

RatingsDirect®

Research Update:

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

Primary Credit Analyst:

Aarti Sakhuja, London +44 (0) 20 7176 7111; aarti.sakhuja@standardandpoors.com

Secondary Contact:

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

Analytical Group Contact:

SovereignEurope; SovereignEurope@standardandpoors.com

Table Of Contents

Overview

Rating Action

Rationale

Outlook

Key Statistics

Ratings Score Snapshot

Related Criteria And Research

Ratings List

Research Update:

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

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 Oct. 31, 2014, 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 slightly exceed \$5,000 in 2014), 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. The central bank's accommodative monetary policy and higher bank lending 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 2014 and 2017, 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 latter potentially via European parent banks retracting support to their Macedonian subsidiaries.

After narrowing slightly in 2011 to 2.6% of GDP, the general government fiscal deficit has widened to 4.2% of GDP in 2013. This year is the third successive year in which the government has had to revise upward its budget deficit from its initial target. 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 3.9% of GDP in 2014 before narrowing to 3.0% in 2017, a pace that is slower than that anticipated by the government. The difference arises from our lower expectation of real GDP growth, and also the government's recent track record of missing its fiscal targets.

General government debt has increased to an estimated 39.9% of 2014 GDP from 20% in 2008 while the stock of guarantees to public-sector enterprises has quadrupled to an estimated 7% of GDP as the government increases off-balance-sheet financing. We anticipate net general government debt will rise to nearly 35% of GDP in 2017, from about 30% in 2014, while the stock of guaranteed debt is set to rise further toward 10% of GDP in 2017 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 construction costs of projects; these are difficult for us to forecast given the low transparency of the public procurement process in Macedonia.

More than 70% of government debt is denominated in foreign currency, which increases the vulnerability of the government's balance sheet to any potential foreign-exchange movements. The banking system holds on average about 15% of its assets in government securities and central bank bills. As such, we do not view it as being able 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 since 2011. Gross external debt has increased by more than 20 percentage points to 96% of estimated 2014 current account receipts (CARs). We anticipate external borrowing, and to a lesser extent foreign investment flows, will continue to finance the current account deficit. This will widen over 2014-2017 as investment-related imports pick up. As a result, we expect gross external debt will exceed CARs in 2016.

The Internal Macedonian Revolutionary Organization-Democratic Party of Macedonian National Unity (VMRO) won parliamentary elections held earlier this year and formed a coalition with the largest ethnic Albanian party, the Democratic Union for Integration (DUI). 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 in place. However, disruptions to policy-making are mitigated by the ruling coalition's majority: it controls 65% of the seats in parliament.

We consider 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 \$3 billion, Macedonia's foreign reserves cover the monetary base 2.5x, 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 0.7x, which is lower than many peers and suggests that external vulnerabilities inherent to a fixed exchange rate regime remain. The exchange rate regime, along with the high, albeit declining, proportion of loans and deposits denominated in euros, restrict monetary policy flexibility. In June 2014, 53% of total deposits and 46% of loans were denominated in or indexed to foreign currency.

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. Bank lending has increased by 9% in 2014, though we note the share of new lending to households is higher than to corporates.

While the banking system seems well-capitalized and profitable, we note that National Bank of Greece S.A. and Nova Ljubljanska Banka (NLB), the Greek and Slovenian parents of two of the largest subsidiaries operating in Macedonia, failed stress tests (in the case of NLB, only under the adverse scenario) conducted by the European Central Bank. If either or both of these banks come under pressure to cut exposure to or sell their subsidiaries in non-core markets, we could potentially see some liquidity pressure for their Macedonian subsidiaries and associated external outflows.

Outlook

The stable outlook balances the risks 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 that off-budget activities were to increase significantly and the probability of contingent liabilities crystallizing on the government's

balance sheet were to rise. Further, if parents of systemically important banks operating in Macedonia were to cut exposure to their subsidiaries, causing 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											
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Nominal GDP (US\$ bil)	8	10	9	9	10	10	10	10	10	11	12
GDP per capita (US\$)	3,996	4,808	4,546	4,549	5,053	4,649	4,944	5,078	4,976	5,311	5,808
Real GDP growth (%)	6.1	5.0	(0.9)	2.9	2.8	(0.4)	2.9	3.3	3.3	3.5	3.5
Real GDP per capita growth (%)	6.0	4.8	(1.1)	2.7	2.5	(0.5)	2.8	3.2	3.2	3.4	3.4
Change in general government debt/GDP (%)	(4.0)	(0.9)	3.4	1.8	5.0	6.3	2.3	5.5	2.5	2.3	2.3
General government balance/GDP (%)	(0.9)	(1.1)	(2.7)	(2.4)	(2.6)	(4.0)	(4.2)	(3.9)	(3.6)	(3.3)	(3.0)
General government debt/GDP (%)	24.0	20.4	23.9	24.4	28.0	34.3	35.6	39.9	40.6	40.9	41.1
Net general government debt/GDP (%)	17.7	16.5	19.8	21.6	20.1	24.0	26.1	29.1	31.4	33.1	34.4
General government interest expenditure/revenues (%)	2.5	2.1	1.8	2.2	2.4	2.8	3.1	2.9	3.6	3.9	4.0
Oth dc claims on resident non-govt. sector/GDP (%)	35.4	42.2	43.8	44.5	45.5	48.0	49.5	51.6	53.4	55.3	57.0
CPI growth (%)	2.3	8.3	(0.8)	1.6	3.9	3.3	2.8	0.3	1.5	2.0	2.2
Gross external financing needs/CARs +use. res (%)	110.7	126.2	126.5	118.5	114.5	117.6	115.4	112.2	113.9	109.8	107.4
Current account balance/GDP (%)	(7.4)	(12.6)	(6.5)	(2.1)	(2.5)	(3.1)	(1.9)	(3.2)	(3.9)	(4.2)	(3.9)
Current account balance/CARs (%)	(11.4)	(20.4)	(12.6)	(3.5)	(3.6)	(4.5)	(2.8)	(4.7)	(5.7)	(6.1)	(5.6)
Narrow net external debt/CARs (%)	6.1	17.1	25.0	25.8	24.9	30.0	37.8	41.0	44.8	43.4	40.4
Net external liabilities/CARs (%)	66.0	75.9	106.7	88.6	71.7	84.5	98.4	101.3	108.6	106.9	101.8

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 S&P's own calculations, drawing on national as well as international sources, reflecting S&P'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 and Governance Effectiveness	Weakness

Table 2

Republic of Macedonia - Ratings Score Snapshot (cont.)	
Economic Structure and Growth	Weakness
External Liquidity and International Investment Position	Neutral
Fiscal Flexibility and Performance	Neutral
Debt Burden	Neutral
Monetary Flexibility	Weakness

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional and governance effectiveness; (ii) economic structure and growth prospects; (iii) external liquidity and international investment position; (iv) the average of government debt burden and fiscal flexibility and fiscal performance; and (v) monetary flexibility. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Government Rating Methodology And Assumptions," published on June 24, 2013, 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

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Defaults And Rating Transition Data, 2013 Update, April 18, 2014
- Supplementary Analysis, Macedonia, May 23, 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 Affirmed

Macedonia (Republic of)

Sovereign Credit Rating	BB-/Stable/B
Transfer & Convertibility Assessment	BB
Senior Unsecured	BB-

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

Copyright © 2014 Standard & Poor's Financial Services LLC, a part of McGraw Hill Financial. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgement as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription) and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.