions and comments) of the financial statements of the 7 largest health care institutions by mid-2007. Audits of the remaining health institutions will be published by mid-2008.

38. **There will be no further accumulation of arrears by the HIF (performance criterion) and the PHIs, and steps will be taken to address the existing stock of arrears**. HIF arrears will be inventoried and audited by mid-2006 and HIF budgets will make allowance for the repayment of arrears over 2007-08. All future purchase contracts will include a clause that prohibits factoring of the resulting receivables. The Ministry of Finance's Central Internal Audit Department will ensure that, in line with the HIF law, no further financial operations which loosen the HIF's budget constraint, are undertaken.

D. Other Public Sector Reforms

39. **The newly constituted municipalities—a key element of the Framework Agreement—begun operations in June 2005, posing significant challenges in the areas of monitoring local government finances and clearing inherited municipal arrears**. Monitoring will be facilitated by a unified treasury: in June all municipalities closed their commercial bank accounts and moved their funds into the government's treasury single account (TSA). Resolving municipal arrears, which were inherited from local governments that no longer exist, poses complex problems. The government will adopt (by September 2005) a debt resolution plan that balances creditors' rights, municipalities' ability to pay, and moral hazard considerations. The terms of the debt resolution plan will be decided through government-facilitated negotiations between municipalities and creditors. The government will cover a limited part of the debt (in addition to claims arising from expropriation) in order to help mobilize burden-sharing by donors and creditors. To prevent new arrears while ensuring high quality local services, budget preparation and execution procedures, including commitment control, will be introduced in all municipalities by end-2005. Borrowing by the municipalities will be limited during the first two years in line with the Law on Local Government Finance and the government will not approve loans unless they are on concessional terms and the municipality is financially sound.

40. **In January 2006 we will introduce a second pillar pension program which is intended to help put the public pension system on a sustainable path.** The reform, which is the culmination of several years' planning, has benefited from technical support by USAID and the World Bank. Since this reform will require major administrative changes, the PDF plans to implement a 3 month pilot phase before bringing the system into operation.

E. Public Sector Management and Governance

41. **Key ministries will be rationalized and reorganized in line with the advice of the World Bank, EAR, DFID.** By end-December we will complete the functional analyses of ministries that is being undertaken with support from DFID (structural benchmark). The findings of these analyses will be presented by individual ministries in their 2007 budget

submissions to the MOF by mid-2006 (structural benchmark). The management of line ministries will be enhanced by institutional reforms that emphasize improved budgeting, merit-based selection and promotion policies, and changes in the organizational structure to improve the linkage between resources and responsibilities. Given the scale of future changes in the composition and capacity of the public sector, we also intend to draw up a medium term plan for public employment.

42. **We will sell the state's minority shares in private enterprises and work to improve transparency in the management of the remaining state assets**. In addition to the large privatization projects (see ¶ 8 above), the Government will sell the equity shares held by the PDF in private companies. In order to enhance transparency in the management and privatization of state assets, the Government will report to Parliament on an annual basis on the remaining public companies and on the state's equity shares in private companies (structural benchmark). The reports will provide basic financial information, list the government's representatives in these companies and describe plans for privatization. In addition, the Law on Public Enterprises will be amended to enhance efficiency and transparency, including by (i) introducing IAS for financial statements of public enterprises, (ii) moving the external audit from the state audit office to a private auditor, and (iii) making the management of public enterprises compliant with EU directives.

43. **By mid-2005, we will strengthen the assessment and audit of income disclosure reports of state officials.** While the law on corruption includes a comprehensive reporting requirement for government officials, these reports are not yet consistently analyzed and audited. The anti-corruption commission will be empowered to audit randomly selected disclosure reports of senior elected and appointed officials and civil servants (structural benchmark).

II. Statistics

44. **We will undertake measures to improve national statistics.** As statistical data is essential for effective economic surveillance, policy management, and FDI, the State Statistic Office (SSO) will further improve its work. With the help of IMF technical assistance, the SSO has produced a work plan to develop quarterly national accounts. Quarterly national account series should be ready by end-2005. Moreover, we will request additional technical assistance from the EAR and ILO in the area of price, employment, and national accounts statistics.

III. Program Monitoring

45. **The program will be reviewed by the IMF semiannually, starting with a first review based on end-December data.** The first, second and third review will be completed by February 15, 2006, August 15, 2006 and February 15, 2007.

46. **Prior actions as well as performance criteria and indicative targets have been set for the first 12 months of the program.** Quantitative performance criteria and indicative

targets, consistent with our intention to maintain contain government borrowing and increase international reserves, are set out in Table 1. Structural conditionality, which focuses on our reforms in the areas of tax administration, public expenditure management (notably in the health sector), and the business climate (labor market and court reforms), are set out in Table 2.

47. **Conditionality for the second and third year of the arrangement will be set in the context of program reviews.** Macroeconomic conditionality will be anchored by the need to achieve the fiscal deficit and gross reserves targets set out in Section II and in the Annex of this MEFP. Structural conditionality will focus on bringing the reform of payroll tax collection to conclusion (¶ 36), further improvements in health sector efficiency (¶ 37 and 38), institutional changes needed for the judicial reform (¶ 15-20), improvements in bank supervision and prudential regulation (¶ 27-30) and in public sector management (¶ 41-43).

