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FOR RECONSTRUCTION AND DEVELOPMENT**

DRAFT

STRATEGY FOR THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

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EXECUTIVE SUMMARY

The Former Yugoslav Republic of Macedonia (FYR Macedonia) continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank.

FYR Macedonia has made further progress on key reforms geared towards integration into the European Union. After it acquired formal status as an EU candidate country in December 2005, the European Commission recommended in October 2009 to open EU accession negotiations. In December 2012 the Council of the European Union concluded that the country meets the criteria for the opening of the EU accession talks, while noting at the same time that a negotiated and mutually acceptable solution to the name issue, under the auspices of the UN, remains essential. The implementation of the Ohrid Framework Agreement, which ended the armed inter-ethnic conflict in 2001, continues to support political stability in the country, highlighted by the multi-ethnic composition of the governing coalition.

The economy was less affected by the global economic and financial crisis than many regional peers. However, the impact of the Eurozone crisis was felt quite strongly in 2012. Growth has been negatively affected by weaker demand for exports, especially from the Eurozone (the main export market), lower FDI and subdued domestic demand. Nevertheless, the government and the central bank have successfully maintained macroeconomic stability in the past few years. External imbalances have remained relatively low, which is important in the context of the currency peg to the euro, and international reserves remain at relatively comfortable levels, covering about four months of imports. The short-term economic outlook for FYR Macedonia, as for other countries in the region, is highly uncertain given the current global turmoil and doubts about recovery prospects for the Eurozone. Overall growth in 2012 was negligible but is expected to pick up to around 2 per cent in 2013. Beyond that, annual growth rates could reach 3-4 per cent, provided global conditions improve significantly and the country's authorities continue to pursue structural reforms. However, the downside risks are significant.

FYR Macedonia has made steady progress in transition over two decades, but still faces significant challenges across sectors. Given that the country is small and landlocked, the key challenge is to increase FYR Macedonia's level of integration into regional and global markets. The Bank is well positioned to assist in this process both by supporting the development of key transport corridors, allied to strong and intensified cooperation with key partners such as the European Union and the European Investment Bank, and by promoting private sector development and cross-border trade and investment, building on the numerous business-friendly reforms introduced by the authorities over recent years.

The key transition challenges and strategic directions for the next Strategy period are:

- **Enhancing competitiveness and facilitating private investment in the corporate and municipal sectors.** The authorities have made significant efforts in recent years to enhance FYR Macedonia's competitiveness and attractiveness as a business-friendly environment. The Bank will continue to assist in attracting and supporting foreign investment, thereby promoting productivity improvements through new skills and processes. In parallel, the Bank will seek

to assist local corporates in improving their competitiveness. Private sector involvement in the municipal sector and the provision of utility services is essential to attracting investment and improving quality of services, and the Bank will seek to enable greater participation by the private sector, as well as adoption of best industry practices across the municipal sectors.

- **Promoting energy efficiency and sustainable energy.** Significant transition gaps remain in the energy sector in terms of moving tariffs towards cost-recovery levels, strengthening the capacity of the regulator and developing renewable sources of energy. The Bank will continue to play a critical role in helping to close the gaps, and will use its expertise to further promote and strengthen energy efficiency in the private and public sectors, as well as the development of renewable energy projects.
- **Advancing regional integration.** The Bank will work closely with the authorities, other IFIs and, where possible, private sector investors to help improve transport networks, thereby facilitating greater cross-border trade and investment. Developing further links with the regional energy market is also key to attracting private investment, encouraging competition and diversifying the sources of energy supply. The Western Balkans Investment Framework (WBIF) will provide the ideal policy dialogue platform for regional integration, as all players and countries in the region are associated with and represented in it. Regional projects will be prioritised and approved under the WBIF.

In all these activities the Bank will seek to align its operations with the priorities of the Government of FYR Macedonia and will work closely with other international financial institutions, multilateral and bilateral donors, including the European Union. The Bank will engage in active policy dialogue and continue to provide technical assistance to maximise transition impact in FYR Macedonia.

1 THE BANK'S PORTFOLIO

1.1 Overview over Bank activities to date

The Bank has been operational in FYR Macedonia since 1993. As of 30 November 2012, the Bank has signed 80 projects with net cumulative business volume of EUR 1.1 billion, and it mobilised additional investment in the same amount. Only 7 per cent of the cumulative commitments were made through regional allocations. In terms of instruments, 75 per cent were debt instruments, 16 per cent guarantees and 9 per cent equity investments. Nearly 36 per cent of cumulative commitments are in the Infrastructure sector, 28 per cent in the Financial sector, 20 per cent in the Energy sector and 16 per cent in Industry, Commerce and Agribusiness. The vast majority (78 per cent) of the signed projects were non-sovereign transactions, totalling EUR 577 million (53 per cent of the cumulative commitments).

The active portfolio at end-November 2012 comprises 48 projects totalling EUR 587 million. Operating Assets account for 31 per cent of the current portfolio due to several large infrastructure projects signed in 2011 and 2012 which will start disbursing in 2013/2014. As at end-November, there were no impaired loans in the country's portfolio.

Table 1: Overview of the Bank's Portfolio in FYR Macedonia as at 30 November 2012

Amount in EUR million	Number of Projects	EBRD Signed	Total Project Cost	EBRD % of Total	Number of Projects	Portfolio	% of Portfolio	Operating Assets	% of Operating Assets
Energy	***10***	***218***	***400***	***19.8%***	***7***	***143***	***24.4%***	***59***	***32.7%***
Natural Resources	1	19	81	1.7%	0	0	0.0%	0	0.0%
Power and Energy	9	199	319	18.1%	7	143	24.4%	59	32.7%
Financial Institutions	***31***	***311***	***470***	***28.3%***	***15***	***63***	***10.7%***	***34***	***18.8%***
Bank Equity	5	26	106	2.4%	2	6	1.0%	6	3.3%
Bank Landing	19	264	320	24.0%	8	46	7.8%	22	12.2%
Small Business	6	20	43	1.8%	5	11	1.9%	6	3.3%
Insurance & Financial Services	1	1	1	0.1%	0	0	0.0%	0	0.0%
Industry, Commerce & Agribusiness	***27***	***175***	***382***	***15.9%***	***16***	***46***	***7.8%***	***35.5***	***19.7%***
Agribusiness	7	36	44	3.3%	5	9	1.5%	6	3.3%
Equity Funds	5	4	16	0.4%	4	1	0.2%	1	0.6%
Manufacturing & Services	6	56	133	5.1%	2	9	1.5%	9	5.0%
Property & Tourism	5	30	110	2.7%	3	25	4.3%	17.5	9.7%
Information & Comm. Technologies	4	49	79	4.5%	2	2	0.3%	2	1.1%
Infrastructure	***12***	***395***	***907***	***35.9%***	***10***	***335***	***57.1%***	***52***	***28.8%***
MEI	3	54	113	4.9%	3	43	7.3%	8	4.4%
Transport	9	341	794	31.0%	7	292	49.7%	44	24.4%
TOTAL	**80**	**1,099**	**2,160**	**100.0%**	**48**	**587**	**100.0%**	**181**	**100.0%**

In the current strategy period (to end-December 2012), the Bank signed 37 projects totalling over EUR 410 million, which represent 63 per cent of the total number of projects and 78 per cent of the net cumulative business volume as at end-2009.

Table 2: Portfolio Development in FYR Macedonia, 2009 – 2012

Amount in EUR million	**2009**	**2010**	**2011**	**30-Nov-12**	**Development in the Strategy Period (2010-2012)**
Net Cumulative Business Volume	527	716	950	1,099	572
Current Portfolio Stock	272	301	485	587	315
Number of Operations	59	68	76	80	21
Operating Assets	176	165	161	181	5
% Undrawn (excl. Guarantees)	29%	41%	65%	66%	
Annual Business Volume	81	44	220	138	402
Number of Operations	10	10	12	12	34
Gross Disbursements	12	23	22	48	93
Annual Cancellations	5	1	1	0	2
Active Pipeline Stock (Reported Rate)	133.2	217.2	180	147.8	
Private Sector Share (% Portfolio)	52%	55%	37%	33%	
Non Sovereign (% Portfolio)	52%	55%	38%	34%	

Portfolio Ratio

The current private/ public portfolio ratio on a 5-year rolling basis is calculated for the period 2007-2011 and it stands at 43 private/57 public. In this period, the Bank signed 40 private (89 per cent of total) and only 5 public sector projects in FYR Macedonia. However, due to the small average size of the private sector projects (EUR 4.5 million), in volume terms the ratio favours the public sector.

At end-2012, the portfolio ratio stands at 38 per cent private/62 per cent public. In this period, the Bank signed 45 private (87 per cent of total) and 7 public sector projects, with average size of EUR 4.5 million and EUR 49 million respectively.

Large investments in the transport and energy infrastructure are crucial for the country's further regional integration, which in turn is essential to further strengthen the competitiveness of local companies, as well as attract foreign direct investments. The needs for infrastructure investments are significant and could only be funded by IFIs, given the current lack of private sector interest to invest in large infrastructure projects in FYR Macedonia. Because of the size of local economy, private sector operations are much smaller in size than the average sovereign infrastructure projects. This suggests that the private/public portfolio ratio will, at least in the short term, continue to weigh in favour of public sector projects. In terms of number of operations, however, it is worth noting that the majority of deals signed by the Bank in the country is already composed of private transactions, mostly reflecting the strong efforts to reach out to the local corporate sector directly (LEF), small renewable and industrial energy efficiency deals (WeBSEDFF) and MSMEs through local financial intermediaries. Over the medium and long term, the Bank expects to see a gradual rebalancing of its volume signings towards the private sector.

1.2 Implementation of the previous country strategy

The previous strategy for FYR Macedonia, approved by the Board in March 2010, outlined the following strategic priorities:

- **Corporate Sector:** Support the real economy in response to the crisis, improve competitiveness and energy efficiency and promote diversification of exports.

- **Financial Sector:** Provide banks with equity and long term funding as well as institutional support to help mitigate the impact of the global crisis; assist banks in developing new products (including co-financing and energy efficiency facilities), grow their business on a sustainable basis, and improve corporate governance; and channel more funding to SMEs and MSMEs

- **Infrastructure:** In the *Energy* sector, (i) invest in new and rehabilitated generation capacity to alleviate growing capacity problems and improve the efficiency and environmental performance of the existing infrastructure; (ii) invest in renewable and sustainable energy to reduce the current high carbon intensity, including through the Western Balkans Sustainable Energy Direct Financing Facility (WeBSEDFF); and (iii) invest in energy projects that support the regional energy market development and integration such as regional electricity and gas interconnections. In the *Transport* sector (i) promote road and railway transport networks in the country and their regional interconnection; (ii) support the Macedonian Airports concession; (iii) assist in restructuring the road maintenance sector; and (iv) promote private investment in infrastructure including through PPPs. In the *Municipal* infrastructure sectors, support water, district heating and public transport investments and promote the commercialisation of utilities.

The Bank's active engagement n FYR Macedonia in the current strategy period enabled it to achieve important transition objectives in a country where transition challenges are still significant, across all sectors.

Support to the **private corporate and MSME sector** was provided both directly, including through mechanisms such as the Local Enterprise Facility (LEF), and through local commercial banks. The Bank was most active in financing the high-potential agribusiness sector, but it also supported the development of the first modern retail centre in the country. The latter was an important example of a cross-border investment between Albanian and local investors. Financing was provided to local MSMEs to enhance their competitiveness, improve efficiency, productivity and implementation of international standards. In addition to the LEF for direct investments, such financing was provided to MSMEs via commercial banks through the SME and Private Sector Support Facility (PSSF) credit lines. Support to local enterprises was also provided through technical cooperation (TC) funding under the Enterprise Growth Programme (EGP, known formerly as Turn-Around Management) and Business Advisory Services programme. 21 MSME were supported through EGP and 185 through BAS.

In the **financial sector**, the Bank's record in improving availability of risk capital to local commercial banks has been mixed. In 2011 the EBRD made an unsuccessful bid to participate through the stock exchange in the capital increase of Komercijalna Banka. Subsequently the Bank participated in the capital increase of ProCredit Bank

Macedonia. The Bank exited two of its investee banks – Stopanska Banka (owned by the National bank of Greece) and Export & Credit Bank (owned by Halk Bank Turkey). In both cases the Bank sold its stakes to the majority owners. Objective market constraints prevented the Bank from achieving further results in promoting banking sector consolidation. Competition in the sector is limited, and the overall conditions are not conducive to consolidation.

The Bank was very active in providing long-term funding to the local banks, which showed high demand for loans under the PSSF (3 banks funded) and the Western Balkans Sustainable Energy Credit Line Facility (WeBSECLF) (3 banks). These loans were supported by TC which helped the banks develop new products. In 2012, the Bank approved its first local currency loan to a Macedonian bank.

To support capital market development, the Bank developed a TC programme with the Macedonian Stock Exchange (MSE), to establish a training centre and implement a "train-the-trainer" programme. In addition, the Bank approved a TC to the Macedonian Security Commission (MSEC) to support implementation of software that will enable MSEC to enhance their supervisory and reporting activities. The Bank also supported insurance market development by strengthening the Insurance Supervision Agency (ISA) through a provision of TC that will enable ISA to implement adequate supervision software.

The Bank was particularly successful in promoting **energy efficiency and sustainable energy investments** in the country. Through the WeBSEDFF, the Bank financed the construction of 18 Small Hydro Power Plants (SHPPs) and one industrial energy efficiency project, while through the Western Balkans Sustainable Energy Financing Facility (WeSEFF) the Bank financed 21 projects, of which 11 were for energy efficiency and 10 for renewable energy investments of private MSMEs. In addition, a large new power generation (HPP) project developed by the state-owned generation company was financed.

The Bank engaged in extensive policy dialogue with the government, the regulator and other stakeholders in relation to the revisions to the Energy Law approved by the Parliament in 2011. The new Energy Law allows for an updated and genuinely cost reflective tariff methodology and sets out a timetable for full market opening. In late 2011, the Bank engaged in policy dialogue with the Macedonian government to oppose the possible retroactive changes of the already approved feed-in-tariffs for SHPPs. Such changes could have had a significant detrimental effect on the existing and any future investment in SHPP projects, as well as on the perception of the overall investment climate in the country.

The Bank is also providing TC assistance to the Macedonian authorities in the drafting of a bankable Power Purchase Agreement (PPA) for renewable energy projects that balances the interests of the developers, buyers and lenders. Such PPA will help to further promote the development of renewable projects in the country in general and, in particular, the wind power development.

In the strategy period, major progress has been made in supporting the modernisation and upgrade of the existing **road and railway networks**. Investments were supported by sectoral reforms and technical assistance for their implementation, a significant portion of which was provided through the Western Balkans Investment Framework

(WBIF). In 2011, the Bank pioneered co-financing of an infrastructure project with Instrument of Pre-Accession (IPA) funding from the European Union. The Bank has engaged in policy dialogue in the roads sector focusing on the introduction of an electronic tolling collection system and the reorganisation of road maintenance through implementation of performance-based maintenance contracts. However, further reforms and significant additional investments are needed to develop and upgrade the key transport corridors in the country.

In the MEI sector, the Bank approved a loan to the City of Skopje, to introduce a modern traffic management system and upgrade one of the key road arteries in the City. This was the first sub-sovereign loan to a Macedonian municipality.

The Bank was less successful in financing transport, energy and municipal infrastructure and utilities through PPP structures, primarily because the Government did not manage to develop commercially viable PPP-type transactions. The Bank will endeavour to promote private sector involvement in these sectors and, where appropriate, assist the authorities in developing PPP structures, drawing on lessons learned from the Bank's participation in similar projects in other countries.

