REPUBLIC OF MACEDONIA
GOVERNMENT OF THE REPUBLIC OF MACEDONIA

FISCAL STRATEGY OF THE REPUBLIC OF MACEDONIA

2015-2017

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Pursuant to Article 16, paragraph 2 of the Budget Law ("Official Gazette of the Republic of Macedonia, nos. 64/2005, 04/2008, 103/2008, 156/2009, 95/2010, 180/2011 and 171/2012), Government fo the Republic of Macedonia, at its session held on __________, adopted the 2015-2017 Fiscal Strategy of the Republic of Macedonia.

I. INTRODUCTION

Government of the Republic of Macedonia and Ministry of Finance set the sound public finance management as one of the top priorities, taking into account the strong economic, social and political significance of the Budget, especially in conditions of uncertainties and harsh challenges faced by the European and the global economy.

Medium-term projections of the main macroeconomic and fiscal parameters impose as an essential element of the professional public finance management, to the end of attaining financial safety and sustainability of public finance.

Fiscal Strategy, as an important strategic document, defines the most important goals and policies, as well as medium-term macroeconomic and fiscal projections by which stronger link between the defined strategic priorities and the available sources of financing, i.e. the Budget, is established. At the same time, guidelines and policies in this document are the basis for medium-term projections of public revenues and expenditures. Stronger fiscal discipline and adequate allocation of available funds, in line with the strategis priorities, are thus ensured. Set guidelines are the first step towards ensuring adequate allocation of budget funds for the purpose of attaining higher development in the prioritiy areas.

Government of the Republic of Macedonia has identified the most important strategic priorities defined in the Decision On Determining Strategic Priorities, as follows:

- increased economic growth and employment, better standard of living and quality of life of the citizens;
- integration of the Republic of Macedonia in both the European Union and NATO;
- uncompromising fight against corruption and crime and efficient law enforcement;
- maintaining good inter-ethnic relations on the principles on mutual tolerance and respect and equal treatment of all before the law;
- investments in education, innovations and information technology, as key elements for creation of knowledge-based society.

Realization of all strategic priorities and adequate allocation of budget funds will provide for higher growth rates of the Macedonian economy in the coming period, at the same time contributing to better living standard of the citizens.

Public Debt Management Policy sets the framework for the Government of the Republic of Macedonia to act towards prudent public debt management on the medium term. Main principles taken into account when managing public debt portfolio, and when preparing and implementing the public debt management policy, are the following:

- determining the optimal structure of debt portfolio and its compliance with thenational macroeconomic policy;
- harmonization of debt portfolio-related costs with the costs set in the state budget for each year separately and in the medium term and
- limiting and eliminating the risk effects on public debt medium- and long-term sustainability.

II. CURRENT ECONOMIC TRENDS

MACROECONOMIC PERFORMANCE

Macroeconomic policy of the Republic of Macedonia is aimed at achieving financial and macroeconomic stability and increasing competitiveness of the economy on permanent basis, job creation, better standard of living and quality of life of the citizens, by improving the business environment, conducting tax and customs policy aimed at underpinning the development of economic entities, boosting investment activity and attracting foreign direct investments, developing human capital and economic infrastructure in the country.

Republic of Macedonia conducts adequate fiscal policy aimed at achieving reasonable balance between both strategic goals of the Government of the Republic of Macedonia, those being preserving macroeconomic stability and encouraging economic activity by increasing the quality of public finance, above all, through substantial capital expenditures related to improving the infrastructure and strengthening the ability of the private sector for growth and job creation.

Main objective of the monetary policy is to maintain price stability by keeping Denar exchange rate stable in relation to the euro in order to achieve favorable macroeconomic environment for long-term economic development.

Fiscal policy, in coordination with monetary policy, is aimed at achieving sustainability of the country's external position and ensuring inflation level aimed at supporting the economic activity in the country.

Global Economic Trends

Global growth rate in 2014 is expected to be 3.4%, as a result of the weak economic activity in the first quarter of the year, especially in the USA, as well as the less optimistic growth outlook for several emerging economies. The projection is also based on the expectation that some of the main factors leading to weaker growth at the beginning of the year will have only temporary effects, and growth is excpected to be driven by the policies implemented in response to the weaker growth. In addition, effects of the key recovery drivers, including the moderating fiscal consolidation and the accommodative monetary policy, will contunie in most of the advanced economies. However, some of the demand weaknesses are expected to last longer, in particular the reduction of the investment volume on global level, which is expected to result in lower global growth in 2014. As a result of the expectation for stronger growth in some of the developed economies next year, global growth rate is projected at 4% in 2015.

Developed economies in 2014 are expected to realize 1.8% growthraising to 2.4% in 2015. Growth in the Eurozone is expected to be 1.1% in 2014 and 1.5% in 2015, however it will remain uneven throughout the region, reflecting the continued financial fragmentation, the impaired private and public sector balance sheets and the high unemployment in some economies. Growth in the emerging economic and developing economies is expected to be 4.6% in 2014, strengthening to 5.2% in 2015.

Inflation in the developed economies is projected at 1.6% in 2014, while as regards the emerging economies and developing ecvonomies, it is projected at 5.4%. Inflation rate in the developed economies is expected to be 1.7% in 2015, while as regards the emerging economies and developing ecvonomies, it is projected at 5.3%.

Geopolitical risks have increased and raise concerns. Risks of oil price spike are higher due to the developments in the Middle East, while risks related to the developments in Ukraine are still present. There is a risk of a renewed rise in long-term interest rates rise in the global financial markets, in particular if long-term interest rates in the USA surge more sharply and rapidly than expected. In major advanced economies, there is a risk of stagnation in the medium term. With respect to the Eurozone, adverse shocks – domestic and external – could lead to persistantly lower inflation or price drops. Emerging market economies, especially those with domestic weaknesses and external vulnerabilities, may face a sudden worsening of the financial conditions and a reversal in capital flows, in case of shift in financial market sentiment. Many of these economies also face the risk that the factors underpinning the weakening of growth will persist into the medium term.

Weaker global growth in the first half of this year underscores that raising actual and potential growth must remain a priority in most economies. There is an urgent need for structural reforms in many developed and emerging markets so as to close infrastructure gaps, strengthen productivity and lift potential growth.

World trade is expected to grow by 4% in 2014 compared to 2013, while in 2015, its growth rate is expected to be 5.3%.

In the medium term, world economy is expected to grow by 4% in 2016 and 2017. Growth of the world economy will be driven by the economic growth of the emerging economis and developing economies, which are expected to grow by 6.7% in 2016, strengthening to 6,6% in 2017. At the same time, growth rates in the developed economies are projected at 2.4% in the same period. Eurozone is expected to realize 1.5% growth in 2016 and 2017.

Economic Trends in the Republic of Macedonia

Gross Domestic Product. According to the preliminary projections, real GDP growth in 2013 amounted to 2.7%. Growth was driven by the construction sector, which registered high growth of 32.2%, as a result of the budget expenditures related to infrastructure projects and investments in technological industrial development zones. Positive trends in 2013 were observed at most of the sectors. Industrial production grew by 5.1%, mainly due to the increased activity of part of the domestic and foreign export-oriented capacities.

Growth in economic activity continued in 2014, however, more intensively compared to the previous year. Hence, real GDP growth rate in the first quarter amounted to 3.5%, reaching 4.3% in the second quarter, hence the average GDP growth in the first half of 2014 accounted for 3.9%. These growth rates are among the highest ones compared to the EU Member States and the region.

GDP growth during this period is on broad basis, whereby positive growth rates were registered across all sectors. Construction continued to contribute significantly to the economic growth, accounting for 5.6% in the first half in 2014. Industrial production continued its positive trends, registering 4.7$ growth in the first seven months, as a result of the growth in the manufacturing industry (10.3%). More significant growth in this category was observed at the production of motor vehicles (multiple increase), machines and devices (24%), electrical equipment (35.8%) and rubber products and plastic mass products (31.5%), as a result of the effects from the increased production by the capacities in the free economic zones. Additional positive impulse was given by the growth in the production of clothing (8.3%), textile (18.1%), food products (5.6%) and beverages (7.5%), etc.

Services sector grew by 2.7% in the first half in 2014, wherein financial activities and insurance activities and information and communications sectors registered the highest growth rates of 4.2%, followed by the 4% growth in the trade, transport and catering sector. Agriculture sector registered growth of 1.1% in the concerned period.

Analyzed according to the expenditure side, growth in the first half in 2014 was driven by the export, experiencing real growth of 13.3%. Gross investments (5.9%) and consumption (3.1%) positively contributed to the growth. Increase in export of goods was mainly a result of the increased export potential of the country. Export growth was accompanied by the change in the structure of the export towards products with higher value added, in line with the industrial production development, as a result of the production and the export by the capacities in the technological-industrial development zones and industrial zones. Growth of gross investments corresponds to the growth in the construction sector, i.e. the realization of capital projects in the public sector and the intensified foreign direct investments in the country. Consumption growth was encouraged by the increased number of employees, which, in the first half in 2014, was by 2% higher compared to the same period in 2013.

Inflation. Inflation rate in 2013 amounted to 2.8%. Quarterly dynamics showed that inflation in the last two quarters of the year experienced a downward trend, mainly reflecting the slowed down increase of prices of food and drop in the energy prices. The highest increase of prices in 2013 was observed at the clothing and footwear category (6.9%) and hygiene and health category (4.7%). Prices of food increased by 3.6% in 2013, while prices of means of transport and services dropped by 0.8%. Average inflation rate in the period January - August of 2014 amounted to -0.2%.

External Sector. Value of export of goods in 2013 was higher by 2.8% compared to the previous year, while import of goods dropped by 2.0%. As a result of such trends, trade deficit narrowed by 9.8%, accounting for 21.7% of GDP in 2013. Inflow of foreign direct investments in the country accounted for 3.3% of GDP in 2013, whereby most of it was realized in a form of share capital and re-infested profit.

Trade deficit in the first seven months in 2014 declined by 0.7%, compared to the same period in 2013, in conditions of nominal growth of export of goods by 12.9% and 7.9% increase of the import. Such increase of export was manily due to the effects from the new production capacities in the technological-industrial development zones. Current account deficit was by 1.7% in the first half of 2014, compared to the same period in 2013, accounting for 2.6% of GDP. Foreign direct investments in the first half in 2014 amounted to EUR 132.5 million, being higher by 12.1% compared to the same period in 2013. Gross foreign currency reserves were kept at adequate level, amounting to EUR 2,449 at end-August 2014 and increasing by almost 23% compared to end-2013.

