International Monetary Fund

Former Yugoslav Republic of Macedonia and the IMF

Press Release: IMF Executive Board Completes Second Review Under Stand-By Arrangement with the Former Yugoslav Republic of Macedonia
April 27, 2007

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

April 10, 2007

> 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.

Also available in Macedonian

Skopje, Macedonia
April 10, 2007

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

Dear Mr. de Rato,

1. **Our new government is committed to create an economically strong and socially just country, which will accomplish full integration into the European community of peoples**. We will work to realize an ambitious, but also realistic and attainable program, which should bring about a better and more prosperous Macedonia. We will seek to achieve sustained, high economic growth and a high degree of employment, with the aim of doubling per capita income in 10-12 years. The key for achieving higher growth and prosperity lies in maintaining macroeconomic stability, while implementing structural reforms to improve the business climate. We will facilitate Macedonia's integration in the global economy, and create an environment that fosters internationally competitive enterprises. The functioning of important markets—including financial markets and the labor market, but also product markets that hold the key to Macedonia's integration in the world economy, such as the telecommunications market—needs to be improved.

2. **Economic performance under the Stand-By Arrangement (SBA) remains strong.** According to preliminary production data, real GDP grew by around 3 percent in 2006, but indirect indicators of economic growth suggest that real economic growth may have been higher. Although average inflation increased to 3.2 percent in 2006, this was largely due to one-off factors, including the increase in tobacco excises and related duties introduced in January 2006 and the increase in household electricity prices in September 2006. The external position continued to improve, owing partly to continued buoyant private transfers and higher-than-anticipated proceeds from the sale of the electricity distribution company (ESM). The trade deficit was slightly higher than projected, with higher exports in virtually all sectors offset by higher imports of investment goods. Gross reserves amounted to €1.4 billion, or 4½ months of imports of goods and services, as of end-December 2006.

3. **We have met all fiscal and monetary program targets under the SBA in 2006** (Table 1). For most of the year, the fiscal balance was in surplus. Though taxes and contributions overperformed, there was a shortfall of non-tax revenues (because of the unpaid 2005 telecom dividend). This was offset by lower than programmed expenditures, mainly investment. In November, parliament approved a supplementary budget authorizing

additional spending of about 2 percent of GDP, to finance increased spending on agriculture, under budgeting of utility bills, mandatory government payments related to accelerated court rulings on a range of contingent liabilities, higher-than-budgeted take-up of the second pillar pension system, and arrears settlement by the health fund. These additional expenditures were met within the 0.6 percent of GDP deficit target. Sound macroeconomic policies have kept central bank interest rates stable at around 5½ percent, down from around 10 percent in October 2005, but commercial banks have only partially matched these cuts.

4. **However, progress in structural reforms slowed in the summer of 2006** (Table 2), owing to the July elections and the subsequent formation of our new government. The new government that took office on August 28, 2006 has taken key steps to overcome these delays:

- We have established a **Large Taxpayer Office** (LTO) on July 1, 2006 within the Public Revenue Office, which has been fully operational since October. In October 2006, we have also established a **Large Contributor Office** (LCO) in the Pension and Disability Fund (PDF) and staffed it with employees from the three funds that collect social security contributions—the PDF, the Health Insurance Fund (HIF) and the Employment Fund (EF). Creation of the LTO and the LCO is an important first step in the harmonization of the bases for social security contributions and the personal income tax, discussed in greater detail below. With these offices now established, we would like to request a waiver for noncompliance with the end-July 2006 performance criterion on the establishment of a Large Taxpayer Office and Large Contributor Office.

- **In line with our existing program commitments, we will implement the harmonization of social security bases.** The First Review envisaged that at the time of the Second Review, this action would be set as a performance criterion for end-December 2006. Given the revised timetable for this Board meeting, this reform is being set as a performance criterion for end-July 2007, starting with salaries for June 2007.

- **As a prior action for completing the Second Review, we will submit to parliament a new banking law that is consistent with technical assistance provided by Fund staff.**

- **We have not been able to sell the government's residual shares in Makedonski Telekomunikacii AD due to weak public interest and the company's failure to complete its 2005 accounts.** We now aim to first implement further measures to liberalize the telecommunications sector—which are already having an effect—and then reconsider our strategy to divest these shares after these measures have taken their full effect (see paragraph 29). In light of this revised strategy, we request a waiver of non-observance of the end-December 2006 structural performance criterion.

5. **Against this favorable backdrop, we request the completion of the Second Review.** We believe that the policies described in this letter (with program conditionality summarized in Tables 3 and 4) will achieve the goals of our economic program: sustained, high economic growth, high employment, and better integration in the world economy. Nevertheless, we stand ready to take any further measures to keep our program on track. We will remain in close consultation with the Fund, in accordance with the Fund's policies on such consultations. We will provide the Fund with such information as it requests on policy implementation and achievement of program objectives. The forthcoming Third Review, scheduled for the second half of 2007, will assess progress in program implementation, reach understandings on any measures that may be needed to reach the program's objectives, and set performance criteria for 2008.

6. **We reaffirm our intention not to make this and future purchases under the SBA that will become available upon observance of performance criteria and completion of reviews**. Going forward, in repaying our obligations to the Fund, we will make advance repayments that mirror a shift from an obligations to an expectations basis, in light of our strong international reserves position. In light of the delayed completion of this review, we would like to rephase purchases under the Arrangement, such that there will be five reviews rather than six reviews. Subsequent reviews will occur on or after August 15, 2007, February 15, 2008 and August 15, 2008 (Table 5).

Economic policies for 2007 and for the medium term

7. **Accelerating economic growth and job creation while maintaining macroeconomic stability is the main goal of our economic program.** The July 2006 election result has provided us with a strong mandate for implementing our ambitious economic reform program. Key elements of this program—discussed in greater detail below—are to:

- **Simplify tax policy and administration,** including by introducing flat and lower personal and corporate income tax rates, while broadening the bases of these taxes to contain revenue losses. In particular, we have eliminated the double deduction for investment in fixed assets from the corporate income tax law;

- **Reduce public expenditure** by 2 percent of GDP by 2010, while increasing the share of investment, education and health expenditures; increase the efficiency of spending on health and education;

- **Develop infrastructure** by expanding road, electricity and irrigation networks, and reducing telecommunication costs;

- **Improve market institutions,** including by simplifying registration and licensing requirements, completing the land cadastre, and improving the functioning of financial markets;

- **Improve governance**, including by strengthening the transparency of public procurement and by establishing an agency to fight organized crime;

- **Promote foreign direct investment**, by improving the business climate and deregulating the economy;

- **Develop agriculture and rural regions**, by implementing structural reforms (improving the functioning of the agricultural land market), undertaking infrastructure investments to improve competitiveness, and harmonizing policies and institutions with the EU's Common Agricultural Policy.

8. **The economic outlook for 2007 and for the medium term is favorable.** To ensure our budget has firm foundations, our macroeconomic framework is prudent: growth is assumed to reach 4½ percent in 2007. However, once our reforms are implemented, our objective is for growth to be considerably higher: as much as 6 percent in 2007, 6½ percent over the medium-term. Growth in 2007 is expected to be fueled by private consumption and investment. Inflation is expected to decrease to around 3 percent in 2007 and 2 to 2.5 percent over the medium term, in line with partner countries. The current account deficit in 2007 is expected to be around 3 percent of GDP, reflecting the payment of both the 2005 and 2006 telecom dividend. Increases in bank credit and greenfield FDI will stimulate consumer and investment goods imports, but exports, especially in iron and steel, are also expected to grow sharply. Increasing private and public capital inflows will continue to improve the capital account. As a result, gross international reserves are expected to further increase to around €1.5 billion by end-2007.