1.3 Transition impact of the Bank's portfolio

Since February 2010, when the previous strategy was adopted, twelve transition-rated[1] operations were signed by the Bank in FYR Macedonia. Most of the projects were in Financial and Infrastructure sectors (five each), with the remaining two signed in Property & Tourism and Power & Energy. Nine of these projects (or 75 per cent) were rated with Good transition impact (TI) potential, which is slightly below the institution-wide target of 80 per cent of projects to be assessed "Good" or better.

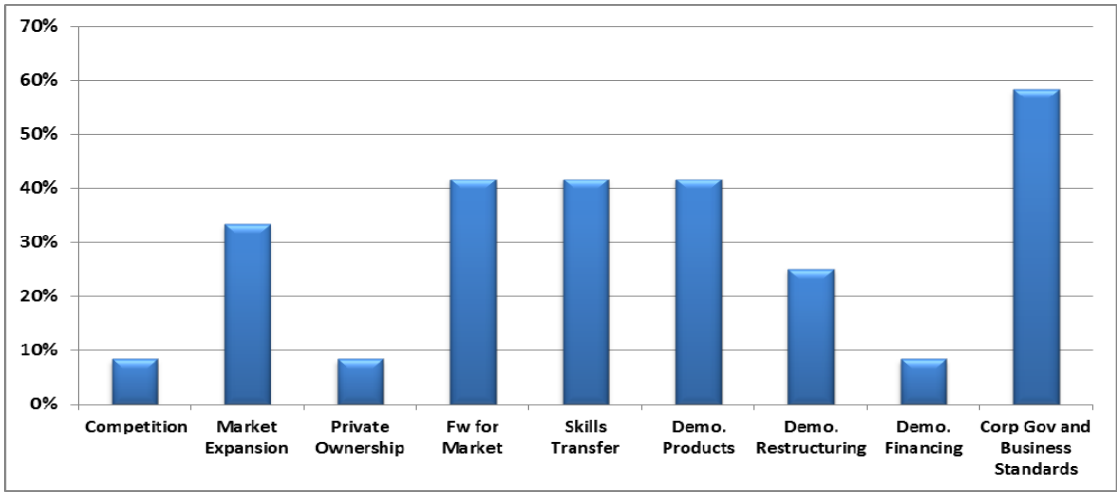
Two of the three projects that were rated with "Satisfactory" TI rating were in the financial sector. They involved loans provided to two commercial banks under the WeBSECLF framework, with the potential to demonstrate commercially viable energy efficiency (EE) lending. However, the risk to create dependence on the use of subsidies for EE and renewables investment constrained their transition impact . The remaining Satisfactory-rated operation, an urban transport project in the country's capital, has modest transition impact potential due to the fact that the road rehabilitation component is not linked to any direct transition challenges in the sector, such as the introduction of sector reforms.

The transition objectives of projects signed during the strategy period reflect the Bank's specific activities in the FYR Macedonia in 2010-2012, namely, providing loans to financial intermediaries (and energy efficiency finance in particular) and addressing institutional challenges in the infrastructure sector, which more visibly was reflected in the Bank's involvement in the railway segment. The key transition objective across projects was the introduction of higher business standards and corporate governance practices (around 60 per cent of all projects signed in FYR Macedonia in 2010 – 2012 address this objective). As Figure 1 shows, over one-third of all projects targeted at least one of the following objectives: improvements in

[1] There were 6 additional operations which were not individually assessed for their transition; these are mostly under WeBSEDFF framework which is assessed and monitored on facility level only.

frameworks for markets, demonstration of new replicable financial products, and transfer of skills (mainly in financial sector).

Figure 1. Targeted transition objectives in FYR Macedonia (share of projects), Feb 2010 – Dec 2012



The projects in the Bank's active TIMS portfolio[2] in FYR Macedonia are overall performing well from the transition perspective, with 17 out of 19 operations (or 89 per cent) on track to achieving their transition impact as of end-November 2012. This includes four active operations in FYR Macedonia that have already fully achieved their desired transition impact, and 13 projects that are on their way to achieving their transition potential. One operation, an equity participation in one of the commercial banks, has only partially achieved its envisaged transition impact due to shortcomings related to governance and management problems at the bank. Finally, the risk to achieving a Good transition impact has been significantly increased to Excessive for one project in the municipal and environmental infrastructure sector, to reflect major delays, particularly on the institutional side (including prevailing government interventions in tariff regulations and management appointments).

The average rank of the FYR Macedonia's active TIMS portfolio at end-November 2012 stood at 4.42, which is below the average for all operations of the Bank (4.07). This is mainly because most of the operations in the Bank's active portfolio in this country are relatively young and as such have not yet had their TI risk rating decreased (11 out of 19 operations in the portfolio have been signed in the last 3 years). The average rank of the portfolio is expected to go down (i.e., improve) as the country's portfolio matures.

Eight operations were completed in 2010-2012 and as such have exited the Bank's active portfolio. Six of these projects, mostly in the financial sector, have fully achieved their desired transition objectives. One completed operation (a loan to non-bank financial institution) only partially achieved its transition impact due to inability to complete its transformation into a bank – the banking license has been turned down by the central bank due to ownership structure issues. Finally, another project in the financial sector (an MSME support loan) has failed to achieve its transition objectives

[2] i.e. All active operations more than 6 months since signing and are monitored for their transition impact at least once.

due to the negative impact of the financial crisis on SME lending and some corporate governance issues related to weak management practices.

The WEBSEDFF, under which four sub-projects were signed in FYR Macedonia in 2010-2012 alone, has so far performed well from a transition perspective, with the achievement of key transition objectives currently on track.

2 OPERATIONAL ENVIRONMENT

2.1 Political Context

In June 2011, the ruling pro-reform centre-right VMRO-DPMNE party of Prime Minister Nikola Gruevski won the general election for the third time in a row and installed a government that has pledged to continue a programme of economic development, strengthening the rule of law, the fight against corruption, and improving inter-ethnic relations on the domestic front, and promoting Euro-Atlantic integration as the key foreign policy priority. While political dialogue was maintained throughout most of the Strategy period, the end of 2012 witnessed a political crisis, triggered by the controversy surrounding the adoption of the budget for 2013. The main opposition political party, centre-left SDSM, initiated a boycott of the parliament, announced that they would boycott the local elections scheduled for March 2013, and called for early general elections.

Efforts towards EU approximation remain the main external anchor for comprehensive reforms. FYR Macedonia was granted EU candidate status in 2005. In 2012 the EU and FYR Macedonia started a "High Level Accession Dialogue" (HLAD). Designed primarily to maintain momentum in the EU accession process, the dialogue covers five key areas: rule of law, public administration reform, freedoms, electoral reform, and the economy. The Council of the EU assessed in its 'Conclusions' of 11 December 2012 that this allowed achieving further progress in a number of key policy areas. The 2012 Progress Report by the European Commission, while re-iterating that the country sufficiently meets the political criteria, issued the strongest ever call for the European Council to sanction the opening of the EU accession talks with FYR Macedonia. With a view to a possible decision of the Council it will examine the implementation of reforms, as well as steps taken to promote good neighbourly relations, in the first half of 2013.

Besides serving as a catalyst for reforms, integration into the EU and other Euro-Atlantic institutions is an essential factor for the stability of the country, which went through an armed inter-ethnic conflict in 2001 and which continues to face occasional ethnic-related tensions despite progress towards reconciliation. The governing coalition includes as a junior coalition partner the main political party representing the ethnic Albanian minority, which makes up a quarter of the country's population. The coalition partners have managed to resolve disagreements through dialogue. The authorities remain committed to the spirit of the Ohrid Framework Agreement (OFA), which prominently includes inter-ethnic reconciliation. In 2012, the government launched, for the first time, a review of the implementation of the OFA.

FYR Macedonia is progressing also with another key element of the OFA – decentralisation. Since the previous Strategy, all but one of the country's 85

municipalities have entered the second phase of fiscal decentralisation, enabling further transfer of responsibilities and financial management to the local level.

FYR Macedonia plays a constructive role in regional cooperation, and the authorities actively support various cross-border and regional projects.

See Annex 1 for a more detailed political assessment.

2.2 Macroeconomic context

The economy was less affected by the global economic and financial crisis than many regional peers. In 2009, a recessionary year for most south-eastern European (SEE) countries, output contracted by only 0.9 per cent compared to an average regional GDP decline of 5.5 per cent, and the subsequent recovery was swifter and stronger in FYR Macedonia than in most SEE countries. The economy grew by about 3 per cent in both 2010 and 2011 on the back of a surge in exports, a recovery in household consumption, and a considerable rise in investment in 2011.

The impact of Eurozone crisis, however, has been felt in 2012. As a result, the economy contracted in the first half of the year by 0.8 per cent relative to the same period in 2011, and according to preliminary estimates from the State statistics office, GDP grew by a mere 0.2 per cent on the year in the third quarter. Growth has been negatively affected by weaker demand for exports, especially from the Eurozone (the main export market), lower FDI and subdued domestic demand.

The government and the central bank have successfully maintained macroeconomic stability in the past few years. Monetary policy has been anchored for more than 15 years by the currency peg to the euro (previously to the DM). Inflation has been relatively low throughout, declining from an average of 3.9 per cent y/y in 2011 to an estimated 3.3 per cent y/y in 2012. At the same time, low fiscal deficits have kept public debt at a moderate level. Over the past two years, the government maintained the budget deficit within the targeted 2.5 per cent of GDP, but the 2012 and 2013 targets were raised to 3.5 per cent of GDP as a result of slower than expected growth and higher expenditures. The rise in spending is associated mainly with the reduction of accumulated arrears as well as increased pension payments. This led to a mild rise in government debt from 28 per cent of GDP in 2011 to 31 per cent of GDP in 2012.

External imbalances have remained relatively low, which is important in the context of the currency peg to the euro. External debt stood at 65 per cent of GDP and at 122 per cent of exports in 2011. The current account deficit is estimated to have declined from 12.8 per cent of GDP in 208 to below 3 per cent of GDP in the past three years. International reserves remain at relatively comfortable levels of 114 per cent of short-term debt and cover more than four months of imports.

In 2011, the Government drew on the Precautionary Credit Line (PCL) from the IMF to finance expenditures. The second review of the PCL (since renamed by the IMF as a Precautionary Liquidity Line, or PLL) was not completed, mainly because of IMF concerns about the degree of public sector arrears. The expired in January 2013.

The financial sector has remained stable. The market is dominated by foreign banks, which account for over 90 per cent of total banking assets, and Greek banks account for about 20 per cent of total market share (see also section 4.1 below). However, banks have relied primarily on domestic deposits to fund lending, so they were not as exposed as those in regional peers to cross-border deleveraging pressures during the global financial and Eurozone crises. Asset quality remains a concern, however, as NPLs have recently started to increase again, reaching 10 per cent of total loans by mid-2012.

The short-term economic outlook for FYR Macedonia, as for other countries in the region, is highly uncertain at present, given the current global turmoil and doubts about recovery prospects for the Eurozone. Overall growth in 2012 is likely to be negligible but is expected to pick up to around 2 per cent in 2013. Beyond that, the economy could achieve annual growth rates of 3-4 per cent, or even higher, provided global conditions improve significantly and the country's authorities continue to pursue structural reforms and implement a sound medium-term fiscal strategy. However, the downside risks are significant; any further deterioration in the external environment would be likely to spill over into FYR Macedonia, primarily through trade and investment channels, and would result in a stagnant or even declining economic output.

See Annex 7 for a table with Selected Economic Indicators.

2.3 Structural reform context

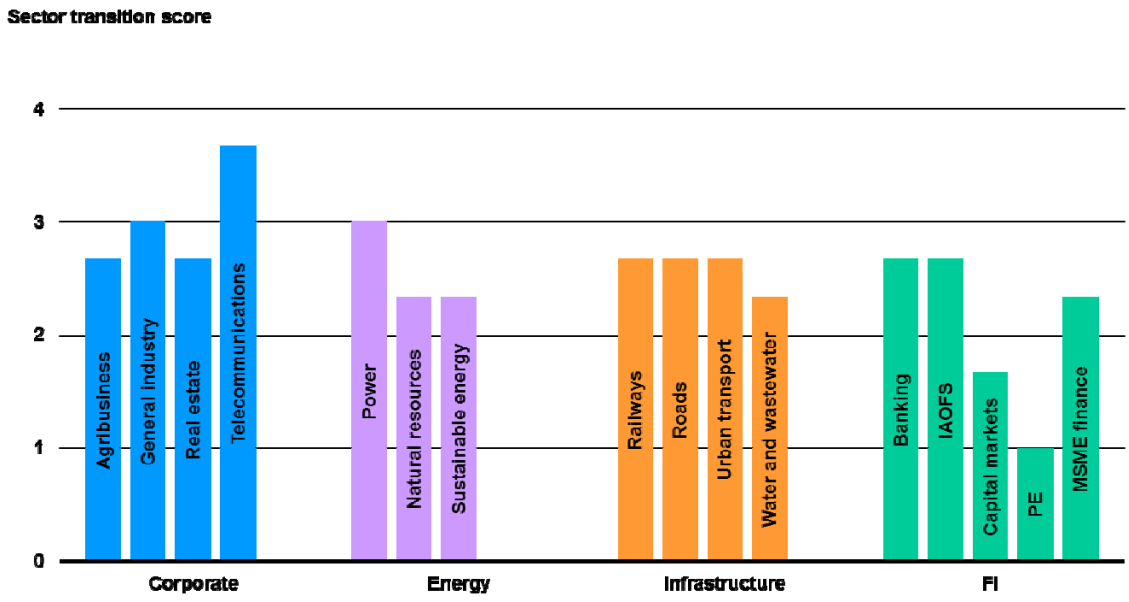
Over the years, FYR Macedonia has made steady, if somewhat slow, progress in structural reforms. In terms of the EBRD's country-level transition indicators, FYR Macedonia has achieved the maximum score (4+) for price liberalisation and trade and foreign exchange system, reflecting the liberalised and open nature of the economy. It also scores highly on small- and large-scale privatisation (4 and 3+ respectively). The country scores less well on governance and enterprise reform as well as competition policy (3- in both cases), two areas in which reforms are traditionally more difficult and high scores are associated with countries at advanced stages of the transition process.

At the sectoral level, notable progress has been accomplished in a few areas. The country made significant progress in the implementation of the Energy Community Treaty with the adoption of a new Energy Law in early 2011. Important upgrades in the transport infrastructure were completed through concession contracts, most noteworthy of which are the modernisation and expansion of the Skopje and Ohrid airports, and the construction of sections of corridor VIII. A significant rise in new foreign direct investments has been realised in recent years in the manufacturing and services sectors. Pension fund assets have also risen considerably over the past few years.

Nevertheless, the detailed analysis carried out each year of the remaining transition challenges across 16 sectors of the economy demonstrates that FYR Macedonia still has a long way to go in its transition. The sector transition scores, on a scale of 1 to 4+, are shown in Figure 2. The scores are based on an assessment of the remaining transition "gaps", in terms both of the structure of the market in question and of the

strength of market-supporting institutions. In all but one of the sectors, the transition gaps in FYR Macedonia are assessed as either "medium" or "large." The highest gaps are present in the non-bank financial institutions (capital markets and private equity) and finance for small and medium enterprises. Significant transition gaps also remain in the energy sector, especially in the natural resources and sustainable energy sectors, as well as in municipal and environmental infrastructure, particularly in water and wastewater.