Labour market. Positive trends were registered on the labour market in 2013. According to the Labour Force Survey, number of employed persons in 2013 was higher by 4.3% compared to the previous year. Increase of employment was accompanied by 5.2% drop in the number of unemployed persons, while total number of active population was higher by 1.4%. Such trends on the labour market caused for the employment rate in 2013 to increase to 40.6%. Unemployment rate in 2013 dropped from 31% to 29%, as it accounted for in 2012. Average net salary in 2013 was higher by 1.2% in nominal terms compared to 2012.

Chart 1 – Empoyment growth (%) and unemployment rate

Source: SSO

Positive trends on the labour market continued in 2014. According to the Labour Force Survey, number of employed persons in Q2 2012 was higher by 1.3% compared to the same quarter of the previous year. Increase of employment was accompanied by the drop of the number of unemployed persons, decreasing by 1.3% on annual basis. Such trends on the labour market caused for the unemployment rate in Q2 2014 to reduce to 28.2%, i.e. to drop by 0.6 p.p. compared to the same quarter of the previous year.

In fact, in Q2 2014, unemployment was at the lowest level since the independence of the country until today. Employment rate in Q2 2014 amounted to 41.1%, being higher by 0.4 p.p. compared to the same quarter of the previous year. Active population in Q2 2014 accounted for 57.3% of total working-able population. Average net salary in the first half of 2014 was higher by 0.3% in nominal terms compared to the same period in 2013.

Monetary sector. In the course of 2013, price stability and exchange rate stability were maintained. In conditions of adequate level of foreign currency reserves and absence of higher pressures on the exchange rate, the Central Bank decreased the maximum reference interest rate twice, by 0.25 p.p. in January and, additionally, by 0.25 p.p. in July 2013., reducing it to 3.25%, which is historically the lowest level.

Total deposits increased by 6.1% on annual basis. New saving was mainly a result of the increased savings of households by 6.7%, while deposits of private enterprises grew by 4.1%. Analyzed according to currency, increase of the deposits was almost fully due to the increased domestic currency deposits, rowing by 10.7% on annual basis, while foreign currency deposits surged by 0.6%. Total credits grew by 6.4% in December 2013, in conditions of increased crediting to households and private enterprises by 10.2% and 3.7% respectively. As regards maturity, long-term credits increased by 6.4% on annual basis, while short-term credits were higher by 2.9%.

Interest rates dropped in 2013. In fact, interest rate on credits was reduced from 7.9% in December 2012 to 7.4% in December 2013, while interest rate on deposits was reduced from 3.3% to 2.8% in the analyzed period.

In 2014, NBRM, in conditions of stable trends, retained the interest rate on CB bills at 3.25%.

Total deposit potential in August 2014 increased by 8.1% on annual basis. From currency point of view, in August 2014, Denar deposits increased by 11.5%, while foreign currency deposits increased by 3.8%. Deposits of households increased by 7.9%, while deposits of enterprises surged by 12.3%.

On annual basis, total credits grew by 8.5% in August 2014, in conditions of growth of credits to enterprises of 6.3% and credits to households of 12%. As regards maturity, long-term credits increased by 9.3% on annual basis, while short-term credits were higher by 6.1%.

Interest rates of the banking sector were further reduced in 2014. In fact, interest rate on credits was reduced from 7.6% in August 2013 to 7.1% in July 2014, while interest rate on deposits was reduced from 3% to 2.5% in the analyzed period.

Fiscal policy will continue to be aimed, as in the period before, at maintaining macroeconomic stability and encouraging economic growth, as main pre-conditions to create jobs and improve the living standard.

Such defined goals of the Fiscal Policy mean further strict control over public finances, as well as continuous improvement of quality of public expenditures through substantial volume of capital investments in the total expenditures.

Budget of the Republic of Macedonia

Budget reveue and inflow performance is in line with the expectations for this period, while expenditures are executed on regular and timely basis. In the period January-August 2014, total revenues were generated in the amount of Denar 91,824 million. Tax revenues and social contributions amounted to Denar 82,020 million, accounting for 89.3% of the total genuine revenues. Tax revenues amounted to Denar 53,568 million. Revenues collected on the basis of VAT accounted for the most in the collected tax revenues, i.e. 52%. Social contributions, as genuine revenues of the Pension and Disability Insurance Fund and the Employment Agency, were realized in the amount of Denar 28,452 million. Denar 19,132 million was collected on the basis of pension insurance, while health insurance contributions were realized in the amount of Denar 8,106 million. Revenues performance corresponded to the positive trends in the real sector and the growth of economic activity respectively.

Non-tax revenues amounted to Denar 6,544 million in the eight months in 2014, whereby non-tax revenues of budget users on their special revenue accounts, in the amount of Denar 3,664 million, and non-tax revenues collected on the basis of administrative fees, in the amount of Denar 1,265 million, accounted for the most. Capital revenues amounted to Denar 1,434 million, Denar 946 million out of which were revenues collected on the basis AD Macedonian Telecom dividend, while the rest of the revenues were generated from the sale of construction land and social flats. Budget users generated Denar 1,826 million on the basis of donations on the basis of international multilateral and bilateral cooperation.

In the period January-August 2014, total budget expenditures amounted to Denar 108,802 million, whereby current expenditures accounted for Denar 98,382 million. During this period, Denar 15,265 million was paid for salaries and allowances to the employees with the budget users. Expenditures related to goods and services were executed in the amount pf Denar 9,750 million, providing for regular settlement of budget users' liabilities.

Transfers predominated in the current expenditures, amounting to Denar 70,153 million in this period. Governemnt liabilities on the basis of payments related to exercising the rights to guaranteed social protection of the citizens were settled on regular basis, accounting for Denar 4,282 million. Most of these funds are pecuniary allowances for the vulnerable categories, including the rights on the basis of deafness and quadriplegia, single parents of children with special needs, as well as allowances on the basis of child allowance and parenting payment. Funds paid also included the 5% increase of the social welfare, starting March 2014, being the best indicatior of the care for this category of citizens. Denar 29,090 million was allocated for payment of pensions, including the 5% increase of pensions in average, starting with the payment of the pensions in February, which speaks of the commitments aimed at improving the living standard of the pensioners. Denar 14,041 million was paid for financing health services and benefits. Denar 949 million was allocated for payment of unemployment benefits through the Employment Agency. Denar 9,245 million was transferred from the Budget of the Republic of Macedonia to the municipalities, as block grants for financing the transferred competences, as well as earmarked grants for financing the operating costs in local public institutions. In addition, Denar 1,011 million was transferred on the basis of VAT revenues. During this period, agricultural subsidies were paid on continuous and regular basis, aimed at improving the quality and the competitiveness of the sector.

Denar 3,214 million was allocated for regular servicing of liabilities on the basis of interest, according to the repayment schedules on domestic and foreign borrowing. Denar 1,658 million out of this amount was allocated for payment of interest on foreign borrowing.

In the period January-August 2014, capital expenditures were executed in the amount of Denar 10,420 million. In this period of the year, activities for realization of major infrastructure projects were intensified, such as the construction of Corridor 10 highway and investments in reconstruction and construction of the railway infrastructure. At the same time, many projects were realized, aimed at improving the infrastructure in education sector, health sector and utilities infrastructure, by constructing schools, sports facilities, playgrounds, water supply and sewerage network, as well as reconstruction of health facilities.

During this period, state budget deficit amounted to Denar 16,978 million. Realized inflows to the Budget provided for regular repayment of principal on the basis of liabilities upon credits amounted to Denar 5,307 million.

Table 1 (Denar million)

Budget of the Republic of Macedonia	2014 Budget	January – August 2014 execution
1.Total revenues	155,554	91,824
1.1. Tax revenues and contributions	131,376	82,020
1.1. 1 Tax revenues	86,673	53,568
1.1. 2 Contributions	44,703	28,452
1.2. Non-tax revenues	14,697	6,544
1.3. Capital revenues	4,177	1,434
1.4. Donations	5,304	1,826
2. Total expenditures	175,157	108,802
2.1. Current expenditures	154,073	98,382
2.1.1 Salaries and allowances	23,605	15,265
2.1.2 Opertaing expenditures	18,636	9,750
2.1.3 Transfers	107,431	70,153
2.1.4 Interest	4,401	3,214
2.2. Capital expenditures	21,084	10,420
3. Deficit	-19,603	-16,978
4. Deficit financing	19,603	16,978
4.1 Inflows	30,463	22,285
4.2 Outflows	10,860	5,307

Local Government Budget

Local government development and fiscal decentralization are among of the priorities stemming from the Accession Partnership of the Republic of Macedonia with the EU, the realization of which opts for careful and phased approach, which is successfully implemented by the Government. Phased approach for transferring and managing the opertaing and financial resources for the transferred competences in the field of education, culture, child care and social protection, was finalized, i.e. all municipalities (except Plasnica) are financed with block grants. On the basis of the carried out evaluation and assessment, Plasnica Municipality has acquired sufficient number of points so as to move to the second fiscal decentralization stage, however, the requirement as regards the number of employees in the municipal administration has not been met.

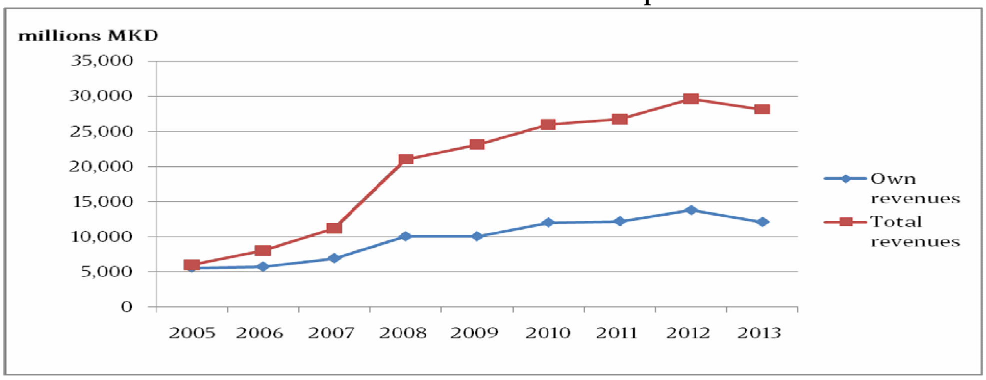
Process of administering and colleting own revenues, performing the transferred competences and managing the financial resources and other resources necessary for their performance, has been successfully continued by strengthening the own revenues of the municipalities and the capacity to manage the funds. Municipalities successfully perform the administrative competences in the field of taxes and fees, they manage more funds in a more flexible manner as a result of the increased volume of transfers (grants) in the field of education, culture, social protection (mainly kindergartens) and fire fighting.

