

**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 11 July 2006

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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. Implementation of the Ohrid Agreement and progress in EU accession continue to support political stability. In December 2005, the country received the status of official EU candidate. The signing of the Ohrid agreement in August 2001 marked the end of the uprising by ethnic-Albanian guerrillas. It provides, inter alia, for a territorial decentralisation programme aimed at giving the local authorities a greater role in local governance. Although the Ohrid Agreement is unpopular with some of the ethnic Macedonians, a referendum on the territorial re-organisation law, held on 7 November 2004, failed. Parliamentary elections took place on 5 July 2006.

A new three-year SDR 51.7 million Stand-By Arrangement, focusing on reforms in health care, the judiciary and the labour market, was approved by the IMF in August 2005. Real GDP growth reached 4 per cent in 2005 with strong performance of the steel, textile and chemical industries. In February 2006, the country joined the Central-European Free Trade Agreement (CEFTA) and this may have a positive impact on trade performance. The stable growth performance at around 4 per cent per year should be sustained in the medium term, supported by progress in EU accession process and further structural reforms. Unemployment remains high, at 36.5 per cent as of the end of 2005. Monetary policy continues to be based on a de facto near-peg of the denar to the euro. Reforms to fiscal management and planning have improved the stability of public finances.

FYR Macedonia has recorded steady progress in structural reforms in recent years. Following a new pension law of September 2005, private pension funds emerged as a result of the pension reform. In January 2006, a one-stop shop system for registration of businesses was enforced, reducing the procedure of establishing a business. In March 2006, a new bankruptcy law was approved by the parliament. Fiscal decentralisation has begun to be implemented which has created opportunities for greater local government autonomy and control of local infrastructure investments. In January 2005, a new power transmission company, AD MEPSO, was unbundled from the previously integrated state power company. In August 2005, further power sector restructuring steps were approved by the government. The new power distribution company, AD ESM, was sold to EVN AG, an Austrian investor in March 2006. The Regulatory Energy Commission is meanwhile working on a new system of calculating electricity tariffs. In May 2005, the government completed talks with the World Bank on a EUR 15 million railways restructuring loan, following the adoption of the railways restructuring legislation by the parliament in April 2005. Recently acquired candidacy status for the EU accession is now providing a further impetus for continuation of structural reforms.

The volume of the Bank's support to FYR Macedonia increased modestly during the last Strategy period (mid-2004 through mid-2006) with 7 new commitments¹ for EUR 86 million², bringing total cumulative commitments to EUR 403.7 million, 55.7 per cent of

¹ 4 new operations, 1 under the West Balkan SME Facility, and 2 under the Regional Trade Facilitation Program.

² Excluding TFP guarantees.

which are in the private sector. It is encouraging that 2 projects were signed with foreign sponsors, despite a general perception about a difficult investment climate in the country.

The main transition challenges are:

- Improving the business environment, particularly for SMEs - speeding up the ongoing judiciary reforms, stepping-up the fight against corruption, reducing bureaucracy (long administrative procedures with unpredictable outcomes, and unequal treatment of licence applications), and reducing ambiguities over property rights;
- Strengthening the banking sector to reduce the high cost of financing, improving access of SMEs to finance; and
- Implementing privatisation and commercialisation, and improving regulation of key utilities to attract strong investment flows to modernise relevant infrastructure in line with the country's new decentralisation process.

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, the Bank, jointly with the relevant authorities and other IFIs, will support the rehabilitation of key infrastructure projects through its support to further privatisations in the power sector and possible concession/PPP projects (e.g. the Skopje Airport). The Bank's continued support to the successful implementation of the existing operations is a key precondition in identifying follow-up projects in the energy, transport and municipal sectors. The Bank's strategic priorities will be:

Corporate Sector: The Bank will target its support towards smaller-scale local export-oriented companies showing good corporate governance, by providing loans, guarantees or making equity investments, including through the new EBRD-Italy Western Balkans Local Enterprise Facility. Assistance to local enterprises will be provided through the TAM/BAS programmes. The Bank will continue its support to strategic foreign investors.

Financial Sector: The Bank will continue to focus on (i) providing banks with funding and institutional support to assist the banks develop new products (including TFP and co-financing), grow their business on a sustainable basis, and improve corporate governance; (ii) channelling more funding to SMEs through commercial banks and micro-lending institutions, including through the implementation of the EU/EBRD Western Balkans SME framework and the MSME Finance Framework for Western Balkans and Croatia; and (iii) supporting the banks in attracting strategic investors and promoting sector consolidation with its possible participation in mergers and acquisitions of smaller creditworthy banks.

Infrastructure: The Bank will focus on (i) supporting privatisation and commercialisation of public utilities, also through the implementation of the pre-privatisation agreement for the newly un-bundled electricity distribution and generation companies, (ii) energy projects that fit the regional energy market development such as regional electricity and gas interconnections, (iii) promoting regional transport networks, including the support to Skopje Airport concession and the restructuring of the road

maintenance sector, and (iv) supporting the new fiscal decentralisation process, including through 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 promoting smaller scale local enterprises and for public sector operations. The Bank will continue its close co-operation with the EU/EAR and bi-lateral donor institutions. A decision to create the new Western Balkans Multi-Donor Fund was made at the EBRD Annual General Meeting in London (21-22 May 2006). Eleven countries agreed to provide a total EUR 10 million in donor funds towards a new EBRD-driven initiative to boost private business investment and infrastructure development in the Western Balkan countries, including FYR Macedonia. The new multi-donor fund will strengthen EBRD – donor coordination in FYR Macedonia and expand the resources available to support economic growth and regional cooperation.

List of Abbreviations

AD ELEM	The Macedonian Power Generation Company
AD ESM	The Macedonian Power Distribution Company
AD MEP SO	The Macedonian Power Transmission Company
AEC	Agency for Electronic Communications
BAS	Business Advisory Services
BRSF	Balkan Regional Special Fund
CARDS	Community Assistance for Reconstruction, Development and Stability
CEFTA	Central European Free Trade Agreement
CEI	Central European Initiative
CSD	Central Securities Depository
DIF	Direct Investment Facility
DUI	Democratic Union for Integration
EAR	European Agency for Reconstruction
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	Export and Credit Bank
EIA	Environmental Impact Assessment
EIB	European Investment Bank
ETC	Early Transition Countries
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
IBRD	International Bank for Reconstruction and Development
ICT	Information and Communication Technology
IDA	International Development Association
IFC	International Finance Corporation
IFI	International Financial Institution
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPA	Instrument for Pre-Accession
IPPC	Integrated Pollution Prevention and Control
ISPA	Instrument for Structural Policies for Pre-Accession
JBIC	Japan Bank for International Cooperation
JETRO	Japan External Trade Organization
JICA	Japan International Cooperation Agency
JSC	Joint Stock Company
KfW	Kreditanstalt für Wiederaufbau
LSG	Local Self Government
MASP	Multi Annual Strategic Plan
MBI	Macedonian Stock Exchange Index
MEAP	Municipal Environment Action Programme
MEDF	Macedonian Enterprise Development Foundation
MEI	Municipal and Environmental Infrastructure
MSE	Macedonian Stock Exchange
MSEC	Macedonian Securities and Exchange Commission
MSME	Micro, Small and Medium Enterprise
NATO	North Atlantic Treaty Organisation
NBRM	National Bank of the Republic of Macedonia

NEAP	National Environmental Action Plan
NLA	National Liberation Army
OBNOVA	EU aid to Bosnia and Herzegovina, Croatia, the Federal Republic of Yugoslavia and the Former Yugoslav Republic of Macedonia
OECD	Organisation for Economic Co-operation and Development
OSCE	Organisation for Security and Co-operation in Europe
PHARE	Pologne, Hongrie Assistance à la Reconstruction Economique
PPP	Private Public Partnership
PTO	Public Telecom Operator
SEAF	Small Enterprise Assistance Fund
SEE	South-eastern Europe
SIDA	Swedish International Development Corporation Agency
SME	Small and Medium Enterprise
TAM	Turn Around Management
TC	Technical Cooperation
TEB	Tetovska Banka
TEC	Thermal Power Company
TFP	Trade Facilitation Program
TKB	Teteks Kreditna Banka
UN	United Nations
UNCITRAL	United Nation Commission on International Trade Law
USAID	United States Agency for International Development
WB	World Bank
WBMDF	Western Balkans Multi-Donor Fund
WHO	World Health Organisation
WTO	World Trade Organization

Currencies

MKD	Denar, FYR Macedonia
EUR	Euro, European Union Currency
SDR	Special Drawing Right
USD	United States Dollar

Exchange Rate¹

1 EUR	61.17 MKD
1 USD	48.66 MKD

¹ 14 June 2006

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 2006, the Bank achieved a cumulative business volume of EUR 403.7 million across all sectors (see Annex 5), having signed projects for EUR 86 million¹ (21 per cent of net cumulative business volume) during the strategy period (July 2004 to May 2006).

The current portfolio has grown by 27 per cent over the last two years. Growth was generated by projects in the power & energy, general industries, and financial institutions (52 per cent, 29 per cent, and 19 per cent, respectively, of new business volume). The current portfolio stock amounts to EUR 261.6 million, of which EUR 145.3 million (56 per cent) are operating assets. The three major infrastructure projects (Regional Roads, FYR Macedonia-Bulgaria Power Transmission, the ESM Power Pre-Privatisation) and the multi-city Municipal Environment Action Program (MEAP) with small procurement packages, represent 83 per cent of the undisbursed portfolio. The disbursement will be accelerated in accordance with progress of procurement and construction activities under these public sector projects.

Table 1: Sector distribution of EBRD commitments as of 31 May 2006

SECTORS	NET CUMULATIVE BUSINESS VOLUME				CURRENT PORTFOLIO STOCK		CURRENT OPERATING ASSETS	
	Num. of projects	Total Project Cost	EBRD Signed	%	Amount	%	Amount	%
Financial Institutions	8.7	151.0	79.0	19%	51.0	19%	38.1	26%
Bank lending/guarantee	4.1	56.0	43.0	11%	22.8	9%	12.5	9%
Bank equity *	3.5	69.0	23.0	6%	19.7	8%	18.9	13%
Non Bank Financial Institutions	0.0	1.0	1.0	0%	0.0	0%	0.0	0%
Equity Funds	1.1	12.0	4.0	1%	2.2	1%	0.4	0%
Small Business	0.1	12.0	8.0	2%	6.3	2%	6.3	4%
Infrastructure	5.0	224.0	88.0	22%	66.8	26%	31.7	22%
Transport	4.0	186.0	71.0	18%	50.8	19%	21.3	15%
Municipal	1.0	38.0	17.0	4%	16.0	6%	10.4	7%
Energy	4.0	204.0	122.0	30%	99.9	38%	35.2	24%
Power & energy	3.0	122.0	103.0	26%	90.2	34%	25.5	18%
Natural resources	1.0	82.0	19.0	5%	9.7	4%	9.7	7%
Specialised Industries	3.3	117.0	69.0	17%	18.9	7%	15.2	10%
Telecommunications	2.0	78.0	47.0	12%	0.0	0%	0.0	0%
Property and Tourism	0.0	15.0	4.0	1%	3.8	1%	0.1	0%
Agribusiness	1.3	24.0	18.0	4%	15.1	6%	15.1	10%
General Industry	4.0	124.0	47.0	12%	25.0	10%	25.0	17%
Country Total	25.1	820.0	403.7	100%	261.6	100%	145.3	100%

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

The sectoral distribution of the portfolio comprises 64 per cent in infrastructure and energy, 19 per cent in financial institutions and small business and 17 per cent in specialised and general industries. Debt is the dominant instrument (85 per cent), with equity concentrated in the financial institutions sector.

¹ Excluding TFP guarantees.

The EBRD-approved projects have mobilised a further EUR 413.1 million of co-investment from sponsors, co-financiers and donors, representing a multiplier of 1.02.

The Bank has also mobilised EUR 12.7 million in technical assistance to FYR Macedonia, with 72 technical co-operation (TC) projects, mainly in the banking, telecommunications, transport and municipal sectors. Disbursement of TC funds as of May 2006 stood at EUR 11.1 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 7.)

1.2. Implementation of the Past Strategy

The last country strategy, approved in July 2004, outlined the following strategic priorities and transition goals for the Bank:

- 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.
- 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.
- 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.

Overall, the Bank has achieved the operational objectives set out in the 2004 Country Strategy. However, the limited flow of FDIs has also constrained the Bank's activities with strategic investors, while the country's very low level of financial intermediation is also a demonstration of a limited impact of the Bank's credit lines to local banks to reach the real economy sectors. Portfolio quality has remained good. Disbursements over the period improved from 37 per cent of the portfolio to the current 55 per cent. Improving the disbursement ratio remains a key challenge.

During the last strategy period, 7 operations (3 new operations and 2 under the existing West Balkan SME Credit Line, and 2 under the regional TFP) were signed, with only one in the public sector. In November 2005, the EBRD extended a EUR 25 million loan to Mittal Steel Skopje. The loan is being used to improve the energy efficiency of the mills,

provide working capital and support further regional integration of the steel industry. With this loan, Mittal Steel Skopje is showing its commitment to supporting cleaner environment, in particular by enhancing energy efficiency at the plant, but also improving local communities. Mittal Steel Skopje was established through the acquisition of two steel-rolling mills in Skopje in 2004 by Mittal Steel Company. Since taking over these companies, Mittal Steel Skopje has contributed to revive a crucial part of the economy that otherwise remained stagnant.

In December 2004, the Bank gave a EUR 20 million syndicated loan to Tutunska Banka, majority owned by Slovenia's largest bank, Nova Ljubljanska Banka. This was a landmark transaction for the country since it was the first international syndication of a Macedonian bank since 1998. The Bank syndicated EUR 13 million to 10 international banks. The loan was fully disbursed and was used to help meet entrepreneurs' and private businesses' growing demands for finance. The Bank's relationship with ECB, a private bank specialising in lending to small and medium-sized enterprises (SMEs), was further extended with the approval of the EUR 5 million SME credit line. In December 2004. ECB is using the EBRD loan to on-lend to entrepreneurs in a variety of sectors, including production and manufacturing, services, wholesale and trade, who plan to expand their business. In October 2005, Investbanka was granted a EUR 4 million loan under the EU/EBRD Western Balkans SME Finance Facility, to on-lend to private local SMEs. Investbanka is a private local bank focused on the SME market segment. The European Agency for Reconstruction provided EUR 460,000 in technical cooperation to support Investbanka in the development and implantation of the SME programme throughout the country. The Bank also made strenuous efforts to improve the performance of the local banks where the Bank has equity participation.

In October 2004, the Bank provided up to EUR 45 million to support the privatisation of the state-owned power utility, ESM. The Bank's investment has supported the sector restructuring and reforms needed for ESM to be sold to a strategic investor. Each of the envisaged seven disbursements is associated with key conditions to be met by the government. These include the appointment of an experienced advisor to structure the privatisation process, the implementation of necessary regulatory reform in the energy sector, and the observance of the appropriate steps to ensure an open, competitive and transparent privatisation process. The Bank has made strenuous efforts to set the ESM Power Pre-Privatisation on the path of accelerated execution. Under the project the power sector has been un-bundled in 2005 and ESM power distribution was successfully sold to EVN AG, an Austrian investor in March 2006. The Bank is considering its possible equity participation in the new company.

The Bank also worked closely with executing agencies of the MEAP, FYR Macedonia-Bulgaria Power Transmission, Regional Road projects and set them on the path of accelerated procurement and disbursement. All new projects have good or excellent transition impact potential and are already under implementation.

