DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

As approved by the Board of Directors at its meeting on 20 July 2004

TABLE OF CONTENTS

I. EXECUTIVE SUMMARY

The Former Yugoslav Republic (FYR) of Macedonia continues to meet the conditions specified in Article 1 of the Agreement Establishing the Bank. The new Government elected in September 2002 has continued the implementation of the Ohrid Framework Agreement. Political stability and military security have been restored since the security crisis in 2001. Following the death of President Trajkovski in February 2004, Branko Crvenkovski, Prime Minister since the 2002 elections, was sworn in as the new President in May 2004. A new Government was appointed on 2 June 2004 with Hari Kostov as Prime Minister and with no major ministerial reshuffle. FYR Macedonia has continued to promote regional co-operation in south-eastern Europe in a number of ways, including through political dialogue, intra-regional trade agreements and regional infrastructural interconnections. Its Stabilisation and Association Agreement with the EU entered into force on 1 April 2004 and the country presented its application for EU membership on 24 March 2004.

The economy is continuing to recover after the severe negative shock of the security crisis in 2001. Growth in 2003 is estimated at around 3.2 per cent, macroeconomic stability has been preserved, inflation is low and monetary policy continues to be based on a de facto near-peg of the denar to the euro. However, there is little sign yet of a sustained take-off in growth. The reported unemployment rate continues to be over 30 per cent and GDP per capita remains low. The IMF stand-by programme, approved in April 2003, is on track and the government has made significant progress in reducing the large budget deficit. The economy continues to run large trade and current account deficits. Over the medium-term, export prospects should be enhanced by WTO membership, increased access to EU markets and free-trade agreements with all of the country's neighbours. Despite some recent successes, FDI, with less than US$ 1 billion of cumulative investments since 1991, is at a low level as many foreign investors continue to be deterred by a difficult investment climate and perceived political and security risks.

Overall progress in transition has been steady but slow, with the pace of structural reforms in the past two years affected by political uncertainty and changes. Good progress was registered in privatisation and private sector represents 60 per cent of GDP in 2003. Price and trade liberalisation and banking sector supervision standards are well advanced, but the regulatory framework for non-bank financial institutions is still weak. In the infrastructure sector, an independent energy regulator was set up in 2003, a restructuring plan for the power company has been approved and its privatisation programme is on track. A railways restructuring plan was agreed with the World Bank in spring 2003, but is being implemented very slowly.

The volume and the depth of the Bank's support to FYR Macedonia increased considerably during the last Strategy period (mid-2002 through mid-2004) with nine new commitments for EUR 126 million, representing a 62 percent increase of total cumulative business volume to date. This allowed the Bank to have a strong impact. It is particularly encouraging that three projects were signed with foreign sponsors, a tentative sign of renewed investors' confidence after the 2001 conflict. The Bank also promoted SME financing in the country through establishing a micro-finance bank, which has already provided finance for over 3,700 MSEs. All infrastructure projects signed in the last strategy period are contributing to further regional integration (e.g. roads, regional electricity interconnection). The low disbursement ratio has started to improve.

The main transition challenges continuing to face the country are as follows:

- Improving the business environment, particularly for SMEs, reducing bureaucracy, improving corporate governance standards, and improving SME access to financing.
- Reforming the judiciary and stepping-up the fight against corruption.
- Improving governance and strengthening the banking sector, including through consolidation.
- Implementing further regulatory reform and commercialisation in key utilities to attract strong investment flows to modernise relevant infrastructure.

In light of the transition challenges as well as the Government's intention to limit the use of new sovereign borrowings, the Bank's focus will be first on the support to the private sector, including the strengthening of the financial sector, as a channel for SME financing. In the public infrastructure sector, in addition to exploring new opportunities, the prime effort of the Bank, jointly with the relevant authorities, will be geared towards the implementation and disbursements of the existing infrastructure projects. Possible new public sector commitments will have to go hand in hand with concrete implementation progress under the existing portfolio.

The Bank's strategic priorities will be:

Corporate Sector
The Bank will mainly target its support towards strategic foreign investors and local export-oriented companies showing good corporate governance, by providing loans, guarantees or making equity investments, including through DIF. Where required, assistance to local enterprises may be provided through the TAM and BAS programmes.

Financial Sector
The Bank will focus on the following priorities: (i) Channel more funding to SMEs through commercial banks and micro-lending institutions, including through the implementation of an EU/EBRD Western Balkans SME framework; (ii) Support for the strengthening and consolidation of the banking sector through mergers and acquisitions of banks, directly with new equity investments or via EBRD's existing equity holdings; the Bank will in particular promote further entry of foreign strategic investors in the banking sector; and (iii) Expand the range of instruments offered to banks by increasing the number of TFP participating banks, offering co-financing for large local corporate clients, and supporting local banks' operations in mortgage lending, consumer finance and leasing.

Infrastructure
In addition to focusing on implementation and disbursement of existing commitments, the Bank will continue to play a crucial role, together with the EIB and the EU, in developing transport and energy projects, with a particular focus on regional linkages,

as well as municipal and environmental infrastructure. The Bank will focus on (i) supporting utility restructuring and privatisation through the implementation of the pre-privatisation agreement for the electricity company, (ii) energy projects that fit the regional energy market development such as regional electricity and gas interconnections, (iii) promoting road network rehabilitation in conjunction with restructuring of the road maintenance sector, and (iv) developing, where possible, municipal guaranteed water sector investments.

All EBRD operations in FYR Macedonia are subject to the Bank's Environmental Policy and will incorporate, where appropriate, Environmental Action Plans, in line with the Bank's mandate to actively support environmentally sound and sustainable development through its investment projects.

TC and official co-financing will remain crucial for project preparation and institution building, particularly in promoting SME lending and for public sector operations. The Bank will continue its good co-operation with the EIB and bilateral donor institutions as well as establish co-operation with the EU (in particular the EAR) through CARDS programmes in order to optimise the respective advantages of each institution, secure TC funding and co-financing, and to co-ordinate policy dialogue and project prioritisation.

II. COUNTRY STRATEGY

1. THE BANK'S PORTFOLIO

1.1. Overview of Activities to Date

The Bank has been operational in FYR Macedonia since 1993. As of 31 May 2004, the Bank achieved a net cumulative business volume of EUR 327 million (24 projects for a total project cost of EUR 805 million) across all sectors (see Annex 4), having signed projects for EUR 126 million (39 per cent of net cumulative business volume) during the last strategy period (July 2002 to May 2004).

The current portfolio has grown by 76 per cent over the last two years. Growth was generated by projects in the transport, power, agribusiness and general industries (41 per cent, 32 per cent, twelve per cent and 8 per cent, respectively, of new business volume). The current portfolio stock amounts to EUR 205 million (19 projects), of which EUR 76 million (37 per cent) are operating assets. Project implementation and accelerated disbursements will represent a key priority going forward. The two major infrastructure projects signed in the second half of 2003 (*Regional Roads* and *FYR Macedonia-Bulgaria Power Transmission Interconnection*) and the multi-city *Municipal Environmental Action Programme* -MEAP- (characterised by many small procurement packages), represent over 72 per cent of the undisbursed portfolio. This gap should gradually be reduced by end-2006 with accelerated disbursements under the MEAP and the implementation of all recent large public sector projects.

Table 1:. Sectoral distribution of EBRD commitments as of 31 May 2004

SECTORS	NET CUMULATIVE BUSINESS VOLUME					CURRENT PORTFOLIO STOCK		CURRENT OPERATING ASSETS	
Amounts in EUR millions	Num. of projects	Total Proj. Cost	EBRD Signed	%	Gross Disbursmt	Amount	%	Amount	%
Financial Institutions	**7**	**148.1**	**55.1**	17%	**44**	**27.4**	14%	**18.5**	24%
Bank lending/guarantee	3	32.2	32.2	10%	25.7	6.5	4%	0.0	0%
Bank equity *	3	105.2	19.2	6%	16.2	18.9	9%	18.2	24%
Equity Funds	1	10.7	3.7	1%	2.1	2.0	1%	0.3	0%
Small Business	**1**	**29.3**	**7.5**	2%	**6.5**	**6.3**	3%	**5.3**	7%
Infrastructure	**5**	**250.4**	**92.2**	28%	**29.5**	**72.0**	35%	**9.3**	12%
Transport	4	187.4	71.4	22%	24.1	51.2	25%	3.9	5%
Municipal	1	63.0	20.8	6%	5.4	20.8	10%	5.4	7%
Energy	**3**	**163.0**	**78.3**	24%	**38.2**	**64.1**	31%	**24.0**	31%
Power	2	77.0	57.8	18%	17.7	48.0	23%	7.9	10%
Natural resources	1	86.0	20.5	6%	20.5	16.1	8%	16.1	21%
Specialised Industries	**4**	**104.3**	**63.5**	19%	**54.3**	**14.7**	7%	**5.5**	7%
Telecommunications	2	85.8	48.8	15%	48.8	0.0	0%	0.0	0%
Agribusiness	2	18.5	14.7	4%	5.5	14.7	7%	5.5	7%
General Industries	**4**	**110.7**	**31.2**	10%	**24.4**	**20.5**	10%	**13.7**	18%
Country Total	**24**	**805.8**	**327.8**	100%	**196.9**	**205.0**	100%	**76.3**	100%

* Portfolio and Operating Assets include compounded interest for Portage Equity.

The sectoral distribution of the portfolio comprises 66 per cent in infrastructure and energy, 17 per cent in financial institutions and small business and 17 per cent in specialised and general industries. Debt is the dominant instrument (94 per cent), with equity concentrated in the financial institutions sector.

The EBRD-approved projects have mobilised a further EUR 478 million of co-investment from sponsors, co-financiers and donors, representing a multiplier of 1.5.

The Bank has also mobilised EUR 11.2 million in technical assistance to FYR Macedonia, with 61 technical co-operation (TC) projects, mainly in the banking, telecommunications, transport and municipal sectors. Disbursement of TC funds as of April 2004 stood at EUR 9.3 million, reflecting the fact that projects are still on-going in the small business finance and infrastructure (transport, municipal) sectors. (Please see details on TC programmes of the Bank in Annex 6.)

1.2. Implementation of the Past Strategy

The last country strategy, approved in July 2002, outlined the following strategic priorities and transition goals for the Bank: (i) support for export-oriented companies, including through DIF and enhanced SME financing, particularly through establishing a micro-finance bank; (ii) financing of key regional infrastructure in roads and energy, promote the privatisation of the power utility as well as explore the scope for expanding the existing municipal project; (iii) active management of EBRD equity investments in local banks, assistance with banking sector strengthening and consolidation through possible new equity investments, and exploration of the scope for projects in the light of the recently started pension reform and the new leasing legislation.

Overall, the Bank has achieved the operational objectives set out in the 2002 Country Strategy. Portfolio quality has remained good. Disbursements over the period were still low (EUR 18 million), but are gathering momentum. Improving the disbursement ratio (only 37 per cent of the portfolio is disbursed) remains a key challenge. This is partly due to two major infrastructure projects (with long implementation lead times) signed in the second half of 2003 and the difficulties with a multi-municipal project.

During the last strategy period, nine operations (seven new and two under existing projects) were signed, covering a wide range of sectors including six in the private sector (three corporate projects and three banking projects) and three regional infrastructure projects, with a total EBRD commitment of EUR 126 million. This represents a record level of commitments compared to any preceding two-year periods. The Bank signed three projects with foreign investors, including the first project in the Agribusiness sector, and one project with a local entrepreneur under the Direct Investment Facility. These projects have important demonstration impact for both foreign and domestic investors. The power interconnection transmission line with Bulgaria, a key regional project, included innovative features as the borrower for the whole project is the FYR Macedonian power utility, while its Bulgarian counterpart repays the loan through electricity supply. All new projects have good or excellent transition impact potential and are already under implementation.

Table 2: Projects signed July 2002 – May 2004

Project	Description	EBRD financing (EUR million)
Foreign Investors		**22.7**
Migros Foodstores Skopje (Turkey)	Debt financing for the construction of the first modern shopping mall in Skopje	6.7
Zitoluks (Greece)	Debt financing to a milling and wholesale bakery with a strategic investor	8.0
Prilep Marble Kombinat (Greece)	Debt financing for an export oriented marble quarry/processing company with strategic investor	8.0
Local Entrepreneurs		**2.2**
DIF – Kimiko Gardine	Equity in a local, export oriented curtain manufacturer	2.2
Financial Institutions and Small Business		**9.3**
ProCredit Bank	Equity in and credit line to a newly established micro-finance bank	7.5
Stopanska banka equity increase	Participation in the bank's equity increase following portfolio clean-up	1.8
Public Infrastructure and Energy		**91.7**
FYR Macedonia-Bulgaria Transmission Interconnection	A new high voltage transmission line and a new substation to improve regional electricity trade	40.5
Regional Roads	Sovereign financing for modernisation of Corridor X and construction of a new part of Corridor VIII	40.0
Civil Aviation Upgrading	Sovereign debt - new ANS equipment, Ohrid runway modernisation to improve regional air navigation services	11.2
TOTAL		**125.9**

The Bank has made strenuous efforts to improve the performance of the local banks where the Bank has equity participation. There have been particularly good results in the turnaround of Stopanska Banka, privatised to a strategic investor together with EBRD and IFC, and in Export-Credit Bank which improved its portfolio and is now regarded as a significant player in micro- and SME-financing. The Bank also set the Municipal Environmental Action Programme, signed in 2000, on the path of accelerated procurement and disbursement, after long preparation work and coordination efforts among the various donors involved in this project.

1.3. Transition Impact and Lessons Learned

1.3.1. Transition Impact

Enterprise sector

In the private enterprise sector, good transition results have been achieved in general by enhancing the companies' competitiveness and export potential, promoting better corporate governance, improved financial reporting and introduction of IAS, and assistance to companies in the development of their medium-term strategies. The

Bank has worked closely with its clients to encourage and support the implementation of these changes. Examples include:

Alkaloid, a locally owned pharmaceutical manufacturer and EBRD partner since 1999, has, through the Bank financed project, achieved GMP certification for its production, has advanced in the introduction of cost-accounting across its four production divisions, and has started using factoring of trade receivables, making it one of the pioneering companies in this field in the country. It has also significantly enhanced its pharmaceutical marketing and, consequently, its sales in its former Yugoslav markets. With the Bank's impetus, it has started discussions with potential strategic investors with a view to expanding its market presence and strengthening its strategic development.