Fiscal policy and public sector reforms

9. **To secure macroeconomic stability, we will keep the 2007 fiscal deficit target at 1 percent of GDP (performance criterion), while improving the composition of the budget:**

- **We are reducing taxes and redirecting government spending to more productive uses**. The introduction of flat and lower personal and corporate income tax rates coupled with zero taxation of reinvested profits in January 2007 will likely cost around 1 percent of GDP in 2007. The possible loss of revenue stemming from the introduction of zero taxation of reinvested profits will be limited in 2007 by capping this deduction to a maximum of 50 percent of the CIT tax base. This cap will be reviewed towards the end of 2007, in light of the experience gained during the year with the new tax laws. Important reforms aimed at streamlining revenue administration, including the introduction of harmonized bases for social security contributions and the elimination of customs declaration fees, will result in a small revenue loss (0.2 percent of GDP). On the expenditure side, a planned decompression of wages in the education sector is estimated to cost 0.3 percent of GDP, while we intend to increase investment and EU-related spending by 0.5 and 0.1 percent of GDP.

- **We are taking steps to finance these reforms**. We have broadened the tax base by abolishing some existing exemptions from the corporate income tax (projected to raise 0.1 percent of GDP). We have also increased fees on gambling establishments and taxes on games of chance: these are projected to raise 0.1 percent of GDP in revenues. Wage expenditures are expected to decline by 0.1 percent of GDP due to lower personal income taxes and social insurance contributions, while spending cuts on furniture and cars and better targeting of social spending (through reduction of subsidies) are expected to generate savings of 0.2 percentage points of GDP.

- **In January 2007, Paris Club creditors accepted our proposal to immediately pay off our debt in the amount of US$104 million.** We expect to complete these prepayments by end-April 2007. As a result, interest payments on our foreign debt will decline and Macedonia's medium-term debt sustainability and public debt structure will improve.

- **Consistent with our commitment to fiscal discipline, we will keep non-HIF central government arrears close to their end-2004 level.** We are also taking steps (see below) to address problems in health and energy sector finances, to make sure these will not require additional transfers from the budget later in the year.

- **Fiscal policy underpins our commitment to macroeconomic stability and debt sustainability**. We stand ready to tighten the budget in the second half of 2007 if risks to meeting our fiscal target emerge or (unless clearly the result of increased FDI) the current account deteriorates by more than 1 percent of GDP compared to the program projections. To prevent spending one-off revenues, we will also cap the contribution of the telecom dividend at 2.5 billion denars in 2007 (when measuring the fiscal deficit under the program). Pending the sale of our remaining shares in Maktel, we will cap the contribution of the dividend at 2.0 billion denars in 2008, and for this to progressively decline. This is consistent with our plan to liberalize telecommunications, and for monopoly profits in this sector to gradually disappear.

10. **Over the medium term, we will maintain a prudent fiscal policy stance.** By keeping the central government deficit to 1-1½ percent of GDP in 2008-10, we will safeguard macroeconomic stability and debt sustainability. Within this framework, we aim to further reduce personal and corporate income tax rates. Government spending will be cut by

2 percent of GDP by 2010. Within this lower limit, we will create room to increase investment and education spending. Gross debt of the general government (including central government, funds and municipalities) will remain below 38 percent of GDP, excluding Treasury bills for monetary policy purposes. We have strengthened the debt management function at the Ministry of Finance, including by establishing a middle office in the public debt management department in December 2006 responsible for formulating policy and strategy for public debt management, tracking implementation of the portfolio targets, risk management and reporting.

11. **We will further develop the domestic public debt market**. Measures will include (i) extending the maturity of the central government's domestic securities, (ii) introducing non-competitive bids by end-March 2007, and (iii) establishing a primary dealer system by end-September 2007. Also, we will review our auction mechanisms and the instruments used to sterilize capital inflows in light of IMF technical assistance.

12. **Our health care reforms will increase accountability for delivering quality within agreed budget limits**:

- **To achieve this goal, we have replaced the entire Board of the Health Insurance Fund (HIF), as we were not satisfied with its performance.** We have secured appropriate representation from the Ministry of Finance and the Ministry of Health among the new Board members, and on September 28, 2006, appointed a budget officer from the Ministry of Finance in the HIF (structural benchmark for September 2006) .

- **Placement of budget officers in health care institutions (HCIs) has been delayed by the need to provide appropriate training**. The initial training has been completed and the officials put in place, with their terms of reference ready (structural benchmark for June 2006). After preparing appropriate legislation, by June 2007 we will appoint economic directors in all HCIs. They will be responsible for sound financial management, while the medical directors will be responsible for clinical aspects of HCI operations. Managers of HCIs that show negative operating results in two consecutive quarters will be replaced.

- **We are taking steps to reduce costs of healthcare provision.** Following a careful costing exercise (undertaken in cooperation with the World Bank), we are revising the standard medical benefits package available to all citizens and introducing a new list of medicines that it will cover. Our new international tendering for drug procurement will be concluded in June (structural benchmark). These reforms are expected to generate financial savings of 0.2 percent of GDP. We also aim to contain the wage bill in the health sector at the end-2006 level.

- **As of end-June 2006, HIF arrears measured using the program definition (obligations that are due but not paid by more than sixty days) were paid in full.** They have remained very low since then. Going forward, we aim not to accumulate any new arrears (the attached Technical Memorandum of Understanding sets a revised and much lower ceiling for HIF arrears) and also to reduce the stock of arrears of HCIs, which we will report under the program.

- **With finances now stabilized, we plan to embark on more fundamental health sector reforms**. We have changed the HIF's de facto role of financing health sector infrastructure to that of financing provision of health services. This should improve efficiency in the health care system and significantly reduce patients' informal out-of-pocket expenditures that currently contribute to poverty and inequality in access to health care services.

13. **We are streamlining tax administration to create a better business climate and to boost revenues:**

- **With technical support from the Netherlands and the Fund's Fiscal Affairs Department, we have embarked on a 3-year program to strengthen the effectiveness and efficiency of revenue administration to increase revenues, support essential government expenditures, and reduce the administrative burden on businesses.** This program includes measures for harmonizing the bases for and integrating the collection of social insurance contributions (for pensions, health, and employment) and personal income tax in a carefully phased, step-by-step manner.

- **Consistent with this strategy, in March 2007 Parliament passed legislation harmonizing the bases for social contributions.** This initiative is based on our recently completed strategy paper for harmonizing the bases for social security contributions that identifies key parameters for harmonization of social contribution bases, including a simple minimum contribution base based on the average wage, use of gross wages in rate calculations, common definitions of employer and employee, common lists of beneficiaries and a common definition of employment income. In line with the commitment made at the First Review, we will implement this new legislation, starting in July 2007 with salaries for June 2007 (structural performance criterion).

- **We plan to fully harmonize PIT and social contributions.** To this end, we will prepare a strategy (structural benchmark) by September 2007 for harmonizing the two sets of bases; phased implementation by the start of 2008 will be set at a subsequent review as a structural performance criterion. The strategy will consider, inter alia, (i) shifting from net to gross wages in calculating personal income tax and social contributions; (ii) phasing out the minimum base for social contributions; and (iii) calculating health care contributions on a per-hour basis. A final decision on the implementation of these reforms will be guided by future Fund technical assistance.