Table 2: Projects signed July 2004 – May 2006

Project	Description	EBRD financing (EUR million)
Foreign Investors		25.0
Mittal Steel Skopje	Debt financing to improve the energy efficiency of the mills with strategic investor.	25.0
Financial Institutions		
Tutunska Banka	Provision of short and medium-term loans to private sector corporate customers.	7.0
Export and Credit Bank	SME credit line for on-lending to small and medium-sized businesses.	5.0
Investbanka	SME credit line for on-lending to small and medium-sized businesses.	4.0
Investbanka	Regional Trade Facilitation Program.	1.0 (TFP Limit)
Eurostandard Bank	Regional Trade Facilitation Program.	1.0 (TFP Limit)
Public Infrastructure and Energy		16.0
ESM Pre-privatisation	Purchase of shares in power utility to support restructuring and privatisation.	45.0
TOTAL		86.0

1.3 Transition Impact of the Bank's Portfolio and Lessons Learnt

Corporate Sector

Agribusiness: The first project, for a large bakery, has so far achieved some restructuring of the company, including labour restructuring, and corporate governance changes. Lasting transition impact will be secured only by commercial success which requires further progress in company restructuring. The second project, a retail operation (Ramstore), has opened for business in a very short time frame, and prospects for achieving transition impact are good.

Industry: The Bank has extended loans to two large steel producer in the country, Makstil (now fully repaid) and Mittal Steel, the largest pharmaceutical company, Alkaloid (now fully repaid), and a marble quarrying and processing company, Prilep Marlbe (now fully repaid). All loans were extended in the context of expansion and modernisation projects. Successfully though they could be in achieving long term transition impact, these projects have yet not fundamentally changed the situation: the country's industrial sector and parts of its service sector remain beset by shortcomings in corporate governance as a result of a privatisation process that often favoured company insiders. Further major improvements in corporate governance, transparency, lowering of corruption, enforcement of commercial legislation and enterprise restructuring are necessary.

Natural resources: the Bank's exposure has been limited to the Thessaloniki-Skopje Crude Oil Pipeline Project. While the project helped set industry standards and transfer of skills, there were several key exclusive concessions that were granted to Greece's Hellenic which had significant transition impact risks, as they had the potential to inhibit competition and private sector development. **A lesson learned from** the Thessaloniki Skopje Crude Oil Pipeline project is that the Bank's policy dialogue should be limited to situations where vested interests of some government officials would not hamper the implementation of the sector reforms required by the project, and in principle agreed with the government (PE03-242). In telecommunications, the Bank extended loans to the state-owned PTO in the 1990s with moderate success. In recent years, the Bank continued to help prepare the privatisation of the state-owned PTO, which in the end proceeded successfully without further financial contribution of the Bank.

Overall, so far, a *minimal* transition impact has been achieved in the *Corporate Sector*.

Financial sector

The Bank has contributed substantially to the development of the banking sector since 1994. When privatisation emerged as the key sector transition challenge, the Bank focused on privatisation of Stopanska Banka, which was successfully privatised in April 2000. Sector privatisation is now almost complete, with state-owned banks having no significant asset share. The Bank and donor-supported SEAF Macedonia is providing finance to a number of local SME's and familiarising local entrepreneurs with private equity funds. However, the private equity market is still at a very early stage of development. **A lesson learned from** the SEAF Macedonia project is that maintaining constant communications with the fund manager and local team of the fund enables the investors to anticipate potential problems and to take proactive actions. (PEX04-218). In addition, the Bank has had transition impact through SME credit lines extended to 5 local banks and a dedicated microfinance bank. Overall, a *moderate* transition impact has been achieved in the *Financial Sector*.

The SME sector in the country has also been supported through the activities of TAM/BAS Programmes. TAM has carried 20 projects in the country so far. BAS Programme has operated in the country since April 2002, and has undertaken a total of 177 projects, of which 144 have been now completed.

Infrastructure Sector

In the energy sector, the Bank is supporting reforms primarily by assisting the restructuring of the state-owned power company, ESM, and the privatisation of the distribution company through an open and transparent international tender. The Bank is also financing the transmission interconnection line between FYR Macedonia and Bulgaria, which is expected to play a major role in promoting power trade in south-eastern Europe (SEE). Unbundling of the previous ESM is completed, and four new companies were established (the assets of generation, distribution and transmission, as well as TEC Negotino). An independent energy regulator has been also established as an independent commission. There is an opinion that the electricity tariffs should be further revised.

In the MEI sector, the Bank's single initiative in the 1990s has been to on-lend to water utilities for rehabilitation and extension of infrastructure in six municipalities. Effective implementation of the commercialisation objectives was delayed, however, due to a slow legislative process and political interference in tariff setting.

In the transport sector, the Bank has made two investments in roads and civil aviation. The latter project was signed in 2002 for the modernisation of the air navigation services in line with Eurocontrol requirements. The implementation of institutional reforms supported by the Bank has been delayed, however, due to lack of consensus among the government entities. A regional roads project was signed in 2003, but significant delays are occurring in project implementation. Overall, a *moderate* transition impact has been achieved in the *Infrastructure* Sector.

1.4. Portfolio Ratio and Quality

Based on the current portfolio of EUR 261.6 million, the private/public portfolio ratio stands at 57/43 per cent, sovereign borrowing accounting for the total financing in the public sector. In terms of number of projects, private sector transactions are expected to dominate the project pipeline in the forthcoming strategy period. 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. With stronger focus on the private sector projects under the new EBRD-Italy Western Balkans Local Enterprise Facility, it is possible that the Bank could achieve a 60/40 private/public sector portfolio in 2006-2008.

Average risk rating of the portfolio stands at 5.67, while the private sector risk rating is better at 5.29. The portfolio should be closely monitored to avoid the possible delay of project implementation of public sector projects by local utilities and state-owned enterprises.

2 Operational Environment

2.1 The General Reform Environment

2.1.1 Political Development

FYR Macedonia continues to meet the criteria specified in Article 1 of the Agreement Establishing the Bank. It is a pluralist, multiparty democracy. Its human rights record is broadly comparable with that of established Western democracies.

The signing of the Ohrid Agreement in August 2001 ended the uprising by ethnic-Albanian armed groups. The Agreement provides, among other things, for a territorial decentralisation programme aimed at giving the local authorities a greater role in local governance. A referendum on the territorial re-organisation law, adopted by parliament in August 2004 and held on 7 November 2004 at the request of the opposition and a Macedonian diaspora organisation, failed because fewer than the required 50 per cent plus one voter participated. The regional reform is now going ahead with fiscal decentralisation in place since July 2005.

In December 2004, Vlado Buckovski formed a three-party coalition which includes the Democratic Union for Integration (DUI), an ethnic Albanian party led by Ali Ahmeti, former leader of the guerrilla uprising in 2001. Local elections were held in March/April 2005. The government coalition lost Skopje but did well enough countrywide to be able to get on with the implementation of the Ohrid Agreement. Parliamentary elections were held on 5 July 2006.

2.1.2 Regional integration

EU membership has been the central aim of FYR Macedonia's foreign policy for a long time. FYR Macedonia applied to EU membership in March 2004. In November 2005 the European Commission recommended that FYR Macedonia be given candidate status. This was granted by the EU Council of Ministers in December 2005. However, the EU did not offer a date for the start of membership talks and attached a list of conditions to be fulfilled first, both within FYR Macedonia and the EU. One of those conditions was a debate to be held within the EU on enlargement strategy. This arose from a threat by some EU member states before the December 2005 Council meeting to block the granting of the candidate status because the EU's future enlargement strategy had not been discussed. The Council also repeated the European Commission insistence that FYR Macedonia must strengthen the rule of law, reform the police and judiciary, tackle corruption, and change its electoral procedures before the next parliamentary election.

In May 2000, FYR Macedonia was one of a group of East European states (later joined by Croatia) that agreed to work together to join NATO en bloc. However, in November 2002 FYR Macedonia was not among the seven East European states invited to join NATO. FYR Macedonia continues to co-ordinate, with US support, its NATO-related activities with Albania and Croatia and is pushing ahead with military reforms, including the creation of a fully professional army. In 2005, NATO said its next round of expansion would not take place before 2008.

On 27 February 2006, FYR Macedonia officially joined the Central-European Free Trade Agreement (CEFTA).

FYR Macedonia's relations with the government in Belgrade improved after the toppling of Slobodan Milosevic in October 2000. In February 2001, Federal Republic of Yugoslavia (now Serbia and Montenegro) signed an agreement with FYR Macedonia marking out the common border between them. But this has never been accepted by Kosovo Albanians, who want to revise it. Regarding Kosovo, the government in Skopje has said that FYR Macedonia will accept any solution regarding Kosovo's final status provided it respects FYR Macedonia's territorial integrity and sovereignty. Relations with Bulgaria and Albania are good. Economic relations with Greece are close: there are extensive trade and investment links between the two countries. However, their political relations have been overshadowed since 1991 by a dispute over FYR Macedonia's official name. Greece maintains that the name "Macedonia" implies a territorial claim on the Greek province of Macedonia. In April 1993 the country joined the UN as 'The Former Yugoslav Republic of Macedonia' (FYR Macedonia). The name was intended as a temporary compromise for international use, allowing time for agreement between the two countries. This has not been reached yet despite international mediation and the fact that the interim accord allowing the use of the name FYR Macedonia expired in 2002. In November 2004, the United States announced that it was recognising the country as the

Republic of Macedonia, its constitutional name. Russia and China had recognised the country under its constitutional name before the US decision. The EU, NATO and the UN continue to use the name FYR Macedonia.

2.1.3 Integrity issues

Corruption is perceived as a serious problem in the executive and legislative branches of government, with instances of corruption in the police and the judicial system of particular concern, according to a US State Department report on human rights in FYR Macedonia published in February 2006. A major corruption-related investigation in May 2005 led to charges being brought against seven police officers for abuse of their authority and soliciting bribes. Four of them were discharged, two had their pay cut, and one resigned. In 2005, the State Anti-Corruption Commission, the body responsible for investigating charges of corruption as well as complaints submitted by citizens, accused the government institutions of lacking the political will to fight corruption. After the government, during the re-balancing of the 2005 budget, significantly reduced the funds available to the Commission, the Commission accused it of deliberately impeding its work. FYR Macedonia's ranking in the Transparency International's 2005 Corruption Perceptions Index reflects widespread concern about the degree of corruption in the country – FYR Macedonia is in the 103rd place out of 155 countries and its score is 2.3 - in a scale from 10 (very clean) and 0 (very corrupt).

In December 2005, parliament addressed one of the main concerns regarding judiciary by approving a series of constitutional amendments aimed at making the judiciary more efficient and freer from political influence. One prominent amendment reduces the influence of parliament over the election and composition of the Judicial Council, the body responsible for selecting, monitoring and dismissing the judges. Another amendment allows the Council to elect judges, rather than merely nominate them for parliament's consideration, as under the previous Constitution. In addition, the prosecutor will - although continuing to be appointed (and, if necessary, removed by parliament) - now be able to seek a second six-year term. A major problem remains – that of clearing a backlog of some 1.2 million cases.

The law prohibits trafficking in persons but according to a US State Department report on human rights in FYR Macedonia published in February 2006, there were reports that persons were trafficked to, through and, to a lesser degree, from the country. During 2005, 32 trafficking-related cases were prosecuted, compared to 20 cases in 2004. During 2005, 83 persons were convicted for trafficking. Government efforts to combat trafficking are coordinated by the national commission for prevention and suppression of trafficking in persons, with the Ministry of the Interior also participating in anti-trafficking efforts. In May 2005 parliament passed a law on witness protection to facilitate witness testimony in trafficking and other sensitive cases. The country is primarily a transit and destination point for trafficking, but it is also a point of origin for a small number of trafficking victims. Women from the country were trafficked throughout the former Yugoslavia. Estimates by OSCE and other agencies suggested that 200-400 women were trafficked to or through the country, primarily for sexual exploitation. They were mainly from Moldova, Romania, Albania or Bulgaria and were mostly en route to Serbia and Montenegro (including Kosovo), Albania and Western Europe.

2.1.4 Social Conditions

According to the 2002 census, FYR Macedonia had 2,022,547 inhabitants. Ethnic Macedonians made up 64.2 per cent of the population, and ethnic Albanians a further 25.2 per cent. Other groups in 2002 were as follows: Turks 3.9 per cent, Roma 2.7 per cent, Serbs 1.8 per cent, Bosniaks 0.8 per cent, Vlachs 0.5 per cent. Those results disproved the claims by some ethnic Albanian politicians that their ethnic group accounted for more than one-third of the population. It also disproved the perception of some ethnic Macedonians that ethnic Albanian population was growing fast while the number of Macedonian was declining. The ethnic Albanians are concentrated in western and north western part of the country where the best agricultural land is. Ethnic Macedonians made up about 30 per cent of that area's population in the early 1990s, but their numbers have decreased since the 2001 insurgency. The two largest religious groups in FYR Macedonia are Orthodox Christians (about 67 per cent of the total population) and Moslems (30 per cent). The autocephalous Macedonian Orthodox Church, in existence since 1967, is not recognised by the Serbian Orthodox Church or any other Eastern Orthodox churches. Nor is it recognised by the Ecumenical Patriarch in Istanbul, who is the head of the world's Orthodox. Relations between the Serbian and Macedonian Church have been strained for some time because of the assistance provided by the Serbian Orthodox Church to dissidents from the Macedonian Orthodox Church (including a bishop) who wants to re-establish the Serbian Orthodox Church in FYR Macedonia. This is seen by the Macedonian authorities as an attempt to undermine FYR Macedonia's statehood. In July 2005 Zoran Vraniskovski, whom the Serbian Orthodox Church recognises as the Orthodox Archbishop of Ohrid, began serving a prison sentence for 'inciting religious intolerance'.

The birth-rate fell from 14.6 live births per 1,000 in 1998 to 13.3 per 1,000 in 2003. Over the same period the death rate per 1,000 people rose from 8.9. Life expectancy after 1990 dropped due to a deterioration in health services and a fall in living standards. WHO data for 2003 estimated life expectancy of 69 years for men and 75 years for women. Roma complain of widespread ethnic discrimination. They have the highest unemployment rate, the lowest personal and family incomes, are the least educated and have highest mortality rates of any ethnic group in the country.

FYR Macedonia inherited from Yugoslavia two universities, one in Skopje and one in Bitola, both with a wide range of departments. The overall literacy was 94 per cent. Since independence, the number of children completing primary education each year has remained unchanged: it was 29,697 in 1990/91 and 29,939 in 2003/04, according to the State Statistical Office. The number of those completing secondary education fell from 21,102 in 1990/91 to 15,704 in 1992/93 but recovered to 23,621 in 2003/04. The number of university graduates fell from 2,500 in 1990/91 to 2,150 in 1994/95, but then rose to 4,178 in 2002/03. The controversial issue in education is that of the right of ethnic Albanians to education in their own language. At primary level 32.7 per cent were taught in Albanian in 2003/04, an adequate provision. At the secondary level the number of those taught in Albanian more than doubled from 7,128 in 1994/95 to 18,361 in 2003/04, still representing only 19.6 per cent of the total number of students enrolled. In February 2004 the Tetovo University was legalised, which means that the university which offers tuition exclusively in the Albanian language now receives state funding along with the Macedonian-language universities in Skopje and Bitola. Previous governments had refused to set up a separate university to teach in Albanian, or to secure a quota system

for the enrolment of ethnic Albanian students at the two state universities. Indeed the Tetovo University was declared illegal in 1996 by the then SSDM-led government in Skopje. A temporary compromise was reached in 2000 when the OSCE and the EU supported the then creation of a private South-East European University (SEEU), also in Tetovo. It opened in 2001 and offered teaching in Albanian, Macedonian and English. However, the majority of ethnic Albanian students remained registered at the (then still illegal) Tetovo University.