Financial capacity of the municipalities has been strengthed by many legal amendments, prescribing new revenues for the municipalities as regards the transferred competences or increase of the existing ones. At the same time, access to the capital market has been easier, under more liberal and transparent requirements for borrowing. Hence, interest of the municipalities for financing larger investment projects on the basis of borrowing increased. To that end, the Government has provided credit lines from international financial institutions (World Bank, EIB, KfW and EBRD), which have provided for substantial investments, especially in: reconstruction and rehabilitation of local streets and bridges, improvement of public hygiene and energy efficiency, construction and reconstruction of water supply and atmospheric water networks and local spatial landscaping.

As regards the level of decentralization, Republic of Macedonia, according to the data on 2013 expenditure execution (6% of GDP), has joined the group of decentralized countries.

Today, compared to 2005, when the fiscal decentralization process commenced, municipal revenues have increased by five time (Denar 5.9 billion in 2005, Denar 28.2 billion in 2013). Tax revenues, which the municipalities are authorized to collect, have increased by more than twice during the same period. Share of local taxes of 1% of GDP in 2006 increased to more than 1.5% in 2013.

Chart 2. Own and total revenues in the period 2005-2013



III. ECONOMIC TRENDS IN THE COMING MEDIUM-TERM PERIOD

MEDIUM-TERM MACROECONOMIC SCENARIO

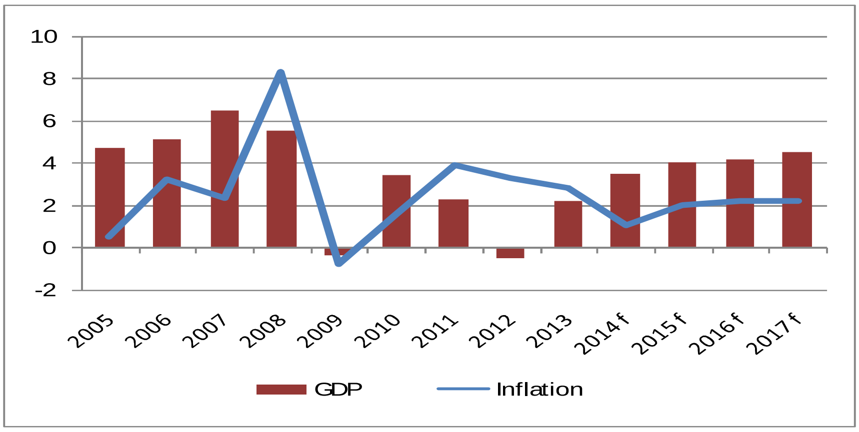
Macroeconomic policy of the Republic of Macedonia is aimed at achieving the strategic committments of the country for long-term and sustainable economic growth, increase of competitiveness of the economy on permanent basis, job creation and better living standard of the population.

2015-2017 Macroeconomic Policy provides conditions for increased economic activity through sustainable fiscal policy, which, in coordination with the monetary policy, will contribute to achieving sustainability of the external position of the country and maintaining macroeconomic stability in the economy.

So-far macroeconomic performance, sound macroeconomic policies and the agenda of the Government, including large number of projects, are a solid basis for continuation of positive economic developments in the coming medium-term period.

In the period 2015-2017, growth of economic activity in the Republic of Macedonia is expected to account for 4.2% in average, with prospects for certain growth intensification. Thus, economic growth in 2015 is expected to be 4%, 4.2% in 2016 and 4.5% in 2017.

Chart 3 - Real GDP growth rate and inflation rate



Source: SSO and MoF calculations

Positive growth of the industrial production, as well as its diversification, are envisaged to continue in the coming medium-term period as well, in line with the expectations for foreign demand and increased production potential of the country as a result of investments in free economic zones. Hence, in the period 2015-2017, industrial production growth is expected to be 4.8% in average. Construction sector, in the forecasted period, is expected to achieve average real growth rate of 7.8%, as a result of the planned infrastructure projects and announced investments in technological industrial development zones (TIDZ) and industrial zones. Services sector, accounting for the most in GDP creation, is expected to register average growth rate of 3.6% in the analysed period, while agriculture sector is grow by 2.3%.

Analysed according to the expenditure side of GDP, domestic demand is expected contribute positively to economic growth. Gross investments in the forecasted period are projected to grow by 8.1% in average in real terms. Envisaged growth of gross investments is based on the expectations for gradual increase of private investments (driven mainly by FDIs) and the increased capital budget expenditures. In fact, as regards public investments, major infrastructure projects are planned to be realized, aimed at improving the transportation network in the country, the energy and the utilities infrastructure, investments in improving the conditions in the education, social and health system, which are to contribute to increased competitiveness of the country, being of crutial importance for increased production and productivity of the economy. In the period 2013-2015, personal consumption is expected to grow by 3.6%, in average in real terms, as a result of the expected increase in the number of employees, as well as salary increase, while public consumption is anticipated to surge by 1.3% in average.

In the forecasted period, export of goods and services is expected to grow by 8.8% in average in real terms, mainly as a resulted of the intensified activity at the exiting and the opening of new export capacities, in conditions of low economic growth of the EU economy, as the most important trade partner. Thereby, increase of the export of goods is expected to be accompanied by further improvement of the export structure. Anticipated increase of domestic demand

and export activity will also bring about increase of the import which, in this period, is expected to be 7.8% in average.

Envisaged economic growth in the period 2015-2017 is expected to have positive effects on labour market trends. According to the projections, average annual increase in the number of employees of 3% is expected. This will, on other hand, result in decline in the number of unemployed persons by 2.7% in average in the analysed period. Increase in labour force, projected to surge by 1.4% in average, is expected to contribute to job creation. Such trends imply for the employment rate in 2017 to increase to 44.4% and the unemployment rate to drop to 24.8%. Active population in 2014 is expected to account for 59% of working-able population.

In the period 2015-2017, inflation rate is expected to be both low and stable. Inflation pace will be influenced by the trends of global prices of primary commodities, and partially by the trends of the economic activity in the national economy. Thus, inflation rate in 2015 is expected to be 2%, while it is projected at 2.2% in 2016 and 2017.

Expected level of foreign direct investments and projections for moderate BOP current account deficit are factors that are to result in stable external position and keeping foreign currency reserves at an adequate level. Stable Denar exchange rate in relation to the euro will be retained in the coming period as well, as a nominal anchor aimed at maintaining price stability, as ultimate goal of macroeconomic policy.

Risks related to macroeconomic projections

Medium-term macroeconomic scenario is accompanied by certain uncertainties and risks. External surrounding, i.e. economic growth in the EU, remains to be the the major risk, taking into account that recovery of the EU economy is still fragile, although moderate intensification of growth in this period is envisaged. Materialization of risks for worse economic performance in the EU and other trade partners to the country can worsen the prospects for growth of the economic activity in the Republic of Macedonia. Possible prolonging of the European debt crisis and weaker dynamics of growth of the global economy can adversely reflect on both the export and the industrial production, leading to restraining of investors and lower inflow of capital in the country.

As regards inflation, risks to projected inflation rates in the forecasted period are related to the trends of primary commodities prices on the global markets, as well as the magnitude of their spillover effect on the prices in the country.

The Governemnt will continue to carefully monitor the risks on daily basis, to the end of prompt reaction by the fiscal policy. At the same time, regular analyses of the needs to implement adequate measures to reduce potential adverse effects from the developments in the debt crisis in the Eurozone on the national economy will continue.

MEDIUM-TERM FISCAL FRAMEWORK

Projection of public finances in the next medium-term period is based on the commitment to their gradual consolidation, in line with the expectations for positive macroeconomic indicators in the coming period, achieving positive growth rates, as well as the effects of the planned structural reforms and expected inflows from FDI.

Projected revenues of the consolidated government budget in the next three-year period decline relatively, as a share of GDP, from 31.7% of GDP in 2014 to 30.3% in 2017. As a result of continuity in implementing disciplined budget policy and strengthened consolidation of public spending, in the period 2014-2017, total expenditures will also decline from 35.5% in 2014 to 33.3% in 2017.

Set basic postulates of the fiscal policy in the coming period provide for gradual reduction of the deficit level and its positioning at optimal level of around 2.9% of the projected GDP in 2017.

Table 2 (Denar million)

Consolidated general government budget	2014	2015	2016	2017
(Denar million)				
Consolidated general government budget - revenues	**166,654**	**175,072**	**181,305**	**188,129**
% of GDP	31.7	31.7	31.1	30.3
Consolidated general government budget - expenditures	**186,257**	**193,569**	**200,263**	**206,391**
% of GDP	35.5	35.1	34.3	33.3
Consolidated general government budget - deficit	**-19,603**	**-18,497**	**-18,958**	**-18,262**
% of GDP	-3.7	-3.4	-3.2	-2.9
Central Budget - revenues	**109,338**	**113,001**	**116,368**	**120,233**
% of GDP	20.8	20.5	19.9	19.4
Central Budget - expenditures	**128,841**	**131,448**	**135,326**	**138,495**
% of GDP	24.5	23.8	23.2	22.3
Central Budget - deficit	**-19,503**	**-18,447**	**-18,958**	**-18,262**
% of GDP	-3.7	-3.4	-3.2	-2.9
Budget Funds - revenues	**29,361**	**33,151**	**35,387**	**37,714**
% of GDP	5.6	6.0	6.1	6.1
Budget Funds - expenditures	**29,461**	**33,201**	**35,387**	**37,714**
% of GDP	5.6	6.0	6.1	6.1
Budget Funds - deficit	**-100**	**-50**	**0**	**0**
% of GDP	0.0	0.0	0.0	0.0
Local government budget - revenues	**27,955**	**28,920**	**29,550**	**30,182**
% of GDP	5.3	5.2	5.1	4.9
Local government budget - expenditures	**27,955**	**28,920**	**29,550**	**30,182**
% of GDP	5.3	5.2	5.1	4.9
Local government budget - deficit	**0**	**0**	**0**	**0**
% of GDP	0.0	0.0	0.0	0.0

Budget of the Republic of Macedonia

Total genuine revenues of the Budget of the Republic of Macedonia (central government) for the period 2014-2017 are projected to around 29% of GDP, whereby their share in GDP by years is reduced in conditions of unchanged tax policy, i.e. keeping low tax rates and low the tax burden of the business sector. Thereby, tax revenues account for around 54.5% in the projected revenue structure, followed by revenues on the basis of social contributions with around 30%, non-tax revenues and capital revenues with around 12.5%, while the rest of the revenues are expected to be realized from IPA Funds and other donations. With respect to tax revenues, most revenues will be realized on the basis of VAT, personal income tax and excises.