Table 1. FYR Macedonia: Quantitative Performance Criteria and Indicative Targets for 2005 and 2006

	2004	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06
		Program	Program	Program	Program	Program	Program
	Actual	PC	PC	PC	PC	PC	PC
			(in millions of euros)				
	End-year stocks		Cumulative changes since end-Dec. 2004				
Floor for net international reserves of the NBRM	613	28	176	296	305	339	345
Reserve assets *	717	55	199	320	325	359	361
Reserve liabilities **	104	27	24	24	20	20	16
Ceiling on new nonconcessional medium- and long-term external debt contracted or guaranteed by the general government or the NBRM with original maturities of more than 1 year	...	209	231	231	239	246	286
Ceiling on short-term external debt of the central government or the NBRM with maturities of up to 1 year (stock); including guarantees for such debt	...	0	0	0	0	0	0
Accumulation of external payments arrears	0	0	0	0	0	0	0
			(in millions of denars)				
	End-year stocks		Cumulative changes since end-Dec. 2004				
Ceiling on net domestic assets of the NBRM	-20,713	-1,346	-9,201	-17267	-17,051	-18,992	-17,980
Ceiling on net domestic assets of the banking system (indicative target)	25,916	8,266	2,896	-1894	2,547	3,880	9,336
Ceiling on net domestic credit to the central government from the NBRM	-8,075	-449	-9,065	-18,226	-16,048	-15,114	-15,757
Ceiling on Health Insurance Fund's arrears	1,710	0	0	0	0	0	0
Ceiling on central government's total domestic arrears (indicative target)	2,019	0	0	0	0	0	0
Memo item: Non HIF domestic arrears	309	0	0	0	0	0	0
			(in millions of denars)				
	Annual flows		Cumulative flows within year				
Central government wages (indicative target)	22,032	...	23,179	...	...		23,900
Floor for central government fiscal balance	1,928	-524	-2,235	-253	-1,364	-2,570	-1,851

Sources: Data provided by the authorities; and IMF staff estimates.

* Quarterly flows for 2005 revised to reflect that the Telecom dividend to foreigners will be paid in the 3rd quarter of 2005 instead of in the 2nd.
** Actuals for Q1-05 and subsequently increase by the increase of net liabilities to the IMF. In line with the NBRM information, the NIR PCs assume no change in pledged foreign assets during the program period.

Table 2. FYR Macedonia: Structural Conditionality, August 2005 to June 2006

Prior Actions	
1. Government approval of the 2005 supplementary budget (MEFP, 10).	
2. Passage by Parliament of a new Law on Labor Relations (MEFP, 14).	
3. Government submission to Parliament of amendments to the Health Insurance Law and Law on Health Care and adoption of the necessary by-laws to tighten selection of HIF Board and implement transparent budget procedures (MEFP, 37).	
4. Government to establish an interministerial steering committee with authority to implement the planned reform of payroll tax collection (MEFP, 36).	
First Review	
Performance Criteria	
1. The 7 largest PHI's prepare 2006 budgets, approved by the MOH, that are in line with the HIF transfers, and become binding ceilings (MEFP, 37).	By end-2005
2. PRO designs new organizational chart and fills identified positions required to implement payroll tax reform (MEFP, 35).	By end-2005
3. Parliament to enact a 2006 budget that is in line with the program (MEFP, 6).	By end-2005
4. Government to submit new Banking Law to Parliament (MEFP, 27).	By end-2005
Benchmarks	
1. Judicial Budget Council to prepare 2006 court budget, including an analysis of the fiscal implications of judicial reform (MEFP, 20).	By end-2005
2. Amend the Law on the Chamber of Commerce to allow existing members of employers' associations to terminate their membership prior to the negotiation of the next collective agreements (MEFP, 14).	By end-2005
3. Remove company registration from courts and establish an integrated company numbering system at the Central Registry (MEFP, 21).	By end-2005
4. Parliament approves amendments to the Bankruptcy Law (MEFP, 21).	By end-2005
5. MOF will start tendering for the sale of residual state shares in commercial banks (MEFP, 8).	By end-2005
6. Government and NBRM to agree on a plan for the use of treasury bills for monetary policy purposes (MEFP, 24).	By end-2005
7. NBRM will start using repo transactions for monetary interventions (MEFP, 23).	By end-September 2005
8. NBRM to prepare a Supervisory Development Plan for risk-based supervision (MEFP, 27).	By end-2005
9. HIF to prepare a 2006 budget and to start monthly reporting on budget execution, including transfers to the PHI's in functional classification, on a cash and commitment basis (MEFP, 37).	By end-2005
10. The government to finalize the functional analysis of line ministries and to prepare a plan for its implementation (MEFP, 41).	By end-2005
Second Review	
Performance Criteria	
1. Establish a Large Taxpayer Office at PRO and a Large Contributor Office at PDF (MEFP, 36).	By July 2006
2. Privatize the distribution component of ESM and sell residual shares in the Makedonski Telekomunikacii AD (MEFP, 8).	By March/June 2006
3. Government to approve a harmonized base for PIT and social contributions (MEFP, 36).	By June 2006
Benchmarks	
1. LTO to pilot test a new computer system which is compatible with systems being developed by the social funds (MEFP, 35).	By June 2006
2. Start publishing comprehensive data on the realization of the government's on-lending agreements and government projections for future on-lending (MEFP, 32).	By June 2006
3. Prepare a report on the government's economic activities (MEFP, 42).	By June 2006
4. Anti-corruption commission to audit the financial disclosure reports of randomly chosen senior elected and appointed officials and civil servants (MEFP, 43).	By June 2006
5. Amend Law on Misdemeanors to allow administrative bodies (such as NBRM, PRO, Customs) to impose sanctions on misdemeanor cases without prior court involvement (MEFP, 19).	By July 2006
6. HIF to report on its spending in economic classification, on a cash and commitment basis, including a breakdown of the PHI's spending, based on the Q1 2006 outcome (MEFP, 37).	By June 2006
7. Pass amendments to the NBRM law that revise provisions on the retention/distribution of NBRM profits (MEFP, 22).	By June 2006
8. The systematization for all line ministries will be revised based on the findings of a functional analysis and will be reflected in the 2007 budget (MEFP, 41).	By June 2006

