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Research Update:

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

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Table Of Contents

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Overview

- Macedonia's low income levels and rising external liquidity requirements are offset by its still-moderate external and public indebtedness, 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 our view of Macedonia's structural rigidities, policy challenges, and external vulnerabilities against its relatively modest indebtedness.

Rating Action

On Nov. 29, 2013, 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 (reflected in per capita GDP of $5,000 in 2013), limited checks and balances between political institutions, and limited monetary policy flexibility. The ratings are supported by moderate, albeit rising, external and public debt levels.

We expect Macedonia's economy to grow by slightly more than 2% in 2013, exceeding our earlier expectation of 1% growth for the year. The improved economic performance has been driven largely by public investment. Net exports continue to be flat owing to weak demand from the EU, where nearly 60% of Macedonia's exports are directed. We expect private investment to be limited by constrained domestic credit conditions, in part a reflection of group-level decisions made by the foreign parents of domestic banks. We believe this will be somewhat offset by improving foreign direct investment (FDI) flows from 2014. We therefore expect real GDP growth to average 2.6% annually in 2013-2016, well below 2004-2008 growth rates.

Unemployment has been on a decreasing trend in recent years but still remains high at an estimated 28.8% in June 2013. Unemployment is highest in the 15-24 age group at nearly 54% in 2012.

We believe that limited checks and balances among Macedonia's political institutions have allowed the quality of public spending to weaken since the global financial crisis. We anticipate that a large portion of recent public investment will increase Macedonia's public debt without bolstering its economy's productive capacity. In doing so, it will likely lower Macedonia's growth prospects over time and raise its vulnerability to external shocks.

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

The government has maintained an expansionary fiscal stance in recent years and the stock of gross general government debt has increased steadily to an estimated 36% of GDP in 2013, from 28% in 2011. Current expenditure has remained high as a proportion of overall spending. We expect the general government deficit to remain at nearly 4% of GDP in 2013, following lower revenue intake as a share of GDP and the government's decision to pay down accumulated arrears on contract works and on VAT refunds to corporate entities. We anticipate the government's consolidation efforts will gradually narrow the general government deficit to 2.7% of GDP in 2016.

More than 70% of government debt is denominated in foreign currency and nearly half of it is owed to multilateral or bilateral institutions. The large proportion of concessional debt has also helped to keep interest costs relatively low; we estimate interest expense at 3.0% of general government revenues in 2013, rising to 4.5% in 2016 as the proportion of commercial debt in the overall borrowing mix increases. The banking system holds, on average, about 14% of government securities and central bank bills. We do not view the banking system as being able to materially increase its creditor share of the domestic government bond market because of its own balance sheet constraints.

We expect the government to finance its deficits through a mix of domestic and external debt. Given our assumptions on growth, deficits, and the concessional mix of funding, we expect general government debt net of fiscal assets to rise to 31% of GDP in 2016 from an estimated 27% in 2013.

During 2013, the government moved the Public Enterprise for State Roads (PESR) off budget. We believe that the government will increasingly use these instruments for public works and will fund them by guaranteeing the loans they undertake from international financial institutions. (Guarantees to PESR and the Macedonian Bank for Development Promotion were 7.8% and 44.2% of total outstanding guarantees in June 2013.) As a result, we expect the stock of government guarantees to increase toward 8.0% of GDP in 2016 from the current 5.3%.

We expect the current account deficit to widen to 6.6% of GDP in 2015, from an estimated 4.2% this year, driven by a pick-up in investment-related imports. Thereafter, the deficit will likely narrow gradually as export-enhancing capacities across various sectors come on board. We expect the current account deficit to be financed primarily by external debt (contracted mostly by the public sector). We also believe net FDI inflows will increase gradually over 2013-2016. After rebounding in 2011, net FDI inflows slowed significantly in 2012 to only one-fifth of those seen in 2011, partly reflecting liquidity withdrawals by foreign parent companies from their Macedonian subsidiaries. However, further withdrawals are not evident in the data available for the first two quarters of 2013.

With narrow net external debt (gross external debt less reserves and liquid external assets) at an estimated 31% of current account receipts (CARs) in 2013, we assess Macedonia's external debt burden as moderate. However, we forecast its external liquidity requirements to rise during 2013-2016 in line with our expectation of higher current deficits and public sector debt repayments coming due (estimated at 1.8% and 4.0% of 2014 and 2015 CARs). In our view, gross external financing needs (the sum of current account payments plus short-term external debt by residual maturity) will increase to nearly 130% of CARs and usable reserves in 2016 from our estimation of 118% in 2013.

