International
Credit Analysis

Republic of Macedonia

Ratings

Foreign Currency
Long-Term IDR* .... BB+
Short-Term IDR* .... B
Outlook .... Positive

Local Currency
Long-Term IDR* .... BB+
Rating Outlook .... Positive

Country Ceiling .... BBB-

* IDR – Issuer Default Rating

Peer Group

BBB-	Croatia India Namibia
BB+	**Macedonia** Azerbaijan Brazil Colombia Egypt El Salvador Guatemala Panama Peru
BB	Costa Rica Philippines

Ratings History

Date	LTFC	LTLC
13 Jun 2006	BB+	BB+
1 Nov 2005	BB	BB

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Summary
Fitch Ratings has revised the Outlook on Macedonia's Long-Term Ratings to Positive from Stable. The government's ambitious reform programme to create an investor-friendly business climate and attract greenfield foreign direct investment (FDI) underpins the improving creditworthiness of the sovereign. Macedonia's moderate public and external debt levels, strong external liquidity position, prudent fiscal policy and macroeconomic stability, as well as its candidacy for EU membership support its ratings. The coalition government formed after parliamentary elections in July 2006 has continued its predecessor's debt buybacks. Macedonia has repaid its IMF debt in full, its Paris Club debt to 12 out of 13 countries, and a fifth of its debt to the World Bank. Fitch Ratings expects Macedonia's general government debt to fall to 26% of GDP in 2007, lower than the 'BB'- and 'BBB'-range medians of 38% and 32% respectively. Macedonia became a net external creditor to the tune of 4% of GDP in 2006. Foreign-exchange reserves were equivalent to five months' import cover in 2006.

Macedonia's key rating weaknesses are its low growth rate compared to regional peers, challenging business climate, low rates of domestic savings and greenfield FDI and large structural trade deficit. The government's reform programme has achieved some tangible results, although it will take time for these reforms to improve growth and investment and reduce the high unemployment rate. Tensions between political parties following the elections appear to have been resolved and Macedonia enjoys political stability, anchored by the goal of EU accession. Fitch believes Macedonia is unlikely to start accession negotiations in 2008.

Credit Outlook
Progress towards EU membership, development of the domestic debt market and continued structural reforms to encourage increased investment and a higher growth rate will be important considerations for an upgrade of Macedonia's ratings. Combined with sustained fiscal discipline and a longer period of political stability, these factors would make a move up to investment grade more likely than not within the rating horizon. Political shocks that derail the reform process and disappointing growth performance could lead to the Outlook being revised back to Stable.

Strengths
- Track record of low inflation and macroeconomic stability
- Sound fiscal policy and moderate public debt burden
- Net external creditor and strong liquidity position
- Candidacy for EU membership providing a reform anchor

Weaknesses
- Sizeable trade deficit
- High unemployment and a challenging business climate
- Low rates of domestic savings and greenfield FDI
- Under-developed domestic debt market

15 August 2007

Key Indicators for Macedonia

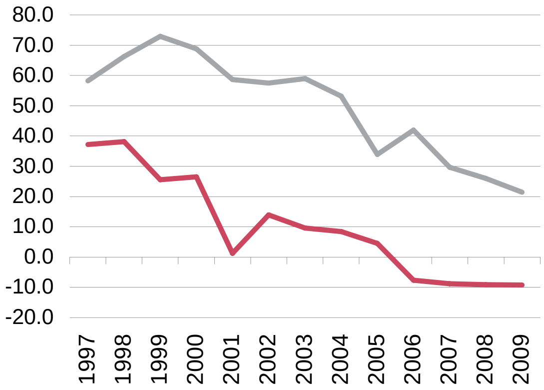
Population (2006): 2.0m **Population Growth Rate (2001-2006):** 0.2% p.a.
GDP (2006): USD6.2bn **GDP per Head at Market Exchange Rates (2006):** USD3,043
GNI Per Head at Purchasing Power Parity (2006): USD7610 (= 17% of USA level)
Modern Sovereign Rescheduling History: Former Yugoslavia: 1984, 1985, 1988 (official creditors); 1983, 1984, 1985, 1988 (commercial banks). Republic of Macedonia: Paris Club official creditors: 1995 (classic terms) and 2000 (ad hoc); London Club commercial banks: 1997.

	2003	2004	2005	2006	2007f	2008f	2009f
Domestic Economy and Finance							
Real GDP Growth (%)	3.8	4.1	3.8	3.0	4.5	4.8	5.0
Unemployment (% of Labour Force)	36.7	37.2	36.5	36.3	35.8	34.7	34.5
Consumer Prices (Annual Average % Change)	1.1	-0.4	0.5	3.2	2.7	2.6	2.5
Gross Domestic Savings (% of GDP)	3.0	1.3	3.2	2.6	2.8	3.6	4.2
Gross Domestic Investment (% of GDP)	20.0	21.6	21.3	22.3	23.7	25.2	27.4
Short-Term Interest Rate (%)(1)	8.2	9.0	8.5	6.1	5.5	5.5	5.0
Broad Money (% Change Dec to Dec)	15.8	16.1	15.2	24.6	21.0	28.0	28.0
MKD per USD (Annual Average)	54.32	49.41	49.28	48.80	45.75	45.49	45.49
REER (CPI, 2000=100)	101.5	102.3	101.1	101.7	101.7	101.7	101.7
REER: % Change (+ = Appreciation)	1.8	0.8	-1.2	0.6	0.0	0.0	0.0
Public Finances							
General Government Balance (% of GDP)	-0.1	0.4	0.2	-0.8	-1.1	-1.4	-1.6
General Government Debt (% of GDP)	38.3	36.6	39.2	31.6	25.8	24.1	22.0
General Government Debt Maturities (% of GDP)(2)	3.9	3.3	3.6	7.6	6.9	3.3	3.5
General Government Debt/Revenue (%)	99.7	100.2	110.6	88.4	73.9	69.2	65.7
Interest Payments/Revenue (%)	2.8	2.4	2.6	3.1	2.4	2.1	2.1
Balance of Payments							
Current Account Balance (USDm)	-149	-415	-81	-23	-230	-273	-336
Current Account Balance (% of GDP)	-3.2	-7.7	-1.4	-0.4	-3.2	-3.5	-4.0
Current Account Balance plus Net FDI (USDm)	-53	-259	16	327.1	-29.9	-73.0	-91.4
Current Account Balance plus Net FDI (% of GDP)	-1.1	-4.8	0.3	5.2	-0.4	-0.9	-1.1
Gross Financing Requirement (% of Official Reserves)(3)	44.0	65.8	26.3	37.2	33.9	25.1	25.1
Current External Receipts CXR (USDm)	2,529	3,002	3,718	4,412	5,015	5,703	6,567
Current External Receipts CXR (Annual % Change)	29.6	18.7	23.9	18.6	13.7	13.7	15.1
Current External Payments CXP (USDm)	2,678	3,417	3,800	4,435	5,244	5,976	6,903
Current External Payments CXP (Annual % Change)	15.9	27.6	11.2	16.7	18.3	13.9	15.5
External Assets and Liabilities							
Gross External Debt (USDm)	1,854	2,068	2,238	2,471	2,515	2,883	3,215
Gross External Debt (% of GDP)	40.0	38.5	38.8	39.6	35.1	37.0	38.3
Gross External Debt (% of CXR)	73.3	68.9	60.2	56.0	50.2	50.5	49.0
Net External Debt (USDm)	244	253	168	-273	-313	-305	-289
Net External Debt (% of GDP)	5.3	4.7	2.9	-4.4	-4.4	-3.9	-3.4
Net External Debt (% of CXR)	9.6	8.4	4.5	-6.2	-6.2	-5.4	-4.4
Public External Debt (USDm)	1,529	1,664	1,758	1,668	1,471	1,556	1,536
Public External Debt (% of GDP)	33.0	31.0	30.5	26.7	20.5	20.0	18.3
Net Public External Debt (% of CXR)	23.5	22.4	11.2	-5.0	-9.8	-13.3	-16.4
Public FC Denominated & FC Indexed Debt (USDm)	2,113	2,231	2,220	2,133	1,925	1,930	1,,830
Short-Term External Debt (% of Gross External Debt)	2.3	3.5	4.2	2.5	3.3	3.6	3.8
External Debt Service (% of CXR)	10.1	8.5	6.3	12.8	9.7	5.4	5.2
External Interest Service (% of CXR)	2.3	1.9	1.5	2.0	1.5	1.6	1.4
Liquidity Ratio (%)(4)	375.5	462.9	498.6	292.1	455.0	637.0	657.7
Official International Reserves Including Gold (USDm)	935	991	1,340	1,889	1,965	2,316	2,614
Official International Reserves in Months of CXP Cover	4.2	3.5	4.2	5.1	4.5	4.7	4.5
Official International Reserves (% of Broad Money)	56.7	47.6	64.2	65.1	54.8	50.5	44.5