Figure 2: Sector Transition Scores, FYR Macedonia 2012



See Annex 2 for a more detailed description of sectoral transition gaps in FYR Macedonia.

2.4 Business environment

A broad set of reforms has been undertaken in FYR Macedonia in recent years to strengthen the business environment. As a result, the regulatory, administrative and financial burden of doing business in the country has been reduced considerably. FYR Macedonia now has one of the easiest, fastest and cheapest procedures for starting a business in the world. Paying taxes and getting credit is also much easier compared to most countries in the world, and FYR Macedonia compares favourably on investor protection regulations. According to the 2013 World Bank Doing Business report, FYR Macedonia ranks 23rd out of 183 countries on overall ease of doing business, which puts it ahead of all but two of the EBRD's countries of operation.

The encouraging trends in regulation and the associated rapid improvements in FYR Macedonia's ranking on these indicators, however, are not reflected to the same extent in business environment surveys. According to the most recent EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS), carried out in 2008/09, a weak judiciary, corruption, limits on access to finance, and a large informal sector appear to significantly constrain businesses in FYR Macedonia. More than a half of all surveyed firms in FYR Macedonia claimed that the competition from the informal sector was a major constraint for their business and more than a third

said that the weak court system was a serious obstacle. Access to finance also appears to be more of a constraint for FYR Macedonian firms relative to the EBRD average, mainly on account of the high collateral requirements.

A less optimistic picture of the business environment is also presented by the World Economic Forum, whose Global Competitiveness Indicator ranks FYR Macedonia at 80 out of 144 countries. On the indicator of the quality of public institutions, the country ranks at 75th place. This puts FYR Macedonia ahead of all but one country in SEE, but it is still significantly below the OECD average. The country scores particularly poorly on several sub-indicators relating to quality of legal institutions, labour market efficiency, and innovation and technology absorption. According to the 2012 Corruption Perceptions Index published by Transparency International, FYR Macedonia ranks 69th out of 176 countries, making it the top ranked country in the Western Balkans region.

2.5 Social context

Over the past decade, per capita income and living standards in FYR Macedonia have improved, albeit at a somewhat slower pace compared to most countries in the SEE region. Real GDP per capita rose by 36.2 per cent in the decade up to 2011, compared to a regional average growth of 55 per cent.

The rise in income, however, has been accompanied by an increase in inequality. In 1998, the richest 20 per cent of the population accounted for less than 40 per cent of the national income, but by a decade later this figure had risen to 50 per cent. Over the same period, the share of national income belonging to the poorest 20 per cent fell from 6.5 per cent to 5.1 per cent. Furthermore, at PPP adjusted per capita income of USD 10,469, and a headcount poverty ratio[3] of around 35 per cent, FYR Macedonia remains one of the poorest countries in Europe.

The unemployment rate in FYR Macedonia is one of the largest in Europe at 30.6 per cent of the labour force (in Q3 2012) and there has been very little progress over the past decade in alleviating this problem. Moreover, labour market statistics have a significant gender and regional dimension. According to the state statistical office, in 2011 the employment rate for women was 35 per cent, significantly lower than the 52 per cent for men owing mainly to the lower activity rate for women (44.7 per cent for women and 68.8 per cent for men). The unemployment rate varies considerably between regions, from lowest in the Southeast region at 9.3 per cent to highest in the Northeast region at 59.6 per cent. Unemployment is higher in urban areas than in rural (32.6 per cent vs. 30.3 per cent) likely due to the significantly higher concentration of the population in urban areas (as of 2010, about 60 per cent of the population lived in urban areas).

The income distribution also varies significantly across the regions. According to data from the statistics office, in 2010 the capital Skopje had the highest income per capita of about 318,000 denars (about €5,170), roughly 50 per cent above than the country average of 211,000 denars (€3,430) and over three times as high as the lowest income region of Polog.

[3] According to the World Bank, the headcount poverty ratio is defined as the proportion of the population that lives on less than US$ 5 a day PPP adjusted.

Access to education is still below OECD standards. Primary school enrolment rates are around 85 per cent, compared to the nearly universal rates in the OECD. While there is no significant difference in education attainment rates between men and women across the entire spectrum of education levels in FYR Macedonia, there is a considerable gap in access to education between urban and rural areas. The discrepancy is particularly pronounced at higher levels of education.

Although the global financial crisis did not affect the FYR Macedonian economy as strongly as its SEE neighbours, evidence from the EBRD-World Bank Life in Transition Survey (LiTS), carried out in late 2010, shows that the perceived impact by its citizens was nevertheless quite high. Around 60 per cent of households reported that the crisis affected them either a great deal or a fair amount, compared with a transition region-wide average of 42 per cent. A large proportion of households reported having to cut back on essential expenditures like staple food and healthcare to cope with the crisis.

2.6 Legal context

The legal framework in FYR Macedonia has undergone a number of positive reforms in recent years and is of a good standard overall, although there is scope for improvement in certain areas. Recent legislative initiatives are broadly in line with the strategic objectives for the next strategy period.

The enhancement of the competitiveness of the economy has been actively pursued by FYR Macedonia through the establishment of special economic zones which also aim at attracting foreign investment. A new patent portal was recently launched with the aim to stimulate patent registrations and promote innovation. FYR Macedonia has also made substantial amendments to its corporate governance legislation to align it to international standards.

In an effort to boost local capital markets and provide companies with alternative sources of financing, the government is considering the introduction of mandatory stock exchange listing for joint stock companies that meet certain pre-set criteria. Further steps however, are needed to facilitate access to finance for small and medium sized enterprises. Such steps include improvements on the existing provisions concerning the creation of pledges and the introduction of legislation on factoring (which at present is not regulated). The insolvency legislation of FYR Macedonia is considered to be of a good standard and creditors are able to follow all the steps of the bankruptcy procedure through an electronic system which has been recently established.

As for the promotion of sustainable energy, FYR Macedonia has been a full member of the International Renewable Energy Agency since 2009 and has adopted a set of rules giving preferential status and the benefit of feed-in tariffs to producers of electricity from renewable sources. The recent announcement that a new power trading exchange will be established by electricity transmission system operator represents a positive development towards the creation of a more efficient energy market. Nonetheless, efforts will be needed to fill the gaps in the existing regulatory framework for the energy efficiency and renewable energy sectors to bring them in line with best international standards.

In the context of the promotion of further regional integration, in the past two years FYR Macedonia has entered into a number of agreements with a view to establishing closer cooperation and removing existing barriers with other countries in the region. In 2011 FYR Macedonia entered into a double taxation treaty with Kosovo and in the same year a memorandum for development cooperation was signed between FYR Macedonia and Slovenia. In addition FYR Macedonia has signed an agreement for the liberalisation of international road transport with the Czech Republic, Slovakia, Hungary, Croatia and Bosnia and Herzegovina. The development of further infrastructure links with neighbouring countries will be further facilitated by the existing legislation regulating public-private partnerships (PPPs) which is relatively advanced and has been made compliant with EU directives through a reform implemented in 2012.

2.7 Energy efficiency and climate change context

FYR Macedonia is heavily dependent on imports for its energy needs, including oil and oil products, natural gas, and electricity. The most used energy resources in the total consumption of primary energy are coal (50 per cent), crude oil and imported oil products (35 per cent), followed by the biomass (7 per cent, mostly used in households). In comparison to the more advanced European countries, the percentage share of natural gas in the energy consumption in Macedonia is very low (2.4 per cent) while the percentage share of electricity consumption is very high. This particularly applies to the household sector. Macedonia has almost 5.5 times higher electricity consumption per unit of GDP in comparison to the advanced European countries.

FYR Macedonia has exceptionally low energy consumption per capita combined with exceptionally high energy intensity per unit of GDP. The final energy consumption per capita in Macedonia is about three times lower than the consumption in the European countries members of the OECD, while the primary energy consumption per unit of GDP is about four times higher, despite a decrease by about 20 per cent in the period 2000-2009. In terms of carbon intensity, at 1.89 CO2/GDP the country is 5 times more carbon intensive than the EU-27 average.

To reduce energy import dependency and vulnerability to supply shocks, and enhance competitiveness of domestic industry in international markets, FYR Macedonia should take steps to improve energy efficiency in the production, transmission, distribution and utilization of energy and increase energy generation from renewable energy sources. Further efforts are needed to increase the share of natural gas in energy consumption and reduce the relative share of electricity.

In 2011, FYR Macedonia adopted a new Energy Law to transpose EU legislation, a five-year energy strategy 2012-2016 and guidelines on renewable energy setting new feed-in tariffs.

Climate change adaptation

Climate change poses a range of risks to a number of the Bank's proposed activities in FYR Macedonia. FYR Macedonia's Second National Communication to the

UNFCCC sets out how average temperatures are projected to increase by up to 2.9°C by 2075 and 3.8°C in 2100. Precipitation is projected to decrease by up to 8 per cent by 2075 and 13 per cent by 2100. This is expected to be accompanied by reduced summer precipitation, and greater precipitation variability overall. As a consequence, Macedonia may experience water deficits during summer months. More variable precipitation may also result in fluctuations in river hydrology and more frequent extreme events such as floods. Water resources and agriculture are identified as the most sensitive sectors.

Water stress will have implications for the Bank's operations in agribusiness and other water-intensive manufacturing. Agribusiness may also be affected by climate change through impacts on agricultural production, thus affecting the availability of primary produce and increasing the need for irrigation. Hydropower investments may also have to take into account climate-related changes in river hydrology. The need for investment in more efficient and better-managed water supply systems will increase in the face of greater water stress caused by climate change.

In response, the Bank will systematically look for opportunities to boost climate resilience through its investments, paying particular attention to climate-sensitive sectors such as water supplies, power and energy (especially hydropower), agribusiness, infrastructure, and water-intensive industries such as mining and manufacturing.

3 STRATEGIC ORIENTATIONS

FYR Macedonia has made steady, if at times slow, progress over the years in its transition to the standards of a well-functioning market economy. However, the Bank's latest annual assessment of transition challenges across 16 sectors, published in the *Transition Report 2012*, shows that the gaps, in terms of both market structure and market-supporting institutions, are assessed in virtually all cases as "medium" or "large". Given that the country is small and landlocked, the key challenge is to increase FYR Macedonia's level of integration into regional and global markets. The Bank is well positioned to assist in this process both by supporting the development of key transport corridors, allied to strong and intensified cooperation with key partners such as the European Union and the European Investment Bank, and by promoting private sector development and cross-border trade and investment, building on the numerous business-friendly reforms introduced by the authorities over recent years.

The key transition challenges and strategic directions for the next Strategy period are:

- **Enhancing competitiveness and facilitating private investment in the corporate and municipal sectors.** The authorities have made significant efforts in recent years to enhance FYR Macedonia's competitiveness and attractiveness as a business-friendly environment. The Bank will continue to assist in attracting and supporting foreign investment, thereby promoting productivity improvements through new skills and processes. In parallel, the Bank will seek to assist local corporates in improving their competitiveness. Private sector involvement in the municipal sector and the provision of utility services is essential to improving efficiency and quality, and the Bank will seek to enable

greater participation by the private sector, as well as adoption of best industry practices across the municipal sector.

- **Promoting energy efficiency and sustainable energy.** Significant transition gaps remain in the energy sector in terms of moving tariffs towards cost-recovery levels, strengthening the capacity of the regulator and developing renewable sources of energy. The Bank will continue to play a leading role in helping to close the gaps, and will use its expertise to further promote and strengthen energy efficiency in the private and public sector, as well as the development of renewable energy projects. The Western Balkans Sustainable Energy Direct Financing Facility (WeBSEDF) and the Western Balkans Sustainable Energy Financing Facility (WeBSEFF) will remain important instruments for financing smaller scale investments in energy efficiency and sustainable energy.
- **Advancing regional integration.** The Bank will work closely with the authorities, other IFIs and, where possible, private sector investors to help improve transport networks, thereby facilitating greater cross-border trade and investment. Developing further links with the regional energy market is also key to attracting private investment, encouraging competition and diversifying the sources of energy supply. The Western Balkans Investment Framework (WBIF) will provide the ideal policy dialogue platform for regional integration, as all players and countries in the region are associated with and represented in it. Regional projects will be prioritised and approved under the WBIF.

Across these strategic areas, and in line with the implementation of the Gender Action Plan and the forthcoming Gender Strategy, the Bank will aim to develop and implement projects that promote gender equality in FYR Macedonia on a selective basis. In all sectors, clients will be encouraged to promote equal opportunities in the work place and will be provided with support where necessary. The Bank will continue to identify opportunities to work with its clients to promote equal opportunities in access to employment as well as in the actual work place. In the MEI sector, in line with its new sector policy, the Bank will seek to identify projects that are amenable to be designed and implemented to ensure that services are responsive to the needs of both men and women. The Bank will look to identify ways, if and where appropriate, to support women entrepreneurs by facilitating their access to finance and supporting women's entrepreneurship.

3.1 Key Sectoral Challenges and Bank Operational Response

3.1.1 Enhancing competitiveness and facilitating private investment in the corporate and municipal sectors

<u>Sectoral challenges</u>

- Foreign direct investment has been limited to date, reflecting the small market and difficult location of the country, and the development of new processes and skills has been lagging.
- Although FYR Macedonia has introduced numerous business-friendly measures in recent years, effective implementation often lags behind and further capacity building, for example in the competition authority, is needed.

- The property market is at an early stage of development and market penetration of innovative construction technologies is low.
- FDI in the agribusiness sector has been low, partly because the land market functions poorly. New investments are needed into technology and new product development in order to boost productivity.
- Access to finance for MSMEs remains particularly constrained. MSMEs account for 99.7 per cent of the total number of registered companies and 74 per cent of total official employment, yet they account for only about a quarter of bank lending.
- Access to medium and long term finance and to certain financial products is limited, especially in local currency. Lending in foreign currency combined with indexed lending presents significant foreign exchange related credit risk. The corporate bond market is at a nascent stage.
- Transition challenges in urban transport and other public utilities are substantial, with the need for effective implementation of integrated solutions, additional investment in higher capacity public transport, and transparent planning processes and better regulation and competition.

Bank's operational response

To encourage investment, the Bank will support local and foreign private companies in expanding, improving productivity and competitiveness, as well as in developing backward linkages to local and international suppliers, environmental and health and safety compliance, by providing long-term financing directly or through the commercial banks. The Bank will facilitate, as required, financial and operational restructuring, alongside other investors or reputable sponsors.

To further develop domestic industry and services, the Bank will seek opportunities to support private investment primarily in the general manufacturing, and the agribusiness sector, including primary agriculture, food processing, packaging, logistics, distribution and retail. Selectively, the Bank will review opportunities to support private investment in the mining, ICT and property and tourism sectors. The Bank will provide financing to private companies in the form of equity and quasi-equity instruments, mostly via the Local Enterprise Facility (LEF). LEF will also provide comprehensive support for governance improvements. The Bank will support projects promoting modernisation and innovation, as well as technologically advanced industries.

To promote private sector development, the Bank will be prepared to follow up on possible Government initiatives for privatisations in the postal services, the fixed line incumbent operator, broadcasting tower operator and the local power generation utility.

To spur growth and development of MSMEs, the Bank will use the Enterprise Growth Programme (EGP) and Business Advisory Services (BAS) to strengthen the competitiveness and export potential of local MSMEs, support adoption of quality standards and improvements of supply chain, as well as operational and marketing efficiencies across various sectors and will also be instrumental to feed in smaller projects to be financed via LEF or the Bank's credit lines.