Table 3. Summary and Timetable for Structural Measures

Objectives and Targets	Selected Strategies and Measures	Implementation Deadline	Lead Agency/ TA	National Agency Responsible
1. Business Environment				
Facilitate company registration	Abolish **court involvement** in company registration and **consolidate the issuance of registration numbers** at the central registry.	End-2005		MOE, Central Registry
Improve bankruptcy procedures	Pass an amendment to the **Bankruptcy Law** that accelerates bankruptcy procedures, enhances creditor rights, and clarifies the role and qualifications of bankruptcy trustees.	End-2005		MOE, MOF
Enhance labor market flexibility	Pass an amended **Law on Labor Relations** to facilitate layoffs, to make part time contracts and overtime arrangements more flexible, to limit sick leave funded by employers, and to limits the applications of collective agreements to signatories.	Prior to the Board meeting		MOL
	Amend the Law on Health Insurance to reduce **sick leave** benefits.	End-September 2005		
	Amend the Law on the Chamber of Commerce to facilitate termination of membership.	End-2005		
Enhance the efficiency of the judiciary	Adopt **legislative changes** to allow for the specialization of department within courts and/or separate courts and to improve the selection process for judges.	End-March 2006		MOJ
	Adopt a **law on civil procedure** that minimizes court delays.	End-June 2005	USAID	MOJ
	Adopt a **law on enforcement** that frees up courts from enforcement obligations.	End-May 2005	USAID	MOJ
	Adopt the **law on the establishment of a school for judges and prosecutors**.	End-November 2005	EU, EAR	MOJ, MOE
	Adopt a new **law on misdemeanor.**	End-July 2006		MOJ
	Fully staff the **Judicial Budget Council administration agency**.	End-June 2005		MOJ
	Prepare a **draft 2006 budget of the court system**.	End- 2005		Judicial Budget Committee
	Prepare the **institutional and personnel changes** necessary to support the new legal structure.	2007 and 2008		MOJ

2. Financial Sector Reform				
Improve the soundness of the financial system	Submit to parliament an amendment to the **Banking Law**, including enhanced regulations on fit and proper criteria, withdrawal of licenses, and on receivership. Enhance the payment system by amending the **Law on Payment Operations.** Amend the **Law on the NBRM** to clarify the NBRM's competencies**.** Enhance **banking supervision,** including by (i) reassessing prudential regulations related to the exchange rate risk in bank's credit portfolio based on the findings of the upcoming IMF TA on credit growth, (ii) strengthening the analysis and publication of trends in banks' lending and interest activities, (iii) preparing a Supervisory Development Plan for risk-based supervision.	End-2005 End-2005 End-2005 End-September 2005 End-2005	IMF FSAP IMF WB	NBRM, MOF
Strengthen financial intermediation	Render the upgraded NBRM **credit register** fully operational and linked with the central registry.	End-2006		NBRM, Central Registry
International reserves management	Improve the **guidelines** on currency composition and maturity of reserves, and on the management of benchmark portfolios in line with MFD recommendations.	End-October 2005	IMF	NBRM
Develop the secondary market for treasury bills	Establish a **framework for secondary trading of treasury bills** by setting up appropriate trading and information systems. Launch **repo transactions for market participants.** Start **monetary interventions through repo transactions.** Develop a plan for the **use of treasury bills for monetary policy purposes.**	End-July 2005 End-July 2005 End-September 2005 End-2005	 IMF IMF	NBRM NBRM and MOF
Recapitalize the NBRM	Include the recapitalization of the NBRM in the **supplementary budget.** Amend the NBRM Law to increase the **NBRM's share in the profit allocation**.	End-September 2005 End-June 2006		MOF
3. Fiscal Sector Efficiency				
Enhance budget planning and execution; improve fiscal transparency	Pass the new **Budget Law**. Strengthen **budget preparation and execution** in the municipalities; enhance monitoring of **municipal financing.** Move toward fully **GFS-consistent definitions** in fiscal planning and reporting. Develop a rolling **medium-term fiscal framework** (fiscal strategy).	End-July 2005 End-2005 For the 2006 budget process	US Treasury	MOF

	Publish data on the government's **on-lending activities.**	End-June 2006		
Broaden the tax base	Abolish **CIT incentive schemes** accounting for at least half of the fiscal costs. Stop granting new **free economic zone privileges.**	End-2005 August 2005		MOF, PR
Enhance the effectiveness of the PRO	Submit a **Law on Tax Administration and a Law on the PRO** to parliament. **Improve tax administration** in line with FAD recommendations: (i) Strengthen **PRO headquarters** by developing a new organizational chart and by filling identified vacant positions**.** (ii) Formulate a **comprehensive set of performance measures** for tax administration functions. (iii) Establishing a **large taxpayer office.** (iv) Set up a **pilot office** for administering small and medium taxpayers. (v) Test a **new computer system** compatible with social funds' systems.	End-July 2005 End-December 2005 June 2006 End-July 2006 July 2007/End-July 2006	IMF	MOF, PDF
Coordinate and merge the collection of taxes and social contributions	Establish an **interministerial committee** with the authority to consolidate social contribution collection and PIT. Establish a **large contributor office** comprising the PDF and the HIF. **Adopt harmonized bases** for PIT and social insurance contribution. **Merge LCO with LTO** and decide on a timeframe for the full merger of PIT and social contribution collection.	Prior to the Board Meeting End-July 2006 End-July 2006 July 2008	IMF	MOF, MOL, MOH
Strengthen debt management capacity	Pass a **Public Debt Law.** Present a **medium-term debt strategy** and report regularly on debt developments. Prohibit **borrowing by local governments** for the first 2 years after the law on local government finances becomes effective.	End-July 2005 For the 2006 budget Continuous	EAR	MOF
Resolve the municipal arrears	Adopt a plan to clear or reschedule **municipal arrears**.	September 2005	USAID, EU	MOF
4. Health Sector Governance				
Improve governance in the health sector	Government approval on amendments in the Health Insurance Law and the Law on Health Care to tighten the selection criteria for **HIF board** members and to enhance **budget preparation and reporting** in Public Health Institutions (PHIs) HIF to **publish monthly information on budget execution,** including an analysis of transfers to the PHIs. **Report** on the HIF website for at least two months on revenues and expenditure of the largest 7 PHIs.	Prior to the IMF Board meeting End-June 2005 End-June 2005	IMF and World Bank	MOH, MOF