Projections for social contributions, which are genuine revenues of the Pension and Disability Insurance Fund, Health Insurance Fund and the Employment Agency, in the next medium-term period, are based on the expected positive economic trends, which will appropriately reflect on the growth rates of employment and salaries. Non-tax revenues in the next medium-term period account for around 10.2% in the overall revenues, and the most significant is the share of revenues on the basis of administrative fees, concessions from mineral raw materials and other non-tax revenues the budget users realize to their own accounts.

Projection of the revenues of the Budget of the Republic of Macedonia with regard to foreign donations in the coming period include the donations the budget users would realize for specific projects, as well as disbursements from the EU pre-accession funds.

Expenditure side of the Budget of the Republic of Macedonia in the next medium-term period is planned for the purpose of fully supporting the Macedonian economy through increased investments in infrastructure projects, as well as improvement of the economic situation of targeted groups of the population (pensioners and beneficiaries of social benefits). Thereby, disciplined budget spending will continue to be implemented, with an emphasis to restrictiveness and rigorous control over less productive costs, on one hand, and increase of investments in capital projects on the other. Average share of expenditures in the Budget of the Republic of Macedonia in the period 2014-2017 is around 32.4% of GDP.

When projecting the **current expenditures** for the next period, the following assumptions were taken into account:

-as regards expenditures related to wages and salaries and allowances, continuation of strict control over new employments and increase of salaries in the public sector in 2014. Further increase of salaries will be a result of detailed calculations for each fiscal year, according to the possibilities of the Budget, and depending on the fiscal condition and effects from the external economic trends;

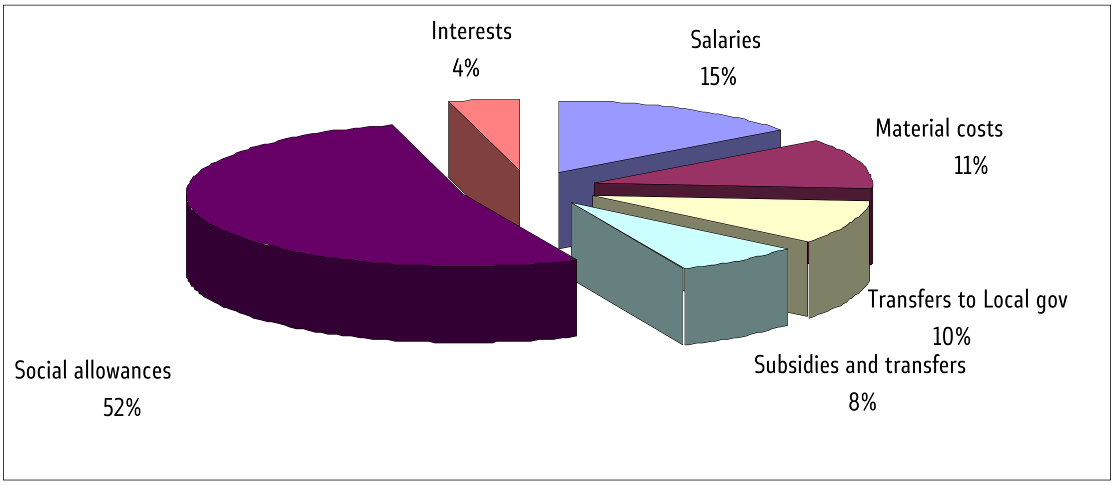
- total and timely payment of increased pensions and social benefits, for the purpose of ensuring the well being of the beneficiaries of these rights; Expenditures for pensions are planned for the purpose of ensuring further protection of this category of citizens, which will be realized according to the possibilities of the Budget of the Republic of Macedonia and the real EU trends. Within the medium-term projections, what is planned is increase of social benefits for socially most vulnerable families as social welfare and regular servicing of liabilities on the basis of child allowance, allowances on the basis of rights of disabled persons, invalids of war and civilian invalids and asylum seekers. Planned reforms in the social sphere, by simplifying the procedures for exercising these rights, as well as the effects from the integration of social centers in unique information system, will provide certain savings at the same time extending the scope and proper targeting of these allowances towards the most vulnerable categories.

Government activities and measures as regards social policy are supported under the Conditional Cash Transfers Project, financed by the World Bank's loan, aimed at supporting the Government of the Republic of Macedonia in its efforts to reduce poverty of vulnerable groups by conditioning the existing pecuniary allowances.

- further provision of significant amounts for payment of agricultural subsidies, to the end of strengthening and supporting this sector. Planned reforms in the agricultural sector, as well as the significant amount of subsidies and funds under IPARD Program will provide for its further enhancement and support, create conditions for establishing efficient and competitive agricultural sector and its successful EU integration, also contributing to boosting the export of Macedonian agricultural products and conquering new markets.

- improvement of the quality of university education and vocational education, as well as public financial support for stimulating the innovations in Macedonian companies. The realization of the Skills Development and Innovation Support Project, funded by the World Bank's loan was commenced for this purpose during 2014. Its implementation will include carrying out reforms in the higher education, as well as strengthening institutional capacities of universities, which will contribute to quality and efficient higher education to correspond the needs of the private sector and the society. At the same time, quality of vocational education will be strengthened, to the end of adjusting to labour market needs. In particular, project realization will provide for defining the necessary vocational skills and their advancement in the course of the educational process, i.e. advancement of the skills young people need during their work. In addition, by esdtablishing the Fund for Innovation and Technological Development, improvement of innovation capacity of companies will be provided through better access to skills, knowledge and technology.

Chart 4. Current expenditure structure



Public investments presenting the development component of the fiscal policy are precondition for improving the economic perspectives and better and more quality life of citizens. To the end of realizing and maintaining positive economic growth rates, significant amount from the Budget is expected to be intended for public investments in the coming three-year period. **Public investments** presenting the development component of the fiscal policy will continue to be of priority and dominant importance. In the past several years, capital projects financed from the Budget of the Republic of Macedonia fully affirmed their justification and strong influence in tackling the effects from the economic crisis. Denar 21,208 million from the 2015 Budget is envisaged for capital investments.

Regarding the budget funds intended for capital expenditures, significant investments are envisaged in completion of the construction of Corridor X highway and railway infrastructure, energy and utility infrastructures, as well as capital investments in improving the conditions in the educational, social and health system, agriculture, environment protection and judiciary.

Chart 5. Capital expenditures in the Budget of the Republic of Macedonia

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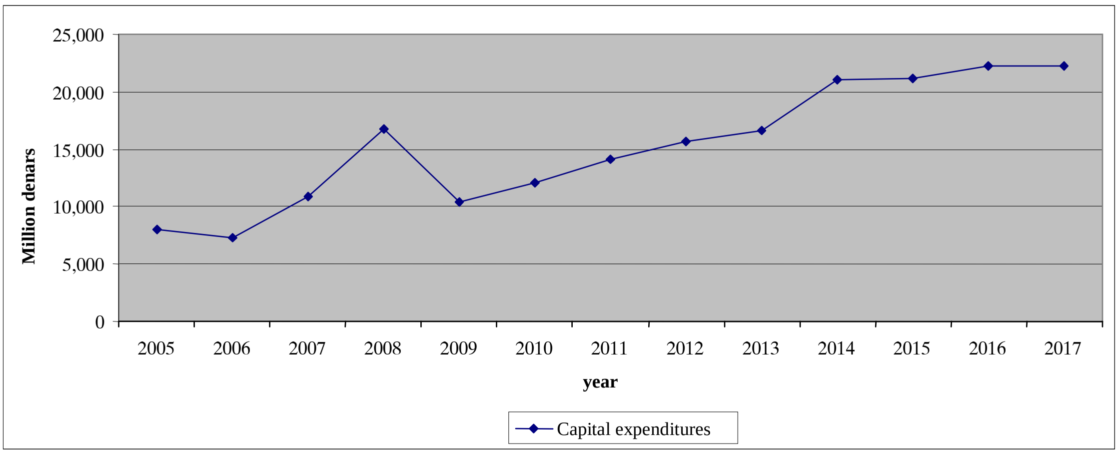


In the next medium-term period, public investments will be focused on:

-Intensification and completion of the construction of new modern highway section Demir Kapija – Smokvica along Corridor X, being 28.18 km long, thus completing the main axis of Corridor X passing through the Republic of Macedonia. Construction of this section is financed with loans from EBRD and EIB, grants under the IPA Regional Development Component and Budget funds.

As for the investments of the Public Enterprise for State Roads, construction and rehabilitation of local and regional roads supported with loans from the World Bank and EBRD continues in the coming period. New loan from the World Bank and EBRD for national and regional roads will start to be implemented in 2015, which will contribute to improving the connection of the selected national and regional roads with Corridor X and Corridor VIII, as well as to increasing the safety on the roads throughout the country.

At the same time, in 2015, construction of road sections Miladinovci- Stip and Kicevo - Ohrid will continue, which will significantly improve the road infrastructure, and under the Project for for Construction and Installation of Electronic Toll Collection System along Corridor X, electronic toll collection system at the existing road tolls will be intruduced, and another new road tolls along Corridor X will be equipped.

-Regarding the railway infrastructure, implementation of the Rail Corridor X Project, financed with EBRD loan will continue, by which several sections along Corridor X, the total length of which is around 53 km, will be repaired. Main purpose of the Project is improvement of the railway line, reduction of its maintenance costs and ensuring safe traffic on the above-mentioned sections. In addition, in the field of railway traffic, in the next period, the focus will be placed on implementation of the Project for Completion of Rail Corridor VIII, being aimed a connecting the Black Sea with Adriatic See, this speaking in favour is its huge strategic and economic significance. Construction of the eastern part of Railway Corridor VIII, i.e. the part towards Bulgaria, will be carried out in 3 phases and it will be financed with loans from EBRD and EIB, as well as IPA funds. Reconstruction of the first section Kumanov-Beljakovce with EBRD loan commenced in 2013. For the purpose of preparing and realizing this Project, technical assistance will be provided from the European Union through the WBIF instryment and other donors. In addition, investment for reconstruction of 17-km railroad tracks on the section Bitola-Kremenica is planned, being part of the railway Corridor X, which will provide for additional railway connection with the Republic of Greece. Railway infrastructure will also be improved with construction activities, the main goal of which is rehabilitation and modernization of the central railway station in Skopje, as well as ten smaller railway stations located along Corridor X. Funds from IPA Regional Development Component were provided for these activities. Realization of the second Beljakovce-Kriva Palanka section, financed with EBRD, will start during 2015. For the purpose of preparing and realizing this Project, technical assistance will be provided from the European Union through the WBIF instryment and other donors.