To enhance access to finance, and to decrease the Euro-isation of the economy, the Bank will explore possibilities to provide long-term local currency funding, including bonds, to private corporates and municipalities.

To facilitate private investment in the municipal sector, the Bank will support private sector involvement in the provision modernisation of communal services (solid waste, urban transport, water and waste water) through, for example, transparent procedures for selection of the private sector partner.

Policy dialogue

The Bank will continue its policy dialogue with the authorities on investment climate and competition issues, drawing where appropriate on cross-country surveys such as the new round of the EBRD / World Bank Business and Environment and Enterprise Performance Survey (BEEPS). The Bank will support changes in the methodology for calculating communal fees in order to remove the barriers for attracting investments in local and regional logistics centres.

In the agribusiness sector, the Bank will promote regulatory and legislative changes for introduction of Geographical Indications that will allow local producers to obtain market recognition.

In the municipal sector, the Bank's policy dialogue will continue to be focused on further decentralisation, capacity building and commercialisation of services. Support will also be provided to municipalities to enhance management accountability of their operations. As appropriate, the Bank will support the government in their efforts to improve regulation and enable development of viable PPP financing structures.

3.1.2 Promoting energy efficiency and sustainable energy

Sectoral challenges

- Despite improvements in the tariff methodology, electricity tariffs are still below cost recovery levels and cross-subsidies are significant, with household prices kept artificially low.
- An energy regulator is in place but its capacity is weak and it is subject to political intervention.
- In the gas sector, full unbundling of transmission and distribution and increased capacity for gas transmission are needed, while tariffs need to be more cost-reflective.
- The only refinery in the country requires immediate investment upgrades. Its energy intensity is materially higher than the average of EU refineries.
- Further steps are needed to close the gap between the needs of public building owners and the constrained economic and legislative environment which is hindering energy-saving investments.
- Energy and resource efficiency remains a challenge in the manufacturing industry, including those in the machine building and metals, alloys or wood processing sectors.

Bank's operational response

The Bank will expand the support for energy efficiency and environmental improvements across all sectors of the economy, as well as in the public and municipal sector. Financing will be provided directly by the Bank or through commercial banks and fund structures for smaller investments. The Bank will encourage energy efficiency improvements in the residential sector by providing long-term financing through the commercial banks.

The Bank will support further development of renewable energy projects in the high-potential hydropower sector, as well as in photovoltaic, wind energy and biogas, including through the WeBSEDF and WeBSEFF facilities for small-scale projects. PPP structures will be supported for financing large-scale renewable energy projects. In addition, the Bank will strengthen and improve the reliability of the domestic transmission network thereby offering commercial opportunities to renewable producers.

Policy Dialogue

The Bank will engage in dialogue on the secondary legislation to the recently approved Energy Law, as well as for the preparation and execution of Market Liberalization Policies.

Where needed, assistance will be provided to the government to prepare new tenders for large-scale renewable generation capacities.

The Bank will consider assisting the authorities improve legislation to support energy efficiency investments in the public sector through Energy Service Companies (ESCOs).

3.1.3 Advancing Regional Integration

Sectoral challenges

- Further development of motorways, including those connecting to neighbouring countries, will likely require private sector involvement, but attempts to tender or close PPP deals so far have been unsuccessful.
- Rail links with the region are fragmented; further unbundling is needed to promote competition and the effectiveness of the newly established railway regulator needs to be improved.
- Developing regional links is key for attracting private investment to the energy sector, encouraging viable competition to state-owned providers and diversifying energy supply away from lignite.
- The creation of a national gas transmission network would facilitate greater integration of the gas market in the SEE region.

Bank's operational response

To promote regional transport integration the Bank will support the development of strategic connections with neighbouring countries including the Trans-European

Corridor VIII and further upgrade of Corridor X, as well as the feed-in connections to these corridors. Where bankable opportunities exist, the Bank will support the financing of these investments through PPP structures.

To promote regional energy integration, the Bank will support integration of the Macedonian energy market into the regional one, especially by supporting interconnection lines with neighbouring countries. In addition, the Bank will support development of a gas infrastructure that could advance the regional integration of gas markets and provide wider use of gas within the country.

Policy Dialogue

The WBIF is gradually shaping up as one of the key regional policy dialogue mechanisms and will provide strong leverage when prioritising and planning investments with a regional impact.

The Bank will remain involved in supporting further reform in the road and rail sectors, including gradual out-sourcing of road maintenance and support for motorway concessions in the road sector, and should a road concession be awarded during the strategy period, support for the establishment of a specialised unit will be considered.
The Bank's efforts to support restructuring of the rail sector will continue with a focus on strengthening the capacity of the rail regulator and separation of the freight and passenger business of the rail operator. Assistance will be provided to improve the energy efficiency policies of both the rail operator and the infrastructure manager.

3.2 Environmental and Social Implications of Bank Proposed Activities

All EBRD projects are subject to the 2008 Environmental and Social Policy (ESP) or its successor.[4] For direct investments, the ESP requires projects to be structured to meet EBRD Performance Requirements, including EU and national environmental and requirements. Where appropriate, EBRD will work with clients to enable them to meet the PRs, good international practice and relevant EU standards in a reasonable timeframe.

The Bank will work with clients to assess each project's environmental and social risks and opportunities, and projects will be monitored closely to ensure that agreed commitments are implemented.

For projects involving transport networks and interconnection energy lines with neighbouring countries, attention will need to be paid to routing of new infrastructure. Any trans-boundary projects requiring an environmental and social impact assessment may be subject to the requirements of the UNECE EIA Convention ("Espoo Convention") and require consultation with neighbouring countries. Land acquisition will need to be reviewed carefully to ensure that the Bank's requirements on resettlement and livelihood restoration are met.

[4] The 2008 Environmental and Social Policy (ESP) will be reviewed during 2013 and is subject to revision. Projects that proceed to Concept Review following the date that any new ESP goes into force will be subject to the revised policy.

Promoting energy efficiency and sustainable energy includes the focus on tariff recovery. Improved energy distribution and collections may result in tariff affordability being a key issue for more vulnerable households. Measures will be undertaken to ensure affordability of the basic minimum service for the poorest families. Renewable energy projects, particularly in the hydropower sector, will need to take account of lessons learned in the areas of biodiversity assessment and cumulative impacts, as well as public consultation.

For projects involving local corporates, the Bank will assess their ability to implement the project in line with the Bank's environmental and social requirements. This may involve capacity building in areas such as environmental management, occupational health and safety, transparency and public consultation including with any vulnerable groups, such as ethnic minorities.

In projects involving financial intermediaries, care will be taken to ensure capacity in the partner bank to assess and manage environmental and social risks and opportunities, including biodiversity, occupational health and safety, labour issues, and gender.

4 ACCESS TO CAPITAL: PRIVATE AND PUBLIC SOURCES OF FINANCE

4.1 Access to capital

Most of FYR Macedonia's public debt continues to be financed through official sources – IFIs and bilateral donors. Official financing accounts for over 50 per cent of total government debt. The remaining funding is approximately equally split between domestic and foreign private sources of capital. The share of domestic public debt isnot very large, reflecting the fact that the domestic government securities market is still developing. As a result, most of the domestic debt is short-term. The majority of foreign private funding has come from commercial bank loans in recent years. The government has issued two Eurobonds since 2005. In the latest issue in 2009, the Government placed a three and-a-half-year €175 million Eurobond at an annual yield of 9.87 per cent; this bond was repaid in January 2013, thereby reducing government debt by more than two percentage points of GDP.

Until late-2011, the authorities were reluctant to venture again into international capital markets because of the current volatile situation in the global economy and political factors, opting instead to draw on a precautionary credit line from the IMF (see section 2.1). However, in 2012 the government secured a €75 million loan from Deutsche Bank, while it also received two other loans partially guaranteed by the World Bank – €130 million from Deutsche Bank and Citibank in December 2011 and €250 million from Deutsche Bank in January 2013 respectively). The largest ratings agencies have assigned FYR Macedonia a sovereign debt rating with stable outlook. According to S&P, the country's sovereign debt rating is BB, two notches below investment grade, while Fitch's rating is only one notch below investment grade at BB+ (Moody's does not rate FYR Macedonia).

The banking sector in FYR Macedonia is largely foreign-owned. Foreign-owned banks account for over 90 per cent of all banking assets in the country. However,

since these banks are not dependent on parent bank capital to finance lending, FYR Macedonia did not experience the strong deleveraging and credit crunch that some of its SEE neighbours did. Credit growth to the private sector has, however, slowed down significantly from rates of 30-40 per cent y/y in the pre-crisis period to around 7-8 per cent y/y as of late-2012.

Household loans represent a smaller share of total loans as compared to the immediate pre-crisis period – they were affected by changes in demand and lending practices more strongly than business loans. This along with increased perceptions of risk in the economy has been reflected in a shifting term structure of loans. Short term loans represent a larger share of total loans than they did prior to the crisis.

4.2 MDB finance and collaboration with other IFIs and multilateral donors

The Bank will continue to work closely with bilateral and multilateral institutions on key infrastructure projects in the transport, energy and municipal sector. The WBIF will be the key platform to discuss with other partners key priorities and financing schemes for proposed actions. The WBIF will also be an important instrument to boost regional policy dialogue, which is a pre-requisite for regional integration.

In the transport sector, the Bank will continue to co-operate with its traditional partners: the EIB, EU, World Bank, Italy, Austria, Germany and other bilateral donors. In the power sector, partners include the EU, World Bank, KfW and IFC. In the municipal sector the Bank will continue co-operation with the WB, EIB and IFC, to leverage and complement financing capabilities. The existing cooperation with KfW on the establishment of the regional municipal fund will continue. The Bank will seek to mobilise bilateral donor funding to deliver investment, policy reform and transition progress consistent with its mandate.

The Bank will engage with other IFIs to ensure that principles of commercial pricing are respected.

The World Bank

Since 1994, the World Bank has provided more than USD 1 billion in loans to support the Country‘s transition to a market economy and build effective institutions, improve education, social protection and pensions, build and rehabilitate basic transport and energy infrastructure, and preserve natural and cultural heritage. The World Bank and the EBRD co-financed the Regional and Local Roads Rehabilitation Project with EUR 70 million and EUR 50 million invested respectively.

The objective of the World Bank‘s Country Partnership Strategy with FYR Macedonia for 2011-2014 is to provide selective and targeted financial support and advisory services in support of faster, more inclusive and greener economic growth. Since FYR Macedonia‘s future growth and development depends fundamentally on the pace of EU accession, the World Bank’s intervention is designed to help FYR Macedonia to prepare for the EU membership. The current programme consists of 7 loans and one grant, totalling USD 305 million.

The International Finance Corporation

To date, the International Finance Corporation (IFC) has invested USD 89 million in FYR Macedonia. Most of the investments were made alongside the EBRD. IFC is focusing its investments services on increasing access to finance by supporting the development of local financial institutions, especially ones that concentrate on small and medium enterprises. IFC also invested in the energy sector, telecommunications and general manufacturing sectors. In 2008, the Bank and the IFC co-financed the loan to EVN Macedonia with EUR 35 million each.

In addition to its investments, IFC has several on-going advisory services programmes. IFC's advisory services aim to improve the investment climate, performance of private sector companies, and to attract private sector participation in development of infrastructure projects. These advisory services projects include: financial sector, with a special emphasis on small and medium enterprise and energy efficiency lending; climate change, including investments in infrastructure and energy sectors; agribusiness, with an emphasis on food retail and manufacturing; value-added manufacturing; and business infrastructure, with a focus on logistics and distribution.

The European Investment Bank

The European Investment Bank (EIB) started its operations in FYR Macedonia in 1998 with the signing of the Protocol for financial cooperation, according to which EIB started granting credits to FYR Macedonia on a sovereign basis. EIB's target sectors include transport, energy, health, SMEs and municipal financing with possible commitments in the range of EUR 150-200 million. EIB's current exposure is in the transport (road), energy (transmission) and SME (through selected financial intermediaries) sectors.

In response to the crisis, in 2009 the EIB extended a EUR 100 million sovereign guaranteed loan to the state-owned Macedonian Bank for Development Promotion (MBDP). The loan is channelled to the economy through local commercial banks. Loan proceeds are used to finance capital expenditure, working capital and refinancing needs for local corporates and SMEs. In 2011 and 2012 an additional 150 million was extended.

The International Monetary Fund

FYR Macedonia joined the International Monetary Fund (IMF) in December 1992. In January 2011, the Macedonian authorities decided to draw EUR 220 million (out of the EUR 390 million available) under the Precautionary Credit Line (PCL) arrangement reflecting the changed circumstances brought by the early elections, including the delay of the planned Eurobond issuance. The PCL (subsequently renamed by the IMF as the precautionary Liquidity Line, or PLL) was designed for countries that, despite having sound policies and fundamentals, have some remaining vulnerabilities. The Government, having reached an agreement on a five-year foreign bank loan in 2012 that will secure its financing needs in 2012 and into 2013, will not need to draw further upon the PLL.

The IMF also supports several technical assistance projects, including projects on domestic debt market development, medium term budgeting, modernizing public revenue administration and improving national account statistics.

4.3 Cooperation with the European Union

EBRD co-operation with the EU will continue under the WBIF.

In the private SME sector, the Bank will boost its actions through the new SME platform devised together with the EU and EIB for the Western Balkans and Croatia and approved under the WBIF, the Enterprise Development and Innovation Facility (EDIF), though which a set of financing mechanisms and TC for structural reforms in the areas of private equity and innovation will be made available to the region. Within EDIF, a new fund, the Enterprise Expansion Fund (ENEF), will be created as a vehicle to co-finance equity-driven projects with LEF, thus representing a key element to the co-operation with all other institutional players in the region.

The Bank will seek further EU funding for Small Business Support activities through national IPA as well as the regional WBIF initiative.

ANNEX 1 – POLITICAL ASSESSMENT

FYR Macedonia is committed to and applying the principles of multiparty democracy, pluralism and market economics in accordance with the conditions specified in Article 1 of the Agreement establishing the Bank.

The constitutional and legislative framework for a pluralistic parliamentary democracy is in place. The separation of powers and checks and balances in the political system, guarantees for fundamental rights and protection of minorities, and for a meaningful role of civil society are largely in line with international and European standards, as assessed by the Council of Europe and European Union. Elections are generally conducted in a manner deemed by the OSCE and the Council of Europe to be free and in line with international standards, although they are sometimes marred by irregularities.

In the period since the adoption of the previous Strategy FYR Macedonia has made further progress in democratic reform, to a great extent geared towards integration into the EU. Progress in particular has been made in the areas considered to be the key weaknesses in the Western Balkans countries, such as public administration, judiciary, and the business environment. The legislative framework for a professional merit-based civil service has been strengthened and its capacity to provide services to citizens improved. While serious challenges remain in the area of judiciary, its overall efficiency has increased, which was seen through reductions in the backlog of cases in the courts. FYR Macedonia continues to score well in the World Bank Doing Business rankings, far ahead the rest of the Western Balkans as well as most other transition countries.

The authorities remain committed to the spirit of the Ohrid Framework Agreement (OFA), which ended the armed inter-ethnic conflict in 2001 and which has since underpinned inter-ethnic reconciliation. Continuing implementation of the OFA has contributed to the consolidation of democracy and the rule of law. It continues to support political stability in the country, which is highlighted by the relatively smooth functioning of the current multi-ethnic governing coalition. In spite of recurring ethnic-related tensions, the coalition partners have managed to resolve disagreements through dialogue.