Makstil, a steel manufacturing and processing company has become the only success story to date out of the eleven successors of the former large integrated steel manufacturing and processing company in the former Yugoslavia, Zhelezara. The Bank's project with the company has had a strong demonstration effect through restructuring and privatisation by sale to a strategic investor, Duferco. The company has now become an integrated part of Duferco's operations and has benefited, inter alia, from restructured corporate management, a new MIS and a joint marketing approach with Duferco. The Bank's investment project also achieved improvement of product quality and increase of production capacity, while gaining in efficiency and flexibility to meet market demands. In 2002 Makstil initiated the creation of a regional steel association with steelmakers in Serbia and Bulgaria. Companies realised that for most of their product ranges they are not in direct competition and that all of them should benefit from the joint marketing approach. Duferco's visible success has contributed to attract interest from another major steel player which has recently entered the market.

Prilep Marble Kombinat has become the first FYR Macedonian company listed on a stock exchange abroad through its very successful IPO in Greece in April 2004. With the support of its parent, FHL Kiriakidis, it is introducing an MIS and has increased its marketing and sales in new markets, enhancing world-wide competition in white marble blocks and slabs.

The transition impact of the *Thessaloniki-Skopje Pipeline* project in general is likely to take rather longer to take full effect than had been hoped. At this stage the project's impact is evaluated as "marginal". The protracted disputes with the government on contractual issues related to the acquisition by Hellenic Petroleum of the OKTA refinery (a related investment in which the Bank is not involved) have set matters back significantly. The project still has the potential for significant transition impact. It can contribute significantly to regional integration reflecting the commercial and physical infrastructure links created with Greece. The project remains very high profile since it is (together with the related refinery) the largest single direct investment in FYR Macedonia from an EU country. Skills transfers and improved corporate practices (operations, health and safety and MIS systems) have ensued from the project. Training and development have been extensive and successful. The pipeline is state of the art at a technical level and has brought new standards of engineering to the country, while significantly reducing the risk of environmental hazard linked to oil transportation.

The Bank's first direct equity investment (through DIF) in *Kimiko Gardine* has provided strong demonstration effect on the ability of small, locally owned, dynamic manufacturing enterprises to grow, be successful in export markets and attract private equity financing.

Finally, the support provided to local companies through the *Business Advisory Services* (BAS) launched in 2002, was highly successful and much appreciated by companies and government alike. Assistance focused on quality certification (ISO and other) and marketing strategies, allowing access by local enterprises to export markets.

Financial Institutions

Stopanska Banka's privatisation has been facilitated by EBRD/IFC's equity investments alongside the strategic investor, National Bank of Greece (NBG). NBG has accomplished tremendous work since then, cleaning up the inherited portfolio substantially, introducing excellent new MIS and expanding substantially into retail banking.

The most active user of the overall successful Trade Facilitation programme in FYR Macedonia has been *Komercijalna Banka*. The Bank assistance to Komercijalna Banka (of which it is also a shareholder) was particularly highly valued during the turbulent years of 1999 and 2001 when other lines were closed for FYR Macedonian banks but Komercijalna Banka, the largest bank in the country, could continue its trade financing services to local SMEs.

Active EBRD participation in the Board of Directors is highly valued particularly at Komercijalna Banka and Export-Credit Bank, where there is no strategic or significant financial investor. Export-Credit Bank in particular has benefited from improved corporate governance but also from a technical assistance programme that enabled the bank to adopt a medium-term strategy, clean up its portfolio, and significantly expand its SME lending. It is now a major financier in the SME sector.

The successful pace of lending of *ProCredit Bank*, established in July 2003, together with the expanding KfW micro-lending programmes at Export-Credit Bank and Tutunska Banka, have opened up access to financing for micro and small companies in a competitive environment for this product. This will no doubt have a significant demonstration impact with other commercial banks that were previously not interested in this market. With seven branches established within less than a year, ProCredit Bank has achieved wide territorial coverage including previously largely under-banked regions in the country.

Infrastructure

The Bank is financing a considerable number of projects in public infrastructure and the preparation and implementation of these projects brought about significant institutional reforms in the areas of sector restructuring/commercialisation as well as financial management and procurement.

The *Municipal Environmental Action Programme*, involving five water utilities in six municipalities, has introduced tighter requirements for financial management and new procurement methodology into a sector hitherto untouched by international or local financial institutions.

The *FYR Macedonia-Bulgaria Transmission Interconnection* brought the electricity utilities of two countries together through an innovative structure: one entity borrowing for the whole project while the other participant is repaying financing through electricity supply. The project is an essential step towards the physical integration of the electricity networks of south-eastern Europe and the creation of a regional effective power trading market. The two parties also work together on procurement, including turn-key contract as a first time experience for Elektrostopanstvo na Makedonija ("ESM"). Incentivised by the project, the FYR Macedonia government has requested from the Bank an expanded study, to be implemented in 2004, on energy affordability, including recommendations for a social safety net.

The Bank's involvement in the electricity sector through the above project as well as the soon to be finalised *ESM Pre-Privatisation Share Purchase* operation, further galvanised on-going sectoral reforms (energy regulator, progress on new tariff methodology and market design, restructuring of ESM and its preparation for privatisation). The preparation of the ESM pre-privatisation operation started in 2002 and bridged now two governments – both supporting it and thus building wide consensus for the process.

The *Civil Aviation Upgrading* project induced the Civil Aviation Authority to tighten its financial management, also in preparation for the separation of the air navigation service provider from civil aviation regulation, following international industry practice. However, the adoption of the separation plan has been delayed with prospects of its approval in summer 2004.

The Bank's work on the *Regional Roads* project highlighted the need for adequate road maintenance and related budget, an issue that will be further developed in the forthcoming five-year Road Plan and road maintenance restructuring plan.

Environmental impact has been an outstanding feature of all EBRD financed projects. Notably improvement on environment has been achieved at Makstil and Alkaloid as well as through the Thessaloniki-Skopje pipeline project. The management of environmental issues relating to the Skopje road by-pass has significantly contributed to develop government awareness and capacity in handling dialogue with NGOs and local communities.

1.3.2. Lessons learned

The lack of appropriate channels (including at a high level) for a *regular discussion between government and the investor community* hamstrings efficient legislative efforts as well as problem-solving on various sector- or investment-related issues. One-off events or individual lobbying can not replace regular exchanges of views. The EBRD initiative to create an Investors Advisory Council, prioritised in the previous strategy, has been agreed but not yet implemented due to delays by the

Government with appointing the council's members and then scheduling the first meeting (also in view of the recent election period). The Bank will continue its efforts to help set up this forum for systematic dialogue.

FYR Macedonia is not the only transition country where *management/employee buy-outs* (MEBO), the dominant form of privatisation, have not proved to be a success for company turn-around. Foreign investor interest in the country has been low and the few that have tried to approach local privatised companies for potential acquisition have often found that the management of these companies has an unrealistic valuation for their companies, which are typically characterised by stagnating or declining sales, over-employment and overvalued but decaying assets. This has prevented the EBRD from significantly expanding its private enterprise portfolio with local companies, focusing instead on new companies with strategic owners or newly created entrepreneurial businesses.

Overall financial intermediation remains low and local banks typically have no or *low appetite to lend to new SME customers* and continue with their collateral based lending approach. Various SME credit lines from bilateral (e.g. export promotion credits) and multilateral (e.g. EIB) are poorly used. This explains why the Bank currently has no outstanding credit lines in FYR Macedonia, other than with the newly established specialised micro-finance institution. A renewed effort is required to boost SME lending, combining EBRD long-term resources with TC supported training and institutional development programmes.

The Bank has also learnt valuable lessons in the context of its dialogue with the Government on commercialisation and privatisation of utilities vs. retaining Government control, on issues of local/central political interference in company matters or public sector procurement and, generally, on constraints to business in the country (e.g. inefficiency of the judiciary, the sluggishness on issuance of various permits, varied respect for commercial agreements signed by the Government and discretionary interpretation and application of legislation). Such lessons have helped the Bank to develop a more concrete policy dialogue with various government bodies, although our efforts to create a channel to address these issues, e.g. through a direct dialogue between private business and Government, as mentioned above, are still to bear fruits.

1.4. Portfolio Ratio and Quality

Based on the current outstanding portfolio of EUR 205 million, the private/public portfolio ratio stands at 42/58 per cent, sovereign borrowing accounting for the total financing in the public sector. The current pipeline stands at EUR 111 million, of which 90 per cent is classified as private. However further public infrastructure transactions may be considered at a later stage. Therefore on balance, it is expected that during the forthcoming strategy period, the private sector share of the portfolio will reach about 50 percent. The continuation of this positive trend will also depend on Government commitment to private sector involvement in infrastructure development, especially in the energy and transport sectors.

The average risk rating of the portfolio stands at 5.98, while the private sector risk rating is somewhat better (5.29). Whilst the overall performance of the Bank's portfolio in FYR Macedonia is good so far and there are no impaired assets, the portfolio should be closely monitored, as many of the borrowers are local utilities with bill collection/budget transfer issues or private companies in highly competitive sectors (e.g. pharmaceutical, steel).

2. OPERATIONAL ENVIRONMENT

2.1. General Reform Environment

2.1.1. Political Developments

The September 2002 parliamentary election was won by a coalition led by the Social Democrats (SDSM) and supported by DUI, the recently formed ethnic Albanian party that had come out of the NLA, the former guerrillas who fought the government in 2001. The new government confirmed the commitment to the full implementation of the Ohrid Framework Agreement that put an end to the 2001 conflict, and it pledged to fight against corruption. Early presidential elections were precipitated by the death of President Boris Trajkovski on 26 February 2004. The victor in the second round on 28 April 2004 was Branko Crvenkovski, leader of the SDSM and Prime Minister from 1992 to 1998 and from 2002 until his election as President. A new Government was appointed (without a major ministerial re-shuffle) on 2 June 2004 with Hari Kostov, a former banker and recently Minister of the Interior, as Prime Minister.

There is a consensus among all the political parties about Western integration as a key national goal. FYR Macedonia was the first ex-Yugoslav state to sign a Stabilisation and Association Agreement (SAA) with the EU in April 2001 and the SAA entered into force on 1 April 2004. FYR Macedonia lodged a membership application with the European Union on 22 March 2004.

2.1.2. Regional Integration

The FYR Macedonia government maintains good relations with all its neighbours. Despite the fact that the name dispute with Greece remains unresolved, relations between the two countries have benefited from many Greek investments in the FYR Macedonian economy. Relations with Bulgaria and Albania are good, with both countries continuing to make efforts to help internal stability in FYR Macedonia. Relations with the government in Serbia have improved significantly since President Slobodan Milosevic was forced to step down in October 2000. The Union of Serbia and Montenegro is FYR Macedonia’s leading export market. FYR Macedonia is highly committed to regional integration, as demonstrated through their sustained promotion of regional infrastructure projects, active participation in the South East Europe Regional Electricity Market (SEEREM) process and efforts to get the bilateral free trade agreements in the region implemented.

2.1.3. Integrity Issues

FYR Macedonia is ranked in the 106^{th} place – together, inter alia, with Serbia and Montenegro and Ukraine – in Transparency International's 2003 Corruption Perceptions Index for 133 countries. According to a European Commission working paper that assesses the progress of the country's Stabilisation and Association Agreement, stepping up the fight against corruption and organised crime should be top priority for the government[1]. The paper noted that organised crime was increasingly challenging state authority and putting at risk both the stability and the development of the society in the country. Urgent action is required to fight organised crime both more efficiently and more comprehensively. The paper recommended the adoption and implementation of a comprehensive strategy, in line with international and European standards and practices, including the setting up of appropriate bodies to prevent, investigate and prosecute corruption, financial as well as organised crime, to increased transparency and objectivity in various procedures performed by the executive bodies, to provide clarity in the financing of political parties, and to ensure the full implementation of public procurement legislation.

One of the most important reasons for the defeat in 2002 of the VMRO-DPMNE-led coalition government was, by general consent, the widespread public perception of the then ruling coalition as corrupt throughout. Well aware of that, the SDSM-led coalition government of Prime Minister Branko Crvenkovski set up an independent Anti-Corruption Commission responsible to parliament and headed by an administrator with a professional police background. A high-profile privatisation case involving a company close to the current ruling coalition provided an encouraging pointer to the Commission's determination to act impartially across the board. The current government appears determined to be seen to respect the rule of law by converting its strong public anti-corruption stance into concrete measures. To date, significant progress was achieved on several of the issues cited by the European Union paper (see above).

Like elsewhere in the region, trafficking in persons remains a serious problem, according to the US State Department Country Report on Human Rights Practices in FYR Macedonia, released on 25 February 2004. The report notes that the 2002 anti-trafficking law has resulted in the arrest, prosecution, and sentencing of important traffickers, and that the government has been strengthening its prevention measures.

2.1.4. Social Conditions

According to the census conducted in November 2002, whose final results were published in December 2003, the ethnic Macedonians make up 64.2 per cent of the population and ethnic Albanians a further 25.2 per cent of the total. The results disproved the claim by some ethnic Albanian politicians that their ethnic group accounted for more than a third of the population, but it also demonstrated that ethnic Albanians surpassed the 20 per cent threshold that formed the basis for the increased minority representation under the 2001 Ohrid Framework Agreement. The

[1] See the European Commission Staff Working Paper: "Former Yugoslav Republic of Macedonia Stabilisation and Association Report 2004", Brussels, SEC (2004) 373.

population's annual growth rate has been slowing down. The birth rate has fallen from 16.6 live births per 1,000 in 1990 to 13.4 per 1,000 in 2002 while the death rate per 1,000 population has risen from 6.9 to 7.7. According to estimates for 2002, life expectancy was 69 years for men and 75.1 years for women.

In the 1980s, the state provided a guaranteed and comprehensive healthcare service, which on paper still remains intact but in practice suffers from acute lack of funds, resulting in scaled back health and related social benefits. The medical profession (204 physicians per 100,000 inhabitants) is seriously underpaid and as a result, many doctors have gone abroad. The state healthcare derives most of its funding from employers' payroll contributions to the Health Insurance Fund. The balance comes from transfers from the state budget and from user fees.