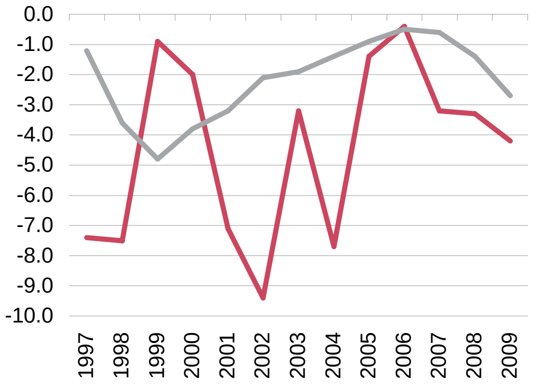
(1) 28 day CB bill (annual average).
(2) Maturities of medium- and long-term debt during year plus short-term debt outstanding at the beginning of the year.
(3) Current account balance plus amortisation of medium- and long-term debt, over official international reserves.
(4) Official reserves incl. gold plus banks' foreign assets/Debt service plus liquid external liabilities.

Peer Comparison

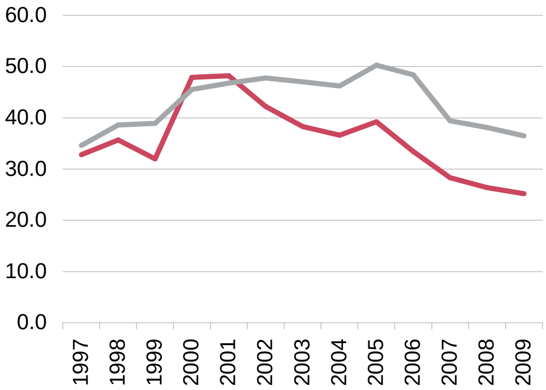
Net External Debt
% of CXR



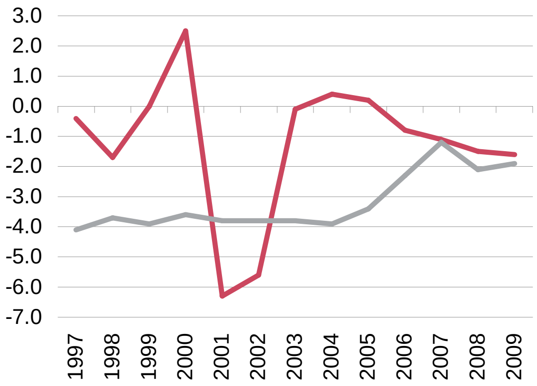
Current Account Balance
% of GDP



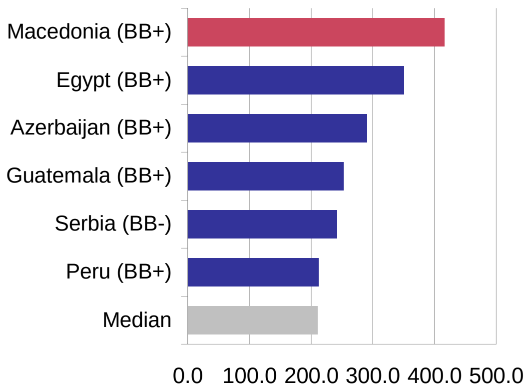
General Government Debt
% of GDP



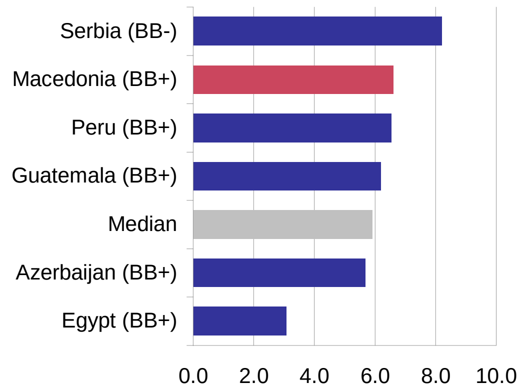
General Government Balance
% of GDP



International Liquidity Ratio, 2007
%



GDP per capita Income, 2006
At market exchange rates, USA=100



Macedonia BB Median

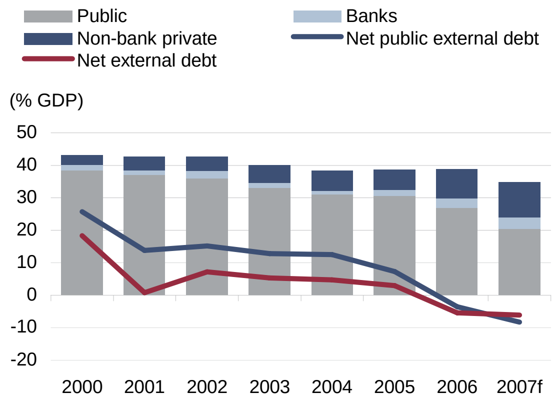
Source: Fitch Sovereign Comparator

Rationale

Fitch has revised the Outlook on Macedonia's Long-Term Ratings ('BB+') to Positive from Stable. The government's ambitious reform programme to create an investor-friendly business climate and attract greenfield foreign direct investment (FDI) underpins the improving creditworthiness of the sovereign. Progress towards EU membership, development of the domestic debt market and continued structural reforms in order to encourage increased investment and a higher trend growth rate will be important considerations for an upgrade of Macedonia's ratings. Political shocks that derail the reform process and disappointing growth performance could lead to the Outlook being revised back to Stable.