The progress in reforms and in consolidating political stability achieved by the Macedonian authorities has been reflected in the conclusions of the latest Progress Report by the European Commission (EC) on FYR Macedonia, published on 10 October 2012, which assesses progress made in the course of the last year towards meeting the Copenhagen criteria, including stability of institutions, the rule of law, human rights and protection of minorities. In this Report, the Commission went beyond re-affirming the assessment that FYR Macedonia sufficiently meets the political criteria and re-iterated, for the fourth time since 2009, the recommendation for the opening of the EU accession talks. It issued the strongest ever call for the European Council to open accession negotiations without further delay. The Council of EU concluded on 11 December 2012 that it would examine in spring 2013 the EC's report on further progress in the context of the High Level Accession Dialogue (HLAD), which was launched in the beginning of 2012, as well as steps taken to

reach a mutually acceptable solution to the name issue with Greece, with a view to a possible decision of the European Council to open the EU accession negotiations.

The end of 2012 witnessed a political crisis, triggered by the controversy surrounding the adoption of the budget for 2013. The main opposition political party, centre-left SDSM, initiated a boycott of the Parliament, announced that they would boycott the local elections scheduled for March 2013, and called for early general elections.

Representative and Accountable Government

Free, fair and competitive elections

The existing legal framework enables a sound basis for democratic elections, provided the authorities and political parties exercise sufficient will to implement it. The legal framework benefited from a series of reforms, including amendments adopted in 2011, which, *inter alia*, took on board several recommendations put forward by the OSCE after the previous elections. Almost all elections in the country were assessed as "free and fair" by observers from the OSCE Office for Democratic Institutions and Human Rights (ODIHR), usually in cooperation with the Parliamentary Assembly of the Council of Europe (PACE).

Elections are generally highly competitive, starting with the inclusive candidate registration that offers a diverse choice to the electorate. The candidates are able to campaign freely. The Central Election Commission is an independent permanent body, appointed by the Parliament for a four-year mandate, and operates normally in an efficient and transparent manner. Media provide voters with diverse and extensive coverage of the electoral campaign, which is appropriately regulated. The Electoral Code provides for domestic and international election observation at all levels of election administration.

Despite the overall good conduct of elections, there have been occasional irregularities. Among recurring procedural irregularities is the so-called 'proxy' (family) voting, particularly present among ethnic minorities where this phenomenon represents a long-term challenge, as well as occasional allegations of pressure on or intimidation of citizens. OSCE has recommended a revision of the voter lists, which is long overdue. This has been linked to the data expected from the new Census, which has been postponed twice due to certain ethnic-related disagreements. The revision of the voters list is currently on-going.

While in the past several elections were marred by electoral violence and various irregularities, there has been consistent progress of late, demonstrated during the presidential and local elections in 2009, and especially in the last general elections, which took place in June 2011. The latter went calmly and peacefully, and only a limited number of technical irregularities were noted. The authorities took seriously the recommendations made by OSCE/ODIHR in the aftermath of the 2011 elections. The government submitted a number of proposals designed to improve legislation based on these recommendations, and the Parliament is working on these proposals.

Separation of powers and effective checks and balances

The constitutional and legislative framework for a parliamentary democracy – underpinned by the separation of powers and checks and balances in the political system, independent legislature and well established procedures of legislative oversight in prescribed domains of decision-making – is in place in FYR Macedonia and largely in line with international and European standards, as assessed by the Council of Europe and EU. The scope of powers of the legislature to hold the government to account and to exercise parliamentary oversight is largely in line with international standards. All public bodies respect the recommendations by the Ombudsman Office.

Overall the functioning of the Parliament is satisfactory and political dialogue between the government and opposition was maintained for much of the Strategy period. Representatives of the opposition head a number of important parliamentary committees. However, at the end of 2012 the main opposition political party initiated a boycott of the Parliament, in protest over the formulation of the 2013 budget.

Prime Minister and Government Ministers participate in monthly Q&A sessions with MPs. In 2012, Ministers participated in several interpellations requested by the parliamentary opposition; as well as in hearings at the parliamentary committees. Exercising its right to initiate and amend legislation, the parliamentary committees in the course of 2012 initiated six bills.

FYR Macedonia is progressing also with decentralisation of government, which is one of the key elements of the Ohrid Framework Agreement (OFA). Since the previous Strategy, all but one of the country's 85 municipalities have entered the second phase of fiscal decentralisation, enabling further transfer of responsibilities and financial management to the local level.

Effective power to govern of elected officials

FYR Macedonia has established institutional, legal, and financial arrangements for elected officials to exercise effective power to govern and they are not constrained by any non-democratic veto powers or other undue influences. As in many other transition countries, there has long been a close relationship between business and political elites. However, this does not compromise the powers of elected officials to govern the country.

Civil Society, Media and Participation

Scale and independence of civil society

There is a satisfactory legal framework for civil society organisations. A new 'Strategy for Cooperation' between the government and civil society for 2012-2017 and respective Action Plan, whose preparation was broadly participatory, were adopted in 2012. The new 'Strategy' envisages establishing a Council for Cooperation with Civil Society, as well as a legally binding framework for state financing for civil society organisations. This should help standardise this area, where in the past NGOs

presented many complaints. As elsewhere in the Western Balkans, CSOs remain heavily dependent on foreign funding.

Most progress has been achieved in inclusion of civil society representatives in the work on the EU-related agenda. The parliamentary committee on EU Affairs and the National Council on EU Integration, which is chaired by one of the leaders of the opposition and includes civil society representatives, hold regular joint sessions on key EU issues, including the national programme for the adoption of the *acquis communautaire*, EU Progress Reports, and on-going accession dialogue with the EU.

NGOs are particularly active in the social field, including protection of vulnerable groups, and in election observation. Among the weaknesses is development of civil society at the local level, especially in the rural areas.

Rights to form trade unions is enshrined in law and respected in practice. However, trade unions in general lack stable finances. The Economic and Social Council plays an increasingly active role in the social dialogue.

A large number of CSOs are currently registered with the tax authorities in FYR Macedonia. However, there are only a handful of well-established and well-funded CSOs, mostly in the largest cities. Some CSOs are highly professional in their respective areas of expertise, particularly those specialised in EU integration related issues, environment, media, and gender.

Independent pluralistic media that operates without censorship

Pluralism in the media, which operate freely and without censorship, has increased overall in recent years. The legal framework is largely in place and in line with international standards. At the same time, as the EC noted in its latest Progress Report on FYR Macedonia, published on 10 October 2012, there are "continued concerns about self-censorship", as well as concerns that "a large share of government-funded advertising is being directed to media supportive of the government".

The Broadcasting Council has begun to enforce legal provisions against concentration of ownership and conflict of interest within the political sphere. The government and the Association of Journalists have launched in 2012 a roundtable designed to address remaining key challenges related to the media. They signed a special MoU, which identified specific areas, including the decriminalisation of defamation, the strengthening of the public broadcaster, transparency of government advertising, and improving journalists' respect for professional standards. In November 2012, the Macedonian parliament adopted a new Law on Civil Liability for Insult and Defamation, which removed insult and defamation from the criminal code. The decriminalisation of defamation was a significant step towards strengthening freedom of expression

There are many independent broadcast outlets and dailies operating in FYR Macedonia. Electronic media dominate the market. The main media outlet is the public broadcaster, Macedonian Radio-Television (MRT), with its three national channels, one satellite channel, and three national radio stations. MRT is funded through a broadcast tax imposed on households and legal entities.

Multiple channels of civic and political participation

Multiple channels of civic and political participation are in place. There are certain rules and procedures regarding public consultations, but they are not always enforced. For example, an advanced system for electronic registry of all newly prepared draft laws, envisaged by the rules, is not widely used in practice. While CSOs are often sought to provide their expertise by parliamentary committees this is often done on ad hoc basis.

Freedom to form political parties and existence of organised opposition

The freedom to form political parties is both guaranteed by the Constitution and implemented in practical terms, highlighted by the existence of a significant opposition able to campaign freely and oppose government initiatives. The main opposition political party currently holds more than 30 per cent of seats in the national parliament, its representatives head a number of parliamentary committees, and they are also in majority in a number of municipalities. 53 political parties participated in the last general elections in FYR Macedonia, and 16 parties and coalitions are currently represented in the Parliament.

Rule of Law and Access to Justice

Supremacy of the law

Necessary legislative and institutional safeguards for the supremacy of the law are in place. FYR Macedonia continued to make progress in comprehensive reforms of the judiciary and in aligning it with European standards. The 2012 EC Progress Report on FYR Macedonia noted progress in reducing the backlog of cases in the courts. This is particularly important, since the main remaining challenges to the practical implementation of the right to a fair trial for all stem from the issues related to the overall efficiency of the courts. The courts at all levels have continued to publish judgements on their websites, which is an important tool in promoting transparency and access to justice.

Independence of the judiciary

The independence of judiciary is guaranteed by the constitution and key safeguards are in place to ensure its impartiality, including the role and composition of the Judicial Council. In 2011 an amendment was adopted that allows the Minister of Justice to participate in the work of the Council, but does not give the Minister voting rights as before. Further efforts are needed, however, to guarantee in practice independent high-quality decision-making by the courts. According to the EC, the current grounds for the dismissal of judges are not sufficiently clear, precise and predictable, which could undermine judicial independence.

Government and citizens equally subject to the law

The authorities have stepped up measures to prevent the abuse of authority by public office-holders, especially in the Ministry of Interior, where the Sector for Internal

Control and Professional Standards initiates hundreds of disciplinary procedures annually, most of which relate to the abuse of official position; and in the Customs Administration, which also strengthened its internal control system.

The Law on Free Access to Public Information is in place, although some provisions are worded vaguely enough to leave scope for arbitrary interpretation. A new piece of legislation has been adopted recently, whose effectiveness still remains to be seen, providing for systematic verification of asset declarations by public office-holders. In 2011, the State Commission for the Prevention of Corruption (SCPC) submitted 48 requests to initiate property examination, which resulted in charges against 10 elected and appointed officials. 128 cases of suspected conflict of interest resulted in 37 confirmed cases.

Effective policies and institutions to prevent corruption

Although corruption remains a serious problem in certain areas, such as public procurement, and is still perceived by Macedonian citizens as a widespread phenomenon, the authorities have made progress over the last years in fighting corruption. Establishing a 'one-stop-shop' for enterprise creation together with comprehensive regulatory reforms of the last years, have contributed to improving the overall atmosphere related to integrity. According to the 2012 Transparency International Corruption Perception Indexes, FYR Macedonia had a score of 4.3, which placed it 69th out of 176 countries, and among the best in South Eastern Europe.

The institutional and legal framework for fighting corruption is in place. According to the latest reports by the Council of Europe's Group of States against Corruption (GRECO), Macedonian criminal legislation provides an effective basis for the investigation and prosecution of corruption offences. At the same time, GRECO considers that several aspects of the national legislation still fall short of the best standards. FYR Macedonia ratified the Criminal Law Convention on Corruption in 1999. Several amendments to the Criminal Code were adopted subsequently over the years in order to transpose the standards of the Convention. Recently adopted amendments to the Law on Financing Political Parties and the Law on the Prevention of Conflicts of Interest improved the verification and enforcement powers of the relevant authorities working on the prevention and prosecution of corruption. The State Audit Office has acquired a leading role in the supervision of political financing. A bylaw to the Law on the Prevention of Conflicts of Interest set out the procedure for checking declarations made by elected and appointed public officials, and other measures have been taken recently to strengthen the legislation against the conflict of interest. The administrative capacity of bodies designed to combat corruption has also improved.

The SCPC has in recent years adopted State programmes for prevention and reduction of corruption and for prevention and reduction of conflict of interest, along with a corresponding Action Plan for 2011-2015. The Action Plan focuses on 11 corruption-prone areas, including the financing of political parties, public procurement, social services and health, customs, the mass media, and the judiciary.

In 2011, the SCPC received 267 complaints of corruption, which was 40 per cent less than in 2010. There were 125 convictions in 2011, and the sentences were in general stricter than in the past. However, only a handful of high-level corruption cases were prosecuted, and most all of them have remained in the court system for years, having been returned for retrial following the appeals. Effective whistle-blowing mechanisms in the public and private sectors have yet to be established.

Civil and Political Rights

Freedom of speech, information, religion, conscience, movement, association, assembly and private property

The Constitution and relevant laws prohibit discrimination on grounds of sex, race, language, religion, national or social origin, property or social status. The Constitution guarantees the basic freedoms and rights of citizens recognized in international law, while international treaties are directly enforceable by domestic courts and their status is superior to the domestic law. Freedom of speech, information, religion and conscience, movement, association and assembly, and private property are therefore fully guaranteed. The Constitution also requires the State to supplement private initiative and responsibility in relation to certain "social objectives", such as the provision of care to persons with disabilities, the aged and orphaned.

FYR Macedonia is a signatory to all major international human rights instruments. The high level of ratifications of the conventions of the United Nations, Council of Europe, and regional human rights instruments represents a significant achievement. The country has recently ratified the revised European Social Charter and the UN Convention on the Rights of Persons with Disabilities and the corresponding Optional Protocol. FYR Macedonia has also put in place the institutional framework for the protection of human rights, which includes the Ombudsman. Two additional religious entities were registered under the Law on the Legal Status of Churches, Religious Communities and Religious Groups, bringing their total number to 30.

According to the 2012 EC Progress Report on FYR Macedonia, the anti-discrimination laws need to be fully aligned with the *acquis*, especially as regards discrimination on the grounds of sexual orientation. The Progress Report also mentioned a controversy caused by the new law on lustration, which was adopted in June 2012, which raised concerns about its proportionality and constitutionality. The previous law on lustration had been contested twice in the Constitutional Court. The new law allows for publication of the names of former collaborators of the secret service, and the scope of its application includes journalists, academics, members of civil society organisations, and individuals who made a profit during the privatisation process.

As regards property rights, progress has been made in returning property confiscated under the communist regime. Property which could not be returned was compensated for in the form of bonds. The land register currently covers 99.96 per cent of the country's territory.

In sum, fundamental rights are broadly respected in FYR Macedonia. The main weaknesses in the consistent enforcement of the guaranteed rights include continuing

stigmatisation of the LGBT community and inadequate social integration of people with disabilities. The Ombudsman still needs a full mandate to promote and protect human rights in accordance with the Paris Principles.

Political inclusiveness for women, ethnic and other minorities

The legislative framework for the protection of ethnic minorities is broadly in place. The country has a complex ethnic composition. According to the 2002 census, ethnic Macedonians are 64.2 per cent, ethnic Albanians 25.2 per cent, ethnic Turks 3.9 per cent, Roma 2.7 per cent, ethnic Serbs 1.8 per cent, ethnic Bosnians 0.8 per cent, and Vlachs 0.5 per cent. FYR Macedonia also has a history of ethnic tensions. However, it has made progress since the 2001 armed inter-ethnic conflict in addressing both the roots and the effects of this conflict.

These efforts included legislative reform and practical measures designed to ensure equitable representation of minority communities in public administration and their integration into society and promotion of inter-ethnic reconciliation. The interests of minority communities are protected at different levels, starting with basic constitutional guarantees (ethnic communities are explicitly mentioned in the Constitution) to the special mechanism ensuring protection of their interests in the Parliament and measures to protect their cultural, linguistic and religious identities. The most tangible results in this respect have been achieved in protecting the interests and ensuring equitable representation of the largest ethnic minority, Albanians. More remains to be done to protect smaller ethnic minorities, particularly the most vulnerable Roma community.