- **As an intermediate step towards integrating the collection of social contributions and taxes, the Pension and Disability Insurance Fund (PDF) will start collecting all social insurance contributions.** By April 2008, the PDF and its network of field offices will design and execute the collection programs for social insurance contributions and their contributors (structural performance criterion). These programs will include registering the contributors, processing declarations and payments, maintaining records of amounts paid and owed, auditing declarations, and recovering late payments and declarations. We have already established a Steering Committee to oversee this initiative, and in March 2007 the Steering Committee appointed a project team—with representatives from the PDF, the HIF, and the EF—to plan, design, and implement the integrated collection of social insurance contributions. By September 2007 draft legislation that vests the PDF with the legal authority for collecting health and employment contributions will be submitted to Parliament (structural benchmark). In addition, by September 2007 the Ministry of Health and Ministry of Labor will sign an inter-agency agreement that sets out the terms and conditions under which the Pension Fund will collect health and employment contributions on behalf of the Health and Employment Funds.

- **In the meantime, the Public Revenue Office (PRO) will be strengthened in preparation for fully integrating the collection of taxes and social insurance contributions.** In February 2007, the PRO finalized a strategic plan to guide its continuing modernization over the period 2007-09. As part of this process, the PRO will each year set operational targets and formulate new initiatives for registering additional taxpayers, improving taxpayer services, recovering tax arrears and delinquent tax returns, and auditing taxpayers. By May 2007, the PRO will identify performance measures for each of these functions, and set target levels of performance to be achieved by end-2007 (structural benchmark). We will further enhance the PRO's operational capacity by conducting an organizational and workforce review, preparing a comprehensive human resource management strategy, designing a new information technology system that is fully compatible with the PDF system, and preparing a comprehensive human resource management strategy under which all PRO staff would be subject to the same human resource policies set out in the Law on the Public Revenue Office. While continuing to improve the large taxpayer office, the PRO will also design a strategy for improving the administration of small- and medium-sized taxpayers (structural benchmark for end-June 2007). The integrated collection of taxes and social contributions will be carefully piloted in 2009. We aim for the PRO to collect all taxes and contributions from all employers by end-2009.

14. **Fiscal decentralization is a key element of our public sector reform program.**

- **On the basis of the Law on Local Self Government, municipalities will assume greater responsibility for various important state functions following the start of the**

second phase of the decentralization process. As a result, the share of local government expenditures in general government expenditures is projected to increase from around 8 percent at present to around 16-18 percent after the completion of the decentralization process and the consolidation of the new local government system.

- **We will strengthen the revenue base of municipalities to finance these expenditures**. Municipalities have now assumed responsibility for the administration of the property tax. This tax has a clear potential for greater revenue as existing valuations are often out of date, and tax rates are low by international standards. By end-2007 the base of the property tax will be broadened by including business premises.

- **We will strengthen the control and monitoring of local government finances.** The Law on Local Financing shall be amended and modified so as to tighten the procedure for domestic and external borrowing and issuance of guarantees by municipalities. These amendments and modifications were submitted to the Parliament in February 2007. From January 2007 we started to prepare quarterly reports on the revenues, expenditures and fiscal balances of local governments; these will be treated as a memorandum item under the program.

15. **In accordance with pre-accession fiscal surveillance required for EU membership, we will start participating in the fiscal notification exercise in 2007**. On 30 November, 2006 we submitted our first pre-accession economic program to the EU. We will work towards the introduction of European System of Accounts 1995 (*ESA 95*) over the medium term, to ensure that statistics are in accordance with EU requirements. As a first step towards *ESA 95*, we will recast cash statistics into the analytical framework of the *Government Financial Statistics Manual 2001* by end-2007.

16. **We will continue to monitor and control finances in public enterprises.** By mid-2007, we will enact legislation requiring public enterprises to submit quarterly reports on their financial position to the government. The first reports will cover the second quarter of 2007 and will be submitted by October 2007 (structural benchmark). On the basis of these reports, we will begin to report the financial position of public enterprises on a quarterly basis, starting with the four largest (ELEM, MEPSO, Macedonian Railways and the State Company for Management of Resident and Business Premises); these will be included as a memorandum item under the program. We have also prepared our first annual report on the government's economic activities (meeting a structural benchmark for December 2006). The report includes a list of the state's equity holdings, and plans for privatization.

17. **We will intensify our efforts to improve the management of major public enterprises, and we are committed to selling remaining government equity stakes in enterprises.** Rationalization of the management of public enterprises and sale of remaining government equity shares will make a crucial contribution to improving both public finances

and the business climate. In the past, inadequate management of the State Company for Management of Resident and Business Premises has contributed to poorly defined property rights and inefficient use of real estate. Following an international tender procedure, a consultant will prepare the privatization of this company in 2007. We have also prepared an action plan for the reorganization of Macedonian Railways, in cooperation with the World Bank. Rail infrastructure will remain in state hands, while rail transport will be privatized in 2008. In addition, tender procedures for selling government equity stakes in two major enterprises are now underway. For remaining state equity holdings, tenders will be announced during 2007.

Monetary and financial sector reform policies

18. **The NBRM will continue to support our economic program by maintaining a de facto pegged exchange rate regime backed by adequate international reserves.** The NBRM's monetary program for 2007 is consistent with broad money growth of about 20 percent, in line with a gradual increase in money demand. We expect that sizable inflows of capital experienced in 2006 will continue in 2007, reflecting confidence in our macroeconomic policies. To ensure the continued success of the de facto pegged exchange rate, we stand ready to continue our policy of sterilizing inflows through the issuance of central bank bills and treasury bills for monetary policy purposes. Increased monetization, supplemented with a moderate increase in external financing and a drawdown of banks' funds abroad, will further increase private sector credit and financial intermediation.

19. **The government remains committed to strengthening the financial soundness of the Central Bank and safeguarding its independence.** In December, Parliament passed amendments to the NBRM law to: (i) let the NBRM retain 70 percent of its profits when general reserves are below the statutory limit, and then 15 percent after that, and (ii) limit the right of appeal to the NBRM Council to internal NBRM decisions, while letting appeals of external decisions go directly to the courts (structural benchmark for end-June).

20. **We have prepared a comprehensive revision of the legal framework to improve the soundness of the banking system.** After consultations between the Ministry of Finance and the NBRM, we produced a draft new Banking Law. In line with international best practice, the new law enhances licensing requirements, strengthens banks' governance, increase minimum capital requirements, tightens provisions on connected lending, and establishes a clear framework for consolidated supervision as well as for corrective actions and resolution of weak or insolvent banks. It also includes measures to allow foreign bank branching. The draft Banking Law also contains provisions to protect the governor's decisions in the areas of bank licensing, receivership and bankruptcy from reversal by the courts, though successful appeals still might seek financial compensation. Submission of the new banking law to Parliament is a prior action for completing this review. In 2007, we

expect to review the Law on Deposit Insurance to ensure its consistency with the new Banking Law, including setting an appropriate target for Deposit Insurance Fund reserves and ensuring more timely payment of insured deposits.

21. **We have strengthened several aspects of banking supervision.** In spite of improving indicators of creditworthiness, for prudential reasons the NBRM has tightened prudential guidelines for banks' lending denominated in or indexed to foreign currency. The NBRM has also introduced a mandatory specific provision of 1 percent on A-type loans, while keeping the voluntary specific provision of 2 percent, and enacted rules requiring a gradual write-off of foreclosed assets. Moreover, as of end-October 2006, we have increased the resources of the supervision and banking regulations department by 10 new staff (structural benchmark); we stand ready to add more resources as needed. We have improved the tax treatment of banks' loan loss provisions by making specific provisions fully tax-deductible.

22. **The NBRM's Supervisory Development Plan, which aims to migrate to a more risk based, anticipatory approach to banking supervision, is now being implemented.** In accordance with this plan, by end-September 2007, the NBRM will prepare a framework for assessing banks' risk profile and test the performance of the prepared procedures on at least two banks (new structural benchmark). The NBRM will then finalize by end-December 2007 a detailed guidance manual which will be used for conducting on-site supervision (new structural benchmark).