Macedonia's ratings are underpinned by moderate public and external debt levels, a strong external liquidity position, prudent fiscal policy and macroeconomic stability. Macedonia is an EU candidate country, which acts as a policy anchor for reform and supports creditworthiness. Macedonia's rating weaknesses are its low growth rate compared to regional peers, challenging business climate, low rates of domestic savings and greenfield FDI, and large structural trade deficit. Inter-ethnic tensions are a political risk factor, though they are tempered by the EU framework.

Gross External Debt Components

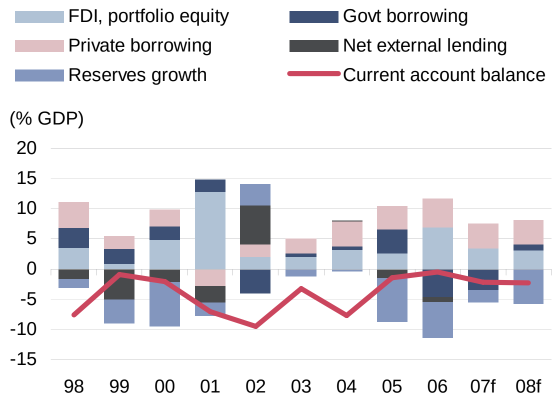


Source: NBRM and Fitch

Macedonia's general government debt fell to 32% of GDP in 2006 following the buyback of the country's London Club debt. The coalition government formed after parliamentary elections in July 2006 has continued its predecessor's programme of buybacks using privatisation proceeds and government deposits. Macedonia repaid its Paris Club debt to 12 out of 13 countries (USD89m) in April 2007 and made an early repayment of a fifth of its total debt to the World Bank (USD125m) in June. Furthermore, the National Bank of the Republic of Macedonia (NBRM) made an early repayment of its entire outstanding obligations to the IMF from its three-year stand-by arrangement (around USD44m) in May. As a result of these buybacks, Fitch expects Macedonia's general government debt to fall to 26% of GDP in 2007 (23% net of government deposits), lower than the 'BB'- and 'BBB'-range medians of 38% and 32% respectively.

Macedonia's gross external debt (GXD) burden was 40% of GDP in 2006, slightly above the 'BB'-range median of 35%. Over two-thirds of Macedonia's GXD is public-sector debt. However, rising official reserves made Macedonia a net external creditor to the tune of 4% of GDP in 2006 (as well as a net public external creditor). Short-term external debt is under 3% of total GXD and wholly owned by the private sector.

External Financing



Source: Fitch

Macedonia's strong external liquidity position provides support to its ratings. Foreign-exchange reserves were equivalent to over five months' import cover in 2006 and Fitch forecasts Macedonia's liquidity ratio in 2007 at over 400%. External debt service was 13% of current external receipts (CXR) in 2006, in line with the median in the 'BB' range.

Macedonia's official growth rate slowed to 3% in 2006 – substantially slower than in Bulgaria, Croatia and Serbia – although the volume of tax receipts and the pace of growth of both credit and wages indicate that economic growth might have been stronger (the country has a large grey economy). The authorities estimate real GDP growth was actually 4% in 2006 – an indication of data insufficiencies. Macedonia's growth is limited by structural weaknesses, including its challenging business climate. Factors impairing the operating environment include ambiguities over property rights, high pay-roll taxes, judicial shortcomings and corruption. The new government's ambitious programme to reform the economy has had some tangible results: the backlog of cases pending in lower courts has been reduced, the time needed to set up a business has fallen, and an extensive campaign to attract greenfield foreign investors has increased interest in the country.

The government's programme to reduce taxes (corporate and personal income tax rates were cut to 12% in 2007) and increase public investment will lead to a fiscal loosening in the medium term. Macedonia's fiscal policy has long been a rating strength – the budget deficit averaged just over 1% of GDP between 1996 and 2006 – although Fitch notes that budget discipline is vulnerable to unforeseen costs, from the energy sector in particular.

Macedonia's current account deficit was just 0.4% of GDP in 2006, although its trade deficit was over 20% of GDP, reflecting the narrow export base. Iron and steel accounted for 28% of exports in 2006, rendering the trade balance vulnerable to commodity shocks. Nevertheless, Fitch believes the private transfers, which buoy the current account (19% of GDP in 2006), are stable. However, while net FDI is low relative to regional peers, it has more than covered the current account deficit since 2005.

Macedonia's political situation remains a material consideration in its rating judgement. Parliamentary elections in July 2006 were generally deemed free and fair, although the EU criticised a deterioration of relations between the political parties, which led to a four-month boycott of parliament by the main ethnic Albanian party. Nevertheless, despite the standoff between the political parties, ethnic tensions have receded and Fitch recognises that the goal of EU accession is a critical anchor to political stability. The agency believes the EU Commission is likely to insist on further reforms in its Progress Report in autumn 2007 and delay recommending a start date for accession negotiations. A failure to obtain a date at the EU Council meeting in December 2007 is unlikely to reverse the reform effort or alter pro-EU sentiment; for its part, the EU is unlikely to make a near-term decision that would jeopardise stability in this fragile region.

Local Currency Rating and Country Ceiling

Macedonia's Local Currency Long-Term IDR is 'BB+' (with a Positive Outlook). The vulnerability of Macedonia's debt to exchange rate volatility weighs less heavily on the Local Currency Rating. However, it is impossible to isolate the risks in the external finances from the Local Currency credit profile because an exchange rate shock would probably have a significant impact on the domestic economy and fiscal position due to Macedonia's high level of euroisation. Local capital markets are also under-developed.

The Country Ceiling is 'BBB–', one notch above the Foreign Currency IDR. The Country Ceiling is an effective cap on all Foreign Currency Ratings of issuers and transactions originating within a country. It captures the risk of the imposition of foreign-exchange controls, which could impede issuers' ability to convert local into foreign currency and/or transfer resources abroad.