Despite the progress achieved, inter-ethnic tensions and lack of mutual trust persist, especially on the local level. Political parties are largely divided along ethnic lines. Ethnic-related disagreements caused the postponement (twice) of the census, which was due in 2011. 2012 witnessed a number of serious ethnic-related incidents.

The implementation of the Ohrid Framework Agreement (OFA), which prominently includes inter-ethnic reconciliation, remains indispensable in order to preserve stability in the country. In 2012, the authorities launched a review of the implementation of the OFA, for the first time in the last ten years. The government subsequently adopted a report, which covers all aspects of the OFA, showing both progress achieved and remaining challenges. This was a positive example of continuing commitment of the multi-ethnic governing coalition to the spirit of the OFA and represented an important tool for strengthening inter-ethnic relations in the country.

Regarding Roma, several measures have been taken, notably to address the issue of persons without documents and to integrate IDPs and Roma refugees from Kosovo. The new strategy on social inclusion of Roma for 2012-2014 was adopted, along with an action plan. The Roma health mediator programme started in 16 municipalities. Education projects continued to be implemented leading to an increase in the enrolment rates of Roma children in secondary education. However, implementation of existing strategies needs to be strengthened. High unemployment rates persist, while access to unemployment benefits and basic health services remains problematic. Stereotyping against Roma persists, including in the media.

The key legislative elements for gender equality are in place in FYR Macedonia. By regional (and wider international) standards women have over the past decade had an impressive representation in the national Parliament. It peaked at 35 per cent in the previous Parliament, and is 29 per cent in the current Parliament. There are currently 3 female members of the Cabinet. During the last presidential elections for the first time a female candidate ran for the office of the President, and although she did not make it into the second round, this was a breakthrough in terms of some previous gender prejudice.

On the local level, however, the situation is different. In 2000-2009 there were 3 female Mayors. In the 2009 municipal elections none were elected. Discriminatory customs and stereotypes are still present in the rural areas, undermining women's basic rights. The national action plan for gender equality is implemented in a piecemeal way, depending largely on external financing.

Freedom from harassment, intimidation and torture

Constitutional guarantees against harassment, intimidation, and torture are in place and are largely upheld in practice. Efforts have been made to increase police officers' knowledge of European standards against ill-treatment in police stations. However, certain gaps remain regarding zero-tolerance strategy for ill-treatment, and conditions in a number of detention facilities remain difficult.

ANNEX 2 – ASSESSMENT OF TRANSITION CHALLENGES

The table and the supporting text below provide an overall assessment of Transition Challenges by sector, based on the Transition Report 2012. There are two separate scores for each sector, rating market structures and market-supporting institutions. Scores range from negligible, small, medium and large. "Negligible" means that the remaining challenges are minor and that the sector is well advanced in moving towards the standards of a well-functioning market economy. "Large" means that the remaining challenges are major and that this dimension of the sector is at an early stage of reform.

Sectors	**Market Structure**	**Market-Supporting Institutions**
Industry, Commerce and Agribusiness		
Agribusiness	Medium	Medium
Manufacturing and Services	Medium	Medium
Real estate	Large	Medium
Telecommunications	Medium	Small
Private Equity	Large	Large
Energy		
Natural resources	Medium	Medium
Power	Medium	Medium
Sustainable energy	Large	Medium
Infrastructure		
Urban Transport	Medium	Large
Water and Wastewater	Medium	Large
Roads	Medium	Medium
Railways	Medium	Medium
Financial Institutions		
Banking	Medium	Medium
MSME	Medium	Medium
Insurance and financial services	Medium	Medium
Capital Markets	Large	Large

INDUSTRY, COMMERCE AND AGRIBUSINESS

Agribusiness
Market structure: *Medium*
Market institutions: *Medium*

The country gradually reduced trade protection under the umbrella of the EU's SAA agreement signed in 2001, the WTO agreement signed in 2003 and CEFTA signed in 2006. Around 80 per cent of arable land is under ownership by private farmers, but the land market functions poorly (despite on-going cadastral reforms land holdings continue to be small and fragmented and there are problems with the land registration system since cadastral records and tradable titles need updating). Most of the agro-processors have been privatised, but are still in severe financial difficulty due to

outdated plant and equipment, excess labour and poor management. FDI into the sector has been low and further investments are needed into technology, new product development as well as energy efficiency. The institutional framework related to building a warehouse and registering property needs further improvements. There has been continued reform of the commercial banking sector, and microfinance banks have been established, but the rural sector still has limited access to bank credit and lacks a functioning warehouse receipts system.

Manufacturing and Services
Market structure: *Medium*
Market institutions: *Medium*

Progress with the privatisation of the remaining state-run loss-making enterprises slowed over recent years and efficiency and productivity levels in the manufacturing and services sector remain low. Four unprofitable state-owned enterprises including the chemical manufacturer, Ohis, the tobacco producer, Tutunski Kombinat, the electronics maker, EMO, and the military equipment production company, Eurokompozit Prilep, were scheduled for privatisation but the process has been delayed due to lack of interest. Property registration was eased by reducing the average time to register a title deed by eight days. The country's cadastre system has been reformed successfully and the authorities are promoting technological industrial development zones in order to attract more FDI. A law on business registration was adopted reducing the time, procedural steps and financial costs required to start a business. In 2010 the second phase of the "one-stop shop" system was initiated, consisting of three components: an online application for the registration of companies; an electronic system for the classification and listing of companies under the court procedures for insolvency; and an electronic system for the registration of collateral and leasing. In spite of on-going reforms, structural challenges remain substantial: priorities in the corporate sector are the reduction or removal of uncertainty over property rights and acceleration in reforming the judicial system.

Real estate
Market structure: *Large*
Market institutions: *Medium*

The property market is at a relatively early stage of development, including the introduction of new products and financing methods. Market penetration of innovative construction technologies is low, and there is a lack of supply of modern commercial property in all segments. The mortgage market remains underdeveloped. Progress has been made in improving the business environment for real estate development, including the introduction of a new law on real estate cadastre. Dealing with construction permits and registering property have improved significantly since the last assessment (the process has been significantly streamlined). There is little state interference in the sector (subsidies etc.), but the lack of effective rule of law and the uncertainty of property rights undermine investment and development in the sector. Gaps in terms of the development of modern secondary legislation supporting the sustainability of real estate (energy efficiency, impact on environment) are still large. Public awareness of the sustainability issues is also low.

Telecommunication
Market structure: *Medium*
Market institutions: *Small*

The telecommunications sector is regulated by the Agency for Electronic Communications (AEC), an independent regulatory body. The regulatory framework is relatively well developed, close to the EU framework (the EU 2003 regulatory framework). Competitive safeguards have been implemented, including local loop unbundling and both fixed and mobile number portability. Further improvements could be achieved in tariff rebalancing or rules for granting rights of way.

Although alternative operators have been able to compete since January 2005, competition only started in February 2007 due to a delay in implementing the new regulatory framework. The incumbent Makedonski Telekom, controlled by Magyar Telecom, continues to dominate the fixed line market, although there is competition coming mainly from mobile and cable operators. The state continues to be a minority shareholder in the fixed line incumbent (it also holds a golden share). The mobile market is well-developed, with three competing operators, T-Mobile, VIP and ONE, although the uptake of mobile broadband has been relatively slow. The Internet market remains relatively under-developed, but increased competition has forced Makedonski Telekom to make significant changes to its broadband services, and broadband Internet is becoming more widely available. On the other hand, a number of regional fixed wireless access licenses have been recently returned to the regulator.

Private equity
Market structure: *Large*
Market institutions: *Large*

A commercial private equity sector is yet to develop and to date the country has not attracted significant interest of international private equity funds. A challenging business environment, limited investment opportunities and poor exit prospects all work against development in this sector, resulting in both the number of participants and transactions in this market remaining low. Regional fund managers including FYR Macedonia in their target region amounted to less than five and no country focused managers were identified, highlighting the remaining challenge of attracting new entrants into the sector. Active capital and capital available for investment are estimated at an unchanged 0.34 and zero per cent of GDP, respectively, in 2011. Net committed capital is focused on buyouts and growth funds with the remaining five investment strategies either non- existent, such as mezzanine, infrastructure, distressed capital, or almost non- existent, such as small and venture capital. On the institutional side, whilst FYR Macedonia shows relatively high conformity with the OECD Principles of Corporate Governance (despite low disclosure and transparency standards), there is virtually no local institutional investor participation in the market.

ENERGY

Natural Resources

Market structure: *Medium*
Market institutions: *Medium*

Although some progress has been made in the area of the internal energy market, the activities of the natural gas transmission system operator and the natural gas distribution system operator are not unbundled and are performed by the same company (ERC GAMA) with ownership shared between the State and Makpetrol. There is free access to the transmission system and the distribution market is open, yet licensed independent companies are not sufficiently present. The ownership of the gas system has still not been resolved.

Large gaps remain in creating market supporting policies and institutions. Gas and electricity tariffs still do not reflect costs due to the presence of cross subsidies, while collection rates are still not sufficient to ensure the viability of the system. The Grid Code for transmission of natural gas distribution was adopted in the first half of 2008. In relation to energy networks, progress was made in the implementation of the Energy Community Treaty. In February 2011, the parliament approved a new Energy Law that provides the basic legislative and regulatory framework for the energy sector, covering electricity, gas, renewable energy and energy efficiency, as well as oil and security of energy supply. The Energy Regulatory Commission (ERC) regulates electricity, natural gas, district heating, oil and oil derivatives and the geothermal energy sector. Its administrative capacity is low and independence should be further strengthened.

Sustainable Energy

Market structure: *Large*
Market institutions: *Medium*

The new Energy Law of February 2011 includes provisions in support of sustainable energy. It is a good step forward although it does not set concrete targets. In the field of energy efficiency, it envisages, among other issues, standards and labelling of household appliances. The recent law on energy efficiency approved in July 2010 aims to foster a use of RES. However, electricity tariffs are still not cost reflective (in particular for households, hence cross-subsidies are widespread) and do not include environmental costs. Therefore price signals do not provide incentives to use energy efficiently and to invest in RES projects. Given its strong hydro resources, FYR Macedonia is currently tendering 400 sites for small (less than 5 MW) hydropower plants with a notional aggregate capacity of 160-240 MW. The government has also established a feed-in tariff mechanism granting a preferential right for generation from renewable sources. FYR Macedonia ratified the UNFCC and Kyoto protocol where it holds the status of the Non-Annex 1 Party. A national action plan for energy efficiency has been adopted but implementation remains a challenge.

Power
Market structure: *Medium*
Market institutions: *Medium*

The new Energy Strategy has been recently approved by the Government. Progress has been achieved in improving the market structure of the Macedonian power sector. Notably, the unbundling of the sector has been completed along the lines of generation, transmission, and distribution as set out in the Energy Law from 2006. Revisions to the Energy Law in 2011 set a clear framework for liberalisation by 2015 as well as providing the basis for improvements to the tariff methodology. However considerable work on the secondary regulations and rules is required to give effect to these. The power generation segment is still dominated by the state-owned AD Elektrani na Makedonija (ELEM) which owns substantially all the generating capacity other than Negotino TPP, which is held separately directly by the state, with a privately owned CHP plant which began operations in 2011. The electricity market is only partially open and competition is very limited. Several attempts to tender for private participation in new generation projects have failed. Distribution and supply are privatised and majority (90 per cent) owned by EVN. The quality of institutions needs to be further strengthened. A regulatory authority is operating but it is still subject to intervention. Despite improvements in the tariff methodology, electricity tariffs are still below costs recovery and cross-subsidies are significant, with household prices being kept artificially low. A feed-in tariff mechanism to support renewable energy is in place but there has been limited progress in taking advantage of this because of shortfalls in the wider investment framework.

INFRASTRUCTURE

Water and wastewater
Market structure: *Large*
Market institutions: *Large*

Local infrastructure has been transferred to municipalities. However, there is still political interference into the water sector and local infrastructure operators are normally not fully converted into joint stock companies. The overall financial and operational performance of municipal utility companies is mixed as collection rates are low by regional standards, cost control is weak and substantial network losses are common among the smaller communities. Tariffs for water and wastewater are set by the municipalities based on a tariff methodology. However, the tariff setting process is often subject to political influence. Cross-subsidies between consumer groups are still widespread. Although the level of tariffs for water is generally low, some municipal utilities manage to cover operational costs through tariffs.

Urban Transport
Market structure: *Medium*
Market institutions: *Large*

Local infrastructure and transport services have been transferred to municipalities and are currently operated by municipal or private companies, such as in Skopje where 25 per cent of the bus services are provided by private sector. Operational and financial performance is typically poor. Private operators have basic licensing arrangements

with the regulator, which is often weak institutionally, and there is still a need for proper PSCs for the public urban transport companies. In the capital, the introduction of urban light rail or other higher capacity public transportation is constrained by the lack of robust institutional and contractual arrangements to make this type of major investment possible.

Roads
Market structure: *Medium*
Market institutions: *Medium*

The agency for state roads (ASR) was created in 2008 as an independent state-owned entity responsible for the operation and maintenance of the main road networks. For the time being, road maintenance is contracted out to one state enterprise (without competition), but the authorities are committed to introduce fair competition as well as best practice maintenance contracts. The transport strategy, which includes institutional restructuring in the road sector, was approved by the Government and ratified by the Parliament in 2007. Moreover, the annual road maintenance expenditures increased significantly from 2007. The authorities are also interested in developing motorway concessions; however, the Government has not yet closed any of the PPP deals. A recent attempt to tender a motorway PPP failed due to inadequate risk allocation within the tender.

Railways
Market structure: *Medium*
Market institutions: *Medium*

The Government started a reform process for railways in 2005. In April 2005, a law was adopted creating the Public Enterprise for Railway Infrastructure (PERI) as an infrastructure manager and the Macedonia Railways Transport Joint Stock Company (MRT JSC) as a transport operations company (established in August 2007). The first phase of restructuring has been completed. There have been significant labour adjustments and tariff reforms. The institutional mechanisms for the introduction of PSO and access charges are under development. An independent Rail Regulator, reporting to the Parliament, was established at the beginning of 2009 with responsibilities for both technical and economic regulation as defined in the new railway law and the MOT is presently in the process of setting up a directorate to take responsibility for railway safety.

FINANCIAL INSTITUTIONS

Banking
Market structure: *Medium*
Market institutions: *Medium*

The entry of foreign banks (Societe Generale, Erste Bank Group, and Demir Halk) into mid-sized banks has so far not changed the highly concentrated market picture, with the three largest banks (Komercijalna Banka, Stopanska Banka and NLB Tutunska Banka) still controlling about 60 per cent of the market and the top 5 controlling 77 per cent. Out of the 17 banks, 13 are controlled by foreign strategic investors, accounting for 93 per cent of assets. Total banking assets remain below

peers, representing 74 per cent of GDP in 2011. Among the South Eastern European countries this penetration is only higher than Romania's. The loan/deposit ratio stood at 89.4 per cent as of end-September 2012. Banks rely primarily on domestic deposits to fund lending and deposits increased by almost 5% in 2012. Credit to the private sector has started to pick up again in the second quarter of 2010 and has since remained fairly stable between 7-9 per cent. Loan dollarisation (5% of loans) combined with indexed lending (30%) resulted in significant foreign exchange related credit risk (the level of dollarisation on the deposit side, 48%, was comparable). After temporarily declining in late 2010 and the first two quarters of 2011 (to 9.3%), NPLs have recently started to rise again slightly, reaching 10.9 % as of end September 2012. However, the solvency of the banks remains relatively high and the capital adequacy ratio remained at above 17 per cent at the end of September of 2012.