In parallel to investments in railway infrastructure, in 2015, realization of the Macedonian Railways Fleet Renewal Project will contine, being financed with EBRD loan, within which, railroad fleet of Macedonian Railways Transport will be repaired.

Construction of National Gasification System will supply the business sector, public sector and households with cheap and environmentally friendly energy, at the same time reducing the emission of harmful gases in the atmosphere. Financial plan of the Project will be completed with the funds from the liabilities of the former USSR towards the Republic of Macedonia, as well as with loans from EBRD and other international financial institutions.

- Capital investments in the energy sector will be mainly realized through investments of ELEM and MEPSO in the next infrastructure projects: Construction of Boskov Most Hydropower Plant, Increase of Installed Capacity of HPP Spilje, Modernization of Thermal Power Plant Bitola, Toplifikacija of Bitola (Company for production and distribution of heat energy), as well as AD MEPSO PROJECT-Energy community of South East Europe APL 3 and Additional financing of AD MEPSO PROJECT, Project for 400 kv long -distance power line interconnection between TC Bitola 2 (Republic of Macedonia) and TC Elbasan (Republic of Albania), as well as Project for Improving the Energy Transmission Network.

- Strengthening of management at local level is supported under the Municipal Services Improvement Project, financed by the World Bank. Project enables the municipalities and the public utility enterprises, which in line with the legislation can borrow funds, to finance investment operations in line with their priorities. In 2015, implementation of Municipal Services Improvement Project continues. Loan funds will be intended for financing infrastructure investment projects in the field of water supply and wastewater drainage, management of solid waste and other investments in municipal services, having potential for generating revenues, i.e. making savings or being of high priority for the municipalities.

- To the end of improving both the conditions and the quality of life, above all in the field of rural areas in the Republic of Macedonia, by supplying clean drinking water, Water Supply and Waste Water Collection Project, financed with EIB loan, will continue to be implemented. This project is part of the priorities of the Government of the Republic of Macedonia for equal regional development and is expected to boost development in rural areas through investments in utility infrastructure. Water and Sewerage Programme Macedonia, Phase I financed from the German Credit Bank for Reconstruction - KfW provides for sustainable supply of potable water to the population in the Municipalities of Bitola, Gevgelija, Gostivar, Kavadarci, Kocani, Negotino, Radovis and Tetovo. This purpose is achieved by improving their water supply systems, performing smaller investment operations within the systems themselves, as well as minor construction works.

Second phase will be realized with EIB support and it will include irrigation, as well as the the third phase, which covers electricity generation thorugh the Zletovica Water Basin Utilization Improvement Project. Technical assistance was allocated to this Project through WBIF instrument, with which detailed assessments for the activities that should be realized within this multipurpose project, will be carried out. Main objective of the second stage is provision of irrigation for 4,570 ha net area in the region of Probistip and Kratovo municipalities. Realization of the third stage, which includes construction of small hydro power plants along the flow of Zletovica River, will provide for reducing electricity shortage in the region, safe, secure and quality supply of energy for the consumers, increasing energy efficiency, as well as creating possibilities for job creation in the region.

Second phase of the Project Irrigation Programme Southern Vardar Valley II is financed with KfW loan and it covers rehabilitation and modernization of the systems for irrigation of land area covering 3.904 hectares, at the following locations: Miravci, Kovanci, Udovo, Valandovo, Negorci, Gevgelija, Grciste, Paljurci and Prdejci. Successful realization of this Programme will contribute to higher productivity and sustainable development of agricultural production in this region.

- In the field of health, realization of the first phase of the Project for Rehabilitation of Health Provider Institutions continues, financed from the Council of Europe Development Bank (CEB) continue, by which the most urgent health provider institutions will be reconstructed and rehabilitated. Main objective of the Project is to improve health infrastructure, operational services for delivery of respective health services, as well as to introduce new and modern equipment and technology to replace most of the existing obsolete equipment. Planned investments in several HPIs will continue to be financed with grant provided from the EU thorugh WBIF instrument. In addition, in 2015, implementation of the Consolidation and Modernization of the University Clinical Centre "Mother Teresa" in Skopje and the Regional Clinical Hospital in Shtip will comemnce, which will be financed with budget funds and loan from the Council of Europe Development Bank (CEB).

- Project for Building Physical Education Facilities in Secondary Schools, financed with CEB loan and contribution of the Republic of Macedonia will continue to be realized in the period to come. This Project covers construction or reconstruction of 30 physical education facilities aimed at improving the pupils' performance in relation to the subjecta they learn, long-term improvement of their health and encourahement of social interaction among pupils with different nationality and ability. In addition, realization of the Project for Building Physical Education Facilities in Primary Schools and Rehabilitation of Primary and Secondary Schools in the Republic of Macedonia will continue, financed with loan from CEB and contribution of the Republic of Macedonia. In addition, under Western Balkans Investment Framework (WBIF), grants were approved, being intended for financing several primary schools and existing physical education facilities, as well as equipment of existing physical education facilities.

- One of the important elements in the social development policy is to increase the quality of life of low-income persons and the vulnerable groups by providing their appropriate housing. Government activities and measures as regards social policy are also supported under the Project for Housing of Vulnerable Groups, by investing in construction of flats for low-income persons, the funds being provided from the Council of Europe Development Bank.

To the end of ensuring, exercising and improving human rights as regards conditions for accommodation, hygiene, health protection and leisure time of the convicted and detained persons, Project for Reconstruction of Houses of Correction, financed with Council of Europe Development Bank loan, continues to be implemented. The realization of this Project will contribute to reconstruction of 4 houses of correction, by implementing the standards set in the European prison rules;

- To the end of continuing the reforms for improvement of protection of property and legal regulations and registration of ownership rights, activities related to upgrading the already commenced cadastre reforms, supported under the additional funding of the Real Estate Cadastre and Registration Project, financed by the World Bank, will be completed in 2015. Project realization will provide for improving delivery of public services in the sector of real estate cadastre and registration of rights, having direct impact on the economic development through the real estate market. Project also supports the Property and Legal Affairs Office by improving the working conditions in the regional offices, as well through automatization of business processes and digitalization of the existing records to the end of creating digital archives.

Projected Deficit and Its Financing

Financing the projected deficit will be ensured from foreign sources (favourable credits from international financial institutions, credit lines intended for financing certain projects, Eurobonds and other type of foreign borrowing) and domestic sources (issues of government securities). In July 2014, Republic of Macedonia borrowed funds on the international capital market by issuing Eurobond in the amount of EUR 500 mllion, thus providing funds for financing the budget needs in 2014 and 2015.

In the next period, the developments on the international capital market will continue to be monitored. Foreign borrowing as source of financing will be used by budget users for realization of specific projects.

As for the borrowing on the domestic market, Ministry of Finance will continue to issue government securities in the next period as well. The purpose is, by regular issuance of government securities, to provide for more efficient financing of budget needs on the short and long run, reduction of financing costs, as well as encouragement of the further development of the financial markets in the Republic of Macedonia. In the upcoming period, Ministry of Finance will intend to retain regular issuance of treasury bills, as well as focused on expanding the maturity structure of the portfolio of government securities with longer maturities. Thus, special emphasis will be put on continuation of maturity of the existing portfolio of government securities by issuing longer-term securities, i.e. by issuing 2-, 3-, 5-, 7- and 10-year government bonds. Special interest in investing longer-term securities issued by the Republic of Macedonia is expected from the pension companies, as well as from commercial banks and insurance companies.

Table 3 (Denar million)

Deficit and financing sources	**2014**	**2015**	**2016**	**2017**
Budget balance	**-19.603**	**-18.497**	**-18.958**	**-18.262**
Deficit financing	**19.603**	**18.497**	**18.958**	**18.262**
Inflows	**30.463**	**44.667**	**39.181**	**37.470**
Foreign sources	36.889	16.159	23.000	18.137
Domestic sources	6.250	5.137	15.898	20.290
Deposits	-12.676	23.371	283	-957
Outflows	**10.860**	**26.170**	**20.223**	**19.208**
Repayment upon foreign borrowing	9.133	20.001	14.004	8.992
Repayment upon domestic borrowing	1.727	6.169	6.219	10.216

Local Government Budget

In the course of 2014, as well as on the medium run, it is expected for the municipalities to continue the trend of strengthened collection of own revenues, strengthening the capacities for development of policies for financing the municipalities and enhancing the capacities for financial management.

For the purpose of realizing the strategic commitments, the strong commitment to implementing the reforms and developing the local government will continue in the next period as well. Increased revenues from VAT grant (general grant), in the amount of 4.5% of VAT collected in 2012 from the Budget of the Republic of Macedonia, provided for addititional stable revenues for municipalities. In the period 2016-2018, additional revenues from the VAT grant will be provided for the municipalities showing success in the collection of local taxes. Payment of the additional part of the VAT grant will be made to municipalities collecting local taxes in the amount of 80% in 2016, 85% in 2017 and 90% in 2018. Conditional part of the VAT grant will gradually increase by 0.25% in 2016, by 0.75% in 2017 and by 1.50% in 2018, by which 6% of the VAT collected in the previous year will be distributed to the municipalities in 2018, as follows: 4.50% unconditional part and 1.50% conditional part

New revenues will provided by allocating funds from lease of state-owned agricultural land to the municipalities the proportion of which is 50% for the Republic of Macedonia and 50% for the municipalities and the municipalities in the City of Skopje depending on the the location of the agricultural land being under lease if the revenue performance on the basis of property tax exceeds 80% in relation to the projected ones. During the interim period, the distribution will be carried out in 2015 the proportion of which will be 90%:10%, 80%:20% in 2016, and 70%:30% in 2017. Additional increase of own revenues of the municipalities is expected to be realized from the fee collected by issuing concession for usage of water resources for electricity generation (50% for the central government budget and 50% for the local authorities), depending on which area the concession activity is performed as of 2016, and, in the meantime, revenues will be distributed in the following proportion: 75%:25%.