■ Political and Social Situation

Parliamentary elections in July 2006 yielded a coalition government headed by the centre-right Internal Revolutionary Organisation-Democratic Party for Macedonian National Unity (VMRO-DPMNE) in coalition with the Democratic Party of Albanians (DPA), an ethnic Albanian party, and the New Social Democratic Party (NSDP). It replaced the coalition government formed by the Social Democratic Union (SDSM), the ethnic Albanian party Democratic Union of Integration (DUI) and the Liberal Democrat Party (LDP). International observers regarded the elections on balance as "free and fair".[1]

Parliamentary Elections: July 2006

	% votes	Seats
Government coalition	46	62
VMRO-DPMNE[a]	33	45
Democratic Party for Albanians (DPA)	7	11
New Social Democratic Party (NSDP)	6	6
Opposition	54	58
Social Democratic Union (SDSM)	22	32
Democratic Union for Integration (DUI)/Party of Democratic Prosperity (PDP)	12	17
VMRO-NP[b]	6	7
Other	14	2
Total	**100**	**120**

[a] Internal Revolutionary Organisation-Democratic Party for Macedonian National Unity
[b] Internal Revolutionary Organisation - People's Party
Source: OSCE

However, DUI left parliament after the elections to protest at its exclusion from the governing coalition. International observers feared the boycott was slowing down important reforms to improve inter-ethnic relations and could throw off course the implementation of the Ohrid Framework Agreement – put in place following armed conflict between the government and Albanian groups in 2001. DUI returned to parliament in May 2007 after a four-month boycott and in June 2007 the government survived a vote of no-confidence called by the main

[1] Office for Democratic Institutions and Human Rights (OSCE), Election Observation Mission Final Report, September 2006.

opposition party, SDSM, in response to disagreements between the main coalition partners, VMRO-DPMNE and DPA. While the disagreements between the political parties appear to have been resolved, Fitch understands that the EU could take a negative view of the episode when it assesses Macedonia's progress in fulfilling the Copenhagen Criteria for starting accession talks. Nevertheless, the agency believes the EU is unlikely to make a near-term decision that would jeopardise stability in this fragile region.

Macedonia was granted EU candidate country status in December 2005, although it has not yet been given a date to start accession negotiations, highlighting that EU accession itself is likely to be a lengthy process, not least because of "enlargement fatigue" among existing EU members. Fitch believes the EU Commission is likely to insist on further reforms in its Progress Report in autumn 2007 before Macedonia is granted a date to start talks. A failure to obtain a date at the EU Council meeting in December 2007 is unlikely to reverse the reform effort or alter pro-EU sentiment. Fitch believes Macedonia could also receive an invitation for NATO membership in 2008.

Despite the standoff between the political parties, tensions between ethnic Albanian and Macedonian citizens appear to have receded and the country has returned to political stability after the events of 2001. While the unresolved status of Kosovo is a source of uncertainty for the whole region, Fitch believes the strength of support for EU and NATO membership in Macedonia reduces the probability of actions that could destabilise inter-ethnic relations.

■ Structural Issues

Income and Growth

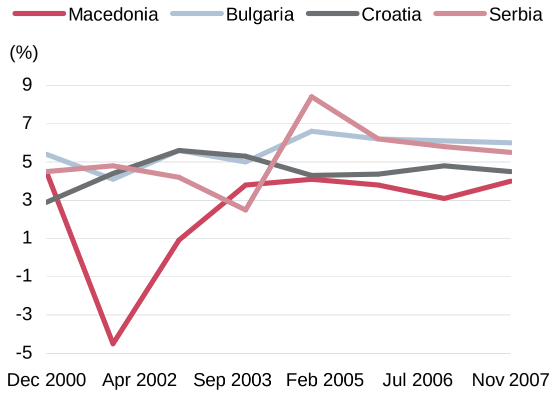
A key challenge for Macedonia is to raise its GDP growth rate, which lags that of its regional peers. GDP growth slowed to 3.0% in 2006 from 3.8% in 2005 as industrial production and construction growth were slower than expected. However, the volume of tax receipts and the pace of growth of both credit and wages indicate that economic growth might actually have been stronger – the authorities estimate real GDP growth was actually 4% in 2006. GDP per capita was USD3,064 in 2006 at market exchange rates, above the 'BB'-range median of USD2,347 and at around the same level as Namibia ('BBB–') and Tunisia ('BBB').

Fitch expects Macedonia's growth rate to pick up in 2007 and 2008 as the government's measures to improve the business climate spur domestic and foreign investment. Private consumption will also rise as higher employment and wage growth increase disposable incomes.

Investment and the Business Climate

Macedonia's FDI receipts are roughly in line with its 'BB'-range peers but low compared to regional peers and largely buoyed by privatisation receipts rather than greenfield investment. In 2007, the Macedonian government appointed two ministers responsible for FDI and launched an extensive publicity campaign to attract greenfield foreign investors to the country, offering preferential tax regimes to foreign companies operating in free economic zones. Fitch expects greenfield FDI to increase gradually as the country gains a higher profile through its campaign, particularly if the government continues its efforts to improve the business environment.

GDP Growth



Source: Fitch and sovereign authorities

The challenging investment climate presents problems including corruption, ambiguities over property rights, high pay-roll taxes, judicial shortcomings and lengthy bureaucratic procedures. The introduction of a "one-stop shop" for company registration in 2006 cut the time needed to set up a business from 48 to 18 days, while the new bankruptcy law and judicial reforms improved contract enforcement and reduced the backlog of cases pending in lower courts.[2] The World Bank ranks Macedonia 92nd out of 175 globally for ease of doing business. More reform is needed if Macedonia is to gain an advantage in competing for investors against its regional peers.

The government's so-called "regulatory guillotine" aims to eliminate or simplify unnecessary or complex regulations by October 2007. Interconnection rates have been cut to facilitate competition in the telecommunications market, although a second fixed-line operator is yet to enter

[2] World Bank Doing Business Survey 2007.

the market. The government has taken steps to harmonise the bases of personal income tax and social security contributions, which should contribute to a reduction in the labour tax wedge. The government plans to reform the land cadastre by 2009, securing property rights for investors. The government has also taken steps to tackle corruption, including measures to increase transparency in public procurement.

Unemployment

Macedonia's unemployment rate fell by 0.9% to 36% in 2006. The employment rate increased by over 4%. However, unemployment figures are overstated, given the extensive grey economy and the incentive to register as unemployed in order to qualify for health benefits (the government plans to remove this loophole). Over half of Macedonian citizens consider unemployment to be the most important problem in the country.[3] Fitch believes declining personal income tax rates and the elimination of automatic health benefits for the unemployed, coupled with stronger GDP growth, should lead to a gradual reduction in the rate of unemployment.

