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Research Update:

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

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Overview

- Despite Macedonia's political crisis, economic growth in 2015 was stronger than we expected, while the deficit is likely to have remained within the supplementary budget envelope.
- We are therefore affirming our 'BB-/B' sovereign credit ratings on Macedonia.
- The stable outlook balances the risks from rising public and external indebtedness against Macedonia's economic prospects, which benefit from recurrent investment inflows.

Rating Action

On April 1, 2016, 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 the country's relatively low income and wealth levels, weak checks and balances between political institutions, and limited monetary policy flexibility arising from the country's fixed-exchange-rate regime. The ratings are supported by moderate--albeit rising--external and public debt.

Macedonia's political situation remains uncertain, as the early elections, initially scheduled for April 2016 under an EU-brokered agreement, have been postponed until June 2016. The postponement is to allow further work on the electoral roll, as well as reforms to the country's media, to ensure free and fair elections. Nevertheless, it remains uncertain whether the opposition will participate in the election or the resulting parliament. Macedonia's 2015 political crisis also highlights what we view as weak checks and balances between institutions. Important reforms remain to be made in the areas of public financial management, media freedom, and the independence of the judiciary, as highlighted in the EU's 2015 progress report. These reforms, combined with the ongoing conflict with Greece over its constitutional name, make Macedonia's EU accession during our forecast horizon to 2019 unlikely, in our view.

Despite the political gridlock, the economy continues expanding solidly. Growth was confirmed at 3.7% in 2015 as exports from the free economic zones and public consumption grew strongly. Going forward, increased interconnection between the free economic zones and the rest of the Macedonian economy will be crucial to maintain growth. Unemployment remains among the highest in Europe (see "Sovereign Risk Indicators," at www.spratings.com/sri) at 26% on average in 2015, indicative of Macedonia's large informal sector and continued reliance on remittances. We believe that ongoing foreign direct investment (FDI), continued net exports, and public-sector investment projects will continue to support economic expansion. However, we believe the government will need to scale back spending if it wants to stick to its fiscal targets. We therefore maintain a weaker growth forecast of 3% on average over 2016-2019, compared with official forecasts of about 4.3%.

Following the 2015 supplemental budget, Macedonia's deficit was lower, at 3.4% of GDP, than in our previous forecast. Nonetheless, we continue to see risks that the government will miss its fiscal targets (3.2% of GDP in 2016; 2.9% of GDP in 2017) as negative budgetary pressures may arise from the uncertain political situation, the ongoing refugee crisis, support for off-balance-sheet entities, and other potential external shocks, such as a weaker recovery in the eurozone, one of Macedonia's most important trading partners. We believe that if any of these risks materialize, the government may try to cushion the negative effects through continuation of its more expansionary fiscal stance. That said, the refugee crisis has so far not posed a risk to public finances because additional outlays on military and police activities have been funded within the budget envelope with some financial assistance, particularly on humanitarian aid, from the EU.

The slower pace of fiscal consolidation will also lead to an increasing debt burden over 2016-2019, in our view. Gross general government debt, while still relatively low, more than doubled between 2008 and 2015 to 43% of GDP. In addition, off-balance-sheet financing pushed up the stock of guaranteed debt to 8.5% of GDP in 2015. In contrast to Macedonia's official statistics, our general government debt calculation includes the increasing debt stock of The Public Enterprise for State Roads (PESR), which the government moved off balance sheet in 2013. This is because we believe that PESR will continue to rely on government transfers and guarantees. In particular, a €580 million loan from the Export-Import Bank of China, contracted in 2013 for the construction of two highway sections, will continue to contribute to a mounting debt burden over the coming years. Nonetheless, external refinancing needs remain relatively contained this year due to the successful Eurobond issuance in November 2015, so Macedonia may be able to satisfy its financing needs domestically.

Although the government may be able to rely on domestic issuance this year, a number of risks exist regarding Macedonia's government debt profile. Seventy-five percent of government debt is denominated in foreign currency, which increases the vulnerability of the government's balance sheet to any potential foreign-exchange movements. In addition, around one-fifth of Macedonia's government external debt has floating interest rates, though the share continues to decline. The banking system holds, on average, about 12% of its assets in government securities and central bank bills.

With the public sector increasingly borrowing abroad, Macedonia's external indebtedness has been on a rising trajectory, despite deleveraging in the country's banking sector. We estimate gross external debt will rise to 95% of 2016 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 relatively low current account deficit. However, 30% of the stock of inbound FDI is in the form of debt-like instruments and thus has lower barriers to exit. In addition, we expect the current account deficit will widen to 2.4% of GDP by 2019 as investment-related imports pick up.