Increase of the own revenues of municipalities, in particular revenues on the basis of taxes on real estate, fully including the tax base of natural persons and legal entities and re-assessment of the value of real estate are expected to continue in the next medium-term period as well. Increase is also expected by applying the improved elements of calculation in the Methodology for Determining the Market value of the Real Estate. Commencing the application of the legal provisions as regards professional training in determining the value of the real estate for the needs of taxation on the basis of property taxes by evaluators is expected to provide for better quality and more objective assessment of the value of real estate, thus providing the municipalities the possibility to employ an expert – an evaluator or to use the services of licensed evaluators.

Government of the Republic of Macedonia will continue to carry out the activties aimed at equal regional development and enhancement of all regions in the country in the next period. Implementation of the Strategy for Equal Regional Development of the Republic of Macedonia in the eight planning regions (Vardar, Eastern, Southwestern, Southeastern, Pelagonija, Polog, Northeastern and Skopje regions) will contrubure to achieving equal development. Council for Equal Regional Development will continue to play significant role as promoter of partnership between the regions/the municipalities and the Government, within which the usage of funds will be coordianted from all sectoral programs indtend for the planning regions and the municipalities. Special efforts will be put for supporting the municipalities by encouraging the local development and creating conditions for more actuve, more effective and more innovative role of the local authorities in fulfilling the national goals for growth and development.

In the coming medium term, the municipalities will continue with more intensive execution of the transferred competences for management of construction land and treatment of facilities illegally built on the construction and agricultural land, for which respective sources of revenues in the municipal budget are determined.

Realization of series of infrastructure projects related to improvement of the quality of life will appropriately improve the regional development and active integration in the economy. To that end, series of projects will be undertaken, which will be aimed at improving the overall road infrastructure, bridges, local streets and roads, followed by projects in the field of utility infrastructure (water supply, sewage systems, waste water treatment station collector, pedestrian crossings, horticultural arrangement, public hygiene), as well as improvement of infrastructure of villages through urbanization, connection of inhabited areas and construction of local roads and pedestrian crossings and lighting, development and support of rural tourism and recreational centers.

More dynamic local development and quality services of citizens in the next period will be provided by implementing the projects selected as priority projects of the municipalities, which will be financed with long-term subloans within the first and second phase of the World Bank's Municipal Services Improvement Project, by which favourable loans were provided for all municipalities in Macedonia intended for financing infrastructure investments in line with the municipal priorities. Therefore, the municipalities have at their disposal funds they may provide under very favourable conditions, intended for construction and reconstruction of utility infrastructure and water supply systems, energy efficiency of public municipal facilities, procurement of specialized vehicles for utility hygiene, street lighting, local road infrastructure, arrangement of urban areas and similar.

At the same time, pursuant to the legal regulations, the municipalities fulfilling the legal criteria to borrow, will be able, in the coming period, to finance their projects by borrowing on the basis of concluding loan agreements at domestic or foreign creditors or on the basis of issuing municipal bonds. Municipalities will be helped to issue first municipal bonds as additional instrument for improving liquidity and providing financial resources for capital and municipal projects.

Government will continue to implement this process within the fully established legal and institutional framework of local government, with developed, responsible and functional local government units and level of local democracy that will bring the citizens closer, as much as possible, to the local government institutions.

Improvement of Public Finance Management

Public finance management is serious obligation and challenge requiring continuous djustments, reforms and improvement particularly in conditions of unevisaged and turbulent economic surrounding.

Efficient public finance management and establishing stable fiscal position on the long run provides for solvency in relation to the assumed liabilities and the paymemt of expenditures.

In this light, significant reform activities are realized in the field of fiscal policy, meaning:

1. Following the example of the European countries, Government of the Republic of Macedonia continued to introduce fiscal rules providing:

- framework for conducting stable, envisageable and sustainable fiscal policy;
- increase of budgetary discipline and responsibility
- increase of the macroeconomic policy credibility
- fair and sustainable distribution of expenditures among the present and future generation of public goods users.

Determination of fiscal rules is basis for fiscal responsibility, transparency and earmarked use of Budget funds. Limitation of the two main fiscal targets -deficit of the Budget of the Republic of Macedonia and the public debt are envisaged to be governed under the highest legal act – the Constitution.

2. Starting April 2014, activities are carried out with technical support from the World Bank, being aimed at analyzing the public finance - Public Finance Review, from the aspect of legal regulations and procedures, as well as efficiency and cost-effectiveness of the public finance use. In fact, such activity with the World Bank will provide for sound basis for further improvement of the public finance management process.

3. Under IPA TAIB 2011, project for building up the capacity within the department dealing with central government budget and strengthening medium - term policy making capacity was proposed, envisaged to start in 2015.

Main Project objective is improving the public finance management, the central focus being placed on medium-term budget planning as main precondition for sound public finance and maintenance of stable fiscal position. Increase of budget planning effectiveness will contribute to increasing the fiscal discipline and credibility, which lead to effective control of total budget distributions.

Use of EU Pre-Accession Assistance

Republic of Macedonia, as candidate country for EU membership, has the possibility to use significant financial support from the European Union through the five IPA Components from the current financial perspective for the period 2007-2013 in the total amount of around Denar 38 billion or around EUR 619 million. Under the new financial perspective that will cover the period 2014-2020, the European Union, through the redefined Instrument for Pre-Accession Assisrance - IPA 2, allocated to the Republic of Macedonia additional EUR 664 million or Denar 41 billion, for the priorities that will be determined in the Strategic Document agreed between the Government of the Republic of Macedonia and the European Commission.

Republic of Macedonia manages the funds obtained through the the Instrument for Pre-Accession Assistance (excep for IPA Component for Cross-Border Cooperation), independently through the established structures at national level within the so-called EU pre-accession assistance decentralized management system. European Commission accredited the respectuve national structures by adopting Decisions on Tansfer of Decentralized Management Competences, as follows:

1. IPA Component 1 Transition Assiatnce and Institution Building in December 2010,
2. IPA Component 3 Regional Development in July 2009,
3. IPA Component 4 Human Resources Development in October 2009, and
4. IPA Component 5 Rural Development in December 2009.

Within IPA Component 1, in conditions of decentralized implementation of IPA assistamce, as of December 2012 inclusive, three annual 2009, 2010 and 2011 National Programmes were prepared and adopted. As for the programme period 2012-2013, 2-year Sectoral Program was adopted, whereby the Financial Agreement for the 2012 allocations was signed by the Government of the Republic of Macedonia and the European Commission, while the Agreement covering the 2013 allocation will be additionally signed.

These programs generally provide support to the state administration in order to enhance its capacities at central and local level, undertake reforms, as well as to fulfil the obligation of the membership more quickly and more efficiently. Assistance under this Programmes is focused on the following areas:

1. Good governance and rule of law
2. Economic development and social cohesion, and
3. Approximatuion and transposition of the European Acquis in the national legislation in different areas.

21st December 2013 was the deadline for concluding all Agreements within the National Programme for TAIB 2009. Ministry of Finance concluded 75 agreements for projects in the total amount of EUR 33.41 million or somewhat more than Denar 2 billion, which will be implemented by the end of 2016. These projects mainly refer to reform of the judicial system and the criminal law, strengthening the capacities of the Ministry of Finance for macroeconomic analyses, supporting the system of state aid control, strengthening the administrative capacities in the field of telecom and media services, agriculture and rural policy, veterinary and phyto-sanitary policy, customs sector, blood security system, as well integrated border management, and similar. One portion of these funds or around Denar 400 million is used for procurement of equipment intended for modernization of the operatuions of the public administration institutions.

Financial Agreemen for the 2010 National Program, in the total amount of around EUR 30 million, was signed on 1st December 2011. Aroun 24 Agreements that should be concluded by 1st December 2014, are planned within this Program.

So far, 5 Agreemens in the amount of Denar 5.74 million, have been concluded, providing funds for procuremen of vaccines for the need of the Agency for Food and Vererinary and Animal Health Protection, enhancement of the capacities of the competent institutions in the field of effective implementation of the EU acquis in the field of free movement of workers, support of efficient prevention and fight against corruption, support of the Customs Administration in finalzing the preparation activities for membership in the Convention on Common Transit Procedure and the Convention on the Simplification of Formalities in Trade in Goods, as well as harmonization of the legislation and procedures with the EU acquis and the best practices related to excises.

Within the 2011 National Program, around 24 projects have been planned, in the total amount of around EUR 27 million. 2012 National Program envisages around 30 projects in the total amount of around EUR 30.6 million.

Second IPA component - Cross-Border Cooperation is aimed at strengthening the cooperation between the border regions in the Republic of Macedonia and all neighbouring countries.

2007-2013 Operational Programs are prepared for usage of the allocations for cross-border cooperation with the Republic of Albania, Bulgari and Greeece and they are adopted by the European Commission. These Programs envisage encouragement of the economic, social and environmental development, focusing on tourism development.

Given that accreditation by the European Commission for decentralized implementation of this Component has not been granted yet, these Programmes are implemented atcentralized level, i.e. by EUD.

This IPA Component also includes the Transnational Program for Cross Border Territorial Cooperation with South East Europe 2007-2013. The main objective of the Program is to enhance the balanced development of territories and territorial integration in this area. The main activities of this Program refer to innovations, which directly contribute to balanced growth, as well as to strengthening the sustainable development in urban areas.

IPA component Regional Development is aimed at preparing the country for using the funds from the EU Structural and Cohesion Funds. This Program provides funding of projects in the field of transport and environment. In the period 2007-2013, Republic of Macedonia has total of around EUR 235 million, available under this Program.

Within the Operational Program for Regional Development, the two so-called “big projects” will be financed:

1. Upgrading of the Road Section of the Pan-European Corridor X and
2. Waste Water Treatment Plant Project in Prilep.

These two projects account for around 30% of the total allocations of the 2007-2013 Program. Construction works for Upgarding Corridor 10 commenced in the third quarter of 2012. Within the Waste Water Treatment Plant Project in Prilep, activities for rehabilitation and extension of the sewage network in Ptrilep, as well as construction of wastewater treatment station in Prilep, have been already commenced. In addition to the big infrastructure projects, in the past period, another smaller infrastructure projects commenced, those being the following:

1. Rehabilitation and Modernization of Railway Station Skopje, and
2. Rehabilitation of Veles-KatlanovoHighway Section , as part of Corridor 10.

In addition, under this Program, there are funds for smaller projects related to planning the preparation of project studies and project documentation for railway sections along Corridor 10, including section 10d, and rehabilitation of the railway line section " Bitola-Kremenica", as well as rehabilitation of several smaller railway stations along Corridor 10, preparation of regional plans for waste management and strategic environmental assessment in the eastern and northeastern region of the Republic of Macedonia, etc. Realization of the most of these projects has already started, i.e. there is ongoing implementatopm of 29 Agreements in the total amount of EUR 261 million.