■ Financial Sector

The Macedonian banking sector is moderate in size, well capitalised and has been almost entirely privatised, while over half of the system's capital is under foreign ownership. As such, the financial system does not appear to represent a major risk to sovereign creditworthiness. Total sector assets were equivalent to 57% of GDP in 2006. Two of the country's three largest banks are under foreign ownership and Fitch expects foreign parent banks would provide support in the event of need.

Key Facts: Banking System

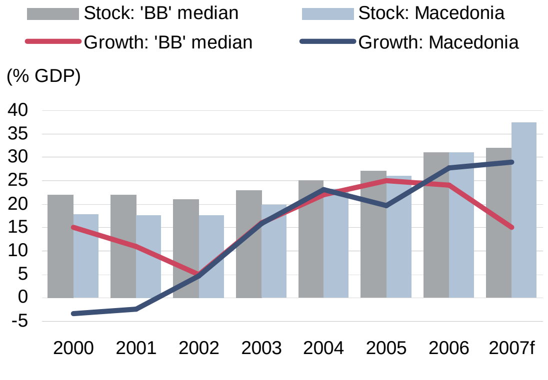
End–2006	
M3 (% GDP)	44.5
NPL ratio	7.9
Capital adequacy ratio	18.3
Private-sector credit (% GDP)	30.8
Private-sector credit growth (%)	27.7
Total bank deposits (% GDP)	41.3
Foreign-currency bank deposits (% GDP)	23.5
Public ownership, % of capital	6.9
Foreign ownership, % of capital	56.1

Source: IMF, NBRM and Fitch

The stock of private-sector credit was 31% of GDP in 2006, compared to 56% in Croatia ('BBB–') and 28% in Serbia ('BB–'). The development of financial intermediation may have been hampered by the high level of concentration in the banking system (the top three banks control two-thirds of system assets), high denar interest rates, cautious lending due to a high volume of legacy non-performing loans (NPLs) and a weak institutional and legal framework, which makes it difficult for banks to foreclose on properties (the EBRD's 2006 Transition Report judges Macedonia's insolvency law to be of "medium" quality). Furthermore, operating costs are high and the scope for economies of scale could be limited in a banking system with 19 banks and 12 savings institutions servicing a population of just over 2 million. While over half of the system's capital is owned by foreign banks, western European banks do not dominate the banking sector, as they do in some other central and eastern European countries. The fragmented shareholding structure of domestic banks could be part of the reason for this. Société Générale entered the Macedonian banking sector in 2007 through its purchase of a majority stake in Ohridska Banka, the country's fourth-largest bank by assets.

However, Fitch understands that the implementation of insolvency laws has improved. Furthermore, interest rates on bank loans declined in 2006 as the NBRM reduced its key policy rate. The central bank is taking steps towards adopting a more risk-based anticipatory approach to banking supervision and will publish its first report on financial stability this year. In addition, the new Banking Law, which came into effect in June 2007, tightens lending regulations and strengthens the central bank's supervisory powers. It also contains provisions to allow foreign banks to establish branches in Macedonia. The NBRM also intends to upgrade the credit registry by the end of Q208.

Bank Credit to the Private Sector



Stocks as % of GDP; year-on-year growth
Source: national authorities, Fitch

The pace of credit growth to the private sector picked up in 2006 as lending expanded by a brisk 28% (2005: 20%) compared to 18% in Serbia and 56% in Romania ('BBB'). The increase in the pace

[3] UNDP Early Warning Report, June 2007.

of credit growth was driven by increased lending to the household sector, which expanded by over 40% in both 2005 and 2006. Credit growth is being funded predominantly by deposit growth and also by banks drawing down their foreign assets rather than external borrowing – deposits grew by 28% in 2006 – and is therefore not significantly increasing the level of external indebtedness.

The banking sector has a high degree of euroisation, with 57% of deposits and 53% of loans denominated in or linked to foreign currency. Nevertheless, the pace of lending in foreign currency declined in 2006 as the denar interest rate declined and confidence in the currency increased. In addition, denar-denominated deposits grew faster than foreign-currency deposits during the year. The NBRM has tightened prudential guidelines for banks extending credit denominated in or indexed to foreign currency to mitigate foreign-currency-induced credit risk (although most lending in foreign currency is to private enterprises, which are more likely to be hedged than households).

■ Public Finance

The Macedonian government delivered a general government budget deficit of 0.8% of GDP in 2006 after a supplementary budget in the second half of the year increased the target deficit from 0.6% of GDP. The supplementary budget authorised additional spending of around 2% of GDP, financed mainly by the over-performance of tax revenue and cutbacks in programmed capital expenditure investment. Macedonia’s fiscal policy is a rating strength, as the country averaged a budget deficit of 1.1% of GDP between 1996 and 2006.

The supplementary budget in 2006 financed several unforeseen expenses, including a higher-than-budgeted take-up of the second-pillar pension scheme, the payment of arrears belonging to the Health Insurance Fund, and an emergency transfer to the state electricity transmission company, MEPSO, which was facing financial difficulties after subsidising electricity consumers. In addition to subsidising end-users, the energy sector also suffers from low collection rates and a lack of capital investment. A law passed in March 2007 has reduced the subsidy offered to companies and the government is undertaking a new project to reform the sector in conjunction with the World Bank. The new second-pillar pension system, which was initiated in January 2006, reduced social security contributions by 0.4% of GDP in 2006 and the government now estimates that contributions for the second pillar will be 0.7% of GDP in 2009.

Hard budget ceilings imposed on healthcare institutions in January 2006 have succeeded in stabilising the stock of arrears and the government has committed to maintaining the wage bill in the health sector at the end-2006 level. Arrears accumulated by municipalities declined from MKD2.8bn in Q304 to MKD1.4bn at end-2006. These are being resolved by the municipalities themselves, as the government has refused to assume responsibility.

Public Finances: Sources and Uses

(% GDP)	2006	2007f	2008f
Uses	12.3	10.8	4.7
Budget balance	-0.8	-1.1	-1.4
Amortisation	7.6	6.5	3.3
Domestic	2.4	2.3	2.4
External	5.2	4.2	0.9
Debt pre-payment	3.9	3.2	0.0
Sources	12.3	10.8	4.7
Gross borrowing	5.0	2.6	3.3
Domestic	1.7	1.3	1.5
External	3.3	1.4	1.7
Privatisation	6.8	1.0	0.0
Change in deposits and other	0.5	7.2	1.4

Source : Ministry of Finance, IMF and Fitch estimates and forecasts

The government is planning to loosen fiscal policy in 2007 and 2008 (budget deficit targets are 1.0% and 1.2% of GDP respectively) to finance reductions in taxes and import tariffs and increase public investment. The supplementary budget in 2007, which is currently before parliament, maintains the budget deficit target but increases expenditure by around 5%, financed by a growth in revenue of a similar magnitude. Corporate and personal income tax rates were reduced to 12% in January 2007 and will be lowered to 10% from 2008, while taxes on reinvested profits were set at zero from 2007. The government estimates these measures to cost 1% of GDP, while its plans to raise wages in the education sector and increase investment and EU-related spending will cost an additional 1.1% of GDP.