	Prepare budgets for 2006 for the 7 largest PHIs. All remaining PHIs to follow the reporting and budgeting procedures described above. HIF to report on budget execution in economic classification, including reporting on PHI's. Undertake **audits for the 7 largest PHIs** and publish the results. Undertake audits of the remaining PHIs.	For the 2006 budget End-June 2006/ For the 2007 budget End-June 2006 Mid-2007 Mid-2008		
5. Public Sector Management and Governance				
Reduce the risk of conflict of interest	Strengthen the anti-corruption commission's capacity to assess and audit randomly state official's **income disclosures statements**.	End-June 2006		MOL
Enhance transparency of state owned enterprises	Amend the **law on public enterprises.** Prepare **annual reports** on the state's economic activities.	End-2005 End-2006	IMF IMF	MOF MOE
Improve the efficiency of line ministries	**Reorganize key ministries** in line with the findings of the functional analysis. Develop a **plan for public employment.**	For the 2007 budget		

Abbreviations used in the text:

CIT	Corporate Income Tax
DFID	Department for International Development
EAR	European Agency for Reconstruction
EU	European Union
EF	Employment Fund
FAD	IMF Fiscal Affairs Department
HIF	Health Insurance Fund
IAS	International Accounting Standards
MOF	Ministry of Finance
MOE	Ministry of Economy
MOH	Ministry of Health
MOT	Ministry of Transportation
MOJ	Ministry of Justice
MOL	Ministry of Labor
NBRM	National Bank of the Republic of Macedonia
PDF	Pension and Disability Fund
PHI	Public Health Institution
PIT	Personal Income Tax
PRO	Public Revenue Office
TA	Technical Assistance
USAID	US Agency for International Development
VAT	Value Added Tax
WB	World Bank

TECHNICAL MEMORANDUM OF UNDERSTANDING

This Technical Memorandum of Understanding (TMU) defines the variables subject to quantitative targets (performance criteria and indicative benchmarks), established in the Memorandum of Economic and Financial Policies (MEFP) and describes the methods to be used in assessing the program performance with respect to these targets.

A. Government and Public Sector

1. For the purpose of this TMU, the term "central government" covers: central government as defined in the Annual Budget Document, (including Special Revenue Accounts), Employment Fund, Health Insurance Fund, Pension Insurance Fund, Road Fund, and agencies and institutions that are currently treated by the Ministry of Finance as part of government and which correspond to the classification followed by the National Bank of the Republic of Macedonia (NBRM) in its monthly submissions to the Fund of balance sheets of the central bank and the consolidated accounts of the commercial banks. The authorities will inform the Fund staff of any new funds, or other special budgetary and extrabudgetary programs that may be created during the program period to carry out operations of a fiscal nature as defined in the IMF's *Manual on Government Financial Statistics*, and will ensure that these will be incorporated within the definition of consolidated central government.

2. The term "general government" covers the central government as defined in ¶1 and the municipalities which are classified as part of general government according the budget documents and which are included by the National Bank of the Republic of Macedonia (NBRM) in its monthly submissions to the Fund of balance sheets of the central bank and the consolidated accounts of the commercial banks.

3. The term "public sector" covers the general government as defined in ¶2 and foreign financed projects of public enterprises.

B. Net International Reserves of the NBRM

4. **Net international reserves** (NIR) of the NBRM are defined as the difference between NBRM's reserve assets and its reserve liabilities.

5. **Reserve assets** are defined as liquid and usable foreign convertible currency claims on nonresidents plus monetary gold. Reserve assets of the NBRM thus include monetary gold, SDRs, foreign currency cash, securities, deposits abroad, and the reserve position at the Fund. Excluded from reserve assets are any assets that are frozen, pledged, used as collateral, or otherwise encumbered, claims in foreign exchange arising from transactions in derivative assets (futures, forwards, swaps, and options), and precious metals other than gold.

6. **Reserve liabilities** are defined as all foreign exchange liabilities of the NBRM to nonresidents and residents, including all credit outstanding from the Fund, arrears on

principal or interest payments to commercial banks, suppliers, or official export credit agencies, and future and contingent commitments to sell foreign exchange arising from transactions in derivative assets (futures, forwards, swaps, and options). Central government's foreign exchange deposits at the NBRM are excluded from reserve liabilities.

7. For program purposes, all foreign currency-related assets and liabilities are valued at program exchange rates as defined in Section J.

8. At end-December 2004, reserve assets so defined stood at EUR 717.0 million; reserve liabilities so defined stood at EUR 104.0 million; and NIR so defined stood at EUR 613.0 million (Table 1).

9. Semi-annual floors (NIR floors) have been established for the cumulative changes in the NIR of the NBRM from the level at end-December 2004 (Table 1 of the MEFP). The changes in the NIR will be measured in euros excluding valuation effects calculated according to the methodology described in Section J.