23. **While our commitment to enhance banking intermediation, strengthen credit culture and market discipline is undiminished, the timing of a few measures envisaged in the previous Letter of Intent was delayed for technical reasons:**

- Owing to the belated finalization of the memorandum of understanding between a donor and the NBRM, the **selection of the consulting company that will help the NBRM to carry out the transition to IFRS** in the banking system was undertaken only in September, and its contract finalized in November. Therefore, the NBRM now aims to issue accounting guidelines, a new chart of accounts and formats for banks' financial statements in line with IFRS by end-September 2007 (rephased structural benchmark). The new Banking Law will allow the NBRM to set additional accounting guidelines and request further information and disclosures from financial institutions that are needed for prudential purposes.

- **The current credit registry is in the process of being upgraded in several respects** where several new supervisory tools have been added, including a transition matrix on borrowers' risk classification. Starting in January 2007, additional information will be obtained by the credit registry from the Central Registry, thus making financial and other data accessible to supervisors. Further enhancements of the quantity and timeliness of data accessible to banks (such as reducing the loan threshold, switching to monthly reporting, and shortening the data processing period) require more advanced hardware and software. The NBRM has, therefore, decided to launch a project aimed at creating a totally new credit registry that is expected to be fully operational by December 2007 (rephased structural benchmark).

Attracting foreign investment and improving the business climate

24. **Implementation of regulatory reforms and improvement of the quality of regulations are among our top priorities**. In close consultation with the business community, and drawing on the expertise of the World Bank, we will simplify the regulatory regime and improve the quality of regulations affecting business activity. In November 2006 we made a government decision introducing the "regulatory guillotine", with clear steps and deadlines for its implementation. Government working groups have submitted a list of laws and by-laws that regulate the economy. We are now reviewing these, in consultation with the business community. As a result of this process, we will publish a list of all licenses administered by line ministries and government agencies, together with their justification, by end-June 2007 (rephased structural benchmark); those that are not needed will be abolished by end-September 2007 (rephased structural benchmark).

25. **We will strengthen our legal system, property rights, and contract enforcement**. At present, about 50 percent of the territory in Macedonia is covered by the Real Estate Registry, while the remaining 50 percent is still covered by the Land Cadastre. In order to resolve this problem, we will expand the coverage of the Unique Real Estate Registry (Cadastre) to 68 percent by end-2007, and aim to complete it by end-2008. This will provide legal security to investors and will allow for use of land as loan collateral, which will help expand credit. We will also improve contract enforcement by reducing the backlog of court cases. Effective implementation of a group of new laws, including the Law on Enforcement, the Law on Courts and the Law on Misdemeanors, will increase the independence and the efficiency of our judiciary. The Judicial Budget Council's analysis of the fiscal implications of judicial reform has been used to determine our court budget request for the 2007 budget (structural benchmark).

26. **Attracting greenfield foreign direct investment by leading international companies is a key objective of our economic program.** In 2007, we will formulate a national program to stimulate investments, which will identify priority measures and activities necessary to attract high quality FDI for the period of 2007-2010. The efforts to promote Macedonia as a favorable destination for foreign investment were intensified with the appointment of two ministers responsible exclusively for foreign investment promotion, organization of a high-level Investor Forum in 2007, reorganization of the Agency for Foreign Investment and a range of other activities. The Investor Forum will track

improvements in the business climate and learn of foreign investors' concerns. In January 2007 Parliament replaced the old free economic zone law with a new Law on Technological Industrial Development Zones. These zones will encourage the development of companies in the information technology, innovation and research sectors and companies producing according to new technologies and high ecological standards. To qualify for the preferred tax regime offered by this new law, firms must export at least 80 percent of their production. We will ensure that our initiatives to encourage FDI will neither compromise our fiscal deficit target, nor the quality of the budget.

27. **We will further liberalize the labor market by reducing the labor wedge and promoting part-time work.** Our reforms of personal income tax and social security contributions discussed have already reduced labor costs, promoting employment. Phased implementation of our strategy to harmonize the bases of PIT and social contributions (discussed in paragraph 13) should contribute to a further reduction in the labor wedge. Phasing out minimum social contributions (which at present are based on 65 percent of the average wage) and calculating health contributions on a per hour basis instead of the current practice of calculating them on a full time basis regardless of hours worked could make important contributions to reduce the labor wedge and promote part-time work.

28. **We will improve the financial condition of the energy sector, and ensure stable energy supply.** The government has unbundled the sector's generation, distribution and transmission assets, and the distribution arm (ESM) was sold to a strategic investor (EVN) in March 2006. We are now privatizing the Negotino thermal power plant, the second largest in the country. In addition, we have initiated private participation in the development of more than 60 small and medium-sized hydro-electric facilities, and the sale of the Skopje gas company. We will develop an action plan, working with the World Bank, to improve finances in this sector, by end-May 2007 (new structural benchmark). This plan will contain the following elements:

- **First, we will provide strong support to the transmission and the distribution companies** in their efforts to cut off non-paying customers—whether they are budget organizations, large industrial users, or households.

- **Second, the supplementary 2006 budget contained sufficient allocations to pay off outstanding arrears of budget users**, and we have ensured that 2007 budget allocations are sufficient to meet the electricity needs of these organizations. We will support EVN-ESM in their efforts to (i) identify any remaining arrears, and reach agreement with budget users on the amounts due; (ii) design mutually agreed payment plans to gradually reduce these arrears; and (iii) ensure that budget users will make timely payments for their current electricity needs.

- **Third, in March 2007 we amended the energy law to limit the quantity of electricity that large industrial users will be allowed to purchase** from MEPSO at a regulated price and provide these users with an option to buy electricity directly from suppliers other than MEPSO.

- **Fourth, we will continue to support the independence of the Energy Regulatory Commission**. We will encourage both ELEM and MEPSO to review their current cost structure and determine whether their prices are adequate to cover both operational and capital costs. If they find that prices do not cover costs, we will not object to these companies submitting a request for a price increase to the Regulatory Commission immediately. ELEM and MEPSO will also make greater efforts to reduce their costs.

- **Fifth, we will consider the options for developing a proper social protection mechanism** to provide an affordable minimum electricity supply to poor households.

If this action plan does not fully address all financial losses incurred in the sector, we will take offsetting measures to protect the fiscal deficit target that do not worsen budget quality.

29. **We are strongly committed to telecommunications liberalization.** This will significantly reduce the cost of doing business, and is critical to increasing the globalization of Macedonia's economy. We have already made significant progress towards reducing telecommunications costs and expanding Internet access:

Progress In Telecom Liberalization

	2005q1	2005q2	2005q3	2005q4	2006q1	2006q2	2006q3	2006q4	2007q1
Number of VOIP providers 1/	...	...	...	20	...	...	...	46	...
Number of internet providers 1/	...	...	...	12	...	...	...	87	...
Fix telephone providers 1/	...	...	...	1	...	...	...	1	2
Internet penetration 2/	...	...	...	...	...	...	...	27	...
Interconnection fees (local call origination) 3/	...	...	...	...	...	1.43	...	...	0.54
Fixed telephone tariff to US 4/	18.0	...	...	...	...	12.90	...	...	8.39
Fixed telephone tariff to Germany 4/	27.0	...	...	...	...	16.90	...	...	8.39

1/ Number of notified providers at the end of the year.
2/ Number of internet users as a fraction of total population, based on 2006 survey.
3/ Denars per minute (MakTel).
4/ Denars per minute (MakTel); drop in price from 2006q2 reflects entry of three new providers.