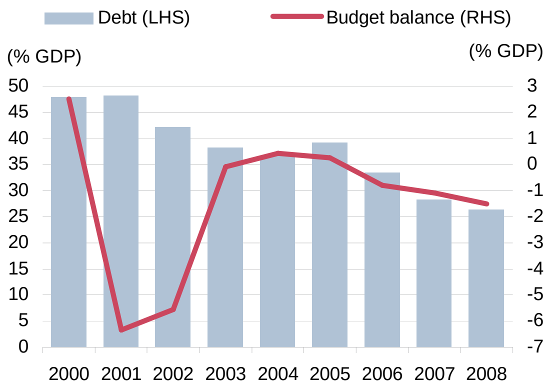
Although the government has taken steps to finance these reforms through measures including broadening the tax base by abolishing exemptions from corporate income tax, these will only increase revenue by 0.5% of GDP. Fitch does not expect significant slippage from the target – outturns for the first five months of 2007 show a surplus of over 1% of GDP, as revenue is on track and expenditure is lower than budgeted. Fitch notes, however, that budget discipline is vulnerable to unforeseen costs, particularly from the energy sector.

Although it has repaid its obligations to the IMF, Fitch expects Macedonia’s stand-by arrangement to continue to provide an anchor for fiscal reform. Macedonia's medium-term budget strategy is to maintain a budget deficit of 1%-1.5% of GDP in 2008-2010, reduce the tax burden and cut government spending by 2% of GDP by 2010 (while also reducing the proportion of non-discretionary expenditure, which is around 80%), and increase the share of local government expenditure in general government spending as part of the decentralisation process.

Public Debt

Macedonia's VMRO-DPMNE-DPA government has continued its predecessor's programme to reduce the public debt burden, reduce the proportion of foreign-currency-denominated debt (almost 90%) and decrease external borrowing through a strategy of active public debt management and buyback operations using privatisation proceeds and government deposits. In April 2007, Macedonia repaid its Paris Club debt (USD89m) with the proceeds of the privatisation of the electricity distribution firm ESM and the sale of a 10% stake in Maktel and also bought back its bond for the rehabilitation of Stopanska Banka (USD28m). In May 2007, the NBRM made an early repayment of its entire outstanding obligations to the IMF from its three-year stand-by arrangement (around USD44m) and in June 2007 the government made an early repayment of a fifth of its total debt to the World Bank (USD125m).

General Government Finances



Source: Ministry of Finance and Fitch

The government is also planning to prepay its EIB loans in 2007 (USD9m). The supplementary budget for 2007 sets total external debt buybacks for the year at USD237m (around 3.3% of GDP), financed through privatisation proceeds (around USD70m) and government deposits. In March 2007, government deposits stood at over USD525m (7% of GDP). The government expects the privatisation of the Negotino power plant, planned in 2007, to raise at least USD50m.

Fitch forecasts Macedonia's general government debt burden to fall to 26% of GDP in 2007 from 32% of GDP in 2006, lower than the 'BB'- and 'BBB'-range medians of 38% and 32% respectively. Counting the buybacks, government debt maturities are estimated at 7% of GDP in 2007, which still compares favourably to peers. Macedonia's debt service costs are relatively low, reflecting the predominance of international financial institutions and bilateral creditors – interest payments were just 3% of budget expenditure in 2006 and Fitch expects this to decrease due to debt buybacks in the medium term. Almost two-thirds of Macedonia's public debt is external, while just less than 90% is denominated in foreign currency, and is therefore vulnerable to exchange rate risk. The IMF estimates that a 30% real depreciation would increase the public debt burden by between 10%-15% of GDP.[4] The maturity structure of external public debt is favourable, with the average maturity of the debt portfolio standing at around nine years (although the average maturity of the domestic debt portfolio is much shorter at around three years). The volume of guaranteed public debt (mostly on public enterprises' external debts) stood at EUR145m (around 2.9% of GDP) at end-2006.

The government is continuing to develop the domestic debt market and issued its first five-year bond in 2007 to increase the maturity of its domestic debt. It will continue to increase net issuance (the stock of treasury bills rose from 1.5% of GDP to over 3% of GDP in 2006) and will also be introducing a primary dealership system in the government securities market in the medium term.

■ Monetary & Exchange Rate Policy

The peg of the nominal denar exchange rate against the euro is the NBRM's main intermediate target for achieving price stability, defined in law as the primary objective of monetary policy. The peg has been stable since 1997 and has been effective in containing inflationary pressures: annual consumer price index (CPI) inflation has averaged 2.2% in the last decade.

Fitch believes Macedonia's fixed-exchange-rate regime is an appropriate policy, as it is a small open and highly euroised economy with limited integration with international financial markets; and most of its trade is with the euro area. Nevertheless, large capital inflows (predominantly private transfers) necessitate intervention to prevent the appreciation of the exchange rate – NBRM's total

[4] IMF Article IV Consultation Staff Report, October 2006.

net purchase on the foreign-exchange market was the equivalent of 4.9% of GDP in 2006, compared to 3.4% of GDP in 2005. The central bank sterilises part of its interventions using monetary instruments. Non-full sterilisation contributed to a 25% growth in broad money in 2006 (2005:15%). In 2006, the central bank sterilised MKD3bn of excess liquidity at a cost of 0.3% of GDP.

However, the appropriateness of the de facto exchange rate peg could come into question if there is an increase in the volume of capital flows (for example, if EU membership prospects firm), which would increase the cost of sterilisation, or a terms-of-trade shock. NBRM is therefore making preparations for a transition to inflation targeting although there is currently no timeframe for adopting a new monetary policy. The central bank retains some restrictions on short-term capital flows to prevent currency speculation.

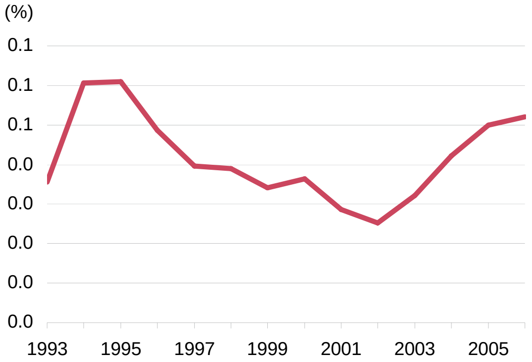
CPI inflation rose in line with the central bank's projections to 3.2% in 2006 due to higher food and global oil prices as well as a rise in electricity prices and higher excise taxes on tobacco. Fitch expects an average inflation rate of 2.7% in 2007 as excise taxes on tobacco and utility prices continue to rise while global oil prices fall.