The banking sector is reasonably well regulated. The central bank (NBRM) has a supervisory role in FYR Macedonia and is a fully independent entity. The Deposit Insurance Fund Skopje covers deposits in a bank, foreign bank branch or savings bank up to EUR 30,000 in Denar equivalent. Supervisory standards are largely harmonised with the Basle accord and the EU directives. The NBRM recently introduced new rules for on-site supervision, shifting from a figure based to a risk based analysis. Several on-site visits were conducted according to the new rules, resulting in a more thorough analysis of bank risk factors. Commercial banks still face problems with regard to the enforcement of financial collateral and the cumbersome, albeit improving, court procedures. Legal changes addressing governance and integrity issues, such as anti- money- laundering policies, are being discussed and developed.

Insurance and other financial services
Market structure: *Medium*
Market institutions: *Medium*

In 2009 the Insurance Supervision Agency started operating, thus creating preconditions for overcoming some of the shortfalls relative to IAIS standards with respect to the independence of the regulator, corporate governance standards and information disclosure requirements. The insurance market remains relatively small and penetration levels very low, with 15 companies generating premiums of 1.5 per cent of GDP. Only four of these companies operate in the life segment. Non-life business generates around 95 per cent of total gross premiums. Challenges remain with respect to the skill level and availability of complex products in this market segment. Private companies account for a little more than half of the total market. The market concentration of the insurance companies measured through the market share of the gross policy premium of the five largest companies was 60 per cent at the end of 2011. The Law on Leasing was adopted in 2002 and amended several times subsequently. There are ten leasing companies operating in the market as of 2011.

Recent pension reform introduced a mandatory defined-contributions pension pillar managed by private pension funds. Membership in the pension funds is mandatory for all persons who became employed for the first time after December 31, 2003, which means that most of the members are young adults aged 35 or lower. In the second half of 2009, third pillar voluntary fully funded pensions started operating. Two voluntary funds were founded, and membership can be obtained through opening a voluntary individual account or through membership in a professional pension scheme

organised by an employer or citizens' association. Pension fund assets have increased since the last review, and now account for 3.02 per cent of GDP (up from 1.22 per cent). This increase in pension penetration as well as a slight decrease in insurance competition warrants an upgrade of FYR Macedonia's market structure in this segment.

Micro, Small and Medium-sized enterprises
Market structure: *Medium*
Market institutions: *Medium*

MSMEs accounted for about 99.8 per cent of the number of companies, and 74 per cent of employment as of end-2008. Micro and small enterprises are dominant in the manufacturing and agriculture sectors. Sources of external finance for MSMEs, including bank lending, have suffered a significant decrease due to crisis since 2009. There is generally limited lending from commercial banks to the MSME sector as medium and small enterprises have difficulty to meet the collateral requirements of commercial banks and lack liquidity. Some businesses access credit through microfinance institutions, albeit with high provision and interest rates. In response to the crisis, in 2009 the government increased the funding of the Macedonian Bank for Development Promotion (MBPR) for co-financing and guarantee schemes applicable to SMEs. Banks were reluctant to use the scheme due to complicated procedures and interest rate ceiling imposed for the borrower. The MBPR guarantee scheme, established together with the Swedish Investment Fund, and the mutual scheme (involving mainly US capital) have ceased to operate. Currently, some support is provided by the Ministry of Labour and Social Policy for new businesses but is limited to the unemployed.

Some progress has been seen in the legal and regulatory environment that supports lending. The credit information system has improved considerably with the establishment of a fully functioning private credit bureau in 2011. However, significant changes in the credit information are not reported quickly risking to undermine the accuracy and validity of credit information. The private bureau contains positive and negative credit information and covers approximately 64 per cent of adults. Up to two years of historical data is available to the public and to financial institutions. A registration system for movable assets is in place in the country but the access to such register is not free. With regard to rules concerning reorganisation, the country lags behind international standards as there is no restraint on suppliers, no facility for on-going finance, no restriction on the voting powers of connected creditors and no provision for post-approval modification of a plan of reorganisation.

Capital Markets
Market structure: *Large*
Market institutions: *Large*

FYR Macedonia showed high compliance with the IOSCO principles, and relatively high quality in laws and regulations. However, the securities market regulator may not be in a position to pursue all cases. The domestic equity market has a capitalisation at 24.2 per cent of GDP at the end of 2011, and low turnover (the turnover ratio stands at 0.02), deterring investors, and limiting the attractiveness of public equity issuance as a

source of capital. In April 2010, the government abolished the 10 per cent ceiling on foreign ownership of securities at the Macedonian Stock Exchange as part of a first step in the development of local capital markets. There is a fairly well-developed primary government bond market with a feasible market size; the secondary market segment, whilst providing price transparency through official listing and an OTC market in place, lacks liquidity. The money market in FYR Macedonia consists of the following segments: foreign exchange market, central bank bill auctions, interbank deposit market, government securities auctions and an OTC market. Benchmark indices include the Skopje Interbank Offered Rate (SKIBOR) and the Macedonian Denar Overnight Index (MKDONIA) and they are used on the interbank market. Corporate bond markets remain nascent with no issuances seen over the last few years.

ANNEX 3 – LEGAL TRANSITION

Introduction

This annex analyses a set of legal topics directly relevant to the Bank's investment strategy for the three-year strategy period.

Overall, the legal framework in FYR Macedonia is adequate to support the Bank's proposed interventions, though further reforms are needed in some areas. In particular, the framework for public-private partnerships (PPPs) is relatively advanced and has been made compliant with EU directives in a 2012 reform. Efforts will be needed to create well-functioning renewable energy and energy efficiency sectors, with a focus on filling gaps in the existing regulatory framework to bringing it in line with best international standards. SME access to finance would benefit from targeted legal changes (regarding among other things features of pledge agreements, pledges over bank accounts, and factoring). FYR Macedonia has a modern insolvency law framework that allows for both reorganisation and liquidation. The introduction of the electronic system for monitoring insolvency proceedings should make the process more efficient and create greater transparency for stakeholders. Finally, FYR Macedonia has recently revised most of its corporate governance legislation in line with the EU's *Acquis Communautaire* and international standards. While the quality of legislation has therefore improved, attention now needs to be paid to building institutions capable of ensuring effective implementation of the legislation.

Advancing regional integration through PPPs

As the Bank plans to finance through public-private partnership structures investments to advance the country's strategic connections with neighbouring states, the legal framework for public-private partnerships and concessions will be of great relevance. In this context, the new Law on Concessions and Other Types of Public-Private Partnership (the "PPP Law") was passed on 11 January 2012 and replaced an earlier version that was already regarded as a modern and fairly comprehensive piece of legislation.

The PPP Law was drafted with a view to harmonising the national legislation with the EU *acquis* since the 'predecessor' act was criticised as being not in full compliance with it. The improvements were acknowledged by the EU in its progress report issued in 2012, which stated that "Alignment of the legislation on concessions and public-private partnerships with the *acquis* is advanced".

The PPP Law clearly defines its scope of application, and follows closely the EU directives distinguishing between public contracts and concessions. It provides for a very detailed and comprehensive definition of PPPs, regulates the selection procedures for concession contracts while referring to the Public Procurement Law for the awards of private public partnership contracts. Further the PPP Law expressly provides for the right of a private party to create security over their rights albeit with the public party's consent. Some uncertainty exists, however, stemming from the fact that according to the PPP Law the government shall prescribe the contents of the project agreement, which leaves some question as to how flexible these will be,

whether such contents will be mandatory or for guidance only. Accordingly, the possibility of international arbitration as the dispute forum is also unclear.

A specialised PPP unit has initially been set up under the Ministry of Finance and has been regarded as not particularly efficient by various commentators. In addition, the PPP Law provides for the establishment of a 'Council', consisting of representatives of various Ministries, local authorities and experts, but its effectiveness is yet to be tested in practice. In addition, there is a Concessions Department under the Ministry of Economy. Both bodies are empowered with making recommendations for regulatory aspects in relation to PPP which does not add clarity as to the delineation of their functions.

While the PPP Law constitutes a solid basis for the development of PPPs in the country, there are still certain gaps and its overall effectiveness will depend on the success of the implementing regulations as well as the procurement framework, thus setting forth a potential agenda for further improvement to the PPP/concessions framework.

On-going PPP projects have been prepared and structured under the previous PPP law. There are a few projects in energy sector, some in health and social care as well as infrastructure projects. Current examples include kindergartens implemented by the local municipalities as PPPs. A visible example in transport is the PPP-reconstructed Skopje airport inaugurated in 2011.

Promoting energy efficiency and sustainable energy

Energy Efficiency

As part of its EU accession bid, FYR Macedonia has undertaken considerable efforts to create a sound policy and regulatory framework for the energy efficiency sector. However, the existing framework remains quite basic and requires further efforts, specifically by creating sound and predictable secondary legislation. Establishment of sector-specific institutional capacity, including capacity training of government officials and local players, particularly banks, should be a top priority for the Government. Well-organised and informative public awareness campaigns are also a necessary element of an enabling environment for a well-functioning energy efficiency sector. Collaboration with international donors and local players would be beneficial for the country both in terms of setting up a regulatory framework in compliance with the best international practices and developing and implementing specific energy efficiency projects. A private energy service companies (ESCO) model should be given further consideration, with the establishment of relevant institutions, such as an ESCO fund.

Renewable Energy

Development of a renewable energy policy compliant with EU standards remains a key governmental priority. While the basic framework for renewable energy sources has been set out, multiple implementation efforts are yet to be undertaken. Among actions considered by the government are preparation and adoption of a renewable energy sector strategy and action plans; simplifying procedures for public tenders and

administrative procedures, such as for issuing construction permits and concessions on land and water, with a view to increasing interest in investment in renewable energy sources; completion of fiscal decentralisation; and capacity building of relevant governmental authorities. Discussions are being held with international donors (including EBRD) and commercial banks with a view to opening credit lines for renewable energy projects. Finally, adoption of specific renewable energy law is being discussed among the policymakers and experts.

Some progress in the sector has been achieved recently, with the adoption of a rulebook on the preferential status of producers of electricity from renewable sources and applicable feed-in tariffs for electricity produced from renewable sources. In 2012, 21 new concessions for small hydropower plants were granted, bringing the total number to 68. The subsidised electricity prices and the burdensome administrative procedures for authorisation, permitting and licensing continue to be obstacles to the adequate uptake of renewables in the country.

Facilitating private investment in the corporate and municipal sectors

Improving the investment climate through better frameworks for access to finance, efficiently dealing with insolvent entities, and fostering better corporate governance practices, remains a priority for FYR Macedonia.

Access to finance (giving security / leasing / factoring)

The 2003 Contractual Pledge Law (developed with World Bank's support) introduced a number of positive features. A pledge can be granted over all types of movable property, tangible assets, securities, claims and other rights. However, according to Article 23 of the law the pledge agreement still needs to include the value of the pledged collateral. The specific description of the pledged assets can prove to be a limiting factor for creating pledges over future assets. This somewhat weakens the overall commercial effectiveness of otherwise sound and developed system.

In 2009 the Financial Collateral Law, based on the EU Financial Collateral Directive, created a regime for the creation of security interest and title transfer structures (e.g. repurchase agreements) over financial assets. The system provides for the removal of administrative burdens and formality in relation to the creation, validity, perfection and enforcement of security interests and creates exceptions to certain insolvency provisions that would inhibit the enforcement of security interests and close-out netting. However, by introducing Financial Collateral into the existing legal system, an ambiguity was introduced as to the way pledges over bank accounts granted by corporations to financial institutions were to operate, as the formalities of notarisation and registration of pledge agreements were not completely removed.

Apart from the traditional security-based finance, market participants have access to others forms of asset based finance such as leasing and factoring as well. The Leasing Law introduced clear definitions of the financial and operative leasing which helped establishing legal certainty and predictability of the transactions. The stability of the system is further entrenched by the obligation to acquire a license from the Ministry of Finance both for the financial leasing companies (involving a business plan and minimum capital review) and their managers (including a fit and proper test). The

leasing industry is spreading in FYR Macedonia and recent trends show an increase in heavy machinery and fixed asset leasing contracts as opposed to leasing of cars.

The 2011 Law on Financial Companies introduced special regulation for non-banking financial institutions performing financing activities in various forms, including factoring. The law regulates the establishment, operation and supervision of these non-banking financial institutions. This should contribute to market awareness and increase transparency of the factoring services. As an additional reform to be considered by the authorities, the introduction of specific contract law provisions defining the different types of factoring services and specific relationships between the parties would help to increase the legal certainty and enforceability of factoring agreements.

Insolvency

The EBRD Insolvency Sector Assessment, completed in late 2009, concluded that FYR Macedonia's insolvency law was of a high standard generally and the law in relation to insolvency office-holders is of a particularly high standard. The assessment praised the provisions on avoidance of pre-bankruptcy transactions and on liquidation proceedings. Amongst potential areas for improvements, the assessment suggested that the debtor should be able to file in the face of anticipated insolvency. At present bankruptcy or reorganisation may only be opened once the debtor is already insolvent, a condition that is defined as non-payment of due debts without grounds within a 45 day period. Other areas in the Bankruptcy Law which were identified as needing improvement included lack of adequate provisions requiring third parties to provide information concerning assets of the debtor and, in relation to reorganisations, lack of restrictions on the voting powers of connected creditors and no provision for post approval modification of a plan of reorganisation.

In 2011, further amendments to the Bankruptcy Law came into force, aimed at improving efficiency of process. The 2011 amendments require the insolvency office holder to use an electronic system to record all phases and actions during the insolvency proceedings. The electronic system has made the insolvency process more transparent for stakeholders. Other amendments introduced reduce the maximum time period for liquidation of assets and conclusion of the bankruptcy case by the insolvency office holder to 18 months.

Corporate governance

The principal legislation on corporate governance in FYR Macedonia is found in the Law on Trade Companies (2004) (the "TC Law"); the Securities Law (2005); and the Banking Law (2007), all as amended. The Corporate Governance Code[5], approved by the Macedonian Stock Exchange ("MSE") in 2006, applies to companies listed on the MSE. Though voluntary in nature, the 'comply-or-explain' principle imposes an obligation for the companies to explain the level of compliance with the best-practice provisions and the reasons for non-compliance. The Code is accompanied by scorecards for one and two tier companies. The objective of the scorecards is an

[5] The Code is available at
http://www.ebrd.com/country/sector/law/corpgov/codes/index.htm

evaluation of the degree of application of the Code. However, the application and publishing of the scorecards is not clear, as their enforceability and use do not appear to be mentioned in any regulation.

The 2007 EBRD corporate governance assessment rated corporate governance legislation in FYR Macedonia to be in medium compliance with the OECD Principles of Corporate Governance, with the major weaknesses found in the transparency and disclosure section. With regards to directors, the legal framework should provide guidance on the role and functions of independent directors (e.g. offering an objective judgment, monitoring conflict of interest). Independent directors should also be members of board committees and audit committees.

ANNEX 4 – SMALL BUSINESS SUPPORT

The EBRD Small Business Support Team (SBS) supports economic transition by facilitating enterprise change in potentially viable micro, small and medium enterprises (MSMEs) and contributing to the development of a sustainable infrastructure of MSME support and local business advisory services. This is achieved through two complementary instruments, the Enterprise Growth Programme (EGP) and Business Advisory Services (BAS).