The Macedonian denar is pegged to the euro. At about $2.7 billion, Macedonia's foreign reserves cover the monetary base about 2x, implying strong backing for the pegged currency regime. The exchange rate regime restricts monetary policy flexibility. However, central bank measures, such as lower reserve requirements for denar-denominated liabilities, have succeeded in lowering overall euro-ization in Macedonia, with foreign currency-denominated deposits and claims remaining below 50% of total deposits and claims. Rather exceptionally for the region, bank lending in Macedonia--including to corporations--has continued to grow briskly, increasing by about 9% in 2015.

Although the banking system seems well capitalized, profitable, and funded by domestic deposits, the two largest bank subsidiaries operating in Macedonia have Greek and Slovenian parents--the National Bank of Greece S.A. and Nova Ljubljanska Banka. However, Macedonia's regulatory and supervisory framework was successful last year in containing the negative effects resulting from concerns over the parent banks' viability. Renewed pressure on parent banks to cut exposure to or sell their subsidiaries in noncore markets could result in a liquidity squeeze for their Macedonian subsidiaries and associated external outflows (see "How A Liquidity Squeeze At Greek Banks Could Affect Their Subsidiaries In Southeastern Europe," published June 24, 2015, on RatingsDirect). Capital flow measures, introduced last year to prevent corporate entities from borrowing domestically only to lend on to Greek entities, were phased out in December 2015, since the most imminent pressures had abated.

Outlook

The stable outlook balances the risks we see from rising public and external indebtedness against Macedonia's economic prospects, benefiting from recurrent investment inflows.

We could raise our ratings on Macedonia if reforms directed toward higher and broader-based growth led to income levels increasing faster than in our base-case scenario and were matched with improved effectiveness and accountability of public institutions.

We could lower our ratings if large fiscal slippages or off-budget activities were to call into question public debt sustainability, raise sovereign borrowing costs, and substantially increase external obligations, given the constraints of the exchange-rate regime. In addition, if parents of systemically important banks operating in Macedonia were to cut exposure to their subsidiaries, heightening pressure on both banking sector liquidity and external finances, we could also consider a negative rating action.

Key Statistics

Table 1

Republic of Macedonia Selected Indicators										
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	437	464	467	502	526	560	588	618	648	679
Nominal GDP (bil. $)	9	10	10	11	11	10	10	11	11	12
GDP per capita (000s $)	4.6	5.1	4.7	5.2	5.5	4.9	4.9	5.1	5.4	5.6
Real GDP growth	3.4	2.3	(0.5)	2.9	3.5	3.7	3.3	2.9	2.8	2.8
Real GDP per capita growth	3.2	2.1	(0.6)	2.8	3.4	3.5	3.1	2.7	2.6	2.6
Real investment growth	(3.8)	17.9	10.2	0.5	13.1	0.1	3.0	3.0	3.0	3.0
Investment/GDP	24.5	26.9	28.9	28.8	30.5	31.9	24.7	24.8	25.0	25.1
Savings/GDP	22.4	24.4	25.7	27.2	29.5	30.5	22.8	22.8	22.8	22.7
Exports/GDP	39.8	47.1	45.4	43.4	47.8	48.5	49.7	51.2	52.8	54.4
Real exports growth	23.7	16.1	2.0	6.1	18.2	4.6	6.5	6.5	6.5	6.5
Unemployment rate	32.0	31.4	31.0	29.0	28.0	26.1	26.0	25.7	25.4	25.1
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(2.1)	(2.5)	(3.3)	(1.6)	(0.9)	(1.4)	(1.9)	(2.0)	(2.2)	(2.4)
Current account balance/CARs	(3.5)	(3.6)	(4.8)	(2.5)	(1.3)	(2.0)	(2.7)	(2.9)	(3.1)	(3.3)
Trade balance/GDP	(21.6)	(25.2)	(26.5)	(22.9)	(21.8)	(20.0)	(19.5)	(19.4)	(19.6)	(19.9)
Net FDI/GDP	2.2	4.5	1.7	2.8	2.3	1.9	2.2	2.2	2.2	2.2
Net portfolio equity inflow/GDP	(0.5)	(0.6)	0.2	(1.0)	0.4	(0.3)	0.0	0.0	0.0	0.0
Gross external financing needs/CARs plus usable reserves	118.5	114.5	117.8	115.2	112.2	111.8	114.0	107.4	107.3	105.0
Narrow net external debt/CARs	25.8	24.9	30.1	37.7	33.0	45.8	42.2	40.6	37.2	34.8
Net external liabilities/CARs	88.6	71.7	84.6	97.2	78.6	100.1	100.1	98.6	95.1	91.9
Short-term external debt by remaining maturity/CARs	33.9	25.9	35.2	35.1	28.2	30.6	27.6	24.8	24.9	22.5
Reserves/CAPs (months)	1.8	1.5	2.1	2.3	1.8	2.2	1.7	2.2	2.3	2.3
FISCAL INDICATORS (%, General government)										
Balance/GDP	(2.4)	(2.6)	(3.9)	(4.0)	(4.2)	(3.4)	(3.4)	(3.2)	(3.0)	(3.0)
Change in debt/GDP	1.8	4.9	6.1	2.7	9.2	4.1	4.7	3.7	3.0	3.0
Primary balance/GDP	(1.7)	(1.8)	(3.0)	(3.1)	(3.3)	(2.3)	(2.1)	(1.8)	(1.5)	(1.5)
Revenue/GDP	32.5	31.7	32.1	30.1	29.8	30.9	31.5	32.0	32.2	32.5
Expenditures/GDP	34.9	34.2	36.0	34.1	34.0	34.3	34.9	35.2	35.2	35.5
Interest /revenues	2.2	2.4	2.8	3.1	3.2	3.8	4.2	4.5	4.6	4.7
Debt/GDP	24.2	27.7	33.7	34.0	41.7	43.2	45.9	47.4	48.2	48.9
Debt/revenue	74.5	87.5	105.1	113.1	139.8	139.9	145.6	148.0	149.6	150.6
Net debt/GDP	21.5	19.9	23.6	25.1	32.6	38.3	41.2	42.9	43.9	44.9
Liquid assets/GDP	2.8	7.8	10.1	8.9	9.1	4.9	4.7	4.5	4.3	4.1