Official international reserves rose to USD1.9bn or the equivalent of 5.2 months' coverage of imports in 2006, which allowed the central bank to continue reducing interest rates throughout 2006 and also in Q107. However, rising euro area interest rates could curtail the scope for further rate cuts.

■ External Finance

Despite a widening trade deficit, Macedonia's current account deficit narrowed to just 0.4% of GDP in 2006 as current transfers rose, the income deficit narrowed and the trade in services recorded a surplus. The narrower income deficit was on account of a deferred dividend payment of around 0.8% of GDP from Maktel to Magyar Telecom. The services surplus was due to an upswing in tourism receipts. Private transfers – namely remittances from migrants – grew 17% in 2006 (2005: 39%) and were equivalent to over 19% of GDP. Macedonia has a significant migrant population, located in a number of European countries, US, Canada and Australia, and remittances seem stable and countercyclical.[5] Nevertheless, Fitch notes that data compilation techniques could be over-estimating the volume of remittances by capturing capital account flows, which would imply that the current account deficit is actually larger.

Market Share
% of total EU imports



Source: IMF DOTS and Fitch calculations

Macedonia has a sizeable and persistent trade deficit and its narrow export base leaves it vulnerable to shocks: iron and steel accounted for 28% of Macedonia's exports in 2006 (2005: 26%) followed by textiles at 21% and food, beverages and tobacco at 16%. The growth of textile exports has slowed dramatically since the elimination of Chinese export quotas. The export sector is dependent on imported intermediary goods: the increase in the trade deficit in 2006 primarily reflected the high energy and raw materials import need of the iron and steel sector. Macedonia's market share of EU imports (its most significant trading partner) has been recovering since a contraction following the political crisis in 2001, although it is yet to return to its 1994 level. Fitch expects the trade deficit to continue to widen gradually in the medium term as global metals prices decline and imports of investment goods rise. Fitch expects the current account deficit to widen to 3.2% of GDP in 2007, largely due to the double dividend payment to Magyar Telecom.

External Financing

Net equity FDI rose 6% in 2006, thanks to the sale of Macedonia's national electricity distribution company (ESM) to Austrian firm EVN and the sale of a 10% stake in fixed-line monopolist Macedonia Telecom to Deutsche Telecom. Official reserves rose to USD1.9bn at the end of the year, equivalent to over five months' import cover. Fitch expects net equity FDI flows of around USD200m in 2007.

Fitch expects Macedonia's gross financing requirement to be equivalent to 30% of official reserves in 2007 due to the foreign debt buybacks and a widening current account deficit. External debt service was 13% of CXR in 2006, the median in the 'BB' range. The country's external liquidity position is strong and provides support to the ratings. Fitch forecasts the liquidity ratio at over 400% in 2007. Even if residents' foreign-currency bank deposits are

[5] IMF Article IV Consultation Staff Report, October 2006.

External Finances: Sources and Uses

(USDbn)	2006	2007f	2008f
Uses	499	744	493
Current account balance	-23	-230	-273
MLT amortisation	316	410	220
Public	195	378	93
Private	121	32	127
Debt pre-payments	160	104	0
Sources	499	744	493
Gross MLT borrowing	577	542	578
Public sector	70	235	161
Private sector	507	307	417
FDI, net	350	200	200
Portfolio equity, net	83	43	45
Net lending abroad	-50	0	0
Capital account	0	0	0
Net change in short-term debt	-31	20	20
Errors & omissions	10	0	0
Change in FX reserves (- = increase)	-440	-61	-350

Source : NBRM, IMF and Fitch estimates and forecasts

counted as a liability in the ratio (to simulate withdrawal in a crisis scenario), the ratio remains well over 100%.

External Debt

Macedonia's GXD was 40% of GDP in 2006, slightly above the 'BB'-range median of 35%. Public-sector debt accounted for 67% of GXD, while 26% was owed by the non-bank private sector and 7% by commercial banks.

Rising official reserves made Macedonia a net external creditor of 4% of GDP in 2006, a far stronger position than the 'BB'-range median of NXD to GDP of 11% and the 'BBB'-range median of 16% of GDP. Macedonia also became a net public external creditor. Short-term debt is low (under 3% of total GXD in 2006) and wholly owed by the private sector.

Fiscal Accounts Summary[a]

(% of GDP)	2003	2004	2005	2006	2007f	2008f	2009f
Revenue & grants	38.4	36.5	35.5	35.8	34.9	34.8	33.5
o/w tax revenue	30.6	30.8	29.7	29.4	29.5	28.3	28.4
non-tax revenue	6.2	4.9	3.7	4.4	3.8	3.4	3.2
grants	1.3	0.6	0.5	0.9	0.5	2.3	1.4
Expenditure & net lending	38.5	36.1	35.2	36.6	36.0	36.3	35.0
o/w wages & salaries	8.5	8.3	8.0	7.8	7.7	4.9	4.7
current purchases	4.9	4.5	4.5	4.6	5.0	6.0	5.3
current transfers & subsidies	19.4	18.9	18.2	18.9	17.8	19.4	19.2
Interest	1.1	0.9	0.9	1.1	0.8	0.7	0.7
capital expenditure	4.1	3.2	3.6	4.0	4.5	5.2	5.0
other	0.4	0.3	0.0	0.1	0.1	0.1	0.1
Primary balance	1.0	1.3	1.2	0.3	-0.2	-0.7	-0.8
Overall balance	-0.1	0.4	0.2	-0.8	-1.1	-1.4	-1.6
Financing:	0.1	-0.4	-0.2	0.8	1.1	1.4	1.6
Domestic, net	-0.5	-0.6	-4.3	4.7	3.9	0.6	1.3
Domestic securities	-1.7	-1.5	-1.6	-0.7	-1.4	-0.9	-0.9
Bank deposits & loans	0.9	0.7	-2.9	-1.4	4.4	1.4	2.2
Privatisation proceeds	0.3	0.2	0.2	6.8	1.0	0.0	0.0
External, net	0.6	0.2	4.0	-3.9	-2.8	0.9	0.2
Disbursements	2.7	1.4	5.2	1.3	1.4	1.7	1.2
Amortisation	2.2	1.2	1.2	5.2	4.2	0.9	0.9
General government debt	38.3	36.6	39.2	31.6	25.8	24.1	22.0
Domestic	16.3	16.4	16.7	15.1	13.8	12.9	11.2
External	27.9	26.2	30.0	23.6	19.6	19.4	18.1
Government debt (% of revenue)	99.7	100.2	110.6	88.4	73.9	69.2	65.7
Public enterprise debt	2.9	3.2	3.1	3.1	3.7	3.8	3.2
Public debt	44.3	42.6	46.6	38.7	33.4	32.3	29.3
memo							
Interest service (% of revenue)	2.8	2.4	2.6	3.1	2.4	2.1	2.1
Foreign-currency debt (% total public debt)	93.1	89.0	86.9	83.9	80.0	76.6	74.4
Government deposits in banking system	4.1	4.2	7.3	9.1	2.9	1.2	0.0
"Net" public debt (debt less deposits in banks)	40.2	38.4	39.8	30.9	30.5	31.1	30.4