Overall literacy is 94 per cent. The educational system has been drained of resources since independence. At the primary and secondary level, parents have had to make the shortfall in resources and teaching materials. Postgraduate students have fewer opportunities to study. The number of university graduates fell from 2,500 in 1990/91 to 2,150 in 1994/95 but then rose to 3,180 in 2000/01. Provision of education in the Albanian language is a highly controversial issue. In 2000/01, 30.7 per cent of primary pupils were taught in Albanian, dropping to 16.4 per cent at secondary level. The legalisation in February 2004 of the Tetovo University, which will now receive state funding along with the two Macedonian-language universities in Skopje and Bitola, represents a highly significant concession to the Albanian minority and a political success for Ali Ahmeti, former NLA leader who now has his own party which supports the SDSM-led government. Previously, governments had refused to set up a separate university teaching in Albanian or to ensure a quota system in Skopje and Bitola for the enrolment of ethnic Albanians, and declared the Tetovo University illegal in 1996.

Levels of poverty are significant in parts of FYR Macedonia. According to the World Bank, 7.5 per cent of the population were living below a consumption level of US$ 2.15 per day in 2000. The World Bank also notes that most of the poor are located in rural areas, as well as in those parts of the country most affected by ethnic tensions. The previous government had begun work on a Poverty Reduction Strategy but the full paper was not completed, as FYR Macedonia graduated from IDA and PRGF assistance from the World Bank and IMF, respectively.

2.1.5. Labour Issues

The Constitution provides for the right to form trade unions. Independent trade unions have been allowed to organise since 1992. The Confederation of Trade Unions (SSM) encompasses 17 separate unions organised according to the industry sectors. More than 50 per cent of the legal workforce is unionised. Unions are particularly strong in the garment industry. Membership is voluntary. Fee-paying members comprise almost 75 per cent of the employed labour force. Several new unions have been formed in recent years, including those for journalists, policemen and farmers. The Confederation is the government's main negotiating partner on labour issues, along with the Chamber of the Economy. Strikes are numerous and, with few exceptions, small, non-violent and confined to company grounds.

The labour market in FYR Macedonia is regarded as rather inflexible, as evidenced by a persistently high unemployment rate. According to the annual labour force survey, the unemployed accounted for about 32 per cent of the labour force in 2002, one of the highest rates among all transition countries. About 85 per cent of the unemployed have been out of work for more than one year. In some areas such as Tetovo in the west of the country, the unemployment rate exceeded 50 per cent. While there is some evidence that these rates may be exaggerated and some of those who report themselves as without a job are in fact working in the informal economy, it is clear that unemployment is one of the major sources of social strain and poverty in FYR Macedonia, and is a problem that needs to be tackled urgently. A number of labour market reforms to enhance flexibility in the labour market have been carried out in recent years, including the reduction of unemployment and severance benefits, but according to a World Bank study in 2003, employment protection legislation remains more restrictive than in neighbouring countries. Nevertheless, the same study concludes that significant reductions to unemployment can only be brought about by a vigorous, growing private sector. According to the US State Department Report on Human Rights Practices in FYR Macedonia, published in February 2004, there is some use of child labour in the informal economy and in illegal small businesses.

2.1.6. Legal Reform

FYR Macedonia is continuing to make progress in implementing legal reforms necessary for a free market economy, and has laws which are generally comparable to those of its neighbours. However, in some areas, these laws still fall short of what is generally acceptable internationally, and, most importantly, a significant gap remains between the "quality" of such laws, and their judicial and administrative implementation and enforcement. FYR Macedonia's bankruptcy law is a case in point. While such bankruptcy law fares comparatively well, FYR Macedonia does not have specialised bankruptcy courts, with bankruptcy proceedings being conducted at district court level, where skills and specialisation are missing. Similarly, FYR Macedonia's corporate governance related laws (e.g., company law) score well when compared to OECD developed criteria in this regard. Their implementation, however, and in particular, the judiciary's role in promoting high standards of corporate governance, is generally considered to be inadequate.

This implementation gap can have the dual effect of undermining the utility of the specific laws in issue and diminishing the confidence that both local and foreign investors and traders have in the legal system as a whole. It has to be noted, however, that the relevant authorities in FYR Macedonia seem to be aware of this problem, and issues relating to the judiciary's integrity, for example, are starting to be openly discussed. Also, on a positive note, in 2003, FYR Macedonia's parliament adopted a modern and advanced secured transactions law which is now in effect. While its success will ultimately depend on its implementation, legal practitioners in FYR Macedonia are optimistic about the positive effect such law will have on supporting the financing of businesses and entrepreneurs.

One of the most significant motivating factors for FYR Macedonia to improve its laws and their implementation is the prospect of EU membership. FYR Macedonia has adopted an "action plan" for harmonising its laws with the EU, and already efforts are under way to amend FYR Macedonia's telecommunications law (see Annex 2 attached).

As already stated in the previous Country Strategy, the continuing challenge facing FYR Macedonia in the coming years is to continue to upgrade its commercial laws to standards that are generally acceptable internationally and to make those laws fully effective, particularly through a strengthening of the court system, the tackling of corruption and the adoption of measures to strengthen the rule of law.

2.1.7. Environmental Issues

FYR Macedonia inherited from the past decades both poor environmental conditions (particularly in a number of hot spot locations such as Veles and Skopje) and an ineffective environmental policy framework. Much of the air pollution was caused by obsolete industrial technologies and lack of air emission control equipment, by power plants, and by increasing traffic.

By signing the Stabilisation and Association Agreement, FYR Macedonia committed itself to gradually bringing the national environmental legislation in line with the EU 'acquis'. The National Environmental Action Plan (NEAP) in1996 as well as EU's Community Assistance for Reconstruction, Development and Stabilization. (CARDS) Programme for 2002-2004 have been prioritising the restructuring and strengthening of the Ministry for Environment and Physical Planning. Until a new Ministry of the Environment, supported by an Environmental Inspectorate, is set-up, the Ministry for Environment and Physical Planning will continue to be responsible for protection of air, water, soil, flora and fauna.

Based on recommendations by the NEAP and supported by CARDS, the Government has identified specific legislative priorities and adopted the Act on Environment and Nature Protection and Promotion. The Act defines responsibilities for legislative compliance, preparing and enforcing regulations and creating conditions for sustainable development in the country. The NEAP also identified key environmental investment priorities as follows: (i) improvement of water supply services, (ii) improvement of municipal solid waste disposal facilities, (iii) development of wastewater treatment plants and (iv) addressing major pollution hot spots. The Fund for Environmental and Nature Protection and Promotion is expected to finance some environmental protection and rehabilitation measures.

All new EBRD operations in FYR Macedonia are subject to the Bank's Environmental Policy and incorporate, where appropriate, Environmental Action Plans into the legal documentation in order to address issues raised during environmental due diligence, in line with the Bank's mandate to actively support environmentally sound and sustainable development through its investment projects.

2.2. Economic Environment

2.2.1. Macroeconomic conditions for Bank operations

The economy is continuing to recover after the severe negative shock of the security crisis in 2001, but the pace of the recovery has been quite slow. Real GDP grew in 2002 by almost 1 per cent, and by an estimated 3.2 per cent in 2003, on the strength of improved export performance and some recovery in the trade and transport sectors. Economic development in FYR Macedonia continues to be impeded by a difficult business environment, high domestic interest rates which restrict access to finance and domestic investment, and very limited foreign direct investment. As a result, many businesses operate in the informal economy. While no official estimate of the size of the informal economy exists, independent estimates indicate that it accounts for a substantial part of GDP. In addition, as noted earlier, the reported unemployment rate is one of the highest in the region at more than 30 per cent of the labour force.

Over the past decade, different governments have generally adhered to strict monetary and fiscal policies, and the macroeconomic framework is one of the most stable among all transition countries. Inflation has been in low single-digit figures for several years and inflationary expectations are firmly anchored within the central bank's exchange rate policy of a de facto near-peg of the denar to the euro. The peg has been maintained at approximately the same rate for nearly seven years. Confidence in the currency was shaken temporarily during the recession of 2001-2002 but has returned in the past year and the central bank was able to lower significantly the interest rate on central bank bills during the first half of 2003. While a new governor of the National Bank was appointed in May 2004, monetary policy is not expected to change significantly in the short-term.

The government has also achieved significant success with fiscal policy over the past year. This was a particular challenge because the security crisis in 2001 had led to ballooning expenditure and the temporary imposition of a 0.5 per cent financial transactions tax that was abolished at end-2002. A substantial fiscal consolidation was achieved during 2003 with a major reduction in the general government deficit to 1.1 per cent of GDP, as a result of disciplined fiscal policy. Further cuts in expenditure are expected in 2004, partly through a planned 4 per cent reduction in public sector employment.

On the external side, FYR Macedonia continues to run large trade and current account deficits, with the latter currently 5.9 per cent of GDP. Some export markets were disrupted by the crisis in 2001 and have not yet been restored. However, export performance of some sectors, notably steel and textiles, improved noticeably during 2003 and have brought about a slight reduction in the current account deficit. Over the medium-term, export prospects should be enhanced by WTO membership, effective from April 2003, and the free-trade agreements signed recently with all of the country's neighbours. However, FDI flows, at less than US$ 100 million in 2003 (and a total accumulated stock of FDI of about US$ 1 billion since 1991), remain at a very low level. In addition to the fact that FYR Macedonia is a small market, foreign investors continue to be deterred by a difficult investment climate and perceived political and security risks, although some positive signs of renewed interest have been observed in the second half of 2003/early 2004.

2.2.2. *Access to capital*

Access to domestic sources of capital in FYR Macedonia is difficult. Domestic credit to the private (non bank) sector in 2003 was around 17.8 per cent of GDP, although it grew by more than 16.6 per cent in real terms relative to the previous year. The situation is especially difficult for SMEs, which have very limited access to bank lending due to high collateral requirements, long and complex procedures for lending, and insufficient credit risk analysis skills within banks. Evidence from the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS) in 2002 shows that SMEs rely predominantly on internal funds (including retained earnings) for financing working capital and new investments.

At the macro level, the country's investment needs are considerable. While the government has an ambitious programme of planned capital investments across various sectors, implementation is likely to be constrained for the foreseeable future by the need to maintain budget discipline and by the lack of alternative sources of funds.

FYR Macedonia currently is not rated by the main credit agencies but will soon receive a rating from Standard and Poor's and from Moody's. The country has virtually no access to international capital markets, but the country has received substantial financial support from IFIs and bilateral donors. An IMF stand-by arrangement was approved in April 2003, after which a significant part of the funds committed at the international donor conference for FYR Macedonia in March 2002 was released. The IMF programme is approaching completion and largely on track, with a public wage bill cut pending. The Fund and the government are likely to discuss the possibility of a successor arrangement in autumn 2004. The World Bank Board adopted a new three-year Country Assistance Strategy in 2003, with the possibility of funding up to US$ 165 million over the period mid- 2003- mid- 2006, provided substantial progress is made in structural reforms.

3. TRANSITION PROGRESS AND CHALLENGES

FYR Macedonia's progress in transition has been steady but rather slow, particularly over the past two years when the pace of structural reforms has been adversely affected by ongoing political uncertainty and changes and, earlier on in 2001, inter-ethnic tensions. As a result, FYR Macedonia lags behind those countries in south-eastern Europe that are candidates for EU accession in terms of progress in transition, as measured by the 2003 EBRD transition indicators (see chart below). Table 2 shows the detailed breakdown of transition indicators for the country, with a comparison to neighbouring, non-accession, countries in SEE. The country has made major progress in areas such as privatisation (which is now close to completion), price and trade liberalisation, and banking sector reform, ahead of other countries (excluding Croatia) in the Stabilisation and Association process. In particular, the country now has a very liberal trading environment and has signed free-trade agreements with all of its neighbours. It is also a member of the World Trade Organisation since April 2003. However, areas where much more needs to be done include governance and competition policy, infrastructure and non-bank financial institutions.

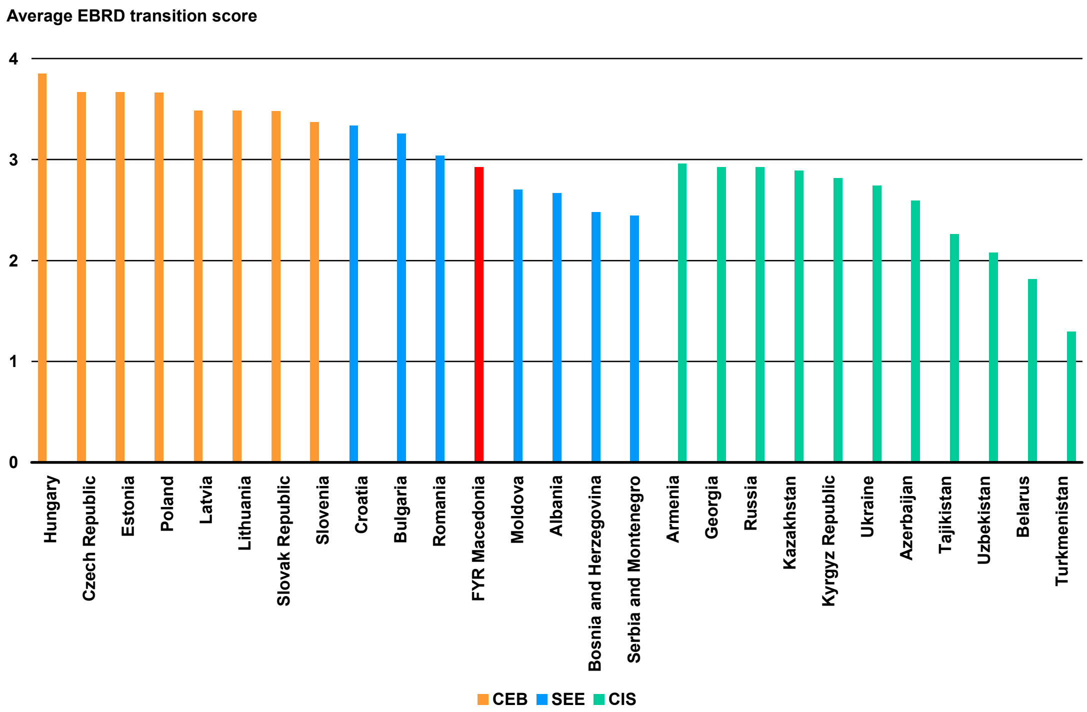


Table 3: Transition Indicators of selected SEE countries, 2003

	Albania	Bosnia and Herzegovina	**FYR Macedonia**	Serbia and Montenegro
Price liberalisation	3.7	4.0	**4.0**	4.0
Forex and trade liberalisation	4.3	3.7	**4.3**	3.3
Small-scale privatisation	4.0	3.0	**4.0**	3.0
Large-scale privatisation	2.3	2.3	**3.0**	2.3
Enterprise reform	2.0	2.0	**2.3**	2.0
Competition policy	1.7	1.0	**2.0**	1.0
Infrastructure	2.0	2.3	**2.0**	2.0
Banking sector	2.3	2.3	**3.0**	2.3
Non-banking financial institutions	1.7	1.7	**1.7**	2.0

The index ranges from 1, indicating little or no progress to 4.3 indicating standards similar to advanced industrial economies. Source: EBRD Transition Report, 2003.