In the 1980s the state had provided a guaranteed and comprehensive healthcare service, which on paper continues. But, in reality, the quality of healthcare has deteriorated since independence due to an acute lack of funds and shortages of medical supplies. Compared with the private sector, the medical service is seriously underpaid. Many doctors have found positions abroad, and medical skills have stagnated due to lack of new technology. The situation is made more difficult by the unclear division between military and civilian health structures. Most of the funding for the state healthcare system comes from employers' payroll contributions to the Health Insurance Fund. The balance comes from transfers from the state budget and from user fees. The IMF is pressing the authorities to strengthen financial controls in the healthcare sector. Its concern is that wage pressure and unfunded spending commitments will increase arrears.

2.1.5 Labour Issues

Unemployment remains high, at 36.5 per cent of the labour force as of the end of 2005, despite 8 per cent increase in employment. The unemployment figures are however open to question as they may be inflated by inclusion of people registering as unemployed to get benefits of the health insurance and the level of informal economic activity is very high. It is expected that unemployment will eventually decline as a result of the new labour regulation, adopted in July 2005, and easier enterprise registration process, in place since January 2006. New labour legislation is easing conditions for hiring and firing employees, particularly in smaller companies. The new rules facilitate the use of fixed-term and part-time contracts, strengthen the position of employers during labour disputes, reduce paid sick leave, and regulate overtime work in larger enterprises. The legislation also regulates annual leave allowance and contains provisions on collective agreements as the basis for labour relations in all firms. However, those not working can still obtain health insurance only after registering with the employment agency, even if they are not actually looking for a job.

More than 50 per cent of the workforce in FYR Macedonia is unionised, and the unions are particularly well represented in the state sector. Unions are not required to belong to the Confederation of the Trade Unions of Macedonia (SSM), which maintains close relations with government officials. In recent years, several new unions have been formed outside the SSM, including unions of journalists, police officers and farmers. In July 2005, the Union of Education, Science, and Culture (SONK) severed ties with the SSM and became independent. Some SONK members alleged that, after the split, local political leaders with ties to the government, attempted to pressure the local SONK union members to oppose the decision by the union's leaders. In September, the government severed wage negotiations with SONK. In November, after SONK had demonstrated that it had strong support from its members as well as from international trade union organisations, the government resumed negotiations with SONK. In December 2005

SONK and several other unions, formerly members of the SSM, formed a new independent union body, the Confederation of Free Unions.

2.1.6 Legal Reform

FYR Macedonia's legal reform efforts received a major boost when the country was granted full European Union candidate status in December 2005. Prior to that, in April 2004, a Stabilisation and Association Agreement had been entered into by FYR Macedonia with the European Union, pursuant to which FYR Macedonia adopted an "action plan" for harmonising its laws with the EU. Most recently, for example, FYR Macedonia adopted changes to its bankruptcy law designed to bring such law in line with the EU Directive on financial collateral arrangements (see Annex 2, under heading *Insolvency*). Also, in 2005, a new Electronic Communication Law was adopted, which is seen as an important step in FYR Macedonia's efforts to harmonise its domestic communications regime with that of the EU (see Annex 2 under heading *Telecommunications*).

Thus it is clear that FYR Macedonia is continuing to make progress in implementing the legal reforms necessary for a free market economy. As regards the "quality" of FYR Macedonia's laws, and as can be seen in the detailed analysis of certain areas of the law provided in Annex 2, many of FYR Macedonia's laws fare well when compared with other countries, or when tested against international benchmarks. For example, both the country's capital markets and company law legislation are considered to be in "high compliance" with the relevant international benchmarks. But, and as has been pointed out in previous country strategies, there remains a significant "implementation gap" between the "quality" of such laws, and their implementation.

This implementation gap can have the dual effect of undermining the utility of the specific laws in issue and diminishing the confidence that both Macedonian and foreign investors and traders have in the legal system as a whole. However, here too, it appears that FYR Macedonia is taking important steps to make improvements, with a case in point being the recent reform efforts under way in connection with the country's judiciary. Thus, in December 2005, a number of constitutional amendments were adopted by FYR Macedonia's parliament which are designed to increase both the efficiency and independence of the country's judiciary, and in March 2006 an academy for the training of judges and prosecutors was officially opened by Prime Minister Vlado Buckovski. There are also other areas of the law where it appears FYR Macedonia is taking concrete steps in narrowing this "implementation gap." For example, a law on arbitration, permitting out-of-court dispute resolutions, has recently been adopted. In the area of company law, early in 2006, a one-stop business registration system has been introduced to reduce red tape and increase the speed at which new businesses can be established. It remains to be seen how successful all of the above efforts will be in actual practise. But it is clear that the country's authorities and political establishment are committed to making progress in this regard.

2.1.7 Environmental Issues

In 1996, FYR Macedonia was one of the first countries in the SEE region to prepare a National Environmental Action Plan (NEAP), and is now one of the first to revise it. This second NEAP, adopted by the Parliament in 2005, is thus an updated and revised version of the 1996 NEAP.

This Second National Environmental Action Plan (NEAP 2) provides the overall guidance and directions for FYR Macedonia in the field of environment over the coming six year period until 2011. Apart from setting the priorities and objectives within the various sectors, the NEAP identifies specific measures and actions that must be implemented in order to attain these objectives. It has been updated in accordance with the stipulations of the Framework Law on Environment (adopted in 2005) as well as built upon the valuable experience from the development and the implementation of the first NEAP and particularly it aims to respond to challenges of EU approximation. The new NEAP has been developed based on the country's strong dedication to comply with environmental requirements by the EU approximation process.

In the field of environment, the EU approximation imposes substantial requirements onto FYR Macedonia not only in terms of investment but also in terms of capacity enhancement, institutional restructuring and enforcement. In recognition of this, the Government has commenced the elaboration of a comprehensive environmental strategy for the EU approximation. This strategy is expected to be ready in 2007. Tentative cost estimates amount to EUR 270 million for investments in urban water, wastewater and waste management. Due to the significant investment requirements for wastewater, water, air and waste management, the NEAP 2 indicates that annual environmental expenditure would more than double in a few years as a result of the EU approximation. Consequently, the NEAP 2 focuses strongly on elaboration of this investment strategy and on providing the necessary strategic and legislative framework to implement the EU legislation and mechanisms to attract the external finance in terms of grants and loans.

Furthermore, the Government has responded to the decentralisation requirements of the Ohrid Framework Agreement by delegating substantial obligations and responsibilities to the Local Self Governments (LSGs). Among other things, the LSGs will come to play a major role in delivering compliance with the EU legislation, for example, municipal environmental infrastructure services and enforcement issues. Therefore, the NEAP aims to ensure rapid capacity building within LSGs to enable them to take on these responsibilities.

The Government has also been working to prepare the Strategy for Sustainable Development of FYR Macedonia, which is expected in late 2008. The aim of this work is to develop a comprehensive strategic approach to ensure steady economic growth combined with social improvements and environmental protection. In order to achieve these difficult challenges, the NEAP 2 explicitly provides directions as to how better integrate environmental requirements into the management and operations of the various economic sectors.

2.2 Progress in Transition and the Economy's Response

2.2.1 Macroeconomic Conditions Relevant to Bank Operations

Real GDP growth reached 4 per cent in 2005, down from 4.1 per cent in 2004. Growth performance has been limited by very low levels of greenfield FDI inflows, infrastructure deficiencies, and insufficient capacity to implement necessary reforms to improve the business/investment environment. Private consumption remained subdued due to high unemployment, as large enterprises continued laying-off staff. However, industrial production has recovered from a contraction in 2004 and grew an estimated 6.9 per cent in 2005, driven by the strong performance of the steel, textile and chemical industries. The entry in 2004 of a strong strategic investor – Mittal Steel – to the metal processing sector has led to a sharp rise in base metal production in 2005. It is expected that Mittal Steel will continue to perform strongly as the further restructuring measures, including skill and technology transfers, are implemented and the Mittal regional network of companies is fully integrated. The stable growth performance at around 4 per cent per year should be sustained in the medium term, supported by progress in negotiations for EU accession and progress in reform of the business environment.

The exchange rate against the euro remains stable at around 61 denar per Euro in line with the Central Bank exchange rate policy of a de facto near-peg to the Euro. No change in exchange rate policy is expected in the short to medium term. Following deflation in 2004 driven by decline in the food prices, consumer prices started growing again in 2005, reaching 1.3 per cent year-on-year in December 2005. Inflation temporarily increased to over 2 per cent in January 2006, reaching 2.8 per cent, due to tax increases (excise taxes on tobacco). By May 2006 consumer price inflation increased further to 4.1 per cent year on year. In the medium term, consumer prices are expected to remain subdued as a result of a credible exchange rate anchor and the expected intensification of competition in the retail sector, once the announced entry of several regional retail chains will materialise. The main source of inflationary pressures would be potential excise tax increases, related to the EU accession, and eventual food price inflation in case of adverse weather conditions for farmers. The official interest rate peaked in the summer at 10 per cent and by the end of the year declined by 150 basis points. Further moderate declines in interest rates are expected over the next two years.

Tight fiscal policy is expected to remain in place in the medium term. Fiscal target of the IMF was met comfortably in 2005. The general government budget recorded surplus of 0.3 per cent of GDP, instead of planned deficit 0.8 per cent of GDP. Public expenditure increased by more than 3 per cent of GDP in 2005 to reach 38 per cent of GDP but the budgetary revenues increased as well, more than offsetting expenditure increase. Public debt remains below 50 per cent of GDP and interest payments are at about 1.3 per cent of GDP.

Reforms to fiscal management and planning have improved the stability of public finances. Fiscal decentralisation was introduced in July 2005 as part of the overall decentralisation plan included in the Ohrid Agreement. Most of municipalities operate with a surplus but the municipalities are not allowed to borrow until mid-2007, with the exception of loans from IFIs without government guarantees. Government's strategy to promote the regionalization of the country's economy is expected to encourage upgrades of municipal infrastructure led by regional authorities. In 2005 tax administration

benefited from significant technical assistance. The Public Revenue Office improved its organizational structure and preparations for the Large Taxpayer Office are on track. FYR Macedonia is expected to start regular reporting and pre-accession fiscal surveillance by the Eurostat in 2006. Two new units required for the management of EU pre-accession funds have been established.

A number of off-budget accounts have also been reformed. Improvement in tax and social contribution collection rates occurred due to the recently implemented pension reform, as the companies are now obliged to report earnings of individual employees instead of the aggregated wage bill. All public health institutions have prepared budgets for 2006 in line with the binding ceilings, and financial management of health care providers is expected to remain under tight control.

The current account deficit declined from 7.8 per cent of GDP in 2004 to 1.3 per cent in 2005, driven by a substantial increase in net current transfers as well as by a decline in the trade deficit. In 2005, exports grew by more than 20 per cent, reflecting the rebound in industry, and imports of consumer goods were restrained, resulting in the decline in the trade deficit from 21 per cent of GDP in 2004 to 18.5 per cent in 2005. On 27 February 2006 FYR Macedonia officially joined the Central-European Free Trade Agreement (CEFTA) and this may also have a positive impact on trade performance in the near future. The positive trend in current account development continued in the first half of 2006.

The level of external debt remains moderate at 40 per cent of GDP at end-2005, out of which 75 per cent is public external debt. The international reserves reached USD 1.4 million at the end of 2005, equivalent to 4.9 months of imports.

Key macroeconomic challenges remain the high unemployment and high trade deficit. Job creation and narrowing of the trade deficit would require dynamic expansion of local SMEs, expanding beyond the small local market, as well as an entry of a few large greenfield, export-oriented, foreign-owned enterprises.

2.2.2 Transition Success and Transition Challenges

Corporate Sector

Significant improvements in business environment were achieved in recent years. The one-stop shop for the registration of businesses came into force in January 2006, reducing the time it takes to establish a business from 48 to 5 days. In the first 2 months of 2006 about 900 companies used its services. It is expected that easier registration of companies would eventually lead to greater job creation. In March 2006, the new bankruptcy legislation was approved by the parliament, streamlining bankruptcy process with the aim to shorten the period for bankruptcy proceedings and reduce their costs.

The business environment however remains challenging for both domestic and foreign investors. According to the 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey, enterprises see corruption and judicial shortcomings as major constraints on their activities. The high cost of financing, further complicated by ambiguities over property rights, is also a key obstacle. Long administrative procedures with unpredictable outcome and unequal treatment of licence applications are further

impediments that adversely affect the business environment. Restructuring and privatisation of the enterprise sector are yet to be completed.

At present less than 50 per cent of real estate assets are properly registered. The reform of land registry, supported by the World Bank programme, is one of the key reforms to be implemented in the medium term. There is little construction activity across all sectors although some regional retail chains are exploring the local market. Around 80 per cent of arable land is under secure ownership by private farmers, but the land market functions poorly (there are problems with the land registration system and cadastral records and tradable titles need updating). Most of the agro-processors have been privatised, but are still in severe financial difficulty due to outdated plant and equipment, excess labour and poor management.

Financial Sector

As of end-2005 the banking sector of the country comprised 20 banks and 14 savings houses. Excluding the Macedonian Bank for Development Promotion (MBDP) a.d. Skopje¹ all other banks are universal banks. Out of these, 15 are licensed to carry out financial activities in the country and abroad, while 4 banks carry out financial activities only in the country.

A microfinance bank has been lending since mid 2003 to micro and small enterprises. Since 1995, Moznosti, a local NGO, has disbursed loans to MSMEs totalling EUR 22.5 million. There is very little lending from other commercial banks to the MSME sector.

In the ownership structure of the banks, private capital is dominant - 91.9 per cent of the total equity capital² (as of end-2005). The share of non-financial private legal entities is 42 per cent in the total nominal value of the equity capital, and the share of the banks and other financial institutions is 36.8 per cent. The share of public sector and public enterprises in the total nominal value of the equity capital of banks is 8.1 per cent.³

Foreign shareholders hold shares in 17, in 8 of which they hold a majority package, having 51.3 per cent in the total banking assets. Total nominal value of foreign equity capital in the banks is 52.6 per cent (as of end-2005). Two out of three largest banks are owned by foreign shareholders, the Greek National Bank and Nova Ljubljanska Banka. The largest bank in the country, Komercijalna banka, is owned by local investors. The authorities are also selling residual state shares in commercial banks.

At end-2005, compared to end-2004 total assets of banks grew by 19 per cent. During 2005 the deposit potential of banks grew by 16 per cent. As of end-2005 the financial intermediation, calculated as total assets, gross credits to clients and total deposits to GDP were 49.4 per cent, 24.2 per cent and 34.5 per cent, respectively.

¹ The Macedonian Bank for Development Promotion was established in accordance with the Law on Establishment of the Macedonian Bank for Development Promotion (Official Gazette of the RM nos. 24/98 and 6/2000, 109/2005) and carries out specific activity for supporting the development via financing SMEs and export support exclusively via other domestic banks. This institution is non-deposit institution, but is licensed by the NBRM.

² Nominal Value of issued ordinary and preferential shares.

³ Macedonian Bank for Development Promotion AD Skopje is the only fully state-owned bank.

Despite stronger credit activity of the banks, credit growth generated low to moderate risk to the financial stability of the economy. In fact, credit portfolio quality has been continuously improving. As of end-2005 inclusive, share of higher-risk claims of the banks (credit exposure classified in C, D and E¹ risk categories) in the total credit portfolio of the banks amounted to 10.9 per cent, and in relation to end-2004, it dropped by 2.3 per cent.

Exchange rate risk to which the banks were exposed as a result of the currency inconsistency of their balance positions is relatively low. Almost all banks are within the prudent limits for open foreign currency positions. Other market risks have a marginal share in the range of risks the banks face. Banks have insignificant trading portfolio, taking into account the insignificant initial activities related to the securities operations and other activities that generate market risks.