[a] All figures refer to the consolidated general government
Source: Ministry of Finance, IMF and Fitch estimates and forecasts

Amortisation Schedule on Medium- and Long-Term Debt

(USDm)	2006	2007	2008	2009	2010
Public sector	355	378	93	104	100
IMF	10	55	0	0	0
Other multilateral creditors	35	169	49	58	63
Bilateral creditors	32	120	6	8	11
Eurobonds	0	0	0	0	0
London club	243	0	0	0	0
Other	16	11	12	14	15
Private sector	121	32	127	141	120
Total	476	410	220	245	220

Source: Ministry of Finance, NBRM and Fitch estimates

Balance of Payments

(USDm)	2003	2004	2005	2006	2007f	2008f	2009f
Current account balance[a]	-149	-415	-81	-23	-230	-273	-336
% of GDP	-3.2	-7.7	-1.4	-0.4	-3.2	-3.5	-4.0
% of CXR	-5.9	-13.8	-2.2	-0.5	-4.6	-4.8	-5.1
Trade balance	-848	-1,112	-1,057	-1,287	-1,479	-1,624	-1,769
Exports, fob	1,363	1,672	2,040	2,399	2,770	3,297	3,940
(annual % change)	22.5	22.7	22.0	17.6	15.5	19.0	19.5
Imports, fob	2,211	2,784	3,097	3,686	4,249	4,921	5,708
(annual % change)	15.3	26.0	11.2	19.0	15.3	15.8	16.0
Services, net	-10	-54	-34	25	-6	6	37
Services, credit	327	408	472	601	694	826	987
Services, debit	337	462	505	576	700	820	950
Income, net	-32	-39	-55	-3	-110	-45	-40
Income, credit	60	85	98	135	150	155	170
Income, debit	92	124	153	138	260	200	210
O/w: interest payments	57	56	57	87	75	90	95
Current transfers, net	741	791	1,065	1,242	1,365	1,390	1,435
Capital & financial account	226	427	510	453	291	623	633
Capital account	-7	-5	-2	0	0	0	0
Non-debt-creating flows, net	97	171	149	433	243	245	290
Equity direct investment, net	96	156	97	350	200	200	245
Portfolio equity investment, net	1	15	52	83	43	45	45
External borrowing, net	139	254	451	70	48	378	343
Debt securities	3	-1	183	-160	-104	0	0
General government	28	38	44	-119	-99	68	18
Monetary authorities	-5	-9	5	-6	-44	0	0
Commercial banks	-34	-24	83	65	65	70	75
Other private sector	147	249	136	290	230	240	250
Net lending abroad	-4	6	-88	-50	0	0	0
Net errors and omissions	-26	8	-13	10	0	0	0
Overall balance = chg in reserves (-=increase)	-51	-19	-415	-440	-61	-350	-297
Memo							
Current account excl official transfers (%GDP)	-5.5	-9.0	-2.5	-1.6	-3.8	-4.0	-4.5
Gross borrowing (incl. short-term)	402	496	702	640	521	681	691
Gross external financing requirement	348	615	260	499	640	493	581
Stock of international reserves, excl. gold	898	905	1,229	1,751	1,812	2,162	2,459

[a] Official grants included in current account
Source: IMF, NBRM and Fitch estimates and forecasts

External Debt & Liquidity

(USDm)	2003	2004	2005	2006	2007f	2008f	2009f
Gross external debt	1,854	2,068	2,238	2,471	2,515	2,883	3,215
% of GDP	40.0	38.5	38.8	39.6	35.1	37.0	38.3
% of CXR	73.3	68.9	60.2	56.0	50.2	50.5	49.0
By maturity:							
Medium- and long-term	1,812	1,996	2,144	2,408	2,432	2,780	3,092
Short-term	42	72	94	63	83	103	123
% total debt	2.3	3.5	4.2	2.5	3.3	3.6	3.8
By debtor:							
Public sector	1,529	1,664	1,758	1,668	1,471	1,556	1,536
o/w General government	1,257	1,350	1,469	1,350	1,147	1,215	1,234
Monetary authority	68	63	62	56	12	12	12
Public enterprises	148	190	169	201	255	282	255
Non-bank private sector	325	404	480	803	1,044	1,327	1,679
Banks	248	342	363	621	797	1,010	1,287
By creditor:							
IMF	68	62	62	56	n.a.	n.a.	n.a.
Other multilateral	858	999	990	1,105	n.a.	n.a.	n.a.
Bilateral	272	252	205	219	n.a.	n.a.	n.a.
Eurobonds	0	0	177	198	n.a.	n.a.	n.a.
London Club	234	233	222	0	n.a.	n.a.	n.a.
Commercial banks other	202	238	265	262	n.a.	n.a.	n.a.
Other private creditors	160	223	260	299	n.a.	n.a.	n.a.
Unidentified creditor	60	61	0	0	n.a.	n.a.	n.a.
Gross external assets[a]	1,610	1,815	2,069	2,744	2,828	3,188	3,504
International reserves, incl. gold	935	991	1340	1,889	1,965	2,316	2,614
Deposit money banks' foreign assets	675	824	729	855	863	872	890
Net external debt	244	253	168	-273	-313	-305	-289
% of GDP	5.3	4.7	2.9	-4.4	-4.4	-3.9	-3.4
% of CXR	9.6	8.4	4.5	-6.2	-6.2	-5.4	-4.4
Debt service (principal & interest)	256	256	236	563	485	310	340
Debt service (% of CXR)	10.1	8.5	6.3	12.8	9.7	5.4	5.2
Interest service (% of CXR)	2.3	1.9	1.5	2.0	1.5	1.6	1.4
Liquidity ratio (%)	375	463	499	292	455	637	658
excl. banks' foreign assets	220	269	272	189	313	443	478
Memo							
Public foreign-currency & FC-indexed debt	2,113	2,231	2,220	2,133	1,925	1,930	1,830

[a] Non-bank private-sector external assets are not taken into account
Source: IMF, World Bank, NBRM and Fitch estimates and forecasts