The main transition challenges facing the country are as follows:

3.1. Private Sector Development

To accelerate growth and lower unemployment, a renewed effort is necessary to improve the business environment, particularly for SMEs. Reducing bureaucracy, improving corporate governance standards and enhancing SME access to financing are key for the promotion of a vigorous, dynamic private sector. As explained in the "Lessons Learned" section above, the implementation of an efficient and constructive dialogue between investors and government remains a priority. The quality of governance at all levels is low and is an obstacle to investment and to mobilising external financing. Corruption remains a serious impediment to business in FYR

Macedonia and, as noted earlier, the new government is giving high priority to addressing the problem, including through the setting-up of an Anti-Corruption Commission. However, the campaign to improve standards in public life is in the early stages and implementation will be the key challenge.

3.2. Financial Sector

Overall, the banking sector has coped well with the security crisis in 2001 and the slow-growing economy, but bad loans remain a significant portion of total credit in the economy, and interest rates on domestic-currency loans are around 13-15 per cent, partially reflecting perceived exchange rate risk. During the past year, banking supervision standards were reinforced and existing legislation was amended to extend supervisory powers and tighten licensing requirements.

However, some banks are facing difficulties and many banks have weak balance sheets. In addition to a high percentage of non-performing loans (15.1 per cent at end of 2003), the stability of the banking sector is also constrained by (i) high dependence of short term deposits, (ii) substantial "euroization" of bank assets and liabilities (about 64 per cent of deposits and 40 per cent of banks' total loans are denominated in foreign currency), and (iii) high concentration of banks deposits. Further strengthening of the banking sector and the continued enforcement of prudential regulation, particularly on corporate governance and market risks, are needed.

Despite the steady progress in the banking sector reform especially in the area of privatisation (direct and indirect state ownership of banks' capital has fallen to 13 per cent), the banking sector in FYR Macedonia remains highly concentrated and is still not competitive enough. The three largest banks hold about three-quarters of total deposits in the banking sector, while the country still has too many banks (20 banks and 15 saving houses), most of which are too small and weak to compete effectively. Weak competition results in high real interest rates, large spreads and a limited appetite for lending. Through promoting consolidation, it is crucial to enable smaller banks to strengthen their capital base, to build market share and compete with foreign and/or the larger domestic banks.

The banking sector remains vulnerable to poor standards of governance in smaller banks with non-transparent or weak ownership structures. Some banks still suffer from a significant related party lending portfolio and are treated as "pocket banks" by their shareholders. Foreign ownership amounted to almost 48.6 per cent of total bank capital at the end of 2003, but interests have generally been limited to investors from neighbouring countries. Further entry of foreign investors would increase competition and efficiency in the sector and would contribute to the improvement of corporate governance.

The development of non-banking financial institutions is still at a very early stage and capital markets are still either inactive or non-transparent. Although basic legal foundations of the non-banking financial sector, including insurance, pension and leasing, are in place, there have been delays in establishing more comprehensive regulatory and supervisory frameworks, and the implementing capacity of supervising authorities is still weak.

3.3. Infrastructure Sector

Several major utility services, including the power, gas, railway, road and water sectors, will require further regulatory and fiscal reform to attract the investment flows that are necessary to modernise infrastructure in these sectors.

Power/Energy Utilities

Since 2002, FYR Macedonia has embarked on an electricity sector reform. Amendments to the Energy Law were adopted in early 2003 to create an independent energy regulator and regulators were appointed in July 2003. The Law on ESM (the national electricity company) Transformation, including privatisation, was approved by Parliament on 24 March 2004 and ESM restructuring through unbundling is under way. The ESM Separation Plan (separating the transmission system operator from the generation/distribution company) is due for approval in summer 2004. The recommendations of the USAID financed studies on the new electricity market design and tariff methodology have been taken on board and amendments to the Energy law on market design and a new tariff methodology are in preparation for adoption in the second half of 2004. The Government intends to consider a new model of social safety measures in the energy sector by the end 2004 based on an expanded energy affordability study commissioned by the EBRD.

The Government is resolved to expand gas distribution, a project that has been blocked for years by ownership issues over the existing gas interconnection pipeline with Bulgaria. The first steps towards oil sector liberalisation have been made towards increasing competition in oil derivatives imports, hitherto largely confined to one dominant importer.

FYR Macedonia is still very wasteful of energy, with an energy intensity ratio well above EU average. Energy inefficiency and carbon intensity are also very high due to the use of locally-extracted lignite as main fuel for power generation. Introducing the use of natural gas and reducing energy waste across the economy (both public and private sectors) will have not only environmental benefits (reduced air pollution and green house gas emissions), but will also improve the competitiveness of the economy and help cut public expenditure. In addition, improved energy efficiency will help FYR Macedonia take advantage of the new international market mechanisms created to address climate change (Kyoto Protocol). In particular project or companies which have cut emissions can sell carbon credits and thus receive an additional income stream. FYR Macedonia is expected to be a net exporter of such credits.

Transport

The transport sector remains in considerable need of new investment and restructuring. A railways restructuring programme was agreed with the World Bank in spring 2003, including debt restructuring, layoffs and the division and commercialisation of the company. Progress has been slow and it is only in spring 2004 that debt-restructuring and the first lay-offs started being considered.

In the road sector, the key challenge will be to restructure the state-owned maintenance company, enhance competition in road maintenance and improve effectiveness of road planning.

The separation between the Air Navigation Services (ANS) provider and regulation aimed at institutional and structural reorganisation of the Civil Aviation Administration through the establishment of an independent financial and autonomous service provider for ANS will remain one of the main priorities in the forthcoming period in air transport. The Government also requested EU assistance with reviewing the operations, investment needs and financing options for new investments at Skopje Airport, that has long suffered from operational/financial inefficiency and under-investment.

Municipal Infrastructure

At the municipal level, in line with the Ohrid Framework Agreement, the Government has prepared draft legislation setting-up a new municipal map and aiming at significant decentralisation of central powers in fiscal and other areas. Under the new legislation, from 2005 municipalities are expected to receive substantial financial gain to their local budgets and, eventually, obtain borrowing rights. The main economic challenge is to finalise and enforce an efficient legislation, providing for a reasonable number of municipalities with strong and predictable budgets, enabling the larger cities to borrow and provide guarantees within their budgets limits. This is essential for the purpose of making investments in key areas of municipal infrastructure, and will allow to build budget planning and management capacity at municipal level.

The Government is also preparing a package of new laws on public companies, and water sector regulation, which currently provides the second major legislative challenge in the municipal sector. The water sector law is expected to be enacted by the end of 2004. New legislation shall open further opportunities for the development of water utilities, providing increasing rights in such areas as enforcing payments for consumed services, contract relations with the clients, possibility of private sector involvement, strengthening water utilities' rights in imposing and reading meters, and establishing a professional and independent regulatory body.

4. STRATEGIC ORIENTATIONS

The Bank will support the efforts of the Government to continue the implementation of the reform agenda and improve the country's investment climate in order to accelerate the development of the local private sector and attract further inflows of FDI, while continuing to modernise infrastructure on a sustainable basis. The Bank's operational priorities will cover the overall development of the private sector, further strengthening of the financial sector and the rehabilitation of the country's transport, energy and water infrastructure. Over the coming two years the following activities and sectors will be the main priorities:

4.1. Private Sector Development

The Bank will support foreign direct investments as well as local export-oriented companies. Particular emphasis will be placed on local companies showing good corporate governance and strong growth potential, and on acquisitions of MEBO privatised enterprises by strategic investors. The Bank's interventions will be through loans and guarantees, with equity mainly through DIF. Where companies wish to benefit from external advisory support, the Bank may, subject to funding availability, provide assistance through its TAM and BAS programmes. Areas of particular focus would be market positioning, quality certification or technical and environmental upgrades.

As a key step to promote improvements to the investment climate, the Bank will continue to work on the establishment of an investors' council in the country. The objective is to stimulate a focused, constructive dialogue between the private investors' community and the government, with a view to eliminating impediments to current and potential investments. The principle and draft statutes of an Investors' Advisory Council (IAC) have been agreed in principle with the government. These now need to be implemented and the IAC be given life.

4.2. Financial Sector

The Bank will seek to enhance financing for SMEs and micro-enterprises and to further strengthen the banking sector. It will in particular:

- **Develop and strengthen financial intermediation mechanisms** to reach SME and micro-enterprises, through establishing new credit lines to local banks to promote their lending to SMEs and micro business with strong capacity building components to improve their lending capacity, in cooperation with EU support and in co-ordination with relevant donors. Support the development of ProCredit Bank in terms of geographic expansion and product development (i.e. rural and agricultural lending).

- **Increase competition and efficiency** of the banking sector**,** by supporting the merger of smaller credit-worthy banks, directly or via EBRD's existing equity holdings in other banks, thereby also supporting consolidation of the sector, and through promoting further entry of foreign investors. In this respect, the EBRD is prepared to invest in a bank with strong growth potential alongside foreign investors or to play a catalytic role in inviting a strategic investor into a bank with existing EBRD equity holding

- **Diversify financial products,** in particular, by supporting local banks' operations in mortgage lending, leasing and consumer finance. Improve access to trade finance by expanding the number of participating banks and introducing pre-export financing.

- Where possible, the Bank will envisage **co-financing** (or co-guaranteeing) with local banks in favour of larger domestic companies with good creditworthiness, whose further access to funding is constrained by the single exposure limits of local banks.

In addition, the Bank will explore possibilities to develop non-banking financial intermediaries, including insurance and pension funds, subject to the development of appropriate regulatory and supervisory frameworks, which several donors are currently assisting with.

4.3. Infrastructure Sector

In addition to exploring new opportunities, the prime effort of the Bank, jointly with the relevant authorities, will be geared towards the implementation and disbursements of the existing infrastructure projects. Possible new public sector commitments will have to go hand in hand with concrete implementation progress under the existing portfolio.

The Bank will continue to work together with the EIB, the EU and the World Bank in developing the energy, municipal and transport infrastructure in the country. Priority will be given to infrastructure projects that have a strong regional dimension and which support the EU's Stabilisation and Association Process and the South-Eastern European Regional Energy Market initiative. Improving regional interconnections as well as integration into the European transport and energy networks are important to strengthen the economic links among the neighbouring countries and with the enlarged European Union.

Power/Energy Utilities

- The Bank's most important focus will be on the conclusion and implementation of the **ESM pre-privatisation project**, an initiative already started during the previous strategy period and that has now gathered renewed political support and momentum. This will be accompanied by sustained electricity sector regulatory reforms and preparation for the privatisation proper.

- The Bank is willing to consider further regional **transmission interconnection** projects, electricity or possibly gas, particularly between **FYR Macedonia and Albania** as well as **power generation projects on a least-cost basis and in the regional context**.

- Subject to solutions to gas sector issues (gas pipeline ownership, gas sector policy, including import rights) the EBRD could mobilise grant funds for the preparation of a Skopje gasification concession tender as requested by the Government. Upon the results of the feasibility studies for the construction of a **Skopje CHP**, prepared currently under WB funding, and for **Skopje gas distribution**, the Bank will explore options for financing either or both of these projects.

- The Bank will assist **energy sector reforms** with the extension of the power affordability study to include specific recommendation for FYR Macedonia safety net measures. Environmental technical assistance will be provided to ESM (introduction of environmental system management) and to the Government (programme for the harmonisation of environmental legislation in the electricity sector in accordance with the requirements of the Athens MOU on the regional electricity market).

Where possible, the Bank will also look for opportunities to include or enhance **energy efficiency** components **in industrial project projects** (particularly in local energy-intensive industries, such as e.g. steel, nickel, cement). The Bank will also explore the potential for ESCO projects.

Transport

- During this strategy period, the Bank's focus will be on the **implementation of the Regional Roads Project** (East-West Corridor VIII and North-South Corridor X), making sure that the environmental issues raised during the preparation of the Skopje bypass component are properly addressed. This will be achieved, inter alia, through the appointment of an Environmental Monitor and the establishment of an Environmental Monitoring and Advisory Group (EMAG) in summer 2004.

- In parallel, the Bank will assist the authorities in preparing an **Institutional Strategy and a Roads Plan**. The objectives are to improve the road financing mechanisms, to bring about competition in road maintenance and to implement an effective road planning system.

- As a follow-up, the Bank will seek to develop a **road rehabilitation project**, possibly with the EIB, which will be **combined with sector reform**, particularly related to enhanced competition in road maintenance and restructuring of the state-owned road maintenance company.

- Under its current Civil Aviation Upgrading project, the Bank will assist with the **separation between the Air Navigation Services provider and regulation** aimed at institutional and structural reorganisation of the Civil Aviation Administration through the establishment of an independent financial and autonomous service provider for ANS.

- In addition, the Bank will consider financing the **modernization of the Skopje airport** and review the most appropriate solution, including possibly private sector participation.

Municipal Infrastructure

In light of the forthcoming adoption of the fiscal decentralisation legislation as well as in the advent of new legislation on public utilities/water sector, including on payment enforcement and the creation of an independent regulator, the Bank will seek to develop a **water rehabilitation project for the city of Skopje.** The investment will be with principal reliance on the city budget, provided the proposed legislation strengthening local finances is passed and, in the absence of any other risk mitigating instrument, a successful track record of its implementation can be established.. This pilot project will be accompanied by substantial institution-building technical assistance for municipal financial management as well as for the water utility proper.

The lessons learnt by the Bank in the implementation of the MEAP project will be applied.

5. CO-OPERATION WITH DONORS AND OTHER IFIs

Co-ordination with international financial institutions and donors as well as TC and official co-financing will remain crucial for the implementation of the strategy. It will also be key to project preparation and institution building, in particular for public sector operations. The Bank will continue to pursue its operational objectives in close co-operation with the other IFIs active in FYR Macedonia, the European Union and bilateral donors in order to optimise the respective impact of each institution.

In particular, the Bank will enhance its co-operation with the European Union within the framework of its new 2005-2006 bi-annual indicative programme, the EU regional initiatives (e.g. Athens MoU on regional electricity market) and the overall Stabilisation and Association Process with FYR Macedonia. The EBRD will continue to co-finance with EIB in the infrastructure sectors and will seek co-operation with the EAR in financing municipal infrastructure, SMEs as well as TAM and BAS programmes.