In addition, as for road transport sector, Agreement for Construction Works Along Corridor 10 is planned, i.e. reconstruction and upgrading of road section Smokvica-Gevgelija. As for railway transportation, agreements are planned, pertaining to preparation of technical documentaton for the railway section Veles-Bitola, as well as preparation of technical documentation of some of the sections along Corridor 8 (Kriva Palanka - border with the Republic of Bulgaria, Skopje-Kicevo, etc.).

As regards environment protection sector, projects for preparation of project and technical documentation for construction of wastewater treatment stations in many cities in the Republic of Macedonia (Bitola, Tetovo, Gostivar, Debar, Kicevo, Kavadarci, Radovis, Kumanovo, Ohrid) are planned, for the purpose of further financing of the construction of such stations. By the end of 2017, construction activities for some of these projects will be carried out.

IPA component Human Resources Development supports projects in the field of employment, education and social inclusion. In the period 2007-2013, Republic of Maceodnia has total of EUR 58 million, available under this Program.

Projects in the field of employment are aimaed at attracting and retaining more people at work by modernizing the operations of the Employment Agency, supporting the implementation of the Employment Strategt, improving the situation of young people, women and long-term unemployed on the labour market, supporting the Employment Agency of the Republic of Macedonia by implementing active employment measures, being part of the Operational Plan for Active Employment Measures of the Government of the Republic of Macedonia, supporting the fight against unregistered employment, as well as promoting social dialogue.

Projects in the field of education are aimed at investments in human capital by improving the educational process to the end of its adjustment to the needs of the labour market, as well as equal access for all ethnic communities to the educational institutions.

Assistance in the field of social inclusion is intended for strengthening the integration of the individuals with special needs, developing infrastructure for alternative forms of social services for promotion of social inclusion, integrating minorities, as well as active participation of the civil sector. Total of 29 Agreements, amounting to around EUR 1`9.08 million, were signed within this Program.

In the period to come, finanining is planned for activities that will be focused on continious support of the Employment Agency for improving its activities, and services it offers, promoting alternative services for sheltering children, enhancing social enterpreunirship and capacities of the State Market Inspectorate, etc. In the field of education, the focus will continue to be placed on improving the life-time learning, by moderninzing the vocational education and training, as well as the system for education of adults, improving the system for implementation of the National Qaulifications Framework, enhancing the capacities for ensuring quality and control of the educational system, strengthening the capacities in the the educational system for better connection with the labour market needs, etc. In the field of social inclusion in the coming period, activities will be refinanced pertaining to reconstruction and modernization of the centers for social work, grants in the field of enhancing the social inclusion of persons with special needs, promotion of services for social inclusion, and similar.

IPA Rural Development component supports projects that will provide for attaining EU standards introduced in the field of agricultural production, food processing and rural development. In the period 2007-2013, Republic of Maceodnia has total of EUR 86,749,815 million, available under this Program.

In addition, so as to avoid decommitment of allocations for 2013, funds amounting to EUR 18 million were transferred from this Component to IPA Component 1. These funds will be awarded as direct grant of the World Bank aimed at supporting the rural infrastructure.

In the period 2009-2014, nine public calls were realized and agreements were signed between the Agency for Financial Support in Agriculture and Rural Development and the final beneficiaries, in the amount of EUR 10.2 million. In addition, three public calls are planned to be realized in the period 2014-2015.

Assistance through this Component is aimed at supporting projects related to investments in agriculture and processing capacities and marketing of agricultural products and fish. These investments will contribute to improvement of the quality and safety of food and cattle, increased competitiveness of farmers by using modern production technologies and reduced production costs, promotion of ecological methods of production, improvement of the performance of farms in primary production and marketing so as to attain EU standards in the field of environment protection, public health status (food quality and safety), safety at work, opening new markets, improvement of management of animal waste and waste waters, as well as job creation.

Measures for diverzification and rural development will be realized through support to rural tourism, support to small- and medium-sized enterprises for modernization of farm production, modernization/adaptation of the infrastructure, encouraging traditional craftsmanship, support to rural and agricultural services (organizing workshops for maintenance and repair of agricultural machines and tools, construction of youth centers, children playgrounds, procurement of office supplies).

IPA 2 Regulation introduces certain changes that influence the programming of the assistance for the period 2014-2020 for more coherent and strategic access to pre-accession assistance. In fact, so-called sectoral access in programming is intrioduced, where the components are replaced with “areas of acting” so as to increase continuity in the actions and encourage closer cooperation among the

European Commissions services in determining one and common strategy for each separate country.

Financial assistance within IPA 2 for the Republic of Macedonia for the programing period 2014-2020, is expected to be approximately the same amount as the one for the previous programing period (2007-2013), i.e. around EUR 600-650 million.

There is ongoing preparation of National Strategic Documeny by the national authorities in cooperation with the European Commission, determining the priorities and types of activities that will be financed through IPA 2 in the period 2014-2020, within different areas.

IV. TRENDS OF PUBLIC DEBT OF THE REPUBLIC OF MACEDONIA

Public debt is broader definition about the debt, including the the government debt and the debt of public enterprises and companies fully or dominantly owned by the state, as well as the debt of municipalities, municipalities in the City of Skopje and the City of Skopje for which the country issued sovereign guarantee.

Government debt comprises all financial liabilities incurred on the basis of borrowing by the Republic of Macedonia, the public institutions established by the Republic of Macedonia, the municipalities, the municipalities in the City of Skopje and the City of Skopje.

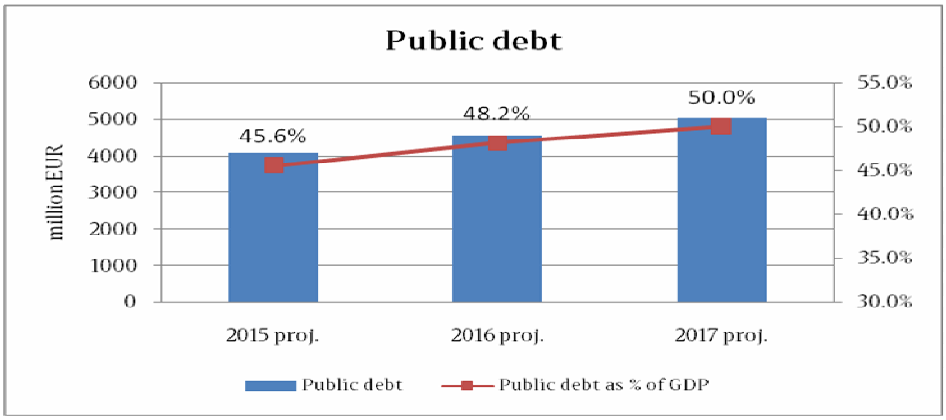
As a result of prudent fiscal policy in the past years, Republic of Macedonia remains to be low indebted country, the government debt being significantly lower than the average at EU level.

In the coming three years, the government debt management policy will continue to be aimed at financing the needs of the state with lowest possible cost in the medium and long run with sustainable level of risk, as well as further development of the domestic government securities market by increasing the average maturity of issued securities.

In the period 2015-2017, realization of investments is expected in the field of road and rail infrastructure, water supply and sewerage, sports facilities, investments in education, health, as well as other projects that are in line with the the Government Program of the Republic of Macedonia. They will be implemented by the state administration bodies with firm determination not to jeopardize the long-term sustainability of the debt level of the country.

On the basis of these commitments, trends of public debt, including the government debt and the guaranteed debt, will be retained within the projections, i.e. there will be moderate growth that will not jeopardize the sustainability of public finance, and hence it is expected for the public debt not to exceed 60% of GDP in the medium and long run.

Chart 6 Public debt



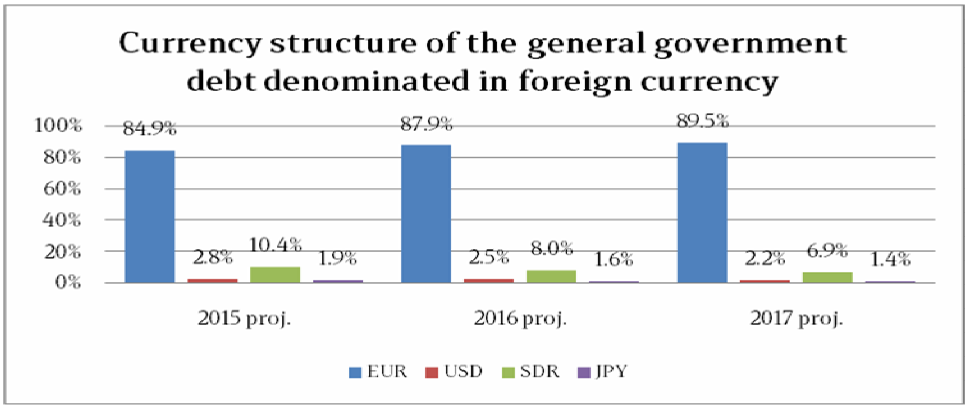
Source: Ministry of Finance

Issuance of sovereign guarantees is a potential obligation of the Budget of the Republic of Macedonia to call the guarantees up. Sustainable level of guarantees over the next three years is of great importance for the Ministry of Finance and therefore when selecting projects to be issued with sovereign guarantee, special emphasis will be placed on those projects that are in line with the strategic priorities of the Government of the Republic of Macedonia, being self-sustaining, generating income and having justification for the purpose for which the funds are used.

Currency Structure of Government Debt Denomained in Foreign Currency

As for the portfolio of government debt in foreign currency, the focus will be placed on gradual increase in the share of euro-denominated debt as opposed to the other currencies. In this regard, the state will be committed to keeping the share of euro-denominated debt in the foreign currency debt portfolio strcuture not to be below 70%.