Adjustors

10. The NIR floors are set based on the assumption that **balance of payments financing** will amount on a cumulative basis, from end-December 2004 to:

End-September 2005	EUR 32.3 million;
End-December 2005	EUR 231.3 million;
End-March 2006	EUR 372.5million;
End-June 2006	EUR 372.5 million;
End-September 2006	EUR 372.5 million;
End-December 2006	EUR 394.5 million.

11. **Balance of payments financing** is defined as the sum of: i) gross disbursement of foreign loans or grants to the central government or the NBRM for balance of payments financing, including the planned issuance of Eurobonds, minus the planned prepayment of foreign loans; ii) privatization proceeds and lump sum proceeds from concession fees in foreign currency; and, iii) proceeds from the restitution of foreign assets of the former SFRY. Project loans and grants, and purchases from the IMF are not considered balance of payments financing for this purpose.

12. If balance of payments financing deviates from the baseline path shown above and in Table 2, the NIR floors of the NBRM will be adjusted as follows:

- The NIR floor will be adjusted upward (downward) to the same extent as any upward (downward) deviation in grants and loan disbursements from bilateral and multilateral donors, with the provision that the downward adjustment to the floor will not exceed the equivalent of EUR 30 million on a cumulative basis.

- In the event that the proceeds from the Eurobond exceed EUR 150 million, the NIR floors will be adjusted upward by the amount of the excess. In the event that the proceeds from the Eurobond issue fall short of EUR 150 million but exceed EUR 130 million, the NIR floors will remain unchanged. In the event that the proceeds from the Eurobond issue fall short of EUR 130 million, the NIR floors will be adjusted downward by the amount of the shortfall.

- The NIR floors will be adjusted upward (downward) by the amount of any prepayment of external debt falling short of (exceeding) the baseline defined in Table 2.

- The NIR floors will be adjusted upward (downward) for any privatization proceeds or lump sum proceeds from concession fees in foreign currency exceeding (falling short of) the baseline defined in Table 2, with the provision that the downward adjustment to the floor will not exceed the equivalent of EUR 50 million on a cumulative basis.

- The NIR floors will be adjusted upward (downward) for the restitution of foreign assets of the former SFRY as a result of succession proceeds exceeding (falling short) of the baseline defined in Table 2.

- The sum of upward and downward adjustments to NIR floor in response to deviations from the baseline balance of payment financing projections will not result in a net downward adjustment exceeding the following limits:

End-September 2005	EUR 30.0 million;
End-December 2005	EUR 166.5 million;
End-March 2006	EUR 81.5 million;
End-June 2006	EUR 76.5 million;
End-September 2006	EUR 71.5 million;
End-December 2006	EUR 66.5 million.

C. Net Domestic Assets of the NBRM

13. **Net domestic assets** (NDA) of the NBRM are defined as reserve money minus the net foreign assets (NFA) of the NBRM.

14. **Reserve money** is defined as currency in circulation (outside banks), vault cash of banks, and required and excess reserve deposits of banks in denars and in foreign currency held at the NBRM or at the NBRM accounts abroad.

15. **Net foreign assets** (NFA) of the NBRM are defined as reserve assets plus those foreign assets of the NBRM that are excluded from reserve assets under the definition in ¶5 of this TMU, minus foreign exchange liabilities of the NBRM to nonresidents.

16. At end-December 2004, reserve money so defined stood at denar 21,111 million; NFA so defined stood at EUR 682.2 million or denar 41,824 million (converted using the exchange rate methodology described in Section J); and NDA so defined stood at denar –20,713 million.

17. Semi-annual ceilings (ceilings for NDA) have been established for the cumulative changes in the NDA of the NBRM from the level at end-December 2004 (Table 1 of the MEFP).

Adjustors

18. If balance of payments financing deviates from the baseline path shown in Table 2, the ceilings for the NDA of the NBRM will be adjusted as follows:

- The NDA ceilings will be adjusted downward (upward) to the same extent as any upward (downward) deviation in grants and loan disbursements from bilateral and multilateral donors, with the provision that the upward adjustment to the floor will not exceed the equivalent of EUR 30 million on a cumulative basis.
- In the event that the proceeds from the Eurobond exceed EUR 150 million, the NDA ceilings will be adjusted downward by the amount of the excess. In the event that the proceeds from the Eurobond issue fall short of EUR 150 million but exceed EUR 130 million, the NDA ceilings will remain unchanged. In the event that the proceeds from the Eurobond issue fall short of EUR 130 million, the NDA ceilings will be adjusted upward by the shortfall.
- The NDA ceiling will be adjusted downward (upward) by the amount of any prepayment of external debt falling short of (exceeding) the baseline defined in Table 2.
- The ceilings for the NDA of the NBRM will be adjusted downward (upward) for any privatization proceeds or lump sum proceeds from concession fees in foreign currency exceeding (falling short of) the baseline defined in Table 2, with the provision that the upward adjustment to the ceiling will not exceed the equivalent of EUR 50 million on a cumulative basis.
- The ceilings for the NDA of the NBRM will be adjusted downward (upward) for the restitution of foreign assets of the former SFRY as a result of succession proceeds exceeding (falling short) of the baseline defined in Table 2.

D. Net Domestic Assets of the Banking System

19. **Net domestic assets** (NDA) of the banking system, which includes the NBRM and the deposit money banks, are defined as broad money (M3) minus the net foreign assets (NFA) of the banking system.

20. **Broad money** (M3) includes currency in circulation, demand deposits, quasi-deposits, and non-monetary deposits (time deposits over 12 months and restricted deposits) of the non-central government denominated in denar and in foreign currency.

21. **NFA of the banking system** are defined as the banking system's foreign assets minus foreign liabilities.