The Bank's policy dialogue will build upon the reforms and dialogue started by the World Bank and USAID in particular in the energy and transport sectors and will closely co-ordinate energy sector projects with the World Bank, particularly on Skopje CHP and in the gas sector.

In its efforts to assist with the improvement of investment conditions in the country, the Bank will build upon the recommendations of the joint EBRD/OECD study on the development of the SME sector in FYR Macedonia as well as on the relevant FIAS study. It will associate the World Bank and the IMF in its efforts to establish a regular dialogue between the investor community and the government of FYR Macedonia.

III. ANNEXES

ANNEX 1: POLITICAL ASSESSMENT

The Socialist Republic of Macedonia was one of the six republics of the Socialist Federal Republic of Yugoslavia (SFRY) from 1945 till 1991. The Yugoslav Constitution recognised the Macedonians as one of the six constituent nations of Yugoslavia, alongside with the Slovenes, the Croats, the Serbs, the Montenegrins and (since the 1960s) the Moslems. In September 1991, the Socialist Republic of Macedonia proclaimed its independence, following a referendum in which 71 per cent of the population voted in favour. In April 1993, it joined the UN as the 'Former Yugoslav Republic of Macedonia'. This was to accommodate Greece's objection to the name 'Republic of Macedonia' which, Greece claimed, implied a territorial claim on the Greek province of Macedonia. The interim accord allowing the use of the name expired in 2002. Negotiations on a definitive solution to the question of the state's name are continuing.

For much of the 1990s, the country enjoyed a relative inter-ethnic peace, at least partly because all post-independence governments included representatives of the majority Macedonians and the ethnic Albanian minority. This changed towards the end of the decade. The deteriorating situation in Kosovo, a majority-Albanian province of the Federal Republic of Yugoslavia (FRY, successor to SFRY), played a negative role. The arrival in the spring of 1999 of hundreds of thousands of ethnic Albanians expelled or fleeing from Kosovo during NATO's conflict with Belgrade led to a rise in inter-ethnic tensions. In February 2001, ethnic Albanian guerrillas, calling themselves the National Liberation Army (NLA), started an insurgency against the government in Skopje demanding increased rights for the country's Albanian minority within a new federal structure for the state. Ethnic Albanian parties condemned the NLA's violent tactics, but the insurgency polarised public opinion along ethnic lines.

With active Western encouragement, a cease-fire was arranged in July 2001 and an agreement was signed by the main ethnic Albanian and Macedonian parties in Ohrid in August 2001. The so-called Framework Agreement is aimed at improving the position of the Albanian minority and includes the following provisions: for the use of Albanian as an official language in areas where ethnic Albanians make up more than 20 per cent of the population; for enhanced power-sharing arrangements; for increased funds for Albanian-language education; for amendments to ethnic references in the Constitution; and for an increase in the number of ethnic Albanians in the police and the civil service. NATO helped disarm and dissolve the NLA in August and September 2001.The government disbanded the so-called Lions – paramilitary units of the special police notorious for extreme nationalism and violence against civilians (especially ethnic Albanians). Ethnic Albanians welcomed the Ohrid agreement, while many ethnic Macedonians voiced misgivings about it on the grounds that concessions to ethnic Albanians would ultimately lead to the break-up of the country. However, the agreement is being implemented, if slowly. In February 2004, an important law came into force legalising the Albanian-language Tetovo University as the country's third state-financed university. However, disputes continue, especially over the implementation of the politically important but sensitive part of the Framework Agreement dealing with decentralisation. In July 2004, the coalition partners in the

Kostov government reached an agreement on the shape of the controversial plan to merge the present 123 local authorities into just 70, thus clearing the way for its immediate parliamentary approval and the holding, as planned, of the local elections in October 2004.
The September 2002 parliamentary election was won by a coalition led by the Social Democrats (SDSM) and supported by DUI, the recently formed ethnic Albanian party that had come out of the NLA. The SDSM and the DUI had campaigned against corruption and for the Ohrid agreement that put an end to the 2001 conflict. VMRO-DPMNE, the nationalist Macedonian party, which had since 1998 been in power in a coalition with the DPA, an ethnic Albanian party, had sought to exploit ethnic tensions, but without success. Early presidential elections were precipitated by the death in an air crash over Bosnia and Herzegovina of President Boris Trajkovski on 26 February 2004. The victor in the second round on 28 April 2004 was Branko Crvenkovski, leader of the SDSM and Prime Minister from 1992 to 1998 and from 2002 till his election as President. Crvenkovski won 62.7 per cent of votes, in a turnout of 53.4 per cent. Sashko Kedev, his VMRO-DPMNE opponent, obtained 37.3 per cent. Following its poor showing in the presidential elections, VMRO-DPMNE has split .

International Relations

There is a consensus among all the political parties about Western integration as a key national goal. FYR Macedonia is a member of NATO's Partnership for Peace. The country's relationship with the United States is close. It coordinates its NATO-related activities with Albania and Croatia, with US support, planning to apply for membership as soon as possible. NATO has had a logistical presence in the country since the Kosovo war in 1999. Its third peace-keeping mission there ended in March 2003 and was replaced by an EU-led mission. The EU-led peacekeeping force was replaced by a police mission in December 2003. FYR Macedonia was the first ex-Yugoslav state to sign a Stabilisation and Association Agreement (SAA) with the EU in April 2001. Together with NATO, the EU has played an active and important role over the past few years in helping resolve the country's internal disputes. FYR Macedonia lodged a membership application with the EU on 22 March 2004.

Regional Integration

The FYR Macedonia government maintains good relations with all its neighbours. Despite the fact that the name dispute with Athens remains unresolved, relations between the two countries have benefited from Greek investments in the FYR Macedonian economy. Relations with Bulgaria and Albania are good, with both countries continuing to make efforts to help internal stability in FYR Macedonia. Relations with the government in Belgrade have improved significantly since President Slobodan Milosevic was forced to step down in October 2000. In February 2001, the Belgrade and Skopje governments signed an agreement marking out their common border. The Union of Serbia and Montenegro is FYR Macedonia's leading export market. However, relations with Kosovo's provisional administration, installed in early 2000, have been beset with problems. The Kosovo Albanians objected to the 2001 border agreement between Belgrade and Skopje, saying it had been reached without their participation.

ANNEX 2: LEGAL TRANSITION

COMPARATIVE ASSESSMENT OF FYR MACEDONIA'S COMMERCIAL LAW

According to the annual EBRD Legal Indicator Surveys which have measured the perceptions of lawyers familiar with FYR Macedonian law between 1997 and 2002[2], the commercial laws in FYR Macedonia have been seen to be of reasonably good quality. However, they are neither as clear and accessible nor as adequately implemented administratively and judicially as would be the case in more advanced transition countries. FYR Macedonia's commercial laws have been gradually improving since 1997, and although in some areas they still fall short of standards that are generally acceptable internationally, they are broadly comparable to the laws of other former Yugoslav republics.

LEGAL SECTOR ASSESSMENT

Bankruptcy

The principal law that governs the liquidation of insolvent enterprises in FYR Macedonia is the Law on Bankruptcy (the "Bankruptcy Law"), which became effective on 8 May 1998 and was most recently modified in March, 2004. This law covers both liquidations and reorganisations and achieved a rating of "medium compliance" with international standards in the 2003 results of EBRD's Insolvency Sector Assessment which examined the quality of the law "on the books" (not its implementation).

Bankruptcy proceedings are conducted at the district court level which is not a specialised bankruptcy court. In practice, however, it appears that all such district courts have a bankruptcy division (although the law does not mandate that this division hear the matter). Bankruptcy proceedings must be conducted in the district where the legal entity is registered, in the case of an enterprise, or in the district where an individual debtor resides.

According to the EBRD's Insolvency Sector Assessment, the Bankruptcy Law of FYR Macedonia scored relatively well, in part, because of the clarity of its commencement criteria. Proceedings can be initiated by either a debtor or a creditor if the debtor has missed a payment and that payment has been overdue for 60 days. In addition, the process can be initiated if it can be shown that the debtor is *likely* to miss a payment (anticipatory default) in the ordinary course of business. While these

[2] From 1997 to 2002, the EBRD has conducted a Legal Indicator Survey each year to measure the progress in legal reform in Central and Eastern Europe, the Baltic States and the Commonwealth of Independent States, as viewed by local lawyers and academics. The results of such survey are based on responses to the questionnaire sent out to lawyers practising in any given country. The survey represented their perception of the country's legal system and, in particular, the degree to which key commercial and financial laws have reached internationally acceptable standards (extensiveness) and to which extent these laws are implemented and enforced (effectiveness). The survey is based purely on local lawyers' perception of their own country legislation and does not represent EBRD's own view on these legal systems. In addition, it must be noted that each respondent is asked to answer the questionnaire for his/her country only, and not on a comparative basis.

criteria are clear and transparent, the 60 day period is slightly excessive and, ideally, would be shortened.

The Bankruptcy Law provides a clear definition of the property that constitutes the estate of the bankrupt corporation. While this property includes receivables owed to the debtor, the law permits set-off for these obligations, which is typically a feature of good insolvency laws.

The priority rights of secured creditors are preserved in bankruptcy, although it appears that these creditors lose the contractual rights they may have to take possession of secured assets and must rely on the insolvency administrator to realise on these assets.

Where the law fares particularly well is in the context of reorganisations. The law imposes a fairly comprehensive stay of proceedings to protect the debtor once a reorganisation has begun. The Bankruptcy Law provides clear provisions for the drafting, submission and voting upon a reorganisation plan and, quite unique for the region, provides for reorganisation financing to be made available on a priority basis. The law could be improved, however, by providing a prohibition upon the termination of certain key services (such as the provision of utilities) during a reorganisation.

Capital Markets

The primary legislation governing the activities of the securities market of FYR Macedonia includes the Securities Law, Law on Takeovers and Law in Investment Funds. While the Securities Law was promulgated in 2000, it has been subsequently amended almost every year since then. The Law on Investment Funds came into force in 2000 and the Law on Takeovers in 2002.

The Securities and Exchange Commission ("MSEC") was established by a Government decree in June 1992. The Securities Law of 2000 confirms that the MSEC is an autonomous and independent organisation with a status of a legal entity, and that the MSEC is the main regulatory body for the securities market of FYR Macedonia, responsible for issuing approval and licenses for securities public offering, brokers and stock exchange. According to the Securities Law, for public issuance of securities, the issuer must publish a prospectus providing information for the investors about its financial performances, business opportunities and rights of share holders. Also, authorised participants on the securities market are restricted to brokerages houses and banks.

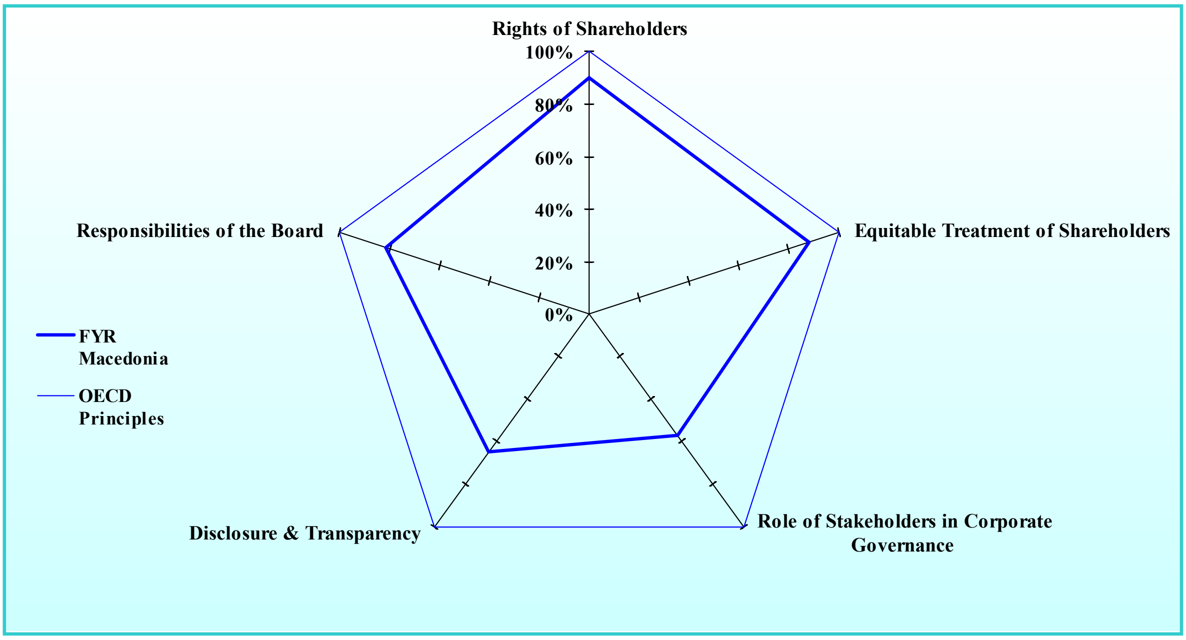
The FYR Macedonian Stock Exchange ("MSE") was founded in September 1995 and commenced trading in March 1996. According to the Securities Law, the MSE is organised as a for-profit joint stock company, with a founding capital of 500.000 Euros. MSE shareholders may be any legal and private domestic and foreign entity. Shareholding per entity is limited up to ten percent of the MSE outstanding shares. Generally speaking, the securities market in FYR Macedonia is relatively small. It has been recommended by the World Bank experts that a government securities market should be developed, which will help expand the range of market instruments and contribute to financial deepening.

The insurance sector is also comparatively small. A reform priority for the Government is to strengthen it regulatory and supervisory framework governing the operations of insurance business in FYR Macedonia.

Company Law and Corporate Governance

According to the 2003 results of the EBRD's Corporate Governance Sector Assessment, FYR Macedonia is a country whose existing corporate governance related laws (i.e., "law on the books", not how the relevant legislation is being implemented) when compared to the OECD *Principles of Corporate Governance* were rated among "high compliance" countries. General reform priorities for countries in this category are to improve effective implementation and enforcement of existing legislation. For example, the regulator should be given sufficient independence and resources to carry out its mandate; the competence of judiciary system in adjudicating corporate governance related disputes should also be enhanced. So far as FYR Macedonia is concerned, despite its good ranking for the quality of its corporate governance related legislation, the above-mentioned EBRD's Assessment in 2003 revealed that particular attention should be paid to strengthening areas such as the role of stakeholders, as well as disclosure and transparency (see chart below).