Previous SBS experience in FYR Macedonia

EGP has been active in FYR Macedonia since 1998 with almost €2.9 million of donor funding mobilised from the EU, the ESSF, Ireland, Italy, Japan and other bilateral donors. To date, 56 Macedonian MSMEs have received EGP assistance, with food manufacturing and fabricated metal production being the most common sectors of intervention. 31 projects have been evaluated of which 39 per cent were rated as highly successful. 40 per cent of beneficiaries reported an increase in the number of employees, and almost 70 per cent an increase in turnover. In addition, EGP has carried out various Sector Development Activities (SDAs) in energy efficiency, energy audits and financing.

Since inception in 2002, BAS FYR Macedonia has received a total of more than €5.7 million in donor funding from the EU, the ESSF, Luxembourg, the Netherlands and others, which has been supplemented by over €2 million in client contributions. To date, BAS has implemented 600 projects, mainly related to quality management and certification and environmental management across a wide number of industries. 431 projects have been evaluated, of which 73 per cent were rated successful or highly successful. 70 per cent of BAS assisted enterprises have reported an increase in turnover, and 45 per cent an increase in their workforce. In addition, 10 per cent have received financing in an average amount of more than €800,000. BAS has also undertaken 20 market development activities (MDAs) to help develop an adequate MSME support infrastructure.

In terms of cross-cutting issues, the SBS Programme in FYR Macedonia has in particular focused on environmental management, and supports rural development with more than 60 per cent of EGP beneficiaries and 50 per cent of BAS projects being located outside Skopje.

MSME and consulting sector in FYR Macedonia

The MSME sector

MSMEs play a vital role in the Macedonian economy. Official data on MSME activity is limited though it is estimated that they account for almost 75 per cent of total employment in FYR Macedonia. Most MSMEs operate in agribusiness and manufacturing, and benefit from their competitive advantage of providing good quality products and services at a relatively inexpensive price. Nevertheless, private sector development – and in particular export activity – is constrained by low productivity levels, low value added, lack of management sophistication and lack of product development and innovation.

The consultancy market
The Macedonian consultancy sector is developing but faces significant challenges with regard to MSMEs. Macedonian consultants offer a wide spectrum of services and the industry shows some signs of maturity, nonetheless demand is lacking. Female participation in the consultancy industry seems adequate but significant disparities exist in the supply of services between rural and more urban areas. Due to legislation encouraging the ISO 9000 (quality management system) and ISO 14000 (environmental management system) certifications, demand for the introduction of quality and environmental standards is high and the supply of consultants offering such services is satisfactory. Nevertheless, consultancy expertise in the areas of strategy, organisation and financial management, as well as in information and communication technology is somewhat restricted and only few local consultants can offer services with international market insights. The industry is well organised and represented through the Macedonian Management Consulting Association and the Chamber of Consultants and Trainers.

Infrastructure of MSME support
Institutional support for the development of the MSME sector is formally in place but remains scattered and incomprehensive. MSME policy falls within the responsibility of the Ministry of Economy and its implementing body, the Agency for the Promotion of Entrepreneurship (APPRM), which implements a small-scale voucher scheme to co-finance business advisory services in the area of export promotion, energy efficiency and innovation. An MSME strategy is place, and the development of the industry is further envisaged under the country's Industrial Policy and the Innovation Strategy. However, the Government has recognised the need to enhance and extend the Agency's impact on MSMEs.

Continuation of SBS in FYR Macedonia

The EBRD will continue supporting the Macedonian MSME sector through direct enterprise support and systemic market development interventions through SBS, thereby contributing to the development of a competitive and sustainable private sector. In close cooperation with other donors and national authorities, SBS will in particular focus on increasing export activity, product development and innovation in the domestic MSME sector, and will work with enterprises in priority sectors including food processing and agribusiness, ICT, automotive and metal processing as well as in tourism and transport/logistics. Particular focus will be placed on facilitating client access to finance through the EBRD and its partner financial institutions in FYR Macedonia. Cross-cutting issues such as environmental improvement, rural development, gender equality and youth entrepreneurship will continue to be addressed in SBS's activities.

At market level, SBS will further aim at promoting best international practises in priority sectors through dissemination of successful showcases and trainings. BAS will focus on developing a sustainable and commercially viable local business advisory services market. Furthermore, BAS will build further existing partnerships with relevant local institutions to strengthen institutional support to the MSME sector in order to sustain assistance to the industry in the long-term.

Subject to funding being mobilised, EGP will further support the transfer of management skills and specific industry knowledge, and will work with mid-sized corporates that have good export and high growth potential. It will assist them in developing and internationalising new, innovative products by enhancing enterprises' exposure to international best practises and creating linkages with other companies in the region and the EU markets. EGP assistance will focus on certain types of services such as business planning, financial management and sales and marketing strategies.

BAS FYR Macedonia plans to further enable MSMEs to access consulting services by facilitating projects with local consultants. A flexible grant scheme will be applied through annual updates of the Grant Guideline Matrix to prioritise intervention and avoid duplication of efforts with international donors and governmental organisations. Typically, higher grants will be allocated for smaller enterprises, for enterprises located outside of Skopje, for more complex consultancy services and for projects involving consultancy services where market demand is less mature. These include but are not limited to market analysis and planning, marketing, ICT systems, financial planning and energy efficiency.

BAS FYR Macedonia will also implement the LEF financial management and reporting programme (AIP) with the objective of raising enterprise financial management practices and standards in order to facilitate clients' access to finance and to potential EBRD investments.

BAS assistance at the enterprise level will be complemented with market development activities in order to maximise the programme's transition impact in FYR Macedonia, including:

(i) *visibility and dissemination* to promote the use of business advisory services, especially in rural areas, and to stimulate demand for more sophisticated consultancy services;
(ii) *consultancy capacity building* focused on investment planning, energy efficiency and training in sales and marketing of consultancy services; and
(iii) *MSME trainings*, which will mainly focus on addressing cross-cutting issues such as women in business, rural development, energy efficiency and environment protection.

In addition, BAS FYR Macedonia will partner with APPRM to strengthen its capacity to fulfil its mandate to support MSMEs and promote entrepreneurship. BAS will endeavour to transfer its knowledge, experience and best practices in executing business advisory projects with domestic MSMEs and building sustainable and commercially viable local business advisory services markets.

ANNEX 5 – TECHNICAL COOPERATION

TC COMMITMENTS BY DONOR THROUGH EBRD, 2009 - 1H 2012

Donor	TC Commitments (€)
Austria	1,410,000
EBRD Shareholder Special Fund	4,785,644
EU	3,094,848
European Western Balkans Joint Fund	1,419,500
France	450,000
Germany	200,000
Italy	224,892
Luxembourg	579,500
Netherlands	100,100
Norway	275,000
Switzerland	87,580
United States of America	99,476
Western Balkans Fund	1,695,000
Total	**14,421,540**

TC COMMITMENTS BY SECTOR THROUGH EBRD, 2009 – 1H 2012

Sector/Team		TC Commitments (€)
SME Development*	Agribusiness	155,705
	Small Business Support Programme (formerly TAM/BAS)	3,434,648
E2C2	E2C2	177,222
Financial Institutions	FI	2,357,776
Infrastructure	MEI	847,580
	Power and Energy	339,809
	Transport	6,505,000
Other	Other	603,800
Total		**14,421,540**

Note: Commitment values based on year end or period end data for each year.

* This sector category encompasses direct assistance to SMEs and indirect assistance through policy dialogue between the EBRD, the authorities and commercial/business associations (e.g. Investment Councils)

ANNEX 6 – SELECTED ECONOMIC INDICATORS

	2007	2008	2009	2010	2011	2012 Estimate	2013 Projection
Output and expenditure			*(Percentage change in real terms)*				
GDP	6.1	5.0	-0.9	2.9	3.1	-0.5	1.8
Private consumption	7.7	6.9	-4.7	1.4	4.1	1.1	n.a
Public consumption	0.2	8.1	0.5	-2.0	-2.9	1.5	n.a
Gross fixed capital formation	23.2	4.7	-0.6	-2.1	n.a	n.a	n.a
Exports of goods and services	12.0	-7.0	-15.7	24.2	10.5	5.0	n.a
Imports of goods and services	16.3	0.0	-14.3	9.4	14.2	4.8	n.a
Labour Market[1]			*(Percentage change)*				
Gross average monthly earnings in economy (annual average)	4.8	8.7	14.1	1.0	1.2	n.a.	n.a
Real LCU wage growth	2.5	0.4	14.9	-0.6	n.a.	n.a.	n.a
			(In per cent of labour force)				
Unemployment rate	34.9	33.8	32.2	32.1	31.4	n.a	n.a
Prices			*(Percentage change)*				
Consumer prices (annual average)	2.3	8.4	-0.8	1.5	3.9	3.3	n.a
Consumer prices (end-year)	6.7	4.1	-1.6	3.0	2.8	4.6	n.a
Fiscal Indicators			*(in per cent of GDP)*				
General government balance	0.6	-0.9	-2.7	-2.4	-2.5	-3.5	n.a
General government revenues	32.2	32.5	30.5	29.6	28.7	28.7	n.a
General government expenditure	31.6	33.4	33.2	32.0	31.2	31.3	n.a
General government debt	24.0	20.6	23.8	24.2	27.7	30.9	n.a
Monetary and financial sectors			*(Percentage change)*				
Broad money (M4, end-year)	29.3	11.2	6.0	12.2	9.7	n.a	n.a
Credit to the private sector (end-year)	39.2	34.4	3.5	7.1	8.5	n.a	n.a
			(In per cent of total loans)				
Non-performing loans ratio	7.5	6.7	8.9	9.0	9.5	10.5	n.a
Interest and exchange rates			*(In per cent per annum)*				
Local currency deposit rate	4.9	5.9	7.0	7.0	5.9	n.a.	n.a
Foreign currency deposit rate	2.0	3.0	3.3	3.1	2.7	n.a.	n.a
Local currency lending rate	10.2	9.7	10.1	9.5	8.9	n.a.	n.a
Foreign currency lending rate	8.5	7.2	7.4	7.4	7.4	n.a.	n.a
Policy rate	6.5	6.5	6.5	6.5	6.5	n.a.	n.a
			(Denars per US dollar)				
Exchange rate (end-year)	41.7	43.6	42.7	46.3	47.5	46.7	n.a
Exchange rate (annual average)	44.6	41.6	44.0	46.4	43.5	46.8	n.a
External sector			*(In per cent of GDP)*				
Current account	-7.1	-12.8	-6.8	-2.1	-2.7	-4.0	n.a
Trade balance	-20.7	-22.7	-20.2	-16.7	-19.9	-20.6	n.a
Merchandise exports	-43.7	-38.7	-32.9	-39.8	-42.6	-44.3	n.a
Merchandise imports	64.4	61.4	53.1	56.5	62.5	64.9	n.a
Foreign direct investment	8.5	6.0	2.2	2.3	4.0	2.6	n.a
External debt stock	50.7	45.5	59.1	58.4	65.0	66.3	n.a
Public external debt	16.1	12.3	17.9	17.0	21.6	n.a.	n.a
Private external debt	34.6	33.3	41.2	41.4	43.4	n.a.	n.a
			(In months of imports of goods and services)				
Gross reserves, excluding gold (end-year)	3.6	4.4	4.2	3.7	4.3	n.a.	n.a
Memorandum items			*(Denominatios as indicated)*				
Population (end-year, million)	2.049	2.045	2.053	2.057	2.060	n.a.	n.a
GDP (in billions of Denars)	365.0	411.7	410.7	434.1	463.4	476.932	n.a
GDP per capita (in US dollars)	3,997.9	4,827.8	4,548.1	4,551.7	5,162.2	4,935.155	n.a
Net FDI (In million of US dollars)	694.7	602.5	190.7	209.2	426.5	263.1	n.a
External debt - reserves (in US$ million)	2,047.6	2,569.0	3,456.1	3,319.6	4,273.9	n.a.	n.a
External debt/exports of goods and services (in per cent)	98.4	90.4	155.4	129.2	123.1	123.9	n.a
Broad money (M4, end-year in per cent of GDP)	48.2	47.5	50.5	53.6	55.037	55.037	n.a

ANNEX 7 – GENDER EQUALITY

Gender Inequality and Human Development

According to the 2011 UNDP Human Development Index (HDI), FYR Macedonia is ranked 78th out of 187 countries, which is around the regional average for Europe and Central Asia. The HDI is comprised of three dimensions: health, education and decent standard of living. The country ranks significantly better in terms of the UNDP Gender Inequality Index (GII), at 23rd globally. The GII is a composite measure, which captures the loss of achievement within a country due to gender inequality, and uses three dimensions to do so: reproductive health, empowerment, and labour market participation.

Labour force participation and gender pay gap

According to the 2012 report '*Women and Men in the Republic of Macedonia'* of the State Statistical Office, the proportion of women aged between 15 and 64 years of age in the labour force was 44.7 per cent as compared to 68.8 per cent for men. Southern and Eastern Europe (SEE) has the lowest female labour participation rates amongst EBRD sub-regions with FYR Macedonia reporting one of the lowest numbers of females in the labour force in this sub-group. Women's employment rates are also lower than that of men in the country (35 per cent for women and 52 per cent for men). There are no significant gender differences in unemployment rates but they are very high for both women and men (around 32 per cent).

According to the State Statistical Office, in 2010 women earned on average 6.3 per cent less than men, when gross hourly earnings were taken into account. The gender pay gap varies according to different characteristics, such as age, education and occupation. For example, the gender gap appears to be the largest for people with university education and primary and lower secondary education. The gap is the most significant for people in the 35-39 age group and for people 65 years and older.
According to the State Statistical Office, in 2011 the proportion of women graduates in postgraduate studies was higher as compared to that of men (57 per cent and 43 per cent). Of note, however, is that 63 per cent of all graduates in the field of humanities were women, whereas only 37 per cent of graduates in the field of sciences were women. This gender segregation in education results in occupational segregation in the labour market as the table below shows.

Employment by sector	Female	Male
Human health and social work	69%	31%
Education	60%	40%
Financial and insurance services	57%	43%
Manufacturing	46%	54%
Real estate activities	46%	54%
Wholesale and retail trade	46%	54%
Agriculture, hunting and forestry	40%	60%
Accommodation and food services	31%	69%
Information and communication	30%	70%
Public administration	30%	70%
Water supply, waste management	20%	80%
Electricity, gas services	14%	86%
Transportation and storage	13%	87%
Construction	9%	91%
Mining and quarrying	4%	96%

Source: Men and Women in the Republic of Macedonia 2012, State Statistical Office of the Republic of Macedonia

According to the World Bank's Women, Business and the Law database, fully-paid maternity leave in FYR Macedonia is 270 days. The law does not provide for paternity leave. There are laws or constitutional provisions mandating equal pay for equal work. Women are also, by law, protected from non-discrimination practices in hiring on the basis of gender and from sexual harassment in the workplace. However, no provisions can be identified that mandates the employer to give an employee the same position when she returns from maternity leave.

Entrepreneurship, access to finance

According to the World Bank's Global Financial Inclusion database that surveys approximately 1,000 people using a randomly selected nationally representative sample, in 2011 over 76 per cent of male and 72 per cent of female adults held an account at a formal financial institution in FYR Macedonia. However, fewer women than men used these accounts for business purposes. According to the 2009 Business Environment and Enterprise Performance Survey (BEEPS), 36.4 per cent of the 366 surveyed firms had women among its owners and 19.1 per cent of the surveyed firms had a female top manager. Of the 36.6 per cent of firms within the BEEPS survey sample that applied for a loan and had a woman among its owners, 16.7 per cent of these firms were rejected for loans. In comparison, 20.5 per cent of 63.4 per cent of firms with no female owners that applied for loans were rejected.