22. At end-December 2004, broad money so defined stood at denar 94,781 million; NFA of the banking system so defined stood at denar 68,865 million; and NDA of the banking system so defined stood at denar 25,916 million.

23. Semi-annual indicative ceilings have been established for the cumulative changes in the NDA of the banking system from the level at end-December 2004 (Table 1 of the MEFP).

Adjustors

24. The ceilings on the NDA of the banking system will be subject to the same adjustors as the ceilings on the NDA of the NBRM.

E. Net Credit to the Central Government from the NBRM

25. **Net credit to the central government** from the NBRM system is defined as credit in denar and foreign currency to the central government from the NBRM minus total central government deposits in denar and foreign currency with the NBRM. For the purpose of this program, accounts of the central government include all accounts recorded as central government accounts in the monetary statistics reported by the NBRM in accordance with the definition of central government ¶1. Excluded from this definition are any T-bills issued for monetary policy purposes and corresponding government deposits at the NBRM, and the unclaimed portion of the payment of principal and interest on frozen foreign currency deposits.

26. At end-December 2004, the amount of outstanding credit from the NBRM to the central government in denar and foreign currency stood at denar 2,881 million; the amount of central government deposits held at the NBRM was equal to denar 10,956 million (excluding denar 1743 million corresponding to the unclaimed portion of the payment of principal and interest on frozen foreign currency deposits which is recorded as Other Items Net). In sum, net credit of the NBRM to the central government so defined stood at denar -8,075 million.

27. Semi-annual ceilings have been established for the cumulative changes in net credit from the NBRM to the central government from the level at end-December 2004 (Table 1 of the MEFP).

Adjustors

28. The ceilings on net credit to the central government from the NBRM will be subject to the same adjustors as the ceilings for the NDA of the NBRM. With the exception that if the proceeds from the Eurobond issue fall short of EUR 150 million but exceed EUR 130 million, the ceiling for the Net Credit to the Central Government from the NBRM will be adjusted upward by one half of the amount of the shortfall. (Given that the NIR floor would remain unchanged in the event that the proceeds from the Eurobond issue fall short of EUR 150 million but exceed EUR 130 million, this adjustor would ensure that the adjustment needed to meet the NIR target would be shared equally between the NIRM and the government.) In the event that the proceeds from the Eurobond issue fall short of EUR 130 million, the ceiling for Net Credit to the Central Government from the NBRM will be adjusted upward by the amount that the proceeds fall short of EUR130 million plus EUR 10 million.

F. Government Fiscal Balances

29. Semi-annual floors for the cumulative changes in central government fiscal balances will be determined and monitored from the financing side beginning end-December 2004 (Table 1 of the MEFP). The financing flows will be measured as a sum of domestic financing, foreign financing, and privatization proceeds.

30. **Domestic financing** for the central government includes net credit from the domestic banking system (excluding any T-bills issued for monetary policy purposes and corresponding government deposits at the NBRM, and the unclaimed portion of the repayment of frozen foreign currency deposits), net placement of securities outside the domestic banking system and other net credit from the domestic non-banking sector, and net variation in domestic arrears. **Foreign financing** for the central government (converted using the valuation methodology described in Section J) includes disbursements of external loans received by the central government, including disbursements received for foreign financed projects of budget users and extrabudgetary funds, and restitution of foreign assets of the former SFRY as a result of succession proceedings minus amortization due or pre-paid, and rescheduled debt service payments programmed to be paid out. **Privatization proceeds** for the central government include privatization proceeds and lump sum proceeds from concession fees in denar and foreign currency.

31. The **general government fiscal balance** includes, in addition to the central government fiscal balance, the financing position of the municipalities included in the definition of general government in ¶2. It is expected that, quantitative targets for the general government fiscal balance will be set on the occasion of the 1st semi-annual program review,

provided that sufficiently comprehensive and reliable data on municipalities' finances will have become available.

32. The **public sector fiscal balance** includes, in addition to the general government fiscal balance, the financing position of the institutions included in the definition of public sector in ¶3. Monitoring will also be done from the financing side.

Adjustors

33. The floors on central government fiscal balance will be adjusted upward by any shortfalls of gross external financing for central government's foreign financed projects spending (including the Road Fund) with respect to the following cumulative baseline:

End-September 2005	EUR 26.7 million;
End-December 2005	EUR 31.4 million;
End-March 2006	EUR 43.0 million;
End-June 2006	EUR 58.7 million;
End-September 2006	EUR 65.2 million;
End-December 2006	EUR 65.8 million.

G. Central Government Wage Bill

34. The ceiling on the central government wage bill includes central government wages and salaries, including allowances.

35. Annual ceilings have been established for the central government wage bill (Table 1 of the MEFP).

H. Debt

36. For assessing fiscal sustainability for program purposes, the standard analysis of the consolidated central government's debt sustainability will be complemented with an analysis that will include debt contracted and guaranteed by central and general governments and available information on government's contingent liabilities, such as external debt contracted by public and state owned enterprises without explicit government guarantees.

37. The limit on medium and long-term debt (Table 1 of the MEFP) applies to the contracting or guaranteeing by any branch of the government or the NBRM of new nonconcessional external debt with an original maturity of more than one year. This performance criterion applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000 by the

Executive Board of the IMF[1], but also to commitments contracted or guaranteed for which value has not been received. Excluded from this performance criterion are changes in indebtedness resulting from refinancing credits and rescheduling operations (including the deferral of interest on commercial debt), credits extended by the IMF and the BIS, and credits on concessional terms, defined as those with a grant element of 35 percent or more calculated using the OECD Commercial Interest Reference Rates (CIRRs) applicable for the program period. Specifically, the discount rates for debts with maturities less than 15 years will be based on the average CIRR of the previous 6 months, and for debts with maturities of 15 years and more the average CIRR of the previous 10 years. Debt falling within the limit shall be valued in euro at the exchange rate prevailing at the time the contract or guarantee becomes effective.