- **In January 2007, the Agency for Electronic Communication reduced interconnection rates by 300 percent**. This has facilitated competition in landline telecommunications, with a second provider now entering this market.

- **In addition, in February 2007, parliament adopted amendments to the law on telecommunications that will in effect terminate the existing concession agreements** between the Ministry of Transport and Makedonski Telekomunikacii AD

(Maktel), Mobimak and Cosmofon by end-March 2007, thereby resolving the conflict between the 2005 telecommunications law and these concession agreements.

- **We also completed the sale of a license for a third mobile operator in March 2007**.

- **We plan to allow telephone number portability by July 2007**.

Since these steps to liberalize the telecommunications market will take time to have their full effect, the government is reconsidering its strategy to divest its remaining shares in Maktel. The continuing audit of Maktel's 2005 accounts also needs to be completed before the government can make an informed decision on the appropriate privatization strategy. If we decide to sell the remaining shares, we will hire a consultant to prepare options for the ownership of our remaining shares in Maktel. Consistent with the objectives of the government, and as established at the First Review, the program will continue to monitor quantitative measures of liberalization in this sector every six months (structural benchmark).

30. **To facilitate Macedonia's integration in the global economy, the air transportation system needs significant improvements.** We will liberalize the market for air transport, consistent with our commitment to meeting the EU *acquis*, and with the aim of easing the conditions for low-cost airlines to establish operations. Macedonian Airlines (MAT) will be stripped of its industry regulatory functions. Ratification by Parliament of the European Common Aviation Area (ECAA) agreement, which took place in February 2007, is a key step towards liberalization of the air transportation market.

Sincerely,

/s/
Nikola Gruevski
Prime Minister

/s/
Zoran Stavreski
Deputy Prime Minister

/s/
Trajko Slaveski
Minister of Finance

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

Table 1. FYR Macedonia: Quantitative Performance Criteria and Indicative Targets for 2006
(Targets and Actual Outcomes)

	Mar-06	Jun-06	Sep-06	Dec-06
	(In million euro)			
	End of Period Stocks for Program Evaluation			
Floor for net international reserves of the NBRM	909	968	1,027	1,058
Adjustor	-66	-20	30	-55
Revised target	844	948	1,057	1,003
Actual	965	1,049	1,176	1,230
	Cumulative Changes for Program Evaluation			
Ceiling on new non-concessional medium- and long-term external debt contracted or guaranteed by the general government or the NBRM with original maturities of more than 1 year	231	239	246	286
Actual	209	280	280	280
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
Actual	0	0	0	0
Accumulation of external payments arrears	0	0	0	0
Actual	0	0	0	0
	(In million denars)			
	Quarterly Stocks for Program Evaluation			
Ceiling on net domestic assets of the NBRM	-37,980	-40,830	-44,303	-44,824
Adjustor	4,020	1,211	-1,855	3,372
Revised target	-33,960	-39,619	-46,158	-41,452
Actual	-44,207	-47,682	-52,149	-51,586
Ceiling on net domestic assets of the banking system (indicative)	24,022	26,797	31,416	30,129
Adjustor	4,020	1,211	-1,855	3,372
Revised target	28,042	28,008	29,561	33,501
Actual	18,666	20,091	21,164	29,780
Ceiling on net domestic credit to the central government from the NBRM	-26,301	-20,808	-19,996	-25,942
Adjustor	4,020	1,211	-1,855	3,372
Revised target	-22,281	-19,597	-21,851	-22,570
Actual	-23,303	-27,247	-28,502	-25,486
Ceiling on central government domestic arrears excluding suppliers (indicative)	0	0	0	0
Actual	0	0	0	0
Ceilings on central government domestic arrears to suppliers (indicative)	979	979	979	979
o/w non HIF domestic central government arrears	309	309	309	309
Actual	1,236	333	482	254
o/w non HIF domestic central government arrears	375	330	458	254
Ceiling on arrears of the Health Insurance Fund (indicative)	670	670	670	670
Actual	861	3	24	0
	Cumulative Flows within the Year			
Ceiling on central government wages (indicative)	...	...	...	24,666
Actual	...	...	...	23,421
Floor for central government fiscal balance	-253	-1,364	-2,570	-1,851
Adjustor	552	530	781	579
Revised target	299	-834	-1789	-1272
Actual	113	437	1778	9
Memo item: Program exchange rate (Denars per Euro)	61.31	61.31	61.31	61.31

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

Table 2. FYR Macedonia: Performance of Structural Conditionality in 2006

Measure	Type 1/	Status
June 2006		
Sale of the first tranche (at least 10 percent of the company) of government's residual shares in Makedonski Telekomunikacii AD.	PC	Met.
LTO to pilot test a new computer system which is compatible with systems being developed by the social funds.	BM	Met.
Start publishing comprehensive data on the realization of the government's on-lending agreements and government projections for future on-lending.	BM	Met.
Anti-corruption commission to audit the financial disclosure reports of randomly chosen senior elected and appointed officials and civil servants.	BM	Met.
HIF to report on its spending by economic classification, on a cash and commitment basis, including a breakdown of HCI spending, based on the Q1 2006 outcome.	BM	Met. Published on the HIF website.
Pass amendments to the NBRM law and other legislation that revise provisions on the retention/distribution of NBRM profits and to strengthen governor's decision-making powers (new commitment).	BM	Partially achieved. Amendments to the NBRM law were passed with delay in December 2006.
Place budget control officers in the 15 largest HCIs.	BM	Achieved with delay (in place November 2006, fully operational January 2007).
Government to prepare a strategy paper for base harmonization among social contributions.	BM	Achieved with delay (January 2007).
Liberalize the telecommunication sector (to be measured, inter alia, by the number of new VOIP and other service providers, new fixed line competition, and additional mobile telephone licenses).	BM	Met.
Introduce prudential regulations on a gradual write-off of foreclosed assets and a mandatory 1 percent general provision on A-type loans.	BM	Met.
July 2006		
Establish a Large Taxpayer Office at PRO and a Large Contributor Office at PDF.	PC	Not observed. LTO established on schedule in July 2006. LCO has been established, but legal problems mean it only has a monitoring role. Revised strategy is to integrate all social fund collections (not just large contributors) by April 2008.
Amend Law on Misdemeanors to allow administrative bodies (such as NBRM, PRO, Customs) to impose sanctions on misdemeanor cases without prior court involvement.	BM	Met.

1/ PC=structural performance criterion; BM=structural benchmark

Table 2. FYR Macedonia: Performance of Structural Conditionality in 2006 (continued)

Measure	Type 1/	Status
September 2006		
Submit to Parliament legislation on a harmonized base for social insurance contributions.	BM	Achieved with delay (January 2007). Implementation will start July 2007.
Establish MOF budget officer in the HIF.	BM	Met.
Complete draft Banking Law agreed with the staff (focused on, inter alia, bank governance, consolidated supervision, the framework for corrective actions and resolution of weak or insolvent banks, connected lending, and harmonization with EU legislation).	BM	Achieved with delay.
Judicial Budget Council to prepare a detailed analysis of the fiscal implications of judicial reform.	BM	Achieved with delay.
Publish a list of all licenses administered by line ministries and government agencies, together with their justification.	BM	Not met. The new government has a more comprehensive approach to regulatory reform. Reset to June 2007.
December 2006		
Sale of all of the government’s residual shares in Makedonski Telekomunikacii AD (except for a minority shareholding of up to 7 percent).	PC	Not met. Put up for sale in June 2006 but attracted insufficient bids. New government to decide on completing sale later. Revised strategy focuses on liberalization.
Issue accounting guidelines, chart of accounts and formats for banks’ financial statements in line with IFRS.	BM	Not met. Technical assistance was delayed. Preparations commenced. Reset for end-September 2007.
Liberalize the telecommunication sector (to be measured, inter alia, by the number of new VOIP and other service providers, new fixed line competition, and additional mobile telephone licenses).	BM	Met.
Prepare a report on the government's economic activities.	BM	Met.
Add 10 staff to the NBRM's Supervision and Regulation Department.	BM	Met.
Revise the systematization of selected line ministries and reflect the new systematization in the 2007 budget.	BM	Met.