Different aspects of corporate governance legal framework (2003)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to OECD *Principles of Corporate Governance*. The fuller the 'web', the closer the corporate governance laws of the country approximates these principles.
Source: EBRD Corporate Governance Sector Assessment Project, 2003 assessment

In this regard, it should be noted that on 30 April 2004, the FYR Macedonian Parliament passed a new Law on Trade Companies. This new law replaced a similar law adopted in 1996, which was assessed under the above-mentioned EBRD Assessment as a part of FYR Macedonia's corporate governance related legislation as of 2003. The new law of 2004 does introduce stricter disclosure rules both with respect to companies' operational and general financial status and to executive compensation. The new law also enhances shareholder protection measures. For medium and large businesses, international financial reporting standards are now applicable.

In addition, pursuant to the new law, a national electronic commercial register will be created and maintained at the Central Registry. A new framework regarding business registrations is also being established to reduce the relevant time needed. The new framework is said to be structured in a manner that will support the eventual removal of registration courts from the business registration process. Pursuant to the new law, the Government is also working on consolidating business filing, licensing and application requirements so that the steps required for a business to become and continue to be operational are minimised. Certainly, despites these positive developments, the principal challenge for the country is to ensure that all the good laws "on the book" will be put into practice.

Concessions

The concessions legal framework is governed by the Law on Concessions of 2 April 2002 (no. 25/02 and 24/03) (the "Concession Law"). The new Concession Law replaces the earlier concession laws no 42/93 and 44/99. The Concession Law appears to be a flexible general framework that is to be implemented through sector laws along basic principles, such as the fundamental principle of protection of initial economic balance and the possibility for a non-winning bidder to challenge the award.

A concession is defined as "an act which regulates the rights to utilise possessions of common interest for FYR Macedonia and carrying out activities related to the possession of common interest, that are made available for concession assignment by a special law". The reference to "possessions of common interest", a concept which is not defined, weakens the law, making it open to potential misuses.

The Concession Law defines clearly the responsibility of the contracting authority. Although it does not provide for a "one stop shop", it sets out in a fairly clear and coordinated manner the division of power between different public authorities involved in the concession granting process. The Concession Law does not permit the contracting authority to enter into agreements that are subject to international arbitration, which raises a major concern for international lenders and investors.

The results of the 2004 EBRD Concession Law Assessment Project reveal that FYR Macedonia has probably one of the most advanced concession laws in south-east Europe, even though it may not yet be sufficiently tested in practice.

Secured Transactions

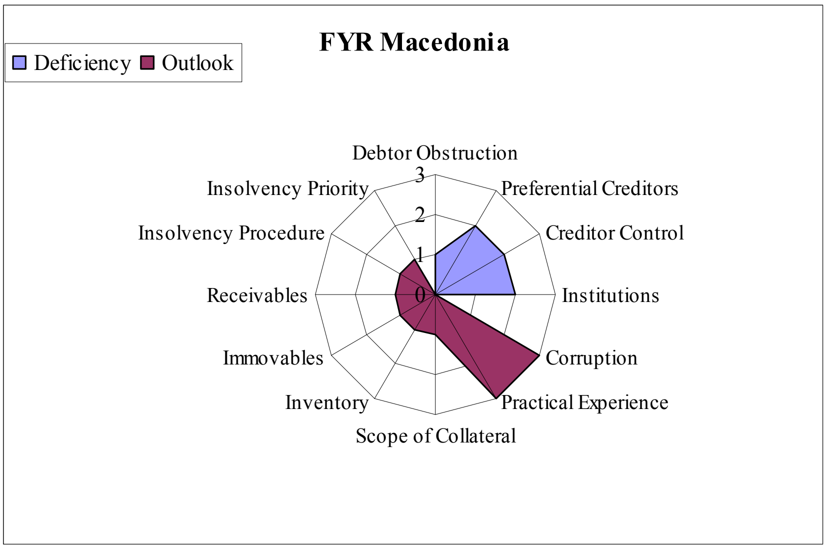
Charges are governed by the 2003 Law on Contractual Pledge (which was supported by the World Bank), which repealed the 1998 Law on Pledge of Movable Property and Rights. A charge can be granted over all types of property, movable tangible assets, securities, claims and other rights. The charge can be either possessory (i.e. requires transfer of collateral to the lender) or non-possessory. Registration in the Pledge Registry is compulsory for non-possessory pledges and optional for possessory pledges. The Law on Contractual Pledge also includes relevant provisions on mortgages over real estate.

The Registry of Pledges on Movable Property and Rights is part of a system of electronic registries administratively combined into the Central Registry of FYR Macedonia. It started operating in October 1998 whereas the Central Registry was completed on 1 November 2000. The registry's principal office is located in Skopje and it has 31 local offices across the country. Registration is made by submitting an application form which must include details of the applicant, the parties, the pledged assets, the legal basis and amount of the secured debt and the list of attached documents, and which must be signed by the applicant, the pledgor and the pledgee (or their representative(s)). The documents to be attached to the application include the pledge contract, the loan contract, the detailed and specific description and inventory of the pledged assets and the relevant powers and authorities of the parties. The pledge agreement is usually notarised in order to give the agreement on "executory title" which avoids the creditor to have to file to the court upon default to have his rights over the collateral recognised. The registrar would rely on the notary to check the identity of the parties, the title to the pledged assets, and the legal basis of the secured debt. In many case the notary also applies for registration. Upon receipt of the application an immediate entry is made in the register against the name of the borrower (pledgor) which generates a registration number and the time of registration. When all information is complete (normally within 2/3 days) the final registration is made and a certificate of registration issued to the applicant.

The 2003 Law on Contractual Pledge has made significant improvements to the legal regime for security, in particular by removing the limitation as to the assets which could be given as collateral (in the past the Law on enforcement was applicable and prohibited enforcement over assets used for the business activities of the debtor). Enforcement has been strengthened, especially by allowing self-help and out-of-court realisation of assets. The Law on Contractual Pledge is also much more detailed on the legal consequences of notarising the charging agreement to facilitate its enforcement. Some problems, however, remain. For example, secured claims still need to be precisely identified in the charging agreement and in the registration statement, which may not offer the contractual flexibility that one may want (such as overdraft facility). In addition, although the sale of assets in the ordinary course of business free from the charge is now specifically provided for in the law, it is unclear how this can function since the creation of the charge will entail the drawing of a precise inventory of assets.

In a survey conducted by the EBRD in the summer 2003 on enforcement of secured transactions, FYR Macedonia scored relatively high. It seems that secured creditors can relatively efficiently realise the charged assets and receive the sale proceeds. The survey highlighted that this finding must, however, be taken with caution as the 2003 Law is still relatively untested (see chart below highlighting the lack of practical experience). Also, experience in the country shows that even when legal provisions are clearly spelled out, it cannot be excluded that courts may actually decide otherwise. The danger is particularly acute as corruption of the judiciary is often reported to be an issue (see chart below).

Qualifying factors in the charge enforcement process



1 = no significant problems or limitations
2 = relatively minor problems or limitations
3 = major problems or limitations

The fuller the "web" of the graph, the more serious the problems are in each of the respective categories.

Process factors	Scope factors
Debtor obstruction: The possibility for the debtor to prevent, slow down or otherwise obstruct the enforcement proceedings to the detriment of the chargeholder. Legitimate exercise of right of defence or appeal is not included. **Preferential creditors:** The impact of claims of other creditors (other than prior-ranking secured claims) on the satisfaction of the secured creditor's claim. **Creditor control:** The ability of the creditor to control or influence the conduct of the enforcement procedure. **Institutions:** The reliability of the courts and other institutions necessary to support the enforcement process. **Practical experience:** The general level of practical experience with the enforcement process in the country in question. **Corruption:** The impact of corruption within the court system on the enforcement process.	**Insolvency procedure:** The impact of the debtor's insolvency on the enforcement process. **Insolvency ranking:** The priority of the secured creditor's claim upon insolvency of the debtor. **Receivables:** An assessment of the simplicity and certainty of the enforcement process for a charge over receivables. **Immovables:** An assessment of the simplicity and certainty of the enforcement process for a charge over immovables. **Inventory:** An assessment of the simplicity and certainty of the enforcement process for a charge over inventory.
	Source: EBRD New Legal Indicator Survey 2003

Telecommunications

The telecommunications sector remains regulated by the Telecommunications Administration ('TA'), a body within the Ministry of Transport and Communications (the 'Ministry'), and is governed by the Telecommunications Law of 1996, as amended in 1998 (the 'Telecom Law').

The Telecom Law adopts some of the important EU telecom regulatory provisions and provides a relatively modern framework with respect to licensing, interconnection, universal service, tariffing and quality of service. However many necessary institutional reforms remain outstanding. FYR Macedonia signed a Stabilisation and Association Agreement with the European Union in 2001 and this agreement came into force on 1 April 2004. As part of that agreement, FYR Macedonia is engaged in a process of further harmonisation of the domestic telecommunications sector with that of the EU.

Makedonski Telekomunikaciji ('MT'), the incumbent telecom operator, still holds an exclusivity to provide fixed voice telephony services, telegraphy services, telex services, public pay phone services, leased lines services and to construct own and operate fixed public telecommunications networks. MT is 51% owned by the Hungarian operator MATAV and the remaining 49% is held by the state. MT's exclusivity was originally due to expire at the end of 2005; however, the EU stabilisation and Association Agreement managed to shorten the period of exclusivity by a year to the end of 2004. During that time the Ministry is not permitted to issue any licences or concessions that infringe the exclusive rights granted to the MT.

The markets for mobile, data, Internet and alternative infrastructure have been liberalised to varying degrees. While the mobile market has been technically open to competition since 2000, meaningful competition did not arrive until November 2003 in the form of a second GSM operator, Cosmofon, a subsidiary of OTE of Greece. Mobile penetration in FYR Macedonia is relatively low; however, the arrival of a new competitor to the marketplace should have a positive effect on service uptake.

Whilst progress has been made in reforming the telecommunications sector in FYR Macedonia, further work is necessary to fully align with the EU regulatory framework. The two most critical elements now are regulatory capacity and the full rebalancing of tariffs. With respect to regulatory capacity, the government must take immediate steps to enable an appropriately empowered, fully independent (yet accountable) telecommunications regulatory authority. Such an authority must be afforded appropriate resources, financial and human, that would enable it to prepare the marketplace for the introduction of full competition at the end of 2004. Only with an effective such authority in place will meaningful competition be possible upon the expiry of the MT exclusivity.

ANNEX 3: SELECTED ECONOMIC INDICATORS

	1996	1997	1998	1999	2000	2001	2002	2003 *estimate*
Output and expenditure				(Percentage change in real terms)				
GDP	1.2	1.4	3.4	4.3	4.5	-4.5	0.7	2.8
Industrial gross output	5.0	-2.8	1.4	1.7	9.4	-4.6	-0.8	4.5
Agricultural gross output	-2.9	0.0	3.3	0.9	1.0	-10.8	-2.0	2.2
Employment 1/				(Percentage change)				
Labour force (annual average)	na	1.4	2.9	-2.1	0.6	6.3	-4.4	4.4
Employment (annual average)	na	-4.7	5.4	1.0	0.9	8.9	-6.3	-2.9
				(In per cent of labour force)				
Unemployment (annual average) 2/	31.9	36.0	34.5	32.4	32.2	30.5	31.9	36.7
Prices and wages				(Percentage change)				
Consumer prices (annual average)	2.3	2.6	-0.1	-0.7	5.8	5.5	1.8	1.2
Consumer prices (end-year)	-0.7	2.7	-2.4	2.4	6.1	3.7	1.1	2.6
Producer prices (annual average)	-0.3	4.2	4.0	-0.1	8.9	-1.2	na	na
Producer prices (end-year)	-0.6	8.6	-0.2	4.2	7.9	-2.5	1.1	na
Gross average monthly earnings in economy (annual average)	2.7	2.8	3.7	2.9	5.5	3.6	6.9	4.8
Government sector 3/				(In per cent of GDP)				
General government balance	-1.4	-0.4	-1.7	0.0	1.8	-7.2	-5.7	-1.2
General government expenditure	37.1	35.1	35.0	35.4	34.9	41.6	41.0	34.1
Monetary sector				(Percentage change)				
Broad money (M3, end-year)	-1.4	21.2	14.5	28.9	24.5	64.0	-9.3	13.9
Domestic credit (end-year)	-11.5	6.8	-31.7	12.8	-10.7	-11.5	28.8	2.7
				(In per cent of GDP)				
Broad money (M3, end-year)	11.1	12.8	14.0	16.8	18.5	30.6	26.6	29.0
Interest and exchange rates				(In per cent per annum, end-year)				
Basic rate of the NB 4/	11.0	8.9	8.9	8.9	8.9	10.7	10.7	6.5
Interbank interest rate	22.5	21.1	18.1	11.6	7.2	11.9	14.4	5.8
Deposit rate 5/	12.8	11.6	11.7	11.3	10.7	10.0	9.2	6.7
Lending rate 6/	21.6	21.4	21.0	20.0	19.0	19.2	17.7	14.5
				Denars per US$				
Exchange rate (end-year)	41.4	55.4	51.8	60.3	66.3	69.2	58.6	49.9
Exchange rate (annual average)	40.0	50.0	54.5	56.9	65.9	na	na	na
External sector				(In millions of US dollars)				
Current account	-289	-289	-269	-32.5	-75.4	-244.7	-320.8	-378.0
Trade balance	-317	-386	-515	-496.0	-690.0	-533.0	-764.0	-852.0
Merchandise exports	1147	1237	1292	1190.0	1321.0	1155.0	1113.0	1359.0
Merchandise imports	1464	1623	1807	1686.0	2011.0	1688.0	1877.0	2211.0
Foreign direct investment, net/7	12	18	118	31.9	176.2	439.0	77.0	97.0
Gross reserves (end-year), excluding gold	240	256	304	468.6	714.0	775.0	735.0	903.0
External debt stock	1123	1141	1437	1490.0	1488.0	1508.0	1635.0	1813.0
				(In months of imports of goods and services)				
Gross reserves (end-year), excluding gold	1.6	1.6	1.8	2.9	3.8	4.8	4.1	4.4
				(In per cent of exports of goods and services)				
Debt service	11.1	8.7	10.1	13.7	13.0	19.3	16.6	13.9
Memorandum items				(Denominations as indicated)				
Population (mid-year, millions)	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
GDP (in millions of denars)	176,444	186,019	194,981	209,010	236,389	233,841	243,970	254,798
GDP per capita (in US dollars)	2,226	1,860	1,790	1,837	1793.4	1718.5	1885.4	2346.2
Share of industry in GDP (in per cent)	19.5	19.9	19.0	18.4	18.1	17.5	na	na
Share of agriculture in GDP (in per cent)	10.7	10.9	11.4	11.0	10.0	9.8	na	na
Current account/GDP (in per cent)	-6.5	-7.8	-7.5	-0.9	-2.1	-7.1	-8.5	-8.1
External Debt - Reserves, in US$ millions	883.5	884.8	1133.1	1021.4	774.0	733.0	900.0	910.0
External Debt/GDP (in per cent)	25.4	30.7	40.1	40.6	41.5	43.9	43.4	38.6
External Debt/Exports of goods and services (in per cent)	86.3	83.6	99.7	101.9	91.0	107.9	119.5	112.0

1/ Figures on employment and labour force up to 1995 are based on census data and are not comparable with later years, which are based on the ILO definition of unemployed.