Table 1

Republic of Macedonia Selected Indicators (cont.)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
MONETARY INDICATORS (%)										
CPI growth	1.6	3.9	3.3	2.8	(0.3)	(0.3)	1.5	2.0	2.2	2.2
GDP deflator growth	2.0	3.7	1.0	4.5	1.1	2.8	1.7	2.0	2.0	2.0
Exchange rate, year-end (LC/$)	46.31	47.53	46.65	44.63	50.56	56.37	58.45	57.42	57.42	57.42
Banks' claims on resident non-gov't sector growth	7.4	8.4	5.3	6.3	10.0	9.5	9.0	8.0	8.0	8.0
Banks' claims on resident non-gov't sector/GDP	44.1	45.1	47.2	46.7	49.0	50.3	52.2	53.7	55.4	57.0
Foreign currency share of claims by banks on residents	42.2	42.3	38.5	36.9	34.9	35.0	47.3	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	53.1	50.2	47.8	44.8	41.9	41.7	40.7	39.7	38.7	37.7
Real effective exchange rate growth	(2.7)	1.6	(0.5)	2.3	(0.2)	(2.4)	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository 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. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. CPI--Consumer price index. 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	Strength
Monetary assessment	Neutral

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

- Central And Eastern Europe Debt Report 2016: Commercial Borrowing To Increase By 12% To EUR114 Billion - February 29, 2016
- Central And Eastern Europe Rating Trends 2016 - January 18, 2016
- Emerging Markets Sovereign Rating Trends 2016 - January 18, 2016
- Global Sovereign Rating Trends 2016 - January 6, 2016
- Sovereign Risk Indicators - December 14, 2015. An interactive version is available at http://www.spratings.com/sri.
- Why Politics Matters To Sovereign Ratings - November 6, 2015
- How A Liquidity Squeeze At Greek Banks Could Affect Their Subsidiaries In Southeastern Europe - June 24, 2015
- 2014 Annual Sovereign Default Study And Rating Transitions - May 18, 2015

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 the fiscal flexibility and performance assessment had deteriorated while the debt burden had improved. All other 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

	Rating	
	To	From
Macedonia (Republic of)		
Sovereign Credit Rating		
Foreign and Local Currency	BB-/Stable/B	BB-/Stable/B
Transfer & Convertibility Assessment	BB	BB
Senior Unsecured		
Foreign Currency[1]	BB-	BB-
Foreign and Local Currency	BB-	BB-

[1] Dependent Participant(s): Citigroup Global Markets Ltd., Deutsche Bank AG (London Branch), Erste Group Bank AG

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information.

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.

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