Chart 7: Currency structure of the general government debt denominated in foreign currency



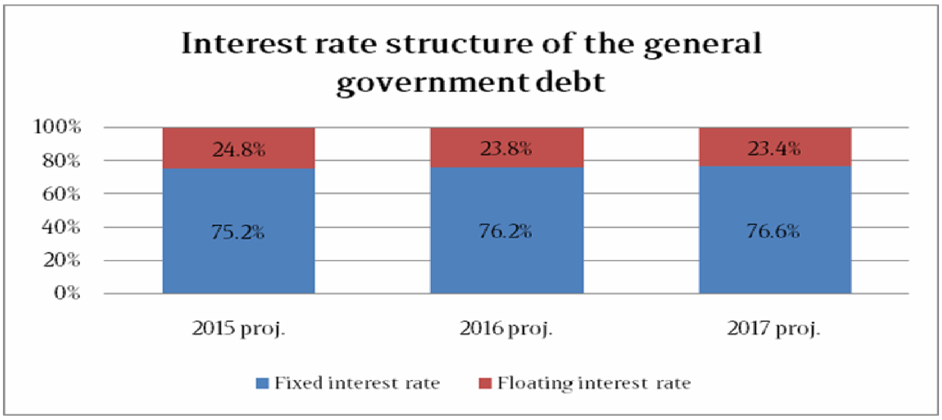
Source: Ministry of Finance

Interest Structure of Government Debt

In order to protect the public debt portfolio against possible future market shocks and adverse changes of interest rates that directly lead to increase of the costs to the Budget of the Republic of Macedonia, maintaining optimal interest structure of the government debt portfolio is one of the objectives at which public debt managers should aim.

Therefore, in the period 2015-2017, the level of government debt with fixed interest rate is projected to be at least below 50%. In line with the projections for the interest structure in the medium run, fixed interest rate debt ranges above the set target as a result of the commitment of the Ministry of Finance to issue long-term securities on the domestic market having fixed interest rate.

Chart 8: Interest rate structure of the general government debt



Source: Ministry of Finance

Risk Management Indicators

Uncertainty arising from the future trends of macroeconomic variables on the international and domestic capital market significantly affects the reaching of decisions for efficient management of debt portfolio of the country. Accordingly, within this Strategy, limits for the debt refinancing indicator (showing the average time for refinincing the debt), as well as for the indictator of measuring the inrerest rate risk (showing the average time for changing the interest rates of the debt portfolio) are calculated.

- In order to protect the central government debt protofilo against the refinancing risk, the minimum level of the "average time to maturity"indicator in 2015 should be 3 years.

- In order to protect the central government debt protofilo against the inrerest rate risk, the minimum level of the "average time to refixing" indicator in 2015 should be 2 years.

MEASURES TO IMPLEMENT PUBLIC DEBT MANAGEMENT STRATEGY

Development of Government Securities Market

Ministry of Finance will continue to regularly issue government securities (GS) on the domestic market in the coming period as well. The purpose is, by regular issuance of government securities, to provide for more efficient financing of budget needs in the short and long run, reduction of financing costs, as well as encouragement of the further development of the financial markets in the Republic of Macedonia.

In the upcoming period, Ministry of Finance will intend to retain regular issuance of treasury bills, as well as staying focused on expanding the maturity structure of the portfolio of government securities with longer maturities. Thus, special emphasis will be put on continuation of maturity of the existing portfolio of government securities by issuing longer-term securities, i.e. by issuing 2-, 3-, 5-, 7- and 10-year government bonds. Special interest in investing longer-term securities issued by the Republic of Macedonia is expected from the pension companies, as well as from commercial banks and insurance companies. In addition, to the end of improving the liquidity of the domestic government securities market, in the coming medium-term period, series of measures and activities are planned to be undertaken, pertaining to gradual reduction of the share of government securities with foreign exchange clause in the total issued government securities, targeting of positive annual net borrowing and re-opening of the already held auctions of government securities.

To the end of improving and further developing the government securities market, activities aimed at expanding the investor base will be continued, by considering the possibility to introduce new financial instruments, adequate to the needs of the market participants, carrying out marketing campaign before different target groups of investors and maintaining regular dialogue with all participants on the government securities market.

So-far experience in issuing GS pointed out to the conclusion that frequency of issuing securities corresponds to the market needs and accordingly, the dynamics will continue to be carried out in line with the market conditions.

RISKS IN PUBLIC DEBT MANAGEMENT

In conditions of large oscillations of economic variables, need arises to actively manage risks to which public debt portfolio in the Republic of Macedonia is exposed.

Following appear as main risks identified at managing the debt portfolio of the Republic of Macedonia:

1. Refinancing risk:

2. Market risk, including the following risks:

-Interest rate risk

- Exchange rate risk

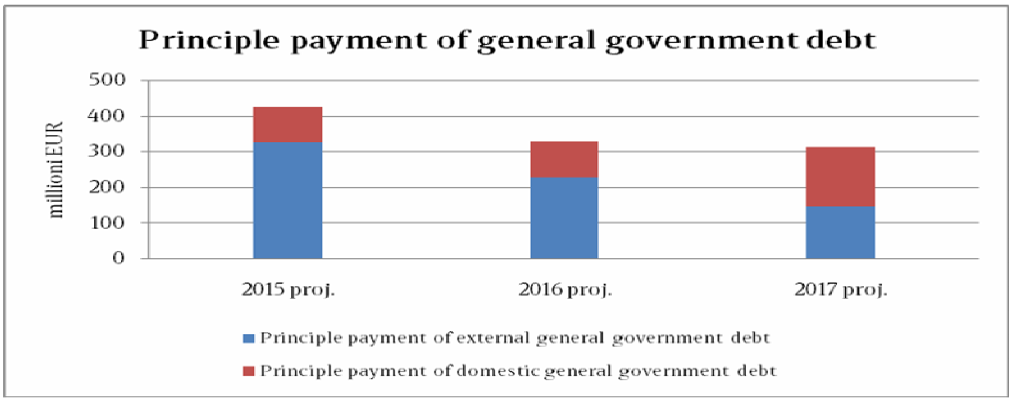
3. Risk associated with the contingent liabilities and

4. Operational risk

Refinancing risk is managed by preventing major part of the liabilities to fall due at once at any time and providing evenly distributed maturity of debt-related liabilities. Exposure of public debt portfolio to refinancing risk is measured by the debt repayment profile and the indicator showing the average time to maturity.

Taking into consideration the projections for the repayment profile in the coming years, one can see that the liabilities for repayment of the external and domestic debt increase, being due to the maturity of the liabilities on the basis of loans. Challenge for efficient refinancing risk management is expected in 2015, when the first Eurobond issued in 2005, will regularly fall due, while the IMF Precautionary Credit Line is to be amortized during 2014, 2015 and 2016. Therefore, Ministry of Finance in July 2014 issued Eurobond with historically the lowest interest rate the Republic of Macedonia obtained when issuing Eurobonds.

Chart 9: Principle payment of general government debt



Source: Ministry of Finance

Table 4: Average Time to Maturity- ATM (years)

	2015	2016	2017
Domestic debt	2.6	2.7	2.6
External debt	5.6	55	49
Total debt of Central government	45	45	40

Source: Ministry of Finance

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

Measuring and managing interest rate risk is especially important in the countries where domestic financial markets are underdeveloped and the need to borrow is covered from external sources under non-concessional terms, where exposure to interest rate risk is greater. The variation of interest rates on the domestic and international markets affects the debt-related costs, especially when the fixed interest rate debt should be refinanced or on the day when the interest is re-set for variable interest rate debt. Hence, close connection between the interest rate risk and the debt re-financing risk is evident.

ATR indicator measures the average time to refixing. Higher value of this indicator shows that larger portion of the debt portfolio will not be subject to significant interest rate refixing and such portfolio is a lower risk one.

Table.5 Average time to refixing ATR (years)

	2015	2016	2017
Domestic debt	2.6	2.7	2.6
External debt	4.0	4.1	3.5
Total debt of Central government	3.5	3.6	3.2

Source: Ministry of Finance

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

Changes in the exchange rate risk could largely affect, i.e. increase the envisaged costs for repayment of public debt – denominated in foreign currency. However, taking into account the fact that since 1995, the Republic of Macedonia applies de facto fixed exchange rate of the denar in relation to the Deutsch Mark , and since 2002 onwards, in relation to the euro, the exposure to such risk would be measured also as a share of the euro in the total public debt portfolio.

As a result of the projected investments being very important for the further development of the energy sector, the infrastructure, as well as the support of small- and medium-sized enterprises, moderate increase of the level of guaranteed public debt is projected in the coming period. In order to obtain better conditions for their financing, the state issues sovereign guarantee. Taking into account the risk the state may face in future in case the issued guarantees are called-up, analysis for the possible increase of the costs for servicing the due liabilities was made.

Liabilities on the basis of guaranted debt in relation to GDP falling due in the period 2015-2017 in the medium run register moderate upward trend, however thet will be independently settled by borrowers. In order for the Budget of the Republic of Macedonia not to be exposed to high risk of calling-up guarantees, the process of issuance of new guarantees is strictly regulated and it is subject to certain criteria the claimants of guarantees should fulfill, as well as to assessment of risks to which they are subject.

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

Sensitivity of Servicing-Related Costs

In order to examine the exposure of public debt portfolio of the Republic of Macedonia to market risk, i.e. interest rate risk and exchange rate risk, influence of variations of interest rates and exchange rate over the costs for servicing the external government debt was analyzed.

Table 6: Sensitivity analysis of servicing-related costs of the external government debt as a result of changes in interst rate and foreign exchange rate

index number	2015	2016	2017
Baseline Scenario	100.0	100.0	100.0
Scenario I – increase of interest rates by 1 percentage point	108.1	107.8	107.1
Scenario II - increase of interest rates by 2 percentage points	116.2	115.6	114.2
Scenario III - appreciation of other currencies in the portfolio against the euro by 10%	103.5	101.9	101.2
Scenario IV - appreciation of other currencies in the portfolio against the euro by 10%	96.5	98.1	98.8

Such sensitivity analysis of the trends at the servicing-related costs in the Budget of the Republic of Macedonia on the basis of external debt is based on the following assumptions:

· According to the change of one variable, all other variables remain unchanged, i.e. ceteris paribus.

· In conditions of possible trends at other currencies in relation to the euro, Denar exchange rate in relation to the euro remains stable;

· Lack of correlation between interest trends and exchange rate trends.

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

1. Interest servicing-related costs on the basis of external government debt are sensitive to the trends at interest rates. Should interest rates in 2015 surge by 1 percentage point, it would cause increase at interest-related costs by 8.1%. Such sensitivity could be explained as a result of exposure of debt portfolio to interest rate risk, being a consequence of relatively high share of debt with variable interest rates.

2. Future euro appreciation/depreciation, in relation to the other currencies in the portfolio (US dollar, Japanese yen and special drawing rights) by 10% will cause increase/decrease, of servicing-related costs by 3.5% in 2015. Possible unfavourable trends at exchange rates of other currencies in relation to the euro will not cause any significant increase of the servicing–related costs, as a result of the fact that most of the external government debt is euro-denominated.