Banks maintain relatively high liquidity position. As of end-2005, average liquidity assets of the banks was 45.1 per cent of the total assets, while the level of coverage of sight deposits of the banks with average liquidity assets was 126.5 per cent. Another indicator of banking system stability is the solvent position of the banks, which is basic prudent indicator. With respect to 8 per cent minimum prescribed by law, banks in FYR Macedonia are relatively well capitalized. As of end-2005, average capital adequacy ratio of the banks was 21.3 per cent.

In parallel to the maintenance of relatively high solvent and liquid position, there was significant increase of the profitable position and efficiency of the banks during last year. Rate of return on assets amounted to 1.32 per cent, while the rate on return on equity was 8.06 per cent.

To the end of further strengthening of the supervisory function of NBRM, at the beginning of 2006, Supervision Development Plan was adopted, prepared in cooperation with the World Bank, as a detailed review of all activities to be undertaken in the coming several years, so as to establish supervision based on risk assessment. Supervision Development Plan is a result of the efforts of the NBRM for further strengthening of its own capacity, as well as of the intention to establish adequate basis for gradual application of the Agreement on New Capital Accord (Basel II), especially the implementation of the second and the third pillar (Supervisory Review and Market Discipline).

The central bank is required by the IMF to apply a number of measures to improve banking supervision, including tighter prudential regulations, provisioning and reporting requirements. By the end of 2006 the central bank is expected to issue accounting guidelines for banking sector, require banks to publish their annual audited accounts on central bank homepage, and require bank auditors to comment on adequacy and quality of lending policies, risk management and internal controls.

¹ According to the Decision on Determination of the Methodology for Classification of Active Balance and Off-Balance Positions of the Banks depending of Risk Level, credit exposure of the banks is classified in five risk categories A, B, C, D and E.

Privately managed mandatory pension pillar was introduced in 2005, with licences for the establishment of the first private pension funds awarded in April 2005. Contributions started to be transferred to private pension funds in January 2006. Second-pillar pension insurance funds have been made mandatory for all workers who entered employment after 1 January 2003. For other workers, participation is optional. Total pension and invalidity insurance contributions are at 20 per cent – 14 per cent of which is paid by the employer into the first pillar, while the employee's second pillar account receives 7 per cent. The retirement age under the new retirement law enacted in September 2005 is set at 64 for men and 62 for women with 15 years minimum service required. It is too early to assess the impact of the pension reform on the securities market. However the pressure of pension funds on the strengthening of shareholder rights as well as easier access to finance for companies through listing on the stock exchange are expected.

Infrastructure Sector

In January 2005 a new power transmission company, AD MEPSO, was created through the partial unbundling of the previously integrated power company. In August 2005, further restructuring steps were approved by the government, with the spinning off of two separate power generation companies. The first company runs the Negotino power station. The second company, AD ELEM, took over remaining thermal and hydro power plants. The authorities are proceeding with the sale of 100 per cent stake in Negotino while AD MEPSO and AD ELEM are to remain state-owned. The authorities have already privatised ESM, a monopoly power distribution company established during the unbundling process. A majority state stake in AD ESM was sold to EVN AG, the Austrian power distribution utility, for EUR 225 million with further EUR 96 million investment commitment for the next three years.

The authorities are progressing with the sale of a residual telecom stake. The government has decided to sell the residual of 45.12 per cent of its shares in Makedonski Telekomunikacii and the auction through Macedonian Stock Exchange is going to be launched in June 2006 in five separate packages.

Despite some progress, the water sector is in need of further reform, including tariff structure and commercialisation. The only district heating network of the country (Skopje) is private (owned by its employees), whereas water and wastewater assets are still state owned and managed. Parts of the urban transport are privately operated.

In May 2005, the government completed talks with the World Bank on a EUR 15 million railways restructuring loan, following the adoption of the railways restructuring legislation by the parliament in April 2005. According to the restructuring plan, the railways will be split into separate infrastructure and transport companies, and the authorities may grant concessions of up to 20 years to private operating companies. About 800 employees out of a total of 3,600 have already been laid off as part of the restructuring.

The Fund for National and Regional Roads is a state fund incorporated into the State Budget, in charge of managing main road network, which is largely funded from a dedicated fuel excise tax, annual fee for motor vehicles subject to registration, as well as toll fees. The government has indicated an interest in motorway concessions, but there are some doubts given low traffic volumes.

2.3 Access to Capital

In December 2005, the authorities issued the first Eurobond worth EUR 150 million with a 10-year maturity and a 4.7 per cent yield. The government used the proceeds to repay its USD 221 million debt to the London Club of Creditors in January 2006. In the short term the authorities do not plan to issue another Eurobond as the government expect sizeable privatisation revenues. However, the government announced its intention to repay in full its EUR 100 million Paris Club debt by the end of 2006.

Inflows of foreign direct investments were EUR 97 million in 2005, less than in the previous year, and mostly concentrated in utilities, mining and metal processing. In 2006 there will be a substantial increase in FDI inflows related to privatisation of ESM, the dominant power company, and sale of the residual state stake in the telecom company. The inflow of greenfield foreign investments is expected to remain low.

A new three-year SDR 51.7 million Stand-By Arrangement, focusing on reforms in health care, the judiciary and the labour market, was approved by the IMF in August 2005. The first review of the IMF program was passed in April 2006. The programme contains quantitative performance criteria and indicative targets. These include ceilings on the budget deficit and borrowing, as well as ceiling on the central government's wage bill and arrears. The ceiling on new non-concessional medium and long term government or government guaranteed external debt is EUR 286 million at the end of 2006.

3. Strategic Orientations

3.1 Bank's Priorities for the Strategy Period

The Bank will support the efforts of the Government to continue the implementation of the reform agenda and improve the country's business environment in order to enhance the development of the local private sector and attract further inflows of FDI, while continuing to modernise key infrastructure on a sustainable basis. The Bank's operational priorities will continue to support the development of the private sector, further strengthening of the financial sector and the rehabilitation of the country's transport (airports and road networks), energy and municipal infrastructure (in particular for water supply and waste water treatment).

In the corporate sector, the Bank will target its support towards smaller-scale local export-oriented companies showing good corporate governance, by providing loans, guarantees or making equity investments, including through the new EBRD-Italy Western Balkans Local Enterprise Facility. Assistance to local enterprises will be provided through the TAM/BAS programmes. The Bank will continue its support to strategic foreign investors.

In the financial sector, the Bank will continue to focus on (i) providing banks with funding and institutional support to assist the banks develop new products (including TFP and co-financing), grow their business on a sustainable basis, and improve corporate governance; (ii) channelling more funding to SMEs through commercial banks and micro-lending institutions, including through the implementation of the EU/EBRD Western Balkans SME framework and the MSME Finance Framework for Western Balkans and Croatia; and (iii) supporting the banks in attracting strategic investors and

promoting sector consolidation with its possible participation in mergers and acquisitions of smaller creditworthy banks.

In the infrastructure sector, the Bank will focus on (i) supporting privatisation and commercialisation of public utilities, also through the implementation of the pre-privatisation agreement for the newly un-bundled electricity distribution and generation companies, (ii) energy projects that fit the regional energy market development such as regional electricity and gas interconnections, (iii) promoting regional transport networks, including the support to Skopje Airport concession and the restructuring of the road maintenance sector, and (iv) supporting the new fiscal decentralisation process, including through possible municipal-guaranteed water sector investments.

3.2 Sectoral Challenges and Bank Objectives

3.2.1 Private Sector Development

- The Bank will enhance its support towards smaller-scale local export-oriented companies showing good corporate governance, by providing loans, guarantees and making equity investments in the range of EUR 1-4 million through **the newly established EBRD-Italy Western Balkans Local Enterprise Facility**. The Facility will target local private enterprises, with growth and export potentials in all sectors, from agribusiness to metal-related industries which are currently not properly supported by local banks, equity funds or the Bank. Many of these enterprises are with high growth rates, entrepreneurial approach and good opportunities to expand regionally.
- The Bank will continue to promote private sector development of SMEs through the **Turnaround Management (TAM) and Business Advisory Services (BAS) Programmes**, designed to assist the development and growth of SMEs in the Bank's countries of operations, enabling them to adapt to free market economy and assist companies to be more competitive on domestic and international markets. Areas of particular focus are management skills, market positioning, information systems, quality certification, technical and environmental upgrades. BAS Programme also provides local companies with support in complying with Environmental legislation such as Environmental Impact Assessments (EIA), Integrated Prevention Pollution and Control (IPPC), Energy Efficiency issues.
- The Bank will continue its **support to strategic foreign investors**. FYR Macedonia remains one of the smallest recipients of foreign direct investments (FDI) in the region, despite authorities' efforts to enhance the business environment through introduction of the "one-stop shop" for registering companies, customs exemption for re-exported goods, increased labour market flexibility and establishment of new agency for foreign investment promotion.
- Where possible, the Bank will look for opportunities to support or participate as a co-investor in the sale of state shares in telecommunications and banking sectors. These possible sales could result in substantial inflows of foreign direct investment, which would provide a further economic boost.

3.2.2 Financial Sector

The Bank will seek to further strengthen the banking sector, promoting the sector consolidation and thereby boosting the financial intermediation in FYR Macedonia. The Bank will in particular focus on:

- **Increasing competition and efficiency** of the banking sector by promoting further entry of foreign strategic investors in the country through the Bank's current investee banks and/or by investing in other banks with strong growth potential alongside foreign investors.
- **Promoting the banking sector consolidation** by supporting mergers of credit-worthy, dynamic local financial institutions, directly or via the Bank's existing equity holdings.
- **Developing and strengthening financial intermediation mechanisms** to reach in particular the SME and the retail sectors. The Bank will pursue establishing credit lines with local banks, micro-finance institutions and leasing companies to enhance their lending capacity to SMEs and micro businesses and to support the development of residential mortgage finance.
- **Promoting institution building and modernisation of the banking sector** in cooperation with the EU and other donors. The Bank will aim at incorporating strong capacity building components into its equity investments as well as into its SME and micro lending credit lines in order to improve the corporate governance standards, business practises and the lending capacity of its local client banks, micro-finance institutions and leasing companies.
- **Boosting capital investment** by establishing co-financing (or co-guarantee) facilities with local banks to support their funding to larger, creditworthy local companies.
- **Improving local banks access to international capital markets** and supporting diversification of their funding base by arranging syndicated loan facilities under the A/B structures.

In addition, the Bank will promote diversification of the financial product offer in the market by providing matched funding to local financial institutions for residential mortgage lending as well as for lease and consumer finance. The Bank will continue to promote regional trade by improving local banks capability to provide trade and export financing to their clients through the Trade Facilitation Program.

The Bank will look to develop business opportunities in the developing leasing sector, which may include the provision of training for leasing companies. The mandatory pension reforms were introduced in 2005 with the establishment of just two mandatory pension funds. Despite efforts by the Bank following support given for the implementation of the reforms, a suitable opportunity to invest in either of the two pension consortia did not materialise. The Bank is also reviewing opportunities in the insurance sector and has provided TC for strengthening the role of the insurance supervisory office. The consumer finance industry is developing - mainly through the commercial banks - which is an area where the Bank may look to be involved. The local capital market is underdeveloped and the bank will closely monitor developments as the pools of assets eligible for refinancing in a secondary market grow.

3.2.3 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

Under the Power Pre-privatisation Share Purchase Project signed in October 2004, the Government of FYR Macedonia has made a good progress with regulatory reforms and restructured the power sector. The former vertically integrated state-owned utility, ESM, was unbundled into 4 major companies: AD ESM (distribution), AD MEPSO (transmission system operator), AD ELEM (generation including hydropower) and AD TEC Negotino (generation).

- The Bank will continue to support **the privatisation of the newly unbundled power companies** through transparent and competitive tender process, supported by sustained electricity sector regulatory reforms. AD ESM was sold to an Austrian investor in March 2006. EBRD would have an option to take a certain amount of shares in accordance with the Conditional Share Purchase Agreement, signed with the GOM.
- Following the implementation of the Bank-financed transmission interconnection line between FYR Macedonia and Bulgaria, which is expected to play a major role in promoting power trade in south-eastern Europe, the Bank will actively support **the further regional transmission interconnection line between FYR Macedonia and Albania.**
- The Bank will support power generation projects, including the newly unbundled AD TEC Negotino, on a least-cost basis and in the context to develop the regional energy market.
- The Bank will continue to assist the energy sector reforms with **the extension of the power affordability study** to include specific recommendation for FYR Macedonia safety net measures and **the environmental technical assistance** which is being provided to the newly unbundled power utility companies (introduction of environmental system management) and to the Government.
- Where possible, the Bank will also look for opportunities to include or enhance energy efficiency components in industrial projects.

Transport

- The Bank together with EIB will continue focusing on **the successful execution of the Regional Roads Project** with its remaining western section of the Skopje

Bypass, a major component of the Pan-European Corridor VIII. The Bank will closely monitor the implementation of the environmental mitigation measures under the project. The Environmental Monitoring Advisory Group was established under the Project and is now fully operational.

- The Bank will continue its **policy dialogue in the roads sector**. The Bank will closely monitor the development in the three main areas: (a) establishing a stable and predictable flow of funds to the road sector; (b) progress achieved with the implementation of a three-year Roads Plan; and (c) adoption of the institutional strategy. In line with key recommendations from the institutional strategy, the Bank will encourage the government to implement a three-stage transition program for the road sector, including **the restructuring the two major players**, the Fund for National and Regional Roads and Makedonijapat, which has a monopoly in the road maintenance sector.
- As a follow-up to the Bank-financed road project, the Bank, jointly with EIB, will seek to develop **the second road project**, which will cover a programme of works to rehabilitate sections of the national and regional road network, to bring them up to a maintainable standard as well as upgrade of the existing sections along the Pan-European corridors, and, where economically justifiable, new construction.
- Macedonian Railways has recently undergone a major programme of restructuring, the main themes of which have been the creation of a joint stock company and the separation of infrastructure from operations. The EBRD will seek to provide assistance in these commercialisation activities, together with investments which would focus on rolling stock. The EBRD is likely to work with the EU's ISPA initiative in this sector.
- The Bank will continue to support the government with its effort to select the most effective way of funding of **the Modernization of Skopje Airport** with the aim of supporting the winning concessionaire, providing that the selection is undertaken in a fair and transparent manner. Alternatively, the Bank will be willing to consider supporting the modernization on a non-sovereign basis if this option were to be selected by the government.
- Under its current Civil Aviation Upgrading Project and through the TC provided by the CEI, the Bank will continue to support the government with **the establishment of an independent financial and autonomous air navigation service provider**. This will require reorganisation of the Civil Aviation Administration, which currently has double functions as a regulator and a service provider.

Municipal and Environmental Infrastructure

The role and the responsibility of the municipalities in the country are changing substantially with the introduction of new policy of the decentralization since mid 2005. Following two years grace period, the municipalities are expected to play a leading role with new responsibility to manage their future investment needs with their revenues, including additional ones through specified taxes. In the new legislation, municipalities will be able to borrow directly from IFIs and to offer financial guarantees in respect of loans to their municipal utility companies. This will provide municipalities with a momentum to modernise their existing obsolete infrastructure in water and wastewater sector. This new policy will need to be supported by enhanced institution building. With the recently granted EU candidate status, the accession-related grant funds are expected to become available for funding of the priority municipal sector's needs.

- The Bank will seek to develop a **water/wastewater rehabilitation project with the city of Skopje**. In support of the very cautious approach of the Central Government with the transfer of its responsibilities to the local level, the Bank secured TC funding in order to assist the City's assessment of expected future revenue and expenditure as well as the financial capacity of the City to borrow or offer financial guarantees and to provide training in planning and budgeting activities under the new legislation. 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 Bank will also develop extensive dialogue with the other credit worthy municipalities to explore the opportunity for developing similar programs in other parts of the country.
- The Bank will accelerate the implementation of the MEAP project and bring it to its successful completion.