1/ PC=structural performance criterion; BM=structural benchmark

Table 3. FYR Macedonia: Quantitative Performance Criteria and Indicative Targets for 2007

	Mar-07 1/	Jun-07	Sep-07	Dec-07
	(In million euro)			
	End of Period Stocks for Program Evaluation			
Floor for net international reserves of the NBRM	1,130	1,186	1,247	1,259
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
	Cumulative Changes for Program Evaluation			
Ceiling on new non-concessional medium- and long-term external debt contracted or guaranteed by the general government or the NBRM with original maturities of more than 1 year	38	64	89	103
Actual	...	...	...	...
Ceiling on new non-concessional medium and long-term external debt contracted by the public enterprises with original maturities of more than 1 year (indicative)	25	33	52	60
Actual	...	...	...	...
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
Actual	...	...	...	...
Accumulation of external payments arrears	0	0	0	0
Actual	...	...	...	...
	(In billion denars)			
	Quarterly Stocks for Program Evaluation			
Ceiling on net domestic assets of the NBRM	-47.2	-48.9	-51.8	-50.1
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
Ceiling on net domestic assets of the banking system (indicative)	35.5	42.4	45.9	55.6
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
Ceiling on net domestic credit to the central government from the NBRM	-24.7	-23.6	-24.6	-19.7
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
Ceiling on central government domestic arrears excluding suppliers (indicative)	0	0	0	0
Actual	...	...	...	...
Ceilings on central government domestic arrears to suppliers (indicative)	0.6	0.6	0.6	0.6
o/w non HIF domestic central government arrears	0.4	0.4	0.4	0.4
Actual	...	...	...	...
o/w non HIF domestic central government arrears	...	...	...	...
Ceiling on arrears of the Health Insurance Fund (indicative)	0.2	0.2	0.2	0.2
Actual	...	...	...	...
	Cumulative Flows within the Year			
Ceiling on central government wages (indicative)	...	...	...	26.0
Actual	...	...	...	...
Floor for central government fiscal balance	0.3	0.5	0.8	-3.4
Adjustor	...	...	...	...
Revised target	...	...	...	...
Actual	...	...	...	...
Memo item: Program exchange rate (Denars per Euro)	61.31	61.31	61.31	61.31

Sources: Data provided by the authorities; and IMF staff estimates.
1/ All targets for March 2007 are indicative since before the Board meeting.

Table 4. FYR Macedonia: Structural Conditionality 2007-08

Measure	Type 1/	Date
Tax policy and administration		
Public Revenue Office to identify performance measures for (i) registering additional taxpayers; (ii) improving taxpayer services; (iii) recovering tax arrears and delinquent tax returns; and (iv) auditing taxpayers; and set target levels of performance to be achieved by end-2007.	BM	May 2007
Public Revenue Office to design a strategy for improving the administration of small- and medium-sized enterprises.	BM	June 2007
Implement the March 2007 legislation harmonizing social security bases (abolishing complexity factors and sectoral minimum wages in calculation of health fund premia).	PC	July 2007 (originally intended for December 2006, but not formally established)
Prepare a strategy for the harmonization of the base of the personal income tax and social security contributions.	BM	September 2007
Submit legislation to parliament that vests the Pension and Disability Fund with the legal authority for collecting health and employment contributions.	BM	September 2007
Initiate phased implementation of the strategy for the harmonization of the base of the personal income tax and social security contributions (details to be specified at Third Review).	PC to be set at Third Review	January 2008
Integration of Social Fund collections. Pension and Disability Fund and its network of field offices will design and execute collection programs for social insurance contributions and their contributors.	PC	April 2008
Fiscal transparency		
Implement legislation requiring state enterprises to submit quarterly reports on their financial position to the government, starting with data for second quarter of 2007.	BM	October 2007
Health sector		
Conclude international tendering for drug procurement.	BM	June 2007
Financial sector		
Submit to parliament a new Banking Law consistent with technical assistance provided by IMF staff.	PA	
Prepare a comprehensive framework for assessing banks' risk profile and test the performance of the prepared procedures on at least two banks.	BM	September 2007
Issue accounting guidelines, a new chart of accounts, and formats for bank's financial statements in line with IFRS.	BM	September 2007 (reset from December 2006)
Finalize detailed guidance manual for conducting on-site supervision.	BM	December 2007
Create a new credit registry and make it fully operational.	BM	December 2007 (reset from June 2007)
Business climate		
Publish a list of all licenses administered by line ministries and social agencies, together with their justification.	BM	June 2007 (reset from September 2006)
Abolish licenses that are no longer needed.	BM	September 2007 (reset from March 2007)
Energy sector		
Develop an action plan, working with the World Bank, to improve energy sector finances.	BM	May 2007
Telecoms liberalization		
Liberalize the telecommunications sector (to be measured, inter alia, by the number of new service providers, new fixed line competition, and additional mobile telephone licenses).	BM	Monitored June and December 2007.

1/ PC=structural performance criterion; BM=structural benchmark; PA=prior action.

Table 5. FYR Macedonia: Revised Schedule of Performance Criteria and Purchases, 2007–08 1/

	Original Schedule				Revised Schedule			
	Performance Criteria	Purchase (SDR millions)	In percent of quota	Scheduled Purchase 2/	Performance Criteria	Purchase (SDR millions)	In percent of quota	Scheduled Purchase 2/
Approved purchases		17.36250	25.20			17.36250	25.20	
Actual		10.50000	15.24			10.50000	15.24	
Treated as precautionary 3/		6.86250	9.96			6.86250	9.96	
Reviews								
	March 31, 2006	3.43125	4.98	May 15, 2006	…	…		…
2nd Review	June 30, 2006	3.43125	4.98	August 15, 2006	December 31, 2006	10.29375 3/	9.96	Approval of 2nd Review
	September 30, 2006	3.43125	4.98	November 15, 2006	…	…		…
3rd Review	December 31,2006	3.43125	4.98	February 15, 2007	June 30, 2007	4.80375 4/	7.97	August 15, 2007
	March 31, 2007	3.43125	4.98	May 15, 2007	September 30, 2007	4.80375 4/	7.97	November 15, 2007
4th Review	June 30, 2007	3.43125	4.98	August 15, 2007	December 31, 2007	4.80375 4/	7.97	February 15, 2008
	September 30, 2007	3.43125	4.98	November 15, 2007	March 31, 2008	4.80375 4/	7.97	May 15, 2008
5th Review	December 31, 2007	3.43125	4.98	February 15, 2008	June 30, 2008	4.80375 4/	7.97	August 15, 2008
	March 31, 2008	3.43125	4.98	May 15, 2008	…	…		…
6th Review	June 30, 2008	3.43125	4.98	August 15, 2008	…	…		…
Total purchases		51.67500	75.00			51.67500	75.00	

1/ The authorities have made one purchase under this program totaling 15.24 percent of quota, and are treating remaining available purchases in a precautionary manner.

2/ Earliest possible date at which a purchase could be made available.

3/ Including purchases originally tied to the end-March, June, and September 2006 test dates.