38. The limit on short-term debt (Table 1 of the MEFP) applies to the outstanding stock of short-term government and government-guaranteed external debt and the NBRM with an original maturity of up to and including one year. The term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000 by the Executive Board of the IMF. Excluded from this performance criterion are changes in indebtedness resulting from rescheduling operations (including the deferral of interest on commercial debt), and normal import-related credits. Debt falling within the limit shall be valued in euro at the program exchange rates. There was no official short-term debt or guarantees on outstanding short-term debt as of end-December 2004.

I. External and Domestic Payments Arrears

39. External payments arrears consist of the total past-due amounts of debt service obligations (interest and principal) on government, government-guaranteed, and the NBRM external debt, excluding arrears on external debt service obligations pending the conclusion of debt rescheduling agreements.[2] Under the program, the nonaccumulation of external payments arrears is a continuous performance criterion. As of December 31, 2004 there were no outstanding external payment arrears as defined above.

40. Central government domestic arrears, excluding those to suppliers, are defined to include all payment delays to: (i) banks for bond payments (including for the repayment of frozen foreign currency deposits); (ii) individuals for Social Assistance Program payments;

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[1] *Decision No. 6230-(79/140) August 3, 1979, as amended by Decision Nos. 11096-(95/100), October 25, 1995, and 12274-(00/85), August 24, 2000.* Under the Guidelines on Performance Criteria with Respect to Foreign Debt adopted on August 24, 2000 by the Executive Board of the IMF the definition of "debt" has been broadened with respect to the conventional definition to include, among other things, such instruments as financial leases.

[2] Amounts are only considered past-due after the contractual grace period expired.

(iii) central government employees including for wages and salaries, and food and travel allowances; (iv) benefit recipients of the Child Care Program; (v) local governments. The definition excludes the customary lag in paying wages, social assistance and child allowance payments, and transfers to the extra-budgetary funds (in the following month after they accrue). According to the definition here, and as reported to IMF staff, central government domestic arrears, excluding those to suppliers, were denar 0 million as of end-December 2004. Under the program, the outstanding stock of domestic arrears, as defined above, will not exceed at any time the amount outstanding as of end-December 2004.

41. Central government domestic arrears to suppliers are defined as obligations to suppliers which are due but not paid by more than 60 days and are non-disputed. As defined here, and as reported to Fund staff, the stock of arrears to suppliers stood at denar 2,019 million as of end-December 2004. Under the program, the outstanding stock of domestic arrears, as defined above, will not exceed the amount outstanding as of end-December 2004.

42. A separate sub-ceiling is set for the Health Fund arrears, as defined above in ¶41 and as reported to Fund staff. Under the program the aggregate outstanding stock of arrears will not exceed the amount outstanding as of end-2004. (The aggregate stock of these arrears stood at denar 1,710 million as of end-December 2004.)

J. Valuation

Valuation of the NBRM balance sheet and the monetary survey

43. For the programmed foreign exchange projections, the program exchange rates were applied.

44. For program purposes, all foreign currency-related assets and liabilities will be evaluated at program exchange rates. For 2005 and 2006, the program exchange rates are those that prevailed on December 31, 2004. In particular, EUR1 = 61.3100 denars, US$1= 45.0676 denars; SDR1= 69.9903 denars, and EUR1=1.3604 U.S. dollars.

45. Performance will be measured in constant exchange rates. For this methodology, assets and liabilities of the banking system will be valued as follows: The stocks of assets and liabilities denominated in foreign currencies outstanding at December 31, 2004 are valued at the program exchange rates defined above in ¶44. Gold is valued at the price fixed in the London market at end-December 2004 (US$ 438.00 per ounce). Changes in assets and liabilities will also be valued at these exchange rates. The exchange rate effects on the foreign currency denominated assets and liabilities of commercial banks will be estimated on the basis of their currency composition, as provided by the NBRM banking supervision department.

Valuation of NIR

46. For the programmed foreign exchange projections, the program exchange rates were applied.

47. For program monitoring, the NBRM estimates the valuation effects on the NIR of the NBRM as follows. On a daily basis all foreign currency denominated balances are converted into Euros using the middle rates from the NBRM official exchange rate list for the same day. These balances are compared to the balances in Euros at the end of the previous day calculated in the same way (i.e., using the middle rates from the NBRM official exchange rate list for that day). The change in the daily Euro denominated balances, so calculated, is compared to the recorded daily transaction flows converted in Euros using the same methodology. Any difference between the two values is attributed to valuation effects.

Valuation of the fiscal deficit

48. For the programmed foreign exchange projections, the program exchange rates were applied.

49. For fiscal deficit measuring purposes, the foreign currency component of deficit financing will also be converted into denars at constant program exchange rates.

K. Monitoring and Reporting Requirements

50. Performance under the program will be monitored from information provided to the IMF by the NBRM and the Ministry of Finance. All data will be monthly, unless otherwise specified, and should be submitted by the authorities to the IMF staff within 30 days of the end of each month, for the minimum of three consecutive months prior to the IMF Board discussion on the arrangement, unless otherwise specified. In addition, data on performance at the program test dates will be submitted with a cover letter signed by an authorized official.

