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Research Update:

Ratings On Republic of Macedonia Affirmed At 'BB-/B'; Outlook Stable

Primary Credit Analyst:

Aarti Sakhuja, Madrid (34) 91-788-7207; aarti.sakhuja@standardandpoors.com

Secondary Contact:

Felix Ejgel, London (44) 20-7176-6780; felix.ejgel@standardandpoors.com

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Overview

- Macedonia's low income levels and high external liquidity requirements are offset by its still-moderate external and public debt burdens, in our view.
- We are therefore affirming our 'BB-/B' long- and short-term foreign and local currency sovereign credit ratings on Macedonia.
- The stable outlook balances the risks from rising public and external indebtedness against Macedonia's economic prospects benefiting from recurrent investment inflows, particularly into the manufacturing sector.

Rating Action

On April 17, 2015, Standard & Poor's Ratings Services affirmed its 'BB-/B' long- and short-term foreign and local currency sovereign credit ratings on the Republic of Macedonia. The outlook is stable.

Rationale

The ratings on Macedonia reflect our view of its relatively low income and wealth levels (we anticipate per capita GDP will amount to \$4,300 in 2015), weak checks and balances between political institutions, and limited monetary policy flexibility. The ratings are supported by moderate, albeit rising, external and public debt levels.

Since 2010, export activity, alongside expansionary fiscal policy, has supported the economy and has helped reduce unemployment. The central bank's accommodative monetary policy, increased bank lending and, more recently, price deflation have also aided private consumption growth, though the strength of the recovery independent of loose monetary and fiscal conditions is more doubtful. Nevertheless, we project average GDP growth of 3.4% between 2015 and 2018, benefiting from steady foreign investment inflows into the manufacturing sector. Risks to this forecast are most likely to stem from economic weakness in Macedonia's export markets (as was visible in 2012), a slowdown in FDI inflows, or a sharp tightening of the fiscal or monetary stance.

The general government fiscal deficit was revised upward to 4% of GDP, from the government's initial target for the fourth successive year in 2014. While, in 2013, the upward revision was driven by the repayment of arrears, in 2014 high pre-election and infrastructure spending have been largely responsible for the deviation. We estimate the general government deficit will amount to 3.6% of GDP in 2015 before narrowing to 3.0% in 2018, which is slower than the government anticipated. The difference arises from our lower expectation for real GDP growth, as well as the government's recent track record of missing its fiscal targets.

General government debt has increased to about 40% of 2014 GDP, from 20% in 2008, while the stock of guarantees to public-sector enterprises has quadrupled to an estimated 8% of GDP as the government has increased off-balance-sheet financing. Despite the early repayment of its outstanding debt to the IMF earlier this year, Macedonia's general government debt will continue to rise through to 2018 as deficits remain debt financed. We anticipate net general government debt will rise to nearly 37% of GDP in 2018, from about 33% in 2015, while the stock of guaranteed debt is set to increase toward 10% of GDP in 2018 as public entities such as the Public Enterprise for State Roads (PESR) draw on loans for infrastructure spending. The actual figures will ultimately depend on project construction costs; these are difficult for us to forecast given the limited transparency of the public procurement process in Macedonia.

Over 60% of government debt is denominated in foreign currency, which increases the vulnerability of the government's balance sheet to any potential foreign-exchange movements. We expect that this ratio could rise further as the debt management office's strategy envisages a greater proportion of financing through external debt issuance. Further, we also expect the share of commercial government debt held by nonresidents, currently at 48%, to rise. The banking system holds, on average, about 12% of its assets in government securities and central bank bills. As such, we do think it would struggle to materially increase its creditor share of the domestic government bond market.

With the public sector increasingly borrowing abroad, Macedonia's external indebtedness has been on a rising trajectory. We estimate gross external debt will rise to nearly 95% of 2015 current account receipts (CARs)--an increase of 20 percentage points since 2011. We anticipate external borrowing, and to a lesser extent foreign investment flows, will continue to finance the current account deficit. This will widen in 2015-2018 as investment-related imports pick up.

The Internal Macedonian Revolutionary Organization-Democratic Party of Macedonian National Unity (VMRO) won parliamentary elections held in April 2014 and formed a coalition with the largest ethnic Albanian party, the Democratic Union for Integration (DUI), together controlling 65% of the seats in parliament. Citing election irregularities, the main opposition party, the Social Democratic Alliance of Macedonia (SDSM), has boycotted parliamentary proceedings and the government has been functioning without an effective opposition for the past year. Political volatility has intensified over the past six months. The opposition leader, Zoran Zaev, has been charged with an attempted coup amid the release of tapes that allegedly implicate the government with fraud, among other serious crimes. We currently do not expect the ongoing domestic political turbulence to have a negative spillover effect on Macedonia's growth prospects over the medium term.

We consider the checks and balances between Macedonia's institutions to be limited. In its 2014 progress report on Macedonia, the EU highlighted deteriorating media freedom and problems related to the independence of the judiciary. In our opinion, fiscal slippages and the weakening quality of public finances since the global financial crisis also point to a loose framework for vetting the cost of public procurement, as well as public current expenditure.

Macedonia has been an EU candidate since 2005, but a dispute with Greece over its constitutional name continues to hamper progress in its accession talks. While negotiations are underway to reach a resolution, our medium-term forecast does not incorporate the benefits of accession.