The Bank will actively coordinate with other institutions, including KfW and the World Bank, in order to maximize the positive impact of policy dialogue and the institution building of the municipal utilities.

4. 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 project preparation and institution building, particularly promoting smaller scale local enterprises and for public sector operations. It will be key factor for the implementation of the strategy. A decision to create **the new Western Balkans Multi-Donor Fund** was made at the EBRD Annual General Meeting in London (21-22 May 2006). Eleven countries agreed to provide a total EUR 10 million in donor funds towards a new EBRD-driven initiative to boost private business investment and infrastructure development in the Western Balkan countries, including FYR Macedonia. The new multi-donor fund will strengthen EBRD – donor coordination in FYR Macedonia and expand the resources available to support economic growth and regional cooperation.

The Bank will continue its strong co-operation with the EU/EAR, especially in the fields of transport and SME support, and bi-lateral donor institutions. In particular, the Bank will enhance its co-operation with the European Union within the framework of EU regional initiatives and the overall Stabilisation and Association Process with FYR Macedonia.

In addition to focusing on implementation and disbursement of existing commitments, EBRD will continue to play a crucial role, together with the European Investment Bank (EIB) and the EU, in developing transport and energy projects, with a particular focus on regional linkages. The EBRD will continue to co-finance with EIB in the infrastructure sectors and will seek co-operation with the EU in financing municipal infrastructure, SMEs as well as TAM and BAS programmes.

The Bank will continue to closely co-ordinate energy, transport, and municipal sector projects with the World Bank.

ANNEX 1: POLITICAL ASSESSMENT

Alone among the six former federal republics of Yugoslavia, which was formed under Marshal Tito's leadership in 1945, FYR Macedonia managed to escape the armed conflict that accompanied its disintegration in 1991. Following the outbreak of war in Slovenia and Croatia in 1991, FYR Macedonia's President Kiro Gligorov negotiated a peaceful withdrawal of the federal army. In September 1991, after a referendum on independence in which 71% of the population voted in favour, FYR Macedonia declared itself independent from the collapsing Yugoslav state. However, its ethnic Albanian minority boycotted the referendum and a vote, in October 1991, on a new Constitution. After an unofficial referendum in January 1992, the 'Republic of Ilirida' was declared in the largely Albanian-inhabited western part of the country. Predictions of a possibly violent break-up of FYR Macedonia proved wrong and moderation prevailed. In December 1992 the United Nations deployed a small force in the country to stop a possible extension of the war to FYR Macedonia. Inter-ethnic tensions were largely contained in the 1990s.

However, in February 2001, an Albanian guerrilla body calling itself the National Liberation Army (NLA) started an insurgency against the government. It called for the restructuring of the country into a federation. Ethnic Macedonians saw this as the first step towards the country's break-up. The insurgency polarised public opinion along ethnic lines, despite the fact that the two main Albanian parties in the country had rejected the NLA's violent tactics. Under strong Western pressure, the main ethnic Albanian and Macedonian parties signed a peace agreement in Ohrid in August 2001, which envisaged the improvement of the position of the Albanian minority in a variety of ways. This included allowing the use of Albanian as an official language in areas where the Albanians made up more than 20% of the population; more power-sharing arrangements; more money for Albanian-language education; amending ethnic references in the Constitution; and adding another 1,000 Albanians to the police force. A 3,500-strong NATO force oversaw the disarmament and dissolution of the NLA in August and September 2001. The Ohrid agreement is being implemented, albeit slowly (especially with respect to increased Albanian participation in the army and the police).

Growing public awareness of massive corruption under the coalition between the nationalist VMRO-DPMNE of Ljubco Georgievski and the Democratic Party of Albanians (DPA) under by Arben Xhaferi, in power since 1998, contributed to its defeat in the elections of 15 September 2002. The new government was formed by the Social Democrats (SDSM) under Branko Crvenkovski and the ethnic Albanian Democratic Union for Integration (DUI under Ali Ahmeti, former leader of the NLA now turned a politician and supporter of the Ohrid Agreement. In the early presidential election in April 2004, which followed the death in February 2004 in an air crash of President Boris Trajkovski, Branko Crvenkovski was elected President. He was replaced as Prime Minister by Hari Kostov, a banker and not a member of the SDSM.

After a prolonged controversy over the local government assuming greater powers in areas such as education, health, culture and urban planning, parliament adopted in August 2004 the law reducing the number of municipalities from 123 to 80, with a further reduction to 76 municipalities in 2008. Macedonian opponents of the law forced a binding referendum on 7 November 2004. If successful, it would have undermined the Ohrid Agreement. However, only 26.6% of the 1.7 million registered voters turned up, well below the 50% required for the referendum to be valid. Of those who voted, 94% opposed the new boundaries. Later the

same month, Hari Kostov resigned. He was replaced as Prime Minister by Vlado Buckovski. At the SDSM's congress in November 2004, Buckovski was elected leader of SDSM. After the local elections in March 2005, which resulted in a sort of a draw between government and opposition, the Buckovski government concentrated on carrying out the rest of the Ohrid Agreement. The adoption by parliament in March 2006 of a revised election law intended to prevent a repeat of the irregularities that had occurred at previous elections opened the way to the calling of parliamentary elections on 5 July 2006

ANNEX 2: LEGAL TRANSITION

COMPARATIVE ASSESSMENT OF FYR MACEDONIA'S COMMERCIAL LAWS

The EBRD has developed and regularly updates a series of assessments of legal transition in its countries of operations, with a focus on selected areas relevant to investment activities: capital markets, company law and corporate governance, concessions, insolvency, secured transactions and telecommunications. The existing tools assess both the quality of the laws “on the books” (also referred to as “extensiveness”) and the actual implementation of such laws (also referred to as “effectiveness”). All available results of these assessments can be found at www.ebrd.com/law. This annex presents a summary of the results for FYR Macedonia, accompanied by critical comments of the Bank’s legal experts who have conducted the assessments.

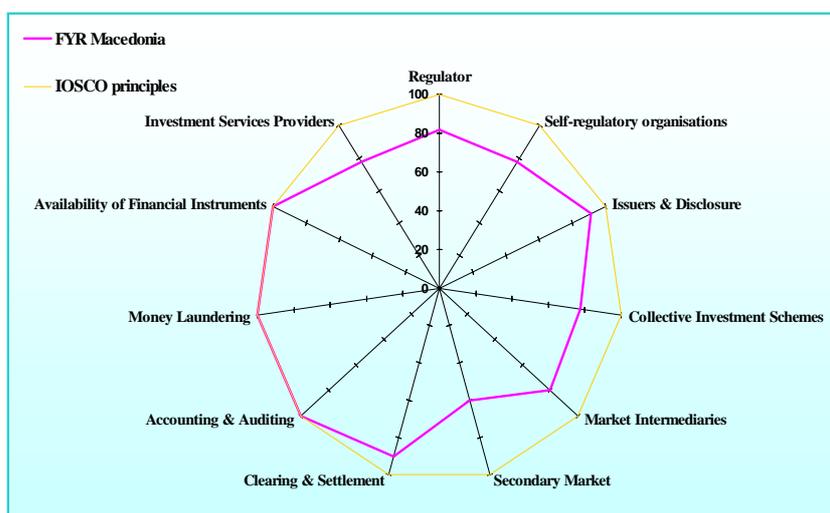
Capital Markets

The primary legislation governing the activities of the securities market of FYR Macedonia includes the Securities Law of 2000, last amended in November 2005; the Law on Takeovers of 2002 and the Law in Investment Funds of 2000.

The securities market regulator is the Securities and Exchange Commission of the Republic of Macedonia (“MSEC”), established on 19 June 1992. The MSEC regulates and supervises all participants in the securities market and is in charge of implementing the securities market legislation. The MSEC is also responsible for the legal and efficient functioning of the securities market and for protection of investors' rights.

The Macedonian Stock Exchange (“MSE”) was founded in September, 1995 and started trading in March 1996. The MSE currently has 15 members (9 brokerage houses and 6 banks) and 20 shareholders (8 brokerage houses, 8 banks, 1 insurance company and 3 private investors). Only authorised brokers can conclude stock exchange transactions. The official stock exchange index MBI at the end of 2004 registered a year on year growth of 14.7%. At the end of 2004, 68 national joint stock companies were listed on the MSE. All trades conducted on the MSE are settled by the Central Securities Depository (CSD), with settlement occurring within 3 days of the transaction (T+3). The CSD maintains securities records of all joint stock companies in the Republic (around 500 companies) in dematerialised form.

Quality of securities market legislation – FYR Macedonia (2004)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO's *Objectives and Principles for Securities Regulations*. The fuller the 'web', the closer the relevant securities market legislation of the country approximates these principles.

Source: EBRD Securities Market Legislation Assessment 2004

In 2004, the EBRD benchmarked the Macedonian Securities Markets legislation against the “Objectives and Principles of Securities Regulation” published by IOSCO. The results showed the national legislation to be in “high compliance” with international standards and only minor flaws were evidenced (see chart above). The Securities Commission has enforcement powers but lacks protection of staff from lawsuits. The Commission should begin to publish its policy decisions and be more transparent about its activities and investigations. The 2004 Assessment also showed a lack of protection of minority shareholders in certain areas, such as appraisal rights and disclosure of shareholder percentage ownership above certain thresholds. Interestingly, FYR Macedonia scored top marks for its accounting policies and procedures regulation in the section on “Accounting and Auditing of Financial Reports”. The country also scored well on clearing and settlement, anti-money laundering laws and financial instruments. Some of these strong results can be attributed to funding from organisations such as the IMF to address areas of greatest concern: auditing and money-laundering, regulation and enforcement ability. The results of a recent update to the Assessment confirmed the high rating and showed that the new Law on Trade Companies improves the protection of minority shareholders by providing for cash out rights, amendment of agreed agendas of shareholders meetings, and rights to inspect company records (see the following section).

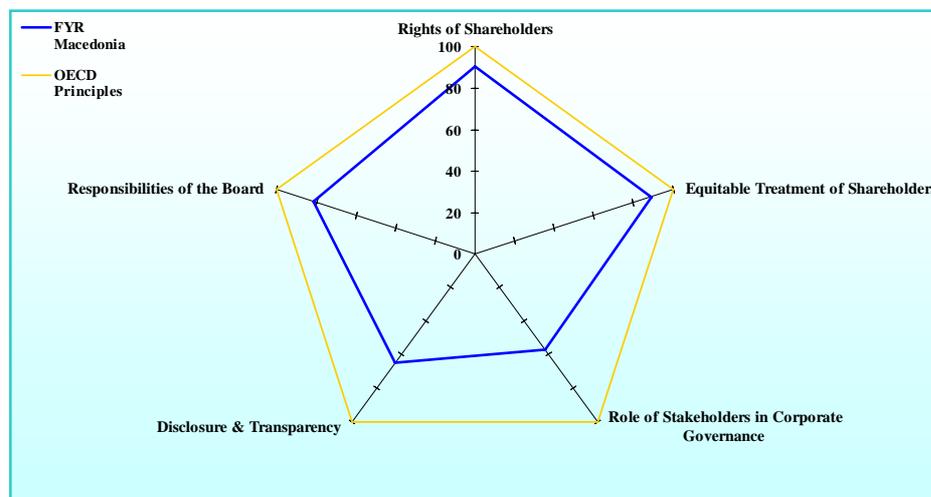
The next steps for FYR Macedonia, purely on the level of implementation of law, will be to improve the publication of information about, and licensing of, financial intermediaries and to establish systems of risk management and internal control.

Company Law and Corporate Governance

On 30 April 2004, the Parliament passed a new Law on Trade Companies replacing a similar law adopted in 1996. This new law is the principal legislation on corporate governance. The 2004 law introduced stricter disclosure rules both with respect to companies’ operational and general financial status and to executive compensation, and enhanced shareholder protection measures. Banks, insurance companies, listed and medium and large companies are required to prepare their financial statements according to the international financial reporting standards (IFRS) and each joint stock companies (JSCs) must prepare an annual report.

According to the 2004 results of the EBRD’s Corporate Governance Sector Assessment, under which corporate governance related “laws on the books” were assessed, FYR Macedonia was rated as having achieved “high compliance” when compared to the OECD Principles of Corporate Governance.

Quality of corporate governance legislation – FYR Macedonia (2004)



Note: The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the ‘web’, the more closely the corporate governance laws of the country approximate these principles.

Source: EBRD Corporate Governance Sector Assessment, 2004 assessment.

In order to assess how the law works in practice, in 2005, the EBRD launched a survey to test the effectiveness of corporate governance. Two case studies dealing with related-party transactions in a listed and unlisted company were designed. The case studies investigated the position of a minority shareholder seeking to access corporate information in order to determine if a related-party transaction had indeed been entered into by the company and how to obtain compensation in case damage was suffered. The effectiveness of legislation was then measured according to four principal variables: institutional environment, enforceability, complexity and speed.

When considering speed, the survey discovered that it could take more than 4 years to have a final and executable judgement and it was reported to be easy for the defendant to delay the procedure. Procedures can be quite complex and enforcement can be a problem. Minority shareholders may have difficulty obtaining information from the company’s auditor or in gaining access to the company’s books for the purposes of inspection. The same difficulties are faced when attempting to seek redress against the company’s directors *via* direct liability actions or through actions for disgorgement of profits.

In terms of the institutional environment, the survey revealed that company books are generally considered of good quality. The main problems seem to be the competence and experience of courts in corporate law cases and the possible partiality of courts and market regulator especially towards powerful defendants. The availability of case law and its use by judges and lawyers is generally limited, which might increase the uncertainty and complexity of proceedings. As a result, despite the good quality of legislation on the books, the principal challenge for the country is to ensure that the good laws on the books are put into practice.

Concessions

The concessions legal framework is governed by the Law on Concessions of 2002 as amended (the “Concession Law”). The Concession Law represents a flexible general framework implemented through sector laws (separate acts on railways, energy, water, etc.) along fundamental principles.

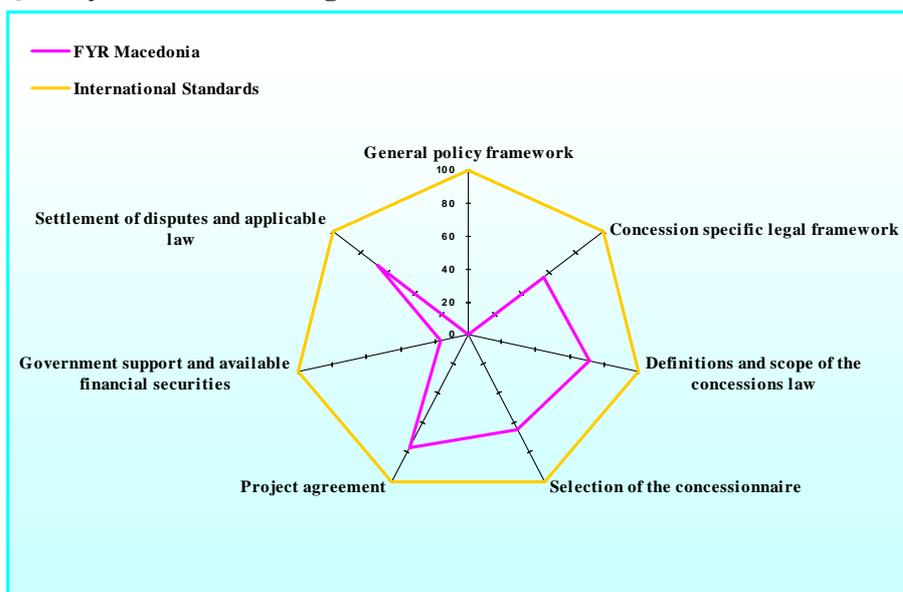
According to the Concession Law, a concession may be granted to domestic or foreign legal entities and individuals registered in the Trade Register of the Republic. A concession is defined as “an act which regulates the rights to utilise possessions of common interest for FYR Macedonia and carrying out of activities related to possessions of common interest, that are made available for concession assignment by a special law.” The reference to “possessions of common interest”, an ambiguous and undefined concept, weakens the law, laying it open to potential misuse.