51. The following information will be supplied to the IMF by the Ministry of Finance: (i) fiscal table for the consolidated central government (i.e., including special revenue accounts and the extra-budgetary funds) (40 days after the end of each month); (ii) monthly information on privatization receipts (including detailed description of cash payments in local and foreign currency and payments with government bonds); (ii) data on workers registered as unemployed with the unemployment fund; (iv) information on guarantees given on new debt, on new debt contracted by the government, government agencies, and public enterprises and on debt stock in gross and net terms; (v) information on domestic arrears, including to suppliers and distinguishing between court disputed and non-disputed arrears; (vi) data on outlays on structural reforms and public administration reforms; (vii) data on the claimed and unclaimed portion of the repayment of frozen foreign currency deposits; and (ix) information on the local government fiscal accounts (starting August 2005). In addition, the MOF, in coordination with the NBRM, will provide quarterly reports on the reconciliation of

monetary and fiscal data on net government position vis-à-vis the banking system, and data on the holders of government securities broken down between banks and non-bank entities.

52. The NBRM will supply: (i) balance sheets of the NBRM and the consolidated accounts of the commercial banks—both should include details of the credit and deposits position of funds and other government entities as listed in ¶1 (20 days after the end of the month); (ii) the monetary survey; (iii) data on components of NIR of the NBRM as defined in section B, valued in euros adjusted for valuation changes; (iv) statement from the Road Fund indicating its balances (in denar and foreign currency) at the NBRM and at the commercial banks separately; (v) the foreign exchange cash flow of the NBRM, including the level of official reserves, if necessary, reconciled with the NBRM balance sheet data for NFA; (vi) daily and monthly closing and average exchange rates; (vii) detailed data on exports and imports; (viii) information on all overdue payments on short-term external debt and on medium- and long-term external debt; (ix) data on foreign borrowing including gross disbursements, amortization, and interest payments by debtors (central government, agencies and public enterprises); (x) information on lending by domestic money banks according to credit ratings of borrowers; (xi) data on off-balance sheet activity of domestic money banks; and (xii) data on each domestic money banks' compliance with prudential regulations will be provided on a quarterly basis within 30 days after the end of the quarter; (xiv) Detailed reporting on commercial banks assets and liabilities, including breakdowns by currency, currency indexation, maturity and sector, on a quarterly basis; (xv) Quarterly information on commercial banks lending and deposits indexed to foreign currencies; (xvi) information on deposit and lending interest rates monthly. Monthly data on all components of balance of payments will be submitted within 2½ months of the end of each month. By the end of the following months, the NBRM will provide preliminary trade data based on customs information. Data on stock of external debt will be provided on a quarterly basis, within 30 days of the end of the quarter.

53. The State Statistics Office (SSO) office will supply monthly updates on CPI, PPI, industrial production, wages, employment, and import and export data. The SSO will also prepare quarterly GDP data three months after the end of the quarter. In case of changes in the statistical methodology, the SSO will provide data in the new and old methodology for at least one reporting point. The SSO will also provide updates when historic time series get corrected. All submissions will be in electronic form.

Table 1. Net International Reserves of the NBRM

(In millions of euros) 1/

	End-Dec. 2004
Net international reserves [1 - 2]	613.0
1. Reserve assets [1.1 - 1.2]	717.0
1.1. Foreign assets	728.9
Gold	63.6
Demand deposits in foreign banks	183.2
Time deposits in foreign banks	460.6
Foreign currency at the NBM	3.3
Foreign securities	18.2
Letters of credits	0.0
Guarantees	0.0
Checks	0.0
1.2. Foreign assets excluded from reserve assets	11.9
Subordinated loan (AY Bank)	3.7
Booked funds (formerly AY Bank)	7.6
Other pledged assets	0.0
Other FA excluded from gross reserves	0.6
2. Reserve liabilities [2.1 + 2.2]	104.0
2.1. To nonresidents	46.7
IMF	46.0
BIS	0.0
Other	0.7
2.2. To residents 2/	57.3
Foreign currency deposits of banks	2.4
Required reserves	54.9
Other	0.0
Memorandum items:	
Net foreign assets [1.1 - 2.1]	682.2
Foreign currency deposits of central government 2/	113.6
Valuation changes to NIR (cumulative from end-2002	-
NIR excluding valuation changes	**613.0**

Source: NBRM

1/ Valued at program exchange rates (denar/U.S. dollar: 45.0676, denar/euro: 61.3100; U.S. dollar/euro;1.3604).

2/ Foreign currency deposits of central government are excluded from reserve liabilities.

Table 2. Balance of Payments Financing Assumptions, from end-December 2004 to end December 2006 1/

(quarterly flows in millions of euros, unless otherwise indicated)

	Mar-05	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06
Grants	0.0	6.3	0.0	7.0	0.0	0.0	0.0	0.0
The Netherlands	0.0	6.3	0.0	7.0	0.0	0.0	0.0	0.0
Loans	0.0	19.2	6.8	185.6	11.2	0.0	0.0	22.1
IBRD/IDA	0.0	14.7	0.0	22.1	0.0	0.0	0.0	22.1
Euro Bond	0.0	0.0	0.0	150.0	0.0	0.0	0.0	0.0
EBRD (ESM pre-privatization loan proceeds)	0.0	4.5	6.8	13.5	11.2	0.0	0.0	0.0
Privatization proceeds in foreign currency	0.0	0.0	0.0	0.0	250.0	0.0	0.0	0.0
Lump-sum proceeds from concession fees	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Restitution of foreign assets of the former SFRY	0.0	0.0	0.0	6.5	0.0	0.0	0.0	0.0
Prepayment of foreign loans (minus)	0.0	0.0	0.0	0.0	-120.1	0.0	0.0	0.0
Total								
BOP financing assumptions for TMU (quarterly flows)	0.0	25.5	6.8	199.0	141.2	0.0	0.0	22.1
BOP financing assumptions for TMU (cumulative from end-December 2002)	0.0	25.5	32.3	231.3	372.5	372.5	372.5	394.5

1/ At program exchange rates.