4/ Includes rephased amounts that were originally tied to the end-December 2006 test date and completion of the third review, and the end-March 2007 test date.

TECHNICAL MEMORANDUM OF UNDERSTANDING

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

A. DEFINITIONS

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 extra-budgetary 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 Finance Statistics 2001*, and will ensure that these will be incorporated within the definition of central government.

2. The term "general government" covers the central government as defined above and the municipalities which are classified as part of general government according to the budget documents and which are included by the 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 enterprises" refers to institutional units that are established and controlled by the Government and the Parliament of the Republic of Macedonia and that perform market activities.

B. NET INTERNATIONAL RESERVES OF THE NBRM

	Floor on level of NIR (in million euros)
March 31, 2007 (indicative target)	1130
June 30, 2007 (performance criterion)	1186
September 30, 2007 (performance criterion)	1247
December 31, 2007 (performance criterion)	1259

4. **Net international reserves** (NIR) of the NBRM are defined as the difference between the 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. On December 31, 2006, reserve assets thus defined amounted to 1,377 million euro.

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. On December 31, 2006, reserve liabilities thus defined amounted to 147 million euro.

Assumptions

7. On a cumulative basis from end-December 2006, privatization proceeds (including lump sum proceeds from concession fees) in foreign currency are assumed to be:

End-March 2007	EUR 0 million
End-June 2007	EUR 45 million
End-September 2007	EUR 45 million;
End-December 2007	EUR 45 million.

8. On a cumulative basis from end-December 2006, repayments of Paris club debt are assumed to be:

End-March 2007	EUR 8 million
End-June 2007	EUR 78 million
End-September 2007	EUR 78 million;
End-December 2007	EUR 78 million.

Adjustors

9. The NIR floors of the NBRM will be adjusted:

- upward (downward) for any privatization proceeds in foreign currency exceeding (falling short of) the baseline;

- downward (upward) for any repayments of Paris club debt exceeding (falling short of) the baseline;

- downward for any government payments to the new owners of the recently privatized electricity distribution company resulting from revisions to the value of the assets of the company as contemplated in the sale contract;

- downward for any prepayment of external debt.

C. Net Domestic Assets of the NBRM

	Ceiling on level of NDA (in billion denars)
March 31, 2007 (indicative target)	-47.2
June 30, 2007 (performance criterion)	-48.9
September 30, 2007 (performance criterion)	-51.8
December 31, 2007 (performance criterion)	-50.1

10. **Net domestic assets** (NDA) of the NBRM are defined as reserve money minus the net foreign assets (NFA) of the NBRM. On December 31, 2006 NDA of the NBRM was minus 51.6 billion denars.

11. **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. On December 31, 2006 reserve money was 31.3 billion denars.

12. **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 defined in this TMU, minus foreign exchange liabilities of the NBRM to nonresidents. On December 31, 2006 NFA of the NBRM was 82.9 billion denars.

Adjustors

13. The NDA ceilings will be adjusted:

- downward (upward) for any privatization proceeds in foreign currency exceeding (falling short of) the baseline defined above;

- upward (downward) for any repayments of Paris club debt exceeding (falling short of) the baseline;

- upward for any government payments to the new owners of the recently privatized electricity distribution company resulting from revisions to the value of the assets of the company as contemplated in the sale contract; upward by the amount of any prepayment of external debt.

D. Net Domestic Assets of the Banking System

	Ceiling on level of NDA (in billion denars)
March 31, 2007 (indicative target)	35.5
June 30, 2007 (indicative target)	42.4
September 30, 2007 (indicative target)	45.9
December 31, 2007 (indicative target)	55.6

14. **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. On December 31, 2006 NDA of the banking system was 29.8 billion denars.

15. **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 denars and in foreign currency. On December 31, 2006 broad money was 135.5 billion denars.

16. **NFA of the banking system** are defined as the banking system's foreign assets minus foreign liabilities. On December 31, 2006 NFA of the banking system was 105.8 billion denars.

Adjustors

17. 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

	Ceiling on level of net credit to central government from NBRM (in billion denars)
March 31, 2007 (indicative target)	-24.7
June 30, 2007 (performance criterion)	-23.6
September 30, 2007 (performance criterion)	-24.6
December 31, 2007 (performance criterion)	-19.7

18. **Net credit to the central government** from the NBRM is defined as claims in denars and foreign currency on the central government from the NBRM minus total central government deposits in denars 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 above definition of central government. Excluded from this definition are any T-bills issued for monetary policy purposes and corresponding government deposits at the NBRM. On December 31, 2006 net credit to central government from the NBRM was 25.5 billion denars.

Adjustors

19. 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.

F. Government Fiscal Balances

	Floors on cumulative changes in central government fiscal balances (in billion denars)
March 31, 2007 (indicative target)	0.3
June 30, 2007 (performance criterion)	0.5
September 30, 2007 (performance criterion)	0.8
December 31, 2007 (performance criterion)	-3.4

20. Quarterly floors for the cumulative changes in central government fiscal balances will be determined and monitored from the financing side relative to end-December 2006. The financing flows will be measured as the sum of domestic financing, foreign financing, and privatization proceeds.

21. **Domestic financing** for the central government includes net credit to the central government from the NBRM as defined above, change of the central government accounts in the commercial banks, change in stock of domestic securities issued by the central government, and net variation in domestic arrears (as defined below).

22. **Foreign financing** for the central government includes disbursements of external loans received by the central government, including disbursements received for foreign financed projects of budget users and extra-budgetary 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.

23. **Privatization proceeds** for the central government include privatization proceeds and lump sum proceeds from concession fees in denars and foreign currency.

24. It is expected that quantitative targets on fiscal balances for the general government will be set for the fiscal year 2008, provided that sufficiently comprehensive and reliable data on municipalities' finances will have become available.

Adjustors

25. The floor on the central government fiscal balances will be adjusted upwards by any dividend receipts in 2007 from the Makedonski Telekomunikacii exceeding 2.5 billion denars.

G. Central Government Wage Bill

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

27. An annual ceiling of 26.0 billion denars (indicative target) has been established for the central government wage bill to be measured at end-December 2007.[1]

H. Medium and Long-Term Debt

	Ceiling on new non-concessional medium- and long-term external debt contracted or guaranteed by the general government or the NBRM (in million euros, cumulative from end-2006)
March 31, 2007 (indicative target)	38
June 30, 2007 (performance criterion)	64
September 30, 2007 (performance criterion)	89
December 31, 2007 (performance criterion)	103

28. The limit on **medium and long-term debt** applies to the contracting or guaranteeing by any branch of the general government and the NBRM of new non-concessional external debt with an original maturity of more than one year. The 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,[2] 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

[1] Under the program, the authorities are committed to holding the ration of the central government wage bill to tax revenues (excluding social security contributions) at the level of the 2005 supplementary budget.

[2] *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.

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.