The Macedonian banking system is largely funded by domestic deposits and appears well capitalized. (The reported capital adequacy ratio averaged 17.3% in September 2013.) However, nonperforming loans (NPLs) have continued to rise to 11.8% of gross loans in September 2013 from 6.8% in December 2008. Two of the three banks that we view as systemically important in the domestic banking sector have weak foreign parents, exposing these subsidiaries to parent-level disruptions, in our opinion. Stopanska Banka AD's parent is Greece-based National Bank of Greece S.A. and NLB Tutunska Banka AD's parent is Slovenia-based Nova Ljubljanska Banka. Credit growth in Macedonia decelerated to about 3% in 2013 from 5% in 2012, with lending to corporate enterprises even slower. In our opinion, the Macedonian regulatory and supervisory framework has appropriate policies in place to address liquidity risks associated with potential withdrawals by parent banks.

The Macedonian denar is pegged to the euro in the band of MKD61.47-61.72:EUR1. The exchange rate regime along with the high proportion of loans and deposits denominated in euros--albeit declining in recent years--restricts monetary policy flexibility. In September 2013, 46% of deposits and 54% of loans were denominated in or indexed to foreign currency.

Outlook

The stable outlook balances our view of Macedonia's structural and monetary rigidities and vulnerabilities to external shocks against its relatively moderate external and fiscal indebtedness.

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

We could lower the ratings if continued government spending on nonproductive assets challenged public debt sustainability and increased external obligations to levels incompatible with the current rating level, 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.

Key Statistics

Table 1

Republic of Macedonia - Selected Indicators

	2006	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Nominal GDP (US$ bil)	7	8	10	9	9	10	10	10	11	11	12
GDP per capita (US$)	3,217	3,996	4,808	4,546	4,549	5,053	4,669	5,002	5,185	5,491	5,830
Real GDP growth (%)	5.0	6.1	5.0	(0.9)	2.9	2.8	(0.2)	2.2	2.5	2.8	3.0
Real GDP per capita growth (%)	4.9	6.0	4.8	(1.1)	2.7	2.5	(0.4)	2.1	2.4	2.6	2.9
Change in general government debt/GDP (%)	(3.4)	(4.0)	(0.9)	3.4	1.8	5.0	6.2	3.6	2.5	3.4	2.7
General government balance/GDP (%)	(0.5)	(0.9)	(1.1)	(2.7)	(2.4)	(2.6)	(4.0)	(3.9)	(3.5)	(3.1)	(2.7)
General government debt/GDP (%)	32.0	24.0	20.4	23.9	24.4	28.0	34.2	36.0	37.0	38.2	38.7
Net general government debt/GDP (%)	20.3	17.7	16.5	19.8	21.6	20.1	23.9	26.6	29.0	30.9	31.3
General government interest expenditure/revenues (%)	3.0	2.5	2.1	1.8	2.2	2.4	2.8	3.3	3.7	4.4	4.5
Oth dc claims on resident non-govt. sector/GDP (%)	29.1	35.4	42.2	43.8	44.5	45.5	47.8	47.0	46.8	46.3	46.4
CPI growth (%)	3.2	2.3	8.3	(0.8)	1.6	3.9	3.3	3.5	2.5	2.0	2.0
Gross external financing needs/CARs +use. res (%)	106.4	110.0	124.0	124.5	117.4	114.4	117.6	116.0	120.8	126.7	127.0
Current account balance/GDP (%)	(0.4)	(7.4)	(12.6)	(6.5)	(2.1)	(2.5)	(3.1)	(4.1)	(5.2)	(6.5)	(6.2)
Current account balance/CARs (%)	(0.6)	(10.3)	(18.2)	(11.3)	(3.1)	(3.3)	(4.0)	(5.6)	(7.0)	(8.6)	(8.2)
Narrow net external debt/CARs (%)	2.1	5.5	15.2	22.5	18.5	21.0	23.9	31.0	35.1	39.5	42.0
Net external liabilities/CARs (%)	55.6	59.3	67.7	95.7	76.4	64.5	74.3	77.6	80.4	84.2	86.3

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.

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, 2012 Update, March 29, 2013
- Emerging Europe Sovereign Ratings Remain Vulnerable To Political And Fiscal Pressures, Sept. 11, 2013
- Emerging Market Sovereigns In Europe Could Be Most At Risk In A Liquidity Squeeze, July 4, 2013

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 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.

Ratings List

Ratings Affirmed

Macedonia (Republic of)	
Sovereign Credit Rating	BB-/Stable/B
Transfer & Convertibility Assessment	BB
Senior Unsecured	BB-

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