The Concession Law clearly defines its scope of application, regulates the selection procedure (publication, pre-selection and procedure for requesting proposals, publication of concession award, possibility of review procedures) and provides for a flexible framework for the project agreement (with references to termination, compensation, tariff setting, services standards, *etc.*). 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.

However, 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. Furthermore, the Concession Law does not contain clear provisions concerning government support and financial security.

The recent EBRD Concession Laws Assessment undertaken in 2004 – 2005 to evaluate applicable regimes throughout the EBRD’s 27 countries of operations (the laws on the books only rather than how they work in practice), revealed that Macedonian laws had “medium compliance” with internationally accepted standards in this sector and that the country has one of the more advanced concession laws in south-east Europe, even though it may not yet be sufficiently tested in practice.

Quality of concession legislation –FYR Macedonia (2005)



Note: the extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the ‘web’, the more closely concessions laws of the country approximate these standards.

Source: EBRD Concessions Sector Assessment 2005

As can be seen from the above graph, while general framework rules as

well as definitions and the scope of the law and project agreement rules, for instance, are regulated fairly extensively, some other areas, in particular, availability of financial

instruments and state support need to be significantly improved in order to meet the requirements of a modern legal framework facilitating private sector participation. One more dimension that will inevitably require the attention of the authorities is policy framework, the absence of which makes any law, even an ideal one, extremely difficult to implement.

Insolvency

The principal law that governs the liquidation of insolvent enterprises in FYR Macedonia is the Law on Bankruptcy (the “Bankruptcy Law”). The Bankruptcy Law came into force in 1998 and was amended in 2002, 2004 and, most recently, in March 2006. The 2003 EBRD Insolvency Sector Assessment rated the Bankruptcy Law as “medium” in terms of its compliance with international standards. In addition, the 2004 EBRD Legal Indicator Survey found that the effective implementation of the law was challenging.

The 2003 Insolvency Sector Assessment indicated that the Bankruptcy Law was relatively strong in its commencement criteria, the definition of property constituting the estate of the debtor and its reorganisation provisions. The main problems identified by the Assessment included a slow commencement period of 60 days, poor notice to creditors and unclear rules regarding avoidance of pre-bankruptcy transactions. The Bankruptcy Law, at the time, provided few rules for the administration and training of trustees and even allowed unlicensed trustees to continue administering certain files. Other key problems with the Bankruptcy Law were the lack of a specialised judiciary and unclear jurisdiction between the courts and the trustee.

Subsequent amendments appear to have addressed some of these problems. One of the main goals of the most recent reform was to establish a process that would allow cases to be handled more quickly. To that end, the Bankruptcy Law now appears to allow proceedings to be commenced if the debtor is incapable of making payments and fails to pay a debt within 45 days, a modest improvement over the previous rules. It also includes strict timelines for the filing of claims and the filing and disposition of appeals. A new appeal procedure has been developed that will allow the Bankruptcy Council to act as the appeal panel, avoiding the need to take disputes to the appellate level. Taken together with changes to other procedural requirements and time limits, these changes should result in a shortened and more predictable bankruptcy process.

It also appears that the amendments significantly improve the notice provisions by requiring direct notice to creditors and electronic filing of information with the Central Registry. The information filed with the Central Registry will be publicly available via its website.

The amendments also appear to have improved the fairness of the system by enhancing the authority of trustees to set aside pre-bankruptcy transactions and strengthening the prohibition on related party transactions.

The most recent amendments adopted the UNCITRAL cross-border insolvency provisions and appear to have been drafted in such a way as to bring the Bankruptcy Law into compliance with the EU Directive on financial collateral arrangements.

Perhaps the most important reforms have been with respect to bankruptcy trustees. Creditors are now allowed to select trustees and to replace court appointed trustees. Trustees now have

the power to assign and otherwise deal with the debtor's contractual rights. The law also appears to contemplate a shift of power away from the courts with trustees taking on more responsibility for the administration of bankruptcy files.

The recent amendments create a Chamber of Trustees which will supervise, train and discipline trustees. The Ministry of Economy will be responsible for the Chamber of Trustees and will have responsibility for setting licensing examinations, licensing trustees and approving the code of conduct and the professional standards to which trustees will be held. It appears that these amendments prohibit unlicensed trustees from continuing to administer files.

The new trustee-related provisions provide the tools to significantly improve the training and governance of trustees and, if properly utilised, could help to improve the effectiveness and predictability of the bankruptcy system.

The amendments do not, however, create a specialised bankruptcy court. Training for judges to give them a certain level of expertise in commercial and insolvency law would improve the efficiency and effectiveness of the system.

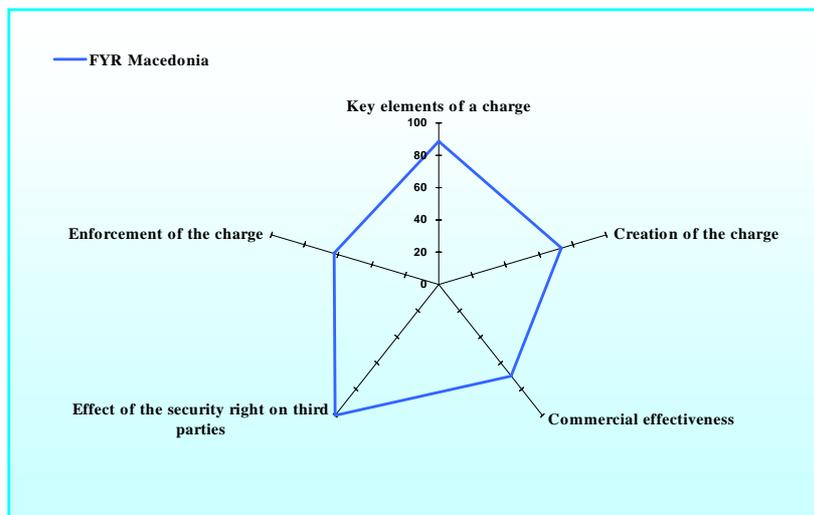
As a result of the 2004 and 2006 amendments, it is anticipated that the medium rating will be improved when the Bankruptcy Law is reviewed as part of the upcoming EBRD Insolvency Sector Assessment. Significant improvement in the functioning of the bankruptcy system, however, will depend on effective implementation of the new rules.

Secured Transactions

The legal regime applicable to secured transactions has been through a series of reforms over the last few years which have markedly improved the conditions by which security over movable assets can be created and enforced. In particular, the 2003 Law on Contractual Pledge (developed with the support of the World Bank) which repealed the 1998 Law on Pledge of Movable Property and Rights, has introduced a number of positive features. As of today, a charge can be granted over all types of movable property (as opposed to real estate), tangible assets, securities, claims and other rights. The charge can be either possessory (i.e. requiring 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 2003 Law on Contractual Pledge has removed 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 realization of assets based on a notarised charging agreement. The Registry of Pledges on Movable Property and Rights is part of a system of electronic registries administratively combined into the Central Registry of the Republic. 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.

Some problems, however, remain: 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). The registration agreement still requires specific description of the charged assets, making the charging of future assets very difficult. This makes the commercial effectiveness of the system weaker than it should be, as shown in the graph below.

Analysis of the current secured transactions legal regime in FYR Macedonia - 2005



Note: The extremity of each axis represents an ideal score. The fuller the ‘web’, the more closely the secured transactions legal regime of the country approximates the EBRD Core Principles for a Secured Transactions Law.

Source: EBRD Survey of Secured Transactions 2005

Telecommunications

The communications sector in FYR Macedonia is governed primarily by the Electronic Communications

Law of 2005 (the “Electronic Communication Law”) and is regulated by the Agency for Electronic Communications (AEC). AEC was established pursuant to the Electronic Communications Law as an independent regulatory authority and is responsible for the introduction and maintenance of a competitive market for communications. More particularly, AEC is responsible for the determination of operators with significant market power; administration of the interconnection framework; interconnection and access price regulation; dispute resolution; and, administration of universal services.

The Electronic Communications Law continues the trend of harmonisation and implementation of the important European Union (EU) communications regulatory provisions and provides a modern framework with respect to licensing, interconnection, universal service, tariffing and quality of service. FYR Macedonia became an EU candidate country in December 2005 and, as such, is obliged to harmonise the domestic communications regime with that of the EU.

Liberalisation of public fixed communications networks and services was scheduled for January 2005, but has been delayed pending adoption of the secondary legislation required under the Electronic Communications Law. While the authorities appear to be aiming for liberalisation in 2006, there is no clear indication when this will actually take place. Fixed line penetration currently stands at just under 30%, and has begun decreasing in overall terms in line with the international trend to mobile substitution.

MakTel, the incumbent operator, is 51% owned by the Hungarian operator MATAV, with 47.1% being held by the state. While there have been recent reports of the government’s

intention to divest itself of its holding, there appears to be no clear public strategy or timetable for making this intention a reality.

The mobile communications market is served by two operators, MobiMak (a subsidiary of MakTel) and Cosmofon (a subsidiary of the Greek OTE) and has experienced strong growth, recently surpassing 50% penetration rate.

Whilst progress has been made in reforming the communications sector in FYR Macedonia, significant further work is necessary to fully harmonise with the EU regulatory framework. The European Commission (EC) observed in its *Analytical Report for the Opinion on the application from the former Yugoslav Republic of Macedonia for EU membership* (December 2005) that the opening of the market has been frustrated by a lack of commitment at political level which, in conjunction with poorly designed regulatory institutions, has led to delays in adopting important liberalising measures. While the Electronic Communications Law addresses a number of the deficiencies highlighted by the EC, given the delays in liberalising the market, significant regulatory intervention will likely be necessary to ensure the full practical implementation of the framework envisaged in sector policy and law. While the establishment of the AEC is a positive development, the government should prove their commitment to a competitive marketplace by ensuring that AEC is provided with all necessary powers and resources to implement regulatory policy and make competition a reality.

ANNEX 3: ENVIRONMENT

In line with the NEA 2, the overall environmentally related objectives of FYR Macedonia in the next 6 years are as follows:

- to continue the process of approximation with the EU's overall environmental policies, framework legislation and directive-specific requirements. This process is well underway e.g. through the adoption of framework legislation as well as secondary legislation and through considering the next important phase which focuses on their implementation.
- to provide for integration of environmental policies into other sectoral policies as a means to achieve better policy making including also the striking of a balance between economic efficiency and environmental effectiveness, among other things also through a focus on the opportunities offered by economic instruments.
- to provide for the administrative structures that are needed to ensure efficient environmental management. This focuses on the new competences of the local self-governments in the ongoing decentralisation process, and pays particular attention to the appropriate division of competences and responsibilities. Another area of particular concern relates to the possible adoption of other national, regional or local structures to prepare RM to take full advantage, without undue delays, of EU funds for environmental capacity building as well as environmental investment projects.
- to ensure platform for efficient implementation and enforcement of environmental requirements through the strengthening of the capacity for efficient environmental management at all governmental levels, and by means of ensuring close cooperation among authorities at horizontal and vertical levels. In this, particular emphasis is put on the level of local self-governments and the need to provide those with practical guidelines on how to administer their environmental competences, thereby supporting their efforts in regard to practical implementation of environmental legislation and the provision of better environmental services.
- to encourage a better sense of environmental responsibility in industry and with environmental service providers as well as other actors in the field of environment, e.g. through mechanisms such as environmental quality self-monitoring.
- to pave the way for an environmentally sustainable approach which integrates environmental considerations into the activities of the various economic sectors while at the same time paying attention to social needs and the strive for economic growth.
- to solve important national environmental problems.. In doing this however, it has also been recognized that priority setting is in accordance with national financial and economic constraints.
- to improve the level of compliance with obligations under regional and global environmental agreements to which FYR Macedonia is a Party implying also an active involvement of the country in the international systems for environment.

The Bank's interventions in the country will support the objectives listed above, particularly in the municipal and environmental infrastructure sectors. Indeed, the Bank has been supporting the country in its attempt to solve urgent problems in urban infrastructure by signing a sovereign loan in 2000 to finance infrastructure improvement in towns of Kumanovo, Ohrid/Struga, Strumica, Stip and Veles. The project is currently being implemented.

In May 2006, the Bank provided environmental risk management training for the local 9 banks in the country which are financed by EBRD.

All new EBRD operations in FYR Macedonia are subject of 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.

ANNEX 4: SELECTED ECONOMIC INDICATORS

FYR Macedonia	2000	2001	2002	2003	2004	2005 <i>Estimate</i>	2006 <i>Projection</i>
Output and expenditure <i>(Percentage change in real terms)</i>							
GDP	4.5	-4.5	0.9	2.8	4.1	4.0	4.0
Industrial gross output	9.4	-4.6	-0.8	5.1	-2.1	6.9	na
Agricultural gross output	1.0	-10.8	-2.0	4.8	4.9	3.0	na
Employment <i>(Percentage change)</i>							
Labour force (end-year)	0.6	6.3	-4.4	4.4	-3.3	6.9	na
Employment (end-year)	0.8	9.0	-6.3	-2.9	3.0	8.0	na
<i>(In per cent of labour force)</i>							
Unemployment (end-year)	32.1	30.5	31.9	36.7	37.2	36.5	na
Prices and wages <i>(Percentage change)</i>							
Consumer prices (annual average)	5.8	5.3	2.4	1.1	-0.3	0.1	2.0
Consumer prices (end-year)	6.1	3.7	1.0	2.5	-1.9	1.3	2.0
Producer prices (annual average)	8.9	2.0	-0.9	-0.3	0.9	3.0	na
Producer prices (end-year)	7.9	-2.5	1.1	-0.2	1.3	2.9	na
Gross average monthly earnings in economy (annual average)	5.5	3.6	6.9	4.8	3.5	3.8	na
Government sector <i>(In per cent of GDP)</i>							
General government balance	2.5	-6.3	-5.6	-0.1	0.7	0.3	-0.6
General government expenditure	33.7	40.3	40.5	38.5	35.8	37.8	na
General government debt	53.2	51.6	49.6	45.7	44.3	47.6	na
Monetary sector <i>(Percentage change)</i>							
Broad money (M2, end-year)	24.4	66.3	-8.0	18.4	16.1	17.7	na
Domestic credit (end-year)	-10.7	-11.5	28.8	14.1	20.0	16.7	na
<i>(In per cent of GDP)</i>							
Broad money (M2, end-year)	17.7	29.8	26.3	30.2	33.3	37.6	na
Interest and exchange rates <i>(In per cent per annum, end-year)</i>							
Basic rate of the National Bank	8.9	10.7	10.7	7.0	6.5	6.5	na
Interbank interest rate	7.2	11.9	14.4	5.8	7.9	8.5	na
Deposit rate	10.7	10.0	9.2	6.7	6.5	5.2	na
Lending rate	19.0	19.2	17.7	14.5	12.0	12.1	na
<i>(Denars per US dollar)</i>							
Exchange rate (end-year)	65.3	69.2	58.6	49.9	49.4	48.9	na
Exchange rate (annual average)	65.9	68.1	64.7	54.3	50.0	48.5	na
External sector <i>(In millions of US dollars)</i>							
Current account	-69	-244	-358	-149	-415	-76	-300
Trade balance	-690	-526	-804	-848	-1,112	-1,052	-1,100
Merchandise exports	1,321	1,155	1,112	1,363	1,672	2,040	2,300
Merchandise imports	2,011	1,682	1,916	2,211	2,785	3,092	3,400
Foreign direct investment, net	175	441	78	96	156	97	300
Gross reserves, excluding gold (end-year)	700	760	730	890	980	1,401	na
External debt stock	1,548	1,494	1,641	1,831	2,034	2,253	na
<i>(In months of imports of goods and services)</i>							
Gross reserves, excluding gold (end-year)	3.5	4.8	4.1	4.2	3.8	4.9	na
<i>(In per cent of exports of goods and services)</i>							
Debt service	11.5	14.7	17.2	14.8	12.2	8.9	na
Memorandum items <i>(Denominations as indicated)</i>							
Population (end-year, million)	2.0	2.0	2.0	2.0	2.0	2.0	na
GDP (in billions of denars)	236	234	244	251	265	276	293
GDP per capita (in US dollar)	1,793	1,717	1,885	2,316	2,653	2,850	na
Share of industry in GDP (in per cent)	18.1	17.5	17.2	17.6	16.5	17.0	na
Share of agriculture in GDP (in per cent)	10.0	9.8	9.5	9.7	9.8	9.7	na
Current account/GDP (in per cent)	-1.9	-7.1	-9.5	-3.2	-7.8	-1.3	-5.0
External debt - reserves (in US\$ million)	848	734	911	941	1,054	852	na
External debt/GDP (in per cent)	43.2	43.5	43.5	39.5	38.3	39.5	na
External debt/exports of goods and services (in per cent)	94.6	106.9	120.0	108.8	100.6	93.1	na