The Macedonian denar is pegged to the euro. At an estimated \$2.5 billion, Macedonia's foreign reserves cover the monetary base about 2x, implying strong backing for the pegged currency regime. At the same time, net reserves (which exclude the foreign exchange needed to convert the monetary base into euros) cover external short-term debt by remaining maturity 0.9x, which is lower than many peers and suggests that external vulnerabilities inherent to a fixed exchange rate regime remain. The exchange rate regime restricts monetary policy flexibility. While central bank measures have succeeded in lowering the overall level of euroization in Macedonia, foreign-exchange-denominated deposits were still slightly above 50% (as of end-2014).

Since 2012, the central bank has eased policy with three cuts to its key interest rate as well as to reserve requirements to incentivize lending. It has also stipulated lower reserve requirements for denar-denominated liabilities compared to those denominated in foreign currency to engineer more lending and deposit-taking activity in the domestic currency. Rather exceptionally for the region, bank lending in Macedonia--including to corporates--has continued to grow briskly, increasing by nearly 10% in 2014.

While the banking system seems well-capitalized, profitable, and funded by domestic deposits, we note that the two largest subsidiaries operating in Macedonia have Greek and Slovenian parents (the National Bank of Greece S.A. and Nova Ljubljanska Banka). If either or both of their parents come under pressure to cut exposure to or sell their subsidiaries in noncore markets, we could potentially see some liquidity pressure for their Macedonian subsidiaries and associated external outflows.

Outlook

The stable outlook balances the risks we see from rising public and external indebtedness against strong investment inflows, particularly into the manufacturing sector.

We could raise the ratings if reforms directed toward higher and broader-based growth were matched with the improved effectiveness and accountability of public institutions.

We could lower the ratings if large fiscal slippages were to challenge public-debt sustainability and substantially increase external obligations given the constraints of the exchange-rate regime. We could also lower the ratings if we saw off-budget activities increasing significantly, and an increasing probability of contingent liabilities crystallizing on the government's balance sheet. Further, if parents of systemically important banks operating in Macedonia were to cut exposure to their subsidiaries, increasing pressure on both banking sector-liquidity and external finances, this could also put downward pressure on the ratings.

Key Statistics

Table 1

Republic of Macedonia Selected Indicators											
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Nominal GDP (bil. US\$)	9.83	9.31	9.34	10.40	9.58	10.20	10.70	9.00	8.94	9.43	9.96
GDP per capita (US\$)	4,808	4,546	4,549	5,053	4,649	4,944	5,179	4,351	4,311	4,544	4,789
Real GDP growth (%)	5.0	(0.9)	2.9	2.8	(0.4)	2.9	3.7	3.3	3.5	3.5	3.5
Real GDP per capita growth (%)	4.8	(1.1)	2.7	2.5	(0.5)	2.8	3.5	3.1	3.3	3.3	3.3
Change in general government debt/GDP (%)	(0.9)	3.4	1.8	5.0	6.3	2.8	6.0	3.6	3.3	3.0	3.0
General government balance/GDP (%)	(1.1)	(2.7)	(2.4)	(2.6)	(4.0)	(4.2)	(4.0)	(3.6)	(3.3)	(3.0)	(3.0)
General government debt/GDP (%)	20.4	23.9	24.4	28.0	34.3	36.1	40.3	42.1	43.3	44.0	44.7
Net general government debt/GDP (%)	16.5	19.8	21.6	20.1	24.0	26.6	30.7	32.9	34.6	35.7	36.8
General government interest expenditure/revenues (%)	2.1	1.8	2.2	2.4	2.8	3.1	3.2	3.6	4.0	4.3	4.3
Other dc claims on resident nongovernment sector/GDP (%)	42.2	43.8	44.5	45.5	48.0	49.5	51.8	54.5	57.0	59.3	61.8
CPI growth (%)	8.3	(0.8)	1.6	3.9	3.3	2.8	(0.3)	1.0	1.5	2.0	2.2
Gross external financing needs/CARs plus usable reserves (%)	126.2	126.5	118.5	114.5	117.5	115.4	112.9	109.7	108.7	107.5	108.3
Current account balance/GDP (%)	(12.6)	(6.5)	(2.1)	(2.5)	(3.1)	(1.9)	(1.5)	(2.1)	(2.7)	(3.3)	(3.7)
Current account balance/CARs (%)	(20.4)	(12.6)	(3.5)	(3.6)	(4.4)	(2.8)	(2.1)	(2.7)	(3.5)	(4.1)	(4.5)
Narrow net external debt/CARs (%)	17.1	25.0	25.8	24.9	30.0	37.9	32.9	42.6	44.5	44.1	43.2
Net external liabilities/CARs (%)	75.9	106.7	88.6	71.7	84.4	97.7	82.3	99.4	102.7	100.7	98.4

Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of Macedonia Ratings Score Snapshot

Key rating factors	
Institutional assessment	Weakness
Economic assessment	Weakness
External assessment	Neutral
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Neutral
Monetary assessment	Weakness

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Sovereign Risk Indicators, January 21, 2015
- Central And Eastern Europe Sovereign Rating Trends 2015, January 22, 2015
- Global Sovereign Debt Report 2015: Borrowing To Drop By 5.7% To US\$6.7 Trillion, March 05, 2015
- Emerging Markets Sovereign Debt Report 2015: Borrowing To Increase By 6.3% This Year, March 05, 2015
- Sovereign Defaults And Rating Transition Data, 2013 Update, September 17, 2014

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative

and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that all key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Ratings	
	To	From
Macedonia (Republic of)		
Sovereign credit rating		
Foreign and Local Currency	BB-/Stable/B	BB-/Stable/B
Transfer & Convertibility Assessment		
T&C Assessment	BB	BB
Senior Unsecured		
Foreign and Local Currency	BB-	BB-

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