2/ Based on a labour force survey.

3/ General government includes the state, municipalities and extrabudgetary funds.

4/ The figure for 2000 is from the October auction, the last one of the year.

5/ Weighted household deposit rate.

6/ Weighted mid-point rates for short-term lending to all sectors.

7/ The large increase in projected FDI for 2001 is mainly due to the sale of a majority stake in the fixed line telephone company.

ANNEX 4: EBRD TECHNICAL CO-OPERATION PROGRAMMES

FYR Macedonia – 1993/2004
Overview of the EBRD TC Fund and Official Co-financing

- Aggregate TC Funds Commitment and Official co-financing signed projects;
- Future scenario.
- Detailed Breakdown of TC Projects
- Detailed Breakdown of Official Co-financing (signed) projects

Aggregate TC Funds Commitment and Official co-financing signed projects;

- Since 2000, the Bank has been actively cooperating with multi and bilateral donors in the framework of both TC projects (for which the aggregate commitments value for the period 1993 - 2004 reached the value of € 11.2 million) and Official co-financing initiatives (€ 121.2 million is the total amount of the signed projects at the end of 2003).

- TC Fund: four Donors (Japan, BRSF, USA and UK) account for more than 70% of the total aggregate commitments. Four are the sectors having more benefited from the EBRD TC Fund. Energy (€ 4.3 million), Finance & Business (€ 3.3 million), Transport (€ 1.2 million) and Telecom (€ 1.0 million) accounts for more than 80% of the committed funds. Other sectors having benefited for the TC Support have been Manufacturing – Commerce - Social services and Construction.

- Official Co-financing: by far, two IFI are the largest official co-financer and, with a total contribution of € 80.3 million, are covering the 66% of the total. The EIB is the largest co-financier with € 60.0 million followed by IFC with 20.3 million. Other co-financers are Portugal (10%), Switzerland (9%), Germany (6%), Greece (4%), Switzerland (4%). Sweden has also contributed with € 300,000.

- Active co-financiers in S&M are: EIB (€ 60.0 m), KfW (€ 7.0 m), SECO (10.5 m), IFC (€ 20.3 mm), etc.

- Key sectors:

    - municipal services (environment infrastructure and energy efficiency),
    - transport (rail , roads, airports),
    - financial institutions,
    - SME Development
    - chemical.

TC Funds and Donors
Aggregate Commitments (1993-2003): € 11.2 million

DONOR	EUR Committed
Japan	3,384,381
Balkan Regional Special Fund (BRSF)	2,657,932
USA	1,669,663
UK	565,374
Italy (including CEI)	463,147
Netherlands	418,163
Sweden	369,480
Germany	311,257
Taiwan	299,663
France	208,900
Canada	195,339
Denmark	150,000
Ireland	113,606
Switzerland	68383
Norway	16,763

Official Co-financing and Donors
Signed projects - Signing years: 1999-2003)
€ 121.1 million

DONOR	EUR Committed
European Investment Bank	60,000,000
IFC	20,297,908
Portugal	12,500,000
Switzerland	10,500,216
Germany	7,087,160
Netherlands	5,500,000
Greece	5,000,000
Sweden	300,000
TOTAL	**121,185,284**

Future scenario

- FYR Macedonia will remain among the priority countries for a wide number of bilateral donors as well as for the EU through the activities of the EAR.
- For the period 2004-2005, funds in the region € 11.0 – 12.0 million could be made available by Donors as follows:

DONOR	EUR potentially available
EAR	1.0-1.5 million
Canada	4.0 million
Italy	5.0 million
United Kingdom	0.5 million
Ireland	0.3 million
Greece	0.2 million
Sweden	Tbc
Germany	Tbc
The Netherlands	Tbc
Japan	Tbc
Denmark	Tbc
Norway	Tbc
France	Tbc
Belgium	Tbc
Portugal	Tbc
Spain	Tbc

This is a more detailed picture:

EAR

Under IP 2004, the amount of € 1.0-1.5 million has been earmarked for the implementation of a joint EAR/EBRD SME Development initiative.

Canada

- FYR Macedonia is a priority country under the Canadian CIDA SEE Fund (total of EUR 4.1 million available as of end of March).
- Grant co-financing is also possible under this fund. The fund can be used most sectors in which EBRD is active: MEI, Transport, Power and Energy, FI, SME, are all referred to in the agreement.

Italy

- FYR Macedonia is a priority Country for Italy. The *Italian TC Fund* has a still non committed budget of € 5.8 million.
- Key sectors of interest are SME Development and MEI and there is need to identify projects that could benefit from this support.
- At the high level meeting on "The Balkans: from Reconstruction to Economic Integration" held in Venice on 30 October 2003 (the "Venice Initiative"), Italy committed to make available a total grant amount of EUR 14 million in support of private sector development and the creation of modern infrastructure in energy and transportation in the Western Balkans (including FYR Macedonia). Such grant resources shall be used to finance technical assistance and other activities aimed at promoting investment projects to be co-financed by

the IFIs. In this context, the Bank will managea € 4 million envelope dedicated to private sector and SME activities, the "Italian Cooperation Fund for Private Sector Development in the Western Balkans"

- In the framework of the *Central European Initiative*, Italian funds in the amount of € 400,000 are currently disbursed to implement an Energy saving project covering, inter alia, FYR Macedonia. The CEI is now planning a replenishment, and the Country will remain a key country priority.

Switzerland, Austria and Greece

- The *Swiss CTF Fund* has been recently replenished, and FYR Macedonia is considered among their priority countries also in the frame of possible co-financing activities.
- Also Austria and Greece are considering FYR Macedonia among their priority countries. Austria has recently signed an agreement for the establishment of a framework agreement to support MEI activities in SEE Countries including FYR Macedonia. Greece funds in the amounts of 950,000 funds are still un-committed and available for TC Projects. Negotiations are on going to unblock the € 5.0 million co-financing grant committed to the MEAP project

UK

- Around £800,000 (untied) remaining in the DFID fund for SE Europe (entire Balkans). DFID has been very flexible in what it will fund - TFP, DIF, LTT, district heating, tariff reform. Projects with a strong poverty alleviation case are encouraged, however

Ireland

- EUR 300,000 available for all countries of operation (tied to Irish consultants).

Sweden

- The Bank has recently held full day consultation with the Swedish Government (Sida and Ministry for Foreign Affairs) to strengthen cooperation in the Balkan Region.
- New funding arrangements may be established in areas of MSE/SME lending, TMG, legal transition and Municipal and Environmental Infrastructure. In large scale infrastructure projects, Sida will remain active on a parallel basis.

Japan

- Japan has in the past been an extremely active donor in the Country. Their focus has shifted towards the Central Asia, but on case by case bases they may still make funding available for the Balkans.

Other

- *Denmark, Norway, France, Belgium, Spain, Portugal, the Netherlands and Germany* all have established TC Funds under which FYR Macedonia is eligible and therefore are potential donors to the TC needs arising in the country.

Detailed Breakdown of TC Projects

Commitment Name	Euro Committed	Euro Disbursed	Fund Approved Date	Commit. Stage Name	Sector
FYR Macedonia Municipal and Environmental Action Programme - Pre-feasibility Study	179,936	179,936	08/03/00	Closed	Energy
Export and Credit Bank: Retail Expert	138,392	138,392	14/07/00	Closed	Finance, Business
Skopje Bypass, Updated Feasibility Study	304,023	304,023	19/12/00	Closed	Construction
FYR Macedonia Municipal and Environmental Action Programme	1,750,000	1,217,601	28/12/00	Disbursing	Energy
Business Advisory Service (BAS) Programme in the Balkans - BAS Programme Director, Chris Rudd	38,015	38,015	13/12/01	Closed	Manufacturing
Export and Credit Bank: Director for Business Development	208,366	208,366	24/10/02	Closed	Finance, Business
Construction of the Wastewater Treatment Plant - Stip/Veles	19,600	17,780	04/12/03	Committed	Energy
Construction of the Wastewater Treatment Plant - Stip/Veles	19,600	17,890	12/12/03	Committed	Energy
Skopje airport site survey and final design	195,399	195,399	22/03/95	Closed	Transport
FYR Macedonia, ATCO refresher courses	235,408	235,408	05/02/03	Closed	Transport
FYR Macedonia, ATCO refresher courses	58,433	58,433	05/02/03	Closed	Transport
Gas distribution and expansion project	150,000	150,000	24/11/95	Closed	Energy
Gas distribution project	41,314	41,314	17/09/93	Closed	Transport
FYR Macedonia Regional Roads Project - Pan European Corridor X - Updated Feasibility Study	47,586	47,586	12/12/00	Closed	Construction
Smokvica to Gevgelija - Lender's Monitoring Consultant	120,000	22,051	12/10/01	Disbursing	Construction
SME line of credit	5,113	5,113	24/09/97	Closed	Finance, Business
Export and Credit Bank: Strategy Expert	85,300	85,300	24/05/00	Closed	Finance, Business
Komercijalna Banka	236,429	236,429	24/04/96	Closed	Finance, Business
Air Traffic Control: Y2K Compliance (phase 1)	45,500	45,500	13/09/99	Closed	Transport, Storage
Air Traffic Control: Y2K Compliance (phase 2)	117,841	117,841	13/09/99	Closed	Transport, Storage
Pilux & Danpex Initial Due Diligence	11,847	11,847	23/11/01	Closed	Finance, Business
Privatisation advisory programme - evaluation manual, training of valuators, management and procedures	198,756	198,756	03/09/93	Closed	Community/Social Services
Tourism advisory project - promotion and marketing	56,551	56,551	30/11/93	Closed	Commerce, Tourism
FYR Macedonian PTT - tender documents preparation	162,856	162,856	11/07/94	Closed	Telecommunications
Telecommunications and post institutional development - management of change programme	14,486	14,486	21/12/95	Closed	Telecommunications

FYR Macedonia Insurance Supervision Department	99,120	39,562	20/02/03	Committed	Finance, Business
Power sub-sector project - ESM project management unit	136,388	136,388	05/06/95	Closed	Energy
FYR Macedonian PTT - international traffic study	32,918	32,918	26/05/94	Closed	Telecommunications
Privatisation Advisory Programme - competition policy, law and restructuring	41,370	41,370	17/11/93	Closed	Community/Social Services
Documentary credit advisor for Komercijaina Banka	44,233	44,233	16/05/94	Closed	Finance, Business
Stopanska Banka - financial and operational audit (Phase I)	349,954	349,954	01/06/94	Closed	Finance, Business
Power sector loan (ESM) - commercial accounting and finance reporting	314,542	314,542	01/06/94	Closed	Energy
FYR Macedonia Telecommunications - corporate strategy and organisational development	121,956	121,956	01/11/94	Closed	Telecommunications
FYR Macedonia Telecommunications institutional reform and regulatory development programme	248,596	248,596	01/11/94	Closed	Telecommunications
FYR Macedonia Telecommunications - management of change	164,645	164,645	01/07/95	Closed	Telecommunications
FYR Macedonia Telecommunications - Finance, accounting and billing	294,858	294,858	01/10/95	Closed	Telecommunications
Small and medium-sized enterprises line of credit - assistance package	323,722	323,722	08/02/96	Closed	Finance, Business
Gas distribution and expansion project	128,795	128,795	08/02/96	Closed	Energy
Municipal and Environmental Action Programme	1,480,500	970,958	29/11/00	Disbursing	Energy
Telecommunications and post institutional development - management of change programme	16,763	16,763	01/12/95	Closed	Telecommunications
TurnAround Management Programme (TAM) - Fustelarko Borec	48,400	36,754	14/11/00	Committed	Manufacturing
Procurement Agent - Implementation of National Payment Card System	20,680	20,680	13/11/01	Closed	Finance, Business
FYR Macedonia Civil Aviation Upgrading Project - Assistance to Project Implementation	300,000	156,443	19/08/02	Disbursing	Transport, Storage
Replek	18,384	18,384	12/06/02	Closed	Finance, Business
Consulting Services for FYR Macedonia Transmission Line Project	49,999	42,566	12/12/02	Disbursing	Energy
Privatisation preparatory programme	79,357	79,357	01/12/91	Closed	Community/Social Services
Air Traffic Control : Y2K Compliance (2) - Computer	100,306	100,306	19/11/99	Closed	Transport, Storage
Air traffic control - Y2K compliance (2) radar display	120,000	120,000	19/11/99	Closed	Transport, Storage
Assistance to the privatisation programme - privatisation of media	119,280	119,280	01/02/94	Closed	Community/Social Services
Komercijalna Banka environmental due diligence	41,618	41,618	24/03/95	Closed	Finance, Business
Training programme - energy conservation	25,671	25,671	01/07/95	Closed	Energy
FYR Macedonia Telecommunications - finance accounting and billing	47,835	47,835	11/07/95	Closed	Community/Social Services
Komercijalna Banka due diligence and business plan	93,108	93,108	10/08/95	Closed	Finance, Business

Assistance in the review of FYR Macedonia's energy law	69,511	69,511	06/11/96	Closed	Energy
Regional Roads Project - Institutional Study	47,924	47,924	06/03/01	Closed	Transport, Storage
Kimico Gardine Market Study	11,146	11,146	31/07/03	Closed	Finance, Business
Business Advisory Service (BAS) Programme in FYR Macedonia - Framework	99,981	17,294	28/10/03	Disbursing	Manufacturing
Kmico Gardine Legal Due Diligence	5,800	5,040	31/10/03	Committed	Finance, Business
Kimico Gardine Re-registration	3,500	0	12/03/04	Committed	Finance, Business
Microfinance Bank FYR Macedonia (MMB) - Establishment	1,125,808	633,773	31/10/02	Disbursing	Finance, Business
Microfinance Bank FYR Macedonia (MMB) - Establishment	543,855	543,855	31/10/02	Closed	Finance, Business
TOTAL	**11,211,274**	**9,266,678**			