ANNEX 5: SIGNED BANK OPERATIONS

As at 31 May 2006 (amounts in EUR million)

Project	Product	Portfolio category	EBRD finance (EUR million)	
Infrastructure			210.5	
<i>MEI</i>				
1	Municipal Environmental Action Programme	Loan	Sovereign	17.3
<i>Transport</i>				
2	Regional Roads	Loan	Sovereign	40.0
3	Civil Aviation Upgrading	Loan	Sovereign	11.2
4	Skopje Airport Rehabilitation	Loan	Sovereign	9.0
5	Air Navigation System Upgrading	Loan	Sovereign	10.7
<i>Power</i>				
6	ESM Pre-privatisation	Equity	Sovereign	45.0
7	FYR Macedonia – Bulgaria Transmission Interconnection	Loan	Sovereign	40.5
8	Power Sub-Sector (Bitola-Skopje Transmission Line)	Loan	Sovereign	17.3
<i>Natural Resources</i>				
9	Thessaloniki-Skopje Crude Oil Pipeline	Loan	Private	19.5
Financial institutions			68.8	
10	Investbanka	Loan	Private	4.0
11	Tutunska Banka	Syndicated loan	Private	7.0
12	Export & Credit Bank	Loan	Private	5.0
13	Export & Credit Bank	Equity	Private	3.1
14	Stopanska Banka	Equity	Private	11.7
15	Komercijalna Banka	Equity & Loan	Private	7.7
16	SEAF – fund	Equity	Private	3.7
17	Trade Facilitation Programme (TFP)*	Guarantees	Private	6.5
18	SME Credit Line (multi-bank)	Loan	Sovereign	20.1
Small Business			7.5	
19	ProCredit Bank	Equity & Loan	Private	7.5
Private Corporate Sector			111.8	
<i>Agribusiness</i>				
20	Migros Foodstores Skopje	Loan	Private	10.1
21	Zito Luks – milling/bakery	Loan	Private	8.0
<i>Telecommunications</i>				
22	Emergency GSM Extension	Loan	Non-Sovereign	14.0
23	Maktel	Loan	Sovereign	33.0
<i>General Industries</i>				
24	Mittal Steel Skopje - steel processing	Loan	Private	22.9
25	Prilep Marble Kombinat	Loan	Private	5.0
26	Kimiko Gardine (DIF) - curtain manufacturing	Equity	Private	2.2
27	Alkaloid – pharmaceutical	Loan	Private	4.9
28	Makstil - steel manufacturing	Loan	Private	11.7
Regional Projects (Macedonian portions total)			5.1	
TOTAL			403.7	

* As at 31 May 2006, EBRD approved limits for confirming trade finance instruments issued by six local banks (Tutunska Banka, Stopanska Banka, Komercijalna Banka, Investbanka, Export & Credit Bank, Eurostandard Bank) totalling EUR 23.6 million. TFP figure is amount which is outstanding amount as at end May 2006.

ANNEX 6: EBRD TECHNICAL CO-OPERATION PROGRAMMES

FYR Macedonia – 1993/2005 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 1993, 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 – 2005 reached the value of EUR 12.7 million) and Official co-financing initiatives (EUR 116 million is the total amount of the signed projects by end 2005).
- TC Fund: four Donors (Japan, BRSF, USA and EAR) account for more than 70% of the total aggregate commitments. Four are the sectors having more benefited from the EBRD TC Fund. Energy (EUR 4.5 million), Finance & Business (EUR 3.8 million), Transport (EUR 1.2 million) and Telecom (EUR 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. In 2005, access to credit for small and medium-sized enterprises (SMEs) has been improved through the EBRD's Western Balkans SME Finance Facility. Additional support has been provided for the TurnAround Management (TAM) and Business Advisory Services (BAS) Programmes. Canada, the European Agency for Reconstruction (EAR) and Ireland have been the key donors. EAR committed EUR 500,000 to help Investbanka develop its small business lending programme and EUR 0.6 million to implement a BAS Programme. Assistance from Canada is helping the EBRD promote the privatisation of Elektrostopanstvo na Makedonija (ESM), the state-owned power utility
- Official Co-financing: by far, two IFI are the largest official co-financer and, with a total contribution of EUR 80.3 million, are covering the 66% of the total. The EIB is the largest co-financier with EUR 60.0 million followed by IFC with EUR 20.3 million. Other co-financers are Portugal (10%), Switzerland (9%), Germany (6%), Switzerland (4%). Sweden has also contributed with EUR 300,000. Like in 2004, no project has been co-funded from official sources in 2005.

TC Funds and Donors
Aggregate Commitments (1993-2005): EUR 12.7 million

DONOR	EUR Committed
Japan	3,384,381
Balkan Regional Special Fund (BRSF)	2,757,932
USA	1,769,663
European Agency for Reconstruction	1,280,000
UK	565,374
Italy (including CEI)	463,147
Netherlands	468,163
Sweden	369,480
Germany	311,257
Taiwan	299,663
France	208,900
Canada	395,339
Denmark	150,000
Ireland	233,606
Switzerland	68383
Norway	16,763
TOTAL	12,742,051

Official Co-financing and Donors
Signed projects - Signing years: 1999-2005
EUR 116.1 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
Sweden	300,000
TOTAL	116,185,284

Future scenario: 2006-2007

- FYR Macedonia will remain among the priority countries for a reduced number of bilateral donors.
- The EAR started the implementation of her exist strategy. By 2008, the Agency activities will come to an end.

- Since December 2005, the FYR Macedonia is an EU Candidate Country and, as such, the Country will benefit from the newly established “**EU-Instrument for Pre-Accession (IPA)**” over the period 2007-2013. The EC has yet to finalise the details of the IPA programme, but has indicated that all previous financial instruments (including the co-funding ISPA instrument) will be merged into one, and planning and budgeting will be on a multi-year basis. It is envisioned by the Commission that the recipient country will have the full management of the programmes, through a decentralised system. The full implications for operational support of activities falling within EBRD’s mandate have yet to be determined. In any case, it’s unlikely the mobilisation of EC funding before end 2007, beginning 2008.
- Over recent months, EBRD has discussed with donors a proposal to create a new multi-donor fund for the Western Balkans, including FYR Macedonia. Preliminary discussion took place at the EBRD donor meeting held in November 2005, where several donors asked the Bank to proceed with plans to create a new fund. In January 2006, the Bank presented a background paper, and detailed sector presentations that outlined the priority needs in the region along with the availabilities of assistance from existing bilateral sources. A decision to create **the new Western Balkans Multi-Donor Fund (WBMDf)** was made at the EBRD Annual General Meeting in London (21-22 May 2006). Eleven countries agreed to provide a total EUR 10 million in donor funds towards a new EBRD-driven initiative to boost private business investment and infrastructure development in the Western Balkan countries, including FYR Macedonia. The new multi-donor fund will strengthen EBRD – donor coordination in FYR Macedonia and expand the resources available to support economic growth and regional cooperation.

Regarding the likely support to the Country from bilateral donors, the following is a detailed picture:

Austria

Austria will remain very interested in sectors such as water, waste management. Austria is expected to join the WBMDf.

Canada

FYR Macedonia is not considered any longer among the top priority country. They withdrew formally in November 2005.

EAR

Under the Annual Programme for 2006, the amount of EUR 700,000 has been earmarked for the implementation of a joint EAR/EBRD TAM initiative.

Ireland

Ireland will now focus its efforts on the WBMDf and the ETCF. Very limited resources are available from the bilateral fund.

Italy

- FYR Macedonia is considered, like other Western Balkans Countries, as a priority Country for Italy.

- Under the *Italy-EBRD Cooperation Fund for Private Sector Development in the Western Balkans* there is a still uncommitted amount of EUR 1.6 million to implement SME and MEI related activities.
- Among the new initiatives developed in 2005, Italian funds in the amount of EUR 12 million have been allocated to implement the "*Italy-EBRD Western Balkans Loan Enterprise Facility*". It is a risk sharing and equity facility supporting local enterprises in the region, inclusive FYR Macedonia.
- The *Italian TC Fund* could be used to implement TC assignments.

Japan

Japan has in the past been an extremely active donor in the Country. Their focus has shifted towards the Central Asia, and additional funding for the Country seems to be unlikely.

The Netherlands

The Netherlands are ready to explore the provision of financial support for the implementation of TC assignment and/or investments in the Country, provided there is a clear commercial Dutch interest. They are expected to join the WBMDf.

Norway

FYR Macedonia is a priority country for Norway. They show a specific interest on energy and environment projects. They are expected to join the WBMDf.

Sweden

The Swedish Government (Sida and Ministry for Foreign Affairs) is interested in strengthening co-operation in the Balkan Region. In large scale infrastructure projects, Sida could remain active on a parallel basis.

Switzerland

The *Swiss CTF Fund* has been replenished in late 2005, and FYR Macedonia is considered among the priority countries, also in the frame of possible Investment grant co-financing activities. Swiss funding are supporting, with an investment grant, the implementation of the MEAP in Kumanovo.

UK

UK fund for SEE is almost fully committed. Any new funding will go to the WBMDf.

USA

USA has a strong "Economic Growth" programme (mainly SME support) in FYR Macedonia (including its support to SEAF and Pro-credit Bank).

Other

France, Germany and Spain expressed interest in joining the WBMDf. They have unallocated TC funding that could be made available to implement assignments in the Country. *Belgium, Denmark, Greece, Portugal and Taiwan*, all have established TC Funds under which FYR Macedonia is eligible and therefore are potential donors to the TC although, so far, their involvement has been sporadic with the exception of Taiwan.

Detailed Breakdown of TC Projects

Commitment Name	Euro Committed	Euro Disbursed	Sector
Skopje airport site survey and final design	195,399	195,399	Transport
Gas distribution and expansion project	150,000	150,000	Energy
Gas distribution project	41,314	41,314	Transport
SME line of credit	5,113	5,113	Financial Institutions
Komercijalna Banka	236,429	236,429	Financial Institutions
Air Traffic Control: Y2K Compliance (phase 1)	45,500	45,500	Transport, Storage
Air Traffic Control: Y2K Compliance (phase 2)	117,841	117,841	Transport, Storage
Privatisation advisory programme - evaluation manual, training of valuers, management and procedures	198,756	198,756	Community/Social Services
Tourism advisory project – promotion and marketing	56,551	56,551	Commerce, Tourism
FYR Macedonian PTT - tender documents preparation	162,856	162,856	Telecommunications
Telecommunications and post institutional development - management of change programme	14,486	14,486	Telecommunications
Power sub-sector project - ESM project management unit	136,388	136,388	Energy
FYR Macedonian PTT - international traffic study	32,918	32,918	Telecommunications
Privatisation Advisory Programme - competition policy, law and restructuring	41,370	41,370	Community/Social Services
Documentary credit advisor for Komercijalna Banka	44,233	44,233	Financial Institutions
Stopanska Banka - financial and operational audit (Phase I)	349,954	349,954	Financial Institutions
Power sector loan (ESM) - commercial accounting and finance reporting	314,542	314,542	Energy
FYR Macedonia Telecommunications - corporate strategy and organisational development	121,956	121,956	Telecommunications
FYR Macedonia Telecommunications institutional reform and regulatory development programme	248,596	248,596	Telecommunications

FYR Macedonia Telecommunications - management of change	164,645	164,645	Telecommunications
FYR Macedonia Telecommunications - Finance, accounting and billing	294,858	294,858	Telecommunications
Small and medium-sized enterprises line of credit – assistance package	323,722	323,722	Finance, Business
Gas distribution and expansion project	128,795	128,795	Energy
Telecommunications and post institutional development - management of change programme	16,763	16,763	Telecommunications
Privatisation preparatory programme	79,357	79,357	Community/Social Services
Air Traffic Control : Y2K Compliance (2) – Computer	100,306	100,306	Transport, Storage
Air traffic control - Y2K compliance (2) radar display	120,000	120,000	Transport, Storage
Assistance to the privatisation programme - privatisation of media	119,280	119,280	Community/Social Services
Komercijalna Banka environmental due diligence	41,618	41,618	Financial Institutions
Training programme - energy conservation	25,671	25,671	Energy
FYR Macedonia Telecommunications - finance accounting and billing	47,835	47,835	Community/Social Services
Komercijalna Banka due diligence and business plan	93,108	93,108	Financial Institutions
Assistance in the review of FYR Macedonia's energy law	69,511	69,511	Energy
FYR Macedonia Municipal and Environmental Action Programme - Pre-feasibility Study	179,936	179,936	Infrastructure
Export and Credit Bank: Retail Expert	138,392	138,392	Financial Institutions
Skopje Bypass, Updated Feasibility Study	304,023	304,023	Infrastructure
FYR Macedonia Municipal and Environmental Action Programme	1,750,000	1,452,046	Infrastructure
Business Advisory Service (BAS) Programme in the Balkans - BAS Programme Director, Chris Rudd	38,015	38,015	Business
Export and Credit Bank: Director for Business Development	208,366	208,366	Financial Institutions
Construction of the Wastewater Treatment Plant - Stip/Veles	19,600	17,780	Infrastructure
Construction of the Wastewater Treatment Plant - Stip/Veles	19,600	17,890	Infrastructure

FYR Macedonia, ATCO refresher courses	235,408	235,408	Infrastructure
FYR Macedonia, ATCO refresher courses	58,433	58,433	Infrastructure
TAM – Ograzden	60,000	16,640	Business
FYR Macedonia Regional Roads Project - Pan European Corridor X - Updated Feasibility Study	47,586	47,586	Infrastructure
Smokvica to Gevgelija - Lender's Monitoring Consultant	120,000	40,133	Infrastructure
FYR Macedonia: Institutional and Road Planning Study	199,400	0	Infrastructure
Export and Credit Bank: Strategy Expert	85,300	85,300	Financial Institutions
Pilux & Danpex Initial Due Diligence	11,847	11,847	Business
FYR Macedonia Insurance Supervision Department	99,120	39,562	Financial Institutions
Municipal and Environmental Action Programme	1,480,500	1,112,723	Infrastructure
TurnAround Management Programme (TAM) - Fustelarko Borec	48,400	36,754	Business
Procurement Agent - Implementation of National Payment Card System	20,680	20,680	Financial Institutions
FYR Macedonia Civil Aviation Upgrading Project - Assistance to Project Implementation	300,000	180,698	Infrastructure
Replek	18,384	18,384	Business
Consulting Services for FYR Macedonia Transmission Line Project	49,999	42,566	Energy
Regional Roads Project - Institutional Study	47,924	47,924	Infrastructure
Kimico Gardine Market Study	11,146	11,146	Business
Business Advisory Service (BAS) Programme in FYR Macedonia – Framework	99,981	69,849	Business
Kmico Gardine Legal Due Diligence	5,800	5,040	Business
Kimico Gardine Re-registration	3,500	0	Business
FYR Macedonia Regional Road Project: Environmental Monitor	90,334	0	Infrastructure
Microfinance Bank Macedonia (MMB) – Establishment	1,015,125	811,267	Small business
Microfinance Bank FYR Macedonia (MMB) – Establishment	543,855	543,855	Small business
BAS Environmental Programme in FYR Macedonia – framework	686,585	0	Business, Environment

Bannock Consulting - Western Balkans SME Finance Framework – EAR	460,000	0	Financial Institutions
Shorebank - Western Balkans SME Finance Framework – EAR	10,775	0	Financial Institutions
LFS Financial Systems - Western Balkans SME Finance Framework – EAR	10,775	0	Financial Institutions
Bankakademie - Western Balkans SME Finance Framework – EAR	10,775	0	Financial Institutions
FYR Macedonia: TTK (TEB and TKB) - Assistance with Reorganisation	49,500	0	Financial Institutions
TAM - IGM Trade	60,000	0	Business
TAM – Ading AD	60,000	0	Business
TOTAL	12,798,735	9,931,914	

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)	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:					116,185,284	

1. Multilateral assistance

EU

European Union is the largest donor in FYR Macedonia, in line with the Macedonian medium-term perspective of becoming a member of the European Union. In the first half of nineties, EU assistance was delivered through ECHO, PHARE, and OBNOVA Programmes. ECHO provided humanitarian aid, OBNOVA provided assistance in reconstruction and rehabilitation, while PHARE focused on institutional building and cross-border cooperation with the Republic of Greece. The total EU assistance provided to FYR Macedonia amounts to more than EUR 700 million since 1992.