	Ceiling on new non-concessional medium- and long-term external debt contracted by the public enterprises (in million euros, cumulative from end-2006)
March 31, 2007 (indicative target)	25
June 30, 2007 (indicative target)	33
September 30, 2007 (indicative target)	52
December 31, 2007 (indicative target)	60

29. A separate limit is established on contracting by the public enterprises of new non-concessional external debt with an original maturity of more than one year. Thirty three public enterprises will be covered under this performance criterion, including: PE Sluzben Vesnik (official gazette), PE Makedonski Zheleznici (railways), Mlekara DOO (trading in dairy products), 11 Octomvri-Eurocompozit AD (production of electrical insulation and materials), PE Agro-Berza (agricultural commodity exchange), Soncogledi (production, trade and services), PE za Stopanisuvanje so Stanben i Deloven Prostor (public housing activities), Veles DOOEL (production of rail vehicles), Remont na Prugi i Niskogradba DOOEL (maintenance of rail tracks and civil engineering), PE Makedonska Radiodifusija (broadcasting), Makedonska Banka za Podrska na Razvojot (Macedonian Bank for Support of Development), PE za Stopanisuvanje so Pasista (pastures management), PE za Stopanisuvanje za Objekti za Sport (management of sport facilities), PE Zletovica (water supply activities), PE Studencica (water supply), PE Lisice (water supply activities), Makedonska Informativna Agencija (information agency), PE Dojransko Ezero (water management), PE Gevgelisko Valandovsko Pole (water supply), PE Jasen (management of pastures), Makedonska Posta (postal services), MEPSO (electricity transmission), PE Makedonski Sumi (forestry), PE Srezevo (irrigation), ELEM (electricity generation), TEC Negotino (electricity generation), Boris Trajkovski DOOEL (construction, management, and leasing of a concert/athletic hall), GA-MA (transportation and distribution of natural gas), Toplik 2001 DOOEL (multi-purpose hall), Arest DOOEL (production, trade and services), PE Makedonija Pat (road maintenance), Drzaven Studentski Centar Skopje (student housing), PE Makedonska Radio-Televizija (radio and television broadcasting). When there is a change of control of any of the listed enterprises due to privatization, the stock of debt contracted or

guaranteed by such enterprises as defined under this performance criterion will be limited to the level reached on the day the control is transferred.

I. Short-Term External Debt

30. The limit on **short-term external debt** applies to the outstanding stock of short-term debt contracted or guaranteed by central government 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. Under the program, non-accumulation of short-term debt as defined above is a continuous performance criterion. On December 31, 2006, short-term external debt as defined above was zero euros.

J. External Payments Arrears

31. **External payments arrears** consist of the total past-due amounts of debt service obligations (interest and principal) on government, government-guaranteed, and NBRM external debt, excluding arrears on external debt service obligations pending the conclusion of debt rescheduling agreements.[3] Under the program, the non accumulation of external payments arrears is a continuous performance criterion. On December 31, 2006, the stock of external payment arrears as defined above was zero euros.

K. Domestic Payments Arrears

32. **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; (iii) central government employees including for wages and salaries, and food and travel allowances; (iv) benefit recipients of the Child Care Program; and (v) local governments. The definition excludes the customary lag in paying wages, social assistance and child allowance payments, and transfers to the Funds (in the following month after they accrue). Under the program, non-accumulation of central government arrears, excluding those to suppliers, as defined above will be an indicative target. On December 31, 2006, central government domestic arrears as defined in this paragraph were zero denars.

33. 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. Under the

[3] Amounts are only considered past-due after the contractual grace period expires.

program, the outstanding stock of domestic arrears, as defined above, will not exceed 0.6 billion denars. On December 31, 2006 the amount of central government domestic arrears to suppliers as defined in this paragraph was 0.3 billion denars.

34. A separate sub-ceiling is set for Health Insurance Fund arrears to suppliers, defined as obligations to suppliers which are due but not paid by more than 60 days and are not disputed. Under the program the aggregate outstanding stock of arrears will not exceed 0.2 billion denars. On December 31, 2006, the Health Insurance Fund arrears as defined in this paragraph were zero denars.

L. Valuation

35. For program purposes, all foreign currency-related assets, liabilities, [and flows] will be evaluated at program exchange rates, with the exception of the government fiscal balances, which will be measured at current exchange rates. For 2007, the program exchange rates are those that prevailed on December 31, 2004. In particular, EUR1 = 61.3100 denars, US$1= 45.0676 denars; SDR1= 69.9903 denars, and EUR1=1.3604 U.S. dollars. Gold is valued at the price fixed in the London market at end-December 2004 (US$ 438.00 per ounce).

36. 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.

37. 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.

M. Monitoring and Reporting Requirements

38. Performance under the program will be monitored from data supplied to the Fund by the NBRM, the Ministry of Finance, and the SSO as outlined in Table 1. The authorities will transmit promptly to the Fund staff any data revisions. In addition, data on performance at the program test dates will be submitted with a cover letter signed by authorized officials.

Table 1. FYR Macedonia: Data to be Reported to the IMF

Item	Periodicity
To be provided by the MOF	
Consolidated central government operations	Monthly, within four weeks of the end of each month
Privatization receipts received by the budget (in denars and foreign exchange, and payments in governments bonds)	Monthly, within four weeks of the end of each month
Data on workers registered as unemployed with the employment fund.	Monthly, within three weeks of the end of each month
Information on new debt and guarantees given on new debt, contracted by the government agencies and public enterprises.	Quarterly, within four weeks of the end of each quarter
Data on central government arrears, including to suppliers	Monthly, within four weeks of the end of each month
Data on the Health Insurance Fund arrears	Monthly, within four weeks of the end of each month
Data on operations of all municipalities	Quarterly, within four weeks of the end of each quarter
Data on operations of four largest public enterprises	Quarterly, within eight weeks of the end of each quarter (to begin in November 2007)
To be provided by the NBRM	
Balance sheet of the NBRM	Weekly, within one week of the end of each week Monthly, within three weeks of the end of each month
Consolidated accounts of the commercial banks	Monthly, within three weeks of the end of each month
Monetary survey	Monthly, within three weeks of the end of each month
Data on components of the NIR of the NBRM	Weekly, within one week of the end of each week
Data on foreign exchange cash flow of the NBRM	Weekly, within one week of the end of each week
Foreign exchange market data (exchange rates, volume of trades, and interventions)	Weekly, within one week of the end of each week
Current and capita account data	Monthly, within eleven weeks of the end of each month
Commercial banks' balance sheets (bank-by-bank)	Monthly, within three weeks of the end of each month
Commercial banks' income statements (bank-by bank)	Monthly, within three weeks of the end of each month
Data on each bank's liquid position (bank-by bank) including breakdown by currency and maturity	Monthly, within three weeks of the end of each month

Table 1. FYR Macedonia: Data to be Reported to the IMF (continued)

Item	Periodicity
Data on lending by domestic money banks (new and rolled-over loans) according to credit rating of borrowers	Monthly, within four weeks of the end of each month
Data on off-balance sheet activity of domestic money banks	Monthly, within four weeks of the end of each month
Detailed data on each bank's assets and liabilities, including breakdown by currency (domestic, foreign, indexed) and maturity	Monthly, within three weeks of the end of each month
Data on commercial banks' deposit and lending rates and underlying stocks	Monthly, within four weeks of the end of each month
Financial soundness indicators	Quarterly, within 50 days of the end of the period ending in March and September, within 70 days of the end of the period ending in June and within 100 days for the period ending in December.
Commercial banks' balance sheets (bank-by-bank)	Same as above.
Commercial banks' income statements (bank-by bank)	Same as above.
Data on structure of each bank's loans by sector (corporate vs. households) and by currency (domestic, foreign, indexed)	Same as above.
Data on each bank's compliance with prudential regulations	Same as above.
To be provided by the SSO	
Overall consumer price index	Monthly, within two weeks of the end of each month
Overall producer price index	Monthly, within two weeks of the end of each month
Data on industrial production	Monthly, within two weeks of the end of each month
Data on wages	Monthly, within two weeks of the end of each month
National accounts by sector of production (nominal and real terms)	Quarterly, within eight weeks of the end of each month
To be provided jointly by the NBRM and MOF	
Data on domestic and foreign borrowing including gross and net debt stock, disbursements, amortization, interest payments by debtors and stock of external payment arrears (including central government, agencies and public enterprises)	Quarterly, within four weeks of the end of each quarter