Detailed Breakdown of Official Co-financing Projects

Op Name	Organisation Name	Financier Type Name Ext	Country Name	Product Type Name	EUR Amount	Signing Year
SEAF FYR Macedonia	DEG	Bilateral Financial Institutions	GERMANY	Equity	2,087,160	1999
SEAF FYR Macedonia	International Finance Corporation	IFI	UNITED STATES	IFI Equity	2,087,160	1999
Alkaloid-AD	International Finance Corporation	IFI	UNITED STATES	IFI Loan	8,700,000	1999
FYR Macedonia Municipal & Environmental Action Programme (MEAP)	BMZ	Donor Government	GERMANY	Grant	5,000,000	2000
FYR Macedonia Municipal & Environmental Action Programme (MEAP)	Ministry of Economy & Finance	Donor Government	GREECE	Grant	5,000,000	2000
FYR Macedonia Municipal & Environmental Action Programme (MEAP)	Ministry of State and Finance	Donor Government	PORTUGAL	Parallel Loan	12,500,000	2000
FYR Macedonia Municipal & Environmental Action Programme (MEAP)	Secretariat d'Etat a l'Economie	Donor Government	SWITZERLAND	Grant	10,500,216	2000
Stopanska Banka a.d., Skopje (portage equity)	International Finance Corporation	IFI	UNITED STATES	IFI Equity	7,680,748	1999
US/EBRD SME - ProCredit Bank (FYR Macedonia)	FMO (The Netherlands Development Finance Company)	Bilateral Financial Institutions	NETHERLANDS	Parallel Loan	5,500,000	2003
FYR Macedonia Regional Roads Project	European Investment Bank	IFI	LUXEMBOURG	IFI Loan	60,000,000	2002
FYR Macedonia: Civil Aviation Upgrading Project	Sida	Donor Government	SWEDEN	Grant	300,000	2003
Stopanska Banka Capital Increase II (portage equity)	International Finance Corporation	IFI	UNITED STATES	IFI Equity	1,830,000	2002
				Report Total:	**121,185,284**	

ANNEX 5: MULTILATERAL AND BILATERAL ASSISTANCE

1. Multilateral assistance

EU-CARDS

The European Commission's CARDS multi-annual programme adopted in December 2001 earmarked EUR 110 million for financial assistance to FYR Macedonia. A further EUR 20 million programme is to be implemented nationally from the CARDS Western Balkans programme. As of January 2002, the European Agency for Reconstruction was put in charge of the implementation of the programme as well as of outstanding projects under the PHARE framework. For the last years, the EU programme has focused on:

1. Assistance with the implementation of the Ohrid Framework Agreement (ethnic representation in civil service) and support to NGOs (1999–2003: EUR 10.5 million).

2. Economic and social development (1997–2003: EUR 113.2 million): projects include the establishment of an Euro Info Correspondence Centre within the Chamber of Economy; progress with the approximation of trade legislation with the 'acquis communautaire', particularly the Company Law and Consumer Protection Law as well as the Competition and Personal Data Protection Laws, assistance with the implementation of the new State Aid Law, reform of the Law on Public Enterprises, assistance with the agricultural policy review in response to the Stabilisation and Association Agreement, preparation of the first ever agricultural report to the Government, preparation of the National Action Plan for Employment and reform of the National Bureau for Employment, small local infrastructure projects, preparation of the national steel industry strategy and strengthening of insurance supervision.

   EU road construction projects along corridors VIII and X were co-ordinated and co-financed with EIB, EBRD and the World Bank. Close co-ordination is on-going in the energy sector with EBRD and USAID where EU provides technical assistance to the newly established Energy Regulatory Commission.

3. Justice and home affairs (1997–2003: EUR 35.5 million): projects include the preparation of the national border management strategy and action plan as well as of the national police reform strategy, the assessment of the needs in the judiciary and follow up through the establishment of a national judicial training institute.

4. Environment and natural resources (1997-2002: EUR 10.43 million): the preparation of the second national environmental action plan and a national solid waste management plan as well as related feasibility studies.

Regionally, EBRD has developed excellent co-operation with EU under the regional Transport Project Preparation Facility, including, in the case of FYR Macedonia, the launch of a feasibility study for financing the modernisation at Skopje Airport.

The 2004 CARDS budget is EUR 38 million, including a project that signals the start of EU/EBRD closer co-operation in the SME sector. An EU/EBRD SME Facility is to be launched in FYR Macedonia in 2004. Its expansion to a western Balkans SME facility, support to the TAM/BAS programme as well as municipal projects, with assistance provided to municipal financial management, thus assisting with the implementation of decentralisation in FYR Macedonia, are under joint EU and EBRD consideration for the 2005-2006 CARDS period.

EUROPEAN INVESTMENT BANK

The EIB started its operations in the FYR Macedonia in the late 1990s by providing financing of EUR 130 million in support of two road infrastructure projects, namely Roads I project (signed in July 1998, EUR 70 million) involving the construction of two sections on the motorway connections between Skopje - Tetovo and Stobi - Demir Kapija, now almost completed, and Roads II project (signed in July 1999, EUR 60 million). The latter is co-financed with EBRD and mainly foresees the construction of the Skopje by-pass. For part of the project, the construction works are already well underway whereas for the other part, the award of the construction contract is expected in autumn 2004.

The EIB also cooperates closely with the EBRD in the energy sector in FYR Macedonia. In December 2003, the EIB signed a loan of EUR 13 million in favour of the ESM Power Substations project. The latter supports the national electricity company's investment plan for the rehabilitation of power substations and associated transmission lines, while EBRD is financing the construction of a new transmission interconnection between FYR Macedonia and Bulgaria.

Long term funding for SME projects and small investments at municipality level in FYR Macedonia has been provided by EIB through an Apex Global Loan facility of EUR 20 million (signed in June 2001). In order to accelerate the utilisation of available funds under this facility (only EUR 3 million disbursed so far), two additional financial intermediaries have recently been authorised to use these EIB funds. The planned EU/EBRD SME Facility, through technical assistance to participating banks, is expected also to support higher disbursement under this EIB project.

With an effort of diversifying its operations in the country, alongside its traditional activity in the transport and energy sectors, the EIB intends to explore the possibility of further co-financing opportunities with the EBRD and the other IFIs active in the region in the fields of environment (water, wastewater or solid waste), health and education.

INTERNATIONAL MONETARY FUND

FYR Macedonia joined the IMF in December 1992. Since the adoption of the last EBRD country strategy in July 2002, a new IMF stand-by arrangement, SDR 20 million, was agreed with the new Government in April 2003. The arrangement, expired on 15 June 2004 and the final review is scheduled to be considered by the IMF Board in July, provided progress is made by the Government on reducing the public sector wage bill. The authorities and the Fund are expected to begin negotiations in autumn 2004 on a new arrangement. Since summer 2002 the IMF has provided extensive technical assistance to the Government and the National Bank in FYR Macedonia, including a comprehensive financial sector assessment, assistance with fiscal decentralisation as well as public expenditure management.

The Bank closely co-ordinated with the IMF its planned approach to municipal financing and has regularly exchanged views on energy sector reforms as well as on Government assistance to private enterprises.

THE WORLD BANK GROUP

FYR Macedonia has been a member of the World Bank Group since 1993. The IBRD and IDA have approved funding for 25 projects in a total amount of over US$ 600 million. The new Country Assistance Strategy, adopted in September 2003, envisages US$90 – 165 million in new IBRD lending. The high case scenario was confirmed in spring 2004. Recent projects approved under this strategy include the areas of health sector management, public sector management adjustment, social protection and education modernisation.

The EBRD has been co-ordinating its activities with IBRD both at the level of special donor working groups and international fora (Infrastructure Steering Group, High Level Steering Group, SEEREM process) and locally. Particular attention has been paid to co-ordination and co-operation with respect to regional transport network development, to the creation of a regional electricity market in south-eastern Europe as well as energy sector reforms and the enhancement of enabling business environment in FYR Macedonia.

To date IFC has committed over US$90 million in direct financing and US$25 million through syndications in FYR Macedonia. Its projects cover a broad range of sectors (finance, general industry, telecommunications). The Bank and IFC have co-financed the Stopanska banka privatisation project with the National Bank of Greece as a strategic investor as well as the modernisation of Alkaloid, a local pharmaceutical company. Both IFIs took equity participation in SEAF, a local equity fund and in ProCredit Bank, a micro-finance institution. IFC is currently focusing on support to SMEs and micro-businesses, post-privatised export-oriented companies as well as infrastructure.

2. Bilateral assistance[3]

GERMANY

In the area of *financial co-operation*, assistance from Germany has focused on
- environment (including water supply and disposal/waste disposal) - EUR 45 million;
- social infrastructure (including municipalities, professional training, strengthening of civil society) - EUR 21 million;
- development of a market economy (including banking sector, SMEs, modernisation of agriculture, EU approximation) - EUR 29 million.

[3] Over 20 countries have been providing various types of economic assistance to FYR Macedonia for the last ten years. In order to illustrate this generous support, some of the largest donors, providing annual assistance in excess of EUR 10 million, have been presented in this strategy paper (in alphabetical order of countries)

Over the next years the focus of financial co-operation will be on municipal infrastructure (e.g. solid waste management in south-western FYR Macedonia, water supply and sewage in Tetovo municipality) and on the financial sector (SME credit lines, including through EBRD client banks).

In the early years, German *technical cooperation* in FYR Macedonia was supporting activities addressing immediate needs in the country like basic health services, rehabilitation of irrigation and water supply systems and planning of traffic infrastructure. In the follow-up, technical co-operation was expanded to other sectors, including assistance with the start-up of private enterprises, the improvement of food control system, new economic legislation and overall technical support to the water sector. Further on, the cooperation was expanded, inter alia, to agriculture, consumer protection and vocational training as well as to support of EU approximation.

Technical assistance funds committed in 1992-2003 are over EUR 52 million and cover the following sectors: market economy, employment, water, environment, infrastructure, civil society, social services, health, legislation and EU approximation.

The focus of technical co-operation in the future is agreed to be on increased support to the EU association process, further assistance with the development of a market economy and the implementation of the process of decentralization as well as on strengthening civil society and democracy.

JAPAN

Japan commenced bilateral assistance in 1994 and remains a significant donor to FYR Macedonia. Assistance began this year with technical cooperation, while grant aid and a grassroots grant aid scheme (municipal level) were started in 1995 and 1996 respectively.

Total disbursements had reached USD 86.8 million at the end of 2001. This consisted of USD 72.8 million in grant aid (84%) and USD 14.1 million in technical cooperation (16%). Areas of grant aid projects include: balance-of-payment support; medical equipment and facilities; primary health care; emergency disaster relief (during the security crisis of 2001); and food production increase. In addition, the re-scheduling of JPY 535 million in debt was agreed in 1997. According to OECD (DAC) data, Japan was the top donor to FYR Macedonia in 1998 and the second in 1999.

More recently, the first yen loan project (concessional loan) worth 9.7 billion yen, for the improvement of water utilisation in the Zletovica basin was signed during the visit to Japan of the late President Boris Trajkovski in October 2003. In addition, a grant aid project worth JPY 697 million was signed in June 2004, for the improvement of the water supply in seven districts adjacent to the capital Skopje. Prior to this signing, assistance was also extended for the preparation of a detailed design of this project.

Japan has implemented almost all of the USD 1 million it committed at the FYR Macedonia donors' meeting held in Brussels in March 2002.

THE NETHERLANDS

The Netherlands' assistance to FYR Macedonia consists, among others, of balance of payment support to help the structural adjustment process in the country as well as of support to education. Furthermore, the Netherlands is promoting good economic governance and the development of private sector.

In the field of good governance, the projects of the Netherlands cover three areas: public finance, decentralisation and the rule of law. In public finance the main activities are channelled through a Trust Fund at the World Bank to support the Public Sector Management Adjustment Loan of the World Bank. Furthermore, the Netherlands have been providing, including in 2004, macroeconomic support to FYR Macedonia. Projects also included twinning between the Ministries of Finance of the Netherlands and FYR Macedonia and assistance with the sale of twenty-two loss-making enterprises.

UNITED STATES OF AMERICA

The USAID programme in FYR Macedonia consists of more than 30 projects with its key focus on assisting the implementation of the Ohrid Framework Agreement. The programme, whose 2004 budget is US$ 30.3 million, is organised under three significant strategic objectives and is supporting activities that are cross-cutting in nature:

1. Accelerated development and growth of the private sector

USAID's programmes are aimed at strengthening the financial sector, improving the competitiveness of selected FYR Macedonian business sectors as well as access to capital, supporting the development of an enabling environment for economic activity and encouraging local economic development.

Areas of enhanced co-ordination and co-operation with EBRD as well as of synergies with EBRD operations:

- FYR Macedonia Financial Sector Strengthening project (implementation of modern standards and practices in accounting, banking, capital markets, the pension system and the non-bank financial sector);
- SME Commercial Finance Fund (short-term working capital financing) – sharing experience with EBRD on new financing instruments in FYR Macedonia (pre-export financing, factoring);
- Micro-lending through "Mozhnosti" Savings House;
- Company Law and Corporate Governance project (assistance with new company law, with increasing understanding about the concept of good corporate governance and with raising awareness among shareholders about their rights);
- WTO Compliance Activity;
- Fiscal Reform Project (including capacity building at the Ministry of Finance to identify and investigate complex financial crimes, like money laundering);
- Electricity Sector Reform (assistance with new market design and tariff methodology).

Co-financing with EBRD:

- - Small Enterprise Assistance Fund (SEAF) – venture capital fund;

- - ProCredit Bank – a new micro-finance bank in FYR Macedonia.

2. More legitimate democratic institutions

The objective is to foster the development of more legitimate democratic institutions, inter alia, by helping local government increase its authority and become more accountable, training citizens to participate in political and social decision making and by strengthening the independence of the judiciary and enhancing the rule of law.

3. Mitigation of adverse social impacts of the transition to a market-based democracy

USAID and its partners are working to improve education and strengthen human capacity in FYR Macedonia.