European Union assistance provided within the CARDS National Programme in the period of 2002 -2005 was in amount of EUR 153.5 million. The amount represents the total funds allocated within the 2002-2005 Annual Action Plans, while the CARDS 2006 (EUR 30.5 million) has been adopted by the Commission and the Financing agreement is about to be signed. 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. The main sectors of EU assistance in FYR Macedonia are: justice and home affairs, economic and social development, democratic stabilisation, environment and natural resources and administrative capacity building.

While National CARDS Programme is focused on a country-based support, Regional CARDS Programme is aimed at promoting horizontal cooperation between all countries in the region, as a complement to the country-based CARDS programme. The funds available within the Regional CARDS (2002-2004) Programme were EUR 197 million, and the budgeted funds within the Regional CARDS (2005-2006) Programme are in the amount of EUR 85 million. As indicated in the 2002-2006 Regional Strategy Paper, main areas of intervention are: integrated broader management, democratic stabilization, institution building, developing regional infrastructure approaches, justice and home affairs, development of the private sector and regional cross border cooperation. As of 2007 FYR Macedonia will, as a candidate country, benefit from the IPA (Instrument for Pre-Accession).

EAR

The European Agency for Reconstruction (EAR) was established in 2000 with the responsibility to manage the main EU assistance programmes in Serbia & Montenegro (Republic of Serbia, Republic of Montenegro, UN-administered Kosovo) and the former Yugoslav Republic of Macedonia. Its operational centre in Skopje was opened in early 2002.

After an initial period of strong involvement in infrastructural rehabilitation and reconstruction, the Agency is now predominantly focusing on institutional capacity building in the key areas of the EU *acquis communautaire* (judiciary and fundamental rights, justice, freedom and

security, environment, agriculture and rural development, financial control, social policy and employment, enterprise and industrial policy, and in other areas of the acquis).

The Agency portfolio in the FYR Macedonia amounts to EUR 320 million, including the amount of EUR 28 million from CARDS 2006. It includes projects financed under CARDS (2001-2005), projects financed under PHARE (1997-2000) and the Emergency Response Programme (2001). Over 85% of the funding that the Agency manages has been contracted, and 71 % disbursed.

The CARDS 2006 Annual Programme is expected to be officially approved with the signing of the financing agreement, by mid-2006. The CARDS Annual Programme 2006 with a budget of EUR 28 million will support the following sectors: judiciary, police, administrative capacity building, decentralisation, trade, infrastructure, environment, employment.

EBRD has established an excellent co-operation with the EAR, especially in the fields of transport and SME Support. In addition to direct cooperation, the EAR is implementing a number of projects which could lead to future EBRD operations, such as the support provided to the Ministry of Transport regarding the National Fund for Road Maintenance and Makedonija Pat.

EUROPEAN INVESTMENT BANK

The European Investment Bank (EIB) started its operations in the FYR Macedonia in 1998, with the signing of the protocol for financial cooperation between EIB and FYR Macedonia, according to which EIB started granting credits to FYR Macedonia as a sovereign borrower. The cooperation was further strengthened in 2000, with the signing of the Framework Agreement that offers opportunities for realization of projects of common interest in the basic infrastructure, but also in other important areas that are of vital meaning for FYR Macedonia. Starting from 1998, EIB assistance in FYR Macedonia (EUR 163 million) was directed towards improvement of the transport and the energy sector, as well as towards development of small and medium-sized enterprises. EIB develops its activities on a project by project basis rather than on a programme basis.

The assistance in the transport sector is consisting of EUR 130 million for two road projects: Road Project I (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 completed and Road Project II (signed in July 1999, EUR 60 million) involving the construction of the Skopje bypass. The Road Project II is co-financed by the EBRD.

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 supporting the national electricity company's investment plan for the rehabilitation of power substations and associated transmission lines, while EBRD is financing the privatisation of the old vertically –integrated power company and construction of a new transmission interconnection between FYR Macedonia and Bulgaria.

In 2001, EIB granted a global loan for small and medium-sized enterprises in the amount of EUR 20 million to the Government. The loan supported small and medium sized investments

by private sector companies, as well as infrastructure projects by municipalities. This APEX Global loan was realized through the local banks. As of end October 2005, the total amount of EUR 20 million was placed and the Project was successfully completed.

The framework of the future cooperation is defined by the strategic priority of the Government, the European membership, as well as with the Corporate Operation Plan of EIB for the period 2005-2007.

INTERNATIONAL MONETARY FUND

FYR Macedonia joined the IMF in December 1992. Since the adoption of the last EBRD country strategy in July 2004, a new IMF stand-by arrangement, SDR 51.7 million, was agreed with the Government in August 2005. The first review of the IMF program was passed in April 2006.

The new Stand-By Arrangement will be focused on reforms in health care, the judiciary and the labour market. The programme contains quantitative performance criteria and indicative targets. These include ceilings on the budget deficit and borrowing, as well as ceiling on the central government's wage bill and arrears. Also, the central bank is required by the IMF to apply a number of measures to improve banking supervision, including tighter prudential regulations, provisioning and reporting requirements.

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. World Bank's mission in FYR Macedonia is focused on promotion and support of job creation, as well as improvement services and exploring toward capacity building, human resources development and infrastructure investments.

To date, the World Bank has approved USD 760 million for 46 projects in FYR Macedonia since 1994. The loans have supported projects in agriculture, health, education, private finance and other sectors. The projects have also managed to leverage considerable grant funding from other donors.

The total amount of loans within the so called high-case scenario of the 2004-2006 Country Assistance Strategy is USD 165 million, as a multi-sector assistance to infrastructure, private sector, law and justice, public administration, education, social and health sector, as well as budget support.

World Bank has begun preparatory work on the new Country Partnership Strategy 2007-2010. The program will be centered on two broad objectives: (i) supporting structural reform to promote growth and employment and (ii) facilitating EU accession.

The EBRD has been co-ordinating its activities with IBRD both at the level of special donor working groups and co-ordination with respect to regional transport network development, as well as energy sector reforms and the enhancement of enabling business environment in FYR Macedonia.

IFC

To date IFC has committed over USD 90 million in direct financing. IFC has invested in the textile, pharmaceutical, telecommunication, glass-machine production, steel, tourism and financial sectors 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 will continue to support the SMEs, post-privatized export-oriented companies and the infrastructure sector.

2. Bilateral assistance¹

GERMANY

Overall, in the period 1993-2006, FYR Macedonia received EUR 147 million within the German development cooperation, of which EUR 95 million as financial cooperation and EUR 52 million as a technical cooperation.

In the area of financial cooperation assistance from Germany has been focused on: environment (in particular water supply and waste water treatment), decentralization and social infrastructure (including municipalities, professional training, strengthening of civil society), economic reforms and development of market economy (including banking sector, SMEs, modernization of agriculture, EU approximation).

Within the technical cooperation Germany has been providing support for a large spectrum of issues: basic health services, rehabilitation of irrigation and water supply systems, planning of traffic infrastructure, start-up of private enterprises, improvement of food control system, new economic legislation, water sector, agriculture, consumer protection, vocational training and EU approximation.

The latest Protocol signed in April 2005, defines the financial and technical cooperation between Germany and FYR Macedonia in the period from 2005 to 2007, within the following thematic areas: (i) water supply, waste water treatment and environmental protection; (ii) democratisation/civil society and (iii) economic reforms/building market economy.

¹ 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)

JAPAN

Japan commenced bilateral assistance in 1995 and remains a significant donor to FYR Macedonia. Grant aid and a grassroots grant aid scheme (municipal level) were started in 1995 and 1996 respectively while the technical assistance cooperation began in 2003.

Starting from 1995, through several modalities, Japan has provided grant assistance amounting to over Yen 10 billion through: (i) general grant assistance (health sector, transport sector, balance of payment support, educations, NGOs,); (ii) grant assistance in culture; (iii) emergency aid and (iv) assistance for increasing food production.

The government of Japan also began the Grant Assistance for Grass Roots Projects (GGP) in 1996. 91 projects with total sum of approximately 468 million Japanese yen (app. EUR 3.4 million) have been implemented up to now.

In 2003, Japan Bank for International Cooperation (JBIC) has approved Yen 9.7 billion (app. EUR 72 million) for construction of the hydro-system Zletovica, which comprises of: construction of dam with backup facilities and water-supply facilities, irrigation of agricultural land and construction of 3 hydro-power plants.

In 2003, Japan International Cooperation Agency (JICA) has passed medium-term plan on technical cooperation between Japan and FYR Macedonia. The document determined the health, water supply management, industry promotion, education and pollution control as priority areas for cooperation. According to the revision of the medium-term plan for 2005, JICA is accepting participants for trainings in Japan, sending experts and providing equipment in the following priority areas: market economy promotion, human security and environment protection (water supply management). Starting from 1996, within this component Japan has provided funds amounting to Yen 2.2 billion.

The policy dialogue between the two governments also sets out the possibility to send business delegations to Japan and to organize seminars and trade fairs through the organisation for external trade (Japan External Trade Organization-JETRO).

THE NETHERLANDS

The Kingdom of the Netherlands is the largest bilateral EU donor in the FYR Macedonia. Due to its status of post-conflict country in transition on its way of the European integration, FYR Macedonia is considered as a unique partner country for the Netherlands. In addition, FYR Macedonia is part of the Dutch World Bank/IMF constituency.

Within the Multi-Annual Strategic Plan (MASP) on the Netherlands development cooperation with FYR Macedonia in the period 2005–2008, the following strategic contributions were determined: Euro-Atlantic integration, increased governance (both political and economic) and increased economic and human development.

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 support of the projects in education, rural and culture development. The Netherlands was already highly

active in the private sector through its support to the Macedonian Enterprise Development Foundation (MEDF) in amount of 5.7 million and to the Macedonian Pro Credit Bank in the amount of EUR 5.5 million.

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.

The Netherlands' Programme for Economic Cooperation (PSO) is an assistance aimed to support the transition process to market-oriented economy in eleven countries in Eastern Europe, via transfer of Dutch business expertise, technology, goods and services in the sectors in which the Netherlands is among the leading countries in the world. Within this programme in the FYR Macedonia, 29 projects have been financed in total amount of EUR 16.7 million.

UNITED STATES OF AMERICA

U.S. Mission in FYR Macedonia includes the United States Agency for International Development (USAID), the U.S. Department of State and professionals from several important U.S. Government Departments and agencies.

USAID Mission in the country works in three main areas: promoting accelerated economic growth, supporting the development of democratic institutions, and helping educate Macedonians for a modern economy. The American people, through USAID, have invested more than USD 450 million in FYR Macedonia since 1993. The 2006 budget of the Mission is USD 31.4 million implemented through more than 20 projects.

Economic Growth

Improving Macedonia's employment levels is a major goal of the USAID mission. USAID is focusing on small and medium-sized enterprises (SMEs) to develop local and export markets and helping SMEs adopt information technology applications that support their competitiveness and growth.

USAID assisted FYR Macedonia to accede to the World Trade Organization (WTO) in April 2003 and supports the Government of FYR Macedonia as it harmonizes laws and practices with its WTO commitments. USAID helped FYR Macedonia to prepare a new Company Law, compatible with the European Union commercial legislation, and is introducing good corporate governance principles. USAID is also providing assistance to improve the overall environment for private sector development, as well as assisting the Government to develop e-government standards and capacity.

The overall committed funds in the support of the economic growth of the country (2006 inclusive) are: (i) Promoting competitiveness of private sector firms – USD 24.6 million; (ii) improving the investment environment – USD 9.6 million and (iii) strengthening of the bank and non-bank financial institutions – USD 1.7 million.

Co-financing with EBRD: Small Enterprise Assistance Fund (SEAF) – venture capital fund and Pro-Credit Bank – a new micro-finance bank in FYR Macedonia.

Democratic institution

USAID is assisting the Parliament to be more accountable and effective while encouraging dialogue between the leadership of political parties and the electorate. USAID is also a strong supporter of decentralization and is helping local government become more effective and responsive. USAID provided USD 39.4 million to increase citizens' participation in political and social decision making, enhance the rule of law and to foster more effective, responsive and accountable government.

Education

USAID supports higher quality education at all levels. It provided USD 23.7 million for human capacity strengthening through targeted education programs and USD 3.7 for cross-cutting programs. In addition to installing computers into labs, it helps teachers and students use information and communications technology (ICT) in primary and secondary schools. Moreover, broadband Internet access has been extended to all schools and communities throughout the country and, as a result FYR Macedonia has been designated as a first "wireless" country. In 2005, USAID also provided basic IT skills training to 6,000 primary and secondary school teachers to help them take advantage of new ICTs and internet access in schools.

USAID plans to provide approximately USD 30 million per year over the forthcoming period: to support the economic growth of the country, strengthen democracy and increase transparency and accountability in democratic institutions, and to strengthen basic education and make it more relevant to the country's needs.

ITALY

Italian Government has provided support to FYR Macedonia in sectors of great importance for economic and social development such as health, water and environmental protection, infrastructure, support for small and medium sized enterprises as well as emergency humanitarian support during the Kosovo crisis. For that purpose it has allocated approximately EUR 25 million in the period 1999 - 2001.

As a great supporter of the private sector development, the Italian Government has approved EUR 12.7 million credit-line aimed to support the import of commodities and services from Italy. Another credit-line of EUR 10 million for support to SMEs is planned to be approved in the forthcoming period. Also, EUR 1.3 million was pledged in 2004 for the economic rehabilitation of former crisis areas.

Italy is one of the rare donors, active in the health sector. In 1999, it provided support consisting of EUR 1.2 million grants and EUR 2.6 million loans aimed for enhancing of the health care system services through rationalization of the management system and modernization of biomedical technology park.

Italy has been also providing substantial support to FYR Macedonia in the following areas: agriculture, environment, education, culture, decentralization, support to disadvantaged ethnic groups and e-government.